Zacks Small-Cap Research

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Silicom Limited

(SILC-NASDAQ)

SILC: Growth Eludes Silicom for the Next Few Quarters- Downgrading to Hold

Current Recommendation	**Hold**
Prior Recommendation	Outperform
Date of Last Change	07/22/14
Current Price (07/22/14)	$29.83
Six- Month Target Price	**$31.00**

OUTLOOK

Silicom engages in the design, manufacture, marketing, and support of add-on cards used to boost the performance of its customers' servers and network appliances. As a component supplier, it is benefiting from the shift to cloud and virtualization as these users and vendors seek to minimize costs. Its recent agreement with Intel will now allow it to sell white label solutions to cloud customers such as Facebook, Google and Amazon. .

SUMMARY DATA

52-Week High	**$73.00**
52-Week Low	**$29.83**
One-Year Return (%)	**-14.13**
Beta	**1.40**
Average Daily Volume (sh)	**135,930**
Dil. Shares Outstanding (mil)	**7.3**
Market Capitalization ($mil)	**$214**
Short Interest Ratio (days)	**2.82**
Institutional Ownership (%)	**16**
Insider Ownership (%)	**25**
Annual Cash Dividend	**$1.00**
Dividend Yield (%)	**3.35**
5-Yr. Historical Growth Rates	
Sales (%)	**32.6**
Earnings Per Share (%)	**43.3**
Dividend (%)	**N/A**
P/E using TTM EPS	**11.4**
P/E using 2014 Estimate	**16.1**
P/E using 2015 Estimate	**14.6**
Zacks Rank	**3**

Risk Level	**Above Average**
Type of Stock	**Small-Blend**
Industry	**Computer Networking**
Zacks Rank in Industry	**9 of 16**

ZACKS ESTIMATES

Revenue
(in millions of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2012	10.1 A	10.4 A	11.5 A	16.7 A	48.7 A
2013	15.0 A	15.7 A	17.2 A	25.4 A	73.3 A
2014	19.0 A	17.9 A	15.0 E	16.1 E	68.0 E
2015					80.0 E

Earnings per Share
(EPS is operating earnings before non-recurring items)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2012	$10.1 A	$0.30 A	$0.32 A	$0.36 A	$1.25 A
2013	$0.46 A	$0.48 A	$0.58 A	$0.97 A	$2.46 A
2014	$0.57 A	$0.50 A	$0.40 E	$0.39 E	$1.85 E
2015					$2.05 E

Zacks Projected EPS Growth Rate - Next 5 Years % **15**

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WHAT'S NEW

Cutting Numbers: Silicom Reports Shortfall and Gives Bleak Guidance for 2014

On July 22, 2014, Silicom Ltd, reported financial results for its second quarter ended June 30, 2014, missing revenues by $2 million and our estimate by $0.06. **Revenues for the quarter were $17.9 million, up 14%** from a year ago and down sequentially from Q1, in contrast with its usual Q2 results. **Non-GAAP fully diluted EPS came in at $0.50 versus $0.48** the year before up only 5.5%. The company cites the loss of a major design win from a 10% customer as the prime cause, but sees weakness across the board in all product lines and all geographies. It is unsure this is just they, the industry as a whole or the economy as a whole. Despite having visibility on this one particular product loss, the other weakness surprised them as, as a whole, the company typically has strength elsewhere when one product falls short.

Uncharacteristically, the company gave guidance for the 2014 year. They expect revenues in a range of $68-74 million, and EPS of $1.82 to $2.09. So certainly we are looking at two more down quarters in EPS for sure and possibly even in revenues for the next two quarters. As a result we are downgrading the stock to a hold because even at 15X the mid range of the stock, we see no catalyst to move the stock up until we reach 2015 and get closer to up earnings. **We now conservatively expect revenues of $68 million for 2014 and EPS of $1.85**. We are cutting revenues to $80 million in 2015 and EPS to $2.05. When we model out the quarters we suspect that it will not be until Q2 2015, that we see up earnings giving investors plenty of time to establish a position later. Adding to product sales uncertainty, it seems that the company could have macro issues as turmoil in Israel distracts its citizens and business could be somewhat disrupted. This quarter North America was 74%; Europe and Israel were 14%, and Far East 12% of sales showing that the vast portion of sales is outside of Israel.

So rather than revenue and earnings growth we expected, the company should have at best flattish revenues and at worst, down revenues and earnings. This is quite a different company than we saw last year when it showed 50% revenue growth and 60% earnings growth, with Q4 astonishing all, by its 52% revenue growth and 92% EPS growth. At its peak of $73, the stock was trading at 27 times 2014 consensus estimates. With down earnings and flat to down revenues, investors may not be willing to pay even as much as 15 times earnings. Thus with an estimate of $2.05 in 2015, the current upside could be only to $31. Until Silicom shows some growth we believe investors have time to accumulate positions in advance of growth starting in the first half of next year.

Quarterly Recap

Gross margin for the three months ended June 30, 2014, was flat with last year at 40.3% and down a half percent sequentially.

Operating expenses were virtually identical with Q1 at $3 million, and are expected to remain at similar levels through out the year.

Operating income grew 17% year over year on a non-GAAP basis. However the biggest dent to EPS was a rise in the tax rate from 6.8% to 14.6% this year. As a result non-GAAP net income only increased 7% from a year ago.

Q3 Estimates

Given comments by management on expectations for the full year, we are now expecting the third quarter to be below the second. We are looking for revenues of $15 million and non-GAAP EPS of $0.40 versus last year's $17.2 million and $0.58. This would be down revenues and earnings year over year as well as sequentially leaving little catalyst for the stock. Due the long sales cycle and the long lead times

from design in to product sales, we expect up earnings only in 2015. We do believe however that the company's dividend, cash per share and solid profitability protects investors on the downside.

Overly Dependent on Two Large Customers

Silicom protects the anonymity of its customers and there are two very large ones. One contributed 33% of sales in 2013 and the other over 10%. The larger customer has a product line that used two Silicom components. When it designed a refresh last year, it chose one Silicom product, and one from someone else, as the offering Silicom had at the time was not as competitive. Thus, as this old line is phased out, revenues to Silicom for this product line will continue decline. However, this customer also had a new system that was to launch later this year that has Silicom parts. Unfortunately, this product line was recently delayed until 2015, and as a result Silicom will have much lower revenues in the second half of 2014, than it expected only a few months ago. Customer product lines last upwards of three years, so the lost business for this particular product will not be able to be regained any time in the near future.

Annual Dividend and Cash Balance

The company remains financially very strong and ended the quarter with $54.4 million in cash and marketable securities or $7.57 per share. Management had no plans to change the dividend policy of paying out a dividend of up to 50% of its annual distributable profits. This year the company declared an annual dividend of $1.00 that was paid April 17, 2014 and used $7.2 million of the company's cash.

INVESTMENT THESIS

- The company's guidance suggests earnings will not show an up comparison until the June 2015 quarter. With a PE of 16 times on a company with $7.57 per share in cash and a prediction of down earnings, we believe the stock may only move up to $31 in the next six months.
- SILC is a high margin supplier to the networking industry that provides cost effective components to customer more cheaply than they can build in-house.
- They are designed into customer product making switching costs high and customers loyal.
- With over 20% net margins, high cash flow and long term growth over 15% we believe the stock has great long term potential.
- The stock is a pure play in the quest for server efficiency for products being sold into high growth markets such as cloud and virtualization.
- The company's new sales venture into white label boards for the major social networks and cloud providers could give the company another large market opportunity and accelerate growth.

COMPANY DESCRIPTION

Silicom provides add-on boards for customers to improve the functionality of generic servers and network appliances. These customers, such as Dell, HP, Intel, Riverbed and SuperMicro, buy from Silicom as an alternative to designing and producing their own boards because it is cheaper. Even though the markets the customers serve are only growing 10-20%, Silicom has been able to grow sales faster than that due to its great value proposition to the customer. And earnings have grown even faster than sales due to economies of scale, which are created by no incremental R&D or marketing costs when the same customers just order more of the same product.

End-user Products	Customers
WAN Optimization Appliances	Riverbed, Blue Coat, Cisco, Citrix, Silver Peak
Security Appliances	Checkpoint, Cisco, Juniper, Trend Micro, McAfee
Load Balancing Appliances	F5, Radware
Storage	EMC, Network Appliance
Telecom	Alcatel-Lucent
General Purpose Servers	Dell, HP, Intel, IBM, Fujitsu

OEM Business Model

95% of Silicom's sales go to OEMs. This creates significant operating leverage through reduced sales and marketing expenses, and gives the firm insight into new technologies. Once selected by a customer, Silicom has never been replaced by a competitor's product. Since Silicom has to be designed into a customer's product, the sales cycle is very long taking over a year for a decision. Fortunately then the average product will last three to four years before replacement during which time Silicom is the sole source supplier. There are very high switching costs. This somewhat mitigates the fact that the company has two very large customers, one of which comprised 33% of 2013 sales and the other another 10%. Between the two however they buy 10 different products. The revenue shortfall this quarter was due to one of two large product lines that are being phased out by one of these two large customers. Due to the economies of scale of the company, operating expenses as a percentage of sales had been falling each year going from 22.4% of sales in 2010 to 16.2% of sales in 2013 but only to 16.1% in the first half of this year.

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VALUATION

Due to an increased tax rate and no revenue growth predicted for this year, Silicom's stock has suffered multiple compression. The company's sales vary as customer's needs plateau and it often finds its sales growth a step function rather than linear. In 2013, the company had multiple factors working together to hit 50% growth, but historically sales have varied. In 2010, it grew 48%, in 2011 only 30% and in 2012, 23% before accelerating back up to 50% in 2013. This year could show down earnings. Adding to the compression is the uphill tax rate moving from 5% to 14%.

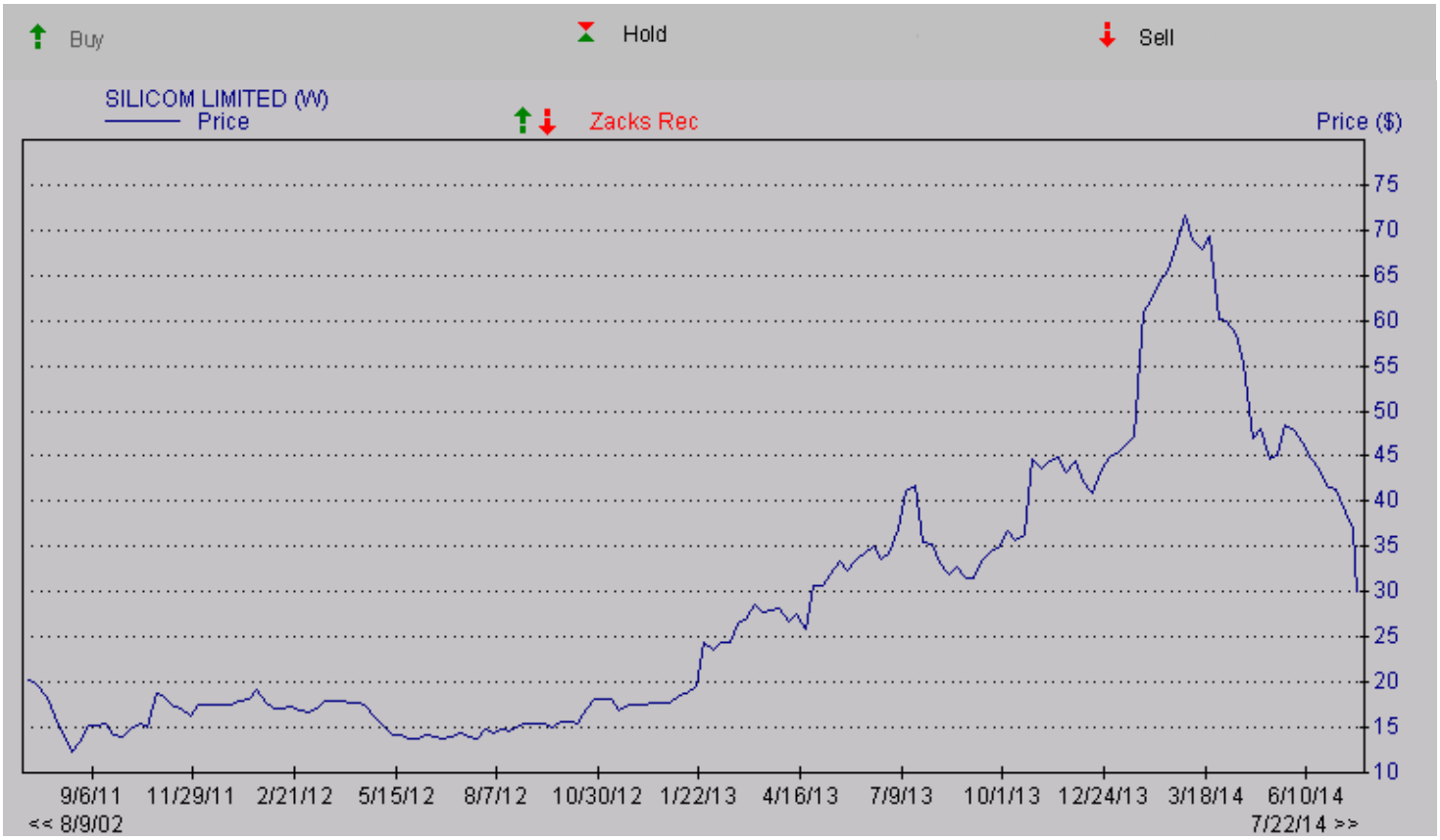
As a result we believe that investors should look beyond 2014 to 2015 when the tax rate will be flat and the company should again grow again. With estimates of $2.05 for 2015, and long-term growth at 15% we believe the stock deserves a 15 multiple or $31 per share up from $29 today, and thus we are rating it a hold until such time that growth is predicted to return and the multiple could once again expand.

PROJECTED INCOME STATEMENT

SILICOM

24-Apr-14	Non-GAAP	Non-GAAP	Non-GAAP	Non-GAAP	Non-GAAP	Non-GAAP	Non-GAAP	Non-GAAP	Non-GAAP				
	Dec	**March**	**June**	**Sept**	**Dec**	**March**	**June**	**Sept**	**Dec**		**Non-GAAP**	**Non-GAAP**	**Non-GAAP**
	Q4 12	**Q1 13**	**Q2 13**	**Q3 13**	**Q4 13**	**Q1 14A**	**Q2 14A**	**Q3 14E**	**Q4 14E**	**2012**	**2013**	**2014E**	**2015E**
REVENUE													
Net Revenue	16.7	15.0	15.7	17.2	25.4	19.0	17.9	15.0	16.1	48.7	73.3	68.0	80.0
Yr-to-yr Gr.		49%	51.1%	49.0%	51.9%	26.4%	14.0%	-12.8%	-36.6%	23.0%	50.4%	-7.2%	17.6%
OPERATING EXPENSES													
Cost of goods sold	10.4	9.0	9.4	10.2	15.2	11.2	10.7	9.0	10.1	28.8	43.8	41.0	48.0
Gross Margin	6.3	6.1	6.3	7.043	10.1	7.8	7.2	6.0	6.0	19.93	29.5	27.0	32.0
% of Sales	37.8%	40.3%	40.3%	40.9%	39.9%	40.8%	40.3%	40.0%	37.4%	40.9%	40.3%	39.7%	40.0%
R&D	1.3	1.2	1.3	1.3	1.6	1.5	1.6	1.6	1.7	4.4	5.5	6.3	7.4
S&M	1.0	0.8	0.9	1.0	1.1	1.0	1.1	1.1	1.1	3.1	3.8	4.3	5.0
G&A	0.8	0.6	0.6	0.6	0.7	0.7	0.6	0.6	0.6	2.4	2.6	2.5	2.9
non-GAAP Adjustments	(0.4)	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)	(0.3)	(0.3)	(0.3)	(0.7)	(0.6)	(1.0)	(1.2)
Tot Operating Exp.	2.7	2.567	2.7	2.8	3.2	2.983	2.9670	3.0	3.1	9.1	11.3	12.1	14.1
Operating Income	3.6	3.487	3.646	4.245	6.9	4.779	4.256	3.0	2.9	10.8	18.3	14.9	17.9
				51.5%	92%	37%	17%	-30%	-58%	22.1%	24.9%	21.9%	22.3%
Interest Income	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.8	0.4	0.4	0.5
Pretax Income	3.7	3.6	3.7	4.3	7.0	4.884	4.314	3.0	2.9	11.5	18.7	15.3	18.4
Pretax Margin						25.7%	24.1%	20.2%	18.3%	23.7%	25.5%	22.5%	23.0%
Taxes	0.3	0.3	0.3	0.2	0.2	0.7	0.6	0.4	0.4	0.9	0.9	2.2	2.7
Tax Rate	7.7%	9.3%	6.8%	3.5%	2.3%	14.1%	14.6%	14.7%	14.7%	7.9%	4.8%	14.4%	14.5%
Non-GAAP Net Income	3.4	3.3	3.5	4.2	6.8	4.193	3.682	2.9	2.9	10.6	17.8	13.7	15.7
Yr-to-yr Gr.					100%	28%	7%	-30%	-58%	28.9%	67.1%	-23.0%	14.9%
Non-GAAP EPS-Basic	$0.49	$0.46	$0.49	$0.59	$0.96	$0.58	$0.51	$0.41	$0.40	$1.53	$2.52	$1.90	$2.15
Non-GAAP EPS-Fully dil.	**$0.49**	**$0.46**	**$0.48**	**$0.58**	**$0.94**	**$0.57**	**$0.50**	**$0.40**	**$0.39**	**$1.52**	**$2.46**	**$1.85**	**$2.05**
Yr-to-yr Gr.		53.4%	40.0%	53.3%	91.7%	24.1%	5.5%	-31.3%	-58.7%	29.4%	61.0%	-24.5%	10.8%
Share Out	7.0	7.1	7.1	7.1	7.1	7.2	7.2	7.2	7.2	6.9	7.1	7.2	7.3
Fully diluted shares	7.0	7.1	7.3	7.2	7.3	7.3	7.3	7.3	7.4	7.0	7.2	7.4	7.6
										-0.4%	4.0%	1.7%	3.7%

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