Zacks Small-Cap Research

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# $O_2$Micro International Ltd (OIIM-NASDAQ)

## OIIM: Turnaround Delayed– Reducing Estimates
## OUTPERFORM

| | |
|---|---|
| **Current Recommendation** | **Outperform** |
| Prior Recommendation | Neutral |
| Date of Last Change | 11/12/2013 |
| Current Price (07/23/14) | $3.21 |
| **Six- Month Target Price** | **$5.00** |

## OUTLOOK

$O_2$Micro International is a fabless semiconductor firm that designs, develops and markets high performance integrated circuits primarily for power management and power saving applications for the LED lighting industry. The company trades at an enterprise value of only $23 m as it has $66 million in cash. It has implemented a massive restructuring by lowering costs and now has the challenge of growing revenues and returning to profitability. A return to growth, expected next quarter, should send the valuation of the company higher and in line with its peer group. New products in LED lighting and smartphones should rejuvenate growth.

## SUMMARY DATA

| | |
|---|---|
| **52-Week High** | **$3.89** |
| **52-Week Low** | **$2.71** |
| **One-Year Return (%)** | **-5.03** |
| **Beta** | **1.35** |
| **Average Daily Volume (sh)** | **24,892** |
| **Shares Outstanding (mil)** | **28** |
| **Market Capitalization ($mil)** | **$89** |
| **Short Interest Ratio (days)** | **1.31** |
| **Institutional Ownership (%)** | **45** |
| **Insider Ownership (%)** | **8** |
| **Annual Cash Dividend** | **$0.00** |
| **Dividend Yield (%)** | **0.00** |
| **5-Yr. Historical Growth Rates** | |
| **Sales (%)** | **-12.7** |
| **Earnings Per Share (%)** | **N/A** |
| **Dividend (%)** | **N/A** |
| **P/E using TTM EPS** | **N/A** |
| **P/E using 2013 Estimate** | **N/A** |
| **P/E using 2014 Estimate** | **N/A** |
| **Zacks Rank** | **3** |

| | |
|---|---|
| **Risk Level** | **Average** |
| **Type of Stock** | **Small-Value** |
| **Industry** | **Elec Comp-Semic** |
| **Zacks Rank in Industry** | **40 of 54** |

## ZACKS ESTIMATES

**Revenue**
(Non-GAAP fully diluted EPS, in millions of $)

| | Q1 (Mar) | Q2 (Jun) | Q3 (Sep) | Q4 (Dec) | Year (Dec) |
|---|---|---|---|---|---|
| 2012 | 30 A | 28 A | 23 A | 17 A | 98 A |
| 2013 | 17 A | 19 A | 19 A | 18 A | 74 A |
| 2014 | 17 A | 17 A | 17 E | 19 E | 73 E |
| 2015 | | | | | 78 E |

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

| | Q1 (Mar) | Q2 (Jun) | Q3 (Sep) | Q4 (Dec) | Year (Dec) |
|---|---|---|---|---|---|
| 2012 | $0.01 A | -$0.04 A | -$0.11 A | -$0.19 A | -$0.33 A |
| 2013 | -$0.15 A | -$0.13 A | -$0.14 A | -$0.11 A | -$0.53 A |
| 2014 | -$0.08 A | -$0.10 A | -$0.08 E | -$0.04 E | -$0.30 E |
| 2015 | | | | | -$0.10 E |

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## WHAT'S NEW

### Reducing Numbers, Turnaround Again Delayed

O2Micro disappointed investors by issuing guidance for the third quarter far short of expectations cause estimates to be lowered across the board. While expenses are under control and remain within expectations, revenue are expected to be lighter as growth eludes the company. Despite having strong performance in LED and power management, as well as near zero legacy TV revenues, weakness in PCs, laptops, notebooks and tablets continue to be a drag on business. As a result we are lowering nu bers for this year and next.

We are now looking for non-GAAP EPS of a loss of $0.30 for 2014 and revenues of $70 million, down from 2013's $73 million. We were hoping to see cash flow breakeven in the third quarter, but now that looks even further off into 2015 rather than 2014. The company has stated that given its current cost structure, it could reach cash flow break-even with revenues between $19-20 million and GAAP profit breakeven at $22-23 million.

For 2015, we are reducing revenues to $78 million, and a non-GAAP loss of $0.10. In 2015 we hope to see some significant revenues from new smartphone products as well as robust uptake of the LED consumer lighting. Due to the company's low valuation, and it's attractiveness as an acquisition candidate, we are hesitant to downgrade the stock to a hold, although we see no short-term catalysts to move the stock upward. All investor eyes are on reaching cash flow breakeven, which could be done by revenue growth or expense control and would stop the cash bleed.

### Q2 2014 Results

Despite what was portrayed as an earnings miss, OIIM reported revenues and earnings inline with our estimates, except for one line item—Foreign Exchange Gain (Loss). What was a gain of $153,000 in Q1, turned into a loss of $180,000, and resulted in a difference of $0.02 per share. Revenue came in at $17.4 million, down 7% year over year but up 6% sequentially from $16.5 in Q1 2014. Strength continues in the LED lighting space and industrial, while PCs and notebooks continue challenging and smartphones continue to pick up steam.

The company's sales for the quarter broke down as follows: consumer 45-55%, computer 20-30%, industrial 20-30%, and communications is less than 5%.

While the company sees lackluster computer and TV sales, it is doing well in power tools and appliances, LED, and a new emerging market of smartphones. There are two products that investor should keep an eye on and could bring some excitement to the story.

The first is a patented "free dimmable" LED light bulb. It has not yet been brought to market in the US but is for sale in Japan, China and Korea. This light bulb can be used in any lamp or fixture whether it has a dimmer switch or not. It instantly turns the light into a dimmable fixture. The dimming is controlled by how long the light is turned off and then turned back on again, rather than by a switch on the lamp. We think that this unique product could be a huge hit with consumers and we look forward to seeing how sales progress.

The packaged LED market was $14 billion in 2013 and analysts Strategies Unlimited forecast the growth for LEDs in lighting to be 27% of CAGR from 2013 to 2018, driven mostly by an increased consumer confidence and continuously increasing sales of replacement lamps, down lights, industrial, commercial, and outdoor products.






The second product is a new lighting chip being sold to the smartphone market. The company has said that the chip has been designed into a Tier 1 smartphone vendor's product and expects shipments to start later in the year. The company calls it "novel" but is under NDA and unable to describe its unique features or what handset or vendor has bought the chip. The chip the vendor bought has been customized for them, but O2Micro is allowed to sell this product to other vendors. Already it has had interest from two second tier smartphone vendors.

In 2013, one billion smartphones were sold, up 38% from the year before according to IDC. The top five vendors are Samsung (314 million), Apple (153 million), Huawei (49 million), LG (48 million) and Lenovo (46 million). This compares to 240 million TV sets sold worldwide and 190 million tablets. This much bigger addressable market should be a big winner for O2 Micro if they can gain market share with a unique product offering

## BACKGROUND

O2Micro, founded in 1995, is a Cayman Island-based fabless analog semiconductor manufacturer that fell on hard times in 2011 as the TV industry rapidly shifted from CCFL LCD TVs to LED TVs. O2Micro had dominant market share for chips that did the backlighting for these TVs and a business that represented a very large portion of sales for the company is now expected to generate less than $500,000 this year. The good news is it can now only go to zero. A company that peaked at $138 million in revenues in 2010 has now potentially troughed in 2013 at $74 million. In 2014, we are expecting revenues to once again increase to over $80 million for the total company. O2Micro's management was blindsided by this rapid decline and over the past five quarters has had to slash the work force by 30% and operating expenses over 40% as it works its way back to profitability. After three years of declining revenues, in the fourth quarter just reported, revenues actually grew 14% and the loss declined by $5.9 million from last year.

The company that remains is now over 50% Consumer products but for LED lights and LED TVs. LED lights are a high growth market and the company is able to compete in both general LED lighting and with its unique dimmable light bulb device that operates with out a dimmer switch. This latter product is at much higher margins than the highly competitive LED bulb market. O2Micro makes a small chip that goes on a small board on the base of the bulb. In the US it sells to GE and Osram, and in Japan to Toshiba and Panasonic. This business should double this year.

The next largest part (approximately 25%) of the business is Computer, the declining part. These power chips are used in notebooks and laptop computers and arrive in your Dell, HP, Sony or Lenovo computer via a Quanta or Compal motherboard. A quarter of this group's business is DC/DC converter chips that are in the brick on your charger cord. This business is not that exciting because of course notebooks and laptops are not that exciting. In this business the company competes with TI, Intersil, Maxim and Linear Technology. They are one of the top three suppliers for notebooks based on the Intel and AMD platforms.

Another approximately 25% of the business sells to the industrial market primarily the portable tool and appliance business. These battery chips end up in Black & Decker power tools as well as Stanley, Makita and Bosch among others. This business is expected to grow over 30%.

## VALUATION

As of the end of Q1 2014, company's balance sheet was very strong with $66 million in cash and no long-term debt. Thus the enterprise value for OIIM is $86 minus $66 million or $23 million. Looking at the Enterprise Value to Sales model the firm is trading well below its peers as shown is the chart below. Were we to use the average enterprise value to trailing twelve-month sales of 4.1 times and apply it to OIIM, we would calculate an enterprise value of $296 million. Adding to it $66 million in cash gives us a market cap of $362 million or $13.20 per share.

| Competitors | EV | TTM Sales | EV/ Sales |
|---|---|---|---|
| ISIL | 1,710 | 584 | 2.9 |
| MSCC | 3,110 | 1,040 | 3.0 |
| MPWR | 1,420 | 247 | 5.8 |
| CREE | 4,840 | 1,590 | 3.0 |
| MCHP | 9,470 | 1,930 | 4.9 |
| LLTC | 10,360 | 1,350 | 7.7 |
| MXIM | 9,420 | 2,420 | 3.9 |
| TXN | 54,450 | 12,550 | 4.3 |
| CRUS | 1,230 | 714 | 1.7 |
| | | | |
| Average | | | 4.1 |

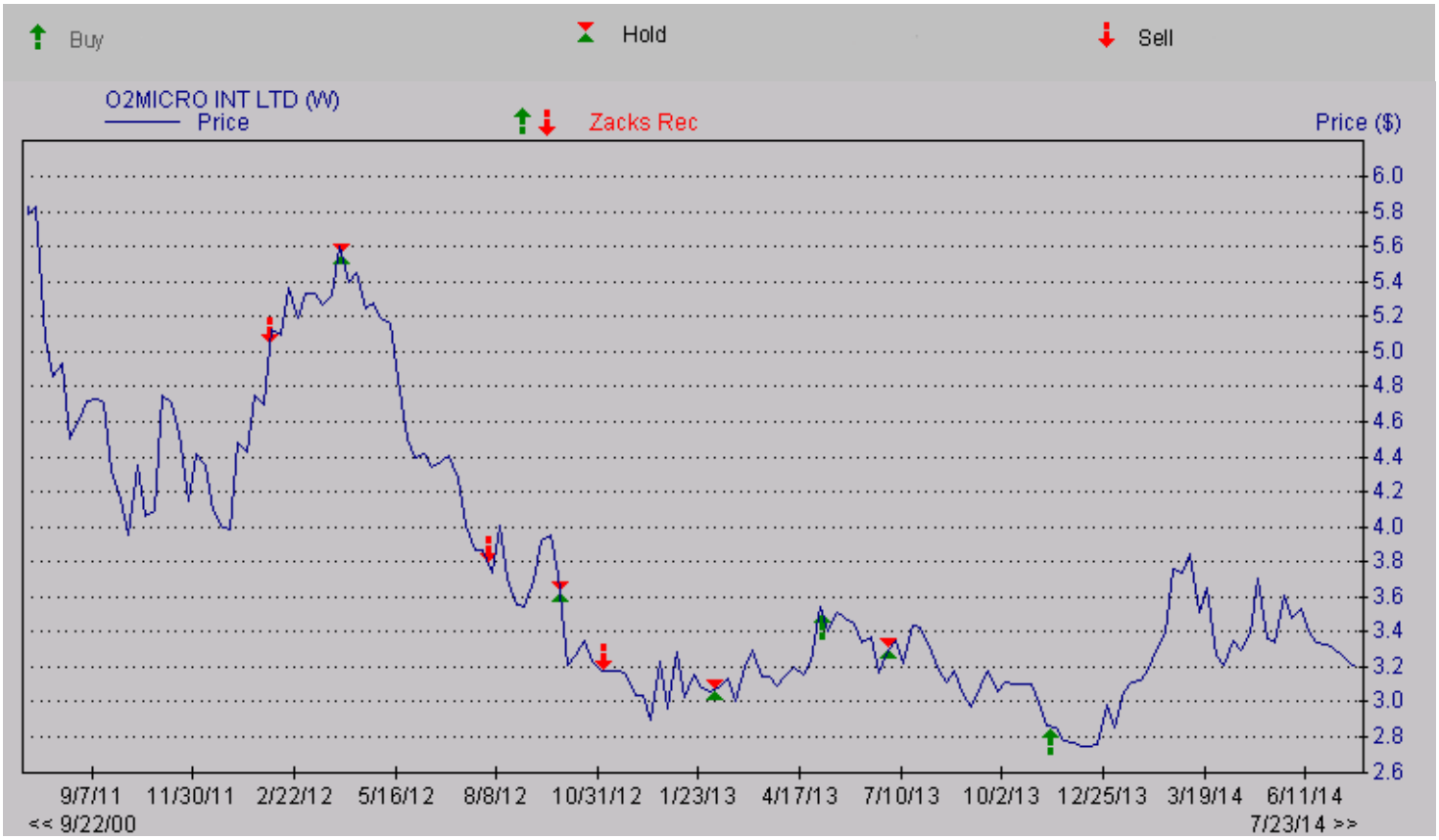
## RISKS

- $O_2$Micro has exposure several slow growing and declining markets such as TVs and laptops. It is depending on LED lighting and other small businesses to give it revenue and margin growth.
- The firm is currently not at breakeven and is cash flow negative.
- Given the large number of patents litigation risk is a possibility as the company enforces its patents.

# PROJECTED INCOME STATEMENT

| | Dec Q4 12 | March Q1 13 | June Q2 13 | Sept Q3 13 | Dec Q4 13 | March Q1 14A | June Q2 14A | Sept Q3 14E | Dec Q4 14E | 2012 | 2013 | 2014E | 2015E |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **REVENUE** | | | | | | | | | | | | | |
| Net Revenue | 16.8 | 17.3 | 18.7 | 18.6 | 19.1 | 16.5 | 17.4 | 17.4 | 18.7 | 97.7 | 73.8 | 70.0 | 78.4 |
| Yr-to-yr Gr. | | -42% | -33.9% | -18.5% | 14% | -5% | -7% | -7% | -2% | | -24% | -5% | 12% |
| | | | | | | | 6% | 0% | | | | | |
| **OPERATING EXPENSES** | | | | | | | | | | | | | |
| Cost of goods sold | 8.1 | 8.7 | 9.1 | 9.1 | 9.6 | 8.0 | 8.4 | 8.5 | 9.0 | 44.1 | 36.4 | 33.9 | 38.0 |
| Gross Margin | 8.7 | 8.7 | 9.6 | 9.6 | 9.5 | 8.5 | 9.0 | 8.9 | 9.7 | 53.6 | 37.4 | 36.1 | 40.4 |
| % of Sales | 51.6% | 50.0% | 51.2% | 51.4% | 49.9% | 51.5% | 51.5% | 51.2% | 51.8% | 54.9% | 50.7% | 51.5% | 51.5% |
| | | | | | | | | | | | | | |
| R&D | 8.2 | 6.6 | 6.7 | 6.5 | 7.2 | 5.1 | 5.8 | 5.5 | 5.5 | 34.3 | 27.0 | 21.8 | 21.8 |
| SG&A | 8.4 | 7.5 | 7.9 | 7.7 | 7.8 | 6.5 | 6.3 | 6.5 | 6.2 | 34.6 | 30.9 | 25.6 | 25.6 |
| One-time expenses & Adj. | 3.3 | | | | | 0.0 | 0.0 | 0.0 | 0.0 | 12.7 | | 0.0 | 0.0 |
| | | | | | | | | | | | | | |
| Tot Operating Exp. | 20.0 | 14.1 | 14.6 | 14.2 | 15.0 | 11.6 | 12.1 | 12.0 | 11.7 | 81.6 | 57.9 | 47.4 | 47.4 |
| | | | | | | | | | | | | | |
| **Operating Income** | (11.3) | (5.4) | (5.0) | (4.7) | (5.4) | (3.1) | (3.1) | (3.1) | (2.0) | (28.0) | (20.5) | (11.3) | (7.0) |
| | | | | | | -42% | | | | | | | |
| Other Income | 0.9 | 0.6 | 0.8 | 0.4 | 0.7 | 0.5 | 0.1 | 0.5 | 0.5 | 2.4 | 2.4 | 1.6 | 2.7 |
| **Pretax Income** | (10.4) | (4.8) | (4.2) | (4.3) | (4.8) | (2.7) | (3.0) | (2.6) | (1.5) | (25.6) | (18.1) | (9.7) | (4.2) |
| | | | | | | -16.1% | -17.0% | -14.9% | -8.1% | -26.2% | -24.5% | -13.9% | -5.4% |
| Taxes | 0.3 | 0.2 | 0.2 | 0.2 | 0.3 | 0.3 | 0.2 | 0.3 | 0.3 | 1.1 | 1.0 | 1.0 | 1.2 |
| Tax Rate | -2.6% | -4.8% | -5.3% | -5.8% | -6.1% | -9.6% | -7.7% | -10.8% | -17.8% | -4.3% | -5.5% | -10.6% | -28.3% |
| | | | | | | | | | | | | | |
| **GAAP Net Income** | (10.7) | (5.1) | (4.4) | (4.5) | (5.1) | (2.9) | (3.2) | (2.9) | (1.8) | (26.7) | (19.1) | (10.8) | (5.4) |
| | | | | | | | | | | | | | |
| **GAAP EPS-Fully dil.** | **($0.35)** | **($0.17)** | **($0.15)** | **($0.16)** | **($0.18)** | **($0.10)** | **($0.12)** | **($0.11)** | **($0.07)** | **($0.83)** | **($0.67)** | **($0.39)** | **($0.21)** |
| Non-GAAP | ($0.19) | ($0.15) | ($0.13) | ($0.14) | ($0.11) | ($0.08) | ($0.10) | ($0.08) | ($0.04) | ($0.33) | ($0.53) | ($0.30) | ($0.10) |
| | | | | | | | | | | | | | |
| Share Out | 30.4 | 29.7 | 28.9 | 28.3 | 28.0 | 27.8 | 27.4 | 27.1 | 26.9 | 31.0 | 28.7 | 27.3 | 26.3 |
| Fully diluted shares | 30.4 | 29.7 | 28.9 | 28.3 | 28.0 | 27.8 | 27.4 | 27.1 | 26.9 | 31.0 | 28.7 | 27.3 | 26.3 |

## HISTORICAL ZACKS RECOMMENDATIONS



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