Zacks Small-Cap Research

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Lisa Thompson
lthompson@zacks.com
www.zacks.com
10 S. Riverside Plaza, Suite 1600, Chicago, IL 60606

TowerJazz

(TSEM-NASDAQ)

TSEM: One-Time Gains Distort Numbers But the Decks Are Cleared For Higher Earnings; OUTPERFORM

OUTLOOK

TowerJazz (formerly know as Tower Semiconductor) is a pure-play semiconductor wafer foundry that manufactures SiGe, MEMS, RF, embedded flash-based memory, analog/mixed-signal, and CMOS image-sensor devices. Its recent joint venture agreement with Panasonic has closed and should add $400 m/yr. in new consolidated revenues. Additionally, with the closing of a fab, increased capacity utilization and lower costs should be a boom to earnings going forward.

Current Recommendation	**Outperform**
Prior Recommendation	Neutral
Date of Last Change	02/23/2012
Current Price (05/14/14)	$8.45
12 Mo. Target Price	**$12.46**

SUMMARY DATA

52-Week High	**$9.74**
52-Week Low	**$3.86**
One-Year Return (%)	**36.95**
Beta	**1.64**
Average Daily Volume (sh)	**159,905**
Shares Outstanding (mil)	**48**
Market Capitalization ($mil)	**$405**
Short Interest Ratio (days)	**0.98**
Institutional Ownership (%)	**3**
Insider Ownership (%)	**1**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**19.5**
Earnings Per Share (%)	**N/A**
Dividend (%)	**N/A**
P/E using TTM EPS	**8.0**
P/E using 2014 Estimate	**5.5**
P/E using 2015 Estimate	**4.5**
Zacks Rank	**3**

Risk Level	**Above Average**
Type of Stock	**Small-Blend**
Industry	**Elec Comp-Semic**

ZACKS ESTIMATES

Revenue
(in millions of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2012	168 A	140 A	176 A	148 R	639 R
2013	113 A	125 A	133 A	135 A	505 A
2014	133 A	225 E	220 E	235 E	810 E
2015					1068 E

Earnings per Share
(Non-GAAP Diluted)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2012	$0.68 A	$0.90 A	$0.90 A	$0.44 R	$2.65 A
2013	$0.15 A	$0.21 A	$0.25 A	$0.30 A	$0.97 A
2014	$0.30 A	$0.35 E	$0.41 E	$0.44 E	$1.53 E
2015					$1.87 E

Income Statement and Valuation use fully diluted shares outstanding

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WHATS NEW

Q1 2014 Marks the End of the Old Tower Jazz

Today TowerJazz reported its last quarter without the Panasonic joint venture. It reported revenues of $132.7 million versus $112.6 million last year up 18% and versus $134.6 million in the fourth quarter of 2013. This was within the range of company guidance of $130-140 million. Since then, the company closed its joint venture with Panasonic on April 1, 2014 and the second quarter of 2014 will have the fully consolidated numbers included the joint venture. Fully diluted non-GAAP EPS came in at $0.30, slightly lower than our estimated $0.33 but very close considering the huge transition occurring in the quarter.

Sales to Micron again declined as that business winds down, but organic growth was 27% and the top five customers grew their business 48%. All the Tower businesses are growing across all the product lines. Masks into the fab grew 28% portending the business could reach its goal of reaching a $1 billion run rate in 2015.

Reported GAAP numbers included two large one-time charges. One is a $150 million gain on the joint venture agreement due to its high value and one a $71 million loss for closing the Nishiwaski fab. A third net charge was for $7 million for restructuring the Jazz bonds.

Gross margin for the quarter improved 3.6 percentage points due to a reduction in low margin business and increased volumes. It went from 29.9% last year to 33.5% this year and 34.1% in Q4 2013.

Operating expenses were down $1.8 million all in R&D. As a result operating income was up 84% on a non-GAAP basis reaching 14.7% of sales up from 5.9% the year before.

Adjusted non-GAAP fully diluted EPS was $0.30 versus $0.15 last year, despite a rise in fully diluted shares of 13%.

Forecast for Q2 2014

In Q2, the joint venture will be operating with management from both companies running operations. Tower will contribute the CEO and CFO and a salesperson to sell to outside customers, while Panasonic will staff COO, CTO and the internal sales executive. While Q1 came in close to estimates, there may be quite a variation in earnings estimates for the second quarter as the joint venture is 100% consolidated and there is little information or guidance on the quarter other than revenues. The company indicted that revenues are expected to come in between $218 and $243 million. We are estimating $225 million, comprised of $140 million Tower revenues and $85 million added from the joint venture. There will be a range of revenues to be expected from Panasonic and not all linear. Panasonic will take up as much as 55% of the utilization of the joint fab. Capacity is 1 million 8” equivalents wafers leaving 500,000 left to sell per year. Panasonic has signed an agreement for five years, but there is no reason to expect it not to continue well beyond.

While the joint venture is expected to add revenues and expenses, it is structured to come in at breakeven on a profits basis, so any earnings improvement for the company will not come from there near term. Revenues should show growth of 80% versus last year without Panasonic. Since the Nishiwaki fab will still be operating, we do not expect any improvement from cost savings in Q2 from closing the fab later in the year.

Forecast for 2014

Starting in the June quarter, TowerJazz will be adding 100% of the joint venture revenues and expenses despite owning only 51% of the joint venture and then the profit (or loss) of the minority interest owned by Panasonic will be subtracted on a line item. The deal is structured so that Panasonic will provide enough in revenues for its products to cover the cost of the fabs. Thus we expect that the operation will show breakeven until the company can attract new business from third parties to these fabs. To add to capacity utilization, TowerJazz will be moving production from its Nishiwaki fab to the Panasonic fabs. This should improve margins at the joint venture, but more importantly will save Tower Jazz as much as $130 million per year in expenses, which could boost profitability to operating margins over 20% up from the 11.1% reported for the year ending 2013 and return it to 2011 margins.

We expect the joint venture to add as much as $85 million to the June quarter, albeit at no additional profit. The deal will add another 870,454 shares to the outstanding. In the September quarter, the deal could add $100 million in revenues, but Micron revenues will fall to zero reducing the quarter by $30 million. By September, we are expecting the company to save approximately $25 million from the fab closing and that much again in December.

Without the joint venture, sales could have reached $610 million by internal growth alone. With the joint venture, the company believes it could be at a $900 million run rate by Q2 and exit Q4 at a $1B run rate. The plan is to let the profits from sales to Panasonic cover the fixed costs of the fabs and all other capacity would be sold to other customers and provide the profit. Much of the new business expected is from higher margin products. Because of these dynamics the company expects to reach GAAP profitability by perhaps year-end. This would be a reversal of a GAAP loss in 2013 of $108 million dollars.

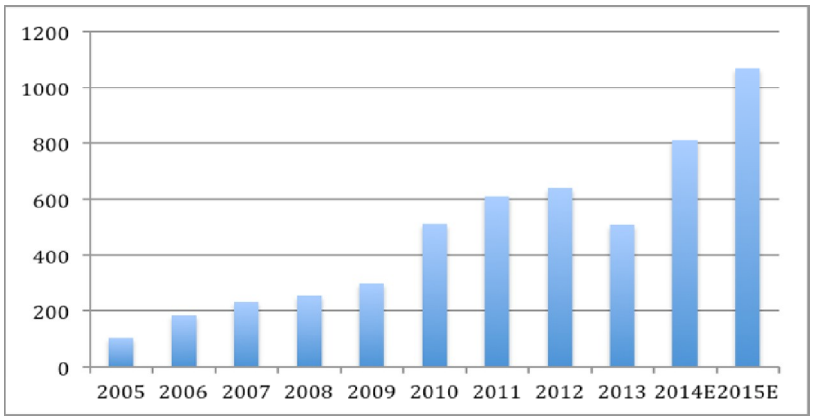
While the expense reduction from the fab closing is a net plus, the fully diluted share count should now be 86 million due primarily to the debt restructuring of March 20th plus the 850,545 shares issued in consideration for the joint venture.

Another event that could occur this year is some word on India. The company had heard that two consortia had been given letters of intent and it is in one of them. Tower is now responding to the LOI and hopes to hear results by the third quarter. However, the elections in India have thrown a monkey wrench into the works as a new government was just elected and there is decent possibility that all decisions from the past regime may be thrown out. It is best always to assume that anything in India takes longer than expected.

Forecast for 2015

Although it is early to tell how revenues and expenses will fall in 2015 given the new joint venture and expense structure we are tentatively forecasting **revenues to reach $1.1 B in 2015** due to improved margins from capacity utilization and higher margin product mix as well as an improved fixed cost structure due to the fab closing. It remains to be seen what the cash needs of the company may be and what dilution may occur to satisfy future plans. As 2014 proceeds will tune our estimates for 2015.

Chart 1. Tower Jazz Revenues



INVESTMENT THESIS

- The company is coming off a year of declining sales and has fallen out of view of investors due to the loss of a major customer and will again gain favor as it proves high growth internally as well as through the new joint venture with Panasonic.
- The stock is undervalued on both a PE and enterprise value to revenues basis compared to its peers.
- The company restructuring has improved liquidity and will reduce long-term debt upon conversion.
- The closing of the Nishiwaki fab should greatly improve profitability and boost margins considerably in late 2014 and beyond.
- The new fab capacity will allow the company to double revenues and improve margins through capacity utilization.
- Having Panasonic as a partner will give the company increased stature in the industry and attract new customers who have a favorable disposition to working with a trusted and known company.

VALUATION

When calculating market cap, we believe the company is valued at $686 million ($8.45 per share X 81.2m shares.)

Enterprise value requires we subtract the cash on the balance sheet and add back the long-term debt that would be remaining assuming conversion of the convertible debt instruments. As of March 31, 2014, that would be $686 - $183 in cash and equivalents + $154 of debt still remaining after theoretical conversion of the debentures or $657 million.

Using a comparable valuation of 1.1 to 1.2 times sales, and looking at 2015 estimated sales, we come up with a value of $12.46 per share that is 47% higher than today's price.

Tower Jazz

Foundary Companies

Company	Ticker	Revenue 2014E	Revenue LTM	EBIDTA Margin	Enterprise Value / Sales 2014E	Enterprise Value / Sales LTM	Included in Average?
Advanced Semiconductor	ASX	$8,120	$7,520	21%	1.2x	1.3x	y
Magnachip	MX	$850	$856	18%	0.7x	0.7x	y
Semiconductor Manufacturing	SMI	$2,200	$2,070	34%	1.3x	1.4x	y
Taiwan Semiconductor	TSM	$22,750	$20,420	61%	0.4x	0.5x	n
United Microelectronics	UMC	$4,470	$4,230	34%	1.1x	1.2x	y
Average				**27%**	**1.1x**	**1.1x**	

	Revenue[1] 2015E	Revenue[1] LTM	EBITDA Margin	Enterprise Value / Sales 2015E	Enterprise Value / Sales LTM	Valuation Range Low	Valuation Range High
Tower Jazz	**$1,000**	**$810**	**14.80%**	**1.1x**	**1.2x**	**$972**	**$1,100**
YoY growth	**20%**						

Conclusion of Enterprise Value	**$1,036,000,000**
Market Value	**$1,071,681,000**
Fully Diluted Shares Outstanding	86,000,000
Price per Share	**$12.46**

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	Dec Q4 12R	March Q1 13	June Q2 13	Sept Q3 13	Dec Q4 13	March Q1 14E	June Q2 14E	Sept Q3 14E	Dec Q4 14E	Non-GAAP 2012	Non-GAAP 2013	Non-GAAP 2014E	Non-GAAP 2015E
REVENUE													
Net Revenue	147.6	112.6	125.2	$132.6	134.6	132.7	225.0	220.0	230.0	638.8	505.0	807.7	997.4
Yr-to-yr Gr.	6%	-24%	11.0%	6.0%	-9%	18%	80%	66%	71%	5%	-21%	60%	23%
OPERATING EXPENSES													
Cost of goods sold	98.3	78.9	81.2	93.1	88.6	88.2	165.0	165.0	171.0	405.4	341.9	589.2	733.0
Gross Margin	49.3	33.7	44.0	39.5	45.9	44.5	60.0	55.0	59.0	233.4	163.2	218.5	264.4
% of Sales	33.4%	29.9%	35.2%	29.8%	34.1%	33.5%	26.7%	25.0%	25.7%	36.5%	32.3%	27.1%	26.5%
R&D	7.1	9.3	7.4	8.1	7.8	7.2	8.2	8.6	8.7	29.1	32.5	32.7	40.0
M, G&A	9.7	9.4	10.9	10.2	10.4	9.9	17.0	8.0	8.6	39.2	40.5	43.5	45.2
One-time charges	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Tot Operating Exp.	16.9	18.8	18.3	18.4	18.2	17.0	25.2	16.6	17.3	68.2	73.0	76.1	85.2
												9.42%	8.54%
Operating Income	32.4	15.0	25.7	21.1	27.8	27.5	34.8	38.4	41.7	165.2	90.1	142.4	179.2
Yr-to-yr Gr.					-14%	84%						18%	18.0%
Net Interest	(8.6)	(8.0)	(8.3)	(8.4)	(8.2)	(8.1)	(8.5)	(5.0)	(5.2)	(31.8)	(33.0)	(26.8)	(26.8)
Other income	0.1	(0.3)	(8.0)	(0.5)	(0.4)	0.1	0.1	(0.4)	(0.4)	(1.0)	(0.9)	(0.6)	(0.6)
Minority Income						0.0	0.0	0.0	0.0	0.0	0.0	0.0	(9.0)
Pretax Income	23.9	6.7	9.4	12.2	19.2	19.5	26.4	33.0	36.1	132.3	56.3	115.0	142.8
		5.9%				14.7%	11.8%	15.0%	15.7%	20.7%	11.1%	14.2%	14.3%
Taxes	1.9	0.2	(1.4)	0.0	0.0	0.0	0.0	0.0	0.0	0.9	0.2	0.0	0.7
Tax Rate	8.1%	2.9%	-15.1%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.6%	0.3%	0.0%	0.5%
Net Income	21.9	6.5	10.8	12.2	19.2	19.5	26.4	33.0	36.1	131.5	56.1	115.0	142.1
Yr-to-yr Gr.					-13%	201%	145%	170%	88%				
Adj Non-GAAP EPS-Basic	$0.96	$0.28	$0.78	$0.26	$0.40	$0.41	$0.55	$0.69	$0.72	$5.94	$1.42	$2.37	$2.79
Adj Non-GAAP EPS-Fully dil.	**$0.36**	**$0.15**	**$0.25**	**$0.21**	**$0.30**	**$0.30**	**$0.37**	**$0.45**	**$0.48**	**$2.65**	**$0.97**	**$1.58**	**$1.88**
Yr-to-yr Gr.													
Share Out	22.8	23.0	39.1	47.0	47.9	48.1	48.1	48.1	50.0	22.2	39.6	48.6	51.0
Fully diluted shares	72.7	72.1	62.3	78.8	79.6	81.2	86.0	86.0	86.0	49.6	76.1	86.0	87.7
						13%					53.4%	13.0%	2.0%

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Sell/Underperform: The analyst expects the company will underperform the broader U.S. Equity market over the next one to two quarters.

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