Zacks Small-Cap Research

May 9, 2017
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TowerJazz

(TSEM-NASDAQ)

TSEM: 2017 on Track, Capacity Plans Need to Be Addressed By Year End

We believe that the stock should be worth $32.30 based on an industry average PE ratio of 17.1xs its 2017 non-GAAP EPS earnings of $1.89.

Current Price (05/08/17)	$24.00
Valuation	**$32.30**

OUTLOOK

TowerJazz is a pure-play analog semiconductor wafer foundry that manufactures SiGe, MEMS, RF, embedded flash-based memory, analog/mixed-signal, and CMOS image-sensor devices in the US, Israel and Japan. It has capacity to $1.6B in sales and is serving high growth markets such as RF High Position analog, CMOS image sensors, and power management. It is expected to grow because of the specific markets it addresses, by fab acquisitions, and by market share gains. We expect it to make a decision by year-end as to increasing capacity significantly for future needs.

SUMMARY DATA

52-Week High	**$24.00**
52-Week Low	**$11.05**
One-Year Return (%)	**91.9**
Beta	**1.1**
Average Daily Volume (sh)	**652,375**
Shares Outstanding (mil)	**96**
Market Capitalization ($mil)	**$2,300**
Short Interest Ratio (days)	**6.5**
Institutional Ownership (%)	**51**
Insider Ownership (%)	**1**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**17.4**
Earnings Per Share (%)	**30.2**
Dividend (%)	**0.0**
P/E using TTM EPS	**12.7**
P/E using 2017 Estimate	**12.7**
P/E using 2018 Estimate	**11.3**
Zacks Rank	**N/A**

Risk Level	**Below Average**
Type of Stock	**Mid-Blend**
Industry	**Elect. Comp-Semi.**

ZACKS ESTIMATES

Revenue
(in millions of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2015	226 A	236 A	244 A	255 A	961 A
2016	278 A	305 A	326 A	340 A	1,250 A
2017	330 A	345 E	348 E	355 E	1,378 E
2018					1,510 E

Earnings per Share
(Adjusted Non-GAAP Fully Diluted)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2015	-$0.03 A	$0.14 A	$0.22 A	$0.29 A	$0.58 A
2016	$0.31 A	$0.40 A	$0.49 A	$0.52 A	$1.71 A
2017	$0.48 A	$0.49 E	$0.50 E	$0.52 E	$1.89 E
2018					$2.12 E

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WHATS NEW

Q2 Earnings on Target; Company Guides Up on Q2 Revenues

TowerJazz reported Q1 2017 revenues of $330 million versus last year's $278 million, **up 19%** and $340 million in Q4 2016. This was in line with guidance and all growth was organic. The company gave midpoint guidance of $345 million in revenue for Q2 2017, pointing to revenue growth of 13%.

Gross margins continue to improve with capacity utilization and product mix. Gross margin for the quarter was 25.7% versus 22.1% last year and 25.8% in Q4 2016 based on higher revenues. While revenues grew 19%, operating income grew 44% to 16% of sales, the same margin as in Q4 2016. Operating leverage from Tower's fixed cost structure should continue to propel earnings growth ahead of revenue growth going forward.

Fully diluted GAAP EPS was $0.45 versus $0.69 a year ago. **Non-GAAP EPS was $0.48 versus $0.32, up 42%.** Adjusted **EBITDA was $101 million** versus $78 million a year ago. At today's price, this is an enterprise value to EBITDA run rate of 5.4 times.

2017 Forecast

Giving the company's revenue guidance for Q2, we are increasing our revenue forecast for the year from $1.367 billion to $1.378 billion. However we are reducing earnings estimates primarily due to a change in our assumption for taxes. In the US and Japan the company pays taxes and we now expect to company to pay as much as $14 million in taxes in 2017 versus the $4 million assumption we previously had. We are now looking for non-GAAP EPS of $1.89 versus our previous $2.10.

Capacity Utilization and Plans

The company continues to accumulate cash and now has net cash of **$86 million versus $37 million a year ago.** Its quick ratio is high at 2.5xs and it has $496 million in working capital. The company is no doubt stockpiling cash for potential acquisitions of fabs or other ventures rather than paying down debt. By Q3 or Q4, TowerJazz will have to make a decision as to whether to build out its San Antonio fab or make some other move to increase capacity. It needs to have something in hand by the end of the year to meet 2018 capacity needs. If it were to build a fab, we believe it is having discussions with a municipality in China that would fund the project while Tower provides the equipment and expertise. Alternatively it could seek out a fab for sale from an owner that would still guarantee to use some production capacity much like Panasonic or Maxim did. There is some hope that industry consolidation in the client base could create some opportunity. Panasonic continues to represent between $90-105 million in revenues per quarter and third party revenues at TPSCo. It ended Q4 2016 at a $100 million run rate. So Panasonic plus Maxim total approximately $500 million of the company's estimated $1.4 billion in 2017 revenues. TPSCo generated $400 million in revenue; Panasonic owns 49% of that business.

The company continues to expand incremental capacity in the fabs it owns and cross certify among fabs to provide more flexibility. Its current fabs have achieved the following capacity utilization:

	Q4 2015	Q1 2016	Q2 2016	Q3 2016	Q4 2016	Q1 2017
Fab1 Migdal Haemek, Israel 6"	65%	71%	70%	70%	78%	87%
Fab2 Migdal Haemek, Israel 8"	91%	91%	91%	91%	87%	89%
Fab3 Newport Beach, California 8"	91%	91%	88%	88%	84%	87%
Three TPSCo factories	41%	41%	42%	42%	50%	50%
San Antonio, 8"	NA	NA	NA	NA	NA	60%

The current fab capacity will allow the company to grow revenues and improve margins through capacity utilization. The following table shows the **operating leverage** the company has. It shows that without improvements, the capacity of TowerJazz is currently $1.6B. Based on its experience, that revenue is projected to yield gross margin of $489 million, EBITDA of $547 million and net profit to TSEM (after subtracting Panasonic's minority interest) of $261 million.

Present Capacity Financial Model

$M	Q3'16 Annualized	Incremental Model	Total
Revenue	1,305	295	1,600
Gross Profit	324	165	489
R&D	62	5	67
SG&A	67	0	67
EBITDA	387	160	547
Net Profit	160	101	261
Cash from operations	344	121	465
Cap-Ex	168	0	168
FCF	176	121	297

INVESTMENT THESIS

- Although the semiconductor market is typically considered cyclical, we believe that based on the end-user markets for which TowerJazz's products used, revenues should continue to grow steadily.
- As a foundry, the company has natural operating leverage given its high fixed costs. Every dollar in revenue tends to add at least $0.45 to gross margin.
- Its largest market segment, RF, was 30% of 2016 revenues. While this segment grew 23% in 2016, the company just increased its expected growth to double the 5% in 2017 it has previously thought, based on current business and customer expectations. The remaining 70% of the business ex-Panasonic and Maxim is expected to have double-digit growth between 10-30%.
- The company has a strong market position in high quality imaging and 3D, which is increasing being used for gesturing controls, machine vision, security anti-crash systems and self driving cars, as well as smartphones with high megapixel cameras. In this area its primary competition is Sony, which makes it a preferable source for many companies that compete with Sony.

- Having Panasonic as a partner gives the company increased stature in the industry and has attracted new customers who have a favorable disposition to working with a trusted and known company with high quality product and leading edge expertise in imaging.
- The major risk to the stock is the need to add capacity, which is currently $1.6 billion in revenue. The company should be making a decision on how to increase that capacity by year-end. This is expected to make a change to earnings estimates, require capital and increases expenses no matter what methodology is chosen either: increasing current fab capacities, buying a new fab either outright or in a joint venture, or partnering with another entity to build a brand new fab.
- We believe the stock is currently undervalued on a PE basis versus its peers, as well as by PE to growth rate. Peer companies trade at an average PE of 17.1 times. At an industry average PE, TSEM's stock should trade at $32.30 per share.

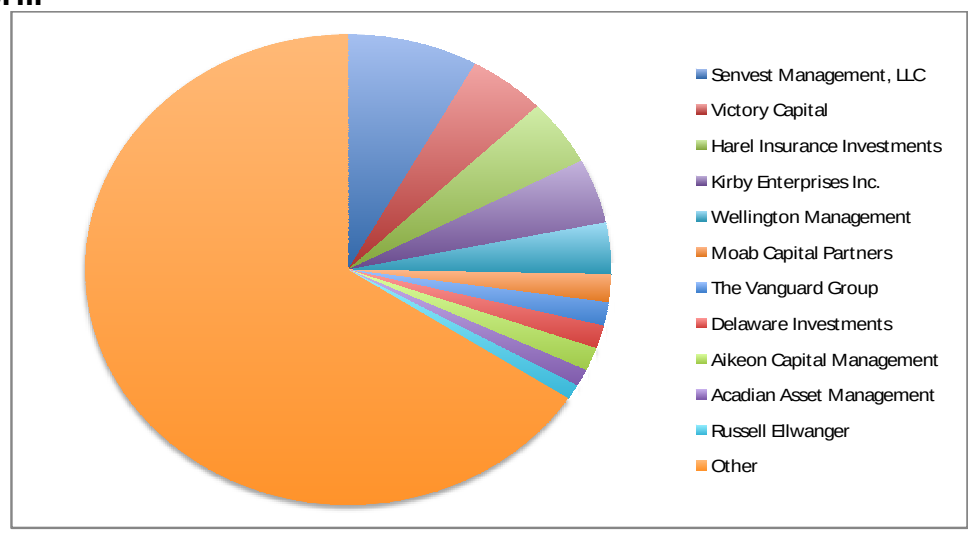
VALUATION

TSEM's public foundry comparables have a PE range of 14.4 to 21.9 times 2018 estimated EPS. Our Fully diluted non-GAAP EPS estimate for 20187 for TSEM is $1.89. Given SMI's outlying PE of 68 in 2017, we choose to use the 2018 PE average. **Using the average PE of 17.1 times for the group gives a current stock price of $32.30 per share**. The biggest risk to the stock is that the company will have to move to increase capacity by year end which cold result in a reduction in earnings estimates as any major capacity add would be expected to reduce earnings in the short term.

Foundry Companies

Company	Ticker	EPS 17E	EPS 18E	Price	PE 2017	PE 2018	Growth Rate
Advanced Semiconductor	ASX	$0.48	$0.56	$6.11	12.7	10.9	17%
Semiconductor Manufacturing	SMI	0.09	0.28	6.12	68.0	21.9	211%
Taiwan Semiconductor	TSM	2.19	2.34	35.00	16.0	15.0	7%
United Microelectronics	UMC	0.11	0.14	2.02	18.4	14.4	27%
Average					28.8	17.1	81.7%

OWNERSHIP



Source: E*TRADE and SEC filings

BALANCE SHEET

$ in thousands	Mar. 31, 2017	Dec. 31, 2016	Qtr-Qtr % Change	Mar. 31, 2016	Yr-Yr % Change
CURRENT ASSETS					
Cash and cash equivalents	**$432,113**	**$389,377**	11.0%	**$244,577**	76.7%
Trade accounts receivable	133,539	141,048	-5.3%	122,918	8.6%
Inventories	140,734	137,532	2.3%	128,031	9.9%
Other current assets	27,235	30,041	-9.3%	16,666	63.4%
Total current assets	**733,621**	**697,998**	5.1%	**521,555**	40.7%
LONG-TERM INVESTMENTS	26,661	25,624	4.0%	11,816	125.6%
PROPERTY AND EQUIPMENT, NET	629,554	616,686	2.1%	582,250	8.1%
INTANGIBLE ASSETS, NET	26,164	28,129	-7.0%	35,601	-26.5%
GOODWILL	7,000	7,000	0.0%	7,000	0.0%
OTHER ASSETS, NET	4,403	4,447	-1.0%	5,688	-22.6%
TOTAL ASSETS	1,427,403	1,379,884	3.4%	1,163,910	22.6%
CURRENT LIABILITIES					
Short term debt	**43,331**	**48,084**	-9.9%	**49,150**	-11.8%
Trade accounts payable	104,084	99,262	4.9%	104,617	-0.5%
Deferred revenue	24,945	26,169	-4.7%	31,061	-19.7%
Other current liabilities	65,469	73,600	-11.0%	73,929	-11.4%
Total current liabilities	**237,829**	**247,115**	-3.8%	**258,757**	-8.1%
LONG-TERM DEBT	**303,152**	**296,144**	2.4%	**260,201**	16.5%
LONG-TERM CUSTOMERS' ADVANCES	34,369	41,874	-17.9%	28,444	20.8%
EMPLOYEE RELATED LIABILITIES	14,447	14,176	1.9%	14,387	0.4%
DEFERRED TAX LIABILITY	91,715	97,961	-6.4%	95,638	-4.1%
Total liabilities	681,512	697,270	-2.3%	659,543	3.3%
SHAREHOLDERS' EQUITY	745,891	682,614	9.3%	504,367	47.9%
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$1,427,403	$1,379,884	3.4%	$1,163,910	22.6%
Current Ratio	3.1	2.8	9.2%	2.0	53.0%
Quick Ratio	2.5	2.3	9.9%	1.5	63.9%
Working Capital	495,792	450,883	10.0%	262,798	88.7%
Debt Percent of Assets	24%	25%	-2.7%	27%	-8.7%
Debt to Equity	0.5	0.5	-7.9%	0.6	-24.3%

INCOME STATEMENT

	March Q1 16	June Q2 16	Sept Q3 16	Dec Q4 16	March Q1 17	June Q2 17E	Sept Q3 17E	Dec Q4 17E	2016	2017E	2018E
REVENUE											
Net Revenue	278.0	305.0	326.2	340.4	330.1	345.0	348.0	355.0	1,249.6	1,378.1	1,509.8
Yr-to-yr Gr.	23%	29%	34%	34%	19%	13%	7%	4%	30%	10%	9%
OPERATING EXPENSES											
Cost of goods sold	216.7	232.3	244.9	252.6	245.3	252.9	254.5	257.6	946.5	1,010.3	1,076.1
Gross Margin	61.3	72.7	81.3	87.7	84.8	92.1	93.5	97.4	303.1	367.8	433.7
% of Sales	22.1%	23.8%	24.9%	25.8%	25.7%	26.7%	26.9%	27.4%	24.3%	26.7%	28.7%
R&D	15.2	16.0	15.5	16.3	15.8	16.0	16.0	16.1	63.1	63.9	66.5
M, G&A	15.9	16.5	16.8	16.2	16.2	16.7	16.9	18.4	65.4	68.2	74.0
One-time charges	(0.6)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	(0.6)	0.0	0.0
Tot Operating Exp.	30.5	32.6	32.3	32.5	32.0	32.7	32.9	34.5	127.9	132.1	140.5
Operating Income	30.8	40.2	49.0	55.2	52.8	59.4	60.6	62.9	175.2	235.7	293.2
Operating Margin	11%	13%	15%	16%	16%	17%	17%	18%	14%	17%	19%
Yr-to-yr Gr.	1445%	87%	104%	61%	44%	31%	16%	9%	113.9%	34.6%	21.8%
Net Interest	(3.4)	(3.0)	(3.3)	(2.2)	(2.2)	(2.1)	(2.0)	(2.0)	(11.9)	(8.3)	(8.3)
Other non-cash financing expense	(4.0)	(7.5)	(2.2)	1.2	(2.0)	(2.0)	(2.0)	(2.0)	(12.5)	(8.0)	(8.0)
Other income	0.0	4.4	5.1	(0.9)	0.5	0.0	0.0	0.0	8.5	0.5	0.0
Gain from acqusiition	41.1	10.2	0.0	0.0	0.0	0.0	0.0	0.0	51.3	0.0	0.0
Profit before tax	64.6	44.2	48.6	53.2	49.0	55.3	56.6	58.9	210.6	219.9	276.9
	23.2%	14.5%	14.9%	15.6%	14.9%	16.0%	16.3%	16.6%	16.9%	16.0%	18.3%
Taxes	(0.1)	(3.8)	3.5	(1.0)	(2.0)	(4.0)	(4.0)	(4.0)	(1.4)	(14.0)	(25.0)
Tax Rate	0.1%	8.7%	-7.1%	1.9%	4.1%	7.2%	7.1%	6.8%	0.7%	6.4%	9.0%
Profit before non-controlling	64.5	40.3	52.0	52.3	47.0	51.3	52.6	54.9	209.2	205.9	251.9
Minority Income	1.3	(1.9)	(0.8)	(4.0)	(1.5)	(3.0)	(4.0)	(4.0)	(5.3)	(12.5)	(36.0)
GAAP Net income	65.9	38.5	51.2	48.3	45.5	48.3	48.6	50.9	203.9	193.3	215.9
Yr-to-yr Gr.	-190%	394%	278%	119%	-31%	25%	-5%	5%	NM	-5%	1%
Non-GAAP Net Income	31.6	39.8	49.4	53.4	52.1	52.7	53.1	55.3	174.2	201.73	225.85
GAAP primary EPS	$0.78	$0.45	$0.58	$0.53	$0.48	$0.50	$0.50	$0.52	$2.33	$2.00	$2.24
Fully diluted GAAP	$0.69	$0.40	$0.52	$0.49	$0.45	$0.45	$0.45	$0.47	$2.10	$1.81	$2.03
Adj Non-GAAP EPS-Fully dil.	**$0.32**	**$0.40**	**$0.49**	**$0.52**	**$0.48**	**$0.49**	**$0.50**	**$0.52**	**$1.71**	**$1.89**	**$2.12**
	-1198%	190%	125%	77%	42%	14%	-7%	-8%	195%		
Primary Share Out	84.5	86.3	87.8	91.2	93.9	96.0	98.0	98.0	87.5	96.5	96.5
Fully Diluted GAAP	98.8	100.2	101.8	103.6	104.9	107.0	107.2	107.2	101.3	106.6	106.6
All in shares	106.9	107.1	107.1	107.1	107.2	107.2	107.2	107.2	107.0	107.2	107.2
EBITDA	**77.7**	**87.0**	**96.8**	**105.2**	**101.0**	**107.7**	**108.9**	**111.2**	**366.7**	**428.8**	**563.3**
EBITDA Margin	28%	29%	30%	31%	31%	31%	31%	31%	29%	31%	37%
Yr-to-yr Gr.	51%	48%	53%	39%	30%	24%	13%	6%		17%	23%

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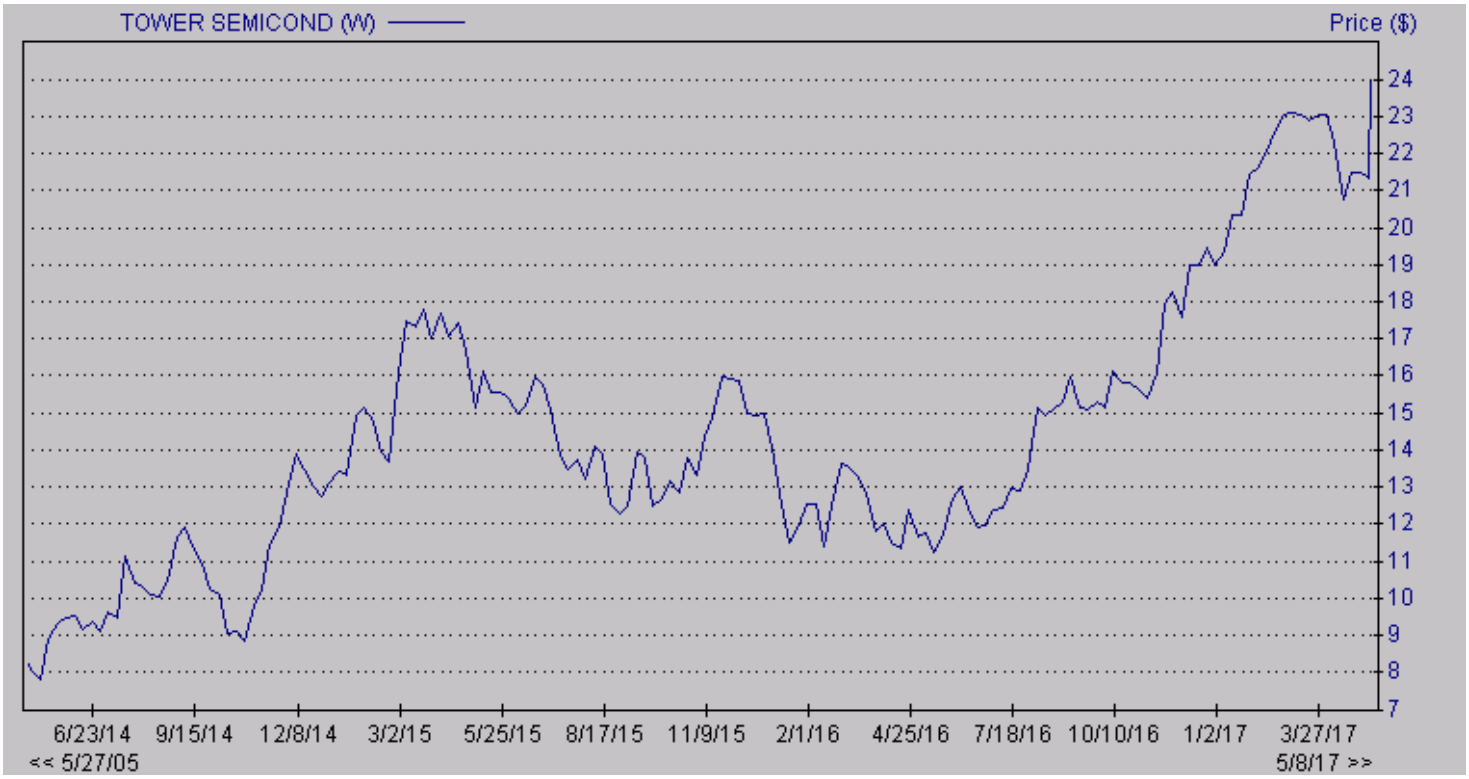
CASH FLOW

	3-months 31-Mar-15	3-months 30-Jun-15	3-months 30-Sep-15	3-months 31-Dec-15	3-months 31-Mar-16	3-months 30-Jun-16	3-months 30-Sep-16	3-months 31-Dec-16	3-months 31-Mar-17
CASH FLOWS - OPERATING ACTIVITIES									
Net profit (loss)	$ 24,071	$ 8,150	$ 14,002	$ 24,071	$ 64,548	$ 40,347	$ 52,018	$ 52,253	$ 47,046
Income and expense items not involving cash flows:									
Depreciation and amortization	43,663	$ 37,343	39,058	43,663	48,584	48,117	49,194	$ 51,711	49,698
Financing expense associated with debentures series F	7,998	$ 1,945	2,696	7,998	0	0	0	$ 150	0
Effect of fair value measurement on debt	3,804	$ 3,547	918	3,804	1,401	6,700	2,808	$ (2,617)	6,888
Financing costs relating to Jazz notes exchange	0	$ 0	0	0	0	0	0	$ 0	0
Other expense (income), net	(70)	$ 4	247	(70)	0	(4,362)	(5,081)	$ 121	(511)
Gain from acquisition	0	$ 0	0	0	(41,140)	(10,158)	0	$ 827	0
Changes in assets and liabilities:									
Trade accounts receivable	11,795	$ (9,258)	(7,325)	11,795	(8,519)	(1,916)	(1,469)	$ (18,200)	9,529
Other receivables and other current assets	(4,463)	$ 2,188	(5,549)	(4,464)	822	(5,476)	4,328	$ 61	(4,439)
Inventories	(1,302)	$ (6,098)	(12,151)	(1,302)	(9,224)	(6,300)	(6,245)	$ (300)	(1,421)
Trade accounts payable	(18,979)	$ (5,072)	(508)	(18,978)	10,143	130	2,624	$ (7,347)	(4,128)
Deferred revenue and customers' advances	8,613	$ 3,264	18,144	8,613	15,030	8,294	(5,377)	$ 5,634	(8,735)
Other current liabilities	(16,413)	$ 15,248	1,597	(16,413)	(1,953)	11,194	(6,938)	$ (2,448)	(9,090)
Employee related liabilities					(245)			$ (385)	(257)
Deferred tax liability, net	(4,612)	$ (245)	133	(4,612)	(2,005)	(4,789)	548	$ 2,375	(2,440)
Other long-term liabilities	(925)	$ (82)	(440)	(925)	0	0	0	$ 0	0
Net cash provided by operating activities	**53,180**	**50,934**	**50,822**	**53,180**	**77,442**	**81,781**	**86,410**	**82,220**	**82,140**
CASH FLOWS - INVESTING ACTIVITIES									
Investments in property and equipment, net	**(58,291)**	**$ (38,641)**	**(40,626)**	**(58,172)**	**(57,533)**	**(54,323)**	**(54,947)**	**$ (42,821)**	**(40,348)**
Investments in other assets	0	$ 0	0	(119)	0	0	0	$ 0	0
Acquisition of subsidiary consolidated for the first time (a)	0	$ 0	0	0	0	0	0	$ 0	0
Interest bearing deposits, including designated deposits	(30,000)	$ 0	0	(30,000)	10,000	19,600	(12,500)	$ (34,201)	(5,118)
Net cash provided by (used in) investing activities	(88,291)	$ 21,719	(40,626)	(88,291)	(47,533)	(34,723)	(67,447)	(77,022)	(45,466)
CASH FLOWS - FINANCING ACTIVITIES									
Excersize of warrants and options	4,168	$ (817)	4,602	4,168	5,881	360	21,918	$ 10,644	12,756
Proceeds from long-term loans	70,592	$ 0	0	70,592	17,000	27,444	8,554	$ (52,998)	0
Short-term loan repayment to Panasonic	0	$ 0	0	0	0	0	0	$ 0	0
Debt repayment	(18,006)	$ (2,000)	(3,000)	33,483	(10,254)	0	0	$ 47,345	(11,805)
Debenture repayment	0	$ 0	0	(51,489)	0	0	0	$ 0	0
TPSCo dividend to Panasonic	(1,570)	$ 0	0	(1,570)	(2,563)	0	0	$ 0	(4,378)
Net cash used in financing activities	10,064	$ (2,817)	1,602	55,184	10,064	27,804	30,472	4,991	(3,427)
Effect of foreign exchange rate change	154	$ (1,189)	1,047	154	9,029	11,623	2,336	$ (17,353)	4,371
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	49,002	$ 8,287	12,845	20,227	49,002	86,485	51,771	$ (7,549)	37,618
CASH AND CASH EQUIVALENTS - BEGINNING OF PERIOD	20,227	$ 156,348	142,503	155,348	175,575	224,577	311,062	362,833	355,284
CASH AND CASH EQUIVALENTS - END OF PERIOD	156,348	$ 142,503	155,348	175,575	224,577	311,062	362,833	355,284	392,902

HISTORICAL STOCK PRICE



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