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Zacks Small-Cap Research

Sponsored – Impartial - Comprehensive

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TowerJazz (TSEM-NASDAQ)

TSEM: 2018 Revenues Expected to Be Back Weighted Due to 300mm Ramp

We believe that the stock could be worth $41.00 using industry average PE ratios given current earnings estimates.

Current Price (02/22/18)	$30.16
Valuation	**$41.00**

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, fab partnerships, and by market share gains. Its goal it to reach $3.5B in revenues organically combined with targeted acquisitions providing horizontal diversification.

SUMMARY DATA

52-Week High	**$35.95**
52-Week Low	**$20.80**
One-Year Return (%)	**31.4**
Beta	**0.92**
Average Daily Volume (sh)	**770,685**
Shares Outstanding (mil)	**98**
Market Capitalization ($mil)	**$2,969**
Short Interest Ratio (days)	**2.4**
Institutional Ownership (%)	**44**
Insider Ownership (%)	**1**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**24.9**
Earnings Per Share (%)	**20.8**
Dividend (%)	**N/A**
P/E using TTM EPS	**13.7**
P/E using 2018 Estimate	**11.8**
P/E using 2019 Estimate	**10.0**
Zacks Rank	**N/A**

Risk Level	**Below Average**
Type of Stock	**Mid-Growth**
Industry	**Elec Comp-Semis**

ZACKS ESTIMATES

Revenue
(in millions of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2016	278 A	305 A	326 A	340 A	1,250 A
2017	330 A	345 A	355 A	358 A	1,387 A
2018	325 E	345 E	370 E	410 E	1,450 E
2019					1,566 E

Earnings Per Share
(Adjusted non-GAAP Diluted)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2016	$0.34 A	$0.42 A	$0.51 A	$0.54 A	$1.80 A
2017	$0.50 A	$0.54 A	$0.60 A	$0.58 A	$2.21 A
2018	$0.36 E	$0.46 E	$0.58 E	$0.77 E	$2.17 E
2019					$2.80 E

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

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WHAT'S NEW

TowerJazz reported its fourth quarter with revenues of $357.6 million, up 5% from a year ago and in line with expectations. This quarter concludes Tower's most profitable and success year ever. However this success was clouded by Q1 guidance and the fourth quarter results. This is the fourth reported quarter of decelerating revenue growth and guidance for Q1 2018 at a midpoint of $325 million continues that streak. Revenue growth should reaccelerate in the second half of the year primarily because of the company's Japanese fab's ramp of 300mm production, a process that has taken two to three years to achieve. Two one-time tax charges, one from Israel, and the other the US, which combined added $95 million in gains to Q4 results, complicated the earnings report. Pealing off these gains, TSEM reported adjusted non-GAAP EPS year over year growth to $0.58 versus $0.54 a year ago and $0.60 in Q3 2017.

Gross margin for the fourth quarter was 25.0% versus $25.8% a year ago and flat with Q3 2017. Gross margin is expected to improve throughout 2018, as high margin SiG capacity should double and higher margin 300mm product ramps in the second half.

R&D costs for the quarter were $2.1 million higher than last year and M,G&A increased $293,000. These increased costs caused operating margin to decline 1% year over year.

There was an increase of $5 million of other expenses resulting in pretax earnings of $47.4 million versus $53.2 million. The company benefited from a one-time tax reversal of $95 million resulting in reported taxes returned in the quarter of $101.2 million resulting in a diluted GAAP EPS profit of $1.40 per share. Adjusting for this one time paper gain, adjusted non-GAAP EPS was $0.58. The diluted share count increased 3.1%.

2017 Year Overview

For the full year revenues increased 11% to $1.37 billion while gross margin improved to 25.5% from 23.4%. The company grew overall revenues 11% in 2017, but stated that subtracting out revenues from Panasonic and Maxim, the remainder grew 23%. This means we can calculate that Panasonic and Maxim contributed $615 million in 2017 revenues, down 1.2% year over year, while the rest of the revenues grew from $628 million in 2016 to $772 million in 2017. If these two growth rates were to be the same in 2018 as 2017, the company could reach $1,558 million in revenues in 2018.

Through operating leverage and product mix, operating profit improved 25.6% year over year to $220 million. Non-GAAP net income increased 30.6%. Adjusted non-GAAP EPS was reported at $2.21 versus $1.80, up 23% with diluted shares increasing 4.6%.

EBITDA reached a record $425 million versus $367 million a year ago.

Q1 2018 Expectations

The company guided to a midpoint revenue range of $325 million plus or minus 5%, which is down 10% sequentially entirely due to industry seasonality. Investors however are not used to this seasonality showing up at TSEM as revenues in Q1 2017 were only down 3.0% sequentially and in Q1 2016 they were up 9.2% due to the acquisition of Maxim in that quarter. The company believes last year's Q4 to Q1 decline was abnormally small because "certain areas that it was involved in then were seeing some surges and market demand outside of seasonality, and it was growing in market share in certain areas that allowed it to curtail seasonality."

This drop off in revenues could lead to a decline in year over year revenues, gross margin, and EPS as gross margin should be down and expenses have ramped since last year. Operating leverage here hurts the company. We are forecasting adjusted non-GAAP EPS of $0.36 versus $0.50 last year.

Balance Sheet and Capacity

The company continues to accumulate cash and now has net **cash and marketable securities of $560 million** compared to $530 million last quarter and versus $389 million a year ago. Its quick ratio is high at 2.4xs and it has $572 million in working capital. The company is stockpiling cash to increase capacity.

The company has a goal to reach $3.5 billion in revenues. It believes that it can grow organically to $2.3 billion to $2.5 billion with all its current and planned initiatives including the Takoma project, a new 8-inch semiconductor fab in Nanjing, China. The rest is expected to come from acquisitions.

The current fab capacity will allow the company to grow revenues and improve margins through capacity utilization. The company targets 85% utilization at its fabs. Its current fabs were at the following capacity utilization at quarter end:

	Q1 2016	Q2 2016	Q3 2016	Q4 2016	Q1 2017	Q2 2017	Q3 2017	Q4 2017
Fab1 Migdal Haemek, Israel 6"	71%	70%	70%	78%	87%	90%	91%	93%
Fab2 Migdal Haemek, Israel 8"	91%	91%	91%	87%	89%	85%	86%	85%
Fab3 Newport Beach, California 8"	91%	88%	88%	84%	87%	86%	81%	76%
Three TPSCo factories	41%	42%	42%	50%	50%	50%	58%	60%
San Antonio, 8"	NA	NA	NA	NA	60%	60%	60%	60%

2017 Business Sector Overview

RF and high precision analog

In 2017, this group provided 29% of total revenues ($400 million) and grew 10% year over year, the slowest of any segment of the company. This was further broken down as 21% from mobile and 8% from infrastructure. Higher growth came from silicon germanium offerings for infrastructure and some high-end mobile applications, which grew 22% year-over-year. Going forward the company is focused on upcoming 5G standards with increased mobile data transmission rates as well as automotive sensors.

Power management

This segment was 30% of total revenues or $420 million. Automotive industrial markets with additional consumer needs drive the high end of this business. Automotive applications include product for batteries, headlight LED, advanced safety features, power savings and charging capabilities particularly in electric and hybrid vehicles.

CMOS image sensor

This segment was 15% of revenues or $210 million and provides the highest margins. The end markets for this business includes medical, machine vision, digital SLR camera, cinematography, and security. In particular this business will be heavily back end weighted to the second half for applications in high end digital SLRs, cinematography and broadcasting.

Mixed Signal Applications

This segment was 26% of revenues or $360 million. Its products include: MCUA6, RFID TAG, logic standard cells, certain special CMOS embedded memory, and advanced sensors including MEMS. They serve computing, industrial, consumer and automotive end markets as well as aerospace and defense. Growth in this segment is being led by partnerships in the automotive market.

KEY POINTS

- 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 about $0.50 to gross margin. When the company adds 12" revenues that blended percentage will trend higher as 12" can sell at 60+ gross margins.
- 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 can do this by increasing current fab capacities, buying a new fab either outright or in a joint venture. It has recently partnered with Tacoma to build a new fab in China.
- 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 16.9 times 2018 estimated earnings and 16.5 times 2019 estimates. At an industry average PE, TSEM's stock should trade at $41.00 per share.

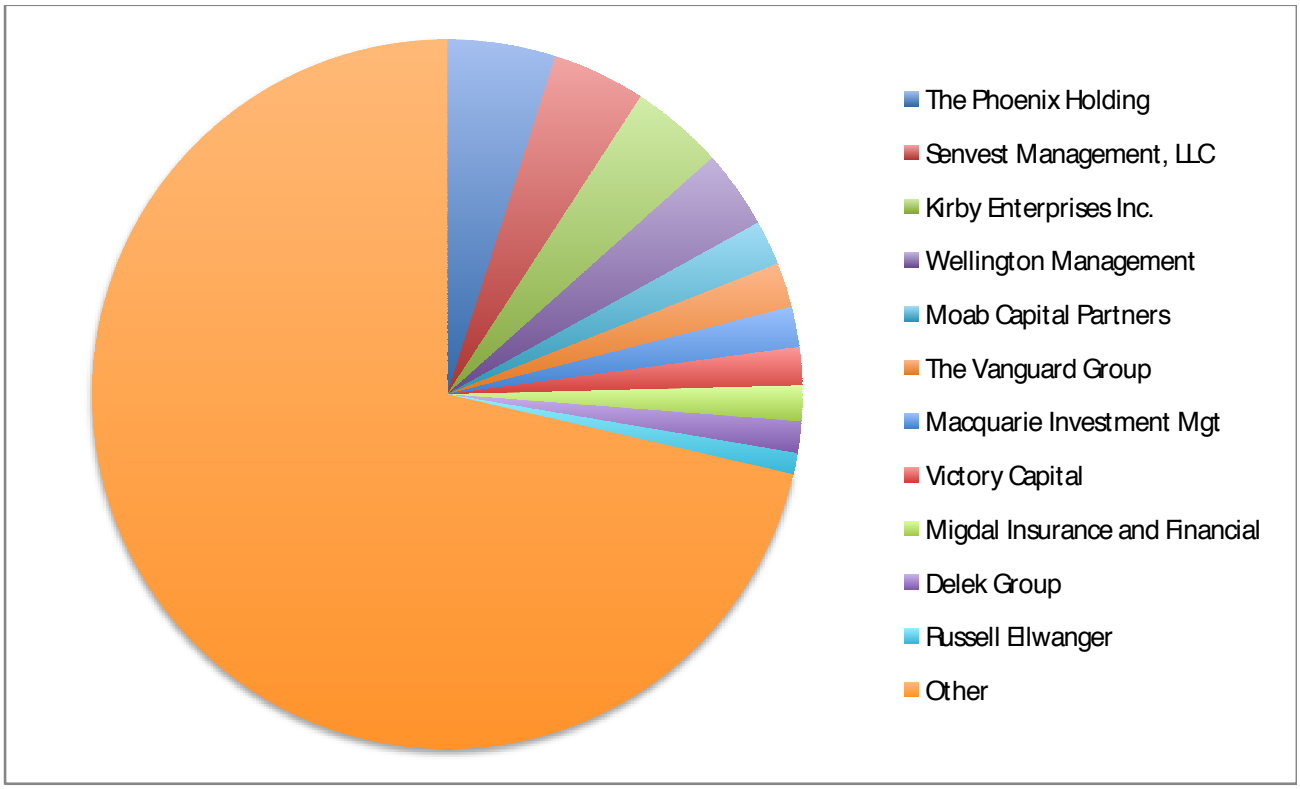
VALUATION

TSEM's public foundry comparables have a PE range of 13.8 to 83.4 times 2018 estimated EPS. Our Fully diluted non-GAAP EPS estimate for 2018 for TSEM is $2.18 and our 2019 EPS estimate is $2.80. Given SMI's outlying PE of 83.4, we choose to use the 2018 PE average without that stock. Using the average PE of 16.9 times for estimated 2018 EPS the group gives a stock price of $36.70 per share. Moving to 2018 estimates, TSEM could be worth 16.2 times $2.80 or $46.20. Averaging the two, we get $41.00 if the company can achieve current earnings estimates. The biggest risk to the stock that an acquisition of a fab or a joint venture could incur short-term earnings dilution.

Foundry Companies

Company	Ticker	EPS 17	EPS 18E	EPS 19E	Price	PE 2017	PE 2018E	PE 2019E	Growth Rate
Advanced Semiconductor	ASX	$0.43	$0.50	NA	$6.90	16.0	13.8	NA	NA
Semiconductor Manufacturing	SMI	0.20	0.08	0.08	6.67	33.4	83.4	83.4	0.0%
Taiwan Semiconductor	TSM	2.17	2.41	2.62	43.83	20.2	18.2	16.7	8.7%
United Microelectronics	UMC	0.13	0.13	0.15	2.43	18.7	18.7	16.2	15.4%
Average						18.3	16.9	16.5	8.0%

OWNERSHIP



Source: E*TRADE and SEC filings

INCOME STATEMENT

	March Q1 17	June Q2 17	Sept Q3 17	Dec Q4 17	March Q1 18E	June Q2 18E	Sept Q3 18E	Dec Q4 18E	2016	2017	2018E	2019E
REVENUE												
Net Revenue	330.1	345.1	354.6	357.6	325.0	345.0	370.0	410.0	1,249.6	1,387.3	1,450.0	1,566.0
Yr-to-yr Gr.	19%	13%	9%	5%	-2%	0%	4%	15%	30%	11%	5%	8%
OPERATING EXPENSES												
Cost of goods sold	245.3	254.0	265.4	268.3	250.6	259.6	270.9	288.9	946.5	1,033.0	1,070.1	1,114.4
Gross Margin	84.8	91.1	89.1	89.4	74.4	85.4	99.1	121.1	303.1	354.3	379.9	451.6
% of Sales	25.7%	26.4%	25.1%	25.0%	22.9%	24.7%	26.8%	29.5%	24.3%	25.5%	26.2%	28.8%
R&D	15.8	16.4	17.1	18.4	18.0	18.0	18.0	18.0	63.1	67.7	72.0	76.0
M, G&A	16.2	17.2	16.8	16.5	16.5	16.5	16.5	16.5	65.4	66.8	66.0	70.0
One-time charges	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	(0.6)	0.0	0.0	0.0
Tot Operating Exp.	32.0	33.7	33.9	34.9	34.5	34.5	34.5	34.5	127.9	134.5	138.0	146.0
Operating Income	52.8	57.4	55.2	54.5	39.9	50.9	64.6	86.6	175.2	219.8	241.9	305.6
Operating Margin	16%	17%	16%	15%	12%	15%	17%	21%	14%	16%	17%	20%
Yr-to-yr Gr.	71%	43%	13%	-1%	-24%	-11%	17%	59%	113.9%	25.5%	10.0%	17%
Net Interest	(2.2)	(2.1)	(1.8)	(1.8)	(1.8)	(1.8)	(1.8)	(1.8)	(11.9)	(7.8)	(7.1)	(7.1)
Other non-cash financing expense	(2.0)	(1.1)	(2.3)	(2.3)	(2.0)	(2.0)	(2.0)	(2.0)	(12.5)	(7.6)	(8.0)	(8.0)
Other income	0.5	0.1	(0.3)	(3.0)	0.0	0.0	0.0	0.0	8.5	(2.6)	0.0	0.0
Gain from acqusiition	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	51.3	0.0	0.0	0.0
Profit before tax	49.0	54.4	50.9	47.4	36.1	47.1	60.8	82.8	210.6	201.8	226.8	290.5
Profit margin	14.9%	15.8%	14.4%	13.3%	11.1%	13.6%	16.4%	20.2%	16.9%	14.5%	15.6%	18.5%
Taxes	(2.0)	(2.7)	3.3	101.2	(1.2)	(1.6)	(2.1)	(2.8)	(1.4)	99.9	(7.7)	(2.0)
Tax Rate	4.1%	4.9%	-6.5%	213.6%	3.4%	3.4%	3.4%	3.4%	0.7%	-49.5%	-3.4%	0.7%
Profit before non-controlling	47.0	51.7	54.2	148.6	34.8	45.5	58.8	80.0	209.2	301.7	219.1	288.5
Minority Income	(1.5)	(1.7)	1.0	(1.4)	(0.5)	(0.5)	(0.5)	(0.5)	(5.3)	(3.6)	(2.0)	(3.0)
GAAP Net income	45.5	50.0	55.2	147.2	34.3	45.0	58.3	79.5	203.9	298.0	217.1	285.5
Yr-to-yr Gr.	-31%	30%	8%	205%	-25%	-10%	5%	-46%	NM	46%	-27%	32%
Non-GAAP Net Income	52.1	54.6	61.2	59.9	38.1	48.8	62.1	83.3	174.4	227.76	232.3	301.49
GAAP primary EPS	$0.48	$0.52	$0.56	$1.50	$0.35	$0.46	$0.59	$0.80	$2.33	$3.08	2.20	$2.88
Fully diluted GAAP	$0.45	$0.49	$0.54	$1.40	$0.32	$0.42	$0.54	$0.74	$2.10	$2.90	2.03	$2.65
Adj Non-GAAP EPS-Fully dil.	**$0.50**	**$0.54**	**$0.60**	**$0.58**	**$0.36**	**$0.46**	**$0.58**	**$0.77**	**$1.80**	**$2.21**	**$2.17**	**2.80**
Yr-to-yr Gr.	46%	28%	18%	9%	-35%	-22%	-9%	27%	211%	23%	-2%	29%
Primary Share Out	93.9	96.4	97.9	98.3	98.3	98.5	98.6	99.0	87.5	96.6	98.6	99.0
Fully Diluted GAAP	104.9	105.6	106.4	106.8	106.8	107.0	107.1	107.5	101.3	105.9	107.1	107.7
All in shares	107.2	107.4	107.7	107.7	107.7	107.7	107.7	107.7	107.0	107.7	107.7	107.7

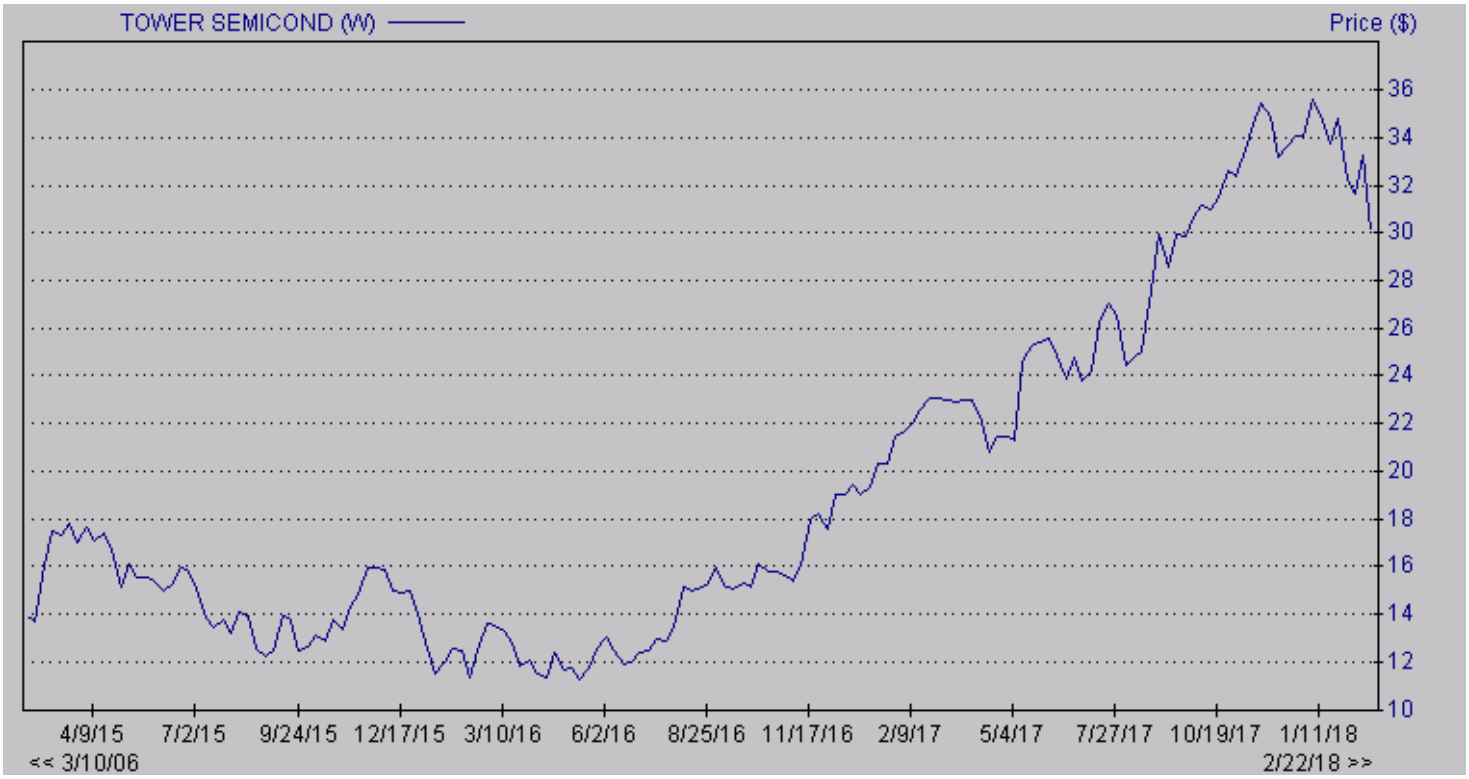
BALANCE SHEET

$ in thousands	Dec. 31, 2017	Sept 30, 2017	Qtr-Qtr % Change	Dec. 31, 2016	Yr-Yr % Change
CURRENT ASSETS					
Cash and cash equivalents	**$445,961**	**$480,407**	-7.2%	**$389,377**	14.5%
Marketable securities	113,874	49,738	128.9%	0	NM
Trade accounts receivable	149,666	150,039	-0.2%	141,048	6.1%
Inventories	143,315	143,300	0.0%	137,532	4.2%
Other current assets	21,516	21,465	0.2%	30,041	-28.4%
Total current assets	**874,332**	**795,211**	9.9%	**697,998**	25.3%
LONG-TERM INVESTMENTS	26,073	27,091	-3.8%	25,624	1.8%
PROPERTY AND EQUIPMENT, NET	635,124	633,107	0.3%	616,686	3.0%
INTANGIBLE ASSETS, NET	19,841	21,627	-8.3%	28,129	-29.5%
GOODWILL	7,000	7,000	0.0%	7,000	0.0%
OTHER ASSETS, NET	111,269	18,484	502.0%	4,447	2402.1%
TOTAL ASSETS	1,673,639	1,502,520	11.4%	1,379,884	21.3%
CURRENT LIABILITIES					
Short term debt	**105,958**	**45,664**	132.0%	**48,084**	120.4%
Trade accounts payable	115,347	109,385	5.5%	99,262	16.2%
Deferred revenue	14,338	26,454	-45.8%	26,169	-45.2%
Other current liabilities	66,730	64,259	3.8%	73,600	-9.3%
Total current liabilities	**302,373**	**245,762**	23.0%	**247,115**	22.4%
LONG-TERM DEBT	**228,723**	**295,485**	-22.6%	**296,144**	-22.8%
LONG-TERM CUSTOMERS' ADVANCES	31,908	37,674	-15.3%	41,874	-23.8%
EMPLOYEE RELATED LIABILITIES	14,662	14,170	3.5%	14,176	3.4%
DEFERRED TAX LIABILITY	66,267	85,380	-22.4%	97,961	-32.4%
Total liabilities	643,933	678,471	-5.1%	697,270	-7.6%
SHAREHOLDERS' EQUITY	1,029,706	873,787	17.8%	682,614	50.8%
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$1,673,639	$1,552,258	7.8%	$1,379,884	21.3%
Current Ratio	2.9	3.2	-10.6%	2.8	2.4%
Quick Ratio	2.4	2.7	-8.9%	2.3	6.6%
Working Capital	571,959	549,449	4.1%	450,883	26.9%
Debt Percent of Assets	20%	23%	-11.9%	25%	-19.8%
Debt to Equity	0.3	0.4	-16.8%	0.5	-35.5%

CASH FLOW

	3-months 31-Mar-16	3-months 30-Jun-16	3-months 30-Sep-16	3-months 31-Dec-16	Year 2016	3-months 31-Mar-17	3-months 30-Jun-17	3-months 30-Sep-17	3-months 31-Dec-17	Year 2017
CASH FLOWS - OPERATING ACTIVITIES										
Net profit (loss)	$ 64,548	$ 40,347	$ 52,018	$ 52,253	$ 209,166	$ 47,046	$ 51,727	$ 54,241	$ 148,642	$ 301,656
Income and non-cash expense items:										
Depreciation and amortization	48,584	48,117	49,194	51,711	197,606	49,698	52,389	55,014	51,310	208,411
Financing expense associated with deb. series F	0	0	0	150	150	0	0	0	0	0
Effect of fair value measurement on debt	1,401	6,700	2,808	(2,617)	8,292	6,888	4,873	(1,177)	2,281	12,865
Other expense (income), net	0	(4,362)	(5,081)	121	(9,322)	(511)	(142)	253	3,027	2,627
Gain from acquisition	(41,140)	(10,158)	0	827	(50,471)	0	0	0	0	0
Changes in assets and liabilities:										
Trade accounts receivable	(8,519)	(1,916)	(1,469)	(18,200)	(30,104)	9,529	(17,242)	361	788	(6,564)
Other receivables and other current assets	822	(5,476)	4,328	61	(265)	(4,439)	(7,307)	2,980	445	(8,321)
Inventories	(9,224)	(6,300)	(6,245)	(300)	(22,069)	(1,421)	1,688	(4,636)	92	(4,277)
Trade accounts payable	10,143	130	2,624	(7,347)	5,550	(4,128)	(6,530)	4,795	(2,786)	(8,649)
Deferred revenue and customers' advances	15,030	8,294	(5,377)	5,634	23,581	(8,735)	(4,564)	9,378	(17,882)	(21,803)
Other current liabilities	(1,953)	11,194	(6,938)	(2,448)	(145)	(9,090)	12,866	(13,760)	1,765	(8,219)
Employee related liabilities	(245)	0	0	(385)	0	(257)	(234)	(274)	(2,482)	(3,247)
Deferred tax liability, net	(2,005)	(4,789)	548	2,375	(3,703)	(2,440)	(3,230)	(3,259)	(99,915)	(108,844)
Other long-term liabilities	0	0	0	0	(798)	0	0	0	0	0
Net cash provided by operating activities	**77,442**	**81,781**	**86,410**	**82,220**	**327,468**	**82,140**	**84,294**	**103,916**	**85,285**	**355,635**
CASH FLOWS - INVESTING ACTIVITIES										
Investments in property and equipment, net	**(57,533)**	**(54,323)**	**(54,947)**	**(42,821)**	**(209,624)**	**(40,348)**	**$ (41,312)**	**$ (41,708)**	**(41,349)**	**(164,717)**
Interest bearing deposits, including designated deposits	10,000	19,600	(12,500)	(108)	16,992	(5,118)	0	(49,869)	(64,867)	(114,736)
Net cash provided by (used in) investing activities	(47,533)	(34,723)	(67,447)	(42,929)	(192,632)	(45,466)	(41,312)	(91,577)	(106,216)	(279,453)
CASH FLOWS - FINANCING ACTIVITIES										
Exercise of warrants and options	5,881	360	21,918	10,644	38,803	12,756	14,254	1,027	3,278	31,315
Proceeds from long-term loans	17,000	27,444	8,554	(52,998)	0	0	$ 0	$ 0	0	0
Debt repayment	(10,254)	0	0	47,345	37,091	(11,805)	$ (5,655)	$ (15,932)	(16,863)	(50,255)
Debenture repayment	0	0	0	0	0	0	$ 0	$ 0	0	0
TPSCo dividend to Panasonic	(2,563)	0	0	0	(2,563)	(4,378)	$ 0	$ 0	0	(4,378)
Net cash used in financing activities	10,064	27,804	30,472	4,991	73,331	(3,427)	8,599	(14,905)	(13,585)	(23,318)
Effect of foreign exchange rate change	9,029	11,623	2,336	(17,353)	5,635	4,371	(91)	(630)	70	3,720
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	49,002	86,485	51,771	26,544	213,802	37,618	$ 51,490	$ 51,771	$ (34,446)	56,584
CASH AND CASH EQUIVALENTS - BEGINNING OF PERIOD	175,575	224,577	311,062	362,833	175,575	355,284	432,113	311,062	480,407	389,377
CASH AND CASH EQUIVALENTS - END OF PERIOD	224,577	311,062	362,833	389,377	389,377	392,902	483,603	362,833	445,961	445,961

HISTORICAL STOCK PRICE



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