Zacks Small-Cap Research

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O_2Micro International Ltd (OIIM-NASDAQ)

OIIM:

OUTPERFORM

Current Recommendation	**Outperform**
Prior Recommendation	Neutral
Date of Last Change	11/12/2013
Current Price (10/31/14)	$1.97
12- Month Target Price	**$5.00**

OUTLOOK

O_2Micro 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 a negative enterprise value, as it has $65 m in cash, as well as $25 m in real estate and $10-20 m in investments in other companies. It continues to lose money and needs change but the company is so undervalued we look for an acquirer to take notice. Without one, new products in LED lighting and smartphones could rejuvenate growth despite declining notebook sales.

SUMMARY DATA

52-Week High	**$3.89**
52-Week Low	**$1.90**
One-Year Return (%)	**-34.3**
Beta	**1.36**
Average Daily Volume (sh)	**97,920**
Shares Outstanding (mil)	**27**
Market Capitalization ($mil)	**$54**
Short Interest Ratio (days)	**0.3**
Institutional Ownership (%)	**44**
Insider Ownership (%)	**8**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**-14.5**
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	**4**

Risk Level	**Average**
Type of Stock	**Small-Value**
Industry	**Elec Comp-Semis**
Zacks Rank in Industry	**40 of 49**

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	15 A	15 E	64 E
2015					66 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	-$0.09 A	-$0.10 E	-$0.37 E
2015					-$0.20 E

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Cost Cutting Exceeds Expectation, Q4 Guidance Disappoints

Since O2Micro preannounced revenues for the third quarter, the only surprises in the just announced quarter were higher gross margins and lower expenses. Versus our model, the company lost $1 million less than expected in operating income. However, guidance for the fourth quarter was for revenues to be flat to down 8% sequentially, lower than our previous forecast of virtually flat, and this means our earnings estimates going forward remain the same.

The company reported revenues of $15.4 million versus $18.6 million last year and $17.4 million in the second quarter. This is down 17% and 12% respectively. The cancelled order for a laptop charger product will reduced revenues $1.2 million per quarter for the next three quarters. All told this cancellation will result in $4.8 million less revenue for the company.

The company surprised on the upside with gross margins being 51.8% rather than the 50% we were anticipating. Also operating expenses were lower than expected, and $570,000 lower than Q2, or 5%. Since revenues declined faster than expenses the operating loss widened to $3.5 million form $3.1 million, clearly the wrong direction. The reason net income was higher than in Q2 was an additional $704,000 in other income, mainly currency translation ($381,000) and gain on sale of a long-term investment, stock in Etrend, a Taiwanese semiconductor company, ($258,000), and investment dividends ($65,000). This generated some cash on the balance sheet allowing the company to keep the reduction in net cash to only $1.3 million and leaving it with $65 million on the balance sheet at the end of Q3. The company is selling its remaining position in ETrend in Q4. Also in Q4, the company plans to sell a portion of the real estate in Hsinchu, Taiwan for a net proceed of $2 million in cash. These two actions plus investment dividends are expected to result in other income in Q4 to be in the range of $350,000-450,000.

With one more quarter to go, we are keeping 2014 revenue estimate at **$64** million, but nudging the **non-GAAP loss down to $0.37** which is a GAAP loss of $0.45. Investors however, may not be happy until they see some revenue growth or some indication that management is willing to sell the company. Either of these two events would move the stock up significantly. The quarterly year over year revenue declines are continuing to accelerate since the up Q4 of 2013. The company continues to lower its cash flow breakeven point through expense controls and it is now between $18 and $19 million in revenues per quarter, while profitability breakeven is running at $21 to $22 million per quarter, but as revenues keep declining it is hard to see when this could be achieved.

Balance Sheet Assets are Worth More than $100 Million

We find it hard to believe that the company can remain as is, at a negative enterprise value. That is, $1.97 per share times 27.2 million shares, minus $65 million in cash or a negative $11.4 million. In addition to customer contracts, the company owns three buildings: one building is in Santa Clara, one in Taiwan and one in Shanghai. They are on the balance sheet $20 million, but management believes market value closer to $25 million. As of December 31, 2013 pricing, there is another $16.2 million in long term investments, which are primarily holdings in two, companies X-FAB Silicon Foundries ($5 million) and Sigurd Microelectronics (Cayman) Co., Ltd ($7.2 million). During the quarter the company sold some of its holdings in public company Etrend. **Thus if we add up just assets of cash, the investment portfolio and real estate we reach $100 million.**

While insiders and directors only own 7% of the company, management reiterated that the company is not for sale and that it has sufficient new product in the pipeline to create growth. It is slowly gaining traction in smartphone and believes its low power consumption expertise will need to be more widely adopted as phones move to six and eight-core processors. Also adoption of dimmer-free LED bulbs and

a unique two-color white/blue bulb will fill niche markets. With two way and three way dimmer free bulbs consumers can turn simple on off lamps into two and three way lamps just be changing the light bulb. Also battery management products are a bright spot as well as planes for a new TV product to regain market share in its once dominate business. However as it has lost upwards of $6 million in business from the rejected charger product, 2015 will be an uphill battle.

VALUATION

The company is now at $65 million in cash versus $66 million in cash at the end of Q2 due to the sale of some long-term investments for cash versus negative cash flow from operations. The market cap of the company is $55 million and the enterprise value is now negative $11 million. As seen in the valuation table below, semiconductor companies have not had an easy quarter and their valuations have come down across the board. In July, the average stood at 4.1 times and now it is down 15% to 3.5 times. The greatest decline came in CREE, the LED lighting darling that went from 3.0 times to 1.6 after reporting a slow down in LED lighting sales.

Were we to use the average enterprise value to trailing twelve-month sales of 3.5 times and apply it to OIIM's $62 revenue run rate, we would calculate an enterprise value of $217 million. Adding to it $65 million in cash gives us a market cap of $279 million or $10.25 per share down from the $13.20 per share calculated at the former ratio. Despite its losses we are somewhat surprised that there has been no takeover offer for the firm at some price between the current $1.97 and $10. Even its liquidating value is above $3.70 a share, giving no value for the business or the patents at all.

Competitors	EV	TTM Sales	EV/Sales
ISIL	1,620	586	2.8
MSCC	2,960	1,090	2.7
MPWR	1,410	257	5.5
CREE	2,710	1,680	1.6
MCHP	8,050	2,000	4.0
LLTC	9,090	1,420	6.4
MXIM	7,880	2,450	3.2
TXN	52,510	12,800	4.1
CRUS	1,020	712	1.4
Average			3.5

RISKS

- O_2Micro has exposure several slow growing and declining markets such as TVs and notebooks. It is depending on General LED lighting and other battery management to give it revenue and margin growth.

- It may be difficult for the company to capture market share in smartphones and tablets as a new entrant in an established field.

- It recently lost a large customer and will need to regain trust in the industry to recapture market share

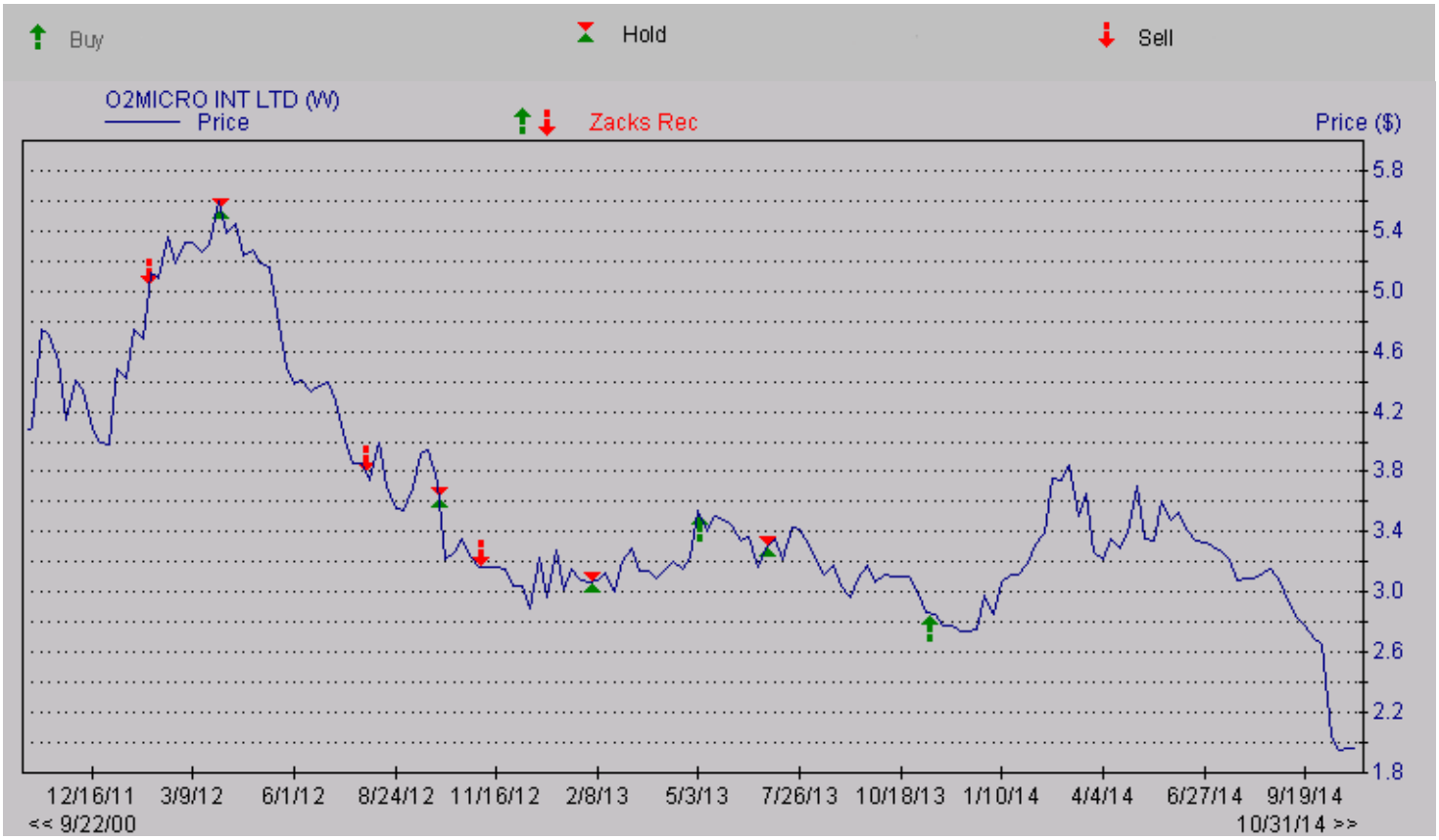
- The firm is currently not at breakeven and is cash flow negative.

- 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 14A	Dec Q4 14E	2012	2013	2014E	2015E
REVENUE													
Net Revenue	16.8	17.3	18.7	18.6	19.1	16.5	17.4	15.4	14.7	97.7	73.8	64.0	66.0
Yr-to-yr Gr.		-42%	-33.9%	-18.5%	14%	-5%	-7%	-17%	-23%	-21%	-24%	-13%	3%
OPERATING EXPENSES													
Cost of goods sold	8.1	8.7	9.1	9.1	9.6	8.0	8.4	7.4	7.1	44.1	36.4	31.0	33.0
Gross Margin	8.7	8.7	9.6	9.6	9.5	8.5	9.0	8.0	7.6	53.6	37.4	33.0	33.0
% of Sales	51.6%	50.0%	51.2%	51.4%	49.9%	51.5%	51.5%	51.8%	51.5%	54.9%	50.7%	51.6%	50.0%
R&D	8.2	6.6	6.7	6.5	7.2	5.1	5.8	5.5	5.0	34.3	27.0	21.3	19.0
SG&A	8.4	7.5	7.9	7.7	7.8	6.5	6.3	6.0	6.0	34.6	30.9	24.9	23.4
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	11.5	11.0	81.6	57.9	46.2	42.4
								-5%					
Operating Income	(11.3)	(5.4)	(5.0)	(4.7)	(5.4)	(3.1)	(3.1)	(3.5)	(3.4)	(28.0)	(20.5)	(13.2)	(9.4)
						-42%							
Other Income	0.9	0.6	0.8	0.4	0.7	0.5	0.1	0.9	0.4	2.4	2.4	1.9	2.7
Pretax Income	(10.4)	(4.8)	(4.2)	(4.3)	(4.8)	(2.7)	(3.0)	(2.7)	(3.0)	(25.6)	(18.1)	(11.3)	(6.7)
						-16.1%	-17.0%	-17.5%	-20.6%	-26.2%	-24.5%	-17.7%	-10.1%
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%	-9.3%	-8.9%	-4.3%	-5.5%	-8.9%	-18.0%
GAAP Net Income	(10.7)	(5.1)	(4.4)	(4.5)	(5.1)	(2.9)	(3.2)	(2.9)	(3.3)	(26.7)	(19.1)	(12.3)	(7.9)
GAAP EPS-Fully dil.	($0.35)	($0.17)	($0.15)	($0.16)	($0.18)	($0.10)	($0.12)	($0.11)	($0.12)	($0.83)	($0.67)	($0.45)	($0.30)
Non-GAAP	**($0.19)**	**($0.15)**	**($0.13)**	**($0.14)**	**($0.11)**	**($0.08)**	**($0.10)**	**($0.09)**	**($0.10)**	**($0.33)**	**($0.53)**	**($0.37)**	**($0.20)**
Share Out	30.4	29.7	28.9	28.3	28.0	27.8	27.4	27.2	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	27.2	26.9	31.0	28.7	27.3	26.3

HISTORICAL ZACKS RECOMMENDATIONS



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