Zacks Small-Cap Research

October 8, 2014

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O_2Micro International Ltd (OIIM-NASDAQ)

OIIM: Preannounces Disappointing Q3 Revenues and Margins– Now Looking For Major Changes

OUTPERFORM

Current Recommendation	**Outperform**
Prior Recommendation	Neutral
Date of Last Change	11/12/2013
Current Price (10/07/14)	$2.67
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 an enterprise value of approximately zero as it has $62 million in cash. 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	**$2.16**
One-Year Return (%)	**-15.24**
Beta	**1.44**
Average Daily Volume (sh)	**64,230**
Shares Outstanding (mil)	**28**
Market Capitalization ($mil)	**$74**
Short Interest Ratio (days)	**1.31**
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	**3**

Risk Level	**Average**
Type of Stock	**Small-Value**
Industry	**Elec Comp-Semic**
Zacks Rank in Industry	**32 of 50**

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 E	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	-$0.13 E	-$0.12 E	-$0.43 E
2015					-$0.20 E

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WHAT'S NEW

Pre-announces Q3 Revenues Below Guidance

Once again, O2Micro disappointed investors by preannouncing revenues for the third quarter just ended far short of its initial guidance and causing estimates to be lowered across the board. The company expects to report revenues of $15 million versus our estimate of $17.4 million. This has been explained by less than expected sales of notebook power chips of $1.2 million combined with the loss of a notebook customer due to a part that failed for another $1.2 million shortfall. This part won a design win last year, but upon delivery this year, the part failed when installed. As a result the customer returned the shipment and cancelled the plan to buy more in the next three quarters. All told this cancellation will result in $4.8 million less revenue for the company.

This lower revenue number, combined with guidance of a 50% gross margin for the quarter should result in a loss of $0.16 GAAP and $0.13 non-GAAP for the quarter. Revenues need also to be reduced for the next three quarters due to the cancellation of $1.2 million. We now see no reason to expect Q4 to be much better than Q3 other than Q4 includes a build for Chinese New Year. **We are lowering those revenues to $15.1 million and EPS to a loss of $0.14 GAAP and $0.12 non-GAAP EPS**.

This brings 2014 estimates down to **revenues of $64** million and a **non-GAAP loss of $0.43** and GAAP loss of $0.52. This is now the fourth year in a row that the company will report down revenues, and its third year of losses. The quarterly revenue losses are now accelerating since the up Q4 of 2013. Clearly there needs to be a change in methodology at the company and no small tweek will fix it as the breakeven point is currently $19 million in revenues per quarter.

We find it hard to believe that the company can remain as is at a current enterprise value of virtually zero. That is $2.35 per share times 27.1 million shares, minus $62 million in cash despite the fact it is burning some $4 million per quarter. In addition to contracts, the company owns three buildings and $26 million in equipment. One building is in Santa Clara, one in Taipei and one in Shanghai, and sum to the $10 million on the balance sheet. 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).

The top ten holders, all mutual funds mutual funds own forty percent of the stock and insiders and directors own 7%. Management has been adamant that the company is not for sale, but it would seem that some big changes have to be made to turn around operations. One idea being floated around is selling off the contracts for the notebook business that is incurring losses and is a low margin, non-growth business, and lowering the break-even point. Another is renting out the buildings. Hopefully the company would entertain some changes to the board that could infuse some new strategic thinking and expertise.

The company will report earnings on October 30, 2014 and we look for further information about the past quarter and future plans. We hesitate to downgrade the stock at this very low valuation, but see little catalyst for improvement unless major steps are taken to shake up the status quo.

VALUATION

We estimate that due to losses, at the end of Q3 2014, company may be down to $62 million in cash versus $66 million in cash at the end of Q2. This would put the company at a mind boggling zero enterprise value. 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 $60 revenue run rate, we would calculate an enterprise value of $209 million. Adding to it $62 million in cash gives us a market cap of $241 million or $10.00 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 $2.35 and $10.

Competitors	EV	TTM Sales	EV/Sales
ISIL	1,500	586	2.6
MSCC	2,880	1,090	2.6
MPWR	1,410	257	5.5
CREE	2,630	1,650	1.6
MCHP	8,600	2,000	4.3
LLTC	8,810	1,390	6.3
MXIM	7,700	2,450	3.1
TXN	50,960	12,550	4.1
CRUS	859	712	1.2
Average			3.5

RISKS

- O_2Micro has exposure several slow growing and declining markets such as TVs and notebooks. 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	15.0	15.1	97.7	73.8	64.0	66.0
Yr-to-yr Gr.		-42%	-33.9%	-18.5%	14%	-5%	-7%	-19%	-21%		-24%	-13%	3%
							6%	-14%					
OPERATING EXPENSES													
Cost of goods sold	8.1	8.7	9.1	9.1	9.6	8.0	8.4	7.5	7.6	44.1	36.4	31.5	33.0
Gross Margin	8.7	8.7	9.6	9.6	9.5	8.5	9.0	7.5	7.6	53.6	37.4	32.5	33.0
% of Sales	51.6%	50.0%	51.2%	51.4%	49.9%	51.5%	51.5%	50.0%	50.0%	54.9%	50.7%	50.8%	50.0%
R&D	8.2	6.6	6.7	6.5	7.2	5.1	5.8	5.5	5.4	34.3	27.0	21.7	19.0
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	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	12.0	11.6	81.6	57.9	47.3	42.4
Operating Income	(11.3)	(5.4)	(5.0)	(4.7)	(5.4)	(3.1)	(3.1)	(4.5)	(4.1)	(28.0)	(20.5)	(14.8)	(9.4)
						-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)	(4.0)	(3.6)	(25.6)	(18.1)	(13.2)	(6.7)
						-16.1%	-17.0%	-26.7%	-23.5%	-26.2%	-24.5%	-20.6%	-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%	-7.0%	-7.6%	-4.3%	-5.5%	-7.8%	-18.0%
GAAP Net Income	(10.7)	(5.1)	(4.4)	(4.5)	(5.1)	(2.9)	(3.2)	(4.3)	(3.8)	(26.7)	(19.1)	(14.2)	(7.9)
GAAP EPS-Fully dil.	**($0.35)**	**($0.17)**	**($0.15)**	**($0.16)**	**($0.18)**	**($0.10)**	**($0.12)**	**($0.16)**	**($0.14)**	**($0.83)**	**($0.67)**	**($0.52)**	**($0.30)**
Non-GAAP	($0.19)	($0.15)	($0.13)	($0.14)	($0.11)	($0.08)	($0.10)	($0.13)	($0.12)	($0.33)	($0.53)	($0.43)	($0.20)
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
											-7.5%	-5.0%	-3.7%

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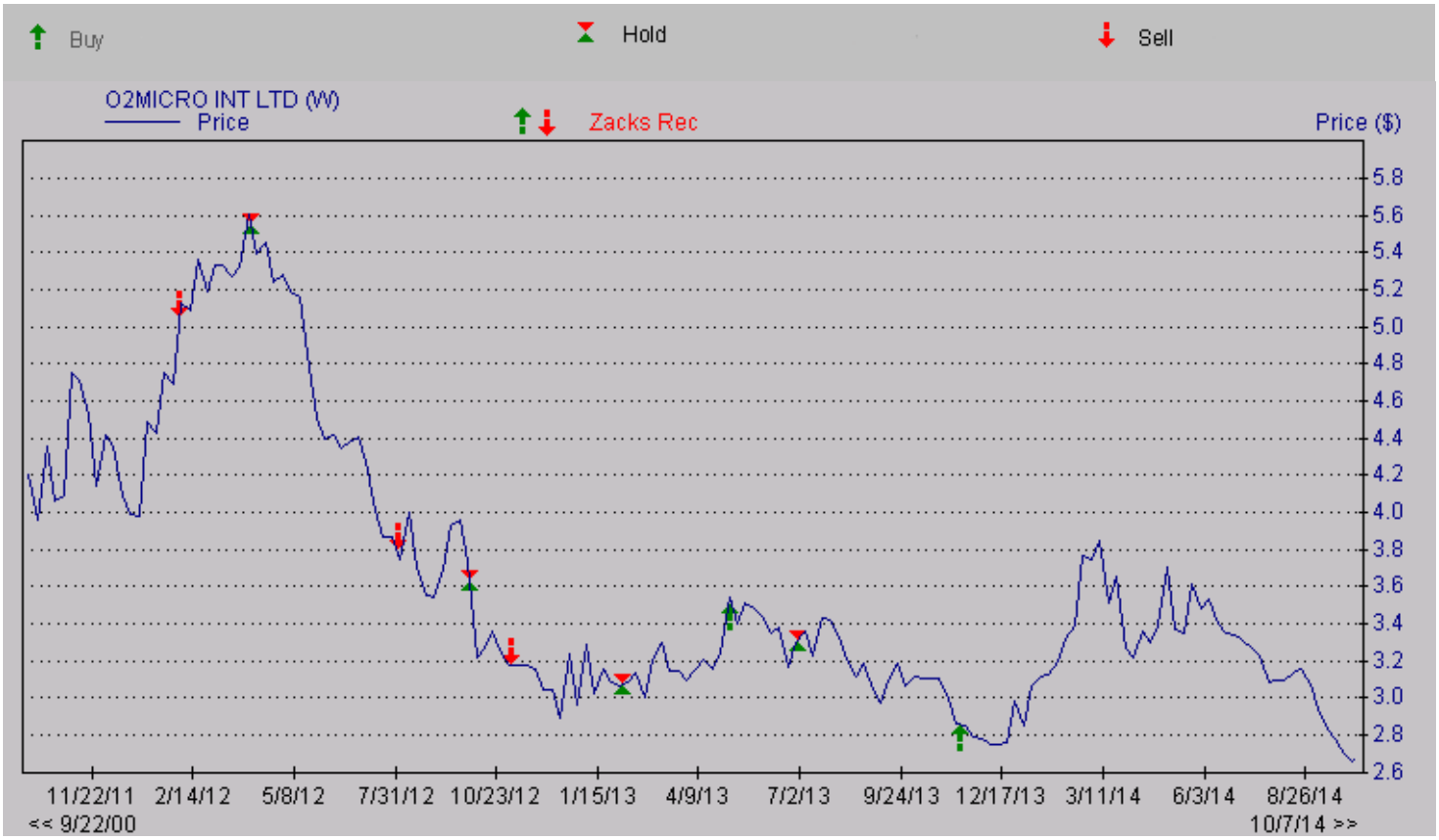

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