Zacks Small-Cap Research

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Silicom Limited (SILC-NASDAQ)

Another Quarter, Another Record: OUTPERFORM

Current Recommendation	**Outperform**
Prior Recommendation	N/A
Date of Last Change	09/09/2010
Current Price (01/29/14)	$62.04
Target Price	**$75.00**

OUTLOOK

Silicom engages in the design, manufacture, marketing, and support of connectivity solutions for a range of servers and server based systems. The firm has several growth engines including Information Technology's return to growth, the march to 10GB per second technology, a large and growing base of OEM customers includes most of the market-leading players, staged launch of new products, and a strong OEM business model which limits operating expenses. SETAC, the firms newly patented Server to Appliance Converter, which combines the best of standard servers with hardware appliances should allow the firm to push its revenues to the $100 million level in coming years. We see value in the shares of Silicom.

SUMMARY DATA

52-Week High	**$62.04**
52-Week Low	**$22.94**
One-Year Return (%)	**171.33**
Beta	**0.95**
Average Daily Volume (sh)	**92,336**
Shares Outstanding (mil)	**7**
Market Capitalization ($mil)	**$441**
Short Interest Ratio (days)	**1.61**
Institutional Ownership (%)	**8**
Insider Ownership (%)	**25**
Annual Cash Dividend	**$0.55**
Dividend Yield (%)	**0.89**
5-Yr. Historical Growth Rates	
Sales (%)	**30.3**
Earnings Per Share (%)	**40.3**
Dividend (%)	**N/A**
P/E using TTM EPS	**25.2**
P/E using 2014 Estimate	**21.8**
Zacks Rank	**3**

Risk Level	**Average,**
Type of Stock	**Small-Blend**
Industry	**Comp-Networks**

ZACKS ESTIMATES

Revenue
(in millions of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2011	9.2 A	9.4 A	10.0 A	11.0 A	39.6 A
2012	10.1 A	10.4 A	11.5 A	16.7 A	48.7 A
2013	15.0 A	15.7 A	17.2 A	25.4 A	73.3 A
2014					85.0 E

Earnings per Share
(EPS is operating earnings before non recurring items)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2011	$0.27 A	$0.30 A	$0.32 A	$0.36 A	$1.25 A
2012	$0.30 A	$0.34 A	$0.39 A	$0.49 A	$1.52 A
2013	$0.46 A	$0.48 A	$0.58 A	$0.94 A	$2.46 A
2014					$2.85 E

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WHATS NEW

Another Quarter, Another Record at Silicom

On January 23, 2014, Silicom Ltd, reported financial results for its fourth quarter and full year, ended December 31, 2013.

The company ended the year with concrete numbers, continuing its momentum of 50 percent quarter over quarter growth, which resulted in record revenue, operating and net income, and record-highs in operating and net margins. Even more impressive is the fact that this phenomenal growth is on the heels of three previous record years with a compound average growth rate of 33 percent.

Revenues for the fourth quarter soared year over year by $8.660 million or nearly 52 percent to $25.353 million, which compares to revenues of $16.693 million for the three months ended December 31, 2012. Sequentially, revenues jumped just over 47 percent from $17.200 million from the third quarter of 2013.

Gross margin for the three months ended December 31, 2013, improved to 39.8 percent compared to 37.7 percent for the fourth quarter fiscal 2012. However, gross margin fell sequentially from 40.8 percent for the three months ended September 30, 2013.

Still, gross margin varies between quarters mainly as a result of the specific mix of products sold during the quarter.

Although total operating expenses increased year over year by $284,000, they fell to 13.3 percent of revenues from 19.1 percent of revenues during the fourth quarter of 2012. Operating expenses as a percent of revenues also fell sequentially from 17.1 percent of revenues for the quarter ended September 30, 2013.

Similarly, operating margin jumped from 21.4 percent in the fourth quarter of last year to 27.2 percent during the fourth quarter of fiscal 2013.

Operating expenses growing at a much lower rate than revenues demonstrates the strong inherent operating leverage and ongoing strength of Silicom's business model.

Operating income for the quarter more than doubled to $6.705 million, which compares to $3.189 million for the comparable quarter of 2012. Sequentially, operating income improved by nearly 65 percent from $4.072 million for the quarter ended September 30, 2013.

On a GAAP basis, the company's fourth quarter net income more than doubled year over year, increasing by $3.634 million to $6.665 million, which represented record net margin of 27 percent and rocketed from net income of $3.031 million for the comparable quarter of 2012. Sequentially, GAAP net income improved by $2.645 million or nearly 66 percent from $4.020 million for the quarter ended September 30, 2013.

Based on a weighted average number of diluted shares of 7.289 million shares, diluted net income per share resulted in net income of $0.91 per share during the fourth quarter of fiscal 2013. This compared to a diluted net income per share of $0.43 on a weighted average number of diluted shares of 7.006 million shares during the three months ended December 31, 2012 and $0.55 per diluted share for the third quarter 2013.

On a non-GAAP basis, the company reported fourth quarter net income of $6.848 million or $0.94 per diluted share. This compares to non-GAAP net income of $3.420 million or $0.49 per diluted share for the

quarter ended December 31, 2012 and $4.139 million or $0.58 per diluted share for the third quarter fiscal 2013.

For the full year ended December 31, 2013, year over year revenues improved by over 50 percent or $24.569 million to $73.298 million from $48.729 million for the comparable twelve months of 2012.

The jump in revenues during fiscal 2013 was diversified across all product lines, particularly the newer ones. Additionally, Silicom sold product across its broad base of 90-plus design wins customers with initial sales to the new customers while continuing to ramp sales to existing customers in all target markets.

Still, this continuing trend of substantial revenue increases at these levels demonstrates that Silicom remains on track and evolving into a different and higher level company.

Gross margin fell slightly year over year from 40.8 percent in 2012 to gross margin of 40.2 percent for the fiscal year ended December 31, 2013.

Once again, gross margin varies between quarters mainly as a result of the specific mix of products sold during the quarter.

Total operating expenses increased year over year by $2.004 million, but fell to 16.2 percent of revenues in 2013 from 20.2 percent of revenues during the full year ended December 31, 2012.

Operating income for the year jumped by $7.549 million or over 75 percent to $17.578 million compared to $10.029 million for fiscal 2012.

GAAP net income jumped over 73 percent or $7.206 million year over year to $17.077 million during fiscal 2013 resulting in record net margin of 24.2 percent. This compares to $9.871 million in net income for the twelve months ended December 31, 2012.

Based on a weighted average number of diluted shares of 7.246 million shares, diluted net income per share resulted in net income of $2.36 per diluted share during the full year ended December 31, 2013. This compared to a diluted net income per share of $1.42 on a weighted average number of diluted shares of 6.968 million shares during fiscal 2012.

On a non-GAAP basis, net income for the year increased year over year by nearly 68 percent to $17.765 million and non-GAAP earnings per diluted share for fiscal 2013 jumped to $2.45 per share compared to $1.52 for the full year ended December 31, 2012.

Additionally, with the SDN, NFV, virtualization and cloud computing concepts all being fueled by the rise of Big Data, Silicom leveraged its positioning in these fast-growing markets by recently acquiring unique virtualization offload engine intellectual property from Net Perform Technology. The virtualization offload engine moves intensive CPU tasks related to the networking transactions involved in virtualization from the host CPU in a virtualized cloud server onto a separate intelligent add-on card. This frees up CPU capacity, enabling a vast improvement in the server's networking and storage IO performance.

With the clear trend towards virtualized cloud-based data centers, this purchase secures the company’s exclusive access to this technology, and should significantly increase Silicom’s total addressable market as well as make a strong positive contribution to revenues and profits over the long term.

In December, Silicom secured a strategic design win from a first-time customer, one of the storage virtualization industry's strongest emerging players and which is the company’s first major design win with a storage virtualization leader. Similarly, management believes it will likely lead to additional business both with this customers and others.

Initial first purchase orders of around $0.5 million have been received but more importantly, the customer expects this product line to grow strongly and focus 2014 deliveries of around $1 million. As a result of the exponential growth in the market and this customer's position within it, management believes that this particular design win could amount to several million dollars of sales per year, as the market matures and this solution becomes main stream.

Along the same lines it should be noted that in the fourth quarter Silicom saw a third OEM customer reach 10 percent of its quarterly revenues for the first time.

Dividend Policy and Financial Flexibility
In mid-January 2013, the Company's Board of Directors adopted a policy for distributing dividends, subject to all applicable laws, where each year Silicom will distribute a dividend of up to 50% of its annual distributable profits.

INVESTMENT THESIS

- The OEM business model provides leverage.
- The firm offers the widest selection of server adapters in terms of speed, ports and chip sets.
- 10 GB Ethernet is replacing 1 GB as the backbone network and has just begun to migrate down to high-end server systems.
- SILC's SETAC combines the best of both Standard Server and Hardware Appliance.
- With $7.74 per share in cash, the firm's balance sheet is a source of strength.
- Silicom appears to have entered a new growth phase which may push revenues to the $100 million mark.

Silicom Ltd. engages in the design, manufacture, marketing, and support of connectivity solutions for a range of servers and server based systems in North America, Europe, and internationally. It primarily offers server networking cards with and without bypass (server adapters). The company's server adapters are used in various applications, such as security appliances, wide area network optimization appliances, load balancing and traffic management appliances, network-attached storage, video on demand servers, content delivery servers, Internet service providers/Web hosting, and computing. It also offers a range of intelligent and programmable cards, such as encryption acceleration cards and redirector cards; and intelligent stand alone bypass units. The company markets most of its products through original equipment manufacturers, and sometimes through distributors, and resellers.

A History of innovation
In late 2002 Silicom began exploring a new direction which has become its primary growth driver and will continue being the main source of growth in the next few years: high-end server networking cards. The firm's core expertise had always been a broad range of Ethernet and connectivity products, which provided personal computer users with solutions to their connectivity problems. In late 2002, the firm decided to employ its core know-how in the realm of server-based systems. SILC was now able to take advantage of its competitive edge by using the expertise it developed in connectivity solutions for

personal computers in industries which require broader connectivity solutions with very high-performance environments. Examples of these industries are security, WAN optimization, load balancing and other network appliances, data storage, video on demand, internet content delivery, high-performance computing and web servers.

By 2003 the company was implementing its "design win" business model and began selling its products to customers that incorporate its products within their networking appliances or server based systems. The server-based network appliance market specifically the server-based security appliances and WAN (Wide Area Network) optimization appliances saw strength.

The firm then added Bypass Adapters, which are networking products that include special functionalities for the server based appliances. Silicom has bypass and non-Bypass Adapters.

The product line was enhanced again in 2006 when it added intelligent and programmable cards such as encryption acceleration cards and redirector cards as well as intelligent stand alone bypass units. In 2008 the firm's line of Server Adapters were updated by adding 10Gbps products. (With and Without Bypass)

Gigabit Ethernet is a term describing various technologies for transmitting Ethernet frames at a rate of a gigabit per second. Higher bandwidth 10 gigabit Ethernet standards have since become available as the IEEE ratified a fiber-based standard in 2002, and a twisted pair standard in 2006. In 2009 10Gb Ethernet began replacing 1Gb as the backbone network and has begun to migrate down to high-end server systems. The accelerating growth of worldwide network traffic is forcing service providers, enterprise network managers and architects to look to ever higher-speed network technologies in order to solve the bandwidth demand crunch. Today, these administrators typically use Ethernet as their backbone technology. Although networks face many different issues, 10 Gigabit Ethernet meets several key criteria for efficient and effective high-speed networks.

In 2009 the firm developed SETAC which is short for "SErver To Appliance Converter." The patent on SETAC was awarded in June of 2012.

SETAC, The best of both worlds

SETAC, which is Silicon's newly patented, product family converts standard servers to network appliances and is designed for systems that require front I/O ports, I/O ports replaceable without opening the system chassis, high quantity of I/O ports and flexibility to provide high quantity of different configurations.

When network appliance providers design their network appliances, they can either use a general server or a specific appliance oriented hardware solution. The server with standard add-on adapters assures server-grade reliability and a stable state of the art technological environment but sacrifices flexibility. On the other hand using specific appliance- oriented hardware solutions allows for superior flexibility and field-re-configurability but lacks in server grade reliability and technological stability.

SETAC offers the benefits of these two options, enabling branded high technology servers to be configured as hardware appliances, and creating an ideal network appliance that combines server grade reliability, front- end access, field- replaceable architecture and a stable state-of-the-art technology environment.

STANDARD SERVER

Pro	Con
Server grade reliability	Server look and feel
State of the Art technology	inconvenient back connectivity
Lower cost/unit	not modular- cant reconfigure

HARDWARE APPLIANCE

Pro	Con
easy to reconfigure	no server grade reliability
appliance look and feel	higher cost
reliable networking modules integration	time to market lag with each new generation

Intelligent Nano-Second Time-Stamping (NICS)
On February 19, 2013 the firm announced that it has launched a new family of Intelligent Nano-Second Time-Stamping (NICS), a breakthrough enabler of next-generation network monitoring in Big Data environments, and that it has already secured an immediate Design Win for the product line's first adapter. The firm recorded its first Time Stamp revenues in the first quarter, and projects a rapid sales ramp-up to reach annual revenues of $15 to $20 million within a few years.

Use
In today's faster and more inter-connected networks, time-stamps at the packet level are prerequisites for effective analysis of network performance-related issues such as latency and jitter, as well as critical enablers of e-trading, digital forensics and other time-sensitive applications.

Widest Selection
SILC has developed a line of products for the server networking industry which facilitates interaction between servers, allowing them to communicate with each other through a larger number of ports and with higher performance than their original capabilities. These are powerful products that allow server-based systems to fully exploit the high speed potential of Gigabit Ethernet. The products have either one, two, four or six ports, which plug into the servers between which interaction is facilitated.

Markets Served	Leaders
WAN Optimization Appliances	Riverbed, Blue Coat, Cisco, Citrix, Silver Peak
Security Appliances	Checkpoint, Cisco, Juniper, Trend Micro, McAfee
Load Balancing Appliances	F5, Radware
Storage	EMC, Network Appliance
Telecom	Alcatel-Lucent
General Purpose Servers	Dell, HP, Intel, IBM, Fujitsu

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backbone technology. Although networks face many different issues, 10 Gigabit Ethernet meets several key criteria for efficient and effective high-speed networks:

The firms products cover a broader scope of features than those of it competitors. SILC's belief that its expanded feature set coupled with the fact that its products are based on two different industry leader chip sets (Intel and Broadcom), which makes them more compatible with potential customers' needs, gives the firm a competitive edge. Silicom is currently the only company offering such a comprehensive range of server networking products.

A Backdrop of Growth
Silicom has 4 major External Growth Drivers in the Networking and Data Infrastructure world.

- Rising Internet Traffic
- Cloud Computing
- Big Data
- Virtualization

The strong trends in rising internet traffic, cloud computing and virtualization that are developing within the information technology market offer Silicom several unique opportunities to dramatically increase revenues.

These external developments strongly escalate Silicom's customer's network appliances needs for WAN optimization, internet security and application delivery. While total global monthly internet traffic is expected to be 4x greater in 2015 than it was in 2010, the Company estimates that the WAN optimization, internet security and application delivery markets are growing at an average of 20 percent per year.

These solid external growth engines combined with internal growth engines such as the Company's increasing sales of SETAC and SETAC based network appliance products, as well as the staged launch of additional new products, has the potential to push the Company's revenues to a $100 million per year run rate in the long-term

What's more, the SETAC (Server To Appliance Converter) product family, not only permits Silicom to address new market segments, but also allows the company to obtain nearly unlimited potential with its existing customer base of 75 OEM businesses that include market leaders within target segments.

OEM Business Model
The firm utilizes an OEM model for approximately 95% of its sales. This creates significant operating leverage through reduced sales and marketing expenses and gives the firm insight into new technologies. OEM partnerships enhance visibility and market reputation and approximately 70 of the firms that SILC works with are market leaders. Once selected by a customer Silicom has never been replaced by competitors.

Operating expenses as a percentage of sales have been falling.

- 2010 Operating Expenses - 22.4%
- 2011 Operating Expenses - 21.0%
- 2012 Operating Expenses - 18.9%
- Q1/13 Operating Expenses - 17.1%

Smart Adapters
The firm's High Performance Multi Protocol Server Adapters are adapter in which one Server Adapter addresses networking, storage, HPC and virtualization. These intelligent programmable adapters improve performance by redirecting traffic based on packet characteristics, thereby offloading the server.

VALUATION

We feel Silicom should be valued by its cash plus business operations. With cash and liquid assets of $7.74 per share, plus the company's business operations value based on 21.8x our 2014 EPS estimate, this gives us a $70.00 company value. According to Zacks.com the average P/E in the peer group is 21.6x. Certainly the stock should trade at a premium given the growth and balance sheet position.

Looking at it another way, we see the SETAC and NICS technology driving the company's growth over the next several years. The discounted free cash flow to the firm model accounts for two periods of growth. One in which the firm outgrows the industry, and another in which the company's products mature and their growth looks more like the economy. We assume the top-line grows at 15.0% for ten years and then levels off at 5% per year. This may actually prove conservative as revenues have grown much faster than that over the past 10 years. We Were also conservative when projecting future discount rates, net income margin, and tax rates.

Assumptions

1. The company is expected to grow at a higher growth rate in the first period.

2. The growth rate will drop at the end of the first period to the stable growth rate.

Rationale for using the Model

As new products are introduced to new customers, we expect the company to grow at a higher overall rate than the industry. As these products mature and the company faces more competition, we expect the growth rate to level off.

Weakness of the Model

As you add more layers to the model, it is more sensitive to the assumptions you make. The growth may look more "lumpy" than we have in the model.

Output

I used the following inputs:

1. A 10-year period with a growth rate of 15.0% (average forecast) and a discount rate of 11.70%.

2. A continuing period assumed to go on forever, with earnings growing at 4% and a discount rate of 10.21%.

With these inputs we arrive at a target price of $80.00. We average the two models to get to a target price of $75.00

Despite the very strong growth and balance sheet characteristics the firm is not without risk. The firm is headquartered in Israel and despite the fact that it has operations in all major parts of the world, some degree of political risk does exist. Also the very nature of the business is the firm must continually find new products and get "buy in" from its customers. This is mitigated by the firm's design win business model where the Silicom will work with the customer for a long period of time before the product is designed and sold. Finally the size of the firm is important to consider. The Networking & Communication Devices industry ranges from $1 million in market capitalization to $130 billion. Silicom is on the lower end of the spectrum at $435 million. Many of the larger firms have great financial flexibility and acquisitions in the space could hurt results. The firm has approximately 7 million shares outstanding and the float is 5 million shares.

PROJECTED INCOME STATEMENT

INCOME STATEMENT ($ Mil)	Dec-12 Q4 12	Mar-13 Q1 13	Jun-13 Q2 13	Sep-13 Q3 13	Dec-13 Q4 13	Mar-14 Q1 14 E	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013 E	FY 2014 E
REVENUE												
Net Revenue	**16.7**	**15.0**	**15.7**	**17.2**	**25.4**	**19.0**	**20.53**	**30.40**	**39.63**	**48.73**	**73.30**	**85.00**
Sequential Growth		*-10%*	*5%*	*9%*	*47%*	*-25%*						
OPERATING EXPENSES												
Cost of Revenues	10.38	8.98	9.41	10.16	15.24	11.25	12.46	17.49	22.4	28.8	43.8	50.6
% of Revenue	*62.2%*	*59.7%*	*59.9%*	*59.1%*	*60.1%*	*59.2%*						
Gross Profit -	**6.31**	**6.1**	**6.3**	**7.0**	**10.1**	**7.8**	**8.07**	**12.9**	**17.2**	**19.9**	**29.5**	**34.4**
Proforma Gross Margin	*37.8%*	*40.3%*	*40.1%*	*40.9%*	*39.9%*	*40.8%*	*39.3%*	*42.5%*	*43.4%*	*40.8%*	*40.3%*	*40.5%*
R&D + Engg	1.29	1.24	1.35	1.31	1.41	1.35	2.7	3.3	4.1	4.4	5.3	6.5
% of Revenue	*7.7%*	*8.3%*	*8.6%*	*7.6%*	*5.5%*	*7.1%*	*13.2%*	*10.8%*	*10.4%*	*9.0%*	*7.2%*	*7.6%*
SG&A	1.42	1.46	1.48	1.64	1.79	1.65	3.13	3.73	4.41	5.45	6.37	7.35
% of Revenue	*8.5%*	*9.7%*	*9.4%*	*9.5%*	*7.1%*	*8.7%*	*15.3%*	*12.3%*	*11.1%*	*11.2%*	*8.7%*	*8.6%*
GW Amort, Restructuring, other	-	-	-	-	-	-	-	-	-	-	-	-
% of Revenue												
Total Operating Expenses	2.71	2.71	2.82	2.95	3.20	3.00	5.85	7.01	8.53	9.85	11.67	13.85
% of Revenue	*16.2%*	*18.0%*	*18.0%*	*17.1%*	*12.6%*	*15.8%*	*28.5%*	*23%*	*22%*	*20%*	*16%*	*16%*
Operating Income -	**3.61**	**3.3**	**3.5**	**4.1**	**6.9**	**4.8**	**2.22**	**6**	**9**	**10**	**18**	**21**
Operating Margin	*21.6%*	*22.3%*	*22.1%*	*23.8%*	*27.3%*	*25.0%*	*11%*	*19%*	*22%*	*21%*	*24%*	*24%*
NON-OPERATING ITEMS												
Non operating Income/Expense	0.13	0.12	0.06	0.10	0.12	0.13	0.91	0.62	0.44	0.75	0.40	0.40
% of Revenue	*0.77%*	*0.79%*	*0.39%*	*0.58%*	*0.49%*	*0.66%*	*4.43%*	*2.03%*	*1.11%*	*1.54%*	*0.55%*	*0.47%*
Tax Provision	0.29	0.34	0.25	0.15	0.16	0.12	0.31	0.60	0.67	0.91	0.91	0.95
Effective Tax Rate												
Net Income -	**3.45**	**3.13**	**3.29**	**4.05**	**6.87**	**4.76**	**2.82**	**5.9**	**8.5**	**9.9**	**17.3**	**20.0**
Net Income Margin	*20.7%*	*20.8%*	*20.9%*	*23.5%*	*27.1%*	*25.0%*	*13.7%*	*19%*	*21%*	*20%*	*24%*	*24%*
EARNINGS PER SHARE												
EPS - Basic	$0.49	$0.46	$0.49	$0.59	$0.97	$0.67	$0.42	$0.84	$1.25	$1.53	$2.52	$2.89
EPS - Diluted	$0.49	$0.46	$0.48	$0.58	$0.94	$0.65	$0.41	$0.82	$1.25	$1.52	$2.46	$2.85

HISTORICAL ZACKS RECOMMENDATIONS



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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.

The current distribution is as follows: Buy/Outperform- 16.6%, Hold/Neutral- 77.3%, Sell/Underperform – 5.5%. Data is as of midnight on the business day immediately prior to this publication.