Zacks Equity Research

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Silicom Limited (SILC-NASDAQ)

SILC: Zacks Company Report – Increasing Top-line Estimate for Q4

Current Recommendation	**Outperform**
Prior Recommendation	N/A
Date of Last Change	09/09/2010
Current Price (01/05/11)	$18.74
Six- Month Target Price	**$20.00**

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, 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 new 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 run rate level in coming years. We see value in the shares of Silicom.

SUMMARY DATA

52-Week High	**$18.88**
52-Week Low	**$8.15**
One-Year Return (%)	**106.39**
Beta	**0.57**
Average Daily Volume (sh)	**43,112**
Shares Outstanding (mil)	**6.8**
Market Capitalization ($mil)	**$128**
Short Interest Ratio (days)	**0.44**
Institutional Ownership (%)	**1**
Insider Ownership (%)	**25**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**15.1**
Earnings Per Share (%)	**2.5**
Dividend (%)	**N/A**
P/E using TTM EPS	**25.3**
P/E using 2010 Estimate	**23.4**
P/E using 2011 Estimate	**18.7**
Zacks Rank	**3**

Risk Level	**Average,**
Type of Stock	**Small-Blend**
Industry	**Comp-Networks**
Zacks Rank in Industry	**N/A**

ZACKS ESTIMATES

Revenue
(in millions of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2008	8 A	5 A	6 A	7 A	26 A
2009	5.0 A	4.0 A	4.6 A	6.8 A	20.4 A
2010	6.4 A	6.7 A	7.4 A	8.5 E	29.0 E
2011	7.3 E	8.7 E	8.9 E	9.0 E	33.9 E

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

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2008	$0.26 A	$0.05 A	$0.14 A	$0.24 A	$0.69 A
2009	$0.13 A	$0.04 A	$0.05 A	$0.19 A	$0.41 A
2010	$0.14 A	$0.20 A	$0.21 A	$0.25 E	$0.80 E
2011	$0.21 E	$0.24 E	$0.27 E	$0.28 E	$1.00 E

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

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WHAT'S NEW

Raising SILC's Top-Line Estimates Due to Broad Strength

We are raising our fourth quarter top-line estimate on SILC from $7.5 to $8.5 million. This is based on strength across all current product lines. Our bottom line estimate of $0.25 EPS will not change at this point due to currency appreciation.

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 $6.60 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.

OVERVIEW

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

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 has 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 is 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.

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

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. As of 2009 10Gb Ethernet is replacing 1Gb as the backbone network and has just 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:

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

According to the market research firm Gartner, global spending on IT products and services is forecast to total US$3.3 trillion in 2010, up almost 4% from 2009, but down from the 5.3% originally forecast by Gartner earlier this year. Worldwide computing hardware spending is forecast to reach US$365bn in 2010, up 9.1% from 2009 spending. Drilling down further the computing hardware sector continues to benefit from a healthy PC sector, which accounts for two-thirds of total spending in this area, and Gartner expect PC shipments to remain robust throughout 2010 and 2011. "Consumer shipments will continue to be powered by strong mobile PC uptake, while professional shipments will be buoyed by a new replacement cycle and migration to Windows 7.

Growth Drivers

Internal Growth Drivers	External Growth Drivers
Growing revenues to existing clients	IT Market's Return to growth
improve offering within existing product line	Continued Evolution to new computing (Nehalem)
SETAC based sales growth	Migration to 10GBPS from 1GBPS

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.

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.

SETAC, The best of both worlds

SETAC, which is Silicon's new patent pending, 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

Early Success
On August 16th, 2010 SILC announced that SETAC has been selected by one of the security industry's dominant players for use in next-generation lines of security appliances to be launched in early 2011. Silicom estimates that sales related to the deal will ramp up over the next year generating revenues of over $3 million in its first production year.

On March 15th the firm announced that MaxStar, a leading Chinese manufacturer of network appliances, had chosen Silicom's SETAC as the basis for its new product line for medium-to-high-end customers. Using the SETAC, MaxStar will offer its customers unique network appliances that combine front-loading modular networking capabilities in a specialized chassis with the robust reliability of a standard motherboard. This combination fits the demands of network application providers in China, a vast, sophisticated and rapidly-growing market.

Strong Balance Sheet
The firm's balance sheet is a source of strength. As of September 30, 2010, the Company's cash and marketable securities totaled $44.9 million, or $6.80 per outstanding share. Silicom has had twenty three straight quarters of profitability and has been cash flow positive since 2005. This included $3.4 million in 2009 despite weak market conditions.

INDUSTRY OUTLOOK

INDUSTRY OUTLOOK -Positive

The outlook for the Computer Hardware industry is Positive relative to the S&P 500. Although enterprise spending has rebounded modestly during 2009, we have yet to see a significant acceleration in spending on Information Technology by large enterprise customers. We believe that while Chief Information Officer's (CIO's) have increased spending in order to keep up with requirements of the business, most are still in the cost savings mode that has existed over the past five years. As confidence in the economy increases, we believe that this mentality will gradually shift from one of cost savings to increasing efficiencies. As this mentality changes, we expect to see increased spending on new technologies, such as Voice over Internet Protocol (VoIP), and an overall acceleration in growth industry wide.

Offsetting our optimism on the future of enterprise spending are concerns about consumer spending. Rising interest rates and a potentially slowing housing market have taken a toll on consumer spending of technology products, leading to disappointing results from companies with consumer exposure. We therefore look to companies with new technologies and mostly enterprise exposure for out-performance in 2010-2012, while other industry participants languish in a still lukewarm environment.

INDUSTRY POSITION

The data server adapters industry is highly competitive. The firm faces competition from numerous companies, some of which are more established, benefit from greater market recognition and have greater financial strength.

In the server networking industry for which SILC has developed Multi-Port Gigabit-Ethernet Server Networking cards, the main competitor is Intel. In the bypass cards industry, competition is not as significant. SILC"s only significant competitors in this industry are Interface Masters, Portwell and Adlink.

In the external bypass cards industry (in which solutions are offered in the form of an external box instead of an embedded card), to the best of our knowledge our main competitor is Netoptics, and to some degree also Interface Masters who recently began to offer such products.

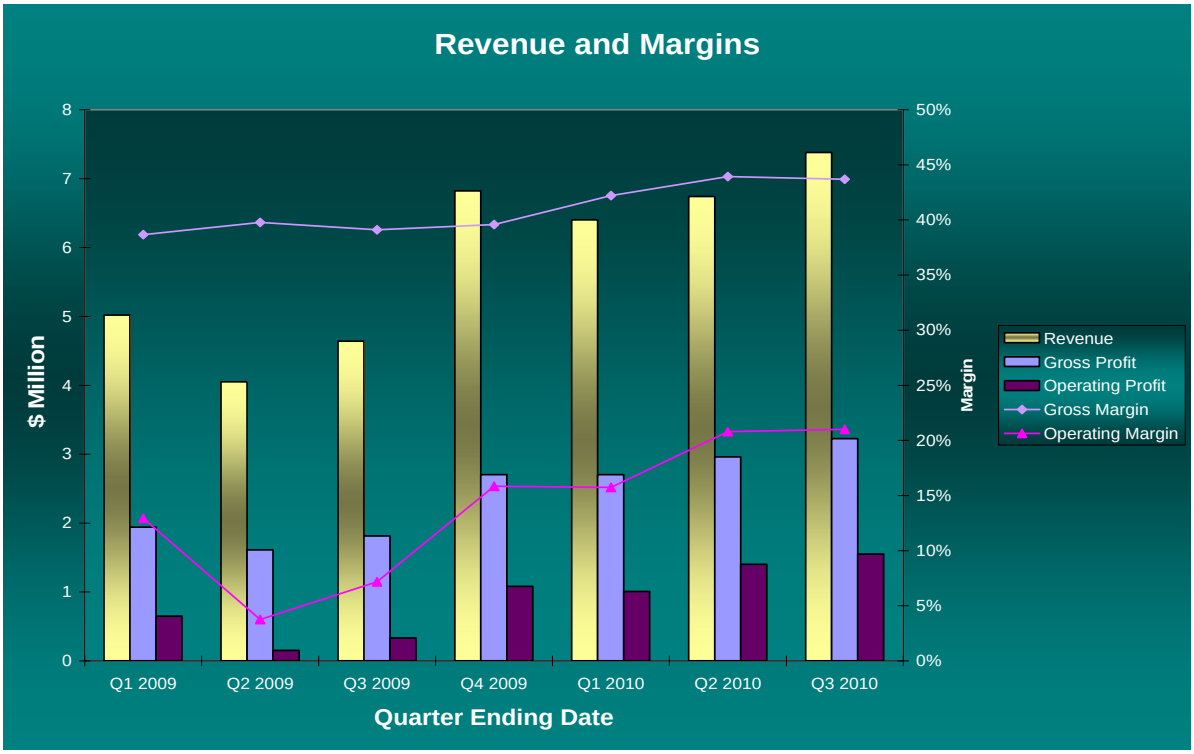
RECENT NEWS

On October 25th 2010 SILC announced results for the third quarter of fiscal year 2010 ending September 2010. Revenue for the period was $7.4 million rising 10.4% sequentially from $6.7 million and up 60.8% year over year.

Operating income for the quarter was $1.6 million, which equates to an operating margin of 21%, a five-fold increase compared with $333,000 in the third quarter of 2009, and an 11% increase compared with the second quarter of 2010. Net income for the quarter was $1.4 million, or $0.21 per share (basic and diluted), up 316% compared with $346,000, or $0.05 per share (basic and diluted), for the third quarter of 2009. In the second quarter of 2010 net income for the quarter was $1.4 million or $0.20 per share (basic and diluted),

Design Wins Piling Up

The firm announced three major wins that illustrate its growing momentum. In co-operation with a Fortune-100 industry giant, SILC achieved a breakthrough with SETAC Server-To-Appliance-Converter product line, selling SETAC-based solutions to a Tier-1 security leader in a deal that will generate $3 million for the firm in its first production year. Further SILC announced two important wins with the established networking server adapter product line: one with a data center-class WAN Optimization leader, and the other with a Japanese server manufacturer, an existing customer that has introduced the firm to another of its divisions.



As of September 30, 2010, the Company's cash, cash equivalents, bank deposits and marketable securities totaled $44.9 million, or $6.60 per outstanding share. This is up $1.0 million compared with the end of the second quarter of 2010.

VALUATION

SILC seems primed to enter a new growth phase. The growth engine in the short term is three fold. The first is the growth of Server Adapters in security markets and optimization, the next growth engine is new customers as well as new product lines every quarter. The strength of the OEM business model is evident in that SILC can roll out new business and keep operating expenses in check. Lastly the evolution of 10GB server adapters should provide growth in the short term. SETAC, which enables branded high technology servers to be configured as hardware appliances, Should push Silicom's revenues to a $100 million per year run rate.

Silicom should outperform given the IT market's bottomless need for faster response times and increased bandwidth against the backdrop of cloud computing, virtualization, and Internet-based applications.

We believe Silicom should be valued by its cash plus business operations. With the cash and liquid assets of $6.60 per share plus the company's business operations value based on 13.4x our 2011 estimate gives us a $20.00 company value**.**

Looking at it another way we value the company based on the average of our P/E multiple (13.5x 2011 estimated EPS) and our two stage intrinsic model. The networking and communication device group average P/E is between 14x-26x. We feel SILC should trade at a premium to its peers, given the fact that the company has high growth/ high margin products.

The intrinsic value is essentially a sum of the company's future earnings, minus any long-term debt (Zero in SILC's case). Dividing the intrinsic value by the number of shares outstanding yields an intrinsic stock price. We used the following inputs:

- A 10-year period with an earnings growth rate of 20.0% and a discount rate of 15%.
- A continuing period assumed to go on forever, with earnings growing at 6% and a discount rate of 12%.

With these inputs we arrive at a target price of **$20.00.**

RISKS

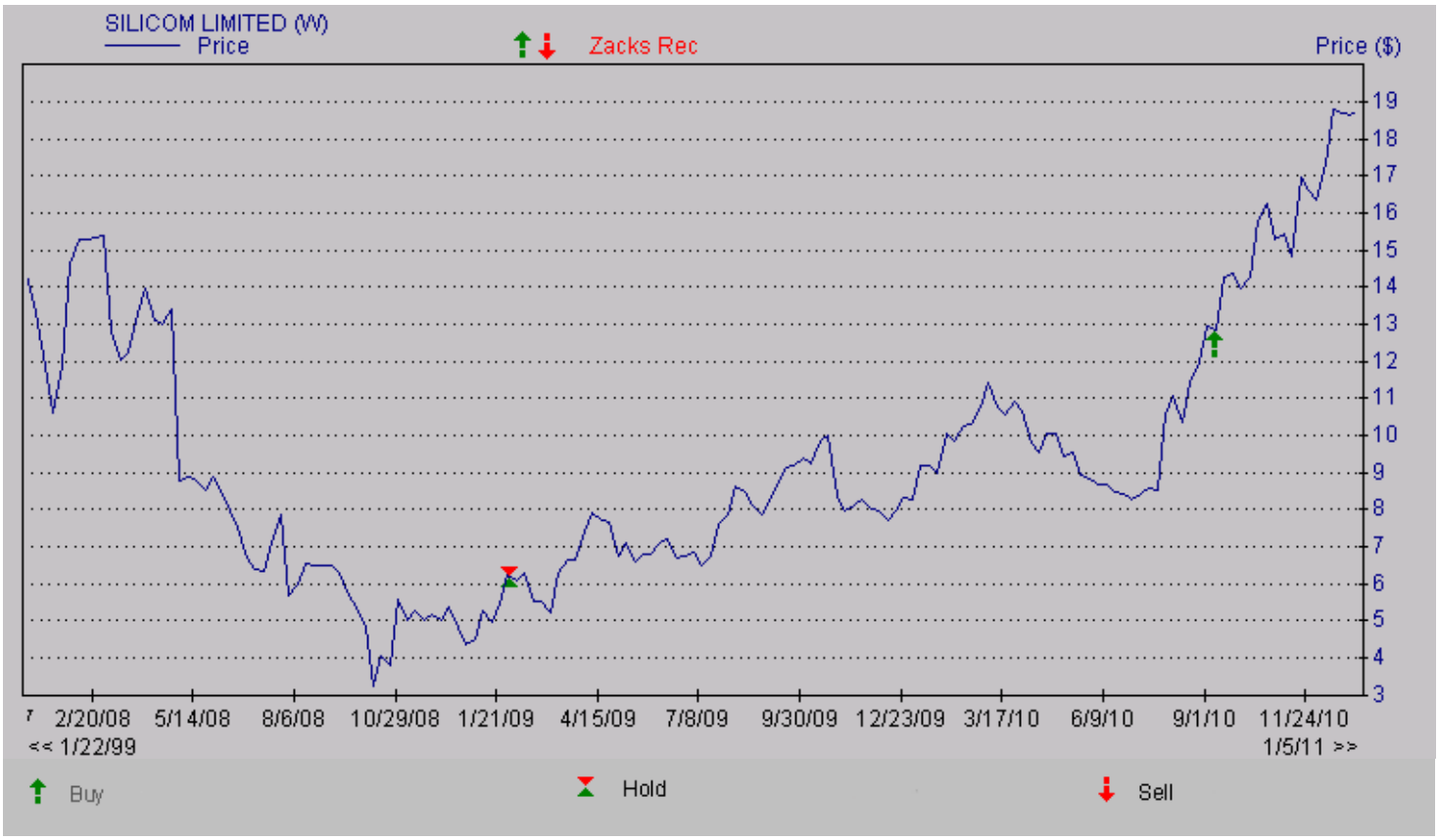
- While the overall world economy and markets have rebounded, the possibility of a double dip or a slow growth environment remains.
- The company is headquartered in Israel and faces political risk.
- Future growth depends on the adoption rate of technology and a delay could result in revenues and earnings dropping below expectations.

PROJECTED INCOME STATEMENT & BALANCE SHEET

INCOME STATEMENT ($ Thousands	Sep-09 Q3 09	Dec-09 Q4 09	Mar-09 Q1 10	Jun-10 Q2 10	Sep-10 Q3 10	Dec-10 Q4 10 E	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010 E	FY 2011 E
REVENUE												
Net Revenue	**4.64**	**6.82**	**6.40**	**6.74**	**7.4**	**8.5**	**16.12**	**26.78**	**25.55**	**20.53**	**29.02**	**33.90**
Sequential Growth		*47%*	*-6%*	*5%*	*10%*	*15%*						
OPERATING EXPENSES												
Cost of Revenues	2.82	4.12	3.70	3.78	4.16	4.85	9.83	16.09	15.41	12.46	16.49	19.3
% of Revenue	*60.9%*	*60.4%*	*57.8%*	*56.1%*	*56.3%*	*57.0%*						
Gross Profit -	**1.8**	**2.70**	**2.70**	**2.96**	**3.2**	**3.7**	**6.29**	**10.69**	**10.15**	**8.07**	**12.5**	**14.6**
Proforma Gross Margin	*39.1%*	*39.6%*	*42.2%*	*43.9%*	*43.7%*	*43.0%*	*39.0%*	*39.9%*	*39.7%*	*39.3%*	*43.2%*	*43.0%*
R&D + Engg	0.63	0.75	0.84	0.69	0.81	0.92	1.8	2.2	3.0	2.7	3.3	3.6
% of Revenue	*13.5%*	*11.1%*	*13.1%*	*10.3%*	*10.9%*	*10.8%*	*11.3%*	*8.2%*	*11.9%*	*13.2%*	*11.2%*	*10.6%*
SG&A	0.85	0.87	0.86	0.87	0.87	0.98	2.09	2.73	3.52	3.13	3.57	3.80
% of Revenue	*18.4%*	*12.7%*	*13.4%*	*12.9%*	*11.8%*	*11.5%*	*12.9%*	*10.2%*	*13.8%*	*15.3%*	*12.3%*	*11.2%*
GW Amort, Restructuring, other	-	-	-	-	-	-	-	-	-	-	-	-
% of Revenue												
Total Operating Expenses	1.48	1.62	1.70	1.56	1.67	1.90	3.91	4.93	6.57	5.85	6.83	7.40
% of Revenue	*31.9%*	*23.7%*	*26.5%*	*23.1%*	*22.7%*	*22.4%*	*24.2%*	*18.4%*	*25.7%*	*28.5%*	*24%*	*22%*
Operating Income -	**0.33**	**1.08**	**1.01**	**1.40**	**1.6**	**1.8**	**2.39**	**5.76**	**3.58**	**2.22**	**6**	**7**
Operating Margin	*7.2%*	*15.8%*	*15.7%*	*20.8%*	*21.0%*	*20.6%*	*15%*	*21%*	*14%*	*11%*	*20%*	*21%*
NON-OPERATING ITEMS												
Non operating Income/Expense	0.19	0.18	0.14	0.23	0.13	0.13	0.17	0.96	1.19	0.91	0.26	0.60
% of Revenue	*4.12%*	*2.67%*	*2.20%*	*3.34%*	*1.73%*	*1.51%*	*1.04%*	*3.57%*	*4.65%*	*4.43%*	*0.88%*	*1.77%*
Tax Provision	0.18	-0.09	0.21	0.24	0.24	0.25	-0.05	0.43	0.12	0.31	0.94	0.95
Effective Tax Rate												
Net Income -	**0.35**	**1.35**	**0.94**	**1.38**	**1.44**	**1.64**	**2.60**	**6.28**	**4.65**	**2.82**	**5.0**	**6.8**
Net Income Margin	*7.5%*	*19.8%*	*14.7%*	*20.5%*	*19.5%*	*19.3%*	*16.1%*	*23.4%*	*18.2%*	*13.7%*	*17%*	*20%*
EARNINGS PER SHARE												
EPS - Basic	$0.05	$0.20	$0.14	$0.20	$0.21	$0.25	$0.51	$1.03	$0.69	$0.42	$0.80	$1.00
EPS - Diluted	$0.05	$0.19	$0.13	$0.20	$0.21	$0.25	$0.49	$1.00	$0.69	$0.41	$0.80	$1.00

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