Zacks Small-Cap Research

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TowerJazz (TSEM-NASDAQ)

TSEM: Long-Term Story Remains Intact; OUTPERFORM

Current Recommendation	**Outperform**
Prior Recommendation	N/A
Date of Last Change	01/31/2010
Current Price (11/16/11)	$0.72
Six- Month Target Price	**$4.00**

OUTLOOK

TowerJazz is a pure-play semiconductor wafer foundry with two IC plants in Israel and one in California, that manufacture SiGe, MEMS, RF, embedded flash-based memory, analog/mixed-signal, and CMOS image-sensor devices. Over the past year the firm has been building capacity due to accelerated design-win momentum, which have been realized within a large group of diversified, global customers, many of which being market share and technology platform leaders for their respective markets. We see value in the shares and reiterate our outperform rating.

SUMMARY DATA

52-Week High	**$1.61**
52-Week Low	**$0.61**
One-Year Return (%)	**-47.22**
Beta	**1.70**
Average Daily Volume (sh)	**321,874**
Shares Outstanding (mil)	**317**
Market Capitalization ($mil)	**$241**
Short Interest Ratio (days)	**3.13**
Institutional Ownership (%)	**3**
Insider Ownership (%)	**1**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**25.9**
Earnings Per Share (%)	**N/A**
Dividend (%)	**N/A**
P/E using TTM EPS	**1.3**
P/E using 2011 Estimate	**1.3**
Zacks Rank	**3**

Risk Level	**Moderate**
Type of Stock	**Small-Blend**
Industry	**Elec Comp-Semic**

ZACKS ESTIMATES

Revenue
(in millions of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2008	58 A	58 A	59 A	77 A	252 A
2009	58 A	61 A	80 A	101 A	297 A
2010	114 A	126 A	135 A	135 A	509 A
2011	121 A	140 A	176 A	175 E	612 E

Earnings per Share
(Non-GAAP)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2008	-$0.04 A	$0.08 A	$0.04 A	$0.04 A	$0.12 A
2009	-$0.02 A	$0.03 A	$0.07 A	$0.11 A	$0.19 A
2010	$0.13 A	$0.15 A	$0.15 A	$0.14 A	$0.55 A
2011	$0.11 A	$0.15 A	$0.14 A	$0.14 E	$0.54 E

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WHATS NEW

Market Share Gains Insulate Against Industry Weakness

On November 15, 2011, Tower Semiconductor Ltd., a global specialty foundry leader, reported financial results for its fiscal 2011 third quarter and nine months, ended September 30, 2011.

A solid third quarter by the Company resulted in quarterly revenues increasing by over 26 percent or $36.405 million sequentially to $176.112 million, which compares to revenues of $139.707 million for the three months ended June 30, 2011.

The third quarter revenue level puts TowerJazz at a run rate of approximately $700 million per year. Along the same lines it should further be noted that the Company is targeting achieving an annualized quarterly run rate of $800 million in the second half of 2012.

The Company's third quarter 2011 GAAP net income increased 5.5 percent or $96,000 sequentially to $1.839 million from $1.743 million during the second quarter of 2011. This included $9 million gain, net from the sale of the Company's holdings of HHSL in China, which was offset by lower gross margin and a $3.053 million sequential increase in total operating expenses.

Still, TowerJazz realized close to 100 design wins during the third quarter as well as began shipping qualified products for a three year supply deal to its new customer Micron Technology. Additionally, it was the first full quarter post-acquisition of the Nishiwaki factory.

In June 2011, the Company acquired Micron Technology's 60,000 wafer-per-month plant in Nishiwaki, Japan, for $140 million. The addition of the Nishiwaki plant will give TowerJazz the capacity to produce 1.7 million wafers per year by year end, doubling the Company's capacity level from the end 2010. Furthermore, TowerJazz is currently examining ways to increase the Nishiwaki capacity by 200,000 wafers per year which would bring the total capacity to 1.9 million wafers per year manufacturing capability.

Based on a weighted average number of basic common shares of 317.1 million, GAAP basic net income per share resulted in net income of $0.01 per basic share during the third quarter of fiscal 2011. This compared to basic net income per share of $0.01 on a weighted average number of basic shares of 295.9 million during the three months ended June 30, 2011.

Non-GAAP net income for the third quarter of 2011 decreased sequentially by $267,000 to $45.753 million and non-GAAP earnings per basic share for the third quarter of 2011 were $0.14 compared to $0.16 for the three months ended June 30, 2011.

For the nine months ended September 30, 2011, year over year revenues improved by nearly 17 percent or $62.297 million to $436.439 million from $374.142 million for the comparable nine months of 2010.

GAAP Net loss for the nine months improved by $41.834 million year over year to a net loss of $1.829 million for the nine months ended September 30, 2011. This compares to a net loss of $43.663 million for the comparable nine months of 2010.

Based on a weighted average number of basic common shares of 296.609 million, GAAP basic net loss per share resulted in a net loss of $0.01 per basic share during the nine months ended September 30, 2011. This compared to basic net loss per share of $0.19 on a weighted average number of basic shares of 228.041 million during the nine months ended September 30, 2010.

On a non-GAAP basis, net income for the nine months ended September 30, 2011 increased year over year by 21.3 percent to $122.154 million while non-GAAP earnings per basic share for the first nine months of 2011 dropped to $0.41 per basic share compared to $0.44 per basic share for the nine months ended September 30, 2010.

TowerJazz's balance sheet continued to improve with cash, short-term deposits and designated deposits increasing by $30.278 million sequentially to $178.194 million and working capital improving by $27.873 million to $77.409 million for the period ended September 30, 2011.

Additionally, management announced guidance for its fiscal 2011 fourth quarter.

Management anticipates fiscal 2011 fourth quarter revenues to be in the range of $170 million to $180 million.

The recently updated guidance would be a 30 percent year over year growth in revenues at the midpoint of the projected range for the quarter and would imply a 20 percent year over year growth in fiscal 2011 revenues over revenues from fiscal 2010 at the midpoint of the projected range.

The firm is now enjoying a substantial ramp in volume productions that were signed in the 2008-2009 time frame. In general the time frame from design win to volume production is a two year process. Design wins per quarter were approximately 50 per quarter in 2008, 75 per quarter in 2009, and 110 per quarter in 2010. The firm received a triple digit number of design wins in the past quarter, which will likely benefit the firm in 2012 and beyond.

On June 5, 2011 TowerJazz announced that it completed its previously announced acquisition of Micron Technology's fabrication facility in Nishiwaki City, Hyogo, Japan. The acquisitions will nearly double TowerJazz's current internal manufacturing capacity, increasing production by 60,000 wafers per month. The deal should also strengthen the company's presence in the Asia-Pacific region as it is likely IDM's in the area would want a partner close by. We feel the deal will help margins eventually, but perhaps not until 2013. 19.7 million shares for increasing your revenues by 80% is dilution we can live with. The first two years will operate with a cost plus model, which will allow the facility to be 80% utilized while the firm builds up a clientele. We feel this is a positive as new facilities can be a drain until the firm fills excess capacity.

Perhaps the recent disconnect in the shares performance versus its operating results lies in the fact that the firm has capital notes and equity options that if converted could increase the number of shares outstanding to 500-550 million shares. The notes along with some other equity options may be a medium term headwind for the firm, yet they were given at a time when the firm was questionable as a going concern and was hemorrhaging cash. What once saved the firm now may be holding it back. The notes can be negotiated or bought out, but that seems to be a longer-term issue for the firm to tackle. Our opinion is the firm is focused on getting to the $1 billion annual sales mark and will then turn its attention to improving the balance sheet.

On Monday October 10th 2011 TSEM announced that Jazz Technologies Inc. completed a voluntary transaction to early redeem the entire remaining $35,091,000 principal amount of its outstanding 8.00% notes originally due December 31, 2011. If not redeemed, the notes were convertible into Tower Semiconductor's shares. The company financed the early redemption through available cash on hand. This could be the first step toward addressing the share count/ balance sheet issue.

Foundry Landscape 2008-2010

($M)	2008		2009		2010	
1	TSMC	10,556	TSMC	,8989	TSMC	13,307
2	UMC	3,070	UMC	2,815	UMC	3,965
3	Chartered	1,743	GlobalFoundries*	2,641	GlobalFoundries	3,510
4	SMIC	1,353	SMIC	1,070	SMIC	1,555
5	Vanguard	511	Dongbu	395	**TowerJazz**	**510**
6	Dongbu	490	Vanguard	382	Vanguard	505
7	X-Fab	368	**TowerJazz**	**299**	Dongbu	495
8	SSMC	340	SSMC	280	SSMC	330
9	HHNEC	290	HHNEC	240	X-Fab	320
10	**TowerJazz**	**252**	X-Fab	212	HHNEC	295
11	Grace	230	He Jian	180	Grace	260
12	He Jian	195	Silterra	170	WIN	221
13	Silterra	175	WIN	145	Altis	215
14	ASMC	134	Grace	100	He Jian	205
15	WIN	117	ASMC	94	Silterra	200
16	Mosel-Vitelic	98	XinXin	55	ASMC	150
17	XinXin	20	Mosel-Vitelic	51	Mosel-Vitelic	80
18	Altis	0	Altis	0	XinXin	75
19	-	-	-	-	-	-
20+	Others	148	Others	171	Others	204

INVESTMENT THESIS

Tower Semiconductor Ltd. operates as a global specialty foundry company. Its wholly owned subsidiary, Jazz Semiconductor, Inc., specializes in analog-intensive mixed-signal (AIMS) foundry solutions. Tower and Jazz manufacture integrated circuits with geometries ranging from 1.0 to 0.13-micron, as well as provide design enablement tools to allow complex designs to be achieved quickly and accurately. The company and its subsidiary offer a range of process technologies, including digital, mixed-signal and RFCMOS, HV CMOS, BCD, non-volatile memory (NVM), embedded NVM, MEMS, and CMOS image sensors. Tower and Jazz maintain two fabrication facilities in Israel, as well as one fabrication facility in the United States, with additional capacity available through manufacturing partnerships in China.

As of March 31, 2011,the firm held 197 patents in force in the United States and 33 patents in force in foreign countries.

Foundry History

Historically semiconductor firms (also called integrated device manufacturers or IDMs) manufactured chips in their own fabs (chip fabrication plant). By the 1990's as chips grew smaller and more complex it was a natural that fab less outsourced manufacturing began to emerge. Semiconductor devices are broadly divided into three categories—analog, digital and radio frequency (RF). Analog semiconductors condition and regulate real world information such as light, temperature, speed, pressure, power and electrical currents. Digital logic semiconductors process information in only two states. Mixed-signal semiconductors combine both analog and digital technology into a single device. Typically, an analog sensor samples real world information, and then converts the input into an electronic analog signal, which is converted into a digital format for further digital processing. The analog and mixed-signal markets tend to be more varied and specialized, with customized products that have longer life cycles than the digital industry segment. There is an ongoing drive to decrease the number of discrete devices, lessen power requirements and shrink the size of the existing devices, which correspondingly increase performance and reliability. Consequently, a greater amount of functionality is being consolidated into increasingly smaller devices

The availability of IC designs require process technologies other than standard digital CMOS have created a market for independent foundries that focus on providing specialized process technologies. Thus, wafer manufacturers may also need to make a significant investment in specialty process technologies to manufacture these semiconductors. Specialty process technologies enable greater analog content and can reduce the die size of an analog or mixed-signal semiconductor, thereby increasing the number of dies that can be manufactured on a wafer and reducing final die cost. In addition, specialty process technologies can enable increased performance, superior noise reduction and improved power efficiency of analog and mixed-signal semiconductors compared to traditional standard CMOS processes. These specialty process technologies include advanced analog CMOS, radio frequency CMOS (RF CMOS),CMOS Image Sensors (CIS), high voltage CMOS, bipolar CMOS (BiCMOS), silicon germanium BiCMOS (SiGe BiCMOS), and bipolar double-diffused metal oxide semiconductor (BCD).

Specialized Markets, higher margin

The company uses CMOS (complementary metal oxide semiconductor) IC technology within the semiconductor devices. Strategically, management has targeted the manufacture of embedded flash-based memory, analog/mixed-signal and CMOS image-sensor device markets. Management asserts that these targeted specialized markets produce relatively higher gross margins and have higher growth characteristics than the general industry. Embedded flash memory is non-volatile erasable memory used within MP3 players, wireless handsets, digital cameras, DVD players, set-top boxes and PCs. The analog/mixed signal ICs are used in a wide variety of end applications that include wireless handsets, PCs, DVD players, automotive electronics and medical imaging equipment. CMOS image sensors are used within wireless handsets, digital cameras, video cameras and video game consoles. Applications within the consumer market account for 50% of revenue, while communications was 15%, PC was 7%, multi-markets 18% and the combined industrial, medical and automotive the remaining 10%.

Some industries that will benefit from optical sensors include certain processing industries that can use sensors for controlling chemical formulations and temperatures. In the medical industry, the sensors will facilitate the development of novel imaging systems. The sensors will help the

construction industry monitor the structural health of different buildings, bridges, and tunnels and facilitate the environmental industry in monitoring pollutants and contamination.
The multiplexing capability of optical sensors makes them an excellent candidate for structural health monitoring in aerospace applications where weight is a major consideration. Degradable polymer sensors are used to deliver antiviral drugs, pain and chemotherapy medications, and contraceptives. Universities and companies can use simulation equipment for their research and teaching needs. A range of basic and applied research programs are being conducted in aeropropulsion, space sciences, photonics, and materials technology

Merger.
Jazz semiconductor was formed as the result of a spin off in 2002 from Conexant (Conexant dates back to Rockwell Semiconductor). Jazz is the owner of the Newport Beach CA 200mm facility and several industry leading technologies such as SiGE, BiCMOS, and MEMS. We feel the merger is significant to Tower for the following reasons.

- The merger was done at a time when the rest of the industry was in survival mode.
- The customer base was doubled.
- Towerjazz is the lead in specialty higher margin foundry.



Diverse Customer Base (Source,Towerjazz)

The firm produces its products with its specialty process technology the designs are typically more complex than the manufacture of standard technology. This has the effect of drawing industry leading customers to the firm and makes it harder for them to leave for the competition.

SiGe
TSEM's BiCMOS process technologies have more features than RF CMOS process technologies and power various RF semiconductors such as wireless transceivers and television tuners. Towerjazz takes it a step further and incorporate high-speed bipolar transistors into an RF CMOS process. The equipment

requirements for BiCMOS manufacturing are specialized and require enhanced tool capabilities to achieve high yield manufacturing. Towerjazz remains the only foundry in the world with multi-fab SiGE capacity.

Power Management
TSEM's high voltage CMOS and BCD process technologies have more features than advanced analog CMOS processes and are well suited for power and driver semiconductors such as voltage regulators, battery chargers, power management products and audio amplifiers.

With worldwide energy standards becoming more stringent, we are optimistic about Towerjazz technology. In particular, several new government standards are being enacted that will force new products to adopt newer technologies, displacing the inefficient legacy linear transformers. The standards imposed by the California Energy Commission (CEC) became mandatory for all external power supplies by July 2008. This is a critical event given that California is the seventh largest economy in the world and usually the pioneer in leading edge legislation that many other states usually adopt later. Washington State and Arizona have both since adopted the same California standard. China recently announced a new voluntary program similar to the Energy Star program and also adopted the California standards. The European Commission has set European standards for energy efficient external AC/DC power supplies that are even more stringent than the CEC standards, although it is initially on a voluntary basis. Australia not only adopted the CEC standards, but made compliance mandatory by April 2006. The current worldwide energy situation has created greater sensitivity to the burgeoning problem. TSEM integrated power products conform to these new standards. As customers begin to design-in integrated power ICs that are in conformance with these new energy efficiency standards, the firm should be able to capitalize on the conversion.

VALUATION

The firm appears undervalued when looking at several metrics.

…Enterprise Multiple

The enterprise multiple looks at a firm as a potential acquirer would, because it takes debt into account - an item which other multiples like the P/E ratio do not include. Enterprise value is calculated as market cap plus debt, minority interest and preferred shares, minus total cash and cash equivalents. The Firm's Enterprise multiple is 2.53x compared to 3.96x for the industry. **According to the enterprise multiple TSEM appears undervalued compared to industry.**

$$\text{Enterprise Multiple} = \frac{\text{Enterprise Value}}{\text{EBITDA}}$$

Metric	TSEM	Industry Average
EV/EBITDA	2.53	3.96

…Two Stage Free Cash Flow to Equity Model

FCFE = Net Income - Net Capital Expenditure - Change in Net Working Capital + New Debt - Debt Repayment

Assumptions

- The firm is expected to grow at a higher growth rate in the first period.
- The growth rate will drop at the end of the first period to the stable growth rate.
- The free cash flow to equity is the correct measure of expected cash flows to stockholders. (rather than dividends)

Rationale for using the Model
As the firm grows its top-line to $1 billion, we expect the firm to grow at a higher overall rate than the industry. As These products mature and the firm 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 it in the model.

Output
We used the following inputs:

- A 5-year period with an earnings growth rate of 8.0% and a discount rate of 13.50%.
- A continuing period assumed to go on forever, with earnings growing at 5% and a discount rate of 13.05%.

With these inputs we arrive at a price of $4.38

According to the model, the firm appears undervalued.

…Price to Earnings Multiples/ Price to Sales Multiples

Due to its simplicity the Price/Earnings ratio is easily the most widely used metric in all of finance. The first strength of the model is that it is intuitive. It is simply the price paid for current earnings. It can also act as a proxy for other firm characteristics such as risk and growth. There is a downside to the P/E ratio in that it has the potential to reflect investor's mood rather than the fundamentals of the firm. It also eliminates assumptions about risk, growth, and retention ratio (something discounted cash flow models account for.)

While not as popular as Price/Earnings or Price/BV, Price/Sales is not influenced by accounting decisions in depreciation, inventory and extraordinary charges. P/S multiples are much less volatile than P/E multiples. However if the problem with the firm lies in cost control the P/S ratio will not reflect this flaw.

The firm appears undervalued compared to the industry.

Metric	TSEM	Industry Average
P/E TTM	1.33	13.91
P/E 2011 (E)	1.33	13.32
P/S	0.24	1.86

*source for background on valuation models: Investment Valuation, Aswath Damodaran

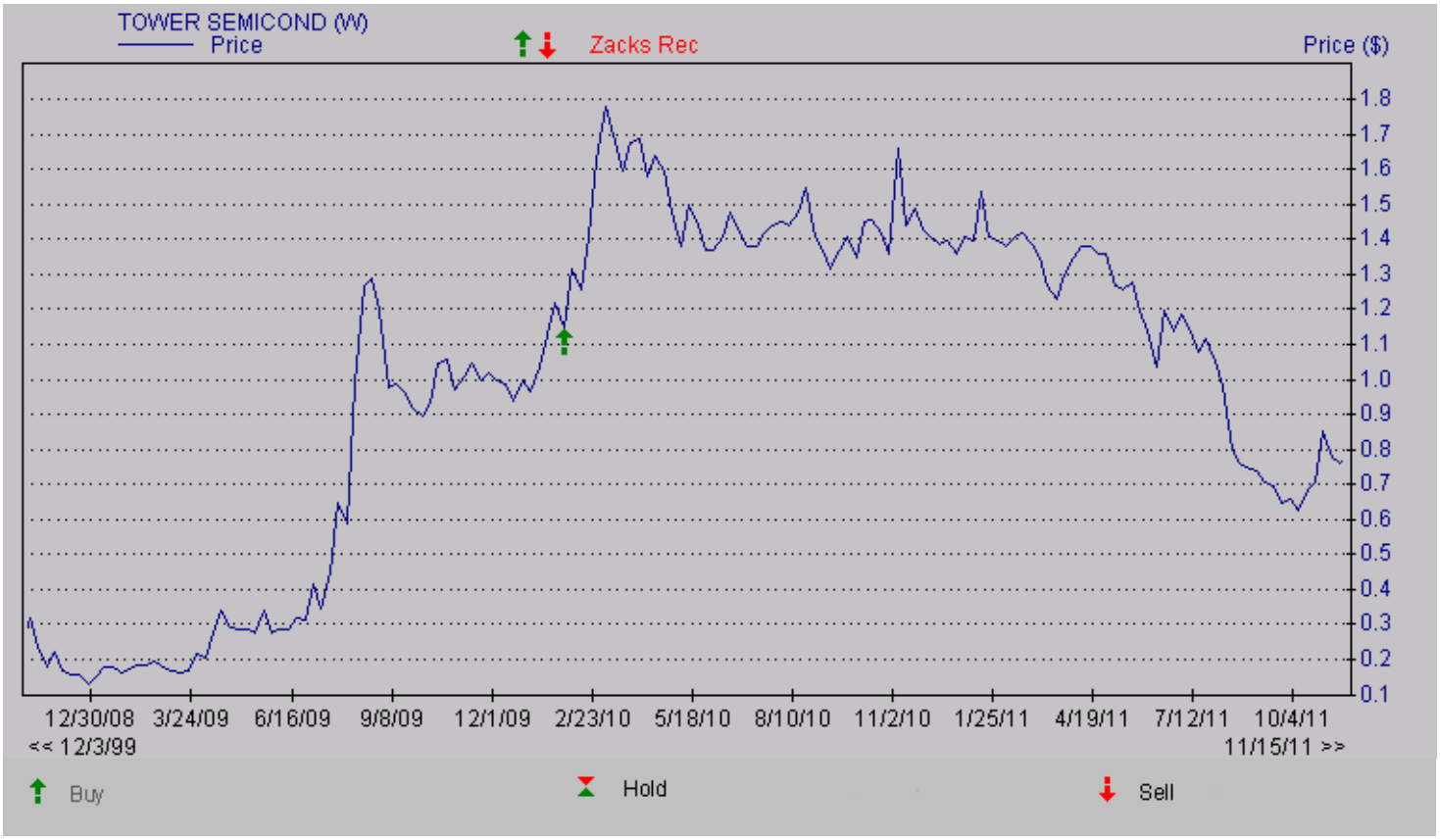
Our price target of $4.00 per share is the average of 6.70x our 2011 EPS estimate and our two stage model. We would add shares at these levels.

PROJECTED INCOME STATEMENT

INCOME STATEMENT ($ Millions)	Sep-10 Q3 10	Dec-10 Q4 10	Mar-11 Q1 11	Jun-11 Q2 11	Sep-11 Q3 11 E	Dec-11 Q4 11 E	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011 E
REVENUE												
Net Revenue	**134.7**	**135.1**	**120.6**	**139.7**	**176.1**	**175.5**	**187.4**	**230.9**	**251.7**	**298.8**	**509.3**	**611.9**
Sequential Growth		*0%*	*-11%*	*16%*	*26%*	*0%*						
OPERATING EXPENSES												
Cost of Revenues	72.89	78.59	67.57	80.20	118.66	117.50	128.3	147.4	174.2	206.5	284.7	383.9
% of Revenue	*54.1%*	*58.2%*	*56.0%*	*57.4%*	*67.4%*	*67.0%*						
Gross Profit -	**61.8**	**56.5**	**53.0**	**59.5**	**57.5**	**58.0**	**59.1**	**83.5**	**77.5**	**92.3**	**224.5**	**228.0**
Proforma Gross Margin	*45.9%*	*41.8%*	*44.0%*	*42.6%*	*32.6%*	*33.0%*	*31.5%*	*36.2%*	*30.8%*	*30.9%*	*44.1%*	*37.3%*
R&D + Engg	6.59	4.31	5.25	4.99	6.06	6.05	10.6	10.4	13.2	22.2	22.6	22.4
% of Revenue	*4.9%*	*3.2%*	*4.4%*	*3.6%*	*3.4%*	*3.4%*	*5.7%*	*4.5%*	*5.3%*	*7.4%*	*4.4%*	*3.7%*
SG&A	9.65	6.16	7.79	9.02	12.36	12.50	21.9	24.2	28.1	29.0	34	42
% of Revenue	*7.2%*	*4.6%*	*6.5%*	*6.5%*	*7.0%*	*7.1%*	*11.7%*	*10.5%*	*11.2%*	*9.7%*	*6.6%*	*6.8%*
GW Amort, Restructuring, other				*1.49*				-	-	-		*1.49*
% of Revenue												
Total Operating Expenses	16.24	10.47	13.05	15.51	18.42	18.55	32.5	34.6	41.4	51.1	56	66
% of Revenue	*12.1%*	*7.7%*	*10.8%*	*11.1%*	*10.5%*	*10.6%*	*17.3%*	*15.0%*	*16.4%*	*17.1%*	*11%*	*11%*
Operating Income -	**45.6**	**46.1**	**40.0**	**44.0**	**39.0**	**39.5**	**26.6**	**48.9**	**36.1**	**41.2**	**168**	**162**
Operating Margin	*33.8%*	*34.1%*	*33.2%*	*31.5%*	*22.2%*	*22.5%*	*14%*	*21%*	*14%*	*14%*	*33%*	*27%*
NON-OPERATING ITEMS												
Non operating Income/Expense	-6	-8	-7	3	7	6	-34.4	-28.8	-19.4	-22.2	-19	8
% of Revenue	*-4.12%*	*-5.75%*	*-5.82%*	*1.90%*	*3.82%*	*3.42%*	*-18.35%*	*-12.48%*	*-7.72%*	*-7.42%*	*-3.79%*	*1.37%*
Tax Provision	3.7	3.0	1.5	0.8	0.0	0.0	0.00	0.00	0.58	-5.0	13	2
Effective Tax Rate												
Net Income -	**36.34**	**35.34**	**31.50**	**45.84**	**45.75**	**45.45**	**-7.77**	**20.08**	**16.08**	**24.06**	**136.2**	**168.5**
Net Income Margin	*27.0%*	*26.2%*	*26.1%*	*32.8%*	*26.0%*	*25.9%*	*-4.1%*	*8.7%*	*6.4%*	*8.1%*	*27%*	*28%*
EARNINGS PER SHARE												
EPS - Basic	$0.15	$0.14	$0.11	$0.15	$0.14	$0.14	-$0.09	$0.17	$0.12	$0.19	$0.55	$0.54
EPS - Diluted	$0.15	$0.14	$0.11	$0.15	$0.14	$0.14	-$0.09	$0.17	$0.12	$0.19	$0.55	$0.54

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HISTORICAL ZACKS RECOMMENDATIONS



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