**Dane Capital Management, LLC**
Value, special situations, long/short equity, hedge fund manager

# Fairchild Semiconductor: Ignored And Unloved Cash Flow/Buyback Story With 50%+ Upside

Mar. 3, 2015 5:00 AM ET | 11 comments | About: Fairchild Semiconductor Corporation (FCS), Includes: IMOS, ONNN, TSEM
**Disclosure:** The author is long FCS, IMOS, ONNN, TSEM. **(More...)**

**Summary**

- Transformative shift in manufacturing strategy will result in $110M ($1/share) greater FCF exit 2015 run-rate than at year-end 2013.
- Fairchild has the most aggressive share repurchase program in the semiconductor industry with 100%+ of FCF used for buybacks in 2014 (8% of outstanding) and the same planned for 2015.
- Despite the aforementioned facts, shares are unloved by the sell-side and not owned by high profile hedge funds. With its $2bn+ market cap this can be owned by large funds.
- The semiconductor sector is rapidly consolidating. With its exceptional free cash flow and net cash position, Fairchild is extremely attractive. In a sale scenario, we believe FCS would fetch $30+.
- With ~10% FCF yield, FCS shares are compelling. At current prices the company could repurchase 35% of its shares over 4 years - we don't expect the opportunity to persist.

We don't find opportunities like Fairchild Semiconductor (NASDAQ:FCS) very often. It is liquid, unloved, and very cheap. At first glance it doesn't appear inexpensive, with a relatively rich p/e and lackluster top-line growth. However, that's not why we believe shares represent compelling value - they are extremely cheap on a multiple of free cash flow. This is a fact that has been largely ignored by the Street.

Over the past 15 months Fairchild has undergone a dramatic shift in capital allocation - both in terms of investment in PP&E and in capital return activity. Specifically, due to a shift to outsourcing and plant closures, Fairchild has dramatically reduced ongoing cap-ex and cash costs of operating facilities, significantly increasing free-cash generation. **On an apples-to-apples basis, Fairchild should exit 2015 with a $110 million greater annual free cash flow run-rate than at year-end 2013 - assuming no top-line growth**. Our long thesis is not predicated on market share gains or new technologies succeeding in the market place, just that Fairchild maintain*status quo*, and continue to aggressively repurchase stock.

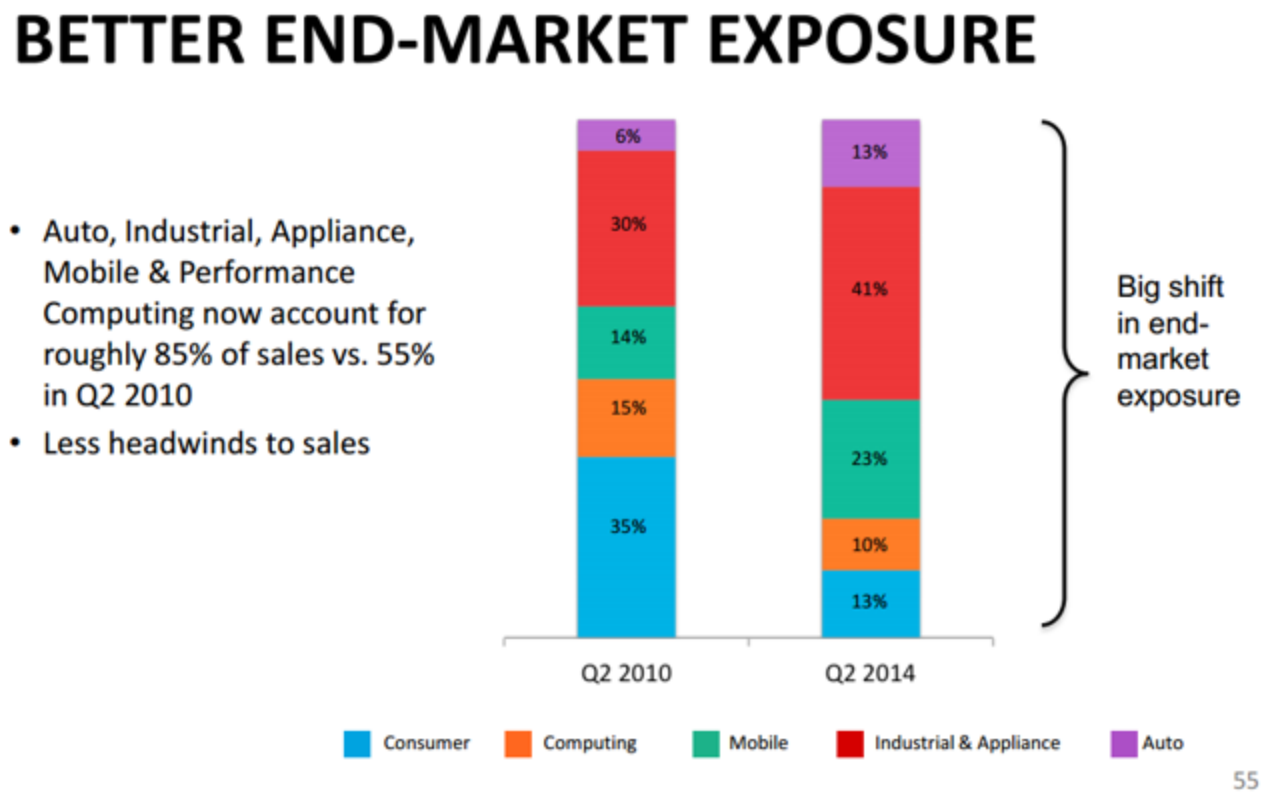
We believe Fairchild's transformative shift has been almost wholly ignored by Wall Street. **Importantly, concurrent with the increase in FCF, management has gained capital allocation wisdom that would make Buffett smile - they are deploying 100%+ of FCF to repurchases of their very undervalued shares (8% of shares repurchased in 2014) and intend to do the same in 2015.** In fact, given their net cash position and credit facility, they possess the flexibility to pursue a larger accelerated repurchase program should they choose. With a near 10% FCF yield based on our exit-2015 expectation, a management that understands capital allocation, and a rapidly consolidating semiconductor industry (NXP Semiconductor (NASDAQ:NXPI) acquiring Freescale Semiconductor (NYSE:FSL) is just the most recent example), **we believe shares are easily worth $25-30 without making grand assumptions about new customers, design wins, technologies, etc.** If any of the initiatives that management detailed during last September's investor day gain traction (we are NOT counting on this), upside could be more substantial. That said, we believe business is currently very strong, and we wouldn't be surprised by positive commentary when the company appears at the Morgan Stanley Technology - Media & Telecom Conference on Wednesday.

## Background

We will keep background on Fairchild brief given there is significant public information, one can easily review that investor day presentation on the company's website, and the investment case is founded not on products, technology and market share gains, but on changes in capital spending and capital allocation. This is not to say we are ignoring the actual business - we have known Fairchild and its peers very well for 15 years - simply that the story is not about an inflection in sales fundamentals, but value creation through dramatically lower capital spending and intelligent capital allocation.

Fairchild traces its roots to the beginnings of the semiconductor industry - Intel (NASDAQ:INTC) was actually spun out of the original Fairchild. Today, Fairchild is a $1.45 billion in revenue company focused on power semiconductors and discretes with sales to tens of thousands of end customers across a wide variety of markets.

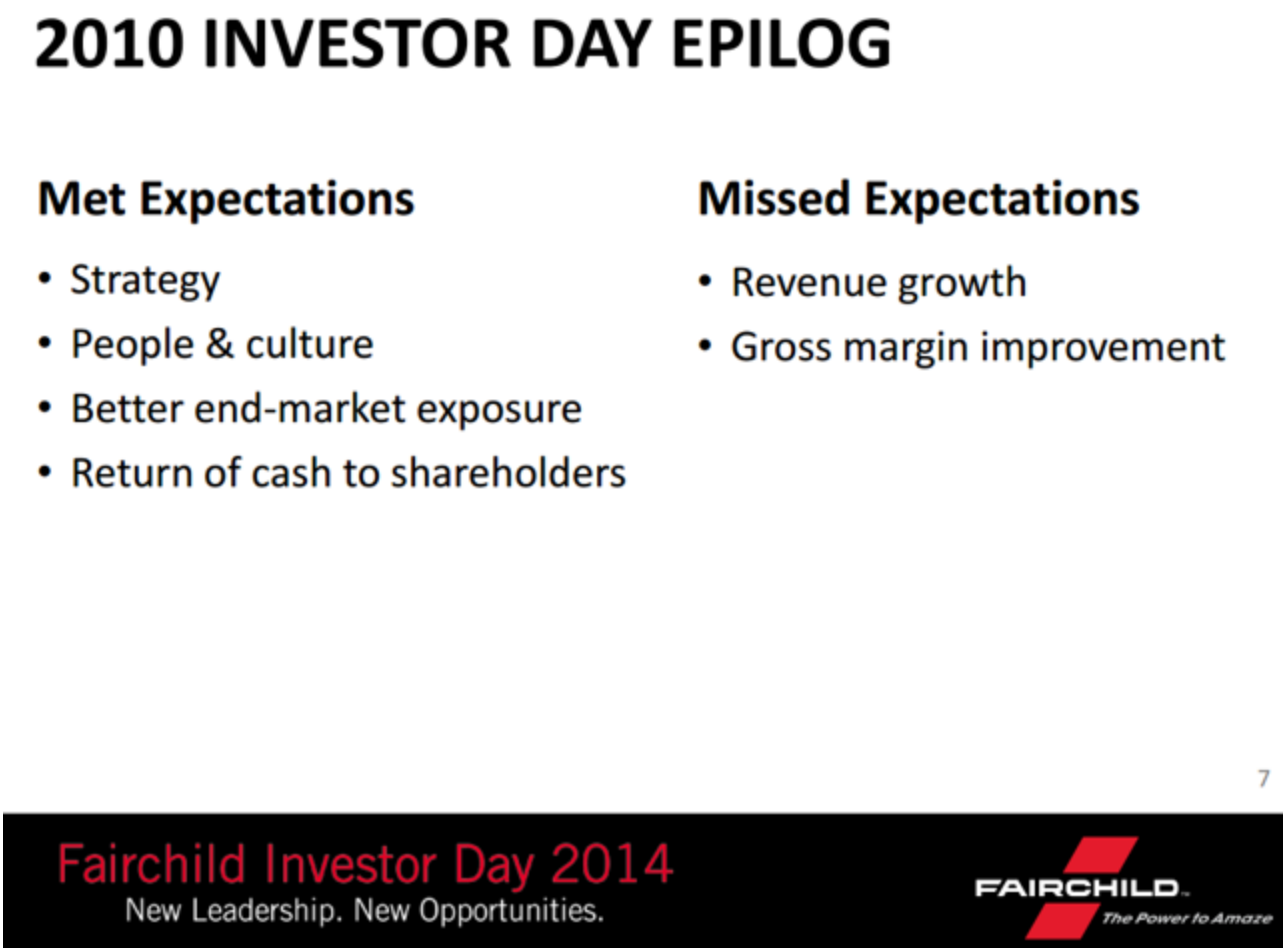
*(click to enlarge)*




Source: Fairchild Investor Day 2014

Over the past several years, Fairchild's growth has been stagnant, a fact the company admitted at last September's investor day.

*(click to enlarge)*




Source: Fairchild Investor Day 2014

At the analyst day management also outlined a target business model that includes gross margin targets of 37-40%, well above the 32.5% ultimately achieved in 2014.

*(click to enlarge)*

# TARGET BUSINESS MODEL

## POST-CURRENT PHASE OF MANUFACTURING CONSOLIDATION

| | |
|---|---|
| Sales Range | $375 – 425M |
| Gross Margin | 37 – 40% |
| Operating Expenses | 25% of Sales |
| EBIT Margin | 12 – 15% |
| Cash Flow from Ops | 16 – 20% of Sales |
| Capital Spending | 4 – 6% of Sales |
| Cash to Shareholders | 100% of Excess FCF |

Source: Fairchild Internal Estimates

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Fairchild Investor Day 2014
New Leadership. New Opportunities.

FAIRCHILD. The Power to Amaze

Source: Fairchild Investor Day 2014

With this as a brief backdrop, it's not shocking that the sell-side is not fond of Fairchild, with just 3 buys, versus 10 holds and 2 sells. In fact it's hard to find many lower rated semiconductor companies. Fairchild by its own admission has failed to grow or expand margins.

The fact is, given this seminal change in Fairchild's capital spending/allocation, its lack of growth doesn't matter. In our view the Street is looking at the wrong thing. Fairchild's change in capital deployment is far more important than if the company grows 2% or 5% or 8% this year. It represents a dramatic transformation that should lift shares to a new level, regardless of potentially modest growth.

### A thought exercise

Let's assume company X spends a given amount per year on factories to produce widgets. After going through a period of modernizing its facilities it decides that going forward it will spend

$80 million less per year on cap-ex than its historic run-rate as it has identified 3rd-party providers that can also manufacture widgets at or below internal costs. In addition X decides to close a couple of its less competitive facilities, saving an additional $35-40 million per year of cash costs. All things being equal (i.e. in a stable business environment) how much value did X create by these measures? If we assume that on an after tax basis incremental cash flow is $110 million per year that will be enjoyed in perpetuity, then we could use the formula PV = PMNT/r.

Of course we have to make an assumption regarding appropriate discount rate, but whether we choose 5%, 6% or 8%, we can agree that these changes created significant value.

What if X chose to use the entirety of this additional FCF for an ongoing dividend in an industry where a 4% dividend is unusually high?

If the value of $110M in perpetuity isn't $2 billion, it's probably not dramatically below it.

## Appropriate value has not accrued to Fairchild equity

The above thought exercise essentially encapsulates what has transpired with Fairchild over the past 15 months, albeit without fanfare or a dividend (thankfully, instead of a dividend, they are utilizing 100%+ of FCF for share repurchases). But clearly this value creation has not yet accrued to the equity.

On Dec. 11, 2013 Fairchild announced that it had authorized a $100 million repurchase program. Importantly, in the press release Fairchild CEO Mark Thompson commented:
"We completed a significant investment cycle to increase our 8" wafer fabrication capabilities last year and **now expect lower capital spending for many years.** The operational efficiency actions we are planning should further increase our profitability and cash flow."
(emphasis added in bold)

There was no discernible stock reaction to this news.

On August 25, 2014 Fairchild announced the realignment of global manufacturing capabilities including eliminating its internal 5" fabrication lines and reducing internal 6" capacity, as well as the closure of some of its internal assembly and test capacity. In addition, the press release noted: "Once completed, the company expects to realize annual savings of approximately $45-55 million from a second quarter of 2014 financial baseline. Of these estimated savings,

approximately 75% are expected to be cash savings, with the balance attributable to lower depreciation costs."

Once again, there was no discernible stock reaction to this news.

The lower capital spending cited by Thompson is reflected in Fairchild's financials, although underappreciated by the Street. Specifically, in 2014, depreciation and amortization exceeded cap-ex by $83 million, resulting in free cash flow of $139 million (a ~7% trailing FCF yield) versus adjusted net income of just $62 million. While we are not fans of adjustments, add-backs, etc, in this case GAAP is obfuscating the underlying, and in our view, sustainable cash generation of Fairchild. Equally important to us is that Fairchild not only generated this substantial cash flow, but also put it to its highest and best use - it executed $142 million in repurchases, reducing share count by 8%.

## Fairchild cash flows, margins and stock price should continue to improve

Using Fairchild's $142 million in 2014 free cash flow as a base line, we believe exit 2015 annual run-rate free cash flow should be near $200M, representing an approximate 10% FCF yield based on the current share price.

Specifically, using 75% (the cash portion) of the mid-point of the $45-55 million in savings from plant closures (after tax) plus 5% growth with 50% GM fall-through, less op-ex (after-tax), we arrive at $200 million in free cash flow.

**Fairchild FCF**

| | |
|---|---|
| 2014 FCF | 142 |
| Closures | 33 |
| 5% growth | 25 |
| **Total** | 200 |

We note that company expects $36 million in cash restructuring costs in 2015 associated with the closures, so FCF in 2015 is likely to be closer to $155-165 million by our estimates. Still, with $200 million FCF going forward, a current market cap of $2.1 billion, and a balance sheet with $150 million in net cash, shares appear very cheap.

In addition, it appears that the high-end of the company's 37-40% gross margin goal appears easily attainable.

*(click to enlarge)*

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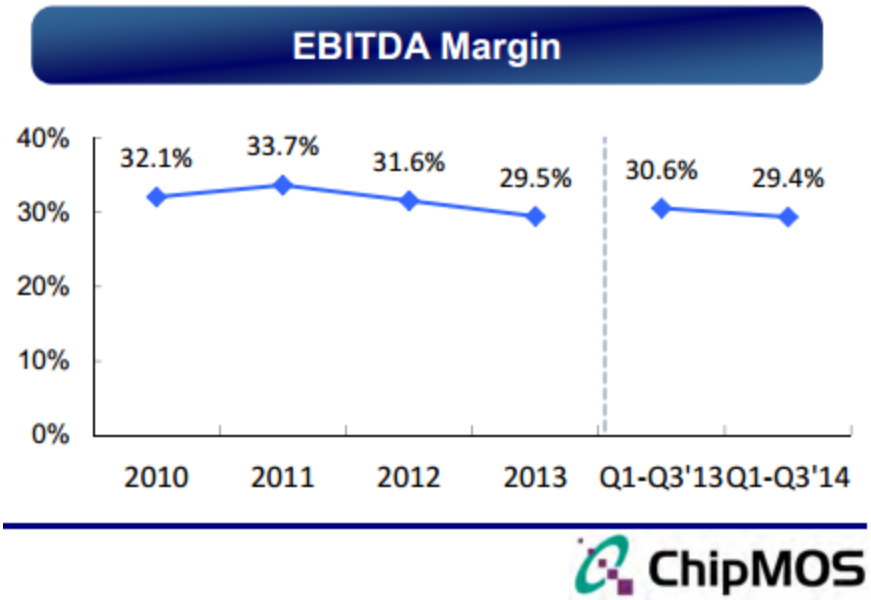
Source: Fairchild Investor Day 2014

Using Fairchild's 32.5% gross margin as a baseline, we assume that depreciation eventually converges on cap-ex (i.e. declines to $60 million from $140 million) which we believe is realistic given Mark Thompson reiterated on Fairchild's 4Q14 earnings call in January to expect annual cap-ex to remain ~$60 million. In addition we expect $35 million of cash costs to be eliminated from COGS coming from plant closures, per management guidance. In sum, we anticipate a $115 million reduction in COGS for reasons entirely under Fairchild's control, which have nothing to do with mix, market share, sales growth, etc. Assuming revenues remain flat this represents almost 800bps improvement in gross margins over the next 12-24 months, with more possible, if they can actually grow top line (with 50% fall-through on incremental sales). Semiconductor investors tend to love margin expansion stories.

While this might seem like fun and games with GAAP accounting, we believe investors will latch onto a story with significant gross margin improvement. As an example of this phenomenon we'd suggest looking at ChipMOS (NASDAQ:IMOS) which has seen its shares rise almost 5-fold over the last 4 years. In 2010 its gross margins were 3%, while they were over 25% in 3Q14 (the last reported quarter). During this same period, EBITDA margins have actually *fallen*.




Source: ChipMOS Investor Presentation

The primary reason for ChipMOS' gross margin improvement is depreciation converging towards cap-ex. An effect of sustainably lower capital requirements is free cash flow that is significantly greater than net income. Anyone who bought ChipMOS while GAAP eps was *de minimus*, benefited handsomely. In our experience, catching cash flow stories like these before they are fully appreciated by the street can generate outsized returns.

**Getting a free lunch**

The question may arise how Fairchild can get such a good deal (i.e. lower wafer costs) by outsourcing more production. After all Fairchild has largely depreciated fabs and should have a competitive cost structure. Fairchild is specifically closing 5" and certain 6" facilities in costlier geographies. Moreover we believe that pricing can be extremely competitive with foundries using 6" or 8" equipment, especially if those foundries have a low cost basis.

For example, Tower Semiconductor (NASDAQ:TSEM), which our friend Jaret Wilson has written on previously, and discusses at length today, has a JV with Panasonic which cost them $8 million in stock. Volumes from Panasonic cover overhead, so Tower can be extremely competitive on pricing, as incremental sales have very low variable costs - we believe below the cost of Fairchild's soon to be mothballed lines.

Of course, Panasonic originally paid in excess of $2 billion for these facilities and apparently grossly miscalculated their needs. So there is no free lunch - Panasonic is paying. However Fairchild stands to be a significant beneficiary, as does Tower if Tower can successfully add customers. As an aside, Tower is one of multiple companies that Fairchild cites as a foundry partner in its 10-K.

## If you like ON Semi, then you should love Fairchild

Shares of ON Semiconductor (NASDAQ:ONNN) have been red hot this year, up more than 30% year-to-date. In our view, they've been up for good reason, with excellent positioning in the industrial and auto segments, excitement about growth prospects thanks to the Aptina acquisition, margin expansion (like Fairchild targeting 40% gross margins - notably Fairchild has a 45% stretch goal, which we believe is attainable if they grow top line), and a management that intends to repurchase $1 billion of stock over the next 4 years. In addition, several highly regarded hedge funds are among ON's top shareholders, which likely has drawn further attention to shares. At the time of the $1 billion buyback announcement, repurchases would have represented over 25% of outstanding shares. Alas, the market is quickly self-correcting, and today the $1 billion would repurchase about 16% of ON's shares.

Fairchild's growth story may not be as robust as ON's, but its path to 40% gross margins seems quite attainable as we've already discussed. Based on our assumptions, Fairchild could repurchase almost 35% of its stock over the next 4 years, should shares remain at current levels. However, we doubt they will. In our experience, in cases like this, a company will either be acquired (LBO economics look very attractive) or shares will go up as more investors take notice. With little love from the sell-side, and few high profile shareholders, we'd suggest there's only one direction for sentiment, and the stock price, to go.

## Industry Consolidation

Anyone following the semiconductor industry is aware of the rapid and accelerating pace of industry consolidation - most recently NXP and Freescale. We are not going to address this possibility at length.

Our thesis is not predicated on the idea of Fairchild being acquired, although we believe it's a reasonable possibility over time. On a cash earnings basis, an acquisition at a healthy premium, would be accretive to many potential acquirers, and that's before factoring in synergies. Last summer, Fairchild was rumored to be under consideration when Infineon acquired International Rectifier. We believe ongoing consolidation activities are likely to provide a floor in shares of Fairchild and many of its peers.

## Risks

Fairchild has not demonstrated an ability to consistently grow. While management believes it has improved its go-to-market strategy, we're not sure their growth will improve or be more consistent.

The company plays in competitive markets that are cyclical in nature.

Fairchild may face dislocation due to its shift to a greater use of outsourcing. We believe this risk is severely mitigated by running extra production internally in 1H15 (which should have a significant positive impact on GM in 2Q), giving foundries multiple quarters to ramp, and having duel sources on most products.

## Outlook and conclusion

Fairchild had a worse than seasonal 4Q with revenues down 12% sequentially, in part due to distributors exiting the year with lean inventory. Given the cyclical nature of semiconductors, we think there's a good probability that a period of undershipment, will be followed by a period of robust shipments. Management noted that book-to-bill in the month of January was 1.2. We wouldn't be surprised if CEO Mark Thompson spoke positively regarding trends at the Morgan Stanley event on Wednesday.

We also note that last year's 2% y/y revenue growth would have been 3% higher if not for below plan sales from Samsung. We'd be surprised by similar slippage from Samsung this year and believe that Fairchild has higher dollar content per phone, including in the new S6.

All that being said, we believe the Street's $0.82 EPS estimate for 2015 will likely prove too low, but is also largely irrelevant. In our view, the key number is the likely $150-170 million of free cash flow Fairchild will generate this year, and the $200 million exit run rate.

As a final thought on Fairchild we'd suggest the following exercise - one we do with many of our stocks. Fairchild has significant capacity on its credit facility. What if tomorrow they announced a self-tender for 20 million shares at $20 - would the full amount be tendered? We don't think so. We expect the Street will soon take note of this exceptional cash flow story, and shares won't stay undervalued for long.