



DSP Group

(NASDAQ: DSPG)

Company Update

Outperform

Above Average Risk

Daniel Meron, Analyst

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Price: 26.50 Price Target: 30.00
 52-Wk High: 27.50 52-Wk Low: 21.81
 Float (MM): 27.4 Debt to Cap: 0.0%
 Shares Out (MM): 29.7 Market Cap (MM): 787
 Dividend: 0.00 Yield: 0.0%
 Tr. 12 ROE: 7.90% Est 3-Yr EPS Gr: 15.00%
 Trading Vol. (MM): 0.218
 Institutional Own.: 86%

(FY Dec)	2004A	2005E	2006E	2007E
EPS Cal	0.97	0.96	1.10	1.26
P/E	27.32x	27.60x	24.09x	21.03x
Revenue Net (MM)	157.50	185.80	213.50	242.50
MktCap/Rev	5.00x	4.24x	3.69x	3.25x

EPS Cal	Q1	Q2	Q3	Q4
2004	0.24A	0.29A	0.33A	0.10A
2005	0.17A	0.28A	0.35A	0.17E
2006	0.16E	0.28E	0.39E	0.26E

Revenue Net (MM)	2004	2005	2006
2004	38.70A	44.00A	46.00A
2005	40.20A	49.00A	55.60A
2006	43.20E	54.40E	64.00E

Diluted EPS, pro-forma: ex. non recurring items, special charges and gains, acquisitions impact, stock based compensation.

All values in USD unless otherwise noted.

Priced as of prior trading day's market close, EST (unless otherwise stated).

DSPG Off To A Good Start For 2006

Event

Previewing 4Q05 results, to be issued January 25 before market open + CES-tradeshaw takeaways.

Investment Opinion

- **We believe DSPG will report solid 4Q05** with backdrop of holiday season driving good demand. DSPG continues to benefit from healthy US sales and rising exposure in other regions, mainly Europe where we expect sales to almost triple Y/Y to \$35-40m. Elsewhere, we see continued traction in Japan and note Panasonic recently launched new models in China using DSPG. We also expect contribution from South-Korea in 2H06.
- **We are modeling for 4Q05 revenue of \$41.5m and \$0.17 EPS, in line with the street.** DSPG should conclude 2005 with 18% Y/Y revenue growth thanks to continued growth in US and initial sales in Europe, Japan and other regions. However, EPS will be essentially flat Y/Y on higher OpEx for its investments in
- **Investors will likely focus on DSPG outlook and the expected ramp-up in sales to new regions, mainly Europe.** We would look for more color on how gross margins are shaping up as management conservatively guided for 300 bps Y/Y drop on higher assembly and packaging costs. We also expect increasing interest in DSPG's newly launched enhanced cordless phones.
- **We came away encouraged by DSPG's outlook and positioning following management meeting and checks at CES tradeshow** (Las Vegas, early January). We believe DSPG is off to a good start for the year with high vendor interest for its designs. We note several cordless players like Panasonic, Motorola and RCA announced new designs based on DSPG's systems. These include Panasonic-Skype VoIP cordless phones to hit stores 2Q06, video-conferencing-enabled handsets, cellular docking-stations carrying wireless calls on cordless phones, home-monitoring cordless phones (e.g. baby-cameras). We were highly impressed with the functionality and ease of use of these products. **We project push from leading brands to materially expand user-adoption towards 2007.**
- **With solid market positioning, execution and management team we reiterate our Outperform rating.**

DSPG Off To A Good Start For 2006

We came away encouraged on DSPG's outlook and positioning following management meeting and checks at CES tradeshow (Las Vegas, early January). We estimate DSPG currently accounts for roughly 30% of the worldwide cordless chip market. We expect DSPG's market share to expand following its continued geographic expansion and waning competition. Indeed, we believe DSPG displaced a major DECT competitor in its own back yard in late 2005.

We believe DSPG is off to a good start for the year with high vendor interest for its designs. DSPG continues to benefit from healthy US sales and rising exposure in other regions, mainly Europe where we expect sales to almost triple Y/Y to \$35-40m. This follows design wins with the likes of Suncorp and CCT Tech that have over a third major OEM like Elsewhere; we see continued traction in Japan and note Panasonic recently launched new models in China using DSPG. We also expect contribution from South Korea in 2H06.

We note that several European brands like Siemens, Phillips and Suncorp are preparing to leverage the approval of DECT frequencies in the US and many of them will likely use DSPG's chipsets. DECT (1.8-1.9 MHz depending on geography) will likely be marketed as WiFi friendly (2.4GHz). DECT introductions may increase vendor competition and support demand yet we view this as incremental positive in US.

In addition we believe DSPG is well positioned in the home networking arena, as it is working closely with the telecom food chain, including consumer electronics vendors and telecom service providers in Europe and in the US. We note several cordless players like Panasonic, Motorola and RCA announced new designs based on DSPG's systems. These include Panasonic-Skype VoIP cordless phones to hit stores 2Q06, Video-conferencing-enabled handsets, cellular docking-stations carrying wireless calls on cordless phones, home-monitoring cordless phones (e.g. baby-cameras). We were highly impressed with the functionality and ease of use of these products.

The home networking arena and convergence attracts many new entrants, from generic based solutions like Texas Instruments (NYSE: TXN, Sector Perform, \$31.66, Above Average Risk) DSP's (Digital Signal Processors) to more specialized players like Broadcom (BRCM, Not Rated) and Marvell (MRVC, Not Rated). We believe DSPG benefits from its understanding of the consumer electronics arena, close OEM relationship, user friendly designs, and technological know-how commercial solutions for voice and video communications, WiFi, Bluetooth and others.

We project push from leading consumer electronics brands to materially expand user-adoption towards 2007. The home networking vision was a drag to DSPG earnings for the past two years and we expect to see increasing contribution from these product-lines in late-2006 and in out-years.

Valuation

DSPG is trading at 27x our FY05E EPS, 24x our FY06E EPS and 21x our FY07E EPS. Excluding its net cash position of \$340m / \$11.3 per share, or 44% of valuation, DSPG trades at 15x, 13x and 11x our forward estimates, respectively. This is essentially in line with semiconductor peers that target the consumer and communications markets that garner P/E of 27x FY05E and 22x FY06E, yet below the 24x and 19x afforded excluding cash.

Our \$30 target is based on 23x FY06E Net Operating Income After Tax plus net cash of \$337m / \$11.3 per share. Our operating multiple is essentially in-line with the multiple afforded to peers. Our \$30 target also reflects 27x FEPS, a P/E that is comparable to the one afforded to DSPG shares in most recent history.

Price Target Impediment

Potential impediments to our price target include:

- **Shift in consumer preferences from fixed telephony to cellular services** (with some subscribers using primarily mobile handsets) may cap long-term growth potential for cordless telephony.
- **Channel concentration, relying largely on Tomen**, its Japanese distributor with whom its been working for over a decade.
- **OEM concentration with two 10% end-customers**, with with Panasonic at the top.
- **Business risks:** Macro backdrop, competition, semiconductor market cyclicity, inventory build up, technology shifts, execution, rate of adoption of new high-end products.

Company Description

DSP Group is a fabless provider of System On Chip for advanced consumer electronics devices, mainly integrated in cordless phones of the likes of Panasonic, Sony, GE, Uniden Motorola, and other leading brands and OEM. DSPG's shares are included in the S&P 600 small-cap index. DSPG's headquarters are in Israel with branch offices located strategically around the globe.

DSP Group Inc. (DSPG)



Income Statements

\$ thousands, except per share, FY ends Dec.

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	1Q04A Mar	2Q04A Jun	3Q04A Sep	4Q04A Dec	FY04A	1Q05A Mar	2Q05A Jun	3Q05A Sep	4Q05E Dec	FY05E	1Q06E Mar	2Q06E Jun	3Q06E Sep	4Q06E Dec	FY06E	FY07E
Revenues	38,708	44,016	46,232	28,555	157,511	40,163	49,047	55,614	41,000	185,824	43,200	54,400	64,000	51,900	213,500	242,500
Q/Q	1%	14%	5%	-38%		41%	22%	13%	-26%		5%	26%	18%	-19%		
Y/Y	33%	14%	-2%	-25%	3%	4%	11%	20%	44%	18%	8%	11%	15%	27%	15%	14%
Cost of revenue	19,858	22,918	23,401	14,191	80,368	22,244	25,990	29,420	22,500	100,154	24,700	31,000	36,400	29,500	121,600	138,200
Gross Profit	\$ 18,850	\$ 21,098	\$ 22,831	\$ 14,364	\$ 77,143	\$ 17,919	\$ 23,057	\$ 26,194	\$ 18,500	\$ 85,670	\$ 18,500	\$ 23,400	\$ 27,600	\$ 22,400	\$ 91,900	\$ 104,300
Gross Margin	48.7%	47.9%	49.4%	50.3%	49.0%	44.6%	47.0%	47.1%	45.1%	46.1%	42.8%	43.0%	43.1%	43.2%	43.0%	43.0%
Research and Development, net	7,554	7,310	8,463	8,820	32,147	9,399	10,542	10,487	10,000	40,428	10,200	10,400	10,600	10,500	41,700	45,500
% of rev.	19.5%	16.6%	18.3%	30.9%	20.4%	23.4%	21.5%	18.9%	24.4%	21.8%	23.6%	19.1%	16.6%	20.2%	19.5%	18.8%
Sales and Marketing, net	2,803	3,282	2,929	2,278	11,292	2,886	3,290	3,706	3,100	12,982	3,200	3,400	3,600	3,300	13,500	14,700
% of rev.	7.2%	7.5%	6.3%	8.0%	7.2%	7.2%	6.7%	6.7%	7.6%	7.0%	7.4%	6.3%	5.6%	6.4%	6.3%	6.1%
General and Administrative	1,806	1,734	1,718	1,854	7,112	1,865	1,783	1,904	1,900	7,452	1,800	1,900	1,900	1,800	7,400	8,100
% of rev.	4.7%	3.9%	3.7%	6.5%	4.5%	4.6%	3.6%	3.4%	4.6%	4.0%	4.2%	3.5%	3.0%	3.5%	3.5%	3.3%
Unusual Items	-	2,727	-	2,682	5,409	-										
Proforma Operating Expenses	\$ 12,163	\$ 12,326	\$ 13,110	\$ 12,952	\$ 50,551	\$ 14,150	\$ 15,615	\$ 16,097	\$ 15,000	\$ 60,862	\$ 15,200	\$ 15,700	\$ 16,100	\$ 15,600	\$ 62,600	\$ 68,300
OpEx / Rev	31.4%	28.0%	28.4%	45.4%	32.1%	35.2%	31.8%	28.9%	36.6%	32.8%	35.2%	28.9%	25.2%	30.1%	29.3%	28.2%
Q/Q	-11%	-11%	1%	60%	5%	9%	10%	3%	-7%	32.8%	1%	3%	3%	-3%	3%	9%
Y/Y	35%	24%	9%	-4%	14%	16%	27%	23%	16%	20%	7%	1%	0%	4%	3%	9%
Operating Income *	\$ 6,687	\$ 8,772	\$ 9,721	\$ 1,412	\$ 26,592	\$ 3,769	\$ 7,442	\$ 10,097	\$ 3,500	\$ 24,808	\$ 3,300	\$ 7,700	\$ 11,500	\$ 6,800	\$ 29,300	\$ 36,000
Operating Margin	17.3%	19.9%	21.0%	4.9%	16.9%	9.4%	15.2%	18.2%	8.5%	13.4%	7.6%	14.2%	18.0%	13.1%	13.7%	14.8%
Q/Q	27%	15%	6%	-76%	16.9%	90%	62%	20%	-53%	13.4%	-11%	85%	27%	-27%	13.7%	14.8%
Y/Y	108%	19%	2%	-73%	5%	-44%	-15%	4%	NA	-7%	-12%	3%	14%	NA	18%	23%
NOPAT (Net Operating Income After Tax)	\$ 22,070	\$ 3,124	\$ 6,175	\$ 8,381	\$ 2,900	\$ 20,610	\$ 2,700	\$ 6,400	\$ 9,500	\$ 5,600	\$ 24,200	\$ 2,700	\$ 6,400	\$ 9,500	\$ 29,500	\$ 29,500
Interest income, Net	2,125	2,159	2,069	2,169	8,522	2,272	2,499	2,565	2,600	9,936	2,700	2,800	2,900	3,100	11,500	12,400
% of pretax income	24%	38%	25%	20%	43%	29%	45%	27%	20%	29%	45%	27%	20%	31%	26%	26%
Other income	21,317	7,671	15,460	-	44,448	-										
Pro forma Pretax income *	\$ 8,812	\$ 10,931	\$ 11,790	\$ 3,581	\$ 35,114	\$ 6,041	\$ 9,941	\$ 12,662	\$ 6,100	\$ 34,744	\$ 6,000	\$ 10,500	\$ 14,400	\$ 9,900	\$ 40,800	\$ 48,400
Proforma income taxes	1,498	1,859	2,005	609	5,971	1,034	1,693	2,152	1,000	5,879	1,000	1,800	2,400	1,700	6,900	8,700
% of rev.	17.0%	17.0%	17.0%	17.0%	17.0%	17.1%	17.0%	17.0%	17.0%	16.9%	17.0%	17.0%	17.0%	17.0%	16.9%	18.0%
Net Income *	\$ 7,314	\$ 9,072	\$ 9,785	\$ 2,972	\$ 29,143	\$ 5,007	\$ 8,248	\$ 10,510	\$ 5,100	\$ 28,865	\$ 5,000	\$ 8,700	\$ 12,000	\$ 8,200	\$ 33,900	\$ 39,700
Net Margin	18.9%	20.6%	21.2%	10.4%	18.5%	12.5%	16.8%	18.9%	12.4%	15.5%	11.6%	16.0%	18.8%	15.8%	15.9%	16.4%
Y/Y	71%	18%	2%	-50%	6%	-32%	-9%	7%	72%	-1%	0%	5%	14%	61%	17%	17%
EPS (Diluted, adj. for one-time items)	\$ 0.24	\$ 0.29	\$ 0.33	\$ 0.10	\$ 0.97	\$ 0.17	\$ 0.28	\$ 0.35	\$ 0.17	\$ 0.96	\$ 0.16	\$ 0.28	\$ 0.39	\$ 0.26	\$ 1.10	\$ 1.26
Q/Q						66%	64%	26%	-52%	15.5%	-3%	72%	37%	-32%	15.9%	16.4%
Y/Y	59%	12%	4%	-48%	4%	-29%	-5%	5%	65%	0%	-3%	1%	11%	56%	14%	15%
Wtd. Avg., Diluted Shares Outstanding	30,698	30,975	29,358	29,092	30,031	29,606	29,718	30,079	30,300	29,926	30,500	30,900	31,000	31,200	30,900	31,500

Note: Proforma figures, ex. special charges and gains
Source: RBC Capital Markets, Company data

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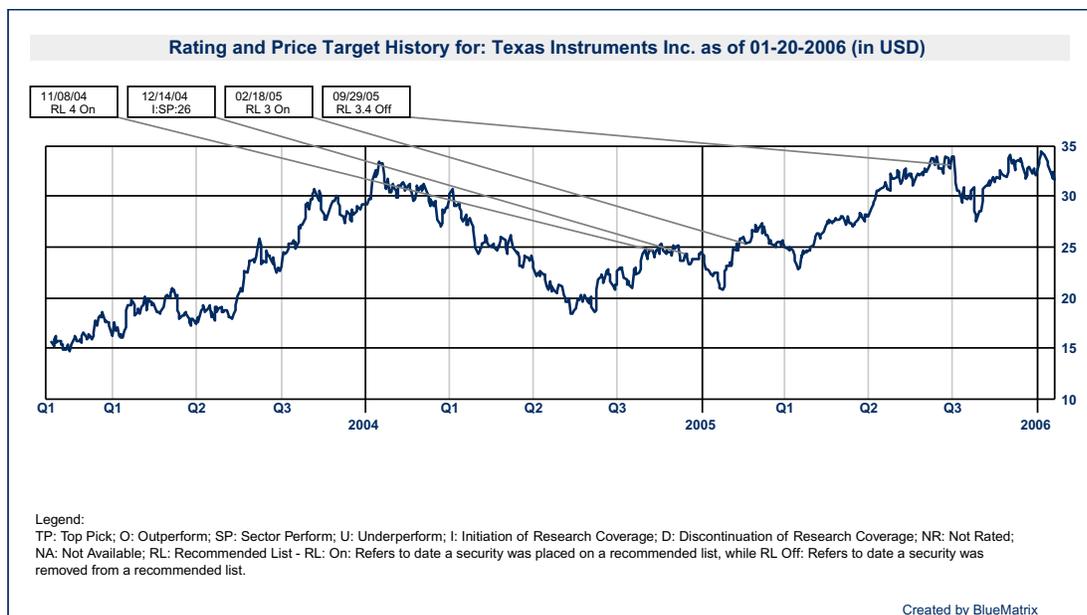
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