



COMPANY UPDATE | COMMENT

JANUARY 27, 2010

DSP Group (NASDAQ: DSPG)
Solid Outlook Underscores Our Positive Stance

Outperform
Above Average Risk

Price:	7.11	Price Target:	10.00
Shares O/S (MM):	23.1	Implied All-In Return:	41%
Dividend:	0.00	Market Cap (MM):	164
Float (MM):	21.6	Yield:	0.0%
Debt to Cap:	0%	Enterprise Val. (\$MM):	38.5
Institutional Ownership:	83%	Avg. Daily Volume (MM):	0.30
Priced as of 12:17pm ET, January 27, 2010.		3-Yr. Est. EPS Growth:	15.00%

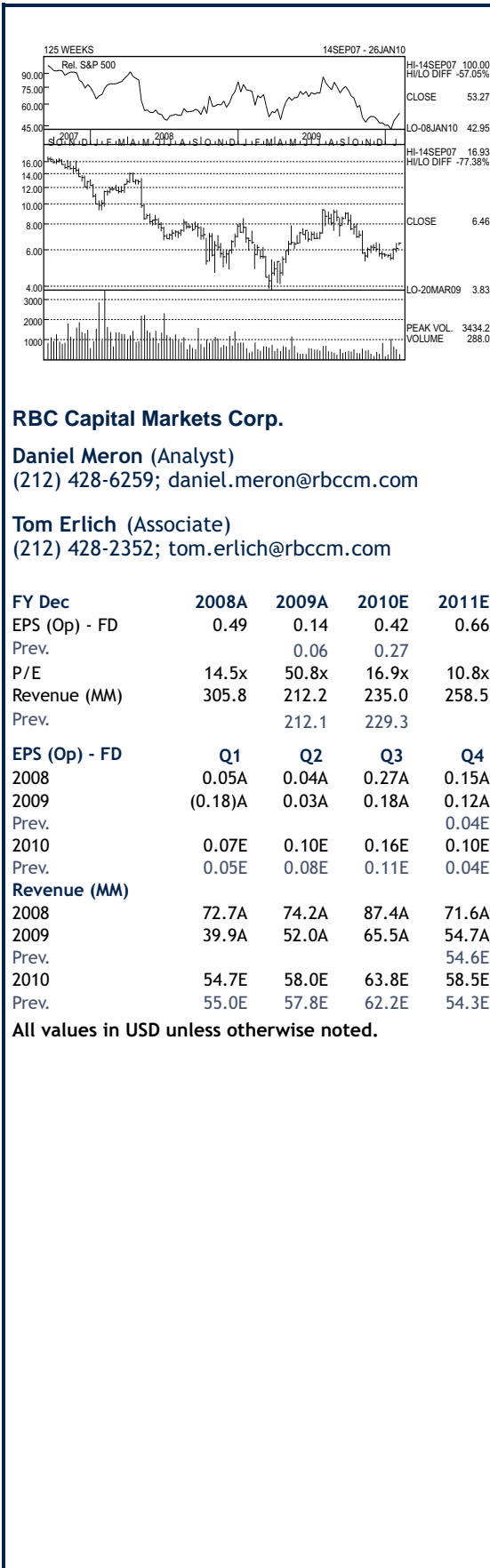
Investment Opinion

DSPG reported healthy 4Q09 results with revenues ahead of Street and in line with our estimates, accompanied by strong EPS upside. We're encouraged by management's upbeat commentary on recovering end-markets and expected 2H10 kick-in of next-gen products. We believe visibility recovered, backed by backlog almost covering 1Q10 guidance; furthermore, management provided full-year guidance, matching Street estimates. We highlight that management tends to be conservative with targets. We reiterate Outperform rating, which we established January 25 on improving outlook, firming fundamentals, and expect positive newsflow around next-gen products to drive multiple expansion from 0.2x EV/S closer to peers' 1.6x.

- **Good 4Q09 performance:** DSPG reported 4Q09 revenue of \$54.7m (-17% Q/Q on seasonality), compared to peers'/RBC \$53.5m/\$54.6m. DECT remained strong at 72% mix (3Q09:79%). Solid gross margins, OpEx control and lower share-count drove material non-GAAP EPS upside of \$0.12, well ahead of peers/RBC at \$0.06/\$0.04. Operating cash flow was strong at \$13m and net cash up to \$123m or \$5.4/share.
- **Upbeat management commentary:** We believe DSPG's performance supports our view the cordless market has stabilized. We're encouraged by management's positive commentary on improving business tone in end-markets like Europe and US. Following initial intro's at the CES tradeshow, management expects several of its Next-generation products available by 2H10, which may get support from major carriers. These products include form factors like tablets, wifi-phones, and non-phone DECT connected devices, which management factors at \$20m or ~9% of FY10 guidance.
- **Guidance may prove conservative:** Management set 1Q10 midpoint at \$53.5m/\$0.06, compared to our \$55m/\$0.05 and peers' \$52m/\$0.01. More importantly, DSPG expects 9%-10% FY10 top-line to \$233m at midpoint, broadly in line with our/Street's \$229m/\$236m, with EPS midpoint also in line at ~\$0.40. Provision of 2010 guidance is positive indicator for visibility and we note management has a history of being conservative with forward guidance; starting with in line indicates possible upward trajectory as FY10 unfolds.
- **Raising estimates:** We're adjusting estimates to account for improving end-markets and visibility. For 1Q10 we now model \$54.7m/\$0.07, and considering \$49m in year end backlog, the target looks very realistic. For FY10 we now model top-line of \$235m (+11% Y/Y). We expect gradual gross margin improvement and now model FY10 EPS of \$0.42. We're introducing preliminary FY11 estimates of \$259m/\$0.66.

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

For Required Conflicts Disclosures, see Page 5.



Details

Good 4Q09 performance....

DSPG reported 4Q09 revenues of \$54.7m, ahead of our two peers average at \$53.5m and in line with our \$54.6m. Revenue was down 17% Q/Q on seasonality and down 24% Y/Y. DECT sales remained strong at 72% mix (3Q09:79%).

Gross margins hit 39.4%, a four-quarter high and following a spike in 3Q09, opex returned to normalized levels at \$19.4m, with lower R&D (RBC OpEx:\$21m). With good operational performance, the company soundly beat EPS estimates with \$0.12 in non-GAAP EPS, way above our \$0.04, Street's \$0.06 and management's \$0.03 midpoint. GAAP EPS was (\$-0.13) on 12c in stock based compensation and 13c in amortization expenses.

We were also impressed with strong operating cash flow of \$13m (3Q09: \$2.4m), driving Net Cash of \$123m at the end of FY09, up ~\$10m Q/Q. The net cash position is now up to \$5.4/share, up from \$4.8/share last quarter and balance sheet is clean.

Exhibit 1: DSPG 4Q09: Estimates vs. Actuals (\$ thousands)

	4Q09A DSPG	4Q09E RBC	3Q09A	4Q08A
Revenues	\$ 54,720	\$ 54,600	\$ 65,532	\$ 71,551
<i>Q/Q</i>	-16%	-17%	26%	-18%
<i>Y/Y</i>	-24%	-24%	-25%	-16%
Operating Profit	\$ 2,185	\$ -	\$ 3,820	\$ 4,235
<i>Margin</i>	4.0%	0.0%	5.8%	5.9%
EPS	\$ 0.12	\$ 0.04	\$ 0.18	\$ 0.15
<i>Q/Q</i>	-33%	-79%	484%	-44%
<i>Y/Y</i>	-17%	-74%	-31%	-48%

Source: RBC Capital Markets estimates, Company reports.

...Caps a year of transition:

DSPG ended FY09 with \$212m in revenues, down 31% Y/Y, as macro and semi industry's de-stocking hit 1Q, followed by gradual recovery and limited visibility. Nevertheless, DSPG returned to profitability earlier than expected, swiftly adjusted OpEx and recorded FY09 EPS of \$0.14 and \$27m in cash flow from operations, in addition to aggressively reducing share count by 3.8m YTD.

In addition, after 13 years at the helm, CEO & BoD Chairman Eli Ayalon stepped down as CEO at the end of 2Q09, and was replaced by current CEO Mr. Ofer Elyakim. We believe CEO transition at DSPG was seamless. Mr. Ayalon, a highly-regarded hi-tech persona, remains involved as Executive Chairman.

Upbeat management commentary

We were encouraged by management's positive commentary on end markets as DSPG expects conditions in its major end markets, including Europe and the US, to improve. Concurrently, visibility in the company's traditional handset market is improving, evident in \$49m of December 31st backlog, covering most of 1Q10.

Management highlighted it expects several of its Next-generation designs and products in the marketplace by 2H10 with backing from several carriers, we believe mainly in Europe with prospects elsewhere as well. These products include the likes of tablets, wifi-phones, non-phone DECT connected devices, which management factors at \$20m / 9% of FY10 guidance. We believe these devices may offer good price - performance in the cordless and handset market.

Good 1Q10 and FY10 Guidance:

Management set the 1Q10 midpoint at \$53.5m / \$0.06, compared to our \$55m / \$0.05 and peers' \$52m/\$0.01. More importantly, the company expects FY10 top-line to increase by 9%-10%, implying \$233m at the midpoint (\$225m-\$240m range) broadly in line with our \$229m and our peer average of \$236m. EPS midpoint is ~\$0.40, also broadly in line.

We note that the provision of 2010 guidance is positive indicator for visibility and that management has a history of being conservative with forward guidance, so starting out with in line guide is good enough and we expect some upward move as year unfolds.

Raising estimates for FY10; Introducing FY11 figures

We are adjusting our estimates to account for improving end markets and better visibility into both traditional end markets. For 1Q10 we now model \$54.7m in revenues, compared to our prior \$55m. We are slightly lowering our gross margin estimates on product mix and seasonality as well as OpEx figures on good cost controls and model 1Q10 EPS of \$0.07, two cents above our previous estimates.

For FY10 we now model 11% top line growth (was:8%) to \$235m, on the upper-half of guidance range and expect gradual gross margin improvement as mix shifts towards more lucrative XpandR product. We account for lower OpEx and interest income and now model FY10 EPS of \$0.42, above our previous estimate of \$0.27 and a touch above midpoint of \$0.40.

We're introducing our preliminary FY11 estimates, conservatively modeling 10% top line increase as we expect broadly flattish cordless revenues and uptick in the next-gen product family. Improved revenue mix may drive gross margins upwards and we model EPS of \$0.66.

Valuation

- Despite what we believe is stabilization in pricing and end markets as well as achievable FY10 targets, DSPG's valuation has been depressed and has not rebounded like other peers in semi.
- We believe long term risk / reward is compelling with limited downside as DSPG is trading just above cash level of \$5.4 per share at 0.2x EV/S our F2010 estimates. This is well below peers' median of 1.6x these respective years, and at the bottom of peers' range of 0.25x-3.4x range. DSPG also trades at ~5x EV / Taxed earnings and ~1x EV/FCF.
- We expect improved news flow and performance to drive multiple expansion closer to peers. Our \$10 target is based on 0.5x EV/S our FY10 estimates, at the low-end of peers and accounts for estimated cash position of \$123m and post-buyback share count.

Price Target Impediment

- **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.
- **OEM concentration** with several 10% end-customers, including VTech, Panasonic, Uniden, Suncorp and CCT Tech.
- **Integration risks associated with the NXP Cordless unit acquisition.**
- **Business risks:** Macro backdrop, competition, semiconductor market cyclically, 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 key OEM and ODM like Vtech, Panasonic, Philips, Uniden, Ascalade, GE, Sony, Thomson, CCT Tech, Suncorp and others. DSPG's shares are included in the S&P 600 small-cap index. DSPG's headquarters are in Israel with additional branch offices worldwide.

DSP Group Inc. (DSPG)

Income Statements

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

	FY07E	1Q08A Mar	2Q08A Jun	3Q08A Sep	4Q08E Dec	FY08E	1Q09A Mar	2Q09A Jun	3Q09A Sep	4Q09A Dec	FY09A	1Q10E Mar	2Q10E Jun	3Q10E Sep	4Q10E Dec	FY10E	FY11E
Revenues	248,788	72,729	74,152	87,368	71,551	305,800	39,914	52,020	65,532	54,720	212,186	54,700	58,000	63,800	58,500	235,000	258,500
Q/Q		-15%	2%	18%	-18%		-44%	30%	26%	-16%		0%	6%	10%	-8%		
Y/Y	15%	48%	41%	41%	-16%	23%	-45%	-30%	-25%	-24%	-31%	37%	11%	-3%	7%	11%	10%
Cost of revenue	146,796	45,519	47,936	54,295	43,143	190,900	26,296	32,745	40,596	33,175	132,812	33,800	35,700	39,300	36,200	145,000	157,700
% of revenue	59.0%	62.6%	64.6%	62.1%	60.3%	62.4%	65.9%	62.9%	61.9%	60.6%	62.6%	61.8%	61.6%	61.6%	61.8%	61.7%	61.0%
Gross Profit	\$ 101,992	\$ 27,210	\$ 26,216	\$ 33,073	\$ 28,408	\$ 114,900	\$ 13,618	\$ 19,275	\$ 24,936	\$ 21,545	\$ 79,374	\$ 20,900	\$ 22,300	\$ 24,500	\$ 22,300	\$ 90,000	\$ 100,800
Gross Margin	41.0%	37.4%	35.4%	37.9%	39.7%	37.6%	34.1%	37.1%	38.1%	39.4%	37.4%	38.2%	38.4%	38.4%	38.2%	38.3%	39.0%
Research and Development, net	51,345	17,937	16,998	16,267	15,409	66,600	12,163	12,229	14,093	12,410	50,895	12,500	12,700	12,800	12,700	50,700	52,400
% of rev.	20.6%	24.7%	22.9%	18.6%	21.5%	20.0%	30.5%	23.5%	21.5%	22.7%	24.0%	22.9%	21.9%	20.1%	21.7%	21.6%	20.3%
Sales and Marketing, net	17,444	5,514	5,192	5,127	5,183	21,000	4,058	3,816	4,213	4,029	16,116	4,100	4,300	4,400	4,300	17,100	18,000
% of rev.	7.0%	7.6%	7.0%	5.9%	7.2%	6.5%	10.2%	7.3%	6.4%	7.4%	7.6%	7.5%	7.4%	6.9%	7.4%	7.3%	7.0%
General and Administrative	10,014	3,144	3,530	3,539	3,581	13,800	3,034	3,167	2,810	2,921	11,932	2,900	3,000	3,100	3,000	12,000	12,400
% of rev.	4.0%	4.3%	4.8%	4.1%	5.0%	4.0%	7.6%	6.1%	4.3%	5.3%	5.6%	5.3%	5.2%	4.9%	5.1%	5.1%	4.8%
Unusual Items	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Proforma Operating Expenses	\$ 78,803	\$ 26,595	\$ 25,720	\$ 24,933	\$ 24,173	\$ 101,400	\$ 19,255	\$ 19,212	\$ 21,116	\$ 19,360	\$ 78,943	\$ 19,500	\$ 20,000	\$ 20,300	\$ 20,000	\$ 79,800	\$ 82,800
OpEx / Rev	31.7%	36.6%	34.7%	28.5%	33.8%	33.2%	48.2%	36.9%	32.2%	35.4%	37.2%	35.6%	34.5%	31.8%	34.2%	34.0%	32.0%
Q/Q		-1%	-3%	-3%	-3%		-20%	0%	10%	-8%		1%	3%	1%	-1%		
Y/Y	24%	61%	57%	31%	-10%	29%	-28%	-25%	-15%	-20%	-22%	1%	4%	-4%	3%	1%	2%
Operating Income *	\$ 23,189	\$ 615	\$ 496	\$ 8,140	\$ 4,235	\$ 13,500	\$ (5,637)	\$ 63	\$ 3,820	\$ 2,185	\$ 431	\$ 1,400	\$ 2,300	\$ 4,200	\$ 2,300	\$ 10,200	\$ 18,000
Operating Margin	9.3%	0.8%	0.7%	9.3%	5.9%	4.4%	-14.1%	0.1%	5.8%	4.0%	0.2%	2.6%	4.0%	6.6%	3.9%	4.3%	7.0%
Q/Q		-93%	-21%	129%	-36%		NA	NA	NA	-43%		NA	NA	NA	-45%		
Y/Y	-9%	-79%	-90%	28%	-53%	-42%	NA	NA	NA	-48%	NA	NA	NA	NA	5%	NA	NA
NOPAT (Net Operating Income After Tax)	\$ 19,700	\$ 500	\$ 400	\$ 7,000	\$ 3,600	\$ 10,800	\$ (5,200)	\$ 100	\$ 3,900	\$ 2,100	\$ 509	\$ 1,100	\$ 1,900	\$ 3,400	\$ 1,900	\$ 8,338	\$ 14,609
Interest income, Net	11,538	1,234	898	486	503	3,100	603	582	582	559	2,326	600	600	600	600	2,400	2,700
% of pretax income	33%	67%	64%	6%	11%	19%	-12%	90%	13%	20%	84%	30%	21%	13%	21%	19%	13%
Pro forma Pretax income *	\$ 34,727	\$ 1,849	\$ 1,394	\$ 8,626	\$ 4,738	\$ 16,600	\$ (5,034)	\$ 645	\$ 4,402	\$ 2,744	\$ 2,757	\$ 2,000	\$ 2,900	\$ 4,800	\$ 2,900	\$ 12,600	\$ 20,700
Proforma income taxes	5,497	408	375	1,259	751	2,793	(411)	(73)	66	(83)	(501)	400	500	900	500	2,300	3,900
% of rev.	15.8%	22.1%	26.9%	14.6%	15.9%	19.9%	8.2%	11.3%	-1.5%	3.0%	-18.2%	20.0%	17.2%	18.8%	17.2%	18.3%	18.8%
Net Income *	\$ 29,230	\$ 1,441	\$ 1,019	\$ 7,367	\$ 3,987	\$ 13,800	\$ (4,623)	\$ 718	\$ 4,336	\$ 2,827	\$ 3,258	\$ 1,600	\$ 2,400	\$ 3,900	\$ 2,400	\$ 10,300	\$ 16,800
Net Margin	11.7%	2.0%	1.4%	8.4%	5.6%	4.5%	-11.6%	1.4%	6.6%	5.2%	1.5%	2.9%	4.1%	6.1%	4.1%	4.4%	6.5%
Q/Q		-73%	-86%	-3%	-56%		NA	NA	-41%	-29%		NA	NA	-10%	-15%	216%	195%
Y/Y	-13%	-75%	-86%	3%	-48%	-51%	NA	-13%	-31%	-17%	-72%	NA	218%	-13%	-21%	211%	56%
EPS (Diluted, adj. for one-time items)	\$ 0.99	\$ 0.05	\$ 0.04	\$ 0.27	\$ 0.15	\$ 0.49	\$ (0.18)	\$ 0.03	\$ 0.18	\$ 0.12	\$ 0.14	\$ 0.07	\$ 0.10	\$ 0.16	\$ 0.10	\$ 0.42	\$ 0.66
Q/Q		-84%	-23%	63%	-44%		NA	-118%	484%	-33%		NA	48%	60%	-39%		
Y/Y	-13%	-75%	-86%	3%	-48%	-51%	NA	-13%	-31%	-17%	-72%	NA	218%	-13%	-21%	211%	56%
Wtd. Avg., Diluted Shares Outstanding	29,646	30,757	28,373	27,740	26,892	28,441	26,023	22,901	23,662	23,058	23,911	23,700	24,100	24,500	24,700	24,300	25,400

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

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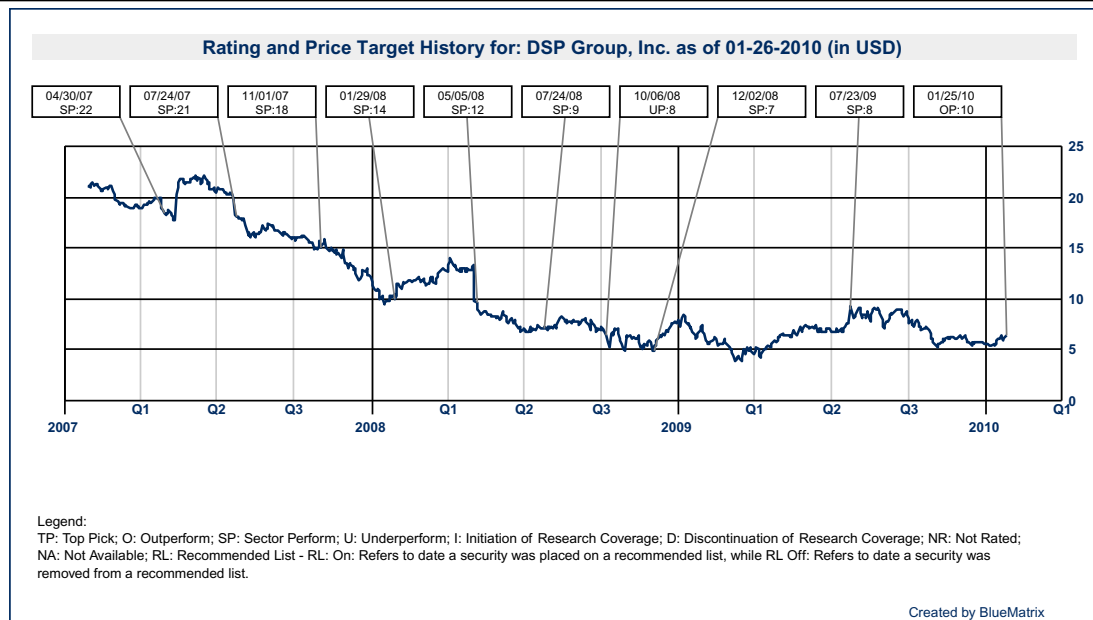
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