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SEMICONDUCTOR DEVICES

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NASDAQ: DSPG
PRICE: \$18.50
RATING: BUY

DSPG: DISAPPOINTING Q3 OUTLOOK – ALL EYES ON COMPLETION OF NXP DEAL

Investment Conclusion: Before the market open today, DSP Group reported Q2:07 results of pro forma EPS of \$0.25 on revenue of \$52.4M. Revenues were mostly in line with the Street's and our estimate of \$52M and \$0.25. The highlight of the call was the disappointing Q3 guidance of \$45-49M, much lower than consensus at \$58M largely because of declining unit sales in the 2.4GHz US market and a drop off in one of DSP Group's major US 5.8GHZ OEM customers. While guidance is disappointing and the company continues to face pressures in both its 2.4GHz and 5.8GHz markets, we believe that the completion of the NXP acquisition and the potential positive financial impact is a strong selling point to owning the stock at these levels. With the acquisition expected to be completed in late Q3, we believe that it will have a positive impact as: 1) NXP is very strong in both DECT and Analog – two areas which are seeing strength in the market currently; 2) Strong Opex and product development synergies as both companies are the two leaders in the cordless phone market; 3) Additional customer base like Vtech which currently is gaining market share in the 5.8Ghz US market and Siemens provides new customer penetration opportunity for the combined company; and 4) Significant expected financial accretion in 2008 on the heels that NXP has a much stronger operational model than DSPG. We are maintaining our BUY rating on DSPG and our \$24 price target.

- In-Line Q2 results though disappointing Q3 outlook.** Before the market open today, DSP Group reported Q2:07 results of pro forma EPS of \$0.25 on revenue of \$52.4M. The revenue growth in the quarter was largely associated with the European DECT and the US DECT (6.0) markets. Nevertheless, we were disappointed in management's guidance for Q3 at revenues of \$45-49M compared to our and street estimates of \$58M. Management commented that the falloff in revenues was due to three major issues: 1) The company's 5.8GHz business is falling off as one major OEM customer has reduced its exposure to this market as it is having difficulty competing in the US market; 2) The unit falloff in 2.4GHz continues to be greater than expected as customers are shifting to 5.8GHz and to DECT 6.0; 3) The challenging US digital market – there has been surprisingly some market share gains in Analog, to which DSPG has little exposure.
- Reducing Q3 and 2007 Estimates.** The company provided a revenue range in Q3:07 of \$45-49M with GM essentially flat with that of Q2. As a result of the company's revised guidance range, we are cutting our Q3:07 revenue estimate to \$47M (-10% Q/Q growth) compared to our previous estimate of \$58M (+11% Q/Q); we are also cutting our pro forma EPS estimate to \$0.18 (from \$0.27). We are disappointed in the company's guidance

Stock Data

12-Month Price Target	\$24.00
52-Week Range	\$25.74 - 17.69
10-Day Avg. Daily Volume	217,566

Revenues

	2006A	2007E	2008E
FY ends December			
Revenue (MM)	\$216.9	\$193.2	\$221.8
Previous Estimate (MM)	\$216.9	\$208.3	\$232.8
Price/Revenue	2.4x	2.7x	2.4x
EV/Revenue	0.9x	1.0x	0.9x
Secular Growth Rate			NA

Capitalization

Shares Outstanding (MM)	28.5
Market Capitalization (MM)	\$526.7
Enterprise Value (MM)	\$191.8
Debt/Total Cap. (6/30/07)	4.8%
Cash (6/30/07) (MM)	\$353.7
Cash/Share (6/30/07)	\$12.42

Earnings Per Share*

	2006A	2007E	2008E
Q1	\$0.26	\$0.19 A	\$0.18
Q2	\$0.34	\$0.25 A	\$0.26
Q3	\$0.37	\$0.18	\$0.35
Q4	\$0.16	\$0.15	\$0.21
Fiscal Year EPS	\$1.13	\$0.77	\$1.01
Previous Estimate	\$1.13	\$0.90	\$1.11
P/E	16.3x	24.0x	18.4x

Please see the [Important Disclosures Section](#) at the end of this report.

NC indicates no change from current estimate. NE indicates no estimate. NM indicates not meaningful.

Sources: WR Hambrecht + Co estimates and company reports

considering that Q3 tends to be the strongest quarter of the year. Overall, 2007 is coming down to be a year of rapid product transition away from 2.4GHz, in which the company was not well prepared to deal with. Our 2007 revenue and EPS estimates are \$193M and \$0.77, respectively. Nevertheless, as the acquisition of NXP is expected to be completed at the end of this quarter, both Q3 and 2007 numbers are likely to change significantly and become more accretive.

- **All eyes on the NXP acquisition.** As the acquisition is expected to be completed at the end of this quarter, we believe that investors should see the NXP transaction as very positive for the following reasons: 1) make DSP Group a much stronger vendor in Europe where NXP has traditionally been quite dominant (we estimate the combined company will likely have ~60% share in the DECT segment); 2) add new important OEM customers such as Vtech and Siemens, one of the few OEMs whom DSP had not had access to in the past. Vtech has been gaining 5.8GHz share in the US; 3) potential leverage in the combined entity's operating model based on management's comments that NXP has a similar level of revenues and GM but a "materially" lower overall opex run-rate which should make the deal immediately accretive on a pro forma basis; 4) give the combined company a total of 300 R&D personnel as well as the addition of R&D centers in Switzerland, Germany, France, and India; and 5) As part of this purchase DSP Group will also gain access to 90nm technology from NXP for future VOIP products that could save the company time, effort, and money.
- **Maintaining Buy rating as NXP should make the story look brighter.** Despite the disappointing guidance and the lack of growth, we recommend long-term investors take any pullback in the stock to build their long-term positions in DSPG shares as we believe that: 1) potential leverage in the model given the cost savings that are to be derived from the combined entity with NXP makes this deal accretive on a pro forma basis; 2) the possibility for further revenue expansion and GM improvement beyond current DSP Group's standalone estimates in 2008 from new products; 3) potential growth opportunities with its new COIP phone, which is shipping to Europe and the new VoIP Panasonic products; and 4) remaining buy back program (13% of outstanding shares before dilution) provides support to the stock at these levels. We are maintaining our Buy rating and \$24 price target, based upon 12x forward CY:08E pro forma EPS estimate of \$1.01 plus ~\$12.00 of cash per share before the close of the transaction.

DSP Group Inc. (DSPG)

Historical & Projected Income Statement

(\$ thousands, except per share data)

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DSP Group Inc. (DSPG) FY ENDS DECEMBER	Q1:06 Mar	Q2:06 Jun	Q3:06 Sep	Q4:06 Dec	Q1:07 Mar	Q2:07 Jun	Q3:07E Sep	Q4:07E Dec	Q1:08E Mar	Q2:08E Jun	Q3:08E Sep	Q4:08E Dec	2006A	2007E	2008E
REVENUE	\$51,952	\$60,737	\$ 63,875	\$ 40,383	\$49,288	\$52,436	\$47,000	\$44,500	\$48,000	\$55,800	\$64,500	\$53,500	\$216,947	\$193,224	\$221,800
COST OF REVENUE	30,277	35,502	37,563	24,756	29,835	31,067	27,542	25,810	27,600	32,085	37,088	30,763	128,098	114,254	127,535
% of revenues	58.3%	58.5%	58.8%	61.3%	60.5%	59.2%	58.6%	58.0%	57.5%	57.5%	57.5%	57.5%	59.0%	59.1%	57.5%
GROSS PROFIT	21,675	25,235	26,312	15,627	19,453	21,369	19,458	18,690	20,400	23,715	27,413	22,738	88,849	78,970	94,265
% of revenues	41.7%	41.5%	41.2%	38.7%	39.5%	40.8%	41.4%	42.0%	42.5%	42.5%	42.5%	42.5%	41.0%	40.9%	42.5%
OPERATING EXPENSES:															
Research & development	9,679	10,706	10,589	10,197	10,669	10,536	10,900	11,300	11,900	12,000	12,200	12,400	41,171	43,405	48,500
% of revenues	18.6%	17.6%	16.6%	25.3%	21.6%	20.1%	23.2%	25.4%	24.8%	21.5%	18.9%	23.2%	19.0%	22.5%	21.9%
Sales & marketing	3,538	3,716	4,013	3,720	3,997	3,910	4,000	4,000	4,200	4,300	4,500	4,500	14,987	15,907	17,500
% of revenues	6.8%	6.1%	6.3%	9.2%	8.1%	7.5%	8.5%	9.0%	8.8%	7.7%	7.0%	8.4%	6.9%	8.2%	7.9%
General & administrative	1,875	1,724	1,917	1,631	1,896	1,916	1,900	1,900	1,900	2,000	2,150	2,150	7,147	7,612	8,200
% of revenues	3.6%	2.8%	3.0%	4.0%	3.8%	3.7%	4.0%	4.3%	4.0%	3.6%	3.3%	4.0%	3.3%	3.9%	3.7%
Total operating expenses	15,092	16,146	16,519	15,548	16,562	16,362	16,800	17,200	18,000	18,300	18,850	19,050	63,305	66,924	74,200
% of revenues	29.0%	26.6%	25.9%	38.5%	33.6%	31.2%	35.7%	38.7%	37.5%	32.8%	29.2%	35.6%	29.2%	34.6%	33.5%
PRO FORMA OPERATING INCOME (EBIT)	6,583	9,089	9,793	79	2,891	5,007	2,658	1,490	2,400	5,415	8,563	3,688	25,544	12,046	20,065
% of revenues	12.7%	15.0%	15.3%	0.2%	5.9%	9.5%	5.7%	3.3%	5.0%	9.7%	13.3%	6.9%	11.8%	6.2%	9.0%
Other income (expense):															
Interest and other Income	3,109	3,351	3,372	3,366	3,652	2,927	3,700	3,800	3,850	3,900	3,950	4,000	13,198	14,079	15,700
Income after financial and other:	9,692	12,440	13,165	3,445	6,543	8,930	6,358	5,290	6,250	9,315	12,513	7,688	38,742	27,121	35,765
PRO FORMA PRETAX INCOME	9,692	12,440	13,165	3,445	6,543	8,930	6,358	5,290	6,250	9,315	12,513	7,688	38,742	27,121	35,765
% of revenues	18.7%	20.5%	20.6%	8.5%	13.3%	17.0%	13.5%	11.9%	13.0%	16.7%	19.4%	14.4%	17.9%	14.0%	16.1%
Benefit (provision) for income tax	1,648	2,115	2,262	(1,295)	1,210	1,760	1,144	952	1,125	1,677	2,252	1,384	4,730	5,067	6,438
Tax rate	17.0%	17.0%	17.2%	(37.6%)	18.5%	19.7%	18.0%	18.0%	18.0%	18.0%	18.0%	18.0%	12.2%	18.7%	18.0%
PRO FORMA NET INCOME	\$8,044	\$10,325	\$10,903	\$4,740	\$5,333	\$7,170	\$5,214	\$4,338	\$5,125	\$7,638	\$10,260	\$6,304	\$34,012	\$22,054	\$29,327
% of revenues	15.5%	17.0%	17.1%	11.7%	10.8%	13.7%	11.1%	9.7%	10.7%	13.7%	15.9%	11.8%	15.7%	11.4%	13.2%
GAAP NET INCOME	5,638	7,088	8,052	1,600	1,364	4,870	2,914	2,038	2,825	5,338	7,960	4,004	22,378	11,185	20,127
% of revenues	10.9%	11.7%	12.6%	4.0%	2.8%	9.3%	6.2%	4.6%	5.9%	9.6%	12.3%	7.5%	10.3%	5.8%	9.1%
PRO FORMA EPS	\$ 0.26	\$ 0.34	\$ 0.37	\$ 0.16	\$ 0.19	\$ 0.25	\$ 0.18	\$ 0.15	\$ 0.18	\$ 0.26	\$ 0.35	\$ 0.21	\$ 1.13	\$ 0.77	\$ 1.01
GAAP EPS	\$ 0.18	\$ 0.23	\$ 0.27	\$ 0.06	\$ 0.05	\$ 0.17	\$ 0.10	\$ 0.07	\$ 0.10	\$ 0.18	\$ 0.27	\$ 0.14	\$ 0.74	\$ 0.39	\$ 0.69
Basic shares outstanding	29,477	29,871	29,279	28,746	28,455	28,257	28,357	28,457	28,657	28,857	29,057	29,257	29,343	28,382	28,957
Fully diluted shares outstanding	30,784	30,632	29,748	29,031	28,691	28,469	28,569	28,669	28,869	29,069	29,269	29,469	30,049	28,600	29,169
Y/Y % CHANGE															
REVENUE	29.4%	23.8%	14.9%	(4.8%)	(5.1%)	(13.7%)	(26.4%)	10.2%	(2.6%)	6.4%	37.2%	20.2%	15.9%	(10.9%)	14.8%
GROSS PROFIT	21.0%	9.4%	0.5%	(17.7%)	(10.3%)	(15.3%)	(26.0%)	19.6%	4.9%	11.0%	40.9%	21.7%	3.1%	(11.1%)	19.4%
PRO FORMA OPERATING INCOME (EBIT)	74.7%	22.1%	(3.0%)	(98.0%)	(56.1%)	(44.9%)	(72.9%)	1,786.1%	(17.0%)	8.1%	222.1%	147.5%	0.8%	(52.8%)	66.6%
PRO FORMA NET INCOME	60.7%	25.2%	3.7%	(17.0%)	(33.7%)	(30.6%)	(52.2%)	(8.5%)	(3.9%)	6.5%	96.8%	45.3%	15.4%	(35.2%)	33.0%
PRO FORMA EPS	54.5%	21.4%	4.9%	(14.3%)	(28.9%)	(25.3%)	(50.2%)	(7.3%)	(4.5%)	4.3%	92.1%	41.4%	14.7%	(31.9%)	30.4%
Q/Q % CHANGE															
REVENUE	22.5%	16.9%	5.2%	(36.8%)	22.1%	6.4%	(10.4%)	(5.3%)	7.9%	16.3%	15.6%	(17.1%)			
GROSS PROFIT	14.2%	16.4%	4.3%	(40.6%)	24.5%	9.8%	(8.9%)	(3.9%)	9.1%	16.3%	15.6%	(17.1%)			
PRO FORMA OPERATING INCOME (EBIT)	63.1%	38.1%	7.7%	(99.2%)	3,559.5%	73.2%	(46.9%)	(43.9%)	61.1%	125.6%	58.1%	(56.9%)			
PRO FORMA NET INCOME	40.9%	28.4%	5.6%	(56.5%)	12.5%	34.4%	(27.3%)	(16.8%)	18.1%	49.0%	34.3%	(38.6%)			
PRO FORMA EPS	37.2%	29.0%	8.7%	(55.5%)	13.8%	35.5%	(27.5%)	(17.1%)	17.3%	48.0%	33.4%	(39.0%)			

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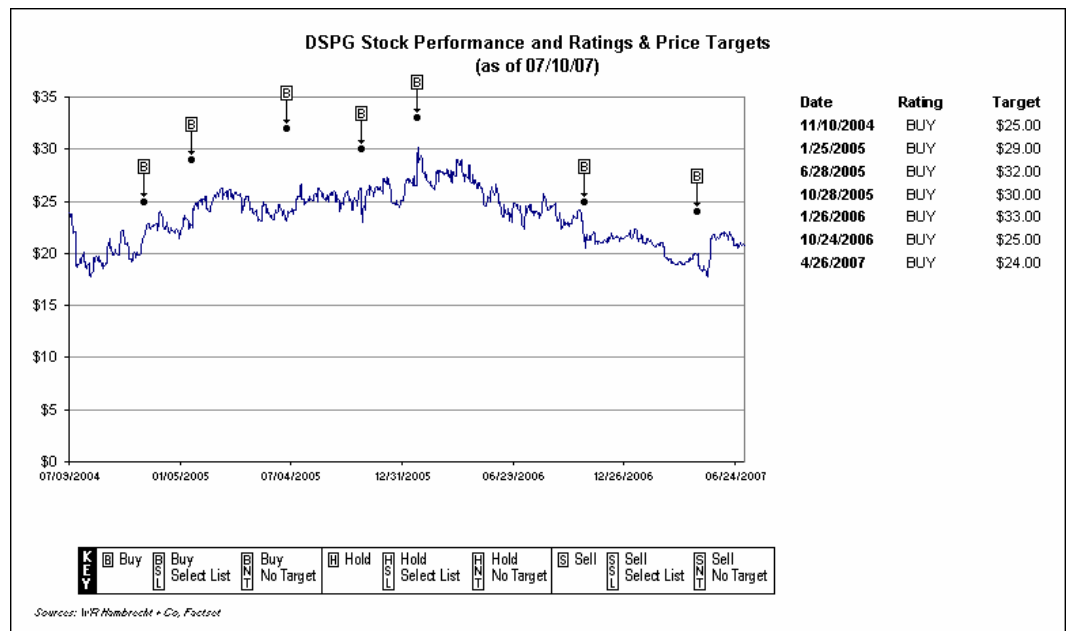
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Our DSP Group (DSPG) \$24 price target is based on 12x forward CY:08E pro forma EPS estimate of \$1.01 plus \$~12.00 of cash per share before the close of the transaction.

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