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Semiconductors

Vest Fest Revisited - The Party Continues

Reason for Report: Industry Update

Industry

Highlights:

- As mandatory options expensing draws closer, we've been following how the companies in our universe of coverage are likely to react. One step that many of our companies are contemplating is accelerated vesting for out-of-the-money options.
- Accelerated vesting allows companies to report the expense associated with options for the quarter in which they're vested. That means that companies are able to take a substantial one-time hit and report the item only as a footnote. Of course, the other result is a substantial increase in exercisable options, and a decrease in the retention value of the options program.
- Since our initial report published in April, 13 more semiconductor and semiconductor equipment companies have announced accelerated vesting. As of today, 23 companies or 42% of our semiconductor and semiconductor equipment coverage universe have announced accelerated vesting. With a few months left before FAS123 kicks in, we think that many other companies are contemplating the move.
- For most companies, accelerated vesting has a significant impact on total options outstanding. If we assume that the remainder of our companies take out options just above the current price, with no additional premium, the result is an average 39% **reduction** in the number of unvested options. Taking out options with strikes at a 20% premium to the current price, a more conservative approach that some companies are taking, drives a 28% reduction in unvested options.
- Tying the reduction in unvested options back to stated options expense is difficult. What we can say is that the companies that have accelerated options vesting to date have reported total expense reductions that vary between 26% and 100% of the 2004 options expense run rate as calculated under FAS 123R. At a very simplistic level, the percentage reduction in the unvested options count should signal the magnitude of reduction in the expensing run rate. See the table on page 3 for more details.

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■ Companies now taking options expensing seriously

As mandatory options expensing draws nearer we continue to look at the details of how options expensing will be implemented, and how companies are likely to react. Companies are now taking options expensing seriously, and acting accordingly – one result of that has been increased focus on accelerated options vesting.

■ We think FAS 123R numbers could change

It's easy enough to figure out what reported income would be for 2005 under FAS 123R. What's more interesting is to examine how options expense calculated under the FAS 123R rules is likely to change over time. We've already pointed that key input assumptions for options pricing models used by our universe of companies vary substantially, which raises questions about the comparability of the FAS 123R numbers as reported. We expect companies to take a hard look at their model assumptions for new options grants.

■ Accelerated vesting could have a significant impact

Another issue that hasn't received sufficient attention is the impact that accelerated vesting will have on stated options expense. Our checks indicate that many, if not all, of the companies that we cover are looking at accelerating vesting for out-of-the-money options in the remaining months before FAS123 takes effect. Accelerated vesting allows companies to report the expense associated with options for the quarter in which they're vested. That means that companies are able to take a substantial one-time hit and report the item only as a footnote. Of course, the other result is a substantial increase in exercisable options, and a reduction in the employee retention value associated with the options program.

On the following page we've summarized data for our universe of semiconductor and capital equipment companies that have not announced accelerated vesting. Specifically, we've measured how many outstanding options each company has reported in total, and how many of those options are vested or unvested. Additionally, we've looked at how many unvested options are in the money now, and how many strike within either a 10% or 20% premium to the current stock price.

The analysis of how the strike price distribution breaks down is important, because approaches to accelerated vesting vary. Some companies are taking everything off the table that has a strike price above the stock price on a given day. Other companies are taking a more conservative approach, only accelerating vesting for options with strike prices more than 10% or even 20% above the current stock price.

■ Up to 37% of current unvested options could vest if companies accelerate

For most companies, even using the more conservative approach, accelerated vesting has a significant impact on total options outstanding. If we assume that our companies take out options above the current price, with no additional premium, the result is an average **39% reduction** in the number of unvested options. At a 10% premium, an average 34% of unvested options vest, and at a 20% premium the result is a 28% reduction.

■ Tying back to options expense is difficult, but expect a significant impact

Tying the reduction in unvested options back to stated options expense would be nice. Unfortunately, working backwards to figure out how options were valued when granted, which is what matters for the expense calculation, turns out to be impossible. What we can say is that the companies that have accelerated options vesting to date have reported total expense reductions that vary between 26% and 100% of the 2004 options expense run rate as calculated under FAS 123R. At a very simplistic level, the percentage reduction in the unvested options count should signal the magnitude of reduction in the expensing run rate. See the table on page 3 for more details.

The relative benefit of accelerated vesting will decline over time as new options are granted and expensed. Then again, we expect companies to become more judicious with future options grants now that expensing is becoming mandatory.

■ 23 of 55 semi and semi equipment companies have accelerated vesting so far – expect more

23 of the 55 companies that we've included in this report have already announced accelerated options vesting, per the table below. We think that many of the remaining 32 companies take similar action during the next several months.

Table 1: Companies already announced accelerated vesting

Semiconductor		Semiconductor Equipment		
ADI	LLTC	AEIS	ENTG	TER
AGR	MCHP	AMAT	ESIO	UTEK
AMD	MU	AMKR	LRCX	VECO
FCS	RFMD	ASYT	MKSI	
ISIL	VTSS	CYMI	PHTN	

Source: Company SEC filings

(Continued)

Table 2: Summary Option Count Information – Companies that have not announced accelerated options vesting

	Options Outstanding	Vested Options	Unvested Options	Est percentage of unvested options that vest at a...		
				0% premium	10% premium	20% premium
Semiconductors						
AATI	5,033	770	4,263	0%	0%	0%
ALTR	62,367	35,338	27,029	82%	78%	72%
AMIS	6,074	2,349	3,725	77%	77%	77%
ATYT	27,883	13,771	14,112	67%	64%	45%
BRCM	97,640	51,866	45,774	13%	12%	11%
CY	43,095	25,330	17,765	49%	47%	45%
INTC	883,900	397,500	486,400	53%	37%	25%
FSL	34,572	4,551	30,021	0%	0%	0%
IDTI	19,447	12,381	7,066	91%	88%	51%
LSI	67,733	44,301	23,432	50%	41%	33%
MPWR	8,001	2,294	5,708	2%	0%	0%
MRVL	50,232	18,123	32,109	1%	0%	0%
MXIM	101,887	46,523	55,365	45%	22%	11%
NETL	2,250	1,483	767	0%	0%	0%
NSM	76,700	53,200	23,500	1%	1%	1%
NVDA	46,160	29,061	17,099	3%	2%	1%
SGTL	3,883	2,271	1,612	72%	67%	62%
SLAB	9,981	3,897	6,084	55%	45%	36%
SMTC	16,054	10,039	6,015	76%	53%	29%
SNDK	22,632	12,017	10,616	1%	1%	0%
TXN	241,089	142,778	98,311	41%	36%	30%
XLNX	60,643	45,444	15,199	96%	73%	68%
Semiconductor Capital Equipment						
A	70,976	31,023	39,953	25%	17%	9%
ATMI	4,263	2,433	1,830	13%	9%	5%
KLAC	33,379	17,332	16,047	19%	11%	3%
KLIC	8,160	4,451	3,709	69%	69%	69%
NVLS	26,705	15,647	11,058	99%	99%	93%
PLAB	1,969	1,412	556	54%	47%	40%
STAK	3,691	2,075	1,615	23%	22%	20%
TSRA	6,618	3,671	2,947	11%	8%	5%
WFR	9,279	2,658	6,621	1%	1%	1%

Source: Company Information, Merrill Lynch

Analyst Certification

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Buy	83	36.56%	Buy	17	20.48%
Neutral	133	58.59%	Neutral	19	14.29%
Sell	11	4.85%	Sell	1	9.09%

Investment Rating Distribution: Global Group (as of 30 September 2005)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1076	40.21%	Buy	350	32.53%
Neutral	1399	52.28%	Neutral	412	29.45%
Sell	201	7.51%	Sell	36	17.91%

* Companies in respect of which MLPF&S or an affiliate has received compensation for investment banking services within the past 12 months.

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