Company Name: Ezchip Semiconductor Ltd
Company Ticker: EZCH IT
Date: 2011-05-04
Event Description: Q1 2011 Earnings Call

Market Cap: 2,772.61
Current PX: 10650
YTD Change($): +510
YTD Change(%): +5.030

Bloomberg Estimates - EPS
Current Quarter: 0.267
Current Year: 1.147
Bloomberg Estimates - Sales
Current Quarter: 16.360
Current Year: 69.080

Q1 2011 Earnings Call

Company Participants

- Ehud Helft, CCG Investor Relations
- Eli Fruchter, President and Chief Executive Officer
- Dror Israel, Chief Financial Officer

Other Participants

- Gary Mobley
- Jeff Schreiner
- Daniel Meron
- Joseph Wolf
- Jay Srivatsa
- Sandeep Shyamsukha
- Quinn Bolton
- Paul McWilliams

MANAGEMENT DISCUSSION SECTION

Operator

Ladies and gentlemen, thank you for standing by. Welcome to the EZchip First Quarter 2011 Results Conference Call. All participants are at present in a listen-only mode. Following management's formal presentation, instructions will be given for the question-and-answer session. [Operator Instructions] As a reminder, this conference is being recorded May 4, 2011.

I would like to remind everyone that forward-looking statements for the respective company's business, financial condition and the result of its operations are subject to risks and uncertainties which could cause actual results to differ materially from those contemplated. Such forward-looking statements include, but are not limited to, product demand, pricing, market acceptance, changing economic conditions, risks in product and technology development, and the effect of the company's accounting policies, as well as certain other risk factors which are detailed from time-to-time in the company's filing with the various securities authorities.

I'd now like to turn the call over to Mr. Ehud Helft of CCG Investor Relations. Please go ahead, sir.

Ehud Helft, CCG Investor Relations

Thank you, operator, and good day to everybody. I would like to welcome all of you to EZchip's first quarter 2011 conference call, and thank EZchip's management for hosting this call. With us on the line today are Mr. Eli Fruchter, the CEO, and Mr. Dror Israel, the CFO.

Before we begin, I would like to point out that during this call certain non-GAAP financial measures will be discussed. These non-GAAP measures are used by management to make strategic decisions and forecast future results, and the company believes that these figures provide a better method of evaluating the company's current performance. A full reconciliation of the company's non-GAAP financial measures to GAAP financial measures is included in the earnings release issued earlier today.

I would now like to hand over the call to EZchip's CEO, Eli Fruchter. Eli?

Eli Fruchter, President and Chief Executive Officer

Thank you, Ehud. Good day everyone and welcome to our first quarter 2011 conference call. This has been a quarter where two of our three larger customers went through an inventory adjustment. Despite the declining revenues, we presented a healthy non-GAAP net income of 41% of revenues, with record gross margins of 78.5%, operating cash flow of $4.9 million, and $108.5 million in cash at the end of the quarter with zero debt.

Looking at our quarterly revenues in further detail. Revenues from our specialized NP-3 processors, sold to Cisco through Marvell, grew significantly to $4.6 million, reaching 35% of revenues in the first quarter, up 104% sequentially and up 205% from the first quarter of last year.

We are pleased with Cisco's return to that revenue level following the inventory adjustment that took place during the fourth quarter. We continue to believe that we are still in the ramp-up phase at Cisco and we expect it will become our biggest customer over time.

First quarter revenues from Juniper totaled $2.9 million, or 22% of the quarter's revenues, down 57% sequentially and down 58% from the first quarter last year. We believe that the decline was mostly a result of seasonal patterns, as well as an inventory adjustment.

Due to the Q1 decline, our full year 2011 sales to Juniper is expected to decline versus 2010, despite Juniper's continued strong sales of MX products that are based on the NP-2. As we progress into 2011, we expect to be able to better assess sales to Juniper and update you on our next earnings call. It is important, however, to reiterate that while NP-2 revenues from Juniper are expected to decline in 2011 versus 2010, we expect such 2011 NP-2 revenues to be more than offset by 2011 NP-3 and NP-4 revenues from other customers.

First quarter revenues from ZTE, China's second largest networking and telecom equipment vendor, totaled $350,000, or 3% of revenues, down 78% sequentially and down 67% from the first quarter last year. We believe that excess inventory that was created by ZTE in the fourth quarter of 2010 was consumed during the first quarter, resulting in a significant decline in revenues from ZTE in the first quarter.

We continue to believe ZTE is still early in its ramp and we are pleased to see that orders for the second quarter are back at previous levels. All other customers as a group, excluding Cisco, Juniper and ZTE, totaled $5.3 million, or 40% of the first quarter's revenues, down 19% sequentially and up 29% from the first quarter of last year.

Looking ahead, there are several large CESR customers in this group that are now designing several important platforms based on the NP-4, and we expect these large CESR customers will move to production with these NP-4 based systems during the second half of the year.

Turning now to our next generation products. NP-4 is making good progress and is on track to move into production in the second half of 2011, when it is expected to start generating meaningful revenues. I would like to reiterate that we believe the NP-4 represents four times the revenue opportunity of NP-2 and NP-3 combined, since NP-4 has already accumulated twice as many high volume design wins as NP-2 and NP-3 combined. And NP-4 is expected to be sold at approximately twice the average selling price of NP-2 and NP-3.

During the first quarter, we continued to see strong interest in the NP-5. NP-5 doubles NP-4's processing power and triples the port density, and our key customers view the NP-5 as the natural next step of their NP-4 based CESR platforms. As with NP-4, we believe the NP-5 will provide a significant time to market advantage over competing solution, as our customers will be able to reuse their huge NP-4 software investments.

The NPA family, it's introduction and we continue to win NPA designs and continue developing additional NPA products that are broadening our offering. Our customers attain significant benefits from the common architecture across our high speed and access product lines, and we are seeing many of our customers, including Tier 1 customers,

adopting both the NP and the NPA lines.

We are also making good progress in our new design center in Kiryat Gat, and they have already hired over 25 people there. The new product line that we are developing there is high-end, high ASP and high margins, and we've significantly increased our total available market.

Our long-term strategy is to enter new markets where we can differentiate ourselves through placing the bar extremely high for the competition to catch up. We believe that the new product line that we are now developing falls into that category, and we are extremely encouraged by the responses we are receiving from the limited number of strategic customers that we are working closely with throughout our development cycle.

During the quarter, The Linley Group published the 2010 Guide to Network Processors. The Linley Group estimates that EZchip's 2010 network processor revenues is $75 million including the Marvell portion, placing EZchip number two in market share for merchant network processors, second to Intel.

As you recall, Intel exited the NPU market five years ago and has now declined in market share for the first time. EZchip was ranked number five in 2006 – sorry, number seven in 2006, number five in 2007, number four in 2008, number three in 2009, and now number two in 2010, with the goal of becoming the market share leader in network processors.

In summary, 2011 is shaping to be a transition year for EZchip, transitioning from Juniper to Cisco and from NP-2 to NP-3 and NP-4. We now expect a decline from Juniper compared to 2010 that will be offset by our other customers, resulting in a year-over-year growth in 2011 compared to 2010. We are also expecting additional Tier 1 CESR customers that are not major customers today to become more significant for us in 2012 when their NP-4 based platforms are expected to ramp up.

With regards to guidance for the upcoming quarter, we believe that revenues in the second quarter of 2011 will be close to our record revenues in the fourth quarter of 2010. Gross margin in the second quarter are expected to be in the 78% range, similar to the first quarter, driven by a similar product mix.

I would now like to turn over the call to our CFO, Dror Israel, for a more detailed financial review. Dror?

Dror Israel, Chief Financial Officer

Thank you, Eli. In order to better understand our business, we are providing both GAAP and non-GAAP results. While we discuss the non-GAAP results on this call, the GAAP results and the reconciliation between the figures are included in our earnings release. The non-GAAP financial measures exclude the effect of stock-based compensation, amortization of intangible assets and changes in the deferred tax asset.

Now to the results. Revenues for the first quarter of 2011 totaled $13.2 million, down 3% from the $13.6 million in the first quarter of 2010, and down 23% from the $17.1 million in the prior quarter. Juniper accounted for $2.9 million, or 22% of revenues, for the quarter. Cisco, through Marvell, accounted for $4.6 million, or 35% of revenues.

ZTE accounted for $350,000, or 3% of revenues, for the quarter. Our other customers, which includes some of the world's other Tier 1 networking vendors, as a group accounted for $5.3 million, or 40% of revenues.

Non-GAAP gross margin for the quarter totaled 78.5%, up from the 73.1% in the first quarter of 2010 and above the 74.7% last quarter. As we have mentioned in the past, the special version NP-3 processor that we sell to Marvell bears a royalty model, and as Marvell represents a larger share of our revenues, we see gross margins growing accordingly.

Non-GAAP R&D expenses, net, for the quarter totaled $3.3 million. This amount included $0.9 million in R&D grants received from the Israeli Office of the Chief Scientist. On a gross basis, our R&D expenses for the quarter totaled $4.2 million.

Non-GAAP operating expenses for the quarter totaled $5.3 million, compared to $4.2 million in the first quarter last year and compared to $4.5 million in the prior quarter. We expect that our annual OpEx level in 2011 will be around $23 million with the OpEx growth resulting primarily from a significant increase in our R&D staff in Kiryat Gat.

Non-GAAP operating income for the quarter was $5 million, a decrease of 12% from the $5.7 million operating income in the first quarter last year, and down 39% from the $8.3 million operating income in the prior quarter. Non-GAAP net income for the quarter totaled $5.4 million, a decrease of 10% from the $6 million net income last year, and down 37% from the $8.6 million in the previous quarter.

Fully diluted EPS on non-GAAP basis was $0.19, down from $0.23 in the first quarter last year and from $0.31 in the previous quarter. Cash, cash equivalent and marketable securities totaled $108.5 million as of March 31st, compared to $101.3 million at the end of the previous quarter. Cash generated from operations during the quarter was $4.9 million, cash used in investing activities was $0.1 million, cash provided by financing activities was $2.5 million resulting from the exercise of stock options, and additional $0.1 million decrease resulted from unrealized loss in marketable securities.

With that, I would like to open the call for the Q&A session. Operator?

Q&A

Operator

Thank you, sir. Ladies and gentlemen, at this time we will begin the question-and-answer session. [Operator Instructions] The first question is from Gary Mobley of Benchmark Capital. Please go ahead, sir.

<Q - Gary Mobley>: Hi, guys. I guess the question probably on most investors' minds relates to the timing of the NP-4 ramp, whether it's the third quarter or fourth quarter of this year. And I was hoping you could provide some commentary regarding that? And then as well, about the beyond and before, what type of visibility or what degree of visibility do you have in Q3 as it relates to sales to existing customers and as well their inventory levels?

<A - Eli Fruchter>: Hi, Gary. Thank you for the question. So, regarding the NP-4, we feel pretty certain that NP-4 will move to production in the second half. It's a little bit still early to say if it's Q3 or Q4. Hopefully, we'll be able to know at the end of the current quarter, but right now we still don't know. But as I said, I feel comfortable about moving the NP-4 to production this year. Regarding Q3, it's a little bit too early to talk about Q3. As we said about Q2, we said that it's going to be close to Q4, and we'll have to wait until the results of Q2 to have a clear picture on the third quarter.

<Q - Gary Mobley>: Okay, fair enough. I guess there's been some speculation that NP-4 isn't ready for full production and possibly it might take a re-spin, is there any truth to that?

<A - Eli Fruchter, President and Chief Executive Officer>: Well, what was the question, sorry?

<Q - Gary Mobley>: Is NP-4 ready for production or are there additional tweaks that have to be made to the part?

<A - Eli Fruchter, President and Chief Executive Officer>: We are not talking about development cycles or things that are happening with any of our chips during the development phase. But I did say that NP-4 will move to production in the second half of the year. So, I think that that by itself provides the answer.

<Q - Gary Mobley>: Okay. The ramp of NP-4 or the shipment of NP-4, is that correlated mostly with the shipment of 10-terabit-per-second routers?

<A - Eli Fruchter, President and Chief Executive Officer>: NP-4, yeah, I would say that NP-4 will be used mostly on 10-gigabit line card, while the NP-3 is used on 1-gigabit and 10-gigabit. Simply the NP-4 will provide more 10-gigabit ports, and therefore the line cards that will use the NP-4 will have much higher port density than the ones that are shipping with the NP-3.

<Q - Gary Mobley>: Okay. Last question for me. Based on your revenue guidance and your margin guidance for the second quarter, it would indicate that your sales to Marvell would be in the range of $5.8 million to $6 million in the quarter, nice sequential ramp. Do you have any visibility as to the inventory levels for Marvell shipping into Cisco or is that more indicative of actual shipper levels to end-demand?

<A - Eli Fruchter, President and Chief Executive Officer>: We don't have visibility into the inventory levels. And I cannot – this is still a ramp-up phase and during ramp-up phases, we always said that revenues could be lumpy and we continue to say that. But we feel comfortable that NP-4 will grow very significantly starting in the second half of the year and next year. And we believe that NP-3 is also – NP-4 is obviously early, but NP-4 is – also the NP-3 is still early and we believe that NP-3 will evolve as well. But I'm talking about annual growth, I cannot be sure that we will grow quarter-over-quarter and we will not have lumpy quarters with inventory adjustments, such as the one that we just saw.

<Q - Gary Mobley>: Right, great. Thanks, guys.

<A - Eli Fruchter, President and Chief Executive Officer>: Thank you, Gary.

Operator

The next question is from Jeff Schreiner of Capstone Investments. Please go ahead, sir.

<Q - Jeff Schreiner>: Yeah, good morning, gentlemen. Thank you very much for taking my question. Eli, obviously we've established with a lot of your answers there that the NP-4 is going to be shipping in the – going into production through the end of second half. However, last conference call you talked about NP-4 shipments being meaningful in fiscal year '11, and meaningful possibly being 10% of revenue. How do you view the NP-4 shipment at this time? Are they still looking to be meaningful in the back half?

<A - Eli Fruchter, President and Chief Executive Officer>: Obviously, Jeff, it will be meaningful once it's in production. So, if it goes to production in Q3, obviously it will be more meaningful than if it will only go into production in Q4. But I think that that's a very short-term thing. And as we said many times, we feel that the opportunity for NP-4 is big, and I don't think that it matters a lot if it's Q3 or Q4. We believe that NP-4 will grow very significantly for us in the coming years.

<Q - Jeff Schreiner>: Okay. You've talked more about some continued NPA design wins on the access side. And I think we've heard about that for a couple of quarters now, and I'm just wondering if you have anymore visibility or anything you can maybe talk to us about outside the high-speed area, when we can look at NPA becoming a much more meaningful part of revenues, maybe 10% or so revenues?

<A - Eli Fruchter, President and Chief Executive Officer>: We don't know yet. We believe that it can get to that level. We don't know how long it will take and we don't think that it will happen in 2011, so I don't think that NPA will become 10% in 2011. It is also important to mention here that when we are talking on access versus metro, there are many access systems that are using the NP family. So, the fact that we have the NPA, even though that we don't see the revenues from the NPA yet, we are winning NP deals in the access space in boxes that require higher bandwidth, because we have the NPA.

So, I think that the NPA is contributing not just revenues, but it's contributing to the fact that we are the only company in the NPU space that provides chips from the low to the high-speed, the entire range that uses the same software and the same architecture. And that by itself is very meaningful and customers like it, and that's one of the reasons that they select EZchip.

<Q - Jeff Schreiner>: Okay, very helpful, Eli. Dror, final question for me. Just wondering about the overall kind of linearity of gross margin throughout the year. Obviously had a big step up due to kind of the overall mix and you've kind of guided to Q2. But I'm wondering if the NP-2, Juniper type shipments are going to be down this year. That would say that mix is probably going to be more towards a Marvell-Cisco type shipment, meaning possibly higher gross margins. Should we expect margins to move any higher from 78% throughout this year?

<A - Dror Israel>: Hi, Jeff. So, it may, but I think for modeling purposes we should stay at 78%, and assume a similar product mix to what we have in Q1.

<Q - Jeff Schreiner>: Okay. Gentlemen, thank you very much for your time this morning.

<A - Dror Israel, Chief Financial Officer>: Thank you, Jeff.

Operator

The next question is from Daniel Meron of RBC. Please go ahead, sir.

<Q - Daniel Meron>: Hello, Dror and Eli. Can you guys provide us with a little bit more color on your progress with NP-5. I think last quarter you said that you had some wins of NP-5 design. So, where do you sit right now?

<A - Eli Fruchter, President and Chief Executive Officer>: Hi, Daniel. So, as we move forward and the NP-5 is becoming more and more real and closer, I think that more and more customers are planning on using the NP-5, and as I mentioned, NP-5 is really an expansion of the NP-4. It's a high level of integration. It's a higher bandwidth, higher port density, and it is only natural for our customers to move from NP-4 to NP-5, because of the huge software investment that was made on the NP-4 and in many cases also the NP-3.

So, I think that our customers view that as a natural step forward. And we specifically mentioned the first design wins, because we got them a lot earlier than we originally felt we will get them, and that's why we mentioned it once we got them. And we will continue to get more and more design wins from – for NP-5, I have no doubt on that, but I don't think that we will be reporting each quarter we got another one or another one. I think that we are – we feel pretty comfortable that our NP-4 customers will use NP-5.

<Q - Daniel Meron>: Okay, that's helpful. And Eli, please tell us so we can be on – at least we have a sense where we stand right now. Can you quantify how many of the top ten Carrier Ethernet providers you already signed up with or top five or top fifteen whatever number you can provide us with, that would be helpful?

<A - Eli Fruchter, President and Chief Executive Officer>: So, there are seven CESR vendors. Those are the seven biggest ones. I think that you can see that on our investors presentation. We only mentioned the names that owned more than 5% in the market and we are working today with six of them, and five of them selected NP-4. So, we work with most of them as you can see. And so we go up from NP-2, which we had only one, to NP-3 that we have two of them, and now with NP-4 we have five of them, so I think that we are making good progress in that market segment.

<Q - Daniel Meron>: Okay, I'll leave it there. And on Juniper, you mention that you expected to go down despite the ongoing growth in MX. Can you provide us with a sense on what is the extent of the decline one way or the other that you expect in 2010 – sorry, 2011? And where do you think the inventory levels stand right now? I think Sanmina already pre-announced pretty low numbers and it is a reflection, I guess, of the inventory correction that's happened with Juniper, but where do you stand right now with the Juniper inventory? Thank you.

<A - Eli Fruchter, President and Chief Executive Officer>: So, as for revenues from Juniper, they continue to sell the MX. And actually if you look at MX revenues for Juniper, it's pretty steady in the last several quarters, according to what they said in the earnings call it's around $130 million, and so there is no decline there. The MX family is growing through the MX 3D that uses their internal ASICs, so that's where the growth for the MX is coming from, but MX that uses NP-2 is now declining.

We are talking about the decline from Juniper mainly because of the first quarter and the inventory correction. So, they went from – to inventory levels at the end of the first quarter which are very, very minimal, close to zero. Based on what we are seeing now, we believe that Q1 was the lowest quarter in the year for our revenues from Juniper. So, we think that it will get better from now, but still revenues from Juniper for the year will be lower than last year. Okay?

<Q - Daniel Meron>: Okay, very good. Thank you, good luck.

<A - Eli Fruchter, President and Chief Executive Officer>: Thank you, Daniel.

Operator

The next question is from Joseph Wolf of Barclays Capital. Please go ahead, sir.

<Q - Joseph Wolf>: Thanks. Just a couple of follow-ons; one is, given the inventory correction at ZTE, where you just became a 10% customer – were a 10% customer last year. What kind of visibility do you have into the recovery there or the ordering patterns and stability at ZTE, and do you expect them to be a 10% customer at the end of the year?

<A - Eli Fruchter, President and Chief Executive Officer>: Thank you for the question, Joseph. So, we did see an inventory correction at ZTE. And as I said, we see the order for Q2 back at a level that we had in Q4. So, that was an inventory correction. Going forward, I cannot tell you that they will not do it again. But I think that the level that we are seeing now, which is the Q4 level, represents their current consumption.

<Q - Joseph Wolf>: Okay. Now a question maybe for – on the R&D side. If we look at as a percentage of sales with or without the contribution from the state, should we be thinking about R&D at the dollar level that it is now and growing with sales for the rest of the year or is this kind of steady state quarterly run rate at that $4.3 million or so?

<A - Dror Israel, Chief Financial Officer>: So, Joseph, I think that instead looking at the R&D as a separate line item, look at the entire operating expenses. We guided for $23 million for this year, so of course to reach the $23 million, it means that it will trend a little bit higher from quarter-to-quarter, which goes together with the increase in – mainly in head count, which is mainly resulting from the new design center in Kiryat Gat. So, most of that will come from R&D, but we provide general OpEx number and not just specifically R&D numbers.

<Q - Joseph Wolf>: But is the ramp-up in cost at Kiryat Gat, is some of that one-time in terms of costs associated with getting it up and running or are we at a new level with head counts and costs into a – into an out-year model?

<A - Dror Israel, Chief Financial Officer>: Yes, so the new design center is – will create a step-up in operating expenses that will remaining in the following years. Actually some of that will even effect 2011. So, I think in general – again for modeling purposes, I think $23 million for 2011, and then it may go up by maybe 15%, and maybe even to 20%, above $27 million in 2012. Again, it's very early now to discuss this number as a general trend. And then I think that in the following years it will start growing by 10% each year to sustain the market segment that we will be at that point, meaning the current NP product lines and new product lines that will be developed in Kiryat Gat.

<Q - Joseph Wolf>: Thank you, Dror.

Operator

The next question is from Jay Srivatsa of Chardan Capital Markets. Please go ahead, sir.

<Q - Jay Srivatsa>: Thanks for taking my questions. Congratulations on a good quarter. In terms of Juniper, given that MX revenues at Juniper appears to have reached some stability, as you mentioned, are you expecting that your revenues from Juniper from Q2 onward would be a steady state?

<A - Eli Fruchter, President and Chief Executive Officer>: Hi, Jay, we – as I said, I think that Q1 was – since we have that inventory correction, I think that that would probably turn out to be the lowest quarter in the yield for us with Juniper. I think that it will trend up, but again it will trend up quarterly, but not compared to the first quarter, but it will not be higher than 2010 annually.

<Q - Jay Srivatsa>: All right. In terms of Juniper's own initiatives towards the next-generation ASIC, do you have any insight into where they are? And do you expect that to become a threat to NP-3 or NP-4 as you look ahead?

<A - Eli Fruchter, President and Chief Executive Officer>: I don't think that I can discuss here Juniper's internal ASIC. So, I believe that what they currently have is aligned more or less to the NP-3. I believe that NP-4 is better than what they have. I don't know about – or I don't want to discuss their plan for their next chip. I'm sure that they will discuss it once it is available. Our business plan currently for NP-4 does not include Juniper.

<Q - Jay Srivatsa>: Last question, in terms of your new design center and what's going on there in terms of product development, what kind of timing are we looking at? Do you expect to have something materialize in 2012 or is it more beyond that?

<A - Eli Fruchter, President and Chief Executive Officer>: It's beyond that.

<Q - Jay Srivatsa>: Okay. And maybe one more question. It appears several service providers, including Verizon and some of the operators in Russia, appear to be moving very quickly to upgrading their networks and backbone and backhaul portions. Do you expect – and looks like they have selected some of your customers as a part of their selection process. Do you expect to benefit from that? And if so, what kind of timing are you looking at?

<A - Eli Fruchter, President and Chief Executive Officer>: I don't think that I can discuss our customers' customers or projects. This is the kind of information that our customers will be able to provide. But obviously, if our customers are winning projects that – in different parts of the world, we will obviously benefit from that.

<Q - Jay Srivatsa>: All right. Thank you.

<A - Eli Fruchter, President and Chief Executive Officer>: Thank you, Jay.

Operator

The next question is from Sandeep Shyamsukha of Auriga USA.

<Q - Sandeep Shyamsukha>: Well, thanks for taking my question. Actually my question – first question is regarding your largest customer, Cisco. You mentioned that you have other design wins apart from ASR 9000 at Cisco. Do you think those design wins could be as meaningful or it would be at a similar revenue level as the ASR 9000 in the future?

<A - Eli Fruchter, President and Chief Executive Officer>: We cannot really discuss the platforms that we are winning and we cannot discuss the ASR 9000. We've not said that we have won that one. So, we are very sensitive about our customers' platforms, and we really don't want to discuss them. We can just say in general that we have won several platforms with the NP-4 and those are potentially high volume platforms.

<Q - Sandeep Shyamsukha>: Okay. Thank you. Other question I had was regarding ZTE. Obviously it is down significantly this year and you mentioned that you expect it to grow in 2011. I mean, what sort of visibility do you have from a longer-term standpoint 2012-2013, like where do you think you are in the ramp phase and where can it go going forward in the long term?

<A - Eli Fruchter, President and Chief Executive Officer>: So, ZTE declined in the first quarter, not in the year. We will still have to see how ZTE will be doing in 2011 versus 2010. It's still early for us to say. What I can say is that we have won several new platforms at ZTE with NP-4. So, when we take the NP-3, the current platform that uses that with additional platforms that we have won with NP-4, I believe that we will continue to see ZTE growing for us in the coming year.

<Q - Sandeep Shyamsukha>: Okay. And your inventory seems to have grown significantly this quarter. Could you just describe what might be driving it and how do you expect it to trend going forward?

<A - Dror Israel, Chief Financial Officer>: Right. So, actually inventory level started to go up in the second half of last year when we witnessed some shortage in the supply chain and along with that we started to increase inventory level. Then of course, we did not anticipate the Q1 revenue dip, which created even higher level. But it turns out that today with the Japan tsunami and the supply shortage that is created, that we feel pretty good with the current situation.

So, I think we're pretty happy with the inventory level that we have today.

<Q - Sandeep Shyamsukha>: And you would expect to keep it at this level through the course of this year then?

<A - Dror Israel, Chief Financial Officer>: It may remain at the current level for a time. And then when we feel more comfortable, it will start going down to reflect like maybe one quarter ahead, not more than that. This will be the long term, model for now it's a bit higher because of what's happening in the world.

<Q - Sandeep Shyamsukha>: Okay. Thank you. That's all I have for today.

Operator

The next question is from Quinn Bolton of Needham & Company. Please go ahead.

<Q - Quinn Bolton>: Hi. Thanks for taking my question. I apologize if I missed it, but just was wondering if you could comment about the mix in the second quarter of Juniper and ZTE as far as the inventory correction. So, just wondering if those customers represent a higher percent of sales in the second quarter. And then I'm assuming as you get through the end of the year that that given your guidance for Juniper to be down year-over-year, that Juniper probably from the second quarter level represents a smaller percentage of revenue by year end. I just wanted to make sure I've got that pattern right.

<A - Eli Fruchter, President and Chief Executive Officer>: I think you got it right. As for ZTE, we said that we already see orders for Q2 that will get the Q2 back to the Q4 level. And we said about Juniper that Q1 is probably the lowest for the year. So, we expect Juniper to go to higher level, but be lower than last year. And we said that we expect Q2 to be similar to Q1 in the product mix, and that's why we expect the gross margins to be in the 78%, similar to what we have seen in Q1.

<Q - Quinn Bolton>: Great. Okay. And then just a question about the NP,-5 you said you are already well engaged in the design process and have already announced a couple of design wins. But just sort of curious, are these mostly designs for higher density 10-gig line cards or are you starting to see activity for 40 or even 100-gig line cards with the NP-5?

<A - Eli Fruchter, President and Chief Executive Officer>: It's all is 10 and 40 and 100. The NP-5 as well as the NP-4 support all those speeds, and it's just that we support more ports, higher density. So, I think that if we see NP-3 used mostly for 1-gig line cards, NP-4 will be used mostly for 10-gig and NP-5 will be 10, 40, 100. So, it would be, I think, a combination of all.

<Q - Quinn Bolton>: Great. And then just the last question, I know you're expecting the volume production for NP-4 to commence in the second half of '11. Any sense when you would think initial revenue from NP-5, is that a late 2012 time – any timeline you can give us on NP-5 production?

<A - Eli Fruchter, President and Chief Executive Officer>: We typically see three years between our product, so if NP-4 moved to production in 2011, we have seen NP-3 moving to production in 2008 and NP-2 in 2005. So, just based on that, it seems that NP-5 will be 2014, meaning revenue production. Obviously, it will sample earlier than that and we will see sample related revenues earlier than that, but production will start in 2014.

<Q - Quinn Bolton>: Is the NP-5 then right now what you are engaged with customers? Is that an FPGA version or have you already started producing samples of the actual chip to customers?

<A - Eli Fruchter, President and Chief Executive Officer>: No, no, no, we are now still providing samples of the NP-4 to customers. NP-4 will move to production in the second half of the year. And it's still going to take a couple of years before customers will get NP-5 sample. The reason for the early engagement, which in a way we felt came earlier than we thought, is because of the software investment that customers are making with NP-4 and they want to engage early on the NP-5 to make sure that all of their software investments can be used in their next-generation products.

<Q - Quinn Bolton>: Okay. So, it sounds like NP-5 is still sort in the design phase that you're actively engaged with customers to make sure that they can re-use the software base that they've developed on NP-3 or 4 on the NP-5 when it samples, yeah, over the next one to two years.

<A - Eli Fruchter, President and Chief Executive Officer>: Yeah, that's correct.

<Q - Quinn Bolton>: Okay, great. Thank you very much.

<A - Eli Fruchter, President and Chief Executive Officer>: Thank you.

Operator

The next question is from Paul McWilliams of Next Inning. Please go ahead, sir.

<Q - Paul McWilliams>: Hi, guys. Thank you for taking my call and congratulations on your strategic progress. I'm very happy with where you're going. On the NP-5, could you give me a rough idea on ASP of that relative to the NP-4?

<A - Eli Fruchter, President and Chief Executive Officer>: Yeah, ASP of NP-5 will be approximately 50% higher than the NP-4. And that's because of the higher level of integration, because of the throughput, because of the higher port density. Overall, the price per port – although the ASP is 50% higher, the price per port will be significantly lower.

<Q - Paul McWilliams>: Did I note correctly that it's 3X the number of ports on the NP-4?

<A - Eli Fruchter, President and Chief Executive Officer>: Yes, so it's 2X the bandwidth or the throughput and 3X the density.

<Q - Paul McWilliams>: Okay. So, in figuring ratio of how many NP-5 somebody might use in comparison to an NP-4, there would be some variances there, but it might be three or two NP-4s for every NP-5?

<A - Eli Fruchter, President and Chief Executive Officer>: That is correct. If you are using the same port density on the line card, but since line cards tend to be higher densities and it always end up being 40. So, it's 40 1-gigabit ports today, you still don't see 40-gigabit port – 40, 10-gigabit port; you see eight, 12, so at some point we will have 40, 10-gigabit ports from a line card. Then it will be – at that time it will be maybe one, two or four 100-gigabit ports. And then a few years from now it will be 40, 100-gigabit ports. So, it always end up being 40. So, the number of chips, the line card can always be eight, but it is always more ports on the line card.

<Q - Paul McWilliams>: Got you, very good explanation. Thank you. The most popular question that I've been fielding lately deals with getting to a little bit more detail on the NP-4. So, let me ask the question, and then you tell me what you can answer comfortably. What I'd like to understand better is, what final steps are left prior to moving the NP-4 to production?

<A - Eli Fruchter, President and Chief Executive Officer>: The NP-4, and the NP-3 before that, and then the NP-5 are highly complex chips. They are huge, a lot of functionality, lot of features that are integrated into the chip that takes a lot of time to test for us and for customers. So, I would say that it's mainly time or test time until the chip is fully qualified and tested and ready to move to production.

<Q - Paul McWilliams>: Very good. So, you and your customers are now testing what you would determine to be the final iteration of the silicon?

<A - Eli Fruchter, President and Chief Executive Officer>: Yes.

<Q - Paul McWilliams>: Excellent, thank you. Now you mentioned earlier and I didn't jot it down, how many NP-2 customers and NP-3 customers were there?

<A - Eli Fruchter, President and Chief Executive Officer>: I think that in total we have about 50 customers. And I cannot – we don't say exactly how many are using NP-2 and NP-3 and NP-4. But if you are looking at CESR customers, those are the ones that can generate high volume from the platforms that they're building our chips into. I

would say that for NP-2 Juniper was the biggest one, and for NP-3 obviously Cisco and ZTE, and for NP-4 in addition to those two, we added three more. As I said, NP-4 was selected by five of the seven leading CESR vendors. So, the number of platforms, high volume platforms that we have won with NP-4 is at least two times the NP-2 and 3 combined. And as I said many times, the ASP is two times, so that's why we are saying that the potential is four times.

<Q - Paul McWilliams>: Absolutely. I didn't ask that question very well, Eli, I'm sorry. Out of the seven CESR vendors, the large seven, on the NP-2, how many were active?

<A - Eli Fruchter, President and Chief Executive Officer>: Actually one.

<Q - Paul McWilliams>: Okay. And then on the NP-3 how many?

<A - Eli Fruchter, President and Chief Executive Officer>: Two.

<Q - Paul McWilliams>: Two. Okay, wonderful. That helps me with that very much. Now I think all I've got left is couple of housekeeping questions. What was the OCS royalty for Q1?

<A - Dror Israel, Chief Financial Officer>: It was a bit above $0.5 million.

<Q - Paul McWilliams>: Okay. And for your total OpEx of $23 million, the target there, how much OCS royalty is assumed for the year?

<A - Dror Israel, Chief Financial Officer>: It will be -

<Q - Paul McWilliams>: I mean, not royalty, OCS grant.

<A - Dror Israel, Chief Financial Officer>: Yeah, yeah, I understand. It will be – we get close to $4 million, $3 million to $4 million.

<Q - Paul McWilliams>: Okay. Now, on the Cisco shipments, because you are receiving a royalty on that, that is essentially a 100% gross profit. I've got to assume the OCS royalty as a percentage of what you received is higher than what you would pay on a non-Cisco shipment. Could you help me model there just within a rough order magnitude what the royalty is that you pay on these Cisco royalties?

<A - Dror Israel, Chief Financial Officer>: So, I can help you model, I cannot help you with the precise number, but in general the royalties that we pay are calculated based on 3% to 5% of the selling price for products developed with the Chief Scientist. Now in the case of Cisco, this calculation will be based on Marvell selling price to Cisco.

<Q - Paul McWilliams>: Okay. So, you can't help me fudge that up a little bit?

<A - Dror Israel, Chief Financial Officer>: Let's say about double.

<Q - Paul McWilliams>: Okay. Yeah, I've been modeling seven to eight, so I think relatively close -

<A - Dror Israel, Chief Financial Officer>: Yes, close enough, yes.

<Q - Paul McWilliams>: Very good. Now what is your full year gross profit target?

<A - Dror Israel, Chief Financial Officer>: 78%.

<Q - Paul McWilliams>: Okay, very good. Thank you, guys, for being so clear with me. I appreciate it.

<A - Eli Fruchter, President and Chief Executive Officer>: Thank you.

Operator

The next question is a follow-up from Gary Mobley. Please go ahead. Mr. Mobley, are still on the line?

<Q - Gary Mobley>: Sorry, guys, I had it on mute. I had a follow-up question regarding your R&D initiative in your new design center. It doesn't sound as if you're willing to share with us the products you're specifically developing. But I was hoping you can share with us the potential market size and opportunity there. And why does it make more sense to develop this product internally from a grassroots effort versus going out and making an acquisition?

<A - Eli Fruchter, President and Chief Executive Officer>: This is a very good question, Gary. I can tell you that in general we are always looking at in-house development and acquisitions, and we look at each opportunity specifically and decide what to do. And in that case I think that internal development made sense, and I think that once we will announce the product, it will be pretty clear.

<Q - Gary Mobley>: All right. Thanks, guys.

Operator

There are no further questions at this time. Before I turn the call over to Mr. Fruchter for the concluding statement, I would like to remind participants that a replay of this call will be available on the company website at www.ezchip.com. Mr. Fruchter, would you like to make your concluding statement?

Eli Fruchter, President and Chief Executive Officer

Yes. I would just like to thank everyone for joining us today. And we are looking forward to have you all on our next earnings call. Thank you.