This 3DAdvisors Report Covers:
✓ **Insider Trading**: Insider Trading Behavior
✓ **Accounting**: Quality of Earnings Issues
Governance: Corporate Governance Issues

Disclosure Tweaks, Insider Selling About Competition
SiRF Technology Holdings Inc. (NASDAQ:SIRF) Update

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SiRF Technology Holdings, Inc., through its subsidiary, engages in the development and marketing of global positioning system (GPS) semiconductor solutions that provide location awareness capabilities in high-volume mobile consumer and commercial applications. SiRF Technology Holdings markets and sells its products through a combination of direct sales, independent sales representatives, and distributors in wireless handheld, automotive, portable computing devices, and dedicated or embedded consumer and commercial devices platforms. It also sells its products to value added manufacturers, which incorporate its chip sets into modules. The company was founded by Kanwar Chadha in 1995 and is headquartered in San Jose, California.

Summary of 3DAdvisors Findings for SIRF

- **Insider Trading:** Insiders suddenly re-emerge en masse, but with twists this time
- **Fundamentals:** Changes to disclosures suggest competition is accelerating
- **Fundamentals:** Analysts appear to be underestimating impact of competition
- **Fundamentals:** Legal fight with Global Locate may just be the beginning
- **Accounting:** The rising tide of rebates may mask the effects of price erosion
- **Accounting:** Although small part of overall revenue, royalty income declining

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Discussion of 3DAdvisors Findings

We have been monitoring volatile SIRF shares since December of 2005 when a number of unique forward sales by Chairman **Diosdado Banatao** caught our eye. Initially, our inspection of the Company drew us to a number of interesting revenue timing opportunities which, combined with a persistent Controls and Procedures issue, made the study all that much more interesting. By the time of our next SIRF update on May 17, 2006, the shares had just dropped from all-time highs and were trading in the $32 range. We found the Company's Controls and Procedures problems persisted amidst a CFO switch; a non-core acquisition that inured to the benefit of Banatao; continued revenue timing issues and sustained insider selling all painted a picture that strongly suggested that the shares were trading ahead of reality. Indeed they were as SIRF shares were to subsequently drop to as low as $18 in the wake of a July miss.

True to their volatile form, SIRF shares have been working their way back up for the past two quarters, recently hitting $34 (intra-day) in a short-lived rally on February 23rd. Late in the move, in February, seven of the Company's key insiders dropped a record 432,100 shares, a cluster of sales from this group of insiders the likes of which we last saw back in February of 2006 just prior to the aforementioned swoon which ultimately caused the shares to shed 50% of their value from the all-time highs (see Figure 1 below). Aside from the convergence and timing aspects, there were several other features of the recent round of selling that were quite unusual.

Clearly, it was time for us to once again drill into the detail involving the Company. The effort was not wasted as it has uncovered what we consider to be significant fundamental issues involving the effects of increasing competition which give meaning to several subtle disclosure changes as well as provide an explanation as to why management feels its time to take profits with its own shares.

<u>Insider Trading: Insiders suddenly re-emerge en masse, but with twists this time</u>

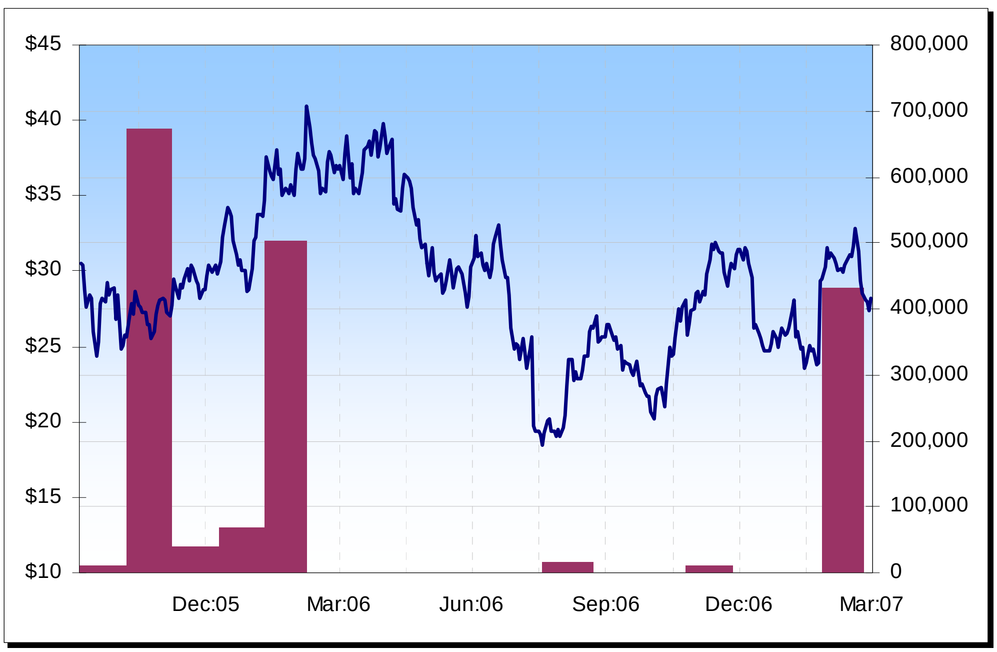
After a long period of silence, the collective actions of management spoke with a loud voice as a cross section of its core members surfaced to sell in February, immediately on the heels of the Q4 earnings release and into the subsequent 20% rally in SIRF shares. Though the holdings reductions were not particularly large, it was the sudden emergence of similar decisions by the seven that has sharpened our focus at this time.

In all, the 432,100 shares sold by seven SIRF insiders in February is the largest-ever at the Company for any given year, let alone a single month. None of the options exercised in the process was scheduled to expire until 2013 at the earliest. The only times the volume of shares "sold" had exceeded this number in the past (see Figure 1 below) occurred as a result of founder Diasdado Banatao's significant forward sales totaling just under 1.2 million shares which were entered into between August of 2005 and May of 2006. The two largest ones are scheduled to settle this year (400,000 on 8/17; 400,000 on 11/19). This time, not only has Banatao sold directly in the open market, he has been flanked by a contingent of key operating executives behaving similarly. Our mentor, Perry Wysong, who pioneered the discipline of studying insider behavior decades ago, always spoke to the "consensus" of decisions being made by executives. Each executive is believed to be acting on his/her own. It is the confluence of decisions that speak boldly. In this case, we hear them loud and clear.

In addition to the fact that the number of shares sold by this group was most notable, there were several other features of the selling that were highly unusual. Almost 20% of the shares sold were moved on the very day of the errant spike on February 23rd which temporarily pushed the shares as much as 10% higher intra-day. It was unclear what precipitated the rally; there was a rumor that Garmin Ltd. (NASDAQ:GRMN) was in takeover talks with the company, a rumor that was quickly discredited by analysts. There was also a bullish analyst note published that day which others thought caused the rally. What ever the reason, four insiders immediately jumped on the move to sell shares, including Banatao, who dropped 60,000 shares that day. Over the next couple of sessions, the shares gave back most of the gains.

Another oddity in this recent round of selling was the behavior displayed by CEO **Michael Canning**. On February 26th, Canning sold 50,000 shares at prices in the $31 to $32 range. Though he exercised options in the process, none of them would expire until 2013. In one of the more bizarre series of events we've seen, just two days later, the Company filed an SEC Form 8-K announcing the filing of a 10b5-1 sales plan by Canning covering the sale of "up to 500,000 shares" of SIRF stock over a period of twelve months. The press release altruistically states that "no sales will be made (by Canning) thereunder prior to May 1, 2007" [1]. By now, readers of this should have guessed that no mention was made of Canning's out-of-plan sales immediately prior to the announcement. **Assuming the sale of the entire amount indicated in the 10b5-1, Canning will have dropped 35% of his actionable holdings.** This figure includes all options scheduled to vest through the term of the 10b5-1 plan (remember we calculate actionable holdings as the sum of common stock *and* vested options and restricted stock).

Figure 1. SIRF Daily Closing Price, 10/03/05 through 03/07/07 (blue line and left scale) and Total Shares Sold by Insiders by Month, October 2005 through February 2007 (red bars and right scale). (Note: Monthly shares sold in October 2005 and February 2006 includes two separate 400,000 share forward sales, one in each month, entered into by Diosdado Banatao). Source: SIRF SEC Filings.



Other sellers of note in the recent group include:

- **Joseph Lavalle (56) –** V.P. Sales. With extensive experience in Asia, Lavalle heads up SIRF's sales which are concentrated in Japan and China. He joined SIRF in 2003 after spending six years at sales and marketing with Intel. Lavalle had cleared out the majority of his holdings in late 2005, slashing them by 90%. Now that his holdings

[1] SIRF Technology Holdings Inc. SEC Form 8-K, filed 02/28/07.

have been somewhat replenished through vested options, he has again begun selling. **His February sale of 25,000 shares at $31 reduced his holdings by 36%**.

- **Diasdado Banatao** – Chairman and Co-founder. Instead of executing his usual forward sales, Banatao sold 120,000 shares in February at prices between $30.83 and $31.95. Taking his forward sales into account, **Banatao has monetized 32% of his holdings in the past year**.

- **Jamshid "Jim" Basiji** – V.P. Engineering. He has been a consistent seller during the past year, demonstrating a certain proclivity toward exercising options when they vest and selling the underlying shares. He picked up his pace with February sales of 30,000 shares, at prices between $31 and $32, **dropping his holdings by 27%**. There was only one other time when Basiji had ever sold this much in one month. That was February of 2006 when SIRF shares were trading in the $36 to $37 range. It seems he is not waiting for a return to those levels at this time.

- **Moiz Beguwala (59) –** Director. Beguwala had served as SIRF's interim CEO in 2002 and 2003. His recent February sale of 8,000 shares, at prices in the $31 to $32 range, though seemingly insignificant**, trimmed his holdings by 25%.**

<u>Fundamentals: Changes to disclosures suggest competition is accelerating</u>

The risk section of the just filed 2006 SEC Form 10-K (02/27/07) reveals some very interesting, yet subtle, changes. At first glance, some of the changes seemed benign, but when taken in the context of SIRF's competitive position in the marketplace and combined with several other related disclosures, their significance should be viewed as far from trivial. The first change we note has to do with a subtle change in the risk section associated with the length of the sales cycle:

> ***Our lengthy sales cycle makes it difficult for us to forecast revenue and increases the variability of quarterly fluctuations, which could cause our stock price to decline.*** [2]

Prior to Q3 of 2006, the above risk disclosure stated SIRF's sales cycle as follows: *"We have a lengthy sales process in some of our target markets and our sales cycles typically range from **six months to two years.**"* This changed in Q3 and the Company now discloses that it has moved the cycle out three months*: "We have a lengthy sales process in some of our target markets and our sales cycles typically range from **nine months to two years**".*

While this change may seem minor and trivial at first, the same risk disclosure contains revealing information about changes in customer validation times*: "Our customers may need **three to six months** or longer to test and evaluate our technology and an additional 12 months or more to begin volume production of products that incorporate our technology."* We note, with much interest, how the period for testing and evaluation was extended by three months: *"Our customers may need **three to nine***

[2] SIRF Technology Holdings Inc. 2006 SEC Form 10-K, filed February 27, 2007, page 17.

months *or longer to test and evaluate our technology and an additional 12 months or more to begin volume production of products that incorporate our technology."*

The extension of these important time frames served us notice that SIRF may be seeing increasing competitive pressures that could be affecting the decision process of its customers. To confirm this, we consulted both a key individual at a large GPS-enabled handset manufacturer and a semiconductor industry expert who has been involved not only in the design area but in the build-out of semiconductor fabrication plants as well. Both individuals quickly agreed that the extension of the validation process is a significant signal. The failure rate of this type of chipset is relatively easy to predict and, if anything, the time period for customer validation should be shrinking, not expanding. Both sources concluded that it is highly likely that the customer decision-making process has become more complicated, most likely due to competition.

<u>Fundamentals: Analysts appear to be underestimating the impact of competition</u>

Both analysts and SIRF alike acknowledge that competition will eventually erode the Company's market share. SIRF has done an effective job at easing such concerns by convincing followers that explosive growth in the GPS marketplace (especially for GPS-enabled phones, PDAs, Cameras, etc.) will allow for significant revenue and earnings trajectory even at lower market share levels. The Company also does an interesting job at allaying fears that Average Sale Price (ASP) erosion, currently estimated by SIRF to be "between 10 and 20% annually" across all product lines, should not be a problem. From the recent Q406 conference call:

> **Analyst:** Okay and then like on the SiRFstarIII in the next year, how much do you think you can bring the cost down of that architecture?
>
> **Michael Canning, President & CEO:** Well, we have managed the cost of our products over the last four years to hold gross margins essentially flat and at the same time reduce our selling prices by anywhere from 10 to 20% per year and we expect to be able to continue to do the same thing with our product range.

The above mantra of holding margins in the Company-targeted 52% to 56% range is oft-repeated by SIRF management. Recent and, again, subtle disclosure changes in related risk sections of the Company's SEC Form 10-Ks put us on a path that proved revealing:

> ***Our reliance on third-party distributors subjects us to certain risks that could negatively impact our business.*** [3]

Addressing the above risk, SIRF's financials, prior to the recent 2006 SEC Form 10-K, disclosed the following: *"In the event of an unexpected significant decline in the price of our products, the price protection rights we offer to our distributors could materially adversely affect us because our revenue would decline."* Beginning in the 2006 Q2 SEC Form 10-Q, SIRF added "Product Margin" to the text (bolding is ours):

[3] SIRF Technology Holdings Inc. 2006 SEC Form 10-K, filed February 27, 2007, pages 13-14.

*"However, in the event of an unexpected significant decline in the price of our products, the price protection rights we offer to our distributors could materially adversely affect us because our revenue and **product margin** would decline."*

At first, we dismissed the addition of "Profit Margin" as an innocuous inclusion. Again, our conversation with one of our experts, who is involved with a large GPS-enabled handset manufacturer, revealed that SIRF may very well be facing the possibility of increasingly dramatic price erosion, particularly from its arch-rival Global Locate. It's no secret the two are trading counter-punches in a patent dispute that could indeed provide a potential catalyst affecting SIRF down the road. It is also no secret that SIRF's largest customer, Tom Tom (Promate), accounting for 48% of revenues and 40% of receivables (as of 12/31/06), made the decision to include Global Locate's Hammerhead II chipset in its best-selling GPS product called "ONE". Tom Tom now uses either Global's Hammerhead II *or* SIRF's SirfstarIII chipsets in each ONE sold. According to Tom Tom, the end user will not know the difference as to whether a unit carries either SIRFstarIII or the less-expensive Hammerhead II. What's more, Hammerhead II, a single-die chip allows the Tom Tom software application and the GPS chip and navigation software application to share the same processor resources.

Perhaps the most important aspect of this potential threat from Global Locate is the fact that the SIRFstarIII chip can be easily swapped for the less expensive Hammerhead. This fact comes from the above-referenced source who indicates that should the Hammerhead chipset prove to be up to expectations, Global Locate would be in a position to seriously erode SIRF's position at Tom Tom. To this, we would add that Global Locate is saying that it can get the cost of the Hammerhead chip down to $2 by 2008. Not an insignificant fact since SIRFstarIII's estimated pricing is in the $15 area.[4] If the Tom Tom erosion is not enough, on March 1st, news broke that Garmin International had completed validation of another competitor's chipsets, Taiwan-based MediaTek, and will begin placing orders by the end of the first quarter.

Fundamentals: Legal fight with Global Locate may be just the beginning

The lawsuits that have been filed between SIRF and Global Locate are significant and could provide an important catalyst event should SIRF not prevail. Clearly Global Locate has been effective at penetrating SIRF's space as the Company's complaint asks the ITC to investigate "illegal importation into the U.S. of GPS receiver chips, and products containing such chips, that infringe SIRF's U.S. patents." The suit and countersuit by Global Locate are on the radar screens of bullish sell-side analysts as well. Clearly, any resolve of such a dispute is down the road, however the uncertainty created by it, coupled with the significant inroads being made by Global Locate into SIRF's territory, should serve to provide certain resistance to further upside momentum in the shares. This in spite of their relatively high short interest of almost 14%.

To this, we would add that, for the first time SIRF indicates, in its recent SEC Form 10-K, that legal expenses are mounting. Though the Company falls short of quantifying their amount, the disclosure reads, "We expect general and administrative expense, including legal expenses associated with ongoing and future litigation matters,

[4] GPS World, 'Global Locate, SIRF Vie for ONE Position', January 2007. http://www.gpsmagazine.com/2007/01/

to increase in absolute dollars as we hire additional personnel and incur costs related to the anticipated growth of our business, our operation as a public company and investments in our information technology infrastructure."

Accounting: The rising tide of rebates may mask the effects of price erosion

It seems that SIRF has terminated one type of behavior and shifted to another. Either could serve to aid the practice of out of period revenue timing. In Q4, the Company discontinued its practice of estimating royalties from certain "estimated licensees":

> **"The Company earns royalties on licensees' worldwide sales of their products incorporating the licensed intellectual property or premium software based upon the specific criteria included in the associated royalty agreements. The Company's licensees; however, do not report and pay royalties owed for sales in any given quarter until after the conclusion of that quarter. During the periods preceding the fourth quarter of 2006, the Company estimated and recorded the royalty revenues earned for sales by certain licensees (the Estimated Licensees) in the quarter in which such sales occurred, but only when reasonable estimates of such amounts could be made."** [5]

The prior practice not only allowed for SIRF to book these revenues one quarter earlier but also, depending on the estimate, shift revenue between periods. Coincident with the cessation of this practice, which resulted in the one-time effect of a reduction in royalty revenue of $1.2 million in Q4, SIRF offered a new disclosure relating to estimates regarding rebates [bolding is ours]:

> **"We enter into co-branding rebate agreements with certain customers and provide marketing incentives to certain distributors. Payments to be made under such agreements and marketing incentives are recorded as a reduction of revenue. In certain circumstances, we estimate the proportion of product shipments that are rebate-applicable from a larger population of shipments, as well as we estimate the likelihood of whether or not such rebates will be claimed over time. If our estimates of product rebates differ from actual results, adjustments to estimated net revenues could result."** [6]

This is the first disclosure involving estimates involving "rebate-applicable" shipments. Clearly, such estimates amount to reserves, a normal practice and are not a new item. We must note here, however, that rebates due to customers are on the rise, and dramatically, jumping 80% YOY (period ending 12/31/06) to $5.3 million with the majority of the increase occurring in Q4 where they rose 55% sequentially. One wonders whether the recent change to this disclosure has been driven by the sudden

[5] SIRF Technology Holdings Inc. 2006 SEC Form 10-K, filed February 27, 2007, page 64.
[6] SIRF Technology Holdings Inc. 2006 SEC Form 10-K, filed February 27, 2007, page 36.

acceleration in rebate use and the need for more disclosure of related estimates. This rapidly increasing use of rebates, and associated estimates, not only provides more opportunity for out of period recognition of costs, but more importantly, can serve to mask the actual amount of ASP declines that the Company may be experiencing.

Accounting: Although small part of overall revenue, licensing income declining

SIRF's licensing income in Q4 dropped by more than can be explained by the one-time, $1.2 million effect that resulted when the Company ceased recording estimates for licensee royalties one quarter in advance. When factoring that $1.2 million back into the equation, license royalty revenue shows a decrease of 17% YOY from $11.7 million to $9.6 million. Since there is no cost of sales associated with license revenues, they contribute 100% to operating income, or about $.04 per share.

It is interesting to note that the Company still maintained, during the Q4 conference call, that the accounting related dip in license royalties was a one-time situation and that they should move back to normal afterwards:

> **Analyst:** Just on the royalty rate, is it fair to assume we jump back up to let's say to $2.5 million range starting in next quarter off of this one-off?
>
> **Geoff Ribar, CFO:** Yes. The change was just going to affect Q4. We will go back to pretty much our normal run rate in Q1.

We note this since, license royalties, assuming the inclusion of the one-time effect, would have been $1.9 million in Q4, indicating a drop from the $2.6 average for the first three quarters of the year and a far cry from the $3.5 million posted in Q4 of 2005.