

Equity Research | China | Semiconductor

10 August 2018

Silver lining in sight

- SMIC's revenue growth and earnings continued to improve in 2Q18, though not as strong as we expected. The company guided softening growth and a sizeable decline in gross margin for 3Q18.
- SMIC said it has achieved significant progress in 14nm FinFET and completed 28nm HKC+, in addition to 28nm PolySiON and HKC.
- We cut our FY18E/19E earnings estimates by 10.4%/31.4% respectively and lowered our DCF-based price target to HK\$9.80 (from HKD10.0). Upgrade rating on SMIC from Sell to Hold.

Good efforts, but challenges to remain in the near term. SMIC's revenue reached a record high (even excluding licensing revenue) in 2Q18, whilst it also saw a substantial recovery in earnings. Gross margin came in at 24.5% in 2Q18, versus 26.5% in 1Q18 and 25.8% in 2Q17. Encouragingly, 2Q18 saw a strong ramp-up of 28nm, contributing to 8.4% of 2Q18 revenue. In our view, the strong revenue and earnings trend could be short-lived, with diminishing licensing revenue and rising gross margin pressure on 28nm ramp-up. The company guided flat to 2% QoQ revenue growth (excluding licensing revenue) and lower gross margin of 19%-21% for 3Q18.

Encouraging progress in technological development. SMIC said it has achieved significant progress in 14nm FinFET and completed 28nm HKC+ (in addition to 28nm PolySiON and HKC) and expects a strong ramp-up of 28nm going forward. With continuously strong demand, SMIC would likely be able to maintain utilisation at high levels (94.1% in 2Q18, versus 88.3% in 1Q18 and 85.7% in 2Q17). On the basis of the current progress in 14nm FinFET, SMIC is deemed to return to strong revenue growth along with rapid margin expansion from 2H19, in our view.

Strong government backing. Amid escalating China-US trade tensions, China is likely to step up support (e.g. government grant, taxation holidays, etc.) for the semiconductor industry, making SMIC a major beneficiary given its position as the largest foundry in China.

Value emerging from long term perspective. To adjust for diminishing licensing revenue, we have raised our FY18E revenue estimate slightly by 1.1% but trimmed our FY19E revenue estimate by 3.4%. Meanwhile, we have cut our FY18E/19E earnings forecasts by 10.4%/31.4% respectively, on lower gross margin assumption. Accordingly, we have lowered our DCF-based price target to HKD9.80 for end-2019 (from HKD10.0 for end-2018). With an over 30% drop in share price since the beginning of the year, we see value emerging for SMIC from a longer perspective. We upgrade our rating on SMIC from Sell to Hold.

SMIC (981 HK)

Hold

(from Sell)

Price Target	HK\$9.80
(Revision)	(-2.0%)
(up/downside)	(3.7%)

EPS	2018E	2019E
revision	(-10.4%)	(-31.4%)

Close price	HKD9.45
Market cap.	USD6,012mn
Free float	82.6%
52-week range	HKD6.91–HKD14.76
3-mth ave. T/O	HKD396.3mn

Price as of 9 Aug 2018

Stock rel HSI performance (%)



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FY Dec (USD mn)	1Q17	2Q17	3Q17	4Q17	1Q18	2Q18	2Q18 YoY	1H18 YoY
Revenue	793.1	751.2	769.7	787.2	831.0	890.7	18.6%	11.5%
Cost of sales	(572.3)	(557.1)	(592.4)	(638.7)	(610.9)	(672.9)	20.8%	13.7%
Gross profit	220.8	194.1	177.3	148.5	220.2	217.8	12.2%	5.6%
Gross margin	27.8%	25.8%	23.0%	18.9%	26.5%	24.5%	-1.3ppt	-5.1%
R&D expenses	(107.8)	(111.2)	(106.8)	(101.3)	(123.0)	(147.2)	32.4%	23.4%
Sales and marketing	(10.4)	(9.4)	(9.6)	(6.4)	(8.5)	(8.1)	-13.8%	-16.0%
G&A expenses	(39.4)	(54.2)	(46.1)	(58.2)	(51.5)	(48.8)	-10.0%	7.2%
Other operating income (expense)	14.1	2.3	7.9	20.6	5.1	5.4	135.9%	-36.0%
Profit (loss) from operations	77.4	21.6	22.7	3.2	42.3	19.1	-11.5%	-38.0%
Interest income	5.6	6.7	6.5	8.3	12.9	12.6	89.9%	108.2%
Finance costs	(12.0)	(9.5)	12.9	(9.4)	(13.5)	(10.6)	11.5%	12.4%
Change in the FV of commitments	-	-	-	-	-	-	-	-
Foreign exchange gains or losses	(2.8)	(7.4)	(11.7)	9.2	(4.2)	10.5	-241.8%	-161.5%
Other gains or losses	2.2	27.1	(1.7)	(11.1)	2.3	4.4	-83.9%	-77.1%
Share of profits of associates	(5.4)	(2.3)	1.2	(3.0)	3.3	(1.9)	-16.7%	-118.8%
Total other income (expense)	(12.4)	14.5	7.3	(6.1)	0.8	15.0	2.9%	625.3%
Profit (loss) before tax	65.0	36.2	30.0	(2.9)	43.0	34.1	-5.8%	-23.8%
Income tax (expense) benefit	(0.8)	(2.9)	0.6	1.2	(16.0)	(2.4)	-15.1%	402.6%
Profit for the period	64.2	33.3	30.6	(1.7)	27.1	31.7	-5.0%	-39.8%
Non-controlling interests	(5.4)	(3.0)	4.7	(49.4)	(2.3)	(19.9)	574.6%	165.7%
Owners of the Company	69.6	36.3	25.9	47.7	29.4	51.6	42.3%	-23.5%

FY Dec (USDmn)	1Q17	2Q17	3Q17	4Q17	1Q18	2Q18	2Q18 YoY	1H18 YoY
Revenue by applications								
Communication	361.6	328.3	348.7	334.5	279.2	359.0	9.3%	-7.5%
Consumer	296.6	280.9	284.8	296.0	295.9	330.5	17.6%	8.4%
Computer	50.8	45.1	44.6	52.0	56.5	50.8	12.6%	12.0%
Auto/industrial	52.3	60.8	62.3	69.3	70.6	65.9	8.3%	20.6%
Others	31.7	36.1	29.2	35.4	128.8	84.6	134.7%	214.9%
Total	793.1	751.2	769.7	787.2	831.0	890.7	18.6%	11.5%
Revenue by technology								
0.25 / 0.35um	20.6	21.0	23.9	25.2	32.4	33.8	60.9%	59.1%
0.15 / 0.18um	267.3	220.9	291.0	297.6	323.3	330.5	49.6%	33.9%
0.13um	122.1	128.5	62.3	49.6	63.2	67.7	-47.3%	-47.8%
90nm	10.3	10.5	10.8	14.2	31.6	10.7	1.6%	103.0%
55 / 65nm	174.5	177.3	155.5	125.9	173.7	215.6	21.6%	10.7%
40 / 45nm	158.6	143.5	158.6	185.8	180.3	155.9	8.6%	11.3%
28nm	39.7	49.6	67.7	89.0	26.6	76.6	54.5%	15.6%
Total	793.1	751.2	769.7	787.2	831.0	890.7	18.6%	11.5%
Revenue by geographical segments								
China (incl. HK)	369.6	340.3	351.8	403.8	518.6	522.0	53.4%	46.6%
USA	304.5	314.0	322.5	299.9	237.7	293.9	-6.4%	-14.1%
Eurasia	119.0	96.9	95.4	83.4	74.8	74.8	-22.8%	-30.7%

Source: Company

Income statement (USDmn)

Year end: Dec	2016	2017	2018E	2019E	2020E
Revenue	2,914	3,101	3,431	3,829	4,412
COGS	(2,064)	(2,360)	(2,665)	(2,926)	(3,314)
Gross profit	850	741	766	904	1,097
Selling and marketing	(35)	(36)	(34)	(36)	(37)
R&D	(318)	(427)	(460)	(481)	(541)
Admin	(67)	(198)	(228)	(245)	(272)
Operating profit	339	80	44	142	246
Other income / (expenses), net	(1)	32	41	33	29
EBIT	338	112	86	175	275
Net interest	(12)	9	2	(7)	(11)
Associates and JVs	(14)	(10)	(8)	(7)	(5)
Exceptional items	(2)	16	8	6	5
Pretax profit	310	128	87	168	264
Taxation	7	(2)	(8)	(12)	(29)
Net profit	316	126	79	156	235
Minority	(60)	(53)	(42)	(34)	(27)
Attrib profit	377	180	121	190	263
Basic EPS (USD cents)	8.92	3.88	2.45	3.83	5.26
EPS (adjusted) (USD cents)	8.13	4.15	2.73	4.08	5.49

Balance sheet (USDmn)

Year end: Dec	2016	2017	2018E	2019E	2020E
Cash	2,126	1,838	1,041	840	721
Short term investments	82	721	371	34	32
Accounts receivables	646	616	670	723	795
Inventory	464	623	669	722	791
Other current assets	365	370	382	393	405
Total current assets	3,684	4,169	3,132	2,712	2,744
PP&E	5,687	6,523	7,905	8,870	9,499
Intangible Assets	249	220	192	164	137
Associates and JVs	254	790	783	778	775
Other long term assets	241	216	223	231	241
Total long term assets	6,432	7,749	9,102	10,043	10,651
TOTAL ASSETS	10,115	11,918	12,235	12,755	13,395
Short term debt	296	441	339	407	488
Convertible bonds	391	-	-	-	-
Accounts payables	941	1,050	1,145	1,248	1,360
Other current liabilities	353	416	445	476	510
Total current liabilities	1,981	1,907	1,929	2,131	2,359
Long term debt	1,943	2,469	2,707	2,889	3,083
Deferred tax	15	16	17	17	18
Convertible bonds	395	403	403	403	403
Other long term liabilities	378	401	377	355	336
Total long term liabilities	2,731	3,290	3,503	3,665	3,841
TOTAL LIABILITIES	4,712	5,197	5,432	5,796	6,200
Shareholders' funds	4,151	5,233	5,356	5,547	5,811
Minority Interests	1,253	1,488	1,447	1,412	1,385
TOTAL LIAB AND EQUITY	10,115	11,918	12,235	12,755	13,395
Net cash / (debt)	(899)	(1,475)	(2,408)	(2,859)	(3,254)

Source: Company, Bloomberg, CSCI Research estimates

Cash flow statement (USDmn)

Year end: Dec	2016	2017	2018E	2019E	2020E
EBIT	338	112	86	175	275
Depreciation & amortisation	730	971	1,124	1,207	1,346
Net interest	(12)	9	2	(7)	(11)
Taxes paid	(2)	(0)	(8)	(12)	(29)
Changes in working capital	(70)	(52)	328	320	(36)
Others	(7)	41	8	6	5
Cash flow from operations	977	1,081	1,539	1,689	1,550
Capex	(2,757)	(2,287)	(2,437)	(2,100)	(1,900)
Acquisitions	(86)	(44)	(38)	(42)	(46)
Disposals	260	688	-	-	-
Others	140	(1019)	-	-	-
Cash flow from investing	(2,443)	(2,662)	(2,475)	(2,142)	(1,946)
Issue of shares	-	326	2	1	1
Change in debt	1,766	634	136	250	276
Others	849	311	-	-	-
Cash flow from financing	2,615	1,272	138	251	276
Change in cash	1,149	(310)	(797)	(201)	(119)
Free cash flow	(1,780)	(1,207)	(897)	(411)	(350)

Key ratios

Year end: Dec	2016	2017	2018E	2019E	2020E
Operating ratios					
EBIT margin (%)	11.6	3.6	2.5	4.6	6.2
EBITDA margin (%)	36.5	36.0	36.0	36.4	37.0
Net margin (%)	(2.1)	(1.7)	(1.2)	(0.9)	(0.6)
Effective tax rate (%)	(2.1)	1.4	9.0	7.0	11.0
Revenue growth (%)	30.3	6.4	10.6	11.6	15.2
Net income growth (%)	48.6	(52.3)	(32.7)	57.4	38.0
EPS growth adj (%)	48.6	(52.3)	(32.7)	57.4	38.0
Efficiency ratios					
ROE (%)	(15)	(10)	(0.8)	(0.6)	(0.5)
ROCE (%)	5.2	1.4	0.9	1.7	2.6
Asset turnover (x)	0.3	0.3	0.3	0.3	0.3
Op cash / EBIT (x)	2.9	9.6	18.0	9.7	5.6
Depreciation / CAPEX (x)	0.3	0.4	0.5	0.6	0.7
Accounts receivable days	71.7	74.3	68.4	66.4	62.8
Accounts payable days	175.8	153.9	150.4	149.3	143.6
Leverage ratios					
Net gearing (%)	21.7	28.2	45.0	51.5	56.0
Net debt / EBITDA (x)	0.8	1.3	2.0	2.0	2.0
Interest cover (x)	14.7	6.2	3.7	8.4	12.4
Current ratio (x)	1.9	2.2	1.6	1.3	1.2
Valuation					
PER (x)	15.4	30.1	40.5	24.3	16.4
EV/EBITDA (x)	3.9	4.9	4.9	4.3	3.7
PBR (x)	1.1	0.9	0.8	0.7	0.6

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Company Rating Definition

The Benchmark: Hong Kong Hang Seng Index; Time Horizon: 12 months

Buy	12-month absolute total return: $\geq 10\%$
Hold	12-month absolute total return: $> -10\%$ but $< 10\%$
Sell	12-month absolute total return: $\leq -10\%$

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