

IQE

Trading update

Short-term VCSEL slowdown hits profits

IQE has announced an immediate slowdown in shipments of VCSEL wafers, which materially affects FY18 revenues and profitability, and has issued revised guidance. Although we have cut our EPS estimates by 43% and 24% for FY18 and FY19 respectively, we note this is a short-term problem that does not impact the prospects for photonics growth in the medium term. Our revised estimates give an indicative value of 73p/share.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
12/16	132.7	20.6	2.89	0.0	19.5	N/A
12/17	154.5	24.3	3.36	0.0	16.7	N/A
12/18e	162.5	16.8	1.81	0.0	31.1	N/A
12/19e	194.8	34.1	3.48	0.0	16.2	N/A

Note: *PBT and EPS are normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments.

Short-term impact on revenues and profitability

On Monday, IQE announced that earlier that day one of its customers in the VCSEL supply chain, had received notice from one of its largest customers for 3D sensing laser diodes that it was materially reducing shipments for the current quarter. IQE ramped up production for this application (which we previously inferred is for FaceID in new iPhones) during H217, following which production dropped back as the inventory overbuild was worked through, so IQE only started to build-up inventory for this application again this quarter. It now has to cut back production for this application. The temporary dip in production will materially affect FY18 revenues and profitability.

Other volume VCSEL programmes reduce risk

We note that the lull in VCSEL production for Apple is not the result of IQE losing a customer to a competitor, so shipments are expected to resume by Q219. Although Apple warned in June that demand for new iPhone parts could decline by 20% in H218, FaceID is included in three of the models launched in H218, rather than just one model in H217, so we believe consumer demand is less likely to be the cause of the set-back than availability of OLED panels, where Apple is rumoured to have issues. Component availability can be addressed relatively easily, supporting our view that volume production will resume by Q219. We note that IQE is involved in VCSEL ramp-ups for at least eight customers engaged in several market segments, providing alternative sources of photonics growth and reducing the risk of destocking in future.

Valuation: Upside when confidence returns

Using our revised estimates as the basis for a DCF analysis gives an indicative valuation of 73p/share. Modelling segmental growth from FY20 onwards at the high end of management guidance provided in September gives an indicative valuation of 132p/share. We see potential for share price improvement as investor confidence in photonics demand returns.

Tech hardware & equipment

15 November 2018

Price **56.25p**

Market cap **£437m**

Net cash end June 2019 (£m) 40.6

Shares in issue 776m

Free float 95.5%

Code IQE

Primary exchange AIM

Secondary exchange N/A

Share price performance



% 1m 3m 12m

Abs (30.4) (45.7) (68.0)

Rel (local) (30.6) (41.2) (66.2)

52-week high/low 178.8p 56.2p

Business description

IQE is the leading supplier of epitaxial compound semiconductor wafers globally. The principal applications include radio frequency semiconductors, devices for optical networks, vertical cavity lasers, infrared semiconductors, power electronics and CPV solar cells.

Next events

Prelims March 2019

Analysts

Anne Margaret Crow +44 (0)20 3077 5700

Dan Ridsdale +44 (0)20 3077 5729

tech@edisongroup.com

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Revisions to estimates

Exhibit 1: Management revenue guidance

	Previous FY18 guidance*	Previous FY18e Edison	New FY18 guidance*	New FY18 Edison	Previous FY19 guidance*	Previous FY19e Edison	New FY19 guidance	New FY19 Edison	3-5 year guidance*
Wireless growth	0-5%	4.0%	8%	4.5%	0-5%	1.5%	-	5.0%	0-10%
Photonics growth	35-50%	40.0%	11%	9.0%	40-60%	40.0%	40-60%	50.0%	40-60%
Infrared growth	5-15%	7.0%	15%+	12.0%	5-15%	7.0%	5-15%	12.0%	5-15%
Licence income	£0m	£0m	£0m	£0m	£0m	£0m	£0m	£0m	£0-2m

Source: Edison Investment Research, company statements. Note: *Constant currency.

Following the announcement on Monday that it had received notice from one of its largest customers for 3D sensing laser diodes, management has assessed the impact on FY18 and FY19 performance. On Tuesday it issued revised guidance, which is summarised in Exhibit 2. It now expects to deliver revenues of around £160m for FY18 and adjusted EBITDA of around £31m. (We infer that the customer is Lumentum, who issued an announcement earlier on Monday.)

Exhibit 2: Changes to estimates

	FY17	FY18e			FY19e		
	Actual	Old	New	Change	Old	New	Change
Revenue (£m)	154.5	176.2	162.4	-7.8%	205.2	194.8	-5.0%
EBITDA (£m)	38.4	44.5	31.2	-29.8%	59.9	50.0	-16.6%
Adjusted PBT (£m)	24.3	30.1	16.8	-44.1%	44.0	34.1	-22.6%
Adjusted EPS (p)	3.36	3.18	1.81	-43.1%	4.55	3.48	-23.6%
Capitalised R&D	16.9	13.0	13.0	0.0%	13.0	13.0	0.0%
PPE	18.0*	33.0	33.0	0.0%	25.0	25.0	0.0%
Net cash	45.6	29.3	22.5	-23.4%	40.2	23.0	-42.7%

Source: Edison Investment Research *Including £6.7m funded through finance leases

Valuation

As the share prices of stocks in this sector are highly volatile at present, we have focussed on a DCF analysis rather than a peer multiples approach. Moreover, for the reasons stated above, we believe that the reduction in VCSEL shipments is temporary and that photonics will continue to grow at 40% or more per annum from FY19 onwards and a DCF methodology captures the impact of this medium-term growth. We present three scenarios: the base case adopts the rate of market growth used in our estimates; the low case adopts the rate implied by the current share price; and the high case adopts the higher bound of the market growth for FY20–FY23 given in management guidance at the Capital Markets Day in September. Our analysis gives an indicative valuation of 73p/share, rising to 132p/share if the upper bound of management guidance is adopted. The current share price is slightly below the lower bound of this range, indicating that investors are taking a more cautious view of photonics growth than our estimates, adopting a level towards the lower bound of FY19 management guidance rather than the middle of the range. Further newsflow on the VCSEL programmes that have recently started production and resumption of shipments on the original volume VCSEL programme should help address this.

Exhibit 3: DCF analysis

	FY18e	FY19e	FY20e	FY21e	FY22e
Base case					
Wireless growth	4.5%	5.0%	2.0%	2.0%	2.0%
Photonics growth	9.0%	50.0%	40.0%	40.0%	40.0%
IR growth	12.0%	12.0%	7.0%	7.0%	7.0%
Licence revenues (£m)	0.0	0.0	0.0	0.0	0.0
Group revenues (£m)	162.5	194.8	229.0	275.8	340.2
EBIT (£m)	16.7	34.1	51.3	68.9	93.4
Indicative valuation (WACC 10% Terminal growth 2%) 73p/share					
Low case					
Wireless growth	4.5%	5.0%	2.0%	2.0%	2.0%
Photonics growth	9.0%	41.0%	40.0%	40.0%	40.0%
IR growth	12.0%	12.0%	7.0%	7.0%	7.0%
Licence revenues (£m)	0.0	0.0	0.0	0.0	0.0
Group revenues (£m)	162.5	190.1	222.5	266.7	327.4
EBIT (£m)	16.7	32.5	48.7	65.2	88.2
Indicative valuation (WACC 10% Terminal growth 2%) 67p/share					
High case					
Wireless growth	4.5%	5.0%	10.0%	10.0%	10%
Photonics growth	9.0%	60.0%	60.0%	60.0%	60.0%
IR growth	12.0%	12.0%	15.0%	15.0%	15.0%
Licence revenues (£m)	0.0	0.0	2.0	2.0	2.0
Group revenues (£m)	162.5	200.0	264.2	357.6	500.3
EBIT (£m)	16.7	35.8	62.4	96.2	149.3
Indicative valuation (WACC 10% Terminal growth 2%) 132p/share					

Source: Edison Investment Research

Exhibit 4: Financial summary

	£'000s	2016	2017	2018e	2019e
Year End 31 December		IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS		restated			
Revenue		132,707	154,480	162,449	194,807
Cost of Sales (Inc D&A + SBP)		(98,538)	(115,857)	(116,151)	(137,339)
Gross Profit		34,169	38,623	46,298	57,468
EBITDA		33,057	38,384	31,238	50,008
Depreciation and Amortisation		(10,938)	(12,025)	(14,527)	(15,932)
Operating Profit (before amort. and except.)		22,119	26,359	16,711	34,076
Acquired Intangible Amortisation		(1,374)	(1,429)	(1,429)	(1,429)
Exceptionals		1,962	(385)	0	0
Share based payments		(2,881)	(7,526)	(3,000)	(3,000)
Operating Profit		19,826	17,019	12,282	29,647
Underlying interest		(1,463)	(2,099)	100	0
Exceptionals		(26)	80	0	0
Profit Before Tax (norm)		20,630	24,340	16,811	34,076
Profit Before Tax (FRS 3)		18,363	14,920	12,382	29,647
Tax		(340)	(435)	(2,229)	(5,336)
Profit After Tax (norm)		20,692	24,823	14,582	28,739
Profit After Tax (FRS 3)		18,023	14,485	10,153	24,310
Average Number of Shares Outstanding (m)		671.5	689.5	751.7	776.0
EPS - normalised (p)		2.89	3.36	1.81	3.48
EPS - (IFRS) (p)		2.66	2.09	1.34	3.12
Dividend per share (p)		0.0	0.0	0.0	0.0
BALANCE SHEET					
Fixed Assets		214,043	224,836	254,880	275,519
Intangible Assets		103,972	108,513	113,057	116,196
Tangible Assets		85,001	90,875	116,375	133,875
Other		25,070	25,448	25,448	25,448
Current Assets		64,323	111,559	95,470	114,812
Stocks		28,498	33,707	36,940	44,299
Debtors		30,868	32,240	36,050	47,501
Cash		4,957	45,612	22,479	23,012
Other		0	0	0	0
Current Liabilities		(51,522)	(44,916)	(44,589)	(53,123)
Creditors		(43,870)	(44,916)	(44,589)	(53,123)
Short term borrowings		(7,652)	0	0	0
Long Term Liabilities		(39,021)	(666)	(666)	(666)
Long term borrowings		(36,854)	0	0	0
Other long term liabilities		(2,167)	(666)	(666)	(666)
Net Assets		187,823	290,813	305,095	336,542
CASH FLOW					
Operating Cash Flow		22,463	29,717	23,867	39,733
Net Interest		(1,489)	(2,125)	100	0
Tax		(839)	(5,844)	(1,100)	(1,200)
Capex		(19,060)	(28,190)	(46,000)	(38,000)
Acquisitions/disposals		(11,250)	0	(3,846)	0
Financing		578	94,912	3,846	0
Dividends		0	0	0	0
Net Cash Flow		(9,597)	88,470	(23,133)	533
Opening net debt/(cash)		23,223	39,549	(45,612)	(22,479)
HP finance leases initiated		0	0	0	0
Other		(6,729)	(3,309)	0	0
Closing net debt/(cash)		39,549	(45,612)	(22,479)	(23,012)

Source: Company accounts, Edison Investment Research

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