

IQE

Interim results

Record revenues in H120 despite pandemic

Tech hardware & equipment

8 September 2020

IQE's revenues grew by 35% year-on-year during H120 to a record £89.9m, taking the group from a £1.9m adjusted operating loss in H119 to a £4.3m adjusted operating profit. We upgrade our FY20 estimates in line with management's guidance. The resultant 15% revenue upgrade changes the outcome from a loss to £3.1m adjusted PBT.

Year end	Revenue (£m)	EBIT* (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)
12/18	156.3	16.0	14.0	1.38	0.0	44.6
12/19	140.0	(4.7)	(7.0)	(2.46)	0.0	N/A
12/20e	165.6	5.0	3.1	0.28	0.0	222.3
12/21e	178.2	12.0	10.9	1.05	0.0	58.5

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

Price 61.5p
Market cap £490m

Net debt (£m) at end June 2020 (excluding £48.1m finance leases) 7.4

Shares in issue 797.3m

Free float 86.7%

Code IQE

Primary exchange AIM

Secondary exchange N/A

Share price performance



%	1m	3m	12m
Abs	0.2	36.1	22.9
Rel (local)	1.4	46.9	47.7
52-week high/low	75.05p		20p

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 and power electronics

Next events

FY20 results March 2021

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Record first half revenues return group to profit

In line with June guidance, group revenues grew by 35% year-on-year during H120 to a record £89.9m. Wireless revenues jumped by 51% to £45.5m as IQE's long-standing customers benefited from major design wins and investment in 5G infrastructure. Additionally, we believe IQE took market share in Asia. Photonics revenues rose by 22% to £43.4m. Production for IQE's major vertical cavity surface emitting laser (VCSEL) customer was consistently strong throughout the period. Given the high proportion of fixed costs, the strong year-on-year revenue growth took the group from a £1.9m adjusted operating loss in H119 to a £4.3m adjusted operating profit. Net debt reduced by £8.6m during H120 to £7.4m at the end of June (excluding £48.1m IFRS 16 lease liabilities). Cash generated from operations more than trebled year-on-year to £15.1m, while capital expenditure was only £1.1m as the major infrastructure investment programmes all completed in FY19.

Estimates upgraded

Given the strong performance for the year to date and positive trading updates and outlooks from key customers, management has provided guidance for FY20. This is for revenues of at least £165m, which is a year-on-year increase of over 18%, with an adjusted EBIT of at least mid-single digits. We have updated our FY20 and FY21 forecasts accordingly, while noting that this guidance assumes an atypically weaker second half performance, reflecting the uncertainty in the global economy.

Valuation: Share price above pre-pandemic levels

IQE's share price has more than recovered the ground lost during the panic selling in March. At current levels IQE is trading at a premium to the mean of the sample of companies engaged in manufacturing VCSEL epitaxy. Given IQE's broader product portfolio we believe it is reasonable for IQE to trade on multiples that are at the upper bound of this sample. However, we believe that further share price improvement will require greater visibility of how handset demand will be affected by any pandemic induced recession and whether the switch to 5G and the availability of as yet unknown 'killer apps' will be sufficient motivation for cash-strapped consumers to justify upgrading their handsets.

H120 performance

Record first half revenues return group to profit

In line with June guidance, group revenues grew by 35% year-on-year during H120 to a record £89.9m. While this result was flattered by £2.5m of forex tailwind, the Q120 performance was slightly ahead of internal expectations and trading in Q2 was strong, with no disruption to production from coronavirus related lockdowns or any significant impact on the supply of materials. Wireless revenues jumped by 51% to £45.5m. H119 wireless revenues were adversely affected by customers destocking in response to the uncertainty caused by lengthening smartphone replacement cycles and by the disruption to global semiconductor supply chains caused by Huawei's addition to the US Bureau of Industry and Security's Entity List. In contrast, during H120 IQE's long-standing wireless customers have benefited from major design wins and investment in 5G infrastructure. In addition, we believe that IQE is taking market share in Asia. Photonics revenues rose by 22% to £43.4m. Production for IQE's major VCSEL customer was consistently strong throughout the period.

Given the high proportion of fixed costs, the strong revenue growth took the group from a £1.9m adjusted operating loss in H119 to a £4.3m adjusted operating profit. The adjusted cost of sales increased by £14.3m to £70.4m and adjusted indirect costs rose by £2.5m to £15.0m. £2.3m of the cost increases relate to an increase in amortisation, the remainder primarily to ramping up production in the Newport facility and taking on all of the costs of Singapore JV when the group increased its ownership of the JV to 100% in October 2019. The group incurred £7.5m exceptional costs, which are described in Exhibit 1. £1.1m of these exceptional costs were cash items.

Exhibit 1: H120 P&L breakdown of exceptional items

Category	Value* (£m)	Details
Share-based payments	0.3	
Exceptional legal fees	0.7	Fees incurred defending a non-core patent. The arbitration hearing in September determined entirely in IQE's favour.
Impairment of intangible assets	6.5	Impairment of cREO patent and development costs that are not related to filters, following a decision to focus cREO activity on the filter market.
Onerous contract provision	1.8	Cost of minimum guaranteed future royalty payments to Translucent agreed when the cREO technology was acquired. These are still payable although the date when IQE will start to generate revenues from commercial exploitation of the technology has been delayed.

Source: IQE. Note: *Before adjustment for tax.

Strongly cash generative now expansion programme complete

Net debt reduced by £8.6m during H120 to £7.4m at the end of June (excluding £48.1m IFRS 16 lease liabilities). Cash generated from operations more than trebled year-on-year to £15.1m despite the £1.1m exceptional cash-cost related to legal fees (see Exhibit 1). Capital expenditure dropped from £19.0m to £1.1m. This is because the programmes to build infrastructure at the Mega Foundry in Newport, South Wales, and expand capacity in Taiwan and Massachusetts all completed in FY19. Newport Mega Foundry already has bays for an additional 10 reactors, so future investment will be primarily only in reactors rather than the supporting infrastructure and thus proportional to incremental revenue development. Capitalised development expenditure fell from £4.8m in H119 to £2.6m reflecting a more disciplined, commercially orientated new product development process.

During H219 management agreed a £30m asset financing facility, increasing total available facilities to around £57m. This will provide support if the longer-term impact of the coronavirus is to reduce demand for new mobile phones. During H120 management has negotiated an agreement with HSBC to relax debt covenants in December 2020 and June 2021. This is a precautionary measure to ensure continued access to debt facilities in severe downside scenarios.

Exhibit 2: Revenue analysis and top-line estimates

	2018 actual	2019 actual	2020e Old	2020e New	2021e Old	2021e New
Wireless (£m)	87.9	68.2	61.3	79.8	68.1	81.3
Photonics (£m)	66.8	69.8	80.2	83.7	94.7	94.7
CMOS++ (£m)	1.6	2.1	2.1	2.1	2.1	2.1
Total (£m)	156.3	140.0	143.7	165.6	164.9	178.2
Growth						
Wireless		-22%	-10%	17%	11%	2%
Photonics		4%	15%	20%	18%	13%
CMOS++		29%	0%	0%	0%	0%
Total		-10%	3%	18%	15%	8%

Source: IQE data, Edison Investment Research estimates

Outlook and estimates

Given the strong performance for the year to date and positive trading updates and outlooks from key customers, management has introduced guidance for FY20. This is for revenues of at least £165m, which is a year-on-year increase of over 18%, with an adjusted operating profit of at least mid-single digits. We have updated our FY20 and FY21 forecasts accordingly.

- **Wireless segment demand:** There remains considerable uncertainty as to how demand for IQE's epitaxy will develop over the remainder of the forecast period. In July Skyworks provided guidance of double-digit sequential revenue growth during the quarter ended September 2020, citing strong demand related to design wins for its front-end Sky5 platform in handsets for Samsung, Oppo, Vivo, Xiaomi, Motorola and other Tier-1 players. A week later RF chip manufacturer Qorvo provided guidance of sequential revenue of at least 17% for the same quarter, noting long-term drivers in 5G handsets and infrastructure. In August research house IDC predicted that the worldwide smartphone market would decline 9.5% y-o-y in 2020, then grow by 9% in 2021 and return to pre-COVID-19 levels in 2022. This view is much less pessimistic than the 21% drop in global wholesale smartphone revenues during FY20 predicted by Strategy Analytics in April.

In our opinion IQE should outperform the global smartphone market in FY20 for several reasons: (1) IQE suffered from severe inventory destocking during FY19, which has reversed; (2) its long-standing wireless customers have benefited from major design wins and (3) IQE itself is, we believe, taking market share in Asia. In addition, IQE also supplies epitaxy for wireless infrastructure and is therefore likely to be a beneficiary if individual governments opt to invest in 5G infrastructure as part of post-pandemic stimulus packages. There is already some evidence of this in Asia. We model 17% year-on-year growth in wireless revenues for FY20 as a whole, followed by modest (2%) growth during FY21. The guidance implies that H220 performance will be weaker than that for H120, although the second half is usually stronger one,

- **Photonics segment demand:** We assume that IQE will continue to be the major supplier of epitaxy for the original VCSEL customer, which we have previously assumed is part of the Apple supply chain. While the details of the iPhone12 have not yet been announced, concept illustrations posted by PhoneArena suggest that it will contain a LiDAR system, potentially for use in virtual reality/augmented reality applications. If so, the number of VCSELs per phone will increase by around 1.5 times, which is consistent with IQE's comment that the continued growth is related to content gain. Our view of 20% segmental growth for FY20 as a whole, which is only a modest decline in revenues from H120 to H220, is supported by content gain in this major supply chain. This gives both upside and downside risk to our segmental estimate, depending on whether the iPhone12 launch this autumn, which has already been pushed back

from the usual September to late-October, is delayed any further and whether consumer appetite for the potential new features and 'killer apps' is sufficient to encourage them to upgrade their phones.

- **Cost base:** We increase our estimates for indirect costs in line with H120 levels. This, together with a change in the underlying FY21 tax rate from 18% to 19%, cancels out the higher revenue estimate in FY21.
- **Capital expenditure:** Our estimate of £10.0m capex for FY20 is at the upper end of management guidance. The actual amount will depend on how quickly management expects the market to grow in FY21 and beyond.
- **Capitalised development costs:** We have cut our FY20 and FY21 estimates from £10.0m to £6.0m in line with H120 levels.

Exhibit 3: Changes to estimates

	FY19	FY20e			FY21e		
	Actual	Old	New	% change	Old	New	% change
Revenue (£m)	140.0	143.7	165.6	15.2%	164.9	178.2	8.1%
Adjusted PBT (£m)	(7.0)	(6.2)	3.1	N/A	11.6	10.9	-6.2%
Adjusted EPS (p)	(2.46)	(0.83)	0.28	N/A	1.13	1.05	-6.7%
Capitalised R&D (£m)	10.0	10.0	6.0	-40.0%	10.0	6.0	-40.0%
Property, plant and equipment (£m)	31.9	9.0	10.0	11.1%	9.0	10.0	11.1%
Net (cash)/debt excluding finance leases at year end (£m)	16.0	22.7	10.3	-54.4%	6.5	(2.6)	N/A

Source: Company accounts, Edison Investment Research

Given that future demand for both wireless and photonics epitaxy will be determined by the severity of any global recession caused by the coronavirus pandemic, we have prepared a sensitivity analysis showing the impact on FY20 adjusted operating loss of alternative year-on-year changes in wireless and photonics revenues. This is shown in Exhibit 4.

Exhibit 4: Sensitivity analysis – adjusted operating profit FY21 (£000s)

		FY21 wireless revenue growth/decline				
		5%	2%	0%	-2%	-5%
FY201 photonics revenue growth	0%	6,377	4,819	3,781	2,742	1,185
	5%	9,102	7,544	6,506	5,467	3,910
	10%	11,826	10,269	9,230	8,192	6,634
	13%	13,543	11,985	10,947	9,909	8,351
	15%	14,551	12,993	11,955	10,917	9,359

Source: Edison Investment Research

Valuation: Share price above pre-pandemic levels

We include a comparative valuation of IQE versus its broader (if imperfect) peer group below. Unlike some of its peers, IQE's share price has more than recovered the ground lost during the panic selling in March. At current levels IQE is trading at a premium on an EV/EBITDA basis with regards to the mean of the larger sample and the mean of the sample of companies engaged in manufacturing VCSEL epitaxy. It is trading above the upper bound of the sample of VCSEL peers with regards to year two P/E multiples.

Given IQE's broader product portfolio than its VCSEL peers, as well as its ability to manufacture VCSELs on 6" rather than 3" wafers, which confers cost-competitive advantages, and its ability to manufacture on multiple sites, which gives it relative resilience to US-China trade disputes, we believe it is reasonable for IQE to trade on multiples that are at the upper bound of the VCSEL sample. However we believe that further share price improvement will require greater visibility of how handset demand will be affected by any pandemic induced recession and whether the switch to 5G and the availability of as yet unknown 'killer apps' will be sufficient motivation for cash-strapped consumers to justify upgrading their handsets.

Exhibit 5: Peer valuation

Name	ytd performance (%)	Market cap (\$m)	EV/Sales 1FY (x)	EV/Sales 2FY (x)	EV/EBITDA 1FY (x)	EV/EBITDA 2FY (x)	P/E 1FY (x)	P/E 2FY (x)
Epitaxy								
GCS Holdings	(29.9)	150	2.1	N/A	N/A	N/A	42.4	N/A
N/IntelliEPI (Cayman)	(17.0)	66	2.5	2.2	14.0	13.5	55.4	31.4
LandMark Optoelectronics	(23.9)	729	8.8	6.7	18.2	13.5	40.3	25.6
Soitec SA	14.0	4,195	5.9	4.4	19.8	14.1	37.8	23.4
Visual Photonics Epitaxy Co	(34.7)	486	5.4	4.5	13.8	11.2	25.0	20.1
WIN Semiconductors	(2.9)	4,129	4.9	4.4	10.8	9.9	19.3	17.9
Opto-electronics								
II-VI	15.8	4,043	1.9	1.8	9.3	7.9	15.2	12.0
EMCORE	10.9	99	0.7	0.6	(96.7)	11.1	(16.0)	48.1
Lumentum Holdings	(3.7)	5,742	2.9	2.7	8.6	7.8	13.2	11.7
Mean – Epitaxy and Opto-electronics			3.9	3.4	13.5	11.1	31.1	20.3
IntelliEPI (Cayman)	(17.0)	66	2.5	2.2	14.0	13.5	55.4	31.4
LandMark Optoelectronics	(23.9)	729	8.8	6.7	18.2	13.5	40.3	25.6
Visual Photonics Epitaxy Co	(34.7)	486	5.4	4.5	13.8	11.2	25.0	20.1
Mean – VCSELS			5.5	4.5	15.4	12.7	40.2	25.7
IQE	20.8	652	3.0	2.8	17.3	13.5	222.3	58.5

Source: Refinitiv, Edison Investment Research. Note: Prices at 7 September 2020. Grey shading indicates exclusion from mean. IQE's EBITDA includes losses from JV.

Exhibit 6: Financial summary

	£'000s	2018	2019	2020e	2021e
Year end 31 December		IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS		restated			
Revenue		156,291	140,015	165,555	178,158
Adjusted Cost of Sales		(119,536)	(119,145)	(130,500)	(134,898)
Adjusted Gross Profit		36,755	20,870	35,055	43,259
EBITDA		26,404	16,246	28,715	36,753
Depreciation and Amortisation		(12,882)	(22,289)	(23,968)	(25,068)
Operating Profit (before amort. and except.)		16,040	(4,676)	5,047	11,985
Acquired Intangible Amortisation		0	0	0	0
Exceptionals		(8,424)	(14,897)	(9,346)	0
Share based payments		1,044	771	(550)	(550)
Operating Profit		8,660	(18,802)	(4,849)	11,435
Underlying interest		(66)	(1,606)	(1,600)	(800)
Exceptionals and losses from JVs		(1,847)	(4,540)	(300)	(300)
Profit Before Tax (norm)		13,974	(7,019)	3,147	10,885
Profit Before Tax (FRS 3)		6,747	(24,948)	(6,749)	10,335
Reported tax		(5,558)	(10,180)	1,826	(2,068)
Profit After Tax (norm)		11,229	(19,010)	2,549	8,817
Profit After Tax (FRS 3)		1,189	(35,128)	(4,923)	8,267
Average Number of Shares Outstanding (m)		761.8	787.2	796.8	797.3
EPS - normalised (p)		1.38	(2.46)	0.28	1.05
EPS - (IFRS) (p)		0.13	(4.51)	(0.66)	0.99
Dividend per share (p)		0.0	0.0	0.0	0.0
BALANCE SHEET					
Fixed Assets		267,476	300,047	292,079	283,011
Intangible Assets		121,775	118,456	116,648	114,240
Tangible Assets		124,520	136,557	130,397	123,737
Other		21,181	45,034	45,034	45,034
Current Assets		94,531	72,533	87,477	109,813
Stocks		35,709	30,668	32,657	39,048
Debtors		38,015	33,065	40,368	43,441
Cash		20,807	8,800	14,452	27,324
Other		0	0	0	0
Current Liabilities		(48,893)	(32,646)	(37,576)	(39,958)
Creditors		(48,893)	(27,529)	(32,459)	(34,841)
Short term borrowings*		0	(5,117)	(5,117)	(5,117)
Long Term Liabilities		(3,836)	(69,491)	(69,491)	(69,491)
Long term borrowings*		0	(67,631)	(67,631)	(67,631)
Other long term liabilities		(3,836)	(1,860)	(1,860)	(1,860)
Net Assets		309,278	270,443	272,490	283,375
CASH FLOW					
Operating Cash Flow		16,988	8,948	23,252	29,672
Net Interest		(66)	(671)	(1,600)	(800)
Tax		(665)	(151)	0	0
Capital expenditure and capitalised R&D		(42,362)	(41,834)	(16,000)	(16,000)
Acquisitions/disposals		0	10	0	0
Financing		813	712	0	0
Dividends		0	0	0	0
Net Cash Flow		(25,292)	(32,986)	5,652	12,872
Opening net debt/(cash)*		(45,612)	(20,807)	63,948	58,296
HP finance leases initiated		0	0	0	0
Other		487	(51,769)	0	0
Closing net debt/(cash)*		(20,807)	63,948	58,296	45,424

Source: Company accounts, Edison Investment Research. Note: *Including IFRS 16 finance lease liabilities.

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