EDISON

IQE

Trading update

Photonics growth supports upgrades

Tech hardware & equipment

IQE has announced that it will exceed current market expectations for both FY16 revenue and adjusted operating profit. This is primarily driven by strong growth in the photonics business, with a helping hand from sterling's weakness, and highlights the benefits of IQE's diversification strategy. We upgrade our FY16 and FY17 estimates, while maintaining a conservative stance and raise our valuation range from 40-45p to 45-49p.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
12/14	112.0	16.2	2.42	0.0	15.7	N/A
12/15	114.0	17.6	2.60	0.0	14.6	N/A
12/16e	129.0	20.3	2.88	0.0	13.2	N/A
12/17e	130.0	21.9	3.11	0.0	12.2	N/A

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

Photonics growth and forex effects benefit FY16

While trading was strong in multiple markets throughout FY16, with wireless revenues returning to growth, photonics remains the fastest growing business. The two key applications: vertical cavity surface emitting lasers (VCSELs), which are used in data communications, consumer and industrial applications; and indium phosphide (InP), which is used in fibre to the premises and other short-haul optical networks, are experiencing strong demand. Revenues also benefited from weakness in sterling throughout FY16. We raise our FY16 revenue and profit estimates to reflect these positive factors.

Photonics growth set to continue

Growth in photonics revenues is expected to continue. For example, Philips Photonics recently announced that it was to double VCSEL production capacity at its site in Ulm to reflect the huge potential for the devices in many applications. A recent report by Zion Research noted that the global VCSEL market was worth $760m in 2015 and forecasts 21.3% CAGR between 2016 and 2021. For IQE, confidence in continued growth in photonics revenues is underpinned by the progress made on customer qualifications for photonics applications during FY16. At this stage, our FY17 estimates model only relatively modest constant currency year-on-year revenue and profit growth.

Valuation: Photonics growth key to further re-rating

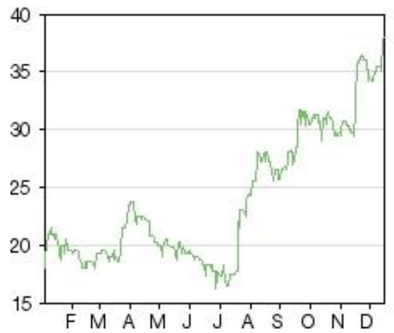
Although the share price has more than doubled from the low of 16.25p in June 2016, our analysis, which is based on peer group multiples, indicates that IQE's rating remains undemanding relative to its peers. Our revision to the indicative valuation range of 45-49p (previously 40-45p) is based on the 2016 earnings upgrade, peers re-rating upwards and IQE's diversifying revenue profile. Continued newsflow about photonics growth and stable wireless demand should help reduce the remaining discount to peers.

16 December 2016

Price	**38.00p**
Market cap	**£257m**

Net debt (£m) at end June 2016	33.6
Shares in issue	675.3m
Free float	88%
Code	IQE
Primary exchange	AIM
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	26.7	39.5	120.3
Rel (local)	23.3	35.0	93.0
52-week high/low		38.0p	16.2p

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 event

FY16 results	21 March 2017

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Edison profile page

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Estimates

We have made several adjustments to our estimates in response to the information in the trading update:

- We have upgraded our FY16 revenue estimates by 6% to reflect the trading update, which noted that H2 revenues would be higher than H1. Our estimate implies a 49/51% H1/H2 split. As a high proportion of the group's revenues are denominated in currencies other than sterling, this has a beneficial impact.
- Management is anticipating strong growth in photonics volumes related to the progress made in customer qualifications during FY16. However, given the lack of forward visibility, we are taking a cautious stance at this stage, modelling only a small uplift in revenues in constant currency for FY17. The full year results in March will be the first opportunity to review this.
- Our FY16 PBT and EPS estimates increase by 7% and 6% respectively. This reflects the fact that the majority of group costs are denominated in currencies other than sterling, as well as some reinvestment back into the business. As a result, our FY17 EBIT and EPS estimates are unchanged.
- Our FY16 net debt estimate rises from £30.5m to £39.1m. This reflects higher capex (£18.0m vs £14.5m including capitalised R&D costs) and higher receivables (£33.0m vs £24.0m) resulting from weak sterling and a strong finish to the year. Our FY17 net debt estimate rises from £10.1m to £19.1m, reflecting the higher debt level at the end of FY16 and higher capex (£12.0m vs £9.5m). The higher capex costs are attributable to the investment required to support photonics growth While photonics epitaxy may be manufactured using the same tools as wireless epitaxy, the photonics wafers are significantly more complicated. This means that investment needs to be made in modifying the tools to cope with the increased complexity and in additional equipment to check on the quality of the output.

Exhibit 1: Revision to estimates

	EPS (p)			PBT (£m)			Revenue (£m)		
	Old	New	% chg.	Old	New	% chg.	Old	New	% chg.
2015	2.60			17.6			114.0		
2016e	2.73	2.88	+5.5	19.0	20.3	+6.8	122.0	129.0	+5.7
2017e	3.11	3.11	N/A	21.9	21.9	N/A	127.8	130.0	+1.7

Source: Edison Investment Research

Valuation

Although the share price has more than doubled from the 16.25p low in June, IQE's rating still remains undemanding relative to its peers. This level of discount does not, in our opinion, appear justified, given that the factors which previously held the share price back (see below) have disappeared. Our indicative valuation range of 45-49p (previously 40-45p) is based on a comparison of IQE's multiples with those of the peer group mean. Selecting the 45-49p range places IQE on multiples that are close to the mean of our sample. The uplift in the valuation is a combination of the upward revisions to our FY16 profit estimates and an increase in the sample means. We suggest that the increase in sample means is linked to investor positivity about the photonics sector, in which IQE is a significant participant. Further newsflow confirming photonics growth and stable wireless demand should help close the remaining valuation gap.

Exhibit 2: Multiples of listed peers

Company	Market cap	Current EV/Sales (x)	Next EV/Sales (x)	Current EV/ EBITDA (x)	Next EV/ EBITDA (x)	Current P/E (x)	Next P/E (x)
Epitaxy							
Visual Photonics Epitaxy Co	£219m	3.0	3.2	8.7	7.8	15.4	16.1
IntelliEPI Inc	£68m	2.6	2.4	12.2	10.1	22.3	18.4
Land Mark Optoelectronics Corp	£609m	10.0	8.9	16.3	13.7	24.0	21.8
SOITEC	£744m	4.4	3.6	26.1	19.8	91.3	42.9
Wireless							
Broadcom	£56,845m	4.5	4.2	9.6	8.6	12.7	11.7
Qorvo Inc	£5,509m	2.4	2.2	7.3	6.6	11.9	9.6
Skyworks Solutions Inc	£11,248m	3.7	3.4	8.6	7.7	12.5	11.0
Opto-electronics							
II-VI Inc	£1,577m	2.2	2.0	12.0	10.3	29.2	21.8
EMCORE Corp	£181m	1.5	1.4	12.1	10.0	20.8	18.1
Mean		**3.0**	**2.8**	**10.8**	**9.4**	**18.6**	**16.1**
IQE at 37.75p	£255m	2.2	2.1	8.7	8.3	13.1	12.1
IQE at 45p	£304m	2.5	2.5	10.2	9.7	15.6	14.5
IQE at 49p	£331m	2.7	2.7	11.0	10.5	17.0	15.8

Source: Edison Investment Research. Note: Grey shading indicates exclusion from mean. Calculated on historic debt. Prices at 14 December 2016.

We believe that a number of factors contributed to the substantial discount between IQE and its peers during H116. These included uncertainty over both the prospects for the wireless business and the timing and rate at which revenues in new non-wireless fields would grow. The company's net debt and deferred consideration liability, together with the suppressing effect on cash flows of the RFMD wafer discounts, probably had an impact as well.

With regard to concerns about the wireless market, the interim results and recent trading update confirm that the destocking that bedevilled H215 is over and the market is growing again, albeit at a modest rate compared with five or six years ago. In addition, reliance on the wireless sector is reducing because of strong growth in photonics revenues and the creation of a new revenue stream from licence income. The announcement in both the interims and the trading update of strong growth in photonics gives reassurance that the contribution from this sector is here to stay. While there remains considerable uncertainty as to just how large revenues from this sector could become, our estimates treat the substantial growth that may result from existing photonics development programmes converting to volume deliveries as upside to FY17 performance. As revenues from volume photonics projects, as well as material revenues from power electronics or advanced solar are excluded from our FY17 estimates, there is no reason to apply a discounted multiple to reflect downside risk to earnings from these sectors.

Examining the potential cash flow and balance sheet concerns, both of these disappeared during H216. The RFMD wafer discount finished in H216, improving cash conversion and the deferred consideration balance was eliminated in full by the end of September 2016.

Exhibit 3: Financial summary

	£'000s	2014	2015	2016e	2017e
Year End 31 December		IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Revenue		112,011	114,024	129,003	130,034
Cost of Sales (Inc D&A + SBP)		(80,459)	(81,585)	(93,699)	(93,627)
Gross Profit		31,552	32,439	35,304	36,407
EBITDA		27,009	29,001	32,070	33,688
Depreciation and Amortisation		(9,391)	(10,024)	(10,200)	(10,800)
Operating Profit (before amort. and except.)		17,618	18,977	21,870	22,888
Acquired Intangible Amortisation		(1,101)	(1,208)	(1,208)	(1,208)
Exceptionals		(7,892)	5,398	0	0
Share based payments		(1,458)	(2,001)	(2,001)	(2,001)
Operating Profit		7,167	21,166	18,661	19,679
Underlying interest		(1,429)	(1,403)	(1,543)	(1,020)
Exceptionals		(495)	(387)	0	0
Profit Before Tax (norm)		16,189	17,574	20,327	21,868
Profit Before Tax (FRS 3)		5,243	19,376	17,118	18,659
Tax		(3,247)	773	500	500
Profit After Tax (norm)		16,701	18,066	20,327	21,868
Profit After Tax (FRS 3)		1,996	20,149	17,618	19,159
Average Number of Shares Outstanding (m)		650.8	662.6	670.1	675.3
EPS - normalised fully diluted (p)		2.42	2.60	2.88	3.11
EPS - (IFRS) (p)		0.25	3.00	2.60	2.84
Dividend per share (p)		0.0	0.0	0.0	0.0
Gross Margin (%)		28.2	28.4	27.4	28.0
EBITDA Margin (%)		24.1	25.4	24.9	25.9
Operating Margin (before GW and except.) (%)		15.7	16.6	17.0	17.6
BALANCE SHEET					
Fixed Assets		160,999	174,207	180,799	180,791
Intangible Assets		82,079	86,843	87,135	87,427
Tangible Assets		66,588	65,154	71,454	71,154
Other		12,332	22,210	22,210	22,210
Current Assets		48,323	48,909	58,528	67,196
Stocks		18,276	21,215	23,760	24,260
Debtors		24,463	23,050	33,000	34,200
Cash		5,584	4,644	1,768	8,736
Other		0	0	0	0
Current Liabilities		(46,667)	(48,050)	(47,857)	(48,357)
Creditors		(31,947)	(44,809)	(44,616)	(45,116)
Short term borrowings		(14,720)	(3,241)	(3,241)	(3,241)
Long Term Liabilities		(41,480)	(28,032)	(41,032)	(28,032)
Long term borrowings		(22,115)	(24,626)	(37,626)	(24,626)
Other long term liabilities		(19,365)	(3,406)	(3,406)	(3,406)
Net Assets		121,175	147,034	150,438	171,598
CASH FLOW					
Operating Cash Flow		14,861	20,971	13,882	32,488
Net Interest		(1,428)	(1,403)	(1,543)	(1,020)
Tax		1,258	(459)	500	500
Capex		(9,426)	(10,002)	(18,000)	(12,000)
Acquisitions/disposals		0	0	(11,691)	0
Financing		278	544	977	0
Dividends		0	0	0	0
Net Cash Flow		5,543	9,651	(15,876)	19,968
Opening net debt		34,351	31,251	23,223	39,099
HP finance leases initiated		0	0	0	0
Other		(2,443)	(1,623)	0	0
Closing net debt		31,251	23,223	39,099	19,131

Source: Company accounts, Edison Investment Research

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