

IQE

Trading update

Start of mass market VCSEL ramp-up

IQE's pre-close trading update notes a 16% year-on-year increase in wafer revenues in H117, driven by strong double-digit growth in photonics and currency tailwinds. Importantly, the photonics growth heralds the start of a mass-market ramp up in VCSEL (vertical cavity surface emitting laser) wafers for consumer applications, encouraging management to proceed with plans to substantially expand capacity ahead of anticipated demand in H218. We make modest upwards revisions to our estimates, noting the potential for further upgrades as there is greater clarity on photonics volumes.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
12/15	114.0	17.6	2.60	0.0	40.2	N/A
12/16	132.7	20.6	3.00	0.0	34.8	N/A
12/17e	145.3	23.5	3.27	0.0	32.0	N/A
12/18e	160.3	25.9	3.58	0.0	29.2	N/A

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

Strong photonics growth

The strong photonics growth noted since FY14 has continued into H117. Importantly, part of this growth is attributable to the onset of deliveries of VCSEL wafers for multiple, multi-year contracts addressing mass-market consumer applications. This is in addition to continued work on a range of programmes which also have potential to become volume contracts in future. This includes VCSELs for other consumer applications including 3D sensing, data comms and industrial applications such as heating; InP (indium phosphide) wafers for high-speed data networks and GaN (gallium nitride) wafers for radio frequency and power applications. The 16% y-o-y increase in total wafer revenues to c £70m during H117 was helped by a 10% currency tailwind caused by the devaluation of sterling last June. There was also c £1m licence revenue.

Capacity expansion underpinned by demand

Noting higher levels of expected demand for H218 than it had initially anticipated, the board of IQE has committed to a capacity expansion plan. It is leasing new premises in South Wales and placed orders for the equipment that will initially be required. We note that if deliveries for the current volume VCSEL contracts do not ramp up as expected to utilise this capacity, it will be used to fulfil volume orders for other programmes as they reach the commercialisation phase.

Valuation: Share price reflects further upgrades

The share price has doubled since the interims in March as investors have speculated on the potential impact of volume VCSEL programmes on earnings. As a result, the shares already price in further upgrades. Based on our updated estimates, IQE currently trades at a 2018e P/E of 29x vs a sector average of 19x. In our September results note we plan to present a detailed scenario analysis considering the impact of a faster ramp up in VCSEL volumes on earnings and profit related multiples.

Tech hardware & equipment

26 July 2017

Price 104.5p
Market cap £714m

Net debt (£m) at 31 December 2016	39.5
Shares in issue	683.0m
Free float	88.5%
Code	IQE
Primary exchange	AIM
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	(2.0)	51.1	378.9
Rel (local)	(0.9)	45.4	326.9
52-week high/low		112.3p	22.5p

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

Interims	5 September 2017
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Changes to estimates

We have revised our estimates to reflect:

- A modest ramp-up in VCSEL wafer volumes during H217 and into FY18 reflecting the onset of deliveries of VCSEL wafers for multiple, multi-year contracts addressing mass-market consumer applications. Previously our estimates excluded the potential impact of any of the VCSEL development programmes moving into volume production.
- Higher fixed costs associated with supporting the ramp-up in VCSEL wafers
- Higher levels of capitalised R&D associated with VCSEL activity
- Higher levels of capex to support the VCSEL ramp-up

Exhibit 1: Revisions to estimates

Year end December	FY16	FY17e			FY18e		
(£m)		Old	New	% change	Old	New	% change
Revenue	132.7	137.0	145.3	6.1%	140.2	160.3	14.3%
EBITDA	31.7	34.5	35.5	2.8%	35.0	39.7	13.2%
Adjusted PBT	20.6	22.5	23.5	4.4%	24.0	25.9	7.6%
Adjusted EPS (fully diluted) (p)	3.00	3.15	3.27	3.7%	3.37	3.58	6.5%
Capitalised R&D	8.1	5.5	11.0	100.0%	5.5	7.5	36.4%
PPE	11.0	6.5	20.0	207.7%	4.5	4.5	0.0%
Net debt	39.5	24.2	44.5	83.9%	5.4	26.9	401.5%

Source: Edison Investment Research

Valuation

Exhibit 2: Multiples of listed peers

Name	Market cap (\$m)	EV/sales FY1 (x)	EV/sales FY2 (x)	EV/EBITDA FY1 (x)	EV/EBITDA FY2 (x)	P/E FY1 (x)	P/E FY2 (x)
Epitaxy							
VISUAL PHOTONICS EPITAXY CO	385	4.6	4.1	14.1	10.6	22.8	18.6
INTELLIEPI	103	3.3	2.7	14.8	10.2	29.5	19.6
S.O.I.T.E.C.	1,849	5.3	4.1	26.3	17.1	65.7	33.3
Wireless							
BROADCOM	103,437	6.6	6.1	12.2	11.3	16.1	14.9
QORVO	8,603	2.8	2.6	8.5	7.6	12.1	10.5
SKYWORKS SOLUTIONS	19,451	5.0	4.5	11.4	10.2	16.7	14.6
Opto-electronics							
II-VI	2,393	2.6	2.4	-	-	28.4	23.4
EMCORE	294	1.8	1.7	12.5	10.9	20.2	17.3
Mean		4.0	3.5	14.3	11.1	26.4	19.0
IQE	£714m	5.2	4.7	21.2	19.0	32.0	29.2

Source: Edison Investment Research. Note: Prices at 20 July 2017. EV calculated on historic debt.

IQE's share price has doubled since the interims in March as investors have speculated on the potential impact of higher volume VCSEL programmes on earnings. As a result, the shares seem to already price in some further upgrades. Based on our updated forecasts, IQE currently trades at a 2018e P/E of 29x compared to a sector average of 19x. We note that SOITEC, which is currently trading on multiples that are at the upper end of our sample, reported a 22% year-on-year increase in revenues (constant currency) for the quarter ended June 2017. This was partly attributable to strong growth in wafers for digital mobile and low power applications including those used in consumer products that are already on the market such as connected watches, personal digital assistants and driver assistance systems. This suggests that IQE's multiples may be justified if it too is able to achieve stronger revenue and earnings growth than is presented in our estimates, which is feasible given the additional capacity coming on line in H218. The accelerated earnings

growth would result in a reduction in EV/EBITDA and P/E multiples. We intend to present a detailed scenario analysis examining the potential impact of a range of different rates of volume ramp up on IQE's earnings in our September note commenting on the interim results.

Exhibit 3: Financial summary					
	£'000s	2015	2016	2017e	2018e
Year End 31 December		IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Revenue		114,024	132,707	145,346	160,303
Cost of Sales (Inc D&A + SBP)		(81,585)	(96,292)	(105,303)	(115,664)
Gross Profit		32,439	36,415	40,043	44,639
EBITDA		29,001	31,730	35,462	39,665
Depreciation and Amortisation		(10,024)	(9,611)	(10,000)	(12,300)
Operating Profit (before amort. and except.)		18,977	22,119	25,462	27,365
Acquired Intangible Amortisation		(1,208)	(1,327)	(1,327)	(1,327)
Exceptionals		5,398	1,915	0	0
Share based payments		(2,001)	(2,042)	(3,000)	(3,000)
Operating Profit		21,166	20,665	21,135	23,038
Underlying interest		(1,403)	(1,489)	(2,000)	(1,500)
Exceptionals		(387)	(144)	0	0
Profit Before Tax (norm)		17,574	20,630	23,462	25,865
Profit Before Tax (FRS 3)		19,376	19,032	19,135	21,538
Tax		773	408	500	500
Profit After Tax (norm)		18,066	21,440	23,462	25,865
Profit After Tax (FRS 3)		20,149	19,440	19,635	22,038
Average Number of Shares Outstanding (m)		662.6	671.5	680.0	683.0
EPS - normalised (p)		2.60	3.00	3.27	3.58
EPS - (IFRS) (p)		3.00	2.87	2.89	3.23
Dividend per share (p)		0.0	0.0	0.0	0.0
BALANCE SHEET					
Fixed Assets		174,207	215,154	234,827	233,200
Intangible Assets		86,843	103,972	109,645	111,018
Tangible Assets		65,154	85,001	99,001	96,001
Other		22,210	26,181	26,181	26,181
Current Assets		48,909	64,323	68,506	95,557
Stocks		21,215	28,498	34,213	38,755
Debtors		23,050	30,868	34,278	39,163
Cash		4,644	4,957	14	17,639
Other		0	0	0	0
Current Liabilities		(48,050)	(46,012)	(48,572)	(50,297)
Creditors		(44,809)	(38,360)	(40,920)	(42,645)
Short term borrowings		(3,241)	(7,652)	(7,652)	(7,652)
Long Term Liabilities		(28,032)	(39,021)	(39,021)	(39,021)
Long term borrowings		(24,626)	(36,854)	(36,854)	(36,854)
Other long term liabilities		(3,406)	(2,167)	(2,167)	(2,167)
Net Assets		147,034	194,444	215,740	239,439
CASH FLOW					
Operating Cash Flow		20,971	22,463	28,896	31,963
Net Interest		(1,403)	(1,489)	(2,000)	(1,500)
Tax		(459)	(839)	(839)	(839)
Capex		(10,002)	(19,060)	(31,000)	(12,000)
Acquisitions/disposals		0	(11,250)	0	0
Financing		544	578	0	0
Dividends		0	0	0	0
Net Cash Flow		9,651	(9,597)	(4,943)	17,624
Opening net debt/(cash)		31,251	23,223	39,549	44,492
HP finance leases initiated		0	0	0	0
Other		(1,623)	(6,729)	0	0
Closing net debt/(cash)		23,223	39,549	44,492	26,867
Source: Edison Investment Research					

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