

## Revenue diversification driving growth

**IQE's ability to apply its epitaxial IP to multiple market segments is expected to deliver year-on-year revenue growth of over 15% for H116. In yesterday's trading statement, management states that the group is on track to achieve full-year expectations. We leave our estimates unchanged, noting that this confirmation of growth through diversification should help catalyse an upwards rerating of the shares.**

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
12/14	112.0	16.2	2.42	0.00	9.1	N/A
12/15	114.0	17.6	2.60	0.00	8.5	N/A
12/16e	122.0	19.0	2.75	0.00	8.0	N/A
12/17e	127.8	21.9	3.16	0.00	6.7	N/A

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

### Demonstrating benefits of diversification strategy

The key driver of the strong H116 revenue growth is the Photonics business. This is expected to show double-digit growth during H116, as multiple applications have started to transition to volume production. Growth is being driven by an increasing demand for VCSELs (vertical cavity lasers) in data communications, gesture recognition in consumer devices and industrial heating applications and for InP (indium phosphide) lasers in fibre optic communication systems. Photonics revenues are typically higher margin than those derived from wireless applications, so this trend is expected to have a beneficial impact on profits as well. Reassuringly, wireless revenues showed a small year-on-year increase, suggesting that the segment has stabilised. The move to leverage IP through involvement in JVs is also paying off, with licence income expected to total c £3.5m for the period.

### Trading update provides support for estimates

A 15% increase in H116's revenues (£53.2m to £61.2m) puts IQE in a good position to achieve our FY16 estimates. The business is typically weighted towards the second half because of customer ordering patterns. Moreover, the progress made on new product development and qualifications during H1 should result in additional volume business in H2. Brexit is not expected to have a material impact other than currency fluctuations – over 90% revenues are denominated in US\$.

### Valuation: Diversification key to rerating

IQE's rating is undemanding and remains at a substantial discount to its peers. In our [March note](#) we identified the potential catalysts for an upwards rerating of the shares as continued revenue diversification, improvement in cash conversion as the RFMD wafer discount tapers off (completing FY16) and strengthening of the balance sheet as the final tranche of deferred consideration for Kopin is paid (completed H116). With wireless revenues stable and all three of these catalysts now present or close, the start of an upwards rerating should not, in our opinion, be far off.

### Tech hardware & equipment

21 July 2016

**Price** 22.0p  
**Market cap** £148m

Net debt (£m) at 31 December 2015	23.2
Shares in issue	672.3m
Free float	88%
Code	IQE
Primary exchange	AIM
Secondary exchange	N/A

### Share price performance



%	1m	3m	12m
Abs	20.6	0.0	(8.3)
Rel (local)	12.8	(3.8)	(7.0)
52-week high/low	26.75p		16.25p

### 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, infra-red semiconductors, power electronics and CPV solar cells.

### Next events

Interim results	13 September 2016
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**Exhibit 1: Financial summary**

	£'000s	2014	2015	2016e	2017e
Year End 31 December		IFRS	IFRS	IFRS	IFRS
<b>PROFIT &amp; LOSS</b>					
Revenue		112,011	114,024	122,043	127,836
Cost of Sales (Inc D&A + SBP)		(80,459)	(81,585)	(89,092)	(92,042)
Gross Profit		31,552	32,439	32,952	35,794
EBITDA		27,009	29,001	31,169	34,469
Depreciation and Amortisation		(9,391)	(10,024)	(10,800)	(11,600)
Operating Profit (before amort. and except.)		17,618	18,977	20,369	22,869
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	17,160	19,660
Underlying interest		(1,429)	(1,403)	(1,343)	(1,007)
Exceptionals		(495)	(387)	0	0
Profit Before Tax (norm)		16,189	17,574	19,027	21,862
Profit Before Tax (FRS 3)		5,243	19,376	15,818	18,653
Tax		(3,247)	773	500	500
Profit After Tax (norm)		16,701	18,066	19,027	21,862
Profit After Tax (FRS 3)		1,996	20,149	16,318	19,153
Average Number of Shares Outstanding (m)		650.8	662.6	669.7	671.1
EPS - normalised fully diluted (p)		2.42	2.60	2.75	3.16
EPS - (IFRS) (p)		0.3	3.0	2.4	2.9
Dividend per share (p)		0.0	0.0	0.0	0.0
Gross Margin (%)		28.2	28.4	27.0	28.0
EBITDA Margin (%)		24.1	25.4	25.5	27.0
Operating Margin (before GW and except.) (%)		15.7	16.6	16.7	17.9
<b>BALANCE SHEET</b>					
Fixed Assets		160,999	174,207	171,699	168,391
Intangible Assets		82,079	86,843	87,135	87,027
Tangible Assets		66,588	65,154	62,354	59,154
Other		12,332	22,210	22,210	22,210
Current Assets		48,323	48,909	48,328	75,690
Stocks		18,276	21,215	22,000	23,900
Debtors		24,463	23,050	24,000	27,000
Cash		5,584	4,644	2,328	24,790
Other		0	0	0	0
Current Liabilities		(46,667)	(48,050)	(42,857)	(45,757)
Creditors		(31,947)	(44,809)	(39,616)	(42,516)
Short term borrowings		(14,720)	(3,241)	(3,241)	(3,241)
Long Term Liabilities		(41,480)	(28,032)	(28,032)	(28,032)
Long term borrowings		(22,115)	(24,626)	(24,626)	(24,626)
Other long term liabilities		(19,365)	(3,406)	(3,406)	(3,406)
Net Assets		121,175	147,034	149,138	170,292
<b>CASH FLOW</b>					
Operating Cash Flow		14,861	20,971	18,741	32,469
Net Interest		(1,428)	(1,403)	(1,343)	(1,007)
Tax		1,258	(459)	500	500
Capex		(9,426)	(10,002)	(9,500)	(9,500)
Acquisitions/disposals		0	0	(11,691)	0
Financing		278	544	977	0
Dividends		0	0	0	0
Net Cash Flow		5,543	9,651	(2,316)	22,462
Opening net debt/(cash)		34,351	31,251	23,223	25,539
HP finance leases initiated		0	0	0	0
Other		(2,443)	(1,623)	0	0
Closing net debt/(cash)		31,251	23,223	25,539	3,077

Source: IQE, Edison Investment Research

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