

IQE PLC (LON:IQE)

Semiconductor Wafer Pioneer

SUMMARY

IQE is a leading global supplier of advanced semiconductor wafers that are used in various applications ranging from mobile communications to industrial power. The company boasts a diversified global customer base and a unique IP portfolio with over 150 patents that enables the firm to provide a unique service to its customers. Headquartered in Cardiff, Wales, IQE shares were often misunderstood or underappreciated by investors in the past. However, as the company continued to deliver healthy growth winning volume contracts for new technologies (e.g. VCSEL), the share price nearly tripled in 2017 and the company successfully placed new shares raising £95m in November. Recent reports published by funds with short positions questioning IQE's accounting with regard to profit and cash flow contribution from its joint ventures sent the stock price down by 45% from its November high. That said, the company rejected the allegation with the statement saying that the information in the short sellers report is "either factually inaccurate or has previously been disclosed in IQE's annual reports and financial statements". The company also appointed KPMG as a new auditor replacing PwC as of 12th February saying "the company holds itself to the highest standards of transparency, governance and integrity". We find the management responses were timely and expect the share price to be stabilised going forward.

KEY INVESTMENT POINTS

- High growth potential in various addressable markets – IQE has secured a unique and competitive position in the semiconductor supply chain by specialising in complex epitaxy processes. With increasing demand for compound semiconductors within expanding applications, contract wafer manufacturing has become a key strategy for semiconductor device manufacturers. The epitaxy process is one of the most critical parts of the value chain and requires a high-level of expertise. IQE is well positioned to benefit from an a) increased wafer outsourcing with higher standards; and b) expanding end markets along with the fast development of IoT.

- Solid customer relationship with a unique IP portfolio – Albeit a widely implemented strategy in the industry, IQE has developed a combination of various advanced materials technology IP via acquisitions as well as partnering with reputable research institutions. The company owns over 150 IPs and provides bespoke R&D services to deliver customised materials for specific applications. Due to high complexity and operational risks, customers tend to employ limited numbers of vendors: usually one or two. This means IQE can take 50% or more of market share in each customer or product, which strengthens the relationship and leads to a possibility of leveraging various IPs for further product development with the customer.

- Solid execution track record with technology leadership – IQE has proved its ability of identifying and commercialising cutting edge technologies in epitaxial growth processes. The company processes the largest independent manufacturing capacity globally, hence is capable of achieving enhanced economy of scale. IQE boasts 30 years of process know-how and has achieved volume production of emerging technologies including recently launched VCSEL wafers.

TECHNOLOGY AND HARDWARE

06/03/2018

SHARE PRICE

▲ **130.20p**

52 WEEK LOW

▲ **48.25p**

MARKET CAP

▲ **£984m**

52 WEEK HIGH

▲ **178.75p**

NET CASH

▲ **£5.4m**

*5th Sep 17

NAV

▲ **£197.2m**

*5th Sep 17

MAJOR SHAREHOLDERS

- 1) **T Rowe Price:** 8.2%
- 2) **Hargreaves Lansdown** 6.9%
- 3) **Schroder Investment:** 5.1%

Shares in Issue 756.11m

Avg Volume Daily 1,976,651

Primary index AIM

EPIC LON:IQE

Next Key

Announcement -

Sector Tech and Hardware

SHARE PRICE CHART



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INDUSTRY OVERVIEW

Background & Outlook

According to KSI market research, global compound semiconductor market is expected to grow at a CAGR of 11% to reach \$69bn by 2022, increasing from \$40bn in 2017. The compound semiconductor is expected to be driven by 5G technologies that requires higher speed and minimum latency. By end-user industry segment, consumer electronics accounted for the major of market share in 2016 and is expected to grow at a reasonable CAGR. This growth is largely driven by the introduction of smartphones powered by GaAs-based communication chips coupled with an increase in the number of smartphones and other smart devices in the market. Moreover, increasing adoption of LEDs in consumer electronics is further expected to boost this segment's growth.

Competitive Landscape

The global compound semiconductor market is highly competitive with a large number of regional and international players. The vendors mainly focus on technology development that can differentiate their product and prices from their peers. Given a wide range of application and end-user industry, many players diversify product lines organically as well as via merger and acquisitions. Major global players include Skyworks Solution, Qorvo, Broadcom, NXP Semiconductors, TSMC, Cree, and Analog Devices.

COMPANY OVERVIEW

Business Description

IQE provides outsourced foundry services with a one-stop-shop for the wafer needs of global semiconductor manufacturers. The company's core business lies in the manufacturing of epiwafers with epitaxy process that have unique performance features of the wafers according to the customers' needs or targeted user market.

The company's growth has largely been driven by product diversification as the end market for compound semiconductor develops. IQE has four main business segments: Wireless (69% of group revenue as of 2016), Photonics (17%), Infrared (8%), and CMOS++ (1%). Wireless covers electronic devices that communicate wirelessly including mobile phones, mobile networks, WiFi, smart metering, satellite navigation, and many other connected/smart devices. Photonics represents applications that emit and detect light. This segment is currently the fastest growing area particularly with commercialisation of an advanced laser technology called VCSEL (Vertical Cavity Surface Emitting Lasers). The company operates multiple manufacturing and R&D facilities across Europe, Asia and the USA.

Key Competitive Advantage

IQE has differentiated itself in the industry through its broad IP portfolio of materials technologies and its ability to scale up to mass market by specialising in the complex epitaxy process. While both customer base and products are highly diversified, the company has a leadership in its own market with strong customer relationships. Its track record of developing cutting-edge technologies and developing into mass production is based on its c. 30 years of execution know-how. IQE dominates wireless communication Power Amplifier Chip with market share of c. 60% and is the first company to mass market commercialise VCSEL technology.

Management Team Background

Dr Drew Nelson is the president and CEO of IQE and has over 30 years' experience in the semiconductor industry. Following a PhD in Semiconductor Physics, he joined BT Research Laboratories in 1981, leading the group responsible for the development of advanced optoelectronic devices for optical fiber communications and also managed the technology transfer from BT to Agilent. He co-founded EPI in 1983 (became IQE in 1999) and was appointed CEO of IQE in April 1999. He is currently a member of the High Level Group appointed by the EC to oversee the implementation of Key Enabling Technologies (KETs) throughout Europe.

Phillip Rasmussen is CFO of IQE and a qualified chartered account. Prior to IQE he was Director of Transaction Services with PwC in Bristol and worked with IQE on two major acquisitions during 2006. He was appointed to the Board of IQE Plc in March 2007.

Recent Earnings Review and Outlook

IQE released pre-close trading update for 2017 in December and the management confirmed the company is set for a record financial results driven by the adoption of VCSEL. Double digit topline growth is expected with healthy growth across the segments. Photonics business topline is estimated to have doubled, InfraRed has grown c.10%, and Wireless sales are expected to come broadly flat YoY. The profit margin for 2017 appears to have improved thanks to an improved sales mix as well as completion of the upfront investment in new foundry that will begin operations in 2018. The full year results for 2017 will be reported on 20th March 2018.

While the company has a diverse products offering across various markets, we believe VCSEL will be a key growth driver for the near term considering its wide range of applications including sensing, LIDAR, optical communications, industrial heating, machine vision and heat assisted magnetic recording.

VALUATION

Despite a recent drop, IQE shares are still trading at a historically high range: 12m trailing P/E of 37x, EV/EBITDA 10x, and P/S of 5x. However, the stock has gone through a short period of transition being recognised by the market as an established semiconductor market player with multiple growth drivers. Therefore, historical valuation multiples cannot be appropriate comparable in our view. Our DCF driven fair value calculation sits at 141p, implying 32% upside from the current price. Our estimates assume top-line 10-year CAGR of 12%, EBIT CAGR of 9% and WACC of 7.2%.

RISKS

While IQE does not compete in commoditised semiconductor market, greater than expected price cuts can lead to margin erosion. Historical price drops for the past 10 years averages at c.5% and the company has successfully protected profitability by improving efficiency and sales mix. We find the key risk lies in end market development. Given the company's long-term R&D commitment to new technologies, forecasting new application market development and end demand is beneficial but an extremely difficult task. Longer than expected market development or slower demand could hinder the growth of IQE. As for foreign currency, the company is largely exposed to USD transaction. However, the net impact from currency move appears limited as they are naturally hedged.

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