

Technology	Last Close	Target Price	Upside	10 May 2018
	HK\$10.18	HK\$13.00↑	+28%	

SMIC (981 HK)

Righting the ship, earnings bottoming out; upgrade to Buy

- Earnings bottoming out:** SMIC's 1Q18 operational revenue (excluding one-time licensing) came in 3% ahead of our estimates on pick-up in customer demand. Due to higher-than-expected capacity utilization, GPM came in better than our expectation. For 2Q18, SMIC guides for wafer revenue to rise 15-18% QoQ, but this is partly caused by the timing of 28nm wafer shipment being pushed from 1Q18 to 2Q18 due to inventory correction. Without this, we estimate revenue would rise 8% QoQ. The company also raised capex from US\$1.9bn to US\$2.3bn on more R&D equipment spending and capacity expansion (mostly 8" capacity).
- Upside to guidance:** Given better-than-expected 2Q18 guidance, management's positive commentary on the demand outlook and the increase in capex this year, we believe the company may revise up its revenue/GPM guidance later this year. This could be a repeat of 2H16 when the market was overly pessimistic on the earnings outlook, followed by guidance revision by the company which led to a share rally. The overall foundry sector outlook seems to be improving as other foundries such as Vanguard and UMC also guided positively.
- Better positioned for sustainable growth with improving technology:** Technology roadmap remains on track with production of 28nm HKC+ starting in 2H18 and 14nm risk production starting in 1H19. With improving R&D capabilities, capacity expansion and strategic alliance with key China customers, we believe the company remains a major beneficiary of China fabless growth. We remain cautious on 14nm outlook (a sentiment shared by the market), but is encouraged by the company's prudent ramp-up approach. We also expect SMIC South JV partners to bear some of the losses at the initial stages, similar to the SMIC North (Beijing) JV.
- Raising estimates/TP; upgrade to Buy:** We raise 2018/19E net profit from US\$56m/112m to US\$119m/167m, on better-than-expected wafer shipments and GPM outlook, offsetting the possibility of higher tax ahead. Shares trade at 1.3x 2018E P/B (vs 5-year average of 1.2x). We expect sequential improvement in earnings, possible revision of guidance and 14nm ramp-up to be catalysts. Our new TP of HK\$13.00 is based on 1.5x 2019E P/B (previously HK\$9.00 on 1.1x 2018E P/B).

Stock Rating

BUY↑

1-year stock performance



Source: Bloomberg

Stock data

52w high (HK\$)	14.76
52w low (HK\$)	6.91
Market cap (HK\$ m)	52,962.49
Avg daily vol (m)	44.28
YTD change (%)	-20.56
200d MA (HK\$)	10.24

Source: Bloomberg

Chris Yim

christopher.yim@bocomgroup.com
(852) 3766 1803

Xinhe Deng

xinhe.deng@bocomgroup.com
(852) 3766 1856

Financial highlights

Y/E 31 Dec	2016	2017	2018E	2019E	2020E
Revenue (US\$ m)	2,914	3,101	3,435	3,867	4,348
YoY growth (%)	30	6	11	13	12
Net profit (US\$ m)	377	180	119	167	229
EPS (US cents)	7.75	3.57	2.41	3.37	4.61
YoY growth (%)	31	-54	-33	40	37
Previous EPS (US cents)			1.08	2.16	
Change (%)			123	56	
P/E (x)	17.9	38.7	57.5	41.1	30.0
BVPS (US\$)	0.9	1.0	1.1	1.1	1.1
P/B (x)	1.6	1.4	1.3	1.3	1.2
Dividend yield (%)	0.0	0.0	0.0	0.0	0.0

Source: Company data, BOCOM Int'l estimates

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Figure 1: SMIC (981 HK) quarterly earnings forecasts

(US\$ m)	1Q17	2Q17	3Q17	4Q17	1Q18	2Q18E	3Q18E	4Q18E	1Q19E	2Q19E	3Q19E	4Q19E	2017	2018E	2019E	2020E
Revenue	793	751	770	787	831	899	855	850	880	934	1,014	1,040	3,101	3,435	3,867	4,348
Seq %	-3	-5	2	2	6	8	-5	-1	4	6	9	3	6	11	13	12
COGS	572	557	592	639	611	680	679	696	696	730	777	801	2,361	2,665	3,004	3,342
% of sales	72	74	77	81	74	76	79	82	79	78	77	77	76	78	78	77
Depreciation cost	180	172	178	210	195	212	213	228	225	225	235	235	741	849	920	1,016
% of sales	23	23	23	27	23	24	25	27	26	24	23	23	24	25	24	23
Non-depreciation costs	392	385	414	428	416	468	466	467	471	504	542	567	1,620	1,817	2,084	2,326
% of sales	49	51	54	54	50	52	55	55	54	54	54	55	52	53	54	54
Gross profit	221	194	177	149	220	219	176	154	184	204	237	239	741	769	863	1,005
GPM%	27.8	25.8	23.0	18.9	26.5	24.4	20.6	18.1	20.9	21.9	23.4	22.9	23.9	22.4	22.3	23.1
OPEX	143	173	155	145	178	192	171	168	185	185	196	198	616	709	763	840
% of sales	18.1	23.0	20.1	18.5	21.4	21.3	20.0	19.8	21.0	19.8	19.3	19.0	19.9	20.6	19.7	19.3
R&D expense	108	111	107	101	123	133	120	119	132	131	137	140	427	495	540	599
% of sales	13.6	14.8	13.9	12.9	14.8	14.8	14.0	14.0	15.0	14.0	13.5	13.5	13.8	14.4	14.0	13.8
SG&A and others	36	61	48	44	55	58	51	49	53	54	59	57	189	214	223	241
% of sales	4.5	8.2	6.2	5.6	6.6	6.5	6.0	5.8	6.0	5.8	5.8	5.5	6.1	6.2	5.8	5.5
Operating profit	77	22	23	3	42	28	5	(14)	(1)	19	41	41	125	61	100	165
OM%	9.8	2.9	2.9	0.4	5.1	3.1	0.6	-1.7	-0.1	2.1	4.1	3.9	4.0	1.8	2.6	3.8
Pretax profit	65	36	30	(3)	43	36	16	(7)	8	23	48	44	128	87	123	188
Taxes (benefit)	1	3	(1)	(1)	16	2	1	(0)	0	1	2	2	2	18	6	9
Net Profit after minorities	70	36	26	48	29	52	30	8	23	37	56	52	180	119	167	229
Wafer shipments (k 8" equiv)	1,096	1,014	1,076	1,125	1,084	1,224	1,237	1,224	1,249	1,324	1,430	1,444	4,311	4,769	5,446	5,961
QoQ (%)	0	-7	6	5	-4	13	1	-1	2	6	8	1				
YoY (%)	26	8	2	3	-1	21	15	9	15	8	16	18	9	11	14	9
ASP per wafer (US\$)	702	717	704	698	640	676	682	682	682	689	696	703	705	671	693	713
QoQ (%)	-2	1	0	-3	-8	6	1	0	0	1	1	1				
YoY (%)	0	1	-1	-3	-9	-6	-3	-2	7	2	2	3	0	-5	3	3
Revenue by technology (%)																
28nm	5	7	9	11	3	9	8	8	8	9	10	10	8	7	9	12
40/45nm	20	19	21	24	22	23	23	23	22	21	21	21	21	23	21	20
55/65nm	22	24	20	16	21	20	20	20	19	19	18	18	20	20	18	18
90nm	1	1	1	2	4	1	1	2	3	4	2	2	1	2	3	2
0.13um	15	17	8	6	8	7	7	7	8	8	9	8	12	7	8	8
0.15/0.18um	34	29	38	38	39	37	37	36	37	36	36	36	35	37	36	32
0.25um/0.35um	3	3	3	3	4	3	4	4	3	3	3	3	3	4	3	3
Capacity (8", thousand)	1,265	1,315	1,344	1,328	1,343	1,405	1,441	1,473	1,489	1,516	1,589	1,619	5,252	5,662	6,213	6,931
seq%	4	4	2	-1	1	5	3	2	1	2	5	2	18	8	10	12

Source: Company data, BOCOM Int'l estimates

Financial Statements

Income statement (US\$ m)					
Y/E 31 Dec	2016	2017	2018E	2019E	2020E
Revenue	2,914	3,101	3,435	3,867	4,348
COGS	(2,064)	(2,361)	(2,665)	(3,004)	(3,342)
Gross profit	850	741	769	863	1,005
Opex	510	616	709	763	840
OP	339	125	61	100	165
Net interest expense	(2)	9	(4)	(4)	(4)
Equity Method	(14)	(10)	(1)	(1)	(1)
Others	(9)	4	31	28	28
Non-op income	(29)	3	27	23	23
Pre-tax income	310	128	87	123	188
Tax	(7)	2	18	6	9
Net income (before minority interest)	316	126	69	117	179
Minority interest	(60)	(53)	(50)	(50)	(50)
Net income	377	180	119	167	229
EPS (US cents)	7.75	3.57	2.41	3.37	4.61

Cash flow statement (US\$ m)					
Y/E 31 Dec	2016	2017	2018E	2019E	2020E
Net profit	316	180	119	167	229
Depreciation/amortization	730	971	1,075	1,243	1,373
Changes in work capital	(70)	(19)	(20)	(26)	(29)
Forex gain/loss	-	(13)	-	-	-
Others	1	21	-	-	-
Cash flow from operations	977	1,140	1,174	1,384	1,573
Capex	(2,757)	(2,490)	(2,300)	(2,000)	(1,800)
Sales of tangible assets	524	-	-	-	-
Investments	(53)	(106)	(82)	(106)	(117)
Others	(157)	(121)	-	-	-
Cash flow from investing	(2,443)	(2,717)	(2,382)	(2,106)	(1,917)
Dividends paid	-	-	-	-	-
New share issued	-	326	-	-	-
Debt issuance/(repayment)	1,766	570	500	500	500
Other	849	376	-	-	-
Cash flow from financing	2,615	1,272	500	500	500
Other	(28)	17	-	-	-
Net cash flow	1,121	(288)	(708)	(222)	156
Cash at beginning	1,005	2,126	1,838	1,131	909
Cash at end	2,126	1,838	1,131	909	1,065

Balance sheet (US\$ m)					
As of 31 Dec	2016	2017	2018E	2019E	2020E
Cash & cash equiv.	2,126	1,838	1,131	909	1,065
Marketable securities	369	1,020	1,020	1,020	1,020
Account receivables	646	616	683	769	864
Inventory	464	623	690	777	873
Others	28	34	34	34	34
Current assets	3,633	4,132	3,557	3,508	3,856
Land/CIP	99	98	98	98	98
PP&E, net	5,687	6,523	7,749	8,505	8,932
Investment in associates/JV	240	758	840	945	1,063
Investment property	-	-	-	-	-
Intangible asset	249	220	220	220	220
Other fixed assets	207	188	188	188	188
Total assets	10,115	11,919	12,651	13,465	14,356
Accounts payable	941	1,051	1,164	1,310	1,473
Short-term debt	687	441	454	467	481
Others	353	416	416	416	416
Current liabilities	1,981	1,907	2,033	2,193	2,370
Long term debt	2,338	2,870	3,357	3,844	4,330
Others	393	420	420	420	420
Total liabilities	4,712	5,197	5,810	6,457	7,119
Common stock	4,968	4,847	4,847	4,847	4,847
Reserves	(817)	322	441	608	837
Shareholder equity	4,151	5,169	5,288	5,456	5,685
minority interest	1,253	1,552	1,552	1,552	1,552
Total Liabilities & Capital	10,115	11,919	12,651	13,465	14,356

Financial ratios					
Y/E 31 Dec	2016	2017	2018E	2019E	2020E
P/E (x)	17.9	38.7	57.5	41.1	30.0
P/B (x)	1.6	1.4	1.3	1.3	1.2
P/S (x)	2.3	2.2	2.0	1.8	1.6
EV/EBITDA (x)	55.4	59.8	65.3	59.4	53.6
Dividend yield (%)	0.0	0.0	0.0	0.0	0.0
Net debt/equity	0.2	0.3	0.5	0.6	0.7
ROE (%)	9.6	3.9	2.3	3.1	4.1
ROA (%)	3.7	1.1	0.6	0.9	1.3
ROIC (%)	5.5	1.6	0.8	1.2	1.8

Source: Company data, BOCOM Int'l estimates

BOCOM International

10/F, Man Yee Building, 68 Des Voeux Road Central, Central, Hong Kong
Main: (852) 3766 1899 Fax: (852) 2107 4662

Rating System

Analyst Stock Ratings:

Buy: The stock's total return is expected to **exceed** that of the corresponding industry over the next 12 months.

Neutral: The stock's total return is expected to be **in line with** that of the corresponding industry over the next 12 months.

Sell: The stock's total return is expected to be **below** that of the corresponding industry over the next 12 months.

Not-Rated: The analyst **does not have conviction** regarding the outlook of the stock's total return relative to that of the corresponding industry over the next 12 months.

Analyst Industry Views:

Outperform: The analyst expects the industry coverage universe to be **attractive** relative to the relevant broad market benchmark over the next 12 months.

Market perform: The analyst expects the industry coverage universe to be **in line with** the relevant broad market benchmark over the next 12 months.

Underperform: The analyst expects the industry coverage universe to be **unattractive** relative to the relevant broad market benchmark over the next 12 months.

Broad market benchmark for Hong Kong is **the Hang Seng Composite Index**, for China A-shares is the **MSCI China A Index**, for US-listed Chinese companies is **S&P US Listed China 50 (USD) Index**.

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