

Striving to become China's leading semiconductor equipment manufacturer via the acquisition of NMC

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Investment Highlights

- ❖ **Private placement to fund acquisition of China's premium semiconductor equipment manufacturer – Beijing NMC.** As the only A-share listed semiconductor equipment manufacturer, Sevenstar is China's leading player in the production of oxidation furnaces and wafer cleaning systems. Sevenstar plans to fully acquire Beijing North Microelectronics (China's leading player in silicon etching and PVD equipment) from its parent (Beijing Electronics Holding). The deal is priced at 14.6x 2016 earnings and Sevenstar plans to fund the acquisition with an Rmb924mn share placement (issuing 52.81mn new shares priced at Rmb17.49/share). As part of the deal, NMC is committed to 2016 net profit of Rmb63.17mn and revenue of Rmb510/660/840mn over 2016-18. In addition, Sevenstar is looking to raise a further Rmb924mn from three institutional investors in a separate private placement, to fund NMC's capacity expansion project. Upon completion of the deals, Sevenstar's share capital would have increased by 30%.
- ❖ **Domestic companies facing both challenges and opportunities in a semiconductor market with massive potential.** Due to a number of factors including: (i) high technological barriers and market concentration; (ii) protracted R&D cycle; as well as (iii) technology transfer embargo put in place jointly by developed nations, Japan and the US have five and four companies ranked amongst the top-10 semiconductor equipment manufacturers worldwide. Meanwhile, the top-4 companies in this industry account for over 60% of the market share, of which, the US based Applied Materials and the Dutch giant ASM (70% share of the global mask aligner market) hold 19% and 17% global market shares respectively. On the other hand, numerous global giants have set up manufacturing bases in China in recent years, which enabled the domestic semiconductor equipment market to expand to US\$6.6bn as of 2015, accounting for over 15% of the global total. Over the past five years, the market in China has witnessed CAGR of 12.4%, far outstripping the global growth of 1.9%. Nevertheless, the domestic industry is still facing challenges. Despite the continued migration of the semiconductor industry to mainland China, constrained by technological limitations, domestic firms are yet to benefit substantially from this trend. In fact, market shares of domestic manufacturers have been on the decline over the recent years, putting urgency on Chinese companies to lift their game.
- ❖ **Playing to each other's strengths with the acquisition of NMC.** Sevenstar is China's top player in manufacturing of oxidation furnaces and wafer cleaning systems while NMC has leading technology in silicon etching, PVD and CVD equipment. In particular, the latter owns exclusive 28nm silicon etching and PVD technology in China. By



BUY (Initial Coverage)

Current price: Rmb24.55

Target price: Rmb29.50

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Performance relative to the index



Source: CITICS Quantitative Investment Analysis System

Main data

CSI 300	3617.66
Total equity/shares o/s (mn)	337/352
LTM High/low (Rmb)	60.2/16.8
1-month absolute gain	-14.9%
6-month absolute gain	-33.53%
YTD Absolute gain	12.55%
LTM Average daily turnover (Rmb mn)	190.02

acquiring NMC, Sevenstar will expand its business coverage to the five major processes of manufacturing integrated circuits (wafer development, wafer cleaning, oxidation, etching and membrane deposition). Playing to each other's strengths, we anticipate leap-frog growth for Sevenstar going forward.

- ❖ **Expected to replicate the AMAT's path to success and establish a semiconductor equipment manufacturing platform.** The US based Applied Materials is the world's largest supplier of semiconductor equipment, which relied heavily on M&As (around nine major deals during its 30 years of rapid expansion) to bolster its product range throughout its development. We believe Sevenstar may replicate the development path of AMAT, which is also aligned with the government's intention of fostering 1-2 major players for China's semiconductor equipment industry amidst a fragmented domestic market at present. Over the long-term, we believe Sevenstar's domestic market share could progressively rise to 40% with revenue to exceed US\$2.0bn (~15x of its current level), enabling the Company to be ranked in the top-echelon of the semiconductor equipment industry.
- ❖ **Risks:** (i) business development falling short of expectations; (ii) disappointing technology R&D.
- ❖ **Earnings forecast, valuation and investing rating.** We forecast its 2016-17E EPS to be Rmb0.27/0.32. The stock is currently trading at Rmb24.55, implying 2016/17 P/E and P/B of 89/76x and 3.6/3.4x respectively. Due to the protracted R&D cycle and substantial investments involved in the production of semiconductor equipment, the acquisition of Beijing North Microelectronics is unlikely to give an immediate boost the Company's earnings. Nevertheless, it will not undermine Sevenstar's competitiveness and industry status. Within the A-share electronics sphere, semiconductor equipment manufacturers are highly sought after by investors thanks to their scarcity, while they are also expected to benefit extensively from favorable industry policies. Drawing reference from the development path of its peers, we are upbeat on the Company's long-term prospects as we believe it will focus on both organic and inorganic growth going forward. Initiate coverage with BUY and a target price of Rmb29.5 (4.3x P/B).

Item/Year	2013	2014	2015E	2016E	2017E
Turnover (Rmb mn)	859.5	961.7	854.5	1,533.4	1,890.4
Growth rate (YoY, %)	(15.1)	11.9	(11.2)	79.5	23.3
Net profit (Rmb mn)	103.1	41.9	38.6	125.8	148.3
Growth rate (YoY, %)	(27.0)	(59.4)	(7.9)	226.1	17.9
EPS (Fully diluted, Rmb)	0.29	0.12	0.11	0.27	0.32
EPS (Market consensus, Rmb)			0.11	0.29	0.45
Gross margin (%)	41.9	34.6	39.2	40.1	39.9
ROE (%)	5.5	2.2	1.9	4.9	4.6
PE (x)	84	206	224	89	76
PB (x)	4.5	4.4	4.2	3.6	3.4
EV/EBITDA (x)	53.7	60.5	81.7	(110.0)	275.5

Source: CITICS Quantitative Investment Analysis System

Note: Closing price as of 18 Mar 2016

Income Statement (Rmb mn)						Balance Sheet (Rmb mn)					
Indicator	2013	2014	2015E	2016E	2017E	Indicator	2013	2014	2015E	2016E	2017E
Turnover	860	962	854	1,533	1,890	Cash and cash equivalents	263	213	162	480	320
Operating cost	499	629	520	918	1,136	Inventory	615	566	520	918	1,136
Gross margin	41.9%	34.6%	39.2%	40.1%	39.9%	Accounts receivable	597	594	538	966	1,036
Business tax & surcharge	4	5	4	8	9	Other current assets	101	93	83	77	63
Selling expense	48	45	51	92	95	Current assets	1,576	1,466	1,303	2,441	2,554
Selling expense ratio	5.6%	4.6%	6.0%	6.0%	5.0%	Fixed assets	552	621	1,181	1,295	1,400
Administrative expense	160	179	222	690	699	Long-term equity investment	0	0	0	0	0
Administrative expense ratio	18.7%	18.6%	26.0%	45.0%	37.0%	Intangible assets	511	687	687	687	687
Financial expense	1	10	12	14	17	Other long-term assets	1,107	1,112	824	991	1,175
Financial expense ratio	0.1%	1.1%	1.4%	0.9%	0.9%	Non-current assets	2,170	2,420	2,693	2,973	3,263
Investment revenue	9	38	0	0	0	Total assets	3,746	3,886	3,996	5,414	5,817
Operating profit	137	57	45	-189	-65	Short-term borrowing	117	195	209	266	295
Operating profit margin	16.0%	5.9%	5.3%	-12.3%	-3.5%	Accounts payable	305	307	253	448	554
Non-operating income	23	45	51	380	280	Other current liabilities	305	300	300	300	300
Non-operating expenditure	1	1	0	0	0	Current liabilities	727	801	762	1,014	1,149
Total profit	159	100	96	191	215	long-term liabilities	0	0	0	0	0
Income tax	27	27	26	33	36	Other long-term liabilities	1,093	1,121	1,199	1,283	1,373
Income tax rate	17.0%	26.6%	26.6%	17.0%	17.0%	Non-current liabilities	1,093	1,121	1,199	1,283	1,373
Minority interests	29	32	32	33	30	Total liabilities	1,820	1,922	1,961	2,297	2,522
Net profit attributable to shareholders of parent company	103	42	38.6	125.8	148.3	Share capital	352	352	352	458	458
Net margin	12.0%	4.4%	4.5%	8.2%	7.8%	Capital reserve	1,472	1,479	1,518	2,462	2,610
						Owner's equity	1,926	1,964	2,035	3,117	3,295
						Minority interests	102	133	165	198	228
						Liabilities & owner's equity	3,746	3,886	3,996	5,414	5,817

Cash Flow Statement (Rmb mn)					
Indicator	2013	2014	2015E	2016E	2017E
Pre-tax profit	159	100	96	191	215
Change in working capital	-27	-27	-26	-33	-36
Depreciation & amortization	44	68	71	79	88
Change in working capital	-219	-100	60	-626	-167
Others	17	51	-32	-33	-30
Operating cash flow	-26	93	169	-421	69
CAPEX	-166	-196	-159	-159	-159
Investment revenue	0	0	0	0	0
Disposal of assets	3	0	0	0	0
Others	-2	2	-184	-201	-219
Investing cash flow	-164	-194	-343	-360	-378
Stock issuance	0	0	0	924	0
Change in liabilities	-90	78	13	58	29
Dividend paid	-45	-27	0	0	0
Others	0	0	110	117	120
Financing cash flow	-135	51	124	1,098	149
Net increase in cash and equivalents	-326	-50	-51	318	-160

Main Financials					
	2013	2014	2015E	2016E	2017E
Growth (%)					
Turnover	-15.1	11.9	-11.2	79.5	23.3
Operating profit	-26.1	-58.9	-20.0	N.A.	N.A.
Net profit	-27.0	-59.4	-7.9	226.1	17.9
Margin (%)					
Gross margin	41.9	34.6	39.2	40.1	39.9
EBIT Margin	16.0	5.9	5.3	-12.3	-3.5
EBITDA Margin	22.1	17.8	15.0	-6.2	2.1
Net margin	15.4	7.6	8.2	10.4	9.4
Return (%)					
ROE	5.5	2.2	1.9	4.9	4.6
ROA	3.6	1.9	1.8	3.4	3.2
Others (%)					
Liability/asset ratio	48.6	49.5	49.1	42.4	43.3
Income tax rate	17.0	26.6	26.6	17.0	17.0
Dividend payout ratio	43.9	65.3	0.0	0.0	0.0

Source: Company announcement, CITICS Research forecast

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	OVERWEIGHT	Increase relative to market representative index between 5% and 20%
	HOLD	Increase relative to market representative index between -10% and 5%
	SELL	Decrease relative to market representative index over 10%
	OUTPERFORM	Increase relative to market representative index over 10%
	NEUTRAL	Increase relative to market representative index between -10% and 10%
	UNDERPERFORM	Decrease relative to market representative index over 10%

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