

Dialog Semiconductor

Price EUR26.41

To remain capped until the core business regains its historical sales growth momentum

Fair Value EUR38 vs. EUR34 (+44%)

NEUTRAL

| | |
|----------------------------|-------------|
| Bloomberg | DLG GR |
| Reuters | DLGS.DE |
| 12-month High / Low (EUR) | 53.3 / 26.4 |
| Market Cap (EURm) | 2,057 |
| Ev (BG Estimates) (EURm) | 1,598 |
| Avg. 6m daily volume (000) | 18.20 |
| 3y EPS CAGR | 18.4% |

Yesterday, Atmel announced that the Board had reviewed the Microchip offer and deemed it superior to the one from Dialog. As a result, with the Atmel acquisition very likely to fail, we must now revert to Dialog's core business. Over the few last months, however, this core business has been hit by weaknesses in the Apple value chain, maintaining pressure on the management to accelerate the diversification strategy. This leads to a tricky situation where the stock retains a high risk profile and weak momentum until Apple returns to shipment growth. In our view, it explains the limited positive reaction of the stock yesterday after the Atmel announcement. Our FV is up to EUR38 but, given the particularly unsupportive momentum, we maintain our Neutral recommendation.

| | 1 M | 3 M | 6 M | 31/12/14 |
|----------------|--------|--------|--------|----------|
| Absolute perf. | -18.7% | -32.0% | -47.3% | -9.9% |
| Semiconductors | -8.6% | -2.6% | -13.9% | -16.2% |
| DJ Stoxx 600 | -3.5% | -5.1% | -11.7% | 0.2% |

ANALYSIS

| YEnd Dec. (USDm) | 2014 | 2015e | 2016e | 2017e |
|------------------|-------|-------|-------|-------|
| Sales | 1,156 | 1,355 | 1,468 | 1,693 |
| % change | | 17.2% | 8.4% | 15.3% |
| EBITDA | 286 | 359 | 387 | 455 |
| EBIT | 230.3 | 301.9 | 319.1 | 383.0 |
| % change | | 31.1% | 5.7% | 20.0% |
| Net income | 172.2 | 213.7 | 233.6 | 294.5 |
| % change | | 24.1% | 9.3% | 26.1% |

| | 2014 | 2015e | 2016e | 2017e |
|------------------|-------|-------|-------|-------|
| Operating margin | 19.9 | 22.3 | 21.7 | 22.6 |
| Net margin | 14.9 | 15.8 | 15.9 | 17.4 |
| ROE | 22.1 | 18.2 | 16.9 | 18.0 |
| ROCE | 36.8 | 41.7 | 45.5 | 55.0 |
| Gearing | -18.3 | -46.9 | -55.6 | -62.3 |

| (USD) | 2014 | 2015e | 2016e | 2017e |
|-----------------|-------|-------|-------|-------|
| EPS | 2.27 | 2.74 | 2.99 | 3.77 |
| % change | | 20.5% | 9.3% | 26.1% |
| P/E | 11.6x | 9.7x | 8.8x | 7.0x |
| FCF yield (%) | 11.2% | 8.2% | 9.4% | 11.6% |
| Dividends (USD) | 0.00 | 0.00 | 0.00 | 0.00 |
| Div yield (%) | NM | NM | NM | NM |
| EV/Sales | 1.7x | 1.2x | 1.0x | 0.7x |
| EV/EBITDA | 6.8x | 4.5x | 3.6x | 2.6x |
| EV/EBIT | 8.4x | 5.3x | 4.4x | 3.0x |

- Microchip offer on Atmel is seen as superior to the one from Dialog.** In a press release published yesterday, Atmel announced that the Board had reviewed the Microchip proposal and deemed it superior to the one from Dialog. As a result, Atmel intends to terminate the Dialog merger agreement and enter into a definitive merger agreement with Microchip. Microchip's bid is USD8.15/share including USD7/share in cash (DLG was USD7.85/share). If Atmel terminates the Dialog agreement, it will have to pay breakup fees of USD137m to Dialog. However, note that despite Atmel's Board preferring the Microchip proposal, Atmel has yet to confirm that they will terminate the Dialog merger agreement. This also explains the limited positive impact on yesterday's stock price, even if it looks difficult to go backward after such an announcement.
- A higher bid is technically possible but very unlikely in our view.** We recall that the Atmel deal is a cash and equity deal. On the one hand, the group has a very limited possibilities regarding the cash part of the deal since it is mainly raising debt resulting in a pro forma Net debt to EBITDA ratio of about 3x. On the other hand, proposing more equity is likely to require a new vote by shareholders, which we believe would have little chance of passing at a new GM. Indeed, the original deal involved significant dilution for DLG shareholders with 49m shares planned to be issued. This was barely acceptable to shareholders with only 62% voting "for". As a result, in our view, there is a very limited chance of seeing a higher bid from Dialog.
- In addition, Dialog's core business has proved more fragile than expected over the last few months, leading to a challenging situation.** This is due to both a degradation in the economic situation in Asia and high comps with the exceptional performance of the iPhone 6 one year ago. As a result, in addition to the controversial Atmel deal, Dialog has been impacted by a poor news flow over the last few months with: 1/disappointing Q4-15 guidance announced in October, 2/ an update with a cut in the guidance in December and 3/ disappointing FY16 guidance few days ago. With the recent weakness in the core business, we believe that Dialog has no choice but to find a way to accelerate its diversification.
- Three scenarii but none of them is sexy while the core business remains under pressure.** In our view, there are 3 scenarii: **1/** the group chose to accelerate its diversification organically through higher investments in the connectivity business (9% of total group sales in Q3-15) and the power conversion division (6.5% of group sales in Q3-15) or through small acquisitions. This scenario would probably lead to some margin pressure (R&D+Sales and marketing or integration) and the dilution of the first client would come gradually, leading to a progressive increase on the stock price. **2/** Dialog continues to scan the market for a new target with a similar size to Atmel to reduce the Apple part of the business to below 50% with one deal. This second scenario would lead to a similar situation to the Atmel deal and, given the current net cash position, leads to potentially high dilution for current shareholders. **3/** the group fails to diversify. In our view, the first scenario remains the most attractive but we expect the stock momentum to remain poor until the core business regains its historical sales growth momentum.



VALUATION

- Note that our previous FV included all the negative impact of Atmel (our estimates did not). Given the low chance of Dialog finally acquiring Atmel, we withdraw the negative impacts of the Atmel deal in the Dialog accounts (used to calculate our previous FV). However, with 1/ Apple shipments slowing (Apple represents about 80% of Dialog sales), 2/ a degradation in smartphone market conditions, and 3/ a new potentially dilutive deal motivated by a determination to dilute the main client as a proportion of total group sales, we consider fair it to maintain the beta at 1.6 in our DCF and the 15% discount vs. peers applied as of the Atmel acquisition announcement. Our new FV is EUR38 versus our FV of EUR57 prior to 1/ the announcement of the Atmel deal, 2/ the series of disappointments mainly driven by lower volumes and 3/ a weaker environment. **Given the particularly unsupportive momentum, we maintain our Neutral recommendation.**
- Less than 6 months ago, Dialog was one of our favorite stocks in the European semiconductor landscape. The group benefited from strong momentum, a business model offering limited volatility compared with peers (developing custom products creating strong partnership with clients vs. catalog products), and an increasing, although limited, diversification. In early 2016, the group's profile significantly changed due to both internal and external factors. Today, Dialog's share trades at a 12m fwd P/E of 9.6x versus 17.8x 6 months ago.

NEXT CATALYSTS

- FY15 results to be published during the week commencing 7 March 2016.

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| | |
|---------|--|
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