

ARM Holdings

Price 954.00p

The group confirms its resilience to Smartphone slowdown

Fair Value 1340p (+40%)

BUY

Bloomberg	ARM.LN
Reuters	ARM.L
12-month High / Low (p)	1,201 / 848.5
Market Cap (GBPm)	13,436
Ev (BG Estimates) (GBPm)	12,461
Avg. 6m daily volume (000)	3,585
3y EPS CAGR	15.2%

Yesterday, ARM published Q1 results and 2016 guidance that confirmed our view. The group's sensitivity to the slowing smartphone market has been significantly reduced thanks to higher diversification and an ongoing increase in the smartphone royalty rate (see our [first take](#) from yesterday). In addition, we understand that the group is particularly confident for the mid-term thanks to the currently high demand for Licenses. We reiterate our Buy rating and our FV of 1,340p.

ANALYSIS

- Strong licensing activity ahead.** Given the current demand for licensing driven by new applications, the group was particularly confident for the mid-term during the conference call. The high level of licenses signed in Q1 (we believe late-Q1) materialised by higher receivables in Q1 vs. Q4. As such, the increase in the number of licensees should therefore have a positive impact on royalties over the mid-term. We believe most of these licenses are for applications in IoT and networking infrastructure, i.e. a mix of high and low ASP. As a result, the group remains particularly confident and continues to see a strong opportunity in networking infrastructure (NFV + SDF + Increasing sophistication), servers (opportunity in China, stronger silicon partners with Qualcomm...) and IoT (increasing ubiquity of smart connected devices using ARM chips). Note that in Q1, smartphones accounted for 45% of shipment estimates at about 4.1bn chips (around 55% in revenue terms).
- Further market share gains by ARM's new technologies in smartphones.** The group highlighted a continuous trend of market share gains with ARMv8-A penetration at about 60% in Q1, octa-core is close to 25%, and Mali graphic technology is now included in 50% of smartphones. We believe that the adoption of ARMv8 increase by 100bp the Royalty rate, octa-core technology increments by another 50bp and Mali by 100bp. As a result, increasing penetration of this technology drives the average royalty rate higher (BG ests. current ARMv8-A Royalty rate at about 2.5% vs. 1.5% for the previous technology). The group expects to see a continuous improvement in the penetration of these technologies over FY16 and is targeting market share of around 80/85% for ARMv8 by FY16, around 30% for octa-core and 60% for Mali.
- The group continues to benefit from weak sterling.** Because the group records more than 90% of revenue in USD while 40% of OPEX are in GBP, 40% in USD and 20% in other currencies, ARM benefits from a stronger Dollar. With Brexit as a hot topic, this must be kept in mind. In addition, the group also said that a Brexit would have a negative impact on ARM due to higher challenges in engineer recruitment. Regarding OPEX, the group is guiding for GBP130-133m in Q2 (GBP133m in Q1), broadly in line with our expectations.
- Overall, yesterday's publication and conference call confirmed our view.** The group should continue to benefit from an increasing penetration of its technologies in smartphones (leading to a higher royalty rate per device) while new applications should gradually come and offer incremental opportunities.

	1 M	3 M	6 M	31/12/15
Absolute perf.	-5.5%	0.6%	-0.9%	-8.2%
Semiconductors	-2.6%	6.2%	1.0%	-5.0%
DJ Stoxx 600	2.6%	8.8%	-3.3%	-4.1%

YEnd Dec. (GBPm)	2015	2016e	2017e	2018e
Sales	968.3	1,152	1,291	1,437
% change		18.9%	12.1%	11.3%
EBITDA	542	630	729	823
EBIT	499.8	576.9	668.9	756.1
% change		15.4%	15.9%	13.0%
Net income	429.0	497.3	580.6	654.9
% change		15.9%	16.8%	12.8%

	2015	2016e	2017e	2018e
Operating margin	51.6	50.1	51.8	52.6
Net margin	44.3	43.2	45.0	45.6
ROE	18.9	18.3	18.5	17.8
ROCE	34.9	39.9	46.6	52.4
Gearing	-36.0	-45.6	-53.6	-60.4

(p)	2015	2016e	2017e	2018e
EPS	30.20	35.09	40.97	46.21
% change	-	16.2%	16.8%	12.8%
P/E	31.6x	27.2x	23.3x	20.6x
FCF yield (%)	0.0%	0.0%	0.0%	0.0%
Dividends (p)	7.60	11.24	13.94	14.49
Div yield (%)	0.8%	1.2%	1.5%	1.5%
EV/Sales	13.2x	10.8x	9.4x	8.1x
EV/EBITDA	23.6x	19.8x	16.6x	14.1x
EV/EBIT	25.6x	21.6x	18.1x	15.4x



VALUATION

- We have updated our model to integrate Q1 reported results and an updated FX exchange rate (GBP/USD from 1.419 to 1.428). Overall, our EPS estimates are down by 1% due to FX.
- Based on our estimates, ARM's shares are trading on 2016e P/E of 26.8x, well below its 5y historical average of 39.3x.

NEXT CATALYSTS

- 28th April 2016: Annual General Meeting.
- 27th July 2016: Q2 results

Detailed P&L

[GBPm]	1Q16	2Q16e	3Q16e	4Q16e	FY16e	FY17e	FY18e
Total Group	276	278	294	303	1152	1291	1437
<i>Q/Q growth</i>	2.7%	0.5%	6.0%	2.9%	18.9%	12.1%	11.3%
<i>Y/Y growth</i>	21.5%	21.6%	21.1%	12.6%	18.9%	12.1%	11.3%
Cost of goods sold	-9	-11	-11	-12	-42	-48	-49
Gross margin	96.7%	96.2%	96.3%	96.1%	96.3%	96.3%	96.6%
SG&A	-65	-64	-66	-66	-261	-282	-309
R&D	-68	-68	-68	-68	-272	-293	-323
Adj. EBIT	134	135	150	158	577	669	756
<i>adj. operating margin</i>	48.6%	48.7%	50.8%	52.0%	50.1%	51.8%	52.6%
Net financial result	2	2	2	2	8	8	9
Income tax	-21	-22	-24	-26	-93	-102	-116
<i>tax rate</i>	-15.1%	-16.0%	-16.0%	-16.0%	-15.8%	-15.0%	-15.0%
Adj. Net income (loss)	91	91	101	107	391	467	530
Net income (loss)	117	116	129	135	497	581	655
Diluted adjusted EPS	8.2	8.2	9.1	9.6	35.1	41.0	46.2

Source: Bryan Garnier & Co. ests.

P&L changes highlights

[GBPm]	Old			New			Old vs. New
	2016e	2017e	2018e	2016e	2017e	2018e	avg. Δ%
Net revenue	1170	1301	1448	1152	1291	1437	-1%
<i>% change</i>	20.8%	11.2%	11.3%	18.9%	12.1%	11.3%	
Adj. EBIT	593	674	762	577	669	756	-1%
<i>Adj. operating margin</i>	50.7%	51.8%	52.6%	50.1%	51.8%	52.6%	
Adj. EPS	36.0	41.3	46.5	35.1	41.0	46.2	-1%

Source: Bryan Garnier & Co. ests.

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