11th April 2016

TMT

Dialog Semiconductor

Price EUR34.54

The group might accelerate R&D investments to catch upcoming opportunities

Fair Value EUR39 (+13%) **BUY**

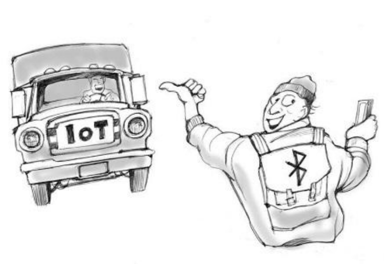
Bloomberg	DLG GR
Reuters	DLGS.DE
12-month High / Low (EUR)	53.3 / 24.4
Market Cap (EUR)	2,690
Ev (BG Estimates) (EUR)	1,953
Avg. 6m daily volume (000)	13.50
3y EPS CAGR	10.4%

	1 M	3 M	6 M	31/12/15
Absolute perf.	8.2%	28.3%	-9.5%	10.6%
Semiconductors	4.0%	11.0%	5.0%	-1.4%
DJ Stoxx 600	-1.7%	-2.8%	-8.2%	-9.3%

YEnd Dec. (USDm)	2015	2016e	2017e	2018e
Sales	1,355	1,381	1,619	1,754
% change		*1.9%*	*17.2%*	*8.3%*
EBITDA	360	359	438	477
EBIT	317.7	291.3	365.6	404.9
% change		*-8.3%*	*25.5%*	*10.7%*
Net income	238.4	214.8	282.0	312.3
% change		*-9.9%*	*31.3%*	*10.7%*

	2015	2016e	2017e	2018e
Operating margin	23.4	21.1	22.6	23.1
Net margin	17.6	15.6	17.4	17.8
ROE	17.3	14.9	16.3	16.0
ROCE	46.9	46.4	59.2	64.7
Gearing	-54.0	-61.1	-66.6	-71.4

(USD)	2015	2016e	2017e	2018e
EPS	3.02	2.80	3.67	4.07
% change	-	*-7.3%*	*31.3%*	*10.7%*
P/E	11.4x	12.3x	9.4x	8.5x
FCF yield (%)	9.0%	6.9%	8.4%	10.0%
Dividends (USD)	0.00	0.00	0.00	0.00
Div yield (%)	NM	NM	NM	NM
EV/Sales	1.6x	1.4x	1.1x	0.8x
EV/EBITDA	5.9x	5.4x	4.0x	3.1x
EV/EBIT	6.7x	6.7x	4.7x	3.6x



While we expect 2016 to be a transition year for Dialog, we continue to see numerous opportunities for the group over the mid/long-term. However, to catch these opportunities we believe that the company will accelerate its investments in R&D which may lead to higher operating expenses. As a result, we adjust our model to integrate higher research costs which implies a cut of 2% on average in our EPS for FY16/17/18e. We maintain our Buy rating and FV of EUR39.

ANALYSIS

- **2016 is a transition year, but opportunities remain in the mid-term.** While the group remains strongly tied to Apple's momentum, we believe diversification remains a key topic at Dialog. It was the main driver of the acquisition of Atmel and the failure of the deal is likely to lead the group to adopt a new strategy to accelerate diversification organically and boost top line growth. Early March, the group had been clearer regarding its strategy for M&A: Dialog is now looking for smaller acquisition (vs. Atmel) and prefers to take time to find the right opportunity rather than focusing on a diversification fast track. As a result, the group may play two different strategies at the same time: 1/ focus on the acceleration of customer recruitment and 2/ boosts content per chip in order to increase the average selling price (ASP) per chip. Regarding the ASP, we believe there is a good chance to see the group increasing it investments in R&D since opportunities remain strong in the segments where Dialog operates, namely the analog market. In terms of content per chip, we identify some opportunities in different applications such as audio, wireless and wireless charging which are mixed-signal technologies falling right into Dialog's expertise. First, regarding audio, note that the group used to sell low to mid-range PMIC equipped with audio capabilities and it would make sense to leverage this historical knowledge to approach the dynamic Chinese players with an all-in-one cost-efficient product (also for IoT). Then, we see the latest iPad Pro teardowns as an indication of what might come to smartphone in the coming years, i.e. multiple Power Management (PM) chips as PM complexity increases with Application Processor rapid evolution. In our view, by splitting the Power Management IC into two different chips in the two iPad Pro, Dialog can handle higher power requirement while keeping decent thermal level but this adds to the complexity of the PMIC system and drives higher ASP. Another source of incremental revenue per phone could come from BT LE implemented into high volume smartphones. Finally, we see another opportunity coming thanks to the move to wireless charging. The group could leverage this new technology by integrating directly into the PMIC a wireless charging receiver and increase content per chip.
- **We update ou model on Dialog and apply adjustments in seasonality and R&D spending.** During Q1-16, the smartphone supply chain has been deeply impacted by a slowdown in demand that began in December 2015. As a result, January was particularly weak but the environement started to improve through February and we believe the situation is now stabilizing. We have even started to see positive newsflow regarding the smartphone market very recently. According to the initial feedback, the iPhone SE enjoyed a warm welcome and is rumoured to generate descent sales. In addition, the Samsung Galaxy S7 strong start fuels hopes in the smartphone segment. While Dialog's momentum is still closely tied to Apple's one, we believe the group is constantly looking for diversification which is likely to lead it to accelerate its investments in R&D (as detailed above) and to increase its OPEX from 2016. Usually, OPEX at Dialog show a strong seasonality but we think that it might be different in 2016 due to a longer term view on R&D program. As a result, we adjust our expectations with higher OPEX for FY16/FY17/FY18 (Operating margin 21.1%/22.6%/23.1% for FY16/17/FY18e respectively vs. 22.7%/22.8%/23.1%), while we slightly adjust upward our top line growth estimate for FY18 (+8% growth vs. +7% used previously). Overall, our changes lead to an 2% cut in EPS on average over the next three years.

VALUATION

- Based on our estimates, the share is trading on 2016e EV/EBIT of 6.7x and 2016e P/E of 12.3x. Over 2016/18e our estimates show average annual EPS growth of 10.4%, pointing to 2016e PEG of 1.3x.

NEXT CATALYSTS

- May 4th 2016, Q1-16 results.

Our new scenario

[USDm]	1Q16e	2Q16e	3Q16e	4Q16e	FY16e	FY17e	FY18e
Total Group	**242**	**254**	**351**	**533**	**1381**	**1619**	**1754**
Q/Q growth	*-39.0%*	*5.0%*	*38.0%*	*51.9%*	*1.9%*	*17.2%*	*8.3%*
Y/Y growth	*-22.1%*	*-19.6%*	*6.3%*	*34.3%*	*1.9%*	*17.2%*	*8.3%*
Cost of goods sold	-133	-139	-189	-284	-745	-873	-945
Gross margin	**45.2%**	**45.5%**	**46.2%**	**46.7%**	**46.1%**	**46.1%**	**46.1%**
SG&A	-41	-40	-41	-46	-169	-162	-156
R&D	-53	-54	-58	-60	-225	-283	-302
Other operating income	10	10	11	17	48	65	54
Adj. EBIT	**25**	**32**	**74**	**160**	**291**	**366**	**405**
adj. operating margin	*10.5%*	*12.5%*	*21.1%*	*29.9%*	*21.1%*	*22.6%*	*23.1%*
EBIT	16	22	63	143	244	303	352
operating margin	*6.6%*	*8.7%*	*17.9%*	*26.8%*	*17.7%*	*18.7%*	*20.1%*
Net financial result	-1	-1	0	-1	-3	-2	-2
Income tax	-4	-6	-18	-33	-62	-68	-79
tax rate	*-28.5%*	*-28.5%*	*-28.5%*	*-23.5%*	*-25.5%*	*-22.5%*	*-22.5%*
Adj. Net income (loss)	**20**	**25**	**56**	**125**	**215**	**282**	**312**
Net income (loss)	11	15	45	108	180	233	272
Diluted adjusted EPS	**0.27**	**0.33**	**0.73**	**1.63**	**2.80**	**3.67**	**4.07**

Sources: Bryan, Garnier & Co. ests.

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