17th June 2016

TMT

ASML

Price EUR83.91

Additional proof that potential upside is currently limited

Fair Value EUR81 (-3%) **SELL**

Bloomberg	ASML NA
Reuters	ASML.AS
12-month High / Low (EUR)	99.7 / 71.8
Market Cap (EURm)	36,361
Ev (BG Estimates) (EURm)	34,935
Avg. 6m daily volume (000)	1,257
3y EPS CAGR	21.9%

	1 M	3 M	6 M	31/12/15
Absolute perf.	3.2%	-3.5%	2.7%	1.6%
Semiconductors	4.1%	-2.8%	-6.4%	-6.2%
DJ Stoxx 600	-3.3%	-5.1%	-10.0%	-11.5%

YEnd Dec. (EURm)	2015	2016e	2017e	2018e
Sales	6,287	6,487	7,415	8,742
% change		*3.2%*	*14.3%*	*17.9%*
EBITDA	1,864	1,774	2,337	3,031
EBIT	1,565	1,469	2,017	2,666
% change		*-6.1%*	*37.3%*	*32.2%*
Net income	1,387	1,266	1,758	2,353
% change		*-8.7%*	*38.8%*	*33.8%*

	2015	2016e	2017e	2018e
Operating margin	24.9	22.7	27.2	30.5
Net margin	22.1	19.5	23.7	26.9
ROE	16.5	15.5	20.0	23.8
ROCE	22.9	19.1	26.4	25.9
Gearing	-27.2	-17.5	-23.6	-7.4

(EUR)	2015	2016e	2017e	2018e
EPS	3.21	3.02	4.26	5.82
% change	-	*-6.0%*	*41.2%*	*36.6%*
P/E	26.1x	27.8x	19.7x	14.4x
FCF yield (%)	4.1%	1.9%	5.1%	NM
Dividends (EUR)	0.70	1.05	1.21	1.39
Div yield (%)	0.8%	1.3%	1.4%	1.7%
EV/Sales	5.4x	5.4x	4.6x	4.1x
EV/EBITDA	18.3x	19.7x	14.7x	11.8x
EV/EBIT	21.8x	23.8x	17.0x	13.4x

Yesterday, ASML announced the acquisition of Hermes Microvision for EUR2.75bn cash (see our previous comment here). The deal is expected to close by Q4-16 and is said to be immediately accretive. From a business point of view, the acquisition also makes sense, adding a new asset to the offering of ASML in holistic lithography and expanding the TAM. However, despite this positive news, the share reaction has been very limited and, somehow, it confirms our view that the potential upside is limited.

ANALYSIS

- **In April, we downgraded ASML to Sell and we highlighted some risks regarding 1/ the timing of the 7nm ramp** (expected to start from H2-17) given that orders for 10nm are expected to ramp by Q2-16 (i.e. about 1.5 years later) and **2/ the interest and readiness to start 7nm production with EUV tools** given that the output would be significantly reduced with EUV and that 10nm DUV tools could be reused (upgraded) for 7nm. Indeed, there is a risk that 10nm overall capacity remains limited after 7nm introduction given the declining number of customers able to afford leading edge production while the industry would then focus on 7nm. As a result, there are some risks that foundries reuse 10nm tools to ramp 7nm production, while keeping a tight control on capex and moving slowly production (and capex) to EUV. In addition, during the Q1 conference call, we understood that ASML saw rising interest in reuse. In our view, this adds pressure on the 2020 plan (targeting revenues of EUR10bn), although management said it has been factored in so far.
- **Note that industry habits regarding new node ramp are changing.** During the Q1 conference call (May 2016), the group highlighted a change in customer habits regarding new node ramp. Management noted that 28nm capacity is still increasing and generating orders of DUV systems, while only a few customers plan to adopt 10nm in the near term. As a result, we believe this should result in a rapid but short increase in orders, compared to a longer wave of orders seen in the past (bear in mind that 10nm ramp-up started in Q2-16).
- **EUV systems revenue recognition mechanism adds lumpiness to results for the coming quarters.** We recall that we are entering a period (1-2 years) of revenue uncertainty. Indeed, we should expect revenue from EUV systems already shipping for tests (at a c. EUR100m tag price), however revenue are recorded on performance achievement (not on shipment). As 1/ neither ASML, nor customers have full control over performance achievement of EUV tools and 2/ the group does not communicate on the performance milestone, investors and analysts lack visibility on the revenue for the coming quarters.
- **Margin pressure due to EUV.** In addition to that, shipments of EUV (even if it remains limited currently, with few systems shipped annually) add to pressure on margin. We estimate EUV systems are sold with a gross margin of about 25-30% vs. >50% for latest DUV systems.
- **Finally, while we agree that this deal is a good fit, it might also be seen as an admission by ASML that its 2020 target will be hard to achieve** (at least the group is less confident) and that it needs external growth to succeed. Note that current Street expectations for HMI's 2018e revenue are around EUR327m.

VALUATION

- Overall, we continue to see a lot of uncertainty while current valuation metrics offer no room for a disappointment (2016e P/E ratio of 27.8x; PEG of 1.3x).
- We reiterate our Sell rating and would favour stocks with higher potential upside such as ARM (Buy, FV 1,340p), Dialog (Buy, FV EUR35) or Infineon (Buy, FV EUR15).

NEXT CATALYSTS

- 20th July 2016: FQ2-16 results.

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