

STMicroelectronics

Price EUR6.51

Business gains momentum, but don't forget the risks

Fair Value EUR6.5 (0%)

NEUTRAL

| | |
|----------------------------|-----------|
| Bloomberg | STM FP |
| Reuters | STM.FR |
| 12-month High / Low (EUR) | 7.1 / 4.6 |
| Market Cap (EURm) | 5,934 |
| Ev (BG Estimates) (EURm) | 5,281 |
| Avg. 6m daily volume (000) | 2,592 |
| 3y EPS CAGR | 33.4% |

Overall, yesterday's publication and conference call were positive. During the conference call, management was particularly confident regarding the second part of the year and admittedly made more positive comments about the automotive and industrial semiconductor markets. Nevertheless, despite being attractive at first-take in view of improving momentum, we would point out that ST is not a risk-free investment given the approaching change in CEO and the ongoing restructuring plan.

ANALYSIS

| | 1 M | 3 M | 6 M | 31/12/15 |
|----------------|-------|-------|-------|----------|
| Absolute perf. | 30.6% | 14.2% | 3.8% | 5.4% |
| Semiconductors | 30.2% | 25.9% | 26.7% | 21.1% |
| DJ Stoxx 600 | 11.0% | -1.6% | 0.7% | -6.3% |

| YEnd Dec. (USDm) | 2015 | 2016e | 2017e | 2018e |
|------------------|-------|-------|-------|-------|
| Sales | 6,897 | 6,977 | 7,102 | 7,261 |
| % change | | 1.2% | 1.8% | 2.2% |
| EBITDA | 910 | 977 | 1,143 | 1,286 |
| EBIT | 174.0 | 251.0 | 404.1 | 531.3 |
| % change | | 44.3% | 61.0% | 31.5% |
| Net income | 175.0 | 178.8 | 303.8 | 411.6 |
| % change | | 2.2% | 69.9% | 35.5% |

| | 2015 | 2016e | 2017e | 2018e |
|------------------|-------|-------|-------|-------|
| Operating margin | 2.5 | 3.6 | 5.7 | 7.3 |
| Net margin | 2.5 | 3.1 | 4.3 | 5.7 |
| ROE | 2.2 | 3.8 | 6.5 | 8.6 |
| ROCE | 5.1 | 4.7 | 8.2 | 11.5 |
| Gearing | -10.5 | -14.0 | -18.4 | -23.0 |

| (USD) | 2015 | 2016e | 2017e | 2018e |
|-----------------|-------|-------|-------|-------|
| EPS | 0.20 | 0.20 | 0.34 | 0.47 |
| % change | - | 2.4% | 68.9% | 37.1% |
| P/E | 32.8x | 32.0x | 19.0x | 13.8x |
| FCF yield (%) | 4.5% | 6.5% | 8.3% | 10.1% |
| Dividends (USD) | 0.40 | 0.24 | 0.30 | 0.39 |
| Div yield (%) | 6.1% | 3.7% | 4.6% | 6.1% |
| EV/Sales | 0.8x | 0.8x | 0.7x | 0.7x |
| EV/EBITDA | 6.0x | 5.4x | 4.4x | 3.8x |
| EV/EBIT | 31.3x | 21.0x | 12.5x | 9.1x |

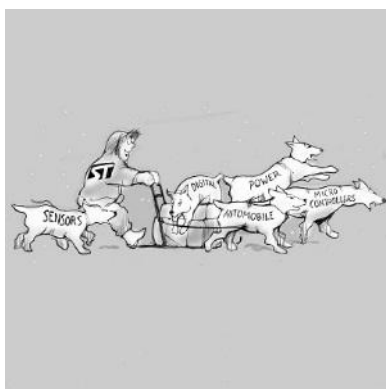
- Regarding momentum, management appeared to be very confident regarding the booking trend in Q2 and during the first weeks of July.** Indeed, management said that the positive booking trend has continued during July while the backlog remains solid. In addition, ST said it should benefit from its broad customer base and innovation in its broad product portfolio. Unsurprisingly, traction is said to be particularly strong in the automotive division this should start a new trend of continuous yoy growth. Also in Q3, MCUs should continue to sell particularly well. Finally we note that the group expects to see a recovery in MEMS driving the AMG division to sequential growth. An additional comment was made concerning EMV, which is said to be decreasing but ST also added that its implication in EMV is limited and that it is not a main driver. Finally, regarding Imaging, the group stated that Time of flight technology showed strong momentum with design-in in several smartphones. As a result, the imaging business, which was loss making, could be above break even this year. Overall, management expects higher growth at ST than the overall business and since forecasts for the semiconductor industry point to a decrease in the range of 0% to -2% for 2016, we understand that management expects slight growth.
- For Q3, the group expects to see an improvement in gross margin to 35.5% despite higher unused capacity charges.** Unused capacity could provide a headwind of 65bp, compared with 45bp in Q2. This is due to seasonal production activity for the Crolles 300mm, which is always lower in Q3. Nevertheless, it should be offset by an overall positive change in the mix making up for price pressure and manufacturing efficiencies.
- The group also said it is in line with its plan and continues to see cost reductions of about USD100m by the end of 2016.** Management added that about 35% of this had already been achieved by the end of Q2, but there is still more to come.
- We are trimming our estimates with an average cut to EPS of 1%.** Following the conference call, we applied changes in our model. Given supportive momentum in both the automotive and industrial sectors, we now expect a slight revenue increase of 1% over 2016 (vs. -0.2% before), however our margin expectations are negatively impacted by the new guidance regarding grants. Indeed, management now expects that level of grants during the current and the next quarter are more in the range of USD20m as opposed to about the USD28m in the first half, in each quarter of the first half of the year.
- Finally, the group said that small M&A deals are possible but nothing is on the table.** The group would then focus on IP in order to strengthen key activities. In addition, management stated that ST already has the means to compete in terms of R&D.

VALUATION

- Overall, Q2 results and the conference call comments were positive and encouraging. The group should benefit from a supportive environment while the restructuring plan seems to bear fruits. Nevertheless, we continue to see risks on valuation given 1/ the pending CEO transition next year and 2/ the restructuring plan given the group's historical track record.
- Based on our estimates, STMicroelectronics' shares are trading on 2016e P/E and PEG ratios of 30.8x and 0.9x respectively.

NEXT CATALYSTS

- Late in October 2016: Q3 results



Detailed P&L

| [USDm] | Q1 16 | Q2 16 | Q3 16 | Q4 16e | 2016e | 2017e | 2017e |
|--------------------------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|
| Net revenue | 1613 | 1703 | 1794 | 1868 | 6977 | 7102 | 7261 |
| <i>% change</i> | -3.3% | 5.6% | 5.3% | 4.1% | 1.2% | 1.8% | 2.2% |
| COGS | -1075 | -1126 | -1158 | -1162 | -4522 | -4506 | -4596 |
| Gross Margin | 33.4% | 33.9% | 35.4% | 37.8% | 35.2% | 36.5% | 36.7% |
| SG&A | -229 | -229 | -219 | -223 | -900 | -937 | -951 |
| R&D | -342 | -336 | -326 | -326 | -1330 | -1279 | -1282 |
| Other exceptional gains | 0 | 16 | 7 | 2 | 25 | 25 | 100 |
| Adjusted EBIT | -33 | 28 | 97 | 159 | 251 | 404 | 531 |
| <i>% of revenue</i> | -2.0% | 1.6% | 5.4% | 8.5% | 3.6% | 5.7% | 7.3% |
| D&A | -184 | -179 | -180 | -183 | -726 | -739 | -755 |
| EBITDA | 151 | 207 | 277 | 342 | 977 | 1143 | 1286 |
| Cost of net debt | -5 | -6 | -5 | -1 | -17 | -17 | -17 |
| Profit from associates | 0 | 9 | 0 | -6 | 3 | 3 | 3 |
| Gain from investments | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Profit before tax | -38 | 31 | 92 | 152 | 237 | 390 | 517 |
| Income taxes | -2 | -6 | -21 | -30 | -59 | -87 | -106 |
| Tax rate | 5% | -19% | -23% | -20% | -25% | -22% | -20% |
| Consolidated net profit | -40 | 25 | 71 | 123 | 179 | 304 | 412 |
| <i>% of revenue</i> | -2.5% | 1.5% | 4.0% | 6.6% | 2.6% | 4.3% | 5.7% |
| Adjusted EPS (in USD) | -0.05 | 0.03 | 0.08 | 0.14 | 0.20 | 0.34 | 0.47 |

Source: Bryan Garnier & Co. ests.

P&L changes highlights

| [USDm] | Old | | | New | | | Old vs. New |
|-------------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| | 2016e | 2017e | 2018e | 2016e | 2017e | 2018e | avg. Δ% |
| Net revenue | 6882 | 6998 | 7151 | 6977 | 7102 | 7261 | 1% |
| <i>% change</i> | -0.2% | 1.7% | 2.2% | 1.2% | 1.8% | 2.2% | |
| EBIT | 264 | 405 | 513 | 251 | 404 | 531 | -1% |
| <i>Operating margin</i> | 3.8% | 5.8% | 7.2% | 3.6% | 5.7% | 7.3% | |
| Adj. EPS | 0.21 | 0.35 | 0.45 | 0.20 | 0.34 | 0.47 | -1% |

Source: Bryan Garnier & Co. ests.

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| | |
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