STMicroelectronics

Price EUR7.98

Q3 came out with a compelling message; ST is heading to the right direction.

Fair Value EUR7.3 vs. EUR6.5 (-9%) **NEUTRAL**

Bloomberg	STM FP
Reuters	STM.FR
12-month High / Low (EUR)	8.0 / 4.6
Market Cap (EURm)	7,274
Ev (BG Estimates) (EURm)	6,853
Avg. 6m daily volume (000)	2,342
3y EPS CAGR	46.2%

	1 M	3 M	6 M	31/12/15
Absolute perf.	11.7%	22.6%	40.0%	29.2%
Semiconductors	1.5%	3.0%	29.6%	24.7%
DJ Stoxx 600	0.4%	-0.3%	-1.9%	-6.6%

YEnd Dec. (USDm)	2015	2016e	2017e	2018e
Sales	6,897	6,974	7,291	7,572
% change		*1.1%*	*4.6%*	*3.8%*
EBITDA	910	1,025	1,232	1,424
EBIT	174.0	300.0	474.1	636.6
% change		*72.4%*	*58.0%*	*34.3%*
Net income	164.0	235.5	369.9	507.6
% change		*43.6%*	*57.1%*	*37.2%*

	2015	2016e	2017e	2018e
Operating margin	2.5	4.3	6.5	8.4
Net margin	2.4	3.4	5.1	6.7
ROE	2.2	3.3	6.3	10.6
ROCE	4.9	5.3	8.7	12.6
Gearing	-10.5	-9.7	-12.0	-16.4

(USD)	2015	2016e	2017e	2018e
EPS	0.19	0.27	0.42	0.58
% change	-	*43.9%*	*56.2%*	*38.9%*
P/E	46.8x	32.5x	20.8x	15.0x
FCF yield (%)	4.9%	3.8%	4.9%	7.7%
Dividends (USD)	0.40	0.30	0.30	0.40
Div yield (%)	4.6%	3.4%	3.4%	4.6%
EV/Sales	1.1x	1.1x	1.0x	0.9x
EV/EBITDA	8.2x	7.3x	6.0x	5.0x
EV/EBIT	42.8x	24.9x	15.6x	11.2x

Yesterday, STMicroelectronics hosted a conference call to comment Q3 results. In our view, there were several compelling messages. Following the conference call and discussions with ST, it looks like FY17 opportunities are promising in multiple markets and applications while margin improvement will continue in FY17. We already expected a positive evolution, but it looks like FY17e and FY18e might be better than we anticipated. On the back of a supportive environment and additional proofs that the Set-Top Box exit is on track, we adopted a more aggressive margin scenario. Our FV is up to EUR7.3 from EUR6.5.

ANALYSIS

- **STMicroelectronics is working hard to be able to fire on all cylinders.** We often highlighted the complexity for STMicroelectronics to achieve growth on all of its divisions due to its very broad and diversified product portfolio and customer base. However, it looks like most of the elements are now aligned (at least on the NT), to generate growth on all divisions. Visibility is better than it was in Q2 2016 and, on the short term, the outlook is strong in almost all segments. Note also that the strong booking trend observed during Q3 (+15%) remained strong in October: while the smartphone market is seen to be particularly strong by ST, the good point that has been mentioned during the conference call is that it is not only due to one specific customer demand (i.e. Apple and the design-win in the iPhone 7) but rather a broad customer panel from Korea, China and the US. As such, it appears that ST is gaining market share in this segment and we are now seeing a real traction for ST's Time-Of-Flight sensors. Then, in automotive, the demand from German and Chinese OEMs is said to remain strong and there is no sign of a slow-down due to weaker end-market demand. Finally, the industrial has been said to be healthy, a message in line with other comments from competitors.

- **ToF is a competitive field but ST keeps the lead.** In the smartphone space, Time of Flight technology is under spotlight right now. This technology allows fast focus for camera and/or proximity sensing (e.g. used to shut-down the touch screen during a phone call). ams' (Neutral, FV EUR27) recent move to buy Heptagon (see our Morning Mail – ams, 26/10/2016) is a proof that ams is a serious competitor but we understand that ST is confident regarding other applications. Indeed, ST sees strong opportunities in full camera assist modules from 2017. On a shorter term, design-wins in about 13 smartphones so far are proof of ST's technology edge.

- **The group keeps fighting hard in the automotive space:** regarding the autonomous driving opportunity, ST says that its current portfolio of 24Ghz and 77Ghz is well positioned and the group has some design-ins recently (77Ghz radars at ST are based on 28nm FD-SOI which adds differentiation). Shipments are expected to start in the course of 2017. In the electrification of cars, ST benefits from the current technological advantages of its SiC products and expects to see a good traction from the next quarters (already some design-ins with Asian OEMs). While it still represents a very small portion of revenue today (BG ests. USD50-100m) it should be an important contributor to growth next year. As such, the automotive product line is now expected to growth at a rate >5%. While we see Infineon (Buy, FV EUR17.5) as better positioned in car electrification (GaN technology + clear leading position in Power Semiconductor used in Electric Vehicle (EV)), it is worth to remind that ST's portfolio has also interesting and differentiating technologies.

- **The margin pressure due to low utilization rate of fabs to reduce:** Currently, the utilization rate of ST's fab is above 85% for 200mm (8-inches) fabs and below 70% in Crolles 300mm fab. This is seen to move to 90% for 200mm fabs and above 80% in Crolles 300mm in Q4. As such, the 60bp weight, from underutilization, impacting Q3 gross margin will decrease to 20bp in Q4. In addition, the problems linked to unused capacity are expected to be over after 2017, especially because Crolles 2 utilization rate should improve. Using 20bp of unused charges for Q4e leads to a negative impact of 50bp on GM on average for FY16. On the OPEX side then, we must keep in mind that seasonality of OPEX will play negatively in Q4 (Net OPEX should be about USD550m in Q4 vs. USD525m in Q3). Again, we expected to see improving margin in FY17e since we have now more proofs that the exit of STB business is on track. As such, including positive impact from higher expectations on the top-line and lower than expected OPEX, we tuned our model and now have higher margin profile.

VALUATION

- **In our view, Yesterday's publication and conference call were convincing.** We update our model in order to adopt a more aggressive scenario implying a 5% growth in FY17e and 4% in FY18e. Additionally, we also tuned our expectations of gross margin (lower unused charges) and lower OPEX. As such, we now expect FY17e/FY18e adjusted operating margin of 6.5% and 8.4% respectively vs. 5.7% and 7.3% previously. **As such, our FV is up to EUR7.3 vs. EUR6.5 previously.**
- **However, given the risks about management transition and unattractive valuation metrics (most of the improvements is already priced in), we keep our Neutral recommendation.** Based on our estimates, STMicroelectronics' shares are trading on 2017e EV/EBIT and P/E ratios of 15.6x and 20.8x respectively.

NEXT CATALYSTS

- Late January 2017: FY16 and Q4 results. (not confirmed yet)

Our new estimates – P&L

[in USDm]	2015	1Q16	2Q16	3Q16	4Q16e	2016e	2017e	2018e
Sales	**6897**	**1613**	**1703**	**1797**	**1861**	**6974**	**7291**	**7572**
Seq. growth	-6.8%	-3.3%	5.6%	5.5%	3.5%	1.1%	4.6%	3.8%
Gross profit	**2332**	**538**	**577**	**643**	**695**	**2453**	**2619**	**2877**
Gross margin	33.8%	33.4%	33.9%	35.3%	37.4%	35.2%	35.9%	38.0%
SG&A	-897	-229	-229	-224	-233	-915	-916	-962
R&D	-1425	-342	-336	-318	-335	-1331	-1303	-1355
Other exceptional gains	164	28	28	18	19	93	74	76
Adjusted EBIT	**174**	**-5**	**40**	**119**	**146**	**300**	**474**	**637**
EBIT magin	2.5%	-0.3%	2.3%	6.6%	7.8%	4.3%	6.5%	8.4%
D&A	-736	-184	-179	-172	-190	-725	-758	-787
EBITDA	910	179	219	291	336	1025	1232	1424
Cost of net debt	-22	-5	-6	-5	-5	-21	-22	-23
Profit from associates	2	0	9	-1	-2	6	7	7
Gain from investments	0	0	0	0	0	0	0	0
Adj. pre-tax profit	**154**	**-10**	**43**	**113**	**139**	**285**	**459**	**621**
Adjusted tax	16	-5	-8	-12	-21	-46	-89	-113
Tax rate	10.4%	0.0%	-18.6%	-10.6%	-15.0%	-16.1%	-19.4%	-18.2%
Non-control. interest	-6	-1	-2	-1	0	-4	0	0
Adj. net profit	**164**	**-16**	**33**	**100**	**118**	**235**	**370**	**508**
% of revenue	2.4%	-1.0%	1.9%	5.6%	6.4%	3.4%	5.1%	6.7%
Adj. EPS (in USD)	**0.19**	**-0.02**	**0.04**	**0.11**	**0.13**	**0.27**	**0.42**	**0.58**
Seq. growth	-23.9%	n.s.	n.s.	+202.6%	+19.6%	44%	56%	39%

Sources: Bryan, Garnier & Co ests.

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