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Innochips (080420 KQ) – Entering China

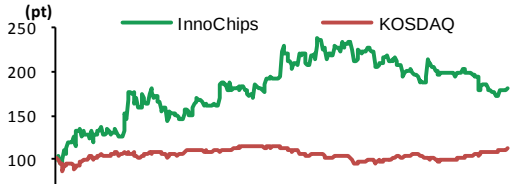
BUY(TP Raise)

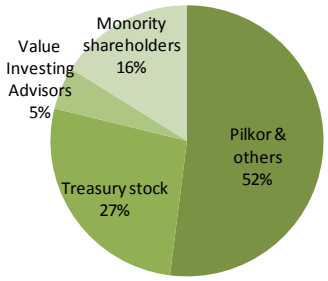
Target Price	**W14,700**
Current Price	**W10,600**
Upside Potential (%)	**38.7%**

Key Data	**September 24, 2012**
KOSDAQ	158.0
Market Cap. (Wbn)	14.9
Foreign Ownership (%)	6.7
52 Week High (KRW)	14,300
Low (KRW)	5,770
60-d avg. turnover (Wbn)	0.4
Major Shareholders	**(%)**
Pilkor & 5 others	52.0
Innochips treasury stock	26.8
KOSDAQ	528.06

Performance (%)	**1M**	**6M**	**12M**
Absolute	(9.4)	(20.3)	83.7
Relative	(16.4)	(22.0)	64.5

Relative Performance





Key issues…

- ✓ **Securing a future growth engine by developing a new concept product**
- ✓ **Beneficiary of Chinese smartphone vendors adopting high-value ceramic chip**
- ✓ **Despite market entry of a new competitor, Innochips is expected to grow in 3Q12 driven by new demands from smartphone market growth in China**

Revaluation of company's value and share prices with entry into the Chinese smartphone market and the new product

CMEF chips was a monopoly play of Innochips until 2Q12 when Amotech (052710 KS) entered the domestic market as the only competitor. As a result, domestic sales decreased and the company's sales decreased.

Until recently, Chinese smartphone vendors insisted on ESD and EMI filters, but recently began to turn to CMEF chips as a substitute. As a result, Innochips' export to China is increasing made up for the decrease in domestic sales.

The company also successfully developed new concept ceramic chips for anti-static and anti-noise functions in smartphones. It is expected to be mass produced before the end of the year and become a growth catalyst.

As the Chinese smartphone market continues to grow, exports of CMEF and ceramic chips are expect to grow as well. Also, the ceramic chips are expected to command strong demand in the domestic market. Thus, we believe Innochips will be an ultimate beneficiary of the Chinese smartphone market growth which requires Innochips products.

Revenue of W19bn (18.2% qoq), OP of W5.1bn (21.7% qoq) in 3Q12

Revenue and operating profit are expected to record W19bn (+18.2% qoq) and W5.1bn (+21.7% qoq) respectively in 3Q12. However, in the yoy trend, revenue will be likely to decrease 6.7% yoy, and OP will also decline 25.8% yoy. Such is a result of a decline in M/S and ASP due to competitor's entry in the CMEF chip market.

Raising target price to W14,700

Handset part companies are trading at 6.3x 2013F consensus EPS. While other handset parts have wide fluctuations in sales, Innochips has stable revenue with higher profitability and growth thanks ceramic chip which is widely used component with a strong demand from China. We believe the company deserves 10% PER valuation premium as a result. Thus we apply 6.9x PER to 2013F EPS of W2,130 to reach W14,700 per share, which is our new target price.

Valuation Forecast

FY	Sales (Wbn)	% chg yoy	OP (Wbn)	OPM (%)	NP (Wbn)	EPS (W)	EPS Growth (%)	P/E (x)	EV/EBITDA (x)	ROE (%)	P/B (x)
2009	50.3	29.9	11.4	22.7	10.7	719	271.9	14.7	10.5	19.5	2.6
2010	53.1	5.7	7.6	14.4	7.9	533	(25.8)	19.9	13.5	13.4	2.7
2011	70.3	32.3	17.2	24.5	17.7	1,619	203.6	6.5	7.1	27.4	2.2
2012F	75.1	6.8	19.1	25.4	16.6	1,522	(5.9)	7.0	5.8	20.9	1.8
2013F	100.5	33.8	26.1	26.0	23.2	2,130	39.9	5.0	4.1	23.4	1.4
2014F	117.3	16.7	30.6	26.1	26.7	2,449	15.0	4.3	3.1	21.5	1.1

Maintaining Buy rating (TP raised) – W14,700

New TP of W14,700 – applying target PER 6.9x to 2013F EPS of W2,130

We maintain our buy rating with the target price of W14,700, which is 59% higher than our previous TP of W9,240. We derived at the new target price of W14,700 by applying 10% valuation premium to the industry consensus PER of 6.3x, which renders a fair PER valuation of 6.9x.

We believe that applying the valuation premium seems appropriate because:

- Ceramic chips are widely used product that delivers a rather stable revenue stream, whereas competitors' chips that have a wild fluctuation in sales as they are easy to substitute
- The company maintains its profitability with miniaturization of products , which allows the company to maintain a leading edge in the market
- The company is expected to enter Chinese smartphone market with a full-scale force beginning early 2013
- The company is expected to become a leader in the China CMEF and ceramic chip market

Target price of W14,700 implies 36.1% upside potential from current price of W10,800

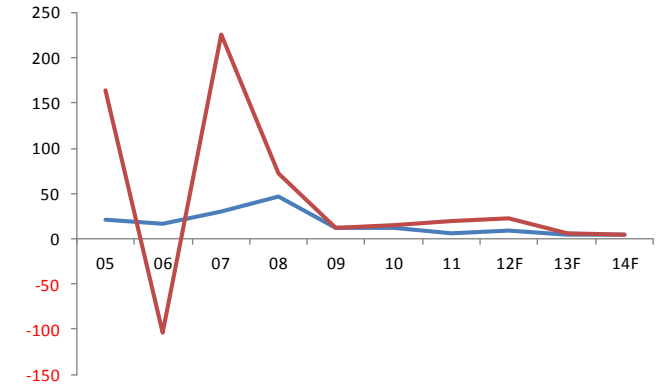
Therefore, applying 10% premium to the industry consensus PER 6.3x to arrive at a fair PER multiple of 6.9x seems appropriate. Applying the PER 6.9x to the 2013F EPS of W2,130, we derive at our new target price of W14,700, which implies 36.1% upside potential from the current price of W 10,800.

Exhibit 1. Handset part industry PER vs. Innochips premium/discount

	05	06	07	08	09	10	11	12F	13F	14F
Company PER high (X)	20.4	17.1	29.6	46.7	11.8	11.3	6.7	9.4	5.1	4.5
Industry PER high (X)	164.8	(104.1)	226.3	72.5	12.5	15.1	19.0	22.5	6.3	4.9
Premium/(Discount) to industry(%)	(87.6)	NA	(86.9)	(35.6)	(6.2)	(24.6)	(64.6)	(58.2)	(18.6)	(10.0)

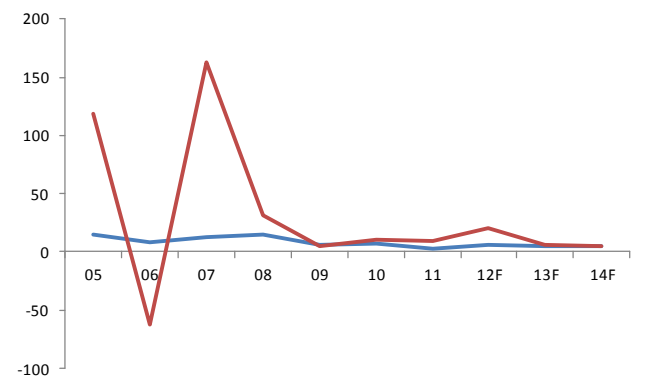
Source: Leading research

Exhibit 2. Innochips year-high PER vs. Industry year-high PER (x)



Source: Company data, Leading Research Center

Exhibit 3. Year-high EV/EBITDA (x) - Innochips vs. Industry



Source: Company data, Leading Research Center

Innochips' market position and tech development overview

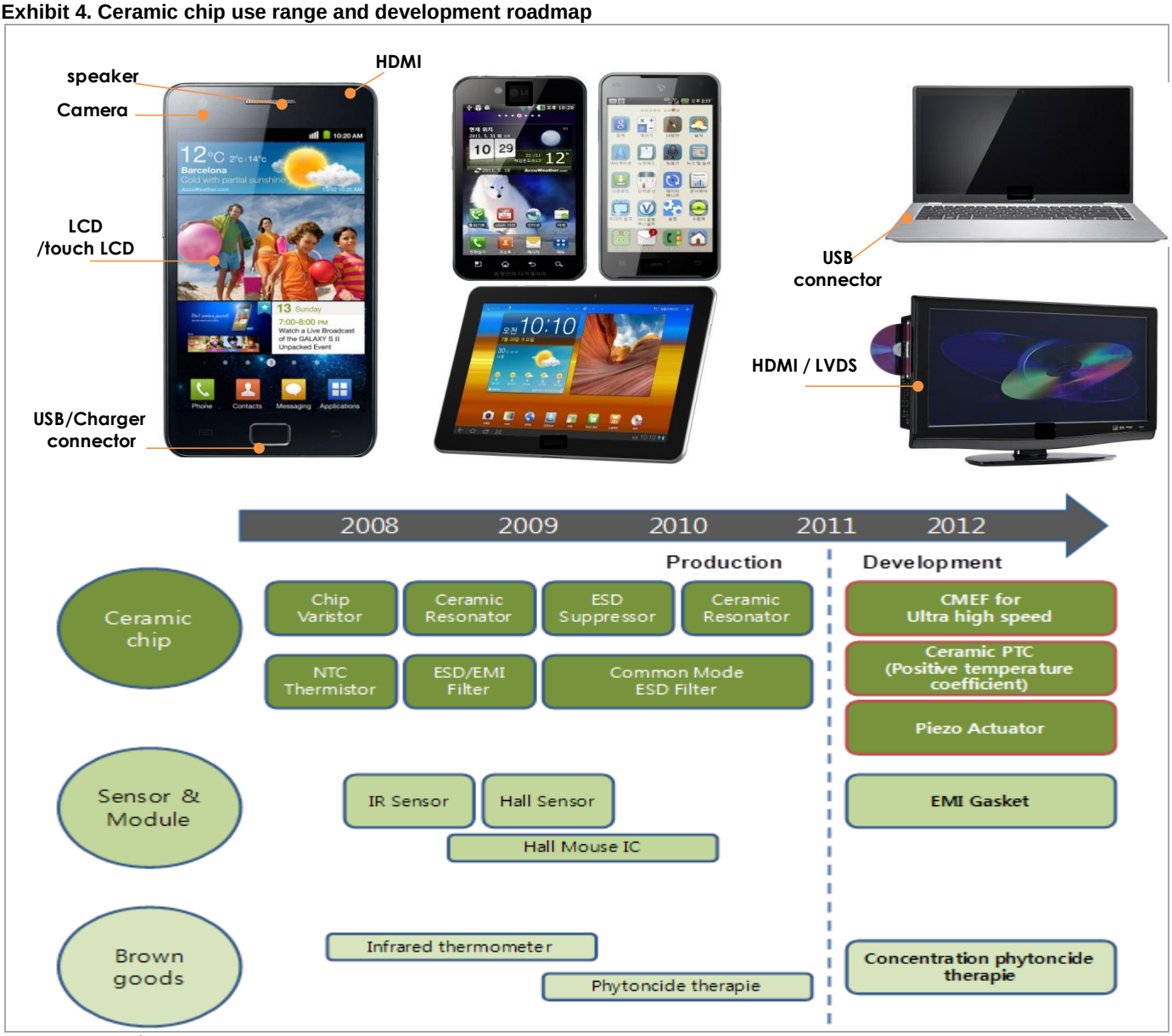
Korean No.1 smartphone ceramic chip maker

In the early stage of the mobile business, most Korean handset maker depended on chips of Japanese and American companies. Innochips, however, replaced imported protection chips through own development. Currently, the company supplies products to 250 Korean companies and 200 overseas companies including Samsung and LG. The company secures Korean top technologies and experiences in ceramic chips for smartphones.

Securing competiveness through technology innovation

Innochips successfully developed the world's first CMEF unifying CMF (Common Mode Filter) and ESD (Electrostatic Discharge) functions in 2009. Sales of CMEF chips has surged since 2H11 driven by smartphone market growth. Therefore, the company was able to maintain its dominance in the market. The company has developed new products through its outstanding technologies compared to competitors. The company completed to develop a new concept product which is able to be adopted to major products in 2013 and is concentrating technology development.

Exhibit 4. Ceramic chip use range and development roadmap



Source: Company data

Growth of Chinese smartphone market and ceramic chips

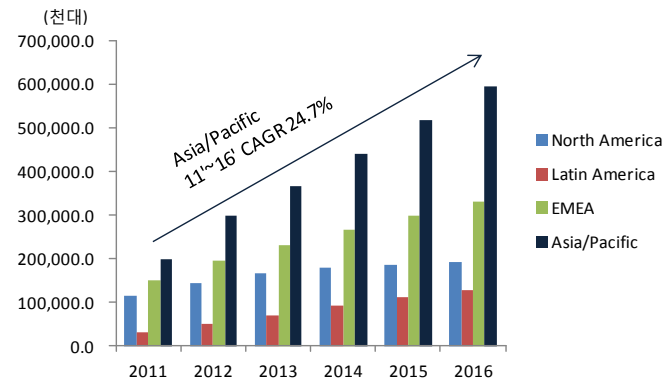
Huge revenue increase is hardly estimated only by new products

A competitor began to supply CMEF chips which Innochips is dominant in the market. Therefore, ASP and M/S have decreased simultaneously. The company maintains its profitability with downsized new products based on higher technologies than the competitor. However, the company is hardly expected to increase its sales in 2013 through only supplying products to Korean handset makers.

Growth with Chinese smartphone from 2013

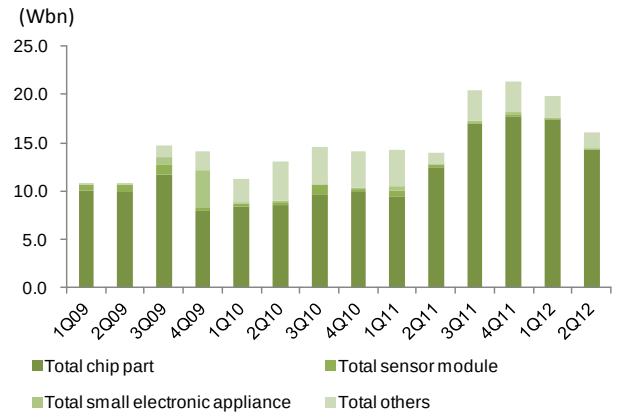
Chinese handset makers begin to adopt Innochips' CMEF chips which unify two functions. Revenue proportion of China will be likely to largely increase in 2013. According to IDC, Chinese and Asian smartphone market is expected to grow CAGR 24.7%. CMEF adoption is increasing and will play an important role to lead the company's earnings.

Exhibit 5. Global smartphone shipment outlook



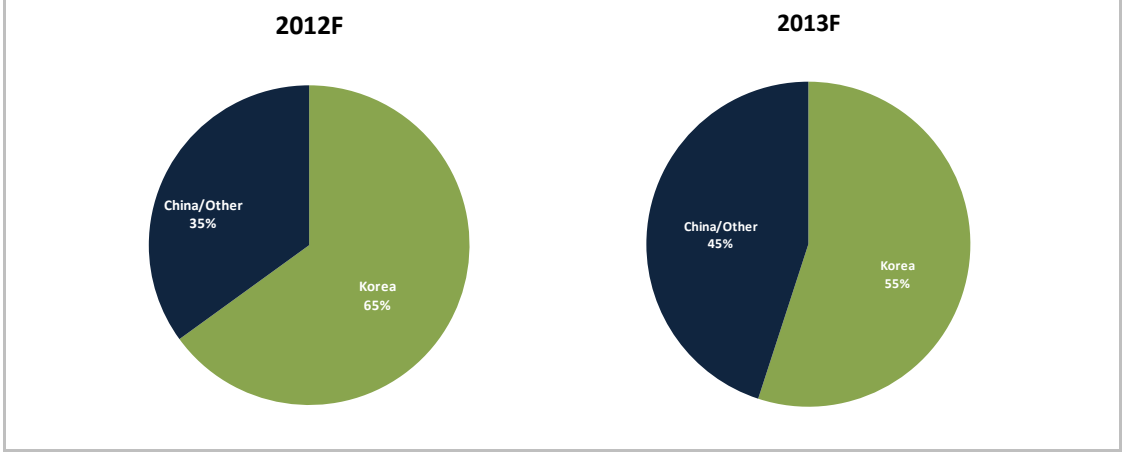
Source: IDC, Leading Research Center

Exhibit 6. Quarterly product revenue



Source: Company data, Leading Research Center

Exhibit 7. Increasing proportion of sales in China from 2013



Source: Company data, Leading Research Center

3Q12 Earnings Preview

In 3Q12F, sales of W19bn (+18.2% qoq), OP of W5.1bn (+21.7% qoq)

Revenue and operating profit are expected to record W19bn (+18.2% qoq) and W5.1bn (+21.7% qoq) respectively in 3Q12. However, in the yoy trend, revenue will be likely to decrease 6.7%p yoy, and OP also will decline 25.8%p yoy. We believe that this result comes from decline in M/S and ASP due to competitor's entry in the CMEF chip market.

The largest quarterly earnings is expected over seasonal off-season in 4Q12

Innochips is expected to keep operating the factory in full scale to respond to customers' requests in 4Q12. In spite of seasonal factors, the company is estimated to record revenue and operating profit above earrings in 3Q12.

Exhibit 8. 3Q12 Earnings Preview

(Wbn,%)	2Q11	3Q11	1Q12	2Q12	**3Q12F**	4Q12F	**3Q12 QoQ(%)**	**3Q12 YoY(%)**
Revenue	14.0	20.4	19.8	16.1	19.0	20.2	18.2	(6.7)
Adj. OP	4.0	6.2	5.0	3.8	4.9	5.5	28.9	(21.1)
Announced OP	4.1	6.9	5.1	4.2	5.1	5.8	21.7	(25.8)
Pre-tax Profit	4.2	6.9	5.1	4.2	5.6	6.1	32.0	(19.0)
Net Profit	4.2	6.6	5.6	1.8	4.5	4.8	142.6	(32.7)
OP margin (%)	29.1	33.7	25.7	26.0	26.8	28.7	N/A	N/A
NP Margin (%)	30.1	32.6	28.1	11.5	23.5	23.8	N/A	N/A

Source: Company data, Leading Research Center

CMEF chip adoption of Chinese smartphone from 2013

Chinese companies began to adopt CMEF chips in 2H12. CMEF will be adopted widely from 2013 and lead Innochips' earnings. The company is estimated to record revenue of W100.5bn in 2013 increasing 33.8%p from W75.1bn in 2012. OP is also expected to be maintained at the high level given the company's dominance in the CMEF chip market.

Exhibit 9. Annual earnings forecast

(Wbn,%)	2010	2011	2012F	2013F	2014F	2011 YoY(%)	2012F YoY(%)	2013F YoY(%)	2014F YoY(%)
Revenue	53.1	70.3	75.1	100.5	117.3	32.3	6.8	33.8	16.7
Adj. OP	7.6	17.2	19.1	26.1	30.6	125.2	10.9	36.9	17.2
Announced OP	7.6	18.0	20.2	28.0	31.6	135.5	12.3	38.3	13.1
Pre-tax Profit	8.2	18.3	21.0	29.4	33.8	124.2	14.7	39.9	15.0
Net Profit	7.9	17.7	16.6	23.2	26.7	122.1	(5.9)	39.9	15.0
OP margin (%)	14.4	25.6	26.9	27.8	27.0	-	-	-	-
NP Margin (%)	15.0	25.1	22.1	23.1	22.8	-	-	-	-

Source: Company data, Leading Research Center

Financial Statement

Income statement

(Wbn)	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F	2014F
Revenue	**34.7**	**52.4**	**38.0**	**38.7**	**50.3**	**53.1**	**70.3**	**75.1**	**100.5**	**117.3**
% chg yoy	84.3	51.1	(27.4)	1.8	29.9	5.7	32.3	6.8	33.8	16.7
COGS	16.4	22.2	24.0	26.1	28.4	35.6	42.1	42.4	56.4	65.8
Gross profit	**18.2**	**30.1**	**14.0**	**12.6**	**21.9**	**17.5**	**28.2**	**32.7**	**44.1**	**51.5**
GP margin (%)	52.6	57.6	36.8	32.6	43.6	32.9	40.2	43.6	43.9	43.9
SG&A	**7.9**	**13.3**	**11.4**	**9.5**	**10.5**	**9.9**	**11.0**	**13.7**	**18.0**	**20.9**
Operating income	**10.4**	**16.9**	**2.6**	**3.1**	**11.4**	**7.6**	**17.2**	**19.1**	**26.1**	**30.6**
Adj. OP margin (%)	**29.9**	**32.3**	**6.8**	**7.9**	**22.7**	**14.4**	**24.5**	**25.4**	**26.0**	**26.1**
Net other income	0.1	(0.4)	0.2	1.4	(0.5)	0.8	0.8	1.1	1.8	1.0
Reported OP	**10.4**	**16.9**	**2.6**	**3.1**	**11.4**	**7.6**	**18.0**	**20.2**	**28.0**	**31.6**
Net equity method gains	0.0	0.0	0.0	(1.2)	(0.4)	(0.6)	0.0	0.0	0.0	0.0
Financial income	0.1	0.9	1.5	1.0	1.2	1.0	1.2	1.8	1.9	2.4
Financial expenses	0.3	1.4	0.6	1.0	0.6	0.7	0.9	1.0	0.5	0.2
Income before tax	10.3	16.0	3.8	3.2	11.1	8.2	18.3	21.0	29.4	33.8
Income tax	1.3	2.3	(0.2)	0.4	0.4	0.2	0.7	4.4	6.2	7.1
Tax rate (%)	0.1	0.1	(0.0)	0.1	0.0	0.0	0.0	0.2	0.2	0.2
Net profit	**9.0**	**13.7**	**3.9**	**2.9**	**10.7**	**7.9**	**17.7**	**16.6**	**23.2**	**26.7**
Controlling interest	0.0	0.0	0.0	0.0	0.0	0.0	17.7	16.6	23.2	26.7
Non-controlling	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other comprehensive inc	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.0	0.0	0.0
Total comprehensive inc	9.0	13.7	3.9	2.9	10.7	7.9	17.7	16.6	23.2	26.7

Balance sheet

(Wbn)	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F	2014F
Current assets	**38.3**	**43.9**	**34.8**	**30.2**	**48.3**	**44.4**	**61.2**	**67.4**	**81.6**	**108.1**
Cash & equivalents	9.3	7.7	2.0	4.4	11.8	2.0	3.9	3.6	4.3	10.3
ST financial assets	17.0	24.0	19.0	13.7	16.2	18.0	28.1	31.7	32.1	43.6
Accounts receivables	8.0	5.3	4.9	3.6	10.1	12.3	16.1	19.4	25.6	31.3
Inventory	3.3	6.2	7.7	8.3	9.8	11.7	10.9	12.3	19.1	22.4
Others	0.6	0.5	1.2	0.1	0.4	0.3	2.2	0.4	0.5	0.4
Non-current assets	**14.0**	**22.6**	**33.0**	**34.7**	**32.5**	**31.0**	**39.8**	**36.7**	35.2	41.7
Tangible Assets	10.6	20.3	26.7	27.3	25.3	23.4	35.4	34.1	33.1	32.3
LT financial assets	1.7	1.3	4.0	3.6	4.0	4.8	1.7	1.1	1.5	2.0
Inv in related co's	0.0	0.0	0.0	2.2	2.1	1.6	0.0	0.0	0.0	0.0
Inv in joint ventures	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Others	1.7	1.0	2.3	1.6	1.1	1.1	2.7	1.5	0.6	7.4
Total assets	**52.3**	**66.5**	**67.8**	**64.9**	**80.8**	**75.4**	**101.0**	**104.0**	**116.8**	**149.8**
Current liabilities	**8.4**	**9.6**	**11.9**	**6.6**	**13.5**	**11.5**	**19.9**	**11.2**	**4.7**	**11.1**
Accounts payables	0.4	0.4	0.4	0.4	1.7	0.9	0.8	0.8	1.2	1.4
ST financial liabilities	2.1	4.7	8.7	4.8	8.4	7.5	11.5	7.5	2.5	2.5
Others	5.9	4.5	2.8	1.4	3.5	3.1	7.5	2.8	1.0	7.1
Non-current liabilities	**3.1**	**6.4**	**9.1**	**9.0**	**6.8**	**5.9**	**10.1**	**5.3**	**1.3**	**1.2**
LT payables	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
LT financial liabilities	2.6	4.7	7.3	6.8	5.4	3.9	9.5	4.5	0.5	0.5
Others	0.5	1.7	1.8	2.2	1.3	2.0	0.7	0.8	0.8	0.7
Total liabilities	**11.5**	**16.0**	**21.0**	**15.7**	**20.3**	**17.5**	**30.1**	**16.5**	**6.0**	**12.3**
Paid-in capital	3.4	5.1	5.2	7.5	7.5	7.5	7.5	7.5	7.5	7.5
Capital surplus	25.2	23.7	23.7	21.5	21.5	21.5	23.1	23.1	23.1	23.1
Others	(0.0)	(4.3)	(11.9)	(9.5)	(8.2)	(15.7)	(22.0)	(22.0)	(22.0)	(22.0)
Retained earnings	12.2	25.9	29.8	29.7	39.8	44.7	62.4	79.0	102.2	129.0
Non-controlling interest	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total shareholder equity	**40.7**	**50.5**	**46.8**	**49.2**	**60.5**	**57.9**	**71.0**	**87.6**	**110.8**	**137.5**

Free cashflow analysis

(Wbn)	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F	2014F
Net profit	**9.0**	**13.7**	**3.9**	**2.9**	**10.7**	**7.9**	**17.7**	**16.6**	**23.2**	**26.7**
Adj. for non-cash exp.	**(1.5)**	**5.7**	**7.6**	**9.4**	**10.0**	**11.4**	**6.5**	**2.1**	**1.7**	**1.8**
Depreciation	0.7	0.9	1.0	1.0	1.4	2.7	3.3	3.3	3.3	3.3
Provision for reserves	0.2	0.3	0.4	0.3	0.0	0.2	0.3	0.3	0.3	0.3
Net FX gains	0.0	0.0	(0.0)	0.7	(0.2)	(0.1)	(0.1)	0.0	0.4	0.5
Net eq method gains	0.0	(0.1)	(0.2)	(4.2)	(4.1)	(3.5)	0.0	0.0	0.0	0.0
Others	(2.8)	3.4	2.4	3.5	3.3	4.2	2.7	2.5	2.5	2.3
Chg in op assets & liab	**(12.5)**	**2.5**	**5.8**	**3.9**	**(1.7)**	**(9.4)**	**0.1**	**(4.4)**	**(12.5)**	**(8.6)**
Incr in WC (decr)	2.4	0.2	1.0	(0.6)	6.7	4.9	3.1	4.6	12.7	8.8
Others	10.1	(2.7)	(6.9)	(3.3)	(4.9)	4.4	(3.2)	0.2	0.2	0.2
Cash from operations	**(5.0)**	**21.9**	**17.4**	**16.2**	**19.0**	**10.0**	**24.3**	**14.3**	**12.4**	**20.0**
Capital expenditures	5.8	1.5	1.3	6.3	0.1	0.6	1.5	2.0	2.3	2.5
Free cash flow	**(10.8)**	**20.4**	**16.1**	**9.9**	**18.9**	**9.4**	**22.8**	**12.3**	**10.1**	**17.5**
Dividend	1.8	2.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Incr in investment assets	0.0	0.0	(3.5)	(0.3)	(0.1)	0.0	0.0	0.0	0.0	0.0
Share issues	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Increase in debt	0.7	4.7	6.6	(4.3)	2.2	(2.4)	9.6	(9.0)	(9.0)	0.0
Others	(27.0)	21.3	45.2	9.0	14.1	17.0	14.7	0.0	0.0	0.0
Net cash flow	**8.7**	**(1.5)**	**(5.7)**	**2.4**	**7.4**	**(9.8)**	**1.9**	**(0.3)**	**0.7**	**6.0**
Beginning cash	0.6	9.3	7.7	2.0	4.4	11.8	2.0	3.9	3.6	4.3
Ending cash	9.3	7.7	2.0	4.4	11.8	2.0	3.9	3.6	4.3	10.3

Stability ratios

	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F	2014F
Current ratio	454.9	456.5	293.1	454.7	357.1	384.6	307.4	601.7	1,725.4	973.9
Quick ratio	24.3	17.6	5.8	14.5	24.4	4.5	6.4	5.3	5.3	9.5
Inv. holding period (d)	105.9	114.6	121.9	127.0	138.8	116.1	100.8	135.3	61.9	62.2
A/R collection period (d)	68.4	46.6	49.1	40.3	49.8	76.9	73.7	86.1	81.7	88.6
A/P period (days)	7.3	5.6	5.6	5.5	12.7	12.6	7.6	7.0	5.9	6.9
Interest bear debt (Wbn)	4.7	9.4	16.0	11.7	13.8	11.4	21.0	12.0	3.0	3.0
Cash & equivalents (Wbn)	26.3	31.8	21.0	18.1	28.0	20.0	32.1	35.3	36.4	53.9
Net int. bear debt (Wbn)	(21.5)	(22.4)	(5.1)	(6.4)	(14.1)	(8.5)	(11.0)	(23.3)	(33.4)	(50.9)
Net debt/equity (%)	(52.9)	(44.3)	(10.8)	(13.1)	(23.3)	(14.7)	(15.5)	(26.6)	(30.1)	(37.0)
Liability/equity (%)	28.2	31.7	44.8	31.8	33.6	30.2	42.3	18.8	5.4	8.9
Interest coverage (X)	31.1	55.8	4.6	3.4	20.1	13.1	20.4	19.2	57.8	168.4

Valuations and margins

	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F	2014F
EV/EBITDA (X)	4.4	4.6	14.5	29.7	10.5	13.5	7.1	5.8	4.1	3.1
EPS (W)	1,313	1,334	379	193	719	533	1,619	1,522	2,130	2,449
EPS yoy chg (%)	-4.4%	1.6%	-71.6%	-49.0%	271.9%	-25.8%	203.6%	-5.9%	39.9%	15.0%
PER (X)	8.1	7.9	28.0	54.8	14.7	19.9	6.5	7.0	5.0	4.3
BVPS (W)	8,524	5,894	4,531	3,894	4,058	3,885	4,761	5,875	7,434	9,226
P/BVPS (X)	1.2	1.8	2.3	2.7	2.6	2.7	2.2	1.8	1.4	1.1
Dividend/sh (W)	300	0	0	0	0	0	0	0	0	0
Dividend yield (%)	2.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
ROE (%)	33.5	30.1	8.1	6.0	19.5	13.4	27.4	20.9	23.4	21.5
ROA (%)	24.7	23.1	5.9	4.3	14.7	10.2	20.0	16.2	21.0	20.0
GP margin (%)	52.6	57.6	36.8	32.6	43.6	32.9	40.2	43.6	43.9	43.9
OP margin (%)	29.9	32.3	6.8	7.9	22.7	14.4	24.5	25.4	26.0	26.1
NP margin (%)	25.9	26.2	10.3	7.4	21.3	15.0	25.1	22.1	23.1	22.8
EBITDA margin (%)	33.0	35.9	19.0	13.2	27.2	20.9	29.4	31.1	30.3	29.8
ROIC (%)	52.2	61.2	7.7	6.4	24.7	15.5	30.3	24.3	29.1	29.5
WACC (%)	N/A	5.4	4.8	3.2	4.8	6.2	6.8	N/A	10.5	12.1
ROIC less WACC (%)	N/A	55.8	2.9	3.3	19.9	9.4	23.6	N/A	18.6	17.4

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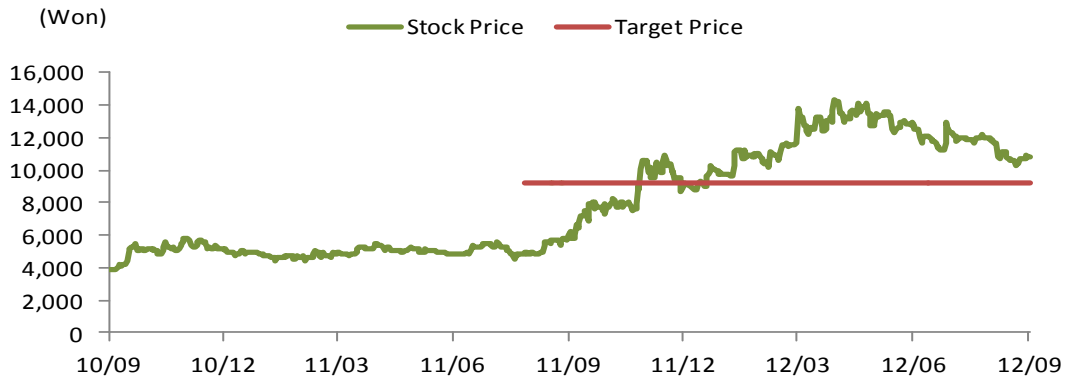
▶ Ratings and target price history in past two years

Innochips (080420 KQ)		
Date	2011-08-16	2012-9-24
Rating	BUY	BUY
Target Price	9,240	14,700

▶ Target price changes in past two years



▶ Investment period and ratings

Company	
BUY	The stock is expected to outperform the market by at least 15%p over the next 12 months.
HOLD	The stock is expected to either outperform or underperform the market by less than 15%p over the next 12 months.
SELL	The stock is expected to underperform the market by at least 15%p over the next 12 months

Industry	
OVERWEIGHT	Industry indicators are expected to outperform the by at least 5%p over the next 12 months.
NEUTRAL	Industry indicators are expected to be in line with the market within 5%p over the next 12 months.
UNDERWEIGHT	Industry indicators are expected to underperform the market by at least 5%p over the next 12 months

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