

MEC COMPANY (4971 JP)

FY20 COMPANY GUIDANCE SUGGESTS TRENDING DOWN IN 2H WITH CONSERVATIVE ASSUMPTIONS

FY20 1H EARNINGS RESULT

MEC reported FY20 (Dec year-end) 1H OP of ¥1,133mil (+85.8% YoY) on sales of ¥5,701mil (+14.6% YoY). The 1H results largely surpassed the 1H guidance announced at the beginning of the year (OP of ¥600mil on sales of ¥5,000mil). 1H sales achieved 51.4% of the revised FY20 sales guidance. Similarly, 1H OP reached 56.7% of the full-year OP guidance.

A boost in server demand, bolstered by the increase in sales of devices such as PCs and tablets on the back of Covid-led remote working and home schooling, was a key driver of MEC's sales growth. FY20 1H OPM improved to 19.9% vs 12.3% in FY19 1H and 17.7% in FY20 1Q, thanks to rise in sales volume and an improved sales mix, as well as a reduction in SG&A.

1H Chemicals segment sales rose 12.3% YoY to ¥5,491mil, bolstered by the 13.4% YoY increase in sales of Copper Surface Treatment Chemicals (¥5,253mil), which includes 1) Adhesive Enhancer (CZ series, V-Bond etc) sales of ¥3,416mil (+15.8% YoY) and 2) Etching chemicals sales of ¥1,836mil (+9.2% YoY). Overall Chemical segment shipment volumes rose 10.6% YoY.

CZ series Q2 sales were ¥1,491mil (+8.2% YoY / -0.7% QoQ), taking 1H sales up 16.9% YoY to hit ¥2,999mil. Sales of CZ-8101 hit a record quarterly level of ¥820mil (+3.9% YoY / +4.1% QoQ). A surge in data transmission on the back of the rapid rise in remote working and home schooling, due to COVID-19, pushed up demand for data centre servers. Demand for PCs also rose by the shift to working from home, which helped boost sales of CZ-8101. On the other hand, quarterly sales of CZ-8100 fell to ¥225mil (-13.5% YoY / -8.5% QoQ) due to continued weakness in package boards used in automobiles amid low automobile production.

V-Bond, another adhesive enhancing chemical, used in automotive applications, was also affected by the weakness in automobile production. 2Q sales were ¥148mil (-17.8% YoY / -4.1% QoQ).

Etching Chemicals 1H sales was ¥1,836mil (+9.2% YoY) thanks to SF, a key material used in touch panel sensors, whose shipments have been rising since February amid the rapid increase in demand for tablets. In 2Q alone, sales of SF was ¥299mil (+45.7% YoY / +64.1% QoQ).

On the other hand, 2Q sales of EXE – another etching chemical used fine wiring formation – were ¥362mil (+3.9% YoY / +20.4% QoQ), thanks to stable demand for COF (chip-on-film) – as was evident in 1Q (¥301mil, +1.3% YoY).

FY20 2Q OP was ¥635 (+56.8% YoY / +27.6 QoQ) on sales of ¥2,891 (+9.2% YoY / +2.9% QoQ). In addition to stronger chemical sales and volumes, the chemical segment gross profit margin (GPM) improved from 61.8% in Q1 to 62.2%. Furthermore, SG&A/sales ratio fell again from

EXECUTIVE SUMMARY

- MEC reported FY20 (Dec year-end) 1H OP of ¥1,133mil (+85.8% YoY) on sales of ¥5,701mil (+14.6% YoY), largely ahead of its 1H guidance thanks to higher sales volumes as well as an improved sales mix.
- 1H sales of Chemicals rose 12.3% YoY to ¥5,491mil. Copper Surface Treatment Chemicals, which include the CZ series, enjoyed 15.8% YoY sales growth.
- 1H sales of CZ series rose 16.9% YoY. In the 2Q alone, CZ-8101 sales hit a quarterly record thanks to demand from PCs and servers, triggered by the rapid shift to remote working and home schooling.
- Another chemical that enjoyed a boost was SF – a key material used in touch panel sensors – thanks to increased demand for tablet devices.
- On the other hand, chemicals exposed to automotive industry, such as V-Bond and CZ-8100, remained weak. 1H sales of etching chemical EXE showed stable growth.
- MEC revised FY20 OP forecast from ¥1,700mil (+3.8% YoY) to ¥2,000mil (+22.2% YoY) on sales of ¥11,100mil (+2.2% YoY), which is down from ¥11,600mil (+6.8% YoY). Under the new guidance, 2H estimates were revised down due to the following assumptions:
 - a) The macroeconomic environment will remain weak, especially for consumption.
 - b) Pre-empted demand in 1H.
- In 2H, CZ-8101 sales will likely remain strong thanks to demand related to data centre servers and 5G infrastructure. Shipments of new generation CZ series, such as CZ-8201 / 8401, have started but will not yet make a notable contribution to earnings. COVID restrictions has led to delays in EXE demand, which is used for the HDI subtractive method.

44.1% in 1Q (-6.6pp YoY) to 40.3% in 2Q (-6.6pp YoY) due to the suspension of marketing activities under COVID-19 restrictions which led to fewer business trips. As a result, OPM improved from 17.7% in 1Q to 22.0% in 2Q.

Earnings Summary (Cumulative)										
¥mil)	FY19			FY20						
	1Q	1H	FY	1Q	1H	1HCE	YoY (%)	vs. CE (%)	FY20CE (new)	YoY (%)
Sales	2,328	4,976	10,865	2,809	5,701	5,000	14.6	14.0	11,100	2.2
OP	205	610	1,637	498	1,133	600	85.8	88.8	2,000	22.2
OPM (%)	8.8	12.3	15.1	17.7	19.9	12.0	+7.6pp	+7.9pp	18.0	+2.9pp
RP	240	638	1,722	463	1,126	600	76.4	87.7	2,000	16.1
RPM (%)	10.3	12.8	15.9	16.5	19.8	12.0	+7.0pp	+7.8pp	18.0	+2.1pp
NP	158	457	1,236	317	794	400	73.8	98.5	1,400	13.2
EPS (¥)	n/a	24.09	65.16	n/a	41.85	21.07	73.7	98.6	73.77	13.2
DPS (¥)	n/a	12.00	26.00	n/a	12.00	12.00	0.0	0.0	26.00	0.0

Source: MEC FY20 2Q results presentation material

Chemical Sales by Products (Quarterly)												
¥million)	FY2018				FY2019				FY20			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	QoQ (%)	YoY (%)
Copper surface treatment chemicals	2,454	2,617	2,716	2,685	2,134	2,497	2,919	2,592	2,551	2,701	5.9	8.2
Adhesive enhancer (CZ, V-Bond)	1,598	1,641	1,640	1,577	1,360	1,588	1,718	1,695	1,720	1,695	-1.5	6.7
CZ-8100	270	279	272	253	232	260	257	269	246	225	-8.5	-13.5
CZ-8101	723	733	725	713	540	789	752	753	787	820	4.2	3.9
Other CZ chemicals	392	407	420	382	413	330	475	446	474	446	-5.9	35.2
Etching chemicals (EXE, SF etc.)	855	975	1,076	1,108	773	909	1,200	897	830	1,006	21.2	10.7
SF	191	275	347	321	145	205	407	222	182	298	64.1	45.7
EXE	277	286	296	381	297	349	369	278	301	362	20.4	3.9
Other surface treatment chemicals	158	156	181	162	132	125	133	122	109	127	16.5	1.6
Chemical Sales Total	2,612	2,773	2,898	2,847	2,266	2,623	3,052	2,715	2,661	2,829	6.3	7.9

Source: Nippon-IBR based on MEC's FY20 2Q earnings presentation material

REVISED FY20 GUIDANCE

MEC disclosed its revised FY20 guidance following the 1H results as it had more clarity of the situation surrounding its end application markets. The revised FY20 OP guidance was revised up from ¥1,700mil (+3.8% YoY) to ¥2,000mil (+22.2% YoY), however, the sales guidance was slightly reduced from ¥11,600mil (+6.8% YoY) to ¥11,100mil (+2.2% YoY).

After a strong 1H, the new guidance suggests that MEC has revised down its 2H OP target of ¥1,100mil to ¥866mil and its 2H sales estimate down from ¥6,600mil to ¥5,398mil. The weaker 2H guidance is mainly due to:

1. A cautious view on the macroeconomic environment, particularly regarding any sharp recovery in the consumption of expensive, luxurious items such as automobile and smartphones. The US-China trade friction will likely remain a negative factor on the global economy activities.
2. Demand for laptops and tablets that triggered higher than expected sales due to COVID-19 may have also preempted the traditional Xmas demand, therefore, the seasonally stronger 3Q demand might not appear this year.

Management does not expect demand for such devices – triggered by need for working remotely – will not likely last forever, eventually running its course.

The new FY20 estimates were based on the weak sentiment in June, having seen the earnings trend peak in March and April and suddenly fall in May. While the monthly earnings trend recovered in June, the consensus within the firm on the outlook for the year remains cautious.

Earnings results and company estimate							
(¥mil)	FY19		FY20				
	FY	YoY (%)	IH	YoY (%)	CE Old	CE New	YoY (%)
Sales	10,865	-4.1	5,701	14.6	11,600	11,100	2.2
OP	1,637	-26.4	1,133	85.8	1,700	2,000	22.2
OPM (%)	15.1		19.9	+7.6pp	14.7	18.0	+2.9pp
RP	1,722	-23	1,126	76.4	1,750	2,000	16.1
NP for the parent's s/holders	1,236	-30.5	794	73.8	1,250	1,400	13.2
EPS (¥)	65.16	-29.8	41.85	73.8	65.87	73.77	13.2

Source: Nippon-IBR based on MEC's FY20 2Q results material

CZ sales will likely remain solid in 2H, however, MEC's outlook remains conservative: Although the special demand associated with COVID-triggered remote working and home schooling may die out, 2H sales of CZ-8101 will likely be boosted by a pickup in demand from servers and 5G infrastructure. On the other hand, a recovery of automobile-related demand which affect sales of CZ-8100 will likely be delayed to FY21.

Meanwhile, sales of newer generation CZ series products, CZ-8201 and CZ-8401 have gradually started to pick up in 1H. CZ-8201 1H sales hit ¥34mil (¥12mil in 1Q and ¥22mil in 2Q) for the next generation packaging technology. Sales of the latest CZ-8401 product, used for AiP – Antenna-in-Package – and is designed for millimetre wave 5G high-end smartphones, hit ¥23mil (¥10mil in 1Q and ¥13mil in 2Q). CZ-8401 is. Although there are signs that volume production of new package boards might start to come through some time before the end of the fiscal year, the impact on FY20 earnings will likely remain small. 5G infrastructure and server will continue to be the growth drivers for the CZ series in FY20, but the company thinks that 5G devices will still comprise just a small part of the 1,100mil-unit global smartphone market (down 200mil units YoY in CY2020) for the next 5 years or so. MEC has high hopes for CZ-8201 as a growth driver from FY21 onwards. However, assuming millimetre wave smartphones occupy 50% of the overall smartphone market by 2026~27, the full growth potential of CZ-8401 will be still some years away.

Within Adhesive Enhancing Chemicals, CZ-8100 and V-Bond are used in automobile parts. MEC expects the recovery of V-Bond will depend on how quickly the automobile industry recovers, which the firm thinks will be unlikely in FY20. However, the weakness of CZ-8100 and V-Bond will be more than offset by solid sales growth of CZ-8101 and, in part, CZ-8201.

In Etching Chemicals, sales of SF are expected to drop as some high-end smartphone / tablet touch panels are now being replaced by Y-OCTA which does not require touch panel sensors. So far in 2H, tablet sales remained strong. Subsequently, sales of SF were been better than expected. MEC reckons that strong sales of CZ series will sufficiently offset the likely decline in SF sales in FY21 and beyond.

For EXE, another etching chemical product, its sales growth is assumed to be led by applications on COF for displays, although in 1H, demand for use in COF remained flat. Further upside would be possible if EXE is to be used in smartphones' HDI motherboards as the subtractive method partially replaces the existing MSAP (Modified Semi-additive Process). The subtractive method presents a big opportunity for EXE, however, due to restrictions under COVID, the employment of this process has been slower than expected. On the other hand, MEC expects applications on COF for displays will likely recover in 2H.

For FY20, the firm is not assuming strong seasonality in 3Q due to possibility there was pre-empted demand in 1H. Furthermore, MEC expects marketing activities and business trips will resume in 2H.

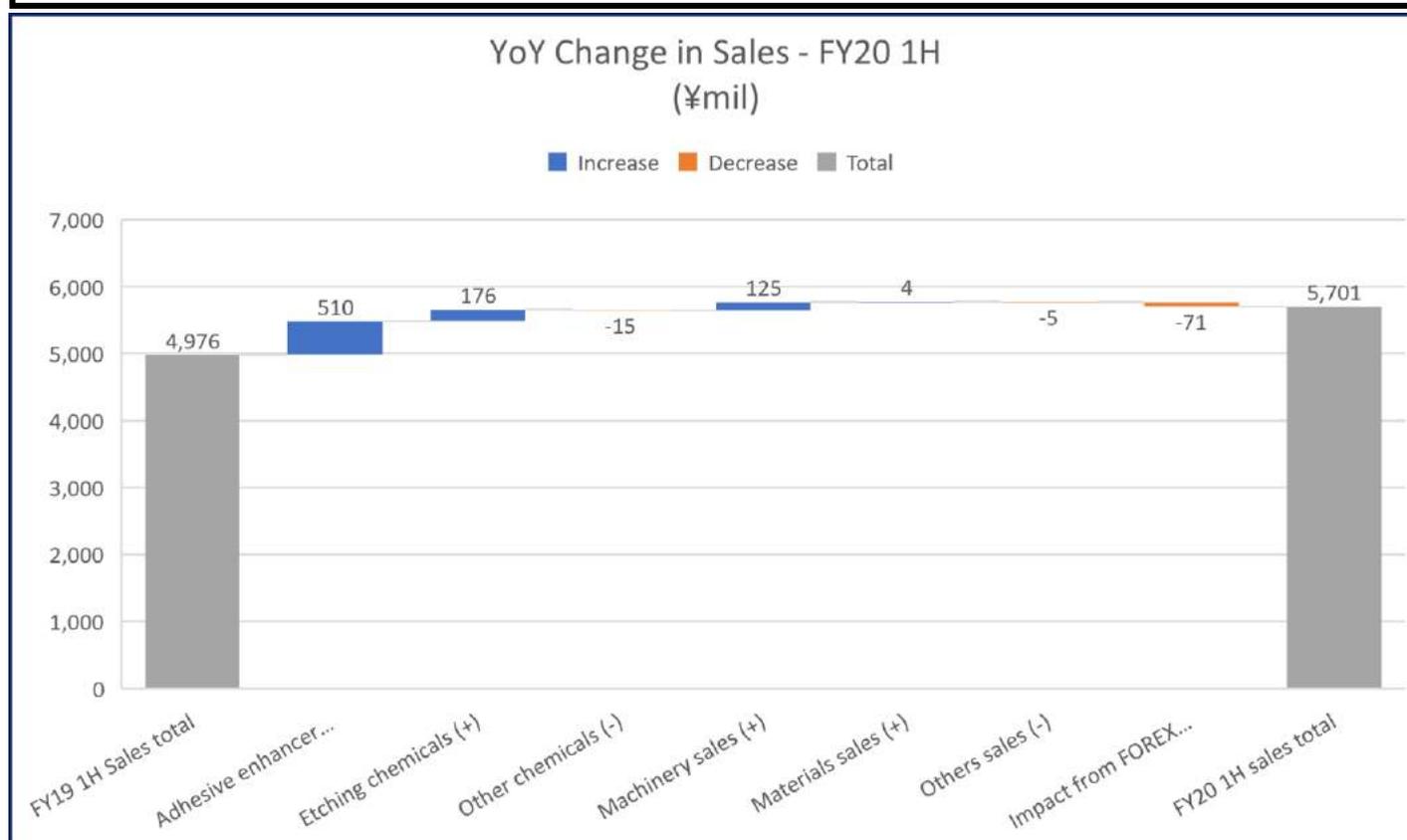
MEC reckons that earnings risks might be:

- Possibility of delay in 5G infrastructure. Although such a risk may be low, supply disruption by Huawei amid the continuing US-China trade friction can delay the infrastructure installation.
- Further damage to the global macroeconomy.

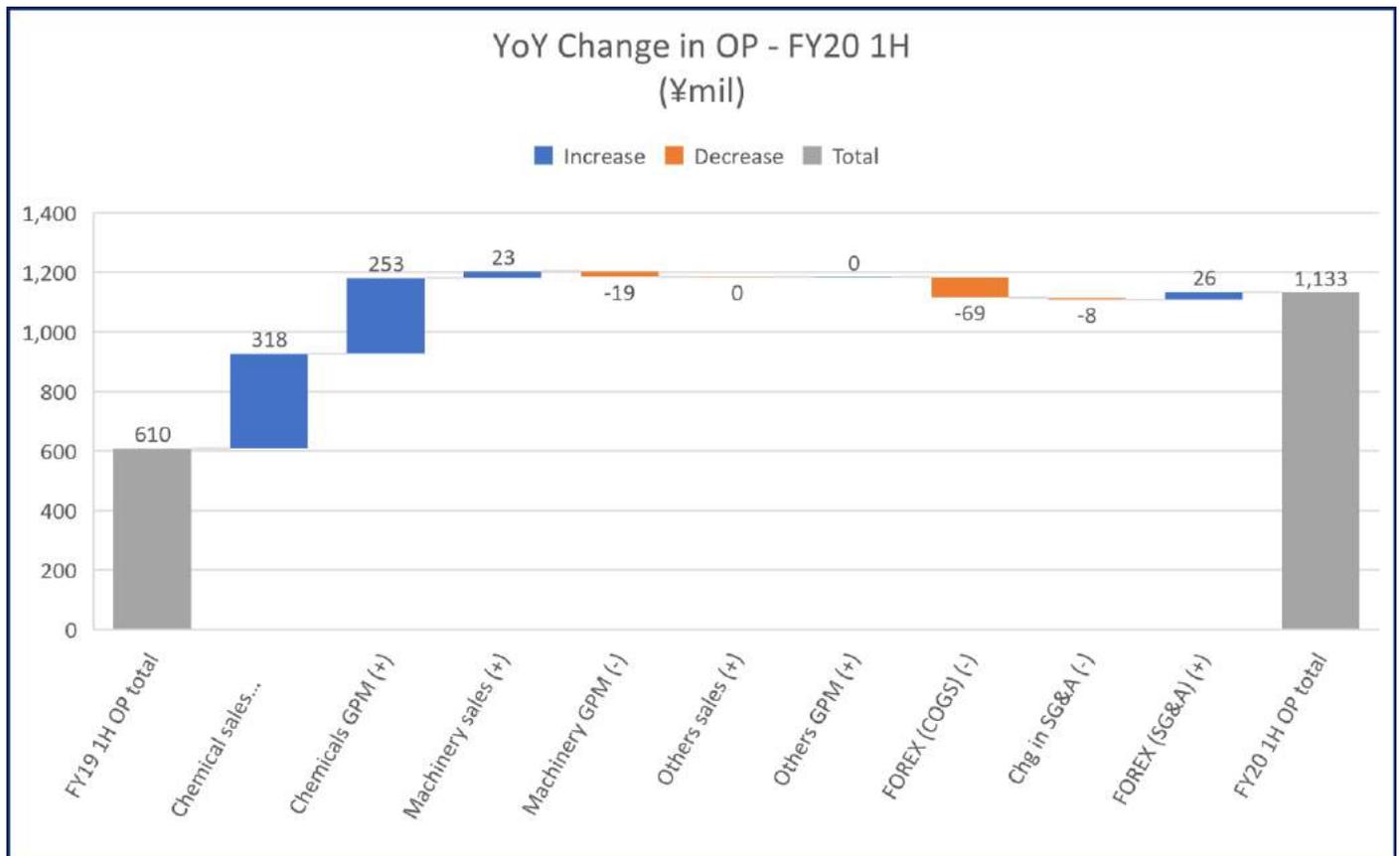
MEC aims to pay out 30% of EPS as a cash dividend. In FY20, the annual dividend is estimated at ¥26/share.

Potential demand for CZ series - trend in technology for 5G infrastructure				
Chip Maker	Packaging Technology	Specifications	Change in packaging	Applications
Intel	EMIB	2.nD packaging by silicon bridge	Embed silicon bridge together with miniaturisation	Servers
Intel	Foveros	3D packaging with TSV	Miniaturisation	PCs
Intel	Co-EMIB	Combining Foveros and EMIB	Embed silicon bridge together with miniaturisation	Super computers, servers
AMD	Chiplets	2D packaging competing with Intel's EMIB and Foveros	Larger package with miniaturisation	Servers, PCs

Source: MEC's FY19 earnings results material



Source for the above two charts: MEC's FY20 2Q earnings results material



Source for the above two charts: MEC's FY20 2Q earnings results material

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For further enquiry, please contact:

Nippon Investment Bespoke Research UK Ltd
First Floor,
35 Little Russell Street
London WC1A 2HH
TEL: +44 (0)20 7993 2583
Email: enquiries@nippon-ibr.com



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Japanese Equity Specialist

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