MEC CO., LTD (4971 JP)

FY24 EARNINGS GROWTH WILL CONTINUED TO BE LED BY CZ-8101, WHICH WILL SEE FULL FLEDGED RECOVERY FROM 2H ONWARDS

FY23 RESULTS SUMMARY

MEC (4971 JP) reported FY23 (Dec year-end) earnings that overshot its full-year guidance for OP of ¥2,250mil (-43.8% YoY) on sales of ¥13,800mil (-15.5% YoY). FY23 landed with OP of ¥2,492mil (-37.7% YoY) on sales of ¥14,020mil (-14.1% YoY). Budgeted expenses – for travel and subsistence, and distribution – were not spent, so better than expected profits were recorded.

Earnings Summary (Cumulative)

Dec year-end (¥mil)	FY21	FY22		FY23				
	FY	1H	FY	1H	FY	YoY (%)	FY CE	vs CE (%)
Sales	15,038	8,127	16,329	6,198	14,020	-14.1	13,800	1.6
incl. Chemicals	14,756	8,032	16,042	6,085	13,764	-14.2	N/A	N/A
GP	9,323	4,919	9,803	3,646	8,316	-15.2	N/A	N/A
GPM (%)	62.0	60.5	60.0	58.8	59.3	-0.7ppt	N/A	N/A
SG&A	5,383	2,834	5,799	2,807	5,824	0.4	N/A	N/A
SG&A/Sales (%)	35.8	34.9	35.5	45.3	41.5	+6.0ppt	N/A	N/A
OP	3,939	2,084	4,004	838	2,492	-37.7	2,250	10.8
OPM (%)	26.2	25.6	24.5	13.5	17.8	-6.7ppt	16.3	+1.5ppt
RP	4,104	2,374	4,246	1,003	2,683	-36.8	2,500	7.3
RPM (%)	27.3	29.2	26.0	16.2	19.1	-6.9ppt	18.1	+1.0ppt
NP	2,949	1,661	3,064	1,076	2,304	-24.8	2,150	7.2
EPS (¥)	155.28	87.4	161.22	56.79	122.29	N/A	114.07	7.2
DPS (¥)	35.00	20.00	45.00	20.00	45.00	N/A	45.00	N/A

Source: Nippon-IBR based on MEC's results presentation material

FY23 Chemical segment sales, which constitutes nearly 98.2% of the firm's total revenue, declined -14.2% YoY to ¥13,764mil [quarterly sales trend: Q1 ¥2,712mil / Q2 ¥3,372mil / Q3 ¥3,749mil / Q4 ¥3,929mil].The segment has two product groups: 1) Adhesive Enhancer Chemicals, whose FY23 sales were down -15.1% YoY to ¥9,728mil primarily with adjustments in sales of MEC's core products, CZ series, and 2) Etching Chemicals, which produced FY23 sales of ¥3,257mil (-14.5% YoY).

In the Q4 alone, Adhesive Enhancer sales rose +4.2%YoY / +11.8% QoQ to ¥2,915mil. Sales of CZ series bottomed in Q1 and started recovering from Q2 onwards. However, etching Chemicals sales fell -4.9% YoY / -11.5% QoQ to ¥821mil due to the expected slump in SF sales (-38.5% YoY / -35.9% QoQ). On the other hand, sales of EXE remained stable at ¥259mil (+14.6% YoY / -17.0% QoQ) thanks to completion of inventory adjustment for chip-on-film [COF].

Although the full year FY23 gross profit margin [GPM] contracted -0.7ppt YoY to 59.3%, it improved vs the performance of the 1H (58.8%) and cumulative Q1~Q3 (59.0%). While a drop in chemical sales volumes reduced

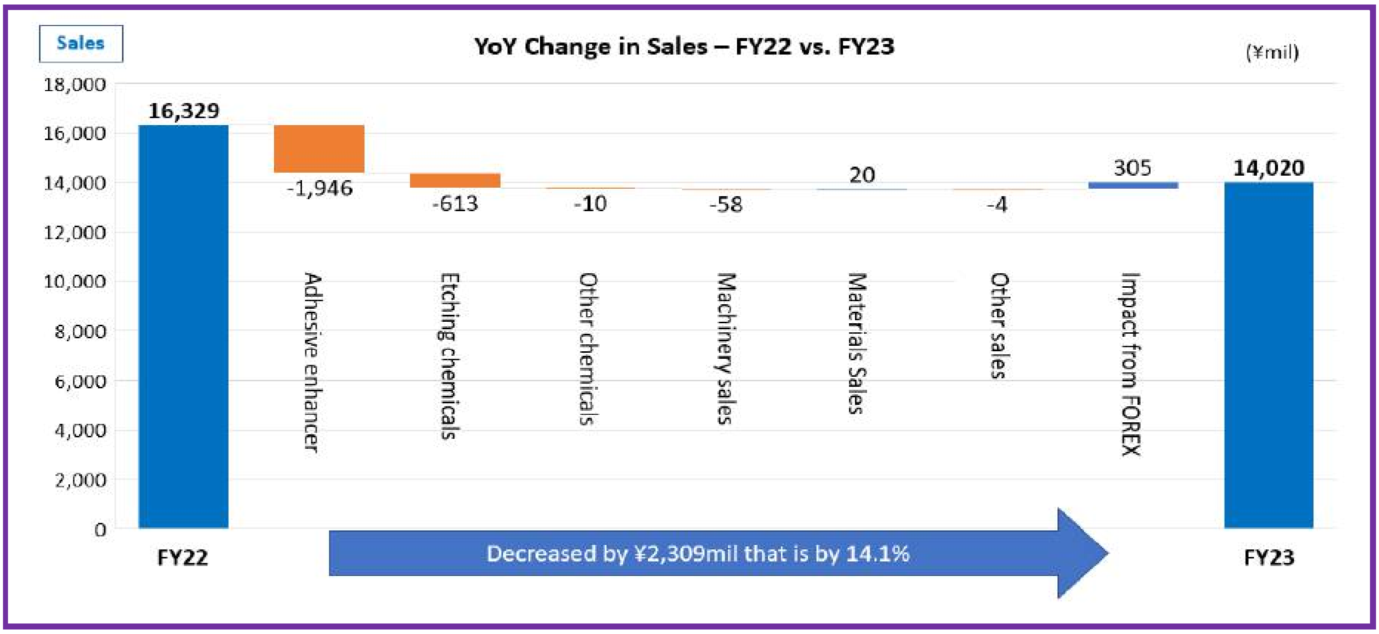
EXECUTIVE SUMMARY

- MEC (4971 JP) reported FY23 (Dec year-end) earnings that overshot its full-year guidance of OP of ¥2,250mil (-43.8% YoY) on sales of ¥13,800mil (-15.5% YoY). FY23 landed with OP of ¥2,492mil (-37.7% YoY) on sales of ¥14,020mil (-14.1% YoY).
- FY23 Adhesive Enhancer sales declined -15.1% YoY to ¥9,728mil, as did CZ series sales (-16.3% YoY to ¥8,629mil). Quarterly sales of CZ series, however, appear to have bottomed in Q1, which saw sales of ¥1,638mil -31.8% YoY / -34.9% QoQ, as evidenced by the Q2 performance (¥2,071mil -20.6% YoY / +26.4% QoQ), Q3 CZ series sales of ¥2,311mil (-17.0% YoY / +11.6% QoQ), followed by Q4 sales of ¥2,609mil (+3.7% YoY / +12.9% QoQ).
- FY23 Etching Chemicals sales fell -14.5% YoY to ¥3,257mil. In Q4 alone, the segment reported sales of ¥821mil (-4.9% YoY / -11.5% QoQ), due to 1) peak out in sales of EXE after seeing a recovery up to FY23 Q2, and 2) expected weakness in sales of SF.
- MEC is guiding for FY24 1H OP of ¥1,300mil (+55.0% YoY) on sales of ¥7,850mil (+26.6% YoY) and FY24 OP of ¥3,000mil (+20.3% YoY) on sales of ¥16,300mil (+16.3% YoY). The firm maintains an annual dividend unchanged at ¥45.0/share, which will make the pay-out ratio of 39.2%.
- MEC plans to spend approx. ¥4,000mil on the new Kita Kyushu plant including cost of the land, financed by cash flow as well as long-term debt. The new factory will meet the expected rapid surge in demand for CZ chemicals.

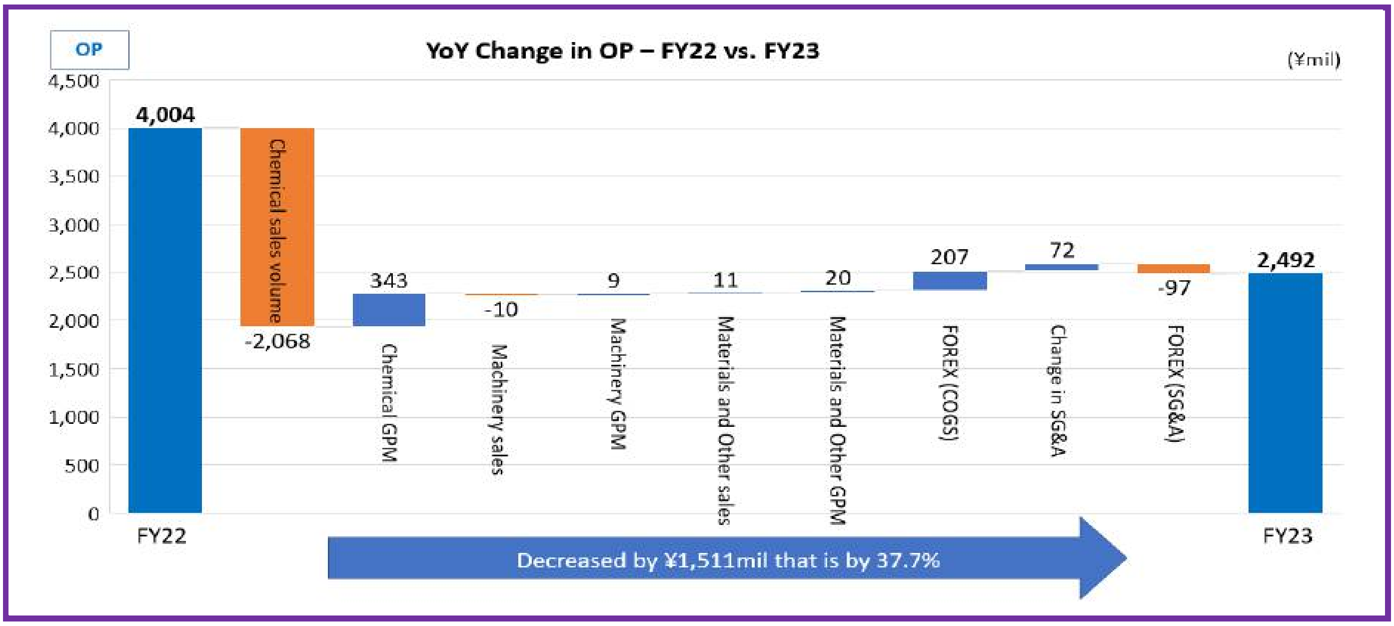
consolidated OP by -¥1,511mil, an improved sales mix reflecting the recovery in EXE sales, and the impact of price hikes of CZ series implemented in FY22 coming into effect in FY23 improvements led to rise in the segment's GPM.

Regarding the performance of CZ-8101 – MEC's core adhesion enhancing chemical product – sales bottomed in Q1. Sales in Korea, which is included in Japan sales [NB: MEC does not have a factory in Korea, so it exports to distributors there] are improving as inventory adjustments in Korea have run their course. The recovery in sales to Korea, therefore, is apparent in the Japan QoQ performance:

FY23 Japan OP declined -54.9% YoY to ¥1,216mil on sales of ¥5,544mil (-16.6% YoY), but in Q4 alone, OP was ¥538mil (-14.1% YoY / +24.2% QoQ). Although the inventory adjustment at MEC's customers and distributors in Korea seems to have run its course, demand for CZ-8101 has not returned to FY22 Q3 peak level, for demand for end applications such as PCs and servers still remains lacklustre. Meanwhile, demand associated with generative AI and automobile production has picked up, though it was not enough to lead growth of CZ-8101 sales afresh. Earnings in Taiwan showed a similar trend to Japan, with sluggish demand for PCs and servers impacting demand for packages. FY23 Taiwan OP was ¥308mil (-34.5% YoY) on sales of ¥2,620mil (-25.0% YoY).



Source: MEC Co., Ltd. FY23 Q4 earnings results presentation



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SEGMENTS PERFORMANCE

Adhesive Enhancers

FY23 Adhesive Enhancer sales fell -15.1% YoY to ¥9,728mil, as did CZ series sales (-16.3% YoY to ¥8,629mil).However, CZ series' sales appear to have bottomed in Q1, which saw sales of ¥1,638mil -31.8% YoY / -34.9% QoQ, as evidenced by the following quarterly performances – Q2 ¥2,071mil -20.6% YoY / +26.4% QoQ) / Q3 ¥2,311mil (-17.0% YoY / +11.6% QoQ) / Q4 ¥2,609mil (+3.7% YoY / +12.9% QoQ).

MEC's core product in this product group, CZ-8101 – an adhesive-enhancing chemical used in packages primarily for PCs, servers and chiplet packaging such as CoWoS – which had enjoyed sales growth in FY22, slumped in FY23 Q1 to ¥883mil (-30.8% YoY / -30.8% QoQ). However, in Q2 alone, sales recovered +22.3% QoQ to ¥1,080mil (-23.4% YoY), followed by a +13.8% QoQ improvement to ¥1,229mil (-16.1% YoY) in Q3, then a further +9.8% QoQ increase to ¥1,350mil (+5.8% YoY), thanks to 1) inventory adjustments at customers and distributors being cleared, 2) a recovery in demand for memory, and 3) the impact of price hikes implemented in FY22.

During FY21~FY22, the main growth driver behind the strong CZ-8101 sales was the rising demand for packages used in servers and base stations, bolstered by the increase in data transmission as the penetration of 5G communication progresses. However, although MEC's CZ-8101 sales were strong up to FY22 Q3, demand turned down in FY22 Q4 due to (1) production adjustments in packages as demand for PCs and smartphones waned, and (2) a temporary adjustment in demand for servers. Throughout FY23, demand remained weak given the lacklustre demand for PCs and a slow recovery in demand for servers, but as we note above, CZ-8101 sales started to show signs of a recovery from Q2 on.

The FY23 performance of Other CZ chemicals sales, which includes adhesive chemicals using pre- and post-adhesive processes, fell -17.8% YoY to ¥2,961mil. In the FY22 Q1~Q3 period, sales of these chemicals had benefited from strong demand from package makers as they boosted the density of packages used in servers – particularly as they have become larger and, therefore, have more layers during. However, in FY22 Q4, sales peaked, and in FY23 Q1, they slumped -45.6% QoQ to ¥505mil (-37.7% YoY). Sales of the newer generation of CZ series products – CZ-8201 and CZ-8401 – used in conjunction with the miniaturisation of wiring, are also included in this category. In Q4 alone, sales of other CZ chemicals recovered +1.5% YoY / +17.9% QoQ to ¥942mil.

The CZ-8100 product, which is partly used in packages for auto components, had also reported record annual sales of ¥1,284mil (+4.8% YoY) in FY22, despite the semiconductor and components shortage affecting auto production. However, FY23 Q1 sales declined -20.1% QoQ to ¥250mil (-20.6% YoY), partly on the back of a slower-than-expected recovery in auto production but also due to inventory adjustments of memory package substrates. However, from Q2 onwards, sales of CZ-8100 has been gradually recovering thanks to a pickup in demand for packages used in EVs and ADAS. The performance of CZ-8100 sales has improved each quarter: Q1 ¥250mil (-20.6% YoY / -20.1% QoQ) / Q2 ¥276mil (-12.7% YoY / +10.4% QoQ) / Q3 ¥283mil (-16.8% YoY / +2.5% QoQ) / Q4 ¥317mil (+1.3% YoY / +12.0% QoQ).

V-Bond, another adhesive-enhancing chemical used in multilayer substrates for autos and mid-end smartphones, reported FY23 sales of ¥746mil (-5.6% YoY). In Q4 alone, V-Bond sales recovered to ¥187mil (+0.0%YoY / +5.6% QoQ).

Etching Chemicals

FY23 Etching Chemicals sales fell -14.5% YoY to ¥3,257mil. However, the segment performance saw the YoY rate of decline in sales ease (-4.9% YoY / -11.5% QoQ) to ¥821mil. MEC reported (1) FY23 EXE sales of ¥1,114mil (+3.1% YoY). In Q4 alone, EXE saw sales of ¥259mil (+14.6% YoY / -17.0% QoQ). Sales for COF bottomed on the back of a recovery in TV monitor production postproduction adjustment during FY22 up to FY23 Q2, and (2) a -38.5% YoY fall in SF (a key material used in displays) sales to ¥118mil (-35.9% QoQ) in Q4 alone. As the new models of high-end smartphones now use a different technology, the weak sales in SF were expected as this technology shift had already been factored in. FY23 SF sales declined -37.7% YoY to ¥544mil.

Chemical Sales by Products (Cumulative)

(¥mil / Dec year-end)	FY22				FY23				
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	YoY (%)
Copper surface treatment chemicals	3,695	7,626	11,607	15,267	2,564	5,714	9,250	12,986	-14.9
Adhesive enhancer (CZ, V-Bond etc.)	2,676	5,587	8,660	11,457	1,870	4,205	6,813	9,728	-15.1
CZ Series Total	2,403	5,011	7,795	10,312	1,638	3,709	6,020	8,629	-16.3
CZ-8100	315	631	971	1,284	250	526	809	1,126	-12.3
CZ-8101	1,276	2,686	4,150	5,426	883	1,963	3,192	4,542	-16.3
Other CZ chemicals	811	1,694	2,674	3,602	505	1,220	2,019	2,961	-17.8
Etching chemicals (EXE, SF etc.)	1,019	2,039	2,947	3,810	694	1,508	2,436	3,257	-14.5
SF	204	450	684	877	130	242	426	544	-37.7
EXE	360	668	855	1,081	224	543	855	1,114	3.1
Other surface treatment chemicals	202	404	604	770	148	370	583	776	0.8
Chemical Sales Total	3,898	8,032	12,213	16,042	2,712	6,085	9,834	13,764	-14.2

Source: Nippon-IBR based on MEC's earnings presentation materials

Chemical Sales by Products (Quarterly)

(¥mil / Dec year-end)	FY22				FY23					
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	QoQ (%)	YoY (%)
Copper surface treatment chemicals	3,695	3,931	3,981	3,660	2,564	3,150	3,536	3,736	5.7	2.1
Adhesive enhancer (CZ, V-Bond etc.)	2,676	2,911	3,073	2,797	1,870	2,335	2,608	2,915	11.8	4.2
CZ Series Total	2,402	2,609	2,784	2,517	1,638	2,071	2,311	2,609	12.9	3.7
CZ-8100	315	316	340	313	250	276	283	317	12.0	1.3
CZ-8101	1,276	1,410	1,464	1,276	883	1,080	1,229	1,350	9.8	5.8
Other CZ chemicals	811	883	980	928	505	715	799	942	17.9	1.5
Etching chemicals (EXE, SF etc.)	1,019	1,020	908	863	694	814	928	821	-11.5	-4.9
SF	204	246	235	192	130	112	184	118	-35.9	-38.5
EXE	360	308	187	226	224	319	312	259	-17.0	14.6
Other surface treatment chemicals	202	202	200	166	148	222	213	193	-9.4	16.3
Chemical Sales Total	3,898	4,134	4,181	3,827	2,712	3,372	3,749	3,929	4.8	2.7

Source: Nippon-IBR based on MEC's earnings presentation materials

FY24 OUTLOOK

MEC is guiding for FY24 1H OP of ¥1,300mil (+55.0% YoY) on sales of ¥7,850mil (+26.6% YoY) and full-year FY24 OP of ¥3,000mil (+20.3% YoY) on sales of ¥16,300mil (+16.3% YoY). The annual dividend will remain at ¥45.0/share, which generates a pay-out ratio of 39.2%.

MEC's FY24 guidance are based on the following assumptions:

1. MEC expects a gradual recovery in end applications such as server and PC during 1H, and assumes a full-fledged recovery of server demand, which should boost earnings of MEC's core product CZ-8101, from FY24 2H. As a result, CZ chemicals will still be MEC's main growth driver, with the firm guiding for an improvement of +15~20% YoY in FY24.

Demand for packages used in high-end servers that support generative AI technology has been strong, however, the number of packages used for PCs is some 50x more than the amount used in high-end servers, hence, the trend in PC production is still important for CZ-8101. The firm assumes around +20% YoY growth in CZ-8101 and CZ-8201, respectively, while CZ-8100 YoY growth is estimated at flat YoY.

2. A decline in V-Bond sales due to weakness in demand for middle-end smartphones, although demand for use in automobiles will likely remain solid. MEC assumes FY23 V-Bond sales to see -10% YoY.
3. A cautious view on Etching Chemical sales, SF and EXE. MEC assumes sales of EXE to be solid, however, unlike FY23, where the firm saw an increase in production of TV displays after inventory adjustments peaked, there is uncertainty regarding demand for COF in FY24. Sales of SF will likely continue to decline due to the technology shift in touch panel used in high-end smartphones.

CAPITAL ALLOCATION POLICY

CAPEX: For FY23, MEC spent ¥1,870mil for CAPEX, of which ¥933mil was for the new Kita Kyushu plant, which will be completed in April 2024, with operations due to commence in July 2025. CAPEX on the plant will be spread over four years – FY23 ¥933mil / FY24 ¥1,730mil / FY25 ¥1,026mil / FY26 ¥311mil.

In FY24, the total CAPEX is budgeted at ¥3,107mil, with plans to spend approx. ¥4,000mil, which includes the cost of the land for the new Kita Kyushu plant, financed by cash flow as well as debt. The new factory will meet the expected rapid surge in demand for CZ chemicals as this is when package makers start full mass production of packages using chiplet packaging, such as EMIB, and also improved distribution-to the firm's Korean customers.

Post-completion depreciation costs related to the Kita Kyushu plant is estimated at ¥150mil~¥200mil/annum. In FY24, MEC is guiding for total depreciation costs of ¥813mil. This compares to FY23 depreciation of ¥773mil (+5.2% YoY).

Shareholder Return: MEC maintained its annual dividend payment of ¥45/share in FY23. Based on the FY23 EPS of ¥122.29, the dividend pay-out ratio was 36.8%. Management aims to achieve a dividend pay-out ratio of at least 30% under the ongoing medium-term management plan. In FY24, the firm will continue to pay a dividend of ¥45/share, which will make the pay-out ratio 39.2%.

Between 11 May~23 June 2023, the firm also completed a share buyback of 286,000 shares at a total cost of ¥899,860,700 (of a maximum of 300,000 shares / ¥900mil, which amounts to approx. 1.56% of shares outstanding). Repurchased shares will be used as remunerations to directors.

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