

MEC CO., LTD (4971 JP)

FY23 GUIDANCE WAS REVISED DOWN DUE TO WEAKER-THAN-EXPECTED Q1 EARNINGS

FY23 Q1 RESULTS SUMMARY

MEC (4971 JP) reported FY23 Q1 (Dec year-end) earnings with OP of ¥168 mil (-83.9% YoY) on sales of ¥2,765mil (-30.1% YoY). Given the Q1 results, the firm revised down its FY23 forecast from 1H OP of ¥800mil (-61.6% YoY) on sales of ¥6,500mil (-20.0% YoY) to OP of ¥450mil (-78.4% YoY) on sales of ¥6,000mil (-26.2% YoY), and full year FY23 OP of ¥3,000mil (-25.1% YoY) on sales of ¥15,000mil (+8.1% YoY) to OP of ¥1,800mil (-55.1% YoY) on sales of ¥13,500mil (-17.3% YoY).

On 23 May, following the downward revision made at the time of Q1 results, MEC released the sale of fixed asset, from which the firm gained extraordinary gain of ¥550mil. As a result, 1H net profit [NP] was revised up from ¥300mil (-81.9% YoY) to ¥680mil (-59.1% YoY), and FY22 NP from ¥1,350mil (-55.9% YoY) to ¥1,730mil (-43.5% YoY).

While sales of CZ-8101 – MEC’s core product in adhesion enhancing chemicals – were solid until Dec 2022, they sharply fell in January, especially in Korea. There are primarily two reasons behind the sharp fall 1) demand for CZ-8101 fell along with fall in production of memory substrates, and 2) since MEC has no facilities in Korea, its customers there tend to hold inventory of CZ chemicals. So, with the memory industry’s inventory adjustment, and the subsequent drop in demand for CZ chemicals, customers started tapping into their inventory of CZ chemicals that they held during Q1.

Earnings Summary (Cumulative)						
(¥mil)	FY21	FY22			FY23	
	actual	Q1	FY	YoY (%)	Q1	YoY (%)
Sales	15,038	3,955	16,329	8.6	2,765	-30.1
incl. Chemicals	14,756	3,898	16,042	8.7	2,712	-30.4
GP	9,323	2,428	9,803	5.2	1,583	-34.8
GPM (%)	62.0	61.4	60.0	-2.0ppt	57.3	-4.1ppt
SG&A	5,383	1,377	5,799	7.7	1,414	2.7
SG&A/Sales (%)	35.8	34.8	35.5	-0.3ppt	51.2	+16.4ppt
OP	3,939	1,051	4,004	1.6	168	-83.9
OPM (%)	26.2	26.6	24.5	-1.7ppt	6.1	-20.5ppt
RP	4,104	1,186	4,246	3.5	223	-81.2
RPM (%)	27.3	30.0	26.0	-1.3ppt	8.1	-21.9ppt
NP	2,949	793	3,064	3.9	82	-89.6
EPS (¥)	155.28	41.76	161.22	N/A	4.32	-89.6
DPS (¥)	35.00	N/Aa	45.00	N/A	N/A	N/A

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

Demand for PCs, displays, and tablets, which had surged during COVID closures, have also run their course. Additionally, although demand for servers had been strong up to FY22 Q3, sales of high-end packages used in servers started to trend down in FY22 Q4 due to inventory adjustments.

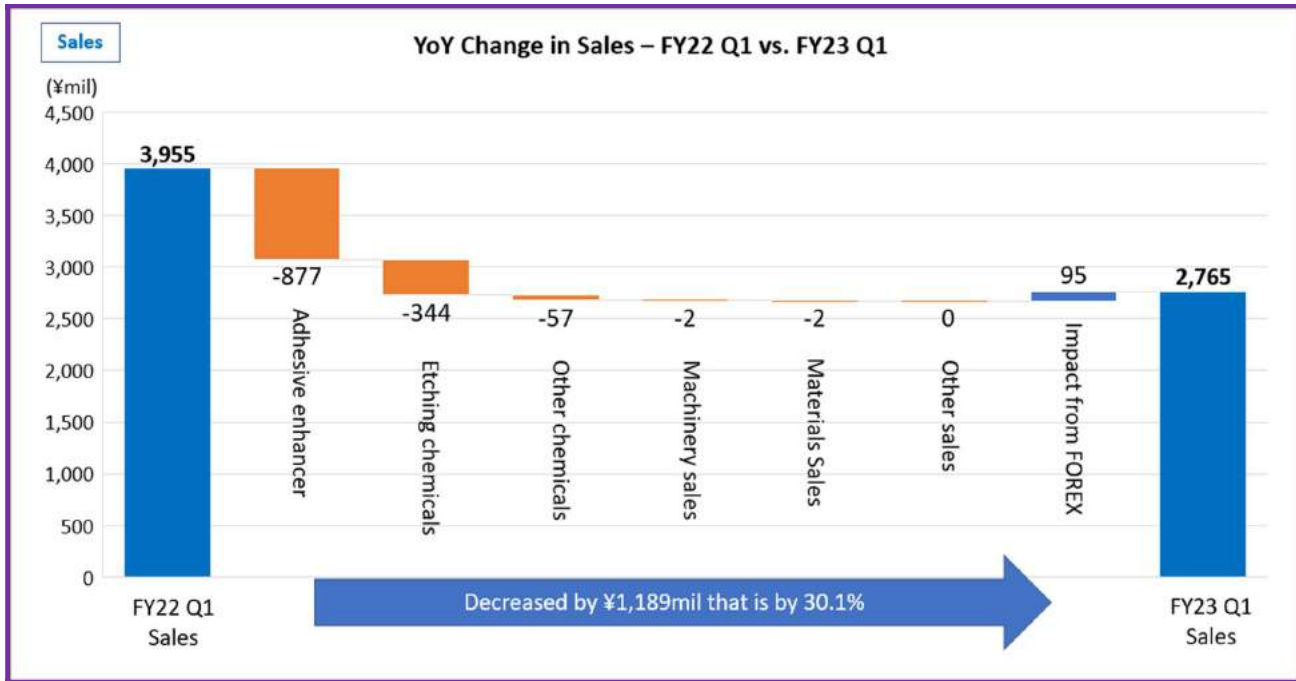
EXECUTIVE SUMMARY

- Given the FY23 Q1 results, MEC revised down its estimates, taking FY23 1H OP of ¥800mil (-61.6% YoY) on sales of ¥6,500mil (-20.0% YoY) to OP of ¥450mil (-78.4% YoY) on sales of ¥6,000mil (-26.2% YoY), and full year FY23 OP of ¥3,000mil (-25.1% YoY) on sales of ¥15,000mil (+8.1% YoY) to OP of ¥1,800mil (-55.1% YoY) on sales of ¥13,500mil (-17.3% YoY).
- On 23 May, following the downward revision made at the time of Q1 results, MEC released the sale of fixed asset, from which the firm gained extraordinary gain of ¥550mil. As a result, 1H net profit [NP] was revised up from ¥300mil (-81.9% YoY) to ¥680mil (-59.1% YoY), and FY22 NP from ¥1,350mil (-55.9% YoY) to ¥1,730mil (-43.5% YoY).
- MEC’s core products, CZ-8101 sales sharply fell in Jan 2023 on inventory adjustments of package substrate for memory, which had started from Autumn 2022 and affected demand for CZ chemicals – especially in Korea. Since MEC does not have any factory in the region, and given its customers there tend to hold inventory of CZ chemicals, demand slumped.
- MEC has maintained its annual dividend payment of ¥45/share. Based on the FY23 EPS estimate, the dividend pay-out ratio will be 62.8%. A share buyback plan to repurchase 300,000 shares (1.56% of shares outstanding) or ¥900mil, was also announced.
- MEC is preparing to commence production at a new factory in Kita Kyushu City, Fukuoka, Japan in FY25. Capex of approx. ¥4,000mil will be dedicated to the project (including the cost of the land) and financed by cash flow as well as long-term debt.

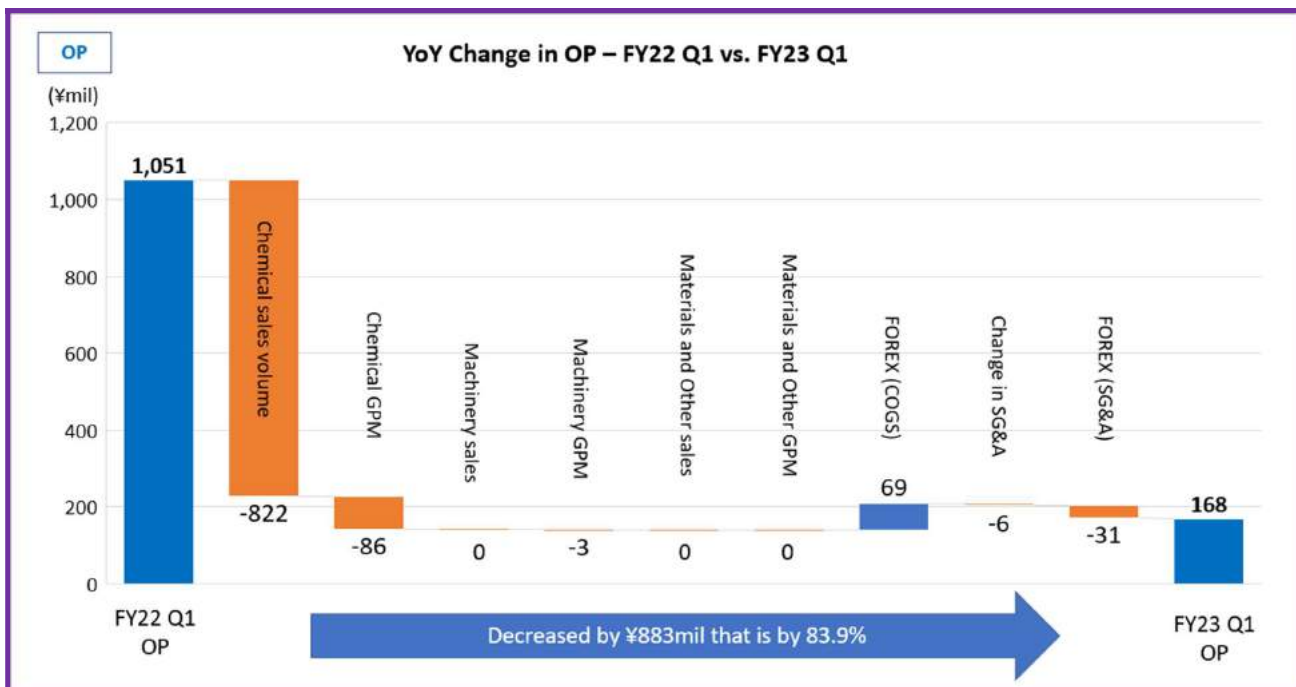
In FY23 Q1, monthly sales of CZ-8101 in Korea fell to approx. 1/5th of FY22 Q4’s level. In Q1 alone, sales of CZ-8101 fell -30.8% YoY / -30.8% QoQ to ¥883mil.

FY23 Q1 Chemical segment sales, which constitutes nearly 98% of the firm’s total revenue, fell -30.4% YoY to ¥2,712mil: Adhesive Enhancer chemical sales declined -30.1% YoY with sharp adjustments in core CZ chemicals sales. Etching Chemicals sales also fell -31.9% YoY to ¥694mil due to the expected slump in sales of SF (-35.9% YoY) and EXE (-37.7% YoY).

FY23 Q1 gross profit margin [GPM] contracted by -4.1ppt YoY to 57.3% on the back of drop in sales volume and the subsequent deterioration in utilisation rate at factories, which reduced the OP for chemical products by ¥86mil.



Source: MEC Co., Ltd. FY23 Q1 earnings results presentation



Source: MEC Co., Ltd. FY23 Q1 earnings results presentation

SEGMENTS PERFORMANCE

Adhesive Enhancers

FY23 Q1 Adhesive Enhancer sales declined -30.1 % YoY / -33.1% QoQ as CZ series sales (¥1,638mil (-31.8% YoY / -34.9% QoQ)) were affected by end application demand peaking out. MEC's core product in this product group, CZ-8101 – an adhesive-enhancing chemical used in packages primarily for PCs, servers and chiplet packaging – which had enjoyed sales growth in FY22, also started trending down in FY23 Q1 to ¥883mil (-30.8% YoY / -30.8% QoQ).

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 and further lost momentum due to (1) production adjustments in packages as demand for PCs and smartphones waned, and (2) a temporary adjustment in demand for servers.

Over FY22 Q1~Q3, demand for adhesive chemicals using pre- and post-adhesive processes had benefited from the rise in 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. However, in FY22 Q4, sales peaked, and fell further, down -45.6% QoQ to ¥505mil (-37.7% YoY). Sales of the newer generation of the CZ series, CZ-8201 and CZ-8401, are also included in this category.

The CZ-8100 product, which is partly used in packages for auto components, had also reported record annual sales of ¥1,284mil (+5.2% YoY) in FY22, despite the semiconductor and components shortage affecting auto production. However, in FY23 Q1 alone, sales declined further, down -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.

V-Bond, another adhesive-enhancing chemical used in multilayer substrates for autos and mid-end smartphones, reported FY23 Q1 sales of ¥181mil (-12.6% YoY / -3.2% QoQ).

Etching Chemicals

FY23 Q1 Etching Chemicals sales fell -31.9% YoY to ¥694mil due to 1) a -37.7% YoY decline in sales of EXE, another of MEC's etching chemical products used in chip-on-film [COF] as display production as several TV display makers entered an inventory adjustment phase – the degree of which was more drastic and slower in recovery than MEC had thought, and 2) weak SF sales (¥131mil -35.9% YoY / -31.8% QoQ), a key material used in displays, as the new models of high-end smartphones now use a different technology. However, this technology shift had already been factored in.

Chemical Sales by Products (Quarterly)											
(¥mil / Dec year-end)	FY21				FY22				FY23		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	QoQ (%)	YoY (%)
Copper surface treatment chemicals	3,278	3,301	3,814	3,621	3,695	3,931	3,981	3,660	2,564	-29.9	-30.6
Adhesive enhancer (CZ, V-Bond etc.)	2,150	2,216	2,624	2,625	2,676	2,911	3,073	2,797	1,870	-33.1	-30.1
CZ Series Total	1,906	1,964	2,313	2,294	2,402	2,609	2,784	2,517	1,638	-34.9	-31.8
CZ-8100	301	310	312	302	315	316	340	313	250	-20.1	-20.6
CZ-8101	1,026	1,038	1,199	1,244	1,276	1,410	1,464	1,276	883	-30.8	-30.8
Other CZ chemicals	579	616	802	747	811	883	980	928	505	-45.6	-37.7
Etching chemicals (EXE, SF etc.)	1,128	1,084	1,190	996	1,019	1,020	908	863	694	-19.6	-31.9
SF	326	241	281	210	204	246	235	192	131	-31.8	-35.9
EXE	407	449	443	318	360	308	187	226	224	-0.9	-37.7
Other surface treatment chemicals	174	178	193	191	202	202	200	166	148	-10.8	-26.7
Chemical Sales Total	3,452	3,480	4,008	3,814	3,898	4,134	4,181	3,826	2,712	-29.1	-30.4

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

Chemical Sales by Products (Cumulative)										
(¥mil / Dec year-end)	FY21				FY22				FY23	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	YoY (%)
Copper surface treatment chemicals	3,278	6,579	10,393	14,014	3,695	7,626	11,607	15,267	2,564	-30.6
Adhesive enhancer (CZ, V-Bond etc.)	2,150	4,366	6,990	9,615	2,676	5,587	8,660	11,457	1,870	-30.1
CZ Series Total	1,906	3,870	6,183	8,477	2,403	5,011	7,795	10,312	1,638	-31.8
CZ-8100	301	611	923	1,225	315	631	971	1,284	250	-20.6
CZ-8101	1,026	2,064	3,263	4,507	1,276	2,686	4,150	5,426	883	-30.8
Other CZ chemicals	579	1,195	1,997	2,744	811	1,694	2,674	3,602	505	-37.7
Etching chemicals (EXE, SF etc.)	1,128	2,212	3,402	4,398	1,019	2,039	2,947	3,810	694	-31.9
SF	326	567	848	1,058	204	450	684	877	131	-35.9
EXE	407	856	1,299	1,617	360	668	855	1,081	224	-37.7
Other surface treatment chemicals	174	352	545	736	202	404	604	770	148	-26.7
Chemical Sales Total	3,452	6,932	10,940	14,756	3,898	8,032	12,213	16,042	2,712	-30.4

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

FY23 OUTLOOK

MEC revised down FY23 guidance from is guiding for from 1H OP of ¥800mil (-61.6% YoY) on sales of ¥6,500mil (+20.0% YoY) to ¥450mil (-78.4% YoY) on sales of ¥6,000mil (-26.2% YoY), and FY23 OP of ¥3,000mil (-25.1% YoY) on sales of ¥15,000mil (-8.1% YoY), to OP of ¥1,800mil (-55.1% YoY) on sales of ¥13,500mil (-17.3% YoY). As a result, 2H estimates were also revised from 2H OP of ¥2,200mil (+14.6% YoY) on sales of ¥8,500mil (+3.6% YoY) to OP of ¥1,350mil (-29.7% YoY) on sales of ¥7,500mil (-8.6% YoY). MEC's guidance is based on the following assumptions:

1. Although semiconductor makers announced plans to start full production of a next generation processor in CY23, the firm does not expect server demand to recover until 2H, which will affect 1H package production levels.
2. Weak sales of Etching Chemicals, SF and EXE.
3. V-Bond sales will also decline due to weakness in demand for multilayer substrates used in automobiles and middle-end smartphones.

FY23 guidance										
(¥mil)	FY22		FY23 (Previous CE)				FY23 (Revised CE, 10th May 23)			
	1H	FY	1HCE	YoY (%)	FYCE	YoY (%)	1HCE	YoY (%)	FYCE	YoY (%)
Sales	8,127	16,329	6,500	-20.0	15,000	-8.1	6,000	-26.2	13,500	-17.3
Operating Profit [OP]	2,084	4,004	800	-61.6	3,000	-25.1	450	-78.4	1,800	-55.1
OP Margin [OPM] (%)	25.6	24.5	12.3	-13.3	20.0	-4.5ppt	7.5	-18.1ppt	13.3	-11.2ppt
Recurring Profit [RP]	2,374	4,246	850	-64.2	3,100	-27.0	500	-78.9	1,900	-55.3
NP for the parent's s/holders	1,661	3,064	600	-63.9	2,200	-28.2	300	-81.9	1,730	-43.5
EPS (¥)	87.40	161.22	31.56	n/a	115.72	-28.2	15.85	-81.9	91.89	-55.5

Source: Nippon-IBR based on MEC Co., Ltd.'s FY23 Q1 Earnings Results Material

Adhesive Enhancers

MEC assumes a short-term down trend in the segment performance. In 1H, the firm expects the weak semiconductor market will affect CZ chemical sales. Although chiplet package production was said to have started in FY22, it was affected by inventory adjustments. In 2H, MEC is looking for demand for its core product, CZ-8101, to recover on the back of a rebound in server demand.

Moreover, the new processor for servers is said to deploy chiplet technology that requires die-stacking and larger size packages, such as EMIB, and will likely further boost package makers' demand for adhesive chemicals. However, MEC revised down its forecast of FY23 CZ chemicals sales from ¥9,962 mil (-3.4% YoY) to ¥8,450mil (-18.1% YoY)

For V-Bond, MEC is guiding for a -8.1% YoY decline in sales to ¥705mil as it anticipates both a gradual recovery in auto production, and further inventory adjustments of auto parts. Additionally, given the current macroeconomic climate, demand for smartphones is expected to be weak.

Etching Chemicals

Etching Chemicals will likely remain weak during FY23. MEC assumes SF sales to high-end smartphones will continue to decline due to the well-flagged shift to a new technology, although demand for tablet PC touch panels will remain stable. Sales of EXE used in chip-on-film [COF] will also likely be affected by inventory adjustments at display makers. MEC estimates FY23 sales of SF to fall -19.8% YoY to ¥703mil and EXE sales to decline -18.9% YoY to ¥877mil. A risk to the FY23 guidance is whether server demand will recover in 2H.

CAPITAL ALLOCATION POLICY

CAPEX: Although there is a temporary weakness in demand for CZ due to inventory adjustment, the firm reckons that the growth potential of the CZ chemicals, over a longer-period of time, is solid. Given the potential demand for CZ chemicals, MEC boosted production capacity at the Nagaoka (Japan) and Zhuhai (China) factories in FY22. This raised the group's total production capacity by +10%. In addition, the firm plans to expand production capacity at its facility in Suzhou, Jiangsu Province, China in FY23.

For FY23, MEC has allocated ¥1,763mil for CAPEX, of which approx. ¥400mil will be spent on the Suzhou plant expansion. Depreciation costs are estimated to rise from ¥759mil in FY22 to ¥827mil in FY23. In addition, the company is preparing to commence production at a new factory in Kita Kyushu City, Fukuoka, Japan in FY25. MEC plans to spend approx. ¥4,000mil 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 as this is when package makers start full mass production of packages using chiplet packaging such as EMIB, and also improve distribution network to the firm's Korean customers.

Shareholder Return: MEC has maintained its annual dividend payment of ¥45/share despite drastic revision on FY23 guidance. Based on the FY23 EPS estimate of ¥71.71, the dividend pay-out ratio will be 62.8%. Management's target is to achieve a dividend pay-out ratio of at least 30% under the ongoing medium-term management plan. MEC also announced share buyback plan to repurchase max of 300,000 shares, which amounts to approx. 1.56% of shares outstanding, or maximum of ¥900mil. Repurchased shares will be used as remunerations to directors.

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