MEC CO., LTD (4971 JP)

FY23 1H RESULTS SURPASSED THE GUIDANCE DUE TO DELAY IN SPENDING BUDGET. NO CHANGE IN FY23 GUIDANCE

FY23 1H RESULTS SUMMARY

MEC (4971 JP) reported FY23 1H (Dec year-end) earnings with OP of ¥838 mil (-59.8% YoY) on sales of ¥6,198mil (-23.7% YoY). Both sales and OP surpassed the company's guidance for 1H OP of ¥450mil (-78.4% YoY) on sales of ¥6,000mil (-26.2% YoY), though both were revised down with the Q1 results.

1H sales landed in line with the company forecast, however, budgeted expenses – for travel and subsistence, personnel, and research for new products – were not spent, so better than expected profits were recorded. Given those expenses will likely be realised during FY23, the firm has maintained its FY23 guidance for OP of ¥1,800mil (-55.1% YoY) on sales of ¥13,500mil (-17.3% YoY).

Earnings Summary (Cumulative)

Dec Yr-end ¥mil	FY21	FY22				FY23		
	actual	Q1	1H	FY	YoY (%)	Q1	1H	YoY (%)
Sales	15,038	3,955	8,127	16,329	8.6	2,765	6,198	-23.7
incl. Chemicals	14,756	3,898	8,032	16,042	8.7	2,712	6,085	-24.2
GP	9,323	2,428	4,919	9,803	5.2	1,583	3,646	-25.9
GPM (%)	62.0	61.4	60.5	60.0	-2.0ppt	57.3	58.8	-1.7ppt
SG&A	5,383	1,377	2,834	5,799	7.7	1,414	2,807	-1.0
SG&A/Sales (%)	35.8	34.8	34.9	35.5	-0.3ppt	51.2	45.3	+10.4ppt
OP	3,939	1,051	2,084	4,004	1.6	168	838	-59.8
OPM (%)	26.2	26.6	25.6	24.5	-1.7ppt	6.1	13.5	-12.1ppt
RP	4,104	1,186	2,374	4,246	3.5	223	1,003	-57.7
RPM (%)	27.3	30.0	29.2	26.0	-1.3ppt	8.1	16.2	-13.0ppt
NP	2,949	793	1,661	3,064	3.9	82	1,076	-35.2
EPS (¥)	155.28	41.76	87.4	161.22	n/a	4.32	56.79	-35.0
DPS (¥)	35.00	n/a	20.00	45.00	n/a	n/a	20.00	0.0

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

FY23 1H Chemical segment sales, which constitutes nearly 98% of the firm's total revenue, fell -24.2% YoY to ¥6,085mil (Q1 sales of ¥2,712mil / Q2 sales of ¥3,372mil): Adhesive Enhancer chemical sales declined -24.7% YoY to ¥4,205mil with adjustments in sales of CZ series as well as V-Bond series. In Q2 alone, MEC recorded Adhesive Enhancer sales of ¥2,335mil (-19.8% YoY / +24.9% QoQ). 1H Etching Chemicals sales also fell 26.0 % YoY to ¥1,508mil due to the expected slump in sales of SF (-46.0% YoY) and EXE (-18.6% YoY).

FY23 1H Chemical segment gross profit margin [GPM] contracted by -1.7ppt YoY to 58.8% on the back of drop in sales volume, which reduced the OP for chemical products by ¥1,495mil.

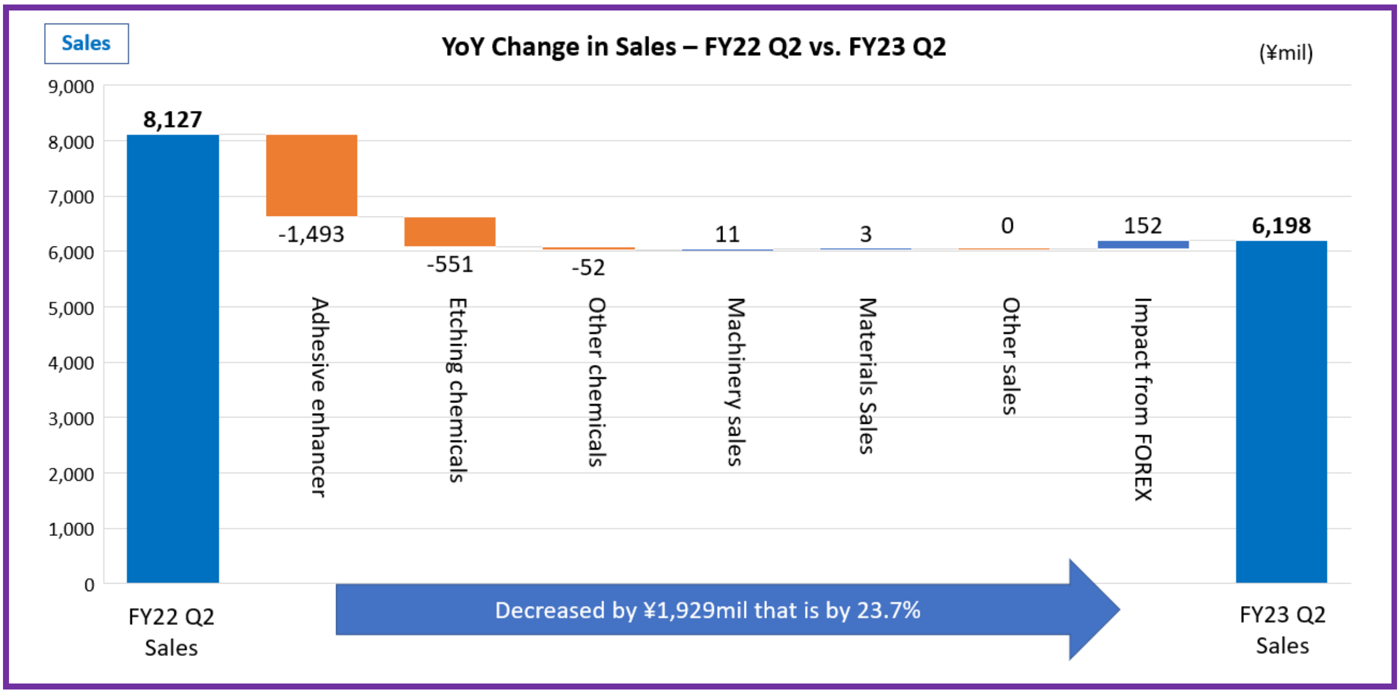
Regarding the performance of CZ-8101 – MEC's core adhesion enhancing chemical product – sales bottomed in Q1. Sales in Korea, which is included in sales in Japan [NB: MEC doesn't have a factory in Korea, so it exports to distributors there], showed a recovery trend, thanks to inventory adjustment in Korea running its course.

EXECUTIVE SUMMARY

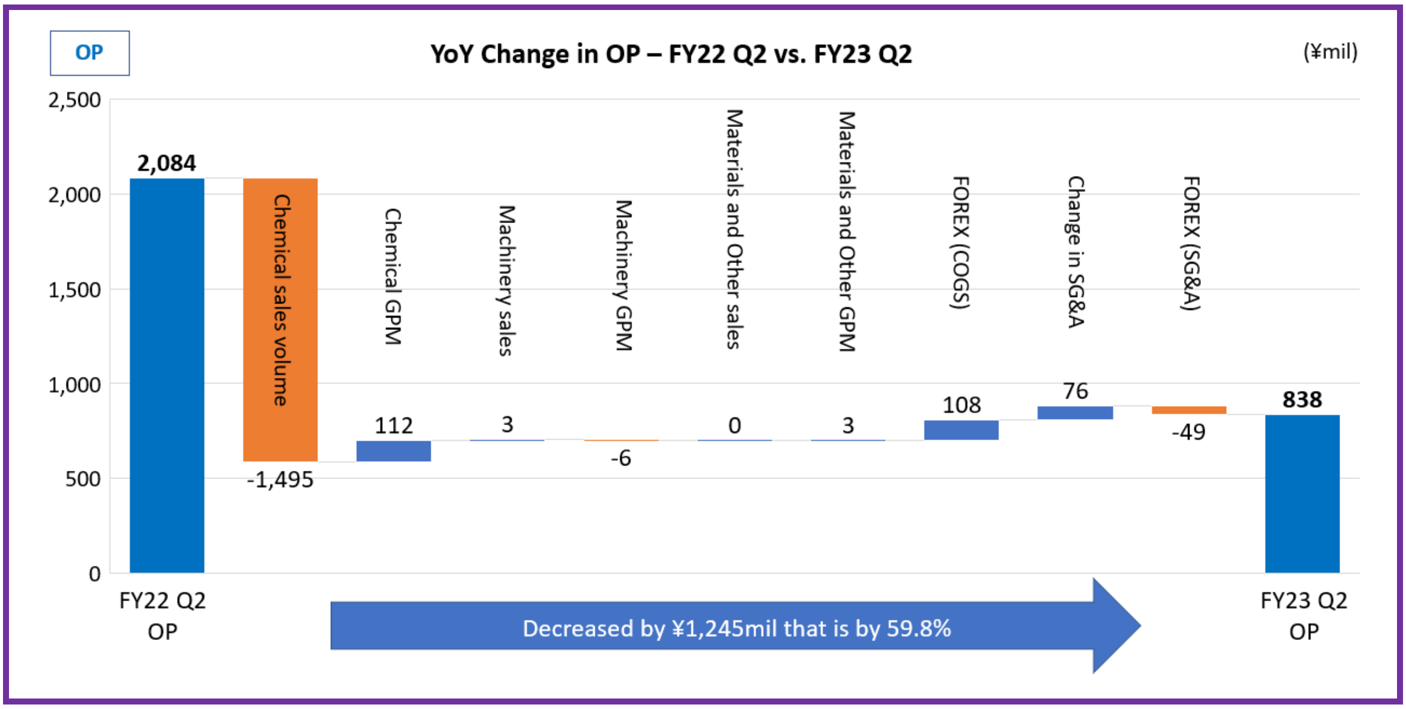
- MEC (4971 JP) reported FY23 1H OP of ¥838 mil (-59.8% YoY) on sales of ¥6,198mil (-23.7% YoY). Both figures surpassed the 1H guidance for OP of ¥450mil (-78.4% YoY) on sales of ¥6,000mil (-26.2% YoY), though they had been revised down at the time of the Q1 results. 1H OP surpassed the guidance, due mainly to an increase in unrealised profit as budgeted expenses were not spent.
- Sales of CZ-8101 – MEC's core adhesion enhancing chemical product – bottomed in Q1. With inventory adjustment completed, sales in Korea, which is part of MEC's Japan earnings, have started to recover as of Q2. Although Japan's 1H OP fell -82.3% YoY to ¥245mil, on sales of ¥2,423mil (-25.6% YoY), the Q2 performance saw OP move into the black to ¥297mil (-64.3% YoY) vs FY23 Q1's loss of ¥52mil, on sales of ¥1,376mil (-18.0% YoY / +31.5% QoQ).
- V-Bond, another adhesive-enhancing chemical used in multilayer substrates for autos and mid-end smartphones, remains weak.
- In Etching Chemicals segment, EXE, used in Chip-on-Film [COF] bottomed out in Q2 along with TV production recovery. On the other hand, sales of SF, a key material used in displays, remained weak.
- MEC has kept its FY23 guidance for OP of ¥1,800mil (-55.1% YoY) on sales of ¥13,500mil (-17.3% YoY). The annual DPS is also unchanged at ¥45. Based on the FY23 EPS estimate of ¥91.89, the dividend pay-out ratio will be 49.0%. A buyback of 286,000 shares was completed at a total cost of ¥899,860,700.

By region, Japan OP fell -82.3% YoY to ¥245mil in FY23 1H, on sales of ¥2,423mil (-25.6% YoY). In Q2 alone, the Japan segment generated an OP of ¥297mil (-64.3% YoY) – moving into the black from Q1's ¥52mil loss – on sales of ¥1,376mil (-18.0% YoY / +31.5% QoQ).

Although the inventory adjustment at MEC's customers and distributors in Korea seems to have run its course, demand for CZ-8101 remained weak, as did production of memory substrates and packages – as an end application, PC demand still remains lacklustre. Meanwhile, high-performance server demand has gradually started to recover, though it was not enough to lead the growth of CZ-8101 sales afresh.



Source: MEC Co., Ltd. FY23 Q2 earnings results presentation



Source: MEC Co., Ltd. FY23 Q2 earnings results presentation

SEGMENTS PERFORMANCE

Adhesive Enhancers

FY23 1H Adhesive Enhancer sales declined -24.7 % YoY as did the firm's CZ series sales (¥3,709mil, -26.0% YoY). However, MEC reckons that total sales of CZ series bottomed in Q1 at quarterly sales of ¥1,638mil (-31.8% YoY / -34.9% QoQ), as evidenced by the Q2 +26.4% QoQ improvement to ¥2,071mil (-20.6% YoY).

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). However, in Q2 alone, sales recovered +22.3% QoQ to ¥1,080mil (-23.4% YoY).

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 the Q4 due to (1) production adjustments in packages as demand for PCs and smartphones waned, and (2) a temporary adjustment in demand for servers. In Q2, although CZ-8101 sales showed signs of a recovery, demand still remains weak given the lacklustre demand for PC and slow recovery in demand for servers.

The 1H performance of other CZ chemicals sales, which includes adhesive chemicals using pre- and post-adhesive processes, fell -28.0% YoY to ¥1,220mil. In the FY22 Q1~Q3 period, sales of these chemicals had benefited from an increase 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 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 the CZ series products, CZ-8201 and CZ-8401, are also included in this category. In Q2 alone, sales of other CZ chemicals recovered +41.6% QoQ to ¥715mil (-19.0% YoY).

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. In Q2, MEC reported quarterly CZ-8100 sales of ¥276mil (-12.7% YoY / +10.4% QoQ)

V-Bond, another adhesive-enhancing chemical used in multilayer substrates for autos and mid-end smartphones, reported FY23 Q2 sales of ¥178mil (-13.6% YoY / -1.7% QoQ).

Etching Chemicals

FY23 1H Etching Chemicals sales fell -26.0% YoY to ¥1,508mil. In Q2 alone, the segment saw sales recover +17.3% QoQ to ¥814mil (-20.2% YoY) thanks improved sales in EXE, as Chip-on-Film [COF] sales bottomed out on the back of a recovery in TV monitor production post-production adjustments during FY22. On the other hand, sales of SF, a key material used in displays, remained weak with Q2 sales of ¥112mil (-54.5% YoY / -13.8% QoQ) as the new models of high-end smartphones now use a different technology. However, weak sales in SF were expected as 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	Q2	QoQ (%)	YoY (%)
Copper surface treatment chemicals	3,278	3,301	3,814	3,621	3,695	3,931	3,981	3,660	2,564	3,150	22.8	-19.9
Adhesive enhancer (CZ, V-Bond etc.)	2,150	2,216	2,624	2,625	2,676	2,911	3,073	2,797	1,870	2,335	24.9	-19.8
CZ Series Total	1,906	1,964	2,313	2,294	2,402	2,609	2,784	2,517	1,638	2,071	26.4	-20.6
CZ-8100	301	310	312	302	315	316	340	313	250	276	10.4	-12.7
CZ-8101	1,026	1,038	1,199	1,244	1,276	1,410	1,464	1,276	883	1,080	22.3	-23.4
Other CZ chemicals	579	616	802	747	811	883	980	928	505	715	41.6	-19.0
Etching chemicals (EXE, SF etc.)	1,128	1,084	1,190	996	1,019	1,020	908	863	694	814	17.3	-20.2
SF	326	241	281	210	204	246	235	192	130	112	-13.8	-54.5
EXE	407	449	443	318	360	308	187	226	224	319	42.9	3.9
Other surface treatment chemicals	174	178	193	191	202	202	200	166	148	222	50.0	9.9
Chemical Sales Total	3,452	3,480	4,008	3,814	3,898	4,134	4,181	3,826	2,712	3,372	24.3	-18.4

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	Q2	YoY (%)
Copper surface treatment chemicals	3,278	6,579	10,393	14,014	3,695	7,626	11,607	15,267	2,564	5,714	-25.1
Adhesive enhancer (CZ, V-Bond etc.)	2,150	4,366	6,990	9,615	2,676	5,587	8,660	11,457	1,870	4,205	-24.7
CZ Series Total	1,906	3,870	6,183	8,477	2,403	5,011	7,795	10,312	1,638	3,709	-26.0
CZ-8100	301	611	923	1,225	315	631	971	1,284	250	526	-16.6
CZ-8101	1,026	2,064	3,263	4,507	1,276	2,686	4,150	5,426	883	1,963	-26.9
Other CZ chemicals	579	1,195	1,997	2,744	811	1,694	2,674	3,602	505	1,220	-28.0
Etching chemicals (EXE, SF etc.)	1,128	2,212	3,402	4,398	1,019	2,039	2,947	3,810	694	1,508	-26.0
SF	326	567	848	1,058	204	450	684	877	131	243	-46.0
EXE	407	856	1,299	1,617	360	668	855	1,081	224	543	-18.6
Other surface treatment chemicals	174	352	545	736	202	404	604	770	148	370	-8.4
Chemical Sales Total	3,452	6,932	10,940	14,756	3,898	8,032	12,213	16,042	2,712	6,085	-24.2

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

FY23 OUTLOOK

Although 1H earnings landed better than expected compared to the 1H company guidance for OP of ¥450mil (-78.4% YoY) on sales of ¥6,000mil (-26.2% YoY), which were revised down in May, MEC did not change its full year guidance. For FY23, management has kept its forecast for OP of ¥1,800mil (-55.1% YoY) on sales of ¥13,500mil (-17.3% YoY) because the better-than-expected 1H earnings were largely due to a delay in spending planned SG&A budget. However, this will be realised at some point over the remainder of FY23 as expected budgets are booked.

MEC's FY23 guidance is based on the following assumptions:

1. Although semiconductor makers have announced plans to start full production of a next generation processor in CY23, the firm does not expect server demand to recover until 2H. During 1H, package production levels remained weak.
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. Although the semiconductor shortage situation has been improving in the auto sector, demand for middle-end smartphone remains weak.

FY23 Guidance

(¥mil)	FY22		FY23 (Previous CE)				FY23 (Revised CE, 23rd 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	-4.5pp	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	-43.0

Source: Nippon-IBR based on MEC Co., Ltd.'s FY23 Q2 Earnings Results Material

Adhesive Enhancers

MEC assumes a short-term down trend in the segment performance. In 2H, the firm 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 high-performance 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. MEC forecasts FY23 CZ chemicals sales of ¥8,450mil (-18.1% YoY), based on the assumption that during FY23, sales of CZ chemicals will be affected by lacklustre semiconductor markets.

For V-Bond, MEC is guiding for sales to decline -8.1% YoY 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 from 2H onwards. Sales of EXE will see a gradual recovery after inventory adjustment at display makers ran its course.

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 weakness in the semiconductor market, the firm reckons that the growth potential of the CZ chemicals, over the long-term, is solid on the back of the increase in the number of packages, and an increase in the size and layers of packages used in high-performance servers. 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 the drastic revisions to its FY23 guidance. Based on the FY23 EPS estimate of ¥91.89, the dividend pay-out ratio will be 49.0%. Management's target is to achieve a dividend pay-out ratio of at least 30% under the ongoing medium-term management plan.

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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