

Innolight (300308 CH)

Expect higher contribution from AI revenue in 3Q; Upgrade to Buy

Since our downgrade report on 14 Aug ([link](#)), we have seen a continuous decline on Innolight's share price by more than 23%. Our current view on the stock is becoming increasingly favourable, driven by: 1) continuous strong momentum observed in building up AI infrastructure globally; and 2) quick uptake seen in downstream application market (e.g., AI-powered Ads adopted by Meta, Google and Amazon, GitHub copilot by Microsoft). In addition, companies within the AI hardware value chain start to report strong earnings. On Thursday night (19 October), TFC (300394 CH, NA), a leading integrated solution provider for optical sub-assemblies, released impressive 3Q23 earnings, delivering revenue/NP growth of 73.6% and 95.0% YoY, respectively. As we believe Innolight is one of the true AI beneficiaries, we expect AI-related revenue to contribute more in Innolight's revenue starting from the upcoming 3Q earnings and accelerate in 2024, we **upgrade to BUY with adjusted TP of RMB109.30**.

- **Share price is getting attractive again.** We downgrade the share price in August as the stock has gone far ahead its earnings fueled by generative AI frenzy. Valuation was overly high and production ramp-up of 800G transceivers should take time. We believe lots of negative news have been baked into the price, e.g., profit taking, challenging macro, updated US restriction on advanced chip exports. Current share price is getting attractive considering: 1) transceiver is one of the critical components that is widely used in AI datacenters and the global demand on building AI infrastructure remains strong with visibility into 2024; 2) newly announced US restriction should have non-material impacts on the company's near- to mid-term revenue; and 3) continuous progress on monetization of generative AI should yield stable investments in the field.
- **True AI beneficiaries apart from Nvidia start riding the tailwind.** TFC just released strong 3Q results. Positioned upstream in Innolight's supply chain and TFC's strong earnings further substantiate the ongoing capacity expansion among the beneficiaries in the AI sector. This also underscores our observation in our recent AI sector report ([link](#)) that the players in the AI value chain are gradually experiencing positive outcome in 2023.
- **Upgrade to BUY with TP of RMB109.30.** Considering recent additional orders reported by UDN ([link](#)) regarding hyperscalers and better-than-expected ramp-up of TSMC's CoWoS capacity, we expect Innolight's revenue to come in better than our previous estimates. We revised up revenue forecasts by 12%, 13% and 4% and slightly lifted GPM for 2023E/24E/25E. We maintain the same multiple of 35x 2025E P/E.
- **Upside catalysts:** 1) faster-than-expected ramp-up of 800G, and 2) slower-than-expected decline of non-AI revenue. **Downside risks:** 1) continuous rise in interest rates, 2) intensified geopolitical tensions, and 3) lower-than-expected production.

Earnings Summary

(YE 31 Dec)	FY21A	FY22A	FY23E	FY24E	FY25E
Revenue (RMB mn)	7,695	9,642	11,386	14,819	15,690
YoY growth (%)	9.2%	25.3%	18.1%	30.2%	5.9%
Gross margin (%)	25.6%	29.3%	31.3%	31.8%	31.7%
Net profit (RMB mn)	877	1,224	1,708	2,321	2,501
YoY growth (%)	1.3%	39.6%	39.5%	35.9%	7.7%
EPS (RMB)	1.21	1.54	2.13	2.90	3.12
EPS (Consensus)	-	1.54	2.14	4.33	5.45
P/E (x)	78.2	61.5	44.4	32.7	30.3
ROE (%)	7.6%	10.2%	12.6%	14.8%	13.9%

Source: Company data, Bloomberg, CMBIGM estimates

BUY (Upgrade)

Target Price **RMB109.30**

(Previous TP RMB104.00)

Up/Downside **15.5%**

Current Price **RMB94.64**

China Technology

Lily YANG, Ph.D

(852) 3916 3716

lilyyang@cmbi.com.hk

Kevin ZHANG

(852) 3761 8727

kevinzhang@cmbi.com.hk

Stock Data

Mkt Cap (RMB mn)	75,977.0
Avg 3 mths t/o (RMB mn)	3,939.0
52w High/Low (RMB)	170.00/26.33
Total Issued Shares (mn)	802.8

Source: FactSet

Shareholding Structure

Shandong Zhongji Investment Holdings Co.	11.3%
Wang Weixiu	6.2%

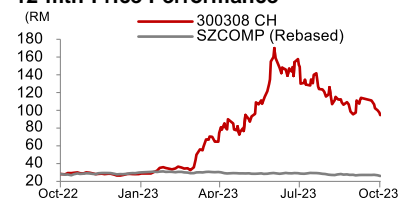
Source: Bloomberg

Share Performance

	Absolute	Relative
1-mth	-1.9%	2.2%
3-mth	-36.5%	-29.2%
6-mth	25.2%	45.6%

Source: FactSet

12-mth Price Performance



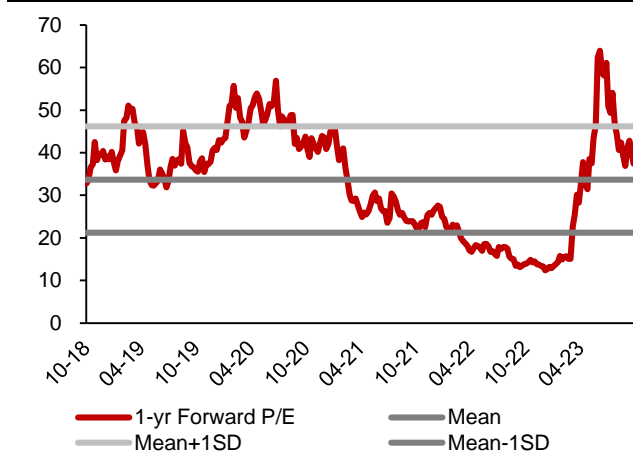
Source: FactSet

Figure 1: Earnings revision

RMB mn	New			Old			Diff (%)		
	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E
Revenue	11,386	14,819	15,690	10,177	13,133	15,110	12%	13%	4%
Gross Profit	3,565	4,707	4,980	3,100	4,097	4,795	15%	15%	4%
Operating Profit	1,943	2,624	2,836	1,671	2,273	2,733	16%	15%	4%
Net profit	1,708	2,321	2,501	1,469	2,011	2,410	16%	15%	4%
EPS (RMB)	2.13	2.90	3.12	1.83	2.51	3.01	17%	15%	4%
Gross Margin	31.3%	31.8%	31.7%	30.5%	31.2%	31.7%	0.8 ppt	0.6 ppt	0 ppt
Operating Margin	17.1%	17.7%	18.1%	16.4%	17.3%	18.1%	0.6 ppt	0.4 ppt	0 ppt
Net Margin	15.0%	15.7%	15.9%	14.4%	15.3%	15.9%	0.6 ppt	0.4 ppt	0 ppt

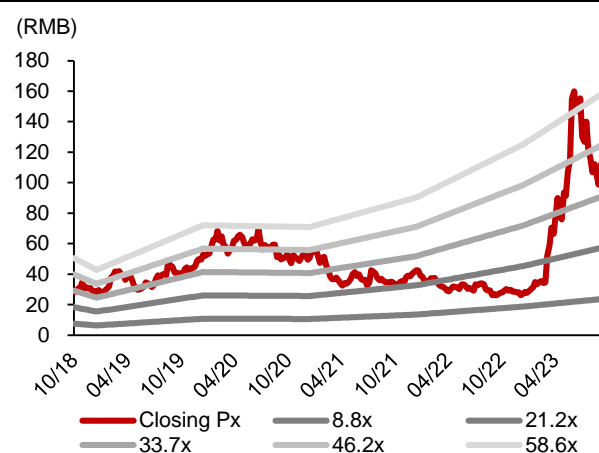
Source: Company data, CMBIGM estimates

Figure 2: 12M forward P/E band



Source: Bloomberg, CMBIGM estimates

Figure 3: 12M forward P/E chart



Source: Bloomberg, CMBIGM estimates

Financial Summary

INCOME STATEMENT	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec (RMB mn)						
Revenue	7,050	7,695	9,642	11,386	14,819	15,690
Cost of goods sold	(5,257)	(5,727)	(6,816)	(7,821)	(10,112)	(10,711)
Gross profit	1,793	1,968	2,826	3,565	4,707	4,980
Operating expenses	(803)	(1,005)	(1,499)	(1,622)	(2,083)	(2,144)
Sales tax	(22)	(21)	(63)	(68)	(92)	(95)
SG&A expense	(477)	(507)	(598)	(623)	(805)	(855)
R&D expense	(506)	(541)	(767)	(921)	(1,184)	(1,238)
Others	202	64	(71)	(10)	(2)	45
Operating profit	990	963	1,327	1,943	2,624	2,836
Other income	0	1	28	4	24	16
Other expense	(3)	(4)	(4)	(2)	(4)	(4)
Pre-tax profit	987	960	1,352	1,945	2,644	2,848
Income tax	(111)	(73)	(118)	(171)	(233)	(251)
After tax profit	876	886	1,234	1,774	2,411	2,597
Minority interest	11	10	10	66	90	97
Net profit	865	877	1,224	1,708	2,321	2,501

BALANCE SHEET	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec (RMB mn)						
Current assets	7,982	10,022	9,587	11,232	13,895	14,929
Cash & equivalents	1,679	3,515	2,831	3,898	4,799	6,998
Account receivables	1,514	1,997	1,509	1,424	2,394	1,648
Inventories	3,774	3,799	3,888	3,826	5,039	4,057
Prepayment	40	72	64	82	106	113
Other current assets	973	638	1,295	2,002	1,557	2,113
Non-current assets	5,634	6,543	6,970	7,497	8,265	9,010
PP&E	2,726	3,152	3,217	3,579	4,102	4,657
Right-of-use assets	0	21	11	5	6	6
Deferred income tax	38	46	48	57	66	72
Intangibles	360	382	322	263	206	149
Goodwill	1,915	1,980	1,949	1,917	1,886	1,854
Other non-current assets	595	962	1,422	1,675	1,999	2,272
Total assets	13,616	16,565	16,557	18,729	22,160	23,939
Current liabilities	3,772	3,166	3,264	2,857	3,910	2,915
Short-term borrowings	1,041	794	385	456	703	347
Account payables	1,367	1,205	1,136	878	1,338	1,010
Tax payable	35	68	93	89	115	119
Other current liabilities	1,128	932	1,349	1,197	1,418	1,107
Contract liabilities	22	1	22	15	19	20
Accrued expenses	179	166	279	221	318	313
Non-current liabilities	1,850	1,796	1,224	2,138	2,276	2,701
Long-term borrowings	1,430	1,262	696	1,568	1,585	1,964
Bond payables	29	0	0	0	0	0
Obligations under finance leases	0	9	2	3	4	4
Deferred income	154	277	264	283	344	367
Other non-current liabilities	238	248	261	282	342	365
Total liabilities	5,622	4,962	4,488	4,994	6,185	5,616
Share capital	713	800	801	801	801	801
Retained earnings	2,090	2,861	3,893	5,420	7,489	9,657
Other reserves	5,086	7,828	7,251	7,324	7,405	7,489
Total shareholders equity	7,889	11,489	11,945	13,544	15,695	17,947
Minority interest	104	114	124	190	279	376
Total equity and liabilities	13,616	16,565	16,557	18,729	22,160	23,939

CASH FLOW	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec (RMB mn)						
Operating						
Profit before taxation	987	960	1,352	1,945	2,644	2,848
Depreciation & amortization	340	436	493	507	551	668
Tax paid	(111)	(73)	(118)	(171)	(233)	(251)
Change in working capital	(1,096)	(587)	291	(175)	(1,074)	401
Others	(99)	77	432	34	250	172
Net cash from operations	22	813	2,449	2,141	2,138	3,839
Investing						
Capital expenditure	(956)	(840)	(792)	(1,068)	(1,391)	(1,472)
Acquisition of subsidiaries/ investments	(3,728)	(980)	(5,967)	0	0	0
Net proceeds from disposal of short-term investments	8	(542)	302	31	31	31
Others	3,803	1,143	4,904	63	72	79
Net cash from investing	(873)	(1,219)	(1,553)	(974)	(1,288)	(1,362)
Financing						
Dividend paid	(121)	(168)	(233)	(253)	(323)	(408)
Net borrowings	1,421	(259)	(699)	55	264	23
Proceeds from share issues	0	2,665	33	0	0	0
Others	0	26	(742)	102	120	120
Net cash from financing	1,300	2,264	(1,641)	(96)	61	(265)
Net change in cash						
Cash at the beginning of the year	1,236	1,648	3,489	2,809	3,874	4,776
Exchange difference	(37)	(17)	64	64	64	64
Others	449	1,859	(745)	1,001	838	2,134
Cash at the end of the year	1,648	3,489	2,809	3,874	4,776	6,974

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CMB International Global Markets Limited

Address: 45/F, Champion Tower, 3 Garden Road, Hong Kong. Tel: (852) 3900 0888 Fax: (852) 3900 0800

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