SHARP CORP 6753.T S

July 12, 2017 - 11:32pm EST by puppyeh

			2017	2018
Price:	400.00	EPS	5.5	0
Shares Out. (in M):	4,983K	P/E	50	0
Market Cap (in $M):	18,500	P/FCF	0	0
Net Debt (in $M):	4,000	EBIT	650	0
TEV (in $M):	20,500	TEV/EBIT	32	0
Borrow Cost:	Tight 15-50% cost			

Description

Thesis summary:

We are short Sharp, the Japanese consumer electronics + display device company. We believe it is one of the most egregiously over-valued large-cap securities worldwide, and, more importantly, we feel there are numerous near-term catalysts likely to test the lazy bull thesis built around an open-ended restructuring narrative, a temporary surge in panel and TV prices, retail domination of the float, and a tight borrow. We feel a more realistic valuation of the stock would be somewhere around book value – 50-75 JPY/share, or -80% vs current – but even in a more optimistic scenario we struggle to see how the stock is worth more than 200 JPY/share – implying at least 50% downside from the current price.

While the stock is not the easiest borrow (5-6% fee), it is a large cap ($24bn EV) and extremely liquid ($40mm+ ADV), making this an actionable and scalable trade.

Background:

We have followed this company for many years, previously having been short as Sharp endured a number of equity-dilutive restructurings needed to recast a debt-heavy balance sheet and bloated cost structure. This process concluded last year when Hon Hai Group, a Taiwanese contract manufacturer, took a controlling stake in the business by purchasing 66% of the company for JPY 288bn, or 88 JPY/share (as well as injecting 100bn for a convertible preferred stake). Hon Hai promptly installed new managers and began to cut costs, all the while telling investors that Sharp's key end markets – display panels for smartphones and TVs, as well as other consumer electronics like microwaves, fridges, washing machines, and printers – would somehow return to outsized growth. While sceptical of Hon Hai's ultimate success, the story had shifted from a balance sheet recapitalization play to more of a valuation call on the restructured forward business, so we covered and initially moved on.

However, the market's response to Hon Hai's brief stewardship has been nothing short of incredible, with the stock – newly diluted by a factor of 3 – rallying over 550% to recent levels around 500 JPY/share, all in barely 9 months! The stock has since retreated a bit to 400 JPY/share but even at this level, Sharp's enterprise value is ~2.45tn JPY (ie, $22.5bn USD), or back above 2007 peak levels – even though sales (-33%) and earnings (EBITDA -75%) remain but a fraction of what they once were. Said another way, Sharp's new-found premium valuation implied more than double the enterprise value for a business that – even on one-year forward numbers – may generate just one quarter the profits of its direct competitor, LG Display.

The business today:

It is important to highlight this at the outset: Sharp is not Tesla, Amazon, or Netflix. That is to say, it is not threatening to reshape commerce as we know it; and it is not a beneficiary of some huge, secular, 'blue sky' growth opportunity for which no earnings multiple would be too high. Rather, Sharp remains a hodge-podge of mostly-commoditized consumer electronic businesses cobbled around the mainstay Display Device segment (~40% of sales; note this segment also includes LCD TVs as well). Some of the major others are 'Business Solutions' – copiers, printers, retail POS systems – at ~15% of sales (but more of operating profit); 'IoT Communications' – cellphones, calculators, translators, fax machines (!) – at 10% of sales; and 'Health and Environment Equipment' – fridges, white goods, some MRIs, etc – at ~15% of sales. The remaining sales are made up of other semiconductor devices (camera modules, etc) and commoditized solar cells.

Fax machines and fridges – that's right, this isn't the Hyperloop, the Gigafactory, or Amazon Prime. Most all of these businesses are commoditized, low operating margin businesses (5-10% OPM) either in structural decline; or GDP+ growers but highly competitive. In most all these segments Sharp is sub-scale (I define this as <5% market share), has under-invested in capex/R&D for years (a legacy of its chronic under-capitalization), and is unlikely to be a secular winner over the long-term.

However, the majority of this writeup will focus on the display devices segment, because this is the segment that will either make or break Sharp – it is the most volatile in underlying profitability; it is the largest component of the overall business; it is by far the most capital-consumptive business that Sharp is involved in; and it is currently undergoing seismic technological change. Simply put, we feel a bet on Sharp is basically a bet on its display business, one way or another, and so it makes sense to focus the majority of our attention here (I would be happy to answer questions re the other segments in the comments).

The Display Segment, and its coming crash (again):

As mentioned, the Display Device segment constitutes around 40% of Sharp's sales base today. Of this, the LCD TV component – ie, Sharp manufacturing their own branded large-screen TVs – is around 25% of segment sales, while LCD panels – small, medium and large sizes – are around 75% of sales. Thus, pure LCD panel exposure is around 30% of total Sharp sales. In reality, Sharp's exposure to the LCD panel market is larger, as they still own a minority stake (~25%) in Sakai Display Products, a large-size panel manufacturer they used to control but sold down during their many restructurings over the years. SDP income/losses are reported below the line, but were significant in FY16 (-20bn vs total operating profits of 62bn), even though Sharp goes to significant lengths not to emphasize this exposure. (We shall return to SDP later).

As you might imagine, the LCD panel industry is a very tough business to be in. It is highly cyclical; largely commoditized; subject to the captive demand of a few very large OEMs; and demands continuous investment in R&D and high capex. Making matters worse, for the last few years the Chinese government has made developing its own LCD supply chain a national priority, such that a huge number of new fabs – financed at uneconomic levels and not driven by natural end-market demand – have been coming, and will continue to come, online. The majority of Chinese players in the industry exhibit low single digit operating margins and do not earn returns above their cost of capital through the cycle. Even the best players in the industry – Samsung Display and LG Display (with the newest fabs and most captive supply) – likely generate only ~10% operating margins at cyclical peaks (ie basically inline or slightly above their cost of capital on a post-tax basis). It should be no surprise that all these names tend to trade well below book value (Japan Display trades at 0.4x book value, while LG Display is at the pointy end of the range at ~1x book value).

Sharp has had a terrible time in the LCD panel industry; it is the main reason why they almost went bankrupt numerous times over the last 3-4 years. They spend $6bn on a new fab (Kameyama no 1) that came online in 2006; we reckon at least 2/3rds of this investment has since been written off. Despite the problems at the first Kameyama plant, they decided to double down and built another multi-billion dollar fab – mostly using Apple to finance through advance receipts of orders – called Kameyama no 2. This plant – along with a few other legacy fabs, mostly old and third/fourth quartile assets – constitute the back-bone of Sharp's panel business today.

Sharp was done in by a well-worn combination in technology: poor investment timing and commoditization. Years ago – before the likes of AU Optronics, BOE, Tianma, and CEC arrived on the scene – Sharp's IGZO backplane technology was thought of as the 'next big thing' in display technology. There was some hope that it could be used as a higher-quality, battery-life-conserving technology, instead of the then-standard backplanes (amorphous silicon, 'A-Si', and low-temperature poly-silicon, 'LTPS'). But due to some self-inflicted wounds (namely, over-investment at the peak of the cycle), Sharp never had the ability to develop IGZO properly; was beset by yield and production issues; and in the end has bled share at high-quality OEMs (ie, Apple) ever since as the competition caught up and then superseded them on quality.

The problems facing the company now are three-fold: 1) it is quite clear the premium OEMs are planning to fully shift to OLED; 2) Sharp is many years behind and cannot conceivably compete in OLED, even assuming they had the capital to built out new fabs/production lines; and 3) the outcomes for Sharp if they lose Apple, et al, are likely dire. Let's look at each point one by one.

) Apple is shifting to OLED and this will drive most of the premium smartphone market in the same direction: I will not spend too much time on this as it is fairly common knowledge. Organic light emitting diode ('OLED'), the next-gen technology, has been commercialized by Samsung and used in their phones exclusive for a couple of years but now Apple is shifting to OLED as well (OLED consumes less power, has brighter colors, a truer black, etc – and now only costs 2x an LCD LTPS screen vs 3-4x a few years ago). This will necessarily hurt **Sharp as Apple is still ~20-25% of total company sales** (and thus the majority of panel revenue in the display business)

) Sharp is far too far behind to compete in OLED and has no hope of catching up: instead of trying to develop OLED, Sharp appears to be following a 'batten down the hatches' approach. They do not talk a lot about OLED and when they do they suggest LCD still has a future. More importantly, they aren't investing much at all in OLED – in FY16, Sharp spent 34bn **($300mm)** JPY TOTAL on all display capex, including some minor OLED spend, while total company R&D (comprising all the other crappy consumer electronics and semiconductor products) amounted to just $**1bn**. Contrast this with Samsung – which spent **$8 billion** last year, has spent over $20bn developing OLED in past years, and has committed another $8bn in fab capex in the coming year. LG Display, another key competitor, has also spent multi-billions and is on the verge of committing additional multi-billions. I could go on to detail the host of other Chinese panelmakers all spending billions on OLED but the point is pretty clear: it is simply not credible to think Sharp can compete in this space when they have literally under-spent key comps by, cumulatively, tens of billions of dollars

) When Sharp loses Apple, they will likely be completely marginalized: Sharp's argument – such as it is – is that LCD will still have a home in other smartphones for years to come, as a) not every OEM can afford to provision an OLED screen for their phones; and b) even if they could, there is a massive production bottleneck such that only Apple and Samsung will have OLED phones this year (and even then not in all new Apple models). The problem of course with this reasoning is that Apple and Samsung are the only OEMs whose phones command premium ASPs (ie, >$600-700); the average price for all other smartphones is <$300, and indeed the majority of those Chinese OEMs gaining share in the smartphone landscape are priced much lower (of course, the overall global smartphone market has basically stopped growing). In effect, this condemns Sharp to supplying the likes of Xiaomi, Oppo, Huawei, etc – companies whose phone operations are by all accounts barely profitable and whom are notorious for squeezing their suppliers.

This would be bad enough, but it gets worse. Remember how we mentioned that the Chinese government made LCD panels a strategic industry, handing out subsidies to all and sundry? Well, that has meant that a ton of new LCD-dedicated fabs were commissioned in the last 2-3yrs, and the majority of them will hit the market in the next 1-2yrs – right at the moment OLED is driving a shift away from LCD as a technology more generally. Thus – Sharp is likely to find a whole host of new capacity coming online, competing for business at the exact moment it is losing its highest-quality, highest-ASP, most-profitable client to the vicissitudes of technological change.

As a result, unable to invest to catch up, and with a ton of excess capacity from their likely lost Apple business, we fully expect the display device segment to show increasing operating losses from 2H of the current fiscal. Sharp, by contrast, forecasts display devices sales increasing by 25% over the next three years (though no discrete profit guidance has been given). We simply find this incredible (in the worst sense of the word). We do not think it is unrealistic to expect gross sales related to Apple to fall to near zero in 2yrs or so, ie, removing around 25% of total group sales right off the top.

So why has the stock gone up in a straight line?

We have to admit – none of the above is exactly ground-breaking. The shift in display technology, and Sharp's potential obsolescence, has been well documented by the sell-side (it is a consensus sell) and some of Sharp's competitors are really suffering (cf. Japan Display). But reading all this, you may be surprised the stock is +400% or so off the lows, and has more than doubled this year; you may be even more shocked at the current valuation (45x P/E, >7x book value, and 15x EV/EBITDA) especially when considering the relative outrageousness versus other display names (generally <10x P/E, <1x book, and

<4x EV/EBITDA). Indeed – this is the key question: what has driven such a gargantuan rally, and why is the market so wrong today?

First, the reasons for the rally - there are a few potential explanations:

) Restructuring and the nature of 'quick wins': when Hon Hai recapitalized Sharp, the business was at its lowest ebb: losses had been endemic for years; morale was terrible; and recent results into the recap had been absolutely abysmal. There had been stories emanating from Sharp of a business in total chaos, with line managers allowed to authorize large purchases up to $1mm USD without oversight; to chronic brain drain, lack of effort, over-staffing, etc. The recapitalization allowed for a number of 'quick wins': some layoffs occurred, loss-making units were shuttered, poorly-negotiated supply agreements (eg in the solar business) were recut using Hon Hai's supply chain muscle; and, in general, morale was improved. The market has overreacted to the cost-cutting driven recovery and now extrapolates a secular growth story where there is instead likely a secular decline;

) Cosmetic tricks: in addition to the 'real' restructuring, Hon Hai performed a few other cosmetic tricks as well to portray the operating business in a more positive light than we think it deserved:

a. For example, they **changed their pension liability accounting** (reducing the survivability estimates in the pension fund from 14yrs to 13yrs), which reduced annual service costs (booked through operating earnings) by 6bn on a like-for-like basis. This seems strange, in a country where life expectancy only continues to increase, and is quite significant versus the underlying business (around 10% of reported EBIT);

b. Additionally, they **cut R&D budget** from 130bn to 106bn year-over-year – a 24bn decrease that simply adds back to Operating Profit (R&D is fully expensed) – very significant at 40% of reported EBITD. Again – in an environment where all your competitors are spending much more on R&D, this seems an incredibly short-sighted move and unsustainable;

c. Finally, they **took 20bn of losses in the unconsolidated Sakai Display Products (SDP) division**, which we believe is likely masking of losses that would otherwise be felt by the Display Devices division (and hence Operating Profit losses for consolidated Sharp). Here's how it works: SDP produces large-size TV panels; these are then sold, mostly internally, to the Device division for use in Sharp's own branded large-size TVs. Since Hon Hai majority owns both Sharp and SDP, if it wanted to dress up Sharp's operating earnings, it could easily strike the transfer prices at levels favorable to Sharp (who would need to sell its TVs at a profit in end consumer markets) over SDP (who could then suffer operating losses below the line). Hon Hai, of course, is a much bigger entity and can absorb the losses (without reporting the exact breakdown – they don't even break-out Sharp's earnings from their own). **This explanation makes further sense as it is the only one that explains exactly how SDP lost ~80bn (at 100% ownership) last fiscal year during a massive rally in LCD panel price**s (large-size LCD panel prices rose 40-50% yoy over the last 12months through May)

) Temporary spike in panel prices: as mentioned above, LCD panel prices (small to medium size) actually rose for sixteen straight months through May 2017 – a function of a shortage of supply as some of Samsung's fabs were taken out of the market due to their transitioning from LCD to OLED production lines. This undoubtedly drove profitability for Sharp, as it did for the whole space – but production is not only normalizing, as alluded to above, a whole host of new capacity is coming as well;

) Temporary spike in LCD TV prices: even though the market for global LCD TVs is stagnant (around 220mm units a year), there was a spike in prices for large-size TVs (where Sharp specializes), again because some capacity was taken out for the conversion to OLED, but also because Sharp decided to stop supplying Samsung with panels and instead hoard inventory (for its own TVs). This seems likely to be penny wise but pound foolish as it means a) they now have a larger inventory position at a moment the market is turning; and b) the TV market is not growing meaning as new capacity comes online they will likely be forced to dump inventory at decreasing prices (something Sharp has done on numerous occasions before);

) A large squeeze in the stock: undoubtedly one of the main technical factors during the rally has been the tightness of the borrow. Many hedge funds kept their short positions on through the Hon Hai recapitalization, as that transaction was viewed as a band-aid solution (it was), only to be surprised at the extent of restructuring-driven gains as well as the un-expected rally in panel and TV prices. No doubt this was a very painful short for some (indeed, we covered a small position earlier in the year) – but we feel now the valuation is so egregious, and the catalysts so much clearer and nearer, that risk reward is much more favorable today.

) Retail participation in the stock: after the recap, the shares were trading around 100 JPY – perfect territory for the Japanese retail punter, a sizeable market participant and one who tends to traffic in low-priced stocks (cf, Takata). We have spoken to many institutions who know Sharp, and are yet to find one – onshore or offshore Japan – that thought Sharp was an interesting investment at 150 JPY, let alone 400-500 JPY. We believe the retail participation has been partially responsible for the extraordinary rise, since as the name gathered momentum and shorts began to cover, it began to trade in feverish volumes and garnered a following on domestic Japanese stock trading boards (which we monitor). As such we consider a large amount of speculation to be priced into the stock, divorced from underlying fundamentals as we have outlined above

While this is not a perfect explanation for the rally, we do feel that a number, if not the majority of these points are subject to change in the near-term – and as such we feel now is the right time to re-enter the short in significant size.

Catalysts:

Here are a few of the near-term catalysts as we see them:

) Roll-over in LCD panel prices (large and small): this is already happening. June prices for small, medium and large size panels fell for the first time in 17 months. As a large amount of new supply comes online in 2H'17 and through 2018-2019, we expect this to continue (even if the transition to OLED by the high end phone OEMs takes longer to occur);

) Roll-over in large size TV prices: Skyworth – one of the larger global Chinese TV OEMs – reported June TV sales -31% year-on-year (and -34% in overseas sales). While monthly results are lumpy, most China TV market analysts feel inventories at retail are high, and again – new supply is likely to come online in the coming 12-18months (pent-up Sharp inventories; new capacity from Chinese/Taiwanese/Korean OEMs);

) Potential equity sale by Hon Hai: Sharp has recently applied for relisting to the first section of the Tokyo Stock Exchange (one of the last technical positive catalysts). We do not yet know if they will be approved for relisting (they probably will), but Sharp would be required to have at least 35% of its stock 'free floating' to meet TSE rules. As of today, Hon Hai controls are 66% of shares, although their converts are deep in the money such that if those are treated as shares (they may well be), then Hon Hai would potentially need to sell from a few percent of its shares to up to 7-8% of its share in an offering. Since this is still a large amount of stock (Sharp's market cap is $20bn), and no institutions we think would touch the stock near

400 JPY, this could actually be a meaningful repricing event;

) Potential equity issuance to fund an acquisition of Japan Display: Japan Display, the competing panel-maker, is even more distressed and at high risk of bankruptcy since they are so much more dependent on Apple (55% of sales) and just as behind in OLED development. There is some risk that the government will force Sharp to acquire JDI (since the government is a major shareholder in JDI). If Sharp used stock to acquire the business (which I think it would), it would shine a light on how expensive Sharp's shares are relative to the underlying value of these kinds of assets and, we think, force the market to reprice Sharp. Alternately, JDI's major shareholder, the INCJ, could simply turn around and dump their new Sharp shares at a huge implied premium to their distressed JDI holding. Either outcome would be bad for Sharp shares.

Valuation:

Frankly I don't think these assets are worth much more than book value, if that - indeed, most all other panelmakers trade substantially below book valu. Some of the non-LCD assets may gain higher multiples but being generous and according say 20x P/E on the whole entity would only suggest a stock price of ~180 JPY/share. Book value today is I think ~50-60 JPY/share (on a fully diluted basis). Either way the current price is at least 50% too high, being generous.

Risks:

) Hon Hai continues to use bogus accounting to make Sharp look more profitable than it realistically could be (for example by inter-party transactions that support Sharp at Hon Hai parent's detriment)

) Sharp posts better than expected earnings in the first quarter of the year and retail keeps buying

) Sharp does buy JDI at a cheap price and the market assumes they can generate huge synergies and bids up the stock

) Other stuff happens

I do not hold a position with the issuer such as employment, directorship, or consultancy.
I and/or others I advise hold a material investment in the issuer's securities.

Catalyst

see above

Messages

Subject Question
Entry 07/13/2017 05:32 PM
Member jmxl961

I apologise if you have indeed implied this not to be the case:

1. Is there any chance that Apple will use Sharp for an OLED iPhone screen? (Following article suggests maybe Samsung will do OLED for Apple)

2. Does Hon Hai / Foxconn have any display R&D or manufacturing? Should we be looking at Sharp's R&D as part of a larger Foxconn group R&D spend on display etc?

3. Did Foxconn get any indication of future committment from Apple before it bought Sharp?

Subject Re: Question
Entry 07/13/2017 11:30 PM
Member puppyeh

hi, thanks for the questions. please see below:

1. There is a chance that Apple eventually uses Sharp for OLED...the problem is this cannot happen for at least 2+, probably 3+ years. It took Samsung around 4yrs to scale OLED for mass production (yield ramp for OLED using the main technology, vapor deposition, is very tricky) and they threw - literally - tens of billions at developing it. To date I would peg Sharp's total investment in all forms of OLED related R&D/capex at sub $1.5bn, perhaps sub $1bn. Frankly even if they flicked a switch and decided to try to get to a place where they could re-dedicate their current Apple-dedicated LCD output all to OLED, it would be a number of years and cost billions of $ to get to that point. More significantly - they are not trying to get there (and Apple is soft-signalling they are going with other suppliers further up the curve, like LG Display).

2. Hon Hai also controls Innolux, another Taiwanese panelmaker. I don't recall off the top of my head when they gained control of Innolux, but that investment has been basically a failure for HH - it has lost share to other panelmakers (AUO and the Chinese). Within HH itself, there is very little/no display technology background (recall they have historically simply been a control manufacturer). Their original exposure/entry into the panel business came via the SDP JV that I discussed in the writeup. There, again, Sharp was a technology donor from a position of weakness. Both before and after the HH acquisition, Sharp capex/R&D levels were declining because they had no capital. While capex has gone up marginally in recent quarters, R&D spend, as outlined in the writeup, has continued to fall. There is little to no chance Sharp is gaining R&D know-how in panel technology from HH without having to pay for it (in fact quite the opposite).

3. While we don't know the answer for this, recent events would suggest no - otherwise Apple would not be making noises about co-investing in new OLED production facilities at LG Display. In any case - Apple is known to be highly opportunistic (even mercenary) in how it treats its supply chain so this would seem unlikely.

Subject Questions
Entry 07/19/2017 03:04 PM
Member nha855

Thank you for the writeup. The thesis makes a lot of sense, and after doing some independent research, they do appear to be positioned poorly for their Display segment. I have two questions.

First, the revenue growth seems to be predicated primarily on their focus on the Smart Homes as well as IoT Electronic Devices. Is it possible that investors look past 2017 and 2018 as transition years in display, and any traction in Smart Homes & IoT Electronic Devices fuels further irrational excitement?

http://www.sharp-world.com/corporate/ir/event/policy_meeting/pdf/shar170526e_1.pdf

http://www.foxbusiness.com/features/2017/05/27/sharp-targets-smart-home-appliances-wsj.html

Second, is there an opportunity for Sharp, through its relationship with Hon Hai, to gain market share in non-OLED models over the next year. As an example, Oppo Vivo. And related to that question, how would you suggest I quantify the net lost revenue/profits from the lost Apple market share with potential gains with other customers?

Thank you.

Subject Re: Questions
Entry 07/19/2017 04:54 PM
Member puppyeh

You raise a couple of interesting points. Let me take each in turn:

1) Growth in non-display spheres: while this is a risk, frankly I don't think management has any credibility here. They are pointing to massive growth in these segments, which, despite the fancy names, refer to largely commoditized components or household appliances. They did not explain in any granular way how the growth would be achieved (nor how much capital would be needed to achieve these growth rates, what cash returns/ROI would look like, etc). While I do expect the Hon Hai relationship will open up some distribution channels, recall this is not a small company (sales have been $30bn historically and Sharp is still one of the more recognized electronics brands worldwide) so absent large capital investment I simply don't see how they can come close to achieving these targets.

As to the risk of 'investors looking past 2017/2018' - I believe this has already happened and is in the price, hence my thesis. Clearly the market is not expecting 2018 earnings, even, to be new base-line earnings levels as then the stock would not be trading at 15x EBITDA and call it 40-45x P/E. Of course they could have one or two OK more quarters before the display business falls off, which could fuel temporary excitement, but unless something concrete changes in the core of their business I would view these as opportunities to add to the position.

2) Quantifying the non-OLED replacement opportunity: this is a little tricky as both Sharp (as well as most all the other panelmakers) don't give much granular breakdown by screen type/segment/etc. However here is one big-picture way to think about it: Apple makes ~92% of all the operating profits in smartphones, while Samsung makes ~14% (according to IDC I believe). Note that Samsung is entirely self-sufficient in displays. As such all other smartphone vendors combined generate operating losses (3rd party researchers think ~0-5% neg operating margins on average) vs the ~35-40% operating margins that Apple generates.

As I mentioned in the article - most panelmakers chronically lose money (or earn low single digit operating margins that don't earn back the cost of capital). Sharp's peak display segment operating margins (around 5-6% for one or two quarters a few yrs ago) came when their Apple share was much higher (I think closer to 25-30% of Apple iPhone supply). It is simply unfathomable that they could replicate anywhere near this level of profits - even assuming they could somehow get back to peak earnings power for the business - with clients that aren't making any money (or trying to make money, for that matter). I could envisage a scenario, for example, where they replace over half of their current Apple-related sales profile but where marginal profitability on those sales is profoundly negative (mid-single digit OP negative at least). Of course, a more extreme scenario would not surprise me either (since as I discussed, there will be huge excess LCD capacity coming into a market that is not growing anymore in absolute terms).

I know this is not the granular, exact math you are looking for - but we are not debating a stock trading at 10x needing to determine if the multiple goes to 12x or 15x. This is a stock priced for further exponential growth where there are in fact huge existential business risks. Given my confidence in the overall industry trajectory, I am ok with being less quantitative in this case.

Hope that helps

Subject Panel prices are rolling over
Entry 07/19/2017 11:32 PM
Member puppyeh

Quick update - LG Display (the best Korean display name) is -7% today after an industry report suggesting June panel price declines for large size panels (ie the ones used in TVs) are accelerating. Recall panel prices stopped increasing in May (after 16 straight months of increases) and in June apparently fell 6-7%, more than expected. While supply/demand is actually still reasonably tight in both large and small panels, for reasons I mentioned in the writeup, this likely changes as we head into the end of 2017 and 2018. With prices already rolling over it is hard to see how a rebound could be sustained in the face of stagnant end market demand and a large wave of new capacity coming.

Subject 1Q earnings
Entry 07/28/2017 05:13 AM
Member puppyeh

On the face of it a pretty positive report but there is a lot to worry about under the hood and overall I am more confident than less post this report. I had been slightly worried that much of YoY sales improvement (+20%) would be driven by leveraging Hon Hai's distribution channels into better sales for the 'core' consumer elec products (phones, fridges, etc). Actually, this is not what happened: sales growth in 'Smart Homes' (new segment including consumer elec, health equipment, and solar) was just +4%, while office equipment continues to lose share (-7%) in a difficult market. There was minimal pickup in the semis/component segment (and on lower margins), meaning the entire growth was driven by a big comeback in Displays (+49% YoY). I am not really worried about this, because a) LCD panel prices are running 40-50% higher YoY (in the mar-Jun quarter) meaning a lot of this is price-based; b) the Display business includes Sharp's large-screen TV business, which anecdotally has been building inventory massively since they stopped supplying Samsung, and in preparation for the re-entry into the US; c) receivables build in the quarter was pretty large (+33bn vs normally a seasonal reduction); and d) I think Display profits are being over-stated (see the writeup)

Given the working capital build, cash flow was actually negative in 1Q (operating cash flow was negative too), despite the increase in EBITDA. Investment remains anemic (capex just 19bn total, only 3.2bn in displays, -50% YoY!), and R&D is still running at lower levels YoY. These are simply unsustainable – it is worth remembering that all the hyped US panel plant talk at Hon Hai will be done by, and remain owned by, Hon Hai, and not Sharp.

With panel prices now rolling over, I would estimate 2Q may be OK but absent further accounting shenanigans or a big turnaround in the trajectory of panel prices and competitor investment plans, I can't see how they can maintain, let alone grow, earnings in 2H and beyond. They should definitely use a report like this to sell stock.

Subject Stock Move
Entry 10/04/2017 02:38 PM
Member lpartners

Thanks for an excellent writeup. Do you think the recent move is in sympathy with JDI? I haven't seen any change in fundamentals over the last week.

Subject Re: Stock Move
Entry 10/05/2017 03:48 AM
Member puppyeh

yes there has been no news - part in sympathy to JDI (not sure why them remaining in the industry is good for Sharp, but hey), as well as it being a heavily-shorted, retail stock in a rising Japanese market. frustrating but no change here

---

Subject update
Entry 12/04/2017 11:11 AM
Member puppyeh

Sharp stock has rallied ~15% the last couple of days after it was announced the company would be re-admitted to the TSE first section. This will likely generate ~5days volume of passive buy demand from trackers, hence the move in the heavily shorted stock. This is frustrating but I think the last positive catalyst for quite a while. The stock is now back close to where I first wrote it up, which is interesting because:

- LCD prices have collapsed (as predicted), especially for mid-size TV panel, and are down ~15% since earlier in the year. This is likely to continue next year as a huge amount of capacity comes online (principally BOE's new G10 fab) and hasn't fed through to numbers yet because of lag/cost-cutting/funky accounting. Every other LCD name (and Chinese TV names) have rollen over (look at Japan Display), only Sharp is defying gravity for technical reasons mostly

- Sharp has done absolutely nothing in OLED and they are still largely dependent on Apple iPhones (~15-20% of group sales) for which they have developed no OLED substitute and so will lose at some point over next couple of years

- the stock now trades at 40x P/E, 15x EV/EBITDA with no earnings growth in consensus numbers, whereas I think earnings will actually decline appreciably next year

- I am becoming increasingly convinced they are stuffing the channel given the huge discrepancy between their sales and profits (especially in the Chinese TV market) and the results of other China-exposed TV names and think parent Hon Hai is effectively subsidizing the group for now. This could turn out to be temporary, as and when the other shoe drops in the LCD business at some point in 2018

All in all, still short, I still think this is the most egregiously over-valued large-cap stock in Japan, and I still think fair value is ~100 JPY/share

---

Subject update for earnings
Entry 02/14/2018 10:55 AM
Member puppyeh

The reported numbers continue the trend of recent quarters – large headline improvements in revenues and in operating earnings, but ongoing deterioration in cash flow. The sensitivity of the business to the LCD cycle seems to be much lessened now that they have essentially stopped external sales (ie they simply supply Hon Hai or their own captive TV business) but at the same time I cannot fathom how current profitability is maintained next year (buttressed as it is by TV inventory builds; Apple 3D sensor device demand, which has peaked; and restructuring benefits). At the end of the day this is still trading at >30x P/E (on my numbers) with likely declining earnings next 2yrs, no more technical positive catalysts to come, and a terribly-under invested technology platform that may yet still throw further $$ into the Japan Display maw at some point.

A couple more miscellaneous points on the Q:

Advanced Displays (LCDs for phones, TVs, tablets, etc, as well as the TV business): reported sales +16% QoQ and OP of 13bn (4.2% OPM vs 3.5% in 2Q) while LG Display reported OPM -8pts QoQ (on higher sales) and near breakeven in absolute terms. There is a similar (actually worse) picture at the Taiwanese panelmakers. The outsized revenue growth is driven by chasing volume in the TV market (where Sharp has been cutting prices to win share) so that part makes sense, but the profit sustainability in the face of declining prices is unexplainable

Smart Homes (this is the old white goods, appliances, home electronics business, including phones): maintained 7% OPM (same level as 1Q, 2Q) on higher sales despite broadly higher component prices and competitors in various fields missing badly (eg Fujitsu General in airconditioners, Fujitsu in mobile phones)

Smart Business Solutions (copiers/printers): the only segment where they reported declining QoQ profits – OPM now down to 5%, even on rising sales (+10%) as there is very aggressive price competition going on in this space (see the Fujifilm/Xerox comments today)

Working capital: they continue to build working capital instead of generating cash. Cumulatively through 3Q this fiscal, there has been a net ~100bn swing in cash out through working capital (most entirely receivables build) vs 50bn increase in reported operating profit YoY – this led to a net FCF burn of ~40bn through 3Q

Capex: they continue to spend next to nothing on capex (just 34bn in the Q, this was actually down YoY despite net sales up double digits) and display capex was only 11bn so they are definitely not investing anything in OLED

Subject update
Entry 05/15/2018 12:08 PM
Member puppyeh

Updating thoughts here for 4Q earnings from a couple of weeks ago. Overall, while this has clearly worked (-20% vs Nikkei +14%), it has been a frustrating short as the stock has not re-rated (much) lower despite what I consider a continuing pattern of extremely low quality earnings 'beats.' I guess the takeaway is that without a balance sheet/debt angle, it is a tough market to see valuations re-ratings occur on their own (as has been discussed on the Shorts thread in the discussion forum). Still, this is clearly not an open-ended growth story type name, and the valuation remains beyond egregious, to me, so I am maintaining the short.

Comments on 4Q: bit of a miss in 4Q and a few worrying signs under the hood but as expected they guided quite firm. It is becoming quite well known that the reported numbers wildly diverge from cash flow, and I am quite skeptical they come close to hitting guidance for next year as most everything should be moving against them (Apple sell-through trends, component costs, increasing capex/R&D budgets), other than HH’s willingness to keep subisidizing parts of the entity. While I acknowledge it is hard to see how this changes near-term as long as HH remains the controlling shareholder, in the meantime it remains a very expensive stock with neither fundamental nor cash flow support (I have it at 24x P/E and 40x P/FCF, excluding working capital, on next years guidance; and 40x P/E and negative FCF on my numbers), but admittedly waiting for a catalyst (HH attempted exit?) to see a real deterioration to a less egregious multiple.

Reported numbers: 4Q reported numbers were actually worse than expected (20bn OP, 598bn sales vs 28bn OP, 636bn sales consensus) and, on an adjusted basis, a good deal lower year over year (20bn this yr vs 29bn a year ago). The main culprit was the devices segment (CMOS sensors, 3D sensing modules), a function of lower demand from Apple, etc, as segment profits turned negative (-4bn, -4% OPM vs +5bn, 3% OPM QoQ) as sales collapsed QoQ (110bn vs 189bn). There was also some moderation in reported Advanced Display Systems profits, as OPM fell to 3% (and OP to 7bn) vs 4%, 13bn, QoQ. Nevertheless the extent of the deterioration is still far too low given what competitors have reported, so I think HH is definitely still warehousing losses. Against this, there was a noticeable pickup in copiers/printers (seasonality), though profits are still lower YoY due to competition; and Smart Homes, where profits remained high, again somewhat inexplicably, given the business mix. Interestingly, they booked 2bn in losses below the operating line at the affiliate income level – I think this could be some portion of transfer price differential in the Display business (it was a reversal of gains earlier in the year and prices have rolled over considerably since so it could recur).

Cash flow and balance sheet: the change – or lack thereof – in the balance sheet over the past year is instructive. Equity ratio is now 20% (vs 17% last year), as nominally equity has increased from reported net income. But net debt has increased from 175n to 215bn (ie they burnt ~40bn in cash net) despite optically recording 165bn in EBITDA. This was consumed by a net 55bn W/C swing (big increase in receivables for the second year in a row), interest (6bn), income taxes (16bn), capex (102bn vs 77bn YoY), and a few other items. Note, however, that R&D was still lower YoY (despite the big increase in sales) and capex – though it did increase marginally – is still very low versus historical and competitive standards (essentially ~4% of sales in Display where maintenance capex is around 7% normally). Thus, *Sharp has reported a 130bn increase in OP improvement over three years, but net cash outflow of 150bn, driven by (partial) normalization of working capital after emergency drawdowns in 2016, and capex returning to less-low levels. Fully ¼ of OP improvement has been driven by R&D cuts alone. Even assuming no further W/C draws (which is impossible as receivables growth is driving sales growth), I still don’t see how this company can generate more than 30-40bn of FCF a year, max, meaning it is on 40x FCF currently*.

Subject pending dilution is a big issue for stock technicals and valuation
Entry 06/21/2018 04:43 AM

Member puppyeh

while the stock has been weak (-31% this yr, -16% this quarter), I still think this is an opportune and high conviction trade. Sharp announced they would redeem a huge amount of prefs from the banks (issued during its last debt/equity swap a few years back) and **pay for them by issuing ~$2bn of stock sold publically sometime in the next 9mos or so** (I think it happens before Mar 2019). This is a big issue since the liquidity and float (stock still 65% owned by Hon Hai) was one of the main issues supporting the irrational valuation. We should not underestimate how massive an equity issuance this is and why it is a big test of market demand for a huge consensus sell name. By adoption this approach the company is tacitly suggesting they need to find the real clearing price for $2bn of Sharp stock in the public markets, and - since it has already been readmitted to the TSE 1st section and so has already tapped passive demand - this needs to come from active investors, either retail or institutional. I do not think there are many or any institutional investors who would pay 25x pro-forma P/E, or ~10x EV/EBITDA, for this non-growth, non-cash generating suite of consumer electronics businesses that have been prettified for two years by aggressive accounting and under-investment.

Said another way at some point this financial year the free float will increase by 40%, and the sharecount itself will increase by 20%. Even if you think there are investors willing to commit capital in large size at the current price, there is simply no reason to do so before the actual offering is filed, meaning no incentive to buy it even when market rallies (look at behaviour of the stock last few days). This is important as previously this was a high beta stock (to the upside), pretty scary to be short these in Japan as many likely know - but now it seems at the very least to be an excellent funding short for the near-term.

In any case I feel there is still substantial fundamental downside and - finally - the technicals are in our favour. As such now is the time to press the short. I could easily see this falling to an acceptable valuation range - maybe 15x P/E, 6-7x EV/EBITDA, even though I think this is still rich for this crap business - which would imply another 40% downside on my numbers next year. Hon Hai may end up canceling the maneouvre if the shares fall too low (although its unlikely). It goes without saying that fundamentals (smartphone demand; LCD prices; TV demand; etc) are all firmly against the company as well.

Subject share issue cancelled
Entry 06/30/2018 02:22 AM
Member puppyeh

Sharp pulled the issuance as the stock had fallen 20% since they announced it, something i speculated was possible but still did not think would happen. this is pretty frustrating, especially in light of the rally back, although at the end of the day it doesnt change that much:

- Sharp was going to use the proceeds to buy back convertible prefs that can be converted from July next year at, perhaps, much more dilutive terms than the current issuance

- Sharp was going to extract a discount for the advance repurchase of the prefs that may not be available if they dont accelerate the purchase now

- business trends in many of the company's core businesses (LCDs, TVs, smartphone components, solar panels) are trending poorly and it is unlikely, in my view, that they find a better time to sell the stock

So I still think they end up revisiting this stock sale in the near term (6mos?) and even if they dont the market will constantly worry about it.

Subject Terry Gou may have gotten a margin call and just sold 7% of the company to Mizuho
Entry 08/24/2018 08:35 AM
Member puppyeh

Mizuho announced after the close they bought ~7% of Sharp from a seller 'who needed to sell' - a weird set of events that I think signifies a margin call on Terry Gou. Here is the logic:

- we do not know who the seller of this block is but it is likely either ES Platform or SIO International Holdings (both entities own ~7% of Sharp shares today).

- ES Platform formerly held prefs, that were converted to common, to provide Sharp management with bonus shares over time. It appears to be a simple holding company and it is unclear how they would run into liquidity issues or why they would sell down like this if they did. So perhaps this is not the seller;

- SIO Holdings is the personal investment holdco for Terry Gou personally. It owns two important assets: 1) the ~7% stake in Sharp; and 2) a controlling stake in Sakai Display Products;

- I have long believed that SDP has been essentially subsidizing Sharp profits for at least 2+ years, and has likely been burning cash directly to do this; Sharp has also not paid any material dividends back to its owners since HH took over. So purely on this basis SIO has likely been drained of at least some cash in the last years;

- More importantly, if we look at the development plans for the Wisconsin fab, SIO International is directly named as the Legal Owner of the Wisconsin plant (a fab that will apparently cost $10bn to develop), despite only have $1.3bn of assets (most all the investments in Sharp and SDP) and minimal revenues (again, SDP related). The below also discloses that SIO's stake in SDP is 53%.

https://foxconnwi.com/sio-international-legal-owner-wisconsin-foxconn

Concluding, it seems likely that Gou's personal investment vehicle needed to make a substantial cash outlay related to the Wisconsin fab (they were meant to start construction in late April, per below, so expected funding needs have probably ratcheted up in recent months) and despite Gou's resources perhaps he also ran into liquidity issues getting money out of China (would not be the first Chinese tycoon of late to have this issue).

The biggest question mark is still why Mizuho announced this before taking delivery of the shares (they will apparently take delivery on Monday - in Japan block trades do not normally happen this way). in any case the market will need to find a clearing price for $1bn of Sharp stock, of course many fast money shorts will use this to cover but even so I think the level is substantially lower than where we are (and of course the signal from Gou selling is quite bad). More importantly it will free up a good amount of borrow as these are essentially new shares coming into the borrow pool.

This also I think calls into question the ethics and motivations of proposing an equity offering to refi the prefs, then cancelling it because of market conditions, only for an insider - who clearly would have been locked up from selling for an extended period if the offer went ahead - then turning around and selling his own shares anyway.

Needless to say i think the stock will break new lows as these shares find their way to market.

Subject Update
Entry 10/31/2018 05:21 AM
Member puppyeh

this has done well (Sharp - 56% since posting vs NKY +9%) and is now much closer to perceived fair value - but I am not closing it out just yet as I still think there is at least another 30%+ to play for. Essentially the thesis has played out as planned - the co has lost an unsustainable growth multiple as the market realizes many of HH's fixes were either based upon aggressive accounting or one-timish in nature. There is more of that to go, especially in the context of a parent who is now more likely a seller of the asset (as discussed at length in earlier posts) and as the end markets in many of Sharp's business lines are turning.

Thoughts in 2Q:
No surprises in the reported headline numbers (they had pre-announced). They marginally raised FY guidance at the OP level (110bn-> 112bn), essentially incorporating the 2bn beat from 1H, but they took down sales guidance for 2H by ~7% in real terms (they key their 2H f'cast unchanged but didn't mention Toshiba PC business, newly consolidated which is adding 7% or more to sales).

The narrative is now about quality over quantity, apparently – still, the business stopped growing in 2Q (revs -2% yoy) and operating profit was lower as well (22bn vs 23bn), even if reported margins were a bit higher (3.7% vs 3.3%). In terms of the specific segments, there was a continuation of trends seen in 1Q: the domestic consumer electronics segments seem to be doing fine, while the Devices segment is seeing a rapid decline in profitability and Displays remains something of a black box. The reasons for the decent sales/margins in Smart Homes seem to be at least partially transitory (they released new smartphone models earlier than expected this year, and got a bump in 1Q/2Q); while the reasons for the big dropoff in Devices are two fold (declining profits in solar cells, as well as price competition in sensing components). Display profit margins were essentially flat (at 3.5%) despite a 12% YoY decline in sales – again, extremely difficult to explain in this kind of business.

Once again the detail is below the line and in cash flow. For the quarter, Sharp booked 1bn of equity method losses (Sakai Display) – lower than 1Q (-2.3bn) because panel prices rallied a bit in the quarter, but still enough to dent Display margins another 80bps if properly accounted. Note that panel prices have rolled over again in October.

They burnt another ~40bn in working capital in the quarter. Interestingly this was not in inventories (which fell sequentially, though by less than implied by seasonality), but in receivables, which showed quite a large jump QoQ and ahead of sales growth. Inventories however still look high, at 1.25 months of sales (versus last year they were at 1 months sales) to me.

Once again there is a big discrepancy between portrayed and actual capex. In 1H they claimed they spent a total of 72bn on capex, but the cash flow statement says 92bn. They also spent 8bn on intangibles and 2bn on purchasing of subsidiaries (which juices sales growth) so all in all I think real capex was more like 100bn for 1H.

Total cash burn, then, was ~115bn for 1H (80bn in 1Q, 35bn in the most recent Q) – versus 33bn in 1H last year. Consider this is versus the reported improved EBITDA (85bn this yr vs 73bn last year) so it really puts the business quality into perspective.

The only real positive to me was the announcement that they would buy back a portion of the pref shares from Mizuho/BoTM. It looks like they are buying back 46% of the prefs, with a notional face value of 92bn, for only 85.1bn – in other words the banks are accepting 92.5c on the dollar, there is no explanation for why they would do this. This transaction explains the entirety of the below-the-line upgrade to forecasts (since Sharp is booking gains on this transaction). Right now I think Sharp is ~3x adjusted net levered (treating prefs as debt) but only 1.8x net levered on reported debt. Since this appears to be cash funded, reported year end net leverage would rise to 2.3x…not that low for this kind of name.

While there could be a short term squeeze based on the OK headlines and perceived lower risk of dilution, I expect it to be short-lived and Mizuho to hit the bid if it happens. I continue to think this will print new lows into the end of the year.

Subject Author Exit Recommendation
Entry 12/17/2018 04:33 AM
Member puppyeh
The author has recommended exiting the position

Subject Re: Author Exit Recommendation
Entry 12/17/2018 04:37 AM
Member puppyeh
While this probably continues to make new lows, and I somewhat expect the stock to revisit the levels where HH bought their stake (around 900 JPY), the risk reward is no longer what it was and this has been a large alpha generator for most of the last 1.5yrs so we are booking profits on this one. Longer term I would not be surprised to see this company run into financial distress, again, if/when HH exits their ownership stake (as I expect they will) in the coming years.

Since recommendation, Sharp is -56% vs the NKY +7%, so 63% of outperformance. To be fair, borrow was expensive for much of this time (around 10-15% average lets say), however even so this generated 45-50% of net alpha in a large cap name, so was a good outcome. On to the next.

Subject Re: Re: Author Exit Recommendation
Entry 12/17/2018 11:49 AM
Member ima
congrats. Great call!

Subject update
Entry 05/10/2019 04:50 AM
Member puppyeh
when we closed this in the December swoon at similar levels to today i speculated that it was quite likely the stock would revisit/make new lows. Q4 results basically confirmed most aspects of the bear thesis and introduced a few new ones:

- Display profits have collapsed (both within the Pnl, the Advanced Display segment, and through the equity method line (Sakai Display Products)). There is no reason to expect this to come back given the equity method line is mid/large size LCD panel price related (commoditized, over-supplied, and losing share to OLED) and the Advanced Display segment still has a largeish reliance on AAPL (where the OLED transition happens for good in 1+ yrs)

- Smart Home profits includes domestic consumer electronics (especially handsets) which have been surprisingly profitable the last 2yrs but either stops growing or goes down due to new handset pricing rules, as well as the overall glut of smartphones affecting developed markets globally

- Sharp suggested they would continue to buy back the pref shares - which effectively just levers the balance sheet again. Since they are still 1.1x net debt/equity levered today (and around 2.6x net debt/EBITDA), while still basically burning cash, I don't see how an equity offering isn't back on the table again in the next 1.5yrs (probably sooner)

- they missed guidance by a mile (84bn OP vs 107bn guidance) meaning new guidance for FY20 (100bn) should really be taken with a grain of salt.

Optically, the stock doesn't look too expensive on P/E (around 10x) but with the still substantial leverage, capex needs well ahead of depreciation, and the likely need to delever the balance sheet (again) in the near-term I think the stock keeps going down.

It is also worth mentioning that Terry Gou (HH founder/major owner of Sharp) is running for Taiwan presidency; I am not sure of the implications but it seems an added political risk given the majority stake in Sharp (leading perhaps to pressure to dispose of enough shares to go below 50% ownership).

The stock is still around 2x book value and (I think) sustainably unable to generate FCF. I have reinitiated a modest short position.

Subject retiring prefs with cash = this is a levered POS again w impairment risk
Entry 06/12/2019 09:44 AM

Member puppyeh
some companies never learn. as expected, Sharp announced the purchase of the remaining class A shares for cash (97bn). this leaves the entity with pro-forma net debt of ~480bn, well in excess of book value (370bn), and more than 5x operating profits. recall Sharp is still burning cash and the outlook on most of their segments isn't great..so I still really like this as a re-short opportunity, both because I expect them to try to delever through the equity markets in the next 12mos, and also because of the increasing risk of impairment losses on the Sakai Display Products stake (held in equity investments). this could be marked somewhere in the 50bn range and is facing many of the issues JDI is suffering from (transition to OLED, declining LCD demand, technological obsolescence), and has recently turned loss-making in the last few quarters after a multi-year rebound. as the environment remains tough, this could precipitate a large impairment, which, combined with the potential for a large amount of stock to enter the market in the next year (at least 100-150bn if they do a deal, in my view), means this should do well as a Japan funding name over the next 12mos.

Subject q1 update - weak
Entry 08/01/2019 05:10 AM
Member puppyeh
Fairly weak print. YoY declines in all segments except ICT (the acquired Toshiba Dynabook PC biz, not exactly high quality). Some of the more pressing issues:

- operating profits fell 40% YoY and while FY f'cast wasn't changed, it looks extremely difficult to contemplate how they get close to 100bn this yr (I am at 85bn)

- with the buyback of the prefs, leverage is up dramatically (around 200% debt/equity now), highest it has been in many years...

- inventory levels relative to monthly sales (1.6x) are the highest they have been in 4yrs (and lower quality too now with the consolidation of Dynabook)

- they reshuffled reporting segments AGAIN (third time in last 4yrs I believe), to hide (I think) the ongoing deterioration of LCD/device earnings within the new '8K' segment

- they are still burning cash - despite capex falling below D&A for the 5th consecutive quarter (and guiding capex below D&A for the whole yr)

With the OLED transition at Apple likely to happen fully next year; more of the business transitioning to very low value/structurally challenged segments (Dynabook, etc); and the likely consolidation of Sakai Display; and the insane leverage the company is now running, I think it is just a matter of time until the company is forced to do a very dilutive further stock offering. Optically this co trades at ~10x P/E but with no growth, the leverage and no cash generation it still seems a walking disaster waiting to happen...again.