

THOMSON REUTERS

FINAL TRANSCRIPT

Q1 2017 Semiconductor Manufacturing International Corp
Earnings Call

EVENT DATE/TIME: 05/11/2017 08:30 AM GMT



CORPORATE PARTICIPANTS

En-Ling Feng *Semiconductor Manufacturing International Corporation - VP of IR*

Gareth Kung *Semiconductor Manufacturing International Corporation - EVP of Investment, Strategic Business Development & Finance and Company Secretary*

Haijun Zhao *Semiconductor Manufacturing International Corporation - CEO*

Tzu-Yin Chiu *Semiconductor Manufacturing International Corporation - Vice Chairman and Advisor*

Yonggang Gao *Semiconductor Manufacturing International Corporation - CFO, EVP of Strategic Planning and Executive Director*

CONFERENCE CALL PARTICIPANTS

Charlie Chan *Morgan Stanley, Research Division - Technology Analyst*

Chi Keung Hui *Huatai Financial Holdings (Hong Kong) Limited, Research Division - Analyst*

Donald Lu *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Gokul Hariharan *JP Morgan Chase & Co, Research Division - Head of Taiwan Equity Research and Senior Tech Analyst*

Leping Huang *China International Capital Corporation Limited, Research Division - Analyst*

Maurice Chow

Michael Chou *Deutsche Bank AG, Research Division - Semiconductor Analyst*

Randy Abrams *Credit Suisse AG, Research Division - MD and Head of Taiwan Research in the Equity Research Department*

Rick Hsu *Daiwa Securities Co. Ltd., Research Division - Head of Regional Technology and Head of Taiwan Research*

Sebastian Hou *CL Securities Taiwan Company Limited, Research Division - Research Analyst*

Stefan Chang *Maybank Kim Eng Holdings Limited, Research Division - Research Analyst*

Steven C. Pelayo *HSBC, Research Division - Regional Head of Technology Research, Asia-Pacific*

Bill Lu *UBS Investment Bank, Research Division - MD and Asia Semiconductors Analyst*

PRESENTATION

Operator

Welcome to Semiconductor Manufacturing International Corporation's First Quarter 2017 Webcast Conference Call. Today's conference call is hosted by Dr. TY Chiu, Vice Chairman; Dr. Haijun Zhao, Chief Executive Officer; Dr. Yonggang Gao, Chief Financial Officer; Mr. Gareth Kung, Executive Vice President of Strategic Business Development and Finance and Company Secretary; and Mr. En-Ling Feng, Vice President of Investor Relations.

Today's webcast conference call will be simultaneously streamed through the Internet at SMIC's website. (Operator Instructions)

The earnings press release is available for download at www.smics.com. Webcast playback will also be available approximately 1 hour after the event.

Without further ado, I would like to introduce to you Mr. En-Ling Feng, Vice President of Investor Relations for the cautionary statement.

En-Ling Feng *Semiconductor Manufacturing International Corporation - VP of IR*

Thank you. Good morning and good evening. Welcome to SMIC's First Quarter 2017 Earnings Webcast Conference Call. For today's call, our Vice Chairman, Dr. TY Chiu, will make a few comments first; then our CEO, Dr. Haijun Zhao will provide some business remarks. Afterwards, our CFO, Dr. Gao Yonggang will highlight our financial performance and give guidance on the next quarter. Then, our Executive VP of Strategic Business Development, Finance, and Company Secretary, Mr. Gareth Kung, will give the detailed financial commentary. This will then be followed by our Q&A session.

As usual, our call will be approximately 60 minutes in length. The earnings press release and the quarterly financial presentation are available for you to download at our website under Investor Relations in the Events and Presentations section.

Let me also remind you that the presentation we'll be making today includes forward-looking statements. These statements and other comments are not guarantees of future performance but represent the company's estimates and are subject to risk and uncertainty. Our actual results may differ significantly from those projected or suggested in any forward-looking statements. For a more complete discussion of risks and uncertainties that could impact our future operating results and financial condition, please see our filings and submissions with the U.S.



Securities and Exchange Commission and the Hong Kong Stock Exchange Limited, including our annual report on Form 20-F filed with the U.S. Securities and Exchange Commission on April 27, 2017.

During the call, we will make reference to financial measures that do not conform to generally accepted accounting principles, GAAP. These measures may be calculated differently than similar non-GAAP data presented by other companies. Please refer to the tables in our press release for a reconciliation of GAAP to the non-GAAP numbers we will be discussing. Please note that all currency figures are in U.S. dollars, unless otherwise stated.

I would now turn the call over to our Vice Chairman, Dr. TY Chiu, for some opening comments.

Tzu-Yin Chiu Semiconductor Manufacturing International Corporation - Vice Chairman and Advisor

Thank you, En-Ling. Greetings to everyone. As most of you are aware, SMIC yesterday announced that I have stepped down as CEO. Dr. Haijun Zhao, as nominated by me, was appointed by the board as the new CEO to take the company forward. This is a tough personal decision for me, but my family commitments have called for me to devote more time to them.

Although I no longer serve in an executive capacity with SMIC, I continue to serve on the board as Vice Chairman and a Non-Executive Director, and I will continue to contribute to SMIC's future growth and success.

It was an honor to lead the SMIC team in transforming the company these last 6 years. Challenges were many, but as a team, we have overcome those challenges. We improved our product portfolio, tightened factory operations, raised the fab utilization, strengthening our financial position and earning the respect from our stakeholders. SMIC is now well positioned as a leading player in the global foundry market. I'm extremely proud of our team's achievement as well as thankful to their dedication.

Now as we move on to our next chapter of growth, the opportunities and challenges in front of us are still many, but both the board and I are highly confident that under Haijun's leadership the SMIC team can continue to deliver outstanding results for the benefit of all stakeholders.

Since joining SMIC 7 years ago, Haijun has been an invaluable leader and is critical part of the team which brought about transformation in these past few years.

Haijun joined SMIC in October 2010 and has moved quickly through the company's rank. In April 2013, he became of the Executive VP and Chief Operating Officer. And in July 2013, he also assumed the role of General Manager of SMNC, our joint venture in Beijing, which has been the most significant investment made by SMIC in recent years.

I believe in Haijun and his energetic leadership that he will continue to lead the company as a global, professionally managed and independent company. In the meantime, I'll stay full time to support Haijun and ensure a smooth and seamless transition.

Over the last 6 years, we have strived to improve our management system and have come to cultivate very strong teamwork. Now we benefit from outstanding management team with a diverse range of experienced leaders and thousands of dedicated employees. This is a perfect time to make the handover and transition.

I will now have the call over to Haijun for Q1 results and business remarks.

Haijun Zhao Semiconductor Manufacturing International Corporation - CEO

Thank you, TY. Greetings to all listeners, and thank you for joining us. I'm increasingly honored to have this opportunity to lead the SMIC team at this exciting moment in our history. I would like to thank TY for his guidance and mentorship. I look forward to continuing working with SMIC team as we continue to enhance our competitive position in the foundry market. As a global and independent foundry player, we are committed to delivering results, benefiting our shareholders, customers and employees.

Now to address SMIC's business, I will highlight our quarterly performance, the challenges we are facing, how we are confronting these challenges, our long-term opportunities, the preparation for continued long-term sustainable growth.



In the face of seasonal weakness and our customers' transitions, our team delivered a good quarter with decent year-on-year growth, improved operating income and a record-high EBITDA in Q1 2017.

Revenue grew 25% year-on-year, representing a sequential decline of 2.7%. Gross margin was 27.8% compared with 24.2% in Q1 last year and 32 -- 30.2% Q4 last year. Operating profit grew 17% year-on-year and 57.9% quarter-over-quarter.

Consolidated net profit was [\$64.2 million], an increase of 24.1% year-on-year and 10.6% quarter-over-quarter. Net profit attributable to SMIC was at \$69.8 million compared to \$61.4 million in Q1 last year and \$104 million in Q4 last year. EBITDA was a record high of \$312.4 million, an increase of 42.8% year-on-year and 13.9% quarter-on-quarter and representing an EBITDA margin of 39.4%.

In the first half of 2017, we are confronting the challenges of customer undergoing changes in the market positioning, seasonal inventory adjustment and overall muted handset market in China. As such, we have guided Q2 to decline 3% to 6% quarter-on-quarter, which, however, represents an increase of 17.5% to 21.3% year-on-year. We have actively pursued new incremental revenue from a variety of customers in the market to mitigate the impact of such headwinds.

In the first quarter of 2017, from a technology node perspective, 28-nanometer and 55-nanometer wafer revenue sequentially grew 39% and 9.1%, respectively. By application, smartphone weakness was countered by growth in feature phones, tablets and other consumer applications. We continue to ramp up 28 nanometer, 55 nanometer and additional products on 8-inch wafers.

From a device perspective, we are pursuing growth in areas where we are seeing meaningful demand, such as NOR Flash, RF/connectivity, Power IC and others. We acknowledge this year is challenging but remain confident in SMIC's long-term potential and opportunities. We believe we are in a great position, both strategically and financially, to weather this cyclical downturn and benefit from some exciting future trends.

We strongly believe SMIC is in a great position to benefit from an array of long-term trends, and today, I'd like to highlight the market opportunities in automotive and the Internet of Things.

LFoundry serves us a platform for SMIC, providing a more significant presence in the auto and industrial sector and has opened opportunities for collaboration in the future, both in Europe and in China. Since the acquisition of LFoundry, SMIC has become the market leader in auto-related CIS. In addition, situated in China, the largest market for auto, [IC design companies] have the incentive to explore ways to break into the supply chain, and SMIC may benefit from this in the long term.

IoT is another exciting area. As an example, one of our domestic customers recently reported 1 billion shipments of IoT-related chips, for which SMIC is their primary supplier. Some IoT chips manufactured by SMIC are being utilized in everyday items such as shared bicycles. There are reportedly millions of shared bikes in China, and they are growing exponentially and branching into international markets. Shared bikes are just one example of IoT chips applied in China, and we believe this is only the beginning. We are excited to be part of this trend.

In the last 2 years, utilization was running close to 100%, which, inadvertently, made juggling production and R&D requirements a challenge. We are currently taking advantage of the low fab utilizations to accelerate the R&D program for both advanced and mature nodes. The turnaround time for R&D project has accelerated. R&D-related wafer moves more than tripled in Q1 this year compared to Q1 this last year. We believe these activities are vital to the company's long-term sustainable profitability and growth.

Our 28 nanometer is ramping up and reached 5% of the wafer revenue in Q1, representing a growth of 39% Q-on-Q. We continue to work with our customers on 28-nanometer new tape-outs for a diverse set of applications. Going forward, we believe we will see an increasing variety of applications requiring this line-width.

The R&D activities on 14 nanometer also well underway and on track.

On larger nodes, we continue our efforts in diversification and the differentiation of technology. In addition to new technologies, we are working hard on the next generation for a range of existing technologies, such as PMIC, CMOS image sensors and the nonvolatile memory.

We are also well positioned financially. We have more than \$2.1 billion cash on hand, including financial assets as of the end of Q1. In addition to stronger liquidity, we completed the conversion of our convertible bonds in March this year. We believe that the company has adequate funding to finance our near-term capacity expansion.

To conclude my remarks, SMIC is well positioned to meet the challenges of this year. We are optimistic about the long-term prospects and continue to work hard in preparing the right technologies and a strategic path to grow the company profitably.

Thank you to our loyal customers, supporting investors, hard-working employees and other dedicated stakeholders.

I now hand the call over to Yonggang for the financial highlights and the next quarter guidance.

Yonggang Gao *Semiconductor Manufacturing International Corporation - CFO, EVP of Strategic Planning and Executive Director*

Okay. Thank you, Haijun. Greetings to all our listeners. First, I will highlight our first quarter 2017 results and then will give our second quarter 2017 guidance. Now I will highlight our first quarter 2017 results.

Our revenue was \$793 million. Gross profit was \$221 million. Gross margin was 27.8%. Profits for the period attributable to SMIC were \$70 million.

Now looking ahead into the second quarter of 2017. Our revenue is expected to decline by 3% to 6% quarter-on-quarter. Gross margin is expected to range from 25% to 27%. Non-GAAP operating expenses are expected to range from \$178 million to \$184 million. Noncontrolling interests of our majority-owned subsidiaries are expected to range from positive \$6 million to positive \$8 million, which are losses borne by noncontrolling interest.

I will now hand the call over to Gareth for more detailed financial commentary.

Gareth Kung *Semiconductor Manufacturing International Corporation - EVP of Investment, Strategic Business Development & Finance and Company Secretary*

Thank you, GaoZong. And thank you, everyone, for joining us today. I will now comment on the details of our last quarter financial results.

On the income statement, revenue decreased by 2.7% Q-on-Q to \$793 million, mainly due to decreased shipments and change in the product mix. On a year-on-year basis, our revenue in Q1 2017 still increased 25%.

Gross profit was \$221 million. Gross margin was 27.8%, at the high end of our guidance range.

Operating expenses decreased to \$143 million in Q1 2017.

R&D expenses decreased by \$10.5 million Q-on-Q to \$108 million. The change was mainly due to high level of R&D activities in Q4 2016.

Funding of R&D contracts from the government was \$14 million in Q1 2017.

G&A expenses decreased by \$22 million to \$39 million in Q1 2017. The change was mainly due to a decrease of accrued employee bonus.

Excluding the effect of employee bonus accrual, government funding and gain from disposal of living quarters, non-GAAP operating expenses were \$165 million in Q1 2017.

Profit from operations was \$77 million. Operating margin was \$9.8 million.

Profit for the period attributable to SMIC was \$70 million, while noncontrolling interests were \$6 million of credit to SMIC's attributable profit.

If excluding the impact of the finance cost, depreciation and amortization and income tax benefits and expenses, our EBITDA was a record high of \$312 million, and EBITDA margin of -- EBITDA margin was 39.4% in Q1 2017.

Moving to the balance sheet at the end of the first quarter 2017. Cash and cash equivalents plus other financial assets were \$2.1 billion.

Our net debt decreased to \$663 million at the end of Q1 2017 because of the conversion of \$404 million CB into common equity during the quarter.

At the end of Q1 2017, our gross debt-to-equity decreased to 47%. Our net debt-to-equity decreased to 11%.

In terms of cash flow, we generated \$147 million of cash from operating activities. Cash used in investing activities was \$849 million. Cash from financing activities was \$126 million.

To examine our revenue by application. Communication, consumer and computing segments contributed 46%, 37% and 6% of our revenue, respectively.

From Q1 onwards, we split -- we also highlight our auto industrial segment to increase -- to improve our transparency. The auto industrial segment contributed 6.6% of revenue in Q1 2017.

Geographically, revenue from China, North America and Eurasia contributed 47%, 38% and 15% of revenue, respectively.

In terms of technology. Revenue from [28 nanometer] (corrected by company after the call) contributed 5%; revenue from 40/45 nanometers contributed 20%, and revenue from 55/65 nanometers and 90 nanometers contributed 22% and 1.3%, respectively.

Meanwhile, 0.11 micron and above line widths contributed 51.7% of wafer revenue.

In terms of our overall capacity, total monthly capacity at the end of first quarter increased to 422,000 8-inch equivalent wafers per month. The increase was primarily due to the capacity expansion in our Beijing 300-millimeter fab and the majority-owned Beijing 300-millimeter fab.

We reiterate our planned 2017 CapEx for foundry to be approximately \$2.3 billion, of which about \$900 million is expected to be spent for the expansion of our joint venture fab in Beijing. The planned 2017 CapEx for nonfoundry operations are approximately \$70 million, mainly for the construction of employee living quarters. Our planned 2017 depreciation and amortization is approximately \$1 billion. So it's down from the previous forecast of \$1.1 billion due to some delays in the move-in scheduled for some equipments.

En-Ling Feng Semiconductor Manufacturing International Corporation - VP of IR

Thank you, Gareth. We would now like to open up the call for Q&A. (Operator Instructions) Operator, please assist.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Randy Abrams from Credit Suisse.

Randy Abrams Credit Suisse AG, Research Division - MD and Head of Taiwan Research in the Equity Research Department

First, I want to congratulate Dr. Chiu on the work you've done, and best of luck. And also look forward to working with Dr. Zhao. I wanted to ask the first question on the growth outlook. I think you've targeted over the long term 20% year-over-year growth, maybe in light of the headwinds from mobile and inventory, your updated view for this year. And if you could give an initial view on second half, just your



Gareth Kung Semiconductor Manufacturing International Corporation - EVP of Investment, Strategic Business Development & Finance and Company Secretary

We are still keeping the CapEx guidance for this year, \$2.3 billion, but I think there's some changes in the timing for some moving of some equipment. So that have slightly impacted our depreciation schedule, yes.

Operator

Your next question comes from the line of Steven Pelayo from HSBC.

Steven C. Pelayo HSBC, Research Division - Regional Head of Technology Research, Asia-Pacific

I was reviewing the annual report for last year that came out a few weeks ago, and it showed 2 of your top customers represented roughly 2/3 of the incremental dollar growth, and I think if you excluded the LFoundry acquisition maybe more than 75% of the incremental dollar growth last year, so it was a very concentrated growth year. I guess as you look out to 2017, what's your outlook for kind of these top customers? And do you see a much more expanding breadth that's going to allow to drive this double-digit growth you're looking at this year?

Gareth Kung Semiconductor Manufacturing International Corporation - EVP of Investment, Strategic Business Development & Finance and Company Secretary

Steve, actually, if you tracked our performance in the last few years, our top 5 customers consistently contribute about 55%, 60% of revenue. Of course, among the top 5 there's some changes in the ranking for different customers, okay? So what I'm trying to say is that our major customer all have been having engagement with us for a long, long time, okay, but their own performance will vary from year-to-year, okay? So I don't think our customer concentration is a big issue, I mean, if you look at our performance historically. Although, note individual customer performance may vary, but overall, I think our overall customer concentration remains more or less the same.

Steven C. Pelayo HSBC, Research Division - Regional Head of Technology Research, Asia-Pacific

Okay. And then, maybe just a longer-term question maybe for Dr. Zhao. Are things changing, I guess, with the management change in terms of strategy longer term? Are you looking to maybe accelerate maybe some development and move to 14 nanometer and beyond as well? I'm curious just kind of the longer-term strategy, does it change with management shifts as well?

Haijun Zhao Semiconductor Manufacturing International Corporation - CEO

Thanks, Steve, and thank you for the question. Basically, we should say this way, just now Dr. Chiu addressed the transition. And I have been one of the key members of this team under the leadership of Dr. Chiu, and I really believe that the strategy in the past 6 years we formed, and we already verified proof that the strategy works very well for SMIC. And I will continue to focus on the careful expansion of existing facilities and everything; more likely that we'll stick to the successful strategy. I won't make drastic change. And with the new challenges like 14 nanometer and moving to even smaller dimensions, that's the area we like to enhance. From the introduction by Dr. Chiu, we also mentioned that SMIC will go for a smooth transition. And in the meantime, we'll go for very steady technology we already in practice in the past few years. So in other words, we'll stick to the existing strategy. We will not make a change, at least we do not make a drastic change in the near term. And in the meantime, we have to cope with the new challenges, both in-line and on the technology front end. So we have to make sure that we have stronger technology competition and we have a lot of scale of capacity to serve our customers. And that's the balance, and we already tried this balance very well in the past many years, and we will continue that.

Steven C. Pelayo HSBC, Research Division - Regional Head of Technology Research, Asia-Pacific

Okay. Maybe I can just follow up and related to Randy's question and that question. Do you have some targets for your 28 nanometer? How much do you think it contributes to the fourth quarter this year? And then maybe as you look to maybe end of next year, what does 28 nanometer or even 14 nanometer start to contribute?

Gareth Kung Semiconductor Manufacturing International Corporation - EVP of Investment, Strategic Business Development & Finance and Company Secretary

I think our target is still the same. We're still looking at high single-digit contribution by Q4 this year.

Steven C. Pelayo *HSBC, Research Division - Regional Head of Technology Research, Asia-Pacific*

And do you have 14-nanometer revenue next year? Or is that more 2019?

Gareth Kung *Semiconductor Manufacturing International Corporation - EVP of Investment, Strategic Business Development & Finance and Company Secretary*

Right now for 14 nanometers, we are looking to start risk production in the 2019 time frame. Yes.

Operator

Your next question comes from the line of Gokul Hariharan from JPMorgan.

Gokul Hariharan *JP Morgan Chase & Co, Research Division - Head of Taiwan Equity Research and Senior Tech Analyst*

A couple of questions that I had. And first of all, congrats, Dr. Chiu, and welcome, Zhao. I wanted to ask, when you reiterate your long-term growth outlook of 20%, could you now attach some kind of a profitability metric also to that? Are we expecting the EBITDA margins also to stay in this high-30s kind of levels when you kind of go towards that kind of 20% growth target? And how do we manage that growth between your very successful investments that we have seen and in the older nodes versus your recently ramped-up efforts in terms of growing a little bit more faster towards the advanced nodes?

Gareth Kung *Semiconductor Manufacturing International Corporation - EVP of Investment, Strategic Business Development & Finance and Company Secretary*

Yes. With the challenges that we face this year in terms of growth, right now we're looking at our gross margin guidance average for the whole year. We'll target about mid-20s. In terms of our EBITDA margin, we still target a high 30 EBITDA margin. Because at the same time, we're also managing this downturn with very strict -- tight control over our cost. So actually, we also review all the expenses in the -- both in the fab and also in the back office to make sure that our cost structure's in line with the new growth scenario.

Gokul Hariharan *JP Morgan Chase & Co, Research Division - Head of Taiwan Equity Research and Senior Tech Analyst*

Okay. And on the near-term stuff, could you talk a little bit about -- I think you've talked previously about 8 inch potentially having a pretty long backlog of customers. How does the backlog look like right now given that the in-demand environment seems to have changed quite a bit? And could you also talk about what is your outlook in terms of requalifying some of these fabs for new customers, your accommodated backlog and when do we kind of expect to get back to near full utilizations on 8 inch?

Gareth Kung *Semiconductor Manufacturing International Corporation - EVP of Investment, Strategic Business Development & Finance and Company Secretary*

Yes, obviously -- no, the overall business environment is sort of more challenging now. So that was [also] impact 8-inch business as well. Backlog is obviously not as long as last year. But we still qualified a lot of new products in 8-inch business, and we are hopeful that some of this new product will start ramping in the second half. At the same time, as you know, through our foundry, we have entered into the auto CIS business, and that business growing very strong.

Gokul Hariharan *JP Morgan Chase & Co, Research Division - Head of Taiwan Equity Research and Senior Tech Analyst*

Okay. Understood, understood. Just one last question. Just to give -- get more granularity on your 28 comments. Is there any change in terms of the 28 capacity addition plans through the end of the year? And could you also talk a little bit about how many 28-nanometer tape-outs that you are -- that you currently have on hand?

Haijun Zhao *Semiconductor Manufacturing International Corporation - CEO*

Yes, Gokul, thank you. For 28-nanometer capacity expansion, more or less we stick to the original forecast. And we do see the demands are still very strong for this long technology nodes, so called. And we do have both the overseas and the domestic customers are working on this technology nodes with SMIC. We see mainly 2 parts. One part comes from the 40 nanometer and the transition for the year -- existing product transit to 28 nanometer, so the capacity for 28 nanometer keep getting higher. And the second thing that we do see and the new applications for 28 nanometer, they use this technology from other parts. For example, RF, SOC and this kind of showing up for the 28-nanometer capacity. So my comment is that for 28-nanometer capacity expansion, we'll will more likely stick to the original forecast. We still have strong expectation on these technology nodes for growth.



Gokul Hariharan *JP Morgan Chase & Co, Research Division - Head of Taiwan Equity Research and Senior Tech Analyst*

Do you have any details on the number of tape-outs that you have? Or is it too few to kind of disclose at this point?

Haijun Zhao *Semiconductor Manufacturing International Corporation - CEO*

I'm afraid I can't disclose.

Gareth Kung *Semiconductor Manufacturing International Corporation - EVP of Investment, Strategic Business Development & Finance and Company Secretary*

Yes, we don't usually disclose such a detailed information.

Operator

Your next question comes from the line of Charlie Chan from Morgan Stanley.

Charlie Chan *Morgan Stanley, Research Division - Technology Analyst*

So first of all, I want to thank for contribution from Dr. Chiu over the past 6 years. And we look forward to the new leadership from Dr. Zhao, and we hope all the transition will be very smooth. So my first question is regarding your 8' business because you mentioned that this year demand is a little bit weak. So my question is that whether you consider to fill up the 8' fab with some commodity products, for example, the NOR Flash because as you can see the NOR Flash market price continue to go up? So this is my first question.

Gareth Kung *Semiconductor Manufacturing International Corporation - EVP of Investment, Strategic Business Development & Finance and Company Secretary*

Yes, well, first of all, our NOR Flash run on the 12-inch fabs. It's not an 8-inch fab, okay? But you make a good point that we're also increasing wafer start on some of what we call filler products like the NOR Flash and the NAND Flash to keep our fab at a relatively reasonable utilization. But we do have -- on the 8-inch side, we do have some new product tape-outs, as I said, and that we hope to start ramping in the second half. I mean, we have new products in the BCD area. We have new products in the LED drivers area. These are all exciting large-volume business. So we are hopeful that we can transition this downturn quite successfully.

Charlie Chan *Morgan Stanley, Research Division - Technology Analyst*

Okay. So just a quick follow-up on this one. For the driver IC offering, when do you think there will be some small production?

Gareth Kung *Semiconductor Manufacturing International Corporation - EVP of Investment, Strategic Business Development & Finance and Company Secretary*

I think actually we should start shipping in Q3, my understanding. Yes.

Charlie Chan *Morgan Stanley, Research Division - Technology Analyst*

Okay. And my second question is regarding your depreciation guidance. Because you mentioned that some change of [tool] moving schedule and some impact to the depreciation. So can you give us some numbers? And also I noticed that actually your gross margin holds up quite well in 1Q. And even for 2Q the revenue scale is smaller, gross margin still maintained okay, right? So why do you think the full year gross margin guidance will be only 25%?

Gareth Kung *Semiconductor Manufacturing International Corporation - EVP of Investment, Strategic Business Development & Finance and Company Secretary*



Rick Hsu Daiwa Securities Co. Ltd., Research Division - Head of Regional Technology and Head of Taiwan Research

I think one quick follow-up to the previous question about the 28 nanometer. I think Haijun mentioned about a new product ramp up in commercialization sometime in second half this year for a new customer. Can I know more about this? What kind of application products this ramp-up is going to be about?

Haijun Zhao Semiconductor Manufacturing International Corporation - CEO

Rick, I cannot mention the specific type of product applications, but mainly I have to tell you that on the new technology platform for this 28-nanometer technology currently we're working on 3 fronts: the wireless terminal phase, wireless and consumer. And the first ramp-up, we're -- currently, we are working on the ramp-up it will consumer products, relatively medium size of volume type of a consumer product. But in the meantime, we do working on a phase of wireless that we have multiple tape-outs at this moment to ramp up this consumer products and the phase wireless. (inaudible) [classified] the applications to wireless terminal, fixed wireless and consumer, and we have both the consumer and the fixed wireless. Yes.

Rick Hsu Daiwa Securities Co. Ltd., Research Division - Head of Regional Technology and Head of Taiwan Research

Yes, let me just make sure to get this right. So you mentioned about 3 product platforms for 28 nanometer. One's wireless; the second one is a consumer, which is going ramp up and it's going to happen. And what's the third one?

Haijun Zhao Semiconductor Manufacturing International Corporation - CEO

Consumer. The wireless terminal, fixed wireless and consumer. More likely we classify it this way. That's the things I can share with you.

Rick Hsu Daiwa Securities Co. Ltd., Research Division - Head of Regional Technology and Head of Taiwan Research

Okay. One more question is in the fingerprint space -- the fingerprint foundry space. Can you talk about your diversification? Are you diversifying into new customers in this platform? And if so, when are we going to see the real benefit from this diversification?

Gareth Kung Semiconductor Manufacturing International Corporation - EVP of Investment, Strategic Business Development & Finance and Company Secretary

Yes, we are diversifying. We have new customer engagement in the fingerprint areas, and we plan to start to ramp up in the second half.

Operator

Your next question comes from the line of Ken Hui from Huatai.

Chi Keung Hui Huatai Financial Holdings (Hong Kong) Limited, Research Division - Analyst

So in terms of the full year outlook, you talked about the revenue, you talked about the gross margin. Can you also give us some guidance in terms of the expenses? Because it seems like the first half it is actually growing faster than the revenue. That's my first question.

Gareth Kung Semiconductor Manufacturing International Corporation - EVP of Investment, Strategic Business Development & Finance and Company Secretary

Yes. That's right. If you look at our normalized CapEx -- normalized OpEx, Q1 is about 21%. So we try to target to keep control of this normalized OpEx in the low 20s for the rest of this year.

Chi Keung Hui Huatai Financial Holdings (Hong Kong) Limited, Research Division - Analyst

So can I get more details regarding the reason for the increasing OpEx? Is it because of the 28-nanometer new tape-outs or the 14 nanometer or even the new 8-inch [order] that you need to develop in order to fill the fabs? Or other (inaudible).

Gareth Kung Semiconductor Manufacturing International Corporation - EVP of Investment, Strategic Business Development & Finance and Company Secretary

Yes, in general we're still increasing our R&D spending. Obviously, we are looking at many version of 28 right now. At the same time, 14-nanos R&D is well on the way. And as a matter of fact, given the fact that right now our fabs are actually -- the loading has come down. And we also take advantage of this opportunity to accelerate the R&D activities so that we'll be better positioned for growth in the near term. Yes.

utilization rate is low, so you're desperate for the new business? Or you're getting -- you see this as good opportunity so you getting to there? So what's the long-term strategy of your -- I mean the product commitment? And who's your customer here? And how do you see the NOR Flash business to grow for the second half of this year into next year?

Gareth Kung Semiconductor Manufacturing International Corporation - EVP of Investment, Strategic Business Development & Finance and Company Secretary

Okay. I think this is not a [hot] strategy. It's not that hot because -- things like that, so we started to do NOR. I think this is a well-planned strategy that we have. This node -- we know that industry go through cycles. So actually under Dr. Chiu's leadership, we have [replanned] for some of what we call filler products to include the NOR Flash and some of the NAND Flash products. Okay? So as we enter into a downturn in industry, I think we are able to have some product we can actually fill the fabs to maintain a stability in the loading for the fabs. So I think this is well-planned and well-executed strategy.

Tzu-Yin Chiu Semiconductor Manufacturing International Corporation - Vice Chairman and Advisor

Let me add a little bit. This strategy was also employed in the previous -- when we had some -- deal with weakness inventory adjustment in the market, this exact strategy was used to really ensure good continuous business and good loading in the fab.

Operator

Your next question comes from the line of Stefan Chang from Kim Eng Maybank.

Stefan Chang Maybank Kim Eng Holdings Limited, Research Division - Research Analyst

Most of the questions are already answered, but I just have one follow-up regarding the operating expense. You just previously indicated the normalized operational target for this year is low 20s. But may I follow up with more details about what is your expectation of the R&D subsidy? And also, if possible, can you provide an expectation on this for both Q2 and full year? And also for the full year NCI can you also advise us if you have any preliminary expectation at the current time?

Gareth Kung Semiconductor Manufacturing International Corporation - EVP of Investment, Strategic Business Development & Finance and Company Secretary

Yes, in terms of the government funding for R&D contracts, right now, we are targeting about \$75 million to \$80 million for this year. And in terms of the -- I think the NCI we are looking at -- will continue to be a credit to our income statement in the next 3 quarters.

Stefan Chang Maybank Kim Eng Holdings Limited, Research Division - Research Analyst

Okay. Understood. So just to clarify, so when you indicate about low 20s of operating expense ratio for this year target, that's already after you consider government R&D funding. Is this the case?

Gareth Kung Semiconductor Manufacturing International Corporation - EVP of Investment, Strategic Business Development & Finance and Company Secretary

No. No. Our normalized OpEx excludes the R&D funding. Yes.

Operator

Your next question comes from the line of Bill Lu from UBS.

Bill Lu UBS Investment Bank, Research Division - MD and Asia Semiconductors Analyst

First of all, I also want to congratulate Dr. Chiu for a job well done over the last 6 years I think. We can all see the changes the company has made in terms of technology, financials, et cetera. So thank you very much. And also I want to congratulate Dr. Zhao. Looking forward toward to working more with in the future. A couple of follow-up questions. One is on 28 nanometers. Can you tell us -- can you give us an update on when you are going to ramp High-K Metal Gate?

Haijun Zhao Semiconductor Manufacturing International Corporation - CEO

Okay, Bill. You mentioned a specific name for the 28-nanometer High-K Metal Gate, and actually, for this technology, we have been running -- this High-K Metal Gate 28 nanometer actually has developed into generally 3 versions. And we have been running the first

high-performance metal gate called [CPM] type of standard platforms since last year in low volume, mainly for the learning curve. Another thing is last year and the [I5C5] for the 12 inch has been fully jammed. And so we do not have that much free capacity to give to this new learning. And this year, we continued the ramp-up of this 28-nanometer first version, but we also start to diversification and (inaudible) of the second version. And in the third quarter of this year, we will ramping into the production. Currently, we are on a running on a pilot line case with very small volume for the second version. And to answer your question, 28-nanometer High-K Metal Gate. We'll start to increase the capacity and volume from the third quarter this year. And for the running, we have been running the small volume since last year.

Bill Lu *UBS Investment Bank, Research Division - MD and Asia Semiconductors Analyst*

Okay. So when you mentioned the 3 new products in the second half of this year, those are in fact High-K Metal Gate?

Haijun Zhao *Semiconductor Manufacturing International Corporation - CEO*

I note 3 products, 3 platforms High-K Metal Gate.

Yes, actually the High-K Metal Gate has been divided at a different stage into 3 -- or more than 3 platforms. So they come interchangeable in a certain sense. So what I mean is we have been running in a small volume for the first technology platform since last year. And this year, we're running both that platform on the new platform.

Bill Lu *UBS Investment Bank, Research Division - MD and Asia Semiconductors Analyst*

So how should we think about margins as you ramp up these new platforms? Because I think ASP should be better for High-K Metal Gate. At the same time, there might be some yield improvement initially and a bit of a learning curve. So how do we think about margins in the second half for 28?

Gareth Kung *Semiconductor Manufacturing International Corporation - EVP of Investment, Strategic Business Development & Finance and Company Secretary*

Yes, I think that -- as you rightly pointed out, I think the margin is tied to yield as well as to volume. Okay? So we don't disclose the margin by technology node, but we -- in general, as we increase the volume and production scale, the margins improve.

Bill Lu *UBS Investment Bank, Research Division - MD and Asia Semiconductors Analyst*

Okay. Second follow-up is on what, I guess, we're calling fab fillers in terms of NAND and NOR Flash. Can you give me an idea of how much of total revenues this could be, let's say, by the second half of the year?

Gareth Kung *Semiconductor Manufacturing International Corporation - EVP of Investment, Strategic Business Development & Finance and Company Secretary*

Actually, I will say that I don't have this number on hand, but we will try to get back to you later on. But we are actually increasing the capacity for our NOR Flash and also some of our NAND products right now.

Operator

Your next question comes from the line of Michael Chou from Deutsche bank.

Michael Chou *Deutsche Bank AG, Research Division - Semiconductor Analyst*

I have several follow-up questions. Regarding your High-K Metal Gate, you mentioned Q3 to see ramped up business. Revenue contribution in Q3 or Q4 this year. This is my first question.

Haijun Zhao *Semiconductor Manufacturing International Corporation - CEO*

Michael, just now mentioned that 28-nanometer High-K Metal Gate we have small volume since last year, and we'll ramp up the second version in the third quarter this year and -- because just now we mentioned that we have another version of high-volume mature keep running already committed the capacity to one of the long-term customer there. And we are in the ramp-up in the meantime putting the machines for 28-nanometer High-K. So the High-K for this year I do not expect a very high volume, but they will continue to increase.

Michael Chou Deutsche Bank AG, Research Division - Semiconductor Analyst

So you mean -- maybe you have very limited revenue contribution in the second of this year. Am I, right?

Haijun Zhao Semiconductor Manufacturing International Corporation - CEO

Yes, limited by the existing capacity for the High-K Metal Gate loop. And -- yes, High-K Metal Gate does share most of the common tools with another mature, high-volume production. For the High-K Metal Gate loop, we are putting the machines in.

Michael Chou Deutsche Bank AG, Research Division - Semiconductor Analyst

Okay. Could you give some updates for your 28-nanometer capacity this year? If the maturity of the -- your 28 nanometer should be fully sound this year, could we assume that it could be -- nearly 100% of your capacity will be fully found this year? Or you'll have maybe 5% capacity for High-K Metal Gate this year?

Haijun Zhao Semiconductor Manufacturing International Corporation - CEO

I do not have that number exactly on hand because the sharing of the High-K Metal Gate Loop capacity we also use it for the new platform development for the R&D process. And I do not know that exactly the assurance of how much go to the R&D and how much go to the new products ramp-up.

Gareth Kung Semiconductor Manufacturing International Corporation - EVP of Investment, Strategic Business Development & Finance and Company Secretary

Yes, I think, as what Haijun said, we are trying to pull in the capacity for High-K right now. But some of the -- I think some of the moving schedules is not confirmed, so we cannot have the precise number at this stage. But as you know, originally, most of the capacities will be -- werepolysion, and right now we are increasing the capacity on High-K. Yes.

Michael Chou Deutsche Bank AG, Research Division - Semiconductor Analyst

The other thing is you mentioned before you will use 28 nanometer to do some 40 nanometer. Is that still the planning for this year?

Gareth Kung Semiconductor Manufacturing International Corporation - EVP of Investment, Strategic Business Development & Finance and Company Secretary

As I said, our 40 nanometers -- of course, we are still running 40 nanometers right now, but do -- we are seeing increasingly some of this product will be transitioned to 28.

Operator

Your next question comes from the line of Donald Lu from Goldman Sachs.

Donald Lu Goldman Sachs Group Inc., Research Division - Equity Analyst

First, thank you, TY, for successfully turning around SMIC. And also congrats to Dr. Zhao for becoming the CEO of SMIC in the new era. I think this new era, actually there's both good and bad. The more challenging part is UMC will start 28 production in Xiamen this year, and TSMC will start 16 nanometer in Nanjing. So my question is how -- what is the board and you Dr. Zhao will do differently next year? And how would you compete with those guys? And also, I mean, comparing your comments 6 months ago and today, clearly the demand is a lot worse, which is actually very natural for SMIC. You have very high customer concentration for 28 and 40. And going forward, if you want to grow fast, you -- or you will suffer. Would you or board has a bottom line for ROE in the next few years?

Haijun Zhao Semiconductor Manufacturing International Corporation - CEO

Donald, I just now already mentioned that, like Dr. Chiu addressed this at the beginning, that we won't change strategy drastically. We will continue our strategy, go for very careful expansion of our capacity. And -- but we do have more freedom this year and from now on, we'll continue to do this that we will allocate more capacity to get faster moves for our TD activities. By doing so, I can expect that our R&D progress will be better than before. And just now from so many questions and answers that -- and we will go for 28-nanometer High-K Metal Gate ramp-up third quarter this year, and we are putting machines to expand the capacity for that. So we really want to see a successful

smooth ramping up of 28-nanometer High-K Metal Gate. And in the meantime, for the future technology development, since our strategy has been geared that and we will allocate more capacity and get a faster move for 14 nanometer. We can also see a solid growth on 14-nanometer development.

Gareth Kung Semiconductor Manufacturing International Corporation - EVP of Investment, Strategic Business Development & Finance and Company Secretary

I think in terms of the competition, as we said time and time again, we welcome competition into China. I mean, if you look at our -- our 8-inch business. I mean, UMC and TSMC have built 8' fab in China, almost the same time as we ramped the fab -- SMIC ramped up the 8-inch fab in China. But history have proven to us that SMIC can compete very effectively. We do believe that the China market is still growing nicely. It's big enough to accommodate all this competition. So we are still very confident that we are able -- we will be able to compete very effectively with our competitors.

Donald Lu Goldman Sachs Group Inc., Research Division - Equity Analyst

Okay. Great. Can you give us guidance for free operating cash flow this year and CapEx? And also recently, I think SMIC increased their number of shares, which will give you more flexibility to raise money. Is that something TSMC -- SMIC expects to do in the next 12 months?

Gareth Kung Semiconductor Manufacturing International Corporation - EVP of Investment, Strategic Business Development & Finance and Company Secretary

In terms of the operating cash flow, we are still targeting high 30s EBITDA margin this year. So we will still be generating a lot of cash from operations, which ties to the question that we don't have any plan for any equity or equity-linked financing because we are actually very well funded. We have \$2.1 billion cash on hand, and our net debt-to-EBITDA -- net debt-to-equity is only in 11%. So I think that again highlight the point that SMIC has always been very prepared in terms of withstanding business cycles. I mean, we have been in the business long enough to know that the business is always in cycles, and we always run our business in such a way that at some point in time industry goes through cycles, and SMIC will be able to go through the cycle smoothly.

Operator

Your next question comes from the line of Leping Huang from CICC.

Leping Huang China International Capital Corporation Limited, Research Division - Analyst

I have 2 questions. One is also into the competitive landscape. So you delivered very good growth profile in last 2 years, but we see the -- a lot of foundry built in China supported by either the local government or in the mature (inaudible) and also TSMC and [KT] also come to China. So how you look the competition landscape in China's supply-demand or whether the foundry market in China? And do you think that the way you develop a business, Dr. Zhao, in the next 2 years, how we should -- SMIC sort of look your growth profile in terms of -- and the profitability? And a very general question.

Haijun Zhao Semiconductor Manufacturing International Corporation - CEO

Leping, basically, we will do this way. We believe that the new technology development and the competition will come from the market side. That means SMIC will focus on the market-driven type of technologies. In the meantime, we also set up the baseline. Just now Gareth answered the last question that and -- actually it doesn't make a very, very big difference to set up the wafer fab locations in China and overseas because SMIC is an international company. We've always been working with international customers and domestic customers. So our (inaudible) competition, if there's any, has been there. And we will continue our customer-oriented type of strategy to develop the diversified and the differentiation type of technologies to ramp our wafer fab and go for very careful expansion of our capacities. And this is mainly for the capacity and the technology part. We do not see a very big difference in the scenario after the new foundries are set up in Mainland China. And but we do improved our side, but like probably we have very high utilization. And we do have insufficient allocation to the technology development wafer mode, but we already modified it so that we can deliver things on time and faster. And for the probability type of things, we will continue the successful strategy for the past 6 years, and we will maintain a very careful and solid move for the CapEx spending for the ramp-up speed and for the customer diversifications.



Maurice Chow

High 30s. Just in the second half or for the full year?

Haijun Zhao *Semiconductor Manufacturing International Corporation - CEO*

For the whole year. Yes.

Maurice Chow

For the full year. Okay.

Operator

Thank you. I will now like to hand the call back to CEO, Dr. Zhao, for closing remarks.

Haijun Zhao *Semiconductor Manufacturing International Corporation - CEO*

In closing, I'd like to thank everyone who participated in today's telephone conference call. And again, thank all of our shareholders, customers and employees and the suppliers for their trust and support. Thank you.

Operator

This is the end of SMIC first quarter earnings conference call. We thank you for joining us today.

DISCLAIMER

Thomson Reuters reserves the right to make changes to documents, content, or other information on this web site without obligation to notify any person of such changes.

In the conference calls upon which Event Briefs are based, companies may make projections or other forward-looking statements regarding a variety of items. Such forward-looking statements are based upon current expectations and involve risks and uncertainties. Actual results may differ materially from those stated in any forward-looking statement based on a number of important factors and risks, which are more specifically identified in the companies' most recent SEC filings. Although the companies may indicate and believe that the assumptions underlying the forward-looking statements are reasonable, any of the assumptions could prove inaccurate or incorrect and, therefore, there can be no assurance that the results contemplated in the forward-looking statements will be realized.

THE INFORMATION CONTAINED IN EVENT BRIEFS REFLECTS THOMSON REUTERS'S SUBJECTIVE CONDENSED PARAPHRASE OF THE APPLICABLE COMPANY'S CONFERENCE CALL AND THERE MAY BE MATERIAL ERRORS, OMISSIONS, OR INACCURACIES IN THE REPORTING OF THE SUBSTANCE OF THE CONFERENCE CALLS. IN NO WAY DOES THOMSON REUTERS OR THE APPLICABLE COMPANY ASSUME ANY RESPONSIBILITY FOR ANY INVESTMENT OR OTHER DECISIONS MADE BASED UPON THE INFORMATION PROVIDED ON THIS WEB SITE OR IN ANY EVENT BRIEF. USERS ARE ADVISED TO REVIEW THE APPLICABLE COMPANY'S CONFERENCE CALL ITSELF AND THE APPLICABLE COMPANY'S SEC FILINGS BEFORE MAKING ANY INVESTMENT OR OTHER DECISIONS.

©2017 Thomson Reuters. All Rights Reserved.

