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981.HK - Q4 2016 Semiconductor Manufacturing International Corp
Earnings Call

EVENT DATE/TIME: FEBRUARY 15, 2017 / 12:30AM GMT



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T.Y. Chiu *Semiconductor Manufacturing International Corporation - CEO*

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Steven Pelayo *HSBC - Analyst*

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Leping Huang *CICC - Analyst*

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PRESENTATION

Operator

Welcome to the Semiconductor Manufacturing International Corporation's fourth quarter 2016 webcast conference call. Today's conference call is hosted by Dr. T.Y. Chiu, Chief Executive Officer, Dr. Yonggang Gao, Chief Financial Officer, Mr. Gareth Kung, Executive Vice President of Strategic Business Development, Finance, and Company Secretary, and Mr. En-Ling Feng, Vice President of Investor Relations.

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

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

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

Thank you, Operator. Good morning and good evening. Welcome to SMIC's fourth quarter 2016 earnings webcast conference call. For today's call, our CEO, Dr. T.Y. Chiu, will first provide some general 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 quarterly financial presentation are available for you to download at our website under Investor Relations, in the Events and Presentations section.

Before I turn the call over to Dr. T.Y. Chiu, let me 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 the risks and uncertainties that could impact our future operating results and financial condition, please see our filings and submissions with the US Securities and Exchange Commission and the Hong Kong Stock Exchange Limited, including our annual report, our Form 20-F, filed on April 25, 2016.

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 US dollars unless otherwise stated. Please also note that all 2016 full year figures are based on the summation of the audited quarterly results for the year of 2016.

I will now turn the call over to our CEO, Dr. T.Y. Chiu, for the opening remarks.

T.Y. Chiu - *Semiconductor Manufacturing International Corporation - CEO*

Thank you, En-Ling. Greetings to everyone. We wish every one of you an exciting, prosperous and healthy Year of the Rooster. We just finished another record year in 2016 with great performance and significant business growth. We recorded historical high revenue of \$2.9 billion, an annual revenue growth of 30% over 2015, outpacing the foundry industry average.

Operating profit reached an all-time high of \$340 million, representing 12% operating margin. Net margin was a high of 11% and a net profit attributable to SMIC reached a record high of \$376 million. EBITDA surpassed \$1 billion for the first time, \$1.1 billion to be precise, and we've achieved an improved annual ROE of 9.6% from 7.6% in the previous year.

In terms of significant accomplishments in the last year, we successfully acquired the LFoundry in Italy, thus securing a significant foothold in the auto IC market. I am also proud of the team's quick ramp up of Beijing JV fab, as well as the Shenzhen fab, while maintaining high overall utilization of 97.5% to 2016.

Over the past few years, we continued to improve productivity with an increase of 8.9% last year -- 8.9% revenue per headcount in 2016. In addition, SMIC engaged several dozen new customers and the number of new products to enter risk production increased 50% compared to 2015. In 2016, we also successfully completed 10-to-1 consolidation of our ordinary shares, which we believe has attracted a broader range of investors.

We had another solid quarter in Q4 to wrap up the strong 2016 year. We achieved our eighth consecutive quarter of record high revenue, \$815 million, representing a growth of 33.5% year-over-year and a 5.2% quarter-over-quarter. Our Q4 gross margin was 30.2% and annualized ROE maintained double digits of 10.1%.

28-nano, 40-nano and 0.13 micron drove most of the growth in Q4 2016. 28-nano more than doubled sequentially, contributing 3.5% of our wafer revenue in Q4. 40-nano grew 92% year-over-year and 9.3% quarter-over-quarter and the 0.13 micron grew 103% year-over-year and 21% quarter-over-quarter.

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In this year, we continue to focus on careful expansion of our existing facilities in response to customers' needs, while executing our strategy of keeping a balanced focus on both growth and the profitability. In 2017, we target to maintain a mid- to high-20% growth margin and an EBITDA margin of high 30%.

With regard to key growth driver for 2017, 28-nanometer will be one of the primary contributors to growth: we target 28-nano wafer revenue contributing to reach high single digit contribution by the end of the year on a quarterly basis. We experienced great demand from 40-nano in 2016 and in 2017, we are able to begin to transition some of our 28-nano/40-nano flexible capacity towards 28-nanometer.

Other growth drivers in 2017 include a more diverse variety of mature technologies. This year we expect revenue growth will be from various geographic regions and particular strength from North America based customers. We continue to benefit from our strong position in China, not only the growing domestic fabless industry, but also from international customers, with a desire to capture more content share in China.

In 2017, we expect to increase absolute dollar of R&D spending to low to mid-teens of revenue, the highest as a percentage of revenue amount all major pure play foundries. We continue to follow our technology strategy of diversification and paced advancement, which feed us continuous growth opportunities.

Our R&D spending covers both advanced and specialty technology, allowing our customers a platform for a longer term collaborative roadmap. We are preparing the baseline for diversified technology and we are investing much of our R&D this year on 14nm FinFET, which is in early stage, with the process flow and features defined. SMIC is among the world's top five patent filers for FinFET both domestically and globally.

Meanwhile, given 2016's high utilization of 97.5%, to address the need of more capacity, planned consolidated foundry CapEx of 2017 (corrected by company after the call) is \$2.3 billion, of which about \$850 million is for the Beijing joint venture fab, which will be 49% funded by our joint venture partners. We plan to add an estimated 11% total install capacities to close out 2017 with 450,000 wafers per month, compared to 406,000 at the end of 2016.

In terms of overall annual effective capacity, the planned capacity growth is approximately 25% in 2017 versus 2016. All capacity addition this year will be to our currently running fabs, in addition to the Shenzhen 12-inch fab, which will install a mini line by the year end.

With more than \$2.1 billion cash on hand as of December 2016 and increasing cash generation from operations, we are in excellent position to fund our 2017 CapEx plan. We will continue to expand carefully as we gauge our demand and overall markets.

I would like to take time now to welcome our newest Board members. We welcome Dr. Shang-yi, renowned foundry industry R&D veteran; Dr. Tong Guohua, a distinguished businessman, entrepreneur, chairman and president of Datang; and Dr. Jason Cong, influential professor and a researcher of advanced computing at UCLA. We are very honored to have such prestigious and seasoned experts joining our Board to contribute their valued insight to our Company's vision and direction.

To conclude my remarks, SMIC has delivered excellent performance in 2016 and continues to strive to grow profitably and add value. We reiterate our target of 20% compound annual growth from 2016 to 2019. We have an advantageous position here in China and will continue to work hard to seize opportunities for the benefit of our stakeholders.

In this time of growth, our team strives to perform above par, executing our strategy of differentiation and diversification, serving our customers with excellence and building value through balancing growth and profitability.

We thank you for your continued support and for your time. I will now hand the call over to Yonggang for the financial highlights and 2017 Q1 guidance.



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Yonggang Gao - *Semiconductor Manufacturing International Corporation - CFO*

Thank you, T.Y. Greetings to all our listeners. First I will now highlight our 2016 full year unaudited results, which are based on the summation of our audited quarterly results for the year of 2016 and our fourth quarter 2016 results and we give our first quarter of 2017 guidance.

Revenue in 2016 was \$2.9 billion, a record high compared to \$2.2 billion in 2015. Gross margin in 2016 was 29.2% compared to 30.5% in 2015. Profit for the period attributable to SMIC of 2016 was \$377 million, a record high, compared to \$253 million in 2015.

Net profit margin was 12.9%, a record high, compared to 11.3% in 2015. ROE reached a record high of 9.6% in 2016 compared to 7.6% in 2015. EBITDA reached a record high of \$1.1 billion in 2016 compared to \$0.8 billion in 2015.

Now I will highlight our fourth quarter 2016 results. Our revenue was a record high of \$815 million. Gross profit was a record high of \$246 million. Gross margin was 30.2%. Profit for the period attributable to SMIC was \$104 million.

Now looking ahead into the first quarter of 2017, our revenue is expected to decline by 2% to 4% quarter-over-quarter. Gross margin is expected to range from 25% to 28%. Non-GAAP operating expenses are expected to range from \$158 million to \$164 million.

Non-controlling interest of our majority-owned subsidiaries are expected to range from positive \$6 million to positive \$8 million, which are losses to be borne by non-controlling interests. The planned 2017 CapEx for foundry operations are approximately \$2.3 billion, while the planned 2017 CapEx for non-foundry operations are approximately \$70 million.

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

Gareth Kung - *Semiconductor Manufacturing International Corporation - EVP of Investment and Strategic Business*

Thank you Gao and thank you everyone for joining us today.

I will now comment on the details of the last quarter financial results. On the income statements, revenue increased by 5.2% Q-on-Q to \$815 million, mainly because of an increase in wafer shipments in 4Q 2016, excluding LFoundry and also the revenue contributed by LFoundry. LFoundry only contributed for two months in Q3 2016 whereas it contributed to the full quarter in Q4 2016.

Gross margin was 30.2%, above the guided range, mainly due to product mix change. Operating expenses increased to \$197 in Q4 2016. R&D expenses increased by \$36 million Q-on-Q to \$118 million. The change was mainly due to a higher level of R&D activities. Funding of R&D contracts from the government was \$23 million in Q4 2016.

G&A expenses increased by \$25 million to \$61 million in Q4 2016. The increase was mainly due to accrued employee bonus. Excluding the effect of employee accrued bonus, government funding, and gain from disposal of living quarters, non-GAAP operating expenses were \$193 million in Q4 2016.

Profit from operation was \$49 million. Profit for the period attributable to SMIC was \$104 million, while the non-controlling interests were \$46 million of credit to SMIC attributable profit. The change in non-controlling interest was mainly due to the recognition in Q4 2016 of the contribution to SMIC Group's advanced technology R&D expenses incurred in 2015 by the Company's majority-owned subsidiary in Beijing. If excluding the impact of the finance cost, depreciation and amortization and income tax benefits and expenses, our EBITDA margin was 34% in Q4 2016.

Moving to the balance sheet. At the end of the fourth quarter 2016, cash and cash equivalent increased to \$2.2 billion, if including other financial assets. At the end of Q4 2016, our gross debt to equity ratio was 56%. Our net debt to equity ratio was a healthy level of 16%. In terms of cash flow, we generated \$406 million of cash from operations for the quarter. On a full year basis, we generated \$977 million cash from operations in 2016, compared to \$669 million in 2015. Cash used in investing activities was \$128 million. Cash from financing activities was \$231 million.



To examine our revenue by applications, the communication and consumer segments contributed 44% and 37% of revenue respectively for the quarter. On a full year basis, the communications and consumer segments contributed 48% and 38%(corrected by company after the call) of our revenue respectively in 2016.

Geographically, revenue from China, North America and Eurasia contributed 48%, 33% and 19% of total revenue respectively for the quarter. On a full year basis, revenue from China contributed 50%, North America contributed 29% of total revenue and Eurasia contributed 21%.

In terms of technology, revenue from 28-nanometer contributed 3.5%. Revenue from 40/45-nanometer contributed 23.6%. Revenue from 55/65-nanometer and 90-nanometers contributed 19.8% and 1.6% respectively.

Meanwhile 0.11 micron and above line width contributed 51.5% wafer revenue for the quarter. On a full year basis, revenue from 45-nanometers and below contributed 24%.

In terms of our overall capacity, total monthly capacity at the end of the fourth quarter increased to 406 thousand 8-inch equivalent wafers. The increase was mainly because of the capacity in expansion in our Beijing 300mm fab, as well as our majority-owned fab in Beijing, during the quarter.

The planned 2017 CapEx for foundry operations is approximately \$2.3 billion, of which about \$900 million will be spent for the expansion of a capacity in our majority-owned Beijing 300mm fab. The planned 2017 CapEx for non-foundry operations are around \$70 million, mainly for the construction of employees' living quarters. Our planned 2017 depreciation and amortization is around \$1.1 billion, an increase of about \$380 million year-over-year.

I will now hand the call to En-Ling for Q&A session.

QUESTIONS AND ANSWERS

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

Thank you Gareth. I would now like to open up the call for Q&A. As usual, please be reminded to limit your questions to two per person. Operator, please assist.

Operator

Thank you. Ladies and gentlemen, we will now begin our question and answer session. (Operator instructions) Randy Abrams, Credit Suisse.

Randy Abrams - *Credit Suisse - Analyst*

Okay, yes, thank you, good morning. My first question, I wanted to ask just on the change in guidance from the original expectation to grow in first quarter. Could you talk about how broad-based the slowdown you saw in first quarter or whether it was isolated to a few applications? Then maybe talk about the rebound, if you see it more a matter of new products being qualified or it's the same applications coming back. If you could characterize

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Gareth Kung - *Semiconductor Manufacturing International Corporation - EVP of Investment and Strategic Business*

I think I would add that actually I think the slight correction in Q1 is really in line with what we see in industry. I wouldn't say it's anything specific about SMIC in this regard.

Randy Abrams - *Credit Suisse - Analyst*

Okay, great. I wanted to ask a follow-up question on the margins. Could you go through the factors on the gross margin dipping to 25% to 28%, maybe how much is the depreciation coming in or ramping through the year. And if you could also talk to the impact of now moving some business from 40-nano to 28-nano, if there's any headwind at this stage ramping up 28-nano relative to the mature 40-nanometer. I guess that margin, 25% to 28%, if you think that should be reasonable range through the full year, or any headwind from those factors, depreciation or 28-nanometer.

Gareth Kung - *Semiconductor Manufacturing International Corporation - EVP of Investment and Strategic Business*

Yes. Well, first of all, regarding the dip in the Q1 gross margin, I think there are the two impact here. First of all, you're right to point out the depreciation is affected because we could see about \$30 million increase in the depreciation in Q1 compared to Q4.

And, secondly, as mentioned by T.Y., we're going to see some slight correction in business in Q1. So you're going to see our utilization is going to drop below about 90% in Q1, so that has some impact on the gross margin for sure.

Randy Abrams - *Credit Suisse - Analyst*

Okay, and I guess the follow up, can you maybe give a look as we go through the year, if you improve utilization but then factor in depreciation and 28-nano, if there's a rough feel, for maybe a medium-term or through the year, how gross margins may trend.

Gareth Kung - *Semiconductor Manufacturing International Corporation - EVP of Investment and Strategic Business*

Yes. As I said, let me just clarify. I think we are looking at a utilization of high-80%, close 90% in Q1. For the gross margin for the rest of the year, as mentioned earlier, that we're going to experience I would say an increase in depreciation in 2017, over 2016, to the tune of about \$380 million. And that is in line with the expansion in our fab capacity. We're going to ramp up our fab in Beijing and Shenzhen.

So obviously that will have an impact on our gross margin. But we are still guiding -- I would say we are still targeting a mid- to high-20% gross margin. But, as I say, at this point in time, we don't have a clear picture about 2017, but this is our initial feelings.

Randy Abrams - *Credit Suisse - Analyst*

Okay. And is 28-nano still dilutive, like as you shift from 40-nano to 28-nano, or yields are far enough long that it's less headwind now?

T.Y. Chiu - *Semiconductor Manufacturing International Corporation - CEO*

Our yield has actually been along our expectations. And I think that -- and it's still doing steady improvements. So I think that it should not be a significant drag to our margin. But I think it's just simply the increase in depreciations.



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Randy Abrams - *Credit Suisse - Analyst*

Okay, great, thanks a lot T.Y. and Gareth.

Gareth Kung - *Semiconductor Manufacturing International Corporation - EVP of Investment and Strategic Business*

Thank you.

Operator

Steven Pelayo, HSBC.

Steven Pelayo - *HSBC - Analyst*

Yes, a few questions. First of all, 2017 growth you're talking about 20% year-on-year growth with North America outperforming, so that's roughly one-third of revenues growing faster. Does that mean China underperforms, do you think Eurasia actually can decline? Or when you think about the other regions for 2017, maybe a little bit of color there.

Then also could you comment a little bit on 2017 from a node perspective? With 28-nanometer ramping to, I think you said, high-single digits by the end of the year, does that mean 40-nanometer still grows this year? Help us understand kind of the node outlook for 2017 as well, geographically and by nodes.

Gareth Kung - *Semiconductor Manufacturing International Corporation - EVP of Investment and Strategic Business*

Hey Steve, we commented North America is going to grow quite well in 2017 there for two reasons. First of all, 28-nanometers will be a major growth drivers in 2017. As you know, we have major US customers for the 28-nanometers.

And, secondly, we are For LFoundry. We only consolidated the company for about five months in 2016, and for 2017 there'll be a full-year consolidation. And the customer base are mostly in the North America, so that also contributed to the growth in the US customers.

In terms of the node perspective, I think the major growth, as we can see right now -- of course this is really -- there's not enough visibility to say precisely at this point in time; will be mainly from 28-nanometers, 65-nanometers and 55-nanometers. As well as the growth, as I mentioned, the contribution from LFoundry.

Steven Pelayo - *HSBC - Analyst*

And so 40-nanometer node you think would actually decline year-on-year?

Gareth Kung - *Semiconductor Manufacturing International Corporation - EVP of Investment and Strategic Business*

No, we are seeing the major growth. We still think that the 40-nanometers would remain to be a major node for us.

Steven Pelayo - *HSBC - Analyst*

Okay. And then we struggle to forecast your model here with your operating expense volatility, with R&D credits and some of the other things that go on, property sales and other benefits that you can get through there and then now bonus accruals as well. So could you talk just a little bit more



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-- I know you like to guide excluding those things, but could you talk a bit about including those things? What kind of expectations you have for those in the first quarter, as well as 2017?

Gareth Kung - *Semiconductor Manufacturing International Corporation - EVP of Investment and Strategic Business*

What we've guided in Q1 in terms of the OpEx, we don't think there's any extraordinary items in Q1 that you should be concerned about. In terms of the full-year OpEx guidance, in terms of the normalized OpEx, we're still looking at a high-teens % number relative to the revenue.

The main increase will be in the R&D area, as mentioned by T.Y. We will continue to invest heavily in R&D, but we will continue maintaining very disciplined spending in terms of G&A expenses and sales expenses.

Steven Pelayo - *HSBC - Analyst*

See this is the struggle though, because I think R&D in 2016 was about 13% I think of revenue if I exclude the R&D credits, maybe around 11% including. So I guess on a comparable basis you talked about that, I think, going to the low-teens %, if I remember correctly, of R&D. Is that including or excluding R&D credits? Do you expect R&D subsidies to increase in 2017 and what kind of numbers should we think about?

Gareth Kung - *Semiconductor Manufacturing International Corporation - EVP of Investment and Strategic Business*

Yes, we expect -- right now we are guiding the R&D spending probably in the low-teens % to mid-teens % level, and that is excluding the R&D funding. In terms of the R&D funding for 2016, for the whole year it's about \$52 million.

We expect this number would go up in 2017, maybe close to \$65 million to \$70 million. But this number, as we mentioned earlier, that there's some uncertainties depending on the completion of these R&D projects, as well as the funding availability from the government.

Steven Pelayo - *HSBC - Analyst*

Okay, and then the last line item that I also struggle on is the non-controlling interest line. I guess I'm trying to understand, as this fab ramps up does it ramp up initially where you have more losses and then there's a greater add-back? Or does that number then decrease over time? When you think about that line through 2017 or maybe just on a full-year basis, how do you think that will track this year or contribute this year?

Gareth Kung - *Semiconductor Manufacturing International Corporation - EVP of Investment and Strategic Business*

So, first of all, the Q4 number, in terms of the contribution from the non-controlling interest, was high because of this sharing out expenses with our majority-owned subsidiary in Beijing. That part contribute about \$29 million for the quarter. So actually, if you remove that number, actually the number is quite consistent quarter-on-quarters. Right now we are still looking at similar number in 2017, yes.

Steven Pelayo - *HSBC - Analyst*

I'm sorry, similar every quarter, that's \$7 million to \$8 million I think is what you guided --

Gareth Kung - *Semiconductor Manufacturing International Corporation - EVP of Investment and Strategic Business*

Yes, that's right.



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Steven Pelayo - HSBC - Analyst

-- \$6 million to \$8 million per quarter. Okay.

Gareth Kung - Semiconductor Manufacturing International Corporation - EVP of Investment and Strategic Business

Yes, that's right.

Steven Pelayo - HSBC - Analyst

Okay, excellent. Alright, I'll get back in the queue, thank you.

Operator

Roland Shu, Citigroup.

Roland Shu - Citigroup - Analyst

Yes, thanks for taking my question. First question is can you repeat the overall capacity increase number this year?

Gareth Kung - Semiconductor Manufacturing International Corporation - EVP of Investment and Strategic Business

Just give me a second. The increase in the capacity for 2017, we are looking at an annualized capacity increase of about 25%. And then on a year-end basis, the increase is about 11%.

Roland Shu - Citigroup - Analyst

So year-end means year-end compared with year-end in last year, right?

Gareth Kung - Semiconductor Manufacturing International Corporation - EVP of Investment and Strategic Business

Yes, that is right. We talk about year-end over year-end about 11% increase. And on an annualized capacity basis, it's about 25% increased.

T.Y. Chiu - Semiconductor Manufacturing International Corporation - CEO

May I add that this is because --

Roland Shu - Citigroup - Analyst

So how about 12-inch and 8-inch increase?

Gareth Kung - Semiconductor Manufacturing International Corporation - EVP of Investment and Strategic Business

(Inaudible) it's combined, yes. (Multiple speakers)



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Roland Shu - Citigroup - Analyst

But how about the increase on the 12-inch? Do you have the breakdown (inaudible) increase? (Multiple speakers)

Gareth Kung - Semiconductor Manufacturing International Corporation - EVP of Investment and Strategic Business

Obviously the increase in 12 inch is more than 8 inch. I think the major expansion in the capacity will still be in our 28-nano capacity, and also there'll be quite a bit of increase in our 65-nano 55-nano capacity, yes.

Roland Shu - Citigroup - Analyst

Okay, yes. Okay, thank you. And also you talk about first quarter --

T.Y. Chiu - Semiconductor Manufacturing International Corporation - CEO

I'd just like to add that 25% annualized effective capacity increase, also a lot of it is because the full-year LFoundry's capacity will come in, yes.

Roland Shu - Citigroup - Analyst

Okay, thank you, yes. Also for your utilization in first quarter, talk about close to 90%. So how about the 12-inch and the 8-inch utilization specifically?

Gareth Kung - Semiconductor Manufacturing International Corporation - EVP of Investment and Strategic Business

Well we don't break down the utilization for each fabs. But I would say it's quite even, yes.

Roland Shu - Citigroup - Analyst

Okay, so both the 12-inch and 8-inch are close to 90%.

Gareth Kung - Semiconductor Manufacturing International Corporation - EVP of Investment and Strategic Business

I would say 8-inch is still better than 12-inch, yes.

Roland Shu - Citigroup - Analyst

Okay, yes, thank you. And for the whole year the first quarter revenue will correct a little bit and the whole-year revenue targets still grow by 20%. So what's the quarterly revenue linearity in this year? Will it be increased gradually or will it be more back end loaded?

Gareth Kung - Semiconductor Manufacturing International Corporation - EVP of Investment and Strategic Business

I think it's too early for us to comment on that. I think the 20% growth is a target, okay. But at this point in time, I think we don't have much visibility beyond the first quarter. So we will update the market as we see more visibility.



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Roland Shu - Citigroup - Analyst

Okay, thanks. And I think the last question is, so your others revenue by application increased a lot in 4Q last year, so what contributes into this category and was it just a one-off or it will be recurring in this year? Thank you.

Gareth Kung - Semiconductor Manufacturing International Corporation - EVP of Investment and Strategic Business

Yes, that category actually, we have put in the revenue from LFoundry. As you know, LFoundry's customers are mostly in the auto-industrial sectors.

Roland Shu - Citigroup - Analyst

Okay, so then we'll expect it will be increased mainly for this year, because we'll have the full-year consolidation number from LFoundry this year, right?

Gareth Kung - Semiconductor Manufacturing International Corporation - EVP of Investment and Strategic Business

That's correct, yes.

Roland Shu - Citigroup - Analyst

Okay, thank you, yes.

Operator

Thank you. Your next question comes from the line of Leping Huang of CICC, please ask your question.

Leping Huang - CICC - Analyst

Okay, thank you take my questions. So the first question is about your 28-nanometer migration strategy. I remember that your previous mainly the competition in 28-nano was too intense and the profitability, you would prefer to focus on the 40-nano, 45-nanometer process which is much better in terms of profitability. So what has changed that this time you start to migrate into 28-nanometer? It's more customer-driven or it's more that you have excess capacity to migrate out, which application you will first migrate? Thank you.

T.Y. Chiu - Semiconductor Manufacturing International Corporation - CEO

Okay, I think last year basically we had a very, very tight capacity year, and a lot of our 40-nano customers or 40-nano products are single-sourced in SMIC. So any discontinuity in these products' supply will really impact a significantly larger economic range. And so that is the reason that we had actually -- and even at the beginning of the year, I think that our 28-nano, the market was softer than we had thought. That's why our capacity has shifted towards meeting the 40-nano demand. It wasn't straight economic margin considerations.

This year we have always intend, even as of last year, to quickly ramp up our event capacity so that we can meet both the 40-nano, as well as the 28-nano demand. So at the second half of last year, we have increased our capacity sufficiently at this point of time to meet both the 40-nano, as well as 28-nanometer customer demand. So that's the reason this year we can see a significantly faster 28-nano ramp up.



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Leping Huang - CICC - Analyst

Okay. The second question is that we see -- I think October last year you announced that you would build the new factory in Ningbo. So can you elaborate what's the plan in Ningbo?

Also, these days we see that the local government do provide like a favorable financial condition to attract the foundry to the local city, like recently Chengdu have a copper with global foundry. So do you also consider to expand your geographic expansion in China? I remember you previously mainly focused on Shanghai and Beijing because of your constraint on R&D resource. Yes, thank you.

T.Y. Chiu - Semiconductor Manufacturing International Corporation - CEO

Certainly SMIC is exploring all potential opportunities. But I think, as consistent with our previous announcement, our main focus will still be in our present production site. That is Shanghai, Beijing, Tianjin and Shenzhen, as well as expanding some of our capacity in Italy.

So that certainly doesn't preclude us to consider other opportunities. But I think, at this moment, I think that we are still putting in capacities in our present production sites and that is our main focus.

Leping Huang - CICC - Analyst

So the Ningbo will not be a factory or it will be? What Ningbo will be, yes.

T.Y. Chiu - Semiconductor Manufacturing International Corporation - CEO

Ningbo right now, we are exploring design service centers, we are exploring and converting some of the specialty technology into production. And there are a number of conditions that needs to be, how should I say, proven and verified, such as a working specialty technologies and a very strong customer set base, before we start any fab constructions.

Leping Huang - CICC - Analyst

Thank you.

Operator

Sebastian Hou, CLSA.

Sebastian Hou - CLSA - Analyst

Good morning guys, thanks for taking my questions. The first question is on 28-nanometers, I wonder what's your strategy on 28-nano for this year. Is more on PolySiON or HKMG by the end of the year, given your high-single digit revenue guidance? And another follow on, that is your strategy is more on -- or your existing customers' migration need or are you going to gain some new applications or new customers?

T.Y. Chiu - Semiconductor Manufacturing International Corporation - CEO

Okay, our 28-nano certainly is focused not only on a single customer, we have a number of customers both globally as well as domestically. So indeed that certainly we are going to first meet our customer demand that is put in front of us right away. But at the same time, we're going to -- there are a number of customers still interested in the Poly/SiON. Of course we are also getting NTOs our product tapeout in our high K technology. So this is also a significant focus for SMIC this year.



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Sebastian Hou - CLSA - Analyst

Okay, so in terms of your revenue guidance for 28-nano about you account for a high-single digit by the end of this year, can we assume that most of that, or nearly all of that, will be PolySiON?

T.Y. Chiu - Semiconductor Manufacturing International Corporation - CEO

I think there will be -- a significant portion will be PolySiON. But we are targeting some high K revenue.

Sebastian Hou - CLSA - Analyst

Okay. And in terms of your position, what do you compare yourself in terms of performance, pricing, versus the other foundries who are offering 28-nanometers for years?

T.Y. Chiu - Semiconductor Manufacturing International Corporation - CEO

Competitive.

Sebastian Hou - CLSA - Analyst

Competitive on performance and pricing or performance --

T.Y. Chiu - Semiconductor Manufacturing International Corporation - CEO

Both.

Sebastian Hou - CLSA - Analyst

-- or pricing? Both.

T.Y. Chiu - Semiconductor Manufacturing International Corporation - CEO

Both.

Sebastian Hou - CLSA - Analyst

Okay, thank you T.Y. My second question is on your first-quarter guidance. You guided to decline by 2% to 4% and I think T.Y. you already mentioned about this. One or some specific customer and some specific area see witness. Can we -- and also to comment about that you think that you can backfill the capacity pretty soon. So how soon is that? Can we expect that you can backfill that within one to two quarters, given that right now major 8-inch foundries all in tight right now?

Gareth Kung - Semiconductor Manufacturing International Corporation - EVP of Investment and Strategic Business

Yes, I think it has been mentioned that, for example, we have our customers in the fingerprint sensor areas, there have been some correction of business. But we're also seeing other new customers coming in for the same applications, and which it'll ramp up this year.

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At the same time, for example, we are seeing record orders from our PMIC as well as from our smart card business to fill the gap. So we are pretty -- I would say cautiously optimistic in terms of our growth this year.

Sebastian Hou - CLSA - Analyst

Okay, so --

T.Y. Chiu - Semiconductor Manufacturing International Corporation - CEO

So --

Sebastian Hou - CLSA - Analyst

-- you mentioned about the -- yes, sorry, please go ahead.

T.Y. Chiu - Semiconductor Manufacturing International Corporation - CEO

So I think that, indeed, we will be able to -- at least we target to backfill within a few quarters' time.

Sebastian Hou - CLSA - Analyst

A few quarters, which means not one quarter.

T.Y. Chiu - Semiconductor Manufacturing International Corporation - CEO

A few quarters, I mean one or a few quarters. Right, right.

Sebastian Hou - CLSA - Analyst

So what I'm trying to -- sorry, thanks -- what I'm trying to get a sense is that is because you need to backfill that, so your 8-inch capacity come back to 100%. So when do you expect your 8-inch capacity utilization rate to return to your 100% level, or close to 100% level (multiple speakers)?

Sebastian Hou - CLSA - Analyst

Second quarter or third quarter?

T.Y. Chiu - Semiconductor Manufacturing International Corporation - CEO

This year we have forecast the -- we have targeted 20% growth, and so to achieve 20% growth you can project that it still needs to be fairly high utilization.

Sebastian Hou - CLSA - Analyst

Okay, thank you.



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Operator

Charlie Chan, Morgan Stanley.

Charlie Chan - Morgan Stanley - Analyst

Thanks for taking my question and happy Chinese New Year. So first question is regarding your gross margin guidance because it seems like your depreciation increased a lot. So just put it into perspective, the depreciation was around 20% of last year's revenue, and this year it was increased to 30% of this year's revenue. So it is like 10 percentage points increase.

You mentioned that EBITDA margin will maintain at the high-30%, but your gross margin guidance implies only 5 percentage point decline. And lastly what was the gap here? Are you going to reduce your OpEx significantly? Or is there any big chance for cost reduction in your variable costs?

Gareth Kung - Semiconductor Manufacturing International Corporation - EVP of Investment and Strategic Business

Charlie, I think my calculation is somewhat different from yours. Because we are guiding a \$380 million increase in depreciations, that will going to have an impact on the gross margin for sure. And at the same time, we also said that we intend to maintain an OpEx of high-teens %. So, with that, I think we're still quite confident about achieving, or at least it's on target to achieve a mid- to high-teens % gross margin, yes.

Charlie Chan - Morgan Stanley - Analyst

Okay. Maybe I misunderstood. So what was the \$1.1 billion depreciation guidance for?

Gareth Kung - Semiconductor Manufacturing International Corporation - EVP of Investment and Strategic Business

That is including both -- the total depreciation, the majority amount goes to the cost of goods sold, but part of it is also relating to the R&D spending as well.

Charlie Chan - Morgan Stanley - Analyst

Got it, I'm sorry. Okay, and next question is regarding your free cash flow. Because you made around \$1 billion EBITDA next year which is a good number. But it seems like your CapEx was above \$2 billion this year, it continues to be above \$2 billion. So it seems like there is ongoing cash outflow. So how are you going to fund for those cash flows?

Gareth Kung - Semiconductor Manufacturing International Corporation - EVP of Investment and Strategic Business

Yes, you are right, I think SMIC is still not in a free cash flow positive situation yet. But what we are seeing right now is that we are continuing our CapEx this year, at the same time we are increasing our total EBITDA generations. So that should help to reduce the gap. At the same time, as mentioned by T.Y., we have more than \$2 billion cash holding on hand, so we should be able to fund the CapEx without too much of a problem.

Charlie Chan - Morgan Stanley - Analyst

Okay, got it. And lastly, 28-nanometer, so when do you think revenue would significant run up this year? I think your guidance implies revenue's going to double, right? So is it 2Q, 3Q or very back loaded?



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Gareth Kung - *Semiconductor Manufacturing International Corporation - EVP of Investment and Strategic Business*

Right now we are targeting to increase gradually over each quarters. But maybe we're going to see a bigger increase in the second half.

Charlie Chan - *Morgan Stanley - Analyst*

Okay. Yes, so I think another topic, I'm not sure if management team has discussed about that, regarding US protectionism on the semiconductor industry. And it seems like your own some customers from North America and Qualcomm, they also work with you on some international R&D, like 40-nanometer.

So do you think there's going to be any impact to SMIC in the long-term and do you expect any friction between China and the US in terms of semiconductor cooperation?

T.Y. Chiu - *Semiconductor Manufacturing International Corporation - CEO*

I think that, indeed, we are cautiously optimistic in terms of the market growth and overall market trend. This is, of course disregarding the potential trade wars that may really come around. But we think and hope that semiconductor industry is a very, very global industry.

I think the market here in China is a great opportunity for everyone outside of China as well as in China. I think that anyone that really have a careful study will find that China market and the arrangement at this point of time is good for everyone. So we hope that there will be a good environment for business for foundry, for fabless as well as for all other customers in China.

Charlie Chan - *Morgan Stanley - Analyst*

Okay, understood, thank you very much.

Operator

Gokul Hariharan, JP Morgan.

Gokul Hariharan - *JPMorgan - Analyst*

Yes, hi, thanks for taking my call. I just wanted to ask first on the R&D spending increasing with emphasis on 14-nanometer. Is there any change in direction in terms of 14-nanometer development and applying to bring it on production earlier than expected? I think previously it was kind of more like a 2020 kind of target.

And the second question is, with that increase in R&D spending, how does it affect the operating leverage expectations in terms of operating margins, as we target the 20% growth CAGR over the next few years?

T.Y. Chiu - *Semiconductor Manufacturing International Corporation - CEO*

Okay, indeed, 14-nanometers, we are providing a faster turnaround time, a better R&D support to our team. And definitely, if possible, we will try to bring it up to production earlier. It would be great if we can bring it before 2020. But I think that, in general, SMIC's strategy is to continuously have a strong support to our R&D efforts, both in advanced technology, as well as in our specialty mature technology as well.



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Gareth Kung - *Semiconductor Manufacturing International Corporation - EVP of Investment and Strategic Business*

We are now, as mentioned earlier, we are targeting low teens % to mid-teens % R&D spending. And in terms of the OpEx spending, in terms of normalized OpEx, it will be in the high-teens level %. So I think in terms of impact on the operating margin, I think the major impact will be coming from the gross margin, I think.

Gokul Hariharan - *JPMorgan - Analyst*

Okay, got it. Can I also ask, what is the status on LFoundry in terms of utilization as well as new customer qualifications? When do we expect some of the new customers to start filling up the capacity?

T.Y. Chiu - *Semiconductor Manufacturing International Corporation - CEO*

Let me take that. We already see the LFoundry utilization increase by about 10% to 15% after the conclusion of our merger. Certainly, right now we are introducing additional customers to bring them into LFoundry. So it will take a few quarters to bring in more than a few customers to fully fill the fab, but we think that this year we should be able to maintain a reasonably high utilization in LFoundry consistently.

Gareth Kung - *Semiconductor Manufacturing International Corporation - EVP of Investment and Strategic Business*

I think just to add onto what T.Y. said, we are also seeing a pretty strong recovery of orders from the auto customers. And I think the major reason for that, or course, as you know, the end market for autos is doing well, and secondly is also the increasing confidence of the customers in terms of LFoundry's future, given the fact that they are combined with a much bigger group now than before.

Gokul Hariharan - *JPMorgan - Analyst*

Okay, good, and thanks.

Operator

Michael Chou, Deutsche Bank.

Michael Chou - *Deutsche Bank - Analyst*

Hi, good morning. Thanks for taking my questions. One question is, as we know the fingerprint sensor will shift to 12-inch in the future, so what's your planning for 12-inch fingerprint sensor for the rollout this year and next year? Or do you expect your fingerprint sensor will be still from 8-inch process going forward?

T.Y. Chiu - *Semiconductor Manufacturing International Corporation - CEO*

Okay. At this moment, I think the requests to shift from 8-inch to 12-inch are still limited, and our traditional customers as well as the new customers are still mainly focused in the 8-inch capacities. Certainly, I think that we are preparing additional 12-inch capacities for similar applications if there is such a need. This has already been set up and will come online in Shenzhen at the end of 2017.

Michael Chou - *Deutsche Bank - Analyst*

Okay. So does that mean you will use the 65-nanometer to do fingerprint sensor by the end of this year in Shenzhen fab?

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T.Y. Chiu - *Semiconductor Manufacturing International Corporation - CEO*

Well, we will withhold comment at this point in time. Right now we still have a lot of activities in our traditional technology arena for this application.

Gareth Kung - *Semiconductor Manufacturing International Corporation - EVP of Investment and Strategic Business*

Yes. I think we'll be seeing most of our fingerprint customers are still focused on an 8-inch application at this point in time.

Michael Chou - *Deutsche Bank - Analyst*

Okay. So do you expect that they will shift to 12-inch next year or do you think most of the customers still stay in 8-inch even next year? (Multiple speakers)

Gareth Kung - *Semiconductor Manufacturing International Corporation - EVP of Investment and Strategic Business*

I think for 2017, we don't see any migration at this point in time.

Michael Chou - *Deutsche Bank - Analyst*

Okay. In terms of yield rate, do you think your 12-inch fingerprint sensor will be quite okay if you want to enter production at some point, let's say maybe 2018? It seems that 65-nanometer fingerprint sensor yield rate is very challenging for some time, in the early stage. So what is your view?

Gareth Kung - *Semiconductor Manufacturing International Corporation - EVP of Investment and Strategic Business*

As I say, right now because most of our customers still require only 8-inch production for this application, so we don't have any experience in the 12-inch yet.

Michael Chou - *Deutsche Bank - Analyst*

Okay. My second question is you guide for high single-digit percentage of sales from 28-nanometer, but we remember that in the past you have been quite aggressive in guiding 28-nanometer sales portion, but do you think that there is some change so you cannot meet the guidance. But this time what cost differential or you think the -- or you have more customers than before or more product or you do see some sort of complication?

Because it seems that TSMC finished 28-nanometer depreciation in the first half of this year, so in theory 28-nanometer pricing competition should be very severe in the second half this year. And if you can see the UMC situation, they will be more aggressive in 28-nanometer ramp-up in terms of pricing and the sales contribution.

So what's your age going forward, because it seems that UMC will move 28-nanometer to the Xiamen fab so they may have some benefit from the joint venture with the Xiamen government. So what's your view? What would you think about your 28-nanometer sales contribution in the long term?

T.Y. Chiu - *Semiconductor Manufacturing International Corporation - CEO*

Okay, I think again, last year, indeed we had a -- we did not meet our 28-nano forecast. That was basically because we have extremely tight capacities and we had made a strategic decision to do the 40-nano first because the demand can come in first and a lot of the product are single source.



This year, we are able to ramp 28-nano, at the same time maintaining good 40-nano output. The main reason is that we have expanded our capacities to a situation where we can take care of both our 40-nano as well as 28-nano customers. So as far as the dilemma of coming in with a technology that is slightly behind our competitors, that dilemma we have faced all throughout our last 16 years.

And we have -- we were -- we came in with our 40-nano and I guess a lot of our peers would think that 40-nano for SMIC is probably a node that has not worth pursuing, but we had a very, very successful 2016 ramp-up in the 40-nano. So we believe that as long as we can do good quality 28-nano, as long as there is customer demand, I think our 28-nano ramp-up is still a very important node for us.

Michael Chou - *Deutsche Bank - Analyst*

Okay. One follow-up question.

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

Thank you. I think we are running out of time here and so -- Michael, and I think we have to stop here.

Michael Chou - *Deutsche Bank - Analyst*

Oh, OK. Thank you.

Operator

Thank you. I would now like to hand the call back to CEO Dr. Chiu for closing remarks.

T.Y. Chiu - *Semiconductor Manufacturing International Corporation - CEO*

In closing, I would like to thank everyone who participated in today's call, and again thank all of our shareholders, customers, employees and the suppliers for their trust and support. We'll see you next time. Thank you.

Operator

Thank you. This is the end of SMIC's fourth quarter earnings conference call. We thank you for joining us today.

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