

KLA Corporation (KLAC)

\$199.83 (As of 07/31/20)

Price Target (6-12 Months): **\$210.00**

Long Term: 6-12 Months

Zacks Recommendation:

Neutral

(Since: 10/07/19)

Prior Recommendation: Outperform

Short Term: 1-3 Months

Zacks Rank: (1-5)

2-Buy

Zacks Style Scores:

VGM: C

Value: C

Growth: B

Momentum: F

Summary

KLA is driven by a strong process control market, revenue diversification, solid execution and expanded demand at the trailing edge nodes. Growing Foundry and Logic investments remain major positives. Transition to advanced nodes and the insertion of EUV lithography are expected to continue accelerating customer investments in Foundry and Logic. Additionally, enhanced wafer cleanliness and geometry specifications in the bare wafer market and the introduction of EUV and non-EUV projects at 7 NM in mask shops are driving demand for the company's wafer and mask inspection products. Notably, the stock has outperformed the industry it belongs to on a year-to-date basis. However, ongoing weakness in the memory market and the COVID-19 pandemic remain concerns.

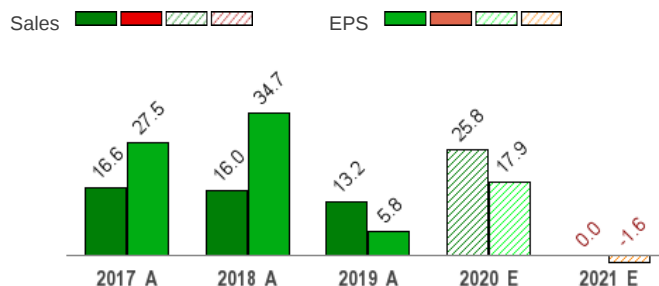
Price, Consensus & Surprise



Data Overview

52 Week High-Low	\$209.30 - \$110.19
20 Day Average Volume (sh)	1,172,682
Market Cap	\$31.0 B
YTD Price Change	12.2%
Beta	1.34
Dividend / Div Yld	\$3.40 / 1.7%
Industry	Electronics - Miscellaneous Products
Zacks Industry Rank	Bottom 34% (167 out of 253)

Sales and EPS Growth Rates (Y/Y %)



Last EPS Surprise	5.1%
Last Sales Surprise	0.6%
EPS F1 Est- 4 week change	1.0%
Expected Report Date	08/03/2020
Earnings ESP	0.7%
P/E TTM	21.3
P/E F1	20.4
PEG F1	1.8
P/S TTM	5.5

Sales Estimates (millions of \$)

	Q1	Q2	Q3	Q4	Annual*
2021	1,386 E	1,422 E	1,504 E	1,570 E	5,748 E
2020	1,413 A	1,509 A	1,424 A	1,403 E	5,749 E
2019	1,093 A	1,120 A	1,097 A	1,258 A	4,569 A

EPS Estimates

	Q1	Q2	Q3	Q4	Annual*
2021	\$2.26 E	\$2.35 E	\$2.57 E	\$2.78 E	\$9.81 E
2020	\$2.48 A	\$2.66 A	\$2.47 A	\$2.35 E	\$9.97 E
2019	\$2.46 A	\$2.44 A	\$1.80 A	\$1.78 A	\$8.46 A

*Quarterly figures may not add up to annual.

The data in the charts and tables, including the Zacks Consensus EPS and Sales estimates, is as of 07/31/2020. The reports text is as of 08/03/2020.

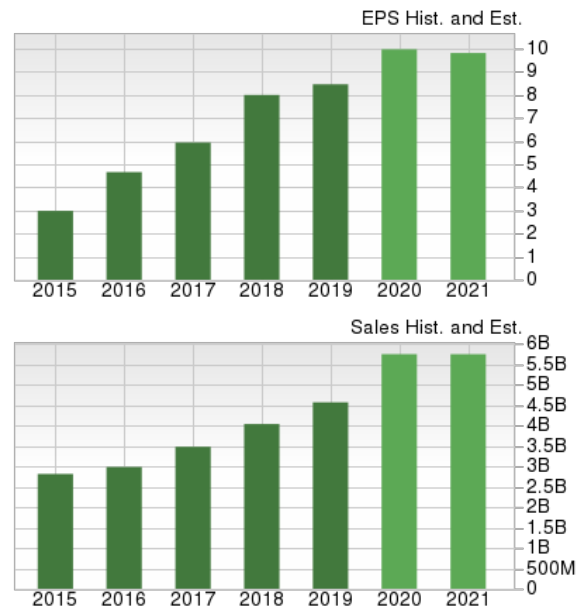
Overview

San Jose, CA-based KLA Corporation is an original equipment manufacturer (OEM) of process diagnostics and control (PDC) equipment and yield management solutions required for the fabrication of semiconductor integrated circuits (ICs) or chips. The firm has a comprehensive portfolio of products addressing each major PDC subsegment—photomask (reticle) inspection, wafer inspection/defect review and metrology.

Reticle production is vital to the semiconductor device formation process. Reticles are used to control the precise deposition of materials onto the wafer, which ultimately change its chemical characteristics, imparting specific functionalities to the ICs thus created. Inspection and metrology tools measure the quality of the reticles, helping to improve reticle production yields. As a result of the broader applicability of semiconductors, shrinking form factors and increasing functionalities of individual chips, reticle design and production are growing in importance. Intel and Taiwan Semiconductor were the largest customers in the last three years, accounting for more than 10% of total sales in each year. The two main product lines are defect inspection and metrology. KLA's defect inspection tools have very broad application in chip, wafer, reticle, storage, compound semiconductor and MEMS manufacturing. Metrology tools are used to gather critical dimension measurements of the wafer and process dimensions such as film thickness, lithography overlay and surface profiling. The company's metrology products are used in chip, wafer, reticle and solar device manufacturing. KLA also offers other products and services.

In addition to new tools, the company also offers a comprehensive portfolio of refurbished tools that upgrade and improve yields of existing equipment under the KT-Certified program. Refurbished tools are currently sold to IC, reticle, substrate, MEMS and data storage manufacturers.

Although the company is a major player in each of its served markets, it faces competition from other large equipment suppliers such as Applied Materials and Hitachi High-Technologies Corporation.



Reasons To Buy:

▲ KLA is a major player in each of its served markets. The company offers **complete yield management solutions**, including hardware, software and services that help improve the output and reduce overall production costs. Cost reduction is of primary importance today, as increasing competition across all growing end markets leads to demand for lower-cost components. Since yield management solutions improve manufacturing costs, demand for these products remains strong at any point in the business cycle. Therefore, the company's revenues are generally more stable than other equipment suppliers and its performance more steady in recessionary conditions.

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▲ **Technology transitions** are generally positive for equipment companies, since companies need to extend capacity and tooling to try out new processes and technologies, and improve yields on them. Production ramps only after satisfactory yields are achieved, so demand for yield management solutions are high. There are a number of technology transitions (FinFET, 3D NAND, TSV and multi-patterning) that will drive KLA's demand in the following quarters. The demand for greater densities and efficiencies within chip packages are increasing complexities of semiconductor devices, which will continue to drive demand for yield management solutions.

▲ Process control is a critical function for foundries, since they are large-scale manufacturers of semiconductors. With new-age technologies increasing process complexities, foundries are hard-pressed to increase yields sufficiently in order to lower costs. Moreover, with such a large percentage of semiconductors currently going into consumer goods, they are also under pressure to speed up the manufacturing process. This is because consumer goods producers compete on the basis of new products and they also often want very large quantities of products at short notice in order to build a market position. These **market dynamics favor KLAC**, as demand for consumer electronic products (particularly, smartphones and tablets) continues to increase. At the moment, there is a great push to shift production to lower geometries (20nm to 16nm to 14nm), with each transition requiring significant investment in process control equipment, particularly inspection tools. KLA's exposure to the memory segment remains relatively low, but memory typically requires lower investment in process control, so this is not really a prime segment for KLA.

▲ KLA has also benefited from its **new product** development strategy. Equipment companies typically work closely with customers, who make the actual purchase long after they have looked at the product and tested its suitability. Therefore, new products are usually an instant success. In the last fiscal year, KLA introduced a number of new front-end defect inspection products that are expected to augment its existing portfolio. KLA's focus on innovation continues to date.

Reasons To Sell:

- ▼ The primary concern regarding KLA shares is the **uncertainty regarding the timing of capex spending**. While demand is definitely there, it is not in the markets KLA serves, so will not benefit the company. But since KLA is extremely well positioned at both Samsung and TSM foundries, their expected increase in FinFET-related spending should benefit the company in going forward. Exposure to memory makers like SanDisk, Toshiba, Micron, Hynix, etc has been increasing over time, but it still isn't significant to move the needle for KLA.
- ▼ While not an immediate concern, **e-beam inspection technology** could be disruptive for KLA's inspection tools. The technology has been slow to develop and even now, remains a slower process. However, it does provide material advantages over traditional inspection tools from KLA that could materially improve yields at lower nodes. It is likely that adoption will not speed up overnight, but we would like to see KLA's solution to the problem, especially considering the fact that inspection is a major chunk of its business.
- ▼ **Competition** in the refurbished equipment market is likely to remain. While there are just a handful of suppliers making new tools, the refurbished space is more crowded, with many players including auctioneers, universities and even online sales channels, such as eBay. The number of companies going out of business during the last downturn has increased the supply of used equipment at very attractive prices. Additionally, buyers are loath to spend more on new equipment when they have the option of using perfectly functional old equipment.
- ▼ KLA-Tencor's balance sheet remains highly leveraged. As of Mar 31, 2020, the company's net debt was \$1.8 billion versus \$1.7 billion as of Dec 31, 2019. . Accumulating high debt levels may impede sufficient cash flow generation, which is needed to meet future debt obligations. Moreover, this may keep the company from accessing the debt market and refinancing at suitable rates. Notably, debt-to-total capital was 59.7% as of Mar 31, 2020 which increased from 55.8% as of Dec 31, 2019.

Intensifying competition, concentrated customer base and e-beam inspection technology pose serious threat to KLA.

Last Earnings Report

KLA Corp. Beats Q3 Earnings and Revenue Estimates

KLA Corporation reported third-quarter fiscal 2020 earnings per share of \$2.47, beating the Zacks Consensus Estimate of \$2.35. The figure was up 37.2% year over year but down 7.1% sequentially.

Revenues increased 29.8% from the year-ago quarter but decreased 5.6% sequentially to \$1.42 billion, surpassing the Zacks Consensus Estimate by 0.6%. The figure was at the midpoint of the company's guided range of \$1.325-\$1.525 billion.

During the quarter, the company witnessed record shipments driven by strong demand in Semiconductor Process Control systems.

It also saw increased Semiconductor device demand for enterprise and cloud applications due work from home surge and a strengthening gaming market, partially offset by a decline in some consumer-facing end markets.

Management continues to expect overall process control intensity to grow in 2020, driven by expanding value of inspection and measurement in addressing critical customer problems.

Demand for advanced logic nodes is expected to remain healthy through 2020 and in 2021, driven by investment in EUV, competitive dynamics, as well as capacity additions.

Foundry and logic is expected to continue performing well in 2020. The optimistic outlook is driven by next-generation technology development, capacity additions at leading-edge nodes, increasing competitive dynamics and investment in EUV infrastructure.

Top-Line Details

Products revenues (accounting for almost 74% of total revenues) increased 32.5% year over year to \$1.05 billion.

Services revenues (26% of total revenues) increased 22.6% from the year-ago quarter to \$372.9 million.

In terms of reportable segments, Semiconductor Process Control revenues increased 28.8% year over year to \$1.18 billion, driven by continued strength in foundry and logic.

Specialty Semiconductor Process revenues were \$85.1 million, up 0.8% year over year, driven by strength in RF, MEMS and advance packaging.

The segment is expected to further benefit from expanding RF demand to support 5G infrastructure investment, particularly in China.

PCB, Display and component inspection revenues increased exponentially from a year ago to \$160.4 million. Other revenues were \$0.469 million.

KLA Corp. continues to experience strong growth for Wafer Inspection solutions. Management stated that new capacity addition by Wafer manufacturers and the adoption of more complex architectures by IC customers are driving demand for bare wafer products. These are needed to support more stringent wafer flatness and process tool cleanliness specifications in advanced technologies.

Operating Details

Non-GAAP gross margin was 61.2% versus 60.8% in the prior quarter. The gross margin was at the upper end of the guided range of 59.5-61.5%. The increase was driven by a favorable product mix.

Total operating expenses increased 9.3% year over year to \$401.2 million. As a percentage of sales, research and development as well as selling, general and administrative costs slightly decreased from the prior-year quarter.

Non-GAAP operating margin was 34.6% versus 34% in the prior quarter.

Balance Sheet

KLA Corp. ended the quarter with cash, cash equivalents and a marketable securities balance of \$1.63 billion compared with \$1.68 billion in the fiscal second quarter.

Cash from operations was \$442 million in the fiscal third quarter versus \$387.7 million in the prior quarter.

Fiscal Fourth-Quarter 2020 Guidance

For fourth-quarter fiscal 2020, revenues are expected between \$1.26 billion and \$1.54 billion.

Memory is expected to be 39% of system revenues in the fiscal fourth quarter. Foundry is expected to constitute 51% of total shipments and Logic is anticipated to account for 10% of semi-process control system revenues.

The company expects gross margin in the range of 59-61% and non-GAAP EPS within \$1.81-\$2.87.

GAAP EPS is projected within \$1.58-\$2.64.

Quarter Ending 03/2020

Report Date	May 05, 2020
Sales Surprise	0.56%
EPS Surprise	5.11%
Quarterly EPS	2.47
Annual EPS (TTM)	9.39

Recent News

On **Jun 15, 2020**, KLA revealed about providing a grant of \$1 million to national and local initiatives for addressing and improving systemic racial inequality.

On **Mar 23, 2020**, KLA revealed about the creation of COVID-19 global relief fund worth \$2 million which will focus on public hospitals and medical units, food supplies, elderly communities and educational infrastructure. Notably, the fund will be created by KLA Foundation.

On **Feb 24, 2020**, KLA unveiled two metrology systems namely Archer 750 and SpectraShape 11k. Notably, the former is an imaging-based overlay metrology system and the latter is an optical critical dimension metrology system.

Valuation

KLA shares are up 12.2% in the year-to-date period and 58.1% over the trailing 12-month period. Stocks in the Zacks sub-industry are down 7% but up 18.1% in the Zacks Computer & Technology sector in the year-to-date period. Over the past year, the Zacks sub-industry is up 10.5% and the sector is up 36.7%.

The S&P 500 index is up 15.5% in the year-to-date period but up 6% in the past year.

The stock is currently trading at 18.97X forward 12-month earnings, which compares to 18.02X for the Zacks sub-industry, 25.42X for the Zacks sector and 22.51X for the S&P 500 index.

Over the past five years, the stock has traded as high as 20.98X and as low as 8.81X, with a 5-year median of 14.32X. Our Neutral recommendation indicates that the stock will perform in-line with the market. Our \$210 price target reflects 9.3X forward 12-month earnings.

The table below shows summary valuation data for KLAC

Valuation Multiples - KLAC					
		Stock	Sub-Industry	Sector	S&P 500
P/E F 12M	Current	18.97	18.02	25.42	22.51
	5-Year High	20.98	18.75	25.58	22.51
	5-Year Low	8.81	12.4	16.72	15.25
	5-Year Median	14.32	15.75	19.33	17.52
P/S F12M	Current	4.01	1.17	3.11	2.94
	5-Year High	4.92	1.48	3.58	3.44
	5-Year Low	2.54	0.58	2.32	2.54
	5-Year Median	3.7	1.07	3.09	3
EV/EBITDA TTM	Current	12.73	12.71	11.27	11.15
	5-Year High	15.81	18.4	12.61	12.82
	5-Year Low	5.91	8.32	7.68	8.49
	5-Year Median	11.35	11.37	10.55	10.3

As of 07/31/2020

Industry Analysis Zacks Industry Rank: Bottom 34% (167 out of 253)



Top Peers

Company (Ticker)	Rec	Rank
ASML Holding N.V. (ASML)	Outperform	3
Lam Research Corporation (LRCX)	Outperform	1
Teradyne, Inc. (TER)	Outperform	1
Agilent Technologies, Inc. (A)	Neutral	2
Applied Materials, Inc. (AMAT)	Neutral	4
Amkor Technology, Inc. (AMKR)	Neutral	2
Garmin Ltd. (GRMN)	Neutral	3
Trimble Inc. (TRMB)	Neutral	4

Industry Comparison Industry: Electronics - Miscellaneous Products				Industry Peers		
	KLAC	X Industry	S&P 500	AMAT	ASML	LRCX
Zacks Recommendation (Long Term)	Neutral	-	-	Neutral	Outperform	Outperform
Zacks Rank (Short Term)	2	-	-	4	3	1
VGM Score	C	-	-	B	B	D
Market Cap	30.98 B	215.67 M	22.59 B	58.96 B	148.50 B	54.75 B
# of Analysts	7	3	14	10	3	9
Dividend Yield	1.70%	0.00%	1.83%	1.37%	0.70%	1.22%
Value Score	C	-	-	B	D	D
Cash/Price	0.06	0.12	0.07	0.10	0.03	0.11
EV/EBITDA	19.83	6.21	12.94	15.37	40.99	19.66
PEG Ratio	1.84	2.12	3.04	1.24	1.80	1.62
Price/Book (P/B)	13.32	1.71	3.17	6.53	10.62	10.58
Price/Cash Flow (P/CF)	20.38	7.16	12.51	18.35	43.60	21.67
P/E (F1)	20.37	22.36	21.87	16.87	41.07	20.80
Price/Sales (P/S)	5.53	0.87	2.44	3.82	10.50	5.45
Earnings Yield	4.91%	3.86%	4.31%	5.92%	2.43%	4.81%
Debt/Equity	1.48	0.12	0.75	0.69	0.36	0.96
Cash Flow (\$/share)	9.80	1.31	6.94	3.51	8.11	17.40
Growth Score	B	-	-	B	B	D
Hist. EPS Growth (3-5 yrs)	26.96%	-3.16%	10.85%	31.78%	23.00%	31.25%
Proj. EPS Growth (F1/F0)	-1.60%	-8.41%	-7.75%	25.46%	25.01%	17.76%
Curr. Cash Flow Growth	18.14%	-4.64%	5.39%	-35.58%	-4.32%	-4.44%
Hist. Cash Flow Growth (3-5 yrs)	18.07%	3.79%	8.55%	13.90%	14.58%	23.38%
Current Ratio	2.61	1.60	1.31	2.67	2.91	3.43
Debt/Capital	59.70%	17.55%	44.32%	40.78%	26.70%	49.01%
Net Margin	18.26%	0.41%	10.44%	18.89%	22.70%	22.42%
Return on Equity	57.76%	4.79%	14.73%	37.13%	23.21%	49.72%
Sales/Assets	0.62	0.96	0.52	0.78	0.56	0.78
Proj. Sales Growth (F1/F0)	-0.03%	0.00%	-1.95%	14.10%	12.91%	9.62%
Momentum Score	F	-	-	D	A	C
Daily Price Chg	1.42%	0.00%	-0.92%	1.85%	-0.52%	4.91%
1 Week Price Chg	-4.56%	-2.13%	0.37%	-2.70%	-4.15%	-0.16%
4 Week Price Chg	1.69%	1.09%	3.81%	5.46%	-5.22%	16.52%
12 Week Price Chg	21.97%	20.00%	11.93%	25.52%	18.07%	52.31%
52 Week Price Chg	46.11%	-4.52%	-1.92%	32.72%	59.74%	83.30%
20 Day Average Volume	1,172,682	38,243	1,887,986	5,467,960	956,787	1,523,933
(F1) EPS Est 1 week change	0.00%	0.00%	0.00%	0.00%	1.17%	0.00%
(F1) EPS Est 4 week change	1.03%	0.00%	0.38%	0.00%	18.53%	0.00%
(F1) EPS Est 12 week change	3.51%	-9.24%	-0.07%	1.90%	18.26%	-0.06%
(Q1) EPS Est Mthly Chg	0.00%	0.00%	0.16%	0.00%	36.51%	12.70%

Zacks Stock Rating System

We offer two rating systems that take into account investors' holding horizons: Zacks Rank and Zacks Recommendation. Each provides valuable insights into the future profitability of the stock and can be used separately or in combination with each other depending on your investment style.

Zacks Recommendation

The Zacks Recommendation aims to predict performance over the next 6 to 12 months. The foundation for the quantitatively determined Zacks Recommendation is trends in the company's estimate revisions and earnings outlook. The Zacks Recommendation is broken down into 3 Levels; Outperform, Neutral and Underperform. Unlike many Wall Street firms, we have an excellent balance between the number of Outperform and Neutral recommendations. Our team of 70 analysts are fully versed in the benefits of earnings estimate revisions and how that is harnessed through the Zacks quantitative rating system. But we have given our analysts the ability to override the Zacks Recommendation for the 1200 stocks that they follow. The reason for the analyst over-rides is that there are often factors such as valuation, industry conditions and management effectiveness that a trained investment professional can spot better than a quantitative model.

Zacks Rank

The Zacks Rank is our short-term rating system that is most effective over the one- to three-month holding horizon. The underlying driver for the quantitatively-determined Zacks Rank is the same as the Zacks Recommendation, and reflects trends in earnings estimate revisions.

Zacks Style Scores

The Zacks Style Score is as a complementary indicator to the Zacks rating system, giving investors a way to focus on the highest rated stocks that best fit their own stock picking preferences.

Academic research has proven that stocks with the best Value, Growth and Momentum characteristics outperform the market. The Zacks Style Scores rate stocks on each of these individual styles and assigns a rating of A, B, C, D and F. We also produce the VGM Score (V for Value, G for Growth and M for Momentum), which combines the weighted average of the individual Style Scores into one score. This is perfectly suited for those who want their stocks to have the best scores across the board.

Value Score	C
Growth Score	B
Momentum Score	F
VGM Score	C

As an investor, you want to buy stocks with the highest probability of success. That means buying stocks with a Zacks Recommendation of Outperform, which also has a Style Score of an A or a B.

Disclosures

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