

KLA Corporation (KLAC)

\$178.80 (As of 02/04/20)

Price Target (6-12 Months): **\$188.00**

Long Term: 6-12 Months

Zacks Recommendation:
Neutral

(Since: 10/07/19)

Prior Recommendation: Outperform

Short Term: 1-3 Months

Zacks Rank: (1-5)

3-Hold

Zacks Style Scores:

VGM:B

Value: C

Growth: B

Momentum: A

Summary

KLA reported solid fiscal Q3 results driven by a strong process control market, revenue diversification and customer acceptance of key products. The growing Foundry and Logic investments remain major positives. Moreover, transition to advanced nodes and the increasing adoption of EUV lithography is expected to continue accelerate customer investments in Foundry and Logic. Enhanced wafer cleanliness and geometry specifications in the bare wafer market and EUV at 7 NM in mask shops are positives. Also the recovering memory market is a tailwind. However, softness in China and memory pushouts remain concerns. The stock has outperformed the industry it belongs to in the past year.

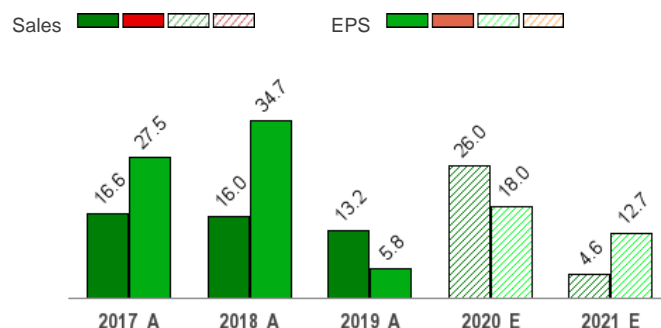
Price, Consensus & Surprise



Data Overview

52 Week High-Low	\$184.50 - \$101.34
20 Day Average Volume (sh)	1,122,270
Market Cap	\$28.2 B
YTD Price Change	0.4%
Beta	1.65
Dividend / Div Yld	\$3.40 / 1.9%
Industry	Electronics - Miscellaneous Products
Zacks Industry Rank	Top 40% (101 out of 255)

Sales and EPS Growth Rates (Y/Y %)



Last EPS Surprise	4.3%
Last Sales Surprise	2.1%
EPS F1 Est- 4 week change	1.0%
Expected Report Date	05/04/2020
Earnings ESP	8.9%
P/E TTM	20.5
P/E F1	17.9
PEG F1	1.6
P/S TTM	5.3

Sales Estimates (millions of \$)

	Q1	Q2	Q3	Q4	Annual*
2021	1,420 E	1,468 E	1,525 E	1,604 E	6,017 E
2020	1,413 A	1,509 A	1,412 E	1,450 E	5,755 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	\$2.49 E	\$2.65 E	\$2.83 E	\$3.09 E	\$11.25 E
2020	\$2.48 A	\$2.66 A	\$2.43 E	\$2.59 E	\$9.98 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 02/04/2020. The reports text is as of 02/05/2020.

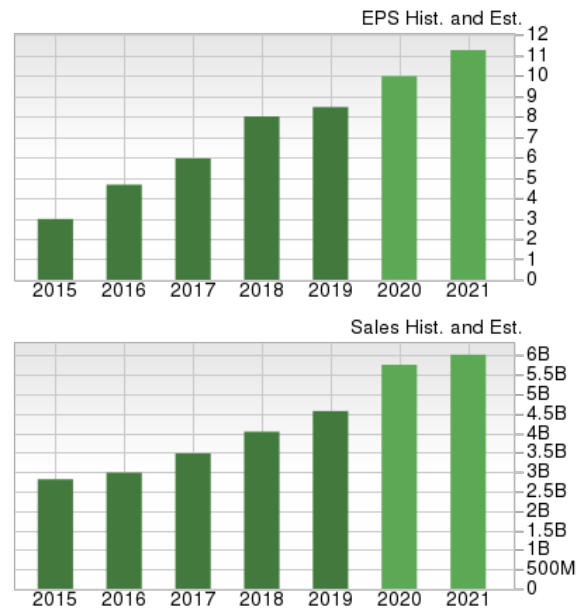
Overview

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 KLA**, 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.

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

Last Earnings Report

KLA Corp. Beats Earnings and Revenue Estimates in Q2

KLA Corporation reported second-quarter fiscal 2020 earnings per share of \$2.66, beating the Zacks Consensus Estimate of \$2.55. Moreover, the figure was up 9% year over year and 7.3% sequentially.

Revenues increased 34.7% from the year-ago quarter and 6.8% sequentially to \$1.51 billion, surpassing the Zacks Consensus Estimate by 2.1%. The figure was at the higher end of the company's guided range of \$1.435-\$1.515 billion.

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.

Management expects WFE demand to improve in 2020, driven by investments, strong foundry demand and improving business conditions in memory.

Top-Line Details

Products revenues (accounting for almost 76% of total revenues) increased 34.3% year over year to \$1.14 billion.

Services revenues (24% of total revenues) increased 36.3% from the year-ago quarter to \$364.9 million.

In terms of reportable segments, Semiconductor Process Control increased 14% year over year to \$1.25 billion, driven by continued strength in foundry and logic.

Specialty Semiconductor Process revenues were \$75.1 million, up 9% sequentially.

The segment is expected to benefit from expanding RF demand to support 5G investments and a potential recovery in the automotive electronics market in the second half of the calendar year.

PCB, Display and component inspection revenues increased exponentially from a year ago to \$186.3 million and Other revenues were \$0.517 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

Per the press release, KLA Corp's gross margin contracted 550 basis points (bps) on a year-over-year basis to 58%.

Total operating expenses increased 48.4% year over year to \$413 million. As a percentage of sales, research and development expenses slightly decreased, while selling, general and administrative costs increased.

As a result, operating margin contracted 890 bps to 28.2%.

Balance Sheet

KLA Corp ended the quarter with cash, cash equivalents and a marketable securities balance of \$1.68 billion compared with \$1.75 billion in the fiscal first quarter.

Cash from operations was \$387.7 million in the fiscal second quarter versus \$496.2 million in the prior quarter.

Fiscal Third-Quarter 2020 Guidance

For third-quarter fiscal 2020, revenues are expected between \$1.325 billion and \$1.525 billion, indicating growth of 3-5% sequentially.

Memory is expected to be 28% of system revenues in the fiscal third quarter. Foundry is expected to constitute 60% of total shipments and Logic is anticipated to account for 12% of semi-process control system revenues.

The company expects non-GAAP gross margin in the range of 59.5-61.5% and non-GAAP EPS within \$1.79-\$2.57.

GAAP EPS is projected within \$2.04-\$2.82.

Quarter Ending **12/2019**

Report Date	Feb 04, 2020
Sales Surprise	2.05%
EPS Surprise	4.31%
Quarterly EPS	2.66
Annual EPS (TTM)	8.72

Recent News

On **Nov 6, 2019**, KLA's Board of Directors approved quarterly dividend of 85 cents per share for the shareholders of the record as of Nov 18, 2019, which will be paid on Dec 3, 2019.

Valuation

KLA shares are up 25% in the six-month period and 57.2% over the trailing 12-month period. Stocks in the Zacks sub-industry and the Zacks Computer & Technology sector are up 12.7% and 19.2% in the six-month period, respectively. Over the past year, the Zacks sub-industry is up 29.4% and the sector is up 24.9%.

The S&P 500 index is up 13.4% in the six-month period and 18.1% in the past year.

The stock is currently trading at 16.65X forward 12-month earnings, which compares to 16.81X for the Zacks sub-industry, 22.16X for the Zacks sector and 18.61X for the S&P 500 index.

Over the past five years, the stock has traded as high as 19.67X and as low as 8.81X, with a 5-year median of 14.24X. Our Neutral recommendation indicates that the stock will perform in-line with the market. Our \$188 price target reflects 17.6X 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	16.65	16.81	22.16	18.61
	5-Year High	19.67	18.75	22.16	19.34
	5-Year Low	8.81	12.4	16.87	15.18
	5-Year Median	14.24	15.87	19.28	17.46
P/S F12M	Current	4.54	1.2	3.24	3.43
	5-Year High	4.92	1.5	3.44	3.43
	5-Year Low	2.54	0.58	2.29	2.54
	5-Year Median	3.67	1.07	2.93	3
EV/EBITDA TTM	Current	15.3	15.16	11.28	11.15
	5-Year High	15.3	18.24	12.56	12.82
	5-Year Low	5.91	7.65	7.66	8.49
	5-Year Median	11.26	10.4	10.08	10.3

As of 02/04/2020

Industry Analysis Zacks Industry Rank: Top 40% (101 out of 255)



Top Peers

Garmin Ltd. (GRMN)	Outperform
Lam Research Corporation (LRCX)	Outperform
Teradyne, Inc. (TER)	Outperform
Agilent Technologies, Inc. (A)	Neutral
Applied Materials, Inc. (AMAT)	Neutral
Amkor Technology, Inc. (AMKR)	Neutral
ASML Holding N.V. (ASML)	Neutral
Trimble Inc. (TRMB)	Neutral

Industry Comparison Industry: Electronics - Miscellaneous Products				Industry Peers		
	KLAC Neutral	X Industry	S&P 500	AMAT Neutral	ASML Neutral	LRCX Outperform
VGM Score	B	-	-	D	C	A
Market Cap	28.21 B	242.85 M	24.31 B	57.88 B	126.02 B	47.21 B
# of Analysts	6	2	13	10	3	9
Dividend Yield	1.90%	0.00%	1.78%	1.33%	0.66%	1.41%
Value Score	C	-	-	D	D	B
Cash/Price	0.07	0.09	0.04	0.07	0.04	0.11
EV/EBITDA	17.92	6.34	13.98	15.24	34.24	16.76
PEG Ratio	1.57	1.71	2.01	2.02	2.12	1.10
Price/Book (P/B)	10.53	1.84	3.29	7.09	8.94	10.78
Price/Cash Flow (P/CF)	18.24	10.07	13.58	17.98	37.00	18.45
P/E (F1)	17.36	20.50	18.82	16.56	34.21	19.34
Price/Sales (P/S)	5.34	0.94	2.66	3.96	9.50	4.94
Earnings Yield	5.58%	4.86%	5.30%	6.05%	2.92%	5.17%
Debt/Equity	1.18	0.11	0.71	0.57	0.25	0.86
Cash Flow (\$/share)	9.80	1.09	6.92	3.51	8.09	17.63
Growth Score	B	-	-	D	A	B
Hist. EPS Growth (3-5 yrs)	30.74%	3.02%	10.80%	39.24%	22.07%	34.37%
Proj. EPS Growth (F1/F0)	17.93%	10.02%	7.40%	25.20%	26.95%	15.62%
Curr. Cash Flow Growth	18.14%	-0.51%	10.22%	-35.58%	-4.32%	-25.33%
Hist. Cash Flow Growth (3-5 yrs)	18.07%	2.38%	8.55%	13.90%	14.58%	23.38%
Current Ratio	2.24	1.94	1.21	2.30	2.58	3.30
Debt/Capital	54.22%	19.08%	42.91%	36.46%	19.80%	46.37%
Net Margin	21.55%	0.40%	11.79%	18.52%	23.36%	21.67%
Return on Equity	50.64%	5.83%	17.24%	35.13%	22.93%	45.81%
Sales/Assets	0.58	1.02	0.55	0.77	0.56	0.78
Proj. Sales Growth (F1/F0)	25.96%	0.00%	4.10%	14.94%	10.78%	9.07%
Momentum Score	A	-	-	A	F	A
Daily Price Chg	5.22%	0.00%	1.49%	5.51%	3.84%	5.50%
1 Week Price Chg	-7.61%	-2.29%	-2.60%	-6.47%	-5.13%	-2.72%
4 Week Price Chg	1.34%	0.00%	0.51%	2.26%	0.15%	9.84%
12 Week Price Chg	2.51%	0.00%	4.44%	11.68%	11.82%	20.51%
52 Week Price Chg	67.45%	3.83%	14.65%	61.07%	64.76%	87.35%
20 Day Average Volume	1,122,270	31,875	1,935,862	6,650,626	746,765	1,733,961
(F1) EPS Est 1 week change	0.00%	0.00%	0.00%	0.85%	0.00%	10.14%
(F1) EPS Est 4 week change	1.00%	0.00%	0.00%	0.85%	-6.32%	10.60%
(F1) EPS Est 12 week change	1.00%	-1.47%	-0.10%	15.68%	-5.10%	10.60%
(Q1) EPS Est Mthly Chg	2.75%	-0.23%	0.00%	1.95%	-29.50%	14.17%

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	A
VGM Score	B

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.

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