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Invasion insurance

Evan Lorenz writes:

"A bet on Intel is a hedge against geopolitical instability in the world," CEO Patrick Gelsinger proclaimed at the company's Feb. 17 investor day meeting, "and government leaders are recognizing this."

Grant's agrees, though at the risk of giving constant readers whiplash. We argued the bull case in the issue dated Oct. 16, 2020, only to reverse ourselves in the issue dated Dec. 25, 2020. Microsoft Corp.'s following Apple, Inc. into the field of microchip design was the news that broke our conviction.

But now that invasions are back in style and Intel (INTC on the Nasdaq) is making progress in its corporate turnaround, we've re-reconsidered. Our new verdict, if not ringing, is simple enough: A domestic manufacturer of semiconductors trading at a reasonable valuation is no bad thing to own in 2022.

What made the turnaround obligatory? Customer defections, the loss in manufacturing leadership to Samsung Group and Taiwan Semiconductor Manufacturing Co. Ltd. (TSMC to its friends). Along the way, Advanced Micro Devices, Inc., which outsources its chip-making to TSMC, caught up to and, in some cases, surpassed Intel's own semiconductor designs.

Gelsinger, the former chief of VMWare, Inc. and a 30-year Intel veteran, took over as CEO in February of last year. To retrieve the corporate fortunes, Gelsinger is separating the functions of chip-making design and manufacturing. Henceforth, if Intel can design it but can't make it, TSMC's fabs will get the manufacturing nod.

Meantime, Intel Foundry Services is spending big to make that fallback unnecessary. It's likewise soliciting work from non-Intel chip designers. The hope and expectation is that the manufacturing division, now responding to signals from outside the Intel corporate bubble, will become nimbler and more resourceful.

"[T]he world desperately needs more geographically resilient supply chains," Gelsinger said last month. "Over the last 30 years . . . we went from 80% of semiconductor manufacturing in the West (U.S. and Europe) to 80% in Asia." Gelsinger contends that the American and European share of manufacturing could rise to 50% by the end of the decade.

Whether it's bullish or bearish, we'll know later, but governments are pitching in, too. Congress is in the midst of funding the $52 billion Creating Helpful Incentives to Produce Semiconductors (Chips) Act and is contemplating the Facilitating American-Built Semiconductors (FABS) Act, which, if passed, would provide tax incentives for building domestic manufacturing capacity. The European Union is working on its own €43 billion ($47 billion) Chips Act to incentivize the construction of fabs in the Old Continent.

"But of course this doesn't come cheap," Stacy Rasgon, Bernstein Research's senior semiconductor analyst who rates Intel a sell, observed last month, "and even if they can manage

Just in case

source: The Bloomberg

to stick this landing in 2025 [and beyond], the next few years look dour, with muted gross margins and spending (on both capex and opex) increasing through 2024, and with free cash flow essentially zero until 2025 as they put into place the massive amounts of capacity needed to support a growth story like this."

While Gelsinger has been in the top position for only 13 months, he's already led Intel to a few commercial victories. A team of JPMorgan Chase & Co. analysts led by Harlan Sur recently described a few: "The team brought the Intel 7 process [a new semiconductor fab] online and launched [consumer CPU] Alder Lake on time late last year and is poised to ramp [server CPU] Sapphire Rapids next month, and they are on or ahead of schedule on [semiconductor fabs] Intel 4/3/20A/18A. In fact the team has pulled in their manufacturing road map by a year on the launch of the Granite Rapids Xeon server CPU on Intel 3 (3nm equivalent) versus their prior view on ramping Granite Rapids on their Intel 4 process."

This was a pleasant "contrast to the execution issues the company has had in the past," as the Morgan analysts, who follow but don't rate Intel, pointed out.

Intel's stock changes hands at 12.9 times the 2022 estimate and sports a 3.3% dividend yield. And, while the turnaround will be costly, single-A-plus-rated Intel is starting it from a position of financial strength with net debt of $9.7 billion or just 0.3 times trailing Ebitda as of Dec. 31, 2021.

Intel insiders purchased a net 72,562 shares over the past 12 months at a cost of $3.5 million; short interest sums to 1.5% of the equity float. On Wall Street, 16 of the 47 analysts on the case say buy, 8 say sell.

Of course, the turnaround is no sure thing. Intel may once again flag in the competition with TSMC, and there's no guarantee it will retake the design lead from AMD.

Yet, Gelsinger's plan wouldn't matter if China followed Russia's lead in pursuing its extra-territorial ambitions. At year-end 2020, TSMC controlled 59% of the global foundry market and is now a mainstay for competitors like AMD. If Xi Jinping were to invade Taiwan, the Jan. 19, 2024 $50 calls, which cost $6.30 in premium, might just be the ticket. Applying TSMC's 24.3 times trailing multiple to the Street's guess for Intel's earnings per share this year would yield a stock value of $84.32 versus the current price of $44.81.

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