

Vimicro International Corporation (NASDAQ: VIMC)

Turnaround story continues; first GAAP profit since 2007; upgrade to Overweight with US\$1.90 target

Bottom-line handily beat estimates, first profit since 2007

Vimicro recorded its first GAAP profit of US\$2.9 million since 2007 as a result of continuous growth in revenue and improvement in cost structure. For the second consecutive quarter, Vimicro delivered better-than-expected results, which reinforces our confidence that the management team is on track to transition the company. **We upgrade Vimicro to Overweight from Neutral with a target price of US\$1.90 with 38.7% upside.**

Revenues in-line with our expectations at US\$21.7 million

Combined revenues of US\$21.7 million from two segments are in-line with our expectation of US\$21.8 million. The multimedia IC segment showed a stronger-than-expected growth of 2.7% quarter-over-quarter (QoQ), attributed to new product that offers better performance and pricing. We expect the strong performance in the multimedia segment to continue in Q4 for two reasons: 1. Q4 typically experiences stronger demand attributed to holiday shopping, and 2. The introduction of Windows 8 is likely to result in a wave of PC and notebook (laptop) replacement.

On the other hand, growth for the security and surveillance segment is slightly below our expectation at 20% QoQ growth. We were overly optimistic with the pace at which Vimicro was able to grow in this segment. However, Vimicro management indicated that there are several additional SVAC-standard related projects in the pipeline, which will be announced later this year. We have lowered our growth forecast for the security and surveillance segment, but remain positive on its long-term prospect and expect the segment to continue to grow at double digits.

Improving margins – gross margin improve to 38%

Gross margin improved to 38% from 34% in Q2-2012 and 31% in Q1-2012. The continuous improvement is again attributed to the introduction of new products in the multimedia IC segment, which has performed better at lower costs. However, as we pointed out in our initiating report, margins may be increasingly difficult to maintain as time passes due to increases in competition and technology advancements.

November 08, 2012

OVERWEIGHT

Target price US\$1.90
Upside 38.7%

Company data

Price (US\$)	1.37
Market cap. (US\$m)	40.7
Shares (ADS) OS (mn)	29.7
52-week range (\$)	0.69 – 1.95
Dividend yield (%)	-
EV/sales 2012E	0.40x
P/BV 2012E	0.54x
Sector	Information Technology
Industry	Semiconductor / Security

Note: Market data as of November 7, 2012

Financials

FYE Dec; US\$m	2011A	2012E	2013E
Sales	63.7	77.0	86.0
Gross margin	32.6%	35.9%	37.6%
Net income (adj.)	(25.1)	(5.2)	4.4
Net margin (adj.)	N.M.	N.M.	5%
ROE	N.M.	N.M.	4.4%
ROA	N.M.	N.M.	3.0%
D/E	0.0%	5.0%	14.1%
R&D as % of sales	32.3%	12.0%	7.5%

Source: BlackOre Research, company filings

Share price history



All figures in the report are in US\$ unless otherwise stated

Miller Chu, BCom
Lead Coverage Analyst
miller.chu@blackore.com
+1.604.229.2788 ext. 801

Peter Fang, CFA, MSc, BCom
Head of Research
peter.fang@blackore.com

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Following the restructuring earlier this year, Vimicro managed to further lower its R&D expenses to US\$1.6 million in Q3 compared to US\$2.6 million in Q2 and US\$3.4 million in Q1. We believe that this level of R&D expenses is reasonable as it is approximately 7.4% of the total revenues, which is in-line with the peer range of 5% to 11%. We believe Vimicro's future profitability will depend significantly on the company's ability to maintain the right level of R&D expenses while introducing new products.

Bottom-line improves; expect to remain positive in Q4

GAAP net income before deducting the loss from non-controlling interest came in at US\$1.7 million (US\$2.9 million attributed to Vimicro), significantly better than our original forecast of breakeven. The adjusted¹ GAAP net income before non-controlling interest was US\$1.2 million (US\$2.5 million attributed to Vimicro). The improvement reaffirms Vimicro's statement that company transition is on track.

Valuation

Our revised revenue forecast of US\$23.5 million represents an 8.1% QoQ increase, and is slightly above the upper range of the US\$20.0 to US\$23.0 million guidance. However, we believe that growth is achievable given the historically strong Q4, introduction of Windows 8 for the multimedia IC segment, and pipeline projects for the security and surveillance segment. We have also adjusted our operating expenses forecast to reflect this quarter's figures.

Following the better-than-expected results, we revised our target price to US\$1.90, an upside of 38.7% to the current share price. Our revised valuation is presented in Exhibit 1 and Exhibit 2, showing Vimicro's valuation against its peers.

¹ Adjusted net income includes adjustment for income (loss) from discontinued operations, asset impairment, foreign exchange gain (loss), and other non-operating items.

Exhibit 1 – Valuation summary

				Implied value/share	Premium/(discount) to current price*	Weight
DCF valuation		Terminal factor				
DCF - terminal multiple (EBITDA)		3.5x		\$1.97	43.8%	30.0%
DCF - terminal growth		1.0%		\$1.91	39.4%	30.0%
Peer trading multiple	Multimedia IC	Security & surveillance	Overall			
EV/sales (FY2012)	1.09x	1.50x	1.65x	\$4.17	204.4%	-
P/BV (FY2012)	1.40x	1.80x	1.52x	\$4.75	246.7%	-
EV/sales (FY2013)	1.00x	1.20x	1.07x	\$4.79	249.6%	-
P/BV (FY2013)	1.30x	1.80x	1.48x	\$4.93	259.9%	-
EV/EBITDA (FY2013)	3.7x	5.8x	4.5x	\$3.57	160.6%	20.0%
P/E (FY2013)	7.0x	12.0x	8.8x	\$1.59	16.1%	-
Historical implied multiples**	High	Low	Target			
P/sales (1-year forward)	5.26x	0.74x	1.20x	\$3.03	121.2%	-
EV/sales (1-year forward)	4.40x	0.14x	0.50x	\$2.61	90.5%	-
P/sales (2-year forward)	6.68x	0.85x	0.85x	\$2.40	75.2%	-
EV/sales (2-year forward)	6.68x	0.85x	0.50x	\$2.76	101.5%	-
P/BV (1-year forward)	4.67x	0.56x	1.00x	\$2.48	81.0%	20.0%
Weighted average price per share				\$2.37	73.0%	
Discount				20.0%		
Final target price				\$1.90	38.7%	

Source: Capital IQ and BlackOre Research estimates; market values as of November 7, 2012

Note: * Current Vimicro share price of US\$1.37 as of November 7, 2012

** Historical implied multiples are forward multiples derived from historical market prices and actual sales, EBITDA, or BV figures reported in company's filings.

Exhibit 2 – Multiples

	Ticker	Mkt Cap (US\$ mn)	EV/Revenue**		EV/EBITDA**		P/E (Dil.)		P/BV
			LTM	FY2012	LTM	FY2012	LTM	FY2012	Latest
Multimedia semiconductor									
Hewlett-Packard (H3C Technologies)	HPQ	26,917	0.40x	0.41x	3.3x	3.2x	NM	3.7x	NM
Ricoh Co. Ltd.*	7752	6,035	0.60x	-	6.7x	-	NM	-	0.60x
Marvell Technology Group Ltd.	MRVL	4,418	0.70x	0.74x	3.9x	4.6x	10.1x	10.4x	1.70x
Realtek Semiconductor Corp.*	2379	983	0.80x	-	7.2x	-	16.1x	-	1.70x
Silicon Motion Technology Corp.	SIMO	433	1.00x	0.94x	4.5x	3.8x	8.7x	9.5x	2.00x
PixArt Imaging Inc.	3227	285	1.30x	-	15.5x	-	19.8x	-	1.60x
Ali Corp.*	3041	351	1.20x	-	5.7x	-	12.0x	-	1.80x
Sonix Technology Company Ltd.*	5471	211	1.10x	-	5.9x	-	12.2x	-	2.00x
Sunplus Technology Co. Ltd.*	2401	164	0.40x	-	61.5x	-	NM	-	0.60x
QuickLogic Corporation	QUIK	103	4.90x	4.03x	NM	NM	NM	NM	3.50x
Multimedia IC average			1.24x	1.53x	12.7x	3.9x	13.2x	7.9x	1.72x
Multimedia IC median			0.90x	0.84x	5.9x	3.8x	12.1x	9.5x	1.70x
Vimicro International Corp.	VIMC	41	0.44x	0.40x	N.M.	N.M.	N.M.	29.5x	0.51x
Security surveillance									
Texas Instruments Inc.*	TXN	32,828	2.60x	2.82x	8.1x	10.4x	19.2x	18.4x	7.90x
Sony Corporation*	6758	11,482	0.30x	0.33x	15.0x	4.7x	NM	-	1.10x
Hangzhou Hikvision Digital Technology Co., Ltd.*	002415	9,700	8.60x	-	29.1x	-	32.5x	-	8.10x
NXP Semiconductors NV*	NXPI	6,295	2.30x	2.08x	10.3x	7.4x	NM	11.5x	NM
STMicroelectronics NV*	STM	4,969	0.50x	0.49x	9.4x	5.0x	NM	166.1x	0.90x
Zhejiang Dali Technology Co. Ltd.	002214	3,740	8.20x	-	42.6x	-	42.8x	-	13.20x
Samsung Techwin Co., Ltd.	A012450	2,912	1.30x	-	15.0x	-	24.3x	-	2.30x
Zhejiang Dahua Technology Co., Ltd.	002236	258	7.30x	-	33.5x	-	49.6x	-	3.80x
Shenzhen Infinova Limited	002528	496	3.10x	-	NM	-	NM	-	1.70x
Avigilon Corporation	AVO	349	4.40x	2.94x	50.4x	28.2x	65.2x	43.8x	8.10x
Av Tech Corporation	8072	307	1.60x	-	5.4x	-	10.7x	-	2.00x
Beijing Jiaxun Feihong Electrical Co., Ltd.	300213	183	2.70x	-	-	-	28.2x	-	1.70x
Shenzhen Division Video Communications Co., Ltd.	300167	166	2.80x	-	26.7x	-	39.5x	-	1.60x
Napco Security Technologies, Inc.	NSSC	63	1.10x	-	13.2x	-	27.6x	-	2.40x
Vicon Industries Inc.	VII	13	0.10x	-	NM	-	NM	-	0.60x
ANV Security Group, Inc.	ANVS	7	0.30x	-	NM	-	NM	-	3.80x
Security surveillance average			2.95x	1.73x	21.6x	11.1x	34.0x	59.9x	3.95x
Security surveillance median			2.45x	2.08x	15.0x	7.4x	30.4x	31.1x	2.30x

Source: Capital IQ & BlackOre Research estimates

Note: * Competitors identified by Vimicro in 20F filings

** Enterprise value (EV) calculated based on market capitalization + net debt + minority interest. Cash used to calculate net debt includes cash and cash equivalents, investment in securities, but excludes restricted cash for comparability purpose.

FINANCIAL SUMMARY

Income statement													
(US\$m)	Dec-31 2010	Dec-31 2011	Mar-31 Q1A	Jun-30 Q2A	Sep-30 Q3A	Dec-31 Q4E	Dec-31 2012	Mar-31 Q1E	Jun-30 Q2E	Sep-30 Q3E	Dec-31 Q4E	Dec-31 2013	Dec-31 2014
Sales													
Multimedia IC	68.6	46.9	8.8	14.7	15.1	15.6	54.2	12.3	13.2	14.4	14.9	54.9	55.8
Security and surveillance	7.8	16.8	2.7	5.5	6.6	7.9	22.8	6.9	7.4	8.2	8.6	31.1	34.5
Total sales	76.5	63.7	11.6	20.1	21.7	23.5	77.0	19.2	20.6	22.6	23.5	86.0	90.3
COGS													
Multimedia IC	(44.9)	(29.7)	(5.9)	(9.0)	(9.1)	(9.4)	(33.4)	(7.5)	(8.1)	(8.8)	(9.1)	(33.5)	(34.6)
Security and surveillance	(6.2)	(13.2)	(2.2)	(4.3)	(4.3)	(5.1)	(15.9)	(4.5)	(4.8)	(5.3)	(5.6)	(20.2)	(22.4)
Gross profit	25.3	20.7	3.5	6.9	8.3	8.9	27.7	7.2	7.8	8.5	8.8	32.3	33.3
Multimedia IC	23.7	17.1	3.0	5.7	6.0	6.2	20.8	4.8	5.1	5.6	5.8	21.4	21.2
Security and surveillance	1.6	3.6	0.6	1.2	2.3	2.8	6.9	2.4	2.6	2.9	3.0	10.9	12.1
Gross margin (%)	33.1%	32.6%	30.6%	34.1%	38.0%	38.0%	35.9%	37.6%	37.6%	37.5%	37.5%	37.6%	36.9%
Operating expenses													
Stock-based compensation	(4.1)	(2.4)	(0.2)	(1.1)	(0.4)	(0.4)	(2.1)	(0.4)	(0.4)	(0.4)	(0.4)	(1.7)	(1.5)
Research & Development	(17.7)	(20.5)	(3.4)	(2.6)	(1.6)	(1.7)	(9.3)	(1.5)	(1.6)	(1.6)	(1.7)	(6.4)	(6.8)
Sales and marketing	(6.0)	(12.8)	(2.5)	(2.3)	(2.4)	(2.4)	(9.6)	(2.1)	(2.1)	(2.1)	(2.1)	(8.5)	(8.5)
G&A	(7.5)	(11.2)	(3.0)	(2.5)	(2.3)	(2.8)	(11.0)	(2.5)	(2.5)	(2.5)	(2.5)	(10.2)	(10.4)
EBIT	(10.0)	(26.2)	(5.5)	(1.6)	1.5	1.6	(4.3)	0.7	1.1	1.7	2.0	5.5	6.1
EBIT margin (%)	(13.1%)	(41.1%)	(47.2%)	(8.1%)	6.8%	7.0%	(5.6%)	3.6%	5.4%	7.6%	8.5%	6.4%	6.7%
Interest income/(expenses)	1.1	0.7	0.1	0.1	0.0	(0.1)	(0.0)	(0.1)	(0.1)	(0.1)	(0.1)	(0.3)	(0.3)
EBT before unusual and infrequent items	(8.9)	(25.5)	(5.4)	(1.5)	1.5	1.5	(4.4)	0.6	1.0	1.6	1.9	5.2	5.7
Other non-operating & unusual items													
Asset impairment	-	(6.6)	-	-	-	-	-	-	-	-	-	-	-
FX gain/(loss)	0.6	1.7	0.0	(0.2)	(0.1)	-	(0.2)	-	-	-	-	-	-
Gain (loss) on disposal of mkt. securities	0.4	1.5	-	-	-	-	-	-	-	-	-	-	-
Others, net	0.5	0.5	0.0	0.0	0.0	-	0.0	-	-	-	-	-	-
EBT after non-operating and unusual items	(7.5)	(28.4)	(5.3)	(1.7)	1.4	1.5	(4.6)	0.6	1.0	1.6	1.9	5.2	5.7
Income tax (expense)/benefits	(0.8)	0.9	(0.2)	(0.2)	(0.2)	(0.2)	(0.8)	(0.1)	(0.2)	(0.2)	(0.3)	(0.8)	(1.4)
Net income (loss) before unconsolidated	(8.2)	(27.5)	(5.5)	(1.8)	1.2	1.3	(5.4)	0.5	0.9	1.4	1.6	4.4	4.3
Equity in profit of unconsolidated affiliate	-	-	-	-	-	-	-	-	-	-	-	-	-
Net income (loss) from continuing op.	(8.2)	(27.5)	(5.5)	(1.8)	1.2	1.3	(5.4)	0.5	0.9	1.4	1.6	4.4	4.3
Income (loss) from discontinued operating	(16.9)	(12.6)	-	-	0.5	-	-	-	-	-	-	-	-
Net income (loss)	(25.1)	(40.1)	(5.5)	(1.8)	1.7	1.3	(5.4)	0.5	0.9	1.4	1.6	4.4	4.3
Net margin (%)	(32.8%)	(63.0%)	(47.7%)	(9.1%)	7.7%	5.5%	(7.0%)	2.7%	4.2%	6.2%	7.0%	5.2%	4.8%
Net income (loss)													
Attributable to non-controlling interest	(6.5)	(11.9)	(1.8)	(1.5)	(1.3)	(1.0)	(5.6)	(0.4)	(0.7)	-	-	(1.1)	-
Attributable to Vimicro International Corp.	(18.6)	(28.2)	(3.7)	(0.3)	2.9	2.3	1.2	0.9	1.5	1.4	1.6	5.5	4.3
Adjusted figures including non-controlling interest													
Adjusted net income*	(9.5)	(25.1)	(5.6)	(1.7)	1.2	1.3	(5.2)	0.5	0.9	1.4	1.6	4.4	4.3
Adjusted figures attributable to Vimicro													
Adjusted net income*	(\$3.01)	(\$13.16)	(\$3.71)	(\$0.21)	\$2.52	\$2.28	\$1.38	\$0.92	\$1.54	\$1.40	\$1.64	\$5.50	\$4.29
Adj. basic earnings per ADS	(\$0.08)	(\$0.36)	(\$0.11)	(\$0.01)	\$0.09	\$0.08	\$0.05	\$0.03	\$0.05	\$0.05	\$0.06	\$0.18	\$0.14
Adj. diluted earnings per ADS	(\$0.08)	(\$0.36)	(\$0.11)	(\$0.01)	\$0.08	\$0.07	\$0.05	\$0.03	\$0.05	\$0.05	\$0.05	\$0.18	\$0.14
Supplemental data													
EBITDA	(6.3)	(21.7)	(4.5)	(0.7)	2.4	2.6	(0.6)	2.4	2.8	3.4	3.7	12.4	14.6
Effective tax rate	(10.0%)	3.0%	(3.6%)	(10.5%)	16.2%	15.0%	(18.0%)	15.0%	15.0%	15.0%	15.0%	15.0%	25.0%
WASO - basic**	147.8	145.1	134.9	121.9	118.6	118.8	118.8	118.9	118.9	118.9	118.9	118.9	118.9
WASO - diluted**	147.8	145.1	134.9	121.9	121.7	121.7	121.7	121.7	121.7	121.7	121.7	121.7	121.7

* Adjusted for one-time items, profit/loss from discontinued operations, unrealized gain/loss, and FX gain/loss.

**WASO: weighted average of common shares outstanding. The ADS ratio is 1 ADS to 4 common shares

Balance sheet				
(US\$m)	Dec-31 2010A	Dec-31 2011A	Dec-31 2012E	Dec-31 2013E
Current assets				
Cash and cash equivalents	69.5	49.2	42.5	60.7
Securities and restricted cash	18.8	3.5	5.2	7.1
A/R and notes receivable	18.6	17.9	16.5	15.8
Amounts due from related party	10.5	4.8	2.3	-
Inventories	13.8	18.7	10.2	14.7
Other current assets	4.2	4.4	8.6	5.5
Total current assets	135.3	98.6	85.2	103.8
PP&E	9.6	14.3	20.9	24.6
Land use rights	20.7	21.5	14.3	14.0
Other assets	6.3	2.9	7.3	7.3
Total assets	171.9	137.3	127.6	149.7
Current liabilities				
Accounts payable	7.4	9.3	6.6	10.3
Notes payable	0.0	1.0	-	-
Amounts due to related party	4.8	1.0	0.5	-
Taxes payable	1.0	1.2	2.6	1.0
ST bank loans	-	-	-	1.9
Other current liabilities	12.5	16.2	17.6	22.3
Total current liabilities	25.7	28.6	27.2	35.5
Deferred tax liabilities	0.0	0.0	0.0	0.0
Product warranty	0.1	0.3	0.5	0.5
LT bank loans	-	-	4.8	12.4
Total liabilities	25.9	29.0	32.4	48.4
Shareholders' equity				
Common equity	167.8	168.0	163.6	165.3
Retained earnings (deficits)	(54.4)	(82.6)	(88.0)	(83.6)
Non-controlling interest	32.7	22.9	19.6	19.6
Total shareholders' equity	146.0	108.3	95.2	101.3
Total liabilities and shareholders' equity	171.9	137.3	127.6	149.7

Ratios				
	Dec-31 2010A	Dec-31 2011A	Dec-31 2012E	Dec-31 2013E
Profitability				
ROA - total assets	N.M.	N.M.	N.M.	3.0%
ROA - tangible assets	N.M.	N.M.	N.M.	3.0%
ROE	N.M.	N.M.	N.M.	4.4%
ROIC	N.M.	N.M.	N.M.	3.8%
Adj. ROA - total assets	(5.5%)	(18.3%)	(4.1%)	3.0%
Adj. ROA - tangible assets	(5.7%)	(18.3%)	(4.1%)	3.0%
Adj. ROE	(6.5%)	(23.1%)	(5.5%)	4.4%
Adj. ROIC	(6.5%)	(23.1%)	(5.2%)	3.8%

Margins				
Gross margin - total	33.1%	32.6%	35.9%	37.6%
Gross margin - multimedia IC	34.6%	36.6%	38.3%	39.0%
Gross margin - surveillance	20.8%	21.4%	30.1%	35.0%
SG&A as % of revenue	17.7%	37.6%	26.8%	21.7%
EBITDA margin	N.M.	N.M.	N.M.	14.4%
EBIT margin	N.M.	N.M.	N.M.	6.4%
Net margin	N.M.	N.M.	N.M.	5.2%
Adj. net margin	N.M.	N.M.	N.M.	5.2%

Turnovers & liquidity				
Total assets turnover - total	0.4x	0.5x	0.6x	0.6x
AR turnover	4.1x	3.6x	4.7x	5.5x
AP turnover	6.9x	4.6x	7.5x	5.2x
Inventory turnover	3.7x	2.3x	4.8x	3.7x
Cash cycle	134.5	183.0	105.0	96.9

Liquidity				
Current ratio	5.3x	3.4x	3.1x	2.9x
Quick ratio	3.4x	1.8x	1.8x	1.9x
EBIT / interest expense	n.a.	n.a.	N.M.	17.5x

Solvency				
Total debt / equity	0.0%	0.0%	5.0%	14.1%
Total debt / capital	0.0%	0.0%	4.8%	12.3%

Cash flow statement				
(US\$m)	Dec-31 2010A	Dec-31 2011A	Dec-31 2012E	Dec-31 2013E
Operating activities				
Net income (loss)	(25.1)	(40.1)	(5.4)	4.4
Non-cash items				
Depreciation	3.7	4.5	3.8	6.8
Stock-based compensation	4.1	2.4	2.1	1.7
Other non-cash items	2.0	5.8	-	-
Total non-cash items	9.8	12.7	5.9	8.5
Working capital				
Restricted cash	-	1.4	(1.7)	(1.9)
A/R and notes receivable	(9.6)	(0.7)	1.4	0.7
Amount due from related party	(10.5)	0.6	2.6	2.3
Inventories	(4.9)	(3.8)	8.5	(4.5)
A/P	2.4	1.9	(2.7)	3.7
Amount due to related party	4.8	(3.9)	(0.5)	(0.5)
Notes payable	0.0	1.0	(1.0)	-
Taxes payable	0.1	0.2	1.3	(1.6)
Other working capital items	1.9	3.9	(2.8)	7.8
Net change in working capital	(15.7)	0.7	5.2	6.1
Total operating cash flows	(31.1)	(26.8)	5.6	19.0
Investing activities				
Sale (purchase) of securities	31.9	14.0	-	-
Change in restricted cash	(4.8)	-	-	-
Purchase of PP&E	(5.5)	(11.7)	(10.4)	(10.6)
Cash payment for business acquisition	-	-	-	-
Land use rights payments	(9.4)	-	7.2	0.3
All other investing activities	(0.1)	4.8	(4.1)	-
Total investing cash flows	12.1	7.0	(7.3)	(10.3)
Financing activities				
Repurchase of shares	(1.2)	(2.7)	(6.6)	-
Proceeds from exercise of share options	0.1	-	-	-
Proceeds from bank loans	-	-	4.8	9.5
Repayment of bank loans	-	-	-	-
Issuance of shares	-	-	-	-
Non-controlling interest	2.9	0.7	(3.3)	-
Total financing cash flows	1.8	(1.9)	(5.1)	9.5
FX effect on cash and cash equivalents	2.1	1.4	-	-
Net increase (decrease) in cash	(15.0)	(20.3)	(6.7)	18.2
Cash at the start of year	84.5	69.5	49.2	42.5
Cash at the end of year	69.5	49.2	42.5	60.7

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BlackOre Research Inc.

355 Burrard Street, Suite 1000
Vancouver BC, Canada V6C 2G8