AMD: Q3 And Q4 Expectations Still Offer Significant Upside

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For the second quarter in a row, AMD delivered a solid revenue and earnings beat ($1.027bn and -$0.05, respectively vs. $952m and -$0.08). AMD's Q2 revenue surged 9% year-on-year (after a 19% decline in Q1) and 23% quarter-on-quarter thanks to impressive sales of semi-custom SoCs (Enterprise, Embedded and Semi-Custom was up 59% quarter-on-quarter) and strong momentum in graphics cards (first half GPU sales increased by a double digit percentage year-on-year).

The better leverage on fixed costs, combined with a solid gross margin of 31% (down 100bps sequentially due to a higher mix of semi-custom SoCs but up 300bps year-on-year) and the contribution of the high-margin licensing business ($26m for the recent Chinese server JV), enabled the company to return to non-GAAP operating profitability ($3m vs. -$55m in Q1 and -$87m one year ago).

This quarterly performance, the impressive Q3 guidance (revenue to increase 18% quarter-on-quarter, plus or minus 3%, 7% above consensus) and AMD's confidence in its ability to deliver non-GAAP operating profitability in the second half of the year suggest in our view that the turnaround is well on track and that investors are likely to shift their focus from AMD's weak balance sheet to the company's numerous growth opportunities and long-term earnings power.

Starting with the short-term outlook, we believe that AMD's expectations are still on the cautious side and leave significant upside even if the Q3 guide is likely to spark ~ 10% EPS revisions today. While AMD expects increased seasonality this year in Q3 compared to last year (18% revenue growth vs. 13% last year), we doubt this forecast fully factors in the company's rich product release schedule. Indeed, Polaris-based RX 480 GPUs shipped at the end of June and the RX 470 and RX 460 desktop GPUs and Polaris-based notebooks are expected to launch soon. In the Semi-Custom segment, shipments and/or ASP will probably get a boost from the expected launches of the Xbox One S and PS4 Neo.

In our view, this rich release schedule points to 20-25% sequential revenue growth in Q3 and to ~5% revenue upside. Strong product activity is also likely to fuel Q4 expectations which are underwhelming for now as AMD's full year revenue guidance (low single digit growth) implies Q4 revenue down 12-13% sequentially, compared to a 10% revenue decline last year. Hence, a 7-8% revenue upside in Q4 appears reasonable in our view.

We estimate the impact from this revenue upside on the operating margin around 200bps in the second half and around 400bps on a full year basis, suggesting that expectations for a mid single digit operating margin as soon as 2017 are realistic.

This clearly strengthens our view (that investors could be tempted to model long-term operating margins in the mid or high teens for AMD assuming the company gets a significant chunk of its revenues from high-end GPUs (for VR and artificial intelligence applications) and/or from licensing. In our valuation model, we assume a 15% long-term margin, still well below Intel and Nvidia's current margins.

Regarding licensing, the CEO's comments during the conference call were encouraging: "In terms of the overall pipeline, I would say we have a nice set of interesting opportunities. They are very much – as you know, they take a while for them to come to fruition. But we feel good about the model, which is partnering with folks that need high performance technology and we'll continue to work those deals as we go through the next couple of quarters."

We estimate that any $100m additional licensing revenues would bring at least 200bps of margin expansion.

We remain Buyers of the stock with a $7.90 target price.