

Qualcomm-NXP and China

Chinese Opposition Unlikely

Merger between Qualcomm and NXP

We think this is a win-win deal between NXP and Qualcomm, providing more upside for Qualcomm. On the one hand, Qualcomm is seizing the burgeoning automotive market and IoT (Internet of Things), which is expected to bring economic scale and client loyalty in the near future. On the other hand, NXP has achieved its long-term goal of selling itself at a good price. In addition, the transaction fits within China's goal to achieve significant present in "strategic" industries, which includes semiconductors.

Active restructuring dominated by PE in order to quit with a good return

NXP Semiconductors, which was formerly known as Philips Semiconductors, was founded in 1953 and sold to a group of private equity investors in 2006. The time Kohlberg Kravis Roberts Co. & and their business partners in private equity took over the company turned out to be a disaster, especially when the following was the great recession of U.S. **Since then, the company's PE shareholders have struggled in splitting and restructuring NXP's business to finally sell it at a good price.** After selling part of its business to China to get lean, NXP bought Freescale, which made itself ready for the ultimate buyer: Qualcomm.

Figure 1: Active splitting & restructuring before its listing in 2010

| Time | Type | Target Company | Business |
|--------|----------------------|---------------------------|---|
| May-07 | Acquisition | Silicon Laboratories Inc. | Cellular Communications |
| Sep-07 | Sell-off | DSPG | Cordless phone system-on-chip |
| Jul-08 | Split | Ericsson | Wireless business |
| | Sell-off | | All stake in ST-NXP Wireless (JV) |
| 2008 | Internal integration | NuTune (JV) | Combined CAN tuner module operations with those of Thomson and included in the home business unit |
| 2008 | Split | STMicroelectronics (JV) | Wireless operations of M&P |
| 2009 | Sell-off | | All stake (20%) in the JV |
| 2009 | Internal integration | NXP | Moved remaining parts of M&P into Multi-Market Semiconductor business |
| 2009 | Sell-off | | Wafer fabs and redesigned operations |
| 2009 | Sell-off | Virage Logic | System on chip business |
| Dec-10 | Sell-off | Knowles | Sound solutions business |
| 2010 | Listing | | Restructring into four reportable segments |

Source: Company data, OCR

Except for the automotive segment recording 7% QoQ and 5% YoY increase in 2Q16 revenue, all other businesses of NXP were dragged down by the consolidation of Freescale's financial results. Specifically, the combined adjusted revenue of SIS recorded its biggest declines of 6% QoQ and 22% YoY, respectively. Following SIS are SI & I and SCD, which experienced 19% YoY and 10% YoY decline, respectively. As a result, total revenue of HPMS dropped 8% YoY, suggesting the tough integration between NXP and Freescale.

However, we're not worried about the integration as Qualcomm may continue selling other low-profitability product lines of NXP to SOE buyers in China.

Recently, China has been aggressively strengthening its semiconductor capabilities to free itself from heavy reliance on imports that have drawn almost as much cash out of the country as oil purchases. We see China's push to acquire overseas expertise catering to Qualcomm's future need to continue selling NXP's diversified product lines despite low profitability. In fact, NXP has a good track record of selling its products to SOE buyers in China. For example, NXP sold its standard products business to China's Beijing Jianguang Asset Management Co. (JAC Capital) and Wise Road Capital Ltd. for \$2.75bn in June 2016. NXP also sold its RF Power business to JAC Capital for US\$1.8bn in 2015.

In addition, NXP and JAC Capital established a Bipolar Power joint venture WeEn Semiconductors to capture the opportunities arising from China's growing demand for electronic products in the consumer, automotive, smart manufacturing and medical equipment sectors. Notably, Beijing Jianguang, part of China Jianyin Investment Ltd., was established by the Chinese government to invest in businesses in the semiconductor, information technology, networking, data service, cloud computing and telecommunications industries. As a result, JAC

Capital successfully introduced NXP’s front-end and back-end business to China, which is revitalizing the country’s integrated device manufacturing (IDM) by combining IC (integrated circuit) simulating manufacturing, design and encapsulation.

Figure 2: Diversified product lines of NXP

| Automotive | Secure Identification Solutions | Secure Connected Devices | Secure Interfaces and Infrastructure |
|--|--|--|---|
| <ul style="list-style-type: none"> • Car access & immobilizers • In vehicle networking • Car entertainment • ADAS • Telematics • ABS • Transmission/throttle control • Automotive Lighting | <ul style="list-style-type: none"> • Secure identity • Tagging | <ul style="list-style-type: none"> • Secure transactions • Mobile handset • Tablet • Personal computer • Smart metering • White goods & home appliances • Medical/Personal Healthcare • Industrial/ IoT • Consumer/TV/Set top box | <ul style="list-style-type: none"> • Wireless base stations • Networking • Satellite & CATV infra • Radar • Power supplies • Lighting • Mobile Handsets • Pachinko machines |

Source: Company data, OCR

Given the underlying logic from a Chinese strategic point of view, therefore, we don’t think China will step into the deal even if U.S. President Donald Trump maintains his strong stand on China. Instead, China may wait for the deal to be complete so that it can buy the technology it has sought for a significant period of time. The Ministry of Commerce had approved the NXP-Freescale acquisition, after an eight-month review, along similar criteria used by the U.S. and Europe.

This is confirmed by comments from Qualcomm during a presentation at NASDAQ on November 29, 2016. George Davis, Qualcomm EVP, said positive discussions with China’s planning board, the National Development and Reform Commission (NDRC), had proceeded well. He noted:

I think, certainly the NDRC experience was a turbulent experience at the time and — but if you look at the state and the nature of the relationship we have broadly in China with a number of governmental entities, with large, both customers and then suppliers our relationships are actually quite good in China now. We feel very comfortable and it’s something that has been hard won and we are making significant investments in China as part of our long-term

relationship we announced for instance, a data center chip program in Guizhou that is well underway. We're a very important partner for SMIC and we've helped them qualify 28 nanometer. So we look to play a very constructive role in the areas where the government is keen for development within the country. So we actually — we view the NDRC experience as having really built a much stronger foundation for relationship in China going forward. So we probably look at a little bit differently than you're interested.

The bigger issues concerns CFIUS approval under the new administration. If MOFCOM requires divestiture of certain sensitive assets and they are purchased by Chinese corporates, this could raise security issues that would be analyzed under CFIUS. Given that CFIUS may be a likely vehicle for the Trump administration to express its antipathy toward China, this is a potential risk to the overall transaction.

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For additional information on China's regulatory stand on this transaction, or for custom research on outbound China transactions, please contact Orient Capital Research at Andrew@collierchina.com.

