

China Hardware – Optical Transceiver

Expert call takeaways: Steady demand outlook for market leaders

We hosted an expert call on optical transceiver sector, to discuss the sector outlook and competitive dynamics among domestic and overseas players. Overall, the expert reaffirmed that the demand for optical transceivers from overseas cloud companies remains steady for 2022. Unless the manufacturing costs of silicon photonics go lower significantly, domestic suppliers still have advantages compared with overseas players in module manufacturing and are likely to keep a significant global market share. We also believe leading cloud companies will continue to invest in datacenters infrastructure/AI-related projects (including optical transceivers), because these businesses are expected to outperform during tough economy. Therefore, we maintain our positive outlook for the sector. We summarize key takeaways as below.

- **Overseas demand remains steady for 2022.** Although the leading cloud companies gave very opportunistic capex outlook at the beginning of the year, the market is worried that they will lower spending now due to tough macros. Per the expert's view, investment in datacenter has infrastructure characteristic, which is non-cyclical. In addition, the demand for data is strong now. Therefore, it is unlikely for the cloud companies to cut capex for optical transceivers. Our observation matches with the expert's opinion as the cloud/datacenter segments outperformed in the past several quarters. The growth of AWS/Google cloud/Microsoft cloud was 36.6%/43.8%/26% YoY vs. -1.8%/23.0%/18.4% YoY for their total revenue in 1Q22, suggesting cloud business positively contributed to their respective revenue growth.
- **Technology trend and competitive dynamics.** The current optical transceiver industry favors the Chinese suppliers, because they have advantages in module manufacturing. That is why the domestic players kept gaining shares globally in the past years. However, the expert also pointed out that for 1.6T and beyond, silicon photonics may become a feasible solution as manufacturing cost comes down further. Should new technology can help to reduce production cost meaningfully in a relatively short time, adoption of silicon photonics may ramp up fast and change competitive landscape. This would increase overseas suppliers' competitiveness.
- **China-US trade/tax issue has limited impact on domestic suppliers.** Cloud companies are diversifying their supply chain but more than half of the suppliers are China-based suppliers. Domestic suppliers have even larger share in low-end optical modules, which means there are a few alternative options for their clients. In high-end market, domestic players may be affected. However, we see top suppliers like Innolight have built overseas factories to address this issue.
- **Top pick:** Innolight (300308 CH) is well positioned given its greater revenue exposure to global top Cloud companies (70% revenue generated from overseas). We reiterate BUY on Innolight with TP of RMB45.6. Potential risks include weaker capex from global cloud companies, innovative tech advancement such as mass adoption of silicon photonics.

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