Sumitomo Electric Industries (5802.T): Conf. takeaways: Optical device output normalized, set to improve in 2Q; valuation attractive; Buy

Era of Optics: Innovation behind AI
Insights into optical product technology and trends
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On September 18, we hosted a group call for investors with Fumihiro Kawano, General Manager, IR Office, Accounting Division at Sumitomo Electric Industries (SEI).

Although SEI's 1Q results were favorable overall, the market reacted negatively to some weakness in the infocommunications segment. However, the weakness was mainly caused by a temporary shutdown of an optical device plant, an issue that has been resolved. **While some impact will remain on shipments in 2Q, we expect improvement from 1Q to 2Q, considering factors such as the high marginal profit ratio for this product group. As demand remains strong, SEI is looking to accelerate its announced production capacity expansion plan ahead of FY3/29, and also looks to be making progress with discussions on capacity increase plans from FY3/30.**

Investment in AI-related stocks has completed a cycle and is in a lull, and SEI's shares have not been immune to this trend. However, **we believe fundamentals remain strong and see little risk of a collapse in earnings. SEI's earnings visibility is also relatively high, partly due to its many long-term agreements (LTAs). SEI's valuation has already fallen to 17X forward P/E, and we think investors will start to see the stock as inexpensive relative to its earnings growth.**

Key takeaways

Unless otherwise noted, comments below are from the company.

Infocommunications-optical devices and InP substrates

Impact of 1Q optical device plant shutdown and current situation

- A plant was shut down for just over half a month (including over the May holidays) for construction work in preparation for future capacity expansion. Equipment problems also occurred, reducing the yield of non-defective products.
- The issues have been resolved. Production normalized during 1Q. SEI tried to make up for the lost production during the Obon holiday period in August, and

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while output has not yet caught up fully, the company will continue its efforts to catch up.

- Due to the long manufacturing lead time of optical device products, 2Q shipments will be impacted as well. 2Q sales are poised to be slightly below initial expectations. However, shipments have also already normalized.
- SEI facilities are operating at 100% production levels and the company is trying to increase output even modestly by improving yields.
- The company does not think unexpected costs associated with the catch-up production will emerge (it expects no impact on the marginal profit ratio).
- The risk of customer churn is limited. Competitors are also operating at full capacity, and there are no alternative suppliers that can quickly step in. SEI has asked customers to wait for shipments.

Demand environment for optical devices

- The demand trend has not changed compared to three months ago; if anything, it has strengthened. Negotiations with customers on future business are intensifying.

Production expansion plan for optical devices and InP substrates

- The plan through FY3/29 (vs. FY3/25: optical devices 4X, InP substrates 3X) is unchanged. However, the company is considering what can be done to accelerate implementation or raise the target for FY3/29.
- SEI is working out details of plans from FY3/30 onward, and some measures have already been decided and initiated. Additional capacity expansion is also under consideration, including the construction of new buildings, and it is taking time to finalize the details.
- Production increases will be executed via a combination of new equipment investment, yield improvement, and increased equipment operating time.
- The investment will be undertaken mostly by the company itself. However, in negotiations with customers on future contracts, SEI is including whether clients can pay part of the funds necessary for capital investment as an advance payment. The possibility of a joint venture is almost nil.
- SEI is aware of production increases by Chinese and other competitors, but is hedging the risk by securing demand through long-term contracts and by securing investment capital through advance payments.

Increasing diameter of InP substrates

- Increasing diameter: The industry mainstream is 3-inch or 4-inch. SEI is a leader in increasing diameters. Specifically, it is able to provide products with fewer defects in the crystal and less variation, making them easier for customers to process.
- For internal use, SEI basically uses 4-inch wafers. Each process line is streamlined for 4-inch, making it efficient. Increasing diameters is included among the themes the company is considering.

Pricing and contract structure

- SEI has a relatively high proportion of LTAs compared to other companies. LTAs are basically fixed-price, but are structured to allow for the pass-through of inflation. For new negotiations, the company is negotiating for favorable terms and has no policy of not raising prices.
- The start and end dates of LTAs are mainly on a calendar-year (CY) basis due to the large number of overseas customers.
- About 80% of optical wiring for data centers (connectors, etc.) is under long-term contracts. Optical cables are often under annual contracts rather than long-term contracts.
- For connectors, selling prices are fixed under long-term contracts. The proportion of fiber in the cost is small, so rising fiber prices are not a significant issue. For cables, SEI requests price increases as necessary in response to rising fiber prices.
- Mechanism for absorbing demand fluctuations in long-term contracts: Annual transaction volume is stipulated in a comprehensive agreement, and specific orders are handled on a case-by-case basis. If projects are delayed too much, this violates the minimum order quantity stipulated in the contract, resulting in an additional order or a penalty payment. (To date, demand has been on a front-loaded trend, and there have been no cases of penalty claims.)

CPO/NPO

- Lasers: SEI plans to start selling CW lasers. Development is already complete, and it is proceeding with procedures to obtain product certification for multiple customers.
- Fiber and connector-related: SEI is proceeding with business discussions for multiple products, including MMC ferrules, connectors for external light sources, and fiber array units (FAUs). Some shipments and sales recognition are slated to begin within this fiscal year, with the amount expected to increase in 2027.
- Compared to Lumentum: At this point, Lumentum may be slightly ahead in the field. However, SEI plans to proceed with preparations for shipments once it receives certifications, so it thinks it is not far behind. The CPO market is small in the initial stage, and volume is set to increase from FY3/29 onward, and SEI is working with that launch period in mind.
- ELS modules: The company envisions sales of chips. Modularization is an area that becomes closer to transceiver assembly. It also sells chips for transceivers, and as well as chips for high-power lasers used in external light sources.
- NPO (Near-Packaged Optics): SEI is in discussions with customers. A laser for light output is necessary in both CPO and NPO, so NPO is also a business opportunity for the company. It is working with customers to align on specifications, and said it cannot comment on the timing of commercialization at this time.

Optical fiber and cables

- The impact of the polyethylene shortage due to tensions in the Middle East has been

resolved.

- SEI is working to increase FY3/27 fiber capacity by 1.3X versus FY3/25. This includes the drawing process outsourced to external vendors.

On the possibility of US regulations on Chinese-made optical transceivers

- Information is very limited at this time, so visibility is currently low. For reference: (1) SEI has a balanced business with both Chinese and US transceiver manufacturers; (2) in the industry, Chinese transceiver manufacturers have a very strong presence, and there is a debate whether a 100% exclusion is realistic; (3) Chinese manufacturers also have manufacturing operations outside mainland China in ASEAN, and how that portion is treated is a point of discussion.
- SEI is not considering in-house production of transceivers. It used to manufacture them in-house but shifted to focus on the more technical core chip portion because the assembly process for transceivers is labor-intensive, and SEI struggled to maintain competitiveness.

Full-year guidance and 2H outlook

- Reason for leaving the 2H plan unchanged as of July 31: The constraint is on production capacity, not on the demand side, and production expansion plans are progressing on schedule. Despite strong demand in 2Q, SEI did not revise guidance.

Automotive

- Total global shipment volume is progressing in line with guidance. By region, shipments are decreasing to China but increasing to other regions such as the US.

Company-wide

Impact of rising interest rates

- About half of SEI's interest-bearing debt is procured in yen, and much of it is long-term borrowing, so the impact of rising interest rates is somewhat mitigated.
- In areas other than infocommunications, some businesses may face tighter spreads due to a rise in WACC. SEI looks to raise ROIC through cost reduction efforts, price increases, and improvement of the product mix. Even if ROIC falls below WACC in the short term, it will not lead to immediate discussions of business withdrawal; decisions will be made with a longer-term perspective.

Upside/downside potential for full-year guidance

- Each segment is on pace to beat guidance. Upside factors include the initial guidance being conservative, the favorable demand environment, and the USD/JPY assumption of 150.
- In the automotive segment, the demand trend for Japanese manufacturers in China is a concern, and conditions need to be monitored closely, especially in China.

Price Target Risks and Methodology - Sumitomo Electric Industries
We are Buy rated. Our 12-month target price is ¥3,300. We apply a target EV/EBITDA multiple of 13.0X (based on FY3/28E, using an SOTP approach). Key downside risks: **Automotive segment:** Decline in automobile production volume; slower-than-expected pass-through of material procurement costs to selling prices. **Infocommunications segment:** Longer-than-expected inventory adjustments due to a slowdown in hyperscaler capex; catch-up by competitors in ultra-high density optical fiber cables. **Environment & energy segment:** Delays in new and replacement power infrastructure projects due to difficulties in procuring materials and securing workers; slower-than-expected earnings contributions from the Japanese government's clean energy strategy. **Industrial materials and other segments:** Slowdown in demand for cemented carbide tools, etc., due to a macroeconomic slowdown; increase in manufacturing costs for sintered parts, etc., due to rising energy prices. **Company-wide:** FX fluctuations; sustained high material prices.

5802.T	12m Price Target: **¥3,300**	Price: **¥2,095**	Upside: **57.5%**

Buy

Market cap: ¥6.5tr / $42.0bn
Enterprise value: ¥6.8tr / $44.0bn
3m ADTV: ¥53.3bn / $333.0mn
Japan
Japan Industrial Electronics
M&A Rank: 3
Leases incl. in net debt & EV?: No

GS Forecast

	3/26	3/27E	3/28E	3/29E
Revenue (¥ bn)	5,110.2	5,383.4	5,792.8	6,308.5
Op. profit (¥ bn)	418.2	470.3	582.5	727.2
Op. profit CoE (¥ bn)	375.0	450.0	–	–
EPS (¥)	118.4	118.2	146.5	182.8
P/E (X)	10.7	17.7	14.3	11.5
P/B (X)	1.4	2.5	2.2	2.1
Dividend yield (%)	3.0	1.9	2.4	2.9
N debt/EBITDA (ex lease,X)	0.6	0.5	0.3	0.3
CROCI (%)	8.8	15.5	36.8	41.6

	6/26	9/26E	12/26E	3/27E
EPS (¥)	21.3	26.1	29.7	41.0

Source: Company data, Goldman Sachs Research estimates, FactSet. Price as of 18 Sep 2026 close.

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Reg AC

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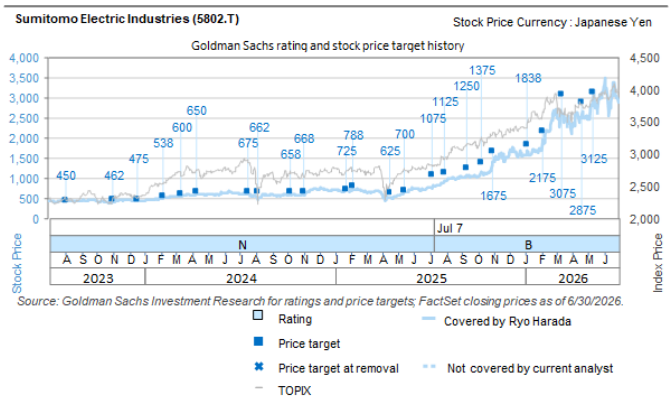
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Sumitomo Electric Industries (5802.T)

Date of report	Target price (¥)	Closing price (¥)
31-Jul-26	3,300	2,184
07-Jul-26	3,400	2,443
12-May-26	12,500	2,913
20-Apr-26	11,500	2,494
13-Mar-26	12,300	2,598
03-Feb-26	8,700	1,914
05-Jan-26	7,350	1,678
31-Oct-25	6,700	1,413
09-Oct-25	5,500	1,158
10-Sep-25	5,000	1,073
31-Jul-25	4,500	940
07-Jul-25	4,300	756
13-May-25	2,800	658
16-Apr-25	2,500	516
04-Feb-25	3,150	752
22-Jan-25	2,900	727
01-Nov-24	2,670	583
07-Oct-24	2,630	606
07-Aug-24	2,650	530
18-Jul-24	2,700	600
09-Apr-24	2,600	602
12-Mar-24	2,400	556
05-Feb-24	2,150	501
19-Dec-23	1,900	443
02-Nov-23	1,850	404

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