With the industry still trading at around a 10% discount to the broader tech sector, CIO continues to see a favorable risk-reward for global semis names. (UBS)

Semiconductors are one of CIO's preferred ways to ride the AI wave

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The semiconductor industry has led the broader technology sector in the rally driven by generative artificial intelligence (AI). Year-to-date, the Philadelphia Semiconductor Index has risen over 15%, while the MSCI All Country World IT index is up 10.1%. Since late October, the gains are 51% and 31%, respectively.

Despite the strong rally, CIO thinks the outperformance of global semis looks set to continue, with faster revenue growth, higher operating margins, and stronger balance sheets.

Profits for global semis are expected to grow by 50% this year. TSMC shares hit new records during Asia trading hours on Monday after a 60%year-over-year jump in April sales. This underlines how the semiconductor industry is benefiting from sustained AI demand, especially as big tech companies raised their capital expenditure significantly during the first-quarter earnings season. We believe the bulk of the capex increase will go to AI computing, and therefore expect global semis to see earnings growth of 50% this year and 25% in 2025. This compares with our estimates for global tech earnings growth of 20% and 16% this year and next, respectively. In our view, strong demand for high performance computing led by AI and cloud should offset mixed end-demand for other segments like smartphones and PCs.

Operating margins have continued to improve. The software industry has historically been the leader in operating margins (around 35%) within the global tech space, followed by semiconductors at around 25–30%. However, strong pricing power and operating efficiencies should lead to a rise in global semiconductor operating margins to around 35% this year and 37.5% in 2025, according to our estimates. With highly cyclical factors like inventories and capacity changes playing less important roles in the industry's performance, we believe more structural drivers like AI, cloud, and rising silicon content in chips should support stronger pricing power in the future.

Better free cash flow margins should bolster the industry's balance sheets. Given their high capex intensity compared to other tech segments, semiconductor companies have not been known traditionally for strong balance sheets. However, with capex discipline and strong pricing power, the industry's balance sheets are rapidly improving. In fact, we expect the industry's free cash flow margins to increase from 15% in 2023 to around 22% this year and around 26% in 2025. This should help semiconductor companies to potentially increase their cash distributions and allow investments in the start-up ecosystem.

So, with the industry still trading at around a 10% discount to the broader tech sector, we continue to see a favorable risk-reward for global semis names. Coupled with tactical opportunities in memory, we view semiconductors as one of our preferred ways to ride the AI wave. We like industry leaders in logic, foundries, and semicap equipment.

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