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Technology Hardware
Taiwan

TSMC

#Flashnote

Buy

Warren Lau
+852 9181 4766
warren.lau@aletheia-capital.com

All Good Except Margins

- While TSMC reported a strong set of results and issued equally impressive guidance, margins came in below our optimistic forecast. Beyond this, TSMC's comments on robust AI demand, capacity supply tightness in 2027 and significant uplift in capex for 2026-2028 are consistent with our expectations. We forecast TSMC's revenue and earnings to double from 2026-2028 and retain Buy rating, with a target price of NT$5,000 / $1,000.
- **Our initial take on the profit margins:** Our quick analysis suggests the faster than expected rise in variable costs (depreciation is within our expectations) is probably due to the initial ramp of 2nm wafers as well as the overseas businesses - both lack scale for the time being. Variable cost increased more than 33% sequentially in 3Q26 (vs our forecast of 15-20%). This resulted in a shortfall in gross margin of 2.5ppts: 66.4% as compared to our estimates of 68-69%. The company reported gross margin of 67.7% in 2Q. Given the 4Q margin guidance of 65-67% vs our expectation of 68-70%, we will need to recalibrate our assumptions on the company's variable cost structure.
- **4Q revenue guidance points to acceleration of momentum:** TSMC expects revenue to be $52.3-54.3bn, implying mid-teen QoQ and nearly 60% YoY growth, compared to our expectation of $51-53bn. 3Q revenue grew just below 51% YoY. We believe TSMC continues to execute well on manufacturing by improving the productivity of its tools as well as leveraging its under-utilized mature capacity to generate more advanced wafers. These are in addition to the richer mix of leading-edge wafers as well as rapid expansion of advanced packaging services. We expect TSMC's revenue to sustain well over 40% growth run rate in FY27E/28E, with cutting edge wafer revenue (N5-A14) to double in FY26E-28E and advanced packaging to jump four-folds in the same period.
- **The sustainability of AI demand:** TSMC revealed that it has sent teams to perform due diligence on the build out of AI datacentre and power supply in the US. This is in addition to investigation into its customers' demand. The due diligence is to ensure that TSMC does not over invest in capacity which may negatively impact its profitability. We will publish a more detailed update on TSMC shortly.

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Alētheia Research Team

Macro/Strategy	LEAD ANALYST	Sector	LEAD ANALYST
Global Strategy	Jonathan Wilmot	Technology Hardware	Warren Lau
Asianomics	Dr. Jim Walker	Consumer & Internet	Nirgunan Tiruchelvam
Tech Thematic Strategy	Keith Woolcock	China Technology	Eric Wen
Asia Equity Strategy	David Scott	Telecoms	Chris Hoare
China Strategy	Vincent Chan	CrossASEAN	Angus Mackintosh
Tactical Alpha Strategy	Justin Collazo	India	Maulik Patel
Global Commodities	Steven Schlegel	MENA	Jaap Meijer

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- **Al Park**
  1 201 962 0539
  al.park@aletheia-capital.com
  AMERICAS - NEW YORK
- **Linda Gustafsson**
  44 791 91 21 365
  linda@nordlinkcapital.com
  EUROPE - NORDICS
- **Michael Chambers**
  65 9858 9759
  michael.chambers@aletheia-capital.com
  ASIA - SINGAPORE
- **Graeme Bateman**
  852 2534 7437
  graeme.bateman@aletheia-capital.com
  ASIA - HONG KONG
- **Wayne Chang**
  1 646 256 3366
  wayne.chang@aletheia-capital.com
  AMERICAS - NEW YORK
- **Daren Riley**
  44 748 31 59 865
  daren.riley@aletheia-capital.com
  EUROPE - LONDON
- **Richard Wallace**
  852 2534 7429
  richard.wallace@aletheia-capital.com
  ASIA / EUROPE - HONG KONG
- **Terrence Alford**
  1 469 403 9936
  terrence.alford@aletheia-capital.com
  AMERICAS - DALLAS
- **Dhananjay Mahurkar**
  44 777 55 26 870
  dhananjay.mahurkar@aletheia-capital.com
  EUROPE - LONDON
- **Augustine Chen**
  8869 2739 8793
  augustine.chen@aletheia-capital.com
  ASIA - HONG KONG

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