# Strategy | TAIWAN

## 2011 Outlook

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**And the Taiwan Research Team**

NOMURA
NOMURA INTERNATIONAL (HK) LIMITED
TAIPEI BRANCH

TOP DOWN

ANCHOR REPORT




# Be selective in the year of the rabbit (Erratum)

We forecast total US dollar-denominated returns of 14.3% for the Taiex in 2011F comprising index upside of 6.0% (to 9,500 points), cash dividends of 4.0% and Taiwan dollar appreciation of 4.3%. We are more conservative than the street in our index target, as we assume decelerating earnings growth and rising cost of capital. In our view, earnings growth in 2011 will be increasingly concentrated, so stock selection will be key to performance. We believe the non-tech sector will continue to outperform the tech sector in 2011, due to likely earnings upgrades in the non-tech sector. Taiwan is experiencing the strongest job recovery in 20 years and the early signs of wage inflation could help inflate the economy, which has seen deflation for decades. We think the activation of pent-up investments and consumption implies multiple years of superior growth. On the other hand, the tech sector continues to suffer from weakening profitability given both ASP deflation and cost inflation. Also, replacement capex to capture China's residual population dividends in inland areas should yield unsatisfactory returns. We recommend investors gain exposure to the themes of domestic demand (consumer, banks and asset plays), tourism (airlines), counter-inflation (telcos and chemicals), and smartphones.

① **Total US dollar-denominated return of 14.3% in 2011F**

② **Non-tech will likely continue to outperform tech in 2011F**

③ **10 must-know investment themes in Taiwan**

Erratum. Cover, line 2 — changed to 9,500 (from 9,400). Page 1, paragraph 1, line 2 — changed to 6% (from 5.3%). Page 5, line 2, same change. We apologise for any inconvenience caused.

Nomura Anchor Reports examine the key themes and value drivers that underpin our sector views and stock recommendations for the next 6 to 12 months.

## Taiwan basket

The stocks below are those with strong execution ability and positioned to benefit from our preferred top-down themes.

| Stock | Rating | Price (NT$) | Price target |
|---|---|---|---|
| HTC Corporation (2498 TT) | BUY | 921 | 1,000 |
| TPK (3673 TT) | BUY | 671 | 820 |
| Acer Inc ** (2353 TT) | BUY | 90.0 | 110 |
| Synnex Technology (2347 TT) | BUY | 77.3 | 90 |
| Simplo Technology * (6121 TT) | BUY | 210.5 | 230 |
| Chinatrust FHC * (2891 TT) | BUY | 21.85 | 24 |
| President Chain Store (2912 TT) | BUY | 135 | 159 |
| Formosa Chem & Fibre (1326 TT) | BUY | 97.7 | 106 |
| Eva Airways Corp (2618 TT) | BUY | 36.6 | 40 |
| Chunghwa Telecom (2412 TT) | BUY | 73.6 | 75 |

* PT under review
** PT revised on 4 January from NT$112
Pricing as of 3 January closing

## Analysts

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**Don't miss our companion outlook reports on Asia and Global Economics, published 6 December 2010.**

**Any authors named on this report are research analysts unless otherwise indicated.**
**See the important disclosures and analyst certifications on pages 93 to 96.**

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## 2011 Outlook

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TOP DOWN

### Action

We forecast the Taiex will post total US$-denominated returns of 14.3% in 2011F. Stock selection will be key to performance as growth is increasingly concentrated. We prefer names with exposure to the themes of domestic demand (consumer, banks and asset plays), tourism (airlines), counter-inflation (telcos and chemicals), and smartphones. We have also identified 10 stocks as *Stocks for action*.

### Anchor themes

We think strong job creation and wage inflation will activate pent-up consumption and investments, which have been depressed by deflation for decades. Property price appreciation is no longer limited to the luxury segment in Taipei.

Tech manufacturers face weakening profitability owing to the sustained squeeze of ASP deflation and cost inflation. Some have even been forced to start capex cycles in a bid to capture residual population dividends in inland China.

### Stocks for action

The stocks below are those with strong execution ability and positioned to benefit from our preferred top-down themes.

| Stock | Rating | Price (NT$) | Price target |
|---|---|---|---|
| HTC Corporation (2498 TT) | BUY | 921 | 1,000 |
| TPK (3673 TT) | BUY | 671 | 820 |
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# Be selective in the year of the rabbit

### ① A total US dollar-denominated return of 14.3% in 2011F

We expect the Taiex to post total US$-denominated returns of 14.3% in 2011F, which includes 6.0% potential upside in the index (or 9,500 points), cash dividend of 4.0%, and NT dollar appreciation of 4.3%. Our estimates are more conservative than consensus, as we take into consideration Taiwan's decelerating earnings growth and rising COE. Still, we believe stock selection is key to performance in 2011, as we see increasingly concentrated growth. Our index target implies the Taiex will trade at 1.0 standard deviation above its long-term average.

### ② Non-tech to continue to outperform tech in 2011F

We believe the non-tech sector will continue to outperform tech in 2011F on scope for earnings upgrades. We are especially Bullish on the sub-sectors of domestic demand (consumer, banks and asset plays), tourism (airlines), counter-inflation (telcos and chemicals), and smartphones. *Stocks for action* are HTC, TPK, Acer, Synnex, Simplo, Chinatrust, President Chain Store, CHT, EVA Airways, and Formosa Chemical.

### ③ 10 must-know investment themes in Taiwan

Our investment strategies are based on the following themes: 1) NT dollar appreciating to NT$28.7:US$1 by end-2011F on steady capital repatriation; 2) the CBC accommodating higher inflation in the near term and undertaking slow and gradual rate normalisation; 3) few policy headwinds amid the pre-election honeymoon; 4) strong job recovery and wage inflation to help spark pent-up consumption and investment; 5) property price appreciation in the mass market beyond Taipei; 6) IFRS compliance to fuel speculative sentiment on property re-valuation beneficiaries; 7) life insurers to accumulate counter-inflation dividend plays as they exhaust overseas investment quotas; 8) tech manufacturers to continue to suffer weakening profitability on ASP deflation amid cost inflation; 9) a 'peace dividend' with China to grow on a more diversified basis; and 10) investors not giving up hope on financial M&A.

### Analysts

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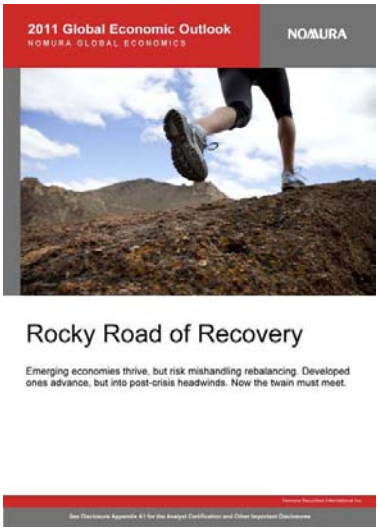
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**Also see our Anchor Report: Asia Pacific Strategy — *Deflation, inflation and the return of the productive economy* (6 December, 2010)**




**Also see our NOMURA: 2011 Global Economic Outlook — *Rocky Road of Recovery* (6 December, 2010)**



Drilling down

# Investment outlook

## Taiex index target of 9,500

We expect total US$-denominated returns of 14% in 2011F

We forecast the Taiex index will reach 9,500 by end-2011F, representing potential upside of 6.0%. Note that we are more conservative than many since we take into consideration Taiwan's decelerating earnings growth and rising cost of equity. Despite this, if we were to include a dividend yield of 4.0% and an estimated NT$ appreciation of 4.3% in 2011F, we see total US$-denominated returns reaching 14.3% in 2011. Note:

- The Taiex rose by only 8.8% in 2010, underperforming the Asia ex-Japan Index by 6.3%, although it delivered the strongest year-on-year earnings growth, 67.4%, in 2010. Nevertheless, if we were to include NT$ appreciation of 5.1% in 2010, the Taiex would still have delivered the strongest performance in Greater China.

Taiwan's tech sector is weighed down by ASP deflation and cost inflation

- We estimate earnings growth in the Taiex will decelerate to 11.1% in 2011F, near the lower band of earnings growth in Asia ex-Japan (see Exhibit below). We attribute this to a high base effect and the tech sector's continuing weak profitability, a result of ASP deflation and cost inflation.
- On the other hand, Taiwan's cost of equity (COE) is rising. Although we believe Taiwan's Central Bank of the Republic of China (CBC) will accommodate greater inflation in the near term to reflate the economy, which has been weighed down by deflation for decades (i.e., average CPI was as low as 0.98% per annum since 2000), we forecast Taiwan will hike the re-discount rate by 50bp in each of 2011F and 2012F, respectively. The higher cost of equity will depress the valuation, in our view.
- Our analysis suggests that ROE in the Taiex will rise to 13.9% in 2011F, from 13.01% in 2010, which will be 0.5 standard deviation (SD) above the long-term average of 12.8%, in line with our assumption that Taiwan will be in the mid to late stage of an economic expansion cycle.

Our index target implies the Taiex will trade at 1.1 standard deviation on a PBR basis

- Our index target implies that the Taiex will trade at 2.0x 2011F P/BR, or 1.1 SD above the long-term average. Our index target has already built in optimism of valuation expansion from capital repatriation and pre-election sentiment.
- Our index target implies the Taiex will trade at 14.1x P/E at end-2011F.

**Exhibit 1. Total return comparison in 2010**

| Country | Index universe | Equity Rtn YTD (%) | Currency | Curncy Rtn YTD (%) | Total Return (%) |
|---|---|---|---|---|---|
| Thailand | SET | 40.6 | THB | 9.6 | 50.2 |
| Indonesia | JCI | 46.1 | IDR | 4.3 | 50.5 |
| Philippines | PASHR | 37.6 | PHP | 5.1 | 42.7 |
| Malaysia | KLCI | 19.3 | RM | 10.0 | 29.3 |
| Korea | KOSPI | 21.9 | W | 2.5 | 24.4 |
| Singapore | FSTAS | 11.5 | S$ | 8.3 | 19.8 |
| India | SENSEX | 16.7 | INR | 3.4 | 20.1 |
| Taiwan | TWSE | 8.8 | NT$ | 5.7 | 14.5 |
| HK | HSI | 5.2 | HK$ | (0.4) | 4.8 |
| China | CSI 300 | (14.3) | RMB | 3.2 | (11.1) |
| Australia | AOI | 0.1 | A$ | (13.3) | (13.2) |

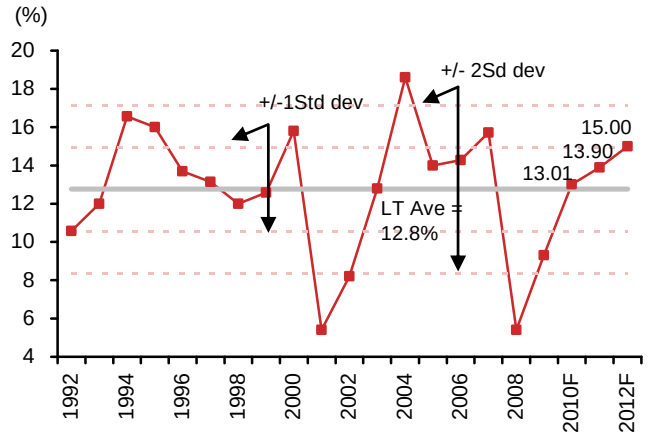
Source: Bloomberg; Nomura estimates

**Exhibit 2. Asia ex-Japan earnings growth**

| Country | Index universe | EPS gth (%) | | Div yield (%) | | ROE (%) | |
|---|---|---|---|---|---|---|---|
| | | FY10F | FY11F | FY10F | FY11F | FY10F | FY11F |
| Australia | AOI | 22.4 | 17.6 | 4.2 | 4.5 | 12.8 | 14.3 |
| China | CSI 300 | 33.2 | 18.2 | 2.1 | 2.6 | 16.4 | 17.2 |
| HK | HIS | 27.5 | 15.5 | 3.1 | 3.4 | 13.8 | 14.8 |
| India | SENSEX | 15.7 | 17.8 | 1.3 | 1.5 | 17.9 | 17.9 |
| Indonesia | JCI | 32.6 | 21.6 | 2.0 | 2.6 | 21.6 | 22.8 |
| Korea | KOSPI | 48.0 | 15.3 | 1.8 | 2.3 | 13.7 | 14.0 |
| Malaysia | KLCI | 36.6 | 13.5 | 3.2 | 3.5 | 13.8 | 14.2 |
| Philippines | PASHR | 29.6 | 11.3 | 2.6 | 3.0 | 15.1 | 15.5 |
| Singapore | FSTAS | 29.2 | 10.3 | 2.7 | 2.9 | 10.7 | 11.0 |
| Taiwan | TWSE | 67.4 | 12.3 | 4.0 | 4.5 | 13.0 | 13.9 |
| Thailand | SET | 31.4 | 16.6 | 3.4 | 3.8 | 15.2 | 16.2 |

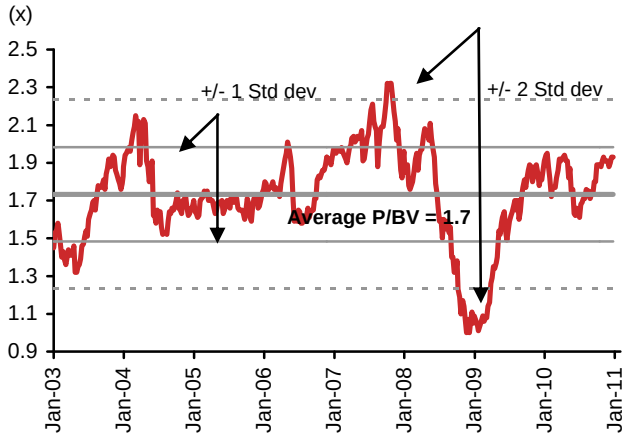
Source: Nomura estimates

**Exhibit 3. Taiwan ROE trend**




Source: Taiwan Economic Journal, Nomura Research estimates

**Exhibit 4. Taiwan PBR trend**




Source: Taiwan Economic Journal, Nomura Research estimates

## Non-tech to outperform tech in 2011

We expect to see an increasing divergence in performance in various sub-sectors in Taiwan. That said, asset allocation and stock selection will be key to capturing outperformance. In our view, the non-tech sector will outperform the tech sector in 2011.

- Taiwan's non-tech sector (including financials) now accounts for 48% of the Taiex by market capitalisation. In our opinion, investors who buy Taiwan based on a bullish view on tech or ignore this market because of a bearish view on tech have missed the importance of the island's non-tech economy.
- Indeed, Taiwan's non-tech sector significantly outperformed the tech sector in 2010. Although historical trends show that Taiwan's non-tech sector has rarely outperformed the tech sector for two consecutive years, we believe 2011F may be an exception.

**Non-tech sector will likely outperform tech sector in 2011F on scope for earnings upgrades**

- In our view, Taiwan's non-tech sector is better positioned for earnings upgrades than the tech sector, because:
  - NT$ appreciation is positive for the non-tech sector but negative for tech; for the latter, more than 80% of revenue is denominated in US$.
  - Taiwan's job recovery is the strongest in 20 years and with wage inflation likely to kick in, we expect domestic consumption and investment, both depressed by deflation for decades, to sustain the recovery. That said, the length of earnings expansion in domestic demand plays has not been fully discounted, in our view.

**Taiwan is experiencing the strongest job recovery in 20 years**

  - In our view, markets are currently assuming that Taiwan's interest rates will return to pre-Financial Crisis levels by end-2014. We think this is overly conservative. Accelerating rate hikes will contribute to faster expansion of net interest margin at banks and, thus stronger profitability growth, in our opinion.

**An accelerated rate hike cycle will strengthen profit growth at banks**

  - The "peace dividend" of easing tension with China will be mostly concentrated in the non-tech sector, in our view. The peace dividend could include: 1) growing tourism to boost domestic consumption; 2) reduced tariffs for made-in-Taiwan products in China, and; 3) better investment opportunities on the mainland (say, for Formosa Group).

**Peace dividends are more concentrated in non-tech sectors**

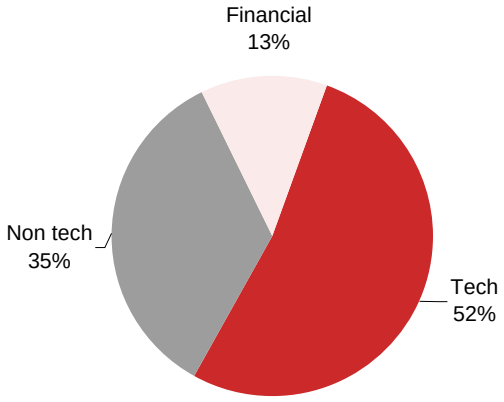
  - On the other hand, we see structurally weakening profitability at Taiwan's tech manufacturers, given the sustained trends of deflationary ASPs but inflationary costs. Nevertheless, we note that the handset sector is better positioned owing to the smartphone boom. However, this could become a crowded trade since smartphone plays account for only 6% of the Taiex by market capitalisation.

**A likely crowded trade in smartphone foodchain**

- 2010 saw an aggressive capacity expansion cycle with capex growth of almost 100%, on our numbers. This could translate into margin risk, especially in 2H11F, in our view.
- We see earnings upside risk in the tech sector, if any, materialising only in 2H11F. In our opinion, there are two major swing factors − the pace of mid-to low-end smartphone penetration in emerging economies and the growth pattern of Android-based tablet PCs. Nevertheless, we expect these themes to play out only in 2H11F, at the earliest.

**Upside earnings risks in tech, if any, will only materialise in 2H11F, in our view**

### Exhibit 5. Taiex market-cap breakdown




Note: Data are as of 28 December, 2010.

Source: Bloomberg; Nomura Research

### Exhibit 6. 2010 Sector performance comparison

| (Unit: %) | 2009 | 2010 |
|---|---|---|
| Financial | 152.7 | 14.5 |
| Rubber | 234.6 | 11.5 |
| Electric | 227.8 | 7.3 |
| Electronic | 194.4 | (0.0) |
| Oil and Gas Sector | 126.0 | 19.4 |
| TWSE | 178.3 | 9.6 |
| Construction | 237.2 | 26.6 |
| Plastic | 175.9 | 36.4 |
| Non Tech Non Financial | 164.5 | 23.4 |
| Food | 157.5 | 24.1 |
| Semiconductor | 186.2 | (5.6) |
| Cement | 127.2 | (2.2) |
| Steel | 156.1 | 1.6 |
| Transportation | 133.5 | 47.8 |

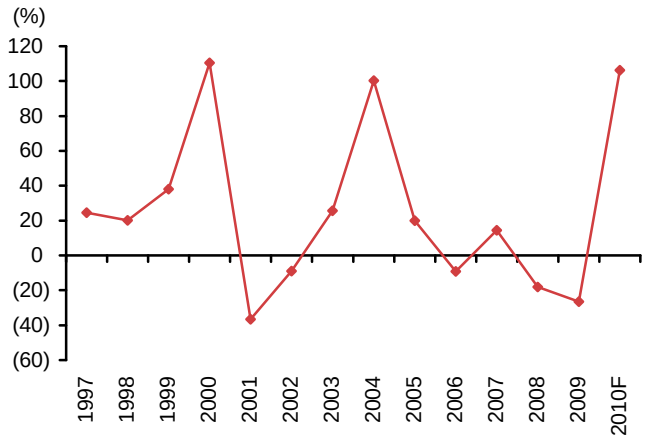
Source: Bloomberg; Nomura Research

### Exhibit 7. Taiwan earnings growth forecasts

| (Unit: %) | 2011F | 2012F |
|---|---|---|
| Financial | 25.3 | 9.4 |
| Rubber | 17.1 | 16.1 |
| Electric | 16.7 | 8.6 |
| Electronic | 14.8 | 11.4 |
| Oil and Gas Sector | 13.8 | 17.4 |
| TWSE | 12.3 | 9.8 |
| Construction | 9.4 | 12.5 |
| Plastic | 8.5 | 7.0 |
| Non Tech Non Financial | 8.2 | 3.9 |
| Food | 6.9 | 3.2 |
| Semiconductor | 5.6 | 5.3 |
| Cement | 2.5 | 8.5 |
| Steel | 0.0 | 18.6 |
| Transportation | (18.4) | 1.3 |

Source: Nomura estimates

### Exhibit 8. Taiwan tech capex y-y growth




Source: Nomura estimates

## Sector weighting and *Stocks for action*

The Exhibit overleaf shows our recommendations on sub-sector weightings. In short, we are Bullish on the domestic demand theme, where beneficiaries include financials, consumer/retailing and asset plays, in our view. We also like the tourism theme and believe airliners are the best proxies. We like telecom operators as their business models are counter-inflation with strong and stable dividends yield attracting investment interest from cash-rich life insurers. Within global cyclical sub-sectors, we are most positive on chemicals on better demand/supply conditions.

**We are bullish on the themes of domestic demand, tourism, counter-inflation, and smartphones**

On the other hand, within the tech sector, we are most positive on the handset sub-sector, though note market timing could be key to performance, since it has become a crowded space, in our view. We are Neutral on the NB food chain and believe company execution will be key to outperformance in 2011. We are negative on the IC design sub-sector and believe this segment is falling behind the product upgrade cycle.

### Exhibit 9. Nomura Taiwan sector weighting recommendations

| Sector | Recommendation |
|---|---|
| IC Design | Underweight |
| Solar & LED | Underweight |
| Handsets & Components | Overweight |
| PC/NB & Components | Equal weight |
| Networking | Underweight |
| DRAM | Underweight |
| Cement | Underweight |
| Petrochem | Overweight |
| Steel | Underweight |
| Tourism (Airlines) | Overweight |
| Consumer | Overweight |
| Property | Overweight |
| Telecom | Overweight |
| Financials | Overweight |

Source: Nomura Research

The Exhibit below shows our top Taiwan *Stocks for action*. These names are all BUYs with ratings based on a bottom-up approach. Meantime, these names also comply with our top-down preference of exposure in Taiwan. This is a fast-moving economy and we expect the constituents to change as the year goes on.

### Exhibit 10. Taiwan *Stocks for action*

| Company name | Ticker | Analyst | Price (LCY) | TP | % of upside (%) | P/E (x) | | PBR (x) | | Div yld (%) | | ROE (%) | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | FY11F | FY12F | FY11F | FY12F | FY11F | FY12F | FY11F | FY12F |
| HTC Corporation | 2498 TT | Aaron Jeng, CFA | 921 | 1,000 | 8.6 | 13.0 | 12.1 | 7.3 | 6.3 | 6.0 | 6.3 | 63.8 | 56.0 |
| TPK | 3673 TT | Anne Lee, CFA | 671 | 820 | 22.2 | 14.7 | 13.1 | 5.9 | 4.4 | 1.0 | 1.8 | 48.9 | 38.8 |
| Acer Inc | 2353 TT | Eve Jung | 90 | 110* | 22.0 | 12.3 | 9.8 | 2.2 | 2.0 | 4.9 | 6.0 | 19.1 | 21.6 |
| Synnex Technology | 2347 TT | Eve Jung | 77 | 90 | 16.4 | 17.5 | 13.3 | 2.9 | 2.5 | 2.9 | 3.8 | 17.4 | 20.4 |
| Simplo Technology | 6121 TT | Eve Jung | 211 | 230 | 9.3 | 13.8 | 11.8 | 3.4 | 2.9 | 3.2 | 3.7 | 26.1 | 25.9 |
| Chinatrust FHC | 2891 TT | Jesse Wang | 22 | 24 | 9.8 | 12.4 | 10.2 | 1.3 | 1.2 | 5.5 | 6.8 | 13.4 | 15.3 |
| President Chain Store | 2912 TT | Brandon Chen | 135 | 159 | 17.8 | 20.2 | 18.1 | 6.2 | 5.8 | 3.6 | 4.0 | 31.8 | 33.2 |
| Formosa Chem & Fibre | 1326 TT | Yong Liang Por | 98 | 106 | 8.5 | 11.8 | 11.3 | 2.2 | 2.1 | 7.6 | 7.9 | 19.0 | 19.2 |
| Eva Airways Corp | 2618 TT | Shirley Lam | 37 | 40 | 9.3 | 7.5 | 7.2 | 1.7 | 1.4 | - | - | 26.7 | 21.4 |
| Chunghwa Telecom | 2412 TT | Leping Huang, PhD | 74 | 75 | 1.9 | 15.7 | 15.7 | 2.1 | 2.1 | 7.1 | 7.1 | 13.0 | 13.3 |

Note: Pricing as of 03 January, 2011; Ratings and Price Targets are as of the date of the most recently published report (http://www.Nomura.com) rather than the date of this document.

* Revised on 4 Jan from NT$112

Source: Nomura Research estimates

Themes

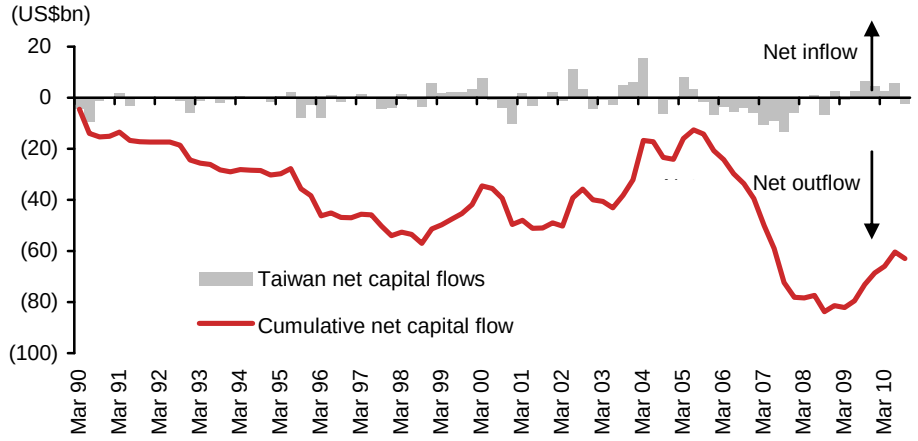
# 10 themes in 2011

## 1) Capital repatriation and NT dollar appreciation

**Capital repatriation in 2011 should be supported by expectation of NT$ appreciation**

Taiwan has suffered from cumulative net capital outflows for decades. It started from increased outbound direct investments in China throughout the 1990s, followed by capital flight during 2005-2008, or during the second-term of then President Chen. In our view, the worst is clearly passed. Since early 2009, Taiwan has started to see capital repatriation, supported by diminished cross-Strait tension and inheritance tax cuts. Indeed, we expect 2011 to be another year of strong capital repatriation, with additional support coming from expectations of further NT$ appreciation and reversal of carry trades as Taiwan's interest rates normalise. Indeed, we believe upside risk of capital repatriation will increase on a long-term basis, if Taiwan decides to open up to Chinese investment capital. In our view, this sort of move is but a matter of time, although political sensitivities mean that this move is not as openly discussed as it might be.

**Exhibit 11. Taiwan cumulative capital flows**

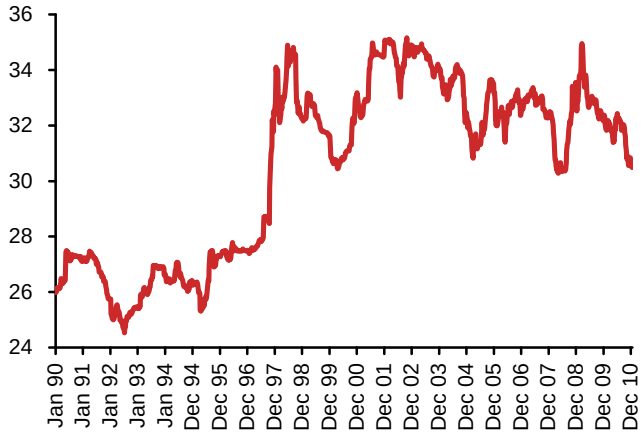



Source: Central Bank of China (Taiwan), Nomura Research

**We forecast the NT$ will appreciate to NT$28.7:US$1 in 2011 and NT$27.5 in 2012**

The NT dollar had appreciated to NT$30.40:US$1 as at 28 December 2010, up 5.1% YTD and near an 11-year high. Interestingly, the NT dollar ranked among the strongest currencies in North Asia in 2010 on robust capital repatriation. Our Taiwan economist, Tomo Kinoshita, forecasts the NT dollar will appreciate to NT$28.7:US$1 (up 4.3% y-y) in 2011F and to 27.5 (up 4.2% y-y) in 2012F. We note that the magnitude of NT$ appreciation in 2011F is less than we expect at major comparable economies (eg, Korea). That said, we do not expect Taiwan to lose its export competitiveness, though some export-oriented tech sub-sectors could face margin pressure. On the other hand, we expect the non-tech sector, especially financials and domestic consumption plays, to be the primary beneficiaries.

### Exhibit 12. NT$/US$ hits 11-year highs




Source: Bloomberg; Nomura Research

### Exhibit 13. Nomura NT$/US$ forecast

| | | | | | % of change | | |
|---|---|---|---|---|---|---|---|
| | | 2010 | 2011F | 2012F | 2010 | 2011 | 2012 |
| Taiwan Dollar | NT$ | 30.4 | 28.7 | 27.5 | 5.7 | 5.5 | 4.2 |
| Chinese Renminbi | RMB | 6.61 | 6.22 | 5.90 | 3.2 | 5.9 | 5.1 |
| Hong Kong | HK$ | 7.77 | 7.75 | 7.75 | (0.4) | 0.3 | - |
| Indonesian Rupiah | IDR | 8,996 | 8,520 | 8,200 | 4.3 | 5.3 | 3.8 |
| Indian Rupee | INR | 44.71 | 42.30 | 40.30 | 3.4 | 5.4 | 4.7 |
| Korean Won | W | 1,126 | 1,020 | 960 | 2.5 | 9.4 | 5.9 |
| Malaysian Ringgit | RM | 3.06 | 2.88 | 2.72 | 10.0 | 6.0 | 5.6 |
| Philippine Peso | PHP | 43.8 | 40.9 | 38.9 | 5.1 | 6.6 | 4.9 |
| Singapore Dollar | S$ | 1.28 | 1.22 | 1.17 | 8.3 | 4.9 | 4.1 |
| Thai Baht | THB | 30.1 | 27.8 | 26.8 | 9.6 | 7.5 | 3.6 |

Source: Bloomberg; Nomura Research estimates

## 2) Slow interest-rate normalisation

Taiwan is one of a few economies that have been weighed by deflation since the bursting of asset bubbles in the early 1990s. Since then, infrastructure investment and domestic demand have been depressed. In our view, the CBC is likely willing to accommodate higher inflation to sustain growth momentum to reflate the domestic economy. That said, we forecast Taiwan will adopt a low and gradual approach to rate normalisation.

**The CBC will likely accommodate higher inflation to ensure Taiwan exits deflation**

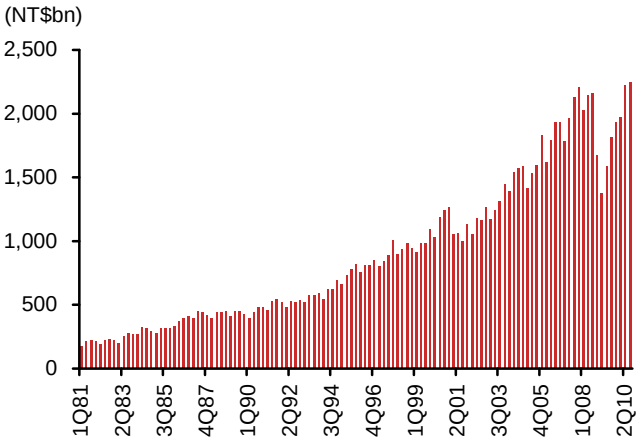
Specifically, we forecast Taiwan's CBC will hike the re-discount rate by 12.5bp in each quarter through end-2012F (ie, the end of our forecast period). In other words, our GDP model assumes Taiwan's re-discount rate will reach 2.625% at end-2012 (from 1.625% currently, which still stands significantly below the pre-Financial Crisis level of 3.625%. That said, assuming that the CBC hikes the re-discount rate by 12.5bp in each quarter from 2012 onwards, Taiwan's rates would not return to its pre-crisis levels until end-2014F.

**We forecast a re-discount rate hike of 12.5bp in each quarter until end-2012F**

We see a possibility the CBC will accelerate its rate hikes once the sustainability of economic growth momentum is more assured. Indeed, we are beginning to see early signs that the economic recovery is taking root. Specifically, Taiwan's gross exports already returned to the pre-crisis level in November 2010. Meantime, with the employment rate falling to 4.73% in November (from 6.13% in August 2009), Taiwan is enjoying the strongest job market recovery in almost 20 years. Investors should that note if the CBC decides to accelerate rate hikes, interest-rate plays, which mainly include banks and life insurers, will likely benefit the most.

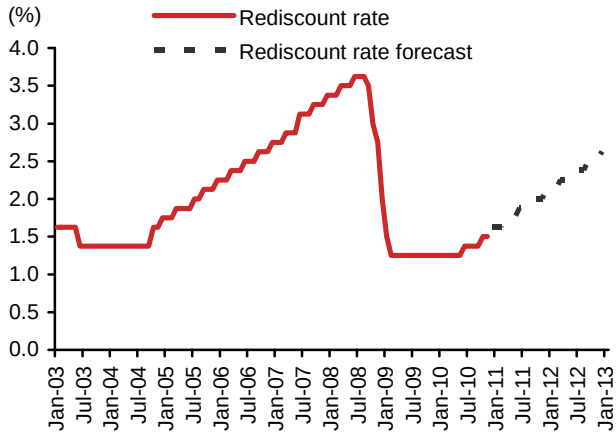
**Financial sector will likely be the major beneficiary if Taiwan accelerates rate hikes**

### Exhibit 14. Taiwan quarterly gross exports




Source: Taiwan Economic Journal; Nomura Research

### Exhibit 15. Rediscount rate assumption




Source: Nomura Research estimates

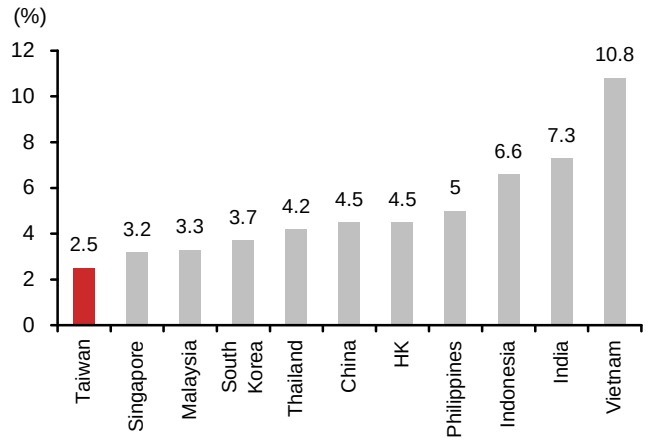
## 3) Little threat of policy headwinds

Despite ever-rising property prices, which have raised concerns and public dissatisfaction, we see little risk the local government will introduce serious austerity measures in 2011 and risk derailing the economic recovery. We present our major arguments below:

- We note that rising property prices are largely concentrated in the Greater Taipei area. Despite growing civil complaints, the ruling KMT party still managed to win the mayoral elections in both Taipei and Xinbei in 2010. Given this, we think maintaining the status quo will likely be the politically correct stance for the ruling party. A risk is that the KMT introduces overly harsh austerity measures aimed at cooling the property market, which could backfire.
- We forecast Taiwan's CPI will rise to 2.5% in 2011F, among the lowest in Asia ex-Japan. Currently, owing to modest inflation, Taiwan's real interest rate is near zero despite strong liquidity from the significant current account surplus. But we think local inflation will likely reach a plateau/steady state in 2011, which could help activate pent-up investment and consumption, but which might not create conditions that would invite austerity measures.
- Taiwan plans to hold elections for legislators and the president in 1Q12. The outcome of these could influence the sustainability of the first prolonged cross-Strait peace agreement since WW2. In our view, policymakers will likely be in favour of economic growth ahead of the elections. Indeed, the election campaign will start as early as 2Q11, when the KMT and DPP will select their respective presidential candidates.

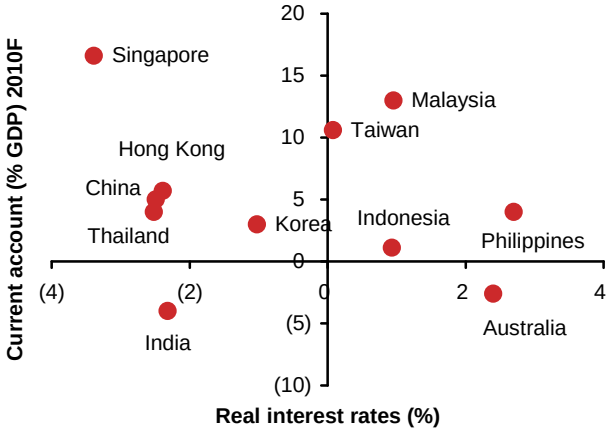
**We forecast Taiwan's CPI will rise to 2.5% in 2011F, among the lowest levels in Asia ex-Japan**

**Exhibit 16. Inflation forecasts**




Source: Nomura Research

**Exhibit 17. Taiwan and regional real interest rates**

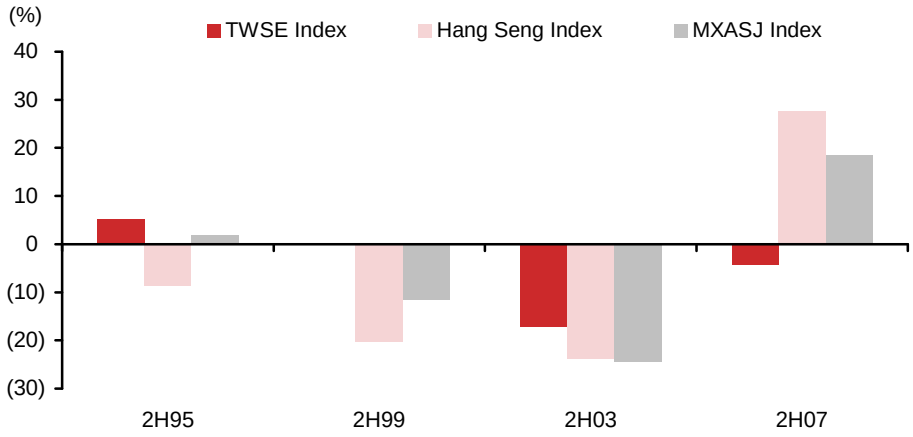



Source: Nomura Research

In short, although the Taiwanese government could attempt to address civil concerns such as rising property prices, we think the impact of any new measures will likely be insignificant due to lack of political will. Last, as shown in the Exhibit below, historical trading patterns establish that the Taiex has generally outperformed wider Asian markets six months ahead of the Legislator/President elections in Taiwan; the only exception being 2007, owing to political instability on ugly KMT/DPP confrontations.

**The Taiex tends to outperform in the second-half of the year, ahead of the Presidential elections**

**Exhibit 18. Pre-election Taiex performance**




Source: TEJ; Nomura Research

## 4) Improved job market activates pent-up consumption

**It will take years for pent-up demand to be fully unleashed, in our view**

In our view, the combined forces of capital repatriation, NT$ appreciation, a slow rate of normalisation, and modest inflation have contributed to the strong recovery in domestic consumption which, in turn, has helped create jobs and even expand wages. Indeed, if momentum of job creation and wage inflation continues as we expect, there will only be greater and sustained upside to domestic consumption. This is because it will take years for pent-up demand, which has been depressed by deflation for decades, to be fully activated. We consequently remain bullish on the domestic consumption theme in 2011F, despite impressive share-price performance as 2010 drew to a close.

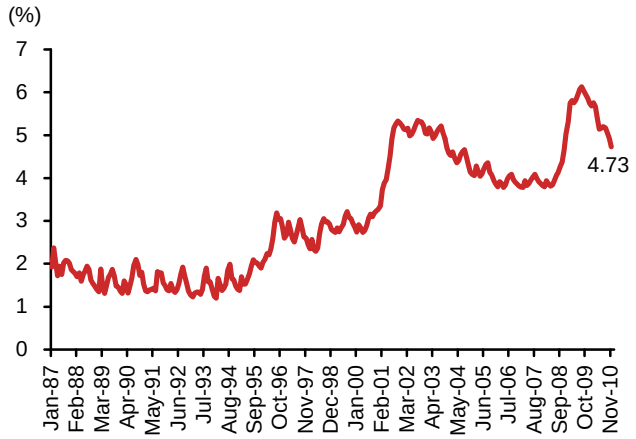
**Taiwan is now experiencing the strongest job market recovery in 20 years**

- Taiwan's unemployment rate has declined by 1pp over the past 12 months, which makes it the strongest job market recovery since 1987. Our analysis suggests that during the previous economic recovery (post-SARS), it took Taiwan almost three years to experience a job recovery of the same magnitude. The strong job creation in the current economic cycle can be attributed to domestic consumption recovery. Currently, the service sector accounts for 58% of job positions in Taiwan (vs the manufacturing sector at only 28% with a downward trend).

**Some corporates in China have decided to re-allocate white-collar staff to Taiwan**

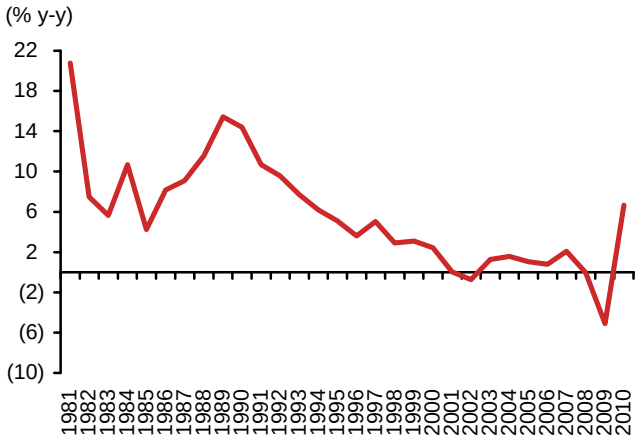
- More importantly, wages in Taiwan, which have experienced growth deceleration since the early 1990s, began to rebound strongly in 2010. Although the bounce can be attributed to a low base effect, our analysis suggests that annualised wages in 2010 were indeed at a record-breaking high. In our view, the years of salary adjustments in China's coastal areas have eased the wage differences across the Strait. According to our channel checks, some corporates have decided to re-allocate white-collar headcount to Taiwan (from China). More importantly, positions in the service sector cannot be filled by Chinese labour owing to regulatory restrictions, and this implies less deflationary pressure.

**Exhibit 19. Taiwan unemployment rate**




Source: Nomura Research; Note: Data are as of Nov, 2010.

**Exhibit 20. Taiwanese wage growth (y-y)**

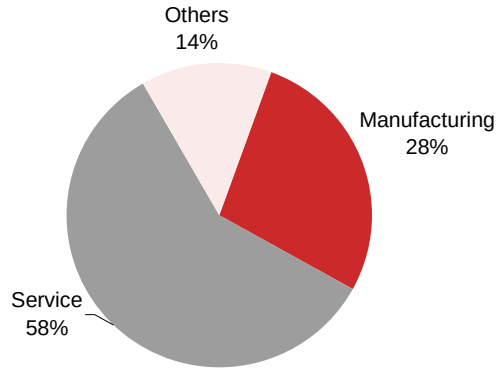



Source: Nomura Research

Strong job creation and wage growth have contributed to a robust recovery in domestic consumption in Taiwan. This resulted in strong retail sales growth in Taiwan. For instance, as shown below, President Chain Store has benefited from same-store-sales growth of almost 15% in 2010, on our estimates. We believe earnings risks for domestic consumption plays will likely remain on the upside in 2011F and beyond. We would recommend investors continue to accumulate exposure upon any dips.

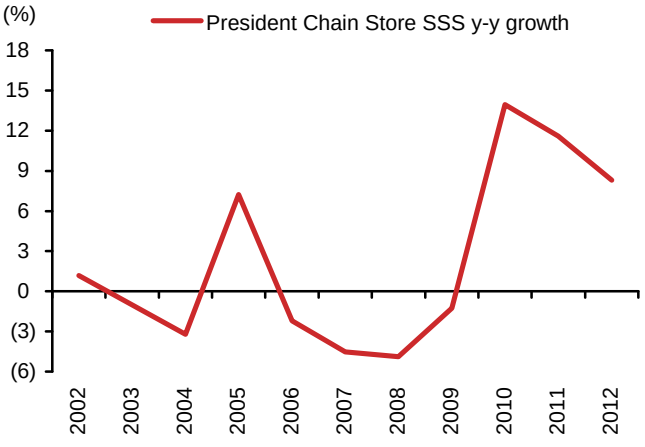
**We remain bullish on domestic consumption plays**

**Exhibit 21. Taiwan job breakdown in 3Q10**




Source: Nomura Research

**Exhibit 22. Same store growth at 7-11**




Source: Company data, Nomura estimates

## 5) Property price appreciation, an island-wide phenomenon

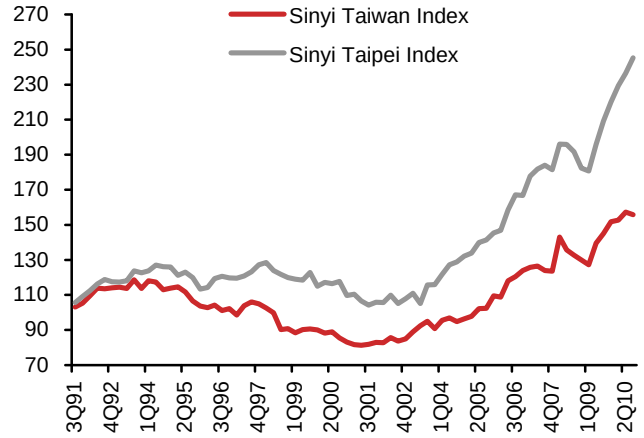
Taiwan's property market has been in an upcycle for almost eight years. Indeed, the asset-reflation cycle initially started in 2003 on robust replacement demand and gradually evolved in 2008 to be primarily driven by investment demand, owing to rising liquidity and negligible financing costs. Investors may have consequently noted that the characteristics of Taiwan's property market in the second stage of the cycle include concentrated price appreciation in affluent areas (Taipei City), or in the luxury-housing segment, for example. This is because speculators have only limited resources.

**Since 2008, Taiwan's property upcycle has been mainly driven by investment demand**

We believe Taiwan's property market will likely soon enter the third stage of the upcycle, which will be mainly driven by an improved job market and wage growth owing to the activation of pent-up investment and consumption. This, we believe, will improve affordability and support property prices. More importantly, we believe the phenomenon of property price appreciation will be widely seen across the island, instead of being concentrated only in the luxury segment in Taipei City.

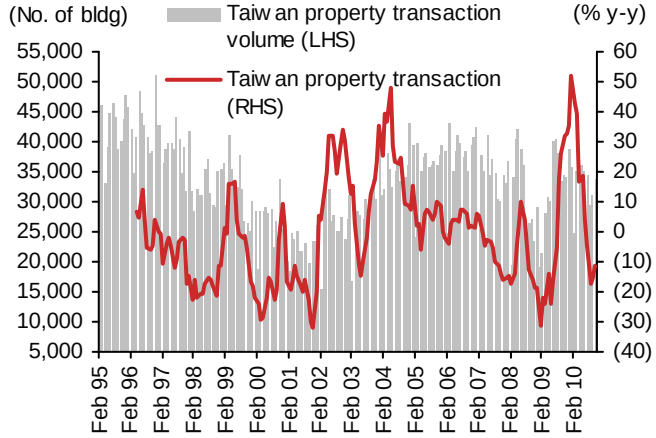
**Property price appreciation will be largely seen across the island in 2011**

**Exhibit 23. SinYi Property Index**




Source: Nomura Research

**Exhibit 24. Taiwan property transaction volume y-y**



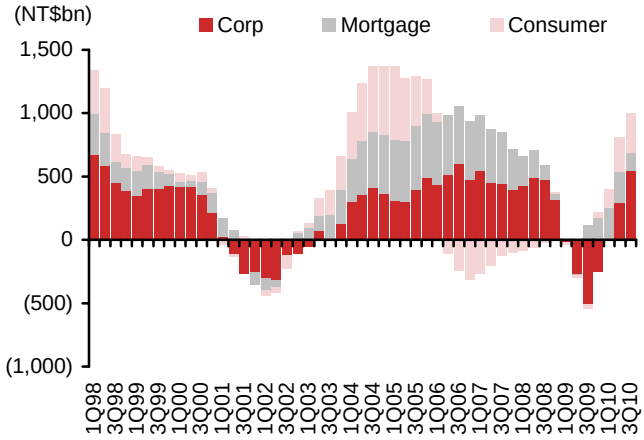

Source: Nomura Research; Note: Data as of Oct, 2010

Our Bullish view on Taiwan's property market is also supported by:

- Our belief that the CBC will likely accommodate higher inflation in the near term to help ensure that Taiwan moves well out of deflation. That said, Taiwan's rate of normalisation will likely lag the rise in the CPI in 2011F, which implies that the real interest rate will remain low, or even stand in negative territory.
- We believe restrictions on bank lending will not be an effective tool to depress local property prices. This is because banks have been quite disciplined in the mortgage business, in our view. Mortgage loan growth (y-y) has decelerated since 2006 to only 2.7% in 3Q10. Also, the loan-to-value ratio in our coverage universe is low, at 45-70% as of 3Q10. That said, we believe CBC's credit tightening efforts will likely have a marginal impact on property prices.

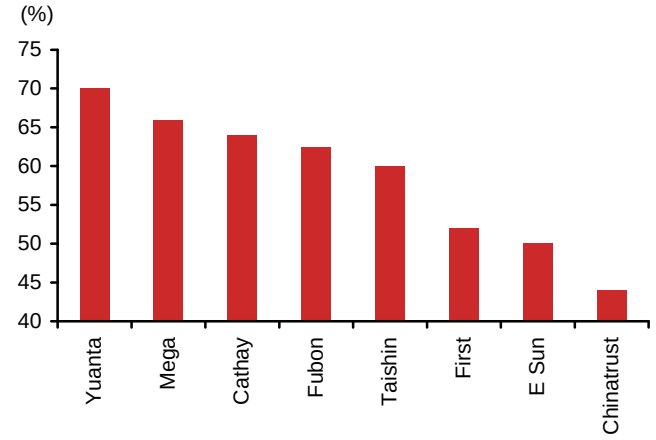
**Taiwan's mortgage loan growth (y-y) has decelerated since 2006**

**Exhibit 25. Bank loan growth breakdown**




Source: Nomura Research

**Exhibit 26. Mortgage loan-to-value ratio (3Q10)**




Source: Nomura Research

## 6) IFRS compliance puts property re-valuation in the spotlight

Taiwan targets complying with International Financial Reporting Standards (IFRS) in 2013. Nevertheless, we believe the market will begin to price in the likely impact by end-2011. This is because, according to local regulations, Taiex-listed corporates are required to offer, by end-2011, guidance regarding the changes in accounting principles and the best-effort estimates on the magnitude of the impact. We believe an important theme of IFRS compliance will likely be property re-valuation. That said, asset plays could benefit from stronger sentiment and a better performance in 2011, in our view.

**Listed corporates are required to offer guidance on IFRS impact by end-2011**

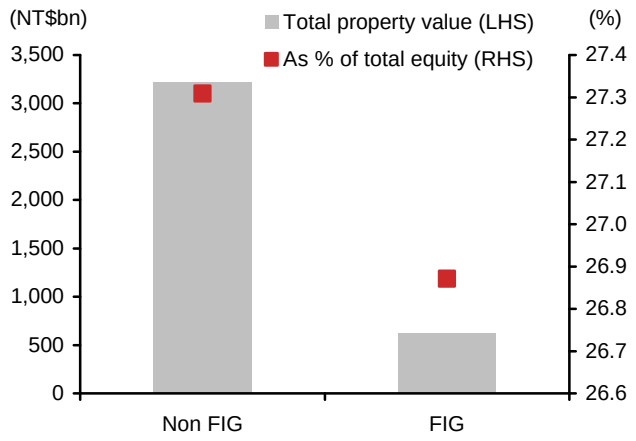
Taiwan GAPP promotes more conservatism, and property holdings are mostly held on balance sheets at historical cost. On the other hand, IFRS promotes more transparency and allows corporates to mark up property holdings to market value, upon the IFRS adoption in 2013. That said, listed corporates are offered an opportunity to revalue their property holdings. Such a decision should be made by end-2011. Investors should not underestimate the magnitude of the likely impact. This is because our analysis suggests that all Taiex-listed companies have a combined book value of NT$3.2tn in property holdings, including land (NT$700bn) and buildings (NT$2.5tn). As Taiwan's property prices could have doubled over the past 10 years, and will continue to be on an uptrend in 2011F, in our view, the re-valuation exercises will likely offer significant excitement for (retail) investors.

**Listed corporates have a combined book value of NT$3.2tn in property holdings as of 3Q10**

Indeed, we believe financial companies, including banks and life insurers, will likely re-value their property holdings to strengthen capitalisation. Meanwhile, traditional conglomerates, with high financial leverage, will also likely consider revaluing their property holdings to boost their capacity to take on debt. To date, most tech manufacturing companies are continuing with a wait-and-see attitude. We believe a move by respective sector leaders to re-state property values will likely be emulated by all followers in a bid to allow ready apple-to-apples comparisons.

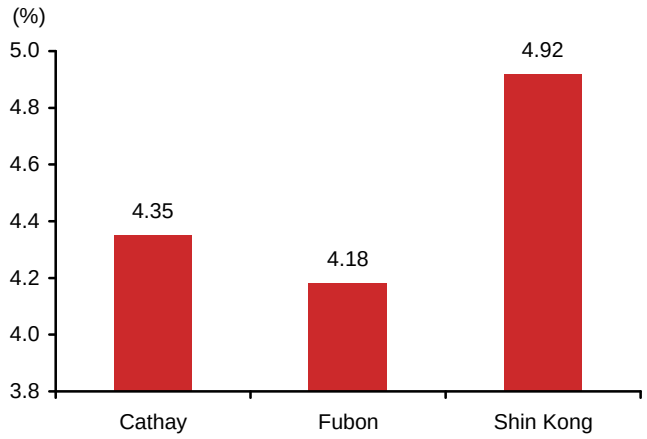
**Financial companies and high-leverage conglomerates are likely candidates to re-value property holdings**

**Exhibit 27. Property market**




Source: TEJ; Nomura Research

**Exhibit 28. Cost of liability at life insurers**




Source: Companies; Nomura Research

Separately, we suggest investors do *not* assume Taiwan would comply with IFRS at any cost. For example, we only expect 'soft compliance' with the accounting principles applied to the life insurance industry. This is because sudden compliance would likely see most players under-capitalised (because of the need to mark insurance liabilities to market value). Taiwan's life insurance industry would consequently either be nationalised or disposed to foreign investors at a significant discount to fair value. Since the cost of compliance is too big to absorb, we expect a pragmatic approach: soft compliance with IFRS in the life insurance industry. This is no surprise; even the US, Japan and China have not indicated a clear timetable to fully comply with IFRS. And it is not in any way compulsory for Taiwan to fully comply with IFRS by 2013.

**We expect soft IFRS compliance in the life insurance industry, given that the cost of full compliance would likely break the affected industries**

## 7) Dividend yield key to investment matrix

In our view, dividend plays will likely deliver strong share-price performance in 2011. Names that have counter-inflation business models, such as CHT, will be especially favoured by investors, in our view. This is because:

- We expect Taiwan's life insurers, which commanded investable assets of up to NT$8tn as of 3Q10, to begin increasing exposure to the domestic equity market through dividends plays in 2011. First, it's simply because some major names (eg, Cathay and Shin Kong) will soon exhaust their overseas investment quotas, which

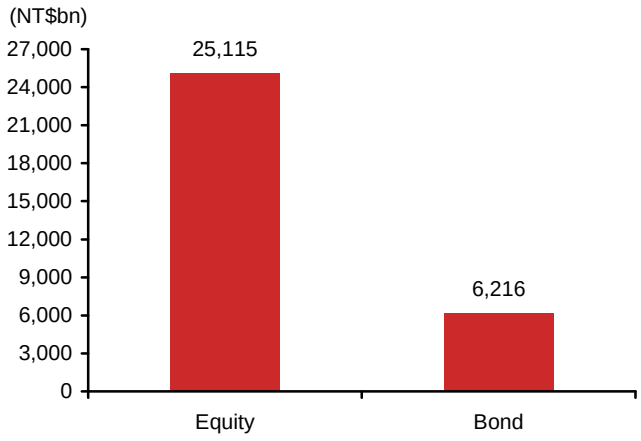
**Taiwan's life insurers will soon run out of overseas investment quotas**

are set by the Insurance Act at 45% of total assets. Amendment of this act will take time, given the track record of Taiwan's Legislative Yuan. Second, it is increasingly hard for Taiwan's life insurers to justify investing overseas. They will either suffer directly from likely NT dollar appreciation or face a declining rate of returns on the required FX hedging activities. So, their preferred asset class should be NT$-denominated investments. Domestic equity market is more accessible than the fixed-income market owing to stronger liquidity on greater market depth. Meantime, our analysis suggests that the domestic equity market also offers a higher yield than the bond market. Last, we expect Taiwan's life insurers to cherry pick dividend plays in a bid to better manage downside risk.

**Bond investors may shift exposure into dividend plays for better inflation protection**

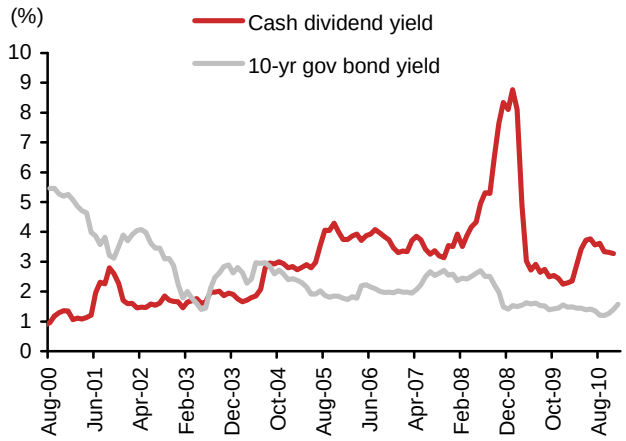
- We expect some bond investors to switch exposure into the domestic equity market for better inflation protection. This is because Taiwan's bond yield in 2011 will likely be depressed, in our view, due to sustained capital repatriation and the CBC's slow and gradual rate normalisation to help reflate the economy. We think bond investors will likely see the value of their bond investments begin to decline with lower purchasing power. At the same time, these bond investors will be under increasing pressure to find investments that offer better inflation protection. In our view, the dividend plays on the Taiex will likely be the major beneficiaries.

**Exhibit 29. Market cap comparison**




Source: Nomura Research

**Exhibit 30. Dividend yield vs bond yield**

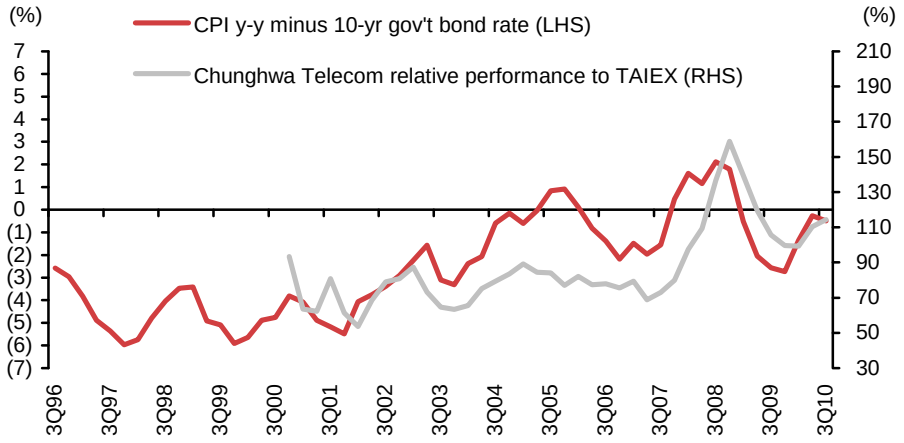



Source: Nomura Research

**Taiwan's telecom tariff is pegged to changes in CPI**

Among all the dividend plays in Taiwan, telcos appear to offer the most attractive exposure, in our view. Specifically, Taiwan's CPI growth rate (year-on-year basis) overshot the 10-year government bond yield during 2Q04-4Q05 and 3Q07-3Q08. We note that CHT, for example, has consequently outperformed the Taiex index (itself amid a marked correction). In addition, the fact that Taiwan's telecom tariff is pegged to the change of CPI helps enhance the ability of telcos to defend against rising inflation.

**Exhibit 31. CHT outperformed Taiex when CPI exceeds 10-year bond yield**




Source: TEJ; Nomura Research

## 8) Divergent fundamentals in tech

Taiwan's tech sector posted a clear de-rating in 2010. Specifically, although Taiwan's exports have returned to the pre-crisis level with record-breaking year-on-year growth throughout most of 2010, Taiwan's Tech Index failed to gain even three-quarters of the decline it suffered following the collapse of Lehman Brothers. We attribute this to:

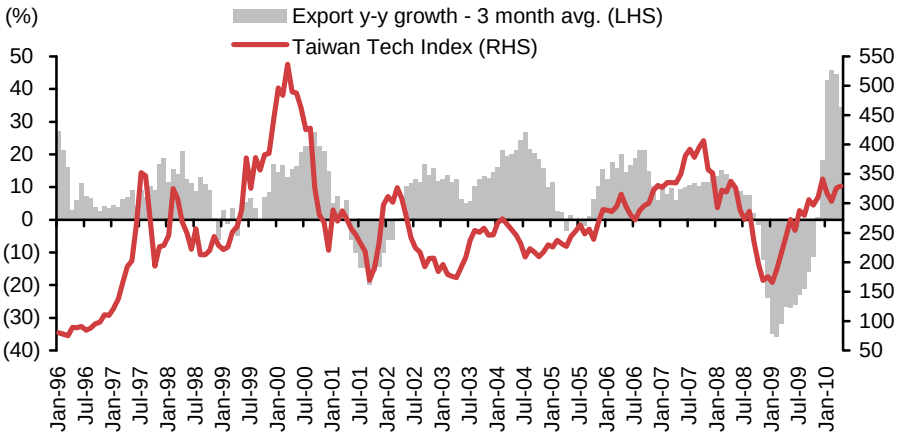
**Margin will be under pressure on cost-push inflation**

- In our view, investors were generally concerned over the structural profitability deterioration at tech companies. This includes sustained margin pressure from the headwinds of cost-push inflation, which is primarily driven by factors that include Asian currency appreciation, wage hikes and rising commodity prices. These factors look set to prevail into 2011 and perhaps beyond.

**Capex cycle to kick off to capture China's residual population dividends**

- In order to capture China's residual population dividends, the Taiwanese tech manufacturers have no choice but to enter another wave of capex cycle to migrate production facilities into the inland territory, in our view. We note that parallel production during the transition period will erode margin. Most importantly, the rate of return on forthcoming replacement capex will likely be unsatisfactory, as it can hardly warrant additional topline revenue growth.

**Exhibit 32. Export vs. Tech Index**




Source: Nomura Research

**PC/NB sector will have declining market value in 2011 due to severe ASP erosion**

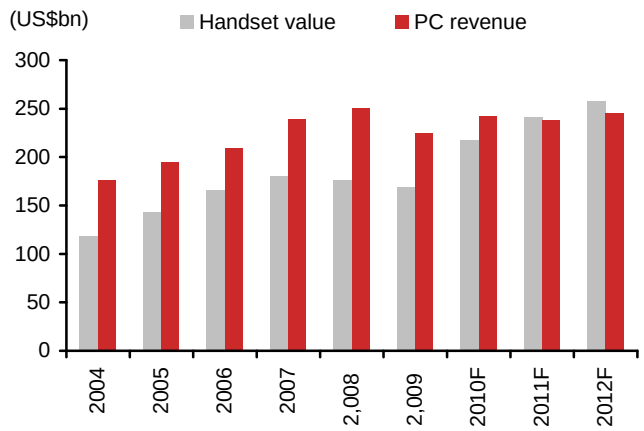
Deflationary pressure remains severe for revenue, especially in the NB sector. The introduction of netbooks and Tablet PCs, the de-graded versions of NBs, will likely cannibalise mainstream NB demand in the near term, at least. Our PC/NB analyst, Eve Jung, consequently forecasts global PC/NB shipment growth of only 8% in 2011. Despite this, she forecasts the market value will decline 1.7%+ on severe ASP erosion

(down almost 9% y-y). Given the sustained squeeze of topline deflation and cost inflation in 2011, we believe it is the sector where only selective companies with remarkable execution have growth opportunities.

The handset sector remains the bright spot for investors in 2011, in our view. The growing popularity of smartphones, which are replacing feature phones at higher ASPs, helps resist the gravity of sustained ASP deflation within the tech space. Indeed, our analysis suggests that the handset sector will for the first time have a market value greater than that of NB/PC sector in 2011. As smartphone penetration stands at only 23.4% at present, we believe the handset sector will continue to outgrow the PC/NB sector in the near future.

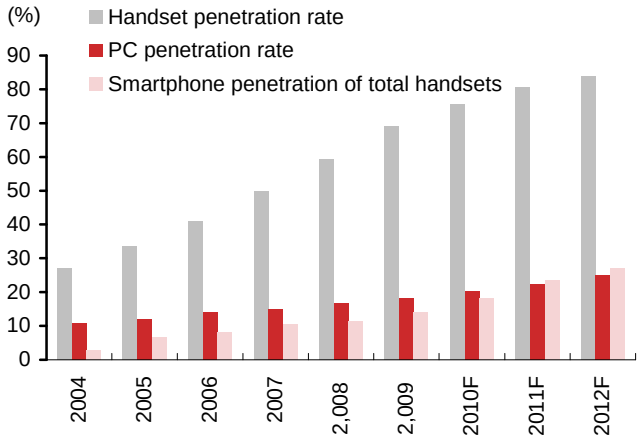
**Handset sector has greater market value than the PC/NB sector in 2011 thanks to the boom in smartphones**

### Exhibit 33. Handset outstrips PC/NB in market value




Source: Nomura Research

### Exhibit 34. Smartphone penetration




Source: Nomura Research

The smartphone boom could not prompt Taiwan's tech sector to re-rate as a whole. This is because Taiwan has a significantly weaker industry position in the (smartphone) handset foodchains than in the PC/NB foodchains. Our analysis suggests that the smartphone plays (i.e., those with 30% of revenue derived from smartphone business) represent only 6% of the Taiex by market capitalisation. Indeed, as the growth is concentrated in only a few beneficiaries, we believe it could become a crowded trade. That said, a minor disappointment in execution could rapidly translate into significant downside for share prices.

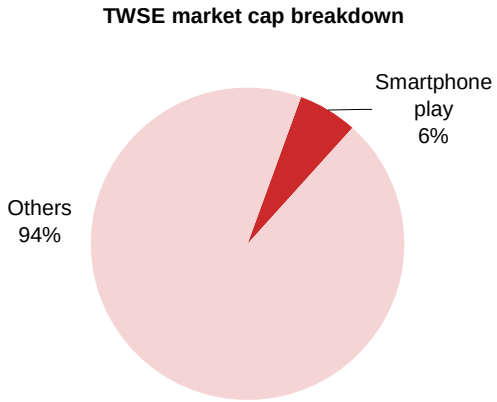
**Smartphone plays account for only 6% of the Taiex by market capitalisation**

### Exhibit 35. Smartphone beneficiaries

| | | | Smartphone revenue contribution (%) | |
|---|---|---|---|---|
| **Business** | **Ticker** | **Company** | **2010F** | **2011F** |
| Brand | 2498 TT | HTC | >99 | >99 |
| Assembly | 2317 TT | Hon Hai | >10 | >10 |
| | 4938 TT | Pegatron | 0 | 8 - 10 |
| Camera lens | 3008 TT | Largan | 50 | 50 |
| | 3406 TT | Genius | >40 | >50 |
| PCB | 3037 TT | Unimicron | 25 | 30 - 35 |
| | 2313 TT | Compeq | <10 | 10 - 15 |
| | 3044 TT | Tripod | <3 | 5 |
| | 3189 TT | Kinsus | 25 - 30 | 35 - 40 |
| Flexible PCB | 6153 TT | Career | 50 | 55 |
| | 6269 TT | Flexium | 30 | 35 |
| Connector | 2392 TT | Cheng Uei | 5 | 10 |
| Casing | 2354 TT | Foxconn Tech | 3 | >5 |
| | 2474 TT | Catcher | 30 - 35 | 40 - 45 |
| Quartz crystal | 3042 TT | TXC | 20 | >25 |
| Touch Panel | 2384 TT | Wintek | 45 | 65 |
| | 3673 TT | TPK | 90 | 70 |
| | 3622 TT | Youngfast | 90 | 80 |
| | 3584 TT | J Touch | 75 | 85 |

Source: Nomura Research

### Exhibit 36. Smartphone plays as % of Taiex




Source: Taiwan Economic Journal; Nomura Research

## 9) Diversifying sources of peace dividends

**Ruling parties across the Strait will likely accelerate economic cooperation to secure cross-Strait peace**

Against the backdrop of intensified tension along the Korean Peninsula, the fact that Taiwan and China have peacefully agreed to put aside decades of political/military confrontations to pursue economic cooperation appears to be much appreciated. Despite this, we think whether the cross-Strait peace can be maintained depends on the results of the legislator and presidential elections to be held in 1Q12. In our view, the ruling parties across the Strait will likely endeavour together to assume the economic benefits of peace dividends to be generally felt by the Taiwanese. To date, the DPP remains reluctant to rectify the so-called '92 consensus' (i.e., one China principle), which is the foundation of cross-Strait trade talks and economic deals starting from 2H08.

That said, we expect more diversified sources of peace dividends in 2011. This will include but not be limited to the following in our view:

**Daily quota of packaged tourists raised to 4,000 in 2011 (from 3,000)**

- **Tourism:** Taiwan and China have agreed to increase the daily quota of packaged tourists to 4,000 (from 3,000) in 2011. Meantime, the liberalisation of individual tourism will also likely take place in 2011 to broaden the scope of impact upon retail shops. This will boost Taiwan's domestic consumption and create jobs. The total number of tourists to Taiwan should jump to 5.4m in 2010, from 4.4m in 2009. Investors should note the significance of an increase by 1m tourists a year. It took ex-President Chen eight years (2000-08) to increase the number of tourists by 1.2m, for example. On the other hand, our analysis suggests that tourist spending will likely reach almost NT$300bn in 2011, or near 2% of GDP.

**Tariff reduction will become effective in 2011 to boost trade across the Strait**

- **Trades of products:** The tariff reduction, which has been committed in the Economic Cooperation Framework Agreement (ECFA), will become effective in 2011 in selected industries including chemical, textiles, and machinery. Moreover, the tariff reduction will be gradually applied to the majority of made-in-Taiwan products traded across the Strait in the following 10 years. We note that the reduced tariff is mostly applied to non-tech products, which cater to Chinese consumption demand.

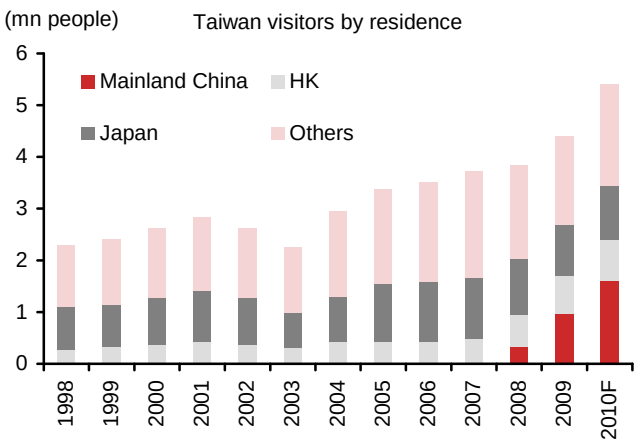
**Formosa Group — given better business opportunities in the mainland**

- **Outbound investments:** Taiwanese companies have been given better investment opportunities on the mainland, in our view. We think the Formosa Group is also likely to get approval to establish an upstream chemical production facility in China. In our view, these investments reflect an improving cross-Strait relationship. We expect more corporate-cooperation deals to be concluded to help broaden the addressable markets of Taiwanese companies.

**High restrictions for the Chinese to invest in Taiwan**

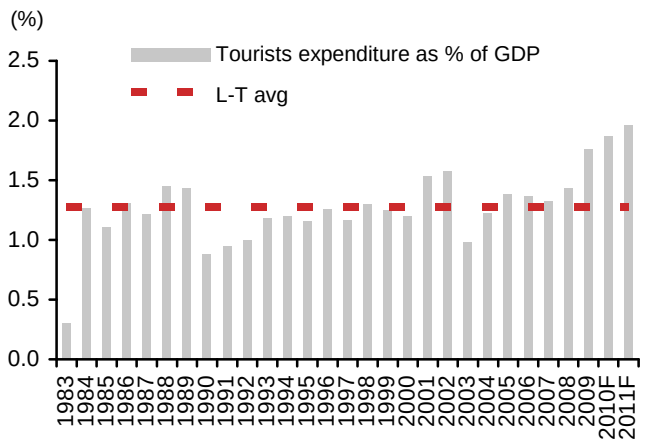
- **Inbound investments:** Taiwan remains conservative in opening up Chinese capital to invest in Taiwan. There remain high restrictions for not only direct investments but indirect investments into the property market, equity market, bond market, and corporate ownership. In our view, the opening-up will offer greater upsides, although the timing could arrive only after 2012, or during the second term of President Ma.

**Exhibit 37. Number of tourists to Taiwan**




Source: Nomura Research

**Exhibit 38. Tourist Spending as % of GDP**




Source: Nomura Research

## 10) Financial M&A?

In our view, Taiwan's economy looks set to benefit from an auto-piloted recovery, which requires little support from government. Nevertheless, we could see greater upside risks if the long-awaited financial consolidation starts. Although it will require government effort, a private-sector-led consolidation is not impossible. That said, we suggest investors do not completely write off the possibility of positive surprises. To be specific:

**A private-sector-led bank consolidation remains possible in 2011**

- The four private-equity-invested banks in Taiwan have a combined loan market share of 3%. These PE investors mostly established their positions in 2006-2007 and should be keen to formulate exit strategies. The recent valuation recovery offers an attractive opportunity, in our view. These banks could be M&A candidates for local larger financial holding companies or foreign players which are convinced of Taiwan's medium-term economic prosperity with support from China. These PE-invested banks include EnTie Bank, Ta Chong Bank, Cosmos Bank and Jih Sun Financial Holding Company.

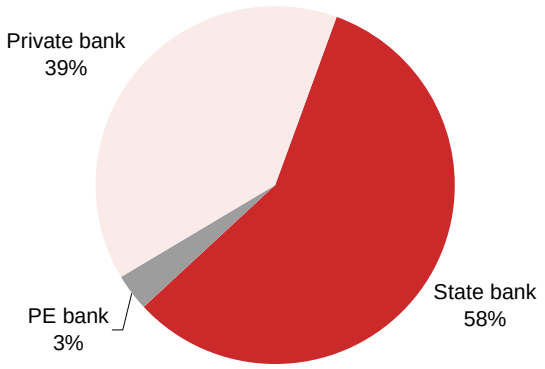
**Private equity investors could consider exiting their positions built in 2006-2007**

- Taiwan has allowed Chinese strategic investors to command up to 5% of local banks. In reality, however, M&A interest should be low, given little strategic or symbolic value is associated with 5% ownership. Nevertheless, we expect cross-Strait corporate activity to accelerate immediately, if the Taiwan government raises the ownership ceiling to 10% or higher.

- We think real consolidation in Taiwan's banking industry cannot be done without government effort. This is because eight state banks have a combined loan market share of almost 58% as of 3Q10. We think the government has no incentive to consolidate state banks, given likely opposition from employees and legislators. Despite this, as cross-Strait bank investments are further liberalised, Taiwan will need a national banking champion which has sufficient scale to make a meaningful acquisition in China.

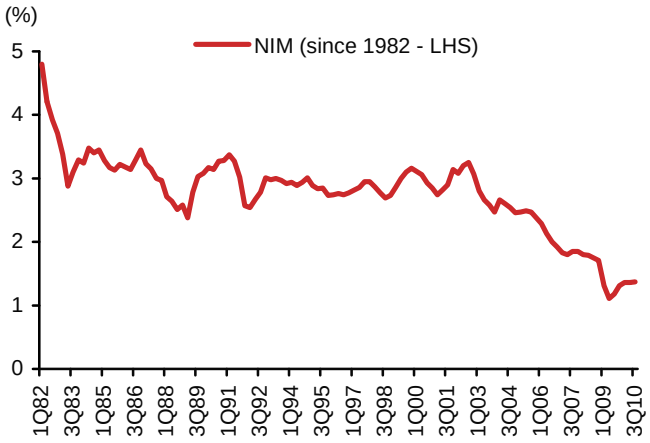
**Eight state banks have a combined loan market share of 58% in 3Q10**

### Exhibit 39. Bank market share structure in 3Q10




Source: TEJ; Nomura Research

### Exhibit 40. Net Interest Margin at Bank Industry




Source: TEJ; Nomura Research

Nomura Taiwan Coverage Universe

# Nomura Taiwan Coverage Universe

## Exhibit 41. Nomura Taiwan Coverage Universe

| Ticker | Company name | Analyst name | Rating | Price 3-Jan-11 (NT$) | Market caps (US$mn) | 1m | 3m | 6m | YTD | PER (x) | | PBR (x) | | ROE (%) | | Div yield (%) | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | | | FY10F | FY11F | FY10F | FY11F | FY10F | FY11F | FY10F | FY11F |
| **Coverage** | | | | 76.3 | 357,955 | | | | | 14.6 | 13.2 | 2.4 | 2.2 | 16.8 | 17.5 | 4.5 | 4.7 |
| **Tech** | | | | 204.2 | 184,913 | | | | | 14.4 | 12.0 | 2.5 | 2.2 | 17.6 | 19.6 | 3.7 | 4.2 |
| **IC Design** | | | | 241.3 | 20,405 | | | | | 14.6 | 16.7 | 4.5 | 4.4 | 28.6 | 26.8 | 5.4 | 4.9 |
| 2379 TT | Realtek | Aaron Jeng, CFA | REDUCE | 68.6 | 1,144 | (5.4) | (4.9) | (3.2) | (1.4) | 17.1 | 15.6 | 1.9 | 1.8 | 11.2 | 11.9 | 4.4 | 5.8 |
| 2454 TT | Mediatek | Aaron Jeng, CFA | REDUCE | 415.0 | 15,542 | (1.8) | (7.6) | (2.3) | (0.6) | 14.4 | 17.6 | 5.3 | 5.4 | 32.3 | 30.2 | 5.5 | 4.6 |
| 6286 TT | Richtek | Aaron Jeng, CFA | BUY | 243.5 | 1,191 | (10.3) | 3.6 | (8.2) | 0.2 | 15.3 | 13.2 | 5.6 | 4.6 | 40.6 | 38.5 | 4.1 | 4.9 |
| 3534 TT | Ralink | Aaron Jeng, CFA | REDUCE | 102.0 | 612 | (9.3) | (19.7) | (22.9) | (0.5) | 14.3 | 14.5 | 2.3 | 2.5 | 17.5 | 18.5 | 3.9 | 4.9 |
| 3034 TT | Novatek | Aaron Jeng, CFA | NEUTRAL | 93.6 | 1,916 | (5.0) | 4.6 | 6.4 | (0.4) | 11.7 | 10.7 | 2.5 | 2.3 | 22.2 | 22.3 | 6.4 | 7.5 |
| **Panel** | | | | 50.2 | 17,932 | | | | | 12.7 | 7.9 | 1.4 | 1.2 | 11.5 | 16.3 | 0.9 | 1.0 |
| 2409 TT | AUO | James Kim | BUY | 30.4 | 9,205 | 1.2 | (7.2) | 6.7 | 0.2 | 8.7 | 5.8 | 0.8 | 0.7 | 9.8 | 13.4 | - | - |
| 3622 TT | Young Fast | Anne Lee, CFA | NEUTRAL | 271.0 | 1,320 | (12.0) | (24.7) | 14.2 | (2.7) | 11.6 | 10.2 | 3.4 | 2.8 | 35.0 | 30.5 | 3.9 | 4.4 |
| 3673 TT | TPK | Anne Lee, CFA | BUY | 671.0 | 5,166 | (8.5) | na | na | 0.1 | 28.4 | 14.7 | 9.1 | 5.9 | 48.5 | 48.9 | 1.0 | 1.0 |
| 2384 TT | Wintek | Anne Lee, CFA | BUY | 50.4 | 2,241 | (7.2) | (1.9) | 94.2 | 0.6 | 31.1 | 10.4 | 2.3 | 2.0 | 7.7 | 20.4 | 2.6 | 3.0 |
| **Solar & LED** | | | | 88.5 | 6,059 | | | | | 15.7 | 12.4 | 2.1 | 1.9 | 14.4 | 15.7 | 2.5 | 2.6 |
| 3452 TT | E-Ton | Nitin Kumar | REDUCE | 46.6 | 399 | 23.3 | 9.6 | 3.6 | (2.5) | nm | 22.0 | 1.1 | 1.1 | (26.6) | 5.0 | - | - |
| 6244 TT | Motech | Nitin Kumar | NEUTRAL | 108.0 | 1,411 | (4.8) | (7.3) | 8.5 | 0.5 | 8.9 | 8.2 | 1.7 | 1.4 | 25.2 | 19.3 | 1.9 | 1.9 |
| 2393 TT | Everlight | Anne Lee, CFA | NEUTRAL | 83.7 | 1,205 | 0.5 | (4.0) | 2.2 | (0.8) | 13.2 | 12.7 | 2.2 | 2.1 | 17.5 | 16.9 | 4.9 | 5.1 |
| 2448 TT | Epistar | Anne Lee, CFA | NEUTRAL | 104.5 | 3,043 | 1.5 | 6.5 | 28.4 | (1.9) | 16.8 | 15.3 | 2.2 | 2.1 | 13.9 | 14.0 | 3.2 | 3.5 |
| **Handsets & Components** | | | | 189.4 | 38,717 | | | | | 16.4 | 12.4 | 4.5 | 3.9 | 29.3 | 34.4 | 4.4 | 5.8 |
| 2498 TT | HTC | Aaron Jeng, CFA | BUY | 921.0 | 25,874 | 4.3 | 30.3 | 119.3 | 2.3 | 19.2 | 13.0 | 9.6 | 7.3 | 53.4 | 63.8 | 4.2 | 6.0 |
| 2301 TT | Lite-on Tech | Anne Lee, CFA | BUY | 40.0 | 3,144 | (1.7) | 2.2 | 13.7 | (0.1) | 10.1 | 9.5 | 1.4 | 1.3 | 13.7 | 14.1 | 7.9 | 8.4 |
| 2439 TT | Merry | Anne Lee, CFA | BUY | 52.0 | 284 | 2.0 | (6.3) | 18.0 | (1.1) | 10.5 | 9.0 | 1.7 | 1.6 | 16.9 | 18.6 | 7.3 | 8.5 |
| 3008 TT | Largan | Anne Lee, CFA | NEUTRAL | 734.0 | 3,383 | 0.1 | 20.3 | 43.4 | 1.2 | 22.9 | 17.7 | 6.4 | 5.4 | 29.5 | 33.1 | 2.7 | 3.6 |
| 3037 TT | Unimicron | Anne Lee, CFA | BUY | 55.7 | 2,961 | (2.3) | 5.1 | 17.1 | (1.9) | 11.5 | 10.4 | 1.9 | 1.7 | 17.6 | 17.3 | 3.9 | 4.3 |
| 3044 TT | Tripod | Anne Lee, CFA | BUY | 119.5 | 1,944 | (8.4) | (1.2) | 3.5 | 0.4 | 11.6 | 9.8 | 2.7 | 2.3 | 25.0 | 25.2 | 4.1 | 5.1 |
| 3311 TT | Silitech | Anne Lee, CFA | NEUTRAL | 90.5 | 557 | (6.0) | (1.2) | 15.7 | 0.2 | 10.2 | 9.9 | 2.6 | 2.3 | 27.2 | 24.6 | 5.3 | 5.5 |
| 3042 TT | TXC | Anne Lee, CFA | BUY | 55.8 | 569 | (3.6) | (1.1) | 13.8 | 0.2 | 13.1 | 11.7 | 2.5 | 2.2 | 19.9 | 20.0 | 4.3 | 4.8 |
| **PC** | | | | 87.9 | 100,080 | | | | | 13.9 | 12.3 | 2.3 | 2.0 | 16.4 | 17.5 | 3.6 | 4.1 |
| 2308 TT | Delta | Eve Jung | NEUTRAL | 139.5 | 11,460 | (0.7) | 6.5 | 29.8 | (2.1) | 20.8 | 18.1 | 4.1 | 3.9 | 19.1 | 19.4 | 3.9 | 4.5 |
| 2354 TT | Foxconn Tech | Eve Jung | REDUCE | 115.5 | 4,417 | 11.6 | 18.3 | 24.2 | (1.3) | 16.6 | 15.1 | 2.2 | 2.0 | 14.6 | 14.0 | 1.5 | 1.5 |
| 2385 TT | Chicony | Eve Jung | REDUCE | 65.1 | 1,399 | 1.4 | (1.5) | (3.5) | 0.2 | 11.8 | 11.9 | 2.8 | 2.5 | 25.8 | 22.3 | 5.2 | 5.3 |
| 6121 TT | Simplo Tech | Eve Jung | BUY | 210.5 | 1,843 | (1.6) | 16.3 | 33.5 | (0.7) | 16.2 | 13.8 | 3.9 | 3.4 | 26.2 | 26.1 | 2.8 | 3.2 |
| 2347 TT | Synnex | Eve Jung | BUY | 77.3 | 4,032 | (0.4) | 8.0 | 21.9 | (1.8) | 21.1 | 17.5 | 3.2 | 2.9 | 16.2 | 17.4 | 2.4 | 2.9 |
| 2324 TT | Compal | Eve Jung | NEUTRAL | 38.9 | 5,902 | (1.9) | 2.9 | 5.1 | 0.5 | 7.5 | 8.4 | 1.5 | 1.4 | 21.7 | 17.2 | 7.4 | 6.6 |
| 2382 TT | Quanta | Eve Jung | BUY | 61.5 | 8,099 | (0.5) | 22.0 | 9.4 | 0.5 | 10.8 | 9.2 | 2.1 | 1.9 | 18.5 | 20.0 | 5.6 | 6.6 |
| 3231 TT | Wistron | Eve Jung | BUY | 59.8 | 4,037 | 2.0 | 7.0 | 24.4 | 0.7 | 9.9 | 7.9 | 2.0 | 1.8 | 21.3 | 23.7 | 5.6 | 7.0 |
| 4938 TT | Pegatron | Eve Jung | NEUTRAL | 41.8 | 3,241 | (6.7) | 2.0 | 39.3 | (0.5) | 14.2 | 11.7 | 1.0 | 0.9 | 6.9 | 8.2 | 4.2 | 5.1 |
| 2353 TT | Acer | Eve Jung | BUY | 90.0 | 8,333 | (5.3) | 13.5 | 19.5 | (0.1) | 15.5 | 12.3 | 2.5 | 2.2 | 16.4 | 19.1 | 3.9 | 4.9 |
| 2357 TT | ASUS | Eve Jung | BUY | 272.5 | 5,871 | 1.7 | 21.9 | 22.2 | (1.6) | 10.8 | 11.3 | 1.6 | 1.5 | 11.4 | 13.9 | 4.6 | 4.4 |
| 2317 TT | Hon Hai | Eve Jung | NEUTRAL | 117.5 | 39,003 | 4.4 | 2.6 | 17.5 | - | 15.4 | 13.0 | 2.4 | 2.2 | 16.3 | 17.6 | 2.6 | 3.1 |
| 2474 TT | Catcher | Eve Jung | REDUCE | 107.0 | 2,444 | 12.6 | 49.4 | 57.1 | (0.9) | 19.5 | 16.1 | 2.2 | 2.0 | 11.3 | 12.9 | 2.1 | 2.5 |
| **Networking** | | | | 40.1 | 1,721 | | | | | 16.2 | 13.4 | 1.7 | 1.6 | 10.4 | 12.0 | 3.8 | 4.6 |
| 2332 TT | D-Link | Anne Lee, CFA | BUY | 30.1 | 670 | (4.6) | (13.8) | 19.0 | 0.3 | 16.3 | 13.5 | 1.3 | 1.2 | 7.9 | 9.1 | 3.6 | 4.3 |
| 2485 TT | Zinwell | Anne Lee, CFA | NEUTRAL | 57.1 | 623 | 10.2 | 4.2 | 10.4 | (0.5) | 12.9 | 11.9 | 2.6 | 2.3 | 20.8 | 20.6 | 4.4 | 4.7 |
| 4906 TT | Gemtek | Anne Lee, CFA | REDUCE | 44.0 | 428 | (5.2) | (17.1) | (0.2) | (0.6) | 25.5 | 16.1 | 1.6 | 1.5 | 6.2 | 9.7 | 3.1 | 4.9 |
| **DRAM** | | | | 15.1 | 4,016 | | | | | nm | nm | 1.4 | 2.0 | (24.3) | (34.6) | - | - |
| 2408 TT | NTC | CW Chung | REDUCE | 16.4 | 2,266 | (3.0) | (20.4) | (33.1) | 0.6 | nm | nm | 1.8 | 2.7 | (27.5) | (42.9) | - | - |
| 3474 TT | Inotera | CW Chung | REDUCE | 14.1 | 2,229 | (2.4) | (19.3) | (21.5) | 0.7 | nm | nm | 1.2 | 1.6 | (21.9) | (28.9) | - | - |
| **Non-tech incl. Fin** | | | | 49.0 | 257,291 | | | | | 16.0 | 15.2 | 2.1 | 2.0 | 13.2 | 13.4 | 4.7 | 4.8 |
| **Non-tech ex Fin** | | | | 63.0 | 189,648 | | | | | 14.7 | 14.5 | 2.3 | 2.2 | 16.0 | 15.5 | 5.2 | 5.1 |
| **Basic Materials** | | | | 33.3 | 22,387 | | | | | 14.4 | 13.9 | 1.5 | 1.5 | 11.1 | 11.1 | 4.9 | 4.7 |
| 1101 TT | Taiwan Cement | Josephine Ho | BUY | 33.4 | 3,778 | 4.2 | 1.1 | 23.4 | 1.8 | 18.0 | 13.5 | 1.4 | 1.4 | 8.3 | 10.5 | 5.0 | 4.1 |
| 1102 TT | Asia Cement | Josephine Ho | BUY | 32.5 | 3,433 | 5.4 | 2.5 | 17.9 | 0.6 | 14.1 | 14.3 | 1.3 | 1.2 | 9.2 | 8.6 | 3.7 | 3.6 |
| 1103 TT | Chia Hsin Cement | Josephine Ho | NEUTRAL | 17.7 | 441 | 7.9 | 15.7 | 29.0 | 2.9 | 16.7 | 16.3 | 0.8 | 0.7 | 3.8 | 3.7 | - | - |
| 2002 TT | China Steel | Josephine Ho | BUY | 34.1 | 14,734 | 8.4 | 6.1 | 18.8 | 1.9 | 13.7 | 13.9 | 1.7 | 1.7 | 13.1 | 12.4 | 5.2 | 5.2 |
| **Petrochem** | | | | 91.0 | 91,294 | | | | | 16.3 | 14.4 | 2.7 | 2.6 | 16.9 | 18.2 | 5.6 | 6.3 |
| 1301 TT | Formosa Plastics | Yong Liang Por | BUY | 97.0 | 20,400 | 3.4 | 26.0 | 46.1 | (0.5) | 13.8 | 12.8 | 2.5 | 2.4 | 18.5 | 19.1 | 6.5 | 7.0 |
| 1303 TT | Nan Ya Plastics | Yong Liang Por | BUY | 72.6 | 19,587 | 4.2 | 6.0 | 42.4 | (0.1) | 13.4 | 12.4 | 2.0 | 2.0 | 16.0 | 16.2 | 6.8 | 7.3 |
| 1326 TT | FCFC | Yong Liang Por | BUY | 97.7 | 19,102 | 5.9 | 28.6 | 32.9 | (0.5) | 12.8 | 11.8 | 2.3 | 2.2 | 18.3 | 19.0 | 7.0 | 7.6 |
| 6505 TT | Formosa | Yong Liang Por | NEUTRAL | 98.4 | 32,206 | 13.1 | 21.6 | 25.4 | (0.5) | 27.2 | 21.0 | 4.1 | 3.9 | 15.2 | 18.8 | 3.4 | 4.4 |

| Ticker | Company name | Analyst name | Rating | Price 3-Jan-11 (NT$) | Market caps (US$mn) | 1m | 3m | 6m | YTD | PER (x) | | PBR (x) | | ROE (%) | | Div yield (%) | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | | | FY10F | FY11F | FY10F | FY11F | FY10F | FY11F | FY10F | FY11F |
| **Transportation** | | | | 33.7 | 14,058 | | | | | 6.9 | 10.4 | 1.7 | 1.5 | 27.5 | 15.2 | 3.1 | 1.7 |
| 2603 TT | Evergreen Marine | Andrew Lee | REDUCE | 30.9 | 3,260 | 21.4 | 41.0 | 40.7 | 2.1 | 6.4 | 11.9 | 1.3 | 1.3 | 25.4 | 11.1 | 4.2 | 2.1 |
| 2605 TT | Sincere Navigation | Cecilia Chan | REDUCE | 35.4 | 690 | (0.8) | (4.2) | (6.5) | 0.1 | 7.3 | 7.5 | 1.3 | 1.2 | 19.0 | 17.0 | 6.2 | 6.1 |
| 2606 TT | U-Ming | Cecilia Chan | NEUTRAL | 63.1 | 1,860 | 0.5 | 2.6 | 1.3 | (0.6) | 11.8 | 16.8 | 1.7 | 1.6 | 18.8 | 9.8 | 3.1 | 1.8 |
| 2609 TT | Yang Ming | Andrew Lee | REDUCE | 30.1 | 2,646 | 22.2 | 50.3 | 74.2 | 6.4 | 5.5 | 13.8 | 1.7 | 1.6 | 36.4 | 12.0 | 5.5 | 2.2 |
| 2615 TT | Wan Hai | Andrew Lee | REDUCE | 25.9 | 1,876 | 13.6 | 18.3 | 29.9 | 0.8 | 5.9 | 10.3 | 1.6 | 1.5 | 24.8 | 14.9 | 2.7 | 1.9 |
| 2618 TT | Eva Airways | Shirley Lam | BUY | 36.6 | 3,726 | 7.3 | 34.8 | 83.0 | (0.5) | 7.9 | 7.5 | 2.4 | 1.7 | 35.4 | 26.7 | - | - |
| **Consumer** | | | | 68.1 | 16,546 | | | | | 23.9 | 20.5 | 3.5 | 3.3 | 15.5 | 16.8 | 1.8 | 2.2 |
| 1216 TT | Uni-President | Brandon Chen | BUY | 43.1 | 6,351 | 3.4 | 6.3 | 28.5 | (0.3) | 18.2 | 16.8 | 2.6 | 2.5 | 15.7 | 14.7 | 1.7 | 1.6 |
| 2903 TT | Far Eastern | Brandon Chen | NEUTRAL | 50.0 | 2,135 | 15.7 | 24.4 | 94.9 | 2.6 | 34.2 | 25.1 | 2.5 | 2.4 | 7.6 | 9.5 | 1.5 | 1.4 |
| 2912 TT | PCS | Brandon Chen | BUY | 135.0 | 4,824 | 5.9 | 2.3 | 45.0 | 0.4 | 22.9 | 20.2 | 6.6 | 6.2 | 31.6 | 31.8 | 2.7 | 3.6 |
| 2704 TT | Ambassador | Brandon Chen | REDUCE | 49.7 | 640 | 7.3 | (1.2) | 30.1 | 3.5 | 63.2 | 47.4 | 2.1 | 2.0 | 3.4 | 4.4 | 0.4 | 0.6 |
| 2707 TT | Formosa Intl Hotel | Brandon Chen | BUY | 539.0 | 1,344 | 7.6 | 5.1 | 52.0 | 4.5 | 39.6 | 27.8 | 12.8 | 11.0 | 34.5 | 42.6 | 1.6 | 2.3 |
| 2723 TT | Gourmet Master | Brandon Chen | BUY | 284.5 | 1,251 | (25.0) | na | na | (2.9) | 42.0 | 29.6 | 7.3 | 6.3 | 25.0 | 22.8 | 0.5 | 1.2 |
| **Property** | | | | 91.9 | 7,066 | | | | | 15.4 | 14.7 | 2.1 | 2.0 | 14.2 | 13.9 | 3.4 | 3.6 |
| 1722 TT | Taiwan Fertilizer | Josephine Ho | BUY | 116.0 | 3,906 | 2.2 | 17.1 | 35.5 | 6.4 | 42.3 | 41.1 | 2.3 | 2.2 | 5.4 | 5.4 | 1.8 | 1.9 |
| 2548 TT | Huaku | Brandon Chen | BUY | 90.8 | 811 | 4.0 | 5.0 | 21.3 | 2.7 | 8.6 | 7.3 | 2.4 | 2.1 | 29.6 | 30.3 | 6.1 | 6.6 |
| 5522 TT | Farglory | Brandon Chen | BUY | 79.5 | 1,929 | 0.8 | 5.7 | 26.2 | 1.3 | 8.7 | 8.5 | 2.0 | 1.8 | 27.0 | 22.5 | 4.8 | 5.5 |
| 2536 TT | Hung Poo | Brandon Chen | NEUTRAL | 42.0 | 419 | 0.2 | (5.1) | 4.2 | (3.4) | 8.2 | 8.6 | 1.2 | 1.2 | 15.8 | 13.9 | 5.9 | 5.6 |
| **Telecom** | | | | 66.4 | 38,298 | | | | | 15.4 | 15.4 | 2.2 | 2.2 | 14.1 | 14.4 | 7.4 | 5.5 |
| 2412 TT | Chunghwa Telecom | Leping Huang, PhD | BUY | 73.6 | 24,521 | (0.3) | 5.1 | 13.2 | (0.7) | 15.5 | 15.7 | 2.0 | 2.1 | 12.6 | 13.0 | 9.9 | 7.1 |
| 4904 TT | Far EasTone | Leping Huang, PhD | NEUTRAL | 42.1 | 4,713 | (2.0) | (4.1) | 4.9 | (0.5) | 15.6 | 15.8 | 1.9 | 1.9 | 12.2 | 11.9 | 5.8 | 5.7 |
| 3045 TT | Taiwan Mobile | Leping Huang, PhD | BUY | 69.4 | 9,063 | 2.5 | 8.1 | 3.0 | (0.4) | 14.7 | 14.4 | 4.9 | 4.8 | 26.7 | 26.6 | 6.1 | 6.3 |
| **Financials** | | | | 29.4 | 67,643 | | | | | 21.8 | 17.7 | 1.6 | 1.5 | 7.3 | 8.8 | 3.0 | 3.7 |
| 2882 TT | Cathay FHC | Jesse Wang | REDUCE | 53.1 | 17,670 | 12.9 | 11.2 | 16.2 | 2.7 | 62.3 | 33.0 | 2.4 | 2.3 | 3.9 | 7.0 | 0.8 | 1.5 |
| 2881 TT | Fubon FHC | Jesse Wang | BUY | 40.7 | 11,381 | 7.4 | 6.0 | 15.8 | 1.8 | 15.1 | 13.4 | 1.5 | 1.5 | 10.3 | 11.2 | 4.3 | 4.8 |
| 2884 TT | E Sun FHC | Jesse Wang | BUY | 20.0 | 2,614 | 14.0 | 23.8 | 50.1 | (0.2) | 17.0 | 13.8 | 1.4 | 1.3 | 8.0 | 9.7 | 3.5 | 4.8 |
| 2885 TT | Yuanta FHC | Jesse Wang | NEUTRAL | 22.0 | 6,103 | 8.4 | 15.8 | 26.1 | 0.9 | 21.5 | 19.2 | 1.5 | 1.5 | 7.1 | 7.9 | 3.6 | 4.1 |
| 2886 TT | Mega FHC | Jesse Wang | NEUTRAL | 22.9 | 12,694 | 8.0 | 8.6 | 26.9 | 1.8 | 17.3 | 15.6 | 1.3 | 1.2 | 7.4 | 8.0 | 4.6 | 5.1 |
| 2887 TT | Taishin FHC | Jesse Wang | NEUTRAL | 17.9 | 3,624 | 24.8 | 24.8 | 55.4 | 3.5 | 12.8 | 12.9 | 1.1 | 1.0 | 12.4 | 11.2 | 3.4 | 3.9 |
| 2891 TT | Chinatrust FHC | Jesse Wang | BUY | 21.9 | 7,492 | 12.6 | 10.6 | 26.0 | 2.1 | 14.7 | 12.4 | 1.4 | 1.3 | 11.2 | 13.4 | 4.6 | 5.5 |
| 2892 TT | First FHC | Jesse Wang | BUY | 27.3 | 6,064 | 18.5 | 30.4 | 50.2 | 1.5 | 38.2 | 22.6 | 1.7 | 1.6 | 4.4 | 7.3 | 1.7 | 2.2 |

Source: Nomura Research estimates

# Nomura Taiwan GDP Model

## Exhibit 42. GDP

| % y-y growth unless otherwise stated | 3Q10 | 4Q10 | 1Q11 | 2Q11 | 3Q11 | 4Q11 | 1Q12 | 2Q12 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Real GDP [sa, % q-q annualized] | **0.10** | (0.90) | 12.20 | 6.00 | 6.30 | 1.20 | 8.00 | 5.20 | - | - | - |
| Real GDP | **9.80** | 4.40 | 3.20 | 4.20 | 5.80 | 6.30 | 5.30 | 5.10 | 9.90 | 4.90 | 5.30 |
| Private consumption | **4.50** | 3.10 | 4.40 | 3.70 | 3.90 | 3.80 | 4.10 | 3.80 | 3.70 | 3.90 | 3.90 |
| Government consumption | **0.40** | 0.60 | 1.40 | 0.50 | 1.10 | 1.60 | 0.40 | 0.40 | 1.20 | 1.20 | 0.40 |
| Gross fixed capital formation | **23.70** | 12.00 | 8.20 | 6.40 | 8.00 | 9.00 | 8.40 | 8.90 | 23.10 | 7.90 | 8.80 |
| Exports (goods & services) | **20.10** | 15.50 | 13.10 | 9.10 | 9.20 | 9.30 | 10.70 | 10.70 | 25.70 | 10.10 | 11.00 |
| Imports (goods & services) | **22.80** | 19.00 | 15.90 | 10.50 | 9.10 | 8.90 | 10.90 | 11.30 | 29.70 | 11.00 | 11.40 |
| **Contributions to GDP:** | | | | | | | | | | | |
| Domestic final sales | **6.70** | 3.90 | 4.10 | 3.20 | 3.80 | 4.00 | 3.90 | 3.80 | 6.20 | 3.80 | 3.80 |
| Inventories | **1.60** | (0.10) | (0.90) | 0.40 | 0.60 | 0.70 | 0.20 | 0.10 | 2.10 | 0.20 | 0.10 |
| Net trade (goods & services) | **1.40** | 0.60 | - | 0.60 | 1.40 | 1.70 | 1.20 | 1.30 | 1.60 | 0.90 | 1.40 |
| Exports | **27.10** | 17.50 | 14.60 | 11.10 | 11.70 | 12.30 | 14.20 | 14.20 | 33.80 | 12.40 | 14.50 |
| Imports | **31.50** | 21.00 | 17.90 | 12.50 | 11.60 | 11.90 | 14.40 | 14.80 | 42.00 | 13.40 | 14.90 |
| Merchandise trade balance (US$bn) | **6.20** | 6.50 | 3.70 | 7.10 | 7.00 | 7.50 | 4.10 | 7.70 | 24.70 | 25.30 | 27.80 |
| Current account balance (US$bn) | **9.00** | 17.30 | 9.50 | 10.10 | 8.50 | 18.30 | 9.90 | 10.60 | 47.70 | 46.40 | 48.90 |
| (% of GDP) | **8.30** | 14.80 | 8.20 | 8.40 | 6.60 | 13.60 | 7.60 | 7.90 | 11.10 | 9.30 | 8.70 |
| Fiscal balance (% of GDP) | **(1.20)** | (1.30) | (1.00) | | | | | | | | |
| Consumer prices index | **0.40** | 1.10 | 2.00 | 2.50 | 1.80 | 1.90 | 1.90 | 1.90 | 1.00 | 2.50 | 3.10 |
| Unemployment rate (%) | **5.10** | 5.00 | 4.90 | 4.70 | 4.60 | 4.30 | 4.30 | 4.20 | 5.70 | 4.30 | 4.00 |
| Discount rate (%) | **1.50** | 1.63 | 1.75 | 1.88 | 2.00 | 2.13 | 2.25 | 2.38 | 1.63 | 2.13 | 2.63 |
| Overnight call rate (%) | **0.22** | 0.35 | 0.47 | 0.60 | 0.72 | 0.85 | 0.97 | 1.10 | 0.35 | 0.85 | 1.35 |
| 10-year T-bond (%) | **1.20** | 1.32 | 1.45 | 1.57 | 1.82 | 2.30 | 2.43 | 2.55 | 1.32 | 2.30 | 2.80 |
| Exchange rate (NT$/US$) | **31.30** | 30.00 | 29.60 | 29.30 | 29.00 | 28.70 | 28.40 | 28.10 | 30.00 | 28.70 | 27.50 |

Notes: Numbers in bold are actual values; others forecast. Interest rate and currency forecasts are end of period; other measures are period average. All forecasts are modal forecasts (i.e., the single most likely outcome). Table last revised 6 December 2010.

Source: CEIC and Nomura Global Economics

Sector Summaries

# IC Designs Sector

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## 2011F outlook – no structural positive catalyst; inventory correction has ended

We turn NEUTRAL from bearish on the IC design sector, given: 1) the end of inventory digestion and 2) positive sequential sales growth in 1Q11F

We have been Bearish on Taiwan's fabless sector from 2Q10 amid concerns over inventory overbuild, growing competition and margin pressure. However, for 4Q10 to 1Q11, we would turn NEUTRAL on the sector, as we believe inventory correction likely ended by the end of 4Q10 or is likely to end in early 1Q11. We believe most companies would have seen their sales bottom in either October or November and expect positive sequential sales growth into 1Q11F, which should serve as potential near-term catalysts. In addition, as local funds and foreigners have low investments in Taiwan's fabless sector, this should imply limited share price downside in fabless names when orders start to return.

Cyclically, we are turning more positive although we remain concerned about: 1) limited growth drivers; and 2) unattractive valuations vs a poor 2011 earnings growth outlook.

In our opinion, smartphone and tablets, in which Taiwan fabless companies have relatively limited exposure (vs their exposure to PC), will continue to be the major sub-sectors with strong growth in 2011F. Although some may argue that almost all PC makers will launch tablet products into 2011, we question their rate of success. We believe handset companies have an advantage in making tablet products since they are familiar with ARM architecture and Android OS. MediaTek has the biggest handset exposure among Taiwan fabless companies, but its advanced 3G chips are not ready yet, which makes it hard to benefit from the uptrend in converging devices.

Given our view that Taiwan fabless companies are likely to have difficulties finding growth drivers into 2011F, we believe most companies will be unable to grow their earnings in 2011F. We expect MediaTek to see a severe earnings decline in 2011F. As most companies are still trading at above-average valuations, this is a risk, we think, particularly when inventory rebuild momentum ends and if end demand fails to pick up.

## Investment Strategy

We recommend BUY on Richtek on its market-share gain but keep REDUCE on MediaTek, Realtek and Ralink due to limited/negative earnings growth in 2011F

For 2011F, we recommend companies capable of growing market share (since demand is uncertain, market-share gain becomes more important) and sustaining or even improving gross margin. Hence, we like Richtek. We expect Richtek to post strong market-share gain in high-margin handsets and TV panel applications (with different Korean customers), which will likely improve the company's product mix, particularly given our expectation that the company will exit from low-margin NB applications. We also believe that the market is overly concerned about TI's 12" fab and have not conducted enough reality checks. We are not worried about Richtek's 2011 gross margin.

We also like Novatek for its growing market share (at CMI), inexpensive valuations and return of orders (ie, Novatek was the first among its peers to see orders returning in November 2010). However, we believe its share price is susceptible to the panel cycle, as we have seen no other structural positive improvement by the company so far. We have a NEUTRAL rating on Novatek.

We continue to maintain our REDUCE ratings on MediaTek, Ralink and Realtek on: 1) intensifying pricing competition, which will likely have an adverse impact on their margins and market share; 2) lack of growth catalysts for 2011; and 3) our expectation that their earnings will stay lacklustre in 2011F — in our opinion, MediaTek is likely to

witness a severe earnings decline in 2011F; and 4) high valuations vs a poor earnings growth outlook.

## Key Risks

1) Better-than-expected end demand, particularly for PC applications; and 2) FX volatility.

**Key risks include stronger demand and FX volatility**

### Exhibit 43. Summary of our company views

| Ticker | Realtek 2379 TT | MediaTek 2454 TT | Novatek 3034 TT | Ralink 3534 TT | Richtek 6286 TT |
|---|---|---|---|---|---|
| Key products | Ethernet - 30%<br>Audio codec - 25%<br>WLAN - 20%<br>Others - 25% | Handset - 70-75%<br>TV - 5-10%<br>PC ODD 10-15%<br>Consumer DVD - 5-10% | Large DDI - 65%<br>Mobile DDI - 15%<br>SOC - 20% | Retail WiFi - 50%<br>PC WiFi - 15-20%<br>Broadband WiFi - 20-30%<br>CE WiFi - 5% | Panel - 30%<br>NB - 20%<br>Handset - 10%<br>MB/VGA - 10%<br>Netowrking - 10%<br>Others - 20% |
| **Sales outlook for the next 6-12 months** | | | | | |
| Market share change by product | Ethernet - stop rising<br>Audio codec - flat<br>WLAN - stop rising | Handset - falling<br>TV - flat<br>PC ODD - flat<br>Consumer DVD - flat | Large DDI - rising<br>Mobile DDI - rising<br>SOC - flat | Retail WiFi - flat<br>PC WiFi - rising<br>Broadband WiFi - flat | Panel - rising<br>NB - rising<br>Handset - rising<br>MB/VGA - rising<br>Networking |
| New products/applications | DMP | Mobile analog TV chip<br>3.5G Feature phone<br>3.5G Smartphone | LED driver | TV-use WiFi<br>IAD | TV panel PMIC<br>TV set PMIC<br>NB Vcore<br>LED driver |
| Price competition | High | High | Moderate | High | High |
| **Margin outlook for the next 6-12 months** | | | | | |
| Pricing pressure | High | High | Moderate | High | High |
| Company-specific cost saving capability* | Low | Low | Low | Low | High |
| Margin downside risk | High/Moderate** | High | Moderate | High | Moderate*** |
| **Fundamental conclusion** | | | | | |
| Unit demand outlook by key application*** | PC demand:2010 19%yoy; 2011 14%yoy | Emerging market handset demand: 2010 40-50%yoy; 2011 20%yoy | Panel demand: 2010 14%yoy; 2011 11%yoy | WiFi demand (excluding Mobile): 2010 14%yoy; 2011 15%yoy | PC demand/Panel demand/Handset demand: 2010 14%yoy; 2011 12%yoy |
| Market share trend as a whole | Stop rising | Falling | Rising | Rising | Rising |
| Margin pressure | High | High | Moderate | High | Moderate** |
| **-> 2011 EPS growth** | **c.10%** | **-18%** | **c.10%** | **Zero** | **20%** |
| vs consensus 2011 EPS growth | 13% | -10% | 10% | Zero | 15% |
| **Valuation** | | | | | |
| Current 1y forward PER | 16x | 17x | 11x | 15x | 14x |
| **Historical PER range - reported EPS** | | | | | |
| Peak | 20x | 17x | 12x | 23x | 20x |
| Trough | 7x | 7x | 7x | 12x | 11x |
| Average | 14x | 12x | 10x | 18x | 16x |
| Current PER vs. Average | 14% | 42% | 10% | -17% | -13% |
| Current 1y forward consensus PER | 15x | 15x | 11x | na | 15x |
| **Historical PER range - consensus EPS** | | | | | |
| Peak | 20x | 15x | 15x | na | 25x |
| Trough | 8x | 8x | 7x | na | 10x |
| Average | 14x | 12x | 11x | na | 18x |
| Current PER vs. Average | 7% | 25% | 0% | na | -17% |
| **Our call** | | | | | |
| **Rating** | **Reduce** | **Reduce** | **Neutral** | **Reduce** | **BUY** |
| **vs. consensus** | **Below-consensus EPS forecast** | **Non-consensus call** | EPS forecast matchs consensus | **Non-consensus call** | **Non-consensus call** |
| Comments | We disagree with bullish investors' view on the turnaround story driven by digital home concept. With falling PC demand, weakening market share and limited new product cycle, our EPS forecasts are below consensus | We remain the most bearish broker on MediaTek since we believe valuation de-rating will be longer and deeper when product transition takes two years. We expect 2011 earnings growth to be zero, with risk on the downside. | We are worried about inventory correction in 2H10 though we like the company on continued share gain at CMI for 2011 and limited margin downside risk. | We expect zero earnings growth for 2011 given our view of upcoming inventory correction and rising ASP/GM pressure for 4Q10/1Q11 despite that WiFi device volume growth is growing fast. | We believe its fundamentals remain solid thanks its diversified product portfolio and continuous cost down. |
| Latest update | "Nothing New?" dated on Nov 2 | "Preparing for the heated competition?" dated on Nov 1 | "No surprise" dated on Oct 27 | "1+1=1?" dated on Nov 10 | "Upturn is around the corner" dated on Nov 10 |

Note:

*A natural cost decrease every quarter and production node migration are not counted since all competitors are benefiting

**Richtek's production migration from 6" to 8" wafer can naturally save cost per die by 10-20%

Source: IDC, Displaysearch, Nomura estimates

Sector Summaries

# Solar Sector

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**Pure-play makers likely to see peaking margins in 3Q10F**

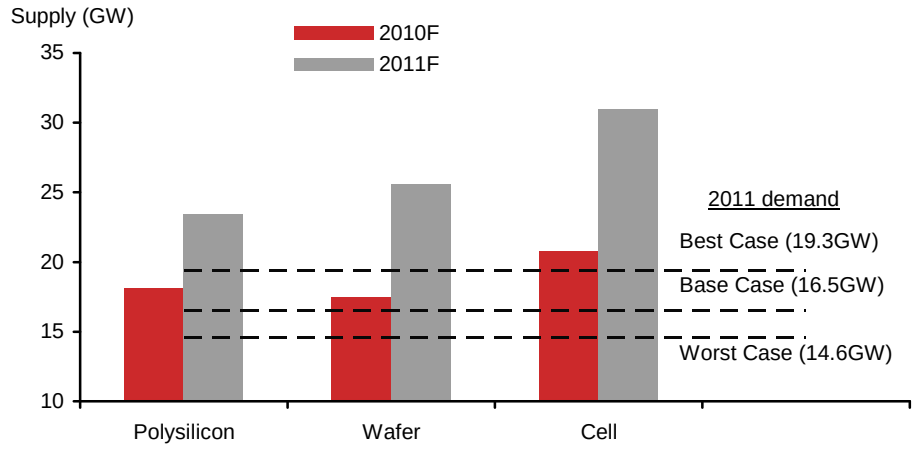
Over 2010, pure-play cell makers and wafer makers have benefitted from a surge in demand and thus ASP improvements, which are reflected in their share prices outperforming the broader solar sector. We believe pure-play cell and wafer makers are likely to see their earnings margins peak in 3Q10 and 4Q10F, respectively, with continued bullish comments, as impacts from changed industry dynamics are only starting to manifest themselves, in our opinion. We expect 2011F to see three changes:

**2011F to see steady shift change as industry moves to oversupply, given demand growth from Europe looks set to slow**

- **Undersupply to oversupply.** Looking at the expansion plans of companies in the different segments of the value chain, we see mean available capacity across the chain at 23-24GW (+50% y-y) by end-2011F. In contrast, even under our best-case scenario, we see demand growth of 29% y-y to 19.3GW in 2011F, suggesting oversupply. Under our base-case scenario, we assume demand growth of 10% y-y to 16.5GW, also suggesting oversupply at 40-45% of demand.

**Oversupply in 2011F even in our best-case scenario**

**Exhibit 44. Oversupply across the value chain**




Source: Nomura estimates

- **ASPs to see pressure across the supply chain.** With the German government having announced a 13% cut in feed-in-tariffs (FIT) from January, we believe ASP pressure will increase across the supply chain. We estimate a 12-18% y-y decline in module ASPs in 2011F.
- **Polysilicon industry enters oligopoly.** With the exit of GCL Polysilicon from the pure polysilicon market, only three key suppliers remain – Hemlock, Wacker and OCI – in the market. Note that GCL has forward integrated into wafers and is unlikely to be a key supplier of poly in future. As such, we expect pricing wars to be minimal and spot prices to revert to long-term pricing contracts. Based on our checks with companies, we estimate polysilicon ASPs under long-term contracts will fall to US$45-50/kg by 2H11F from US$55-60/kg currently. Thus, ASP pressure is unlikely to be offset by sharp declines in poly ASPs.

## Market-share consolidation likely in 2011F

Deteriorating demand-supply dynamics are likely to raise ASP pressure and we see module ASPs falling 12-18% y-y to US$1.4-1.5/W in 2011F from US$1.7-1.8/W currently. This will likely have a ripple effect across the solar value chain and we expect companies with better cost management to drive market-share gains, resulting in consolidation.

We believe companies best positioned to ride the market dynamics in 2011F require the key characteristics of: 1) better cost management, which favours companies with vertical integration; 2) R&D in cell-efficiency improvements – key to continued cost reductions in the segment, in our view; and 3) geographical sales diversification to capture demand from new growth markets as demand growth from Europe slows.

**Switch to companies with: 1) vertical integration; 2) strong R&D roadmap; and 3) sales diversification outside Europe**

## Vertically integrated model — the winning strategy

Within the solar industry, we believe vertically integrated players are best placed to stabilise margins, given: 1) streamlined cost structure; 2) better access to diversified end-markets; and 3) strong supplier relations.

We see companies with a pure-play business model as most vulnerable to ASP pressure, given they have fewer avenues for cost reductions and are exposed to market-share shifts at their customers. Here, among the pure-play makers, we see a business model shifting towards increased vertical integration, which we believe is the right step forward.

**Pure-play makers evaluating vertical integration strategies**

We reaffirm our BUY ratings on Trina (price target: US$36.0) and Yingli (price target: US$15.0), as we see their margins as defensive due to: 1) their leading status in vertical integration; 2) 2011F to see R&D efforts bearing fruit; and 3) investments into improving their brand name. In our view, Suntech has the best brand name among China-based peers and a well-documented R&D programme, although its progress in 2010 has been disappointing due to balance-sheet restructuring and execution delays in the launch of its high-efficiency Pluto cells. We see potential positive catalysts in 2011F from: 1) expected upstream integration into wafers; and 2) a wider Pluto cell launch looks to be on track for 2011F. We reaffirm our BUY rating on Suntech (price target: US$11.0).

**In our view, Trina, Yingli and Suntech look best placed to outperform the industry; reiterate BUY**

Solargiga (price target: HK$1.1) and E-Ton (price target: NT$37.0) have lagged in their vertical strategies. In our view, the slower business transformation will manifest itself in declining margins and we expect the stocks to underperform unless there are new investments to change their profiles.

## Valuation methodologies and company-specific risks

### Trina

We value the company using the YTD average FY11F PER of the module peer group to which we assign a 10% discount to reflect market concerns about slowing growth. Downside risks include: 1) slower market-share gains in new regions; and 2) demand at new growth centres being unable to offset lower demand from Germany.

### Yingli

We value the company using the YTD average FY11F PER of the module peer group to which we assign a 10% discount to reflect market concerns about slowing growth. Downside risks include: 1) slower market-share gains in new regions; and 2) demand at new growth centres being unable to offset lower demand from Germany.

### Suntech

We value the company using the YTD average FY11F PER of the module peer group to which we assign a 10% discount to reflect market concerns about slowing growth. Downside risks include: 1) slower market-share gains in new regions; and 2) demand at new growth centres being unable to offset lower demand from Germany.

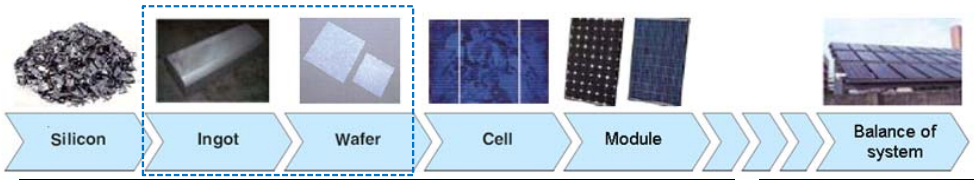
### Solargiga

We value the company based on 6x FY11F earnings, the average P/E multiple of Greater China peers. Upside risks include: 1) Margin expansion ahead of our expectations on the back of faster cost reductions; and 2) earnings upside from the Qinghai Chenguang investment.

### E-Ton

We value the company using the industry average P/B and apply a 20% discount to reflect the company's stretched balance sheet. Upside risks include: 1) E-Ton raising additional funding at attractive rates; and 2) a faster-than-expected ramp-up of new R&D projects helping to meaningfully improve the cost structure.

**Exhibit 45. Value chain exposure of companies under coverage**




| | Solar panel (45~55% of system ASP) | | | | Balance of System (45~55% of system ASP) | |
|---|---|---|---|---|---|---|
| | **Silicon** | **Ingot/Wafer** | **Cell** | **Module** | **Inverters** | **Installation** |
| **System ASP breakdown (%)** | 10~12% | 12~15% | 8~10% | 15~18% | 8~10% | 35~45% |
| **Typical Cost (US$/W)** | 0.12~0.20 | 0.30~0.35 | 0.20~0.25 | 0.30~0.35 | 0.25~0.35 | N/A |
| **Gross margins* (%)** | 40~60% | 15~25% | 15~25% | 5~10% | 35~40% | N/A |
| | | Trina Solar | | | | |
| | Partial fulfilment | Yingli Green | | | | |
| | | Expansion in 2011 | Suntech Power | | | |
| | | Future expansion | Canadian Solar | | | |
| | | Future expansion | JA Solar | White-brand | | |
| | | Future expansion | Motech | Own Brand | | |
| | | | E-Ton | via subsidiary | | |
| | Ramping | LDK Solar | Ramping capabilties | | | |
| | GCL Holdings | 3.5GW capacity by end-10 | | | | |
| | | Solargiga | | | | |
| **2011 performance expectations** | | | | | | |
| **- Pure play** | NEUTRAL | UNDERPERFORM | UNDERPERFORM | UNDERPERFORM | | |
| **- Vertically Integrated** | | | NEUTRAL | | | |
| | | OUTPERFORM | | | | |
| | | OUTPERFORM | | | | |

* Asterisk for approximate gross margin
Source: Bloomberg, Nomura Research

Sector Summaries

# PC/NB Sector

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## Likely lacklustre PC growth for 2011F

**Time to revisit the PC hardware sector — focus on the names with margin improvement**

We expect PC shipment growth to slow at 8% in 2011F from a high base in 2010. As procurement decisions were delayed during the financial crisis, we saw a strong shipment pick-up in 2H09, which led to slower y-y growth in global PC shipments in 2H10 with 10%/4% y-y growth in 3Q10/4Q10 vs 26%/20% in 1Q10/2Q10. Additionally, Intel's new product launch and the rising importance of the China PC market also changed normal seasonality in 2010. Going forward, we expect the shipment split between 1H and 2H to change from 40:60 to 45:55 or 47:53.

While investors generally hold a conservative view on the PC hardware sector and the share prices of these names underperformed the TAIEX from 2Q10, we think now is the time to revisit the widely unloved sector. Market expectations have been set low after the slow growth in 2H10. We believe PC shipment growth likely bottomed in 4Q10F. New product launches in 1Q11, easing component pricing and continued growth from China are potential positive catalysts for share prices in the near term.

- **2011F PC growth likely to be slower:** We forecast 2011F client PC shipment growth of 8% vs 14% in 2010F with NB shipment (including traditional NB and netbook) growth of 12%. Our PC forecast is below consensus of 9-14% for 2011. We believe netbook will continue to be cannibalised by tablet PC and netbook shipments could decline by 34% in 2011F, while traditional NB shipments will be supported by rising adoption rates in emerging markets and a recovery in corporate demand.
- **China is the growth engine for the global PC market:** Given rising consumer and SME demand in China, we expect China to surpass the US and Europe to become the largest PC market in 2012F. We forecast China PC shipments will grow 20% y-y in 2011F, outperforming 8% industry growth. Asian brands, which continue to gain market share in China, should benefit from this trend.
- **Intel's new platform to support PC demand in 2011F:** Intel recently launched Sandy Bridge CPU, and we expect consequent volume shipments to NB ODMs in late-4Q10. Many PC OEMs had aggressively planned their new products supporting Sandy Bridge CPUs and prepared volume shipments after the Consumer Electronics Show (CES) in Las Vegas (6-9 January 2011). Intel is adding new features and integrating graphics, memory controller and CPU on the same die for better cost structure and performance. PC OEMs expect Sandy Bridge to boost corporate demand as well as consumer demand in 2011. Before the new product launch, we expect channel distributors to clean out inventories of old models. Therefore, we believe 4Q10 PC shipment growth will likely be muted.
- **Strength from commercial segment to last into 2011F:** As many enterprises have not completed their PC replacement cycles, and as the PC replacement cycle usually lasts six to eight quarters, we expect PC OEMs with higher exposure to the corporate sector (eg, Lenovo and Dell) to benefit from demand improvements in the commercial segment in 2011F. We forecast corporate PC shipments will grow 9% in 2011F, vs. 7% for consumer PC. Additionally, NB ODMs, such as Wistron, with higher exposure to the commercial segment should also benefit from this trend.
- **Tablet PC creates additional demand, but very few PC OEMs could benefit from the strong growth of tablet PCs in 2011F:** We believe Apple will continue to be the biggest winner, grabbing a 60-70% market share in the tablet market in 2011F. The remaining 30-40% market share could be shared by other PC OEMs. This implies that the tablet PC contribution will be small for most PC OEMs in

2011F. As the software support for Google's Honeycomb is unlikely to be ready until 1H11F, we believe tablet PC shipments from other PC OEMs are unlikely to pick up until 2H11F.

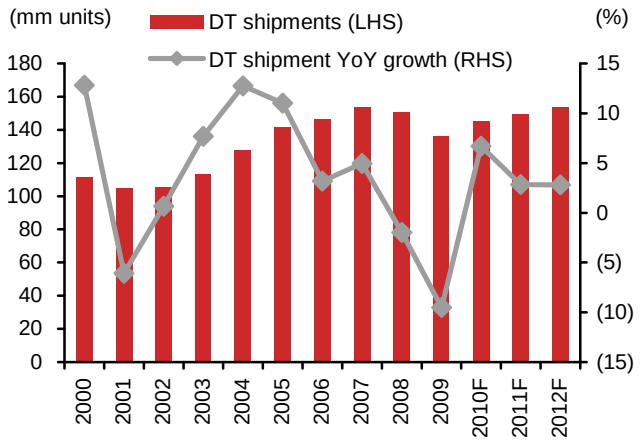
- **2011F: A better year for downstream players than 2010:** After suffering from tight component supply and intense price competition from EMS players, we believe 2011F is likely to be a better year for downstream makers, compared with 2010, on aggressive capacity increase from IC and component makers. With easing component supply and softening prices, we think volume growth is likely to surprise on the upside on price elasticity.

## Exhibit 46. Global PC shipments and y-y growth

| Shipment (unit in '000) | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010E | 2011E | 2012E |
|---|---|---|---|---|---|---|---|---|---|---|
| Total PC (including x86 servers) | 156,058 | 180,487 | 211,445 | 234,023 | 272,198 | 300,494 | 311,149 | 355,157 | 383,370 | 422,914 |
| (% y-y) | 12.4 | 15.7 | 17.2 | 10.7 | 16.3 | 10.4 | 3.5 | 14.1 | 7.9 | 10.3 |
| x86servers | 4,732 | 5,689 | 6,473 | 6,966 | 7,531 | 7,752 | 6,366 | 7,546 | 8,252 | 8,827 |
| (US$ y-y) | 20.8 | 20.2 | 13.8 | 7.6 | 8.1 | 2.9 | (17.9) | 18.5 | 9.4 | 7.0 |
| Total Client PC (desktops+notebooks) | 151,326 | 174 797 | 204,971 | 227,056 | 264,667 | 292,742 | 304,783 | 347,611 | 375,118 | 414,088 |
| (% y-y) | 12.2 | 15.5 | 17.3 | 10.8 | 16.6 | 10.6 | 4.1 | 14.1 | 7.9 | 10.4 |
| Client PC - Desktops | 113,208 | 127,651 | 141,829 | 146,622 | 157,100 | 150,488 | 136,123 | 145,298 | 149,429 | 153,632 |
| (% y-y) | 7.7 | 12.8 | 11.1 | 3 4 | 7.1 | (4.2) | (9.5) | 6.7 | 2.8 | 2.8 |
| (q-q) | | | | | | | | | | |
| Client PC - Notebooks | 38,117 | 47,146 | 63,142 | 80,434 | 107,566 | 142,253 | 168,659 | 202,313 | 225,689 | 260,455 |
| (% y-y) | 27.9 | 23.7 | 33.9 | 27.4 | 33.7 | 32.2 | 18.6 | 20.0 | 11.6 | 15.4 |
| Tablet PC | | | | | | | | 15,000 | 50, 00 | 80,000 |
| (US$ y-y) | | | | | | | | | 233.3 | 60.0 |
| Total PC + Tablet PC | 156,058 | 180,487 | 211,445 | 234,023 | 272,198 | 300,494 | 311,149 | 370,157 | 433,370 | 502,914 |
| (% y-y) | | | | | | | 3.5 | 19.0 | 17.1 | 16.0 |

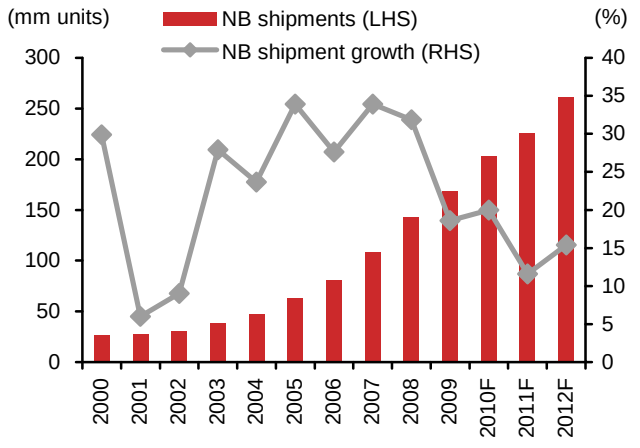
Source: IDC; Nomura estimates

## Exhibit 47. DT shipments and y-y growth




Source: IDC; Nomura estimates

## Exhibit 48. NB shipments and y-y growth




Source: IDC; Nomura estimates

## Investment Strategy

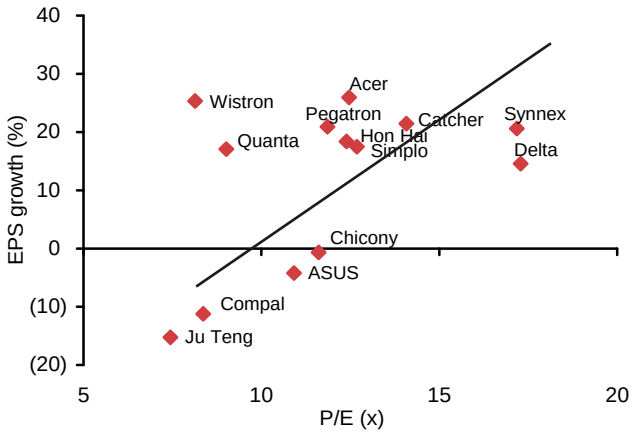
**Prefer PC OEMs over NB ODMs; we are Bearish on the NB component sector. We prefer Simplo**

For 2011, we prefer PC OEMs to NB ODMs and hold a cautious view on component makers. We believe Asian PC OEMs are well positioned to outgrow their peers on rising market share in China and other emerging markets. In addition, easing pressure from component cost hikes should help improve margins. We prefer Acer and Asustek to Lenovo in the Asian PC OEM space. Although we are positive on Lenovo's market-share gains in China, we think market expectations on Lenovo's margin recovery are too high and most of the positives are in the price based on high valuations. While we are positive on China PC/handset shipment growth, we prefer Synnex to Lenovo given its widening product portfolio and channel coverage. Moreover, we expect Synnex to enjoy operating margin expansion on product mix adjustments and operating leverage.

In the NB ODM space, although we are relatively conservative (more so than we are on PC OEMs), until we see signs of consolidation, we believe margin erosion will be milder in 2011F than in 2010. NB ODMs have turned less aggressive on price competition after suffering from severe margin erosion over the past five quarters. Valuations have been declining for NB ODMs and QFII holdings in NB ODMs have declined by 0-5ppt from the peak in 2010. We are selective on NB ODMs and prefer Quanta and Wistron to Compal and Pegatron given their positive changes in margin structure. In the component space, we like names with additional new growth drivers but generally hold a Bearish view on the component sector for 2011. Simplo is our preferred name in the NB component space.

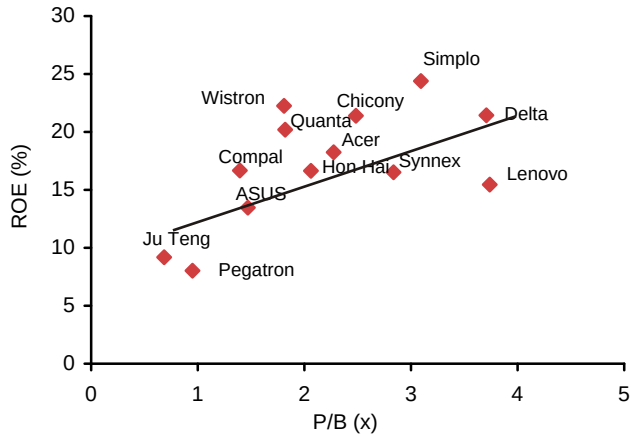
We recommend focusing on names with margin improvements on product/client mix change or increasing sales contribution from new businesses. Although we hold a conservative view on the PC industry, we think most concerns about slowing growth and potential cannibalisation from tablet PC are already in the price, as PC downstream tech names generally have underperformed the TAIEX from 2Q10. Of our six BUY-rated stocks, we prefer Acer most, followed by Asustek, Quanta, Wistron, Synnex and Simplo. We have a Bearish view on components and have REDUCEs on Catcher, Ju Teng, and Chicony.

**Exhibit 49. P/E vs. EPS growth (FY11F)**




Source: Bloomberg; Nomura estimates

**Exhibit 50. P/B vs. ROE (FY11F)**




Source: Bloomberg; Nomura estimates

## Key Risks

**Macro still the biggest risk, which could impact both consumer and corporate demand**

For the PC hardware sector, we think the biggest investment risk could still come from changes in the macroeconomic environment. As the procurement decision for PCs and consumer electronics still depends highly on buyers' budgets, if global economic growth softens again in 2011/2012, we believe PC shipment growth will be negatively impacted. We also think China demand should be a swing factor for PC shipment growth in 2011 and 2012 given its rising importance. The China PC market has been delivering strong shipment growth in the past few years. If demand from China in

2011/2012 is weaker than we expect, PC OEMs with high exposure to China (eg, Lenovo) could see a greater impact on earnings growth.

On the cost front, we expect renminbi appreciation and labour-cost hikes to have a negative impact on NB ODMs' and component makers' cost structures as China has become the largest site for PC production. While we expect softening component prices, we cannot completely exclude the risk of supply-chain disruption in 2011, which could impact PC shipments. Shortening production lead times and output cuts by component makers (to retain stable pricing) could lead to PC production bottlenecks.

Sector Summaries

# Handset Sector

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## 2011 outlook — smartphones continue to rock

**We forecast smartphones will continue to show resilient growth of 42% in 2011F in terms of units**

We expect the global handset market to grow 11% to 1,769mn units in 2011F and 10% to 1,943mn in 2012F, from 1,595mn in 2010F. The trend in 2011F will largely follow the 2010 pattern, in our view. We estimate that smartphones will grow 42% to 415mn units in 2011F, with the penetration rate rising to 23.4% from 18.3% in 2010F. We forecast that smartphone revenue will exceed 50% of industry revenue in 2011F (from 44% in 2010F), driven by North America and Western Europe, and that mid-range smartphones (driven by Asia Pacific) are likely to take off to sustain smartphone growth beyond 2011F. By smartphone OS, we expect Android and iOS to deliver 89% and 57% volume growth, respectively, in 2011F. On our estimates, the Android market share will rise from 21% in 2010F to 28% in 2011F, while iOS will increase from 16% in 2010F to 18% in 2011F.

As higher-end smartphones, which so far are the best-selling products, usually compete on component specs as a marketing tools, higher-end component makers will continue to gain share in 1H11F, in our view. Into later-2011F, we expect an increasing shift to mid-range smartphones. At that time, we believe component makers' cost-reduction capability will be as important as their technology leadership. Higher-end Taiwan/China component makers, in our view, are well-positioned. Touch panel is obviously the largest beneficiary of the smartphone boom, given it is now the preferred user interface. Higher-end HDI PCB makers should benefit, as the increased complexity of smartphone functions will require higher-end HDI PCBs (eg, anylayer) and the higher technology barrier will likely keep the supply tight in 2011F.

## Investment Strategy

With smartphones likely to remain popular in 2011F, we think the growth trend bodes well for handset companies with higher exposure to smartphones. HTC, TPK, and Unimicron are our top picks in the Taiwan handset sector.

We like HTC and maintain our price target of NT$1,000, as we expect further share-price upside driven by expected market-share gains on its leading technology in hardware and software, as well as on rising brand awareness. We believe the company is well-positioned within the industry to benefit from the trend of device convergence. We like its strategy to keep strengthening the "sense experience", which in our view will prove to be an important differentiator as the market matures in 2012F.

TPK and Unimicron are our key BUYs in the Taiwan handset component universe. We have a price target of NT$820 for TPK and we expect it to continue to see strong Apple demand from new product launches, strong sales- and earnings-growth momentum, and market share gain. With timely expansion and a better yield rate, we like TPK the most in the touch panel industry. Unimicron is one of the biggest smartphone beneficiaries in the PCB industry, in our view, given its leading technology in high-end HDI PCBs, mass HDI capacity, and deep penetration into core smartphone vendors such as Apple and Nokia.

## Valuation methodologies and investment risks

### HTC

Our target price of NT$1,000 is based on 14x 2011F EPS and our target P/E of 14x is in line with the current global peer average P/E. Key risks include: 1) technology evolution slowdown; 2) weak acceptance in the mid- to low-end smartphone market; and 3) too-high expectations for smartphones.

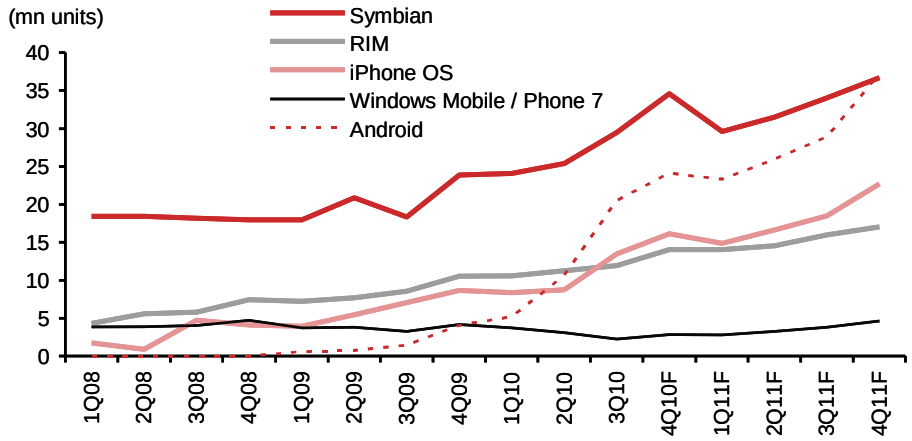
### TPK

Our price target of NT$820 is based on 18x 2011F EPS. We think that TPK deserves a valuation premium (vs its peer-group average of 13x for FY11F), due to TPK's leading position in the fast-growing P-CAP touch panel industry, solid relationship with smartphone leaders (Apple and HTC), and limited free float. Key risks for TPK are: 1) smaller-than-expected sales volumes of Apple's iPhone and iPad; 2) worse-than-expected market share at key customers; 3) oversupply risk; and 4) worse-than-expected yield in new products and TFT-LCD lamination might harm margins.

### Unimicron

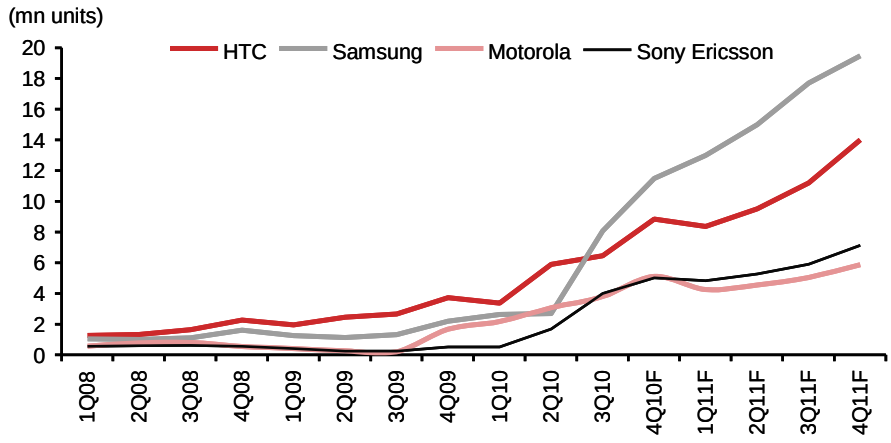
Our target price of NT$64 is based on 12x FY11F EPS. Key risks to our investment view include: 1) worse-than-expected demand for handsets and IC substrates; 2) unexpected market-share loss in handset PCBs, NB PCBs and IC substrates, and; 3) lower-than-expected margins (eg, owing to changes in product mix, utilisation rate, FX and rising raw-material prices).

**Exhibit 51. Android poised to overtake Symbian in 4QFY11F**



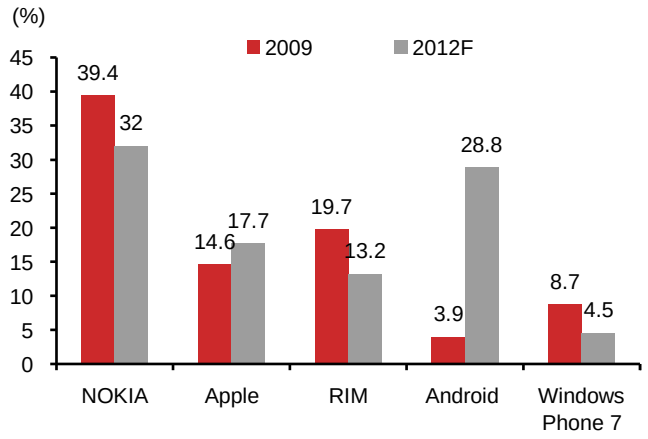

Source: Gartner Group. Nomura International

**Exhibit 52. Samsung and HTC seen leading the Android charge**



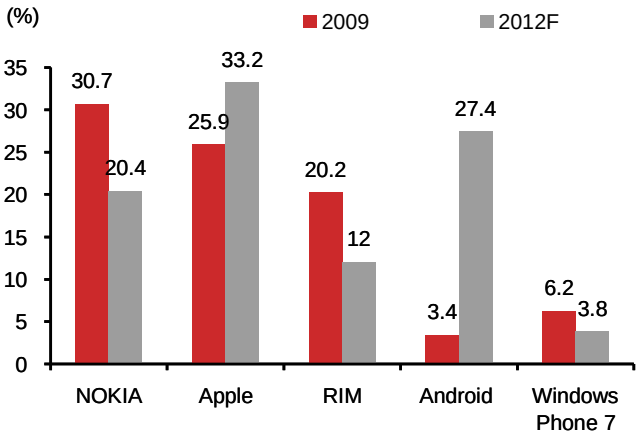

Source: Gartner Group. Nomura International

### Exhibit 53. Smartphone unit share 2009/2012



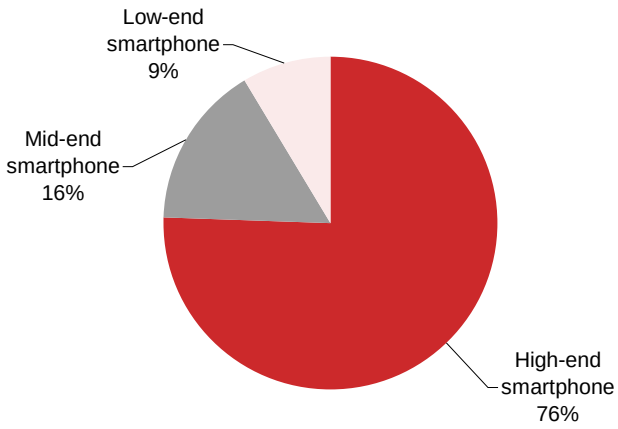

Source: Gartner Group. Nomura International

### Exhibit 54. Smartphone revenue share 2009/2012



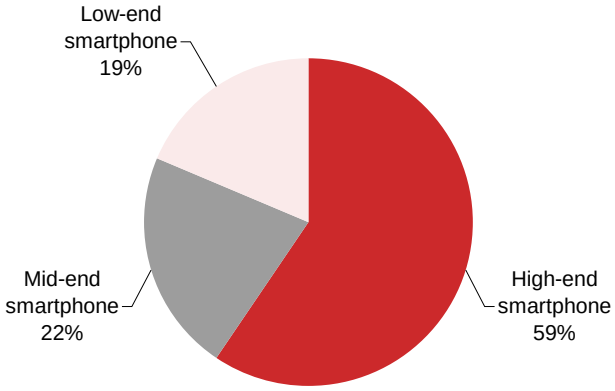

Source: Gartner Group. Nomura International

### Exhibit 55. HTC: Smartphone shipment mix (FY10F)




Source: Nomura estimates

### Exhibit 56. HTC: Smartphone shipment mix (FY12F)




Source: Nomura estimates

Sector Summaries

# Cement Sector

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## 2011 outlook — inexpensive valuations, possible re-rating

Both Taiwan Cement and Asia Cement have underperformed the TAIEX in the past three months by 1.3-5.4% due to concern over domestic overcapacity and demand slowdown in China. However, the Taiwan government has started to tackle the overcapacity issues. Furthermore, cement prices in South China (Taiwan Cement's major market in China) have actually beaten market expectations, and cement prices in Sichuan (30% of Asia Cement's shipment in China) are already in a trough after dropping 28% from January to October 2010. We believe now is good time to revisit the cement sector, given inexpensive valuations and the possibility of a re-rating with better-than-expected performance in the Chinese market.

## Capacity reduction in Taiwan

**Capacity reductions likely to improve domestic supply-demand balance in 2011F**

During our recent visit to Taiwan Cement, the company confirmed that the Ministry of Economic Affairs (MoEA) (Taiwan) aims to reduce cement exports from Taiwan to 30% of output by 2015 (from 50% currently) in order to reduce overall energy consumption and CO2 emissions in Taiwan. The policy is expected to be finalised by 2010.

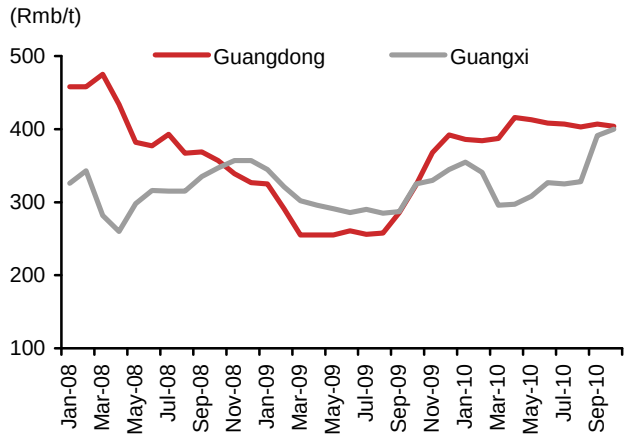
To reach the 30% target, we believe the following will be needed: 1) closure of 2mtpa of cement capacity in Taiwan; 2) replacement of cement imports by domestic production (imports are about 10-20% of domestic consumption); and 3) increased domestic cement consumption in Taiwan. In our view, option 1 seems likely once the policy becomes effective. Taiwan Cement has already closed 1mtpa of cement capacity, so there should be no more capacity loss after 2015. Asia Cement has closed 0.7mtpa of capacity so far. The remaining 0.3mtpa capacity shutdown is expected to come from other producers such as Universal Cement, Southeast Cement, and Hsin Hsin Cement. We believe this capacity reduction will help improve the overall supply-demand balance in Taiwan.

## Better-than-expected prospects for cement market in China

In South China, where Taiwan Cement's capacities in China are predominantly located, cement prices rose 23% y-y and 2% m-m to RMB434/t in October as a result of a strong push from the property and infrastructure sectors, fuelled by power rationing in Guangxi. In Guangdong, cement prices rose 25% y-y in October to RMB404/t while in Guangxi, prices gained 23% y-y in October. According to Digital Cement, Guangdong had a net cement supply shortage of more than 20mtpa as of 2009 and it could take some time for the supply to catch up given China's strict controls on capacity expansions. Moreover, Guangdong has a rational cement market because the top seven local cement producers (including Anhui Conch, Taiwan Cement and CR Cement) command over 70% of the market and thus could collaborate on cement prices. As such, we believe cement prices in South China are likely to remain strong in 2011F.

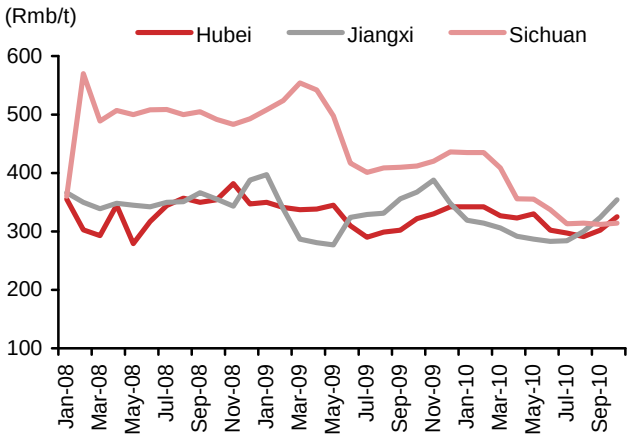
In Sichuan, while there are still no clear signs of a price recovery, we believe cement prices have bottomed after dropping 28% from January to October 2010. We believe the Sichuan government's efforts to control supply (phasing out old capacity and pushing for consolidation) should improve the supply-demand balance in the Sichuan cement market. According to Digital Cement, Sichuan will eliminate all of its outdated cement capacity by 2012. We note that cement prices tend to trend up with improved structural supply.

**Exhibit 57. Cement prices in Taiwan Cement's major China markets**




Source: China Cement Net, Nomura Research

**Exhibit 58. Cement price in Asia Cement's major China markets**




Source: China Cement Net, Nomura Research

## Rapid capacity expansion in China

**Both Taiwan Cement and Asia Cement rolled out aggressive capital-raising plan recently**

Encouraged by the bright outlook for the China cement market, both Taiwan Cement and Asia Cement have carried out very rapid expansions in capacity in China in recent years. Taiwan Cement currently has 42.4mtpa of cement capacity in China and it aims to reach 48.4mtpa by 2011 (14% y-y) and 50mtpa by 2012 (3% y-y). To meet the very aggressive target, Taiwan Cement has issued 400mn shares to raise roughly NT$10bn for capacity expansion, according to a company announcement.

Asia Cement currently has 12.7mtpa of clinker capacity (around 17mtpa of cement capacity) in China. The company plans to boost its China capacity to 20mtpa) (26mtpa of cement capacity) by 2014F via organic expansion while looking actively for potential acquisition targets, according to the company. Asia Cement recently announced to join hands with Shanshui Cement, one of the top seven cement producers in China, to establish JVs in lucrative Liaoning and Inner Mongolia markets, among some other potential cooperation. Please refer to our note, *MOU between Asia Cement and Shanshui to strengthen market position* on Nov. 21 for further details. Following Taiwan Cement's example, Asia Cement has raised a total of US$600mn in capital for potential expansion by issuing convertible and exchangeable bonds, according to a company announcement.

## Remaining Bullish on the Taiwan Cement sector

We remain Bullish on Taiwan's cement sector due to its improved domestic supply structure from capacity reductions and strong contributions from China operations.

**Taiwan Cement.** We reiterate our BUY call on Taiwan Cement, with a price target of NT$40.8. We continue to value the stock on sum-of-the-parts net asset value (NAV) and apply the same target multiple of 7.7x EV/EBITDA, but we roll over to our FY11F forecasts.

**Risks to our rating and price target** include: 1) lower-than-expected China GDP and FAI growth; 2) any sharp change in raw material prices; and 3) execution risks.

**Asia Cement.** We also have a BUY rating on Asia Cement with a price target of NT$36.2 based on NAV. Recent weakness in the share price has fully discounted all the negatives (softening cement prices in Taiwan and Sichuan), in our view. While there are no near-term catalysts in sight, we believe value has emerged for long-term investors.

**Risks to our investment view** include: the complicated cross-holding structure, any delay in new capacity ramp-up or cement price recovery, the company's exposure to bulk shipping cyclicality, and higher- or lower-than-assumed coal prices.

Sector Summaries

# Chemical Sector

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## 2011 Outlook

We believe Asian refining margins are poised for another year of modest gains in 2011F on slowing capacity additions and a tightening diesel balance. We forecast Singapore complex margins of US$4.2/bbl and US$5/bbl for 2010F and 2011F, respectively.

We are more bullish on the outlook for the chemical sector, and believe the sector is poised to enter a Golden Age, benefiting from rising consumption growth in China, brought about by favourable government policies, structural factors and the 12th Fifth-Year Plan. In terms of supply, we believe we are close to passing the peak of new cracker start-ups, while capacity growth is set to slow for major mid- and down-stream products.

**Exhibit 59. Key refining and chemical margin assumptions**

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010F | 2011F | 2012F |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Refining margin (US$/bbl)** | | | | | | | | | | | | |
| Sg complex | 2.1 | 1.6 | 3.4 | 6.7 | 6.9 | 5.5 | 7.6 | 6.2 | 3.7 | 4.2 | 5.0 | 4.4 |
| **Chemical margin (US$/t)** | | | | | | | | | | | | |
| Ethylene-Naphtha | 242 | 177 | 186 | 512 | 419 | 554 | 452 | 346 | 287 | 380 | 360 | 420 |
| HDPE-Naphtha | 368 | 285 | 325 | 555 | 535 | 629 | 603 | 582 | 521 | 440 | 410 | 540 |
| Propylene-Naphtha | 201 | 219 | 279 | 434 | 456 | 518 | 392 | 371 | 343 | 460 | 400 | 460 |
| PP-Naphtha | 319 | 331 | 414 | 570 | 568 | 641 | 616 | 593 | 481 | 520 | 480 | 580 |
| AN-Propylene | 259 | 179 | 294 | 301 | 401 | 405 | 670 | 633 | 336 | 880 | 840 | 900 |
| SM-Naphtha | 291 | 377 | 415 | 660 | 646 | 610 | 578 | 469 | 396 | 460 | 520 | 600 |
| ABS-Naphtha | 645 | 563 | 644 | 903 | 922 | 946 | 1,002 | 1,014 | 796 | 1,100 | 1,150 | 1,080 |
| Phenol-Naphtha | 310 | 332 | 409 | 752 | 559 | 597 | 869 | 558 | 300 | 800 | 750 | 780 |
| PVC-Ethylene | 274 | 338 | 382 | 432 | 362 | 246 | 360 | 428 | 355 | 400 | 440 | 430 |
| MEG-Ethylene | 174 | 176 | 374 | 380 | 318 | 169 | 421 | 252 | 125 | 160 | 260 | 300 |
| PX-Naphtha | 228 | 186 | 336 | 431 | 419 | 577 | 440 | 340 | 432 | 300 | 350 | 400 |
| PTA - Naphtha | 247 | 252 | 293 | 388 | 325 | 317 | 182 | 55 | 275 | 230 | 270 | 250 |

Source: Reuters, Thomson Reuters Datastream, Nomura estimates

## Investment Strategy

We are Bullish on the three Formosa parent companies – Formosa Plastics (FPC), Formosa Chemicals (FCFC) and Nan Ya Plastics (NYP) – on expectations of improving chemical margins in the next two years.

Our top pick in the group is FCFC due to the recent strength in PTA margins (currently US$375/t vs US$230/t at end-Sep 10), which we believe introduces upside risks to our FY10F net profit estimates. We believe the outlook remains bright for PTA due to strong polyester demand and limited expansions next year. We also forecast other products such as phenol and ABS will remain strong. FCFC also offers the highest FY10F dividend yield in the group of 7.7%, on our estimates.

We also like FPC, which has benefited from a strong expansion in specialty chemical (MMA, ECH, Acrylic) margins this year. For 2011F, we believe FPC's margins are likely to benefit from relatively benign olefin feedstock prices, while we expect prices of end-products such as PVC to rise from continued strong demand, although supply could be crimped due to a greater emphasis on environmental protection in China. FPC's previous historical peak forward P/BV multiple was 2.6x, vs the current level of 2.2x (FY11F).

We have a BUY rating on NYP, as we expect MEG margins to improve while CCL contributions should remain steady due to the ongoing glass fibre shortage. We believe NYP's share price performance may have lagged FPC and FCFC over the past three months due to concerns over a weakening operational outlook at Nanya Tech and Nanya PCB.

We like Formosa Petrochemicals (FPCC) for its high complexity and consistent record of generating above-industry returns, but rate it as NEUTRAL mainly due to its rich valuations (3.3x FY11F P/BV) while its dividend yield is inferior to its three parent companies. We will revisit our investment case later in 2011 when repairs to the damaged RDS unit are expected to be completed and olefin supply/demand tightens further.

**Exhibit 60. Formosa group valuation comparison**

| | | | Mkt cap | Sh price | PT | P/E (x) | | P/BV (x) | | ROE (x) | | Div. yld (%) | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Bbg | Rating | (US$mn) | (NT$) | (NT$) | 10F | 11F | 10F | 11F | 10F | 11F | 10F | 11F |
| Formosa Petro | 6505 TT | Neutral | 26,661 | 98.9 | 80.0 | 27.4 | 21.1 | 4.1 | 3.9 | 14.8 | 18.7 | 3.9 | 5.1 |
| Nan Ya Plastics | 1303 TT | Buy | 18,030 | 72.7 | 84.0 | 13.4 | 12.4 | 2.0 | 2.0 | 16.1 | 16.2 | 7.1 | 7.6 |
| Formosa Plastics | 1301 TT | Buy | 18,197 | 97.5 | 106.0 | 13.9 | 12.8 | 2.5 | 2.4 | 18.5 | 19.1 | 6.9 | 7.5 |
| Formosa Chems | 1326 TT | Buy | 16,749 | 98.2 | 106.0 | 12.9 | 11.9 | 2.3 | 2.2 | 18.3 | 19.0 | 7.7 | 8.3 |
| | | | | | Average | 16.3 | 14.5 | 2.7 | 2.6 | 16.5 | 18.0 | 6.0 | 6.7 |

Prices as of 3 January 2011. Source: Bloomberg, Nomura estimates

## Key Risks

**Volatile crude prices**. A sharp decline in crude prices is likely to have a negative impact on FPCC's refining margins as it could lead to significant inventory losses. Conversely, sharply rising crude prices may hurt chemical margins as it may be difficult to pass rising feedstock costs through fully.

**Volatile refining and chemical margins**. Refining and chemical margins tend to be volatile as supply can be uneven due to delays, unplanned shutdowns and severe weather. Demand is subject to seasonality and, to a growing extent, Chinese policies, which are difficult to predict.

## Valuation methodologies and company-specific risks

**Formosa Chemical & Fibre:** Our PT of NT$106 is based on a sum-of-the-parts analysis, which values FCFC's core business at 2.2 EV/IC (average FY10F-12F ROIC of 19.1%; WACC of 8.5%), investments in the Formosa group at our price targets, other listed investments at market prices and unlisted investments at 1.5x book value. Key risks include volatile crude prices, volatile aromatic margins and plant mechanical failure.

**Formosa Petrochemical:** Our PT of NT$80 is based on a 13x p/CF multiple, based on an average FY11-12F OpFCF and WACC of 7.6%. Upside risks to our PT include stronger-than-expected refining/olefin margins and crude prices. Downside risks include plant mechanical failure or weaker-than-expected refining/olefin margins.

**Formosa Plastics:** Our price target of NT$106 is based on sum-of-the-parts analysis, which values FPC's core business at 3.5x EV/IC (average FY11F-12F ROIC of 29.5%; WACC of 8.5%), investments in the Formosa group at our price targets, other listed investments at market prices and unlisted investments at 1.5x book value. Key risks include volatile crude prices, volatile chemical margins and plant mechanical failure.

**Nan Ya Plastics:** Our PT of NT$84 is based on sum-of-the-parts analysis, which values NYP's core business at 2.2x EV/IC (average FY10F-12F ROIC of 18.9%; WACC of 8.5%), investments in the Formosa group at our price targets, other listed investments at market price and unlisted investments at book value. Key risks include volatile crude prices, volatile chemical margins and plant mechanical failure.

Sector Summaries

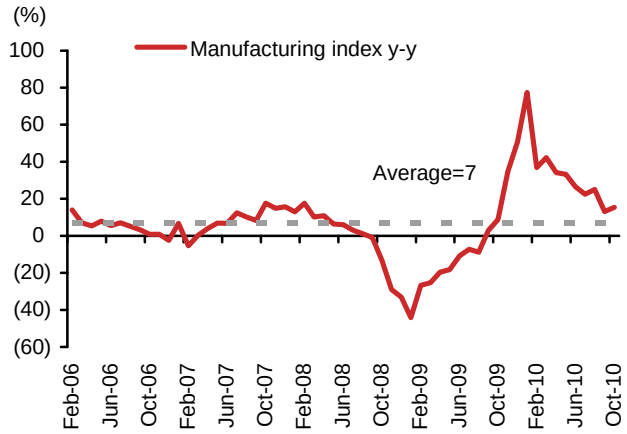
# Steel Sector

**Josephine Ho**
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## Stable domestic market

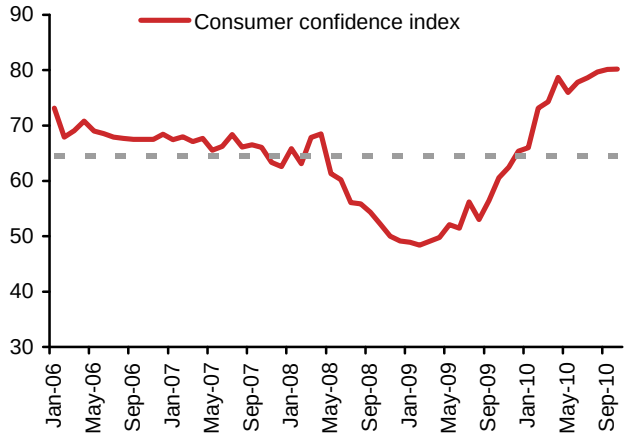
Domestic demand in Taiwan has been relatively stable, according to China Steel. China Steel's gross profit per tonne steel has remained relatively stable at around NT$2,625/t (US$88/t) since 2Q10. The manufacturing index in Taiwan grew 15% y-y to 129.3 in October, higher than the historical average growth rate of 7% y-y (since January 2006), albeit slowing down from its peak of 77% y-y in 1Q10. On the other hand, as an indicator of the overall economy, the consumer confidence index in Taiwan continued its upward trend and rose to 80 in October, the highest level since 2006. As steel demand is closely tied to the overall economy, we believe the healthy macro fundamentals lay a solid foundation for domestic steel consumption for 2011F.

**Exhibit 61. Taiwan manufacturing index y-y**




Source: Wind, Nomura Research

**Exhibit 62. Taiwan consumer confidence index**

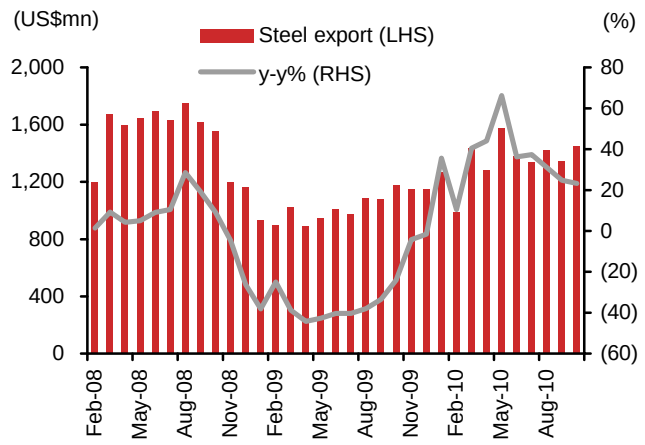



Source: Wind, Nomura Research

## Exports remain strong but growth is slowing down

Steel export remains strong in Taiwan, up 23% y-y and 8% m-m in October to US$1.5bn. However, we note that export growth has been decelerating from its peak of 66% y-y in May 2010 due to the strengthening NT$ against US$. Steel prices varied among markets globally in October. HRC prices were down 3% and 5% m-m in Europe and the US to US$710/t and 631/t, respectively; prices were flat m-m in China at US$638/t ( including 17% VAT), but were up 3% m-m in Japan to US$782/t in October 2010.

**Exhibit 63. Taiwan steel export value**




Source: Wind, Nomura Research

**Exhibit 64. NT$/US$**




Source: Wind, Nomura Research

China Steel exported 1.94mt of steel in 9M10, representing 26% of its total steel shipment. The top three overseas markets in 9M10 were Southeast Asia (31.9% of total export), Hong Kong (China) (27.8%) and Japan (24.7%). We note that the spot HRC price in Japan at US$782/t is still at a premium to China Steel's November and December HRC prices at around US$656/t and US$696/t, respectively. However, the average export prices to Southeast Asia is around US$600/t, or 9-13% lower than China Steel's November and December prices due to an increasing influx of steel from neighbouring countries, according to the company.

## Potential benefits from ECFA

According to the Cross-Strait Economic Cooperation Framework Agreement (ECFA), as many as 539 Taiwanese products (including steel) and services placed on the "early harvest" list will enjoy tariff cuts or market access treatment to the China market as early as 2011. We expect Taiwan flat steel producers such as China Steel to benefit from ECFA directly as China is in short supply of high-end flat steel products such as auto sheet and home appliance plate, etc. According to ECFA, China will remove its tariffs (currently 5-10% for steel products from Taiwan) for all Taiwanese goods on the "early harvest" list in three phases over two years, which will enhance the competitiveness of the flat products from Taiwan against those from Korea and Japan, which currently dominate China's flat imports.

## Maintain BUY on China Steel with a PT of NT$37.0

We maintain our BUY rating on China Steel, with a price target of NT$37.0, which is based on a mid-cycle multiple of 1.8x FY11F P/B. We believe China Steel, given its defensive nature and attractive dividend yield of 5.7% on our estimates, will outperform its peers when the steel cycle turns.

Risks include a delay in price recovery, disappointment in supply-demand balance, disposal gains and the impact from Dragon Steel.

Sector Summaries

# Financial Sector

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## Rate normalisation expands margin

**Our base case calls for a rate hike of 50bps each in 2011 and 2012. 30%+ in US$-denominated profits until 2012, on our estimates**

Taiwan's financial sector has underperformed since the TAIEX bottomed in early 2009 (i.e., the tech sector performed the best in 2009, while non-tech and non-financial sectors followed in 2010). In our view, the trading patterns of performance convergence will likely work in 2011 to offer the financial sector a lead in performance. Indeed, our analysis suggests that our coverage universe will deliver a two-year CAGR of 30%+ in US$-denominated profits until 2012F, which stands among the highest across many key sectors, thanks to Taiwan's decoupled rate hike cycle, which not only strengthens NT$ against US$ (ie, headwinds for export-driven techs) but also improves net interest margin (NIM) from historical lows. To date, foreign investors remain largely underweight Taiwan's financial sector, which is still trading at the mid-point of the historical range. Against the US$, we forecast NT$ to appreciate to 28.6 at end-2011F and 27.25 at end-2012F.

We have built in our earnings models a gradual re-discount rate hike of 50bps each in 2011 and 2012. It reflects our view that Taiwan will slowly normalise its rate close to the neutral level, in a bid to reduce property speculation ahead of the elections in 2012. The rising CPI of late could imply upside risks to our rate forecast, thus translating into stronger profit growth. Our sensitivity analysis suggests that a rate hike of 12.5bps would boost the profitability of our coverage universe by 4%+ on an annualised basis. Meantime, our sensitivity analysis suggests that NIM expansion normally peaks in the four to six months after rate hikes. That said, the margin expansion theme will continue to play in the TAIEX until mid-2013, in our view.

## Low provision cycle

**Provisioning costs will likely remain low to account for 38bps of loans in 2012F (from 24bps in 2010)**

We note that Taiwan continues to enjoy low provisioning costs at banks, which are forecast by Nomura to rise gradually to 38bps of loan book in 2012 (from 24bps in 2010). Firstly, the legacy problems have been mostly cleaned up, as the sector now has the best asset quality since 2000, with the NPL ratio standing at 0.78% and the coverage ratio of 129%. Meanwhile, multiple phases of de-risking — as prompted by the bursts of various bubbles since early-2000, including tech, cash card, subprime and sovereign debt, etc — have supported loan book quality. Although we see Taiwan's property market as a bubble in the making, we think it remains premature to worry about the quality of mortgage loans because both rate normalisation and austerity measures (if any) will likely be very gradual to induce an election-friendly soft-landing scenario. Lastly, we also expect a total loan-loss recovery of NT$37bn for the next three years (from the write-offs of unsecured consumer loans since 2005), which should help reduce the provisioning charges below the normalised level.

## Cross-Strait liberalisation accelerates ahead of 2012 elections

**Cross-Strait (post-ECFA) liberalisation appear to concentrate on the trades of services where financials are key beneficiaries**

Liberalisation of the financial sector across the Strait has finally started its first and the most difficult step, following the signature of the regulatory MOU and the ECFA (Economic Cooperation Framework Agreement). Despite this, significant room for improvement remains through further elimination of operational restrictions and reduced criteria for entry to the banking, securities, and life insurance industries. Through near-term catalysts such as the sixth cross-Strait trade talks and the establishment of Economic Cooperation Committee, we believe the magnitude of liberalisation will likely accelerate into 2012, as the four-year political cycle of the Presidential and Legislative elections in Taiwan will arrive in early-2012. That said, we expect sentiment to remain constructive on the financial sector throughout 2011, which we think may help key beneficiaries overshoot their fundamental value.

## Consolidation has accelerated

**Consolidation has accelerated in the life insurance and brokerage businesses**

The fact that Taiwan has failed to accelerate industry consolidation in the past decade has been one of major reasons behind investors' decision to underweight Taiwan, in our view. Despite low market expectations, we have begun to see increasing frequency of M&A deals in life insurance and securities industries, driven by the raising of capital requirements in preparation for entry into the mainland market. We expect this trend to continue in the near term. On the other hand, bank consolidation has stalled for years following the failure of the second financial reforms. Despite this, we remain optimistic as we think the need to establish national champions will become ever clearer, once Taiwan and China allow cross-Strait investments in banks. In our view, one of the more politically-correct strategies would be to establish national champions through the consolidation of state banks.

## Stock selection and Investment Strategy

**Our preference is banks, followed by life insurers and securities companies**

Our preferred exposure within the financial sector is banks, followed by life insurance and lastly securities companies. Firstly, we expect the banks to benefit from stable profit growth on NIM expansion and at the same time, be less affected by the value volatility in the marked-to-market trading portfolio. Secondly, we see cross-Strait liberalisation taking place in the banking sector (more so than the others), driven by mutual economic interests. Lastly, banks face fewer regulatory headwinds than life insurers, in our view; the latter would face increasing pressure to strengthen capitalisation if their insurance liabilities are gradually marked to market value. Within our coverage universe of eight stocks, we prefer Chinatrust, E.Sun, First FHC and Fubon Financial.

Sector Summaries

# Property Sector

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## Positive on developers in FY11

As the KMT party secured a majority win in the mayoral elections in November, the political uncertainties that held back buying interest should cease, in our view. We expect the property market to recover in FY11, backed by an accommodative monetary environment and the government's continued internationalisation efforts. We expect positive policy moves, including internationalisation efforts and normalisation of the cross-Strait relationship, to outweigh government tightening measures.

**We expect the property market to recover in FY11 backed by an accommodative monetary environment and positive government policy**

## Residential property sector

We expect firm residential property prices in Taipei, given the difficulty in land procurement and a relatively low-cost borrowing environment. We see this having a ripple effect on areas surrounding Taipei, given the government's focus on urban development and improving public transportation.

**We expect residential property prices to remain firm**

## Commercial property sector

We also see escalating demand for commercial properties as the government's continued internationalisation (such as a competitive tax system) and normalisation of cross-Strait relationship will likely stimulate foreign investment in Taiwan. We expect increasing Chinese investments in Taiwan from closer integration with China's economy following the Economic Cooperation Framework Agreement.

**We expect escalating demand for commercial properties from the government's internationalisation efforts and normalisation of the cross-Strait relationship**

## Top picks

We like property developers that focus on Taipei, maintain a balanced exposure between residential and commercial properties, and have abundant land bank. On this basis, we maintain our positive view on Farglory and Huaku − both have balanced exposure between residential and commercial properties, and we project an earnings upcycle in FY11F-12F, backed by project launches in FY10-12F.

We look for an FY10-12F earnings CAGR of 21% and FY11F ROE of 23% for Farglory, and a CAGR of 15% and ROE of 30% for Huaku. We maintain NEUTRAL on Hung Poo as we do not expect strong revenue growth until FY12F given delays in project launches.

**BUY Farglory and Huaku, given their balanced exposure between residential and commercial properties and their earnings upcycle in FY11F-12F**

## Key Risks

### Global economic slowdown

Any unexpected slowdown of the global economy would adversely affect the property sector as Taiwan, an export-driven economy, is heavily influenced by global activity.

### Larger-than-expected rate hike

While we expect gradual interest-rate hikes by the central bank by 2011, we expect the overall interest-rate environment to remain accommodative of economic growth. Our calculations suggest limited impact − a 2.38%/4.8% increase in monthly loan instalments with a 25bp/50bp interest-rate hike for a NT$7mn outstanding mortgage. However, any substantial increase in the interest rate should be negative, given that the sector is sensitive to interest rates.

**Macro-factors and the government's restrictive measures are key risks, in our view**

### Worse-than-expected tightening

Property transaction volume declined by 15-23% in 3Q10 on the back of the government's tightening measures and uncertainties over the mayoral elections in November. While we expect the property market to recover gradually in FY11F after the election uncertainties are removed, worse-than-expected tightening measures could cap the property market.

Sector Summaries

# Consumer Sector

**Brandon Chen**
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**We expect solid domestic consumption backed by resilient exports, improving labour market conditions, strong consumer confidence and wealth effects**

We expect domestic consumption to remain solid in 2011 backed by resilient exports growth, improving labour market conditions, strong consumer confidence and wealth effects from high property and equity prices. We forecast 3.9% growth in private consumption in 2011F from 3.7% in 2010F. Further cross-Strait co-operation and integration with China's economy under the Economic Cooperation Framework Agreement (ECFA) should continue to bolster the confidence of corporate bodies and consumers as regards investment or consumption. Specifically, the government's internationalisation efforts (such as a competitive tax system) together with ECFA have attracted the interest of foreign companies to invest in Taiwan, which should in turn increase job opportunities and prove positive for consumption, in our view.

The Directorate-General expects inbound receipts from 1.2mn Chinese tourists to total NT$65.2bn or equivalent to 0.48% of GDP in 2010. For 2011, it expects inbound receipts from 1.3mn Chinese tourists to reach NT$67.7bn or 0.5% of GDP. If the Individual Travel Scheme for Chinese tourists is implemented in 2011, the Directorate-General estimates an additional NT$19.3bn, or 0.15% contribution to GDP. Inbound tourist receipts contribute to domestic consumption through a multiplier effect.

## Our top pick — President Chain Store (PCS)

**PCS places more emphasis on same-store sales**

We remain positive on PCS in 2011 given its continuing expansion of its store sizes, its offering of more products and services in-store, and through its on-line 7net portal. With PCS's 4,734 stores, or near-50% market share in Taiwan, it now places more emphasis on same-store sales than on number of stores.

PCS further leverages its massive network by expanding the size of its stores to enable it to sell more products and services. PCS targets to expand the size of 500 stores in 2011 to offer more F&B and daily necessities. PCS's 7net online portal aims to also increase product SKUs, which were not previously available due to store size constraints. PCS's Shanghai 7-11 operation is entering a fast-expansion phase that we expect to drive the company's mid- to long-term earnings growth.

## Key Risks

**Adverse macro-recovery and raw material price fluctuations are key risks**

### Slower- or weaker-than-expected recovery

The main risk to our view is a weaker or slower-than-expected recovery of the domestic economy, given that Taiwan depends heavily on exports and consumer confidence. PCS's products are largely consumer staples in nature, and so penetration in consumers is high. Thus we expect it can weather the storm if the recovery is much weaker or slower than we expect.

### Adverse raw material price fluctuations

We also think that raw-material price fluctuations may have a negative impact on PSC if it is unable to pass through increased costs to consumers. However, given PCS's bargaining power from its strong network, we believe the company is likely to be able to pass raw material price increases fully or at least partially.

### Slower-than-expected ramp-up of Shanghai CVS operations

Part of our BUY thesis is based on PCS's China CVS operations and, thus, a slower-than-expected ramp-up of its operations would affect its profitability and valuation.

Sector Summaries

# Telecom Service Sector

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## 2011 Outlook

Focus on smartphone and fixed-line broadband competition

Taiwan players offer one of the highest dividend yields within the Asian telecom sector (FY10F median over Asia-ex-Japan telecom universe: 5.4%), but the sustainability of these dividends is an ongoing concern given the shrinking voice-services market. We believe recent trends in smartphone and associated mobile data services will help operators stabilise their mobile voice revenue. On the other hand, after the shift in ownership of two of the largest cable TV operators from a private equity fund to Taiwanese entrepreneurs in 2010, we expect competition in fixed-line broadband service to intensify in 2011, and thus stimulate the development of optical fibre-based broadband service and IPTV service in Taiwan.

**Exhibit 65. Comparison of Taiwan Telecom operator within Asia — 2Q10**

| Country | Population (mn) | GDP per cap (US$) | Mobile Penetration (%) | Mobile Subscribers (mn) | Voice ARPU (US$) | MOU ($) | Data of rev (%) | EBITDA margin (%) |
|---|---|---|---|---|---|---|---|---|
| Australia | 21.3 | 41,982 | 130 | 27.6 | 29.0 | 115 | 35 | 26 |
| New Zealand | 4.3 | 25,354 | 115 | 5.0 | - | 56 | - | 33 |
| Singapore | 5.0 | 34,346 | 137 | 6.8 | 21.8 | 327 | 30 | 37 |
| Hong Kong | 7.1 | 29,559 | 171 | 12.1 | 14.9 | - | 25 | 21 |
| South Korea | 49.4 | 16,450 | 98 | 48.6 | 26.9 | 198 | 19 | 23 |
| Malaysia | 28.3 | 7,469 | 104 | 29.4 | 11.9 | 209 | 26 | 44 |
| **Taiwan** | **22.8** | **15,373** | **117** | **26.6** | **19.8** | **201** | **13** | **39** |
| Thailand | 67.0 | 3,973 | 98 | 65.5 | 5.1 | 254 | 14 | 32 |
| Philippines | 98.0 | 1,721 | 89 | 87.2 | 2.6 | 16 | 50 | - |
| Japan | 127.1 | 39,573 | 92 | 117.3 | 30.7 | 139 | 43 | 34 |

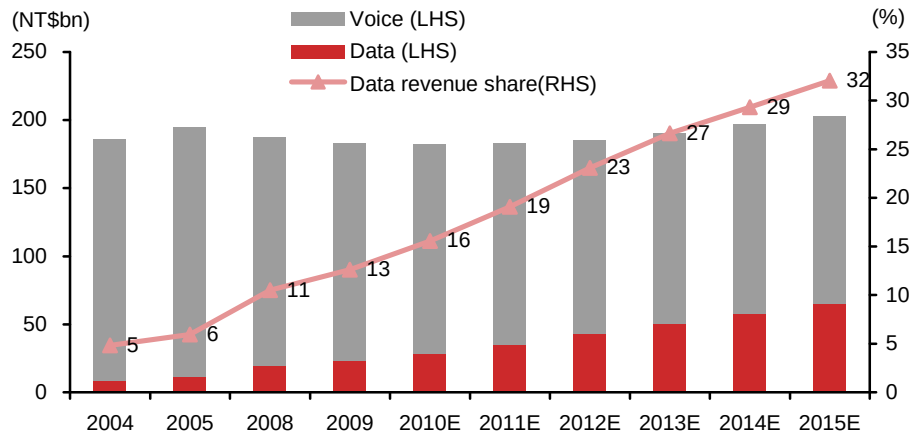
Source: Company data, Nomura Research

## Investment Strategy

We expect healthy growth of mobile data in 2011

Telecom operators experienced significant EBITDA margin erosion in 2010 due to rising subsidies for smartphone/iPhone. For 2011F, we expect the ratio of smartphone shipments to total handset shipments to rise, but total expenses for handset subsidies to be flattish y-y because of launches of mid-range smartphones based on Android OS. As a result, we think Taiwan's telecom sector will continue to enjoy above 20% y-y growth in mobile data revenue, which could help to offset the decline in mobile voice revenue due to the mandatory tariff cut, and to maintain a stable EBITDA margin.

**Exhibit 66. Taiwan Mobile Data Market Forecast**




Source: Nomura Research estimates

**Smartphone competition: from availability to quality**

After Far Eastone (FET) and Taiwan Mobile (TWM) launched their iPhone models in March 2010, competition in the smartphone business has gradually shifted to content and sales channels from the availability of specific models. We expect all FET, TWM and Chunghwa Telecom (CHT) to expand their sales channels by enhancing their partnership with IT product distributors and their own application stores to differentiate themselves.

**Digital convergence to intensify competition in fixed-line broadband**

Regarding the fixed-line broadband service, we expect competition to intensify in 2011F. We expect China Network Systems (CNS) and Kbro, the two major cable-TV operators in Taiwan to accelerate their digital TV and cable broadband developments in 2011 after their ownership change in 2010.

**IPTV service to take off**

In preparation for intensifying competition — after CHT has migrated its customer base from ADSL to FTTx, which has higher bandwidth — CHT plans to improve its FTTx coverage and provide attractive IPTV (Multimedia on Demand, MOD) content. This should help the company to alleviate the impact of tariff cuts because only ADSL tariffs are regulated under the tariff-cut scheme.

**Limited possibility for capital management in 2011, in our view**

CHT and TWM have already announced capital management plans to be executed in 2011, while FET is pending any capital management action since its request for approval to place new share to China Mobile is still pending. As a result, we do not expect any new capital management actions in 2011.

## Key Risks

**We see limited regulatory risk ahead**

Since most of the tariff reduction scheme has been introduced, we expect limited regulatory risks in the telecom sector in 2011. On the voice front, Taiwanese operators enjoy a much higher APRU and profit margin than peers in other Asian countries, given Taiwan's stable regulatory and moderately competitive environment. After the regulator's recent decision on mobile tariff cuts, we expect very little regulatory uncertainty in the voice segment over the next three years. This favourable regulatory environment, in our view, bodes well for market leader CHT.

**Exhibit 67. Telecom service tariff regulation framework**

| | Applicable services | Action | Effective Period of Time | Notes |
|---|---|---|---|---|
| Voice | Off-net mobile | -5%-ΔCPI y-y tariff cut on retail price | 2010/04/01 -- 2013/3/31 | |
| | On net mobile | no tariff control | | |
| | Mobile-fixed call | -5%-ΔCPI y-y tariff cut on retail price | 2010/04/01 -- 2013/3/31 | |
| | Fixed-to-mobile call | Return pricing right to caller side | From 2011/01/01 | Benefit CHT in long term |
| | Interconnection fee | Under discussion | | Regulate wholesale rate instead of retail price in the long term |
| Data | Domestic SMS | -5%-ΔCPI y-y tariff cut on retail price | 2010/04/01 -- 2013/3/31 | |
| | Other Data | no tariff control | | The growth area that the regulator will protect/promote in the future |

Source: NCC, Nomura

**Positive surprise 1: cross-Strait cooperation**

Because of the sensitive nature of the telecom business, we and the market do not expect significant progress in cross-Strait cooperation between Chinese and Taiwanese operators. If FET's application to place new shares to Chinas Mobile is approved, it would be a big positive surprise for FET and the whole telecom sector, in our view.

**Positive surprise 2: market focus on landbank story**

CHT has emphasised many times that its property business will focus on generating more rental revenue from renewal of properties used to install telecom equipment. However, recent rallies in Taipei property prices could attract investors' attention on the non-cash gain on revaluation of CHT's property, especially considering that CHT may need to disclose such information from 2012 due to the adoption of IFIS in Taiwan.

Sector Summaries

# Airlines Sector

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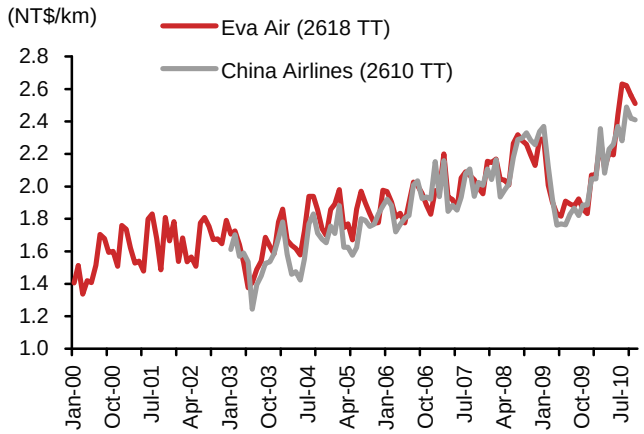
## 2011 Outlook

**Earnings likely to see record high in 2010F, and likely to improve further in 2011F**

We expect Eva Airways to post record-high earnings in 2010F. We also expect its reported earnings to see year-on-year growth into 2011. With the confirmation of cargo traffic rebound in October 2010, we believe the cargo outlook in 2011 may improve, while we are more positive on passenger traffic in 2011 on: 1) possible increase in the number of direct flights; 2) confirmation of increase in the daily quota of mainland China tourists; 3) possible liberalisation of the individual visit scheme; 4) possible benefits from the Flora Expo Taipei (6 November 2010 to 25 April 2011), although we estimate that the impact will be limited; and 5) possible benefits from the Europe visa exemption.

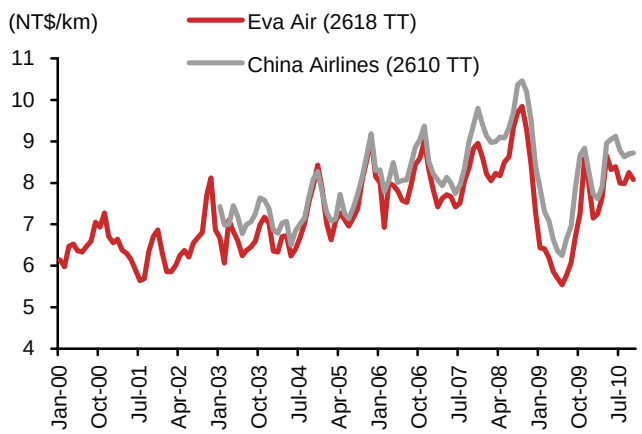
Overall, we are looking for both high single-digit percentage growth for cargo and passenger traffic, while we are looking 1% real passenger yield growth in 2011F and flat real yield growth for cargo during the same period.

**Exhibit 68. Taiwanese airlines passenger yield trend**




Source: Company data

**Exhibit 69. Taiwanese airlines cargo yield trend**




Source: Company data

## Investment Strategy

**More positive news from direct links may come through in 2011**

With October 2010 air cargo revenues rebounding, we believe concerns about this may temporarily ease and, following the China-Taiwan direct link talks in December 2010, this may provide additional catalysts in the possible increase in direct air flights and liberalisation of individual China tourist visits. Earnings may continue to see improvement in 2011 on continued firm operating numbers and continued benefits from direct links, in our view.

## Key Risks

One of the risks to our Buy call may come from a possible further slowdown in the economies of US and Europe, from which Eva Airways derived 50% and 15% of its 2009 traffic revenue. Other main risks to our price target for Eva would be if passenger / cargo throughput growth, passenger / cargo yield growth and/or oil prices differ substantially from our estimates, and a possible delay in the implementation of direct air links between Taiwan and the mainland. Currency movements play a significant part in an airline's profitability and, hence, currency-exchange rates that differ significantly from our macro assumptions are also risks.

# Stock picks

# HTC Corporation 2498 TT

TECHNOLOGY/HANDSETS | TAIWAN

Maintained

BUY

NOMURA
NOMURA INTERNATIONAL (HK) LIMITED
TAIPEI BRANCH

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**Peter Liao** +886 2 2176 9964 peter.liao@nomura.com

## Action

We maintain our BUY rating on HTC, given our view that further upside remains, driven by expected market share gains on its leading technology in hardware and software, as well as on rising brand awareness. We believe the company is well-positioned within its industry to benefit from the trend of device convergence. We like its strategy to continue enhancing the "Sense experience", which in our view will prove to be an important differentiator as the market matures in 2012F.

## Catalysts

Rollout of more high-end innovative products in 1H11F, market share upside and further upward revisions to consensus earnings estimates.

## Anchor themes

Device convergence is a prominent and long-term trend, in our view. We favour companies with proven knowledge in both hardware and software design for advanced mobile devices.

| | |
|---|---|
| Closing price on 3 Jan | NT$921 |
| Price target* | **NT$1,000** |
| | (from NT$893) |
| Upside/downside | 8.6% |
| Difference from consensus | **16.3%** |
| FY11F net profit (NT$mn) | 57,943 |
| Difference from consensus | **11.2%** |

* Price target under review

Source: Nomura

## Nomura vs consensus

Our FY11F EPS estimates are higher than consensus; however, we are relatively cautious on FY12F earnings growth.

# Right trend, right strategy

### ① BUY reaffirmed; price target of NT$1,000

Nomura's global handset team has identified key trends for the smartphone market in FY11: 1) we expect smartphone revenues to exceed 50% of handset industry revenue in 2011; 2) driven by Samsung and HTC, we expect Android to overtake Symbian as the leading smartphone platform from 4Q11 onward; and 3) given high smartphone penetration in North America and Western Europe (over 50% and 40% respectively by 2011, according to Nomura estimates), sustaining growth will likely increasingly rely on APAC from 2H11.

### ② Right trend – converging devices

From a top-down perspective, we believe HTC is well-positioned for the trend of device convergence, in which smartphones and, going forward, tablets, will likely grow at the expense of traditional PCs. In our opinion, handset companies have an advantage over PC companies to ride this trend, as tablets are more like a product extension from smartphones. Thus, we believe companies familiar with ARM architecture and Android OS, such as HTC, should benefit.

### ③ Right strategy – building "Sense experience" to differentiate itself even in mid to low end

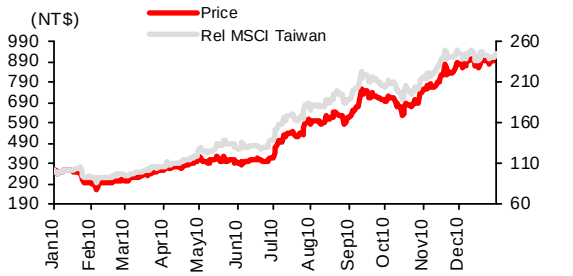
HTC's main challenge, in our view, lies in replicating its niche and high-end smartphone success in the mass and mid- to low-end segment from FY12F onward. Our structural thesis is that the low-end Android phone market will be highly competitive, since Google has reduced the entry barriers for making an Android phone with each OS upgrade. We believe HTC is aware of this risk and will leverage its "Sense experience" (Sense UI + Sense.com) into low-end models to differentiate itself — the right approach, in our view.

**Key financials & valuations**

| 31 Dec (NT$mn) | FY09 | FY10F | FY11F | FY12F |
|---|---|---|---|---|
| Revenue | 144,881 | 272,697 | 445,779 | 523,162 |
| Reported net profit | 22,583 | 38,336 | 57,943 | 62,263 |
| Normalised net profit | 22,583 | 38,336 | 57,943 | 62,263 |
| Normalised EPS (NT$) | 28.7 | 47.9 | 70.9 | 76.1 |
| Norm. EPS growth (%) | (24.4) | 67.2 | 47.8 | 7.5 |
| Norm. P/E (x) | 32.1 | 19.2 | 13.0 | 12.1 |
| EV/EBITDA (x) | 27.0 | 15.7 | 10.2 | 9.2 |
| Price/book (x) | 11.1 | 9.6 | 7.3 | 6.3 |
| Dividend yield (%) | 2.6 | 4.2 | 6.0 | 6.3 |
| ROE (%) | 35.8 | 53.4 | 63.8 | 56.0 |
| Net debt/equity (%) | net cash | net cash | net cash | net cash |
| **Earnings revisions** | | | | |
| Previous norm. net profit | | 38,336 | 57,943 | 62,263 |
| Change from previous (%) | | - | - | - |
| Previous norm. EPS (NT$) | | 47.9 | 70.9 | 76.1 |

Source: Company, Nomura estimates

**Share price relative to MSCI Taiwan**



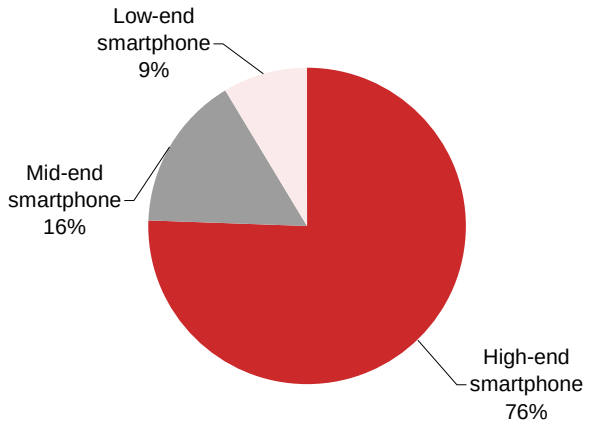

| | 1m | 3m | 6m |
|---|---|---|---|
| Absolute (NT$) | 4.3 | 30.3 | 119.3 |
| Absolute (US$) | 8.6 | 38.7 | 142.9 |
| Relative to Index | 0.5 | 22.0 | 106.0 |
| Market cap (US$mn) | | | 25,867 |
| Estimated free float (%) | | | 75.0 |
| 52-week range (NT$) | | | 921/264.8 |
| 3-mth avg daily turnover (US$mn) | | | 152.7 |
| Stock borrowability | | | Hard |
| Major shareholders (%) | | | |
| Capital World | | | 7.9 |
| Fidelity | | | 6.1 |

Source: Company, Nomura estimates

## Valuation and Risks to our view

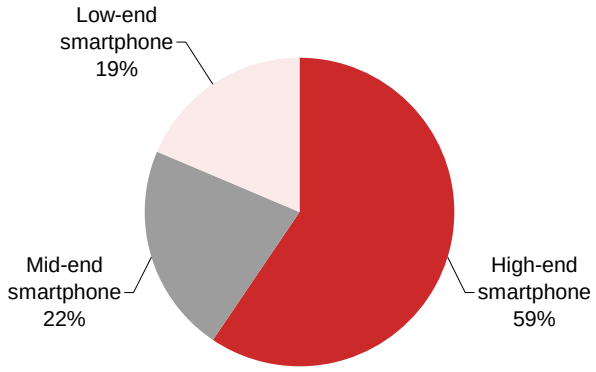
Our target price of NT$1000 (under review with an upward bias) is based on 14x 2011 EPS forecast and the target P/E of 14x is in line with the current global peer average P/E. Key risks include 1) technology evolution slowdown; 2) weak acceptance in the mid- to low-end smartphone market; and 3) too-high expectations for smartphones

**Exhibit 70. HTC: smartphone shipment mix (FY10F)**




Source: Nomura estimates

**Exhibit 71. HTC: smartphone shipment mix (FY12F)**




Source: Nomura estimates

# Financial statements

| Income statement (NT$mn) | | | | | |
|---|---|---|---|---|---|
| **Year-end 31 Dec** | **FY08** | **FY09** | **FY10F** | **FY11F** | **FY12F** |
| **Revenue** | 152,559 | 144,881 | 272,697 | 445,779 | 523,162 |
| Cost of goods sold | (101,917) | (99,018) | (192,633) | (315,219) | (374,504) |
| **Gross profit** | **50,642** | **45,862** | **80,064** | **130,560** | **148,657** |
| SG&A | (13,699) | (16,402) | (29,158) | (53,254) | (63,847) |
| Employee share expense | (6,727) | (5,312) | (9,006) | (13,613) | (14,627) |
| **Operating profit** | **30,215** | **24,149** | **41,900** | **63,693** | **70,183** |
| | | | | | |
| **EBITDA** | **30,820** | **24,823** | **42,552** | **64,356** | **70,872** |
| Depreciation | (568) | (634) | (600) | (613) | (638) |
| Amortisation | (36) | (40) | (53) | (50) | (51) |
| **EBIT** | **30,215** | **24,149** | **41,900** | **63,693** | **70,183** |
| Net interest expense | 1,368 | 349 | 280 | 290 | 337 |
| Associates & JCEs | 603 | 781 | 1,120 | 1,121 | 1,046 |
| Other income | (637) | (92) | (176) | - | - |
| **Earnings before tax** | **31,549** | **25,187** | **43,124** | **65,104** | **71,567** |
| Income tax | (2,955) | (2,604) | (4,788) | (7,161) | (9,304) |
| **Net profit after tax** | **28,594** | **22,583** | **38,336** | **57,943** | **62,263** |
| Minority interests | - | - | - | - | - |
| Other items | - | - | - | - | - |
| Preferred dividends | - | - | - | - | - |
| **Normalised NPAT** | **28,594** | **22,583** | **38,336** | **57,943** | **62,263** |
| Extraordinary items | - | - | - | - | - |
| **Reported NPAT** | **28,594** | **22,583** | **38,336** | **57,943** | **62,263** |
| Dividends | (20,396) | (18,731) | (31,888) | (44,971) | (47,424) |
| **Transfer to reserves** | **8,199** | **3,852** | **6,447** | **12,972** | **14,839** |
| | | | | | |
| **Valuation and ratio analysis** | | | | | |
| FD normalised P/E (x) | 24.3 | 32.1 | 19.2 | 13.0 | 12.1 |
| FD normalised P/E at price target (x) | 26.4 | 34.9 | 20.9 | 14.1 | 13.1 |
| Reported P/E (x) | 24.3 | 32.1 | 19.2 | 13.0 | 12.1 |
| Dividend yield (%) | 2.9 | 2.6 | 4.2 | 6.0 | 6.3 |
| Price/cashflow (x) | 18.5 | 26.3 | 19.3 | 13.5 | 11.2 |
| Price/book (x) | 11.5 | 11.1 | 9.6 | 7.3 | 6.3 |
| EV/EBITDA (x) | 22.0 | 27.0 | 15.7 | 10.2 | 9.2 |
| EV/EBIT (x) | 22.4 | 27.7 | 15.9 | 10.3 | 9.2 |
| Gross margin (%) | 33.2 | 31.7 | 29.4 | 29.3 | 28.4 |
| EBITDA margin (%) | 20.2 | 17.1 | 15.6 | 14.4 | 13.5 |
| EBIT margin (%) | 19.8 | 16.7 | 15.4 | 14.3 | 13.4 |
| Net margin (%) | 18.7 | 15.6 | 14.1 | 13.0 | 11.9 |
| Effective tax rate (%) | 9.4 | 10.3 | 11.1 | 11.0 | 13.0 |
| Dividend payout (%) | 71.3 | 82.9 | 83.2 | 77.6 | 76.2 |
| Capex to sales (%) | 3.0 | 1.0 | 0.6 | 0.3 | 0.3 |
| Capex to depreciation (x) | 8.0 | 2.2 | 2.8 | 2.0 | 2.1 |
| ROE (%) | 49.0 | 35.8 | 53.4 | 63.8 | 56.0 |
| ROA (pretax %) | 69.4 | 45.0 | 50.3 | 50.1 | 46.9 |
| | | | | | |
| **Growth (%)** | | | | | |
| Revenue | 28.7 | (5.0) | 88.2 | 63.5 | 17.4 |
| EBITDA | (0.9) | (19.5) | 71.4 | 51.2 | 10.1 |
| EBIT | (1.1) | (20.1) | 73.5 | 52.0 | 10.2 |
| Normalised EPS | (24.9) | (24.4) | 67.2 | 47.8 | 7.5 |
| Normalised FDEPS | (24.9) | (24.4) | 67.2 | 47.8 | 7.5 |
| | | | | | |
| **Per share** | | | | | |
| Reported EPS (NT$) | 37.9 | 28.7 | 47.9 | 70.9 | 76.1 |
| Norm EPS (NT$) | 37.9 | 28.7 | 47.9 | 70.9 | 76.1 |
| Fully diluted norm EPS (NT$) | 37.9 | 28.7 | 47.9 | 70.9 | 76.1 |
| Book value per share (NT$) | 80.3 | 83.2 | 95.5 | 126.7 | 145.2 |
| DPS (NT$) | 27.0 | 23.7 | 39.0 | 55.0 | 58.0 |

Source: Nomura estimates

Strong EPS growth to continue into FY11F

| Cashflow (NT$mn) | | | | | |
|---|---|---|---|---|---|
| **Year-end 31 Dec** | **FY08** | **FY09** | **FY10F** | **FY11F** | **FY12F** |
| EBITDA | 30,820 | 24,823 | 42,552 | 64,356 | 70,872 |
| Change in working capital | 8,849 | 1,555 | (3,046) | (7,264) | (2,569) |
| Other operating cashflow | (2,074) | 1,164 | (1,371) | (1,119) | (1,355) |
| **Cashflow from operations** | **37,594** | **27,542** | **38,135** | **55,973** | **66,948** |
| Capital expenditure | (4,570) | (1,423) | (1,704) | (1,216) | (1,368) |
| **Free cashflow** | **33,025** | **26,119** | **36,431** | **54,757** | **65,580** |
| Reduction in investments | (2,229) | (3,861) | (1,887) | (866) | (462) |
| Net acquisitions | - | - | - | - | - |
| Reduction in other LT assets | (856) | (1,880) | 0 | (40) | (40) |
| Addition in other LT liabilities | 6 | (5) | (1) | - | - |
| Adjustments | 946 | 2,015 | 889 | 40 | 40 |
| **Cashflow after investing acts** | **30,892** | **22,387** | **35,432** | **53,891** | **65,118** |
| Cash dividends | (19,487) | (20,126) | (20,122) | (32,424) | (48,952) |
| Equity issue | (3,410) | (2,407) | (7,700) | (3,800) | (4,000) |
| Debt issue | - | - | - | - | - |
| Convertible debt issue | - | 0 | 0 | - | - |
| Others | (1,204) | (5) | (1,501) | (1,500) | (1,500) |
| **Cashflow from financial acts** | **(24,101)** | **(22,538)** | **(29,323)** | **(37,724)** | **(54,452)** |
| **Net cashflow** | **6,791** | **(150)** | **6,109** | **16,167** | **10,666** |
| Beginning cash | 55,036 | 61,827 | 61,676 | 67,786 | 83,953 |
| Ending cash | 61,827 | 61,676 | 67,786 | 83,953 | 94,619 |
| Ending net debt | (61,827) | (61,676) | (67,786) | (83,953) | (94,619) |

Source: Nomura estimates

| Balance sheet (NT$mn) | | | | | |
|---|---|---|---|---|---|
| **As at 31 Dec** | **FY08** | **FY09** | **FY10F** | **FY11F** | **FY12F** |
| Cash & equivalents | 61,827 | 61,676 | 67,786 | 83,953 | 94,619 |
| Marketable securities | - | 2,516 | 401 | 401 | 401 |
| Accounts receivable | 29,799 | 27,571 | 66,258 | 88,478 | 96,716 |
| Inventories | 7,418 | 4,739 | 19,166 | 26,799 | 29,815 |
| Other current assets | 2,228 | 4,524 | 4,149 | 4,149 | 4,149 |
| **Total current assets** | **101,272** | **101,025** | **157,760** | **203,780** | **225,700** |
| LT investments | 5,161 | 6,506 | 10,507 | 11,373 | 11,835 |
| Fixed assets | 7,376 | 8,314 | 9,686 | 10,902 | 12,270 |
| Goodwill | - | - | - | - | - |
| Other intangible assets | - | - | - | - | - |
| Other LT assets | 1,418 | 3,298 | 3,298 | 3,337 | 3,378 |
| **Total assets** | **115,226** | **119,143** | **181,251** | **229,392** | **253,182** |
| Short-term debt | - | - | - | - | - |
| Accounts payable | 27,907 | 24,882 | 63,524 | 86,395 | 95,357 |
| Other current liabilities | 26,651 | 28,619 | 39,671 | 39,388 | 39,112 |
| **Total current liabilities** | **54,558** | **53,502** | **103,195** | **125,783** | **134,469** |
| Long-term debt | - | - | - | - | - |
| Convertible debt | - | - | - | - | - |
| Other LT liabilities | 6 | 1 | 1 | 1 | 1 |
| **Total liabilities** | **54,565** | **53,503** | **103,196** | **125,784** | **134,469** |
| Minority interest | - | - | - | - | - |
| Preferred stock | - | - | - | - | - |
| Common stock | 7,554 | 7,889 | 8,177 | 8,177 | 8,177 |
| Retained earnings | 56,454 | 57,738 | 69,907 | 95,460 | 110,565 |
| Proposed dividends | - | - | - | - | - |
| Other equity and reserves | (3,346) | 13 | (29) | (29) | (29) |
| **Total shareholders' equity** | **60,661** | **65,640** | **78,055** | **103,608** | **118,713** |
| **Total equity & liabilities** | **115,226** | **119,143** | **181,251** | **229,392** | **253,182** |
| | | | | | |
| **Liquidity (x)** | | | | | |
| Current ratio | 1.86 | 1.89 | 1.53 | 1.62 | 1.68 |
| Interest cover | na | na | na | na | na |
| | | | | | |
| **Leverage** | | | | | |
| Net debt/EBITDA (x) | net cash | net cash | net cash | net cash | net cash |
| Net debt/equity (%) | net cash | net cash | net cash | net cash | net cash |
| | | | | | |
| **Activity (days)** | | | | | |
| Days receivable | 59.1 | 72.3 | 62.8 | 63.3 | 64.8 |
| Days inventory | 24.3 | 22.4 | 22.6 | 26.6 | 27.7 |
| Days payable | 89.6 | 97.3 | 83.8 | 86.8 | 88.8 |
| Cash cycle | (6.2) | (2.6) | 1.7 | 3.2 | 3.6 |

Source: Nomura estimates

Zero debt operation

# TPK 3673 TT

TECHNOLOGY | TAIWAN


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Maintained

**BUY**


NOMURA
NOMURA INTERNATIONAL (HK) LIMITED
TAIPEI BRANCH


## Action

We like TPK most in our Taiwan handset component coverage universe and maintain our BUY rating with a price target of NT$820, on its strong near-term growth momentum from Apple's upcoming new product launches and its leading long-term position in the fast-growing touch panel industry.

## Catalysts

We expect strong sales growth, the launch of new Apple products, and new non-Apple tablet PC orders to be positive share price catalysts.

## Anchor themes

The glass-based P-CAP touch technology will surpass the mainstream resistive touch in 2011F and show resilient growth in the coming years, in our view. According to Displaysearch, the P-CAP touch technology will see a CAGR of 53% over 2009-2012F, while the CAGR of the resistive touch is put at only 10%.

| | |
|---|---|
| Closing price on 3 Jan | NT$671 |
| Price target | **NT$820** |
| | (set on 7 Dec 10) |
| Upside/downside | 22.2% |
| Difference from consensus | **18.2%** |
| FY11F net profit (NT$mn) | 10,211 |
| Difference from consensus | **23.2%** |

Source: Nomura

## Nomura vs consensus

Our earnings forecast for FY11F is 23% higher than consensus, given our more aggressive sales growth assumption.

# Jump on the touch bandwagon

### ① Smartphone and tablet offer another good year

We believe the continued strength in smartphones offers TPK a promising outlook for 2011F, and the rosy tablet market is a bonus, as the average selling price (ASP) of tablet touch panels is four times higher than that of smartphones. We forecast tablet PC shipments will rise to 50mn units and 80mn units in 2011F and 2012F, respectively, from 15mn units in 2010, for a 131% CAGR over 2010-12F. Touch panels are undoubtedly the biggest beneficiary of the boom in tablet PCs and smartphones, in our view. Given its competitiveness in the P-CAP space, strong customer relationship with smartphone giants Apple and HTC, and timely capacity expansion, TPK appears well-positioned to ride on the touch panel boom, we believe.

### ② Rosy near-term outlook on product launches

TPK sales will likely beat seasonality during 4Q10-1Q11F, due to the upcoming launches of a CDMA iPhone and the iPad 2. On the margin side, we forecast TPK's 4Q10F GM will improve to 15.5%, on improving yield rates, greater sales scale, and increasing proportion of in-house sensors. Although there is concern over yield rates upon new product launches, we don't foresee much negative impact on margins. We forecast GM will decline slightly to 14.8% in 1Q11F from 15.5% in 4Q10F, and rise to 15.9% in 2Q11F, on account of TPK's ability to ramp up yield rates rapidly.

### ③ Top pick in the Taiwan handset component

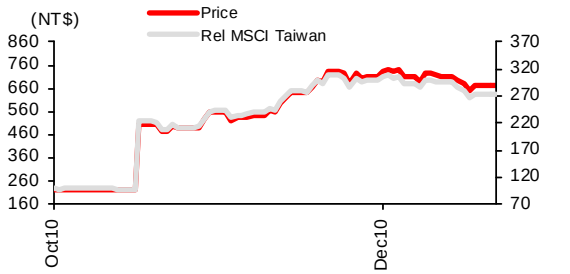
TPK is our top pick in the Taiwan handset component coverage universe, on its near-term strong growth momentum from Apple's new product launches and long-term leading position in the promising P-CAP touch panel industry. We reaffirm our BUY rating and price target of NT$820 (18x FY11F EPS).

## Key financials & valuations

| 31 Dec (NT$mn) | FY09 | FY10F | FY11F | FY12F |
|---|---|---|---|---|
| Revenue | 18,709 | 62,082 | 110,226 | 126,825 |
| Reported net profit | 2,317 | 5,291 | 10,211 | 11,511 |
| Normalised net profit | 2,317 | 5,291 | 10,211 | 11,511 |
| Normalised EPS (NT$) | 12.9 | 23.6 | 45.6 | 51.4 |
| Norm. EPS growth (%) | 496.4 | 83.4 | 93.0 | 12.7 |
| Norm. P/E (x) | 52.1 | 28.4 | 14.7 | 13.1 |
| EV/EBITDA (x) | 45.6 | 19.4 | 10.3 | 8.5 |
| Price/book (x) | 22.7 | 9.1 | 5.9 | 4.4 |
| Dividend yield (%) | 0.2 | 1.0 | 1.0 | 1.8 |
| ROE (%) | 54.1 | 48.5 | 48.9 | 38.8 |
| Net debt/equity (%) | 10.8 | net cash | net cash | net cash |
| **Earnings revisions** | | | | |
| Previous norm. net profit | | 5,291 | 10,211 | 11,511 |
| Change from previous (%) | | - | - | - |
| Previous norm. EPS (NT$) | | 23.6 | 45.6 | 51.4 |

Source: Company, Nomura estimates

## Share price relative to MSCI Taiwan



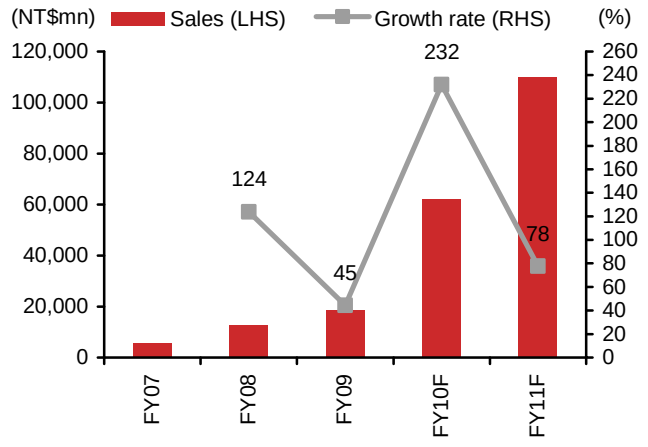

| | 1m | 3m | 6m |
|---|---|---|---|
| Absolute (NT$) | (8.5) | na | na |
| Absolute (US$) | (4.7) | na | na |
| Relative to Index | (12.7) | na | na |
| Market cap (US$mn) | | | 5,164 |
| Estimated free float (%) | | | 50.0 |
| 52-week range (NT$) | | | 740/220.0 |
| 3-mth avg daily turnover (US$mn) | | | 35.30 |
| Stock borrowability | | | Hard |
| Major shareholders (%) | | | |
| Chao-Jui Chang | | | 26.2 |
| Balda Investments Singapore Pte. Ltd. | | | 16.3 |

Source: Company, Nomura estimates

**Valuation methodology.** Our price target of NT$820 is based on 18x FY11F EPS. We think TPK deserves a valuation premium (vs a peer group average P/E of 13x for FY11F), due to its leading position in the fast-growing P-CAP touch panel industry, solid relationship with smartphone leaders (Apple and HTC), and limited free float.

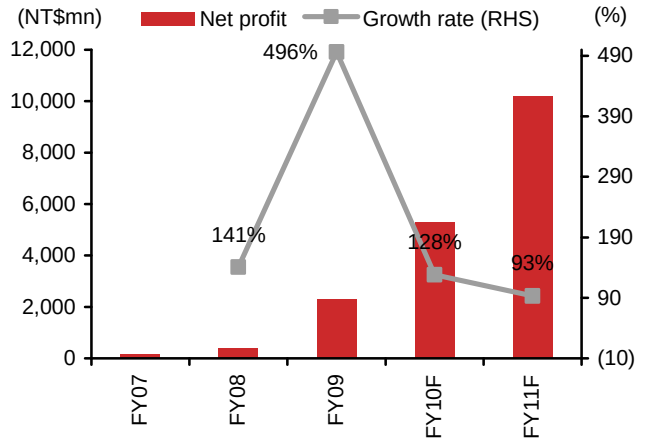
**Key risks to our price target**: 1) Lower-than-expected sales of Apple's iPhone and iPad; 2) worse-than-expected market share in key customers; 3) oversupply risk; and 4) worse-than-expected yields in new products and TFT-LCD lamination may weigh on margins.

**Exhibit 72. TPK: FY07-11F sales and growth**



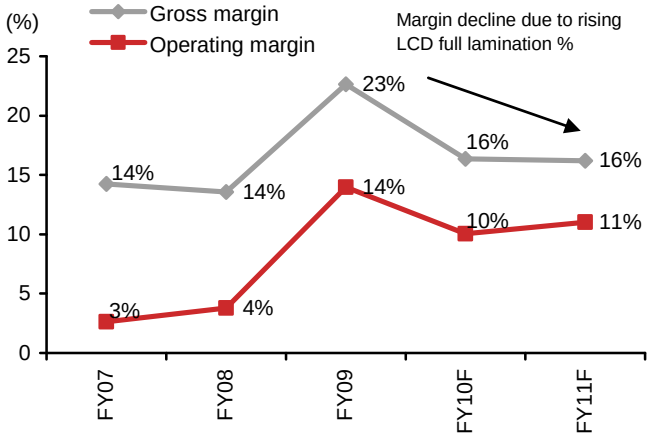

Source: Company data, Nomura forecasts

**Exhibit 73. TPK: FY07-11F earnings and growth**



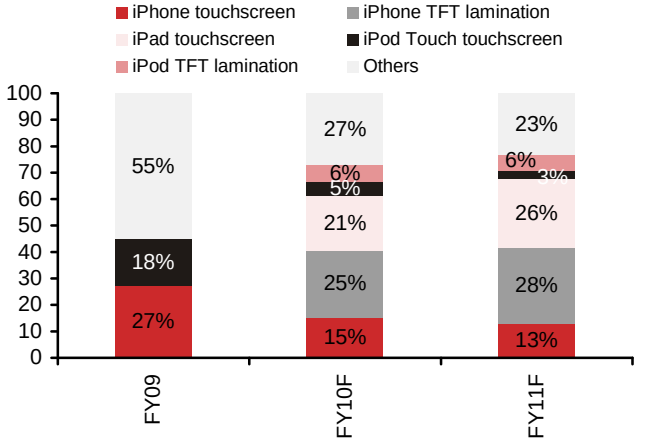

Source: Company data, Nomura forecasts

**Exhibit 74. TPK: FY07-11F margin trends**




Source: Company data, Nomura forecasts

**Exhibit 75. TPK: FY09-11F product mix**




Source: Company data, Nomura forecasts

# Financial statements

| Income statement (NT$mn) | | | | | |
|---|---|---|---|---|---|
| **Year-end 31 Dec** | **FY08** | **FY09** | **FY10F** | **FY11F** | **FY12F** |
| **Revenue** | 12,942 | 18,709 | 62,082 | 110,226 | 126,825 |
| Cost of goods sold | (11,188) | (14,473) | (51,934) | (92,383) | (106,800) |
| **Gross profit** | **1,755** | **4,236** | **10,148** | **17,843** | **20,025** |
| SG&A | (1,262) | (1,624) | (3,902) | (5,686) | (6,322) |
| Employee share expense | | | | | |
| **Operating profit** | **492** | **2,612** | **6,246** | **12,157** | **13,703** |
| | | | | | |
| **EBITDA** | **992** | **3,312** | **7,426** | **14,216** | **16,403** |
| Depreciation | (499) | (700) | (1,180) | (2,060) | (2,700) |
| Amortisation | | | | | |
| **EBIT** | **492** | **2,612** | **6,246** | **12,157** | **13,703** |
| Net interest expense | (130) | (66) | - | - | - |
| Associates & JCEs | - | - | - | - | - |
| Other income | 32 | 18 | 67 | - | - |
| **Earnings before tax** | **394** | **2,564** | **6,313** | **12,157** | **13,703** |
| Income tax | (5) | (254) | (1,012) | (1,945) | (2,192) |
| **Net profit after tax** | **388** | **2,310** | **5,302** | **10,211** | **11,511** |
| Minority interests | - | 7 | (11) | - | - |
| Other items | | | | | |
| Preferred dividends | | | | | |
| **Normalised NPAT** | **388** | **2,317** | **5,291** | **10,211** | **11,511** |
| Extraordinary items | - | - | - | - | - |
| **Reported NPAT** | **388** | **2,317** | **5,291** | **10,211** | **11,511** |
| Dividends | - | (192) | (1,522) | (1,429) | (2,757) |
| **Transfer to reserves** | **388** | **2,125** | **3,769** | **8,783** | **8,754** |
| | | | | | |
| **Valuation and ratio analysis** | | | | | |
| FD normalised P/E (x) | 310.9 | 52.1 | 28.4 | 14.7 | 13.1 |
| FD normalised P/E at price target (x) | 379.9 | 63.7 | 34.7 | 18.0 | 16.0 |
| Reported P/E (x) | 310.9 | 52.1 | 28.4 | 14.7 | 13.1 |
| Dividend yield (%) | - | 0.2 | 1.0 | 1.0 | 1.8 |
| Price/cashflow (x) | 52.9 | 39.1 | 12.6 | 20.5 | 10.5 |
| Price/book (x) | 37.3 | 22.7 | 9.1 | 5.9 | 4.4 |
| EV/EBITDA (x) | 153.0 | 45.6 | 19.4 | 10.3 | 8.5 |
| EV/EBIT (x) | 308.1 | 57.8 | 23.0 | 12.0 | 10.2 |
| Gross margin (%) | 13.6 | 22.6 | 16.3 | 16.2 | 15.8 |
| EBITDA margin (%) | 7.7 | 17.7 | 12.0 | 12.9 | 12.9 |
| EBIT margin (%) | 3.8 | 14.0 | 10.1 | 11.0 | 10.8 |
| Net margin (%) | 3.0 | 12.4 | 8.5 | 9.3 | 9.1 |
| Effective tax rate (%) | 1.3 | 9.9 | 16.0 | 16.0 | 16.0 |
| Dividend payout (%) | - | 8.3 | 28.8 | 14.0 | 24.0 |
| Capex to sales (%) | 13.8 | 7.2 | 15.5 | 7.3 | 3.8 |
| Capex to depreciation (x) | 3.6 | 1.9 | 8.1 | 3.9 | 1.8 |
| ROE (%) | 13.1 | 54.1 | 48.5 | 48.9 | 38.8 |
| ROA (pretax %) | 6.6 | 30.1 | 38.8 | 41.2 | 35.8 |
| | | | | | |
| **Growth (%)** | | | | | |
| Revenue | 123.7 | 44.6 | 231.8 | 77.5 | 15.1 |
| EBITDA | 189.0 | 234.0 | 124.2 | 91.4 | 15.4 |
| EBIT | 222.7 | 430.7 | 139.1 | 94.6 | 12.7 |
| Normalised EPS | 140.7 | 496.4 | 83.4 | 93.0 | 12.7 |
| Normalised FDEPS | 140.7 | 496.4 | 83.5 | 92.9 | 12.7 |
| | | | | | |
| **Per share** | | | | | |
| Reported EPS (NT$) | 2.2 | 12.9 | 23.6 | 45.6 | 51.4 |
| Norm EPS (NT$) | 2.2 | 12.9 | 23.6 | 45.6 | 51.4 |
| Fully diluted norm EPS (NT$) | 2.2 | 12.9 | 23.6 | 45.6 | 51.4 |
| Book value per share (NT$) | 18.0 | 29.6 | 73.6 | 112.8 | 151.9 |
| DPS (NT$) | - | 1.1 | 6.8 | 6.4 | 12.3 |

Source: Nomura estimates

Strong sales growth on Apple's iPhone and iPad

| Cashflow (NT$mn) | | | | | |
|---|---|---|---|---|---|
| **Year-end 31 Dec** | **FY08** | **FY09** | **FY10F** | **FY11F** | **FY12F** |
| EBITDA | 992 | 3,312 | 7,426 | 14,216 | 16,403 |
| Change in working capital | 1,200 | (691) | 5,446 | (4,948) | 157 |
| Other operating cashflow | 92 | 468 | (956) | (1,945) | (2,192) |
| **Cashflow from operations** | **2,284** | **3,089** | **11,916** | **7,323** | **14,368** |
| Capital expenditure | (1,791) | (1,354) | (9,600) | (8,000) | (4,800) |
| **Free cashflow** | **493** | **1,735** | **2,316** | **(677)** | **9,568** |
| Reduction in investments | (34) | 34 | - | - | - |
| Net acquisitions | - | - | - | - | - |
| Reduction in other LT assets | (24) | (49) | (1,617) | - | - |
| Addition in other LT liabilities | (2) | 20 | 0 | - | - |
| Adjustments | (61) | (668) | 1,617 | - | - |
| **Cashflow after investing acts** | **372** | **1,072** | **2,316** | **(677)** | **9,568** |
| Cash dividends | - | (192) | (1,522) | (1,429) | (2,757) |
| Equity issue | - | - | 6,160 | - | - |
| Debt issue | 28 | 399 | 2,175 | - | - |
| Convertible debt issue | | | | | |
| Others | (423) | (136) | - | - | - |
| **Cashflow from financial acts** | **(396)** | **71** | **6,813** | **(1,429)** | **(2,757)** |
| **Net cashflow** | **(24)** | **1,143** | **9,129** | **(2,106)** | **6,810** |
| Beginning cash | 551 | 528 | 1,671 | 10,800 | 8,694 |
| Ending cash | 528 | 1,671 | 10,800 | 8,694 | 15,504 |
| Ending net debt | 1,318 | 574 | (6,380) | (4,274) | (11,085) |

Source: Nomura estimates

| Balance sheet (NT$mn) | | | | | |
|---|---|---|---|---|---|
| **As at 31 Dec** | **FY08** | **FY09** | **FY10F** | **FY11F** | **FY12F** |
| Cash & equivalents | 528 | 1,671 | 10,800 | 8,694 | 15,504 |
| Marketable securities | 34 | - | - | - | - |
| Accounts receivable | 720 | 835 | 3,300 | 6,614 | 7,610 |
| Inventories | 1,022 | 971 | 2,400 | 6,467 | 7,476 |
| Other current assets | 239 | 776 | 776 | 776 | 776 |
| **Total current assets** | **2,543** | **4,253** | **17,276** | **22,550** | **31,366** |
| LT investments | - | - | - | - | - |
| Fixed assets | 5,302 | 5,959 | 14,380 | 20,320 | 22,420 |
| Goodwill | 373 | 364 | - | - | - |
| Other intangible assets | | | | | |
| Other LT assets | 348 | 397 | 2,014 | 2,014 | 2,014 |
| **Total assets** | **8,566** | **10,974** | **33,670** | **44,885** | **55,801** |
| Short-term debt | 1,846 | 1,650 | 3,350 | 3,350 | 3,350 |
| Accounts payable | 2,198 | 2,204 | 11,425 | 13,857 | 16,020 |
| Other current liabilities | 1,268 | 1,173 | 1,290 | 1,290 | 1,290 |
| **Total current liabilities** | **5,312** | **5,026** | **16,065** | **18,497** | **20,660** |
| Long-term debt | - | 595 | 1,070 | 1,070 | 1,070 |
| Convertible debt | | | | | |
| Other LT liabilities | 12 | 33 | 33 | 33 | 33 |
| **Total liabilities** | **5,324** | **5,654** | **17,168** | **19,600** | **21,763** |
| Minority interest | | | | | |
| Preferred stock | | | | | |
| Common stock | 1,011 | 987 | 2,241 | 2,241 | 2,241 |
| Retained earnings | 507 | 2,618 | 6,387 | 15,169 | 23,923 |
| Proposed dividends | | | | | |
| Other equity and reserves | 1,724 | 1,715 | 7,875 | 7,875 | 7,875 |
| **Total shareholders' equity** | **3,242** | **5,320** | **16,502** | **25,285** | **34,038** |
| **Total equity & liabilities** | **8,566** | **10,974** | **33,670** | **44,885** | **55,801** |
| | | | | | |
| **Liquidity (x)** | | | | | |
| Current ratio | 0.48 | 0.85 | 1.08 | 1.22 | 1.52 |
| Interest cover | 3.8 | 39.7 | na | na | na |
| | | | | | |
| **Leverage** | | | | | |
| Net debt/EBITDA (x) | 1.33 | 0.17 | net cash | net cash | net cash |
| Net debt/equity (%) | 40.6 | 10.8 | net cash | net cash | net cash |
| | | | | | |
| **Activity (days)** | | | | | |
| Days receivable | 35.1 | 15.2 | 12.2 | 16.4 | 20.5 |
| Days inventory | 28.0 | 25.1 | 11.8 | 17.5 | 23.9 |
| Days payable | 63.4 | 55.5 | 47.9 | 49.9 | 51.2 |
| Cash cycle | (0.3) | (15.2) | (23.9) | (16.0) | (6.8) |

Source: Nomura estimates

Improving balance sheet structure

# Acer Inc 2353 TT

TECHNOLOGY/PC HARDWARE | TAIWAN

Maintained

BUY


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NOMURA
NOMURA INTERNATIONAL (HK) LIMITED
TAIPEI BRANCH


## Action

We reiterate our BUY on Acer with a 12-month PT of NT$110. Acer's continued market share gains in emerging markets and progress in China should support future growth momentum, in our view. Given its strong execution, we believe Acer could continue to expand its operating margin. With an improving ROE and a widening gap with its peers, Acer is our top pick among PC brand names.

## Catalysts

Acer shares could be driven by: 1) market share gains in DT and NB markets; 2) continuous operating margin expansion; and 3) progress in tablet PC shipments.

## Anchor themes

Our 2011F global client PC forecast is 8% y-y growth, which is below consensus. For 2010, we estimate global client PC shipments were up 14%, with NB shipments up 20%. As tablet PCs cannibalise netbooks, we expect combined shipments of NBs and netbooks to grow 12% y-y in 2011F vs 20% in 2010F.

| | |
|---|---|
| Closing price on 3 Jan | NT$90.0 |
| Price target* | **NT$110.0** |
| | (from NT$91.0) |
| Upside/downside | 22.2% |
| Difference from consensus | **6.9%** |
| FY11F net profit (NT$mn) | 18,357 |
| Difference from consensus | **-4.5%** |

*Revised on 4 January from NT$112

Source: Nomura

## Nomura vs consensus

Our estimates for Acer's FY11F/FY12F earnings are 3%/10% higher than consensus. We think market estimates of Acer's profitability remain conservative.

# Solidifying its leading position

### ① Promising growth in emerging markets

Thanks to solid PC growth in emerging markets and China, Acer grabbed the number-one spot in the global NB market (market share of 18.8% in 3Q10), as per data from IDC. We expect the sales mix from emerging markets to rise to 45% in FY11F, from 35% in 3Q10. For 2011F, we expect Acer's NB shipments to grow 20% y-y, with market share rising to 20%. Emerging markets, especially China, could be the next growth driver, in our view. After cooperating with Founder, sales from China could account for 12% of Acer's FY11F sales, up from 7% in 3Q10, and Acer should secure a top-three position in China in 2011F, in our view.

### ② Improving profitability through execution

Acer continues to improve its operating margin through cost-cutting efforts. Leveraging its experience in managing component inventories, alongside its sheer scale and strict opex control, Acer has been improving its operating margin faster than peers, especially as component prices have softened. We expect Acer's operating margin to improve to 3.3% in FY11F from 2.9% in FY10F and FY11F earnings could grow 17% on 14% sales growth.

### ③ New products on the way

Eyeing strong growth from the tablet PC market, Acer rolled out new tablet PCs in 4Q10. While we have low expectations on its tablet PC shipments in 1H11, we think it should see momentum build in 2H11 as its software, Clear.fi and applications mature.

### ④ Progress in commercial segment

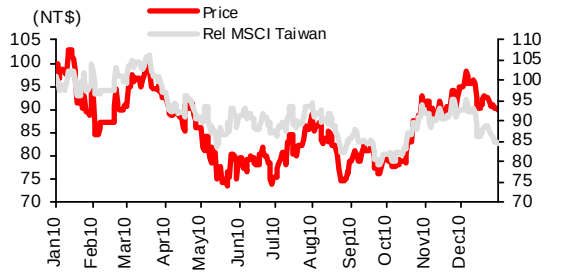
While Acer has a secure leading position in the consumer segment, we expect more progress in the commercial segment, especially in China, which we think could be an additional growth driver for 2011F.

**Key financials & valuations**

| 31 Dec (NT$mn) | FY09 | FY10F | FY11F | FY12F |
|---|---|---|---|---|
| Revenue | 573,983 | 631,996 | 717,043 | 851,969 |
| Reported net profit | 11,353 | 15,728 | 18,357 | 23,611 |
| Normalised net profit | 11,353 | 15,728 | 18,357 | 23,611 |
| Normalised EPS (NT$) | 4.22 | 5.82 | 6.80 | 8.74 |
| Norm. EPS growth (%) | (4.1) | 37.9 | 16.7 | 28.6 |
| Norm. P/E (x) | 21.3 | 15.5 | 13.2 | 10.3 |
| EV/EBITDA (x) | 11.0 | 10.7 | 8.5 | 6.6 |
| Price/book (x) | 2.6 | 2.5 | 2.3 | 2.0 |
| Dividend yield (%) | 3.4 | 3.9 | 4.5 | 5.8 |
| ROE (%) | 13.0 | 16.5 | 17.9 | 20.9 |
| Net debt/equity (%) | net cash | net cash | net cash | net cash |
| **Earnings revisions** | | | | |
| Previous norm. net profit | | 15,625 | 19,680 | 24,707 |
| Change from previous (%) | | 0.7 | (6.7) | (4.4) |
| Previous norm. EPS (NT$) | | 5.80 | 7.30 | 9.17 |

Source: Company, Nomura estimates

**Share price relative to MSCI Taiwan**




| | 1m | 3m | 6m |
|---|---|---|---|
| Absolute (NT$) | (5.3) | 13.5 | 19.5 |
| Absolute (US$) | (1.3) | 20.9 | 32.4 |
| Relative to Index | (10.0) | 3.5 | (5.3) |
| Market cap (US$mn) | | | 8,351 |
| Estimated free float (%) | | | 90.4 |
| 52-week range (NT$) | | | 102.9/73.4 |
| 3-mth avg daily turnover (US$mn) | | | 36.73 |
| Stock borrowability | | | Hard |
| Major shareholders (%) | | | |
| CAPITAL WORLD INVEST | | | 11.7 |
| CHEN-JUNG SHIH | | | 2.8 |

Source: Company, Nomura estimates

Investment thesis

## Gaining momentum in Asia Pacific market

Expect more positive results from Asia Pacific PC market

Given strong PC growth in the Asia Pacific market, Acer has been allocating more resources in Asia, and it delivered strong growth of 41% in the first three quarters of 2010. Acer, as a result, replaced HPQ as the second-largest NB OEM in the Asia Pacific market, with its market share rising to 15% in 3Q10, vs 13% in 3Q09. HPQ saw its market share in the Asia Pacific market decline to 13.2% in 3Q10, from 22.7% in 3Q09, due to setbacks in China. Looking ahead, we think China will clearly be the major growth driver for Acer on the back of China's strong PC growth. After cooperating with Founder, Acer should see market share increase in both the commercial and consumer segments, in our view. Combined with Founder's market share, Acer had an 11% market share in the Chinese PC market in 3Q10, vs Asustek's 6.7%. By leveraging Founder's channel network, we believe the sales contribution from China could rise to 12% in 2011F vs 7% in 3Q10.

## Leveraging volume growth in emerging markets

We believe Acer has been doing well in the emerging markets. From IDC's 3Q10 data, we gather Acer has gained the number two spot in the emerging markets excluding China, having experienced significant market share gains in recent quarters. Acer expects sales from emerging markets to account for 40-45% of its 2011F total sales, up from 35% in 3Q10. Given its early entry into emerging markets and widening channel network, we think its progress there could be key to determining whether Acer can secure No. 1 position in the global NB market.

## Valuation still attractive

We have a DCF-based price target of NT$110, implying 15.3x/12.2x FY11F/12F EPS. At our price target, the stock would trade at the mid-range of its adjusted five-year forward P/E trading band of 9-19x. We are using a DCF-based valuation to reflect PC OEMs' capability to generate stable cash inflows. Our DCF assumes revenue growth will be maintained at 1% after FY18F, as growth in the global NB market might gradually become saturated. We apply a cost of equity of 8.91%, which assumes a risk-free rate of 2.6%, a market risk premium of 6.0% and an equity beta of 1.1. On the back of continuous market share gains, margin expansion and improving ROE performance, we believe Acer should enjoy re-rating opportunities.

## Investment risks

Downside risks to our price target include: 1) weaker-than-expected global PC demand; 2) worse-than-expected operating margin performance due to irrational price competition from leading PC OEMs; 3) slow market share gains and 4) disappointing cost synergies or sales performance if restructuring and resource integration with Founder are protracted.

# Financial statements

| Income statement (NT$mn) | | | | | |
|---|---|---|---|---|---|
| **Year-end 31 Dec** | **FY08** | **FY09** | **FY10F** | **FY11F** | **FY12F** |
| **Revenue** | 546,274 | 573,983 | 631,996 | 717,043 | 851,969 |
| Cost of goods sold | (488,988) | (515,655) | (569,005) | (644,964) | (766,944) |
| **Gross profit** | **57,286** | **58,328** | **62,991** | **72,079** | **85,026** |
| SG&A | (41,628) | (41,866) | (42,792) | (46,629) | (52,515) |
| Employee share expense | (1,586) | (1,122) | (1,649) | (1,742) | (2,242) |
| **Operating profit** | **14,072** | **15,339** | **18,549** | **23,708** | **30,268** |
| | | | | | |
| **EBITDA** | **16,274** | **18,046** | **21,190** | **26,861** | **33,302** |
| Depreciation | (956) | (846) | (719) | (776) | (826) |
| Amortisation | (1,246) | (1,860) | (1,922) | (2,377) | (2,208) |
| **EBIT** | **14,072** | **15,339** | **18,549** | **23,708** | **30,268** |
| Net interest expense | (98) | (260) | (779) | (1,137) | (1,029) |
| Associates & JCEs | 404 | 400 | 610 | - | - |
| Other income | 428 | (496) | 1,308 | 300 | 200 |
| **Earnings before tax** | **14,807** | **14,983** | **19,687** | **22,871** | **29,439** |
| Income tax | (3,169) | (3,630) | (3,960) | (4,514) | (5,828) |
| **Net profit after tax** | **11,637** | **11,353** | **15,727** | **18,357** | **23,611** |
| Minority interests | 5 | 1 | 1 | - | - |
| Other items | - | - | - | - | - |
| Preferred dividends | - | - | - | - | - |
| **Normalised NPAT** | **11,642** | **11,353** | **15,728** | **18,357** | **23,611** |
| Extraordinary items | 100 | - | - | - | - |
| **Reported NPAT** | **11,742** | **11,353** | **15,728** | **18,357** | **23,611** |
| Dividends | (8,545) | (5,215) | (8,211) | (9,437) | (11,014) |
| **Transfer to reserves** | **3,197** | **6,138** | **7,517** | **8,920** | **12,597** |
| | | | | | |
| **Valuation and ratio analysis** | | | | | |
| FD normalised P/E (x) | 20.4 | 21.3 | 15.5 | 13.2 | 10.3 |
| FD normalised P/E at price target (x) | 25.0 | 26.0 | 18.9 | 16.2 | 12.6 |
| Reported P/E (x) | 20.3 | 21.3 | 15.5 | 13.2 | 10.3 |
| Dividend yield (%) | 2.2 | 3.4 | 3.9 | 4.5 | 5.8 |
| Price/cashflow (x) | na | 6.3 | na | 16.1 | 12.3 |
| Price/book (x) | 2.9 | 2.6 | 2.5 | 2.3 | 2.0 |
| EV/EBITDA (x) | 14.1 | 11.0 | 10.7 | 8.5 | 6.6 |
| EV/EBIT (x) | 16.2 | 12.9 | 12.1 | 9.6 | 7.3 |
| Gross margin (%) | 10.5 | 10.2 | 10.0 | 10.1 | 10.0 |
| EBITDA margin (%) | 3.0 | 3.1 | 3.4 | 3.7 | 3.9 |
| EBIT margin (%) | 2.6 | 2.7 | 2.9 | 3.3 | 3.6 |
| Net margin (%) | 2.1 | 2.0 | 2.5 | 2.6 | 2.8 |
| Effective tax rate (%) | 21.4 | 24.2 | 20.1 | 19.7 | 19.8 |
| Dividend payout (%) | 72.8 | 45.9 | 52.2 | 51.4 | 46.6 |
| Capex to sales (%) | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 |
| Capex to depreciation (x) | 0.6 | 0.9 | 1.0 | 1.0 | 1.0 |
| ROE (%) | 14.8 | 13.0 | 16.5 | 17.9 | 20.9 |
| ROA (pretax %) | 6.8 | 6.9 | 7.9 | 8.3 | 8.8 |
| | | | | | |
| **Growth (%)** | | | | | |
| Revenue | 18.2 | 5.1 | 10.1 | 13.5 | 18.8 |
| EBITDA | 43.7 | 10.9 | 17.4 | 26.8 | 24.0 |
| EBIT | 38.2 | 9.0 | 20.9 | 27.8 | 27.7 |
| Normalised EPS | (14.8) | (4.1) | 37.9 | 16.7 | 28.6 |
| Normalised FDEPS | (14.8) | (4.1) | 37.9 | 16.7 | 28.6 |
| | | | | | |
| **Per share** | | | | | |
| Reported EPS (NT$) | 4.44 | 4.22 | 5.82 | 6.80 | 8.74 |
| Norm EPS (NT$) | 4.41 | 4.22 | 5.82 | 6.80 | 8.74 |
| Fully diluted norm EPS (NT$) | 4.41 | 4.22 | 5.82 | 6.80 | 8.74 |
| Book value per share (NT$) | 31.15 | 34.37 | 36.29 | 39.48 | 44.03 |
| DPS (NT$) | 2.00 | 3.10 | 3.49 | 4.08 | 5.18 |

Source: Nomura estimates

Continuous operating margin expansion

| Cashflow (NT$mn) | | | | | |
|---|---|---|---|---|---|
| **Year-end 31 Dec** | **FY08** | **FY09** | **FY10F** | **FY11F** | **FY12F** |
| EBITDA | 16,274 | 18,046 | 21,190 | 26,861 | 33,302 |
| Change in working capital | (9,181) | 24,764 | (39,999) | (8,613) | (7,669) |
| Other operating cashflow | (12,259) | (4,618) | (3,887) | (3,158) | (5,849) |
| **Cashflow from operations** | **(5,166)** | **38,192** | **(22,697)** | **15,091** | **19,783** |
| Capital expenditure | (598) | (772) | (710) | (800) | (800) |
| **Free cashflow** | **(5,764)** | **37,421** | **(23,406)** | **14,291** | **18,983** |
| Reduction in investments | 6,632 | 1,015 | 1,818 | - | - |
| Net acquisitions | - | - | - | - | - |
| Reduction in other LT assets | 644 | (2,106) | (1,334) | - | - |
| Addition in other LT liabilities | | | | | |
| Adjustments | 639 | 871 | (1,291) | - | - |
| **Cashflow after investing acts** | **2,152** | **37,199** | **(24,213)** | **14,291** | **18,983** |
| Cash dividends | (8,545) | (5,215) | (8,211) | (9,437) | (11,014) |
| Equity issue | - | - | 54 | - | - |
| Debt issue | (8,709) | (552) | 17,854 | - | - |
| Convertible debt issue | - | - | - | - | - |
| Others | (702) | 42 | 40 | - | - |
| **Cashflow from financial acts** | **(17,955)** | **(5,725)** | **9,737** | **(9,437)** | **(11,014)** |
| **Net cashflow** | **(15,804)** | **31,474** | **(14,476)** | **4,854** | **7,969** |
| Beginning cash | 37,945 | 22,142 | 53,616 | 39,140 | 43,994 |
| Ending cash | 22,142 | 53,616 | 39,140 | 43,994 | 51,963 |
| Ending net debt | (8,670) | (40,696) | (10,254) | (15,108) | (23,078) |

Source: Nomura estimates

| Balance sheet (NT$mn) | | | | | |
|---|---|---|---|---|---|
| **As at 31 Dec** | **FY08** | **FY09** | **FY10F** | **FY11F** | **FY12F** |
| Cash & equivalents | 22,142 | 53,616 | 39,140 | 43,994 | 51,963 |
| Marketable securities | 1,969 | 1,656 | 698 | 698 | 698 |
| Accounts receivable | 108,668 | 112,459 | 122,787 | 177,961 | 207,777 |
| Inventories | 40,028 | 51,185 | 53,129 | 69,208 | 80,869 |
| Other current assets | 13,584 | 13,192 | 14,365 | 20,819 | 24,308 |
| **Total current assets** | **186,391** | **232,108** | **230,119** | **312,680** | **365,615** |
| LT investments | 6,774 | 8,873 | 8,031 | 8,031 | 8,031 |
| Fixed assets | 9,336 | 8,676 | 8,636 | 8,660 | 8,634 |
| Goodwill | - | - | - | - | - |
| Other intangible assets | 34,747 | 35,444 | 33,296 | 30,919 | 28,711 |
| Other LT assets | 6,195 | 5,924 | 6,842 | 6,842 | 6,842 |
| **Total assets** | **243,442** | **291,025** | **286,924** | **367,131** | **417,832** |
| Short-term debt | 9,337 | 548 | 5,574 | 5,574 | 5,574 |
| Accounts payable | 72,116 | 106,064 | 81,826 | 118,951 | 138,994 |
| Other current liabilities | 67,862 | 73,234 | 70,919 | 102,888 | 120,142 |
| **Total current liabilities** | **149,315** | **179,847** | **158,319** | **227,414** | **264,710** |
| Long-term debt | 4,135 | 12,372 | 23,311 | 23,311 | 23,311 |
| Convertible debt | - | - | - | - | - |
| Other LT liabilities | 7,115 | 5,929 | 6,895 | 9,388 | 10,496 |
| **Total liabilities** | **160,565** | **198,147** | **188,525** | **260,113** | **298,517** |
| Minority interest | 559 | 483 | 417 | 417 | 417 |
| Preferred stock | - | - | - | - | - |
| Common stock | 26,429 | 26,882 | 27,002 | 27,002 | 27,002 |
| Retained earnings | 13,985 | 18,614 | 24,271 | 31,085 | 41,051 |
| Proposed dividends | - | - | - | - | - |
| Other equity and reserves | 41,905 | 46,898 | 46,709 | 48,514 | 50,846 |
| **Total shareholders' equity** | **82,319** | **92,395** | **97,981** | **106,601** | **118,898** |
| **Total equity & liabilities** | **243,442** | **291,025** | **286,924** | **367,131** | **417,832** |
| | | | | | |
| **Liquidity (x)** | | | | | |
| Current ratio | 1.25 | 1.29 | 1.45 | 1.37 | 1.38 |
| Interest cover | 143.7 | 58.9 | 23.8 | 20.9 | 29.4 |
| | | | | | |
| **Leverage** | | | | | |
| Net debt/EBITDA (x) | net cash | net cash | net cash | net cash | net cash |
| Net debt/equity (%) | net cash | net cash | net cash | net cash | net cash |
| | | | | | |
| **Activity (days)** | | | | | |
| Days receivable | 70.7 | 70.3 | 67.9 | 76.5 | 82.9 |
| Days inventory | 27.6 | 32.3 | 33.5 | 34.6 | 35.8 |
| Days payable | 57.2 | 63.1 | 60.3 | 56.8 | 61.5 |
| Cash cycle | 41.1 | 39.5 | 41.1 | 54.4 | 57.1 |

Source: Nomura estimates

Asset-light business model

# Synnex Technology 2347 TT

TECHNOLOGY/PC HARDWARE | TAIWAN

Maintained

BUY


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NOMURA

NOMURA INTERNATIONAL (HK) LIMITED
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## Action

We reiterate our BUY rating and PT of NT$90 as we believe Synnex will be a major beneficiary of rising PC/handset demand in China given its widening channel coverage in tier-3 to tier-5 cities. In addition, expansion into Indonesia and other emerging markets, coupled with margin expansion, should underpin FY11-12F earnings growth of 21-32% y-y.

## Catalysts

Progress in gaining market share in emerging markets and operating margin expansion through product portfolio adjustment could serve as catalysts.

## Anchor themes

Our 2011F global client PC growth forecast of 8% y-y is below consensus. For 2010F, we estimate global client PC shipment growth of 14% y-y, with NB shipments up 20% y-y. As tablet PCs continue to cannibalise netbooks, we expect combined NB and netbook shipment growth of 12% y-y, vs 20% y-y in 2010F.

| | |
|---|---|
| Closing price on 3 Jan | NT$77.3 |
| Price target | **NT$90.0** |
| | (set on 1 Dec 10) |
| Upside/downside | 16.4% |
| Difference from consensus | **12.5%** |
| FY11F net profit (NT$mn) | 6,699 |
| Difference from consensus | **-2.8%** |

Source: Nomura

## Nomura vs consensus

Our FY11-12F earnings estimates are in line with consensus. We see a re-rating on strong growth from China and margin expansion through product portfolio adjustment.

# Sustainable growth on expansion

### ① Secular growth story from China

Amid rising IT and handset demand from China, we expect the sales contribution from China to account for 78% of Synnex's FY11F sales. Increasing sales from Nokia handset distribution should help to improve Synnex's margin structure. In addition, stronger ties with Acer, Dell, Lenovo and Asustek could boost Synnex's IT distribution sales in China. Synnex's market share in China remains low at around 10%, thus we see ample room for growth given its cost competitiveness and widening channel coverage.

### ② Rising sales contribution from handset distribution

We expect handset distribution to be the major growth driver for Synnex in FY11F. Rising handset distribution sales from China to 19% in FY10F, from 15% in FY09, could lead to margin expansion given that handset distribution provides better margins than IT product distribution. As Synnex strengthens ties with Nokia, we expect share allocation from Nokia to rise to 15% in FY11F from 9% in FY10F.

### ③ Benefiting from PC OEMs' aggressive move in China

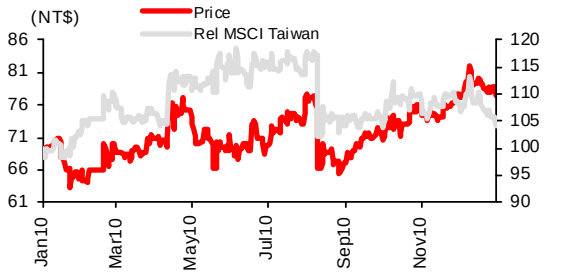
With Acer, Asustek, Lenovo and Dell aggressively vying for market share in China, Synnex is seeing increasing volume allocation from leading PC OEMs. Synnex is also seeking growth opportunities from the commercial segment given better profitability. The company aims to lift the sales mix from the commercial segment to 15% in FY11F, from 10% in FY10F, and it expects improving corporate demand from 2Q11F with Intel's launch of the Sandy Bridge CPU. Given better margins from the commercial segment, we believe that Synnex's expansion into the commercial segment will help to lift its margins.

## Key financials & valuations

| 31 Dec (NT$mn) | FY09 | FY10F | FY11F | FY12F |
|---|---|---|---|---|
| Revenue | 220,725 | 272,774 | 343,607 | 431,252 |
| Reported net profit | 4,828 | 5,555 | 6,699 | 8,812 |
| Normalised net profit | 4,828 | 5,555 | 6,699 | 8,812 |
| Normalised EPS (NT$) | 3.64 | 3.66 | 4.41 | 5.80 |
| Norm. EPS growth (%) | 32.9 | 0.7 | 20.6 | 31.5 |
| Norm. P/E (x) | 21.3 | 21.1 | 17.5 | 13.3 |
| EV/EBITDA (x) | 26.3 | 20.8 | 16.5 | 13.0 |
| Price/book (x) | 3.2 | 3.2 | 2.9 | 2.5 |
| Dividend yield (%) | 3.1 | 2.4 | 2.9 | 3.8 |
| ROE (%) | 16.2 | 16.2 | 17.4 | 20.4 |
| Net debt/equity (%) | 36.1 | 33.0 | 46.3 | 50.8 |
| **Earnings revisions** | | | | |
| Previous norm. net profit | | 5,555 | 6,699 | 8,812 |
| Change from previous (%) | | - | - | - |
| Previous norm. EPS (NT$) | | 3.66 | 4.41 | 5.80 |

Source: Company, Nomura estimates

## Share price relative to MSCI Taiwan




| | 1m | 3m | 6m |
|---|---|---|---|
| Absolute (NT$) | (0.4) | 8.0 | 10.9 |
| Absolute (US$) | 3.7 | 15.0 | 22.9 |
| Relative to Index | (4.3) | (1.7) | (14.0) |
| Market cap (US$mn) | | | 4,031 |
| Estimated free float (%) | | | 0.0 |
| 52-week range (NT$) | | | 82.0/63.1 |
| 3-mth avg daily turnover (US$mn) | | | 12.49 |
| Stock borrowability | | | Easy |
| Major shareholders (%) | | | |
| MITAC INC | | | 14.6 |
| T ROWE PRICE ASSOCIA | | | 3.4 |

Source: Company, Nomura estimates

## Investment thesis

### Secular growth in China

**Growing market share in China**

Given its widening coverage in China, we expect Synnex to benefit from rising IT and handset demand in China. Synnex's channel coverage in tier-1 to tier-3 cities has already reached 100%, while its coverage in tier-4 and tier-5 cities has also increased to 85% and 40%, respectively, in 2010. In addition, Synnex has been increasing its product offering by strengthening ties with leading PC OEMs. Aside from distributing a large portion (35-40%) of PC products for HPQ and Toshiba, Synnex also works closely with Acer, Asustek, Dell and Lenovo. We expect sales contribution from selling these emerging PC brands to rise significantly, and Synnex to have a more diversified product portfolio.

Synnex currently enjoys a 10% market share in China's consumer electronics segment. Given its cost competitiveness, Synnex also started distributing IT products to Suning and Gome. On its expanding channel network, Synnex targets a 20% market share in China's IT distribution market within three years.

### Rising sales from handset distribution

**Benefiting from rising allocation of handset distribution from Nokia**

We expect the sales contribution from handset distribution to rise in the coming years given the company's strengthening relationship with Nokia. In FY10, Synnex distributed 10% of Nokia's handsets, with the main focus on smartphones. Compared with other major handset distributors in China, we believe that Synnex still has ample room to grow. Its major competitors include Telling Telecom and China Postel, with market shares of 29% and 29%, respectively. However, we note that the leading players have reached dominant market share, and Synnex boasts cost advantages, inventory management capability and a strong IT distribution network, which suggest that Synnex still has ample room for growth in China's handset distribution market. Synnex aims to grow its handset distribution sales contribution to 30% within three years, from 15% in FY09.

### Valuation

**We expect share price re-rating on improving ROE and earnings momentum from China**

Our DCF-based price target of NT$90 implies 20x/16x FY11/12F EPS. At our price target, the stock would trade at the mid range of its adjusted five-year forward P/E trading band of 6-30x. We use a DCF-based valuation to reflect channel distributors' capability to generate stable cash inflows. In our DCF valuation, we assume the company maintains revenue growth of 1% y-y in FY18F as growth in the global PC/handset market is likely to gradually become saturated. We apply a cost of equity of 9.02%, which assumes a risk-free rate of 2.6%, a market risk premium of 6.0% and an equity beta of 1.07. On the back of secular growth in China's IT/handset market, margin expansion, and improving ROE performance, we see re-rating opportunities for Synnex.

### Investment risks

Downside risks include: 1) weaker-than-expected PC and handset demand; 2) worse-than-expected operating margin performance due to irrational price competition; 3) inventory write-down if end demand turns out to be much worse than expected; 4) higher-than-expected operating expenses; and 5) unexpected bad debt write-offs on tight credit conditions.

# Financial statements

| Income statement (NT$mn) | | | | | |
|---|---|---|---|---|---|
| **Year-end 31 Dec** | **FY08** | **FY09** | **FY10F** | **FY11F** | **FY12F** |
| **Revenue** | 190,002 | 220,725 | 272,774 | 343,607 | 431,252 |
| Cost of goods sold | (181,813) | (211,804) | (262,570) | (330,345) | (414,432) |
| **Gross profit** | **8,189** | **8,922** | **10,204** | **13,262** | **16,820** |
| SG&A | (5,702) | (5,302) | (5,488) | (6,649) | (8,135) |
| Employee share expense | | | | | |
| **Operating profit** | **2,487** | **3,620** | **4,716** | **6,613** | **8,685** |
| | | | | | |
| **EBITDA** | **2,774** | **3,920** | **4,996** | **6,900** | **8,997** |
| Depreciation | (268) | (277) | (260) | (267) | (292) |
| Amortisation | (20) | (24) | (20) | (20) | (20) |
| **EBIT** | **2,487** | **3,620** | **4,716** | **6,613** | **8,685** |
| Net interest expense | (394) | (223) | (220) | (188) | (252) |
| Associates & JCEs | 970 | 978 | 1,240 | 1,328 | 1,829 |
| Other income | 826 | 1,286 | 823 | 200 | 200 |
| **Earnings before tax** | **3,889** | **5,660** | **6,559** | **7,953** | **10,462** |
| Income tax | (551) | (833) | (1,004) | (1,254) | (1,650) |
| **Net profit after tax** | **3,338** | **4,828** | **5,555** | **6,699** | **8,812** |
| Minority interests | (45) | - | - | - | - |
| Other items | | | | | |
| Preferred dividends | - | - | - | - | - |
| **Normalised NPAT** | **3,293** | **4,828** | **5,555** | **6,699** | **8,812** |
| Extraordinary items | - | - | - | - | - |
| **Reported NPAT** | **3,293** | **4,828** | **5,555** | **6,699** | **8,812** |
| Dividends | (2,168) | (1,565) | (3,230) | (2,777) | (3,349) |
| **Transfer to reserves** | **1,125** | **3,263** | **2,325** | **3,922** | **5,462** |
| | | | | | |
| **Valuation and ratio analysis** | | | | | |
| FD normalised P/E (x) | 28.3 | 21.3 | 21.1 | 17.5 | 13.3 |
| FD normalised P/E at price target (x) | 32.9 | 24.8 | 24.6 | 20.4 | 15.5 |
| Reported P/E (x) | 28.3 | 21.3 | 21.1 | 17.5 | 13.3 |
| Dividend yield (%) | 1.7 | 3.1 | 2.4 | 2.9 | 3.8 |
| Price/cashflow (x) | 88.5 | 143.5 | 110.4 | na | na |
| Price/book (x) | 3.3 | 3.2 | 3.2 | 2.9 | 2.5 |
| EV/EBITDA (x) | 34.2 | 26.3 | 20.8 | 16.5 | 13.0 |
| EV/EBIT (x) | 37.0 | 28.0 | 21.7 | 17.1 | 13.4 |
| Gross margin (%) | 4.3 | 4.0 | 3.7 | 3.9 | 3.9 |
| EBITDA margin (%) | 1.5 | 1.8 | 1.8 | 2.0 | 2.1 |
| EBIT margin (%) | 1.3 | 1.6 | 1.7 | 1.9 | 2.0 |
| Net margin (%) | 1.7 | 2.2 | 2.0 | 1.9 | 2.0 |
| Effective tax rate (%) | 14.2 | 14.7 | 15.3 | 15.8 | 15.8 |
| Dividend payout (%) | 65.8 | 32.4 | 58.1 | 41.5 | 38.0 |
| Capex to sales (%) | 0.3 | 0.3 | 0.2 | 0.1 | 0.1 |
| Capex to depreciation (x) | 2.2 | 2.3 | 2.0 | 1.5 | 1.4 |
| ROE (%) | 12.1 | 16.2 | 16.2 | 17.4 | 20.4 |
| ROA (pretax %) | 6.2 | 7.3 | 8.3 | 9.5 | 10.2 |
| | | | | | |
| **Growth (%)** | | | | | |
| Revenue | 11.1 | 16.2 | 23.6 | 26.0 | 25.5 |
| EBITDA | (19.7) | 41.3 | 27.4 | 38.1 | 30.4 |
| EBIT | (21.3) | 45.6 | 30.3 | 40.2 | 31.3 |
| Normalised EPS | (22.0) | 32.9 | 0.7 | 20.6 | 31.5 |
| Normalised FDEPS | (22.0) | 32.9 | 0.7 | 20.6 | 31.5 |
| | | | | | |
| **Per share** | | | | | |
| Reported EPS (NT$) | 2.73 | 3.64 | 3.66 | 4.41 | 5.80 |
| Norm EPS (NT$) | 2.73 | 3.64 | 3.66 | 4.41 | 5.80 |
| Fully diluted norm EPS (NT$) | 2.73 | 3.64 | 3.66 | 4.41 | 5.80 |
| Book value per share (NT$) | 23.09 | 24.04 | 24.14 | 26.72 | 30.32 |
| DPS (NT$) | 1.30 | 2.42 | 1.83 | 2.21 | 2.90 |

Source: Nomura estimates

Rising ROE

| Cashflow (NT$mn) | | | | | |
|---|---|---|---|---|---|
| **Year-end 31 Dec** | **FY08** | **FY09** | **FY10F** | **FY11F** | **FY12F** |
| EBITDA | 2,774 | 3,920 | 4,996 | 6,900 | 8,997 |
| Change in working capital | (823) | (3,449) | (4,238) | (10,492) | (11,257) |
| Other operating cashflow | (899) | 244 | 306 | 86 | 127 |
| **Cashflow from operations** | **1,051** | **716** | **1,063** | **(3,507)** | **(2,133)** |
| Capital expenditure | (595) | (641) | (524) | (400) | (400) |
| **Free cashflow** | **456** | **75** | **538** | **(3,907)** | **(2,533)** |
| Reduction in investments | 241 | 334 | (140) | - | 1,306 |
| Net acquisitions | 138 | - | - | - | - |
| Reduction in other LT assets | (90) | (50) | (132) | - | - |
| Addition in other LT liabilities | | | | | |
| Adjustments | (128) | 388 | (218) | - | - |
| **Cashflow after investing acts** | **618** | **746** | **49** | **(3,907)** | **(1,227)** |
| Cash dividends | (2,168) | (1,565) | (3,230) | (2,777) | (3,349) |
| Equity issue | - | - | 494 | - | - |
| Debt issue | 4,265 | (1,903) | 10,151 | - | 1,854 |
| Convertible debt issue | | | | | |
| Others | 940 | 35 | 115 | - | - |
| **Cashflow from financial acts** | **3,037** | **(3,433)** | **7,530** | **(2,777)** | **(1,495)** |
| **Net cashflow** | **3,654** | **(2,687)** | **7,579** | **(6,684)** | **(2,722)** |
| Beginning cash | 3,450 | 7,104 | 4,417 | 11,995 | 5,312 |
| Ending cash | 7,104 | 4,417 | 11,995 | 5,312 | 2,590 |
| Ending net debt | 10,582 | 11,524 | 12,105 | 18,789 | 23,365 |

Source: Nomura estimates

| Balance sheet (NT$mn) | | | | | |
|---|---|---|---|---|---|
| **As at 31 Dec** | **FY08** | **FY09** | **FY10F** | **FY11F** | **FY12F** |
| Cash & equivalents | 7,104 | 4,417 | 11,995 | 5,312 | 2,590 |
| Marketable securities | 682 | 1,327 | 1,306 | 1,306 | - |
| Accounts receivable | 20,963 | 26,511 | 28,632 | 38,030 | 48,107 |
| Inventories | 17,485 | 20,856 | 22,030 | 29,267 | 36,991 |
| Other current assets | 3,341 | 5,901 | 6,794 | 9,024 | 11,416 |
| **Total current assets** | **49,575** | **59,011** | **70,758** | **82,939** | **99,103** |
| LT investments | 9,013 | 9,479 | 10,171 | 10,171 | 10,171 |
| Fixed assets | 2,692 | 3,053 | 3,278 | 3,411 | 3,518 |
| Goodwill | | | | | |
| Other intangible assets | 688 | 730 | 855 | 835 | 816 |
| Other LT assets | 1,181 | 1,292 | 1,343 | 1,343 | 1,343 |
| **Total assets** | **63,150** | **73,566** | **86,405** | **98,700** | **114,951** |
| Short-term debt | 12,441 | 7,539 | 17,689 | 17,689 | 17,689 |
| Accounts payable | 11,950 | 17,668 | 17,931 | 23,822 | 30,109 |
| Other current liabilities | 5,561 | 7,873 | 7,560 | 10,042 | 12,691 |
| **Total current liabilities** | **29,953** | **33,079** | **43,180** | **51,553** | **60,488** |
| Long-term debt | 5,244 | 8,402 | 6,411 | 6,411 | 8,266 |
| Convertible debt | - | - | - | - | - |
| Other LT liabilities | 150 | 161 | 174 | 174 | 174 |
| **Total liabilities** | **35,346** | **41,643** | **49,766** | **58,139** | **68,928** |
| Minority interest | - | - | - | - | - |
| Preferred stock | - | - | - | - | - |
| Common stock | 12,040 | 13,281 | 15,180 | 15,180 | 15,180 |
| Retained earnings | 4,608 | 6,338 | 6,666 | 9,917 | 14,499 |
| Proposed dividends | 11,155 | 12,304 | 14,793 | 15,463 | 16,344 |
| Other equity and reserves | | | | | |
| **Total shareholders' equity** | **27,803** | **31,923** | **36,639** | **40,560** | **46,023** |
| **Total equity & liabilities** | **63,150** | **73,566** | **86,405** | **98,700** | **114,951** |
| | | | | | |
| **Liquidity (x)** | | | | | |
| Current ratio | 1.66 | 1.78 | 1.64 | 1.61 | 1.64 |
| Interest cover | 6.3 | 16.2 | 21.4 | 35.3 | 34.4 |
| | | | | | |
| **Leverage** | | | | | |
| Net debt/EBITDA (x) | 3.81 | 2.94 | 2.42 | 2.72 | 2.60 |
| Net debt/equity (%) | 38.1 | 36.1 | 33.0 | 46.3 | 50.8 |
| | | | | | |
| **Activity (days)** | | | | | |
| Days receivable | 40.2 | 39.3 | 36.9 | 35.4 | 36.6 |
| Days inventory | 34.3 | 33.0 | 29.8 | 28.3 | 29.3 |
| Days payable | 25.7 | 25.5 | 24.7 | 23.1 | 23.8 |
| Cash cycle | 48.8 | 46.8 | 42.0 | 40.7 | 42.0 |

Source: Nomura estimates

# Simplo Technology 6121 TT

TECHNOLOGY/PC HARDWARE | TAIWAN

Maintained

BUY


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NOMURA INTERNATIONAL (HK) LIMITED
TAIPEI BRANCH

## Action

We reaffirm our BUY rating on Simplo and put our PT under review. Simplo is our preferred name in the NB component sector on market-share gains with additional client wins, cost advantages on enviable scale and proprietary sorting technology, and easing material pricing. Moreover, its early entry into the EV battery system area could bring re-rating opportunities, in our view.

## Catalysts

We see shipment growth from tablet PCs and strong growth in the EV business as potential positive catalysts for Simplo in 2011F.

## Anchor themes

Our 2011F global client PC growth forecast is 8%, which is below consensus. For 2010F, we expect global client PC shipments to grow 14%, with NB shipments up 20%. As tablet PCs continue to cannibalise netbooks, we look for combined shipments of NBs and netbooks to grow 12% in 2011F vs 20% in 2010F.

| | |
|---|---|
| Closing price on 3 Jan | NT$210.5 |
| Price target* | **NT$230.0** |
| | (set on 1 Dec 10) |
| Upside/downside | 9.3% |
| Difference from consensus | **4.5%** |
| FY11F net profit (NT$mn) | 3,898 |
| Difference from consensus | **-1.8%** |

* Price target under review

Source: Nomura

## Nomura vs consensus

Our earnings forecast for FY10/11F is 1%/2% lower than market consensus. Given its solid growth outlook and attractive valuation, we retain our positive view on this stock.

# Fully charged for the next run

## ① Promising growth outlook for 2011

We reaffirm BUY on Simplo and put our PT under review. We believe Simplo will likely see strong NB battery pack shipment growth from Apple, Asustek, Toshiba, Sony, and Lenovo in 2011F. In particular, Simplo should be able to benefit from Apple's strong growth in iPad and Macbook, given its niches in polymer battery packs, in our view.

## ② Riding on EV battery's story

Simplo's progress in the EV battery business should serve as the next growth opportunity. We project the EV battery system will account for 3-4% of Simplo's revenue in 2011F. In our view, its cooperation with China's Potevio to expand into the EV business should serve as a potential re-rating catalyst for Simplo in the long term.

## ③ Major beneficiary from tablet PC growth

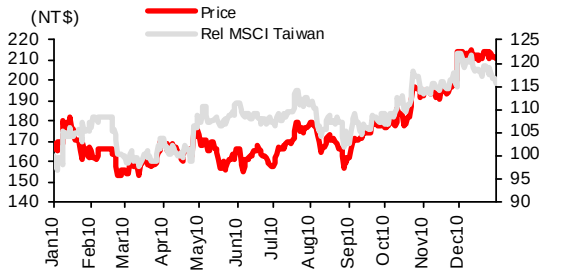
For 2011F, we see tablet PC battery pack as the main growth driver for Simplo. While the market is concerned about tablet PCs cannibalising the netbook market, we expect Simplo, a primary NB component maker, to see limited impact. As tablet PCs usually use polymer battery packs for longer battery life and thin-and-light design, the rising shipment mix of polymer battery packs could help lift Simplo's margin trend, as polymer battery packs are priced 20% higher than lithium-ion battery packs. Simplo currently enjoys a leading position in the polymer battery pack market and supplies 60-70% of iPad's battery packs, according to our supply chain check. As we expect Apple to be the biggest winner in the tablet PC market in 2011F, grabbing a 70% market share, we believe Simplo will likely be the major beneficiary from tablet PC growth.

## Key financials & valuations

| Error 2029 (NT$mn) | FY09 | FY10F | FY11F | FY12F |
|---|---|---|---|---|
| Revenue | 34,253 | 38,466 | 45,336 | 52,508 |
| Reported net profit | 2,458 | 3,318 | 3,898 | 4,534 |
| Normalised net profit | 2,458 | 3,318 | 3,898 | 4,534 |
| Normalised EPS (NT$) | 10.61 | 13.02 | 15.30 | 17.80 |
| Norm. EPS growth (%) | 3.5 | 22.7 | 17.5 | 16.3 |
| Norm. P/E (x) | 19.8 | 16.2 | 13.8 | 11.8 |
| EV/EBITDA (x) | 13.9 | 10.7 | 8.7 | 7.3 |
| Price/book (x) | 4.3 | 3.9 | 3.4 | 2.9 |
| Dividend yield (%) | 2.4 | 2.8 | 3.2 | 3.7 |
| ROE (%) | 22.6 | 26.2 | 26.1 | 25.9 |
| Net debt/equity (%) | net cash | net cash | net cash | net cash |
| **Earnings revisions** | | | | |
| Previous norm. net profit | | 3,318 | 3,898 | 4,534 |
| Change from previous (%) | | - | - | - |
| Previous norm. EPS (NT$) | | 13.02 | 15.30 | 17.80 |

Source: Company, Nomura estimates

## Share price relative to MSCI Taiwan




| | 1m | 3m | 6m |
|---|---|---|---|
| Absolute (NT$) | (1.6) | 16.3 | 33.5 |
| Absolute (US$) | 2.4 | 23.8 | 47.8 |
| Relative to Index | (5.6) | 7.1 | 11.0 |

| | |
|---|---|
| Market cap (US$mn) | 1,842 |
| Estimated free float (%) | 57.1 |
| 52-week range (NT$) | 215.5/153.2 |
| 3-mth avg daily turnover (US$mn) | 8.53 |
| Stock borrowability | Hard |
| Major shareholders (%) | |
| HYIELD VENTURE CAPIT | 4.4 |
| QUANTA COMPUTER INC | 4.3 |

Source: Company, Nomura estimates

Investment thesis

# Rosy 2011F growth outlook

## Continued market share gains

Rising NB battery pack shipments to Apple, Asustek, Toshiba, Sony and Lenovo in 2011

While we are conservative on global NB shipment growth, forecasting combined NB and netbook growth of 12% for 2011F. We expect Simplo's NB battery pack shipments to grow 17% in 2011F on rising shipments to Apple, Asustek, Toshiba, Sony, and Lenovo. In particular, Simplo should, in our view, be able to benefit from Apple's strong growth in iPad and Macbook. After the official launch of Macbook Air, we see rising interest from PC buyers, based on our channel checks and feedbacks from retailers. We believe Simplo is well positioned to benefit from this trend, as it supplies 70% of Macbook Air battery demand. Sales contribution from Apple has continued to grow over the past four quarters, and we estimate Apple will account for 10% of Simplo's 2010F sales. In addition to Apple's business, Asustek will switch volume orders away from Celxpert, which supplies 70% of Asustek's NB battery pack, to Simplo starting from 2011, according to our channel checks. We believe this will serve as one new growth drivers for Simplo in 2011F, given that for 2010F, we estimate that Simplo will have supplied less than 10% of Asustek's demand. As Asustek continues to gain market share in the global NB market, from 7% in 2009 to 8.4% in 2010F, on our numbers, we believe new order wins from Asustek will support Simplo's growth in the NB battery pack business in the next two years. Based on Simplo's new client wins, we expect Simplo's worldwide market share to rise to 23% in 2011F, from 22% in 2010F.

## Valuation remains attractive

Simplo is our top pick in the NB component sector on the back of market share gains with additional client wins, cost advantages on enviable scale and proprietary sorting technology, and easing material pricing. In addition, its progress in the EV battery business should provide re-rating opportunities for this stock, in our view.

Our DCF-based price target of NT$230 implies 15.0x/12.9x FY11F/12F EPS. At our price target, the stock would trade at the mid-to-higher range of its adjusted five-year forward P/E trading band of 6.0-20.0x. We use a DCF-based valuation to reflect Simplo's capability to generate stable cash inflows. Our DCF assumes revenue growth would continue at 1% after FY18F, given saturating PC growth. We apply a cost of equity of 9.8%, which assumes a risk-free rate of 2.6%, a market risk premium of 6.0%, and an equity beta of 1.2.

## Investment risks

Downside risks to our price target include: 1) weaker-than-expected global PC demand; 2) worse-than-expected operating margin performance due to irrational price competition; 3) slower-than-expected market share gains; 4) slower-than-forecast progress in the EV business; and 5) supply shortages in NB battery cells.

# Financial statements

| Income statement (NT$mn) | | | | | |
|---|---|---|---|---|---|
| **Year-end Error 2029** | **FY08** | **FY09** | **FY10F** | **FY11F** | **FY12F** |
| **Revenue** | 30,736 | 34,253 | 38,466 | 45,336 | 52,508 |
| Cost of goods sold | (25,540) | (28,351) | (31,599) | (37,406) | (43,323) |
| **Gross profit** | **5,197** | **5,902** | **6,867** | **7,931** | **9,185** |
| SG&A | (2,690) | (2,576) | (2,410) | (2,434) | (2,794) |
| Employee share expense | - | - | (450) | (755) | (878) |
| **Operating profit** | **2,507** | **3,326** | **4,007** | **4,742** | **5,512** |
| | | | | | |
| **EBITDA** | **2,933** | **3,566** | **4,446** | **5,344** | **6,225** |
| Depreciation | (426) | (240) | (439) | (602) | (712) |
| Amortisation | - | - | - | - | - |
| **EBIT** | **2,507** | **3,326** | **4,007** | **4,742** | **5,512** |
| Net interest expense | 117 | 53 | 36 | 17 | 33 |
| Associates & JCEs | - | - | - | - | - |
| Other income | 551 | 14 | 152 | 80 | 80 |
| **Earnings before tax** | **3,175** | **3,392** | **4,196** | **4,839** | **5,626** |
| Income tax | (830) | (961) | (876) | (941) | (1,092) |
| **Net profit after tax** | **2,345** | **2,431** | **3,320** | **3,898** | **4,534** |
| Minority interests | 8 | 27 | (1) | - | - |
| Other items | - | - | - | - | - |
| Preferred dividends | - | - | - | - | - |
| **Normalised NPAT** | **2,354** | **2,458** | **3,318** | **3,898** | **4,534** |
| Extraordinary items | - | - | - | - | - |
| **Reported NPAT** | **2,354** | **2,458** | **3,318** | **3,898** | **4,534** |
| Dividends | (928) | (1,043) | (1,158) | (1,509) | (1,715) |
| **Transfer to reserves** | **1,426** | **1,415** | **2,160** | **2,388** | **2,819** |
| | | | | | |
| **Valuation and ratio analysis** | | | | | |
| FD normalised P/E (x) | 20.5 | 19.8 | 16.2 | 13.8 | 11.8 |
| FD normalised P/E at price target (x) | 22.4 | 21.7 | 17.7 | 15.0 | 12.9 |
| Reported P/E (x) | 20.5 | 19.8 | 16.2 | 13.8 | 11.8 |
| Dividend yield (%) | 2.4 | 2.4 | 2.8 | 3.2 | 3.7 |
| Price/cashflow (x) | 24.6 | 18.9 | 13.7 | 15.5 | 13.3 |
| Price/book (x) | 4.8 | 4.3 | 3.9 | 3.4 | 2.9 |
| EV/EBITDA (x) | 17.3 | 13.9 | 10.7 | 8.7 | 7.3 |
| EV/EBIT (x) | 20.3 | 14.9 | 11.9 | 9.9 | 8.2 |
| Gross margin (%) | 16.9 | 17.2 | 17.9 | 17.5 | 17.5 |
| EBITDA margin (%) | 9.5 | 10.4 | 11.6 | 11.8 | 11.9 |
| EBIT margin (%) | 8.2 | 9.7 | 10.4 | 10.5 | 10.5 |
| Net margin (%) | 7.7 | 7.2 | 8.6 | 8.6 | 8.6 |
| Effective tax rate (%) | 26.1 | 28.3 | 20.9 | 19.4 | 19.4 |
| Dividend payout (%) | 39.4 | 42.4 | 34.9 | 38.7 | 37.8 |
| Capex to sales (%) | 4.1 | 1.5 | 2.3 | 2.2 | 1.9 |
| Capex to depreciation (x) | 2.9 | 2.1 | 2.0 | 1.7 | 1.4 |
| ROE (%) | 25.3 | 22.6 | 26.2 | 26.1 | 25.9 |
| ROA (pretax %) | 18.6 | 21.6 | 23.7 | 23.7 | 22.8 |
| | | | | | |
| **Growth (%)** | | | | | |
| Revenue | 33.1 | 11.4 | 12.3 | 17.9 | 15.8 |
| EBITDA | 0.1 | 21.6 | 24.7 | 20.2 | 16.5 |
| EBIT | (7.9) | 32.7 | 20.5 | 18.3 | 16.2 |
| Normalised EPS | 1.8 | 3.5 | 22.7 | 17.5 | 16.3 |
| Normalised FDEPS | 1.8 | 3.5 | 22.7 | 17.5 | 16.3 |
| | | | | | |
| **Per share** | | | | | |
| Reported EPS (NT$) | 10.3 | 10.6 | 13.0 | 15.3 | 17.8 |
| Norm EPS (NT$) | 10.3 | 10.6 | 13.0 | 15.3 | 17.8 |
| Fully diluted norm EPS (NT$) | 10.3 | 10.6 | 13.0 | 15.3 | 17.8 |
| Book value per share (NT$) | 43.4 | 49.5 | 53.3 | 62.7 | 73.8 |
| DPS (NT$) | 5.0 | 5.0 | 5.9 | 6.7 | 7.8 |

Source: Nomura estimates

Sustainable ROE to provide downside protection

| Cashflow (NT$mn) | | | | | |
|---|---|---|---|---|---|
| **Year-end Error 2029** | **FY08** | **FY09** | **FY10F** | **FY11F** | **FY12F** |
| EBITDA | 2,933 | 3,566 | 4,446 | 5,344 | 6,225 |
| Change in working capital | (854) | (484) | 87 | (1,046) | (1,219) |
| Other operating cashflow | (114) | (503) | (608) | (844) | (978) |
| **Cashflow from operations** | **1,966** | **2,579** | **3,925** | **3,454** | **4,027** |
| Capital expenditure | (1,256) | (500) | (897) | (1,000) | (1,000) |
| **Free cashflow** | **709** | **2,079** | **3,028** | **2,454** | **3,027** |
| Reduction in investments | 18 | 247 | (47) | - | - |
| Net acquisitions | - | - | - | - | - |
| Reduction in other LT assets | (59) | 33 | 91 | - | - |
| Addition in other LT liabilities | | | | | |
| Adjustments | 147 | (128) | (37) | - | - |
| **Cashflow after investing acts** | **814** | **2,230** | **3,035** | **2,454** | **3,027** |
| Cash dividends | (928) | (1,043) | (1,158) | (1,509) | (1,715) |
| Equity issue | - | - | - | - | - |
| Debt issue | 329 | (8) | 546 | - | - |
| Convertible debt issue | - | - | - | - | - |
| Others | 46 | 35 | (3) | 84 | 148 |
| **Cashflow from financial acts** | **(553)** | **(1,016)** | **(615)** | **(1,425)** | **(1,567)** |
| **Net cashflow** | **262** | **1,214** | **2,420** | **1,029** | **1,460** |
| Beginning cash | 2,846 | 3,108 | 4,322 | 6,742 | 7,771 |
| Ending cash | 3,108 | 4,322 | 6,742 | 7,771 | 9,231 |
| Ending net debt | (2,779) | (4,002) | (5,875) | (6,904) | (8,364) |

Source: Nomura estimates

| Balance sheet (NT$mn) | | | | | |
|---|---|---|---|---|---|
| **As at Error 2029** | **FY08** | **FY09** | **FY10F** | **FY11F** | **FY12F** |
| Cash & equivalents | 3,108 | 4,322 | 6,742 | 7,771 | 9,231 |
| Marketable securities | 676 | 438 | 460 | 460 | 460 |
| Accounts receivable | 5,837 | 6,829 | 7,695 | 9,662 | 12,025 |
| Inventories | 4,239 | 4,712 | 5,616 | 7,015 | 8,751 |
| Other current assets | 1,044 | 297 | 348 | 437 | 544 |
| **Total current assets** | **14,904** | **16,598** | **20,861** | **25,345** | **31,010** |
| LT investments | 72 | 59 | 144 | 144 | 144 |
| Fixed assets | 3,021 | 3,265 | 3,718 | 4,116 | 4,404 |
| Goodwill | - | - | - | - | - |
| Other intangible assets | - | - | - | - | - |
| Other LT assets | 174 | 147 | 82 | 82 | 82 |
| **Total assets** | **18,171** | **20,068** | **24,805** | **29,686** | **35,639** |
| Short-term debt | 329 | 320 | 867 | 867 | 867 |
| Accounts payable | 5,547 | 5,303 | 6,360 | 7,944 | 9,909 |
| Other current liabilities | 1,993 | 2,470 | 3,321 | 4,146 | 5,167 |
| **Total current liabilities** | **7,869** | **8,093** | **10,547** | **12,956** | **15,942** |
| Long-term debt | - | - | - | - | - |
| Convertible debt | - | - | - | - | - |
| Other LT liabilities | 182 | 377 | 529 | 613 | 761 |
| **Total liabilities** | **8,051** | **8,469** | **11,076** | **13,569** | **16,703** |
| Minority interest | 154 | 129 | 137 | 137 | 137 |
| Preferred stock | - | - | - | - | - |
| Common stock | 2,086 | 2,316 | 2,548 | 2,548 | 2,548 |
| Retained earnings | 3,863 | 4,834 | 6,432 | 8,431 | 10,796 |
| Proposed dividends | - | - | - | - | - |
| Other equity and reserves | 4,017 | 4,319 | 4,612 | 5,002 | 5,455 |
| **Total shareholders' equity** | **9,966** | **11,470** | **13,592** | **15,981** | **18,799** |
| **Total equity & liabilities** | **18,171** | **20,068** | **24,805** | **29,686** | **35,639** |
| | | | | | |
| **Liquidity (x)** | | | | | |
| Current ratio | 1.89 | 2.05 | 1.98 | 1.96 | 1.95 |
| Interest cover | na | na | na | na | na |
| | | | | | |
| **Leverage** | | | | | |
| Net debt/EBITDA (x) | net cash | net cash | net cash | net cash | net cash |
| Net debt/equity (%) | net cash | net cash | net cash | net cash | net cash |
| | | | | | |
| **Activity (days)** | | | | | |
| Days receivable | 65.6 | 67.5 | 68.9 | 69.9 | 75.6 |
| Days inventory | 51.5 | 57.6 | 59.6 | 61.6 | 66.6 |
| Days payable | 71.0 | 69.8 | 67.4 | 69.8 | 75.4 |
| Cash cycle | 46.2 | 55.3 | 61.2 | 61.7 | 66.8 |

Source: Nomura estimates

# Chinatrust FHC 2891 TT

FINANCIALS | TAIWAN


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Maintained

**BUY**


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NOMURA INTERNATIONAL (HK) LIMITED
TAIPEI BRANCH


## Action

We reaffirm BUY on Chinatrust FHC and put our PT under review. We expect Chinatrust FHC to enjoy strong organic growth as Taiwanese consumers begin to re-leverage balance sheets on improved job market and wage growth. The potential acquisition of AIG (Taiwan) will help diversify profitability, in our view.

## Catalysts

The potential acquisition of AIG (Taiwan) and market-share gains in the more profitable consumer-lending business could serve as share price catalysts.

## Anchor themes

We believe net interest margin of Taiwan banks will expand alongside rate hikes, which could last until 2012F. Trade barriers in services across the Strait are likely to reduce post ECFA, offering business opportunities in China. In addition, benefits from domestic consolidation could exceed current market expectations.

| | |
|---|---|
| Closing price on 3 Jan | NT$21.85 |
| Price target* | **NT$24.10** |
| | (set on 24 Nov 10) |
| Upside/downside | 10.3% |
| Difference from consensus | **14.8%** |
| FY11F net profit (NT$mn) | 17,633 |
| Difference from consensus | **11.7%** |

* Price target under review

Source: Nomura

## Nomura vs consensus

We are more bullish than consensus on 2011F profits due to unsecured consumer loan growth and the lower provisioning charges from Chinatrust USA.

# Insuring growth recovery

### ① Beneficiary of consumer re-leveraging

Taiwan is experiencing the strongest job market recovery in 20-plus years with wage inflation likely to appear. We expect Taiwanese consumers to continue re-leveraging into 2011F. We believe Chinatrust is well positioned due to its scale leadership, strong know-how and capitalisation. More importantly, easing competition will likely improve profitability of the consumer banking business.

### ② Strong earnings quality with growth potential

We believe Chinatrust has the best earnings quality in our coverage universe, with fee income accounting for almost 50% of gross income in 2010F (vs the average of 27.2% for peers). We expect it to continue to benefit from lower provisioning costs due to recovery gains on unsecured loan losses, which we estimate to amount to NT$14-17bn, subject to its collection team's execution efficiency.

### ③ Worst of Chinatrust USA is behind

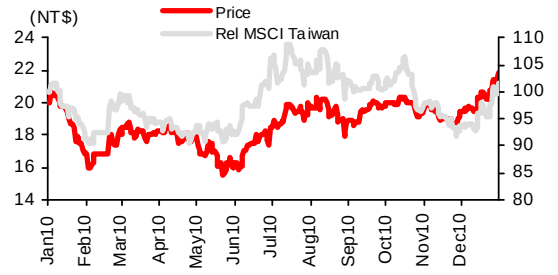
With an NPL ratio of 0.6%, Chinatrust USA has streamlined its operations to account for only 3%-plus of Chinatrust's loan book. In addition, we note that the impairment assets it recently disposed of (to its parent company) are already priced at less than 48 cents to the dollar, which implies little downside risks, in our view.

**Key financials & valuations**

| 31 Dec (NT$mn) | FY09 | FY10F | FY11F | FY12F |
|---|---|---|---|---|
| PPOP | 15,888 | 19,782 | 25,515 | 31,968 |
| Reported net profit | 1,381 | 13,826 | 17,633 | 21,330 |
| Normalised net profit | 1,381 | 13,826 | 17,633 | 21,330 |
| Normalised EPS (NT$) | 0.15 | 1.49 | 1.77 | 2.14 |
| Norm. EPS growth (%) | (90.8) | 876.5 | 18.6 | 21.0 |
| Norm. P/E (x) | 143.2 | 14.7 | 12.4 | 10.2 |
| Price/adj. book (x) | 1.71 | 1.73 | 1.63 | 1.52 |
| Price/book (x) | 1.35 | 1.38 | 1.32 | 1.25 |
| Dividend yield (%) | 2.9 | 4.6 | 5.5 | 6.8 |
| ROE (%) | 1.2 | 11.2 | 13.4 | 15.3 |
| ROA (%) | 0.08 | 0.77 | 0.94 | 1.10 |
| **Earnings revisions** | | | | |
| Previous norm. net profit | | 13,826 | 17,633 | 21,330 |
| Change from previous (%) | | - | - | - |
| Previous norm. EPS (NT$) | | 1.49 | 1.77 | 2.14 |

Source: Company, Nomura estimates

**Share price relative to MSCI Taiwan**




| | 1m | 3m | 6m |
|---|---|---|---|
| Absolute (NT$) | 12.6 | 10.6 | 18.4 |
| Absolute (US$) | 17.3 | 17.8 | 31.2 |
| Relative to Index | 9.2 | 1.1 | (5.7) |

| | |
|---|---|
| Market cap (US$mn) | 7,490 |
| Estimated free float (%) | 80.0 |
| 52-week range (NT$) | 21.85/15.50 |
| 3-mth avg daily turnover (US$mn) | 25.98 |
| Stock borrowability | Hard |
| Major shareholders (%) | |
| Koo Family | 20.0 |

Source: Company, Nomura estimates

## Valuation methodology

Our price target of NT$24.10 is based on a dividend discount model, which assumes a terminal growth rate of 4% and a dividend payout ratio of 65%. This implies a multiple of 18.8x 2011F PER and 1.4x 2011F PBR, the mid-point of its historical trading band. One standard-deviation (1xSD) would translate into a valuation of 1.65x PBR. We note that our target valuation multiple (1.4x 2011F PBR) is also justified by our Golden Growth Model where we assume a sustainable ROE of 14% with cost of equity of 8%. We assume Taiwan's risk-free rate at 2%.

## Risks to our investment view

**Disposed impaired assets are now booked at less than 48 cents to one dollar based on the original book value**

In a bid to improve asset quality, in 2Q10, Chinatrust's US subsidiary disposed of impaired assets to its holding company, Chinatrust Capital Corp (CCC), at a transfer price of US$194mn, despite an original book value of US$394m (or 49 cents to the dollar). These impaired assets are currently booked in CCC under the category of loans held for sale (LHFS) and other real estate owned (OREO). Before these assets can be disposed of, CCC would have to incur losses if the US economy continues to deteriorate on falling property prices. For instance, CCC already booked an additional mark-to-market loss of US$6.1m in 3Q10 (1.5% of the original book value). To date, we see little downside risks from this, as the value of these impaired assets has been written down to less than 48 cents to the dollar on historical costs.

Other major risks stem from M&A. Chinatrust could overpay to acquire Nan Shan Life (AIG Taiwan), resulting in a greater-than-expected earnings dilution. Also, Chinatrust does not have much experience in running the life insurance business in Taiwan.

# Financial statements

| Profit and Loss (NT$mn) | | | | | |
|---|---|---|---|---|---|
| **Year-end 31 Dec** | **FY08** | **FY09** | **FY10F** | **FY11F** | **FY12F** |
| Interest income | 58,639 | 36,594 | 34,410 | 40,568 | 47,081 |
| Interest expense | (28,873) | (14,234) | (10,174) | (11,617) | (12,927) |
| **Net interest income** | **29,767** | **22,360** | **24,236** | **28,951** | **34,154** |
| Net fees and commissions | 22,525 | 22,677 | 25,851 | 28,437 | 31,280 |
| Trading related profits | 1,713 | 1,649 | 1,732 | 1,766 | 1,855 |
| Other operating revenue | 6,546 | (506) | - | - | - |
| **Non-interest income** | **30,784** | **23,820** | **27,583** | **30,203** | **33,135** |
| **Operating income** | **60,551** | **46,180** | **51,819** | **59,154** | **67,289** |
| Depreciation | (2,599) | (2,428) | (2,501) | (2,626) | (2,757) |
| Amortisation | | | | | |
| Operating expenses | (28,237) | (27,865) | (29,536) | (31,013) | (32,564) |
| Employee share expense | | | | | |
| **Op. profit before provisions** | **29,714** | **15,888** | **19,782** | **25,515** | **31,968** |
| Provisions for bad debt | (12,621) | (12,433) | (1,840) | (2,985) | (4,984) |
| Other provision charges | - | - | - | - | - |
| **Operating profit** | **17,093** | **3,455** | **17,942** | **22,530** | **26,984** |
| Other non-operating income | (731) | 301 | - | - | - |
| Associates & JCEs | - | - | - | - | - |
| **Pre-tax profit** | **16,362** | **3,756** | **17,942** | **22,530** | **26,984** |
| Income tax | (1,584) | (1,317) | (3,050) | (3,830) | (4,587) |
| **Net profit after tax** | **14,778** | **2,439** | **14,892** | **18,700** | **22,397** |
| Minority interests | (71) | (8) | (17) | (17) | (17) |
| Other items | | | | | |
| Preferred dividends | (1,050) | (1,050) | (1,050) | (1,050) | (1,050) |
| **Normalised NPAT** | **13,657** | **1,381** | **13,826** | **17,633** | **21,330** |
| Extraordinary items | | | | | |
| **Reported NPAT** | **13,657** | **1,381** | **13,826** | **17,633** | **21,330** |
| Dividends | (1,629) | (5,939) | (9,980) | (11,975) | (14,931) |
| **Transfer to reserves** | **12,027** | **(4,558)** | **3,846** | **5,658** | **6,399** |
| | | | | | |
| **Valuation and ratio analysis** | | | | | |
| FD normalised P/E (x) | 13.2 | 143.2 | 14.7 | 12.4 | 10.2 |
| FD normalised P/E at price target (x) | 14.5 | 158.0 | 16.2 | 13.6 | 11.3 |
| Reported P/E (x) | 13.2 | 143.2 | 14.7 | 12.4 | 10.2 |
| Dividend yield (%) | 0.8 | 2.9 | 4.6 | 5.5 | 6.8 |
| Price/book (x) | 1.4 | 1.4 | 1.4 | 1.3 | 1.2 |
| Price/adjusted book (x) | 1.8 | 1.7 | 1.7 | 1.6 | 1.5 |
| Net interest margin (%) | 2.60 | 1.90 | 1.95 | 2.13 | 2.34 |
| Yield on interest earning assets (%) | 5.12 | 3.11 | 2.77 | 2.99 | 3.22 |
| Cost of interest bearing liabilities (%) | 1.85 | 0.89 | 0.62 | 0.68 | 0.73 |
| Net interest spread (%) | 3.27 | 2.22 | 2.15 | 2.31 | 2.49 |
| Non-interest/operating income (%) | 50.8 | 51.6 | 53.2 | 51.1 | 49.2 |
| Cost to income (%) | 50.9 | 65.6 | 61.8 | 56.9 | 52.5 |
| Effective tax rate (%) | 9.7 | 35.1 | 17.0 | 17.0 | 17.0 |
| Dividend payout (%) | 11.9 | 430.0 | 72.2 | 67.9 | 70.0 |
| ROE (%) | 12.2 | 1.2 | 11.2 | 13.4 | 15.3 |
| ROA (%) | 0.80 | 0.08 | 0.77 | 0.94 | 1.10 |
| Operating ROE (%) | 15.3 | 3.0 | 14.5 | 17.2 | 19.3 |
| Operating ROA (%) | 1.00 | 0.20 | 1.00 | 1.20 | 1.39 |
| | | | | | |
| **Growth (%)** | | | | | |
| Net interest income | (9.1) | (24.9) | 8.4 | 19.5 | 18.0 |
| Non-interest income | 13.2 | (22.6) | 15.8 | 9.5 | 9.7 |
| Non-interest expenses | (2.1) | (1.3) | 6.0 | 5.0 | 5.0 |
| Pre-provision earnings | 4.5 | (46.5) | 24.5 | 29.0 | 25.3 |
| Net profit | 11.1 | (89.9) | 901.1 | 27.5 | 21.0 |
| Normalised EPS | 7.8 | (90.8) | 876.5 | 18.6 | 21.0 |
| Normalised FDEPS | 7.8 | (90.8) | 876.5 | 18.6 | 21.0 |

Source: Nomura estimates

Fee income accounts for 45%+ of gross income, the highest among local peers

Chinatrust's preferred shares of NT$30bn (3.5% yield) to mature at end-2012F

Payout ratio could decline if Chinatrust acquires AIG (Taiwan)

| Balance Sheet (NT$mn) | | | | | |
|---|---|---|---|---|---|
| **As at 31 Dec** | **FY08** | **FY09** | **FY10F** | **FY11F** | **FY12F** |
| Cash and equivalents | 378,391 | 408,831 | 417,007 | 429,517 | 442,403 |
| Inter-bank lending | | | | | |
| Deposits with central bank | | | | | |
| Total securities | 252,260 | 272,554 | 278,005 | 286,345 | 294,935 |
| Other interest earning assets | | | | | |
| Gross loans | 933,355 | 919,623 | 1,039,174 | 1,132,700 | 1,234,643 |
| Less provisions | (11,680) | (13,743) | (12,834) | (11,327) | (12,346) |
| **Net loans** | **921,675** | **905,880** | **1,026,340** | **1,121,373** | **1,222,296** |
| Long-term investments | | | | | |
| Fixed assets | 33,494 | 34,142 | 34,996 | 35,346 | 35,699 |
| Goodwill | 2,229 | 2,265 | 2,322 | 2,345 | 2,369 |
| Other intangible assets | | | | | |
| Other non IEAs | 139,217 | 136,914 | 83,441 | 36,270 | (13,330) |
| **Total assets** | **1,727,266** | **1,760,586** | **1,842,110** | **1,911,196** | **1,984,373** |
| Customer deposits | 1,226,171 | 1,307,717 | 1,373,103 | 1,428,027 | 1,485,148 |
| Bank deposits, CDs, debentures | | | | | |
| Other interest bearing liabilities | 356,370 | 296,382 | 304,592 | 310,996 | 317,592 |
| **Total interest bearing liabilities** | **1,582,541** | **1,604,098** | **1,677,695** | **1,739,023** | **1,802,740** |
| Non interest bearing liabilities | 4,458 | 6,673 | 6,873 | 6,976 | 7,081 |
| **Total liabilities** | **1,586,999** | **1,610,771** | **1,684,568** | **1,745,999** | **1,809,821** |
| Minority interest | 76 | 90 | 90 | 90 | 90 |
| Common stock | 90,987 | 93,844 | 93,844 | 93,844 | 93,844 |
| Preferred stock | 30,000 | 30,000 | 30,000 | 30,000 | 30,000 |
| Retained earnings | 37,072 | 34,425 | 41,864 | 49,518 | 58,872 |
| Proposed dividends | | | | | |
| Other equity | (17,867) | (8,544) | (8,255) | (8,255) | (8,255) |
| **Shareholders' equity** | **140,191** | **149,725** | **157,453** | **165,107** | **174,462** |
| **Total liabilities and equity** | **1,727,266** | **1,760,586** | **1,842,110** | **1,911,196** | **1,984,373** |
| *Non-performing assets (NT$)* | *15,651* | *11,970* | *6,755* | *5,663* | *6,173* |
| | | | | | |
| **Balance sheet ratios (%)** | | | | | |
| Loans to deposits | 76.1 | 70.3 | 75.7 | 79.3 | 83.1 |
| Equity to assets | 8.1 | 8.5 | 8.5 | 8.6 | 8.8 |
| | | | | | |
| **Asset quality & capital** | | | | | |
| NPAs/gross loans (%) | 1.7 | 1.3 | 0.7 | 0.5 | 0.5 |
| Bad debt charge/gross loans (%) | 1.35 | 1.35 | 0.18 | 0.26 | 0.40 |
| Loss reserves/assets (%) | 0.68 | 0.78 | 0.70 | 0.59 | 0.62 |
| Loss reserves/NPAs (%) | 74.6 | 114.8 | 190.0 | 200.0 | 200.0 |
| Tier 1 capital ratio (%) | 9.1 | 9.1 | 9.1 | 9.4 | 9.7 |
| Total capital ratio (%) | 12.2 | 12.2 | 14.3 | 14.3 | 14.5 |
| | | | | | |
| **Growth (%)** | | | | | |
| Loan growth | 5.2 | (1.7) | 13.3 | 9.3 | 9.0 |
| Interest earning assets | 5.1 | 0.4 | 10.7 | 7.9 | 7.8 |
| Interest bearing liabilities | 3.2 | 1.4 | 4.6 | 3.7 | 3.7 |
| Asset growth | 2.3 | 1.9 | 4.6 | 3.8 | 3.8 |
| Deposit growth | 3.9 | 6.7 | 5.0 | 4.0 | 4.0 |
| | | | | | |
| **Per share** | | | | | |
| Reported EPS (NT$) | 1.66 | 0.15 | 1.49 | 1.77 | 2.14 |
| Norm EPS (NT$) | 1.66 | 0.15 | 1.49 | 1.77 | 2.14 |
| Fully diluted norm EPS (NT$) | 1.66 | 0.15 | 1.49 | 1.77 | 2.14 |
| DPS (NT$) | 0.18 | 0.64 | 1.00 | 1.20 | 1.50 |
| PPOP PS (NT$) | 3.61 | 1.76 | 2.13 | 2.56 | 3.20 |
| BVPS (NT$) | 15.49 | 16.13 | 15.78 | 16.54 | 17.48 |
| ABVPS (NT$) | 12.06 | 12.79 | 12.67 | 13.43 | 14.37 |
| NTAPS (NT$) | 15.24 | 15.89 | 15.54 | 16.31 | 17.24 |

Source: Nomura estimates

Our ABVPS estimate excludes all preferred shares

# President Chain Store 2912 TT

CONSUMER RELATED/RETAIL | TAIWAN

Maintained

BUY


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NOMURA

NOMURA INTERNATIONAL (HK) LIMITED
TAIPEI BRANCH

## Action

We reaffirm our BUY on PCS with a PT of NT$159. We expect it to maintain strong top-line growth in FY11F, backed by its real and virtual business models, intra-group sales ability, cross-industry ventures with its large retail network and a resilient consumption environment.

## Catalysts

PCS' solid top-line growth backed by its growth strategies and a resilient consumption environment should continue to support a re-rating.

## Anchor themes

PCS' established mega network (more than 4,730 CVS stores and other retail outlets) should enable it to drive further growth by cross-industry ventures with other service providers, as well as its tangible plus virtual 7net on-line portal.

| | |
|---|---|
| Closing price on 3 Jan | NT$135.0 |
| Price target | **NT$159.0** |
| | (set on 16 Dec 10) |
| Upside/downside | 17.8% |
| Difference from consensus | **44.5%** |
| FY11F net profit (NT$mn) | 6,950 |
| Difference from consensus | **8.5%** |

Source: Nomura

## Nomura vs consensus

We are bullish on the outlook for PCS' convenience and retail operations in FY11F because of its growth strategy.

# Meaner cash machine (IV)

### ① We expect another year of resilient growth in FY11

We expect domestic consumption to remain buoyant in FY11F, backed by resilient export growth, continuous improvement in the labour market, strong consumer confidence and wealth effects from the equity and property markets. We expect PCS to further store expansion and deepen efforts in product and service diversification, which we estimate will support top-line growth of 11% in FY11F and 9% in FY12F.

### ② Sales growth from large store re-formatting …

PCS places more emphasis on lifting store sales than increasing the number of stores. We expect PCS to expand its store size over FY11-12F, as large stores (exceeding 100sqm) tend to generate 30% more revenue. In FY11F, PCS expects to expand 500 stores so that large stores account for 35% of total stores (currently 4,734), up from 26% in FY10F.

### ③ … and ventures with other industry leaders

We expect PCS' 7net online retailing to post accelerating sales in FY11F due to an increased number of members and product SKUs, and estimate this business will contribute 1-2% of total revenue in FY11F, from 0.2% in FY10. We also see it becoming a more significant revenue contributor in the medium term, backed by strong pan-PCS group resources. PCS' large network should also enable it to team up with leaders in other industries (such as Metro Taipei, Chunghwa Telecom, airlines, etc) to boost in-store traffic, we believe.

### ④ Valuation and risk

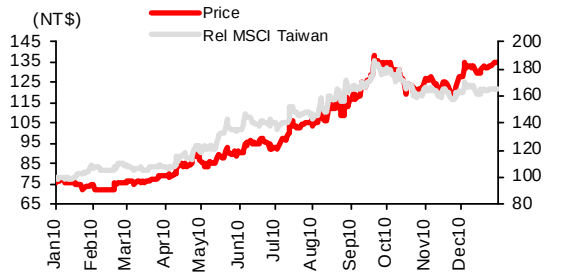
Our SOTP-based PT of NT$159 incorporates 19x FY11F P/E for PCS' CVS and profit-making operations and 1x FY11F P/BV for its other retail and distribution operations (0.9x P/BV if loss making). Risks include lower-than-expected domestic consumption and slower-than-expected ramp-up of CVS stores in China.

## Key financials & valuations

| 31 Dec (NT$mn) | FY09 | FY10F | FY11F | FY12F |
|---|---|---|---|---|
| Revenue | 101,756 | 115,130 | 128,229 | 139,550 |
| Reported net profit | 4,059 | 6,340 | 6,950 | 7,752 |
| Normalised net profit | 3,359 | 6,133 | 6,950 | 7,752 |
| Normalised EPS (NT$) | 3.23 | 5.90 | 6.69 | 7.46 |
| Norm. EPS growth (%) | (16.0) | 82.6 | 13.3 | 11.5 |
| Norm. P/E (x) | 41.8 | 22.9 | 20.2 | 18.1 |
| EV/EBITDA (x) | 21.4 | 16.2 | 14.5 | 13.1 |
| Price/book (x) | 6.5 | 6.6 | 6.2 | 5.8 |
| Dividend yield (%) | 1.5 | 2.7 | 3.6 | 4.0 |
| ROE (%) | 23.0 | 31.6 | 31.8 | 33.2 |
| Net debt/equity (%) | 9.5 | net cash | net cash | net cash |
| **Earnings revisions** | | | | |
| Previous norm. net profit | | 6,133 | 6,950 | 7,752 |
| Change from previous (%) | | - | - | - |
| Previous norm. EPS (NT$) | | 5.90 | 6.69 | 7.46 |

Source: Company, Nomura estimates

## Share price relative to MSCI Taiwan




| | 1m | 3m | 6m |
|---|---|---|---|
| Absolute (NT$) | 5.9 | 2.3 | 45.0 |
| Absolute (US$) | 10.2 | 8.9 | 60.6 |
| Relative to Index | 2.2 | (7.8) | 23.7 |
| Market cap (US$mn) | | | 4,823 |
| Estimated free float (%) | | | 40.0 |
| 52-week range (NT$) | | | 138.0/72.3 |
| 3-mth avg daily turnover (US$mn) | | | 9.44 |
| Stock borrowability | | | Hard |
| Major shareholders (%) | | | |
| Uni-President | | | 45.4 |
| - | | | - |

Source: Company, Nomura estimates

# Financial statements

| Income statement (NT$mn) | | | | | |
|---|---|---|---|---|---|
| **Year-end 31 Dec** | **FY08** | **FY09** | **FY10F** | **FY11F** | **FY12F** |
| **Revenue** | 102,191 | 101,756 | 115,130 | 128,229 | 139,550 |
| Cost of goods sold | (69,456) | (68,791) | (78,960) | (87,542) | (94,990) |
| **Gross profit** | **32,735** | **32,965** | **36,171** | **40,687** | **44,561** |
| SG&A | (28,126) | (28,071) | (30,480) | (33,969) | (36,964) |
| Employee share expense | - | - | - | - | - |
| **Operating profit** | **4,609** | **4,894** | **5,691** | **6,718** | **7,597** |
| | | | | | |
| **EBITDA** | **6,425** | **6,760** | **7,580** | **8,550** | **9,382** |
| Depreciation | (1,793) | (1,759) | (1,784) | (1,727) | (1,682) |
| Amortisation | (23) | (107) | (105) | (104) | (103) |
| **EBIT** | **4,609** | **4,894** | **5,691** | **6,718** | **7,597** |
| Net interest expense | (154) | (41) | (40) | (45) | (45) |
| Associates & JCEs | 146 | (116) | 1,106 | 1,030 | 1,238 |
| Other income | (217) | (793) | 500 | 570 | 550 |
| **Earnings before tax** | **4,384** | **3,944** | **7,257** | **8,274** | **9,340** |
| Income tax | (862) | (585) | (1,124) | (1,324) | (1,588) |
| **Net profit after tax** | **3,522** | **3,359** | **6,133** | **6,950** | **7,752** |
| Minority interests | - | - | - | - | - |
| Other items | - | - | | - | - |
| Preferred dividends | - | - | - | - | - |
| **Normalised NPAT** | **3,522** | **3,359** | **6,133** | **6,950** | **7,752** |
| Extraordinary items | | 700 | 207 | - | - |
| **Reported NPAT** | **3,522** | **4,059** | **6,340** | **6,950** | **7,752** |
| Dividends | (2,928) | (1,866) | (3,746) | (5,096) | (5,560) |
| **Transfer to reserves** | **594** | **2,193** | **2,593** | **1,853** | **2,192** |
| | | | | | |
| **Valuation and ratio analysis** | | | | | |
| FD normalised P/E (x) | 35.1 | 41.8 | 22.9 | 20.2 | 18.1 |
| FD normalised P/E at price target (x) | 41.3 | 49.2 | 27.0 | 23.8 | 21.3 |
| Reported P/E (x) | 35.1 | 34.6 | 22.1 | 20.2 | 18.1 |
| Dividend yield (%) | 2.4 | 1.5 | 2.7 | 3.6 | 4.0 |
| Price/cashflow (x) | 22.5 | 18.9 | 15.9 | 14.4 | 14.2 |
| Price/book (x) | 7.5 | 6.5 | 6.6 | 6.2 | 5.8 |
| EV/EBITDA (x) | 21.9 | 21.4 | 16.2 | 14.5 | 13.1 |
| EV/EBIT (x) | 30.3 | 29.8 | 20.7 | 18.0 | 15.7 |
| Gross margin (%) | 32.0 | 32.4 | 31.4 | 31.7 | 31.9 |
| EBITDA margin (%) | 6.3 | 6.6 | 6.6 | 6.7 | 6.7 |
| EBIT margin (%) | 4.5 | 4.8 | 4.9 | 5.2 | 5.4 |
| Net margin (%) | 3.4 | 4.0 | 5.5 | 5.4 | 5.6 |
| Effective tax rate (%) | 19.7 | 14.8 | 15.5 | 16.0 | 17.0 |
| Dividend payout (%) | 83.1 | 46.0 | 59.1 | 73.3 | 71.7 |
| Capex to sales (%) | 2.1 | 1.3 | 1.1 | 1.2 | 1.1 |
| Capex to depreciation (x) | 1.2 | 0.7 | 0.7 | 0.9 | 0.9 |
| ROE (%) | 21.5 | 23.0 | 31.6 | 31.8 | 33.2 |
| ROA (pretax %) | 12.1 | 11.2 | 15.1 | 16.3 | 17.6 |
| | | | | | |
| **Growth (%)** | | | | | |
| Revenue | (0.2) | (0.4) | 13.1 | 11.4 | 8.8 |
| EBITDA | (3.5) | 5.2 | 12.1 | 12.8 | 9.7 |
| EBIT | (5.1) | 6.2 | 16.3 | 18.1 | 13.1 |
| Normalised EPS | (2.8) | (16.0) | 82.6 | 13.3 | 11.5 |
| Normalised FDEPS | (2.8) | (16.0) | 82.6 | 13.3 | 11.5 |
| | | | | | |
| **Per share** | | | | | |
| Reported EPS (NT$) | 3.85 | 3.90 | 6.10 | 6.69 | 7.46 |
| Norm EPS (NT$) | 3.85 | 3.23 | 5.90 | 6.69 | 7.46 |
| Fully diluted norm EPS (NT$) | 3.85 | 3.23 | 5.90 | 6.69 | 7.46 |
| Book value per share (NT$) | 17.97 | 20.68 | 20.40 | 21.68 | 23.25 |
| DPS (NT$) | 3.20 | 2.04 | 3.60 | 4.90 | 5.35 |

Source: Nomura estimates

Resilient top-line growth for FY11-12F

| Cashflow (NT$mn) | | | | | |
|---|---|---|---|---|---|
| **Year-end 31 Dec** | **FY08** | **FY09** | **FY10F** | **FY11F** | **FY12F** |
| EBITDA | 6,425 | 6,760 | 7,580 | 8,550 | 9,382 |
| Change in working capital | 1,217 | 1,401 | 1,545 | 1,553 | 1,149 |
| Other operating cashflow | (2,157) | (716) | (299) | (355) | (628) |
| **Cashflow from operations** | **5,485** | **7,445** | **8,826** | **9,748** | **9,902** |
| Capital expenditure | (2,097) | (1,298) | (1,300) | (1,500) | (1,500) |
| **Free cashflow** | **3,388** | **6,147** | **7,526** | **8,248** | **8,402** |
| Reduction in investments | (4,031) | (2,543) | (2,479) | (2,086) | (2,283) |
| Net acquisitions | 2,107 | (109) | 995 | 601 | 798 |
| Reduction in other LT assets | (8) | 30 | - | - | - |
| Addition in other LT liabilities | 208 | 254 | (16) | (15) | (15) |
| Adjustments | (235) | (105) | (100) | (100) | (100) |
| **Cashflow after investing acts** | **1,429** | **3,674** | **5,926** | **6,648** | **6,802** |
| Cash dividends | (2,928) | (1,866) | (3,746) | (5,096) | (5,560) |
| Equity issue | - | - | - | - | - |
| Debt issue | 1,301 | (2,000) | (300) | (300) | (300) |
| Convertible debt issue | - | - | - | - | - |
| Others | (165) | (15) | (344) | (532) | (579) |
| **Cashflow from financial acts** | **(1,792)** | **(3,881)** | **(4,391)** | **(5,928)** | **(6,439)** |
| **Net cashflow** | **(363)** | **(207)** | **1,535** | **720** | **363** |
| Beginning cash | 5,879 | 5,514 | 5,305 | 6,839 | 7,559 |
| Ending cash | 5,516 | 5,307 | 6,840 | 7,559 | 7,922 |
| Ending net debt | 3,586 | 1,795 | (39) | (1,059) | (1,722) |

Source: Nomura estimates

Strong cashflow generation capabilities

| Balance sheet (NT$mn) | | | | | |
|---|---|---|---|---|---|
| **As at 31 Dec** | **FY08** | **FY09** | **FY10F** | **FY11F** | **FY12F** |
| Cash & equivalents | 5,514 | 5,305 | 6,839 | 7,559 | 7,922 |
| Marketable securities | 6,150 | 7,261 | 7,261 | 7,261 | 7,261 |
| Accounts receivable | 637 | 348 | 394 | 439 | 477 |
| Inventories | 3,294 | 2,946 | 3,421 | 3,804 | 4,137 |
| Other current assets | 1,327 | 1,556 | 1,864 | 2,074 | 2,257 |
| **Total current assets** | **16,922** | **17,416** | **19,778** | **21,137** | **22,054** |
| LT investments | 19,848 | 21,280 | 23,759 | 25,845 | 28,128 |
| Fixed assets | 7,806 | 7,620 | 7,136 | 6,909 | 6,727 |
| Goodwill | - | - | - | - | - |
| Other intangible assets | 273 | 283 | 278 | 274 | 271 |
| Other LT assets | 2,282 | 2,252 | 2,252 | 2,252 | 2,252 |
| **Total assets** | **47,131** | **48,851** | **53,203** | **56,416** | **59,432** |
| Short-term debt | - | - | - | - | - |
| Accounts payable | 10,611 | 10,686 | 12,205 | 13,573 | 14,760 |
| Other current liabilities | 8,632 | 9,550 | 10,404 | 11,228 | 11,744 |
| **Total current liabilities** | **19,243** | **20,236** | **22,609** | **24,801** | **26,503** |
| Long-term debt | 9,100 | 7,100 | 6,800 | 6,500 | 6,200 |
| Convertible debt | - | - | - | - | - |
| Other LT liabilities | 2,340 | 2,594 | 2,578 | 2,563 | 2,548 |
| **Total liabilities** | **30,683** | **29,930** | **31,987** | **33,864** | **35,251** |
| Minority interest | - | - | - | - | - |
| Preferred stock | - | - | - | - | - |
| Common stock | 9,152 | 10,396 | 10,402 | 10,402 | 10,402 |
| Retained earnings | 6,873 | 7,820 | 9,168 | 8,209 | 8,501 |
| Proposed dividends | - | - | - | - | - |
| Other equity and reserves | 423 | 705 | 1,646 | 3,941 | 5,277 |
| **Total shareholders' equity** | **16,448** | **18,921** | **21,216** | **22,552** | **24,180** |
| **Total equity & liabilities** | **47,131** | **48,851** | **53,203** | **56,416** | **59,432** |
| | | | | | |
| **Liquidity (x)** | | | | | |
| Current ratio | 0.88 | 0.86 | 0.87 | 0.85 | 0.83 |
| Interest cover | 29.9 | 119.4 | 142.3 | 149.3 | 168.8 |
| | | | | | |
| **Leverage** | | | | | |
| Net debt/EBITDA (x) | 0.56 | 0.27 | net cash | net cash | net cash |
| Net debt/equity (%) | 21.8 | 9.5 | net cash | net cash | net cash |
| | | | | | |
| **Activity (days)** | | | | | |
| Days receivable | 1.8 | 1.8 | 1.2 | 1.2 | 1.2 |
| Days inventory | 16.6 | 16.6 | 14.7 | 15.1 | 15.3 |
| Days payable | 46.3 | 56.5 | 52.9 | 53.7 | 54.6 |
| Cash cycle | (27.9) | (38.2) | (37.0) | (37.5) | (38.1) |

Source: Nomura estimates

# Formosa Chem & Fibre 1326 TT

OIL & GAS/CHEMICALS | TAIWAN

Maintained

BUY


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NOMURA

NOMURA INTERNATIONAL (HK) LIMITED

## Action

FCFC is our top pick in the Formosa group as it is our preferred play on exceptionally strong polyester fundamentals − record-low inventories, rising consumer demand and substitution of cotton by synthetic fibres. We remain Bullish on FCFC and maintain our PT of NT$106 (under review with an upward bias), equivalent to 2.4x FY11F P/BV, the stock's historical peak-cycle multiple.

## Catalysts

We believe that the likely improvement in margins of PTA in 2011 and further evidence of resilient phenol and ABS margins are key positive catalysts.

## Anchor themes

We believe the chemical sector is poised to enter a golden age, benefiting from rising demand and restrained capacity additions in the next two years. We believe the sector's rerating will be underpinned by expectations of an ethylene upcycle, receding fears of oversupply and upward revisions in street estimates.

| | |
|---|---|
| Closing price on 3 Jan | NT$97.7 |
| Price target* | **NT$106.0** |
| | (set on 3 Nov 10) |
| Upside/downside | 8.5% |
| Difference from consensus | **30.9%** |
| FY11F net profit (NT$mn) | 47,047 |
| Difference from consensus | **0.3%** |

* Price target under review

Source: Nomura

## Nomura vs consensus

We believe our FY11F estimates are largely in line with consensus.

# Preferred polyester play

### ① Most geared towards consumption

We believe FCFC is well placed to benefit from the theme of rising China consumer demand as key products such as PTA (feedstock for polyester), ABS (consumer appliances) and phenol (feedstock for PCBs) are primarily geared towards consumer demand.

### ② Significant expansion in 2013

FCFC is planning the largest capacity expansion in the Ningbo Phase 2 buildout within the Formosa group, and has committed to investing over US$1bn to construct new capacity of PTA (1.5mn tpa/+53% volume growth), phenol (300k tpa/+75% volume growth), PS (200k tpa/+38% volume growth) and ABS (150k tpa/+21% volume growth). This significant volume growth should help to offset the anticipated weaker margin environment in 2013F, in our view.

### ③ Valuations look undemanding despite recent run

Despite FCFC's recent strong share price performance (+28% over the past three months, outperforming the Taiex by 21%), we believe valuations remain undemanding as it still offers an FY10-12F dividend yield of 7-8%, the highest in the Formosa group on our reading.

### ④ Reiterate BUY

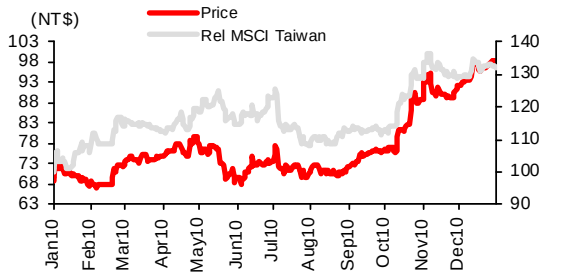
With a PT of NT$106 (under review with an upward bias), we reaffirm our BUY rating.

## Key financials & valuations

| 31 Dec (NT$mn) | FY09 | FY10F | FY11F | FY12F |
|---|---|---|---|---|
| Revenue | 219,729 | 277,481 | 300,587 | 321,887 |
| Reported net profit | 29,489 | 43,336 | 47,047 | 48,995 |
| Normalised net profit | 29,329 | 43,378 | 47,047 | 48,995 |
| Normalised EPS (NT$) | 5.15 | 7.62 | 8.27 | 8.61 |
| Norm. EPS growth (%) | 250.3 | 47.9 | 8.5 | 4.1 |
| Norm. P/E (x) | 19.0 | 12.8 | 11.8 | 11.3 |
| EV/EBITDA (x) | 14.4 | 10.8 | 10.1 | 9.8 |
| Price/book (x) | 2.4 | 2.3 | 2.2 | 2.1 |
| Dividend yield (%) | 4.6 | 7.0 | 7.6 | 7.9 |
| ROE (%) | 14.5 | 18.3 | 19.0 | 19.2 |
| Net debt/equity (%) | 32.3 | 22.6 | 22.6 | 22.4 |
| **Earnings revisions** | | | | |
| Previous norm. net profit | | 43,378 | 47,047 | 48,995 |
| Change from previous (%) | | - | - | - |
| Previous norm. EPS (NT$) | | 7.62 | 8.27 | 8.61 |

Source: Company, Nomura estimates

## Share price relative to MSCI Taiwan




| | 1m | 3m | 6m |
|---|---|---|---|
| Absolute (NT$) | 5.9 | 28.6 | 32.9 |
| Absolute (US$) | 10.2 | 36.9 | 47.2 |
| Relative to Index | 2.2 | 20.2 | 10.4 |

| | |
|---|---|
| Market cap (US$mn) | 19,097 |
| Estimated free float (%) | 60.0 |
| 52-week range (NT$) | 98.2/67.1 |
| 3-mth avg daily turnover (US$mn) | 30.10 |
| Stock borrowability | Hard |
| Major shareholders (%) | |
| Wang family | 31.6 |
| Formosa Plastics | 3.4 |

Source: Company, Nomura estimates

Drilling down

## PTA – riding the polyester boom

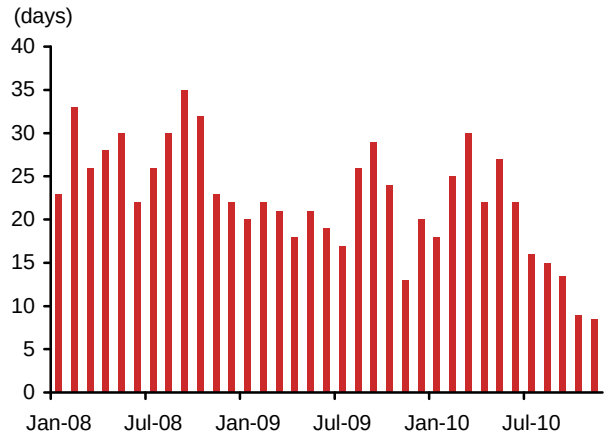
Exceptionally strong polyester fundamentals

We believe that rising consumer spending in Taiwan and the recent spike in cotton prices have led to the strongest polyester fundamentals in many years, resulting in record-low inventory levels even with increased polyester production in China.

We believe PTA offers the best exposure to polyester strength, as it has the tightest supply/demand balance among polyester intermediates. Over the past two months, PTA margins have risen to US$374/t from US$220/t – if margins were to be sustained at this level in 2011, this would introduce upside risks to our earnings estimates (based on a US$270/t margin forecast for FY11F).

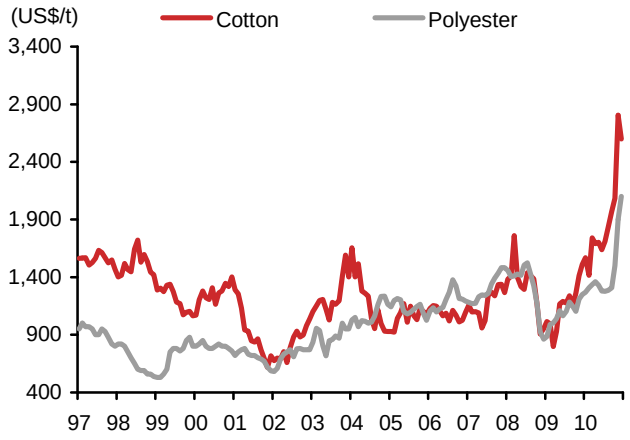
We think FCFC looks well placed to take advantage of rising PTA margins with its PTA production capacity of 2.8mn tpa (8% of Asian capacity) and vertical integration into PX. We estimate that each US$10/t improvement in PTA margins would increase FCFC's net profit by 1.5%.

**Exhibit 76. China polyester fiber inventory**




Source: CMAI

**Exhibit 77. Polyester vs cotton prices**




Source: Thomson Reuters Datastream

## ABS, SM and Phenol — stable to improving trends

ABS – benefiting from strong appliance demand

We believe that the outlook for FCFC's other key products are also stable to positive. ABS prices have remained strong due to consistently growing end-demand of appliances and cars. SM margins have been weak recently, but we forecast a tightening supply/demand balance over the next few years. Finally, phenol margins remain at elevated levels, which we expect to be sustained due to limited supply expansions over the next two years.

## Improving contributions from FPCC

We believe that FPCC's earnings would have bottomed out in 3Q10F (net profit down 49% y-y) as a majority of the impact of its plant fires occurred during that period. We forecast FPCC's earnings to improve as plant utilization rates pick up while refining margins remain robust. As FPCC earnings constitute 25% of FCFC's net profit, this should have a significant positive impact on FCFC's net profit.

### Price target derivation and investment risks

Our PT of NT$106 is based on a sum-of-the-parts analysis, which values FCFC's core business at 2.2 EV/IC (average FY10F-12F ROIC of 19.1%; WACC of 8.5%), investments in the Formosa group at our price targets, other listed investments at market price and unlisted investments at 1.5x book value. Key risks include volatile crude prices, volatile aromatic margins and plant mechanical failure.

# Financial statements

| Income statement (NT$mn) | | | | | |
|---|---|---|---|---|---|
| **Year-end 31 Dec** | **FY08** | **FY09** | **FY10F** | **FY11F** | **FY12F** |
| **Revenue** | 249,817 | 219,729 | 277,481 | 300,587 | 321,887 |
| Cost of goods sold | (245,628) | (202,891) | (246,465) | (265,909) | (285,391) |
| **Gross profit** | **4,190** | **16,839** | **31,016** | **34,678** | **36,495** |
| SG&A | (6,978) | (6,597) | (6,987) | (7,815) | (8,369) |
| Employee share expense | - | - | - | - | - |
| **Operating profit** | **(2,788)** | **10,242** | **24,029** | **26,863** | **28,126** |
| | | | | | |
| **EBITDA** | **7,255** | **24,166** | **34,184** | **35,206** | **36,132** |
| Depreciation | (10,043) | (13,924) | (10,155) | (8,343) | (8,006) |
| Amortisation | - | - | - | - | - |
| **EBIT** | **(2,788)** | **10,242** | **24,029** | **26,863** | **28,126** |
| Net interest expense | (2,307) | (1,429) | (1,090) | (751) | (770) |
| Associates & JCEs | 8,669 | 19,759 | 22,653 | 25,445 | 26,391 |
| Other income | 983 | 757 | 884 | 892 | 900 |
| **Earnings before tax** | **4,557** | **29,329** | **46,476** | **52,448** | **54,647** |
| Income tax | 3,571 | - | (3,097) | (5,401) | (5,651) |
| **Net profit after tax** | **8,128** | **29,329** | **43,378** | **47,047** | **48,995** |
| Minority interests | - | - | - | - | - |
| Other items | - | - | - | - | - |
| Preferred dividends | - | - | - | - | - |
| **Normalised NPAT** | **8,128** | **29,329** | **43,378** | **47,047** | **48,995** |
| Extraordinary items | (2,030) | 159 | (43) | - | - |
| **Reported NPAT** | **6,098** | **29,489** | **43,336** | **47,047** | **48,995** |
| Dividends | (4,970) | (25,621) | (39,040) | (42,342) | (44,096) |
| **Transfer to reserves** | **1,128** | **3,868** | **4,295** | **4,705** | **4,900** |
| | | | | | |
| **Valuation and ratio analysis** | | | | | |
| FD normalised P/E (x) | 66.4 | 19.0 | 12.8 | 11.8 | 11.3 |
| FD normalised P/E at price target (x) | 72.1 | 20.6 | 13.9 | 12.8 | 12.3 |
| Reported P/E (x) | 88.5 | 18.9 | 12.8 | 11.8 | 11.3 |
| Dividend yield (%) | 0.9 | 4.6 | 7.0 | 7.6 | 7.9 |
| Price/cashflow (x) | 93.5 | 81.1 | 16.1 | 20.3 | 19.5 |
| Price/book (x) | 3.0 | 2.4 | 2.3 | 2.2 | 2.1 |
| EV/EBITDA (x) | 39.8 | 14.4 | 10.8 | 10.1 | 9.8 |
| EV/EBIT (x) | na | 21.0 | 13.1 | 11.7 | 11.3 |
| Gross margin (%) | 1.7 | 7.7 | 11.2 | 11.5 | 11.3 |
| EBITDA margin (%) | 2.9 | 11.0 | 12.3 | 11.7 | 11.2 |
| EBIT margin (%) | (1.1) | 4.7 | 8.7 | 8.9 | 8.7 |
| Net margin (%) | 2.4 | 13.4 | 15.6 | 15.7 | 15.2 |
| Effective tax rate (%) | (78.4) | - | 6.7 | 10.3 | 10.3 |
| Dividend payout (%) | 81.5 | 86.9 | 90.1 | 90.0 | 90.0 |
| Capex to sales (%) | 2.4 | 1.6 | 0.8 | 1.3 | 1.2 |
| Capex to depreciation (x) | 0.6 | 0.2 | 0.2 | 0.5 | 0.5 |
| ROE (%) | 2.8 | 14.5 | 18.3 | 19.0 | 19.2 |
| ROA (pretax %) | 1.7 | 9.4 | 13.6 | 14.9 | 15.1 |
| | | | | | |
| **Growth (%)** | | | | | |
| Revenue | 4.1 | (12.0) | 26.3 | 8.3 | 7.1 |
| EBITDA | (76.5) | 233.1 | 41.5 | 3.0 | 2.6 |
| EBIT | (112.4) | na | 134.6 | 11.8 | 4.7 |
| Normalised EPS | (81.9) | 250.3 | 47.9 | 8.5 | 4.1 |
| Normalised FDEPS | (81.9) | 250.3 | 47.9 | 8.5 | 4.1 |
| | | | | | |
| **Per share** | | | | | |
| Reported EPS (NT$) | 1.10 | 5.18 | 7.62 | 8.27 | 8.61 |
| Norm EPS (NT$) | 1.47 | 5.15 | 7.62 | 8.27 | 8.61 |
| Fully diluted norm EPS (NT$) | 1.47 | 5.15 | 7.62 | 8.27 | 8.61 |
| Book value per share (NT$) | 32.06 | 40.50 | 42.90 | 44.31 | 45.48 |
| DPS (NT$) | 0.90 | 4.50 | 6.86 | 7.44 | 7.75 |

Source: Nomura estimates

Earnings growth to slow on higher taxes

| Cashflow (NT$mn) | | | | | |
|---|---|---|---|---|---|
| **Year-end 31 Dec** | **FY08** | **FY09** | **FY10F** | **FY11F** | **FY12F** |
| EBITDA | 7,255 | 24,166 | 34,184 | 35,206 | 36,132 |
| Change in working capital | 8,640 | (10,076) | 5,380 | (2,584) | (2,042) |
| Other operating cashflow | (10,122) | (7,235) | (4,935) | (5,260) | (5,529) |
| **Cashflow from operations** | **5,774** | **6,854** | **34,630** | **27,362** | **28,561** |
| Capital expenditure | (6,075) | (3,446) | (2,234) | (4,000) | (4,000) |
| **Free cashflow** | **(301)** | **3,408** | **32,396** | **23,362** | **24,561** |
| Reduction in investments | 62,535 | (47,998) | (5,629) | (11,606) | (9,609) |
| Net acquisitions | - | - | - | - | - |
| Reduction in other LT assets | (5,511) | 4,347 | (319) | - | - |
| Addition in other LT liabilities | 195 | (755) | 185 | - | - |
| Adjustments | (56,126) | 45,512 | 7,293 | (463) | 11,767 |
| **Cashflow after investing acts** | **791** | **4,514** | **33,925** | **11,293** | **26,718** |
| Cash dividends | (38,607) | (4,970) | (25,621) | (39,040) | (42,342) |
| Equity issue | - | - | - | - | - |
| Debt issue | 15,131 | (4,495) | (9,253) | (4,649) | - |
| Convertible debt issue | - | - | - | - | - |
| Others | 22,939 | 4,360 | 11,107 | 25,907 | 14,632 |
| **Cashflow from financial acts** | **(537)** | **(5,106)** | **(23,766)** | **(17,782)** | **(27,711)** |
| **Net cashflow** | **254** | **(591)** | **10,159** | **(6,489)** | **(993)** |
| Beginning cash | 993 | 1,247 | 655 | 10,814 | 4,326 |
| Ending cash | 1,247 | 655 | 10,814 | 4,326 | 3,333 |
| Ending net debt | 78,448 | 74,543 | 55,132 | 56,972 | 57,965 |

Source: Nomura estimates

| Balance sheet (NT$mn) | | | | | |
|---|---|---|---|---|---|
| **As at 31 Dec** | **FY08** | **FY09** | **FY10F** | **FY11F** | **FY12F** |
| Cash & equivalents | 1,247 | 655 | 10,814 | 4,326 | 3,333 |
| Marketable securities | 32,837 | 56,218 | 53,560 | 53,560 | 53,560 |
| Accounts receivable | 19,526 | 30,320 | 33,611 | 35,973 | 37,841 |
| Inventories | 31,312 | 20,761 | 23,241 | 25,529 | 27,338 |
| Other current assets | 1,694 | 3,648 | 3,031 | 3,031 | 3,031 |
| **Total current assets** | **86,615** | **111,602** | **124,257** | **122,419** | **125,102** |
| LT investments | 107,331 | 131,949 | 140,235 | 151,841 | 161,451 |
| Fixed assets | 93,267 | 88,217 | 82,100 | 77,757 | 73,751 |
| Goodwill | - | - | - | - | - |
| Other intangible assets | - | - | - | - | - |
| Other LT assets | 13,050 | 8,703 | 9,022 | 9,022 | 9,022 |
| **Total assets** | **300,264** | **340,470** | **355,614** | **361,039** | **369,326** |
| Short-term debt | 27,922 | 19,394 | 9,297 | 9,297 | 9,297 |
| Accounts payable | 36,254 | 27,685 | 38,853 | 40,920 | 42,553 |
| Other current liabilities | 655 | 1,344 | 711 | 711 | 711 |
| **Total current liabilities** | **64,831** | **48,424** | **48,861** | **50,928** | **52,562** |
| Long-term debt | 51,772 | 55,805 | 56,649 | 52,000 | 52,000 |
| Convertible debt | - | - | - | - | - |
| Other LT liabilities | 6,530 | 5,775 | 5,960 | 5,960 | 5,960 |
| **Total liabilities** | **123,133** | **110,003** | **111,469** | **108,888** | **110,522** |
| Minority interest | - | - | - | - | - |
| Preferred stock | - | - | - | - | - |
| Common stock | 55,247 | 56,905 | 56,905 | 56,905 | 56,905 |
| Retained earnings | 94,770 | 117,585 | 135,314 | 143,320 | 149,973 |
| Proposed dividends | - | - | - | - | - |
| Other equity and reserves | 27,113 | 55,977 | 51,926 | 51,926 | 51,926 |
| **Total shareholders' equity** | **177,131** | **230,466** | **244,144** | **252,151** | **258,804** |
| **Total equity & liabilities** | **300,264** | **340,470** | **355,614** | **361,039** | **369,326** |
| | | | | | |
| **Liquidity (x)** | | | | | |
| Current ratio | 1.34 | 2.30 | 2.54 | 2.40 | 2.38 |
| Interest cover | (1.2) | 7.2 | 22.0 | 35.8 | 36.5 |
| | | | | | |
| **Leverage** | | | | | |
| Net debt/EBITDA (x) | 10.81 | 3.08 | 1.61 | 1.62 | 1.60 |
| Net debt/equity (%) | 44.3 | 32.3 | 22.6 | 22.6 | 22.4 |
| | | | | | |
| **Activity (days)** | | | | | |
| Days receivable | 38.5 | 41.4 | 42.0 | 42.2 | 42.0 |
| Days inventory | 48.7 | 46.8 | 32.6 | 33.5 | 33.9 |
| Days payable | 58.9 | 57.5 | 49.3 | 54.7 | 53.5 |
| Cash cycle | 28.3 | 30.7 | 25.4 | 21.0 | 22.3 |

Source: Nomura estimates

Debt levels stabilising

# Eva Airways Corp 2618 TT

TRANSPORT/LOGISTICS | TAIWAN


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## Action

With Oct 10 air cargo revenues rebounding, we believe concerns on this front may temporarily ease and attention will shift to the China-Taiwan direct link talks, which may provide additional catalysts, such as a possible rise in direct air flights and liberalisation of individual China tourist quotas. We expect the group to post even stronger results in 2011 as direct link impacts continue to feed through.

## Catalysts

Further increases in daily scheduled flights, liberalisation of mainland tourist quota and concrete signs of improvement in macro outlook are near-term catalysts.

## Anchor themes

With the Asian economies (led by China) likely to recover at a much faster pace than the US and Europe, airlines with hubs in Asia could see an earlier recovery than their global peers.

| | |
|---|---|
| Closing price on 3 Jan | NT$36.60 |
| Price target* | **NT$40.00** |
| | (set on 5 Nov 10) |
| Upside/downside | 9.3% |
| Difference from consensus | **53.7%** |
| FY11F net profit (NT$mn) | 14,380 |
| Difference from consensus | **25.1%** |

* Price target under review

Source: Nomura

## Nomura vs consensus

We are higher than market consensus; we believe other analysts are likely to raise their earnings forecasts post strong 3Q results.

# Growth to continue into 2011F

### ① Rebound in cargo revenue in October eased concerns of slowdown

Eva Airways' October cargo revenue was up 4% m-m (36% y-y) and cargo yields continued to hold up well, rebounding 1.6% m-m in Nov 2010. The rebound in cargo revenue and yields has confirmed that the slowdown of cargo volume in 3Q10 is just seasonality adjustment as volumes picked up in 4Q (the peak season). This should ease investor concerns on possible cargo slowdown, we believe.

### ② Catalysts: further liberalisation of direct links

While the implementation of 100 additional direct flights per week in 4Q10 could continue to feed through into 2011F numbers, the recent confirmation of a rise in Chinese tourists' quota to 4,000 from 3,000 and possible liberalization of the individual travel scheme in June 2011 should continue to support the share price, in our view. We expect a further increase in the number of direct air flights in 2011F.

### ③ More contribution from direct air links in 4Q10

Revenue from direct air links contributed 11% of passenger revenue and 3% to cargo revenue in the first nine months of 2010; this compares to 8% of total passenger revenue and 2% of cargo revenue in 2009. We believe that direct link-related revenues may account for over 20% of revenues when fully implemented.

### ④ Deserves to trade above mid-cycle valuation

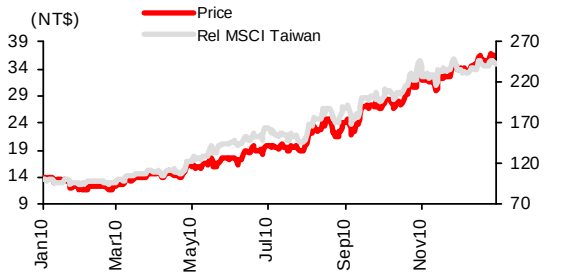
With concerns of a possible cargo slowdown having eased, we believe net profit could see a record high in FY10F and move higher still in FY11F. Consequently, we believe Eva deserves to trade at an above mid-cycle valuation. Our PT of NT$40.0 (under review with an upward bias) is based on 1.9x FY11F P/BV.

**Key financials & valuations**

| 31 Dec (NT$mn) | FY09 | FY10F | FY11F | FY12F |
|---|---|---|---|---|
| Revenue | 73,280 | 105,797 | 118,568 | 133,363 |
| Reported net profit | (2,844) | 13,758 | 14,380 | 15,165 |
| Normalised net profit | (2,902) | 13,739 | 14,380 | 15,165 |
| Normalised EPS (NT$) | (1.19) | 4.64 | 4.85 | 5.12 |
| Norm. EPS growth (%) | na | na | 4.7 | 5.5 |
| Norm. P/E (x) | na | 7.9 | 7.5 | 7.2 |
| EV/EBITDA (x) | 32.6 | 7.1 | 6.1 | 5.1 |
| Price/book (x) | 3.4 | 2.4 | 1.7 | 1.4 |
| Dividend yield (%) | 0.0 | 0.0 | 0.0 | 0.0 |
| ROE (%) | (9.8) | 35.4 | 26.7 | 21.4 |
| Net debt/equity (%) | 254.2 | 137.6 | 69.2 | 25.4 |
| **Earnings revisions** | | | | |
| Previous norm. net profit | | 13,739 | 14,380 | 15,165 |
| Change from previous (%) | | - | - | - |
| Previous norm. EPS (NT$) | | 4.64 | 4.85 | 5.12 |

Source: Company, Nomura estimates

**Share price relative to MSCI Taiwan**




| | 1m | 3m | 6m |
|---|---|---|---|
| Absolute (NT$) | 7.3 | 34.8 | 83.0 |
| Absolute (US$) | 11.8 | 43.5 | 102.7 |
| Relative to Index | 3.7 | 26.8 | 65.8 |

| | |
|---|---|
| Market cap (US$mn) | 3,725 |
| Estimated free float (%) | 68.0 |
| 52-week range (NT$) | 37.00/11.85 |
| 3-mth avg daily turnover (US$mn) | 43.88 |
| Stock borrowability | Hard |
| Major shareholders (%) | |
| Evergreen Marine | 19.3 |
| Evergreen International | 12.7 |

Source: Company, Nomura estimates

## Valuation methodology

Our price target of NT$40.0 is based on 1.9x FY11F P/BV (one standard deviation above its mid-cycle valuation). While the historical mid-cycle valuation since Eva Airway's listing in 1999 should be 1.1x, we believe it is more justifiable to use the mid-cycle valuation post the commencement of direct air links, since this would suggest a more favourable business operating environment.

## Risks to our investment view

Risk to our rating include: 1) a possible further slowdown in the US and Europe economies, where Eva Airways derives 50% and 15% of its traffic revenue, respectively; 2) passenger/cargo throughput growth, passenger/cargo yield growth and/or oil prices, which if they differ substantially from our assumptions, would have an impact on our estimates; and 3) currency movements, which play a significant part in an airline's profitability and hence, currency exchange rates that differ significantly from our macro assumptions are also risks.

# Financial statements

| Income statement (NT$mn) | | | | | |
|---|---|---|---|---|---|
| **Year-end 31 Dec** | **FY08** | **FY09** | **FY10F** | **FY11F** | **FY12F** |
| **Revenue** | 90,656 | 73,280 | 105,797 | 118,568 | 133,363 |
| Cost of goods sold | (99,262) | (76,100) | (92,284) | (104,795) | (119,301) |
| **Gross profit** | **(8,607)** | **(2,820)** | **13,513** | **13,773** | **14,062** |
| SG&A | - | - | - | - | - |
| Employee share expense | - | - | - | - | - |
| **Operating profit** | **(8,607)** | **(2,820)** | **13,513** | **13,773** | **14,062** |
| | | | | | |
| **EBITDA** | **(774)** | **5,551** | **22,828** | **23,255** | **23,711** |
| Depreciation | (7,833) | (8,371) | (9,315) | (9,482) | (9,649) |
| Amortisation | - | - | - | - | - |
| **EBIT** | **(8,607)** | **(2,820)** | **13,513** | **13,773** | **14,062** |
| Net interest expense | (2,601) | (1,942) | (1,637) | (1,301) | (927) |
| Associates & JCEs | 192 | 278 | 1,336 | 1,463 | 1,606 |
| Other income | (6,545) | 701 | 579 | 587 | 574 |
| **Earnings before tax** | **(17,561)** | **(3,783)** | **13,789** | **14,522** | **15,314** |
| Income tax | 501 | 881 | (50) | (142) | (149) |
| **Net profit after tax** | **(17,060)** | **(2,902)** | **13,739** | **14,380** | **15,165** |
| Minority interests | - | - | - | - | - |
| Other items | - | - | - | - | - |
| Preferred dividends | - | - | - | - | - |
| **Normalised NPAT** | **(17,060)** | **(2,902)** | **13,739** | **14,380** | **15,165** |
| Extraordinary items | 170 | 58 | 19 | - | - |
| **Reported NPAT** | **(16,890)** | **(2,844)** | **13,758** | **14,380** | **15,165** |
| Dividends | | | | | |
| **Transfer to reserves** | **(16,890)** | **(2,844)** | **13,758** | **14,380** | **15,165** |
| | | | | | |
| **Valuation and ratio analysis** | | | | | |
| FD normalised P/E (x) | na | na | 7.9 | 7.5 | 7.2 |
| FD normalised P/E at price target (x) | na | na | 8.6 | 8.2 | 7.8 |
| Reported P/E (x) | na | na | 7.9 | 7.5 | 7.2 |
| Dividend yield (%) | - | - | - | - | - |
| Price/cashflow (x) | na | na | 4.8 | 4.5 | 4.0 |
| Price/book (x) | 3.2 | 3.4 | 2.4 | 1.7 | 1.4 |
| EV/EBITDA (x) | na | 32.6 | 7.1 | 6.1 | 5.1 |
| EV/EBIT (x) | na | na | 11.5 | 9.9 | 8.2 |
| Gross margin (%) | (9.5) | (3.8) | 12.8 | 11.6 | 10.5 |
| EBITDA margin (%) | (0.9) | 7.6 | 21.6 | 19.6 | 17.8 |
| EBIT margin (%) | (9.5) | (3.8) | 12.8 | 11.6 | 10.5 |
| Net margin (%) | (18.6) | (3.9) | 13.0 | 12.1 | 11.4 |
| Effective tax rate (%) | na | na | 0.4 | 1.0 | 1.0 |
| Dividend payout (%) | na | na | - | - | - |
| Capex to sales (%) | 17.8 | 19.3 | 2.4 | 2.1 | 1.9 |
| Capex to depreciation (x) | 2.1 | 1.7 | 0.3 | 0.3 | 0.3 |
| ROE (%) | (48.3) | (9.8) | 35.4 | 26.7 | 21.4 |
| ROA (pretax %) | (5.9) | (1.8) | 10.2 | 10.6 | 11.0 |
| | | | | | |
| **Growth (%)** | | | | | |
| Revenue | (2.6) | (19.2) | 44.4 | 12.1 | 12.5 |
| EBITDA | (114.4) | na | 311.3 | 1.9 | 2.0 |
| EBIT | na | na | na | 1.9 | 2.1 |
| Normalised EPS | na | na | na | 4.7 | 5.5 |
| Normalised FDEPS | na | na | na | 4.7 | 5.5 |
| | | | | | |
| **Per share** | | | | | |
| Reported EPS (NT$) | (7.46) | (1.17) | 4.64 | 4.85 | 5.12 |
| Norm EPS (NT$) | (7.54) | (1.19) | 4.64 | 4.85 | 5.12 |
| Fully diluted norm EPS (NT$) | (7.54) | (1.19) | 4.64 | 4.85 | 5.12 |
| Book value per share (NT$) | 11.38 | 10.81 | 15.41 | 20.98 | 26.95 |
| DPS (NT$) | - | - | - | - | - |

Source: Nomura estimates

Mainly on oil hedging

| Cashflow (NT$mn) | | | | | |
|---|---|---|---|---|---|
| **Year-end 31 Dec** | **FY08** | **FY09** | **FY10F** | **FY11F** | **FY12F** |
| EBITDA | (774) | 5,551 | 22,828 | 23,255 | 23,711 |
| Change in working capital | 6,360 | (5,047) | (555) | (2,282) | (543) |
| Other operating cashflow | (8,261) | (1,093) | 501 | 3,381 | 4,246 |
| **Cashflow from operations** | **(2,675)** | **(590)** | **22,774** | **24,354** | **27,414** |
| Capital expenditure | (16,123) | (14,167) | (2,500) | (2,500) | (2,500) |
| **Free cashflow** | **(18,798)** | **(14,757)** | **20,274** | **21,854** | **24,914** |
| Reduction in investments | 4,362 | (3,959) | (1,264) | (1,597) | (1,744) |
| Net acquisitions | (429) | (254) | (1,255) | (1,463) | (1,606) |
| Reduction in other LT assets | 27 | (156) | - | - | - |
| Addition in other LT liabilities | 437 | (3,424) | 76 | 79 | 82 |
| Adjustments | 7,402 | 6,425 | 1,188 | 1,384 | 1,524 |
| **Cashflow after investing acts** | **(6,999)** | **(16,125)** | **19,019** | **20,257** | **23,170** |
| Cash dividends | - | - | - | - | - |
| Equity issue | - | 7,420 | - | - | - |
| Debt issue | 10,997 | 11,530 | (16,003) | (20,310) | (15,254) |
| Convertible debt issue | - | - | - | - | - |
| Others | (3,727) | (1,835) | - | - | (5,000) |
| **Cashflow from financial acts** | **7,270** | **17,115** | **(16,003)** | **(20,310)** | **(20,254)** |
| **Net cashflow** | **271** | **991** | **3,016** | **(54)** | **2,915** |
| Beginning cash | 2,957 | 3,228 | 4,219 | 7,235 | 7,181 |
| Ending cash | 3,228 | 4,219 | 7,235 | 7,181 | 10,096 |
| Ending net debt | 73,496 | 81,410 | 62,828 | 43,022 | 20,316 |

Source: Nomura estimates

Share placement to existing and new shareholders

| Balance sheet (NT$mn) | | | | | |
|---|---|---|---|---|---|
| **As at 31 Dec** | **FY08** | **FY09** | **FY10F** | **FY11F** | **FY12F** |
| Cash & equivalents | 3,228 | 4,219 | 7,235 | 7,181 | 10,096 |
| Marketable securities | 1,560 | 4,509 | 4,509 | 4,644 | 4,782 |
| Accounts receivable | 5,969 | 6,968 | 9,988 | 11,174 | 12,548 |
| Inventories | 8,631 | 8,690 | 10,539 | 11,967 | 13,624 |
| Other current assets | 2,026 | 1,202 | 1,454 | 1,684 | 1,934 |
| **Total current assets** | **21,413** | **25,588** | **33,724** | **36,650** | **42,985** |
| LT investments | 10,201 | 11,211 | 12,475 | 13,937 | 15,543 |
| Fixed assets | 97,874 | 102,607 | 96,424 | 89,823 | 83,108 |
| Goodwill | - | - | - | - | - |
| Other intangible assets | 13,685 | 10,565 | 10,043 | 9,536 | 9,045 |
| Other LT assets | 82 | 238 | 238 | 238 | 238 |
| **Total assets** | **143,255** | **150,209** | **152,904** | **150,186** | **150,920** |
| Short-term debt | 15,674 | 16,991 | 16,447 | 16,897 | 17,361 |
| Accounts payable | 1,667 | 2,247 | 2,527 | 2,753 | 3,010 |
| Other current liabilities | 23,887 | 18,496 | 22,779 | 23,117 | 25,598 |
| **Total current liabilities** | **41,229** | **37,733** | **41,754** | **42,767** | **45,969** |
| Long-term debt | 61,050 | 68,638 | 53,616 | 33,305 | 13,051 |
| Convertible debt | | | | | |
| Other LT liabilities | 15,235 | 11,811 | 11,887 | 11,966 | 12,048 |
| **Total liabilities** | **117,513** | **118,182** | **107,256** | **88,039** | **71,067** |
| Minority interest | - | - | - | - | - |
| Preferred stock | - | - | - | - | - |
| Common stock | 22,627 | 29,627 | 29,627 | 29,627 | 29,627 |
| Retained earnings | (16,890) | (2,915) | 10,843 | 25,223 | 40,388 |
| Proposed dividends | - | - | - | - | - |
| Other equity and reserves | 20,005 | 5,315 | 5,177 | 7,298 | 9,838 |
| **Total shareholders' equity** | **25,742** | **32,027** | **45,647** | **62,147** | **79,853** |
| **Total equity & liabilities** | **143,255** | **150,209** | **152,903** | **150,186** | **150,920** |
| | | | | | |
| **Liquidity (x)** | | | | | |
| Current ratio | 0.52 | 0.68 | 0.81 | 0.86 | 0.94 |
| Interest cover | (3.3) | (1.5) | 8.3 | 10.6 | 15.2 |
| | | | | | |
| **Leverage** | | | | | |
| Net debt/EBITDA (x) | na | 14.67 | 2.75 | 1.85 | 0.86 |
| Net debt/equity (%) | 285.5 | 254.2 | 137.6 | 69.2 | 25.4 |
| | | | | | |
| **Activity (days)** | | | | | |
| Days receivable | 29.0 | 32.2 | 29.3 | 32.6 | 32.6 |
| Days inventory | 33.5 | 41.5 | 38.0 | 39.2 | 39.3 |
| Days payable | 7.8 | 9.4 | 9.4 | 9.2 | 8.8 |
| Cash cycle | 54.7 | 64.4 | 57.8 | 62.6 | 63.0 |

Source: Nomura estimates

Net gearing ratio is likely to decrease

# Chunghwa Telecom 2412 TT

TELECOMS | TAIWAN

Maintained

BUY


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## Action

Because of its high dividend yield and stable earnings trend, CHT can be seen as a bond-like equity. This is important amid prevailing volatility. We expect CHT's stable earnings will be underpinned by a stable regulatory environment and growth in smartphone, and fibre broadband service to offset the decline in voice service due to mandatory tariff cut. Maintain BUY and NT$75 PT.

## Catalysts

As a bond-like equity, CHT's share price should be driven by 1) Taiwan/US market liquidity; and 2) property prices in Taiwan, which affect the market expectation of CHT's revaluation gain of its properties in addition to monthly KPIs.

## Anchor themes

Differentiation in smartphone trend and growth strategy in broadband and IPTV are key themes in 2011. We believe CHT is well positioned in these two growth areas with strong handset distribution network and dominant fibre coverage.

| | |
|---|---|
| Closing price on 3 Jan | NT$73.6 |
| Price target* | **NT$75.0** |
| | (set on 25 Jun 10) |
| Upside/downside | 1.9% |
| Difference from consensus | **23.6%** |
| FY11F net profit (NT$mn) | 46,454 |
| Difference from consensus | **-1.0%** |

* Price target under review

Source: Nomura

## Nomura vs consensus

We are in line with consensus.

# Stability is what investors want

### ① FTTx and IPTV service: growth to accelerate in 2011

In preparation for the intensifying competition in fixed-line broadband after the recent cable TV acquisition, CHT is migrating its customer base from ADSL to FTTx by improving its FTTx coverage and providing attractive IPTV (Multimedia on Demand, MOD) content. This should also help the company to alleviate the impact of tariff cuts, because only ADSL tariffs are regulated under the tariff cut scheme.

### ② Smartphone: differentiation strategy

CHT is providing localised content and enhancing its sales channels to differentiate itself from the other two operators in smartphone strategy. In addition, the company believes that it can maintain total expense for handset subsidies by adjusting the proportion between feature phones and smartphones, and thus does not expect EBITDA margin to be negatively affected by smartphone subsidies.

### ③ Capital management: room for higher pay-out ratio

CHT sees potential in four to five years to increase its dividend payout ratio to 100%, from the current 90%, with its accumulated legal reserve exceeding its capital stock. However, the company expects less room for capital reduction given the narrowing gap between depreciation and capex, which is a major source of capital reduction.

### ④ Valuation and risks to our investment view

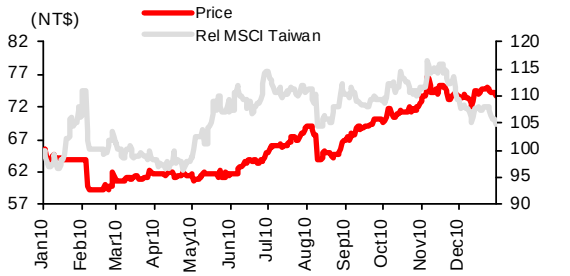
Our price target of NT$75 is based on a 10-year discounted cashflow methodology with WACC of 10.4% and long-term FCF growth of 0%. **Downside risks** include lower-than-expected mobile data revenue growth, due to changes in consumer behaviour and a faster-than-expected drop in voice tariffs because of competition.

## Key financials & valuations

| 31 Dec (NT$mn) | FY09 | FY10F | FY11F | FY12F |
|---|---|---|---|---|
| Revenue | 198,361 | 197,400 | 196,800 | 197,400 |
| Reported net profit | 44,849 | 47,017 | 46,454 | 46,563 |
| Normalised net profit | 44,849 | 47,017 | 46,454 | 46,563 |
| Normalised EPS (NT$) | 4.63 | 4.85 | 4.79 | 4.80 |
| Norm. EPS growth (%) | (3.6) | 4.8 | (1.2) | 0.2 |
| Norm. P/E (x) | 15.9 | 15.2 | 15.4 | 15.3 |
| EV/EBITDA (x) | 6.8 | 7.1 | 7.2 | 7.2 |
| Price/book (x) | 1.9 | 2.0 | 2.1 | 2.1 |
| Dividend yield (%) | 8.2 | 9.9 | 7.1 | 7.1 |
| ROE (%) | 11.9 | 13.0 | 13.3 | 13.6 |
| Net debt/equity (%) | net cash | net cash | net cash | net cash |
| **Earnings revisions** | | | | |
| Previous norm. net profit | | 45,900 | 45,400 | 45,500 |
| Change from previous (%) | | 2.4 | 2.3 | 2.3 |
| Previous norm. EPS (NT$) | | 4.73 | 4.68 | 4.69 |

Source: Company, Nomura estimates

## Share price relative to MSCI Taiwan




| | 1m | 3m | 6m |
|---|---|---|---|
| Absolute (NT$) | (0.3) | 5.1 | 13.2 |
| Absolute (US$) | 3.8 | 12.0 | 25.4 |
| Relative to Index | (4.2) | (4.7) | (11.5) |
| Market cap (US$mn) | | | 24,514 |
| Estimated free float (%) | | | 64.0 |
| 52-week range (NT$) | | | 76.7/59.3 |
| 3-mth avg daily turnover (US$mn) | | | 43.11 |
| Stock borrowability | | | Hard |
| Major shareholders (%) | | | |
| Ministry of Transportation and Communications | | | 35.3 |

Source: Company, Nomura estimates

# Financial statements

| Income statement (NT$mn) | | | | | |
|---|---|---|---|---|---|
| **Year-end 31 Dec** | **FY08** | **FY09** | **FY10F** | **FY11F** | **FY12F** |
| **Revenue** | 201,670 | 198,361 | 197,400 | 196,800 | 197,400 |
| Cost of goods sold | (113,546) | (112,736) | (112,700) | (112,200) | (112,200) |
| **Gross profit** | **88,124** | **85,625** | **84,700** | **84,600** | **85,200** |
| SG&A | (29,556) | (29,231) | (29,500) | (29,900) | (30,300) |
| Employee share expense | | | | | |
| **Operating profit** | **58,568** | **56,394** | **55,200** | **54,700** | **54,900** |
| | | | | | |
| **EBITDA** | **96,781** | **92,711** | **90,700** | **89,500** | **88,900** |
| Depreciation | (38,213) | (36,317) | (35,500) | (34,800) | (34,000) |
| Amortisation | | | | | |
| **EBIT** | **58,568** | **56,394** | **55,200** | **54,700** | **54,900** |
| Net interest expense | 1,912 | 463 | 417 | 354 | 363 |
| Associates & JCEs | (1,168) | (110) | - | - | - |
| Other income | 1,898 | 1,582 | 1,600 | 1,500 | 1,500 |
| **Earnings before tax** | **61,210** | **58,330** | **57,217** | **56,554** | **56,763** |
| Income tax | (13,892) | (12,743) | (9,500) | (9,400) | (9,500) |
| **Net profit after tax** | **47,317** | **45,587** | **47,717** | **47,154** | **47,263** |
| Minority interests | (781) | (738) | (700) | (700) | (700) |
| Other items | - | - | - | - | - |
| Preferred dividends | - | - | - | - | - |
| **Normalised NPAT** | **46,536** | **44,849** | **47,017** | **46,454** | **46,563** |
| Extraordinary items | - | - | - | - | - |
| **Reported NPAT** | **46,536** | **44,849** | **47,017** | **46,454** | **46,563** |
| Dividends | (37,139) | (39,369) | (41,297) | (40,847) | (40,937) |
| **Transfer to reserves** | **9,397** | **5,480** | **5,720** | **5,606** | **5,626** |
| | | | | | |
| **Valuation and ratio analysis** | | | | | |
| FD normalised P/E (x) | 15.3 | 15.9 | 15.2 | 15.4 | 15.3 |
| FD normalised P/E at price target (x) | 15.6 | 16.2 | 15.5 | 15.7 | 15.6 |
| Reported P/E (x) | 15.3 | 15.9 | 15.2 | 15.4 | 15.3 |
| Dividend yield (%) | 6.5 | 8.2 | 9.9 | 7.1 | 7.1 |
| Price/cashflow (x) | 7.8 | 9.2 | 8.4 | 8.8 | 8.9 |
| Price/book (x) | 1.9 | 1.9 | 2.0 | 2.1 | 2.1 |
| EV/EBITDA (x) | 6.4 | 6.8 | 7.1 | 7.2 | 7.2 |
| EV/EBIT (x) | 10.6 | 11.2 | 11.6 | 11.7 | 11.6 |
| Gross margin (%) | 43.7 | 43.2 | 42.9 | 43.0 | 43.2 |
| EBITDA margin (%) | 48.0 | 46.7 | 45.9 | 45.5 | 45.0 |
| EBIT margin (%) | 29.0 | 28.4 | 28.0 | 27.8 | 27.8 |
| Net margin (%) | 23.1 | 22.6 | 23.8 | 23.6 | 23.6 |
| Effective tax rate (%) | 22.7 | 21.8 | 16.6 | 16.6 | 16.7 |
| Dividend payout (%) | 79.8 | 87.8 | 87.8 | 87.9 | 87.9 |
| Capex to sales (%) | 14.9 | 12.8 | 14.2 | 14.3 | 14.1 |
| Capex to depreciation (x) | 0.8 | 0.7 | 0.8 | 0.8 | 0.8 |
| ROE (%) | 12.1 | 11.9 | 13.0 | 13.3 | 13.6 |
| ROA (pretax %) | 14.8 | 14.8 | 14.9 | 15.1 | 15.4 |
| | | | | | |
| **Growth (%)** | | | | | |
| Revenue | 2.2 | (1.6) | (0.5) | (0.3) | 0.3 |
| EBITDA | (3.0) | (4.2) | (2.2) | (1.3) | (0.7) |
| EBIT | (3.0) | (3.7) | (2.1) | (0.9) | 0.4 |
| Normalised EPS | (4.7) | (3.6) | 4.8 | (1.2) | 0.2 |
| Normalised FDEPS | (4.7) | (3.6) | 4.8 | (1.2) | 0.2 |
| | | | | | |
| **Per share** | | | | | |
| Reported EPS (NT$) | 4.80 | 4.63 | 4.85 | 4.79 | 4.80 |
| Norm EPS (NT$) | 4.80 | 4.63 | 4.85 | 4.79 | 4.80 |
| Fully diluted norm EPS (NT$) | 4.80 | 4.63 | 4.85 | 4.79 | 4.80 |
| Book value per share (NT$) | 38.83 | 38.69 | 36.17 | 35.64 | 35.11 |
| DPS (NT$) | 4.82 | 6.03 | 7.26 | 5.21 | 5.22 |

Source: Nomura estimates

Corporate income tax is changed to 17% from 25% from beginning of 2010

| Cashflow (NT$mn) | | | | | |
|---|---|---|---|---|---|
| **Year-end 31 Dec** | **FY08** | **FY09** | **FY10F** | **FY11F** | **FY12F** |
| EBITDA | 96,781 | 92,711 | 90,700 | 89,500 | 88,900 |
| Change in working capital | 11,382 | (11,945) | 2,713 | (128) | 128 |
| Other operating cashflow | (16,300) | (3,480) | (8,413) | (8,372) | (8,428) |
| **Cashflow from operations** | **91,863** | **77,286** | **85,000** | **81,000** | **80,600** |
| Capital expenditure | (30,119) | (25,478) | (28,000) | (28,100) | (27,800) |
| **Free cashflow** | **61,744** | **51,808** | **57,000** | **52,900** | **52,800** |
| Reduction in investments | 319 | (3,637) | (34) | - | - |
| Net acquisitions | - | - | - | - | - |
| Reduction in other LT assets | | | | | |
| Addition in other LT liabilities | | | | | |
| Adjustments | (4,726) | (356) | (366) | (400) | (400) |
| **Cashflow after investing acts** | **57,337** | **47,815** | **56,600** | **52,500** | **52,400** |
| Cash dividends | (41,202) | (37,836) | (39,369) | (41,297) | (40,847) |
| Equity issue | (9,558) | (19,116) | (29,090) | (9,697) | (9,697) |
| Debt issue | 239 | 806 | (880) | (9) | (212) |
| Convertible debt issue | - | - | - | - | - |
| Others | (1,761) | 302 | 348 | (297) | (344) |
| **Cashflow from financial acts** | **(52,282)** | **(55,844)** | **(68,991)** | **(51,300)** | **(51,100)** |
| **Net cashflow** | **5,055** | **(8,029)** | **(12,391)** | **1,200** | **1,300** |
| Beginning cash | 76,233 | 81,288 | 73,259 | 60,868 | 62,068 |
| Ending cash | 81,288 | 73,259 | 60,868 | 62,068 | 63,368 |
| Ending net debt | (80,993) | (72,158) | (60,647) | (61,856) | (63,368) |

Source: Nomura estimates

| Balance sheet (NT$mn) | | | | | |
|---|---|---|---|---|---|
| **As at 31 Dec** | **FY08** | **FY09** | **FY10F** | **FY11F** | **FY12F** |
| Cash & equivalents | 81,288 | 73,259 | 60,868 | 62,068 | 63,368 |
| Marketable securities | 15,210 | 18,678 | 18,700 | 18,700 | 18,700 |
| Accounts receivable | 10,845 | 11,973 | 11,915 | 11,879 | 11,915 |
| Inventories | 6,412 | 6,398 | 6,367 | 6,348 | 6,367 |
| Other current assets | 4,453 | 4,184 | 2,073 | 2,995 | 3,455 |
| **Total current assets** | **118,208** | **114,492** | **99,923** | **101,990** | **103,805** |
| LT investments | 8,919 | 9,088 | 9,100 | 9,100 | 9,100 |
| Fixed assets | 323,050 | 313,022 | 305,484 | 298,821 | 292,584 |
| Goodwill | - | - | - | - | - |
| Other intangible assets | 7,486 | 6,737 | 5,997 | 5,256 | 4,516 |
| Other LT assets | 5,928 | 5,658 | 5,700 | 5,700 | 5,700 |
| **Total assets** | **463,591** | **448,997** | **426,204** | **420,868** | **415,705** |
| Short-term debt | 266 | 880 | - | - | - |
| Accounts payable | 11,360 | 10,155 | 10,106 | 10,075 | 10,106 |
| Other current liabilities | 58,309 | 48,665 | 51,338 | 51,185 | 51,338 |
| **Total current liabilities** | **69,935** | **59,700** | **61,443** | **61,260** | **61,443** |
| Long-term debt | 29 | 221 | 221 | 212 | - |
| Convertible debt | - | - | - | - | - |
| Other LT liabilities | 13,932 | 10,112 | 10,084 | 10,084 | 10,084 |
| **Total liabilities** | **83,896** | **70,033** | **71,748** | **71,556** | **71,527** |
| Minority interest | 3,137 | 3,752 | 3,752 | 3,752 | 3,752 |
| Preferred stock | - | - | - | - | - |
| Common stock | 276,174 | 266,478 | 237,388 | 227,691 | 217,994 |
| Retained earnings | 96,812 | 103,413 | 108,016 | 112,569 | 117,131 |
| Proposed dividends | - | - | - | - | - |
| Other equity and reserves | 3,571 | 5,321 | 5,300 | 5,300 | 5,300 |
| **Total shareholders' equity** | **376,557** | **375,212** | **350,704** | **345,560** | **340,425** |
| **Total equity & liabilities** | **463,590** | **448,997** | **426,204** | **420,868** | **415,705** |
| | | | | | |
| **Liquidity (x)** | | | | | |
| Current ratio | 1.69 | 1.92 | 1.63 | 1.66 | 1.69 |
| Interest cover | na | na | na | na | na |
| | | | | | |
| **Leverage** | | | | | |
| Net debt/EBITDA (x) | net cash | net cash | net cash | net cash | net cash |
| Net debt/equity (%) | net cash | net cash | net cash | net cash | net cash |
| | | | | | |
| **Activity (days)** | | | | | |
| Days receivable | 20.2 | 21.0 | 22.1 | 22.1 | 22.1 |
| Days inventory | 17.3 | 20.7 | 20.7 | 20.7 | 20.7 |
| Days payable | 37.0 | 34.8 | 32.8 | 32.8 | 32.9 |
| Cash cycle | 0.5 | 6.9 | 9.9 | 9.9 | 9.9 |

Source: Nomura estimates

Source of capital reduction

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## Any Authors named on this report are Research Analysts unless otherwise indicated

## ANALYST CERTIFICATIONS

I, Jesse Wang, Aaron Jeng, Anne Lee, Eve Jung, Brandon Chen, Yong Liang Por, Shirley Lam, Leping Huang, hereby certify (1) that the views expressed in this Research report accurately reflect my personal views about any or all of the subject securities or issuers referred to in this Research report, (2) no part of my compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this Research report and (3) no part of my compensation is tied to any specific investment banking transactions performed by Nomura Securities International, Inc., Nomura International plc or any other Nomura Group company.

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48% have been assigned a Buy rating which, for purposes of mandatory disclosures, are classified as a Buy rating; 41% of companies with this rating are investment banking clients of the Nomura Group*.
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As at 30 September 2010.
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### Explanation of Nomura's equity research rating system in Europe, Middle East and Africa, US and Latin America for ratings published from 27 October 2008

The rating system is a relative system indicating expected performance against a specific benchmark identified for each individual stock. Analysts may also indicate absolute upside to price target defined as (fair value - current price)/current price, subject to limited management discretion. In most cases, the fair value will equal the analyst's assessment of the current intrinsic fair value of the stock using an appropriate valuation methodology such as discounted cash flow or multiple analysis, etc.

#### STOCKS

A rating of '**Buy**', indicates that the analyst expects the stock to outperform the Benchmark over the next 12 months.
A rating of '**Neutral**', indicates that the analyst expects the stock to perform in line with the Benchmark over the next 12 months.
A rating of '**Reduce**', indicates that the analyst expects the stock to underperform the Benchmark over the next 12 months.
A rating of '**Suspended**', indicates that the rating and target price have been suspended temporarily to comply with applicable regulations and/or firm policies in certain circumstances including when Nomura is acting in an advisory capacity in a merger or strategic transaction involving the company.
Benchmarks are as follows: **United States/Europe**: Please see valuation methodologies for explanations of relevant benchmarks for stocks (accessible through the left hand side of the Nomura Disclosure web page: http://www.nomura.com/research);**Global Emerging Markets (ex-Asia):** MSCI Emerging Markets ex-Asia, unless otherwise stated in the valuation methodology.

#### SECTORS

A '**Bullish**' stance, indicates that the analyst expects the sector to outperform the Benchmark during the next 12 months.
A '**Neutral**' stance, indicates that the analyst expects the sector to perform in line with the Benchmark during the next 12 months.
A '**Bearish**' stance, indicates that the analyst expects the sector to underperform the Benchmark during the next 12 months.
Benchmarks are as follows: **United States**: S&P 500; **Europe**: Dow Jones STOXX 600; **Global Emerging Markets (ex-Asia)**: MSCI Emerging Markets ex-Asia.

## Explanation of Nomura's equity research rating system for Asian companies under coverage ex Japan published from 30 October 2008 and in Japan from 6 January 2009

**STOCKS**

Stock recommendations are based on absolute valuation upside (downside), which is defined as (Price Target - Current Price) / Current Price, subject to limited management discretion. In most cases, the Price Target will equal the analyst's 12-month intrinsic valuation of the stock, based on an appropriate valuation methodology such as discounted cash flow, multiple analysis, etc.
A '**Buy'** recommendation indicates that potential upside is 15% or more.
A '**Neutral'** recommendation indicates that potential upside is less than 15% or downside is less than 5%.
A '**Reduce'** recommendation indicates that potential downside is 5% or more.
A rating of '**Suspended'** indicates that the rating and target price have been suspended temporarily to comply with applicable regulations and/or firm policies in certain circumstances including when Nomura is acting in an advisory capacity in a merger or strategic transaction involving the subject company.
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SECTORS

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A '**Bearish'** rating means most stocks in the sector have (or the weighted average recommendation of the stocks under coverage is) a negative absolute recommendation.

## Explanation of Nomura's equity research rating system in Japan published prior to 6 January 2009 (and ratings in Europe, Middle East and Africa, US and Latin America published prior to 27 October 2008)

STOCKS

A rating of '1' or '**Strong buy'**, indicates that the analyst expects the stock to outperform the Benchmark by 15% or more over the next six months.
A rating of '2' or '**Buy'**, indicates that the analyst expects the stock to outperform the Benchmark by 5% or more but less than 15% over the next six months.
A rating of '3' or '**Neutral'**, indicates that the analyst expects the stock to either outperform or underperform the Benchmark by less than 5% over the next six months.
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A '**Bearish'** stance, indicates that the analyst expects the sector to underperform the Benchmark during the next six months.
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## Explanation of Nomura's equity research rating system for Asian companies under coverage ex Japan published prior to 30 October 2008

**STOCKS**

Stock recommendations are based on absolute valuation upside (downside), which is defined as (Fair Value - Current Price)/Current Price, subject to limited management discretion. In most cases, the Fair Value will equal the analyst's assessment of the current intrinsic fair value of the stock using an appropriate valuation methodology such as Discounted Cash Flow or Multiple analysis etc. However, if the analyst doesn't think the market will revalue the stock over the specified time horizon due to a lack of events or catalysts, then the fair value may differ from the intrinsic fair value. In most cases, therefore, our recommendation is an assessment of the difference between current market price and our estimate of current intrinsic fair value. Recommendations are set with a 6-12 month horizon unless specified otherwise. Accordingly, within this horizon, price volatility may cause the actual upside or downside based on the prevailing market price to differ from the upside or downside implied by the recommendation.
A '**Strong buy'** recommendation indicates that upside is more than 20%.
A '**Buy'** recommendation indicates that upside is between 10% and 20%.
A '**Neutral'** recommendation indicates that upside or downside is less than 10%.
A '**Reduce'** recommendation indicates that downside is between 10% and 20%.
A '**Sell'** recommendation indicates that downside is more than 20%.

**SECTORS**

A '**Bullish'** rating means most stocks in the sector have (or the weighted average recommendation of the stocks under coverage is) a positive absolute recommendation.
A '**Neutral'** rating means most stocks in the sector have (or the weighted average recommendation of the stocks under coverage is) a neutral absolute recommendation.
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