

Company Flash

21 October 2008 | 10 pages

AU Optronics (2409.TW)

 Target price change
 Estimate change

Buy: Over 35% YoY Capex Cut in 2009E likely to Slow Supply

- BUY into trough** — AUO is now trading below the prior three cycles' trailing trough P/BVs of 0.9x for 2001, 1.1x for 2003, and 1.6x for 2H04. We believe downside is limited and reiterate our Buy (1L) rating. However, we are slashing our target price to NT\$40 from NT\$66.5 as losses might last and widen for 2-3 quarters to drag the share price to 1x book.
- Near-term losses widen** — As TV and monitor panels demand is affected by the global financial crisis, we expect AUO's 4Q08 sales to decline 10% QoQ (slightly up in shipment but with blended ASP decline of 10-15% QoQ), resulting in op margin to the -5 to -10% level. However in this downturn, we do not expect AUO to report -15 to -25% op margin, which happened in 2001.
- Structural changes in the sector** — 1) Lowering utilization across the board by vendors should accelerate the supply demand balance starting 2Q09E and price might reverse upward starting 3Q09E; 2) Following LGD 2009E capex cut of over 50% YoY, we expect AUO and CMO to cut 2009E capex by at least over 35% YoY, suggesting new factories ramp up to push back; 3) Many 2nd tier TFT names might need to cut production by over 50% as panel price is approaching to their cash cost level.
- Slashing estimates** — By factoring in larger than expected panel price contraction and demand fall for next 2-3 quarters, we are cutting our 2008E EPS by 4% to NT\$5.0 and 2009E EPS by 71% to NT\$1.05. We now forecast AUO sales to decline 10-15% YoY in 2009 from 2% YoY decline earlier.

| | |
|------------------------------|-----------------------|
| Buy/Low Risk | 1L |
| Price (20 Oct 08) | NT\$28.45 |
| Target price | NT\$40.00 |
| | <i>from NT\$66.50</i> |
| Expected share price return | 40.6% |
| Expected dividend yield | 10.5% |
| Expected total return | 51.1% |
| Market Cap | NT\$241,988M |
| | US\$7,420M |

Price Performance (RIC: 2409.TW, BB: 2409 TT)



Figure 1. AUO – Statistical Abstract

| Year to | Net profit | EPS | EPS | P/E | ROIC | ROE | P/B | I/B/E/S | % diff |
|---------|--------------|--------|------------|------|------|-----|-----|---------|--------|
| 31-Dec | (NT\$ Mils.) | (NT\$) | Growth (%) | (x) | (%) | (%) | (x) | (NT\$) | |
| 2006 | 9,103 | 1.1 | -54% | 24.5 | 2% | 5% | 0.9 | | |
| 2007 | 56,418 | 6.8 | 509% | 4.0 | 12% | 21% | 0.7 | | |
| 2008E | 42,541 | 5.0 | -27% | 5.5 | 9% | 14% | 0.7 | 5.2 | -3% |
| 2009E | 8,989 | 1.1 | -79% | 26.1 | 2% | 3% | 0.8 | 1.4 | -23% |
| 2010E | 32,839 | 3.8 | 265% | 7.2 | 7% | 10% | 0.7 | 2.9 | 35% |

Source: Company Reports and Citi Investment Research estimates

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See Appendix A-1 for Analyst Certification and important disclosures.

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¹Citigroup Global Markets Inc - Taipei Branch

| Fiscal year end 31-Dec | 2006 | 2007 | 2008E | 2009E | 2010E |
|--|-----------------|----------------|-----------------|----------------|----------------|
| Valuation Ratios | | | | | |
| P/E adjusted (x) | 25.3 | 4.2 | 5.7 | 27.0 | 7.4 |
| EV/EBITDA adjusted (x) | 5.3 | 2.5 | 2.4 | 3.2 | 2.4 |
| P/BV (x) | 1.0 | 0.8 | 0.8 | 0.8 | 0.8 |
| Dividend yield (%) | 0.7 | 0.7 | 8.8 | 10.5 | 7.0 |
| Per Share Data (NT\$) | | | | | |
| EPS adjusted | 1.12 | 6.83 | 5.00 | 1.05 | 3.84 |
| EPS reported | 1.12 | 6.83 | 5.00 | 1.05 | 3.84 |
| BVPS | 28.49 | 36.43 | 37.88 | 35.77 | 37.58 |
| DPS | 0.20 | 0.20 | 2.50 | 3.00 | 2.00 |
| Profit & Loss (NT\$M) | | | | | |
| Net sales | 293,107 | 480,184 | 458,311 | 409,943 | 490,758 |
| Operating expenses | -278,891 | -416,909 | -407,940 | -397,309 | -452,160 |
| EBIT | 14,216 | 63,275 | 50,371 | 12,633 | 38,598 |
| Net interest expense | -2,266 | -4,458 | -3,605 | -3,300 | -3,300 |
| Non-operating/exceptionals | -1,750 | -253 | 542 | 230 | 397 |
| Pre-tax profit | 10,200 | 58,564 | 47,308 | 9,563 | 35,695 |
| Tax | -1,068 | -2,088 | -4,767 | -574 | -2,856 |
| Extraord./Min.Int./Pref.div. | -29 | -58 | 0 | 0 | 0 |
| Reported net income | 9,103 | 56,418 | 42,541 | 8,989 | 32,839 |
| Adjusted earnings | 9,103 | 56,418 | 42,541 | 8,989 | 32,839 |
| Adjusted EBITDA | 66,976 | 144,980 | 132,481 | 104,461 | 133,624 |
| Growth Rates (%) | | | | | |
| Sales | 34.8 | 63.8 | -4.6 | -10.6 | 19.7 |
| EBIT adjusted | -16.3 | 345.1 | -20.4 | -74.9 | 205.5 |
| EBITDA adjusted | 30.1 | 116.5 | -8.6 | -21.1 | 27.9 |
| EPS adjusted | -53.8 | 508.6 | -26.8 | -79.0 | 265.0 |
| Cash Flow (NT\$M) | | | | | |
| Operating cash flow | 66,316 | 135,519 | 122,847 | 104,112 | 127,784 |
| Depreciation/amortization | 52,760 | 81,706 | 82,110 | 91,828 | 95,026 |
| Net working capital | 2,695 | -2,403 | -1,804 | 3,294 | -81 |
| Investing cash flow | -245,917 | -55,702 | -110,200 | -80,000 | -80,000 |
| Capital expenditure | -213,184 | -63,990 | -110,000 | -80,000 | -80,000 |
| Acquisitions/disposals | -8,807 | 4,263 | 0 | 0 | 0 |
| Financing cash flow | 197,554 | -34,186 | -49,096 | -25,617 | -17,094 |
| Borrowings | 131,235 | -47,271 | -27,737 | 0 | 0 |
| Dividends paid | -1,749 | -1,515 | -1,573 | -21,256 | -25,617 |
| Change in cash | 17,953 | 45,631 | -36,449 | -1,505 | 30,690 |
| Balance Sheet (NT\$M) | | | | | |
| Total assets | 578,126 | 617,459 | 613,468 | 589,485 | 626,832 |
| Cash & cash equivalent | 45,774 | 91,406 | 54,957 | 53,451 | 84,142 |
| Accounts receivable | 57,458 | 75,911 | 77,850 | 69,634 | 83,362 |
| Net fixed assets | 381,551 | 363,835 | 391,725 | 379,897 | 364,871 |
| Total liabilities | 347,050 | 316,639 | 291,363 | 284,007 | 305,609 |
| Accounts payable | 74,355 | 96,577 | 95,532 | 93,013 | 106,534 |
| Total Debt | 225,008 | 177,737 | 150,000 | 150,000 | 150,000 |
| Shareholders' funds | 231,076 | 300,820 | 322,105 | 305,477 | 321,223 |
| Profitability/Solvency Ratios (%) | | | | | |
| EBITDA margin adjusted | 22.9 | 30.2 | 28.9 | 25.5 | 27.2 |
| ROE adjusted | 4.7 | 21.2 | 13.7 | 2.9 | 10.5 |
| ROIC adjusted | 4.3 | 15.7 | 11.6 | 3.0 | 9.3 |
| Net debt to equity | 77.6 | 28.7 | 29.5 | 31.6 | 20.5 |
| Total debt to capital | 49.3 | 37.1 | 31.8 | 32.9 | 31.8 |

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Figure 2. AUO – Quarterly Earnings Adjustment

| | 1Q08A | 2Q08A | 3Q08E | 4Q08E | 1Q09E | 2Q09E | 3Q09E | 4Q09E |
|--------------------------|-------------|-------------|-------------|---------------|---------------|---------------|-------------|-------------|
| Original forecast | | | | | | | | |
| Revenue in NT\$m | 136,630 | 123,476 | 104,313 | 101,063 | 104,475 | 108,177 | 118,505 | 124,858 |
| Gross Profit | 37,084 | 30,815 | 9,483 | 4,363 | 7,935 | 10,706 | 20,086 | 25,717 |
| Gross Margin (%) | 27% | 25% | 9% | 4% | 8% | 10% | 17% | 21% |
| Op Profit | 30,310 | 24,062 | 1,783 | -3,337 | 1,335 | 3,556 | 12,846 | 18,417 |
| Op Margin (%) | 22% | 19% | 2% | -3% | 1% | 3% | 11% | 15% |
| Net Profit | 27,156 | 20,530 | 742 | -4,023 | 596 | 2,657 | 11,354 | 16,493 |
| Net Margin (%) | 20% | 17% | 1% | -4% | 1% | 2% | 10% | 13% |
| Net EPS (NT\$) | 3.19 | 2.41 | 0.09 | -0.47 | 0.07 | 0.31 | 1.33 | 1.93 |
| Annual EPS (NT\$) | | | | 5.22 | | | | 3.64 |
| New forecast | | | | | | | | |
| Revenue | 136,630 | 123,476 | 104,313 | 93,892 | 83,498 | 96,179 | 108,750 | 121,516 |
| Gross Profit | 37,084 | 30,815 | 9,477 | 1,923 | -1,164 | 6,356 | 14,646 | 21,085 |
| Gross Margin (%) | 27% | 25% | 9% | 2% | -1% | 7% | 13% | 17% |
| Op Profit | 30,310 | 24,062 | 1,777 | -5,777 | -7,764 | -794 | 7,406 | 13,785 |
| Op Margin (%) | 22% | 19% | 2% | -6% | -9% | -1% | 7% | 11% |
| Net Profit | 27,156 | 20,530 | 955 | -6,099 | -7,957 | -1,433 | 6,240 | 12,140 |
| Net Margin (%) | 20% | 17% | 1% | -6% | -10% | -1% | 6% | 10% |
| Net EPS (NT\$) | 3.19 | 2.41 | 0.11 | (0.72) | (0.93) | (0.17) | 0.73 | 1.42 |
| Annual EPS (NT\$) | | | | 5.00 | | | | 1.05 |
| Blomg EPS (NT\$) | | | 0.45 | (0.29) | (0.44) | (0.17) | 0.80 | 1.18 |
| % Revision | | | | | | | | |
| Sales | 0% | 0% | 0% | -7% | -20% | -11% | -8% | -3% |
| Gross Profit | 0% | 0% | 0% | -56% | nm | -41% | -27% | -18% |
| Op Profit | 0% | 0% | 0% | -73% | nm | nm | -42% | -25% |
| Net Profit | 0% | 0% | 29% | -52% | nm | nm | -45% | -26% |
| Annual EPS | | | | -4% | | | | -71% |

Source: Company Reports and Citi Investment Research estimates

Figure 3. CMO – Quarterly Income Statement

| | 2008E | | | | | 2009E | | | | | 2010E | | | | | |
|---------------------------|----------------|----------------|----------------|----------------|---------------|----------------|---------------|---------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|
| | FYE '07 | 1QA | 2QA | 3Q | 4Q | FYE '08 | 1Q | 2Q | 3Q | 4Q | FYE '09 | 1Q | 2Q | 3Q | 4Q | FYE '10 |
| NET REVENUES | 480,184 | 136,630 | 123,476 | 104,313 | 93,892 | 458,311 | 83,498 | 96,179 | 108,750 | 121,516 | 409,943 | 118,459 | 127,488 | 123,539 | 121,273 | 490,758 |
| Depreciation | -81,706 | -19,803 | -19,983 | -20,774 | -21,550 | -82,110 | -22,039 | -22,498 | -23,416 | -23,875 | -91,828 | -22,806 | -23,281 | -24,232 | -24,707 | -95,026 |
| Other COGS | -312,230 | -79,743 | -72,678 | -74,062 | -70,419 | -296,902 | -62,623 | -67,325 | -70,687 | -76,555 | -277,191 | -73,444 | -82,867 | -84,006 | -87,317 | -327,634 |
| GROSS PROFIT | 86,248 | 37,084 | 30,815 | 9,477 | 1,923 | 79,298 | -1,164 | 6,356 | 14,646 | 21,085 | 40,923 | 22,208 | 21,339 | 15,301 | 9,250 | 68,098 |
| R&D | -10,650 | -3,000 | -3,100 | -3,200 | -3,200 | -12,500 | -2,600 | -3,000 | -3,000 | -3,100 | -11,700 | -2,900 | -3,000 | -3,100 | -3,100 | -12,100 |
| SG&A | -12,324 | -3,774 | -3,654 | -4,500 | -4,500 | -16,428 | -4,000 | -4,150 | -4,240 | -4,200 | -16,590 | -4,200 | -4,200 | -4,500 | -4,500 | -17,400 |
| OPERATING INCOME | 63,275 | 30,310 | 24,062 | 1,777 | -5,777 | 50,371 | -7,764 | -794 | 7,406 | 13,785 | 12,633 | 15,108 | 14,139 | 7,701 | 1,650 | 38,598 |
| Int&other in/(exp) | -4,711 | -1,284 | -307 | -761 | -711 | -3,063 | -701 | -730 | -768 | -871 | -3,070 | -713 | -730 | -764 | -696 | -2,903 |
| PRETAX INCOME | 58,564 | 29,026 | 23,755 | 1,016 | -6,488 | 47,308 | -8,465 | -1,524 | 6,638 | 12,914 | 9,563 | 14,395 | 13,409 | 6,937 | 954 | 35,695 |
| Tax credit (exp) | -2,146 | -1,870 | -3,225 | -61 | 389 | -4,767 | 508 | 91 | -398 | -775 | -574 | -1,152 | -1,073 | -555 | -76 | -2,856 |
| NET INCOME | 56,418 | 27,156 | 20,530 | 955 | -6,099 | 42,541 | -7,957 | -1,433 | 6,240 | 12,140 | 8,989 | 13,243 | 12,337 | 6,382 | 877 | 32,839 |
| NET EPS IN NT\$ | 6.83 | 3.19 | 2.41 | 0.11 | -0.72 | 5.00 | -0.93 | -0.17 | 0.73 | 1.42 | 1.05 | 1.55 | 1.44 | 0.75 | 0.10 | 3.84 |
| Fully diluted shares (mn) | 8,258 | 8,502 | 8,502 | 8,502 | 8,502 | 8,502 | 8,539 | 8,539 | 8,539 | 8,539 | 8,539 | 8,547 | 8,547 | 8,547 | 8,547 | 8,547 |
| Operating Ratios | | | | | | | | | | | | | | | | |
| Gross margins | 18% | 27% | 25% | 9% | 2% | 17% | -1% | 7% | 13% | 17% | 10% | 19% | 17% | 12% | 8% | 14% |
| Operating margin | 13% | 22% | 19% | 2% | -6% | 11% | -9% | -1% | 7% | 11% | 3% | 13% | 11% | 6% | 1% | 8% |
| Pre-tax margin | 12% | 21% | 19% | 1% | -7% | 10% | -10% | -2% | 6% | 11% | 2% | 12% | 11% | 6% | 1% | 7% |
| Net margin | 12% | 20% | 17% | 1% | -6% | 9% | -10% | -1% | 6% | 10% | 2% | 11% | 10% | 5% | 1% | 7% |
| Year-to-Year % | | | | | | | | | | | | | | | | |
| Net revenues | 64% | 69% | 16% | -24% | -40% | -5% | -39% | -22% | 4% | 29% | -11% | 42% | 33% | 14% | 0% | 20% |
| Gross profit | 189% | 10680% | 154% | -70% | -95% | -8% | N/A | -79% | 55% | 997% | -48% | N/A | 236% | 4% | -56% | 66% |
| Pretax income | 474% | N/A | 284% | -96% | N/A | -19% | N/A | N/A | 554% | N/A | -80% | N/A | N/A | 4% | -93% | 273% |
| Net income | 520% | N/A | 237% | -96% | N/A | -25% | N/A | N/A | 554% | N/A | -79% | N/A | N/A | 2% | -93% | 265% |
| Qtr-to-Qtr % | | | | | | | | | | | | | | | | |
| Net revenues | | -12% | -10% | -16% | -10% | | -11% | 15% | 13% | 12% | | -3% | 8% | -3% | -2% | |
| Gross profit | | -12% | -17% | -69% | -80% | | N/A | N/A | 130% | 44% | | 5% | -4% | -28% | -40% | |
| Operating income | | -13% | -21% | -93% | N/A | | N/A | N/A | N/A | 86% | | 10% | -6% | -46% | -79% | |
| Net income | | -17% | -24% | -95% | N/A | | N/A | N/A | N/A | 95% | | 9% | -7% | -48% | -86% | |

Source: Company Reports and Citi Investment Research estimates

AU Optronics

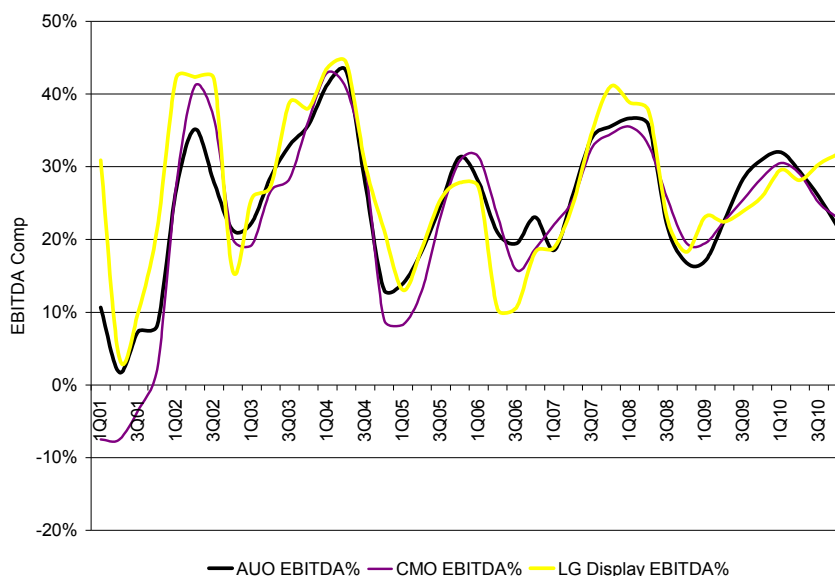
Company description

AU Optronics is the largest TFT-LCD panel maker in Taiwan and the third largest globally. Following its merger with QDI on 1 October 2006, AUO has similar capacity to Samsung and LPL.

Investment strategy

AUO is trading below the prior three cycles' trailing trough P/BV of 0.9x for 2001, 1.1x for 2003, and 1.6x for 2H04. We see downside as limited and reiterate our Buy (1L) rating with a NT\$40 target price as losses may last and widen for 2-3 quarters to drag the share price to 1x book. Near-term losses widen — As TV and monitor panels demand is hit by the global financial crisis, we expect AUO 4Q08 sales to decline 10% QoQ (slightly higher shipments but with blended ASP declining 10-15% QoQ), resulting in op margin to -5 to -10%. However in this downturn, we do not expect AUO to report -15 to -25% op margin, which happened in 2001. Structural changes in the sector — 1) Lowering utilization across the board by vendors should accelerate the supply-demand balance starting 2Q09E and price might rebound in 3Q09E or earlier; 2) Following LGD's 2009E capex cut of over 50% YoY, we expect AUO and CMO to cut 2009E capex by at least 35% YoY, suggesting new factories ramp up to push back; 3) Many second-tier TFT names might need to cut production by over 50% as panel prices approach their cash cost level (about 10-15% away from cash cost level).

EBITDA margin comparison for top 3 TFT names

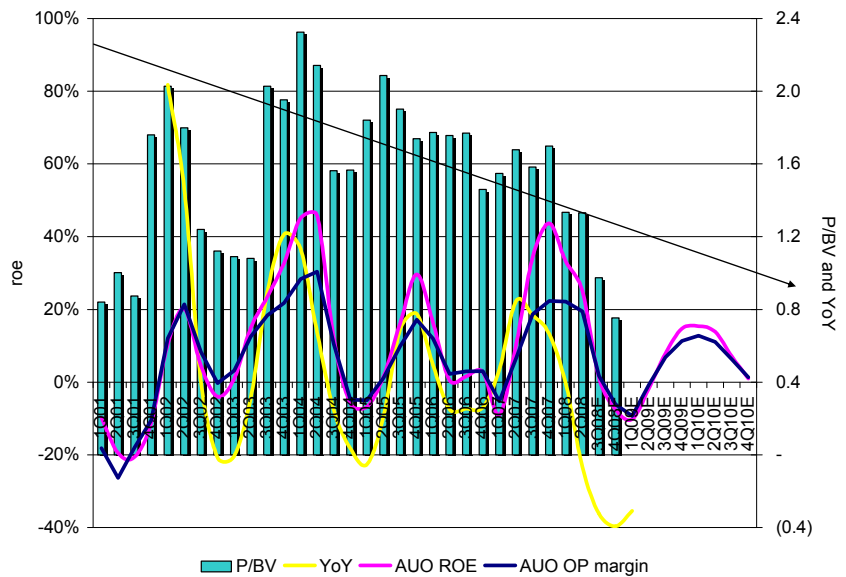


Source: Company Reports and CIR Estimates

Valuation

We factor 2-3 quarters of losses into our NT\$40 target price, or nearly 1x 2008-10E book. We use P/B as our primary valuation method due to company and sector earnings volatility. Over the past five years, AUO traded at 1.6x average trailing book with an average ROE of 10-15%. As we estimate long-term ROE for AUO to contract to 6-10% for the next five years, we expect the long-term average P/BV to slip to 1x from 1.6x by assuming the same P/BV to ROE ratio of 1.2-1.3x. However, if AUO improves its free cash flow position and does better capital management to return its long-term ROE to the 15% level, we are not ruling out a re-rating. But, till now, we do not see this.

AUO – P/BV, ROE, Op margin, and YoY sales comparison



Source: Company Reports and CIR Estimates

Risks

We assign AUO shares Low Risk based on our quantitative risk-rating system, which tracks 260-day historical share price volatility. Downside risks that could prevent the shares from reaching our target price are: Disappointing LCD TV sell-through and PC seasonality turns out worse than expected; if AUO fails to ramp up its future capacities smoothly, or cannot offer large-sized TV panels in significant volumes; if industry spending turns out to be more than expected, it could result in industry oversupply; if there is a greater-than-expected price cut, our profit estimates would be at risk.

Appendix A-1

Analyst Certification

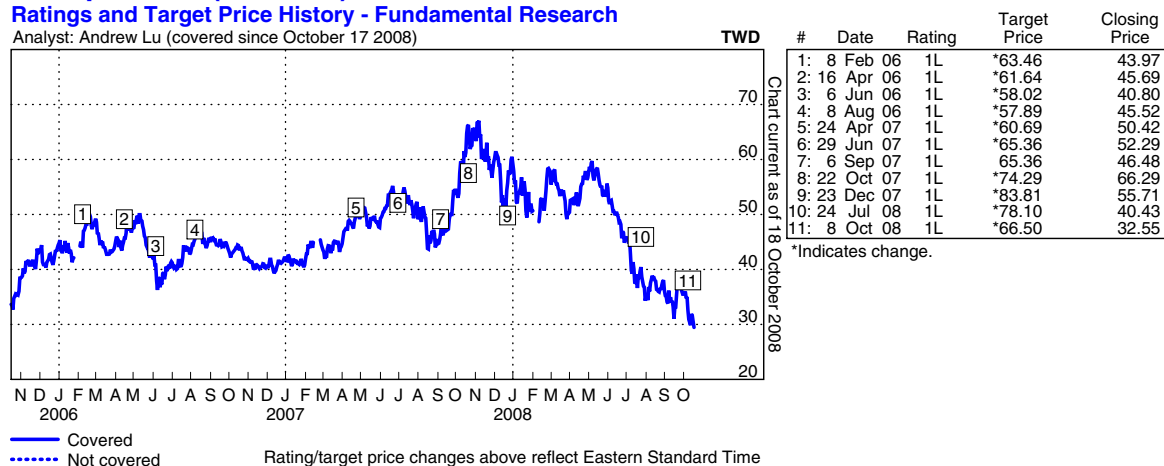
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Analyst: Andrew Lu (covered since October 17 2008)



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