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Stock Rating
Equal-weight

Industry View
In-Line

Merry Electronics

Cost Saving Benefits Offset Revenue Slowness in 3Q

Quick comment – Small-cap name punished amid market turmoil: Merry's share price has dipped by more than 30% this month, which we believe is mainly attributable to the stock's smaller liquidity and company's higher business volatility, similar to other small-cap peers that the market dislikes in an unstable macroenvironment. Still, we read Merry's better 3Q results as positive (on OpM expansion) with its healthy balance sheet and net cash position and historical trough valuations at 6.5x/6.9x 08/09E. Nonetheless, we believe its share price might not rebound sharply anytime soon, given cautious market sentiment and worries about decelerating handset industry growth in 2009E. We suggest investors revisit the name after market turmoil settles or when we have better visibility for 2009, likely in early 2Q09.

Better 3Q on continuous cost-down efforts: 3Q EPS beat our and Street expectations by 20-30% at NT\$1.65 (+52% QoQ, +12% YoY), thanks to procurement savings and internal cost-control benefits plus tax credit (headquartered in Taiwan incentives), more than offsetting slower revenue (+19% QoQ vs. guidance of 25%+). GM sustained at 20% on stabilized product mix (hands-free headset for 80%) while OpM recovered 2ppt to 11% on well-controlled OPEX. We are encouraged by the signs of OpM recovery from the trough in 1Q.

Uptrend in 4Q but lower visibility: Mgt expects Oct revenue to stay upward, followed by likely flattish Nov and declining Dec. It is unable to quantify sequential growth in 4Q yet, given firm order visibility is only up to 2-3 weeks. This suggests most handset brands are turning more cautious on holiday sell-through momentum in 4Q. We now expect Merry's 4Q to grow 8% QoQ, mainly driven by new hands-free headset model sell-in strength (the third model to Nokia) with peak month likely in Oct. GM should sustain at 20% level for similar product mix as 3Q, with OpM at around 10% on slightly higher year-end expenditure recognition.

Key Ratios and Statistics

Reuters: 2439.TW Bloomberg: 2439 TT

Taiwan Hardware Components

Price target	NT\$46
Shr price, close (Oct 22, 2008)	NT\$28.20
Mkt cap, curr (mn)	US\$138
52-Week Range	NT\$131.50-28.20
Sh out, basic, curr (mn)	159.1
EV, curr (mn)	NT\$4,004
S'hldr eqty (12/08e) (mn)	NT\$4,608

Fiscal Year ending	12/07	12/08e	12/09e	12/10e
ModelWare EPS (NT\$)	4.94	4.35	4.08	4.18
EPS, basic (NT\$)	5.63	4.59	4.41	4.59
Revenue, net (NT\$ mn)	8,845	9,665	10,961	12,607
ModelWare net inc (NT\$ mn)	785	692	649	665
P/E	20.2	6.5	6.9	6.7
P/BV	3.5	1.0	0.9	0.9
EV/EBITDA	12.4	3.9	4.2	3.9
Div yld (%)	2.1	10.6	15.7	13.1

e = Morgan Stanley Research estimates

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Risks to Our Price Target

The key downside risks to our price target are: 1) weaker-than-expected end-market demand in 2008/09E, especially in handsets; 2) changes in the dynamics of the competitive landscape; and 3) any deviation from handset OEMs' expectations of sell-through strength, and the market's response to the specific phones for which Merry is responsible.

Upside risks include a major breakthrough for Merry in new project wins on both speakers/receivers and hands-free headsets, which would likely boost its top line.

Company Description

Merry is a dedicated acoustic component maker, specializing in producing receivers/speakers for handsets and hands-free headsets, capturing around 8% of the global market share. On our estimates, handset-related products accounted for 75% of sales in 2005, with major customers including Sony-Ericsson, Sagem, Plantronics, and NEC.

Taiwan Hardware Components

Industry View: In-Line

MSCI Country: Taiwan

Asia Strategist's Recommended Weight: 11.9%

MSCI Asia/Pac All Country Ex Jp Weight: 12.0%

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Exhibit 1

Merry: 3Q Result Summary Table

NT\$ m	3Q08 Results			MS Est.	Variance	3Q07	2Q08
	Actual	QoQ	YoY				
Sales	2,563	19%	8%	2,672	-4%	2,375	2,156
COGS	-2,044	19%	12%	-2,145	-5%	-1,822	-1,718
Gross profit	518	18%	-6%	526	-2%	553	438
Operating expense	-235	-4%	6%	-274	-14%	-222	-246
Promotion	-57	-3%	34%	-274	-79%	-42	-58
ADM	-104	-6%	3%	-70	49%	-102	-112
R&D	-74	-2%	-5%	-120	-38%	-79	-76
Operating profit	283	48%	-14%	252	12%	331	192
Total non-operating income	-13	1556%	103%	2	NM	-7	-1
Pre-tax profit	270	41%	-17%	254	6%	324	191
Income tax	9	-156%	-114%	-38	-122%	-62	-15
Minority	1	-73%	NM	0	NM	0	3
Reported net profit	279	56%	7%	216	29%	262	178
Reported EPS (NT\$)	1.75	56%	7%	1.36	29%	1.65	1.12
Employee bonus expense	-16	167%	-53%	-19	-16%	-35	-6
Modelware net profit	262	52%	12%	200	31%	234	173
Modelware EPS (NT\$)	1.65	52%	12%	1.26	31%	1.47	1.09

Margins (%) - Pre-bonus adjusted

Gross margin	20.2%	-0.1 ppt	-3.1 ppt	19.7%		23.3%	20.3%
Operating margin	11.1%	2.2 ppt	-2.9 ppt	9.4%		13.9%	8.9%
Pre-tax margin	10.5%	1.7 ppt	-3.1 ppt	9.5%		13.6%	8.9%
Net margin	10.9%	2.6 ppt	-0.1 ppt	8.1%		11.0%	8.3%

Margins (%) - Post-bonus adjusted

Gross margin	20.2%			19.7%		23.3%	20.3%
Operating margin	10.4%			8.7%		12.5%	8.6%
Pre-tax margin	9.9%			8.8%		12.2%	8.6%
Net margin	10.2%			7.5%		9.8%	8.0%

Source: Company data, Morgan Stanley Research

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Exhibit 2

Merry: Earnings Summary, 1Q07-4Q08E

NT\$ m	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08	3Q08P	4Q08E	2007	2008E	2009E
Sales	1,912	2,055	2,375	2,504	2,181	2,156	2,563	2,766	8,845	9,665	10,961
COGS	-1,449	-1,542	-1,822	-2,025	-1,808	-1,718	-2,044	-2,217	-6,838	-7,787	-9,085
Gross profit	462	513	553	478	373	438	518	549	2,007	1,878	1,876
Operating Exp.	-189	-214	-222	-244	-214	-246	-235	-270	-870	-964	-1,065
Promotion	-44	-46	-42	-42	-32	-58	-57	-64	-174	-211	-215
ADM	-70	-100	-102	-110	-103	-112	-104	-120	-382	-438	-486
R&D	-75	-68	-79	-92	-79	-76	-74	-85	-314	-315	-363
Operating profit	273	299	331	234	160	192	283	279	1,138	914	811
Total non-operating Inc.	2	4	-7	-68	-44	-1	-13	-14	-69	-72	9
Net Interest Inc.	2	3	4	4	2	-2	0	2	13	2	8
Net Investment Inc.	4	13	-10	20	0	16	0	0	28	16	0
Disposal of Investment	0	3	0	-83	0	0	0	0	-80	0	0
Disposal of Fixed Assets	0	0	0	0	0	0	0	0	0	0	0
Exchange Gain (Loss)	0	-15	-8	10	-45	1	0	0	-13	-44	0
Others Income (Loss)	-4	-1	7	-19	-1	-16	-13	-16	-17	-46	1
Pre-tax profit	275	303	324	166	116	191	270	265	1,068	841	819
Income Tax	-35	-40	-62	-38	-21	-15	9	-90	-175	-118	-123
Minorities	0	1	0	3	0	3	1	3	3	6	6
Net profit	240	264	262	131	94	178	279	178	896	730	702
EPS-Pre-Employee Bonus	1.51	1.66	1.65	0.82	0.59	1.12	1.75	1.12	5.63	4.59	4.41
EPS-Post-Employee Bonus	1.33	1.49	1.47	0.65	0.57	1.09	1.65	1.05	4.94	4.35	4.08
Margins (Pre-Employee Bonus)											
Gross margin	24.2%	25.0%	23.3%	19.1%	17.1%	20.3%	20.2%	19.8%	22.7%	19.4%	17.1%
Operating margin	14.3%	14.6%	13.9%	9.4%	7.3%	8.9%	11.1%	10.1%	12.9%	9.5%	7.4%
Pre-tax margin	14.4%	14.7%	13.6%	6.6%	5.3%	8.9%	10.5%	9.6%	12.1%	8.7%	7.5%
Net margin	12.6%	12.8%	11.0%	5.2%	4.3%	8.3%	10.9%	6.4%	10.1%	7.6%	6.4%
Margins (Post-Employee Bonus)											
Gross margin					17.1%	20.3%	20.2%	19.8%		19.4%	17.1%
Operating margin					7.1%	8.6%	10.4%	9.4%		9.0%	6.8%
Pre-tax margin					5.0%	8.6%	9.9%	8.9%		8.2%	6.9%
Net margin					4.1%	8.0%	10.2%	6.0%		7.2%	5.9%
QoQ Growth (Pre-Employee Bonus)											
Sales	3.2%	7.5%	15.6%	5.4%	-12.9%	-1.2%	18.9%	7.9%	YoY 50.1%	9.3%	13.4%
Gross profit	1.4%	11.0%	7.8%	-13.5%	-22.0%	17.3%	18.4%	5.8%	25.4%	-6.5%	-0.1%
Operating profit	15.4%	9.6%	10.6%	-29.2%	-31.9%	20.2%	47.7%	-1.4%	23.3%	-19.7%	-11.3%
Pre-tax profit	28.5%	10.1%	7.1%	-48.9%	-30.3%	65.3%	41.3%	-1.7%	19.1%	-21.2%	-2.6%
Net profit	42.5%	9.8%	-0.6%	-50.2%	-27.8%	89.3%	56.5%	-36.1%	18.9%	-18.6%	-3.8%
QoQ Growth (Post-Employee Bonus)											
Sales					-12.9%	-1.2%	18.9%	7.9%		9.3%	13.4%
Gross profit					-22.0%	17.3%	18.4%	5.8%		-6.5%	-0.1%
Operating profit					-22.6%	20.7%	43.8%	-2.1%		-23.7%	-13.8%
Pre-tax profit					-15.8%	68.4%	37.1%	-2.4%		-25.5%	-4.9%
Net profit					-12.8%	91.7%	51.8%	-36.5%		-12.0%	-6.2%

E = Morgan Stanley Research Estimates; P = Preliminary Results

Source: Company data, Morgan Stanley Research

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Exhibit 3

Hardware Technology Valuation Comparisons- US GAAP-Adjusted

Ticker	Closing Price		Price Target (Local Dollar)	Market Cap (US\$ m)	EPS (Local Dollar)			P/E (X)		P/S (X)		P/B (X)		EV/EBITDA		ROA (%)		ROE (%)		
	10/21/2008	Rating			07	08E	09E	08E	09E	08E	09E	08E	09E	08E	09E	08E	09E	08E	09E	
EMS & PC system																				
2353.TW	Acer	46.0	O	75.0	3,402	4.34	4.89	5.50	9.4	8.4	0.2	0.2	1.4	1.3	7.5	5.0	4.7	4.8	14.8	15.6
2324.TW	Compal	22.6	E	27.0	2,865	2.92	3.22	3.34	7.0	6.8	0.2	0.2	1.1	1.0	6.6	6.6	7.9	7.6	16.7	16.1
2308.TW	Delta Electronics	74.5	O	94.0	4,798	5.66	4.99	5.52	14.9	13.5	1.0	0.9	2.1	2.0	9.0	7.5	9.0	9.4	15.0	16.4
2317.TW	Hon Hai	81.1	O	150	18,384	11.72	10.33	11.36	7.8	7.1	0.3	0.2	1.3	1.2	5.0	4.2	8.2	7.8	18.4	17.4
0992.HK	Lenovo	2.70	E	4.10	3,379	0.05	0.05	0.05	7.3	7.1	0.2	0.2	1.6	1.4	3.4	3.0	6.8	6.7	26.8	22.8
2315.TW	Mitac	13.05	E	13.0	581	3.40	1.87	1.77	7.0	7.4	0.3	0.3	0.6	0.6	4.4	3.8	4.7	4.6	8.4	7.8
3518.TW	Paragon	60.8	O	105.0	130	8.76	7.77	9.86	7.8	6.2	2.1	1.8	1.2	1.0	4.8	4.2	14.4	16.0	15.0	17.7
2382.TW	Quanta	33.8	E	45.0	3,704	4.37	4.70	4.82	6.4	6.3	0.1	0.1	1.2	1.1	3.0	2.6	5.5	5.3	17.4	16.4
3231.TW	Wistron	30.7	O	55.0	1,295	3.52	4.53	5.49	6.8	5.6	0.1	0.1	1.2	1.1	5.4	4.8	5.4	5.5	21.1	23.2
Handset & Networking																				
2018.HK	AAC Acoustic	4.52	O	8.3	641	0.44	0.60	0.72	6.6	5.5	1.9	1.5	1.5	1.2	4.3	3.3	20.0	18.9	24.9	23.5
0285.HK	BE	2.65	O	5.3	685	0.58	0.59	0.59	4.0	4.0	0.5	0.3	0.8	0.6	2.2	2.5	13.7	10.2	23.2	17.8
1211.HK	BYD	17.44	E	10.2	4,065	0.79	0.90	0.90	17.1	17.1	1.0	0.8	2.1	1.9	8.7	8.3	5.5	4.7	13.2	11.6
3095.TWO	Chi Cheng	13	U	25.8	58	2.10	2.27	2.71	5.7	4.8	0.2	0.2	0.4	0.4	6.0	5.6	2.8	3.3	7.5	8.6
8078.TW	CCI	24.9	U	22.5	782	5.67	2.42	2.16	10.3	11.5	0.4	0.4	1.2	1.2	2.3	1.1	6.7	6.4	12.3	11.4
2332.TW	D-Link	23.1	E	31.0	493	3.69	2.88	2.91	8.0	7.9	0.5	0.5	0.8	0.8	4.0	3.5	5.9	5.8	10.5	10.3
0722.HK	Delta Networks	1.39	O	2.40	215	0.20	0.19	0.20	7.3	7.0	0.5	0.4	0.7	0.6	-1.9	-2.8	6.9	6.4	9.7	9.1
2038.HK	FIH	2.70	E	3.7	2,426	0.10	0.07	0.06	4.8	5.4	0.2	0.2	0.6	0.6	2.6	2.5	6.9	5.4	14.1	11.0
4906.TW	Gemtek	40	O	75.0	288	2.82	4.83	5.37	8.3	7.5	0.4	0.4	1.2	1.1	4.9	4.0	9.6	9.7	15.5	16.1
2498.TW	HTC	420	O	645	9,700	41.02	39.24	41.96	10.7	10.0	2.0	1.7	4.9	4.0	9.7	8.4	30.5	28.1	49.1	44.1
3008.TW	Largan	321	O	435	1,277	14.58	25.66	28.36	12.5	11.3	5.2	4.7	3.4	2.9	9.8	8.4	27.3	25.5	29.9	27.7
2439.TW	Merry	28.2	E	46.0	138	4.94	4.35	4.08	6.5	6.9	0.5	0.4	1.0	0.9	3.9	4.2	8.8	8.0	15.1	13.9
3311.TW	Silitech	74.6	O	98	344	6.07	6.15	6.82	12.1	10.9	1.2	1.0	2.7	2.5	6.3	4.9	11.6	11.8	23.5	23.4
2000.HK	SIM Tech	0.39	E	0.52	76	0.16	0.16	0.16	2.2	2.2	0.2	0.2	0.4	0.4	-0.5	-0.7	11.5	10.7	18.0	16.2
3044.TW	Tripod	46.35	E	72	656	7.87	7.31	7.23	6.3	6.4	0.7	0.6	1.3	1.2	4.0	3.2	10.6	9.2	23.0	19.5
3037.TW	Unimicron	20.1	O	32.6	672	4.80	2.86	3.26	7.0	6.2	0.5	0.4	0.7	0.7	3.2	2.6	5.3	5.9	10.8	11.5
8046.TW	Nan Ya PCB	79	O	155.0	1,493	13.80	11.11	13.78	7.1	5.7	1.2	1.1	1.3	1.2	4.0	3.4	15.4	18.6	18.0	21.9
0763.HK	ZTE	17.4	E	32.2	2,651	0.93	1.27	1.42	12.0	10.8	0.5	0.4	1.4	1.2	6.0	5.2	3.6	3.4	12.4	12.2
Consumer & LED																				
2474.TW	Catcher	85.2	U	79.1	1,552	11.66	8.25	8.16	10.3	10.4	2.7	2.5	1.7	1.5	7.6	7.3	12.7	11.4	17.8	15.6
2392.TW	Cheng Uei	52	U	44.0	638	4.25	4.33	3.83	12.0	13.6	0.4	0.3	1.1	1.1	5.9	6.1	4.9	4.2	10.7	9.0
2448.TW	Epistar	43.2	U	30.5	819	2.29	1.70	2.12	25.5	20.4	2.4	2.2	1.2	1.2	12.0	9.8	3.7	4.7	4.5	5.6
2393.TW	Everlight	53	E	74.5	569	4.93	4.95	5.16	10.7	10.3	1.6	1.4	1.8	1.8	8.1	6.6	10.3	10.0	17.2	17.1
2354.TW	Foxconn Tech	76.7	O	148	1,780	8.70	7.47	8.98	10.3	8.5	0.4	0.3	1.7	1.5	6.7	5.9	6.8	8.5	14.4	18.8

Source: Company data, Morgan Stanley Research

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(as of September 30, 2008)

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Underweight/Sell	387	17%	90	14%	23%
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Data include common stock and ADRs currently assigned ratings. An investor's decision to buy or sell a stock should depend on individual circumstances (such as the investor's existing holdings) and other considerations. Investment Banking Clients are companies from whom Morgan Stanley or an affiliate received investment banking compensation in the last 12 months.

Analyst Stock Ratings

Overweight (O or Over) - The stock's total return is expected to exceed the total return of the relevant country MSCI Index, on a risk-adjusted basis over the next 12-18 months.

Equal-weight (E or Equal) - The stock's total return is expected to be in line with the total return of the relevant country MSCI Index, on a risk-adjusted basis over the next 12-18 months.

Underweight (U or Under) - The stock's total return is expected to be below the total return of the relevant country MSCI Index, on a risk-adjusted basis, over the next 12-18 months.

More volatile (V) - We estimate that this stock has more than a 25% chance of a price move (up or down) of more than 25% in a month, based on a quantitative assessment of historical data, or in the analyst's view, it is likely to become materially more volatile over the next 1-12 months compared with the past three years. Stocks with less than one year of trading history are automatically rated as more volatile (unless otherwise noted). We note that securities that we do not currently consider "more volatile" can still perform in that manner.

Unless otherwise specified, the time frame for price targets included in Morgan Stanley Research is 12 to 18 months.

Analyst Industry Views

Attractive (A): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be attractive vs. the relevant broad market benchmark, as indicated below.

In-Line (I): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be in line with the relevant broad market benchmark, as indicated below.

Cautious (C): The analyst views the performance of his or her industry coverage universe over the next 12-18 months with caution vs. the relevant broad market benchmark, as indicated below.

Benchmarks for each region are as follows: North America - S&P 500; Latin America - relevant MSCI country index or MSCI Latin America Index; Europe - MSCI Europe; Japan - TOPIX; Asia - relevant MSCI country index.

Other Important Disclosures

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Industry Coverage: Taiwan Hardware Components

Company (Ticker)	Rating (as of)	Price (10/22/2008)
Anya Chang		
Nan Ya PCB (8046.TW)	O-V (07/28/2008)	NT\$79
Tripod Technology (3044.TW)	E (04/30/2008)	NT\$46.35
Unimicron (3037.TW)	O (01/08/2008)	NT\$20.1
Grace Chen		
Catcher Technology (2474.TW)	U (04/16/2008)	NT\$85.2
Foxconn Technology (2354.TW)	O (07/30/2007)	NT\$76.7
Jasmine Lu		
Largan Precision (3008.TW)	O (06/21/2007)	NT\$321
Sharon Shih		
Cheng Uei Precision (2392.TW)	U (02/14/2008)	NT\$52
Compal Communications (8078.TW)	U (03/02/2007)	NT\$24.9
Epistar (2448.TW)	U (09/30/2008)	NT\$43.2
Everlight Electronics Co., Ltd. (2393.TW)	E (09/30/2008)	NT\$53
Merry Electronics (2439.TW)	E (07/24/2008)	NT\$28.2
Silitech Technology (3311.TW)	O (11/22/2007)	NT\$74.6
Taiwan Chi Cheng (3095.TWO)	U (02/13/2008)	NT\$13

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