

Our view

We see Unimicron's fundamentals improving with easing margin pressure (due to NT dollar depreciation and falling raw material prices) and Nokia's potential market share recovery in 4Q08F. Its lead in HDI PCBs should also give it solid footing in the downcycle. With the shares at trough levels, we upgrade to NEUTRAL.

Anchor themes

- Handset vendors are increasingly sourcing components from Taiwan and China, amid mounting pressure to cut costs. For example, Nokia's higher-end PCB orders placed with Unimicron have increased, a trend we expect to continue in FY08-09F.
- The FC segment is seeing a reversal of fortunes on: 1) stabilised CPU layer count; and 2) strength in the graphics and chipset segments, owing to Vista requirements for more advanced substrates. Japanese makers seem to be widening their lead in CPUs, but we see ample room for other Asian makers to grow here.

Back to ground level

- Easing margin pressure
- PCB to benefit from Nokia's potential market share recovery
- Leadership matters in the downcycle
- Upgrade to NEUTRAL; fair value cut to NT\$22.10, from NT\$26.60

① Easing margin pressure

Unimicron shares (-62%) have significantly underperformed the TWSE index (-42%) this year, on slowing growth and sharp margin contraction in 1H08. We believe that the negatives are fully reflected, and upgrade to NEUTRAL, from Sell, given the following:

- Margin pressure should ease in 2H08F, on NT dollar depreciation and raw material price declines.
- Potential market share recovery at Nokia bodes well for Unimicron.
- Unimicron looks better positioned to benefit from potential industry consolidation in the macro downturn, owing to its lead in HDI PCBs, positive cashflow, and strong management.
- The shares have hit historical trough valuations at 0.7x and 7.5x FY08F BVPS and EPS, respectively.

Gross margin deteriorated sharply in 1H08 (-9.6pp from end-FY07 to 12.4%), mainly owing to the NT dollar strength, weak substrate demand, and rising raw material prices, and to a lesser extent, higher employee bonus and labour costs. However, with the local currency likely to depreciate by 6.8%, and gold and copper prices set to drop by 14% and 46%, respectively, in 2H08F (from end-1H08), gross margin is likely to exceed our earlier expectations. Thus, we raise our 3Q-4Q08F gross margin forecasts to 14.9-15.3%, from 13.8-14.3%, offering further support to valuations.

Closing price on 20 Oct	NT\$20.80
Fair value estimate	NT\$22.10
Upside/downside	6.3%
Difference from consensus	-32.8%
FY09F net profit (NT\$m)	3,210
Difference from consensus	-13.6%
Source: Nomura	

Nomura vs consensus

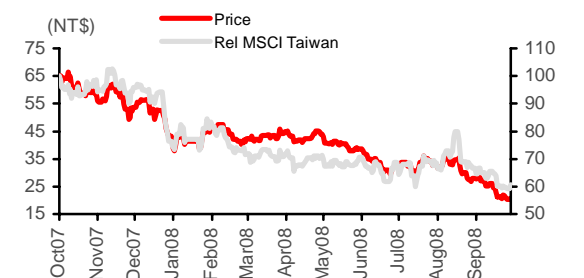
Our FY08F bonus-adjusted net profit forecast is 10% below consensus, likely owing to our more conservative 4Q08F sales and gross margin forecasts for IC substrates.

Key financials & valuations

31 Dec (NT\$m)	FY07	FY08F	FY09F	FY10F
Revenue	47,281	47,802	49,423	53,449
Reported net profit	5,762	2,986	3,210	3,394
Normalised net profit	5,762	2,986	3,210	3,394
Normalised EPS (NT\$)	5.45	2.77	2.94	3.11
Norm. EPS growth (%)	26.3	(49.2)	6.0	5.7
Norm. P/E (x)	3.8	7.5	7.1	6.7
EV/EBITDA (x)	2.4	3.1	2.7	2.2
Price/book (x)	0.7	0.7	0.6	0.6
Dividend yield (%)	10.8	5.4	5.7	6.0
ROE (%)	19.5	9.1	9.3	9.2
Net debt/equity (%)	12.9	14.9	7.1	net cash
Earnings revisions				
Previous norm. net profit		3,001	3,453	3,717
Change from previous (%)		(0.5)	(7.0)	(8.7)
Previous norm. EPS (NT\$)		2.84	3.27	3.52

Source: Company, Nomura estimates

Share price relative to MSCI Taiwan



	1m	3m	6m
Absolute (NT\$)	(25.7)	(35.9)	(52.8)
Absolute (US\$)	(26.7)	(40.3)	(56.2)
Relative to Index	(7.1)	(8.0)	(7.3)
Market cap (US\$m)			697
Estimated free float (%)			80.9
52-week range (NT\$)			66.5/20.30
3-mth avg daily turnover (US\$m)			9.30
Stock borrowability			Hard
Major shareholders (%)			
United Microelectronics Corp.			19.1
Tseng Tzu Chang			0.7

Source: Company, Nomura estimates

See the important disclosures and analyst certifications on pages 9 to 11.

② PCB to benefit from Nokia's potential market share recovery

Nokia has long been Unimicron's largest client (25-30% of sales) and the handset maker's shrinking market share appears to be to blame for the stagnant sales growth at Unimicron in late-2Q08 and early-3Q08. Nokia saw its market share narrow to 38% in 3Q08 (from 40% in 2Q08) on a 3% q-q decline in unit shipments, we think owing to its tactical decision not to meet aggressive pricing of competitors (eg, Samsung Electronics and Chinese handset makers), industry competition, and slow ramping up of its mid-range device. However, with a polished product portfolio, Nokia expects to maintain or slightly increase its market share in 4Q08F, assuming industry growth of about 14% q-q. As a key PCB supplier to Nokia, we think Unimicron will benefit from stronger sell-in demand for Nokia handsets in the near term.

Despite the improving margins and outlook for its key client, we are still cautious on Unimicron's overall growth prospects for 4Q08F and FY09F, due to the deteriorating macro environment and unfavourable supply-demand situation for IC substrates (about 20% of sales). We look for 4Q08F sales to decline by 3% q-q, with flat sequential HDI PCB sales but a weaker IC substrate supply-demand situation owing to inventory built-up at leading customers Intel and AMD in 3Q08. We also believe that 1Q09F will be weaker than normal. The deteriorating macro outlook has us projecting a muted FY09F for Unimicron, with sales and earnings growth of only 3% y-y and 7% y-y.

Nokia looks set for a comeback

Outlook on IC substrates remains gloomy

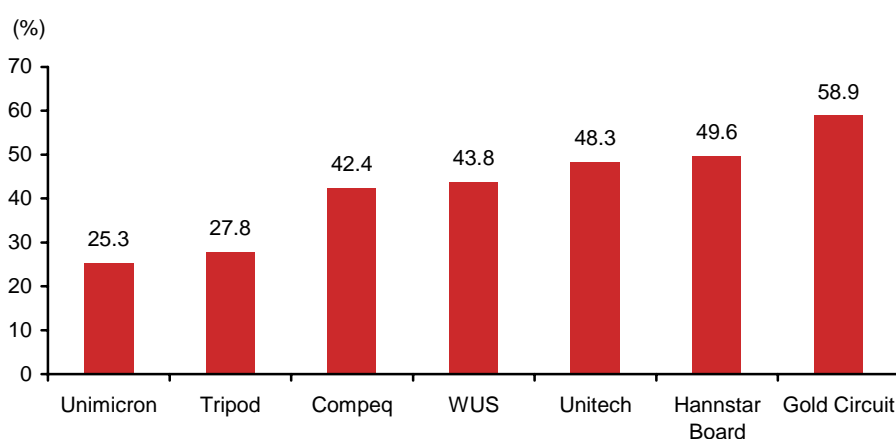
③ Leadership matters in the downcycle

Although we remained concerned about Unimicron's market share saturation in handset PCBs, its leadership and scale (23-25% global market share in handset PCBs) should keep it relatively resilient in the downcycle. Compared with other major PCB makers in Taiwan, Unimicron has the lowest net debt/equity ratio (Exhibit 1). With solid operating cashflow and plans to reduce capex in FY09F, Unimicron looks set to build a stronger cash position next year.

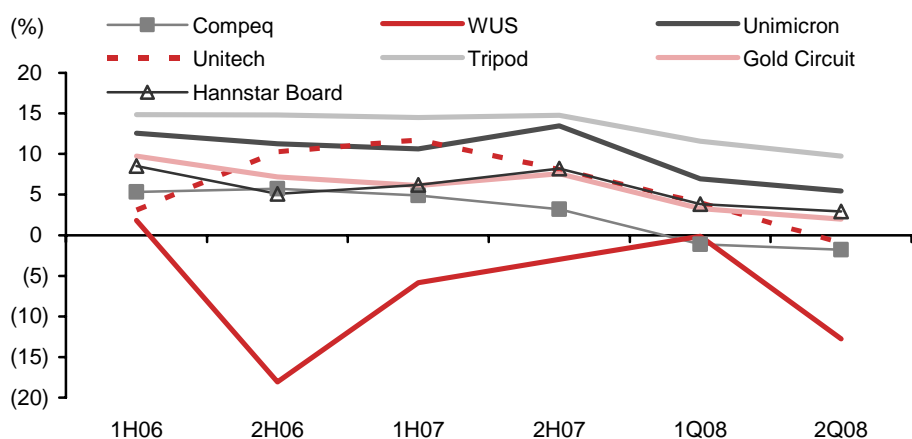
In the downturn, the retreat of smaller players will likely see industry leaders such as Unimicron expand market share. We see this playing out next year, since many second-tier PCB players have started to see deeper losses this year. Moreover, as banks tighten credit lines, smaller players are likely to find it more difficult to re-finance.

Unimicron is a likely beneficiary of potential industry consolidation

Exhibit 1. Taiwan PCB makers: net debt/equity (end-2Q08)



Source: Company data

Exhibit 2. Taiwan PCB makers: net margin comparison (consolidated)


Source: Company data

④ Upgrade to NEUTRAL; fair value cut to NT\$22.10, from NT\$26.60

We pare our FY08-10F revenue forecasts by 3-8%, but raise gross margin by 0.2-0.5pp to reflect more favourable raw material prices and NT dollar depreciation. Our revised FY08-10F earnings forecasts come in 0.5%, 7.0%, and 8.7% lower than our previous forecasts, and are 10-15% short of consensus estimates. We assume flattish top-line growth (+3%) for FY09F and moderate growth (+8%) for FY10F, given the macro concerns.

Based on our earnings revisions, our DCF-based fair value falls to NT\$22.10 (previously NT\$26.60), which is equivalent to 8.0x and 7.5x FY08-09F bonus-adjusted EPS. Our main DCF assumptions are unchanged: 2% terminal growth and an 11.4% discount rate. At 7.5x and 7.1x FY08-09F bonus-adjusted EPS, the shares are at the bottom of the historical P/E range since late-FY05. We believe that the negatives are largely factored in and upgrade our rating to NEUTRAL, from Sell.

While the current environment does not look conducive to a strong share price rebound, downside looks limited and the shares should show resilience in the downcycle, given the company's dominant position in HDI PCBs.

To the upside, we would expect a positive re-rating for Unimicron on: 1) strong handset sell-through a revival of consumer demand; 2) any significant market share gains in HDI PCBs; and 3) an improved supply-demand balance for IC substrates.

We cut our FY09-10F earnings forecasts by 7-9%

Trading at trough valuations. Upgrade to NEUTRAL

But, a V-shape share price rebound looks unlikely

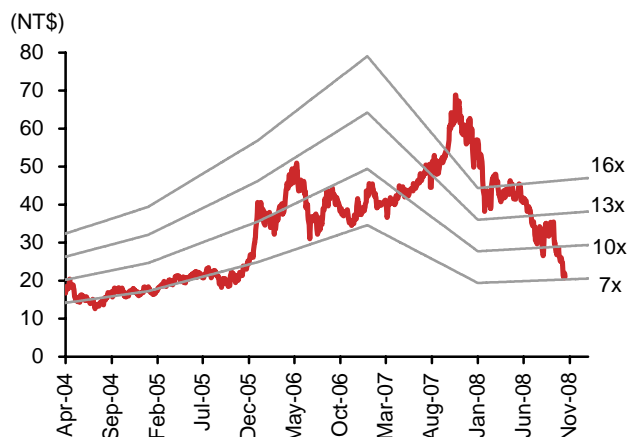
Exhibit 3. Unimicron: earnings revisions

(NT\$m)	Revised			Previous			Change (%)		
	FY08F	FY09F	FY10F	FY08F	FY09F	FY10F	FY08F	FY09F	FY10F
Revenue	47,802	49,423	53,449	49,133	53,124	57,994	(2.7)	(7.0)	(7.8)
Gross profit	7,214	7,361	7,762	7,145	7,806	8,297	1.0	(5.7)	(6.5)
Operating profit	4,329	4,487	4,735	4,219	4,815	5,176	2.6	(6.8)	(8.5)
Pre-tax profit	3,948	4,419	4,667	3,968	4,747	5,108	(0.5)	(6.9)	(8.6)
Net profit	2,986	3,210	3,394	3,001	3,453	3,717	(0.5)	(7.0)	(8.7)
EPS (NT\$)	2.8	2.9	3.1	2.8	3.3	3.5			
Margins (%)									
Gross margin	15.1	14.9	14.5	14.5	14.7	14.3	0.5	0.2	0.2
Operating margin	9.1	9.1	8.9	8.6	9.1	8.9	0.5	0.0	(0.1)
Pre-tax margin	8.3	8.9	8.7	8.1	8.9	8.8	0.2	0.0	(0.1)
Net margin	6.2	6.5	6.3	6.1	6.5	6.4	0.1	(0.0)	(0.1)

Note: Based on local GAAP; bonus-adjusted FY08-10F earnings

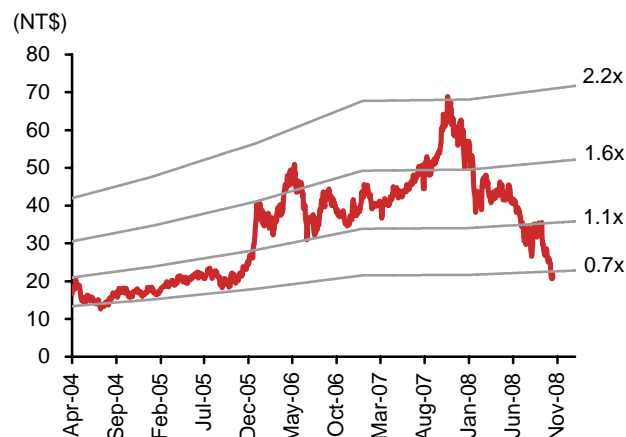
Source: Company data, Nomura International (Hong Kong) Limited, Taipei Branch

Exhibit 4. Unimicron: P/E bands (bonus adjusted)



Source: TEJ, Nomura International (Hong Kong) Limited, Taipei Branch

Exhibit 5. Unimicron: P/BV bands



Source: TEJ, Nomura International (Hong Kong) Limited, Taipei Branch

⑤ Earnings and fair value sensitivity to US recession

After growing by 1.0% (q-q, annualised) in 1Q08, the US economy avoided negative growth in 2Q08, expanding 1.9% q-q on the back of personal consumption and net exports. Real personal consumption growth remained positive at 1.5% during 2Q08, as the boost to disposable income from the retroactive income tax rebate was largely put toward consumption. The weak US dollar and sustained demand in the rest of the world, especially in the emerging economies, contributed to an increase in net exports. Although we have revised up our US real GDP growth assumptions (from 0.8% to 1.5% for 2008F) to reflect incoming data for the first half of the year, and consensus has been revising down its over-optimistic forecasts, we have scaled back our forecast for 2009F to 0.8%, from 1.3%. We remain significantly below consensus estimates of 2008F and 2009F real GDP growth in all Asia-Pacific ex-Japan markets under Nomura coverage, with the exception of India and Australia. (See our 6 August Economics Anchor Report, *China factor governs global inflation*.)

Our cautious stance reflects our view that consumer and business sentiment — primarily in the US, with the risk of contagion first to other Western markets and then globally — are vulnerable to: 1) inflation resulting from higher prices for oil and other commodities; and 2) tight credit conditions. Many major economies other than the US are already experiencing economic slowdown in the face of rising inflation.

- Under our revised **Base Case** assumptions, to which we assign a 60% probability, we expect the US economy to contract q-q during 4Q08F and 1Q09F as the positive effects of fiscal stimulus wear off. The economy should enter a recovery phase after 2Q09F, but growth is likely to remain sub-par due to: 1) relatively low consumer spending; 2) a further decline in residential investment; and 3) continued tight credit conditions. Our revised US real GDP growth assumptions are 1.5% for 2008F and 0.8% for 2009F, compared with consensus estimates of 1.5% for 2008F and 1.5% for 2009F. Real GDP growth in most of Asia is forecast at 4-5% under this scenario, with China at 9.6% and India at 8.1% continuing to stand out. Singapore, with growth of 3.2%, is the laggard. There have been no significant changes to our growth rate forecasts except for Taiwan. Although Asia's exports did not slow as much as we expected owing to the higher-than-projected growth in the US, oil prices overshoot our expectations and higher inflation, coupled with lower asset prices, has started to weigh on Asian economies. For Taiwan, the 2Q08 export figure was very robust, and we have lifted our 2008F real GDP growth forecast to 4.1%, from 2.4%.

US managed to avoid negative economic growth in 1H08...

...but our revised forecasts for real GDP growth in Asia largely remain below scaled-back market estimates

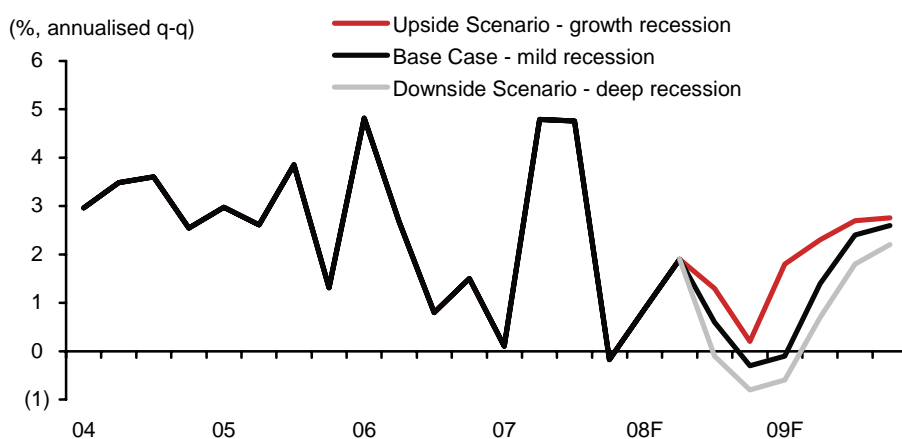
Our revised Base Case (60% probability) assumes negative growth in the US in both 4Q08F and 1Q09F as the impact of fiscal stimulus fades

- Our revised **Upside Scenario** assumes that the US steers clear of q-q contraction, thanks to improving consumer sentiment supported by the tax cut and increased stability in financial markets. We ascribe a 30% probability to this scenario and look for US real GDP growth of 1.6% in 2008F and 1.7% in 2009F. In this scenario, Asian growth rates are boosted by 0.3-1.0pp, with Singapore the most sensitive. In 2008F, China gets an extra 0.5pp and India an extra 0.4pp.
- Our new **Downside Scenario** is based on the assumption that US economic conditions deteriorate, as the favourable effects of fiscal policy are offset by the negative effects of rising inflation. We give this scenario a 10% probability and look for US real GDP growth of 1.4% in 2008F and 0.3% in 2009F, with three straight quarters of q-q contraction (3Q08 through 1Q09). The impact on Asia: a slight shaving of growth rates, from 0.3pp at the mild end (Hong Kong, Korea and Vietnam) to the worst hits of 0.7pp in Malaysia and 0.8pp in Singapore. China remains the top performer in 2008F, with growth of 9.1%, and India is the runner-up, with 7.7%.

In our **Upside Scenario (30% probability)**, the US avoids q-q contraction on improved consumer sentiment and greater stability in financial markets

Our **Downside Scenario (10% probability)** has the US economy deteriorating amid rising inflation. Malaysia and Singapore are most affected

Exhibit 6. US real GDP growth rate assumptions under different scenarios



Source: Nomura estimates

Specifically for Unimicron, our assumptions in the **Base Case** are top-line growth of 1.1% and 3.4% to NT\$47,802mn in FY08F and NT\$49,423mn in FY09F, respectively. These result in FY08F earnings of NT\$2,986mn (FY09F: NT\$3,210mn), FY08F EPS of NT\$2.77 (FY09F: NT\$2.94), and a DCF-based fair value of NT\$22.10.

In our **Downside Scenario**, our assumptions would be top-line growth of -0.7% in FY08F and -4.2% in FY09F. These would result in FY08F earnings of NT\$2,881mn and EPS of NT\$2.67, FY09F earnings of NT\$2,683mn and EPS of NT\$2.46, and a DCF-based fair value of NT\$18.80.

In our **Upside Scenario**, our assumptions would be top-line growth of 3.1% in FY08F and 9.5% in FY09F. These would result in FY08F earnings of NT\$3,104mn and EPS of NT\$2.88, FY09F earnings of NT\$3,678mn and EPS of NT\$3.37, and a DCF-based fair value of NT\$25.40.

Set out below is a table summarising our fair value estimate and FY08F and FY09F earnings forecasts under each scenario. Note: these estimates are approximate and are based on the economic scenarios outlined above, all other things being equal.

Exhibit 7. Unimicron: earnings and fair value sensitivity

(NT\$mn)	Base Case = "mild recession" 60% probability		Downside Scenario = "deep recession" 10% probability		Upside Scenario = "growth recession" 30% probability	
	FY08F	FY09F	FY08F	FY09F	FY08F	FY09F
Sales	47,802	49,423	46,942	44,975	48,758	53,377
Net profit	2,986	3,210	2,881	2,683	3,104	3,678
EPS (NT\$)	2.77	2.94	2.67	2.46	2.88	3.37
Downside/upside (%)			(3.5)	(16.4)	3.9	14.6
Fair value (NT\$)	22.1		18.8		25.4	

Source: Nomura estimates

Financial statements

Income statement (NT\$m)					
Year-end 31 Dec	FY06	FY07	FY08F	FY09F	FY10F
Revenue	37,908	47,281	47,802	49,423	53,449
Cost of goods sold	(29,549)	(36,990)	(40,588)	(42,062)	(45,687)
Gross profit	8,359	10,291	7,214	7,361	7,762
SG&A	(2,751)	(3,039)	(2,886)	(2,874)	(3,027)
Employee share expense	-	-	-	-	-
Operating profit	5,608	7,252	4,329	4,487	4,735
EBITDA	8,799	11,247	8,824	9,316	10,363
Depreciation	(3,191)	(3,995)	(4,495)	(4,829)	(5,629)
Amortisation	-	-	-	-	-
EBIT	5,608	7,252	4,329	4,487	4,735
Net interest expense	(355)	(343)	(419)	(416)	(413)
Associates & JCEs	222	(14)	-	-	-
Other income	110	670	38	348	345
Earnings before tax	5,584	7,565	3,948	4,419	4,667
Income tax	(824)	(1,207)	(729)	(906)	(957)
Net profit after tax	4,760	6,358	3,218	3,513	3,710
Minority interests	(282)	(596)	(232)	(303)	(316)
Other items	-	-	-	-	-
Preferred dividends	-	-	-	-	-
Normalised NPAT	4,478	5,762	2,986	3,210	3,394
Extraordinary items	-	-	-	-	-
Reported NPAT	4,478	5,762	2,986	3,210	3,394
Dividends	(1,628)	(2,370)	(1,227)	(1,300)	(1,374)
Transfer to reserves	2,850	3,392	1,760	1,910	2,019

We re-allocate 35% of employee bonus expenses to COGS and 65% to operating expenses for FY08-09F

Valuation and ratio analysis

FD normalised P/E (x)	4.8	3.8	7.5	7.1	6.7
FD normalised P/E at fair value (x)	5.1	4.1	8.0	7.5	7.1
Reported P/E (x)	4.8	3.8	7.5	7.1	6.7
Dividend yield (%)	7.7	10.8	5.4	5.7	6.0
Price/cashflow (x)	3.1	1.9	2.7	2.7	2.5
Price/book (x)	0.8	0.7	0.7	0.6	0.6
EV/EBITDA (x)	3.1	2.4	3.1	2.7	2.2
EV/EBIT (x)	4.7	3.7	6.4	5.6	4.7
Gross margin (%)	22.1	21.8	15.1	14.9	14.5
EBITDA margin (%)	23.2	23.8	18.5	18.8	19.4
EBIT margin (%)	14.8	15.3	9.1	9.1	8.9
Net margin (%)	11.8	12.2	6.2	6.5	6.3
Effective tax rate (%)	14.8	16.0	18.5	20.5	20.5
Dividend payout (%)	36.4	41.1	41.1	40.5	40.5
Capex to sales (%)	19.4	20.3	12.6	8.1	7.5
Capex to depreciation (x)	2.3	2.4	1.3	0.8	0.7
ROE (%)	18.6	19.5	9.1	9.3	9.2
ROA (pretax %)	14.5	14.6	7.9	7.9	8.2

Sharp gross margin decline in FY08F

Growth (%)

Revenue	34.6	24.7	1.1	3.4	8.1
EBITDA	46.2	27.8	(21.5)	5.6	11.2
EBIT	58.0	29.3	(40.3)	3.7	5.5
Normalised EPS	41.6	26.3	(49.2)	6.0	5.7
Normalised FDEPS	41.6	26.3	(49.2)	6.0	5.7

Per share

Reported EPS (NT\$)	4.32	5.45	2.77	2.94	3.11
Norm EPS (NT\$)	4.32	5.45	2.77	2.94	3.11
Fully diluted norm EPS (NT\$)	4.32	5.45	2.77	2.94	3.11
Book value per share (NT\$)	26.23	30.75	30.51	32.58	34.78
DPS (NT\$)	1.60	2.24	1.12	1.19	1.26

Source: Nomura estimates

Cashflow (NT\$mn)					
Year-end 31 Dec	FY06	FY07	FY08F	FY09F	FY10F
EBITDA	8,799	11,247	8,824	9,316	10,363
Change in working capital	(791)	1,461	512	25	256
Other operating cashflow	(1,091)	(1,409)	(1,110)	(974)	(1,491)
Cashflow from operations	6,918	11,300	8,226	8,367	9,128
Capital expenditure	(7,371)	(9,614)	(6,000)	(4,000)	(4,000)
Free cashflow	(453)	1,686	2,226	4,367	5,128
Reduction in investments	(2,943)	(450)	(500)	(700)	(1,000)
Net acquisitions	-	-	-	-	-
Reduction in other LT assets	9	(31)	(114)	17	14
Addition in other LT liabilities	956	251	-	-	-
Adjustments	388	(939)	114	(17)	(14)
Cashflow after investing acts	(2,043)	517	1,726	3,667	4,128
Cash dividends	(1,156)	(1,628)	(2,370)	(1,227)	(1,300)
Equity issue	-	-	-	-	-
Debt issue	3,143	1,507	1,200	-	-
Convertible debt issue	-	-	-	-	-
Others	(946)	1,715	(134)	-	-
Cashflow from financial acts	1,041	1,594	(1,304)	(1,227)	(1,300)
Net cashflow	(1,001)	2,112	422	2,440	2,828
Beginning cash	4,741	3,739	5,851	6,273	8,713
Ending cash	3,739	5,851	6,273	8,713	11,541
Ending net debt	4,898	4,192	4,969	2,529	(298)

Source: Nomura estimates

Less capex planned for FY09F

Balance sheet (NT\$mn)					
As at 31 Dec	FY06	FY07	FY08F	FY09F	FY10F
Cash & equivalents	3,739	5,851	6,273	8,713	11,541
Marketable securities	1,142	861	861	861	861
Accounts receivable	9,530	10,804	10,995	11,861	12,828
Inventories	3,746	4,033	4,428	4,589	4,985
Other current assets	1,283	1,121	1,121	1,121	1,121
Total current assets	19,440	22,670	23,677	27,145	31,335
LT investments	4,062	4,793	5,293	5,993	6,993
Fixed assets	25,104	31,445	32,950	32,121	30,959
Goodwill	186	183	183	183	184
Other intangible assets	-	-	-	-	-
Other LT assets	518	549	663	645	632
Total assets	49,309	59,641	62,766	66,087	70,103
Short-term debt	5,293	5,280	5,580	5,580	5,580
Accounts payable	7,141	8,814	9,259	9,594	10,424
Other current liabilities	5,334	6,523	7,175	7,893	8,682
Total current liabilities	17,769	20,616	22,014	23,066	24,685
Long-term debt	3,344	4,763	5,663	5,663	5,663
Convertible debt	-	-	-	-	-
Other LT liabilities	1,501	1,752	1,752	1,752	1,752
Total liabilities	22,614	27,131	29,429	30,481	32,100
Minority interest	-	-	-	-	-
Preferred stock	-	-	-	-	-
Common stock	10,176	10,571	10,927	10,927	10,927
Retained earnings	14,169	17,266	17,644	19,627	21,722
Proposed dividends	-	-	-	-	-
Other equity and reserves	2,350	4,672	4,765	5,051	5,354
Total shareholders' equity	26,695	32,509	33,337	35,606	38,003
Total equity & liabilities	49,309	59,641	62,766	66,087	70,103

Liquidity (x)

Current ratio	1.09	1.10	1.08	1.18	1.27
Interest cover	15.8	21.2	10.3	10.8	11.5

Leverage

Net debt/EBITDA (x)	0.56	0.37	0.56	0.27	net cash
Net debt/equity (%)	18.3	12.9	14.9	7.1	net cash

Activity (days)

Days receivable	82.0	78.5	83.5	84.4	84.3
Days inventory	39.6	38.4	38.2	39.1	38.2
Days payable	77.6	78.7	81.5	81.8	80.0
Cash cycle	44.0	38.1	40.1	41.7	42.6

Source: Nomura estimates

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Issuer	Ticker	Price (as at last close)	Closing Price Date	Rating	Disclosures
Unimicron Technology	3037 TT	20.80 TWD	20 Oct 2008	Sell	

Previous Ratings

Issuer	Previous Rating	Date of change
Unimicron Technology	Neutral	01 Aug 2008

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Sources: Nomura International plc, Nomura Securities Co. Ltd. and Nomura International (Hong Kong) Ltd. as at 30 September 2008.

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