

## Company Focus

7 November 2008 | 10 pages

# AU Optronics (2409.TW)

 Target price change   
 Estimate change 

## Buy: Consensus Cut Might Accelerate Again Due to Weaker Oct

- Mixed shift to PC panels from TV** — AUO reported Oct. consolidated sales of NT\$27.3bn, down 21% mom and 49% yoy, falling short of our estimates of 10-15% mom decline in Oct. We believe the larger than expected fall is not driven by shipment (-9% mom in large panel and flattish on small panel) but by mix shift to PC panel from TV, resulting in blended ASP decline of 15-17% mom for AUO vs. apple-to-apple price decline of 5-7% mom in Oct.
- Capex cut a must to stop cash burn** — Due to the Oct miss, we now expect much larger losses in 4Q08-1Q09E and expect more consensus cuts. We estimate AUO 4Q08E sales to decline by 25-30% qoq, vs. consensus of 15-20%, resulting in over NT\$30bn losses within the next three quarters. Caused by falling EBITDA to approach cash cost level but slow cut in capex, AUO is accelerating its cash burning rate. We thus expect at least over 40% cut (from over 35% cut expectation earlier) in 2009E capex of NT\$100bn by AUO to reserve cash.
- Cutting EPS and target price** — Due to mix shift to lower price and lower margin PC panels and weaker than expected ASP in November, we are cutting our 2008E EPS by 10% NT\$4.45 from NT\$4.92 and 2009E EPS to -NT\$0.7 from NT\$1.03. We maintain our Buy rating even though losses are expected to continue through 1Q09E, but lower our target price to NT\$35 from NT\$40 on further book and earnings contraction.

<b>Buy/Low Risk</b>	<b>1L</b>
Price (06 Nov 08)	NT\$22.35
Target price	NT\$35.00
	<i>from NT\$40.00</i>
Expected share price return	56.6%
Expected dividend yield	11.2%
<b>Expected total return</b>	<b>67.8%</b>
Market Cap	NT\$190,103M
	US\$5,809M

### 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%	19.9	2%	5%	0.7		
2007	56,418	6.8	509%	3.3	12%	21%	0.6		
2008E	37,875	4.5	-35%	5.0	9%	12%	0.6	4.2	6%
2009E	(6,004)	(0.7)	-116%	(31.8)	-1%	-2%	0.7	(0.0)	-2579%
2010E	29,376	3.4	-590%	6.5	6%	10%	0.6	3.1	12%

Source: Company Reports and Citi Investment Research Estimates

### Andrew Lu<sup>1</sup>

+886-2-8725-1706  
 andrew.lu@citi.com

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

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<sup>1</sup>Citigroup Global Markets Inc - Taipei Branch

Fiscal year end 31-Dec	2006	2007	2008E	2009E	2010E
<b>Valuation Ratios</b>					
P/E adjusted (x)	19.9	3.3	5.0	nm	6.5
EV/EBITDA adjusted (x)	4.5	2.2	2.1	3.5	2.3
P/BV (x)	0.8	0.6	0.6	0.7	0.6
Dividend yield (%)	0.9	0.9	11.2	11.2	2.2
<b>Per Share Data (NT\$)</b>					
EPS adjusted	1.12	6.83	4.45	-0.70	3.44
EPS reported	1.12	6.83	4.45	-0.70	3.44
BVPS	28.49	36.43	37.32	33.98	36.94
DPS	0.20	0.20	2.50	2.50	0.50
<b>Profit &amp; Loss (NT\$M)</b>					
Net sales	293,107	480,184	439,721	346,909	461,442
Operating expenses	-278,891	-416,909	-391,160	-350,837	-426,409
<b>EBIT</b>	<b>14,216</b>	<b>63,275</b>	<b>48,560</b>	<b>-3,928</b>	<b>35,033</b>
Net interest expense	-2,266	-4,458	-2,557	-2,690	-3,500
Non-operating/exceptionals	-1,750	-253	-2,098	230	397
<b>Pre-tax profit</b>	<b>10,200</b>	<b>58,564</b>	<b>43,905</b>	<b>-6,388</b>	<b>31,930</b>
Tax	-1,068	-2,088	-6,030	383	-2,554
Extraord./Min.Int./Pref.div.	-29	-58	0	0	0
<b>Reported net income</b>	<b>9,103</b>	<b>56,418</b>	<b>37,875</b>	<b>-6,004</b>	<b>29,376</b>
Adjusted earnings	9,103	56,418	37,875	-6,004	29,376
Adjusted EBITDA	66,976	144,980	128,960	80,518	122,057
<b>Growth Rates (%)</b>					
Sales	34.8	63.8	-8.4	-21.1	33.0
EBIT adjusted	-16.3	345.1	-23.3	-108.1	991.9
EBITDA adjusted	30.1	116.5	-11.1	-37.6	51.6
EPS adjusted	-53.8	508.6	-34.8	-115.8	589.5
<b>Cash Flow (NT\$M)</b>					
<b>Operating cash flow</b>	<b>66,316</b>	<b>135,519</b>	<b>116,456</b>	<b>81,697</b>	<b>115,684</b>
Depreciation/amortization	52,760	81,706	80,399	84,446	87,024
Net working capital	2,695	-2,403	-1,819	3,255	-717
<b>Investing cash flow</b>	<b>-245,917</b>	<b>-55,702</b>	<b>-100,200</b>	<b>-80,000</b>	<b>-80,000</b>
Capital expenditure	-213,184	-63,990	-100,000	-80,000	-80,000
Acquisitions/disposals	-8,807	4,263	0	0	0
<b>Financing cash flow</b>	<b>197,554</b>	<b>-34,186</b>	<b>-70,121</b>	<b>-10,296</b>	<b>-4,267</b>
Borrowings	131,235	-47,271	-48,787	11,050	0
Dividends paid	-1,749	-1,515	-1,573	-21,264	-21,346
<b>Change in cash</b>	<b>17,953</b>	<b>45,631</b>	<b>-53,864</b>	<b>-8,599</b>	<b>31,417</b>
<b>Balance Sheet (NT\$M)</b>					
<b>Total assets</b>	<b>578,126</b>	<b>617,459</b>	<b>582,752</b>	<b>547,073</b>	<b>601,763</b>
Cash & cash equivalent	45,774	91,406	37,541	28,942	60,359
Accounts receivable	57,458	75,911	74,692	58,927	78,382
Net fixed assets	381,551	363,835	383,436	378,989	371,965
<b>Total liabilities</b>	<b>347,050</b>	<b>316,639</b>	<b>265,287</b>	<b>256,958</b>	<b>286,540</b>
Accounts payable	74,355	96,577	92,365	82,267	100,396
Total Debt	225,008	177,737	128,950	140,000	140,000
<b>Shareholders' funds</b>	<b>231,076</b>	<b>300,820</b>	<b>317,465</b>	<b>290,114</b>	<b>315,224</b>
<b>Profitability/Solvency Ratios (%)</b>					
EBITDA margin adjusted	22.9	30.2	29.3	23.2	26.5
ROE adjusted	4.7	21.2	12.3	-2.0	9.7
ROIC adjusted	4.3	15.7	10.9	-0.9	8.3
Net debt to equity	77.6	28.7	28.8	38.3	25.3
Total debt to capital	49.3	37.1	28.9	32.5	30.8

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**Figure 2. AUO – Quarterly EPS Adjustment**

	1Q08A	2Q08A	3Q08A	4Q08E	1Q09E	2Q09E	3Q09E	4Q09E
<b>Original forecast</b>								
Revenue in NT\$bn	137	123	104	89	81	95	107	119
Gross Profit	37	31	8	1	-3	4	13	22
Gross Margin (%)	27%	25%	8%	1%	-3%	4%	12%	19%
Op Profit	30	24	3	-5	-8	-2	7	15
Op Margin (%)	22%	19%	3%	-5%	-10%	-2%	6%	13%
Net Profit	27	20	1	-6	-8	-3	6	14
Net Margin (%)	20%	16%	1%	-7%	-10%	-3%	5%	12%
Net EPS (NT\$)	3.16	2.37	0.10	-0.71	-0.96	-0.31	0.69	1.61
Annual EPS (NT\$)				4.92				1.03
Blomg EPS (NT\$)			0.23	(0.60)	(0.82)	(0.38)	0.49	0.90
<b>New forecast</b>								
Revenue	137	123	104	76	59	76	96	116
Gross Profit	37	31	8	-3	-8	-2	10	21
Gross Margin (%)	27%	25%	8%	-4%	-14%	-3%	10%	18%
Op Profit	30	24	3	-8	-13	-8	3	14
Op Margin (%)	22%	19%	3%	-11%	-23%	-11%	3%	12%
Net Profit	27	20	1	-10	-13	-8	2	13
Net Margin (%)	20%	16%	1%	-13%	-22%	-11%	3%	11%
Net EPS (NT\$)	3.16	2.37	0.10	(1.18)	(1.54)	(0.95)	0.29	1.49
Annual EPS (NT\$)				4.45				-0.70
Blomg EPS (NT\$)				(0.60)	(0.82)	(0.38)	0.49	0.90
<b>% Revision</b>								
Sales	0%	0%	0%	-15%	-26%	-20%	-10%	-2%
Gross Profit	0%	0%	0%	nm	-190%	nm	-27%	-5%
Op Profit	0%	0%	0%	-88%	-65%	-260%	-52%	-7%
Net Profit	0%	0%	0%	-66%	-60%	-206%	-58%	-7%
Annual EPS				-10%				nm

Source: Company Reports and Citi Investment Research Estimates

Figure 3. AUO Quarterly Income Statement (NT\$ m, Percent)

	2008E					2009E					2010E					
	FYE '07	1QA	2QA	3QA	4Q	FYE '08	1Q	2Q	3Q	4Q	FYE '09	1Q	2Q	3Q	4Q	FYE '10
<b>NET REVENUES</b>	<b>480,184</b>	<b>136,630</b>	<b>123,476</b>	<b>104,072</b>	<b>75,543</b>	<b>439,721</b>	<b>59,364</b>	<b>75,738</b>	<b>96,030</b>	<b>115,777</b>	<b>346,909</b>	<b>112,055</b>	<b>120,417</b>	<b>115,810</b>	<b>113,160</b>	<b>461,442</b>
Depreciation	-81,706	-19,803	-19,983	-20,252	-20,361	-80,399	-20,520	-20,943	-21,112	-21,872	-84,446	-21,321	-21,756	-21,756	-22,191	-87,024
Other COGS	-312,230	-79,743	-72,678	-75,460	-58,168	-286,049	-46,897	-56,803	-65,301	-72,940	-241,941	-71,715	-77,067	-79,330	-83,173	-311,285
<b>GROSS PROFIT</b>	<b>86,248</b>	<b>37,084</b>	<b>30,815</b>	<b>8,360</b>	<b>-2,987</b>	<b>73,272</b>	<b>-8,054</b>	<b>-2,008</b>	<b>9,618</b>	<b>20,966</b>	<b>20,522</b>	<b>19,019</b>	<b>21,594</b>	<b>14,724</b>	<b>7,796</b>	<b>63,133</b>
R&D	-10,650	-1,687	-1,613	-1,260	-1,222	-5,782	-1,200	-1,500	-1,600	-1,700	-6,000	-1,700	-1,700	-2,000	-2,200	-7,600
SG&A	-12,324	-5,087	-5,140	-4,417	-4,285	-18,929	-4,200	-4,500	-4,750	-5,000	-18,450	-4,500	-5,000	-5,500	-5,500	-20,500
Op Ex	-22,974	-6,774	-6,754	-5,677	-5,507	-24,712	-5,400	-6,000	-6,350	-6,700	-24,450	-6,200	-6,700	-7,500	-7,700	-28,100
<b>OPERATING INCOME</b>	<b>63,275</b>	<b>30,310</b>	<b>24,061</b>	<b>2,683</b>	<b>-8,494</b>	<b>48,560</b>	<b>-13,454</b>	<b>-8,008</b>	<b>3,268</b>	<b>14,266</b>	<b>-3,928</b>	<b>12,819</b>	<b>14,894</b>	<b>7,224</b>	<b>96</b>	<b>35,033</b>
Int&other in/(exp)	-4,711	-1,456	-444	-1,239	-1,517	-4,655	-548	-577	-615	-718	-2,460	-763	-780	-814	-746	-3,103
<b>PRETAX INCOME</b>	<b>58,564</b>	<b>28,855</b>	<b>23,618</b>	<b>1,443</b>	<b>-10,010</b>	<b>43,905</b>	<b>-14,002</b>	<b>-8,586</b>	<b>2,653</b>	<b>13,548</b>	<b>-6,388</b>	<b>12,056</b>	<b>14,114</b>	<b>6,410</b>	<b>-650</b>	<b>31,930</b>
Tax credit (exp)	-2,146	-1,994	-3,452	-584	0	-6,030	840	515	-159	-813	383	-964	-1,129	-513	52	-2,554
<b>NET INCOME</b>	<b>56,418</b>	<b>26,861</b>	<b>20,166</b>	<b>859</b>	<b>-10,010</b>	<b>37,875</b>	<b>-13,162</b>	<b>-8,070</b>	<b>2,494</b>	<b>12,735</b>	<b>-6,004</b>	<b>11,091</b>	<b>12,985</b>	<b>5,897</b>	<b>-598</b>	<b>29,376</b>
NET EPS IN NT\$	6.83	3.16	2.37	0.10	-1.18	4.45	-1.54	-0.95	0.29	1.49	-0.70	1.30	1.52	0.69	-0.07	3.44
Fully diluted shares (mn)	8,258	8,506	8,506	8,506	8,506	8,506	8,538	8,538	8,538	8,538	8,538	8,533	8,533	8,533	8,533	8,533
<b>Operating Ratios</b>																
Gross margins	18%	27%	25%	8%	-4%	17%	-14%	-3%	10%	18%	6%	17%	18%	13%	7%	14%
Operating margin	13%	22%	19%	3%	-11%	11%	-23%	-11%	3%	12%	-1%	11%	12%	6%	0%	8%
Pre-tax margin	12%	21%	19%	1%	-13%	10%	-24%	-11%	3%	12%	-2%	11%	12%	6%	-1%	7%
Net margin	12%	20%	16%	1%	-13%	9%	-22%	-11%	3%	11%	-2%	10%	11%	5%	-1%	6%
<b>Year-to-Year %</b>																
Net revenues	64%	69%	16%	-25%	-51%	-8%	-57%	-39%	-8%	53%	-21%	89%	59%	21%	-2%	33%
Gross profit	189%	10680%	154%	-74%	N/A	-15%	N/A	N/A	15%	N/A	-72%	N/A	N/A	53%	-63%	208%
Pretax income	474%	N/A	282%	-94%	N/A	-25%	N/A	N/A	84%	N/A	N/A	N/A	N/A	142%	N/A	N/A
Net income	520%	N/A	231%	-96%	N/A	-33%	N/A	N/A	190%	N/A	N/A	N/A	N/A	136%	N/A	N/A
<b>Qtr-to-Qtr %</b>																
Net revenues		-12%	-10%	-16%	-27%		-21%	28%	27%	21%		-3%	7%	-4%	-2%	
Gross profit		-12%	-17%	-73%	N/A		N/A	N/A	N/A	118%		-9%	14%	-32%	-47%	
Operating income		-13%	-21%	-89%	N/A		N/A	N/A	N/A	337%		-10%	16%	-51%	-99%	
Net income		-18%	-25%	-96%	N/A		N/A	N/A	N/A	411%		-13%	17%	-55%	N/A	

Source: Company Reports and Citi Investment Research Estimates

## AU Optronics

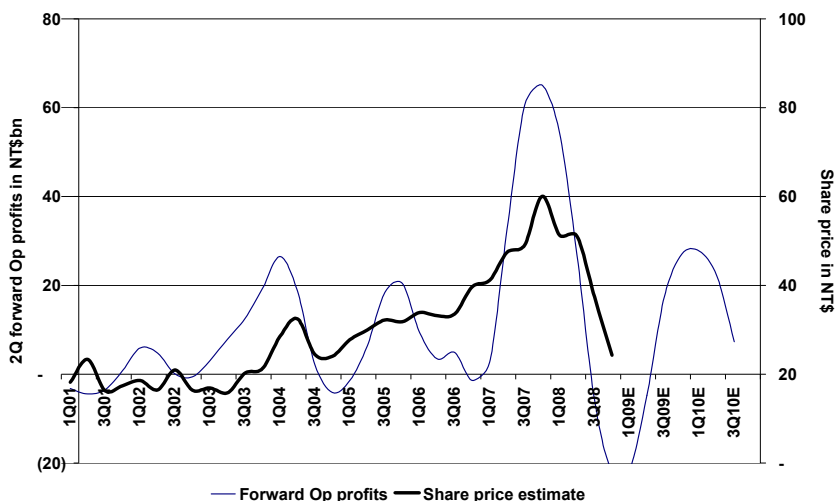
### Company description

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 revised target price of NT\$35 from NT\$40 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 25-30% QoQ, resulting in op margin to -10 to -15%. 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 40% YoY (from 35% yoy cut earlier), suggesting new factories ramp up to push back; 3) Many second-tier TFT names might need to cut production and to cut capex by over 50% as panel prices approach their cash cost level.

AUO – Forward profits vs. share price

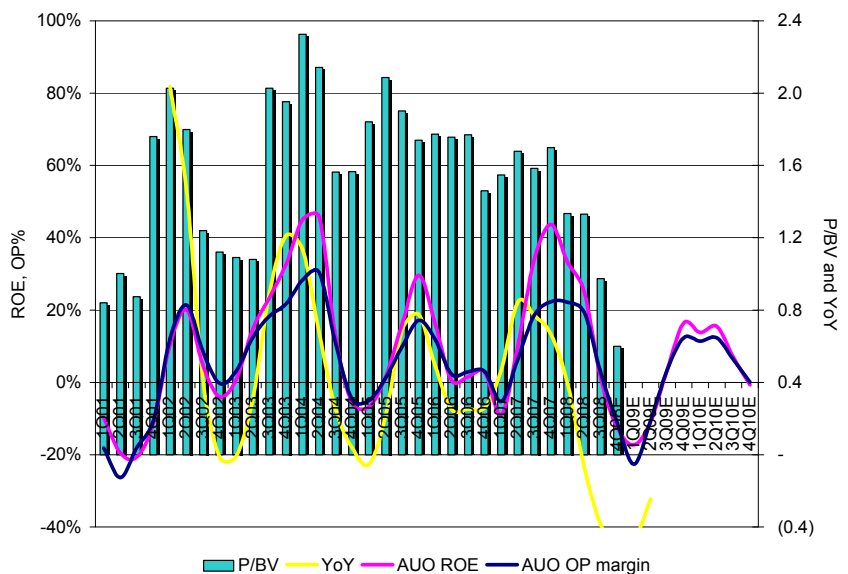


Source: Company Reports and Citi Investment Research Estimates

## Valuation

Due to further earnings cut to affect our 2008-2010E book, we are lowering our target price to NT\$35 from NT\$40. We factor 3 quarters of losses into our NT\$35 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, YoY, ROE, and Op margin



Source: Company Reports and Citi Investment Research 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

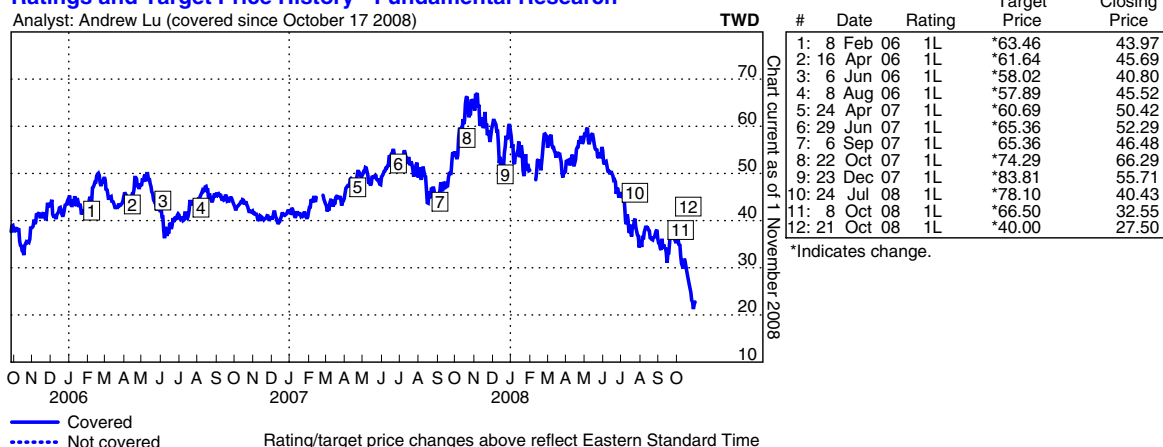
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### AU Optronics (2409.TW)

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Analyst: Andrew Lu (covered since October 17 2008)



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