

Asia Taiwan

Technology Semiconductor & Semiconductor Equipment

Deutsche Bank



25 October 2008

Faraday

Reuters: **3035.TW** Bloomberg: **3035 TT** Exchange: **TAI** Ticker: **3035**

Weakening growth outlook; retain Sell

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Structural negatives remain

The company is competing with fabless customers directly by working with system makers. This should trigger market share loss in fabless customers in the long term. We expect the company to experience gross margin erosion and an earnings growth slowdown from 2009 onwards due to an unfavorable product mix and poor design capability on advanced technology nodes. We maintain our earnings forecast and TP and reiterate our Sell rating.

3Q08 above our expectations; severe outlook for 4Q08

Sales grew 24% QoQ in 3Q08, in line with our estimate and at the high end of the guided 15-25%. GM stayed flat at 43.3% in 3Q08 (higher than our estimate of 42.5%) due to NTD depreciation of 3% QoQ (1-2ppt positive impact). EPS came in at NT\$0.65, above our estimate (NT\$0.57) but below consensus of NT\$0.73. Management guided sales to decline in 4Q08 but to be higher than the level of 2Q08 (0-24% QoQ decline in 4Q08) on the weakening macro picture, for GM to slightly improve in 4Q08 due to NTD depreciation, and for a better product mix.

More earnings downside risks in 2009

Management indicated that Faraday will focus more on system makers. We believe the company, as an IC design service provider, should lose market share in fabless customers as it tries to gain share at system makers (40-45% of sales) at the expense of these fabless customers (45-50% of sales). We expect GM to continue to trend down to 42.9% in 2009 and 42.3% in 2010 from 44.4% in 2008 due to the worsening product mix and uncompetitive design capability.

Maintain TP at NT\$27; unfavorable risk/reward

Our TP is based on 12.8x US GAAP 2009E EPS, which is in line with the 2003-07 trough. We believe this is justified by its 2009E-10E earnings CAGR of 4%, which is lower than the 2003-07 CAGR of 48%. We believe growth deceleration may lead the stock to trade close to the historical trough. Upside risks include faster share gain in system makers and technology migration.

Forecasts and ratios

Year End Dec 31	2006A	2007A	2008E	2009E	2010E
Sales (TWDm)	5,543.6	5,091.9	5,048.2	5,306.0	6,079.0
EBITDA (TWDm)	1,560.2	1,525.6	813.4	1,032.8	1,192.3
Reported NPAT (TWDm)	1,475.4	1,697.4	751.2	756.9	805.5
Reported EPS FD(TWD)	4.12	4.74	2.10	2.11	2.25
DB EPS FD(TWD)	2.09	2.59	2.10	2.11	2.25
DB EPS growth (%)	-13.3	23.9	-19.2	0.8	6.4
PER (x)	24.8	39.7	17.3	17.1	16.1
EV/EBITDA (x)	8.9	20.0	15.9	12.6	10.9
DPS (net) (TWD)	3.30	3.50	1.50	1.55	1.65
Yield (net) (%)	6.4	3.4	4.1	4.3	4.6

Source: Deutsche Bank estimates, company data

¹ DB EPS is fully diluted and excludes non-recurring items

² Multiples and yields calculations use average historical prices for past years and spot prices for current and future years, except P/B which uses the year end close

Company Update

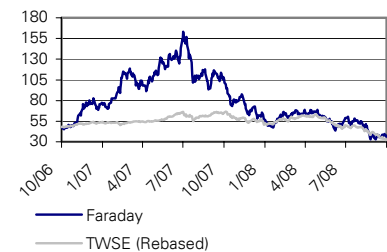
Sell

Price at 24 Oct 2008 (TWD)	36.20
Price target - 12mth (TWD)	27.00
52-week range (TWD)	106.00 - 32.80
TWSE	4,731

Key changes

Sales (FYE)	5,115 to 5,048	↓	-1.3%
Op prof margin (FYE)	12.6 to 13.0	↑	2.9%
Net profit (FYE)	751.1 to 751.2	↑	0.0%

Price/price relative



Performance (%)	1m	3m	12m
Absolute	-8.4	-38.6	-65.7
TWSE	-22.9	-35.8	-49.9

Stock data

Market cap (TWDm)	12,971
Market cap (USDm)	389
Shares outstanding (m)	328.6
Major shareholders	UMC (17%)
Free float (%)	76
Avg daily value traded (USDm)	16.1

Key indicators (FY1)

ROE (%)	12.4
Net debt/equity (%)	-22.6
Book value/share (TWD)	17.07
Price/book (x)	2.1
Net interest cover (x)	-
Operating profit margin (%)	13.0

Deutsche Bank AG/Hong Kong

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Model updated: 24 October 2008

Running the numbers**Asia****Taiwan****Semiconductor & Semiconductor****Faraday**

Reuters: 3035.TW

Bloomberg: 3035.TT

Sell

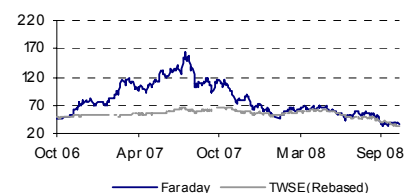
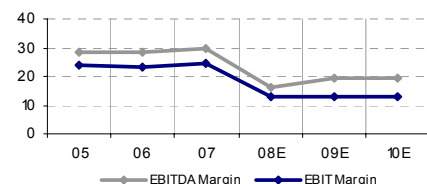
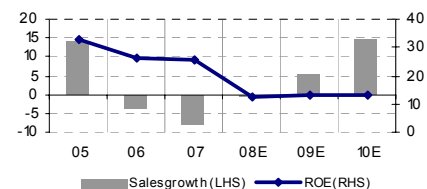
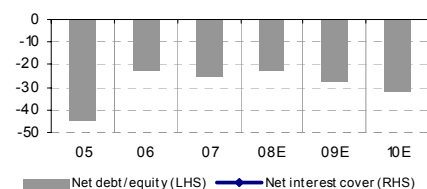
Price (24 Oct 08) TWD 36.20

Target price TWD 27.00

52-week Range TWD 32.80 - 106.00

Market Cap (m) TWDm 12,971
USDm 389**Company Profile**

Faraday Technology Corp is the largest IC design service provider in Asia. It service offerings include IP licensing, ASIC design and subsequent manufacturing turnkey service. Its IP portfolio extends from functional IP (e.g. USB 2.0) to system platforms (e.g. PDA). Faraday's IP modular reuse business model positions the company in the next wave of value chain disintegration.

Price Performance**Margin Trends****Growth & Profitability****Solvency**

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Fiscal year end 31-Dec

Financial Summary

	2005	2006	2007	2008E	2009E	2010E
DB EPS (TWD)	2.42	2.09	2.59	2.10	2.11	2.25
Reported EPS (TWD)	4.02	4.12	4.74	2.10	2.11	2.25
DPS (TWD)	3.30	3.30	3.50	1.50	1.55	1.65
BVPS (TWD)	19.5	25.1	21.8	17.1	17.6	18.9
Weighted average shares (m)	239	268	297	329	340	340
Average market cap (TWDm)	12,167	13,927	30,575	12,971	12,971	12,971
Enterprise value (TWDm)	12,167	13,927	30,575	12,971	12,971	12,971

Valuation Metrics

P/E (DB) (x)	21.1	24.8	39.7	17.3	17.1	16.1
P/E (Reported) (x)	12.7	12.6	21.8	17.3	17.1	16.1
P/BV (x)	2.73	3.07	3.32	2.12	2.06	1.92
FCF Yield (%)	10.4	9.4	4.7	7.4	7.4	7.8
Dividend Yield (%)	6.5	6.4	3.4	4.1	4.3	4.6
EV/Sales (x)	2.1	2.5	6.0	2.6	2.4	2.1
EV/EBITDA (x)	7.5	8.9	20.0	15.9	12.6	10.9
EV/EBIT (x)	8.8	10.7	24.4	19.7	19.1	16.5

Income Statement (TWDm)

Sales revenue	5,745	5,544	5,092	5,048	5,306	6,079
Gross profit	2,734	2,803	2,889	2,398	2,632	2,979
EBITDA	1,617	1,560	1,526	813	1,033	1,192
Depreciation	238	258	274	156	355	407
Amortisation	0	0	0	0	0	0
EBIT	1,378	1,302	1,251	657	678	786
Net interest income/(expense)	24	17	28	26	37	40
Associates/affiliates	0	0	0	0	0	0
Exceptionals/extraordinaries	0	0	0	0	0	0
Other pre-tax income/(expense)	17	159	417	75	49	-13
Profit before tax	1,420	1,478	1,696	758	764	813
Income tax expense	-21	2	-2	6	7	8
Minorities	0	0	0	0	0	0
Other post-tax income/(expense)	0	0	0	0	0	0
Net profit	1,441	1,475	1,697	751	757	805
DB adjustments (including dilution)	-576	-725	-768	0	0	0
DB Net profit	866	750	930	751	757	805

Cash Flow (TWDm)

Cash flow from operations	1,860	1,286	1,551	978	1,006	1,095
Net Capex	-594	22	-99	-96	-95	-130
Free cash flow	1,265	1,308	1,452	882	911	965
Equity raised/(bought back)	0	0	0	0	0	0
Dividends paid	-865	-933	-1,155	-1,191	-511	-528
Net inc/(dec) in borrowings	160	-164	0	0	0	0
Other investing/financing cash flows	-200	-928	-172	-82	-16	-16
Net cash flow	360	-717	125	-391	385	421
Change in working capital	348	-195	-57	264	-37	-102

Balance Sheet (TWDm)

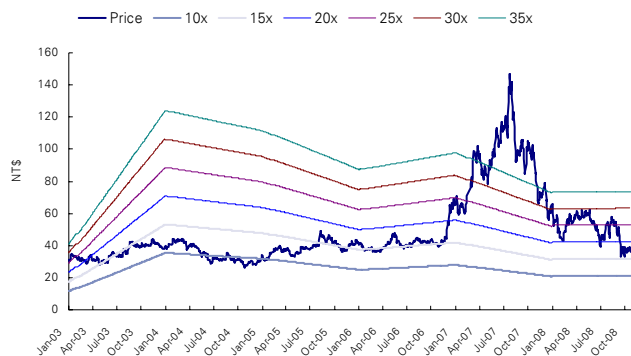
Cash and other liquid assets	2,252	1,535	1,660	1,269	1,654	2,075
Tangible fixed assets	1,105	987	1,001	842	582	306
Goodwill/intangible assets	0	0	0	0	0	0
Associates/investments	1,018	3,403	2,851	2,709	2,725	2,741
Other assets	2,000	2,158	2,368	2,259	2,566	2,995
Total assets	6,374	8,084	7,879	7,079	7,527	8,117
Interest bearing debt	164	0	0	0	0	0
Other liabilities	1,563	1,339	1,408	1,471	1,549	1,684
Total liabilities	1,728	1,339	1,408	1,471	1,549	1,684
Shareholders' equity	4,646	6,745	6,471	5,608	5,978	6,433
Minorities	0	0	0	0	0	0
Total shareholders' equity	4,646	6,745	6,471	5,608	5,978	6,433
Net debt	-2,087	-1,535	-1,660	-1,269	-1,654	-2,075

Key Company Metrics

Sales growth (%)	13.9	-3.5	-8.1	-0.9	5.1	14.6
DB EPS growth (%)	1.2	-13.3	23.9	-19.2	0.8	6.4
EBITDA Margin (%)	28.1	28.1	30.0	16.1	19.5	19.6
EBIT Margin (%)	24.0	23.5	24.6	13.0	12.8	12.9
Payout ratio (%)	54.7	60.0	61.2	65.6	69.7	69.7
ROE (%)	32.7	25.9	25.7	12.4	13.1	13.0
Capex/sales (%)	10.7	3.3	1.9	1.9	1.8	2.1
Capex/depreciation (x)	2.6	0.7	0.4	0.6	0.3	0.3
Net debt/equity (%)	-44.9	-22.8	-25.7	-22.6	-27.7	-32.3
Net interest cover (x)	nm	nm	nm	nm	nm	nm

Source: Company data, Deutsche Bank estimates

Figure 1: Faraday's forward PE band – US GAAP



Source: Deutsche Bank estimates

Figure 2: TP sensitivity analysis for Faraday

2009 gross margin (%)	2009 sales growth (%)				
	-5%	0%	5%	10%	15%
40.9%	18	20	21	23	25
41.9%	21	23	24	26	29
42.9%	23	25	27	29	31
43.9%	25	28	30	31	34
44.9%	29	31	33	35	38

Source: Deutsche Bank estimates

Figure 3: Earnings model for Faraday – US GAAP

(NT\$m;n;%)	1Q08	2Q08	3Q08	4Q08E	2008E	1Q09E	2Q09E	3Q09E	4Q09E	2009E
Net Sales	1,152	1,188	1,473	1,235	5,048	1,096	1,200	1,450	1,560	5,306
Gross Profit	549	516	638	539	2,242	469	508	625	676	2,278
Operating profit	117	158	215	182	672	140	148	187	203	678
PBT	215	142	231	173	760	157	166	211	228	762
PAT	214	142	230	168	754	156	166	210	223	755
EPS (NT\$)	0.60	0.40	0.64	0.47	2.10	0.44	0.46	0.59	0.62	2.11
Margin (%)										
Gross Margin	47.7%	43.4%	43.3%	43.6%	44.4%	42.8%	42.3%	43.1%	43.3%	42.9%
Operating margin	10.2%	13.3%	14.6%	14.7%	13.3%	12.8%	12.3%	12.9%	13.0%	12.8%
Net Margin	18.6%	12.0%	15.6%	13.6%	14.9%	14.2%	13.8%	14.5%	14.3%	14.2%
Growth (%)										
Sales YoY	0%	3%	5%	-11%	-1%	-5%	1%	-2%	26%	5%
PAT YoY	-32%	-30%	14%	-19%	-19%	-27%	17%	-9%	33%	0%
Sales QoQ	-17%	3%	24%	-16%		-11%	9%	21%	8%	
PAT QoQ	3%	-34%	62%	-27%		-7%	6%	26%	6%	

Source: Deutsche Bank estimates

Appendix 1

Important Disclosures

Additional information available upon request

Disclosure checklist

Company	Ticker	Recent price*	Disclosure
Faraday	3035.TW	37.50 (TWD) 23 Oct 08	6

*Prices are sourced from local exchanges via Reuters, Bloomberg and other vendors. Data is sourced from Deutsche Bank and subject companies.

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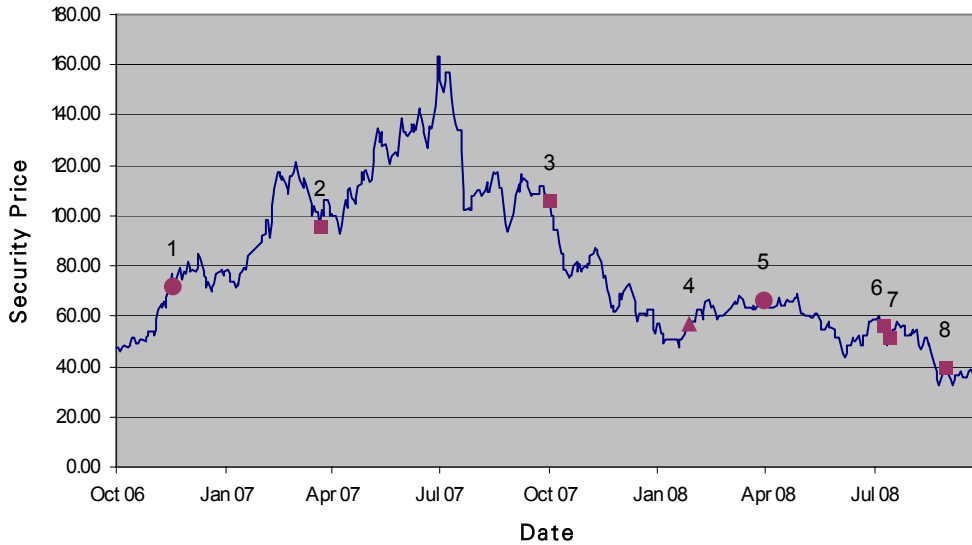
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Historical recommendations and target price: Faraday (3035.TW)

(as of 10/24/2008)



Previous Recommendations

- Strong Buy
- Buy
- Market Perform
- Underperform
- Not Rated
- Suspended Rating

Current Recommendations

- Buy
- Hold
- Sell
- Not Rated
- Suspended Rating

*New Recommendation Structure as of September 9, 2002

1. 13/12/2006:	Downgrade to Sell, Target Price Change TWD50.00	5. 24/4/2008:	Downgrade to Sell, TWD50.00
2. 16/4/2007:	Sell, Target Price Change TWD58.00	6. 3/8/2008:	Sell, Target Price Change TWD39.00
3. 26/10/2007:	Sell, Target Price Change TWD70.00	7. 8/8/2008:	Sell, Target Price Change TWD38.00
4. 21/2/2008:	Upgrade to Hold, Target Price Change TWD50.00	8. 25/9/2008:	Sell, Target Price Change TWD27.00

Equity rating key **Equity rating dispersion and banking relationships**

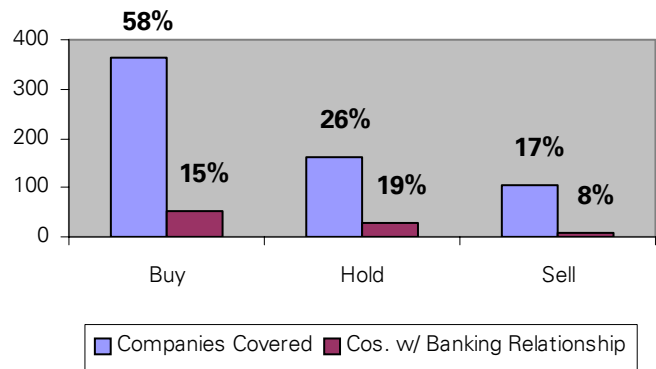
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Asia-Pacific Universe

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