

COMPANY UPDATE

Hon Hai Precision (2317.TW)

Neutral

Valuations may be close to trough, but fundamentals likely peaked

What's changed

Hon Hai reported October sales of NT\$169 bn (up 8% mom, up 29% yoy), slightly better than market expectations; but we think this is likely the peak in 4Q, vs. the historical peak in the month of December. Consistent with our previous commentary that Hon Hai's 4Q momentum may be below normal seasonality due to DT weakness and demand slowdown for iPhone, Cisco (Hon Hai's key customer for the networking devices business) has guided CY4Q08 sales growth to decline 5%-10% yoy. In addition, our industry checks suggest the NB and TV businesses may also be below our original forecast for 2009. As such, we lower our 2008E/2009E/2010E revenue estimates by 0.7%/4.2%/7.2% and 2008E/2009E/2010E earnings estimates by 1%/11%/12%.

Implications

On November 7, Hon Hai's board approved the issuance of a NT\$12bn corporate bond. This could add to market concerns on Hon Hai's high cash conversion cycle (60+ days) with net debt/equity of 18% as of 3Q08. We believe Hon Hai's fast expansion/relocation over the past few years has not only increased the company's spending, but also raises risks to yield as new manufacturing sites may not ramp up according to schedule. In order to save on costs, Hon Hai has moved factories to inner China and duplicated its operating model there.

Valuation

We maintain our Neutral rating, but cut our 12-m target price to NT\$86 (on 9X our new 2009E EPS) from NT\$107 (10X 2009E EPS). We lower the target multiple to discount macro and relocation risks. Our target price implies 1.7X trailing one-quarter P/B, versus historical range of 1.4X-5.0X.

Key risks

Weaker than expected demand, intensified competition with US EMS companies, and balance sheet management.

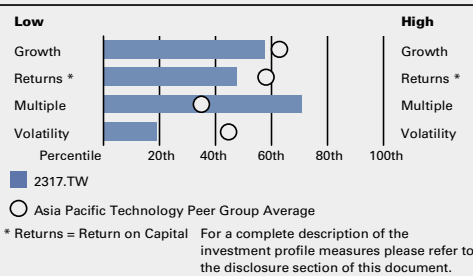
INVESTMENT LIST MEMBERSHIP

Neutral

Coverage View: NeutralTaiwan:
Hardware

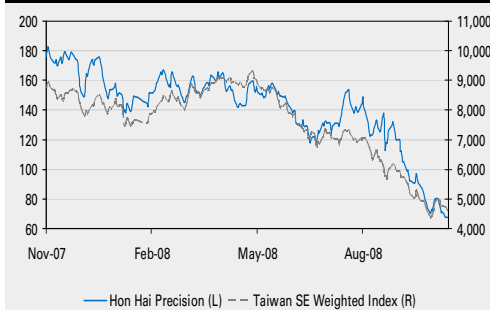
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Investment Profile: Hon Hai Precision

Key data	Current
Price (NT\$)	67.50
12 month price target (NT\$)	86.00
Market cap (NT\$ mn / US\$ mn)	491,795.3 / 14,963.2
Foreign ownership (%)	44.6

	12/07	12/08E	12/09E	12/10E
EPS (NT\$) New	12.47	9.15	9.53	10.44
EPS revision (%)	0.0	(1.0)	(11.0)	(12.1)
EPS growth (%)	42.5	(26.6)	4.1	9.6
EPS (dil) (NT\$) New	12.58	9.15	9.53	10.44
P/E (X)	5.4	7.4	7.1	6.5
P/B (X)	1.4	1.3	1.2	1.0
EV/EBITDA (X)	27.1	13.9	13.2	11.3
Dividend yield (%)	4.4	3.5	3.8	4.3
ROE (%)	25.5	18.6	17.7	16.7

Price performance chart

Share price performance (%)	3 month	6 month	12 month
Absolute	(55.6)	(53.0)	(62.1)
Rel. to Taiwan SE Weighted Index	(29.9)	(10.0)	(28.9)

Source: Company data, Goldman Sachs Research estimates, FactSet. Price as of 11/12/2008 close.

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Hon Hai Precision: Summary financials

Profit model (NT\$ mn)	12/07	12/08E	12/09E	12/10E	Balance sheet (NT\$ mn)	12/07	12/08E	12/09E	12/10E
Total revenue	1,235,581.2	1,499,677.8	1,604,884.6	1,849,893.8	Cash & equivalents	7,086.7	14,698.1	21,904.6	21,930.1
Cost of goods sold	(1,176,540.2)	(1,435,665.8)	(1,539,643.0)	(1,774,084.2)	Accounts receivable	199,308.7	233,368.0	255,780.3	286,403.7
SG&A	(17,128.5)	(22,620.9)	(22,538.4)	(25,054.5)	Inventory	98,784.4	123,615.0	115,152.0	119,444.8
R&D	(6,423.5)	(9,523.0)	(10,057.4)	(10,670.2)	Other current assets	12,591.3	11,153.0	11,153.0	11,153.0
Other operating profit/(expense)	0.0	0.0	0.0	0.0	Total current assets	317,771.1	382,834.0	403,989.9	438,931.6
ESO expense	--	(4,864.4)	(5,074.5)	(5,560.7)	Net PP&E	37,703.5	37,627.3	36,622.0	35,890.4
EBITDA	44,567.2	39,118.8	41,554.3	48,615.1	Net intangibles	772.3	962.5	962.5	962.5
Depreciation & amortization	(9,078.2)	(7,250.7)	(8,908.5)	(8,530.2)	Total investments	264,354.1	307,442.4	363,718.8	420,861.8
EBIT	35,489.0	31,868.1	32,645.8	40,085.0	Other long-term assets	340.7	513.0	513.0	513.0
Interest income	479.0	197.5	280.9	327.7	Total assets	620,941.8	729,379.2	805,806.2	897,159.3
Interest expense	(2,809.6)	(3,447.9)	(7,135.3)	(7,372.3)	Accounts payable	132,295.0	180,668.0	194,479.0	215,000.7
Income/(loss) from uncons. subs.	56,189.7	50,943.9	56,276.8	57,143.0	Short-term debt	34,993.6	38,545.0	48,545.0	48,545.0
Others	196.3	(1,203.8)	0.0	0.0	Other current liabilities	64,671.8	105,212.8	105,271.5	105,377.4
Pretax profits	89,544.4	78,357.8	82,068.2	90,183.4	Total current liabilities	231,960.3	324,425.8	348,295.5	368,923.1
Income tax	(11,854.8)	(11,690.2)	(12,653.2)	(14,105.5)	Long-term debt	28,760.0	29,057.9	29,057.9	29,057.9
Minorities	0.0	0.0	0.0	0.0	Other long-term liabilities	9,530.8	9,381.0	9,381.0	9,381.0
Net income pre-preferred dividends	77,689.5	66,667.6	69,414.9	76,077.9	Total long-term liabilities	38,290.8	38,439.0	38,439.0	38,439.0
Preferred dividends	0.0	0.0	0.0	0.0	Total liabilities	270,251.1	362,864.8	386,734.4	407,362.0
Net income (pre-exceptionals)	77,689.5	66,667.6	69,414.9	76,077.9	Preferred shares	0.0	0.0	0.0	0.0
Post-tax exceptionals	679.8	0.0	0.0	0.0	Total common equity	350,690.7	366,514.5	419,071.8	489,797.3
Net income	78,369.3	66,667.6	69,414.9	76,077.9	Minority interest	0.0	0.0	0.0	0.0
EPS (basic, pre-except) (NT\$)	12.47	9.15	9.53	10.44	Total liabilities & equity	620,941.8	729,379.2	805,806.2	897,159.3
EPS (basic, post-except) (NT\$)	12.58	9.15	9.53	10.44	BVPS (NT\$)	48.93	50.30	57.52	67.23
EPS (diluted, post-except) (NT\$)	12.58	9.15	9.53	10.44	Ratios	12/07	12/08E	12/09E	12/10E
EPS excl. ESO expense (basic) (NT\$)	12.47	9.70	10.12	11.09	ROE (%)	25.5	18.6	17.7	16.7
EPS excl. ESO expense (dil.) (NT\$)	12.47	9.70	10.12	11.09	ROA (%)	14.5	9.9	9.0	8.9
DPS (NT\$)	3.00	2.38	2.57	2.92	ROACE (%)	22.9	16.8	16.8	16.1
Dividend payout ratio (%)	23.9	26.0	27.0	28.0	Inventory days	27.9	28.3	28.3	24.1
Free cash flow yield (%)	(0.9)	14.1	2.8	5.1	Receivables days	51.8	52.7	55.6	53.5
Growth & margins (%)	12/07	12/08E	12/09E	12/10E	Payable days	39.6	39.8	44.5	42.1
Sales growth	36.2	21.4	7.0	15.3	Net debt/equity (%)	16.2	14.4	13.3	11.4
EBITDA growth	21.4	(12.2)	6.2	17.0	Interest cover - EBIT (X)	15.2	9.8	4.8	5.7
EBIT growth	21.0	(10.2)	2.4	22.8	Valuation	12/07	12/08E	12/09E	12/10E
Net income growth	30.9	(14.9)	4.1	9.6	P/E (analyst) (X)	5.4	7.4	7.1	6.5
EPS growth	43.8	(27.2)	4.1	9.6	P/B (X)	1.4	1.3	1.2	1.0
Gross margin	4.8	4.3	4.1	4.1	EV/EBITDA (X)	27.1	13.9	13.2	11.3
EBITDA margin	3.6	2.6	2.6	2.6	Dividend yield (%)	4.4	3.5	3.8	4.3
EBIT margin	2.9	2.1	2.0	2.2	Cash flow statement (NT\$ mn)	12/07	12/08E	12/09E	12/10E
Cash flow statement (NT\$ mn)	12/07	12/08E	12/09E	12/10E	Net income pre-preferred dividends	77,689.5	66,667.6	69,414.9	76,077.9
Net income pre-preferred dividends	77,689.5	66,667.6	69,414.9	76,077.9	D&A add-back	9,114.1	10,160.5	8,908.5	8,530.2
D&A add-back	9,114.1	10,160.5	8,908.5	8,530.2	Minorities interests add-back	0.0	0.0	0.0	0.0
Minorities interests add-back	0.0	0.0	0.0	0.0	Net (inc)/dec working capital	(41,516.5)	33,132.8	(138.5)	(14,394.5)
Net (inc)/dec working capital	(41,516.5)	33,132.8	(138.5)	(14,394.5)	Other operating cash flow	(38,665.1)	(29,708.0)	(55,171.2)	(35,931.5)
Other operating cash flow	(38,665.1)	(29,708.0)	(55,171.2)	(35,931.5)	Cash flow from operations	7,301.7	83,383.4	27,307.2	38,974.1
Cash flow from operations	7,301.7	83,383.4	27,307.2	38,974.1	Capital expenditures	(15,071.3)	(11,512.0)	(7,903.2)	(7,798.6)
Capital expenditures	(15,071.3)	(11,512.0)	(7,903.2)	(7,798.6)	Acquisitions	(5,605.7)	(2,938.4)	0.0	0.0
Acquisitions	(5,605.7)	(2,938.4)	0.0	0.0	Divestitures	914.8	885.7	0.4	0.0
Divestitures	914.8	885.7	0.4	0.0	Others	(1,295.5)	(26,288.6)	0.0	0.0
Others	(1,295.5)	(26,288.6)	0.0	0.0	Cash flow from investments	(21,057.7)	(39,853.2)	(7,902.8)	(7,798.6)
Cash flow from investments	(21,057.7)	(39,853.2)	(7,902.8)	(7,798.6)	Dividends paid (common & pref)	(15,504.4)	(18,872.3)	(17,333.6)	(18,742.0)
Dividends paid (common & pref)	(15,504.4)	(18,872.3)	(17,333.6)	(18,742.0)	Inc/(dec) in debt	20,789.9	7,034.1	10,000.0	0.0
Inc/(dec) in debt	20,789.9	7,034.1	10,000.0	0.0	Common stock issuance (repurchase)	0.0	(20,247.4)	(3,817.5)	(11,302.3)
Common stock issuance (repurchase)	0.0	(20,247.4)	(3,817.5)	(11,302.3)	Other financing cash flows	(993.0)	(3,833.2)	(1,047.0)	(1,105.6)
Other financing cash flows	(993.0)	(3,833.2)	(1,047.0)	(1,105.6)	Cash flow from financing	4,292.4	(35,918.7)	(12,198.0)	(31,150.0)
Cash flow from financing	4,292.4	(35,918.7)	(12,198.0)	(31,150.0)	Total cash flow	(9,463.5)	7,611.5	7,206.4	25.6
Total cash flow	(9,463.5)	7,611.5	7,206.4	25.6					

Note: Last actual year may include reported and estimated data.
Source: Company data, Goldman Sachs Research estimates.

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Hon Hai's NB business in 2009 could be weaker than we originally expected

We had previously been optimistic on Hon Hai's 2009 revenues as we believed Hon Hai's potential growth in NBs and TVs could offset weakness in DT.

However, as what we stated in our 2008/10/8 note "*Likely missing unit target despite inexpensive valuation; to Neutral*", our industry checks indicate that some of Sony's 2009 NB order may shift to Quanta as Sony could be concerned about Hon Hai's new factory that is still ramping up. On the other hand, our channel checks suggest that Hon Hai may ship one NB model for each of HP and Dell in 2009, although the contribution to Hon Hai's top line will likely be limited in the initial stage.

As we stated in our 2008/9/8 note "*NB: Mixed end demand with supply constraint in IMR casing*", finding a second supplier for its large-volume products has been Apple's top priority in diversifying risk. According to our supply chain checks, Hon Hai has begun to ship Apple's Macbook in 4Q08, following Apple's two-year search for a second supplier of Macbooks, in addition to its primary source – Quanta. We forecast Hon Hai's new Macbook order may only account for 10%-15% of Apple's total Macbook shipment in 4Q and 2009E, based on our industry checks.

We have also previously mentioned that Apple is likely to be looking for a second supplier for the iPhone in order to diversify its risk.

In conclusion, we had originally expected Hon Hai to generate strong growth in its NB business in 2009, driven by incremental growth from the existing Sony model together with the new models from HP, Dell and Apple. However, we now believe any upside to the business from Sony may be capped, while the volume from the new models for HP, Dell and Apple may also provide limited contribution to its 2009E revenues

Exhibit 1: Goldman Sachs forecast revisions

Parent-only financials	Revised	Original	
(NT\$ mn)	(fully-loaded)	(fully-loaded)	Difference
	2008E	2008E	
Revenue	1,499,678	1,510,699	-0.7%
Gross profits	64,012	64,992	-1.5%
Operating profits	31,868	32,617	-2.3%
Pretax earnings	78,358	79,129	-1.0%
Net earnings	66,668	67,323	-1.0%
Fully loaded EPS (NT\$)	9.15	9.24	-1.0%
Gross margin	4.3%	4.3%	
Operating margin	2.1%	2.2%	
Net margin	4.4%	4.5%	

Parent-only financials	Revised	Original	
(NT\$ mn)	(fully-loaded)	(fully-loaded)	Difference
	2009E	2009E	
Revenue	1,604,885	1,674,479	-4.2%
Gross profits	65,242	69,290	-5.8%
Operating profits	32,646	35,296	-7.5%
Pretax earnings	82,068	92,202	-11.0%
Net earnings	69,415	77,992	-11.0%
Fully loaded EPS (NT\$)	9.53	10.70	-11.0%
Gross margin	4.1%	4.1%	
Operating margin	2.0%	2.1%	
Net margin	4.3%	4.7%	

Parent-only financials	Revised	Original	
(NT\$ mn)	(fully-loaded)	(fully-loaded)	Difference
	2010E	2010E	
Revenue	1,849,894	1,993,587	-7.2%
Gross profits	75,810	82,355	-7.9%
Operating profits	40,085	43,855	-8.6%
Pretax earnings	90,183	102,624	-12.1%
Net earnings	76,078	86,561	-12.1%
Basic EPS (NT\$)	10.44	11.88	-12.1%
Fully loaded EPS (NT\$)	10.44	11.88	-12.1%
Gross margin	4.1%	4.1%	
Operating margin	2.2%	2.2%	
Net margin	4.1%	4.3%	

Source: Goldman Sachs Research estimates.

Reg AC

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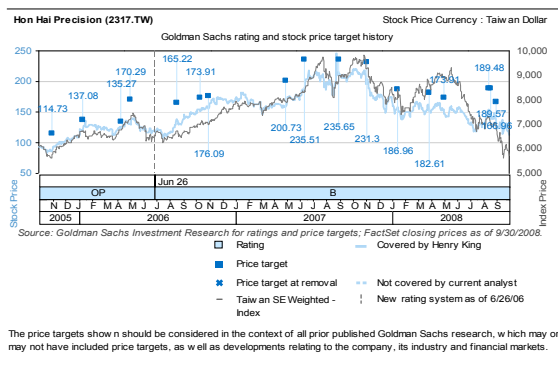
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Price target and rating history chart(s)



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