

Company Flash

29 October 2008 | 6 pages

HTC Corporation (2498.TW)

Maintain Buy Despite 4Q Headwinds

- Cautious on 4Q outlook** — Given the CDMA Diamond hasn't been launched by Verizon now, we believe HTC may have encountered some delay. Moreover, Raphael's sell-through appears to be lackluster since its launch. On the positive side, Diamond continues to sell well in Europe, while Android phone's ramp up is on schedule of 600K in 4Q after some initial supply bottleneck in mechanical parts. While HTC does not appear to be seeing particular price pressure, the deteriorating product mix (CDMA Diamond delay and Raphael weakness), rising ODM and Android contribution (both lower margin) and weak Euro are all negative for margin. We already assume 4Q GM to drop 210bps Q/Q, but there could be further potential downside to our forecasts.
- Significant upside potential to our Android phone assumption** — Given HTC's 600K Android phone shipments in 4Q08 (mostly in US), it implies 20-25% penetration in T-Mobile US (T-Mobile US has 31M subscribers, assuming 2-year replacement cycle). Assuming the ratio drops to 10% in 2009, it would give HTC another 1m units in 2009. We note that T-Mobile has 63m subscribers in Europe. Assuming 5% penetration, T-Mobile Europe could also contribute more than 1m units in 2009. Given HTC will launch Android phone with other operators in Europe and Asia and there should be another 5 models in the pipeline, we believe that HTC could easily ship 3m-4m units of Android phone in 2009, which is much higher than our current assumption of 2m units. We do not expect much competition on Android phone for most of 2009 given Samsung could be the only vendor to launch Android phone in 1H09. As such, we feel confident about our current 2009 earnings forecast.
- Share price under near-term pressure** — HTC stock's trailing P/E fell to 8x in 1Q07 after a very poor sell-through momentum in 4Q06. If this were to happen again, HTC's share price could pull back to close to NT\$300. Given HTC's current product cycle is rather successful (good Diamond sell-through and strong demand for Android phone), we do not expect HTC's P/E to fall to previous trough. However, HTC outperformed the index by more than 10% in the past three weeks. With muted 4Q outlook, we believe the share price could potentially give back its outperformance. We would see the shares as even more attractive as a result of any price dips following the investor conference given we do not expect the company to provide encouraging guidance.

Buy/High Risk	1H
Price (29 Oct 08)	NT\$375.00
Target price	NT\$507.00
Expected share price return	35.2%
Expected dividend yield	9.1%
Expected total return	44.3%
Market Cap	NT\$283,273M
	US\$8,466M

Price Performance (RIC: 2498.TW, BB: 2498 TT)



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

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HTC Corporation

Company description

HTC is a leading manufacturer of Windows PDA phones and smartphones, accounting for roughly 70% of global market share. HTC sells Windows converged handhelds under operator brands as well as the "hTc" brand. In 2007, the Americas represented around 42% (including ODM revenue from Palm) of revenues, while Europe, and Asia and ROW accounted for 40% and 18%, respectively. However, as its business model is shifting toward the brand business, we expect the revenue mix by region to change. We expect Europe, the Americas, and Asia and ROW to account for 50%, 30% and 20%, respectively.

Investment strategy

We rate HTC shares Buy / High Risk (1H) with a target price of NT\$507. We believe the bear-case scenario (involving margin pressure on rising competition from Apple / Nokia and slowing demand in US / Europe) has now been mostly priced in. While consensus for 2009E earnings dropped only 15% since late May, we believe the share price almost always falls faster than consensus earnings. As such, while consensus may drop another 10-15%, we believe HTC's share price is getting close to its bottom.

Valuation

Our DCF-based target price for HTC shares is NT\$507. We are using a DCF-based valuation to reflect HTC's capability to generate stable cash inflows. Our DCF assumes revenue growth will slow from 28% in 2008E to 0% in 2018E due to slowing shipment growth and continued ASP erosion. We apply a WACC of 9.92%, which assumes a risk-free rate of 2.6%, a market risk premium of 6%, and an equity beta of 1.22. Our target price is equivalent to a P/E of 14x FY09E EPS.

Risks

We have a High Risk rating on HTC shares based on our quantitative risk rating system, which tracks 260-day historical share price volatility. Downside risks which could prevent the shares from reaching our target price include: 1) Weaker-than-expected demand for high-end handsets in 2009, 2) HTC's operating margin deteriorating faster than we expect, and 3) a slow share gain for Android or for Microsoft's in the enterprise wireless email market.

Appendix A-1

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HTC Corporation (2498.TW)

Ratings and Target Price History - Fundamental Research

Analyst: Kevin Chang (covered since May 23 2008)



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Data current as of 30 September 2008

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