

29 October 2008 | 11 pages

# Novatek (3034.TW)

 Target price change   
 Estimate change 

## Buy: Cash Flow Remains Strong; Priced at Attractive Level

- Lower target price** — We are maintaining our Buy (1M) rating on Novatek but lowering our target price to NT\$59 (from NT\$69) to reflect further cut in our 2009E sales and earnings outlook. Despite the challenges, the company remains strong in profitability and should maintain its margins in 2H08E by focusing on cost-down measures.
- Results and outlook** — Novatek reported 3Q revenue of NT\$6.9 billion, -5% qoq and -31% yoy, due to weaker shipments for its large panels. Large panel shipments fell to 198 million, which is near the 4Q06 level. Gross margin improved to 30.3%, from 28.5% in 2Q, on favorable FX rate. It expects 4Q revenue to drop 15% qoq and gross margin down 1-2ppt due to weaker panel demand and year-end inventory adjustments.
- Weaker sales in 2009** — Our revised forecast assumes Novatek sales and net income to decline by 10% and 24% YoY in 2009E, to account for uncertainty in end-market demand and pricing. Our new model factors in large panel driver shipment to drop by 10% yoy in 2009E, after 11% drop in 2008E. However, we believe margins will be defensive due to its volumes. In a severe downturn, we expect Novatek to benefit from better cost structure and is in better position to maintain profitability than smaller players.
- Revising estimates** — We are revising up our 2008E EPS estimates by 4% to reflect better 2H08E gross margins, but lower our 09/10E earnings forecast by 19% and 20% respectively to reflect weaker demand outlook.

<b>Buy/Medium Risk</b>	<b>1M</b>
Price (28 Oct 08)	NT\$33.30
Target price	NT\$59.00
	<i>from NT\$69.00</i>
Expected share price return	77.2%
Expected dividend yield	9.0%
<b>Expected total return</b>	<b>86.2%</b>
Market Cap	NT\$19,500M
	US\$581M

### Price Performance (RIC: 3034.TW, BB: 3034 TT)



### Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Dec	(NT\$M)	(NT\$)	(%)	(x)	(x)	(%)	(%)
2006A	6,277	11.93	9.8	2.8	1.2	46.2	24.0
2007A	7,585	14.15	18.6	2.4	1.0	46.5	24.0
2008E	4,035	7.22	-49.0	4.6	1.2	23.7	27.0
2009E	3,079	5.35	-25.9	6.2	1.1	17.9	9.0
2010E	3,205	5.56	4.0	6.0	1.0	17.5	12.0

Source: Powered by dataCentral

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

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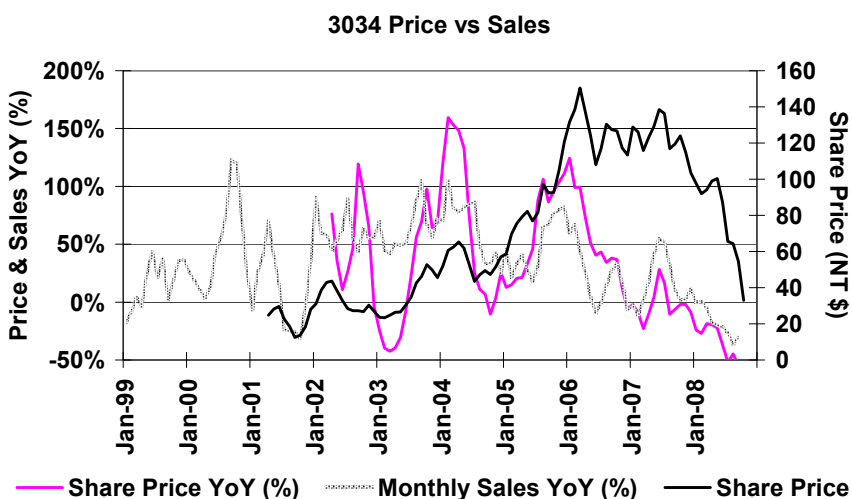
<sup>1</sup>Citigroup Global Markets Inc - Taipei Branch

Fiscal year end 31-Dec	2006	2007	2008E	2009E	2010E
<b>Valuation Ratios</b>					
P/E adjusted (x)	2.8	2.4	4.6	6.2	6.0
EV/EBITDA adjusted (x)	2.0	1.7	3.0	3.7	3.2
P/BV (x)	1.2	1.0	1.2	1.1	1.0
Dividend yield (%)	24.0	24.0	27.0	9.0	12.0
<b>Per Share Data (NT\$)</b>					
EPS adjusted	11.93	14.15	7.22	5.35	5.56
EPS reported	11.93	14.15	7.22	5.35	5.56
BVPS	28.58	32.22	28.74	30.97	32.41
DPS	8.00	8.00	9.00	3.00	4.00
<b>Profit &amp; Loss (NT\$M)</b>					
Net sales	31,428	36,117	27,598	24,857	27,213
Operating expenses	-25,074	-28,542	-23,513	-21,668	-23,780
<b>EBIT</b>	<b>6,354</b>	<b>7,575</b>	<b>4,085</b>	<b>3,189</b>	<b>3,433</b>
Net interest expense	-24	-39	130	45	22
Non-operating/exceptionals	81	214	-49	113	29
<b>Pre-tax profit</b>	<b>6,410</b>	<b>7,750</b>	<b>4,167</b>	<b>3,347</b>	<b>3,484</b>
Tax	-134	-166	-132	-268	-279
Extraord./Min.Int./Pref.div.	0	0	0	0	0
<b>Reported net income</b>	<b>6,277</b>	<b>7,585</b>	<b>4,035</b>	<b>3,079</b>	<b>3,205</b>
Adjusted earnings	6,277	7,585	4,035	3,079	3,205
Adjusted EBITDA	6,587	7,876	4,434	3,614	3,944
<b>Growth Rates (%)</b>					
Sales	21.2	14.9	-23.6	-9.9	9.5
EBIT adjusted	11.0	19.2	-46.1	-21.9	7.6
EBITDA adjusted	11.2	19.6	-43.7	-18.5	9.1
EPS adjusted	9.8	18.6	-49.0	-25.9	4.0
<b>Cash Flow (NT\$M)</b>					
<b>Operating cash flow</b>	<b>4,031</b>	<b>5,563</b>	<b>5,050</b>	<b>3,756</b>	<b>3,218</b>
Depreciation/amortization	233	301	349	425	512
Net working capital	-2,467	-2,288	666	292	-498
<b>Investing cash flow</b>	<b>-2,998</b>	<b>104</b>	<b>-1,142</b>	<b>-1,227</b>	<b>-1,377</b>
Capital expenditure	-662	-436	-585	-700	-800
Acquisitions/disposals	-2,105	655	-400	-360	-400
<b>Financing cash flow</b>	<b>-2,461</b>	<b>-4,546</b>	<b>-4,920</b>	<b>-3,736</b>	<b>-3,320</b>
Borrowings	630	761	0	-2,000	-1,000
Dividends paid	-4,165	-4,332	-5,189	-1,736	-2,320
<b>Change in cash</b>	<b>-1,428</b>	<b>1,121</b>	<b>-1,013</b>	<b>-1,207</b>	<b>-1,479</b>
<b>Balance Sheet (NT\$M)</b>					
<b>Total assets</b>	<b>24,145</b>	<b>26,815</b>	<b>24,732</b>	<b>23,739</b>	<b>24,002</b>
Cash & cash equivalent	7,295	8,416	7,404	6,197	4,718
Accounts receivable	8,948	11,849	9,452	8,853	9,692
Net fixed assets	1,123	1,405	1,799	2,241	2,706
<b>Total liabilities</b>	<b>8,974</b>	<b>9,367</b>	<b>8,161</b>	<b>5,824</b>	<b>5,203</b>
Accounts payable	4,629	4,137	3,216	2,934	3,229
Total Debt	3,422	4,183	4,183	2,183	1,183
<b>Shareholders' funds</b>	<b>15,170</b>	<b>17,449</b>	<b>16,571</b>	<b>17,914</b>	<b>18,799</b>
<b>Profitability/Solvency Ratios (%)</b>					
EBITDA margin adjusted	21.0	21.8	16.1	14.5	14.5
ROE adjusted	46.2	46.5	23.7	17.9	17.5
ROIC adjusted	87.6	74.6	35.7	26.6	27.3
Net debt to equity	-25.5	-24.3	-19.4	-22.4	-18.8
Total debt to capital	18.4	19.3	20.2	10.9	5.9

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Figure 1. Novatek – Price vs. Sales YoY Comparison



Source: Citi Investment Research

Figure 2. Novatek – Quarterly Earnings Adjustment

	1Q08A	2Q08A	3Q08A	4Q08E	1Q09E	2Q09E	3Q09E	4Q09E
<b>Old Forecast</b>								
Total sales	7,506	7,238	7,079	6,914	6,510	6,864	8,031	7,855
Gross profits	2,189	2,057	1,969	1,923	1,782	1,856	2,300	2,172
Gross margin%	29%	28%	28%	28%	27%	27%	29%	28%
Op profits	1,243	1,040	881	861	910	922	1,207	1,103
Op margin%	17%	14%	12%	12%	14%	13%	15%	14%
Net profits	990	1,139	884	864	831	844	1,109	996
Net margin%	13%	16%	12%	13%	13%	12%	14%	13%
EPS in NT\$	1.77	2.04	1.58	1.55	1.44	1.47	1.93	1.73
Yearly EPS in NT\$				6.94				6.57
<b>Revision</b>								
Total sales	7,506	7,238	6,908	5,947	5,635	5,866	6,706	6,651
Gross profits	2,189	2,057	2,089	1,698	1,574	1,611	1,946	1,878
Gross margin%	29%	28%	30%	29%	28%	27%	29%	28%
Op profits	1,243	1,040	1,037	766	712	710	909	858
Op margin%	17%	14%	15%	13%	13%	12%	14%	13%
Net profits	991	1,140	1,091	813	692	695	874	818
Net margin%	13%	16%	16%	14%	12%	12%	13%	12%
EPS in NT\$	1.77	2.04	1.95	1.46	1.20	1.21	1.52	1.42
Yearly EPS in NT\$				7.22				5.35
<b>% of Revision</b>								
Total sales	0%	0%	-2%	-14%	-13%	-15%	-16%	-15%
Gross profits	0%	0%	6%	-12%	-12%	-13%	-15%	-14%
Op profits	0%	0%	18%	-11%	-22%	-23%	-25%	-22%
Net profits	0%	0%	23%	-6%	-17%	-18%	-21%	-18%
Net EPS	0%	0%	23%	-6%	-17%	-18%	-21%	-18%
Yearly EPS				4%				-19%

Source: Company Reports and Citi Investment Research estimates

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**Figure 3. Novatek – Earnings Revision**

Year to 31-Dec	Net Profit (NT\$ Mils.)		Diluted EPS (NT\$)		
	Old	New	Old	New	% Chg
2008E	3878	4035	6.94	7.22	4.1%
2009E	3780	3079	6.57	5.35	-18.5%
2010E	4006	3205	6.96	5.56	-20.1%

Source: Citi Investment Research estimates

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Figure 4. Novatek – Quarterly Income Statement (2006-2010E, NT\$ in Millions)

	2007A					2008E					2009E					2010E					
	FYE '06	1Q	2Q	3Q	4Q	FYE '07	1QA	2Q	3Q	4Q	FYE '08	1Q	2Q	3Q	4Q	FYE '09	1Q	2Q	3Q	4Q	FYE '10
NET REVENUES	<b>31,428</b>	7,620	9,021	10,065	9,411	<b>36,117</b>	7,506	7,238	6,908	5,947	<b>27,598</b>	5,635	5,866	6,706	6,651	<b>24,857</b>	6,015	6,350	7,292	7,556	<b>27,213</b>
Total cost of good sold	<b>(22,919)</b>	(5,610)	(6,507)	(7,150)	(6,680)	<b>(25,947)</b>	(5,317)	(5,181)	(4,819)	(4,249)	<b>(19,565)</b>	(4,061)	(4,255)	(4,760)	(4,773)	<b>(17,849)</b>	(4,341)	(4,608)	(5,240)	(5,451)	<b>(19,641)</b>
GROSS PROFIT	<b>8,509</b>	2,010	2,514	2,915	2,731	<b>10,170</b>	2,189	2,057	2,089	1,698	<b>8,033</b>	1,574	1,611	1,946	1,878	<b>7,009</b>	1,673	1,742	2,052	2,105	<b>7,572</b>
R&D	<b>(1,361)</b>	(359)	(405)	(399)	(438)	<b>(1,602)</b>	(646)	(727)	(693)	(606)	<b>(2,672)</b>	(552)	(578)	(668)	(654)	<b>(2,452)</b>	(588)	(613)	(711)	(730)	<b>(2,642)</b>
SG&A	<b>(794)</b>	(226)	(243)	(272)	(253)	<b>(993)</b>	(300)	(290)	(359)	(327)	<b>(1,276)</b>	(310)	(323)	(369)	(366)	<b>(1,367)</b>	(331)	(349)	(401)	(416)	<b>(1,497)</b>
Operating expenses	<b>(2,155)</b>	(585)	(648)	(671)	(691)	<b>(2,595)</b>	(946)	(1,016)	(1,053)	(933)	<b>(3,948)</b>	(862)	(901)	(1,037)	(1,020)	<b>(3,820)</b>	(919)	(963)	(1,112)	(1,146)	<b>(4,139)</b>
OPERATING INCOME	<b>6,354</b>	1,425	1,866	2,244	2,040	<b>7,575</b>	1,243	1,040	1,037	766	<b>4,085</b>	712	710	909	858	<b>3,189</b>	755	779	940	959	<b>3,433</b>
Int&other inc/(exp)	<b>56</b>	290	(6)	(48)	(60)	<b>175</b>	(222)	131	100	73	<b>82</b>	40	45	41	31	<b>158</b>	15	17	20	1	<b>51</b>
PRETAX INCOME	<b>6,410</b>	1,715	1,860	2,196	1,980	<b>7,750</b>	1,021	1,171	1,136	838	<b>4,167</b>	752	755	950	890	<b>3,347</b>	769	795	959	960	<b>3,484</b>
Taxes or tax credit	<b>(134)</b>	(33)	(39)	(46)	(47)	<b>(166)</b>	(30)	(32)	(45)	(25)	<b>(132)</b>	(60)	(60)	(76)	(71)	<b>(268)</b>	(62)	(64)	(77)	(77)	<b>(279)</b>
NET INCOME	<b>6,277</b>	1,682	1,820	2,149	1,933	<b>7,585</b>	991	1,140	1,091	813	<b>4,035</b>	692	695	874	818	<b>3,079</b>	708	732	883	883	<b>3,205</b>
NET EPS IN NT\$	<b>11.93</b>	3.14	3.40	4.01	3.60	<b>14.15</b>	1.77	2.04	1.95	1.46	<b>7.22</b>	1.20	1.21	1.52	1.42	<b>5.35</b>	1.23	1.27	1.53	1.53	<b>5.56</b>
Fully diluted shares (mn)	<b>526</b>	536	536	536	536	<b>536</b>	559	559	559	559	<b>559</b>	575	575	575	575	<b>575</b>	576	576	576	576	<b>576</b>
<b>Operating Ratios</b>																					
Gross margins	<b>27%</b>	26%	28%	29%	29%	<b>28%</b>	29%	28%	30%	29%	<b>29%</b>	28%	27%	29%	28%	<b>28%</b>	28%	27%	28%	28%	<b>28%</b>
Operating margin	<b>20%</b>	19%	21%	22%	22%	<b>21%</b>	17%	14%	15%	13%	<b>15%</b>	13%	12%	14%	13%	<b>13%</b>	13%	12%	13%	13%	<b>13%</b>
Pre-tax margin	<b>20%</b>	23%	21%	22%	21%	<b>21%</b>	14%	16%	16%	14%	<b>15%</b>	13%	13%	14%	13%	<b>13%</b>	13%	13%	13%	13%	<b>13%</b>
Net margin	<b>20%</b>	22%	20%	21%	21%	<b>21%</b>	13%	16%	16%	14%	<b>15%</b>	12%	12%	13%	12%	<b>12%</b>	12%	12%	12%	12%	<b>12%</b>
<b>Year-to-Year %</b>																					
Net revenues	<b>21%</b>	-4%	36%	29%	4%	<b>15%</b>	-2%	-20%	-31%	-37%	<b>-24%</b>	-25%	-19%	-3%	12%	<b>-10%</b>	7%	8%	9%	14%	<b>9%</b>
Gross profit	<b>10%</b>	-9%	41%	36%	14%	<b>20%</b>	9%	-18%	-28%	-38%	<b>-21%</b>	-28%	-22%	-7%	11%	<b>-13%</b>	6%	8%	5%	12%	<b>8%</b>
Operating income	<b>11%</b>	-12%	46%	40%	10%	<b>19%</b>	-13%	-44%	-54%	-62%	<b>-46%</b>	-43%	-32%	-12%	12%	<b>-22%</b>	6%	10%	3%	12%	<b>8%</b>
Net income	<b>12%</b>	8%	50%	30%	5%	<b>21%</b>	-41%	-37%	-49%	-58%	<b>-47%</b>	-30%	-39%	-20%	1%	<b>-24%</b>	2%	5%	1%	8%	<b>4%</b>
<b>Qtr-to-Qtr %</b>																					
Net revenues		-15%	18%	12%	-6%		-20%	-4%	-5%	-14%		-5%	4%	14%	-1%		-10%	6%	15%	4%	
Gross profit		-16%	25%	16%	-6%		-20%	-6%	2%	-19%		-7%	2%	21%	-3%		-11%	4%	18%	3%	
Operating income		-23%	31%	20%	-9%		-39%	-16%	0%	-26%		-7%	0%	28%	-6%		-12%	3%	21%	2%	
Net income		-9%	8%	18%	-10%		-49%	15%	-4%	-25%		-15%	0%	26%	-6%		-14%	3%	21%	0%	

Source: Company Reports and Citi Investment Research estimates

## Novatek

### Company description

Novatek Microelectronics Corp., Ltd. designs, manufactures, and markets integrated circuits (ICs). The company's products are used in telecommunication, computer peripherals, consumer electronics, and LCD (liquid crystal display) drivers.

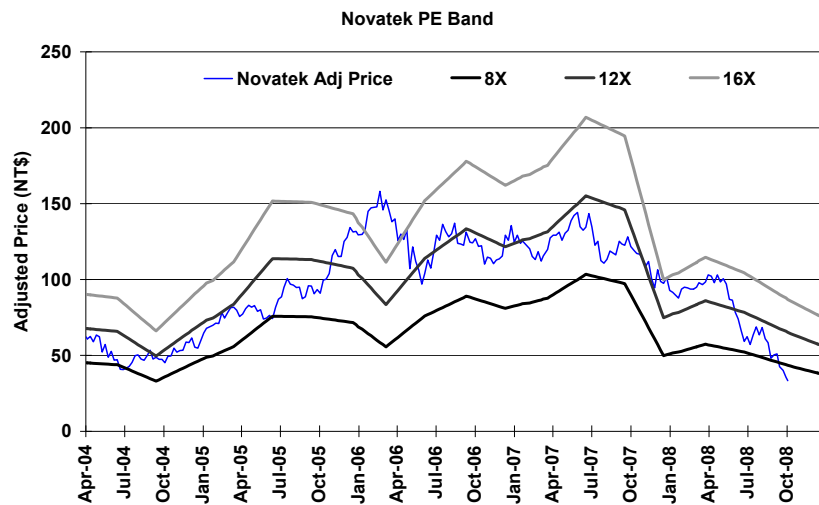
### Investment strategy

We rate Novatek shares Buy/Medium Risk, with a target price of NT\$59 (lowered from NT\$69 to reflect weaker earnings in 2009E). We believe most of the bad news has been priced in, and the company will likely see a soft 2H08 after clearing up its backlog orders. Downside risks appear contained due to Novatek's strong dividend yield, low valuation and good free cash flow generating capability. The company has been moving aggressively to re-structure Cheertek, and we see Cheertek as an opportunity for Novatek to expand its share of components in the small panel supply chain, especially in consumer electronics such as digital photo frames and portable media players. If successful, it could provide further upside to 2009E earnings.

### Valuation

Our target price of NT\$59 for Novatek is based on 10-11x bonus adjusted 2009E earnings. We use P/E as our primary valuation method as the company was able to deliver stable earnings and profit margin throughout the volatile TFT cycles. Our target multiple is comparable to the multiple we use for companies with limited sales growth in the sector. Our target multiple is toward the low-end of the stock's historical 3-year range of 9-15x as we see risks from the deceleration in the panel space. On a price to trailing sales basis, the stock is now two standard deviations below the historical average of 3x, which suggests the current valuation is defensive.

Figure 5. Novatek – PE Band (2004-2008E)



Source: Citi Investment Research estimates

## Risks

We assign a Medium Risk rating to Novatek based on our quantitative risk-rating system, which tracks 260-day share price volatility. Downside risks that could prevent the stock from reaching our target price include a weaker than expected pickup in 2H08, charge-offs related to the Cheertek merger, stronger than expected ASP erosion, and market share loss in the LCD driver business.

# Appendix A-1

## Analyst Certification

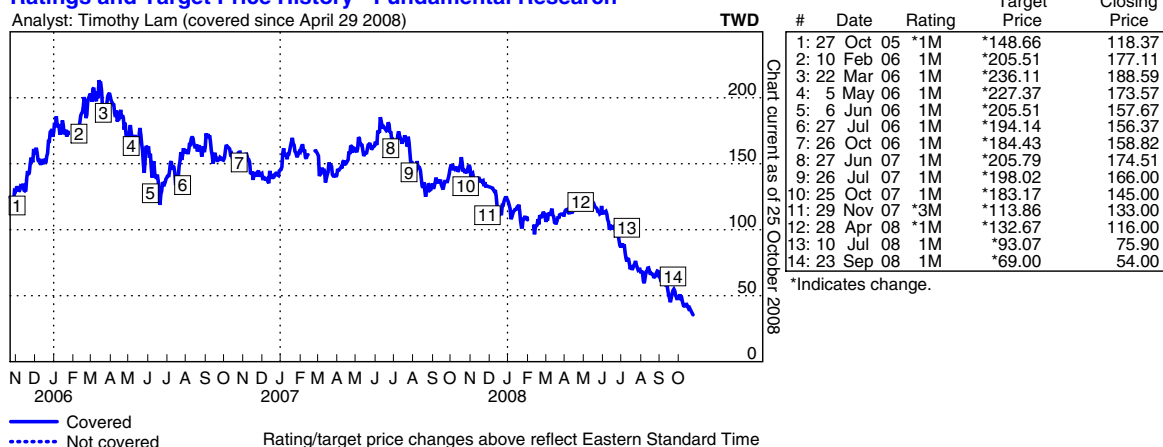
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### Novatek (3034.TW)

#### Ratings and Target Price History - Fundamental Research

Analyst: Timothy Lam (covered since April 29 2008)



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