

TAIWAN

# Oriental Union Chemical

25 November 2008

**1710 TT** **Underperform**

Stock price as of 24 Nov 08	NT\$	13.05
12-month target	NT\$	11.00
Upside/downside	%	-15.7
Valuation	NT\$	15.82
- DCF (WACC 8.2%)		

GICS sector		materials
Market cap	NT\$m	10,508
30-day avg turnover	NT\$m	88.8
Market cap	US\$m	315
Number shares on issue	m	805.2

## Investment fundamentals

Year end 31 Dec		2007A	2008E	2009E	2010E
Total revenue	m	13,369	13,807	9,688	9,633
EBIT	m	3,124	2,672	1,208	1,122
EBIT Growth	%	90.0	-14.5	-54.8	-7.2
Reported profit	m	2,332	1,908	827	917
Adjusted profit	m	2,332	1,908	827	917
EPS rep	NT\$	2.93	2.37	1.03	1.14
EPS rep growth	%	58.0	-19.2	-56.6	10.9
EPS bonus growth	%	58.0	-19.2	-56.6	10.9
PE rep	x	4.4	5.5	12.7	11.5
PE bonus exp	x	4.4	5.5	12.7	11.5
Total DPS	NT\$	2.15	1.78	0.92	1.03
Total div yield	%	16.5	13.6	7.1	7.9
ROA	%	20.9	17.1	8.0	7.4
ROE	%	17.8	14.3	6.5	7.4
EV/EBITDA	x	2.7	3.2	5.8	5.3
Net debt/equity	%	-16.2	-8.0	-5.8	-4.6
Price/book	x	0.8	0.8	0.9	0.8

## 1710 TT rel Taiex performance, & rec history



Source: Datastream, Macquarie Research, November 2008 (all figures in NT\$ unless noted)

## Analyst

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## Weak demand facing new capacity

### Event

- We reduce our Oriental Union Chemical (OUCC) target price to NT\$11 from NT\$16 after cutting our EBIT projections. We believe the demand outlook is more challenging than we had previously projected. Amid a very weak demand environment, we expect added stress to be supplied by rapidly-approaching new ethylene glycol (EG) capacity the Middle East. We look for the combination to produce a substantial decline in OUCC's earnings. We maintain our Underperform rating.

### Impact

- Macquarie vs consensus.** We are generally in line with consensus EPS for FY08E, but are 35% below for FY09E and 48% below for FY10E.
- Tumbling sales as demand weakens.** The stress of declining demand is heavily impacting OUCC's sales numbers. October sales of NT\$797m were down 28% MoM and 33% YoY. The figure was down 54% from NT\$1.5bn in June. We are projecting OUCC's sales will decline by 30% YoY in FY09.
- New EG supply in the Middle East is approaching.** We remain concerned that new EG supply in the Middle East, which is produced using ethylene from inexpensive ethane. We expect pro-rated capacity of ethylene oxide (EO), the intermediate step to EG, to increase by about 9% YoY next year, with most of the new capacity coming from the Middle East.
- A tough combination.** We look for a combination of slumping demand and new capacity to create a very difficult environment for OUCC in FY09. We estimate a 57% YoY decline in EPS next year.

### Earnings revision

- We reduce our FY08E EPS by 11%, our FY09E projection by 53% and our FY10 outlook by 43%. We believe the demand outlook has worsened more than we originally projected, making for a more challenging outlook next year.

### Price catalyst

- 12-month price target: NT\$11.00 based on a Sum of Parts methodology.
- Catalyst: Sustained steep YoY declines in monthly sales numbers and a substantial decline in earnings next year.

### Action and recommendation

- We maintain our Underperform rating for OUCC. Although the share price has declined significantly, we do not believe it yet fully reflects the rapidly deteriorating outlook for FY09. Also, we believe EG conditions will come under further pressure in 1H09 as new EG capacity in the Middle East begins to come on-stream.

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## Weak demand facing new capacity

We reduce our OUCC target price to NT\$11 from NT\$16 after reducing our earnings outlook and reducing our valuation of OUCC's investment portfolio. We believe the share price does not yet fully reflect the challenges ahead from a combination of a dramatic decline in demand and new capacity in the Middle East that should come on-stream next year.

We've reduced our EBIT projections significantly after factoring in recent results, changes to our regional oil and petrochemical price outlook and a weaker global GDP outlook. Within this, we've reduced both product price and equipment utilisation assumptions. For FY09E, we've reduced our EBIT outlook by 45% to NT\$1.2bn from NT\$2.2bn. For FY10E, we've lowered our EBIT estimate by 42% to NT\$1.1bn from NT\$1.9bn. Aside from reduced projections for OUCC's EO/EG operations, we've also factored in a reduced outlook for its specialty chemical operations.

Figure 1 provides our sum-of-the-parts based target price calculation. The main change is that we've reduced our valuation for OUCC's core business to NT\$12ps from NT\$18ps after incorporating steeply lower projections for OUCC's operations.

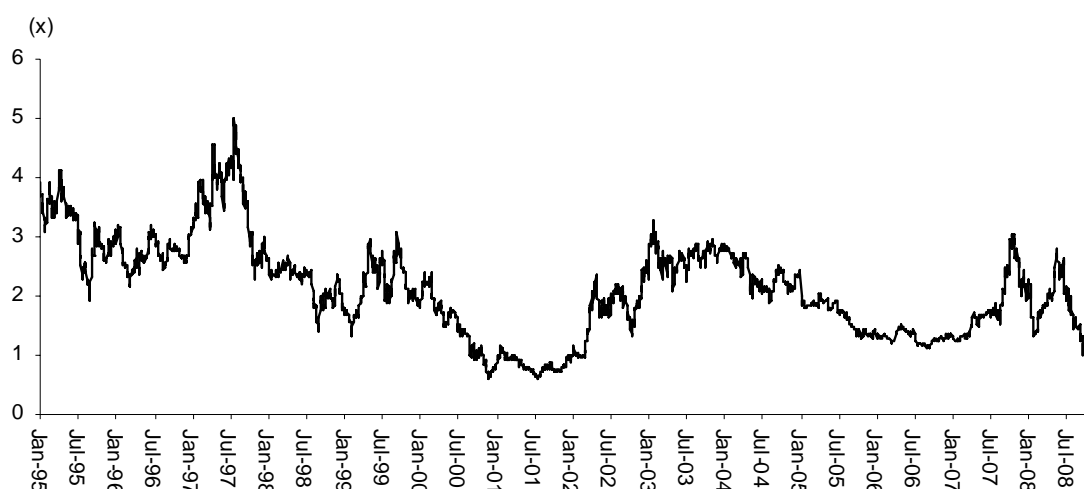
**Fig 1 OUCC per share valuation**

	Target px NT\$ps	Pre-premiums/disc NT\$ps	Stake (%)	Share price (NT\$ps)	Comments
NPV of core business FCF	11.86	11.86			
Long-term investments	2.67	4.50			
Far Eastern Bank (2845 TT, NR)	0.26	0.32	3.0	4.60	Mkt value, with 20% holding co discount
Far Eastern Dep't Stores (2903 TT, NR)	0.18	0.23	1.0	15.80	Mkt value, with 20% holding co discount
Everest Textile (1460 TT, NR)	0.11	0.14	6.0	3.89	Mkt value, with 20% holding co discount
China investments	0.56	0.70	40.0		At 0.8x BV
Other LT invest	1.55	3.10			50% discount to BV
<b>Adjusted asset value</b>	<b>14.53</b>	<b>16.36</b>			
Net cash	1.29	1.29			BV
<b>Per share equity value</b>	<b>15.82</b>	<b>17.65</b>			
At 30% downcycle discount	11.07				
<b>Target price (NT\$)</b>	<b>11.00</b>				

Source: Macquarie Research, November 2008

OUCC's 0.8x FY08E P/BV multiple represents a 33% premium to the company's trough P/BV multiple of 0.6x in the downturn of 2001. At our NT\$11 target price, the stock would be trading at 0.7x FY08E P/BV. Given the challenges ahead, we look for the company's P/BV to move toward the level set in 2001. Figure 2 provides OUCC's historical P/BV trend.

**Fig 2 OUCC's P/BV trend**



Source: TEJ, Macquarie Research, November 2008

**Oriental Union Chemical (1710 TT, Underperform, Target price: NT\$11.00)**

Quarterly Results		3Q/08A	4Q/08E	1Q/09E	2Q/09E	Profit & Loss		2007A	2008E	2009E	2010E
<b>Revenue</b>	m	3,322	2,267	1,938	2,422	<b>Revenue</b>	m	13,369	13,807	9,688	9,633
<b>Gross Profit</b>	m	563	346	348	435	<b>Gross Profit</b>	m	3,634	3,238	1,741	1,651
Operating Expenses	m	-125	-140	-107	-133	Operating Expenses	m	-510	-566	-533	-530
<b>Operating Income</b>	m	438	206	242	302	<b>Operating Income</b>	m	3,124	2,672	1,208	1,122
Net Non-operating income	m	-165	5	-34	-42	Net Non-operating income	m	-82	-301	-168	-8
<b>Pre-Tax Income</b>	m	273	212	208	260	<b>Pre-Tax Income</b>	m	3,042	2,372	1,040	1,113
Tax Expense	m	-32	1	-43	-53	Tax Expense	m	-710	-464	-213	-196
Exceptionals	m	0	0	0	0	Exceptionals	m	0	0	0	0
Minority Interests	m	0	0	0	0	Minority Interests	m	0	0	0	0
<b>Reported Earnings</b>	m	241	213	165	207	<b>Reported Earnings</b>	m	2,332	1,908	827	917
Reported Earnings (bonus exp)	m	241	213	165	207	Reported Earnings (bonus exp)	m	2,332	1,908	827	917
Bonus exp / Reported Earnings	%					Bonus exp / Reported Earnings	%				
<b>Adjusted Earnings</b>	m	241	213	165	207	<b>Adjusted Earnings</b>	m	2,332	1,908	827	917
<b>EBITDA</b>	m	575	344	363	454	<b>EBITDA</b>	m	3,584	3,219	1,816	1,798
EPS (rep)	NT\$	0.30	0.26	0.21	0.26	EPS (rep)	NT\$	2.93	2.37	1.03	1.14
EPS pcg growth (rep)	%	-54.9	-70.6	-77.1	-71.7	EPS growth (rep)	%	58.0	-19.2	-56.6	10.9
EPS (rep bonus exp)	NT\$	0.30	0.26	0.21	0.26	EPS (rep bonus exp)	NT\$	2.93	2.37	1.03	1.14
EPS pcg growth (rep bonus exp)	%	-54.9	-70.6	-77.1	-71.7	EPS growth (rep bonus exp)	%	58.0	-19.2	-56.6	10.9
EPS (adj)	NT\$	0.30	0.26	0.21	0.26	EPS (adj)	NT\$	2.93	2.37	1.03	1.14
EPS pcg growth (adj)	%	-54.9	-70.6	-77.1	-71.7	EPS growth (adj)	%	58.0	-19.2	-56.6	10.9
Revenue pcg growth	%	5.3	-41.2	-52.5	-41.5	PE (rep)	x	4.4	5.5	12.7	11.5
Operating Income pcg growth	%	-29.9	-84.0	-77.2	-68.7	PE (rep bonus adj)	x	4.4	5.5	12.7	11.5
Reported Earnings pcg growth	%	-54.3	-70.2	-77.1	-71.7	PE (adj)	x	4.4	5.5	12.7	11.5
Gross Profit Margin	%	16.9	15.3	18.0	18.0	Total DPS	NT\$	2.15	1.78	0.92	1.03
Operating Income Margin	%	13.2	9.1	12.5	12.5	Total Div Yield	%	16.5	13.6	7.1	7.9
Reported Earnings Margin	%	7.3	9.4	8.5	8.5	Weighted Average Shares	m	795.0	805.0	805.0	805.0
EBITDA Margin	%	17.3	15.2	18.7	18.7	Period End Shares	m	795.0	805.0	805.0	805.0
<b>Profit and Loss Ratios</b>		<b>2007A</b>	<b>2008E</b>	<b>2009E</b>	<b>2010E</b>	<b>Cashflow Analysis</b>		<b>2007A</b>	<b>2008E</b>	<b>2009E</b>	<b>2010E</b>
Revenue Growth	%	25.2	3.3	-29.8	-0.6	<b>Reported Earnings</b>	m	2,332	1,908	827	917
Gross Profit Growth	%	68.6	-10.9	-46.2	-5.1	Depreciation & Amortisation	m	460	547	608	676
Operating Income Growth	%	90.0	-14.5	-54.8	-7.2	Chgs in Working Cap	m	446	-98	266	-34
Reported Earnings Growth	%	59.4	-18.2	-56.6	10.9	Other	m	715	327	211	40
EBITDA Growth	%	70.6	-10.2	-43.6	-1.0	<b>Operating Cashflow</b>	m	3,953	2,684	1,912	1,599
Gross Profit Margin	%	27.2	23.5	18.0	17.1	Acquisitions	m	-32	-1,350	0	0
Operating Income Margin	%	23.4	19.4	12.5	11.6	Capex	m	-1,452	-800	-800	-1,000
Reported Earnings Margin	%	17.4	13.8	8.5	9.5	Asset Sales	m	0	0	0	0
EBITDA Margin	%	26.8	23.3	18.7	18.7	Other	m	-776	0	0	0
Payout Ratio	%	73.2	75.0	90.0	90.0	<b>Investing Cashflow</b>	m	-2,260	-2,150	-800	-1,000
EV/EBITDA	x	2.7	3.2	5.8	5.3	Dividend (Ordinary)	m	-1,156	-1,707	-1,431	-744
EV/EBIT	x	3.1	3.9	9.3	8.6	Equity Raised	m	0	0	0	0
<b>Balance Sheet Ratios</b>						Debt Movements	m	0	0	500	0
ROE	%	17.8	14.3	6.5	7.4	Other	m	-29	0	0	0
ROA	%	20.9	17.1	8.0	7.4	<b>Financing Cashflow</b>	m	-1,185	-1,707	-931	-744
ROIC	%	22.1	18.8	8.1	7.9	<b>Net Chg in Cash/Debt</b>	m	508	-1,173	181	-145
Net Debt/Equity	%	-16.2	-8.0	-5.8	-4.6	Free Cashflow	m	2,501	1,884	1,112	599
Interest Cover	x	nmf	nmf	nmf	nmf	FCF per Share	NT\$	3.15	2.34	1.38	0.74
Price/Book	x	0.8	0.8	0.9	0.8	P/FCF	x	4.1	5.6	9.4	17.5
Book Value per Share	NT\$	17.2	16.1	15.3	15.6	<b>Balance Sheet</b>		<b>2007A</b>	<b>2008E</b>	<b>2009E</b>	<b>2010E</b>
						Cash	m	2,208	1,035	1,216	1,071
						Receivables	m	1,243	1,284	901	896
						Inventories	m	623	724	544	547
						Investments	m	73	623	623	623
						Fixed Assets	m	4,350	4,603	4,795	5,119
						Intangibles	m	0	0	0	0
						Other Assets	m	7,379	7,022	6,895	6,941
						<b>Total Assets</b>	m	15,876	15,291	14,974	15,197
						Payables	m	957	1,039	781	785
						Short Term Debt	m	0	0	0	0
						Long Term Debt	m	0	0	500	500
						Provisions	m	34	34	34	34
						Other Liabilities	m	1,219	1,262	1,307	1,353
						<b>Total Liabilities</b>	m	2,210	2,335	2,622	2,672
						<b>Total S/H Equity</b>	m	13,666	12,956	12,352	12,525
						<b>Total Liab &amp; S/H Funds</b>	m	15,876	15,291	14,974	15,197

All figures in NT\$ unless noted.

Source: Company data, Macquarie Research, November 2008

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Recommendation definitions	Volatility index definition*	Financial definitions
<p><b>Macquarie - Australia/New Zealand</b>            Outperform – return &gt;5% in excess of benchmark return (&gt;2.5% in excess for listed property trusts)            Neutral – return within 5% of benchmark return (within 2.5% for listed property trusts)            Underperform – return &gt;5% below benchmark return (&gt;2.5% below for listed property trusts)</p> <p><b>Macquarie – Asia/Europe</b>            Outperform – expected return &gt;+10%            Neutral – expected return from -10% to +10%            Underperform – expected return &lt;-10%</p> <p><b>Macquarie First South - South Africa</b>            Outperform – expected return &gt;+10%            Neutral – expected return from -10% to +10%            Underperform – expected return &lt;-10%</p> <p><b>Macquarie – Canada</b>            Outperform – return &gt;5% in excess of benchmark return            Neutral – return within 5% of benchmark return            Underperform – return &gt;5% below benchmark return</p> <p><b>Macquarie – USA</b>            Outperform (Buy) – return &gt;5% in excess of benchmark return            Neutral (Hold) – return within 5% of benchmark return            Underperform (Sell) – return &gt;5% below benchmark return</p> <p><b>Recommendations</b> – 12 months  <b>Note:</b> Quant recommendations may differ from Fundamental Analyst recommendations</p>	<p>This is calculated from the volatility of historic price movements.</p> <p><b>Very high–highest risk</b> – Stock should be expected to move up or down 60–100% in a year – investors should be aware this stock is highly speculative.</p> <p><b>High</b> – stock should be expected to move up or down at least 40–60% in a year – investors should be aware this stock could be speculative.</p> <p><b>Medium</b> – stock should be expected to move up or down at least 30–40% in a year.</p> <p><b>Low–medium</b> – stock should be expected to move up or down at least 25–30% in a year.</p> <p><b>Low</b> – stock should be expected to move up or down at least 15–25% in a year.            * Applicable to Australian/NZ stocks only</p>	<p>All "Adjusted" data items have had the following adjustments made:            Added back: goodwill amortisation, provision for catastrophe reserves, IFRS derivatives &amp; hedging, IFRS impairments &amp; IFRS interest expense            Excluded: non recurring items, asset revals, property revals, appraisal value uplift, preference dividends &amp; minority interests</p> <p><b>EPS</b> = adjusted net profit / efpowa*  <b>ROA</b> = adjusted ebit / average total assets  <b>ROA Banks/Insurance</b> = adjusted net profit / average total assets  <b>ROE</b> = adjusted net profit / average shareholders funds  <b>Gross cashflow</b> = adjusted net profit + depreciation            *equivalent fully paid ordinary weighted average number of shares</p> <p>All Reported numbers for Australian/NZ listed stocks are modelled under IFRS (International Financial Reporting Standards).</p>

## Recommendation proportions – For quarter ending 30 September 2008

	AU/NZ	Asia	RSA	USA	CA	EUR
Outperform	43.17%	61.57%	63.08%	53.60%	71.54%	43.00%
Neutral	41.37%	16.43%	30.77%	37.60%	24.61%	48.00%
Underperform	15.47%	22.00%	6.15%	8.80%	3.85%	9.00%

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## Sales

### Regional Heads of Sales

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Futures - Tim Smith (852) 2823 4637  
Hedge Fund Sales - Darin Lester (852) 2823 4736  
Structured Products - Andrew Terlich (852) 2249 3225