

Government's new policy is of limited help, in our view


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Still negative on Taiwan auto industry

We maintain our negative view on Taiwan's auto industry and reiterate our Underperform ratings on Hotai Motor and China Motor for two reasons: (1) the government's proposed policy to save the industry appears to be of limited help, and (2) domestic vehicle demand remains fragile with no signs of recovery. We lower our PO on Hotai Motor to NT\$54.5, from NT\$68, due to a 14% earnings cut and reduced P/E multiple from 13x 2009E EPS to 12x 2009E EPS, which is the historical trading average. We also cut our PO on China Motor to NT\$11.3, from NT\$14, on 0.35x 2009E P/BV, due to a 5% earnings cut.

New policy looks like a bailout in disguise...

The government seems intent on saving major domestic automakers, such as China Motor and Yulon Motor, which have suffered losses in the first nine months of the year. Among other things, we believe the new policy will (1) offer a 5-10% cost subsidy (via lower commodity tax rate) for those wishing to buy a new car, (2) help stimulate used-car exports, and (3) facilitate export of made-in-Taiwan cars to China and/or other countries.

...but is of limited help, in our view

To our minds, lowering commodity tax will only help those who are already planning and can afford to buy a car. We believe it is hardly a demand stimulant since cars are luxury goods, not necessities. As for export of Taiwan-made cars, this has seen slow progress because of the delay of approval by technology partners, whose interests often conflict with those of their Taiwanese partners.

Lower ASP likely in 2009

While we maintain our demand forecast of 245,000 vehicle units (+9% YoY) for 2009, we are aware that lower disposal income, sluggish stock market and low confidence in the new government's execution may cause some consumers to switch to smaller cars and basic versions from prior large cars and luxury versions. If so, this would weaken auto players' ASPs and profitability. Between Hotai Motor and China Motor, the former should take a bigger hit because it has a higher share in the mid- to high-end car market compared to the latter.

Earnings cut for both Hotai Motor and China Motor

We lower our 2008E/09E earnings for Hotai Motor by 6%/14% to NT\$2.46bn (-28% YoY)/NT\$2.48bn (+1% YoY) in anticipation of lower ASP. We also cut our 2008E/09E earnings for China Motor by 8%/5% to NT\$457mn loss (-124% YoY) /NT\$271mn (+159% YoY) to reflect lower ASP.

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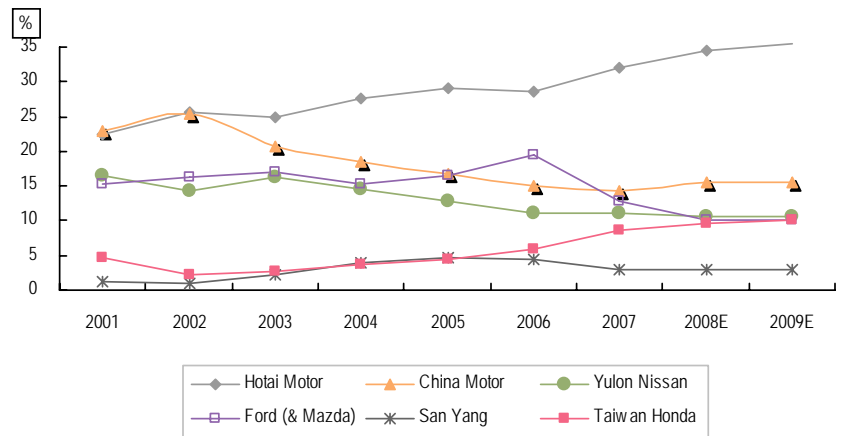
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Table 1: Taiwan: Cars sold by the top six auto players in January-October 2008

	Cars sold	Market share	YoY growth
Hotai Motor (Toyota)	68012	34.1%	-21.1%
China Motor (Mitsubishi)	32592	16.3%	-19.0%
Ford & Mazda	19462	9.8%	-46.2%
Yulon Nissan (Nissan)	22290	11.2%	-24.0%
Taiwan Honda (Honda)	17129	8.6%	-28.1%
San Yang (Hyundai)	5552	2.8%	-32.2%
Others	34303	17.2%	-33.7%
Total	199340	100.0%	-27.7%

Source: MOTC

Chart 1: Hotai continues to gain market share



Source: MOTC

Table 2: Hotai Motor: Cut in earnings

(NT\$m)	Old			New			% change		
	2008E	2009E	2010E	2008E	2009E	2010E	2008E	2009E	2010E
Sales	54401	62629	70257	51276	56991	63897	-6%	-9%	-9%
Gross profits	4127	4658	5117	3996	4436	4868	-3%	-5%	-5%
Operating profits	1872	2061	2204	2000	2218	2381	7%	8%	8%
Pre-tax profits	3454	3611	3864	3237	3263	3651	-6%	-10%	-6%
Net Profits	2625	2889	3092	2460	2480	2775	-6%	-14%	-10%
EPS(NT\$/share)	4.8	5.3	5.7	4.5	4.5	5.1	-6%	-14%	-10%
Gross margin	7.6%	7.4%	7.3%	7.8%	7.8%	7.6%			
Operating margin	3.4%	3.3%	3.1%	3.9%	3.9%	3.7%			
Net margin	4.8%	4.6%	4.4%	4.8%	4.4%	4.3%			

Source: Merrill Lynch estimates

Table 3: Hotai Motor: Quarterly earnings forecasts

(NT\$mnn)	1Q08	2Q08	3Q08	4Q08E	2007	2008E	2009E
Sales	20,955.1	13,635.9	8,692.5	7,992.7	71,066	51,276	56,991
Gross profits	1,527.5	1,070.3	831.4	566.5	5,053	3,996	4,436
Operating profits	971.7	448.3	400.8	179.1	2,437	2,000	2,218
Pre-tax profits	1,350.6	916.7	633.4	336.7	4,301	3,237	3,263
Net Profits	1,050.4	681.4	478.5	250.1	3,405	2,460	2,480
EPS(NT\$/share)	1.92	1.25	0.88	0.46	6.44	6.23	4.50
Gross margin	7.3%	7.8%	9.6%	7.1%	7.1%	7.8%	7.8%
Operating margin	4.6%	3.3%	4.6%	2.2%	3.4%	3.9%	3.9%
Net margin	5.0%	5.0%	5.5%	3.1%	4.8%	4.8%	4.4%

Source: Merrill Lynch estimates, Company

Table 4: China Motor: Cut in earnings

(NT\$mnn)	Old			New			% change		
	2008E	2009E	2010E	2008E	2009E	2010E	2008E	2009E	2010E
Sales	21952	24140	26820	22492	23294	25884	2%	-4%	-3%
Gross profits	1834	2162	2431	1887	2117	2377	3%	-2%	-2%
Operating profits	(164)	74	158	(161)	78	156	-2%	5%	-1%
Pre-tax profits	(451)	304	628	(486)	288	586	-8%	-5%	-7%
Net Profits	(424)	286	590	(457)	271	551	-8%	-5%	-7%
EPS(NT\$/share)	(0.3)	0.2	0.4	(0.3)	0.2	0.4	-8%	-5%	-7%
Gross margin	8.4%	9.0%	9.1%	8.4%	9.1%	9.2%			
Operating margin	-0.7%	0.3%	0.6%	-0.7%	0.3%	0.6%			
Net margin	-1.9%	1.2%	2.2%	-2.0%	1.2%	2.1%			

Source: Merrill Lynch estimates

Table 5: China Motor: Quarterly earnings forecasts

(NT\$mnn)	1Q08	2Q08	3Q08	4Q08E	2007	2008E	2009E
Sales	6,487.3	7,083.6	5,237.7	3,683.3	29,493	22,492	23,294
Gross profits	566.4	631.5	463.5	225.6	3,195	1,887	2,117
Operating profits	69.0	85.9	(22.0)	(293.7)	838	(161)	78
Pre-tax profits	457.5	(353.5)	(370.3)	(219.5)	1,793	(486)	288
Net Profits	336.5	(242.5)	(325.3)	(225.3)	1,867	(457)	271
EPS(NT\$/share)	0.24	-0.17	-0.23	-0.16	1.35	-0.33	0.19
Gross margin	8.7%	8.9%	8.8%	6.1%	10.8%	8.4%	9.1%
Operating margin	1.1%	1.2%	-0.4%	-8.0%	2.8%	-0.7%	0.3%
Net margin	5.2%	-3.4%	-6.2%	-6.1%	6.3%	-2.0%	1.2%

Source: Merrill Lynch estimates, Company

Table 6: Hotai Motor: Financial forecasts

NT\$m (year-end Dec)	2007	2008E	2009E	2010E
Income statement				
Net sales	71066	51276	56991	63897
Sales growth	7.8%	-27.8%	11.1%	12.1%
Gross profit	5053	3996	4436	4868
Gross margin	7.1%	7.8%	7.8%	7.6%
Operating income	2437	2000	2218	2381
Operating margin	3.4%	3.9%	3.9%	3.7%
Pre-tax income	4301	3237	3263	3651
Pre-tax margin	6.1%	6.3%	5.7%	5.7%
Income tax rate	20.8%	24.0%	24.0%	24.0%
Net income	3405	2460	2480	2775
EPS (NT\$)	6.23	4.50	4.54	5.08
Earnings growth	-3.2%	-27.7%	0.8%	11.9%
Net margin	4.8%	4.8%	4.4%	4.3%
Fully diluted EPS (NT\$)	6.08	4.25	4.54	5.08
EBIT	4,336	3,267	3,293	3,681
EBIT margin	6.1%	6.4%	5.8%	5.8%
EBITDA	4,459	3,418	3,469	3,879
EBITDA margin	6.3%	6.7%	6.1%	6.1%
Balance sheet				
Cash & mkt. securities	5,439	3,862	3,837	3,950
Total current assets	8558	6142	6370	6790
Non-current assets	14912	15861	16804	17904
Total assets	23471	22003	23174	24694
Total current liab.	3,628	2,599	2,889	3,244
Non-current liab.	606	6	7	8
Total liabilities	4234	2605	2896	3252
Common stocks	5,462	5,462	5,462	5,462
Total Equity	19,237	19,398	20,279	21,442
IB debt	0	0	0	0
Net debt	(5,439)	(3,862)	(3,837)	(3,950)
Cash flow				
Net income	3405	2460	2480	2775
Depreciation & amortization	123	151	176	198
Cash earnings	3528	2611	2656	2973
Change in working capital	515	171	-50	-60
Other op. CF changes	-556	-1560	-532	-690
Operating cash flow	3487	1222	2074	2223
Net capital expenditures	-180	-200	-200	-200
Change in LT investment	-99	-300	-300	-300
Other inv. CF changes	883	0	0	0
Investing cash flow	603	-500	-500	-500
Free cash flow	4090	722	1574	1723
Dividend paid	-2,294	-2,299	-1,599	-1,612
Equity financing	0	0	0	0
Debt financing	0	0	0	0
Other fin. CF changes	-128	0	0	0
Financial cash flow	-2422	-2299	-1599	-1612
Exchange influence	0	0	1	2
Change in cash flow	1669	-1577	-25	113

Source: Merrill Lynch estimates, Company

Table 7: China Motor: Financial forecasts

NT\$m (year-end Dec)	2007	2008E	2009E	2010E
Income statement				
Net sales	29493	22492	23294	25884
Sales growth	-18.2%	-23.7%	3.6%	11.1%
Gross profit	3195	1887	2117	2377
Gross margin	10.8%	8.4%	9.1%	9.2%
Operating income	838	-161	78	156
Operating margin	2.8%	-0.7%	0.3%	0.6%
Pre-tax income	1793	-486	288	586
Pre-tax margin	6.1%	-2.2%	1.2%	2.3%
Income tax rate	-4.1%	6.0%	6.0%	6.0%
Net income	1867	-457	271	551
EPS (NT\$)	1.35	-0.33	0.19	0.40
Earnings growth	-41.5%	-124.3%	-159.2%	103.7%
Net margin	6.3%	-2.0%	1.2%	2.1%
Fully diluted EPS (NT\$)	1.13	-0.33	0.19	0.40
EBIT	1,852	(421)	368	676
EBIT margin	6.3%	-1.9%	1.6%	2.6%
EBITDA	2,646	494	1,391	1,797
EBIT margin	9.0%	2.2%	6.0%	6.9%
Balance sheet				
Cash & mkt. securities	4,767	3,010	3,448	3,126
Total current assets	13335	9774	10452	10899
Non-current assets	43318	42868	42930	43194
Total assets	56653	52642	53382	54093
Total current liab.	5,562	4,494	4,601	5,039
Non-current liab.	5,439	3,515	4,016	4,017
Total liabilities	11001	8009	8617	9055
Common stocks	13,913	13,913	13,913	13,913
Total Equity	45,651	44,633	44,765	45,038
IB debt	3,539	4,139	4,639	4,639
Net debt	(1,228)	1,128	1,191	1,513
Cash flow				
Net income	1867	-457	271	551
Depreciation & amortization	794	915	1023	1121
Cash earnings	2661	458	1294	1672
Change in working capital	2036	1146	-127	-436
Other op. CF changes	-5	-2399	-92	-282
Operating cash flow	4693	-795	1075	954
Net capital expenditures	-2,197	-1,000	-1,000	-1,000
Change in LT investment	-685	0	0	0
Other inv. CF changes	-639	0	0	0
Investing cash flow	-3521	-1000	-1000	-1000
Free cash flow	1172	-1795	75	-46
Dividend paid	-1,298	-561	-139	-278
Equity financing	0	0	0	0
Debt financing	-191	600	500	0
Other fin. CF changes	-1,142	0	0	0
Financial cash flow	-2632	39	361	-278
Exchange influence	0	0	1	2
Change in cash flow	-1460	-1756	437	-322

Source: Merrill Lynch estimates, Company

Price objective basis & risk

China Motor (CHUYF, NT\$8.45, C-3-8)

We derive our fair value at NT\$11.3/share, by using DCF, based on our assumptions for WACC of 8pct, a long-term growth rate of 3pct and long-term operating margin of 3pct. Our PO also implies 0.35x 2009E P/B. Risks to our price objective: Better-than-expected auto demand in Taiwan leading to market share gains. The share price could decline in excess of our PO if Taiwan auto demand is worse than expected and/or its competitors aggressively cut prices to gain market share.

Hotai Motor Co (HOTAF, NT\$47.5, C-3-8)

We derive our fair value at NT\$54.5/share, assuming WACC of 8.8pct, long-term growth rate of 3pct and long-term operating margin of 2.8pct. Our PO also implies on 12x 2009E EPS. This multiple is a modest discount to the group, owing to the company's below-average growth rate. Risks to our price objective: Better-than-expected auto demand in Taiwan leading to market share gains. Also, the share price could decline in excess of our PO if Taiwan auto demand is worse than expected and/or its competitors aggressively cut prices to gain market share.

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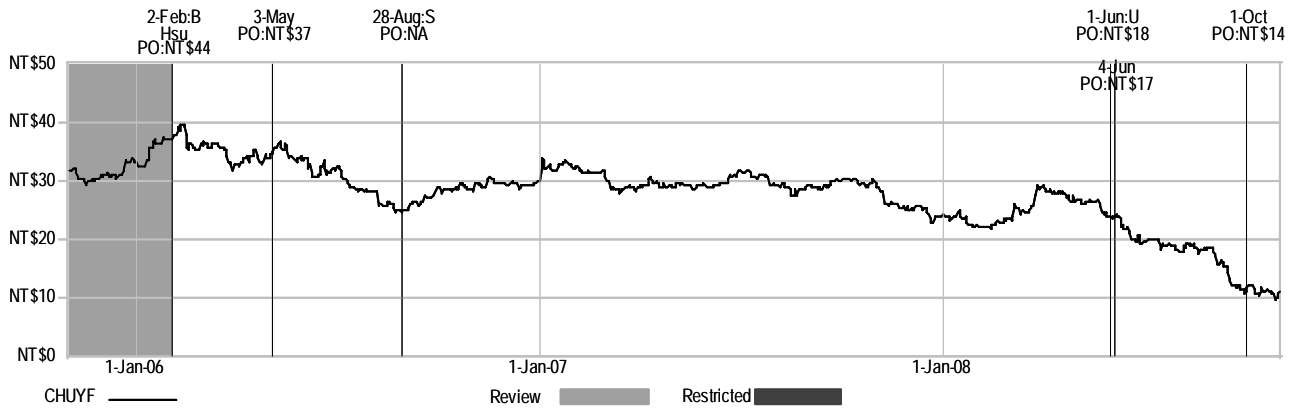
24 November 2008

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Investment rating	Company	ML ticker	Bloomberg symbol	Analyst
BUY				
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	China Life	CHLJF	2823 TT	Sophia Cheng
	Chinatrust	CTFHF	2891 TT	Katherine Hu
	Depo Auto Parts	DUOPF	6605 TT	Albert Hsu
	Far Eastern Textile	FREYF	1402 TT	Albert Hsu
	Fubon FHC	FUISF	2881 TT	Sophia Cheng
	Nak Sealing Tech	XMOOF	9942 TT	Albert Hsu
	SinoPac Financial Holdings	SPACF	2890 TT	Katherine Hu
NEUTRAL				
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	E.Sun FHC	ESUFF	2884 TT	Katherine Hu
	Far East Dept.	FEDTF	2903 TT	Brandon Chen
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	Asia Cement	ASIXF	1102 TT	Albert Hsu
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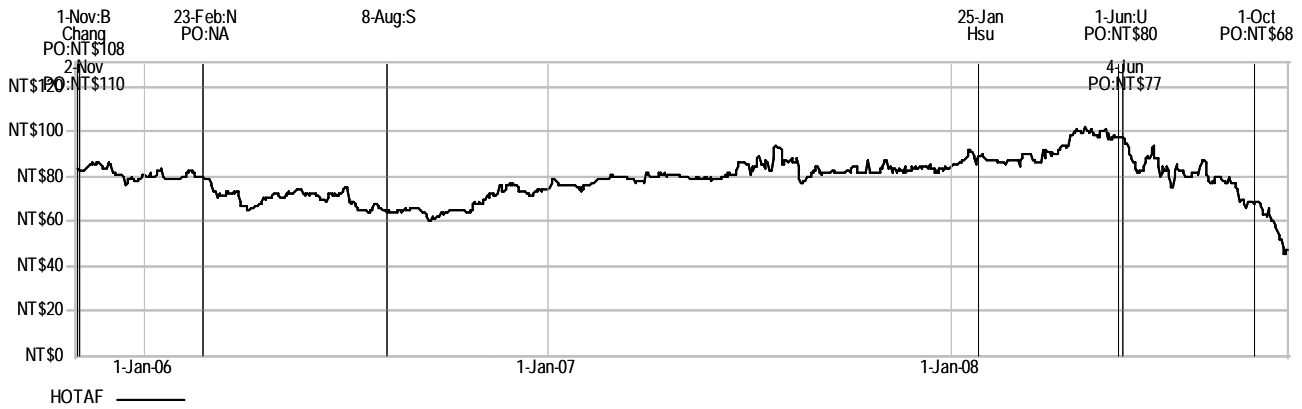
CHUYF Price Chart



B : Buy, N : Neutral, S : Sell, U : Underperform, PO : Price objective, NA : No longer valid

Prior to May 31, 2008, the investment opinion system included Buy, Neutral and Sell. As of May 31, 2008, the investment opinion system includes Buy, Neutral and Underperform. Dark Grey shading indicates that a security is restricted with the opinion suspended. Light grey shading indicates that a security is under review with the opinion withdrawn. The current investment opinion key is contained at the end of the report. Chart is current as of October 31, 2008 or such later date as indicated.

HOTAF Price Chart



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Investment Rating Distribution: Autos Group (as of 01 Oct 2008)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	31	36.47%	Buy	3	10.00%
Neutral	16	18.82%	Neutral	9	69.23%
Sell	38	44.71%	Sell	7	24.14%

Investment Rating Distribution: Distributors Group (as of 01 Oct 2008)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	6	54.55%	Buy	0	0.00%
Neutral	1	9.09%	Neutral	0	0.00%
Sell	4	36.36%	Sell	0	0.00%

Investment Rating Distribution: Global Group (as of 01 Oct 2008)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1647	45.31%	Buy	429	28.83%
Neutral	858	23.60%	Neutral	240	31.41%
Sell	1130	31.09%	Sell	227	22.02%

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