

TAIWAN

TSRC

24 November 2008

2103 TT Underperform

Stock price as of 21 Nov 08	NT\$	22.80
12-month target	NT\$	18.00
Upside/downside	%	-21.1
Valuation	NT\$	22.25
- DCF (WACC 8.2%)		

GICS sector		materials
Market cap	NT\$m	14,818
30-day avg turnover	NT\$m	181.9
Market cap	US\$m	444
Number shares on issue	m	649.9

Investment fundamentals

Year end 31 Dec		2007A	2008E	2009E	2010E
Total revenue	m	13,188	18,074	13,204	11,823
EBIT	m	1,413	2,429	895	538
EBIT Growth	%	52.5	71.9	-63.2	-39.9
Reported profit	m	3,262	2,969	1,605	1,736
Adjusted profit	m	3,262	2,969	1,605	1,736
EPS rep	NT\$	5.02	4.57	2.47	2.67
EPS rep growth	%	59.9	-9.0	-45.9	8.2
EPS bonus growth	%	59.9	-9.0	-45.9	8.2
PE rep	x	4.5	5.0	9.2	8.5
PE bonus exp	x	4.5	5.0	9.2	8.5
Total DPS	NT\$	4.40	3.20	1.98	2.14
Total div yield	%	19.3	14.0	8.7	9.4
ROA	%	9.2	14.2	5.3	3.3
ROE	%	29.5	25.2	13.9	15.0
EV/EBITDA	x	4.5	4.2	7.4	7.0
Net debt/equity	%	4.5	11.5	8.4	7.2
Price/book	x	1.3	1.3	1.3	1.3

2103 TT rel Taiex performance, & rec history



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

Analyst

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A hard road ahead

Event

- We reduce our target price for synthetic rubber producer TSRC to NT\$18 from NT\$31 after significantly reducing our FY09 and FY10 EPS outlook and increasing the downcycle discount to sum-of-the-parts-based target price to 20% from 10%. We believe the challenges ahead for raw material suppliers to the global tyre industry have increased. We maintain our Underperform rating for TSRC.

Impact

- Macquarie vs consensus.** We believe consensus earnings projections are too optimistic, and look for a relatively steep decline in TSRC's earnings next year. Our EPS forecast is 8% below consensus for FY08, 35% below for FY09 and 38% below for FY10.
- Good company, tough outlook.** We continue to view TSRC as being above average in the Taiwan petrochemical sector in terms of long-term potential. However, we believe a severe downturn in its operating environment will place further downward pressure on its share price.
- P/BV of 1.3x is overly demanding.** We don't believe that TSRC's FY09E 1.3x P/BV yet fully reflects the challenges that lie ahead. This multiple is still well above the 0.3x level the stock reached in the downturn of 2001.
- High Speed Rail shouldn't be a significant factor.** TSRC's 1% stake in Taiwan High Speed Rail (THSRC: 2633 TT, NT\$3.99, Not rated) may be negative for sentiment in terms of a potential need to infuse funds. However, even though TSRC is a member of the Continental Group, which is the lead group for THSRC, we believe TSRC is too small to be able to make a significant difference in terms of funding, and believe the risk of such an infusion remains small.

Earnings revision

- After reviewing recent results and incorporating a more challenging outlook for the synthetic rubber industry, we raise our FY08 EPS forecast by 6% but reduce it for FY09 by 21% and for FY10 by 31%.

Price catalyst

- 12-month price target: NT\$18.00 based on a Sum of Parts methodology.
- Catalyst: Steep decline in sales and earnings amid slump in global tyre sector.

Action and recommendation

- We maintain our Underperform rating for TSRC, as we view its 1.3x FY09E P/BV multiple as overly demanding in light of what we expect will be a steep decline in earnings, with FY09E EPS down 46% YoY. TSRC is a good company, but we would wait for an entry point that is less expensive and further along in the downcycle.

Please refer to the important disclosures and analyst certification on inside back cover of this document, or on our website www.macquarie.com.au/research/disclosures.

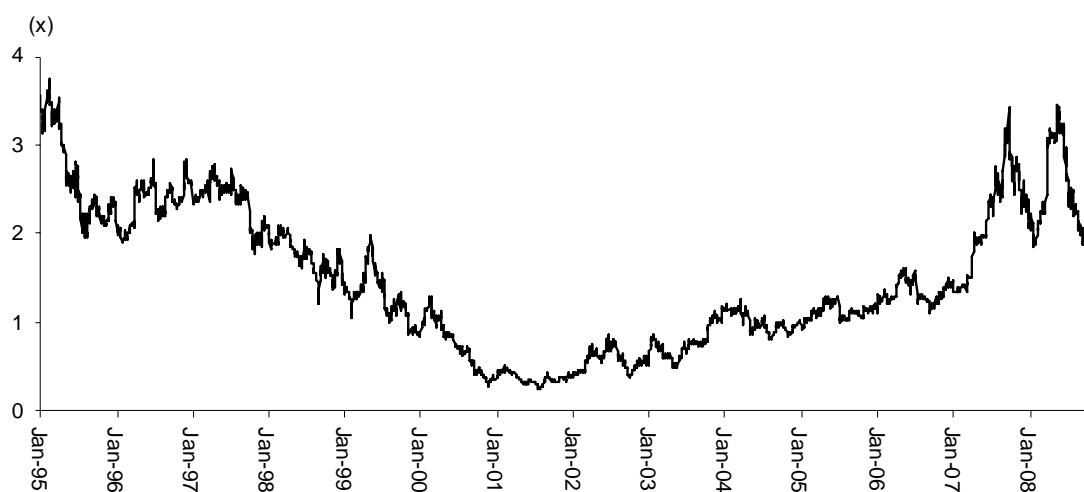
A hard road ahead

We reduce our target price for synthetic rubber producer TSRC to NT\$18 from NT\$31 after reducing our FY09E and FY10E EPS outlook significantly and increasing the downcycle discount to sum-of-the-parts-based target price to 20% from 10%. We believe the challenges ahead for raw material suppliers to the global tyre industry have increased. We maintain our Underperform rating for TSRC.

We believe 4Q08 and 1H09 could be particularly challenging. A 19% MoM tumble in TSRC's October monthly sales was, in our view, an indication that pressures on the company are building. Although prices for the synthetic rubber raw material butadiene have come down significantly, we believe this is primarily because of contracting demand from tyre producers as well as lower oil prices. TSRC will typically have a month or so of butadiene on-hand, and we believe a combination of lags in reductions in butadiene prices and downward pressure on TSRC's pricing and volumes will result in lower EBIT numbers in 4Q08 and FY09E than were posted in the first nine months of this year.

Although TSRC's share price has come down significantly this year, we believe its 1.3x FY09E P/BV remains overly demanding. As indicated in Figure 1, TSRC's P/BV multiple reached 0.3x in the 2001 economic downturn. We don't believe the stock will re-touch these very low levels in this downturn. Its China operations have benefited since then from strong growth in the Chinese tyre and automobile industries. Also, the early part of this decade represented a period of restructuring from unsuccessful non-core investments made in the late 1990s. However, although TSRC is a stronger company than it was in 2001, we believe the challenges ahead are significant, and look for its P/BV to decline from its current level. At our NT\$18 target price, the stock would be trading at 1.0x FY09E P/BV.

Fig 1 TSRC – P/BV trend



Source: TEJ, Macquarie Research, November 2008

Reduction in target price

Figure 2 provides our target price calculation. The main factors behind the reduction of our target price to NT\$18 from NT\$31 are as follows. We've reduced our value for its core business to NT\$15.9 from NT\$21.2 after incorporating much lower EBIT projections. In light of difficult conditions in the Chinese synthetic rubber as well as equity markets, we've reduced our P/BV multiple estimate for its China operations to 0.8x from 1.5x previously, bringing our valuation of these assets down to NT\$6.6 from NT\$12.4. After reducing our earnings estimates significantly, we've also increased our downcycle discount to the sum-of-the-parts calculation to 20% from 10% previously.

Fig 2 TSRC – per-share valuation

Asset	Stake (%)	Price (NT\$)	Target price (NT\$)	SOP calc. (NT\$)	Comments
NPV of core business FCF				15.91	Based on DCF
Investments				8.43	
China investments				6.61	Based on 0.8x FY08E BV
Continental Engineering (2526 TT, OP)	2.3	8.1	9.5	0.23	Based on 20% discount to target price
THSRC (2633 TT, grey market)	1.0	3.99	N/A	0.25	Based on 20% discount to market value
Other investments				1.34	Based on 0.5x current est BV
Adjusted asset value				24.34	
Net cash/(debt)				-2.09	Based on FY08E BV/shr
Per share equity value				22.25	
At 20% discount				17.80	
Target price				18.00	

Source: Macquarie Research, November 2008

Earnings changes

We've reduced our earnings outlook for TSRC significantly, as we believe the sharp contraction underway in the automobile and construction industries will put downward pressure on the tyre sector and on TSRC's pricing and utilisation. We've also incorporated recent changes to our regional oil and petrochemical price assumptions. We increase our EPS forecast for FY08 by 6% but reduce it for FY09 by 21% and for FY10 by 31%.

TSRC benefited on the way up in terms of crude oil prices, partly because we believe its raw material costs at the parent level lagged those on a spot basis. Strong demand for tyres, which we believe held up roughly through the first half of this year, was also a positive. However, as the reach of the global economic slowdown spread, auto sales and tyre demand began to wane. TSRC's operations held up through 3Q08, and exceeded our expectations. However, October sales slid by 19% MoM, and we believe the trend will continue to be down with falling prices and utilisation.

We've reduced our overall FY09 utilisation projection for TSRC to 86% from 95% previously and down from an estimated 98% this year on a name-plate capacity basis. Utilisation was 86% in 2001 and 82% in 2002. Our FY09E EBIT of NT\$895m would return the company to a similar level it earned in FY06.

For FY10, we look for TSRC to continue to be affected by weak demand, and also project that an appreciation in the NT\$/US\$ rate that year will hobble TSRC's attempts to improve on FY09. This is in contrast to FY09, for which we expect a significant depreciation of the NT\$/US\$ rate to provide some support to TSRC. We assume that the NT\$ depreciates to an average of NT\$34.4/US\$1 next year from NT\$31.9/US\$ this year, and then strengthens to NT\$31.5/US\$1 in FY10.

We've also reduced our investment income assumptions for TSRC. These are primarily driven by TSRC's synthetic rubber units in China. We believe the global downturn in the tyre segment will also negatively impact these operations.

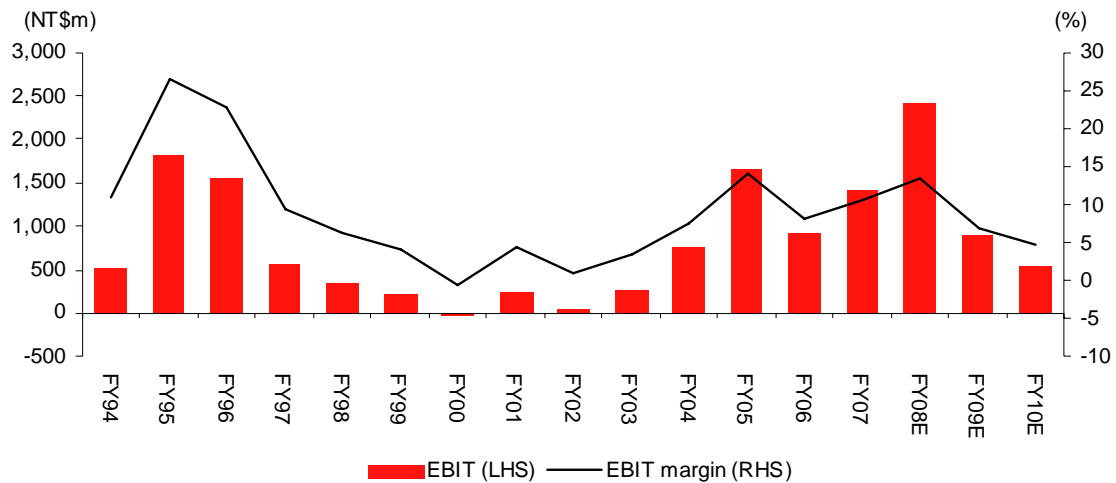
Fig 3 Changes to our TSRC earnings outlook

	FY08E			FY09E			FY10E		
	previous (NT\$m)	new (NT\$m)	Change (%)	previous (NT\$m)	new (NT\$m)	Change (%)	previous (NT\$m)	new (NT\$m)	Change (%)
Sales	18,616	18,074	-3	16,124	13,204	-18	15,243	11,823	-22
COGS	-15,671	-14,796	-6	-14,171	-11,544	-19	-13,203	-10,458	-21
Gross profit	2,945	3,278	11	1,953	1,661	-15	2,040	1,365	-33
Gross margin (%)	15.8	18.1	15	12.1	12.6	4	13.4	11.5	-14
SG&A	-968	-849	-12	-967	-766	-21	-930	-828	-11
EBIT	1,977	2,429	23	986	895	-9	1,110	538	-52
EBIT margin (%)	10.6	13.4	27	6.1	6.8	11	7.3	4.5	-38
Net interest	-118	-84	-29	-153	-91	-40	-153	-63	-59
Investment income	1,417	1,274	-10	1,456	1,066	-27	1,914	1,538	-20
China contribution	959	816	-15	998	608	-39	1,556	1,180	-24
Other investment income	458	458	0	458	458	0	358	358	0
Other non-operating items	200	175	-13	199	150	-25	201	150	-25
Pre-tax profit	3,476	3,794	9	2,488	2,019	-19	3,072	2,163	-30
Taxes	-665	-825	24	-444	-414	-7	-552	-426	-23
Net profit	2,811	2,969	6	2,044	1,605	-21	2,520	1,736	-31
EPS (NT\$)	4.32	4.57	6	3.14	2.47	-21	3.88	2.67	-31

Source: Macquarie Research, November 2008

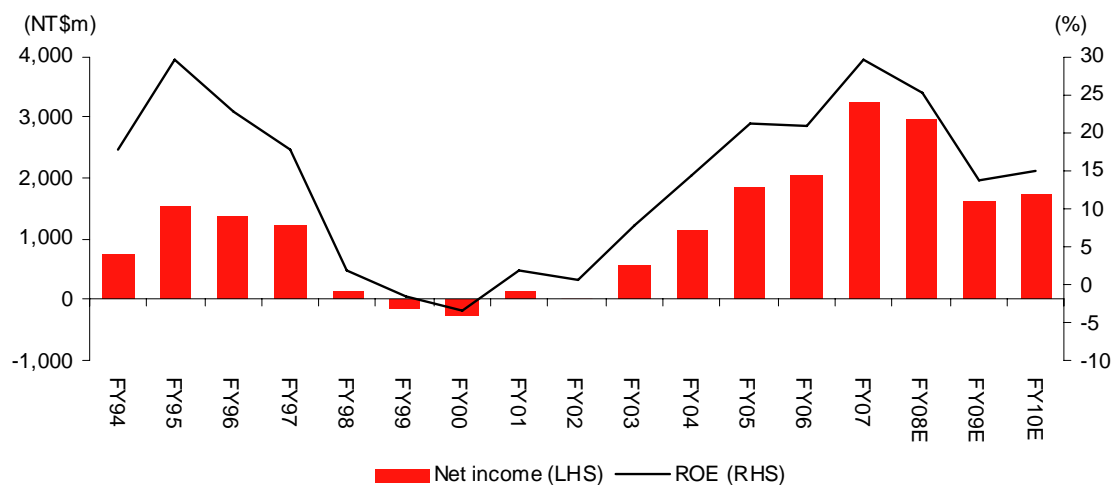
TSRC's EBIT pattern is very volatile, as indicated in Figure 3. It is driven by its Taiwan operations, which have changed to some extent over the years, but not significantly, in our view. TSRC's core customers remain the major Japanese and Taiwanese tyre makers. When tyre demand globally, and in China, was strong over the past few years, TSRC benefited. Also, we believe its butadiene pricing tended to lag increases in spot prices on the way up, although these prices are not released by supplier state-owned CPC Taiwan (unlisted). On the way, down, we expect TSRC to suffer from a lag in spot price reductions to butadiene and the need to use expensive raw material inventories while selling into a synthetic rubber market weakened by declining demand and weakness in natural rubber prices. We expect the company to suffer not only from narrowing product spreads but also reduced volumes. We also expect its China operations to come under similar pressures, although to some extent different as its China operations are geared toward the spot market for raw materials and product pricing rather than the contract environment that dominates for its parent operations. We look for TSRC's China operations to begin to recover before its Taiwan operations, aided by new capacity being added by TSRC in China. Figure 4 provides TSRC's historical net profit trend and our outlook going forward.

Fig 4 TSRC – EBIT and margin trend



Source: Company data, Macquarie Research, November 2008

Fig 5 TSRC – net profit and ROE trend



Source: Company data, Macquarie Research, November 2008

TSRC (2103 TT, Underperform, Target price: NT\$18.00)

Quarterly Results		3Q/08A	4Q/08E	1Q/09E	2Q/09E	Profit & Loss					
						2007A	2008E	2009E	2010E		
Revenue	m	5,341	4,312	3,037	3,301	Revenue	m	13,188	18,074	13,204	11,823
Gross Profit	m	1,056	515	382	415	Gross Profit	m	2,286	3,278	1,661	1,365
Operating Expenses	m	-233	-180	-176	-191	Operating Expenses	m	-873	-849	-766	-828
Operating Income	m	823	335	206	224	Operating Income	m	1,413	2,429	895	538
Net Non-operating income	m	377	96	259	281	Net Non-operating income	m	2,205	1,365	1,125	1,625
Pre-Tax Income	m	1,200	431	464	505	Pre-Tax Income	m	3,618	3,794	2,019	2,163
Tax Expense	m	-280	-100	-95	-104	Tax Expense	m	-356	-825	-414	-426
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
Reported Earnings	m	920	331	369	401	Reported Earnings	m	3,262	2,969	1,605	1,736
Reported Earnings (bonus exp)	m	920	331	369	401	Reported Earnings (bonus exp)	m	3,262	2,969	1,605	1,736
Bonus exp / Reported Earnings	%					Bonus exp / Reported Earnings	%				
Adjusted Earnings	m	920	331	369	401	Adjusted Earnings	m	3,262	2,969	1,605	1,736
EBITDA	m	892	404	273	297	EBITDA	m	1,675	2,706	1,187	842
EPS (rep)	NT\$	1.42	0.51	0.57	0.62	EPS (rep)	NT\$	5.02	4.57	2.47	2.67
EPS pcg growth (rep)	%	3.4	-56.3	-52.9	-57.0	EPS growth (rep)	%	59.9	-9.0	-45.9	8.2
EPS (rep bonus exp)	NT\$	1.42	0.51	0.57	0.62	EPS (rep bonus exp)	NT\$	5.02	4.57	2.47	2.67
EPS pcg growth (rep bonus exp)	%	3.4	-56.3	-52.9	-57.0	EPS growth (rep bonus exp)	%	59.9	-9.0	-45.9	8.2
EPS (adj)	NT\$	1.42	0.51	0.57	0.62	EPS (adj)	NT\$	5.02	4.57	2.47	2.67
EPS pcg growth (adj)	%	3.4	-56.3	-52.9	-57.0	EPS growth (adj)	%	59.9	-9.0	-45.9	8.2
Revenue pcg growth	%	66.8	21.0	-18.8	-29.4	PE (rep)	x	4.5	5.0	9.2	8.5
Operating Income pcg growth	%	103.2	-9.6	-60.2	-70.3	PE (rep bonus adj)	x	4.5	5.0	9.2	8.5
Reported Earnings pcg growth	%	3.4	-56.3	-52.9	-57.0	PE (adj)	x	4.5	5.0	9.2	8.5
Gross Profit Margin	%	19.8	11.9	12.6	12.6	Total DPS	NT\$	4.40	3.20	1.98	2.14
Operating Income Margin	%	15.4	7.8	6.8	6.8	Total Div Yield	%	19.3	14.0	8.7	9.4
Reported Earnings Margin	%	17.2	7.7	12.2	12.2	Weighted Average Shares	m	650.0	650.0	650.0	650.0
EBITDA Margin	%	16.7	9.4	9.0	9.0	Period End Shares	m	650.0	650.0	650.0	650.0
Profit and Loss Ratios		2007A	2008E	2009E	2010E	Cashflow Analysis	2007A	2008E	2009E	2010E	
Revenue Growth	%	13.8	37.1	-26.9	-10.5	Reported Earnings	m	3,262	2,969	1,605	1,736
Gross Profit Growth	%	40.9	43.4	-49.3	-17.8	Depreciation & Amortisation	m	262	278	292	304
Operating Income Growth	%	52.5	71.9	-63.2	-39.9	Chgs in Working Cap	m	386	-768	801	236
Reported Earnings Growth	%	59.9	-9.0	-45.9	8.2	Other	m	-1,123	-174	-16	-688
EBITDA Growth	%	40.4	61.6	-56.2	-29.0	Operating Cashflow	m	2,787	2,305	2,682	1,588
Gross Profit Margin	%	17.3	18.1	12.6	11.5	Acquisitions	m	395	-27	0	0
Operating Income Margin	%	10.7	13.4	6.8	4.5	Capex	m	-163	-250	-200	-200
Reported Earnings Margin	%	24.7	16.4	12.2	14.7	Asset Sales	m	0	0	0	0
EBITDA Margin	%	12.7	15.0	9.0	7.1	Other	m	-2	0	0	0
Payout Ratio	%	87.7	70.0	80.0	80.0	Investing Cashflow	m	230	-277	-200	-200
EV/EBITDA	x	4.5	4.2	7.4	7.0	Dividend (Ordinary)	m	-1,789	-2,860	-2,078	-1,284
EV/EBIT	x	4.8	4.5	8.5	8.0	Equity Raised	m	0	0	0	0
Balance Sheet Ratios						Debt Movements	m	9	1,075	-1,000	0
ROE	%	29.5	25.2	13.9	15.0	Other	m	-61	0	0	0
ROA	%	9.2	14.2	5.3	3.3	Financing Cashflow	m	-1,841	-1,785	-3,078	-1,284
ROIC	%	10.7	15.5	5.4	3.5	Net Chg in Cash/Debt	m	1,176	243	-596	104
Net Debt/Equity	%	4.5	11.5	8.4	7.2	Free Cashflow	m	2,624	2,055	2,482	1,388
Interest Cover	x	17.2	29.0	9.8	8.6	FCF per Share	NT\$	4.04	3.16	3.82	2.14
Price/Book	x	1.3	1.3	1.3	1.3	P/FCF	x	5.6	7.2	6.0	10.7
Book Value per Share	NT\$	18.0	18.2	17.5	18.2	Balance Sheet	2007A	2008E	2009E	2010E	
						Cash	m	1,496	1,739	1,143	1,247
						Receivables	m	1,945	2,377	1,736	1,555
						Inventories	m	1,295	1,743	1,360	1,232
						Investments	m	473	500	500	500
						Fixed Assets	m	2,115	2,087	1,995	1,891
						Intangibles	m	0	0	0	0
						Other Assets	m	9,116	9,359	9,447	10,209
						Total Assets	m	16,440	17,805	16,181	16,634
						Payables	m	902	1,013	791	716
						Short Term Debt	m	1,425	1,200	1,200	1,200
						Long Term Debt	m	600	1,900	900	900
						Provisions	m	57	57	57	57
						Other Liabilities	m	1,738	1,808	1,880	1,955
						Total Liabilities	m	4,722	5,978	4,827	4,828
						Total S/H Equity	m	11,718	11,827	11,353	11,805
						Total Liab & S/H Funds	m	16,440	17,805	16,181	16,634

All figures in NT\$ unless noted.

Source: Company data, Macquarie Research, November 2008

Important disclosures:

Recommendation definitions	Volatility index definition*	Financial definitions
<p>Macquarie - Australia/New Zealand Outperform – return >5% in excess of benchmark return (>2.5% in excess for listed property trusts) Neutral – return within 5% of benchmark return (within 2.5% for listed property trusts) Underperform – return >5% below benchmark return (>2.5% below for listed property trusts)</p> <p>Macquarie – Asia/Europe Outperform – expected return >+10% Neutral – expected return from -10% to +10% Underperform – expected return <-10%</p> <p>Macquarie First South - South Africa Outperform – expected return >+10% Neutral – expected return from -10% to +10% Underperform – expected return <-10%</p> <p>Macquarie – Canada Outperform – return >5% in excess of benchmark return Neutral – return within 5% of benchmark return Underperform – return >5% below benchmark return</p> <p>Macquarie – USA Outperform (Buy) – return >5% in excess of benchmark return Neutral (Hold) – return within 5% of benchmark return Underperform (Sell) – return >5% below benchmark return</p> <p>Recommendations – 12 months Note: Quant recommendations may differ from Fundamental Analyst recommendations</p>	<p>This is calculated from the volatility of historic price movements.</p> <p>Very high–highest risk – 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>High – 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>Medium – stock should be expected to move up or down at least 30–40% in a year.</p> <p>Low–medium – stock should be expected to move up or down at least 25–30% in a year.</p> <p>Low – 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 & hedging, IFRS impairments & IFRS interest expense Excluded: non recurring items, asset revals, property revals, appraisal value uplift, preference dividends & minority interests</p> <p>EPS = adjusted net profit / epfowa* ROA = adjusted ebit / average total assets ROA Banks/Insurance = adjusted net profit / average total assets ROE = adjusted net profit / average shareholders funds Gross cashflow = 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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