

COMPANY UPDATE

ZyXEL Communications Corp. (2391.TW)

Neutral

Relatively defensive but macro headwind remains strong, Neutral**What's changed**

We now assume ZyXEL's 4Q08 sales will decline 10% qoq as our channel checks suggest ZyXEL is experiencing a shipment delay from an Asian telecom company. We have also trimmed our 4Q GM assumption to 30.9% (from 32.3%) due to its worse product mix in the quarter (heavier reliance on carrier business).

Implications

Despite our view that ZyXEL is a relatively defensive stock in the networking universe (we expect ZyXEL 09 sales to grow 3.3% but D-Link 09 sales to drop 5.5%) given the potential WiMAX ramp in 2009 and a confirmed contract with the Taiwan Defense Department, we still believe there is downside risk in the core business, i.e., broadband CPE/COE. The magnitude of the economic slowdown in Europe where ZyXEL has the highest exposure should continue to cap ZyXEL's sales momentum; in addition, we think slowing demand from emerging markets also implies that these markets may no longer be a safe harbor; please refer to our note "D-Link: Struck by slowing emerging markets and FX, maintain Neutral" dated Dec. 22. Even though ZyXEL focuses more on carrier business, its revenues from carriers are mostly from consumer related broadband CPE products which could still be impacted by weak demand from both emerging and developed markets. As a result, we have trimmed our 08E/09E/10E sales forecasts by 1%/4%/11% and revised down our earnings forecasts by 10%/19%/9% respectively to further factor in the macro slowdown. We maintain our Neutral rating and suggest investors to stay on the sidelines.

Valuation

ZyXEL is trading at 13X 2009E EPS, below its historical trough (since 2002) of 15X. We revise down our 12-month target price to NT\$19 (from NT\$22) based on 1X PEG in 2008E-11E, implying 15X 2009E EPS.

Key risks

Slower-than-expected ramp-up of WiMAX; DSL CPE/COE upgrade cycle.

INVESTMENT LIST MEMBERSHIP

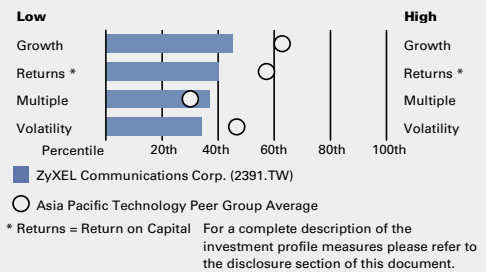
Neutral

Coverage View: Neutral

Taiwan:
Communications Technology

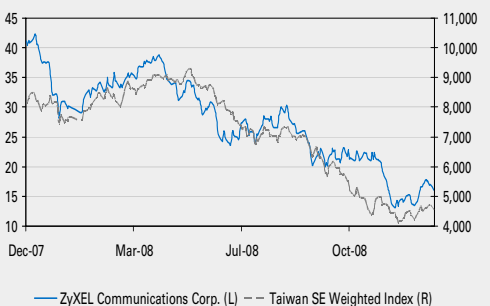
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Investment Profile

Key data	Current
Price (NT\$)	16.05
12 month price target (NT\$)	19.00
Market cap (NT\$ mn / US\$ mn)	7,915.6 / 240.2
Foreign ownership (%)	19.8

	12/07	12/08E	12/09E	12/10E
EPS (NT\$) New	3.11	0.87	1.29	1.44
EPS revision (%)	0.0	(10.4)	(19.1)	(8.9)
EPS growth (%)	16.0	(71.9)	47.3	11.9
EPS (dil) (NT\$) New	3.11	0.87	1.29	1.44
P/E (X)	5.2	18.4	12.5	11.1
P/B (X)	0.8	0.8	0.8	0.8
EV/EBITDA (X)	11.3	3.9	4.6	3.5
Dividend yield (%)	7.9	10.0	3.2	5.0
ROE (%)	15.5	4.2	6.5	7.0

Price performance chart

Share price performance (%)	3 month	6 month	12 month
Absolute	(28.5)	(34.6)	(59.8)
Rel. to Taiwan SE Weighted Index	(3.7)	14.0	(29.6)

Source: Company data, Goldman Sachs Research estimates, FactSet. Price as of 12/22/2008 close.

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Exhibit 1: We cut our 2009E-2010E sales forecasts by 1%-11% and earnings forecasts by 9%-19% respectively to further factor in the macro slowdown.

Top: non-GAAP; bottom: GAAP

ZyXEL Communications (2391.TW)

P&L (non-GAAP, NT\$m n)	2008E New	2008E Old	Diff.	2009E New	2009E Old	Diff.	2010E New	2010E Old	Diff.
Revenues	14,946	15,118	-1%	15,440	16,104	-4%	17,103	19,120	-11%
Gross profits	4,865	4,971	-2%	4,814	5,196	-7%	5,339	5,882	-9%
Operating profits	686	748	-8%	697	882	-21%	756	839	-10%
Non-operating income	(142)	(143)	NM	49	48	1%	64	60	7%
Pre-tax Profits	544	605	-10%	746	931	-20%	820	899	-9%
Net earnings	491	549	-11%	738	912	-19%	823	904	-9%
EPS (NT\$)	1.00	1.11	-11%	1.50	1.85	-19%	1.67	1.83	-9%
Margin analysis									
Gross margin (%)	32.5%	32.9%		31.2%	32.3%		31.2%	30.8%	
EBIT margin (%)	4.6%	4.9%		4.5%	5.5%		4.4%	4.4%	
Tax and minorities (as % of EBT)	7.7%	7.5%		1.2%	2.2%		-0.4%	-0.6%	
Net margin (%)	3.3%	3.6%		4.8%	5.7%		4.8%	4.7%	
Return analysis									
ROA (% , annualized)	3.6%	4.0%		5.3%	6.4%		5.5%	5.9%	
ROE (% , annualized)	4.8%	5.4%		7.5%	9.2%		8.1%	8.7%	

ZyXEL Communications (2391.TW)

P&L (GAAP, NT\$m n)	2008E New	2008E Old	Diff.	2009E New	2009E Old	Diff.	2010E New	2010E Old	Diff.
Revenues	14,946	15,118	-1%	15,440	16,104	-4%	17,103	19,120	-11%
Gross profits	4,852	4,956	-2%	4,792	5,169	-7%	5,314	5,855	-9%
Operating profits	621	674	-8%	587	746	-21%	633	703	-10%
Non-operating income	(142)	(143)	NM	49	48	1%	64	60	7%
Pre-tax Profits	478	531	-10%	635	794	-20%	697	763	-9%
Net earnings	431	481	-10%	635	785	-19%	711	780	-9%
EPS (NT\$)	0.87	0.98	-10%	1.29	1.59	-19%	1.44	1.58	-9%
Margin analysis									
Gross margin (%)	32.5%	32.8%		31.0%	32.1%		31.1%	30.6%	
EBIT margin (%)	4.2%	4.5%		3.8%	4.6%		3.7%	3.7%	
Tax and minorities (as % of EBT)	7.6%	7.4%		0.0%	1.2%		-2.2%	-2.4%	
Net margin (%)	2.9%	3.2%		4.1%	4.9%		4.2%	4.1%	
Return analysis									
ROA (% , annualized)	3.1%	3.5%		4.5%	5.5%		4.8%	5.1%	
ROE (% , annualized)	4.2%	4.7%		6.5%	7.9%		7.0%	7.5%	

Source: Company data, Goldman Sachs Research estimates.

Exhibit 2: ZyXEL's quarterly profit model (consolidated; NT\$m)

Non-GAAP basis

Summary P&L (non-GAAP)	1Q2008	2Q2008	3Q2008	4Q2008E	1Q2009E	2Q2009E	3Q2009E	4Q2009E	2007	2008E	2009E	2010E
Net sales	3,325	4,267	3,867	3,487	2,962	3,463	4,185	4,831	15,995	14,946	15,440	17,103
Cost of good sold (COGS)	(2,321)	(2,758)	(2,598)	(2,405)	(2,041)	(2,394)	(2,891)	(3,300)	(10,898)	(10,082)	(10,626)	(11,764)
Gross profits	1,005	1,509	1,269	1,083	920	1,069	1,295	1,530	5,097	4,865	4,814	5,339
Operating expenses	(1,028)	(1,177)	(1,067)	(907)	(831)	(943)	(1,107)	(1,235)	(3,613)	(4,179)	(4,117)	(4,582)
SG&A	(667)	(784)	(698)	(510)	(465)	(532)	(630)	(710)	(2,590)	(2,659)	(2,338)	(2,676)
R&D	(360)	(393)	(369)	(397)	(366)	(411)	(477)	(525)	(1,023)	(1,519)	(1,779)	(1,907)
Operating profits	(23)	332	201	176	89	126	187	295	1,484	686	697	756
Non-operating incomes/(losses)	(155)	44	(41)	9	13	14	12	10	357	(142)	49	64
Earnings before tax (EBT)	(178)	376	161	185	101	140	199	305	1,841	544	746	820
Income tax credit/(expense)	10	(66)	11	(2)	1	(0)	(3)	(9)	(251)	(47)	(11)	(1)
Extraordinary gain/(loss)	-	-	-	-	-	-	-	-	-	-	-	-
Minority interests	(1)	(6)	0	1	0	1	1	1	15	(6)	3	4
Earnings after tax (EAT)	(169)	305	172	183	103	140	197	297	1,604	491	738	823
EPS (NT\$)	(0.34)	0.62	0.35	0.37	0.21	0.28	0.40	0.60	3.11	1.00	1.50	1.67
EPS (fully diluted; NT\$)	(0.34)	0.62	0.35	0.37	0.21	0.28	0.40	0.60	3.11	1.00	1.50	1.67
Ratio analysis and assumptions												
As % of sales												
Gross margin	30.2%	35.4%	32.8%	31.0%	31.1%	30.9%	30.9%	31.7%	31.9%	32.5%	31.2%	31.2%
Operating expense ratio	-30.9%	-27.6%	-27.6%	-26.0%	-28.1%	-27.2%	-26.5%	-25.6%	-22.6%	-28.0%	-26.7%	-26.8%
Operating margin	-0.7%	7.8%	5.2%	5.0%	3.0%	3.6%	4.5%	6.1%	9.3%	4.6%	4.5%	4.4%
Pretax margin	-5.4%	8.8%	4.2%	5.3%	3.4%	4.0%	4.8%	6.3%	11.5%	3.6%	4.8%	4.8%
Tax rate (as % of EBT)	5.8%	17.5%	-6.9%	1.1%	-1.2%	0.1%	1.3%	3.1%	13.6%	8.6%	1.5%	0.2%
Net margin	-5.1%	7.1%	4.5%	5.3%	3.5%	4.1%	4.7%	6.1%	10.0%	3.3%	4.8%	4.8%
QoQ growth (%)												
Sales	-24.2%	28.3%	-9.4%	-9.8%	-15.1%	16.9%	20.9%	15.4%				
Gross profits	-32.2%	50.1%	-15.9%	-14.6%	-15.0%	16.1%	21.1%	18.2%				
Operating profits	NM	NM	-39.3%	-12.9%	-49.4%	41.4%	48.8%	57.9%				
Non-operating profits	NM	NM	NM	NM	35.6%	12.3%	-14.5%	-17.7%				
Pre-tax profits	NM	NM	-57.2%	14.9%	-45.1%	37.8%	42.4%	53.3%				
Net profits	NM	NM	-43.5%	6.5%	-43.7%	35.9%	40.6%	50.5%				
EPS (weighted averaged)	NM	NM	-43.5%	6.5%	-43.7%	35.9%	40.6%	50.5%				
YoY growth (%)												
Sales	-14.4%	6.1%	4.4%	-20.5%	-10.9%	-18.8%	8.2%	38.5%	14.4%	-6.6%	3.3%	10.8%
Gross profits	-7.4%	21.7%	-1.7%	-27.0%	-8.4%	-29.1%	2.0%	41.3%	15.0%	-4.5%	-1.0%	10.9%
Operating profits	NM	-7.2%	-50.2%	-62.5%	NM	-62.1%	-7.1%	68.2%	33.1%	-53.8%	1.6%	8.5%
Non-operating profits	NM	-51.1%	NM	-87.1%	NM	-67.9%	NM	7.2%	-38.0%	NM	NM	31.1%
Pretax profits	NM	-16.0%	-70.0%	-65.8%	NM	-62.8%	23.8%	65.2%	8.9%	-70.5%	37.2%	10.0%
Net profits	NM	-18.6%	-59.4%	-64.6%	NM	-53.9%	14.6%	61.9%	15.8%	-69.4%	50.3%	11.6%
EPS	NM	-14.9%	-57.5%	-63.0%	NM	-53.9%	14.6%	61.9%	13.6%	-68.0%	50.3%	11.6%
Dividend policies												
Cash dividends (NT\$ per share)									1.27	1.60	0.51	0.80
Payout ratio (%)									47.3%	49.3%	51.3%	53.3%

Source: Company data, Goldman Sachs Research estimates.

Exhibit 3: ZyXEL's quarterly profit model (consolidated; NT\$m)

GAAP basis

Summary P&L (GAAP)	1Q2008	2Q2008	3Q2008	4Q2008E	1Q2009E	2Q2009E	3Q2009E	4Q2009E	2007	2008E	2009E	2010E
Net sales	3,325	4,267	3,867	3,487	2,962	3,463	4,185	4,831	15,995	14,946	15,440	17,103
Cost of good sold (COGS)	(2,321)	(2,762)	(2,602)	(2,410)	(2,044)	(2,398)	(2,897)	(3,309)	(10,948)	(10,095)	(10,648)	(11,789)
Gross profits	1,005	1,505	1,264	1,077	917	1,065	1,289	1,521	5,047	4,852	4,792	5,314
Operating expenses	(1,028)	(1,190)	(1,084)	(929)	(844)	(960)	(1,131)	(1,271)	(3,868)	(4,231)	(4,205)	(4,681)
S&A	(667)	(787)	(702)	(516)	(468)	(536)	(636)	(719)	(2,651)	(2,672)	(2,360)	(2,700)
R&D	(360)	(403)	(382)	(413)	(376)	(424)	(495)	(551)	(1,217)	(1,558)	(1,845)	(1,981)
Operating profits	(23)	315	180	148	73	105	158	251	1,179	621	587	633
Non-operating incomes/(losses)	(155)	44	(41)	9	13	14	12	10	357	(142)	49	64
Earnings before tax (EBT)	(178)	359	140	157	86	119	170	261	1,536	478	635	697
Income tax credit/(expense)	10	(62)	11	(2)	1	(0)	(2)	(8)	(210)	(42)	(9)	(1)
Extraordinary gain/(loss)	-	-	-	-	-	-	-	-	-	-	-	-
Minority interests	(1)	(6)	0	2	2	2	2	3	(27)	(5)	9	15
Earnings after tax (EAT)	(169)	292	151	158	89	121	170	256	1,299	431	635	711
EPS (GAAP, NT\$)	(0.34)	0.59	0.31	0.32	0.18	0.24	0.34	0.52	2.52	0.87	1.29	1.44
EPS (GAAP, fully diluted, NT\$)	(0.34)	0.59	0.31	0.32	0.18	0.24	0.34	0.52	2.52	0.87	1.29	1.44
Ratio analysis and assumptions												
As % of sales												
Gross margin	30.2%	35.3%	32.7%	30.9%	31.0%	30.7%	30.8%	31.5%	31.6%	32.5%	31.0%	31.1%
Operating expense ratio	-30.9%	-27.9%	-28.0%	-26.6%	-28.5%	-27.7%	-27.0%	-26.3%	-24.2%	-28.3%	-27.2%	-27.4%
Operating margin	-0.7%	7.4%	4.7%	4.2%	2.5%	3.0%	3.8%	5.2%	7.4%	4.2%	3.8%	3.7%
Pretax margin	-5.4%	8.4%	3.6%	4.5%	2.9%	3.4%	4.1%	5.4%	9.6%	3.2%	4.1%	4.1%
Tax rate (as % of EBT)	5.8%	17.3%	-7.9%	1.1%	-1.2%	0.1%	1.3%	3.1%	13.7%	8.9%	1.5%	0.2%
Net margin	-5.1%	6.8%	3.9%	4.5%	3.0%	3.5%	4.1%	5.3%	8.1%	2.9%	4.1%	4.2%
QoQ growth (%)												
Sales	-24.2%	28.3%	-9.4%	-9.8%	-15.1%	16.9%	20.9%	15.4%				
Gross profits	-31.6%	49.8%	-16.0%	-14.8%	-14.8%	16.1%	21.0%	18.1%				
Operating profits	NM	NM	-42.7%	-18.0%	-50.4%	42.6%	50.5%	59.3%				
Non-operating profits	NM	NM	NM	NM	35.6%	12.3%	-14.5%	-17.7%				
Pre-tax profits	NM	NM	-61.1%	12.5%	-45.3%	38.1%	42.8%	53.8%				
Net profits	NM	NM	-48.1%	4.2%	-43.7%	36.0%	40.7%	50.6%				
EPS (weighted averaged)	NM	NM	-48.1%	4.2%	-43.7%	36.0%	40.7%	50.6%				
YoY growth (%)												
Sales	-14.4%	6.1%	4.4%	-20.5%	-10.9%	-18.8%	8.2%	38.5%	14.4%	-6.6%	3.3%	10.8%
Gross profits	-6.4%	22.7%	-1.1%	-26.7%	-8.7%	-29.3%	1.9%	41.2%	16.0%	-3.9%	-1.2%	10.9%
Operating profits	NM	12.2%	-46.0%	-61.5%	NM	-66.8%	-12.7%	69.4%	94.7%	-47.4%	-5.5%	7.9%
Non-operating profits	NM	-51.1%	NM	-87.1%	NM	-67.9%	NM	7.2%	-38.0%	NM	NM	31.1%
Pretax profits	NM	-3.2%	-69.9%	-65.5%	NM	-66.9%	21.2%	65.8%	30.0%	-68.9%	32.8%	9.7%
Net profits	NM	-5.5%	-56.1%	-61.9%	NM	-58.6%	12.3%	62.3%	38.0%	-66.8%	47.3%	11.9%
EPS	NM	-1.2%	-54.1%	-60.2%	NM	-58.6%	12.3%	62.3%	35.4%	-65.3%	47.3%	11.9%
Dividend policies												
Cash dividends (NT\$ per share)									1.27	1.60	0.51	0.80
Payout ratio (%)									47.3%	49.3%	51.3%	53.3%

Source: Company data, Goldman Sachs Research estimates.

Reg AC

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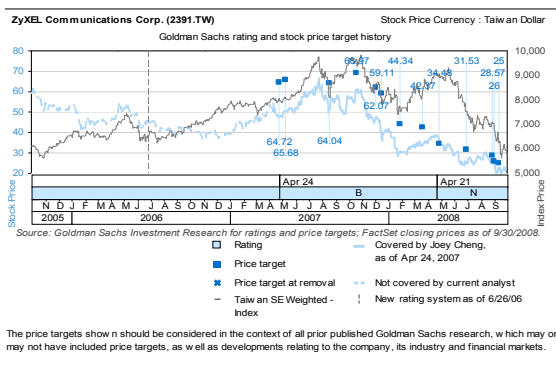
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Price target and rating history chart(s)



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