

# Not immune to global slowdown this time



## Downgrading to Underperform with PO of NT\$61.6

We downgrade Hon Hai from Neutral to Underperform and lower our PO to NT\$61.6 (8x 2009E) from NT\$92.5. We reduce 2009E EPS by 17% to NT\$7.7 (-10% YoY) due to our PC forecast reductions, particularly for DT PCs, and more conservative outlook from key customers (ie, Cisco). We've been cautious on Hon Hai since early 2008 given its multiple challenges.

## Very muted growth for 4Q08

We now expect parent-only sales to grow only 8% QoQ to NT\$467bn for 4Q08 (vs. an average of 25% historically) due to the sharp slowdown across major IT sectors (ie, DT PCs, handsets, networking, iPhone and PS3) from early 4Q and a high base in 3Q (up 38% QoQ). We think November revenue will likely decline MoM (up in both 2006 and 2007).

## Flat revenue with earnings decline again for 2009

We now expect 2009 revenue to grow only 2% YoY (down from 15% previously) due to our caution on global DT PCs (revenue down 20% YoY) and its key customers (ie, Dell, Cisco, Motorola, SEMC and Sony), despite its further share gains. With larger margin pressure on slower end demand, we expect earnings to decline another 10% YoY for 2009 (-19% for 2008E) with OPM of 3.7% (flat YoY).

## Prefer names in the NB PC sector than Hon Hai

The benefits Hon Hai will gain from consolidation and a gradual improvement in cost structure will be largely offset by the bleak industry outlook, in our view – we estimate it generates over 80% of revenue from sectors with negative growth in 2009E. We prefer names in the NB PC chain given higher industry growth, better transparency, solid earnings delivery in 1H08, and compelling P/E (5-7x).

### Estimates (Dec)

(NT\$)	2006A	2007A	2008E	2009E	2010E
Net Income (mn) Taiwan GAAP	59,863	77,690	63,231	57,140	63,039
EPS (Pre Bonus)	8.074	10.478	9.269	8.377	9.241
EPS (Post Bonus)	5.621	5.056	8.528	7.706	8.502
EPS Change (YoY)	27.8%	-10.0%	68.7%	-9.6%	10.3%
Dividend / Share	2.09	2.55	2.10	2.50	3.00
Free Cash Flow / Share	2.36	1.99	(0.675)	(0.322)	(1.34)

\* Taiwan GAAP changed from Pre Bonus to Post Bonus earnings from 2008.

### Valuation (Dec)

	2006A	2007A	2008E	2009E	2010E
P/E (Post Bonus)	10.67x	11.87x	7.04x	7.79x	7.06x
Dividend Yield	3.49%	4.24%	3.50%	4.17%	5.00%
Free Cash Flow Yield*	3.93%	3.32%	-1.13%	-0.536%	-2.23%

\* For full definitions of *iQmethod*<sup>SM</sup> measures, see page 9.

Tony Tseng, CFA >> +886 2 2376 3727

Research Analyst  
Merrill Lynch (Taiwan)  
tony\_tseng@ml.com

Daniel Kim, CFA >> +852 2536 3443

Research Analyst  
Merrill Lynch (Hong Kong)  
daniel\_kim@ml.com

### Stock Data

Price	NT\$60.00
Price Objective	NT\$92.50 to NT\$61.60
Date Established	17-Nov-2008
Investment Opinion	C-2-7 to C-3-7
Volatility Risk	HIGH
52-Week Range	NT\$60.00-NT\$186.09
Mrkt Val / Shares Out (mn)	US\$13,410 / 7,414.6
Average Daily Volume	39,665,150
ML Symbol / Exchange	HNHAF / TWO
Bloomberg / Reuters	2317 TT / 2317.TW
ROE (2008E)	15.7%
Net Dbt to Eqty (Dec-2007A)	-3.2%
Est. 5-Yr EPS / DPS Growth	5.0% / 10.0%
Free Float	63.0%



No part of this report may be used or reproduced or quoted in any manner whatsoever in Taiwan by the press or other persons.

>> Employed by a non-US affiliate of MLPF&S and is not registered/qualified as a research analyst under the NYSE/NASD rules.

Refer to "Other Important Disclosures" for information on certain Merrill Lynch entities that take responsibility for this report in particular jurisdictions.

Merrill Lynch does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that the firm may have a conflict of interest that could affect the objectivity of this report. Investors should consider this report as only a single factor in making their investment decision.

Refer to important disclosures on page 10 to 11. Analyst Certification on Page 7. Price Objective Basis/Risk on page 7.

# iQprofile<sup>SM</sup> Hon Hai Precision Industry

## Key Income Statement Data (Dec)

(NT\$ Millions)	2006A	2007A	2008E	2009E	2010E
Sales	1,320,375	1,702,663	1,928,061	1,968,048	2,225,935
Gross Profit	128,945	167,523	160,051	157,125	171,163
Sell General & Admin Expense	(53,581)	(74,059)	(88,951)	(85,135)	(90,596)
Operating Profit	75,364	93,464	71,100	71,990	80,567
Net Interest & Other Income	5,797	7,674	12,474	1,900	1,950
Associates	NA	NA	NA	NA	NA
Pretax Income	81,161	101,138	83,573	73,890	82,517
Tax (expense) / Benefit	(14,884)	(16,449)	(16,715)	(13,300)	(15,678)
Net Income (Adjusted)	59,863	77,690	63,231	57,140	63,039
Average Fully Diluted Shares Outstanding	7,415	7,415	7,415	7,415	7,415

## Key Cash Flow Statement Data

Net Income (Reported)	59,863	77,690	63,231	57,140	63,039
Depreciation & Amortization	17,624	26,168	37,238	48,900	61,235
Change in Working Capital	(37,424)	(3,716)	(2,610)	13,231	698
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	30,539	2,278	(12,865)	(26,655)	(34,908)
Cash Flow from Operations	70,602	102,420	84,994	92,616	90,064
Capital Expenditure	(53,133)	(87,633)	(90,000)	(95,000)	(100,000)
(Acquisition) / Disposal of Investments	(2,246)	(3,760)	(2,066)	(3,168)	(2,616)
Other Cash Inflow / (Outflow)	(4,280)	(6,595)	(8,733)	(9,538)	(11,196)
Cash Flow from Investing	(59,659)	(97,988)	(100,799)	(107,705)	(113,812)
Shares Issue / (Repurchase)	0	0	0	0	0
Cost of Dividends Paid	(14,257)	(16,859)	(26,267)	(37,956)	(48,869)
Cash Flow from Financing	26,664	98,936	2,900	(17,280)	(24,508)
Free Cash Flow	17,469	14,787	(5,006)	(2,384)	(9,936)
Net Debt	(20,988)	(12,339)	33,580	96,898	176,856
Change in Net Debt	(9,856)	(41,205)	37,822	63,814	72,617

## Key Balance Sheet Data

Property, Plant & Equipment	132,537	202,570	288,266	378,541	474,026
Other Non-Current Assets	48,997	84,838	88,862	94,029	98,845
Trade Receivables	227,137	273,429	296,080	291,103	321,038
Cash & Equivalents	90,243	145,776	129,023	86,382	30,785
Other Current Assets	127,689	160,685	181,505	180,894	199,315
Total Assets	626,603	867,298	983,735	1,030,948	1,124,008
Long-Term Debt	28,461	28,792	32,603	33,280	37,641
Other Non-Current Liabilities	8,808	11,094	11,094	11,094	11,094
Short-Term Debt	40,794	104,645	130,000	150,000	170,000
Other Current Liabilities	263,124	339,260	388,465	394,820	448,249
Total Liabilities	341,187	483,791	562,163	589,194	666,983
Total Equity	285,416	383,505	421,573	441,754	457,024
Total Equity & Liabilities	626,603	867,296	983,735	1,030,948	1,124,008

## iQmethod<sup>SM</sup> - Bus Performance\*

Return On Capital Employed	20.7%	18.1%	10.7%	10.0%	10.3%
Return On Equity	24.9%	23.2%	15.7%	13.2%	14.0%
Operating Margin	5.7%	5.5%	3.7%	3.7%	3.6%
EBITDA Margin	7.0%	7.0%	5.6%	6.1%	6.4%

## iQmethod<sup>SM</sup> - Quality of Earnings\*

Cash Realization Ratio	1.2x	1.3x	1.3x	1.6x	1.4x
Asset Replacement Ratio	3.0x	3.3x	2.4x	1.9x	1.6x
Tax Rate (Reported)	18.3%	16.3%	20.0%	18.0%	19.0%
Net Debt-to-Equity Ratio	-7.4%	-3.2%	8.0%	21.9%	38.7%
Interest Cover	29.0x	17.3x	10.3x	12.4x	12.6x

## Key Metrics

Stock comp. adjusted ROIC	18.3%	11.1%	10.4%	9.5%	9.8%
Stock comp. adjusted ROE	17.31%	11.21%	14.45%	12.18%	12.91%
Stock comp. adjusted EPS	5.62	5.06	8.53	7.71	8.50
Stock comp. adjusted P/E	10.67x	11.87x	7.04x	7.79x	7.06x

\* For full definitions of iQmethod<sup>SM</sup> measures, see page 9.

## Company Description

Hon Hai Precision has emerged as the largest EMS provider in the world with a focus on PCs, handsets (via FIH), networking and consumer. Key customers include HP, Dell, Apple, Intel, Motorola, Nokia, Cisco and Sony. Hon Hai started with the manufacturing of connectors (mainly for PCs) and has expanded into PCBA/barebone and system assembly with facilities in China, Eastern Europe and Mexico.

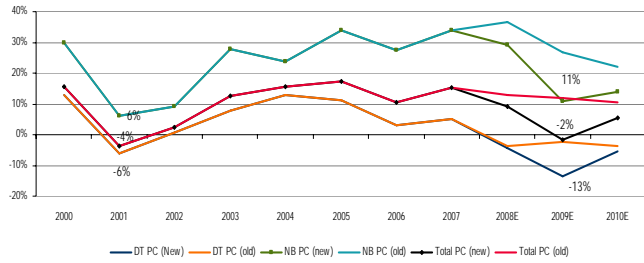
## Investment Thesis

We anticipate soft revenue growth for Hon Hai given its exposure to lackluster sectors (DT PCs and handsets), limited share gains at key customers and slower penetration into fast-growing segments (NB PCs and LCD TVs). In addition, its margin is under pressure due to the product mix change, increase in labor cost/currency and lower utilization rates at new sites. Soft earnings growth coupled with limited disclosure of its succession plan should prolong its de-rating/underperformance.

## Stock Data

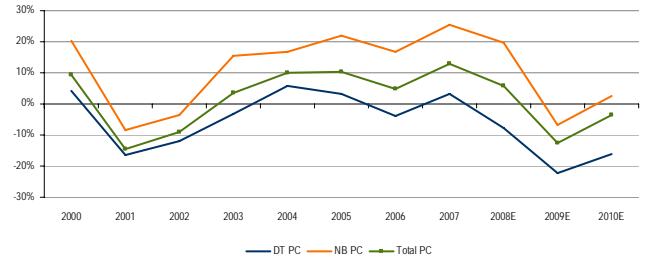
Price to Book Value 1.1x

Chart 1: YoY unit growth for global PC shipments



Source: IDC, Merrill Lynch estimates

Chart 2: YoY revenue growth for global PC shipments



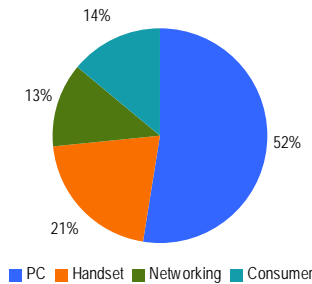
Source: IDC, Merrill Lynch estimates

Table 1: Hon Hai - adjusting estimates for 2008/09 (consolidated)

NT\$m	New		Diff.		YoY		Old	
	2008E	2009E	2008E	2009E	2008E	2009E	2008E	2009E
Sales	1,928,061	1,968,048	-1%	-12%	13%	2%	1,949,503	2,240,982
Gross profit	160,051	157,125	-2%	-14%	-4%	-2%	163,091	183,328
Operating expense	(88,951)	(85,135)	-2%	-11%	20%	-4%	(90,675)	(95,673)
Operating profit	71,100	71,990	-2%	-18%	-24%	1%	72,416	87,655
Non-ope Inc.	12,474	1,900	25%	3%	63%	-85%	9,959	1,850
Pre-tax income	83,574	73,890	1%	-17%	-17%	-12%	82,374	89,505
Tax expense	(16,715)	(13,300)	1%	-17%	2%	-20%	(16,475)	(16,111)
Minority interest	(3,628)	(3,450)	0%	-28%	-48%	-5%	(3,628)	(4,800)
Net income	63,231	57,140	2%	-17%	-19%	-10%	62,271	68,594
EPS	8.53	7.71					8.40	9.25
Gross Margin	8.3%	8.0%					8.4%	8.2%
Operating expense	-4.6%	-4.3%					-4.7%	-4.3%
Operating margin	3.7%	3.7%					3.7%	3.9%
Pre-tax margin	4.3%	3.8%					4.2%	4.0%
Net margin	3.3%	2.9%					3.2%	3.1%
Tax rate	-20.0%	-18.0%					-20.0%	-18.0%

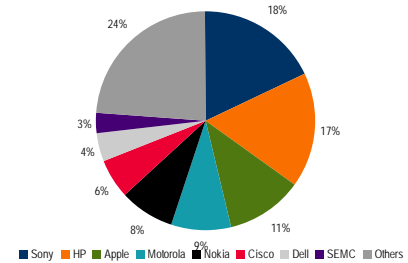
Source: Merrill Lynch estimates

Chart 3: Hon Hai - Product breakdown for 2007 (cons.)



Source: Hon Hai, Merrill Lynch estimates

Chart 4: Hon Hai - Customer breakdown for 2007 (cons.)

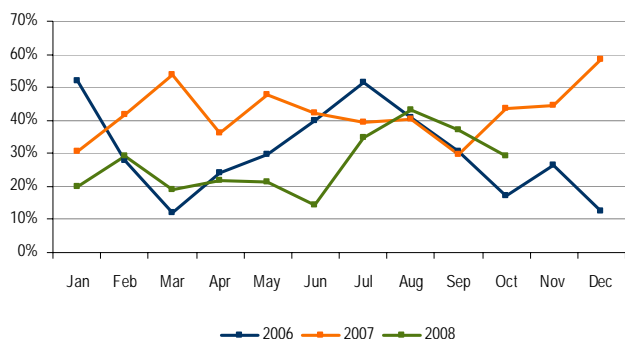


Source: Hon Hai, Merrill Lynch estimates

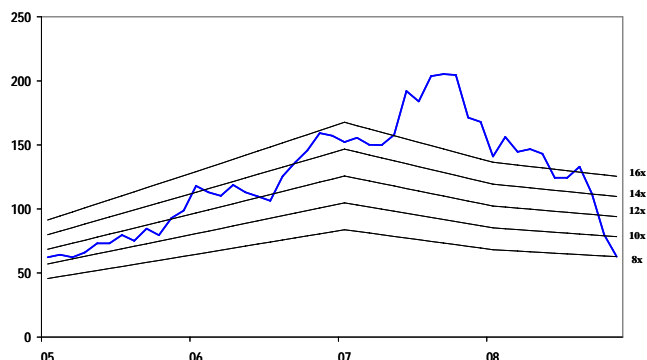
**Table 2: Hon Hai - Better 3Q08 results (parent-only)**

NT\$m	3Q08	3Q08E	Diff.	2Q08	QoQ	1Q08	QoQ	1-3Q08
Sales	431,214	431,280	0%	313,579	38%	301,803	4%	1,046,596
Gross profit	18,530	19,408	-5%	11,679	59%	14,562	-20%	44,771
Operating profit	8,560	9,919	-14%	6,329	35%	7,253	-13%	22,142
Non-ope Inc.	11,168	8,502	31%	9,374	19%	11,157	-16%	31,699
Investment Inc.	12,581	8,500	48%	10,326	22%	11,479	-10%	34,386
Others	(1,413)	2		(952)	48%	(322)	196%	(2,687)
Pre-tax income	19,728	18,422	7%	15,703	26%	18,410	-15%	53,841
Net income	17,820	14,822	20%	11,934	49%	16,074	-26%	45,828
EPS	2.40	2.00		1.61		2.17		6.18
Gross Margin	4.3%	4.5%		3.7%		4.8%		4.3%
Operating expense	-2.3%	-2.2%		-1.7%		-2.4%		-2.2%
Operating margin	2.0%	2.3%		2.0%		2.4%		2.1%
Pre-tax margin	4.6%	4.3%		5.0%		6.1%		5.1%
Net margin	4.1%	3.4%		3.8%		5.3%		4.4%
Tax rate	-9.7%	-19.5%		-24.0%		-12.7%		-14.9%

Source: Hon Hai, Merrill Lynch estimates

**Chart 5: Hon Hai- YoY growth for parent sales**


Source: Hon Hai

**Chart 6: Hon Hai - Forward Taiwan GAAP PE**


Source: Merrill Lynch estimates

**Table 3: Valuation comparison table**

	ML Symbol	ML Rating	Price 13-Nov-08	Mkt Cap (US\$m)	EPS (Local)		EPG		PER(x)		ROE (%)		Cash Yield	Price YTD
					2008E	2009E	2008E	2009E	2008E	2009E	2008E	2009E		
Hon Hai	HNHAF	C-3-7 Underpe	62.8	15,019	8.53	7.71	-19%	-10%	7.4	8.1	16%	13%	3%	-63%
FTC	FXTCF	C-2-8 Neutral	73.2	2,000	8.50	8.00	-22%	-6%	8.6	9.2	14%	12%	3%	-68%
Catcher	CHERF	C-3-8 Underpe	62.8	1,215	7.82	7.60	-35%	-3%	8.0	8.3	17%	15%	4%	-61%
Innolux	INXDF	C-3-8 Underpe	20.3	2,018	1.9	0.52	-68%	-72%	10.9	39.3	6%	2%	2%	-79%
Asustek	AKCPF	C-3-7 Underpe	39.5	5,403	5.78	4.40	-19%	-24%	6.8	9.0	13%	9%	6%	-59%
Quanta	QUCPF	C-3-7 Underpe	37.3	4,391	5.00	4.50	-1%	-10%	7.5	8.3	19%	16%	10%	-9%
FIH	FXCNF	C-3-9 Underpe	2.4	2,229	0.37	0.33	-52%	-10%	6.4	7.2	10%	8%	0%	-86%
Lenovo	LNVGF	C-2-7 Neutral	5.5	6,314	0.22	0.27	-42%	23%	25.2	20.4	17%	19%	0%	-21%
Flextronics	FLEX	C-1-9 Buy	3.1	2,590	0.94	0.95	25%	1%	3.3	3.3	10%	9%	0%	-74%
Dell	DELL	C-1-9 Buy	10.5	22,433	1.37	1.45	20%	6%	7.7	7.2	74%	79%	0%	-57%
HPQ	HPQ	B-1-7 Buy	31.1	82,677	3.62	4.30	24%	19%	8.6	7.2	29%	36%	1%	-38%
APPLE	AAPL	C-1-9 Buy	90.1	80,571	5.40	7.28	1%	35%	16.7	12.4	22%	25%	0%	-55%
Nokia	NOK	B-2-7 Neutral	12.7	47,019	1.93	1.64	-5%	-15%	6.6	7.8	36%	31%	6%	-67%
Motorola	MOT	C-2-7 Neutral	4.0	8,965	0.07	0.27	-71%	286%	56.4	14.6	1%	4%	5%	-75%
Cisco	CSCO	B-1-9 Buy	16.6	97,339	1.39	1.25	16%	-10%	11.9	13.2	26%	20%	0%	-39%

Source: Merrill Lynch estimates, BBG

17 November 2008

**Table 4: Hon Hai - Quarterly Consolidated Income Statement (bonus-adjusted from 1Q08)**

NT\$m	1Q08A	2Q08A	3Q08E	4Q08E	1Q09E	2Q09E	3Q09E	4Q09E	2007	2008E	2009E	2010E
Sales	415,196	395,837	534,855	582,174	431,857	439,728	508,223	588,240	1,702,663	1,928,061	1,968,048	2,225,935
Cost of Sales	(377,396)	(363,109)	(492,041)	(535,464)	(396,446)	(404,545)	(468,065)	(541,867)	(1,535,140)	(1,768,010)	(1,810,922)	(2,054,772)
Gross Profit	37,800	32,728	42,814	46,709	35,412	35,183	40,158	46,372	167,523	160,051	157,125	171,163
Operating Expense	(19,479)	(19,129)	(23,855)	(26,489)	(19,088)	(19,260)	(21,904)	(24,883)	(74,059)	(88,951)	(85,135)	(90,596)
Promotion	(6,269)	(4,433)	(6,204)	(7,277)	(5,485)	(5,497)	(6,251)	(7,059)	(25,174)	(24,183)	(24,291)	(26,489)
ADM	(8,569)	(9,251)	(10,965)	(11,643)	(8,421)	(8,487)	(9,656)	(11,000)	(33,544)	(40,428)	(37,564)	(39,176)
R&D	(4,641)	(5,445)	(6,686)	(7,568)	(5,182)	(5,277)	(5,997)	(6,824)	(15,341)	(24,340)	(23,280)	(24,930)
Operating Profit	18,321	13,599	18,959	20,220	16,324	15,923	18,254	21,490	93,464	71,100	71,990	80,567
Non-Operating Income	3,315	4,264	3,246	1,648	(20)	700	(100)	1,320	7,674	12,474	1,900	1,950
Net Interest Income	(981)	(613)	(819)	(800)	(750)	(750)	(750)	(750)	(2,753)	(3,213)	(3,000)	(3,400)
Investment Income		658		1,300		750		1,250	3,856	1,958	2,000	2,200
Disposal Gain		100	200	200	150	150	100	100	566	500	500	500
Exchange Gain	4,237	3,717	2,815						6,520	10,769	-	-
Others	59	403	1,050	948	580	550	550	720	(515)	2,460	2,400	2,650
Pre-tax Profit	21,636	17,863	22,205	21,868	16,304	16,623	18,154	22,810	101,138	83,574	73,890	82,517
Tax Expense	(4,711)	(5,202)	(3,435)	(3,367)	(2,935)	(2,992)	(3,268)	(4,106)	(16,449)	(16,715)	(13,300)	(15,678)
Minority Interest	(851)	(727)	(950)	(1,100)	(750)	(700)	(900)	(1,100)	(6,999)	(3,628)	(3,450)	(3,800)
Net Profit	16,074	11,934	17,820	17,401	12,619	12,931	13,986	17,604	77,690	63,231	57,140	63,039
EPS	2.17	1.61	2.40	2.35	1.70	1.74	1.89	2.37	10.48	8.53	7.71	8.50
									-	-	-	-
Gross Margin	9.1%	8.3%	8.0%	8.0%	8.2%	8.0%	7.9%	7.9%	9.8%	8.3%	8.0%	7.7%
Operating Expense	-4.7%	-4.8%	-4.5%	-4.6%	-4.4%	-4.4%	-4.3%	-4.2%	-4.3%	-4.6%	-4.3%	-4.1%
Operating Margin	4.4%	3.4%	3.5%	3.5%	3.8%	3.6%	3.6%	3.7%	5.5%	3.7%	3.7%	3.6%
Pre-tax Margin	5.2%	4.5%	4.2%	3.8%	3.8%	3.8%	3.6%	3.9%	5.9%	4.3%	3.8%	3.7%
Net Margin	3.9%	3.0%	3.3%	3.0%	2.9%	2.9%	2.8%	3.0%	4.6%	3.3%	2.9%	2.8%
Tax Rate	-21.8%	-29.1%	-15.5%	-15.4%	-18.0%	-18.0%	-18.0%	-18.0%	-16.3%	-20.0%	-18.0%	-19.0%
Sequential Growth												
Sales	-25%	-5%	35%	9%	-26%	2%	16%	16%	29%	13%	2%	13%
Cost of Sales	-25%	-4%	36%	9%	-26%	2%	16%	16%	29%	15%	2%	13%
Gross Profit	-30%	-13%	31%	9%	-24%	-1%	14%	15%	30%	-4%	-2%	9%
Operating Expense	-21%	-2%	25%	11%	-28%	1%	14%	14%	38%	20%	-4%	6%
Operating Profit	-39%	-26%	39%	7%	-19%	-2%	15%	18%	24%	-24%	1%	12%
Non-operating Income	-16%	29%	-24%	-49%	-101%	-3600%	-114%	-1420%	32%	63%	-85%	3%
Pre-Tax Profit	-36%	-17%	24%	-2%	-25%	2%	9%	26%	25%	-17%	-12%	12%
Tax Expense	-5%	10%	-34%	-2%	-13%	2%	9%	26%	11%	2%	-20%	18%
Net Profit	-39%	-26%	49%	-2%	-27%	2%	8%	26%	30%	-19%	-10%	10%

Source: Merrill Lynch estimates

17 November 2008

**Table 5: Hon Hai - Quarterly Parent Income Statement (bonus-adjusted from 1Q08)**

NT\$m	1Q08A	2Q08A	3Q08E	4Q08E	1Q09E	2Q09E	3Q09E	4Q09E	2007A	2008E	2009E	2010E
Sales	301,803	313,579	431,214	467,320	342,310	350,815	407,645	473,740	1,235,527	1,513,916	1,574,510	1,737,947
Cost of Sales	(287,241)	(301,900)	(412,684)	(446,758)	(326,906)	(335,028)	(390,116)	(454,317)	(1,176,963)	(1,448,583)	(1,506,367)	(1,663,215)
Gross Profit	14,562	11,679	18,530	20,562	15,404	15,787	17,529	19,423	58,564	65,333	68,143	74,732
Operating Expense	(7,309)	(5,350)	(9,970)	(9,346)	(7,531)	(7,718)	(8,153)	(9,001)	(23,075)	(31,975)	(32,403)	(33,021)
Promotion	(3,738)	(2,648)	(6,472)	-	-	-	-	-	(13,570)	-	-	-
ADM	(1,226)	(927)	(1,267)	-	-	-	-	-	(3,559)	-	-	-
R&D	(2,346)	(1,775)	(2,231)	-	-	-	-	-	(6,424)	-	-	-
Operating Profit	7,253	6,329	8,560	11,216	7,873	8,069	9,376	10,422	35,489	33,358	35,740	41,711
Non-Operating Income	11,157	9,374	11,168	10,486	8,646	8,962	9,510	12,682	54,054	42,185	39,800	43,328
Net Interest Income	(443)	(507)	(533)	(400)	(400)	(400)	(400)	(400)	(2,330)	(1,883)	(1,600)	(1,400)
Investment Income	11,479	10,326	12,581	11,000	8,600	9,000	9,800	12,500	55,974	45,386	39,900	43,200
Disposal Gain	17	(17)	-	200	200	200	200	200	299	200	800	600
Exchange Gain	-	(251)	(491)	-	-	-	-	-	374	(742)	-	-
Others	104	(177)	(389)	(314)	246	162	(90)	382	(263)	(776)	700	928
Pre-tax Profit	18,410	15,703	19,728	21,701	16,519	17,031	18,886	23,104	89,543	75,542	75,540	85,039
Tax Expense	(2,336)	(3,768)	(1,908)	(4,300)	(3,900)	(4,100)	(4,900)	(5,500)	(11,854)	(12,312)	(18,400)	(22,000)
Net Profit	16,074	11,934	17,820	17,401	12,619	12,931	13,986	17,604	77,689	63,229	57,140	63,039
<b>EPS</b>	<b>2.17</b>	<b>1.61</b>	<b>2.40</b>	<b>2.35</b>	<b>1.70</b>	<b>1.74</b>	<b>1.89</b>	<b>2.37</b>	<b>10.48</b>	<b>8.53</b>	<b>7.71</b>	<b>8.50</b>
Gross Margin	4.8%	3.7%	4.3%	4.4%	4.5%	4.5%	4.3%	4.1%	4.7%	4.3%	4.3%	4.3%
Operating Expense	-2.4%	-1.7%	-2.3%	-2.0%	-2.2%	-2.2%	-2.0%	-1.9%	-1.9%	-2.1%	-2.1%	-1.9%
Operating Margin	2.4%	2.0%	2.0%	2.4%	2.3%	2.3%	2.3%	2.2%	2.9%	2.2%	2.3%	2.4%
Pre-tax Margin	6.1%	5.0%	4.6%	4.6%	4.8%	4.9%	4.6%	4.9%	7.2%	5.0%	4.8%	4.9%
Net Margin	5.3%	3.8%	4.1%	3.7%	3.7%	3.7%	3.4%	3.7%	6.3%	4.2%	3.6%	3.6%
Tax Rate	-12.7%	-24.0%	-9.7%	-19.8%	-23.6%	-24.1%	-25.9%	-23.8%	-13.2%	-16.3%	-24.4%	-25.9%
Sequential Growth												
Sales	-27%	4%	38%	8%	-27%	2%	16%	16%	36%	23%	4%	10%
Cost of Sales	-28%	5%	37%	8%	-27%	2%	16%	16%	37%	23%	4%	10%
Gross Profit	-18%	-20%	59%	11%	-25%	2%	11%	11%	18%	12%	4%	10%
Operating Expense	-2%	-27%	86%	-6%	-19%	2%	6%	10%	14%	39%	1%	2%
Operating Profit	-30%	-13%	35%	31%	-30%	2%	16%	11%	21%	-6%	7%	17%
Non-operating Income	-43%	-16%	19%	-6%	-18%	4%	6%	33%	31%	-22%	-6%	9%
Pre-Tax Profit	-39%	-15%	26%	10%	-24%	3%	11%	22%	27%	-16%	0%	13%
Tax Expense	-33%	61%	-49%	125%	-9%	5%	20%	12%	10%	4%	49%	20%
Net Profit	-39%	-26%	49%	-2%	-27%	2%	8%	26%	30%	-19%	-10%	10%

Source: Merrill Lynch estimates

## Price objective basis & risk

### Hon Hai Prec. (HNHAF)

Our PO of NT\$61.6 is based on 8x EPS for 2009E, at the low end of its P/E band for 2001-08, due to its decelerating earnings growth from 2008E. However, the P/E of 8x is finally comparable with P/E of 7-8x for NB PC ODMs in Taiwan, some of which have better earnings growth than Hon Hai. Downside risks: further slowdown in end-markets such as DT PCs and handsets, slower share gains at key customers, and more margin pressure. Upside risks: stronger demand for customers' new products (ie, iPhone) and faster share gains in fast-growth products, such as LCD TVs and NB PCs.

## Analyst Certification

I, Tony Tseng, CFA, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

## Special Disclosures

Foreign investment in Taiwan securities is regulated and restricted. Currently, foreign investment in Taiwan securities is permitted by investment through: (1) global depository receipts, (2) convertible bonds, (3) mutual funds issued offshore of Taiwan, and (4) a special foreign institutional investors (FINIs) and foreign individual investors (FIDIs) program supervised by the Taiwan SFB whereunder FINIs/FIDIs may apply for investment ID to invest in Taiwan securities by registration with Taiwan Stock Exchange. FINIs will additionally need consent from the foreign exchange authority, ie, the Central Bank of China. In addition to the limitations above, various industry-specific percentage-based limitations on foreign ownership of Taiwan companies (and in some cases prohibitions) may apply. Investments are subject to exchange rate and currency conversion restrictions and risks. Dividends and interest earned by foreign investors' Taiwan securities/instruments are generally subject to a 20% withholding tax. Ordinary shares are not available to ML private client accounts in the U.S.

This report is distributed in the Republic of China by Merrill Lynch, Pierce, Fenner & Smith Inc., Taiwan Branch, which is regulated by the US SEC and the SFB of the Republic of China.

Research provided by Merrill Lynch Global (Taiwan) Limited, a registered SICE, for distribution in Taiwan is provided under contract to Merrill Lynch, Pierce, Fenner & Smith Inc., Taiwan Branch.

17 November 2008

**APR - Technology Hardware Coverage Cluster**

Investment rating	Company	ML ticker	Bloomberg symbol	Analyst
<b>BUY</b>				
	Acer, Inc	ASIYF	2353 TT	Tony Tseng, CFA
	BYD	BYDDF	1211 HK	Daniel Kim, CFA
	Cheil Industries	CLFUF	001300 KS	Simon Dong-je Woo, CFA
	Compal Electron	CMPLF	2324 TT	Tina Chang, CFA
	Coretronic	CCOCF	5371 TT	Jeffrey Su
	Delta Elect	DLTEF	2308 TT	Jeffrey Su
	Ju Teng Intl	JUTGF	3336 HK	Ronnie Ho
	Largan Precision	LGANF	3008 TT	Laura Chen
	LG Electronics	LGEAF	066570 KS	Daniel Kim, CFA
	Samsung Techwin	SGTWF	012450 KS	Simon Dong-je Woo, CFA
	Simplo Tech	SPLOF	6121 TT	Tina Chang, CFA
	SSCP CO LTD	SSCPF	071660 KS	Daniel Kim, CFA
	TPV	TPVTF	903 HK	Daniel Kim, CFA
	Venture Corp.	VEMLF	VMS SP	Ronnie Ho
<b>NEUTRAL</b>				
	Alpha Networks I	AHNWF	3380 TT	Laura Chen
	AU Optronics	AUO	AUO US	Jeffrey Su
	AU Optronics	AUOPF	2409 TT	Jeffrey Su
	Foxconn Tech	FXTCF	2354 TT	Tony Tseng, CFA
	Kingboard	KBDCF	148 HK	Ronnie Ho
	Lenovo Group	LNVGF	992 HK	Daniel Kim, CFA
	Lenovo Group	LNVGY	LNVGY US	Daniel Kim, CFA
	Lite-On Tech	LOTZF	2301 TT	Jeffrey Su
	Merry Electron	MMECF	2439 TT	Laura Chen
	Qisda Corp	BNQCF	2352 TT	Jeffrey Su
	Shin Zu Shing	SZUSF	3376 TT	Tina Chang, CFA
	Sillitech	SLKCF	3311 TT	Laura Chen
	Wistron	WICOF	3231 TT	Tony Tseng, CFA
	Yageo Corp	YGEQF	2327 TT	Ronnie Ho
<b>UNDERPERFORM</b>				
	Asustek	AKCPF	2357 TT	Tony Tseng, CFA
	Catcher Tech	CHERF	2474 TT	Tony Tseng, CFA
	Chi Mei Opto	CMEOF	3009 TT	Jeffrey Su
	Chicony Elect	CCNYF	2385 TT	Tina Chang, CFA
	Compal Comm	CPCMF	8078 TT	Laura Chen
	Epistar Corp	EPIPF	2448 TT	Jeffrey Su
	Everlight Elec	EVLEF	2393 TT	Jeffrey Su
	Foxconn Intl Hld	FXCNF	2038 HK	Tony Tseng, CFA
	Gemtek Technolog	GTKTF	4906 TT	Laura Chen
	Hon Hai Prec.	HNHAF	2317 TT	Tony Tseng, CFA
	HTC Corp.	HTCCF	2498 TT	Tony Tseng, CFA
	InnoLux	INXDF	3481 TT	Jeffrey Su
	Inventec	IVCJF	2356 TT	Tina Chang, CFA
	Inventec Applan	IVAPF	3367 TT	Tina Chang, CFA
	LG Display Co., Ltd.	LPHLF	034220 KS	Daniel Kim, CFA
	LG Display Co., Ltd.-A	LPL	LPL US	Daniel Kim, CFA
	Mitac Intl	MTCXF	2315 TT	Tina Chang, CFA
	Quanta Computer	QUCPF	2382 TT	Tony Tseng, CFA
	Radiant	ROPTF	6176 TT	Jeffrey Su
	Samsung Elec M	SSEMF	009150 KS	Daniel Kim, CFA
	Samsung SDI	SSDIF	006400 KS	Daniel Kim, CFA
	Seoul Semicon	SLSOF	046890 KS	Simon Dong-je Woo, CFA
	Wellypower	XTTWF	3080 TT	Jeffrey Su
	ZTE Corp - H	ZTCOF	763 HK	Ronnie Ho

**iQmethod<sup>SM</sup> Measures Definitions**

<b>Business Performance</b>	<b>Numerator</b>	<b>Denominator</b>
Return On Capital Employed	$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) * (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
<b>Quality of Earnings</b>		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
<b>Valuation Toolkit</b>		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	$\text{EV} = \text{Current Share Price} * \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} + \text{Sales} + \text{Other LT Liabilities}$	
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

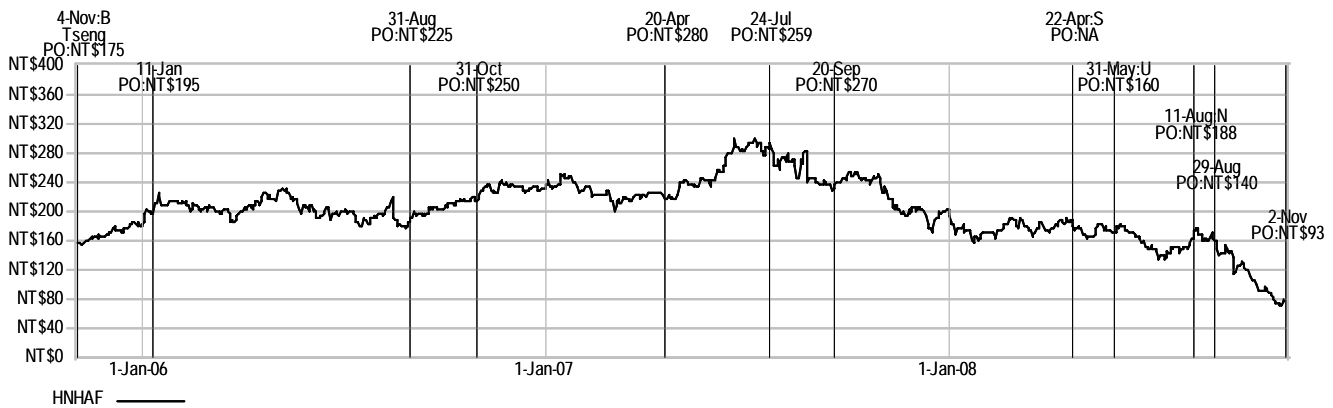
*iQmethod<sup>SM</sup>* is the set of Merrill Lynch standard measures that serve to maintain global consistency under three broad headings: Business Performance, Quality of Earnings, and validations. The key features of *iQmethod* are: A consistently structured, detailed, and transparent methodology. Guidelines to maximize the effectiveness of the comparative valuation process, and to identify some common pitfalls.

*iQdatabase<sup>®</sup>* is our real-time global research database that is sourced directly from our equity analysts' earnings models and includes forecasted as well as historical data for income statements, balance sheets, and cash flow statements for companies covered by Merrill Lynch.

*iQprofile<sup>SM</sup>*, *iQmethod<sup>SM</sup>* are service marks of Merrill Lynch & Co., Inc. *iQdatabase<sup>®</sup>* is a registered service mark of Merrill Lynch & Co., Inc.

## Important Disclosures

### HNHAF 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.

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

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	42	40.00%	Buy	8	20.51%
Neutral	32	30.48%	Neutral	3	11.11%
Sell	31	29.52%	Sell	2	7.41%

### 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%

\* Companies in respect of which MLPF&S or an affiliate has received compensation for investment banking services within the past 12 months. For purposes of this distribution, a stock rated Underperform is included as a Sell.

**FUNDAMENTAL EQUITY OPINION KEY:** Opinions include a Volatility Risk Rating, an Investment Rating and an Income Rating. **VOLATILITY RISK RATINGS**, indicators of potential price fluctuation, are: A - Low, B - Medium and C - High. **INVESTMENT RATINGS** reflect the analyst's assessment of a stock's: (i) absolute total return potential and (ii) attractiveness for investment relative to other stocks within its *Coverage Cluster* (defined below). There are three investment ratings: 1 - Buy stocks are expected to have a total return of at least 10% and are the most attractive stocks in the coverage cluster; 2 - Neutral stocks are expected to remain flat or increase in value and are less attractive than Buy rated stocks and 3 - Underperform stocks are the least attractive stocks in a coverage cluster. Analysts assign investment ratings considering, among other things, the 0-12 month total return expectation for a stock and the firm's guidelines for ratings dispersions (shown in the table below). The current price objective for a stock should be referenced to better understand the total return expectation at any given time. The price objective reflects the analyst's view of the potential price appreciation (depreciation).

Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster*
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

\* Ratings dispersions may vary from time to time where Merrill Lynch Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

**INCOME RATINGS**, indicators of potential cash dividends, are: 7 - same/higher (dividend considered to be secure), 8 - same/lower (dividend not considered to be secure) and 9 - pays no cash dividend. *Coverage Cluster* is comprised of stocks covered by a single analyst or two or more analysts sharing a common industry, sector, region or other classification(s). A stock's coverage cluster is included in the most recent Merrill Lynch Comment referencing the stock.

In the US, retail sales and/or distribution of this report may be made only in states where these securities are exempt from registration or have been qualified for sale: Hon Hai Prec.

MLPF&S together with its affiliates beneficially owns one percent or more of the common stock of this company. If this report was issued on or after the 10th day of the month, it reflects the ownership position on the last day of the previous month. Reports issued before the 10th day of a month reflect the ownership position at the end of the second month preceding the date of the report: Hon Hai Prec.

The country in which this company is organized has certain laws or regulations that limit or restrict ownership of the company's shares by nationals of other countries: Hon Hai Prec.

The analyst(s) responsible for covering the securities in this report receive compensation based upon, among other factors, the overall profitability of Merrill Lynch, including profits derived from investment banking revenues.

## Other Important Disclosures

UK readers: MLPF&S or an affiliate is a liquidity provider for the securities discussed in this report.

---

### Information relating to Non-U.S. affiliates of Merrill Lynch, Pierce, Fenner & Smith Incorporated (MLPF&S):

MLPF&S distributes research reports of the following non-US affiliates in the US (short name: legal name): Merrill Lynch (France): Merrill Lynch Capital Markets (France) SAS; Merrill Lynch (Frankfurt): Merrill Lynch International Bank Ltd, Frankfurt Branch; Merrill Lynch (South Africa): Merrill Lynch South Africa (Pty) Ltd; Merrill Lynch (Milan): Merrill Lynch International Bank Limited; MLPF&S (UK): Merrill Lynch, Pierce, Fenner & Smith Limited; Merrill Lynch (Australia): Merrill Lynch Equities (Australia) Limited; Merrill Lynch (Hong Kong): Merrill Lynch (Asia Pacific) Limited; Merrill Lynch (Singapore): Merrill Lynch (Singapore) Pte Ltd; Merrill Lynch (Canada): Merrill Lynch Canada Inc; Merrill Lynch (Mexico): Merrill Lynch Mexico, SA de CV, Casa de Bolsa; Merrill Lynch (Argentina): Merrill Lynch Argentina SA; Merrill Lynch (Japan): Merrill Lynch Japan Securities Co, Ltd; Merrill Lynch (Seoul): Merrill Lynch International Incorporated (Seoul Branch); Merrill Lynch (Taiwan): Merrill Lynch Securities (Taiwan) Ltd.; DSP Merrill Lynch (India): DSP Merrill Lynch Limited; PT Merrill Lynch (Indonesia): PT Merrill Lynch Indonesia; Merrill Lynch (KL) Sdn. Bhd.: Merrill Lynch (Malaysia); Merrill Lynch (Israel): Merrill Lynch Israel Limited; Merrill Lynch (Russia): Merrill Lynch CIS Limited, Moscow; Merrill Lynch (Turkey): Merrill Lynch Yatirim Bankasi A.S.; Merrill Lynch (Dubai): Merrill Lynch International Bank Ltd, Dubai Branch; MLPF&S (Zürich rep. office): MLPF&S Incorporated Zürich representative office.

This research report has been prepared and issued by MLPF&S and/or one or more of its non-U.S. affiliates. MLPF&S is the distributor of this research report in the U.S. and accepts full responsibility for research reports of its non-U.S. affiliates distributed in the U.S. Any U.S. person receiving this research report and wishing to effect any transaction in any security discussed in the report should do so through MLPF&S and not such foreign affiliates.

This research report has been approved for publication in the United Kingdom by Merrill Lynch, Pierce, Fenner & Smith Limited, which is authorized and regulated by the Financial Services Authority; has been considered and distributed in Japan by Merrill Lynch Japan Securities Co, Ltd, a registered securities dealer under the Securities and Exchange Law in Japan; is distributed in Hong Kong by Merrill Lynch (Asia Pacific) Limited, which is regulated by the Hong Kong SFC; is issued and distributed in Taiwan by Merrill Lynch Securities (Taiwan) Ltd.; is issued and distributed in Malaysia by Merrill Lynch (KL) Sdn. Bhd., a licensed investment adviser regulated by the Malaysian Securities Commission; is issued and distributed in India by DSP Merrill Lynch Limited; and is issued and distributed in Singapore by Merrill Lynch International Bank Limited (Merchant Bank) and Merrill Lynch (Singapore) Pte Ltd (Company Registration No.'s F 06872E and 198602883D respectively). Merrill Lynch International Bank Limited (Merchant Bank) and Merrill Lynch (Singapore) Pte Ltd. are regulated by the Monetary Authority of Singapore. Merrill Lynch Equities (Australia) Limited, (ABN 65 006 276 795), AFS License 235132, provides this report in Australia. No approval is required for publication or distribution of this report in Brazil.

Merrill Lynch (Frankfurt) distributes this report in Germany. Merrill Lynch (Frankfurt) is regulated by BaFin.

### Copyright, User Agreement and other general information related to this report:

Copyright 2008 Merrill Lynch, Pierce, Fenner & Smith Incorporated. All rights reserved. This research report is prepared for the use of Merrill Lynch clients and may not be redistributed, retransmitted or disclosed, in whole or in part, or in any form or manner, without the express written consent of Merrill Lynch. Merrill Lynch research reports are distributed simultaneously to internal and client websites eligible to receive such research prior to any public dissemination by Merrill Lynch of the research report or information or opinion contained therein. Any unauthorized use or disclosure is prohibited. Receipt and review of this research report constitutes your agreement not to redistribute, retransmit, or disclose to others the contents, opinions, conclusion, or information contained in this report (including any investment recommendations, estimates or price targets) prior to Merrill Lynch's public disclosure of such information. The information herein (other than disclosure information relating to Merrill Lynch and its affiliates) was obtained from various sources and we do not guarantee its accuracy. Merrill Lynch makes no representations or warranties whatsoever as to the data and information provided in any third party referenced website and shall have no liability or responsibility arising out of or in connection with any such referenced website.

This research report provides general information only. Neither the information nor any opinion expressed constitutes an offer or an invitation to make an offer, to buy or sell any securities or other investment or any options, futures or derivatives related to such securities or investments. It is not intended to provide personal investment advice and it does not take into account the specific investment objectives, financial situation and the particular needs of any specific person who may receive this report. Investors should seek financial advice regarding the appropriateness of investing in any securities, other investment or investment strategies discussed or recommended in this report and should understand that statements regarding future prospects may not be realized. Investors should note that income from such securities or other investments, if any, may fluctuate and that price or value of such securities and investments may rise or fall. Accordingly, investors may receive back less than originally invested. Past performance is not necessarily a guide to future performance. Any information relating to the tax status of financial instruments discussed herein is not intended to provide tax advice or to be used by anyone to provide tax advice. Investors are urged to seek tax advice based on their particular circumstances from an independent tax professional.

Foreign currency rates of exchange may adversely affect the value, price or income of any security or related investment mentioned in this report. In addition, investors in securities such as ADRs, whose values are influenced by the currency of the underlying security, effectively assume currency risk.

Officers of MLPF&S or one or more of its affiliates (other than research analysts) may have a financial interest in securities of the issuer(s) or in related investments.

**Merrill Lynch Research policies relating to conflicts of interest are described at <http://www.ml.com/media/43347.pdf>.**

Fundamental equity reports are produced on a regular basis as necessary to keep the investment recommendation current.

iQmethod, iQmethod 2.0, iQprofile, iQtoolkit, iQworks are service marks of Merrill Lynch & Co., Inc. iQanalytics®, iQcustom®, iQdatabase® are registered service marks of Merrill Lynch & Co., Inc.