

ACTION Sell

Epistar (2448.TW)

Return Potential: (28%)

Wider-than-expected 4Q08 loss a near-term negative; reiterate Sell

Source of opportunity

We expect Epistar to be loss-making in 4Q08 for the first time in the past four years. With utilization sliding to <50% in Dec and likely continuing to trend lower in Jan (<30%), the bottom line will remain under pressure in 1Q09. Moreover, we are concerned that Epistar may recognize significant losses from inventory write-offs during 4Q08/1Q09 given falling ASP, unexpected order cancellations, and adoption of SFAS No. 10. We expect a 4Q08 net loss of NT\$437mn vs. consensus ranging from NT\$312mn profit to NT\$86mn loss. Despite recent share price resilience on possible restocking demand, the weak 4Q08 earnings and dull 1H09 outlook will be negative surprises for the market.

Catalyst

Epistar's revenues declined 27% qoq in 4Q08 on the back of weakness in handsets and home appliance applications and hence sinking utilization (50%-60% in 4Q08 from 70% in 3Q08). We forecast a 28% qoq drop in 1Q09 sales due to limited order visibility and to factor in likely limited improvement in utilization rates and product mix. Despite capex cuts at LED upstream in 2009, we believe demand will drop proportionally and upstream is in a weaker spot than downstream to weather the downturn owing to higher operating leverage. We think the loss-making scenario in 4Q08 will force investors to re-examine Epistar's business model, which we consider unfavorable, and adjust the valuation premium they are currently ascribing to LED upstream players.

Valuation

We cut 2008E/2009E/2010E EPS by 78%/81%/66% to reflect the loss-making scenario in 4Q08-1Q09 and margin pressure. We cut our WACC assumption to 8.8% from 9.3% after updating beta to 1.2. Our new 12-month target price of NT\$24.5 (from NT\$25.9) is based on DCF and equivalent to 0.7X 2009E P/B. Note that non-operating losses are not captured in our DCF valuation.

Key risks

Faster-than-expected end-demand recovery and more stable pricing trend.

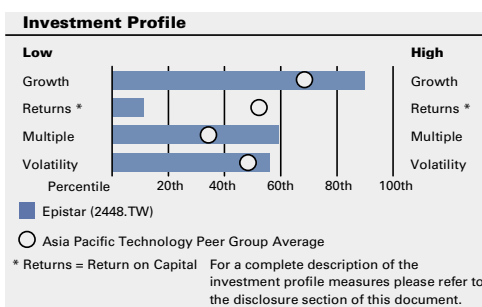
INVESTMENT LIST MEMBERSHIP

Asia Pacific Sell List

Coverage View: Neutral

Taiwan:
Hardware

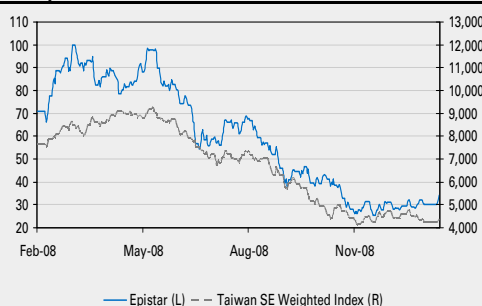
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Key data	Current
Price (NT\$)	34.20
12 month price target (NT\$)	24.50
Market cap (NT\$ mn / US\$ mn)	20,178.7 / 598.7
Foreign ownership (%)	12.9

	12/07	12/08E	12/09E	12/10E
EPS (NT\$) New	4.28	0.27	0.26	0.66
EPS revision (%)	0.0	(77.5)	(80.6)	(66.2)
EPS growth (%)	18.5	(93.7)	(4.0)	156.4
EPS (dil) (NT\$) New	4.28	0.26	0.25	0.65
P/E (X)	8.0	126.6	131.9	51.4
P/B (X)	0.7	0.9	1.0	0.9
EV/EBITDA (X)	14.9	6.6	8.8	6.7
Dividend yield (%)	5.5	7.4	0.4	0.5
ROE (%)	13.0	0.7	0.7	1.8

Price performance chart



Share price performance (%)	3 month	6 month	12 month
Absolute	(9.0)	(48.0)	(51.8)
Rel. to Taiwan SE Weighted Index	3.9	(16.7)	(15.5)

Source: Company data, Goldman Sachs Research estimates, FactSet. Price as of 2/03/2009 close.

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Epistar: Summary financials

Profit model (NT\$ mn)	12/07	12/08E	12/09E	12/10E	Balance sheet (NT\$ mn)	12/07	12/08E	12/09E	12/10E
Total revenue	10,205.9	10,320.9	8,007.4	9,536.3	Cash & equivalents	8,291.3	6,657.4	8,393.6	8,621.0
Cost of goods sold	(6,946.9)	(8,365.4)	(6,844.0)	(7,901.4)	Accounts receivable	3,845.7	3,889.1	3,017.3	3,593.4
SG&A	(791.2)	(901.2)	(679.5)	(784.7)	Inventory	3,138.5	2,871.2	2,251.9	2,602.0
R&D	(357.1)	(430.8)	(269.4)	(307.9)	Other current assets	477.5	477.5	477.5	477.5
Other operating profit/(expense)	0.0	0.0	0.0	0.0	Total current assets	15,851.2	13,993.3	14,238.4	15,392.0
ESO expense	--	(92.4)	(27.2)	(64.7)	Net PP&E	12,960.2	14,110.6	13,765.9	13,051.3
EBITDA	3,792.5	2,451.0	1,797.0	2,337.4	Net intangibles	0.0	0.0	0.0	0.0
Depreciation & amortization	(1,681.8)	(1,919.9)	(1,609.6)	(1,859.9)	Total investments	419.2	419.2	419.2	419.2
EBIT	2,110.7	531.0	187.4	477.6	Other long-term assets	551.2	551.2	551.2	551.2
Interest income	12.7	97.0	97.0	97.0	Total assets	29,781.7	29,074.2	28,974.6	29,413.7
Interest expense	(94.0)	(101.0)	(106.0)	(106.9)	Accounts payable	1,020.7	918.8	750.6	867.3
Income/(loss) from uncons. subs.	1.2	0.7	0.0	0.0	Short-term debt	407.8	906.7	906.7	906.7
Others	194.2	(402.1)	0.0	0.0	Other current liabilities	2,988.4	2,988.4	2,988.4	2,988.4
Pretax profits	2,224.9	125.6	178.4	467.6	Total current liabilities	4,416.8	4,813.8	4,645.7	4,762.4
Income tax	(131.3)	33.7	(14.3)	(46.8)	Long-term debt	1,683.9	1,683.9	1,683.9	1,683.9
Minorities	0.0	0.0	0.0	0.0	Other long-term liabilities	28.7	28.7	28.7	28.7
Net income pre-preferred dividends	2,093.6	159.3	164.2	420.9	Total long-term liabilities	1,712.5	1,712.5	1,712.5	1,712.5
Preferred dividends	0.0	0.0	0.0	0.0	Total liabilities	6,129.4	6,526.4	6,358.2	6,474.9
Net income (pre-exceptionals)	2,093.6	159.3	164.2	420.9	Preferred shares	0.0	0.0	0.0	0.0
Post-tax exceptionals	0.0	0.0	0.0	0.0	Total common equity	23,652.4	22,547.8	22,616.4	22,938.7
Net income	2,093.6	159.3	164.2	420.9	Minority interest	0.0	0.0	0.0	0.0
EPS (basic, pre-except) (NT\$)	4.28	0.27	0.26	0.66	Total liabilities & equity	29,781.7	29,074.2	28,974.6	29,413.7
EPS (basic, post-except) (NT\$)	4.28	0.27	0.26	0.66	BVPS (NT\$)	48.36	38.22	35.73	36.23
EPS (diluted, post-except) (NT\$)	4.28	0.26	0.25	0.65					
EPS excl. ESO expense (basic) (NT\$)	4.28	0.42	0.30	0.76					
EPS excl. ESO expense (dil.) (NT\$)	4.28	0.41	0.29	0.74					
DPS (NT\$)	1.88	2.52	0.15	0.16					
Dividend payout ratio (%)	43.8	934.6	58.2	23.4					
Free cash flow yield (%)	0.6	(3.4)	9.1	2.4					
Growth & margins (%)	12/07	12/08E	12/09E	12/10E	Ratios	12/07	12/08E	12/09E	12/10E
Sales growth	62.2	1.1	(22.4)	19.1	ROE (%)	13.0	0.7	0.7	1.8
EBITDA growth	94.0	(35.4)	(26.7)	30.1	ROA (%)	9.9	0.5	0.6	1.4
EBIT growth	83.4	(74.8)	(64.7)	154.9	ROACE (%)	16.4	0.9	1.0	2.5
Net income growth	68.9	(92.4)	3.0	156.4	Inventory days	122.3	131.1	136.6	112.1
EPS growth	18.5	(93.7)	(4.0)	156.4	Receivables days	109.6	136.8	157.4	126.5
Gross margin	31.9	18.9	14.5	17.1	Payable days	42.5	42.3	44.5	37.4
EBITDA margin	37.2	23.7	22.4	24.5	Net debt/equity (%)	(26.2)	(18.0)	(25.7)	(26.3)
EBIT margin	20.7	5.1	2.3	5.0	Interest cover - EBIT (X)	26.0	132.6	20.9	48.0
					Valuation	12/07	12/08E	12/09E	12/10E
Cash flow statement (NT\$ mn)	12/07	12/08E	12/09E	12/10E	P/E (analyst) (X)	8.0	126.6	131.9	51.4
Net income pre-preferred dividends	2,093.6	159.3	164.2	420.9	P/B (X)	0.7	0.9	1.0	0.9
D&A add-back	1,681.8	1,919.9	1,609.6	1,859.9	EV/EBITDA (X)	14.9	6.6	8.8	6.7
Minorities interests add-back	0.0	0.0	0.0	0.0	Dividend yield (%)	5.5	7.4	0.4	0.5
Net (inc)/dec working capital	(2,760.1)	122.1	1,322.9	(809.5)					
Other operating cash flow	1,228.7	78.1	34.3	82.9					
Cash flow from operations	2,242.8	2,278.7	3,131.0	1,554.1					
Capital expenditures	(1,820.3)	(2,954.6)	(1,162.2)	(1,026.6)					
Acquisitions	(4,109.0)	(115.0)	(102.7)	(118.7)					
Divestitures	1,108.2	0.0	0.0	0.0					
Others	3,290.9	21.3	0.0	0.0					
Cash flow from investments	(1,530.1)	(3,048.4)	(1,264.9)	(1,145.3)					
Dividends paid (common & pref)	(917.6)	(1,489.2)	(95.6)	(98.5)					
Inc/(dec) in debt	1,912.1	498.9	0.0	0.0					
Common stock issuance (repurchase)	7,233.9	126.0	(34.3)	(82.9)					
Other financing cash flows	(2,549.2)	0.0	0.0	0.0					
Cash flow from financing	5,679.1	(864.3)	(129.9)	(181.4)					
Total cash flow	6,391.7	(1,634.0)	1,736.2	227.4					

Note: Last actual year may include reported and estimated data.
Source: Company data, Goldman Sachs Research estimates.

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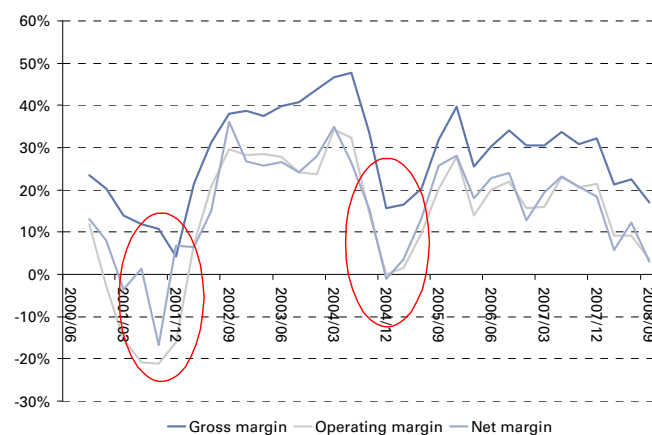
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4Q08 to bring out the red ink; 1Q09 remains tough

We expect Epistar to be loss-making in 4Q08, the first time in the past four years. Utilization has experienced a sharp decline from 60%-70% in October to below <50% in December on the back of unexpected order cancellations due to demand shrinkage. In addition, we are concerned that Epistar may have to recognize significant losses from inventory write-offs during 4Q08-1Q09 given falling ASP, high inventory and implementation of SFAS No. 10. We forecast a net loss of NT\$437mn in 4Q08, vs. consensus (Reuters) estimates ranging from NT\$312mn profit to NT\$86mn loss. The company suggested that utilization will likely continue to trend lower in January (<30%) due to low order visibility. Given its high operating leverage, we believe Epistar will struggle to turn a profit in 1Q09.

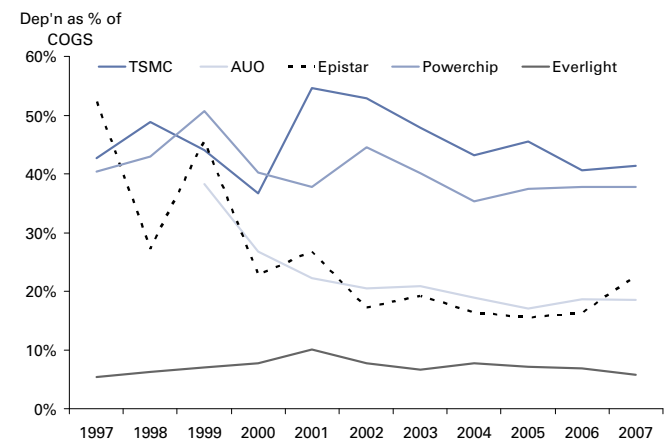
Despite our cautious view towards the whole LED market, we maintain our view that packagers' earnings quality is better than their upstream counterparts. EBIT margin volatility at Epistar has been much greater than that of Everlight (Sell, 2393.TW). The highly leveraged upstream companies (similar operating leverage to that of TFT LCD companies) are more vulnerable to a downturn than the low-leverage packaging companies. Aggressive investment is likely to lead to cyclical and volatile earnings over the cycle, in our view.

Exhibit 1: Historical data shows that Epistar has struggled to maintain its profitability during downturns
Epistar's historical margin trend



Source: Company data, Goldman Sachs Research estimates.

Exhibit 2: Operating leverage (depreciation as a % of COGS) comparison



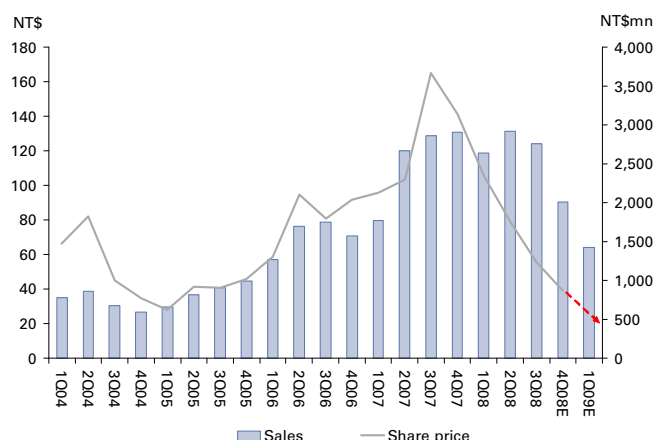
Source: Company data.

Fundamentals do not support the share price; retain Sell

Epistar's share price has been resilient in recent months on the back of positive news flow such as Delta's (2308.TW, Sell, on Conviction Sell list) potential strategic alliance with Epistar (Economic Daily, Jan 15) and rush orders on restocking demand in January/February (Economic Daily, Feb 4). In our view, Delta's potential entrance signals that more tech heavyweights are eyeing the lucrative LED market and that there could be intense jockeying amongst those companies hoping to get a foothold in this space. Moreover, the rush orders from inventory re-stocking might only be temporary without sustainable support from real end-demand recovery.

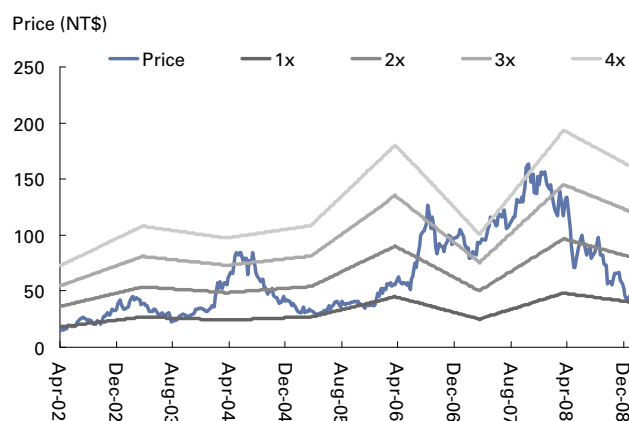
We cut our 2008E/2009E/2010E EPS by 78%, 81% and 66%, respectively, to reflect our expectation of very disappointing 4Q08 results (lackluster core business performance plus inventory write-offs), a dull 1H09 outlook, and continued margin pressure. Our new 2008E/2009E/2010E EPS of NT\$0.27/NT\$0.26/NT\$0.66 (basic, post-exceptional) is 76%/73%/66% lower than consensus (Reuters). We cut our WACC assumption to 8.8% from 9.3% after updating our beta assumption to 1.2. Our new 12-month target price of NT\$24.5 (from NT\$25.9) is based on DCF and equivalent to 0.7X 2009E P/B. Note that non-operating losses are not captured in our DCF valuation.

Exhibit 3: Epistar's sales momentum vs. share price



Source: Company data, Goldman Sachs Research estimates.

Exhibit 4: Epistar's trailing P/B band



Source: Company data, Goldman Sachs Research.

Exhibit 5: Epistar's new vs. old estimates

Epistar (2448.TW)	2008E			2009E			2010E			
	Summary P&L (NT\$m)	New	Old	Diff.	New	Old	Diff.	New	Old	Diff.
Revenues		10,321	10,838	-5%	8,007	11,657	-31%	9,536	12,998	-27%
Gross profits		1,937	2,143	-10%	1,158	2,323	-50%	1,622	2,785	-42%
Operating profits		531	717	-26%	187	804	-77%	478	1,199	-60%
Non-operating income		(405)	75	-644%	(9)	102	-498%	(10)	102	-498%
Pretax earnings		126	791	-84%	178	905	-80%	468	1,301	-64%
Net earnings		159	745	-79%	164	851	-81%	421	1,232	-66%
EPS (NT\$)		0.3	1.2	-77%	0.3	1.3	-81%	0.7	1.9	-66%
Ratio analysis										
Gross margin (%)		18.8%	19.8%		14.5%	19.9%		17.0%	21.4%	
EBIT margin (%)		5.1%	6.6%		2.3%	6.9%		5.0%	9.2%	
Tax expense (as % of EBT)		-26.8%	5.8%		8.0%	6.0%		10.0%	5.3%	
Net margin (%)		1.5%	6.9%		2.1%	7.3%		4.4%	9.5%	

Source: Company data, Goldman Sachs Research estimates.

Exhibit 6: Epistar's P/L assumptions (in NT\$mnn)

Summary P&L	1Q08	2Q08	3Q08	4Q08E	1Q09E	2Q09E	3Q09E	4Q09E	2007	2008E	2009E	2010E
Net sales	2,638	2,914	2,756	2,013	1,443	1,804	2,198	2,562	10,206	10,321	8,007	9,536
Cost of good sold (COGS)	(2,073)	(2,260)	(2,292)	(1,758)	(1,278)	(1,564)	(1,862)	(2,146)	(6,947)	(8,384)	(6,849)	(7,914)
Gross profits	565	654	464	254	165	240	337	416	3,259	1,937	1,158	1,622
Operating expenses	(320)	(412)	(378)	(296)	(177)	(222)	(264)	(307)	(1,148)	(1,406)	(971)	(1,144)
SG&A	(198)	(270)	(259)	(211)	(127)	(159)	(187)	(218)	(791)	(938)	(690)	(811)
R&D	(122)	(143)	(118)	(85)	(51)	(63)	(77)	(90)	(357)	(468)	(280)	(334)
Operating profits	245	242	86	(42)	(12)	18	73	108	2,111	531	187	478
Non-operating income/(loss)	(92)	131	11	(455)	(1)	(2)	(3)	(3)	114	(405)	(9)	(10)
Earnings before tax (EBT)	153	372	97	(496)	(13)	16	70	106	2,225	126	178	468
Income tax credit/expense	2	(13)	(14)	60	1	(1)	(6)	(8)	(131)	34	(14)	(47)
Extraordinary gain/(loss)	-	-	-	-	-	-	-	-	-	-	-	-
Earnings after tax (EAT)	154	359	83	(437)	(12)	15	64	97	2,094	159	164	421
EPS (NT\$)	0.25	0.58	0.13	(0.69)	(0.02)	0.02	0.10	0.15	4.28	0.27	0.26	0.66
EPS (fully diluted, NT\$)	0.24	0.57	0.13	(0.67)	(0.02)	0.02	0.10	0.15	4.28	0.26	0.25	0.65
Ratio analysis and assumptions												
Gross margin	21.4%	22.4%	16.8%	12.6%	11.5%	13.3%	15.3%	16.2%	31.9%	18.8%	14.5%	17.0%
Operating expense ratio	-12.1%	-14.2%	-13.7%	-14.7%	-12.3%	-12.3%	-12.0%	-12.0%	-11.3%	-13.6%	-12.1%	-12.0%
Operating margin	9.3%	8.3%	3.1%	-2.1%	-0.8%	1.0%	3.3%	4.2%	20.7%	5.1%	2.3%	5.0%
Pre-tax margin	5.8%	12.8%	3.5%	-24.6%	-0.9%	0.9%	3.2%	4.1%	21.8%	1.2%	2.2%	4.9%
Tax rate (as % of EBT)	-1.0%	3.6%	14.5%	12.0%	8.0%	8.0%	8.0%	8.0%	5.9%	-26.8%	8.0%	10.0%
Net margin	5.9%	12.3%	3.0%	-21.7%	-0.8%	0.8%	2.9%	3.8%	20.5%	1.5%	2.1%	4.4%

Source: Company data, Goldman Sachs Research estimates.

Exhibit 7: DCF assumptions

WACC calculation	
Cost of debt (Rd)	3.5%
Interest tax shield (T)	8.7%
Cost of equity (Re)	12.5%
Risk-free rate (Rf)	3.0%
Beta	1.2
Equity risk premium (Rf-Re)	8.0%

Source: Goldman Sachs Research estimates.

Exhibit 8: DCF sensitivity analysis

		FCF growth (Stage III)						
		-0.5%	0.0%	0.5%	1.0%	1.5%	2.0%	2.5%
WACC	7.8%	24.3	24.9	25.6	26.3	27.2	28.2	29.5
	8.3%	23.6	24.1	24.7	25.4	26.1	27.0	28.0
	8.8%	23.0	23.4	23.9	24.5	25.1	25.9	26.7
	9.3%	22.4	22.8	23.3	23.7	24.3	24.9	25.6
	9.8%	21.9	22.3	22.6	23.1	23.6	24.1	24.7

Source: Goldman Sachs Research estimates.

Reg AC

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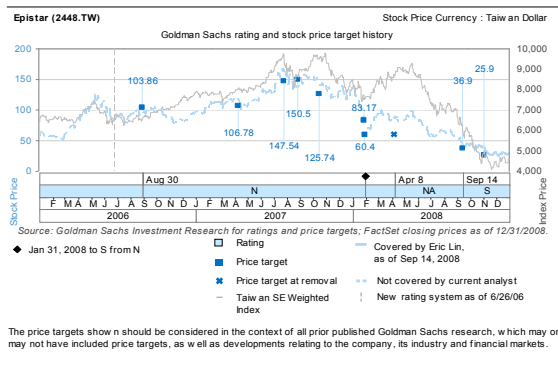
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Price target and rating history chart(s)



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