

AU Optronics (2409.TW)

Bumpy Road Ahead; Premium Products as Double-Edged Sword

- **2Q results surprised on downside** — AUO reported 2Q loss per share (LPS) of NT\$1.39, below Citi/Street forecast LPS of NT\$0.64/NT\$1.03. GM/OPM improved to -3.3%/-11% (vs. -8%/-16.6% in 1Q12) with OP loss narrowing to NT\$10.5bn, still significantly below our/Street est. of NT\$4.7bn/NT\$8.1bn. Besides lackluster demand and limited panel price recovery, the ramping of new products also curbed the scale of margin enhancement and led to the larger-than-expected loss.
- **Sub-seasonal 3Q; expect no immediate turnaround** — AUO guided that large-size panel unit shipments will be flat Q/Q due to macro uncertainty, while ASP could increase 1-3%. Its guidance reconfirmed our view of weakening TV demand, which was highlighted in our 14 May report [TFT LCD and Glass Sector - China LCD TV Watch: China Labor Holiday Sell-Thru Weaker than Expected; See 2H Weakness Ahead](#). Utilization in 3Q will increase by low-single digit (vs. 80% in 2Q) with slight increase in area shipment. However, large area shipment will decline in July, as part of the Gen 6 equipment was impacted by the June earthquake, according to AUO.
- **Premium product could be double-edged sword; yield issue to cap cost reduction ability** — AUO guided that premium products (e.g., narrow-bezel TV, ultra-slim NB) made up of c.40% of revenue. However, we believe the inferior yield resulted in higher cost and impeded margin enhancement. The tech obstacles in ramping those high-end products include high-resolution backlight gate on array (for ultra-slim NB) and copper process (for narrow-bezel TV). As AUO is working on the mass production of iPad mini and AMOLED, we expect yield issues to extend in 3Q.
- **Lacking catalysts; maintain Neutral** — We cut our FY12E/FY13E EPS estimates to NT\$-5.35/NT\$-3.55 (from NT\$-2.09/NT\$-0.73). After recent share price correction, we believe market is pricing in a muted 2H; however, we will not turn positive unless we see a sustainable TV panel price rebound along with significant margin improvement. We cut target price to NT\$10.9 based on 0.55x FY12E P/B (from NT\$15.5 based on 0.7x FY12E P/B).

- Company Update
- Target Price Change
- Estimate Change

Neutral	2
Price (25 Jul 12)	NT\$9.50
Target price	NT\$10.90
	from NT\$15.50
Expected share price return	14.7%
Expected dividend yield	0.0%
Expected total return	14.7%
Market Cap	NT\$83,857M
	US\$2,783M

Price Performance (RIC: 2409.TW, BB: 2409 TT)



Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Dec	(NT\$M)	(NT\$)	(%)	(x)	(x)	(%)	(%)
2010A	6,693	0.76	124.9	12.5	0.3	2.4	4.2
2011A	-61,264	-6.94	na	-1.4	0.4	-24.3	0.0
2012E	-47,243	-5.35	22.9	-1.8	0.5	-23.9	0.0
2013E	-31,335	-3.55	33.7	-2.7	0.6	-19.7	0.0
2014E	-24,320	-2.76	22.4	-3.4	0.7	-18.5	0.0

Source: Powered by dataCentral

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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2409.TW: Fiscal year end 31-Dec						Price: NT\$9.50; TP: NT\$10.90; Market Cap: NT\$83,857m; Recomm: Neutral					
Profit & Loss (NT\$m)	2010	2011	2012E	2013E	2014E	Valuation ratios	2010	2011	2012E	2013E	2014E
Sales revenue	467,158	379,712	369,561	394,290	422,051	PE (x)	12.5	-1.4	-1.8	-2.7	-3.4
Cost of sales	-430,859	-407,899	-386,663	-398,403	-418,022	PB (x)	0.3	0.4	0.5	0.6	0.7
Gross profit	36,299	-28,187	-17,102	-4,113	4,029	EV/EBITDA (x)	1.4	5.0	4.8	3.2	2.8
Gross Margin (%)	7.8	-7.4	-4.6	-1.0	1.0	FCF yield (%)	6.9	-34.2	-11.4	-10.9	15.5
EBITDA (Adj)	99,632	31,094	34,849	51,863	58,931	Dividend yield (%)	4.2	0	0	0	0
EBITDA Margin (Adj) (%)	21.3	8.2	9.4	13.2	14.0	Payout ratio (%)	53	0	0	0	0
Depreciation	-89,136	-88,752	-79,608	-82,394	-83,180	ROE (%)	2.4	-24.3	-23.9	-19.7	-18.5
Amortisation	0	0	0	0	0	Cashflow (NT\$m)	2010	2011	2012E	2013E	2014E
EBIT (Adj)	10,497	-57,659	-44,758	-30,531	-24,249	EBITDA	99,632	31,094	34,849	51,863	58,931
EBIT Margin (Adj) (%)	2.2	-15.2	-12.1	-7.7	-5.7	Working capital	-1,637	-6,013	8,990	-5,918	3,933
Net interest	-3,946	-4,473	-4,740	-3,959	-3,935	Other	-7,552	3,163	-9,707	-5,111	164
Associates	681	-64	486	430	352	Operating cashflow	90,443	28,244	34,132	40,834	63,028
Non-op/Except	1,364	-3,457	419	197	211	Capex	-84,621	-56,920	-43,710	-50,000	-50,000
Pre-tax profit	8,596	-65,652	-48,594	-33,863	-27,621	Net acq/disposals	0	0	0	0	0
Tax	-1,188	4,205	864	2,370	3,179	Other	-2,693	-17,607	20,938	-430	-352
Extraord./Min.Int./Pref.div.	-715	183	486	157	122	Investing cashflow	-87,314	-74,526	-22,772	-50,430	-50,352
Reported net profit	6,693	-61,264	-47,243	-31,335	-24,320	Dividends paid	0	-3,531	0	0	0
Net Margin (%)	1.4	-16.1	-12.8	-7.9	-5.8	Financing cashflow	965	47,279	-12,162	-29,667	-11,224
Core NPAT	6,693	-61,264	-47,243	-31,335	-24,320	Net change in cash	4,094	997	-801	-39,263	1,452
Per share data	2010	2011	2012E	2013E	2014E	Free cashflow to s/holders	5,822	-28,675	-9,578	-9,166	13,028
Reported EPS (\$)	0.76	-6.94	-5.35	-3.55	-2.76						
Core EPS (\$)	0.76	-6.94	-5.35	-3.55	-2.76						
DPS (\$)	0.40	0	0	0	0						
CFPS (\$)	10.25	3.20	3.87	4.63	7.14						
FCFPS (\$)	0.66	-3.25	-1.09	-1.04	1.48						
BVPS (\$)	31.98	25.07	19.80	16.25	13.49						
Wtd avg ord shares (m)	8,827	8,827	8,827	8,827	8,827						
Wtd avg diluted shares (m)	8,827	8,827	8,827	8,827	8,827						
Growth rates	2010	2011	2012E	2013E	2014E						
Sales revenue (%)	30.0	-18.7	-2.7	6.7	7.0						
EBIT (Adj) (%)	168.9	-649.3	22.4	31.8	20.6						
Core NPAT (%)	125.0	nm	22.9	33.7	22.4						
Core EPS (%)	124.9	nm	22.9	33.7	22.4						
Balance Sheet (NT\$m)	2010	2011	2012E	2013E	2014E						
Cash & cash equiv.	89,926	90,922	90,121	50,858	52,310						
Accounts receivables	59,916	51,532	52,106	58,565	59,041						
Inventory	44,568	47,882	41,685	46,852	46,052						
Net fixed & other tangibles	383,868	358,479	301,809	269,416	236,236						
Goodwill & intangibles	0	0	0	0	0						
Financial & other assets	51,038	63,963	66,731	68,990	69,481						
Total assets	629,316	612,778	552,453	494,680	463,121						
Accounts payable	93,783	82,699	86,066	91,774	95,384						
Short-term debt	37,113	54,283	46,188	42,956	37,476						
Long-term debt	146,403	178,428	172,078	145,487	139,620						
Provisions & other liab	69,693	76,091	73,383	71,063	71,560						
Total liabilities	346,991	391,501	377,716	351,279	344,040						
Shareholders' equity	282,325	221,277	174,736	143,401	119,081						
Minority interests	0	0	0	0	0						
Total equity	282,325	221,277	174,736	143,401	119,081						
Net debt	93,590	141,789	128,146	137,584	124,786						
Net debt to equity (%)	33.1	64.1	73.3	95.9	104.8						

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For definitions of the items in this table, please click [here](#).

Figure 1. AUO – 2Q12 Results Summary

NT\$ Billion	2Q12 Actual	2Q12 Citi	Diff %	1Q12	%Q/Q	2Q11	% Y/Y
Sales	95.2	92.9	2%	81.1	17.4%	98.0	-2.9%
Gross Profit	-3.2	1.8	nm	-6.4	nm	-2.5	nm
Gross margin	-3.3%	1.9%	-526.4 bps	-8.0%	460.4 bps	-2.5%	-81.6 bps
Operating profit	-10.5	-4.7	nm	-13.5	nm	-9.1	nm
Operating margin	-11.0%	-5.1%	-591.6 bps	-16.6%	562.9 bps	-9.3%	-169.8 bps
Net Income	-12.3	-5.7	nm	-13.6	nm	-10.8	nm
EPS (NT\$)	-1.39	-0.64	nm	-1.54	nm	-1.22	nm

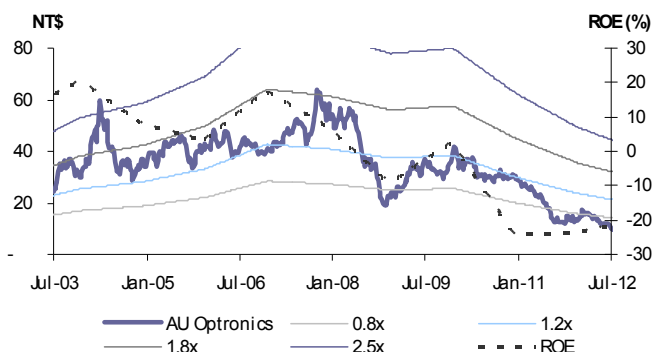
Source: Citi Research

Figure 2. AUO – Estimates Revisions

NT\$ Billion	3Q12E			4Q12E			2012E			2013E		
	Revised	Prior	Diff.	Revised	Prior	Diff.	Revised	Prior	Diff.	Revised	Prior	Diff.
Sales	98.2	103.7	-5%	95.1	99.6	-5%	369.6	377.3	-2%	394.3	408.4	-3%
Gross profit	(3.8)	8.2	nm	(3.7)	7.0	nm	(17.1)	10.5	nm	(4.1)	22.2	nm
Gross margin	-3.8%	7.9%	-1,170 bps	-3.9%	7.0%	-1,091 bps	-4.6%	2.8%	-740 bps	-1.0%	5.4%	-649 bps
Operating profit	(10.5)	1.7	nm	(10.3)	0.8	nm	(44.8)	(15.7)	nm	(30.5)	(4.3)	nm
Operating margin	-10.7%	1.7%	-1,240 bps	-10.8%	0.8%	-1,161 bps	-12.1%	-4.2%	-796 bps	-7.7%	-1.1%	-669 bps
Net Income	(10.9)	0.8	nm	(10.5)	(0.0)	nm	(47.2)	(18.5)	nm	(31.3)	(6.5)	nm
EPS (NT\$)	(1.23)	0.09	nm	(1.19)	(0.00)	nm	(5.35)	(2.09)	nm	(3.55)	(0.73)	nm

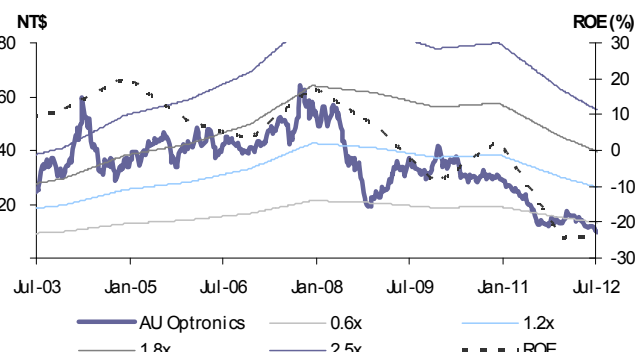
Source: Citi Research estimates

Figure 3. AUO – Forward 12M P/B



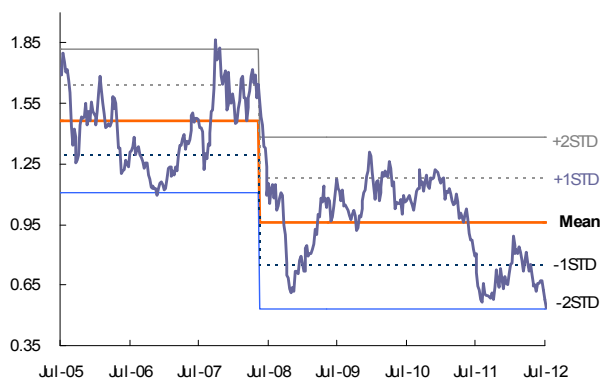
Source: Citi Research

Figure 4. AUO – Trailing 12M P/B



Source: Citi Research

Figure 5. AUO – Forward P/B Range



Source: Citi Research

Figure 6. AUO – Trailing P/B Range



Source: Citi Research

Figure 7. AUO – Estimates Summary

	2011				2012E				2013E				2010	2011	2012E	2013E
NT\$ billion	1Q	2Q	3Q	4Q	1Q	2Q	3QE	4QE	1QE	2QE	3QE	4QE				
Revenue	93.2	98.0	98.9	89.5	81.1	95.2	98.2	95.1	85.2	94.8	107.5	106.9	467.2	379.7	369.6	394.3
Depreciation	-22.4	-22.4	-22.3	-21.6	-20.1	-19.4	-19.9	-20.3	-20.0	-20.3	-20.8	-21.2	-89.1	-88.8	-79.6	-82.4
COGS	-99.5	-100.5	-108.1	-99.8	-87.6	-98.4	-101.9	-98.8	-90.9	-97.2	-105.3	-105.0	-430.9	-407.9	-386.7	-398.4
Gross Profit	-6.3	-2.5	-9.1	-10.3	-6.4	-3.2	-3.8	-3.7	-5.8	-2.4	2.2	1.9	36.3	-28.2	-17.1	-4.1
Operating Expense	8.0	6.6	7.7	7.2	7.0	7.3	6.8	6.6	5.7	6.3	7.2	7.2	25.8	29.5	27.7	26.4
EBIT	-14.2	-9.1	-16.8	-17.5	-13.5	-10.5	-10.5	-10.3	-11.5	-8.8	-5.0	-5.3	10.5	-57.7	-44.8	-30.5
Net Interest Income	-0.9	-1.1	-1.2	-1.3	-1.3	-1.2	-1.2	-1.0	-1.0	-1.0	-1.0	-1.0	-3.9	-4.5	-4.7	-4.0
Net Other Income	0.6	-1.1	0.3	-3.3	0.7	-0.1	0.1	0.1	0.1	0.2	0.2	0.2	2.0	-3.5	0.9	0.6
Pre Tax Profit	-14.6	-11.3	-17.7	-22.0	-14.0	-11.8	-11.6	-11.2	-12.3	-9.6	-5.9	-6.1	8.6	-65.7	-48.6	-33.9
Tax	-0.7	-0.6	-1.9	-1.1	-0.2	0.6	-0.6	-0.6	-0.9	-0.7	-0.4	-0.4	-1.2	4.2	0.9	2.4
Net Profit	-14.0	-10.8	-15.8	-20.7	-13.6	-12.3	-10.9	-10.5	-11.4	-8.9	-5.4	-5.6	6.7	-61.3	-47.2	-31.3
EPS (NT\$)	-1.6	-1.2	-1.8	-2.3	-1.5	-1.4	-1.2	-1.2	-1.3	-1.0	-0.6	-0.6	0.8	-6.9	-5.4	-3.5
Revenue breakdown																
Small and medium	11%	12%	14%	15%	14%	11%	12%	12%	11%	13%	14%	13%	9%	13%	12%	13%
IT	33%	34%	33%	33%	37%	36%	35%	35%	35%	34%	33%	34%	32%	33%	36%	34%
TV	46%	45%	44%	42%	40%	42%	44%	45%	47%	46%	46%	48%	51%	45%	43%	47%
Others	9%	9%	8%	9%	9%	11%	8%	8%	7%	7%	7%	5%	7%	9%	9%	7%
Unit shipment & ASP																
Total large-size shipment (mn)	28.4	29.6	29.7	26.8	27.3	31.7	31.9	32.0	30.8	33.9	37.9	37.8	113.6	114.5	122.9	140.4
TV	7.8	8.6	8.6	7.9	7.5	8.5	8.7	8.7	8.3	8.9	9.8	10.3	32.8	32.9	33.4	37.4
IT	19.6	20.2	20.2	18.0	18.8	22.1	22.3	22.4	21.7	24.0	27.0	26.7	77.6	78.0	85.6	99.5
Blended ASP / unit (US\$)	99.4	100.6	97.5	93.7	87.3	90.7	90.2	87.6	83.0	82.9	83.0	83.5	118.1	97.8	89.0	83.1
TV	190.6	179.2	174.8	159.7	148.5	159.9	166.9	165.3	162.7	167.0	171.4	168.8	232.3	175.8	160.7	167.7
IT	53.9	56.7	55.0	54.8	54.2	52.6	52.0	49.6	45.9	45.2	44.6	45.8	61.7	55.1	52.0	45.4
Output area result																
Total glass output ('000 sq M)	4,242	4,401	4,512	4,156	3,961	4,720	4,812	4,813	4,546	4,999	5,572	5,672	17,547	17,311	18,306	20,788
% change	-2%	4%	3%	-8%	-5%	19%	2%	0%	-6%	10%	11%	2%	38%	-1%	6%	14%
ASP / m2 (US\$)	750	773	751	713	694	684	680	659	635	643	654	639	844	747	679	643
% change	-3%	3%	-3%	-5%	-3%	-2%	-1%	-3%	-4%	1%	2%	-2%	-1%	-12%	-9%	-5%
COGS / m2 (US\$)	801	792	820	795	749	707	706	684	678	659	641	627	779	802	710	650
% change	-1%	-1%	4%	-3%	-6%	-6%	0%	-3%	-1%	-3%	-3%	-2%	-7%	3%	-11%	-8%
Margins (%)																
Gross Margin	-6.7	-2.5	-9.2	-11.5	-8.0	-3.3	-3.8	-3.9	-6.8	-2.5	2.0	1.8	7.8	-7.4	-4.6	-1.0
Operating Margin	-15.3	-9.3	-17.0	-19.5	-16.6	-11.0	-10.7	-10.8	-13.5	-9.2	-4.7	-4.9	2.2	-15.2	-12.1	-7.7
EBITDA Margin	8.8	13.6	5.6	4.6	8.2	9.4	9.5	10.5	10.1	12.2	14.6	14.9	21.3	8.2	9.4	13.2
Net Margin	-15.0	-11.0	-16.0	-23.1	-16.8	-12.9	-11.1	-11.0	-13.4	-9.4	-5.0	-5.2	1.4	-16.1	-12.8	-7.9
Sequential Growth (%)																
Revenue	-9.1	5.2	0.9	-9.5	-9.4	17.4	3.1	-3.1	-10.5	11.3	13.4	-0.6	30.0	-18.7	-2.7	6.7
Gross Profit	n.m.	n.m.	n.m.	n.m.	n.m.	n.m.	n.m.	n.m.	n.m.	n.m.	n.m.	-11.6	415.5	n.m.	n.m.	n.m.
EBIT	n.m.	n.m.	n.m.	n.m.	n.m.	n.m.	n.m.	n.m.	n.m.	n.m.	n.m.	n.m.	n.m.	n.m.	n.m.	n.m.
EPS	n.m.	n.m.	n.m.	n.m.	n.m.	n.m.	n.m.	n.m.	n.m.	n.m.	n.m.	n.m.	n.m.	n.m.	n.m.	n.m.

Source: Citi Research estimates

AU Optronics

Company description

AUO was established in 1996 (named Acer Display Technology before it merged with Unipac Optronics in 2001) and it successfully shrank the capacity gap with Korean panel makers after its acquisition of Quanta Display (QDI) in 2006. With a global market share of 16% in terms of shipments in 2011, AUO now ranks as the fourth-largest display panel company.

Investment strategy

We rate AUO shares Neutral (2). Given weak end-demand outlook and overhang from unsettled US litigation, we believe the company lacks earning catalysts in the near-term. On the other hand, we view AUO's OLED investment as a potential opportunity to penetrate non-Apple smartphone clients; yet we need to see meaningful revenue contribution and improving production yield to change our view.

Valuation

We cut target price to NT\$10.9 based on 0.55x FY12E P/B (from NT\$15.5 based on 0.7x FY12E P/B).

We set our price target of NT\$10.9 based on 0.55x FY12E P/B, close to the trough valuation of 3-year trading range of 0.4-1.3x. We apply a lower P/B multiple as we believe there will not be quick turnaround given weak demand outlook, limited panel price recovery, and the yield issue over premium products. We use P/B to value the stock because historically the sector has had high revenue and earnings volatility.

Risks

Key upside risks to our call include any brisk TV panel demand recovery along with panel price rebound. Key downside risks to our call include rapid ramp-up of Chinese panel makers' (e.g., BOE) G8 fabs that can further exacerbate the oversupply situation. Any of these risks could cause the shares to deviate from our target price.

Appendix A-1

Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

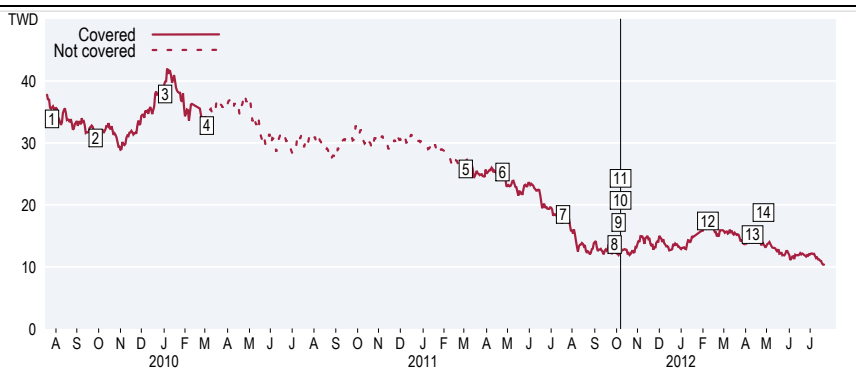
IMPORTANT DISCLOSURES

AU Optronics (2409.TW)

Ratings and Target Price History Fundamental Research

Analyst: Arthur Lai

Covered since March 3 2011



	Date	Rating	Target Price	Closing Price
1	28-Jul-09	1L	*42.72	35.73
2	28-Sep-09	1L	*42.50	30.85
3	4-Jan-10	1L	*45.00	39.90
4	3-Mar-10	Coverage terminated		
5	3-Mar-11	*2M	*30.00	27.10

* Indicates change

	Date	Rating	Target Price	Closing Price
6	25-Apr-11	2M	*29.00	24.80
7	19-Jul-11	2M	*20.00	17.30
8	29-Sep-11	2M	*14.00	12.45
9	5-Oct-11	2M	*13.50	11.90
10	7-Oct-11	Stock rating system changed		

	Date	Rating	Target Price	Closing Price
11	7-Oct-11	*2	13.50	12.30
12	8-Feb-12	2	*17.50	16.90
13	11-Apr-12	2	*16.00	14.55
14	26-Apr-12	2	*15.50	13.65

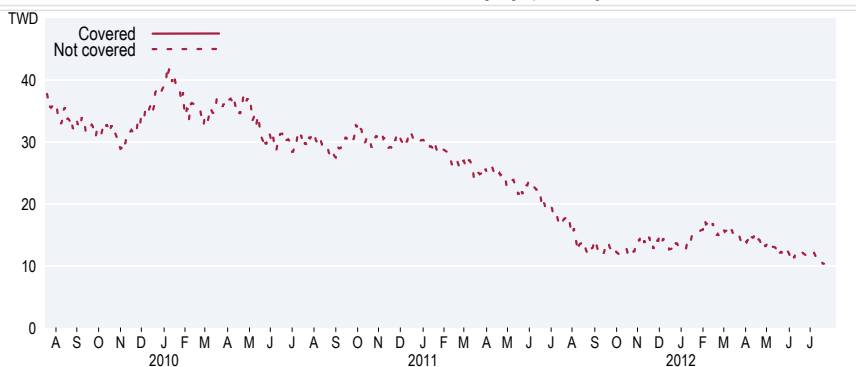
Rating/target price changes above reflect Eastern Standard Time

AU Optronics (2409.TW)

Ratings and Target Price History Best Ideas Research Relative Call (3 Month)

Analyst: Arthur Lai

Covered since March 3 2011



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12 Month Rating			Relative Rating		
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44%	43%	40%	48%	43%	45%

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