

Equities

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Hard Disk Drives

Alert: Why Supply Shortage Could Be a Good Thing

■ Industry Overview

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- **Quick Call** – Two weeks following the earthquake in Japan, what is becoming evident is that PC OEMs and distributors are concerned about drive supply, which in turn, is enabling drive makers to negotiate better pricing. We suspect that PC vendors are also feeling the urgency to secure inventory for the next 2-3 months. The result should be upside to both 1CQ TAM expectations and 2CQ GM guidance when the HDD vendors report earnings in April. We remain constructive on the HDD sector with Buys (1H) on both STX and WDC mainly based on our belief that the cycle will continue to recover during the next 2-3 quarters.
- **Recovery in the HDD Supply Chain** – The main concerns within the supply chain have revolved around the manufacturing disruptions at Kobe Steel and Furukawa Denko—which supply 100% of the aluminum blanks that are used in 3.5" desktop and enterprise drives. While Kobe does have a ground AI factory in Penang, our understanding is that the majority of the blanks are punched in Japan. Our checks indicate Furukawa has already been in operation for almost a week, and Kobe is planning to restart shortly. We note that the industry appears to have enough inventory of AI blanks until the end of April. Meanwhile, issues at TI's Miho plant have raised concerns about motor driver IC supply. While the Miho plant is not scheduled to come back on line until late April, we believe this should not affect STX and WDC materially given that they receive most of their ICs from TI's plant in Dallas.
- **1Q TAM Hinges on Last Two Week** – 1CQ TAM expectations have come down during the qtr primarily due to the unusually weak Feb notebook ODM shipment results (-26% mom). Recall that STX CFO Pat O'Malley also made some cautious comments earlier this month suggesting that the TAM could be "closer to the low end of the (155-165M) range". However, we continue to be comfortable with a TAM in the 160-162M range—vs street estimate of <160M—given that 1) March ODM units are tracking to a sharp 40-50% mom increase, but more importantly, 2) both PC OEMs and distributors are trying to secure near-term supply, which should lead to flurry of sales activity during the last two weeks of the qtr.
- **Supply Tightness Equals Pricing Power** – From the perspective of PC vendors, the fear of not having enough components trumps the fear of overpaying, which is why we believe PC OEMs will pay up for drives when they try to secure inventory for 2CQ. Our belief is further reinforced by the fact that drive inventory at the OEMs were already lean exiting February. In our opinion, this indicates a clear benefit to gross margin outlook for 2CQ, and meaningful estimate revisions following 1CQ results. We are currently forecasting 2CQ gross margins of 20-21% for both WDC and STX, above the street's 18.0% and 19.2%, respectively. We remind investors that a 1% change in gross margin equals a 10-15% change in EPS.

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

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Seagate Technology

(STX.O; US\$14.42; 1H)

Valuation

Our 12-month target price of \$23 is based primarily on a P/E analysis and is supported by our discounted cash flow analysis. We have chosen to apply our target P/E multiple to a “normalized EPS”, which is the annualized average EPS over the next 24 months. Our rationale is that the drive industry cycle (peak to peak) has occurred roughly every 2 years during the past 4 cycles. Hence, by averaging the earnings during the next 8 quarters, we are deriving the earnings power of the company through the next cycle.

During the past five years, STX shares have traded in a range of 4-13x F12 EPS with a median of 9-10x. We have chosen a mid-cycle multiple of 9x as we believe the HDD cycle will be in full swing by 2H11. The target multiple is a slight discount to WD (10x) based on a lower earnings growth profile. Applying the target multiple of 9x to our normalized EPS of estimate of \$2.53 (based on eight quarters of estimates beginning 3FQ11) results in a 12-month target price of \$23.

Our conservative DCF analysis assumes 1% annual decline in revenues during the next 10 years, a 1% terminal growth in free cash flow, and a weighted average cost of capital of 10.3%. This analysis yields a 12-month target of \$22.50.

Risks

We rate STX shares High Risk primarily because of the stock’s volatility (beta of 1.5). Earnings visibility can be relatively low given the cyclical nature of the drive industry, and lack of recurring profits.

The primary downside risks involved in investing in STX shares include the following: 1) A secular headwind in mission-critical Enterprise drives, as adoption of near-line drives accelerate, 2) a meaningful cannibalization of the notebook market by media tablets, 2) irrational pricing by competitors, which generally occur during periods of supply-demand imbalance, 3) a further narrowing in the price gap between NAND and HDD, 4) high dependency on the PC market (65-70% of units), and 5) potential mis-execution during product transitions, which could make the company less cost competitive. Should any of these risks have a greater negative impact on the company than we anticipate, the shares could materially underperform our target price.

Western Digital Corp

(WDC.N; US\$37.39; 1H)

Valuation

Our 12-month target price of \$60 is based on a combination of P/E and discounted cash flow analysis. We have chosen to apply our target P/E multiple to a “normalized EPS”, which is the annualized average EPS over the next 24 months. Our rationale is that the drive industry cycle (peak to peak) has occurred roughly every 2 years during the past 4 cycles. Hence, by averaging the earnings during the next 8 quarters, we are deriving the earnings power of the company through the next cycle.

During the past five years, WDC shares have traded in a range of 4-13x F12 EPS with a median of 9-10x. We have chosen a mid-cycle multiple of 10x as we believe the HDD cycle will be in full swing by 2H11. Applying the target multiple of 10x to our normalized operating EPS of estimate of \$4.68 (based on eight quarters of estimates beginning 3FQ11) and adding back \$13/share in cash results in a 12-month target price of \$60.

Our conservative DCF analysis assumes only 1% revenue growth during the next 10 years, and no terminal growth in free cash flow, and a weighted average cost of capital of 10.26%. This analysis yields a 12-month target of \$59.

Risks

We rate WDC shares High Risk primarily because of the stock's volatility (beta of 1.5). Earnings visibility can be relatively low given the cyclical nature of the drive industry, and lack of recurring profits.

The primary downside risks involved in investing in WDC shares include the following: 1) Meaningful cannibalization of the notebook market by media tablets, 2) irrational pricing by competitors, which generally occur during periods of supply-demand imbalance, 3) a further narrowing in the price gap between NAND and HDD, 4) high dependency on the PC market (~70% of units), and 5) potential mis-execution during product transitions, which could make the company less cost competitive. Should any of these risks have a greater negative impact on the company than we anticipate, the shares could materially underperform our target price.

Appendix A-1

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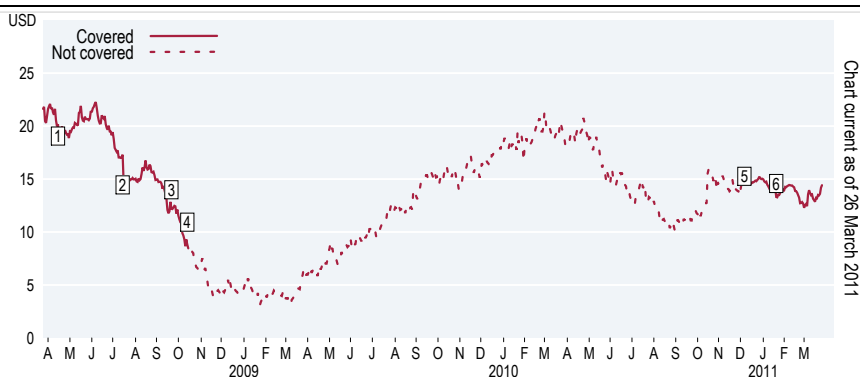
Seagate Technology (STX)

Ratings and Target Price History

Fundamental Research

Analyst: Joe Yoo

Covered since December 7 2010



	Date	Rating	Target Price	Closing Price
1	15-Apr-08	2H	*22.00	20.17
2	15-Jul-08	2H	*20.00	17.30

* Indicates change

	Date	Rating	Target Price	Closing Price
3	22-Sep-08	2H	*14.00	12.19
4	14-Oct-08	Coverage terminated		

	Date	Rating	Target Price	Closing Price
5	7-Dec-10	*1H	*20.00	15.16
6	20-Jan-11	1H	*23.00	13.31

Rating/target price changes above reflect Eastern Standard Time

Seagate Technology (STX)

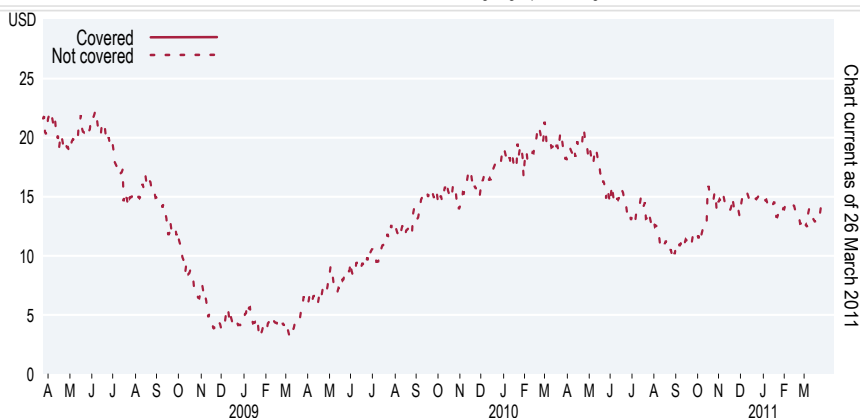
Ratings and Target Price History

Best Ideas Research

Relative Call (3 Month)

Analyst: Joe Yoo

Covered since December 7 2010



* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Western Digital Corp (WDC)

Ratings and Target Price History

Fundamental Research

Analyst: Joe Yoo
Covered since December 7 2010



	Date	Rating	Target Price	Closing Price
1	24-Apr-08	2H	*35.00	31.25
2	25-Jul-08	2H	*32.00	30.94

* Indicates change

	Date	Rating	Target Price	Closing Price
3	22-Sep-08	2H	*27.00	21.79
4	14-Oct-08	Coverage terminated		

	Date	Rating	Target Price	Closing Price
5	7-Dec-10	*1H	*55.00	35.08
6	19-Jan-11	1H	*60.00	32.97

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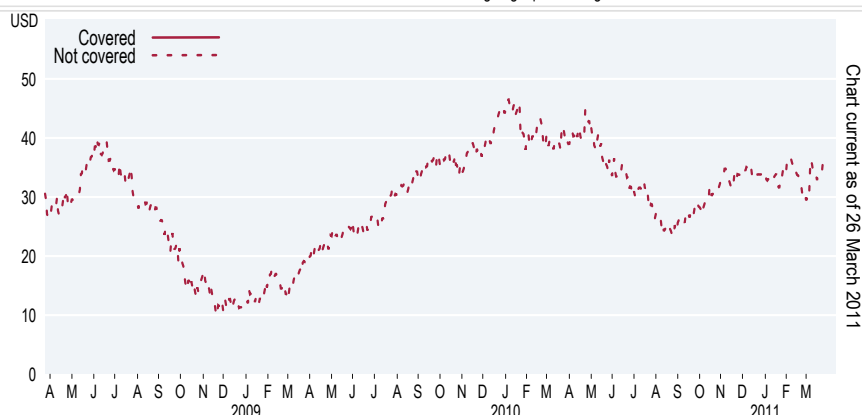
Western Digital Corp (WDC)

Ratings and Target Price History

Best Ideas Research

Relative Call (3 Month)

Analyst: Joe Yoo
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Rating/target price changes above reflect Eastern Standard Time

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