



26 October 2005

# MEMC Electronic Materials

Reuters: **WFR.N** Bloomberg: **WFR UN** Exchange: **NYSE** Ticker:

## Rita rains on MEMC

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### Gross margin miss, but fundamentals intact

Despite what we see as slightly lower than anticipated gross margin that, for conservatism's sake, we carry forward into 2006, we believe higher revenue should compensate, and we leave C2006 EPS estimates unchanged. We expect near term weakness in the stock, but believe fundamentals remain intact. We reiterate our Buy rating and \$24 price target, and look for incremental gross margin improvement, and 2006 revenue upside from polysilicon.

### F3Q05 (Sep) misses expectations

MEMC posted revenue and operating EPS of \$288.3M and \$0.25 below our and consensus estimates of \$289M and \$0.29. Gross margin of 35.1% missed our estimate of 36.8% due to hurricane Rita (Houston facility impact), and costs related to unrecognized revenue. Revenue upside was erased by the hurricane and a change in revenue recognition policy with respect to polysilicon.

### F4Q05 (Dec) ahead of expectations, but must normalize in relation to F3Q

MEMC guided F4Q05 revenue to \$310M to \$313M and gross margin to 39%. Revenue and GM include the benefit of \$7.3M in deferred revenue with associated cost booked in F3Q. Again, we believe revenue guidance is modestly conservative. Adjusting for the impact of deferred revenue, "normalized" gross margin for Q3 and Q4 would be 36.7% and 37.1% respectively, slightly below our prior expectations. We project F4Q05 revenue and EPS of \$311M and \$0.34, above prior estimates. 2H05 will yield higher revenue on slightly lower than anticipated gross margin. We moderate our margin assumptions, but believe discrete stock catalysts remain intact. (We note backlog is greater than F3Q rev.)

### Maintain Buy rating, \$24 price target

At \$19.34 WFR trades at 13.8x our 2006 EPS estimate of \$1.40, at a discount to peers. As a commodity supplier offset by operational performance and positively converging industry fundamentals, we believe a modest discount could be justified, and maintain our price target of ~\$24 or ~17x our C2006 EPS estimate. We anticipate discrete stock catalysts of spot wafer shortages, and revenue upside from polysilicon.

### Forecasts and ratios

Year End Dec 31	2004A	2005E	2006E
1Q EPS (USD)	0.16	<b>0.23</b>	0.32
2Q EPS (USD)	0.20	<b>0.26</b>	0.33
3Q EPS (USD)	0.27	<b>0.25</b>	0.36
4Q EPS (USD)	0.25	<b>0.34</b>	0.39
FY EPS (USD)	0.89	<b>1.08</b>	1.40
OLD FY EPS (USD)	0.89	<b>1.09</b>	1.40
Dividend yield (%)	0.0	<b>0.0</b>	0.0
EV/EBITDA (x)	6.7	<b>11.5</b>	8.8
Revenue (USDm)	1,028.0	<b>1,132.5</b>	1,306.5

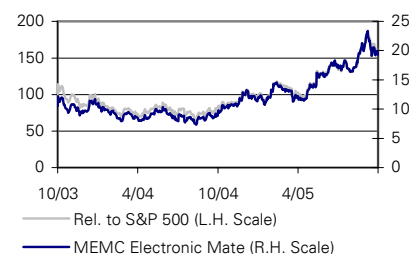
Source: Company, Deutsche Securities

## Results Review

### Buy

Price at 26 Oct 2005 (USD)	<b>19.34</b>
Price target	<b>24.00</b>
52-week range	<b>23.39 - 9.40</b>

### Price/price relative



Performance (%)	1m	3m	12m
Absolute	-6.9	9.6	118.0
S&P 500	-2.0	-3.2	7.2

### Stock data

Market Cap (USDm)	<b>4,075.6</b>
Shares outstanding (m)	<b>210.7</b>
Volume	<b>2,762,100</b>
S&P 500	<b>1,196.54</b>

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**Looking at aggregate 2H05 numbers to gauge operating performance**

2H05 adjusted expectations are for revenue, EPS and gross margin of \$600M, \$0.59 and 36.9% respectively versus our prior expectation of \$593.4M, \$0.60 and 37%. Under prior assumptions the \$600M revenue number would have generated \$0.61. The modest shortfall was due to slightly lower gross margin, and slightly higher operating expenses. The majority of the F3Q operational shortfall (with respect to our expectations) pushes to FQ4, but does fall a bit short of our expectations. Although in-line with the company's model, we temper our gross margin expectations modestly through 2006.

**Adjusting estimates – EPS unchanged on slightly higher revenue**

We are tweaking our C2005 revenue and EPS estimates to \$1.132.5M and \$1.08 from \$1,126.6M and \$1.09 on slightly lower gross margin. We are modestly adjusting our C2006 revenue estimates to \$1,306.5M from \$1,286.9M, and maintaining EPS at \$1.40 on a slightly more conservative modeling of gross margin through 2006.

**Polysilicon's contribution to upside**

Sales of polysilicon to the solar panel industry were roughly \$25M in F3Q, and should ramp commensurate with MEMC's excess polysilicon supply. MEMC indicated it would ramp polysilicon production capacity incrementally in early 2006 with significantly more capacity coming on line in 2H06. (The company can ramp polysilicon production capacity by ~40% in existing facilities.) We believe this should add upside to our estimates in 2006.

**Restatement of prior periods – reversing a tax benefit**

MEMC will restate 1Q05 and 2Q05 results to reverse a favorable tax adjustment of \$18.8M made in 1Q05. The restatement should result in a \$0.08 decrease in reported 1Q05 EPS, but not have a material impact to revenue, operating EPS, or cashflow.

**The stock**

Although EPS estimates do not change in 2006, we anticipate that slightly lower gross margins combined with the impact of accounting changes will generate near term weakness in the stock. We view weakness as a good buying opportunity as we believe that industry fundamentals have not changed, and we believe upside to 2006 estimates is likely.

**Valuation**

At \$19.34 WFR trades at 13.8x our 2006 EPS estimate of \$1.40, at a discount to peers. We value semiconductor materials companies at ~15x to ~21x C2006 EPS estimates. As a commodity supplier offset by operational performance and positively converging industry fundamentals, we believe a modest discount could be justified, and maintain our price target of ~\$24 or ~17x our C2006 EPS estimate. We anticipate discrete stock catalysts of spot wafer shortages, and revenue upside from polysilicon sales that should ramp with MEMC's production ramp in 2006. We also look for instances of pricing strength in contracts to be negotiated with chipmakers in F4Q.

**Risks**

Risks include (1) a high degree of industry cyclicality, (2) competitive pressures and market share shifts, (3) a change in the polysilicon supply/demand dynamic, (4) delayed adoption of new technologies, (5) operational execution missteps, and (6) general economic risk.

**Figure 1: MEMC - F3Q actuals versus estimates**

Fiscal year ending December	3Q05A	3Q05E	Difference
<b>Total Sales</b>	\$288.3	\$289.2	(0.9)
Cost of Goods	187.0	182.7	4.2
<b>Gross Income</b>	101.3	106.4	(5.1)
R&D	13.9	10.8	3.1
SG&A	18.1	18.9	(0.8)
<b>Operating Income</b>	69.2	76.6	(7.4)
Other Income (Exp)	(1.5)	0.0	(1.5)
JV Royalty Income			
Pretax Income	67.7	76.6	(8.9)
Taxes	9.1	10.3	(1.2)
Equity in (loss)/income of JVs			
Minority Interest	(1.5)	(1.5)	0.0
Extraordinary Item	(40.8)	1.9	(42.7)
<b>Net Income</b>	97.9	62.9	35.0
<b>Net Income-Continuing Operations</b>	57.1	64.8	(7.7)
Avg. Shares Outstanding - Basic	214.7	209.8	4.9
<b>Basic EPS</b>	\$0.46	\$0.30	\$0.16
Avg. Shares Outstanding - Diluted	227.1	224.9	2.2
<b>Diluted EPS</b>	\$0.43	\$0.28	\$0.15
Avg. Shares Outstanding - Diluted	227.1	224.9	2.2
<b>Diluted EPS (Excl. Charges)</b>	\$0.25	\$0.29	(\$0.04)

**3Q05 Review:**

<b>Sales: Actual</b>	\$288.3 million
DB Estimate	\$289.2 million
Company Guidance	\$283.6 - \$289.2 million (Up 3% to 5%)
Street consensus	\$288.8 million

<b>EPS: Actual</b>	\$0.25
Company Guidance	None
DB Estimate	\$0.29
Street consensus	\$0.29

**Margin Structure\***

	3Q05A	3Q05E	Difference
Cost of Goods Sold	64.9%	63.2%	1.7
Gross Margin	35.1%	36.8%	(1.7)
R&D	4.8%	3.8%	1.1
SG&A Expenses	6.3%	6.6%	(0.3)
Operating Margin	24.0%	26.5%	(2.5)
EBITDA Margin	29.0%	31.5%	(2.5)
Tax Rate	13.5%	13.5%	0.0
Net Margin	19.8%	22.4%	(2.6)

**Outlook: 4Q05**

<b>Sales:</b>	
Company Guidance	\$310 - \$313 million
DB Estimate	\$304.2 million
<b>Revised DB Est</b>	<b>\$311.0 million</b>

<b>EPS:</b>	
Company Guidance	None
DB Estimate	\$0.31
<b>Revised DB Est</b>	<b>\$0.34</b>

**Growth Leverage\***

	3Q05A	3Q05E	Difference
Sales	4.7%	5.0%	(0.3)
Cost of Goods Sold	13.6%	11.1%	2.6
Gross Income	-8.5%	-3.9%	(4.6)
R&D	48.1%	15.2%	32.9
SG&A Expenses	2.1%	6.6%	(4.5)
Operating Income	-17.1%	-8.3%	(8.8)
EBITDA	-12.0%	-4.2%	(7.8)
Net Income	-4.4%	8.5%	(12.8)
Diluted EPS	-7.2%	6.3%	(13.5)

Source: Company Reports and DB estimates.

\* All numbers are on an operating basis and exclude special charges.

Source: Company reports and Deutsche Bank

# Appendix 1

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Disclosure checklist			
Company	Ticker	Recent price	Disclosure
MEMC Electronic Materials	WFR.N	19.94 (USD) 24 Oct 05	6,13

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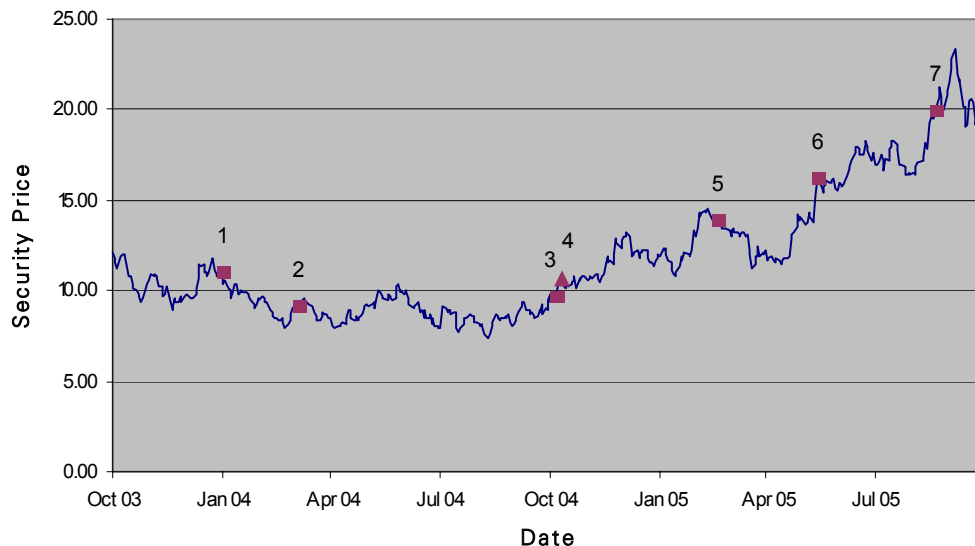
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**Historical recommendations and target price: MEMC Electronic Materials (WFR.N)**

(as of 10/26/2005)

Previous Recommendations

Strong Buy  
Buy  
Market Perform  
Underperform  
Not Rated  
Suspended Rating

Current Recommendations

Buy  
Hold  
Sell  
Not Rated  
Suspended Rating

\*New Recommendation Structure  
as of September 9, 2002

- |  |   |
|--|---|
| 1. 1/27/2004: Buy, Target Price Change USD14.00            | 5. 3/18/2005: Buy, Target Price Change USD16.00 |
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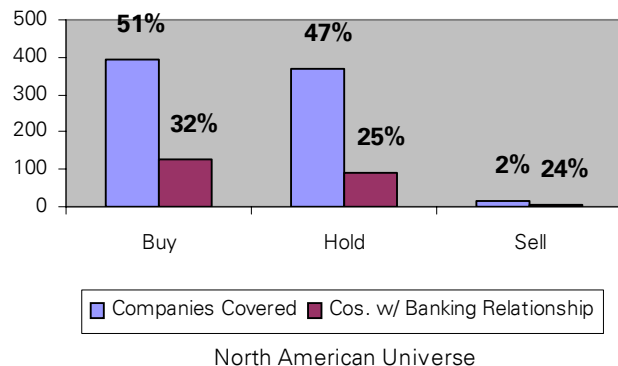
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