



26 July 2005

MEMC Electronic Materials

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

Long term prognosis is good

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Long-term trend is positive

We believe the secular trend of wafer starts growth, the company's improved market position and operational performance, and a building polysilicon supply imbalance bode well over the longer term for MEMC. Despite seemingly conservative F3Q revenue guidance, earnings power remains intact, and we expect upside to manifest in 2006. We maintain our Buy rating and \$19 price target.

F2Q05 (Jun) slightly ahead of expectations

MEMC posted revenue and EPS of \$275M and \$0.26 versus our estimates of \$274M and \$0.26, and consensus of \$270M and \$0.26. Gross margin of 36.5% and operating margin of 25.8% were slightly ahead of our expectation. Although less pronounced than in Q105, pricing pressure persisted in Q205, but should wane as wafer demand increases in 2H05.

F3Q05 (Sep) revenue guidance may be a bit conservative

MEMC guided to F3Q05 revenue growth of 3% to 5%, below our expectation of 6%, albeit off a slightly higher base. We believe this guidance is conservative, and project F3Q05 revenue and EPS of \$289M (up 5%) and \$0.29, in-line with our prior estimate of \$290M and \$0.29, and consensus of \$289M and \$0.30. We believe continued pricing pressure in F3Q due to lingering contractual obligations contributes to revenue guidance. We expect pricing power to begin to build toward year end as polysilicon shortages could begin to manifest as wafer shortages in an increasing demand environment.

Maintain Buy rating, \$19 price target

At \$17.50 WFR trades at 13.5x our 2006 EPS estimate of \$1.30, a discount to peers. We are adjusting F2006 EPS estimates to \$1.30 from \$1.28 due to a more favorable tax rate. As a commodity supplier offset by operational performance and positively converging company and industry fundamentals, we believe a modest discount could be justified, and maintain our price target of ~\$19 or 15x our C2006 EPS estimate. We believe that an industry leading margin structure and operating profitability should help lift a persistent valuation discount.

Forecasts and ratios

Year End Dec 31	2004A	2005E	2006E
1Q EPS (USD)	0.16	0.23	0.30
2Q EPS (USD)	0.20	0.26	0.31
3Q EPS (USD)	0.27	0.29	0.34
4Q EPS (USD)	0.25	0.31	0.36
FY EPS (USD)	0.89	1.09	1.30
Revenue (USDm)	1,028.0	1,126.6	1,286.9

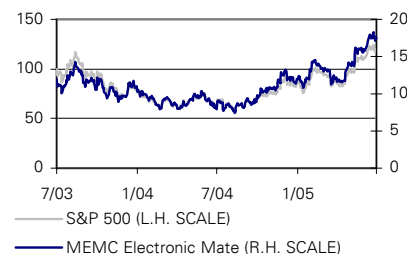
Source: Deutsche Bank

Results Review

Buy

Price at 27 Jul 2005 (USD)	17.50
Price target	19.00
52-week range	18.29-7.39

Price/price relative



Performance(%)	1m	3m	12m
Absolute	12.9	43.8	120.7
S&P 500	3.9	7.0	13.0

Stock data

Market Cap (USDm)	3,666.5
Shares outstanding (m)	209.5
Volume	2,085,200
S&P 500	1,231.16

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Pricing dynamics

With polysilicon supply consistently at 100% of industry capacity, many have expected near term pricing power for wafer suppliers with captive polysilicon production. Such a market dynamic builds in over time. With wafer manufacturing utilization at 85% to 90%, polysilicon consistently sold out, and lingering contractual wafer supply obligations, conditions are converging to drive pricing power for wafer manufacturers. Historically, spot shortages of wafers tend to occur when utilization exceeds 95%. With rising wafer demand, slowly increasing polysilicon supply, and wafer supply contracts expiring in the near term, we would anticipate spot wafer shortages to drive new pricing and supply agreements in which companies like MEMC can exercise a measure of pricing power. We believe this should begin to occur in 2H05, with effectivity in 1H06. Consequently, we anticipate upside to numbers from the anticipated pricing dynamic in 2006, and not likely before.

New long term business model

MEMC updated its long term business model, increasing operating metrics to be consistent with recent operational performance and future expectations.

Figure 1: MEMC Long term business model

	<u>New Model</u>	<u>Old Model</u>
Operating Profit	25% to 30%	23%+
Gross Margin	35% to 40%	35%+
Operating Expenses	Approx. 10%	12% or less
Capital Expenditures	15% or less	15% or less
Operating Cash Flow	25% to 30%	20%+
Free Cash Flow	10% to 15%	5% to 10%
Avg. Annual EPS Growth	Approx. 20%	Not stated

Source: MEMC Electronics publication

Adjusting numbers

We are very modestly adjusting our C2006 revenue and EPS estimates to \$1,287M and \$1.30 from \$1,291M and \$1.28 to reflect a more favorable tax rate.

Risks

Risks include (1) a high degree of industry cyclicality, (2) competitive pricing pressures and market share shifts, (3) operational execution missteps, (4) delayed adoption of new technologies, (5) rapid product life cycles, and (6) general economic risk.

Figure 2: MEMC actuals versus estimates

Fiscal year ending December	2Q05A	2Q05E	Difference
Total Sales	\$275.4	\$273.7	1.6
Cost of Goods	175.0	174.4	0.6
Gross Income	100.4	99.4	1.1
R&D	11.0	11.5	(0.5)
SG&A	18.3	18.8	(0.4)
Operating Income	71.1	69.1	2.0
Other Income (Exp)	(1.5)	(0.1)	(1.4)
JV Royalty Income			
Pretax Income	69.6	69.0	0.6
Taxes	8.7	10.4	(1.7)
Equity in (loss)/income of JVs			
Minority Interest	(2.0)	(1.5)	(0.5)
Extraordinary Item			0.0
Net Income	58.9	57.2	1.7
Net Income-Continuing Operations	58.9	57.2	1.7
Avg. Shares Outstanding - Basic	209.2	208.7	0.5
Basic EPS	\$0.28	\$0.27	\$0.01
Avg. Shares Outstanding - Diluted	224.7	222.4	2.3
Diluted EPS	\$0.26	\$0.26	\$0.01
Avg. Shares Outstanding - Diluted	224.7	222.4	2.3
Diluted EPS (Excl. Charges)	\$0.26	\$0.26	\$0.01

Margin Structure*	2Q05A	2Q05E	Difference
Cost of Goods Sold	63.5%	63.7%	(0.2)
Gross Margin	36.5%	36.3%	0.2
R&D	4.0%	4.2%	(0.2)
SG&A Expenses	6.7%	6.9%	(0.2)
Operating Margin	25.8%	25.3%	0.6
EBITDA Margin	30.7%	30.1%	0.5
Tax Rate	12.4%	15.0%	(2.6)
Net Margin	21.4%	20.9%	0.5

Growth Leverage*	2Q05A	2Q05E	Difference
Sales	7.8%	7.1%	0.6
Cost of Goods Sold	3.9%	3.6%	0.3
Gross Income	15.2%	14.0%	1.2
R&D	18.8%	24.1%	(5.3)
SG&A Expenses	2.8%	5.1%	(2.3)
Operating Income	18.4%	15.1%	3.3
EBITDA	20.1%	17.3%	2.8
Net Income	34.5%	30.5%	4.0
Diluted EPS	32.3%	29.7%	2.6

Source: Company Reports and DB estimates.

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

Source: Deutsche Bank

2Q05 Review:**Actual**

Sales:	\$275.4 million
DB Estimate	\$273.7 million
Company Guidance	\$263 - \$271 million (Up 2% to 5%)
Street consensus	\$269.5 million

Actual

EPS:	\$0.26
Company Guidance	None
DB Estimate	\$0.26
Street consensus	\$0.26

Outlook: FY 3Q05**Sales:**

Company Guidance	\$283.6 - \$289.2 million (Up 3% to 5%)
DB Estimate	\$290.2 million
Revised DB Est	\$289.2 million

EPS:

Company Guidance	None
DB Estimate	\$0.29
Revised DB Est	No Change

Appendix 1

Important Disclosures

Additional information available upon request

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Company	Ticker	Recent price	Disclosure
MEMC Electronic Materials	WFR.N	17.66 (USD) 25 Jul 05	7,13

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

(as of 7/27/2005)

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. 8/6/2003: Buy, Target Price Change USD15.00 | 5. 11/8/2004: Buy, Target Price Change USD14.00 |
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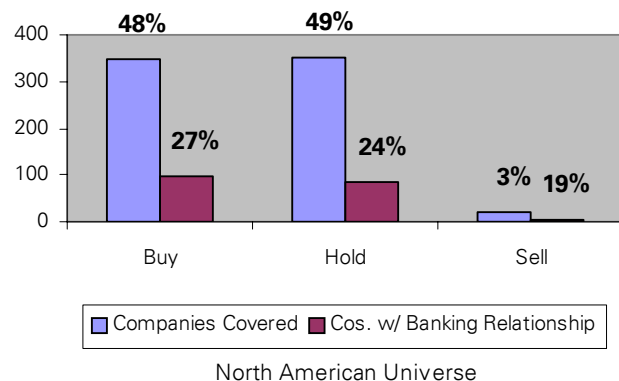
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