



16 September 2005

# MEMC Electronic Materials

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

## Raising price target to \$24

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### Reiterate Buy, raising price target to \$24

We reiterate our Buy rating and raise our price target on WFR to \$24 from \$19 based on (1) a modest increase in our 2006 EPS estimate (\$1.40 vs \$1.30 prior), and (2) a modest expansion in P/E multiple (17x vs 15x) for valuation purposes. We believe operational performance and fundamentals are aligned positively for 2006, and justify our improved outlook.

### Operational performance calls for multiple expansion

MEMC's sales growth trajectory (16%+ CAGR since 2001), market share gains (from ~12% in 2001 to ~15%-16% now), cost structure rationalization (operating margins of ~30% in 2001 to ~26% in 2005), cash generation capability (FCF margin of ~12% in 2001 to ~8% in 2005), and positioning for growth with expanded markets (i.e. solar wafers), driving a new business model with 13%-15% revenue growth and ~20% EPS growth, point to a fully reinvigorated company. We believe the improved operational performance justifies valuation multiple expansion.

### Business fundamentals well aligned, raising C2006 EPS to \$1.40 from \$1.30

Noting polysilicon supply-demand dynamics, we believe MEMC's vertically integrated business model (1) enhances its competitive positioning within the semiconductor industry via a cost advantage, a possible supply advantage, and the ability to fully leverage potential pricing power in 2006, (2) helps it capitalize on the secular shift toward 300mm wafers, which we estimate at ~50% of sales in C2006 from ~40% currently, and (3) increases its potential to negotiate long-term supply relationships with solar panel manufacturers. In view of these positive themes we are modestly increasing our C2006 EPS estimate by \$0.10 to \$1.40.

### Valuation discount far too wide

At \$19.88 WFR trades at 14.2x our 2006 EPS estimate of \$1.40, a 24% discount to peers. With the turnaround complete and noting strong operational performance, offset somewhat by being a commodity supplier, we believe a 5%-10% valuation discount to the peer group's ~19x EPS multiple is more appropriate. Accordingly, we value WFR at \$24 or ~17x our C2006 EPS estimate.

### 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>0.29</b>	0.36
4Q EPS (USD)	0.25	<b>0.31</b>	0.39
FY EPS (USD)	0.89	<b>1.09</b>	1.40
P/E (x)	10.6	<b>18.2</b>	14.2
Revenue (USDm)	1,028.0	<b>1,126.6</b>	1,286.9

Source: Deutsche Bank

### Estimate Revision

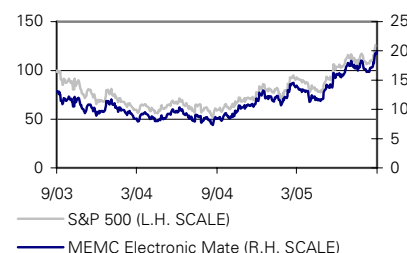
#### Buy

Price at 16 Sep 2005 (USD)	<b>19.88</b>
Price target	<b>24.00</b>
52-week range	<b>19.62-8.05</b>

#### Key changes

Price target	19.00 to 24.00	↑	<b>26.3%</b>
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#### Price/price relative



Performance(%)	1m	3m	12m
Absolute	12.3	25.0	136.7
S&P 500	0.7	1.4	9.3

#### Stock data

Market Cap (USDm)	<b>4,165.2</b>
Shares outstanding (m)	<b>209.5</b>
Volume	<b>3,130,800</b>
S&P 500	<b>1,227.73</b>

#### Key indicators

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## A closer look at valuation

### Asset write downs

MEMC's asset write downs totaling nearly \$1.8B in the gross PPE asset base in 2001 coupled with periods of over/under investment resulted in depreciation and amortization expenses currently running ~10% below capital expenditures as a percentage of sales. This has raised the question of earnings quality as the perception may exist that MEMC's earnings benefit unduly from these past asset write-offs, and that earnings multiples appear artificially low. We believe this is a valid argument up to a point, but given that lower D&A expenses are a business reality, that the underlying operational improvement in MEMC is unmistakable, and is clearly reflected in an earnings growth trend, we do not see it as a major issue. We see the lower D&A issue more as a relic of the past, one that needed to be scrutinized and adjusted while the company was in a turnaround stage. Although D&A being close to capital expenditures may be an ideal investor preference, we note that the disparity is unlikely to be bridged anytime soon as the asset intensity of the business has come down from write-offs.

### Tax rate

MEMC currently has ~\$113M in valuation allowance (of which roughly 75% is realizable) that serves as a tax offset and reduces the company's tax rate. We expect MEMC's C2005 tax rate to hover around 13.5%, and to track ~15% over the next couple of years when considering tax planning and deferred tax assets. We estimate MEMC's deferred tax assets will be mostly utilized by C2007, and we expect tax rates to hover in the 20%-25% range in C2008 and beyond before eventually reaching a more normal corporate tax rate in-line with other operating companies. MEMC's tax rates are unlikely to see a sharp increase due to tax planning opportunities, tax holidays, and the business mix from lower tax jurisdictions that can help offset the eventual rise in the company's effective tax rate.

### Free cash flow valuation

Given the asymmetry in MEMC's capital expenditures (that are reflected in the cash flow statement), its D&A expenses (which flow through the income statement and cash flow statement), and its lower tax rate versus peers, we believe a fair way to resolve any earnings valuation controversy is to look at free-cash flow multiples. On a free cash flow basis, MEMC trades in-line with peers, and at a 6% discount to ATMI, a smaller company with more specialty products that completed a major restructuring in 2004.

All things considered, our \$24 price target implies at ~15% premium to peers on a free cash flow basis, which we believe is not a stretch given MEMC's unique position to be able to leverage positively converging company and industry fundamentals (i.e. 2006 pricing strength and cost advantages, as well as lower D&A and lower tax rates).

### P/E multiple expansion

Over the past year MEMC's P/E multiple expanded from ~9x forward year earnings to ~15x currently, as the company transitioned from a turnaround story to a solid operating story. We believe MEMC's operating catalysts and earnings power are well aligned for a sustained period of growth for the near to medium term. We do note the commodity nature of MEMC's business, and believe a valuation discount of 5%-10% to peers, or 17x 2006 EPS, is justifiable.

### Peer group comp valuation table

Materials	Rating &	Price		Market	CY EPS		Calendar P/E		TEV/Sales		TEV/EBITDA		Price/		Price/FCF
		Target	9/16/05		2005E	2006E	2005E	2006E	2005E	2006E	2005E	2006E	TBV	2005E	2006E
MEMC Electronic Materials	WFR	Buy, \$24	\$19.88	4,467	1.09	1.40	18.2	14.2	4.0	3.5	12.8	10.2	7.9	51.9	26.8
Entegris	ENTG	Buy, \$13	\$11.43	1,559	NA	0.67	NA	17.1	NA	1.9	NA	7.9	2.9	NA	20.1
ATMI Inc.	ATMI	Hold, \$29	\$31.35	1,161	0.96	1.35	32.7	23.3	3.2	2.8	13.7	10.4	2.9	129.2	28.4
Photronics	PLAB	NR	\$21.21	960	1.16	1.03	18.3	20.6	2.0	1.9	5.7	5.0	2.3	NA	NA
Cabot Microelectronics	CCMP	Hold, \$30	\$29.80	733	1.31	1.70	22.8	17.6	2.1	1.9	9.0	7.3	2.2	38.8	31.4
MEAN							23.0	18.5	2.8	2.4	10.3	8.1	3.6	73.3	26.7

### **TPG ownership**

Texas Pacific Group (TPG) recently reduced its ownership in MEMC to ~25%. Often cited as an overhang to the stock, considering company and industry fundamentals we believe present TPG ownership no longer presents a meaningful concern.

### **Risks**

Risk factors include, but are not limited to, (1) a high degree of industry cyclicality, (2) competitive pressures and market share shifts, (3) delayed adoption of new technologies, (4) operational execution missteps, (5) rapid technology changes and product cycles, and (6) general economic risk.

# Appendix 1

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Additional information available upon request

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Company	Ticker	Recent price	Disclosure
MEMC Electronic Materials	WFR.N	19.89 (USD) 15 Sep 05	13

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

(as of 9/16/2005)

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  | 4. 11/8/2004: Buy, Target Price Change USD14.00 |
| 2. 3/31/2004: No Recommendation, USD14.00        | 5. 3/18/2005: Buy, Target Price Change USD16.00 |
| 3. 11/2/2004: Hold, Target Price Change USD10.00 | 6. 6/10/2005: Buy, Target Price Change USD19.00 |

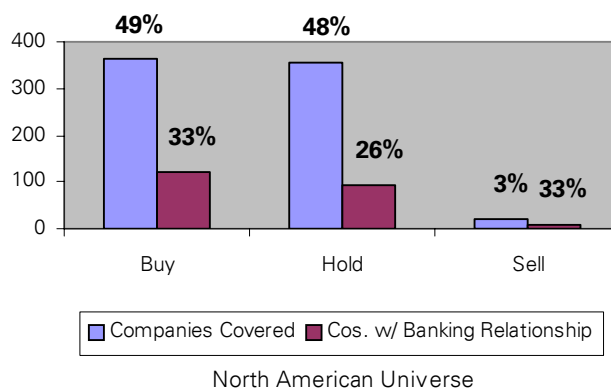
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