LEADING

Mid-Cap Research

STS Semiconductor (036540 KQ)

Mar 26, 2012

(SEC↑+ Hyunix↑) ÷ Elpida↓ = STS Semi↑

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Leading Traffic Light: Green

STS Semiconductor is…

- ✓ A back-end process company that is expected to benefit from Elpida's bankruptcy
- ✓ Expected to generate W1.0tr in revenue by 2013F

Green light because:

- ✓ Stabilization of product lines in Philippines
- ✓ Earnings expected to recover from April 2012 after inventory adjustment in 1Q12E
- ✓ New non-memory product line is the company's new growth engine

Growth potential:

- ➢ Rapid growth expected as the prime beneficiary of SEC's back-end outsourcing
- ➢ Will fully implement batch production system in NAND packaging beginning 2012

Management and shareholder value:

- ➢ CEO was the division head of back-end process at SEC, thus has thorough knowledge of the process and experience to deal with unforeseen situations
- ➢ Focusing on accumulation of and investing in capex rather than high dividend yield

Value creation:

- ➢ Improved margin in Philippines Branch dramatically improves ROE:
  2011: 5.2% → 2012:12.1% → 2013: 21.4%
- ➢ Continuous returns from investments to increase ROIC less WACC
  2011: -3.1% → 2012:2.9%% → 2013: 6.6%

Valuation:

- ➢ Derived a target price of W15,400 by applying the EV/EBITDA of 6.6X
- ➢ 64.5% upside potential from the current share price of W9,360

CAVEAT EMPTOR!!! – Watch out for…

- ➢ Need to check the status of Philippines branch as the company is not obligated to post the status of subsidiaries on quarterly basis

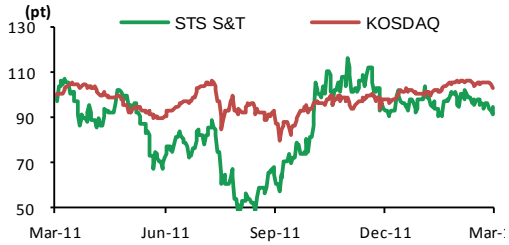
BUY

Target Price (KRW)	**W15,400**
Current Price (KRW)	**W9,360**
Upside potential	**64.5%**

Key Data	**Mar 23, 2012**
Sector	Semiconductor
Kosdaq	527.47
Market Cap. (Wbn)	405.3
Share Outstanding (m)	43.3
Foreign Ownership (%)	21.2%
52 Week High (W)	11,450
52 Week Low (W)	4,670
60-d avg.turnover (Wbn)	14.4
Major Shareholders	**(%)**
BK LCD Co., Limited	28.36
STS Treasury stock	1.68

Performance (%)	**1M**	**6M**	**12M**
Absolute	(0.6)	46.9	(2.5)
Relative	2.4	28.8	(5.2)

Relative Performance



Valuation Forecast

FY	Sales (Wbn)	% chg yoy	OP (Wbn)	OPM (%)	NP (Wbn)	EPS (W)	EPS Growth (%)	PER (x)	EV/EBITDA (x)	ROE (%)	P/B (x)
2009	335.6	17.0	(15.8)	(4.7)	(41.3)	(1,866.6)	N/A	N/A	22.9	(24.7)	1.1
2010	530.5	58.1	8.5	1.6	(3.0)	(86.8)	N/A	N/A	8.0	(1.6)	1.3
2011	463.5	(12.6)	25.4	5.5	11.0	253.3	흑전	36.9	5.9	5.2	1.6
2012E	719.0	55.1	58.2	8.1	28.8	664.7	162.4	14.1	4.0	12.1	1.6
2013E	1,083.4	50.7	93.2	8.6	56.4	1,302.9	96.0	7.2	3.0	21.4	1.5
2014E	1,419.3	31.0	122.1	8.6	80.8	1,866.2	43.2	5.0	2.3	25.9	1.2

Table of contents

Semiconductor supply chain series #3 – STS Semiconductor..... 3

Key checkpoints..... 5

Section 1-1: Valuation – Target price..... 6

Section 1-2: Valuation – Peer Valuation..... 7

Section 2: Company snapshot..... 8

Section 3: Facts and figures? 11

Section 4: What is the management philosophy?..... 13

Section 5: Operations overview..... 14

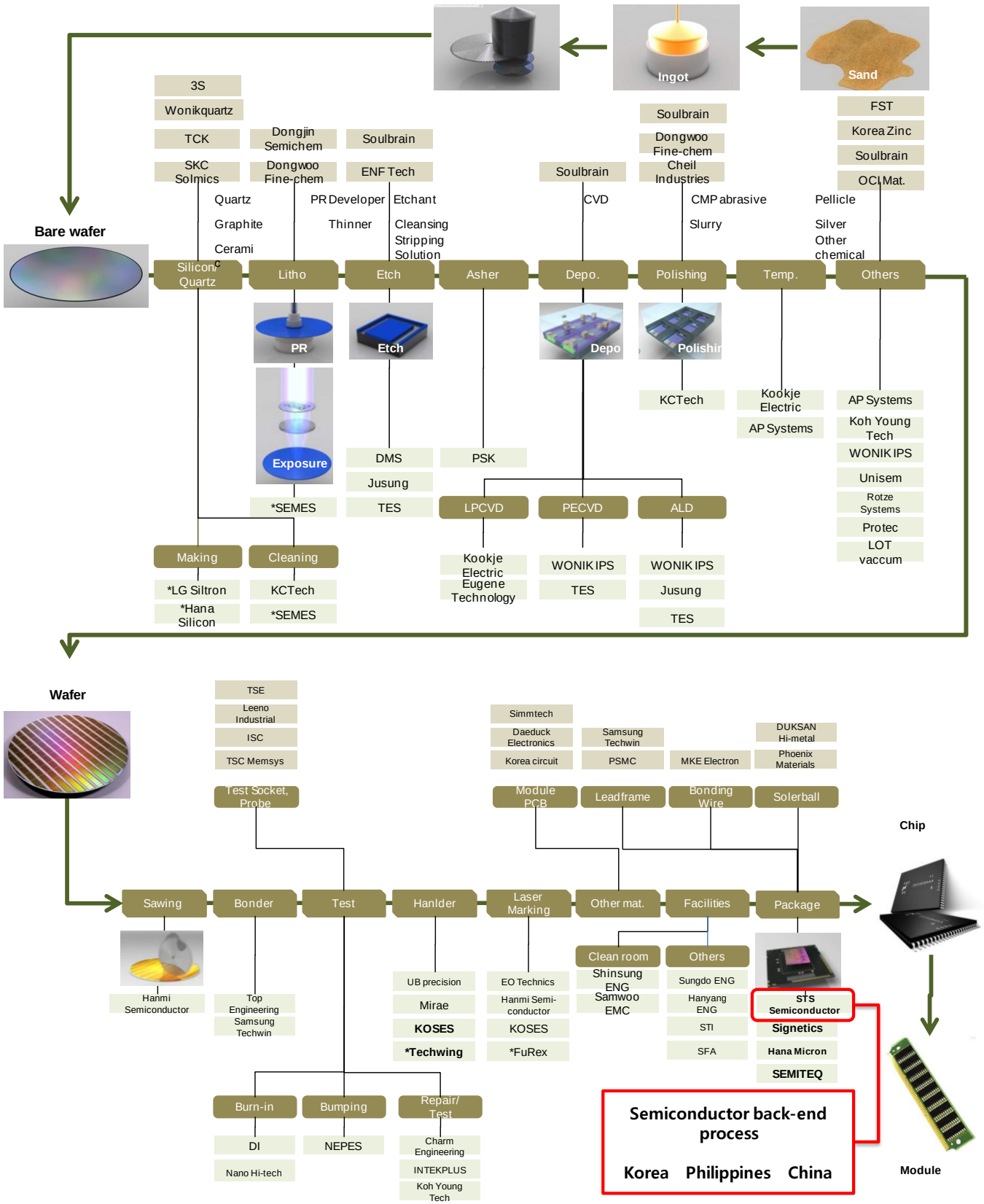
Semiconductor supply chain series #3 – STS Semiconductor

- **Domestic semiconductor manufacturers will be beneficiaries of Elpida's bankruptcy and the end of semiconductor chicken game**

- **STS Semiconductor will be the prime beneficiary of SEC's back-end process outsourcing**

- **STS Semiconductor will be the prime beneficiary of growing semiconductor storage market**

Exhibit 1. Semiconductor Supply chain



Source: Leading Research Center

Key checkpoints

✓ Significant growth through a Win-Win business strategy of batch-processing

Even Samsung Electronics (SEC: 005930 KS), the best semiconductor producer in the world, needs to outsource packaging process to maintain competitiveness. SEC experienced a drop in profitability in PC DRAM as they instituted batch-production system.

SEC is adopting back-end batch-packaging system to improve profitability in PC DRAM that is suffering from adverse market conditions. The back-end batch-packaging system will be implemented by STS as it is the sole outsourcing agent for such a system designated by SEC.

As a result, SEC will be able to achieve reductions in 1) labor cost, 2) transportation cost, and 3) production time. At the same time, STS will be able to realize profitability of mid-end products by processing low-end products. Such is a Win-Win business strategy for both SEC and STS (Page 22).

✓ The company′s non-memory chip is a beneficiary of the growing CIS market

Explosive growth in smart device market is increasing the demand for CIS (CMOS Image Sensor) which is used in smartphones. CIS is a non-memory chip used in not only smartphones but also in tablet PCs, notebook PCs, and monitors. SEC is purchasing ISP (Image Signal Processor), a vital component for CIS, from Fujitsu. In order to keep SEC at arm's length, Fujitsu outsources the packaging process to STS, a major outsourcing agent for SEC.

✓ STS Semiconductor is the prime beneficiary of growing semiconductor storage market (SSD, SD card)

Storage market is expected to go through dramatic changes in 2012. Due to the last year's flood in Thailand, hard disk (HDD) production experienced a major setback, while Solid State Drive (SSD) market is rapidly growing with strong demand. We believe SEC will be the prime beneficiary of growing SSD market, as it has the largest market share in NAND (basic unit for SSD) industry. STS Semiconductor should also benefit from this changing trend as it acquired the exclusive right to package SEC's SSD. Furthermore, as 100% of SD cards in Galaxy series are packaged by STS Semiconductor, the growth of smartphone market will improve the company's earnings.

✓ The long term effect of Elpida′s bankruptcy is likely to strengthen the semiconductor market

Elpida's bankruptcy did not immediately affect the semiconductor market significantly despite its considerably high market share. However, Elpida's bankruptcy will eventually influence the global semiconductor market in long-term and we believe domestic companies will be prime beneficiaries of the bankruptcy. In other words, considering the fact that SEC, Hynix, and Elpida are only companies capable of producing mobile DRAM, the mobile DRAM market is likely to transform into a seller's market.

✓ Large scale investment in the process, but there is no plan to increase capital

To finance capital investments to secure future growth engine, the company had raised the capital of W120.5bn by issuing new stocks from 2009 to 2011. Therefore, the company was able to invest W90bn for capex despite the accumulated loss of W62.3bn in 2010. The company's investments are yielding returns as displayed by a net profit of W11bn in 2011. As a result, the company is expected to continue to generate sufficient free cashflow to fund capital needs in the future. Therefore, we believe the company will not ask for money from its shareholders.

✓ Target price of W14,000 implies a 64.5% upside potential from the current share price of W9,360

STS Semi is trading at an EV/EBITDA of 4.4x, which implies a 47.2% discount to the market's 2012 year-high EV/EBITDA of 8.3x. However, as the company is rapidly increasing the revenue through batch production and maintaining a sustainable relationship with its captive client, Samsung Electronics, such valuation discount is excessive. Therefore we applied a 20% discount, rendering the EV/EBITDA of 6.6x. Applying the EV/EBITDA of 6.6x, we derived a fair target price of W15,400, which implies a 64.5% upside potential from the current share price.

Section 1-1: Valuation – Target price W14,500

Valuation discount of 47.2% is excessive considering the recovery of semiconductor industry and growth potential of non-memory chips

We derived a fair share price of W15,400 for following reasons:

1. **A solid partnership with SEC and resulting growth in revenue and earnings is a strong reason to deny past undervaluation relative to the market.**

2. **High chance of securing mid- to long-term growth potential as SSD&SD card market is finally growing**

3. **Having the exclusive right to package Fujitsu's ISP, the company is expected to improve its earnings through packaging non-memory chips**

EV/EBITDA is an appropriate valuation tool considering the company's large-scale capex

Considering 2012F capex spending of W75bn and depreciation cost of W30bn which accounts for 50% of 2012F operating profit of W58.2bn, we believe EV/EBITA is the most suitable valuation tool to assess the target price of STS Semiconductor.

Setting up the overseas packaging lines for low-margin DRAM in Philippines is dramatically increasing the company's revenue. Furthermore, the company is expected to maintain a stable relationship with its major client, SEC. However, STS Semiconductor is currently trading at a 2012 year-high EV/EBITDA of 4.4x –a 47.2% discount to the market year-high EV/EBITDA of 8.3x. Considering the company's increasing revenue and the captive client, we believe a 20% discount rate is more suitable than the 47.2% discount rate.

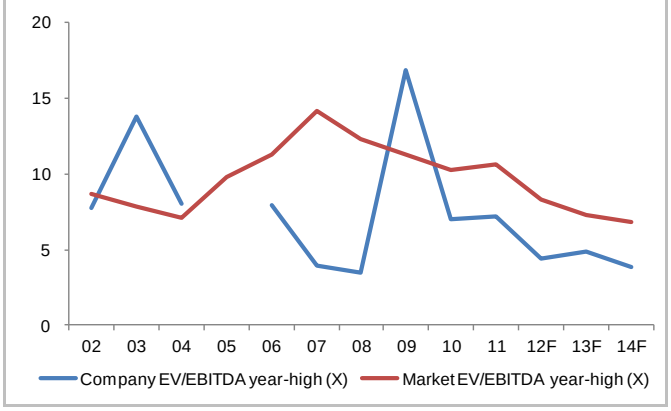
We applied a EV/EBITDA of 6.6x – a 20% discount to 2012 year-high market EV/EBITDA of 8.3x – to derive the target price of W15,400, which implies a 64.5% upside potential from the current price.

Exhibit 2. STS Semi Valuation VS. Market Valuation

(X, %)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012F	2013F	2014F
Company EV/EBITDA year-high (X)	13.8	8.0	N/A	7.9	4.0	3.5	16.8	7.0	7.2	4.4	4.9	3.8
Market EV/EBITDA year-high (X)	7.9	7.1	9.8	11.3	14.2	12.3	11.3	10.3	10.6	8.3	7.3	6.8
Premium/(Discount) to market (%)	75.2	13.0	1,009.3	(29.7)	(72.2)	(71.7)	49.4	(31.9)	(32.6)	(47.2)	(33.3)	(44.2)
Company PER year- high (X)	44.0	43.5	N/A	41.6	40.8	(5.9)	(3.7)	N/A	60.3	15.5	11.9	8.3
Market PER year- high (X)	20.7	9.9	13.9	17.9	22.3	42.4	20.4	16.0	11.2	10.4	9.0	7.4
Premium/(Discount) to market (%)	**112.6**	**339.5**	**6,358.2**	**132.4**	**83.2**	**NA**	**NA**	**NA**	**438.3**	**49.5**	**32.0**	**12.5**

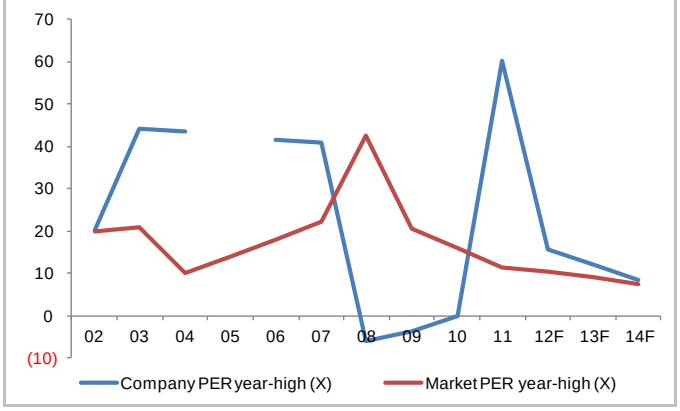
Source: Company data, Leading Research Center
**Market = KOSPI + KOSDAQ,*

Exhibit 3. STS Semi yr-hi EV/EBITDA vs. Market



Source:Fnguide, Leading Research Center

Exhibit 4. STS Semi yr-hi PER vs. Market PER



Source: Fnguide, Leading Research Center

Section 1-2: Valuation – Peer Valuation

Global Peers: ASE, SPIL, PTI, AMKOR

Domestic packaging market is dominated by STS Semi, Signetics (033170 KQ), and Hana Micron (067310 KQ). In addition, as the company is likely to grow into a global company, we have selected Global top 4 packaging companies (ASE, SPIL, PTI, and AMKOR) as its peers as well.

Large-scale revenue growth compared to its domestic peers and recovering profitability

STS Semiconductor is expected to generate higher sales revenue than its domestic peers (Signetics and Hana Micron). As revenues from the Philippines branch and China branch are included in the company's revenue (IFRS Consolidated), 2013F revenue is expected to reach W1.0tn. The company's margin is only at the industry average at the moment. However, as the revenue increases on the back of the increasing operating rate, the company's margin is expected to exceed the industry average.

Lowest EV/EBITDA among its peers

The company's 2012F OPM and ROE are similar to those of its peers. However, we believe the company will record highest 2013F OPM and ROE among its peers on the basis of improved earnings.

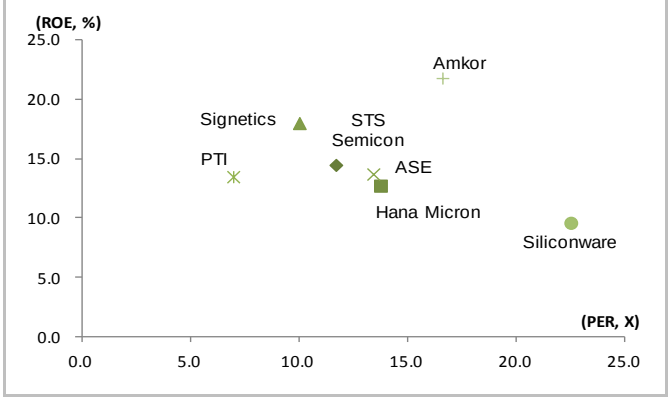
Exhibit 5. Peer valuation

Company	Ticker	Country	Market cap. (mn US$)	Revenue (mn US$)				OPM (%)			
				10	11	12E	13E	10	11	12E	13E
STS SEMICON	036540 KS	KOR	433.9	322.5	413.0	640.7	965.4	6.5	6.4	8.2	8.7
SIGNETICS	033170 KS	KOR	293.4	206.5	259.1	315.4	394.2	10.0	7.2	8.0	9.5
HANA MICRON	067310 KS	KOR	212.0	229.2	265.2	269.8	321.9	11.6	5.2	6.8	8.1
ASE	2311 TT	TWN	6,490.4	5,997.6	6,306.4	6,242.5	6,707.5	12.8	12.1	9.4	9.4
SPIL	2325 TT	TWN	3,701.5	2,029.2	2,083.6	2,071.6	2,244.9	10.0	9.7	8.2	9.8
PTI	6239 TT	TWN	1,546.4	907.7	1,202.1	1,335.3	1,374.9	19.7	22.6	18.8	15.5
AMKOR	AMKR US	USA	1,070.7	2,939.5	2,776.4	2,779.0	2,911.0	12.7	7.0	6.8	8.6

Company	PER (X)				EV/EBITDA (X)				P/B (X)				ROE (%)			
	10	11	12E	13E	10	11	12E	13E	10	11	12E	13E	10	11	12E	13E
STS SEMICON	15.5	36.6	11.7	6.4	8.1	5.8	3.9	2.9	1.7	1.5	1.4	1.2	14.7	5.2	14.5	22.8
SIGNETICS	9.7	13.5	10.0	7.7	5.0	6.2	5.1	3.9	1.4	2.0	1.7	1.4	18.1	15.8	18.0	19.5
HANA MICRON	6.8	21.4	13.8	8.8	5.9		7.0	6.3	1.8	1.5	1.5	1.4	31.1	7.8	12.7	17.4
ASE	10.9	10.9	13.4	13.0	5.6	5.6	6.0	5.8	2.2	2.2	1.8	1.7	22.9	22.9	13.7	16.0
SPIL	19.3	19.3	22.5	18.8	6.5	6.5	7.0	6.2	1.8	1.8	1.8	1.8	9.1	9.1	9.6	12.2
PTI	14.6	8.9	7.0	8.5	5.7	4.7	3.3	3.1	2.9	2.1	1.2	1.2	26.7	26.7	13.5	15.4
AMKOR	7.8	9.9	16.6	9.5	3.3	3.1	3.8	3.2	2.2	1.1	1.5	1.2	15.4	15.4	21.8	N/A

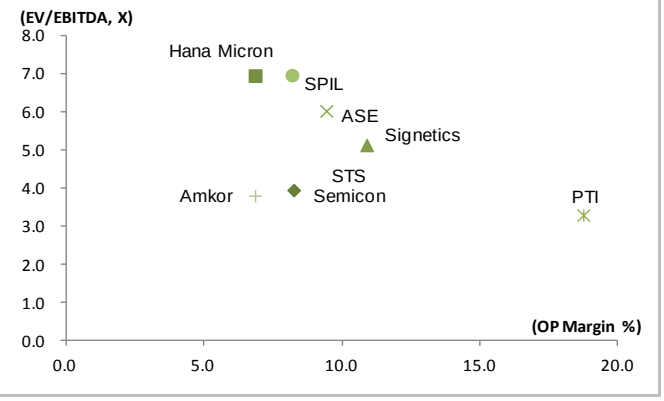
Source: Company data, Bloomberg, Leading Research Center (as of Mar.22, 2011)
**KRWUSD W1,122, STS Semiconductor, Signetics, Leading Research Center, Bloomberg*

Exhibit 6. Peer group PER vs. ROE



Source: Bloomberg, Leading Research Center

Exhibit 7. Peer group EV/EBITDA vs. OPM



Source: Bloomberg, Leading Research Center

Section 2: Company Snapshot

The spinoff from SEC

Backend Process Company that spun off from Samsung Electronics in 1998

STS Semiconductor, which specializes in semiconductor packaging, spun off from Samsung Semiconductor's backend process plant (Onyang) in 1998. Backend process is relatively simpler than front-end process, and it focuses on labor management, timely delivery, and capacity rather than the quality of equipment and other materials. Therefore, SEC has been outsourcing the backend process, and outsourcing proportion is increasing.

The necessity of batch manufacturing

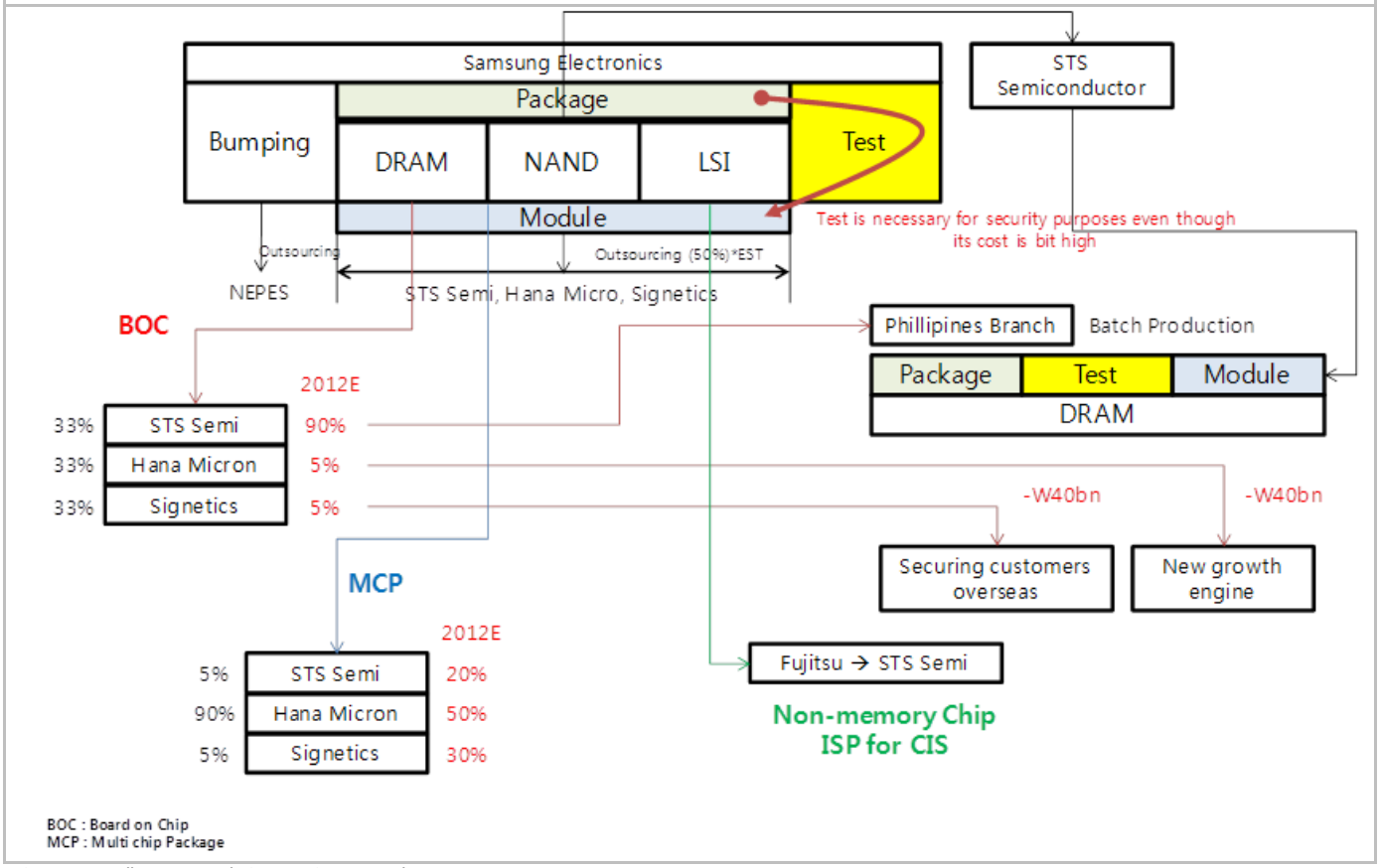
The necessity of batch manufacturing is increasing

SEC has been concerned with the efflux of technology ever since it started outsourcing packaging. Therefore, it has been testing the products itself after the packaging process and sending them to the Chinese plant for modulation. However, batch manufacturing will be necessary for SEC in the near future due to lower memory price, long delivery time, and high expense for delivery

Chosen as the most creditworthy company by Samsung Electronics

SEC outsourced its backend process to STS Semiconductor because it is the most creditworthy company regarding security issues. The company established the Philippines branch in 2010 and has a plan to complete the transfer of DRAM product lines (backend process) to Philippines by 1H12.

Exhibit 8. Samsung Electronics semiconductor logistics system



Source: Leading Research Center, Company data
** The ratio may not be correct as the diagram was provided for providing the brief outline*

STS Semiconductor currently has three factory sites in Cheonan, China, and Philippines. The main office in Cheonan produces high-margin products and semiconductor storage products while the Philippines branch is batch manufacturing DRAM products. The China branch mainly produces low-end non-memory products

Exhibit 9. STS Semiconductor packaging plants

Cheonan main office (STS Semi)

Site location	Cheonan-si, Chungcheongnam-do
Established	1998. 6. 30
Production Capa.	100,000 Kpcs / Mo. (Data from 2010)
Area	Land 20,790㎡/ Plant 2,150㎡
Products	Advanced package

Wujiang, China(PSTS)

Site location	Wujian economic development zone
Established	2004.03
Production Capa.	86,010 Kpcs / Mo. (Data from 2010)
Area	Land 66,100㎡/ Plant 7,095㎡
Products	Mid-end, System LSI

Clark, Philippines (PSPC)

Site location	Clark Freeport Zone
Established	2010.01
Production Capa.	100,000 Kpcs / Mo. (Full capacity expected in 2Q12)
Area	Land 146,090㎡/ Plant 21020㎡
Products	Low-end Memory (DRAM Board On Chip)

Source: Leading Research Center

Philippines plant getting off to a smooth start

Philippines branch, which opened last year, is operating smoothly

The Philippines plant, which started operating in 2H11, is planning to run at a full capacity by the end of 1H2012. At first, the company was concerned with laborers' lack of experience, but the plant reached its BEP in December 2012 and recorded the net profit of W2.5bn. The plant is expected to produce 1.0tn units every month and record W250bn of sales revenue by the end of 1H12E.

Exhibit 10. Present state of the Philippines branch's revenue

Wbn	1Q11	2Q11	3Q11	4Q11	2011
Revenue	**1.7**	**15.2**	**34.3**	**44.0**	**95.2**
Net profit	N/A	N/A	N/A	N/A	**2.5**
NPM (%)	N/A	N/A	N/A	N/A	**2.6**

Source: Company data, Leading Research Center

2011 NPM of 2.6% implies the ramp-up faster than expectations

Revenue from the Philippines branch will account for 40% of the total revenue in 2013F

We expect the Philippines branch to generate sales revenue of W331.8bn from DRAM and W116.7bn from NAND (assuming that NAND plant will be transferred) in 2013F. The revenue generated from the Philippines branch (W1.0tn) is expected to account for 40% of the company's total revenue in 2013F.

NAND product lines expected to be transferred in 2013 for higher profit

Once DRAM product lines are successfully settled in Philippines, NAND product lines are expected to be transferred to the Philippines branch as well. DRAM (2Gb) is currently trading near $1 yielding a very low margin for the company. Especially, PC Dram and modules are generating very low margins. The company secured OPM of 5~7% for DRAM though bath production at the Philippines branch because the company was able to reduce labor cost. Given that SEC can strengthen itself by reducing labor cost and production time, we believe there is a high possibility that SEC will transfer its NAND product lines as well.

Transitioning its product portfolio to high margin products

The main office is planning to focus on its product mix in 2012

STS Semiconductor is improving its product mix by including more high-margin products. As low margin DRAM transferred to the Philippines plant, high-end products proportion at the main office is increasing. Furthermore, the company is increasing NAND packaging as it does not need to focus on DRAM packaging as much.

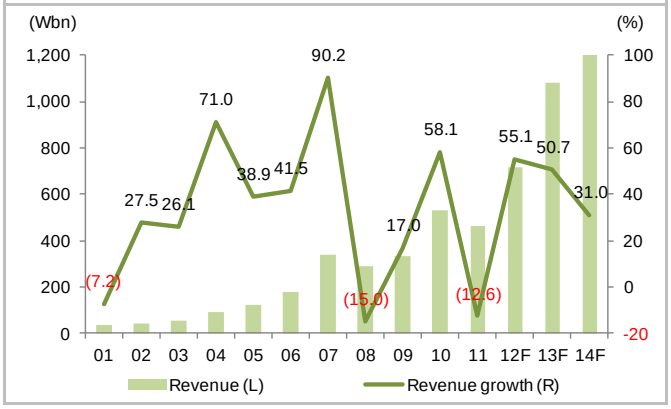
2012F revenue from the main office is expected record W490bn and OPM of 8.2%

We expected the main office to post sales revenue of W490bn and OPM of 8.4% in 2012F for following reasons.

1) The ASP of DRAM packaging is increasing.
2) NAND packaging proportion is increasing by 93% yoy
3) The ASP of semiconductor storage increasing (+16% yoy)

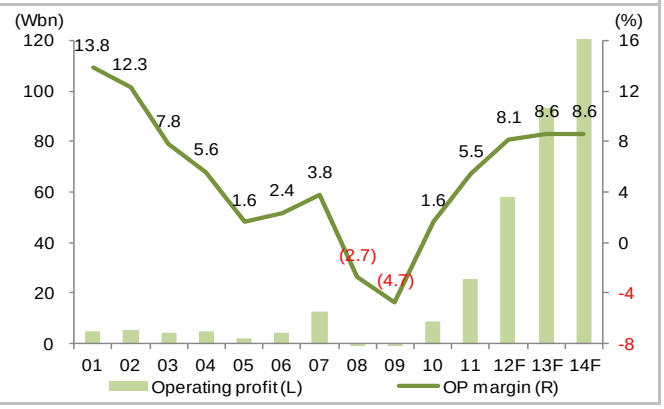
Section 3: Facts & Figures

Exhibit 11. Revenue and growth trend



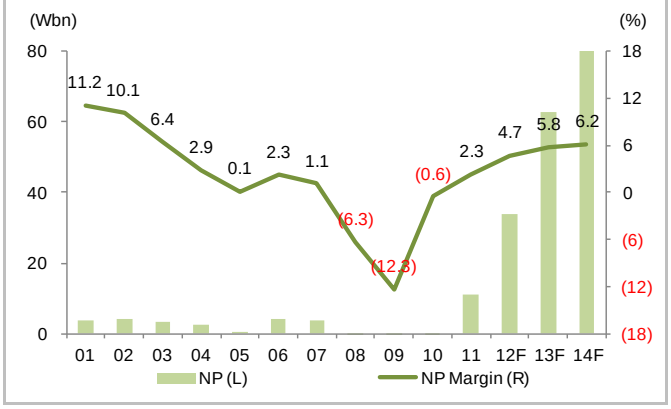
Source: Company data, Leading Research Center

Exhibit 12. Operating profit and OPM trend



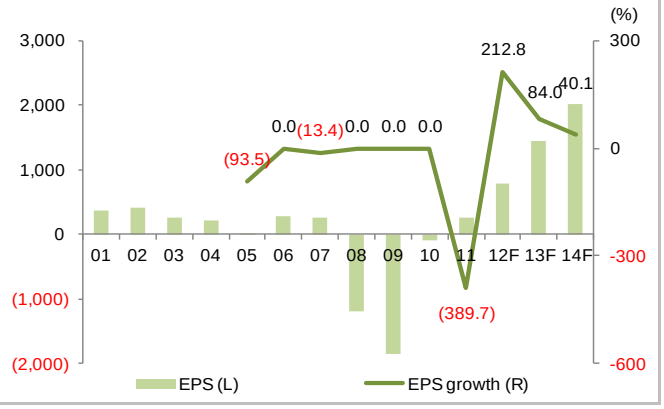
Source: Company data, Leading Research Center

Exhibit 13. Net profit and NPM trend



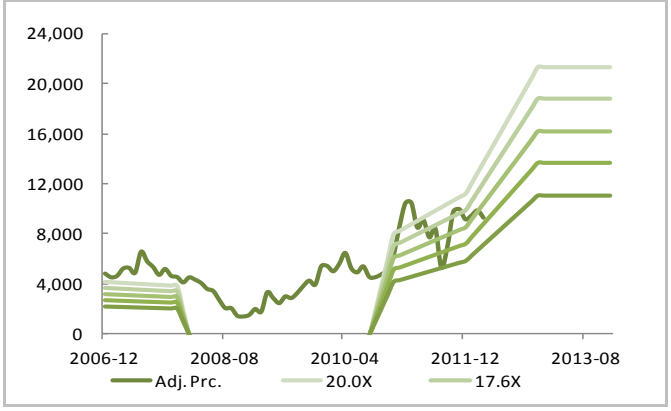
Source: Company data, Leading Research Center

Exhibit 14. EPS and EPS growth trend



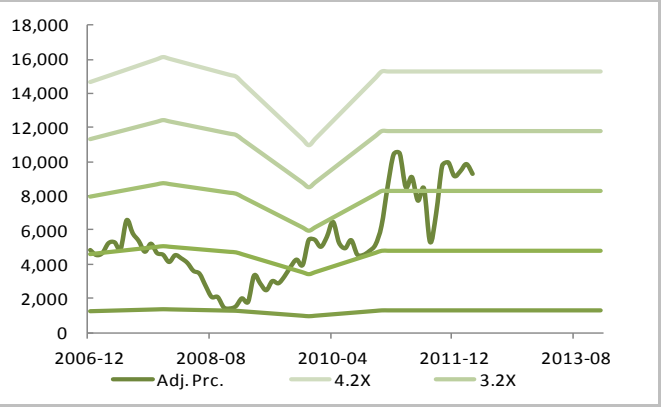
Source: Company data, Leading Research Center

Exhibit 15. PER Band



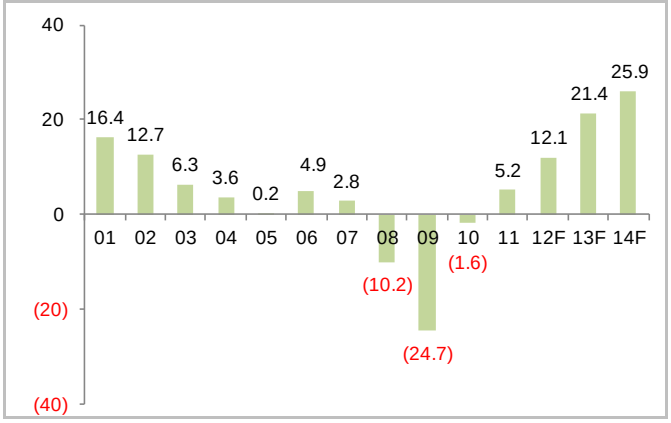
Source: FnGuide

Exhibit 16. PBR Band



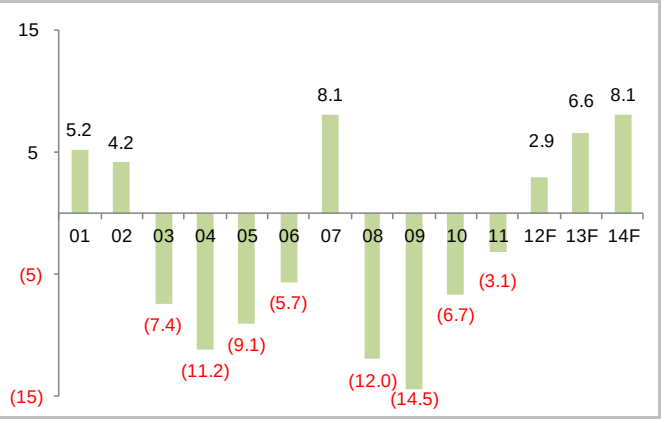
Source: FnGuide

Exhibit 17. ROE (%)



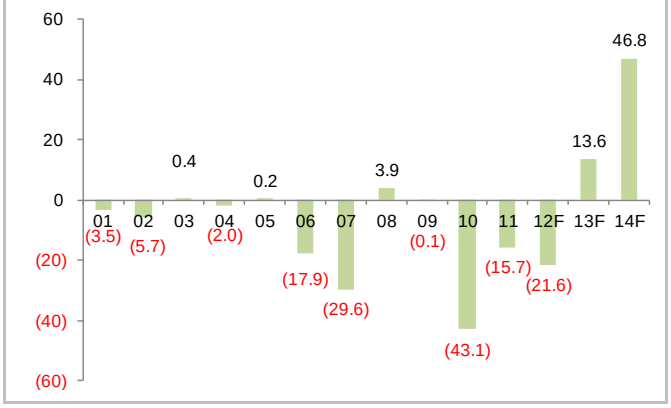
Source: Company data, Leading Research Center

Exhibit 18. ROIC less WACC (%)



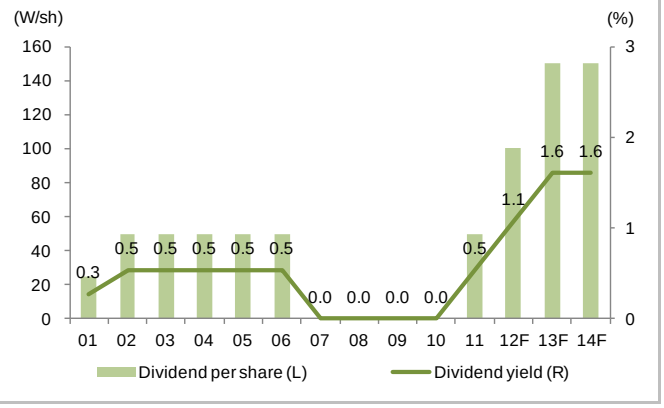
Source: Company data, Leading Research Center

Exhibit 19. Free cashflow trend (Wbn)



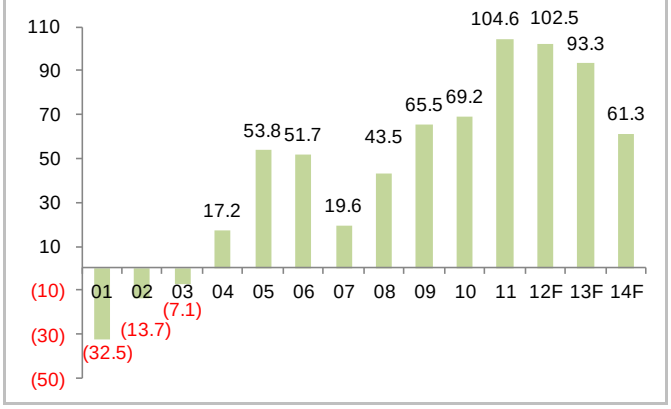
Source: Company data, Leading Research Center

Exhibit 20. Dividend per share and yield trend



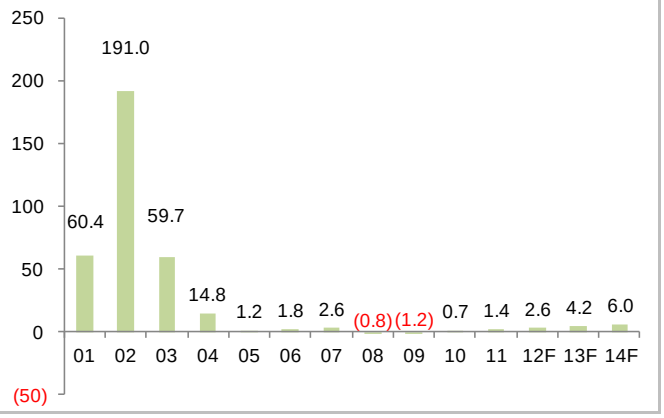
Source: Company data, Leading Research Center

Exhibit 21. Net debt to equity ratio (%)



Source: Company data, Leading Research Center

Exhibit 22. Interest Coverage (X)



Source: Company data, Leading Research Center

Section 7: What is the management philosophy?

CEO with extensive back-end process experience

CEO with backend process experience at Samsung Electronics

Jae-Won Lee, the CEO of STS Semiconductor, is a management specialist with Samsung Semiconductor background. Having obtained extensive knowledge at SEC, he became the CEO of the company in 2011. Utilizing accumulated know-how and technology, he is in charge of operating the company. Having SEC background, his ability to negotiate important deals with SEC is well recognized.

CEO with Samsung background and Chairman of the Bokwang Group creating a synergy effect

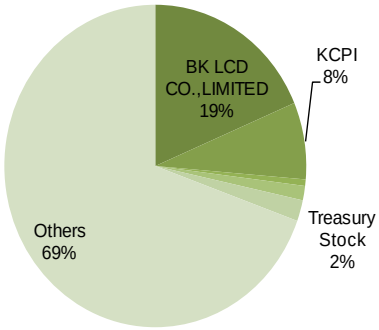
In the past, SEC did not allow batch production for backend process companies because it was concerned with the efflux of technology. However, the CEO's background and the company's management structure made it possible for the company to build a business structure that generates benefit for both companies.

Optimistic outlook for STS Semi's backend process

Samsung Electronics is expected to maintain its dominant position in semiconductor industry while coordinating with STS Semiconductor. Therefore, we believe the company's business will stay in a good shape in the future.

Management profile

Exhibit 23. Shareholders (%)



Source: Company data

Exhibit 24. CEO Profile

	Notes
Career	CEO, STS Semiconductor CEO, STECO Head of the center, SEC Director of SEC Manufacturing division Department head, SEC
Education	B.S. Inha University (Electronic Engineering)

Section 9: Operations overview

Long-term effect of Elpida's bankruptcy

Domestic companies will be beneficiaries of Elpida's bankruptcy in long-term

Three possible outcomes regarding Elpida's bankruptcy

1) Elpida is acquired by non-memory manufacturers, such as TSMC, Global Foundry, and Intel:

If non-memory manufacturers acquire Elpida, DRAM price is likely to increase due to lower DRAM production. Hence, domestic companies should benefit the most from this case.

2) Elpida is acquired by existing memory manufacturers, such as Micron and Toshiba:

Even if existing memory manufacturers acquire Elpida, it is going to be difficult to narrow the technology gap with domestic players. Given that Elpida's DRAM had already lost its cost-competitiveness, acquiring Elpida will not provide much leverage to existing companies.

3) Elpida is saved by Japanese government

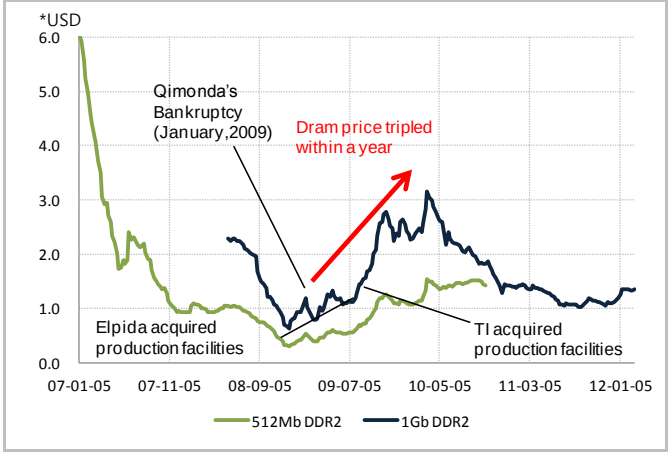
Even if Elpida is saved by Japanese government, it will be very difficult to keep up with SEC and Hynix, since Elpida's DRAM price cannot compete with those of domestic players.

Therefore, we believe domestic companies will benefit from Elpida's bankruptcy regardless of what happens with Elpida in the future. Therefore, DRAM market has a potential to transform into a producer market in long term.

Explosive growth of DRAM market after Qimonda's bankruptcy

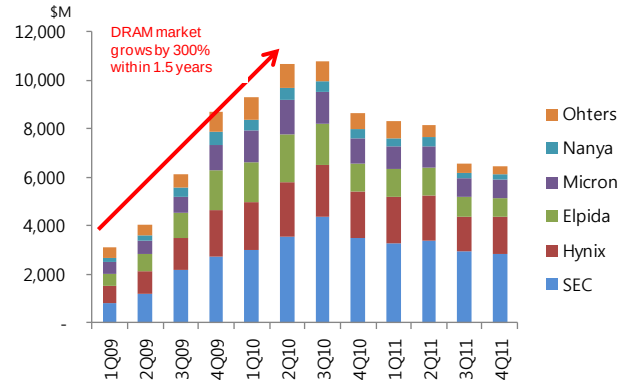
DRAM price has not increased since Elpida's bankruptcy, and this trend is similar to when Qimonda filed for bankruptcy. DRAM spot price fluctuated over six month after Qimonda filed for bankruptcy in Janurary 2009. However, after non-memory manufacturer, Texas Instrument, acquired Elpida, DDR2 price skyrocketed as the total DRAM production declined.

Exhibit 25. DDR2 price after Qimonda's bankruptcy



Source: Bloomberg, Leading Research Center

Exhibit 26. DRAM market after Qimonda's bankruptcy



Source: Gartner, Leading Research Center

Packaging industry is expect to grow

Packaging industry will benefit from dominant domestic semiconductor manufacturers

NAND market is expected to grow on the back of increasing SSD demand

SEC and Hynix have been maintaining very high market shares in DRAM market. As they are winners of long-lasting semiconductor chicken game, we believe their market shares will increase even if Elpida recovers from the current situation.

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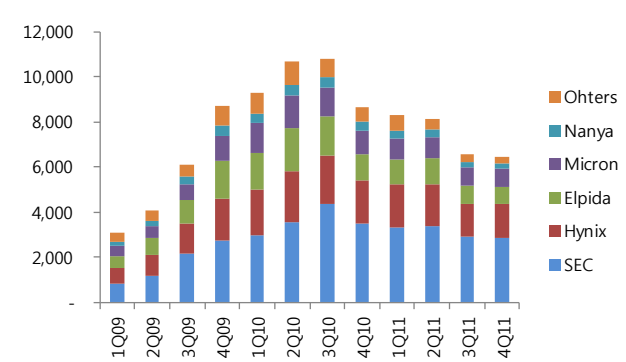
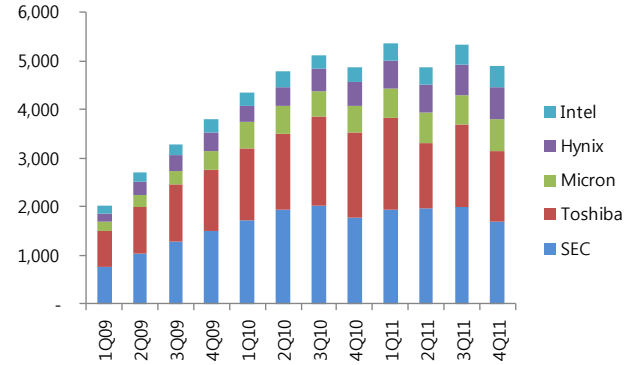
As growing SSD market increases NAND demand worldwide, NAND market is expected to continue its uptrend. Furthermore, as NAND price declines in 2012, SSD price is expected to decline as well, providing a growth engine to SSD market.

Exhibit 27. Quarterly DRAM market size ($M)



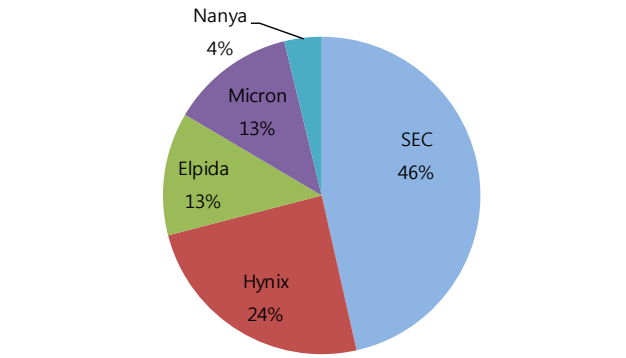
Source: Gartner, Leading Research Center

Exhibit 28. Quarterly NAND market size ($M)



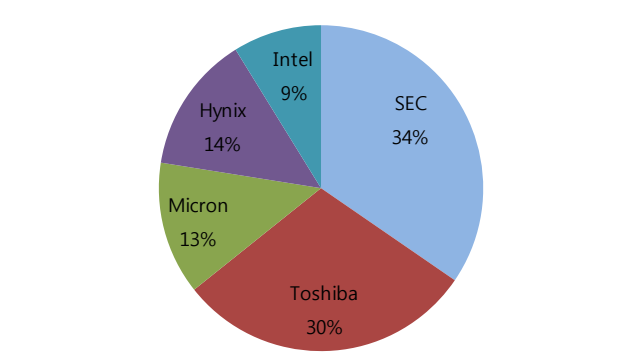
Source: Gartner, Leading Research Center

Exhibit 29. 4Q11 DRAM Industry M/S (%)



Source: Gartner, Leading Research Center

Exhibit 30. 4Q11 NAND Industry M/S (%)



Source: Gartner, Leading Research Center

Improved product mix is improving the profitability

Main office OPM:
2011 6.3% → 2013 9.8%

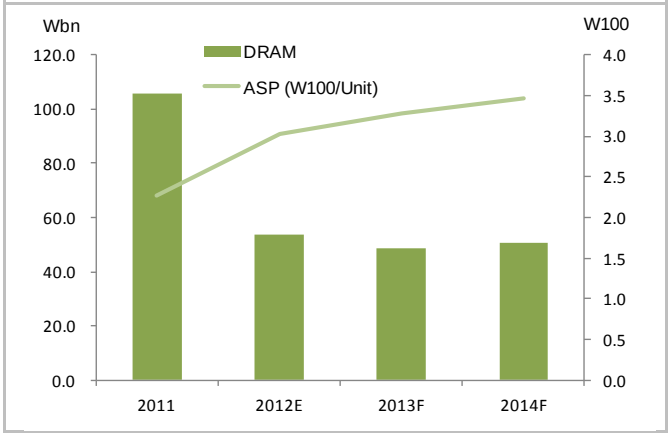
Earnings at the main office are expected to improve as DRAM product lines were relocated in Philippines.

1. **Transitioning to high-margin products**
2. **NAND packaging generates higher profit than DRAM packaging**
3. **4th plant at the main office is expected to produce high-end products**

The company's operating margin is expected to increase from 6.3% in 2011 to 9.3% in 2013F, and then to 10.9% in 2014F.

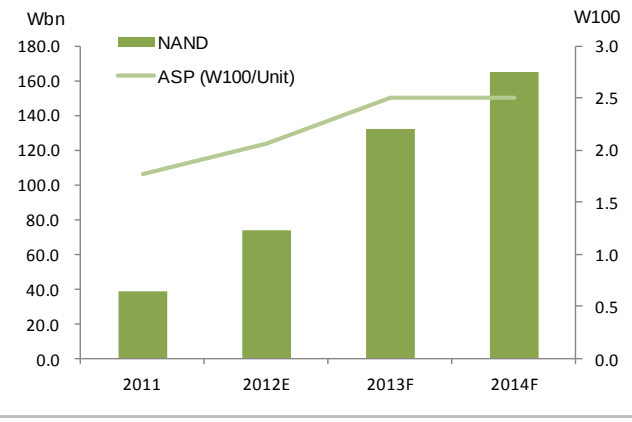
Earnings have improved as average selling prices of DRAM packaging and NAND packaging increased in 2011. DRAM ASP increased by 13% from 1Q11.

Exhibit 31. DRAM packaging revenue and ASP uptrend



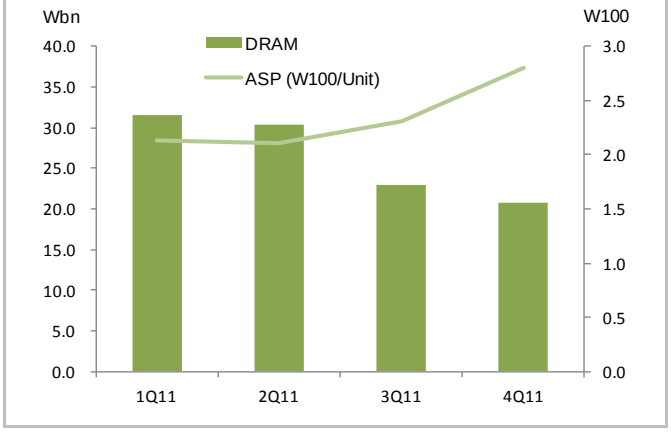
Source: Company data, Leading Research Center

Exhibit 32. NAND packaging revenue and ASP uptrend



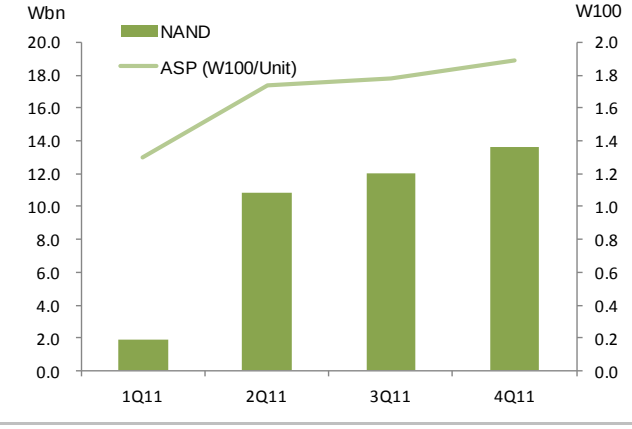
Source: Company data DC, Leading Research Center

Exhibit 33. DRAM packaging ASP uptrend



Source: Company data, Leading Research Center

Exhibit 34. NAND packaging revenue and ASP uptrend



Source: Company data, Leading Research Center

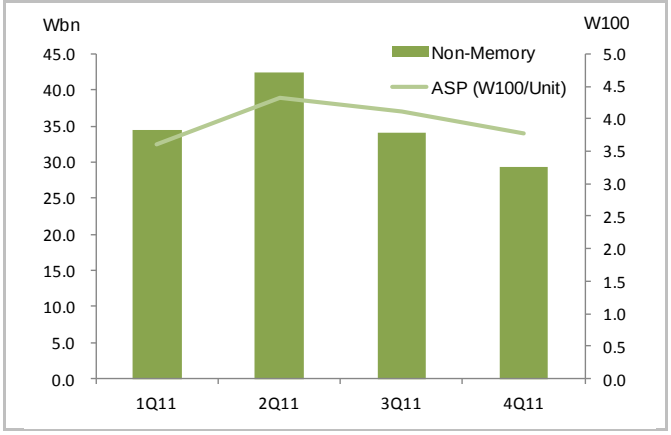
Beneficiary of growing smartphone market

Fujitsu is outsourcing ISP chip packaging to STS Semiconductor

Fujitsu, which supplies ISP to SEC, is outsourcing packaging process to STS Semi because it is most cost and time effective. ISP, a vital component for CIS to operate, is integrated in Samsung Electronics' smartphones. We believe it has a high growth potential as Samsung Electronics' smartphone sales are increasing.

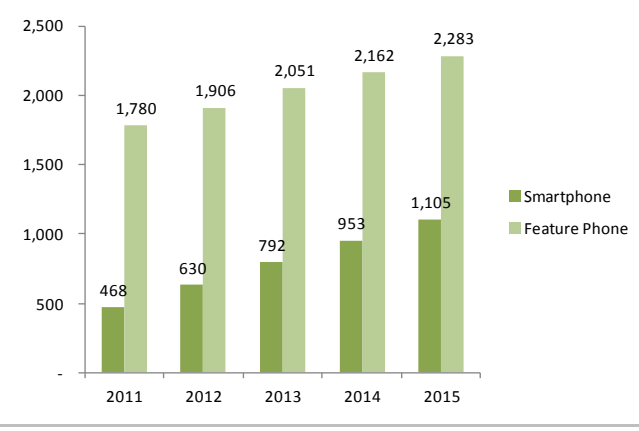
However, as Fujitsu has been asking STS Semi to lower the price of ISP packaging, it is going to be difficult to generate high earnings from ISP packaging.

Exhibit 35. ISP ASP downtrend



Source: Company data, Leading Research Center

Exhibit 36. Smartphone market size



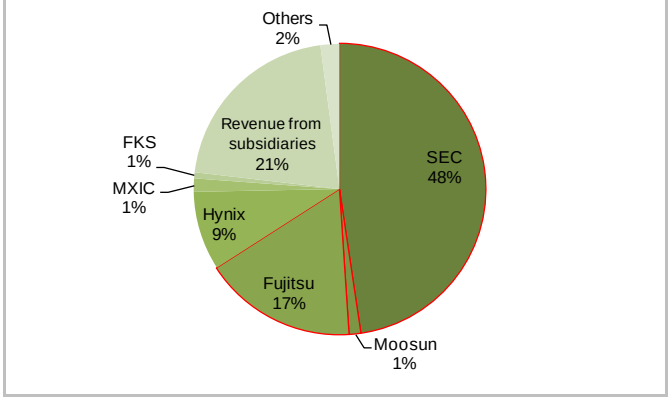
Source: Gartner, Leading Research Center

New product line to meet increasing non-memory chip demand

Revenue from non-memory chips is expected to increase

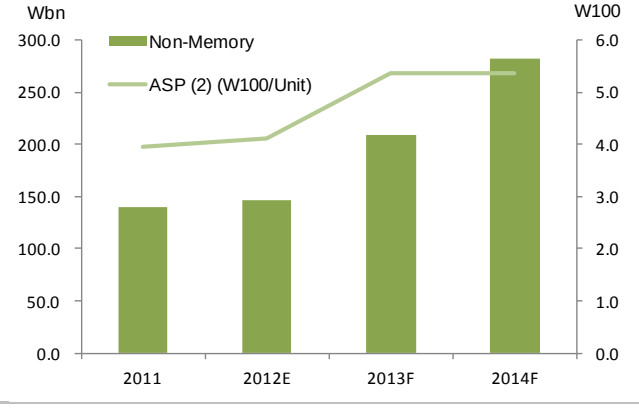
Non-memory chips market is rapidly growing, and we believe global companies will outsource packaging process to STS Semi to meet Samsung's demand more effectively. As the company is planning to expand its existing plants to meet increased non-memory chip packaging, the company should generate a higher revenue from non-memory chip packaging.

Exhibit 37. 4Q11 Revenue breakdown by clients



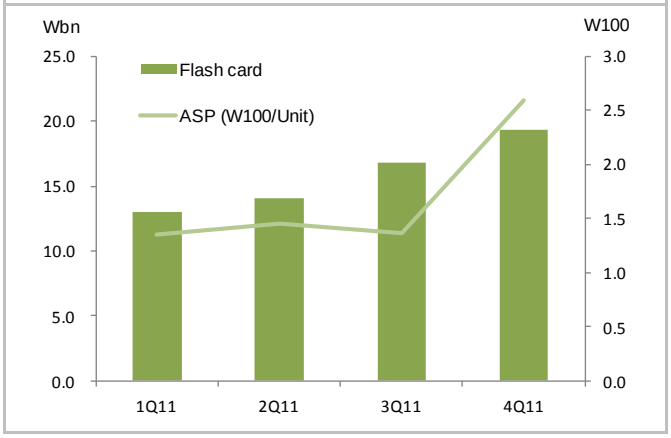
Source: Company data, Leading Research Center

Exhibit 38. Non-memory revenue and ASP forecast



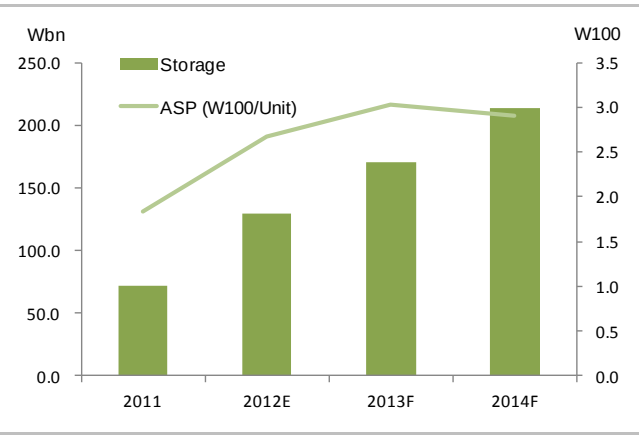
Source: Company data, Leading Research Center

Exhibit 39. ASP uptrend starting 4Q11



Source: Company data, Leading Research Center

Exhibit 40. Semiconductor storage revenue and ASP forecast



Source: Company data, Leading Research Center

Earnings forecast

Low 1Q12 earnings provide an opportunity to buy shares at a lower price

Improved product mix is expected to improve the company's 2Q12 earnings. The company is improving its earnings by transferring low-margin products to Philippines while producing high-end products at its main office.

Semiconductor industry is expected to gain a strong momentum as Elipida filed for bankruptcy protection. Therefore, the low earnings in 1Q12 should be treated as an opportunity to purchase shares at a discount.

2012F revenue W719bn (+55.1% YoY)
2012F OP W59.2bn (+99.2% YoY)

Improved earnings from the main office and the Philippines branch should improve the company's total revenue by 55.1% yoy. We believe the company will generate over W1.0tn of revenue starting 2013F.

Exhibit 41. Consolidated revenue foreceast

(Wbn)		2011	2012E	2013F	2014F
Revenue (1)	Package	284.5	273.8	389.4	497.1
	DRAM	105.7	53.6	48.8	50.5
	NAND	38.4	74.1	131.8	164.8
	Non-memory	140.4	146.1	208.8	281.9
Revenue (2)	Storage	72.2	129.1	170.4	214.2
	Flash card	63.1	111.7	133.9	174.1
	SSD	9.1	17.4	36.4	40.1
Revenue (3)	Others	65.8	87.2	93.4	94.3
Revenue (Main office) (1)+(2)+(3)	**Main office**	**422.5**	**490.1**	**653.1**	**718.4**
Revenue (Overseas)	**Philippines**	**95.2**	**248.6**	**448.5**	**627.9**
	China	**60.3**	**72.4**	**73.8**	**75.5**
Excluding double counting		**(114.5)**	**(92.0)**	**(92.0)**	**(92.0)**
Revenue (consolidated): KOR + Overseas – double counting		**463.5**	**719.0**	**1,083.4**	**1,419.3**

Source: Leading Research Center

Exhibit 42. Key assumptions for revenue forecast

(Wbn)		2011	2012E	2013F	2014F
ASP (1) (W100/unit)	**Package**	1.6	1.5	1.8	1.8
	DRAM	2.3	3.0	3.3	3.5
	NAND	1.8	2.1	2.5	2.5
	Non-memory	4.0	4.1	5.4	5.4
ASP (2) (W100/unit)	**Storage**	1.8	2.7	3.0	2.9
	Flash card	1.6	2.3	2.4	2.4
	SSD	40.7	30.1	24.6	18.0
Q: Sales volume (1) (10,000 units)	**Package**	**18,232.9**	**18,572.9**	**21,922.5**	**28,014.1**
	DRAM	4,657.2	1,774.1	1,488.2	1,458.4
	NAND	2,169.0	3,596.8	5,266.0	6,582.5
	Non-memory	3,544.7	3,546.8	3,901.5	5,267.0
Q: Sales volume (2) (10,000 units)	**Storage**	**3,930.9**	**4,827.6**	**5,633.4**	**7,353.1**
	Flash card	3,908.6	4,769.7	5,485.2	7,130.8
	SSD	22.4	57.9	148.2	222.3
YoY (%)	**Package**		**1.9**	**18.0**	**27.8**
	DRAM		(61.9)	(16.1)	(2.0)
	NAND		65.8	46.4	25.0
	Non-memory		0.1	10.0	35.0
	Storage		**22.8**	**16.7**	**30.5**
	Flash card		22.0	15.0	30.0
	SSD		159.1	155.9	50.0
Revenue breakdown (%)					
	Package	**67.3**	**55.9**	**59.6**	**69.2**
	DRAM	25.0	10.9	7.5	7.0
	NAND	9.1	15.1	20.2	22.9
	Non-memory	33.2	29.8	32.0	39.2
	Storage	**17.1**	**26.3**	**26.1**	**29.8**
	Flash card	14.9	22.8	20.5	24.2
	SSD	2.2	3.6	5.6	5.6

Source: Leading Research Center

Summary of financials

Income statement

(Wbn)	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F	2014F
Revenue	**41.9**	**52.8**	**90.3**	**125.4**	**177.5**	**337.5**	**287.0**	**335.6**	**530.5**	**463.5**	**719.0**	**1,083.4**	**1,419.3**
% chg yoy	27.5	26.0	71.0	38.9	41.5	90.1	(15.0)	16.9	58.1	(12.6)	55.1	50.7	31.0
COGS	35.2	46.0	79.0	116.4	166.5	274.0	243.9	310.1	487.9	416.4	625.5	937.2	1,227.7
Gross profit	**6.7**	**6.7**	**11.3**	**9.0**	**11.0**	**63.4**	**43.0**	**25.5**	**42.6**	**47.1**	**93.5**	**146.3**	**191.6**
GP margin (%)	16.0	12.8	12.5	7.2	6.2	18.8	15.0	7.6	8.0	10.2	13.0	13.5	13.5
SG&A	**1.5**	**2.6**	**6.2**	**7.0**	**6.8**	**50.6**	**50.8**	**41.3**	**34.1**	**21.6**	**35.2**	**53.1**	**69.5**
Adjusted OP	**5.1**	**4.1**	**5.1**	**2.0**	**4.2**	**12.8**	**(7.8)**	**(15.8)**	**8.5**	**25.4**	**58.2**	**93.2**	**122.1**
Adj. OP margin (%)	**12.3**	**7.8**	**5.6**	**1.6**	**2.4**	**3.8**	**(2.7)**	**(4.7)**	**1.6**	**5.5**	**8.1**	**8.6**	**8.6**
Net other incomes	(0.2)	0.0	(0.2)	0.4	(0.6)	(7.3)	(3.0)	(11.8)	0.3	4.3	1.0	1.4	1.4
Reported OP	**5.1**	**4.1**	**5.1**	**2.0**	**4.2**	**12.8**	**(7.8)**	**(15.8)**	**8.5**	**29.7**	**59.2**	**94.6**	**123.5**
Net equity method gains	(0.4)	(0.0)	(1.4)	(0.0)	(0.8)	(1.3)	(1.2)	(3.0)	(4.3)	(0.9)	0.0	0.0	0.0
Interest incomes	0.2	0.1	0.2	0.1	6.0	4.1	10.3	8.9	5.8	5.8	6.0	5.1	4.9
Interest expenses	0.0	0.1	0.6	1.9	2.9	6.1	15.6	20.5	19.4	21.5	29.3	29.2	27.4
Profit before tax	4.8	4.2	3.0	0.6	5.8	1.8	(17.1)	(41.6)	(8.5)	13.1	36.0	70.5	101.0
Tax	0.5	0.8	0.4	0.4	1.7	(3.9)	1.0	1.9	(5.6)	2.2	7.2	14.1	20.2
Tax rate (%)	0.1	0.2	0.1	0.7	0.3	(2.1)	(0.1)	(0.0)	0.7	0.2	0.2	0.2	0.2
Net profit	**4.2**	**3.4**	**2.6**	**0.2**	**4.1**	**3.8**	**(18.1)**	**(41.3)**	**(3.0)**	**11.0**	**28.8**	**56.4**	**80.8**
Controlling	0.0	0.0	0.0	0.4	0.0	3.8	(19.9)	(18.7)	12.6	13.2	0.0	0.0	0.0
Non-controlling	0.0	0.0	0.0	(0.3)	0.0	0.0	1.8	(22.6)	(15.5)	1.1	0.0	0.0	0.0
Other comprehensive inc.	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total comprehensive	4.2	3.4	2.6	0.2	4.1	3.8	(18.1)	(41.3)	(3.0)	11.0	28.8	56.4	80.8

Balance sheet

(Wbn)	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F	2014F
Current Assets	**12.3**	**18.4**	**16.3**	**36.0**	**41.9**	**172.9**	**155.1**	**153.6**	**173.9**	**187.8**	**219.4**	**294.3**	**367.9**
Cash and equivalents	6.0	5.4	1.7	2.5	1.7	28.8	21.0	27.9	16.6	19.0	20.0	19.0	19.3
Marketable securities	0.0	0.5	0.0	0.3	3.2	84.2	91.9	43.3	43.5	65.8	40.4	38.3	35.6
A/R	4.4	9.7	8.6	16.4	23.1	32.1	19.1	41.1	61.2	53.1	84.8	125.7	166.1
Inventory	1.7	2.7	5.7	16.2	13.5	21.1	19.3	37.5	48.7	46.2	70.7	107.8	142.4
Other current assets	0.1	0.1	0.4	0.5	0.3	6.8	3.8	3.8	3.9	3.7	3.5	3.5	4.5
Non-current Assets	**29.8**	**59.7**	**80.9**	**113.9**	**123.5**	**203.8**	**233.9**	**260.3**	**312.8**	**420.2**	**426.0**	396.4	378.4
Tangible Assets	27.1	31.3	42.6	84.4	88.0	117.8	116.1	134.6	161.2	329.2	288.2	288.2	278.2
LT financial assets	0.4	0.5	1.4	1.3	6.1	17.4	35.4	60.4	40.5	38.0	61.9	43.2	33.1
Inv in related co's	1.4	1.6	12.6	4.6	9.6	14.8	32.9	18.8	55.2	0.0	0.0	0.0	0.0
Other non-current	0.9	26.2	24.4	23.5	19.7	53.8	49.5	46.4	56.0	53.0	75.9	65.0	67.1
Total Assets	**42.1**	**78.1**	**97.3**	**149.9**	**165.4**	**376.7**	**389.0**	**413.8**	**486.7**	**608.0**	**645.4**	**690.7**	**746.3**
Current Liabilities	**4.9**	**6.4**	**24.9**	**43.8**	**55.8**	**118.9**	**137.5**	**182.4**	**219.9**	**225.4**	**237.7**	**261.0**	**255.1**
Account payables	1.3	3.0	4.2	11.4	11.4	26.2	11.0	55.4	53.2	32.0	46.3	71.2	92.1
ST int bear debt	0.2	0.3	14.0	25.9	26.0	75.2	117.9	114.3	143.1	169.1	172.3	166.3	136.3
Other current liabs	3.3	3.2	6.7	6.6	18.5	17.5	8.6	12.6	23.6	24.3	19.1	23.5	26.7
Non-current Liabilities	**0.8**	**0.5**	**0.8**	**22.9**	**24.4**	**76.3**	**78.1**	**70.2**	**63.1**	**155.0**	**154.6**	**154.8**	**142.1**
LT payables	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
LT int bear debt	0.8	0.5	0.0	21.8	23.0	73.4	70.4	62.4	58.0	147.5	147.5	147.5	132.5
Other LT liabs	0.0	0.0	0.8	1.1	1.4	2.9	7.7	7.8	5.1	7.5	7.1	7.3	9.6
Total liabilities	**5.7**	**6.9**	**25.7**	**66.7**	**80.3**	**195.2**	**215.5**	**252.6**	**283.0**	**380.4**	**392.3**	**415.8**	**397.2**
Paid-in capital	5.3	6.9	6.9	7.6	7.8	7.8	7.8	11.3	17.4	21.9	21.9	21.9	21.9
Capital surplus	16.3	46.8	46.8	54.2	56.3	56.8	56.9	66.9	110.5	163.3	168.5	141.2	141.2
Other comprehensive	0.1	(0.2)	(0.6)	(0.5)	(0.8)	(0.2)	13.9	12.4	10.5	(0.1)	1.3	(0.9)	(0.9)
Others	(3.3)	(0.0)	(1.1)	(1.1)	(0.9)	(0.7)	(3.7)	(3.7)	(4.0)	(0.3)	(0.3)	(0.3)	(0.3)
Retained earnings	18.1	17.6	19.5	19.3	22.7	25.6	5.7	(13.0)	(0.4)	8.4	32.8	82.8	157.1
Non-controlling	0.0	0.0	0.0	3.6	0.0	92.1	92.8	87.3	69.8	28.4	28.9	30.2	30.1
Total shareholder equity	**36.4**	**71.2**	**71.6**	**83.2**	**85.1**	**181.4**	**173.4**	**161.2**	**203.7**	**221.6**	**253.2**	**274.9**	**349.1**

Free cashflow analysis

(Wbn)	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F	2014F
Net profit	**4.2**	**3.4**	**2.6**	**0.2**	**4.1**	**3.8**	**(18.1)**	**(41.3)**	**(3.0)**	**11.0**	**28.8**	**56.4**	**80.8**
Add non-cash expenses	**6.3**	**8.3**	**14.7**	**0.0**	**16.4**	**34.1**	**56.9**	**49.0**	**45.9**	**48.9**	**55.3**	**45.2**	**55.2**
Depreciation	5.2	6.7	9.1	0.0	16.1	23.7	26.8	16.4	23.4	35.0	35.0	35.0	45.0
Allowance for reserves	0.7	0.8	1.1	0.0	2.0	2.5	4.8	3.8	3.8	8.2	4.5	4.3	4.3
Net FX gains	0.0	(0.0)	0.0	0.0	0.6	(0.4)	(2.7)	0.9	(0.2)	(0.2)	(0.1)	(0.2)	(0.2)
Net eq method gains	(0.4)	(0.0)	(1.4)	0.0	(0.8)	(0.6)	(1.2)	(3.0)	(4.3)	0.5	0.5	0.5	0.5
Others	0.0	0.5	0.7	0.0	(4.5)	4.4	9.5	18.1	6.1	3.0	(7.9)	2.3	2.3
Add. Changes in OP asset & liabilities	**(2.4)**	**(3.3)**	**1.8**	**0.0**	**4.4**	**(12.7)**	**(12.9)**	**8.1**	**(33.9)**	**(10.6)**	**(30.7)**	**(53.0)**	**(54.2)**
Investment in WC	1.3	4.6	0.6	11.2	3.9	1.7	0.4	(4.3)	33.6	10.6	42.0	53.0	54.2
Others	1.1	(1.3)	(2.5)	(11.2)	(8.3)	11.0	12.5	(3.8)	0.3	0.0	11.3	0.0	0.0
Cash from operation	**8.1**	**8.4**	**19.1**	**0.2**	**24.9**	**25.1**	**26.0**	**15.8**	**9.1**	**49.3**	**53.4**	**48.6**	**81.8**
Subtract capital expenditure	13.8	8.1	21.2	0.0	42.8	54.8	22.1	15.9	52.2	65.0	75.0	35.0	35.0
Free cash flow	**(5.7)**	**0.4**	**(2.0)**	**0.2**	**(17.9)**	**(29.6)**	**3.9**	**(0.1)**	**(43.1)**	**(15.7)**	**(21.6)**	**13.6**	**46.8**
Dividend	0.0	0.5	0.7	0.0	0.7	0.7	0.0	0.3	0.0	2.2	4.3	6.5	6.5
Net investments	0.0	0.0	0.0	0.0	0.0	6.4	14.5	7.7	35.8	1.0	1.0	1.0	1.0
Share issues	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Increase in debt	(0.2)	(0.2)	13.2	33.6	1.3	99.6	39.7	(11.5)	24.3	19.0	3.2	(6.0)	(45.0)
Others	(0.7)	(0.1)	15.1	33.0	(14.2)	47.1	38.7	(16.8)	(41.4)	(22.6)	3.7	6.3	(0.3)
Net cash flow	**(3.7)**	**(0.6)**	**(3.7)**	**0.8**	**(0.8)**	**27.1**	**(7.8)**	**6.9**	**(11.3)**	**2.4**	**1.0**	**(1.1)**	**0.4**
Beginning cash	9.7	6.0	5.4	1.7	2.5	1.7	28.8	21.0	27.9	16.6	19.0	20.0	19.0
Ending cash	6.0	5.4	1.7	2.5	1.7	28.8	21.0	27.9	16.6	19.0	20.0	19.0	19.3

Stability ratio

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F	2014F
Current ratio	252.8	288.0	65.7	82.2	75.0	145.4	112.8	84.2	79.1	83.3	92.3	112.7	144.2
Quick ratio	49.1	29.4	10.2	7.1	4.1	16.6	13.5	18.2	9.5	10.1	9.1	6.5	5.2
Inventory holding period (days)	22.9	33.0	50.6	46.7	38.0	26.9	42.5	50.7	35.5	51.2	52.1	21.0	21.2
A/R collection period (days)	61.5	63.4	50.7	57.5	56.7	27.7	38.3	55.6	39.3	54.3	53.4	21.2	21.4
A/P period (days)	11.9	16.7	15.9	22.4	25.3	24.4	28.1	37.0	39.7	37.6	22.0	22.0	23.6
Interest bear debt (Wbn)	1.0	0.8	14.0	47.6	49.0	148.6	188.3	176.7	201.0	316.6	319.8	313.8	268.8
Cash &equivalents (Wbn)	6.0	5.9	1.7	2.9	4.9	113.0	112.9	71.2	60.1	84.8	60.4	57.3	54.9
Net int. bear debt (Wbn)	(5.0)	(5.1)	12.3	44.8	44.0	35.6	75.4	105.5	140.9	231.8	259.4	256.5	213.9
Net debt/equity (%)	(13.7)	(7.1)	17.2	53.8	51.7	19.6	43.5	65.5	69.2	104.6	102.5	93.3	61.3
Liability/equity (%)	15.6	9.7	35.9	80.2	94.3	107.6	124.3	156.8	138.9	171.7	155.0	151.3	113.8
Interest coverage (X)	191.0	59.7	14.8	1.2	1.8	2.6	(0.8)	(1.2)	0.7	1.7	2.6	4.2	6.0

Valuations and margins

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F	2014F
EV/EBITDA (X)	8.6	10.8	8.2	89.4	6.2	3.6	4.6	22.9	8.0	5.9	4.0	3.0	2.3
EPS (W)	421	269	209	14	288	250	(1,200)	(1,867)	(87)	253	665	1,303	1,866
EPS change (%)	14.8%	-36.0%	-22.3%	-93.5%	2035.1%	-13.4%	N/A	N/A	N/A	-	162.4%	96.0%	43.2%
PER (X)	22.3	34.8	44.8	693.1	32.5	37.5	N/A	N/A	N/A	36.9	14.1	7.2	5.0
BVPS (W)	3,626	6,095	5,398	5,972	5,739	12,043	11,511	8,669	7,223	5,711	5,847	6,348	8,062
P/BVPS (X)	2.6	1.5	1.7	1.6	1.6	0.8	0.8	1.1	1.3	1.6	1.6	1.5	1.2
Dividend (W)	50	50	50	50	50	0	0	0	0	50	100	150	150
Dividend Yield (%)	0.5	0.5	0.5	0.5	0.5	0.0	0.0	0.0	0.0	0.5	1.1	1.6	1.6
ROA (%)	12.7	6.3	3.6	0.2	4.9	2.8	(10.2)	(24.7)	(1.6)	5.2	12.1	21.4	25.9
GP Margin (%)	10.8	5.7	2.9	0.1	2.6	1.4	(4.7)	(10.3)	(0.7)	2.0	4.6	8.4	11.2
OPM (%)	16.0	12.8	12.5	7.2	6.2	18.8	15.0	7.6	8.0	10.2	13.0	13.5	13.5
NPM (%)	12.3	7.8	5.6	1.6	2.4	3.8	(2.7)	(4.7)	1.6	5.5	8.1	8.6	8.6
EBITDA margin (%)	10.1	6.4	2.9	0.1	2.3	1.1	(6.3)	(12.3)	(0.6)	2.4	4.0	5.2	5.7
ROIC (%)	24.8	20.9	18.5	1.6	12.9	11.6	10.8	2.7	7.6	15.0	14.1	12.6	12.4
ROIC less WACC (%)	17.6	6.9	5.8	0.6	2.3	23.2	(3.5)	(6.4)	1.0	5.3	9.6	14.3	17.8
EV/EBITDA (X)	13.4	14.3	17.0	9.7	8.0	15.1	8.5	8.1	7.6	8.5	6.7	7.7	9.7
EPS (W)	4.2	(7.4)	(11.2)	(9.1)	(5.7)	8.1	(12.0)	(14.5)	(6.7)	(3.1)	2.9	6.6	8.1

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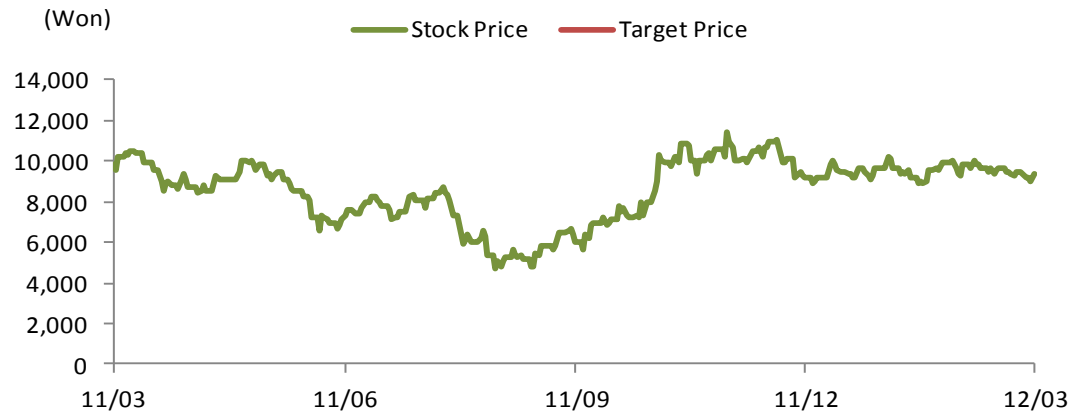
▶ Ratings and target price history in past two years

STS Semiconductor (036540 KQ)	
Date	2012-03-26
Ratings	BUY
Target Price	15,400

▶ Target price changes in past two years



▶ Investment period and ratings

Company

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HOLD	The stock is expected to either outperform or underperform the market by less than 15%p over the next 12 months.
SELL	The stock is expected to underperform the market by at least 15%p over the next 12 months.

Industry

OVERWEIGHT	Industry indicators are expected to outperform the market by at least 5%p over the next 12 months.
NEUTRAL	Industry indicators are expected to be in line with the market within 5%p over the next 12 months.
UNDERWEIGHT	Industry indicators are expected to underperform the market by at least 5%p over the next 12 months.

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