



26 October 2010

Lexmark International

Reuters: **LXK.N** Bloomberg: **LXK UN** Exchange: **NYS** Ticker: **LXK**

Margin peak in the rear-view mirror

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Margin peak in the rear view mirror

LXK reported revs/EPS of \$1,020M/\$1.09 (ex charges), which missed on the top line but beat on EPS (DB at \$1,059M/\$0.99; Street at \$1,040M/\$0.97). Revs missed on weak HW results and EPS beat primarily on lower taxes (\$0.06 impact) and better OMs (favorable mix). Looking forward, we expect rev and margin pressure to intensify and we expect FY11 Consensus to trend down to our est (Street at \$4.41, DB at \$3.70). At ~\$37 mid session we view shares of LXK as fairly valued; maintain Hold.

Negatives: HW revs miss despite inventory build/end of capacity constraints

Lexmark revenue increased 6% to \$1,020M and missed our model in all segments (DB at \$1,059M). In particular, Hardware revs of \$264M missed by 7% (DB at \$284M) and Supplies were light (\$698M vs. DB at \$704M). The revenue miss is particularly concerning given the fact that supply constraints in laser hardware alleviated in 3Q as LXK grew inventories 15% Q/Q, suggesting demand conditions are actually even weaker than expected. In addition, a handful of enterprise deals slipped into 4Q and Europe was down 4% Y/Y. Further, LXK saw weak LE inkjet demand at Walmart / other mass retailers.

Positives: HE laser /workgroup strength, Best Buy returns as channel partner

LXK posted GMs of 36.7% (vs. DB at 35.8%) aided by favorable HW mix as HE laser units were particularly strong at +20% Y/Y (vs. total laser +5% Y/Y). In addition, LXK saw strength in its workgroup products which supported positive product mix (ASPs +14% Y/Y). Lexmark also saw solid growth in HE Inkjet units which helped offset the decline in LE products. In addition, Best Buy returned as a channel partner (~2 year absence) and will offer 3 products with prices ranging from \$99-299 which will be available at Best Buy locations by Christmas.

FY11 estimates unchanged; maintain Hold and \$37 PT; risks

To reflect the beat we adjust FY10 rev/EPS (ex items) to \$4.2B/\$4.75 (vs. prior \$4.3B/\$4.60). However, FY11 is unchanged at \$4.3B/\$3.70 and our PT remains \$37 which is based on 10x FY11E EPS (lower end of 5-year historical range of 7-25x). We view the multiple as appropriate based on LXK's growth and profit profile. Downside risks to our investment thesis include operational execution risk and declining hardware growth. Upside risks include better-than-expected NT cartridge sales & a sharp increase in install base growth; see page 4 for additional valuation and risk details.

Forecasts and ratios

Year End Dec 31	2009A	2010E	2011E
1Q EPS ¹	0.89	1.35A	1.21
2Q EPS	0.55	1.23A	0.89
3Q EPS	0.65	1.09A	0.81
4Q EPS	1.17	1.09	0.79
FY EPS (USD)	3.26	4.75	3.70

Source: Deutsche Bank estimates, company data

¹ Includes the impact of FAS123R requiring the expensing of stock options.

Forecast Change

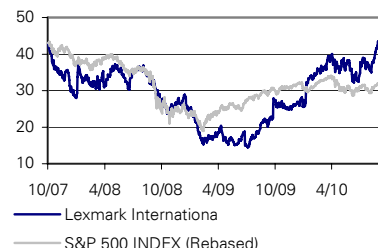
Hold

Price at 25 Oct 2010 (USD)	47.72
Price target	37.00
52-week range	47.72 - 24.75

Key changes

EPS (USD)	4.60 to 4.75	↑	3.3%
Revenue (USDm)	4,273.5 to 4,224.8	↓	-1.1%
Revenue (USDm)	4,101.7 to 4,273.5	↑	4.2%

Price/price relative

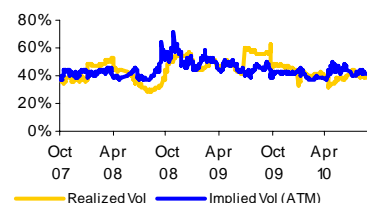


Performance (%)	1m	3m	12m
Absolute	10.3	40.4	73.5
S&P 500 INDEX	3.2	7.5	9.8

Stock & option liquidity data

Market Cap (USDm)	3,792.5
Shares outstanding (m)	79.5
Free float (%)	100
Volume (25 Oct 2010)	651,877
Option volume (und. shrs., 1M avg.)	327,367

Implied & Realized Volatility (3M)



Implied Volatility (3M, ATM) vs. Peers

*Weighted-avg. of index components
Data as of 25-Oct-10

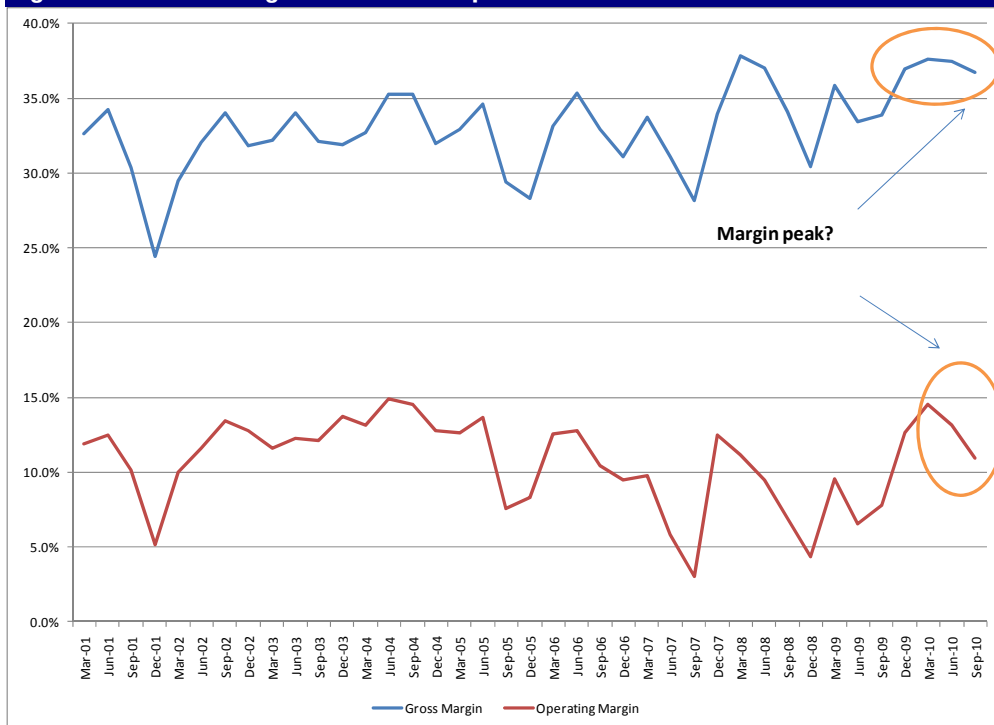
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Investment thesis

LXK revenues increased 6% Y/Y to \$1,020M but missed our model by 4% (DB at \$1,059M) as all business segments were light: hardware and supplies revenues up 10% Y/Y and 4% Y/Y, respectively (vs. DB at HW up 18% and supplies revs up 5%). The hardware miss is particularly concerning (7% below our model) given a 15% Y/Y inventory build in the quarter as prior capacity constraints alleviated (laser hardware) ahead of expectation. Beyond 3Q, we expect product mix to decline (i.e., back towards mid and LE laser) and we expect greater competition as industry supply is normalized (i.e. HP / Canon's supply constraint also appears to be moderating). The combination of these factors suggests LXK will experience both revenue and margin pressure going forward and we believe LXK's margins peaked at / near decade high levels in 1H10 (see Figure 1).

Figure 1: Lexmark margin trend 1Q01 to present



Source: Deutsche Bank

Lexmark's laser business supported 3Q results due to mix improvements and cartridge sales. Laser units increased 5% Y/Y (vs. +7% Y/Y in 2Q10) and laser ASPs increased 14% Y/Y driven by a positive product mix shift toward HE laser and workgroup products. On the other hand, Lexmark's inkjet hardware revenues declined 15% Y/Y (vs. -2% in 2Q10) with IJ units down 28% Y/Y (vs. down 7% Y/Y in 2Q10). However, inkjet ASPs were up 17% Y/Y (vs. +5% Y/Y in 2Q10) driven by better mix towards higher end inkjet products. We estimate LXK's laser supplies sales grew ~13% Y/Y as a result of a cyclical improvement in printed pages and associated pantry restocking. Meanwhile, we estimate inkjet supplies declined ~8% Y/Y.

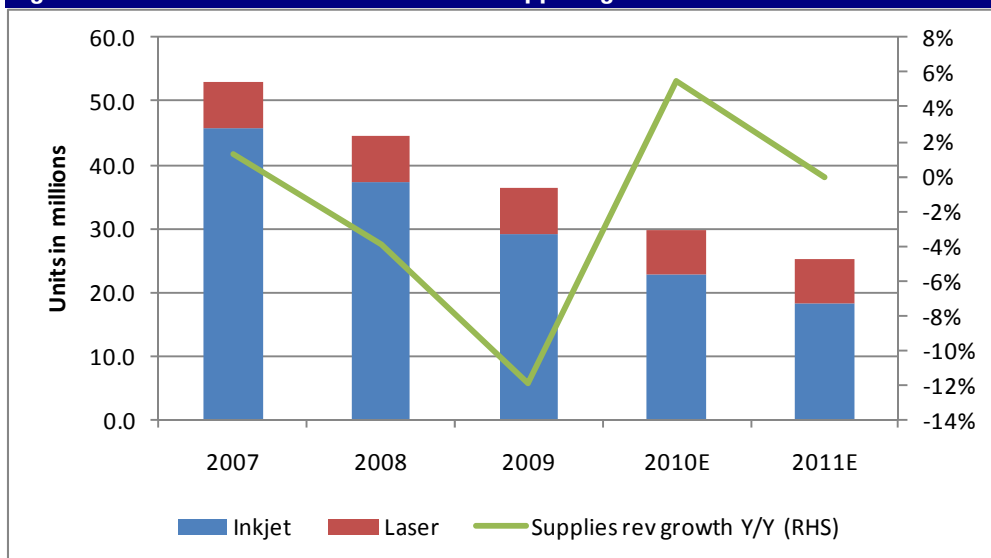
Gross margins in 3Q10 of 36.7% were above our model (vs. DB at 35.8%) due to favorable hardware and supplies mix (i.e. HW units mixed upwards and light HW (relative to supplies) is beneficial to margins). LXK posted OM of 11.0% which beat our model (DB at 10.3%). SGA on an absolute dollar basis was below our model (\$171M vs. DB at \$175M) which helped offset the top line miss and resulted in Operating income topping our estimate by \$3M (\$112M vs. DB at 109M). In aggregate, a lower tax rate (18.4% vs. DB at 23.0%) helped facilitate an EPS beat of \$0.10 (\$1.09 vs. DB at \$0.99). The lower tax rate was ~\$0.06 of the EPS upside.

LXK guided 4Q10 revenue to be up low-single digits Y/Y and non-GAAP EPS in the range of \$1.03-1.13 (ex. \$0.17 acquisition and restructuring adjustments) which compares to current Consensus at \$1.03. The company guided FY10 revs to be up 8% Y/Y and Op Inc margins in the range of 12.0%-12.5% (vs. 9.3% in FY09). Additionally, LXK guided FY10 non-GAAP EPS in the range of \$4.70-4.80 (vs. the Street at \$4.56).

As highlighted in Fig 2 below, we estimate LXK's installed base has declined dramatically over the past few years which we estimate totals roughly 36M units in 2009 (~29M inkjet and 7M laser) assuming a ~3 year usable life on IJ and ~4.5 year usable life on laser hardware. Following the improvement in 1H10, we believe supplies revenues will increase 6% Y/Y in 2010 and moderate to 0% Y/Y 2011 (following a severe inventory adjustment in 2008/09). This estimate assumes that the average cartridge consumption / installed unit grows by 28% in 2010 and 18% in 2011 (reflecting expected mix improvement).

We continue to believe multiple years of weak hardware sales, a shrinking installed base and a mature print market will make it difficult for LXK to sustain revenue growth. In addition, we expect the pricing environment to become more aggressive in 2011 as existing players (HPQ, Brother, Epson, Canon, EK, XRX) alleviate supply constraints and compete for share in a declining industry. Although LXK benefited from improving end market demand we believe long-term growth and profitability will remain pressured at LXK.

Figure 2: Estimated LXK installed base vs. Supplies growth



Source: Deutsche Bank and company data

Estimate revisions and valuation

To reflect the beat we adjust FY10 rev/EPS (ex items) to \$4.2B/\$4.75 (vs. prior \$4.3B/\$4.60). However, FY11 is unchanged at \$4.3B/\$3.70 and our PT remains \$37 which is based on 10x FY11E EPS (lower end of 5-year historical range of 7-25x). We view this multiple as appropriate given LXK's long-term growth and profit profile.

Figure 3: Valuation

	2010E	2011E
EV/Sales	0.6	0.5
EV/EBITDA	3.4	3.6
P/E	7.9	10.1

Source: Deutsche Bank estimates

Risks

Risks to our thesis include better/worse-than-expected competitive pressure in the printer market, an extended price war, better/worse-than-expected margins on cartridges, and better/worse-than-expected uptake of color laser and photo printers. Company-specific risks include operational and management execution risks, a continued decline in hardware growth, and the loss of the Dell business. Upside risk to our thesis includes better-than-expected near-term cartridge sales and/or less-than-expected competitive pricing pressure.

Operating results / performance versus expectations

Revenue

Revenue grew 6% Y/Y to \$1,020M (down 1.3% Q/Q), and missed our \$1,059M estimate. Hardware revenue of \$264M (up 10% Y/Y) missed our \$284M estimate by a wide margin (~\$20M), while supplies revenue of \$698M (up 4% Y/Y) missed our estimate of \$704M by ~\$6M. Laser units increased 5% Y/Y while Inkjet units declined 28% Y/Y. Our ASP and unit estimates are highlighted below.

Figure 4: Revenue Growth Rates by Segment (Y/Y)

	3Q08	4Q08	1Q09	2Q09	3Q09	4Q09	1Q10	2Q10	3Q10	2008A	2009A	2010E
Total Printers	-14%	-29%	-30%	-29%	-24%	0%	18%	26%	10%	-20%	-21%	17%
Supplies	-1%	-12%	-16%	-18%	-12%	-1%	9%	10%	4%	-3%	-12%	6%
Other	4%	-15%	-17%	-14%	-10%	-8%	-3%	19%	23%	-5%	-12%	17%
Total	-5%	-17%	-20%	-21%	-15%	-1%	10%	14%	6%	-9%	-14%	9%

Source: Deutsche Bank and Company data

Figure 5: Estimated ASP (Y/Y) and Unit Growth (Y/Y)

	3Q08	4Q08	1Q09	2Q09	3Q09	4Q09	1Q10	2Q10	3Q10	2008A	2009A	2010E
ASP Y/Y Growth												
Inkjet	15%	0%	-3%	13%	14%	30%	28%	5%	17%	14%	12%	15%
Laser	2%	-14%	-5%	-7%	0%	27%	12%	28%	14%	-3%	0%	14%
Total	45%	19%	-2%	13%	19%	23%	32%	20%	33%	32%	11%	30%

Unit Y/Y Growth												
Inkjet	-46%	-43%	-30%	-43%	-38%	-34%	-23%	-7%	-28%	-45%	-36%	-21%
Laser	-1%	-8%	-25%	-21%	-22%	-16%	15%	7%	5%	-7%	-21%	6%
Total	-41%	-34%	-29%	-39%	-35%	-29%	-14%	-4%	-20%	-38%	-31%	-13%

Source: Deutsche Bank estimates and Company data

Margins

Gross margins of 36.7% were 90bps above our estimate of 35.8% due to favorable HW mix to HE laser while non-GAAP operating margins of 11.0% were 70bps above our estimate of 10.3%.

Figure 6: Gross and Operating Margins

	3Q09	4Q09	1Q10	2Q10	3Q10
Gross Profit Margin	33.9%	36.9%	37.6%	37.5%	36.7%
Operating Margin	7.8%	12.6%	14.5%	13.1%	11.0%

Source: Deutsche Bank estimates and Company data

EPS

Lexmark reported non-GAAP EPS of \$1.09 (ex \$0.19 restructuring), above our \$0.99 estimate (Street at \$0.97) as lower hardware unit shipments and OPEX helped offset top line weakness. In aggregate, a lower tax rate (18.4% vs. DB at 23.0%) helped facilitate an EPS beat of \$0.10 (\$1.09 vs. DB at \$0.99). The lower tax rate was ~\$0.06 of the EPS upside.

Figure 7: Income Statement versus DB expectations**Lexmark**

Income Statement

December FY

(\$ millions except EPS data)

	3Q-09A	DB 3Q-10E	% change	Actual 3Q-10A	% change
Hardware	240	284	18%	264	10%
Supplies	671	704	5%	698	4%
Other	47	70	50%	58	23%
Total Revenue	958	1,059	11%	1,020	6%
Cost of Goods Sold	634	680	7%	645	2%
Gross Profit	324	379	17%	374	15%
R&D	92	95	4%	91	0%
SG&A	158	175	11%	171	8%
Operating Income	75	109	46%	112	50%
EBITDA	126	159	26%	163	29%
Interest Expense	5	7	46%	7	35%
Other	4	0	NA	(1)	NA
Pretax Income	66	102	55%	106	62%
Taxes	15	23	60%	20	33%
Net Income (Operating)	51	79	54%	87	70%
Operating EPS (Diluted)	\$0.65	\$0.99	53%	\$1.09	68%
Avg. Shares (Diluted)	79	79	1%	80	1%
Margin Summary					
Gross Margin	33.9%	35.8%		36.7%	
Operating Margin	7.8%	10.3%		11.0%	
EBITDA Margin	13.2%	15.0%		16.0%	
Net interest income	6.9%	9.6%		10.4%	
Pretax Income	0.5%	0.7%		0.6%	
Tax rate	22.4%	23.0%		18.4%	
Net Margin	5.3%	7.4%		8.5%	
R&D: Sales	9.6%	9.0%		9.0%	
S,G&A: Sales	16.5%	16.5%		16.8%	

Source: Deutsche Bank and Company data

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Appendix 1

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Additional information available upon request

Disclosure checklist

Company	Ticker	Recent price*	Disclosure
Lexmark International	LXK.N	47.72 (USD) 25 Oct 10	6

*Prices are sourced from local exchanges via Reuters, Bloomberg and other vendors. Data is sourced from Deutsche Bank and subject companies.

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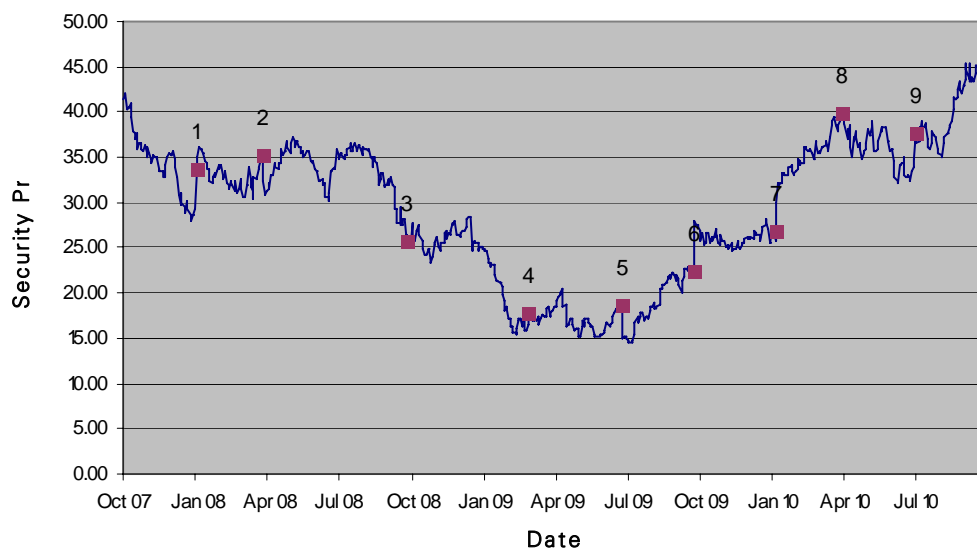
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Historical recommendations and target price: Lexmark International (LXK.N)

(as of 10/25/2010)



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.	1/29/2008:	Hold, Target Price Change USD30.00	6.	10/20/2009:	Hold, Target Price Change USD23.00
2.	4/22/2008:	Hold, Target Price Change USD28.00	7.	2/2/2010:	Hold, Target Price Change USD30.00
3.	10/21/2008:	Hold, Target Price Change USD25.00	8.	4/27/2010:	Hold, Target Price Change USD40.00
4.	3/26/2009:	Hold, Target Price Change USD18.00	9.	7/28/2010:	Hold, Target Price Change USD37.00
5.	7/21/2009:	Hold, Target Price Change USD15.00			

Equity rating key

Equity rating dispersion and banking relationships

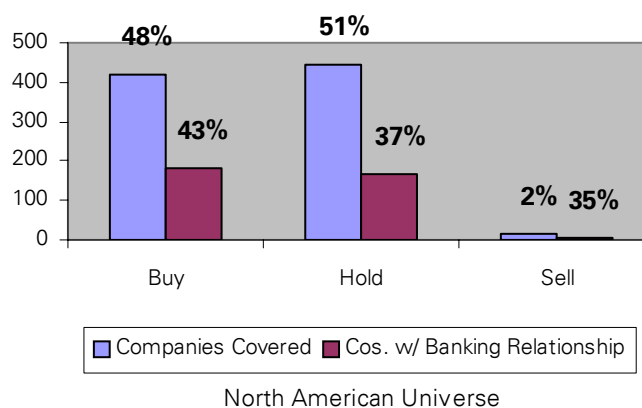
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