Corporate Snippet

Wed, 06 Dec 2006

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Earnings visibility remains low — Hong Kong Electronics

Johnson Electric (179 HK, HK$5.89) — Not Rated

1H FY3/07 results review. Johnson Electric reported a YoY 22.5% increased in net profit to US$64.7m, or US$0.018/share for 1H FY3/07A, against a YoY 68.0% surge in sales to US$1,052.3m. The group proposed an interim dividend of HK$0.045/share, or US$0.006/share.

Sales surged. The strong growth in sales was attributable to contribution from Saia-Burgess Electronic and Parlex, which the group acquired in November 2005. Besides, the group consolidated Shanghai Ri Yong and China Autoparts' financials into its owned accounts, after it increased stakes in these former JVs. Total sales contributed by the aforementioned entities amounted to US$385.0m during the period under review. Excluding contributions from the newly acquired subsidiaries, the group's sales would have increased by 6.5% YoY. It posted a YoY 68.2% surge in EBITDA to US$141.9m, due to the YoY 56.1% increase in operating profit and approximately two-fold surge in depreciation & amortization charges.

Revenue sources. Revenue derived from the group's automotive products division, industry products division and other business units were US$520.5m, US$375.5m and 156.3m, representing 49.0%, 36.0% and 15.0% of the group's total turnover, respectively.

Table 1: Geographical sales breakdown

Year to Mar (US$m)	1H07	1H06	*YoY (%)*
Asia	583.0	462.9	*26*
Americas	123.3	20.6	*500*
Europe	346.0	142.9	*142*

Source: Company

Margin expansion. Blended profit margin increased 1.1 pcp to 26.4%. Nevertheless, excluding the newly acquired companies, the group's gross profit margin would have increased further by over 2.0 pcp. The expansion in gross profit margin was mainly due to the higher ASP, lower steel cost and change in product mix. Nevertheless, high copper price remained a drag. Given the lower steel cost and the projected soften demand, the upside of the group's products ASP is expected to be limited in 2H FY3/07F. Besides, higher copper price will continue to erode the group's profitability.

Restructuring charges. The group incurred a restructuring charge of US$5.1m on the closure of plants in Dalian, China and Cranston, USA. Its selling and administrative expenses leapt YoY 79.2% to US$182.8m as its operations expanded. As a result, SG&A to sales ratio reached 17.4% vs. 16.3% reported in the corresponding period last year.

Surge in interest expenses. Finance costs surged 4x to US$15.2m on the net interest-bearing loan of US$475.7m, against a net cash position of US$158.2m as at the end of September 2005. The group borrowed US$525.0m from bank for the acquisition of Saia-Burgess. Besides, the group's effective tax rate rose to 18.5% in 1H FY3/07A from 16.2% in 1H FY3/06A, as Saia-Burgess's tax expenses were included into the group's results.

Performance of newly acquired subsidiaries. The recently acquired Saia-Burgess Electronics performed in line with management expectation. Meanwhile, Parlex achieved revenue growth slightly ahead of the group's target. Nevertheless, the one-off charges dragged down Parlex's profitability. Besides, Parlex has been undergoing restructuring and whether it can turn around remains an uncertainty.

Consolidate the newly acquired subsidiaries. The group will consolidate Saia-Burgess's Guangzhou operations into its main manufacturing operation in Shajing. Synergy is expected to emerge between the group and Saia-Burgess, in terms of lower manufacturing overhead and procurement costs, broadened product and expanding sales channel, especially in Europe. Parlex is still undergoing restructuring. It is expected that the group will shut down Parlex's production facilities in the U.S. and transfer its production to China. Thus, more provision for the restructuring of Parlex is expected.

Earning visibility remains low. Due to the fluctuation in raw materials, especially copper prices and softer demand in some of its major market, the management is cautious about the outlook for near-term sales growth and opportunity for margin expansion. Besides, unexpected restructuring charges, together with swelling SG&A expenses, expanding DD&A charges, rising finance costs and higher effective tax rate would continue to erode the group's profitability in the near term. The group is trading at P/E of 19.9x and 16.8x for FY3/07F and FY3/08F, respectively, compared with the sector average of 21.8x and 19.0x for FY07F and FY08F, respectively.

Table 2: Peer comparisons

Company name	Ticker	Year End	Price (US$)	Market Cap (US$m)	P/E (x) FY07F	P/E (x) FY08F
Baldor Electric	BEZ US	Dec	34.65	1,120	20.2	16.3
Mabuchi Motor	6592 JP	Dec	59.29	2,791	30.8	27.2
Techtronic Industries	669 HK	Dec	1.35	1,972	10.0	8.9
Average					*21.8*	*19.0*

Source: Bloomberg.