

Dramatic turnaround**Hong Kong Electronics****Daisho Microline (567 HK, HK\$2.57)****Not Rated**

Company background. Daisho Microline (DM) is a printed circuit board manufacturer focused on high-end PCBs – high density interconnect (HDI). The company is 10.73%-owned by renowned Japanese electronic component solutions provider Daisho Denshi. The privately-held Japanese company bought into DM in 2001, transferring technologies over to DM and facilitating its entry into the HDI business. DM supplies its PCB products to Taiwan/Japan/US/European electronic manufacturing services (EMS) companies in China. Around 90% of DM's HDIs are used in handsets, with the remaining used in other consumer electronic products such as digital cameras, MP3s and portable digital printers. The company's plant is based in Huizhou, Guangdong with around 2,000 employees.

FY3/06 results

- FY3/06 turnover rose 141.3% YoY to HK\$623.2m while net profit totalled HK\$109.1m (EPS: HK\$0.233) compared to a loss of HK\$14.3m a year ago. For the year, HDIs contributed 65% of total revenues, while non-HDIs contributed the remaining 35%.
- Gross margin was 44.6%, up 31.7 pcp YoY. Considering 1H FY3/06 gross margin was 36.2%, 2H FY3/06 gross margin reached 50.3%.
- The dramatic turnaround was a result of several factors including: 1) increased plant capacity, 2) increased demand after obtaining some new customer product quality approvals and 3) better production yield (from 30 to >90%). DM added HK\$149m worth of production capacity during the reporting year.
- Free cash flow reached HK\$90.6m from HK\$2.8m in FY3/05. At the end of 31 Mar 2006, the company had a net gearing of 7.2%.

Outlook

- DM had a run rate of turnover of HK\$42m per month in 1H FY3/06 and rose to HK\$62m in 2H FY3/06. With increased orders and production capacity, we estimate run rate in 1Q FY3/07 will be up another 30% YoY sequentially over 4Q FY3/06.
- Management noted that demand for HDIs currently exceeds supply in China. Our read is that DM has not experienced significant downside pressure to ASPs so far this year. The company has good earnings visibility given that its EMS customers typically provide a 1-year rolling forecast which is reviewed on a semi-annual basis.
- Moreover, the significant ramp up in operating scale should allow Daisho to largely offset the price increase in raw materials. We expect 1H FY3/07 margins to be largely in line with that in FY3/06.
- The company currently has scheduled HK\$100m of capacity to be installed in FY3/07. HK\$70m of which is scheduled to be implemented between Apr to Sep 2006, while the remaining will be implemented after Sep 2006. Note that HK\$228m worth of plant and equipment was ordered in FY3/06 with HK\$149m worth installed. We estimate that DM's installed capacity will rise by a further 42-45% over FY3/06 by the end of 1H FY3/07.

Valuation. The counter is currently trading at 11.0x FY3/06 P/E and 5.1x P/B.

Corporate governance issues. The company's substantial shareholders include Chairman Chan Sik Ming (29.98%), Daisho Senshi (10.73%), Young Kai Tai (8.96%) and Lau Wing Hung (7.41%). Mr. Young disposed

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a total of 9.36m shares between 27/07/06 and 02/08/06 to independent third parties while Mr. Lau disposed a total of 8.64m shares between 12/06/06 and 21/07/06 to the Chairman (6.8m shares) and other independent third parties. The company was listed in 1990 on HKEx Main Board and has not undertaken any further fund raising since IPO. DM paid a 13.1% dividend payout in FY3/05 but management indicated that they would maintain a dividend payout of 20%+ going forward, depending on the company's capex requirements. The company appoints Ernst & Young as its financial auditor.

Table 1: P&L

Year to Mar (HK\$m)	2003A	2004A	2005A
Turnover	241.7	258.2	623.2
Cost of sales	(208.0)	(224.8)	(345.0)
Gross profit	33.7	33.4	278.2
Other income and gains	1.4	1.6	4.4
Selling and distribution costs	(14.9)	(24.3)	(114.0)
Administrative expenses	(20.6)	(22.7)	(33.1)
Other operating expenses	(3.2)	(0.8)	(2.8)
Finance costs	(1.8)	(1.5)	(2.6)
Profit before taxation	(5.5)	(14.3)	130.2
Taxation	-	-	(21.1)
Profit after taxation	(5.5)	(14.3)	109.1
Minority interests	-	-	-
Profit attributable to shareholders	(5.5)	(14.3)	109.1
% chg	na	na	na
Dividend	-	-	(14.3)

Source: Company data