

Datronix: A beneficiary of defense spending

Recommendation: Not Rated

Hong Kong Industrials

Price	HK\$1.55	Yield (3/06A)	6.0%
12 mth range	HK\$0.61-1.92	ROE (12/05A)	26.67%
Market cap.	US\$66.1m	Net gearing (1H FY12/06)	Net Cash
No. shares o/s	320.0m	Net debt/sh. (1H FY12/06)	HK\$0.47
Daily t/o, 3 mth	<US\$0.24m	BV/sh. (12/05A)	HK\$0.78
Free float %	26%	Consensus EPS	
Major shareholder	Paul Siu – 72.8%	- 12/06F	HK\$0.23
Ticker	0889.HK/ 889 HK	- 12/07F	HK\$0.28

Key points:

- Achieved an interim profit growth of 33% YoY for FY12/06, mainly driven by stronger growth in the military, aerospace applications, high reliability products, medical device and power conversion products from US.
- Management expects that the momentum will continue in 2H FY12/06F and FY12/07.
- Products are sold under its own brand name Datatronics.
- Has the ability to satisfy customers' needs by providing customized products that meet quality, technical and delivery requirements.
- Enjoyed net margin of >28% and sat on net cash of HK\$0.41 per share.
- Trading at c.6.5x FY12/06F P/E and 5.2x FY12/07F P/E.

Background. Established in 1971, Datronix is principally engaged in manufacture, design and sale of magnetic products used in consumer electronics, data processing appliances and other electronics system. All of the products are sold under its own brand name "Datatronics". The company focuses on the high-end segment of the magnetic industry by offering a comprehensive range of products. Datronix serves a broad range of customers (>300) ranging from manufacturers of military, aerospace, medical equipment, data processing equipment and telecommunication. The production requires high workmanship because there is high level of customization involved.

Interim results summary. The company's revenue increased approximately 39% YoY to HK\$136.9m and net profit grew by 32.7% to HK\$38.4m in 1H FY12/06. 95% of sales are derived from customized magnetic products, which are tailored-made according to the requirement of the customers, while 5% of sales are catalogue items. CAPEX amounted to approximately HK\$1.2m. CAPEX was relatively small as the company had sufficient production capacity to meet demand going forward. The financial position of the company was strong with no debt and gross cash of HK\$130.8m in 1H FY06/12. Dividend payout ratio is set at 30%.

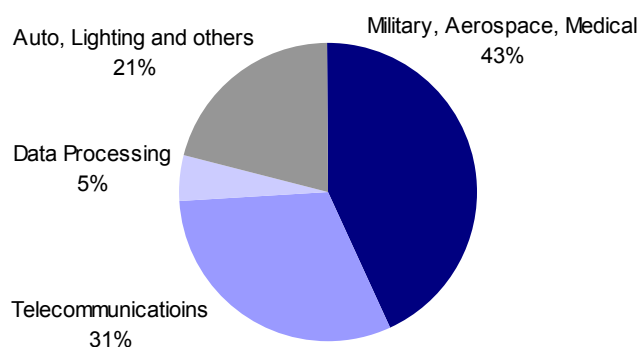
Datatronics Romoland, Inc. ("DRI"). DRI manufactures and sells very high reliability magnetics that conform to the demanding technical specifications of the aerospace, military and medical industries. DRI is a related company in which Mr. Paul Siu holds approximately 96.5% of its issued capital. Datronix is the sole outsourcing producer to DRI, and DRI accounted for 36% of the company sales in 2005. In order to maximize its competitive position, DRI outsources production of some magnetic components to Datronix, which are considered less sensitive and approved by the customers. We expect the proportion of production allocated to Datronix will increase going forward as customers (such as those in the medical industry) seek to alleviate rising cost pressures.

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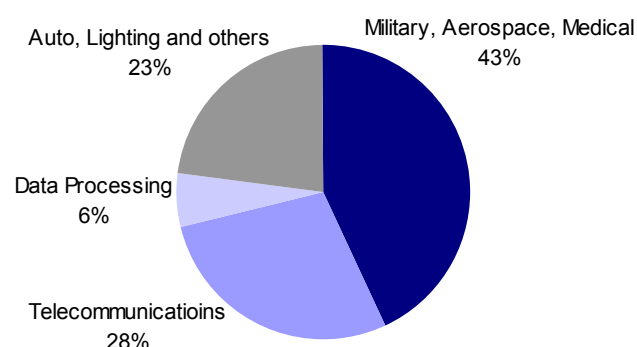
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Chart 1: Revenue breakdown 1H FY06

Source: Company data

Chart 2: Revenue breakdown FY05

Source: Company data

Customer base. DRI was the largest customer of the company, accounting for 36% of sales in 2005. DRI, Lutron, Vicor, Bourns and Alcatel were the 5 largest customers in aggregate, accounting for 68% of the sales in FY12/05.

Materials. The major materials are copper (accounted for 15% of the cost of materials), iron or ferrite (15%). Plastic, chemical and packaging materials together accounted for the rest of the cost. The cost of materials in 1H FY12/06 had increased by 10%. The raw material price fluctuation has little effect on the company as it can certainly pass the cost to the customers, as they place a higher value on Datronix's ability to customize products to meet their demanding specifications.

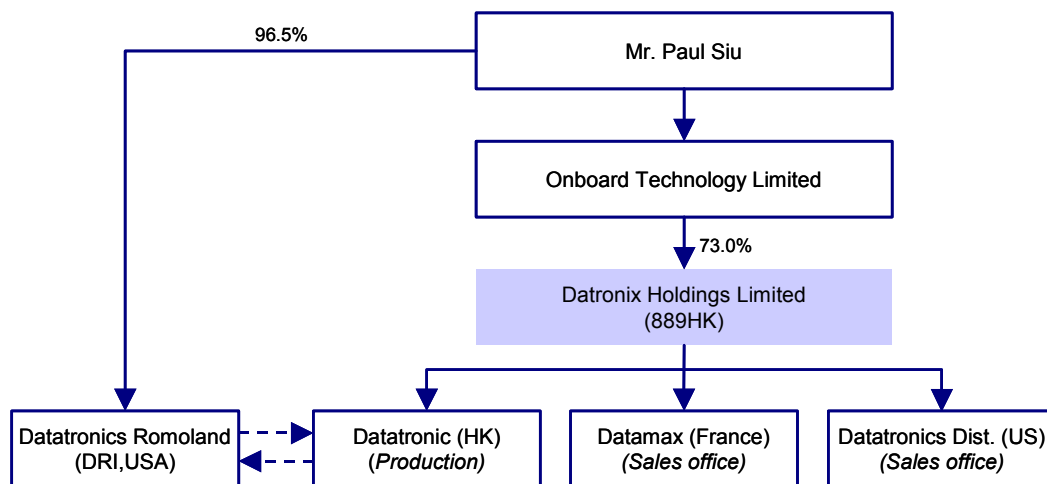
Pricing. The company implements the cost plus mark-up pricing strategy. Generally, the company will mark up around 30%-50% of price based on the cost of the materials.

Entry barriers. The entry barrier for magnetic industry is low, as the market is very fragmented. But the entry barriers for some sensitive segments such as military, aerospace components and medical device are high, thus the competition in these segments is not intense. Datronix has one competitive advantage over its rivals, namely the longstanding relationship with its main customers. A majority of the customers has a relationship with the company for more than 10 years. One of the reasons why the company owns such a loyal customer base is because the company provides customized services to each customer and fulfills each customer's specific requirements on a timely basis. If there is a case of emergency (when the key customer needs the products urgently), the company will take only 48 hours to finish and ship the products to its key customers. Thus, the company is well recognized for its reliability, good services and high quality products.

Suspension and resumption of trading. Datronix was listed since Jun 2001, but trading was suspended in August 2002 due to the shareholding structure of the company. The company was alleged in breaching of listing rules because less than 25% of the issued share capital was deemed to be in the hands of public. In May 2006, the company placed 75.6m shares at HK\$1.10 and the public float issue was solved upon the completion of the placement.

Future prospect. Due to the US military actions in the Middle East and other world trouble spots, the demand for aerospace and military component is expected to grow. Nowadays, most of the electronics manufacturers like to outsource production to third parties, thus Datronix can benefit from this outsourcing trend. Going forward, DRI will outsource more less sensitive products such as medical devices to the company. We expect the sales of medical components will increase by 25% YoY and sales of military components will increase about 10%-15% YoY in FY12/07. Management also revealed that they will expand the plant in China and the new factory is expected to be operational by early 2008.

Valuation. The counter is trading at c.6.5x FY12/06F P/E and 5.2x FY12/07F P/E.

Chart 3: Company structure

Source: Company data

Pic 1: Power Inductor

Source: www.datatronix.com

Pic 2: Inductor, high frequency, SMT

Source: www.datatronix.com

Pic 3: Transformer

Source: www.datatronix.com

Pic 4: Common mode inductor

Source: www.datatronix.com

P & L (HK\$m)	03A	04A	05A	Cash Flow (HK\$m)	03A	04A	05A
Year to Mar				Year to Mar			
Turnover	144.7	184.5	208.6	EBIT	23.8	44.1	64.9
% chg		27.5	13.1	Depre./amort.	4.4	5.1	5.0
Gross profit	59.2	80.7	106.9	Net int. paid	0.4	0.7	1.8
				Tax paid	(0.7)	(0.1)	(6.2)
EBITDA	28.2	49.2	69.9	Dividends received	-	-	-
Depre./amort.	(4.4)	(5.1)	(5.0)	Gross cashflow	27.9	49.8	65.5
EBIT	23.8	44.1	64.9				
Net int. income/(exp.)	0.5	0.7	1.8	Chgs. in working cap.	(13.4)	(3.1)	(15.5)
Exceptionals	-	-	-	Operating cashflow	14.5	46.7	50.0
Associates	-	-	-				
Jointly-controlled entit.	-	-	-	Capex	(1.8)	(11.7)	(6.0)
Pre-tax profit	24.3	44.8	66.7	Free cashflow	12.7	35.0	44.0
Tax	(4.6)	(4.3)	(5.9)				
Minority interests	-	-	-	Dividends paid	(19.2)	(10.9)	(16.6)
Net profit	19.7	40.5	60.8	Net distribution to MI	-	-	-
% chg		105.6	50.1	Investments	-	-	-
				Disposals	-	0.0	0.1
Dividends	(10.2)	(14.1)	(19.2)	New shares	-	-	-
Retained earnings	9.5	26.4	41.6	Others	0.2	1.5	(1.1)
				Net cashflow	(6.3)	25.6	26.4
EPS (HK\$) - Basic	0.06	0.12	0.19				
EPS (HK\$) - F.D.	-	-	-	Net (debt)/cash - Beg.	65.0	58.7	84.3
DPS (HK\$)	0.012	0.022	0.030	Net (debt)/cash - End.	58.7	84.3	110.7
No. sh.s o/s (m) - W.A.	320.0	320.0	320.0				
No. sh.s o/s (m) - Y.E.	320.0	320.0	320.0	Interim Results (HK\$m)	04A	05A	06A
No. sh.s o/s (m) - F.D.	-	-	-	Six months to Sep			
				Turnover	97.9	98.4	136.9
Margins (%)				% chg	44.8	0.5	39.1
Gross	40.9	43.7	51.2				
EBITDA	19.5	26.7	33.5	Profit from operations	20.6	31.9	44.3
EBIT	16.4	23.9	31.1	Interest expenses	-	-	-
Pre-tax	16.8	24.3	32.0	Associates	-	-	-
Net	13.6	22.0	29.1	Jointly-controlled entit.	-	-	-
				Pre-tax profit	20.6	31.9	44.3
Balance Sheet (HK\$m)	03A	04A	05A	Tax	(2.9)	(3.0)	(5.8)
Year to Mar				Minority interests	-	-	-
Fixed assets	46.3	31.8	33.8	Net profit	17.7	28.9	38.5
Intangible assets	1.0	-	-	% chg	126.9	63.3	33.2
Other LT assets	-	21.2	20.7				
Cash	58.7	84.3	110.7	EPS (HK\$) - Basic	0.05	0.01	0.10
Accounts receivable	30.2	26.9	47.0	DPS (HK\$)	0.020	0.030	0.037
Other receivables	3.5	5.8	1.0				
Inventories	53.5	54.9	61.5	Shareholding Structure			
Due from related co.s	0.0	0.0	0.0		Shares o/s (m)	%	
Other current assets	13.6	13.6	13.6	Paul Siu	233.0	72.8	
Total assets	206.8	238.5	288.3	Invesco HK Limited	16.1	5.0	
				Public	70.9	22.2	
Accounts payable	(8.3)	(7.7)	(11.9)	Total	320.0	100.0	
Other payable	(4.6)	(3.7)	(5.1)				
Tax payable	(14.4)	(18.6)	(18.1)	Background			
Due to related co.s	0.0	0.0	0.0	Datronix is principally engaging in manufacture, design and sale of magnetic used in consumer electronics, data processing appliances and other electronics system. The company focuses on the high-end segment of magnetic industry by offering a comprehensive range of magnetic products. Datronix serves a broad range of customers ranging from manufacturers of military, aerospace, medical device, data processing equipment and telecommunication.			
ST debts	0.0	0.0	0.0				
Other current liab.	0.0	0.0	0.0				
LT debts	0.0	0.0	0.0				
Other LT liabilities	(2.7)	(3.2)	(2.8)	Key Ratios	03A	04A	05A
Total liabilities	(30.0)	(33.2)	(37.9)	Net gearing (%)	33.2	44.1	48.6
				Net ROE (%)	11.1	21.2	26.7
Share capital	32.0	32.0	32.0	EBIT ROCE (%)	13.5	23.1	28.5
Reserves	144.9	173.3	218.6	Dividend payout (%)	51.8	34.8	31.6
Shareholders' funds	176.9	205.3	250.6	Effective tax rate (%)	18.9	9.6	8.8
Minority interest	-	-	-	Net interest coverage (x)	na	na	na
Total	176.9	205.3	250.6	A/R turnover (days)	76.2	56.5	64.7
				A/P turnover (days)	20.9	15.8	17.1
Capital employed	176.9	205.3	250.6	Stock turnover (days)	228.4	190.6	208.9
Net (debt)/cash	58.7	84.3	110.7				