

Plenty of work to do

China PCs

Lenovo (992 HK, HK\$3.46)

SELL (unchanged)

Target price: HK\$2.11 (-39%)

2Q FY3/07 results slightly below expectations. Lenovo posted net profit of US\$38m (-17% YoY) with revenue of US\$3,700m (+1% YoY); slightly below market expectation of US\$40m.

Gross margins under pressure. Gross margins continue to be under pressure as 2Q07 gross margin of 13% was lower than 1Q07's 14.3% and 2Q06's 14%. Operating margin has however improved slightly to 1.2% cf. 1Q07's 1.0% due to reduced operating expenses.

Operating margins declined in the Great China market. Lenovo's market share in Mainland China has increased to 36.5% from 35.3% in 1Q07. However, we are concerned with the accompanying 1% pcp drop in operating margin (ie. 5.7% vs. 6.7% in 1Q07).

Table 1: 2Q FY3/07 results

Year to Mar (US\$m)	2Q07	2Q06	YoY%
Revenue	3,700	3,653	1.3
GP	480	512	(6.3)
Pre-tax profit before restructuring cost	45	65	(30.81)
Restructuring cost	2	-	n.a.
Pre-tax profit	43	65	(33.8)
Net profit	38	45	(16.6)
Margins			
Gross (%)	13.0	14.0	
Pre-tax (%)	1.2	1.8	
Net (%)	1.0	1.2	

Source: Company data

Mixed performance in other markets. Lenovo continued to face market share loss in U.S. while performance in EMEA and Asia Pacific markets are seeing improvement. Strong performance is seen in France and Germany that led to increased revenue as well as market share in EMEA. Asia Pacific (ex. Greater China) region saw strong performance in India. However, this segment's performance was partially offset by weakness in Japan market.

Keeping up on global market share. Latest IDC's 3Q2006 PC shipment survey showed that Lenovo's market share of PC shipment was maintained at 7.8%, behind Hewlett Packard and Dell which commanded 17.2% each.

Table 2: Financial summary

Year to Mar	Net profit HK\$m	EPS HK\$	EPS Δ%	P/E x	P/B x	EV/EBITDA x	Yield %	ROE %	ROCE %	N. Gearing %
04A	1,053	0.103	-	33.5	6.75	23.1	1.2	23.3	20.6	Cash
05A	1,120	0.110	6.4	31.5	5.83	20.6	1.3	21.4	19.5	Cash
06A	173	0.017	(84.5)	203.6	3.74	12.1	1.5	2.1	1.2	Cash
07F	952	0.093	449.3	37.1	4.08	10.7	1.3	12.7	6.2	Cash
08F	1,193	0.117	25.4	29.6	3.41	7.8	1.4	13.3	7.1	Cash

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Lenovo's 3Q shipment growth was slightly ahead of industry average globally, helped by its strong China market performance but offset by market share loss in US. Lenovo's latest set of results is largely in line with IDC survey.

Notebook and mobile handset led the shipment growth. The shipment volume of notebook (ie. accounted for 52% of revenue) and mobile handset (ie. 5% of revenue) grew 20% and 39% YoY respectively. On the other hand, desktop shipment (ie. 42% of revenue) is lackluster with a mere 4% YoY growth.

Still plenty of work to do. We are concerned that Lenovo's market share gain in Mainland China could be at the expense of margin. There are also little signs of recovery in the U.S. market while the EMEA and Asia Pacific markets are not recovering at a quick pace. We believe there is also room for Lenovo to further improve its global supply chain (outside China) to cut costs and improve delivery efficiency. More brand equity building is also necessary outside China in the consumer segment in order to capture growth of the global notebook market. We have slashed our FY3/07 and FY3/08 profit forecast by 40% and 43% to HK\$952m (US\$122m) and HK\$1,193m (US\$153m). Valuation at 37x FY07 and 30x FY08 P/E on fully diluted basis is not compelling. Our target price is HK\$2.11, based on 18x FY08 P/E which international PC vendors trades on average. Maintain SELL.