Corporate Snippet

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Waiting for momentum to pick up — Hong Kong Industrials

Karrie International (1050 HK, HK$2.16) — HOLD (unchanged)

Target price: HK$2.59 (+19.9%)

EMS – the worst is over. The group's EMS business has been adversely affected by changes in the focus of Konica Minolta, one of its major customers, which shifted from volume to profitability. The new strategy seems quite successful, in our view. In 3Q FY03/07A, unit sales of Konica Minolta's Laser Beam Printer (LBP) dropped 45.0% YoY, while its external sales value rose 8.0% YoY and operating income 19.0%. We do not expect orders from Konica Minolta to return to the previous level, as the company will sell fewer units. Nevertheless, as the profitability of its LBP division improved, orders from Konica Minolta should stabilize.

Bottleneck still a problem. Turnover has increased about six fold, or at a 9-year CAGR of 21.9%, since FY03/97A but the company's capacity has barely been coping with the expansion. The bottleneck hurdle has to be cleared before Karrie can capitalize on new opportunities, especially in the plastic and metal segment, arising from some of its major customers moving the procurement offices to China. Phase 1 of its new Yu Quan Plant, which has already commenced operations, should boost its overall production capacity by 15% and ease the bottleneck problem. The company plans to continue expanding the plant's production capacity. Another area of concern is the shortage of skilled labor in the Pearl River Delta.

Gross profit margin bottomed out. Due to a 17.0% drop in revenue at the EMS division, the sales split between the metal and plastic division, and the low-margin EMS division was 45:55 in 1H FY03/07A, compared with 39:61 a year earlier. As a result, the gross profit margin stabilized at 9.8% and we expect it to improve due to price increases and less contribution from the EMS division.

Price hikes possible. The company is an ODM manufacturer and is appointed as a sole supplier of a particular project for the whole shipment cycle, which can run, from the development of prototype to the shipment of final goods, for 18 to 24 months. Products prices are decided 12 to 15 months before shipments, on the cost plus model. Thus, once projects from clients are taken, the company cannot change the price until the end of the shipment cycle. With some projects in hand already finished and production overhead costs as well as the RMB appreciating, we believe the company will increase its product prices.

Value for money. Trading at P/E of 5.5x for FY03/07F and 4.7x for FY03/08F, with the prospective dividend yield of 7.8% for FY03/07F, the valuation remains appealing and downside is limited. Nevertheless, we believe expected flat FY03/07F results and poor sentiment over small industrial plays will cap its share price performance in the near term and reiterate our HOLD recommendation.

Financial position. As of the end of September 2006, its net debt position was HK$493.6m and gearing ratio 25.7%. The company generated HK$97.7m of free cash flow in 1H FY03/07F. Its trade receivables increased to

Table 1: 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 %
05A	146.6	0.362	57.4	6.7	2.2	5.7	8.6	35.5	20.0	57.0
06A	186.4	0.455	25.6	5.3	1.9	4.1	10.3	38.2	21.4	22.8
07F	151.6	0.368	(19.2)	6.6	1.7	5.1	7.0	26.7	18.5	23.9
08F	183.2	0.444	20.9	5.5	1.4	4.2	7.8	27.7	21.4	11.9
09F	213.6	0.518	16.5	4.7	1.2	3.4	8.2	27.4	21.8	0.6

Source: SBI E2-Capital

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HK$609.8m at end-September 2006 from HK$560.1m at end-March 2005, representing 41.3% of its current assets, which is not a concern, we believe, as the company can obtain financing by other means, such as factoring, and its customers are big enterprises unlikely to default on payments.