

HL Technology

Growth on track though mild margin pressure spotted

to summarize...

- Top line went up 39% in 1H FY12/11A while bottom line 27%.
- Share price dropped as RMB17m non-operating income was reported, which affected earnings quality. Excluding this factor, pre-tax income picked up by 3%, suggesting moderate margin pressure.
- Although margin squeeze could be a result of market competition, especially for mature products, surged operating expenses are more like a signal of business expansion.
- We maintain positive towards the company, given new product rollout and new client acquisition is still on track, suggesting high-growth potential.
- We pencilled down our preliminary forecast lightly to reflect 1H results. Our reference target price, thereafter, has been reset from HK\$3.27 to HK\$3.09, based still on 10x FY12/11FP/E.

Momentum retained at top line level. Revenue in 1H FY12/11A increased 39% to RMB882m. Stripping off near RMB100m (our estimates: RMB96m) contribution from the two newly acquired subsidiaries, Tianjin Rituo (TJRT) and Huizhou Daya Bay (HDB), turnover of existing businesses enhanced by 24% YoY. After further adjusting this figure to ~15% copper price hike during the period, we arrived an estimate of ~10% volume growth in 1H, which seems satisfactory, considering the slowdown of entire PC industry in 2Q and negative impact of Japanese earthquake on the global consumer electronic market.

Table 1. Top line growth in 1H

Year to Dec (RMB m)	1H 10A	1H 11A	YoY change
Revenue	635.7	881.7	38.7%
ESCA	160.4	181.9	13.5%
ISCA	137.4	169.1	23.1%
PCA	112.8	136.4	20.9%
STWC excl. HDB	153.2	209.1	36.5%
Connectors	20.4	28.2	38.5%
Antenna	3.9	18.9	379.8%
Others	51.6	41.6	-19.3%
TJRT	0.0	69.0	n.a.
HDB*	0.0	27.4	n.a.

YoY growth excl. antenna, TJRT and HDB

20.6%

YoY growth excl. TJRT and HDB

23.5%

Source: Company data, SBI E2-Capital

Note: * estimated by SBI E2-Capital

Some pressure spotted on margins. Despite this, the stock tumbled immediately after results announcement. We reckon a potential reason is that, although bottom line rose 27% to RMB88m, pre-tax profit edged up only 3% to RMB81m after excluding RMB17m non-operating gain (1H FY12/10A: RMB2m loss). Profit margin was eroded at both gross and operating levels.

- Blended gross margin narrowed from 22.6% to 21.3%, down 1.3 pcp, mainly attributed to: 1) 0.4 pcp from acquisition of TJRT and HDB, which carried lower gross margin; 2) 0.5 pcp from decline of ESCA gross margin from 22.8% to 20.3%; 3) 0.6 pcp from decline of PCA gross margin from 17.6% to 13.6%. We expect TJRT and HDB's gross margins to improve following their integration into HLT's existing production chain. However, the margin squeeze of ESCA and PCA drew our attention about potential intensified competition. New product rollout / ramp-up (e.g. HDMI assembly, LSFH) could be critical, in our

Please refer to important disclosures at the end of this report

Ticker	1087 HK
Rating	Not Rated
Price (HK\$)	1.95
Target Price (HK\$)	n.a.
12m Price Range (HK\$)	1.65-2.95
Market cap. (US\$m)	180.0
Daily t/o (US\$m)	0.4
Free float (%)	35.4

Financial summary

Year to Dec	08A	09A	10A
Turnover (RMBm)	898	872	1,414
Net Profit (RMBm)	54	88	153
EPS (RMB)	0.112	0.169	0.275
P/E (x)	19.6	13.0	8.0
P/B (x)	5.37	3.75	1.31
EV/EBITDA (x)	16.2	11.8	7.2
Yield (%)	0.0	0.0	0.0
ROE (%)	27.8	32.8	24.9
ROCE (%)	17.2	17.7	15.2
N. Gear. (%)	83.6	72.9	8.4

Source: SBI E2-Capital

	11F	12F	13F
Consensus EPS (RMB)	0.273	0.373	0.505
Previous earnings (RMBm)	-	-	-
Previous EPS (RMB)	-	-	-

Price performance

Year to Dec	1m	3m	12m
Relative to HSI (%)	+1.1	(8.3)	n.a.
Actual price changes (%)	(6.2)	(18.8)	n.a.



Source: Bloomberg

Research Team

(852) 2533 3700

sbie2research@sbie2capital.com

eyes.

- Operating expenses picked up 76% in aggregate to RMB96m mainly due to headcount increase backed by acquisition and business / capacity expansion. We regard this as a normal phenomenon, considering the company is still in its rapid expansion stage. With its strong top line growth, operating leverage may enhance gradually thereafter.

Table 2. Gross margin in 1H

Year to Dec	1H 10A	1H 11A	YoY change (pcp)
Blended gross margin	22.6%	21.3%	-1.3
ESCA	22.8%	20.3%	-2.6
ISCA	27.7%	29.0%	1.3
PCA	17.6%	13.6%	-4.0
STWC excl. HDB	19.7%	21.0%	1.3
Connectors	30.6%	31.6%	0.9
Antenna	13.4%	22.2%	8.8
Others	25.3%	19.6%	-5.7
TJRT	n.a.	20.4%	n.a.
HDB*	n.a.	16.0%	n.a.

Source: Company data, SBI E2-Capital

Note: * estimated by SBI E2-Capital

Table 3. Gross margin movement

Year to Dec	Gross margin	Contribution to margin change (pcp)
1H 10A	22.6%	
Dilution from acquisition of TJRT and HDB		-0.4
Sale mix change		-0.1
From each existing segment		
ESCA		-0.5
ISCA		0.2
PCA		-0.6
STWC		0.3
Connectors		0.0
Antenna		0.0
Others		-0.3
1H 11A	21.3%	

Source: SBI E2-Capital

Table 4. Operating expenses and headcount in 1H

Year to Dec (RMB m)	1H 10A	1H 11A	YoY change
Operating expenses	(54.6)	(96.2)	76.1%
Distribution and selling expenses	(12.9)	(22.1)	71.6%
Administrative and general expenses	(29.0)	(48.9)	68.5%
Research and development expenses	(12.7)	(25.2)	97.9%
Headcounts (people)	1,056	2,497	136.5%
Manufacturing	305	1,038	240.3%
Distribution and selling expenses	89	175	96.6%
Administrative and general expenses	364	655	79.9%
Research and development expenses	143	274	91.6%
Quality control	155	355	129.0%

Source: Company data

Adjustments on preliminary forecasts. Looking into 2H, we expect a considerable HoH gain at top line, which, other than seasonal factor, may include full 6-month operation of the two acquisitions (~RMB130m), delivery of some delayed orders due to the Japanese earthquake as well as contribution from new products (e.g. SPC, solar connector) and new clients (e.g. Apple, Dell). Thus, we only fine-tuned our preliminary forecast from previous RMB2,113m to RMB2,078m. Gross margin outlook is a bit blurred. Although more contribution from TJRT and HDB may further dilute HLT's gross margin, it is possible to observe some major margin expansion in these two subsidiaries after effective internal operation restructuring and optimization. We, then, followed FY12/10A pattern, assuming mild HoH margin enhancement. After further adjustment on operating expenses estimates in cope with 1H figures, we have our new FY12/11F earnings forecast at RMB185m, 6% lower than the old one of RMB196m.

Table 5. FY12/11F preliminary forecast adjustments

Year to Dec (RMBm)	Old	New	Change
Revenue	2,112.8	2,077.8	-1.7%
Gross profit	465.0	445.3	-4.2%
Operating profit	267.0	242.7	-9.1%
Net profit	196.1	185.1	-5.6%

Source: SBI E2-Capital

Position view unchanged for high-growth perspective. Margin deterioration of ESCA and PCA is a bit out of expectation, which reminds us about the market risk. Another issue, operating expenses, however, should be still well under control, given the increase is largely own to headcount expansion, which, in turn, can be regarded as a signal of further business growth. HLT maintains its good record in new product development and client acquisition in 1H, which is critical, in our view, for a high-growth company. Therefore, we maintain positive towards the counter despite our downwards forecast revision. By applying a same 10x multiple on FY12/11F earnings, our reference target price now is HK\$3.09.

Table 6. Preliminary forecasts

Year to Dec (RMBm)	07A	08A	09A	10A	11F	12F
Revenue	652.6	898.0	872.4	1,414.0	2,077.8	2,583.4
ESCA	314.9	427.2	322.5	353.4	395.8	435.3
ISCA	72.3	83.9	126.6	307.0	368.5	430.6
PCA	59.7	115.3	170.2	246.8	296.1	349.5
STWC	142.2	173.4	172.1	348.3	627.0	877.8
Connector	1.4	23.1	36.1	46.4	62.7	69.7
Antenna				11.8	37.8	40.0
Special power cable					20.0	40.0
Solar connector					20.0	40.0
Automotive wiring harness					170.0	212.5
Others	62.0	75.0	44.9	100.2	80.0	88.0
Gross profit	135.3	174.8	198.0	325.6	445.3	555.4
Operating profit	77.3	81.7	110.5	192.3	242.7	292.4
Net profit	62.7	54.4	88.3	152.7	185.1	212.0
Gross margin	20.7%	19.5%	22.7%	23.0%	21.4%	21.5%
ESCA	23.2%	20.2%	23.0%	22.6%	20.3%	20.3%
ISCA	17.8%	25.3%	25.5%	27.9%	29.1%	29.1%
PCA	18.2%	15.5%	18.7%	16.3%	14.0%	14.0%
STWC	19.8%	20.0%	26.8%	22.5%	20.7%	21.0%
Connector	8.1%	15.1%	27.3%	31.5%	31.7%	31.7%
Antenna				10.5%	22.5%	22.5%
Special power cable					10.0%	15.0%
Solar connector					10.0%	15.0%
Automotive wiring harness					22.0%	22.0%
Others	16.7%	14.8%	8.3%	25.5%	20.5%	20.5%

Source: Company data, SBI E2-Capital

Table 7. Key financials

Year to Dec (Rmb m)	08A	09A	10A
Revenue	898.0	872.4	1,414.0
Gross profit	174.8	198.0	325.6
Operating profit	81.7	110.5	192.3
Net profit	54.4	88.3	152.7
EBITDA	102.2	139.7	230.2
Fixed assets	268.4	308.6	448.9
Inventories	115.3	115.6	178.5
Receivables	338.8	423.5	725.5
Payables	335.3	302.0	384.6
Cash	58.4	115.2	585.1
Short-term debt	243.3	353.4	663.1
Long-term debt			
Shareholders' fund	221.1	316.6	909.9
Total equity	221.1	327.0	923.5
Net cash from operating activities	1.7	0.5	n.a.
Net cash used in investing activities	(117.5)	(70.5)	n.a.
Net cash from financing activities	119.4	120.4	n.a.
Net change in cash and cash equivalents	3.6	50.3	n.a.

Source: Company data

Table 8. P&L

Year to Dec (Rmb m)	09A	10A	1H 10A	1H 11A
Revenue	872.4	1,414.0	635.7	881.7
Cost of sales	(674.4)	(1,088.3)	(491.7)	(693.8)
Gross profit	198.0	325.6	144.0	187.9
Other gains and losses	8.3	(2.6)	(2.0)	17.4
Distribution and selling expenses	(20.5)	(27.2)	(12.9)	(22.1)
Administrative and general expenses	(48.0)	(72.5)	(29.0)	(48.9)
Research and development expenses	(27.3)	(30.9)	(12.7)	(25.2)
Profit from operations	110.5	192.3	87.4	109.1
Finance costs	(13.9)	(19.1)	(8.9)	(11.0)
Profit before taxation	96.6	173.3	78.5	98.1
Income tax expenses	(8.1)	(18.2)	(8.3)	(7.4)
Profit for the period	88.5	155.0	70.2	90.8
Attributable to:				
Owners of the Company	88.3	152.7	69.7	88.2
Non-controlling interests	0.2	2.4	0.5	2.6
EPS - Basic (Rmb)	0.169	0.275	0.133	0.122

Source: Company data

Table 9. Shareholding structure

Shareholders	Interest
Chi Shaolin	40.87%
Yongchang Joint Stock Company Limited	18.59%
Hongxin Joint Stock Company Limited	5.11%
Others	35.43%
Total	100.00%

Source: HKEx

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