

An undervalued gem**Hong Kong Electronics****Sinotronics (1195 HK, HK\$1.27)****Not Rated**

Background. Sinotronics is a vertically integrated printed circuit board (PCB) and EMS provider with a specialized strategy of high-mix/low-volume manufacturing. With increased demand for its services, the company has forged solid roadmap comprising capacity expansion and new product lines to drive top and bottom line growth. Backed by a three-year net profit CAGR of 26% and net cash of RMB68.9 cents, the present valuation of 7.5x FY6/06F and 6.0x FY6/07F P/E is undemanding. We forecast FY6/06 net profit to surge 25% YoY to RMB100m (fully diluted EPS of RMB17.3 cents).

A niche PCB/EMS play. Sinotronics is a vertically integrated EMS services provider offering a suite of services along the value chain, including proto-type engineering, schematic capture, PCB layout design and manufacturing, as well as assembly services. The smaller, more flexible scale of Sinotronics allows it to adopt a high-mix/low-volume manufacturing strategy, compared with the larger counterparts, which rely more heavily on economies of scale and the mass market. The end result is that the company can command higher ASPs, deriving above-industry-average growth rates and margins.

Reputable clientele base. The company currently operates three plants, each with a different product focus, in Fuqing, Huizhou and Mawei. Its main products are chiefly 4-8 layer multi-layered PCBs though it has the ability to produce high-end PCBs of up to 30 layers. Sinotronics boasts a solid customer base, with the largest being Start Network, CIROATS, Newland and TPV (903 HK, HK\$7.67, BUY), with the top 3 customers accounting for 13%, 10% and 8% of turnover respectively. Other customers include Epson, NEC, Samsung and Nidec Sankyo, a renowned PCB products provider to tier one manufacturers such as Sony and Sharp.

New products drive growth. The EMS provider has been growing solidly over the past few years through a combination of capacity expansion and a launch of new products, including aggressively adding multi-layer PCB capacity and broadening into the manufacturing of flexible PCB (FPCB) and PCB assembly (PCBA) services since 2H FY6/05. For 1H FY6/06, Sinotronics' turnover surged 40% to RMB223m, aided by the maiden contribution from FPCB/PCBA services of RMB26m. Meanwhile, single/double-sided and multi-layered PCBs recorded revenues of RMB84m and RMB114m, jumping 15% and 32% YoY, respectively. Net profit was RMB51m, up 23% YoY.

Above-average margins. 1H FY6/06 gross margin amounted 39.6%, representing an improvement of 4.0 pcp HoH, but down 5.6 pcp YoY. The YoY decline was mainly attributed to a combination of initial depreciation costs on its Huizhou and Mawei plants, as well as higher laminate/copper prices. Despite the cost pressure, Sinotronics continues to enjoy a gross margin well above the industry norm of around 21%. The company attributes its higher-than-average margins to its design capability (i.e. acting as an ODM instead of OEM) and the focus on higher-margin but lower volume businesses (designing tailor-made PCB-related products for customers' new products) in addition to close relationship with the Fujian clientele, which helps mitigate supply chain cost and facilitate a leaner cost structure. Note that copper only accounts for 7-8% (up from 5% before) of its cost of production at present while cost of materials usually represents 40% of turnover.

More nimble than the large players. The pricing mechanism for low volume products differs from the traditional mass market EMS. Sinotronics' customers are more willing to pay a premium to ensure a fast turnaround, while large scale mass-market EMS plays are subject to price squeeze from customers as they strive to secure large volumes. The company's ASPs are in the order of 10%+ higher than those charged by mass-market EMS counterparts. Other niche players and specialists in the industry can also derive similar margins including Daisho Microline (567 HK, HK\$2.63, NR) (45%), Career Tech (28%), Eucon (39%) and Plotech (24%).

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Capacity expansion. Sinotronics will continue its capacity expansion strategy. With its Fuqing plant close to full capacity, the company aims to construct a second plant (or the fourth overall) in the area due to strong demand from clients (mainly TPV). The plant will have a PCB production capacity of 45,000m² per month, which will be developed over several phases. First phase is scheduled to be commissioned by 1H FY6/08. Furthermore, the company will also need to expand the production capacity of its Huizhou plant. It is currently operating at around 55% capacity, though an order ramp up from Sankyo commencing July 2006 is likely to fuel utilization rate to around 80%. The management plans to double its FPCB capacity to 10,000m² per month by the end of FY6/07 and increase PCBA lines from the current 5 lines to 11 lines over the same period. We estimate the company's capex requirement in the region of RMB390m to RMB450m over the next two years.

Launch of R-FPCB. To further combat margin erosion, the company plans to launch a new product in the form of rigid-flexible PCB (R-FPCB). The monolithic rigid/flexible PCB product has improved durability and can command gross margin up to 75%. Sinotronics currently has 5 models for this product under qualification with various customers.

Contribution from new businesses to kick in from 2006. Sinotronics' growth will be derived from both newly installed capacity and margin expansion from its FPCB/PCBA businesses. The new segment was close to breakeven at the end of 1H FY6/06 and is expected to start making profit from 2H FY6/06 onwards. Growing profitability in this segment will offset some of the margin pressure stemming from increased raw material prices. Note that the company incurred a loss of >RMB10m from its two new plants (SMT and FPBC) in FY6/05 and a slightly loss in 1H FY6/06 as they only began operational in Sep 2004 and Jan 2005 respectively.

Fund-raising history. 1) The company was listed in GEM board in May 2001 by issuing 67.5m new shares at HK\$0.9 per share, raising HK\$47.6m. It switched to the main board in Jan 2003. 2) In Mar 2002, it did a top-up placement by issuing 25m shares at HK\$1 each. 3) In Jun 2002, it did another top-up placement by issuing 35m shares at HK\$1.35m each. 4) In Jan 2004, it did a 57m-share top-up placement at HK\$1.4 per share. 5) The company issued a 2% 3-year US\$10m CB (with a floating conversion price term) to CSFB on April 27, 2005.

Chairman increasing stake. Chairman Lin has bought back 38.11m shares (6.9% of current share capital) between HK\$0.697 to HK\$1.197 during the period Aug 5, 2005 to May 15, 2006. On 19 July 2006, CSFB converted the CB at a conversion price of HK\$0.909 (85.5m shares, representing 15.46% of the enlarged share capital). Pursuant to the conversion, Chairman Lin purchased CSFB's entire lot of Conversion Shares at HK\$1.02 per share, hence increasing his stake from 51.1% to 66.6%. Moreover, the toxic CB has been dissolved.

Corporate governance issues. 1) Though the company does not have a strict dividend policy, it generally maintains a dividend payout ratio of around 20% (21.6% in FY6/05, 19.8% in FY6/04 and 23.3% in FY6/03). 2) The management is proactive in improving the company's corporate governance and financial disclosure transparency, changing its auditors from CCIF CPA to KPMG In July 2005. 3) After the CB conversion and dilution, the Chairmen holds a 66.6% stake (368.3m shares) in the company, while Fidelity is the other substantial shareholder with a 4.2% stake (23.4m shares).

Valuation. We project the company's FY6/06 net profit to increase 25% YoY to RMB100m (fully diluted EPS: RMB17.3 cents) on a turnover of RMB490m. Thereafter, capacity addition over the subsequent two years is expected to propel the bottom line to RMB124m (fully diluted EPS: RMB22.1 cents) and RMB160m (fully diluted EPS: RMB28.4 cents) in FY6/07F and FY6/08F, representing YoY increases of 23% and 29% respectively. Gross margin is expected to retreat to 37.1% from 39.8% a year ago. Currently trading at 7.5x FY6/06F and 6.0x FY6/07F earnings, we believe Sinotronics is undervalued. The counter is backed by net cash of RMB68.9 cents, or 53% of its stock price, suggesting latent value to be unlocked. Domestic and international comparables from Singapore and Taiwan are presently trading at an average of 10.0x forward earnings.

Table 1: Valuation comparisons

Company Name	Stock Code	Country	Mkt Cap (US\$m)	Price	HIS Turnover (US\$m)	HIS Net Profit (US\$m)	Cur Yr PE (x)	Nxt Yr PE (x)
Daisho Microline	567 HK	HK	159	HK\$2.63	79.9	14.0	n/a	n/a
Kingboard	148 HK	HK	2,771	HK\$22.55	1,679.3	184.1	9.5	8.2
Global Flex	471 HK	HK	111	HK\$0.69	176.9	14.2	4.4	4.4
MFS Technology	MFS SP	SP	417	SG\$1.00	240.4	22.2	13.6	11.6
Elec & Eltek Int'l	ELEC SP	SP	442	SG\$2.47	437.5	42.6	8.2	7.1
Tripod Technology	3044 TT	TW	984	TW\$100	461.1	64.8	10.8	8.5
Unimicron Technology	3037 TT	TW	1,176	TW\$39.42	858.0	92.3	7.9	6.5
Average							9.1	7.7
Sinotronics	1195 HK	HK	90	HK\$1.27	46.5	10.1	7.5	6.0

Source: Bloomberg & SBI E2-Capital

Table 2: Industry gross margin comparisons

Company	Stock Code	Mkt Cap (US\$m)	Description	Gross Margin (%)
Niche player/ specialists				
Daisho Microline	567 HK	160	High density interconnect PCB	45
Eucon	EUCON SP	76	Specialist in laser drilled PCBs	39
Career Tech	6153 TT	214	Focus on flexible PCBs	28
Kingboard	148 HK	1,997	Vertically integrated PCB manufacturer	24
Plotech	6141 TT	92	Focus on multi-layer PCBs	24
Industry average*				21
Sinotronics	1195 HK	64	Focus on high-mix/low-volume orders	39.8 (FY6/05A) 37.1 (FY6/06F)

Source: Bloomberg & SBI E2-Capital; *Industry average is based on figures from: Kingboard (148 HK), Topsearch (2323 HK), Global Flex (471 HK), MFS (MFS SP), Elec & Eltek (ELEC SP), Tripod Technology (3044 TT), Unimicron (3037 TT), Career Tech (6153 TT), Hannstar (5469 TT), Nan Ya (8046 TT), New Era (4909 TT), Plotech (6141 TT), Taiwan Union Tech (6274 TT), EUCON (EUCON SP) & Multi-Chem (MC SP)

Table 3: Top 5 customers (approx 40% revenue in FY6/05)

1. Fujian Start Network Technology
2. CIROATS MUFLEX USD
3. Fujian Newland Computer
4. TPV
5. Epson

Source: Company data & SBI E2-Capital

Table 4: Plant expansion schedule

Plant No.	Location	Commissioning Date	Current Capacity	Planned Ultimate Capacity	Scheduled Commissioning Date
1	Fuqing	2004	40,000m ² /mth	40,000m ² /mth	n/a
2	Huizhou	Jan 2005	10,000m ² /mth	20,000m ² /mth 10,000m ² /mth (PH I)	In phases from Jan 2007
3	Fuzhou Mawei	Sept 2004	5 SMT lines	17 SMT lines	In phases from Jan 2007
4	Fuqing		Nil	20,000m ² /mth 15,000m ² /mth (PH I)	Jun 2007

Source: Company data & SBI E2-Capital

Table 5: P&L

Year to Jun (RMBm)	FY6/03A	FY6/04A	FY6/05A	1H FY6/05A	1H FY6/06A
Turnover	242	301	370	159	223
Cost of sales	(124)	(165)	(223)	(87)	(135)
Gross profit	117	136	147	72	88
Other revenues	1	2	3	2	1
Selling & distribution costs	(6)	(6)	(4)	(4)	(6)
Administrative expenses	(15)	(16)	(28)	(10)	(10)
Other operating expenses	(8)	(8)	(6)	(3)	(2)
Operating profit	89	108	112	56	72
Finance expenses	(3)	(7)	(9)	(3)	(7)
Share of profit/(losses) of associates	1	3	7	1	-
Loss on disposal of associates	-	-	(5)	-	-
Profit before tax	87	103	105	54	65
Tax	(4)	(15)	(18)	(10)	(12)
After-tax profit	83	89	87	44	54
MI	(10)	(7)	(6)	(3)	(3)
Net profit	73	81	80	41	51
% chg	30.4	10.7	(1.1)	(0.7)	23.0
Dividends	(17.1)	(16.1)	(17.4)	-	-

Source: Company data

Table 6: Segment results

Year to Jun (RMBm)	FY6/04A	FY6/05A	1H FY6/05A	1H FY6/06A
Turnover				
Single/double sided PCBs	121	160	73	84
Multi-layer PCBs	180	198	86	114
Flexible PCB & PCB assembly	-	12	-	26
	301	370	159	223
Segment results				
Single/double sided PCBs	43	48	21	27
Multi-layer PCBs	64	83	36	46
Flexible PCB & PCB assembly	-	(19)	-	(1)
	108	112	56	72
Finance expenses	(7)	(9)	(3)	(7)
Share of profit/(losses) of associates	3	7	1	-
Loss on disposal of associates	-	(5)	-	-
	103	105	54	65

Source: Company data