

## Sinotronics: Delivering strong results

**Recommendation: BUY (unchanged)**

**Hong Kong Electronics**

Price	HK\$1.12	Year to Net profit	EPS	EPS	P/E	P/B	EV/EBITDA	Yield	ROE	ROCE	N. Gear.	
Target price	HK\$1.70 (+52%)	Jun	RMBm	RMB	Δ %	x	x	x	%	%	%	
12 mth range	HK\$0.65-1.35	05A	80.4	0.172	(8.3)	6.8	0.91	1.5	3.0	14.6	14.8	Cash
Market cap.	US\$79.4m	06A	101.8	0.218	26.6	5.3	0.78	1.9	4.1	15.7	11.4	Cash
Daily t/o, 3 mth	US\$1.8m	07F	132.0	0.239	9.6	4.9	0.78	2.0	4.5	17.3	17.7	Cash
Free float %	36.6%	08F	150.5	0.272	14.1	4.3	0.67	1.2	5.1	16.9	17.4	Cash
Ticker	1195.HK/1195 HK	09F	175.6	0.318	16.7	3.7	0.58	0.6	6.0	16.9	17.9	Cash

Relative to Hang Seng Index (1 mth, 3 mth, 12 mth): -1.1%, -3.0%, +28.0%

Actual price changes (1 mth, 3 mth, 12 mth): +6.7%, -2.4%, -14.0%

Consensus EPS (07F-08F): RMB0.220, RMB0.287

Previous forecasts (07F-08F): RMB123.4 (RMB0.223), RMB161.3 (RMB0.292)

### Key points:

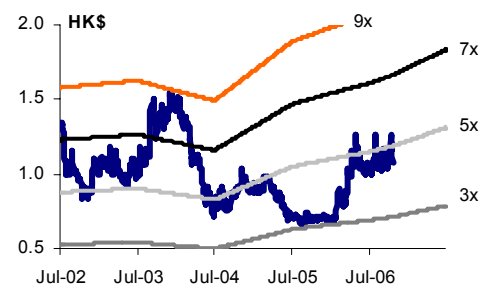
- FY6/06 net profit rose 26.6 % YoY to RMB101.8m, in line with our expectations.
- Growth was driven by the company's ramp up in new operations of FPCB manufacturing and PCBA services.
- Gross margin declined from 39.8% to 35.4%, mainly due to change in revenue mix. EBIT margin for core PCB business remained strong at 41.1%.
- FPCB and PCBA operations will be the company's growth drivers in FY6/07F and FY6/08F.
- We project net profit to grow 29.6% in FY6/07F and 14.1% in FY6/08F
- Sinotronics remains one of the most undervalued plays. Maintain BUY call, upgrading our target price to HK\$1.70 (from previous HK\$1.65), implying 7.5x FY06/07F P/E.

**Results in-line with expectations.** Sinotronics' has commenced its transformation from a niche PCB design and manufacturing services provider to an integrated one-stop shop EMS provider offering PCB, flexible PCB (FPCB) and PCB assembly (PCBA) services. FY6/06 turnover surged 42.2% YoY to RMB526.0m while net profit of RMB101.8m represented an increase of 26.6% YoY. While the bottom line was in line with expectation, turnover significantly beat our estimate. The difference was due to the company's decision to engage in the sales of PCB products. The business involves sourcing PCBA components for resale to its customers, which generates high revenues, but slimmer margins. Excluding contribution from this segment, turnover and net profit amounted to RMB480.6 and RMB100.7m respectively and in line with our previous estimates.

**New business lines deliver.** The company's growth in FY6/06 was mainly driven by ramp up in the new business lines of FPCB and PCBA services. FPCB sales surged to RMB72.3m from RMB3.1m a year ago. Sales of PCBA products rose over 3x to RMB45.4m while PCBA services contributed maiden revenue of RMB25.8m. The company's core business of rigid PCB was steady, growing 6.9% YoY to RMB382.5m. Growth from FPCB and PCBA businesses accounted for 84.1% of the revenue increase in FY6/06.

**Gross margin dropped mainly due to product mix.** Gross margin fell 4.4 pcp to 35.4% during the reporting period. While higher staff and material costs were contributing factors, the key reason for the margin compression was due to the changing revenue mix of the company. Increased contribution from FPCB and PCBA services, which generally has margins that are more in line with industry average, diluted the blended gross margin. In fact, EBIT margin for its core PCB business rose 1.5 pcp YoY to 41.1%. In contrast, FPCB

**Chart 1: P/E bands**



Source: SBI E2-Capital

EBIT margin was 11.2% while sales of PCBA products and provision of PCBA services recorded EBIT margins of 2.9% and 11.2% respectively.

**Difference in margins related to business models.** Sinotronics' PCB business has historically derived margins significantly above industry average through a niche strategy of: 1) differentiated strategy of high mix/low volume manufacturing and 2) strategic focus on international clientele in proximity to its plant in Fuqing. Note that a majority of Sinotronics' clients in this business segment is located within 2 hours by road from its Fuqing plant. The company's new FPCB business on the other hand is more mass market oriented, with international customers such as Japanese based Nidec Sankyo and Epson. Meanwhile, the decision to broaden downstream into PCBA services, despite its low margins, was a strategic one. By offering the additional value added services of component sourcing and SMT, the company can position itself as a one-stop shop solution for PCB services, secure higher order quantities and increase lock-in with its customers.

**Capacity expansion to focus on FPCB and PCBA.** The company's near-term plans are to focus on increasing its FPCB and PCBA production capacity. In FY6/07, Sinotronics will increase its FPCB production capacity at its Huizhou plant by 50% to 15,000m<sup>2</sup> from its current monthly capacity of 10,000m<sup>2</sup>. Moreover, management also plans to add another 2-3 SMT lines to boost PCBA services at its Mawei plant. Over the long term, with its Fuqing plant at full capacity, the company will construct a second plant (or the fourth overall) in the area to meet strong demand from clients (mainly TPV). The plant will have a PCB production capacity of 45,000m<sup>2</sup> per month, with an initial 15,000m<sup>2</sup> coming on line in 1H FY6/09. We note that the schedule for this new plant has been push back by around 6 months from previous indication from the management.

**Finance costs weighed down profitability.** In large part due to the company's 2% 3-year US\$10m CB issued to CSFB in April 2005, Sinotronics' finance costs increased dramatically to RMB33.2m from RMB8.8m a year ago. However, CSFB converted the CB at a conversion price of HK\$0.909 (85.5m shares, representing 15.46% of the enlarged share capital) in July 2006. Pursuant to the conversion, Chairman Lin purchased CSFB's entire lot of conversion shares at HK\$1.02 per share (10% premium to the conversion price), and increased his stake from 51.1% to 66.6% at the time. As the toxic CB has been dissolved, we expect finance costs to substantially reduce going forward, providing further upside to our profit estimates.

**Other corporate governance issues.** After the conversion of the CB, the Chairman placed out 40m vendor shares, (representing 7.23% of the share capital) on 18 September 2006. The placement was made at a price of HK\$1.10 per share. After the placement, the Chairman's stake in Sinotronics has been reduced to 59.4%.

**FPCB and PCBA to drive growth in FY6/07 and FY6/08.** We have updated Sinotronics' forecast taking into consideration: 1) contribution from sales of PCB products and 2) modified capacity ramp up schedule. For FY6/07F and FY6/08F, the company's growth will continue to be driven by ramp up in its FPCB and PCBA businesses. We project the company's net profit to grow 29.6% to RMB132.0m (fully diluted EPS: RMB23.5 cents) in FY6/07F and 14.1% to RMB150.5m in FY6/08F (fully diluted EPS: RMB26.8 cents)

**Maintain BUY with a target price of HK\$1.70.** Currently trading at 4.9x FY6/07F and 4.3x FY6/08F fully diluted earnings, Sinotronics remains one of the most undervalued plays. The company remained in a solid net cash position of RMB343.4m (RMB0.612 cash per share) after the CB conversion, representing 52.5% of the current share price. With significant value to be unlocked, we maintain our BUY call counter, upgrading our target price to HK\$1.70 (from previous HK\$1.65), representing 7.5x FY6/07F and 6.6x FY6/08F P/E. Domestic and international comparables from Singapore and Taiwan are presently trading at an average of 9.8x current year and 8.2x next year earnings based on consensus estimates.

**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	158.4	HK\$2.57	79.9	14.0	n/a	n/a
Kingboard	148	HK	2,840.3	HK\$28.20	1,679.3	184.1	11.0	9.7
Global Flex	471	HK	92.9	HK\$0.58	176.9	14.2	7.4	6.7
MFS Technology	MFS	SP	383.9	SG\$0.93	242.8	18.5	11.3	9.4
Elec & Eltek Int'l	ELEC	SP	472.2	SG\$2.64	475.9	52.0	7.8	6.8
Tripod Technology	3044	TT	1,109.9	TW\$101.5	461.1	64.8	12.4	9.7
Unimicron Technology	3037	TT	1,242.8	TW\$40.7	858.0	92.3	8.6	7.0
<b>Average</b>							<b>9.8</b>	<b>8.2</b>
Sinotronics	1195	HK	79.4	HK\$1.12	65.0	12.5	4.9	4.3

Source: Bloomberg & SBI E2-Capital

Table 2: P&amp;L

Year to Jun (RMBm)	04A	05A	06A	07F	08F	09F
<b>Turnover</b>						
PCB	301.3	357.7	382.5	356.7	343.1	370.1
FPCB	-	3.1	72.3	286.1	491.0	654.0
Sales of PCBA products	-	8.9	45.4	70.6	111.6	147.7
PCBA services	-	-	25.8	41.1	67.9	92.6
	<b>301.3</b>	<b>369.8</b>	<b>526.0</b>	<b>754.5</b>	<b>1,013.6</b>	<b>1,264.4</b>
Cost of sales	(164.9)	(222.8)	(339.7)	(530.2)	(739.9)	(929.3)
<b>Gross profit</b>	<b>136.3</b>	<b>147.0</b>	<b>186.3</b>	<b>224.3</b>	<b>273.7</b>	<b>335.1</b>
Other revenues	1.9	2.9	8.7	4.1	5.1	6.3
Selling & distribution costs	(6.5)	(3.9)	(6.5)	(8.0)	(12.6)	(21.9)
Administrative expenses	(15.9)	(27.6)	(25.0)	(30.2)	(46.7)	(61.2)
Other operating expenses	(8.1)	(6.2)	(1.0)	(1.9)	(6.8)	(15.1)
<b>Operating profit</b>	<b>107.7</b>	<b>112.3</b>	<b>162.6</b>	<b>188.3</b>	<b>212.7</b>	<b>243.2</b>
Finance expenses	(7.0)	(8.8)	(33.2)	(14.1)	(15.2)	(13.7)
Share of profit/(losses) of associates	2.7	6.7	-	-	-	-
Loss on disposal of associates	-	(5.1)	-	-	-	-
<b>Profit before tax</b>	<b>103.4</b>	<b>105.1</b>	<b>129.3</b>	<b>174.1</b>	<b>197.4</b>	<b>229.5</b>
Tax	(14.7)	(18.3)	(21.2)	(33.0)	(36.4)	(41.6)
<b>After-tax profit</b>	<b>88.7</b>	<b>86.8</b>	<b>107.1</b>	<b>141.1</b>	<b>161.0</b>	<b>187.9</b>
MI	(7.4)	(6.4)	(6.3)	(9.2)	(10.5)	(12.2)
<b>Net profit</b>	<b>81.2</b>	<b>80.4</b>	<b>101.8</b>	<b>132.0</b>	<b>150.5</b>	<b>175.6</b>
% chg	10.7	(1.0)	26.6	29.6	14.1	16.7
Dividends	(16.1)	(17.4)	(19.9)	(26.4)	(30.1)	(35.1)

Source: Company data & SBI E2-Capital

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**BUY** : absolute upside of >10% over the next six months

**HOLD** : absolute return of -10% to +10% over the next six months

**SELL** : absolute downside of >10% over the next six months

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