

## Banking on brand and distribution

## China Handset Components

### Scud Group (1399 HK)

### Not Rated

**Company profile.** Established in 1997, Scud manufactures and sells secondary rechargeable battery packs for mobile phones in the PRC under its own brand, “SCUD 飞毛腿”. It is also an OEM manufacturer for Lenovo, ZTE, AMOI, Huawei, Sangfei and UTStarcom. Scud’s own brand and OEM business accounted for 71% and 29% of its total sales in 1H FY12/06A respectively. In 2005, it captured a 10.6% market share based on the total retail sales of mobile phone batteries in the PRC and is expected to grow to 15% within the next three years. The production plant is based in Fujian, with total annual production capacity of 30.8m battery packs and 7.6m chargers at a utilization rate of over 100% and 92% respectively in FY12/05A. All the Group’s products are produced in-house. For its own brand business, it has over 1,600 models of mobile phone rechargeable packs, which are compatible with over 2,200 mobile phone models. It sells through a network of 315 independent first-tier distributors with c. 30,000 point-of-sales covering 31 provinces, focusing the Southern and Eastern parts of the PRC. These first-tier distributors will resell the products to other second-tier distributors and retail stores. The Group retains control on the wholesale price and the suggested retail price. Scud’s own brand products are sold under four series, namely “Gold”, “Business”, “Standard” and “Economy”, targeting different market segments. Raw materials accounted for the majority of its cost of good sold, c.90% in 1H FY12/06A.

**Table 1: Offer statistics**

No. of shares offered (new shares) (greenshoe option: 15%)	260m
Fund raised:	HK\$356-525m
Price range	HK\$1.37-2.02
Offer P/E (FY12/06F F.D.)	8.1-12.0x
FY12/05A EPS F.D.	HK\$0.120
FY12/06F EPS F.D. (exclude the potential dilution from the convertible bond issues)	HK\$0.171
Market cap	US\$151-223m
IPO open	11 Dec
IPO close	14 Dec
Listing	21 Dec

Source: Company data

**Table 2: Use of proceeds**

	HK\$m
Construction of new factory in Fuzhou, PRC	160
Sponsoring the shop refurbishment projects	100
To fund the establishment of new product lines	60
Setting up a sales network for digital product chargers	50
Advertising & promotion expenses	45
Repayment of bank loans	35
Research & development	15
Setting up new counters in large retail chain stores in the PRC	5
The establishment of e-commerce capabilities & general working capital	Remaining balance

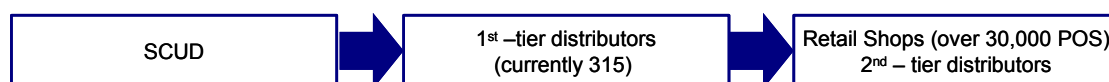
Source: Company data

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**Chart 1: Distribution channels**

Source: Company data

### Investment highlights

#### Demand of mobile phone rechargeable battery packs will arise from:

- ❑ the demand for mobile phones;
- ❑ the demand for a second battery from power hungry 3G phones;
- ❑ mobile phones penetration rate and
- ❑ the technical limitations of rechargeable lithium batteries in terms of life span and power capacity, which create demand for back-up and replacement battery packs.

In the PRC, demand for mobile phones comes from replacement cycle and personal needs. According to the MII, the net addition of new mobile phone service subscribers in 2005 amounted to c.58.6m. The average mobile phone penetration rate in the PRC as a whole is still low at 30.3% compared with developed countries like Europe (84.5%), U.S. (67.6%) and H.K. (123.5%). The demographics and consumption patterns in the PRC are very different from that of the developed countries, i) the life cycle of a mobile phone is longer in the PRC, since people are less likely to replace their handsets as frequent as in the affluent countries and ii) the secondary handset market in the PRC is huge. Besides, the life span of Li-ion battery is shorter than the average life span of mobile phones. The average recharging cycles of a mobile phone battery pack is around 300 to 1,000 times. Therefore, all the above factors create a market for replacement rechargeable battery packs for mobile phones, especially in less affluent cities in the PRC.

**Diversifying product portfolios to consumer electronics battery packs.** Apart from the mobile phone rechargeable battery packs, Scud has diversified its product portfolio to include battery packs for other portable electronic devices such as digital cameras and camcorders under its own brand. It plans to further upgrade its brand image by revamping the display counters of c. 6,000 POS and will enhance the marketing and promotion campaigns to further promote these battery packs.

**Financials.** Sales and net profit recorded a remarkable growth in the past three years, increasing at a 3-year (2003-2005) CAGR of 29.4% and 41.4% respectively. Despite a downward ASP trend, both gross and operating margins have been on an uptrend (refer to chart 4 and 5). Operating margin was at 18.6% in 1H FY12/06A, compared with 11.9% by BYD (1211 HK). These were attributed to the roll out of higher margin “Gold” and “Business” rechargeable battery pack series, as well as effective cost control. Dividend payout is expected to be c.30% in FY12/06F. The sudden increase in inventory turnover days was due to a change in policy with respect to the purchase of raw materials. The Group agrees with key raw material suppliers to use its premises to store the battery cells to be used in its production. It would enjoy flexible inventory management at a lower battery cells purchase price. In 2004, Scud decided to terminate this arrangement, resulting in an increase of inventory of raw materials. The Group forecasts net profit to grow 42% to no less than RMB147m for FY12/06F. It has issued US\$10m convertible bonds to CLSA Private Equity in Jan 2006 with a maturity date on 23<sup>rd</sup> Jan 2010. The conversion price is HK\$0.82, equivalent to a potential dilution of c.15% based on the high-end of the IPO offer price.

**Valuations.** The handset component manufacturers on average are trading at 9x-17x forward P/E compared with Scud’s target 8.1x-12.0x P/E for FY12/06F on a fully diluted basis. Scud’s operating margin is higher at 18.6% in 1H FY12/06A, compared with BYD’s 11.9% (1211 HK), a battery cell manufacturer. Scud’s valuation seems undemanding. In our view, the rechargeable battery pack business’s entry barrier is low since limited R&D is required. Competition is intense with many domestic brands because the market is highly fragmented for own brand products and OEM products. The major upside will come from volume growth as the market is huge and margin enhancement through POS expansion and brand management.

**Table 3: Financial highlights**

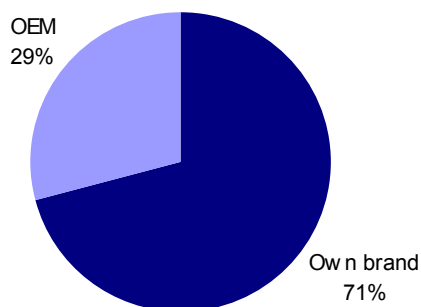
Year to Dec (RMBm)	2003A	2004A	2005A	2006F	1H05A	1H06A
Turnover	422.0	515.8	707.0	n.a.	369.8	482.4
Operating profit	56.0	74.8	116.2	n.a.	61.5	89.6
Net profit	52.4	65.2	103.3	147.0	54.9	79.7
<b>YoY % change</b>						
Sales (%)	n.a.	22.2	37.1	n.a.	n.a.	30.5
Operating profit (%)	n.a.	33.7	55.2	n.a.	n.a.	45.7
Net profit (%)	n.a.	24.4	58.4	42.3	n.a.	45.1
<b>Margins (%)</b>						
- Gross	19.6	20.7	20.8	n.a.	21.3	26.1
- Operating	13.3	14.5	16.4	n.a.	16.6	18.6
- Net	12.4	12.6	14.6	n.a.	14.8	16.5
Payout (%)	42.5	81.1	-	30	-	38.6
Gearing (%)	23.3	27.7	22.3	n.a.	n.a.	32.9
Current ratio (x)	1.56	1.42	1.95	n.a.	n.a.	2.27
Quick ratio (x)	1.51	1.01	1.53	n.a.	n.a.	1.83
Inventory turnover (days)	6	28	39	n.a.	42	38
Debtors turnover (days)	60	63	66	n.a.	51	65
Creditors turnover (days)	90	52	28	n.a.	27	23
Effective tax rate (%)	0	6.8	7.5	n.a.	7.6	9.2

Source: Company data

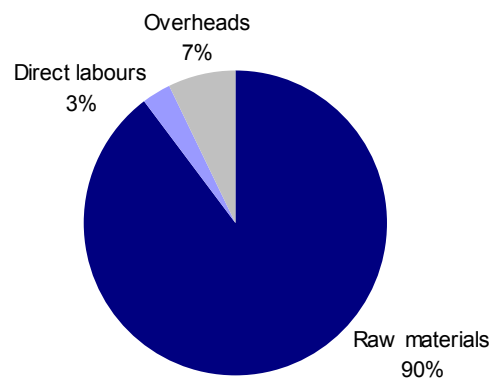
**Table 4: Peer comparisons**

Company Name	Ticker	Curr	Price	Mkt cap. (US\$m)	Hist. P/E (x)	Fwd 1-yr P/E (x)	Fwd 2-yr P/E (x)	ROA (%)	ROE (%)	Op margin (%)
<b>Battery manufacturers</b>										
BYD	1211 HK	HKD	28.4	1,940.1	20.6	16.4	13.8	5.3	12.7	11.9
Coslight	1043 HK	HKD	4.9	271.0	19.2	19.8	17.1	5.0	11.5	12.3
Average					19.9	18.1	15.4	5.2	12.1	12.1
<b>EMS &amp; OEM</b>										
Flextronics	FLEX SI	USD	11.6	6,783.7	16.7	14.7	12.1	1.3	2.7	2.8
Foxconn	2038 HK	HKD	24.9	21,814.9	55.7	30.2	21.0	14.6	36.0	7.0
Solectron	SLR US	USD	3.3	2,979.9	25.4	15.2	11.8	2.5	5.5	1.1
Quanta	2382 TT	TWD	54.5	5,516.5	16.3	15.0	12.2	4.0	16.2	1.5
Average					16.3	15.0	12.2	4.0	16.2	1.5
<b>Handset components</b>										
Green Point	3007 TT	TWD	108.0	877.7	22.3	18.1	14.4	10.1	17.3	8.5
Ichia	2402 TT	TWD	33.0	304.3	n.a.	9.0	8.2	-2.0	-4.7	-5.7
Merry	2439 TT	TWD	88.0	382.8	22.3	13.8	10.7	11.1	16.8	17.9
SILITECH	3311 TT	TWD	148.0	604.0	19.3	15.9	12.5	22.9	41.5	18.8
AAC Acoustic	2018 HK	HKD	8.4	1,334.4	27.1	17.0	12.3	25.4	37.1	32.8
Average					23.2	16.4	12.4	24.2	39.3	25.8

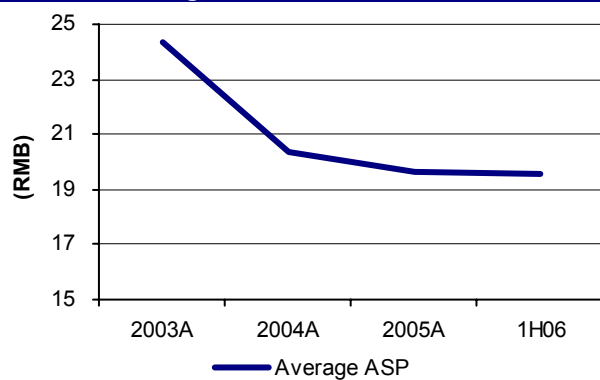
Source: SBI E2-Capital &amp; Bloomberg

**Chart 2: Sales breakdown by segments**

Source: Company data

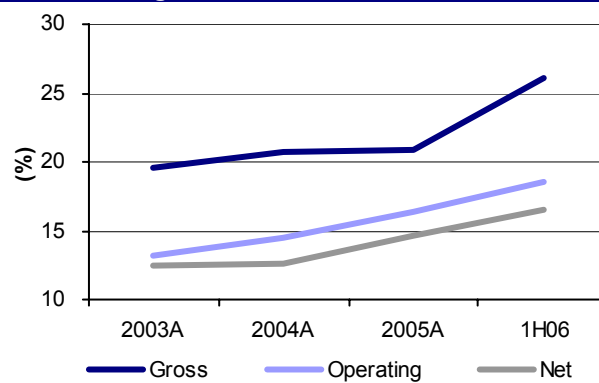
**Chart 3: Cost structure**

Source: Company data

**Chart 4: \*Average ASP**

Source: Company data, SBI-E2 Capital

\* Average ASP is compiled according to the percentage of sales and ASP of respective product segments

**Chart 5: Margin trends**

Source: Company data