

Growing on product mix changes, HDI ramp

China Electronics

3CEMS (1828 HK)

Not Rated

Company profile. Formed in 1997, 3CEMS is a Taiwanese-owned, vertically integrated PCB solutions provider in China. The company focuses on providing PCB and PCB assembly (PCBA) services for 3C products, which comprise consumer electronics, communications and computers/computer peripherals. The company has three PCB fabrication facilities and two PCBA facilities located in Guangzhou, with a total production capacity of 2.05m sq.ft/mth and 1,050m components/month respectively. 3CEMS manufactures a wide variety of PCB products ranging from rigid PCBs (2-16 layers) to high density interconnection (HDI) PCBs.

Industry overview. According to IDC, the global EMS market is forecast to increase at a CAGR of 11.0% between 2004 to 2009F, with industry revenues reaching US\$178.0b by 2009F. The growth is driven by 1) outsourcing trend; 2) increased capabilities of EMS providers to offer value added services and 3) increased demand for 3C products. Backed by the gradual relocation of production facilities to the Mainland and increasing domestic demand, the EMS industry growth in China is expected to outpace the global industry growth. IDC estimates that China's EMS industry to grow from US\$31.3b in 2004 to US\$100.7b in 2009F, representing a CAGR of 26.3% over this period.

Customer base. Typical of an EMS company, 3CEMS has a high concentration of customers that is responsible for a large proportion of its earnings. During the track record period from FY3/03A to FY3/05A and 1H FY3/06A, the company's top five customers accounted for 49.1%, 38.6%, 39.6% and 42.2% of overall revenues. The largest customer accounted for 15.1%, 20.2%, 13.5% and 14.5% of the total sales. FIC Global, 3CEMS' largest shareholder (27.61% post-IPO) is a connected party, as well as one of the company's largest customers. During the track record period, sales to FIC accounted for 6.5%, 23.5%, 15.2% and 10.4% of the total respectively.

Table 1: Offer statistics

No. of shares offered (65% new shares/35% sale shares) (with greenshoe option: 15%)	344.82m
Fund raised:	HK\$482.75-706.88m
Price range	HK\$1.40-2.052
Offer P/E (FY12/06F F.D.)	7.0-10.3x
FY12/05A EPS F.D.	HK\$0.102
FY12/06F EPS F.D.	HK\$0.199
Market cap	US\$161.5-236.5m
IPO open	8 Dec
IPO close	13 Dec
Listing	20 Dec

Source: Company data

Table 2: Use of proceeds

	HK\$m
Purchasing machinery/equipment to upgrade existing PCB fabrication and assembly facilities for HDI	90
Construction of new production facility for HDI	240
The establishment of e-commerce capabilities & general working capital	Remaining balance

Assuming that the over-allotment option is not exercised, and based on offer price of HK\$1.73 (being the mid-point of the indicative offer price range between HK\$1.40 and HK\$2.05), the net proceeds are estimated to be approximately HK\$358.9m.

Source: Company data

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High overall utilization rate. 3CEMS' vertically integrated business model enables the company to maintain a high overall utilization rate. During peak periods, the company's PCB fabrication capabilities provide a stable and cost effective supply of PCBs for its PCBA operations. On the other hand, in non-peak periods, 3CEMS' PCBA operations can keep its PCB fabrication facilities operating at a higher utilization rate.

Improving product mix. During the track record period, 3CEMS has steadily improved its product mix to focus on higher margin products, such as 6+ layer and HDI PCBs. In particular, HDI PCB has increased its contribution from nil in FY3/03 to 9.7% at the end of 1H FY12/06A. This shift in product mix has enabled 3CEMS to hold PCB fabrication gross margin steady at around 16%. Going forward, a continuing shift of revenues towards the higher margin HDI should give the company scope to further enhance gross margins.

Table 3: Revenue breakdown and gross margins

	2003A	2004A	2005A	1H 05A	1H 06A
Turnover					
PCB fabrication revenues					
1-4 layer PCBs	109.7	157.3	169.9	73.4	70.4
6+ layer PCBs	15.4	32.6	81.3	32.7	56.5
HDI PCBs	0.0	1.4	9.7	3.2	13.6
	125.1	191.2	260.9	109.3	140.5
Provision of PCBA services	53.8	206.6	136.0	56.6	72.0
	178.9	397.8	397.0	165.9	212.5
Gross profit					
PCB fabrication revenues					
1-4 layer PCBs	16.0	17.3	21.5	9.5	9.1
6+ layer PCBs	4.8	5.5	15.7	3.6	9.5
HDI PCBs	-	0.1	5.3	1.6	4.2
	20.8	22.9	42.4	14.8	22.8
Provision of PCBA services	8.1	6.5	4.6	2.1	4.3
	28.9	29.4	47.0	16.8	27.0
Revenue breakdown (%)					
PCB fabrication revenues					
1-4 layer PCBs (%)	87.7	82.3	65.1	67.1	50.1
6+ layer PCBs (%)	12.3	17.0	31.2	29.9	40.
HDI PCBs (%)	-	0.7	3.7	3.0	9.7
	100.0	100.0	100.0	100.0	100.0
Provision of PCBA services (%)	100.0	100.0	100.0	100.0	100.0
Gross margins (%)					
PCB fabrication revenues					
1-4 layer PCBs (%)	14.6	11.0	12.6	13.0	12.9
6+ layer PCBs (%)	31.3	16.8	19.3	11.2	16.8
HDI PCBs (%)	(316.7)	5.1	54.5	48.3	30.9
	16.6	12.0	16.3	13.5	16.2
Provision of PCBA services (%)	15.1	3.2	3.4	3.6	5.9
	16.2	7.4	11.8	10.1	12.7

Source: Company data

HDI ramp up. The company has plans to invest HK\$624.0m (US\$80.0m) to construct a new HDI plant. The plant, which will be completed at the end of FY3/07 and commence operation in FY3/08, will have a production capacity of 191,666 sq.ft/mth. We note that the company's high-end plant currently has a combined high layer/HDI production capacity of 400,000 sq.ft/mth. The additional HDI production facility will assist the company's overall strategy to improve product mix and raise overall ASPs. As at 1H FY3/06A, ASPs of two layer, four-layer, high layer and HDI PCBs were approximately US\$6.70, US\$9.57, US\$19.13 and US\$32.81/sq.ft.

Entry into new markets. 3CEMS plans to enhance horizontal integration by broadening into new areas such

as the automotive and the medical equipment industries. In each of these new industries, the company will leverage its existing expertise to develop high-end, critical component products.

Table 4: Financial highlights

Year to Dec (US\$m)	2003A	2004A	2005A	2006F	1H05A	1H06A
Turnover						
PCB fabrication	125.1	191.2	260.9	n.a.	109.3	140.5
Provision of PCBA services	53.8	206.6	136.0	n.a.	56.6	72.0
	178.9	397.8	397.0	n.a.	165.9	212.5
Gross profit	28.9	29.4	47.0	n.a.	16.8	27.0
Operating profit	11.0	7.7	16.9	n.a.	4.8	13.4
Net profit	9.5	5.4	11.8	23.0	2.9	9.7
YoY % change						
Sales (%)	n.a.	122.3	(0.2)	n.a.	n.a.	28.1
Gross profit (%)	n.a.	1.6	59.9	n.a.	n.a.	60.8
Operating profit (%)	n.a.	(30.0)	119.5	n.a.	n.a.	179.2
Net profit (%)	n.a.	(43.3)	118.5	94.9	n.a.	234.7
Margins (%)						
- Gross	16.2	7.4	11.8	n.a.	10.1	12.7
- Operating	6.1	1.9	4.3	n.a.	2.9	6.3
- Net	5.3	1.4	3.0	n.a.	1.7	4.6
Effective tax rate (%)	5.9	11.2	11.1	n.a.	14.8	9.1
Payout (%)	52.7	26.9	-	n.a.	-	81.3

Source: Company data

Financials. The company's sales and net profit growth during the track record period has been volatile. Revenue growth in FY3/04A and FY3/05A were 122.3% and -0.2% YoY respectively while net profit dropped 43.3% YoY in FY3/04A but surged 118.5% YoY in FY3/05A. The main reason of the volatility stems from the revenue contribution of PCBA services. The segment has high absolute revenues, as it includes the component cost of the SMT components, but low margins. Thus the percentage of overall revenue contribution from this segment tends to have a large impact on the company's profitability. Excluding PCBA services, revenues grew 52.8% and 36.5% YoY between FY3/04A and FY3/05A. The jump in bottom line in FY3/05A was mainly due to ramp up and improving yield for its HDI products. Gross margin for HDI was 54.5% in FY3/05A, compared to 5.1% in the previous year. For 1H FY3/06, revenue and net profit grew 28.1% YoY and 234.7% YoY respectively as improving product mix yielded a 2.7 pcp YoY gross margin gain to 16.2%.

Valuation and our view. The offer price represents 7.0x to 10.3x FY12/06F fully diluted P/E. At the high end of the offer price, the valuation is generally in line with industry peers based on consensus estimates. Therefore, potential upside of the counter will very much depend on price determination. 3CEMS appears to have timed its listing to take advantage of the current market interest in IPOs. The key risks of this company is 1) dependency on a few key customers and 2) execution and transition to higher margin HDI products.

Table 5: Valuation comparisons

Company Name	Stock Code	Country	Mkt Cap (US\$m)	Price	His. Turnover (US\$m)	His. Net Profit (US\$m)	Cur Yr P/E (x)	Nxt Yr P/E (x)
Daisho Microline	567 HK	HK	141.7	HK\$2.43	79.9	14.0	n.a.	n.a.
Kingboard	148 HK	HK	3,298.8	HK\$33.1	1,679.3	184.1	12.8	10.9
Global Flex	471 HK	HK	84.9	HK\$0.53	176.9	14.2	6.8	6.2
Sinotronics	1195 HK	HK	90.1	HK\$1.27	65.0	12.5	7.5	6.0
MFS Technology	MFS SP	SP	338.5	SG\$0.84	242.8	18.5	10.6	8.3
Elec & Eltek Int'l	ELEC SP	SP	490.0	SG\$2.72	475.9	52.0	8.0	7.0
Tripod Technology	3044 TT	TW	1,181.0	TW\$110.0	461.1	64.8	12.8	10.0
Unimicron Technology	3037 TT	TW	1,245.9	TW\$40.45	858.0	92.3	8.9	7.8
Average							9.6	8.0
3CEMS	1828 HK	HK	162-237	HK\$1.40-2.05	397.0	11.8	7.0-10.3	n.a.

Source: Bloomberg & SBI E2-Capital