

Driven by the demand for LED-based products

China Industrials

Neo-Neon (1868 HK)

Not Rated

Company profile. Founded in 1981, Neo-Neon is engaged in design, manufacturing and sales of incandescent-based decorative lighting products, LED-based decorative lighting products and entertainment lighting products, with its production facility situated in Heshan, Guangdong Province, China. Its products are sold directly under its own brands, such as Neo-Neon or Neo-Laser, and its customers' brands. Its products are sold to the retail and commercial segments. The group's retail customers include Home Depot, Canadian Tire and Target. Commercial customers include hotels, casinos, architecture companies, decorative lighting stores, trading agents and distributors. More than 50% of the group's sales are derived from the U.S. and Europe markets.

Table 1: Offer stats

Price range	HK\$5.10-HK\$6.40
No. of new shares offered	160m
No. of sale shares offered	40m
Over-allocation option	30m
Fund raised	HK\$816.0m-HK\$1,024.0m
Offer P/E (FY12/06F)	15.3x-19.2x
Market cap	US\$498.2m-HK\$625.2m
IPO open	7 Dec
IPO close	7 Dec
Listing	15 Dec

Source: Company data

Growth driven by LED-based products. The group reported 2-year earnings CAGR of 22.4% between FY12/03 and FY12/05, against a 2-year revenue CAGR of 27.5%. Its profit surged 1,014% YoY in 1H FY12/06, on 38.0% YoY increase in turnover. The brilliant growth in its bottom line was mainly driven by the sales of high-margin LED-based decorative lighting products. Revenue derived from the sales of LED-based decorative lighting products leaped at a 2-year CAGR of 262.9% between FY12/03 and FY12/05. Meanwhile, proportion of LED-based lighting products in its total sales increased from 2.7% to 22.1%. Since LED-based decorative lighting products commanded higher gross profit margin of 52.0% in FY12/05, compared to its blended gross profit margin of 34.9%, the increase in LED-based products sales substantially enhanced the group's profitability.

Sales of high-margin products would increase on expanding capacity. Some of the proceeds from the IPO are earmarked for capacity expansion. The group intends to increase its LED-based light bulb production capacity by approximately nineteen-fold to 4.8b units p.a. by 2009 from 242.0m units p.a. in 2005. Utilization rate at its LED-based light bulb production capacity reached 100% in both FY12/05 and 1H FY12/06. Sales growth in the high-margin LED-based decorative lighting products is expected to accelerate further on capacity expansion.

OBM and China concept could be catalyst. Some of the group's products are sold under its own brands, such as Neo-Neon or Neo-Las. Should the sales derived from OBM business increase, its profitability would enhance further. Besides, OBM manufacturers trade at a valuation higher than that of the ODM/OEM manufacturers. Sales derived from China market accounted for only 8.4% of revenue in 1H FY12/06. The group is eyeing to expand its presence in China, as well as other emerging markets.

Table 2: Key financials

Year to Dec (HK\$m)	2003A	2004A	2005A	1H05A	1H06A
Revenue	648.2	834.0	971.3	276.6	381.6
Gross profit	195.7	275.9	339.1	72.2	144.4
Pre-tax profit	86.5	44.6	152.3	8.5	62.5
Net profit	88.3	42.9	143.5	5.4	60.6
YoY % Change					
Revenue (%)	-	28.7	16.5	-	38.0
Gross profit (%)	-	41.0	22.9	-	100.0
Pre-tax profit (%)	-	(48.4)	241.6	-	634.4
Net profit (%)	-	(51.4)	234.3	-	1014.4
Gross margin (%)	30.2	33.1	34.9	26.1	37.8
Pre-tax margin (%)	13.3	5.3	15.7	3.1	16.4
Net margin (%)	13.6	5.1	14.8	2.0	15.9

Source: Company data

Growth prospect of LED-based lighting. LED lighting has variety of advantages over traditional lightings, including energy efficiency, longer life, environmental friendliness, better reliability and design flexibility. Meanwhile, the price-to-performance of LED-based lighting has also been improving. Therefore, it is expected that a significant portion of traditional lighting that dominant the market now would be replaced by LED-based lighting, going forward. Strategies Unlimited, a market research firm which specializes in the electronic industry projected that the global High Brightness LED market size will expand at 5-year CAGR of 16.2%, from US\$3.92b in 2005 to US\$8.31b in 2010. The U.S. Department of Energy also estimated that by 2010, 55% of the general illumination market in the U.S. would be LED-based.

Table 3: Revenue and gross profit margin by product types

Year to Dec	2003A	2004A	2005A	1H05A	1H06A
Revenue (HK\$m)					
Incandescent-based decorative lighting	521.4	537.1	538.9	145.4	140.7
LED-based decorative lighting	17.5	120.7	230.5	60.3	118.6
Entertainment lighting	89.2	128.2	169.2	61	114.5
Others	20.1	48	32.7	9.8	7.8
YoY % Change					
Incandescent-based decorative lighting (%)	-	3.0	0.3	-	(3.2)
LED-based decorative lighting (%)	-	589.7	91.0	-	96.7
Entertainment lighting (%)	-	43.7	32.0	-	87.7
Others (%)	-	138.8	(31.9)	-	(20.4)
Gross profit margin					
Incandescent-based decorative lighting (%)	31.5	32.4	32.2	22.4	34.5
LED-based decorative lighting (%)	50.9	54	52	43.9	53.9
Entertainment lighting (%)	22.9	24	25.2	19.8	26.9
Others (%)	9.5	11.9	9.8	10.1	12.8

Source: Company data

Expose to the risk of fluctuation in raw material price and supplies. LED chips are the major component of the group's LED-based decorative lighting products. The group sources LED chips from two suppliers that are based in Taiwan. Other principal raw materials of its products include PVC, DOP oil and copper wire. Thus, the group is vulnerable to the fluctuation in copper and crude oil price.

Vulnerable to currency fluctuation. Since more than half of the group's sales are generated from U.S and Europe markets and are denominated in USD, while most of its manufacturing overhead costs are denominated in RMB, the appreciation of RMB and/or depreciation in USD would hurt its profitability.

Table 4: Revenue by geographical region

Year to Dec (HK\$m)	2003A	2004A	2005A	1H05A	1H06A
U.S.	219.8	238.5	292.7	83.4	117.0
Europe	225.2	286.3	352.5	87.6	150.0
Asia	147.3	230.1	253.8	78.1	80.8
China	54.1	75.6	67.2	26.2	32.0
Others	1.8	3.5	5.1	1.3	1.8

Source: Company data

Table 5: Capacity and utilization rate

	2003A	2004A	2005A	1H06A
Production capacity				
Tungsten light bulbs (m Units)	4,800	4,800	4,800	2,400
LED light bulbs (m Units)	98	154	242	179
Utilization rate				
Tungsten light bulbs (%)	73.9	51.1	49.3	73.8
LED light bulbs (%)	100	100	100	100

Source: Company data

Substantial shareholders reduce their stake. Maclare, a wholly-owned subsidiary of Transpac, and Valewater, a wholly-owned subsidiary of Transpac Capital, will sell 40.0m sale shares collectively at the group's IPO. Following the disposal, Maclare and Valawater interests in the group will reduce to 9.0% and 10.6%, from 14.5% and 17.0%, respectively. Maclare and Valawater are subject to a six-month lock up period for their remaining stakes in the group. Maclare and Valewater have been the substantial investors of the group since 1996.

Earnings forecast and valuation. FY12/06F net profit is projected to be no less than HK\$253m, representing an annualized growth rate of 77.1%. The issue price range of HK\$5.10 – HK\$6.40 represents a 15.3x-19.2x FY12/06F P/E, comparing to the sector average P/E of 25.0x and 19.2x for FY07F and FY08F, respectively.

Table 6: Peer group comparisons

Company	Ticker	Currency	Year end	Mkt cap (US\$m)	Fwd Yr1 P/E (x)	Fwd Yr2 P/E (x)	ROE (%)
Forhouse Corp	6120 TT	TWD	Dec	210	11.9	9.3	21.4
Color Kinetics Inc	CLRK US	USD	Dec	418	74.1	42.1	6.5
Craftmade International Inc	CRFT US	USD	Jun	96	12.9	9.3	26.6
Genlyte Group Inc	GLYT US	USD	Dec	2,396	19.3	17.2	17.2
LSI Industries Inc	LYTS US	USD	Jun	365	16.7	14.2	9.5
<i>Average</i>					25.0	19.2	15.6

Source: Bloomberg, I.B.E.S.