

Overseas markets drive growth

Hong Kong Electronics

SIM Tech (2000 HK, HK\$3.87)

Not Rated

Interim results in-line with market expectations. Net profit jumped 84% to HK\$202m on an 87% increase in turnover to HK\$1.7b in 1H FY12/05. The strong results were mainly driven by strong shipments growth of handset design solutions (i.e. IP and SKD/ CKD) and wireless module solution. For instance, shipments of handset design solution reached around 3.5m units in FY12/06 (cf. 1.23m units in 1H FY12/05), while wireless module solution topped 1.3m units (cf. 263k units a year earlier). However, strong shipment growth came at the expense of lower ASPs. We estimate that ASP for handset design solutions declined 15% sequentially from that of the end of 2005. Management claimed it was the company's strategy to gain market share by lowering ASP (or selling more lower end products). As a result, gross margin dropped slightly to 16.2% in 1H FY12/06 (cf. 18.6% in 1H FY12/05). Nevertheless, the company managed to report stable net margin of around 11~12% thanks to the effective cost control. SIM Tech proposed to pay an interim dividend of HK\$0.068 per share (payout of 51%) and expects to maintain the payout ratio for no less than 35% for the full year.

Table 1: Interim results comparison

(HK\$m)	1H FY12/06	1H FY12/05	YoY (%)	2H FY12/05	HoH (%)
Revenue	1,733	927	87	1,793	(3.4)
Gross profit	280	172	62	270	3.6
Operating profit	213	123	74	190	11.9
Net profit	202	110	84	181	11.3
Gross margin (%)	16.2	18.6		15.1	
Operating margin (%)	12.3	13.2		10.6	
Net margin (%)	11.6	11.8		10.1	

Source: Company data and SBI E2-Capital

Table 2: Unit shipments

(k units)	2004	1H05	2H05	2005	1H06F
Handset design solutions (IP + SKD/CKD)	1,846	1,233	3,012	4,245	3,520
Complete mobile handsets	170	280	45	325	20
LCD modules and others (SKD/CKD)	5,357	1,686	2,757	4,443	2,470
Wireless module solutions (SKD/CKD)	348	263	729	992	1,300
Total shipment	7,721	3,462	6,543	10,005	7,310

Source: Company data and SBI E2-Capital

Robust shipment growth. SIM Tech launched 125 new handset models on 12 motherboard platforms during the period (cf. 61 model on 6 platforms in 1H05). The company launched MP4 phones in 3Q05. Ultra-low cost handset solution has also been launched in 1Q06 and is being shipped to the Brazilian market. Overseas market contributed around 5% of handset shipments in 1H FY12/06. The company signed two new high-end projects with Telco Italia Mobile in 1H FY12/06 to boost overseas shipments going forward. SIM Tech has also increased effort in industrial design to launch different casing designs including slim phones. SIM Tech increased R&D engineers to 686 (cf. 580 at the end of 2005). Most of the increases are to prepare for the next growth phase from 3G phones and overseas markets. Meanwhile, wireless module solution used in wireless phones continued to grow on the back of operators' effort to tap the rural areas. In 1H FY12/06, handset design solutions and complete handset accounted for 61% of revenue, followed by LCD modules (22%) and wireless modules (16%).

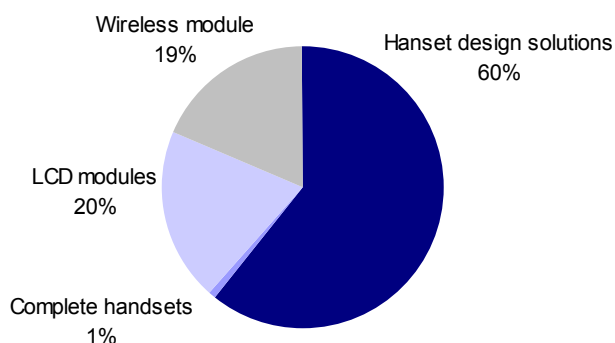
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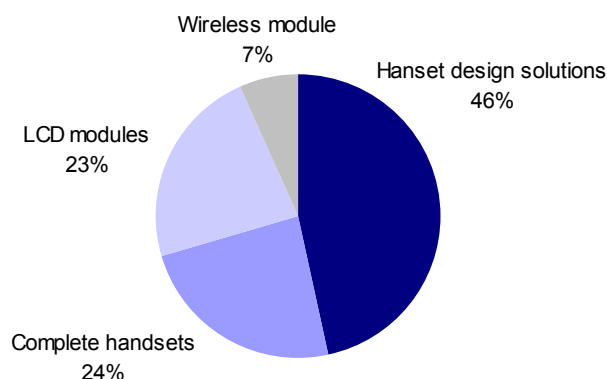
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Chart 1: Revenue breakdown in 1H06



Source: Company data and SBI E2-Capital

Chart 2: Revenue breakdown in 1H05



Source: Company data and SBI E2-Capital

Healthy financials. The company continued to report free operating cash flow and had net cash of HK\$520m in 1H FY12/06. Inventory turnover was 58 days, while AR and AP turnovers were 25 days and 53 days. All of these turnover ratios in 1H06 were similar to the figures reported at the end of 2005. Full-year capex will be around HK\$200m in 2006 (cf. HK\$110m in 1H06).

Market potential is bigger than market anticipated. SIM Tech expects revenue split for 1H:2H to be 40:60. Going forward, SIM should continue to serve nearly all the big handset brands in China as well as the overseas markets. While one may worry about its Chinese clients losing market share in the China market (with less than 35% share nowadays), management argued that market might have underestimated the export market for its clients. The company stated that its Chinese clients have been paying more attention to the overseas markets and shipments to the overseas markets could be as big as the domestic market. Also, SIM argued that Chinese handset makers were losing market share in the low-end market, but they actually have been doing well in the mid-end market. This should be positive to SIM Tech, given that the company's main focus on mid-end phones.

Will margin fall further in second half? Historical pattern showed that gross margin in the second half was usually lower than in the first half. Management did not rule out the possibility that gross margin will slid further in the second half of this year. This will depend on the company's strategy whether to increase shipments of lower end products. Its major competitor Longcheer also reported its 4QFY6/06 results yesterday, with margin decline due to dropping ASP. We remain concerned that the declining ASP in the industry is more inevitable (i.e. new products with more new features failed to support the ASP), instead of the management discretion.

China 3G (TD-SCDMA) market is due soon. The 3G licenses are expected to be issued in 4Q06 or 1H07. SIM Tech is one of the early local design houses to develop TD-SCDMA handset solution. SIM has established a TD-SCDMA joint engineering laboratory with Da Tang (China). The company also signed a TD-SCDMA/GSM dual mode handset development project with LG (Korea). We believe the company is well positioned to ride on 3G expansions, despite that meaningful shipments of 3G phones may only be realized in 2H07 at the earliest.

Developed and developing countries offer big potentials. SIM partners with Philips Semiconductor on EDGE/WiFi phones and Kineto for UMA technology. SIM believes EDGE/WiFi combo handsets will receive strong demand from European and US operators in 2H06, thanks to better WiFi infrastructure. EDGE/WiFi solution is under testing in Europe and sampling will start in US market in 3Q06. Meanwhile, developing countries will be the major growth driver for the overall handset market and ultra low cost handsets will be used to raise penetration in these areas. The company has already shipped ultra low cost handsets to Brazil.

Valuation. The stock currently trades at consensus 11.8x 06F P/E and 8.6x 07F P/E.

Table 3: Peer group comparisons

Company	Stock Code	Currency	Price	Market cap. (US\$m)	P/E (x)		ROE (%)		Yield (%)
					2006F	2007F	2006F	2007F	
SIM Tech	2000 HK	HKD	3.87	747	11.8	8.6	36.3	39.7	3.6
China Techfaith Wireless	CNTF.US	USD	7.15	314	11.0	7.3	13.6	15.8	0.0
Longcheer*	LHL SP	SGD	0.845	213	7.3	5.1	55.0	52.0	6.2

* June year-end

Source: IBES and SBI E2-Capital