

Bottoming out in 2007

China Telecom

Comba (2342 HK, HK\$2.09)

BUY (unchanged)

Target price: HK\$3.5 (+69%)

Delay in the timing of 3G licenses. Previously, we expect the Chinese government to release its first home-grown 3G license (i.e. TD-SCDMA) in 3Q06. However, with the trial results likely to be delayed to August (from July originally due to unsatisfactory progress), we believe that the release of 3G license is likely to be postponed to 4Q06 at the earliest. Given that the process from bidding to final inspection usually takes around 6 months, we now expect Comba to book its revenue contribution from TD-SCDMA coverage equipment in 2Q07 at the earliest. Assuming the licenses for the other two standards (i.e. WCDMA and CDMA 2000) to be released in 2H07, we believe Comba will reap the full benefit of all three standards in 2008.

Repeaters in 3G game. A school of thought suggests that TD-SCDMA does not require as many repeaters (indoors and outdoors) as that of the other 3G standards due to the design improvement. However, Comba argues that higher frequency of 3G standard (and thus shorter wavelength) should lead to more repeaters to be deployed given that 3G signal is more likely to be affected by obstacles. Our industry contacts suggested that the improved capacity of TD-SCDMA will not reduce the requirement of repeaters but cut the requirement of base stations instead. In a situations where they need repeaters for 2G today will continue to require repeaters for 3G in the future. Meanwhile, shorter wavelengths do not necessarily increase the requirement of repeaters, given the fact that the difference between 2G's 1.9GHz and 3G's 2.7G Hz is not too significant. Consequently, we believe that TD-SCDMA will need as many repeaters as that of both the other 3G and the existing 2G standards. We believe the coverage equipment will account for around 10% of the total 3G infrastructure capex.

Legacy products facing increasing pricing pressure. The company admitted that pricing pressure for its 2G products are expected to intensify further this year. As China Mobile has started to adopt centralized procurement instead of decentralized approach for local subsidiaries in different provinces for antenna and outdoor repeaters in August 2005, we expect Comba's shipments of these products will suffer more price decline in 2006. Comba indicated that ASP for those products is expected to drop >20% on a yearly basis. Management did not rule out the possibility that the pricing pressure will be extended to other coverage equipment (e.g. indoor coverage equipment) in the near future. Outdoor coverage equipment and subsystem & antenna accounted for 19% and 5% of revenue respectively in 2005, while indoor coverage equipment commanded 67%.

Furthermore, we estimate that copper cables used in wireless coverage product account for roughly 10~15% of Comba's COGS while copper price has increased over 20% in 1H06. Even though Comba has been trying hard to cut down cost to partially buffer the pricing pressure, the company still has to continue to ramp up R&D expenses for 3G during 2006 in order to remain competitive. It was reported that there are over 100 competitors in the wireless coverage equipment arena in China. Even though we expect the smaller players will exit the game

Table 1: Financial summary

Year to	Net profit	EPS	EPS	P/E	P/B	EV/EBITDA	Yield	ROE	ROCE	N. Gearing
Dec	HK\$m	HK\$	Δ %	x	x	x	%	%	%	%
04A	237.5	0.28	12.5	7.4	1.61	5.1	4.31	23.5	35.6	Cash
05A	82.1	0.10	(65.4)	21.5	1.49	10.9	1.44	7.2	11.1	Cash
06F	68.8	0.08	(16.2)	25.7	1.46	13.1	0.97	5.7	8.4	5.3
07F	116.4	0.14	69.1	15.2	1.31	10.0	1.97	9.1	13.5	2.6
08F	299.6	0.35	157.4	5.9	1.20	5.6	4.23	21.2	33.3	Cash

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sooner or later, we believe cut-throat price war is not inevitable in the near future.

Microwave and antenna businesses are growing, but still not too significant. We expect the contribution from the higher margin digital microwave system (DMS) and smart antenna to grow significantly (>100%) in 2006. However, DMS contributed only 1% of revenue in 2005, while smart antenna also contributed a similar amount.

1H06 results will be disappointing again. The company is due to announce its 1H FY12/06 results in Sept. We believe they will be disappointing again. We currently estimate that 1H06 net profit to be around HK\$24m, down 33% YoY. We have applied more conservative gross margin assumption of 37% in 1H FY12/06 (cf. 39% in 1H FY12/05).

Financial position. At the end of 2005, Comba managed to have a net cash position of HK\$186m. The company expects capex to be around HK\$100m in 2006 (cf. HK\$65m in 2005) due to plant expansion. Should the company need more funding for working capital in 2006, management is likely to resort to debts. AR turnover was 174 days at the end of 2005 and is expected to go up slightly in 1H FY12/06. AP (170 days) and inventory (286 days) turnovers are expected to stay at similar levels in 1H06.

A longer-term play. Given the delay 3G license issuance, more pricing pressure for the existing 2G equipment and increasing R&D expenses for 3G, we have cut our earnings estimate by 27% to HK\$68.8m for 2006 and by 62% to HK\$116.4m for 2007. At the same time, we forecast an earnings of HK\$299m in 2008. The stock currently trades at 25.7x FY12/06F PE, 15.2x FY12/07F PE and 5.9x FY12/08F PE. Although contribution from 3G is later than we previously expected, we continue to believe that the company is well positioned for the 3G build out in the longer-term.

Current share price has discounted most of the bad news. Although 1H06 results are expected to be poor, we believe the current share price has discounted most bad news already. As we are getting closer to the expected release of 3G licenses in China, we stick with our BUY call. We revised down our target price to HK\$3.5 (10x FY12/08F PE), from HK\$3.9 previously.

Table 2: Peer group comparisons

Company	Stock Code	Currency	Price	Market cap. (US\$m)	P/E (x)		ROE (%)		Net gearing (%)
					2006F	2007F	2006F	2007F	
Comba Telecom	2342 HK	HK\$	2.09	224	25.7	15.2	5.7	9.1	5.3
ZTE corp.	763 HK	HK\$	22.8	3,006	25.3	13.4	11.5	13.3	Cash
Powerwave Tech	PWAV US	US\$	7.93	889	12.6	9.8	8.7	12.0	15
Andrew corp.	ANDW US	US\$	8.25	1,378	14.7	15.0	4.8	5.5	16
Grentech	GRFF US	US\$	11.28	282	14.5	8.9	11.6	15.9	Cash
Average					18.6	12.5	8.5	11.2	

Source: Bloomberg; SBI E2-Capital