

Rural expansions provided upside surprises HK Telecom Equipment

Comba Telecom (2342 HK, HK\$2.38) BUY (unchanged)

Target price: HK\$3.5 (+47%)

Interim results beat our expectations. Comba reported a net profit of HK\$46m in 1H FY12/06 (up 27% YoY), which was better than market expectations. Revenue was up 43% YoY to HK\$589m on the back of (1) increased shipments of new products such as Digital Microwave System (DMS), antennas and base station subsystems, (2) increased existing coverage products to China Mobile, and (3) more contribution from the international sales. International business accounted for 7% of revenue in 1H FY12/06 (cf. 3.6% in 1H FY12/05). Revenue contribution from China Mobile increased significantly in 1H FY12/06, partially due to the fact that China Mobile has become more aggressive in improving its coverage network in the rural areas. Gross margin was 43% in 1H FY12/06 (cf. 48.6% in 1H05) due to the continuing pricing pressure for its existing 2G products as a result of central procurement by China Mobile. The company proposed no interim dividend. Overall, we are quite surprised by the robust sales performance on Comba's existing 2G products.

Table 1: Interim results comparisons

(HK\$m)	1H06	1H05	YoY (%)	2H05	HoH (%)
Revenue	589	413	42.7	758	(22.2)
Gross profit	253	201	25.9	274	(7.6)
Operating profit	59	48	23.9	59	0.3
Pre-tax profit	52	39	33.0	47	9.8
Net profit	46	36	26.8	46	(1.3)
Gross margin (%)	42.9	48.6		36.1	
Operating margin (%)	10.1	11.6		7.8	
Net margin (%)	7.7	8.7		6.1	

Source: Company data and SBI E2-Capital

Table 2: Client breakdown

	2004	2005	1H06
China Mobile	49%	54%	65%
China Unicom	38%	34%	22%
CDMA	29%	15%	13%
GSM	9%	18%	9%
Agents	14%	12%	13%
Total	100%	100%	100%

Source: Company data and SBI E2-Capital

Table 3: Financial summary

Year to Dec	Net profit HK\$m	EPS HK\$	EPS Δ %	P/E x	P/B x	EV/EBITDA X	Yield %	ROE %	ROCE %	N. Gearing %
04A	237.5	0.28	12.5	8.3	1.80	5.1	3.85	23.5	35.6	Cash
05A	82.1	0.10	(65.4)	24.1	1.67	10.9	1.28	7.2	11.1	Cash
06F	105.8	0.13	28.9	18.7	1.63	10.0	1.34	8.7	12.9	5.3
07F	120.5	0.14	13.9	16.4	1.47	9.7	1.83	9.4	14.0	2.6
08F	305.7	0.36	153.7	6.5	1.35	5.5	3.86	21.7	34.0	Cash

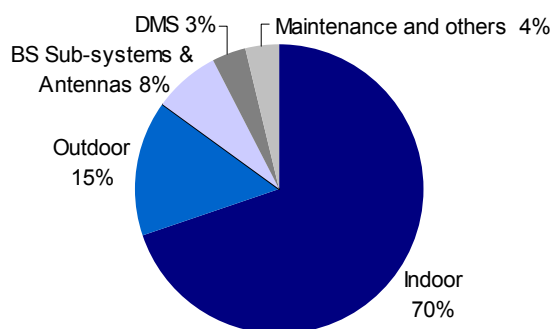
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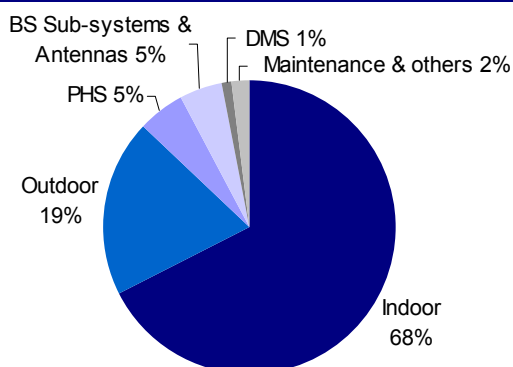
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Chart 1: Revenue breakdown in 1H06



Source: Company data

Chart 2: Revenue breakdown in 2005



Source: Company data

Cashflow cycles maintained at high levels. AR, AP and inventory turnovers all stayed at rather high levels in 1H FY12/06. AR was 233 days (cf.230 in 1H05), AP was 221 days (cf. 249 in 1H05) and inventory was 339 days (cf. 476 days in 1H05). We believe such high level of AR turnover is somewhat a norm in the China telecom equipment industry. Inventory turnover looked high at around 340 days in 1H FY12/06, but management stated that over 50% of that was for the equipment installed on the site waiting for inspection. Comba will book revenue after operators' inspection. Given the high working capital requirement, the company started to book a net debt of HK\$8.6m in 1H FY12/06 (down from net cash of HK\$186m at the end of 2005). Net gearing ratio was less than 1% in 1H FY12/06 and the company may have to fund its working capital by bank loans and better arrangement with suppliers in the second half of the year.

Momentum remains upbeat in 2H06. As China Mobile is committed to investing in rural areas. Comba should continue to benefit from this trend with more meaningful contribution from rural areas going forward. In addition, Comba expects to see more orders from China Unicom in 2H05, despite the fact that shipments to Unicom were down significantly in 1H06. Comba claimed that China Unicom has been focused on improving the network infrastructure (e.g. base stations) in 1H06 and will spend more aggressively in coverage equipment in 2H FY12/06. The biggest risk in 2H06 will be on margins, since it has been quite volatile in the past 2 years.

3G is coming. The results of the 3G trials were not out yet (supposed to be announced at the end of August), but Comba believes the trial runs were going quite smoothly. Comba believes the problem of 3G handsets may be the one that causes the problems. However, the situation can only be fixed after putting the 3G network in place for commercial use.

Still a 3G theme play. Market generally believes that 3G licenses in China will be issued in 1H07. Comba makes coverage equipment for all 3G standards. It should be one of the major beneficiaries of the upcoming 3G deployment in China. To reflect the better results in 1H06, we have revised up our earnings by 20% to HK\$106m in 2006F. The stock currently trades at 18.7x FY12/06F P/E, 16.4x 07F P/E and 6.5x 08F P/E. Comba has been trading at a price range of HK\$1.5~3.5 in the last 12 months. We still like the 3G story and maintain our BUY rating and target price of HK\$3.5 (10x 08F P/E).