

Not out of the woods yet

Hong Kong Electronics

Solomon Systech (2878 HK, HK\$2.24)

HOLD (unchanged)

Target price: HK\$2.1 (-6%)

1H FY12/06 results well below expectations. Solomon Systech (SS) reported a net profit of US\$17.9m (down 50.7% YoY) and we believe the results were well below market expectations of US\$25~35m. Revenue declined 20% YoY due to pricing pressure on its CSTN display ICs and sluggish shipments of TFT display ICs (which carry higher ASP). Note that blended ASP dropped to US\$1.2 in 1H FY12/06 (cf. US\$1.71 in 1H FY12/05 and US\$1.35 in 2H FY12/05) in the light of intense competition from Japanese and Taiwanese peers. Due to a tight foundry supply, the company has difficulty in cutting cost in 1H FY12/06. The company reported a record low gross margin of 24.7% in 1H FY12/06 (cf. 29.6% in 2H FY12/05). Meanwhile, additional 100 engineers inflated the R&D expenses (e.g. costs extra of US\$2.3m), while administrative expenses surged as a result of new accounting standard on employee's share options (costs US\$1.5m). SS somewhat booked higher interest income of HK\$3.2m in 1H FY12/06. The company announced interim dividend of HK\$2 cents per share (dividend payout was similar to last year's, 36%).

Table 1: Interim results comparisons

(US\$K)	1H FY12/06	1H FY12/05	YoY (%)	2H FY12/05	HoH (%)
Revenue	149,415	185,713	(19.5)	208,376	(28.3)
Gross profit	36,951	57,931	(36.2)	61,620	(40.0)
Operating profit	18,807	43,595	(56.9)	48,639	(61.3)
Pre-tax profit	21,604	44,790	(51.8)	47,226	(54.3)
Net profit	17,892	36,304	(50.7)	39,950	(55.2)
Gross margin (%)	24.7	31.2		29.6	
Operating margin (%)	12.6	23.5		23.3	
Net margin (%)	12.0	19.5		19.2	

Source: Company data and SBI E2-Capital

Electrophoretic display ("e-paper") - the only bright spot in second half. SS guide a better outlook in 2H FY12/06, thank to the new electrophoretic display, which seems to attract a lot of market attention. Generally speaking, electrophoretic display is a kind of flexible display (instead of rigid displays like TFT-LCD), which is made of plastic components. Electrophoretic display offers several advantages such as (1) low power consumption, (2) high contrast screen view even under bright sunlight, (3) low material costs, and (4) inexpensive production cost. However, electrophoretic display also has several disadvantages such as (1) monochrome-only solution, and (2) difficult to read under low lighting condition. Note that LCD technology

Table 2: Financial summary

Year to Dec	Net profit US\$m	EPS HK\$	EPS Δ %	P/E X	P/B x	EV/EBITDA x	Yield %	ROE %	ROCE %	N. Gearing %
04A	57.9	0.195	155.4	11.5	3.8	6.4	1.8	51.1	51.1	Cash
05A	76.3	0.240	23.5	9.3	3.4	4.6	8.5	39.7	39.7	Cash
06F	44.9	0.139	(42.0)	16.1	3.1	8.7	3.1	20.5	20.5	Cssh
07F	61.2	0.190	36.3	11.8	2.8	6.2	6.8	25.0	25.0	Cash
08F	66.5	0.207	8.7	10.8	2.5	5.6	7.4	24.2	24.2	Cash

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works well for rigid display because the backlight and substrates remain constant, making it easier to apply color filters to create images. However, bending both the backlight and substrates could cause the image quality to deteriorate that is why this technology is so challenging. SS claims itself as one of the three companies in this world that has the know-how to produce e-paper.

Motorola is testing the water with e-paper. Motorola has recently launched a new low-end phone (called Motofone) under the “Saclpel” platform, which targets at emerging markets with an estimated retail price of US\$40~50. In order to lower the production costs and produce a super-slim mobile phone, monochrome electrophoretic display will be used instead of CSTN or TFT screen. News has reported that Motorola plans to launch GSM Motofone in India in 4Q06 and expand into CDMA Motofone in US and other Asian countries in 1Q07. Market also suggested news also quoted that Motorola has already received an order of 500k units from an operator and expects to ship up to 30m units over a six-month period (i.e. 4Q06~1Q07).

Chart 1: Motorola's low-end model (Motofone)

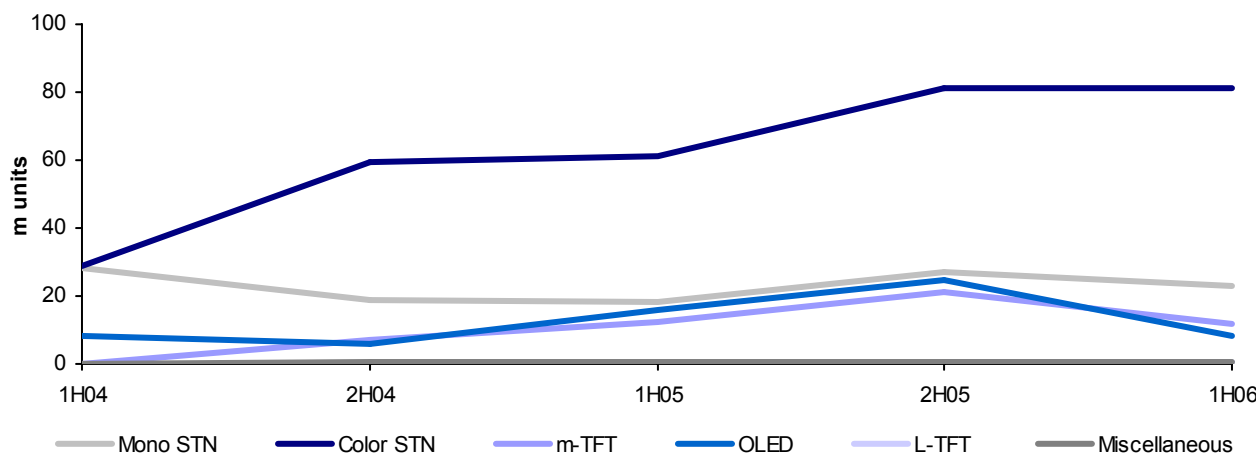


Source: Motorola website

e-paper could go beyond handsets in the longer term. Management has been quite positive about the shipment of e-paper and expects Motofone to ramp up in late 3Q06 at the earliest. In the longer term, management believes that e-paper could go beyond just handsets to credit cards and other electronic appliances.

Can e-paper save Solomom Systech? Our first impression on Motofone is quite positive (considering its super-slim appearance and attractive pricing), however we do not think SS could benefit too much from it in the near term. SS has already captured a global market share of approximately 25% (or 45.3m units) in the monochrome handset display IC market in 2005. Increasing shipments of e-paper will somewhat cannibalize its original mono display ICs shipments. Even if we assume Motofone will be very well received by the market, we believe the bottom-line contribution will not be too significant. We understand e-paper will be sold at slightly higher ASP and gross margin than that of mono display ICs, but at a slightly lower ASP and gross margins than that of more advanced CSTN and TFT display ICs. We estimate that mono ICs only contributed 7% of SS's revenue in 2005. Given the increasing competitive landscape of CSTN and TFT display ICs, we remain concerned on its near term outlook.

CSTN and TFT display ICs - a bumpy road ahead. Shipments of CSTN display ICs were sequentially flat in 1H06, while shipments of TFT display ICs decreased significantly. SS guided that shipments for both products should grow in line with its clients in 2H FY12/06. While we believe the normal seasonal strength for SS in 2H FY12/06, we do not expect any significant improvement for SS in these arenas. For instance, after SS losing Motorola's TFT display ICs orders to Japanese peers in 1H FY12/06, we have not heard any news about SS receiving Motorola orders on other recent high-end models. Meanwhile, we keep hearing that SS's peer Sitronics (8016 TT) has been aggressively cutting pricing on CSTN display ICs in order to gain market share.

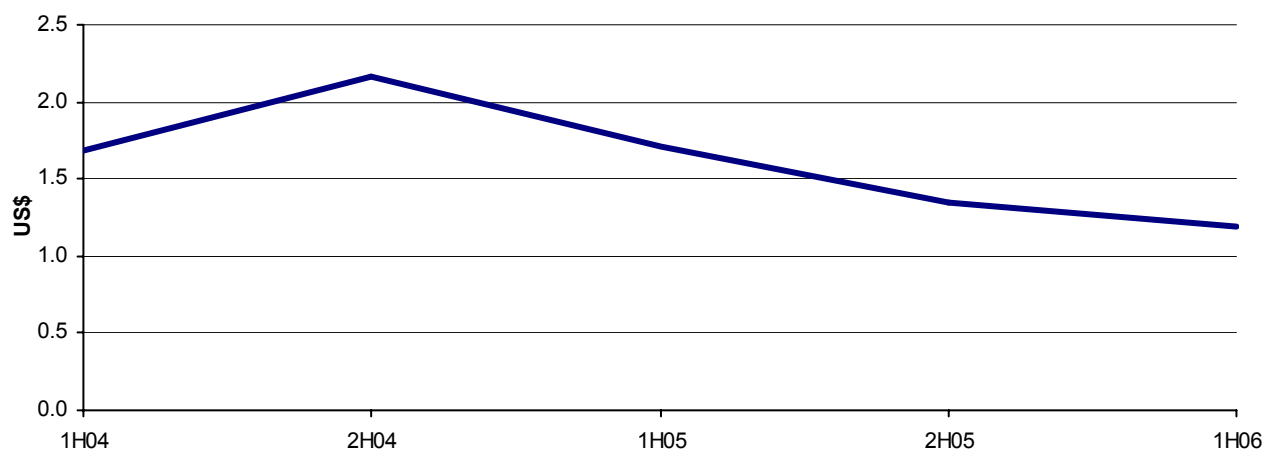
Chart 2: SS's driver IS shipments

Source: Company data and SBI E2-Capital

Shipments of OLED display ICs bottoming out. SS shipped only 8m units of OLED display ICs in 1H FY12/06 (cf. 24.5m units in 2H FY12/05 and 16m units in 1H FY12/05) due to inventory issues on MP3. SS now expects shipments of OLED to accelerate again in 2H FY12/06, as the old clients have increased order flow. We estimate that OLED display ICs accounted for around 10% of its revenue in 1H FY12/06.

Large-sized driver ICs not going anywhere. We still believe that the merger of AUO and QDI should pose threat (instead of opportunity) to SS. In the past, SS did ship large-sized driver ICs to QDI, but AUO is now in charge after the merger. Given that AUO already has a few close suppliers, we believe it will not be easy for SS to break in. Note that large sized driver ICs are considered as a somewhat mature product so maintaining a good relationship with clients and securing foundry supply play an important role in securing orders.

Gross margin still under pressure. Management expects that the overall blended ASP will drop 5~10% more in 2H FY12/06, following a 30% ASP decline in 1H FY12/06. While management claims that the foundry supply in 2H FY12/06 will not be as tight as that in 1H FY12/06, we believe there is a limited room for cost down, given that utilization for various foundries supply will remain relatively high in 3Q FY12/06 for the manufacturing process of 0.18um and 0.25um.

Chart 3: Blended ASP trend

Source: Company data and SBI E2-Capital

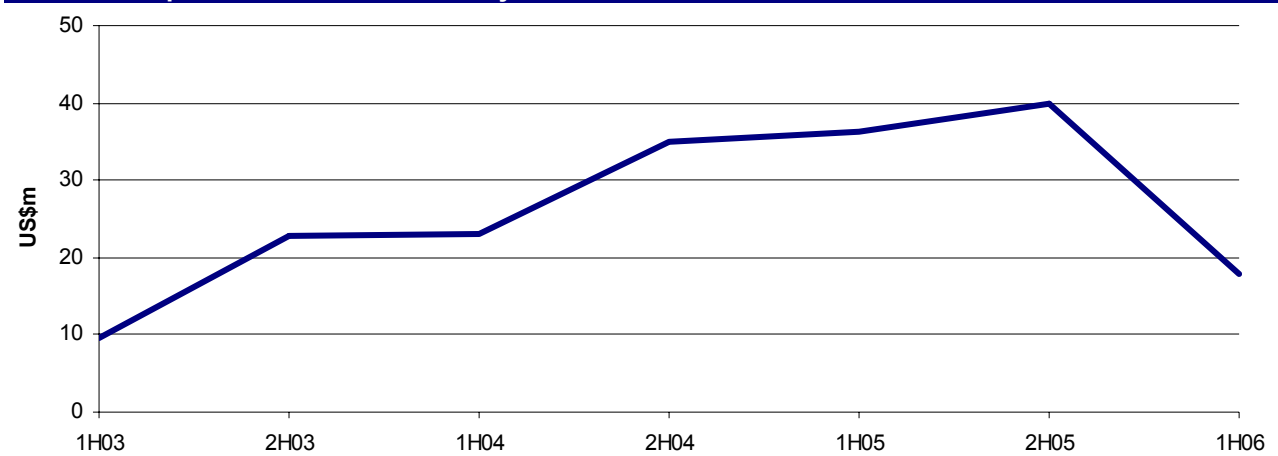
Conclusions. We still do not believe the worst is over for SS yet. We expect many street analysts will have to cut their earnings forecast. To reflect the poor 1H results and lower gross margin assumptions, we have also cut our 2006 and 2007 earnings by 34% and 19% respectively. The stock currently trades at 16.1x FY12/06F PE and 11.8x FY12/07F PE. We set our new target price at HK\$2.1 (previously HK\$2.8), which is equivalent to 11x 07F PE (in line with the industry average).

Table 3: Peer group comparisons

Company Name	Ticker	Currency	Price	Market Cap. (US\$m)	P/E (x)		ROE (%)	
					2006F	2007F	2006F	2007F
Solomon Systech	2878 HK	HK\$	2.24	579	16.1	11.8	20.5	25.0
Novatek	3034 TT	NT\$	163.5	2,702	16.8	13.4	35.3	35.2
Sitronix	8016 TT	NT\$	95.4	264	10.6	8.5	32.3	31.3
Himax	HIMX US	US\$	6.29	1,224	13.8	11.1	35.8	32.2
Sunplus	2401 TT	NT\$	29.9	963	11.2	11.4	16.2	14.6
Average					14.3	11.2	28.0	27.8

Source: IBES and SBI E2-Capital

Chart 4: Net profit trend for Solomon Systech



Source: Company data and SBI E2-Capital