

China Fiber Optic Network System

Distressed valuation opportunity

to summarize...

- Net profit slightly better-than-expected by 4.7% at RMB272m for 2012A
- Media report and our supportive view on CFONS clarification
- Expect to resume volume growth in 2013F
- Margin to stabilize on product mix and internal soft optical cables
- TP remains at HK\$1.80 on distressed 2.8x P/E for 2013F. Reiterate BUY

Net profit slightly better-than-expected by 4.7% at RMB272m for 2012A.

CFONS released FY12/12A results last Thu during lunch break. Revenue increased 18.9% YoY to RMB1,494m. It was in line with our estimation of RMB1,476m. As for gross profit and net profit, while we anticipated margin squeeze on increased sales proportion of bundle patch cords, overall impact on CFONS margin was smaller-than-expected. Gross profit and net profit were RMB456m and RMB272m respectively for FY12/12A, which were 3.0% and 4.7% higher than our estimates. As for sales breakdown for 2012A, a slightly higher proportion of 70.5% was direct sales to Telecom operators, which was auditable.

Table 1. Actual results and our estimates for 2012A

RMBm	2011A	2012A	YoY	Our est.	Deviation
Revenue	1,257.0	1,494.2	18.9%	1,476.40	1.2%
Gross profit	399.5	426.5	6.8%	414.2	3.0%
Operating profit	326.3	366.1	12.2%	343.1	6.7%
Total profit	254.8	272.2	6.8%	259.9	4.7%

Table 2. Majority direct sales to Telecom operators

RMBm	2011A	% of total	2012A	% of total
Total Sales	1,257	100%	1,494	100%
Direct sales to Telecom operators	852	67.8%	1,053	70.5%
Sales to Broadcast and TVs	73	5.8%	119	8.0%
Sales to specialized networks	23	1.8%	21	1.4%
Other domestic sales	88	7.0%	100	6.7%
Overseas sales	221	17.6%	201	13.5%

Source: SBI E2-Capital

Media report and our supportive view on CFONS clarification. Earlier this month, certain media had an investigative coverage on China Fiber Optic Network System (CFONS) that questioned its financial performance and industry leadership position. CFONS later issued a [clarification announcement](#) yet the counter fell substantially that day. We understand that CFONS has been under questions partly due to untransparent sales contracts and pricing together with high margin and low labour input. We continue to view that main entry barrier of this industry is on capital and track record. For sales and net profit of RMB1,494m and RMB272m, PP&E and trade receivables were as much as RMB843m and RMB777m by the end of 2012A. Corresponding ROE was 20.1%, which partly reflected capital intensiveness. Even if a new-comer would invest heavily on equipment and willing to take 200 days+ receivables, it does not benefit telecom operators to earn limited savings on patch cords that would likely affect overall performance of the fiber infrastructure. For more details, we suggest readers referring to our [clarification on media coverage](#).

Ticker	3777 HK
Rating	BUY
Price (HK\$)	1.09
Target Price (HK\$)	1.80 (+65%)
12m Price Range (HK\$)	0.90 - 1.68
Market cap. (US\$m)	170.1
Daily t/o (US\$m)	3.1
Free float (%)	42.7

Financial summary

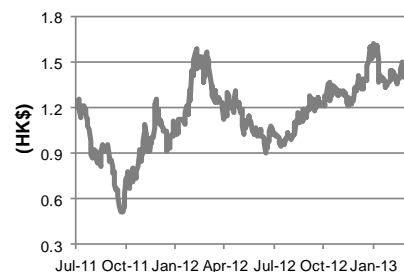
Year to Dec	11A	12A	13F	14F	15F
Turnover (RMBm)	1,257	1,494	2,040	2,511	3,077
Net Profit (RMBm)	255	272	380	484	611
EPS (RMB)	0.242	0.224	0.312	0.398	0.502
P/E (x)	3.6	3.9	2.8	2.2	1.7
P/B (x)	0.87	0.71	0.57	0.47	0.38
EV/EBITDA (x)	2.7	1.6	1.0	0.7	0.4
Yield (%)	0.0	0.7	5.7	7.3	9.2
ROE (%)	26.9	20.1	22.7	23.4	24.1
ROCE (%)	22.8	20.5	21.1	21.7	22.1
N. Gear. (%)	Cash	Cash	Cash	Cash	Cash

Source: SBI/Bloomberg

	13F	14F	15F
Consensus EPS (RMB)	0.318	0.397	-
Previous earnings (RMBm)	365.0	467.1	-
Previous EPS (RMB)	0.300	0.384	-

Price performance

Year to Dec	1m	3m	12m
Relative to HSI (%)	(19.6)	(20.3)	(18.3)
Actual price changes (%)	(22.1)	(21.6)	(12.8)



Source: Bloomberg

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Expect to resume volume growth in 2013F and margin to stabilize. As we have discussed in earlier notes, sales and profit may only increase YoY at limited pace in 2012A due to 5m sets out-sourced volume in 2011A. For 2013F onwards, we expect volume growth to resume at a faster pace. Table 3 shows our revised assumptions on volume, product mix and tax issues. With 22m, 27m and 33m nameplate capacity for 2013F, 2014F and 2015F, assuming 40% over-drive on 7-day shift instead of 5-day and 85% utilization, sales potential for the next 3 years would be 26.2m, 32.1m and 39.3m respectively. On the other hand, we expect sales portion of bundle patch cords to stable. With gradually increase in internal produced soft optical cables, we expect profit margin to stabilize and slightly rebounded from the low made in 2012A. As for tax, with dividend tax to be provided under certain of CFONS subsidiary, effective tax rate could be at 17% on top of 15% tax rate applicable to Chinese high-tech enterprise.

Table 3. Our revised assumptions on volume, product mix and tax issues

RMB m	FY12/11A	FY12/12A	FY12/13F	FY12/14F	FY12/15F
<u>Volume restriction</u>					
Total sales potential	17.9	19.2	26.2	32.1	39.3
Sales of outsourced products (m sets)	5.0	0.0	0.0	0.0	0.0
Total output (m sets)	12.9	19.2	26.2	32.1	39.3
<u>Product mix impact</u>					
Domestic patch cord sales	1,012.1	1,276.0	1,735.9	2,124.9	2,590.3
Estimated domestic gross margin	26.2%	24.2%	24.2%	24.4%	24.5%
Overseas patch cord sales	221.4	201.0	283.9	365.8	467.1
Overseas gross margin	57.9%	56.4%	57.0%	57.7%	58.3%
CFONS overall revenue	1,257	1,494	2,040	2,511	3,077
CFONS overall gross profit margin	31.8%	28.5%	28.7%	29.2%	29.7%
<u>Tax impact</u>					
EBT	300	328	458	583	736
Effective tax rate	15.2%	17.1%	17.0%	17.0%	17.0%

Source: SBI E2-Capital

TP remains at HK\$1.80. Reiterate BUY. Base on our forecast for 2013F and 2014F with net profit of RMB380m and RMB484m respectively, CFONS is currently trading at distressed valuation of 2.8x and 2.2x P/E for the 2 years. With industry prospect in China improving especially on policy aspect, we expect CFONS to perform well in short-to-medium term. While CFONS was listed in 2011A, we suggest investors to continue looking closely at its performance and cash flow items. Our target price at HK\$1.80 remains unchanged. Reiterate BUY.

Table 4. Revised profit and loss forecast

RMB m	FY12/11A	FY12/12A	FY12/13F	FY12/14F	FY12/15F
Revenue	1,257.0	1,494.2	2,039.8	2,510.7	3,077.5
Cost of goods sold	(857.5)	(1,067.7)	(1,453.5)	(1,777.1)	(2,164.2)
Gross profit	399.5	426.5	586.3	733.7	913.3
Operating expenses	(73.2)	(60.4)	(112.2)	(138.1)	(169.3)
(including: listing expenses)	(25.7)	-	-	-	-
Operating profit	326.3	366.1	474.1	595.6	744.0
Finance costs	(25.9)	(37.7)	(16.0)	(12.4)	(8.5)
Profit before tax	300.4	328.3	458.1	583.2	735.5
Income tax expense	(45.6)	(56.1)	(77.9)	(99.1)	(125.0)
Total profit	254.8	272.2	380.2	484.1	610.5
Reported EPS (RMB)	0.242	0.224	0.312	0.398	0.502

Source: SBI E2-Capital

Table 5. Revised balance sheet items

RMB m	FY12/11A	FY12/12A	FY12/13F	FY12/14F	FY12/15F
Non-current assets	813.9	859.3	984.1	1,143.1	1,332.6
Property, plant and equipment	665.2	777.3	902.9	1,062.7	1,253.2
Payment in advance	105.4	38.5	38.5	38.5	38.5
Goodwill	15.6	15.6	15.6	15.6	15.6
Deferred tax assets	27.7	27.9	27.1	26.3	25.3
Current assets	1,384.4	1,705.6	1,849.0	2,230.3	2,704.9
Inventories	28.4	36.7	42.9	54.4	76.0
Trade receivables	751.1	843.4	1,084.6	1,391.8	1,727.8
Pledged deposits	31.2	3.9	3.9	3.9	3.9
Cash and cash equivalents	550.4	795.8	683.0	737.7	841.9
Other current assets	23.3	25.8	34.6	42.5	55.3
Non-current liabilities	11.4	14.9	14.9	14.9	14.9
Current liabilities	966.8	1,056.8	954.6	1,086.8	1,237.3
Trade and notes payables	105.2	190.0	208.3	254.3	309.0
Other payables and accruals	280.2	353.3	443.1	579.3	725.1
Interest-bearing bank loans	497.5	410.3	200.0	150.0	100.0
Other current liabilities	83.9	103.2	103.2	103.2	103.2
Total equity	1,220.0	1,493.2	1,863.5	2,271.6	2,785.2

Source: SBI E2-Capital

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