

## China Fiber Optic Network System

### Recent pressure from export sales

to summarize...

- MIIT issued compulsory measures on FTTB/FTTH infrastructure construction
- Potential disappointment on high-profitability overseas sales in 2012F
- Conservative on 2012F due to volume restriction, product mix and tax impact
- Continue to expect capacity growth and margin improvement in 2013F
- TP remains at HK\$1.80 with lowered short-term forecast and improving prospects. Reiterate BUY

**Compulsory measures on telecom infrastructure to promote FTTB/FTTH.** On 31 Dec 2012, MIIT (工信部) announced that FTTB/FTTH installation regulatory documents 《住宅区和住宅建筑内光纤到户通信设施工程设计规范》和《住宅区和住宅建筑内光纤到户通信设施工程施工及验收规范》 were issued. Effectively on 1 Apr 2013, compulsory measures include the followings: 1) in cities with public fiber network, residential area and residential buildings are obliged to install fiber optic to building / to home; 2) fiber to building / home connections need to be compatible with various telecom service providers to ensure user selection; 3) for telecom infrastructure including underground fiber pipe network, cable distribution system, telecommunications room and equipments room, construction and final acceptance of which are required to be simultaneous with that of residential main structure. As such, MIIT would coordinate with Ministry of Construction (建设部) to establish details to promote and monitor FTTB/FTTH development in China.

**Table 1. Compulsory measures in latest regulatory document**

- 1) Compulsory FTTH/FTTB installation in cities with public fiber network  
In cities with public fiber network, fiber optic has to be installed to home / residential
- 2) Compulsory fiber optic infrastructure compatibility  
Fiber to building / home connections need to be compatible with various telecom service
- 3) Fiber optic as one prerequisite of occupation permit issue  
Telecom infrastructure verification becomes part of residential main structure acceptance

Source: MIIT

**Potential disappointment on high-profitability overseas sales in 2012F.** While we are positive towards industry prospects, 2012F performance is subject to slight downward adjustment. According to cbresearch under Chinese Academy of International Trade and Economic Cooperation (商务部国际贸易经济合作研究院), total national fiber optic patch cord export was RMB1.56b, RMB2.28b and RMB2.17b for Q1, Q2 and Q3 2012, which were +60.5%, +6.7% and -9.9% respectively on YoY basis. As 2H may represent larger proportion of exports in general, CFONS may still see weaker-than-expected overseas sales in 2012F unless there is significant surprise in Q4. As such, we initially lower our overseas sales forecast to RMB179m from RMB243m for 2012F and expects rebound in 2013F onwards. In fact, in addition to impact of overseas sales, we believe volume restriction, product mix and tax impact would also weigh on 2012F overall performance of CFONS.

<b>Ticker</b>	<b>3777 HK</b>
<b>Rating</b>	<b>BUY</b>
Price (HK\$)	1.59
Target Price (HK\$)	1.80 (+13.2%)
12m Price Range (HK\$)	0.90 - 1.66
Market cap. (US\$m)	248.1
Daily t/o (US\$m)	2.4
Free float (%)	39.7

#### Financial summary

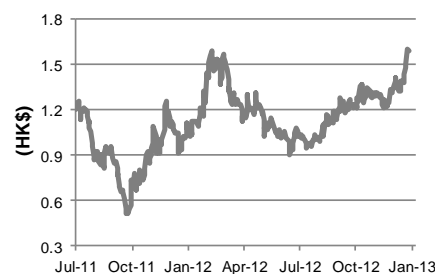
Year to Dec	10A	11A	12F	13F	14F
Turnover (RMBm)	838	1,257	1,476	1,940	2,388
Net Profit (RMBm)	183	255	260	365	467
EPS (RMB)	0.202	0.242	0.213	0.300	0.384
P/E (x)	6.3	5.3	6.0	4.3	3.3
P/B (x)	2.30	1.28	1.05	0.87	0.71
EV/EBITDA (x)	6.6	4.0	3.0	2.2	1.6
Yield (%)	0.0	0.0	2.7	3.8	4.8
ROE (%)	29.9	26.9	19.2	22.3	23.5
ROCE (%)	28.9	22.8	19.4	21.7	22.3
N. Gear. (%)	21.4	NCash	NCash	NCash	NCash

Source: SBI/Bloomberg

	12F	13F	14F
Consensus EPS (RMB)	0.235	0.307	0.360
Previous earnings (RMBm)	287.0	395.1	481.4
Previous EPS (RMB)	0.236	0.325	0.395

#### Price performance

Year to Dec	1m	3m	12m
Relative to HSI (%)	22.1	15.5	24.2
Actual price changes (%)	27.2	28.2	54.4



Source: Bloomberg

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**Conservative on 2012F due to volume restriction, product mix and tax impact.** As we have discussed in earlier notes, sales and profit may only increase YoY at limited pace in 2012F, especially after we adjust overseas sales downward for the year. Table 2 shows our estimates on volume restriction, product mix and tax impact on 2012F performance. Although total output is expected to increase to 20.2m sets in 2012F from 12.9m sets in 2011A, total sales potential in 2012F is expected to increase by only 2.3m sets due to 5m sets outsourced volume in 2011A. As such, top line growth is partly limited by volume growth. In addition, during interim announcement last year, the management already indicated that there is an increased sales mix of FTTX products of comparatively lower margin in 2H. Decreased sales proportion overseas also lowered overall gross margin in 2012F. Furthermore, 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. Nevertheless, despite potential weaker-than-market expected 2012F performance, we are positive towards its longer-term prospects.

**Table 2. Potential weaker-than-market expected 2012F performance on volume, product mix and tax issues**

RMB m	FY12/10A	FY12/11A	FY12/12F	FY12/13F	FY12/14F
<u>Volume restriction</u>					
Total sales potential	11.8	17.9	20.2	26.2	32.1
Sales of outsourced products (m sets)	0.0	5.0	0.0	0.0	0.0
Total output (m sets)	11.8	12.9	20.2	26.2	32.1
<u>Product mix impact</u>					
Domestic patch cord sales	589.4	1,012.1	1,274.0	1,645.9	2,014.8
Estimated domestic gross margin	27.5%	26.8%	24.2%	24.4%	24.6%
Overseas patch cord sales	195.9	221.4	178.9	270.3	349.6
Overseas gross margin	53.9%	57.9%	59.0%	59.5%	59.8%
CFONS overall revenue	838	1,257	1,476	1,940	2,388
CFONS overall gross profit margin	32.0%	31.8%	28.1%	29.0%	29.5%
<u>Tax impact</u>					
EBT	212	300	313	440	563
Effective tax rate	14.2%	15.2%	17.0%	17.0%	17.0%

Source: SBI E2-Capital

**Continue to expect capacity growth and margin improvement in 2013F.** Table 3 shows our revised profit and loss forecast on the company. We revise down revenue and net profit from RMB1,529m and RMB287m for FY12/12F to RMB1,476m and RMB260m respectively mainly on concern on overseas sales in 2012F. There were one-time listing expenses of RMB25.7m in 2011A, which implied that core net profit was slightly down in 2012F compared to 2011A. While for FY12/13F and FY12/14F, we expect rebound in overseas sales volume and gradual improvement in segment gross margins. As such, we believe CFONS to grow at considerable rate beyond 2012F. Net profit may increase by 40% in 2013F and 28% in 2014F.

**Table 3. Revised profit and loss forecast**

RMB m	FY12/10A	FY12/11A	FY12/12F	FY12/13F	FY12/14F
Revenue	838.1	1,257.0	1,476.4	1,939.7	2,387.9
Cost of goods sold	(570.2)	(857.5)	(1,062.2)	(1,376.9)	(1,683.0)
Gross profit	268.0	399.5	414.2	562.8	704.9
Operating expenses	(40.3)	(73.2)	(71.1)	(96.0)	(118.2)
(including: listing expenses)	-	(25.7)	-	-	-
Operating profit	227.7	326.3	343.1	466.8	586.7
Finance costs	(15.9)	(25.9)	(30.0)	(27.1)	(24.0)
Profit before tax	211.9	300.4	313.1	439.7	562.7
Income tax expense	(30.0)	(45.6)	(53.2)	(74.7)	(95.7)
Total profit	181.9	254.8	259.9	365.0	467.1
Reported EPS (RMB)	0.202	0.242	0.213	0.300	0.384

Source: SBI E2-Capital

Table 4. Balance sheet items

RMB m	FY12/10A	FY12/11A	FY12/12F	FY12/13F	FY12/14F
Non-current assets	538.1	813.9	753.3	882.9	1,046.5
Property, plant and equipment	471.9	665.2	710.8	841.1	1,005.6
Payment in advance	23.2	105.4	0.0	0.0	0.0
Goodwill	15.6	15.6	15.6	15.6	15.6
Deferred tax assets	27.4	27.7	27.0	26.2	25.3
Current assets	728.4	1,384.4	1,674.6	1,921.1	2,261.0
Inventories	25.0	28.4	31.2	51.8	63.5
Trade receivables	563.7	751.1	866.9	1,099.4	1,386.6
Pledged deposits	1.2	31.2	0.0	0.0	0.0
Cash and cash equivalents	127.6	550.4	751.2	736.8	765.5
Other current assets	10.9	23.3	25.3	33.2	45.3
Non-current liabilities	7.8	11.4	11.4	11.4	11.4
Current liabilities	581.2	966.8	936.6	999.7	1,109.1
Trade and notes payables	19.5	105.2	121.7	142.3	180.4
Other payables and accruals	189.4	280.2	330.9	423.5	544.8
Interest-bearing bank loans	273.5	497.5	400.0	350.0	300.0
Other current liabilities	98.8	83.9	83.9	83.9	83.9
Total equity	677.4	1,220.0	1,479.9	1,792.8	2,186.9

Source: SBI E2-Capital

**TP remains at HK\$1.80 with lowered short-term forecast and improving prospects. Reiterate BUY.** Base on our forecast for 2012F and 2013F with net profit of RMB260m and RMB365m respectively, CFONS is currently trading at 6.0x and 4.3x P/E for the 2 years. While industry prospect in China is generally improving especially on policy aspect, we suggest looking closely at management execution ability especially on overseas sales arrangement and raw material manufacturing arrangement. CFONS is to announce 2012F results on 28 March. For the time being, our target price at HK\$1.80 remains unchanged. Reiterate BUY.

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