

China Fiber Optic Network System

Fiber optic story remains intact

to summarize...

- Profit margin lowered in 1H due to increase in product mix of multiple-nodes
- Expect sales volume to further raise in 2H on continual capacity expansion
- 2H domestic profit margin may stay at similar level due to FTTX applications
- Net profit forecast for 2012F largely unadjusted at RMB287m
- Remain positive with current valuation at 3.6x and 0.8x P/E and P/B FY12/12F

Profit margin lowered in 1H due to increase in multiple-nodes. China Fiber Optic announced interim results yesterday. Revenue came in at RMB715m for 1H FY12/12A, representing 14.4% YoY increase. The turnover increment was the result of a fall in sales volume yet increase in ASP. The volume drop in the latest interim was mainly due to a 5m outsourced volume plus 5.35m in-house production in 1H 2011, compared to 9.6m in-house production for 1H 2012A. Nevertheless, there was an increase in product mix of multiple-nodes patch cords up to 30% sales as FTTX installment was on the rise in the period. Multiple-nodes had higher ASP but lower margin in percentage terms per set. As such, for 1H 2012A, gross profit was up only 8.6% YoY to RMB186.2m while net profit increased 11.5% YoY to RMB111.2m.

Table 1. Key P&L items for 1H FY12/12A

RMBm	1H FY12/11A	1H FY12/12A	YoY
Revenue	624.8	714.6	+14.4%
Gross profit	171.5	186.2	+8.6%
Net profit	99.7	111.2	+11.5%

Table 2. Sales and margin of major fiber optic patch cords segment

RMBm	1H FY12/11A	1H FY12/12A	YoY
Total fiber optic patch cords revenue	605.6	702.7	+16.0%
Total sales volume (m sets)	10.35	9.63	(6.9%)
Average ASP (RMB per set)	58.5	73.0	+24.7%
Segment gross margin	27.4%	26.1%	-1.3 pcp
Overall net margin	24.3%	21.6%	-2.7 pcp

Source: SBI E2-Capital

Expecting higher sales volume in 2H. While 1H results was pressured by volume growth restriction and slight margin contraction, the management indicated their capacity was raised from 12m sets by end of 2011A to 16m at Jun 2012, and further to 18m sets by end of the year. With 9.63m sets sales in 1H 2012A, our forecast sales volume for 2H is 10.6m, up 0.94m from 1H this year. Table 3 shows our capacity and output assumptions for 2010A to 2012F.

Table 3. Capacity and output assumptions for 2010A to 2012F

RMBm	FY12/10A	FY12/11A	FY12/12F
Nameplate capacity (m sets)	9.0	9.0	18.0
Output potential (m sets)	12.6	12.6	25.2
Expected utilization	93.7%	102.4%	80.0%
Total output (m sets)	11.8	12.9	20.2
Outsourcing volume (m sets)	0.0	5.0	0.0
Unsold volume (m sets)	1.0	0.0	0.0

Source: SBI E2-Capital

Please refer to important disclosures at the end of this report

Ticker	3777 HK
Rating	Not Rated
Price (HK\$)	1.03
Target Price (HK\$)	n.a.
12m Price Range (HK\$)	0.50 - 1.61
Market cap. (US\$m)	160.7
Daily t/o (US\$m)	0.52
Free float (%)	33.4

Financial summary

Year to Dec	10A	11A	12F
Turnover (RMBm)	838	1,257	1,529
Net Profit (RMBm)	182	253	287
EPS (RMB)	0.202	0.242	0.236
P/E (x)	4.2	3.5	3.6
P/B (x)	1.85	1.03	0.83
EV/EBITDA (x)	4.6	2.6	1.7
Yield (%)	0.0	0.0	4.6
ROE (%)	29.7	26.7	21.0
ROCE (%)	28.9	22.8	20.9
N. Gear. (%)	21.4	Cash	Cash

Source: SBI/Bloomberg

	12F	13F	14F
Consensus EPS (RMB)	0.250	0.305	0.348
Previous earnings (RMBm)	287.9	--	--
Previous EPS (RMB)	0.237	--	--

Price performance

Year to Dec	1m	3m	12m
Relative to HSI (%)	2.0	(8.0)	22.6
Actual price changes (%)	0.7	(12.0)	20.1



Source: Bloomberg

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2H domestic profit margin may stay at similar level due to FTTX applications. Table 4 shows sales and gross margin breakdown of fiber optic segment in 1H. For domestic sales, the management indicated that there was an obvious increase in multiple-nodes fiber optic patch cords sales up to 30% in 1H this year. With increasing portion of sales for the purpose of FTTX to connect to increasing number of ports, this particular change in product mix may persist and seen in 2H this year as well. For multiple-nodes, ASP was higher due to increase number of nodes at RMB2.1 per node cost. Nevertheless, ASP increment generally does not fully compensate increase in costs. As such, margin in percentage terms for this particular product is lowered at around 20%, according to the management. Table 5 shows CAPEX and breakdown by 3 major telecom operators in China. For overseas sales, fiber optic patch cords sales amount was especially small in 1H with almost no change in ASP. Based on previous years' experience, the management indicated that overseas sales will be seen largely in 2H and represents 15%+ of sales. Thus, 2H profit margin was generally higher than 1H; we expect overall gross margin to be 28.9% for the full year 2012F.

Table 4. Sales and gross margin breakdown of fiber optic segment in 1H

RMBm	1H FY12/11A	1H FY12/12A	YoY
Fiber optic patch cords domestic sales	592.8	648.2	+9.3%
Domestic sales volume (m sets)	10.28	9.33	(9.3%)
Average ASP (RMB)	58.0	69.5	+19.8%
Gross margin	26.7%	23.2%	-3.5 pcp
Fiber optic patch cords overseas sales	12.8	54.6	+328%
Overseas sales volume (m sets)	0.07	0.31	+343%
Average ASP (US\$)	27.9	27.9	-0%
Gross margin	61.8%	60.7%	-1.1 pcp

Table 5. CAPEX and breakdown by 3 major telecom operators in China

	FY12/09A	FY12/10A	FY12/11A	FY12/12F
China Telecom (0728 HK)	38.0	43.0	49.6	58.0
(including) Broadband and internet services	20.6	27.6	33.1	40.0
China Mobile (0941 HK)	129.4	124.3	128.5	131.9
(including) Broadband and data business	n.a.	n.a.	n.a.	n.a.
China Unicom (0762 HK)	112.5	70.2	76.7	100.0
(including) Broadband and data business	27.6	22.5	25.7	25.8
Total CAPEX	279.9	237.5	254.7	289.9
Known CAPEX on broadband and data	48.2	50.1	58.8	65.8

Source: SBI E2-Capital

Valuation and our view. We revise our revenue and net profit forecast slightly from RMB1,470.6m and RMB287.9m to RMB1,528.6m and RMB287.0m respectively, taken into account the effect of RMB25.7m listing expenses in 2011A. Under this assumption, the company is currently trading at 3.6x P/E for FY12/12F.

Table 6. Profit and loss forecast (Full-year)

RMB m	FY12/10A	FY12/11A	FY12/12F
Revenue	838.1	1,257.0	1,528.6
Cost of goods sold	(570.2)	(857.5)	(1,087.2)
Gross profit	268.0	399.5	441.3
Operating expenses	(40.3)	(73.2)	(73.7)
Operating profit	227.7	326.3	367.6
Finance costs	(15.9)	(27.5)	(30.0)
Profit before tax	211.9	298.8	337.6
Income tax expense	(30.0)	(45.6)	(50.6)
Net profit	181.9	253.3	287.0
Reported EPS (HK\$)	0.202	0.242	0.236

Source: SBI E2-Capital

Table 7. Balance sheet items

RMB m	FY12/10A	FY12/11A	FY12/12F
Non-current assets	538.1	813.9	753.3
Property, plant and equipment	471.9	665.2	710.8
Payment in advance	23.2	105.4	0.0
Goodwill	15.6	15.6	15.6
Deferred tax assets	27.4	27.7	27.0
Current assets	728.4	1,384.4	1,712.5
Inventories	25.0	28.4	32.6
Trade receivables	563.7	751.1	924.0
Pledged deposits	1.2	31.2	0.0
Cash and cash equivalents	127.6	550.4	728.9
Other current assets	10.9	23.3	27.0
Non-current liabilities	7.8	11.4	11.4
Current liabilities	581.2	966.8	947.4
Trade and notes payables	19.5	105.2	133.1
Other payables and accruals	189.4	280.2	330.4
Interest-bearing bank loans	273.5	497.5	400.0
Other current liabilities	98.8	83.9	83.9
Total equity	677.4	1,220.0	1,507.0

Source: SBI E2-Capital

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