

China Fiber Optic Network System

Clarification on media coverage

to summarize...

- CFONS issued clarification announcement against certain media coverage
- Customized products secured by auditable sales contracts
- It is irrelevant to judge per staff output of a capital intensive business
- Claims of only several RMB a set does not survive simple math
- Remain BUY with TP at HK\$1.80 with no fundamental change; results due Thu

Media coverage questioned company's leadership position within its industry.

Last Friday, certain media had an investigative coverage on China Fiber Optic Network System (CFONS) that questioned its financial performance and industry leadership position. The report questioned on 1) why CFONS did not appear to win telecom operators auctions on channel checks, where competitors such as Sunsea (002313 CH) and Ceuturyman did appear on the list; 2) if CFONS did not win auctions by China Telecom (0762 HK) in 2012, CFONS should not be able to supply products to China Telecom in 2012; and implied that CFONS might not have won previous auctions as well that CFONS might have faked sales in previous years; 3) why CFONS revenue and net profit per staff was higher than Tencent (0700HK), Trigiant Group (1300 HK), Sunsea and China Communication Services (0552 HK); 4) why CFONS products priced RMB69.5 per set versus several RMB a set in market. CFONS issued [clarification announcement](#) and resumes trading. Below is our view.

Customized products secured by auditable sales contracts; comment on points 1 and 2.

As far as we understand, China fiber optic patch cord market was of RMB7b sales in 2012. In different regions, among different stations and within different buildings, local telecom operators have various requirements on patch cords such as length, number of nodes and speed for different projects. There are standard patch cords and customized patch cords. Standard patch cords are usually centrally procured in vast volume at lower price. Customized products are usually priced slightly higher due to complications. As we have discussed in our initiation note, national offices of telecom operators determine the qualification of suppliers. For projects involving standard products, companies obtain sales through a bidding process. For projects involving customized products, companies are selected as a qualified supplier based on negotiations with the telecommunication operators. Once a company is selected for a project, the company enters into a sales contract with the local subsidiary of the particular operator. Such contracts should be audited by auditors; in this case, EY is the auditor of CFONS. In fact, even with no presence in certain biddings, a company could still secure contracts for customized products.

It is irrelevant to judge per staff output of a capital intensive business; comment on point 3.

The media report points out per staff income and net profit of CFONS is comparable to Internet giant Tencent, and effectively higher than coaxial cable producer Trigiant Group, ICT manufacturer and servicer Sunsea and telecom support services provider China Communication Services. Among the 5 companies quoted, Tencent is a successful integrated internet company with highest per staff output which largely relies on human capital. CFONS and Trigiant are both capital intensive players that produce cables for telecom infrastructure. For instance, CFONS RMB665m PP&E and RMB751m trade receivables by the end of 2011A reflected its capital intensiveness. CFONS ROE was fair at 20.1% for the year compared to stunning 49.9% of Trigiant on Bloomberg data. While Sunsea and China Communication Services employed large number of staff that yields low per staff output, their respective ROE were 14.8% and 13.8%. We do not spot alarmingly high return of CFONS.

Ticker	3777 HK
Rating	BUY
Price (HK\$)	1.46
Target Price (HK\$)	1.80 (+23.3%)
12m Price Range (HK\$)	0.90 - 1.68
Market cap. (US\$m)	227.9
Daily t/o (US\$m)	2.9
Free float (%)	42.7

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	5.5	3.9	3.1
P/B (x)	2.30	1.28	0.97	0.80	0.65
EV/EBITDA (x)	6.6	4.0	2.7	1.9	1.4
Yield (%)	0.0	0.0	2.9	4.1	5.3
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)	0.240	0.316	0.388
Previous earnings (RMBm)	259.9	365.0	467.1
Previous EPS (RMB)	0.213	0.300	0.384

Price performance

Year to Dec	1m	3m	12m
Relative to HSI (%)	7.4	10.1	7.8
Actual price changes (%)	4.3	8.1	14.1



Source: Bloomberg

Kevin Mak, CFA
 (852) 2533 3708
 kevinmak@sbie2capital.com

Claims of only several RMB a set does not survive simple math; comment on point 4. According to certain professors, fiber optic patch found in the market costs merely several dollars, usually below RMB10. We agree that as for standard product for retail use, ASP is low and profit margin is minimal. For video cords for television and audio cords for devices such as hi-fi, pricing of fiber optic cords within are much higher. For telecom operator level, city fiber optic patch cords are of even higher quality that we believe CFONS average pricing of RMB69.5 per set in 1H 2012A can be reasonable. On a separate measurement, raw material for fiber optic patch cords are soft optical cable and ceramic ferrules, which are both commodities, costing RMB0.7+ per meter and RMB2 per head respectively in 2012. With a length of 50m, which is common in telecom infrastructure requiring as long as 200m fiber optic patch cords, raw material cost of a 50m single-node patch cord is RMB39 a set. Professors' comment of below RMB10 ASP and media tracked per set prices between US\$3 and US\$6 are merely references to part of bigger picture.

Our view and valuation; remain BUY with TP at HK\$1.80. 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. While it should be easy to take several staff to produce low quality fiber optic patch cords selling at several RMB each, only a few companies would apply auto automation like overseas players or semi-automation like CFONS. Even if one 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. At the end of the day track record matters; it is more-or-less a chicken-and-egg problem for new-comers. As for CFONS itself, in 2011 the company earned RMB1,257m revenue and RMB255m net profit. ROA and ROE were 11.6% and 20.1% respectively, which was within reasonable level, in our view. PP&E and trade receivables were as much as RMB665m and RMB751m by the end of 2011A reflected capital intensiveness. We maintain our BUY rating on CFONS and recommend accumulation on weakness. Our target price is HK\$1.80, which represents 6.8x P/E and 1.2x P/B for 2012F.

SBI E2-Capital is a dedicated small/mid cap investment banking/ stockbrokerage house. Find our research on: sbie2capital.com, thomsononeanalytics.com, factset.com and multex.com

SBI E2-Capital stock ratings:

STRONG BUY : absolute upside of >50% over the next three months

BUY : absolute upside of >10% over the next six months

HOLD : absolute return of -10% to +10% over the next six months

SELL : absolute downside of >10% over the next six months

Investors should assume that SBI E2-Capital is seeking or will seek investment banking or other related businesses with the companies in this report.

Analyst certification: The views expressed in this report accurately reflect the analyst's personal views of the subject securities and that the analyst has not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report.

Disclaimer: This research report is not an offer to sell or the solicitation of an offer to buy or subscribe for any securities. The securities referred to in this report may not be eligible for sale in some jurisdictions. The information contained in this report has been compiled by the Research Department of SBI E2-Capital Financial Services Limited ('SBI E2-Capital') from sources that it believes to be reliable but no representation, warranty or guarantee is made or given by SBI E2-Capital or any other person as to its accuracy or completeness. All opinions and estimates expressed in this report are (unless otherwise indicated) entirely those of SBI E2-Capital as of the date of this report only and are subject to change without notice. Neither SBI E2-Capital nor any other person, accepts any liability whatsoever for any loss howsoever arising from any use of this report or its contents or otherwise arising in connection therewith. Each recipient of this report shall be solely responsible for making its own independent investigation of the business, financial condition and prospects of the companies referred to in this report. SBI E2-Capital and their respective officers, directors and employees, including persons involved in the preparation or issuance of this report, may from time to time (1) have positions in, and buy or sell, the securities of companies referred to in this report (or related investments); (2) have a consulting, investment banking or broking relationship with any company referred to in this report; and (3) to the extent permitted under applicable law, have acted upon or used the information contained or referred to in this report including effecting transactions for their own account in an investment (or related investment) in respect of any company referred to in this report, prior to or immediately following its publication. This report may not have been distributed to all recipients at the same time. This report is issued only for the information of and may only be distributed to professional investors and dealers in securities and must not be copied, published, reproduced or redistributed (in whole or in part) by any recipient for any purpose. This report is distributed in Hong Kong by SBI E2-Capital. Any recipient of this report who requires further information regarding any securities referred to in this report should contact the relevant office of SBI E2-Capital located in such recipient's home jurisdiction.

Copyright © SBI E2-Capital Financial Services Limited. All rights reserved.