Initiate Coverage

KFM Kingdom Holdings Limited 3816 HK

Outstanding among peers in a highly competitive industry

- *KFM Kingdom is a bellwether in the precision metal processing and EMS sector in Greater China.*
- *Serving customers across different industry sectors, risks associated with the group's business are well diversified.*
- *The group's net earnings is expected to recover strongly in FY03/15E, and surge robustly at a 3-year CAGR of 61.6% between FY03/14 and FY03/17E.*
- *We initiate the group with a BUY rating at a target price of HKD1.63 per share, representing a prospective P/E of 19.0x and 10.3x for FY03/15E and FY03/16E respectively, indicating an upside potential of 37.0% to the current stock price.*

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Stock Data (3816 HK)

Rating	BUY
Price (HK$)	1.19
Target Price (HK$)	1.63
12m Price Range (HK$)	0.81-1.42
Market cap. (HK$m)	714.0
Daily t/o (HK$m)	3.8
Free float (%)	25.6

Source: Bloomberg

Outstanding among peers in a highly competitive industry. By assuming a proactive role at the early stage of its customers' product design and providing specific advice to its customers for resolving design and technical issues, the group differentiates from traditional original equipment manufacturers and original design manufacturers.

Expanding into Internet of Things (IOT). The group is developing its own-branded kiosk products. Differing from conventional kiosk products in the market, the group's kiosk products are equipped with more advanced design and transactional functions to suit a wide variety of customers in the retail, hospitality, leisure, telecom, healthcare, education and transport markets. Although the business is still at its start-up phase, the group has already been receiving orders from customers in Hong Kong and South East Asia.

New Suzhou Production Base would contain costs and boost earnings. The group acquired a new site in Suzhou with a GFA of 52,000m^2 and is developing it into new production facilities with a GFA of 37,000m^2. It will terminate its existing production facilities in KPP-Suzhou, which is operating on a leased factory and move into its owned premise, thus substantial rental expenses is expected to be contained.

Two horses carriage. Auto tooling sector is expected to be an additional revenue stream for the group on top of its existing five specialized industry segments. We expect the group to register a double digit growth in revenue generated from the sales of medical and equipment sector in the coming years, as its top-tier listed corporate customers, such as Agilent Technologies and Thermo Fisher Scientific, are placing more orders.

Robust growth in net earnings going forward. The group's net earnings increased by 20.4% YoY to HKD30.5m for 1H FY03/15, or approximately 87.1% of its annual earnings for FY03/14. Going forward, we expect the group's net earnings to increase at a 3-year CAGR of 61.6%, to HKD147.6m for FY03/17E due to increase in revenue, margin expansion and a reduction in operating costs arising from rental expenses.

Figure 1. Financials and valuation

	FY03/13	FY03/14	FY03/15E	FY03/16E	FY03/17E
Total revenue (HKD m)	**846.5**	**945.8**	**1,101.9**	**1,322.2**	**1,586.7**
Revenue growth (YoY)	*-11.0%*	*11.7%*	*16.5%*	*20.0%*	*20.0%*
PBT (HKD m)	**49.3**	**37.5**	**65.5**	**119.2**	**182.3**
PBT growth (YoY)	*-58.0%*	*-23.9%*	*74.6%*	*81.8%*	*52.9%*
Net profit (HKD m)	**40.2**	**35.0**	**53.1**	**96.5**	**147.6**
Net profit growth (YoY)	*-57.5%*	*-12.8%*	*51.6%*	*81.8%*	*52.9%*
EPS (HKD cents)	**7.7**	**6.1**	**8.6**	**15.9**	**24.4**
DPS (HKD cents)	14.2	3.3	2.6	4.8	7.3
P/E (x)	17.8	19.6	13.8	7.5	4.9
Dividend yield	11.9%	2.8%	2.2%	4.0%	6.1%

Source: Company data

Please refer to important disclosures at the end of this report

Company Background

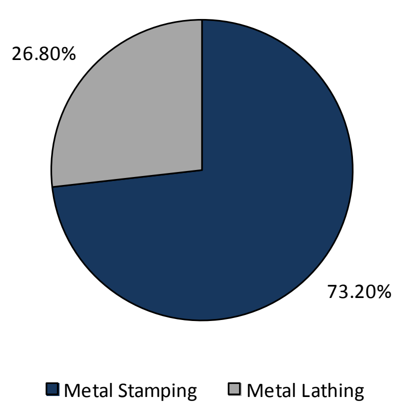
Overview: KFM Kingdom is engaged in the provision of precision metal processing solutions and services, including i) design and fabrication services of precision metal stamping tools; and ii) manufacturing services of precision metal products, components, modules and systems. Its products and services are offered to customers from a wide range of industries. In particular, it has a strategic focus on five specialized industry sectors, including office automation, consumer electronics, medical and equipment, finance equipment, and network/data storage. The group also offers product assembly, integration services and logistics support to its customers. The group's headquarters is located in Hong Kong and its four production plants (with a total gross floor area of not less than 90,000m^2) are located in Shenzhen (Guanlan and Xili), Suzhou and Shanghai.

Figure 2. Factory locations

Source: Company data

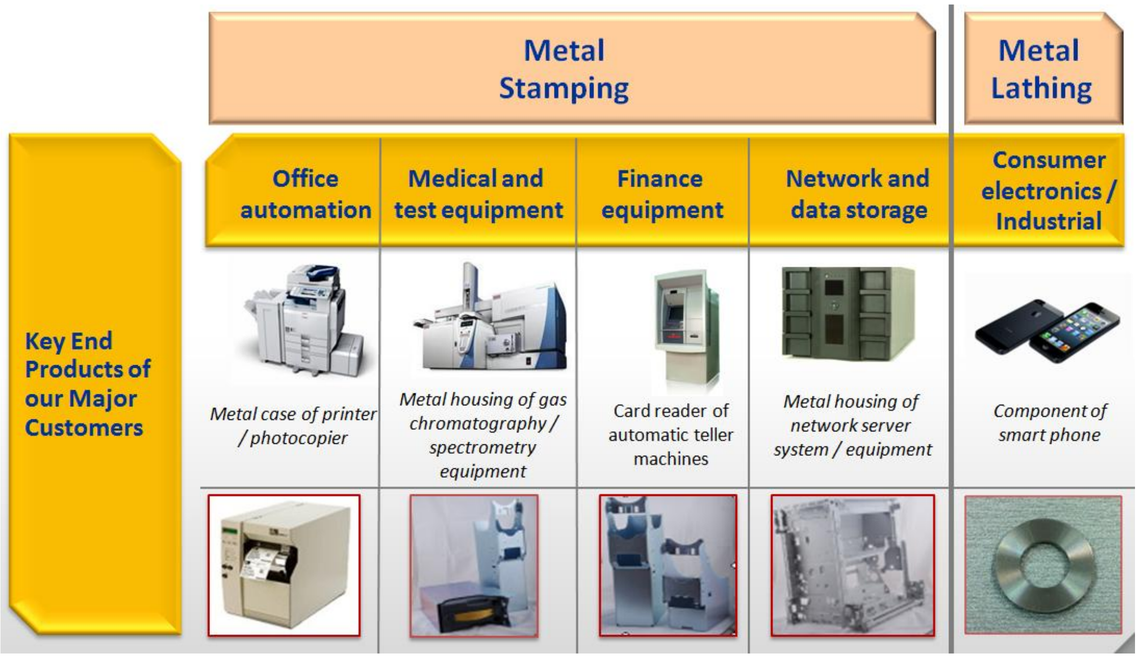
The manufacturing business of the group is divided into two segments: i) metal stamping and ii) metal lathing. Metal stamping is the process of bending, forming and cutting a sheet metal into the desired shape and size through the use of a die on a stamping machine. The stamping process is employed by the group to produce metal products in the industry sectors of office automation, medical and equipment, finance equipment, and network/data storage. Metal lathing is a metal cutting operation so as to remove excess material from a work piece to produce parts in desired shapes. The process is used to shape the inner and outer cylindrical surface, end surface, cone surface, finished surface and screw thread, etc. The metal lathing process is employed by the group to produce products mainly in consumer electronics sector.

Figure 3. Revenue breakdown of business segments in FY03/14



Source: Company data

Figure 4. Product portfolio



Source: Company data

In the focused industry sectors of the group, assuming the revenue distribution of FY03/14 is similar to FY03/13, the biggest revenue contribution of approximately 35.6% was generated from office automation in FY03/14, amounting to around HKD337.0m. The group mainly manufactures automatic document feeder trays and metal frames as well as mounting structures of the commercial grade photocopiers, digital printing machines, barcode printers and facsimile machines. Its customers includes Fuji Xerox and Ricoh, both of which are listed in Tokyo Stock Exchange and ranked 437 and 500 in Fortune Global 500 2013 respectively.

Medical and test equipment sector is the second largest revenue contributor of the group. It contributed a quarter of total revenue in FY03/14, amounting to around HKD238.4m. The medical and test equipment principally includes producing chemical testers, blood testing equipment, gas chromatography and body monitor machines. Some of the customers of the group are world-class top tier companies, including Tektronix, Thermo Fisher and Agilent Technologies, ranked 152, 220 and 371 in Fortune US 500 2013 respectively.

The group produces metal parts of chargers for mobile devices, portable chargers for personal tablet computers and safety products to customers in the consumer electronics industry. The group derived 19.1% of its total revenue from this sector in FY03/14, amounting to approximately HKD180.8m. For finance equipment sectors, the group mainly manufactures automatic teller machines, bank note sliders and credit card readers. The group also produces data storage system and network server equipment for NEC, one of the group's customers in Japan. Finance equipment and network/data storage business cumulatively contributed approximately 12.8% of total revenue in FY03/14, amounting to HKD121.0m.

Figure 5. World-class Top Tier Clientele

	Customers	Years of collaboration	Country of origin	Ticker	Fortune Global 500 2013 Ranking	Fortune U.S. 500 2013 Ranking
Office automation	FUJI xerox	15	Japan	TYO:4901(2)	437(2)	--
	KONICA MINOLTA	8	Japan	TYO:4902	--	--
	RICOH	20	Japan	TYO:7752	500	--
Consumer electronics / industrial	ADVANCED ENERGY	5	USA	NASDAQ:AEIS	--	--
	FLEXTRONICS	3	Singapore	NASDAQ:Flex	492	--
	FOXLINK	3	Taiwan	TWSE: 2392	--	--
	Amphenol	2	USA	NYSE: APH	--	--
Medical and test equipment	Agilent Technologies	11	USA	NYSE:A	--	371
	Tektronix	8	USA	NYSE:DHR(1)	--	152 (1)
	ThermoFisher SCIENTIFIC	8	USA	NYSE:TMO	--	220
Finance Equipment	DIEBOLD	8	USA	NYSE:DBD	--	--
	mei	6	USA	Private	--	--
Network and data storage	BDT	9	Germany	Private	--	--
	NEC	12	Japan	TYO:6701	295	--

Source: Company data

The group is one of the most advanced precision metal engineering solution providers in Hong Kong and China. It is a record holder in receiving 3 prestigious grand awards at the Hong Kong Awards for Industries. The group has also earned the ISO9002-1994 certification in quality management standard since 1995. With proven quality, strong R&D capability and superior services, the group stands out among its peers in the highly competitive metal processing industry.

Management profile: Mr. Sun Kwok Wah, Peter M.H., one of the founders of the group, is the Chairman and Executive Director of the group. He has more than 24 years of experience in the metal stamping industry. In 1989, he established Kingdom Fine Metal Limited and established his Shenzhen Shunan Kingdom Contract Processing Factory in 1990. He was awarded associateship (metal industry) from the Professional Validation Council of Hong Kong Industries in 2002 and the Medal of Honor (MH) by HKSAR in 2007. Currently, he is responsible for finance management, overall strategic planning, partnership development as well as international key customer relations of the group.

Mr. Sun is not only dedicated to his business, but also devotes his time to technology development. In 2004, EuAuto Technology, a company of Mr. Sun, and PolyU launched “MyCar” in Hong Kong, which is the first home-grown electric vehicle. The car had obtained the World Manufacturer Identification code and is fully compliant with European standards. It went on sale in the UK, France, Italy, Austria and Denmark in 2009. It also met the roadworthiness requirements stipulated by HKSAR Government’s Transport Department and had been granted the vehicle type-approval as a private car. Notwithstanding the unpopularity of this type of electric car nowadays, Mr. Sun owns a sense of mission to contribute himself to the society.

The group has an experienced management team with 4 executive directors, namely, Mr. Sun Kwok Wah, Peter M.H., Mr. Wong Chi Kwok, Mr. Lam Kin Shun and Mrs. Chow Suen Christina. They have over 15 to 40 years of experience in the manufacturing industry. For the senior management, Ms. Sin-Ling Chung is the CEO, Mr. Edmond Kwok is the CFO & Company Secretory and Mr. He Lin is the Managing Director in KPP-SuZhou.

Prof. Chung Chi Ping Roy BBS, JP, is an independent non-executive Director of KFM since 2012. Prof. Chung is a prominent industrialist and entrepreneur with over 40 years experience in the electronic and electrical appliances industry. Prof. Chung is a co-founder and non-executive Director of Techtronic Industries Company Limited (TTI, 0669 HK). TTI is a world-class leader in the manufacturing of power tools, outdoor power equipment and appliances with a current market capital of HKD47.5b. Prof. Chung was also the Chairman of the Federation of Hong Kong Industries from July 2011 to July 2013.

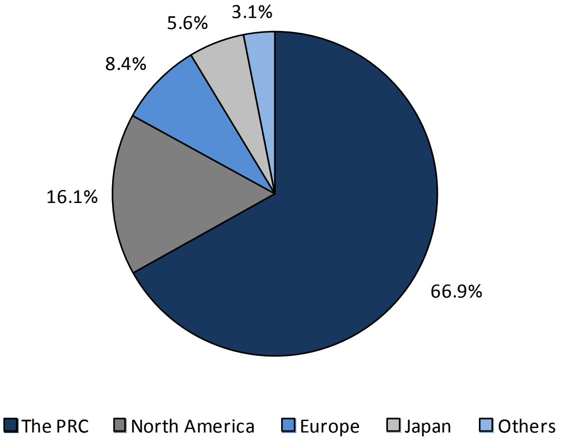
Figure 6. Management profile

Source: Company data

Our views

Diversification minimize risks while maximizing utilization rate. The group is engaged in the provision of precision engineering services. The precision metals parts industry in China is expected to grow at a 4-year CAGR of 12.7% from 2012 to 2016, according to CCID forecasts. It is expected that growth in the downstream products will directly benefit the precision metal parts industry in China. Since precision engineered fine metals parts form critical fundamental components of a wide variety of manufactured products, the numerous applications for precision engineering parts and the variety of end customers mitigate risks associated with the precision engineering services industry. Thus, sales performance in the industry tends to be stable. Furthermore, the group has more than 100 customers in five specialized industry sectors, namely medical and test equipment, finance equipment, consumer electronics, network/data storage and office automation industries, with markets located worldwide, including China, the United States, Singapore, Japan, and certain European countries. Its diversified client portfolio helps counter the potential negative impact of fluctuation in business performance among industries; meanwhile, it would also maximize the utilization of the group's diverse engineering knowledge, skills and production lines which are capable of producing a wide range of products.

Figure 7. Geography breakdown of revenue in FY03/14



Source: Company data

Outstanding among peers in a highly competitive industry. The precision metal processing industry is very competitive. Upstream manufacturers tend to emphasize on research and development of new product features and the cosmetic appearance of products. The increasing number of specialized or customized product models has led to smaller batches of products being delivered. As a result, manufacturers are required to adapt to a high mix of product types, low batch volume and non-standardized products that are not ideal in terms of achieving economies of scale. Therefore, it becomes more challenging to maintain efficiency investing in equipment and the procurement of raw materials. The determinant between competitive precision engineering service providers and average OEM's depends on whether such manufacturers have complete supply chain capabilities to competitively offer high mix – low volume products to customers.

Figure 8. Integrated value chain

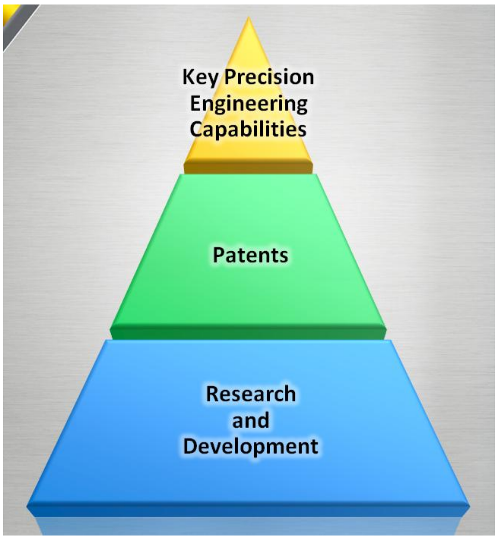
Source: Company data

Traditional OEM passively follows the design and specifications provided by its customer in the manufacture of products, whereas conventional ODM designs as well as manufactures products for sale to its customers. In contrast, the group, as a precision metal engineering solutions provider, assumes a proactive role at the early stages of its customers' product design and development cycles by providing value-adding and innovative design engineering solutions as well as specific advice to them. The products of its key customers are generally regarded as highly complex, precise, technologically advanced and innovative products, of which production processes require strong design capabilities as well as stringent quality control procedures. The value-adding design engineering solutions provided by the group aims to offer its customers the engineering knowledge, skills and techniques at the beginning of their product design cycles. This will help customers identify technical issues and provide them with more cost effective solutions at the initial product design stage, enhance the quality of their products as well as resolve challenges during the production process such as product reliability and production efficiency. The capability of integrating its own design engineering solutions with customers in their early product development process and the wide range of services offered by the group have distinguished the group from traditional OEM and ODM as well as its competitors in China, enabling the group to solidify its working relationships with key customers.

The group has accumulated an extensive engineering knowledge pool through serving customers in various industry sectors over many years. Customers can benefit from the group's expertise across industry sectors in terms of quality improvement, shorter production lead time and cost efficiency. By providing design engineering solutions at an early stage of the customers' product development process, the group can also capture additional potential business opportunities.

Strong R&D. The group has strong R&D capabilities. It owns more than 33 registered patents, including 3 invention patents, 29 utility model patents and 1 design patent. Most of them are able to improve manufacturing processes by increasing process efficiency and productivity as well as reducing cost. Moreover, the group has signed a strategic collaboration agreement with the Hong Kong Polytechnic University in 2011 to collaborate on research and development in the areas of fine metal blanking and stamping, laser cutting and related work flows.

Figure 9. R&D pyramid



Source: Company data

Expanding into Internet of Things (IOT). The group is also developing its own-branded kiosk products. Differing from the conventional kiosk products in the market, the group's kiosk products are equipped with more advanced design and transactional functions to suit a wide variety of customers in the retail, hospitality, leisure, telecom, healthcare, education and transport markets. The varied applications of the kiosk products include guest check-in, electronic way finding, quick-serve ordering, ticket dispensing, bill payment, medical health check, surveillance control, etc. Apart from standard kiosk models, the capabilities of designing and producing custom kiosks with the alignment of technical specifications and application requirements as well as user interfacing bring extra orders to the group. Besides offering purpose-built hardware, the group provides bespoke application software development services. This enables a fully functional kiosk system to its customers. Although the business is still at its start-up phase, the group has already been receiving orders from customers in Hong Kong and South East Asia. The group plans to operate the kiosk devices together with its customers to earn operating fees in addition to selling the kiosk products. The own-branded kiosk business is expected to contribute HKD10.0m to HKD20.0m of revenue in FY03/15E and register a rapid growth going forward. The kiosk products have a higher profit margin than traditional metal stamping products. As a high tech and fast growing product segment, the kiosk business is expected to become a profit driver for the group in the future.

Figure 10. Examples of kiosk products

Source: Company data

New Suzhou Production Base would contain costs and boost earnings. The group acquired a new site in Suzhou with a GFA of 52,000m^2 for the establishment of new production facilities with a GFA of 37,000 m^2. It is expected that once the development of new production facilities in Suzhou is completed, the group would have sufficient production capacity and R&D capabilities to expand further into the high value medical and test equipment market. Furthermore, since the group will terminate its existing production facilities in KPP-Suzhou, which is currently operating on a leased factory premise, substantial rental expenses is expected to be contained, which will boost its operating margin in return. According to the development plan, once machinery in the first phase of the new production facilities is put on stream in early 2015, the group's bending and punching capacities are expected to increase by 2.9m units and 37.3m units, respectively. Phase 2 of the production facilities is expected to commence operation in 2016. The expansion in production capacity does not only cater to the fast expanding demand for the group's products, but also contains production costs through economies of scale. To counter the rising labor costs in China, the new production facilities would be equipped with robotic arms to replace a number of staffs.

Robust growth in medical and test equipment as well as automotive toolings business. Despite a general expectation for slower growth in China's consumption market as compared to the past, the consumption in automobiles is still in its ascending channel and is far from saturation. According to ACMR, China is now the largest passenger vehicle market in the world. The sales volume of passenger vehicles in China grew from 10.3m units in 2009 to 17.9m unit in 2013, representing a CAGR of 14.8%. The increased urbanization and investment in the construction of transportation infrastructure has fuelled demand for automobiles. Low penetration rate at 7.2% in 2013 in China, compared with more mature economies typically ranges from 30.0% to 60.0%, implies a long term significant growth potential for the automobile market in China. Automotive toolings is a new business line of the group in 2014. The group started to ramp up the metal production rapidly in automobiles as orders from this segment are witnessing a substantial increase. The revenue from automotive business in FY03/15E is expected to be HKD40.0m. We also expect a gross margin expansion as metal modules and components in automobiles can be mass-produced as compared to other sectors, it is therefore relatively easy to benefit from cost containment by achieving economies of scale. We expect to see a 15.0% growth in sales value of automotive toolings sector going forward.

Figure 11. Automotive tooling and parts

Source: Company data

Further, we expect the group to register 15.0% growth in revenue from medical and equipment sector and reach approximately HKD260.0m in FY03/15E. Orders flow from China and overseas to the group has been increasing. Some of its top-tier listed corporate customers, such as Agilent Technologies and Thermo Fisher Scientific, are placing more orders for more medical equipments due to strong demand. The demand was driven by enhancement and replacement of medical equipments due to new invention of medical technologies. The group is also planning to expand its medical and equipment business to minimally invasive surgery sector. We view the expansion a good move because of the huge potential surgery equipment market in the globe. Furthermore, the group is planning to cooperate with the hospitals in the PRC to manufacture the medical and surgery equipments. Under the strong medical equipment market demand in China, the group will certainly benefit from favourable market condition given its strong R&D capability and superior craftsmanship.

Benefit from the expansion in the medical equipment sector, consumer electronics sector, financial sector and data storage sector. According to the CCID Report, the size of China's medical equipment market grew from RMB12.7b in 2008 to RMB27.4b in 2011, representing a CAGR of approximately 28.6%. Thanks to the increase in population, health awareness and health related expenses, the medical equipment market has reached approximately RMB27.4 billion in 2011, representing a 31.1% YoY growth. CCID estimates that the size of China's medical equipment market has grown by 30.0% YoY to RMB62.7b in 2014.

China is the world largest consumer electronic products manufacturing base and the second largest consumer electronics products market. In 2011, consumer electronics products manufactured in China increased by 5.1% YoY to 1,669.4m pieces. The size of China's consumer electronics market in 2011 increased by 9.1% YoY to RMB1,506.1b, According to the CCID Report, the size of the consumer electronics market will continue to expand, due to the strong demand for tablet PCs and smart phones. Since China is a production base for the global consumer electronics industry, demand in precision engineered metal parts for products in this segment is expected to grow alongside with the demand for end products. CCID estimates that China's consumer electronics output and output value in 2012 reached 1.79b units and RMB1,652.7b, respectively, representing an annualized growth rate of 7.3%. and 9.7%. CCID estimates that consumer electronics output in China to grow at a CAGR of 7.0% for three years up to 2014. By then, China consumer electronics output shall exceed 2.045b units and total output value shall reach RMB1,918.4b.

Owing to the increase in currency circulation and strong economic growth, demand for finance machines has experienced strong and steady growth in China. Government policies concerning the R&D and upgrading of currency processing equipment has been driving the development of the finance machines market in China. Total sales of the finance machine market in the country increased by 17.8% YoY to RMB23.1b in 2011.

In 2010, the gradual popularization of Metro Banks, Union Pay Standard Card Convenience Service Stations and other personal finance convenience services, has led financial institutions to focus more on the development and implementation of personal finance convenience services such as ATM machines and self-service terminal products. Sales of finance machines manufactured for the purpose of such financial clearing services has reached RMB12.9b in 2011, contributing approximately 55.7% of the total sales of the finance machines market in China. In 2011,the size of China's finance machines market was about RMB23.1b, around half of which was dominated by the top 6 players. CCID expects the demand for financial clearing equipment to remain at a high level from 2012 through to 2014. However, growth in the demand for ATM machines, self-service terminals and related equipment may decline as upgrades for such systems were completed in 2013. Financial clearing equipment sales in China are expected to reach

RMB37.7b by 2014.

According to the CCID Report, total shipment of China disk data storage systems surged by 35.1% YoY to 114,872 TB in 2011, while total sales grew by 21.3% YoY to RMB10.37b. As the information technologies for the financial sector, telecommunications and government organizations have been advancing rapidly, which in return boost up the demand for network and data storage products in the country, China's disk data storage systems market has been booming over the past three years. CCID expects the market to grow further from 2012 to 2014 in view of the strong demand on the country's relatively strong GDP growth.

A good old recovery story. The group's net earnings for FY03/13 plunged by 57.5% YoY to about HKD40.2m, due to expenses related to the IPO, the absence of disposal gain; and end customers optimizing their vendors list which led to a reduction in order flow to the group. In FY03/14, the group's net earnings dropped 12.9% YoY to HKD35.0m, due to the absence of disposal gain. We saw the group's earnings starting to recover from 1H FY03/15 onwards. The group's net earnings increased by 20.4% YoY to HKD30.5m for 1H FY03/15, or approximately 87.1% of its annual earnings for FY03/14 due to the increase in revenue. Driven by the expansion in demand from the office automation, medical and test equipment and finance equipment industries, revenue from the metal stamping segment, which accounted for 75.4% of its total revenue, increased by 20.6% YoY. Furthermore, the automotive toolings business has started contributing to segmental revenue. Meanwhile, a recovery in order flow from one of its major end customer has increased revenue generated from the metal lathing segment, which accounts for 24.6% of total revenue, by 1.6% YoY to HKD138.8m.

Financial Forecasts

Revenue: We forecast the group's revenue to increase from HKD945.8m in FY03/14 to HKD1,589.7m in FY03/17E, representing a 3-year CAGR of 19.0%. The increase in revenue will be mainly driven by the strong demand from medical and test equipment, automotive toolings and finance equipment industries.

Gross Profit Margin: Historically, the group commanded GPM ranging from 22.0% to 24.3%. We expect its GPM to expand from 22.0% FY03/14 to 26.7% FY03/17E, due to the launch of high margin products and automation that will contain labour cost.

Operating costs: Reduction in operating costs in respect to rental expense, as one of the group's production bases will move into the self-owned premises in Suzhou. We expect the group to save 18.3% and 44.7% in rental expenses for FY03/15E and FY03/16E, respectively.

Net profit: The group's net earnings increased by 20.4% YoY to HKD30.5m for 1H FY03/15, or approximately 87.1% of its annual earnings of FY03/14, as a result of an increase in revenue. We expect that the group's net earnings attributable to shareholders for FY03/15E to surge by 42.2% YoY to HKD51.7m as a result of an increase in revenue and, expansion in both gross and operating margin. Recovery in order flow from one of its major customers, strong demand from office automation, medical and test equipment and finance equipment industries, and an increase in contribution from the automotive toolings business will also boost the group's revenue. Owing to the containment of the group's production and operating costs mentioned previously, we expect the group's gross margin and operating margin to expand by 2.4bpts and 2.1bpts, respectively, to 24.4% and 6.7%. Going forward, we expect the group's net earnings to increase at a 3-year CAGR of 61.6%, to HKD147.6m for FY03/17E due to the increase in revenue, margin expansion and a reduction in operating costs arising from rental expenses.

Dividend policy: The dividend payout ratio in FY03/14 was 54.4%. We conservatively assume in our model that the group will maintain a dividend payout ratio of 30% in the 3-year forecast.

Valuation

Based on the average value derived from our 2-stage valuation model, DCF approach and price-multiple method, we put the target price for the group's share at HKD1.63, representing a prospective P/E of 19.0x and 10.3x for FY03/15E and FY03/16E respectively. With potential upside of 37.0%, we initiate the group with a BUY rating.

DCF approach: Using a risk free rate of 1.7%, market risk premium of 10.7%, beta of 0.6 and a 1.0% terminal growth rate after FY03/24E, we derived a fair value of equity of HKD1.69 per share, which is equivalent to a prospective P/E of 19.7x for FY03/15E, representing an upside potential of 42.0%.

Figure 12. DCF valuation

	FY03/15E	FY03/16E	FY03/17E	FY03/18E	FY03/19E	FY03/20E	FY03/21E	FY03/22E	FY03/23E	FY03/24E
WACC@6.5%										
FCFF (HKD m)	(104.7)	43.7	118.0	111.2	104.4	97.7	91.0	84.5	78.0	71.5
Discount Factor	0.9	0.9	0.8	0.8	0.7	0.7	0.6	0.6	0.6	0.5
Discounted FCFF (HKD m)	(98.3)	38.5	97.7	86.4	76.1	66.9	58.5	51.0	44.2	38.0
PV of estimated FCFF (HKD m)	459.0									
PV of terminal FCFF (HKD m)	576.9									
Value of Firm (HKD m)	**1,035.9**									
Minus: debt (HKD m)	150.6									
Plus: cash and cash equivalent (HKD m)	128.8									
Value of Equity (HKD m)	**1,014.1**									
No. of share (m)	600.0									
Intrinsic value of share (HKD)	**1.69**									

Source: SBI China Capital

At HKD1.19, the group is trading at a P/E of 13.8x of the projected FY03/15E EPS, or a FY03/15E PE/G of 0.23x. The group is undervalued given our projected three-year net earning CAGR of 61.6% and its high earnings visibility. Based on the FY03/15E PEG of 0.29, we arrive our target price at HKD1.57, representing an upside potential of 31.9%.

Figure 13. Peer comparison

Company	Ticker	Mkt Cap (HK$ m)	3M avg turnover (HK$ m)	2013 P/E (x)	2014E P/E (x)	2015E P/E (x)	P/book (x)	ROIC (%)	ROE (%)	ROA (%)	Dvd Yield (%)	Net Debt/Total Equity
KFM Kingdom	**3816 HK**	**708.0**	**3.8**	**19.5**	**n.a.**	**n.a.**	**1.4**	**6.1**	**7.2**	**4.2**	**0.4**	**6.4**
Kingboard Chemical	148 HK	13,661.0	15.8	4.0	5.8	5.6	0.4	3.1	10.3	4.9	3.0	44.4
Sun East Technology	365 HK	330.8	0.5	23.2	n.a.	n.a.	1.0	1.6	4.3	1.9	0.0	(8.3)
Ka Shui International	822 HK	992.1	3.4	16.4	n.a.	n.a.	1.4	n.a.	(2.8)	(1.3)	6.6	19.9
EVA Precision Industrial	838 HK	3,210.6	10.2	21.0	13.4	10.3	1.4	4.1	7.1	3.5	1.4	17.7
Elec & Eltek international	1151 HK	1,813.1	0.4	39.7	n.a.	n.a.	0.7	1.7	3.1	1.8	n.a.	17.1
TK Group	2283 HK	1,430.0	8.3	7.9	9.5	7.3	2.6	22.6	37.5	12.7	n.a.	(44.1)
Yorkey Optical International	2788 HK	720.2	0.2	12.2	n.a.	n.a.	0.6	4.8	5.1	4.5	6.9	(79.9)
	Average	3,165.4	5.5	17.8	9.6	7.7	1.2	6.3	9.2	4.0	3.6	(4.7)

Source: Bloomberg

**KFM Kingdom is not included in the average figures.*

Figure 14. Per share items

	FY03/13	FY03/14	FY03/15E	FY03/16E	FY03/17E
EPS (HK cents)					
- Basic (HK cents)	7.7	6.1	8.6	15.9	24.4
- Diluted (HK cents)	7.7	6.1	8.6	15.9	24.4
DPS (HKD cents)	14.2	3.3	2.6	4.8	7.3
BVPS (HKD)	0.8	0.9	1.0	1.1	1.4

Source: Company data

Figure 15. Ratio analysis

	FY03/13	FY03/14	FY03/15E	FY03/16E	FY03/17E
Growth (YoY)					
Revenue	-11.0%	11.7%	16.5%	20.0%	20.0%
Profit before tax	-58.0%	-23.9%	74.6%	81.8%	52.9%
Net profit	-57.5%	-12.8%	51.6%	81.8%	52.9%
Margins					
EBIT margin	6.5%	6.5%	4.6%	6.7%	9.7%
Net profit margin	4.7%	4.7%	3.7%	4.8%	7.3%
Other ratios					
Return on average assets	5.0%	4.1%	5.9%	9.4%	12.4%
Return on average equity	8.5%	6.9%	9.7%	15.3%	19.7%
Dividend payout ratio	212.2%	54.5%	30.0%	30.0%	30.0%
Valuation measures					
P/E (x)	17.8	19.6	13.8	7.5	4.9
P/B (x)	1.4	1.4	1.2	1.1	0.9
Dividend yield	12%	2.8%	2.2%	4.0%	6.1%

Source: Company data

Figure 16. Income statement (HKD m)

	FY03/13	FY03/14	FY03/15E	FY03/16E	FY03/17E
Revenue	**846.5**	**945.8**	**1,101.9**	**1,322.2**	**1,586.7**
COGS	(641.2)	(737.9)	(832.6)	(981.9)	(1,163.7)
Gross profit	**205.3**	**207.9**	**269.3**	**340.3**	**423.0**
Other gains, net	7.8	0.1	0.0	0.0	0.0
Distribution and selling expenses	(17.6)	(22.4)	(41.5)	(44.8)	(53.8)
General and administrative expenses	(140.1)	(142.1)	(153.8)	(166.5)	(175.8)
Operating profit	**55.3**	**43.5**	**73.9**	**128.9**	**193.4**
Finance income	0.3	0.7	0.1	0.2	0.3
Finance costs	(6.3)	(6.7)	(8.5)	(9.9)	(11.4)
Profit before income tax	**49.3**	**37.5**	**65.5**	**119.2**	**182.3**
Income tax expenses	(9.1)	(2.5)	(12.5)	(22.6)	(34.6)
Profit for the year	**40.2**	**35.0**	**53.1**	**96.5**	**147.6**
Currency translation differences	4.4	0.4	0.0	0.0	0.0
Non-controlling interests	0.0	1.4	(1.4)	(1.4)	(1.4)
Profit for the year attributable to equity holders of company	**40.2**	**36.4**	**51.7**	**95.2**	**146.3**
Dividend	**85.2**	**19.8**	**15.5**	**28.5**	**43.9**

Source: Company data

Figure 17. Balance sheet (HKD m)

	FY03/13	FY03/14	FY03/15E	FY03/16E	FY03/17E
Non-current assets					
Property, plant and equipment	224.1	300.8	419.4	445.0	441.1
Leasehold land and land use right	0.0	26.0	25.6	25.1	24.7
Intangible assets	11.3	11.8	12.8	14.8	18.1
Goodwill	24.5	24.5	24.5	24.5	24.5
Deferred income tax assets	5.6	4.8	4.8	4.8	4.8
Total non-current assets	**265.5**	**367.9**	**487.1**	**514.3**	**513.3**
Current assets					
Inventories	110.5	138.9	170.5	204.6	245.5
Trade and other receivables	229.2	199.6	249.8	299.7	359.7
Current income tax recoverable	0.0	3.9	3.9	3.9	3.9
Derivatives financial asset	0.3	0.0	0.0	0.0	0.0
Available-for-sale financial assets	0.0	12.5	0.0	0.0	0.0
Restricted bank deposit	46.8	23.4	0.0	0.0	0.0
Cash and cash equivalents	218.7	105.4	47.3	75.6	163.6
Total current assets	**605.5**	**483.7**	**471.4**	**583.7**	**772.7**
Total assets	**871.0**	**851.6**	**958.5**	**1,098.1**	**1,286.0**
Current liabilities					
Trade and other payables	144.3	169.9	191.7	226.1	267.9
Bank borrowings	211.0	150.6	170.0	180.0	190.0
Current income tax liabilities	7.5	5.1	0.0	0.0	0.0
Total current liabilities	**362.8**	**325.6**	**361.7**	**406.1**	**457.9**
Non-current liabilities					
Deferred income tax liabilities	14.7	10.8	12.4	12.4	12.4
Total liabilities	**377.5**	**336.4**	**374.1**	**418.5**	**470.3**
Capital and reserves					
Share capital	60.0	60.0	60.0	60.0	60.0
Share premium	26.1	26.1	26.1	26.1	26.1
Reserves	407.4	424.3	503.1	598.2	734.3
-proposed dividends					
-others					
Total	**493.5**	**510.5**	**589.2**	**684.4**	**820.4**
Minority interest	0.0	(4.7)	(4.7)	(4.7)	(4.7)
Equity attributable to shareholder	**493.5**	**515.2**	**584.4**	**679.6**	**815.7**

Source: Company data

Figure 18. Cash flow statement (HKD m)

	FY03/13	FY03/14	FY03/15E	FY03/16E	FY03/17E
Operating activities					
Pre-tax profit	49.3	37.5	65.5	119.2	182.3
Depreciation of fixed assets	29.8	34.7	41.4	44.4	43.9
Amortisation of leashold land and land use right	0.0	0.4	0.4	0.4	0.4
Amortisation of intangible assets	3.8	4.2	4.2	4.2	4.2
Loss/gain on derivative financial instrument	(0.1)	0.3	0.0	0.0	0.0
Gain on disposal of property, plant and equipment	(10.3)	(1.9)	0.0	0.0	0.0
Finance income	(0.3)	(0.7)	(0.1)	(0.2)	(0.3)
Finance costs	6.3	6.7	8.5	9.9	11.4
Operating profit before change in working capital	**78.5**	**81.3**	**120.0**	**178.0**	**242.0**
Change in inventory	(5.9)	(29.3)	(23.9)	(26.3)	(31.5)
Change in receivables	(19.7)	31.6	(50.2)	(50.0)	(59.9)
Change in payable	16.1	26.4	21.8	34.4	41.8
Change in working capital	**(9.5)**	**28.7**	**(52.4)**	**(41.8)**	**(49.6)**
Operating cash flow	**69.0**	**110.0**	**67.6**	**136.2**	**192.4**
Income tax paid	(12.5)	(12.2)	(12.5)	(22.6)	(34.6)
Income tax refunded	1.3	0.3	0.0	0.0	0.0
Interest received	0.3	0.7	0.1	0.2	0.3
Net cash generated from operating activities	**58.0**	**98.9**	**55.3**	**113.7**	**158.0**
Investing activities					
Proceeds from sale of property, plant and equipment	37.9	4.4	0.0	0.0	0.0
Purchase of property plant and equipment	(97.6)	(113.8)	(160.0)	(70.0)	(40.0)
Acquisition of leasehold land and land use right	0.0	(26.9)	0.0	0.0	0.0
Acquisition of available-for-sale financial assets	0.0	(199.4)	0.0	0.0	0.0
Proceeds from disposal of available-for-sale financial assets	0.0	186.9	12.5	0.0	0.0
Acquisition of business	(26.0)	0.0	0.0	0.0	0.0
Net cash used in investing activities	**(85.7)**	**(148.8)**	**(147.5)**	**(70.0)**	**(40.0)**
Financing activities					
Proceeds from issue of shares	102.0	0.0	0.0	0.0	0.0
Share issue expenses	(16.0)	0.0	0.0	0.0	0.0
Proceeds from bank borrowings	185.0	38.0	170.0	180.0	190.0
Repayment of bank borrowings	(86.8)	(97.4)	(150.6)	(170.0)	(180.0)
Decrease in restricted bank deposits	0.0	23.4	23.4	0.0	0.0
Capital injection by non-controlling interests	0.0	0.2	0.0	0.0	0.0
Receipt of amounts due from shareholders	20.0	0.0	0.0	0.0	0.0
Interest paid	(6.3)	(7.0)	(8.5)	(9.9)	(11.4)
Dividends paid	0.0	(85.2)	(19.8)	(15.5)	(28.5)
Net cash (used in)/generated from financing activities	**197.9**	**(128.0)**	**14.5**	**(15.4)**	**(29.9)**
(Decrease)/increase in cash and cash equivalents	170.2	(178.0)	(77.7)	28.3	88.1
Cash opening balance	132.0	302.7	125.0	47.3	75.6
Currency translation differences	0.5	0.2	0.0	0.0	0.0
Cash closing balance	**302.7**	**125.0**	**47.3**	**75.6**	**163.6**

Source: Company data

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