

## Tongda Group

### Margin expansion may continue

to summarize...

- Net profit reached HK\$300m for 2012A, 4% higher than our estimation.
- Templeton became strategic investor with 6.3% stake Dec last year
- Handset growth remained strong for Chinese vendors as a whole in 2012A
- Rapid structural shift towards smartphone might pressure on volume
- Potential margin expansion on strong demand, lowered cost and product mix
- Raised TP to HK\$0.633 on adjusted forecast. Reiterate BUY

**Net profit reached HK\$300m for 2012A, 4% higher than our estimation.** Tongda announced 2012A annual results yesterday night. Total turnover increased 8.3% YoY to HK\$3,408m, which was 7% lower than our estimates. While handset segment increased 9.6% YoY to HK\$1,556m, it was 13.6% lower than our expectation. It was partly due to slightly slower than expected orders from major clients such as Huawei, in our view. Electrical appliances and notebook computer income were largely in line with our projections. What surprised us most was relatively substantial increase in ironware parts income as well as margin classified as others. From management point of view, it was partly due to squeezed electrical appliances market in 2012. Overall, with improved profit margin, gross profit and net profit came in at HK\$731m and HK\$300m respectively for the year. Table 1 shows 2012A key profit loss items and deviations from our estimates.

**Table 1. Major forecast changes for 2012F and 2013F**

HK\$m	2011A	2012A	YoY	Our est.	Deviation
Total turnover	3,147.1	3,408.1	8.3%	3,663.8	-7.0%
Handset	1,420.3	1,556.1	9.6%	1,800.0	-13.6%
Electrical appliances	784.0	702.3	-10.4%	700.0	0.3%
Notebook computer	449.2	555.0	23.6%	550.3	0.9%
Light guide plate	n.a.	n.a.	n.a.	120.0	n.a.
Others	493.6	594.7	20.5%	493.6	20.5%
Gross profit	605.3	730.6	20.7%	707.6	3.3%
Net profit	250.3	300.0	19.9%	288.4	4.0%

Source: SBI E2-Capital

**Templeton became strategic investor with 6.3% stake Dec last year.** Templeton Strategic Emerging markets Funds acquired a block of 300m shares at HK\$0.310 per share last Dec, which represented 6.3% shares of the company. At the same time, Chairman Wang Yanan has an additional derivative interest of 300m shares with effective period from Dec 2015 to Jan 2016, which is a put option granted to Templeton embedding a return for the fund. While there is a put option, we still believe the fund gave the company and the industry a vote of confidence. Table 2 shows shareholder structure of Tongda by latest applicable date.

**Table 2. Templeton became a strategic shareholder of Tongda in Dec 2012**

	% without exercising options	% upon exercising put option
Chairman Wang Yanan	51.3%	57.6%
Templeton Asset Mgmt	6.3%	0.0%
Public and others	42.4%	42.4%
Total	100.0%	100.0%

Source: SBI E2-Capital

Ticker	0698 HK
Rating	BUY
Price (HK\$)	0.550
Target Price (HK\$)	0.633 (+15.1%)
12m Price Range (HK\$)	0.250 - 0.620
Market cap. (US\$m)	335.9
Daily t/o (US\$m)	1.5
Free float (%)	43.3

#### Financial summary

Year to Dec	11A	12A	13F	14F	15F
Turnover (HK\$m)	3,147	3,408	4,441	6,152	7,285
Net Profit (HK\$m)	250	300	402	578	739
EPS (HK\$)	0.053	0.064	0.084	0.121	0.155
P/E (x)	10.8	9.0	6.8	4.7	3.7
P/B (x)	1.46	1.29	1.13	0.96	0.80
EV/EBITDA (x)	6.0	5.2	4.0	3.1	2.4
Yield (%)	3.0	3.5	4.4	6.4	8.2
ROE (%)	14.0	14.6	17.0	20.7	22.0
ROCE (%)	15.1	15.6	18.3	21.5	23.5
N. Gear. (%)	17.5	15.9	15.0	19.4	10.9

Source: SBI E2-Capital

	13F	14F	15F
Consensus EPS (HK\$)	0.081	0.098	n.a.
Previous earnings (HK\$m)	360.7	509.1	n.a.
Previous EPS (HK\$)	0.076	0.107	n.a.

#### Price performance

Year to Dec	1m	3m	12m
Relative to HSI (%)	12.2	64.7	55.6
Actual price changes (%)	7.8	64.2	64.2



Source: Bloomberg

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**Handset growth remained strong for Chinese vendors as a whole in 2012A...** For 2012A, global handset sales (sell-in) growth slowed to 2.1% YoY increment to 1,590m units, compared to a growth rate of 14.5% in 2011A. As for Chinese vendors, a double-digit growth rate was maintained at 16.5%. It was slower than 2011A pace partly on Huawei's sales decline. Huawei aggressively focused on smartphone market in 2012A and released higher-priced models. At the lower-end, it appeared to be losing market share to local competitors such as Lenovo, Coolpad and ZTE. TCL and Lenovo recorded substantial increase in sales volume especially in 2H 2012A. For Tongda, as it provided IML plastic casings to major Chinese vendors, an overall volume growth for Chinese vendors was still encouraging.

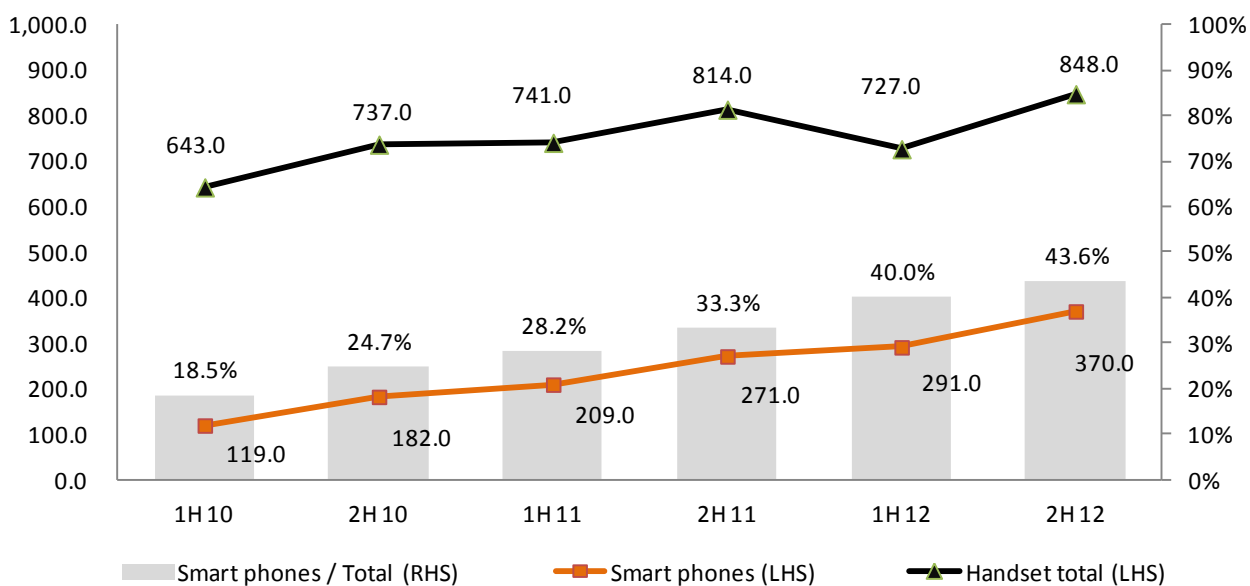
**... yet rapid structural shift towards smartphone might pressure on volume.** For 2013F onwards, companies such as Huawei and ZTE target a higher proportion of smartphone sales. For instance, ZTE plans to achieve 100m smartphone sales in 2015F. For 2013F alone, ZTE management targets to achieve 50m smartphone sales out 70m-80m total handset sales. That said, while target proportion of smartphone sales is targeted at 60%-70% for the year, further up from ~50% in Q4 2012, total shipment for ZTE in 2013F may be flat compared to 2012F between 70m-80m, in our view. We believe Tongda have to secure contracts from various domestic clients in order to maintain considerable volume growth. Tongda management expects noticeable increase in ASP and profit margin together with certain volume growth for handset segment in short-term.

**Table 3. Handset shipments of global top vendors (sell-in)**

Million units	1H 10	2H 10	1H 11	2H 11	1H 12	2H 12
ZTE	17.9	18.2	34.8	38.9	38.6	38.4
Huawei	12.8	14.6	21.0	30.5	21.3	23.6
TCL (Alcatel mobile phones)	10.5	21.5	16.6	17.5	18.6	23.9
Lenovo	n.a.	n.a.	1.7	2.0	9.1	16.4
<b>Chinese vendors total</b>	<b>41.2</b>	<b>54.3</b>	<b>74.1</b>	<b>88.9</b>	<b>87.6</b>	<b>102.3</b>
Samsung	128.1	152.1	144.0	178.5	188.0	209.1
Apple iPhone	17.2	30.3	39.0	54.1	61.1	74.7
Sub-total	145.3	182.4	183.0	232.6	249.1	283.8
Nokia	218.9	234.1	197.0	220.0	166.4	169.2
LG	57.7	59.0	49.3	41.1	26.8	29.8
SonyEricsson	21.5	21.6	15.7	18.5	14.7	17.5
Blackberry	21.7	26.3	28.1	25.9	18.9	14.3
HTC	8.7	15.9	21.8	23.3	15.0	13.2
Motorola	16.8	20.4	19.6	23.2	16.9	12.6
Others	92.5	122.1	153.1	141.8	145.6	206.0
Sub-total	437.8	499.4	484.6	493.8	404.3	462.6
<b>Total</b>	<b>624.3</b>	<b>736.1</b>	<b>741.7</b>	<b>815.3</b>	<b>741.0</b>	<b>848.7</b>

Source: SBI E2-Capital, ABI Research

**Illustration 1. Smartphones sales as percentage of overall handset sales (m units)**



Source: ABI Research

**Potential margin expansion on strong demand, lowered cost and product mix.** Table 4 shows our revised sales forecast while Table 5 shows revised gross profit breakdown. On overall basis, management also expects to see noticeable margin improvement in at least short-term with 1) strong 3Cs demand that enables Tongda to exercise certain selections of higher margin orders; 2) weaker yen that lower costs of Japanese components input that made up considerable COGS; 3) a shift towards smartphone with slightly higher profit margin. We adjust our sales forecast slightly upwards with and considerably raise gross margin projections. Gross profit would be HK\$968m in 2013F and HK\$1,367m in 2014F, up from HK\$731m in 2012A as gross margin widened to 21.8% in 2013F and 22.2% in 2014F respectively. Under our assumption, handset and notebook segments are to realize 25% gross margin, while electrical appliances segment is to pick up in 2013F and gross margin to stay between 20%-22.5% in next 1-3 years.

**Table 4. Revised sales forecast**

HK\$m	FY12/11A	FY12/12A	FY12/13F	FY12/14F	FY12/15F
Total turnover	3,147	3,408	4,441	6,152	7,285
Electrical fittings revenue	2,654	2,813	3,846	5,557	6,690
Handset	1,420	1,556	2,113	3,250	3,900
Electrical appliances	784	702	800	960	1,128
Notebook computers	449	555	694	867	1,062
Light guide plate	n.a.	n.a.	240	480	600
Ironware parts	377	492	492	492	492
Communication facilities and others	117	103	103	103	103

**Table 5. Revised gross profit breakdown**

HK\$m	FY12/11A	FY12/12A	FY12/13F	FY12/14F	FY12/15F
Handset	305	381	528	813	975
Electrical appliances	149	141	180	192	226
Notebook computers	108	133	173	217	266
Light guide plate	n.a.	0	36	96	150
Others	43	75	50	50	50
<u>Gross margin estimation</u>					
Handset	21.5%	24.5%	25.0%	25.0%	25.0%
Electrical appliances	19.0%	20.1%	22.5%	20.0%	20.0%
Notebook computers	24.0%	24.0%	25.0%	25.0%	25.0%
Light guide plate	n.a.	7.5%	15.0%	20.0%	25.0%

Source: SBI E2-Capital

**Remain BUY on solid technical background in growing electronic market in China; TP raised to HK\$0.633 on margin adjustment.**

Tongda is to further gain competitive advantage in growing handset and notebook market. In 2013F, Tongda is to focus on laser direct structuring (LDS), which could be essential in 4G ra. According to the management, LDS is a fast developing technology originated in German and largely applied by Korean brand names. We believe Tongda to continue leveraging from its strong technical background in the fast growing electronic market in China. As for further capacity expansion, Tongda is yet to receive a specific land piece in Xiamen. We value Tongda with discounted cash flow model at 17.5% discount rate and the new target price is HK\$0.633 per share, which represents 7.5x and 5.2x FY12/13F and FY12/14F P/E based on HK\$394.6m and HK\$587.5m net profit for the respective years. Table 6 and Table 7 on the next page show profit and loss forecast as well as balance sheet items respectively.

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

HK\$m	FY12/11A	FY12/12A	FY12/13F	FY12/14F	FY12/15F
Revenue	3,147.1	3,408.1	4,441.0	6,065.8	7,085.2
Cost of goods sold	(2,541.8)	(2,677.4)	(3,493.4)	(4,716.6)	(5,461.1)
Gross profit	605.3	730.6	947.6	1,349.2	1,624.1
Operating expenses	(217.3)	(284.3)	(362.0)	(494.5)	(577.6)
Operating profit	388.1	446.4	585.5	854.7	1,046.5
Share of profit of an associate and JV	2.1	3.5	0.0	0.0	0.0
Finance costs	(53.3)	(49.0)	(51.2)	(56.5)	(41.0)
Profit before tax	336.9	400.9	534.3	798.3	1,005.5
Income tax expense	(77.4)	(67.4)	(93.5)	(139.7)	(176.0)
Total profit	259.5	333.5	440.8	658.6	829.6
Net profit	250.3	300.0	394.6	587.5	744.3
Reported EPS (HK\$)	0.053	0.064	0.083	0.123	0.156

**Table 7. Balance sheet items**

HK\$m	FY12/11A	FY12/12A	FY12/13F	FY12/14F	FY12/15F
Non-current assets	1,327.2	1,478.1	1,527.8	1,682.3	1,675.5
Property, plant and equipment	1,077.6	1,229.7	1,282.2	1,439.6	1,436.1
Investment property	51.0	52.0	52.0	52.0	52.0
Prepayments	59.1	62.9	61.2	59.2	57.1
Investment in associates	47.0	40.9	40.9	40.9	40.9
Other assets	92.5	92.6	91.7	90.6	89.5
Current assets	2,411.5	2,725.1	3,240.0	3,923.4	4,667.4
Inventories	672.9	802.0	1,016.5	1,374.1	1,618.3
Trade and bills receivables	1,303.9	1,455.8	1,707.6	2,031.6	2,433.1
Pledged deposits	57.4	92.4	92.4	92.4	92.4
Cash and cash equivalents	253.8	219.9	231.0	195.6	241.9
Other current assets	123.5	154.9	192.5	229.7	281.7
Non-current liabilities	278.4	145.1	336.3	376.3	296.3
Interest-bearing bank borrowings	236.9	88.8	280.0	320.0	240.0
Other non-current liabilities	41.5	56.3	56.3	56.3	56.3
Current liabilities	1,545.1	1,866.0	1,903.1	2,184.0	2,366.7
Trade and bills payables	857.2	1,014.4	1,186.9	1,397.5	1,669.7
Accrued liabilities and other payables	122.8	115.2	124.1	134.4	164.9
Tax payable	162.3	172.0	172.0	172.0	172.0
Interest borrowings	402.6	564.3	420.0	480.0	360.0
Other current liabilities	0.1	0.1	0.1	0.1	0.1
Total equity	1,915.1	2,192.0	2,528.3	3,045.4	3,679.9
MI	56.9	90.8	137.0	208.1	293.4

Source: SBI E2-Capital

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