Corporate Snippet

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Still more work to do — China PCs

Lenovo (992 HK, HK$3.23) — SELL (unchanged)

Target price: HK$2.11 (-34.7%)

Higher than expected net profit. 3Q FY3/07 net profit of US$57.7m (+23% YoY) is better than the market expectation of US$51.8m, boosted by the lower effective tax rate, as 3Q pre-tax profit was flat YoY.

Gross margins widen marginally. 3Q FY3/07 GP margins improved only marginally to 13.5% from 2Q FY3/07's 13%.

Operating margin shrinks further. Lenovo's share of the China market increased to 36.2% from 35.5% in 2Q FY3/07 but the operating margin narrowed to 5.1% from 5.7% in 2Q07 and 6.8% in 1Q07 due to strong competition.

Gradual improvement in other markets. Losses narrowed for American markets on QoQ basis, however the shipment volume remained weak. The higher revenue for EMEA has led to a strong profit recovery in this segment. The performance of the Asia-Pacific market remains relatively lackluster.

Table 1: Summary of 3QFY07 results

Year to Mar (US$m)	3Q07	3Q06	YoY%
Revenue	3,998	3,983	*0.4*
GP	542	525	*3.2*
Pre-tax profit before restructuring cost	66	64	*.3.5*
Restructuring cost	2	0	*n.m.*
Pre-tax profit	64	64	*-0.1-*
Net profit	58	*47*	*23.3*
Margins			
GP (%)	*13.5*	*13.2*	
Pre-tax (%)	*1.6*	*1.6*	
Net (%)	*1.5*	*1.2*	

Source: Company data

Concern over margin pressure in the China market. We are concerned that Lenovo's market share gain in China could be at the expense of margins. The sharp decline in its operating margin from 6.8% in 1Q FY3/07 to 5.1% in 3Q FY3/07 indicates that its pricing environment is weak.

Maintain SELL. We keep our earning forecasts unchanged at HK$952m for FY3/07F and HK$1.2bn for FY3/08F. Valuation at fully diluted 35x FY3/07 and 28x FY3/08 P/E remains excessive in view of its continuing margin pressure in the China market and the slow recovery in other markets. Maintain SELL with a target price of HK$2.11, based on 18x FY08 P/E, which international PC vendors trade on average.