Small Cap Charm

Thesis and Ideas for 3Q 12

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BUY	**:** absolute upside of >10% over the next six months
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Our research portfolio in 2Q

Company	Ticker						
Core coverage		Target (HK$)	Latest update	Initiation	Abs. QoQ price return (%)	MSCI QoQ return (%)	Abs. up-to-date price return (%)
Comtec Solar	0712 HK	1.44	4 Sep 2012	08 Jun 2010	-28.0%	1.5%	-53.5%
Leoch International	0842 HK	1.15	31 Aug 2012	19 Jul 2011	-38.6%	1.5%	-42.2%
Tongda Group	0698 HK	0.561	20 Aug 2012	29 Feb 2012	7.7%	1.5%	-1.8%
Watch list							
IRC	1029 HK	-	-	-	-31.9%		-
Hanking	3788 HK	-	-	-	-1.0%		-
Sino Oil and Gas	0702 HK	-	-	-	-11.1%		-
Sinoref Holdings	1020 HK	-	-	-	-9.5%		-
China Fiber Optic	3777 HK	-	-	-	0.0%		-
Tao Heung	573 HK	-	-	-	9.2%		-
Tianyi Fruit	756 HK	-	-	-	1.7%		-
Tenfu Holding	6868 HK	-	-	-	-12.1%		-
OTO Holdings	6880 HK	-	-	-	38.1%		-
China Liansu	2128 HK	-	-	-	-1.9%		-

*Note: * QoQ return calculated based on closing price on 25 May and 3 Sep, non-annualized   ** MSCI Hong Kong Small Cap Index*

Updated portfolio in 3Q

Company	Ticker	Target (HK$)	Latest update	Initiation	Analyst
Core coverage					
Comtec Solar	0712 HK	1.44	04 Sep 2012	08 Jun 2010	Kevin Mak
Tongda Group	0698 HK	0.561	20 Aug 2012	29 Feb 2012	Kevin Mak
Chu Kong Pipe	1938 HK	3.78	04 Sep 2012	04 Sep 2012	Isaac Lau
Watch list					
Leoch International	0842 HK	-	-	-	Kevin Mak
China Fiber Optic	3777 HK	-	-	-	Kevin Mak
IRC	1029 HK	-	-	-	Isaac Lau
Sino Oil and Gas	0702 HK	-	-	-	Isaac Lau
Shengli	1080 HK	-	-	-	Isaac Lau

Note: Our watch list largely reduces in size due to internal changes

Core Coverage

Comtec Solar (0712 HK) (click here…)

Stock statistics	Market cap: US$100.3m (closing price: HK$0.69); daily turnover: US$0.11m
Summary / review	• Comtec Solar is a pure-play monocrystalline solar ingot and wafer manufacturer based in China. In 1H 2012, 74.4% turnover was from n-type wafers sales to SunPower (SPWR US) fabrication facilities in Philippines. According to feedback from customer, highest efficiency achieved reached 24%. The company expects to raise n-type sales to another customer, Sanyo (6764 JP), possibly later this year or next year. • The company recorded RMB456.2m revenue for 1H FY12/12A, with RMB218.5m in Q1 and RMB237.7m in Q2. For the latest interim, gross margin was 12.5%. While there was loss on CB redemption, loss on new warrants, warrants cancellation and other one-off items, unadjusted and adjusted net profit for the period was –RMB121.1m and RMB44.9m. We attribute the higher-than-peers margin to sales of n-type wafers.
Drivers / catalysts	• Comtec has been outperforming its peers in latest quarters, and its outlook of 2H is generally neutral-to-positive, maintaining our view that it is bottoming-out in mid of the year. With potentially stable gross margin of 10% to 15% in 2H due to general price stability of polysilicon, there is potential for improvement in volume from 100-120MW wafer sales in 1Hto 200MW+ with 66%+ utilization in 2H. • Comtec had heavy reliance on SunPower in 1H due to n-type wader sales which presents moderate counterparty risk. Nevertheless, for the latest 6-month interim by non-GAAP standard, revenue was US$1,231m with US$26.0m operating income. By end of Jun, their net debt-to-equity ratio was still at satisfactory level of 39.5%. That said, as a major client of Comtec, we believe SunPower is to keep itself floating with certain profit and moderate financial health during this late stage of industry consolidation.
Our opinions	• Despite profitability and sustainability of Comtec, solar industry consolidation due to decrease in ASP is complicated with trade wars among major countries. While we continue to believe that at least Comtec is bottoming out in mid of the year, the prolonged consolidation does not provide quick recovery and slightly revise down our estimation from 2013F onwards. • The counter is currently trading at 0.40x P/B based on RMB1,572m net equity FY12/12F. We revise our Target Price to HK$1.44 from HK$2.02, representing 14.9x and 8.4x P/E for FY12/12F and FY12/13F.

Tongda Group (0698 HK) (click here…)

Stock statistics	Market cap: US$167.9m (closing price: HK$0.275); daily turnover: US$0.10m
Summary / review	• TDG is the world largest manufacturer for in-mould lamination (IML) plastic casings with patented technology. Its products are applied in consumer electronics such as handset, notebook and electrical appliances. Major customers include fast-growing domestic brands such as ZTE (0763 HK), Huawei, Lenovo (0992 HK), Haier (1169 HK) and Midea (000527 CH). • Different from in-mould decoration (IMD) technology, which simply prints designs onto a certain surface, IML covers the patterns with a protective layer so that the finished product is much more scratch proof. Although IMD has currently larger market share and it is within 10% cheaper than IML-made products, IML is observed to be increasingly adopted.
Drivers / catalysts	• Tongda turnover was up 9.2% YoY to HK$1,398m for 1H FY12/12A. Of HK$118m increment, handset continued to be the major contributor which offset weakness in electrical appliances segment. At the same time, gross profit increased 29.6% YoY to HK$309m, representing an gross margin of 22.1%. Net profit was HK$113m for the period, up 11% YoY from a year ago partly due to HK$16.1m MI. • While handset and notebook computers sales assumption largely remain the same at HK$5,000m and HK$3,250m, we lower our sales forecast of electrical appliances to HK$784m for 2012F from HK$941m. As such, our revised total revenue forecast will be HK$3,916m and HK$5,493m for FY12/12F and FY12/13F. Due to robust demand at least in handset and notebook computer segments, gross profit was lowered slightly to HK$732m this year from HK$751m.
Our opinions	• In the past four years, Tongda recorded increase in top-line as well as profit margin despite global economic headwind. With strong sales growth of its major domestic customers, we expect Tongda to capture net earnings of HK$300m+ for 2012F and achieve bottom-line growth of 20% in short-term. • We value Tongda with discounted cash flow model at 17.5% discount rate and the new target price is HK$0.561 per share, which represents 8.8x and 6.1x FY12/12F and FY12/13F P/E based on HK$300.2m and HK$431.2m net profit for the respective years

Chu Kong Pipe (1938 HK) [(click here…)]

Stock statistics	Market cap: US$347.4m (closing price: HK$2.68); daily turnover: US$0.74m
Summary / review	• Chu Kong Pipe is the leading LSAW steel pipe producer, and one of the four approved LSAW suppliers for national pipeline projects with maximum capacity of 1.3mtpa. • Chu Kong Pipe is the industry pioneer. It is the first LSAW producer, first to introduce UOE method for LSAW pipes, first developed deep sea LSAW steel pipes with 1,500m depth and first Chinese brand recognized by Shell in China. • Different from its Chinese competitors, CKPNG's customers' base is globally diversified with over 600 customers in over 50 regions. Overseas sales accounted for 63%, 39% and 52% of total sales from 09A to 11A orderly. • Company's products are more defensive and less sensitive to the national pipeline project down cycle. . Other appliances of LSAW pipes are 1) transmission pipe for deep-sea project, 2) construction/ infrastructure 3) city gas networks, etc.
Drivers / catalysts	• Three key grow drivers, 1) commencing next up-cycle for national pipe sector 2) accelerating offshore development 3) emerging demand from power tower. • Cku Kong's LSAW production capacity will increase by 600ktpa to 1.9mtpa from 1.3mtpa by end of 12F, and will further increase by 300ktpa to 2.2mtpa by end of 13F. Two new SSAW steel pipe production lines of total capacity of 660ktpa are coming online in 3Q 12F and 1Q 13F.
Our opinions	• The overall domestic pipeline industry will be benefited from the acceleration of national pipeline expansion. We are bullish on the pipeline industry with CKPNG as the top pick among peers. • We initiates BUY coverage at target price HK$3.78. Target price HK$3.78 implied target 12F P/E of 8.9x and 12F P/B of 1.3x.

From Coverage to Watch-list

Leoch Int'l (0842 HK) (click here...)

Stock statistics	Market cap: US$179.8m (closing price: HK$1.05); daily turnover: US$0.40m
Summary / review	• Leoch is principally engaged in the manufacture and development of lead-acid batteries. It has a wide range of products including UPS (Uninterruptible power supply), telecom, consumable products, SLI batteries, renewable energy and motive batteries. Leoch developed moulds for wide range of 1,600+ customized products. • Customers of Leoch include Emerson Electric (EMR US), Eaton Corp (ETN US), BMW, Juguar, US batteries, Black & Decker (SWK US), to name a few. Leoch is one of the largest exporter in sales volume in China.
Drivers / catalysts	• As we have discussed in the previous note, Zhaoqing facility was under suspension for self-examination and rectification, which was accounted for 20% of Leoch production capacity. As a matter of fact, production and sales for UPS clients, the core business, was negatively affected. While the management expects heavy allocation to Anhui facilities with UPS and SLI focus, Leoch needs to take time to repair relationship with major clients. Besides, the management needs to ramp-up another round of Anhui new equipments and involves as much as 7,000 staff in the base, which largely challenges management execution ability. Sales for 2H have to be revised. Sales in 1H were around 3.2m kVAh, while in base scenario full year estimates was revised down to 7.5m kVAh from previous 9.0m kVAh forecast.
Our opinions	• For general lead acid battery providers, Leoch and its peers faced tightened regulation since 2H 2011, where a lot of facilities were suspended at least for 2012. In short-term, Leoch is still subject to the effect of increasing fixed costs due to expansion yet limited sales growth on partial capacity suspension. We would like to wait for higher visibility in respect to industry consolidation and company execution. For the time being, we downgrade Leoch to HK$1.15 from HK$2.53 though share price rose sharply yesterday after the results announcement. Net profit for FY12/12F and FY12/13F were lowered to RMB137m and RMB308m respectively from RMB293m and RMB478m. The counter is currently trading at 8.5x and 3.8x P/E according to our new forecasts.

Watch-list

China Fiber Optic (3777 HK)

Stock statistics	Market cap: US$171.7m (closing price: HK$1.1); daily turnover: US$1.8m
Summary / review	• **Largest fiber optic patch cord producers in China with 21.4% market share.** China Fiber Optic Network System (CFONS) was listed in HK in Jun last year at HK$1.20 per share. Through processing soft optical cables and ceramic ferrules, the company offers 100+ models of fiber optic patch cords to communication industry since "Network Access License for Telecommunications Equipment" (电信设备进网许可证) was granted in 2001. Fiber optic patch cords are devices consist of soft optical cables with each of their ends connected to one or more connectors for light signal transmission purpose. In terms of sales volume, CFONS market share in 2011 was 21.4% in China. By end of 2011 production capacity of fiber optic patch cords was 12m sets a year, which contributed to 12.9m units self-produced in addition to 5m outsourced units in 2011. In 2011A, it recorded RMB1,257m revenue with 31.2% gross margin and 20.1% net margin. • **Profit margin lowered in 1H due to increase in multiple-nodes.** China Fiber Optic 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. • **2H domestic profit margin may stay at similar level due to FTTX applications.** For domestic sales, the management indicated that there was an obvious increase in multiple-nodes fiber optic patch cords sales up to 30% due to FTTX installations; this product mix may persist and seen in 2H. While 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.

IRC (1029 HK)

Stock statistics	Market cap: US$246.4m (closing price: HK$0.55); daily turnover: US$0.14m
Summary / review	• IRC (1029 HK) is an iron ore producer. Its key assets are located in Far East of Russia at regions namely Amur and EAO. These mines sites situated relatively close to the North-eastern Chinese border. • Currently developing iron mine assets are namely Kuranakh, K&S and Garinskoye. They are all open-pit mines along with access to national railway networks. Three prospective mining projects sustains long term development, they are namely Garinskoye Flanks, Kostenginskoye and Bolshoi Seym. • Total Measured, Indicated and Inferred Resources are 1,514m tons, of which 1,051m tons are Measured and Indicated Resources. **Update** • June and July iron ore spot price did not recover as expected and continue to drop in August. China import 62% Spot price of 62% iron ore imports into China dropped sharply since the beginning of the 2H 12A to current US$96/t • The decrease in spot price at the first two months exceeded our expectation, while there is no indication that the price will resume in the short-run. **Our opinions** • IRC reported its interim result on Wednesday followed by a profit warning on 12 July 2012. Turnover dropped by 4% YoY to US$51.7m, which consisted of iron ore sales of US$51.7m (dropped by 4% YoY) and turnover from engineering of US$5.3m (dropped by 19% YoY), while net loss was US$19.9m as compared to previous profit of US$3.6m. Iron ore concentrates ASP dropped by 17% YoY to US$121.8/t from US$146.8/t. • We expect another profit warning for year end result due to 1) previous annual 'accounting' profit to this year annual net loss 2) operating loss in 4Q (4QF IRC's iron ore ASP: US$100/t – (Mining cash cost: US$65/t + Railway cost: US$46/t) = Net operating loss: (US$11)/t), and therefore we lowered our target price to HK$1.12 with HOLD rating.

Sino Oil and Gas(0702 HK)

<table>
<tr><td>Stock statistics</td><td>Market cap: US$239.1m (closing price: HK$0.154); daily turnover: US$0.8m</td></tr>
<tr><td>Summary / review</td><td>Overview
• Sino Oil and Gas (SOG) is a resource investment company that focuses on upstream business of oil and gas as well as CBM exploration and development.
• SOG’s key asset is Sanjiao CBM project in Shaanxi which acquired in Nov 10 for consideration of HK$2.3b.
• The Sanjiao CBM project is located in Shanxi and Shaanxi, with area of 382km2(previously 462km2) that operates via 70% PSC with PetroChina (857 HK). The net gas 2P and 3P reserves are 7.7b cubic meters and 15.9b cubic meters.
• We estimate that taking into account of other major costs include other essential infrastructures, the aggregate capital investment will be RMB685m and RMB670m in 12 and 13, in which 30% investment cost will be undertaken by PetroChina as a result of PSC agreement.
Update
• On 16 Aug, Sino Oil and Gas (SOG) announced that they received an approval letter from national energy administration (NEA) in relation to consent on the work for the development coal bed methane gas reserve in the Sanjiao region.
• The approval from NEA is the critical turning point of company CBM development:
1. upon the approval, SOG has become the first foreign PSC partner obtaining overall development plan (ODP) approval.
2. the approval released the remaining conditional CDB loan facility of RMB800m, which sufficiently cover next two years planed capex.
3. released part of the capital expenditure pressure and the risk of project development that the PSC partner, PetroChina, will share the capital expenditure incur in accordance to the PSC share split (30%)
• We believe the development denote potential near term re-rating of the stock.</td></tr>
</table>

Shengli(1080 HK)

Stock statistics	Market cap: US$184.5m (closing price: HK$0.58); daily turnover: US$0.18m
Summary / review	**Overview** • Shengli is the one of four authorized SSAW pipe producer in national pipe projects in China. Their current production capacity of 1,150k tonnes denoted roughly 33% of market share. • SSAW steel pipe is the largest pipe used in the national pipe network, representing roughly 70% of use. • Being the pure domestic player, Shengli's performance is highly correlated to the national pipeline development. • Pursuant to the 12th five-year plan, it was set to increase the total length of PRC national pipeline by 95% to 150,000km. By end of 2011, the total national length was 82,500km representing a short of 67,500km. **Update** • Shengli Oil & Gas Pipe (Shengli) released its annual result for 1H FY12/11A after the profit warning on 22 June 2012. Turnover increased by 45% YoY to RMB617.4m, while net profit increased by 2% YoY to RMB12.5m, of which included fair value gains of derivative financial instrument of RMB18m as compared to previous period gain of RMB1.3m. • The July contract announcement of 96,517 tonnes new order from China-Asia Natural Gas pipeline project with total contract price of RMB723.5m, representing 117% of 1H FY12/12A result, 170% of 1H FY12/11A result and 52% of 2H FY12/11A, and adding up the 1H 12/12A result, total turnover represents 74% of previous annual turnover. • On May 21, controlling shareholder Mr, Yan Tangfeng disposed 24.99% share capital of the company at cash consideration of HK$0.95 per share to Mr. Jiang Yong. **Our opinion** • As the commencement of the next national capital expenditure up-cycle coming ahead, we are bullish the welded pipe sector, while we believe Shengli has the ability to catch the rapid growth and rebound of the industry for the next three years.

Thank You!

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