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NEW THEME

ANCHOR REPORT

The RMB1,000 revolution

The advent of RMB1,000 (circa US$150) smartphones promises to revolutionise China's telecom industry and the global handset space. As well as driving 3G subscriber growth in China, we expect the availability of affordable, capable entry-level smartphones to lead to consolidation in the domestic handset industry, since small white-box vendors don't have a reliable upgrade path to 3G from either a chipset sourcing or product distribution standpoint. Moreover, we think these phones will help Chinese handset OEMs move up to the mid-range product segment, paving the way for a further convergence in their valuations relative to handset brand vendors. We forecast that China's smartphone market will expand from 20mn units in 2010F to 62mn in 2012F, making it the world's second-largest smartphone market (after the US) by volume. We highlight a broad spectrum of beneficiaries from the arrival of smartphones for the masses: handset vendors such as BYDE, TCL Com, ZTE and HTC, along with retailer Gome. Qualcomm, China Wireless and Digital China also look set to benefit, though we view prevailing valuations as fair. We see MediaTek as a potential loser from the 2G-to-3G transition.

① **China to be the second-largest smartphone market by 2012F**

② **Android to spur convergence of handset brand vendors and OEMs**

③ **3G transition to consolidate Chinese handset industry**

④ **Top picks: TCL Com, BYDE**

Stocks for action

We believe the market has yet to recognise TCL Com as a key beneficiary of the growing popularity of social network services (SNS) in emerging markets or BYDE as a proxy for China 3G subscriber growth.

Stock	Rating	Price	Price target
TCL Com (2618 HK)	BUY*	HK$8.08	HK$11.00
BYD Electronic (285 HK)	BUY	HK$5.13	HK$6.00
China Wireless (2369 HK)	NEUTRAL*	HK$4.60	HK$4.50
Digital China (861 HK)	NEUTRAL*	HK$16.04	HK$17.00
ZTE (763 HK)	BUY	HK$29.95	HK$36.00
HTC (2498 TT)	BUY	NT$894	NT$1,000
Gome (493 HK)	BUY	HK$2.89	HK$4.30
Qualcomm (QCOM US)	NEUTRAL	US$51.33	US$45.00
MediaTek (2454 TT)	REDUCE	NT$398	NT$275

* Initiating coverage; prices as at 20 Jan close

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Nomura Asia-ex-Japan Research

Nomura U.S. Research

Nomura Anchor Reports examine the key themes and value drivers that underpin our sector views and stock recommendations for the next 6 to 12 months.

Any authors named on this report are research analysts unless otherwise indicated. See the important disclosures and analyst certifications on pages 93 to 96.

Smartphones | CHINA

TELECOMS & TECHNOLOGY

NOMURA

NOMURA INTERNATIONAL (HK) LIMITED

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NEW THEME

Action

We look at the emerging entry-level smartphone trend from the perspective of the whole handset supplier chain covering chipset vendors, handset OEMs, distributors and operators. BUY TCL Com (initiation), BYDE, ZTE and HTC as handset vendor beneficiaries. In distribution, Synnex and Gome look well placed. We reiterate our REDUCE on MediaTek as a potential loser of the 2G-to-3G transition. We like China Wireless (initiation) and Digital China (initiation) but their valuations look fair.

Catalysts

Positive catalysts include higher-than-expected 3G subscriber growth in China.

Anchor themes

Entry-level smartphones are an important trend in China and globally. Entry-level smartphones should help Chinese operators drive 3G subscriber growth and reshape the handset manufacturing and distribution industry.

Stocks for action

We believe the market has yet to recognise TCL Com as a key beneficiary of the growing popularity of social network services (SNS) in emerging markets or BYDE as a proxy for China 3G subscriber growth.

Stock	Rating	Price	Price target
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The RMB1,000 revolution

① China to be the second-largest smartphone market by 2012F

We forecast China's smartphone market will expand from 20mn in 2010F to 62mn in 2012F, and become the world's second-largest smartphone market (after the US) by volume in 2012F. Our affordability analysis shows that RMB1,000-2,000 smartphones will drive 3G subscriber growth in China. We note that the iPhone is targeted at the top 5% of total 3G subscribers in China. We think the difference in user experience and associated service plans between high-end and low-end smartphones will change the smartphone ecosystem.

② Android to spur convergence of handset brand vendors and OEMs

We believe the emergence of the Android OS has lowered the technology barriers between handset brand vendors (eg, Nokia, Motorola) capable of high-end product development and handset OEMs capable only of handset manufacturing and low-end handset design. These lower barriers should help handset OEMs to penetrate mid-range segments and present investors with re-rating opportunities in handset OEMs, given a possible convergence in valuation between the two groups, in our view.

③ 3G transition to consolidate Chinese handset industry

We think the transition from 2G to 3G in China will encourage consolidation in the handset OEM industry, because small vendors do not have a reliable upgrade path to 3G due to licensing restrictions between MediaTek and Qualcomm, and will likely face challenges in distribution due to the shift to an operator-centric model in 3G. From a distributor perspective, we expect PC and handset distribution to converge, especially in smartphones, creating opportunities for existing PC distributors such as Digital China and Synnex.

④ Top picks: TCLC, BYDE

We call BUY on BYDE, TCL Com, ZTE, and HTC as beneficiaries in the handset vendor sector. In distribution, we think Synnex and Gome look well placed. We reiterate our REDUCE rating on MediaTek as a potential loser from the 2G-to-3G transition.

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Contents

Summary

Entry-level smartphones — why now?

In this report, we discuss the emerging entry-level smartphone trend from the perspective of the whole handset supplier chain, covering chipset vendors, handset OEMs, distributors and operators. We discuss the scale and timetable for 3G and smartphones in China, analyse the affordable price range of smartphones in China, and assess the impact of smartphones on the whole handset supplier chain, especially with the emergence of the Android OS for Chinese handset OEMs.

Why are we focusing on entry-level smartphones now?

Why now (1)? Important products to drive China 3G subscriber numbers

After nearly two years of China's development of 3G subscribers, the total number of 3G subscribers had reached 38mn by the end of October 2010, progress that was far behind the plan for 150mn subscribers by end-2011 set by the Ministry of Industry and Information Technology (MIIT), China's telecom regulator. Handsets are one major bottleneck to 3G growth. In 2011, we believe 3G subscriber growth will be a key theme for China's telecom industry, and entry-level smartphones could be an important accelerant of it.

Why now (2)? Android is booming in China

We are seeing a boom in smartphone development among Chinese handset OEMs. Most companies are aiming to capitalise on the growth opportunities presented by 3G in China and want to penetrate the mid-range segment of the global handset market. Such a "step-up" strategy has proved challenging in the past. We look at the prospects of the Android OS changing the picture this time around. We believe this trend will have a significant impact on the existing global handset industry.

Exhibit 1. Smartphones made by Chinese handset vendors

Brand	Lenovo	ZTE	K-Touch	Huawei	Coolpad	TCL	Meizu	Huawei
Model	LePhone	X850	W606	Ideos/U8150	W711	OT-980	M9	Ideos X5/U8800
Photo								
Wireless	HSPA/GSM	HSPA/GSM	HSPA/GSM	HSPA/GSM	HSPA/GSM	HSPA/GSMMSM	HSPA/GSM	HSPA/GSM
Screen size (inch)	3.7	2.8	3.5	2.8	3.5	2.8	3.5	3.8
Touch screen	Capacitive	Resistive	Capacitive	Capacitive	Resistive	Resistive	Capacitive	Capacitive
Processor	Qualcomm Snapdragon 1GHz	Qualcomm MSM 7227 600MHz	STE ST6715 468MHz	Qualcomm MSM 7225 528MHz	STE PHX6715 468MHz	Qualcomm MSM7227 600MHz	Samsung S5PC110 1GHz	Qualcomm MSM 7230 800MHz
OS	Android 2.1	Android 2.1	Android 2.1	Android 2.2	Android 2.1	Android 2.1	Android 2.2	Android 2.2
Camera (m pixels)	3MP	3MP	2MP	3MP	2MP	2MP	5MP	5MP
Announced	May-2010	June-2010	Aug-2010	Sep-2010	Sep-2010	Sep-2010	Dec-2010	Dec-2010
Retail price (RMB)	2,700	850	1,500	1199	1,500	1,600	2,500	2,600

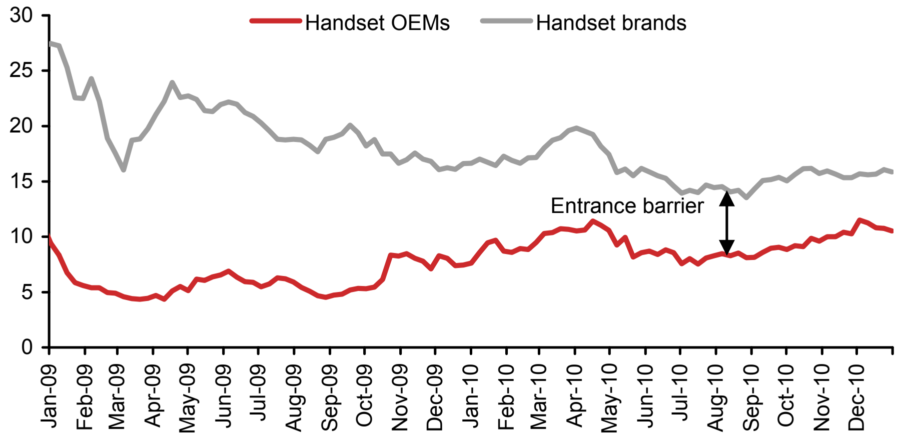
Source: GSM Arena, PC Online, ZOL.

Key conclusions

Android to spur convergence in valuations among handset OEMs/brands

We note the shares of OEMs have historically traded at a discount to handset brands, though that gap is narrowing. We believe the entry barriers in technology and brand equity are the main reasons for the valuation gap. And we believe the Android OS and Google as a brand could break down these barriers still further.

Exhibit 2. P/E comparison between handset OEM and handset brands

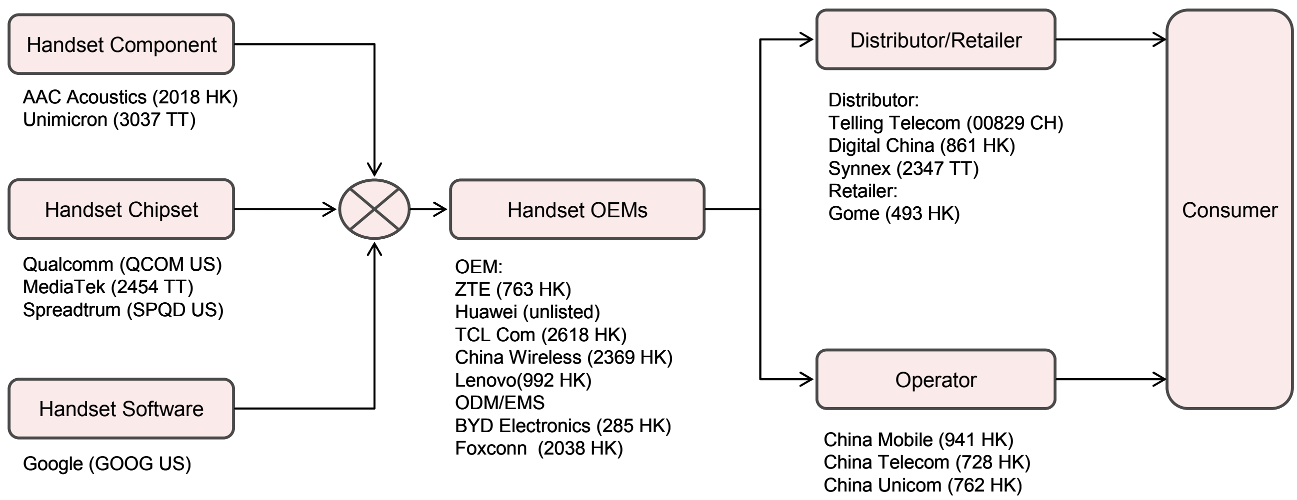


Note: 12-month forward P/E, handset brands includes Nokia and Apple Computer, handset OEMs includes China Wireless, BYD Electronics and TCL Communications, Apple's forecast is Bloomberg consensus, others are Nomura forecasts

Source: Nomura estimates

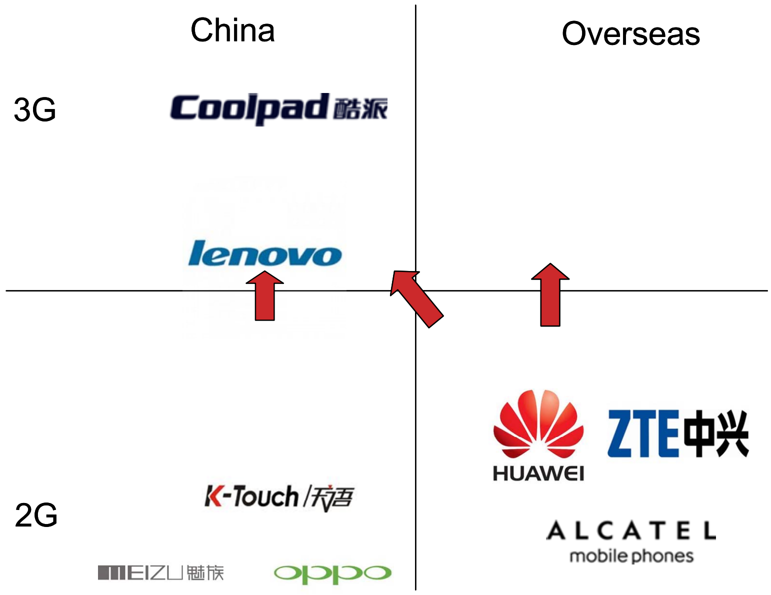
The following Exhibits show the handset supplier chain in China. We highlight ZTE, TCL Com, BYD Electronics, Synnex and Gome as key beneficiaries of this story — all are rated BUY. While we see Qualcomm, China Wireless and Digital China as potential beneficiaries, too, we see prevailing valuations as fair. We think MediaTek stands to lose from this trend, and we reaffirm our REDUCE rating.

Exhibit 3. 3G transition to trigger industry consolidation



Source: Nomura research

Exhibit 4. Position of Chinese handset vendors



Source: Nomura research

Top picks: TCLC, BYDE

We initiate coverage of TCL Communications with a BUY rating and a PT of HK$11 (36% potential upside), Digital China with a NEUTRAL rating and a PT of HK$17, and China Wireless with a NEUTRAL rating and a PT of HK$4.5. We reaffirm our BUY calls on BYD Electronics, ZTE, Synnex and Gome, REDUCE on MediaTek, and NEUTRAL on Qualcomm.

Exhibit 5. Universe snapshot: what's changed?

Ticker	Company name	Action	Rating	Currency	Price Jan-20	Price target	Var (%)	Method xFY11 P/E	Reason
2618 HK	TCL Com	Initiate	BUY	HK$	8.08	11.00	36	12	In line with handset OEMs average (12x)
2369 HK	China Wireless	Initiate	NEUTRAL	HK$	4.60	4.50	(2)	14	15% premium to handset OEMs because of China exposure
861 HK	Digital China	Initiate	NEUTRAL	HK$	16.04	17.00	6	-	1x PEG. Company is in transition from distributor to IT services provider.
285 HK	BYD Electronic	unchanged	BUY	HK$	5.13	6.00	17	10	Historical (from FY07) average
763 HK	ZTE	unchanged	BUY	HK$	29.95	36.00	20	24	5% premium to historical (from FY2005) average

Source: Nomura research

- **TCL Communications (2618 HK, not rated→ BUY, PT: HK$ 11):** We initiate on TCL Communication Technology with a BUY rating and PT of HK$11.0, which implies upside of 36% from current levels. We believe the market has yet to recognise that the company is a key beneficiary of the popularity of social network services (SNS) in emerging markets. Growth in the company's SNS phone offerings and entry-level smartphone business offer investors a distinctive ASP and margin expansion story within handset OEMs, in our view.
- **BYD Electronics: (285 HK, BUY, PT: HK$6.0):** We reiterate our BUY call and PT of HK$6.00. We suggest investing ahead of the FY10 results announcement, slated for the end of March. We believe the company will beat consensus FY10F earnings, driven by a transformation to the higher-margin ODM business from EMS to offset the impact of wage inflation. We believe the ODM business will continue to drive robust earnings growth in FY11-12F, backed by strong 3G handset demand in China.

- **China Wireless (2369 HK, not rated → NEUTRAL, PT: HK$4.50):** We initiate coverage on China Wireless Technologies with a NEUTRAL rating and a HK$4.50 PT. We think the company's strong R&D capability and product portfolio will help to capitalise on 3G and smartphone demand in China. However, we believe the company still needs to boost its marketing expenses and learn how to manage its brand image before becoming an established brand handset vendor (eg, China's HTC). The stock's 14.5x FY11F P/E looks fair, in our view.
- **Digital China (861 HK, not rated → NEUTRAL, PT: HK$17):** We initiate on Digital China with a NEUTRAL call and PT of HK$17.00. We like Digital China's position as key beneficiary of the digital city and other national IT projects in China's 12th Five-Year Plan, and see any progress as a re-rating opportunity.
- **ZTE (763 HK, BUY, PT: HK$36):** We believe the market has long seen ZTE as a telecom equipment vendor, but its terminal (handset, and data card) business is one of its key revenue drivers now (26% of sales in FY10F). Looking to FY11F, we believe entry-level smartphones will help ZTE to realise both market-share and margin expansion. Reaffirming BUY, with price target of HK$36.
- **HTC (2498 TT, BUY, PT: NT$1,000):** We reaffirm our BUY rating on HTC, given our view of further upside, driven by expected market-share gains on its leading technology in hardware and software, as well as on rising brand awareness. We believe the company is well-positioned within its industry to benefit from the trend of device convergence. We like its strategy to keep strengthening the "Sense experience", which in our view will prove to be an important differentiator as the market matures in 2012F.
- **Gome (493 HK, BUY, PT: HK$4.30):** According to Gome, demand for new products such as smartphone is high owing to rising incomes and improving lifestyles. We believe new products bode well for SSS and sales efficiency improvement, given relatively high ASPs. Gome is likely to accelerate its new store openings in FY11F, from 150-200 to 200-250, and we believe faster-than-expected store expansion will drive earnings from FY11F. We reiterate our BUY rating and PT of HK$4.3.
- **Qualcomm (QCOM US, NEUTRAL, PT: US$45):** Qualcomm has strong secular tailwinds that should help it drive revenue growth in FY12F. We expect Qualcomm to: 1) gain share in the baseband market (current share stands at 40%), driven by the growth of 3G handsets in emerging markets; 2) add US$0.20-0.25 from design wins in the Verizon iPhone 4 (CDMA chipset) and the upcoming iPhone 5 (for baseband, replacing Infineon); and 3) improve its royalty revenues due to a growing 3G subscriber base and other data devices such as eReaders and tablets.
- **MediaTek (2454 TT, REDUCE, PT: NT$275):** We maintain our REDUCE rating and price target of NT$275 for MediaTek; our PT implies 31% potential downside. We expect MediaTek to record two consecutive years of earnings declines (the worst performance in the company's history), followed by only a moderate recovery in FY12F.

Exhibit 6. Valuation table

Bloomberg ticker	Company name	Rating	Currency	Price Jan-20	Market cap (US$mn)	P/E (x) FY10F	P/E (x) FY11F	P/BV (x) FY10F	P/BV (x) FY11F	ROE (%) FY10F
	Handset chipset									
QCOM US	Qualcomm	NEUTRAL	US$	51.33	83,037	18.9	17.4	3.5	3.1	14.6
2454 TT	MediaTek	REDUCE	NT$	398	14,939	13.8	16.9	5.1	5.2	32.3
	Handset/PC vendor									
2618 HK	TCL Com	BUY	HK$	8.08	1,140	12.6	8.8	5.4	3.8	52.4
285 HK	BYD Electronic	BUY	HK$	5.13	1,486	9.7	8.1	1.3	1.1	14.3
2369 HK	China Wireless	NEUTRAL	HK$	4.60	1,243	17.2	14.5	7.5	4.2	50.9
763 HK	ZTE	BUY	HK$	29.95	11,033	24.3	18.1	3.7	3.1	16.1
2498 TT	HTC	BUY	NT$	894	25,172	18.6	12.6	9.4	7.1	53.4
	Distributors and retailers									
861 HK	Digital China	NEUTRAL	HK$	16.04	2,247	17.7	15.4	3.6	3.1	21.0
493 HK	Gome Electrical	BUY	HK$	2.89	5,591	18.4	14.9	2.6	2.3	16.2
	Telecom Service Provider									
941 HK	China Mobile	BUY	HK$	77.30	199,322	11.6	10.8	2.4	2.1	21.8
728 HK	China Telecom	NEUTRAL	HK$	4.54	47,218	21.2	18.6	1.4	1.3	6.7
762 HK	China Unicom	BUY	HK$	12.06	36,834	44.5	30.2	1.2	1.2	2.7

Note: For Qualcomm: year ends in Sep. For Digital China: year ends in March. Estimates have been provided above for FY11 and FY12 for these companies

Source: Nomura estimates

Changing market place

Market dynamics

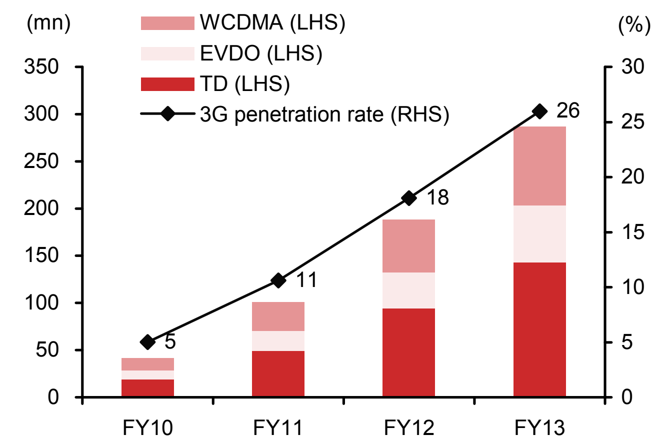
China: second-largest smartphone market by 2012F

Our 3G subscriber forecast: 150mn by 3Q12F

We forecast China's 3G subscriber base will reach 100mn by end-2011F and pass the 150mn end-2011F target set by the Ministry of Industry and Information Technology, MIIT, China's telecoms regulator) within 2012F. We think acceleration in 3G subscriber growth is being driven by operators' handset subsidy policies (Exhibit, below left), an increasing number of affordable 3G handsets, and enhanced 3G network coverage (Exhibit, below right).

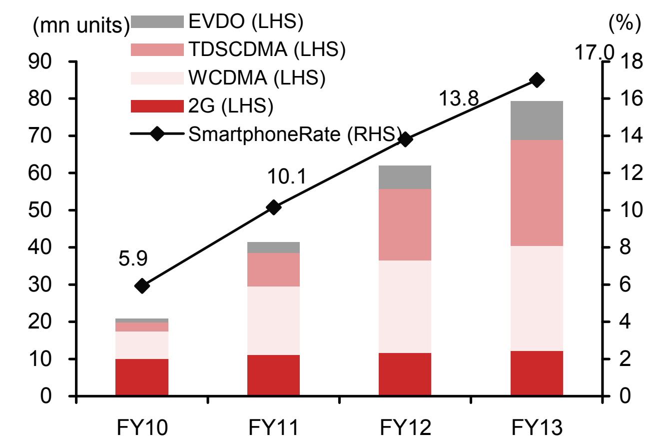
We believe entry-level smartphones (below RMB1,000, or US$150) will be a key driver of this trend. We forecast China's 3G handset market will grow from 37mn in 2010F to 151mn in 2012F, during which time smartphone penetration will rise from 6% to 17%. In this context, we forecast the smartphone market in China will expand from 20mn in 2010F to 79mn in 2013F (58% CAGR between 2010 and 2013).

Exhibit 7. China 3G subscriber forecasts



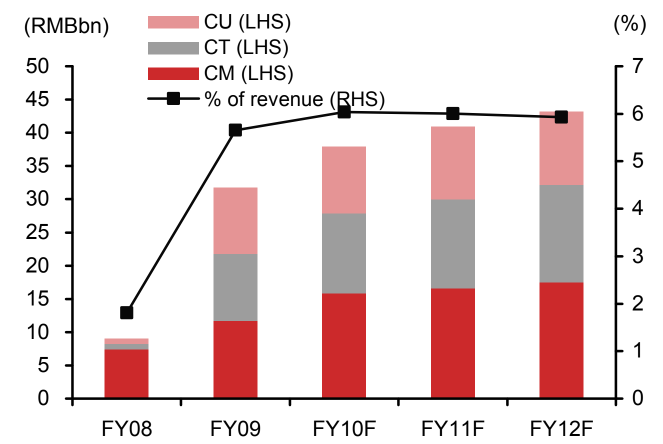
Source: Gartner, Nomura estimates

Exhibit 8. China smartphone shipment forecasts



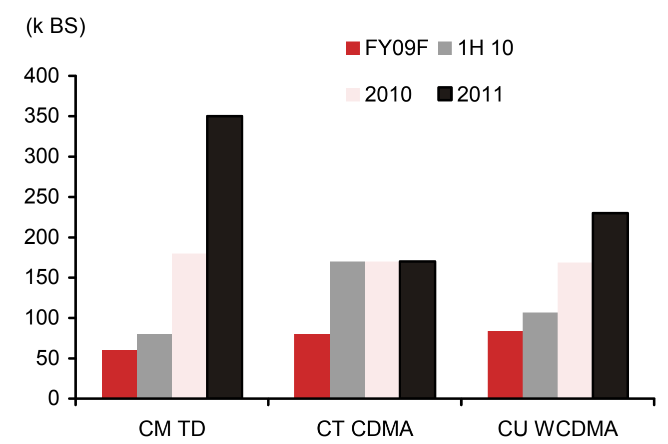
Source: Gartner, Nomura estimates

Exhibit 9. Handset subsidy forecasts



Source: Company Data, Nomura estimates

Exhibit 10. Progress in 3G network rollout

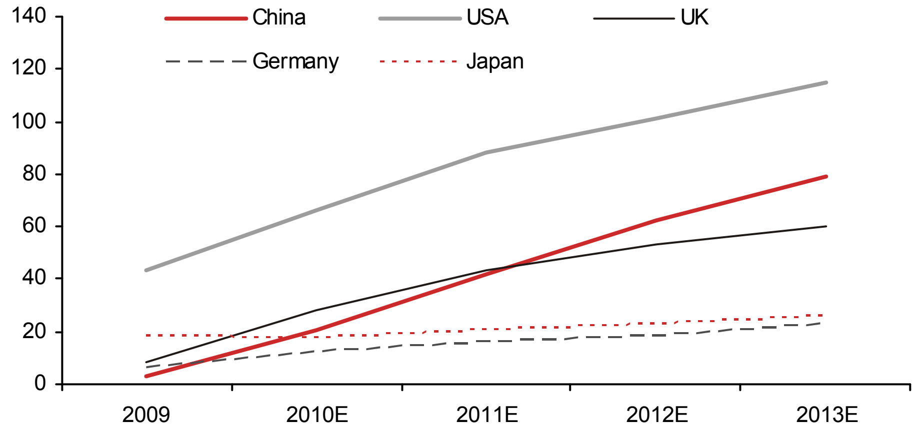


Source: Company Data, Nomura estimates

China to be world's second-largest smartphone market by 2012F

Looking at China's 3G smartphone market from a global perspective, we conclude that China will pass the UK to become the second-largest smartphone market by 2012F.

Exhibit 11. Smartphone volume (mn) forecasts by country



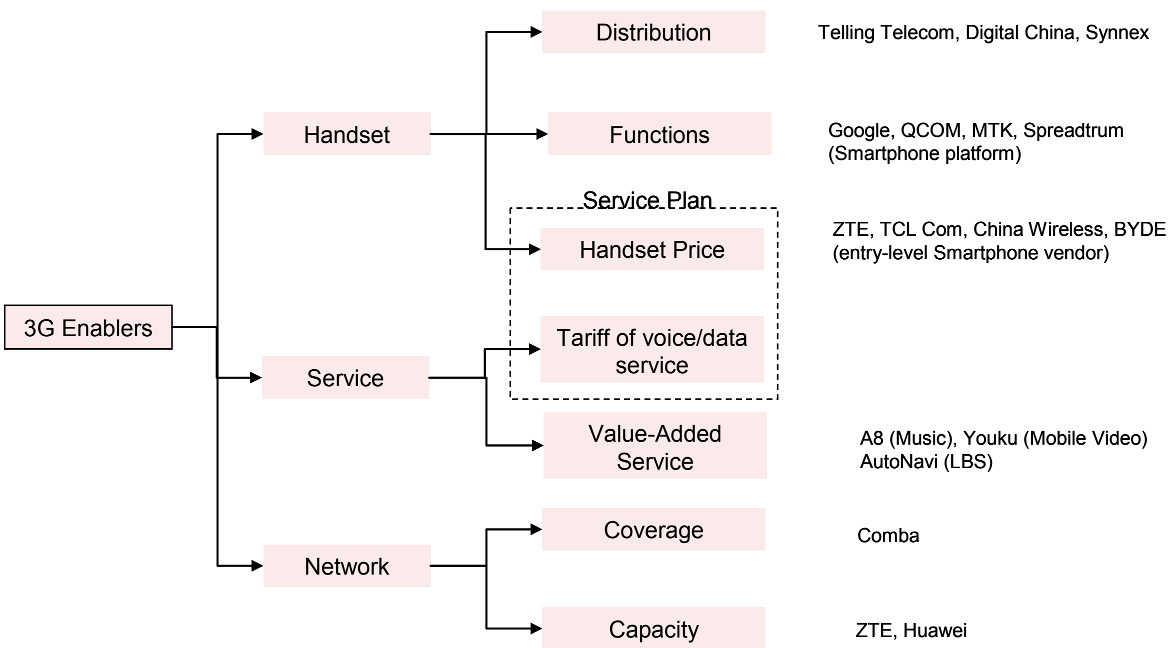
Source: Gartner, Nomura research

Drivers: handset+ service+ network

Several factors underpin our 150mn subscriber base assumption for China within 2012F.

- **Handsets**: affordable pricing, attractive features and efficient distribution networks are key issues for handsets. Chinese subscribers have a different affordability level for handsets compared with developed countries, reflecting differing income levels, as well as different user behaviour for handsets and mobile applications, on account of language and cultural differences.
- **Service**: affordable pricing for basic mobile voice and data services bundled with handsets, along with value-added services to attract users.
- **Network**: we think 3G outdoor coverage has improved in the past few years. We believe capacity enhancement along with increasing 3G subscriber/traffic and indoor coverage enhancement are remaining issues.

Exhibit 12. 3G enablers in China



Source: Nomura research

In this report, we focus on handsets and service. For more on network-related issues, see our report, *Rising with convergence*, published 29 September, 2010.

RMB1,000~2,000 smartphones to be the main driver

Debate on whether iPhone-level smartphones or entry-level smartphones will drive the market in China

Investors seem split on whether the iPhone and similar high-end smartphones (ASPs of more than US$300) or entry-level smartphones (ASP below US$200) will drive smartphone growth and 3G penetration in China.

- Our affordability analysis, based on ARPU distribution in China, shows that RMB1,000-1,200 is the sweet-spot price for smartphones in China, given our view that fully subsidised service plans (subscribers getting a handset free of charge) are essential to the mass-market adoption of smartphones in China (see page 11 for details).
- China Unicom's iPhone 4 plan costs RMB250-300 (US$40-45) per month on average over a two-year contract period, or ~2.2x more than an entry-level smartphone plan (RMB15-20). Since we estimate that only the top 5% of subscribers in China are spending more than US$30 per month we believe the iPhone 4 is mainly targeted at the top 5% of subscribers in China. Hence, we believe entry-level smartphones will be the key driver of 3G subscriber numbers in China, given affordability considerations.

The Exhibit below compares Asia ex-Japan telecom operators' key performance indicators (KPIs) with those of major developed countries. China, India and Indonesia, the three largest Asia counties by mobile subscriber base, have low average revenue per user (ARPUs) compared with developed countries.

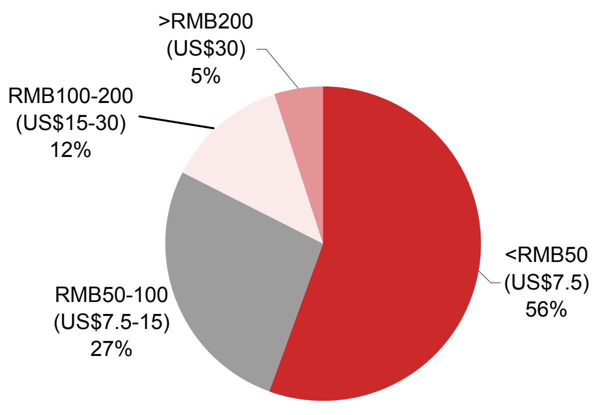
Exhibit 13. Comparison of APRU by countries/regions

Country	Population (mn)	GDP per cap (2010, in US$)	Mobile penetration 2010	Mobile subscribers (mn, 2010)	ARPU (US$; 2010)	EBITDA margin (%; 2010)
Australia	22	54,869	123%	27	49	33
China	1,398	4,283	60%	850	11	42
India	1,216	1,176	61%	730	3.6	31
Indonesia	235	2,963	86%	201	4.4	53
Singapore	5	42,653	143%	7	30	34
South Korea	49	20,165	103%	50	29	33
Malaysia	28	7,755	113%	33	18	43
Taiwan	23	18,304	119%	28	24	42
Thailand	68	4,621	102%	69	6.9	50
Philippines	94	2,011	90%	84	4.2	55
Japan	127	42,325	95%	121	56	32
USA	310	47,132	94%	293	50	34
UK	62	36,298	133%	82	30	22
Germany	83	40,512	128%	107	19	40
Brazil	194	10,471	104%	203	15	26

Source: Company materials, IMF, Nomura research

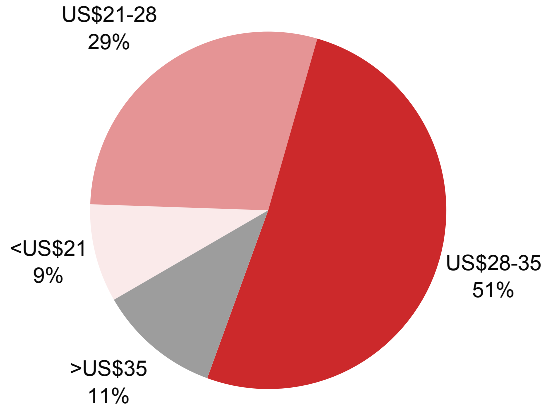
The next Exhibit (below left) shows that in China, only the top 5% of subscribers have an ARPU of more than RMB200 (US$30). In Korea, a big market for high-end smartphones, a full 62% of subscribers have an ARPU that tops US$28 (FY10). We believe this highlights the large difference in affordability between China and Korea if operators were to launch a smartphone service plan requiring monthly payment of US$30.

Exhibit 14. Subscriber distribution by ARPU (China, FY10)



Source: Nomura research

Exhibit 15. Subscriber distribution by ARPU (Korea, FY10)



Source: Nomura research

Cost for operators

The next Exhibit illustrates some principles operators typically use for handset subsidy/service revenue when devising service plans. The idea is to yield the maximum subsidy that an operator can afford.

Handset subsidy = sourcing cost + commission – selling price

Operators typically source handsets at a discount to the retail price from handset vendors, and then sell the handsets under the "operator price" bundled with a service plan. We note that the handset subsidy is equal to the difference between the operator's sourcing cost and both the channel commission and the handset's selling price.

Cost for consumers

From a subscriber perspective, in addition to the handset cost, he/she commits to pay a minimum monthly fee over a certain contract period (eg, two years).

From an operator's perspective, to avoid the risk of making losses on a subscriber contract, the operator needs to restrict the handset subsidy within the range of the minimum EBITDA it can get.

- *Rule 1: Handset subsidy < Minimum service revenue * EBITDA margin*

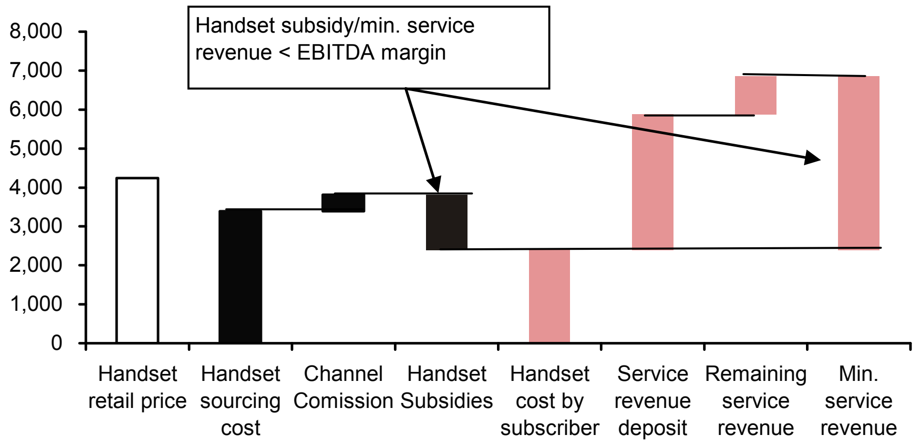
To avoid a situation where a subscriber terminates the contract (defaults) and resells the handset on the open market, the operators typically configure plans so that the initial cost (handset cost + deposit) is greater than the handset's retail price. This is a common practice in emerging countries, given the lack of a mature credit system in some markets.

- *Rule 2: subscribers' initial expense > handset's retail price*

China Unicom's iPhone reselling problem is due to buoyant iPhone retail prices in China triggered by product shortages

Recently, China Unicom has run into the problem of subscribers buying the iPhone with a service plan and then reselling the phone immediately (source: Sina News). We believe this reflects buoyant iPhone retail prices in China triggered by product shortages.

Exhibit 16. Relationship between handset subsidy and service plan (RMB)



Source: Nomura research

US/UK consumer is willing to pay at most US$200 for smartphone

According to Stuart Jeffery, Nomura's European tech analyst, European and the US subscribers are willing to pay up to US$200 for the initial cost of a smart phone. Then, the maximum price of a smartphone a US$50/month subscriber can afford will be:

Handset price = monthly fee * EBITDA margin * 24 month + initial cost

= US$50/month * 35% * 24 month + US$200

= US$620

Chinese consumer prefers "free" because the lack of credit system

However, in China, since a credit system has not been established, subscribers need to deposit a certain sum larger than the handset's retail price. So, it is reasonable to assume that most consumers do not want to pay extra for their handset.

As a result, to target a RMB120 subscriber (top 20% of the total subscriber base) in China, the maximum subsidy an operator can afford should be:

*RMB1,440 = RMB120 * 50% * 24month + RMB0*

As a result, a RMB4,000 iPhone or high-end smartphone is targeted at subscribers with ARPUs of more than RMB333/month — or less than 5% of the subscriber base in China, we estimate.

RMB333 = 4,000 /24/50%

iPhone service plan is 3.2x more in initial cost and 2.2x more in total cost than for typical entry-level smartphone

The Exhibit below compares China Unicom's service plan for the iPhone4 and ZTE's X850, a typical entry-level smartphone. The fully subsidised service plan (handset for free) for the iPhone is 3.2 times more costly than for the ZTE X850 in initial outlay, and 2.2 times more expensive in minimum total expense over the two-year contract period. We believe higher initial expenses will hold back the iPhone's penetration in China.

Target market for high-end smartphones: 5% of total (40mn)

We also use the minimum total expense per month (total expense including monthly fee and handset cost over contract period) to analyse different service plans. Subscribers spend RMB250-300/month on average over the two-year contract period. As noted, only 5% of total subscribers (~40mn) are now spending more than RMB200/month. We think this group can be seen as the potential market for the iPhone and other high-end smartphones.

Target market for entry-level smartphones: ~20% of total (160mn)

Yet an entry-level user spends RMB90-130 per month on average over the two-year contract period. More than 20% of subscribers (160mn) are spending more than RMB100/month today. We believe this group of subscribers comprises the addressable market for entry-level smartphones. In our view, entry-level smartphones will be an important driver if the MIII's target of 150mn 3G subscribers by end-2011F is to be met.

Exhibit 17. Comparison of China Unicom's smartphone service plans (current)

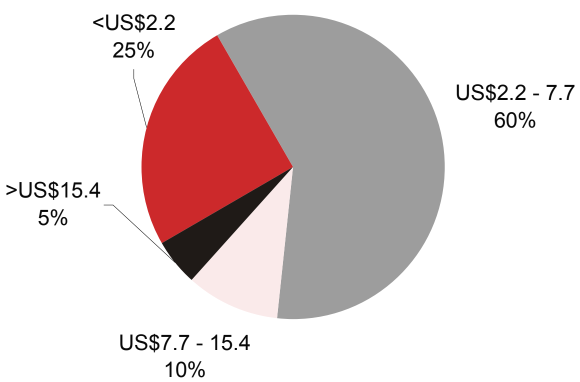
	iPhone 4 (16G)		ZTE X850	
Monthly fee (RMB)	96	286	66	126
Handset selling price	3,899	0	609	0
Deposit of monthly fee	1,981	5,880	600	1,820
Refund (RMB/month)	82	245	25	75
Subscribers' cost				
Initial expense	5,880	5,880	1,209	1,820
Minimum total expense over contract period	6,203	6,864	2,193	3,024
Minimum total expense per month	258	286	91	126
Operators' cost				
handset list price	4,240	4,240	1,180	1,180
handset sourcing cost (estimate)	3,392	3,392	826	826
Channel commission (estimate)	424	424	118	118
Handset subsidy (estimate）	(83)	3,816	35	944
Service plan				
Voice (min)	240	900	50	320
Data (Mbyte)	340	1,100	300	400
Voice (RMB/min)	0.15		0.15	
Data (RMB/Mbyte)	0.3		0.3	

Source: China Unicom, Nomura research

Entry-level smartphones have global potential

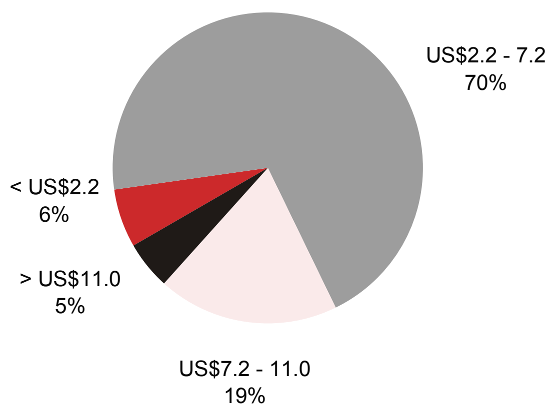
We think our affordability analysis for China also applies to other emerging countries such as India and Indonesia. As shown in the Exhibits below, we estimate that less than 5% of subscribers in India are paying more than US$15 per month and less than 5% of subscribers in Indonesia are paying more than US$11 per month. Hence, we believe sub-US$150 smartphones will also be important drivers of 3G subscriber numbers in these countries.

Exhibit 18. ARPU distribution in India (2010F)



Source: Company data, Nomura research

Exhibit 19. ARPU distribution in Indonesia (2010F)

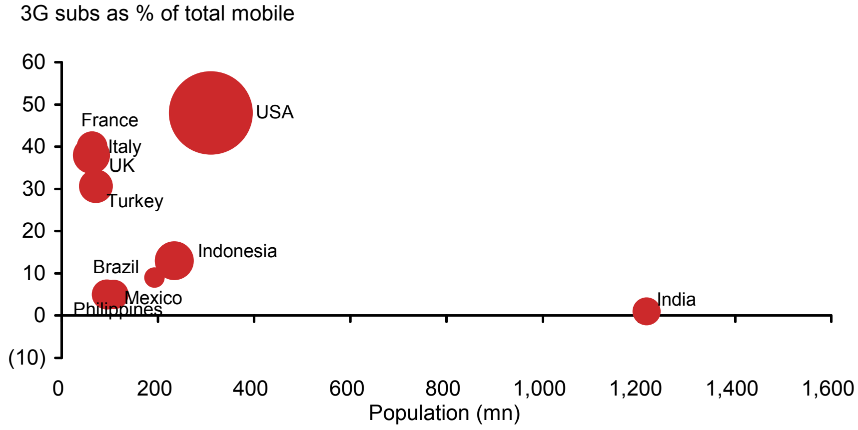


Source: Company data, Nomura research

Significant potential in global market

We highlight the emerging popularity of social networks in some countries. The Exhibit below shows the number of Facebook users by country with reference to that country's 3G penetration and total population. On this basis, Indonesia and India are some of the largest "Facebook countries" outside the US, but they still have very low 3G penetration. In such markets, we believe GSM handsets designed for social network usage have an important role to play. Chinese vendors such as TCL Communications have had success in these markets by offering products at competitive price points.

Exhibit 20. Facebook users by country

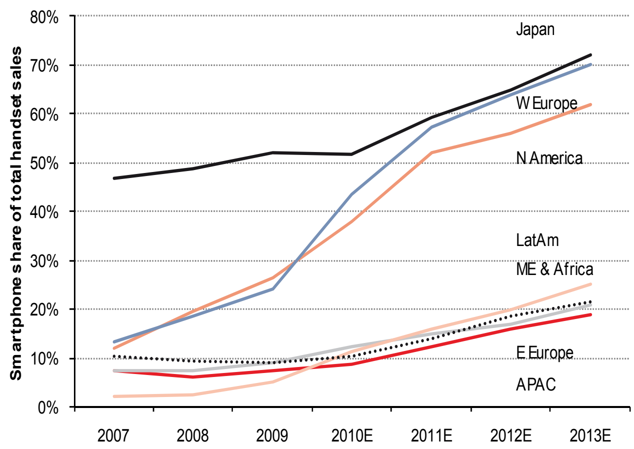


Source : IMF, Checkfacebook.com, ITPopular.com, WCIS, Nomura research

Developed countries: smartphones penetrating low-end to mid-range subscribers

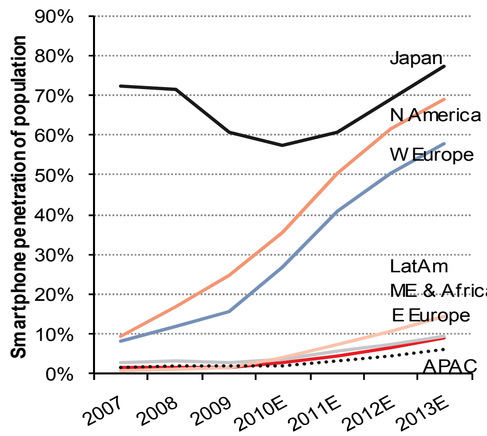
On the other hand, with smartphone penetration in North America, Western Europe, and Japan set to exceed 36%, 27%, and 57% by end-2010F, respectively, we believe operators in these countries are seeking competitively priced products to prompt midrange users to migrate to smartphones.

Exhibit 21. Smartphone share of annual sales



Source: WCIS, Nomura estimates

Exhibit 22. Smartphone penetration of population



Source: WCIS, Nomura estimates

Entry-level smartphone to replace existing feature phones

Based on our discussions with operators, we believe operators prefer to promote entry-level smartphones because of higher data service revenue — operators noted that smartphone subscribers tend to subscribe to mobile data services, since it is much easier to use mobile data applications such as Facebook and YouTube on smartphones than on feature phones.

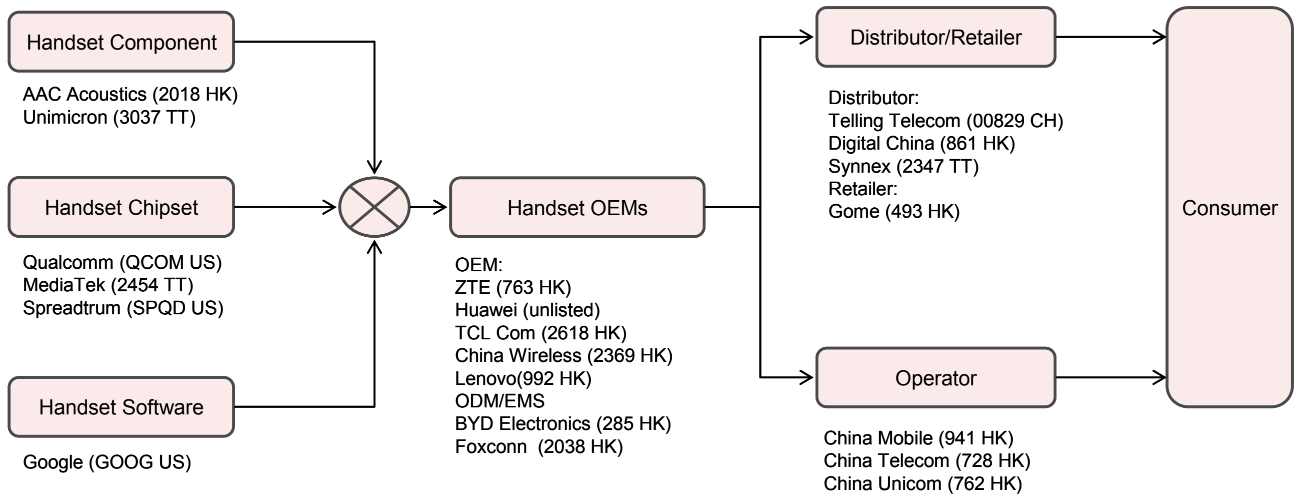
Market dynamics

Competitive landscape

Handset supplier chain in China

The Exhibit below illustrates the handset supplier chain in China. Handset OEMs first design their handset model's hardware and software features, and then purchase the chipsets, components, and software from relevant vendors. They assemble the components and software into finished handset products, and then sell them to either operators (operator channel) or distributors (open market channel).

Exhibit 23. Handset supplier chain: China



Source: Nomura research

The Exhibit below illustrates the role of China-based handset vendors, as well as their FY10F production volume and revenue, on our estimates. We find that total shipments by Chinese handset OEMs account for 9% of global volume share in FY10F but only 3% of global revenue share, because these companies are concentrating on low-end product segments.

Chinese handset OEMs have ~9% volume share and ~3% revenue share globally

Exhibit 24. Major China-based handset OEMs

	Volume	Sales	Process				Sales	
	(mn)	(US$mn)	CPU/Chip	Component	Design	Assembly	Operator	Open Market
Handset EMS								
FIH	na	7,500		√	√	√		
BYDE	na	1,200		√	√	√		
Hand et OEM								
ZTE	55	1,800			√	√	√	
Huawei	40	1,500	√		√		√	
Lenovo	4	936			√	√	√	
TCL Communications	36	1,091			√	√	√	
China Wireless	5	658			√	√	√	
Tianyu	na	na			√	√		√
China OEM total	140	5,985						
Global total	1,595	217,600						
% of global	**9**	**3**						

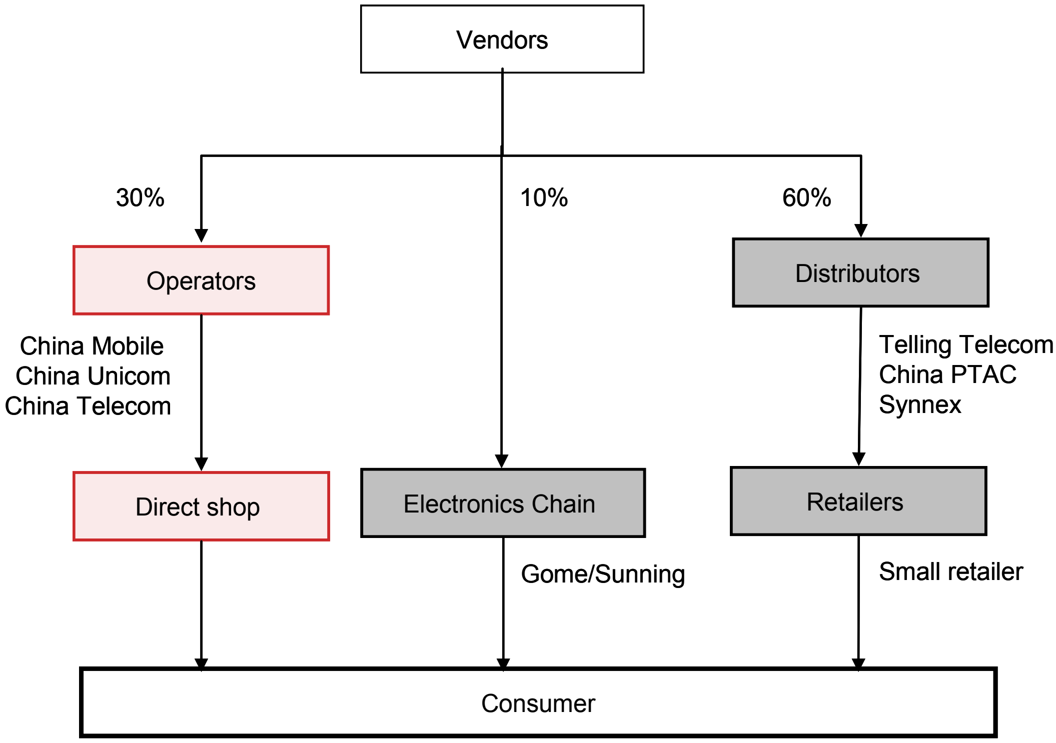
Note: revenue/shipment volume excluding data card in FY10F, FIH, BYDE is excluded to avoid duplication since they are OEM for other vendors

Source: Gartner, Nomura forecast

The distribution of GSM handsets in China is done mainly through an open market business model, through three channels: 1) direct sales (~10%) from handset vendors to large electronics chains such as Gome and Sunning; 2) distribution network (~60%) to small retailers via handset distributors such as Telling Telecom and China PTAC; and 3) operators' direct shops.

2G handset distribution in China: open-market-centric

Exhibit 25. GSM handset distribution in China



Source: GfK, Nomura research

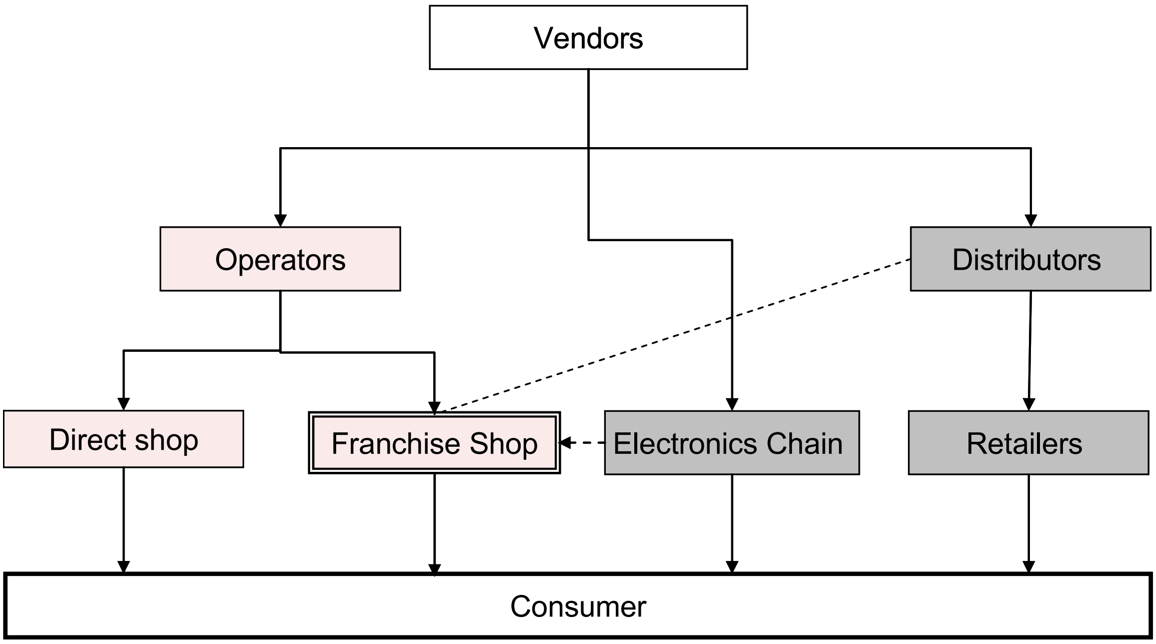
3G smartphones to reshape handset distribution

Trend 1: shift to operator-centric handset distribution

We think the 3G transition and smartphone trends are shifting handset distribution to an operator-centric model. We have noticed that operators are becoming involved in 3G handset distribution by expanding their direct shops and establishing franchise shops with distributors and electronics chains. We think this trend is the result of:

- **Availability:** Since the three operators use different 3G technologies, the availability of handset models is one important differentiating factor to attract subscribers (similar to the US market), and the operators (especially China Mobile and China Telecom) are involved in handset sourcing and distribution.
- **Affordability:** Given much higher 3G handset prices compared with GSM models, handset subsidy is an important factor in facilitating 3G migration, which requires a higher level of involvement from operators.
- **Attractive service:** Attractive mobile applications and value-added services are an important part of 3G service; since existing small retailers ("mom 'n' pop" shops) often lack the expertise to explain these complicated features, operators need to build new distribution networks, either by themselves or via cooperation with distributors.

Exhibit 26. 3G handset distribution



Source: Nomura research

JV on franchise shops as a trend

We think this trend is negative for players in the open market including distributors, electronics chains, and small retailers since the total share of handsets distributed over these channels will decrease. Distributors (eg, Telling Telecom) and electronics chains are establishing franchised stores with operators to avoid these negative impacts.

Trend 2: convergence of PC/smartphone distribution

Given the increasing skill requirement/complexity in smartphone sales, we think handset and PC distribution channels may converge eventually and large IT product distributors with adequate resources to train employees will gain market share at the expense of small franchise retailers. We think this will create business opportunities for IT product distributors, such as Synnex and Digital China, that provide better training to help employees understand new products.

3G transition to consolidate handset OEMs

>3,000 handset OEMs in China

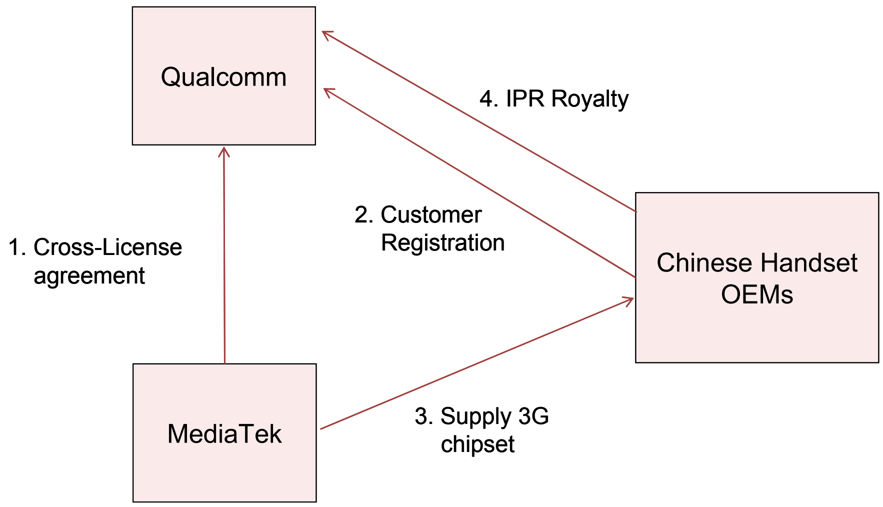
According to market research firm iSuppli, there are more than 400 handset design houses and more than 3,000 handset assembly vendors in China. Most of them design and manufacture GSM handsets based on MediaTek's turnkey solution. Those vendors are called "white-box" or "shanzhai," since they do not have their own brands, and some of them may not even be legal, registered companies, we believe.

We think the transition from 2G to 3G in China will consolidate the handset manufacturing industry from both the perspective of chipset/platform sourcing, and distribution networks.

White-box players lack a reliable 3G upgrade path

We think that white-box handset OEMs do not have a reliable upgrade path to 3G even after MediaTek launched its 3G solution in 3Q FY11. This is due to the license agreement between MediaTek and Qualcomm signed in 2009. According to that agreement, MediaTek cannot sell 3G chipsets to a handset OEM that has not registered with Qualcomm. The intention of this agreement is to make sure that Qualcomm can receive royalty revenue from handset OEMs, but meanwhile it will rule out those small white-box vendors that do not have a stable business operation and sufficient scale to be recognized by Qualcomm in the registration phase.

Exhibit 27. Contract between MediaTek and Qualcomm



Source: Nomura research

Industry consolidation

According to Aaron Jeng, Nomura's Taiwan technology analyst, Qualcomm had 65 customers (including indirect customers) in China by the end of 2010. We think this includes some large white-box handset OEMs such as Tianyu and Meizu. We suspect large white-box OEMs are trying to upgrade themselves to brand vendors, and most of the small vendors face a shrinking domestic market over the long term, and are being forced to focus more on overseas markets.

Operator-centric model ruled out small vendors

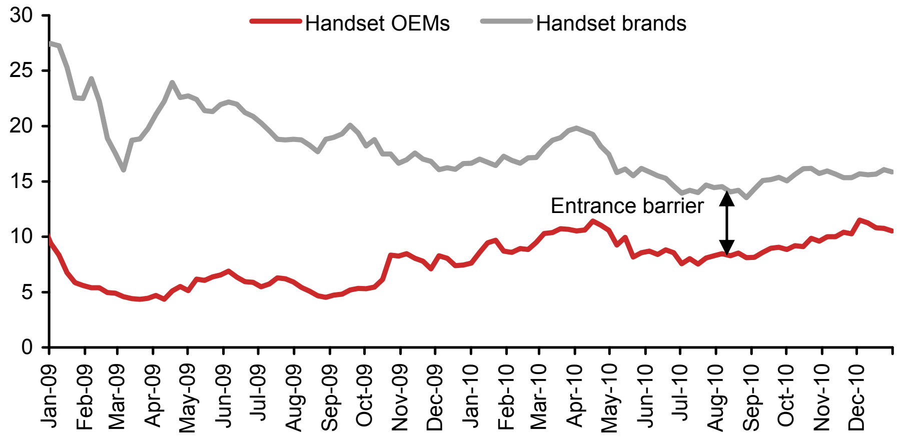
We think the shift in handset distribution to an operator-centric model will also hurt small vendors, given a higher entry barrier in the operator market regarding product quality, requirements for customized features, and sustainability and scale of the companies themselves.

Android to converge handset brands and handset OEMs

Valuation gap between handset OEMs and handset brands

Although Chinese handset OEMs already had a 9% global volume share in FY10, they had only a 3% value share due to their focus on low-end segments. We think the current market structure formed because handset brand vendors such as Nokia and Apple established a vertically integrated business model in high-end handsets, as illustrated in the next but one Exhibit. Technology and brands are the main entrance barriers for other companies, in our eyes. This is reflected in the difference in valuation between handset brands vendors such as Nokia and China-based handset OEMs.

Exhibit 28. P/E comparison between handset OEMs and handset brands



Note: 12-month forward P/E, handset brands includes Nokia and Apple Computer, handset OEMs includes China Wireless, BYD Electronics and TCL Communications, Apple's forecast is Bloomberg consensus, others are Nomura forecasts

Source: Bloomberg, Nomura research

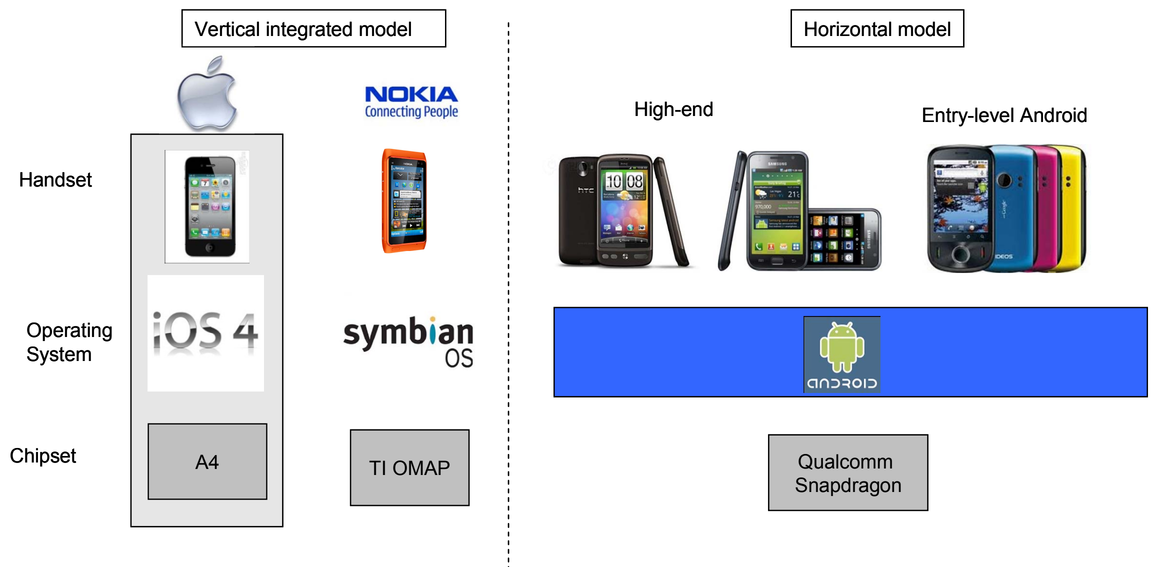
Android OS lowered the technology barrier

Still, we believe the launch of Android OS by Google has lowered technology entry barriers to mid-end market segments. Google established a horizontal business model for high-end handset OEMs such as Samsung and HTC, as well as low-end handset vendors in China. Chinese handset OEMs can use the Android OS and software application assets developed on it to compete with vendors with vertically integrated business models, such Nokia and Apple.

"Google" has become a brand, similar to "Intel Inside"

Some operators (eg, Far Eastone, Taiwan) are starting to promote Android-based entry-level smartphones under the brand name "Google phone" if the models are not clearly different from other Android OS-based models. We believe an operator does not need three brands (operator, handset vendor, and Google) if there is no major differentiating factor. "Google" has become a brand similar to the "Intel Inside" brand Intel Corp uses in PCs.

Exhibit 29. Smartphone business model



Source: Nomura

Big Chinese handset vendors are leveraging the Android platform and their low-cost manufacturing knowledge to enter the entry-level smartphone (ASP below US$200) market in China and globally. We believe these vendors can succeed.

Chinese to upgrade

- **Strong relationships with operators:** Huawei/ZTE has established strong customer relationships with Chinese and international operators via its existing telecom equipment business, and its operator-branded handsets ("Vodafone" and "Orange") are selling well. TCL inherited Alcatel's global handset distribution network with international operators through its 2004/2005 acquisition. China Wireless has developed strong customer relationships with China Telecom and China Mobile, and Lenovo has established relationships with China Unicom via LePhone.
- **Low-cost manufacturing knowledge:** Chinese vendors have gained low-cost manufacturing knowledge from low-end GSM handset manufacturing. For example, TCL Communications and ZTE have delivered 25-30% GPM where ASP is merely US$30. This experience in achieving low costs should help them to maintain cost leadership when they enter the middle market, in our view.
- **Low-cost R&D labour:** We expect rising weight toward software-related R&D costs in smartphones compared with 2G feature phones (~15% of cost for smartphones vs. ~5% for feature phones, according to our estimates). This should bring with it a cost advantage for China-based handset OEMs given that the average wage of an R&D engineer in China is only 20% that of an engineer in the US, in our view. The smartphone trend is helping Chinese OEMs gain cost advantages similar to what we have already seen in the telecom equipment industry where Huawei/ZTE are gaining market share via cost advantages in R&D.
- **Localized products.** Cultural and language differences have resulted in large differences in user behaviour, such as handwriting. This requires vendors to develop localized user interfaces dedicated to the China market. Vendors such as China Wireless (under Coolpad) are enjoying solid sales in China because they have a better understanding of Chinese consumers, in our view.

Entry-level smartphones to form a distinctive ecosystem in China

Entry-level smartphones to form a different ecosystem

There has been debate about whether entry-level smartphones will result in fragmentation of the Android platform, given some applications can be used only on high-end models. We think the answer is "yes". Still, given the large market size in China (79mn smartphones by 2013, in our estimate), the Android OS for entry-level smartphones will form a distinctive ecosystem dedicated to entry-level smartphones, in our view.

Two difference between high-end and low-end smartphones

Although the software developed for high-end smartphones also works on low-end models if they are based on the same version of Android OS, given the difference in user experience and associated service plans, we believe entry-level smartphones will be used mainly to access a subset of mobile applications.

Difference vs. high-end smartphone 1: user experiences

As illustrated in the Exhibit below, typical entry-level smartphones use a 600MHz CPU with a 2.8 inch screen today versus high-end Android phones, which use an above-1GHz CPU and an above-3.5 inch screen. These hardware differences could result in a large difference in user experience, and disappoint some who buy an entry-level smartphone looking for a user experience similar to that for a high-end smartphone.

Difference vs. high-end smartphone 2: service plan

Operators tend to associate lower data volume for entry-level smartphones in their fully subsidized service plan. For example, China Unicom's free iPhone plan includes 1.1Gbytes traffic vs ZTE's plan for 400Mbytes. We believe this will result in users avoiding video and other data-heavy applications. We see two ways to solve the fragmentation issue:

Solution 1: wait for BOM to decline

- Wait for the BOM (bill of materials) to fall, since hardware costs decline 10-20% y-y anyway, and sub-US$150 smartphones will probably be capable of using those CPU-rich applications in two years' time.

- Be specific to one large country, such as China. Because of language differences, most consumers will use applications written in Chinese, anyway. So, when application developers localize their software for the Chinese market, they can optimize the application performance targeting the popular entry-level smartphones, or operators' reference platforms (such as China Mobile's OPhone or China Unicom's UPhone).

Solution 2: optimization together with localization

Exhibit 30. Comparison between high-end and entry-level smartphones

	iPhone 4 (16G)	ZTE X850
Service plan		
Monthly Fee (RMB)	286	126
Voice (min)	900	320
Data (Mbyte)	1100	400
Hardware Spec		
CPU	1.0GHz	600MHz
Screen size	3.5 inch capacitive	2.8inch resistive
Typical smartphone applications		
Facebook	Y	Y
Google Map	Y	Y
YouTube	Y	N (too data hungry)
Twitter	Y	Y
Angry Bird	Y	N (not enough CPU power)
Evernote	Y	Y

Note: Y/N based on own user experience, service plan is based on China Unicom's cheapest fully subsidized plan

Source: Nomura

Company focus

Company dynamics

Operators

Chinese operators are involved in smartphone development in China by specifying their own smartphone platforms, buying some models directly from vendors via a bidding process (centralized procurement scheme), and paying handset subsidies to promote sales to customers.

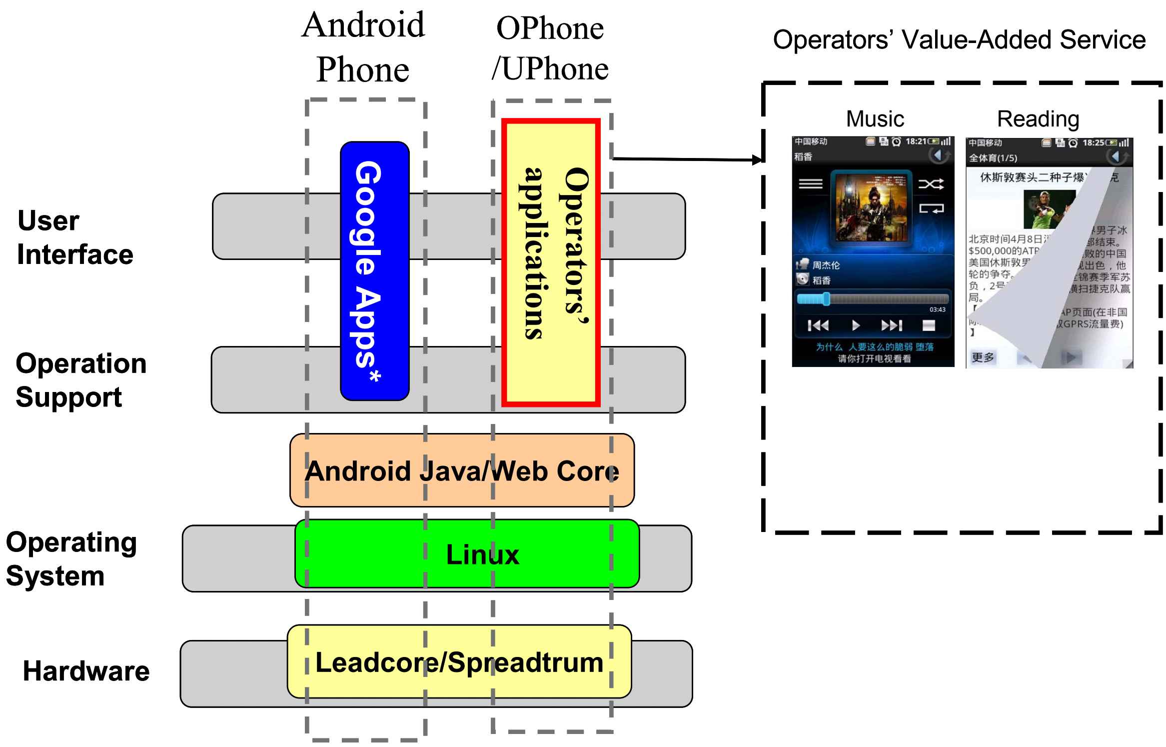
OPhone

The Exhibit below illustrates the structure of China Mobile's OPhone. OPhone is a set of software based on OMS (Open Mobile System), an operating system based on the Android OS and developed by China Mobile. Compared with the original Android OS, OMS adds functions including support for TD-SCDMA technology, CMMS (China Multimedia Mobile Broadcasting, China's mobile TV standard), China Mobile's own value-added services such as music, mailbox, and SNS (to replace the original Google service), and China Mobile's user interface optimized for Chinese-language input.

Good vision, but slow progress

We believe CM's vision in OPhone is to develop a smartphone platform for TD-SCDMA to lower the entrance barrier for TD-SCDMA handset development and help it to accelerate the deployment of value-added services. According to SINO-MR, a China-based IT research firm, from January to September 2010 OPhone shipment volume was 330,000 units, a much lower rate of progress than China Mobile's original plan of 1-2mn during 2010.

Exhibit 31. China Mobile's vision for the OPhone



Source: Company data, Nomura research

We believe that China Mobile will continue to upgrade its OMS platform and invite more international handset brands, while at the same time it will introduce more models using standard smartphone software with the China Mobile service preinstalled to accelerate its smartphone penetration rate.

Long term benefits

Over the long term, we believe, these activities should help China Mobile enhance the "stickiness" of its mobile subscriber base and enhance its ARPU from the higher usage of popular China Mobile applications embedded inside OPhone.

On the other hand, China Mobile is actively in purchasing handsets via the handset bidding system. The Exhibit below shows the result of the most recent bidding round. Local Chinese vendors secured a big portion of market share from this bidding round in November 2010. According to a 10 January 2011 Sina News report, China Mobile plans to purchase 30mn TD-SCDMA handsets during 2011 via the same bidding scheme to boost its 3G subscriber growth. China Mobile requires vendors to support CMMB (China Multimedia Mobile Broadcasting) in their models in order to accelerate the development of a handset TV service in China.

30mn TD-SCDMA handset in 2011

Exhibit 32. China Mobile's TD-SCDMA handset bidding in November 2010

Lower-end 3G (~RMB500)		Mid-range 3G (RMB800-1,000)	
Vendor	**No. of models**	**Vendor**	**No. of models**
ZTE	2	ZTE	1
Coolpad(China Wireless)	1	Coolpad (China Wireless)	1
Lenovo	1	Lenovo	1
Hisenses	1	Huawei	1
Huawei	1	NewPostcom	1
T-smart	1		
Sub-total	7		5
Total			12
Total volume (mn)			6

Source: Nomura research

China Unicom and UPhone

In 2010, China Unicom's smartphone strategy depended mainly on iPhone. To fill the gap in low-end smartphones, the company announced that it would partner with Huawei, ZTE, and other handset manufacturers. It is said UPhone will also run its own variant of Android OS (uniplus) in order to support China Unicom's own mobile applications, but the details have not yet been disclosed.

Even so, China Unicom is also actively purchasing handsets through the bidding scheme. The Exhibit below illustrates the results of latest round of handset bidding, in January 2011. Given their wider choice of handset models, most of the handsets CU purchased were international brands.

Exhibit 33. China Unicom's handset bidding (January 2011)

Vendor	Model
Nokia	2730c
Nokia	7230
Samsung	S3370
Sony Ericsson	J108i
LG	T320
ZTE	E850
Huawei	U7520
Total Model	7
Total volume (mn)	5

Source: Company data

China Telecom: EVDO smartphone

Since the launch of its CDMA mobile business, China Telecom has worked with many handset manufacturers to develop an EV-DO-based smartphone. Based on our rough estimates, we believe there are a minimum of 200 EV-DO handset models compatible with China Telecom's CDMA mobile services. At the moment, China Telecom has around 10 EV-DO-based smartphones, only two of which are priced below RMB1,000. We believe the company will rely on domestic handset manufacturers for the introduction of more models of RMB1,000-priced smartphones in future years.

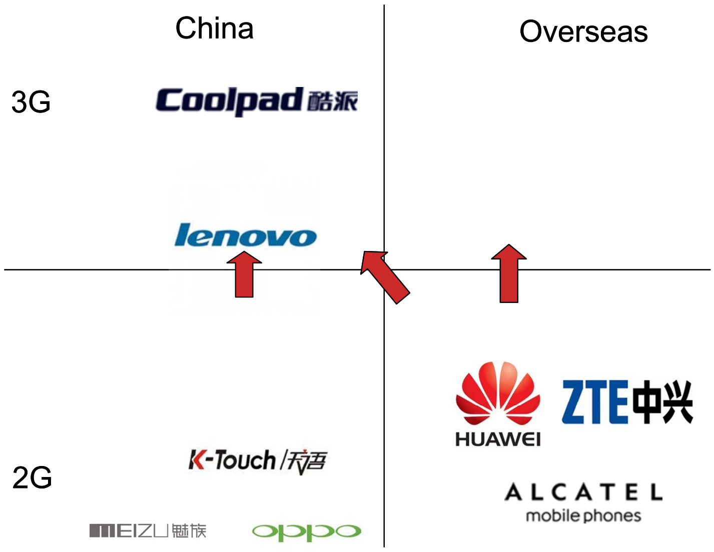
CDMA iPhone

The timing to launch CDMA iPhone will be a major concern between investors given that at the end of 2010 China Telecom was the world's largest CDMA operator by subscriber number. We do not expect an imminent launch of a CDMA iPhone given China Telecom's strong commitment on its financial performance, and China Telecom's strong stance not to be solely reliant on one handset vendor for its CDMA business.

Handset vendors

The next Exhibit compares handset OEMs' current position and future strategy on entry-level smartphones.

Exhibit 34. Exhibit 28. Position of Chinese handset vendors



Source: Nomura research

ZTE: smartphone as a growth driver

ZTE launched more than 10 Android-based smartphones in 2010 for Chinese and European operators, mainly in the entry-level segment (sub US$200). We expect ZTE to ship 5mn smartphones in 2011F, up from 2mn in 2010, and for revenue contribution from smartphones within the handset and data card (terminal) segment to rise to 15% in FY11F, from less than 5% in FY10.

Top share in China Mobile

Compared with other Chinese handset vendors, factors that differentiate ZTE are its strong relationships with global operators via business relations on wireless equipment, and its strong R&D capability covering all three 3G technologies. For example, in the latest round of China Mobile' TD-SCDMA centralized procurement (volume: 6mn units) in November 2010, the company secured the largest market shares (3 of 12 models, roughly 25% volume share).

Huawei: handset and data card sales volume reached 120mn in 2010

Huawei's terminal business sales reached US$4.5bn in 2010, and handset and datacard shipment volume reached 120mn units (~30% y-y) in 2010. Within the terminal business, 25% of sales were generated from the China market, and 75% was generated from the overseas market (company data).

Smartphones: targeting 12mn in 2011F, from 3mn in 2010

According to *Sina News*, the company has shipped more than 3mn smartphones in 2010, driven by its IDEOS-brand entry-level smartphone, and is targeting the shipment of 12mn smartphone units in 2011.

TCL Communications: leverage global scale

Sales from the China market accounted for less than 10% of TCL Communications' total sales in FY10F. Given the fast growth of 3G handset sales in the Chinese market, TCL is also involved in development for Chinese operators. We think TCL's strategy is to maximize the scale benefit by customizing existing global models into a new series of mobile Internet phones targeting domestic consumers. The company expects China and the APAC region to contribute one-third of total sales in two-three years.

Chinese Wireless: heading toward the mid-range to low-end markets

China Wireless is a high-end handset maker in China focusing on China Telecom and China Mobile. It has strong technical competence in localized user interface software and dual-mode dual-working handset (CDMA/GSM or TD-SCDMA/GSM). To support operators' 3G growth strategy focusing on low-end segments, the company has been launching low-end 3G models (less than RMB500) since 2H10, and we forecast the company to deliver 52% and 24% revenue growth in FY11/12F backed by strong 3G handset demand in China.

Lenovo: LePhone

Lenovo is the leading PC brand in China. While it specializes in mobile computing, the company still has limited exposure to the smartphone area. Lenovo debuted its first smartphone, "LePhone," in January 2010. Lenovo is working with telecom service providers in China and leveraging its existing channel advantages in an effort to capture growth opportunities from 3G applications in the China market.

While LePhone gained much attraction after its official launch, shipments were slow in the September quarter due to panel shortages. Lenovo shipped 120,000 smart phones in the September quarter. While management has maintained its confidence in its ability to ship 1mn smartphones before May 2011, we believe Lenovo will need to speed up its marketing and promotion activities in the next quarter and reach 400,000-500,000 in quarterly shipments to meet its target. Given competitors' aggressive moves in penetrating the Chinese smartphone market, coupled with remaining small scale, we expect very limited earnings contribution from Lenovo's smartphone business. As smartphones require more R&D support for the Android platform compared with feature phones or PC-related products, we expect rising R&D expenses from the smartphone business if Lenovo plans to widen its product offering.

The Exhibit below illustrates popular handset models manufactured by Chinese and international vendors. From this Exhibit, we can see that in 2010 Chinese vendors were focusing mainly on low-end segment (RMB1,000/USD$150) smartphones. Lenovo was the first Chinese vendor to enter a mid-range model, but by the end of 2010 other vendors had started to enter this market as well (Meizu's M9, Huawei's IDEOS X5 and K-Touch's W700).

Exhibit 35. Popular smartphones in China in 2010

Brand	**Apple**	**Apple**	**Samsung**	**HTC**	**Motorola**	**Nokia**	**Lenovo**	**Lenovo**
Model	**iPhone 3GS**	**iPhone 4**	**Galaxy S**	**Desire HD**	**Droid X**	**N8**	**LePhone**	**O1**
Photo								
Wireless	HSPA/GSM	HSPA/GSM	WCDMA CDMA2000 TD-SCDMA	HSPA/GSM	CDMA2000 /EVDO	HSPA/GSM	HSPA/GSM	TD-SCDMA /GSM
Screen size (inch)	3.5	3.5	4.0 AMOLED	4.3	4.3	3.5 AMOLED	3.7	3.5
Touch screen	Capacitive	Capacitive	Capacitive	Capacitive	Capacitive	Capacitive	Capacitive	Capacitive
Processor	ARM Cortex A8 600 MHz	Apple A4 1GHz	ARM Cortex A8 1GHz	Qualcomm Snapdragon 1GHz	TI OMAP 3630 1GHz	ARM 11 680 MHz	Snapdragon 1GHz	624MHz
OS	iOS	iOS	Android 2.2	Android 2.2	Android 2.2	Symbian^3	Android 2.1	OMS 1.0
Camera (m pixels)	3MP	5MP	5MP	8.0	8MP	12MP	3MP	5MP
Announced	June-2009	June-2010	March-2010	Sep-2010	May-2010	Apr-2010	May-2010	Sep-2009
Retail price (RMB)	RMB3,500	RMB5,000	RMB3,200	RMB3,150	RMB3,150	RMB3,800	RMB2,700	RMB1150
Brand	**ZTE**	**ZTE**	**Huawei**	**Huawei**	**Coolpad**	**TCL**	**Meizu**	**K-Touch**
Model	**X850**	**V880/Blade**	**Ideos/U8150**	**Ideos X5/U8800**	**W711**	**OT-980**	**M9**	**W700**
Photo								
Wireless	HSPA/GSM	HSPA/GSM	HSPA/GSM	HSPA/GSM	HSPA/GSM	HSPA/GSMMSM	HSPA/GSM	HSPA/GSM
Screen size (inch)	2.8	3.5	2.8	3.8	3.5	2.8	3.5	3.8
Touch screen	Resistive	Capacitive	Capacitive	Capacitive	Resistive	Resistive	Capacitive	Capacitive
Processor	Qualcomm MSM 7227 (600MHz)	Qualcomm MSM 7227 (600MHz)	Qualcomm MSM 7225 528MHz	Qualcomm MSM 7230 800MHz	STE PHX6715 468MHz	Qualcomm MSM7227 600MHz	Samsung S5PC110 1GHz	NVIDIA Tegra 2 1GHz
OS	Android 2.1	Android 2.1	Android 2.2	Android 2.2	Android 2.1	Android 2.1	Android 2.2	Android 2.3
Camera (m pixels)	3MP	3MP	3MP	5MP	2MP	2MP	5MP	8MP
Announced	June-2010	Oct-2010	Sep-2010	Dec-2010	Sep-2010	Sep-2010	Dec-2010	Dec-2010
Retail price	850	US$150	1199	2,600	1.500	US$150	2,500	na

Source: GSM Arena, PC Online, ZOL.

Distributors/retailers

Synnex: handsets to contribute 30% of sales by 2013F, from 15% in 2009

In addition to the PC business, Synnex has entered China's handset distribution market to secure further growth momentum. We expect the handset distribution sales mix to rise for Synnex in the coming years given its strengthening relationship with Nokia. In 2010, Synnex distributed 10% of Nokia's handsets with the main focus on smartphones. Synnex's major competitors include Telling Telecom and China Postel, with market share of 29% and 29%, respectively. However, as the leading players have reached dominant market shares, coupled with Synnex's cost advantages, inventory management capability, and strength in IT distribution network, we believe Synnex still has ample room for further growth in China's handset distribution market. Synnex targets to increase its handset distribution sales mix to 30% within three years, versus 15% in 2009.

Digital China: focus on Apple/RIM/HTC now

We think Digital China has a conservative view on feature phone distribution because there are few overlaps with its existing distribution network for its core PC distribution business, as well as its painful experience in 2003/2004 due to large inventory write-offs. However, the company is involved in smartphone distribution. The company is one of Apple's largest distributors in China, and distributes products including the iPad and the iPhone in more than 200 authorized shops. We estimate that sales from handset distribution accounted for 5% of its distribution business in FY10, and it focuses on Apple, RIM, and HTC. We believe the smartphone trend is triggering the convergence of PC and handset distribution in China, and believe the company can leverage its PC distribution network to capitalize on the rising smartphone trend. We forecast sales from handset distribution will contribute ~15% of Digital China's distribution business in FY12.

Gome: smartphone sales take off from 2H2010

According to Gome, demand for new products is high owing to rising incomes and improving lifestyles. For example, smartphones already account for 40% of handset sales, although they were rolled out on a large scale only in 2H10. Also, 3G mobile phones have maintained their sales momentum and now account for 30% of Gome's handset sales. We believe the new products bode well for SSS and sales efficiency improvement, given their relatively high ASPs.

TCL Communication Tech 2618 HK

TECHNOLOGY | CHINA

Initiation

BUY

NOMURA

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Action

We initiate coverage of TCL Communication Technology (TCT) with a BUY rating and a price target of HK$11.00, implying potential upside of 36% from the current level. We believe the market has yet to recognise TCT as a key beneficiary of the popularity of social-network services (SNS) in emerging markets. Growth in the company's SNS phone and entry-level smartphone business offer a distinct ASP and margin-expansion story within handset OEMs, in our view.

Catalysts

New product launches and higher-than-expected market growth are potential catalysts.

Anchor themes

We forecast the smartphone market will see a 29% unit CAGR over 2010-13, and China will become the second-largest smartphone market by volume in 2013, driven by the take-off of the entry-level smartphone segment.

Closing price on 20 Jan	HK$8.08
Price target	**HK$11.00**
Upside/downside	36.1%
Difference from consensus	69.2%
FY11F net profit (HK$mn)	1,010
Difference from consensus	18.5%

Source: Nomura

Nomura vs consensus

Our FY11F sales and earnings are 17% and 19% above consensus estimates: we are more confident on TCL's ASP and margin expansion owing to SNS and smartphones.

From SNS to smartphones

① Beneficiary of SNS phones in emerging markets

From being a basic handset (sub-US$50) vendor, TCT has successfully penetrated the feature-phone market by capturing the social-network trend in emerging markets with competitive products. In addition to the SNS phone, the company launched its first Android-based smartphone in 2010, and plans to launch another 13 models in 2011. We estimate these new products will help the company deliver 42% and 45% revenue growth in FY11F and FY12F.

② Alcatel DNA provides the edge for its global expansion

Differentiating TCT from other Chinese handset vendors is the company's European market-focused design team, localised global distribution network and well established brand (Alcatel), all inherited following the acquisition of Alcatel's handset business in 2004/2005. This acquisition is providing the springboard for TCT's faster global expansion than its Chinese handset peers, in our view.

③ Step-up strategy: a margin and ASP expansion story

The company is adopting a "step-up" strategy, shifting from basic phone OEM before 2008 to feature-phone OEM in 2009-2010, and entry-level smartphone OEM beyond 2011. Although this strategy could risk the company losing its existing ODM process, if it is successful, we think it could lead to a margin and ASP expansion story – something that is quite uncommon in the technology sector these days. We believe the Android OS has effectively reduced the technology barrier for the "step-up" strategy, and think the company can succeed in the near future.

④ PT of HK$11.00; 36% potential upside

Our price target is based on 12x FY11F EPS of HK$0.94, in line with the average P/E of global branded handset names. We are neutral on the impact of the company's proposed issue of Taiwan depositary receipts (TDR), as we see the dilution effect likely to be offset by a revaluation of Hong Kong tech stocks relative to those in Taiwan.

Key financials & valuations

31 Dec (HK$mn)	FY09	FY10F	FY11F	FY12F
Revenue	4,361	8,506	12,044	15,772
Reported net profit	23	706	1,010	1,408
Normalised net profit	23	706	1,010	1,408
Normalised EPS (HK$)	0.03	0.66	0.94	1.31
Norm. EPS growth (%)	(25.9)	2,521.8	42.9	39.3
Norm. P/E (x)	321.8	12.6	8.8	6.3
EV/EBITDA (x)	45.4	11.4	7.0	4.8
Price/book (x)	6.8	5.4	3.8	2.6
Dividend yield (%)	0.5	2.4	3.5	4.9
ROE (%)	2.1	52.4	51.8	50.3
Net debt/equity (%)	47.1	net cash	net cash	net cash
Earnings revisions				
Previous norm. net profit		na	na	na
Change from previous (%)		na	na	na
Previous norm. EPS (HK$)		na	na	na

Source: Company, Nomura estimates

Share price relative to MSCI China

	1m	3m	6m
Absolute (HK$)	6.3	26.3	127.0
Absolute (US$)	6.3	25.9	126.8
Relative to Index	2.6	28.6	114.8
Market cap (US$mn)			1,140
Estimated free float (%)			36.6
52-week range (HK$)			8.19/1.78
3-mth avg daily turnover (US$mn)			2.11
Stock borrowability			
Major shareholders (%)			
TCL Corp			56.4
Leung (Lai Bing)			6.1

Source: Company, Nomura estimates

Summary

Executive summary

Making it in the featurephone market

From being a basic handset (sub US$50) vendor, TCT has successfully penetrated the feature-phone market by capturing the social-network trend in emerging markets with competitive products. In addition to the SNS phone, the company launched its first Android-based smartphone in 2010, and plans to launch another 13 models in 2011. We estimate these new products will help the company deliver 42% and 45% revenue growth in FY11F and FY12F.

Valuation methodology

PT: 12x FY11F P/E

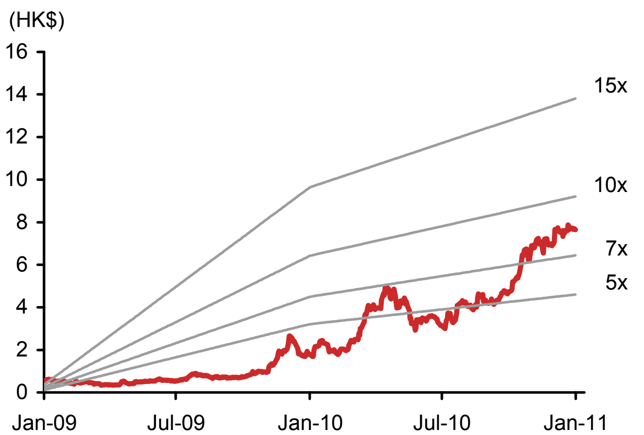
Our price target is based on 12x FY11F EPS of HK$0.94, the average P/E of global branded handset names and OEMs. We expect the convergence of valuation between branded handset names and OEMs along with the development of Android OS to support the company in achieving a 12x P/E multiple.

Exhibit 36. Valuation snapshot

				Price	Price	Mkt cap	P/E (x)		P/B(x)		ROE (%)
Ticker	Name	Rating	Crny	20-Jan	target	(US$mn)	FY10F	FY11F	FY10F	FY11F	FY10F
2618 HK	TCL Com	BUY	HK$	8.08	11.00	1,139	12.3	8.6	5.4	3.8	52.4
2369 HK	China Wireless	NEUTRAL	HK$	4.60	4.50	1,242	17.4	14.6	7.4	4.1	50.9
763 HK	ZTE	BUY	HK$	29.95	36.00	10,536	25.2	19.8	3.8	3.3	16.1
285 HK	BYD Electronic	BUY	HK$	5.13	5.90	1,485	10.0	8.8	1.3	1.1	14.0
2038 HK	Foxconn	REDUCE	HK$	5.67	4.2	5,244	n.a	n.a	10.7	10.1	3.8
NOK1V FH	Nokia	NEUTRAL	EUR	7.84	8.4	39,254	13.8	12.4	2.0	2.0	14.9
ERICB SS	Ericsson	BUY	SEK	76.70	91.0	37,479	12.5	11.8	1.8	1.7	14.6
RIMM US	RIM	NEUTRAL	US$	62.92	65.0	32,846	na	9.9	na	3.8	37
MMI US	Motorola Mobility	REDUCE	US$	35.04	22.5	10,305	na	62.6	na	2.0	na
2498 TT	HTC	BUY	NT$	894.00	1,000.0	25,119	18.6	12.6	9.4	7.1	50.2
Median							13.1	12.4	4.6	3.5	15.5

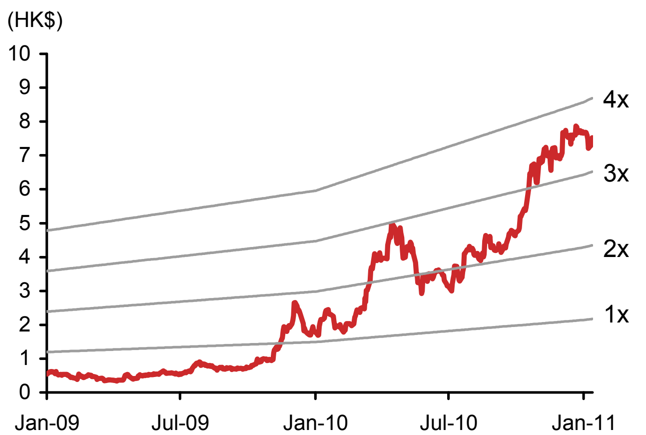
Source: Bloomberg, Nomura estimates

Exhibit 37. 12-month forward P/E



Source: Company data, Nomura estimates

Exhibit 38. 12-month forward P/B



Source: Company data, Nomura estimates

Nomura vs consensus

Our FY11F revenue and earnings forecasts are 17% and 19% above consensus estimates. We think the market has yet to fully appreciate the growth potential of the company's SNS and entry-level smartphones.

Exhibit 39. Nomura vs consensus

	FY10F			FY11F			FY12F		
(HK$mn)	Nomura	Consensus	(%)	Nomura	Consensus	(%)	Nomura	Consensus	(%)
Revenue	8,506	8,139	4.5	12,044	10,286	17.1	15,772	12,351	27.7
Operating income	626	726	(13.7)	956	1,001	(4.5)	1,388	1,206	15.1
Net profit	706	654	7.9	1,010	853	18.5	1,408	1,114	26.4
EPS (HK$)	0.66	0.63	4.5	0.94	0.79	19.1	1.31	0.98	33.8

Source: Nomura estimates; Consensus numbers from Datastream

Risks to our investment view

Intensified competition in 2G SNS phone

We expect competition in the feature-phone market, especially feature-phones for social-network usage, to remain moderate. We believe the company still has price leadership vis-à-vis peers in products that have similar features (such as Nokia C3), but we caution that aggressive marketing undertaken by the likes of Nokia, Samsung Electronics and LG may erode the company's shipment volume.

Unexpected delay in smartphone projects

TCT is planning to launch 13 entry-level smartphone models in 2011 and is rapidly expanding its R&D team. Although the company successfully launched its first smartphone model in September 2010, any unexpected delay in project development will be a downside risk to our forecasts.

Higher-than-expected number of TDR issues

In December 2010, the company announced its TDR listing plan, and the company management got the mandate for less than 20% new share issuance. To be conservative, and considering the company's robust balance sheet (HK$) and future capex plan (including new factory construction), we assume the TDR would involve new shares amounting to 10% of current total shares. The share price of TCT may react negatively if the actual number of new shares issued is much larger than expected, or if the company uses the funds raised for other purposes.

Loss of ODM clients possible owing to conflict of interests

The company is trying to penetrate into the mid-end handset market, and at the same time, supply low-end handset to another handset OEM. The potential for conflict of interest from this arrangement could risk the loss of ODM clients.

Business model

From social network to smartphones

Business model

As a handset vendor, TCT mainly purchases handset chipsets and other components such as LCD panel and casing. The company's main supplier of 2G handset components is MediaTek. According to TCT, it was MediaTek's biggest customer in FY09. However, unlike most white-box vendors that rely on MediaTek's turnkey solution, TCT designs the handset platform itself. This gives TCT flexibility in terms of component sourcing and cost advantages against other Chinese handset vendors. For 3G smartphones, it mainly uses chipsets provided by Qualcomm.

Largest customer of MediaTek

2G chipsets are the most expensive components in low-end handsets, according to the company. A sharp decline in the average selling price (ASP) of 2G chipsets due to intensified competition among MediaTek, Spreadtrum, and MStar has lifted the company's gross-profit margin. According to Aaron Jeng, an analyst of our Taiwan tech team, the ASP of GSM/EDGE chipsets declined by about 40% in 2010. Aaron expects another 10-15% decline in 2011F, owing to intensified competition between the two major 2G chipset suppliers, MediaTek and Spreadtrum.

Beneficiary of intensified competition among MediaTek, MStar and Spreadtrum

The company has major R&D centres located in Shenzhen and Milan and, as of end-2010, had more than 1,300 R&D engineers. Its current R&D resources are allocated mainly to developing feature-phones suitable for the European and South American markets, but cannot accommodate the rising number of new model projects, especially social-network and smartphone models.

R&D centres in China and Italy

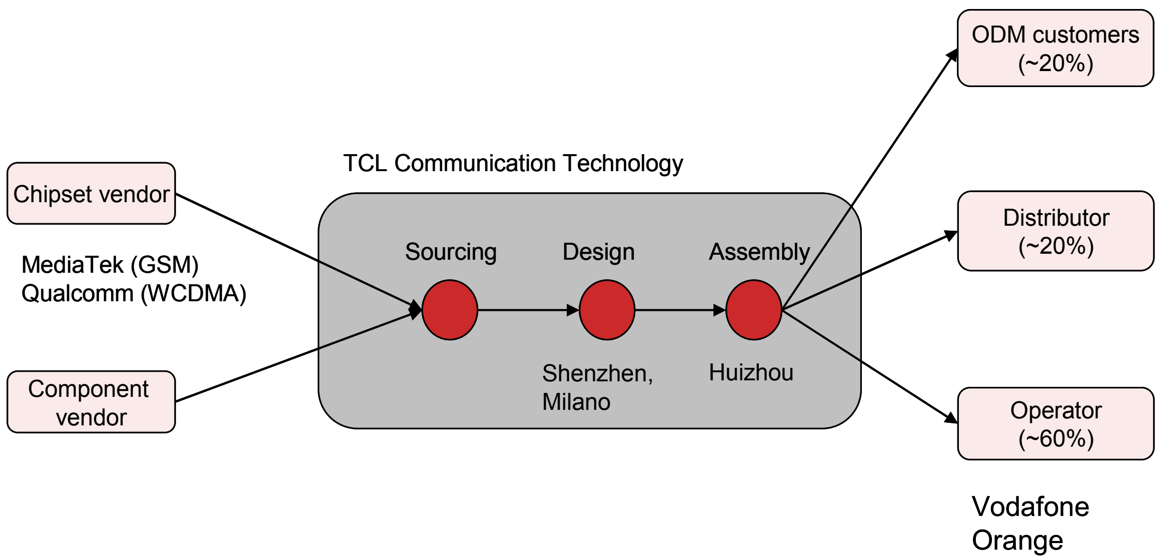
To fit the company's strategy in the entry-level smartphone segment, TCT is recruiting new R&D resources for smartphone-related projects. It is also leveraging more external R&D resources, such as design houses for the smartphone.

Increasing R&D efforts on China products and smartphones

TCT has one handset factory located in Huizhou. TCT Corp's headquarter has a maximum manufacturing capacity of 50mn units per year. With its strong sales momentum, the company has said that it is considering expanding its manufacturing capacity to 70mn units per year by 2012.

50mn units annual capacity, targeting 70mn by 2012

Exhibit 40. Manufacturing process



Source: Nomura research

Alcatel's distribution network became an important asset during recovery

The company inherited its overseas sales and distribution network from Alcatel. Unlike Huawei and ZTE's distribution network, which was mainly established and is managed by Chinese employees sent from the headquarters, TCT's network is fully operated by local employees that have a better understanding of the local market. This has become an important asset for the company during the recovery from the financial crisis and, we think, provides it with an edge over other Chinese handset vendors pursuing overseas expansion.

- Operator channel (~60% of FY10F sales): The company mainly sells its product to global operators under the Alcatel brand. It has inherited customer relationships between Alcatel and major European and South American operators – including Vodafone, Orange, Telefornia, America Movil, and T-Mobile – through acquisition, and supplies them with a wide range of products from basic phone to entry-level smartphones.
- Open-market channel (~20% of FY10F sales): It mainly sells its products to global chain stores including those in Western Europe and Russia.
- ODM customer (~20% of FY10F sales): The company started to design and sell handsets for other handset vendors and operators under customers' brandnames (ODM model) from 4Q09 to better utilise idle capacity. Currently, its ODM business has both lower ASP and gross margin than its own Alcatel and TCT brand products. However, the company is also looking to produce more mid-end products including smartphones for its ODM clients to improve ASP and gross margin.

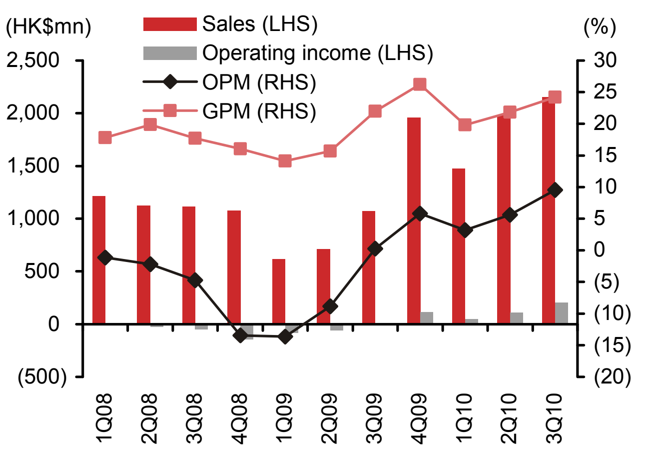
Revenue analysis

Result review: a typical turnaround story

The company operated at a loss during the financial crisis as a result of a sudden drop in demand, but it recovered quickly from 3Q09 due to: 1) significant market-share gains in Latin America driven by the successful launch of Qwerty keyboard models; 2) substantial growth in the low-end handset market in Africa, and 3) lack of competition in the low-end market as other vendors exited the market (eg, Sony Ericsson).

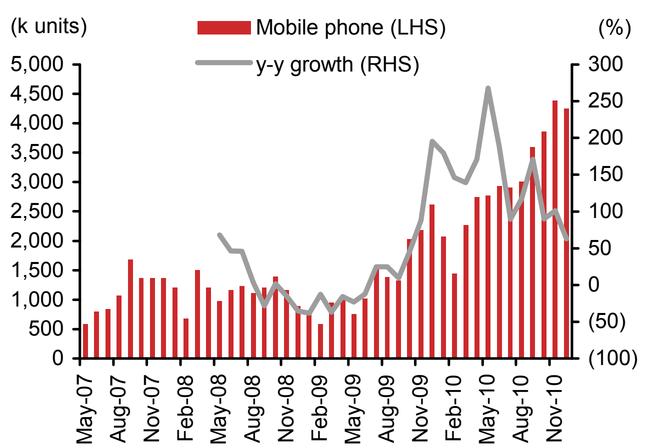
The company's monthly shipment volume surpassed 4mn in 2H 2010 and it continues to witness high volume growth currently, according to the company.

Exhibit 41. Quarterly revenue and profit margin trend



Source: Company data

Exhibit 42. Monthly shipment volume



Source: Company data

We believe there are three drivers that will sustain TCT's growth in FY11F: 1) SNS phones; 2) entry-level smartphones, and; 3) the market in China.

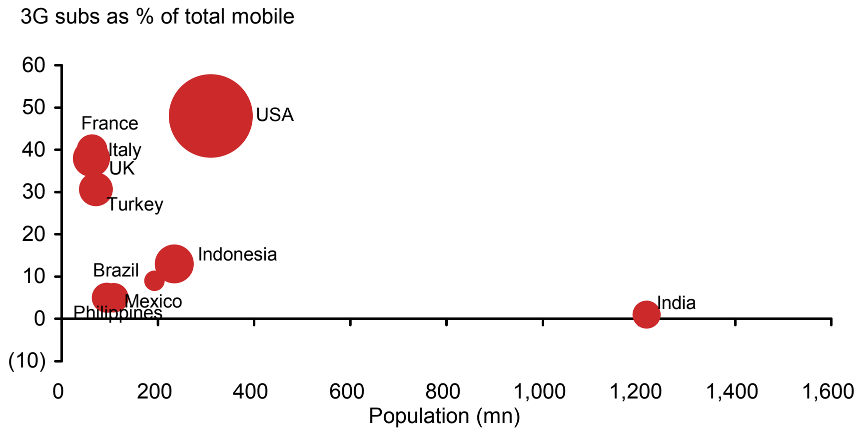
According to feedback from the company, other handset vendors and telecom operators, we believe there is strong demand for the Qwerty keyboard GSM handset in emerging countries to access social-network applications.

For example, the Exhibit below shows Indonesia has the most Facebook users outside the US with 32mn subscribers (9% of total), but its 3G penetration rate is only 13% according to our estimates. India, Turkey and the Philippines are in a similar situation to Indonesia. In those countries, mobile users prefer to use Qwerty keyboard GSM handset to access social networks, which generates huge demand for such products.

SNS likely to provide a short-term growth driver

The company launched handset OT-800 in 2009, one of the first Qwerty keyboard models priced below US$100. This product has received strong support from consumers, and is driving revenue growth now, according to the company.

Exhibit 43. Facebook population distribution



Source : IMF, ITPopular.com, Checkfacebook.com, WCIS, Nomura research

Entry-level smartphone as the next growth stage

We believe the launch of Android-based smartphones and tablets and the rising ratio of mid-range Qwerty keyboard handsets within the whole handset portfolio will likely improve the company's product mix in FY11F and FY12F. We forecast the company's blended ASP will grow by 10% in FY11F and 8% in FY12F.

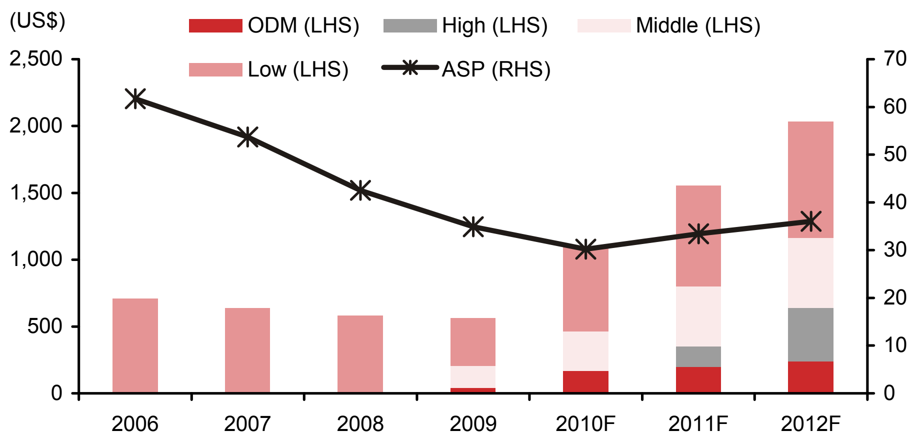
Strong smartphone pipeline in FY11

The company successfully launched its first Android-based smartphone (OT-980) in September 2010 for the European market. It plans to launch another 13 Android-based phones in 2011.

Advantages and disadvantages to other Chinese vendors

Compared to other Chinese vendors making similar Android-based entry-level smartphones, we believe the company has an advantage including: 1) strong relations with global operators and experience; 2) Alcatel brand recognition in Europe and America, and; 3) low-cost high-quality manufacturing know-how. However, it currently lags in smartphone development experience, including user-interface design.

Exhibit 44. ASP recovering as product mix improves



Source: Company data from 2006 to 2009; Nomura estimates

China Strategy: leverage strength in global volume

Sales from China accounted for less than 10% of TCT's total sales in FY10F. Given strong growth of 3G handsets in the Chinese market, TCT is also actively involved in the development of 3G handsets for Chinese operators. TCT's strategy is to maximise the scale benefits by customising existing global models into new series of mobile Internet phones targeting domestic consumers. The company is expecting China and the APAC region to contribute one-third of total sales in the next two to three years.

Long-term strategy

TCL's step-up strategy

The company is executing a long-term product strategy named "step-up". From gradually penetrating the basic phones business in 2007 and entry-level cameras and music phones in 2008-09 to SNS phones in 2009-10, the company has delivered a good record in the low-end markets and now aims to penetrate the mid-range market in 2011.

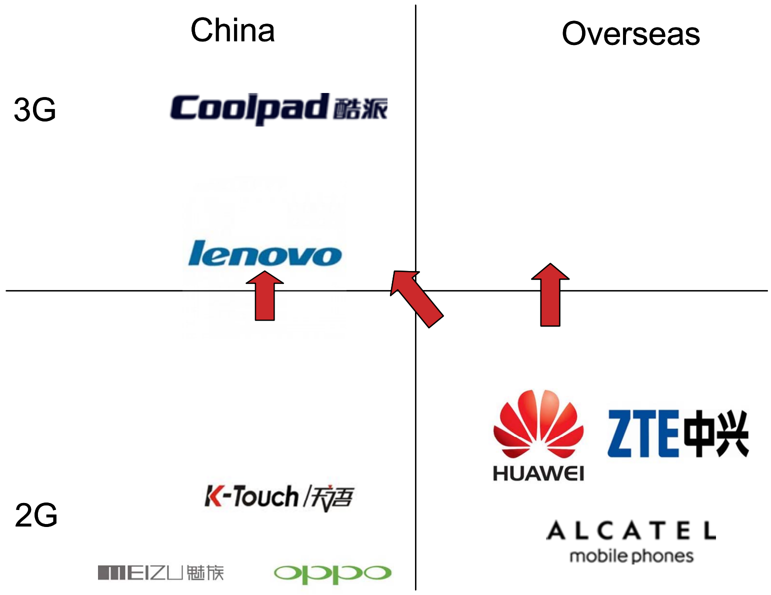
Exhibit 45. Company's "step-up" strategy

Source: Nomura research

A painful process, but Android makes it less painful

We believe the "step-up" process will be painful, given the technology barriers of moving from the low- to the high-end market and the risk of losing existing handset OEM clients if there is any conflict of interest among clients. However, as mentioned earlier, we believe the emergence of smartphone OS Android has greatly reduced the technology barriers, and the reduced competition in the low- to mid-end handset market — due to the weakening positions of Nokia, Sony Ericsson and LG — has helped cushion the company from potential loss of clients.

Exhibit 46. The company's position within Chinese handset OEMs



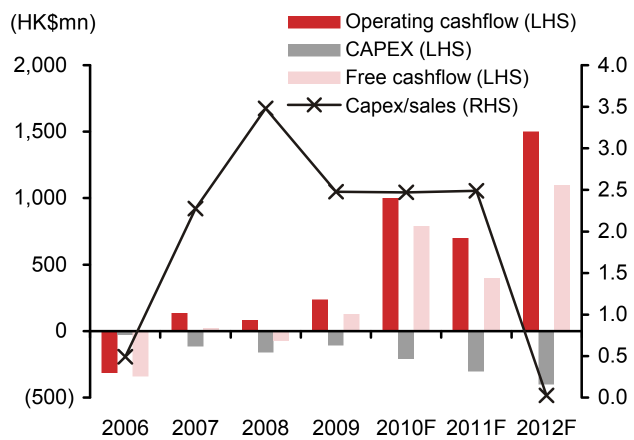
Source: Nomura research

Financial analysis

Healthy cashflow and strong balance sheet

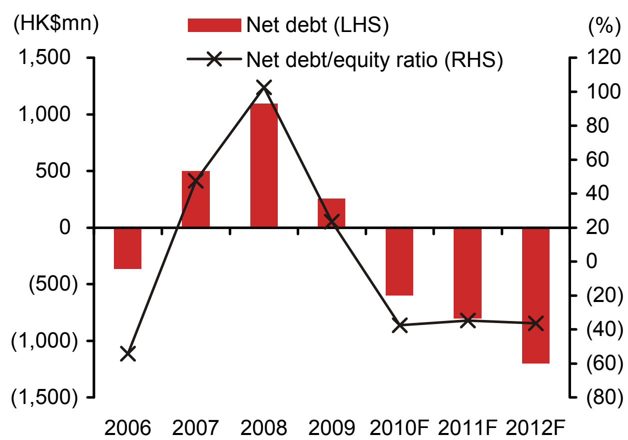
We see TCT capable of delivering strong free cashflow and maintaining a good cash position.

Exhibit 47. Cashflow analysis



Source: Company data, Nomura estimates

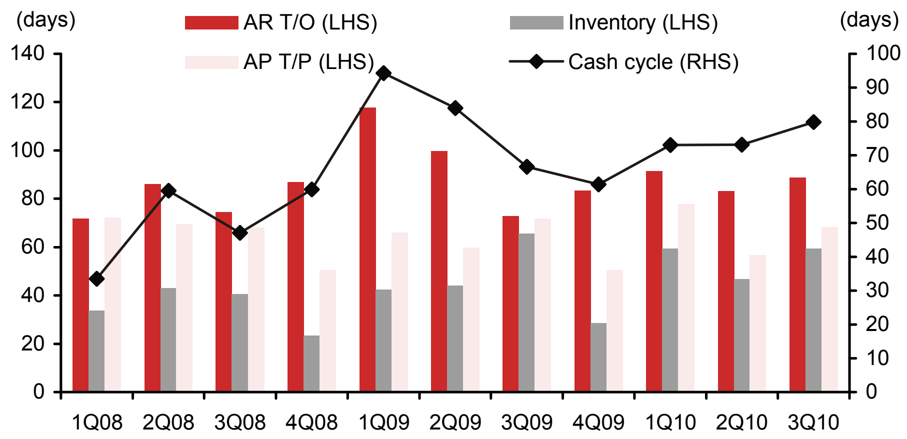
Exhibit 48. Net cash and cash/equity ratio



Source: Company data, Nomura estimates

The company's cash cycle increases slightly due to recent geographical expansions.

Exhibit 49. Working capital trend



Source: Company data, Nomura estimates

TDR Listing

The company announced that it would proceed with a TDR listing in December 2010. Considering its strong net cash position (HK$170mn at end-FY10F) and cash flow, we assume the listing will likely involve new shares amounting to 10% of current shares, and the funds raised will be used for the construction of its factory (~HK$100mn for land and initial construction, plus equipment) in 2011-12. Considering the regulatory restrictions of the Hong Kong Stock Exchange, we expect the actual TDR listing process to happen between March and April 2011.

Neutral to existing shareholders

We believe the impact of the TDR listing is likely to be neutral to existing shareholders. Although it will likely have a ~10% dilution effect on existing shareholders, according to the company, it could also prompt a valuation correction in Taiwan tech stocks, since the Hong Kong tech sector trades at a discount to Taiwan.

Company background: a turnaround story

TCL Corp's handset arm

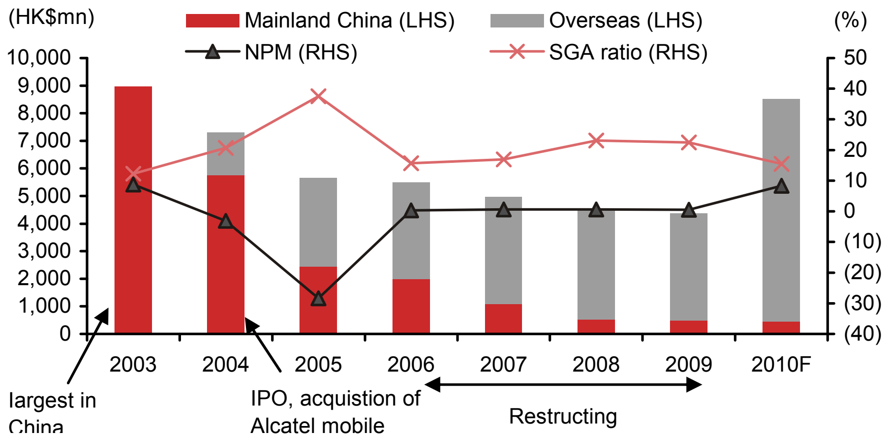
TCL Communication Technology (previous known as TCL Mobile) was established in 1999 as TCL Group's handset arm. TCT was the largest Chinese handset vendor by sales in 2003 in the China market before the emergence of the white-box trend, and pursued overseas expansion by first forming a joint venture with Alcatel's mobile phone unit in 2004 with a 55% stake. It later acquired the whole JV in 2005.

Painful period after acquisition

The company suffered from revenue and market-share losses from 2003 due to competition with white-box vendors and rising high fixed costs associated with its parallel business operations in France and China.

After a series of restructuring exercises, including merging product lines for the global and China markets, focusing on low-end handset segments for the major five operators in Europe and South America, and relocating and centralising its finance operation and production units to China, the company improved its operating efficiency; SG&A-to-sales reduced from 37% in 2005 after the acquisition of the whole JV to 23% in FY08.

Exhibit 50. Revenue and earnings trend



Source: Nomura research; actual data from 2003 to 2009

Alcatel asset key for recovery

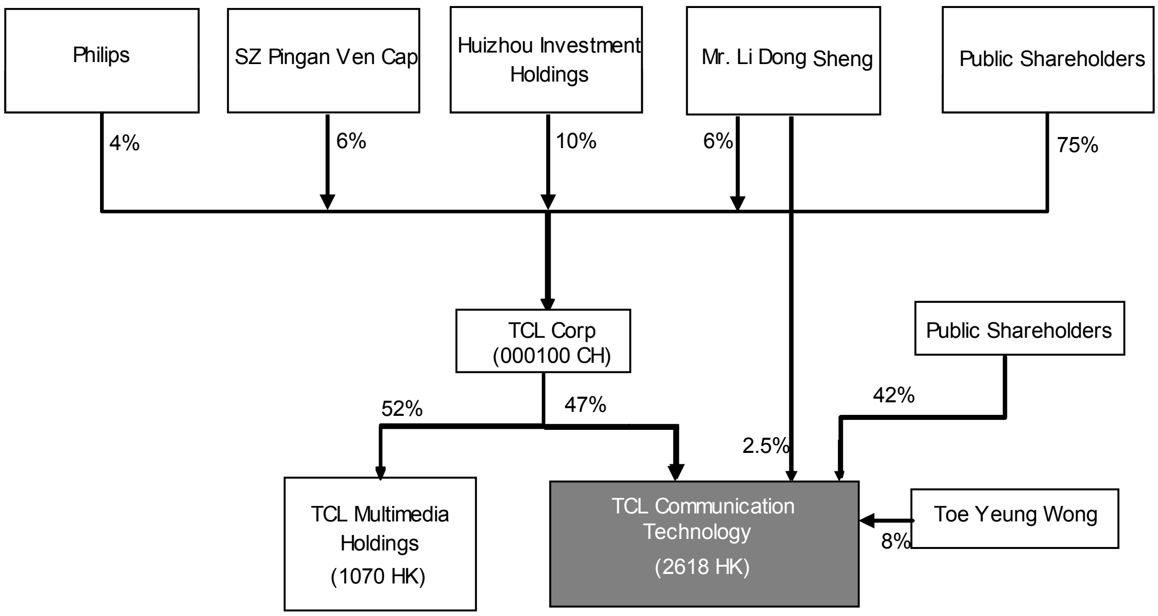
Although Alcatel's handset business has proved to be a heavy overhead over the past few years, it has helped TCT gain several important assets, including: 1) Alcatel's sales and distribution channels in South America and EMEA; 2) Alcatel's handset design process and quality-control system suitable for operator-level product production; and 3) a design team and design philosophy suitable for European markets. We believe these assets helped TCT to recover in 2010, and will likely continue to support TCT's expansion to the mid-range smartphone market in 2011.

Shareholder structure

Shareholder structure

TCL Corp is the largest shareholder of TCL Communication Technologies with a 47% stake. Dongsheng Li, founder and chairman of TCL Corp, holds a 3.25% share. TCL Group's TV business is listed on the Hong Kong Stock Exchange as TCL Multimedia (1070 HK, not rated). TCL Group is listed on the Shenzhen Stock Exchange, and the major shareholders of TCL Corp include Dongsheng Li, the Huizhou city government, the Shenzhen city government, and Philips.

Exhibit 51. Shareholder structure



Source: Bloomberg, Nomura research

Management team

Mr Dongsheng Li, Chairman and President

Li Dongsheng, founder of TCL Corporation, is responsible for overseeing the company's corporate strategies and operations. He has more than 20 years of experience in manufacturing and sales of electronic products. He holds a Bachelor's Degree in Science from South China University of Technology.

Dr Aiping Guo (George), CEO and Vice President

Dr Aiping Guo joined TCL Group in 2001 and was appointed the COO, Senior Vice President and President of the company in 2010. Prior to joining TCL, Mr. Guo held positions as Project Coordinator for IBM, Senior Business Consultant in Arthur Andersen and Chief Technology Officer in Zhaodaola Internet Company. Dr. Guo graduated from Stanford University with a Ph.D. in Management Science.

Financial statements

Income statement (HK$mn)					
Year-end 31 Dec	**FY08**	**FY09**	**FY10F**	**FY11F**	**FY12F**
Revenue	4,538	4,361	8,506	12,044	15,772
Cost of goods sold	(3,727)	(3,412)	(6,563)	(9,287)	(12,071)
Gross profit	**812**	**949**	**1,942**	**2,757**	**3,701**
SG&A	(927)	(850)	(1,317)	(1,801)	(2,313)
Employee share expense					
Operating profit	**(115)**	**99**	**626**	**956**	**1,388**
EBITDA	**42**	**207**	**726**	**1,156**	**1,588**
Depreciation	(158)	(108)	(100)	(200)	(200)
Amortisation	-	-	-	-	-
EBIT	**(115)**	**99**	**626**	**956**	**1,388**
Net interest expense	(68)	(46)	-	-	-
Associates & JCEs	-	-	-	-	-
Other income	220	(19)	142	143	143
Earnings before tax	**36**	**34**	**768**	**1,099**	**1,531**
Income tax	(8)	(11)	(62)	(88)	(123)
Net profit after tax	**28**	**23**	**706**	**1,010**	**1,408**
Minority interests	-	-	-	-	-
Other items					
Preferred dividends					
Normalised NPAT	**28**	**23**	**706**	**1,010**	**1,408**
Extraordinary items					
Reported NPAT	**28**	**23**	**706**	**1,010**	**1,408**
Dividends	-	(38)	(212)	(303)	(422)
Transfer to reserves	**28**	**(15)**	**494**	**707**	**985**
Valuation and ratio analysis					
FD normalised P/E (x)	2,182.3	321.8	12.6	8.8	6.3
FD normalised P/E at price target (x)	2,970.9	438.1	17.1	12.0	8.6
Reported P/E (x)	238.5	321.6	12.3	8.6	6.2
Dividend yield (%)	-	0.5	2.4	3.5	4.9
Price/cashflow (x)	80.9	31.2	8.7	12.4	5.8
Price/book (x)	6.9	6.8	5.4	3.8	2.6
EV/EBITDA (x)	245.6	45.4	11.4	7.0	4.8
EV/EBIT (x)	na	94.6	13.2	8.4	5.5
Gross margin (%)	17.9	21.8	22.8	22.9	23.5
EBITDA margin (%)	0.9	4.7	8.5	9.6	10.1
EBIT margin (%)	(2.5)	2.3	7.4	7.9	8.8
Net margin (%)	0.6	0.5	8.3	8.4	8.9
Effective tax rate (%)	21.4	32.5	8.0	8.0	8.0
Dividend payout (%)	-	163.3	30.0	30.0	30.0
Capex to sales (%)	3.5	2.5	2.5	2.5	2.5
Capex to depreciation (x)	1.0	1.0	2.1	1.5	2.0
ROE (%)	2.7	2.1	52.4	51.8	50.3
ROA (pretax %)	(3.1)	2.1	9.6	12.0	15.0
Growth (%)					
Revenue	(8.7)	(3.9)	95.0	41.6	31.0
EBITDA	(80.4)	389.5	251.1	59.2	37.4
EBIT	(204.4)	na	531.2	52.7	45.2
Normalised EPS	(27.8)	(25.9)	2,521.8	42.9	39.3
Normalised FDEPS	(25.6)	578.1	2,461.5	43.1	39.3
Per share					
Reported EPS (HK$)	0.03	0.03	0.66	0.94	1.31
Norm EPS (HK$)	0.03	0.03	0.66	0.94	1.31
Fully diluted norm EPS (HK$)	0.00	0.03	0.64	0.92	1.28
Book value per share (HK$)	1.16	1.20	1.49	2.14	3.07
DPS (HK$)	-	0.04	0.20	0.28	0.39

Source: Nomura estimates

One of the lowest SG&A/sales ratio among handset OEMs/brands

Cashflow (HK$mn)					
Year-end 31 Dec	**FY08**	**FY09**	**FY10F**	**FY11F**	**FY12F**
EBITDA	42	207	726	1,156	1,588
Change in working capital	119	(289)	(911)	(400)	(400)
Other operating cashflow	(78)	319	1,185	(56)	312
Cashflow from operations	**84**	**237**	**1,000**	**700**	**1,500**
Capital expenditure	(158)	(108)	(210)	(300)	(400)
Free cashflow	**(74)**	**129**	**790**	**400**	**1,100**
Reduction in investments	(0)	(0)	20	-	-
Net acquisitions					
Reduction in other LT assets					
Addition in other LT liabilities					
Adjustments	(701)	71	(20)	-	-
Cashflow after investing acts	**(775)**	**200**	**790**	**400**	**1,100**
Cash dividends	-	-	(38)	(212)	(303)
Equity issue	6	1,962	357	-	-
Debt issue	808	(606)	-	-	-
Convertible debt issue	-	-	-	-	-
Others	(85)	(1,049)	1,378	12	(397)
Cashflow from financial acts	**729**	**307**	**1,697**	**(200)**	**(700)**
Net cashflow	**(46)**	**507**	**2,487**	**200**	**400**
Beginning cash	709	663	1,170	2,300	2,500
Ending cash	663	1,170	3,657	2,500	2,900
Ending net debt	1,504	516	(600)	(800)	(1,200)

Source: Nomura estimates

Balance sheet (HK$mn)					
As at 31 Dec	**FY08**	**FY09**	**FY10F**	**FY11F**	**FY12F**
Cash & equivalents	663	1,170	2,300	2,500	2,900
Marketable securities	-	-	-	-	-
Accounts receivable	1,261	1,815	3,000	3,900	4,700
Inventories	230	448	700	900	1,200
Other current assets	1,862	2,845	2,892	2,892	2,892
Total current assets	**4,016**	**6,278**	**8,892**	**10,192**	**11,692**
LT investments	20	20	-	-	-
Fixed assets	262	220	600	700	900
Goodwill					
Other intangible assets	-	-	-	-	-
Other LT assets	246	248	200	200	200
Total assets	**4,544**	**6,766**	**9,692**	**11,092**	**12,792**
Short-term debt	2,020	1,685	1,700	1,700	1,700
Accounts payable	591	1,074	1,600	2,300	3,000
Other current liabilities	717	2,551	4,392	4,392	4,392
Total current liabilities	**3,328**	**5,310**	**7,692**	**8,392**	**9,092**
Long-term debt	147	1	-	-	-
Convertible debt	-	-	-	-	-
Other LT liabilities	4	360	400	400	400
Total liabilities	**3,479**	**5,671**	**8,092**	**8,792**	**9,492**
Minority interest	-	-	-	-	-
Preferred stock	-	-	-	-	-
Common stock	715	716	716	716	716
Retained earnings	350	379	884	1,584	2,584
Proposed dividends			-	-	-
Other equity and reserves					
Total shareholders' equity	**1,065**	**1,095**	**1,600**	**2,300**	**3,300**
Total equity & liabilities	**4,544**	**6,766**	**9,692**	**11,092**	**12,792**
Liquidity (x)					
Current ratio	1.21	1.18	1.16	1.21	1.29
Interest cover	(1.7)	2.2	na	na	na
Leverage					
Net debt/EBITDA (x)	35.61	2.50	net cash	net cash	net cash
Net debt/equity (%)	141.2	47.1	net cash	net cash	net cash
Activity (days)					
Days receivable	115.8	128.7	103.3	104.6	99.8
Days inventory	33.9	36.3	31.9	31.4	31.8
Days payable	80.7	89.0	74.3	76.6	80.4
Cash cycle	69.1	76.0	60.9	59.4	51.3

Source: Nomura estimates

BYD Electronic 285 HK

TECHNOLOGY/HANDSETS | CHINA

NOMURA

NOMURA INTERNATIONAL (HK) LIMITED

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Maintained

BUY

Closing price on 20 Jan	HK$5.13
Price target	HK$6.00
	(set on 17 Jan 11)
Upside/downside	17.0%
Difference from consensus	23.5%
FY11F net profit (RMBmn)	1,151
Difference from consensus	12.4%

Source: Nomura

Action

We reaffirm our BUY on BYDE and price target of HK$6.00. We suggest investing ahead of the FY10 results announcement slated for the end of March. We believe the company will beat consensus FY10F earnings, driven by a transformation to the higher-margin ODM business from EMS to offset the impact of wage inflation. We believe the ODM business will continue to drive robust earnings growth in FY11F-12F, backed by strong 3G handset demand in China

Catalysts

Stronger-than-expected growth in 3G subscriber numbers in China.

Anchor themes

The challenge of sustaining margins amid general wage inflation is a key theme for the handset OEM industry, in our view.

Nomura vs consensus

For FY11F earnings, we are 12% ahead of consensus estimates due to our view that ODM will sustain margins.

A proxy for China 3G

① Front and centre in China 3G

BYDE began providing ODM and EMS services to Chinese vendors in 2008, and we think sales to Huawei are now greater than those to Motorola, placing second at ~20% in FY10F sales. We believe the rising position of Chinese vendors in the global market will continue to help the company to diversify its client base.

② ODM growth to sustain margins

We believe the company has successfully developed a new ODM business line within its handset assembly business to help major clients design and manufacture TD-SCDMA handsets for the China market. This is helping the company to enhance blended margin amid wage inflation. Backed by strong demand for TD-SCDMA handsets, we forecast the ODM business will account for 23% of revenue in FY12F from 10% in FY09.

③ Components: metal casing leads growth

In our view, metal casing used in high-end smartphone and tablet PC is the key product that will likely drive growth in the company's component business beyond 2011F, offsetting weak keypad demand.

④ BUY with PT of HK$6.00

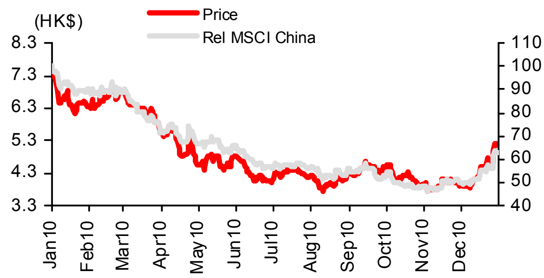
We think the stock is 20% below its historical average (since its listing in 2007 but excluding the 2008 financial crisis) of 10x P/E because investors are concerned about the sustainability of its EMS business amid wage inflation and an overdependence on Nokia. We believe recent developments at ODM and Chinese customers have relieved those concerns, and the company deserves a historical average P/E of 10x FY11F EPS of RMB0.51 (HK$0.6).

Key financials & valuations

31 Dec (RMBmn)	FY09	FY10F	FY11F	FY12F
Revenue	11,199	16,334	18,891	21,738
Reported net profit	759	1,011	1,151	1,296
Normalised net profit	759	1,011	1,151	1,296
Normalised EPS (RMB)	0.34	0.45	0.51	0.58
Norm. EPS growth (%)	(2.0)	33.2	13.8	12.6
Norm. P/E (x)	13.4	9.7	8.1	6.8
EV/EBITDA (x)	8.0	5.6	4.3	3.2
Price/book (x)	1.5	1.3	1.1	0.9
Dividend yield (%)	1.5	2.0	2.5	2.9
ROE (%)	12.2	14.3	14.2	13.9
Net debt/equity (%)	net cash	net cash	net cash	net cash
Earnings revisions				
Previous norm. net profit		1,011	1,151	1,296
Change from previous (%)		-	-	-
Previous norm. EPS (RMB)		0.45	0.51	0.58

Source: Company, Nomura estimates

Share price relative to MSCI China



	1m	3m	6m
Absolute (HK$)	30.5	17.4	25.7
Absolute (US$)	30.5	17.1	25.6
Relative to Index	26.8	19.7	13.7
Market cap (US$mn)			1,486
Estimated free float (%)			35.0
52-week range (HK$)			7.46/3.74
3-mth avg daily turnover (US$mn)			2.47
Stock borrowability			Hard
Major shareholders (%)			
BYD			65.7
Gold Dragonfly			7.5

Source: Company, Nomura estimates

Drilling down

Summary

We have a BUY rating on BYDE and our PT is HK$6.00. We believe the company will beat consensus FY10F earnings, driven by a successful transformation to the higher-margin ODM (original design manufacturing) business from EMS (electronics manufacturing service) to offset wage inflation. We believe the ODM business will continue to drive robust growth in FY11F-12F, backed by strong 3G handset demand in China.

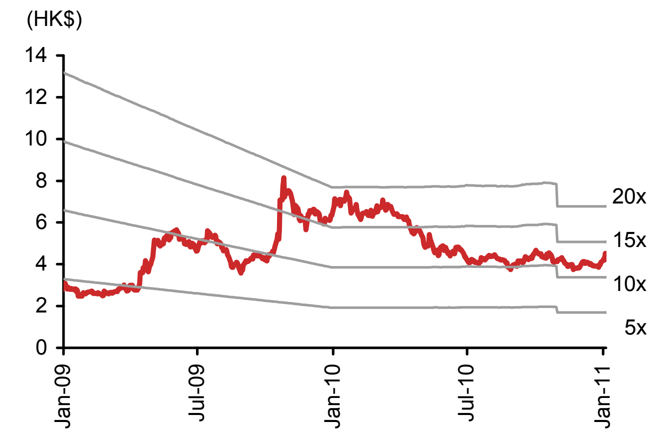
Transformation of business model

Valuation methodology

We peg BYDE's PT at HK$6.00, which is 10x FY11F EPS of RMB0.51 (HK$0.60) and is based on the company's historical average P/E since its IPO in 2007 (excluding the 2008 financial crisis period). For reference, this is at a 10% premium to direct peers Flextronics and Jabil, since we believe it deserves a premium given its exposure to ODM and TD-SCDMA business.

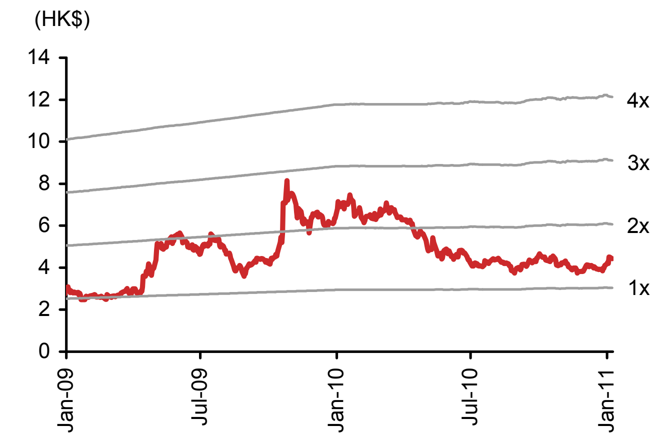
PT: HK$6.00 based on 10x FY11F P/E

Exhibit 52. 12-month forward P/E



Source: Company Data, Nomura estimates

Exhibit 53. 12-month forward P/B



Source: Company Data, Nomura estimates

Compared with consensus forecasts, we are in line with revenue but 16% above consensus net profits, since we forecast a stable gross margin trend backed by growth at the ODM business.

Exhibit 54. Nomura vs. consensus estimates

	FY10F			FY11F			FY12F		
(RMBmn)	**Nomura**	**Consensus**	**(%)**	**Nomura**	**Consensus**	**(%)**	**Nomura**	**Consensus**	**(%)**
Revenue	16,334	16,412	(0.5)	18,891	18,529	2.0	21,738	21,162	2.7
Operating Income	1,022	921	10.9	1,180	1,025	15.2	1,354	1,147	18.1
Net Profit	1,011	879	15.0	1,151	1,026	12.4	1,296	1,146	13.1
EPS (RMB)	0.45	0.39	15.1	0.51	0.44	16.1	0.58	0.48	19.8
EPS (HK$)	0.52	0.46	15.1	0.60	0.51	16.1	0.67	0.56	19.8

Source: Nomura estimates, consensus estimates from Bloomberg

Risks to our investment view

Any faster-than-expected increase in wages would cast a cloud over our investment view. Our forecasts are based on the assumption of a 15% minimum wage increase in China's coastal areas. We think the company can maintain margins at current levels by shifting to the higher-margin ODM business. We believe a faster-than-expected wage increase would hurt margins — a 10% wage increase would pare GPM by 0.5%. A lower-than-expected volume growth for the global handset market would also hurt our revenue forecasts.

Risks: Faster-than-expected wage inflation; lower-than-expected handset demand

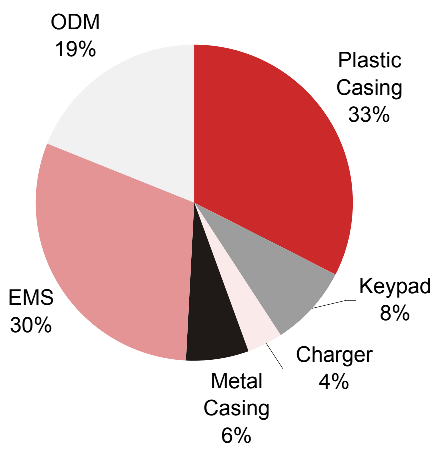
Drilling down

ODM to underpin margins

Business model

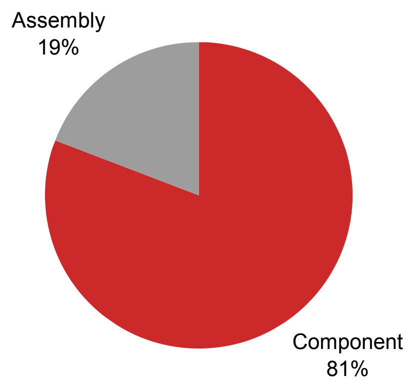
BYDE is the handset component manufacturing and handset assembly arm of BYD and was spun off from BYD in December 2007. BYDE has two major business lines: 1) handset component and module manufacturing (47% of FY10F sales, 81% of FY10F gross profit) and 2) handset assembly services (53% of FY10F sales, 19% of FY10F gross profit).

Exhibit 55. Sales breakdown by product lines



Source: Company Data

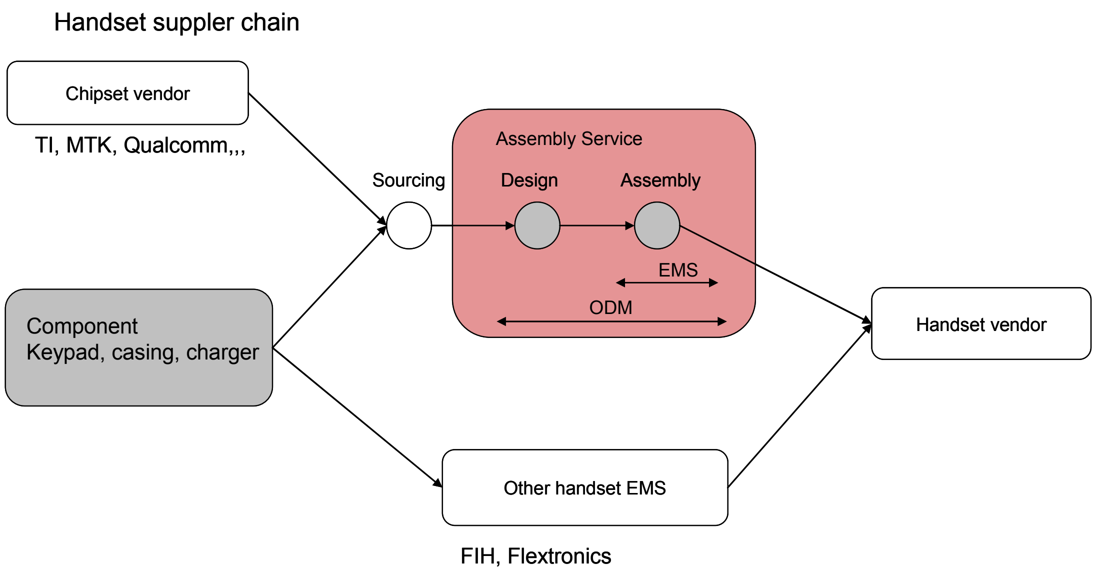
Exhibit 56. Gross Profit breakdown by product lines



Source: Company Data, Nomura research

The following exhibit further illustrates these two business models. According to the company, in the component business, BYDE designs and manufactures various components including plastic casings, keypads, chargers and metal casings for handset vendors, and ships to assembly service providers including the company itself. The components business generates a much higher gross margin (20~40%) compared with the assembly business (~5%), but gross margin varies depending on the mix of products, according to the company.

Exhibit 57. Business model



Note: Green part is business area of BYD Electronics

Source: Nomura research

In handset assembly services, BYDE buys components from component suppliers and chipset suppliers, and then assembles finished handsets (EMS model). It is labour intensive, involving extensive manual testing. As a result, we believe wage hikes will have a big impact on profitability.

EMS is a labour-intensive business model

In our view, the company entered the EMS business to help clients in assembly, in return for more component orders. However, given wage hike problems and with its main competitors relocating to inland China from Shenzhen, the market is concerned about the sustainability of this business model.

To offset margin pressure in the EMS business, the company provides ODM services to major customers mainly in China's TD-SCDMA handset market. In ODM, the company designs and manufactures (assembles) the handset itself and then ships to its clients. We believe ODM generates a much higher gross margin (~8-10% in FY09-10) compared with the traditional EMS business (~3-5% in FY09-10), since it has a higher technology entry barrier compared with handset R&D.

The company posted a 52% revenue CAGR over 2006-2010F, but earnings saw only a 7% CAGR during the same period. We attribute this to a sharp decline in gross margin due to:

Major concern on this company: sustainability of margin under wage inflation

- A worse product mix due to growth in the assembly business.
- A gross margin decline in the existing component business.
- Rising cost pressure due to wage inflation.

This has raised investor concerns about the sustainability of BYDE's business mode.

Industry assumptions

We forecast 11% and 10% unit growth for the global handset market in 2011F and 2012F. Global smartphone unit growth will be 42% and 26% in 2011F-12F, and smartphone revenue will exceed 50% in 2011F, on our estimates. For smartphones, we believe that the strong demand for sub-US$200 smartphones is key to sustaining growth momentum.

Key assumptions 1) smartphone market to grow 42% and 26% by volume in 2011/12F…

In line with forecasts from our China economics team, we assume a 15% y-y increase in the minimum wage in China in our model. Note that personnel expenses accounted for 11% of FY09 sales, according to company data. For reference, we forecast that further wage inflation of 15% would pare gross margin by ~1%, assuming BYDE can pass through part of the higher cost to clients.

…and 2) 15% wage hike pares GPM by ~1%

Revenues

We forecast the company will post 13% and 16% revenue growth in FY11F and FY12F, respectively. Component business revenue should grow by 14% y-y and 13% y-y — slightly faster than the industry average because of market share gains in key clients such as Nokia, in our view. Assembly business revenues will likely grow by 13% and 20% in FY11F and FY12F, respectively, driven by robust TD-SCDMA-related growth at its ODM business, backed by China's strong 3G demand.

Exhibit 58. Revenue and profit trend by product segments

	FY07	FY08	FY09	FY10F	FY11F	FY12F
Sales	5,767	8,555	11,199	16,334	18,891	21,738
Components	3,869	4,684	6,201	8,282	9,442	10,637
Assembly	1,898	3,870	4,998	8,052	9,449	11,102
EMS	1,898	3,870	3,898	4,952	5,574	6,064
ODM	-	-	1,100	3,100	3,875	5,038
y-y (%)	89.5	48.3	30.9	45.9	15.7	15.1
Components (%)	29.4	21.1	32.4	33.6	14.0	12.6
Assembly (%)		103.9	29.1	61.1	17.3	17.5
Gross profit	1,569	1,775	1,634	2,313	2,691	3,093
GPM (%)	27.2	20.7	14.6	14.2	14.2	14.2
Components	37.0	30.2	22.0	22.5	22.5	22.5
Assembly	5.0	5.0	5.0	5.5	6.0	6.3

Source: Nomura research

Stable margin trend on improving product mix

We forecast the company will maintain a gross margin at 14% over our forecast horizon. We think the gross margin of the component business will be stable because the launch of new product lines, such as metal casing, will offset margin compression in existing product lines. We forecast the assembly business' margin will stabilise from FY11F onward by shifting the product mix in favour of the higher-margin ODM business (~8-10% gross margin) from the lower-margin EMS business within the assembly segment (~3-4% gross margin).

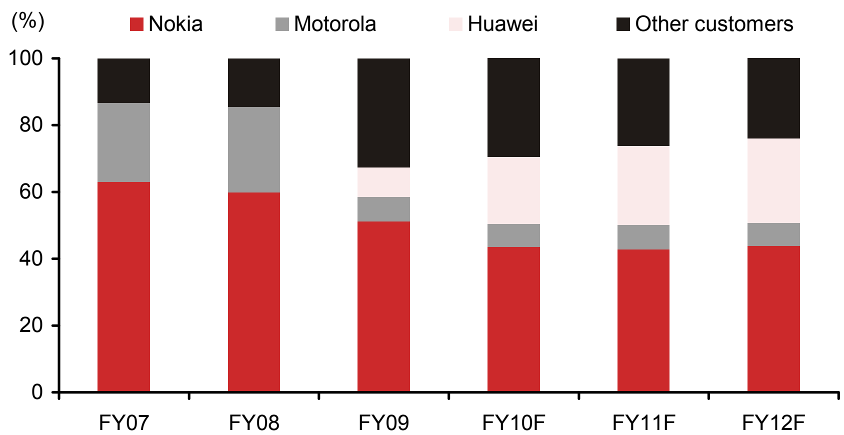
Rising sales weight from Chinese vendors

According to the company, BYDE started providing TD-SCDMA-related ODM and EMS services to Chinese vendors such as Huawei and ZTE after the 2008 financial crisis, to offset a sudden decline in orders from its existing major customers, Nokia and Motorola. By FY10, Huawei had overtaken Motorola to become BYDE's second-largest client, accounting for ~20% of sales, according to our estimates.

Sales to Huawei rise to 30% in FY12F from 20% in FY10F

We believe Huawei and other Chinese vendors will account for a larger proportion of BYDE's sales, driven by strong growth in data card and handset shipments among Chinese vendors. Through the development of business with Chinese handset vendors, we see the company's dependency on Nokia declining to ~40% in FY12F from above 50% in FY10F.

Exhibit 59. Sales, by customer



Source: Company data, Nomura estimates

Financial analysis

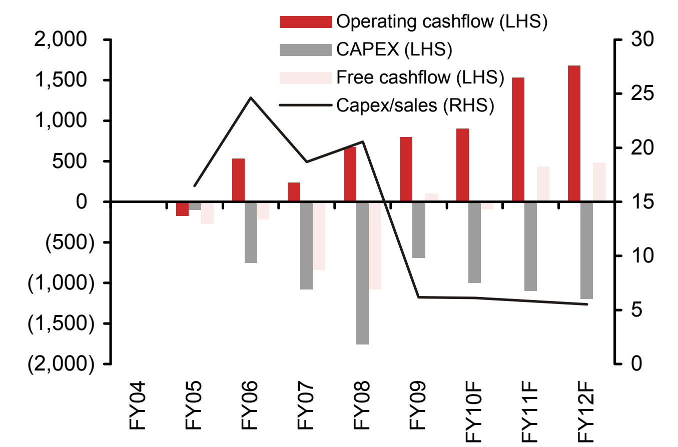
The company is in a strong net cash position following its IPO in 2007, though it faces the problem of cash outflows due to large assembly equipment-related investment. After speaking with management, we believe the company has passed its capex peak, and will likely maintain its capex around RMB1bn annually (~6% capex/sales ratio) over the next few years. This would help free cash flow and the net cash/equity ratio, in our view.

Healthy cash flow and strong balance sheet, in our view

If the company can sustain positive free cash flow over the next few years based on its current business model, this will likely raise the question of whether it should buy the remaining part of BYD's (its parent) hardware component business given that BYD is facing rising capex demand from its automobile and new-energy business, according to Nomura analysts Yankun Hou and Ming Xu (see our China auto and auto parts Anchor Report, *Electric vehicles: So near and yet so far*, 17 January 2011). If the parent injects capital into BYDE, we believe this would be positive for BYDE as it would reinforce BYDE's status as the handset arm of the BYD group.

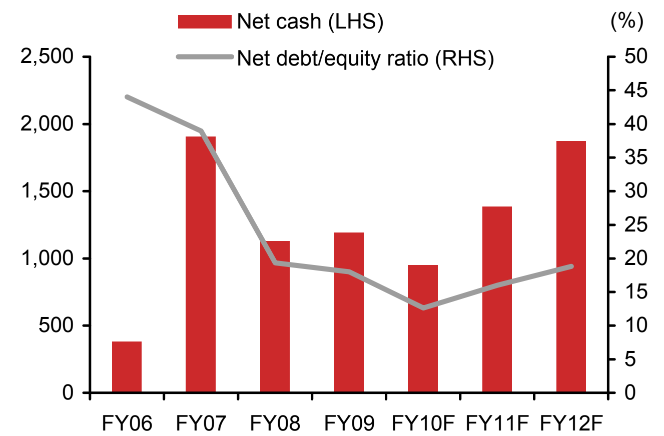
Stable positive cash flow may trigger a potential asset injection from the parent company

Exhibit 60. Cash flow analysis



Source: Company data, Nomura estimates

Exhibit 61. Net cash and cash/equity ratio



Source: Company data, Nomura estimates

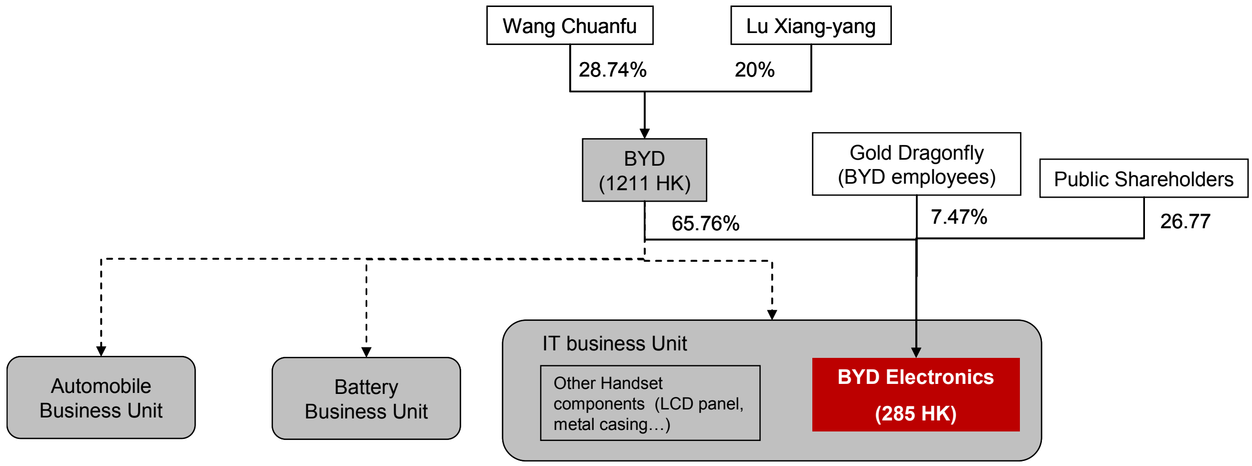
Company background: BYD's handset arm

BYDE is the handset component manufacturing and handset assembly arm of BYD and was spun off from BYD in December 2007. BYD is the largest shareholder of BYD Electronics with a 65.7% stake. Gold Dragonfly (a trustee company owned by 35 BYD employees) owns a 7.47% stake. In total, BYD and its employees own 73% of BYDE shares, based on company data.

BYD and associates own 73% of BYDE shares

BYDE is part of the BYD group's IT business unit. There are still some handset component businesses at the parent company level, such as LCD module and metal casting, which accounted for 10% of BYD group's sales in FY10F, according to company data.

Exhibit 62. Shareholder structure



Note: Solid line indicates shareholder relations, dotted line indicates BYD's organization chart

Source: Company data, Nomura research

Management team

Chairman Mr Wang Chuan-fu

Mr Wang Chuan-fu is the founder of BYD Group. He is a Non-Executive Director and Chairman of the company, and also the Chairman, an Executive Director and the President of the BYD Group. In February 1995, he founded Shenzhen BYD Battery Company Limited with Lu Xiang-yang. Mr. Wang graduated from Central South University of Technology in 1987 with a bachelor's degree majoring in metallurgy physical chemistry, and then graduated from Beijing Non-Ferrous Research Institute in the PRC in 1990 with a master's degree majoring in metallurgy physical chemistry (source: company data).

CEO Ms Li Ke

Ms Li Ke is Executive Director and Chief Executive Officer of the company. She joined the BYD Group in September 1996 as a manager in the marketing division and later as general manager of sales. Ms. Li joined BYD Electronics Group in January 2003 and is responsible for the overall strategic planning and business management (source: company data).

Financial statements

Income statement (RMBmn)					
Year-end 31 Dec	**FY08**	**FY09**	**FY10F**	**FY11F**	**FY12F**
Revenue	8,555	11,199	16,334	18,891	21,738
Cost of goods sold	(6,846)	(9,637)	(14,021)	(16,200)	(18,646)
Gross profit	**1,710**	**1,562**	**2,313**	**2,691**	**3,093**
SG&A	(1,020)	(897)	(1,290)	(1,511)	(1,739)
Employee share expense	-	-	-	-	-
Operating profit	**690**	**665**	**1,022**	**1,180**	**1,354**
EBITDA	**1,054**	**1,124**	**1,583**	**1,852**	**2,147**
Depreciation	(364)	(459)	(560)	(672)	(794)
Amortisation	-	-	-	-	-
EBIT	**690**	**665**	**1,022**	**1,180**	**1,354**
Net interest expense	31	23	23	23	23
Associates & JCEs	-	-	-	-	-
Other income	82	107	48	48	48
Earnings before tax	**803**	**795**	**1,093**	**1,251**	**1,425**
Income tax	(38)	(36)	(82)	(100)	(128)
Net profit after tax	**765**	**759**	**1,011**	**1,151**	**1,296**
Minority interests	-	-	-	-	-
Other items	-	-	-	-	-
Preferred dividends	-	-	-	-	-
Normalised NPAT	**765**	**759**	**1,011**	**1,151**	**1,296**
Extraordinary items	-	-	-	-	-
Reported NPAT	**765**	**759**	**1,011**	**1,151**	**1,296**
Dividends	-	(151)	(201)	(229)	(258)
Transfer to reserves	**765**	**608**	**810**	**922**	**1,039**
Valuation and ratio analysis					
FD normalised P/E (x)	14.0	13.4	9.7	8.1	6.8
FD normalised P/E at price target (x)	16.4	15.7	11.4	9.4	7.9
Reported P/E (x)	14.0	13.4	9.7	8.1	6.8
Dividend yield (%)	-	1.5	2.0	2.5	2.9
Price/cashflow (x)	15.8	12.7	10.9	6.0	5.2
Price/book (x)	1.9	1.5	1.3	1.1	0.9
EV/EBITDA (x)	9.2	8.0	5.6	4.3	3.2
EV/EBIT (x)	14.1	13.5	8.7	6.7	5.1
Gross margin (%)	20.0	13.9	14.2	14.2	14.2
EBITDA margin (%)	12.3	10.0	9.7	9.8	9.9
EBIT margin (%)	8.1	5.9	6.3	6.2	6.2
Net margin (%)	8.9	6.8	6.2	6.1	6.0
Effective tax rate (%)	4.7	4.5	7.5	8.0	9.0
Dividend payout (%)	-	19.9	19.9	19.9	19.9
Capex to sales (%)	20.3	6.2	6.1	5.8	5.5
Capex to depreciation (x)	4.8	1.5	1.8	1.6	1.5
ROE (%)	14.3	12.2	14.3	14.2	13.9
ROA (pretax %)	11.2	8.1	9.7	9.2	9.4
Growth (%)					
Revenue	48.3	30.9	45.9	15.7	15.1
EBITDA	(16.3)	6.6	40.8	17.0	15.9
EBIT	(36.6)	(3.6)	53.8	15.4	14.7
Normalised EPS	(40.5)	(2.0)	33.2	13.8	12.6
Normalised FDEPS	(40.5)	(2.0)	33.2	13.8	12.6
Per share					
Reported EPS (RMB)	0.34	0.34	0.45	0.51	0.58
Norm EPS (RMB)	0.34	0.34	0.45	0.51	0.58
Fully diluted norm EPS (RMB)	0.34	0.34	0.45	0.51	0.58
Book value per share (RMB)	2.59	2.94	3.33	3.84	4.42
DPS (RMB)	-	0.07	0.09	0.10	0.11

Source: Nomura estimates

Cashflow (RMBmn)					
Year-end 31 Dec	**FY08**	**FY09**	**FY10F**	**FY11F**	**FY12F**
EBITDA	1,054	1,124	1,583	1,852	2,147
Change in working capital	(78)	(531)	(683)	(287)	(405)
Other operating cashflow	(300)	206	7	(29)	(57)
Cashflow from operations	**676**	**799**	**907**	**1,536**	**1,685**
Capital expenditure	(1,735)	(692)	(1,000)	(1,100)	(1,200)
Free cashflow	**(1,059)**	**107**	**(93)**	**436**	**485**
Reduction in investments	7	-	-	-	-
Net acquisitions	(121)	-	-	-	-
Reduction in other LT assets	(275)	198	-	-	-
Addition in other LT liabilities	-	-	-	-	-
Adjustments	88	(256)	-	-	-
Cashflow after investing acts	**(1,361)**	**49**	**(93)**	**436**	**485**
Cash dividends	(341)	-	(151)	-	-
Equity issue	634	-	-	-	-
Debt issue	(1,283)	(14)	-	-	-
Convertible debt issue	-	-	-	-	-
Others	279	13	-	-	-
Cashflow from financial acts	**(711)**	**(1)**	**(151)**	**-**	**-**
Net cashflow	**(2,072)**	**48**	**(244)**	**436**	**485**
Beginning cash	3,217	1,145	1,193	949	1,386
Ending cash	1,145	1,193	949	1,386	1,870
Ending net debt	(1,131)	(1,193)	(949)	(1,386)	(1,870)

Source: Nomura estimates

Balance sheet (RMBmn)					
As at 31 Dec	**FY08**	**FY09**	**FY10F**	**FY11F**	**FY12F**
Cash & equivalents	1,145	1,193	949	1,386	1,870
Marketable securities	-	-	-	-	-
Accounts receivable	1,527	3,048	4,446	4,917	5,658
Inventories	1,824	1,769	2,574	3,107	3,576
Other current assets	337	484	822	924	1,038
Total current assets	**4,833**	**6,494**	**8,791**	**10,333**	**12,142**
LT investments	-	-	-	-	-
Fixed assets	3,031	3,428	3,868	4,296	4,703
Goodwill	-	-	-	-	-
Other intangible assets	13	11	11	11	11
Other LT assets	541	343	343	343	343
Total assets	**8,418**	**10,276**	**13,012**	**14,983**	**17,198**
Short-term debt	14	-	-	-	-
Accounts payable	2,026	3,391	5,267	6,086	7,005
Other current liabilities	541	258	240	240	240
Total current liabilities	**2,581**	**3,649**	**5,506**	**6,326**	**7,245**
Long-term debt	-	-	-	-	-
Convertible debt	-	-	-	-	-
Other LT liabilities	-	-	-	-	-
Total liabilities	**2,581**	**3,649**	**5,506**	**6,326**	**7,245**
Minority interest	-	-	-	-	-
Preferred stock	-	-	-	-	-
Common stock	216	216	216	216	216
Retained earnings	5,620	6,260	7,089	8,011	9,049
Proposed dividends	-	151	201	430	688
Other equity and reserves	-	-	-	-	-
Total shareholders' equity	**5,837**	**6,627**	**7,506**	**8,657**	**9,953**
Total equity & liabilities	**8,418**	**10,276**	**13,012**	**14,983**	**17,198**
Liquidity (x)					
Current ratio	1.87	1.78	1.60	1.63	1.68
Interest cover	na	na	na	na	na
Leverage					
Net debt/EBITDA (x)	net cash	net cash	net cash	net cash	net cash
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash
Activity (days)					
Days receivable	71.0	74.6	83.7	90.4	89.0
Days inventory	77.2	68.0	56.5	64.0	65.6
Days payable	105.1	102.6	112.7	127.9	128.5
Cash cycle	43.1	40.0	27.6	26.5	26.1

Source: Nomura estimates

China Wireless Technologies 2369 HK

TECHNOLOGY | CHINA

Initiation

NEUTRAL

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NOMURA INTERNATIONAL (HK) LIMITED

Action

We initiate coverage of China Wireless Technologies with a NEUTRAL rating and HK$4.50 PT. We think the company's strong R&D capability and product portfolio will help to capitalise on 3G and smartphone demand in China. Yet it seems a long way from being an established brand handset vendor (eg, China's HTC), especially in know-how in branding and marketing. The stock's 14.7x FY11F P/E looks fair.

Catalysts

New product launches, news flow regarding the next round of operators' centralised procurement scheme and monthly 3G net adds are key catalysts.

Anchor themes

We forecast China's smartphone market will expand from 20mn in 2010F to 62mn in 2012F, and became the world's second-largest smartphone market (after the US) by volume in 2012F, backed by the take-off of entry-level (RMB1k/US$150) smartphones.

Closing price on 20 Jan	HK$4.60
Price target	**HK$4.50**
Upside/downside	-2.2%
Difference from consensus	-16.2%
FY11F net profit (HK$mn)	727
Difference from consensus	-13.5%

Source: Nomura

Nomura vs consensus

We are below consensus earnings, reflecting our conservative view on margin decline from the rising weight of low-end models in the product mix.

China's HTC in the making?

① Major beneficiary of China's 3G growth

We think China Wireless has the key assets (e.g., localised user interface technology) and applications to be a major beneficiary of 3G and smartphone growth in China. Its strong customer relationships with China Telecom and China Unicom also bode well. We forecast 52% and 24% revenue growth in FY11-12F, respectively, backed by strong 3G handset demand in China.

② A long way from becoming China's HTC

Some in the market see China Wireless becoming a well-established brand handset vendor in the mould of HTC. We concur that it is following a similar expansion strategy, transforming from a niche handset vendor in the high-end market into a mass-market player. But we believe the company will first need to boost marketing expenses for branding, gain cost-control-related knowledge in low-end handset manufacturing, and cultivate relations with operators.

③ Investment risk: CDMA iPhone

In our view, since there is a large overlap between the company's high-end CDMA phone and the CDMA version of the iPhone, the CDMA iPhone launch and related news could crimp earnings and margins.

④ PT of HK$4.50, based on 14x P/E

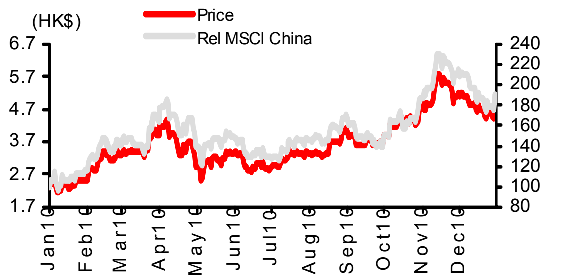
Global handset brand companies are trading at an average 12x FY11F P/E. In setting our price target of HK$4.50 based on 14x P/E, we apply a 15% premium given its high revenue growth prospects backed by buoyant growth prospects for China's 3G market.

Key financials & valuations

31 Dec (HK$mn)	FY09	FY10F	FY11F	FY12F
Revenue	2,605	5,187	8,268	10,532
Reported net profit	163	557	727	965
Normalised net profit	163	557	727	965
Normalised EPS (HK$)	0.08	0.27	0.32	0.42
Norm. EPS growth (%)	na	238.1	18.3	32.3
Norm. P/E (x)	57.4	17.2	14.5	11.0
EV/EBITDA (x)	39.1	14.0	10.3	7.8
Price/book (x)	10.8	7.5	4.2	3.3
Dividend yield (%)	0.9	1.9	2.2	2.9
ROE (%)	21.5	50.9	38.0	33.7
Net debt/equity (%)	20.4	25.4	net cash	net cash
Earnings revisions				
Previous norm. net profit		na	na	na
Change from previous (%)		na	na	na
Previous norm. EPS (HK$)		na	na	na

Source: Company, Nomura estimates

Share price relative to MSCI China



	1m	3m	6m
Absolute (HK$)	(11.7)	28.5	59.7
Absolute (US$)	(11.7)	28.2	59.6
Relative to Index	(15.4)	30.8	47.6
Market cap (US$mn)			1,243
Estimated free float (%)			49.8
52-week range (HK$)			5.75/2.15
3-mth avg daily turnover (US$mn)			17.99
Stock borrowability			
Major shareholders (%)			
Mr Guo Deying and Ms Yang Xiao			39.5
Value Partners			9.1

Source: Company, Nomura estimates

Summary

Executive summary

We think China Wireless has the key assets (e.g., localised user interface technology) and applications to be a major beneficiary of 3G and smartphone growth in China. Its strong customer relationships with China Telecom and China Unicom also bode well, in our view. We forecast 52% and 24% revenue growth in FY11-12F, respectively, backed by strong 3G handset demand in China.

Major beneficiary of China 3G market growth

Valuation

Global handset brand companies are trading at an average 12x FY11F P/E. In setting our price target based on 14x P/E, we apply a 15% premium given its high revenue growth prospects backed by buoyant growth prospects for China's 3G market.

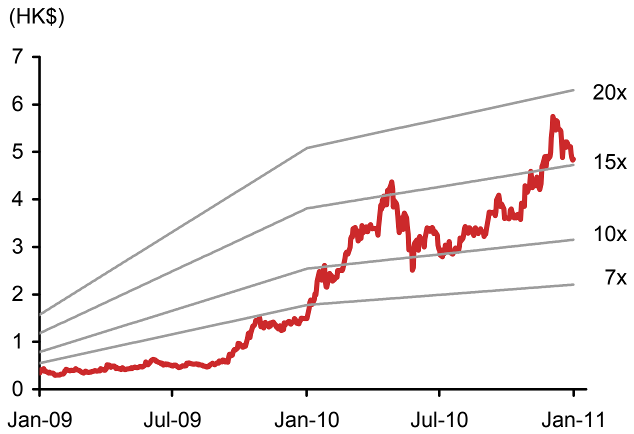
Exhibit 63. Valuation comparison

Name	Ticker	Crny	Price 20-Jan	Rating	Market cap (US$mn)	P/E (x) FY10F	P/E (x) FY11F	P/B(x) FY10F	P/B(x) FY11F	ROE (%) FY10F
TCL Com	2618 HK	HK$	8.08	BUY	1,139	12.3	8.6	5.4	3.8	44
China Wireless	2369 HK	HK$	4.60	NEUTRAL	1,242	17.4	14.6	7.4	4.1	43
ZTE	763 HK	HK$	29.95	BUY	10,536	25.2	19.8	3.8	3.3	15
BYD Electronic	285 HK	HK$	5.13	BUY	1,485	10.0	8.8	1.3	1.1	13
Foxconn	2038 HK	HK$	5.67	REDUCE	5,244	n.a	n.a	10.7	10.1	4
Nokia	NOK1V FH	€	7.84	NEUTRAL	39,254	13.8	12.4	2.0	2.0	15
Ericsson	ERICB SS	SEK	76.70	BUY	37,479	12.5	11.8	1.8	1.7	15
RIM	RIMM US	US$	62.92	NEUTRAL	32,846	na	9.9	na	3.8	
Motorola Mobility	MMI US	US$	35.04	REDUCE	10,305	(106.2)	62.6	na	2.0	
HTC	2498 TT	NT$	894.00	BUY	25,119	18.6	12.6	9.4	7.1	50
	Median					**13.1**	**12.4**	**4.6**	**3.5**	**15**

Note: pricing as of 20 January 2011.

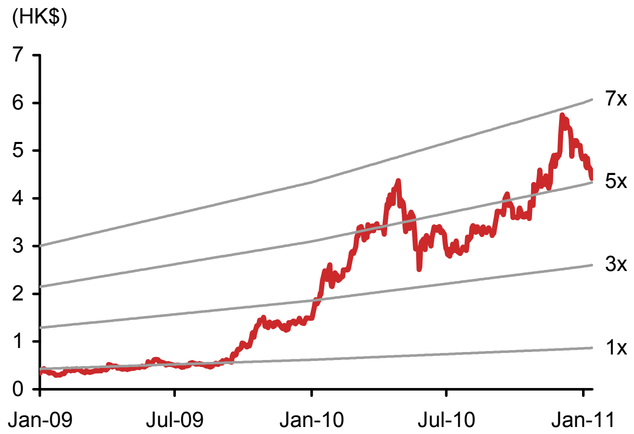
Source: Nomura estimates

Exhibit 64. 12-month forward P/E



Source: Nomura research

Exhibit 65. 12-month forward P/BV



Source: Nomura research

Nomura versus consensus

We are 3% and 17% below FY11F consensus revenue and net profit forecasts, respectively. We assume the company will maintain about a 15% market share in China's 3G handset market in FY11-12F, with ASP and margin declines of around 15% y-y and 2-3pp y-y, respectively. We think the market is more bullish than we are on the company's ability to maintain existing margins.

Exhibit 66. Nomura vs consensus

	FY10F			FY11F			FY12F		
(HK$mn)	Nomura	Consensus	Var (%)	Nomura	Consensus	Var (%)	Nomura	Consensus	Var (%)
Revenue	5,187	5,573	(6.9)	8,268	8,082	2.3	10,532	9,976	5.6
Operating profit	621	676	(8.1)	802	975	(17.7)	1,064	1,128	(5.7)
Net profit	557	621	(10.3)	727	830	(12.4)	965	957	0.9
EPS (HK$)	0.27	0.30	(9.7)	0.32	0.40	(19.8)	0.42	0.46	(7.8)

Source: Bloomberg, Nomura estimates

Investment risks

Deviation from our volume growth assumptions could affect company turnover

- We forecast China's 3G handset market will grow by 130% y-y in 2011F and 50% y-y in 2012F. Slower-than-expected market growth would have a negative impact on the company's turnover, and vice-versa, in our view.
- Given the considerable overlap between the company's high-end CDMA phone and the CDMA version of the iPhone, the CDMA iPhone launch and related news would likely crimp earnings and margins.

Company dynamics

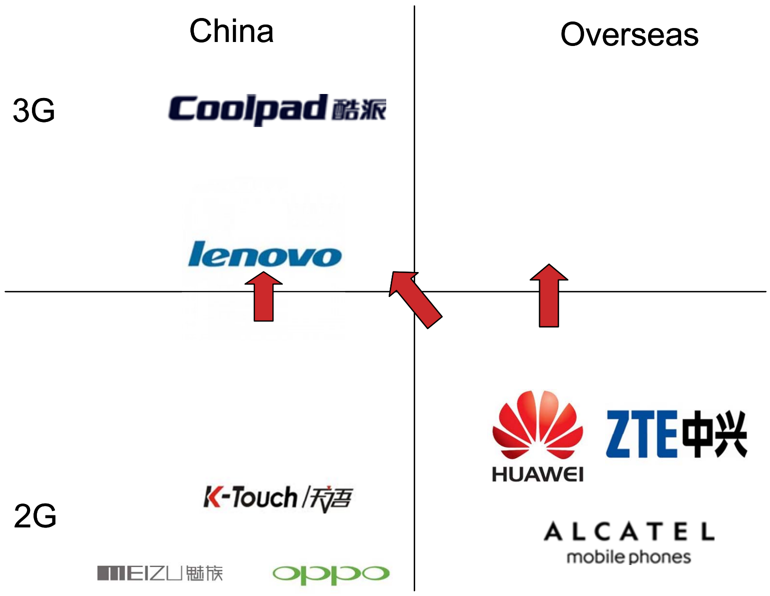
A long way from becoming a big name

Comparison between Sony Ericsson and HTC

We think China Wireless' current market position and its strategy is similar to HTC's in 2009-10 and Sony Ericsson's in 2006-07. All three companies focused on a niche high-end market (Sony Ericsson on music phones, HTC on smartphones, and China Wireless' Coolpad on China business phones), and then took a similar market share expansion strategy from high-end to middle-to-low end at the expense of margin and ASP compression.

Coolpad's low-end expansion strategy is similar to Sony Ericsson's in 2006-07and HTC's in 2009-10

Exhibit 67. Position of Coolpad within Chinese vendors



Source: Nomura research

SonyEricsson was very successful before 2006 via its high-end Walkman phone, and led the high-end trend at that time. But it failed to maintain its leadership in the high-end segment during its expansion into the mid-to-low segment, resulting in market-share losses in both the high- and low-end segments.

SonyEricsson's diversification efforts led to market share losses…

On the other hand, HTC was suffering from the loss of its ODM client when it first started its own brand business. The company eventually exited the ODM business and instead capitalised on the Android opportunity. It has since become a global brand and is now starting to expand into the mid-range market.

… while HTC has been more successful

China Wireless' Coolpad has become a well-recognised brand, and we think its Chinese-language user interface has a good reputation with customers. However, most of its sales still depend on two operators (China Telecom and China Mobile) and it has little experience in open-market business, which requires considerable effort and expense in terms of branding and marketing. Thus, we believe it is too early for the company to price in this potential now.

Business model

As a handset vendor, China Wireless mainly buys handset chipsets and other components, including LCD panel casings, from chipset and component suppliers. We believe the company mainly uses GSM chipsets from MediaTek, CDMA2000/EVDO and WCDMA chipsets from Qualcomm, and TD-SCDMA chipsets from Leadcore/ MediaTek.

Most of its chips (by volume) are sourced from MediaTek

The company's major R&D centre is in Shenzhen, with 1,500-plus R&D engineers as of the summer of 2010. It is also expanding its R&D capability in other regions (Xi'an and Beijing), according to the company. From more than 10 years of handset development, it has gained two R&D assets that are core competences, in our view.

R&D centres in China and Italy

- We think it is the technology leader in dual-mode dual-working GSM/CDMA handsets, and holds important patents for this technology. The dual-mode dual-working handset (or four-channel handset under China Telecom's brand name) is a distinctive type of handset for the China market, which supports simultaneous call waiting and phone calls on both the GSM and CDMA networks. We think this type of product was developed to support smooth subscriber migration between GSM and CDMA network without mobile number portability.

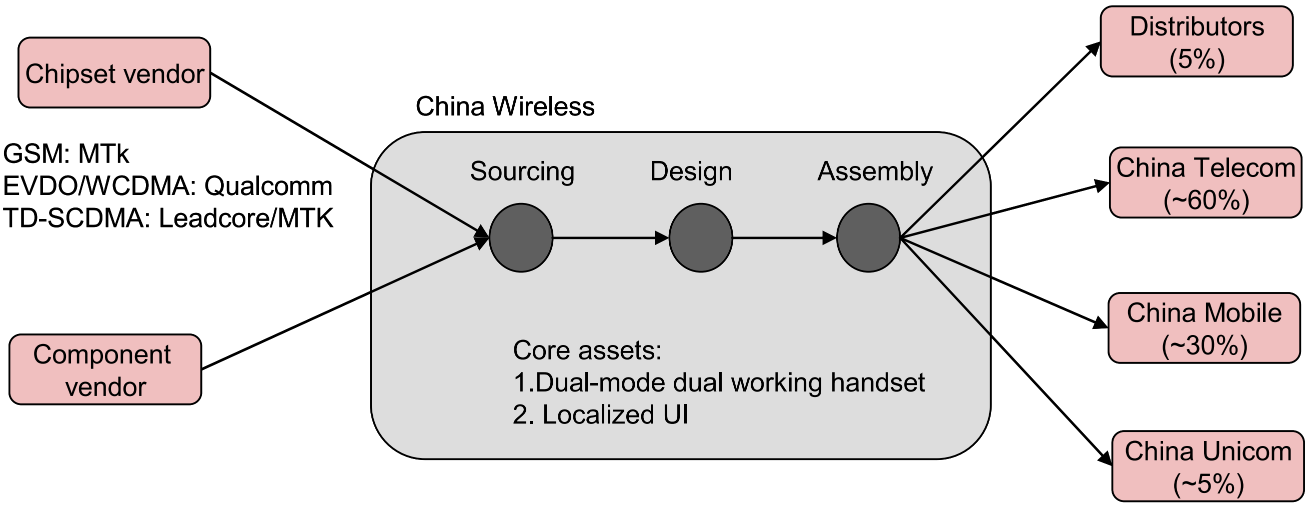
Core competence #1: leader in dual-mode dual working GSM/CDMA handset

- The company has developed a set of localised user interfaces and application software for business use in China including: full-screen Chinese character handwriting input; and privacy protection and incoming call/message filters. We believe these functions are popular, especially among local business people.

Core competence #2: localised user interface and application software

We believe the company outsourced the handset assembly process to handset EMS until February 2010, and then started making its own handsets from February 2010 in Dongguan (Guangdong, China), with a maximum annual capacity of 15mn units. Depending on the growth of this business, this factory can be expanded to at most 40mn units/year instep with demand. Total capex related to factory expansion should be less than RMB300mn, according to company estimates.

Exhibit 68. Shareholder structure

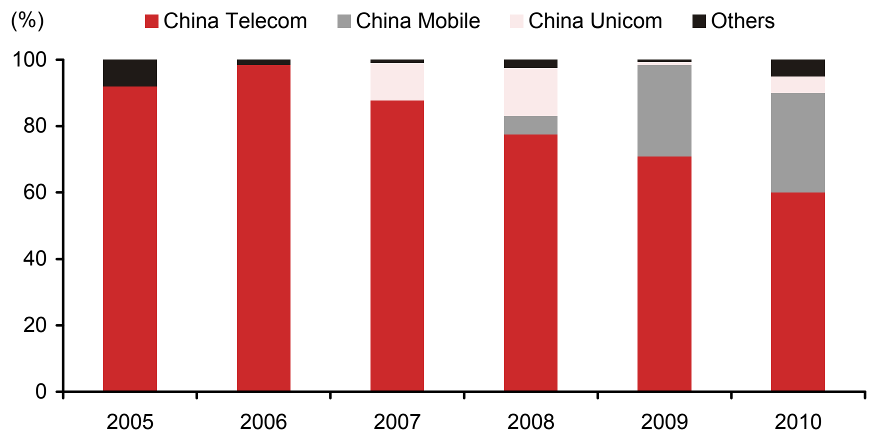


Source: Nomura research

We think the company's major customers are the three Chinese operators. Sales to China Telecom and China Mobile accounted for 60% and 30% of FY10F sales respectively, according to our forecasts. The company's dependency on China Telecom (China Unicom's CDMA business before 2008) was around 70% in FY09, and this ratio continues to fall as it does more business with China Mobile, in our view.

Customer base in FY10F: CT 60%, CM 30%

Exhibit 69. Revenue trend by customer/technology



Source: Nomura research

Central procurement system for handsets

Chinese operators use a centralised procurement system for 3G handsets. Vendors design customised handsets according to the operator's specification, and the operator in turn chooses models based on quality and price.

From the vendors' perspective, this business model carries the risk of price pressure and loss on R&D expense if a customised model is not picked, in our view. But vendors don't need to worry about excess inventory since there are certain guarantees for shipment volumes. In China Mobile's latest (November 2010) centralised procurement exercise, two models from China Wireless were chosen together with 10 models from ZTE, Lenovo and Huawei, and total volume for this round was 6mn units, according to Sina News.

Exhibit 70. China Mobile's TD-SCDMA handset bidding in November 2010

Low-end 3G (~RMB$500)		Mid-end 3G (RMB$800-1k)	
Vendor	**No. of models**	**Vendor**	**No. of models**
ZTE	2	ZTE	1
Coolpad(China Wireless)	1	Coolpad (China Wireless)	1
Lenovo	1	Lenovo	1
Hisenses	1	Huawei	1
Huawei	1	NewPostcom	1
T-smart	1		
Sub-total	7		5
Total			**12**
Total volume (mn)			**6**

Source: Nomura research

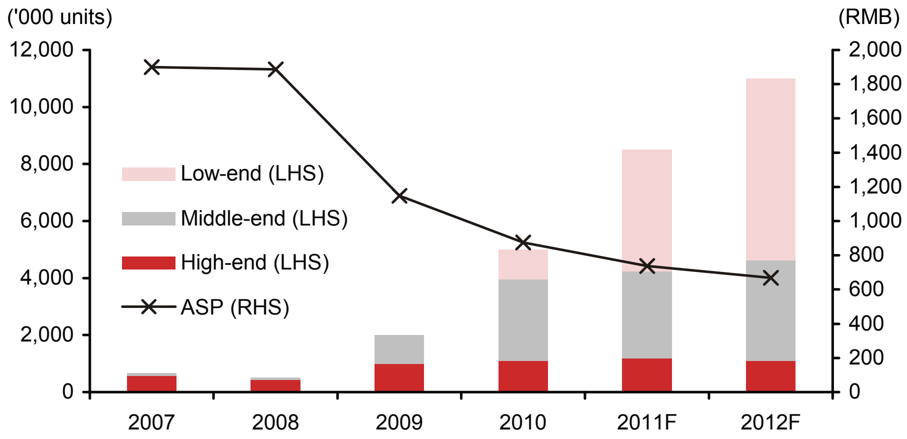
Revenue drivers

We believe the company's revenue growth will continue to be driven by 3G subscribers in China, especially in China Mobile and China Telecom accounts.

Robust growth in low-end segment, high-end to be affected by CDMA iPhone

Aligning with China operators' strategy to enhance the quality of low-end handsets, we expect China Wireless' low-end handset (ASP: <RMB500) shipment volumes will grow from ~1mn in FY10F to ~4mn in FY11F and 6mn in FY12F, and its middle-end handset (ASP: RMB800-1,500) will maintain volume growth of around 25% y-y in FY11-12F. Meanwhile, we forecast a flattish trend for the high-end segment (ASP: >RMB1,200), given the shift in operators' focus towards the low-end segment and the probable hit from the expected launch of the CDMA iPhone on its high-end CDMA models (next exhibit).

Exhibit 71. Handset shipment volume and ASP trend



Source: Company data, Nomura estimates

Robust growth in China Mobile account, moderate growth in China Telecom account

The next exhibit shows revenue trend by customer and gross margin. We expect 12% y-y revenue growth for its China Telecom account, considering China Telecom's conservative strategy on subscriber development and the likely negative impact from the CDMA iPhone. On the other hand, we expects its China Mobile account will post revenue growth of 125% y-y in FY11F and 52% in FY12F driven by strong handset shipments of low-end TD-SDMA handsets.

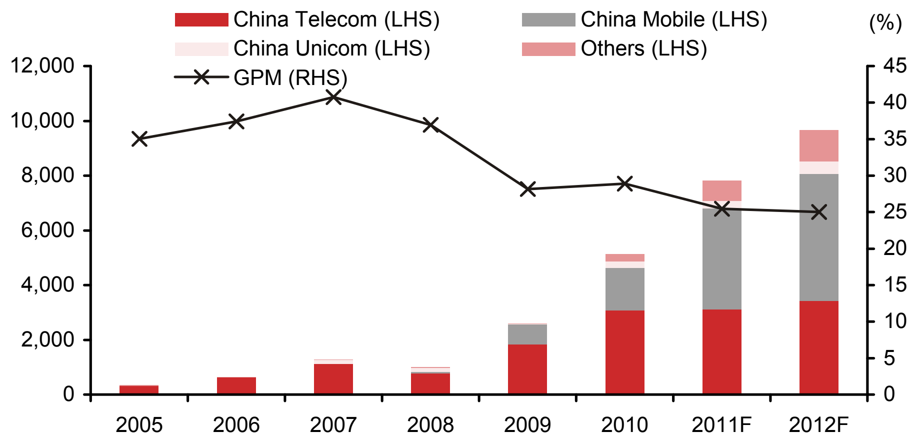
Overseas and China Unicom accounts remain small

We believe the company is looking at growth potential in overseas markets, e.g., India (Tata Mobile and Reliance) and Taiwan. We expect revenue contributions from China Unicom and others (open channel) will stay small in the next two years.

Margin decline

We think the company will face greater competition from other Chinese handset vendors when it shifts focus to middle-to-low end models from high-to-middle end. As a result, we expect gross margin will continue to decline to around 25% in FY12F.

Exhibit 72. Revenue and gross profit margin trend

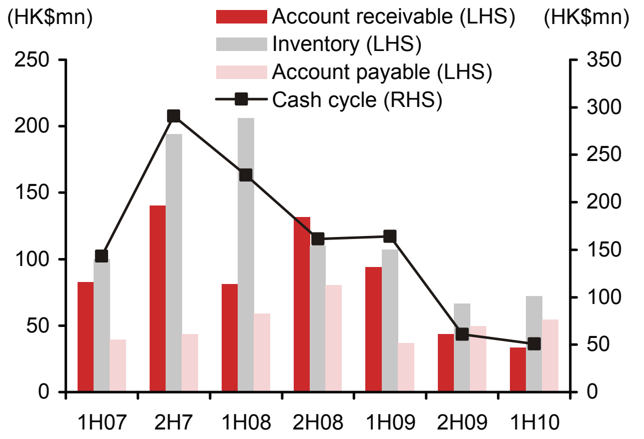


Source: Company data, Nomura forecasts

Financial analysis

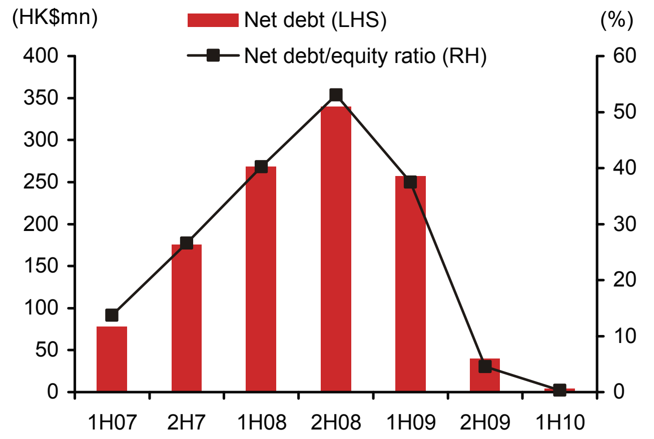
We think the company has a robust balance sheet with a low net debt-equity ratio, and working capital is decline given strong handset shipments to Chinese telecom operators (next exhibits).

Exhibit 73. Working capital trend



Source: Company data

Exhibit 74. Net debt-equity ratio trend



Source: Company data

Company background

Leading Chinese handset vendor

China Wireless is a China-based handset vendor that was established by CEO Mr. Guo Deying in 2002, and listed in Hong Kong in 2004. Through its indirectly wholly owned subsidiary, Yulong Computer Telecommunication Scientific (Shenzhen) (founded in April 1993 by its CEO Gao Deying), China Wireless mainly researches, designs and manufactures wireless handsets, and sell them under the Cooldpad brand in mainland China.

Shareholder structure

Shareholder structure

Founder, chairman and CEO Mr Guo Deying is the largest shareholder of the company with a 40.22% share in August 2010. Other directors own 2% of the company. Public shareholders own 58%.

Exhibit 75. Shareholder structure

Source: Nomura

Management team

Mr Guo Deying, founder and chairman, CEO

Mr Guo Deying is the founder and chairman, executive director and CEO. He is responsible for the group's overall management and strategic development. Mr Guo has been the chairman, the legal representative and the general manager of the group since its establishment in 1993. Mr Guo has about 15 years of experience in the wireless communication industry. He received a master's degree in engineering from Shanghai Jiao Tong University according to the company.

Financial statements

Income statement (HK$mn)					
Year-end 31 Dec	**FY08**	**FY09**	**FY10F**	**FY11F**	**FY12F**
Revenue	1,007	2,605	5,187	8,268	10,532
Cost of goods sold	(681)	(1,890)	(3,687)	(6,182)	(7,899)
Gross profit	**326**	**715**	**1,500**	**2,085**	**2,633**
SG&A	(459)	(514)	(879)	(1,283)	(1,569)
Employee share expense					
Operating profit	**(133)**	**201**	**621**	**802**	**1,064**
EBITDA	**(93)**	**252**	**717**	**920**	**1,212**
Depreciation	(40)	(51)	(96)	(118)	(148)
Amortisation	-	-	-	-	-
EBIT	**(133)**	**201**	**621**	**802**	**1,064**
Net interest expense	(23)	(14)	(4)	-	-
Associates & JCEs	-	-	-	-	-
Other income					
Earnings before tax	**(156)**	**187**	**617**	**802**	**1,064**
Income tax	(12)	(24)	(60)	(75)	(99)
Net profit after tax	**(168)**	**163**	**557**	**727**	**965**
Minority interests	-	-	-	-	-
Other items					
Preferred dividends					
Normalised NPAT	**(168)**	**163**	**557**	**727**	**965**
Extraordinary items					
Reported NPAT	**(168)**	**163**	**557**	**727**	**965**
Dividends	-	(83)	(184)	(230)	(302)
Transfer to reserves	**(168)**	**80**	**373**	**497**	**664**
Valuation and ratio analysis					
FD normalised P/E (x)	na	57.4	17.2	14.5	11.0
FD normalised P/E at price target (x)	na	56.2	16.8	14.2	10.7
Reported P/E (x)	na	57.4	17.0	14.3	10.8
Dividend yield (%)	-	0.9	1.9	2.2	2.9
Price/cashflow (x)	45.7	16.3	33.6	30.5	13.8
Price/book (x)	14.6	10.8	7.5	4.2	3.3
EV/EBITDA (x)	na	39.1	14.0	10.3	7.8
EV/EBIT (x)	na	49.0	16.1	11.9	8.9
Gross margin (%)	32.3	27.4	28.9	25.2	25.0
EBITDA margin (%)	(9.3)	9.7	13.8	11.1	11.5
EBIT margin (%)	(13.3)	7.7	12.0	9.7	10.1
Net margin (%)	(16.7)	6.3	10.7	8.8	9.2
Effective tax rate (%)	na	12.6	9.8	9.4	9.3
Dividend payout (%)	na	50.9	33.0	31.7	31.2
Capex to sales (%)	28.2	4.6	4.8	3.6	3.8
Capex to depreciation (x)	7.1	2.4	2.6	2.5	2.7
ROE (%)	(25.8)	21.5	50.9	38.0	33.7
ROA (pretax %)	(10.2)	11.6	25.1	22.7	23.2
Growth (%)					
Revenue	(21.2)	158.7	99.1	59.4	27.4
EBITDA	(167.9)	na	184.7	28.3	31.8
EBIT	(216.4)	na	209.2	29.1	32.6
Normalised EPS	(260.6)	na	238.1	18.3	32.3
Normalised FDEPS	(253.8)	na	233.9	18.5	32.3
Per share					
Reported EPS (HK$)	(0.08)	0.08	0.27	0.32	0.42
Norm EPS (HK$)	(0.08)	0.08	0.27	0.32	0.42
Fully diluted norm EPS (HK$)	(0.08)	0.08	0.27	0.32	0.42
Book value per share (HK$)	0.31	0.43	0.62	1.11	1.41
DPS (HK$)	-	0.04	0.09	0.10	0.13

Source: Nomura estimates

Strong volume growth to China Mobile and China Telecom

Cashflow (HK$mn)					
Year-end 31 Dec	**FY08**	**FY09**	**FY10F**	**FY11F**	**FY12F**
EBITDA	(93)	252	717	920	1,212
Change in working capital	52	(131)	(428)	(543)	(394)
Other operating cashflow	244	452	(8)	(35)	(58)
Cashflow from operations	**203**	**573**	**281**	**342**	**760**
Capital expenditure	(284)	(120)	(250)	(300)	(400)
Free cashflow	**(81)**	**453**	**31**	**42**	**360**
Reduction in investments	-	-	-	-	-
Net acquisitions					
Reduction in other LT assets					
Addition in other LT liabilities					
Adjustments	(37)	(113)	-	-	-
Cashflow after investing acts	**(118)**	**340**	**31**	**42**	**360**
Cash dividends	-	(20)	(184)	(230)	(302)
Equity issue	0	6	-	669	-
Debt issue	179	(174)	400	300	200
Convertible debt issue	-	-	-	-	-
Others	(27)	(25)	-	-	-
Cashflow from financial acts	**152**	**(214)**	**216**	**739**	**(102)**
Net cashflow	**34**	**126**	**247**	**781**	**258**
Beginning cash	91	125	251	498	1,279
Ending cash	125	251	498	1,279	1,537
Ending net debt	429	179	332	(149)	(207)

Source: Nomura estimates

Moderate increase in capex

Balance sheet (HK$mn)					
As at 31 Dec	**FY08**	**FY09**	**FY10F**	**FY11F**	**FY12F**
Cash & equivalents	125	251	498	1,279	1,537
Marketable securities					
Accounts receivable	282	340	649	1,034	1,313
Inventories	236	518	1,003	1,599	2,031
Other current assets	221	309	309	309	309
Total current assets	**863**	**1,418**	**2,459**	**4,221**	**5,190**
LT investments					
Fixed assets	593	640	794	976	1,228
Goodwill					
Other intangible assets	130	192	192	192	192
Other LT assets	-	-	-	-	-
Total assets	**1,585**	**2,249**	**3,445**	**5,389**	**6,610**
Short-term debt	352	218	218	218	218
Accounts payable	160	370	736	1,174	1,491
Other current liabilities	207	538	538	538	538
Total current liabilities	**719**	**1,126**	**1,492**	**1,930**	**2,247**
Long-term debt	201	212	612	912	1,112
Convertible debt					
Other LT liabilities	24	33	33	33	34
Total liabilities	**944**	**1,371**	**2,137**	**2,875**	**3,393**
Minority interest	-	-	-	-	-
Preferred stock	-	-	-	-	-
Common stock	220	173	173	173	172
Retained earnings	421	705	1,135	2,341	3,045
Proposed dividends	-	-	-	-	-
Other equity and reserves					
Total shareholders' equity	**641**	**878**	**1,308**	**2,514**	**3,217**
Total equity & liabilities	**1,586**	**2,249**	**3,445**	**5,389**	**6,610**
Liquidity (x)					
Current ratio	1.20	1.26	1.65	2.19	2.31
Interest cover	(5.9)	14.2	155.3	na	na
Leverage					
Net debt/EBITDA (x)	na	0.71	0.46	net cash	net cash
Net debt/equity (%)	66.8	20.4	25.4	net cash	net cash
Activity (days)					
Days receivable	89.1	43.6	34.8	37.1	40.8
Days inventory	140.8	72.8	75.3	76.8	84.1
Days payable	66.6	51.2	54.7	56.4	61.7
Cash cycle	163.3	65.2	55.4	57.6	63.1

Source: Nomura estimates

Digital China 861 HK

TECHNOLOGY | CHINA

NOMURA
NOMURA INTERNATIONAL (HK) LIMITED

Initiation

NEUTRAL

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Action

We initiate coverage of Digital China with a NEUTRAL call and PT of HK$17.00. We like the company's market leader position in China's PC distribution industry, and believe it stands to be a key beneficiary of the digital city and other national IT projects in China's 12th Five-Year Plan. We would see tangible progress on this front as a re-rating opportunity.

Catalysts

Positive catalysts include increasing IT spending from government and favourable industry policies such as VAT tax refunds.

Anchor themes

The software industry is a key industry that the Chinese government intends to promote in its 12th Five-Year Plan. We see the planned digital city as a good approach to support the IT software industry and boost government efficiency.

Closing price on 20 Jan	HK$16.04
Price target	**HK$17.00**
Upside/downside	6.0%
Difference from consensus	6.3%
FY12F net profit (HK$mn)	1,141
Difference from consensus	-7.2%

Source: Nomura

Nomura vs consensus

We are below consensus on FY11F earnings because we think it is too early to price in the growth potential from digital city-related initiatives.

Potential to capitalise

① Distribution business: solid market leader

By leveraging its comprehensive distribution network, we expect Digital China to maintain its market leader position (~25%) in China's PC distribution business, and to register revenue growth of around 18% y-y for FY11-12F, in line with that of the overall market.

② Planned digital city: re-rating opportunity

We believe the plans for a digital city and other national IT projects in China's 12th Five-Year Plan will create a significant growth opportunity in the long term for China's IT software industry. Digital China looks well positioned to capitalise on such opportunities, in our view, by leveraging strong ties with the central and regional governments. Still, we don't expect revenue contributions from digital city-related projects to come through until FY12F. The company has already signed some major contracts, including the recent Shenzhen City.

③ Smartphone distribution: new growth driver

Sales from handset distribution remain modest as a portion of Digital China's distribution revenue (~5%) and small in product line (RIM, Apple, HTC) in FY10F, but we believe the smartphone trend is triggering the convergence of PC and handset distribution, and the company can leverage its PC distribution network to capitalise on the growing smartphone trend. We forecast sales from handset distribution will contribute ~15% of distribution business in FY12F.

④ NEUTRAL, with PT of HK$17.00

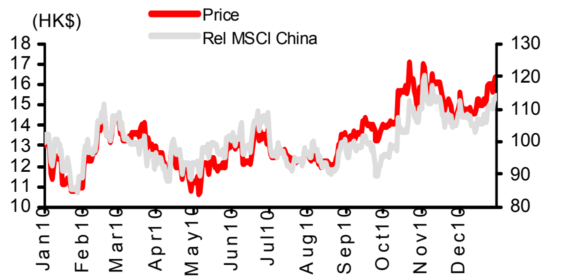
We derive our PT of HK$17 by applying a PEG of 1x to our FY11F EPS growth forecast (16%). Since the company is in a transition phase from distributor to total IT service provider, covering distribution, software service and operation of developed software, we find it appropriate to derive our PT based on earnings growth. We will revisit our forecast once there is better visibility on its new business model.

Key financials & valuations

31 Mar (HK$mn)	FY10	FY11F	FY12F	FY13F
Revenue	50,178	56,974	66,497	77,774
Reported net profit	825	957	1,141	1,319
Normalised net profit	825	957	1,141	1,319
Normalised EPS (HK$)	0.86	0.91	1.05	1.21
Norm. EPS growth (%)	28.7	6.4	14.7	15.6
Norm. P/E (x)	18.9	17.7	15.4	13.3
EV/EBITDA (x)	11.7	12.8	11.7	9.0
Price/book (x)	3.9	3.6	3.1	2.7
Dividend yield (%)	1.8	1.6	2.0	2.3
ROE (%)	22.5	21.0	21.5	21.5
Net debt/equity (%)	net cash	net cash	net cash	net cash
Earnings revisions				
Previous norm. net profit		na	na	na
Change from previous (%)		na	na	na
Previous norm. EPS (HK$)		na	na	na

Source: Company, Nomura estimates

Share price relative to MSCI China



	1m	3m	6m
Absolute (HK$)	8.4	16.4	17.3
Absolute (US$)	8.3	16.1	17.2
Relative to Index	4.7	18.7	5.2
Market cap (US$mn)			2,247
Estimated free float (%)			58.2
52-week range (HK$)			16.96/10.58
3-mth avg daily turnover (US$mn)			8.68
Stock borrowability			
Major shareholders (%)			
Legend Holdings			15.3
Guo Wei			14.8

Source: Company, Nomura estimates

Investment summary

Overview

We initiate coverage of Digital China with a NEUTRAL rating and PT of HK$17.00. Digital China is the largest IT product distributor in China and one of the major IT software vendors in China. We like the company's position as a potential beneficiary of the planned digital city and other national IT projects in China's 12th Five-Year Plan, and would view any progress as a re-rating opportunity.

Largest IT product supplier in transition

Valuation

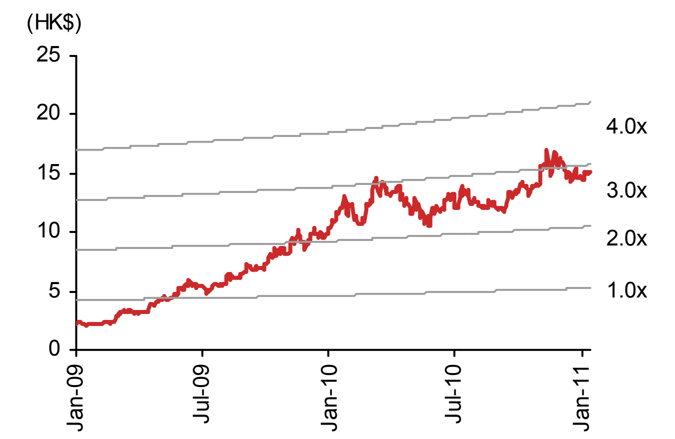
As illustrated below, the shares are trading near their historical high P/E. We believe this is mainly owing to market expectations of a successful transformation into an IT service company, and the converging valuation gap with its peer Synnex in the distribution business.

P/E near historical high

Given the uncertainty during the transition of its business model from distributor to total IT service provider covering distribution, software service and even service operation (operation of e-citizenship cards), we find it appropriate to derive our PT of HK$17 by applying 1x PEG to our FY11F EPS growth forecast. We will revisit our valuation once there is better visibility on the new business model.

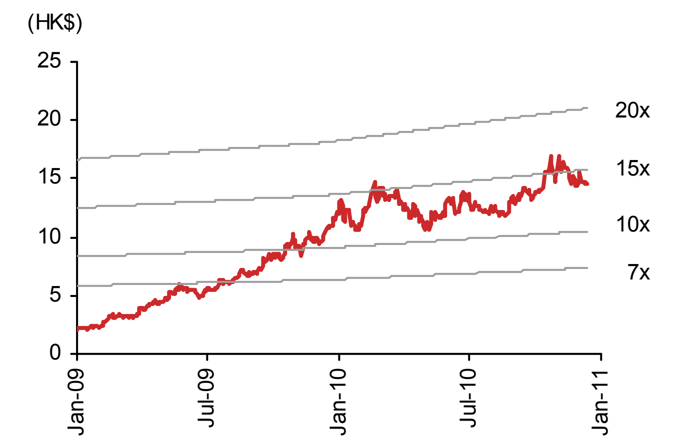
PT of HK$17 based on 1x PEG

Exhibit 76. 12-month forward P/BV



Source: Nomura research

Exhibit 77. 12-month forward P/E



Source: Nomura research

We are only slightly above consensus on revenue, but about 6% below consensus on FY12F EPS, likely reflecting our more cautious view of growth in the higher-margin software segment, backed by the planned digital city and related government projects. We expect actual revenue contribution from these to begin in FY12F, considering planning issues.

6% below consensus on FYI12 net profit

Exhibit 78. Nomura vs consensus

	FY11F			FY12F			FY13F		
(HK$mn)	**Nomura**	**Consensus**	**Var (%)**	**Nomura**	**Consensus**	**Var (%)**	**Nomura**	**Consensus**	**Var (%)**
Revenue	56,974	56,835	0.2	66,497	65,531	1.5	77,774	76,366	1.8
Operating income	1,067	976	9.2	1,205	1,266	(4.8)	1,428	1,459	(2.2)
Net profit	957	978	(2.2)	1,141	1,230	(7.2)	1,319	1,430	(7.8)
EPS (HK$)	0.91	0.92	(0.9)	1.05	1.13	(7.4)	1.21	1.34	(9.7)

Source: I/B/E/S consensus by Datastream, Nomura estimates

Digital China vs Synnex

Look similar, but different

Digital China vs Synnex is one of the first questions that investors ask when looking into Digital China. While there are large overlaps in their existing business areas, there are also large differences in business development strategy.

Margin expansion via integration between distribution and service

Digital China, being the largest IT products distributor in China, is well connected with China's IT industry, with links to hardware, software vendors, and the government. Digital China's strategy is to shift into higher-margin segments, including: 1) IT product distribution and systems integration for the corporate and government sectors; and 2) IT software services for governments and mission-critical industries, such as telecoms and finance.

Synnex: horizontal product line expansion

Synnex, the largest distributor from Taiwan, has strength in logistics and inventory management, and is well connected with Taiwan's PC and other technology hardware vendors. As a latecomer to China's PC/handset distribution business, Synnex is still expanding its product line and client base by leveraging the business know-how it accumulated in Taiwan.

Exhibit 79. Digital China vs Synnex

	Digital China	Synnex
Market position	No.1 in China	No.2 in China, No.1 in Taiwan
China sales breakdown (US$bn)		
Consumer PCs	4.60	3.0
Corporate PCs/Servers	2.10	0.8
IT services	0.60	0
Handsets	0.30	1.2
IC Components	0	1.1
Strategy	Margin expansion via vertical integration between distribution and IT software	Revenue growth via expanding product lines in China

Source: Nomura research

Digital city project: when and how?

IT software: key industry in next Five-Year Plan

The software industry is a key industry that the Chinese government intends to promote in its 12th Five-Year Plan. The State Council has just decided on policies to encourage further development of the software and integrated-circuit (IC) industries, including financing support (eg, promoting PE fund), tax refunds, R&D, HR and intellectual property protection.

When: strategic focus in China's 12th Five-Year Plan

Digital city represents a series of regional and central government IT projects aimed at digitalising internal and external service platforms to provide better service to the public. We believe this is a good approach to both support China's IT software industry and improve government efficiency. However, we believe 2011F will be a year of planning and vendor selection, given that the policy was only recently announced. Thus, we only expect major revenue contributions starting in FY12F.

How big: same as government IT spending

China's government IT spending is US$1.6bn, and will record a 14% CAGR over 2010-14F, according to IDC. We expect the major components of government IT spending, such as taxation and surveillance monitoring, will be included in the digital city concept. In this sense, we see a sizable addressable market for the digital city in the long run.

Risk factors

Risk factors in distribution businesses

We see the following risk factors for the distribution businesses: 1) margin erosion due to a switch to lower-margin distribution models by key clients; and 2) excess inventory due to a sudden decline in IT demand in China.

Risk factors in IT service businesses

On the other hand, we see service business units facing the following risks: 1) delays in IT spending due to management changes in the government, telecoms, and financial sectors, and 2) additional costs due to the delay in software developments.

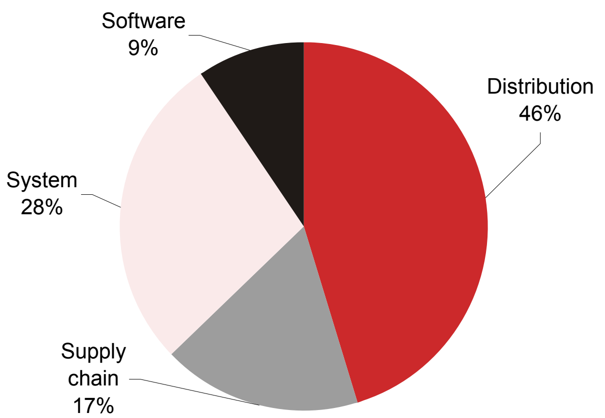
Business model

Potential to capitalise

IT product distributor + IT software service provider

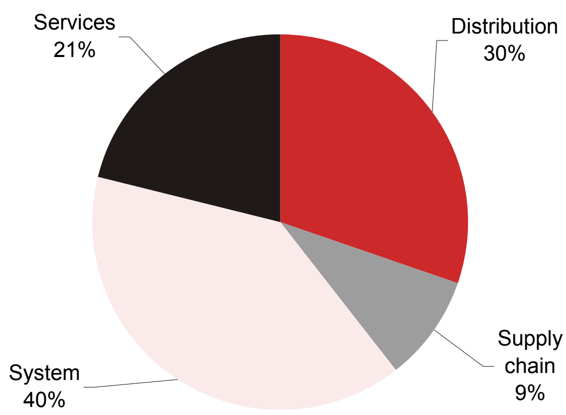
Digital China is the largest IT products distributor in China and one of the major IT software vendors in China. In the distribution business, it distributes to consumers and corporate customers mainly PCs and other IT products such as servers, digital cameras, and handsets made by foreign companies. In the software service business, it mainly develops software for telecoms and finance companies, as well as government. According to the company, its distribution business (distribution, supply chain, and system segment) should account for 91% of revenue, and 79% of gross profit in FY10, while software service contributes the remaining 9% of sales and 21% of gross profit.

Exhibit 80. Sales breakdown by segment (FY10)



Source: Nomura estimates

Exhibit 81. Gross profit breakdown by segment (FY10)



Source: Nomura estimates

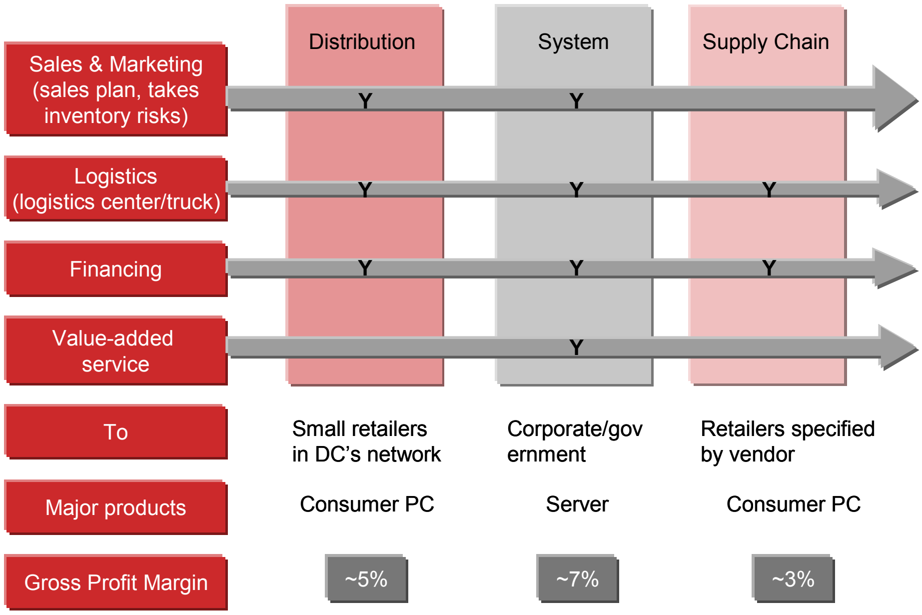
Mid-term vision: B2C, B2B and software to each contribute one-third of gross profit by 2013F

After Mr Guo Wei became CEO and a major shareholder in August 2007, Digital China further honed its vision of transforming itself into an IT services company, and now aims to generate a third of earnings from each of B2C distribution (distribution/supply chain segment), B2B distribution (system) and software service by 2013F.

Business model

The next exhibit illustrates Digital China's business model in its distribution business. Basically Digital China provides IT vendors with sales networks, logistics infrastructure (logistics centre, trucks, etc), and financing (credit management, and accounts receivable management) and technical support to local resellers and consumers. Depending on which processes are involved within the total distribution business, the business is then further classified into three types, namely: 1) distribution, 2) supply-chain management, and 3) systems.

Exhibit 82. Business model for channel business



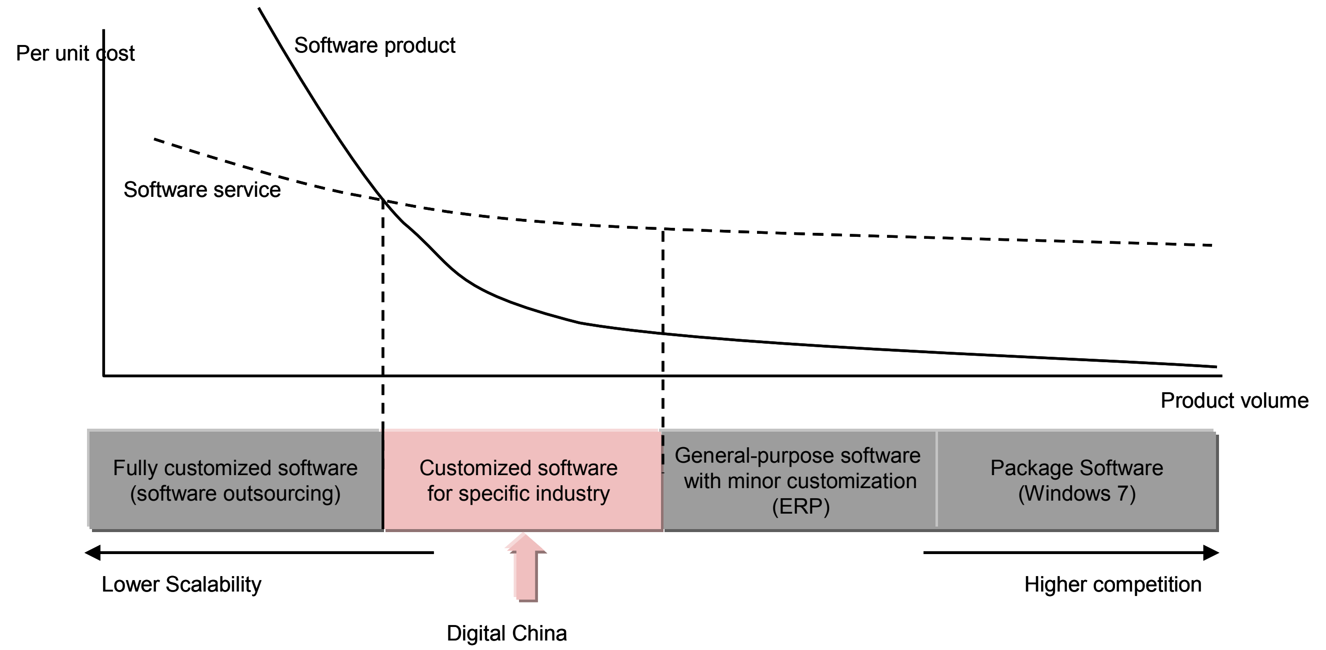
Source: Nomura research

- Distribution: Digital China distributes consumer IT products to the large group of retailers registered in its distribution network. In this business model, Digital China purchases products from vendors, builds its own sales plans, and takes the inventory risk by itself. We find that over the past few years, a typical PC distribution business has generated a gross profit margin averaging ~4-5%.
- Supply chain: In this model, vendors manage the retailers (mainly large electronics chains) directly, and the distributor provides only logistics and financing services. Typically it generates a relatively lower margin than the distribution business.
- Systems: In this model, Digital China sells mainly high-end IT products such as Unix servers, networking products, storage products, and packaged software to corporate and government users. The barriers to entry in this business are higher than for the distribution and systems businesses.

Software service business

In addition to its distribution businesses, Digital China provides software services to the telecoms, finance, and government sectors. Compared with IT outsourcing sub-markets, we believe the sub-market on which Digital China focuses has a higher technological barrier to entry.

Exhibit 83. Position of Digital China's software business

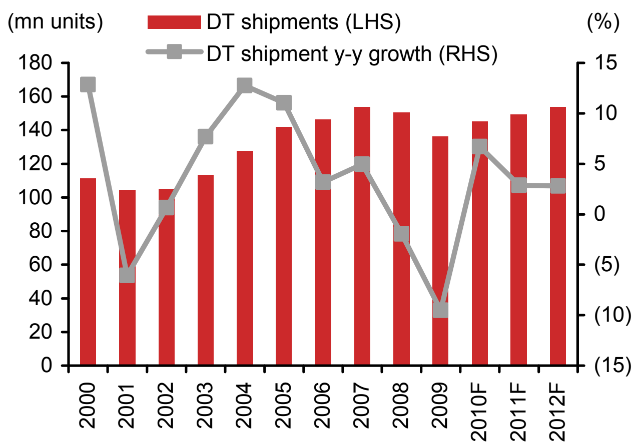


Source: Nomura research

Industry forecasts

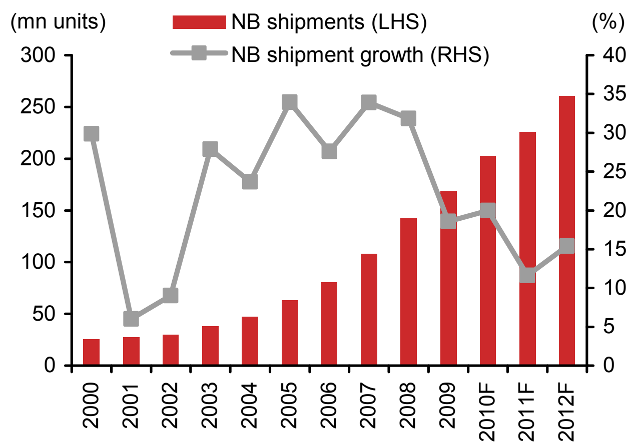
Eve Jung, Nomura's Asia PC hardware analyst, estimates that global PC shipment volumes will grow by 7.9% and 10.3% y-y in 2011F and 2012F, respectively, and that the APAC region will lead the world's growth rate with 13.9% and 15.5% growth in 2011F and 2012F, respectively.

Exhibit 84. Global desktop PC shipment forecasts



Source: Nomura research

Exhibit 85. Global NB shipment forecasts



Source: Nomura research

IT software industry to record a 14% CAGR, according to IDC

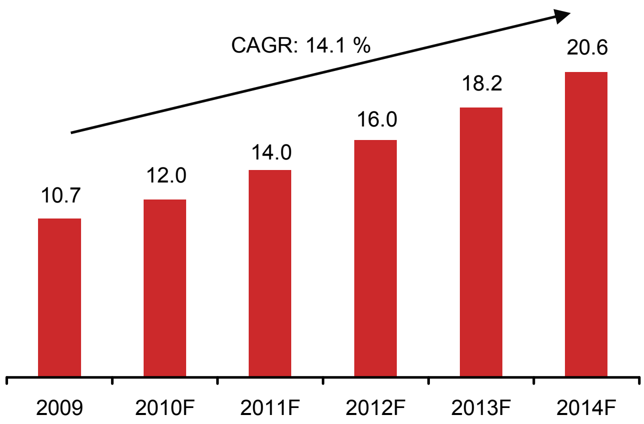
China is one of the largest and fastest-growing markets for IT services, and China's IT services market is expected to grow significantly faster than the overall global IT services industry, according to IDC. According to an IDC report in July 2010, China's IT services market was worth some US$10.7bn in 2009 and is projected to reach US$20.6bn in 2014F – a CAGR of 14% over 2009-14F (Exhibit below left).

Telecom, finance, and government are three key areas

Telecoms, finance and the government are the three major markets for China's domestic IT service industry, respectively accounting for 23%, 24% and 14% of IT service revenue in 2009, according to IDC. Given the characteristics of mission-critical businesses, there are higher entry barriers to those industries. Digital China is the second-largest software service provider in the telecoms software industry (next to

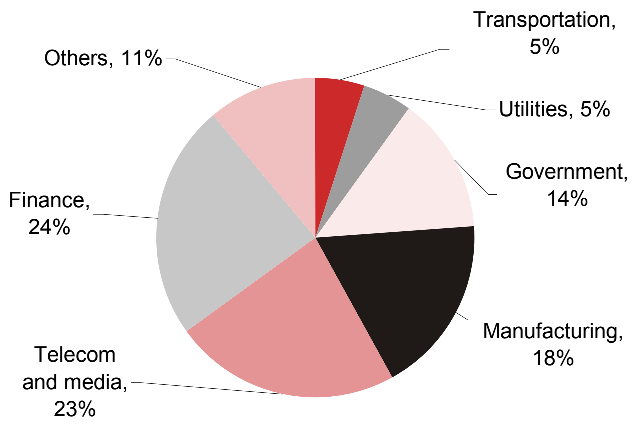
AsiaInfo-Linkage) and the second-largest in finance (next to Longtop). Government-related IT business is highly fragmented, but we think Digital China is a key player.

Exhibit 86. China's domestic IT services market (US$bn)



Source: IDC

Exhibit 87. 2009 China IT Services market by sector



Source: IDC, Nomura research

IT software: key industry to promote in next Five-Year Plan

The software industry is one of key industries that the Chinese government intends to promote in its 12th Five-Year Plan. At an executive meeting on 13 January, China's State Council discussed policies to encourage further development of the software and integrated-circuit (IC) industries, and decided on the folllowing measures:

- Financial support (government subsidies, encouragement of M&A, setup investment funds, and PE fund, etc)
- R&D support
- Tax benefits (VAT, income tax, revenue tax)
- HR support
- Protection of intellectual property
- Achievement of better market discipline

We believe these measures will help the growth of the software industry in China.

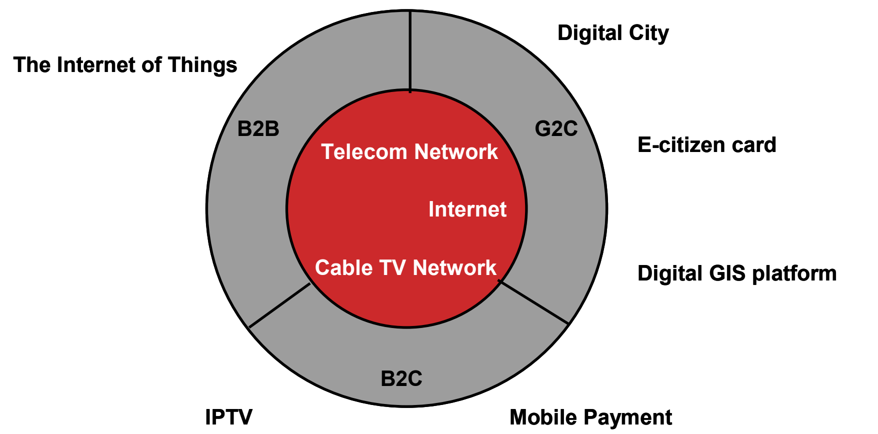
Digital city / Sm@rt City: series of government IT projects

We think that the digital city concept (or Sm@rt City in Digital China's terminology) is a good example of how the government supports the development of the Chinese IT software industry via government spending. The digital city refers to a community connected via a converged communications infrastructure and to the innovative public services provided by the government over this network. It involves mainly the development of a national and regional geographical information system (GIS), and identity-management system (e-citizen card).

Sm@rt City: Chinese-style cloud computing

In November 2010, Digital China published its vision in its annual seminar, called its "Sm@rt City" vision, which is similar to government's digital city plan. It envisions a city that provides citizens with a "safe city, a convenient city, a healthy city, and a green city" through the integration of hardware and software technology. We believe this can be seen as the G2C (government-to-citizen) part of China's IT platform development plan.

Exhibit 88. Sm@rt City concept



Source: Nomura research

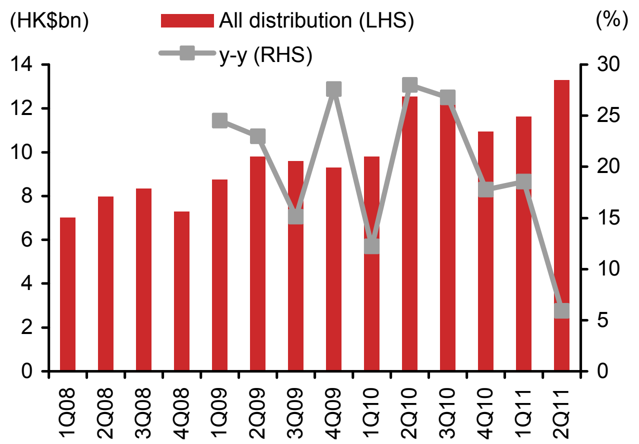
Revenue analysis

Although we have seen turnover growth for Digital China's distribution business slow to 9% y-y in 2Q FY11F (July-September 2010), we believe this was due mainly to: 1) a high base last year, 2) weaker-than-expected corporate spending, 3) loss of market share by foreign brands in China to Lenovo.

FY12-13F: 18% y-y revenue growth

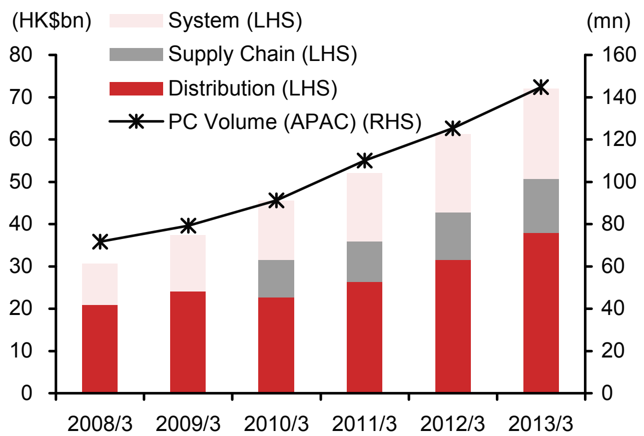
In FY12F and beyond, we expect that Digital China will grow in line with the market average, but that it will grow faster in the systems business for the corporate and government sectors. In general, we forecast revenue growth of 18% y-y in FY12-13F.

Exhibit 89. Quarterly turnover trend of distribution business



Source: Company data, Nomura research

Exhibit 90. Distribution business performance



Source: Company data, Nomura research

Distribution business under long-term margin pressure

The gross margin of Digital China's distribution business will come under pressure over the long term, in our view, because of 1) intensified competition from new comers such as Synnex, and because 2) vendors tend to simplify the channel to maximise their profits after gaining more knowledge of the local market. HP/Dell's shift from distribution to supply chain in Tier 1-3 cities is a good example.

Focus on rural areas, and corporate/government to improve margins

To offset margin pressure in Tier-1-3 cities, Digital China has continued to expand its distribution network to Tier-4-6 cities, but it maintains a conservative view on expanding product lines in other IT products such as handsets. Today, Digital China's handset business focuses only on smartphone distribution, including HTC, Apple, and

RIM. Meanwhile, it is also actively enhancing its distribution business with corporate and government customers.

Smartphone distribution

In China, Digital China runs more than 200 authorised Apple shops that distribute iPhones, iPads and other Apple products.

Exhibit 91. Digital China: Apple shop

Source: Nomura research

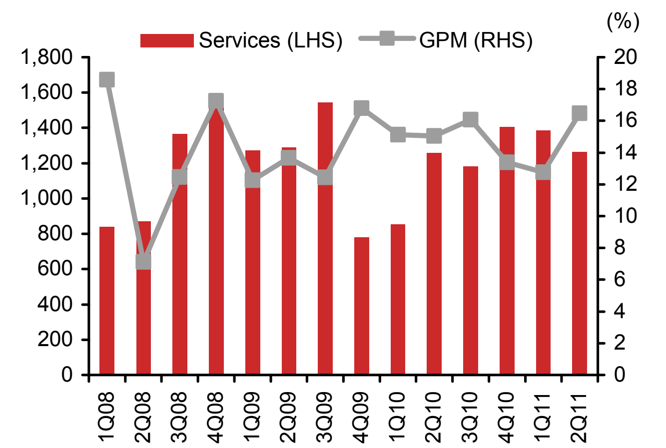
ST trend: sales growth slows down, GPM improves

Digital China's software business also slowed in 2010, due to capex reductions by telecom operators, but the software business's gross margin has improved to 16% in 2Q FY11, from 12% in 1Q FY11 owing to the rising proportion of pure software revenue.

Long-term growth: growth from government sector

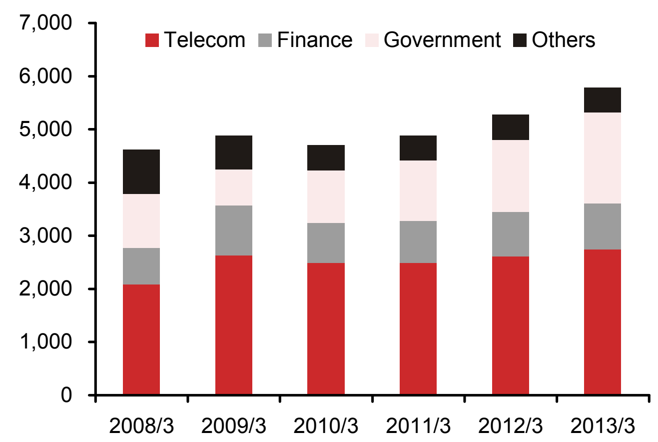
We expect significant revenue for Digital China's software business to come from the government sector, including Sm@rt City projects and related government projects. We expect a flattish revenue trend for Digital China's software service revenue in the finance and telecom sectors, given the company's weak position relative to major competitors (AsiaInfo-Linkage in telecom, Longtop in finance).

Exhibit 92. Quarterly sales trend for software service



Source: Company data, Nomura research

Exhibit 93. Earnings for software unit



Source: Company data, Nomura research

How DC intends to benefit from Sm@rt City: 1) software service, 2) distribution, 3) system operation

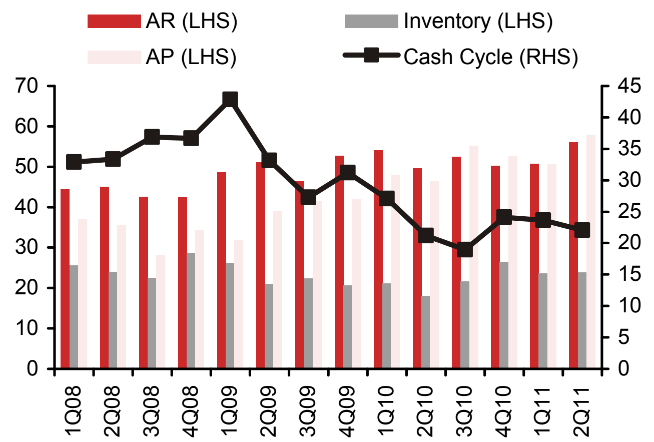
Digital China aims to construct system architecture for regional cities' digital cities. It intends to generate revenue in the form of: 1) software service revenue from regional governments for projects related to e-government and, 2) revenue from its distribution business for hardware related to e-government. In the long term, it also aims to generate revenue through operating the government's system.

Financial analysis

Healthy cash cycle

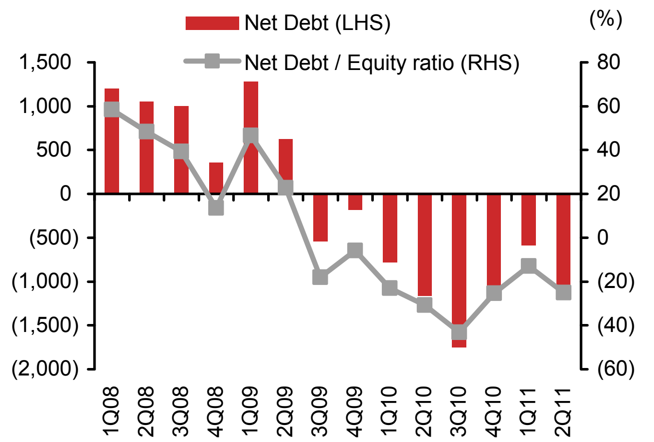
As illustrated below, Digital China has kept its cash cycle within 25 days over the past few quarters, and has been in a net cash position since 2Q FY09.

Exhibit 94. Working capital trend



Source: Company data, Nomura research

Exhibit 95. Net D/E ratio trend



Source: Company data, Nomura research

Shareholders and management team

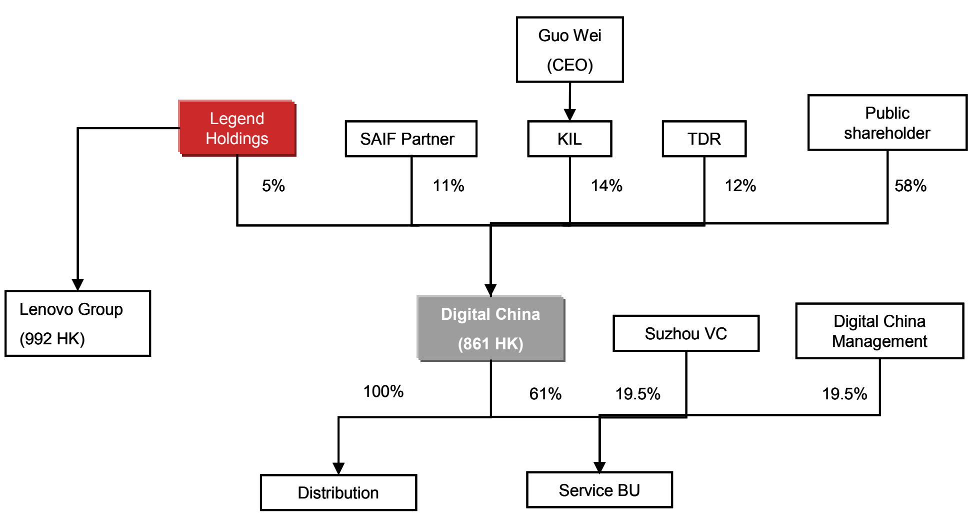
Digital China was spun off from the former Legend Group (now Lenovo Group) and listed in June 2001 in Hong Kong. Initially, Digital China engaged mainly in the distribution of IT products in China but, as early as November 2001, it began to transform its business toward IT services as marked by the formation of a joint venture to tap into the enterprise resource planning (ERP) market in China.

Transformation to a service company under CEO Mr. Guo

Digital China's current Chairman and Chief Executive Officer, Mr. Guo Wei, joined the Legend group in 1988. He has been the Vice Chairman, the President, and the Chief Executive Officer at Digital China since February 2001. In December 2007, Mr. Guo engineered a management buy-out (MBO) with venture capital funds SAIF and IDG and was appointed as the Chairman of the Board of Digital China after this transaction.

After TDR listing, Digital China's major shareholders include CEO Mr. Guo (KIF, 14%), Legend Holdings (11%), and SAIF (11%), TDR (12%). The company sold a 39% stake in the software business unit to Suzhou Venture Capital and Digital China management, and is planning to list this unit on the A-share market in 2012F.

Exhibit 96. Shareholder structure



Source: Nomura research

Financial statements

Income statement (HK$mn)					
Year-end 31 Mar	**FY09**	**FY10**	**FY11F**	**FY12F**	**FY13F**
Revenue	42,326	50,178	56,974	66,497	77,774
Cost of goods sold	(39,368)	(46,879)	(53,226)	(62,196)	(72,763)
Gross profit	**2,959**	**3,300**	**3,749**	**4,300**	**5,011**
SG&A	(2,302)	(2,543)	(2,682)	(3,095)	(3,584)
Employee share expense					
Operating profit	**656**	**757**	**1,067**	**1,205**	**1,428**
EBITDA	**1,084**	**1,400**	**1,267**	**1,405**	**1,628**
Depreciation	(428)	(643)	(200)	(200)	(200)
Amortisation	-	-	-	-	-
EBIT	**656**	**757**	**1,067**	**1,205**	**1,428**
Net interest expense	(159)	(125)	(100)	(100)	(100)
Associates & JCEs	-	-	-	-	-
Other income	239	416	229	320	320
Earnings before tax	**736**	**1,048**	**1,196**	**1,425**	**1,648**
Income tax	(127)	(174)	(199)	(237)	(274)
Net profit after tax	**609**	**874**	**997**	**1,189**	**1,374**
Minority interests	32	(49)	(40)	(48)	(55)
Other items					
Preferred dividends					
Normalised NPAT	**641**	**825**	**957**	**1,141**	**1,319**
Extraordinary items					
Reported NPAT	**641**	**825**	**957**	**1,141**	**1,319**
Dividends	(140)	(289)	(287)	(342)	(396)
Transfer to reserves	**501**	**536**	**670**	**799**	**923**
Valuation and ratio analysis					
FD normalised P/E (x)	24.3	18.9	17.7	15.4	13.3
FD normalised P/E at price target (x)	25.8	20.0	18.8	16.4	14.1
Reported P/E (x)	24.1	18.7	17.6	15.3	13.3
Dividend yield (%)	0.9	1.8	1.6	2.0	2.3
Price/cashflow (x)	21.2	15.3	33.7	87.5	7.3
Price/book (x)	4.9	3.9	3.6	3.1	2.7
EV/EBITDA (x)	16.0	11.7	12.8	11.7	9.0
EV/EBIT (x)	26.4	21.7	15.2	13.7	10.3
Gross margin (%)	7.0	6.6	6.6	6.5	6.4
EBITDA margin (%)	2.6	2.8	2.2	2.1	2.1
EBIT margin (%)	1.6	1.5	1.9	1.8	1.8
Net margin (%)	1.5	1.6	1.7	1.7	1.7
Effective tax rate (%)	17.3	16.6	16.6	16.6	16.6
Dividend payout (%)	21.8	35.0	30.0	30.0	30.0
Capex to sales (%)	0.2	0.2	0.3	0.2	0.2
Capex to depreciation (x)	0.2	0.2	0.8	0.8	0.8
ROE (%)	22.2	22.5	21.0	21.5	21.5
ROA (pretax %)	7.2	6.7	8.2	8.5	9.3
Growth (%)					
Revenue	20.1	18.6	13.5	16.7	17.0
EBITDA	9.9	29.1	(9.5)	11.0	15.8
EBIT	21.2	15.4	40.9	13.0	18.5
Normalised EPS	45.0	28.7	6.4	14.7	15.6
Normalised FDEPS	43.6	28.7	6.7	14.7	15.6
Per share					
Reported EPS (HK$)	0.67	0.86	0.91	1.05	1.21
Norm EPS (HK$)	0.67	0.86	0.91	1.05	1.21
Fully diluted norm EPS (HK$)	0.66	0.85	0.91	1.04	1.20
Book value per share (HK$)	3.26	4.11	4.49	5.23	6.05
DPS (HK$)	0.15	0.28	0.26	0.31	0.36

Source: Nomura estimates

Revenue growth in line with China PC demand

Cashflow (HK$mn)					
Year-end 31 Mar	**FY09**	**FY10**	**FY11F**	**FY12F**	**FY13F**
EBITDA	733	865	1,267	1,305	1,528
Change in working capital	(45)	72	(496)	1,000	1,300
Other operating cashflow	39	71	(271)	(105)	(128)
Cashflow from operations	**727**	**1,008**	**500**	**2,200**	**2,700**
Capital expenditure	(77)	(108)	(150)	(150)	(150)
Free cashflow	**650**	**900**	**350**	**2,050**	**2,550**
Reduction in investments	(853)	164	20	-	-
Net acquisitions					
Reduction in other LT assets					
Addition in other LT liabilities					
Adjustments	307	239	(20)	-	-
Cashflow after investing acts	**104**	**1,304**	**350**	**2,050**	**2,550**
Cash dividends	(140)	(140)	(289)	(280)	(338)
Equity issue	-	371	-	-	-
Debt issue	200	(81)	-	-	-
Convertible debt issue	-	-	-	-	-
Others	572	(417)	(33)	47	(9)
Cashflow from financial acts	**632**	**(266)**	**(322)**	**(233)**	**(347)**
Net cashflow	**736**	**1,038**	**28**	**1,817**	**2,203**
Beginning cash	998	1,734	2,772	2,800	4,600
Ending cash	1,734	2,772	2,800	4,617	6,803
Ending net debt	(157)	(1,049)	(1,100)	(2,900)	(5,100)

Source: Nomura estimates

Balance sheet (HK$mn)					
As at 31 Mar	**FY09**	**FY10**	**FY11F**	**FY12F**	**FY13F**
Cash & equivalents	1,734	2,772	2,800	4,600	6,800
Marketable securities	544	-	-	-	-
Accounts receivable	6,838	8,046	8,400	8,000	7,300
Inventories	2,136	3,368	3,100	3,600	4,300
Other current assets	(516)	16	-	-	-
Total current assets	**10,736**	**14,202**	**14,300**	**16,200**	**18,400**
LT investments	340	720	700	700	700
Fixed assets	398	374	600	600	600
Goodwill					
Other intangible assets	-	-	-	-	-
Other LT assets	72	374	400	400	400
Total assets	**11,546**	**15,670**	**16,000**	**17,900**	**20,100**
Short-term debt	875	682	700	700	700
Accounts payable	4,698	7,210	6,800	7,900	9,200
Other current liabilities	1,814	2,064	2,100	2,100	2,100
Total current liabilities	**7,387**	**9,956**	**9,600**	**10,700**	**12,000**
Long-term debt	702	1,041	1,000	1,000	1,000
Convertible debt	-	-	-	-	-
Other LT liabilities	226	-	-	-	-
Total liabilities	**8,315**	**10,997**	**10,600**	**11,700**	**13,000**
Minority interest	91	473	500	500	500
Preferred stock	-	-	-	-	-
Common stock	96	102	102	102	102
Retained earnings	3,044	4,098	4,798	5,598	6,498
Proposed dividends			-	-	-
Other equity and reserves					
Total shareholders' equity	**3,140**	**4,200**	**4,900**	**5,700**	**6,600**
Total equity & liabilities	**11,546**	**15,670**	**16,000**	**17,900**	**20,100**
Liquidity (x)					
Current ratio	1.45	1.43	1.49	1.51	1.53
Interest cover	4.1	6.1	10.7	12.1	14.3
Leverage					
Net debt/EBITDA (x)	net cash	net cash	net cash	net cash	net cash
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash
Activity (days)					
Days receivable	51.1	54.1	52.7	45.1	35.9
Days inventory	21.8	21.4	22.2	19.7	19.8
Days payable	37.2	46.4	48.0	43.3	42.9
Cash cycle	35.6	29.2	26.8	21.6	12.8

Source: Nomura estimates

Strong cash position

ZTE Corp 763 HK

TELECOMS | CHINA

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Maintained

BUY

NOMURA

NOMURA INTERNATIONAL (HK) LIMITED

Action

ZTE has long been seen by the market as a telecom equipment vendor, but its terminal (handset and data card) business is one of its key revenue drivers now, and already contributes 26% of sales (as of FY10F). Looking to FY11F, we believe entry-level smartphones will help ZTE to realise both market share and margin expansion. We are reaffirming our BUY rating, with a price target of HK$36.

Catalysts

Positive catalyst: further consolidation in the telecom equipment industry. Negative: any regulatory policy change that is unfavourable to Chinese vendors.

Anchor themes

The convergence of the telecom, Internet and television networks is an element of China's 12th Five-Year Plan. We believe this will spur both telecom and cable-TV operators to accelerate optical fibre network development, and benefit the whole optical network supplier chain in China.

Closing price on 20 Jan	HK$29.95
Price target	HK$36.00
	(set on 2 Dec 10)
Upside/downside	20.2%
Difference from consensus	16.8%
FY11F net profit (RMBmn)	3,700
Difference from consensus	-4.7%

Source: Nomura

Nomura vs consensus

FY11F earnings are -2% but revenue is +3% vs consensus. This reflects our view that the low-margin smartphone business will grow faster than the market expects.

Smartphone as a key driver

① Smartphone: chance to step up

ZTE launched more than 10 Android-based smartphones and tablets in 2010 for Chinese and European operators, mainly in the entry-level segment (sub US$200). We expect ZTE to ship 5mn smartphones in FY11F, up from 2mn in FY10F, and for revenue contribution from smartphones within the handset and data card (terminal) segment to rise to 15% in FY11F, from less than 5% in FY10F. ZTE differentiates itself from other China vendors by its strong relationships with global operators via business on wireless equipment, and its strong R&D capability covering all three 3G technologies.

② Network convergence: sustainable revenue driver

ZTE is the second-largest optical vendor in China and had a 22% market share in 1Q FY10. We expect the network-convergence policy to generate sustainable demand for optical network equipment in the coming years, and believe ZTE can use its strong product portfolio and customer relationships to capitalise on the business opportunities. We forecast ~35% y-y growth in ZTE's optical and data communication revenue in FY11F.

③ Mobile: India 3G rollout and TD-LTE

Our initial analysis shows the TD-LTE capex will be around RMB42bn over the next few years, assuming coverage similar to TD-SCDMA today, but its contribution to ZTE's FY11F revenue will still be too small to compensate for the decline in 3G, we believe. On the other hand, we note that ZTE has secured several important contacts in the Indian 3G market, including Reliance Communications and BSNL. We expect these overseas revenue contributions to offset the decline in China, and forecast 7% y-y growth in its wireless business in FY11F.

④ Valuation: PT of HK$36

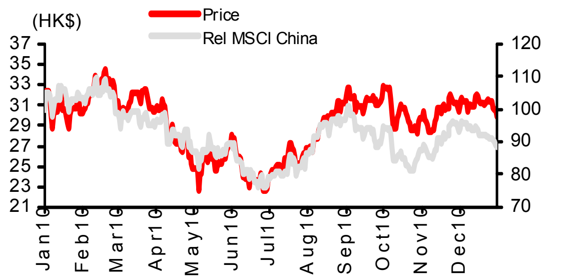
We base our PT of HK$36 on 24x FY11F EPS.

Key financials & valuations

31 Dec (RMBmn)	FY09	FY10F	FY11F	FY12F
Revenue	60,273	70,500	86,500	107,300
Reported net profit	2,458	2,900	3,700	4,600
Normalised net profit	2,458	2,900	3,700	4,600
Normalised EPS (RMB)	0.90	1.02	1.29	1.60
Norm. EPS growth (%)	42.3	13.0	26.7	24.3
Norm. P/E (x)	29.1	24.3	18.1	14.6
EV/EBITDA (x)	23.3	18.7	15.0	12.6
Price/book (x)	4.3	3.7	3.1	2.6
Dividend yield (%)	0.8	0.9	1.2	1.5
ROE (%)	15.8	16.1	18.0	19.3
Net debt/equity (%)	net cash	net cash	net cash	net cash
Earnings revisions				
Previous norm. net profit		2,900	3,700	4,600
Change from previous (%)		-	-	-
Previous norm. EPS (RMB)		1.01	1.29	1.60

Source: Company, Nomura estimates

Share price relative to MSCI China



	1m	3m	6m
Absolute (HK$)	(1.5)	(5.5)	25.8
Absolute (US$)	(1.5)	(5.8)	25.7
Relative to Index	(5.2)	(3.1)	13.8
Market cap (US$mn)			11,033
Estimated free float (%)			18.3
52-week range (HK$)			34.47/22.65
3-mth avg daily turnover (US$mn)			18.03
Stock borrowability			Hard
Major shareholders (%)			
Shenzhen Zhongxingxin			32.5
HKSCC Nominees Limited			18.3

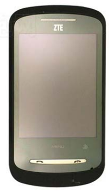
Source: Company, Nomura estimates

Drilling down

Drilling Down

ZTE has launched more than 10 Android-based smartphones and tablets since the beginning of 2010 for three Chinese operators and several European operators, including Vodafone and Orange. The retail prices of these models are US$150-US$200. In October, it demonstrated its first 7-inch Android-based tablet at a Chinese communication equipment show. The company expects 2mn smartphone shipments in FY10F. We expect ZTE will ship 5mn smartphones in FY11F, with the revenue contribution from smartphones within the handset and data card (terminal) segment rising to 15% in FY11F, from less than 5% in FY10F.

Exhibit 97. ZTE's entry-level smartphones

Model	ZTE Blade/Orange San Francisco	ZTE X850
Photo		
Screen	3.5inch QVGA Capacitive touch	2.8inch QVGA Resistive touch
Communication standard	GSM/HSPA	GSM/HSPA
OS	Android 2.2	Android 2.1
CPU	Qualcomm MSM 7227	Qualcomm MSM 7227
Market	France, China	UK, France, China
Retail price	~US$150	~US$150
Launch date	3Q 2010	1Q 2010

Source: Company data, Nomura estimates

Top share in China Mobile

The company secured the largest market shares (3 of 12 models, roughly 25% volume share) in China Mobile's latest round of handset procurement bidding.

Exhibit 98. China Mobile's TD-SCDMA handset bidding in November 2010

Lower-end 3G (~RMB$500)		Mid-end 3G (RMB$800-1k)	
Vendor	**No. of Model**	**Vendor**	**No. of Model**
ZTE	2	ZTE	1
Coolpad(China Wireless)	1	Coolpad(China Wireless)	1
Lenovo	1	Lenovo	1
Hisenses	1	Huawei	1
Huawei	1	NewPostcom	1
T-smart	1		
Sub-total	7		5
Total			12
Total volume (mn)			6

Source: Nomura research

Revenue contribution analysis: 25% market share in China Mobile = RMB2.0bn (~9% of terminal sales)

We expect China Mobile to continue its centralised procurement scheme for handsets in 2011, and this will benefit local companies such as ZTE. If we assume ZTE's product is competitive enough to maintain its 25% market share in China Mobile, and China Mobile purchased 60% of its handsets via this scheme, it would generate around a RMB2.0bn (~9% of its sales in the terminal business) revenue contribution to ZTE.

RMB2.0bn = 34mn units * 60% (share via bidding process) * 25% (ZTE share)

The exhibit below summarises our forecasts. Revenue in the wireless communication segment should decline by 9% y-y in FY10F due to weak demand in China, but should recover somewhat on overseas sales, we believe. Growth in the optical and data segment and wireline switch segment should accelerate, driven by the network convergence policy in China and a global shortage of network capacity due to the smartphone trend. We see terminal business revenue growing 31% in FY11F, driven by the smartphone business taking off.

Sales by product: growth in terminal and optical offsets decline in wireless

Exhibit 99. Summary of earnings forecast by product

(RMBmn)	2008	2009	2010F	2011F	2012F
Sales	**44,293**	**60,273**	**70,500**	**86,500**	**107,300**
(by products)					
Carrier Networks	28,964	39,982	43,800	52,100	64,200
Wireless Comm	17,500	27,900	25,400	27,200	31,000
Optical and Data	8,300	8,900	12,000	16,300	22,000
Wireline Switch	3,164	3,182	6,400	8,600	11,200
Terminal	9,693	13,072	18,000	23,500	29,500
Telecom Services	5,637	7,219	8,700	10,900	13,600
y-y % growth					
Carrier Networks (%)	28	38	10	19	23
Wireless Comm (%)	18	59	(9)	7	14
Optical and Data (%)	30	7	35	36	35
Wireline Switch (%)	134	1	101	34	30
Terminal (%)	27	35	38	31	26
Telecom Services (%)	23	28	21	25	25
Gross Profit	**14,801**	**19,649**	**23,200**	**28,000**	**34,300**
% of sales	33.4	32.6	32.9	32.4	32.0

Note: Sales of wireless communication, optical and wireline switch in FY08-FY09 are Nomura estimates

Source: Company data, Nomura estimates

Valuation Methodology

We derive our PT using a 24x P/E multiple (unchanged). The stock has traded at 2.5x 12-month forward P/BV and 23x 12-month forward P/E on average since 2005. Since on our forecasts its net profit CAGR from FY10 to FY12F is higher (24%) than that from FY05 to FY09 (around 19%), we believe it is reasonable to apply a 24x P/E multiple to FY11F EPS of RMB1.29 (HK$1.50) to derive our revised price target of HK$36 per share.

Higher P/E than historical average reflects acceleration in EPS growth

Downside risks include: 1) any regulatory policy change that is unfavourable to Chinese vendors; 2) larger-than-expected capex reduction plans by Chinese and overseas operators; 3) mounting price competition in the 2G/3G market; and 4) a significant increase in bad debt and failure to control operating costs.

Downside risk: 1) unfavourable regulatory policy; 2) capex cut at operators

Upside risks include: 1) larger-than-expected volume of 3G handsets owing to operators' active subsidy strategy; 2) further consolidation in the telecom equipment industry; 3) stronger-than-expected recovery in the overseas infrastructure market; and 4) margin strength and better cost control.

Upside risk: 1) operators' active subsidiary strategy; 2) industry consolidation

Financial statements

Income statement (RMBmn)					
Year-end 31 Dec	**FY08**	**FY09**	**FY10F**	**FY11F**	**FY12F**
Revenue	44,293	60,273	70,500	86,500	107,300
Cost of goods sold	(29,493)	(40,623)	(47,300)	(58,500)	(73,000)
Gross profit	**14,801**	**19,649**	**23,200**	**28,000**	**34,300**
SG&A	(13,114)	(17,179)	(20,300)	(24,500)	(30,000)
Employee share expense					
Operating profit	**1,687**	**2,470**	**2,900**	**3,500**	**4,300**
EBITDA	**2,387**	**3,233**	**3,800**	**4,500**	**5,400**
Depreciation	(700)	(763)	(900)	(1,000)	(1,100)
Amortisation	-	-	-	-	-
EBIT	**1,687**	**2,470**	**2,900**	**3,500**	**4,300**
Net interest expense	(442)	(406)	(500)	(500)	(600)
Associates & JCEs	-	-	-	-	-
Other income	1,017	1,261	1,600	2,100	2,500
Earnings before tax	**2,263**	**3,325**	**4,000**	**5,100**	**6,200**
Income tax	(351)	(629)	(800)	(1,000)	(1,200)
Net profit after tax	**1,912**	**2,696**	**3,200**	**4,100**	**5,000**
Minority interests	(252)	(238)	(300)	(400)	(400)
Other items					
Preferred dividends					
Normalised NPAT	**1,660**	**2,458**	**2,900**	**3,700**	**4,600**
Extraordinary items					
Reported NPAT	**1,660**	**2,458**	**2,900**	**3,700**	**4,600**
Dividends	(403)	(552)	(652)	(832)	(1,034)
Transfer to reserves	**1,257**	**1,906**	**2,248**	**2,868**	**3,566**
Valuation and ratio analysis					
FD normalised P/E (x)	42.3	29.1	24.3	18.1	14.6
FD normalised P/E at price target (x)	50.9	35.0	29.2	21.8	17.5
Reported P/E (x)	42.3	29.1	24.3	18.1	14.6
Dividend yield (%)	0.6	0.8	0.9	1.2	1.5
Price/cashflow (x)	19.3	19.2	19.1	19.7	19.7
Price/book (x)	4.9	4.3	3.7	3.1	2.6
EV/EBITDA (x)	32.8	23.3	18.7	15.0	12.6
EV/EBIT (x)	46.5	30.5	24.5	19.3	15.8
Gross margin (%)	33.4	32.6	32.9	32.4	32.0
EBITDA margin (%)	5.4	5.4	5.4	5.2	5.0
EBIT margin (%)	3.8	4.1	4.1	4.0	4.0
Net margin (%)	3.7	4.1	4.1	4.3	4.3
Effective tax rate (%)	15.5	18.9	20.0	19.6	19.4
Dividend payout (%)	24.3	22.5	22.5	22.5	22.5
Capex to sales (%)	4.3	3.4	3.1	2.7	2.2
Capex to depreciation (x)	2.7	2.7	2.4	2.3	2.2
ROE (%)	12.6	15.8	16.1	18.0	19.3
ROA (pretax %)	4.7	5.3	5.2	5.7	6.1
Growth (%)					
Revenue	27.4	36.1	17.0	22.7	24.0
EBITDA	30.8	35.4	17.5	18.4	20.0
EBIT	38.9	46.4	17.4	20.7	22.9
Normalised EPS	32.6	42.3	13.0	26.7	24.3
Normalised FDEPS	32.6	42.3	13.0	26.7	24.3
Per share					
Reported EPS (RMB)	0.63	0.90	1.02	1.29	1.60
Norm EPS (RMB)	0.63	0.90	1.02	1.29	1.60
Fully diluted norm EPS (RMB)	0.63	0.90	1.02	1.29	1.60
Book value per share (RMB)	5.44	6.12	6.66	7.67	8.93
DPS (RMB)	0.15	0.20	0.23	0.29	0.36

Source: Nomura estimates

Margin declines due to growth in low-margin smartphone sales

Cashflow (RMBmn)					
Year-end 31 Dec	**FY08**	**FY09**	**FY10F**	**FY11F**	**FY12F**
EBITDA	2,387	3,233	3,800	4,500	5,400
Change in working capital	1,365	(629)	(1,491)	(2,200)	(2,800)
Other operating cashflow	(104)	1,126	1,391	1,100	800
Cashflow from operations	**3,648**	**3,729**	**3,700**	**3,400**	**3,400**
Capital expenditure	(1,912)	(2,054)	(2,200)	(2,300)	(2,400)
Free cashflow	**1,736**	**1,675**	**1,500**	**1,100**	**1,000**
Reduction in investments	(115)	(274)	(6)	-	-
Net acquisitions					
Reduction in other LT assets					
Addition in other LT liabilities					
Adjustments	40	27	6	(1,000)	(600)
Cashflow after investing acts	**1,660**	**1,428**	**1,500**	**100**	**400**
Cash dividends	(830)	(1,045)	(552)	(652)	(832)
Equity issue	43	46	-	-	-
Debt issue	468	2,286	1,260	250	285
Convertible debt issue	3,961	-	-	-	-
Others	(306)	301	(4)	2	46
Cashflow from financial acts	**3,337**	**1,588**	**704**	**(400)**	**(500)**
Net cashflow	**4,997**	**3,017**	**2,204**	**(300)**	**(100)**
Beginning cash	6,483	11,480	14,497	16,700	16,400
Ending cash	11,481	14,497	16,700	16,400	16,300
Ending net debt	(1,009)	(1,621)	(1,300)	(800)	(400)

Source: Nomura estimates

Trend of positive operating cash will continue, in our view

Balance sheet (RMBmn)					
As at 31 Dec	**FY08**	**FY09**	**FY10F**	**FY11F**	**FY12F**
Cash & equivalents	11,480	14,497	16,700	16,400	16,300
Marketable securities	-	-	-	-	-
Accounts receivable	21,171	29,286	29,500	33,800	38,900
Inventories	8,978	9,325	11,300	14,000	17,400
Other current assets	1,659	2,870	2,900	2,900	2,900
Total current assets	**43,288**	**55,978**	**60,400**	**67,100**	**75,500**
LT investments	420	694	700	700	700
Fixed assets	4,103	4,715	5,886	7,086	8,286
Goodwill					
Other intangible assets	589	614	614	614	614
Other LT assets	2,466	6,342	6,300	6,300	6,300
Total assets	**50,866**	**68,342**	**73,900**	**81,800**	**91,400**
Short-term debt	5,664	6,846	6,100	6,500	6,500
Accounts payable	23,169	31,001	31,700	36,500	42,200
Other current liabilities	1,164	3,247	3,300	3,300	3,300
Total current liabilities	**29,997**	**41,095**	**41,100**	**46,300**	**52,000**
Long-term debt	1,293	2,396	5,700	5,500	5,800
Convertible debt	3,515	3,633	3,600	3,600	3,600
Other LT liabilities	878	3,269	3,300	3,300	3,300
Total liabilities	**35,682**	**50,393**	**53,700**	**58,700**	**64,700**
Minority interest	934	1,124	1,100	1,100	1,100
Preferred stock	-	-	-	-	-
Common stock	1,343	1,831	1,831	1,831	1,831
Retained earnings	12,906	14,994	17,269	20,169	23,769
Proposed dividends			-	-	-
Other equity and reserves					
Total shareholders' equity	**14,250**	**16,825**	**19,100**	**22,000**	**25,600**
Total equity & liabilities	**50,866**	**68,342**	**73,900**	**81,800**	**91,400**
Liquidity (x)					
Current ratio	1.44	1.36	1.47	1.45	1.45
Interest cover	3.8	6.1	5.8	7.0	7.2
Leverage					
Net debt/EBITDA (x)	net cash	net cash	net cash	net cash	net cash
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash
Activity (days)					
Days receivable	163.3	152.8	152.2	133.6	124.0
Days inventory	101.8	82.2	79.6	78.9	78.7
Days payable	252.0	243.4	241.9	212.8	197.3
Cash cycle	13.1	(8.4)	(10.2)	(0.3)	5.4

Source: Nomura estimates

HTC Corporation 2498 TT

TECHNOLOGY/HANDSETS | TAIWAN

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Maintained

BUY

NOMURA

NOMURA INTERNATIONAL (HK) LIMITED
TAIPEI BRANCH

Closing price on 20 Jan	NT$894
Price target	NT$1,000
	(set on 23 Nov 10)
Upside/downside	11.9%
Difference from consensus	16.3%
FY11F net profit (NT$mn)	57,943
Difference from consensus	7.6%

Source: Nomura

Action

We reaffirm our BUY rating on HTC given our view that further upside remains, driven by expected market-share gains on its leading technology in hardware and software, as well as on rising brand awareness. We believe the company is well-positioned within its industry to benefit from the trend of device convergence. We like its strategy to keep strengthening the "Sense experience", which in our view will prove to be an important differentiator as the market matures in 2012F.

Catalysts

Rollout of more high-end innovative products in 1H11F, market share upside and further consensus earnings upward revisions.

Anchor themes

Converging devices are a prominent and long-term trend, in our view. We favour companies with proven knowledge in both hardware and software design for advanced mobile devices.

Nomura vs consensus

Our FY11F EPS estimates are higher than consensus; however, we are relatively cautious on FY12F earnings growth.

Right trend, right strategy

① Maintain BUY and NT$1,000 price target

We maintain our BUY rating and price target of NT$1,000 for HTC, based on 14x FY11F EPS. We expect Android handsets to evolve into a fragmented market, with mid- to low-end models becoming relatively standardised, while high-end models remain differentiated. We believe HTC has positioned itself well for further market-share gains, which support our target P/E multiple of 14x.

② Mid- to low-end smartphones to be launched in 2H11

HTC stated it plans to launch its smartphones Marvel and Chacha in late 2Q11F, in the low-end price category (retail price below US$400). We have high expectations for the two low-end models and expect mid- to low-end smartphones to continue to underpin HTC's shipment growth. In our view, the high-end smartphone market is mature and we expect low-end smartphones to pick up in 2H11F. The company keeps building/developing the "Sense experience" by not only making its UI more user friendly but extending the experience to a cloud service (Sense.com). With the value-added "Sense experience", we expect HTC to enjoy some price premium even in the mid- to low-end market, which should help it to sustain gross margin.

③ Microsoft support for ARM core to extend innovation cycle

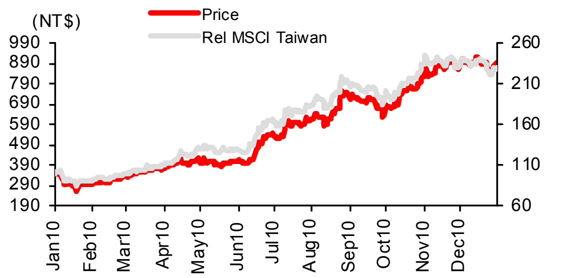
We believe HTC will continue to innovate in 1H11F, with the launch of the first LTE phone and the first Qualcomm-based dual core smartphone being cases in point. Microsoft's recent announcement of support for ARM's core architecture is likely to further extend both the hardware and software innovation cycle beyond 2011F, boding well for technology leaders like HTC, in our view.

Key financials & valuations

31 Dec (NT$mn)	FY09	FY10F	FY11F	FY12F
Revenue	144,881	272,697	445,779	523,162
Reported net profit	22,583	38,336	57,943	62,263
Normalised net profit	22,583	38,336	57,943	62,263
Normalised EPS (NT$)	28.7	47.9	70.9	76.1
Norm. EPS growth (%)	(24.4)	67.2	47.8	7.5
Norm. P/E (x)	31.2	18.6	12.6	11.7
EV/EBITDA (x)	26.1	15.2	9.9	8.8
Price/book (x)	10.7	9.4	7.1	6.2
Dividend yield (%)	2.7	4.4	6.2	6.5
ROE (%)	35.8	53.4	63.8	56.0
Net debt/equity (%)	net cash	net cash	net cash	net cash
Earnings revisions				
Previous norm. net profit		38,336	57,943	62,263
Change from previous (%)		-	-	-
Previous norm. EPS (NT$)		47.9	70.9	76.1

Source: Company, Nomura estimates

Share price relative to MSCI Taiwan



	1m	3m	6m
Absolute (NT$)	3.4	33.2	62.7
Absolute (US$)	6.3	41.7	80.1
Relative to Index	(0.8)	21.0	48.7
Market cap (US$mn)			25,172
Estimated free float (%)			75.0
52-week range (NT$)			921/264.8
3-mth avg daily turnover (US$mn)			146.4
Stock borrowability			Hard
Major shareholders (%)			
Capital World			7.9
Fidelity			6.1

Source: Company, Nomura estimates

Valuation methodology and investment risks

Our target P/E of 14x is at the high end of the historical (FY08-FY10) P/E range, reflecting strong earnings growth prospects into FY11F. Key investment risks include: 1) technology evolution slowdown; 2) weak acceptance in the mid- to low-end smartphone market; and 3) too-high expectations for smartphones.

Financial statements

Income statement (NT$mn)					
Year-end 31 Dec	**FY08**	**FY09**	**FY10F**	**FY11F**	**FY12F**
Revenue	152,559	144,881	272,697	445,779	523,162
Cost of goods sold	(101,917)	(99,018)	(192,633)	(315,219)	(374,504)
Gross profit	**50,642**	**45,862**	**80,064**	**130,560**	**148,657**
SG&A	(13,699)	(16,402)	(29,158)	(53,254)	(63,847)
Employee share expense	(6,727)	(5,312)	(9,006)	(13,613)	(14,627)
Operating profit	**30,215**	**24,149**	**41,900**	**63,693**	**70,183**
EBITDA	**30,820**	**24,823**	**42,552**	**64,356**	**70,872**
Depreciation	(568)	(634)	(600)	(613)	(638)
Amortisation	(36)	(40)	(53)	(50)	(51)
EBIT	**30,215**	**24,149**	**41,900**	**63,693**	**70,183**
Net interest expense	1,368	349	280	290	337
Associates & JCEs	603	781	1,120	1,121	1,046
Other income	(637)	(92)	(176)	-	-
Earnings before tax	**31,549**	**25,187**	**43,124**	**65,104**	**71,567**
Income tax	(2,955)	(2,604)	(4,788)	(7,161)	(9,304)
Net profit after tax	**28,594**	**22,583**	**38,336**	**57,943**	**62,263**
Minority interests	-	-	-	-	-
Other items	-	-	-	-	-
Preferred dividends	-	-	-	-	-
Normalised NPAT	**28,594**	**22,583**	**38,336**	**57,943**	**62,263**
Extraordinary items	-	-	-	-	-
Reported NPAT	**28,594**	**22,583**	**38,336**	**57,943**	**62,263**
Dividends	(20,396)	(18,731)	(31,888)	(44,971)	(47,424)
Transfer to reserves	**8,199**	**3,852**	**6,447**	**12,972**	**14,839**
Valuation and ratio analysis					
FD normalised P/E (x)	23.6	31.2	18.6	12.6	11.7
FD normalised P/E at price target (x)	26.4	34.9	20.9	14.1	13.1
Reported P/E (x)	23.6	31.2	18.6	12.6	11.7
Dividend yield (%)	3.0	2.7	4.4	6.2	6.5
Price/cashflow (x)	17.9	25.6	18.7	13.1	10.9
Price/book (x)	11.1	10.7	9.4	7.1	6.2
EV/EBITDA (x)	21.3	26.1	15.2	9.9	8.8
EV/EBIT (x)	21.7	26.8	15.4	10.0	8.9
Gross margin (%)	33.2	31.7	29.4	29.3	28.4
EBITDA margin (%)	20.2	17.1	15.6	14.4	13.5
EBIT margin (%)	19.8	16.7	15.4	14.3	13.4
Net margin (%)	18.7	15.6	14.1	13.0	11.9
Effective tax rate (%)	9.4	10.3	11.1	11.0	13.0
Dividend payout (%)	71.3	82.9	83.2	77.6	76.2
Capex to sales (%)	3.0	1.0	0.6	0.3	0.3
Capex to depreciation (x)	8.0	2.2	2.8	2.0	2.1
ROE (%)	49.0	35.8	53.4	63.8	56.0
ROA (pretax %)	69.4	45.0	50.3	50.1	46.9
Growth (%)					
Revenue	28.7	(5.0)	88.2	63.5	17.4
EBITDA	(0.9)	(19.5)	71.4	51.2	10.1
EBIT	(1.1)	(20.1)	73.5	52.0	10.2
Normalised EPS	(24.9)	(24.4)	67.2	47.8	7.5
Normalised FDEPS	(24.9)	(24.4)	67.2	47.8	7.5
Per share					
Reported EPS (NT$)	37.9	28.7	47.9	70.9	76.1
Norm EPS (NT$)	37.9	28.7	47.9	70.9	76.1
Fully diluted norm EPS (NT$)	37.9	28.7	47.9	70.9	76.1
Book value per share (NT$)	80.3	83.2	95.5	126.7	145.2
DPS (NT$)	27.0	23.7	39.0	55.0	58.0

Source: Nomura estimates

Strong EPS growth to continue into FY11F

Cashflow (NT$mn)					
Year-end 31 Dec	**FY08**	**FY09**	**FY10F**	**FY11F**	**FY12F**
EBITDA	30,820	24,823	42,552	64,356	70,872
Change in working capital	8,849	1,555	(3,046)	(7,264)	(2,569)
Other operating cashflow	(2,074)	1,164	(1,371)	(1,119)	(1,355)
Cashflow from operations	**37,594**	**27,542**	**38,135**	**55,973**	**66,948**
Capital expenditure	(4,570)	(1,423)	(1,704)	(1,216)	(1,368)
Free cashflow	**33,025**	**26,119**	**36,431**	**54,757**	**65,580**
Reduction in investments	(2,229)	(3,861)	(1,887)	(866)	(462)
Net acquisitions	-	-	-	-	-
Reduction in other LT assets	(856)	(1,880)	0	(40)	(40)
Addition in other LT liabilities	6	(5)	(1)	-	-
Adjustments	946	2,015	889	40	40
Cashflow after investing acts	**30,892**	**22,387**	**35,432**	**53,891**	**65,118**
Cash dividends	(19,487)	(20,126)	(20,122)	(32,424)	(48,952)
Equity issue	(3,410)	(2,407)	(7,700)	(3,800)	(4,000)
Debt issue	-	-	-	-	-
Convertible debt issue	-	0	0	-	-
Others	(1,204)	(5)	(1,501)	(1,500)	(1,500)
Cashflow from financial acts	**(24,101)**	**(22,538)**	**(29,323)**	**(37,724)**	**(54,452)**
Net cashflow	**6,791**	**(150)**	**6,109**	**16,167**	**10,666**
Beginning cash	55,036	61,827	61,676	67,786	83,953
Ending cash	61,827	61,676	67,786	83,953	94,619
Ending net debt	(61,827)	(61,676)	(67,786)	(83,953)	(94,619)

Source: Nomura estimates

Balance sheet (NT$mn)					
As at 31 Dec	**FY08**	**FY09**	**FY10F**	**FY11F**	**FY12F**
Cash & equivalents	61,827	61,676	67,786	83,953	94,619
Marketable securities	-	2,516	401	401	401
Accounts receivable	29,799	27,571	66,258	88,478	96,716
Inventories	7,418	4,739	19,166	26,799	29,815
Other current assets	2,228	4,524	4,149	4,149	4,149
Total current assets	**101,272**	**101,025**	**157,760**	**203,780**	**225,700**
LT investments	5,161	6,506	10,507	11,373	11,835
Fixed assets	7,376	8,314	9,686	10,902	12,270
Goodwill	-	-	-	-	-
Other intangible assets	-	-	-	-	-
Other LT assets	1,418	3,298	3,298	3,337	3,378
Total assets	**115,226**	**119,143**	**181,251**	**229,392**	**253,182**
Short-term debt	-	-	-	-	-
Accounts payable	27,907	24,882	63,524	86,395	95,357
Other current liabilities	26,651	28,619	39,671	39,388	39,112
Total current liabilities	**54,558**	**53,502**	**103,195**	**125,783**	**134,469**
Long-term debt	-	-	-	-	-
Convertible debt	-	-	-	-	-
Other LT liabilities	6	1	1	1	1
Total liabilities	**54,565**	**53,503**	**103,196**	**125,784**	**134,469**
Minority interest	-	-	-	-	-
Preferred stock	-	-	-	-	-
Common stock	7,554	7,889	8,177	8,177	8,177
Retained earnings	56,454	57,738	69,907	95,460	110,565
Proposed dividends	-	-	-	-	-
Other equity and reserves	(3,346)	13	(29)	(29)	(29)
Total shareholders' equity	**60,661**	**65,640**	**78,055**	**103,608**	**118,713**
Total equity & liabilities	**115,226**	**119,143**	**181,251**	**229,392**	**253,182**
Liquidity (x)					
Current ratio	1.86	1.89	1.53	1.62	1.68
Interest cover	na	na	na	na	na
Leverage					
Net debt/EBITDA (x)	net cash	net cash	net cash	net cash	net cash
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash
Activity (days)					
Days receivable	59.1	72.3	62.8	63.3	64.8
Days inventory	24.3	22.4	22.6	26.6	27.7
Days payable	89.6	97.3	83.8	86.8	88.8
Cash cycle	(6.2)	(2.6)	1.7	3.2	3.6

Source: Nomura estimates

Zero debt operations

Gome Electrical Appliances 493 HK

CONSUMER RELATED/GENERAL CONSUMER | CHINA

Maintained

BUY

NOMURA
NOMURA INTERNATIONAL (HK) LIMITED

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Action

According to Gome, demand for new products is high owing to rising incomes and improving lifestyles. We believe new products bode well for SSS and sales efficiency improvement, given their relatively high ASPs. Gome is likely to accelerate its new store openings in FY11F, from 150-200 to 200-250. We believe faster-than-expected store expansion will be the earnings driver from FY11F. We reiterate our BUY rating and PT of HK$4.3.

Catalysts

Better-than-expected results, accelerating SSS and more favourable macro policies would be positive catalysts.

Anchor themes

With China's GDP growth likely to remain strong at 9.8% in 2011F, we are positive on the growth outlook for retail stocks. The transformation of China's economic growth appears to be under way, with consumption increasingly important.

Closing price on 20 Jan	HK$2.89
Price target	**HK$4.30**
	(set on 7 Dec 10)
Upside/downside	48.8%
Difference from consensus	33.5%
FY11 net profit (RMBmn)	2,320
Difference from consensus	na

Source: Nomura

Nomura vs consensus

Our price target is higher than consensus since we are more upbeat on Gome's growth outlook.

Rising demand for new products

① Smartphone sales took off in 2H10

According to Gome, demand for new products is high owing to rising incomes and improving lifestyles. For example, smartphones already account for 40% of handset sales, although they were rolled out on a large scale only in 2H10. We forecast China will be the second-largest smartphone market (after the US) in terms of volume by 2012 driven by growth of entry-level (sub-US$200) 3G smartphones. Also, 3G mobile phones have maintained their sales momentum and now account for 30% of Gome's handset sales. We believe the new products bode well for SSS and sales efficiency improvement, given their relatively high ASPs.

② Likely to accelerate new store openings

According to management, Gome is likely to guide up on new store openings from 150-200 in FY11F to 200-250, in view of good demand from smaller cities and the improved logistics/distribution system. Most new store openings will be in smaller cities, in our view, to deepen penetration and sustain long-term growth. We believe the expense ratio will remain high in 4Q10 and FY11F, in view of new store openings. For example, its expense ratio rose from 11.4% in 2Q10 to 12.9% in 3Q10 when net new store openings rose from 12 to 47 over the same period. Nevertheless, we believe the dilution in 4Q could be less significant than in 3Q owing to strong SSS and additional supplier income booked on seasonality. For FY11F, we expect operating margins to remain solid at 5.2%.

③ Reiterate BUY

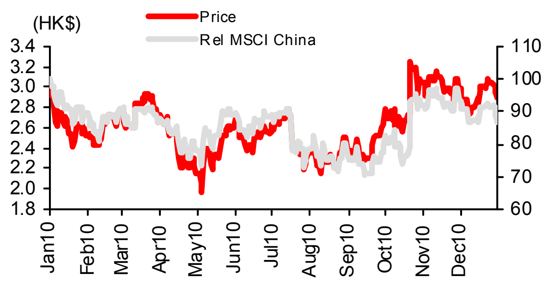
Based on our latest discussion with management, we believe 4Q SSS remained strong despite a difficult comparison (4Q09: 25.7% y-y), on account of consumer confidence and ongoing new product initiatives. The company is studying the feasibility of accelerating new store openings in FY11F, which bodes well for top-line growth, in our view. We reiterate our BUY rating and PT of HK$4.3.

Key financials & valuations

31 Dec (RMBmn)	FY09	FY10	FY11	FY12
Revenue	42,668	50,243	59,317	70,749
Reported net profit	1,409	2,042	2,320	2,788
Normalised net profit	1,598	2,319	2,780	3,228
Normalised EPS (RMB)	0.089	0.129	0.155	0.180
Norm. EPS growth (%)	(35.2)	45.1	19.9	16.1
Norm. P/E (x)	27.7	18.4	14.9	12.8
EV/EBITDA (x)	18.0	11.2	8.7	7.0
Price/book (x)	3.1	2.6	2.3	2.0
Dividend yield (%)	0.0	1.5	2.0	2.4
ROE (%)	13.8	16.2	16.3	17.3
Net debt/equity (%)	net cash	net cash	net cash	net cash
Earnings revisions				
Previous norm. net profit		2,319	2,780	3,228
Change from previous (%)		-	-	-
Previous norm. EPS (RMB)		0.129	0.155	0.180

Source: Company, Nomura estimates

Share price relative to MSCI China



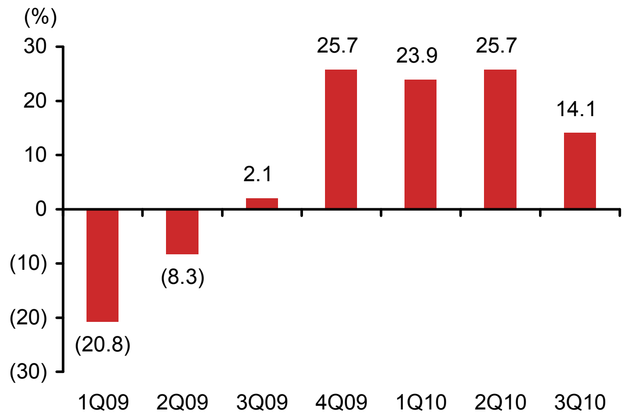
	1m	3m	6m
Absolute (HK$)	(2.0)	8.6	12.5
Absolute (US$)	(2.1)	8.4	12.4
Relative to Index	(7.8)	9.1	(1.8)
Market cap (US$mn)			5,591
Estimated free float (%)			59.0
52-week range (HK$)			3.24/1.97
3-mth avg daily turnover (US$mn)			39.43
Stock borrowability			Easy
Major shareholders (%)			
Huang Guangyu			31.0
Bain capital			10.0

Source: Company, Nomura estimates

Valuation and risks

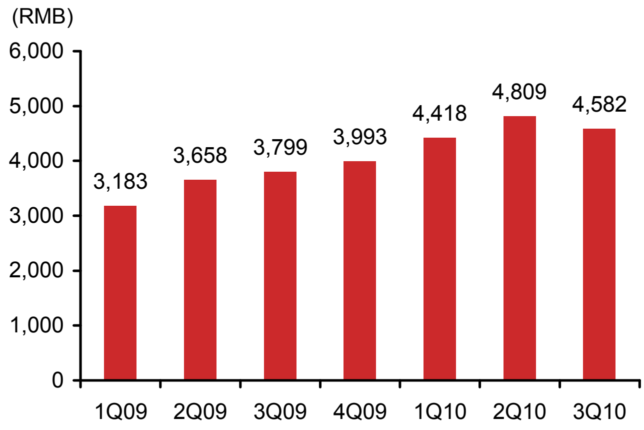
Our price target of HK$4.3 is based on 22x FY11F P/E (EPS: RMB0.155), in line with the stock's historical 12-month forward P/E. Upside would come from better-than-expected store efficiency and store numbers. Downside risks include weaker-than-expected consumption, rising competition and lower SSS.

Exhibit 100. Gome: same-store sales



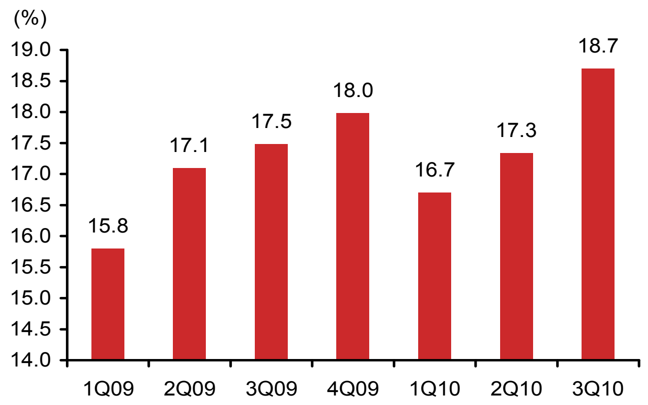
Source: Company data, Nomura research

Exhibit 101. Gome: sales per sqm



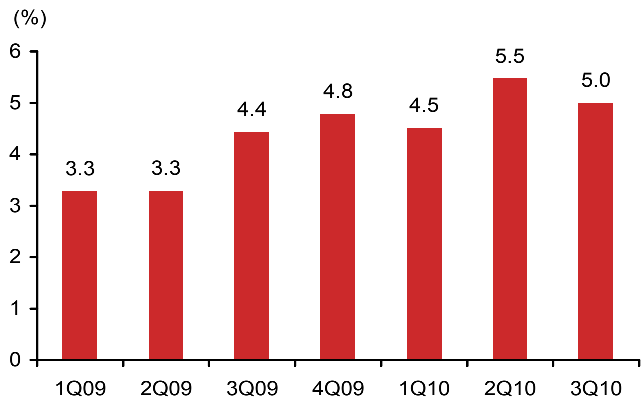
Source: Company data, Nomura research

Exhibit 102. Gome: consolidated gross margin



Source: Company data, Nomura research

Exhibit 103. Gome: EBIT margin



Source: Company data, Nomura research

Events to watch

Gome announced the results of the poll held at the Special General Meeting on 17 December. As we had expected, the proposal to enlarge the board (from 11 to 13 seats) and the appointment of ex-chairman Huang Guangyu's lawyer and sister as new directors were passed with votes in favour (97.7%, 93.3% and 92.7%, respectively).

We believe the worst is over with regard to the apparent conflicts between the ex-chairman and current chairman. The enlargement of the board should help the ex-chairman secure greater control, while maintaining stability of the unlisted stores, which is positive for Gome's operations, in our view. According to our discussion with management, operations remain normal after the enlargement of the board.

Financial statements

Income statement (RMBmn)					
Year-end 31 Dec	**FY08**	**FY09**	**FY10**	**FY11**	**FY12**
Revenue	45,889	42,668	50,243	59,317	70,749
Cost of goods sold	(41,381)	(38,408)	(44,724)	(52,624)	(62,625)
Gross profit	**4,508**	**4,260**	**5,518**	**6,693**	**8,124**
SG&A	(2,564)	(2,563)	(2,981)	(3,601)	(4,473)
Employee share expense					
Operating profit	**1,944**	**1,696**	**2,538**	**3,091**	**3,651**
EBITDA	**2,250**	**2,051**	**2,920**	**3,536**	**4,159**
Depreciation	(306)	(355)	(382)	(445)	(508)
Amortisation					
EBIT	**1,944**	**1,696**	**2,538**	**3,091**	**3,651**
Net interest expense	441	325	361	384	384
Associates & JCEs					
Other income				-	-
Earnings before tax	**2,385**	**2,021**	**2,898**	**3,475**	**4,035**
Income tax	(435)	(406)	(580)	(695)	(807)
Net profit after tax	**1,950**	**1,615**	**2,319**	**2,780**	**3,228**
Minority interests	(51)	(17)	-	-	-
Other items					
Preferred dividends					
Normalised NPAT	**1,899**	**1,598**	**2,319**	**2,780**	**3,228**
Extraordinary items	(851)	(189)	(277)	(460)	(440)
Reported NPAT	**1,048**	**1,409**	**2,042**	**2,320**	**2,788**
Dividends	(344)	-	(552)	(696)	(836)
Transfer to reserves	**704**	**1,409**	**1,490**	**1,624**	**1,952**
Valuation and ratio analysis					
FD normalised P/E (x)	19.0	27.7	18.4	14.9	12.8
FD normalised P/E at price target (x)	28.2	41.3	27.4	22.2	19.0
Reported P/E (x)	34.4	31.4	20.9	17.9	14.8
Dividend yield (%)	1.0	-	1.5	2.0	2.4
Price/cashflow (x)	16.2	na	20.1	17.1	14.9
Price/book (x)	3.8	3.1	2.6	2.3	2.0
EV/EBITDA (x)	17.8	18.0	11.2	8.7	7.0
EV/EBIT (x)	20.6	21.8	12.8	9.9	8.0
Gross margin (%)	9.8	10.0	11.0	11.3	11.5
EBITDA margin (%)	4.9	4.8	5.8	6.0	5.9
EBIT margin (%)	4.2	4.0	5.1	5.2	5.2
Net margin (%)	2.3	3.3	4.1	3.9	3.9
Effective tax rate (%)	18.2	20.1	20.0	20.0	20.0
Dividend payout (%)	32.9	-	27.0	30.0	30.0
Capex to sales (%)	2.6	0.8	1.6	1.3	1.1
Capex to depreciation (x)	3.9	0.9	2.1	1.8	1.6
ROE (%)	11.1	13.8	16.2	16.3	17.3
ROA (pretax %)	8.1	6.3	8.5	9.8	10.6
Growth (%)					
Revenue	8.0	(7.0)	17.8	18.1	19.3
EBITDA	8.8	(8.8)	42.4	21.1	17.6
EBIT	7.8	(12.7)	49.6	21.8	18.1
Normalised EPS	7.9	(35.2)	45.1	19.9	16.1
Normalised FDEPS	7.9	(35.2)	45.1	19.9	16.1
Per share					
Reported EPS (RMB)	0.08	0.08	0.11	0.13	0.16
Norm EPS (RMB)	0.14	0.09	0.13	0.16	0.18
Fully diluted norm EPS (RMB)	0.14	0.09	0.13	0.16	0.18
Book value per share (RMB)	0.67	0.78	0.89	1.00	1.13
DPS (RMB)	0.03	-	0.04	0.05	0.06

Source: Nomura estimates

Revenue driven by store openings

Cashflow (RMBmn)					
Year-end 31 Dec	**FY08**	**FY09**	**FY10**	**FY11**	**FY12**
EBITDA	2,250	2,051	2,920	3,536	4,159
Change in working capital	(267)	1,363	1,711	(327)	(534)
Other operating cashflow	238	(3,588)	(2,504)	(779)	(852)
Cashflow from operations	**2,220**	**(175)**	**2,126**	**2,430**	**2,772**
Capital expenditure	(1,180)	(330)	(800)	(800)	(800)
Free cashflow	**1,041**	**(504)**	**1,326**	**1,630**	**1,972**
Reduction in investments	-	-	-	-	-
Net acquisitions	(3,350)	(3)	-	-	-
Reduction in other LT assets	(927)	(3,163)	-	(0)	(0)
Addition in other LT liabilities	(2)	25	-	-	-
Adjustments	2,979	3,176	1,814	17	(2)
Cashflow after investing acts	**(259)**	**(469)**	**3,140**	**1,647**	**1,970**
Cash dividends	(661)	-	(276)	(624)	(766)
Equity issue	(2,068)	1,266	-	-	-
Debt issue	(130)	180	-	-	-
Convertible debt issue	-	2,037	-	-	-
Others	(101)	(37)	-	-	-
Cashflow from financial acts	**(2,960)**	**3,447**	**(276)**	**(624)**	**(766)**
Net cashflow	**(3,219)**	**2,978**	**2,865**	**1,023**	**1,204**
Beginning cash	6,270	3,051	6,029	8,894	9,917
Ending cash	3,051	6,029	8,894	9,917	11,121
Ending net debt	688	(324)	(3,188)	(4,211)	(5,415)

Source: Nomura estimates

Balance sheet (RMBmn)					
As at 31 Dec	**FY08**	**FY09**	**FY10**	**FY11**	**FY12**
Cash & equivalents	3,051	6,029	8,894	9,917	11,121
Marketable securities					
Accounts receivable	45	54	62	72	82
Inventories	5,473	6,532	7,759	9,312	11,303
Other current assets	9,913	10,657	9,484	10,201	11,029
Total current assets	**18,483**	**23,273**	**26,198**	**29,501**	**33,536**
LT investments					
Fixed assets	3,720	3,392	3,810	4,165	4,457
Goodwill	3,363	4,015	4,015	4,015	4,015
Other intangible assets	134	125	116	107	98
Other LT assets	1,795	4,958	4,958	4,958	4,958
Total assets	**27,495**	**35,763**	**39,098**	**42,746**	**47,065**
Short-term debt	170	2,530	2,530	2,530	2,530
Accounts payable	12,918	15,815	17,082	18,550	20,275
Other current liabilities	2,059	2,337	2,842	3,327	3,897
Total current liabilities	**15,147**	**20,682**	**22,454**	**24,406**	**26,703**
Long-term debt					
Convertible debt	3,570	3,175	3,175	3,175	3,175
Other LT liabilities	78	103	103	103	103
Total liabilities	**18,795**	**23,961**	**25,733**	**27,685**	**29,981**
Minority interest	140	-	-	-	-
Preferred stock					
Common stock	332	382	382	382	382
Retained earnings	8,228	11,420	12,983	14,679	16,701
Proposed dividends					
Other equity and reserves					
Total shareholders' equity	**8,560**	**11,802**	**13,365**	**15,062**	**17,083**
Total equity & liabilities	**27,495**	**35,763**	**39,098**	**42,746**	**47,065**
Liquidity (x)					
Current ratio	1.22	1.13	1.17	1.21	1.26
Interest cover	na	na	na	na	na
Leverage					
Net debt/EBITDA (x)	0.31	net cash	net cash	net cash	net cash
Net debt/equity (%)	8.0	net cash	net cash	net cash	net cash
Activity (days)					
Days receivable	0.6	0.4	0.4	0.4	0.4
Days inventory	48.0	57.0	58.3	59.2	60.2
Days payable	117.1	136.5	134.2	123.6	113.5
Cash cycle	(68.5)	(79.1)	(75.5)	(64.0)	(52.8)

Net cash position

Source: Nomura estimates

Qualcomm Inc QCOM US

SEMICONDUCTORS | AMERICAS

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Action

Qualcomm has strong secular tailwinds that should help it drive revenue growth in FY12F. We expect Qualcomm to: 1) gain share in the baseband market (current share stands at 40%) driven by the growth of 3G handsets in emerging markets; 2) add $0.20-0.25 from design wins in Verizon iPhone4 (CDMA chipset) and the upcoming iPhone5 (for baseband, replacing Infineon); and 3) improve its royalty revenues due to a growing 3G subscriber base and other data devices such as eReaders and tablets.

Catalysts

iPhone design wins and share gains in baseband due to TI's exit and market shifting to 3G mobile devices.

Anchor themes

Expanding royalty base from rapid transition to 3G devices in emerging economies, favourable competitive landscape due to TI's exit from baseband.

Closing price on 20 Jan	US$51.33
Price target	US$45
Upside/downside	-12%
Difference from consensus	-20.2%
FY11F net profit (US$mn)	4,415
Difference from consensus	-2.1%

Source: Nomura

Nomura vs consensus

We disagree with the consensus view that chipset margin guidance (22-24%) is overly conservative.

Strong unit growth but margin compression on horizon

① Forecast revenue growth at high end of guidance

We forecast revenue growth of 18% in FY11F, at the high end of guidance, driven by a growing 3G subscriber base and share gains in baseband chipsets, but we think QCT margins will come down to 24% in FY11F and 22% in FY12F due to increasing competitive pressure and a shifting mix toward APAC growth in the sub-$150 range.

② Expected to ride on the strong growth in APAC

According to Nomura's European Telecom team, total handset units in AsiaPac will grow at a 28% CAGR to 1,015mn units in 2012 from 480mn units in 2009. Our research indicates that handset OEMs are embracing integrated baseband solutions (baseband with integrated applications processors), which offer lower system costs. In the low-end segment of the market, Qualcomm sells the MSM7227 chipset that targets sub-$150 smartphones. In the high-end segment of the market, Qualcomm recently announced the third generation of Snapdragon chipset. We expect Qualcomm to capitalise on the strong growth in the APAC region with its sub-$150 integrated solution.

③ No significant competitive threat in integrated baseband offerings

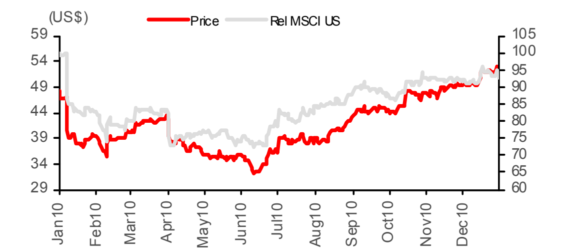
We also expect a favourable competitive landscape in integrated baseband offerings as the subscriber base shifts to 3G. We believe competitors such as MediaTek will find it hard to replicate the success they had in 2/2.5G baseband with 3G. 3G baseband design is much more complex, and we believe that was one of the reasons TI exited the baseband business, as they were finding themselves behind vs competitors such as Broadcom and ST Micro.

Key financials & valuations

30 Sept (US$mn)	FY10	FY11F	FY12F	FY13F
Revenue	10,981	13,000	14,531	na
Reported net profit	4,071	4,415	4,832	na
Normalised net profit	4,071	4,415	4,832	na
Normalised EPS (US$)	2.46	2.71	2.95	na
Norm. EPS growth (%)	45.6	10.2	8.9	na
Norm. P/E (x)	20.9	18.9	17.4	na
Price/book (x)	4.1	3.5	3.1	na
Dividend yield (%)	1.4	1.5	1.5	na
ROE (%)	15.6	14.6	14.3	na
Net debt/equity (%)	-44.1	-51.0	-56.8	na
Earnings revisions				
Previous norm. net profit		na	na	na
Change from previous (%)		na	na	na
Previous norm. EPS (US$)		na	na	na

Source: Company, Nomura estimates

Share price relative to MSCI US



	1m	3m	6m
Absolute (US$)	3.8	15.7	39.7
Absolute (US$)	3.8	15.7	39.7
Relative to Index	1.2	6.7	21.1
Market cap (US$mn)			83,037
52-week range (US$)			53.0/31.96
3-mth avg daily turnover (US$mn)			643
Stock borrowability			Easy
Major shareholders (%)			
FMR LLC			4
VANGUARD GROUP INC			4

Source: Company, Nomura estimates

Valuation methodology

Our price target of US$45 for Qualcomm is based on a 1.25x S&P500 NTM PE or 21x CY11 GAAP EPS multiple of US$2.13. We believe Qualcomm should trade at a premium to the market given a higher expected growth (15% in CY11F versus +6% for our coverage).

Risks to our call

The key risk factors to our price target include:

- Qualcomm is a leader in CDMA-based technology and derives both chipset and licensing revenue from the deployment of the technology. If the deployment of CDMA based technology is delayed, it could have a significant impact on Qualcomm's revenue growth.
- Qualcomm derives its licensing revenue based on the retail price of the devices (handset and data cards). As Qualcomm's technology penetrates into emerging markets such as China and India, the average selling price of the devices will decline, impacting royalty revenues.
- Qualcomm believes that it is entitled to royalty revenue from the next-generation wireless technology known as 4G, or LTE; however, not all 3G licensees have signed licensing agreements for 4G technology, and the royalty rate for 4G is likely to be lower than that for 3G. Also, most major players are expected to use TD-LTE version of 4G technology which has a lower proportion of Qualcomm's IPs. If the telecom players favour deployment of FD-LTE, in which Qualcomm can claim more patents, there could be an upside to our price target.
- Competition in the chipset business is intense with new and existing competitors, which include Texas Instruments (which announced its exit of the business by 2012), STEricsson, MediaTek, Intel (which purchased Infineon's wireless business), Broadcom and Marvell.
- The debate over integrated baseband solutions and stand-alone solutions continues, with Qualcomm and Broadcom siding with integrated solutions, and Texas Instruments and NVIDIA siding with stand-alone solutions.
- Qualcomm is a fabless company and relies on its third-party foundry partners, which include IBM, GlobalFoundries, Samsung, TSMC and UMC.
- We expect an increasing mix of APAC sales driving down the QCT gross margins in CY11F and CY12F. A faster mix shift or ASP deterioration in the APAC region may pose a risk to our price target.
- We expect increase in royalties to partially offset the decline in chipset margins. A slower or faster increase in expected royalty rates could provide downside/upside, posing a risk to our price target.

Financial statements

INCOME STATEMENT

Year End: September ($ in millions)	FY2010 Dec-09	Mar-10	Jun-10	Sep-10	FY2011E Dec-10E	Mar-11E	Jun-11E	Sep-11E	FY2012E Dec-11E	Mar-12E	Jun12E	Sep-12E	FY2010 Sep-10	FY2011 Sep-11E	FY2012 Sep-12E	CY2009 Dec-09	CY2010 Dec-10E	CY2011 Dec-11E
INCOME STATEMENT																		
Total Revenue (pro-forma)	**2,668**	**2,661**	**2,700**	**2,952**	**3,210**	**3,148**	**3,227**	**3,415**	**3,425**	**3,540**	**3,691**	**3,875**	**10,981**	**13,000**	**14,531**	**10,542**	**11,523**	**13,215**
Q/Q	-0.6%	-0.3%	1.5%	9.3%	8.7%	-1.9%	2.5%	5.8%	0.3%	3.4%	4.3%	5.0%						
Y/Y	6.3%	8.7%	-1.6%	10.0%	20.3%	18.3%	19.5%	15.7%	6.7%	12.5%	14.4%	13.4%	5.7%	18.4%	11.8%	-5.9%	9.3%	14.7%
COGS (pro-forma)	759	744	842	911	970	995	1,123	1,193	1,184	1,220	1,327	1,355	3,256	4,282	5,086	3,032	3,467	4,495
Gross profit (pro-forma)	1,909	1,917	1,858	2,041	2,239	2,153	2,104	2,222	2,241	2,320	2,364	2,520	7,725	8,718	9,445	7,510	8,055	8,720
R&D (pro-forma)	503	550	546	547	583	583	594	606	618	637	658	667	2,146	2,365	2,581	2,056	2,226	2,401
SG&A (pro-forma)	272	305	321	364	328	311	321	343	339	331	344	366	1,262	1,302	1,379	1,146	1,318	1,313
Other (pro-forma)	-	(3)	-	-	-	-	-	-	-	-	-	-	(3)	0	0	259	(3)	0
Total operating expenses (pro-forma)	775	852	867	911	910	894	915	949	957	968	1,002	1,033	3,405	3,668	3,960	3,461	3,540	3,714
Operating income (EBIT) (pro-forma)	1,134	1,065	991	1,130	1,329	1,259	1,189	1,273	1,284	1,352	1,362	1,487	4,320	5,050	5,485	4,049	4,515	5,005
Investment income (pro-forma)	176	193	170	231	128	133	137	141	149	155	161	167	770	538	632	342	722	559
Pretax income (pro-forma)	1,310	1,258	1,161	1,361	1,457	1,392	1,326	1,414	1,433	1,507	1,523	1,654	5,090	5,589	6,117	4,391	5,237	5,565
Income tax expense (pro-forma)	269	269	225	256	306	292	278	297	301	316	320	347	1,019	1,174	1,285	1,042	1,056	1,169
One-Time Expenses (Asset Impair)	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Net income - GAAP	841	774	767	865	923	871	819	889	904	962	975	1,078	3,247	3,501	3,919	2,092	3,329	3,482
Net income - Pro-forma	**1,041**	**989**	**936**	**1,105**	**1,151**	**1,099**	**1,047**	**1,117**	**1,132**	**1,191**	**1,203**	**1,307**	**4,071**	**4,415**	**4,832**	**3,349**	**4,181**	**4,396**
Net income - Pro-forma (incl ESO)	927	891	825	985	1,038	986	934	1,004	1,019	1,077	1,090	1,193	3,628	3,961	4,379	2,878	3,739	3,942
EPS - GAAP	$0.50	$0.46	$0.47	$0.53	$0.57	$0.54	$0.50	$0.54	$0.55	$0.59	$0.59	$0.66	$1.96	$2.15	$2.39	$1.24	$2.03	$2.13
EPS - Pro-forma	**$0.62**	**$0.59**	**$0.57**	**$0.68**	**$0.71**	**$0.68**	**$0.64**	**$0.68**	**$0.69**	**$0.73**	**$0.73**	**$0.79**	**$2.46**	**$2.71**	**$2.95**	**$1.99**	**$2.55**	**$2.69**
EPS - Pro-forma (incl ESO)	$0.55	$0.53	$0.50	$0.61	$0.64	$0.61	$0.57	$0.61	$0.62	$0.66	$0.66	$0.73	$2.19	$2.43	$2.67	$1.71	$2.28	$2.42
Shares outstanding - basic	1,662	1,662	1,629	1,608	1,611	1,614	1,617	1,620	1,623	1,626	1,629	1,632	1,640	1,616	1,628	1,647	1,611	1,603
Shares outstanding - fully diluted	1,691	1,678	1,642	1,621	1,624	1,627	1,630	1,633	1,636	1,639	1,642	1,645	1,657	1,628	1,641	1,676	1,640	1,632

Source: Company data, Nomura estimates

BALANCE SHEET

Year End: September ($ in millions)	FY2010 Dec-09	Mar-10	Jun-10	Sep-10	FY2011E Dec-10E	Mar-11E	Jun-11E	Sep-11E	FY2012E Dec-11E	Mar-12E	Jun12E	Sep-12E	FY2010 Sep-10	FY2011 Sep-11E	FY2012 Sep-12E	CY2009 Dec-09	CY2010 Dec-10E	CY2011 Dec-11E
BALANCE SHEET																		
Assets																		
Cash, Equiv & ST Investments	12,164	11,156	9,968	10,279	11,050	11,831	12,549	13,296	14,084	14,913	15,763	16,688	10,279	13,296	16,688	12,164	11,050	14,084
Accounts Receivable	616	680	798	730	794	778	798	845	847	875	913	958	730	845	958	616	794	847
Finance Receivable, Net	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Inventories	350	402	446	528	568	581	649	687	682	701	758	773	528	687	773	350	568	682
Deferred Tax Assets	199	204	213	321	321	321	321	321	321	321	321	321	321	321	321	199	321	321
Collateral under securities lending	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Other Current Assets	245	210	189	275	275	275	275	275	275	275	275	275	275	275	275	245	275	275
Total Current Assets	13,574	12,652	11,614	12,133	13,008	13,787	14,593	15,424	16,209	17,086	18,030	19,016	12,133	15,424	19,016	13,574	13,008	16,209
Marketable Securities	6,764	7,057	7,618	8,123	8,123	8,123	8,123	8,123	8,123	8,123	8,123	8,123	8,123	8,123	8,123	6,764	8,123	8,123
Finance Receivables	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Other Investments	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
P, P & E, Net	2,384	2,374	2,382	2,373	2,309	2,249	2,190	2,129	2,068	2,008	1,948	1,888	2,373	2,129	1,888	2,384	2,309	2,068
Goodwill and Intangibles	1,490	1,483	1,476	1,488	1,488	1,488	1,488	1,488	1,488	1,488	1,488	1,488	1,488	1,488	1,488	1,490	1,488	1,488
Deferred Tax Assets	1,118	1,376	1,774	1,922	1,922	1,922	1,922	1,922	1,922	1,922	1,922	1,922	1,922	1,922	1,922	1,118	1,922	1,922
Other Assets	3,573	3,555	4,537	4,533	4,533	4,533	4,533	4,533	4,533	4,533	4,533	4,533	4,533	4,533	4,533	3,573	4,533	4,533
Total Assets	**28,903**	**28,497**	**29,401**	**30,572**	**31,382**	**32,101**	**32,848**	**33,619**	**34,343**	**35,160**	**36,044**	**36,969**	**30,572**	**33,619**	**36,969**	**28,903**	**31,382**	**34,343**
Liabilities																		
Accts Payable	415	545	640	764	822	840	940	994	987	1,015	1,097	1,119	764	994	1,119	415	822	987
Payroll and benefits related liabilities	385	368	433	467	467	467	467	467	467	467	467	467	467	467	467	385	467	467
Unearned Revenue	567	592	601	623	623	623	623	623	623	623	623	623	623	623	623	567	623	623
Dividends Payable	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Income Taxes Payable	458	764	1,135	1,443	1,443	1,443	1,443	1,443	1,443	1,443	1,443	1,443	1,443	1,443	1,443	458	1,443	1,443
Current Portion of Long Term Debt	0	0	1,061	1,086	1,086	1,086	1,086	1,086	1,086	1,086	1,086	1,086	1,086	1,086	1,086	0	1,086	1,086
Other Current Liabilities	1,123	1,061	1,320	1,085	1,085	1,085	1,085	1,085	1,085	1,085	1,085	1,085	1,085	1,085	1,085	1,123	1,085	1,085
Total Current Liabilities	2,948	3,330	5,190	5,468	5,526	5,544	5,644	5,698	5,691	5,719	5,801	5,823	5,468	5,698	5,823	2,948	5,526	5,691
Unearned Revenues	3,775	3,687	3,587	3,485	3,413	3,342	3,270	3,198	3,127	3,055	2,983	2,912	3,485	3,198	2,912	3,775	3,413	3,127
Long-Term Debt	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Income Taxes Payable	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Other Long-Term Liabilities	827	760	738	761	761	761	761	761	761	761	761	761	761	761	761	827	761	761
Total Liabilities	**7,550**	**7,777**	**9,515**	**9,714**	**9,700**	**9,647**	**9,675**	**9,657**	**9,578**	**9,535**	**9,546**	**9,496**	**9,714**	**9,657**	**9,496**	**7,550**	**9,700**	**9,578**
Minority Interest	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Shareholders' Equity	**21,353**	**20,720**	**19,886**	**20,858**	**21,682**	**22,454**	**23,173**	**23,962**	**24,765**	**25,626**	**26,498**	**27,474**	**20,858**	**23,962**	**27,474**	**21,353**	**21,682**	**24,765**
Total Liabilities and Equity	**28,903**	**28,497**	**29,401**	**30,572**	**31,382**	**32,101**	**32,848**	**33,619**	**34,343**	**35,160**	**36,044**	**36,969**	**30,572**	**33,619**	**36,969**	**28,903**	**31,382**	**34,343**

Source: Company data, Nomura estimates

CASH FLOW STATEMENT

Year End: September ($ in millions)	FY2010 Dec-09	FY2010 Mar-10	FY2010 Jun-10	FY2010 Sep-10	FY2011E Dec-10E	FY2011E Mar-11E	FY2011E Jun-11E	FY2011E Sep-11E	FY2012E Dec-11E	FY2012E Mar-12E	FY2012E Jun12E	FY2012E Sep-12E
CASH FLOWS												
Cash flows from operations												
Net income	841	774	767	865	923	871	819	889	904	962	975	1,078
Depreciation & amortization	162	167	166	171	171	171	171	171	171	171	171	171
Asset impairment charges	0	0	0	0	0	0	0	0	0	0	0	0
Net (gains) losses on securities	(37)	(31)	(63)	(139)	0	0	0	0	0	0	0	0
Share-based compensation expense	151	153	149	159	162	162	162	162	162	162	162	162
Tax benefits from options exercised	(13)	(18)	(3)	(11)	0	0	0	0	0	0	0	0
Gains on derivative instruments	0	0	0	0	0	0	0	0	0	0	0	0
Other than temp losses on inv	57	16	0	0	0	0	0	0	0	0	0	0
Minority int in loss of consol subs	0	0	0	0	0	0	0	0	0	0	0	0
Equity in losses of investees	0	0	0	0	0	0	0	0	0	0	0	0
Non-Cash income tax expense	32	(38)	0	36	0	0	0	0	0	0	0	0
Other Non-Cash Credits	(102)	(80)	0	0	0	0	0	0	0	0	0	0
Other Items, Net	4	(8)	(11)	6	0	0	0	0	0	0	0	0
Changes in working capital:	144	(142)	(54)	6	(118)	(50)	(61)	(101)	(76)	(92)	(83)	(110)
Accounts Receivable	87	(52)	(126)	73	(64)	15	(20)	(47)	(2)	(29)	(37)	(45)
Finance Receivable	0	0	0	0	0	0	0	0	0	0	0	0
Inventories	101	(49)	(45)	(87)	(40)	(13)	(69)	(37)	5	(19)	(57)	(15)
Other Assets	(32)	(38)	(1)	11	0	0	0	0	0	0	0	0
Trade Accounts Payable	(226)	145	104	125	58	19	99	54	(7)	28	83	22
Payroll, benefits and other liabilities	(124)	(115)	78	(68)	0	0	0	0	0	0	0	0
Unearned revenue	338	(33)	(64)	(48)	(72)	(72)	(72)	(72)	(72)	(72)	(72)	(72)
Cash flows from operations	**1,239**	**793**	**951**	**1,093**	**1,138**	**1,154**	**1,091**	**1,120**	**1,161**	**1,204**	**1,224**	**1,301**
Cash flows from investing												
Capital Expenditures	(88)	(108)	(117)	(113)	(107)	(111)	(112)	(111)	(110)	(111)	(111)	(111)
Purchases of wireless licenses	0	0	(1,064)	0	0	0	0	0	0	0	0	0
Purch of avail-for-sale securities	(2,098)	(2,382)	(2,569)	(1,924)	0	0	0	0	0	0	0	0
Proceeds from sale of available-for-sale	2,013	2,228	3,113	3,086	0	0	0	0	0	0	0	0
Purchase of held-to-maturity securities	0	0	0	(850)	0	0	0	0	0	0	0	0
Maturities of held-to-maturity securities	0	0	0	0	0	0	0	0	0	0	0	0
Issuance of finance receivables	0	0	0	0	0	0	0	0	0	0	0	0
Collection of finance receivables	0	0	0	0	0	0	0	0	0	0	0	0
Issuance of notes receivable	0	0	0	0	0	0	0	0	0	0	0	0
Collection of notes receivable	8	25	0	0	0	0	0	0	0	0	0	0
Other investments and acquisitions	(6)	(22)	(17)	(49)	0	0	0	0	0	0	0	0
Change in collateral held under securiti	0	0	0	0	0	0	0	0	0	0	0	0
Other	(1)	4	85	7	0	0	0	0	0	0	0	0
Cash flows from investing	**(172)**	**(255)**	**(569)**	**157**	**(107)**	**(111)**	**(112)**	**(111)**	**(110)**	**(111)**	**(111)**	**(111)**
Cash flows from financing												
Proceeds from issuance of stock	152	332	35	170	170	170	170	170	170	170	170	170
Tax benefits from stk options exercised	13	18	3	11	0	0	0	0	0	0	0	0
Net repurchase of common stock	0	(1,715)	(1,178)	(122)	(122)	(122)	(122)	(122)	(122)	(122)	(122)	(122)
Dividends paid	(284)	(279)	(309)	(305)	(309)	(309)	(310)	(310)	(311)	(311)	(312)	(313)
Proceeds from minority shareholders	0	0	0	0	0	0	0	0	0	0	0	0
Proceeds from the issue of LT debt	0	0	1,064	0	0	0	0	0	0	0	0	0
Payments on long-term debt, net	0	0	0	0	0	0	0	0	0	0	0	0
Other items, net	(1)	0	(1)	(9)	0	0	0	0	0	0	0	0
Cash flows from financing	**(120)**	**(1,644)**	**(386)**	**(255)**	**(261)**	**(261)**	**(262)**	**(262)**	**(263)**	**(263)**	**(264)**	**(265)**
Effect of exchange rate changes	(4)	(1)	(8)	11	0	0	0	0	0	0	0	0
Net cash used by discontinued ops	0	0	0	0	0	0	0	0	0	0	0	0
Net Increase in Cash	943	(1,107)	(12)	1,006	771	781	718	747	788	829	849	925
Cash, beginning of period	2,717	3,660	2,553	2,541	3,547	4,318	5,099	5,817	6,564	7,352	8,181	9,031
Cash, end of period	3,660	2,553	2,541	3,547	4,318	5,099	5,817	6,564	7,352	8,181	9,031	9,956
Cash, end of period - balance sheet	**3,660**	**2,553**	**2,541**	**3,547**	**4,318**	**5,099**	**5,817**	**6,564**	**7,352**	**8,181**	**9,031**	**9,956**
Free Cash Flow	**1,151**	**685**	**834**	**980**	**1,032**	**1,042**	**979**	**1,010**	**1,051**	**1,093**	**1,113**	**1,190**

Year End: September ($ in millions)	FY2010 Sep-10	FY2011 Sep-11E	FY2012 Sep-12E	CY2009 Dec-09	CY2010 Dec-10E	CY2011 Dec-11E
CASH FLOWS						
Cash flows from operations						
Net income	3,247	3,501	3,919	2,092	3,329	3,482
Depreciation & amortization	666	684	684	645	675	684
Asset impairment charges	0	0	0	0	0	0
Net (gains) losses on securities	(270)	0	0	(161)	(233)	0
Share-based compensation expense	612	648	648	590	623	648
Tax benefits from options exercised	(45)	0	0	(76)	(32)	0
Gains on derivative instruments	0	0	0	0	0	0
Other than temp losses on inv	73	0	0	382	16	0
Minority int in loss of consol subs	0	0	0	0	0	0
Equity in losses of investees	0	0	0	0	0	0
Non-Cash income tax expense	30	0	0	(46)	(2)	0
Other Non-Cash Credits	(182)	0	0	(159)	(80)	0
Other Items, Net	(9)	0	0	(43)	(13)	0
Changes in working capital:	(46)	(330)	(362)	1,685	(308)	(289)
Accounts Receivable	(18)	(115)	(114)	428	(169)	(53)
Finance Receivable	0	0	0	0	0	0
Inventories	(80)	(159)	(86)	105	(221)	(114)
Other Assets	(60)	0	0	(71)	(28)	0
Trade Accounts Payable	148	230	125	23	432	165
Payroll, benefits and other liabilities	(229)	0	0	940	(105)	0
Unearned revenue	193	(287)	(287)	260	(217)	(287)
Cash flows from operations	**4,076**	**4,503**	**4,889**	**4,909**	**3,975**	**4,526**
Cash flows from investing						
Capital Expenditures	(426)	(440)	(442)	(615)	(445)	(444)
Purchases of wireless licenses	(1,064)	0	0	0	(1,064)	0
Purch of avail-for-sale securities	(8,973)	0	0	(8,287)	(6,875)	0
Proceeds from sale of available-for-sale	10,440	0	0	4,246	8,427	0
Purchase of held-to-maturity securities	(850)	0	0	0	(850)	0
Maturities of held-to-maturity securities	0	0	0	0	0	0
Issuance of finance receivables	0	0	0	0	0	0
Collection of finance receivables	0	0	0	0	0	0
Issuance of notes receivable	0	0	0	0	0	0
Collection of notes receivable	33	0	0	155	25	0
Other investments and acquisitions	(94)	0	0	(46)	(88)	0
Change in collateral held under securiti	0	0	0	11	0	0
Other	95	0	0	8	96	0
Cash flows from investing	**(839)**	**(440)**	**(442)**	**(4,528)**	**(774)**	**(444)**
Cash flows from financing						
Proceeds from issuance of stock	689	680	680	768	707	680
Tax benefits from stk options exercised	45	0	0	76	32	0
Net repurchase of common stock	(3,015)	(488)	(488)	0	(3,137)	(488)
Dividends paid	(1,177)	(1,238)	(1,247)	(1,377)	(1,202)	(1,240)
Proceeds from minority shareholders	0	0	0	0	0	0
Proceeds from the issue of LT debt	1,064	0	0	0	1,064	0
Payments on long-term debt, net	0	0	0	0	0	0
Other items, net	(11)	0	0	(13)	(10)	0
Cash flows from financing	**(2,405)**	**(1,046)**	**(1,055)**	(546)	(2,546)	(1,048)
Effect of exchange rate changes	(2)	0	0	(1)	2	0
Net cash used by discontinued ops	0	0	0	0	0	0
Net Increase in Cash	830	3,017	3,392	(166)	658	3,034
Cash, beginning of period	2,717	3,547	6,565	3,821	3,655	4,313
Cash, end of period	3,547	6,565	9,956	3,655	4,313	7,347
Cash, end of period - balance sheet	**3,547**	**6,564**	**9,956**	**3,660**	**4,318**	**7,352**
Free Cash Flow	**3,650**	**4,063**	**4,447**	**4,294**	**3,531**	**4,082**

Source: Company data, Nomura estimates

MediaTek 2454 TT

TECHNOLOGY/IC DESIGN | TAIWAN

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Maintained

REDUCE

NOMURA
NOMURA INTERNATIONAL (HK) LIMITED
TAIPEI BRANCH

Action

We maintain our REDUCE rating on MediaTek and price target of NT$275, which implies 31% downside. We expect MediaTek to record two consecutive years of earnings declines (the worst performance in the company's history), followed by only a moderate recovery in FY12F.

Catalysts

Continuation of a consensus earnings downward-revision cycle triggered by intensifying ASP pressure, falling market share and slow new product launches.

Anchor themes

Amid intensifying competition in China's 2G integrated circuit market and a fast transition to the 3G wireless system, companies that can benefit from (or avoid) price competition in 2G chips and grow market share will likely have an edge in the supply chain, and vice-versa.

Closing price on 20 Jan	NT$398.0
Price target	**NT$275.0**
	(set on 1 Nov 10)
Upside/downside	-30.9%
Difference from consensus	**-36.0%**
FY11F net profit (NT$mn)	25,760
Difference from consensus	**-1.9%**

Source: Nomura

Nomura vs consensus

Our PT is one of the lowest on the street, reflecting our outlook for continued de-rating of the shares and earnings deterioration.

No recovery in sight

① Reiterating REDUCE and price target of NT$275

We still see meaningful and fundamental share price downside, as we expect ongoing valuation de-rating, continuing downward revisions to EPS and an immaterial recovery in FY12F. Moreover, the prevailing P/E based on our FY11F EPS estimate is 17x, which we think is demanding in view of MediaTek's deteriorating fundamentals.

② EDGE Android cannot save the day

We identify four problems which we think need to be resolved before EDGE Android phone demand takes off: 1) retail prices remain too high; 2) specifications are too low; 3) white-box feature phone users have no incentive and capability to use smartphones, and; 4) MediaTek's customers have weak brand value in selling the company's smartphones.

③ FY11F – second year of earnings decline

We do not expect MediaTek's 2011 new chips, including a 3.5G feature phone and smartphone, to make any meaningful contribution in FY11F. However, we expect competitors such as Spreadtrum and MStar in the 2G IC market will grow stronger in 2011F, thus further intensifying price competition and accelerating MediaTek's market share deterioration.

④ FY12F – unresolved structural concerns

MediaTek's slow progress in 3.5G chips has given Qualcomm more than enough time to penetrate into smaller smartphone customers in China, which we think will further depress MediaTek's recovery into 2012F, even after it successfully launches its MT6573 3.5G smartphone chip.

Key financials & valuations

31 Dec (NT$mn)	FY09	FY10F	FY11F	FY12F
Revenue	115,512	114,158	111,029	126,699
Reported net profit	36,706	31,507	25,760	30,230
Normalised net profit	36,706	31,507	25,760	30,230
Normalised EPS (NT$)	34.17	28.77	23.52	27.61
Norm. EPS growth (%)	87.6	(15.8)	(18.2)	17.4
Norm. P/E (x)	11.6	13.8	16.9	14.4
EV/EBITDA (x)	8.5	9.9	11.6	9.8
Price/book (x)	4.0	5.1	5.2	4.7
Dividend yield (%)	6.5	5.8	4.8	5.5
ROE (%)	38.5	32.3	30.2	34.1
Net debt/equity (%)	net cash	net cash	net cash	net cash
Earnings revisions				
Previous norm. net profit		31,507	25,760	30,230
Change from previous (%)		-	-	-
Previous norm. EPS (NT$)		28.77	23.52	27.61

Source: Company, Nomura estimates

Share price relative to MSCI Taiwan

	1m	3m	6m
Absolute (NT$)	(7.4)	1.4	(14.8)
Absolute (US$)	(4.8)	7.8	(5.7)
Relative to Index	(11.9)	(12.9)	(37.1)
Market cap (US$mn)			14,939
Estimated free float (%)			68.8
52-week range (NT$)			578/376.0
3-mth avg daily turnover (US$mn)			124.8
Stock borrowability			Hard
Major shareholders (%)			
Li Tsui-Hsin			4.6
Ming-Chieh Tsai			3.7

Source: Company, Nomura estimates

Valuation methodology and investment risks. Our price target for MediaTek is derived from a non-cash market value of NT$190 – assuming an 8x (ex-cash) target P/E multiple to 2011F earnings (equivalent to a 10% discount to the stock's average ex-cash P/E range of 5-13x in the past cycle) – plus net cash of NT$85 per share (no change). Upside risks include: 1) better-than-expected handset IC shipment growth, particularly from emerging-market demand; 2) earlier-than-expected launch of next generation 3G and smartphone chips; and 3) better-than-expected acceptance of MediaTek's EDGE Android smartphone.

Financial statements

Income statement (NT$mn)					
Year-end 31 Dec	**FY08**	**FY09**	**FY10F**	**FY11F**	**FY12F**
Revenue	90,402	115,512	114,158	111,029	126,699
Cost of goods sold	(41,819)	(47,694)	(52,831)	(56,021)	(63,980)
Gross profit	**48,583**	**67,817**	**61,327**	**55,008**	**62,719**
SG&A	(19,871)	(18,207)	(21,594)	(22,152)	(23,892)
Employee share expense	(6,404)	(13,223)	(7,904)	(6,470)	(7,672)
Operating profit	**22,308**	**36,387**	**31,829**	**26,386**	**31,156**
EBITDA	**25,603**	**39,632**	**34,810**	**29,448**	**34,263**
Depreciation	(3,295)	(3,245)	(1,071)	(1,119)	(1,164)
Amortisation	-	-	(1,910)	(1,943)	(1,943)
EBIT	**22,308**	**36,387**	**31,829**	**26,386**	**31,156**
Net interest expense	174	198	488	232	227
Associates & JCEs	(2,315)	242	(376)	61	253
Other income	931	592	899	-	-
Earnings before tax	**21,098**	**37,420**	**32,841**	**26,679**	**31,636**
Income tax	(1,924)	(725)	(1,344)	(934)	(1,424)
Net profit after tax	**19,174**	**36,695**	**31,497**	**25,745**	**30,212**
Minority interests	16	10	10	15	17
Other items	-	-	-	-	-
Preferred dividends	-	-	-	-	-
Normalised NPAT	**19,190**	**36,706**	**31,507**	**25,760**	**30,230**
Extraordinary items	-	-	-	-	-
Reported NPAT	**19,190**	**36,706**	**31,507**	**25,760**	**30,230**
Dividends	(15,024)	(28,343)	(25,298)	(20,899)	(24,199)
Transfer to reserves	**4,166**	**8,363**	**6,208**	**4,862**	**6,031**
Valuation and ratio analysis					
FD normalised P/E (x)	21.9	11.6	13.8	16.9	14.4
FD normalised P/E at price target (x)	15.1	8.0	9.6	11.7	10.0
Reported P/E (x)	21.9	11.6	13.8	16.9	14.4
Dividend yield (%)	3.5	6.5	5.8	4.8	5.5
Price/cashflow (x)	11.8	7.7	13.7	18.5	15.9
Price/book (x)	5.2	4.0	5.1	5.2	4.7
EV/EBITDA (x)	16.4	8.5	9.9	11.6	9.8
EV/EBIT (x)	19.0	9.3	10.8	13.0	10.8
Gross margin (%)	53.7	58.7	53.7	49.5	49.5
EBITDA margin (%)	28.3	34.3	30.5	26.5	27.0
EBIT margin (%)	24.7	31.5	27.9	23.8	24.6
Net margin (%)	21.2	31.8	27.6	23.2	23.9
Effective tax rate (%)	9.1	1.9	4.1	3.5	4.5
Dividend payout (%)	78.3	77.2	80.3	81.1	80.0
Capex to sales (%)	1.8	1.4	1.3	0.3	0.3
Capex to depreciation (x)	0.5	0.5	1.4	0.3	0.3
ROE (%)	22.9	38.5	32.3	30.2	34.1
ROA (pretax %)	42.4	81.4	68.8	53.3	59.1
Growth (%)					
Revenue	12.1	27.8	(1.2)	(2.7)	14.1
EBITDA	(24.7)	54.8	(12.2)	(15.4)	16.4
EBIT	(30.0)	63.1	(12.5)	(17.1)	18.1
Normalised EPS	(44.7)	87.6	(15.8)	(18.2)	17.4
Normalised FDEPS	(44.7)	87.6	(15.8)	(18.2)	17.4
Per share					
Reported EPS (NT$)	18.2	34.2	28.8	23.5	27.6
Norm EPS (NT$)	18.2	34.2	28.8	23.5	27.6
Fully diluted norm EPS (NT$)	18.2	34.2	28.8	23.5	27.6
Book value per share (NT$)	76.0	99.9	78.1	77.0	84.2
DPS (NT$)	14.0	26.0	23.0	19.0	22.0

Source: Nomura estimates

We forecast an 18% y-y decline in FY11F EPS

Cashflow (NT$mn)					
Year-end 31 Dec	**FY08**	**FY09**	**FY10F**	**FY11F**	**FY12F**
EBITDA	25,603	39,632	34,810	29,448	34,263
Change in working capital	10,557	8,663	24,238	(2,566)	(3,111)
Other operating cashflow	(561)	6,946	(27,270)	(3,307)	(3,670)
Cashflow from operations	**35,599**	**55,240**	**31,778**	**23,575**	**27,481**
Capital expenditure	(1,666)	(1,572)	(1,504)	(319)	(332)
Free cashflow	**33,933**	**53,668**	**30,274**	**23,256**	**27,149**
Reduction in investments	2,965	4,085	174	(311)	(323)
Net acquisitions	(1,400)	(99)	(172)	-	-
Reduction in other LT assets	(11,591)	1,370	344	362	342
Addition in other LT liabilities	16	165	219	19	20
Adjustments	1,193	(2,181)	(1,322)	(381)	(362)
Cashflow after investing acts	**25,116**	**57,009**	**29,518**	**22,945**	**26,826**
Cash dividends	(22,906)	(14,915)	(30,015)	(26,999)	(22,289)
Equity issue	-	-	-	-	-
Debt issue	-	-	-	-	-
Convertible debt issue	-	-	33	-	-
Others	223	(467)	223	(0)	(0)
Cashflow from financial acts	**(22,682)**	**(15,383)**	**(29,759)**	**(26,999)**	**(22,290)**
Net cashflow	**2,434**	**41,626**	**(241)**	**(4,054)**	**4,536**
Beginning cash	50,588	53,022	94,648	94,406	90,353
Ending cash	53,022	94,648	94,406	90,353	94,889
Ending net debt	(53,022)	(94,648)	(94,406)	(90,353)	(94,889)

Source: Nomura estimates

Balance sheet (NT$mn)					
As at 31 Dec	**FY08**	**FY09**	**FY10F**	**FY11F**	**FY12F**
Cash & equivalents	53,022	94,648	94,406	90,353	94,889
Marketable securities	4,573	2,199	2,321	2,321	2,321
Accounts receivable	5,429	7,267	6,166	7,929	8,996
Inventories	5,547	8,173	8,932	10,895	12,209
Other current assets	2,656	1,751	3,909	4,137	4,383
Total current assets	**71,226**	**114,038**	**115,735**	**115,634**	**122,798**
LT investments	8,970	6,662	7,653	7,964	8,287
Fixed assets	6,504	6,889	7,855	8,174	8,506
Goodwill	-	-	-	-	-
Other intangible assets	-	0	-	-	-
Other LT assets	12,375	11,005	10,660	10,299	9,956
Total assets	**99,074**	**138,593**	**141,903**	**142,070**	**149,547**
Short-term debt	-	-	-	-	-
Accounts payable	4,907	11,794	8,799	12,025	13,310
Other current liabilities	12,326	17,660	46,711	44,870	43,102
Total current liabilities	**17,232**	**29,454**	**55,509**	**56,896**	**56,412**
Long-term debt	-	-	-	-	-
Convertible debt	-	-	-	-	-
Other LT liabilities	83	248	468	487	506
Total liabilities	**17,316**	**29,703**	**55,977**	**57,382**	**56,919**
Minority interest	148	21	7	7	7
Preferred stock	-	-	-	-	-
Common stock	10,732	10,901	10,901	10,901	10,901
Retained earnings	71,209	98,379	75,292	74,054	81,994
Proposed dividends	-	-	-	-	-
Other equity and reserves	(329)	(411)	(274)	(274)	(274)
Total shareholders' equity	**81,611**	**108,869**	**85,919**	**84,681**	**92,621**
Total equity & liabilities	**99,074**	**138,593**	**141,903**	**142,070**	**149,547**
Liquidity (x)					
Current ratio	4.13	3.87	2.08	2.03	2.18
Interest cover	na	na	na	na	na
Leverage					
Net debt/EBITDA (x)	net cash	net cash	net cash	net cash	net cash
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash
Activity (days)					
Days receivable	25.3	20.1	21.5	23.2	24.4
Days inventory	70.4	52.5	59.1	64.6	66.1
Days payable	54.5	63.9	71.1	67.8	72.5
Cash cycle	41.3	8.7	9.4	19.9	18.1

Source: Nomura estimates

Strong cash position

Analyst Certification

We, Leping Huang, Danny Chu, Eve Jung, Aaron Jeng, Candy Huang, Sachin Gupta, Pankaj Suri and Romit Shah hereby certify (1) that the views expressed in this Research report accurately reflect our personal views about any or all of the subject securities or issuers referred to in this Research report, (2) no part of our compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this Research report and (3) no part of our compensation is tied to any specific investment banking transactions performed by Nomura Securities International, Inc., Nomura International plc or any other Nomura Group company.

Issuer Specific Regulatory Disclosures

Mentioned companies

Issuer name	Ticker	Price	Price date	Stock rating	Sector rating	Disclosures
China Wireless Technologies	2369 HK	4.65 HKD	21-Jan-2011	Not Rated		
Digital China Holdings	861 HK	15.70 HKD	21-Jan-2011	Not Rated		
Tcl Communication Tech	2618 HK	8.04 HKD	21-Jan-2011	Not Rated		

Previous Rating

Issuer name	Previous Rating	Date of change
China Wireless Technologies	Not Rated	
Digital China Holdings	Not Rated	02-Aug-2006
Tcl Communication Tech	Not Rated	02-Aug-2006

China Wireless Technologies (2369 HK) **4.65 HKD (21-Jan-2011)** Not Rated

Chart Not Available

Digital China Holdings (861 HK) **15.70 HKD (21-Jan-2011)** Not Rated

Chart Not Available

Tcl Communication Tech (2618 HK) **8.04 HKD (21-Jan-2011)** Not Rated

Chart Not Available

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STOCKS

A rating of '**Buy**', indicates that the analyst expects the stock to outperform the Benchmark over the next 12 months.
A rating of '**Neutral**', indicates that the analyst expects the stock to perform in line with the Benchmark over the next 12 months.
A rating of '**Reduce**', indicates that the analyst expects the stock to underperform the Benchmark over the next 12 months.
A rating of '**Suspended**', indicates that the rating and target price have been suspended temporarily to comply with applicable regulations and/or firm policies in certain circumstances including when Nomura is acting in an advisory capacity in a merger or strategic transaction involving the company.
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SECTORS

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A '**Neutral**' stance, indicates that the analyst expects the sector to perform in line with the Benchmark during the next 12 months.
A '**Bearish**' stance, indicates that the analyst expects the sector to underperform the Benchmark during the next 12 months.
Benchmarks are as follows: **United States**: S&P 500; **Europe**: Dow Jones STOXX 600; **Global Emerging Markets (ex-Asia)**: MSCI Emerging Markets ex-Asia.

Explanation of Nomura's equity research rating system for Asian companies under coverage ex Japan published from 30 October 2008 and in Japan from 6 January 2009

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A '**Buy**' recommendation indicates that potential upside is 15% or more.
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Explanation of Nomura's equity research rating system in Japan published prior to 6 January 2009 (and ratings in Europe, Middle East and Africa, US and Latin America published prior to 27 October 2008)

STOCKS

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A rating of '2' or '**Buy**', indicates that the analyst expects the stock to outperform the Benchmark by 5% or more but less than 15% over the next six months.
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A '**Bearish**' stance, indicates that the analyst expects the sector to underperform the Benchmark during the next six months.
Benchmarks are as follows: **Japan**: TOPIX; **United States**: S&P 500, MSCI World Technology Hardware & Equipment; **Europe**, by sector - *Hardware/Semiconductors*: FTSE W Europe IT Hardware; *Telecoms*: FTSE W Europe Business Services; *Business Services*: FTSE W Europe; *Auto & Components*: FTSE W Europe Auto & Parts; *Communications equipment*: FTSE W Europe IT Hardware; **Ecology Focus**: Bloomberg World Energy Alternate Sources; **Global Emerging Markets**: MSCI Emerging Markets ex-Asia.

Explanation of Nomura's equity research rating system for Asian companies under coverage ex Japan published prior to 30 October 2008

STOCKS

Stock recommendations are based on absolute valuation upside (downside), which is defined as (Fair Value - Current Price)/Current Price, subject to limited management discretion. In most cases, the Fair Value will equal the analyst's assessment of the current intrinsic fair value of the stock using an appropriate valuation methodology such as Discounted Cash Flow or Multiple analysis etc. However, if the analyst doesn't think the market will revalue the stock over the specified time horizon due to a lack of events or catalysts, then the fair value may differ from the intrinsic fair value. In most cases, therefore, our recommendation is an assessment of the difference between current market price and our estimate of current intrinsic fair value. Recommendations are set with a 6-12 month horizon unless specified otherwise. Accordingly, within this horizon, price volatility may cause the actual upside or downside based on the prevailing market price to differ from the upside or downside implied by the recommendation.
A '**Strong buy'** recommendation indicates that upside is more than 20%.
A '**Buy'** recommendation indicates that upside is between 10% and 20%.
A '**Neutral'** recommendation indicates that upside or downside is less than 10%.
A '**Reduce'** recommendation indicates that downside is between 10% and 20%.
A '**Sell'** recommendation indicates that downside is more than 20%.

SECTORS

A '**Bullish'** rating means most stocks in the sector have (or the weighted average recommendation of the stocks under coverage is) a positive absolute recommendation.
A '**Neutral'** rating means most stocks in the sector have (or the weighted average recommendation of the stocks under coverage is) a neutral absolute recommendation.
A '**Bearish'** rating means most stocks in the sector have (or the weighted average recommendation of the stocks under coverage is) a negative absolute recommendation.

Target Price

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