

Lenovo (992.HK) – Mobile Attraction, Raising Target to HK\$9.25

Technology Sector

31 January 2013

Whats New: Lenovo reported diluted EPS of US\$1.96/share while revenues grew 12% to a record US\$9.36bn. Excluding a onetime gain from the de-recognition of contingent considerations of US\$20m linked to the acquisition of the Medion Group in FY2012, earnings would have been US\$1.77/share, 4cents better than consensus, and revenues were 3% above expectations. Taxes were also lower in the quarter 18.8% vs. 19.7% last year.

Conclusion: While global PC demand remains soft and PC growth for the company has come down from double digits to 6-7% over the past 2 quarters, we expect Lenovo's PC contribution to remain positive going forward. The firm's strategy to expand in emerging markets and strengthen offerings in developed markets should drive market share penetration. For next year we assume a 5% organic growth in PCs plus 2.5% contribution from the CCE Brazil acquisition. On the MIDH business, Lenovo's mobile and tablet execution is ahead of schedule. The explosive growth for smart phones in China and the company's introduction of smart phones to large emerging markets outside of China should support a +10% contribution in revenue growth from MIDH resulting in 18% top line growth in FY14. Additionally, we remain supportive that Lenovo will be able to achieve operating margins of 2.6% in FY14. Resulting in operating profit growth of 39%.

Risks: (1) Weakness in PC shipments impacting Lenovo's ability to grow market share; (2) Increased competition in the PC industry results in gross margin compression; (3) Unable to expand margins due to rising operating costs from growth; (4) Unable to deliver innovative mobile products at the right price points to consumer markets.

Valuation: We maintain our BUY rating on Lenovo and are raising our target price from HK\$8.55/share to HK\$9.25/share, reflecting the company's strong future growth of its mobile business. Our target price is based on a 14.5x earnings multiple on our FY14 estimate of HK\$0.64/share. The share price has risen 31% since we our report on October 18. We see continued potential in the stock given the firm's strong record of execution and growth prospects in mobile.

Figure 1: Estimate Changes

	Actual	Old	New	Old	New
US\$m	FY12	FY13E	FY13E	FY14E	FY14E
Revenues	29,574	34,253	35,117	39,153	41,371
yoy%	37.0%	15.8%	18.7%	14.3%	17.8%
GPM %	11.7%	11.9%	11.9%	12.1%	12.1%
Operating Profit	584	815	785	1,016	1,088
yoy%	52.8%	39.6%	34.4%	24.6%	38.5%
OPM %	2.0%	2.4%	2.2%	2.6%	2.6%
Net Profit	475	626	619	783	858
yoy%	74.0%	31.6%	30.1%	25.1%	38.7%
NPM %	1.6%	1.8%	1.8%	2.0%	2.1%
D. EPS (US\$/sh)	4.6	6.0	5.9	7.6	8.2
D. EPS (HK\$/sh)	35	47	46	59	64
yoy%	67.5%	32.0%	29.5%	25.7%	38.4%

Sources: Bloomberg and Sun Hung Kai Financial

Target Price

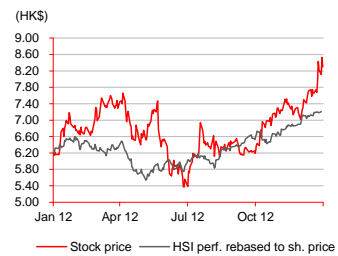
12m Rating

HK\$9.25

Buy

11% upside

Lenovo – Price Chart



Price (HK\$)	8.30
Mkt cap – HK\$m (US\$m)	86,093(11,097)
Free float – % (H-share)	57.5
3M avg. t/o – HK\$m (US\$m)	320(41.2)
Major shareholder (%)	
Legend Holdings	33.6

Sources: Bloomberg and Sun Hung Kai Financial

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Review

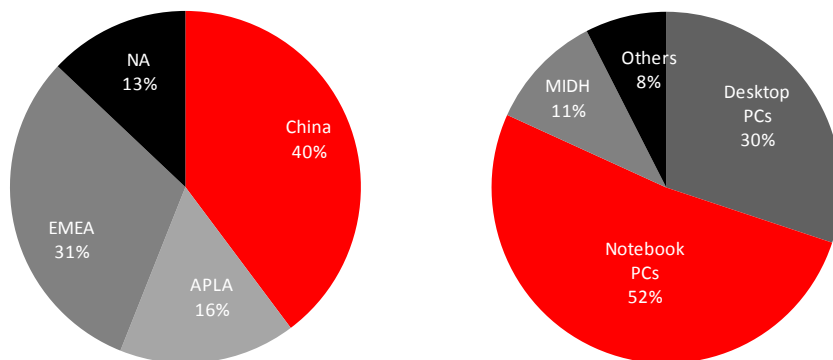
Lenovo reported diluted EPS of US\$1.96/share while revenues grew 12% to a record US\$9.36bn. PC shipments gained 8% in the quarter while the company maintained its global market share at 15.9%. **Excluding a onetime gain from the de-recognition of contingent considerations of US\$20m linked to the acquisition of the Medion Group in FY2012, earnings would have been US\$1.77/share, 4cents better than consensus, while revenues were 3% above expectations.** Gross margins in Q3 were 11.77%, up 37 bps from last year. Excluding onetime gains, adjusted operating profits were US\$224m, +16%yoy and core operating margins improved from 2.30% to 2.39%. Reported operating margins improved from 2.31% to 2.60%.

We highlight a number of concerns. PC shipments in China were up only 2% in the quarter. Additionally, R&D and SG&A costs rose 24%yoy, compared to sales growth of 8%. Operating margins have improved largely on government subsidies. Understandably, significant growth will have near term impacts on costs and working capital.

China & MIDH -The China business grew 17%yoy to US\$4.1bn in sales. China revenues were 43% of total revenues. The main driver was the mobile and tablet business (MIDH). MIDH revenues grew 85%yoy to US\$998m and accounted for 10.7% of the Lenovo’s revenues in the quarter. The company doubled its shipment of smart phones to 9m while overall phone shipments were 9.4m. Tablet volumes grew 77% to about 800K units. PC shipments in China were up 2% while revenues climbed 6% to US\$3.2bn.

ROW - In Asia Pacific/Latin America, revenues were down 2%yoy on shipment growth of 4%. The company achieved 11.3% market share. In Europe Middle East & Africa, PC revenues rose 16.9%yoy to US\$2.3bn on 25.5% volume growth and was the #2 in market share in the region. North American revenues improved 8.1% to US\$1.3bn on volume growth of 11.3%yoy and improving market share to 9%. The company noted that it made significant inroads in the premium PC space in North America due to its success of its Windows 8 Yoga convertible laptop.

Figure 2: Geographic Mix (L) Product Mix (R)



Source: Company, Sun Hung Kai Financial

Operating Expenses & Profits - Operating expenses rose 15.2%yoy to US\$877m. OpEx as a percentage of sales was 9.4% compared to 9.7% last quarter and 9.1% a year ago. We note that year over year comparisons of operating profits continue to be boosted by subsidies. Subsidies in the quarter were US\$77m and are part of the plan by the Chinese government to boost the sale of energy efficient computers. Subsidies in Q1 and Q2 were US\$22m and US\$43m respectively. Core operating profits were US\$224m up 16%yoy and margins were 2.39%, 9bps higher than last year. Adjusted net profits excluding contingent gains were US\$181m. Taxes were 18.8% compared to 19.7% last year and our estimate of 20% in the quarter.



Cash Flows & Balance Sheet - Operating cash flow in the quarter was US\$888m and US\$690m through the first nine months of the fiscal year. CapEx in the quarter was US\$127m and US\$312 through nine months. The firm's calculated cash conversion cycle continued to deteriorate from -9days last quarter to -5 days in Q2. The growth in Lenovo's MIDH business is expected increase working capital requirements going forward.

Figure 3: Cash Conversion Cycle

	Q3 FY13	Q2 FY13	Q1 FY13	Q3 FY12
Days Inventory	20	19	19	17
Days Receivables	36	33	34	34
Days Payables	61	61	66	68
Cash Conversion Cycle	-5	-9	-13	-17

Source: Company, Sun Hung Kai Financial

The balance sheet remained in solid standing with US\$4.5bn in cash and only US\$400m in debt.

Figure 4: PC Vendor Comparables

Ticker	Company	Last Price (LC)	Mkt Cap (US\$mm)	YTD %chg	P/E (x)		%	Estimates (%)	
					FY1	FY2	FY2 EPS Growth	Div Yield	Gross Margins
992 HK	Lenovo	8.30	11,097	18.2	18.1	14.9	22.0	1.8	11.8
HPQ US	HP	16.40	31,950	15.1	4.9	4.7	5.8	3.2	22.6
DELL US	Dell	13.37	23,227	31.9	7.8	8.1	-3.1	1.2	22.1
2353 TT	Acer	25.85	2,481	2.6	26.5	18.7	32.1	1.2	10.0
2357 TT	Asus	335.50	8,550	2.8	11.4	10.7	6.1	4.8	13.4
AAPL US	Apple	456.83	428,981	-14.2	10.2	9.0	13.2	2.4	39.2
Average				9.4	13.2	11.0	12.7	2.4	19.8

Source: Bloomberg, Sun Hung Kai Financial



Figure 5: Financial Model

US\$m	Mar-11	Mar-12	Mar-13	Mar-14	US\$m	Mar-11	Mar-12	Mar-13	Mar-14
P&L	FY2011	FY2012	FY2013E	FY2014E	Balance Sheet	FY2011	FY2012	FY2013E	FY2014E
Revenue	21,594	29,574	35,117	41,371	PPE	209	392	427	440
COGS	(19,230)	(26,128)	(30,954)	(36,358)	Intangibles	2,134	3,091	3,230	3,356
GP	2,364	3,446	4,163	5,013	Total non-current assets	2,769	4,040	4,213	4,353
Other Income	0	1	20	-	Inventories	804	1,218	1,866	1,992
Selling & Distribution	(1,038)	(1,691)	(1,988)	(2,302)	A/R	1,761	2,994	3,464	3,854
Administration	(720)	(730)	(846)	(960)	Cash & Equivalents	2,997	4,171	5,128	6,104
R&D	(303)	(453)	(610)	(716)	Total current assets	7,936	11,820	14,538	16,757
Other Expenses	79	11	46	54	Total Assets	10,706	15,861	18,751	21,110
OpEx	(1,982)	(2,863)	(3,398)	(3,925)	A/P	2,180	4,050	4,762	4,998
Operating Profit	382	584	785	1,088	ST Debt	371	190	102	102
Other Expenses	(24)	(2)	9	16	Total current liabilities	8,033	11,810	13,830	15,632
Profit Before Tax	358	582	794	1,103	Loans	-	-	300	300
Taxes	(85)	(107)	(176)	(245)	Total non-current liabilities	838	1,603	2,071	2,071
Net Profit	273	475	619	858	Total liabilities	8,871	13,413	15,901	17,703
NP Owners	273	473	620	858	Owner's Equity	1,835	2,361	2,764	3,322
D. EPS (US\$ cents/share)	2.7	4.6	5.9	8.2	Total Equity	1,835	2,448	2,850	3,407
D. EPS (HK\$ cents/share)	21	35	46	64					
DPS (HK\$cents/share)	8	14	16	22					
Ratios	FY2011	FY2012	FY2013E	FY2014E	Cash Flow	FY2011	FY2012	FY2013E	FY2014E
Revenue Growth	30.0%	37.0%	18.7%	17.8%	Operating	965	1,940	444	831
Op. Profit Growth	74.8%	52.8%	34.4%	38.5%	CapEx	(148)	(329)	(404)	(393)
NP Growth	111.2%	74.0%	30.1%	38.7%	Other	214	(508)	922	839
GPM	10.9%	11.7%	11.9%	12.1%	Investing	66	(837)	518	446
Exp/Rev	9.2%	9.7%	9.7%	9.5%	Financing	(373)	(316)	(13)	(300)
OPM	1.8%	2.0%	2.2%	2.6%	Net Cash	658	787	950	976
NPM	1.3%	1.6%	1.8%	2.1%	FX	58	16	-	-
Net Debt (Net Cash)	(2,626)	(3,981)	(4,726)	(5,703)	End Cash	2,954	3,758	4,707	5,683
D/E	20.2%	7.8%	14.1%	11.8%					
ROA	2.8%	3.6%	3.6%	4.3%					
ROE	15.9%	22.5%	24.2%	28.2%					
Days Inventory	16.0	14.1	22.0	20.0					
Days Receivable	26.8	29.3	36.0	34.0					
Days Payables	50.3	44.2	55.0	50.0					
Days Cash	(7.6)	(0.8)	3.0	4.0					

Source: Company, Sun Hung Kai Financial



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