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China Tech Update

China TMT Hardware barometer

OUTPERFORM (Maintain)

China Technology Sector

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The world is changing faster than ever before. The sharp tone change of fiscal policy, endless variants of COVID, frequent occurrence of geopolitical tensions, and historical inflation numbers lead to different level of market volatility. Some may have one-off short term impact on a single company, while the others may have profound impacts across multiple sectors. As a result, valuations of listed companies also change dramatically and the change could occur in a relatively short period. In this report, we did a check on valuation across our coverage universe which may serve as a reference.

A. Tough environment to navigate with no company is immune.

1) Since 1Q22, economic activities have slowed down in China due to COVID outbreaks. As the government keeps its zero-COVID policy unchanged, Shanghai and Beijing have experienced prolonged COVID outbreak for months, and investors now expect the economy will take a heavy toll in the second quarter. To ease the burdens on corporates and consumers and support the economy, Chinese government has announced a series of measures including tax credit rebates, postponement on social security payments and loan repayments and roll-out of new investment projects with emphasis on new infrastructure and new energy.

2) On the other side, the Fed has clearly stated it has one singular priority, which is slaying inflation. As the Fed turns from QE to QT and also plans to shrink its balance sheet starting from June, the increasing cost of money flows will impact the real economy across sectors. Inflation brings more expensive labor and raw commodities. As the unprecedented fiscal and monetary stimulus of the past decade, particularly in the period of 2020-2022, comes to the end, the cost of capital has increased rapidly. Recent selloffs in major global markets indicate that the valuation framework over the past several years is no longer relevant.

3) In addition, the long lasting pandemic and intensive geopolitical tensions bring persistent disruptions and constraints on global supply chains which further weigh on already deteriorated economic growth. Not to mention there would be second- and third-order effects, as one company's spending represent other companies' revenue. This is a tough environment that no company is immune.

4) Investors should expect lower returns on investments during this period than a secular bull market. Investors should focus more on the quality and sustainability of earnings (margin, free cash flow, etc.) rather than simple revenues.

B. Adapt to change

1) The pandemic and the frequent geopolitical tensions have revealed the fragility and reliance on JIT (Just-In-Time) inventory systems and supply chains. Some companies in hardware industry took the hit hardest and have been actively seeking solutions to improve its supply chain resilience. Measures that are commonly discussed include the temporarily switch to JIC (Just-In-Case) inventory strategy by double or even triple booking in

advance, the replacement of globalization footprint with regionalization strategy, buying, building and supplying locally, etc.

2) Take measures to counter inflation's negative impact on bottom line. Surging raw material costs, energy bill and labor costs, plus additional investments to secure supply chain are eroding companies' margin and profits. While a company cannot pass all rising costs to end users, it needs to seriously consider how to take necessary technological implementations to improve operation efficiency and defend its margin from erosion. Investors would prefer to hold companies with stable margin businesses.

3) Moreover, investors' appetite have shifted to company with near-term certainty and profitability. Growth at all costs is no longer being rewarded with rich valuation. Companies are required to recognize reality and reassess its operations. Investors are demanding greater certainty in this volatile market. Companies that stay laser-focused on growing business consistently, improving margins, and generating cash are being appreciated by investors. The cut of capex might sound bad, however, it might be crucial for the company to preserve sufficient cash to extend its runway through the tough time and emerge as a stronger name later.

C. Crisis also breeds opportunities

1) Companies might have opportunities to proceed with strategically aligned M&A transactions that cannot be done previously due to stretched valuation and exaggerated expectation of the targets. Companies have difficulty in handling supply chain challenges and inflationary risk would have to cede its market share to other contenders.

2) We believe that the spending on technology sector will remain strong, particularly in semiconductors and datacenters areas, as these areas are directly related to themes of new infrastructure and new energy prioritized by governments around the world. Companies can recognize these new opportunities and provide solutions to improve productivity while reducing energy consumption will thrive even in the tough market. In addition, existing regional leaders might be beneficiaries from greater government support in strategically important industries.

3) Companies with strong balance sheet and low payout ratios can take the opportunity to announce share repurchase, dividend plans. These plans can boost investors' confidence and put up a floor on valuation. Good compound returns in an environment of uncertainty will become more valued by investors.

This is a crucible moment that presents both challenges and opportunities for all. We recommend investors to focus on companies which meet the following criteria: 1) business that has stable margin and generates strong cash; 2) business with sustainable demand; 3) has a solid balance sheet that can provide sufficient financial flexibility; 4) adapt to change and make necessary adjustment to business model to survive in unfavorable market environment.

We suggest investors to focus on companies which are true innovators, disruptors and adapters. We believe companies which can deliver sustainable growth and show disciplined financial management would win investors' votes in any market.

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Coverage updates

Willsemi (603501 CH)'s share price has dropped to the bottom level since the start of pandemic. The gloomy outlook for smartphone market and the uncertainty in resumption of production kept the sentiment low. 1Q22's inventory level continued to climb, which increased investors' concerns. We expect short-term performance to be challenging, but we remain positive on Willsemi's long-term outlook. The Company's CIS is in a leading position, No. 1 in security and healthcare and No.2 in auto. By segment, we expect the growth in non-mobile CIS to remain largely intact. 1Q22 non-mobile CIS is estimated to grow 70% YoY, while full year growth is forecasted at 36.1%, offsetting the decline in mobile CIS (-3.5% YoY in 2022). Maintain BUY. TP is RMB200 based on 35x FY22E P/E multiple.

GalaxyCore (688728 CH) remains as a "show-me" story while the company tries to expand into mid- to high-end CIS segments. The company currently has a dominant position in low-end mobile CIS market (2MP-5MP) and is expected to ramp up production in 16MP/32MP CIS and above. Meanwhile, the Company is transiting into fab-lite model, which will secure capacity and serve as a foundation for tech advancement to gain market share in high-end CIS. Currently, the Company's share price is under pressure, as its revenue is mainly mobile-related. However, GalaxyCore has a broader client coverage, including Samsung and Transsion, which have less exposure to domestic smartphone market. We remain positive on the Company's outlook. Maintain BUY. TP is RMB28.5 based on 40x FY22 P/E multiple.

Maxscend (300782 CH)'s share price has dropped 70% from its peak within one year. The stock remains weak since the majority of revenue is from mobile. 1Q22's revenue still showed double-digit growth, dispelling investors' concerns over the Company's ability to continue to make breakthroughs in product development and win clients' orders. Its GPM was above 50%. Although we expect the margin will be lower as the Company has more non-5G products, such high margin serves as a cushion during this inflationary cycle. Although the sector is under correction, we believe that there are potential M&A opportunities within the sector. Currently, the Company is transiting into a fab-lite model to secure production capacity and full control of its manufacturing process. Maintain BUY. TP is RMB278.0 based on 37x FY22 P/E multiple.

Innolight (300308 CH) became No.1 transceiver suppliers globally in 2021 (vs. No.2 in 2020). We maintain our positive outlook on overseas Cloud demand and believe Innolight will continue to gain share in the optical transceiver market. In our previous report (Link), we pointed out that Amazon, Meta and Microsoft all posted record Capex, and guided very positive budgets for this year to support their cloud services and AI-related businesses. We expect 2Q22-4Q22 sales to deliver steady QoQ growth, following a similar trend as in 2021. We maintain BUY with TP of RMB45.6.

ZTE (763 HK) was a key beneficiary during the 5G roll-out. However, 5G-related capex budget reduced slightly by 5% this year, due to BTS de-spec trend as the growth momentum for 5G investment is easing. Looking forward, we maintain our positive outlook for ZTE and believe its carrier revenue growth should exceed the telco's capex growth (6.1% vs. 3.9%). The Company will still be a key beneficiary as the telco is shifting its investment from 5G infrastructure to industrial digitalization. Currently, ZTE's share in telco's capex is ~22.3%, which we expect to rise slightly to 22.8% in 2022. The Company has recently won China Mobile's PC server bid (No.2 place with RMB4bn). Maintain BUY with TP of HK$29.65.

China Tower (788 HK)'s 2022-23E revenue is expected to grow at mid-single-digit rate. Although we expect non-tower business to deliver double-digit growth, its revenue contribution will be only 14% in FY22E. We forecast core business to grow at 2.9%/2.5% YoY, a slower pace considering the stronger incentive of the telco to lift profitability and its potential plan to increase dividend payout ratio. The next catalyst for China Tower will be the telco's service contract renewal, which could result in a declining expenses ratio for telco to pay for China Tower's services. Maintain HOLD with TP of HK$1.01.

Shennan Circuit (002916 CH)'s FY22 revenue to grow 18.3% YoY, supported by new capacity released this year (Nantong factory Phase III) and strong demand for datacenter/auto/substrate. However, the uncertainty will last for a longer time than expected as supply chain disruption persists and the detailed timeline of 5G BTS deployment is unclear. Although we hold a positive outlook for its substrate business, new capacity of high-end FC IC substrate is expected to contribute in 2023/24. Maintain HOLD, with TP of RMB102. With a lack of catalysts, the stock is trading between RMB85-RMB123. Such price range may provide some trading opportunities.

Shengyi Tech (600183) is a leading player in the CCL industry. However, we are cautious about the industry amid softening demand and tough macro situations. Downstream demand outlook is mixed as domestic consumption will remain soft, telecom demand will remain flat or slightly reduce and auto/server demands could be the growth drivers. We estimate FY22 revenue to grow at 10% YoY. Meanwhile, peers' capacity expansion to put further pressure on the industry. CCL's market has been in an upcycle since 2H20. We see peers also expanded capacities to ride on the tailwind. However, this could further put pressure on the industry considering that the tough macro environment, pandemic and geopolitical issues may keep material and freight prices at high levels, thus negatively impacting GPM. Maintain HOLD with TP of RMB19.0.

Figure 1: Valuation

Company	Ticker	Rating	Mkt Cap US$(mn)	Price (LC)	TP (LC)	P/E (x) FY22E	P/E (x) FY23E	ROE (%) FY22E	ROE (%) FY23E	Dividend yield (%) FY22E	Dividend yield (%) FY23E
Willsemi	603501 CH	BUY	19,545	149.32	198.3	26.4	21.2	22.4	20.4	0.2	0.3
GalaxyCore	688728 CH	BUY	6,658	17.85	24.9	28.7	22.3	16.1	17.1	-	-
Maxscend	300782 CH	BUY	9,346	187.70	187.7	28.0	22.3	23.2	23.1	0.5	0.4
ZTE	763 HK	BUY	15,904	16.54	29.8	9.9	8.6	13.5	13.7	1.2	1.2
China Mobile	941 HK	NR	140,925	50.60	-	8.9	8.1	9.6	10.0	6.5	8.0
China Telecom	728 HK	NR	50,050	3.01	-	8.9	8.0	6.4	6.9	4.2	6.8
China Unicom	762 HK	NR	14,502	3.72	-	14.5	13.8	5.1	5.2	4.4	5.8
China Tower	788 HK	HOLD	20,630	0.92	1.0	18.1	15.4	4.6	5.3	2.4	2.9
Innolight	300308 CH	BUY	3,608	30.23	45.6	22.1	17.9	8.8	10.0	0.4	0.7
Shennan Circuit	002916 CH	HOLD	6,866	89.68	101.8	23.1	18.9	15.3	16.5	1.1	1.1
Shengyi Tech	600183 CH	HOLD	5,447	15.76	19.0	14.2	12.1	18.0	18.8	2.5	3.8

Source: Company data, CMBIGM estimates

Figure 2: Operating financials

Company	Ticker	Revenue (RMBmn) FY22E	Revenue (RMBmn) FY23E	NP shrholders (RMBmn) FY22E	NP shrholders (RMBmn) FY23E	GPM (%) FY22E	GPM (%) FY23E	EBITDA Margin (%) FY22E	EBITDA Margin (%) FY23E	NPM (%) FY22E	NPM (%) FY23E
Willsemi	603501 CH	34.9	35.4	24.0	24.4	34.9	35.4	24.0	24.4	17.7	18.8
GalaxyCore	688728 CH	31.7	30.5	23.4	22.3	31.7	30.5	23.4	22.3	16.9	16.6
Maxscend	300782 CH	52.4	50.2	46.9	46.0	52.4	50.2	46.9	46.0	37.1	35.3
ZTE	763 HK	35.6	35.2	9.8	9.6	35.6	35.2	9.8	9.6	6.1	6.2
China Mobile	941 HK	27.0	27.0	37.6	36.8	27.0	27.0	37.6	36.8	12.5	12.8
China Telecom	728 HK	29.3	29.4	28.5	27.3	29.3	29.4	28.5	27.3	5.9	6.0
China Unicom	762 HK	25.3	25.3	30.0	30.1	25.3	25.3	30.0	30.1	2.2	2.2
China Tower	788 HK	-	-	72.9	72.9	-	-	72.9	72.9	9.6	10.8
Innolight	300308 CH	26.6	26.4	16.3	17.7	26.6	26.4	16.3	17.7	10.9	11.7
Shennan Circuit	002916 CH	24.9	25.5	20.9	21.1	24.9	25.5	20.9	21.1	11.5	12.0
Shengyi Tech	600183 CH	25.0	25.3	18.0	18.2	25.0	25.3	18.0	18.2	11.9	12.4

Source: Company data, CMBIGM estimates

Figure 3: Cash and debt metrics

Company	Ticker	Cash per share (x) FY22E	Cash per share (x) FY23E	FCF per share (x) FY22E	FCF per share (x) FY23E	Debt/EBITDA (x) FY22E	Debt/EBITDA (x) FY23E	Net Debt/EBITDA (x) FY22E	Net Debt/EBITDA (x) FY23E	EBITDA/Int. exp. (x) FY22E	EBITDA/Int. exp. (x) FY23E
Willsemi	603501 CH	7.3	12.7	(0.0)	8.2	1.3	1.0	0.3	(0.4)	16.4	21.2
GalaxyCore	688728 CH	2.7	2.8	0.2	(0.0)	2.8	2.4	(0.4)	(0.2)	13.7	14.1
Maxscend	300782 CH	4.6	7.2	(0.6)	3.3	0.0	0.0	(0.7)	(0.9)	NM	NM
ZTE	763 HK	14.9	17.2	2.4	1.6	3.8	3.8	(1.7)	(2.0)	7.3	6.9
China Mobile	941 HK	20.4	24.4	6.5	6.7	0.1	0.1	(1.1)	(1.3)	129.8	147.8
China Telecom	728 HK	1.4	2.0	0.5	0.6	0.2	0.2	(0.6)	(1.0)	77.8	79.7
China Unicom	762 HK	1.4	1.2	1.3	1.1	0.2	0.2	(0.3)	(0.2)	94.9	103.6
China Tower	788 HK	0.0	0.0	0.1	0.1	1.0	0.8	0.9	0.6	19.2	24.6
Innolight	300308 CH	4.0	3.9	1.4	(0.2)	1.5	1.3	(0.5)	(0.2)	12.4	15.3
Shennan Circuit	002916 CH	7.6	6.9	5.8	2.2	0.8	0.7	(0.3)	(0.2)	17.8	19.6
Shengyi Tech	600183 CH	1.3	1.5	1.3	0.7	0.8	0.7	0.0	(0.0)	17.1	21.6

Source: Company data, CMBIGM estimates

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