



## TCL Communication

2618 HK / 2618.HK

## COMPANY NOTE

➤ **Market Cap**  
**US\$337.5m**  
HK\$2,618m

➤ **Avg Daily Turnover**  
**US\$0.98m**  
HK\$7.63m

➤ **Free Float**  
**49.2%**  
1,128 m shares

Current **HK\$2.32**  
Target **HK\$3.09**  
Previous Target **N/A**  
Up/downside **33.2%**

**SHORT TERM (3 MTH)** **LONG TERM**  
**TRADING BUY** **OUTPERFORM**  
**TRADING SELL** **NEUTRAL**  
**UNDERPERFORM**

### Notes from the Field



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Company Visit ☒ Expert Opinion ☐  
Channel Check ☐ Customer Views ☐

*"We are carrying out a product transition from feature phones to smartphone and paying the way for long term success."*

Li Dongsheng, Chairman

# Ringling the changes with smartphones

*This leading handset maker is in a transition period as it migrates from feature phones to smartphones. Following its launch of improved smartphones over the past few months, we project a strong earnings recovery in FY14-15, driven by higher ASP and smartphone shipments.*

We initiate coverage on TCLC with an Outperform rating and a target price based on 1.5x FY13 P/BV, the mid-cycle valuation (3-year average) which is justified by its earnings recovery. Potential share price catalysts are robust smartphone shipments and stabilising gross margin.

### A recovery play ➤

TCL Communication (TCLC) is a leading international handset manufacturer, carrying two brands – TCL and Alcatel One Touch. The group ranked No. 7 among the global handset manufacturers in 4Q12 with 2.4% market share based on volume.

In view of huge global demand for smartphones, TCLC is transforming its product portfolio from feature phones to smartphone. We take a positive view of TCLC's migration to smartphones given the superior smartphones that it has launched over the past few months – Alcatel One Touch Idol Ultra, which is the slimmest smartphone in the world

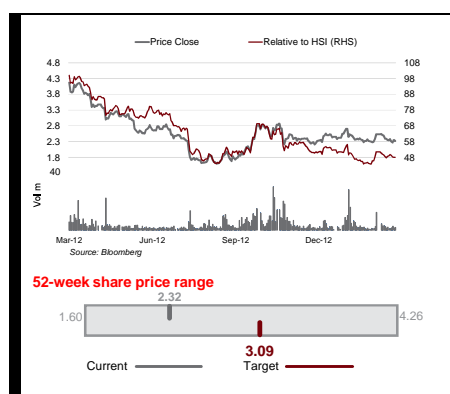
and Alcatel One Touch Idol, the world's lightest Android smartphone. We expect TCLC's smartphone shipments to reach 50% of its total shipments in FY15, in line with the global industry trend. We estimate that smartphone products will contribute more than 80% of total revenue in FY15.

### Strong earnings rebound ➤

Factoring in a rise in its blended ASP and robust smartphone shipments, we project 26% revenue CAGR in FY12-15. Operating leverage should propel the group from losses in FY12 to net profits of HK\$270m in FY14 and HK\$488m in FY15.

### A raft of smartphone rollouts ➤

Our bullish view is supported by the ramp-up of smartphone shipments, which is stoked by a slew of best-in-class and timely smartphone launches, optimisation of distribution channels and development of new overseas markets.



### Financial Summary

	Dec-11A	Dec-12A	Dec-13F	Dec-14F	Dec-15F
Revenue (HK\$m)	10,653	12,031	15,030	19,531	24,372
Operating EBITDA (HK\$m)	1,005	499	526	777	1,013
Operating EBITDA Margin	9.43%	4.15%	3.50%	3.98%	4.16%
Net Profit (HK\$m)	799.9	(207.8)	28.1	270.3	487.9
Normalised EPS (HK\$)	0.73	-0.23	0.02	0.24	0.43
Normalised EPS Growth	13%	(132%)	na	862%	80%
FD Normalised P/E (x)	3.30	NA	95.28	9.90	5.49
DPS (HK\$)	0.29	0.03	0.00	0.10	0.17
Dividend Yield	12.4%	1.3%	0.0%	4.1%	7.5%
EV/EBITDA (x)	2.48	6.92	6.33	4.32	3.27
P/FCFE (x)	NA	10.87	6.37	10.27	6.12
Net Gearing	(2.1%)	36.4%	30.7%	28.9%	24.0%
Recurring ROE	32.7%	(10.6%)	1.2%	11.0%	17.8%
% Change In Normalised EPS Estimates					
Normalised EPS/consensus EPS (x)			0.21	0.87	2.54

SOURCE: CIMB, COMPANY REPORTS

IMPORTANT DISCLOSURES, INCLUDING ANY REQUIRED RESEARCH CERTIFICATIONS, ARE PROVIDED AT THE END OF THIS REPORT.

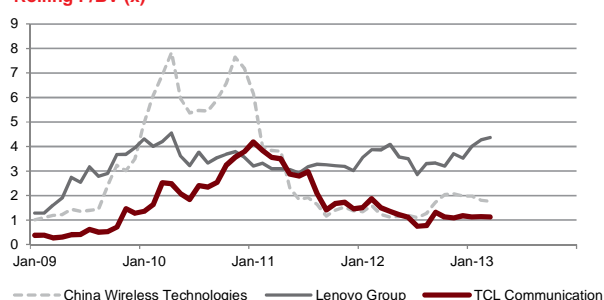
Designed by Eight, Powered by EFA

## PEER COMPARISON

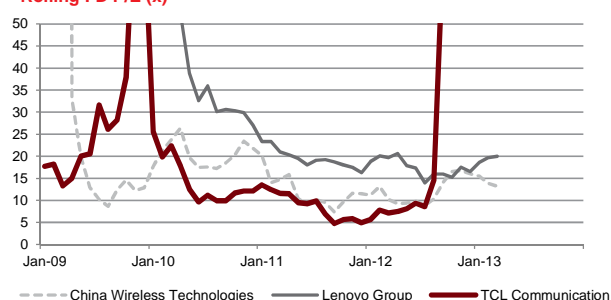
### Research Coverage

	Bloomberg Code	Market	Recommendation	Mkt Cap US\$m	Price	Target Price	Upside
China Wireless Technologies	2369 HK	HK	OUTPERFORM	551	2.04	3.77	84.8%
Lenovo Group	992 HK	HK	OUTPERFORM	12,106	9.00	8.84	-1.8%
<b>TCL Communication</b>	<b>2618 HK</b>	<b>HK</b>	<b>OUTPERFORM</b>	<b>337</b>	<b>2.32</b>	<b>3.09</b>	<b>33.2%</b>

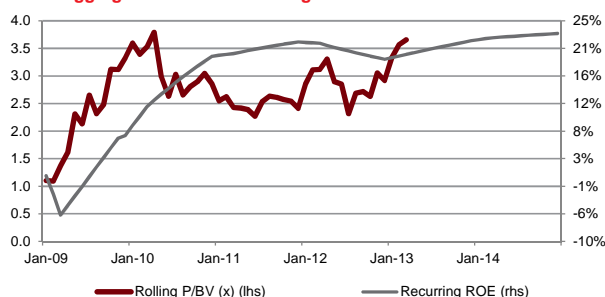
### Rolling P/BV (x)



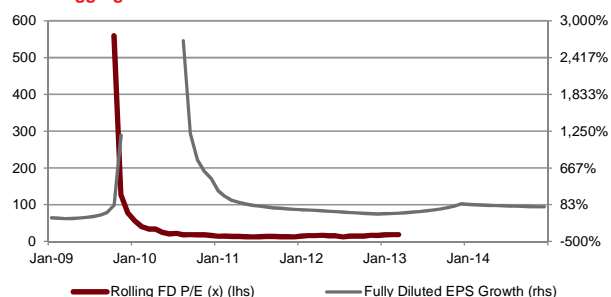
### Rolling FD P/E (x)



### Peer Aggregate: P/BV vs Recurring ROE



### Peer Aggregate: FD P/E vs FD EPS Growth



### Valuation

	P/E (FD) (x)			P/BV (x)			EV/EBITDA (x)		
	Dec-12	Dec-13	Dec-14	Dec-12	Dec-13	Dec-14	Dec-12	Dec-13	Dec-14
China Wireless Technologies	14.60	10.13	8.03	1.81	1.62	1.40	6.77	5.40	4.18
Lenovo Group	21.17	17.26	14.54	4.52	3.86	3.22	8.45	6.04	4.12
<b>TCL Communication</b>	<b>NA</b>	<b>95.28</b>	<b>9.90</b>	<b>1.13</b>	<b>1.13</b>	<b>1.02</b>	<b>6.92</b>	<b>6.33</b>	<b>4.32</b>

### Growth and Returns

	Fully Diluted EPS Growth			Recurring ROE			Dividend Yield		
	Dec-12	Dec-13	Dec-14	Dec-12	Dec-13	Dec-14	Dec-12	Dec-13	Dec-14
China Wireless Technologies	15.0%	44.2%	26.2%	13.3%	17.2%	19.1%	1.75%	3.02%	3.81%
Lenovo Group	33.8%	22.6%	18.7%	23.5%	24.6%	24.5%	1.39%	1.52%	1.52%
<b>TCL Communication</b>	<b>-125.7%</b>	<b>na</b>	<b>862.0%</b>	<b>-10.6%</b>	<b>1.2%</b>	<b>11.0%</b>	<b>1.29%</b>	<b>0.00%</b>	<b>4.13%</b>

SOURCE: CIMB, COMPANY REPORTS

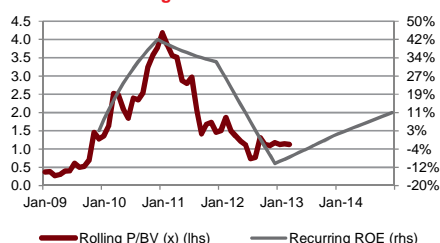
Calculations are performed using EFA™ Monthly Interpolated Annualisation and Aggregation algorithms to December year ends

## BY THE NUMBERS

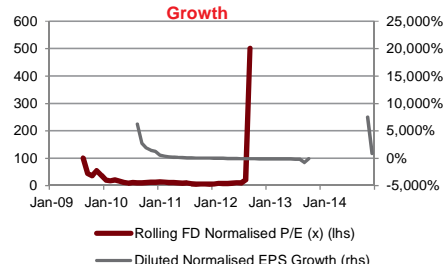
### Share price info

Share px perf. (%)	1M	3M	12M
Relative	4	-2.1	-51.5
Absolute	0.4	1.8	-44.5
<b>Major shareholders</b>	<b>% held</b>		
TCL Corporation	50.8		

### P/BV vs Recurring ROE



### FD Normalised P/E vs FD Normalised EPS Growth



We expect a strong recovery in earnings, driven by blended ASP rise and robust smartphone shipments.

### Profit & Loss

(HK\$m)	Dec-11A	Dec-12A	Dec-13F	Dec-14F	Dec-15F
<b>Total Net Revenues</b>	<b>10,653</b>	<b>12,031</b>	<b>15,030</b>	<b>19,531</b>	<b>24,372</b>
<b>Gross Profit</b>	<b>2,328</b>	<b>2,097</b>	<b>2,555</b>	<b>3,320</b>	<b>4,143</b>
<b>Operating EBITDA</b>	<b>1,005</b>	<b>499</b>	<b>526</b>	<b>777</b>	<b>1,013</b>
Depreciation And Amortisation	-275	-789	-470	-454	-425
<b>Operating EBIT</b>	<b>729</b>	<b>-290</b>	<b>56</b>	<b>323</b>	<b>588</b>
Total Financial Income/(Expense)	55	47	-24	-12	-20
Total Pretax Income/(Loss) from Assoc.	-1	-2	3	8	8
Total Non-Operating Income/(Expense)	0	0	0	0	0
<b>Profit Before Tax (pre-EI)</b>	<b>783</b>	<b>-245</b>	<b>35</b>	<b>319</b>	<b>577</b>
Exceptional Items	0	56	0	0	0
<b>Pre-tax Profit</b>	<b>783</b>	<b>-188</b>	<b>35</b>	<b>319</b>	<b>577</b>
Taxation	17	-32	-4	-45	-81
Exceptional Income - post-tax					
<b>Profit After Tax</b>	<b>801</b>	<b>-220</b>	<b>30</b>	<b>274</b>	<b>496</b>
Minority Interests	-1	12	-2	-4	-8
Preferred Dividends					
FX Gain/(Loss) - post tax					
Other Adjustments - post-tax					
Preference Dividends (Australia)					
<b>Net Profit</b>	<b>800</b>	<b>-208</b>	<b>28</b>	<b>270</b>	<b>488</b>
Normalised Net Profit	801	-276	30	274	496
<b>Fully Diluted Normalised Profit</b>	<b>800</b>	<b>-264</b>	<b>28</b>	<b>270</b>	<b>488</b>

We expect dividends to resume in FY14 as it turns profitable.

### Cash Flow

(HK\$m)	Dec-11A	Dec-12A	Dec-13F	Dec-14F	Dec-15F
<b>EBITDA</b>	<b>1,005</b>	<b>499</b>	<b>526</b>	<b>777</b>	<b>1,013</b>
Cash Flow from Invt. & Assoc.	1	2	-3	-8	-8
Change In Working Capital	-722	-235	53	-386	-415
(Incr)/Decr in Total Provisions					
Other Non-Cash (Income)/Expense					
Other Operating Cashflow	145	264	223	234	247
Net Interest (Paid)/Received	-140	-166	-176	-182	-196
Tax Paid	-36	-32	-4	-45	-81
<b>Cashflow From Operations</b>	<b>253</b>	<b>332</b>	<b>618</b>	<b>390</b>	<b>561</b>
Capex	-399	-300	-350	-300	-300
Disposals Of FAs/subsidiaries	51	0	0	0	0
Acq. Of Subsidiaries/investments	-876	0	0	0	0
Other Investing Cashflow	136	213	152	170	176
<b>Cash Flow From Investing</b>	<b>-1,087</b>	<b>-87</b>	<b>-198</b>	<b>-130</b>	<b>-124</b>
Debt Raised/(repaid)	735	0	0	0	0
Proceeds From Issue Of Shares	44	0	0	0	0
Shares Repurchased	0	0	0	0	0
<b>Dividends Paid</b>	<b>-336</b>	<b>-34</b>	<b>0</b>	<b>-108</b>	<b>-195</b>
Preferred Dividends					
Other Financing Cashflow	75	129	-73	-15	-29
<b>Cash Flow From Financing</b>	<b>518</b>	<b>95</b>	<b>-73</b>	<b>-124</b>	<b>-224</b>

SOURCE: CIMB, COMPANY REPORTS

## BY THE NUMBERS

### Balance Sheet

(HK\$m)	Dec-11A	Dec-12A	Dec-13F	Dec-14F	Dec-15F
Total Cash And Equivalents	7,279	5,191	5,814	6,014	6,557
Total Debtors	3,819	4,560	4,955	6,439	8,034
Inventories	981	1,263	1,409	1,831	2,285
Total Other Current Assets	175	198	30	30	30
<b>Total Current Assets</b>	<b>12,254</b>	<b>11,212</b>	<b>12,207</b>	<b>14,313</b>	<b>16,906</b>
Fixed Assets	683	774	954	1,050	1,124
Total Investments	29	30	30	30	30
Intangible Assets	956	1,174	1,174	1,174	1,174
Total Other Non-Current Assets	106	131	131	131	131
<b>Total Non-current Assets</b>	<b>1,773</b>	<b>2,109</b>	<b>2,289</b>	<b>2,384</b>	<b>2,459</b>
Short-term Debt	7,222	5,726	6,128	6,358	6,855
Current Portion of Long-Term Debt					
<b>Total Creditors</b>	<b>3,693</b>	<b>4,481</b>	<b>5,075</b>	<b>6,595</b>	<b>8,230</b>
Other Current Liabilities	400	398	483	684	882
<b>Total Current Liabilities</b>	<b>11,315</b>	<b>10,606</b>	<b>11,686</b>	<b>13,637</b>	<b>15,967</b>
Total Long-term Debt	0	310	400	400	400
Hybrid Debt - Debt Component					
Total Other Non-Current Liabilities	4	6	7	9	11
<b>Total Non-current Liabilities</b>	<b>4</b>	<b>316</b>	<b>407</b>	<b>409</b>	<b>411</b>
Total Provisions	35	77	77	77	77
<b>Total Liabilities</b>	<b>11,354</b>	<b>10,998</b>	<b>12,170</b>	<b>14,123</b>	<b>16,455</b>
Shareholders' Equity	2,669	2,321	2,324	2,573	2,909
Minority Interests	4	2	2	2	2
<b>Total Equity</b>	<b>2,673</b>	<b>2,323</b>	<b>2,326</b>	<b>2,574</b>	<b>2,910</b>

The huge short-term debt mainly comprises risk-free financial instruments which are fully backed by the cash on hand.

### Key Ratios

	Dec-11A	Dec-12A	Dec-13F	Dec-14F	Dec-15F
Revenue Growth	22.4%	12.9%	24.9%	29.9%	24.8%
Operating EBITDA Growth	12.4%	(50.3%)	5.4%	47.8%	30.4%
Operating EBITDA Margin	9.43%	4.15%	3.50%	3.98%	4.16%
Net Cash Per Share (HK\$)	0.05	-0.75	-0.63	-0.66	-0.62
BVPS (HK\$)	2.40	2.06	2.06	2.28	2.58
Gross Interest Cover	5.21	-1.75	0.32	1.77	3.00
Effective Tax Rate	0.0%	0.0%	13.0%	14.0%	14.0%
Net Dividend Payout Ratio	40.1%	(12.8%)	0.0%	40.0%	40.0%
Accounts Receivables Days	87.71	82.55	72.02	66.36	67.55
Inventory Days	38.61	41.34	39.09	36.48	37.14
Accounts Payables Days	83.21	80.70	75.77	71.20	72.48
ROIC (%)	47.4%	(8.3%)	1.3%	7.8%	13.1%
ROCE (%)	9.91%	(0.84%)	2.39%	5.38%	7.78%

### Key Drivers

	Dec-11A	Dec-12A	Dec-13F	Dec-14F	Dec-15F
Group Mobile Subscribers (m)	-	-	-	-	-
Group Fixed Voice Subscribers (m)	-	-	-	-	-
Grp fixed brdband subscribers (m)	-	-	-	-	-
Group Pay TV Subs (m)	-	-	-	-	-
Group Mobile ARPU (US\$/mth)	-	-	-	-	-
Grp fixed voice ARPU (US\$/mth)	-	-	-	-	-
Grp fixed brdband ARPU (US\$/mth)	-	-	-	-	-
Group Pay TV ARPU (US\$/mth)	-	-	-	-	-

SOURCE: CIMB, COMPANY REPORTS

# Ringling the changes with smartphones

## 1. BACKGROUND

### 1.1 Investment view ►

**Turnaround story** - Although earnings visibility remains poor in the short term due to a period of transition to smartphones, we believe that TCLC's earnings collapse in FY12 was one-off. We expect the group to turn profitable in FY13.

We are positive on TCLC's migration to smartphones given the superior smartphones that it has launched over the past few months – Alcatel One Touch Idol Ultra, which is the slimmest smartphone in the world and Alcatel One Touch Idol, the world's lightest Android smartphone. We expect TCLC's smartphone shipments to reach 50% of its total shipments in FY15, fuelled by a series of smartphone rollouts. We forecast TCLC's smartphone shipment to reach 25m in FY15, a CAGR of 56%. Based on this assumption, revenue from smartphone devices is set to reach 84% of total revenue. We believe the ramp-up of smartphone shipments will drive economies of scale, leading to operating leverage.

Our bullish view is supported by the ramp-up of smartphone shipments, which is stoked by a slew of best-in-class and timely smartphone launches, optimisation of distribution channels and development of new overseas markets.

**Strong earnings turnaround** - We forecast revenue to reach HK\$24bn by 2015 (CAGR of 26% in FY12-15), driven by a blended ASP rise and robust smartphone shipments. Leveraging its 50% exposure to smartphones, we project a strong recovery from losses in FY12 to net profit of HK\$270m in FY14 and HK\$488m in FY15.

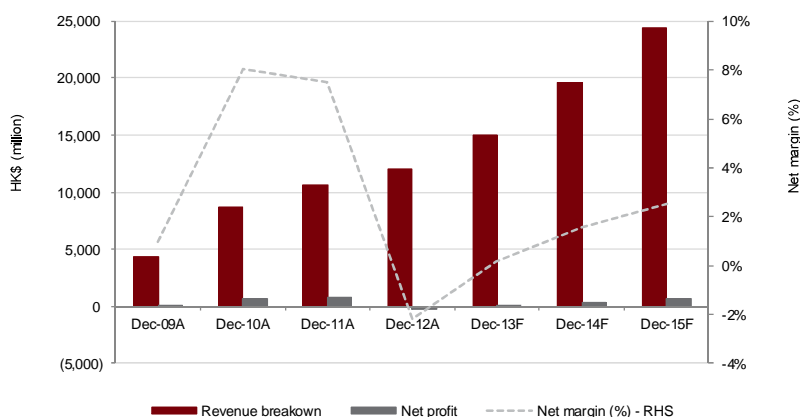
**Outperform call** - We initiate coverage on TCLC with an Outperform rating and a target price of HK\$3.09, based on 1.5x P/BV, the mid-cycle valuation (3-year average), which is justified by its earnings recovery. Potential share price catalysts are robust smartphone shipments and stable gross margin.

#### Notes from the Field

*"We are carrying out a product transition from feature phones to smartphone and paying the way for long term success."*

– Li Dongsheng, Chairman

Figure 1: Revenue and net profit (FY09 - FY15F)



SOURCES: CIMB, COMPANY REPORTS

## **What happened to TCL Communication?**

### **Handset market changing too fast**

2012 was a very bad year for TCLC and its shareholders as earnings plummeted from a peak of HK\$800m in FY11 to a HK\$208m loss as the company failed to tap into global smartphone opportunities and underestimated the demand for smartphones in China.

Although TCL/Alcatel maintained the seventh place in global handset shipments in 2012, it was far down the league table for global smartphone shipments, in contrast to Huawei and ZTE, which joined the ranks of the top 5 in both the global and China smartphone markets, and Lenovo which grabbed the second place in China, according to DisplaySearch and SINO Research Market Ltd.

### **The key problems**

1. TCLC was tardy in its migration to smartphone as the handset market changed very quickly.
2. it faced continued gross margin squeeze for entry-level smartphones in China, reflecting keen competition from domestic handset vendors and declining ASP for feature phones due to subpar demand.
3. it lacked economies of scale in smartphone manufacturing due to low volumes.
4. expenses surged due to a rise in R&D investment and sales & marketing expenses for smartphone business development.
5. there were delays in the launch of products due to longer-than-expected product verification by the telecommunication operators.

### **How to solve the problems**

In view of TCLC's weak smartphone products in the past and relatively less cooperation with telecom operators, especially in China, we believe that the only way to drive its smartphone volume is through timely smartphone products and optimisation of the distribution channels.

1. increase new smartphone rollout to speed up the migration of feature phone to smartphone by increasing R&D manpower and resources
2. revamp brands by launching user-friendly, innovative, differentiated and price-competitive smartphones.
3. In China – focus on low-end smartphones, strengthen its partnership with the Chinese mobile operators and develop mid-range smartphones (Rmb1,000 to Rmb2,000) in open channels
4. Overseas markets – focus on mid- to high-end smartphones in the European and the US markets and continue developing the new and potential emerging markets by tying up with the local telecom operators

### **Financial and operating impacts to return it to profitability**

1. increase its global and China smartphone market share
2. improve its product mix and increase smartphone shipment to drive the blended ASP higher (smartphone price about 4x normal phones) and achieve economies of scales
3. better gross profit margin and higher operating leverage with a better cost structure, leading the earnings recovery



## 1.2 New series of smartphones to drive growth ▶

On 8 Jan 2013, TCLC launched three models of flagship smartphones in the world's largest international consumer electronics show CES 2013. It introduced the world's slimmest smartphone and lightest Android smartphone, which were key attractions to international consumers.

Before that, TCLC had already started its marketing campaign in China in Dec 2012 when it showed 12 new models of smartphones from four series "JOY, STAR, PLAY, YOU". The new smartphones are equipped with dual-core, the slimmest (>4-inch) large screen with the best-in-class performance-to-cost quotients.

- TCL S850 (STAR series) / Alcatel One Touch Idol Ultra, the slimmest smartphone in the world with a thickness of only 6.45mm. Its key specifications include 1.2 GHz dual-core CPU, 4.7-inch HD AMOLED display and brushed metallic coating case. The retail price in China is Rmb2,699 / US\$399.
- TCL S820 (STAR series) / Alcatel One Touch Idol, the lightest Android smartphone in the world weighing only 110 grams. Its key specifications include a 4.7-inch display and 1.2GHz dual-core CPU. It retails for Rmb1,888 in China and US\$299 in overseas.
- TCL D768, a dual-mode smartphone with high performance-to-cost quotient, is a tie-up with Sunning and China Telecom and is specifically for the China market. Its key specs include a 4.5-inch screen, 1.2 GHz dual-core CPU and 5m pixel. It is priced at Rmb1,399.

**Figure 2: TCL S850 / Alcatel One Touch Idol Ultra**

Display : 4.7" HD (1280x720 pixel)  
CPU : dual-core 1.2GHz (Cortex A9)  
Camera : 8 megapixel CMOS  
Retail price : Rmb2,699



SOURCES: CIMB, COMPANY REPORTS

**Figure 3: TCL D768 (GSM / CDMA2000)**

Display : 4.5" qHD (540x960 pixel)  
CPU : dual-core 1.2GHz (MSM8625)  
Camera : megapixel CMOS  
Retail price : Rmb 1,399

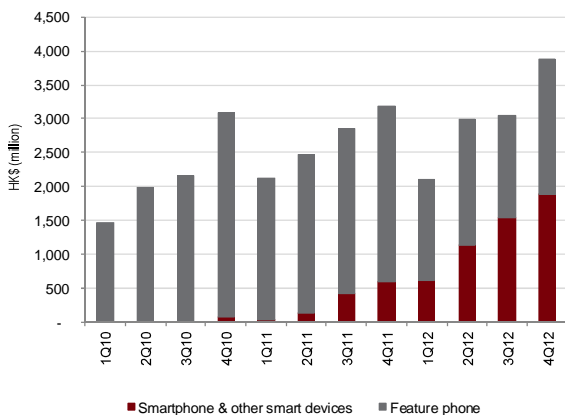


SOURCES: CIMB, COMPANY REPORTS

## 1.3 Transition period in "Step-up" to the smartphone train ▶

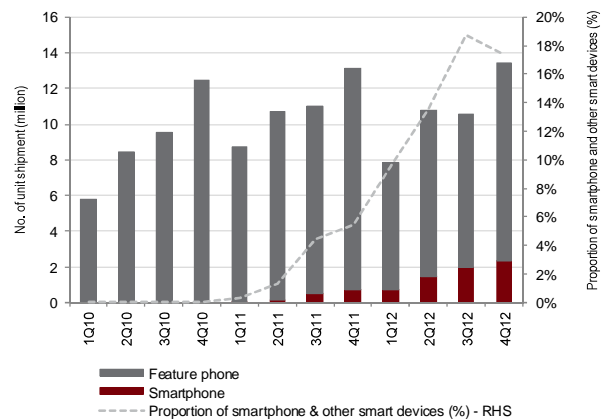
TCLC is in a transition period of implementation of its "Step-up" strategy to increase its competitiveness in the global smartphone market in order to catch up with the tremendous global smartphone demand. Since the launch of its first mid-range smartphone in late 2010, TCLC has gradually ramped up its smartphone output. Its smartphone shipments surged from 0.02m in 1Q11 to 2.34m in 4Q12, accounting for 18% of total shipment (Figure 5). More importantly, revenue generated from smartphones has surpassed revenue from feature phones since 3Q12 (Figure 4).

Figure 4: Quarterly revenue breakdown by handset type



SOURCES: CIMB, COMPANY REPORTS

Figure 5: Quarterly volume breakdown by handset type



SOURCES: CIMB, COMPANY REPORTS

#### 1.4 No pain, no gain ➤

TCLC maintained its 7<sup>th</sup> spot in global handset shipments in 4Q12, in contrast to international rivals such as HTC and BlackBerry which dropped out of the ranks of the top 10 in global handsets, according to Gartner. But TCLC suffered a substantial loss of HK\$208m in FY12 due to gross margin erosion for feature phones and a surge in R&D and marketing costs as it penetrated deeper into the smartphone market.

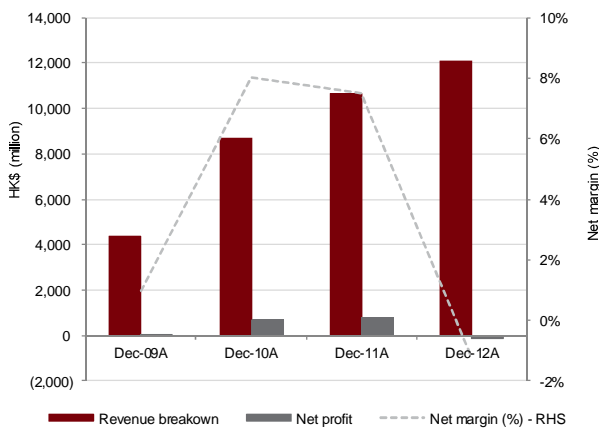
We understand that the pain is necessary given the temporary rise in costs for the rollout of new smartphones. We expect the global launch of its new series of smartphones in 4Q12 to bear fruit this year as the initial feedback from the telecom operators was encouraging. Already, smartphone shipments shot up 322% yoy in the first month of 2013.

#### 1.5 Company background ➤

Founded in 1993 and listed on the HKEx in 2004, TCL Communication Technology Holdings Limited (TCLC) is part of TCL Corporation (000100 CH, Not Rated). Headquartered in Shenzhen, TCLC designs, manufactures, markets and sell handsets and accessories under two brand names, TCL and Alcatel One Touch, to both the overseas and China markets. Its product portfolio includes mobile phones, converged mobile devices, tablets and fixed-line phones. In FY12, the group sold 42.6m handsets and accessories (6.5m smartphones) to over 120 countries throughout the Americas, Europe, the Middle East, Africa and the Asia-Pacific region.

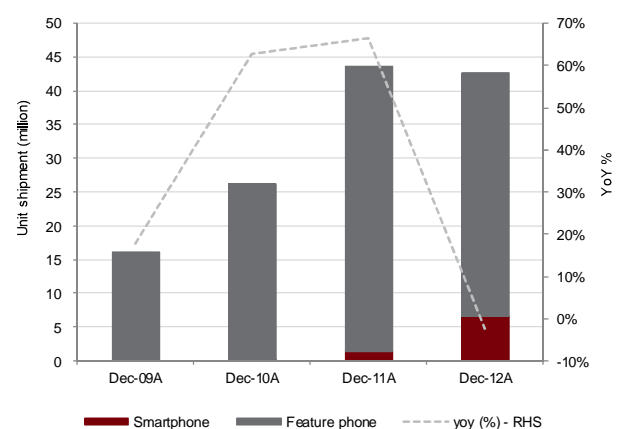


Figure 6: Revenue and net profit (FY09 - FY12)



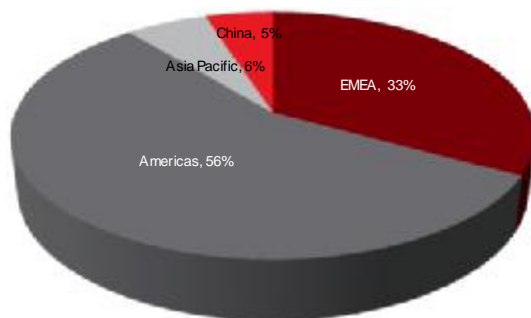
SOURCES: CIMB, COMPANY REPORTS

Figure 7: Unit shipments (FY09-FY12)



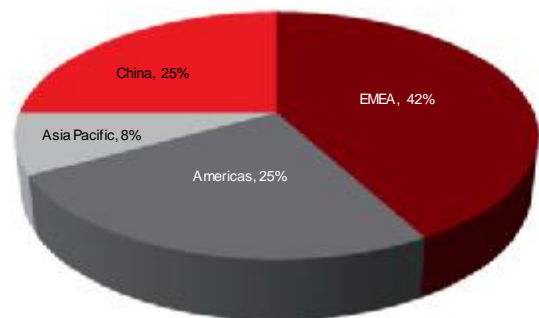
SOURCES: CIMB, COMPANY REPORTS

Figure 8: Feature phone revenue breakdown by geography (2012)



SOURCES: CIMB, COMPANY REPORTS

Figure 9: Revenue breakdown for smartphone and other smart devices by geography (2012)



SOURCES: CIMB, COMPANY REPORTS

## 1.6 Remains one of top 10 global handset manufacturers

According to Gartner's latest report, TCL/Alcatel ranked No. 7 (No. 9 in 4Q11) among the global handset manufacturers in 4Q12 with 2.4% market share based on volume. Although its global feature phone shipments in 4Q12 dropped 10.7% yoy, it was offset by a 224% yoy increase in smartphone shipments. The top 10 names comprised four domestic brands which included ZTE (#4), Huawei (#6) and Lenovo (#8). Samsung snatched the pole position from Nokia with 22.7% share of global handset shipments, thanks to the popularity of its Galaxy series and its targeting of all handset segments.

Although TCL-Alcatel is one of the top 10 global handset manufacturers, its ranking in the global smartphone market was relatively low given that feature phones make up more than 80% of TCLC's handset shipments.

Figure 10: Global handset unit shipment in 4Q 2012

Brand	4Q 2012				2Q 2012			4Q 2011		
	Rank	Est	QoQ change	Est	Rank	Est	Est	Rank	Est	Est
		market share		shipment (m)		market share	shipment (m)		market share	shipment (m)
Samsung	1	22.7%	1.1 ppt	107.0	1	21.6%	90.4	2	19.6%	93.8
Nokia	2	18.0%	0.4 ppt	85.1	2	17.7%	83.4	1	23.4%	111.7
Apple	3	9.2%	3.1 ppt	43.5	3	6.1%	28.9	3	7.4%	35.5
ZTE	4	3.4%	-0.4 ppt	16.2	4	3.8%	17.9	4	4.0%	18.9
LG Electronics	5	3.2%	0.1 ppt	15.0	5	3.0%	14.3	5	3.5%	16.9
Huawei	6	2.9%	0.6 ppt	13.7	6	2.3%	10.9	6	2.9%	14.0
TCL-Alcatel	7	2.4%	0.4 ppt	11.1	7	2.0%	9.4	9	2.2%	10.7
Lenovo	8	1.8%	n.a.	8.3	n.a.	n.a.	n.a.	n.a.	1.1%	5.2
Sony	9	1.7%	n.a.	7.9	n.a.	n.a.	n.a.	n.a.	1.9%	8.9
Motorola	10	1.7%	-0.3 ppt	7.8	9	1.9%	9.2	10	2.1%	10.1
HTC	n.a.	n.a.	n.a.	n.a.	8	2.0%	9.3	8	2.3%	10.8
BlackBerry	n.a.	n.a.	n.a.	n.a.	10	1.7%	8.0	7	2.8%	13.2
Others		33.2%	n.a.	156.6		29.1%	137.3		26.8%	128.0
Total				472.1			419.0			477.7

SOURCES: Gartner, CIMB

## 1.7 Business model ►

Headquartered in Shenzhen, with a highly efficient in-house manufacturing facility in Huizhou, Guangdong province in China, TCLC is a fully integrated handset manufacturer engaged in design, R&D, manufacturing and distribution of feature phones, smartphone and other smart devices. The majority of its smartphones use the Android operating system but it has started producing devices based on Windows 8 and Firefox.

**R&D** - The group operates five R&D centres in China (Shanghai, Ningbo, Huizhou, Shenzhen and Chengdu) and one design centre in Italy. Its two mobile brands share design teams for product R&D in order to save cost and standardise manufacturing.

**Manufacturing** - The production of TCL brand and Alcatel brand handsets is handled by the same factory in Huizhou. Production capacity totals approximately 65m units annually and it plans to expand it to 100m units in 2013 after the relocation of a factory to Huizhou too. TCLC sources the majority of the core handset components such as chipsets (from MediaTek and Qualcomm), cameras and casings etc., from third-party suppliers, except for touch panels, a certain portion of which is provided by the affiliates of its parent company.

Figure 11: Global presence



SOURCES: CIMB, COMPANY REPORTS

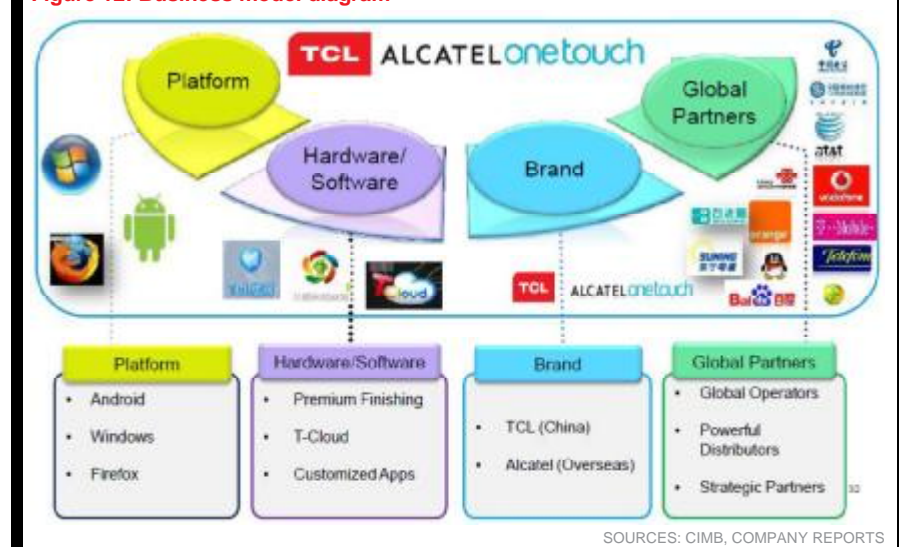
**Two brands** – The TCL brand is a home-grown electronics brand focusing on China's domestic market while Alcatel is a well-recognised international handset brand targeted at the international market.

- **TCL** - TCL stands for "The Creative Life", a slogan that represents TCL's aspirations of building one of China's most innovative and resourceful brand names. TCL boasts a leading position for TV brands in China in 2012. The focus of the TCL brand is on the China market as it is a household name in China and has a well-established distribution channel. The TCL brand currently focuses on the mid- to low-end of China's smartphone market.
- **Alcatel One Touch** - TCLC has the right to use the Alcatel brand name in return for an agreed royalty payable to Alcatel-Lucent. The Alcatel brand is a well-recognised international mobile brand which is particularly strong in Latin America as well as Europe given its original base in Paris. Alcatel One Touch phones target the mid- to high-end market and are distributed through 120 countries worldwide, including China.

**Background on Alcatel mobile business acquisition** - TCL Corporation set up a 55:45 mobile phone manufacturing JV with Alcatel in 2004 and acquired the remaining stake in 2005 to form TCL Communication. In Sep 2011, TCLC agreed to pay HK\$312m to Alcatel-Lucent for the continued use of the Alcatel brand name "Alcatel One Touch" from Jul 2011 to Dec 2024.

**Distribution channels** – More than two-thirds of TCL handsets are sold through 8,600 POS operated by nationwide distributors and chain retailers in China. Alcatel's mobile devices are sold in over 120 countries, mainly through local telecom operators.

Figure 12: Business model diagram



## 1.8 Shareholding structure and management ►

In the eight years since its listing, TCLC has raised approximately HK\$2.0bn through convertibles, rights issues, open offers and placements.

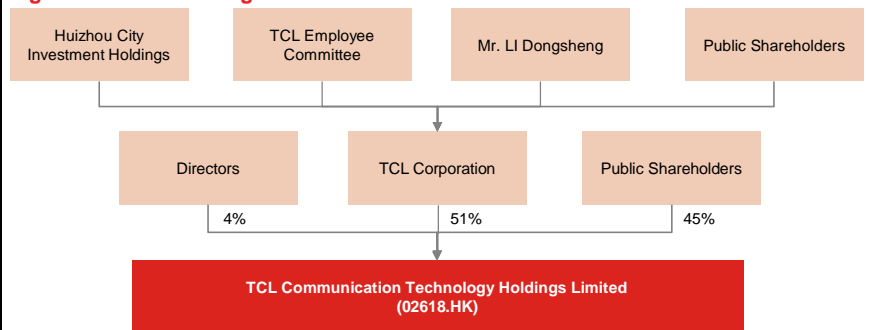
**Figure 13: Funds raised history**

Date	No. of shares issue (m)	Price (HK\$)	Fund Raised (HK\$m)	Method
May 2005	35.0	5.28	185	Convertibles
May 2005	34.3	5.82	200	Convertibles
Feb 2006	297.0	2.00	594	Open offer
Mar 2007	191.1	1.84	352	Convertibles
Jul 2007	121.5	2.21	268	Placement
Dec 2009	357.5	1.00	358	Rights issues

SOURCES: CIMB, COMPANY REPORTS

TCL Corporation (000100 CH, Not Rated) is the holding company of the group and currently holds 50.78%. TCL Corp is 9.8% held by Huizhou City Investment Holdings and 5.4% by Mr. Li Dongsheng.

**Figure 14: Shareholding structure**



SOURCES: CIMB, COMPANY REPORTS

**Mr. Li Dongsheng** is chairman and executive director of TCLC and TCL Multimedia Technology Holdings Limited (1070 HK, Not Rated), chairman and CEO of TCL Corp. He is one of the founders of TCL Corp.

In 1982, Mr. Li began his career as an engineer in TTK Home Electronic Appliances Co. Ltd., the predecessor of TCL. In 1985, he was promoted to general manager of the newly established TCL Communication Equipment Co., Ltd. He subsequently created the TCL brand. He was then transferred to Guangdong Huizhou Industrial Development Company as director of business development. Mr. Li was appointed deputy manager of Huizhou Municipal Electronic Communication Corp. in 1990. In 1993, he became general manager of TCL Electronics Group. After that, TCL went into the colour TV business and quickly became an industry leader. Mr. Li took up the position of chairman and president of TCL Corp in 1996.

In 2003, he was appointed chairman and CEO of TCL Corp. Soon after, TCL Corp was listed on the Shenzhen Stock Exchange.

Mr. Li was elected as a delegate to the 16th National Congress of the Communist Party of China and a deputy to the 10th and 11th National People's Congress. He holds a number of prestigious positions including chairman of China Electronic Imaging Industry Association, vice chairman of China Chamber of International Commerce, chairman of Guangdong Household Electrical Appliances Chamber of Commerce, honorary chairman of Shenzhen Flat Panel Display Industry Association and adjunct professor of Wuhan University.

Mr. Li is also an independent non-executive director of Tencent Holdings Limited (700 HK, Outperform).

He graduated with a Bachelor's Degree in radio technology from South China University of Technology.

## 2. OUTLOOK

### 2.1 Speed up migration of feature phones »

**The reason** - TCLC still enjoyed a decent profit margin in FY11 on more than 42m feature phones shipped globally, thanks to low R&D costs and premium pricing due to the strong brand name of TCL/Alcatel.

Because handset users found entry-level smartphones much more affordable while providing desired functions and features, customer have been migrating from traditional phones to smartphones over the past couple of years. Given the ever-changing handset market, TCLC reversed from a record net profit of HK\$800m in FY11 to a loss in FY12. It slipped into a loss in 3Q12, which it blamed on the shrinking feature phone market and increased R&D and marketing costs due to investment in smartphone development.

In 2012, TCLC's total mobile phone unit shipment retreated by 2% (-10% in 1Q, 0% in 2Q, -4% in 3Q, +2% in 4Q, Figure 15) to 42.6m as a 15% drop in feature phone shipments was largely offset by a 375% yoy jump in smartphone shipments.

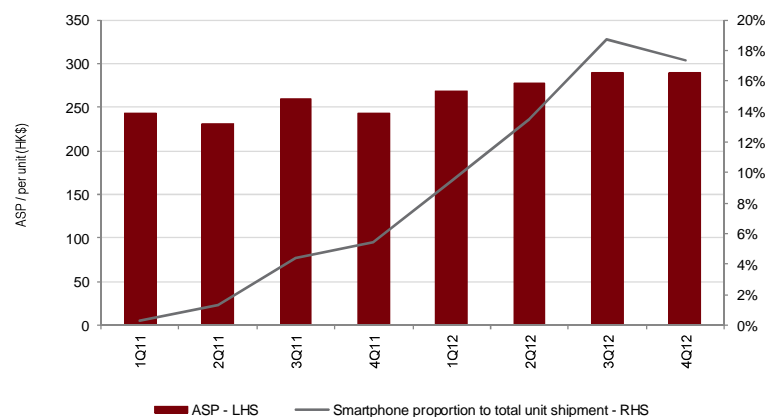
Figure 15: Quarterly unit shipment breakdown by handset type

Unit shipment (million)	2011			2012		
	Total	Feature phone	Smartphone	Total	Feature phone	Smartphone
1Q	8.7	8.7	0.0	7.8	7.1	0.7
2Q	10.7	10.6	0.1	10.8	9.3	1.5
3Q	11.0	10.5	0.5	10.6	8.6	2.0
4Q	13.2	12.4	0.7	13.4	11.1	2.3
<b>Total</b>	<b>43.6</b>	<b>42.2</b>	<b>1.4</b>	<b>42.6</b>	<b>36.1</b>	<b>6.5</b>
Unit shipment (yoy%)						
1Q	51%	50%	n.a	-10%	-18%	3005%
2Q	27%	26%	n.a	0%	-12%	916%
3Q	16%	11%	n.a	-4%	-19%	308%
4Q	5%	0%	n.a	2%	-11%	224%
<b>Total</b>	<b>20%</b>	<b>17%</b>	<b>n.a</b>	<b>-2%</b>	<b>-15%</b>	<b>375%</b>

SOURCES: CIMB, COMPANY REPORTS

**The process** – In order to catch up with the tremendous global smartphone demand, especially in Europe, the Middle East and Africa (EMEA), TCLC continued implementing its “Step-up strategy and launched its first smartphone in 2010. It started shipping smartphone products in Jan 2011 and gradually increased the smartphone shipment volume to 18% of total shipments in 4Q12. More importantly, this helped to lift the blended ASP by 18% from HK\$244 in 1Q11 to HK\$289 in 4Q12 (Figure 16).

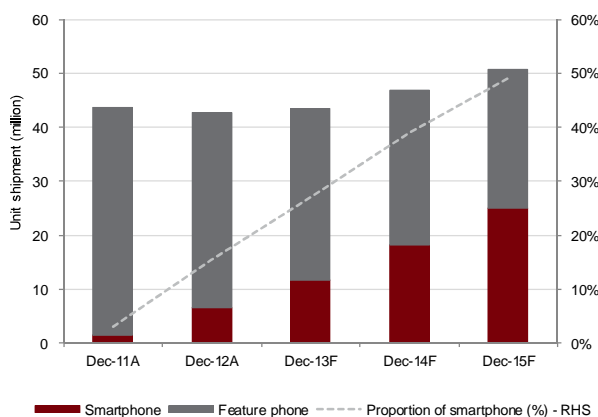
Figure 16: Smartphone proportion to total unit shipment vs blended ASP



SOURCES: CIMB, COMPANY REPORTS

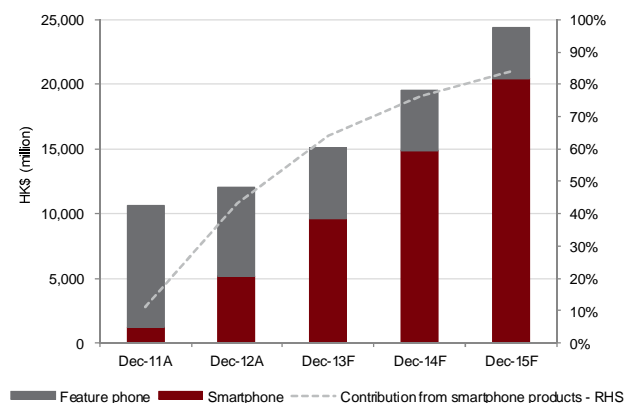
**The results?** – Due to the low base, TCLC's smartphone shipments surged by 375% to 6.5m units in 2012, or 15.3% of total shipments, compared with 1.4m units in 2011. As smartphones are priced ~4x as much as feature phones, we expect smartphone products to lead revenue growth. Stoked by the Latin Americas and EMEA, TCLC's smartphone shipments are set to reach 50% of total shipments in FY15, in line with the global industry trend. In terms of revenue, we estimate that smartphone products will contribute more than 80% of total revenue in FY15, thanks to their higher ASP (Figure 18).

**Figure 17: Unit shipment forecast breakdown by type (FY11 - FY15)**



SOURCES: CIMB, COMPANY REPORTS

**Figure 18: Revenue forecast breakdown by type (FY11 - FY15)**



SOURCES: CIMB, COMPANY REPORTS

## 2.2 Strategy for China market ►

TCLC has placed less emphasis on the China market over the past few years as it felt that this market was too competitive, especially for low-end handsets. However, China's handset market experienced rapid growth in 2011 and 2012 and became the world's largest smartphone market due to the boom in 3G subscribers which generated huge smartphone demand, mainly in the low-end segment. Hence, TCLC missed this market opportunity and let its rivals, especially the domestic Big 4 (Lenovo, Coolpad, Huawei and ZTE), snatch substantial market share in 2011 and 2012.

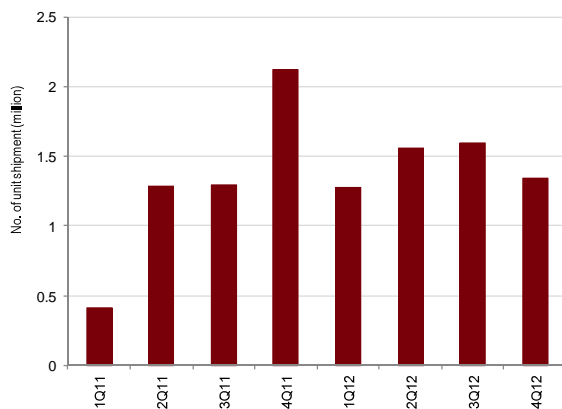
To recapture market share in China's smartphone market, TCLC implemented a series of measures 1) launching low-end smartphones, 2) increasing collaboration with the Chinese telecom operators by offering tailor-made smartphones, 3) expanding its distribution network, and 4) holding marketing campaigns to revamp its brand image.

Despite these moves, TCLC's handset shipment (including feature phone) increased by only 13% to 5.8m units in 2012, making it a laggard in China's smartphone market which saw around 90% shipment growth.

Despite the slower growth in unit shipments, revenue in China surged 60% to HK\$1.6bn in FY12 due to a substantial increase in the shipment of smartphones.

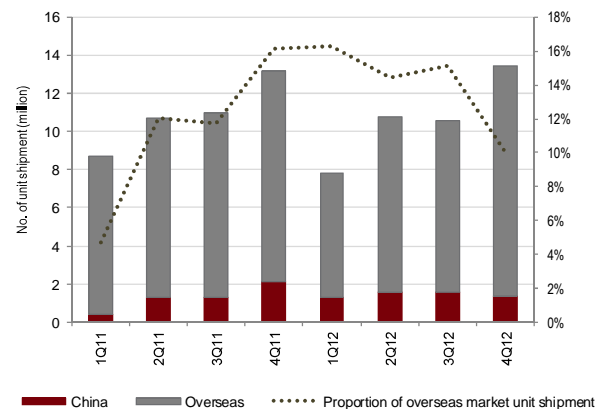


Figure 19: Unit shipment to China



SOURCES: CIMB, COMPANY REPORTS

Figure 20: Shipments to China as % of total shipments



SOURCES: CIMB, COMPANY REPORTS

Revenue from China amounted to HK\$1.6bn in FY12, accounting for 13% of TCLC's total sales. However, it did not contribute earnings as gross margin was low due to tough competition. Nevertheless, we believe that the group's efforts to revamp its TCL brand and optimise its distribution channels will bear fruit this year. We expect steady growth in the China market, driven by 1) brand revamp, 2) entry-level smartphones, 3) smartphones tailor-made for the operators, and 4) network expansion.

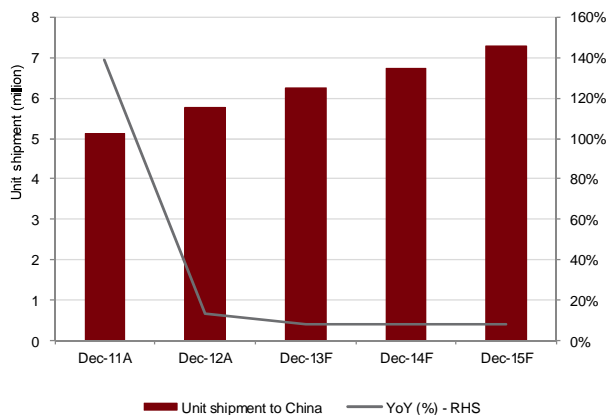
- 1) In 2012, TCLC launched abundant user-friendly smartphones with innovative features such as cloud smartphone and QQ smartphone that were successful in attracting consumers in China. In early 2013, it launched four new series "JOY, STAR, PLAY, YOU" with 12 smartphone models targeted at different market segments. The STAR series include the world's slimmest smartphone TCL S850 and the world's lightest Android smartphone TCL S820.
- 2) Although entry-level smartphones offer low margins, they help provide economies of scale. TCLC will continue to launch affordable smartphones to penetrate deeper into the low-end market given that the majority of smartphone demand still comes from low-ARPU 3G subscribers.
- 3) TCLC has been collaborating with the Chinese telecom operators. It will continue to provide more tailor-made smartphones and strengthen its partnership with the three operators in China in order to enhance its smartphone penetration in China. In 2012, the group launched TCL C995 and TCL W989, specially designed for China Telecom and China Unicom, respectively.
- 4) In 2012, TCLC increased its POS by more than 5,000 across China to over 8,600 POS currently by collaborating with nationwide distribution and retail chains such as Suning (002024 CH, Not Rated). It will continue to strengthen its partnerships with the operators to increase handset distribution via the operators.

China's handset shipments got off to a good start in Jan 2013, thanks to smartphones with features tailor-made for Chinese consumers. TCLC's unit shipments jumped 343% yoy to 0.54m compared with a 3-month average of 0.47m units.

Although we forecast a mild unit shipment growth of 7.3m in 2015 due to the migration from feature phones to smartphones, we expect revenue to achieve faster growth due to higher ASPs. We expect revenue in China to reach HK\$2.5bn in FY15, or 10.5% of total revenue.

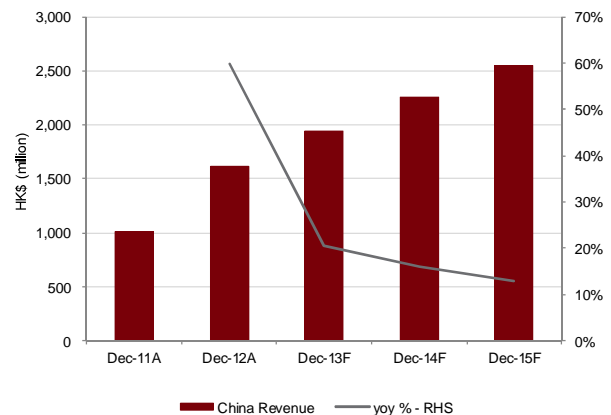


Figure 21: Shipments to China as % of total shipments



SOURCES: CIMB, COMPANY REPORTS

Figure 22: Estimated revenue from China (FY11 to FY15)



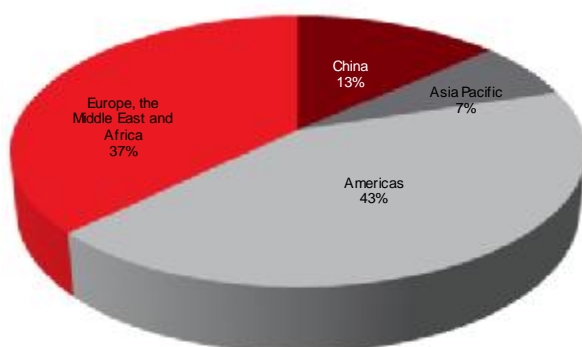
SOURCES: CIMB, COMPANY REPORTS

### 2.3 Boosting smartphone sales in overseas markets

TCLC's overseas (including Europe, Middle East and Africa, Americas, APAC) shipments deteriorated quickly in 1-3Q12, retreating 21% yoy in 1Q, 3% in 2Q and 8% in 3Q as consumers worldwide switched from feature phones to low-end smartphones. However, the group's unit shipments started to recover by 9.5% in 4Q12, thanks to its expansion to new overseas markets such as the EMEA region and the launch of a new series of smartphones such as One Touch 918, 995 and 585.

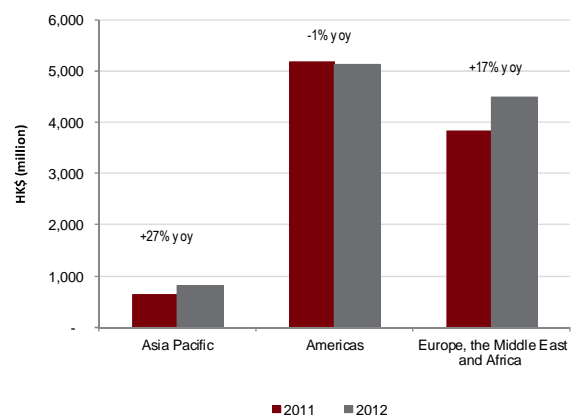
In FY12, unit shipments to EMEA totalled 15.2m, down 7.7% yoy to weak feature phone demand. But revenue rose 17% to HK\$4.5bn, thanks to a higher portion of smartphones. Shipments to the Americas dropped by a mere 1% to 19m units while revenue dipped by 1% to HK\$5.1bn given the slow economic recovery and aggressive pricing of its competitors. Revenue from the APAC region jumped 27% to HK\$817m, mainly fuelled by its rising market share for smartphones which more than offset a 14% drop in volumes to 2.5m units (Figure 24).

Figure 23: Revenue breakdown by geographical (2012)



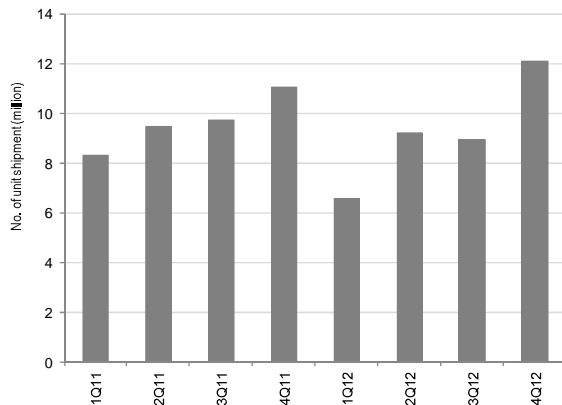
SOURCES: CIMB, COMPANY REPORTS

Figure 24: Revenue growth in overseas market (2012)



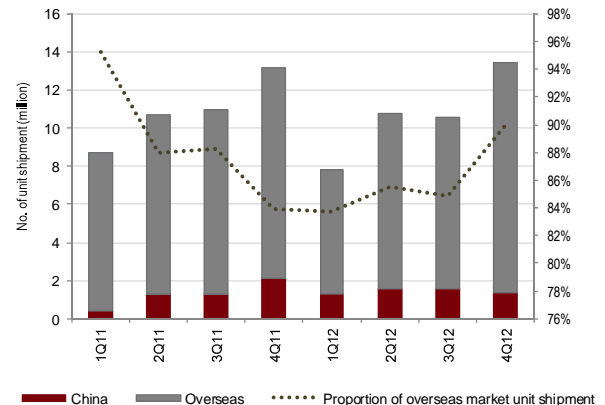
SOURCES: CIMB, COMPANY REPORTS

Figure 25: Overseas markets' unit shipments



SOURCES: CIMB, COMPANY REPORTS

Figure 26: Shipments to overseas markets as % of total shipments

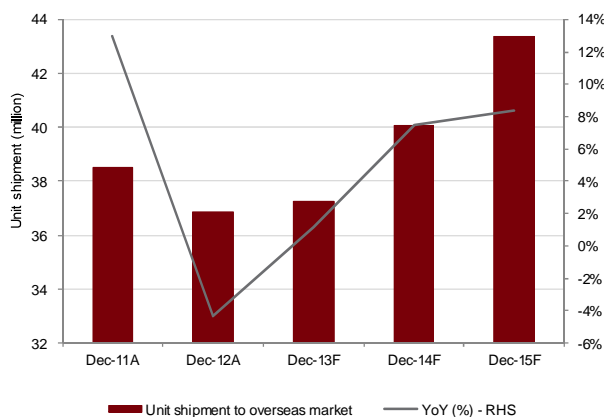


SOURCES: CIMB, COMPANY REPORTS

TCLC will continue to boost its smartphone sales in overseas market, especially Euro and Latin America market, with the help of the launch of best-in-class Alcatel One Touch smartphones with high performance-to-cost. In view of the time to transition from feature phones to smartphones, we expect TCLC's overseas shipments to post growth of just 1% to 37m in FY13 and 8% p.a. to 40m in FY14 and 43m in FY15, driven by a changing product mix and expansion to the new markets (Figure 27).

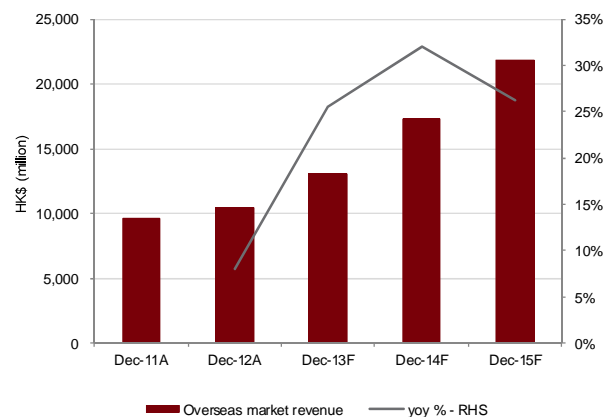
Given the higher proportion of smartphone sales, we project a CAGR of 28% to HK\$22bn for TCL's FY12-15 overseas revenue, fuelled by a rise in blended ASP (Figure 28).

Figure 27: Estimated unit shipment to overseas market (FY11 to FY15)



SOURCES: CIMB, COMPANY REPORTS

Figure 28: Estimated revenue from overseas market (FY11 to FY15)



SOURCES: CIMB, COMPANY REPORTS

**Figure 29: SWOT analysis**

Strengths	Opportunities
* Premium brand name of TCL/Alcatel in China and global market, compared with other domestic handset vendors.	* Launching price-competitive smartphones (high performance-to-cost quotients) to capture global smartphone demand.
* Well-established global distribution network with handsets sold to over 120 countries.	* Expanding to overseas markets, especially in EMEA regions, by increasing cooperation with the local major telecom operators.
	* TCL brand revamp, collaboration with the three Chinese operators and increased penetration into low- to mid-end smartphone market in China.
Weaknesses	Threats
* No economies of scale due to low volume of smartphone shipments.	* Gross margins under pressure from keen competition in feature phones and entry-level smartphones.
* Difficulty in competing in high-end smartphone market because its product development is still behind global vendors.	* Faster-than-expected migration from feature phone to smartphone in global handset industry.

SOURCES: CIMB

### 3. RISKS

#### 3.1 Fierce competition in both China and overseas markets »

TCLC faces fierce competition in China and the global smartphone market, especially in low-end smartphones. In China, its TCL brand has a relatively weak product portfolio and collaborates less with the mobile operators. TCLC needs time to re-establish its relationship with the Chinese telecom operators. In overseas markets, although Alcatel can price its handsets at a premium as it is a well-recognised international brand, it faces keen competition from Samsung and Apple in the smartphone market and Nokia in the feature phone market.

#### 3.2 Subpar outlook for feature phones »

Given the global trend of a switch from feature phones to smartphones as smartphones become much more affordable, we expect the demand for feature phone to continue diving and the overall gross profit margin to keep declining given the subpar global demand.

### 4. FINANCIALS

#### 4.1 Projecting a strong earnings rebound in FY14-15 »

We project TCLC to achieve 26% revenue CAGR in FY12-15 to HK\$24bn, driven by a rise in the blended ASP from HK\$282 to HK\$481, single-digit unit shipment growth and a stable gross profit margin. We expect the overseas market to drive the revenue growth, especially in the EMEA markets, given its strong relationship with the local telecom operators and the popularity of mid-range smartphones in those areas (Figure 30).

We project that gross margin will stabilise at 17% in FY13 due to economies of scale arising from smartphone volume ramp-up and a lower SG&A to sales ratio.

We forecast revenue to reach HK\$24bn by 2015 (CAGR of 26% in FY12-15), fuelled by a blended ASP rise and robust smartphone shipments. Leveraging its 50% exposure to smartphones, we project a strong recovery from losses in FY12 to net profit of HK\$270m in FY14 and HK\$488m in FY15 (Figure 31).

**Figure 30: Revenue projections**

FYE Dec	Dec-10A	Dec-11A	Dec-12A	Dec-13F	Dec-14F	Dec-15F
<b>Unit shipment by geographical area (million)</b>						
China	2.1	5.1	5.8	6.2	6.7	7.3
Overseas	34.1	38.5	36.8	37.3	40.0	43.4
<b>Total</b>	<b>26.2</b>	<b>43.6</b>	<b>42.6</b>	<b>43.5</b>	<b>46.8</b>	<b>50.6</b>
<b>Unit shipment by geographical area (yoy %)</b>						
China	-23.0%	139.0%	13.2%	8.0%	8.0%	8.0%
Overseas	155.2%	13.0%	-4.3%	1.2%	7.5%	8.3%
<b>Total</b>	<b>62.6%</b>	<b>66.3%</b>	<b>-2.3%</b>	<b>2.1%</b>	<b>7.5%</b>	<b>8.3%</b>
<b>Unit shipment by phone type (million)</b>						
Smartphone	0.1	1.4	6.5	11.7	18.2	24.9
Feature phone	26.2	42.2	36.1	31.8	28.6	25.7
<b>Total</b>	<b>26.2</b>	<b>43.6</b>	<b>42.6</b>	<b>43.5</b>	<b>46.8</b>	<b>50.6</b>
<b>Unit shipment by phone type (yoy %)</b>						
Smartphone	n.a.	2189.2%	374.6%	80.0%	55.0%	37.0%
Feature phone	n.a.	61.5%	-14.6%	-12.0%	-10.0%	-10.0%
<b>Total</b>	<b>62.6%</b>	<b>66.3%</b>	<b>-2.3%</b>	<b>2.1%</b>	<b>7.5%</b>	<b>8.3%</b>
<b>Blended ASP (HK\$)</b>						
	<b>332</b>	<b>244</b>	<b>282</b>	<b>346</b>	<b>418</b>	<b>481</b>
YoY (%)	22.7%	-26.0%	15.6%	22.4%	20.8%	15.2%
<b>Revenue (HK\$m)</b>						
	<b>8,701</b>	<b>10,653</b>	<b>12,031</b>	<b>15,030</b>	<b>19,531</b>	<b>24,372</b>
YoY (%)	99.5%	22.4%	12.9%	24.9%	29.9%	24.8%

SOURCES: CIMB, COMPANY REPORTS

**Figure 31: Consolidated Income Statement**

FYE Dec (HK\$m)	Dec-10A	Dec-11A	Dec-12A	Dec-13F	Dec-14F	Dec-15F
Revenue	8,700.7	10,653.0	12,031.2	15,029.5	19,530.7	24,371.7
Cost of sales	(6,752.3)	(8,324.8)	(9,934.6)	(12,474.5)	(16,210.5)	(20,228.5)
<b>Gross profit</b>	<b>1,948.4</b>	<b>2,328.2</b>	<b>2,096.6</b>	<b>2,555.0</b>	<b>3,320.2</b>	<b>4,143.2</b>
Other income	193.6	312.7	273.3	324.2	371.3	415.4
Selling and marketing expenses	(619.6)	(866.3)	(1,153.7)	(1,269.0)	(1,535.1)	(1,801.4)
Administrative expenses	(436.3)	(558.1)	(657.5)	(723.3)	(874.9)	(1,091.8)
Other operating expenses	(5.3)	(28.1)	(109.3)	(54.6)	(65.6)	(73.7)
<b>Operating profit</b>	<b>723.5</b>	<b>729.3</b>	<b>(290.2)</b>	<b>55.7</b>	<b>323.0</b>	<b>588.1</b>
Net finance cost	19.7	55.5	47.4	(24.1)	(12.0)	(19.6)
Shares of associate co.	(0.3)	(1.4)	(1.8)	3.0	8.0	8.0
Extraordinary items	1.9	0.0	56.1	0.0	0.0	0.0
<b>Profit before taxation</b>	<b>744.9</b>	<b>783.3</b>	<b>(188.5)</b>	<b>34.6</b>	<b>319.0</b>	<b>576.6</b>
Taxation	(43.1)	17.3	(31.6)	(4.5)	(44.7)	(80.7)
Minority interests	0.1	(0.7)	12.2	(2.0)	(4.0)	(8.0)
<b>Net profit</b>	<b>701.9</b>	<b>799.9</b>	<b>(207.8)</b>	<b>28.1</b>	<b>270.3</b>	<b>487.9</b>
<b>Recurring net profit</b>	<b>700.0</b>	<b>799.9</b>	<b>(264.0)</b>	<b>28.1</b>	<b>270.3</b>	<b>487.9</b>
<b>Growth (yoy%)</b>						
Revenue	99.5%	22%	13%	25%	30%	25%
Gross profit	105.4%	19%	-10%	22%	30%	25%
Operating profit	1203.2%	1%	-140%	-119%	480%	82%
Net profit	2951.0%	14%	-126%	-114%	862%	80%
Core net profit	1517.8%	14%	-133%	-111%	862%	80%
<b>Ratio analysis (%)</b>						
Gross margin	22.4%	21.9%	17.4%	17.0%	17.0%	17.0%
Operating margin	8.3%	6.8%	-2.4%	0.4%	1.7%	2.4%
Net profit margin	8.1%	7.5%	-1.7%	0.2%	1.4%	2.0%
Core net profit margin	8.0%	7.5%	-2.2%	0.2%	1.4%	2.0%
Selling and marketing expenses to revenue ratio	7.1%	8.1%	9.6%	8.4%	7.9%	7.4%
Administrative expenses to revenue ratio	5.0%	5.2%	5.5%	4.8%	4.5%	4.5%
SG&A cost to sales	12.2%	13.6%	16.0%	13.6%	12.7%	12.2%
Taxation rate	5.8%	-2.2%	-16.7%	13.0%	14.0%	14.0%
Dividend payout	38.3%	39.5%	-16.2%	40.0%	40.0%	40.0%
<b>+/- change %</b>						
Gross margin	n.a.	-0.5%	-4.4%	-0.4%	0.0%	0.0%
Operating margin	n.a.	-1.5%	-9.3%	2.8%	1.3%	0.8%
Net profit margin	n.a.	-0.6%	-9.2%	1.9%	1.2%	0.6%
Core net profit margin	n.a.	-0.5%	-9.7%	2.4%	1.2%	0.6%
SG&A to sales	n.a.	1.4%	2.3%	-2.3%	-0.9%	-0.5%

SOURCES: CIMB, COMPANY REPORTS

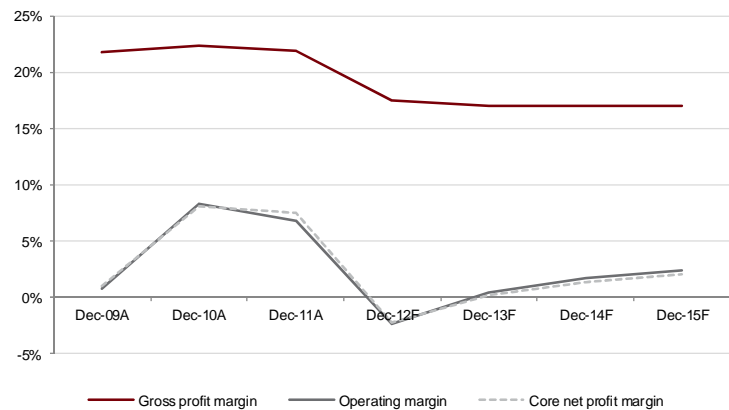
## 4.2 Margin trend ►

TCLC enjoyed a decent gross margin before FY12 given the mature product of feature phones. But gross margin fell sharply from 22% in FY11 to 17.4% (-4.4% pts) in FY12 due to a dip in feature phone ASP and price competition from domestic vendors in low-end smartphone. Supported by a series of new smartphone launches since Dec 12, its smartphone shipments should increase rapidly, allowing it to achieve a better cost structure due to lower merchandise costs for the core components. We expect the group's gross profit margin to stabilise at around 17% in FY13-15, following the improvement in its product mix.

We forecast a doubling of gross profit to HK\$4.1bn in FY15, driven by a blended ASP rise and volume growth.

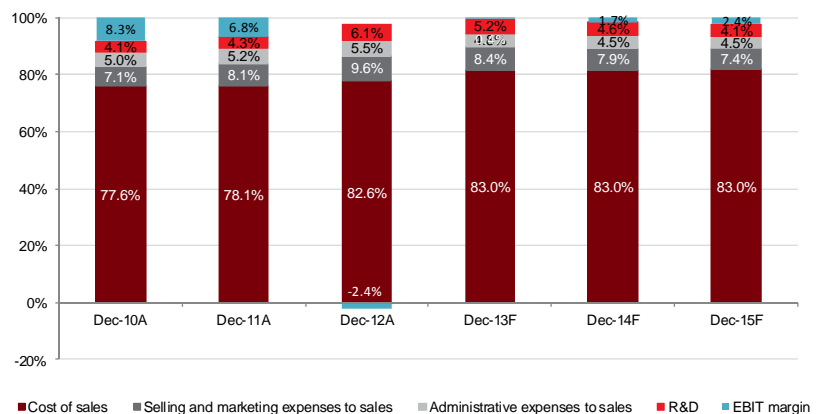
TCLC bumped up its R&D by 61% to HK\$740m in FY12, in order to speed up the rollout of smartphones to meet global smartphone demand. But it hurt profitability in the short term. As it has passed the investment cycle, we expect its R&D and marketing expenses to decelerate. We foresee a bottoming of EBIT margin in FY12, followed by an upturn in FY13-15 to reach 2.0% in FY15, thanks to operating leverage.

Figure 32: Margin trend



SOURCES: CIMB, COMPANY REPORTS

Figure 33: Sales ratio and EBIT margin



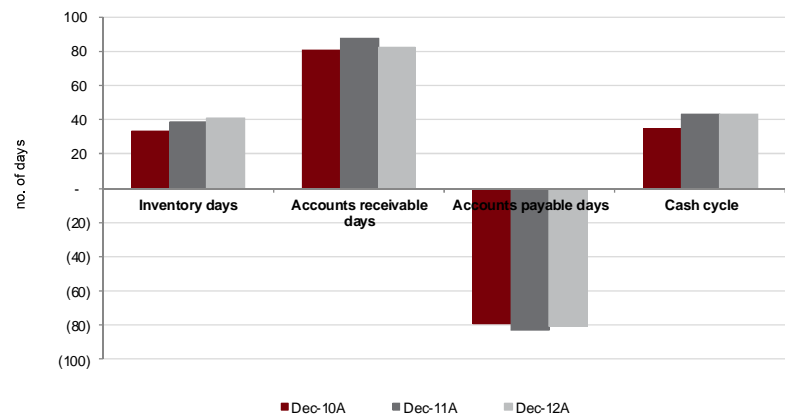
SOURCES: CIMB, COMPANY REPORTS

### 4.3 Cash conversion cycle

Good cash management led to a short cash conversion cycle of around 40 days for TCLC in FY10-12.

Inventory turnover slowed slightly from 33 days in FY10 to 41 days in FY12, mainly due to its transition from a pure feature phone manufacturer to one with smartphone capability. Account receivable days and payable days were relatively stable in the past three years, at around 80 days.

**Figure 34: Cash conversion cycle**



SOURCES: CIMB, COMPANY REPORTS

#### 4.4 Cash flows »

TCLC ended FY12 with HK\$958m net debt (36% net gearing), based on HK\$5.2bn cash and HK\$6.1bn bank borrowings and amounts due to its related company. Net gearing rose during the year due to its losses and higher R&D expenditure. The huge short-term debt mainly comprises risk-free financial instruments which are fully backed by the cash on hand. We forecast its net debt to reduce to HK\$698m (24% net gearing) in FY15, driven by positive free cash outflow (Figure 35).

**Figure 35: Cash Projection**

FYE Dec (HK\$ m)	Dec-10A	Dec-11A	Dec-12A	Dec-13F	Dec-14F	2015E
EBITDA	894	1,005	499	526	777	808
Less : Change in working capital	-194	-722	-235	53	-386	-401
Less : Capital expenditure	-132	-399	-300	-350	-300	-312
Less : Taxation	-43	17	-32	-4	-45	-46
<b>Free cash flow</b>	<b>525</b>	<b>-99</b>	<b>-68</b>	<b>225</b>	<b>47</b>	<b>48</b>
Dividend paid	-125	-336	-34	0	-108	-195
<b>Net (debt) / cash</b>	<b>889</b>	<b>-108</b>	<b>-958</b>	<b>-714</b>	<b>-744</b>	<b>-698</b>
Cash	7,546	7,279	5,191	5,814	6,014	6,557
Total borrowings	-6,657	-7,387	-6,149	-6,528	-6,758	-7,255

SOURCES: CIMB, COMPANY REPORTS



## 5. VALUATION AND RECOMMENDATION

### 5.1 30% below its 3-year average P/BV ►

Given the losses in FY12 and the likelihood of subpar profits in FY13, we prefer to use P/BV to value the company during this turnaround period. TCLC is trading at 1.1x FY13 P/BV, 30% below its 3-year average or 70% off its peak valuation in 2011 (Figure 38).

### 5.2 Initiate with Outperform ►

We initiate coverage on TCLC with an Outperform rating and a target price of HK\$3.09, based on 1.5x P/BV, the mid-cycle valuation (3-year average), which is justified by its earnings recovery. Potential share price catalysts are robust smartphone shipments and stable gross margin.

Risks to our rating and earnings forecast are gross margin disappointment and slower-than-expected smartphone shipment.

**Figure 36: Sector Comparisons**

Bloomberg			Price	Target Price	Market Cap	Core P/E (x)		3-year EPS	P/BV (x)	ROE (%)	EV/EBITDA (x)	Yield (%)
Company	Ticker	Recom.	(local curr)	(local curr)	(US\$ m)	CY2013	CY2014	CAGR (%)	CY2013	CY2013	CY2013	CY2013
China Mobile	941 HK	NEUTRAL	84.55	80.47	219,120	10.9	10.6	-17.0%	1.73	16.5%	3.4	4.9%
China Telecom	728 HK	NEUTRAL	4.01	4.65	41,844	15.9	10.3	23.0%	0.91	5.8%	3.5	2.6%
China Unicom	762 HK	OUTPERFORM	11.04	16.12	33,543	17.3	10.8	35.4%	0.96	5.6%	3.7	0.0%
<b>Average</b>						<b>14.7</b>	<b>10.6</b>	<b>13.8%</b>	<b>1.20</b>	<b>9.3%</b>	<b>3.6</b>	<b>2.5%</b>
<b>Telecom equipment</b>												
China Comm Services	552 HK	NOT RATED	4.98	n.a.	4,448	10.0	8.9	n.a.	1.31	13.1%	5.3	3.9%
China Fiber Optic	3777 HK	NOT RATED	1.39	n.a.	218	3.5	2.9	n.a.	0.73	20.8%	1.9	3.3%
Comba Telecom	2342 HK	OUTPERFORM	2.54	4.65	500	6.5	4.7	n.a.	0.89	14.6%	4.0	0.0%
O-Net Communications	877 HK	NEUTRAL	1.82	2.06	177	10.4	8.3	n.a.	0.83	8.3%	2.6	1.8%
ZTE Corp - H	763 HK	NOT RATED	12.76	n.a.	5,660	17.4	13.2	n.a.	1.40	8.1%	14.6	1.5%
<b>Average</b>						<b>9.6</b>	<b>7.6</b>	<b>n.a.</b>	<b>1.03</b>	<b>13.0%</b>	<b>5.7</b>	<b>2.1%</b>
<b>Handset vendors</b>												
China Wireless	2369 HK	OUTPERFORM	2.04	3.77	551	9.9	7.9	33.2%	1.62	17.2%	5.4	3.0%
Lenovo Group	992 HK	OUTPERFORM	9.00	8.84	12,106	17.0	14.3	n.a.	3.86	24.6%	6.0	1.5%
TCL Communication	2618 HK	OUTPERFORM	2.32	3.09	337	93.2	9.7	n.a.	1.13	1.2%	6.3	0.0%
ZTE Corp - H	763 HK	NOT RATED	12.76	n.a.	5,660	17.4	13.2	n.a.	1.40	8.1%	14.6	1.5%
<b>Average</b>						<b>34.3</b>	<b>11.3</b>	<b>n.a.</b>	<b>2.00</b>	<b>12.8%</b>	<b>8.1</b>	<b>1.5%</b>
<b>Handset components</b>												
AAC Technologies	2018 HK	Outperform	32.70	35.54	5,177	15.2	13.3	13.8%	4.38	31.9%	11.3	2.5%
BYD Electronic	285 HK	NOT RATED	2.74	n.a.	796	8.3	8.3	n.a.	0.56	6.8%	2.0	0.0%
Foxconn Int'l	2038 HK	NOT RATED	3.27	n.a.	3,140	84.3	26.4	n.a.	0.89	1.1%	6.0	0.0%
Sunny Optical Tech	2382 HK	NOT RATED	7.42	n.a.	957	13.3	11.0	n.a.	2.56	19.2%	8.9	2.5%
Tongda Group	698 HK	NOT RATED	0.55	n.a.	338	7.5	6.0	n.a.	1.10	14.6%	4.9	4.2%
Truly International	732 HK	NOT RATED	3.2	n.a.	1,141	13.9	11.7	n.a.	1.28	9.2%	7.2	3.3%
<b>Average</b>						<b>23.8</b>	<b>12.8</b>	<b>n.a.</b>	<b>1.79</b>	<b>13.8%</b>	<b>6.7</b>	<b>2.1%</b>
<b>International handset vendors</b>												
Apple	AAPL US	NOT RATED	441.4	n.a.	414,500	9.6	8.5	7.5%	2.70	28.1%	4.4	2.5%
Blackberry	BB CN	NOT RATED	13.98	n.a.	7,116	n.a.	n.a.	n.a.	0.79	-2.7%	4.3	0.0%
HTC Corp	2498 TT	NOT RATED	280	n.a.	8,051	17.7	14.2	3.4%	2.47	13.9%	12.2	3.3%
LG Electronic	066570 KS	NOT RATED	78300	n.a.	11,815	11.8	9.5	n.a.	1.14	9.7%	n.a.	0.5%
Nokia	NOK1V FH	NOT RATED	2,744	n.a.	13,441	137.2	17.5	n.a.	1.45	1.1%	5.1	1.2%
Samsung Electronic	005930 KS	NOT RATED	1544000	n.a.	209,698	7.9	7.2	n.a.	1.51	19.0%	3.9	0.6%
<b>Average</b>						<b>36.8</b>	<b>11.4</b>	<b>n.a.</b>	<b>1.68</b>	<b>11.5%</b>	<b>6.0</b>	<b>1.3%</b>

SOURCES: Bloomberg, CIMB

Figure 37: Price-to-book ratio



SOURCES: Bloomberg, CIMB

## 6. APPENDIX

Figure 38: Comparison of China Wireless and TCL Communication

FYE Dec	China Wireless					TCL Communication				
	Dec-11A	Dec-12F	Dec-13F	Dec-14F	Dec-15F	Dec-11A	Dec-12A	Dec-13F	Dec-14F	Dec-15F
<b>Unit shipment (million)</b>	<b>11.2</b>	<b>20.1</b>	<b>30.0</b>	<b>45.0</b>	<b>55.0</b>	<b>43.6</b>	<b>42.6</b>	<b>43.5</b>	<b>46.8</b>	<b>50.6</b>
China	10.5	18.9	27.6	40.0	47.0	5.1	5.8	6.2	6.7	7.3
Overseas	0.7	1.2	2.4	5.0	8.0	38.5	36.8	37.3	40.0	43.4
<b>Unit shipment (yoy %)</b>	<b>133%</b>	<b>80%</b>	<b>49%</b>	<b>50%</b>	<b>22%</b>	<b>66%</b>	<b>-2%</b>	<b>2%</b>	<b>8%</b>	<b>8%</b>
China	133%	80%	46%	45%	18%	139%	13%	8%	8%	8%
Overseas	0%	76%	100%	108%	60%	13%	-4%	1%	7%	8%
<b>Estimate blended ASP (HK\$)</b>	<b>658</b>	<b>682</b>	<b>662</b>	<b>662</b>	<b>675</b>	<b>244</b>	<b>282</b>	<b>346</b>	<b>418</b>	<b>481</b>
yoy %	-26%	4%	-3%	0%	2%	-26%	16%	22%	21%	15%
<b>Financial information</b>										
<b>HK\$m</b>										
Revenue	7,340	13,808	19,966	29,919	37,262	10,653	12,031	15,030	19,531	24,372
Gross profit	1,081	1,602	2,236	3,201	3,987	2,328	2,097	2,555	3,320	4,143
EBIT	277	372	506	653	851	729	(290)	56	323	588
Core net profit	208	302	431	543	706	800	(264)	28	270	488
<b>YoY %</b>										
Revenue	59.8%	88.1%	44.6%	49.8%	24.5%	22.4%	12.9%	24.9%	29.9%	24.8%
Gross profit	-3.2%	48.1%	39.6%	43.2%	24.5%	19.5%	-9.9%	21.9%	29.9%	24.8%
EBIT	-47.2%	34.5%	36.0%	28.9%	30.3%	0.8%	-139.8%	-119.2%	480.3%	82.1%
Core net profit	-54.7%	45.0%	42.4%	26.2%	29.9%	14.3%	-133.0%	-110.6%	862.0%	80.5%
<b>Ratio analysis (%)</b>										
Gross margin	14.7%	11.6%	11.2%	10.7%	10.7%	21.9%	17.4%	17.0%	17.0%	17.0%
EBIT margin	3.8%	2.7%	2.5%	2.2%	2.3%	6.8%	-2.4%	0.4%	1.7%	2.4%
Core net margin	2.8%	2.2%	2.2%	1.8%	1.9%	7.5%	-2.2%	0.2%	1.4%	2.0%
SG&A cost to sales	14.0%	10.2%	9.7%	9.4%	9.2%	17.9%	22.1%	18.8%	17.2%	16.3%
Taxation rate	16.4%	15.0%	16.0%	17.0%	17.0%	-2.2%	-16.7%	13.0%	14.0%	14.0%
Net gearing	-40.3%	-49.9%	-35.8%	-32.4%	-36.0%	-2.6%	35.5%	30.7%	28.9%	24.0%
ROE	11.6%	13.3%	17.2%	19.1%	21.2%	32.7%	-10.6%	1.2%	11.0%	17.8%

SOURCES: CIMB, COMPANY REPORTS