Huan Hsin Holdings

A play on demand for notebooks

We expect demand for notebooks to pick up in line with the recovery in the global economy. Taiwanese notebook manufacturers have been gaining market share from increased outsourcing by OEMs, reflected in their valuations. There will be spill over business to sub contractors of these notebook manufacturers. In this regard, Huan Hsin is well positioned, but this is not fully reflected in its valuations. Our 12-month price target has been raised to S$1.35, based on a sum of parts valuation, taking into account revisions to our EPS estimates. Our previous price target was based on an average PE of 10x of locally listed second-tier EMS providers.

· **Notebook casing business poised for growth.** Huan Hsin's newly established notebook casing business is currently operating only at 35% capacity. Aggressive marketing efforts are underway, and could lead to full utilisation being reached by year-end, if a major contract is secured soon. With volumes picking up at Taiwanese notebook manufacturers, there is a strong likelihood that Huan Hsin will benefit from further outsourcing being awarded by these manufacturers. However, we caution that the impact of a major new contract that Huan Hsin is working hard to secure will only be felt in FY03.

· **Raising earnings estimates.** Our recent checks with management indicated that we have been overly conservative in our margin assumptions for both the wire and plastic moulding business segment. We are thus raising estimates for FY01 by 10% and FY02 by 14%. Correspondingly, our price target has been revised to S$1.35, based on sum of parts valuation. However, in our estimates, we have not factored in the potential from a major new notebook contract that Huan Hsin is reportedly working to secure.

Forecasts and Valuation

FY Dec (US$m)	2000A	2001F	2002F	2003F
Turnover	109.4	116.1	134.7	155.4
EBITDA	24.7	26.4	35.6	39.9
Pretax Profit	23.6	21.9	27.7	30.6
Net Profit	22.1	22.0	24.8	27.3
EPS (S cts)	8.8	8.8	9.9	10.9
EPS Gth	52%	-1%	13%	10%
P/E Ratio (x)	11.5	11.6	10.3	9.3
P/B Ratio (x)	1.6	1.8	1.6	1.4
Div Yield	2.0	1.6	1.9	2.0
ROA	14.4%	13.4%	13.3%	12.8%
ROE	19.0%	16.3%	16.1%	15.6%
Net Gearing	cash	cash	cash	cash
NTA (S cts)	63.1	57.6	65.7	74.5

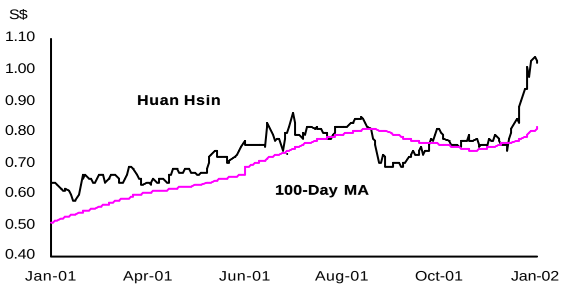
General Data

Issued Capital (m shrs)		250
Mkt Cap (Sm/USm)	255 /	138
Major Shareholders		
Hsu Family		60.4%
Free Float (%)		14%
Avg Daily Vol ('000 shrs)		878

Consensus Analyst Poll

	Curr	1Wk	1Mth	2Mth
Strong Buy	5	5	5	5
Buy	0	0	0	0
Hold	0	0	0	0
Sell	0	0	0	0
Strong Sell	0	0	0	0
Total	5	5	5	5

Share Price Chart



Share Price Performance

	Share Price	Rel STI	Rel Sector
Past 1 mth	33%	29%	16%
Past 3 mths	42%	20%	-13%
Past 6 mths	37%	35%	22%
Past 12 mths	72%	87%	75%

OUTPERFORM
Maintained

S$1.02

At a Glance

Price Target:
1-year S$1.35
from S$0.87

Stock Code:
Bloomberg: HUAN SP
Reuters: HUAN.SI

Sector: EMS
STI: 1,686.20

Stock Rating:
★★★★☆

Sector Rating:
★★★☆☆

Technical Rating:
★★★☆☆

Reason for Report:
Company Update

Implications:
Positive

Earnings Revision:
FY01 up 10%
FY02 up 14%

Consensus EPS:
FY01 9.7 cts
FY02 9.3 cts

DBSV vs Consensus EPS (% variance):
FY01 -9.3%
FY02 +6.5%

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Highlights

· **Newly established notebook casing to be main growth driver.** The notebook casing business contributed to 25% of group revenues in 1H01. Huan Hsin currently has capacity to produce 200,000 notebook casing a month. It is presently operating at 35% capacity, producing 70,000 casings per month. Current customers Quanta and Inventec are likely to raise orders and conservatively, management believes that it should reach 80,000 notebook casings soon. The first order of notebooks was secured in Oct 00 from Inventec. Quanta issued orders around May-Jun 01, with impact felt more in 2H01.

· **PCB associate will incur marginal loss in FY01.** According to management, the PCB business is expected to post a turn around soon by 2002. Given the uncertainty in this segment, we have assumed marginal losses in FY02 to be conservative.

· **Capex is likely to be in the S$9-10m per annum region**, in line with historical trend.

· **Indications that bottomline in FY01 will be relatively flat.** Based on current contracts and utilisation rates, management is confident of achieving 10-15% growth in FY02. This excludes the impact of any new major orders secured for the notebook casing business.

· **Restocking of raw materials will drive up inventory days of sale to 100 days for FY01.** Management had carried this out in anticipation that prices of raw materials, particularly ABS resin, will rise in FY02.

Prospects

· **Wire business is a cash cow.** Management acknowledged that the wire and cable business is mature, with limited growth prospects. However, it has been a good cash cow, contributing an estimated S$10-16m each year to the bottomline. We expect that capex for this business will be very low, mainly for maintenance purposes. In FY00 for instance, the company only spent S$269,000 in capex for the wire business. Depreciation for this business segment has been on the decline, as the machines used are almost fully depreciated. For FY01, we estimate free cash flow from the wire business at S$12.8m, derived from a net profit of S$11.5m, capex capped at S$300,000 and depreciation at S$1.6m. We believe that there is minimal working capital required from this business, due to its base of long term customers, and as we do not project much growth. As a mature and stable business, we believe that it is appropriate to value this business on a DCF basis.

· **Our fair value for the wire business is S$135m.** We derived this value by discounting FY01 FCF from the wire business using a discount rate of 9.5%, based on a risk free rate of 3.5% (using 10-year Singapore government bond yields as a proxy), a market return expectation of 9.4% and Huan Hsin's beta of 1.01. We have conservatively assumed that the terminal cashflow growth rate is zero. A sensitivity table showing the impact of varying discount rates and terminal cashflow growth rates is shown. In our opinion, a fair value range for the wire business is between S$135m-S$171m, assuming a discount rate of 9.5% and terminal cash flow growth rates of 0-2%.

Figure 1: Value of wire business (S$m)

		Terminal Cashflow growth rate				
		0.0%	1.0%	2.0%	3.0%	4.0%
Discount Rate	9.5%	$135	$151	$171	$198	$233
	10.5%	$122	$135	$151	$171	$198
	11.5%	$112	$122	$135	$151	$171
	12.5%	$103	$112	$122	$135	$151
	13.5%	$95	$103	$112	$122	$135

Source: DBS Vickers Research

· **Earnings upside mainly from notebook casing.** Our forecasts have been revised on the back of expectations that rising volumes for notebook casing will lead to economies of scale and hence better margins. Previously, we have assumed very conservative PBIT margins. Our checks with management indicated that our margin estimates were too low. We have not factored the impact of potential new orders in our earnings model, but have inputed moderate growth from existing notebook customers Inventec and Quanta. Our forecast for the notebook casing business is shown below.

Figure 2: Assumptions for Notebook Casing business

	2000A	2001F	2002F	2003F	2004F
Max Production capacity (units per month)	200,000	200,000	200,000	200,000	200,000
Average utilisation rate	22.3%	32.5%	38.8%	50.0%	60.0%
Average units produced per month	44,600	65,000	77,500	100,000	120,000
Average Selling Price S$/unit	53	43	48	54	59
Estimated revenue from notebook casings S$m	11.7	33.2	44.7	64.4	85.2
Estimated net profit from notebook casings S$m	$1.2	$5.0	$6.7	$9.7	$12.8

Source: DBS Vickers Research

· **Current orders indicate marginal rise in notebook casings in FY02.** Management indicated that notebook casing current orders from existing customers are expected to rise marginally to 80,000 in FY02. Assuming that a major contract from a new customer is secured, this would result in full capacity for its notebook casing being reached by end 2002. We therefore believe that the impact for the new notebook casing contract will more likely be felt in 2003, assuming this major order is secured. This is due to the time needed to ramp up production.

· **We value the notebook casing business at S$134-148m.** We peg fair value for Huan Hsin's notebook casing business using Taiwanese peers as a proxy. For the rest of the plastic moulding business, we believe a fair PE multiple would be about 13x, based on historical peer average for the plastics sector in Singapore. On this basis, we value the rest of the plastics business at S$59m.

Figure 3: Peer valuations for Notebook manufacturers as on 9 Jan 2002

	PE (x)	
Taiwanese Notebook Manufacturers	**2001F**	**2002F**
Quanta	26.2	23.5
Compal	20.0	17.9
Inventec	15.0	14.5
Hon Hai	27.1	22.8
Average	22.1	19.7

Source: Bloomberg, IBES estimates

Figure 4: Value of Huan Hsin's notebook casing business based on FY02 forecast

PE Multiple	18.0	19.0	20.0	21.0	22.0
Value for Notebook casing business S$m	$120.8	$127.5	$134.2	$140.9	$147.6

Source: Bloomberg, IBES estimates

Figure 5: Sum of Parts Value for Huan Hsin.

	S$m	Methodology
Value of Wire business	135	DCF
Value of Notebook casing business	134	20x PE based on Taiwanese peers
Value of other plastic business	59	13x PE based on Plastics Sector average
Add net cash end 2001	10	
Sum of parts value	338	
Value per share	$1.35	

Source: Bloomberg, IBES estimates, DBS Vickers Estimates

Action

· **Raising our earnings estimates and price target.** On account of our revision in EPS estimates, the 12-month price target based on sum of parts valuation has been raised correspondingly to S$1.35. Our previous price target of S$0.87 was based on an average PE of 10x of locally-listed second-tier EMS providers. Maintain Outperform.

Timothy Wong
Director of Research

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