Comba Telecom

Company update

BUY

28 February 2005

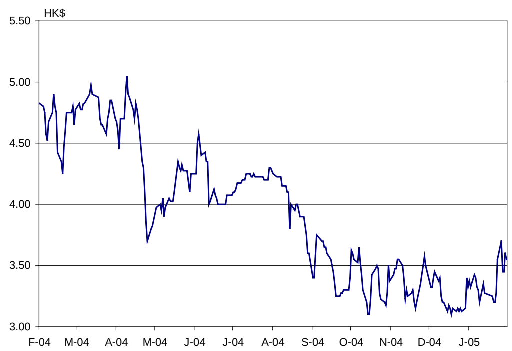
Early bird in 3G

- **Direct beneficiary of 3G at a low PER:** As a leading wireless coverage solutions provider in the PRC, Comba has been preparing for the launch of 3G in the PRC. Its products are now capable to support three standards namely, WCDMA, CDMA2000 and TD-SCDMA. Our profit estimate for FY05 without considering 3G is only 8.7x PER.
- **Rapid subscriber growth drives strong demand:** Apart from the new CAPEX arising from the launch of 3G in the PRC, continuous improvement in the network quality for 2G subscribers in the PRC propels strong demand for coverage solutions, especially indoor coverage. It is estimated that Comba has a 25% market share in the PRC that provides about 33% and 20% of China Mobile and China Unicom's wireless solutions, respectively.
- **Encouraging sales from new product:** New products such as mounted power amplifiers, BTS antennas and WiFi solutions have been well-received by the market. By improving its product coverage, the Group is able to increase its market share as well as to capture the opportunity provided by the promotion of localization.
- **Export potential:** Comba's new digital microwave system (DMS) products are already drawing interests from overseas customers. We believe DMS products could become a new growth driver for Comba given the costs and performance of the products.
- **Initiate coverage with a target price of HK$5.00 for 41% upside potential:** Our target price represents 12x FY05 PER and has yet to factor in the effect of 3G. We believe the counter deserves a better valuation owing to its market leading position as well as the enormous business potential form 3G. **BUY**

KEY DATA

Sector	*Telecom equipment*
Share price	*HK$3.55*
Stock code	*2342*
Shares O/S	*832.73mn*
Mkt. Cap	*HK$2,956mn*
52wks High-Low	*HK$5.01-3.00*
NAV per share	*HK$1.12*
Major Shareholders	*Fok Tung Ling (52.68%)*
	Zhang Yue Jun (14.1%)

Price Performance



Source: Bloomberg

Earnings Summary

YE: 31st Dec	FY02A	FY03A	FY04E	FY05F	FY06F
Net profit (HK$'mn)	**162.4**	**211.2**	**272.2**	**346.7**	**443.7**
Growth (%)		30	29	27	28
EPS (HK cents)	**19.5**	**25.4**	**32.7**	**41.6**	**53.3**
P/E (x)	18.2	14.0	10.9	8.5	6.7
DPS (HK cents)	**-**	**-**	**10.0**	**13.0**	**16.0**
Yield (%)	N/A	N/A	2.8	3.7	4.5

Source: company information, FSSL

First Shanghai Securities Limited
www.mystockhk.com

Strong start for new products

Provides low-cost alternatives

Sales of new products such as tower mount boosters, base station (BTS) antennas and WiFi solutions have been encouraging. During 1H04, the Group recorded about HK$16.7mn of sales from these new products, accounted for about 3.7% of the Group's total revenue for the period. This marks the Group's successful break into the backhaul market. Comba has always been able to provide domestic mobile operators with reliable but cost-effective alternative. We believe these new products would become a new growth driver for its outdoor equipment.

Huge market potential for new products

According to IDC, the BTS antenna market in the PRC is estimated to be worth between RMB1.2bn and 1.4bn from 2005 to 2007. Currently, the PRC's BTS antenna market is dominated by a few foreign companies, namely Andrew (ANDW US), Powerwave (PWAV US) and LGP Allgon (acquired by Powerwave in Dec 2003). Haitian Antenna (8227) is one of the few local players that are competing in this market segment.

New microwave products in the pipeline

A new growth driver

The 60% stake in WaveLab extends Comba's R&D capability into microwave products. It is estimated that the annual global market for microwave products is about US$2bn. WaveLab has successfully developed ODU (outdoor unit) products for frequencies of upto 18GHz. Most products have already obtained CE certification and are ready for sales in the international market. WaveLab is now developing ODU products to cover 23GHz to 38GHz.

Qualified supplier to Huawei

Moreoever, WaveLab's microwave products have recently passed the trial runs by Huawei. This would bring Comba into the peripheral market and broadens its customer base. Again, Comba is providing a quality low-cost alternative for PRC equipment makers to increase their competitiveness in the industry, particularly in the emerging markets.

Products are 3G ready

It is only a matter of time

Being a leading wireless coverage solutions provider in the PRC, Comba is well-prepared for the launch of 3G in the PRC. Comba's new products are able to support three possible 3G standards that are likely to be used in the PRC, namely, W-CDMA, CDMA2000 and TD-SCDMA. In fact, operators are already running trial tests with its projects as part of their preparation.

Comba makes Shenzhen subway 3G ready

Although the timetable for 3G in the PRC has yet to be determined, operators can actually begin replacing or upgrading some of their coverage equipment that is capable to support both 2G and 3G services in order to ensure a smooth and speedy transition. For instance, the Group has recently implemented a multi-system coverage solution for Shenzhen subway system. The solution provides seamless coverage within the subway system from concourses and into the tunnels for all existing and future technologies including GSM, DCS, CDMA, WLAN, Digital TV and 3G. The solution allows virtually instant coverage when 3G services come on stream in the PRC. Hence, we are confident that Comba will be one of the earliest beneficiaries in the launching of 3G in the PRC.

What 3G means to the telecom equipment market

We have identified a few issues that 3G in the PRC would provide much larger business potential than the previous 2G network.

If 2008 Olympic is a deadline

1, timeliness – should the PRC government wishes to launch 3G services before 2008 Olympic, further delay in the licensing issue could mean higher building cost as the deadline is pressing closer and closer.

3 or 4 licenses ?

2, more licenses – although the final number of 3G licenses to be issued in the PRC has yet to be determined, the common expectation is either three or four. More licenses mean more infrastructure spending.

3G network may require more infrastructure spending

3, transmission limitation – transmissions at the higher frequencies utilized by 3G networks have shorter transmission waves as compared to the existing 2G technology. The shortcoming of higher frequency is a shorter transmission distance due to power loss. Moreover, high frequency signals are weaker in penetrating into buildings and other obstacles then low frequency signals. Thus, 3G networks operating at high frequency ranges may require more base stations to cover the same geographic area than existing 2G networks resulting an increased in infrastructure spending.

Establishing an international sales network

2 sales offices covering most of the emerging markets for telecom equipment

During 1H04, Comba successfully penetrated into the Asian market. It recorded more than triple yoy growth in ex-PRC sales. In addition, it took advantage over the acquisition bid by Powerwave on LGP Allgon, both leading wireless coverage equipment providers in the world, by recruiting a team of staff from LGP Allgon to setup its second overseas sales office in Sweden in order to tap on the Russia, Europe, Middle East and Africa markets. Backed by a wide product range and strong track records with the PRC mobile operators, we are optimistic about its overseas expansion plan.

Furthermore, the Group can also leverage on its relationship with PRC telecom equipment makers such as Huawei to enjoy the fast growing export market for PRC telecom equipment.

High potential in emerging markets

Telecom markets in many emerging markets such as India and Russia have experienced high growth rates in recent years. Telecom operators in these markets have been making significant investments in their telecom infrastructure in order to meet the rapidly growing demand for voice and data transfers. As telecom accessibility has become a top priority in most developing countries, markets with low telecom penetration are likely to provide high growth potential for telecom equipment makers in the near future.

According to Gartner Group, the CAGR between 2003 and 2005 for telecom equipment market in the Asia Pacific market and Middle East and Africa market are forecasted to be approximately 11.0% and 12.7%, respectively. The global average for the same period is estimated to be only about 7.5%.

In the table below, teledensity represents the total number of telephone subscribers (mobile and fixed line) per 100 inhabitants. It is a benchmark used to gauge the maturity of telecom coverage in a particular country or area. For developed economies such as the US and Japan, their teledensity is well above 100. Even in a fast growing market like the PRC, the teledensity is only 42.3. Therefore, countries like India and Pakistan where their teledensity is below 10 are likely to represent high market potential for telecom equipment providers.

Telecom indicators in selected countries, 2003

Country	Subscribers per 100 inhabitants, end of 2003 Mobile	Wireline	Teledensity *
Pakistan	1.8	2.7	4.4
India	2.5	4.6	7.1
Indonesia	5.5 [02]	3.7 [02]	9.2
Egypt	8.5	12.7	21.2
Russia	12.0 [02]	24.2	36.2
Thailand	26.0 [02]	10.6	36.6
PRC	**21.4**	**20.9**	**42.3**
Brazil	26.3	22.3 [02]	48.7
US	54.3	62.1	116.4
Japan	68.0	55.8	123.8
UK	84.1 [02]	59.1	143.2
Hong Kong	105.8	55.5	161.3
Taiwan	110.8	59.0	169.8

*Teledensity = total number of telephone subscribers (mobile & wireline) per 100 inhabitants
[02] denotes figures as of end of 2002

Source: ITU

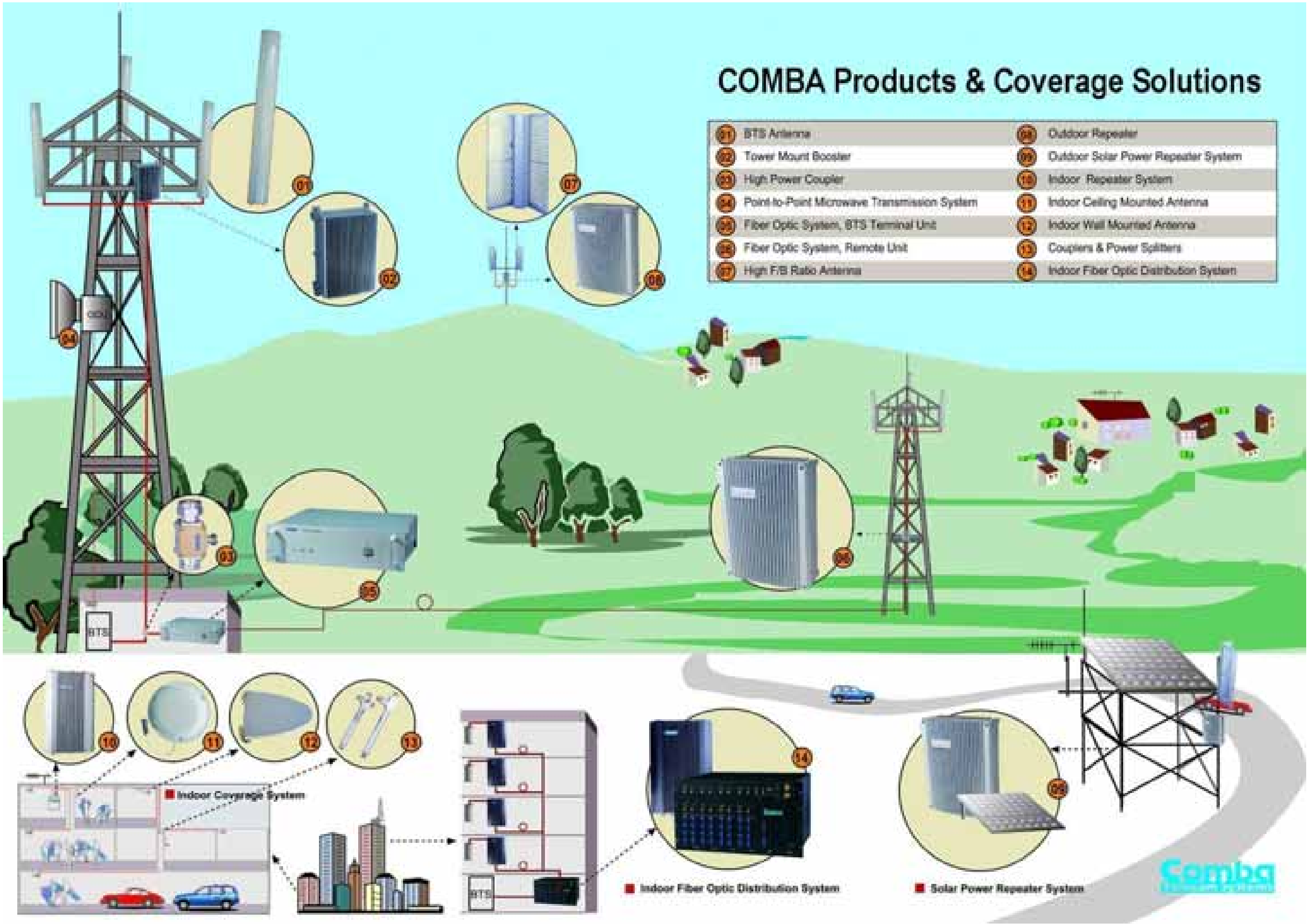
Sound financial

Net cash of HK$0.65 per share

Comba is financially sound with some HK$270mn net cash on hand as of the end of June 2004. We estimate that its net cash on hand per share as at the end of 2004 was about HK$0.65. Average A/R days for 1H04 was 165 days or about RMB487mn outstanding as of the end of 1H04. These debtors are mainly the subsidiaries of the two mobile operators (China Mobile: RMB177mn and China Unicom: RMB306mn) in the PRC. Given their payment records, the risk of bad debts should be very low.

Company background

Listed in July 2003, the Group is principally engaged in the manufacture, design and sale of wireless coverage solutions and equipment. It has a board product range including base station antennas, repeater antennas, combiners, RF repeaters, optical repeaters and other passive RF accessories. Comba's products are sold to major mobile operators as well as network equipment vendors in the PRC and Southeast Asia such as India, Thailand, Indonesia and Singapore. The Group has recently setup a sales office in Sweden to explore the European market.



Source: company information

Earnings Summary

YE: 31st December HK$'000	FY02A	FY03A	FY04E	FY05F	FY06F
Turnover	578,366	806,232	1,108,932	1,439,084	1,819,966
Cost of sales	(308,869)	(432,007)	(597,584)	(780,297)	(988,947)
Gross profit	**269,497**	**374,225**	**511,348**	**658,787**	**831,018**
Other income	835	3,990	3,016	3,168	3,411
Distribution costs	(27,920)	(42,390)	(60,991)	(74,832)	(90,998)
Administrative expenses	(55,803)	(98,309)	(142,548)	(182,462)	(228,077)
Other operating expenses	(6,686)	(10,838)	(15,715)	(20,115)	(25,144)
Operating profit	**179,923**	**226,678**	**295,109**	**384,546**	**490,209**
Finance costs	(2,977)	(5,542)	(6,497)	(6,832)	(6,833)
Profit before tax	176,946	221,136	288,612	377,714	483,377
Taxation	(14,587)	(15,912)	(24,292)	(37,771)	(48,338)
Profit before M.I.	162,359	205,224	264,320	339,942	435,039
Minority interests	-	5,938	7,930	6,799	8,701
Net profit	**162,359**	**211,162**	**272,250**	**346,741**	**443,740**
Dividend	35,000	41,500	81,675	104,022	133,122
EBITDA	**188,354**	**239,227**	**319,796**	**421,987**	**544,358**
Profitability					
GP margin	46.6%	46.4%	46.1%	45.8%	45.7%
Opt margin	31.1%	28.1%	26.6%	26.7%	26.9%
Net margin	28.1%	26.2%	24.6%	24.1%	24.4%
EBITDA margin	32.6%	29.7%	28.8%	29.3%	29.9%

Source: company information, FSSL

Balance sheets

Year ended 31 December HK$'000	FY02A	FY03A	FY04E	FY05F	FY06F
Non-current assets					
Fixed assets	70,530	108,231	167,623	236,215	311,607
Intangible assets	2,061	3,918	7,090	13,387	25,933
Goodwill	-	22,186	19,240	13,741	8,243
	72,591	134,335	193,952	263,343	345,783
Current assets					
Inventories	172,945	235,401	298,792	390,148	494,474
A/R	192,870	320,895	425,344	551,977	698,069
Notes receivable	21,489	-	-	-	-
Other receivables	26,079	40,288	55,447	71,954	90,998
Pledged deposit	-	115,456	102,000	102,000	102,000
Cash and cash equivalent	115,202	471,555	517,332	549,352	629,219
	528,585	1,183,595	1,398,914	1,665,432	2,014,760
Current liabilities					
A/P	93,959	150,435	147,349	160,335	189,661
Tax payable	8,330	13,100	19,433	30,218	38,674
Other payables	91,899	138,432	206,454	265,675	333,614
S-T bank loans	51,318	71,977	80,000	80,000	80,000
Finance lease	360	232	150	120	100
Amt due to a director	-	-	-	-	-
Provision for product warranties	9,655	11,664	15,564	18,575	25,231
	255,521	385,840	468,950	554,923	667,280
Net current assets	273,064	797,755	929,964	1,110,509	1,347,480
Net assets less current liabilities	**345,655**	**932,090**	**1,123,916**	**1,373,851**	**1,693,263**
Non-current liabilities					
Finance lease	603	344	230	300	300
Directors' loans	46,500	-	-	-	-
	47,103	**344**	**230**	**300**	**300**
Net assets	**298,552**	**931,746**	**1,123,686**	**1,373,551**	**1,692,963**
Represented by:					
Issued capital	-	83,000	83,000	83,000	83,000
Proposed dividend	35,000	41,500	48,475	62,415	79,881
Reserves	263,552	794,003	984,578	1,227,302	1,537,949
Shareholders' equity	298,552	918,503	1,116,053	1,372,717	1,700,830
Minority interests	-	13,243	7,633	834	(7,867)
	298,552	931,746	1,123,686	1,373,551	1,692,963

Source: company information, FSSL

Cash flow statement

Year ended 31 December HK$'000	FY02A	FY03A	2004E	2005F	2006F
Profit before tax	176,946	221,136	288,612	377,722	483,422
Interest income/(expense), net	2,682	2,089	3,481	3,655	3,376
Depreciation & amortization	8,726	16,002	27,703	40,610	57,560
Others	4,018	2,583	3,900	3,011	6,656
Operating profit before changes in WC	192,372	241,810	323,696	424,999	551,014
Changes in working capital	(120,887)	(84,518)	(118,062)	(162,290)	(172,196)
Cash generated from (used in) operations	71,485	157,292	205,634	262,708	378,818
Tax paid	(6,257)	(11,142)	(17,958)	(26,988)	(39,886)
Cash flow from operations	65,228	146,150	187,675	235,720	338,932
CAPEX	(28,109)	(47,208)	(85,000)	(110,000)	(140,000)
Other investments	762	(118,243)	16,472	3,177	3,456
Net cash outflow from investing	(27,347)	(165,451)	(68,528)	(106,823)	(136,544)
Equity financing, net	-	395,659	-	-	-
Changes in bank loans, net	32,486	20,659	8,023	-	-
Interest paid	(2,915)	(5,493)	(6,459)	(6,800)	(6,800)
Dividend paid	(30,000)	(35,000)	(74,700)	(90,085)	(115,669)
Others	(467)	(436)	(234)	8	(53)
Net cash in/(out) flow from financing	(896)	375,389	(73,370)	(96,877)	(122,521)
Net Inc/(dec) in cash & cash equivalent	**36,985**	**356,088**	**45,777**	**32,020**	**79,867**
Cash & cash equivalent, opening	77,749	115,202	471,555	517,332	549,352
FX differences	468	265	-	-	-
Cash & cash equivalent, ending	**115,202**	**471,555**	**517,332**	**549,352**	**629,219**

Source: company information, FSSL

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