

AAC Technologies Holdings Inc (2018 HK)

Gross margin deteriorates; downgrade to SELL

- We forecast AAC Tech's ("the Company" or "AAC") revenue to grow by 6.0% in 2020E
- Gross profit margin is expected to lower by 4.7ppt YoY in 2020E due to poor product mix and anemic demand for high-end electronic components
- Net profit is estimated to decline 39.6% YoY in 2020E
- Downgrade to SELL and TP of HK\$40.0. The TP implies 32.4x/ 23.5x FY20E/ FY21E P/E.

Company Report
Aug 31, 2020
Rating: SELL
TP: HK\$ 40.0

Analyst : Ricky Lai

Tel: (852) 2147 8895

rickylai@abci.com.hk

Weak smartphone shipments. Weak global smartphone shipments are affecting demand for smartphone components. According to IDC's data announced on 27th Aug 2020, 2Q20 smartphone shipments declined by 17.0% YoY. Sluggish demand for smartphone and high-end components is affecting AAC's business.

2020E gross profit margin is expected to drop 4.7ppt. Due to weak demand of high-end smartphone products and increased market competition, we expect AAC's gross profit margin to lower by 4.7ppt YoY to 23.9% for 2020E.

Xiaomi (1810 HK) and OPPO invested in AAC's optical business. In July 2020, AAC announced that Xiaomi, OPPO, and other investors will invest RMB 1.15bn in its optics business for a 9.58% equity interest. We think the investment will help the Group form strategic partnerships with smartphone makers and help improve revenue in 2021E.

Net profit in 2020E would fall 39.6% YoY. AAC's net profit in 2020E is estimated to be affected by the drop in gross profit margin, increase in R&D expenses for 2020E.

Valuation. We downgrade the counter to **SELL** with TP of HK\$40.0, which represents 32.4x/ 23.5x FY20E/ FY21E P/E.

Risks: (1) Fierce competition in the electronic component sector; (2) Business may be affected by Sino-US trade tensions; (3) Global smartphone shipments affected by COVID-19.

Results and Valuation

FY ended Dec 31	FY18A	FY19A	FY20E	FY21E	FY22E
Revenue (RMB mn)	18,131	17,884	18,958	21,092	23,333
Chg (% YoY)	(14.1%)	(1.4%)	6.0%	11.3%	10.6%
Net profit (RMB mn)	3,795.9	2,222.4	1,342.4	1,852.3	2,223.7
Chg (% YoY)	(28.7%)	(41.5%)	(39.6%)	38.0%	20.1%
EPS (RMB)	3.106	1.836	1.111	1.533	1.840
Chg (% YoY)	(28.5%)	(40.9%)	(39.5%)	38.0%	20.1%
BPS (RMB)	15.494	15.999	17.032	18.428	20.094
Chg (% YoY)	(28.5%)	(40.9%)	(39.5%)	38.0%	20.1%
P/E (x)	13.84	23.72	39.66	28.74	23.94
P/B (x)	2.77	2.72	2.59	2.39	2.19
ROAE (%)	20.8%	11.6%	6.7%	8.6%	9.6%
ROAA (%)	12.5%	6.9%	4.0%	5.6%	6.7%
DPS (RMB)	1.25	0.36	0.10	0.14	0.17
Dividend Yield (%)	2.9%	0.8%	0.2%	0.3%	0.4%

*Exchange rate assumption for FY20E-22E: HKD 1 = RMB 0.90

Source(s): Bloomberg, ABCI Securities estimates

Share price (HK\$)	48.95
Est. share price return	(18.3%)
Est. dividend yield	0.2%
Est. total return	(18.1%)
Previous rating & TP	HOLD; HK\$41
Previous report date	June 8, 2020

Source(s): Bloomberg, ABCI Securities estimates

Key Data

52Wk H/L(HK\$)	72.90/32.85
Issued shares (mn)	1,208.5
Market cap (HK\$ mn)	59,156.1
Avg daily turnover (HK\$ mn)	1,480.0
Major shareholder(s)	
WU Ingrid Chun Yuan	40.7%
JP Morgan	12.9%
GIC Private Ltd.	6.0%

Source(s): Bloomberg

Share Performance (%)

	Absolute	Relative*
1-mth	(3.6)	0.0
3-mth	37.9	28.0
6-mth	(3.8)	7.4

*Relative to HSI

Source(s): Bloomberg

**Weak smartphone shipments**

According to IDC's data announced on 27th Aug 2020, global smartphone shipments fell 17% YoY in 2Q20. The decline was caused by the COVID-19 pandemic and the resultant shutdown of production facilities, supply chain disruptions, and reduced consumption. Sales and production of smartphones were affected. IDC expects the global smartphone shipments in 2020 to drop by 9.5% YoY to 1.2 bn. We expect AAC's revenue to be affected by weaker smartphone shipments and decreased demand for high-end components.

Exhibit 1: Smartphone shipments in 2Q20

	2Q20 Shipments (mn)	YoY growth	Market share
Huawei	55.8	(5.1%)	20.0%
Samsung (5930 KS)	54.2	(28.9%)	19.5%
Apple (AAPL US)	37.6	11.2%	13.5%
Xiaomi (1810 HK)	28.5	(11.8%)	10.2%
OPPO	24.0	(18.8%)	8.6%
Others	78.4	(22.3%)	28.2%

Remarks: Data are preliminary and subject to change

Source(s): IDC (Quarterly mobile phone tracker, Aug 16, 2020), ABCI Securities

Xiaomi and OPPO invested in AAC's optics business

In July 2020, AAC announced that Xiaomi, OPPO, and other investors will invest RMB 1.15 bn in its optics business for a 9.58% equity interest. The strategic partnerships formed with smartphone makers will help the Group expand production scale and gain market share in the optics market.

2020E gross profit margin is expected to drop 4.7ppt

1H20 revenue grew 3.6% YoY to RMB7.8 bn; net profit dropped 58.4% YoY to RMB320 mn; Results are below expectations (lower than our and market expectations by 4.6%/ 6.1%, respectively) mostly due to weak smartphone shipments and decline in gross profit margin. 1H20 gross profit margin fell 4.3ppt YoY to 23.2% due to weak demand of high-end smartphone products and stiffened market competition. Economic uncertainty worldwide is hampering high-end smartphone shipments, which in turn affects AAC's gross margin. We expect 2020E gross profit margin to lower by 4.7ppt YoY to 23.9%.

Higher R&D expenses

R&D expense (RMB982.9 mn), as a percentage of revenue in 1H20, was up 1.5ppt YoY to 12.5%, on higher expenses for 5G technology development and innovations. We estimate research expenses will increase further for the launch of 5G antenna and other components in 2020. R&D expense, as a percentage of revenue, would be 11.5%/ 10.9%/ 10.7% for 2020E-22E.

Trim 2020E net profit by 35.2%

We lower 2020E revenue by 0.6% due to the weaker-than-expected 2Q20 revenue growth and anemic smartphone shipments. Thanks to optics business and strategic partnerships with smartphone makers, we revise up 2021E/22E revenue by 1.6%/ 5.2%; nonetheless, we

slash 2020E-22E net profit by 35.2%/ 28.0%/ 26.4% mainly due to the lower gross margin and higher R&D expenses.

Exhibit 2: Changes in our financial estimates

(RMB mn)	OLD			NEW			CHANGE		
	FY20E	FY21E	FY22E	FY20E	FY21E	FY22E	FY20E	FY21E	FY22E
Revenue	19,065	20,759	22,172	18,958	21,092	23,333	(0.6%)	1.6%	5.2%
Net Profit	2,070	2,574	3,021	1,342	1,852	2,224	(35.2%)	(28.0%)	(26.4%)

Source(s): Company, ABCI Securities estimates

Valuations

Downgrade to SELL with TP at HK\$40.0

We derive the Company's TP at HK\$40.0 based on DCF analysis (WACC: 11.9%; perpetuity growth rate: 3%). The TP represents 32.4x/ 23.5x FY20E/ FY21E P/E.

Based on the less-than-sanguine near-term demand outlook for smartphone and components, we downgrade the counter to SELL. We slash AAC's near-term earnings more than the reduction in TP because we expect negative factors (sluggish smartphone shipments, trade tensions, COVID-19 pandemic) to remediate in the medium term (around 2024) and the 5G smartphone replacement cycle will occur in 2025.

Exhibit 3: Peer comparison

Ticker	Price*	P/E				P/B				ROE	ROA	EV/EBITDA	
		19A	20E	21E	22E	19A	20E	21E	22E	20E	20E	20E	
HK Listed													
FIH Mobile Ltd	2038 HK	0.90	n.a.	8.1	6.5	n.a.	0.4	0.5	0.4	n.a.	4.9	1.1	0.3
AA Technologies	2018 HK	48.95	17.5	16.7	12.7	11.1	2.0	1.9	1.7	1.6	11.6	6.7	8.8
Comba Telecom	2342 HK	3.37	50.3	22.9	16.0	16.8	2.2	1.9	1.8	1.7	6.1	2.1	n.a.
Q Technology	1478 HK	9.91	18.1	14.5	11.7	10.5	3.5	3.0	2.4	2.1	22.0	6.0	9.2
Cowell E Holdings	1415 HK	3.18	8.0	7.6	5.8	5.5	0.7	0.7	0.7	0.7	10.6	5.9	1.7
Average			19.8	13.9	10.6	11.0	1.5	1.6	1.4	1.5	11.0	4.4	5.0
A-shr													
Goertek Inc	002241	42.87	48.4	32.4	24.5	20.3	3.8	3.5	3.1	2.7	10.9	5.3	16.6
Lens Technology	300433	35.44	29.3	22.6	18.1	14.0	3.5	3.2	2.7	2.2	15.7	7.9	10.7
Luxshare	002475	55.81	53.8	38.6	28.8	23.0	12.5	9.4	7.2	5.6	25.8	11.5	26.0
Average			43.8	31.2	23.8	19.1	6.6	5.4	4.4	3.5	17.5	8.2	17.8

*Based on closing price on Aug 28, 2020

Source(s): Bloomberg, ABCI Securities



Risk factors

Fierce competition in the electronic component sector

The electronic component sector in China is highly competitive with numerous companies (such as Goertek [002241 CH) and Luxshare [002475 CH]). AAC may face pressure in product shipments and ASP if competition intensifies.

Slowdown in smartphone shipments may affect the Company's revenue growth.

The global smartphone recorded a YoY decline in 1H20. As the COVID-19 pandemic is still rampant in non-China regions, global economic activities and smartphone demand may continue to be suppressed. The Company's revenue is highly related to the smartphone shipments - downward pressure in smartphone shipments will affect electronic component demand, hence affecting the Company's income.

Business may be affected by trade tensions

The Company's product shipments may be affected by escalating tensions, sanctions, and disputes among countries.

Generated over 46.3% revenue income from the Americas in 2019

AAC generated most of its revenue from the Americas. Reduced revenue from the regions will affect the Company's financial performance.

Our forecasts may deviate from actual results

We make our forecasts relies on a number of assumptions, such as shipment and ASP and estimates. Therefore, the actual results may deviate from our estimates.



Financial Statements

Consolidated income statement (2018A-2022E)

FY Ended Dec 31 (RMB mn)	2018A	2019A	2020E	2021E	2022E
Total revenue	18,131	17,884	18,958	21,092	23,333
Cost of goods sold	(11,388)	(12,777)	(14,427)	(15,925)	(17,499)
Gross profit	6,743	5,107	4,531	5,168	5,833
Other income	237	247	485	509	545
R&D costs	(1,512)	(1,717)	(2,180)	(2,299)	(2,497)
Distribution and selling expenses	(317)	(275)	(303)	(316)	(350)
Administrative expenses	(650)	(643)	(682)	(753)	(833)
Others	29	19	0	0	0
Exchange (loss) gain	(2)	63	(10)	(6)	(5)
Finance cost	(218)	(248)	(223)	(173)	(137)
Profit before tax	4,310	2,552	1,617	2,129	2,556
Tax	(514)	(330)	(275)	(277)	(332)
Net profit	3,796	2,222	1,342	1,852	2,224
EPS (RMB)	3.106	1.836	1.111	1.533	1.840

Source(s): Company, ABCI Securities estimates



Consolidated balance sheet (2018A-2022E)

As of Dec 31 (RMB mn)	2018A	2019A	2020E	2021E	2022E
PPE	15,440	16,911	11,235	12,111	13,030
Others	2,444	2,489	9,656	9,538	9,424
Total non-current assets	17,884	19,400	20,891	21,648	22,455
Cash & cash equivalents	4,126	5,512	3,525	3,164	3,478
Inventories	3,319	3,664	3,481	3,307	3,141
Others	4,539	5,631	5,076	4,577	4,129
Total current assets	11,985	14,808	12,083	11,048	10,748
Total assets	29,869	34,207	32,974	32,696	33,202
Bank borrowings	3,493	1,876	1,688	1,520	1,368
Trade and note payable	4,548	5,474	5,748	6,035	6,337
Others	276	361	457	463	475
Total current liabilities	8,317	7,711	7,894	8,018	8,179
Bank borrowings	2,428	3,850	2,695	1,886	1,320
Others	190	3,286	3,130	2,992	2,871
Total non-current liabilities	2,618	7,136	5,825	4,879	4,192
Total liabilities	10,935	14,846	13,719	12,897	12,371
Shareholders' equity	18,934	19,351	20,573	22,258	24,271
Minority interests	0	10	10	11	12
Total equity	18,934	19,361	20,583	22,270	24,283

Source(s): Company, ABCI Securities estimates



Consolidated Cash Flow Statement (2018A-2022E)

As of Dec 31 (RMB mn)	2018A	2019A	2020E	2021E	2022E
Operating profit before change in working capital	4,310	2,552	1,617	2,129	2,556
Change in working capital	1,149	(728)	1,007	956	912
Others	1,330	2,019	434	403	333
Operating cash flow	6,789	3,843	3,058	3,489	3,801
CAPEX	(1,086)	(1,268)	(1,332)	(1,398)	(1,468)
Others	(2,513)	(2,126)	(65)	(58)	(51)
Investing cash flow	(3,599)	(3,395)	(1,396)	(1,457)	(1,519)
Change in bank Loan	(555)	(263)	(1,342)	(977)	(718)
Others	(2,692)	518	(333)	(329)	(325)
Financing cash flow	(3,247)	255	(1,675)	(1,306)	(1,043)
Net increase in cash & cash equivalents	(57)	704	(14)	726	1,240
Cash & cash equivalents at beginning of year	4,034	4,059	4,814	4,853	5,634
Effect of changes in foreign exchange rate	81	51	53	55	56
Cash & cash equivalents at end of year	4,059	4,814	4,853	5,634	6,930

Source(s): Company, ABCI Securities estimates

Financial ratios (2018A-2022E)

As of Dec 31	2018A	2019A	2020E	2021E	2022E
Gross profit margin	37.2%	28.6%	23.9%	24.5%	25.0%
Net profit margin	20.9%	12.4%	7.1%	8.8%	9.5%
ROAA	12.5%	6.9%	4.0%	5.6%	6.7%
ROAE	20.8%	11.6%	6.7%	8.6%	9.6%
Costs ratio					
% to revenue					
R&D costs/ revenue	8.3%	9.6%	11.5%	10.9%	10.7%
Distribution and selling expenses/ revenue	1.7%	1.5%	1.6%	1.5%	1.5%
Administrative expenses/ revenue	3.6%	3.6%	3.6%	3.6%	3.6%
YoY growth					
Revenue	(14.1%)	(1.4%)	6.0%	11.3%	10.6%
Gross profit	(4.1%)	(8.6%)	(4.7%)	0.6%	0.5%
Net profit	(28.7%)	(41.5%)	(39.6%)	38.0%	20.1%

Source(s): Company, ABCI Securities estimates



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Rating	Definition
Buy	Stock return rate \geq Market return rate (10%)
Hold	- Market return rate (-10%) \leq Stock return rate < Market return rate (+10%)
Sell	Stock return < - Market return (-10%)

Notes: Stock return rate: expected percentage change of share price plus gross dividend yield over the next 12 months

Market return rate: average market return rate since 2008 (HSI total return index 2008-19 CAGR at 10%)

Time horizon of share price target: 12-month

Stock rating, however, may vary from the stated framework due to factors including but not limited to: corporate governance, market capitalization, historical price volatility relative to corresponding benchmark index, average daily turnover of the stock relative to market capitalization of the stock, competitive advantages in corresponding industry, etc.

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Office address: ABCI Securities Company Limited, 13/F Fairmont House, 8 Cotton Tree Drive, Central, Hong Kong.

Tel: (852) 2868 2183