

## COMPANY NEWS

### O-Net Technologies [0877.HK; HK\$4.67; Not Rated] -

1H 2018 results a mixed bag. Concerns behind it; good foundation for future growth.

Market Cap: US\$477m; Free Float: 48.3%; 3-month Average Daily Turnover: US\$1.0m

Analyst: Mark Po

**The Company.** O-Net Technologies (O-Net), one of the leading high-tech enterprises in China, is engaged in optical networking, business related to electronic cigarettes, coating services, and machine vision solutions.

**Net profit up 51.8%.** O-Net's 1H 2018 net profit attributable to equity holders was up 51.8% YoY to HK\$111.9m, in line with its previous profit alert in Jul 2018. The Company's turnover was up 37.1% YoY to HK\$1,207.6m in 1H 2018, which was mainly due to: a) a 36% YoY increase in turnover in the optical networking segment, and (b) a 63.1% YoY increase in turnover in the smart manufacturing applications segment. Strong growth in the data centre interconnect (DCI) segment was the reason for the strong performance of the optical networking segment. In the smart manufacturing applications segment, the industrial laser business is the major growth driver. The Company's gross profit was up 14% YoY to HK\$362.3m in 1H 2018. O-Net reported a gross profit margin of 30.0% in 1H 2018, down from 36.4% in 1H 2017. Owing to effective budget management and operating leverage, O-Net's OPEX to revenue ratio decreased 3.3ppt YoY.

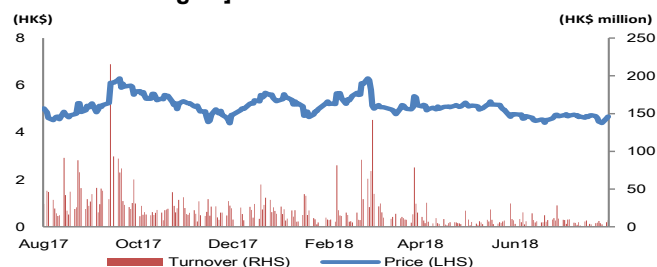
**DCI products to drive growth.** According to ACG Research, the DCI revenue segment is projected to grow at a 20.6% CAGR from 2016 to 2021. O-Net management expects the DCI market to continue to drive growth and said the Company will continue to increase its investment in DCI products, including high-speed optical transceivers, EDFAs, Raman, ICRs, TNF, VCSEL and EMLs. The Company is also monitoring the 5G market closely, which is an obvious trend for the whole industry, and the Company will continue to invest in key transceiver products, focusing on the back-haul, middle-haul and front-haul segments. Most of the Company's major clients are also actively engaged in 5G development, which will be a strong engine for Company's growth over next several years. O-Net management highlighted that starting from 2H18, there will be a whole new growth engine from unique single-mode kilowatt fibre laser products with better beam quality and less energy consumption, which is a long-term synergy result of acquisition of ITF Technologies Inc. (ITF) in 2014.

**Smartphone segment to pick up.** Management highlighted that the consumer electronics segment (mainly coatings for smartphones) faced pressure in 1H 2018 due to weak end demand for smartphones. O-Net has realigned the product and cost structure for mobile phone products, which should set a recovery base in 2H 2018. Management highlighted that demand from the smartphone segment picked up in Jul 2018, that 400G optical products were already adopted in the DCI market (backbone network), and that it expects 400G optical products to see wider application in 2020. O-Net has also made significant strides in other emerging fast-growth sectors, such as the design and manufacturing of laser chips for pump lasers, high-speed optical transceivers, and light detection and ranging (LiDAR) solutions through the acquisition of 3SP Technologies S.A.S. (3SP), a specialist in indium phosphide (InP) and gallium arsenide (GaAs) based laser chips. The acquisition is expected to be completed at the end of 2018. According to O-Net management, the Company is one of the few suppliers of industrial lasers with a vertically integrated model. O-Net management mentioned that the Company's industrial laser products offer high efficiency and costs savings compared to others such as ITG. Management said the industrial laser market is big enough for industry players to grow.

**Cash flow improved.** O-Net reported significant improvement in operating cash flow in 1H 2018, which turned from negative outflow of HK\$20.3m in 1H 2017 to inflow of HK\$262.8m in 1H 2018. The Company's net gearing fell from 12.1% as at the end of 2017 to 3.2% as at the end of Jun 2018. The improvement in cash flow and the reduction in gearing should remove investors concerns about the Company's financial position.

**5G investment is a major driver for the industry and O-Net.** Management highlighted that the upcoming 5G rollout presents a tremendous opportunity for the Company. A third party consultant estimates that there will be 1.5 to 3

### [O-Net Technologies]



Source: Bloomberg, CGIS Research,

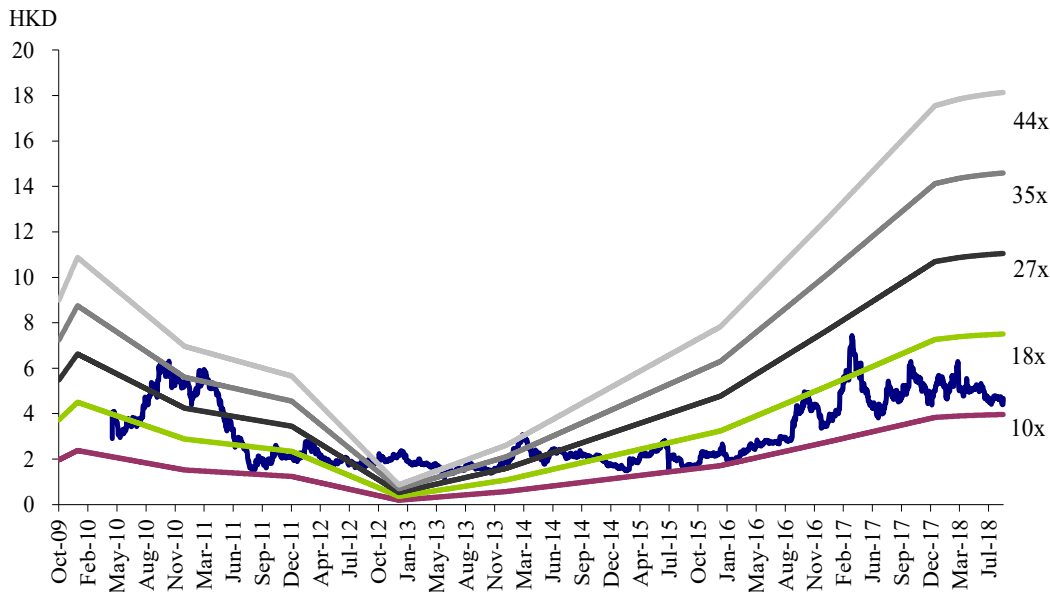
Key Financials (in HKDm)	2015	2016	2017	2018E	2019E
Revenue	1,135.5	1,598.3	2,035.1	2,446.4	3,057.2
Change (YoY %)	36.6	40.8	27.3	20.2	25.0
Gross Profit	362.6	569.7	726.5	805.5	1,020.7
Gross Margin %	31.9	35.6	35.7	32.9	33.4
Net Profit	82.5	130.6	208.9	303.2	346.5
Net Margin %	7.3	8.2	10.3	12.4	11.3
EPS (Basic)	0.12	0.19	0.29	0.40	0.43
Change (YoY %)	105.4	58.3	54.5	37.4	7.4
DPS	\$0.000	\$0.000	\$0.000	\$0.076	\$0.087
ROE (%)	6.2	9.5	12.1	14.1	15.1
Dividend Yield (%)	-	-	-	1.62	1.85
PER (x)	38.9	24.6	15.9	11.6	10.8
PBR (x)	2.6	2.4	1.8	1.6	1.5
FCF Yield (%)	-0.22%	-4.88%	-7.93%	4.90%	1.93%
Capex (m)	(135.9)	(101.9)	(246.5)	(160.0)	(150.0)
Free cash flow per share	(0.0)	(0.2)	(0.4)	0.2	0.1
Net Gearing (%)		Net cash	Net cash	8.7	10.4

Source: Bloomberg, Company Data, CGIS Research

times more Chinese base stations in the 5G era than in the 4G era, and 2 to 3 times more optical modules in each base station. Therefore, demand for optical components, like FSI, WDM, tunable filters, CWDW/WD devices and ROADM systems, is expected to report sharp increase in the 5G era, which will create strong growth potential for O-Net.

**Our view.** We reiterate the view that O-Net is a HK-listed optical component play with a strong global presence. Its current valuation is somewhat unjustified considering its strong growth in operating performance and strong R&D capability. Its non-optical networking products, such as industrial lasers, are growth drivers. In our view, the potential of the Company's existing business (especially the data-communications segment) and new business (LiDAR, sensing and VCSEL) has not been fully appreciated by the market. O-Net is now trading at 11.6x 2018 PER, which is a discount to its peers and lower than its historical mean. O-Net is one of the few HK-listed companies benefitting from increasing demand for equipment and components for high-speed communications. We believe that the concerns are behind it and that the good times are coming. O-Net's current valuation is still lower than its historical mean, and increasing attention to O-Net may boost its share price performance.

**Catalysts.** Higher spending by Internet giants for data centres; increasing policy support for the industry; and news flow on LiDAR & VCSEL development and industrial lasers.

**Figure 1: O-Net PER BAND**


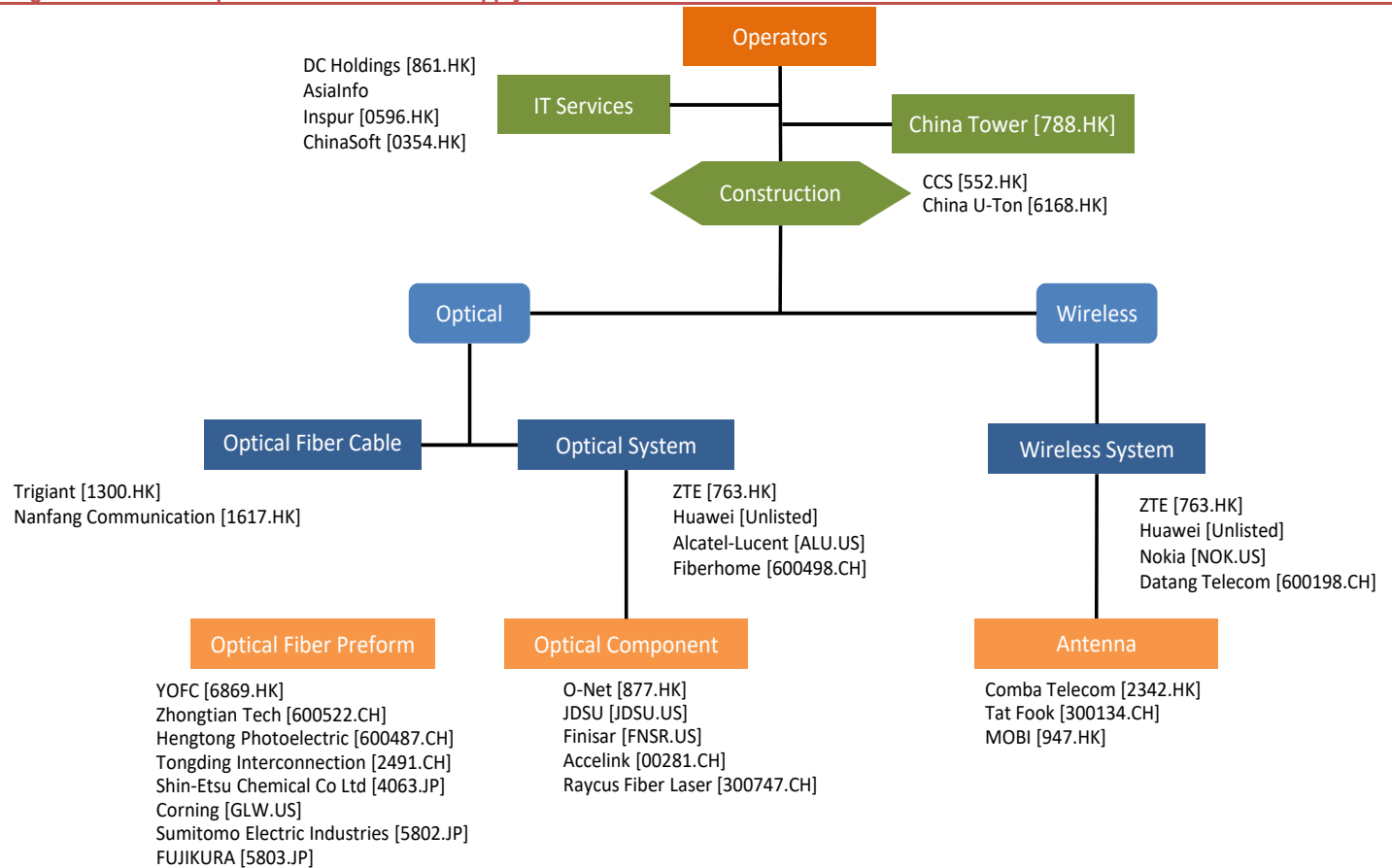
Sources: Bloomberg, Company, CGIS Research

**Figure 2: Assumptions for O-Net**

	2013	2014	2015	2016	2017	2018F	2019F
<b>Turnover (HKDm)</b>							
Optical Networking Business	654.0	781.4	974.7	1,395.7	1,601.0	1,849.4	2,149.1
Automation and Sensing Business	0	34.7	108.0	63.0	95.9	150.8	246.1
Others	7.5	15.2	52.8	139.6	338.2	446.2	662.0
<b>Total</b>	<b>661.5</b>	<b>831.3</b>	<b>1,135.5</b>	<b>1,598.3</b>	<b>2,035.1</b>	<b>2,446.4</b>	<b>3,057.2</b>
<b>YoY Change (%)</b>							
Optical Networking Business		19.5	24.7	43.2	14.7	15.5	16.2
Automation and Sensing Business		n.a.	211.2	(41.7)	52.2	57.3	63.2
Others				164.4	142.2	31.9	48.4
<b>Total</b>		<b>25.7</b>	<b>36.6</b>	<b>40.8</b>	<b>27.3</b>	<b>20.2</b>	<b>25.0</b>
<b>Gross margin (%)</b>							
Optical Networking Business	31.9	44.3	32.5	36.1	36.6	34.6	35.1
Automation and Sensing Business	35.0	35.0	30.0	32.9	32.9	32.9	32.9
Others	28.0	28.0	25.0	32.0	32.0	26.0	28.0
<b>Net margin (%)</b>	<b>2.0</b>	<b>5.2</b>	<b>7.3</b>	<b>8.2</b>	<b>10.3</b>	<b>12.4</b>	<b>11.3</b>
<b>Cost (HKDm)</b>							
S,G&A	(128.5)	(143.6)	(183.5)	(240.9)	(307.0)	(319.2)	(395.0)
Financial Expenses	(0.2)	(0.8)	0	0	(5.7)	(15.6)	(26.0)
<b>YoY Change (%)</b>							
S,G&A	n.a.	11.7	27.8	31.3	27.4	4.0	23.7
Financial Expenses	n.a.	369.3	n.a.	n.a.	n.a.	174.1	66.9
<b>CAPEX (HKDm)</b>	<b>149.7</b>	<b>116.7</b>	<b>135.9</b>	<b>101.9</b>	<b>246.5</b>	<b>160.0</b>	<b>150.0</b>
<b>Net Gearing (%)</b>				<b>12.6</b>	<b>12.1</b>	<b>8.7</b>	<b>10.4</b>

Sources: Company data, CGIS Research

**Figure 3: Domestic optical network business supply chain**



Sources: Bloomberg, CGIHK Research

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