

Hong Kong

HOLD (downgrade from ADD)

Consensus ratings*: Buy 8 Hold 0 Sell 0

Current price:	HK\$4.08
Target price:	HK\$4.10
Previous target:	HK\$5.63
Up/downside:	0.6%
CGS-CIMB / Consensus:	N/A
Reuters:	
Bloomberg:	877 HK
Market cap:	US\$427.3m
	HK\$3,352m
Average daily turnover:	US\$0.34m
	HK\$2.69m
Current shares o/s:	801.9m
Free float:	44.5%
*Source: Bloomberg	

Key changes in this note

- FY19F and FY20F net profit decreased by 26.2% and 26.0% respectively.
- FY19F and FY20F turnover decreased by 5.4% and 6.2% respectively.



Source: Bloomberg

Price performance	1M	3M	12M
Absolute (%)	0.7	3	-11.3
Relative (%)	10.3	9.5	-5.5

Major shareholders	% held
O-Net Holdings	36.3
Shenzhen Kaifa Technology	21.4

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O-Net

1H 2019 results distorted by non-cash items; soft guidance for 2H 2019 a negative surprise

- O-Net reported a YoY decline in net profit in 1H2019, which was due to non-cash items recorded in 1H2019 and non-cash gains in 1H 2018.
- The soft guidance for 2H 2019 was a negative surprise, especially that top-line growth will shift to low gear in 2019.
- We have a major downward revision of net profit forecasts for 2019 and 2020 after factoring-in the non-cash items in 1H2019 and slower growth in 2H 2019.
- We believe there are no near-term catalysts to re-rate O-Net until there is confirmation on acceleration of top-line growth.
- We cut our target price from HK\$5.63 to HK\$4.10 (~15x 2019E PER) after the downward revision of net profit forecasts. We also downgrade O-Net from ADD to HOLD.

1H 2019 results highlights: recurring operating income grew 27%

O-Net reported revenue of HK\$1,403.4m in 1H2019, up 16.2% YoY from HK\$1,207.4m in 1H2018. The Company's gross profit rose by 14.3% YoY to HK\$414.2m in 1H2019, up from HK\$362.3m in 1H2018. Its gross profit margin dropped from 30.0% in 1H2018 to 29.5% in 1H2019, which was due mainly to booking a HK\$28.3m provision for write-down of inventory. Excluding the impact of the inventory write-down, O-Net's gross profit margin was 31.5% in 1H2019, up from 30.0% in 1H2018. The inventory write-down was related to product upgrades from 100G to 400G. O-Net reported a net profit of HK\$83.1m in 1H2019, down 25.7% YoY from HK\$111.9m in 1H2018. The YoY decline in net profit was due to: a) an inventory write-down as discussed above and b) a HK\$4.7m provision for impairment of intangible assets. But there was HK\$44m in gains from a change in fair value of financial instruments in 1H2018. Excluding the non-recurring gains in 1H2018, O-Net's operating income increased 27% YoY in 1H2019. O-Net's revenue growth in 1H2019 was driven mainly by a 22% YoY increase in revenue in its optical networking business and a 92% YoY increase in e-cigarette revenue. But O-Net's other product segments, including machines, consumer electronics, LiDAR and industrial lasers, reported a YoY decline in revenue in 1H2019, due to different factors, such as product upgrades and weak end-market demand.

Shifting to low gear

During the results presentation, O-Net management mentioned that shipments of optical networking products were softer than expected in Q3 2019 and that it was difficult to release guidance for 2H2019. Based on our understanding, the soft guidance is mainly due to inventory digestion by a key customer, as there is no indication when the digestion process will end. The soft guidance was a negative surprise, given its top-line growth in 1H2019 and messages from downstream players. O-Net reported solid top-line growth (CAGR of 31.9%) in 2014–2018, but we expect it to report slower turnover growth (14.1% after revision) in 2019. Previously, we expected investors to rebuild confidence in the Company after its 2018 results and the release of its Q1 2019 turnover figures. But it seems that the whole process has to re-start, and the market might wait for next set of results before a re-rating.

Forecasts revised downward, rating downgrade

We cut our net profit forecasts for 2019 and 2020 by 26.2% and 26.0%, respectively. The downward revision is mainly due to projected lower turnover growth and higher operating expenses. We downgrade O-Net from ADD to HOLD, as the new target price offers limited upside.

Financial Summary	Dec-17A	Dec-18A	Dec-19F	Dec-20F
Revenue (HK\$m)	2,035	2,516	2,871	3,482
Operating EBITDA (HK\$m)	311.5	327.0	341.6	420.0
Net Profit (HK\$m)	208.9	262.5	222.1	275.1
Normalised EPS (HK\$)	0.27	0.33	0.27	0.33
Normalised EPS Growth	53.0%	20.9%	(16.6%)	22.4%
FD Normalised P/E (x)	15.04	12.44	14.91	12.18
DPS (HK\$)	-	0.020	0.020	0.050
Dividend Yield	0.00%	0.49%	0.49%	1.23%
EV/EBITDA (x)	12.05	11.54	11.48	9.83
P/FCFE (x)	NA	NA	52.42	34.55
Net Gearing	30.1%	22.7%	25.2%	29.3%
P/BV (x)	1.60	1.45	1.36	1.23
ROE	12.1%	12.3%	9.4%	10.6%
% Change In Normalised EPS Estimates				
Normalised EPS/consensus EPS (x)			0.69	0.71 0.00

SOURCES: CGIS RESEARCH, COMPANY DATA, BLOOMBERG

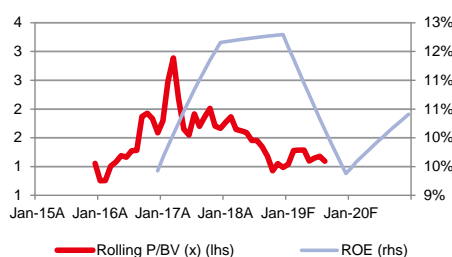
Figure 1: Forecasts revision

Revision (HKD m)	2019F forecasts			2020F forecasts		
	Old	New	change	Old	New	change
Revenue	3,036	2,871	-5.4%	3,713	3,482	-6.2%
Cost of sales and services	(2,084)	(2,003)	-3.9%	(2,543)	(2,420)	-4.8%
Gross profit	952	868	-8.8%	1,170	1,062	-9.3%
Other income and other gains and losses	45	50	11.0%	49	53	8.3%
Distribution and selling expenses	(95)	(90)	-5.4%	(117)	(109)	-6.2%
Administrative expenses	(270)	(235)	-12.9%	(326)	(282)	-13.7%
R&D expenses	(260)	(295)	13.3%	(318)	(358)	12.4%
Finance costs	(33)	(37)	11.3%	(41)	(45)	10.4%
JV & Associates	(1)	(7)	554.2%	(1)	(8)	554.2%
Profit before tax	337	254	-24.8%	417	314	-24.6%
Income tax expense	(41)	(37)	-10.0%	(50)	(45)	-10.1%
MI	4	5	12.8%	4	5	12.8%
Profit for the period	301	222	-26.2%	371	274	-26.1%
			ppt			ppt
Gross margin (%)	31.4	30.2	(1.1)	31.5	30.5	(1.0)
Operating margin (%)	12.2	10.1	(2.1)	12.3	10.3	(2.0)
Net Margin (%)	9.9	7.7	(2.2)	10.0	7.9	(2.1)
Turnover by products (HKDm)						
Optical Networking Business	2,524	2,440	-3.3%	3,029	2,928	-3.3%
Automation and Sensing Business	178	186	4.4%	244	256	4.7%
Others	333	245	-26.6%	439	298	-32.3%

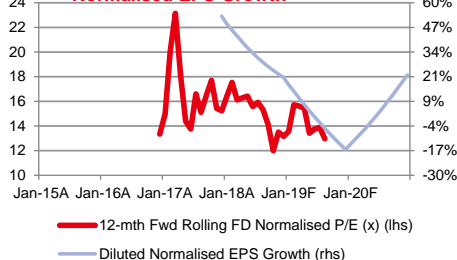
SOURCES: CGIS RESEARCH, COMPANY DATA, BLOOMBERG

BY THE NUMBERS

P/BV vs ROE



12-mth Fwd FD Normalised P/E vs FD Normalised EPS Growth



Profit & Loss

(HK\$m)	Dec-17A	Dec-18A	Dec-19F	Dec-20F
Total Net Revenues	2,035	2,516	2,871	3,482
Gross Profit	796	869	962	1,169
Operating EBITDA	312	327	342	420
Depreciation And Amortisation	(69)	(81)	(94)	(106)
Operating EBIT	242	246	248	314
Financial Income/(Expense)	(24)	(26)	(30)	(37)
Pretax Income/(Loss) from Assoc.	(0)	(1)	(7)	(8)
Non-Operating Income/(Expense)	30	64	44	46
Profit Before Tax (pre-EI)	249	283	254	314
Exceptional Items	0	0	0	0
Pre-tax Profit	249	283	254	314
Taxation	(43)	(24)	(37)	(45)
Exceptional Income - post-tax				
Profit After Tax	206	259	217	269
Minority Interests	3	4	5	6
Preferred Dividends				
FX Gain/(Loss) - post tax				
Other Adjustments - post-tax				
Preference Dividends (Australia)				
Net Profit	209	262	222	275
Normalised Net Profit	206	259	217	269
Fully Diluted Normalised Profit	209	262	222	275

Cash Flow

(HK\$m)	Dec-17A	Dec-18A	Dec-19F	Dec-20F
EBITDA	311.5	327.0	341.6	420.0
Cash Flow from Inv. & Assoc.				
Change In Working Capital	(358.8)	47.6	(132.1)	(227.7)
(Incr)/Decr in Total Provisions				
Other Non-Cash (Income)/Expense	30.9	34.1	(73.0)	0.0
Other Operating Cashflow	33.6	(43.5)	116.8	46.0
Net Interest (Paid)/Received	(26.0)	(32.4)	(37.0)	(44.8)
Tax Paid				
Cashflow From Operations	(8.8)	332.7	216.3	193.5
Capex	(246.5)	(180.0)	(190.0)	(190.0)
Disposals Of FAs/subsidiaries				
Acq. Of Subsidiaries/investments	67.5	(44.3)	0.0	0.0
Other Investing Cashflow	3.8	17.5	(31.9)	(24.8)
Cash Flow From Investing	(175.1)	(206.8)	(221.9)	(214.8)
Debt Raised/(repaid)	(84.5)	(146.4)	68.7	118.4
Proceeds From Issue Of Shares				
Shares Repurchased				
Dividends Paid	0.0	0.0	(16.0)	(16.4)
Preferred Dividends				
Other Financing Cashflow	(43.6)	(51.9)	(69.6)	(85.8)
Cash Flow From Financing	(128.0)	(198.3)	(17.0)	16.2
Total Cash Generated	(311.9)	(72.3)	(22.5)	(5.2)
Free Cashflow To Equity	(268.4)	(20.5)	63.2	97.0
Free Cashflow To Firm	(158.0)	158.4	31.4	23.5

SOURCES: CGIS RESEARCH, COMPANY DATA, BLOOMBERG

BY THE NUMBERS... cont'd

Balance Sheet

(HK\$m)	Dec-17A	Dec-18A	Dec-19F	Dec-20F
Total Cash And Equivalents	408	407	429	477
Total Debtors	975	866	988	1,198
Inventories	377	501	572	693
Total Other Current Assets	20	56	62	72
Total Current Assets	1,781	1,830	2,051	2,439
Fixed Assets	916	1,015	1,111	1,195
Total Investments	0	0	0	0
Intangible Assets	0	0	0	0
Total Other Non-Current Assets	407	374	382	390
Total Non-current Assets	1,323	1,389	1,493	1,585
Short-term Debt	654	488	556	675
Current Portion of Long-Term Debt	367	429	489	593
Total Creditors	0	0	0	0
Other Current Liabilities	33	32	24	26
Total Current Liabilities	1,053	948	1,070	1,294
Total Long-term Debt	0	0	0	0
Hybrid Debt - Debt Component				
Total Other Non-Current Liabilities	15	12	13	14
Total Non-current Liabilities	15	12	13	14
Total Provisions	2	12	13	14
Total Liabilities	1,071	972	1,095	1,322
Shareholders' Equity	2,032	2,249	2,456	2,714
Minority Interests	2	(2)	(7)	(13)
Total Equity	2,033	2,247	2,449	2,702

Key Ratios

	Dec-17A	Dec-18A	Dec-19F	Dec-20F
Revenue Growth	27.3%	23.7%	14.1%	21.3%
Operating EBITDA Growth	58.1%	5.0%	4.5%	22.9%
Operating EBITDA Margin	15.3%	13.0%	11.9%	12.1%
Net Cash Per Share (HK\$)	(0.77)	(0.64)	(0.75)	(0.96)
BVPS (HK\$)	2.54	2.81	2.99	3.30
Gross Interest Cover	9.34	7.59	6.70	6.99
Effective Tax Rate	17.3%	8.4%	14.4%	14.4%
Net Dividend Payout Ratio	NA	6.1%	7.4%	15.0%
Accounts Receivables Days	145.5	133.5	117.8	114.9
Inventory Days	95.3	97.3	102.5	100.1
Accounts Payables Days	-	-	-	-
ROIC (%)	12.5%	9.2%	8.9%	10.1%
ROCE (%)	8.90%	8.09%	7.61%	8.57%
Return On Average Assets	8.22%	9.02%	7.32%	8.10%

SOURCES: CGIS RESEARCH, COMPANY DATA, BLOOMBERG

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We are transferring the rating mechanism from "BUY, SELL, HOLD" to "ADD, REDUCE, HOLD". Please refer to the definitions below.

Explanation on Equity Ratings (Existing mechanism (will be replaced by new mechanism by 01/09/19))

- BUY : share price will increase by >20% within 12 months in absolute terms
- SELL : share price will decrease by >20% within 12 months in absolute terms
- HOLD : no clear catalyst, and downgraded from BUY pending clearer signal to reinstate BUY or further downgrade to outright SELL

Explanation on Equity Ratings (New mechanism)

- ADD : The stock's total return is expected to exceed 10% over the next 12 months.
- REDUCE : The stock's total return is expected to fall below 0% or more over the next 12 months.
- HOLD : The stock's total return is expected to be between 0% and positive 10% over the next 12 months.

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