SECTOR UPDATE

IT Hardware – China

Handset Value Chain – Gloomy Outlook Likely Priced In But No Catalysts In Sight

After a disappointing 2H21, the outlook on 1H22 remained gloomy with sector-wide shipment cuts and sustained despec trend. The companies are still guiding for sequential recovery in 2H22 on the back of resumption of spec upgrade and an easier base, but management's tone has turned increasingly uncertain since the beginning of the year. As such, we continue to favour names with higher exposure to automotive and AR/VR business given their high growth potential. Maintain MARKET WEIGHT.

WHAT'S NEW

- **Sector on a structural downtrend,** which is clearly reflected in the disappointing 2H21/4Q21 results, attributable to worse-than-expected pressure on ASP and margins amid the poor macro environment and subsequent depsec trend. Sunny and Q Tech's 2H21 gross margins both saw sharp plunges in 2H21, while AAC's optics business registered negative gross margins in 4Q21 due to low capacity utilisation and impairment on inventory. Global handset lens set (HLS) leader Largan (3008 TT/Not rated) also reported a 26% yoy decline in 4Q21 net profit, below market expectations.
- **Guidance and management's tone is turning progressively more conservative ytd.** While all companies still expect the smartphone market to sequentially recover in 2H22, their tone had progressively turned more uncertain ytd. Notably, 1Q22/1H22 will likely see sharp declines in net profit due to a combination of poor market and difficult base, similar to the performance of Kunshan Q Tech (Q Tech's CCM subsidiary) which is expected to register a 48-58% yoy decline in core net profit according to its preliminary results announced in Feb 22.
- **Weak demand, despec trend and competition to sustain through most of 2022.** According to market news, both the Android and iOS camps have been making significant cuts in shipment targets since the beginning of the year in response to the worse-than-expected consumption in 1Q22 and the unexpected Russia-Ukraine conflict. However, according to our channel checks, most smartphone OEMs has yet to make adjustments to their shipment target since China's COVID-19 situation worsened, such that we may potentially see more order cuts going forward. Similarly, the despec trend will only rebound when the demand recovers, which is still not in sight in the near future. Focus of the smartphone sector has shift to the low-end and midrange phones, as we see more smartphone brands adding premium features (such as OIS) into the Rmb1.5k-4k range of phones, marginally supporting the sector's deteriorating profitability in the near term.
- **Non-handset components will remain the key drivers going forward,** as: a) the smartphone market remains sluggish in the near term, and b) growth of smartphone shipments will likely slow down vs the previous decade after the market normalises, given the maturing smartphone market. As such, the fast-growing non-handset businesses, such as AR/VR, and automotive, will remain the star businesses going forward. Currently, all four stocks under our coverage have plans in the non-handset businesses, and for the component suppliers our pecking order is Sunny>Q Tech>AAC, based on their exposure/development timeline. For Xiaomi, we believe the entrance into the EV business will be more of an overhang in the near term, given the lack of track record, or visibility and guidance regarding the business' expenditure.

MARKET WEIGHT

(Maintained)

SECTOR PICKS

Company	Ticker	Rec	Share Price (HK$)	Target Price (HK$)
Sunny Optical	2382 HK	BUY	108.20	157.20

Source: UOB Kay Hian

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PEER COMPARISON

Company	Ticker	Rec	Price @ 12 Apr 22 (HK$)	Target Price (HK$)	Upside/ (Downside) to TP (%)	Market Cap (HK$ m)	PE 2022F (x)	PE 2023F (x)	P/B 2022F (x)	P/B 2023F (x)	EV/EBITDA 2022F (x)	EV/EBITDA 2023F (x)	ROE (%)	Net Gearing (%)
Sunny Optical	2382 HK	BUY	108.20	157.20	45.3	118,679	20.4	15.1	3.9	3.3	12.2	9.1	21.0	2.5
Xiaomi	1810 HK	BUY	12.32	17.30	40.4	307,760	15.0	12.0	2.0	1.9	8.5	7.1	11.7	(6.9)
Q Tech	1478 HK	BUY	5.60	8.60	53.6	6,633	8.6	4.8	1.2	1.0	2.9	1.6	15.8	-
AAC	2018 HK	HOLD	16.70	16.10	(3.6)	20,182	14.2	9.4	0.7	0.7	5.3	4.2	8.0	26.5

Source: Bloomberg, UOB Kay Hian

ESSENTIALS

- **Maintain MARKET WEIGHT,** as we believe at the current valuation (1SD below mean or lower). most of the negatives have already been factored into the share price. Nevertheless, we cut our full-year global smartphone shipment growth forecast from +1.9% to -1.0%. Of which, we expect China's smartphone shipment growth to be -5.0% yoy, as we expect consumption to remain sluggish on unfavourable macro environment and lockdown measures.

ACTION

- **Sunny Optical (2382 HK/BUY/Target: HK$157.20).** Sunny Optical remains our top pick among the handset component value chain, primarily thanks to their leading position in handset, AR/VR and automotive optical component value chain. Their automotive and AR/VR business contributed to 11.5% of revenue in 2021 (vs 9.0% in 2020) and even higher in earnings given the two business' higher profitability. This is expected to expand to 15% in 2023, on the back of: a) 20-30% growth in VLS shipment, b) robust growth in vehicle camera modules (~2-3x yoy to Rmb1b), and c) 50% yoy growth in the AR/VR business. For the handset business, we are expecting the business to remain unexciting in the near term, due to poor smartphone demand, as well as mounting competition from Largan (high-end HLS) and AAC (low-end/midrange HLS and HCM). Nevertheless, Sunny should remain one of the best-positioned names in the sector thanks to their leading technology, cost advantage and scale. We trim 2022 earnings estimates by 7.5% to Rmb4,725m to factor in a lower assumption on shipment and margins. Our target price of HK$157.20 is based on 30.3x 2022F PE, now on a par with historical mean. Maintain BUY as we believe the negative are mostly priced in, and its current valuation of 20.8x (vs 1SD below mean at 20.4x) looks attractive given the prosperous outlook of its non-handset businesses.

- **Q Technology (1478 HK/BUY/Target: HK$8.60).** Q Tech as a pure Android supply chain play is facing more pressure compared to peers with exposure to iOS, as Android is losing market share to iOS. Q Tech is also seeing a bigger despec problem compared to Sunny, as their share gains in Samsung are primarily low-end 8MP products at the current stage. Going forward, Q Tech expects margins and ASP to improve sequentially in 2H22, with higher contribution from the better margin new projects, and order wins in Samsung's higher-end CCM products (from low-end telephoto to autofocus modules). For their non-handset business, management targets a 100% yoy growth in 2022, primarily driven by IoT related products, as well as vehicle camera modules, although contribution will remain small at ~4% (vs ~2% in 2021). To factor in lower smartphone sales, we lower our shipment and margin assumptions, and cut our 2022 estimates by 15.0% to Rmb654m. Our target price of HK$8.60 implies 12.6x 2022F PE, 1SD below mean. Maintain BUY on undemanding valuation, but we believe there will be limited upside catalysts in the near term, given the company's high correlation to the Android smartphone market and limited contribution from non-handset businesses in the near future.

- **AAC (2018 HK/HOLD/Target: HK$16.10).** Unsurprisingly, AAC's optic business was the worst performer among our optical instrument component coverage in 2021, with sharp declines in ASP, shipment and margins. Going forward, the company's optics margins will likely recover from the trough level in 4Q21, but we remain cautious on management's target to achieve margin levels similar to full-year 2021's levels (~24-25% for optics business), as according to our understanding AAC's optics capacity is now running on 20-30% utilisation rate, while its inventory level remained high at ~4 months. At the same time, the recent component cost hikes may lead to its US client asking for more price cuts for its legacy business. As such, we adjust down our assumption on shipment and margins, and cut our 2022 net profit estimates by 10.4% to Rmb1,153m, and we expect AAC's 1Q22 earnings to plunge by 60% yoy to Rmb213m due to a combination of high base and a significantly worse operating environment. Our target price is lowered to HK$16.10, based on unchanged 13.7x PE. Maintain HOLD.

- **Xiaomi (1810 HK/BUY/Target: HK$17.30).** While we like Xiaomi for its strong performances in the overseas market, we believe Xiaomi may face several headwinds in the near term: a) the deteriorating smartphone market in China, b) competition from Honor, c) more uncertainty in Xiaomi's growth in Europe given the ongoing Ukraine-Russia conflict, d) slowing advertising revenue growth amid tightening regulations in both the domestic and overseas markets, and e) component cost hikes. Nevertheless, we still expect Xiaomi to register a 1% yoy shipment growth, primarily thanks to share gains in LATAM and Southeast Asia. As such, we lower our assumptions on smartphone shipment, advertising revenue, and margins on smartphone business, and cut our 2022-24 estimates by 9/4/2% respectively. Our new target price is HK$17.30, based on unchanged 20.5x PE. Maintain BUY.

RISKS

- **Upside:** a) Stronger-than-expected smartphone shipment recovery, b) faster-than-expected spec upgrade cycle, and c) chips manufacturers obtaining licences to supply to Huawei.
- **Downside:** a) Another major COVID-19 outbreak, b) slower-than-expected spec upgrade, c) worse-than-expected smartphone recovery, and d) the US imposing sanctions on more Chinese technology companies.

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