China / Hong Kong Company Update

Lenovo Group

Bloomberg: 992 HK EQUITY | Reuters: 0992.HK

Refer to important disclosures at the end of this report

DBS Group Research . Equity

4 Nov 2022

BUY

Last Traded Price (3 Nov 2022): HK$5.96 (HSI : 15,339)
Price Target 12-mth: HK$10.10 (69% upside) (Prev HK$11.90)

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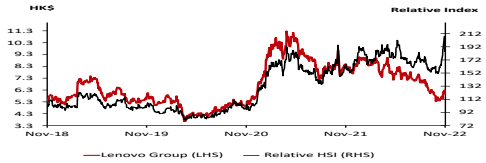
What's New

- 2QFY3/23 net profit rose 6% y-o-y to US$ 541m, in line with the market consensus, driven by margin expansion
- Operating margin increased 0.2ppt y-o-y to 5%, on increased contribution from the service business
- Cut FY3/23-FY3/24 earnings by 10%/24% due to more cautious outlook
- Lower TP to HK$10.1 but maintain BUY on strong earnings growth of 18%/21% in FY24/25F and an undemanding valuation

Price Relative



Forecasts and Valuation

FY Mar (US$m)	2022A	2023F	2024F	2025F
Turnover	71,618	67,000	72,291	77,304
EBITDA	4,338	3,989	4,518	5,180
Pre-tax Profit	2,768	2,532	2,993	3,617
Net Profit	2,030	1,872	2,199	2,658
Net Pft (Pre Ex) (core profit)	2,030	1,872	2,199	2,658
Net Profit Gth (Pre-ex) (%)	67.6	(7.8)	17.5	20.9
EPS (US$)	0.16	0.14	0.17	0.20
EPS (HK$)	1.22	1.12	1.32	1.59
EPS Gth (%)	52.6	(7.8)	17.5	20.9
Diluted EPS (HK$)	1.24	1.12	1.32	1.59
DPS (HK$)	0.31	0.37	0.43	0.52
BV Per Share (HK$)	3.25	3.91	4.72	5.76
PE (X)	4.9	5.3	4.5	3.7
P/Cash Flow (X)	2.4	3.4	2.4	2.3
P/Free CF (X)	3.5	5.4	3.6	3.2
EV/EBITDA (X)	2.2	2.3	1.8	1.3
Net Div Yield (%)	5.2	6.2	7.3	8.8
P/Book Value (X)	1.8	1.5	1.3	1.0
Net Debt/Equity (X)	CASH	CASH	CASH	CASH
ROAE(%)	47.5	34.1	33.2	33.1
Earnings Rev (%):		(10)	(24)	(22)
Consensus EPS (US$)		0.15	0.16	0.17
Other Broker Recs:		B:17	S:3	H:8

Source of all data on this page: Company, DBS Bank (Hong Kong) Limited ("DBS HK"), Thomson Reuters

Services-led transformation on track

Investment Thesis

Tech hardware giant transforming into a service-led company by leveraging on the world's largest active PC user base (218m) and its strong reputation in hardware products, channeling growth into the services and solutions business.

New solutions and services group (SSG) business's operating profit is projected to grow at a CAGR of 30% in FY22-25F, on a strong industry trend and low attached rate, boosting the company's operating margin to 5.2% in FY3/25 from 4.3% in FY3/22, as SSG's operating margin is 22% (vs. 4% of the group).

FY3/24 and FY3/25 net profit forecasts are 1.3% and 18.4% higher than the market, as we expect a stronger boost from structural growth in data centres, edge computing, investment in the "Eastern Data, Western Computing" initiative, and higher contributions from the services and solutions business.

Valuation:

We set our TP at HK$10.1, based on 8.0x FY23 PE, in line with the historical average. The re-rating is supported by a stronger growth profile over the next two to three years.

Where we differ:

FY3/24 and FY3/25 net profit forecasts are 1.3% and 18.4% higher than the market due to stronger operating margins of SSG and IDG.

Key Risks to Our View:

Rigorous competition in PCs, smartphones, and servers.
Prolonged weak consumer sentiment for consumer electronics.

At A Glance

Issued Capital (m shrs)	12,042
Mkt Cap (HKm/US$m)	71,770 / 9,143
Major Shareholders (%)	
Legend Holdings Corporation	29.7
Union Star Ltd	5.9
Sureinvest Holdings Ltd.	5.1
Free Float (%)	59.2
3m Avg. Daily Val. (US$m)	34.2

GICS Industry: Information Technology / Technology Hardware & Equipment

WHAT'S NEW

Hardware business sees headwinds; robust server and service business to sustain growth

2QFY3/23 results highlights

2Q revenue decreased by 4.4% y-o-y to US$17.1bn, because of prolonged weak consumer sentiment on consumer electronics due to economic headwinds, in line with market expectations.

Segment wise, Intelligent Devices Group's (IDG) revenue fell by 10.6% y-o-y to US$ 13.7bn, due to a decline in PC shipments caused by weakened demand from consumer clients. Solutions and Services Group (SSG) revenue increased 26.3% y-o-y to US$1.72bn due to continuous growth in device as a service (DaaS) and managed services. Server business' (ISG) revenue surged 32.9% y-o-y to US$2.61bn on the back of continuous structural growth in the data centre, edge computing, and hybrid cloud business.

Operating margin (OPM) slightly increased by 0.4ppt y-o-y to 5%, due to higher contribution from the OPM service and solution segment, which commands higher margins. IDG's OPM slightly decreased 0.2ppt y-o-y to 7.4%% due to the component cost hike while ISG's OPM increased 1.7 ppts y-o-y to 1.4% driven by recurring profit from CSP clients and better economies of scale. Meanwhile, SSG's OPM decreased 0.5ppt to 21.4% due to a low base last year.

Accordingly, net profit increased 5.7% y-o-y to US$ 541m, largely in line with market consensus, driven by operating margin expansion.

Our View

The result is satisfactory, but the global economic environment is challenging, and the management shares a more cautious outlook. Therefore, we have revised down our earnings projections for the coming few years.

We expect continued weak PC shipments caused by weak market sentiment in 2HFY3/23. Meanwhile, the growth in server business and services should remain intact on the back of 1) the continuous structural growth in the data center and edge computing space, which are being catalysed by the "Eastern Data, Western Computing" initiative in China, and 2) penetration into related services leveraging on the company's large PC user base in the coming few years.

We have further cut IDG FY23-25F revenue by 6.9%/ 6.3%/6.9% to US$ 5.5bn/5.8bn/6.0bn to reflect the expected prolonged softness in the PC market.

However, both the hardware business and services business had recorded OPM contraction q-o-q due to foreign exchange impact.

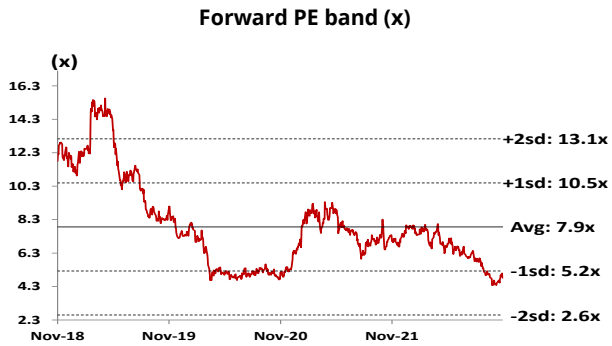
Therefore, we cut our operating margin forecast for Lenovo by 0.1/0.7/0.5ppt to 4.3%/4.7%/5.2% as we were too optimistic on the margin recovery of hardware business and margin expansion on server and services business before.

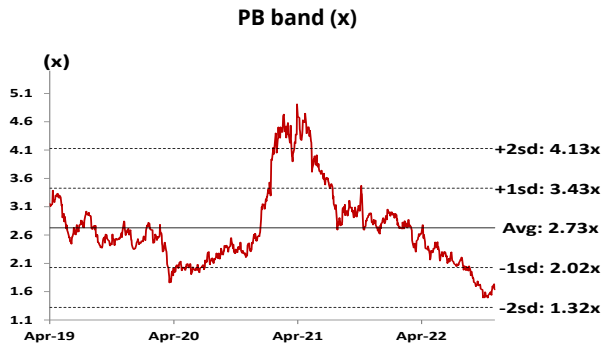
Accordingly, we have reduced our earnings forecasts for FY3/23 and FY3/24 by 9.5% and 23.9% and revised our TP to HK$10.1 on a lower FY3/23 EPS. Lenovo is currently trading at 4.4x FY3/23 PE, well below its five-year average of c.8x. We maintain our BUY rating and TP based on its undemanding valuation and strong earnings growth of 17.5%/20.9% in FY3/24F and FY3/25F respectively.

Company Background

Founded in 1984 and listed in 1994, Lenovo is the largest global PC vendor, with a 24% global market share in 2021. Lenovo expanded into the server business through the acquisition of IBM's x86 server business and the smartphone business through the acquisition of Motorola Mobility in 2014. (1) Intelligent Devices Group (IDG), (2) Infrastructure Solutions Group (ISG), and (3) Solutions and Services Group (SSG) accounted for 89.6%, 10.4%, and 8.0% of FY3/20 gross revenue, respectively. Yang Yuanqing, the Chief Executive Officer (CEO) and Chairman of Lenovo, holds a c.9.3% stake in the company.

Historical PE and PB band





Source: Thomson Reuters, DBS HK

Key Assumptions

FY Mar	2021A	2022A	2023F	2024F	2025F
ISG Revenue ('000 USD)	6,331.1	7,140.1	8,810.5	10,789.9	12,304.8
Operating Margin (%)	(2.1)	0.1	1.1	3.0	4.2
SSG Revenue ('000 USD)	N/A	5,441.5	6,689.5	7,918.3	9,393.8
Operating Margin (%)	N/A	22.0	21.0	21.5	22.5

Source: Company, DBS HK

Segmental Breakdown (US$ m)

FY Mar	2021A	2022A	2023F	2024F	2025F
Revenues (US$ m)					
IDG	54,411	62,310	55,200	57,575	59,875
ISG	6,331	7,140	8,811	10,790	12,305
SSG	0	5,442	6,690	7,918	9,394
Intersegment cancellation	0	(3,274)	(3,700)	(3,992)	(4,269)
Total	60,742	71,618	67,000	72,291	77,304
Gross Profit (US$ m)					
IDG	3,744	4,738	3,950	4,178	4,644
ISG	(130)	7	100	324	520
SSG	855	1,195	1,405	1,702	2,114
Intersegment cancellation	(745)	(1,001)	(1,100)	(1,333)	(1,655)
Total	3,723	4,938	4,355	4,871	5,622
Gross Profit Margins (%)					
IDG	6.9	7.6	7.2	7.3	7.8
ISG	(2.1)	0.1	1.1	3.0	4.2
SSG	N/A	22.0	21.0	21.5	22.5
Intersegment cancellation	N/A	30.6	29.7	33.4	38.8
Total	6.1	6.9	6.5	6.7	7.3

Source: Company, DBS HK

Income Statement (US$ m)

FY Mar	2021A	2022A	2023F	2024F	2025F
Revenue	60,742	71,618	67,000	72,291	77,304
Cost of Goods Sold	(50,974)	(59,569)	(55,796)	(59,898)	(63,632)
Gross Profit	**9,768**	**12,049**	**11,204**	**12,393**	**13,672**
Other Opng (Exp)/Inc	(7,587)	(8,968)	(8,349)	(9,009)	(9,633)
Operating Profit	**2,180**	**3,081**	**2,855**	**3,384**	**4,039**
Other Non Opg (Exp)/Inc	0	0	0	0	0
Associates & JV Inc	(32)	(7)	(46)	(68)	(81)
Net Interest (Exp)/Inc	(374)	(306)	(278)	(323)	(340)
Dividend Income	0	0	0	0	0
Exceptional Gain/(Loss)	0	0	0	0	0
Pre-tax Profit	**1,774**	**2,768**	**2,532**	**2,993**	**3,617**
Tax	(461)	(622)	(557)	(673)	(814)
Minority Interest	(102)	(116)	(103)	(121)	(146)
Preference Dividend	0	0	0	0	0
Net Profit	**1,211**	**2,030**	**1,872**	**2,199**	**2,658**
Net Profit before Except.	1,211	2,030	1,872	2,199	2,658
EBITDA	3,219	4,338	3,989	4,518	5,180
Growth					
Revenue Gth (%)	19.8	17.9	(6.4)	7.9	6.9
EBITDA Gth (%)	33.9	34.8	(8.0)	13.3	14.6
Opg Profit Gth (%)	51.6	41.3	(7.3)	18.5	19.3
Net Profit Gth (%)	68.4	67.6	(7.8)	17.5	20.9
Margins & Ratio					
Gross Margins (%)	16.1	16.8	16.7	17.1	17.7
Opg Profit Margin (%)	3.6	4.3	4.3	4.7	5.2
Net Profit Margin (%)	2.0	2.8	2.8	3.0	3.4
ROAE (%)	35.8	47.5	34.1	33.2	33.1
ROA (%)	3.5	4.9	4.2	4.8	5.3
ROCE (%)	13.7	20.0	16.9	17.4	18.1
Div Payout Ratio (%)	35.9	23.6	30.2	30.2	30.2
Net Interest Cover (x)	5.8	10.1	10.3	10.5	11.9

Source: Company, DBS HK

Balance Sheet (US$ m)

FY Mar	2021A	2022A	2023F	2024F	2025F
Net Fixed Assets	2,675	2,986	2,980	3,092	3,260
Invts in Associates & JVs	65	340	400	476	580
Other LT Assets	11,915	12,188	12,649	13,164	13,519
Cash & ST Invts	3,246	4,137	4,770	7,197	8,784
Inventory	6,381	8,301	7,765	7,986	8,540
Debtors	13,454	16,304	14,908	16,078	17,187
Other Current Assets	254	256	255	255	255
Total Assets	**37,991**	**44,510**	**43,728**	**48,248**	**52,125**
ST Debt	698	788	788	1,018	1,018
Creditors	25,332	30,370	28,306	30,078	31,874
Other Current Liab	1,342	1,601	1,645	1,796	1,968
LT Debt	3,300	2,633	2,633	3,403	3,403
Other LT Liabilities	3,709	3,724	3,776	3,935	4,022
Shareholder's Equity	3,559	4,991	5,995	7,233	8,832
Minority Interests	51	404	585	784	1,008
Total Cap. & Liab.	**37,991**	**44,510**	**43,728**	**48,248**	**52,125**
Non-Cash Wkg. Capital	(6,584)	(7,111)	(7,023)	(7,555)	(7,860)
Net Cash/(Debt)	(752)	715	1,349	2,775	4,363
Debtors Turn (avg days)	70.0	75.8	85.0	78.2	78.5
Creditors Turn (avg days)	161.4	174.4	196.1	181.5	181.2
Inventory Turn (avg days)	41.4	46.0	53.7	49.0	48.3
Asset Turnover (x)	1.7	1.7	1.5	1.6	1.5
Current Ratio (x)	0.9	0.9	0.9	1.0	1.0
Quick Ratio (x)	0.6	0.6	0.6	0.7	0.7
Net Debt/Equity (X)	0.2	CASH	CASH	CASH	CASH
Net Debt/Equity ex MI (X)	0.2	CASH	CASH	CASH	CASH
Capex to Debt (%)	21.8	36.9	33.0	29.9	28.0
Z-Score (X)	0.0	0.0	0.0	NA	NA

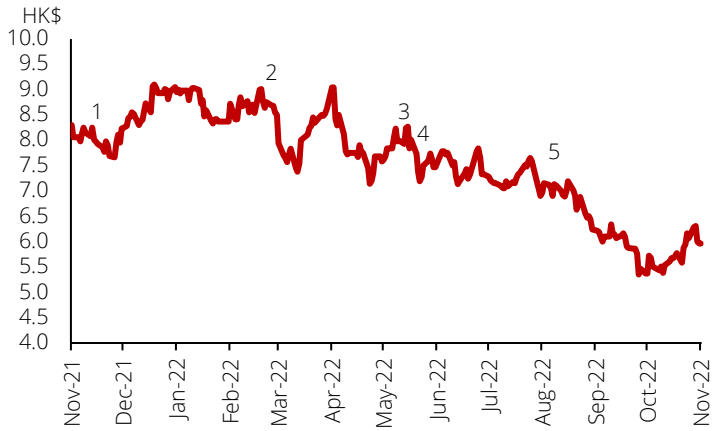
Source: Company, DBS HK

Cash Flow Statement (US$ m)

FY Mar	2021A	2022A	2023F	2024F	2025F
Pre-Tax Profit	1,774	2,768	2,532	2,993	3,617
Dep. & Amort.	1,060	1,264	1,180	1,202	1,222
Tax Paid	(624)	(729)	(557)	(673)	(814)
Assoc. & JV Inc/(loss)	1	7	46	68	81
(Pft)/ Loss on disposal of FAs	(285)	(31)	0	0	0
Chg in Wkg.Cap.	1,661	365	(88)	532	305
Other Operating CF	65	434	(155)	(24)	(75)
Net Operating CF	**3,653**	**4,077**	**2,957**	**4,098**	**4,337**
Capital Exp.(net)	(872)	(1,263)	(1,129)	(1,323)	(1,240)
Other Invts.(net)	(58)	(118)	(15)	0	0
Invts in Assoc. & JV	(48)	(122)	(106)	(144)	(186)
Div from Assoc & JV	2	4	0	0	0
Other Investing CF	0	0	0	0	0
Net Investing CF	**(976)**	**(1,498)**	**(1,251)**	**(1,467)**	**(1,425)**
Div Paid	(434)	(479)	(566)	(665)	(803)
Chg in Gross Debt	(1,076)	(747)	0	1,000	0
Capital Issues	18	0	0	0	0
Other Financing CF	(1,736)	(531)	(394)	(489)	(570)
Net Financing CF	**(3,228)**	**(1,757)**	**(960)**	**(153)**	**(1,373)**
Currency Adjustments	69	41	(128)	(51)	48
Chg in Cash	(483)	862	619	2,426	1,587
Opg CFPS (US$)	0.17	0.28	0.23	0.27	0.31
Free CFPS (US$)	0.23	0.22	0.14	0.21	0.24

Source: Company, DBS HK

Target Price & Ratings History



S.No.	Date	Closing Price	Target Price	Rating
1	19-Nov-21	HK$7.98	HK$12.50	BUY
2	28-Feb-22	HK$8.75	HK$11.80	BUY
3	16-May-22	HK$7.99	HK$11.30	BUY
4	27-May-22	HK$7.27	HK$13.00	BUY
5	11-Aug-22	HK$6.90	HK$11.90	BUY

Source: DBS HK

Analyst: Jim Au

Tsz Wang Tam

DBS HK recommendations are based on an Absolute Total Return* Rating system, defined as follows:

STRONG BUY (>20% total return over the next 3 months, with identifiable share price catalysts within this time frame)

BUY (>15% total return over the next 12 months for small caps, >10% for large caps)

HOLD (-10% to +15% total return over the next 12 months for small caps, -10% to +10% for large caps)

FULLY VALUED (negative total return, i.e., > -10% over the next 12 months)

SELL (negative total return of > -20% over the next 3 months, with identifiable share price catalysts within this time frame)

**Share price appreciation + dividends*

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Sources for all charts and tables are DBS HK unless otherwise specified.

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