

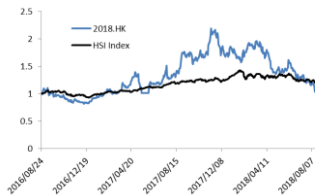
Margin squeeze due to fierce competition

AAC Tech (2018.HK)

Technology	
Stock Rating	Buy
Industry View	Overweight
Price target	HKD118
Up/downside	+43%
Close price	HKD82.35
52-Week	HKD78-185
18EPS	RMB4.35
18EPS growth	-0.2%
18PE	20.3X
Market cap	HKD100.6bn

Source: Bloomberg, CASH

Relative performance chart



Source: Bloomberg, CASH

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Weak results in 2Q18: 2Q18 single quarter revenue was Rmb3,786 mn, down 18% QoQ and 15% YoY, lower than Bloomberg consensus of Rmb4,724 mn, due to stagnant iPhone X demand and high inventory levels for iPhone components. Gross margin was 35.2%, below Bloomberg consensus of 38.9% due to RMB appreciation (up 7.2% YoY in 1H18) and 1.3ppt of the decline to an unfavorable product mix (more metal casings, but lower haptic sales). However, we believe **the ASP erosion driven by competition should be a crucial factor as well**. Operating margin was 21.6%, below Bloomberg consensus of 27.8%. Net profit was Rmb653 mn, below Bloomberg consensus of Rmb1,095 mn.

No revenue guidance: AAC did not provide any revenue guidance (previous guidance: 10-15%).

Weak acoustic: Acoustic segment grew by 4% YoY in 1H18 despite spec upgrades and adoption of SLS. On the other hand, we think GPM erosion mainly came from loss of scale and lower utilization due to fierce competition.

Product upgrade and android migration on the way: Adoption of SLS (super linear speakers) should keep rising, and the second generation of SLS is planned to be launched by 4Q18, this may support ASP and margin in the near term. Though this segment will largely improve HoH due to RMB depreciation, fierce competition creates much uncertainty in 2H, we believe. Looking further, management stated that SLS migration has barely started, and they believe will reach 70-80% Android adoption in the next 1-2 years, at the same time, SLS has much room to upgrade in mini-HiFi sound quality. We think this can also enhance user experience, thus ASP and margin.

Haptics and Precision Component under pressure: Haptic and RF/Mechanical segment declined by 17% YoY, caused by lower haptic volume (weaker end demand and excess haptics inventory at customers). We think the GPM for this segment stood at 39%, flat QoQ.

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We like audio display actuator and android clients additions: Haptic adoption from Android OEMs is on track (30-50mn shipments, no change in guidance), supported by the new design trend of the virtual home button and function keys. Market share gains among current clients (Xiaomi/Oppo), new Android clients additions and new iPhone launch, we expect that may improve the volume of haptics in 2H; On the other hand, Management are optimistic about the adoption of audio display actuator from Android which is capable of using the smartphone screen to produce sounds replacing the traditional receiver, fitting the full screen design (receiver ASP is around USD0.5/units, while audio display actuator is USD1.5/units).

Optics on track: Capacity expansion of plastic lenses is on track (from 20mn/mth currently to year-end 25-30mn/mth), and WLG lens monthly capacity is expected to expand to 5-10mn/mth. We expect higher contribution from new lens business may dilute corporate margin in the near term before WLG goes into full production. But, in the near-medium term, we believe this business segment is too small to bring any significant effect on AAC results.

MEMS is bright: MEMS components sales increased by 25% YoY to RMB344mn in 1H18. AAC Tech goes on to improve its vertical integration with its own digital ASIC chip, expanding its MEMS components margin. AAC is well positioned to enter the smart speaker market with its investment into R&D for better voice recognition ability through hardware. Again, in the near-medium term, we believe this business segment is too small.

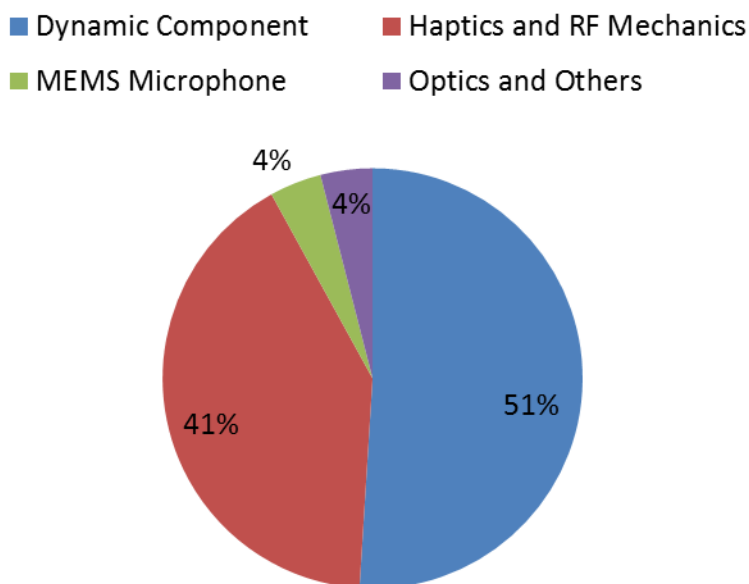
2019 will be a better year: AAC expects double digit sales growth across major product lines in 2019. **(1) Acoustics:** 1st generation of **Super Linear Structure (SLS)** should penetrate the mid-end phones, while 2nd generation of SLS will be adopted by flagship devices. They also guided acoustic business to return to 40% gross margin levels. **(2) Haptics:** AAC plans to expand its product line from a haptic engine to an **audio display actuator**, stepping motor and decelerators (both used for pop-up camera module application). Further, there would be more applications on multiple haptics (advanced gaming); **(3) Precision mechanical:** market share gains should continue among Android clients. And in-house **metal frame + 3D glass solution** will gain more clients' interests, driving up the ASP. **(4) Optics:** ASP will increase with higher 5P mix (4P contribution: 20% in 2018 and AAC is also working on 6P design) and the Company expects to see growth from **lens'** shipments and

ASP in 2019, due to new client additions and spec upgrades.

Retain ‘Buy’ with target price lowered to HKD118: We retain “Buy” rating on AAC Tech, we lower our target price by 35.5% to HKD118 due to fierce competition with PE target of 20X, indicating 43% upside. We like AAC Tech in the long run because of (1) product upgrade (SLS and audio display actuator), (2) rising sales contribution from Android phones, and (3) the fast capacity ramp up of optical lenses.

Key downside risks: Weaknesses in smartphone shipments, rising competition from acoustic business and lower than expected yield rate in the optical lens business.

Figure: AAC’s Tech revenue breakdown in 2018H1



Source: CASH, Company data

AAC Tech

2018.HK, Buy, TargetPrice: 118

Income Statement (million RMB)						Balance Sheet (million RMB)					
Year-end 31 Dec	FY16	FY17	FY18E	FY19E	FY20E	Year-end 31 Dec	FY16	FY17	FY18E	FY19E	FY20E
Revenue	15,507	21,119	23,230	27,412	32,894	Cash & equivalents	3,864	4,034	5,018	6,421	8,607
Cost of goods sold	-9,065	-12,399	-14,333	-16,831	-20,197	Marketable securities	111	9	111	111	9
Gross profit	6,442	8,720	8,897	10,581	12,697	Accounts receivable	6,156	7,155	8,739	10,311	12,707
SG&A	-1,780	-2,468	-2,705	-3,163	-3,760	Inventories	2,623	3,398	3,846	4,516	5,624
R&D	-1,166	-1,664	-1,826	-2,198	-2,691	Other current assets	75	11	99	116	149
Other expense	149	171	171	171	171	Total current assets	12,829	14,607	17,812	21,477	27,095
Operating profit	4,662	6,252	6,192	7,418	8,937	LT investments	0	0	0	0	0
EBITDA	5,589	7,534	7,590	9,068	10,917	Fixed assets	9,494	13,526	17,443	21,113	24,460
Depreciation	-906	-1,256	-1,370	-1,616	-1,939	Goodwill	89	89	89	89	89
Amortization	-21	-26	-28	-34	-40	Other intangible assets	167	256	227	194	154
EBIT	4,662	6,252	6,192	7,418	8,937	Other LT assets	1,678	2,244	1,678	1,678	2,244
Net interest expense	-67	-165	-110	-132	-237	Total assets	24,257	30,722	37,250	44,551	54,042
Associates & JCEs	-9	-7	-7	-7	-7	ST debt	3,303	4,349	4,349	4,349	4,349
Other income	46	-85	-85	-85	-85	Accounts payable	5,346	6,369	7,273	8,540	11,079
Earnings before tax	4,632	5,996	5,991	7,195	8,608	Other current liabilities	476	379	635	746	977
Income tax	-609	-671	-675	-854	-985	Total current liabilities	9,125	11,097	12,257	13,635	16,406
Net profit After tax	4,024	5,325	5,316	6,341	7,624	LT debt	789	1,941	3,359	4,921	6,692
Minority interests	1	-1	-1	-1	-1	Convertible debt	0	0	0	0	0
Other items	0	0	0	0	0	Other LT liabilities	128	133	128	128	133
Preferred dividends	0	0	0	0	0	Total liabilities	10,042	13,171	15,743	18,684	23,231
Normalised NPAT	4,025	5,325	5,315	6,340	7,623	Minority interest	26	0	-1	-1	-2
Extraordinary items	0	0	0	0	0	Preferred interest	0	0	0	0	0
Reported NPAT	4,025	5,325	5,315	6,340	7,623	Common stock	100	99	100	100	99
Dividends	-1,314	-1,662	-1,659	-1,979	-2,380	Retained earnings	12,721	16,383	20,039	24,400	29,643
Transfer to reserves	2,711	3,662	3,656	4,361	5,243	Proposed dividend	-1,314	-1,662	-1,659	-1,979	-2,380
EPS	3.28	4.36	4.35	5.19	6.24	Other equity and reserves	1,369	1,069	1,369	1,369	1,069
DPS	1.07	1.36	1.36	1.62	1.95	Total shareholders' equity	14,215	17,551	21,507	25,867	30,809
						Total equity & liabilities	24,257	30,722	37,250	44,551	54,041
Cashflow statement (million RMB)						Key Ratios					
Year-end 31 Dec	FY16	FY17	FY18E	FY19E	FY20E		FY16	FY17	FY18E	FY19E	FY20E
Net income	4,025	5,325	5,315	6,340	7,623	Growth (%)					
Depreciation	906	1,256	1,370	1,616	1,939	EPS	29.6%	32.9%	-0.2%	19.3%	20.2%
Amortization	21	26	28	34	40	Revenue	32.1%	36.2%	10.0%	18.0%	20.0%
Change in Net Working Capital	-353	-682	-1,062	-883	-662	Profitability (%)					
Cashflow from operations	4,812	5,287	5,651	7,107	8,941	Gross margin	41.5%	41.3%	38.3%	38.6%	38.6%
Capital expenditures	-4,138	-5,286	-5,286	-5,286	-5,286	EBITDA margin	36.0%	35.7%	32.7%	33.1%	33.2%
Other non current assets	-763	-566	566	0	-566	EBIT margin	30.1%	29.6%	26.7%	27.1%	27.2%
Other non current liabilities	37	5	-5	0	5	Net Margin	25.9%	25.2%	22.9%	23.1%	23.2%
CF from investing acts	-4,117	-5,009	-4,726	-5,286	-5,847	Effective tax rate	13.1%	11.2%	11.3%	11.9%	11.4%
CF after investing acts	695	278	926	1,821	3,094	Dividend payout	32.7%	31.2%	31.2%	31.2%	31.2%
Equity issue	157	-326	300	-1	-301	ROE	28.4%	30.3%	24.7%	24.5%	24.7%
Debt issue	2,284	2,197	1,418	1,563	1,771	ROA	16.6%	17.3%	14.3%	14.2%	14.1%
Convertible debt issue	0	0	0	0	1	Liquidity (x)					
Dividends	-1,314	-1,662	-1,659	-1,979	-2,380	Current ratio	1.41	1.32	1.45	1.58	1.65
CF from financial acts	797	-14	58	-417	-909	Interest coverage	69.78	37.96	56.37	56.01	37.67
Net cashflow	1,491	264	984	1,404	2,185	Leverage					
Beginning cash	2,224	3,864	4,034	5,018	6,421	Net Debt/EBITDA (x)	0.04	0.30	0.35	0.31	0.22
Adjustments	149	-95	0	0	0	Net Debt/Equity (%)	0.02	0.13	0.13	0.11	0.08
Ending cash	3,865	4,034	5,018	6,421	8,607	Activity (days)					
Ending net debt	228	2,256	2,690	2,849	2,435	Days receivable	130.5	144.9	137.3	137.3	137.3
						Days inventory	61.7	58.7	60.4	60.1	62.4
						Days payable	125.8	110.1	114.3	113.7	122.9
						Cash cycle	66.4	93.5	83.5	83.7	76.8

Source: Company data, CASH

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