TCL Communication Technology (2618 HK)

Big earnings miss & weak guidance pointing to significant earnings decline in 1H16

- **1Q16 revenue in line but earnings missed significantly given unfavourable mix and higher opex:** 1Q16 revenue declined 17% YoY due to weaker-than-expected smartphone shipments (down 9% Y/Y). GM of 19.4% improved 25bps YoY, but still fell short of JPMe 22.9% and Street 20.7%, given an unfavourable product mix. As the opex reduction failed to offset the revenue decline, TCL-C reported the first operating losses since 2Q13.

- **Smartphone shipment growth in negative territory for two consecutive quarters:** TCL-C witnessed a consecutive YoY decline in smartphone shipments in 4Q15 and 1Q16. Smart devices as a percentage of handsets were at 51% in 1Q16, lower than 56% in 2015. Although management attributed the weaker result to its channel strategy changes in China, we believe TCL-C is still fighting a tough battle of penetrating the smartphone space at this late stage, as the market is crowded and saturated.

- **Muted near-term outlook before new products launch in 2H16:** TCL-C guides for significant earnings decline in 1H16, but expects robust shipment growth and ASP expansion in 2H16, hoping on the launch of mid-to-high end models. Relatively, TCL-C is positive about the US and Europe markets in 2016, but is conservative in Latam due to currency uncertainties. The company aims to focus on mid- to high-end smartphones in China, but the scale remains quite small versus the Big-4 vendors.

- **Limited upside; stay Neutral:** We continue to believe that TCL-C is not immune to a more competitive, saturated smartphone market. As revenue may not expand in 2016/2017, we believe the margin recovery trend is also at risk. Despite undemanding valuations (trading at 5.5x FY16E P/E with a 6-7% dividend yield), we see limited catalysts in the near term for the stock. Stay Neutral.

### Table 1: 1Q16 earnings comparison

<table>
<thead>
<tr>
<th>HK$ in millions</th>
<th>1Q16</th>
<th>JPMe</th>
<th>Variance</th>
<th>Consensus</th>
<th>Variance</th>
<th>1Q15</th>
<th>Y/Y</th>
<th>4Q15</th>
<th>Q/Q</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>5,554</td>
<td>5,808</td>
<td>-4.4%</td>
<td>5,631</td>
<td>-1.4%</td>
<td>6,690</td>
<td>-17.0%</td>
<td>8,275</td>
<td>-32.9%</td>
</tr>
<tr>
<td>Gross profit</td>
<td>1,075</td>
<td>1,333</td>
<td>-19.3%</td>
<td>1,166</td>
<td>-7.8%</td>
<td>1,278</td>
<td>-15.9%</td>
<td>1,940</td>
<td>-44.6%</td>
</tr>
<tr>
<td>Operating profit</td>
<td>-202</td>
<td>183</td>
<td>-210.6%</td>
<td>149</td>
<td>-235.9%</td>
<td>92</td>
<td>-318.6%</td>
<td>209</td>
<td>-196.4%</td>
</tr>
<tr>
<td>PBT</td>
<td>16</td>
<td>256</td>
<td>-93.9%</td>
<td>186</td>
<td>-91.6%</td>
<td>188</td>
<td>-91.7%</td>
<td>295</td>
<td>-94.7%</td>
</tr>
<tr>
<td>Net income</td>
<td>14</td>
<td>243</td>
<td>-94.1%</td>
<td>174</td>
<td>-91.8%</td>
<td>185</td>
<td>-92.3%</td>
<td>288</td>
<td>-95.1%</td>
</tr>
<tr>
<td>EPS (HK$)</td>
<td>0.01</td>
<td>0.19</td>
<td>-94.2%</td>
<td>0.13</td>
<td>-91.6%</td>
<td>0.15</td>
<td>-92.5%</td>
<td>0.23</td>
<td>-95.1%</td>
</tr>
</tbody>
</table>

**Source:** Company reports and J.P. Morgan estimates.
Investment Thesis
We continue to believe that TCL-C will face challenges in the saturated smartphone space. Although TCL-C is slowly gaining market share, we think volume growth will continue to slow and blended ASP will likely head lower into 2016/2017. We remain cautious on the stock with a Neutral rating.

Valuation
Our Dec-16 PT of HK$6.00 implies 6.5x 2016E EPS and a 1.6x 2016E P/B vs a 27% ROE.

Risks to Rating and Price Target
Downside risks include faster-than-expected ASP declines, driven by intense competition, and inflated opex. Upside risks include M&A opportunities and a meaningful ramp-up of new business initiatives (e.g., smart healthcare, virtual reality).

Technology - Semiconductors

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<th>Neutral (%)</th>
<th>Underweight (%)</th>
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<td>J.P. Morgan Global Equity Research Coverage</td>
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<td>44%</td>
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<td>IB clients*</td>
<td>71%</td>
<td>63%</td>
<td>49%</td>
</tr>
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