

Hon Hai Precision Industry (2317 TT)

 Target price: **TWD80.00** (from TWD82.00)

 Share price (12 May): **TWD73.30** | Up/downside: **+9.1%**

 5 4 **3** 2 1


Hold
 (unchanged)

High uncertainty associated with Sharp deal

- 1Q16 results roughly in line with our expectations
- 2016 likely to be year of decline; Sharp deal likely to drag on earnings
- Maintain Hold (3) with reduced target price of TWD80

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What's new: Hon Hai's 1Q16 results (released today) were roughly in line with our estimates. But Sharp's results underlined our concern about the potential dilution to Hon Hai's 2016-17E earnings as a result of the acquisition. Hence, for Hon Hai, we suggest staying on the sidelines.

What's the impact: 1Q16 results. Hon Hai's revenue was TWD958bn (down 33% QoQ, down 6% YoY), in line with our estimate. Despite a relatively small scale, thanks to a better production yield and solid opex control, the operating margin was 3.69% (vs. 3.8% in 4Q15), roughly in line with our estimate of 3.62% but better than the market's estimate of 3.40%. However, Hon Hai's non-operating gain of TWD981m was well below our estimate of TWD4.7bn due to a forex loss of TWD2.6bn. In sum, its 1Q16 EPS of TWD1.76 fell short of Daiwa's and the market's estimates by 1-5%.

Muted 2Q16E on product transition; likely to see earnings decline in 2016. For 2Q16, though the company gave no specific guidance, it does expect a sequential revenue decline as a result of product transition. Due to the prolonged inventory adjustment for the iPhone, we expect Hon Hai's 2Q16 revenue to total TWD933bn, down 3% QoQ and 4% YoY. We forecast its revenue and earnings to improve significantly from 3Q16 on the back of new models from major customers. However, as discussed in [Eyeing spec upgrade trends](#), we expect the iPhone production volume in full-year 2016 to decline by 9% YoY as a result of the slow 1H16E. Hon Hai, the major assembler for iPhones, is not immune to the downward trend, in our view, and we expect its full-year 2016 revenue to decline by 2% YoY and its EPS to come in at TWD8.9, down 6% YoY.

Earnings dilution likely from Sharp deal. As highlighted in [Sharp deal: likely an earnings drag in 2016-17](#), we are concerned about the possible earnings dilution resulting from the deal, though we view the deal as a long-term positive for Hon Hai in terms of building up its capability in panels and enhancing vertical integration. Hon Hai will hold c.45% of Sharp after the deal (whereas Hon Hai group holds 66% in total). Sharp also announced its results today, with a JPY256bn net loss and JPY162bn operating loss for FY15 (ended 31 March 2016). The results echo our worries over the potential earnings dilution to Hon Hai for 2016-17E; a 9-10% dilution for 2016-17E is possible based on losses of JPY100bn a year, but we have not factored this into our model.

What we recommend: We lower our 2016-17E core EPS by 3-5% due to our more cautious revenue assumptions; we maintain our Hold (3) rating but lower our TP to TWD80 (from TWD82) on an unchanged 9x target PER, the low end of its past-3-year trading range of 8-12x, on our 1-year-forward EPS (2016E previously). Key upside risk: better-than-expected smartphone sales; key downside risk: worse-than-expected price competition.

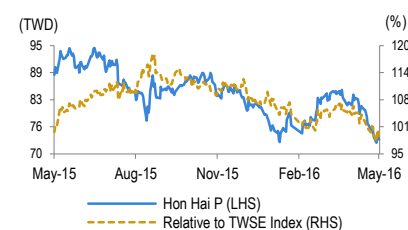
How we differ: We use a lower PER to derive our TP due to our more cautious view versus the market on the potential impact of the Sharp deal.

Forecast revisions (%)

Year to 31 Dec	16E	17E	18E
Revenue change	(2.2)	(3.2)	n.a.
Net profit change	(4.8)	(6.8)	n.a.
Core EPS (FD) change	(2.6)	(4.7)	n.a.

Source: Daiwa forecasts

Share price performance



12-month range	72.60-94.47
Market cap (USDbn)	35.24
3m avg daily turnover (USDm)	71.00
Shares outstanding (m)	15,638
Major shareholder	Terry Kuo (12.4%)

Financial summary (TWD)

Year to 31 Dec	16E	17E	18E
Revenue (m)	4,400,000	4,500,000	4,600,000
Operating profit (m)	163,680	168,750	177,100
Net profit (m)	139,382	145,674	155,361
Core EPS (fully-diluted)	8.913	9.315	9.935
EPS change (%)	(6.4)	4.5	6.6
Daiwa vs Cons. EPS (%)	0.1	1.5	n.a.
PER (x)	8.2	7.9	7.4
Dividend yield (%)	5.5	5.5	5.7
DPS	4.0	4.0	4.2
PBR (x)	1.1	1.0	0.9
EV/EBITDA (x)	2.9	2.4	1.8
ROE (%)	13.3	12.9	12.8

Source: FactSet, Daiwa forecasts

Hon Hai: revisions to revenue and earnings forecasts

TWDm	Revised forecasts			Previous forecasts			Change		
	2016E	2017E	2018E	2016E	2017E	2018E	2016E	2017E	2018E
Revenues	4,400,000	4,500,000	4,600,000	4,500,000	4,650,000	n.a.	-2.2%	-3.2%	n.a.
Gross profit	316,800	324,000	333,500	324,000	334,800	n.a.	-2.2%	-3.2%	n.a.
Operating profit	163,680	168,750	177,100	167,400	177,165	n.a.	-2.2%	-4.7%	n.a.
Pre-tax profit	187,177	197,147	210,472	198,250	212,512	n.a.	-5.6%	-7.2%	n.a.
Net profit	139,382	145,674	155,361	146,339	156,363	n.a.	-4.8%	-6.8%	n.a.
EPS (TWD)	8.91	9.32	9.93	9.15	9.78	n.a.	-2.6%	-4.7%	n.a.
Margins (%)									
Gross Margin	7.2%	7.2%	7.3%	7.2%	7.2%	n.a.			
Operating Margin	3.7%	3.8%	3.9%	3.7%	3.8%	n.a.			
Pre-tax Margin	4.3%	4.4%	4.6%	4.4%	4.6%	n.a.			
Net Margin	3.2%	3.2%	3.4%	3.3%	3.4%	n.a.			

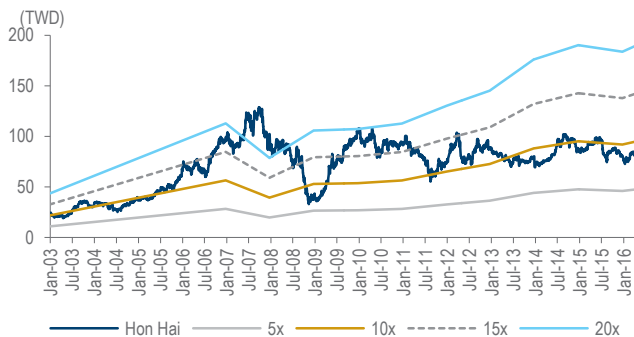
Source: Daiwa forecasts

Hon Hai: quarterly and annual P&L statement

(TWDm)	2015				2016E				2015	2016E	2017E
	1Q	2Q	3Q	4Q	1Q	2QE	3QE	4QE			
Net sales	1,014,122	972,708	1,065,602	1,429,713	958,009	932,891	1,093,850	1,415,250	4,482,146	4,400,000	4,500,000
COGS	941,699	902,666	989,080	1,328,109	890,433	866,948	1,014,214	1,311,605	4,161,554	4,083,200	4,176,000
Gross profit	72,423	70,042	76,522	101,605	67,576	65,942	79,636	103,645	320,592	316,800	324,000
Operating costs	33,821	36,931	38,356	47,215	32,252	33,397	39,269	48,201	156,323	153,120	155,250
Operating profit	38,603	33,111	38,166	54,389	35,325	32,545	40,367	55,443	164,269	163,680	168,750
Pretax profit	40,248	40,538	47,834	70,419	36,306	38,139	46,551	66,181	199,038	187,177	197,147
Net profit	30,385	25,690	37,858	52,934	27,577	26,066	36,525	49,215	146,867	139,382	145,674
Net EPS (TWD)	1.97	1.67	2.45	3.43	1.76	1.67	2.34	3.15	9.52	8.91	9.32
Operating Ratios											
Gross margin	7.1%	7.2%	7.2%	7.1%	7.1%	7.1%	7.3%	7.3%	7.2%	7.2%	7.2%
Operating margin	3.8%	3.4%	3.6%	3.8%	3.7%	3.5%	3.7%	3.9%	3.7%	3.7%	3.8%
Pre-tax margin	4.0%	4.2%	4.5%	4.9%	3.8%	4.1%	4.3%	4.7%	4.4%	4.3%	4.4%
Net margin	3.0%	2.6%	3.6%	3.7%	2.9%	2.8%	3.3%	3.5%	3.3%	3.2%	3.2%
YoY (%)											
Net revenue	15%	11%	12%	-5%	-6%	-4%	3%	-1%	6%	-2%	2%
Gross profit	36%	13%	13%	-7%	-7%	-6%	4%	2%	10%	-1%	2%
Operating income	85%	19%	22%	-14%	-8%	-2%	6%	2%	15%	0%	3%
Pretax income	58%	25%	14%	-5%	-10%	-6%	-3%	-6%	14%	-6%	5%
Net income	55%	27%	11%	-7%	-9%	1%	-4%	-7%	13%	-5%	5%
QoQ (%)											
Net revenue	-32%	-4%	10%	34%	-33%	-3%	17%	29%			
Gross profit	-34%	-3%	9%	33%	-33%	-2%	21%	30%			
Operating income	-39%	-14%	15%	43%	-35%	-8%	24%	37%			
Pretax income	-46%	1%	18%	47%	-48%	5%	22%	42%			
Net income	-46%	-15%	47%	40%	-48%	-5%	40%	35%			

Source: Company, Daiwa forecasts

Hon Hai: 1-year forward PER



Source: Company, Daiwa forecasts

Hon Hai: 1-year forward PBR



Source: Company, Daiwa forecasts

Financial summary

Key assumptions

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Consumer related sales growth (YoY%)	11.5	4.6	20.0	(16.2)	(11.9)	(16.0)	(8.4)	(7.2)
PC and networking related sales growth (YoY%)	(9.3)	(8.5)	6.0	(0.5)	(3.4)	1.1	3.4	4.7
iPhone shipment (mn units)	80.5	119.7	120.0	143.5	164.5	147.0	152.9	159.0
iPad shipment (mn units)	40.0	60.1	55.0	47.7	39.0	36.6	36.5	37.5

Profit and loss (TWDm)

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
PC/NB/networking Revenues	1,505,953	1,312,868	1,283,682	1,241,810	1,190,969	1,195,626	1,229,781	1,282,587
Consumer electronics Revenues	468,801	490,474	588,543	493,263	434,447	365,017	334,227	310,082
Other Revenue	1,477,928	2,102,053	2,080,092	2,478,099	2,856,731	2,839,357	2,935,992	3,007,331
Total Revenue	3,452,681	3,905,395	3,952,318	4,213,172	4,482,146	4,400,000	4,500,000	4,600,000
Other income	0	0	0	0	0	0	0	0
COGS	(3,186,299)	(3,575,766)	(3,697,623)	(3,921,228)	(4,161,554)	(4,083,200)	(4,176,000)	(4,266,500)
SG&A	(142,691)	(175,552)	(98,800)	(99,899)	(103,832)	(99,528)	(100,913)	(101,660)
Other op. expenses	(40,847)	(45,627)	(46,580)	(48,854)	(52,492)	(53,592)	(54,338)	(54,740)
Operating profit	82,845	108,450	109,314	143,191	164,269	163,680	168,750	177,100
Net-interest inc./(exp.)	2,721	3,752	1,593	11,046	7,154	11,075	14,176	17,839
Assoc/forex/extraord./others	16,970	6,177	25,388	19,883	27,615	12,422	14,221	15,533
Pre-tax profit	102,536	118,379	136,296	174,120	199,038	187,177	197,147	210,472
Tax	(20,602)	(26,592)	(28,950)	(41,639)	(48,837)	(46,794)	(50,273)	(53,670)
Min. int./pref. div./others	(344)	2,975	(649)	(1,947)	(3,334)	(1,000)	(1,200)	(1,440)
Net profit (reported)	81,591	94,762	106,697	130,535	146,867	139,382	145,674	155,361
Net profit (adjusted)	81,591	94,762	106,697	130,535	146,867	139,382	145,674	155,361
EPS (reported)(TWD)	5.637	6.504	7.268	8.817	9.519	8.913	9.315	9.935
EPS (adjusted)(TWD)	5.637	6.504	7.268	8.817	9.519	8.913	9.315	9.935
EPS (adjusted fully-diluted)(TWD)	5.637	6.504	7.268	8.817	9.519	8.913	9.315	9.935
DPS (TWD)	1.108	1.218	1.610	3.888	4.000	4.000	4.024	4.173
EBIT	82,845	108,450	109,314	143,191	164,269	163,680	168,750	177,100
EBITDA	134,301	176,334	182,928	213,423	235,526	234,594	244,123	256,932

Cash flow (TWDm)

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Profit before tax	102,536	118,379	136,296	174,120	199,038	187,177	197,147	210,472
Depreciation and amortisation	51,456	67,883	73,613	70,232	71,257	70,914	75,373	79,832
Tax paid	(20,602)	(26,592)	(28,950)	(41,639)	(48,837)	(46,794)	(50,273)	(53,670)
Change in working capital	(64,472)	90,647	(11,471)	(46,857)	11,070	(11,094)	(4,560)	(4,686)
Other operational CF items	(3,067)	1,016	(5,487)	(4,927)	(8,243)	(5,982)	(6,234)	(6,496)
Cash flow from operations	65,852	251,333	164,001	150,930	224,285	194,221	211,454	225,452
Capex	(87,171)	(64,051)	(35,289)	(26,558)	(66,241)	(40,000)	(40,000)	(40,000)
Net (acquisitions)/disposals	64,657	(12,350)	(3,016)	(50,896)	(8,371)	0	0	0
Other investing CF items	(56,878)	(44,325)	(32,904)	(16,211)	18,476	(1,739)	(1,782)	(1,827)
Cash flow from investing	(79,392)	(120,727)	(71,209)	(93,666)	(56,136)	(41,739)	(41,782)	(41,827)
Change in debt	73,134	71,362	85,635	(104,617)	(117,204)	16,288	17,060	17,871
Net share issues/(repurchases)	0	0	0	0	0	0	0	0
Dividends paid	(9,661)	(16,034)	(17,754)	(23,632)	(57,564)	(61,713)	(62,553)	(62,931)
Other financing CF items	25,309	(10,028)	29,195	58,658	(11,904)	0	0	0
Cash flow from financing	88,782	45,300	97,076	(69,590)	(186,673)	(45,426)	(45,493)	(45,060)
Forex effect/others	0	0	0	0	0	0	0	0
Change in cash	75,242	175,906	189,868	(12,326)	(18,523)	107,056	124,179	138,565
Free cash flow	(21,319)	187,282	128,712	124,372	158,045	154,221	171,454	185,452

Source: FactSet, Daiwa forecasts

Financial summary continued ...

Balance sheet (TWDm)

As at 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Cash & short-term investment	330,538	506,445	696,312	683,986	665,463	771,519	894,498	1,031,622
Inventory	380,522	349,883	312,785	369,197	424,625	425,333	435,000	444,427
Accounts receivable	476,050	633,049	747,710	772,381	590,909	602,740	616,438	630,137
Other current assets	96,558	53,582	51,774	106,857	107,222	105,257	107,650	110,042
Total current assets	1,283,668	1,542,957	1,808,581	1,932,421	1,788,219	1,904,849	2,053,585	2,216,228
Fixed assets	355,373	390,298	379,562	358,869	336,738	306,665	272,159	233,219
Goodwill & intangibles	0	0	0	0	0	0	0	0
Other non-current assets	91,270	111,148	124,318	171,425	183,342	190,222	197,372	204,802
Total assets	1,730,311	2,044,404	2,312,461	2,462,715	2,308,300	2,401,737	2,523,116	2,654,249
Short-term debt	271,512	355,790	400,442	254,774	122,903	140,785	147,824	155,215
Accounts payable	548,494	638,371	712,704	735,330	644,058	648,837	663,584	677,964
Other current liabilities	171,710	255,863	245,815	312,498	289,161	283,862	290,313	296,764
Total current liabilities	991,716	1,250,024	1,358,961	1,302,602	1,056,122	1,073,483	1,101,720	1,129,944
Long-term debt	115,979	105,688	132,164	161,791	175,053	172,070	180,674	189,707
Other non-current liabilities	44,785	42,159	56,667	68,091	69,494	70,884	72,302	73,748
Total liabilities	1,152,480	1,397,871	1,547,791	1,532,484	1,300,670	1,316,438	1,354,696	1,393,399
Share capital	106,891	118,359	131,287	147,934	156,383	156,383	156,383	156,383
Reserves/R.E./others	470,941	528,174	633,383	782,297	851,247	928,916	1,012,037	1,104,467
Shareholders' equity	577,832	646,532	764,670	930,231	1,007,630	1,085,299	1,168,420	1,260,850
Minority interests	0	0	0	0	0	0	0	0
Total equity & liabilities	1,730,311	2,044,404	2,312,461	2,462,715	2,308,300	2,401,737	2,523,116	2,654,249
EV	1,203,239	1,101,321	982,580	878,865	778,780	687,622	580,286	459,587
Net debt/(cash)	56,953	(44,966)	(163,707)	(267,422)	(367,506)	(458,664)	(566,000)	(686,700)
BVPS (TWD)	39.786	44.194	51.792	62.580	63.004	69.400	74.715	80.626

Key ratios (%)

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Sales (YoY)	15.2	13.1	1.2	6.6	6.4	(1.8)	2.3	2.2
EBITDA (YoY)	5.5	31.3	3.7	16.7	10.4	(0.4)	4.1	5.2
Operating profit (YoY)	(3.8)	30.9	0.8	31.0	14.7	(0.4)	3.1	4.9
Net profit (YoY)	5.8	16.1	12.6	22.3	12.5	(5.1)	4.5	6.6
Core EPS (fully-diluted) (YoY)	5.1	15.4	11.8	21.3	8.0	(6.4)	4.5	6.6
Gross-profit margin	7.7	8.4	6.4	6.9	7.2	7.2	7.2	7.3
EBITDA margin	3.9	4.5	4.6	5.1	5.3	5.3	5.4	5.6
Operating-profit margin	2.4	2.8	2.8	3.4	3.7	3.7	3.8	3.9
Net profit margin	2.4	2.4	2.7	3.1	3.3	3.2	3.2	3.4
ROAE	15.4	15.5	15.1	15.4	15.2	13.3	12.9	12.8
ROAA	5.2	5.0	4.9	5.5	6.2	5.9	5.9	6.0
ROCE	9.4	10.5	9.1	10.8	12.4	12.1	11.7	11.4
ROIC	11.2	13.6	14.3	17.2	19.0	19.4	20.5	22.4
Net debt to equity	9.9	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Effective tax rate	20.1	22.5	21.2	23.9	24.5	25.0	25.5	25.5
Accounts receivable (days)	46.8	51.8	63.8	65.8	55.5	49.5	49.4	49.5
Current ratio (x)	1.3	1.2	1.3	1.5	1.7	1.8	1.9	2.0
Net interest cover (x)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Net dividend payout	20.6	21.6	24.8	53.5	45.4	42.0	45.2	44.8
Free cash flow yield	n.a.	16.3	11.2	10.8	13.8	13.5	15.0	16.2

Source: FactSet, Daiwa forecasts

Company profile

Established in 1974, Hon Hai Precision Industry (Hon Hai) started out making plastic products, connector products and cable assemblies. It is now the largest electronics manufacturing service (EMS) provider globally in terms of design, manufacturing, global logistics and after-market service.

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Rating	Percentage of total
Buy*	66.9%
Hold**	19.7%
Sell***	13.5%

Source: Daiwa

Notes: data is for single-branded Daiwa research in Asia (ex Japan) and correct as of 31 March 2016.

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