中國銀河國際
CHINA GALAXY INTERNATIONAL

March 17, 2015

VST Holdings Limited [856.HK]

Distribute Further & More. Initiate with BUY

VST is one of the largest IT products distributors in Asia Pacific. We believe the group is able to maintain a gross margin of 4-5% through product mix enhancement and improvement in efficiency. VST should deliver solid earnings growth of 13.5%/18.0%/15.4% in 2014E/2015E/2016E to be driven by: a) continuous IT spending in the region, b) increasing contribution from enterprise services segment and c) well managed working capital. We share the view that the market is unlikely to give high valuation to pure hardware distributors like VST. However, re-rating of distributors including Cogobuy [400.HK] and Eternal Asia should boost sentiment on VST. Increasing contribution from the group's software/services makes VST an indirect proxy to continuous IT spending in the regions. Initiate with ***BUY*** *and a target price of HK$3.25 (based on 8.5x 2014E PER, higher than historical average but discount to its peers).*

- **A regional play.** VST is one of the leading IT product distributor in Asia Pacific. The group's diversified product lines including over 100 renowned IT brands such as Lenovo, HP, Dell, Intel and Apple. The group owned an extensive distribution network of 25,000 channel partners covering the length and breadth of China and Southeast Asia to capture potential from continuous IT spending in the region. IT distribution business is dominated by a few players and the entry barrier is high as it takes time to develop an efficient and effective distribution network. VST strives for territorial growth in various fast-growing emerging markets in the long term. We forecast the group's turnover to grow at a CAGR of 7% in 2013-2017.
- **Booming online sales creates opportunity.** Internet resellers such as JD.com, Yixun, Gome.com.cn, Suning.com and Bhinneka.com accounted for 8.1% of total turnover in 1H FY14, up from 7.5% in FY13. Online resellers are happy to cooperate with VST given less pressure on working capital requirement. Growing e-commerce sales have limited or even no negative effect on VST.
- **Cost control and sound working capital management to sustain growth.** Through optimizing the product mix and exploring new business segment, we expect VST to maintain a stable blended gross margin of 4-5%. Operating expenses are expected to stay steady due to management's continued efforts on internal efficiency enhancement.
- **Risks:** (1) massive slowdown in IT spending in China; (2) Natural disasters.

Key Financials (in HKDm)	2012	2013	2014E	2015E	2016E
Revenue	37,097.8	40,239.3	41,959.9	45,475.6	49,453.2
Change (YoY %)	13.7	8.5	4.3	8.4	8.7
Gross Profit	1,407.6	1,517.0	1,692.7	1,873.5	2,082.8
Gross Margin %	3.8	3.8	4.0	4.1	4.2
Net Profit	444.4	502.7	570.6	673.2	776.8
Net Margin %	1.2	1.2	1.4	1.5	1.6
EPS (Basic)	0.30	0.34	0.38	0.44	0.51
Change (YoY %)	(18.9)	13.1	13.1	15.5	15.4
DPS	$0.080	$0.080	$0.086	$0.088	$0.102
ROE (%)	15.9	15.7	15.6	16.0	16.2
Dividend Yield (%)	3.09	3.09	3.32	3.41	3.93
PER (x)	n.a.	7.7	6.8	5.9	5.1
PBR (x)	1.1	1.1	1.0	0.9	0.8
FCF Yield (%)	-12.07%	1.94%	3.25%	7.64%	8.72%
Capex (m)	(13.8)	(14.9)	(17.1)	(19.7)	(22.7)
Free cash flow per share	(0.5)	0.1	0.1	0.3	0.4
Net Gearing (%)	44.3	45.2	40.6	33.3	26.4

TMT Sector—

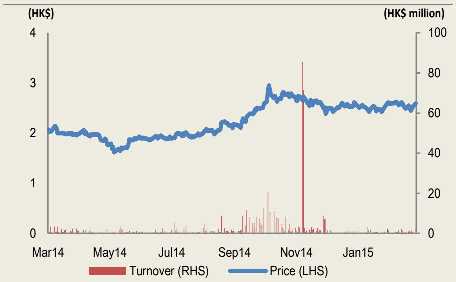
Hardware Distribution

BUY

Close: HK$2.59 (Mar 16, 2015)

Target Price: HK$3.25 (+25.3%)

Share Price Performance



Market Cap	US$509m
Shares Outstanding	1,525m
Auditor	KPMG
Free Float	46.8%
52W range	HK$1.62-2.95
3M average daily T/O	US$0.2m
Major Shareholding	Chairman (36.96%)

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Investment positives

1) Leading play in the region

VST has established strategic partnerships with numerous world leading global IT brands including HP, Seagate, AMD, Western Digital, Apple, Lenovo, IBM, Cisco and Sun Microsystems for over 10 years. The group has a wide range of IT products under its distribution portfolio and an expanding product mix. VST's business is more catering for related component products, including hard disk, memory, CPU, and peripheral. VST also distributes Lenovo's ThinkPad series of notebooks. The group's subsidiary ECS focuses on the distribution of finished type of IT products such as consumer and commercial desktop, notebook, printer, server, storage and database device.

Extensive network

VST's has an extensive distribution network and widespread channel partners in the region. The group's main sales channels for the consumer type of finished IT products (desktop PC, notebook, printer, etc) are IT mall and plaza, electronic supermart, retailer and reseller. PC related components, such as hard disk, CPU, and memory, are distributed through retailer, IT mall and plaza, and also directly sold to computer original equipment manufacturer (OEM) such as Lenovo. The commercial type of IT products (commercial NB, desktop, printer, enterprise server, network equipment, database and storage device, and security product) are mainly procured by mid-to-large sized enterprise customers from the government, financial, telecom, education and industrial sectors. VST also teams up with system integrators and application developers to provide customized enterprise system tools. VST also offer IT services in terms of system design and implementation, post-sales maintenance, training and support to the enterprise clients.

Entry barrier is higher than expected

Main entry barrier for hardware distribution is the relationship with vendors and channel partners, which present a not inconsiderable hurdle for newcomers. Hence, the market is concentrated with the top-four companies accounting for over 50% of market share. Despite smaller in scale comparing with Digital China and Synnex, VST has long been in the distribution business in China and has gradually over the years built up an extensive distribution network. VST's distribution networks consisting of nearly 30,000 channel partners in the region covering a population of nearly 1.8bn people. We believe the OEMs/brand companies are likely to be reluctant to add more distributors to their networks since it is hard for them to manage too many distributors from a logistics/supply chain management perspective. There may also be potential conflict of interest issue between their existing distribution networks and the new ones.

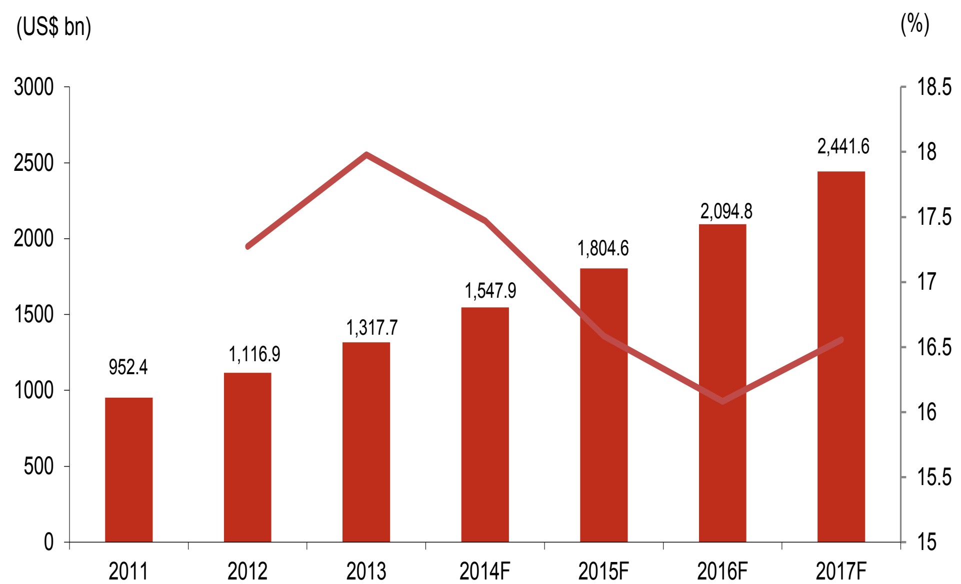
Beneficiary of cloud computing

VST continues to explore new business opportunities by investing in new products. Despite concerns around the slowdown of IT investment due to uncertain macro environment, VST is in fact benefiting from increasing investment in cloud-related products and services. Management sees strong demand for infrastructure-related products such as server, networking product and storage. Major growth drivers are construction of data centers and demand for video surveillance products. Management also highlights that distribution of cloud-based software or services will be another growth driver after investment in infrastructure by corporations.

Cloud-based software/service providers such as Microsoft/IBM are adopting two-tier models, and management believes the stickiness with resellers and end-customers remains high. Distribution of cloud-based software and services required a well-established platform for billing and metering, and management believes the entry barrier is relatively high. VST is also working with vendors such as IBM and Oracle to promote one-stop solution (server, networking product and storage) to corporate customers and system integrators. VST's management also sees the opportunity from distributing Lenovo's x86 Server in the region given their long-term relationship.

Cloud computing market continues to grow

Figure 1: Global cloud computing market



Sources: IDC, CGIHK Research

Figure 2: Renowned vendors under VST's distribution portfolio

Sources: Company Data, CGIHK Research

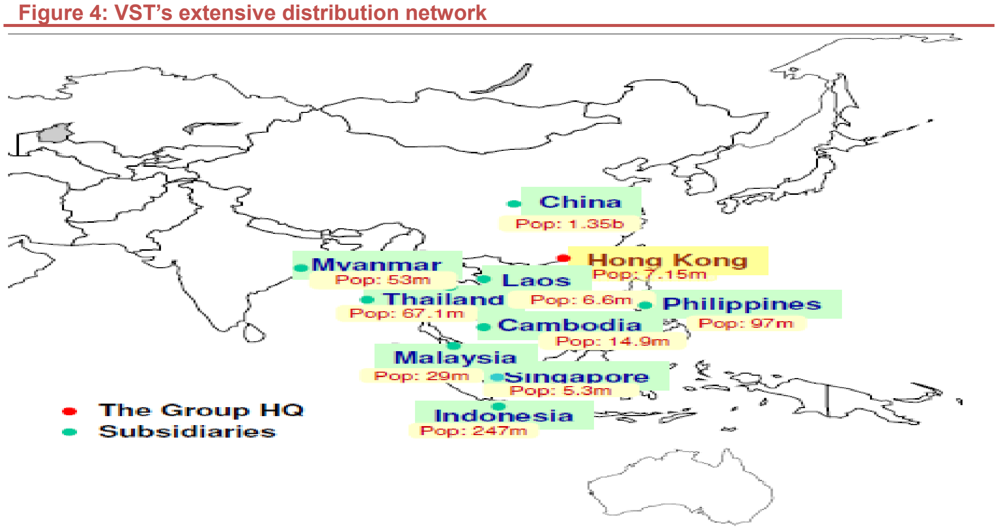
Figure 3: VST's wide range of IT products under distribution

Wide range of products

Sources: Company data, CGIHK Research

Figure 4: VST's extensive distribution network

Covering 1.8bn people in Asia



Sources: Company data, CGIHK Research

Figure 5: VST's channel partners and branches

	Channel Partners	Branches
China	12,000	42
Thailand	4,500	13
Malaysia	4,400	6
Singapore	1,500	2
Indonesia	3,500	9
Philippines	3,000	4
Laos	300	1
Myanmar	500	2
Cambodia	300	2
Total	30,000	81

Sources: Company data, CGIHK Research

2) Well-managed working capital

Stable gross margin

VST's gross margin ranged from 3.77% to 4.75% in 2009-1H2014 with cost of sales comprised mainly the value of supplies purchased from various vendors or brands. Despite concerns triggered by the low gross margin, the group has a good track of maintaining its gross margin level. We also believe VST is able to maintain a stable overall margin trend through investment in products and exploring new business opportunities going forward. Lower gross margin is also a natural barrier to newcomers to this industry. Without extensive distribution and sophisticated inventory management system, a smaller player will easily will be hit by fast changing IT products trends.

Good cost control

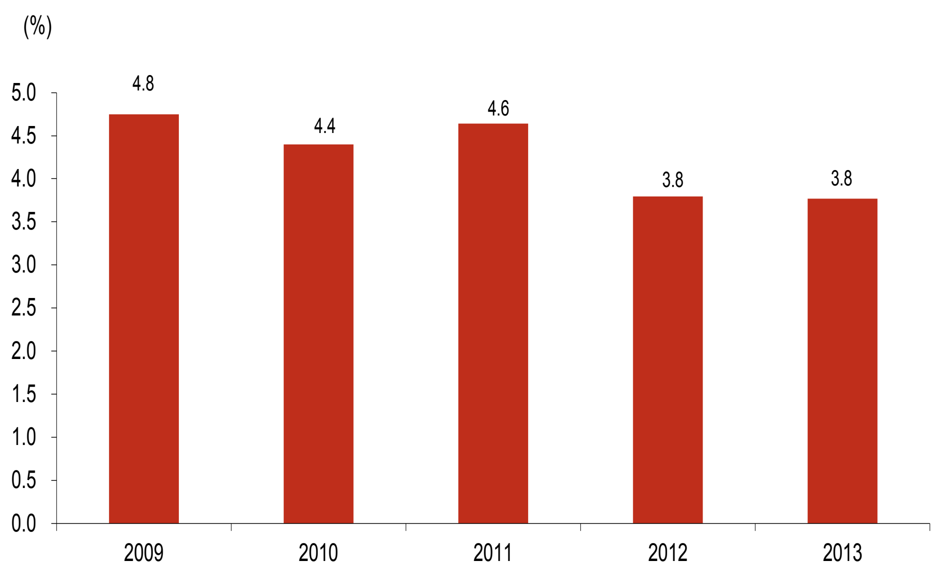
Apart from gross margin, VST also has good track record in controlling operating expenses and enhancing internal efficiencies. The group's operating expenses-to-sales ratio was kept low at an average of 2.5% in 2009-1H 2014. As VST continues to focus on improving internal efficiencies, we expect operating expense-to-sales ratio to stay steady at the current low level as business volume scales up.

VST's operational managers are given strict targets to minimize costs and their KPIs are designed to align with the group's overall goal of maintaining a lean cost structure and healthy working capital turnover. Operational KPI is based on several factors such as collection period and bad debt write-down of the client portfolio. The group's sales, finance and account management functions are grouped under a single department for better management.

Balance sheet is well-managed

Concerns on VST's balance sheet as increasing exposure to the enterprise segment and strong top-line growth imply a substantial increase in working capital requirement. VST has no difficulty securing loan facilities from banks. The group's net gearing is expected to remain at about 50% to 60%. Majority of VST's interest-bearing bank borrowings, part of which through invoice financing, are denominated in USD/HKD and mainly raised in Singapore/Hong Kong.

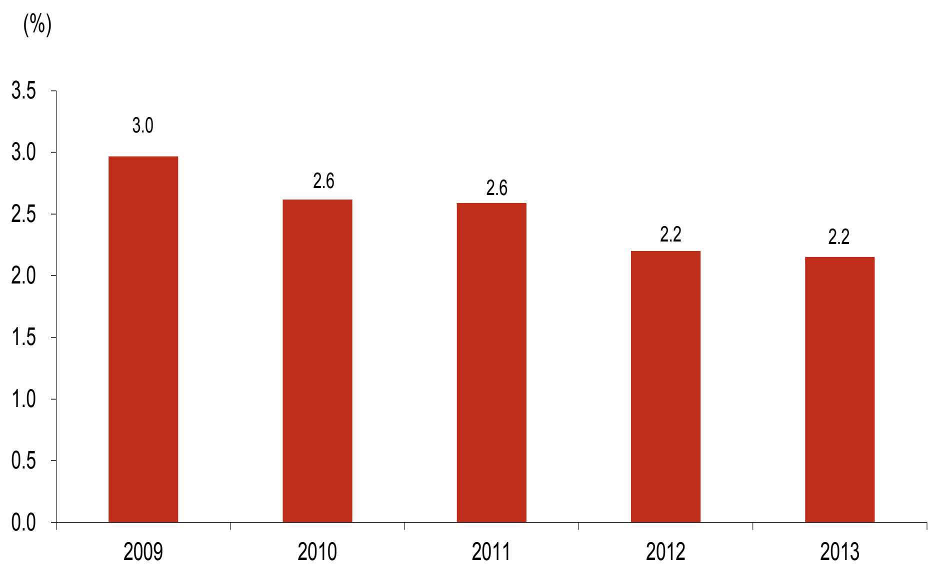
Figure 6: VST's gross margin trend



Sources: Company data, CGIHK Research

Operating expenses as % of turnover is coming down

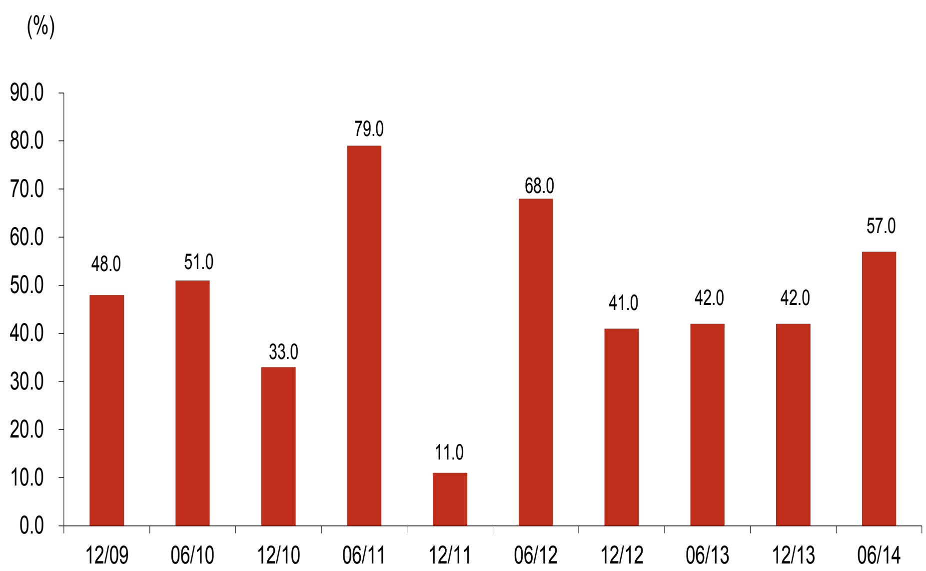
Figure 7: VST's operating expenses as percentage of turnover



Sources: Company data, CGIHK Research

Healthy balance sheet

Figure 8: VST's Net Gearing Trend



Sources: Company data, CGIHK Research

3) Opportunity from booming online sales

Change in distribution model

Under the traditional distribution model, a distributor purchases products from its suppliers at a negotiated price/quantity. The distributor carries inventory risk, and bears responsibility to manage the inventory to ensure adequate supply of the right products in its channel. The distributor sells these goods to its channel partners at a mark-up. The mark-up varies from product to product. Gross margin for consumer electronics ranges from 4% to 6%. The enterprise system hardware offers a gross margin of 8% to 10%. Traditional model is designed to help branded OEMs to penetrate into markets where they do not have distribution channels.

Online retailers Taobao, JD.com and Dangdang are expanding their offering of consumer electronics and IT products. National retail chains including Suning and Gome have also created online shopping platforms to complement their traditional stores. Online retailers generally employ a buy and fulfilment model for consumer electronic and IT products. Under this model, channels will negotiate price/quantity with their suppliers for typically higher ASP products and other better selling products. For these products, online retailers will want to buy directly form their suppliers to reap higher margins that would have normally gone to the distributors and online retailers who have to take on inventory risk.

In China market, leading distributors can still deliver significant services to their services and channel partners in tier 4-6 cities and rural China. In these cities, distributors still enjoy advantage of extensive channel coverage, whereas online shopping may not be as prevalent due to lower internet penetration and local consumer electric products stores still dominate retail market. Distributors can capitalize on their key value-addition of channel coverage among local retailers, wholesalers, value-added resellers, system integrators.

Opportunity instead of threat

Regarding concerns on competition from online electronics resellers, VST's management said vendors would unlikely be fully reliant on online resellers given their limited distribution channels and less logistic support. On the contrary, internet resellers such as JD.com, Yixun, Gome.com.cn, Suning.com and Bhinneka.com accounted for 8.1% of total turnover in 1H FY14, up from 7.5% in FY13. Online resellers are happy to cooperate with VST given less pressure on working capital requirement. Growing e-commerce sales have limited or even no negative effect on VST.

New distribution model will grow

Figure 9: Comparison of distribution model

Distribution model	Services offered	Risk factors	Customers	Future Trend	Gross margin
Buy/Sell and Fulfillment	Buy & sell product/goods at specified quantity/price	Inventory and A/R, and complex channel network	Local dealers, IC malls, VAR/Si, SMEs	Decline due to blooming e-Commerce	Consumer products: 4-5% Enterprise products: 8-10%
Buy and Fulfillment	Inventory management, and/or offering channel financing	Financing risk (distributor not own inventory	Retailers, Online resellers, telco, OEM Brand stores	Growing due to booming e-Commerce	Consumer products: 3-4% Enterprise products: 6-8%
Fulfilment	Provides inventory warehousing and transportation	Without control on price/quantity	OEM/Branded customers	Rising due to increasing brand recognition	Consumer products: 2-3%

Sources: Company data, CGIHK Research

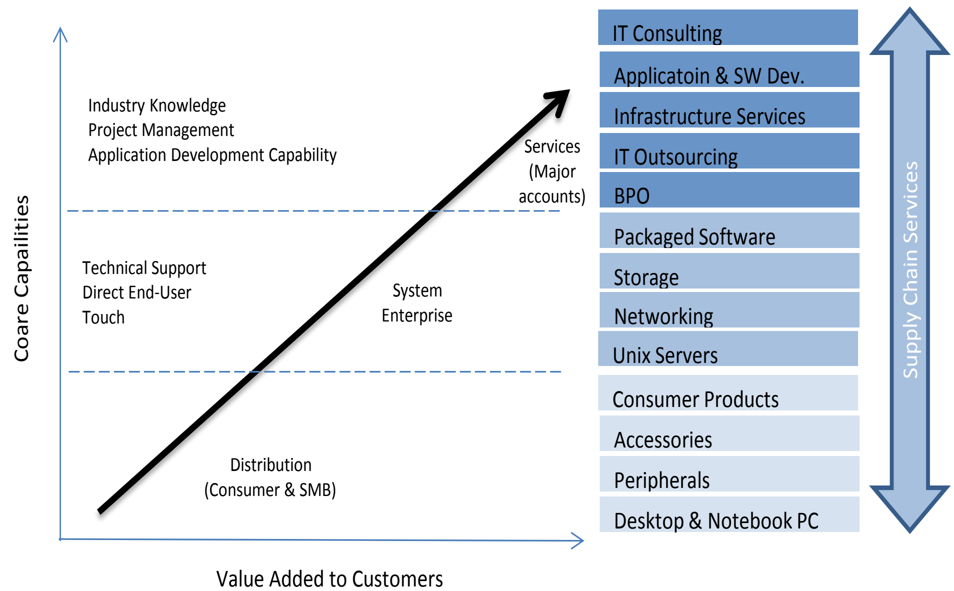
3) Moving up the supply chain

More contribution from services

The IT services segment is a growth area where companies such as Digital China and VST are making headway as they transform themselves to become more all-round service providers. Government, finance, telecom and manufacturing were among the top spenders in IT services in China. Currently ~60% of IT spending in China is on hardware, with the remaining ~40% on software and service. Since the IT spending ratio for hardware, software, and service is roughly 1:1:1 in developed countries such as the US, it is expected that there will be a shift in IT spending trends in China towards the optimal ratio. IT services now only account for 1% of VST's total turnover in 2013 and 1H14. We expect VST with IT services capabilities to grow the IT services segment to capture the growth potential from increasing spending on IT services.

Moving up the ladder

Figure 10: VST's current product/services



Sources: Company data, CGIHK Research

Earnings forecast

- **VST is projected to deliver earnings growth of 13.5%/18.0%/15.4% in 2014E/ 2015E/ 2016E, supported by a steady in turnover growth, tight cost control and good working capital management.**

Steady growth in 2014-2016

- We expect VST to report turnover growth of 4.3% YoY, 8.4% YoY and 8.3% YoY respectively in 2014E, 2015E and 2016E. The group's top line growth is supported by growth of enterprise system segment and IT Services. We conservatively assumed VST's distribution segment to report YoY turnover growth of 2%, 5% and 5% in 2014, 2015 and 2016 respectively. Any pick up growth in distribution segment will offer upside surprise. We also forecast that VST's enterprise system segment and IT services segment will report over 20% YoY in 2014-2016 given continuous growth of IT spending in the region.

Improvement in gross margin

- We expect gross margin to improve from 3.8% in 2013 to 4.0% in 2014 and 4.1% in 2015 given increasing contribution from higher margin products & services. Enterprise system segment and IT services segment offer higher gross margin. We also expect VST's net margin to improve to 1.4% in 2016 from 1.3% in 2014 due to improvement in gross margin and tight cost control.

- VST has a healthy balance sheet. There is a concern on VST's balance sheet as increasing exposure to the enterprise segment and strong top-line growth imply a substantial increase in working capital requirement. VST has no difficulty securing loan facilities from banks. The group's net gearing is expected to remain at about 50% to 60%. Majority of VST's interest-bearing bank borrowings, part of which through invoice financing, are denominated in USD/HKD and mainly raised in Singapore/Hong Kong.

Figure 11: Key assumptions for VST

	2010	2011	2012	2013	2014F	2015F	2016F
Turnover (HKDm)							
Computer Products & Consumer Electronics Products Distribution	19,617.9	26,772.5	29,998.2	31,953.9	32,593.0	34,222.6	35,933.7
Provision of Enterprise Systems	6,455.3	5,669.7	6,873.9	8,064.4	9,112.8	10,935.3	13,122.4
Provision of Computer Services	139.4	174.8	225.5	221.0	254.1	317.7	397.1
Total	26,212.6	32,617.1	37,097.6	40,239.3	41,959.9	45,475.6	49,453.2
YoY Change (%)							
Computer Products & Consumer Electronics Products Distribution		36.5	12.0	6.5	2.0	5.0	5.0
Provision of Enterprise Systems			21.2	17.3	13.0	20.0	20.0
Provision of Computer Services					15.0	25.0	25.0
Total		24.4	13.7	8.5	4.3	8.4	8.7
Gross margin (%)							
Computer Products & Consumer Electronics Products Distribution	4.4	3.9	3.1	3.1	3.3	3.3	3.3
Provision of Enterprise Systems	28.0	8.0	6.5	6.5	6.7	6.7	6.7
Provision of Computer Services	14.0	10.0	9.0	9.0	9.0	9.0	9.0
Net margin (%)	1.4	1.4	1.2	1.2	1.4	1.5	1.6
Cost (HKDm)							
S,G&A	(686.1)	(845.0)	(816.8)	(866.0)	(907.7)	(990.2)	(1,076.0)
Financial Expenses	(60.6)	(103.7)	(75.9)	(81.2)	(101.6)	(107.9)	(115.0)
YoY Change (%)							
S,G&A		23.2	(3.3)	6.0	4.8	9.1	8.7
Financial Expenses		71.2	(26.8)	7.0	25.1	6.2	6.6
CAPEX (HKDm)	21.1	31.0	13.8	14.9	17.1	19.7	22.7
Net Gearing (%)	35.5	11.5	44.3	45.2	40.6	33.3	26.4

Sources: Company, CGIHK Research

Figure 12: Earnings projection

Income Statement (HKDm)	FY2012	FY2013	FY2014F	FY2015F	FY2016F
Revenue	**37,098**	**40,239**	**41,960**	**45,476**	**49,453**
Growth yoy%	*13.7%*	*8.5%*	*4.3%*	*8.4%*	*8.7%*
Gross Profit	**1,408**	**1,517**	**1,693**	**1,873**	**2,083**
Growth yoy%	*(7.0%)*	*7.8%*	*11.6%*	*10.7%*	*11.2%*
Selling General & Admin Exp.	(817)	(866)	(908)	(990)	(1,076)
Others Operating Expenses/Items	13	48	10	11	11
Operating Income	**604**	**699**	**795**	**894**	**1,018**
Growth yoy%	*n.a.*	*15.7%*	*13.8%*	*12.4%*	*13.9%*
Interest Expense	(75.9)	(81.2)	(101.6)	(107.9)	(115.0)
Interest and Invest. Income	7.8	8.5	10.5	12.6	15.2
Income/(Loss) from Affiliates	36.3	32.9	34.6	36.3	38.1
Other Non-Operating Inc. (Exp.)	0	0	0	0	0
Impairment of Goodwill	-	-	-	-	-
Gain (Loss) On Sale Of Invest.	-	-	-	-	-
Gain (Loss) On Sale Of Assets	-	-	-	-	-
Income Tax Expense	(107)	(134)	(143)	(154)	(177)
Minority Int. in Earnings	(20)	(22)	(25)	(8)	(2)
Net Income	**444**	**503**	**571**	**673**	**777**
Growth yoy%	*(3.9%)*	*13.1%*	*13.5%*	*18.0%*	*15.4%*

Cash Flow Statement (HKDm)	FY2012	FY2013	FY2014F	FY2015F	FY2016F
Net Income	**604**	**699**	**795**	**894**	**1,018**
Depreciation & Amort.	19	20	21	22	24
Change in Working Capital	(1,347)	(585)	(599)	(417)	(472)
Cash from Ops.	**(725)**	**134**	**217**	**499**	**570**
Capital Expenditure	(14)	(15)	(17)	(20)	(23)
Sale of Property, Plant, and Equipment	-	-	-	-	-
Change in Investing Acitivities	14	(12)	(10)	(2)	(4)
Cash from Investing	**1**	**(27)**	**(28)**	**(22)**	**(27)**
Net increase in bank borrowings	380	438	336	188	213
Issuance of Common Stock	0	0	90	0	0
Common Dividends Paid	(99)	(99)	(120)	(131)	(135)
Special Dividend Paid	-	-	-	-	-
Other Financing Activities	(248)	(192)	(219)	(233)	(259)
Cash from Financing	**33**	**146**	**88**	**(176)**	**(180)**
Net Change in Cash	**(691)**	**253**	**277**	**301**	**362**

Balance Sheet (HKDm)	FY2012	FY2013	FY2014F	FY2015F	FY2016F
ASSETS					
Cash And Equivalents	936	1,169	1,440	1,732	2,086
Receivables	5,340	6,861	7,566	8,200	8,918
Inventory	2,723	2,644	2,758	2,989	3,250
Other Current Assets	0	0	0	0	0
Total Current Assets	**9,000**	**10,674**	**11,764**	**12,921**	**14,254**
Net Property, Plant & Equipment	123	116	112	109	108
Long-term Investments	-	-	-	-	-
Other Intangibles	-	-	-	-	-
Deferred Tax Assets, LT	-	-	-	-	-
Other Long-Term Assets	725	738	786	826	868
Goodwill	-	-	-	-	-
Accounts Receivable Long-Term	-	-	-	-	-
Total Long Term Assets	**848**	**853**	**898**	**935**	**976**
Total Assets	**9,847**	**11,528**	**12,662**	**13,856**	**15,230**
LIABILITIES & EQUITY					
Accounts Payable	4,266	5,125	5,345	5,792	6,299
Accrued Exp.	-	-	-	-	-
Short-term Borrowings	1,547	2,002	2,248	2,436	2,649
Curr. Port. of LT Debt	-	-	-	-	-
Curr. Income Taxes Payable	-	-	-	-	-
Unearned Revenue, Current	-	-	-	-	-
Other Current Liabilities	26	31	35	38	42
Total Current Liabilities	**5,840**	**7,159**	**7,627**	**8,266**	**8,990**
Long-Term Debt	719	696	787	787	787
Def. Tax Liability, Non-Curr.	30	37	41	45	50
Other Non-Current Liabilities	24	15	16	17	18
Total Liabilities	**6,613**	**7,907**	**8,471**	**9,116**	**9,845**
Common Stock	124	149	153	153	153
Additional Paid In Capital	-	-	-	-	-
Retained Earnings	2,877	3,239	3,780	4,322	4,964
Treasury Stock	-	-	-	0	0
Comprehensive Inc. and Other	-	-	-	-	-
Minority Interest	234.0	231.9	257.0	264.5	266.8
Total Equity	**3,235**	**3,620**	**4,190**	**4,739**	**5,384**
Total Liabilities And Equity	**9,847**	**11,528**	**12,661**	**13,855**	**15,229**

Ratios	FY2012	FY2013	FY2014F	FY2015F	FY2016F
Profitability					
Return on Assets %	4.8%	4.7%	4.7%	5.1%	5.3%
Return on Capital %	10.0%	9.7%	9.8%	10.2%	10.5%
Return on Equity %	15.9%	15.7%	15.6%	16.0%	16.2%
Margin Analysis					
Gross Margin %	3.8%	3.8%	4.0%	4.1%	4.2%
SG&A Margin %	2.2%	2.2%	2.2%	2.2%	2.2%
EBIT Margin %	1.6%	1.8%	1.9%	2.0%	2.1%
EBITDA Margin %	1.7%	1.8%	2.0%	2.0%	2.1%
Net Income Margin %	1.2%	1.2%	1.4%	1.5%	1.6%
Asset Turnover					
Total Asset Turnover	3.8x	3.5x	3.3x	3.3x	3.2x
Fixed Asset Turnover	43.8x	47.2x	46.7x	48.6x	50.7x
Accounts Receivable Turnover	7.9x	6.6x	5.8x	5.8x	5.8x
Inventory Turnover	13.6x	15.2x	15.2x	15.2x	15.2x
Liquidity					
Current Ratio	1.5x	1.5x	1.5x	1.6x	1.6x
Quick Ratio	1.1x	1.1x	1.2x	1.2x	1.2x
Avg. Days Sales Out.	52.5	62.2	65.8	65.8	65.8
Avg. Days Inventory Out.	26.8	24.0	24.0	24.0	24.0
Avg. Days Payable Out.	40.9	44.3	47.5	46.6	46.6
Avg. Cash Conversion Cycle	38.4	40.7	44.3	44.3	44.4
Net Debt to Equity	44%	45%	41%	33%	26%
Growth Over Prior Year					
Total Revenue	13.7%	8.5%	4.3%	8.4%	8.7%
Net Income	(3.9%)	13.1%	13.5%	18.0%	15.4%
Payout Ratio %	21.7%	26.8%	23.7%	22.5%	20.0%

Sources: Company, CGIHK Research

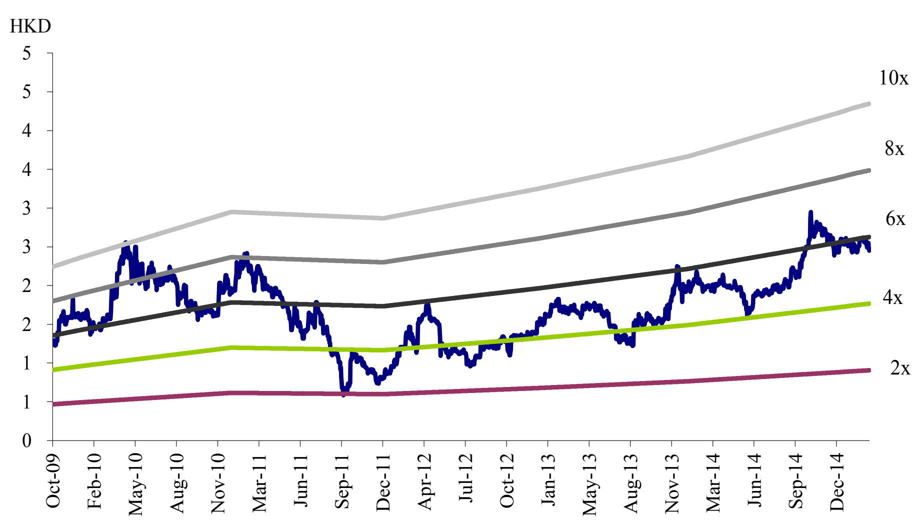
Valuation

Inline with historical average, and deep discount to peers

VST is trading at 6.8x 2014E PER and 5.9x 2015E PER, in line with its historical average of 6x since 2009. There are market concerns on outlook for hardware distributors due to potential slowdown in IT spending and competition from online re-sellers. However, we expect VST will still be able to achieve solid top and bottom line growth between 2014E and 2016E given: a) the steady growth of distribution business, b) increasing contribution from enterprise system and IT services segment and c) expanding product offering and geographical coverage.

In terms of PER, VST is trading at a discount to HK-listed peers, which are on an average 2015 PER of 14.5. The group is also trading at a substantial discount to overseas listed peers of 10.9x 2015 PER. We share the view that the market is unlikely to give high valuation to pure hardware distributors like VST. However, the re-rating of distributors including Cogobuy [400.HK] and Eternal Asia should boost sentiment on VST. Increasing contribution from the group's software/services makes VST an indirect proxy to continuous IT spending in the region. We are initiating coverage on VST with a BUY rating and target price of HK$3.25 based on 8.5x 2014E PER (higher than historical average of 6x but discount to its peer). Our target PER is lower than average of its peers of 2015 PER of 11.0x. Share price catalysts come from more news flow on development of online platform, M&A, strong operating performance and co-operation with industry players.

Figure 13: VST PER trend



Sources: Bloomberg, CGIHK Research estimates

Figure 14: Peer comparison

Ticker	Company			PE			EV/EBITDA			P/B		ROE		ROA		Div yield	
		Price	Market Cap	2014F	2015F	2016F	2014F	2015F	2016F	2013	2014F	2013	2014F	2013	2014F	2013	2014F
		Lcy	US$m	x	x	x	x	x	x	x	x	%	%	%	%	%	%
HK Listed Software plays																	
856 HK	**VST**	**2.59**	**509**	**6.8**	**5.9**	**5.1**	**7.0**	**6.1**	**5.3**	**1.1**	**0.9**	**15.7**	**15.6**	**4.8**	**4.7**	**3.1**	**3.3**
400 HK	Cogobuy	4.69	814	20.7	14.2	10.0	21.0	13.3	10.1	9.2	3.0	44.0	38.2	n.a.	7.9	n.a.	n.a.
1297 HK	Sinosoft Technology Group Lt	3.29	437	19.1	15.3	12.8	12.4	9.7	7.9	4.4	4.0	23.6	18.8	17.9	16.8	0.6	1.4
354 HK	Chinasoft International Ltd	2.84	686	21.6	15.9	12.2	11.8	9.6	7.7	2.8	1.7	7.1	8.6	4.6	4.4	0.0	n.a.
268 HK	Kingdee International Sftwr	2.81	933	27.3	21.8	18.0	10.1	8.9	7.7	3.1	3.1	7.6	12.1	4.9	6.0	0.0	0.4
1588 HK	Chanjet Information Tech-H	15.14	423	17.4	14.3	12.0	24.3	17.9	n.a.	2.2	2.2	22.4	14.9	n.a.	12.8	n.a.	3.4
861 HK	Digital China Holdings Ltd	7.20	1,014	9.2	7.9	7.3	11.0	9.6	8.6	1.0	0.9	3.9	9.8	0.4	3.1	2.5	3.0
2280 HK	Hc International Inc	7.10	610	17.2	12.0	8.2	9.5	6.5	4.9	n.a.	3.1	24.7	22.1	n.a.	10.4	0.0	n.a.
1184 HK	Sas Dragon Holdings Ltd	1.82	146	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1.3	n.a.	24.7	n.a.	5.3	n.a.	7.1	n.a.
Average				**18.6**	**14.5**	**11.7**	**13.2**	**10.4**	**7.4**	**2.3**	**2.5**	**16.2**	**14.4**	**6.3**	**8.9**	**1.9**	**2.0**
Overseas Listed Distributors																	
AVT US	Avnet Inc	44.39	6,054	9.7	9.0	8.5	6.5	6.2	5.9	1.3	1.2	11.0	11.6	5.2	5.6	1.4	1.4
ARW US	Arrow Electronics Inc	59.68	5,708	9.5	8.9	8.7	6.9	6.6	6.2	1.4	1.2	9.8	12.9	4.1	4.8	0.0	0.0
3702 TT	Wpg Holdings Ltd	39.75	2,078	10.1	9.6	n.a.	12.6	11.8	n.a.	1.6	1.5	12.2	14.8	3.7	4.1	n.a.	7.0
ECM LN	Electrocomponents Plc	243.30	1,582	19.0	17.6	15.9	10.5	9.8	9.1	2.9	2.9	15.9	15.6	9.6	n.a.	4.8	4.8
3036 TT	Wt Microelectronics Co Ltd	48.55	624	9.9	9.1	8.5	11.8	9.8	9.3	1.3	1.3	11.4	14.0	4.4	4.6	n.a.	6.4
Average				**11.7**	**10.9**	**10.4**	**9.7**	**8.8**	**7.6**	**1.7**	**1.6**	**12.1**	**13.8**	**5.4**	**4.8**	**2.1**	**3.9**
Overseas Listed Online Platforms																	
BABA US	Alibaba Group Holding-Sp Adr	81.86	201,785	37.8	29.2	21.8	32.3	23.6	17.3	9.3	9.3	n.a.	30.9	14.3	17.3	0.0	0.0
JD US	Jd.Com Inc-Adr	28.08	38,803	423.7	87.1	45.0	n.a.	104.6	28.7	6.4	8.2	-165.4	-0.4	n.a.	-1.4	n.a.	0.0
DANG US	E-Commerce China-Spon Adr -A	8.24	665	40.2	17.7	8.9	17.7	8.0	4.3	6.5	6.2	-21.8	15.2	1.9	1.8	0.0	0.0
LITB US	Lightinthebox Holding-Adr	4.47	227	n.a.	n.a.	n.a.	n.a.	174.8	n.a.	5.3	n.a.	n.a.	n.a.	-26.0	n.a.	0.0	n.a.
JMEI US	Jumei International-Adr	13.07	1,871	23.9	18.3	12.8	16.2	11.4	7.3	17.7	3.4	52.1	23.3	18.8	18.9	0.0	0.0
GSOL US	Global Sources Ltd	5.55	165	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1.0	n.a.	17.7	n.a.	4.1	n.a.	0.0	n.a.
Average				**131.4**	**38.1**	**22.1**	**22.1**	**64.5**	**14.4**	**7.7**	**6.8**	**-29.4**	**17.3**	**2.6**	**9.2**	**0.0**	**0.0**

Sources: Bloomberg, Company, CGIHK Research estimates for covered stocks

Major risk factors

Vendor concentration risk. High vendor concentration can be risky to the IT hardware distributors. VST and its subsidiaries have been making significant progress in diversifying its vendor platform since 2010.

Working capital management risk. Working capital (receivables and inventory) management is critical to hardware distributors as most of their balance sheets are tied up in working capital. VST and its subsidiaries interact with hundreds of vendors and customers on a regular basis. It is an ongoing trade-off for procurement and sales managers to decide whether to take on extra inventory (fighting for vendor market share) and risk having to mark down inventory should demand for products be weaker than anticipated, as well as selling product to customers on credit that would later be written off as bad debt. As we have discussed previously, one of VST's key operational advantages over its larger peers is that its sales, inventory and account functions are grouped under a single unit, so that maximizing operating profit goals are aligned. Because of this structure, VST was able to quickly reduce its working capital in order to pay down short-term borrowing during the 2008/09 financial crisis.

Foreign exchange risk. VST's primary forex exposure is the conversion of RMB into US dollars. A major portion of VST's revenue comes from China where revenue is generated in RMB through onshore sales but payments to vendor for inventory is done through offshore accounts in USD. According to management, the group can pass on the impact of major currency movement to its major corporate accounts. VST hedged its position denominated in other Asian currencies especially Indonesia. Therefore, VST didn't report major exchange losses in last several years despite volatile exchange rate movement.

Liquidity risk. Given the working capital-intensive nature of VST's distribution business, maintaining healthy financial leverage is important. Much of VST's working capital needs is financed by unsecured bank financing.

China slowdown remains biggest risk. The biggest downside risk to our view on distributors is a sudden slowdown in IT spending in China in both consumer and commercial segments. Demand for IT products depends heavily on companies' earnings and consumers' disposable income, both of which are highly correlated to the overall health of the economy. Any slowdown or reversal of economic recovery in China, driven by events such as an asset bubble burst, slower-than-expected global economic recovery or a sudden change in market sentiment, would hurt IT demand. Termination of government subsidies might also slow down demand for consumer electronics in China.

Company background

Found in 1991, VST was listed on HKEX in Feb 2002. In 2007 the group acquired ECS for HK$1.45bn, which was financed through a HK$550m share placement and a bridging loan. VST is one of the leading IT product distribution an services company in Asia-Pacific, specializing in the distribution of the internationally renowed information technology products and related accessories, including PC, notebook, tablet computer, CPU, hard disk, memory accessories and other digital media products. The group built a solid cooperation and a long-term relationship with world famous information technology companies, including HP, Apple, Seagate, AMD, Intel, Western Digital, Dell, Lenovo, IBM, Acer, Oracle, Sun Microsystems, Microsoft, Cisco, Buffaloland, Hitachi. VST has more than 30,000 distribution channel partners serving a wide regional customer base and has 81 offices in nine countries including China, Thailand, Malaysia, Singapore, Indonesia and the Philippines.

Its business operations are categorised under three reporting segments: Distribution, Enterprise Systems, and IT Services.

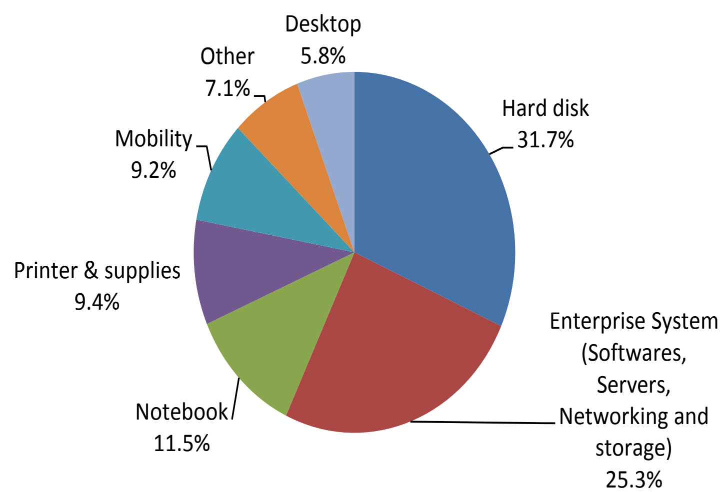
Distribution: VST is specialised in the distribution of a wide range of consumer and commercial IT products such as desktop PCs, notebooks, printers, as well as related computer components, including hard disks, CPUs, memory and other peripherals.

Enterprise Systems: VST caters for the IT equipment requirements of large enterprise customers from the government, financial, telecom, education and industrial sectors, mainly including servers, databases, storage and networking devices.

IT Services: VST carries out IT system infrastructure design, implementation and post-sales maintenance, training and support services.

Distribution segment represented 74% of total revenues in 1H14, whereas Enterprise Systems and IT Services accounted for 25% and 1% of revenues respectively.

Figure 15: VST's product mix



Sources: HKEX, Company, CGIHK Research

Figure 16: VST's shareholding structure

Name	Shares (m)	% of total outstanding
Li Jialin	563.8	36.96%
Eternal Asia	242.2	15.88%
Fidelity	163.8	10.74%
Others	555.4	36.42%
Total	1,525.2	100.00%

Sources: Company data, CGIHK Research

Appendix: Selected Management Profile

Mr. LI Jialin, Chairman and Chief Executive Officer, is responsible for the overall management and strategic positioning of the group. As one of the group founders, Mr Li is also the director of VST Computer (H.K.) Limited, a subsidiary of VST. Mr Li graduated from Tsinghua University of the People's Republic of China with a Degree of Bachelor of Engineering in 1983 and a Master Degree in Management Engineering in 1986.

Ms CHOW Ying Chi, Executive Director and Group Chief Operating Officer, has been with the group since 1996. Ms Chow started working in the business development for the East and North China region and was appointed as operation director of the group in 2002. Currently, Ms Chow is the director of VST Computers and the executive director of ECS Technology (China) Limited, both are subsidiaries of the group. Ms Chow holds a Bachelor Degree of Arts (Honours) in International Business from the University of Huddersfield in the United Kingdom.

Mr ONG Wei Hiam William is an Executive Director and the Chief Financial Officer of the group. Mr Ong is also the director of VST Computers and the Chief Executive Officer of ECS Holdings limited, both are subsidiaries of the group. Mr Ong holds a Bachelor Degree in Economics from University College London and a Master Degree in Analysis, Design & Management of Information Systems from the London School of Economics and Political Science. Mr Ong is a member of the Institute of Chartered Accountants in England and Wales, and Fellow of the Hong Kong Institute of Certified Public Accountants. Prior to joining the group, Mr Ong served in a senior position at PriceWaterhouseCoppers and has extensive working experience in London and Hong Kong.

Mr. CHAN Hoi Chau, appointed as an Executive Director of the group in July 2009. He holds a Bachelor Degree in Electrical Engineering from the University of Wisconsin-Madison in the United States of America. Mr. Chan has over 20 years of experience in personal computer and semiconductor industry. Mr. Chan is currently the Senior Vice President — Product Management of VST Computers, a subsidiary of the Company. Prior to joining the Company in 2005, Mr. Chan served as the Distribution Director of Advanced Micro Devices and was in charge of the distribution business in China and Hong Kong.

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