

Technology	Last Close	Target Price	Upside	14 June 2018
	HK\$4.22	HK\$5.80↑	+37%	

## Lenovo Group (992 HK)

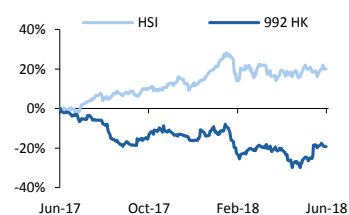
### Earnings to rebound; upgrade to non-consensus Buy

- Turning more confident in DCG:** We turn more confident in Lenovo's server business given (1) YoY growth in its server market share for the first time in six quarters to 6.5% in 1Q18 (vs. 5.8% in 1Q17), per Gartner data; (2) strong near-term order momentum; (3) strong ASP hike due to mix shift to Software-Defined Infrastructure (SDI) and High Performance Computing (HPC), with more room for growth; and (4) improving margins helped by better mix, but still meaningfully below industry average. We forecast 1QFY19 Data Center Business Group (DCG) revenue to rise 51% YoY on strong order momentum and mix shift towards HPC/SDI driving ASP. We expect pre-tax margin improvement to continue.
- PC still a cash cow; smartphone unlikely to get any worse:** We believe stabilizing memory prices and continued display pricing decline in the near term should help keep PC PTI margin stable at ~4.5-5.0%. We are encouraged by management commentary that smartphone restructuring is largely over (cutting cost in Asia-Pacific). While we remain cautious on its smartphone business, we believe it is unlikely to get any worse, and see goodwill write-down as less likely.
- Street earnings outlook overly pessimistic:** We believe the market remains overly pessimistic on Lenovo (high short sell ratios/mostly rated sell or neutral by the brokers). We expect FY19 pre-tax profit to reach US\$641m (vs. FY17/18 of US\$490m/153m), above Bloomberg consensus of US\$549m. We expect improving profit over the next 2-3 quarters and Street estimates upgrade to fuel a share rally. We expect Lenovo PTI to reach US\$91m/153m in 1Q/2QFY19 (vs. 1Q/2QFY18: US\$-69m/35m).
- Non-consensus Buy call; trading opportunity over next six months:** We raise our FY19/20E EPS by 3%/16% to reflect a more bullish outlook on DCG, partly offset by higher finance cost and minority interest (from selling of perpetual bond). We upgrade Lenovo from Neutral to **Buy**, and see trading opportunity in the next six months. We raise TP to HK\$5.80 on 13x FY20E P/E (from HK\$4.10 on 13x FY19E P/E).

#### Stock Rating

**BUY↑**

#### 1-year stock performance



Source: Bloomberg

#### Stock data

52w high (HK\$)	5.14
52w low (HK\$)	3.53
Market cap (HK\$ m)	50,702.42
Avg daily vol (m)	61.59
YTD change (%)	-4.31
200d MA (HK\$)	4.24

Source: Bloomberg

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#### Financial highlights

Y/E 31 Mar	2017	2018	2019E	2020E	2021E
Revenue (US\$ m)	43,035	45,350	49,344	51,091	52,425
YoY growth (%)	-4	5	9	4	3
Net profit (US\$ m)	535	(189)	471	680	861
EPS (US\$)	0.05	(0.02)	0.04	0.06	0.07
YoY growth (%)	21	NM	NM	79	40
Previous EPS (US\$)			0.04	0.05	NA
Change (%)			3	16	NA
P/E (x)	11.0	NA	13.3	9.2	7.3
BVPS (US\$)	0.21	0.22	0.20	0.20	0.22
P/B (x)	2.5	2.4	2.7	2.7	2.5
Dividend yield (%)	6.4	6.3	6.0	5.6	6.6

Source: Company data, BOCOM Int'l estimates

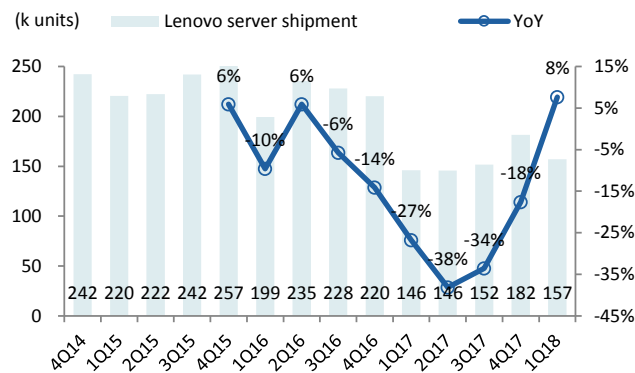
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## Server ASP Rising on Mix Improvement

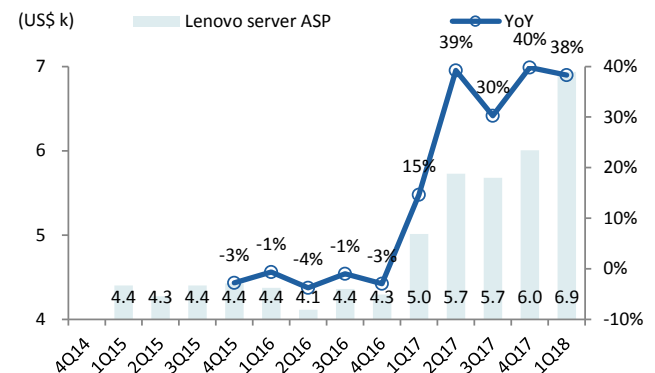
Driven by the decision to let go of lower-end hyper-scale business last year, and growth in SDI and HPC, we see a significant mix improvement in DCG driving ASP increase. Lenovo's server ASP rose from US\$4,000-5,000 per unit to ~US\$6,900 per unit as of 1Q18, per Gartner data, narrowing its ASP gap vs. HPE (HPE US) (~ US\$8,300 per unit). As Lenovo's server product mix remains sub-optimal vs. leaders such as HPE and Dell, we believe there is room for further ASP improvement, driving revenue growth and GPM rebound.

**Figure 1: Lenovo server shipment improving**



Source: Gartner, BOCOM Int'l

**Figure 2: Lenovo server ASP significantly rising**



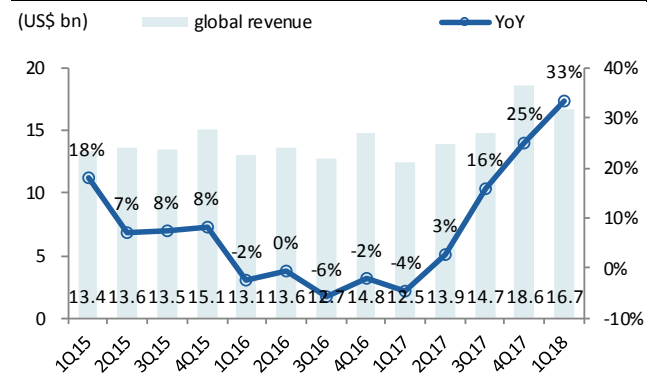
Source: Gartner, IDC, BOCOM Int'l

**Figure 3: Global server shipment rebounding since 2017**



Source: Gartner, BOCOM Int'l

**Figure 4: Global server revenue has grown faster than shipment**

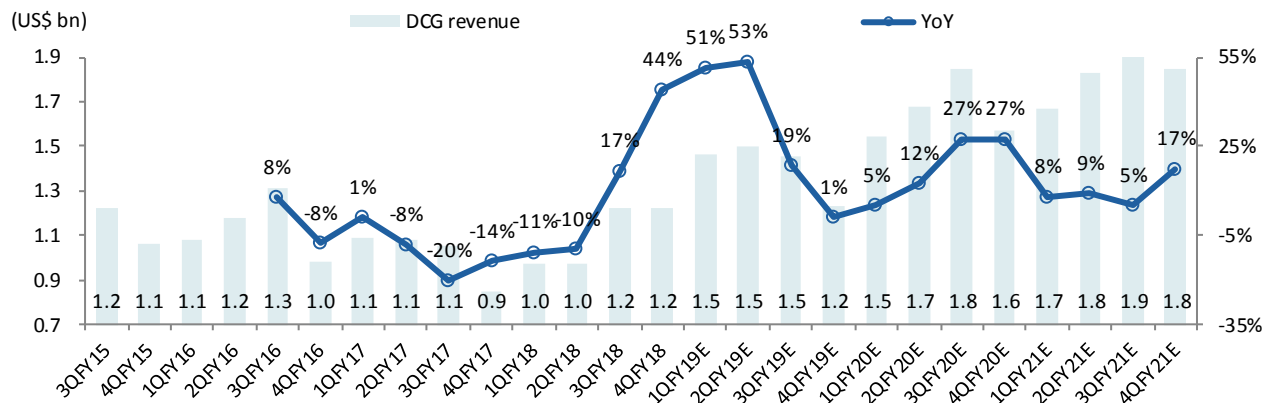


Source: Gartner, BOCOM Int'l

## DCG Strong Momentum to Continue

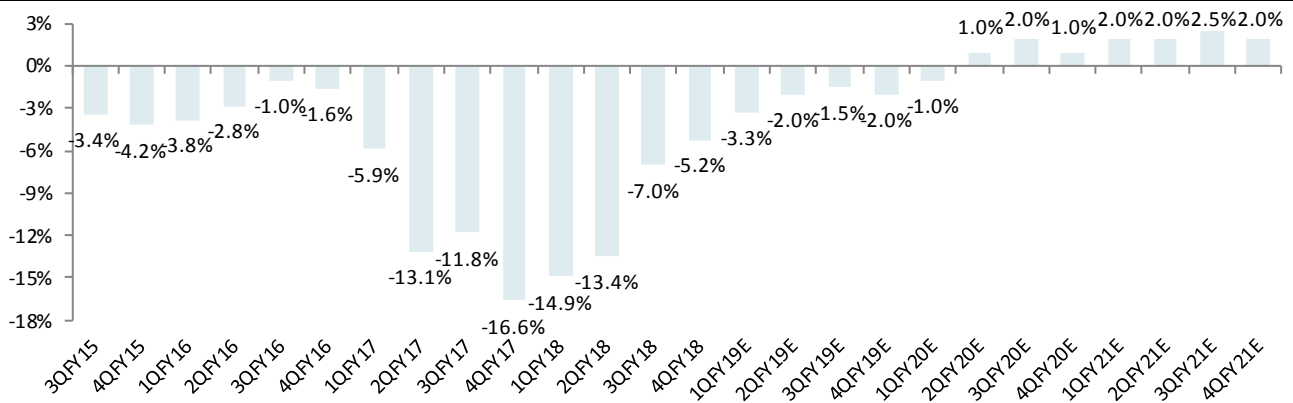
The server business typically has better order visibility than other consumer electronics products such as PC and smartphones. Our checks indicated that the near-term order momentum for Lenovo will likely continue, backed by strong market demand and its improved product portfolio. We expect Lenovo's DCG revenue to rise 51%/53% YoY in 1Q/2QFY19E. With bigger scale and better mix, we forecast DCG pre-tax margin to rise to -3.3%/-2.0% in 1Q/2QFY19E (vs. -14.9%/-13.4%/-5.2% in 1Q/2Q/4QFY18). We expect the improvement in DCG profitability to lead to earnings upgrade by the Street. The GPM of the DCG business is currently ~15% (vs. HPE GPM of 30%), with about US\$1bn in OPEX per year.

Figure 5: Expect DCG revenue growth momentum to continue



Source: Company data, BOCOM Int'l estimates

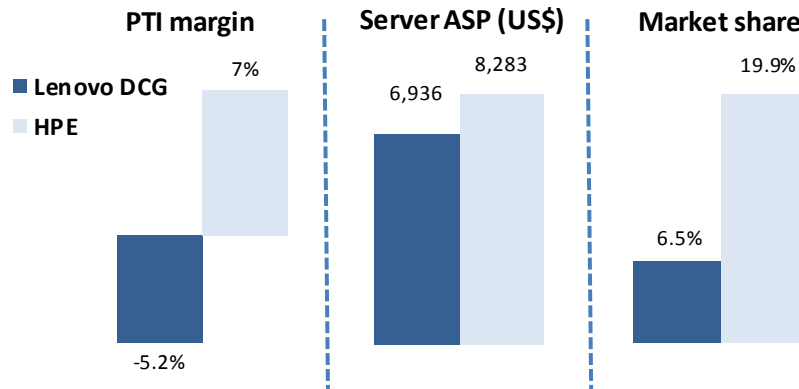
Figure 6: Expect DCG PTI margin to gradually improve



Source: Company data, BOCOM Int'l estimates

**Figure 7: Lenovo DCG margins have room for improvement vs. HPE**

1QCY18 results comparison of Lenovo DCG business and HPE



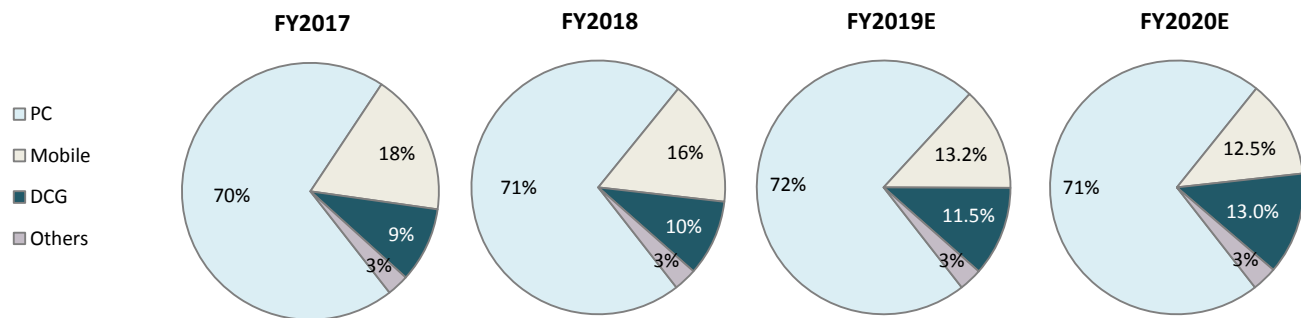
Source: Company data, Gartner, BOCOM Int'l \*HPE PTI calculation excludes the US\$123m transformation cost.

### DCG Revenue to Surpass Smartphones

While smartphones remain a drag, with the company further restructuring the business to narrow losses (lower market exposure in Asia-Pacific), we believe smartphones will have a lesser impact ahead with DCG becoming a bigger revenue contributor. We forecast DCG will account for 11.5%/13% of the company's revenue in FY19/20E (vs. 9%/10% in FY17/18). For smartphones, as the company exits some markets, we forecast revenue contribution to drop to 13.2%/12.5% in FY19/20E (vs. 18%/16% FY17/18).

**Figure 8: Expect DCG revenue to surpass smartphones**

Lenovo revenue breakdown by business segment

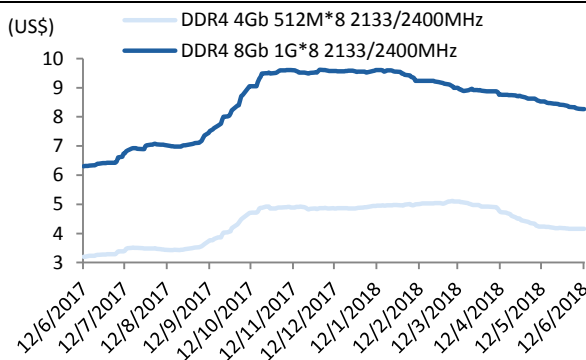


Source: Company data, BOCOM Int'l estimates

## PC Still a Cash Cow; Margins to Remain Solid

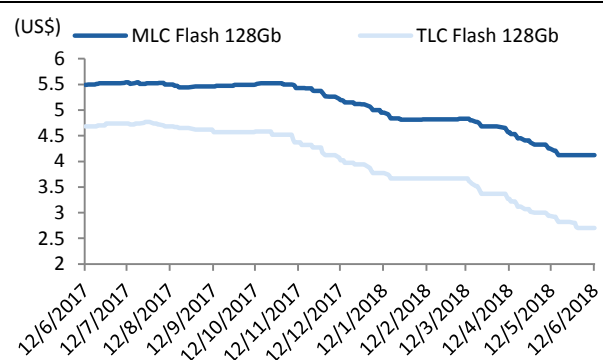
We see that stabilizing memory prices should continue to bode well for device profit margins, and should help keep PC PTI margin stable at ~4.5-5.0%, in our view. DDR 4 8Gb prices have fallen 14% YTD to about US\$8.25 (vs. YE17 of US\$9.55). NAND prices have dropped more severely, with TLC/MLC 128Gb down about 31%/19% YTD. Display prices remain weak, which should also help PC margins, but the impact is less significant. With the PC market stable and higher gaming/workstation mix to drive ASP increase, we expect the PC business to remain a cash cow for the company, delivering US\$1.65bn in FY19E pre-tax profit. We see USD appreciation as a downside risk to PC margins.

**Figure 9: DRAM price stabilizing**



Source: inSpectrum, Bloomberg, BOCOM Int'l

**Figure 10: NAND price declining**

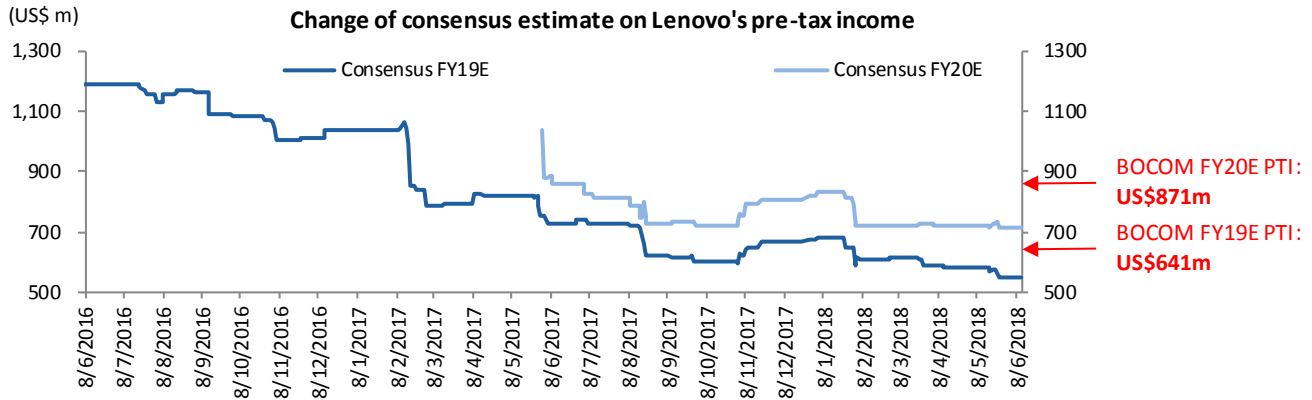


Source: inSpectrum, Bloomberg, BOCOM Int'l

## Street Overly Pessimistic; Expect Earnings Rebound; Upgrade to Buy

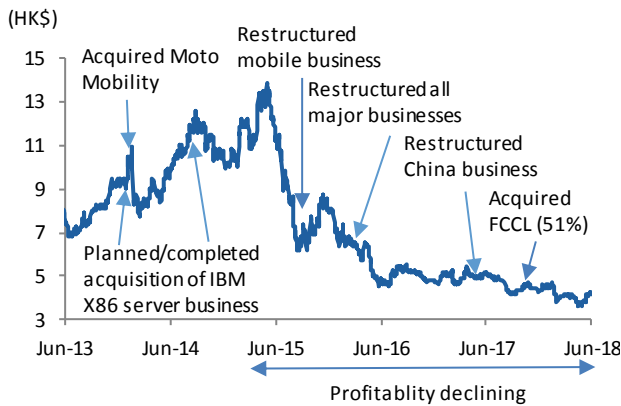
We believe Street's negative estimates revision is coming to an end, and expect earnings estimate upgrade to support share price. Currently, our FY19/20E pre-tax profits of US\$641m/871m are 17%/22% higher than Bloomberg consensus. Based on our understanding of short sell ratio over the past six months and investor sentiment, we believe the market is overly pessimistic on Lenovo's earnings outlook. Its share price has fallen 17% since June 2017, vs. Hang Sang Index's 20% rise. The shares currently trade at 13x/9x FY19/20E P/E based on our earnings estimates, vs. closest peers HP (HPQ US)/Asustek (2357 TW) of 11x/12x CY19E P/E (consensus). We lift TP from HK\$4.10 to HK\$5.80, based on 13x FY20E P/E. We see trading opportunity over the next six months. Upgrade from Neutral to **Buy**.

**Figure 11: We believe Street is overly pessimistic on earnings**



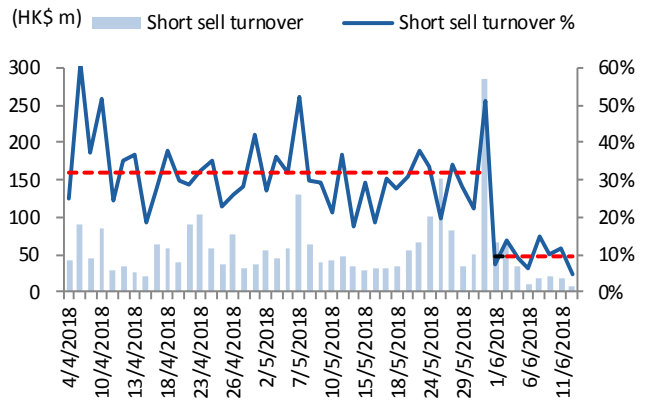
Source: Bloomberg, BOCOM Int'l estimates

**Figure 12: Lenovo share price history**



Source: Bloomberg, BOCOM Int'l

**Figure 13: Short interest ratio declined recently**



Source: Bloomberg, BOCOM Int'l

Figure 14: Lenovo quarterly forecasts and key assumptions

Lenovo consolidated (992 HK)	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Mar-17	Mar-18	Mar-19	Mar-20	Mar-21
US\$ m (FY end March)	1QFY18	2QFY18	3QFY18	4QFY18	1QFY19E	2QFY19E	3QFY19E	4QFY19E	1QFY20E	2QFY20E	3QFY20E	4QFY20E	FY17	FY18	FY19E	FY20E	FY21E
<b>Revenue</b>	<b>10,012</b>	<b>11,761</b>	<b>12,939</b>	<b>10,638</b>	<b>11,657</b>	<b>12,593</b>	<b>13,613</b>	<b>11,482</b>	<b>12,251</b>	<b>13,043</b>	<b>13,925</b>	<b>11,872</b>	<b>43,035</b>	<b>45,350</b>	<b>49,344</b>	<b>51,091</b>	<b>52,425</b>
Seq %	5	17	10	-18	10	8	8	-16	7	6	7	-15	-4	5	9	4	3
COGS	8,648	10,148	11,188	9,094	9,984	10,801	11,706	9,795	10,437	11,104	11,921	10,129	36,929	39,078	42,286	43,590	44,621
% of sales	86	86	86	85	86	86	86	85	85	85	86	85	86	86	86	85	85
Gross Profit	1,365	1,613	1,751	1,544	1,672	1,792	1,907	1,687	1,815	1,939	2,004	1,743	6,106	6,272	7,058	7,501	7,804
GPM%	13.6	13.7	13.5	14.5	14.3	14.2	14.0	14.7	14.8	14.9	14.4	14.7	14.2	13.8	14.3	14.7	14.9
OPEX	1,371	1,525	1,547	1,443	1,515	1,574	1,634	1,435	1,568	1,630	1,657	1,484	5,444	5,885	6,158	6,340	6,412
% of sales	14	13	12	14	13	13	12	13	13	13	12	13	13	13	12	12	12
<b>Operating Profit</b>	<b>(6)</b>	<b>88</b>	<b>205</b>	<b>101</b>	<b>157</b>	<b>218</b>	<b>273</b>	<b>252</b>	<b>246</b>	<b>309</b>	<b>347</b>	<b>259</b>	<b>672</b>	<b>387</b>	<b>900</b>	<b>1,161</b>	<b>1,392</b>
OM%	-0.1	0.7	1.6	1.0	1.3	1.7	2.0	2.2	2.0	2.4	2.5	2.2	1.6	0.9	1.8	2.3	2.7
<b>Pretax Profit</b>	<b>(69)</b>	<b>35</b>	<b>150</b>	<b>37</b>	<b>91</b>	<b>153</b>	<b>210</b>	<b>187</b>	<b>174</b>	<b>237</b>	<b>274</b>	<b>186</b>	<b>490</b>	<b>153</b>	<b>641</b>	<b>871</b>	<b>1,083</b>
PTI%	-0.7	0.3	1.2	0.3	0.8	1.2	1.5	1.6	1.4	1.8	2.0	1.6	1.1	0.3	1.3	1.7	2.1
Tax (benefit)	(15)	(118)	425	(12)	27	23	32	28	26	35	41	28	(41)	280	110	131	163
<b>Net Profit</b>	<b>(72)</b>	<b>139</b>	<b>(289)</b>	<b>33</b>	<b>49</b>	<b>115</b>	<b>164</b>	<b>144</b>	<b>133</b>	<b>186</b>	<b>218</b>	<b>143</b>	<b>535</b>	<b>(189)</b>	<b>471</b>	<b>680</b>	<b>861</b>
EPS (US\$ cents)	(0.7)	1.3	(2.5)	0.3	0.4	1.0	1.4	1.2	1.1	1.6	1.9	1.2	4.9	(1.7)	4.0	5.8	7.3
<b>Revenue by division</b>																	
PCSD (PC/tablets)	7,005	8,382	9,250	7,741	8,310	9,062	9,841	8,509	8,844	9,348	9,788	8,460	30,076	32,379	35,723	36,441	37,079
MBG (Mobile)	1,746	2,077	2,076	1,342	1,530	1,668	1,934	1,393	1,490	1,609	1,851	1,425	7,708	7,241	6,525	6,376	6,249
DCG (Servers)	971	976	1,225	1,223	1,468	1,497	1,452	1,234	1,543	1,682	1,850	1,572	4,068	4,394	5,651	6,647	7,290
Others	290	326	388	332	349	366	385	346	374	404	436	414	1,183	1,336	1,446	1,628	1,807
<b>Total</b>	<b>10,012</b>	<b>11,761</b>	<b>12,939</b>	<b>10,638</b>	<b>11,657</b>	<b>12,593</b>	<b>13,613</b>	<b>11,482</b>	<b>12,251</b>	<b>13,043</b>	<b>13,925</b>	<b>11,872</b>	<b>43,035</b>	<b>45,350</b>	<b>49,344</b>	<b>51,091</b>	<b>52,425</b>
<b>PTI by division</b>																	
PCSD (PC/tablets)	291	367	416	384	382	417	463	391	389	421	450	372	1,494	1,458	1,653	1,632	1,687
MBG (Mobile)	(173)	(164)	(124)	(142)	(138)	(133)	(122)	(88)	(101)	(97)	(102)	(107)	(737)	(603)	(481)	(407)	(339)
DCG (Servers)	(144)	(131)	(86)	(64)	(48)	(30)	(22)	(25)	(15)	17	37	16	(470)	(425)	(125)	54	156
Others	(43)	(37)	(56)	(141)	(105)	(101)	(109)	(92)	(98)	(104)	(111)	(95)	202	(277)	(406)	(409)	(419)
<b>Total</b>	<b>(69)</b>	<b>35</b>	<b>150</b>	<b>37</b>	<b>91</b>	<b>153</b>	<b>210</b>	<b>187</b>	<b>174</b>	<b>237</b>	<b>274</b>	<b>186</b>	<b>489</b>	<b>153</b>	<b>641</b>	<b>871</b>	<b>1,083</b>
<b>PTI margin by division (%)</b>																	
PCSD (PC/tablets)	4.2	4.4	4.5	5.0	4.6	4.6	4.7	4.6	4.4	4.5	4.6	4.4	5.0	4.5	4.6	4.5	4.5
MBG (Mobile)	-9.9	-7.9	-6.0	-10.6	-9.0	-8.0	-6.3	-6.3	-6.8	-6.0	-5.5	-7.5	-9.6	-8.3	-7.4	-6.4	-5.4
DCG (Servers)	-14.9	-13.4	-7.0	-5.2	-3.3	-2.0	-1.5	-2.0	-1.0	1.0	2.0	1.0	-11.6	-9.7	-2.2	0.8	2.1
<b>Shipments</b>																	
<b>Total PC</b>																	
Units ('000)	12,362	14,491	15,695	12,418	12,832	13,902	15,062	13,000	13,562	14,421	15,142	13,224	55,737	54,966	54,796	56,350	57,186
QoQ %	0	17	8	-21	3	8	8	-14	4	6	5	-13	-1	-1	0	3	1
YoY %	-6	0	0	1	4	-4	-4	5	6	4	1	2	-1	-1	0	3	1
<b>Smartphone shipment (m units)</b>	<b>11.2</b>	<b>15.3</b>	<b>12.3</b>	<b>9.8</b>	<b>9.1</b>	<b>9.8</b>	<b>11.1</b>	<b>9.4</b>	<b>9.7</b>	<b>10.3</b>	<b>11.5</b>	<b>9.4</b>	<b>51.7</b>	<b>48.6</b>	<b>39.4</b>	<b>40.9</b>	<b>40.8</b>
Seq %	-3	37	-20	-20	-8	7	14	-15	3	6	12	-18	-22	-6	-19	4	0

Source: Company data, BOCOM Int'l estimates

14 June 2018

**Lenovo (992 HK)**



**Financial Statements**

Income statement (US\$ m)					
Y/E 31 Mar	2017	2018	2019E	2020E	2021E
Revenue	43,035	45,350	49,344	51,091	52,425
COGS	(36,929)	(39,078)	(42,286)	(43,590)	(44,621)
<b>Gross Profit</b>	<b>6,106</b>	<b>6,272</b>	<b>7,058</b>	<b>7,501</b>	<b>7,804</b>
OPEX	(5,444)	(5,885)	(6,158)	(6,340)	(6,412)
OP	672	387	900	1,161	1,392
Net interest expense	(204)	(231)	(273)	(290)	(309)
Equity Method	21	(3)	14	-	-
Others	-	-	-	-	-
<b>Pre-tax income</b>	<b>490</b>	<b>153</b>	<b>641</b>	<b>871</b>	<b>1,083</b>
Tax	41	(280)	(110)	(131)	(163)
Net income (before minority)	530	(127)	531	740	921
Minority interest	5	(63)	(60)	(60)	(60)
<b>Net income</b>	<b>535</b>	<b>(189)</b>	<b>471</b>	<b>680</b>	<b>861</b>
EPS (US\$ cents)	4.9	-1.7	4.0	5.8	7.3

Cash flow statement (US\$ m)					
Y/E 31 Mar	2017	2018	2019E	2020E	2021E
Profit before tax	490	153	641	871	1,083
Depreciation/Amortization	742	739	784	842	861
Changes in work capital	1,618	(1,090)	(133)	(58)	(44)
Forex gain/loss	87	(258)	-	-	-
Others	(817)	(300)	(110)	(131)	(163)
<b>Cash flow from operations</b>	<b>2,120</b>	<b>(756)</b>	<b>1,182</b>	<b>1,524</b>	<b>1,737</b>
Capex	(464)	(503)	(528)	(555)	(583)
Sales of tangible assets	412	41	-	-	-
Investments	(45)	58	(33)	(14)	(11)
Others	(1,301)	(709)	-	-	-
<b>Cash flow from investing</b>	<b>(1,398)</b>	<b>(1,114)</b>	<b>(561)</b>	<b>(569)</b>	<b>(593)</b>
Dividends paid	(377)	(381)	(396)	(377)	(354)
New share issued	-	496	-	-	-
Debt issuance/(repayment)	655	877	-	-	-
Other	(133)	(118)	-	-	-
<b>Cash flow from financing</b>	<b>145</b>	<b>874</b>	<b>(396)</b>	<b>(377)</b>	<b>(354)</b>
Other	(40)	89	-	-	-
<b>Net cash flow</b>	<b>828</b>	<b>(907)</b>	<b>225</b>	<b>578</b>	<b>790</b>
Cash at beginning	1,927	2,755	1,848	2,073	2,651
<b>Cash at end</b>	<b>2,755</b>	<b>1,848</b>	<b>2,073</b>	<b>2,651</b>	<b>3,441</b>

Balance sheet (US\$ m)					
As of 31 Mar	2017	2018	2019E	2020E	2021E
Cash & cash equiv.	2,755	1,848	2,073	2,651	3,441
Marketable Securities	197	84	84	84	84
Account Receivables	4,468	4,973	5,411	5,602	5,749
Inventory	2,794	3,792	4,126	4,272	4,383
Others	4,655	4,967	4,967	4,967	4,967
<b>Current Assets</b>	<b>14,868</b>	<b>15,663</b>	<b>16,660</b>	<b>17,576</b>	<b>18,623</b>
Land/CIP	-	-	-	-	-
PP&E, net	1,649	1,305	1,049	762	484
Investment securities	256	373	406	420	431
Interest bearing asset	-	-	-	-	-
Intangible asset	8,349	8,515	8,515	8,515	8,515
Other fixed assets	2,063	2,639	2,639	2,639	2,639
<b>Total Assets</b>	<b>27,186</b>	<b>28,494</b>	<b>29,268</b>	<b>29,911</b>	<b>30,691</b>
Accounts payable	6,486	7,252	7,891	8,170	8,383
Short-term debt	70	1,167	1,167	1,167	1,167
Others	11,778	11,041	11,041	11,041	11,041
<b>Current Liabilities</b>	<b>18,334</b>	<b>19,460</b>	<b>20,098</b>	<b>20,378</b>	<b>20,591</b>
Long-term debt	2,967	2,649	2,649	2,649	2,649
Others	1,790	1,840	2,058	2,286	2,514
<b>Total Liabilities</b>	<b>23,091</b>	<b>23,948</b>	<b>24,805</b>	<b>25,312</b>	<b>25,754</b>
Common stock	2,690	3,186	3,186	3,186	3,186
Retained earnings	534	333	190	265	544
<b>Shareholder equity</b>	<b>3,224</b>	<b>3,519</b>	<b>3,376</b>	<b>3,451</b>	<b>3,730</b>
minority interest	872	1,027	1,087	1,147	1,207
<b>Total liabilities and equity</b>	<b>27,186</b>	<b>28,494</b>	<b>29,268</b>	<b>29,911</b>	<b>30,691</b>

Financial ratios					
Y/E 31 Mar	2017	2018	2019E	2020E	2021E
P/E (x)	11.0	NA	13.3	9.2	7.3
P/B (x)	2.5	2.4	2.7	2.7	2.5
P/S (x)	0.1	0.1	0.1	0.1	0.1
EV/EBITDA (x)	5.2	9.2	5.6	4.3	3.3
Dividend yield (%)	6.4	6.3	6.0	5.6	6.6
Net debt/equity (x)	0.0	0.5	0.5	0.3	0.1
ROE (%)	17.2	-5.6	13.7	19.9	24.0
ROA (%)	2.1	-0.7	1.6	2.3	2.8
ROIC (%)	4.2	-6.6	3.5	6.3	8.5

Source: Company data, BOCOM Int'l estimates



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### Rating System

#### Analyst Stock Ratings:

**Buy:** The stock's total return is expected to **exceed** that of the corresponding industry over the next 12 months.

**Neutral:** The stock's total return is expected to be **in line with** that of the corresponding industry over the next 12 months.

**Sell:** The stock's total return is expected to be **below** that of the corresponding industry over the next 12 months.

**Not-Rated:** The analyst **does not have conviction** regarding the outlook of the stock's total return relative to that of the corresponding industry over the next 12 months.

#### Analyst Industry Views:

**Outperform:** The analyst expects the industry coverage universe to be **attractive** relative to the relevant broad market benchmark over the next 12 months.

**Market perform:** The analyst expects the industry coverage universe to be **in line with** the relevant broad market benchmark over the next 12 months.

**Underperform:** The analyst expects the industry coverage universe to be **unattractive** relative to the relevant broad market benchmark over the next 12 months.

Broad market benchmark for Hong Kong is **the Hang Seng Composite Index**, for China A-shares is the **MSCI China A Index**, for US-listed Chinese companies is **S&P US Listed China 50 (USD) Index**.

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