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Money Talk

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21 March 2011

ECS Holdings Ltd

Enlarges product portfolio with addition of Dell, Lenovo, Apple and Samsung gadgets

Buy	**+42.2%**
Price / Target	**S$0.83 / S$1.18**
Mkt. Cap / F. Float	**S$303m / 12%**

Investment Highlights

We initiate coverage on ECS Holdings (ECS) with a BUY recommendation and target price of S$1.18, representing a 42.2% upside from the current price. In our view, ECS is an attractive proxy to rising IT spending in Asia and provides exposure to a slice of the rapidly expanding Chinese information and communications technology (ICT) market. In addition, we believe ECS is ripe for a revaluation given its recent high profile additions – distribution rights to Apple's iPhone and iPad, Dell, Lenovo and Samsung products.

Riding on the iPhone and iPad fever. ECS recently clinched regional distribution rights to the iPhone and iPad in China and several other countries in Asia. With ECS's extensive distribution network in China, boasting over 9,000 resellers across Beijing, Shanghai and other smaller cities, the group expects to achieve a 15% market share for the iPhone and iPad in the country. Since Jan 11, ECS has been selling 40,000-50,000 units of the iPad a month.

Aggressively expanding brand portfolio and distribution network. ECS will start distributing Samsung notebooks and the Galaxy Tab in Malaysia through its network of 2,500 resellers in the country. In addition, the group recently clinched distribution rights for Dell servers, notebooks, tablets and Lenovo notebooks in six countries. ECS is also looking to expand its existing network of 23,000 resellers in the region by 10-15% annually.

Margin expansion schemes will enhance profitability. With its growing presence in Asia, ECS plans to expand margins through clinching more regional distribution rights instead of separate country-specific rights. Regional distribution rights will allow ECS to enjoy greater volume discounts on bulk purchases and receive special performance rebates. The group also plans to reduce service cost per customer through gaining economies of scale from a larger customer network and more advanced logistical planning.

Potential listing on Taiwanese exchange could be a catalyst. ECS is planning a secondary listing in Taiwan through issuing Taiwan Depository Receipts. The group plans to use the proceeds for working capital to fund its growth in the region and hopes to achieve a more attractive valuation, with investors in Taiwan being highly savvy about technology stocks. ECS hopes to list on the Taiwan Stock Exchange by mid-11.

Peer Comparison

Company	Ticker	Price (S$)	Market Cap (S$b)	PE FY11F (x)	PEG (x)
AVNET INC	AVT US	40.6	6.2	7.9	0.3
ARROW ELECTRONIC	ARW US	50.0	5.7	8.1	0.6
SYNNEX TECH INTL	2347 TT	2.9	4.4	15.0	0.7
INGRAM MICRO INC	IM US	25.2	4.0	9.0	0.6
TECH DATA CORP	TECD US	61.4	2.9	9.6	0.4
DIGITAL CHINA	861 HK	2.3	2.5	14.8	0.8
Sector Average				**10.8**	**0.6**
ECS HOLDINGS LTD	ECS SP	0.83	0.3	5.0	0.3

Source: Bloomberg, UOB Kay Hian

Technical View

- Price forms consolidation pattern with support at 0.815 and resistance at 0.950.
- MACD indicator forming a whipsaw pattern with no clear signal.
- RSI hovering about 50, ADX below 20, DIs negatively placed.

Financials

FYE 31 Dec (S$m)	2008	2009	2010	2011F	2012F
Net turnover	2,949.9	3,252.0	3,085.4	3,937.2	4,563.3
Gross profit	149.5	158.7	155.1	201.8	228.4
EBITDA	54.9	63.5	71.5	84.7	97.3
EBIT	52.0	60.6	69.2	82.6	95.3
PATMI	29.4	38.2	53.0	60.3	69.2
EPS (S cent)	8.0	10.5	14.5	16.5	18.9
Adj. EPS (S cent)	7.8	11.2	11.9	16.5	18.9
P/E (x)	10.3	7.9	5.7	5.0	4.4
P/BV (x)	1.3	1.2	1.0	0.9	0.8
EV/EBITDA	8.4	7.0	6.1	5.6	5.1
Dividend yield (%)	3.2	3.6	4.3	4.6	4.8
PATMI margin (%)	1.0	1.2	1.7	1.5	1.5
Net gearing (%)	56.2	44.8	44.3	50.9	49.5
Interest cover (x)	4.6	11.4	8.0	7.1	7.4
ROE (%)	14.0	16.3	18.9	19.2	19.1
Consensus PATMI				55.3	67.5
UOBKH/Con (x)				1.1	1.0

Source: ECS, Bloomberg, UOB Kay Hian

Background

ECS is a leading ICT products and services provider with a network of over 23,000 channel partners in China, Thailand, Malaysia, Singapore, Indonesia and the Philippines. The group has three main businesses namely:

- Enterprise Systems – Designs, installs and implements IT infrastructure products for companies and government institutions.
- IT Services – Provides a comprehensive range of professional, technical support and training services.
- Distribution – Leading IT vendors such as HP, Apple, and Samsung use ECS's network of channel partners to distribute their products across the region.

Valuation

We initiate coverage on ECS with a BUY recommendation and target price of S$1.18, representing a 42.2% upside from the current price. Our valuation is based on a target PEG of 0.5x, which is at a 16.7% discount to ECS's peer average of 0.6x. Using our projected two-year EPS CAGR (FY10-12) of 14.3%, we apply a 7.2x PE multiple to our forecasted FY11 EPS of 16.5 S cents.

Digital China and Synnex are the closest competitors in the Chinese IT distribution space. Digital China and Synnex are the first and second largest IT distributors in China respectively, while ECS is a close fourth. Our target FY11F PE of 7.2x is a 51.4% discount to Digital China's FY11F PE of 14.8 and a 52.1% discount to Synnex's FY11F PE of 15.0. In our view, the valuation discount is justified on the basis of: a) a liquidity discount attributed to ECS's smaller market capitalisation and free float and b) ECS is exposed to a different set of growth drivers compared to its peers. Digital China and Synnex are riding on the higher margin IT services and handset product segments respectively.

Peer Comparison

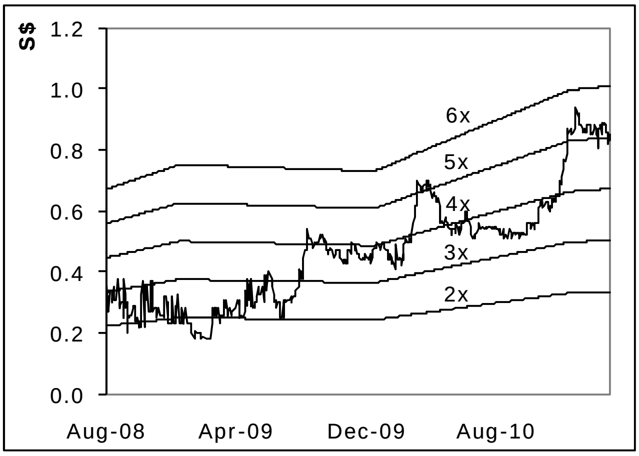
	Digital China	Synnex	ECS
Ticker	861HK 910861TT	2347TT	ECS SP
Geographical Exposure	China	China Taiwan Australia	China Malaysia Thailand Singapore Indonesia
Major Business Segments	Distribution System Supply chain IT services	PC Handset IC component	Distribution Enterprise IT services
Comments	Largest Chinese ICT pure play with strong government links and growing IT services and smart card segment	Market leader in Taiwan with diversified geographical exposure. Growth will come from handset and consumer products	Diversified Asian play which is expected to ride on the success of Apple's iPhone and iPad, Dell, Lenovo and Samsung products

Source: Respective companies, Bloomberg

At current valuations, we believe that there is inherent value. ECS is currently trading at a 5.0x multiple of our FY11 EPS forecasts. Although valuations are near two-year highs, we believe the company is still deeply undervalued considering that: a) we expect a decent two-year EPS growth of 14.3% going forward b) ECS has a very consistent track record of paying out dividends and current valuations imply very attractive yields. The group paid out dividends every year between 2003 and 2010, with dividends growing at a CAGR of 42.6%. We expect dividend yield to be 4.6% in FY11.

Multiple catalysts to drive re-rating. We see potential catalysts coming in the form of a) aggressive product expansion and possible acquisition of more lucrative distribution rights in the near future b) margin expansion schemes to enhance profitability and c) potential listing on the Taiwanese exchange.

Price and 1-Year Forward Core PE Bands



Source: UOB Kay Hian

Earnings Outlook

Top- and bottom line growth to be led by expanding product portfolio and distribution network. We expect to see top-line growth to be heavily driven by the distribution business in FY11, with the group adding a wide range of Apple, Dell, Lenovo and Samsung products to its existing portfolio. In addition, ECS also targets to expand its reseller network by 10-15% a year across the six countries it currently operates in. We forecast a 27.6% yoy revenue growth and 13.8% yoy EPS growth for FY11. Adjusted EPS is expected to grow by 38.9% yoy due to an exceptional gain of S$12.6m in FY10 from the listing of its Malaysian subsidiary.

Gross margin to improve to 5.13% in FY11. We expect gross margin to improve to 5.13% in FY11 from 5.03% in FY10, on the back of increased volume discounts from regional distribution rights of Apple, Dell and Lenovo products. However, gross margin will taper off to 5.01% in FY12 as we expect contribution from the lower margin distribution business to outgrow higher margin enterprise systems and IT services segments. Our sensitivity analysis suggests that a 10bps change in gross margin will result in a 500bps change in FY11 EPS.

We expect operating margin to reach a seven-year high in FY11. Adjusted operating margins have improved consistently from 1.59% in FY06 to 1.93% in FY10, reflecting ECS's constant strive towards cost efficiency. We expect operating margin to reach a seven-year high of 2.10% in FY11, led by: a) increasing economies of scale as the group expands its distribution network within its current operating geographies and b) plans to improve logistical efficiency and reduce service cost per customer.

Key Assumptions

	2010	2011F	2012F
Distribution Revenue, S$b	1.928	2.700	3,240
Enterprise Revenue, S$b	1.132	1.212	1.297
IT Services Revenue, S$b	0.024	0.026	0.027
Gross Margin, %	5.03	5.13	5.01
Adj. Operating Margin, %	1.93	2.10	2.09

Source: ECS, UOB Kay Hian

Working capital management is key. The IT distribution business is balance-sheet heavy with the bulk consisting of working capital. Distributors need to have sufficient inventory to provide on-time deliveries to customers and competitive credit terms to attract new business. Top-line growth is typically dependant on: a) the capacity to finance working capital and b) the cash conversion cycle.

We expect S$82.0m of extra working capital required in FY11. Under our growth forecasts, revenue will grow by 27.6% yoy, or S$851.9m in absolute terms. Assuming a 35 day working capital turnover in FY11, we expect that every S$1.0 of working capital will be able to support approximately S$10.4 of sales annually, implying that an added S$82.0m of working capital will be required. This represents a 23.4% yoy increase from S$351.4m as of 31 Dec 10.

Sufficient debt financing headroom and cash to support growth for now; however, ECS could tap the equity markets to increase free float and liquidity. We estimate that ECS has total term and revolving debt financing capacity of S$500m, while the group has only utilised S$224.4m as of 31 Dec 10. We believe that ECS has more than sufficient debt financing headroom and cash on hand to support its growth targets in the near future. However, management has indicated that the group may tap the equity markets through new share issuances or placements in order to increase its free float and liquidity. ECS's free float is currently 12.4% while market cap is S$303.3m.

Financial Analysis

ROSF enhancement led by improving operating efficiency. Return on average shareholder funds (ROSF) has risen from 11.0% in FY06 to 19.1% in FY10, driven mainly by a higher PATMI margin and better operating efficiency. PATMI margin improved from 0.86% in FY06 to 1.72% in FY10, with the spike in FY10 due mainly to the listing of ECS's Malaysian subsidiary and subsequent accounting of the unit as an associate. Asset turnover and leverage remained mostly consistent between FY06-09, with inconsistencies in FY10 due to similar reasons stated above.

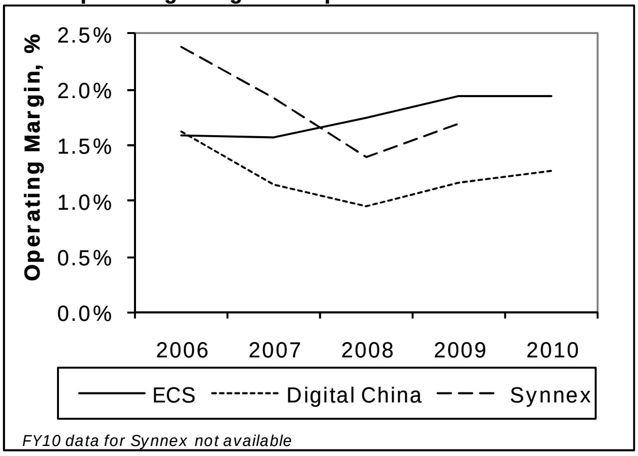
Du Pont Analysis

	2006	2007	2008	2009	2010
Asset turnover, x	4.05	4.45	4.18	4.06	3.39
PATMI margin, %	0.86	0.84	1.00	1.17	1.72
Leverage, x	3.17	3.12	3.14	3.22	3.27
ROSF, %	**11.0**	**11.6**	**13.0**	**15.4**	**19.1**

Source: ECS, UOB Kay Hian

Superior operating margins reflect efficient cost control. ECS's adjusted operating margins have been consistently higher than its peers for the last three financial years. FY10 adjusted operating margin was 1.93% compared to 1.26% for Digital China and 1.69% for Synnex (FY09). We believe that this reflects ECS' superior cost and operational diligence amidst tough times for the ICT sector in last few years.

Peer Operating Margin Comparison



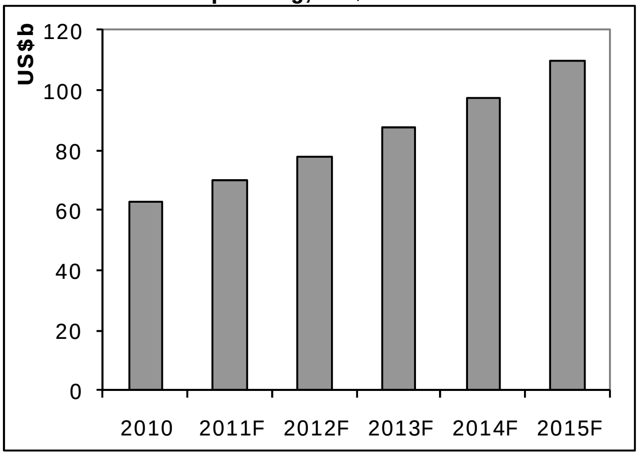
Source: Bloomberg, ECS, UOB Kay Hian

Industry

Asian ICT sector outlook is positive going forward. According to BMI and Gartner research, a decade of falling PC and component prices, coupled with rising disposable incomes will help drive PC penetration higher in Asia. PC and component prices declined at an average of 7.8% for the past six years, and have become increasingly affordable in developing Asian nations. In addition, Asian governments are also rolling out initiatives to increase PC penetration. For example, the Indonesian government recently started an e-learning initiative and targets to increase PC to student ratio from the current 1:3200 to 1:20.

Rising Chinese IT hardware spending remains key driver of growth. According to BMI, China's hardware spending is expected to grow at a four-year CAGR of 12.1% to US$110b by 2015. Already the second largest PC market in the world, PC penetration in the vast rural areas is still very low, providing enormous room for growth going forward. In 2008, PC penetration was 18% in China and is projected to almost double to 30% by 2014. Growth will also be driven by government incentives offering a 13% rebate off the purchase price of PCs for rural farmers, with an estimated 1m PC units sold under the programme in 2009 alone.

China Hardware Spending, US$b



Source: BMI

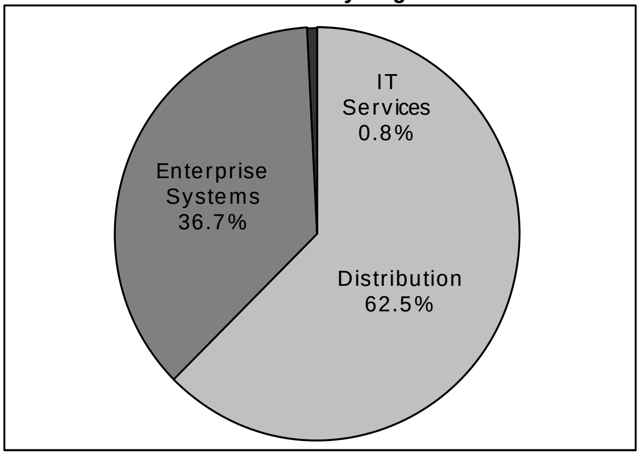
Company Overview

Established in 1998, ECS is one of the leading ICT products and services providers in Asia Pacific. It has a network of over 23,000 resellers across six countries – China, Thailand, Malaysia, Singapore, Indonesia and the Philippines. ECS was partially acquired by VST Holdings (856 HK) in 2007 with an offer price of S$0.67. VST currently holds 89.7% of ECS and is a distributor of upstream IT products such as motherboards, CPUs and data storage devices.

ECS has three business segments – IT distribution, enterprise systems and IT services. The IT distribution segment's operations include the distribution of fast-moving products by leveraging on a well-established and highly-efficient logistical and IT infrastructure. The enterprise systems segment designs, installs and implements IT infrastructure for MNCs and governments, while IT services provides a range of professional and technical services such as consulting, E-services and application integration.

IT distribution is the largest contributor by revenue. In FY10, the IT distribution segment contributed 62.5% of revenue, followed by enterprise systems with 36.7% and IT services with 0.8%. By geography, North Asia generated 57.7% of revenue while Southeast Asia contributed the remainder.

FY10 Revenue Contribution by Segment



Source: ECS

Well diversified with limited customer concentration risk. ECS's major customers include the Ministry of Home Affairs, Singapore Technologies, China Mobile, China Unicom and Huawei. Huawei is currently its largest customer contributing 2% of total revenue.

Stable margins supported by inventory price protection. The IT distribution business is typically characterised by low margins, with operating margins for ECS and its peers averaging between 1-2% over the past five years. ECS receives monetary support from vendors under two circumstances: a) before the vendor releases a new product upgrade which will render existing inventories obsolete eg iPhone 4 and b) if certain product categories do not perform well in the market. Thus ECS's margins are relatively sheltered from inventory obsolescence and market acceptance risk.

Previous over-reliance on HP. In the past, HP used to contribute up to 40% of ECS's total revenue. As a result, ECS was hit by HP's quality assurance issues in early-10 when consumers filed complaints against HP for faulty laptops.

Key Distributorship Agreements

Brand	Countries	Products
Apple	6	iPhone
	Thailand China Indonesia	iPad
Dell	6	Server, Notebook, Tablet
Lenovo	6	Ideapad, Thinkpad
	China	Tablet, Smartphone
Samsung	Malaysia	Galaxy Tab, Printer, Monitor, Notebook

Source: ECS

Vendor diversification is the way forward. ECS plans to mitigate product concentration risk by broadening its brand portfolio and product range. In recent months, ECS has announced high profile regional distribution agreements with Apple, Dell, Lenovo and Samsung in a bid to expand its product range.

Risks

Increased cost of financing. ECS is a balance-sheet intensive business which is highly dependent on debt financing. In our view, the increased cost of financing is the single most imminent risk for the group because ECS's ROCE does not move in tandem with interest rates, and may result in margin compression for the group.

Reputational risks of vendor owned brands. ECS does not have any control over quality, branding or reputation of all the products it carries. Reputational damage to vendor-owned brands in ECS's portfolio will have a negative effect on the group.

Management

Mr Tay Eng Hoe was appointed as the chairman of ECS on 27 Sep 10. Mr Tay is the founder of the ECS Group and brings with him more than 25 years of experience in the IT business. Mr Tay is also an executive director of VST Holdings Limited. Mr Tay holds a Bachelor of Science (Honours) degree from the LaTrobe University and a Master of Business Administration from the University of Melbourne.

Mr Narong Intanate was appointed Group Chief Executive Officer on 1 Jul 10. He is also the founder and Executive Chairman of The Value Systems Co., Ltd. (Thailand subsidiary) since 1988. He holds a Bachelor of Science in Business Administration and a Master of Business Administration from California State University.

Mr Eddie Foo is the Group Chief Financial Officer of the company and is also the Group Company Secretary. Mr Foo is responsible for the corporate finance and treasury, reporting, accounts, tax, information technology and investor relations of ECS Holdings. He is also a director on the boards of various ECS companies. Mr Foo has several years of financial management and audit experience in multinational and public accounting firms. Mr Foo holds a Bachelor degree in Accountancy from the Nanyang Technologycal University and is a member of the Institute of Certified Public Accountants of Singapore.

Important Disclosure

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MICA (P) 048/03/2011
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