

China / Hong Kong Company Update

Lenovo Group

Bloomberg: 992 HK EQUITY | Reuters: 0992.HK

Refer to important disclosures at the end of this report

DBS Group Research . Equity

18 Nov 2024

BUY

Last Traded Price (15 Nov 2024): HKD9.17 (HSI : 19,426)

Price Target 12-mth: HKD12.70 (38% upside) (Prev HKD13.60)

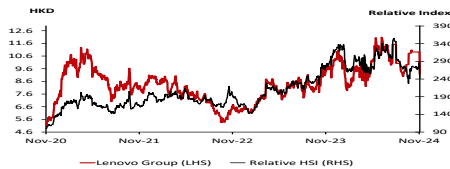
Analyst

Jim Au +852 3668 4172 jimau@db.com

What's New

- 2QFY3/25 net profit rose 44% y/y, slightly ahead, led by ongoing recovery in hardware business
- Server business sees a shift towards lower-margin storage servers, driven by growing sales from cloud service providers
- Cut FY25/26F earnings by 6%/ 3% to reflect a slower turnaround in the server business
- Maintain BUY; expect AI PC growth to accelerate in 2HFY3/25, but lower TP to HKD12.7 on reduced earnings and unchanged 13x forward P/E

Price Relative



Forecasts and Valuation

FY Mar (US\$m)	2024A	2025F	2026F	2027F
Turnover	56,864	63,328	72,108	77,747
EBITDA	3,393	3,831	4,692	5,189
Pre-tax Profit	1,365	1,963	2,846	3,371
Net Profit	1,011	1,481	2,147	2,544
Net Pft (Pre Ex) (core profit)	1,011	1,481	2,147	2,544
Net Profit Gth (Pre-ex) (%)	(37.1)	46.6	45.0	18.5
EPS (US\$)	0.08	0.11	0.17	0.20
EPS (HKD)	0.61	0.89	1.29	1.53
Core EPS (US\$)	0.08	0.11	0.17	0.20
Core EPS (HKD)	0.61	0.89	1.29	1.53
EPS Gth (%)	(37.1)	46.6	45.0	18.5
Core EPS Gth (%)	(37.1)	46.6	45.0	18.5
Diluted EPS (HKD)	0.61	0.89	1.29	1.53
DPS (HKD)	0.38	0.34	0.50	0.59
BV Per Share (HKD)	3.60	3.94	4.58	5.36
PE (X)	15.1	10.3	7.1	6.0
CorePE (X)	15.1	10.3	7.1	6.0
P/Cash Flow (X)	7.6	5.9	3.9	3.5
P/Free CF (X)	20.2	9.6	5.4	4.7
EV/EBITDA (X)	5.2	4.6	3.5	2.9
Net Div Yield (%)	4.1	3.8	5.4	6.4
P/Book Value (X)	2.5	2.3	2.0	1.7
Net Debt/Equity (X)	0.3	0.2	0.0	CASH
ROAE(%)	18.1	25.3	32.5	33.0
Earnings Rev (%)		(6)	(3)	(3)
Consensus EPS (US\$)		0.10	0.14	0.16
Other Broker Recs:		B:29	S:0	H:2

Source of all data on this page: Company, DBS Bank (Hong Kong) Limited ("DBS HK"), Thomson Reuters

AI PCs drive the next wave

Investment Thesis

Tech hardware giant transforming into a service-led company. Lenovo is a leading global PC and server manufacturer, leveraging on the world's largest active PC user base (23% market share) as well as its strong reputation in PCs and servers to channel growth into the services and solutions business. It is also well positioned for the AI boom with its extensive manufacturing expertise and product innovation.

Market leader in PCs with aggressive AI PC development. The company is well positioned to benefit from the inflection point in AI PC adoption that is expected in 2025. The company has a strong pipeline for the expansion of its AI PC offerings through 2024 and 2025, including the latest generations of ThinkPad and ThinkBook by the end of 2024, as well as Yoga-series and IdeaPad-series models from late 2024 to early 2025. We forecast Lenovo's AI PC shipments to surge by 125.9% and 153.8% in FY3/25F and FY3/26F, respectively, representing 20% and 47% of total PC shipments.

Growth in service and PC recovery to drive rerating. We expect earnings to grow by 46.6%/45.0% in FY25/26F, driven by (1) the commercial PC replacement cycle supported by specification upgrade, riding on the standardisation of AI PC specs and increasing Copilot+ adoption; (2) boost in operating margins on its expanding service business; and (3) the anticipated profitability of the server business (accounting for 17% of FY3/25F revenue).

We rate Lenovo a BUY, with a TP of HKD12.7 (prev. TP: HKD13.6), based on an unchanged 13x FY3/25F P/E, pegged to its historical average. We expect Lenovo's PC growth to accelerate in 2HFY3/25, with AI PC shipments surging 125.9% y/y and 153.8% in FY3/25F and FY3/26F, respectively.

Key Risks

Rigorous competition in PCs, smartphones, and servers. Prolonged weak consumer sentiment for consumer electronics.

At A Glance

Issued Capital (m shrs)	12,405
Total Mkt Cap (HKDm/USDm)	113,751 / 14,610
Major Shareholders (%)	
Legend Holdings Corporation	31.4
Free Float (%)	68.6
3m Avg. Daily Val. (USDm)	70.3
GICS Industry: Information Technology / Technology Hardware & Equipment	

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WHAT'S NEW

2QFY3/25 earnings beat, strong momentum toward 2025's AI PC inflection point

2QFY3/25 result highlights

Revenue increased by 22% y/y to USD17.6bn in 2QFY3/25. Segment-wise, IDG (Intelligent Device Group) revenue increased 11.3% y/y to USD10.5bn, driven by robust performance in both commercial PCs and consumer PCs, and market share gains in the smartphone business. The latter benefitted from tailwinds following successful game title launches, including Black Myth: Wukong. ISG (Infrastructure Solutions Group) revenue surged 65.1% y/y to USD3.3bn, driven by a sustainable AI GPU server demand and a continued product shift to GPU servers. SSG (Solutions and Services Group) revenue increased 12.9% y/y to USD2.2bn, driven by the continuous recovery in PC shipments and growth of AI-powered solutions.

Operating margin improved sequentially to 5.9% (vs. 5.6% in 1QFY3/25) due to higher contribution of high-margin service business and narrowing operating losses in the server business.

Net profit increased by 43.9% y/y to USD359mn, slightly ahead of market expectations.

Our view

The sustainable recovery in the hardware business validates our investment thesis on Lenovo's strong positioning in the AI server boom and PC replacement cycle. The company is well-positioned to benefit from the inflection point in AI PC adoption expected in 2025, driven by the launch of PCs equipped with more popular X86-based AI CPUs from late 2024 to early 2025.

While the server business (accounting for 17% of revenue in FY3/25F) is expected to maintain robust growth in 2025, the product mix is shifting towards lower-margin conventional storage servers as cloud service provider clients grow in proportion.

We cut our earnings forecast by 6.3% and 3.3% in FY3/25 and FY3/26, respectively, to account for a slower turnaround of the server business due to a growing proportion of sales from low-margin cloud-service provider (CSP) clients, which tend to have lower margins.

We delay the breakeven of the server business to 4QFY3/25. However, we maintain a solid earnings growth forecast of 46.6% and 45.0% in FY3/25F and FY3/26F, supported by increasing adoption of AI PCs and unmet demand for AI servers.

We maintain BUY with a lower TP of HKD12.7 (prev. TP: HKD13.6) on a lower FY3/25F earnings forecast. The TP is based on an

unchanged multiple of 13x FY3/25F P/E, pegged to its historical average. We expect Lenovo's PC growth to accelerate in 2HFY3/25, with AI PC shipments surging 125.9% y/y and 153.8% y/y in FY3/25F and FY3/26F, respectively, accounting for 20% and 47% of total PC shipments.

Credit Fundamentals

Lenovo's debt decreased to USD3.6bn in 1HFY3/25 from USD3.9bn in 2HFY3/24. EBIT interest coverage ratio (ICR) decreased to 2.9x (vs. 1HFY3/24: 5.9x). The company's financial position was maintained at similar level, with a slightly higher debt/capital ratio of 54.4% vs. 50.2% in 1HFY3/24. Liquidity was low, with cash reserves of USD4.2bn vs. short-term debt of USD4.6bn.

However, 1HFY3/25 cash flow significantly improved. Operating cash flow increased by 61.1% y/y to an inflow of USD1.8bn in 1HFY3/25, driven by the recovery of hardware business. Consequently, free cash flow also increased to USD151.5mn from an outflow of USD12.1mn in 1HFY3/24, with a decrease in capital expenditure to USD550mn (from USD677mn in 1HFY3/24).

Company Background

Founded in 1984 and listed in 1994, Lenovo is the largest global PC vendor, with a 24% global market share in 2021. Lenovo expanded into the server business through the acquisition of IBM's x86 server business and the smartphone business through the acquisition of Motorola Mobility in 2014. (1) Intelligent Devices Group (IDG), (2) Infrastructure Solutions Group (ISG), and (3) Solutions and Services Group (SSG) accounted for 89.6%, 10.4%, and 8.0% of FY3/20 gross revenue, respectively. Yang Yuanqing, the chief executive officer (CEO) and chairman of Lenovo, holds a c.9.3% stake in the company.

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Quarterly Income Statement (US\$m)

FY MAR	2QFY3/24	1QFY3/25	2QFY3/25	% chg yoy	% chg qoq
Revenue	14,410	15,447	17,850	23.9%	15.6%
Cost of Goods Sold	(11,888)	(12,887)	(15,054)	26.6%	16.8%
Gross Profit	2,522	2,560	2,796	10.9%	9.2%
Other Oper. (Exp)/Inc	(2,008)	(2,066)	(2,066)	2.9%	0.0%
Operating Profit	514	494	730	42.0%	47.7%
Other Non Opg (Exp)/Inc	-	-	-	nm	nm
Associates & JV Inc	(8)	(8)	(7)	-15.6%	-6.3%
Net Interest (Exp)/Inc	(148)	(174)	(170)	15.1%	-2.1%
Exceptional Gain/(Loss)				nm	nm
Pre-tax Profit	358	313	552	54.4%	76.7%
Tax	(69)	(60)	(90)	31.1%	51.1%
Minority Interest	(40)	(9)	(104)	161.0%	1008.9%
Net Profit	249	244	359	44.0%	47.1%
Net profit bef Except.	249	244	359	44.0%	47.1%

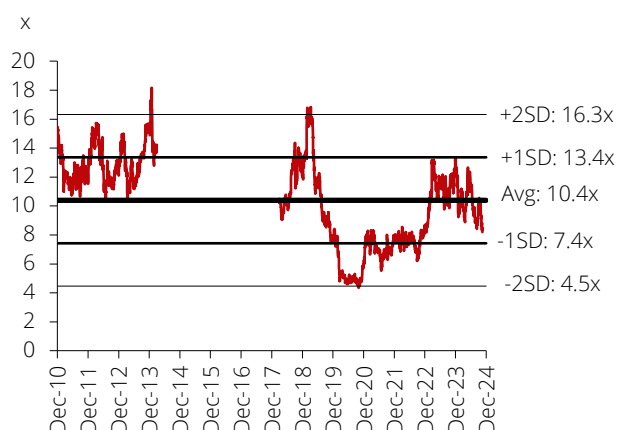
Margins (%)

Gross Margins	17.5	16.6	15.7
Opg Profit Margins	3.6	3.2	4.1
Net Profit Margins	1.7	1.6	2.0

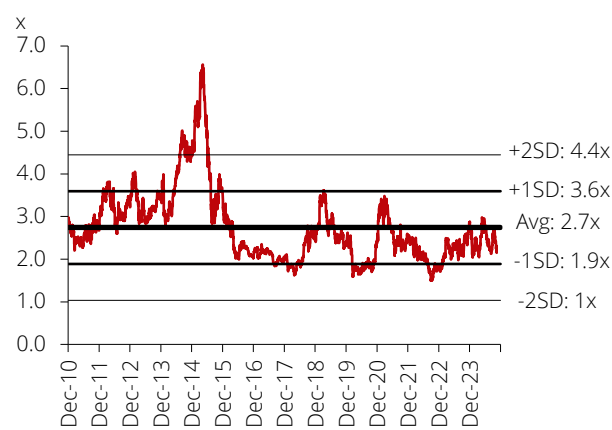
Source: Company, DBS HK

Historical PE and PB band

Forward PE band (x)



PB band (x)



Source: Thomson Reuters, DBS HK

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Key Assumptions

FY Mar	2023A	2024A	2025F	2026F	2027F
ISG Revenue ('000 USD)	9,755.6	8,921.9	11,209.5	13,568.2	14,395.2
Operating Margin (%)	1.0	(2.5)	(1.5)	1.0	1.5
SSG Revenue ('000 USD)	6,663.4	7,472.3	8,741.4	10,996.1	12,854.7
Operating Margin (%)	20.9	20.5	20.5	20.5	20.5

Source: Company, DBS HK

Segmental Breakdown (US\$ m)

FY Mar	2023A	2024A	2025F	2026F	2027F
Revenues (US\$ m)					
IDG	49,371	44,599	47,565	52,443	55,663
ISG	9,756	8,922	11,210	13,568	14,395
SSG	6,663	7,472	8,741	10,996	12,855
Intersegment cancellation	(3,844)	(4,130)	(4,188)	(4,899)	(5,166)
Total	61,947	56,864	63,328	72,108	77,747
Gross Profit (US\$ m)					
IDG	3,598	3,131	3,520	3,986	4,397
ISG	98	(224)	(31)	414	407
SSG	1,392	1,513	1,792	2,254	2,635
Intersegment cancellation	(1,208)	(1,268)	(1,584)	(1,996)	(2,232)
Total	3,880	3,152	3,697	4,658	5,208
Gross Profit Margins (%)					
IDG	7.3	7.0	7.4	7.6	7.9
ISG	1.0	(2.5)	(0.3)	3.1	2.8
SSG	20.9	20.2	20.5	20.5	20.5
Intersegment cancellation	31.4	30.7	37.8	40.7	43.2
Total	6.3	5.5	5.8	6.5	6.7

Source: Company, DBS HK

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Income Statement (US\$ m)

FY Mar	2023A	2024A	2025F	2026F	2027F
Revenue	61,947	56,864	63,328	72,108	77,747
Cost of Goods Sold	(51,446)	(47,061)	(52,038)	(58,715)	(63,062)
Gross Profit	10,501	9,803	11,289	13,393	14,685
Other Opng (Exp)/Inc	(7,832)	(7,797)	(8,768)	(9,983)	(10,764)
Operating Profit	2,669	2,006	2,521	3,410	3,921
Other Non Opng (Exp)/Inc	0	0	0	0	0
Associates & JV Inc	(17)	(26)	(17)	(17)	(18)
Net Interest (Exp)/Inc	(516)	(615)	(541)	(546)	(531)
Dividend Income	0	0	0	0	0
Exceptional Gain/(Loss)	0	0	0	0	0
Pre-tax Profit	2,136	1,365	1,963	2,846	3,371
Tax	(455)	(263)	(412)	(598)	(708)
Minority Interest	(73)	(92)	(70)	(101)	(120)
Preference Dividend	0	0	0	0	0
Net Profit	1,608	1,011	1,481	2,147	2,544
Net Profit before Except.	1,608	1,011	1,481	2,147	2,544
EBITDA	4,005	3,393	3,831	4,692	5,189
Adj EBIT (ex associates / ex revals)	2,669	2,006	2,521	3,410	3,921
Adj EBITDA (add DA)	4,022	3,419	3,848	4,709	5,207
Adj. Interest expense (include perps)	(658)	(763)	(671)	(661)	(615)
Growth					
Revenue Gth (%)	(13.5)	(8.2)	11.4	13.9	7.8
EBITDA Gth (%)	(7.7)	(15.3)	12.9	22.5	10.6
Opg Profit Gth (%)	(13.4)	(24.8)	25.7	35.2	15.0
Net Profit Gth (%)	(20.8)	(37.1)	46.6	45.0	18.5
Adj EBIT Gth (%)	(13.4)	(24.8)	25.7	35.2	15.0
Margins & Ratio					
Gross Margins (%)	17.0	17.2	17.8	18.6	18.9
Opg Profit Margin (%)	4.3	3.5	4.0	4.7	5.0
Net Profit Margin (%)	2.6	1.8	2.3	3.0	3.3
Adj EBIT Margin (%)	4.3	3.5	4.0	4.7	5.0
ROAE (%)	30.4	18.1	25.3	32.5	33.0
ROA (%)	3.9	2.6	3.7	4.9	5.3
ROCE (%)	13.8	10.6	12.8	15.8	16.8
Div Payout Ratio (%)	36.0	57.7	36.0	36.0	36.0
Net Interest Cover (x)	5.2	3.3	4.7	6.2	7.4
Adj EBITDA ICR (x)	6.11	4.48	5.73	7.13	8.47

Source: Company, DBS HK

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Balance Sheet (US\$ m)

FY Mar	2023A	2024A	2025F	2026F	2027F
Net Fixed Assets	3,304	2,919	2,859	2,931	3,012
Invts in Associates & JVs	438	319	405	423	417
Other LT Assets	12,237	12,826	12,981	13,241	13,524
Cash & ST Invts	4,359	3,695	4,511	5,861	7,436
Inventory	6,372	6,703	6,996	7,966	8,589
Debtors	11,886	11,930	13,550	15,416	16,615
Other Current Assets	325	359	342	351	346
Total Assets	38,920	38,751	41,644	46,189	49,939
ST Debt	3,017	2,082	1,581	1,581	1,581
Creditors	21,543	22,738	24,004	27,049	29,143
Other Current Liab	1,534	1,239	1,283	1,453	1,574
LT Debt	3,683	3,569	4,521	4,521	4,521
Other LT Liabilities	3,097	3,041	3,500	3,663	3,798
Shareholder's Equity	5,588	5,583	6,110	7,096	8,299
Minority Interests	459	499	647	826	1,024
Total Cap. & Liab.	38,920	38,751	41,644	46,189	49,939
Non-Cash Wkg. Capital	(4,495)	(4,985)	(4,398)	(4,769)	(5,166)
Net Cash/(Debt)	(2,341)	(1,956)	(1,591)	(241)	1,334
Total Debt incl Perps	6,699,886	5,651,097	6,101,821	6,101,821	6,101,821
PPE	3,304	2,919	2,859	2,931	3,012
Development Properties	0	0	0	0	0
Investment Properties	0	0	0	0	0
Debtors Turn (avg days)	83.0	76.4	73.4	73.3	75.2
Creditors Turn (avg days)	181.3	177.0	168.2	162.3	166.0
Inventory Turn (avg days)	53.5	52.3	49.3	47.6	48.9
Asset Turnover (x)	1.5	1.5	1.6	1.6	1.6
Current Ratio (x)	0.9	0.9	0.9	1.0	1.0
Quick Ratio (x)	0.6	0.6	0.7	0.7	0.7
Net Debt/Equity (X)	0.4	0.3	0.2	0.0	CASH
Net Debt/Equity ex MI (X)	0.4	0.4	0.3	0.0	CASH
Capex to Debt (%)	23.0	22.3	16.3	18.4	18.8
Z-Score (X)	0.0	NA	NA	NA	NA
Debt to EBITDA (x)	1.67	1.65	1.59	1.30	1.17
Net Debt to EBITDA (x)	0.89	1.01	0.68	0.11	(0.31)
(Debt + Perp) / Asset	17.2	14.6	14.7	13.2	12.2
(Debt + Perp) / Asset (ex Intangibles)	21.9	18.6	18.1	15.9	14.4
Debt / Capital (TE + TD + Perp)	52.6	48.2	47.5	43.5	39.6
Debt / Asset (%)	17.2	14.6	14.7	13.2	12.2
Cash/ST debt (%)	140.9	171.0	273.0	358.4	458.0
ST debt / total debt (%)	45.0	36.8	25.9	25.9	25.9

Source: Company, DBS HK

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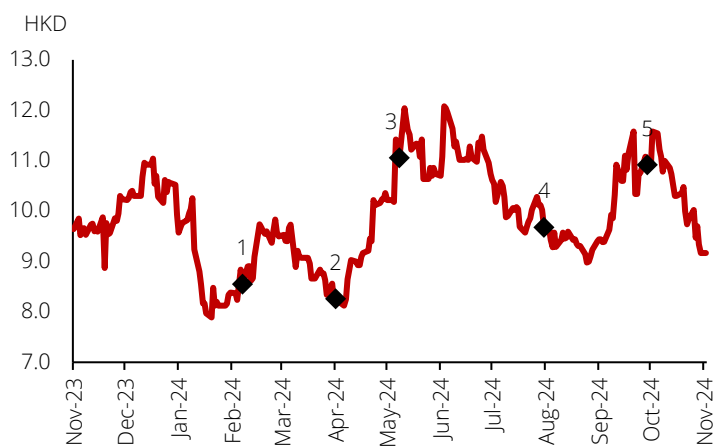
Cash Flow Statement (US\$ m)

FY Mar	2023A	2024A	2025F	2026F	2027F
Pre-Tax Profit	2,136	1,365	1,963	2,846	3,371
Dep. & Amort.	1,353	1,413	1,326	1,300	1,286
Tax Paid	(528)	(614)	(412)	(598)	(708)
Assoc. & JV Inc/(loss)	13	26	17	17	18
(Pft)/ Loss on disposal of FAs	(238)	(233)	0	0	0
Chg in Wkg.Cap.	(228)	(151)	(587)	371	397
Other Operating CF	293	204	271	20	21
Net Operating CF	2,801	2,011	2,578	3,956	4,386
Capital Exp.(net)	(1,543)	(1,258)	(994)	(1,126)	(1,146)
Other Invt.(net)	143	95	(59)	0	0
Invt in Assoc. & JV	(518)	(124)	(103)	(35)	(12)
Div from Assoc & JV	3	3	0	0	0
Other Investing CF	0	0	0	0	0
Net Investing CF	(1,915)	(1,283)	(1,156)	(1,161)	(1,158)
Div Paid	(579)	(583)	(533)	(773)	(916)
Chg in Gross Debt	385	(273)	451	0	0
Capital Issues	0	0	0	0	0
Other Financing CF	(220)	(480)	(455)	(474)	(436)
Net Financing CF	(414)	(1,336)	(538)	(1,247)	(1,352)
Currency Adjustments	(153)	(82)	(127)	(198)	(301)
Chg in Cash	320	(690)	757	1,350	1,574
Opg CFPS (US\$)	0.23	0.17	0.24	0.28	0.31
Free CFPS (US\$)	0.10	0.06	0.12	0.22	0.25
Capex	1,578	1,286	994	1,126	1,146
Free Cashflow	1,223	725	1,584	2,831	3,240

Source: Company, DBS HK

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Target Price & Ratings 12-mth History



S.No.	Date	Closing Price	Target Price	Rating
1	23-Feb-24	HKD8.84	HKD8.40	HOLD
2	17-Apr-24	HKD8.26	HKD10.00	BUY
3	24-May-24	HKD11.32	HKD13.20	BUY
4	16-Aug-24	HKD10.02	HKD12.40	BUY
5	15-Oct-24	HKD11.08	HKD13.60	BUY

Source: DBS HK
Analyst: Jim Au

Lenovo Group

DBS Group Research recommendations are based on an Absolute Total Return* Rating system, defined as follows:

STRONG BUY (>20% total return over the next 3 months, with identifiable share price catalysts within this time frame)

BUY (>15% total return over the next 12 months for small caps, >10% for large caps)

HOLD (-10% to +15% total return over the next 12 months for small caps, -10% to +10% for large caps)

FULLY VALUED (negative total return, i.e., > -10% over the next 12 months)

SELL (negative total return of > -20% over the next 3 months, with identifiable share price catalysts within this time frame)

*Share price appreciation + dividends

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Sources for all charts and tables are DBS HK unless otherwise specified.

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DBS Bank (Hong Kong) Limited

13th Floor One Island East, 18 Westlands Road, Quarry Bay, Hong Kong

Tel: (852) 3668-4181, Fax: (852) 2521-1812

Lenovo Group

DBS Regional Research Offices

HONG KONG

DBS Bank (Hong Kong) Ltd

Contact: Dennis Lam

13th Floor One Island East,

18 Westlands Road, Quarry Bay, Hong Kong

Tel: 852 3668 4181

Fax: 852 2521 1812

e-mail: dbsvhk@dbs.com

SINGAPORE

DBS Bank Ltd

Contact: Andy Sim

12 Marina Boulevard,

Marina Bay Financial Centre Tower 3

Singapore 018982

Tel: 65 6878 8888

e-mail: groupresearch@dbs.com

Company Regn. No. 196800306E

INDONESIA

PT DBS Vickers Sekuritas (Indonesia)

Contact: William Simadiputra

DBS Bank Tower

Ciputra World 1, 32/F

Jl. Prof. Dr. Satrio Kav. 3-5

Jakarta 12940, Indonesia

Tel: 62 21 3003 4900

Fax: 6221 3003 4943

e-mail: indonesiaresearch@dbs.com

THAILAND

DBS Vickers Securities (Thailand) Co Ltd

Contact: Chanpen Sirithanarattanakul

989 Siam Piwat Tower Building,

9th, 14th-15th Floor

Rama 1 Road, Pathumwan,

Bangkok Thailand 10330

Tel. 66 2 857 7831

Fax: 66 2 658 1269

e-mail: research@th.dbs.com

Company Regn. No 0105539127012

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