



Lenovo Group (992 HK)

Share Price: HKD10.96

MCap (USD): 14.7B

Hong Kong

Target Price: HKD12.00 (+9%)

ADTV (USD): 47M

Technology

HOLD

 (From BUY)

Take a breather, D/G to HOLD

- Downgrade Lenovo to HOLD from BUY, but maintain HKD12 target price and earnings forecasts, following the acquisition of Motorola's smartphone business announced this morning.
- This deal will increase the uncertainty of Lenovo's future earnings, and likely neutralize the benefits from the recent acquisition of IBM's server business.
- The potential 7-8% shares dilution and 750-800m of new shares issue will create an overhang, and integration risks could dampen the stock's performance over time.

The risks from acquisition may outweigh the benefits

Lenovo will take over Google's Motorola smartphone division for USD2.9bn. While the deal gives Lenovo immediate access to the developed markets, world-class R&D and Google's IP, the takeover also poses significant risks. First, the penetration rate of smartphones in the developed markets is largely saturated and as such IDC predicts unit growth for this area is likely to be only 5-7% CAGR from 2013-2017. Despite Motorola's latest effort to introduce the new high-end model, "Moto X" in 2013, which has received solid reviews, Google's market share in North America remained at 6-7%. The top-two vendors Apple and Samsung have a combined share of 65%. Secondly, although the deal may bring in USD4.5bn of revenue to Lenovo, the profitability is highly unpredictable. In 3Q13, Motorola reported a gross margin of below 12% and an operating loss of USD317m. Without significant restructuring of operations and headcounts, it will be a challenge for Lenovo to turn around Motorola's business even though the deal is likely to lift Lenovo to be a firm No.3 vendor globally. Thirdly, combined with the purchase of IBM's server business last week and today's announcement, Lenovo will add 11,000 headcounts to its roster. The integration risks could spread management capacity thinly.

Overhang and earnings risks

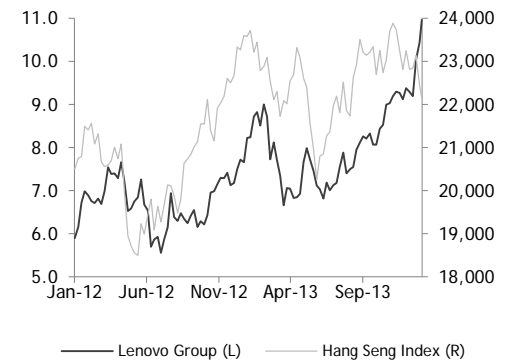
To finance the two deals, Lenovo will issue 750-800m new shares in the medium term and therefore dilute the existing shareholders by 6-8%. This is likely to create an overhang in the next 12-24 months as IBM and Google offload their holdings in Lenovo. On the earnings front, while we are relatively confident IBM's server business will be earnings accretive from FY15 onwards, today's deal may offset the benefits and as such the takeover is likely to raise the earnings uncertainty in the 12-24 months. Considering the strong outperformance of the share price since our initiation in Oct 2012, we downgrade Lenovo to HOLD due to the growing uncertainties.

FYE Mar (USD m)	FY12A	FY13A	FY14E	FY15E	FY16E
Revenue	29,574.4	33,873.2	38,310.1	42,432.7	46,369.3
EBITDA	825.9	969.5	1,333.5	1,539.3	1,742.0
Core net profit	473.0	635.1	840.9	1,019.7	1,153.3
Core EPS (cts)	4.5	6.1	8.1	9.8	11.1
Core EPS growth (%)	16.4	33.9	32.8	21.4	13.1
Net DPS (cts)	1.1	1.9	2.4	3.2	3.9
Core P/E (x)	31.1	23.2	17.5	14.4	12.7
P/BV (x)	6.0	5.5	4.6	3.9	3.3
Net dividend yield (%)	0.8	1.3	1.7	2.3	2.8
ROAE (%)	22.1	24.8	28.7	29.2	27.8
ROAA (%)	3.6	3.9	4.6	5.0	5.2
EV/EBITDA (x)	6.3	7.6	8.6	7.1	6.1
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash

Key Data

52w high/low (HKD)	10.96/6.45
Free float (%)	59.7
Issued shares (m)	10,402
Market capitalization	HKD114.0B
Major shareholders:	
-Legend Holdings Ltd.	32%
-YANG YUAN QING	7%
-First State Investments (Hong Kong) Ltd.	2%

Share Price Performance



	1 Mth	3 Mth	12 Mth
Absolute(%)	16.8	35.8	28.5
Relative to country (%)	22.7	40.1	37.3

Maybank vs Market

	Positive	Neutral	Negative
Market Recs	28	3	4
	Maybank Consensus		% +/-
Target Price (HKD)	12.00	11.46	4.7
2014 PATMI(USDm)	841	804	4.5
2015 PATMI(USDm)	1,020	955	6.7

Source: FactSet; Maybank

Warren Lau
(852) 2268-0644
warrenlau@kimeng.com.hk

FYE 31 Mar (USD m)	FY12A	FY13A	FY14E	FY15E	FY16E
Key Metrics					
P/E (reported) (x)	31.1	23.2	17.5	14.4	12.7
Core P/E (x)	31.1	23.2	17.5	14.4	12.7
P/BV (x)	6.0	5.5	4.6	3.9	3.3
P/NTA (x)	6.0	5.5	4.6	3.9	3.3
Net dividend yield (%)	0.8	1.3	1.7	2.3	2.8
FCF yield (%)	11.1	nm	3.6	5.5	5.2
EV/EBITDA (x)	6.3	7.6	8.6	7.1	6.1
EV/EBIT (x)	8.9	10.3	10.6	8.6	7.3
Income Statement					
Revenue	29,574.4	33,873.2	38,310.1	42,432.7	46,369.3
Gross profit	3,446.2	4,073.0	4,985.8	5,528.5	6,074.9
EBITDA	825.9	969.5	1,333.5	1,539.3	1,742.0
Depreciation	(77.7)	(85.5)	(85.5)	(94.0)	(103.4)
Amortisation	(164.1)	(169.0)	(172.4)	(175.9)	(179.4)
EBIT	584.1	715.0	1,075.6	1,269.4	1,459.2
Net interest income / (exp)	(0.8)	2.0	(50.0)	(60.0)	(60.0)
Associates & JV	(0.9)	84.0	1.2	38.0	20.0
Exceptionals	0.0	0.0	0.0	0.0	0.0
Other pretax income	0.0	0.0	0.0	0.0	0.0
Pretax profit	582.4	801.0	1,026.8	1,247.4	1,419.2
Income tax	(107.0)	(169.8)	(211.6)	(259.9)	(298.0)
Minorities	(2.4)	3.8	25.7	32.2	32.2
Reported net profit	473.0	635.1	840.9	1,019.7	1,153.3
Core net profit	473.0	635.1	840.9	1,019.7	1,153.3
Balance Sheet					
Cash & Short Term Investments	4,234.2	3,454.1	3,726.8	4,180.0	4,505.7
Property, Plant & Equip (net)	510.0	701.0	1,015.5	1,271.5	1,518.0
Intangible assets	3,091.2	3,327.0	3,327.0	3,327.0	3,327.0
Investment in Associates & JVs	0.0	0.0	0.0	0.0	0.0
Other assets	8,025.3	9,399.8	11,669.7	12,509.6	14,146.6
Total assets	15,860.7	16,881.9	19,739.0	21,288.1	23,497.3
ST interest bearing debt	63.0	176.0	176.0	176.0	176.0
LT interest bearing debt	0.0	303.0	303.0	303.0	303.0
Other liabilities	13,349.8	13,722.5	16,075.2	17,012.5	18,529.8
Total Liabilities	13,412.8	14,201.5	16,554.2	17,491.5	19,008.8
Shareholders Equity	2,448.0	2,680.2	3,184.7	3,796.5	4,488.5
Minority Interest	0.0	0.0	0.0	0.0	0.0
Total shareholders equity	2,448.0	2,680.2	3,184.7	3,796.5	4,488.5
Cash Flow					
Pretax profit	582.4	801.0	1,026.8	1,247.4	1,419.2
Depreciation & amortisation	241.8	254.5	257.9	269.9	282.8
Adj net interest (income)/exp	(38.5)	(33.0)	(45.0)	(45.0)	(44.0)
Change in working capital	(107.0)	(1,041.5)	84.6	154.9	(10.5)
Cash taxes paid	(148.3)	(169.8)	(211.6)	(259.9)	(298.0)
Other operating cash flow	0.0	0.0	0.0	0.0	1.0
Cash flow from operations	1,940.4	20.3	930.7	1,157.3	1,106.5
Capex	(306.8)	(383.0)	(400.0)	(350.0)	(350.0)
Free cash flow	1,633.6	(362.7)	530.7	807.3	756.5
Dividends paid	(114.7)	(195.0)	(254.1)	(336.4)	(407.9)
Equity raised / (purchased)	0.0	0.0	0.0	0.0	0.0
Change in Debt	(211.7)	229.0	0.0	0.0	0.0
OTH investing/financing cash flow	(519.3)	36.0	0.0	0.0	0.0
Effect of exch rate changes	15.8	(11.0)	0.0	0.0	0.0
Net cash flow	803.6	(303.7)	276.6	470.9	348.6

FYE 31 Mar (USD m)	FY12A	FY13A	FY14E	FY15E	FY16E
Key Ratios					
Growth ratios (%)					
Revenue growth	34.0	14.5	13.1	10.8	9.3
EBITDA growth	18.0	17.4	37.5	15.4	13.2
EBIT growth	21.0	22.4	50.4	18.0	15.0
Pretax growth	21.2	37.5	28.2	21.5	13.8
Reported net profit growth	16.5	34.3	32.4	21.3	13.1
Core net profit growth	16.5	34.3	32.4	21.3	13.1
Profitability ratios (%)					
EBITDA margin	2.8	2.9	3.5	3.6	3.8
EBIT margin	2.0	2.1	2.8	3.0	3.1
Pretax profit margin	2.0	2.4	2.7	2.9	3.1
Payout ratio	24.3	30.7	30.2	33.0	35.4
DuPont analysis					
Net profit margin (%)	1.6	1.9	2.2	2.4	2.5
Revenue/Assets (x)	1.9	2.0	1.9	2.0	2.0
Assets/Equity (x)	nm	nm	nm	5.6	5.2
ROAE (%)	22.1	24.8	28.7	29.2	27.8
ROAA (%)	3.6	3.9	4.6	5.0	5.2
Liquidity & Efficiency					
Cash conversion cycle	nm	nm	nm	nm	nm
Days receivable outstanding	63.1	69.0	68.4	69.6	69.8
Days inventory outstanding	13.9	19.2	27.2	30.7	32.1
Days payables outstanding	127.9	136.5	135.4	138.6	138.6
Dividend cover (x)	4.1	3.3	3.3	3.0	2.8
Current ratio (x)	1.0	1.0	1.0	1.1	1.1
Leverage & Expense Analysis					
Asset/Liability (x)	1.2	1.2	1.2	1.2	1.2
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash
Net interest cover (x)	nm	na	21.5	21.2	24.3
Debt/EBITDA (x)	0.1	0.5	0.4	0.3	0.3
Capex/revenue (%)	1.0	1.1	1.0	0.8	0.8
Net debt/ (net cash)	(4,171.3)	(2,975.1)	(3,247.8)	(3,701.0)	(4,026.7)

Research Offices

REGIONAL

WONG Chew Hann, CA
Regional Head of Institutional Research
(603) 2297 8686 wchewh@maybank-ib.com

ONG Seng Yeow
Regional Head of Retail Research
(65) 6432 1453
ongsengyeow@maybank-ke.com.sg

Alexander GARTHOFF
Institutional Product Manager
(852) 2268 0638
alexgarthoff@kimeng.com.hk

ECONOMICS

Suhaimi ILIAS
Chief Economist
Singapore | Malaysia
(603) 2297 8682
suhaimi_ilias@maybank-ib.com

Luz LORENZO
Philippines
(63) 2 849 8836
luz_lorenzo@maybank-atrke.com

Tim LEELAHAPHAN
Thailand
(662) 658 1420 tim.l@maybank-ke.co.th

JUNIMAN
Chief Economist, BI
Indonesia
(62) 21 29228888 ext 29682
Juniman@bankbii.com

Josua PARDEDE
Economist / Industry Analyst, BI
Indonesia
(62) 21 29228888 ext 29695
JPardede@bankbii.com

MALAYSIA

WONG Chew Hann, CA Head of Research
(603) 2297 8686 wchewh@maybank-ib.com
• Strategy • Construction & Infrastructure

Desmond CH'NG, ACA
(603) 2297 8680
desmond.chng@maybank-ib.com
• Banking & Finance

LIAW Thong Jung
(603) 2297 8688 tjliaw@maybank-ib.com
• Oil & Gas - Regional • Shipping

ONG Chee Ting, CA
(603) 2297 8678 ct.ong@maybank-ib.com
• Plantations - Regional

Mohshin AZIZ
(603) 2297 8692 mohshin.aziz@maybank-ib.com
• Aviation - Regional • Petrochem

YIN Shao Yang, CPA
(603) 2297 8916 samuel.y@maybank-ib.com
• Gaming - Regional • Media

TAN Chi Wei, CFA
(603) 2297 8690 chiwei.t@maybank-ib.com
• Power • Telcos

WONG Wei Sum, CFA
(603) 2297 8679 weisum@maybank-ib.com
• Property & REITs

LEE Yen Ling
(603) 2297 8691 lee.yl@maybank-ib.com
• Building Materials • Glove Producers

CHAI Li Shin
(603) 2297 8684 lishin.c@maybank-ib.com
• Plantation • Construction & Infrastructure

KANG Chun Ee
(603) 2297 8675 chunee@maybank-ib.com
• Consumer

Ivan YAP
(603) 2297 8612 ivan.yap@maybank-ib.com
• Automotive

LEE Cheng Hooi Regional Chartist
(603) 2297 8694
chenghooi.lee@maybank-ib.com

Tee Sze Chiah Head of Retail Research
(603) 2297 6858 szechiah.t@maybank-ib.com

HONG KONG / CHINA

Howard WONG Head of Research
(852) 2268 0648
howardwong@kimeng.com.hk
• Oil & Gas - Regional

Alexander LATZER
(852) 2268 0647
alexanderlatzer@kimeng.com.hk
• Metals & Mining - Regional

Alison FOK
(852) 2268 0630 alisonfok@kimeng.com.hk
• Consumer

Jacqueline KO, CFA
(852) 2268 0633 jacquelineko@kimeng.com.hk
• Consumer

Karen KWAN
(852) 2268 0640 karenkw@kimeng.com.hk
• Property & REITs

Osbert TANG, CFA
(86) 21 5096 8370
osberttang@kimeng.com.hk
• Transport & Industrials

Philip TSE, CFA FRM
(852) 2268 0643 philiptse@kimeng.com.hk
• Property & REITs

Ricky WK NG, CFA
(852) 2268 0689 rickyng@kimeng.com.hk
• Utilities & Renewable Energy

Simon QIAN, CFA
(852) 2268 0634
simonqian@kimeng.com.hk
• Telecom & Internet

Steven ST CHAN
(852) 2268 0645 stevenchan@kimeng.com.hk
• Banking & Financials

Warren LAU
(852) 2268 0644
warrenlau@kimeng.com.hk
• Technology - Regional

William YANG
(852) 2268 0675
williamyang@kimeng.com.hk
• Technology - Regional

INDIA

Jigar SHAH Head of Research
(91) 22 6623 2601
jigar@maybank-ke.co.in
• Oil & Gas • Automobile • Cement

Anubhav GUPTA
(91) 22 6623 2605
anubhav@maybank-ke.co.in
• Metal & Mining • Capital Goods • Property

Urmil SHAH
(91) 22 6623 2606 urmil@maybank-ke.co.in
• Technology • Media

SINGAPORE

NG Wee Siang Head of Research
(65) 6432 1467 ngweesiang@maybank-ke.com.sg
• Banking & Finance

Gregory YAP
(65) 6432 1450 gyap@maybank-ke.com.sg
• SMID Caps - Regional
• Technology & Manufacturing • Telcos

Wilson LIEW
(65) 6432 1454 wilsonlie@maybank-ke.com.sg
• Property Developers

ONG Kian Lin
(65) 6432 1470 ongkianlin@maybank-ke.com.sg
• S-REITs

James KOH
(65) 6432 1431 jameskoh@maybank-ke.com.sg
• Consumer - Regional

YEAK Chee Keong, CFA
(65) 6432 1460
yeakcheekeong@maybank-ke.com.sg
• Offshore & Marine

Derrick HENG
(65) 6432 1446 derrickheng@maybank-ke.com.sg
• Transport (Land, Shipping & Aviation)

WEI Bin
(65) 6432 1455 weibin@maybank-ke.com.sg
• Commodity • Logistics • S-chips

John CHEONG
(65) 6432 1461 johncheong@maybank-ke.com.sg
• Small & Mid Caps • Healthcare

INDONESIA

Willianto IE Head of Research
(62) 21 2557 1125
willianto.ie@maybank-ke.co.id
• Strategy

Rahmi MARINA
(62) 21 2557 1128
rahmi.marina@maybank-ke.co.id
• Banking & Finance

Aurellia SETIABUDI
(62) 21 2953 0785
aurellia.setiabudi@maybank-ke.co.id
• Property

Anthony YUNUS
(62) 21 2557 1136
anthony.yunus@maybank-ke.co.id
• Consumer • Poultry

Isnaputra ISKANDAR
(62) 21 2557 1129
isnaputra.iskandar@maybank-ke.co.id
• Metals & Mining • Cement

Pandu ANUGRAH
(62) 21 2557 1137
pandu.anugrah@maybank-ke.co.id
• Infrastructure • Construction • Transport

Janni ASMAN
(62) 21 2953 0784
janni.asman@maybank-ke.co.id
• Cigarette • Healthcare • Retail

Lucky ARIESANDI, CFA
(62) 21 2557 1127
lucky.ariesandi@maybank-ke.co.id
• Telcos • Media

PHILIPPINES

Luz LORENZO Head of Research
(63) 2 849 8836
luz_lorenzo@maybank-atrke.com
• Strategy

Laura Dy-LIACCO
(63) 2 849 8840
laura_dyliacco@maybank-atrke.com
• Utilities • Conglomerates • Telcos

Lovell SARREAL
(63) 2 849 8841
lovell_sarreal@maybank-atrke.com
• Consumer • Media • Cement

Rommel RODRIGO
(63) 2 849 8839
rommel_rodrigo@maybank-atrke.com
• Conglomerates • Property • Gaming
• Ports/ Logistics

Katherine TAN
(63) 2 849 8843
kat_tan@maybank-atrke.com
• Banks • Construction

Ramon ADVIENTO
(63) 2 849 8845
ramon_adviento@maybank-atrke.com
• Mining

THAILAND

Maria LAPIZ Head of Institutional Research
Dir (66) 2257 0250 | (66) 2658 6300 ext 1399
Maria.L@maybank-ke.co.th
• Consumer / Materials

Jesada TECHAHUSDIN, CFA
(66) 2658 6300 ext 1394
Jesada.T@maybank-ke.co.th
• Financial Services

Kittisorn PRUITIPAT, CFA, FRM
(66) 2658 6300 ext 1395
Kittisorn.P@maybank-ke.co.th
• Real Estate

Sittichai DUANGRATTANACHAYA
(66) 2658 6300 ext 1393
Sittichai.D@maybank-ke.co.th
• Services Sector

Sukit UDOMSIRIKUL Head of Retail Research
(66) 2658 6300 ext 5090
Sukit.u@maybank-ke.co.th

Mayuree CHOWVIKRAN
(66) 2658 6300 ext 1440
mayuree.c@maybank-ke.co.th
• Strategy

Padon VANNARAT
(66) 2658 6300 ext 1450
Padon.v@maybank-ke.co.th
• Strategy

Surachai PRAMUALCHARONKIT
(66) 2658 6300 ext 1470
Surachai.p@maybank-ke.co.th
• Auto • Conmat • Contractor • Steel

Suttatip PEERASUB
(66) 2658 6300 ext 1430
suttatip.p@maybank-ke.co.th
• Media • Commerce

Sutthichai KUMWORACHAI
(66) 2658 6300 ext 1400
sutthichai.k@maybank-ke.co.th
• Energy • Petrochem

Termporn TANTIVIVAT
(66) 2658 6300 ext 1520
termporn.t@maybank-ke.co.th
• Property

Woraphon WIROONSRI
(66) 2658 6300 ext 1560
woraphon.w@maybank-ke.co.th
• Banking & Finance

Jaroonpan WATTANAWONG
(66) 2658 6300 ext 1404
jaroonpan.w@maybank-ke.co.th
• Transportation • Small cap

Chatchai JINDARAT
(66) 2658 6300 ext 1401
chatchai.j@maybank-ke.co.th
• Electronics

VIETNAM

LE Hong Lien, ACCA
Head of Institutional Research
(84) 844 55 58 88 x 8181
lien.le@maybank-kimeng.com.vn
• Strategy • Consumer • Diversified • Utilities

THAI Quang Trung, CFA, Deputy Manager,
Institutional Research
(84) 844 55 58 88 x 8180 trung.thai@maybank-
kimeng.com.vn
• Real Estate • Construction • Materials

TRUONG Thanh Hang
(84) 844 55 58 88 x 8085 hang.truong@maybank-
kimeng.com.vn
• Consumer

Le Nguyen Nhat Chuyen
(84) 844 55 58 88 x 8082 chuyen.le@maybank-
kimeng.com.vn
• Oil & Gas

NGUYEN Thi Ngan Tuyen, Head of Retail Research
(84) 844 555 888 x 8081
tuyen.nguyen@maybank-kimeng.com.vn
• Food & Beverage • Oil&Gas • Banking

NGUYEN Trung Hoa, Dy Head of Retail Research
(84) 844 555 888 x 8088
hoa.nguyen@maybank-kimeng.com.vn
• Macro • Steel • Real estate

TRINH Thi Ngoc Diep
(84) 44 555 888 x 8208
diep.trinh@maybank-kimeng.com.vn
• Technology • Utilities • Construction

TRUONG Quang Binh
(84) 44 555 888 x 8087
binh.truong@maybank-kimeng.com.vn
• Rubber plantation • Tyres and Tubes • Oil&Gas

PHAM Nhat Bich
(84) 844 555 888 x 8083
bich.pham@maybank-kimeng.com.vn
• Consumer • Manufacturing • Fishery

NGUYEN Thi Sony Tra Mi
(84) 844 555 888 x 8084
mi.nguyen@maybank-kimeng.com.vn
• Port operation • Pharmaceutical
• Food & Beverage

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Malaysia

Maybank Investment Bank Berhad
(A Participating Organisation of
Bursa Malaysia Securities Berhad)
33rd Floor, Menara Maybank,
100 Jalan Tun Perak,
50050 Kuala Lumpur
Tel: (603) 2059 1888;
Fax: (603) 2078 4194

Stockbroking Business:
Level 8, Tower C, Dataran Maybank,
No.1, Jalan Maarof
59000 Kuala Lumpur
Tel: (603) 2297 8888
Fax: (603) 2282 5136


Philippines

Maybank ATR Kim Eng Securities Inc.
17/F, Tower One & Exchange Plaza
Ayala Triangle, Ayala Avenue
Makati City, Philippines 1200

Tel: (63) 2 849 8888
Fax: (63) 2 848 5738


South Asia Sales Trading

Kevin FOY
kevinfoy@maybank-ke.com.sg
Tel: (65) 6336-5157
US Toll Free: 1-866-406-7447


Singapore

Maybank Kim Eng Securities Pte Ltd
Maybank Kim Eng Research Pte Ltd
9 Temasek Boulevard
#39-00 Suntec Tower 2
Singapore 038989

Tel: (65) 6336 9090
Fax: (65) 6339 6003


Hong Kong

Kim Eng Securities (HK) Ltd
Level 30,
Three Pacific Place,
1 Queen's Road East,
Hong Kong

Tel: (852) 2268 0800
Fax: (852) 2877 0104


Thailand

Maybank Kim Eng Securities
(Thailand) Public Company Limited
999/9 The Offices at Central World,
20th - 21st Floor,
Rama 1 Road Pathumwan,
Bangkok 10330, Thailand

Tel: (66) 2 658 6817 (sales)
Tel: (66) 2 658 6801 (research)


North Asia Sales Trading

Alex TSUN
alextsun@kimeng.com.hk
Tel: (852) 2268 0228
US Toll Free: 1 877 837 7635


London

Maybank Kim Eng Securities
(London) Ltd
6/F, 20 St. Dunstan's Hill
London EC3R 8HY, UK

Tel: (44) 20 7621 9298
Dealers' Tel: (44) 20 7626 2828
Fax: (44) 20 7283 6674


Indonesia

PT Maybank Kim Eng Securities
Plaza Bapindo
Citibank Tower 17th Floor
JI Jend. Sudirman Kav. 54-55
Jakarta 12190, Indonesia

Tel: (62) 21 2557 1188
Fax: (62) 21 2557 1189


Vietnam

Maybank Kim Eng Securities Limited
4A-15+16 Floor Vincom Center Dong
Khoi, 72 Le Thanh Ton St. District 1
Ho Chi Minh City, Vietnam

Tel : (84) 844 555 888
Fax : (84) 8 38 271 030


New York

Maybank Kim Eng Securities USA
Inc
777 Third Avenue, 21st Floor
New York, NY 10017, U.S.A.

Tel: (212) 688 8886
Fax: (212) 688 3500


India

Kim Eng Securities India Pvt Ltd
2nd Floor, The International 16,
Maharishi Karve Road,
Churchgate Station,
Mumbai City - 400 020, India

Tel: (91).22.6623.2600
Fax: (91).22.6623.2604


Saudi Arabia

In association with
Anfaal Capital
Villa 47, Tujjar Jeddah
Prince Mohammed bin Abdulaziz
Street P.O. Box 126575
Jeddah 21352

Tel: (966) 2 6068686
Fax: (966) 26068787