

Kingboard: Vertical integration drives margins

Recommendation: BUY (unchanged)

Hong Kong Industrials

Price	HK\$24.10	Year to Net profit	EPS*	EPS	P/E	P/B	EV/EBITDA	Yield	ROE	ROCE	N. Gear.	
Target price	HK\$33.00 (+37%)	Dec	HK\$m	HK\$	Δ %	X	x	x	%	%	%	
12 mth range	HK\$15.67-25.67	04A	1,103.8	1.587	106.5	15.2	3.1	13.3	1.2	24.4	13.6	74.3
Market cap.	US\$2,427.2m	05A	1,435.8	1.826	15.1	13.2	2.3	8.9	1.3	20.9	13.3	57.6
Daily t/o, 3 mth	US\$14.5m	06F	2,068.0	2.386	30.7	10.0	2.0	7.4	1.6	23.3	14.1	50.8
Free float %	46.0%	07F	2,382.7	2.749	15.2	8.7	1.7	6.2	1.8	22.1	14.8	43.1
Ticker	0148.HK/148 HK	08F	2,775.0	3.202	16.5	7.5	1.4	5.1	1.9	21.3	15.8	32.4

* Fully diluted EPS

Relative to Hang Seng Index (1 mth, 3 mth, 12 mth): +4.1%, +7.4%, +13.2%

Actual price changes (1 mth, 3 mth, 12 mth): +3.9%, +14.4%, +27.9%

Consensus EPS (06F-07F): HK\$2.379, HK\$2.743

Key points:

- Interim results were in line with expectations. Net profit surged 55.3% YoY to HK\$1,068.8m on a 25.4% YoY increase in turnover to HK\$7,465.0m.
- Operating margin was the main surprise, expanding 2.9 pcp YoY to 19.3%, led by margin increase across all major product lines of laminates, PCBs and chemicals.
- Kingboard is beginning to benefit from its vertical integration strategy. The chemicals segment will emerge as the company's new growth driver in FY12/07 through its 40:60 JV with CNOOC (883 HK, HK\$4.79, NR).
- We project profit growth momentum to sustain with a CAGR of 24.6% from FY12/06F to FY12/08F. We maintain our target price of HK\$33.00 based on 12x FY12/07F P/E. Maintain BUY.

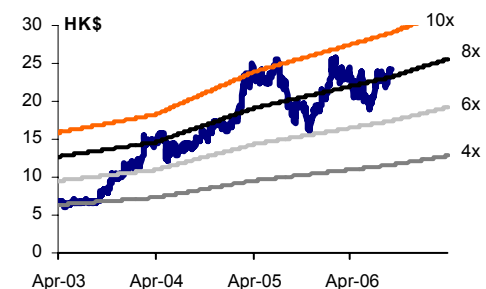
Interim results in line with expectations. Kingboard delivered a strong set of results which were in line with expectations. Turnover rose 25.4% YoY to HK\$7,465.0m, while net profit surged 55.3% YoY to HK\$1,068.8m. Operating profit was up 47.6% YoY to HK\$1,439.4m.

Top line driven by laminates and chemicals. The company's sales of laminates and chemicals were the key drivers in 1H FY12/06. Laminates sales jumped 40.4% YoY to HK\$2,867.2m, while chemicals rose 29.0% YoY to HK\$1,183.3m. PCB sales were solid, with a 17.6% YoY increase to HK\$2,899.2m. 70.6%-owned subsidiary Elec & Eltek accounted for around 25% of the group's overall sales.

Able to pass on rising raw material costs. On the back of strong PCB demand in China, management indicated that laminates production volume grew 23% YoY. Furthermore, the tight supply of laminates on the Mainland allowed the company to pass rising raw material costs onto downstream manufacturers by raising ASP by around 20% so far this year.

Strong margins the real surprise, driven by scale and vertical integration. In our view, the company's strong margins were the real surprise. Gross margin rose 2.5 pcp YoY to 26.7% while operating margin was up 2.9 pcp YoY to 19.3%. The margin expansion was driven by a combination of improved product mix of higher margin products, and margin increases in laminates and chemicals as a result of enlarged operating scale and revenue base. EBIT margin for laminates rose 4.3 pcp to 32.2%, implying a 62.0% YoY surge to HK\$925.4m. Chemicals EBIT margin improved by 2.0 pcp to 29.0% as the company's caustic soda plant in Hengyang and coke-methanol plant in Hebei recorded maiden profits after its ramp up period. Kingboard's vertical integration

Chart 1: P/E bands



Source: SBI E2-Capital

strategy is beginning to derive synergies. The enhanced sourcing power of the group enabled the PCB segment to lift EBIT margin to 11.3% (c. 10.9%).

Methanol JV with CNNOC may provide earnings upside in FY12/07. Trial run has commenced at its 40%-owned gas-based methanol facility with CNNOC (883 HK, HK\$4.79, NR). The plant, located in Hainan, will have an annual capacity of 600k tonnes and is expected to commence production in 1Q FY12/07. When fully ramped up, the chemicals division should emerge as the company's new growth driver. We note that methanol prices in Asia and North America have surged from around US\$320-\$340/tonne at the start of the year to US\$420/tonne, while management indicated that methanol prices in China are presently around US\$380/tonne. While we acknowledge that prices may retreat from current highs with additional production capacity coming on line, we believe that prices will continue to be sustained by increasing demand for the product in China as a processing component for fuel and as industrial feedstock.

Laminates spin-off may unlock value. The strong results in the laminates segment appear to support the company's decision to spin-off its business. Valuations of international comparables vary widely, presently trading at between 8.9x to 16.1x current year P/E based on consensus estimates. In our view, a successful spin-off would allow Kingboard to 1) focus on expanding its chemical business and vertical integration of its PCB business, 2) unlock valuation in its laminates business, 3) reduce inter-segment competition for the company's capital and 4) most importantly reduce the debt level. The company reduced its net gearing to 52.4% from 57.6% at the end of FY12/05.

Strong momentum going into 2H. The company is experiencing strong momentum going into 2H with 1) margin expansion across all segments, 2) M&A synergies from its vertical integration strategy and 3) strong global demand for consumer electronics as well as continuing manufacturing outsourcing to China. Management noted that PCB shipments and order inflows continue to be strong while we have also noticed a pick up in activities among leading PCB manufacturers in Taiwan.

Maintain BUY and target price HK\$33.00. We maintain our profit forecast of HK\$2,068.0m (EPS: HK\$2.836) for FY12/06F and thereafter HK\$2,382.7m (EPS: HK\$2.749) for FY12/07F and HK\$2,775.0m (EPS: HK\$3.202) for FY12/08F, representing a CAGR of 24.6%. Chemical sales will be the key growth driver over this period, increasing its contribution from 15.4% of revenues in FY12/05 to 26.0% in FY12/08F. We expect the combination of scale and vertical synergies to allow Kingboard to sustain its current margins. We maintain our BUY call on the counter with a target price of HK\$33.00, based on 12x FY12/07F P/E.

Table 1: Interim results

6 months to June	Turnover (HK\$m)	Gross profit (HK\$m)	Gross margin (%)	Operating profit (HK\$m)	Operating margin (%)	Net profit (HK\$m)	Basic EPS (HK\$)
1H 06	7,465.0	1,989.6	26.7	1,439.4	19.3	1,068.8	1.362
1H 05	5,954.0	1,438.0	24.2	975.0	16.4	688.3	0.956
YoY (%)	25.4	38.4	2.5	47.6	2.9	55.3	42.5

Source: Company data and SBI E2-Capital

Table 2: Divisional EBIT operating margin

Year to Dec (%)	1H 04	2H 04	1H 05	2H 05	1H 06
Sale of laminates	28.6	27.5	28.0	23.5	32.2
Sale of printed circuit boards	7.6	7.6	11.0	10.5	11.3
Sale of chemicals	13.4	7.1	10.0	7.0	11.9

Source: Company data and SBI E2-Capital

Table 3: Revenue breakdown by products

Year to Dec (HK\$m)	02A	03A	04A	05A	06F	07F	08F
Sale of laminates	1,895.8	2,547.0	3,736.9	4,788.4	5,183.8	5,465.2	6,107.8
Sale of printed circuit boards	256.7	1,008.5	1,832.4	5,284.2	5,826.3	6,319.7	6,642.7
Sale of chemicals	265.1	703.7	1,207.8	2,023.4	2,527.3	3,538.2	4,776.6
Others	46.6	176.4	305.3	1,002.4	738.8	797.9	837.8
Total	2,464.3	4,435.5	7,082.4	13,098.4	14,276.2	16,121.1	18,364.9

Source: Company data and SBI E2-Capital

Table 4: earnings model

Year to Dec (HK\$m)	03A	04A	05A	06F	07F	08F
Turnover	4,435.5	7,082.4	13,098.4	14,276.2	16,121.1	18,364.9
% chg	-	59.7	84.9	8.9	12.9	13.9
Cost of sales	(3,450.0)	(5,126.3)	(9,918.5)	(10,490.3)	(11,829.8)	(13,458.0)
Gross profit	985.5	1,956.1	3,180.0	3,785.9	4,291.2	4,906.9
Other operating income	21.0	33.4	67.1	78.4	65.2	56.9
Distribution costs	(103.7)	(199.9)	(384.9)	(414.4)	(451.9)	(505.6)
Administrative costs	(293.2)	(412.5)	(790.9)	(880.1)	(997.1)	(1,132.2)
Other gains/(losses)	(2.6)	(23.3)	6.3	3.2	3.2	3.2
Operating profit	607.1	1,353.8	2,077.6	2,575.7	2,820.0	3,253.0
Finance costs	(47.1)	(90.3)	(274.4)	(211.0)	(189.9)	(161.4)
Associates	-	(1.7)	-	-	-	-
Jointly-controlled entit.	-	(4.1)	(14.3)	(3.3)	(3.0)	(2.7)
Pre-tax profit	560.0	1,257.5	1,788.8	2,358.7	2,717.7	3,165.1
Tax	(37.6)	(61.2)	(140.0)	(141.5)	(163.1)	(189.9)
Minority interests	(50.0)	(92.5)	(213.0)	(149.2)	(171.9)	(200.2)
Net profit	472.4	1,103.8	1,435.8	2,068.0	2,382.7	2,775.0
% chg	-	133.7	30.1	44.0	15.2	16.5
Dividends	(95.9)	(208.8)	(314.4)	(328.8)	(357.0)	(381.9)

Source: company data and SBI E2-Capital

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