

## 1H results better than expected

## China Consumer

### Huabao (336 HK, HK\$4.09)

### Not Rated

**Results summary.** Huabao International reported 1H FY3/07 net profit of HK\$244.8m, up 251.1% YoY. The results were better than market expectations as the street was looking for a full year profit of HK\$440.0m. Turnover grew 29.4% to HK\$458.3m, mainly due to 33.5% increase in tobacco flavors sales to HK\$407.0m. Operating profit grew 210.8% to HK\$250.9m. An interim dividend of HK\$1.8cents was declared.

**Table 1: 1H FY3/07 results**

Year to Mar	Turnover (HK\$m)	Gross profit (HK\$m)	Gross margin (%)	Pre-tax profit (HK\$m)	Net profit (HK\$m)	Basic EPS (HK cents)
1H07	458.3	299.8	65.4	248.5	244.8	9.23
1H06	354.1	115.4	32.6	77.5	69.7	2.83
YoY (%)	29.4	159.8	100.6	220.6	251.1	226.1

Source: Company data

**Overall margin expansion.** The impressive results of GP improvement were mainly due to the change in the cost structure. Cost of good sold fell by 33.6% in 1H FY3/07 as a result of its upstream expansion of product chain and research and development.

**Table 2: Margin analysis**

Year to Mar	Gross margin (%)	Operating margin (%)	Net margin (%)
1H07	65.4	54.8	53.4
1H06	32.6	22.8	19.7
YoY (%)	100.6	140.4	171.1

Source: Company data

**Key drivers.** Tobacco flavors segment accounted for 89.0% of its total turnover and 97.7% of its operating profit. Gross margin reached 68.5% and operating margin also surged 132.8% to 60.3% YoY. Top ten tobacco companies were estimated to account for 80.0% of its total turnover. Turnover of Hongta (its largest client) was estimated to increase over 35.0% in 1H FY03/07.

Although the food flavors business only had a one-year operation history, its turnover and operating profit grew by 19.1% and 33.4% respectively. Gross and operating margin reached 42.5% and 15.6% respectively. Its AP turnover was 128 days (142 days in FY3/06) and AR turnover was 158 days (165 days in FY3/06).

**Table 3: Turnover breakdown by segment**

Year to Mar	1H FY3/05 (HK\$m)	1H FY3/06 (HK\$m)	YoY (%)
Tobacco flavors	304.9	407.0	33.5
Food flavors	38.8	46.2	19.1
Others	6.7	5.1	(23.9)
Unallocated	3.7	0.044	(98.8)
<b>Total</b>	<b>354.1</b>	<b>458.3</b>	<b>29.4</b>

Source: Company data

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**Table 4: Operating profit analysis**

6 months to Sep (HK\$m)	FY05	FY06	YoY (%)
Tobacco flavours	78.9	245.2	210.8
Food flavours	5.4	7.2	33.4
Others	0.121	(0.138)	(214.0)
Unallocated	(3.7)	(1.349)	(63.5)
<b>Total</b>	<b>80.7</b>	<b>250.9</b>	<b>210.8</b>

Source: Company data

**Turnover expected to double by FY3/09.** According to guidance from Chairlady Chu, turnover is expected to double by FY3/09F on the back of tobacco flavors market share expansion from the current 30% to >50%.

**Sales volume from its top clients is on the rise.** The tobacco industry is under consolidation. Sales volume of Huabao's top ten clients is on the rise. For example, Baisha merged with another cigarette company in Hunan province on 16 Nov. 2006. According to Chairlady Chu, its production volume is expected to reach 6m cases by 2010 from its current 2.9m cases after the merger.

**M&A.** In addition to organic growth, Huabao is actively looking for potential M&A targets especially for its upstream operations. It targets to establish an integrated core industry chain by developing relevant upstream fragrance raw materials.

**Valuation.** Huabao's market share in tobacco flavours segment is expected to reach 50% over the next three years while turnover is expected to grow by 30% in FY3/07F. The counter is trading at FY3/07F P/E of 27.7x and 20.8x FY3/08F P/E.

**Table 5: Peer comparisons**

Company	Ticker	Hist. P/E (x)	Fwd Yr 1 P/E (x)	Fwd Yr 2 P/E (x)	Gross margin (%)	ROE (%)	PEG (x)
International Flavors & Fragrances	IFF US	20.7	19.5	17.7	41.4	21.2	2.0
Givaudan	GIVN VX	16.7	16.9	16.9	48.9	14.5	2.8
T Hasegawa	4958 JP	19.6	18.8	17.7	34.1	7.2	na
Takasago	4914 JP	17.2	19.9	18.1	28.5	5.4	na
China F & F	3318 HK	15.6	16.9	14.3	63.8	37.5	1.6
Huabao	336 HK	na	27.7	20.8	65.4	na	na
<b>Average</b>		<b>18.0</b>	<b>20.0</b>	<b>17.6</b>	<b>47.1</b>	<b>17.2</b>	<b>2.1</b>

Source: Bloomberg & SBI E2-Capital

**Table 6: Latest interim results comparisons**

Company	Turnover growth (%)	Gross profit growth (%)	Operating profit growth (%)	Net profit growth (%)	Gross margin (%)	Operating margins (%)	Net margins (%)
China F&F (3318 HK)	37.6	41.5	37.8	40.2	64.8	35.2	28.7
Huabao (336 HK)	29.4	159.8	210.8	251.1	65.4	54.8	53.4

Source: Bloomberg & SBI E2-Capital