Kennedy Tsang
(852) 2533 3713
kennedytsang@sbie2capital.com

Yip's Chemical: Accelerating growth ahead

Recommendation: BUY (unchanged) **Hong Kong Industrials**

Price	**HK$5.60**
Target price	HK$7.40 (32%)
12 mth range	HK$3.48-5.90
Market cap.	US$351.9m
Daily t/o, 3 mth	US$0.2m
Free float %	37.0%
Ticker	0408.HK/408 HK

Year to Mar	Net profit HK$m	EPS HK$	EPS Δ %	P/E x	P/B x	EV/EBITDA x	Yield %	ROE %	ROCE %	N. Gear. %
06A	168.4	0.355	35.0	15.8	2.99	10.4	2.5	20.4	17.5	27.7
07A	223.6	0.466	31.5	12.0	2.44	7.4	3.6	22.4	11.8	14.0
08F	265.7	0.554	18.8	10.1	2.43	6.3	4.2	23.9	23.7	18.2
09F	324.2	0.676	22.0	8.3	2.04	5.4	5.1	26.2	26.2	22.4
10F	384.8	0.803	18.7	7.0	1.74	5.7	6.0	26.1	27.0	11.6

Relative to Hang Seng Index (1 mth, 3 mth, 12 mth): +9.4%, +29.3%, +19.3%
Actual price changes (1 mth, 3 mth, 12 mth): +3.1%, +10.6%, +48.3%
Consensus EPS (08F-09F): HK$0.555, HK$0.679
Previous forecasts (08F-09F): HK$262.7m ($0.548), HK$314.2m ($0.655)

Key points:

- With its solvents and coating products used in everyday consumption item, Yip's is an under-appreciated beneficiary of China's domestic consumption growth;
- Growth areas include: 1) plastic inks (used for packaging of fast moving consumer goods); 2) self-branded "Bauhinia" architectural paints and 3) diversification into offset printing inks;
- Yip's is benefiting from the recent toy recalls by US toy brand owners. Company has witnessed an increase in requests for qualification and sample submissions, boding well for revenue growth in this area.
- Recently announced acquisition of Taixing will allow Yip's to expand its solvents business to eastern China.
- Revise up our target price to HK$7.40 (previously HK$6.55), representing 11.0x FY3/09F P/E, on a more robust outlook. The counter is currently undemanding, trading at 8.3x FY3/09F P/E.

Increasing exposure to China's domestic consumption. Yip's Chemical is a little known China-based upstream consumption play. It produces coating products in 15 plants and solvents in 2 plants across the country and sells them to domestic consumption-related industries. Taking the company as a whole, management estimates that 90% of its downstream manufacturing clients sell their products domestically.

China's largest ink supplier. Yip's coatings products include gravure inks for packaging printing and printing of decorative carry bags and plastic inks for the printing of plastic wraps and plastic packaging. Its plastic inks are used in the packaging of fast moving consumer goods and its key customers include food and beverage giants such as Tingyi (322 HK) and Want Want. We estimate that the company's total ink sales account for around 25% of its coatings turnover. While demand for gravure inks has been stable, plastic inks have experienced solid growth on the back of China's growing consumption. As consumption units and volume increases, there is a direct increase in demand for Yip's plastic inks, which is used for packaging. The growing proportion of plastic inks in the coatings segment will also benefit the company's profitability, as their margins are higher than those of gravure inks.

Horizontal expansion into offset printing ink. To further capture the printing market, Yip's plans to produce offset printing ink, which is generally used for the printing of magazines. Its addressable market is more than double that of gravure inks. The company undertook production trials and qualifications in FY3/08 and will commence sales in FY3/09.

Leveraging the "Bauhinia" brand for architectural paints. The remaining 75% of its coatings segment turnover comes from sales of paint products such as domestic architectural paints, industrial paints, varnishes and resins. Architectural paints account for around 50% of the paint products in terms of revenue. The main brand under this line is "Bauhinia", one of the domestic leaders, behind international brands such as ICI, Dupont and PPG. The company has recently launched a TV ad campaign on CCTV to further enhance its brand value.

We estimate that this segment is likely to grow between 15-18% over the next few years.

Beneficiary of toy recalls. With the recent series of US toy recalls by Mattel and Toys "R" Us, Yip's will benefit from the increased emphasis on paint safety and quality. Yip's was already a supplier to Mattel prior to the recall and though its products were not involved in any of the quality issues, they have since passed all re-inspections/re-qualifications initiated by customers. Yip's maintains a very stringent quality control system and imports all of raw materials for its colour pigments from renowned overseas suppliers such as Denko and Degussa. Much of the previous quality issues with other domestic industrial paint producers came when they sourced and used domestic colour pigments. The company internally tests every batch of pigments before incorporating it into its paint products. Its plant in Huiyang has both RoHS and national CNAS QC laboratory accreditation.

"Flight to quality" increases Yip's bargaining power. Although toy paint ASPs were stable in 2007, the company believes there's room to increase them in 2008 as a result of the "flight to quality". Requests from potential new customers for qualification samples and quotations surged at the end of 2007 and demand for its paint products jump between 25-30%. In our view, though this magnitude of increase during the off-peak season may not be representative of the full year, it is a solid sign of Yip's good prospects going forward. By our estimation, toy paint products account for just under 20% of the company's coatings turnover. We are not overly concerned about a potential economic slowdown in the US in 2008 because the "toy budget" is generally the last item to be cut in typical household spending. As a testament, Toys "R" Us recently announced that same store sales grew 3.1% YoY during the holiday period, outpacing the performance of other retailers and consumer segments.

Taixing acquisition announced. Yip's announced in Dec 2007 the acquisition of Taixing Jinjiang Chemcial Industry through 75%-owned subsidiary Concord Chemical Storage Ltd. The Huadong-based facility produces ethanol (upstream raw material of the company's solvents products) and absolute alcohol. The total consideration of HK$73.7m comprises a cash payment of HK$33.5m and taking on Taixing's outstanding debt of HK$40.2m. Based on the net asset value at end-Dec 2006, the consideration represents 1.5x P/B, though an independent valuer hired by the company has valued Taixing at HK$68.0m. For FY12/05A and FY12/06A, Taixing recorded net losses of HK$4.2m and HK$2.6m, respectively. The plant's production capacity currently stands at 80,000t.p.a of ethanol and 15,000t.p.a of absolute alcohol.

Strategic expansion into eastern China. The acquisition will allow Yip's to expand its solvent business into the eastern China, extending its geographical reach beyond its current stronghold in southern China. The company plans to construct a 55,000t.p.a solvents plant adjacent to the existing facilities by end-2008 at a cost of around HK$50.0m. An added advantage is that the existing ethanol plant lies on a 110mu (7.3ha) piece of land with ample space on the site and no additional land acquisition necessary for the construction of the new plant. On completion, the company will be able to internally supply ethanol to its solvents plant and sell the unused capacity to third parties.

Geographical expansion advantages. By ensuring Yip's own supply of ethanol, while most other solvent producers in the region purchase from outside sources, the acquisition brings several strategic advantages in terms of the absence of consumption tax (5% on ethanol) and extending its already favourable supply agreement with Celanese to the eastern China area to create cost benefits. Lastly, the plant has "2+3" tax benefits that have yet to be utilized.

Solvents capacity to expand. Yip's solvent capacity could reach 365,000t.p.a. by end-2008 thanks to: 1) the Taixing acquisition, 2) streamlining of its Jiangmen plant and 3) capacity expansion of its recently acquired Shengda plant. Given the company's significant market share in southern China, the trend of "flight-to-quality", cost advantages and new geographical market in Huadong, we expect this expansion to boost its solvents turnover. Yip's solvent plants have historically run at 95-100% utilization.

Still exploring M&As. We understand that Yip's is exploring M&A opportunities, in coatings and solvents segments. The company reduced its net gearing ratio to a comfortable 10.0% in 1H FY3/07A and has HK$501.0m cash and cash equivalents as well as unused banking facilities of around HK$890.6m.

Revised estimates. The Taixing acquisition is expected to be completed in Feb 2008 and we have largely left our FY3/08F net profit estimate unchanged at HK$265.7m. However, on the back of accelerating growth in its coatings segment and solvents capacity expansion, we have revised up our FY3/09F and FY3/10F estimates to HK$324.2m and HK$384.8m (c.f. HK$314.2m and HK$369.3m), respectively.

Target price raised to HK$7.40. With Yip's: 1) focused and increasing exposure to China's overall consumption boom; 2) accelerating growth in paint/ink coatings segment; 3) diversification into gravure inks and 4) strategic expansion into the eastern China region, we believe that Yip's is deserved of a re-rating. We revise up our target price to HK$7.40 (previously HK$6.55), representing 11.0x FY3/09F P/E. The counter is currently undemanding, trading at 8.3x FY3/09F P/E.

Table 1: Earnings model

Year to Mar (HK$m)	06A	07A	08F	09F	10F
Turnover					
Solvents	1,973.6	2,194.7	2,583.5	3,348.1	3,794.2
Coating	1,196.0	1,398.7	1,599.2	1,868.5	2,112.1
Lubricants	219.3	205.1	232.8	267.7	307.8
Others	64.0	115.4	121.2	127.2	133.6
Elimination	(123.3)	-	-	-	-
	3,329.7	**3,913.8**	**4,536.7**	**5,611.5**	**6,347.7**
% chg	*24.4*	*17.5*	*15.9*	*23.7*	*13.1*
Cost of sales	(2,667.2)	(3,121.2)	(3,604.5)	(4,453.7)	(5,039.8)
Gross profit	662.5	792.6	932.2	1,157.9	1,307.9
Other revenue	16.2	26.4	61.2	56.1	57.1
Selling expenses	(98.6)	(106.4)	(131.6)	(179.6)	(203.1)
Administrative expense	(340.1)	(364.7)	(442.9)	(531.3)	(570.1)
Operating profit	240.0	348.0	419.0	503.2	591.8
Interest expense	(21.5)	(26.3)	(23.7)	(20.8)	(19.3)
Associates	-	-	-	-	-
Jointly-controlled entit.	-	-	-	-	-
Pre-tax profit	**218.4**	**321.7**	**395.3**	**482.3**	**572.6**
Tax	(21.7)	(52.0)	(64.0)	(78.1)	(92.8)
Minority interests	(28.3)	(46.1)	(65.6)	(80.0)	(95.0)
Net profit	**168.4**	**223.6**	**265.7**	**324.2**	**384.8**
% chg	*36.7*	*32.8*	*18.8*	*22.0*	*18.7*
Dividends	(66.8)	(81.7)	(111.6)	(136.2)	(161.6)

Source: Company data & SBI E2-Capital