

Yip's Chemical



Paving the way for sustainability

BUY (unchanged)

Key points:

- Net proceed of HK\$269.0m from Yip's first secondary market placement since 1993 to finance M&As.
- Its Chengdu coatings plant ideally located to meet architectural paint demand from reconstruction efforts after the recent Sichuan earthquake.
- New coatings business acquisition to improve product line and help attract high-end clients including Foxconn, Sony, Lenovo and Philips.
- M&A / expansion strategy to ensure future growth sustainability as rising labour costs in China's south may force customers to relocate north.
- Remains our top pick in the sector - maintain BUY with a target price cut to HK\$6.60 (from HK\$7.40) to factor in the placement's dilution effect.

Hong Kong Industrials

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Stock data

Price	HK\$5.40
Target price	HK\$6.60 (+22%)
12 mth range	HK\$4.28-6.27
Market cap.	US\$372.4m
Daily t/o, 3 mth	US\$0.77m
Free float %	43.0%
Ticker	0408.HK/408 HK

Financial summary

Year to Mar	06A	07A	08F	09F	10F
Turnover (HK\$m)	3,329.7	3,913.8	4,536.7	5,661.7	6,455.8
Net Profit (HK\$m)	168.4	223.6	265.7	323.2	390.0
EPS (HK\$m)	0.335	0.466	0.554	0.601	0.725
EPS Δ%	35.0	31.5	18.8	8.4	20.7
P/E (x)	15.2	11.6	9.7	9.0	7.4
P/B (x)	2.88	2.36	2.35	2.14	1.81
EV/EBITDA (x)	10.1	7.2	6.1	5.4	6.0
Yield (%)	2.6	3.7	4.3	4.7	5.6
ROE (%)	20.4	22.4	23.9	26.1	26.4
ROCE (%)	17.5	21.3	23.7	26.1	26.9
N. Gear. (%)	27.7	14.0	18.2	4.8	Cash

Adding to the cash hoard. In Apr 2008, Yip's undertook its first fund raising exercise since 1993 through its largest shareholder's placement of existing shares and subscription of new shares (50.0m in total) at HK\$5.50 each, a 6.8% discount to the closing price on the day before the placement. The placement shares represented about 9.3% of the company's enlarged issued share capital. The net proceeds totaled about HK\$269.0m

Minor earthquake impact. Only one of Yip's plants was affected by the recent earthquake in Sichuan province. Located in Chengdu, the architectural paint coatings plant was forced to temporarily halt production but we understand that there is no significant structural damage and that the plant has already resumed operation. The plant is located next to a highway which was unaffected by the earthquake, meaning that product and raw material deliveries are unlikely to suffer.

Potential beneficiary. Though Yip's may experience some short-term delivery disruptions due to the earthquake, we believe it may benefit from reconstruction efforts in the Sichuan region, which will fuel demand for its architectural paints. However, it is too early at this stage to quantify the P&L impact.

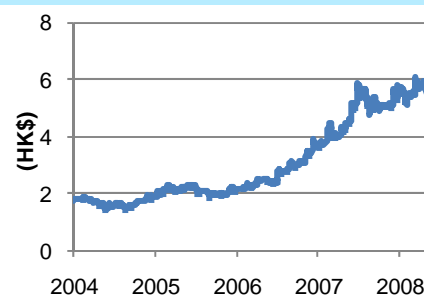
Foothold in the offset inks market. In Mar 2008, Yip's acquired Fusen Ink Chemical Co. Ltd. in a non-discloseable transaction for RMB23.8m. Located in Cangzhou, Jiangsu Province, the deal includes land, a 26,000sqm plant and production equipment. The plant has a production capacity of 6,000 tonnes of gravure and offset printing ink. Already one of China's largest suppliers of gravure inks, Yip's has been looking to break into the more lucrative offset inks market. The company undertook some trial production and qualification in 2007 and planned to commence offset ink sales in FY03/09. The plant is currently serving clients in Tianjin and the acquisition gives Yip's immediate presence in Northern China to develop the growing domestic inks market. Though no financials have been released, we believe the company

Price Performance

	1 mth	3 mth	12 mth
Relative to HSI (%)	-11.9	-8.9	-4.4
Actual price changes (%)	-6.2	-2.7	17.7

	08F	09F	10F
Consensus EPS (HK\$)	0.555	0.690	-
Previous forecasts (HK\$m)	265.7	324.2	384.8
Previous EPS (HK\$)	0.554	0.676	0.803

Price Chart



may be a breakeven or loss-making operation considering Yip's habit of buying underperforming assets and turning them around by developing their sales teams, infusing management best practices and leveraging sourcing scale advantages. As the move represents Yip's entry into a new market, we factor in no positive bottom line contribution in its first year of operations.

Moving into high-end coatings business. Yip's also agreed to acquire a superior specialist coatings maker focusing on casings for electronics and toys in April 2008. The company has a high-end client base, including Foxconn (2038 HK), Lenovo (992 HK), Sony, Vtech (303 HK) and Philips. The deal, expected to be completed in Jun 2008, includes coatings inventories, management, coatings brands, business relationships/data and property rights such as formulas, formula management system and application technologies. Yip's plans to transfer all of the target company's business data and technology know-how to its Huiyang plant, where it can leverage existing competitive advantages of procurement and production scale (coatings capacity of 15,000 tonnes p.a.). Yip's stopped short of acquiring the target company's plant as it lacked scale and did not meet many of the safety regulations.

Paving the way for future sustainability. We believe that Yip's current M&A/expansion strategy focused on new products and geographical markets will pave the way for its future growth sustainability. With rising labour costs, many of Yip's customers may be looking at relocating north. Its base in China's Huadong region, thanks to the Taixing acquisition, will allow Yip's to continue serving its clients. Meanwhile, its horizontal expansion into the offset inks market will help the company build a new client base away from its main southern China region.

Maintain BUY call, new target price HK\$6.70. We like Yip's prudent strategy of acquiring underperforming assets and the counter remains our top pick in the sector. We have left our FY03/08F estimates intact but nominally lower our net profit projections for FY03/09F to HK\$323.2m and FY03/10F to HK\$384.6m (from HK\$324.2m and HK\$384.8m, respectively) to factor in: 1) nominal contributions from its new coatings acquisitions; 2) slight margin shrinkage in FY3/09F and FY3/10F. We maintain our BUY call but cut our target price to HK\$6.60, after taking into consideration the placement's dilution effect.

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	1,918.7	2,220.2
Coating	1,196.0	1,398.7	1,599.2	3,348.1	3,794.2
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	5,661.7	6,455.8
% chg	24.4	17.5	15.9	24.8	14.0
Cost of sales	(2,667.2)	(3,121.2)	(3,604.5)	(4,490.5)	(5,119.3)
Gross profit	662.5	792.6	932.2	1,171.2	1,336.5
Other revenue	16.2	26.4	61.2	56.6	58.1
Selling expenses	(98.6)	(106.4)	(131.6)	(186.8)	(226.0)
Administrative expense	(340.1)	(364.7)	(442.9)	(539.2)	(569.1)
Operating profit	240.0	348.0	419.0	501.7	599.6
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	480.9	580.3
Tax	(21.7)	(52.0)	(64.0)	(77.9)	(94.0)
Minority interests	(28.3)	(46.1)	(65.6)	(79.8)	(96.2)
Net profit	168.4	223.6	265.7	323.2	390.0
% chg	36.7	32.8	18.8	21.7	20.7
Dividends	(66.8)	(81.7)	(111.6)	(135.8)	(163.8)

Source: Company data & SBI E2-Capital

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