

Yip's Chemical: M&As coming

Recommendation: BUY (unchanged)

Hong Kong Chemicals

Price	HK\$4.81	Year to Net profit	EPS	EPS	P/E	P/B	EV/EBITDA	Yield	ROE	ROCE	N. Gear.	
Target price	HK\$6.05 (+26%)	Mar	HK\$m	HK\$	Δ %	x	x	x	%	%	%	
12 mth range	HK\$2.205-4.81	05A	123.2	0.263	26.8	18.3	2.99	11.1	2.5	17.1	17.2	30.3
Market cap.	US\$297.4m	06A	168.4	0.355	35.0	13.6	2.56	9.1	2.9	20.4	17.5	27.7
Daily t/o, 3 mth	US\$2.8m	07F	213.2	0.442	24.7	10.9	2.36	6.9	4.7	22.9	20.6	20.5
Free float %	35.3%	08F	243.6	0.505	14.2	9.5	2.07	6.0	4.7	23.4	22.3	18.3
Ticker	0408.HK/408 HK	09F	298.0	0.618	22.3	7.8	1.78	4.9	5.8	24.9	24.8	11.2

Relative to Hang Seng Index (1 mth, 3 mth, 12 mth): +13.4%, +15.4%, +42.1%

Actual price changes (1 mth, 3 mth, 12 mth): +13.9%, +28.4%, +78.6%

Consensus EPS (07F-08F): HK\$0.442, HK\$0.526

Previous forecasts (07F-08F) HK\$213.2 (HK\$0.442), HK\$243.6 (HK\$0.505), HK\$298.0 (HK\$0.618)

Key points:

- With lower gearing and improving cash position, Yip's is looking to M&A to further accelerate its already robust growth.
- With M&A targets being its nearest competitors, the strategy would eliminate competitors and achieve a faster capacity increase, without putting undue downward pressure on solvent prices.
- With a likely acceleration in growth going forward and new raw material supply contract with Celanese commencing in FY3/08 (which would further improve the company's sourcing power), Yip's is further solidifying its status as a leading solvent and coatings supplier in China.
- We have revised up its target price to HK\$6.05 (previously HK\$5.10), representing 12.0x FY3/08F P/E. Our estimates in FY3/08F and beyond have yet to incorporate any earnings accretive M&As.

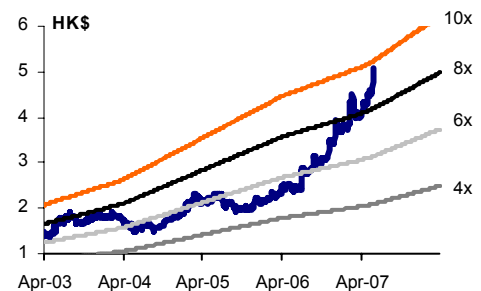
We had a conference call with the company's management recently. Key takeaways are as follows:

Taking on a more aggressive growth strategy. Yip's has been successful in reigning in its gearing ratio from a high of 45% in 1H FY3/06A to 31% in 1H FY3/07A. Taking into seasonal effects, the company is estimated to further reduce this to just over 20% for FY3/07F. With an improving balance sheet, management has decided to take on a more aggressive growth strategy. While management previously had plans to organically expand its solvents capacity from 200,000 tonnes to 260,000 tonnes by 3Q FY3/08, they are now forfeiting this in favour of a M&A strategy.

Targeting nearest competitors for M&A. Currently, management is targeting to acquire the second or third largest competitor, both of which are located in the Guangdong region (Yip's is largest solvent producer in Southern China with around 60% market share according to the management). Furthermore, they have indicated that they would be open to consider multiple M&As. We understand that at present, the second largest solvent producer behind Yip's has a capacity of around 50,000 tonnes, meaning that they would essentially be able to reach their previous organic capacity growth target. In our view, an M&A strategy for growth is more favourable for the following reasons:

- ❑ Yip's can eliminate a competitor as a result of the M&A, and consolidate the industry players.
- ❑ Overall supply capacity will not be affected, resulting in less pricing pressure on solvents.
- ❑ Capacity increase can be achieved faster.
- ❑ Yip's can further leverage their already strong supply sourcing power and put more distance on its nearest

Chart 1: P/E bands



Source: SBI E2-Capital

competitor in terms of operating scale.

Offsetting margin pressure by using substitute raw materials. Though prices for butyl acetate has increased in 2H FY3/06, the company has been able to offset this margin pressure by using mix-butyl acetate as raw material for some of its solvent products. Yip's is the only solvent producer in the world that has the manufacturing process to manufacture certain types of solvents and can source this alternative raw material at near disposal value. Nevertheless, we expect operating margins to come down from the 11.0% recorded in 1H FY3/07A (ex. eliminations) on seasonality and the absence of an inventory gain.

Reiterate BUY call, target price HK\$5.10. The company is on track to meet our FY3/07F net profit forecast of HK\$213.2m. With a likely acceleration in growth going forward and new raw material supply contract with Celanese commencing in FY3/08 (which would further improve the company's sourcing power), Yip's is further solidifying its status as a leading solvent and coatings supplier in China. We have revised up its target price to HK\$6.05 (previously HK\$5.10), representing 12.0x FY3/08F P/E. The valuation is in line with other chemical plays and a conservative 15% valuation discount on other China industrials, which sells the majority of its products domestically. Our estimates in FY3/08F and beyond have yet to incorporate any earnings accretive M&As.

Table 1: Valuation comparisons

Company Name	Ticker	Country	Mkt Cap (US\$m)	Price	Cur Yr PE (x)	Nxt Yr PE (x)
International						
Showa Denko	4004 JP	JP	4,250.0	Yen423.0	15.5	13.2
Huntsman	HUN US	US	4,344.8	US\$19.58	13.8	12.6
FMC	FMC US	US	3,231.7	US\$84.40	13.9	12.5
BASF	BAS GR	GR	56,082.4	Eur90.18	12.7	12.6
Average					14.0	12.7
Domestic						
Lee & Man	2314 HK	HK	3,286.7	HK\$22.05	28.1	20.2
Nine Dragons	2689 HK	HK	8,683.5	HK\$16.12	32.7	22.3
Lung Kee	255 HK	HK	294.1	HK\$3.70	11.2	8.8
Chen Hsong	57 HK	HK	453.7	HK\$5.74	11.2	9.7
Kingboard	148 HK	HK	3,731.6	HK\$33.65	11.9	10.2
Average					19.0	14.2
Blended average					16.8	13.6
Yip's Chemical	408 HK	HK	297.4	HK\$4.81	10.9	9.5

Source: Bloomberg & SBI E2-Capital

Table 2: Earnings model

Year to Mar (HK\$m)	05A	06A	07F	08F	09F
Turnover					
Solvents	1,584.0	1,973.6	2,110.4	2,289.7	2,564.5
Coating	1,067.9	1,196.0	1,370.0	1,616.6	1,859.0
Lubricants	114.9	219.3	203.9	254.9	293.1
Others	22.7	64.0	115.4	126.9	139.6
Elimination	(111.8)	(123.3)	-	-	-
	2,677.6	3,329.7	3,799.6	4,288.1	4,856.3
% chg	48.9	24.4	14.1	12.9	13.3
Cost of sales	(2,131.3)	(2,667.2)	(3,008.1)	(3,397.4)	(3,834.1)
Gross profit	546.3	662.5	791.5	890.7	1,022.2
Other revenue	9.8	16.2	20.2	20.9	23.7
Selling expenses	(82.7)	(98.6)	(112.9)	(115.8)	(126.3)
Administrative expense	(289.5)	(340.1)	(371.4)	(414.9)	(460.6)
Operating profit	183.9	240.0	327.4	380.9	459.1
Interest expense	(4.6)	(21.5)	(24.9)	(23.7)	(20.8)
Associates	-	-	-	-	-
Jointly-controlled entit.	-	-	-	-	-
Pre-tax profit	179.2	218.4	302.6	357.2	438.3
Tax	(13.4)	(21.7)	(48.3)	(57.8)	(71.8)
Minority interests	(42.7)	(28.3)	(41.0)	(55.8)	(68.4)
Net profit	123.2	168.4	213.2	243.6	298.0
% chg	26.8	36.7	31.3	15.9	19.9
Dividends	(56.3)	(66.8)	(109.8)	(109.6)	(134.1)

Source: Company data, SBI E2-Capital

P & L (HK\$m)	05A	06A	07F	08F	09F
Year to Mar					
Turnover	2,677.6	3,329.7	3,799.6	4,288.1	4,856.3
% chg	48.9	24.4	14.1	12.9	13.3
Gross profit	546.3	662.5	791.5	890.7	1,022.2
EBITDA	223.4	278.6	365.9	424.1	508.4
Depre./amort.	(40.3)	(40.4)	(42.7)	(48.6)	(53.7)
EBIT	183.1	238.2	323.2	375.5	454.6
Net int. income/(exp.)	(3.9)	(19.8)	(20.6)	(18.3)	(16.4)
Exceptionals	-	-	-	-	-
Associates	-	-	-	-	-
Jointly-controlled entit.	-	-	-	-	-
Pre-tax profit	179.2	218.4	302.6	357.2	438.3
Tax	(13.4)	(21.7)	(48.3)	(57.8)	(71.8)
Minority interests	(42.7)	(28.3)	(41.0)	(55.8)	(68.4)
Net profit	123.2	168.4	213.2	243.6	298.0
% chg	28.1	36.7	26.6	14.2	22.3
Dividends	(47.1)	(56.6)	(66.8)	(109.8)	(109.6)
Retained earnings	76.0	111.7	146.5	133.8	188.4
EPS (HK\$) - Basic	0.263	0.355	0.442	0.505	0.618
EPS (HK\$) - F.D.	0.261	0.352	0.439	0.502	0.614
DPS (HK\$)	0.120	0.140	0.228	0.227	0.278
No. sh.s o/s (m) - W.A.	468.7	474.8	482.3	482.3	482.3
No. sh.s o/s (m) - Y.E.	472.9	476.6	476.6	476.6	476.6
No. sh.s o/s (m) - F.D.	471.2	478.3	485.6	485.6	485.6
Margins (%)					
Gross	20.4	19.9	20.8	20.8	21.0
EBITDA	8.3	8.4	9.6	9.9	10.5
EBIT	6.8	7.2	8.5	8.8	9.4
Pre-tax	6.7	6.6	8.0	8.3	9.0
Net	4.6	5.1	5.6	5.7	6.1
Balance Sheet (HK\$m)	05A	06A	07F	08F	09F
Year to Mar					
Fixed assets	403.4	453.7	541.9	604.8	632.5
Intangible assets	3.0	2.0	1.0	-	-
Other LT assets	102.0	116.0	24.1	23.6	23.2
Cash	176.7	263.9	339.0	247.5	273.4
Accounts receivable	556.3	610.8	695.3	814.7	937.3
Other receivables	81.1	85.8	97.9	110.5	125.2
Inventories	294.8	341.7	380.0	420.2	461.3
Due from related co.s	-	-	-	-	-
Other current assets	2.8	2.3	2.5	2.7	2.9
Total assets	1,620.1	1,876.3	2,081.7	2,224.1	2,455.8
Accounts payable	(381.2)	(359.4)	(398.3)	(440.5)	(456.5)
Other payable	-	-	-	-	1.0
Tax payable	(12.9)	(18.4)	(41.0)	(49.0)	(60.9)
Due to related co.s	-	-	-	-	-
ST debts	(282.0)	(347.4)	(451.6)	(383.9)	(364.7)
Other current liab.	(0.8)	(0.2)	(0.3)	(0.3)	(1.3)
LT debts	(126.3)	(165.9)	(99.5)	(79.6)	(63.7)
Other LT liabilities	(1.9)	(1.8)	(1.8)	(1.8)	(1.8)
Total liabilities	(805.0)	(893.1)	(992.5)	(955.1)	(947.9)
Share capital	47.3	47.7	47.7	47.7	47.7
Reserves	712.5	846.3	923.3	1,059.3	1,241.8
Shareholders' funds	759.8	894.0	971.0	1,107.0	1,289.4
Minority interest	55.4	89.3	118.2	162.0	218.5
Total	815.1	983.2	1,089.2	1,269.0	1,507.9
Capital employed	1,223.4	1,496.5	1,640.3	1,732.5	1,936.3
Net (debt)/cash	(231.6)	(249.4)	(212.1)	(216.0)	(154.9)
Cash Flow (HK\$m)	05A	06A	07F	08F	09F
Year to Mar					
EBIT	183.1	238.2	323.2	375.5	454.6
Depre./amort.	40.3	40.4	42.7	48.6	53.7
Net int. paid	(3.9)	(19.8)	(20.6)	(18.3)	(16.4)
Tax paid	(9.4)	(15.4)	(25.7)	(49.8)	(59.9)
Dividends received	-	-	-	-	-
Gross cashflow	210.1	243.5	319.5	356.0	432.1
Chgs. in working cap.	(149.1)	(115.4)	(95.9)	(130.1)	(162.2)
Operating cashflow	61.0	128.1	223.6	226.0	269.8
Capex	(136.0)	(97.2)	(110.0)	(110.0)	(80.0)
Free cashflow	(75.0)	30.9	113.6	116.0	189.8
Dividends paid	(96.1)	(70.1)	(93.6)	(119.8)	(129.8)
Net distribution to MI	(46.9)	(10.7)	(12.0)	(12.0)	(12.0)
Investments	-	-	-	-	1.0
Disposals	2.0	3.8	-	-	-
New shares	7.7	5.8	-	-	-
Others	60.7	22.5	29.2	12.0	12.0
Net cashflow	(147.6)	(17.8)	37.2	(3.8)	61.0
Net (debt)/cash - Beg.	(84.0)	(231.6)	(249.4)	(212.1)	(216.0)
Net (debt)/cash - End.	(231.6)	(249.4)	(212.1)	(216.0)	(154.9)
Interim Results (HK\$m)	05A	06A			
Six months to Sep					
Turnover	1,356.1	1,761.0			
% chg	52.1	29.9			
Profit from operations	112.1	124.0			
Interest expenses	(1.5)	(8.8)			
Associates	-	-			
Jointly-controlled entit.	-	-			
Pre-tax profit	110.6	115.1			
Tax	(7.8)	(7.1)			
Minority interests	(26.8)	(14.1)			
Net profit	76.0	93.9			
% chg	26.2	23.5			
EPS (HK\$) - Basic	0.163	0.201			
DPS (HK\$)	0.045	0.050			
Shareholding Structure					
			Shares o/s (m)	%	
Chairman, Tony Ip Chi Shing			189.4	39.6	
Ip Fung Kuen			60	12.5	
Yip Tsz Hin			56.5	11.8	
Public			172.3	36.0	
Total			478.2	100.0	
Background					
Yip's Chemical is engaged in the manufacture and trading of high molecular chemical products and mixed solvents (accounting for 20% of FY3/04 sales), paints (29%), raw solvents (32%), lubricants (6%) and inks (12%). The company is the largest raw solvent manufacturer in China, top 5 in the world, with the annual production capacity of 150,000 tonnes.					
Key Ratios	05A	06A	07F	08F	09F
Net gearing (%)	30.3	27.7	20.5	18.3	11.2
Net ROE (%)	17.1	20.4	22.9	23.4	24.9
EBIT ROCE (%)	17.2	17.5	20.6	22.3	24.8
Dividend payout (%)	38.3	33.6	31.3	45.1	36.8
Effective tax rate (%)	7.5	9.9	16.0	16.2	16.4
Net interest coverage (x)	47.2	12.0	15.7	20.5	27.8
A/R turnover (days)	64.7	64.0	62.7	64.3	65.8
A/P turnover (days)	44.0	40.6	36.4	35.7	33.7
Stock turnover (days)	44.3	43.6	43.8	43.0	42.0

SBI E2-Capital is a dedicated small/mid cap investment banking/ stockbrokerage house. Find our research on: sbie2capital.com, thomsononeanalytics.com, factset.com and multex.com

SBI E2-Capital stock ratings:

STRONG BUY : absolute upside of >50% over the next three months

BUY : absolute upside of >10% over the next six months

HOLD : absolute return of -10% to +10% over the next six months

SELL : absolute downside of >10% over the next six months

Investors should assume that SBI E2-Capital is seeking or will seek investment banking or other related businesses with the companies in this report.

Analyst certification: The views expressed in this report accurately reflect the analyst's personal views of the subject securities and that the analyst has not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report.

Disclaimer: This research report is not an offer to sell or the solicitation of an offer to buy or subscribe for any securities. The securities referred to in this report may not be eligible for sale in some jurisdictions. The information contained in this report has been compiled by the Research Department of SBI E2-Capital Securities Limited ('SBI E2-Capital') from sources that it believes to be reliable but no representation, warranty or guarantee is made or given by SBI E2-Capital or any other person as to its accuracy or completeness. All opinions and estimates expressed in this report are (unless otherwise indicated) entirely those of SBI E2-Capital as of the date of this report only and are subject to change without notice. Neither SBI E2-Capital nor any other person, accepts any liability whatsoever for any loss howsoever arising from any use of this report or its contents or otherwise arising in connection therewith. Each recipient of this report shall be solely responsible for making its own independent investigation of the business, financial condition and prospects of the companies referred to in this report. SBI E2-Capital and their respective officers, directors and employees, including persons involved in the preparation or issuance of this report, may from time to time (1) have positions in, and buy or sell, the securities of companies referred to in this report (or related investments); (2) have a consulting, investment banking or broking relationship with any company referred to in this report; and (3) to the extent permitted under applicable law, have acted upon or used the information contained or referred to in this report including effecting transactions for their own account in an investment (or related investment) in respect of any company referred to in this report, prior to or immediately following its publication. This report may not have been distributed to all recipients at the same time. This report is issued only for the information of and may only be distributed to professional investors and dealers in securities and must not be copied, published, reproduced or redistributed (in whole or in part) by any recipient for any purpose. This report is distributed in Hong Kong by SBI E2-Capital. Any recipient of this report who requires further information regarding any securities referred to in this report should contact the relevant office of SBI E2-Capital located in such recipient's home jurisdiction.

Copyright © SBI E2-Capital Securities Limited 2007. All rights reserved.
