

Yip's Chemical: Shifting up a gear

Recommendation: BUY (unchanged)

Hong Kong Industrials

Price	HK\$5.41	Year to Net profit	EPS	EPS	P/E	P/B	EV/EBITDA	Yield	ROE	ROCE	N. Gear.	
Target price	HK\$6.20 (+15%)	Mar	HK\$m	HK\$	Δ %	x	x	x	%	%	%	
12 mth range	HK\$0.78-1.83	06A	168.4	0.355	35.0	15.3	2.88	10.1	2.6	20.4	17.5	27.7
Market cap.	US\$352.9m	07A	223.6	0.466	31.5	11.6	2.36	7.2	3.7	22.4	11.8	14.0
Daily t/o, 3 mth	US\$2.8m	08F	249.0	0.519	11.3	10.4	2.33	6.4	4.0	22.3	22.2	17.3
Free float %	35.3%	09F	303.3	0.633	21.8	8.6	2.01	5.4	4.9	24.7	24.7	15.2
Ticker	0408.HK/408 HK	10F	375.6	0.783	23.8	6.9	1.72	4.9	6.1	26.0	26.7	9.8

Relative to Hang Seng Index (1 mth, 3 mth, 12 mth): -7.0%, -8.2%, +20.6%

Actual price changes (1 mth, 3 mth, 12 mth): -5.1%, -6.1%, +32.6%

Consensus EPS (08F-09F): HK\$0.526, HK\$0.635

Previous forecasts (08F-09F): HK\$243.6m (\$0.505), HK\$298.0m (\$0.613)

Key points:

- FY3/07A net profit up 32.8% YoY to HK\$233.6m, above expectations.
- First earnings accretive M&A announced. Management indicated that further acquisitions are in the pipeline.
- Yip's is embarking on its next phase of sustainable long-term growth, with a combo strategy of 1) organic growth; 2) M&A and 3) brand building, to tap burgeoning domestic demand.
- Maintain our BUY call, with new target price set at HK\$6.20 (previously HK\$6.10), representing 12.0x FY3/08F P/E.

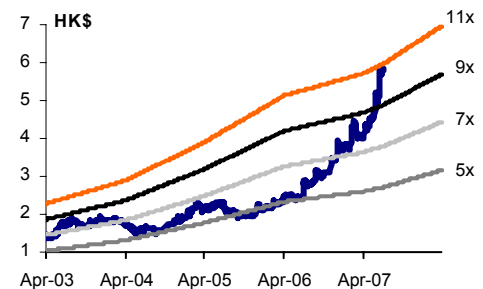
FY3/07A results slightly ahead of expectations. Yip's FY3/07A results came in ahead of expectations. Turnover surged 14.1% YoY to HK\$3,913.8m as net profit jumped 32.8% YoY to HK\$233.6m. In line with previous management guidance, the company was able to improve its profitability. Net margin was up 0.6 pcp to 5.7%.

Solvents again the key driver. Within an environment of sustained high oil prices, the solvents segment was again the key revenue and profitability driver. Solvents revenues was up 15.4% YoY to HK\$2,194.7m with operating profit surging 60.4% YoY to HK\$252.3m. To our surprise, the 11.5% segment margin for the whole year meant that profitability did not recede in 2H FY3/07A as previously expected, despite the absence of an inventory gain, which had boosted margins in the first half of the year. In our view, Yip's was able to sustain its margin as it was able to adjust its formulation to use cheaper raw material, such as mixed-butyl acetates.

Coatings again displayed healthy top line growth. The coatings segment again delivered solid top line growth, increasing 21.6% YoY to HK\$1,398.7m. Yip's "Bauhينيا" branded domestic architectural paints (both water-based emulsion and oil based) continued to be a key driver. The domestic architectural paint accounted for around 30% of the segments' revenue in FY3/07A compared to around 10% a few years ago. The company's coating products also include inks, which are used in consumer packaging and toys. The robust growth is a direct result of the increasing affluence of China's emerging middle class consumers as well as the ongoing construction boom in China. Segment profit edged up 9.8% YoY to HK\$88.5m as the high oil prices impacted margins in this segment. However, this result has been expected and again shows that the company's internal hedging mechanism is working to full effect.

Lubricants losses widened slightly. Yip's losses in the lubricant segment widened slightly to HK\$6.4m in FY3/07A after reaching near breakeven point with a HK\$0.3m loss in FY3/06A. The segment continues to

Chart 1: P/E bands



Source: SBI E2-Capital

struggle, disadvantaged against large petroleum producers, who has their own refinery capacity to produce base oils. Note that base oils account for around 95% of the raw materials used to produce lubricants. Going forward, we expect manufacturing consolidation, and contribution from its new toll blending business for Shell at its Zhanjiang plant.

First acquisition announced, more expected. The company announced on 27 Jun 2007 that it would acquire a solvents acetate producer for a total consideration of HK\$73.8m. This is the first acquisition after management indicated that they were shifting from an organic growth strategy to an M&A strategy to accelerate growth (see *M&As coming (31 May 2007)*). The target company is a competitor located in Guangdong, with a capacity of 40k tonnes per year. According to the announcement, the target company recorded a net profit of HK\$2.2m in FY12/06. However, with Yip's operating scale, pooling of resources, raw material sourcing power as well as management expertise, we believe that the company can significantly improve its profitability. We are currently estimating that the new plant will deliver HK\$15.0m operating profit in FY3/08F. In our view, we have not been aggressive. For FY3/07A, the company derived an operating of HK\$252.3m off a production capacity of 260k tonnes. This roughly translates to an operating profit of HK\$38.8m for an equivalent 40k tonnes capacity. Therefore, our estimate is prudent even when considering the smaller scale of the plant and that in the initial stages, it will be operating at less than 100% capacity. Management has clearly indicated that they will be looking at more acquisitions of this type down the road, including some potentially larger competitors in the Yangtze Delta Area.

Bauhinia brand building through TV advertising. After focusing on building out its distribution network in China over the past few years, the company is looking to TV advertising to further enhance consumer awareness for its Bauhinia branded paints and drive top line sales. The company has done well thus far on brand building with Bauhinia recognized as one of China's top 10 brand names despite no TV advertising. Management had been wise to focus on building the distribution channels first. Otherwise, a situation may occur whereby the additional demand generated by TV advertising was not met due to lack of distribution channels. This would have instead damaged Bauhinia's brand value towards customers.

Strategic shift for the company. It appears that Yip's has completed its internal restructuring, which began in FY3/04A. With a solid management group, improving cash flows, operating efficiency and a consolidated industry leadership position underlining company fundamentals, the company is shifting towards its next phase of growth. The company is now pursuing a more aggressive strategy to deliver sustainable long-term growth with M&As (to eliminate competitors) and brand building (to tap emerging domestic opportunities). To facilitate this shift, management announced that from Apr 2008, the dual Chairman/CEO role will be split up and separately held. In addition, core management group will also be split up with one focusing on day-to-day operations and the other focusing on outlining the strategic development direction of the company.

Maintain BUY call, new target price HK\$6.20. We have revised up our FY3/08F net profit forecast to HK\$249.0m after incorporating the company's new acquisition. With improving fundamentals and further M&A potential, we continue to be bullish on the company's overall long term prospects. We upgrade our target price to HK\$6.20, representing 12.0x FY3/08F P/E.

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	4,122.3	Yen425.00	15.2	12.9
Huntsman	HUN US	US	5,414.4	US\$24.40	17.6	16.1
FMC	FMC US	US	3,442.3	US\$89.90	14.3	12.8
BASF	BAS GR	GR	60,634.6	Eur97.63	13.8	13.5
<i>Average</i>					15.2	13.8
Domestic						
Lee & Man	2314 HK	HK	3,431.0	HK\$22.75	29.3	21.1
Nine Dragons	2689 HK	HK	10,099.5	HK\$18.28	36.4	25.2
Lung Kee	255 HK	HK	310.0	HK\$3.92	11.9	11.0
Chen Hsong	57 HK	HK	520.1	HK\$6.69	12.8	11.0
Kingboard	148 HK	HK	3,966.5	HK\$37.05	12.6	10.7
<i>Average</i>					20.6	15.8
Blended average					18.2	14.9
Yip's Chemical	408 HK	HK	334.5	HK\$5.70	10.4	8.6

Source: Bloomberg & SBI E2-Capital

Table 2: Earnings model

Year to Mar (HK\$m)	06A	07A	08F	09F	10F
Turnover					
Solvents	1,973.6	2,194.7	2,447.0	2,642.8	2,907.1
Coating	1,196.0	1,398.7	1,636.5	1,882	2,164.3
Lubricants	219.3	205.1	258.4	294.8	633.8
Others	64.0	115.4	126.9	139.6	293.2
Elimination	(123.3)	-	-	-	-
	3,329.7	3,913.8	4,466.8	4,959.2	5,998.4
% chg	24.4	17.5	14.1	11.0	21.0
Cost of sales	(2,667.2)	(3,121.2)	(3,540.2)	(3,913.9)	(4,759.6)
Gross profit	662.5	792.6	926.6	1,045.3	1,238.8
Other revenue	16.2	26.4	30.2	33.5	40.5
Selling expenses	(98.6)	(106.4)	(120.6)	(128.9)	(156.0)
Administrative expense	(340.1)	(364.7)	(442.1)	(477.7)	(545.2)
Operating profit	240.0	348.0	394.1	472.1	578.1
Interest expense	(21.5)	(26.3)	(23.7)	(20.8)	(19.3)
Associates	-	-	-	-	-
Jointly-controlled entit.	-	-	-	-	-
Pre-tax profit	218.4	321.7	370.4	451.3	558.8
Tax	(21.7)	(52.0)	(60.0)	(73.1)	(90.5)
Minority interests	(28.3)	(46.1)	(61.4)	(74.9)	(92.7)
Net profit	168.4	223.6	249.0	303.3	375.6
% chg	36.7	32.8	11.4	21.8	23.8
Dividends	(66.8)	(81.7)	(104.6)	(127.4)	(157.7)

Source: Company data & SBI E2-Capital

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