

US toy recalls benefit Yip's

Hong Kong Industrials

Yip's Chemical (408 HK, HK\$5.10)

BUY (unchanged)

Target price: HK\$6.20 (+22%)

Yip's will benefit from toy recalls in the US. The recent series of US toy product recalls by Mattel, Toys "R" US and other US-based toy companies highlights the increasing emphasis placed by governments, consumers and end users placed on safety and quality of goods made in China. We note that in many instances, the issue was related to the printed ink, either on the packaging, or in the actual product. We believe that in the increasing emphasis on quality and the need to improve consumer confidence in Chinese products, Yip's Chemical can become a major beneficiary. The company's solvent products are used in the manufacturing of toys, while its paint products are also used in both toys and packaging. Our read through on the situation are as follows:

- In a bid to maintain margins, toy manufacturers had previously opted for the "low road to profits" by using sub-standard inks and other products. The recent clamp down on safety quality by the US and the Chinese government efforts to protect the "China" brand name will force such toy manufacturers to use paint products that meet international safety standards.
- We expect consolidation in China's paint producers as manufacturers of sub-standard products will be forced out of business, or improve its product quality, which would require additional investment, leading to lower margins.
- We expect Yip's Chemical to be a key beneficiary in this "flight to quality". The company produces industrial paints for toys and furniture, as well as inks for packaging. It is one of the largest producers of plastic and gravure inks in China.
- In 1H FY3/07A, the coatings segment (which includes paints, inks, varnishes and resins) turnover grew 21.6% YoY to HK\$1,398.7m. We are forecasting this segment to grow 15.0% in FY3/07F but we believe that there is upside scope to our estimates in light of the current situation. Management indicated that orders for its paint coatings have increased around 30% since the start of the toy recalls. We estimate that toy coating account for about 8-10% of the segment turnover.
- The company is currently investing around HK\$100m in capacity expansion for its coatings business, in Chengdu, Shantou and Shanghai. A new coatings plant in Tونغxiang, Zhejiang is expected to come on line at the end of 2Q FY3/08.
- We re-iterate our BUY call on Yip's Chemical, with a target price of HK\$6.20, representing 12.0x FY3/08F P/E. The recent pull back of small-to-mid cap stocks provides an opportunity to accumulate this counter.

Table 1: Financial summary

Year to	Net profit	EPS	EPS	P/E	P/B	EV/EBITDA	Yield	ROE	ROCE	N. Gearing
Mar	HK\$m	HK\$	Δ %	x	x	x	%	%	%	%
06A	168.4	0.355	35.0	14.4	2.72	9.6	2.7	20.4	17.5	27.7
07A	223.6	0.466	31.5	10.9	2.23	6.8	3.9	22.4	11.8	14.0
08F	249.0	0.519	11.3	9.8	2.20	6.1	4.3	22.3	22.2	17.3
09F	303.3	0.633	21.8	8.1	1.89	5.1	5.2	24.7	24.7	15.2
10F	375.6	0.783	23.8	6.5	1.62	4.9	6.5	26.0	26.7	9.8

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