Corporate Snippet

SBI E2-Capital

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Positioning to sell underperforming assets — Hong Kong Chemicals

Yip's Chemical (408 HK, HK$3.09) — BUY (unchanged)

Target price: HK$3.45 (+12%)

Additional 40% in Zhanjiang Best Lubricant Blending. Yips's announced that on 10 Oct 2006, the company acquired an additional 40% interest in Zhanjiang Best Lubricant Blending (Zhanjiang Best) through indirectly wholly-owned subsidiary Best Lubricant Blending for a consideration of RMB36.0m. The consideration is based on the estimated net working capital of the target 40% stake in the company. The deal will take Yip's stake in Zhangjiang Best from the existing 40% up to 80%, becoming a non-wholly owned subsidiary of the company. The remaining 20% of Zhanjiang Best is owned by Zhanjiang Port Authority.

Positioning for eventual sell-off. Yip's and the seller presently jointly operate Zhanjiang Best through separate manufacturing divisions while sharing some common overheads. The stake increase is to allow Yip's to position itself for an eventual sell-off of Zhanjiang Best, which had been underperforming in recent years. Moreover, both Yip's and the seller agree that the plant no longer fits in their respective corporate strategies. With the acquisition of Dongguang based Pacific Oil 2005, Yip's considers Zhanjiang Best as inefficient capacity that is surplus to requirements. Yip's undertook to take-up the additional 40% in the company to facilitate negotiations with potential suitors.

Exclusive agreement to utilize Zhanjiang Best capacity. On completion of the deal, Yip's will relocate its existing lubricant blending operation at Zhanjiang Best to Dongguang. To utilize the resulting excess capacity at Zhanjiang Best during this transition period, the company signed a 2.5-year long exclusive agreement with Zhejiang Shell Oil & Petrochemical Co. (ZSOP) to provide ZSOP with toll blending services. The duration of the agreement is in-line with Yip's undertaking to dispose of its 80% stake in Zhanjiang within 3 years after the completion of the deal. Management has reiterated that their diversification into the toll blending business is only temporary, until such time that their interest in Zhanjiang is disposed of and that they have no intention to pursue this line of business over the long term.

Neutral view on deal. The new toll blending business is expected to be earnings accretive, but moderate in terms of growth potential. However, given the overall goal of disposing of Zhanjiang Best, we have a neutral view on the acquisition. We believe there is limited risk in taking on the additional 40% stake in Zhangjiang Best since: 1) Yip's only pays for the estimated net working capital, 2) the exclusive contract with ZSOP and 3) it allows the management to be more proactive in seeking suitors. We expect the toll blending operations will have lower margins compared to the rest of its lubricants business, though this should be largely offset by the efficiency gains in relocating its lubricant blending operations from Zhanjiang to Dongguan. We have mildly adjusted our earnings forecast up by 0.1%, 0.4% and 0.6% for FY3/07F to FY3/09F. We maintain our 8x FY3/07F P/E valuation, yielding a target price of HK$3.45.

Table 1: Financial summary

Year to Mar	Net profit HK$m	EPS HK$	EPS Δ%	P/E x	P/B x	EV/EBITDA x	Yield %	ROE %	ROCE %	N. Gearing %
05A	123.2	0.263	26.8	11.8	1.92	7.5	3.9	17.1	17.2	30.3
06A	168.4	0.355	35.0	8.7	1.65	6.2	4.5	20.4	17.5	27.7
07F	203.9	0.429	21.1	7.2	1.52	5.1	6.3	21.9	18.7	23.5
08F	242.8	0.511	19.1	6.0	1.32	4.5	7.4	23.3	20.0	25.8
09F	282.4	0.595	16.3	5.2	1.15	4.1	8.7	23.5	20.7	27.9