Corporate Flash

SBI E2-Capital

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Yip's Chemical: Still undervalued

Recommendation: BUY (unchanged) — Hong Kong Chemicals

Price	**HK$3.09**
Target price	HK$4.30 (+39%)
12 mth range	HK$1.95-3.25
Market cap.	US$190.6m
Daily t/o, 3 mth	US$0.4m
Free float %	35.3%
Ticker	0408.HK/408 HK

Year to Mar	Net profit HK$m	EPS HK$	EPS Δ %	P/E x	P/B x	EV/EBITDA x	Yield %	ROE %	ROCE %	N. Gear. %
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	22.0
08F	244.6	0.515	20.0	6.0	1.32	4.2	7.5	23.5	20.1	18.0
09F	292.1	0.615	19.4	7.0	1.58	4.8	6.5	24.2	21.3	13.9

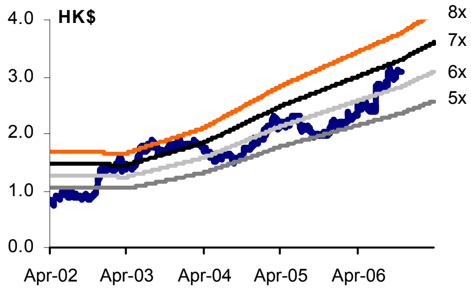
Relative to Hang Seng Index (1 mth, 3 mth, 12 mth): -0.6%%, -0.6%, ++24.0%
Actual price changes (1 mth, 3 mth, 12 mth): +2.3%, +10.7%, +55.0%
Consensus EPS (07F-08F): HK$0.429, HK$0.511
Previous forecasts (07F-08F) HK$203.9 (HK$0.429), HK$242.8 (HK$0.511)

Key points:

- Largest solvent producer in China and fourth largest in the world. Accounting for 60%+ solvents sold in South China, Yip's has significant pricing power.
- New raw material supply contract with Celanese will boost solvent margins commencing FY3/08.
- New Zhongshan inks plant completed on schedule. We expect the segment to continue to be a core driver of the company with robust top line growth and margin expansion.
- Company's "natural hedging mechanism" means that it is less affected by oil price fluctuations. RMB revaluation is also a non-factor as it primarily sells its products within China.
- Yip's trades at steep discount to industry peers. With market leading position, improved earnings visibility and margin expansion, there is substantial scope for valuation gap to narrow.
- Maintain BUY, upgrade target price to HK$4.30 (from HK$3.45), representing 10.0x FY3/07F and 8.3x FY3/08F P/E.

We conducted a company visit with the management of Yip's Chemical (Yip's). Key takeaways are as follows:

Chart 1: P/E bands



Source: SBI E2-Capital

Increasing bargaining power with suppliers. With an annual solvent production capacity of 200,000 tonnes, Yip's is China's largest solvent manufacturer and the fourth largest in the world. The scale of its operations is starting to reap benefits as Yip's recently signed a new supply contract with key supplier Celanese. The new contract, coming into effect in FY3/08, is a testament to the company's improved sourcing power. Under the new terms, Celanese will increase its level of rebate to YC from the current 2.5% to between 3.5-4.5%, depending on actual volumes ordered. Given that raw materials account for around 90% of its solvent products, the new supply contract will provide profitability upside to this segment in FY3/08 and FY3/09. Management estimates that Yip's account for 60%+ of all solvents sold in South China, suggesting that it has strong pricing power.

Zhongshan inks plant completed on schedule. The new inks plant located in Zhongshan commenced production in July 2006 as scheduled. The new facility will raise its inks production capacity to 25,000 tonnes p.a. Yip's specialises in inks production for the manufacturing sector, used in shopping bags, food packaging and cigarette packaging. These inks products are relatively insensitive to price changes given that they typically account for <1.0% of the cost of the final product. So while Yip's may not be able to fully transfer higher raw material costs to its customers, its customers are also unlikely to squeeze their margins given the limited impact on their overall profitability. Since Dec 2005, Yip's has begun to supply ink to a new key customer Tingyi (322 HK, HK$5.48, HOLD). The coatings segment was a key revenue and profitability driver for the company in FY3/06 as revenue rose 12.0% YoY to RMB1,196.0m while EBIT surged 50.1% YoY to RMB80.6m. With additional capacity coming on line this year, we again expect the segment to deliver robust top line growth. Moreover, we project EBIT margin to further expand on 1) operating leverage, 2) securing stable raw material supply, through their 8% equity stake in Lomon Titanium Ltd., and 3) production rationalisation.

Lubricants in a challenging environment, but prospects are good. With high oil prices persisting in 1H FY3/07 and ongoing restructuring, Yip's lubricants business continued to operate under a challenging environment. We are projecting the segment to make a moderate EBIT contribution of RMB3.1m in FY3/07F, reversing a RMB0.3m loss a year ago. However, the long term prospects for the lubricants business is solid. The company is gradually shifting its product portfolio from mass market automotive lubricants to specialty industrial lubricants, which was began via the acquisition of Pacific Oil in Feb 2005. Meanwhile, as mentioned in our previous report "Positioning to sell underperforming assets" (17 Oct 2006) Yip's plans relocate its existing lubricant blending operations at from Zhanjiang Best Lubricant to Pacific Oil's Dongguan based plant to improve production efficiency.

Consistently de-gearing. Yip's has continued de-gearing over the past year. Management indicated that net gearing ratio has dropped to around 31% for 1H FY3/07F compared to 45% in 1H FY3/06. Note that net gearing at the end of FY3/06 was 28% though this ratio is typically lower at financial year-end due to seasonality factors. Yip's business is a cash generative one, with operating cash flow reaching RMB166.8m for FY3/06, up 116.2% YoY. The company was in a solid cash position with RMB263.9m at the end of FY3/06.

Expansion plans further solidifies leading position. Yip's has two main expansion projects in the pipeline. The company plans to expand its solvent production capacity from the current 200,000 tonnes p.a. to 260,000 tonnes p.a. by the beginning of FY3/08. In addition, the company plans to construct a new ink plant in Zhejiang, which will take around 2 years. On completion, Yip's plans to further streamline production efficiencies by transferring the inks production from its Shanghai plant to the new Zhejiang plant, thereby allowing the former to concentrate its capacity on paint coatings manufacturing. We estimate that Yip's capex requirements in FY3/07F and FY3/08F to total around RMB220m.

Upgrade target price to HK$4.30. Yip's currently trades at 7.2x FY3/07F and 6.0x FY3/08F P/E, a steep discount on industry comparables which trades at 14.7x and 11.5x respectively based on consensus estimates. With market leading position, improved earnings visibility and margin expansion, there is scope for the valuation discount to narrow going forward. The company has a "natural hedging mechanism", which allows it to be less affected by oil price fluctuations, making it our pick of the upstream industrials. Furthermore, as the company sells the majority of its products within China, it is not affected by RMB revaluation. Yip's maintains a hefty payout ratio of 40-60%, representing an attractive yield of 6.3%. We have left our FY3/07F estimates unchanged but raise our profit forecast for FY3/08F by 1% and FY3/09F by 3% respectively. We have revised up our target price to HK$4.30 (from HK$3.45), implying 10.0x FY3/07F and 8.3x FY3/08F P/E. The valuation represents approximately 30% valuation discount on its peers, which is justified given the smaller market cap and lesser liquidity of the stock.

Table 1: Valuation comparisons

Company Name	Ticker	Country	Mkt Cap (US$m)	Price	HIS Turnover (US$m)	HIS Net Profit (US$m)	Cur Yr PE (x)	Nxt Yr PE (x)
International								
Showa Denko	4004 JP	JP	5,194.1	Yen525.0	4,770.0	8.0	22.1	17.9
Huntsman	HUN US	US	4,023.8	US$18.16	12,961.6	(34.6)	10.4	9.5
FMC	FMC US	US	2,694.6	US$69.00	2,150.2	116.6	12.6	10.9
BASF	BAS GR	GR	42,667.6	Eur67.34	53,734.6	3,779.7	10.1	10.1
Average							*13.8*	*11.9*
Domestic								
Lee & Man	2314 HK	HK	1,968.7	HK$16.00	484.4	76.9	19.9	13.3
Nine Dragons	2689 HK	HK	4,964.0	HK$9.42	974.1	169.5	22.0	14.4
Lung Kee	255 HK	HK	302.1	HK$3.80	243.5	30.9	15.6	9.8
Chen Hsong	57 HK	HK	350.6	HK$4.44	250.7	34.9	9.0	7.9
Kingboard	148 HK	HK	2,860.5	HK$28.30	1,679.3	184.1	11.0	9.6
Average							*15.5*	*11.0*
Blended average							**14.7**	**11.5**
Yip's Chemical	408 HK	HK	190.6	HK$3.09	426.9	21.6	7.2	6.0

Source: Bloomberg & SBI E2-Capital

Table 2: P&L

Year to Mar (HK$m)	05A	06A	07F	08F	09F
Turnover					
Solvents	1,584.0	1,973.6	1,399.4	1,567.3	1,724.0
Coating	1,067.9	1,196.0	2,131.5	2,216.7	2,283.2
Lubricants	114.9	219.3	307.0	420.6	521.6
Others	22.7	64.0	89.6	116.5	145.7
Elimination	(111.8)	(123.3)	(140.2)	(154.3)	(166.9)
	2,677.6	**3,329.7**	**3,787.3**	**4,166.9**	**4,507.6**
% chg	*48.9*	*24.4*	*13.7*	*10.0*	*8.2*
Cost of sales	(2,131.3)	(2,667.2)	(3,049.4)	(3,353.6)	(3,648.8)
Gross profit	**546.3**	**662.5**	**737.9**	**813.3**	**858.8**
Other revenue	9.8	16.2	18.5	20.3	22.0
Selling expenses	(82.7)	(98.6)	(106.0)	(114.6)	(117.2)
Administrative expense	(289.5)	(340.1)	(355.7)	(369.8)	(351.7)
Operating profit	**183.9**	**240.0**	**294.6**	**349.2**	**411.9**
Interest expense	(4.6)	(21.5)	(24.8)	(25.5)	(25.4)
Associates	-	-	-	-	-
Jointly-controlled entit.	-	-	-	-	-
Pre-tax profit	**179.2**	**218.4**	**269.8**	**323.7**	**386.5**
Tax	(13.4)	(21.7)	(26.8)	(32.1)	(38.4)
Minority interests	(42.7)	(28.3)	(39.1)	(46.9)	(56.0)
Net profit	**123.2**	**168.4**	**203.9**	**244.6**	**292.1**
% chg	*26.8*	*36.7*	*21.1*	*20.0*	*19.4*
Dividends	(56.3)	(66.8)	(91.7)	(110.1)	(132.2)

Source: company data, SBI E2-Capital