

## Yip's Chemical: Firing all cylinders

**Recommendation: BUY (unchanged)**

**Hong Kong Chemicals**

Price	HK\$3.93	Year to	Net profit	EPS	EPS	P/E	P/B	EV/EBITDA	Yield	ROE	ROCE	N. Gear.
Target price	HK\$5.10 (+30%)	Mar	HK\$m	HK\$	Δ %	x	x	x	%	%	%	%
12 mth range	HK\$1.96-4.00	<b>05A</b>	123.2	0.263	26.8	15.0	2.45	9.3	3.1	17.1	17.2	30.3
Market cap.	US\$242m	<b>06A</b>	168.4	0.355	35.0	11.1	2.10	7.6	3.6	20.4	17.5	27.7
Daily t/o, 3 mth	US\$0.4m	<b>07F</b>	213.2	0.446	25.8	8.8	1.93	5.7	5.8	22.9	20.6	20.4
Free float %	36.0%	<b>08F</b>	243.6	0.510	14.2	7.7	1.69	4.9	5.8	23.4	22.3	18.3
Ticker	0408.HK/408 HK	<b>09F</b>	298.0	0.623	22.3	6.3	1.45	4.0	7.1	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\$0.432, HK\$0.515

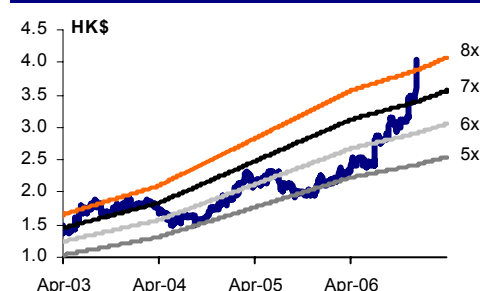
Previous forecasts (07F-08F) HK\$203.9 (HK\$0.429), HK\$244.6 (HK\$0.515)

### Key points:

- Interim profit growth of 37% exceeded our expectation.
- Margin improvements due to economies of scale and dominant market position in China.
- Solvent segment benefited from surging oil price in 1H of the year.
- Plans to construct a second new coatings plant in Zhejiang to better serve the industries in the Yangtze River Delta, where many of its customers have already moved up to.
- Net gearing was reduced from 45% to 31% while interim DPS (including a special dividend) increased 60% YoY.
- Upgrade earnings forecast by 4.6% for FY3/07F and raise our target price from HK\$4.3 to HK\$5.1 based on 10x FY3/08F P/E.
- Still trading at attractive valuation of <8x FY3/08F P/E. As market cap has exceeded US\$200m, we expect more analyst coverage and hence a further re-rating on the stock. BUY.

**Turning in a strong 1H FY3/07.** Yip's interim results well exceeded our expectations. Turnover was up 17.1% YoY to HK\$2,061.8m while operating and net profit surged 54.2% YoY to HK\$191.1m and 37% YoY to HK\$128m. The results were further underlined by expanding margins. Operating margin leaped 2.3 pcp YoY to 9.3% as net margin increased 0.9 pcp to 6.2%. Product mix remained largely stable, with solvents, coatings and lubricants accounting for 56.2%/35.8%/5.0% respectively of overall revenues compared to 58.4%/34.6%/6.5% for the same period last year. To mark the company's 35<sup>th</sup> anniversary, Yip's announced a special dividend of HK\$0.02 per share, on top of the interim dividend of HK\$0.06 per share. The total HK\$0.08 represents a 60% increase in DPS or a 30.8% payout ratio in 1H.

**Chart 1: P/E bands**



Source: SBI E2-Capital

**Solvents segment key contributor to strong results.** Tight raw material supply, coupled with strong domestic demand drove up solvent prices in China during 1H FY3/07A. Solvents turnover was up 12.6% YoY to HK\$1,158.3m. With surging oil prices in the first half of the year, the company's "internal hedging mechanism" worked to full effect as stock gains boosted segment margin to 11.0%, up 3.2 pcp YoY. On a HoH basis, the metric improved 2.2 pcp, reflecting increasing economies of scale and bargaining power as China's largest solvents producer. The segment was a key contributor to Yip's margin gains during the reporting period. With oil prices stabilising and falling towards the end of the year, we expect margins for this segment normalise back down to around 9.0% in 2H FY3/07F. However, this would in turn benefit the company's coatings and lubricants operations.

**Coatings maintaining steady progress.** Yip's coatings operations were steady. Turnover was up 21.0% YoY to HK\$738.2m. Segment margin also improved, edging up 0.7 pcp to 8.1%. The result was encouraging amid the difficult operating environment caused by the rapid rise in oil prices. Going forward, we expect this margin expansion trend to persist as the company focuses on consolidating operations and streamlining the supply chain. The new Zhongshan inks plant, which is now in production, will allow the company to relocate inks production to this new plant, freeing up production capacities at its other plants in Shanghai, Chengdu and Shantou to focus on other coatings production such as paints, thinners and varnishes.

**Two steps forward, one step back for lubricants segment.** The segment fell back into the red during the first half of the year, recording an operating loss of HK\$1.9m compared to an operating profit of HK\$0.6m a year ago. Turnover fell 8.7% YoY to HK\$103.8m on product mix shift. Yip's has been gradually shifting its production from mass market automotive lubricants to specialty industrial lubricants. The strategy makes sense given that the niche industrial lubricant market competes more on pricing and quality (Yip's strengths given its manufacturing expertise and economies of scale), rather than "brand name", which typically dominates the automotive lubricant sector. <sup>1</sup>Over the past two years, automotive lubricants have decreased its contribution in this segment from over 80% to around 25% at present. Yip's recently signed a new contract with Kingboard (148 HK, HK\$32.55, BUY) to supply some of its plants with industrial lubricants. Management insists that the segment is still on track for breakeven for the whole of FY3/07F with oil price pressure easing, product mix changes continuing to show positive results. We expect the company's new toll blending services for Shell in Zhanjiang will commence contribution in 4Q FY3/07, which will further aid this segment to move back into the black.

**Expansion plans increases visibility on growth.** As we reported previously in "Still Undervalued", dated 26 Oct 2006, Yip's plan to construct a new ink plant in Zhejiang, which will take around 2 years. To position itself to benefit from government economic initiatives such as the "China Western Development" and "Cross-Strait Three Direct Links" the company will also expand capacities at their current coatings factories in Shanghai, Chengdu and Shantou. In addition, the company plans to construct a second new coatings plant in Zhejiang, to be located in Tungxiang, to better serve the industries in the Yangtze River Delta. Management indicates that this new second plant will have sufficient capacity to increase annual turnover of HK\$1.0b over the long term. Meanwhile, Yip's plan to expand its solvent production capacity from the current 200,000 tonnes p.a. to 260,000 tonnes p.a. has been delayed from the beginning of 2Q FY3/08F to 3Q FY3/08F due to obstacles related to obtaining design submission approvals. We estimate that Yip's capex requirement in FY3/08F to total around RMB110-140m.

**Lower gearing, improving cash position.** Yip's net gearing ratio has dropped to 31% from 45% a year ago. Operating cashflow was a solid HK\$29.4m, reversing a HK\$66.6m outflow in 1H FY3/06A. The company was in a solid cash position with RMB282.2m at the end of FY3/06A.

**Higher effective tax rate going forward.** Yip's effective tax rate jumped 9.8 pcp to 16.0% as the tax free holiday concluded at several of its ventures. Going forward, we expect the effective tax rate to remain at this higher level though management has indicated that they are currently undertaking some tax planning to lower this metric.

**Upgrading FY3/07F forecast.** We have upgraded our FY3/07F net profit estimate by 4.6% to HK\$213.2m (EPS: HK\$0.446) to reflect the company's strong 1H results. However, we expect 2H FY3/07 margins to contract relative to 1H on normalising of solvent margin and seasonal margin contraction due to lower sales volume in 2H. However, we have largely maintained our FY3/08F forecast at HK\$243.6m (EPS: HK\$0.510) in the absence of stock gains in the solvents segment and a higher effective tax rate. Management has previously indicated that they aim to increase net margin by an average of 0.5 pcp for the next three years going forward. While we are comfortable that this can be achieved at the operation margin level, we opine that this may be more of a challenge at the net margin level given the increased tax burden.

**Upgrade target price to HK\$5.10.** We have upgraded Yip's target price to HK\$5.10 (c, HK\$4.30), rolling over our 10.0x P/E valuation to FY3/08F earnings. Despite the recent run up, Yip's valuation at 8.8x FY3/07F and 7.7x FY3/08F P/E still represents a significant discount to industry comparables which trade at 13.8x and 12.3x respectively based on consensus estimates. We continue to favour Yip's for its 1) market leading position; 2) operating stability due to its "internal hedging mechanism"; 3) quality/prudent management and 4) solid yield. As most of the company's business is done in RMB, it is a beneficiary of RMB upward revaluation. We estimate every 1% rise in RMB will boost bottom line by 1.25%. With improved earnings visibility and margin

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<sup>1</sup> Furthermore, the majority Yip's existing customer base in the solvents and coatings business are manufacturers and the company can cross sell its industrial lubricants to this vast customer base.

expansion, there is scope for the valuation discount to narrow going forward. We see the company's valuation to re-rate further as its growing market cap, now in excess of US\$200m, will invite a broader investor base.

**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)
<b>International</b>								
Showa Denko	4004 JP	JP	4514.0	Yen463.0	4,770.0	8.0	19.1	15.6
Huntsman	HUN US	US	4,063.5	US\$18.34	12,961.6	(34.6)	11.9	11.6
FMC	FMC US	US	2,761.6	US\$71.98	2,150.2	116.6	13.3	11.3
BASF	BAS GR	GR	44,437.5	Eur70.48	53,734.6	3,779.7	10.7	10.6
<b>Average</b>							<b>13.8</b>	<b>12.3</b>
<b>Domestic</b>								
Lee & Man	2314 HK	HK	2,295.6	HK\$18.4	484.4	76.9	22.2	14.9
Nine Dragons	2689 HK	HK	6,96.9	HK\$13.1	974.1	169.5	30.1	19.3
Lung Kee	255 HK	HK	333.8	HK\$4.20	243.5	30.9	17.2	10.9
Chen Hsong	57 HK	HK	446.3	HK\$5.60	250.7	34.9	11.2	9.9
Kingboard	148 HK	HK	3,324.4	HK\$32.55	1,679.3	184.1	12.8	10.9
<b>Average</b>							<b>18.7</b>	<b>13.2</b>
<b>Blended average</b>							<b>16.5</b>	<b>12.8</b>
Yip's Chemical	408 HK	HK	241.9	HK\$3.93	426.9	21.6	8.8	7.7

Source: Bloomberg & SBI E2-Capital

**Table 2: Earnings model**

Year to Mar (HK\$m)	05A	06A	07F	08F	09F
<b>Turnover</b>					
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)	-	-	-
	<b>2,677.6</b>	<b>3,329.7</b>	<b>3,799.6</b>	<b>4,288.1</b>	<b>4,856.3</b>
% 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)
<b>Gross profit</b>	<b>546.3</b>	<b>662.5</b>	<b>791.5</b>	<b>890.7</b>	<b>1,022.2</b>
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)
<b>Operating profit</b>	<b>183.9</b>	<b>240.0</b>	<b>327.4</b>	<b>380.9</b>	<b>459.1</b>
Interest expense	(4.6)	(21.5)	(24.9)	(23.7)	(20.8)
Associates	-	-	-	-	-
Jointly-controlled entit.	-	-	-	-	-
<b>Pre-tax profit</b>	<b>179.2</b>	<b>218.4</b>	<b>302.6</b>	<b>357.2</b>	<b>438.3</b>
Tax	(13.4)	(21.7)	(48.3)	(57.8)	(71.8)
Minority interests	(42.7)	(28.3)	(41.0)	(55.8)	(68.4)
<b>Net profit</b>	<b>123.2</b>	<b>168.4</b>	<b>213.2</b>	<b>243.6</b>	<b>298.0</b>
% 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

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