

## Yip's Chemical: Exposure to China consumption

**Recommendation: BUY (unchanged)**

**Hong Kong Industrials**

Price	HK\$5.42	Year to	Net profit	EPS	EPS	P/E	P/B	EV/EBITDA	Yield	ROE	ROCE	N. Gear.
Target price	HK\$6.55 (+21%)	Mar	HK\$m	HK\$	Δ %	x	x	x	%	%	%	%
<b>12 mth range</b>	HK\$3.68-5.95	<b>06A</b>	168.4	0.355	35.0	15.3	2.89	10.1	2.6	20.4	17.5	27.7
<b>Market cap.</b>	US\$338.1m	<b>07A</b>	223.6	0.466	31.5	11.6	2.36	7.2	3.7	22.4	11.8	14.0
<b>Daily t/o, 3 mth</b>	US\$0.2m	<b>08F</b>	262.7	0.548	17.5	9.9	2.35	6.2	4.2	23.6	23.4	18.0
<b>Free float %</b>	37.0%	<b>09F</b>	314.2	0.655	19.6	8.3	1.99	5.2	5.1	25.5	25.5	16.3
<b>Ticker</b>	0408.HK/408 HK	<b>10F</b>	369.3	0.770	17.5	7.0	1.71	4.9	6.0	25.3	26.1	6.8

Relative to Hang Seng Index (1 mth, 3 mth, 12 mth): +8.8%, -15.6%, -10.6%

Actual price changes (1 mth, 3 mth, 12 mth): +5.7%, +2.1%, +36.9%

Consensus EPS (08F-09F): HK\$0.545, HK\$0.673

Previous forecasts (08F-09F): HK\$249.0m (\$0.519), HK\$303.3m (\$0.633)

### Key points:

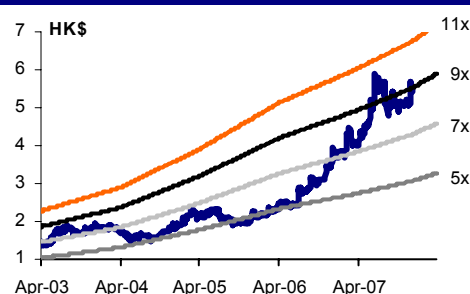
- Adjusted net profit up 12.0% YoY to HK\$143.8m and in line with our estimates. In our view, consensus expectations were over aggressive.
- Management demonstrated ability to improve productivity and profitability of acquired assets by increasing production capacity of newly acquired Shengda plant from 30,000 tons p.a. to 45,000 tons p.a.
- Coatings segment will emerge as the company's key growth driver going forward. Demand for these materials is a direct proxy on China's surging domestic consumption. Company has expanded production capacity to meet oncoming demand.
- Reiterate our BUY call, with new target price set at HK\$6.55 (previously HK\$6.20), representing 12.5x adjusted FY3/08F and 10.0x FY3/09F P/E. Counter is currently undemanding trading at 8.3x FY3/09F P/E.

**1H FY3/08A results were in line with our expectations.** Yip's 1H FY3/08A turnover was up 14.0% to HK\$2,350.4m, while net profit surged 21.1% YoY to HK\$155.4m. The net profit was boosted by a HK\$11.6m gain from the disposal of a 3.0% stake in its investment in Lomon Titanium Ltd. As a result, Yip's holding in Lomon has been reduced to 5.0% (previously 8.0%). Excluding the one-off item, the adjusted net profit of HK\$143.8m represented an increase of 12.0% YoY and in line with our expectations. Note that our estimates are below consensus, which in our view were factoring in over aggressive growth and margin assumptions.

**Solvents margin contracted as expected.** Solvents jumped 14.6% YoY to HK\$1,327.3m. The increase was led by a combination of: 1) optimization at its existing Jiangmen plant to allow a small increase in production capacity; 2) ASP increase in the region of 10% and 3) initial contribution from Shengda Chemical, its acquisition announced in Jun 2007. Though ASP has increased, raw materials prices has also increased by roughly the same amount. This means that Yip's has largely been able to pass on the price increases to its customers. The 0.8 pcp contraction in segment margin to 10.2% was due to the absence of an inventory gain, which was booked in the previous year due to the high oil prices at the time.

**Scope to increase production capacity expansion.** After completing the takeover of Shengda, the company has been able to expand production capacity at the newly acquired plant from 30,000 tons p.a. to 45,000 tons p.a., demonstrating the company's ability to increase the productivity and profitability of acquired assets. The company is currently exploring options to further expand this plant's capacity, including leasing an adjacent plot

**Chart 1: P/E bands**



Source: SBI E2-Capital

of land. Together with production optimization at its Jiangmen plant, management expects capacity to reach between 310,000-340,000 tons p.a. in FY3/09. The high-end of the production capacity expansion will be based on securing the additional piece of land previously mentioned.

**Coatings business will be a key growth driver going forward.** Coatings turnover increased 14.3% YoY to HK\$884.2m, while segment margin improved 0.2 pcp to 8.3% compared to a year ago. Sales of architectural paint was a key driver of the segment. We expect that this growth will be sustained in 2H FY12/08F given that the company commenced TV advertising in Sep 2007 to build its "Bauhinia" brand and drive sales during this peak season. In our view, Yip's coatings segment will be a key growth driver for the company going forward. The business produces a variety of products including architectural paints, industrial paints for toys / furniture / electronic equipment, inks for packaging products and it is one of China's largest producer of plastic and gravure inks. The demand for these materials is a direct proxy on China's surging domestic consumption. To meet upcoming demand, the Yip's has completed plant expansions in Shanghai, Chengdu and Shantou. Meanwhile, its new coatings plant in Tungxiang, Zhejiang is on track to be completed in Oct 2008. We are expecting the margins of this segment to improve going forward on: 1) increasing economies of scale and 2) reallocation of inks/paints capacity among the plants to further streamline production. Furthermore, the company will start producing inks for offset printing next year. The margins for this product are slightly higher and the market size is significantly larger than that for gravure inks.

**Lubricants recorded a small profit.** Yip's lubricants segment recorded a small profit of HK\$1.6m (c.f. HK\$1.9m loss) in 1H FY3/08A off a 14.5% increase in turnover to HK\$118.8m. The key to the turnaround was the contribution from its new toll blending services for Shell in Zhanjiang. The operations recorded around HK\$4.0m in 1H FY3/08A. Though we do not expect significant growth, the contribution will aid the segment in achieving breakeven position going forward. With oil prices maintained at a high level, we do not expect significant profitability improvement in this segment going forward.

**Other income boosts profitability.** Yip's other income increased 304.4% YoY to HK\$43.1m. The breakdown of this included one-off HK\$11.6m from the 3.0% disposal of Lomon, as well as recurring items such as the toll blending operations and rebates from supplier Celanese, which amounted to around HK\$12.0m in 1H FY3/08A. Note that the Celanese rebate is booked on a yearly basis, in the first half of the financial year. Therefore, we expect other income to be less in 2H FY3/08F.

**More M&As on the way.** Yip's has further reduced its net gearing ratio to a comfortable 10.0%, from 31.0% in 1H FY3/07A. The company requires only HK\$70.0m capex for the remainder of the year and with HK\$501.0m cash and cash equivalents in the bank and unused banking facilities of around HK\$890.6m, it is in a solid platform to undertake further M&A activities. We expect that its targets may include upstream feedstock plants or competitors in the Yangtze Delta area.

**Reiterate BUY call, new target price HK\$6.55.** We have revised up our FY3/08F net profit forecast to HK\$262.7m after marginally revising up our full year forecasts and incorporating the one-off disposal gain. For FY3/09F, we have revised up our earnings forecast to HK\$314.2m (from HK\$303.3m). We like Yip's for its: 1) consolidating leadership position; 2) increasing exposure as an upstream consumption play and 3) M&A potential. Meanwhile, continuing RMB appreciation will also benefit Yip's as it sells the majority of its products in China and its P&L reporting is denominated in HK dollars. We upgrade our target price to HK\$6.55 (from previously HK\$6.20), representing 12.5x adjusted FY3/08F P/E (excluding one-off items) and 10.0x FY3/09F P/E.

**Table 1: Earnings model**

Year to Mar (HK\$m)	06A	07A	08F	09F	10F
<b>Turnover</b>					
Solvents	1,973.6	2,194.7	2,523.9	2,952.9	3,425.4
Coating	1,196.0	1,398.7	1,622.5	1,801.0	1,963.1
Lubricants	219.3	205.1	232.8	267.7	307.8
Others	64.0	115.4	121.2	127.2	133.6
Elimination	(123.3)	-	-	-	-
	<b>3,329.7</b>	<b>3,913.8</b>	<b>4,500.3</b>	<b>5,148.8</b>	<b>5,829.9</b>
% chg	24.4	17.5	15.0	14.4	13.2
Cost of sales	(2,667.2)	(3,121.2)	(3,572.7)	(4,081.1)	(4,628.9)
Gross profit	662.5	792.6	927.5	1,067.7	1,200.9
Other revenue	16.2	26.4	60.8	51.5	52.5
Selling expenses	(98.6)	(106.4)	(130.5)	(154.5)	(180.7)
Administrative expense	(340.1)	(364.7)	(443.3)	(476.4)	(503.9)
Operating profit	240.0	348.0	414.5	488.3	568.7
Interest expense	(21.5)	(26.3)	(23.7)	(20.8)	(19.3)
Associates	-	-	-	-	-
Jointly-controlled entit.	-	-	-	-	-
<b>Pre-tax profit</b>	<b>218.4</b>	<b>321.7</b>	<b>390.8</b>	<b>467.5</b>	<b>549.4</b>
Tax	(21.7)	(52.0)	(63.3)	(75.7)	(89.4)
Minority interests	(28.3)	(46.1)	(64.8)	(77.5)	(91.1)
<b>Net profit</b>	<b>168.4</b>	<b>223.6</b>	<b>262.7</b>	<b>314.2</b>	<b>369.3</b>
% chg	36.7	32.8	17.5	19.6	17.5
Dividends	(66.8)	(81.7)	(110.3)	(132.0)	(155.1)

Source: Company data & SBI E2-Capital

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