

Lee Kee Holdings: Proxy to zinc price

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Recommendation: Not Rated

Hong Kong Industrials

Price	HK\$2.83	Yield (12/05A)	42.0%
12 mth range	HK\$2.83-3.24	ROE (12/05A)	69.2%
Market cap.	US\$302.2m	Net gearing (12/05A)	36.5%
No. shares o/s	830.0m	Net debt/sh. (12/05A)	HK\$0.17
Daily t/o, 3 mth	n.a.	BV/sh. (12/05A)	HK\$0.56
Free float %	26.7%	Consensus EPS	
Major shareholder	Chan Pak Chung – 73.3%	- 3/07F	n.a.
Ticker	0637.HK/ 637 HK	- 3/08F	n.a.

Key points:

- A proxy to the high non-ferrous metal prices.
- Foray into the high growth market in Eastern China.
- The metal processing and refining division will be a new source of revenue.
- 3-year earnings CAGR expected to be 19.1% between FY12/05A and FY12/08F.

Background. Founded in 1947 and listed on HKEx on October 2006, Lee Kee is engaged in the sourcing and distribution of non-ferrous metals, include Special High Grade (SHG) zinc and zinc alloy, nickel and nickel-related products, aluminum and aluminum alloy and other electroplating chemicals.

Revenue model. The group sources metals from its suppliers and sells the metals to its customers. Products prices are fixed upon the market prices quoted on the London Metal Exchange (LME) plus a mark-up. After the group receives orders from customer, it places back-to-back orders with suppliers.

Zinc is the major product. In FY12/05A, revenue generated from the sales of zinc and zinc alloy accounted for 73.0% of the group's turnover. Thus, the group's turnover is highly dependent on zinc and zinc alloy prices.

Cost structure. Since the group is a metal trading firm, almost all of its COGS is procurement cost of non-ferrous metals. Since trading business is neither a labor-intensive nor a capital intensive-business, staff costs and depreciation charges accounted for 0.6% and less than 0.1% of the group's turnover, respectively in FY12/05A. Staffs costs and deprecation charges are booked under the administrative expenses. The group has 84 full-time staffs based in Hong Kong.

Inventory management. The group usually maintains inventory turnover between 30 days to 45 days. It adopts the First-In-First-Out approach to report the value of its inventories. The group is required to purchase minimum amount of non-ferrous metals on a monthly basis upon the distributorship agreement with its suppliers.

Hedging and risk management. PricewaterhouseCoopers advised the group in the development of its hedging and risk management polices. The group compares its net inventory exposure (calculated as inventory level plus purchases minus sells) to its pre-set risk tolerance level from time to time. It will take hedging action if the inventory exposure exceeds the risk tolerance level. It calculates statistical parameters of price change in zinc, aluminum and nickel on a weekly basis for the comparison to a preset limit. The preset limit is determined upon its expected profit for the year with the assumption of flat metals prices throughout the year. If the key statistical parameters exceed the limit, the group's risk management committee would decide whether to adjust the inventory level.

Why sources from trader rather than producer? Non-ferrous metals are a necessity in die-casting process and surface treatment. Nevertheless, with over 20,000 foundries established across China, the die-casting industry in

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China is highly fragmental. Thus, it will be difficult for the metal producers to allocate its customers. Further, suppliers produce and sell large volume of metal in standard and marketable size and they are usually remote from the market. Therefore, it will not be economical for suppliers to ship small volume of metals to each of the consumer. Consumers, on the other hand, do not place large order, as most of their customers place just in time orders. It will be risky for consumers to keep excessive inventories of non-ferrous metals, since it will increase their risk exposure to fluctuation in metals prices, and will tighten up their working capital. Thus, an intermediate is needed in the middle of the supply chain, to allocate and match buyers and sellers, arrange logistic services and manage inventories.

Competitive edge 1: Broad and stable sources of supplies. The group's suppliers include Australia-based Zinifex, Korea-based Korea Zinc, Canadian producers Teck Cominco and Alcan, Finland-based OMG and UK producer Johnson Matthey. Five largest suppliers accounted for 88.0% of its procurement in FY12/05A. Zinifex is the largest supplier of the group and accounted for 57.5% of the group's purchase in FY12/05A. The group entered into a 5-year zinc distributorship agreement with Zinifex. Besides, it also secured an exclusive zinc distributorship in Hong Kong and Guangdong with Korea Zinc.

Competitive edge 2: Extensive and diversified customers base. The group has over 1,200 customers situated in six different countries, with 91.6% of them with production facilities based in the Pearl River Delta region in China. Its customers are engaged in a variety of industries, including bathroom fittings, household hardware, toys, home appliances, silver-plated tableware, fashion accessories, automobile accessories, stationeries and jewellery.

Competitive edge 3: Prestigious brand name and leading position. The group's zinc alloy sales represented 77.0% and 72.5% of China and Hong Kong's total import in 2005, respectively. With 60 years of operating history, "Lee Kee" is the recognized brand of non-ferrous metal trading in Hong Kong and China.

Channel expansion. In FY12/05A, the group sold 205,901 tons of non-ferrous metal, representing a 14.7% YoY increase. The group raised approximately HK\$534.0m through the issuance of 200m new shares on October 2006. Of the net proceeds, HK\$125.7m is earmarked for distribution network expansion. The group will establish trading firms in Shanghai and Guangzhou by the end of this year and the trading firms are expected to commence operation in FY12/07. Besides, it will set up representative offices in Chengdu, Dalian and Beijing in 2H FY12/07F. Further, the group will deploy HK\$30m to expand its logistics facilities in Hong Kong. Following the completion of its channel expansion plan, the group's channel capacity in Pearl River Delta and Yangzi River Delta would reach 30,000 t.p.a. and 40,000 t.p.a. by the end of FY12/07F, respectively. By the end of FY12/09F, the group's channel capacity in Pearl River Delta and Yangzi River Delta are both expected to expand further to 90,000 t. p.a.

Expand into refining. The group's 50%-owned Genesis Ningbo is the joint venture with Zinifex and engaged in the manufacturing of zinc alloy using Special High Grade zinc procured in China. The plant's current production capacity is approximately 28,800 t.p.a. HK\$110m is budgeted for the expansion in capacity at the plant. It is expected that the plant's production capacity would double to 57,600 t.p.a. in 2008 and reach 120,000 t.p.a. in 2009. Gross profit margin of Genesis Ningbo is estimated to be between 2.0% and 3.0%. Further, the group intends to set up an aluminum recycling plant that uses aluminum scraps as major raw material to produce aluminum alloy. Capacity at the plant is expected to reach 90,000 t.p.a. by 2009. Although the group will deploy HK\$78.5m into the project, it intends to draw a partner into the project. The recycling plant is expected to command a gross profit margin between 4% and 5%. In addition, the group has the call option to acquire a 70% stake in the stainless steel processing plant, Lee Yip, from its major shareholder, Mr. P.C. Chan, within one year starting from October 2006 at the price of HK\$14m plus interest expenses incurred by Mr. Chan.

Driver 1: New sources of revenue. Genesis Ningbo and the planned aluminum recycling plant could be the new sources of revenue. Nevertheless, with limited information about the overhead expenses of the two plants, we cannot assess whether the manufacturing division is margin accretive.

Driver 2: Tapping into YRD. Currently, most of the group's clients are manufacturers with production facilities based in the Pearl River Delta region in China. By setting up a trading firm in Shanghai, the group can expand into the high-growth Yangzi River Delta. It is worth to mention that many automobile makers' production facilities are situated in the Eastern China. If the group can establish a foothold in the region, it can expand its aluminum sales.

Driver 3: Non-ferrous metal prices. Non-ferrous metal prices are a double-edge sword for the group. Our sensitivity analysis shows that for every 10% increase in zinc price from our base case (US\$3,666.5/ton), earnings would increase by 10.1%. Besides, if the group's customers have high expectation on non-ferrous metal prices, they tend to place early orders.

Preliminary earnings forecasts. Between FY12/03A and FY12/05A, the group's turnover and net profit increased at a 2-year CAGR of 50.4% and 137.9%, respectively, thanks to the 66.9%, 53.5% and 28.1% surge in SHG zinc, nickel and aluminum prices, respectively. Its sales volume increased at a 2-year CAGR of 27.8%. In 5M FY12/06A,

the group registered a 56.1% and 133% YoY surge in turnover and net profit, respectively. Net profits are projected to be HK\$297.9m and HK\$315.1m for FY12/06F and FY12/07F, respectively, representing a 47.2% and 5.8% YoY growth. It is noteworthy that we do not include the refining division at this juncture, as details of the division are yet to be known. Besides, our earnings forecasts are subject to the risk of fluctuation in non-ferrous metal prices. The group is trading at P/E of 8.8x and 8.1x for FY12/05A and FY12/06F, respectively, compared with a sector average of 9.6x for FY05.

Table 1: ASP and volume sold

	03A	04A	05A
ASP			
SHG zinc and zinc alloy (US\$/ton)	829.6	1,050.8	1,384.6
Nickel and nickel-related products (US\$/ton)	9,639.8	13,879.4	14,798.0
Aluminum and aluminum alloy (US\$/ton)	1,435.7	1,713.5	1,839.2
YoY change			
SHG zinc and zinc alloy (%)	-	26.7	31.8
Nickel and nickel-related products (%)	-	44.0	6.6
Aluminum and aluminum alloy (%)	-	19.4	7.3
Volume sold			
SHG zinc and zinc alloy (t.p.a)	111,160	162,533	191,186
Nickle and nickle-related products (t.p.a)	5,071	6,842	5,874
Aluminum and aluminum alloy (t.p.a)	9,888	10,098	8,836
YoY change			
SHG zinc and zinc alloy (%)	-	46.2	17.6
Nickle and nickle-related products (%)	-	34.9	(14.1)
Aluminum and aluminum alloy (%)	-	2.1	(12.5)

Source: Company data

Risk factors. 1) Fluctuation in non-ferrous metals prices. 2) Currency risk: Almost all of the group's incomes are denominated in US\$ and HK\$. Following the commencement of its refining plants, some of its expenses will be denominated in RMB. 3) Softer demand in the U.S. market would post negative impact on the group's sales. 4) Execution risk of the group's refining division. 5) The group adopts a Pre-IPO Share Option Scheme, which allows the holders of the options to acquire the shares at HK\$2.136 each, or at 20% discount to the IPO price of HK\$2.67/share. 22.7m shares will be issued upon the exercise of the options. Nevertheless, none of the options under the scheme will be exercised for at least one year after the listing date on October 4, 2006.

Table 2: Trading companies comparisons

Company name	Ticker	Year End	Price (HK\$)	Market Cap (HK\$m)	P/E (x) FY05A
Kee Shing	174 HK	Dec	0.86	383	6.2
Lei Shing Hong Ltd	238 HK	Dec	3.60	3,818	11.7
World Trade Bun Kee	380 HK	Dec	0.75	181	4.3
VST Holdings Ltd	856 HK	Mar	1.82	1,612	13.7
Digital China	861 HK	Mar	2.77	2,414	9.5
China Hong Kong Photo	1123 HK	Mar	0.84	978	8.1
SAS Dragon	1184 HK	Dec	0.81	196	4.9
Leepport Holdings	387 HK	Dec	1.65	336	6.6
SIS International	529 HK	Dec	1.09	293	3.4
E.Bon Holdings	599 HK	Mar	0.75	150	12.5
Honesty Treasure International	600 HK	Dec	0.18	507	10.1
Yardway Group	646 HK	Mar	0.30	83	9.8
Tan Chong International	693 HK	Dec	1.85	3,725	7.6
Wo Kee Hong	720 HK	Dec	0.39	86	2.4
Sunlink International	2336 HK	Dec	0.17	80	8.5
Average					9.6

Source: Bloomberg

P & L (HK\$m)	03A	04A	05A	Cash Flow (HK\$m)	03A	04A	05A
Year to Dec				Year to Dec			
Turnover	1,390.3	2,438.4	3,143.0	EBIT	45.6	139.8	252.4
% chg	-	75.4	28.9	Depre./amort.	2.5	2.3	2.3
Gross profit	76.8	165.5	285.2	Net int. paid	(1.7)	(2.3)	(7.9)
				Tax paid	(8.1)	(24.6)	(42.2)
EBITDA	48.1	142.1	254.8	Dividends received	-	-	-
Depre./amort.	(2.5)	(2.3)	(2.3)	Gross cashflow	38.3	115.3	204.7
EBIT	45.6	139.8	252.4	Chgs. in working cap.	(61.9)	(211.4)	(116.8)
Net int. income/(exp.)	(1.7)	(2.3)	(7.9)	Operating cashflow	(23.6)	(96.1)	87.9
Exceptionals	-	-	-	Capex	(1.6)	(0.3)	(1.1)
Associates	-	-	-	Free cashflow	(25.2)	(96.4)	86.8
Jointly-controlled entit.	-	-	-	Dividends paid	-	-	-
Pre-tax profit	43.9	137.6	244.5	Net distribution to MI	-	-	-
Tax	(8.1)	(24.6)	(42.2)	Investments	-	-	-
Minority interests	-	-	-	Disposals	-	-	-
Net profit	35.8	113.0	202.4	New shares	-	-	-
% chg	-	215.6	79.1	Others	35.3	115.3	(42.4)
Dividends	-	-	(85.0)	Net cashflow	10.1	18.9	44.4
Retained earnings	35.8	113.0	117.4	Net (debt)/cash - Beg.	-	(61.4)	(165.9)
				Net (debt)/cash - End.	(61.4)	(165.9)	(106.9)
EPS (HK\$) - Basic	0.057	0.179	0.321	5 months Results (HK\$m)		05A	06A
EPS (HK\$) - F.D.	0.057	0.179	0.321	Five months to May			
DPS (HK\$)	-	-	0.106	Turnover		1,184.9	1,849.9
No. sh.s o/s (m) - W.A.	630.0	630.0	630.0	% chg		-	56.1
No. sh.s o/s (m) - Y.E.	630.0	630.0	630.0	Profit from operations		119.9	276.3
No. sh.s o/s (m) - F.D.	630.0	630.0	630.0	Interest expenses		(2.6)	(3.1)
				Associates		-	-
Margins (%)				Jointly-controlled entit.		-	-
Gross	5.5	6.8	9.1	Pre-tax profit		117.2	273.3
EBITDA	3.5	5.8	8.1	Tax		(20.3)	(48.5)
EBIT	3.3	5.7	8.0	Minority interests		-	-
Pre-tax	3.2	5.6	7.8	Net profit		96.9	224.7
Net				% chg		-	131.9
				EPS (HK\$) - Basic		0.154	0.271
				DPS (HK\$)		-	-
Balance Sheet (HK\$m)	03A	04A	05A	Shareholding Structure			
Year to Dec					Shares o/s (m)	%	
Fixed assets	60.0	64.9	13.5	Chan Pak Chung	608.6	73.3	
Intangible assets	-	-	-	JPMorgan Cazenove	45.6	5.5	
Other LT assets	-	0.0	0.1	Public	175.8	21.2	
Cash	20.0	36.1	80.0	Total	830.0	100.0	
Accounts receivable	99.4	151.4	188.0				
Other receivables				Background			
Inventories	166.4	275.2	351.3	Founded in 1947 and listed on HKEx on October, 2006, Lee Kee is engaged in the sourcing and distribution of non-ferrous metals, include Special High Grade (SHG) zinc and zinc alloy, nickel and nickel-related products, aluminum and aluminum alloy and other electroplating chemicals. Its zinc alloy sales represented 77% and 72.5% of China and Hong Kong's total import in 2005, respectively.			
Due from related co.s	0.0	0.3	0.1				
Other current assets	-	-	63.2	Key Ratios		03A	04A
Total assets	345.8	528.0	696.2	Net gearing (%)	50.8	93.6	36.5
Accounts payable	(90.6)	(35.3)	(36.9)	Net ROE (%)	29.6	63.7	69.2
Other payable	-	-	-	EBIT ROCE (%)	22.5	43.8	51.8
Tax payable	(2.8)	(16.0)	(20.6)	Dividend payout (%)	-	-	42.0
Due to related co.s	(1.2)	(6.2)	(9.2)	Effective tax rate (%)	18.5	17.9	17.2
ST debts	(78.1)	(202.0)	(186.9)	Net interest coverage (x)	27.4	61.8	31.9
Other current liab.	-	-	(89.7)	A/R turnover (days)	26.1	18.8	19.7
LT debts	(3.3)	-	-	A/P turnover (days)	23.8	9.4	4.2
Other LT liabilities	(49.1)	(34.7)	(1.6)	Stock turnover (days)	46.2	35.5	40.0
Total liabilities	(225.0)	(294.1)	(344.9)				
Share capital	10.0	10.0	10.0				
Reserves	110.9	223.8	341.2				
Shareholders' funds	120.9	233.8	351.2				
Minority interest	-	-	-				
Total	120.9	233.8	351.2				
Capital employed	202.2	435.8	538.1				
Net (debt)/cash	61.4	165.9	106.9				