

Fong's Industries

Re-rating triggered by sustainable industry prosperity

to summarize...

- Reference target price at HK\$7.14 based on 10x FY12/11F P/E. The stock used to trade at 13.3 P/E during 2002-2006 when textile market was booming.
- The company is a leading supplier of textile dyeing machines with long-history track record.
- Textile market bottomed out in 2H 09 and is expected to stay in good shape in coming 12-24 months.
- Tightening environmental regulations calls for technical upgrade of dyeing equipment. The company has released its own new generation of water-saving dyeing machines.
- The new waste water treatment business unit provides dyeing factories solutions, which can save water consumption by 70%+. We are quite bullish on this business.
- Production capacity is under planned expansion. Two pieces of lands were purchased in Zhongshan for new plants.
- Gross margin is anticipated to be intact from high steel price thanks to strong demand.
- Net profit is expected to reach a historical high profit of HK\$318m in FY12/10F, which may increase another 24% in FY12/11F to HK\$394m.
- Introduction of China Hengtian Group looks positive.

A proven name for textile dyeing and finishing. Established in 1963, Fong's Industries (FI) is a long-history supplier of textile dyeing machines in the world. It currently runs five brands (Fong's, Then, Goller, Xorella, Monforts), all leading names in their own territory. Two non-core business units, Fong's Steel and Tycon Alloy, were set up in 1988 and 1995 as natural extension of internal operation of steel trading and steel casting, respectively. In 1H FY12/10A, dyeing and finishing machine segment accounted for 63% of FI's total revenue (steel trading: 26%; steel casting: 11%) or 75% of operating profit (steel trading: 18%; steel casting: 7%).

Table 1. FI's major brands and subsidiaries

Brands/subsidiaries	Background	Expertise
Fong's	self-developed brand	piece / yarn dyeing and finishing equipment
Then	acquired in 2004	jet dyeing machine, dye-house control and management software
Goller	acquired in 2006	continuous wet finishing system
Xorella	acquired in 2002	yarn conditioning system
Monforts	50:50 JV with A. Monforts since 1999	stenter frame range, shrinking range, continuous dyeing range and relaxation dryer
Tycon Alloy	self-developed entity	metal castings
Fong's Steel	self-developed entity	trading of stainless steel material
Fong's Water	self-developed entity	water re-use solution

Source: compiled by SBI E2-Capital

Well positioned to capture future industry trends. Our guesses towards the textile industry include:

- A general post-crisis market recovery – FI itself reported consecutive HoH sales growth in 2H FY12/09A (37%) and 1H FY12/10A (25%). The management expects the industry prosperity to retain in coming 12-24 months.
- Sustainable demand for new capacity due to the industry's geographical migration – We believe the textile market is highly integrated globally. Closing companies (e.g. brands) may move their sourcing from region in

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Ticker	0641 HK
Rating	Not Rated
Price (HK\$)	5.34
Target Price (HK\$)	n.a.
12m Price Range (HK\$)	2.76-5.98
Market cap. (US\$m)	377.5
Daily t/o (US\$m)	0.8
Free float (%)	34.3

Financial summary

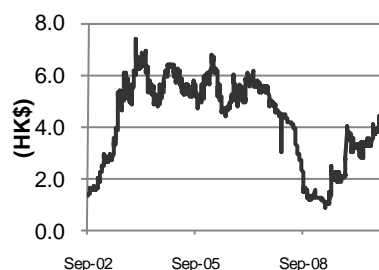
Year to Dec	07A	08A	09A
Turnover (HK\$m)	3,029	2,500	1,798
Net Profit (HK\$m)	274	(143)	(106)
EPS (HK\$)	0.492	(0.258)	(0.193)
P/E (x)	10.9	(20.7)	(27.7)
P/B (x)	2.56	3.27	3.70
EV/EBITDA (x)	8.5	127.6	530.3
Yield (%)	5.1	3.2	0.0
ROE (%)	23.7	(13.9)	(12.5)
ROCE (%)	14.9	(3.2)	(3.6)
N. Gear. (%)	36.2	65.2	43.7

Source: SBI E2-Capital

	10F	11F	12F
Consensus EPS (HK\$)	-	-	-
Previous earnings (HK\$m)	-	-	-
Previous EPS (HK\$)	-	-	-

Price performance

Year to Dec	1m	3m	12m
Relative to HSI (%)	+5.3	+37.6	+41.4
Actual price changes (%)	+1.1	+27.1	+59.1



Source: Bloomberg

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chase for lower cost, which creates extra demand for new capacity in addition to the organic one.

- Technical upgrade need triggered by tightening environmental regulation – Textile industry can cause heavy water pollution, especially during dyeing and treatment. In view of considerably heating-up public attention on environmental protection, we think textile manufacturers will suffer even greater pressure than before, which may lead to acceleration of equipment upgrade and replacement.

And we reckon FI should be able to capture these opportunities because:

- It has successfully built up its name as a leading supplier of various dyeing machines
- New products have been developed, released and accepted by the market. These products, including Fong's Jumboflow, Then Airflow, can be more water-saving. Meanwhile, FI established its own waste water treatment unit, Fong's Water (FW), which provides one-stop water re-use solutions to dyeing factories.
- The hiking labour cost in China may drive some textile capacity to seek cheaper alternative countries. However, it seems a manageable factor for textile equipment vendors. In case of FI, staff wage accounts for 5% of FI's COGS. Meanwhile, the company already has a worldwide distribution network, overseas sales made up 49% of its total revenue in 1H FY12/10A, suggesting comfortable ability in handling overseas customers.

Potential of Fong's Water. We highlight FW given its huge potential in our eyes. By leveraging its extensive knowledge of dye industry, FW is able to offer efficient turn-key waste water treatment and re-use solutions, which can help dyeing factories save water consumption by 70%+. According to the management, orders have been received and will be reflected in FY12/11F results. The system is priced based on its handling capacity and can be worth of from millions to over ten million dollars. By applying a simple assumption of HK\$5m per set, the potential market size is estimated at as much as HK\$15b based on FI's existing 3,000+ dyeing clients.

Capacity under expansion. Utilization rate of FI's Shenzhen plant reached 80%+ while the MonForts JV has been fully occupied. To support its future growth, FI acquired a piece of land (1,250 mu) in Zhonshang, which will be developed into a new manufacturing base to replace the old one with doubled capacity. Construction of this new plant is anticipated to complete in 1H 12 and operation may commence in 2013. Monfots has similar expansion plan and also purchased land (200 mu) in Zhongshan, which will be put into operation in 2012. To solve the capacity bottleneck before 2012, Monfots has leased a four-storey factory premises (7,000 m²), which can start production in 4Q 11 and enhance current capacity by ~20%.

Margin pattern changed by internal optimisation. Although the financial crisis hit the company heavily, it provided chance for cutting redundant costs and improving internal efficiency, which partly explained the 8.4 pcp HoH enhancement on operating margin in 1H FY12/10A. The management believes current operation and labour structure is sustainable, implying probability of: 1) benefit from operating leverage going forward; 2) an upwards parallel shift of the company's long-term profitability curve. Historically between FY12/91A and FY12/09A, FI has an average annual operating margin of 8.4% (highest: 19.8% in FY12/03A; lowest: -5.8% in FY12/09A).

A new historical high profit in expectation. Regarding 2H FY12/10F and FY12/11F, growth drivers are specified as:

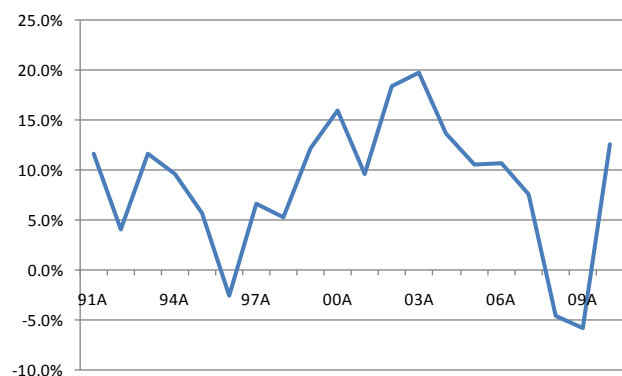
- A moderate volume growth backed by the industry recovery – Dyeing and finishing machine segment is assumed to grow at 5% HoH in 2H FY12/10F and 10% YoY in FY12/11F. For Monfort, we expect an even higher growth rate (15% in FY12/11F).
- Cost-driven selling price increase – Steel represents 80% of FI's COGS. Hot rolled steel sheet price increased from RMB4,096/mt (HK\$4,682) in Jun 2010 to RMB4,573 (HK\$5,255) in Dec. In view of the relatively strong demand, the company is confident in passing on incremental cost and maintain its gross margin.
- Extra contribution from FW – We assume FW can generate HK\$100m revenue in FY12/11F with operating margin at 5%.

According to our preliminary forecast, the company will have HK\$318m net profit for the full FY12/10F, a new historical high since HK\$277m recorded in FY12/03A. We expect the growth to remain in FY12/11F and the company's profit will further increase to HK\$394m, up 24% YoY. Our estimates should be at the conservative side as no assumption was made on market share expansion, which, however, is possible given FI's satisfactory performance in rolling out new environmental-friendly products.

SOE colour from ownership transfer. In Jan 2011, Mr. Fong, FI's founder, Chairman and controlling shareholder (59.8%), agreed to sell 208m shares (37.7%) to China Hengtian Group (HTG) at HK\$5 each. HTG is a SOE with exposure mainly to textile machinery, cargo truck and textile production and trade area. It controls another HK-listed textile machinery company, Jingwei Textile Machinery (0350 HK). We think it is reasonable to expect support from HTG as well as synergy with the latter's other businesses. In addition, Jingwei Textile Machinery acquired 36% interest in Zhongrong Trust, the second largest trust company in China, in 2010. It will not surprise us if HTG undertake a major internal restructuring in the future and consolidate all its textile machinery assets under one listing vehicle.

Reference target price at HK\$7.14. Considering the expected 12-24 months industry prosperity, we employ FI's own historical valuation in between 2002 and 2006 (Consecutive top line growth and double-digit operating margins was registered for the period) as a benchmark, which is averaged 13.3x (max: 18.4x; min: 7.1x). Our reference target price at the moment is set at HK\$7.14 on a 10x FY12/11F P/E.

Chart 1. Historical operating margin (91A-1H 10A)



Source: Bloomberg

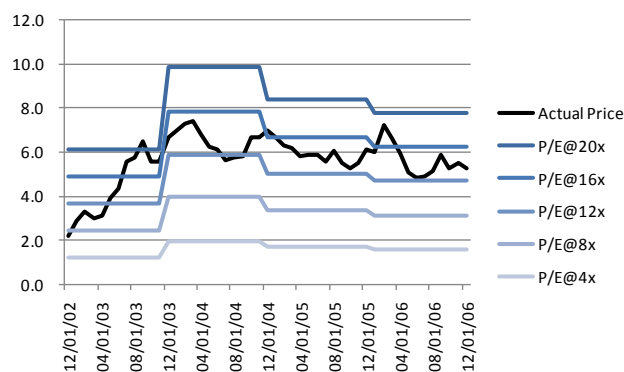
Risks. We think the company mainly expose to market risk. Meanwhile, HTG's acquisition has not completed yet. The potential restructuring within HTG presents another sort of uncertainty.

Table 2. Valuation table

FY12/11F P/E (x)	reference target price (HK\$/share)
4.0	2.86
6.0	4.29
8.0	5.71
10.0	7.14
12.0	8.57
14.0	10.00
16.0	11.43
18.0	12.86
20.0	14.28
22.0	15.71
26.0	18.57

Source: SBI E2-Capital

Chart 2. Monthly PE band (Dec 02 – Dec 06)



Source: Bloomberg

Table 3. Preliminary forecasts

Year to Dec (HK\$m)	07A	08A	09A	1H 10A	2H 10F	10F	11F
Revenue	3,029.2	2,499.9	1,797.7	1,294.9	1,466.1	2,761.0	3,402.6
Dyeing and finishing machines	1,615.4	1,387.1	1,228.0	819.5	944.4	1,763.9	2,181.5
Trading of stainless steel supplies	902.7	623.0	363.7	331.7	364.0	695.7	782.2
Stainless steel casting products	511.2	489.7	206.0	143.7	157.7	301.4	338.9
Fong's Water							100.0
Segmental results							
Dyeing and finishing machines	134.6	(104.0)	(61.1)	120.3	138.6	258.9	320.2
Trading of stainless steel supplies	100.4	16.9	7.4	29.1	31.9	60.9	68.5
Stainless steel casting products	46.1	0.4	(50.3)	11.9	13.1	25.0	28.1
Fong's Water							5.0
Operating profit	299.5	(87.5)	(101.5)	162.7	184.8	347.5	424.3
Share of results of an associate	1.4	(2.1)	(0.2)	0.3	0.3	0.5	0.5
Share of results of jointly controlled entities	78.3	30.3	44.8	44.3	46.6	90.9	117.5
Net profit	274.4	(142.8)	(106.3)	151.6	166.1	317.7	393.8
Segmental margin							
Dyeing and finishing machines	8.3%	-7.5%	-5.0%	14.7%	14.7%	14.7%	14.7%
Trading of stainless steel supplies	11.1%	2.7%	2.0%	8.8%	8.8%	8.8%	8.8%
Stainless steel casting products	9.0%	0.1%	-24.4%	8.3%	8.3%	8.3%	8.3%
Operating margin	9.9%	-3.5%	-5.6%	12.6%	12.6%	12.6%	12.5%
Net margin	9.1%	-5.7%	-5.9%	11.7%	11.3%	11.5%	11.6%

Source: Company data, SBI E2-Capital

Table 4. Key financials

Year to Dec (HK\$m)	07A	08A	09A
Revenue	3,029.2	2,499.9	1,797.7
Gross profit	779.4	423.8	351.7
Operating profit	299.5	(87.5)	(101.5)
Net profit	274.4	(142.8)	(106.3)
EBITDA	385.4	25.6	6.2
Fixed assets	378.9	418.1	399.4
Inventories	951.9	864.7	742.9
Receivables	489.3	357.7	279.9
Payables	409.6	336.5	471.4
Cash	640.9	309.8	328.4
Short-term debt	978.6	240.0	206.9
Long-term debt	82.5	656.7	469.2
Shareholders' fund	1,158.5	900.1	796.0
Total equity	1,159.8	900.1	796.0
Net cash from operating activities	82.8	67.3	286.1
Net cash used in investing activities	37.5	6.0	2.6
Net cash from financing activities	(128.5)	(353.5)	(264.0)
Net change in cash and cash equivalents	(8.2)	(280.2)	24.7

Source: Company data

Table 5. P&L

Year to Dec (HK\$m)	07A	08A	09A	1H 10A
Revenue	3,029.2	2,499.9	1,797.7	1,294.9
Cost of sales	(2,249.8)	(2,076.0)	(1,446.0)	(892.1)
Gross profit	779.4	423.8	351.7	402.8
Interest income	14.2	9.3	2.8	1.2
Other income	91.4	64.3	46.1	26.8
Change on fair value of financial assets held for trading	(2.1)	1.1	(0.3)	0.2
Change on fair value change of financial assets designated as at fair value through profit or loss	2.4	(0.1)	0.0	0.0
Change on embedded derivatives and convertible loan notes	3.9	(11.2)	0.0	0.0
Selling and distribution costs	(163.0)	(156.1)	(127.4)	(73.5)
General and administrative expenses	(353.0)	(351.6)	(320.8)	(172.0)
Other expenses	(73.8)	(67.1)	(53.6)	(22.8)
Profit from operations	299.5	(87.5)	(101.5)	162.7
Finance costs	(64.5)	(81.1)	(49.0)	(21.5)
Share of results of an associate	1.4	(2.1)	(0.2)	0.3
Share of results of jointly controlled entities	78.3	30.3	44.8	44.3
Profit before taxation	314.7	(140.4)	(105.8)	185.8
Income tax expenses	(40.3)	(2.4)	(0.5)	(34.2)
Profit for the period	274.4	(142.8)	(106.3)	151.6
Attributable to:				
Owners of the Company	274.4	(142.8)	(106.3)	151.6
Minority interest	-	-	-	-
EPS - Basic (HK\$)	0.492	(0.258)	(0.193)	0.275
EPS - Diluted (HK\$)	0.479	-	-	-

Source: Company data

Table 6. Shareholding structure

Shareholders	Interest
Fong Sou Lam	59.81%
Deutsche Bank	5.87%
Others	34.32%
Total	100.00%

Source: HKEx

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