

Capacity expansion to meet surging demand

China Consumers

Hengan International (1044 HK, HK\$26.50)

BUY (unchanged)

Target price: HK\$31.86 (+20.2%)

Interim results. Hengan's net profit rose 42.1% YoY to HK\$469.6m in 1H FY12/07A on the back of a 34.6% increase in turnover to HK\$2.74b. The tissue segment accounted for 45.5% of its total turnover and grew 40.8% YoY. An interim dividend of HK\$0.28 was proposed.

Gross margins narrows. The gross margin narrowed to 39.1% from 41.5% a year ago, mainly due to higher raw material costs but stronger-than-expected growth in high-margin products should help to stabilize the gross margin at the current level. High-margin box tissue paper, pocket-handkerchiefs and wet tissues represented about 73.1% of total tissue paper turnover. Mid-to-high end sanitary napkin products contributed 84.3% of total sanitary napkin turnover (79.8% in 1H FY12/06A).

Operating and net margin enhancement. The operating margin widened to 22.9% from 22.5% a year ago mainly due to the company's stringer cost controls on the operational level. Distribution and administrative expenses represented 17.5% of total sales, down 3.5pcp from a year ago. The net margin widened to 17.1% from 16.2% a year ago.

Table 1: 1H FY12/07 results

Year to Dec	Turnover (HK\$m)	Gross profit (HK\$m)	Gross margin (%)	Pre-tax profit (HK\$m)	Tax rate (%)	Net profit (HK\$m)	EPS Basic (HK\$)
FY12/07	2,743.9	1,073.4	39.1	581.4	19.0	469.6	0.434
FY12/06	2,038.3	846.2	41.5	433.0	23.4	330.5	0.306
YoY (%)	34.6	26.8		34.3		42.1	42.1

Source: Company data

Table 2: Turnover breakdown by business segment

(HK\$m)	1H FY12/06A	1H FY12/07A	% of total	% Change
Sanitary napkins	614.5	767.1	28.0	24.8
Disposable diapers	500.5	627.6	22.9	25.4
Tissue paper products	887.6	1,249.7	45.5	40.8
Skincare and cleaning products	35.6	99.5	3.6	179.4
Total	2,038.3	2,743.9	100.0	34.7

Source: Company data

Capacity up 50% by FY12/08F. The company's annualized production capacity is expected to reach about 240,000 tons by the end of 2007 and 360,000 tons by the end of 2008. Phase II of its Shandong production base commenced operation in July 2007, with an annual production capacity of about 60,000 tons. Second phases of

Table 3: Financial summary

Year to Dec	Net profit HK\$m	EPS HK\$	EPS Δ %	P/E x	P/B x	EV/EBITDA x	Yield %	ROE %	ROCE %	N. Gearing %
05A	450.3	0.417	48.8	63.6	12.3	41.1	1.1	20.4	15.8	20.5
06A	696.6	0.645	54.7	41.1	10.3	26.7	1.6	27.2	17.6	29.0
07F	899.0	0.832	29.1	31.9	9.7	21.5	2.1	31.2	19.2	30.9
08F	1,147.7	1.062	27.7	25.0	8.3	17.0	2.7	35.9	22.8	26.5
09F	1,492.7	1.381	30.1	19.2	7.9	13.5	3.5	42.2	26.6	30.7

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its Fujian and Hunan production bases will start operations in March 2008 and December 2008, respectively. More new high-end products in the diaper and napkins segments will be launched in 2H FY12/07 and FY12/08. Annualized production capacity for disposable diapers should reach 3.8b pieces by the end of 2007 by adding 8 new production lines. By the end of 2007, new production capacity for napkins should reach 11.8 b pieces by adding 7 new production lines.

Market share expansion. Major players are expected to take away market share from small and medium companies. The following table shows Hengan's and other players' market shares in 2006, according to the China National Household Paper Industry Association. Hengan's market share in three major product segments expanded in 2006. It achieved above-average revenue growth in sanitary napkins (+28.6%), disposable diapers (+45.9%) and tissue paper (+42.1%) in 2006.

Table 4: Hengan's China market share

	2005	2006
Sanitary napkins (+4.9%)*	8.9% (1 st or 2 nd by revenue); (1 st by volume)	10.7% (1 st by revenue); (1 st by volume)
Baby diapers (+28.5%)*	17.3% (2 nd)	23.9% (2 nd by revenue); (2 nd by volume)
Tissue paper (+8.1%)*	4.7% (1 st or 2 nd)	6.0% (1 st by revenue); (1 st or 2 nd by volume)

Source: China National Household Paper Industry Association

* market growth rate in 2006

Liquidity boost. Hengan's current market capitalization reached US\$3.48b. To further boost its liquidity, the company reduced its board lot size to 1,000 shares from 2,000.

M & A potential. The company plans to identify M &A targets for horizontal or upstream integration. We believe this would help expand its value chain.

Valuation. We have revised up our net profit forecast by 2.9% for FY12/07F to HK\$899.0m and 10.0% to HK\$1,147.7m for FY12/08F estimate. We introduce FY12/09F net profit forecast of HK\$1,492.7m to reflect stronger-than-expected earnings growth. Our new target price of HK\$31.86 is based on 30x FY12/08F P/E.