

Robust growth ahead

China Consumer

Hengan (1044 HK, HK\$16.12)

BUY (unchanged)

Target price: HK\$18.60 (+15.4%)

We visited the company after its 1H06 results. The key takeaways are as follows:

Strong growth momentum. Being the second largest personal hygiene product manufacturer in China (market share: 17% for diapers, 9% for sanitary napkins and 5% for tissue papers), Hengan benefits from the increasing demand both in China and overseas. Currently, overseas sales only account for a tiny portion of its total turnover. However given its cost advantage, there are many big overseas customers (e.g. listed companies in G7 countries) would like to source from Hengan.

New "Space 7" line will be launched in FY12/07. One of the major contributors to higher gross margin in 1H06 was the increase of the sales portion of high margin sanitary napkin products, which represented 79.8% of the overall sales of sanitary napkins (75.7% in 1H05). According to management, the original forecast for napkin sales growth was only 25% (actual sales growth: 34.1% for 1H06) as the whole China market grew only 4.5% in 2005. Thanks to the strong sales from the new high-end product e.g. "Space 7" line, sales were up 90% in 1H06. A new series of Space 7 line targeting mature customers will be launched in FY07.

Lower oil prices and RMB appreciation. According to management's estimates, every 1% drop in oil prices will translate into a 0.7% increase in Hengan's net profit. Hengan also benefits from RMB appreciation: every 1% increase in RMB will bring an estimated 2% increase in net profit.

Operating efficiency lifts margins. The company has appointed management consultant to provide internal training to its staff. In 1H06, while turnover was around 3 times higher than that in 2002, the number of staff remained nearly the same. Moreover, the company is expected to reduce the transportation costs after the Fujian tissue plant becomes operational in 2H06. As the company's main production base is located in Fujian while over 35% tissue consumption takes place in the affluent Eastern China, Hengan should be able to ramp up production relatively quickly.

Gross margins. Although sales of high-end products and new high margin products (with a gross margin of 60%) in sanitary napkins and diapers help enhance margins, paper pulp costs are expected to rise another 5% in 2H06.

New tax planning. The company would like to reduce the current relatively high effective tax rate of 23.4% by adopting a new tax planning scheme by 4Q 2006.

Near-term catalyst. Mr. Sze Man Bok, Chairman of Hengan, increased his stake by 0.08% to 20.47% at HK\$15.82 on 13 Sept and Vice-Chairman/CEO Mr. Hui Chi Lin also increased by 0.1% to 19.8% on 14 Sept between HK\$15.84 to HK\$15.96. This reflects the management's confidence on future growth potential.

Table 1: Financial summary

Year to	Net profit	EPS	EPS	P/E	P/B	EV/EBITDA	Yield	ROE	ROCE	N. Gearing
Mar	HK\$m	HK\$	Δ %	X	x	X	%	%	%	%
04A	298.0	0.280	12.4	57.6	8.4	32.7	1.4	15.2	14.8	11.3
05A	450.3	0.417	48.8	38.7	7.7	25.3	1.7	20.4	17.9	21.1
06F	641.2	0.593	42.4	27.2	6.8	16.7	2.4	26.5	24.8	31.0
07F	874.0	0.809	36.3	19.9	5.9	13.3	3.2	31.7	27.8	28.1
08F	1,036.4	0.959	18.6	16.8	5.2	11.5	3.3	32.8	29.6	23.5

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Valuation. In order to reflect better than expected margin expansion and higher sales volumes, we have revised up our earnings forecast to HK\$641.2m (+10.4%), HK\$874m (+25.5%) and HK\$1,036.4m (+15.4%) for FY12/06 to FY12/08. With its leading market position, well-recognized brand name and strong growth momentum, we reiterate our BUY recommendation. Our new target price of HK\$18.60 is based on 23x FY12/07F P/E and 0.6x PEG.

Risks. 1) Raw materials hikes and 2) Execution risks in capacity expansion.

Table 2: Peer comparisons

Company	Ticker	Currency	Price	Mkt Cap. (US\$m)	Hist. P/E (x)	Fwd Yr1 P/E (x)	Fwd Yr2 P/E (x)	FY05 ROE (%)	FY06 PEG (x)
P & G	PG US	US\$	60.50	192,092.7	22.7	20.2	17.7	21.8	1.8
Kimberly-Clark	KMB US	US\$	64.76	29,673.3	17.1	16.7	15.5	25.7	2.2
Uni-Charm	8113 JP	JPY	6610	3,886.7	28.8	26.5	24.4	9.8	Na
Kao Corp	4452 JP	JPY	3060	14331.6	26.0	29.2	Na	14.1	5.9
Jonhson & Johnson	JNJ US	US\$	64.16	187,669.4	17.9	17.4	16.0	29.9	1.7
Hengan	1044 HK	HK\$	16.12	2,237.6	38.7	27.2	19.9	20.4	0.9
Average					25.2	22.9	18.7	20.3	2.5

Source: Bloomberg & SBI E2-Capital

FY1H/1206 results recap. 1H FY12/06 turnover increased 41.2% YoY to HK\$2,038.3m. Net profit came in at HK\$330.5m (including HK\$22m disposal gain of Shanghai Jahwa), up 61.9%, which was higher than the market consensus. The growth driver mainly came from the 65% increase in production capacity in 1H06, and the increasing contribution from mid to high-end sanitary napkin products. An interim dividend of HK\$0.18 was declared.

Overall gross margin showed an improvement from 40.6% in 1H05 to 41.5% in 1H06 although price of wood pulp rose 5% and super-absorbent polymer, which represents just one of many different kinds of petrochemical products used, increased by 12% due to higher oil prices in 1H06. Gross margin of sanitary napkins reached 54.7%, up from 50.4% in 1H05. Gross margin of tissue products dropped by 1.2% and disposable diapers also decreased by 1.3%, due to increasing raw material costs.

Operating margin improved to 22.5% in 1H06 from 17.5% mainly due to excellent cost control. In 1H06, its distribution and administrative expenses as a percentage of total sales amounted to 21% (1H05: 23.2%). Net margin was 15.1% (1H05: 14.9%) if we exclude the HK\$22m disposal gain of Shanghai Jahwa.

Table 3 : Interim results

Six months to Jun	Turnover (HK\$m)	Gross profit (HK\$m)	Gross margin (%)	Pre-tax profit (HK\$m)	Tax rate (%)	Net profit (HK\$m)	EPS Basic (HK cents)
FY12/06	2,038.3	846.2	41.5	433.0	23.4	330.5	30.58
FY12/05	1,443.7	585.6	40.6	245.8	16.8	204.1	18.88
YoY (%)	41.2	44.5		76.2		61.9	61.9

Source: Company data

Table 4: Turnover breakdown

	1H05(HK\$m)	% of total	1H06(HK\$m)	% of total	% Change
Tissue papers	608.6	42	887.6	43	45.8
Sanitary Napkins	458.4	32	614.5	30	34.1
Disposable diapers	323.3	22	500.5	25	54.8
Others	53.4	4	35.6	2	33.3
Total	1,443.7	100	2,038.3	100	41.2

Source: Company data