

Growth momentum intact

China Consumer

Hengan (1044 HK, HK\$17.7)

BUY (unchanged)

Target price: HK\$20.2 (+14.2%)

Share buy-back. Mr. Sze Man Bok, Chairman of Hengan, bought around 1.1 million shares at an average price of around HK\$17.60 on 14 Nov, 2006 and another 1.1 million shares on 15 Nov, 2006, displaying his strong confidence on the company's growth potential.

Lower oil prices and RMB appreciation. According to management's sensitivity analysis, every 1% drop in oil prices will translate into a 0.7% increase in Hengan's net profit. For the first nine months, the average price of its petrochemical raw materials was 2% lower than the average price that of in that of 1H FY12/06. Hengan also benefits from RMB appreciation: every 1% increase in RMB will bring in an estimated 2% increase in net profit. Note that 97% space of its income is RMB denominated.

Improving net and operating margin. New tax planning scheme has already been implemented and the effective tax rate (23.4%) is expected to reduce to the normal level of around 20%. In addition, operating margin is expected to further improve, as the transportation costs will be reduced when the Fujian tissue plant starts operation in 2H FY 12/06.

Gross margin. Although sales of high-end products and new high margin products (with a gross margin of 60%) in sanitary napkins and diapers help boost margins, paper pulp costs are expected to increase by 6.8% in 2H FY12/06F. However, the increase in lower margin toilet paper sales, (expected to account for 30% of total tissue segment in FY12/06F and is expected to increase to 35% for FY12/07F) will further trim the overall gross margin.

3Q sales growth. 3Q is a low season for Hengan but it would not affect our full-year earnings forecast, we retain our net profit forecast on the back of its over 30% top-line growth.

New high-margin products. A new series of sanitary napkins and tissue products is expected to be launched by mid 2007. By the end of 2007, a new series of diapers will also be launched in the market.

Capacity expansion on track. Annualized production capacity is expected to reach approximately 3.2b pieces for disposable diapers and 10.0b pieces for sanitary napkins by end-2006.

Market share enhancement. All major market players are expected to gain market share from those small and middle size players. Please refer to table 2 for the market shares by major products for Hengan and other players in 2005.

Valuation. In order to reflect the strong demand for personal care products and its high growth potential in China, we reiterate our BUY recommendation. Our new target price of HK\$20.2 is based on 25x FY12/07F P/E and

Table 1: Financial summary

Year to	Net profit	EPS	EPS	P/E	P/B	EV/EBITDA	Yield	ROE	ROCE	N. Gearing
Dec	HK\$m	HK\$	Δ %	X	X	X	%	%	%	%
04A	298.0	0.280	12.4	63.2	9.2	35.9	1.2	15.2	14.8	11.3
05A	450.3	0.417	48.8	42.5	8.4	27.7	1.6	20.4	17.9	21.1
06F	641.2	0.593	42.5	29.8	7.5	18.3	2.2	26.5	24.8	31.0
07F	874.0	0.809	36.3	21.9	6.5	14.5	3.0	31.7	27.8	28.1
08F	1,036.4	0.959	18.6	18.5	5.7	12.6	3.1	32.8	29.6	23.5

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0.7x PEG.

Table 2: Market shares in PRC

	Hengan's market share by revenue	Top ten players by revenue
Sanitary napkins	8.9% (1 st or 2 nd by revenue); (1 st by volume)	40%
Baby diapers	17.3% (2 nd)	80%
Tissue papers	4.7% (1 st or 2 nd)	20%

Source: Figures are extracted from a report issued by China National Household Paper Industry Association

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

Table 3: 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\$	63.52	201,279.3	23.6	21.1	18.5	21.8	1.9
Kimberly-Clark	KMB US	US\$	66.30	30,385.7	17.4	17.1	15.8	25.7	2.2
Uni-Charm	8113 JP	JPY	6180	360.9	29.1	24.5	22.3	9.8	Na
Kao Corp	4452 JP	JPY	3070	14,278.2	27.1	29.3	na	14.1	14.7
Jonhson & Johnson	JNJ US	US\$	66.53	192,894.1	18.1	17.8	16.4	29.9	1.8
Hengan	1044 HK	HK\$	17.70	2,409.7	42.5	29.8	21.9	20.4	1.0
<i>Average</i>					26.3	23.2	19.0	20.3	4.3

Source: Bloomberg & SBI E2-Capital