

Hengan International



BUY (unchanged)

Solid growth ahead

Key points:

- Consumer staples outperform in volatile markets and slowing economy. Hengan displays these defensive qualities
- Wood pulp price decrease provides gross margin relief
- Ad investment in 1H strengthens of brand equity
- Operating margin likely to improve in 2H FY12/08F
- Qin Qin provides +30,000 points of sales overnight and mid-term growth potential
- >HK\$2.0b in cash. No CB redemption pressure
- 3-year net profit CAGR of 22.9%
- DCF derived target price of HK\$24.40, represents 16.5x FY12/09F P/E

Defensive by nature. In volatile markets and slowing economy, consumer staples are defensive and tend to outperform the overall market. Taking 5 consumer staples in the US market for example (Table 6), their price performance averaged a return of -14.7%, -10.2% and -19.2% on a 1-month, 3-month and 6-month basis, outperforming the Dow, which returned, -19.7%, -23.4% and -32.4%. Moreover, consumer staples tend to thrive in hard times. Case in point, Nestle (NSRGY US) announced today that 3Q results that beat street expectations and also raised full year net profit guidance. We think Hengan displays the same defensive qualities. Its 1-month, 3-month and 6-month price return is -4.0%, -18.4%, -27.4%, compared with -30.1%, -42.6% and -48.4% by the HSI.

Segment contribution to revenue. The operations with Carrefour and Wal-Mart generate about 35.0% of revenue and the remainder comes from about 6,500 local distributors. We expect that Hengan's revenue (Qin Qin sales excluded) will grow 35.4% in FY12/08F, 27.2% in FY12/09F and 23.3% in FY12/10F because of:

- ❑ *Shift to high-end sanitary napkins* (including panty liners) - despite solid growth, segmental contribution to overall revenue will decrease due to: 1) a relatively mature market and 2) coming off a higher revenue base. The penetration rate of the sanitary napkins market in China, in terms of revenue, is above 70.0%, of which Hengan holds more than 10.0%¹, placing the brand in the first position. The segmental gross margin should be sustained thanks to the company's shift to high-end products and the consolidation of China's +600 market players. We estimate a YoY growth in sales of 25.5% in FY12/08F, 23.0% in FY12/09F and 20.0% in FY12/10F.
- ❑ *Increasing prominence of disposable diapers* - the segment's revenue contribution will rise due to: 1) its relatively low penetration rate (about 17.0%), which leaves large room for growth, especially in third tier cities. We estimate a YoY growth in sales to reach 36.2%, 38.0% and 33.0%.
- ❑ *Slowdown in the tissue segment* - by far the biggest contributor to Hengan's revenue with HK\$1,816.7m sales in 1HY12/08A.

China Consumer

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Stock data

Price	HK\$20.60
Target price	HK\$24.4 (+18.5%)
12 mth range	HK\$18.6-35.9
Market cap.	US\$3,038.2m
Daily t/o, 3 mth	US\$10.4m
Free float %	34.7%
Ticker	1044.HK/1044 HK

Financial summary

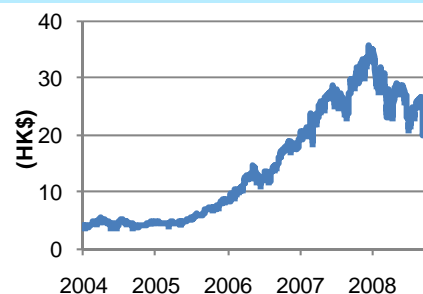
Year to Dec	06A	07A	08F	09F	10F
T/O (HK\$m)	4,114.95	687.07	777.61	1,083.31	2,418.6
NP(HK\$m)	696.61	1,006.01	343.3	1,691.3	1,867.2
EPS (HK\$m)	0.645	0.923	1.175	1.479	1.633
EPS Δ%	63.6	43.1	27.3	25.9	10.4
P/E (x)	32.0	22.3	17.5	13.9	12.6
P/B (x)	13.2	5.8	4.5	3.3	2.5
EV/EBITDA (x)	22.7	16.1	12.1	9.0	7.0
Yield (%)	2.1	3.0	3.7	4.3	4.8
ROE (%)	26.9	24.1	22.0	21.5	21.8
ROCE (%)	17.6	16.9	17.0	17.7	15.8
N. Gear. (%)	(18.0)	Cash	Cash	Cash	Cash

Price Performance

	1 mth	3 mth	12 mth
Relative to HSI (%)	+36.5	+39.4	+40.1
Actual price changes (%)	-0.2	-17.1	-75.5

	08F	09F	10F
Consensus EPS (HK\$)	1.10	1.37	na
Previous forecasts (HK\$m)	1243.8	1,525	na
Previous EPS (HK\$)	1.15	1.41	na

Price Chart



Given its estimated volume CAGR of 5.5%ⁱⁱ in 2006-2010 and Hengan's 32.6% market share (by revenue), we expect the division's YoY growth in sales to slow to 42.6% in FY12/08F, 25.0% in FY12/09F and 20.0% in FY12/10F, as it comes off a higher earnings base.

Table 1: Revenue contribution

(%)	06A	07A	08F	09F	10F
Sanitary napkins	30.4%	27.1%	25.1%	24.2%	23.6%
Disposable diapers	23.2%	23.9%	24.1%	26.1%	28.2%
Tissue paper products	43.5%	45.5%	47.9%	47.0%	45.8%
Skincare and cleaning products	3.0%	3.6%	3.0%	2.6%	2.4%

Source: Company Data, SBI E2-Capital

Wood pulp market trend. According Wood Resources International's August report, wood fiber costs increased in all major pulp-producing global regions in 2Q 2008 due to: 1) the continued weakening of the US dollar; 2) higher transportation costs for pulpwood and wood chips. The only exception was North America where softwood pulp log price fell 1-6% QoQ due to a combination of: 1) slightly lower demand; 2) higher supply. Market pulp prices have almost doubled since 2003 and have reached a 13 year high. We expect them to come off their July peak because of: 1) the global economic slowdown; 2) drop in oil and commodity prices.

Gross margin expansion likely 2H. Hengan imports its pulp from the US (long fibers) and South America (short fibers). Pulp represents about 90.0% and 80.0% of raw material costs of women and tissue products. In 2H FY12/08, we expect Hengan's gross margin to widen 1.0pcp (excluding Qin Qin) as long and short fiber prices tumbled in August (down 10-15% from US\$780.0/ton and US\$810.0/ton from July). Due to uncertainties related to petrochemical and commodity prices, Hengan plans to: 1) use more future contracts; 2) increase wood pulp inventories to about 1-2 months; 3) re-negotiate pulp price with suppliers on a monthly basis. In 2H FY12/08, we expect the gross margin to widen slightly HoH due to 1) a slight decrease in COGS; 2) a 5-10% HoH increase in tissue prices. However, we believe the wood pulp price may rise up again due to the global regulatory tightening aimed to preserve trees, which could pressure the pulp supply.

Table 2: Gross margin

(%)	06A	07A	08F	09F	10F
Sanitary napkins	49.5	49.4	53.2	53.0	52.0
Disposable diapers	32.0	32.0	35.7	35.5	35.0
Tissue paper products	38.4	38.4	37.4	37.0	36.5
Skincare and cleaning products	35.5	35.0	36.7	35.0	34.5

Source: Company Data, SBI E2-Capital

Good cost controls. Administrative expenses and distribution costs are the main cost components. We expect salary growth to slow after a 15.0% 1H FY12/08 increase in staff costs, mainly due to inflation. Advertising expenses accounted for 9.0% of turnover in 1H FY12/08A, up from 6.1% in 1H FY12/07A. We expect advertising costs as a percentage of sales to fall to about 7.0% in 2H FY12/08F and 6.0% in FY12/09F. We estimate that administrative expenses will account for 3.7% of sales in FY12/08F, 3.5% in FY12/09F and 3.4% in FY12/10F, and distribution expenses 17.4%, 17.0% and 16.8%, respectively.

Little room for working capital use improvement. We don't expect much efficiency improvement from the working capital management, mainly due to a necessary increase in inventories and the fundamental features of Hengan's business model. The company's main distribution strength is its de-centralized logistics. This structure requires more warehouses than what competitors need and more than 280 sales offices all over China. Our cash conversion cycle estimates are presented in the infopage Annex.

Bad environment to redeem CBs. In May 2006, Hengan issued about HK\$1.5b of zero-coupon convertible bonds bearing a 4.82% interest rate per annum. The securities are redeemable in May 2011, with a window opened in May 2009. The initial conversion price was adjusted to HK\$19.09 (from HK\$19.12) in late 2007. During 1H FY12/08, Hengan converted about 1.23m CBs at HK\$19.09 for HK\$23.5m. However, due to the current market conditions, we see little incentive for convertible-bond holders and options holders to redeem their rights. Therefore, we keep consistent our weighted average number of shares at a 1,142.8m level until FY12/10.

Qin Qin - sensible acquisition. The company is in the process of acquiring a sweet jelly brand, Qin Qin, for HK\$260.4m. We expect the deal to be completed by end-October. Qin Qin is a leading confectionery manufacturer and distributor of snack food such as fruit jelly and candy sold under "親親" ("QinQin") and "香格里拉" ("Xianggeli") brands. The company has a national sales network of about 30,000 outlets in 28 provinces,

and ranks second in terms of sales among fruit jelly manufacturers in China. The price consideration was based on an historical P/E multiple of about 11.0x of the unaudited combined profit after taxation for FY12/07, and an estimated P/E multiple of about 10.0x based on the guaranteed combined profit of RMB45.0m after taxation and minority interests but before extraordinary items for FY12/08.

Distribution synergy. We believe the Qin Qin deal is positive because 1) snack food and personal hygiene products are fast moving consumer goods; 2) Hengan can capitalize on its experience in distribution and logistics management of personal hygiene products, and integrate snack food products; 3) production facilities of both companies are relatively close and can create logistics synergies; 4) Hengan can leverage on its strong financial and quality control strength to further develop the business. Qin Qin's gearing 9.1% in Apr 2008 fell to 0% in July. We expect Qin Qin to contribute to 4.0%, 3.9% and 4.2% of Hengan's FY12/08F, FY12/09F and FY12/10F consolidated net profit, respectively. We disagree with views that his acquisition could increase downside risks for Hengan, considering the very little impact of its net profits on the group's consolidated results.

Capex. With cash exceeding HK\$2.0b, the company will invest HK\$600-700.0m to expand capacity in each FY12/08F and FY12/09F. We have raised our depreciation rate to 11.0% and 10.5% for each period, from 9.6% in FY12/07A.

Effective tax. We expect Hengan's effective tax rate to rise to 25.0% in FY12/10F from current 16.3% rate) as tax holidays expire.

Payout ratio. Management is willing is likely to maintain a payout ratio above 60.0%, which will give investors more transparency.

Risks. Hengan will be negatively affected if 1) pulp prices rise; 2) US\$/RMB exchange rate drops again.

Earnings estimates. We have revised our net profit estimates up to HK\$1,343.3m (from HK\$1,243.8m) for FY12/08F and HK\$1,691.3m (from HK\$1,525.9m) for FY12/09F. Below is a comparison of our estimates:

Table 4: Estimate comparisons

Items (HK\$m)	Cons. Mean		SBIE2 Estimates	
	FY12/08F	FY12/09F	FY12/08F	FY12/09F
Sales	7,716.3	9,870.4	7,777.6	10,108.3
EBITDA	1,831.4	2,304.1	1,925.0	2,464.6
EBIT	1,563.1	2,003.7	1,608.7	2,084.7
Operating Profit	1,528.4	1,965.4	1,608.7	2,084.7
Pre-Tax Profit	1,517.8	1,966.1	1,606.5	2,029.3
Net Income	1,312.7	1,668.9	1,343.3	1,691.3
EPS (HK\$ cents)	1.108	1.378	1.175	1.479

Source: Bloomberg, SBI E2-Capital

Valuation. We re-iterate our buy call on the counter with a 12-month target price at HK\$24.4 which derives from our DCF valuation, using a 12.0% WACC (beta 1.09, cost of equity of 12.3%, cost of debt of 9.9%) and terminal growth of 5.0%. Our target price represents 16.5x FY12/09F P/E and a 18.5% upside to the current trading price. The counter is currently trading at 13.9x FY12/09F P/E.

Table 5: DCF valuation reference table

	Terminal Growth			
	3.0%	4.0%	5.0%	6.0%
11.0%	24.0	26.3	29.3	33.5
12.0%	20.7	22.3	24.4	27.2
13.0%	18.1	19.3	20.8	22.7
14.0%	15.9	16.9	18.0	19.4

Source: SBI E2-Capital

Table 6: Price performance

Name	Ticker	Last Price	1 month %	3 month %	6 months %
NESTLE SA (ADR)	NSRGY US	\$38.0	-11.2	-9.7	-20.8
PROCTER & GAMBLE CO	PG US	\$60.6	-11.9	-6.1	-9.4
KIMBERLY-CLARK CORP	KMB US	\$57.2	-10.4	3.3	-10.3
COLGATE-PALMOLIVE CO	CL US	\$58.3	-22.1	-16.7	-23.7
UNILEVER PLC (ADR)	UL US	\$22.5	-17.9	-21.9	-32.1
Average (%)			-14.7	-10.2	-19.2
DOW JONES INDUS. AVG	DJI	8,691.3	-19.7	-23.4	-32.4
HENGAN INTL GROUP CO LTD	1044 HK	HKD 20.4	-4.0	-18.4	-27.4
HANG SENG INDEX	HSI	13,251.6	-30.1	-42.6	-48.4

Sources: Bloomberg, SBI E2-Capital

Disclosure of interest: A fellow subsidiary of SBI E2-Capital Securities Ltd. was acted as the Independent Financial Adviser for the independent shareholders of Hengan International Group Company Limited in October 2008.

P & L (HK\$m)	06A	07A	08F	09F	10F
Year to Dec					
Turnover	4,114.9	5,687.0	7,777.6	10,108.3	12,418.6
% chg	35.8	38.2	36.8	30.0	22.9
Gross profit	1,720.6	2,276.3	3,152.6	4,039.3	4,878.3
EBITDA	1,070.2	1,442.9	1,925.0	2,464.6	2,946.5
Depre./amort.	(166.8)	(208.7)	(337.1)	(405.8)	(440.2)
EBIT	918.1	1,255.9	1,608.7	2,084.7	2,543.6
Net Interest Income	(49.2)	(73.3)	(20.2)	(56.6)	(44.3)
Exceptionals	-	-	-	-	-
Associates	14.6	21.7	38.8	27.2	38.7
Jointly-controlled entit.	-	-	-	-	-
Pre-tax profit	868.9	1,182.6	1,606.5	2,029.3	2,500.6
Tax	(171.8)	(175.5)	(260.9)	(335.8)	(631.1)
Minority interests	(0.5)	(1.1)	(2.3)	(2.3)	(2.3)
Net profit	696.6	1,006.0	1,343.3	1,691.3	1,867.2
% chg	54.7	44.4	33.5	25.9	10.4
Dividends	(464.7)	(668.4)	(825.6)	(1,014.8)	(1,120.3)
Retained earnings	231.9	337.6	517.6	676.5	746.9
EPS (HK\$) - Basic	0.645	0.923	1.175	1.479	1.633
EPS (HK\$) - F.D.	0.601	0.868	1.159	1.459	1.611
DPS (HK\$)	0.430	0.618	0.764	0.887	0.980
No. sh.s o/s (m) - W.A.	1,080.8	1,090.5	1,143.5	1,143.7	1,143.7
No. sh.s o/s (m) - Y.E.	1,080.8	1,080.8	1,080.8	1,080.8	1,081.8
No. sh.s o/s (m) - F.D.	1,159.3	1,159.3	1,159.3	1,159.3	1,159.3
Margins (%)					
Gross	41.8	40.0	40.5	40.0	39.3
EBITDA	26.0	25.4	24.8	24.4	23.7
EBIT	22.3	22.1	20.7	20.6	20.5
Pre-tax	21.1	20.8	20.7	20.1	20.1
Net	16.9	17.7	17.3	16.7	15.0
Cash Flow (HK\$m)					
Year to Dec					
EBIT	918.1	1,255.9	1,608.7	2,084.7	2,543.6
Depre./amort.	166.8	208.7	337.1	405.8	440.2
Net Interest Income	(49.2)	(73.3)	(20.2)	(56.6)	(44.3)
Tax paid	(171.8)	(175.5)	(260.9)	(335.8)	(631.1)
Finance Costs	63.8	95.0	41.0	82.6	81.7
Interest Income	(14.6)	(21.7)	(20.8)	(26.0)	(37.4)
Other Items	140.6	185.2	283.7	330.7	626.2
Gross cashflow	1,053.7	1,474.3	1,968.6	2,485.5	2,978.9
Chgs. in working cap.	(222.5)	(369.5)	(204.6)	(379.9)	(533.3)
Operating cashflow	831.2	1,104.8	1,764.0	2,105.6	2,445.6
Capex	(547.7)	(904.7)	(925.2)	(727.4)	(374.9)
Free cashflow	283.5	200.1	838.8	1,378.2	2,070.7
Dividends paid	(369.1)	(576.1)	(829.7)	(1,019.8)	(1,125.9)
Net distribution to MI	(1.7)	(3.0)	(4.1)	(5.1)	(5.6)
Net Proceeds of borrowing	(683.9)	58.5	-	-	-
Disposals	73.1	7.6	2.0	22.8	95.6
New shares	-	1,797.6	-	-	-
Others	405.3	(350.5)	(82.0)	791.5	314.0
Net cashflow	(292.8)	1,134.2	(75.1)	1,167.7	1,348.8
Net (debt)/cash - Beg.	(457.7)	(750.4)	383.8	308.7	1,476.4
Net (debt)/cash - End.	(750.4)	383.8	308.7	1,476.4	2,825.1
Interim Results (HK\$m)	06A	07A	08A		
Six months to Jun					
Turnover	2,038.3	2,743.9	3,755.9		
% chg	32.6	34.6	36.9		
Profit from operations	458.4	620.9	735.4		
Interest expenses	(25.4)	(45.6)	(40.0)		
Associates	-	-	-		
Jointly-controlled entit.	-	-	-		
Pre-tax profit	433.0	575.3	695.4		
Tax	(101.3)	(110.3)	(88.5)		
Minority interests	(1.3)	(1.5)	(1.6)		
Net profit	330.4	470.6	627.5		
% chg	61.9	42.4	33.3		
EPS (HK\$) - Basic	0.306	0.435	0.581		
DPS (HK\$)	0.180	0.280	0.338		
Balance Sheet (HK\$m)	06A	07A	08F	09F	10F
Year to Dec					
Fixed assets	1,655.2	2,552.6	3,453.5	4,147.4	4,522.3
Intangible assets	454.9	454.7	454.6	477.3	572.8
Other LT assets	686.1	966.2	1,098.4	1,404.8	1,404.8
Cash	1,020.7	2,160.0	2,076.7	3,115.1	4,361.1
Accounts receivable	412.5	594.5	772.9	1,004.7	1,205.6
Other receivables	157.9	381.6	246.6	308.3	385.3
Inventories	1,094.3	1,329.1	1,729.5	2,075.4	2,594.3
Due from related co.s	-	-	-	-	-
Other current assets	-	144.9	105.9	84.7	76.2
Total assets	5,481.5	8,583.6	9,938.0	12,617.6	15,122.4
Accounts payable	(443.9)	(672.8)	(874.6)	(1,093.3)	(1,312.0)
Other payable	(328.6)	(370.8)	(408.1)	(448.9)	(493.8)
Tax payable	(96.7)	(56.5)	(72.1)	(252.4)	(252.4)
Due to related co.s	-	-	-	-	-
ST debts	(204.0)	(128.1)	(111.6)	(61.4)	(33.8)
Other current liab.	(1.6)	(120.7)	(91.2)	(82.4)	(78.5)
LT debts	(1,567.2)	(1,648.1)	(1,656.4)	(1,577.3)	(1,502.2)
Other LT liabilities	(2.1)	(26.8)	(27.1)	(29.3)	(31.0)
Total liabilities	(2,664.3)	(3,046.2)	(3,262.9)	(3,562.4)	(3,717.5)
Share capital	108.1	114.8	114.4	114.4	114.4
Reserves	2,685.2	5,400.4	6,536.8	8,914.6	11,261.9
Shareholders' funds	2,793.3	5,515.2	6,651.2	9,029.0	11,376.3
Minority interest	23.8	22.6	23.9	26.2	28.6
Total Equity	2,817.1	5,537.8	6,675.1	9,055.2	11,404.8
Capital employed	4,588.2	7,314.0	8,443.1	10,693.9	12,940.8
Net (debt)/cash	(750.4)	383.8	308.7	1,476.4	2,825.1
Shareholding Structure					
				Shares o/s (m)	%
Sze Man Bok				227.0	19.9
Hui Lin Chit				224.6	19.7
Deutsche Bank AG				76.4	6.7
Baring Asset Management				56.0	4.9
UBS AG				39.6	3.5
Employees and relatives				123.6	10.8
Public				396.2	34.7
Total				1,143.3	100.0
Background					
Hengan is principally engaged in the manufacturing, distribution and sale of personal hygiene products in the PRC. Products include feminine care products, diapers, tissues and skincare products. Its brand portfolio includes "Anerle", "Anle", "Softclear", "Hearttex", "Missmay" and "Banditore".					
Key Ratios	05A	06A	07A	08F	09F
Net gearing (%)	(17.7)	(18.0)	Cash	Cash	Cash
Net ROE (%)	20.1	26.9	24.1	22.0	21.5
EBIT ROCE (%)	18.2	23.2	21.1	20.4	21.8
Dividend payout (%)	67.2	66.7	66.4	61.5	60.0
Effective tax rate (%)	16.9	19.8	14.8	16.2	16.5
Net interest coverage (x)	26.2	18.7	17.1	79.5	36.8
A/R turnover (days)	29.1	36.6	38.2	32.4	33.1
A/P turnover (days)	43.5	39.4	43.2	36.7	40.7
Inventory turnover (days)	88.3	97.1	85.3	121.2	114.4

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