

Hengan International

Fundamental solid, valuation stretched

HOLD (from BUY)

Financial summary

Year to Dec	07A	08A	09F	10F	11F
Turnover (HK\$m)	5687	8001	10152	12288	14451
Net Profit (HK\$m)	1006	1341	1776	1865	2103
EPS (HK\$)	0.923	1.172	1.552	1.630	1.838
EPS Δ%	43.1	27.1	32.4	5.0	12.8
P/E (x)	30.0	23.6	17.8	17.0	15.1
P/B (x)	5.93	4.89	4.40	3.98	3.59
EV/EBITDA (x)	21.7	17.0	12.4	11.3	9.9
Yield (%)	2.2	2.6	3.4	3.6	3.8
ROE (%)	24.1	22.7	26.3	25.0	25.5
ROCE (%)	16.9	18.4	22.0	19.0	19.5
N. Gear. (%)	Cash	Cash	Cash	Cash	Cash

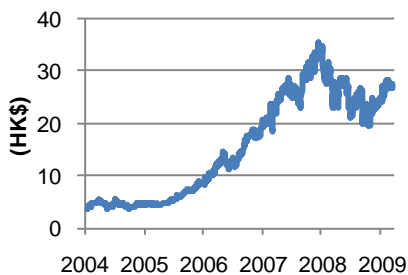
Source: SBI E2-Capital

Price Performance

	1 mth	3 mth	12 mth
Relative to HSI (%)	-1.9	+30.0	+81.6
Actual price changes (%)	-1.1	+12.8	+9.1

	09F	10F	11F
Consensus EPS (HK\$)	1.442	1.663	1.936
Previous forecasts (HK\$m)	1691	1867	n.a.
Previous EPS (HK\$)	1.479	1.633	n.a.

Price Chart



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Ticker:	1044.HK	12 mth range:	HK\$18.6-30.3
Price:	HK\$27.7	Market cap:	US\$4,084.2m
Target:	HK\$27.9 (+1%)	Daily t/o, 3 mth:	US\$6.4m
		Free float %:	53.6%

Key points:

- * Strong momentum spotted for diapers and tissue products.
- * Satisfactory margin performance at high raw materials costs.
- * Margin expansion in expectation for FY12/09F.
- * Lacking of short-term catalysts to push up stock price further.
- * BUY to HOLD. Target at HK\$27.9.

Demand intact for diapers and tissue paper. Turnover increased 40.7% to HK\$8,001.5m in FY12/08A. Selling prices adjustment backed by rising raw materials costs was a key reason, which accounted for ~15% of the total 40.7% growth. The remaining could be attributed to volume gains, especially in disposable diapers and tissue paper, reflecting strong momentum in these two markets.

Table 1: Segmental sales growth

Year to Dec (HK\$m)	08A	07A	Growth	Main drivers
Sanitary napkins	2,015.6	1,538.9	31.0%	Increase in selling prices
Disposable diapers	1,873.5	1,360.9	37.7%	Increase in sales volume
Tissue paper products	3,874.9	2,585.1	49.9%	Increase in both prices (~10%) and volume
Skin care, food and snacks product	237.5	202.1	17.5%	Acquisition of snack food business in Oct 2008
Total	8,001.5	5,687.0	40.7%	

Source: Company data

Steady margin despite hiking pulp cost. Wood pulp represents ~35% of COGS. FOEX PIX pulp BHKP price increased 12.8% in 2008 to an average of US\$791.9/tonne. Nevertheless, the company managed to maintain its blended gross margin at 40.0% with improvement reported in each individual segment thanks to enhancing brand equity, which enabled the company to pass on incremental costs to customers.

Table 2: Segmental gross margin

Year to Dec (%)	08A	07A	YoY change (pcp)
Sanitary napkins	31.6	31.5	0.1
Disposable diapers	35.3	33.3	2.0
Tissue paper products	57.9	56.9	1.0
Blended	40.0	40.0	0.0

Source: Company data

Strengthening brand building. Total operating expenses (distribution costs and administrative expenses) rose from 19.7% of total sales last year to 22.1% due to: 1) more marketing, advertising & promotion expenses during the period (from 7.6% of total sales to 9.4%); 2) higher transportation (i.e. oil) cost.

Qin Qin under consolidation. The company acquired 51% stake in Qin Qin at RMB228.8m in Oct 2008. Qin Qin manufactures and sells snack food under "Qin Qin" and "Xianggeli" brands. Revenue and net profit in whole FY12/08A were ~HK\$844m and ~HK\$53m. Hengan plans to consolidate this new business with existing ones, starting from logistics and then IT management system and distribution networks.

Foreseeable margin expansion. Looking forward, we expect margin expansion to become the main theme in

FY12/09F given the meltdown of global commodities market. The average pulp price (since 1 Jan, 2009) has dropped 30.5% compared to which in 1Q 2008. Cost of another major raw materials, petrochemicals (~35% of COGS, mainly used in women's products), also have declined following the crude oil price crash. On the other side, the company's selling prices stay firmly so far this year. Hence we believe gross margin will widen apparently in FY12/09F, especially in 1H (market competition might push gross margin back to its normal level in 2H).

Earnings forecast. Net profit in FY12/08A increased 33.0% to HK\$1,340.9m, which is in line with our expectation. For FY12/09F, we expect top line to be driven mainly by: 1) consolidation of Qin Qin's results on a full-year basis (~2 months in FY12/08A); 2) growth in diapers and tissue paper (60,000 tonnes capacity to be added in 2009 for tissue papers on existing 360,000 tonnes and a further 120,000 tonnes in 2010). Our forecast is HK\$10,152.2m, up 26.9% YoY. As both pulp and crude oil prices dropped further since our last report ("Solid growth ahead", 24 Oct 2009), we revised our projection and expect blended gross margin to improve 2.7pcp to 42.7% in FY12/09F and net profit to go up 32.3% to HK\$1,802.0m.

Valuation discussion. We agree that, as an operator of consumer staples, Hengan's fundamental seems solid even during the economy slowdown. FY12/09F earnings will shot up due to current downward fluctuation of raw materials costs. Nevertheless, in a middle-term basis (3-year), we think a mid-teen growth rate should be more feasible and sustainable. We believe the counter has been fairly valued at present and, therefore, change our recommendation from BUY to HOLD. Our new target price is HK\$27.9, representing 18x of FY12/09F EPS.

Table 3: P & L

Year to Dec (HK\$m)	07A	08A	09F	10F	11F
Turnover	5,687.0	8,001.5	10,152.2	12,288.3	14,451.3
COGS	(3,410.7)	(4,799.0)	(5,876.0)	(7,392.0)	(8,740.2)
Gross profit	2,276.3	3,202.5	4,276.2	4,896.4	5,711.1
Other revenue	103.4	93.0	166.2	175.8	191.7
Administrative Expenses	(221.4)	(313.5)	(416.5)	(475.6)	(527.1)
Distribution costs	(902.4)	(1,451.0)	(1,856.5)	(2,242.0)	(2,632.3)
Operating profit	1,255.9	1,531.1	2,169.4	2,354.6	2,743.4
Finance costs	(95.0)	(66.9)	(89.8)	(88.7)	(88.5)
Interest Income	21.7	46.5	50.6	56.2	69.2
Profit before tax	1,182.6	1,510.7	2,130.3	2,322.1	2,724.1
Taxation	(175.5)	(166.0)	(324.5)	(423.9)	(585.2)
Minority Interests	(1.1)	(3.7)	(30.0)	(33.0)	(36.3)
Net profit	1,006.0	1,340.9	1,775.7	1,865.2	2,102.6
EPS – basic	0.923	1.172	1.552	1.630	1.838

Source: Company data and SBI E2-Capital

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