

## Guangnan Holdings: A consumption play

Andes Cheng  
(852) 2533 3721  
andescheng@sbie2capital.com

**Recommendation: Not Rated**

**China Conglomerate**

Price	HK\$1.91	Yield (12/05A)	1.6%
12 mth range	HK\$1.18-2.28	ROE (12/05A)	20.5%
Market cap.	US\$221.3m	Net gearing (12/05A)	Cash
No. shares o/s	903.6m	Net cash/sh. (12/05A)	HK\$0.078
Daily t/o, 3 mth	US\$1.2m	BV/sh. (12/05A)	HK\$1.05
Free float %	40.5%	Consensus EPS	
Major shareholder	Guangdong Yue Gang Investment – 59.5%	- 3/07F	na
Ticker	1203.HK/ 1203 HK	- 3/08F	na

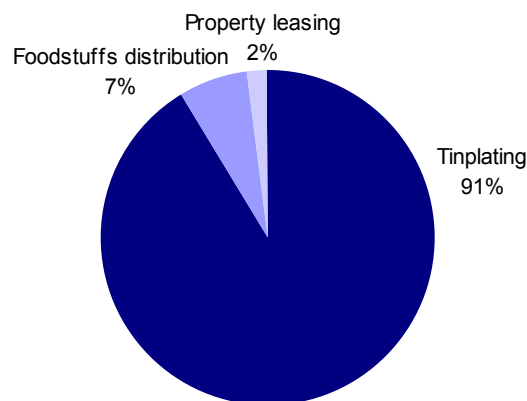
### Key points:

- China's tinsplate market leader
- Set to benefit from the country's consumption boom
- Capacity to surge three-fold by FY12/08F from 120,000 t.p.a in FY12/05A
- Vertical integration to boost margins

**History.** Established in 1982, Guangnan Group was listed on the main board of HKEX in December 1994. It was restructured in 2000 and a tinsplate manufacturing business injected into the group in 2001, while its supermarket operations in Hong Kong and Guangzhou were terminated. In 2004, the group disposed of its Guangnan (Zhan Jiang) Jiafeng Feed Co. Ltd. and Gaoyao Guangnan Stock Development Co., Ltd., exiting the livestock and feed production businesses. In 2005, the group wrote off its entire accumulated losses for FY12/04A and in 1H FY12/06A, it resumed dividend payouts.

**Corporate profile.** Guangnan Group is 59.5%-owned by Guangdong Yue Gang Investment Holdings Co Ltd., which is a wholly-owned window company of the Guangdong Provincial Government. Guangnan Group is engaged in the manufacturing and sales of tinsplate, as well as distribution and trading of live and fresh foodstuffs. The group's 40.0%-owned associate, Yellow Dragon Food Industry Co., Ltd. is engaged in the manufacturing and sales of cornstarch. The group derives rental income from an office unit at Shui On Centre, Wan Chai, Hong Kong, and a plant and staff dormitory leased to Zhongyue Shan Hai Industrial Co.Ltd. at Zhongshan Port No. 2, Export Processing District, Zhongshan, Guangdong Province.

**Chart 1: 1H FY12/06A turnover breakdown**



Source: SBI E2-Capital

SBI E2-Capital is a dedicated small/mid cap investment banking/ stockbrokerage house. Find our research on: [sbie2capital.com](http://sbie2capital.com), [thomsononeanalytics.com](http://thomsononeanalytics.com), [factset.com](http://factset.com) and [multex.com](http://multex.com)

Investors should assume that SBI E2-Capital is seeking or will seek investment banking or other primary businesses with the companies in this report.

**Analyst certification:** the views expressed in this report accurately reflect the analyst's personal views of the subject securities and that the analyst has not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report.

**Disclaimer:** the information and opinions in this report were prepared by SBI E2-Capital Securities Limited. SBI E2-Capital Securities Limited does not undertake to advise you of changes in its opinion or information. SBI E2-Capital Securities Limited and others associated with it may have positions in and effect transactions in securities of companies mentioned and may also perform or seek to perform investment banking services for those companies. This memorandum is based on information available to the public. No representation is made that it is accurate or complete. This memorandum is not an offer to buy or sell the securities mentioned.

**Tinplating - major revenue source.** The tinplating division is the company's major revenue source, providing 91.4% of turnover and 68.3% of operating profit. After disposing of its stake in a tinplating joint venture, Zhongshan Zhongyue Tinplate Industrial Co., to an asset management company as a condition of its restructuring in 2000, it acquired the venture back in 2001. It now operates its tinplate business through its wholly-owned Zhongshan Zhongyue Tinplate Industrial Co. and Zhongshan Shan Hai Industrial Co. It also has a joint venture, Zhongyue Posco (Qinhuangdao) Tinplate Industrial Co., with its supplier POSCO.

**What is tinplate?** The group produces two type of tinplate, electrolytic and electrolytic chromium-coated steel. Electrolytic tinplate is mainly used for canned food and beverage packaging (fruit juice, carbonic drink, beer and tea), confectionary packaging (biscuits, candies, tea leaves) and chemical packaging (paint, lubricates, hair care products, consumer products, pesticide). Electrolytic chromium-coated plate is more anti-vulcanized and paint coating adhesive than electrolytic tinplate and is used for packaging of canned food that contains sulfide (fish and fruit) and steel plate for beverage cans. It is a better suited for the production of turn cap and crown closure for beverage cans.

**Table 1: Tinplating - track record**

	02A	03A	04A	05A	1H 06A
Turnover (HK\$m)	565.9	538.8	574.4	797.8	569.0
Operating profit (HK\$m)	90.5	57.2	48.0	52.0	35.7
Sales volume (ton)	111,157	94,037	84,786	102,174	88,694

Source: Company

**Demand outlook.** China's demand for tinplate has been stable and in-line with consumption growth. According to the China Tinplate Association and China Iron & Steel Association, the country's tinplate consumption increased at a five-year CAGR of 5.2% to 1.79m tons between 2000 and 2005. Meanwhile, China's retail sales value grew at a five-year CAGR of 12.2%. China is a net importer of tinplate due to the scarcity of the raw material. We expect demand for tinplate to increase gradually on the back of the country's strong economic growth, increasing affluence and personal incomes. Besides, the canned food market in China is under penetrated, with per capita consumption averaging less than 1.5kg, compared with 50.0kg in western countries and 23.0kg in Japan.

**Second-largest manufacturer.** The group's flagship tinplate manufacturing arm, Zhongshan Zhongyue Tinplate Industrial, was recognized as the maker of the "Top Brand-name Packaging Product in China" in April 2006. Nine major players, which can produce 1.0m wide tinplate dominate China's standard tinplate market. In terms of production capacity, the group ranks second. Entry barriers of the industry are high due to strict product requirements, the scarcity of the raw material and high environmental protection standards, which most of China's small manufacturers are unable to meet.

**Table 2: Top nine tinplate producers in China**

Producer	Production capacity (m tons)	Black-plate source
Baosteel	0.56	Self-produced
Guangnan Group	0.45	Imported & self-produced
Tonyi	0.42	Sourced from Taiwan Tonyi
Pacific	0.18	Sourced from Nippon Steel
Sino-Japan Metal	0.18	Sourced from JFE
Hainan Haiwoo	0.18	Sourced from JFE
Xinda Zhong Steel Sheet	0.28	Self-produced
Wuhan Steel	0.10	Self-produced
Shandong Fong Yang	0.10	Sourced from third parties

Source: Company

**Margins affected by steel prices.** Tinplate is made from black plate, which is made from cold-rolled sheet, made from hot-rolled sheet. The profit margin of tinplate is affected by the supply of black plate rather than demand, which is always stable. Steel product prices are the main factor affecting the supply of black plate. When they are rising, smelters will sell more hot-rolled sheets reducing the supply of black plate. As a result, the price of black plate will be inflated and this will squeeze the profit margin of tinplate manufacturers.

**Self-sufficient.** Most of Chinese tinplate manufacturers are either associated with smelters or smelters themselves. Guangnan sources 80% of its raw materials from South Korea's steel products manufacturer POSCO (005490KS, KRW375,000), listed on the Korea Stock Exchange, New York, London and Tokyo. In order to secure its supply, the group is setting up its own black plate manufacturing plant, with a production capacity of 150,000 t.p.a. The plant will come on stream by the end of FY12/07F.

**JV with supplier.** The group has formed a 66:34 JV with POSCO to establish a tinplate manufacturing plant with a production capacity of 250,000 t.p.a. in Qinhuangdao, Heibei province, China. Guangnan will invest HK\$308.8m in the HK\$468.0m plant, which will receive POSCO's production facility with a modified Ferrostan type production process, the most advanced tinplate production technology in China. The JV will strengthen the relationship between Guangnan and its major supplier and ensure the company's stable supply of black plate. The group is the only manufacturer sourcing black plate from Korea (most major industry players source from Japan, Taiwan and China), and as such an important partner in POSCO's China strategy, in our view.

**Margin enhancement in FY12/08F.** Gross profit per ton of tinplate is estimated at RMB800.0. The group's black plate plant is expected to meet 33.3% of its requirement. Assuming the average price of cold-rolled sheet at Rmb5,075.0/ton and black plate at RMB5,784.3/ton, the gross margin per ton of black plate is estimated at 14.0% and gross profit RMB709.3 (both excluding production overheads). The gross profit margin of the group's tinplate division is expected to widen when the black plate plant comes on stream but we do not expect any meaningful contribution until FY12/08F, as it will take time for the plant to reach its optimal scale and a steep learning curve is expected as the company lacks know-how in black plate manufacturing. The group's technologically advanced JV with POSCO is expected to further boost its margins. The gross profit margin of the group's counterpart Ton Yi (9907TT, TWD12.0) was 17.6% for tinplate and 14.0% for black plate in 3Q FY12/06F.

**Capacity surge.** The group's tinplate production capacity increased 66.6% YoY to 200,000 t.p.a. in FY12/06F and is expected to remain at this level in FY12/07F. It will surge to 450,000 t.p.a. in FY12/08F when the JV with POSCO comes on stream in 2008.

**Table 3: Projected production capacity**

	05A	06F	07F	08F	09F
Tinplate (tons)	120,000	200,000	200,000	450,000	450,000
Blackplate (tons)	-	-	150,000	150,000	150,000

Source: Company, SBI E2-Capital

**Broad customer base.** The group has more than 1,600 customers and sells directly to more than 400 tinplate end-users. Most of its customers are engaged in the provision of packaging materials to consumer product manufacturers. As one of China's major tinplate manufacturers, the company has high bargaining power among its customers.

**Other business.** The distribution and trading of live and fresh foodstuffs is the company's traditional business, with revenue mainly derived from the distribution of fresh and frozen chicken and pork. In 1H FY12/06A, revenue from the foodstuffs distribution and trading division represented 6.6% of the group's turnover and from the property leasing division 1.8%. The two divisions accounted for 16.1% and 15.6% of the group's total operating profit, respectively. In 1H FY12/06F, Yellow Dragon's profit contribution dropped 1.6% YoY to HK\$11.8m.

**Financial position and valuation.** As of the end of 1H FY12/06A, the group was in a net cash position of HK\$69.2m. We expect it to gear up in this fiscal year as it has to inject HK\$308.8m into the JV with POSCO. Its FY12/05A profit increased 19.9% YoY to HK\$175.8m, or HK\$0.195 per share. Although the group's headline earnings plunged 49.0% in 1H FY12/06A due to lower revaluation gains on investment, the absence of non-operating income and tax refunds, its operating profit increased 31.9% YoY to HK\$55.3m, against a 55.8% rise in turnover to HK\$622.8m. The selected packaging material producers in Asia are trading at P/E of 17.8x for one-year forward and 14.0x for two-year forward.

**Table 4: Peer group comparisons**

Company name	Ticker	Year end	Currency	Market cap (US\$m)	P/E (x)	
					1-yr forward	2-yr forward
EcoGreen Fine Chemicals	2341 HK	Dec	HKD	143	9.6	7.2
AMVIG	2300 HK	Dec	HKD	601	12.9	11.0
Ton Yi Industrial	9907 TT	Dec	TWD	558	15.7	7.5
Taiwan Hon Chuan Enterprise	9939 TT	Dec	TWD	169	10.8	9.1
Hokkan Holdings Ltd	5902 JP	Mar	JPY	229	22.6	17.5
Taisei Lamick Co Ltd	4994 JP	Mar	JPY	170	24.5	22.6
Fuji Seal International Inc	7864 JP	Mar	JPY	628	17.9	15.7
Chuo Kagaku Co Ltd	7895 JP	Mar	JPY	152	38.4	16.1
Fujimori Kogyo Co Ltd	7917 JP	Mar	JPY	199	14.7	22.3
FP Corp	7947 JP	Mar	JPY	787	19.9	16.7
<b>Average</b>					<b>17.8</b>	<b>14.0</b>

Source: SBI E2-Capital, Bloomberg

**Table 5: Track record**

	<b>01A</b>	<b>02A</b>	<b>03A</b>	<b>04A</b>	<b>05A</b>
Turnover (HK\$m)	1,819.4	1,783.0	1,525.8	681.9	921.2
YoY growth (%)	-	(2.0)	(14.4)	(55.3)	35.1
Net profit (HK\$m)	51.5	115.5	102.8	146.6	175.8
YoY growth (%)	-	124.2	(11.0)	42.7	19.9
EPS (HK\$)	0.061	0.128	0.114	0.163	0.195
YoY growth (%)	-	109.8	(10.9)	43.0	19.6
Shareholder's equity (HK\$m)	355.0	494.9	602.2	760.9	949.9

Source: Company

P & L (HK\$m)	03A	04A	05A	Cash Flow (HK\$m)	03A	04A	05A
<b>Year to Mar</b>				<b>Year to Mar</b>			
Turnover	1,525.8	681.9	921.2	EBIT	68.4	76.2	97.0
% chg	(14.4)	(55.3)	35.1	Depre./amort.	7.6	6.3	9.9
Gross profit	152.0	116.4	122.9	Net int. paid	3.1	(3.2)	(3.5)
				Tax paid	(13.5)	(12.3)	6.4
EBITDA	76.0	82.5	106.8	Dividends received	1.6	0.8	18.2
Depre./amort.	(7.6)	(6.3)	(9.9)	<b>Gross cashflow</b>	<b>67.3</b>	<b>67.8</b>	<b>127.9</b>
EBIT	68.4	76.2	97.0	Chgs. in working cap.	5.3	(25.8)	(248.3)
Net int. income/(exp.)	(3.1)	3.2	3.5	<b>Operating cashflow</b>	<b>72.6</b>	<b>42.0</b>	<b>(120.3)</b>
Exceptionals	35.7	76.3	59.7	Capex	(3.7)	(13.7)	(89.2)
Associates	19.4	25.5	20.3	<b>Free cashflow</b>	<b>68.9</b>	<b>28.3</b>	<b>(209.5)</b>
Jointly-controlled entit.	-	-	-	Dividends paid	-	(0.5)	(0.5)
<b>Pre-tax profit</b>	<b>120.3</b>	<b>181.1</b>	<b>180.5</b>	Net distribution to MI	-	-	-
Tax	(12.9)	(28.5)	(0.7)	Investments	-	-	-
Minority interests	(4.6)	(6.0)	(4.0)	Disposals	4.8	3.9	-
<b>Net profit</b>	<b>102.8</b>	<b>146.6</b>	<b>175.8</b>	New shares	-	-	-
% chg	(11.0)	42.7	19.9	Others	(60.9)	57.0	(5.7)
Dividends	-	-	(13.5)	<b>Net cashflow</b>	<b>12.8</b>	<b>88.8</b>	<b>(215.7)</b>
Retained earnings	102.8	146.6	162.2	Net (debt)/cash - Beg.	184.0	196.8	285.5
				Net (debt)/cash - End.	196.8	285.5	69.9
EPS (HK\$) - Basic	0.011	0.163	0.195	<b>Interim Results (HK\$m)</b>	<b>04A</b>	<b>05A</b>	<b>06A</b>
EPS (HK\$) - F.D.	0.011	0.163	0.195	<b>Six months to Sep</b>			
DPS (HK\$)	-	-	0.015	Turnover	389.6	399.8	622.8
No. sh.s o/s (m) - W.A.	9,003.3	901.6	901.6	% chg	(47.7)	2.6	55.8
No. sh.s o/s (m) - Y.E.	9,015.8	901.6	901.6	Profit from operations	32.2	41.9	55.3
No. sh.s o/s (m) - F.D.	9,015.8	901.6	901.6	Interest expenses	(0.3)	-	(1.4)
				Associates	18.1	12.0	11.8
<b>Margins (%)</b>				Jointly-controlled entit.	-	-	-
Gross	10.0	17.1	13.3	<b>Pre-tax profit</b>	<b>126.3</b>	<b>120.5</b>	<b>71.4</b>
EBITDA	5.0	12.1	11.6	Tax	(25.4)	(0.9)	(10.4)
EBIT	4.5	11.2	10.5	Minority interests	(4.6)	(2.3)	(2.4)
Pre-tax	7.9	26.6	19.6	<b>Net profit</b>	<b>96.3</b>	<b>117.4</b>	<b>58.6</b>
Net	6.7	21.5	19.1	% chg	113.7	21.9	(50.0)
				EPS (HK\$) - Basic	0.011	0.013	0.065
				DPS (HK\$)	0.011	0.013	0.065
<b>Balance Sheet (HK\$m)</b>	<b>03A</b>	<b>04A</b>	<b>05A</b>	<b>Shareholding Structure</b>			
<b>Year to Mar</b>					Shares o/s (m)	%	
Fixed assets	518.4	540.5	610.4	Guangdong Yue Gang Investment	536.4	59.5	
Intangible assets	-	-	-	Public	365.20	40.5	
Other LT assets	(12.9)	0.2	0.0	<b>Total</b>	<b>901.6</b>	<b>100.0</b>	
Cash	254.5	293.4	96.9				
Accounts receivable	148.6	120.1	292.0	<b>Background</b>			
Other receivables	-	-	-	Established in 1982, Guangnan Group was listed on the main board of HKEX in December 1994. It is 59.5%-owned by Guangdong Yue Gang Investment Holdings Co Ltd., which is a wholly-owned window company of the Guangdong Provincial Government. Guangnan Group is engaged in the manufacturing and sales of tinsplate, as well as distribution and trading of live and fresh foodstuffs. The group's 40.0%-owned associate, Yellow Dragon Food Industry Co., Ltd. is engaged in the manufacturing and sales of cornstarch.			
Inventories	44.2	30.7	236.3				
Due from related co.s	-	-	-				
Other current assets	3.2	3.2	3.1	<b>Key Ratios</b>	<b>03A</b>	<b>04A</b>	<b>05A</b>
<b>Total assets</b>	<b>956.0</b>	<b>988.1</b>	<b>1,238.6</b>	Net gearing (%)	Cash	Cash	Cash
Accounts payable	(262.4)	(170.1)	(200.6)	Net ROE (%)	17.1	21.5	20.5
Other payable	-	-	-	EBIT ROCE (%)	10.1	10.3	10.8
Tax payable	(3.9)	(14.6)	(19.6)	Dividend payout (%)	-	-	7.7
Due to related co.s	-	-	-	Effective tax rate (%)	10.7	15.8	0.4
ST debts	(57.7)	(7.9)	(27.0)	Net interest coverage (x)	21.8	na	na
Other current liab.	-	-	-	A/R turnover (days)	35.5	71.9	81.6
LT debts	-	-	-	A/P turnover (days)	62.8	115.8	73.4
Other LT liabilities	(9.3)	(9.8)	(12.2)	Stock turnover (days)	11.8	24.2	61.0
<b>Total liabilities</b>	<b>(333.3)</b>	<b>(202.4)</b>	<b>(259.4)</b>				
Share capital	901.6	901.6	450.8				
Reserves	(299.3)	(140.7)	499.1				
<b>Shareholders' funds</b>	<b>602.2</b>	<b>760.9</b>	<b>949.9</b>				
Minority interest	20.4	24.8	29.3				
<b>Total</b>	<b>622.6</b>	<b>785.7</b>	<b>979.2</b>				
Capital employed	680.3	793.6	1,006.2				
Net (debt)/cash	196.8	285.5	69.9				