

## Sunshine Paper

### Paper board supplier for F&B package manufacturer

to summarize...

- Sunshine Paper is a Shandong based package paper manufacturer for the paper package of F&B products.
- Annual capacity of 1.1m tons of paper products; 500,000 tpa production line launched by the end of 2010 has reached utilization rate of 92%.
- Leveraged financing strategy has led to thinner margin, however, higher % upside in earning performance if ASP improved.
- Examined earning sensitive based on 1H 12A result, RMB100/t increase in price might potentially result in 43% increase in net profit.

**China Sunshine Paper (Sunshine)**, founded in 2000, engages in manufacturing and distribution of package paper business in the Shandong province. Products include white-top linerboard, core board products and small amount of specialized paper products such as CCK paper Art Paper and corrugated medium products. The linerboard products dominated ~75% of sales, which are typically used as the surface layer of the carton box (printing layer). Differentiated from listed peers, Sunshine downstream customers are mostly paper container and packaging product manufacturers for food & beverage products. End customers include some F&B conglomerates, such as Mengniu (2319 HK), Uni-President (220 HK), Tingyi (322 HK), Tsingtao (168 HK), etc. Illustration 1 shows key Sunshine's end customers:

Illustration 1. Key end customers



Source: SBI E2-Capital, Sunshine

**1H result delivered high capacity utilization of 91%.** With manufacturing base located in Weifang in the Shandong province, Sunshine has an annual production capacity of 1.1m tons and has delivered ~506k tons of paper production in 1H 2012. Out of 1.1m tons of capacity, 880k tons is for packaging linerboard, such as white-top linerboard and light-coated linerboard. Light-coated linerboard is similar to white-top that adding the lighter weight feature, while their production lines are inter-changeable by minor modification. Remaining capacity include ~200k tons for core board products and 70k tons for specialized products. The core board products are commonly used as the base paper for making textile spindle and industrial tube core (mostly in chemical industry). Table 1 shows the capacity breakdown and corresponding 1H 12A utilization rate:

Table 1. Production capacity breakdown

Product	Capacity	1H 12A Output (t)	Utilization Rate
White top linerboard	110,000	50,000	91%
White top & light-coated linerboard	220,000	104,000	95%
Specialized paper products	70,000	28,000	80%
Core Board	200,000	94,000	94%
Light-coated linerboard	500,000	230,000	92%
Total	1,100,000	506,000	91%
Decorative Paper*	35,000	-	-

Source: SBI E2-Capital, Sunshine; \*51% JV

Ticker	2002 HK
Rating	Not Rated
Price (HK\$)	0.85
Target Price (HK\$)	n.a.
12m Price Range (HK\$)	0.6 – 1.34
Market cap. (US\$m)	87.5
Daily t/o (US\$m)	0.1
Free float (%)	40.8

#### Financial summary

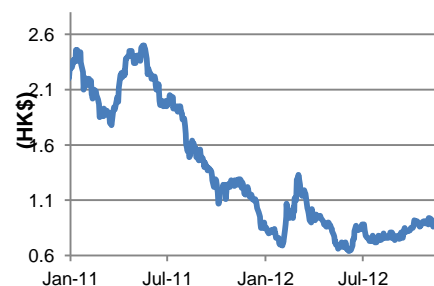
Year to Dec	09A	10A	11A
Turnover (RMBm)	1,697.7	2,456.5	3,721.2
Net Profit (RMBm)	42.15	169.61	82.40
EPS (RMB)	0.06	0.22	0.11
P/E (x)	13.0	3.2	6.7
P/B (x)	0.4	0.4	0.4
EV/EBITDA (x)	9.0	7.8	6.4
Yield (%)	2	5	2
ROE (%)	4	12	6
ROCE (%)	10	15	21
N. Gear. (%)	52	93	176

Source: SBI E2

	12F	13F	14F
Consensus EPS (HK\$)	0.1	-	-
Previous earnings (HK\$m)	-	-	-
Previous EPS (HK\$)	-	-	-

#### Price performance

Year to Dec	1m	3m	12m
Relative to HSI (%)	(5.1)	(2.4)	(39.6)
Actual price changes (%)	(3.4)	10.4	(26.1)



Source: Bloomberg

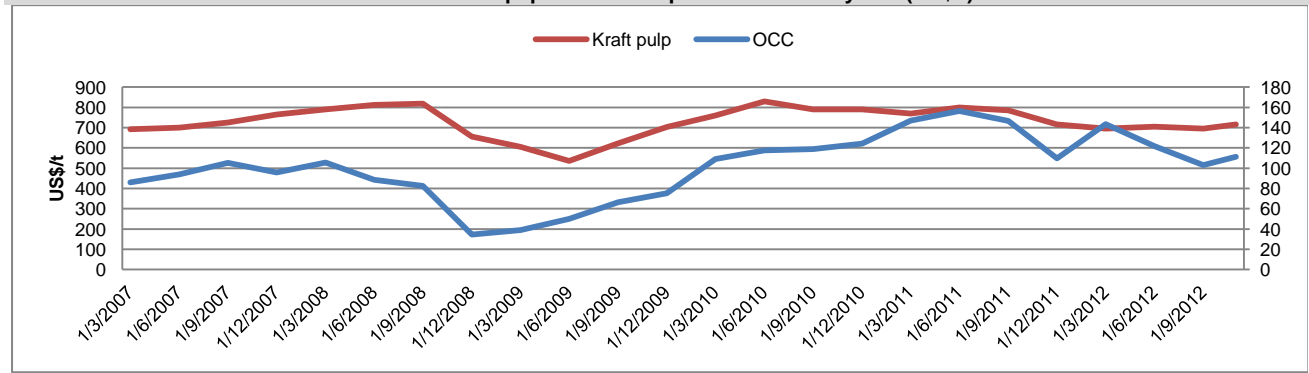
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The paper industry in general has been suffered from rising cost pleasure coupled with high competition over the last few years. The key material component for package paper products is recovered paper. For instance, Sunshine's white-top linerboard products over 90% of material components are made of recovered paper, while the covered paper costs denoted ~50% of company's COGS. Illustration 2 shows the cost of overseas recovered paper (OCC) has increased from ~US\$40/t to over US\$111/t at CAGR of 32% since early 2009. In terms of sales, package papers manufacturers' sales performance can be cyclical since their customers are mostly consumer consumable goods suppliers. In particular, HK listed paper manufactures such as Nine Dragons (2689 HK) and Lee Man (2314 HK)'s package products end customers are suppliers of electronic goods products, hence performance was, to certain extent, linked with the Gov subsidy of home appliance market as well as economic cycle. Despite, the overall uptrend of the sales volume, industry bottom line was not as strong which mainly attributable to 1) increase in the costs raw materials and other operation expenses and 2) over supply leading to high competition, while the probability across firms varied substantial as a result of the differences in operating regions and capital structure. Pursuant to the latest released in July 2012, National Development and Reform Commission announced the plan to eliminate inefficient paper manufacturers with an aggregated production capacity of 8.8mt. Illustration 3 shows the sales growth and net profit growth trend for Sunshine and the Industry peers in the last five years.

Illustration 2. Price trend for overseas recovered paper and Kraft pulp in last three years (US\$/t)



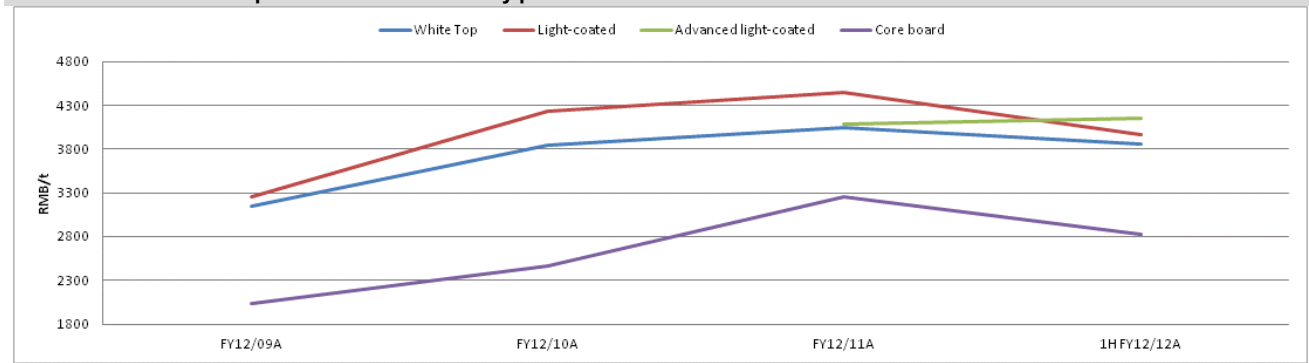
Source: SBI E2-Capital, Bloomberg

Illustration 3. Sales growth rate and net profit growth trend for Sunshine and the Industry from 2007 to 2012



Source: SBI E2-Capital, Bloomberg

Illustration 4. ASP trend per ton of Sunshine's key products from 2009 to 1H 2012



Source: SBI E2-Capital

**Peers companies listed on exchange.** There are numbers of listed paper manufactures engaged in similar business as Sunshine. The largest among them is Nine Dragons Paper (2689 HK), followed by Lee & Man Paper (2314 HK). Nine Dragons and Lee & Man, apart from White-top linerboard, they also engages in manufacturing of other type package paper products, such as Kraftlinerboard, corrugating medium papers, etc with nationwide distribution network and paper capacity of 8.9m tons and 5.5m tons respectively. Smaller size peers, such as Zhengye International (3363 HK), Come Sure (794 HK), are located in Guangdong province. In terms of Shandong province where Sunshine is situated, Chenming Paper (1812 HK) is, the largest paper manufacturer in the region, produces wide range of paper products. The second and third largest player in Shandong are Shandong Bohai paper (600966.CN) and Shandong Sun paper (002078.CN) listed on Shanghai and Shenzhen stock exchange respectively. The table 2 shows the financial performance of the company and the peers for the latest 6 months applicable period, the result shows positive EBITDA growth for the HKEx listco excluded from Chenming. The other two Shandong manufacturers also reported decline of EBITDA during the Jan – Jun period. In particular, all four Shandong manufacturers reported a high double digit decline in net profit with low single digit margin. Among all, all paper manufacturers reported high gearing ratios, at an overall average of 1.2x, while Sunshine had the highest of 2.17x whereas L&M paper had the lowest of 0.65x.

**Table 2. Result comparison for the latest 6 months trailing period**

Latest 6m period	Sunshine (2002 HK)	Chenming (1812 HK)	Sun Paper (002078 CN)	Bohai Paper (600966 CN)	L&M paper (2314 HK)	Nine Dragons (2689 HK)	Zhengye (3363 HK)
FY YE	YE12/12	YE12/12	YE12/12	YE12/12	YE03/13	YE06/13	YE12/12
Period	1H	1H	1H	1H	1H	2H	1H
Profitability Ratios:							
1) Growth							
Turnover	7%	12%	32%	-6%	-2%	23%	4%
Gross Profit	-5%	-	-11%	-24%	10%	19%	18%
Net profit	-76%	-81%	-70%	-70%	4%	-17%	4%
EBITDA	4%	-36%	-21%	-23%	11%	27%	24%
EBIT	-2%	-36%	-38%	-35%	10%	24%	26%
2) Margin							
Gross Profit	16.3%	-	13.1%	14.6%	15.3%	16.0%	22.2%
EBIT	10.9%	5.4%	9.3%	8.3%	12.9%	13.8%	12.3%
Net profit	0.9%	0.9%	2.0%	1.5%	9.3%	4.0%	5.3%
Capital adequacy ratios:							
Net gearing ratios	2.17x	1.04x	1.11x	1.12x	0.65x	1.03x	1.03x
Interest coverage	1.7x	1.0x	2.4x	3.0x	24.6x	3.5x	4.9x

Source: Bloomberg

**External financing for cost of raw materials purchases.** Table 2 shows Sunshine had the highest gearing ratio among peers at 2.17x for the latest applicable date. The reason for high gearing was partly due to the financing policy for raw materials purchases. Raw materials are the major component of COGS, as high as ~75%. Raw materials consist ~63% of recovered paper, ~23% of wood pulp and ~14 % of other chemical and additives. Sunshine purchases recovered paper mostly from US and China and the Kraft pulp from the overseas market. The financing of the raw materials are ~100% via short term bank instrument/ notes, for instance, purchase from overseas market via discount bills whereas purchase from domestic market via shot term domestic bank loan. Given the annualised interest rate for discount bill and domestic short-term bank notes of 6.5% and 7.5% respectively, if the raw material accounted for ~63% of sales and weighted average finance cost of 7%, the finance cost for raw materials purchase would represent ~4.4% of sales, i.e. in dollar term, per RMB100 of sales would consist cost of RMB63 as raw materials purchase and RMB4.4 as finance cost along with other expense items in COGS of RMB20.7, hence we would have an effective gross profit of RMB11.9 or effective gross margin of 11.9%. The leveraged financial operation enables management minimized cash requirement for working capital, however, also led to thinner profit margin and greater impacts on earning as materials costs changed. On the other hand, Sunshine will benefit the most for dollar value increase in products' ASP assuming other factors being constant.

**Table 3. Key financial summary**

RMBm	FY12/09A	FY12/10A	FY12/11A	1H FY12/12A
Revenue	1,697.7	2,456.5	3,721.2	1,880.4
Gross Profit	236.3	455.5	626.1	306.2
Net profit	42.1	169.6	82.4	16.7
EBITDA	192.4	394.2	543.3	298.9
Gross Margin	13.9%	18.5%	16.8%	16.3%
Net margin	2.5%	6.9%	2.2%	0.9%
Interest Cover	3.3	3.9	2.1	1.7
Net Gearing	93%	176%	193%	217%

Source: SBI E2-Capital

**Earning sensitivity analysis in respect of ASP changes.** We further breakdown Sunshine expenses item by item in order to examine the earning volatility as if changes in products price. As mentioned, raw materials as the largely cost item and component of COGS for Sunshine, denoted ~63% of sales. Other standard components of COGS include power and water, labour costs and depreciation as 8%, 2% and 10% to sales respectively. In particular, the high depreciation was due to the extensive capital requirement for manufacturing equipment, equivalent to cost of RMB370 charge to P&L on per ton basis. Apart from COGS, other expense item include market and distribution, administrative expenses and financing costs, they represented 5%, 3% and ~9% of sales in 1H 12A result. For the marketing and distribution expenses, ~95% of the cost was allocated to distribution, i.e. ~RMB175/t. Given the low net profit per ton basis at the current price, we consider the paper business is relatively regional. Table 3 shows the detail breakdown of expenses item in respect to percentage to sales and cost per ton based on latest 1H 12A result.

**Table 4. Detail breakdown of expenses item in respect to % to sales and cost per ton.**

	%	Cost/t	1H 12A	Basis on sales volume
Revenue	100			RMB 3,716/t
COGS:	84			RMB 3,111/t
- Raw materials	64			RMB 2,364/t
a) Overseas recovered paper	19	RMB1,630/t		RMB 709/t
b) Domestic recovered paper	21	RMB1,570/t		RMB 780/t
c) Kraft pulp	15	RMB4,230/t		RMB 544/t
d) Chemical and additives	9			RMB 331/t
- Power and water	8			RMB 297/t
- Labour costs	2		RMB 38m	RMB 74/t
- Depreciation and other	10		RMB188m	RMB 372/t
- Purchase finance cost	4			RMB 149/t
Operating Expenses				
- Marketing & distribution	5			RMB186/t
- Administrative	3		RMB56m	RMB111/t
- General finance costs	5		RMB94m	RMB186/t
- Gov Subsidy				RMB62/t
Gross profit				RMB605/t
Profit before tax and after subsidy				~RMB39/t
Net profit (consisted other income of ~RMB30m)				RMB43/t

Source: SBI E2-Capital

Based on table 4 result, we performed earning sensitive analysis. As expected, the formulated earning result varies substantially as changes in ASP. We fixed and annualised items such as depreciation, administrative and general finance costs (interest expenses were not divided from materials purchase) and adjusted the sales related expenses, such as COGS and marketing and distribution expenses, as an absolute value per ton based on the 1H 12A result. In additional, we anticipated reality factor that the increase of ASP often results from the cash push pressure. Hence, we formulated a 1:1.5 relationship between ASP and key materials costs, i.e. 1.5% increase in costs (Overseas and domestic recovered paper, Kraft pulp) would lead to 1% increase in ASP. The result shows, based on 1H 12A result, the earning breakeven for 1) net profit before tax (EBT) and 2) net profit before tax and depreciation (EBTDA) at average selling price of RMB3,677/t and RMB3,306/t respectively. In terms of ASP sensitivity, 5% increase in price, i.e. + RMB186/t, would lead to 84% increase in net profit. Likewise, 5% decrease in price would result in 88% drop in net profit. Table 5 shows the sensitivity changes in different % change in ASP:

**Table 5. Sensitivity analysis**

RMB	-10%	-5%	1H 12A ASP	5%	10%
ASP	3,344	3,530	3,716	3,902	4,088
Production volume	1,012,000	1,012,000	1,012,000	1,012,000	1,012,000
Variable Expenses (/t)	2,580	2,732	2,885	3,037	3,190
Subsidy (/t)	62	62	62	62	62
Fixed Expenses (Ex-dep)	488,913,100	488,913,100	488,913,100	488,913,100	488,913,100
Depreciation	376,087,000	376,087,000	376,087,000	376,087,000	376,087,000
Net profit b4 tax & dep (/t)	344	377	410	443	477
PBT (/t)	(28)	5	39	72	105
Tax rate	18%	18%	18%	18%	18%
Net profit (/t)	(23)	4	32	59	86

Source: SBI E2-Capital

**Our view and valuation.** Leveraged on its financial position along with low earning base at current stage, Sunshine's profitability is highly sensitive to the change in ASP or key raw materials prices. Our simulation result shows that RMB50/t increase in ASP might potential drive Sunshine's net performance up by over 100%. The consensus sentiment has generally granted a positive outlook for the paper sector and we will keep an eye on the industry. Pursuant to Bloomberg data, Sunshine's 12 months trailing and forward P/E are currently trading at 19.5x and 6.1x as opposed to HK peers at 13.7x and 8.3x respectively.

**Table 6. Peers comparison table**

	Exch	YE	Mkt Cap (HK\$m)	Closing price	12months trailing P/E	forward P/E	2 yr forward P/E	P/B
L&M Paper	2314 HK	03/12	2,1853.6	4.5	15.3	10.9	9.3	1.6
Chenming	1812 HK	12/11	7,705.0	2.7	19.6	5.1	3.7	0.3
Zhengye	3363 HK	12/12	340.0	0.7	5.4			0.6
Nine Dragons	2689 HK	06/12	26,485.4	5.7	15.0	9.3	7.9	1.0
<u>HK Average</u>					<u>13.8</u>	<u>8.4</u>	<u>7.0</u>	<u>0.9</u>
Sun Paper	002078 CH	12/11	5,328.0	5.3	27.0	11.0	7.4	1.1
Bohui Paper	600966 CH	12/11	2,690.0	5.3		18.9	11.3	0.7
<u>China Average</u>					<u>27.0</u>	<u>15.0</u>	<u>9.4</u>	<u>0.8</u>
<b>China Sunshine</b>	<b>2002 HK</b>	<b>12/2011</b>	<b>682.2</b>	<b>0.85</b>	<b>19.8</b>	<b>13.7</b>	<b>6.2</b>	<b>0.4</b>

Source: Bloomberg \*based on adjusted P/E

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