

## Ecogreen: An overlooked gem

**Recommendation: BUY (initiating coverage)**

**China Chemicals**

Price	HK\$1.31	Year to	Net profit	EPS	EPS	P/E	P/B	EV/EBITDA	Yield	ROE	ROCE	N. Gear.
Target price	HK\$2.0 (+52.7%)	Dec	RMBm	RMB	Δ %	X	X	X	%	%	%	%
12 mth range	HK\$1.06 –1.57	04A	61.4	0.156	(14.5)	8.6	1.8	5.5	1.4	30.2	25.9	Cash
Market cap.	US\$77.4m	05A	71.1	0.167	7.4	8.0	1.3	4.5	1.7	18.6	16.7	Cash
Daily t/o, 3 mth	US\$0.02m	06F	90.9	0.197	17.7	6.8	1.0	3.3	2.5	17.6	16.8	Cash
Free float %	50.7%	07F	115.1	0.250	26.9	5.3	0.8	2.5	3.3	17.7	17.8	Cash
Ticker	2341.HK/2341 HK	08F	154.7	0.336	34.4	4.0	0.7	1.8	4.3	19.9	20.9	Cash

Relative to Hang Seng Index (1 mth, 3 mth, 12 mth): +8.8%, -0.5%, +6.5%

Actual price changes (1 mth, 3 mth, 12 mth): +9.2%, +9.2%, +23.6%

### Key Points:

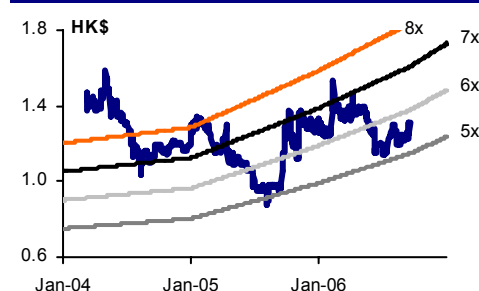
- Turnover and net profit grew 48% YoY and 30% YoY for 1H FY12/06.
- One of the largest upstream fine chemicals producers for flavor and fragrance products in China in terms of production capacity.
- Huge market potential as consumer demand for health-care and daily consumer products such as cosmetics products and toiletries grows robustly.
- Very strong international customer base, including Givaudan, International Flavors and Fragrance (IFF) and Japan-listed Takasago.
- Future growth drivers include capacity expansion and introduction of new products.
- Great price advantage as the production cost of the locally produced products is 30% cheaper than that of foreign competitors.
- Downstream peers Huabao (336 HK) and China F&F (3318 HK) are trading at >20x forward P/E.
- Initiate coverage with BUY and a target price of HK\$2.0, implying 8.0x FY12/07F P/E.

**A market leader in the aroma chemical industry.** Ecogreen is one of the few producers having a one-stop shop from R&D, manufacturing to distribution for pharmaceutical raw materials and aroma raw materials in China and overseas. It has three main types of products: 1) Intermediates; 2) Natural extracts and 3) Aroma chemicals which are sold to downstream producers for the health care industry, food and beverages and daily consumer goods.

Ecogreen's products are branded under "Doingcom" (中坤). Dihydromyrcenol, one of its major aroma chemicals and accounted for 14.1% of its total turnover, is presently estimated to have a 20% market share in the world market in terms of output.

**1H FY12/06 results review.** Ecogreen delivered a 48% turnover growth to RMB253.5m in 1H FY12/06 as a result of a 50% increase in capacity and the launch of new products. Net profit rose 30% to RMB46.5m. Excluding the trading division, the overall blended gross margin in 1H FY12/06 edged down a slight 2.9% to 38.3% as turpentine price was still at a high level of RMB8,000 per tonne, though already off its peak of RMB9,000 per tonne in 2H FY12/05. Nevertheless, its overall ASP has increased by 10% so far this year.

**Chart 1: P/E bands**



Source: SBI E2-Capital

**Table 1: Interim results**

Six months to Jun	Turnover (RMBm)	Gross profit (RMBm)	Gross margin (%)	Pre-tax profit (RMBm)	Tax rate (%)	Net profit (RMBm)	Basic EPS (RMB cents)
FY12/06	253.5	80.0	31.6	50.8	8.5	46.5	10.1
FY12/05	171.0	65.9	38.6	39.1	8.7	35.7	8.6
YoY (%)	48	22				30	17

Source: Company data

**Table 2: Turnover breakdown (RMBm)**

Year to Dec	1H05	1H06	% Change
Aroma chemicals	92.2	123.5	33.9
Natural extracts	38.0	42.6	12.1
Intermediates	26.5	28.4	6.8
Trading and resource management	14.3	59.0	312.6
<b>Total</b>	<b>171.0</b>	<b>253.5</b>	<b>48.2</b>

Source: Company data

**Table 3: Gross profit breakdown by products**

Year to Dec	1H05 gross profit (RMBm)	Gross margin (%)	1H06 gross profit (RMBm)	Gross margin (%)
Aroma chemicals	29.9	32.4	40.0	32.4
Natural extracts	14.0	36.8	15.8	37.1
Intermediates	20.6	77.8	18.7	65.7
<b>Overall (before trading and resource management)</b>	<b>64.5</b>	<b>41.2</b>	<b>74.5</b>	<b>38.3</b>
Trading and resource management	1.4	9.8	5.6	9.5
<b>Overall</b>	<b>65.9</b>	<b>38.5</b>	<b>80.1</b>	<b>31.6</b>

Source: Company data

**International collaboration.** Ecogreen is a beneficiary of the increasing international outsourcing to China due to China's rich resources of gum turpentine and other botanic oils. Its advanced technical know-how helps maintaining a high international quality at low production costs. Most of the world's top 10 flavour and fragrance companies have turned from being Ecogreen's competitors in the international market to being its major customers or industry partners. Ecogreen has been able to achieve a 30-40% annual sales growth rate over the last few years while the worldwide growth rate of the industry was a mere 5-6% p.a.

**Strong partnership in technology advancement.** In China, Ecogreen always collaborates closely with the leading research institutes such as China Academy of Science (Shanghai and Guangzhou), Xiamen University and Nanjing University to develop new technologies to reduce costs and to increase production efficiency. Ecogreen's strong commitment in innovation has resulted in some recent technological breakthrough, allowing it to further outperform its competition going forward.

**New products.** With its efforts in R&D, the company expects to launch about 33 newly developed products to the market over the next two years, in line with the progress of its capacity expansion. In addition to the 33 ready to launch products, the company expects to develop more new products over the next three years, as indicated in the following roadmap. We expect these new product developments to significantly boost Ecogreen's future profitability.

**Table 4: New product development roadmap**

No. of new products	2006	2007	2008
Aroma chemicals	5	5	6
Natural extracts	5	10	15
Intermediates	3	5	8
<b>Total</b>	<b>13</b>	<b>20</b>	<b>29</b>

Source: Company data

**Capacity expansion to boost scale.** Ecogreen expects to increase its annual processing volume of botanic essential oils to 20,000 tonnes (Phase 3 designed capacity) by 2008 from the current 16,000 tonnes. Upon completion of the phase 3 expansion, Ecogreen will have a multi-purpose production facility with an enlarged capacity to further enhance its production efficiency. In other words, by adopting the new functions of the plant, Ecogreen can produce a large number of value-added products of natural pharmaceutical intermediates and aroma chemicals, with larger production economies of scale.

**M&A.** In 2005, Ecogreen acquired a leading research centre, Shanghai Fine Chemical Co. Ltd. (“SFC”). Together with its Xiamen research centre, SFC now owns an integrated R&D platform. The cost of this acquisition was around RMB4.8m. Ecogreen will benefit from the previous R&D results. SFC will be positioned as a chiral pharmaceutical and agro-chemical R&D centre for the company.

**Competitive pricing.** Leveraging on the low production and R&D costs (3% of turnover) in China, Ecogreen has about 30% cost advantage in comparison with its large international counterparts.

**Professional team with international expertise.** Ecogreen has a professional team of management in which all key members are postgraduate degree holders in multi-disciplines and various pharmaceuticals and chemical related areas, in addition to extensive industry and management experience. Its team also comprises of international advisors and consultants. Professor Jin-Quan Yu (Brandeis University, USA) acts as the chief scientist while Mr. Jose Rodriguez (former Senior Vice President of IFF) is the industry advisor.

**Renowned customer portfolio.** Ecogreen has built a strong customer base over the past 12 years through either partnership or partner-competitor relationship. The number of its clients has increased in recent years. The top five customers accounted for <30% of the 2005 turnover. Its major customers include those top international F&F companies (refer to Table 5), which have stringent requirements in terms of product quality and production sources. Ecogreen sells its products to the China branch offices of these international clients or exports directly to their overseas entities. The export ratio (export/total sales) of the company increased from 25% in FY12/04 to 36% in FY12/05.

**Table 5: Customer profile**

**Key customers**

International Flavors & Fragrances (IFF)  
Givaudan  
Firmenich  
Symrise  
Dynamicom  
Takasago  
T. Hasegawa

Source: Company data

**Risk factors.** 1) Raw materials cost hikes; 2) Execution risk in rolling out new products; 3) RMB appreciation; and 4) Keen competition.

**Corporate governance issues.** 1) Management experience – Mr. Yang Yirong, the Chairman and President of the company, holds a bachelor degree in science, majoring in chemistry from Huaqiao University and extensive work experience in fine chemical manufacturing and trading. Mr. Gong Xionghui, operation management and Vice President, has a master degree in chemical engineering from Xiamen University in 1986. He worked in a state-owned fine chemicals enterprise and has over 18 years of experience in fine chemicals industry. 2) Auditor history – Price-WaterHouseCoopers has been the company’s auditor since listing on 27 Feb 2004. 3) Dividend policy – Since listing, the company has maintained a stable dividend policy of around 13% payout. 4) Fund-raising – On 5 Oct 2005, the company placed 46m shares to two institutional investors at HK\$1.29 each through a top-up placement.

**Valuation.** Excluding the trading division, Ecogreen is expected to achieve an above industry average growth rate of 35% per annum thanks to its comparative cost advantage and the ability to launch new products. We expect the company will be the beneficiary of the strong demand of personal care products and medicine in China. Ecogreen is trading at a steep discount to its peers in terms of P/E. Our target price of HK\$2.0 is based on a conservative 8x FY12/07F P/E multiple.

**Table 6: Peer comparisons**

Company	Ticker	Currency	Price	Mkt Cap. (US\$m)	Hist. P/E (x)	Fwd Yr 1 P/E (x)	Fwd Yr 2 P/E (x)	ROE (%)
International Flavors & Fragrances	IFF US	USD	39.75	3,604.14	19.2	17.7	16.1	21.2
Produits Chimiques Auxiliair	PCA FP	EUR	4.4	72.5	NA	18.3	14.6	NA
Rhodia SA	RHA FP	EUR	1.76	2,684.4	NA	23.8	9.0	NA
Dynaction SA	DYT FP	EUR	12.48	52.1	NA	NA	NA	NA
Millennium Chemicals+	LYO US	USD	25.03	6,203.8	8.9	7.4	7.2	18.2
China Flavors & Fragrances	3318 HK	HKD	3.23	184.4	16.5	20.2	16.9	37.5
Ecogreen	2341 HK	HKD	1.31	77.4	8.0	6.8	5.3	18.6
Huabao International*	336 HK	HKD	3.17	1,239.1	28.6	21.7	15.3	NA
<b>Average</b>					<b>16.2</b>	<b>16.6</b>	<b>12.1</b>	<b>23.9</b>

\* Based on EPS of RMB0.115 (2,467,040,961 shares and a net profit RMB283m) - assuming all new convertible preference shares are converted

+ Owned by Lyondell Chemical

Source: Bloomberg and SBI E2-Capital

## APPENDIX: Industry overview

**Global flavour and fragrance industry.** Global sales of flavours and fragrances amounted to approximately US\$16.0b in 2005. According to Leffingwell, annual sales growth rate was around 10% to 15% from 2001 to 2004. Ecogreen achieved an above industry sales growth rate of 35% from 2001 to 2005.

**Table 7: Annual global flavor and fragrance market size**

	2001	2002	2003	2004	2005
Estimated total sales volume (US\$b)	12.7	15.1	16.3	17.7	16.0

Source: www.leffingwell.com

**PRC flavor and fragrance industry.** According to China Chemical Industry Yearbook 2004 and China National Chemical Information Centre, April 2005, the total annual production output of flavors and fragrances increased from c.137,600 tonnes in 1999 to c.224,000 tonnes in 2004, with a CAGR of approximately 10%. The following table shows the total annual output of flavours and fragrances in the PRC during the period from 1999 to 2004.

**Table 8: Annual China flavour and fragrance market size**

	1999	2000	2001	2002	2003	2004
Total annual output (tonnes)	137,600	144,500	155,000	165,000	180,000	224,000
Total sales revenue (RMBb)	9.8	10.0	11.0	11.5	12.0	12.3

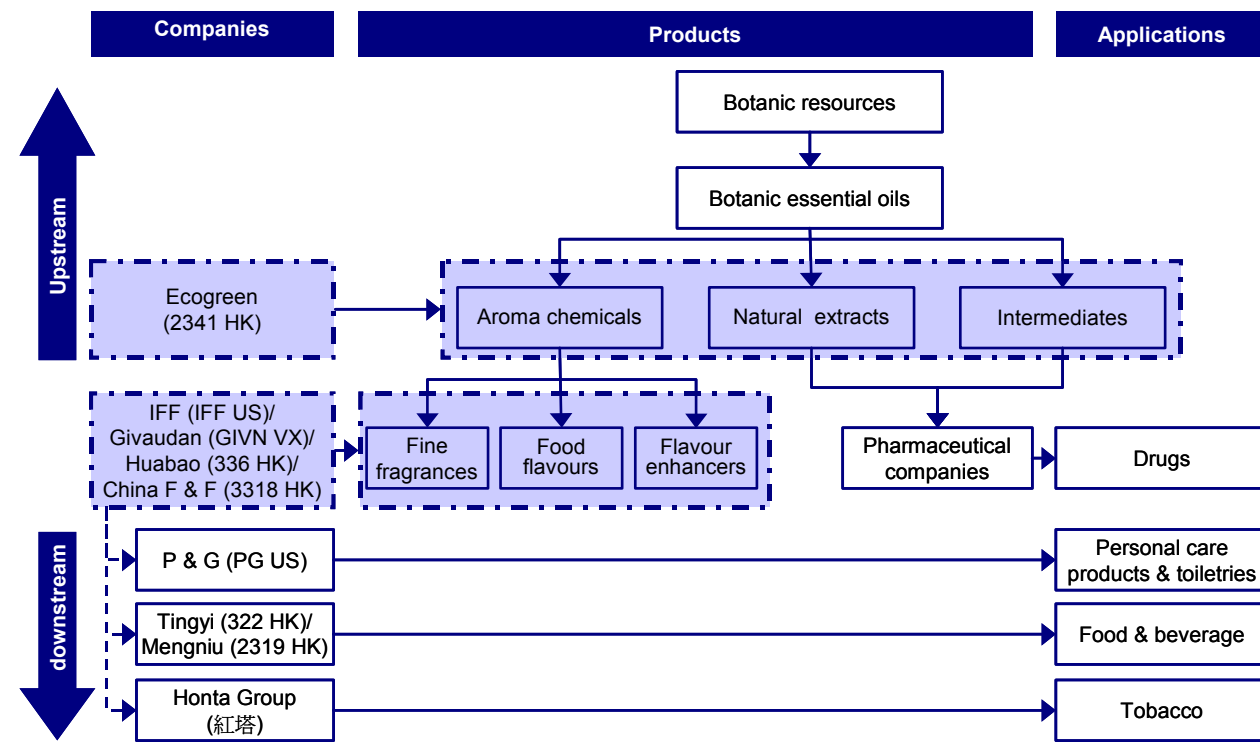
Source: China Chemical Industry Yearbook 2004 and China National Chemical Information Centre-Apr 2005

Sales revenue of flavour and fragrance industry in the PRC increased from approximately RMB9.8b in 1999 to approximately RMB12.3b in 2004, with a CAGR of approximately 5%.

**Natural extracts.** Annual global sales value of natural extracts reached US\$50.0b and is estimated to grow at 15% annually.

**Chiral pharmaceuticals.** In 2004, the value of chiral pharmaceuticals sold amounted to approximately US\$170.0b, accounting for c.30% of the total value of global drug market. It is estimated that approximately 50% of the top 100 drugs sold worldwide in 2004 were chiral pharmaceuticals.

Chart 2: Industry food chain



Source: SBI E2-Capital

P & L (RMBm)	04A	05A	06F	07F	08F	Cash Flow (RMBm)	04A	05A	06F	07F	08F
Year to Dec						Year to Dec					
Turnover	276.5	384.4	510.7	654.2	896.6	EBIT	72.7	84.9	107.7	137.8	189.2
% chg	23.9	39.0	32.8	28.1	37.1	Depre./amort.	7.2	8.6	13.8	19.0	24.0
Gross profit	114.4	133.4	163.9	212.6	298.6	Net int. paid	(6.0)	(6.9)	(8.3)	(11.4)	(15.8)
						Tax paid	(4.0)	(5.8)	(6.9)	(8.5)	(11.4)
EBITDA	79.9	93.5	121.5	156.8	213.2	Others	3.5	2.0	18.6	16.4	35.1
Depre./amort.	(7.2)	(8.6)	(13.8)	(19.0)	(24.0)	Gross cashflow	73.4	82.9	124.9	153.3	221.0
EBIT	72.7	84.9	107.7	137.8	189.2						
Net int. income/(exp.)	(6.0)	(6.9)	(8.3)	(11.4)	(15.8)	Chgs. in working cap.	(0.1)	(27.6)	(5.8)	(27.1)	(61.0)
Exceptionals	-	-	-	-	-	Operating cashflow	73.3	55.3	119.1	126.2	160.1
Associates	-	-	-	-	-						
Jointly-controlled entit.	-	-	-	-	-	Capex	(34.8)	(70.6)	(70.0)	(133.5)	(142.1)
Pre-tax profit	66.6	78.0	99.4	126.4	173.4	Free cashflow	38.5	(15.3)	49.1	(7.3)	18.0
Tax	(5.2)	(6.9)	(8.5)	(11.4)	(18.7)						
Minority interests	-	-	-	-	-	Dividends paid	-	(11.5)	(12.0)	(13.5)	(19.0)
Net profit	61.4	71.1	90.9	115.1	154.7	Net distribution to MI	0.3	-	-	-	-
% chg	12.2	15.8	28.0	26.6	34.4	Investments	-	(0.3)	-	-	-
						Disposals	-	-	-	-	-
Dividends	(7.7)	(9.6)	(15.9)	(20.1)	(26.7)	New shares	168.2	61.8	-	-	-
Retained earnings	53.7	61.4	75.0	94.9	128.0	Others	(58.7)	22.2	14.9	25.8	4.0
						Net cashflow	148.3	56.8	52.0	5.0	3.0
EPS (RMB) – Basic	0.156	0.167	0.197	0.250	0.336						
EPS (RMB) - F.D.	0.148	0.154	0.197	0.250	0.336	Net (debt)/cash - Beg.	(67.1)	81.1	138.0	190.0	195.0
DPS (RMB)	0.019	0.023	0.034	0.044	0.058	Net (debt)/cash - End.	81.1	138.0	190.0	195.0	198.0
No. sh.s o/s (m) - W.A.	393.6	424.3	461.0	461.0	461.0						
No. sh.s o/s (m) - Y.E.	415.0	461.0	461.0	461.0	461.0	Interim Results (RMBm)					
No. sh.s o/s (m) - F.D.	415.0	461.0	461.0	461.0	461.0	Six months to Jun					
						Turnover	127.8	171.0	253.5		
Margins (%)						% chg	37.1	33.9	48.2		
Gross	41.4	34.7	32.1	32.5	33.3						
EBITDA	28.9	24.3	23.8	24.0	23.6	Profit from operations	38.7	42.5	54.1		
EBIT	26.3	22.1	21.1	21.1	21.1	Interest expenses	(4.1)	(3.4)	(3.3)		
Pre-tax	24.1	20.3	19.5	19.3	19.3	Associates	-	-	-		
Net	22.2	18.5	17.8	17.6	17.3	Jointly-controlled entit.	-	-	-		
						Pre-tax profit	34.6	39.1	50.8		
Balance Sheet (RMBm)	04A	05A	06F	07F	08F	Tax	(2.5)	(3.4)	(4.3)		
Year to Dec						Minority interests	-	(0.0)	0.0		
Fixed assets	119.4	184.1	270.3	351.3	427.3	Net profit	32.0	35.7	46.5		
Intangible assets	22.0	27.7	27.8	32.6	35.8	% chg	62.7	11.4	30.3		
Other LT assets	0.4	0.4	0.4	0.4	0.4						
Cash	208.7	260.8	322.8	334.8	354.8	EPS (RMB\$) - Basic	0.086	0.094	0.100		
Accounts receivable	67.2	101.8	130.0	160.0	220.0	DPS (RMB\$)	-	0.008	0.008		
Other receivables	16.8	40.6	32.0	43.0	47.6	Shareholding Structure					
Inventories	19.5	33.3	54.0	70.0	95.0					Shares o/s (m)	%

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**BUY** : absolute upside of >10% over the next six months

**HOLD** : absolute return of -10% to +10% over the next six months

**SELL** : absolute downside of >10% over the next six months

SBI E2-Capital ratings distribution: STRONG BUY/BUY: 26(67%), HOLD: 9(23%), SELL: 4(10%) as of 1 Sep 2006.

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