Theme report

Tue, 09 Jun 2009

Setting up the defense

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Key points:

- HSI surged to a 52-week high of 18,888.6 on 1 Jun and has jumped 13.1% ytd. Meanwhile, the HSCEI also reached a 52-week high on the same day, finishing at 10,937.8, surging 38.6% ytd..
- With the HSI now trading at 16.4x forward P/E and the HSCEI trading at 15.0x forward P/E and 2.1x P/B, downside risk is increasing.
- Investors that have recorded outperformance in the current rally are looking to lock in profits and find safer havens to "park their money" in the off chance the market turns sour.
- We profile 3 companies with a defensive profile: Guangdong Investment (270 HK), Citic 1616 (1883 HK) and Fufeng (546 HK).

Strong rally to date. On the back of optimism that the worse is behind us, global markets have rallied. The Hong Kong market is no exception. The HSI surged to a 52-week high of 18,888.6 on 1 Jun and has jumped 13.1% ytd. Meanwhile, the HSCEI also reached a 52-week high on the same day, finishing at 10,937.8, surging 38.6% ytd. In our view, the current rally has been due to a combination of: 1) market being oversold on the downside at the end of 2008; 2) massive liquidity pumping by the Chinese government and 3) better than expected economic numbers coming out of China.

With the HSI now trading at 16.2x historical, 16.4x forward P/E and 1.7x P/B while the HSCEI trading at 16.3x historical, 15.0x forward P/E and 2.1x P/B, the valuations seems fair given that the Chinese economy is still not completely out of the woods. Investors that have recorded outperformance in the current rally are looking to lock in profits and find safer havens to "park their money" in the off chance the market turns sour. While railway and cement sectors' defensive themes will continue to dominate, we think that risks to the downside are higher, given its current valuations. Railway plays are averaging 20.0.x forward P/E while cement plays are averaging 17.7x forward P/E on consensus.

In light of this, we profile a portfolio of 3 stocks, which in our view, display defensive elements.

Defensive portfolio

Company	Ticker	Price	Mkt Cap (US$m)	Defensive theme
Guangdong Investment	270 HK	HK$4.09	3,245.9	GDI is the exclusive external supply of fresh water to Hong Kong. Charge is on annual lump sum fee basis and has been locked in for 2009, 2010, 2011
Citic 1616	1883 HK	HK$1.72	436.4	Telecommunications hubbing business model is asset light and counter cyclical in our view. Cash hoard of HK$795.0m allows them to further make acquisition to drive growth.
Fufeng	546 HK	HK$2.04	434.2	With its Inner Mongolia plant, Fufeng enjoys cost advantage against other peers, which facilities its market expansion. In short term, the decline in raw materials costs will help the company's gross margin.

Source: Company data

Guangdong Inv

Tue, 09 Jun 2009

Water is staple diet

Not Rated

Financial summary

Year to Dec	06A	07A	08A
Turnover (HK$m)	6,056.3	6,689.1	7,590.7
Net Profit (HK$m)	1,506.9	1,697.0	1,876.7
EPS (HK$)	0.243	0.272	0.301
EPS Δ%	13.1	11.9	10.6
P/E (x)	16.8	15.0	13.6
P/B (x)	2.01	1.82	1.50
EV/EBITDA (x)	9.6	8.6	7.9
Yield (%)	2.5	2.7	2.5
ROE (%)	12.5	12.7	12.8
ROCE (%)	13.6	14.4	14.5
N. Gear. (%)	67.8	46.2	25.6

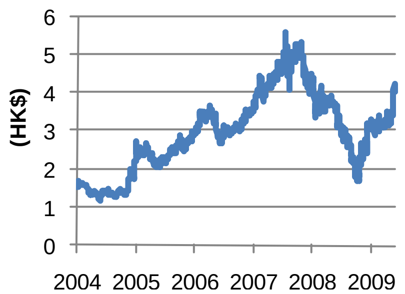
Source: SBI E2-Capital

Price Performance

	1 mth	3 mth	12 mth
Relative to HSI (%)	+17.9	-16.8	+50.2
Actual price changes (%)	+22.5	+32.4	+11.1

	09F	10F	11F
Consensus EPS (HK$)	0.335	0.368	0.390
Previous forecasts (HK$m)	n.a.	n.a.	n.a.
Previous EPS (HK$)	n.a.	n.a.	n.a.

Price Chart



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Ticker:	**0270.HK**	12 mth range:	HK$1.55-4.29
Price:	**HK$4.09**	Market cap:	US$3,245.9m
Target:	**n/a**	Daily t/o, 3 mth:	US$5.4m
		Free float %:	39.1%

Key points:

- Low risk profile as water distribution segment accounts for 45.4% of revenues and 86.1% of EBIT. Segment EBIT margins above 50%.
- Extremely good earnings visibility. Annual water supply revenues for Hong Kong already locked in for FY12/09-11. Water distribution revenues to Hong Kong accounts for 72.4% of water distribution segment.
- Counter is currently trading at 12.2x FY12/09F and 11.1x FY12/10F P/E on consensus.

Overview. The main asset of this South China based, SOE backed conglomerate is an exclusive 30 year concession (granted in 2000) to supply fresh water from Guangdong Province to Hong Kong. The fresh water supplies from GDI is the only external source of Hong Kong and accounts for ~75% of the SAR's water needs. The remaining 25% is serviced by its own internal sources (reservoirs, water treatment plants etc). Other business segments include: toll roads/bridges, electricity power generation, hotel operations and management and department stores.

- Water distribution is the key earnings contributor for GDI. For FY12/08A, the segment accounted for 45.4% of turnover in FY12/08A, but 86.1% of EBIT (85.4% of EBITDA). Revenue was HK$3,443.8m (up 2.4% YoY) and EBIT was HK$2,511.2m up 41.7% YoY.
- Revenue stream from Hong Kong is incredibly stable, as it is derived based on a lump sum annual charge. For FY12/06A-08A, this charge was set at HK$2,494.8m (FY12/08A: 72.4% of total water distribution revenue). Earlier this year, the company announced that the charges for FY12/09F-11F shall be HK$2,959m, HK$3,146m and HK$3,344m. Moreover, the company indicated that they will receive a subsidy of RMB652.0m to compensate for inflationary impacts during 2005-2008, during which the annual charge for water supply to Hong Kong was fixed. The subsidy will be paid in two installments (RMB391.0m in FY12/08A and RMB261.0m in FY12/09F).
- Water supply volumes fell 5.3% YoY in FY12/08A to 408m m^3, impacted by the slowdown in the export economy. However, this was partially offset by a 1.6% YoY increase its supply volumes to Shenzhen, reaching 958m m^3.
- Margins are high. EBIT margin for the water distribution segment was 60.8% in FY12/08A (FY12/07A: 53.8%). The increase was due to subsidy and exchange gains. On a proforma basis, excluding subsidy and exchange gains, water distribution segment was 51.6% (FY12/07A: 52.6%). The segments' FCF margin is around 75% according to management.

Water distribution segment does not require significant capex. Annual maintenance capex for this segment is in the region of HK$40-50m. Majority of the capex is earmarked for its other business segments. At end-FY12/08A, company had a net debt position of HK$4,945.5m (33.6% net gearing). The company's balance sheet is solid as 88.9% of its debt is long term debt.

Other segments. As for the company's other business, we expect the margin relief from lower coal prices to outweigh a possible slight reduction in power demand. This should lead to narrowing losses for the power generation segment. Meanwhile, its toll road and department store and shopping mall businesses are expected to be relatively steady. Prospects for the hotel operations and management segment maybe weaker given the current muted economic climate, though this segment accounted for only 3.4% of EBIT in FY12/08A.

Recent developments. Company announced on 5 Jun that it had successfully auctioned for parcel of land in Tianjin. The company intends to develop the land into a large scale modern shopping mall. The mall will have a total building area of ~193,000m^2 and involve a total capex of around RMB2,129.5m. The mall is expected to come into operation in 2013.

Table 1: P & L

Year to Dec (HK$m)	06A	07A	08A
Turnover	6,056.3	6,689.1	7,590.7
Cost of sales	(3,183.0)	(3,615.5)	(4,377.4)
Gross profit	2,873.4	3,073.7	3,213.3
Other net (loss)/income	147.4	123.6	852.4
Selling and distribution costs	(81.0)	(72.6)	(99.7)
Administrative expenses	(429.9)	(498.1)	(574.9)
Other operating income/(expenses) net	70.1	220.7	(714.0)
Financial costs	(653.1)	(490.8)	(380.3)
Share of loss of a jointly controlled entity	66.9	3.0	134.1
Share of loss of an associate	54.2	44.6	6.2
Pre-tax profit	2,047.7	2,404.0	2,437.2
Tax	(268.7)	(406.1)	(442.4)
Minority interests	(272.1)	(300.7)	(118.1)
Net profit	1,506.9	1,697.0	1,876.7

Source: Company data

SBI E2-Capital

Citic 1616

Tue, 09 Jun 2009

Counter cyclical play

Not Rated

Financial summary

Year to Dec	06A	07A	08A
Turnover (HK$m)	1,364.2	1,486.1	2,486.4
Net Profit (HK$m)	201.5	262.7	332.1
EPS (HK$)	0.110	0.143	0.168
EPS ∆%	n.a.	30.4	17.4
P/E (x)	15.7	12.0	10.2
P/B (x)	9.63	2.45	2.04
EV/EBITDA (x)	9.9	7.4	5.3
Yield (%)	15.7	2.5	4.9
ROE (%)	40.5	32.5	23.7
ROCE (%)	63.5	40.0	35.0
N. Gear. (%)	cash	cash	cash

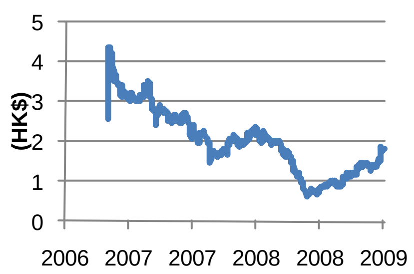
Source: SBI E2-Capital

Price Performance

	1 mth	3 mth	12 mth
Relative to HSI (%)	+17.9	-16.8	+50.2
Actual price changes (%)	+22.9	+43.3	-22.9

	09F	10F	11F
Consensus EPS (HK$)	0.207	0.233	0.235
Previous forecasts (HK$m)	n.a.	n.a.	n.a.
Previous EPS (HK$)	n.a.	n.a.	n.a.

Price Chart



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Ticker:	1883.HK	12 mth range:	HK$0.61-2.31
Price:	HK$1.72	Market cap:	US$436.4m
Target:	n/a	Daily t/o, 3 mth:	US$0.9m
		Free float %:	41.5%

Key points:

- Company is asset light, with a high level of cash.
- International telecommunications is counter cyclical, benefitting as international business travel is cut during the economic downturn.
- Margins sustained through arbitrage business model and improving product mix.
- Has ability to use cash hoard to make acquisitions to boost bottom line and EPS
- Counter is currently trading at 8.3x FY12/09F and 7.4x FY12/10F P/E on consensus.

Overview. Citic 1616 is an asset light, leading telecommunications bulk hubbing services operator in the Asia Pacific region. The company's services are concentrated into the 4 main categories of: 1) voice services; 2) short message services (SMS); 3) mobile value added services (MVAS) and 4) virtual private network (VPN) and others. The value proposition that Citic 1616 offers to its telco operator customers are the following:

- One stop shop plug-and-play international gateway that is neutral and independent;
- Eliminates incompatibilities in standards, protocols, language and network interfaces;
- Fast and efficient connectivity;
- Lowers outgoing traffic costs;
- Expert and customized products to meet the demands and trends of the international telecom industry.
- Allows telco operators to focus on their core business.

Asset light model. Citic 1616 runs an asset light model. Despite possessing a network of >350 telco operators and generating total revenue of HK$2,486.4m, the company's fixed assets only amounted to HK$363.1m, mainly consisting of properties and servers. Citic 1616 had cash HK$795.0m at end-FY12/08A with no debt.

Arbitrage model and product mix changes helps sustain margins. Citic 1616 accounted for around 60% voice minutes into and 20% voice minutes out of China. More importantly, it also accounted for 80% of SMS volume both into and out of China. This solid market share of international traffic minutes/data allows the company to play the arbitrage game to reduce margin pressure. Meanwhile, continuing product mix changes, in favour of higher margin MVAS and VPN segments will further help sustain margins. Voice hubbing revenues accounted for 64.8% of revenue in FY12/08A (FY12/07A: 78.2%), which was aided by contribution from the CPC Net, acquired in 2008.

Counter cyclical play. In our view, Citic 1616 is a counter cyclical play. Reasons are:

- Slowdown in global economy in 4Q 2008 and 1Q 2009 have forced many to cut business travel spending, instead relying on telecommunications conferences, which benefits Citic 1616 as an international hubbing operator.

- Asia has the highest percentage of total international traffic routed through hubs at 64.7% in 2007 according to TeleGraphy (North America: 41.6%, Europe: 45.2%).
- Continuing strong growth in its VPN segment, after integration of CPCNet (acquisition closed in Aug 2007) helps with business diversification. We expect low margin voice to further reduce as percentage of overall revenues in FY12/09F.
- Measures to relax travel restrictions between Hong Kong and China to boost Hong Kong's local economy would stimulate voice and SMS use.
- With a large cash hoard, company has the ability to make earnings accretive acquisitions, to further boost bottom line and EPS.
- Steady geographic expansion. Citic 1616 acquired ChinaMotion Netcom in Sep 2008 (including 49% of CM Tel (USA) LLC) and in the process gaining access to the North America market. Company plans to take its MVAS products into the US and emerging countries such as Mexico.

Table 1: P & L

Year to Dec (HK$m)	06A	07A	08A
Turnover	1,364.2	1,486.1	2,486.4
Other revenue	2.1	62.4	20.8
Other net (loss)/gain	(0.2)	0.1	(11.3)
	1,366.1	1,548.5	2,495.9
Network, operations and support expenses	(944.9)	(988.3)	(1,670.1)
Depreciation and amortisation	(72.4)	(78.8)	(113.2)
Staff costs	(67.4)	(103.3)	(180.0)
Other operating costs	(61.6)	(71.7)	(133.7)
Operating profit	219.9	306.4	398.8
Financial costs	-	-	-
Share of loss of a jointly controlled entity	-	-	-
Share of loss of an associate	-	-	(0.9)
Pre-tax profit	219.9	306.4	397.9
Tax	(38.1)	(43.7)	(65.7)
Discontinued operations	19.7	-	-
Net profit	201.5	262.7	332.1

Source: Company data

SBI E2-Capital

Fufeng

Tue, 09 Jun 2009

Softer cost under inelastic demand

Not Rated

Financial summary

Year to Dec	06A	07A	08A
Turnover (RMBm)	1,787.2	2,445.7	3,585.3
Net Profit (RMBm)	240.5	45.1	294.6
EPS (RMB)	0.200	0.028	0.178
EPS Δ%		(86.0)	533.9
P/E (x)	9.0	64.5	10.2
P/B (x)	0.60	0.30	1.72
EV/EBITDA (x)	10.5	21.0	6.4
Yield (%)	0.0	0.5	5.5
ROE (%)	91.4	4.6	18.5
ROCE (%)	110.1	4.8	25.3
N. Gear. (%)	260.3	36.3	20.1

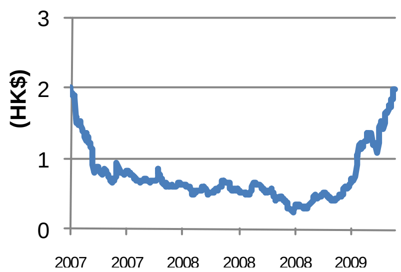
Source: SBI E2-Capital

Price Performance

	1 mth	3 mth	12 mth
Relative to HSI (%)	+27.6	+85.7	+311.4
Actual price changes (%)	+32.5	+195.7	+204.5

	09F	10F	11F
Consensus EPS (RMB)	n.a.	n.a.	n.a.
Previous forecasts (RMBm)	n.a.	n.a.	n.a.
Previous EPS (RMB)	n.a.	n.a.	n.a.

Price Chart



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Ticker:	0546.HK	12 mth range:	HK$0.21-2.12
Price:	HK$2.04	Market cap:	US$434.2m
Target:	n.a.	Daily t/o, 3 mth:	US$1.1m
		Free float %:	40.3%

Key points:

- Relative defensive MSG consumption.
- Corn / coal prices down to favor margins.
- Established cost advantage against peers.
- Expanding market occupancy for major products.
- Optimistic growth picture for FY12/09F.

Background. Headquartered in Shandong province, Fufeng is engaged in refining and processing corns. Principal products include glutamic acid, monosodium glutamate (MSG) and xanthan gum, which contributed 29.4%, 28.0% and 12.6%, respectively, of the total revenue in FY12/08A. The company has production facilities in Junan (Shandong), Baoji (Shannxi) and Hohhot (Inner Mongolia).

Defensive demand with consolidation opportunities. Demand for glutamic acid and MSG is relatively steady, growing at low-middle single-digit organically each year. Nevertheless, aided by its scale and cost advantage, we expect Fufeng to expand its market occupancy continuously. In addition, the softened raw materials costs will likely favor the company's performance in FY12/09F,

- Glutamic acid / MSG: Gross margin hiked in 4.1pcp to 19.9% in 4Q FY12/08A, following the correction in corn and coal prices. We expect selling prices to be dragged down further by enlarging supply this year given that eased cost pressure will encourage small plants to resume operation, resulting in squeezing gross margin from 4Q FY12/08A level. Nevertheless, full FY12/09F gross margin should improve somewhat from 15.6% in FY12/08A, in our view, due to lower raw materials costs.
- Xanthan gum: The company plans to capture more market share this year by adopting an aggressive pricing strategy based on its cost advantage, which might depress gross margin. In 1Q FY12/09F, selling price dipped slightly but gross margin managed to stay flat compared with 37.0% in 4Q FY12/08A (FY12/08A: 34.4%), thanks to enlarged operating scale.

Apparent advantage on coal cost. Coal accounted for 10.9% and 42.3% of Fufeng's production cost at MSG and xanthan gum segments, respectively, in FY12/08A. Inner Mongolia has abundant coal resource and local coal price is considerably lower than the national level. In 1Q 2009, the average price of thermal coal was ~RMB230/tonne, versus RMB400-600 in Qinghuangdao. Fufeng is one of first enterprise, who realized this difference and moved into Inner Mongolia. The company built its plant there in 2006 and completed phase II in 2008, which, after taking into account higher transportation expense, brings it apparent cost advantage against other peers located mainly in Shandong province, especially for xanhan gum (e.g. according to Fufeng's experience, unit production cost of xanthan gum can be as low as ~RMB10,000/tonne in Inner Mongolia but ~RMB17,000 in Shandong).

Expanding capacity in Inner Mongolia. The company intends to further expand its capacity in Inner Mongolia. Production facilities for 100,000tonne MSG and 12,000tonne xanthan gum have been planned for 2009. The prior project will enable the company to fully convert its own glutamic acid output into MSG, enhancing both the effective

ASP and gross margin of MSG segment. In addition, the company will build capacity for 5,000tonne threonine and 1,000tonne branched chain amino acid, which both are newly developed by Fufeng to extend and enrich its product line. Aggregately, capex for FY12/09F are budged at RMB380m, which will be fulfilled by cash reserve (RMB267.6m at end-FY12/08A) and operating cash inflow (FY12/08A: RMB448.9m), according to the management.

Table 2: Capacity expansion

(tonnes)	Effective in 2007	Effective in 2008	Actual at end-2008	Target at end-2009
Glutamic acid	280,000	275,000	350,000	350,000
MSG	75,000	171,667	280,000	380,000
Xanthan gum	11,333	21,000	32,000	44,000
Fertilizers	490,000	405,000	460,000	460,000
Sweetener	100,000	100,000	100,000	100,000

Source: Company data

Table 3: Capex budegt for FY12/09F

Projects	Amount (RMBm)
12,000tonne xanthan gum	200
100,000tonne MSG	50
5,000tonne threonine	40
1,000tonne BCAA	30
Environmental protection facilities	60
Total	380

Source: Company data

Undemanding valuation on decent outlook. We are optimistic towards the company's earnings in FY12/09F, given: 1) relatively inelastic demand for glutamic acid / MSG; 2) decline in raw materials costs; 3) xanthan gum capacity expansion combined with cost advantage. The management guided a ~10% top-line growth and ~30% at bottom line. Comparably, its present valuation (historical 6.0x) seems undemanding, in our view.

Table 3: P & L

Year to Dec (RMBm)	06A	07A	08A
Revenue	1,787.2	2,445.7	3,585.3
Cost of sales	(1,432.1)	(2,196.0)	(2,941.0)
Gross profit	355.1	249.7	644.3
Other income	19.2	75.6	44.3
Selling and marketing expenses	(61.8)	(104.2)	(166.4)
Administrative expenses	(40.5)	(113.7)	(142.0)
Other operating expenses	(7.4)	(16.7)	(12.3)
Profit from operation	264.7	90.7	367.9
Finance costs	(14.8)	(45.2)	(42.7)
Profit before taxation	249.8	45.5	325.3
Income tax	(9.3)	(0.4)	(30.7)
Profit for the period	240.5	45.1	294.6
Attributable to:			
Equity holders of the Company	240.5	45.1	294.6
Minority interests	-	-	-
EPS - Basic (RMB)	0.200	0.028	0.178
Proposed DPS (RMB)	-	0.009	0.100

Source: Company data

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

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