Small-to-Mid Caps

SBI E2-Capital

Time to BUY

Sector Update

Small-to-Mid Caps

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Key points:

- MSCI Hong Kong small cap index trading at valuations not seen since early 2003
- Sharp sell off created a rare chance to invest in small-to-mid caps
- Focus on the basic fundamentals - brand equity, domestic consumption, defensive sectors, in addition to a theme of debt refinancing plays
- Overweight: consumer staples, railway construction, pharmaceutical/healthcare
- Underweight: consumer discretionary, industrials
- BUY: Fuji Catering (1175 HK), Shandong Weigao (8199 HK), Anta (2020 HK)
- Conviction BUY: Zhuzhou CSR (3898 HK), Nine Dragons (2689 HK), Chaoda Modern (682 HK)
- Conviction SELL: China High Speed (658 HK), Ports (589 HK)

Sell-off creates opportunities. The market sell off has been particularly brutal in the small-to-mid cap sector as investors unwind their positions amid de-leveraging within the institutional investor community, asset devaluation and fund redemption. Liquidity has dried up in the sector amid concerns about the refinancing of loans and other derivative financial instruments and about China's slowing economic engine. The MSCI Hong Kong small cap index has plunged 70% YTD to 36.2 (72% from its 52-week high) and is now trading at only 5.5x forward P/E, a level not seen since early 2003, compared to the HSI's 10.1x forward P/E. We believe this sharp sell off has created a rare opportunity to invest in small-to-mid cap counters with compelling valuations and strong cash flows, which will offer good medium-term price appreciation potential. When selecting our picks, we focus on defensive counters with brand equity and domestic consumption exposure, in addition to a theme of debt refinancing plays. Many of our featured companies are trading at all-time low valuations, which we consider compelling even after factoring potential earnings downgrades. We underweight industrials and discretionary consumption plays, which are facing macro headwinds and expectations of significant downgrades from the street.

Brand equity. Current depressed valuations offer a great entry point into stocks that own internationally recognized brands. These counters are typically industry leaders and traditionally command valuation premiums. As the market normalizes, we expect them to continue leading the re-rating in the sector. Our BUY pick is **Anta (2020 HK, HK$3.32, BUY),** China's second largest sportswear apparel retailer with strong brand awareness and 5,468 stores (end-September). Despite intensifying competition and China's looming economic slowdown, the growth momentum of the domestic sportswear sector remains strong. Anta's retail sales are healthy, with the sales volume up 53.1% YoY to 7.7m units of footwear and 69.7% to 7.6m units of apparel in 3Q FY12/08.

Overweight domestic staples... Retail sales of consumer goods continue climbing, up 23.2% YoY in 3Q, the fastest in nine years, supported by rising urban disposable incomes (up 14.7% YoY at RMB11,865 per capita in Jan-Sep 2008). With China's economic growth at 9.0% in 3Q, we expect the government to focus on stimulating domestic consumption. We continue to favour staple stocks and while several counters such as Tingyi (322 HK) and Hengan (1044 HK) continue to trade at high valuations, we do see gems within the sector. We have a BUY call on **Fuji Catering (1175 HK, HK$3.99, BUY)**, which was recently beaten down on concerns of its CB redemption (outstanding RMB484.7m CB due in 2009 and RMB1,500.0m due in 2010). However, with an estimated operating cash flow of RMB988.5m in FY03/09F and RMB1,121.1m FY03/10F, and a cash levels of RMB1,093.9m at end-FY03/08A, the company should be able to refinance its CB. Its recent 1Q results show strong sales growth, at 84.2% YoY and China's stabilizing inflation should provide some margin relief to the company.

…and underweight discretionary consumption. We believe high-end discretionary consumption will suffer as the current economic slowdown and market turmoil is affecting the affluent. Many discretionary consumption counters are fast losing their revenue visibility. We are expecting significant earnings downgrades and are negative on this sector as a whole. In particular, we have a CONVICTION SELL call on **Ports (589 HK, HK$8.88, SELL)**. We note that the company's inventory turnover days surged from 383 to 453 in 1H FY12/08A (due to the opening of Armani and Vivenne Tam stores). We are not concerned about its near-term cash flow as it had RMB671.8m in cash in 1H FY12/08A and RMB356.1m of short-term borrowings (at single digit interest rate) to finance its working capital needs. However, if Ports accelerates its pace of store opening, pressure on its financial resources will rise and, with the current tight credit market and uncertain outlook, risks will increase.

Defensive sectors. China's healthcare/pharmaceutical and railway construction are defensive niche sectors thanks to the government's plans to invest heavily in both between now and 2010. Among healthcare/pharmaceutical counters, we like **Shandong Weigao (8199 HK, HK$10.0, BUY)**, one of China's leading medical equipment suppliers. With 80.2% penetration in first-tier and 23.9% in second-tier hospitals, the company is poised to capitalize on the government's drive to improve rural healthcare. Consumables make up a large proportion of its product portfolio and will help lessen the impact of any investment decrease in large-scale medical equipment. In the railway sector, we have a CONVICTION BUY call on **Zhuzhou CSR (3898 HK, HK$4.50, BUY)**, China's largest rolling stock manufacturer and supplier of train rolling stock. Trading at 10.9x FY12/08F and 8.8x FY12/09F P/E, the counter offers the cheapest pure exposure to China's railway construction sector.

Debt refinancing plays. Similar to Fuji Catering, the market has been wary of many counters with CBs and other financial derivative instruments. This presents opportunities for investors to pick up counters with solid balance sheets, strong cash flows and ability to refinance debt obligations. We have a CONVICTION BUY call on **Chaoda Modern (682 HK HK$6.4, BUY),** which offers good risk-to-reward upside trading at 4.9x FY12/08F and 4.1x FY12/09F, based on consensus estimates. The company has a HK$1,344.0m CB (conversion price of HK$6.72) with a put option exercisable from May 2009 at a 116.0% on the principal amount (HK$1,588.6m exposure). It also has US$225.0m senior notes (around RMB1,539.4m issued in Feb 2005 with an annual interest rate of 7.75%) due in Feb 2010. Though the company has a large capex budget of RMB2.5-2.8b a year in FY6/09-10F, we believe its solid revenue and earnings visibility, operating cash flow of RMB3,034.6m (FY6/08A) and cash balance of RMB1,280.2m should help it avoid any significant earnings pressure. With RMB985.0m worth of land not yet occupied, the company has room to tune down its capex without significantly sacrificing growth.

On the flip side, we have a CONVICTION SELL on **China High Speed Transmission (658 HK, HK$5.95, SELL)**. The company has on its balance sheet a RMB1,996.3m US$ settled zero coupon CB (conversion price HK$17.78) due in 2011 and cash settled equity swap transaction with Morgan Stanley (with an initial price of HK$13.6783) for the company's shares up to a value of HK$1,113.0m. We believe its cash flow is stretched with RMB1,438.4m in cash at end-1H FY12/08A and budgeted capex of ~HK$1.0b a year for the next two years. As a manufacturer, its cash flow is also lumpy and the CB/equity swap issue will continue to be an overhang on its share price. Cash spent on redeeming the bond may pressure the company to reduce capex going forward.

Uphill battle for industrials. Macro headwinds in the industrial sector are picking up. The PMI fell to 45.2 in October from 47.7 in September, the third straight month of decline and the fastest in the survey's history, suggesting that fundamentals of China's manufacturing sector are deteriorating rapidly. According to the survey, new orders received dropped substantially while employment layoffs are on the rise. Though falling commodity prices and export rebates provide some breathing room, industrial companies, many of which are highly geared and facing significant capex, are finding it hard to counter the effect of the waning demand. We are overall underweight in the industrial sector. Many counters have been battered, trading at below 4.0x forward valuations, with some trading at <2.0x forward valuations. We advise bottom fishing in this sector for counters with defensive industry exposure.

We like **Nine Dragons (2689 HK, HK$1.44, BUY),** which operates in the paper industry, a sector with a relatively high degree of consolidation and high entry barriers in the form of capex investment. Though its top line growth will be moderate, falling raw material prices should boost its gross margin in FY06/09A. The average price of wood pulp has declined to RMB4,600/tonne (from a high of RMB5,750/tonne at year beginning). In 1H FY12/08A, the company had debts of RMB14,685.4m (including RMB2,295.5m expiring within one year) and cash reserves of RMB1,956.0m. We do not expect any major impact from its short-term debt as: 1) the company has a strong operating cash inflow (RMB1,395.8m in FY06/08A); 2) China is relaxing its credit control and large enterprise such as Nine Dragons should be able to get bank loans.

Table 1: Featured companies

Company name	Ticker	Price (HK$)	Recommendation	Target Price (HK$)	Upside/Downside (%)
Fuji Catering	1175 HK	3.99	BUY	13.6	241
Zhuzhou CSR	3898 HK	4.50	Convicton BUY	n.a	n.a
Shandong Weigao	8199 HK	10.00	BUY	15.0	50.0
Anta	2020 HK	3.32	BUY	8.29	150
Ports	589 HK	8.88	Conviction SELL	n.a.	n.a
Nine Dragons	2689 HK	1.44	Conviction BUY	n.a.	n.a
Chaoda Modern	682 HK	6.40	Conviction BUY	n.a.	n.a
China High Speed	658 HK	5.95	Conviction SELL	n.a.	n.a

Source: Bloomberg

Table 2: Valuation table

Company name	Ticker	Mkt Cap (US$m)	Price (HK$)	Cur Yr P/E (x)	Nxt Yr P/E (x)	Cur Yr ROE (%)	Nxt Yr ROE (%)	Gearing (%)	Est. Yield (%)
Fuji Catering	1175 HK	278.6	3.99	3.5	3.1	16.8	17.9	46.5	6.7
Zhuzhou CSR	3898 HK	629.4	4.50	10.9	8.8	11.9	13.7	Cash	3.8
Shandong Weigao	8199 HK	1,284.3	10.00	19.3	14.1	25.4	25.4	17.5	1.1
Anta	2020 HK	1,066.4	3.32	9.1	7.0	18.0	20.8	Cash	4.9
Ports	589 HK	3,354.8	8.88	9.6	7.7	44.1	43.9	Cash	6.2
Nine Dragons	2689 HK	4,200.2	1.44	3.6	3.2	10.8	11.4	98.1	6.4
Chaoda Modern	682 HK	321.0	6.40	4.9	4.1	24.0	23.4	2.3	2.0
China High Speed	658 HK	4,965.4	5.95	12.4	8.8	16.3	20.9	Cash	1.4

Source: Bloomberg