JPM-pp1

Asia Pacific Equity Research

23 March 2015

Hengan International Group Ltd (1044 HK)

Overweight

Price: HK$86.60

20 Mar 2015

Price Target: HK$100.00

PT End Date: 31 Dec 2015

FY14 Preview - Reporting on 24 March 2015

Hengan is expected to report its FY14 result on 24 March, 2015 during lunch break. The company will hold its briefing around 4:00pm on 24 March, 2015, Hong Kong time.

- **Benign input costs a tailwind for the sound business:** We have been highlighting Hengan as one of our top picks in Asia consumer space since 2H14 given: i) decent top line growth driven by solid sanitary napkin division, ii) bottoming out tissue margins as Hengan has focused on margins rather than increasing promotions from 2H14 onwards, iii) developing diaper business on the back of increasing maternity store penetration, and iv) solid stable ROIC generation over the past 5-8 years which is rare among China staples. Low petrochem prices is an additional catalyst for Hengan's share price performance as it will benefit mid term earnings given c20% of Hengan's total cost is petrochem related. We now model 8% decline in petrochem costs for FY15.

- **Sanitary napkin is the key growth driver**: Hengan's sanitary napkin division sales growth has been impressive driven by constant product upgrades and market share gains. We expect sanitary napkin division to continue to deliver solid 17% growth in FY15. In tissue segment where over capacity reached its peak in 2014 Hengan refrained from new promotions since 2H14, thus we expect sales growth to be slower than peers but margins slightly improving. Hengan is putting efforts in increasing its maternity store reach for diapers business and with mid to high end diapers showing solid momentum we expect diapers business to deliver c10% sales growth in FY15.

- **Beneficiary of low petrochem costs**: With c20% of its costs related to petrochem, 10% move in petorchem prices alone would impact EBIT by c5%. Outlook for pulp price in FY15 is benign as well posing no threat to margins. Moreover, given rational competition in sanitary napkin space and Hengan's decision to keep promotions under check in tissue segment we expect big part of the GPM gains to move down to EBIT level.

- **2H14 preview:** We expect sales growth of c9% is showing a slowdown vs 1H performance due to currency and some slowdown in tissue (lack of extra promotions) and sanitary napkin (1H was particularly strong). We expect 2H14 EBIT to go up 9% y/y vs flat EBIT in 1H as we expect tissue margins have bottomed out in 1H14 and is showing slight improvement in 2H14. With that we expect Hengan to report HK$1.97bn net profit in 2H14, up c6% y/y. We however think 2H14 earnings will be less of a focus with all ears on FY15 guidance.

Table 1: JPM's estimates on Hengan's 2H14 and FY14 results

	2H13	2H14E	% chg y/y	FY13	FY14E	% chg y/y
Sales revenue	**10,772**	**11,769**	**9%**	**21,186**	**23,867**	**13%**
Gross profit	**4,848**	**5,577**	**15%**	**9,559**	**11,011**	**15%**
Gross margin	45.0%	47.4%		45.1%	46.1%	
Other income	288	264	-8%	443	469	6%
Total operating expenses	-2,738	-3,231	18%	-5,248	-6,492	24%
EBIT	**2,398**	**2,610**	**9%**	**4,754**	**4,988**	**5%**
EBIT margin	22.3%	22.2%		22.4%	20.9%	
Net interest	150	72	-52%	261	44	-83%
Pretax profit	**2,549**	**2,682**	**5%**	**5,015**	**5,031**	**0%**
Tax	-661	-689	4%	-1,245	-1,238	-1%
Effective tax rate	-25.9%	-25.7%		-24.8%	-24.6%	
Minority interests	-25	-24		-50	-50	
Net profit	**1,862**	**1,969**	**6%**	**3,721**	**3,744**	**1%**
Net margin	17.3%	16.7%		17.6%	15.7%	

Source: Company reports. Source: Company data and J.P. Morgan estimates.

Table 2: Revenue, Gross Profit and EBIT breakdown by product category

	2H13	2H14E	% chg y/y	FY13	FY14E	% chg y/y
Revenue Breakdown						
Sanitary napkins	3,113	3,716	19%	5,973	7,302	22%

Disposable diapers	1,506	1,610	7%	2,938	3,156	7%
Tissue papers	5,139	5,500	7%	10,204	11,138	9%
Food and snacks	673	786	17%	1,605	1,733	8%
Skin care and others	340	155	-54%	467	537	15%
Total sales revenue	**10,772**	**11,769**	**9%**	**21,186**	**23,867**	**13%**
Gross profit breakdown						
Sanitary napkins	2,098	2,546	21%	3,960	4,945	25%
Disposable diapers	685	739	8%	1,307	1,422	9%
Tissue papers	1,712	1,896	11%	3,480	3,768	8%
Food and snacks	282	293	4%	679	705	4%
Skin care and others	72	104	44%	134	170	27%
Total gross profit	**4,848**	**5,577**	**15%**	**9,559**	**11,011**	**15%**
Gross margin						
Sanitary napkins	67.4%	68.5%		66.3%	67.7%	
Disposable diapers	45.5%	45.9%		44.5%	45.1%	
Tissue papers	33.3%	34.5%		34.1%	33.8%	
Food and snacks	41.9%	37.2%		42.3%	40.7%	
Skin care and others	21.1%	66.7%		28.6%	31.7%	
Total	**45.0%**	**47.4%**		**45.1%**	**46.1%**	
EBIT breakdown						
Sanitary napkins	1,336	1,562	17%	2,535	2,998	18%
Disposable diapers	302	263	-13%	606	526	-13%
Tissue papers	468	455	-3%	1,142	918	-20%
Food and snacks	60	42	-29%	117	89	-24%
Skin care and others	-6	28	-552%	4	41	881%
Others	240	260	9%	351	417	19%
Total EBIT	**2,398**	**2,610**	**9%**	**4,754**	**4,988**	**5%**
EBIT margin						
Sanitary napkins	42.9%	42.0%		42.4%	41.1%	
Disposable diapers	20.0%	16.3%		20.6%	16.7%	
Tissue papers	9.1%	8.3%		11.2%	8.2%	
Food and snacks	8.9%	5.4%		7.3%	5.1%	
Skin care and others	-1.8%	18.2%		0.9%	7.6%	
Total	**22.3%**	**22.2%**		**22.4%**	**20.9%**	

Source: Company reports. Source: Company data and J.P. Morgan estimates.

Investment Thesis

While overcapacity issues in the tissue segment are putting pressure on margins, this is already built into our estimates. We believe sanitary napkins growth rates are still solid and that diapers could finally provide some upside surprises, as Hengan is now putting effort into “mom-and-baby” stores as the distribution channel. We have seen Hengan generating solid ROIC over the years despite competition across the three segments. This is unusual among China staples, which on average have seen sharp declines in ROIC. Hengan generated average ROIC of 25% over 2006-12, within a relatively tight range of +/-2% from the average. For 2014 and 2015, we are modeling in a decline in ROIC to 21.9% and 23.5%, respectively, but expect a reversion to 25.4% ROIC levels by FY16, driven by margin recovery in tissue as oversupply issues ease. Hengan trades at a one-year forward EV/IC of 5.6x, a c25% discount to its historical average (2006-12) of 7.5x, which appears excessive to us, given that ROIC declines in FY14/FY15 are only about 10% below the historical average, and given our forecast for increasing ROIC generation.

Valuation

Our Dec-15 PT is HK$100, based on 26x one-year forward P/E, which is 1-standard deviation below the historical mean given that growth rates are lower than historical levels.

Risks to Rating and Price Target

Downside risks to our rating and price target include: 1) a larger-than-expected increase in wood pulp prices –wood pulp accounts for c56% of COGS for tissue paper products; we assume a 2% decrease in pulp prices in 2014; and 2) a decline in government grants, which make up ~10% of earnings.

Consumer

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Date	Rating	Share Price (HK$)	Price Target (HK $)
13-Jun-07	N	27.65	25.90
23-Jul-07	OW	27.30	32.40
05-Sep-07	OW	26.50	33.60
30-Jan-08	OW	28.65	36.40
19-Mar-08	OW	25.40	31.50
18-Sep-08	N	20.00	19.00
08-Mar-09	N	27.60	30.00
16-Jun-09	N	36.50	39.00
03-Sep-09	N	43.25	43.00
26-Mar-10	N	58.00	60.00
30-Aug-10	N	68.60	65.00
22-Nov-10	N	68.75	70.00
25-Jan-11	OW	56.70	70.00
30-Mar-11	OW	59.75	67.00
27-Jul-11	N	67.45	67.00
12-Oct-11	UW	65.20	51.00
28-Mar-12	UW	70.85	53.00
30-Aug-12	UW	74.20	62.00
15-Sep-12	UW	76.70	61.00
16-Jan-13	N	73.55	66.00
27-Mar-13	N	77.65	64.00
01-May-13	N	80.20	73.00
27-Aug-13	N	84.80	82.00
28-Jan-14	OW	78.15	90.00
25-Mar-14	OW	82.25	91.00
26-Jul-14	OW	83.25	96.00
24-Sep-14	OW	78.20	90.50
31-Jan-15	OW	88.80	100.00

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