Equity Research

Consumer | Asia ex-Japan Cosmetics and HPC
24 March 2015

Hengan International Group Co., Ltd.

Femcare drives better set of numbers

Earnings for 2H14 were up 18% y/y as Hengan's margins took off while its revenue was up 9% y/y. The improvement was mainly driven by the Femcare business growing revenue at 23% with the division's EBIT margin expanding to 44% in 2H14 vs. 40% in 1H14. The Diapers and Tissue revenues were up but only by a disappointing 3% and 2%, respectively, and while their gross margins expanded by c200bps sequentially for both as the heavy promotional spend saw the EBIT still falling y/y for both segments. The interest and other income lines were marginally stronger too, resulting in a beat of 5% at the bottom line vs. our estimate and 4% vs. the Bloomberg consensus. We reiterate our OW rating as we raise our 12-month price target by 2% to HK$97 given the tweaks to our estimates.

Diapers division needs to be on fire in 2015: Despite the earnings beat for 2014, we have left our estimates for 2015 largely unchanged. We worry that growth in Femcare, which now accounts for 66% of EBIT, can only slow and that Diapers and Tissue need to commence growing again. It was heartening to see that the mid-level to high-end Diapers category saw revenue growth of 12%. We expect that to accelerate in 2015.

Interest income, other gains and forex pushback: These numbers came in despite the cHK$400m swing in forex losses (vs. gains last year) although income from Government Grants was up more than 50% to HK$666mn while net interest income surged as interest costs were cut after the CB issuance in July. Other income and net interest income accounted for 14% of the group's pretax profit. The dividend payout remained generous at c65%.

Valuation and risks: We tweak our target price to HK$97 from HK$95 as we look out a quarter and raise our estimate for 2015 by 1%. Our PT is based on our unchanged methodology of a target P/E of 25x applied to our revised EPS for 2015. Our PT implies total potential upside of 14% from the latest closing price, including the c3% forward dividend yield. We retain our Overweight rating. The key risks to our call are continued overcapacity in Tissue and the lack of traction in the Diapers business.

1044.HK: Financial and Valuation Metrics EPS HKD

FY Dec	2013	2014	2015	2016	2017
EPS	3.02A	3.19A	3.84E	4.30E	4.81E
Previous EPS	3.02A	3.03E	3.80E	4.38E	N/A
P/E	28.9	27.4	22.8	20.4	18.2

Source: Barclays Research.

Stock Rating	OVERWEIGHT Unchanged
Industry View	NEUTRAL Unchanged
Price Target	HKD 97.00 raised 2% from HKD 95.00

Price (24-Mar-2015)	HKD 87.50
Potential Upside/Downside	+11%
Tickers	1044 HK / 1044.HK

Market Cap (USD mn)	13813
Shares Outstanding (mn)	1224.41
Free Float (%)	58.71
52 Wk Avg Daily Volume (mn)	1.9
52 Wk Avg Daily Value (USD mn)	0.00
Dividend Yield (%)	2.1
Return on Equity TTM (%)	22.76
Current BVPS (HKD)	13.50

Source: Thomson Reuters

Price Performance	Exchange-HKG
52 Week range	HKD 94.35-74.05

Link to Barclays Live for interactive charting

Asia ex-Japan Cosmetics and HPC

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Asia ex-Japan Cosmetics and HPC — **Industry View: NEUTRAL**

Hengan International Group Co., Ltd. (1044.HK)

Stock Rating: OVERWEIGHT

Income statement (HKDmn)	2014A	2015E	2016E	2017E	CAGR
Revenue	23,831	26,304	29,094	32,248	10.6%
EBITDA	5,341	6,207	6,953	7,788	13.4%
EBIT	4,586	5,418	6,108	6,887	14.5%
Pre-tax income	5,343	6,318	7,068	7,904	13.9%
Net income	3,916	4,710	5,276	5,907	14.7%
EPS (reported) (HKD)	3.19	3.84	4.30	4.81	14.7%
Diluted shares (mn)	1,228.1	1,228.1	1,228.1	1,228.1	0.0%
DPS (HKD)	2.00	2.49	2.79	3.13	16.1%

Margin and return data					Average
EBITDA margin (%)	22.4	23.6	23.9	24.2	23.5
EBIT margin (%)	19.2	20.6	21.0	21.4	20.5
Pre-tax margin (%)	22.4	24.0	24.3	24.5	23.8
Net margin (%)	16.7	18.1	18.3	18.5	17.9
ROIC (%)	25.6	32.3	35.9	39.8	33.4
ROA (%)	9.2	10.4	11.1	11.8	10.6
ROE (%)	22.2	24.4	25.0	25.5	24.3

Balance sheet and cash flow (HKDmn)					CAGR
Tangible fixed assets	11,597	11,658	11,663	11,612	0.0%
Intangible fixed assets	604	604	604	604	0.0%
Cash and equivalents	21,297	23,193	24,742	26,538	7.6%
Total assets	42,577	45,121	47,563	50,224	5.7%
Short and long-term debt	15,164	15,164	15,164	15,164	0.0%
Net debt/(funds)	-6,132	-8,028	-9,578	-11,373	N/A
Other long-term liabilities	0	0	0	0	N/A
Total liabilities	24,514	25,349	25,885	26,418	2.5%
Shareholders' equity	18,063	19,772	21,678	23,806	9.6%
Change in working capital	690	-125	-407	-444	N/A
Cash flow from operations	5,643	6,008	6,029	6,685	5.8%
Capital expenditure	-1,127	-800	-800	-800	N/A
Free cash flow	4,517	5,208	5,229	5,885	9.2%

Valuation and leverage metrics					Average
P/E (reported) (x)	27.4	22.8	20.4	18.2	22.2
EV/EBITDA (x)	19.1	16.1	14.2	12.4	15.5
Equity FCF yield (%)	4.3	3.2	3.9	4.3	3.9
EV/sales (x)	4.3	3.8	3.4	3.0	3.6
P/BV (x)	5.9	5.4	5.0	4.5	5.2
Dividend yield (%)	2.3	2.8	3.2	3.6	3.0
Total debt/capital (%)	35.6	33.6	31.9	30.2	32.8
Net debt/EBITDA (x)	-1.1	-1.3	-1.4	-1.5	-1.3

Selected operating metrics				
Group gross margins (%)	46.1	47.1	46.7	47.1
Napkins gross margins (%)	68.5	68.0	66.0	66.0
Diapers gross margins (%)	45.3	47.0	46.0	46.0
Tissue gross margins (%)	34.5	35.2	35.2	35.2
Food snacks gross margins (%)	42.4	43.0	43.0	43.0
Effective tax rate (%)	25.6	24.5	24.5	24.5
Capex/sales (%)	4.7	3.0	2.7	2.5

Price (24-Mar-2015)	**HKD 87.50**
Price Target	**HKD 97.00**

Why Overweight? Overall, revenue growth momentum should accelerate going into 2015 when falling wood pulp and petrochemical prices should drive margin uplift.

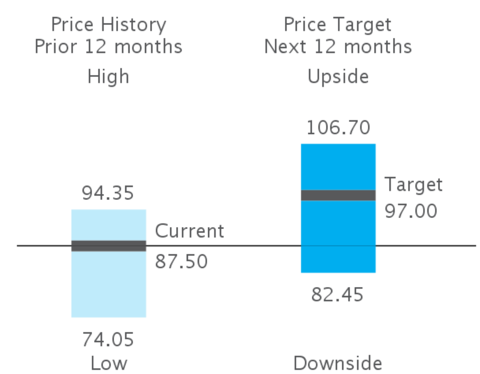
Upside case — **HKD 106.70**

The key sources of upside would be a stronger-than-expected ASP increase from an improved product mix, a decrease in prices of soft commodities and less intense competition. This is based on earnings 10% above our current estimate.

Downside case — **HKD 82.45**

The key downside risk to our call would be any reversal in input cost declines or a higher-than-expected A&P spend in 2015. This is based on earnings 15% below our current estimate.

Upside/Downside scenarios



Source: Company data, Barclays Research
Note: FY End Dec

2014 results

Overall, Hengan reported a net profit for 2014 of HK$3,916mn (EPS: HK$3.20), 5% above our estimate and 4% above the Bloomberg consensus. The company proposed a final dividend of HK$1.15 per share in addition to its interim dividend of HK$0.85 per share, which implied a full-year payout ratio of 63%.

Divisional results snapshots

Tissues

Revenue for 2014 grew by 6.4% y/y to HK$10,857mn for the division to account for 45.6% of total revenue (-2.6ppts y/y). On an h/h basis, revenue growth slowed to 1.6% y/y in 2H14 from 11.3% y/y in 1H14. According to company, it did not step up efforts in marketing and brand promotion in 2H14 as it had wanted to in order to protect the profit margin of the business.

The gross margin for 2014 for Tissues expanded by 0.4ppts y/y to 34.5% on the decrease in the price of tissue wood pulp. This was partly offset by the c.2% decline in the average selling price for Tissues due to intense market competition and overcapacity. The division's EBIT margin, however, was down by 3.0ppts y/y to 8.2%.

In 2014, the company's annualized production capacity was 1,020,000 tons.

Napkins

Revenue for 2014 grew by 24.4% y/y to HK$7,428mn for the division to account for 31.2% of total revenue (+3.0ppts y/y). On an h/h basis, revenue growth was well maintained at 23.4% y/y for 2H14 from 25.4% y/y for 1H14. During the year, the proportion of mid-level to high-end products in sales increased, which enhanced sales growth; and the new products were well received by the market with the company's market share expanding.

The division's gross margin for 2014 widened by 2.2ppts y/y to 68.5% on the improved product portfolio and the decline in the price of petrochemicals. The EBIT margin was relatively stable at 42.2% (-0.2ppts y/y).

Diapers

2014 revenue grew by 5.3% y/y to HK$3,095mn and accounted for 13.0% of total revenue (-0.9 ppts y/y). On an h/h basis, revenue growth slowed to 2.8% y/y in 2H14 from 8.0% y/y in 1H14. Of note, sales of mid-level and mid-level to high-end disposable diapers increased by 11.9% y/y, suggesting high demand for these products. On the other hand, sales of low-end diapers decreased by 15.4% y/y, mainly due to market competition.

2014 gross margin was up by 0.8ppts y/y to 45.3% on improved product portfolio and the drop in petrochemical prices. The EBIT margin was down by 3.2ppts y/y to 17.5%.

Food and snacks

Revenue for 2014 dropped by 4.4% y/y to HK$1,535mn for the division to account for 6.4% of total revenue (-1.2ppt y/y). On an h/h basis, revenue rose by 1.6% y/y in 1H14 but declined by 12.6% y/y in 2H14. The gross margin for 2014 was stable at 42.4% (+0.1ppt y/y). The positive impact was brought about by the sugar and palm oil price declines but partly offset by the intense market competition. The division's EBIT margin was relatively stable at 7.5% (+0.2ppts y/y).

FIGURE 1

Hengan – divisional financial summary

HK$ mn	Revenue			Gross margin			EBIT margin		
	2014	2013	y/y	2014	2013	y/y (ppts)	2014	2013	y/y (ppts)
Tissues	10,857	10,204	6.4%	34.5%	34.1%	0.4	8.2%	11.2%	(3.0)
Napkins	7,428	5,973	24.4%	68.5%	66.3%	2.2	42.2%	42.4%	(0.3)
Diapers	3,095	2,938	5.3%	45.3%	44.5%	0.8	17.5%	20.6%	(3.2)
Food and snacks	1,535	1,605	-4.4%	42.4%	42.3%	0.1	7.5%	7.3%	0.2
Exports, skin care, bandages	916	467	96.3%	11.1%	28.6%	(17.6)	0.1%	0.9%	(0.8)
Total	**23,831**	**21,186**	**12.5%**	**46.1%**	**45.1%**	**1.0**	**19.6%**	**20.8%**	**(1.1)**

Source: Company data, Barclays Research

Changes to our estimates

Hengan delivered a set of solid results for 2014. We trim our revenue estimate for 2015 by 3% but factor in wider gross and EBIT margins as well as a lower tax rate, according to company guidance. Overall, we nudge up our net profit estimate for 2015 by 1%.

FIGURE 2

Hengan – changes to our estimates

HK$ mn	2015E		
	New	Old	Change
Revenue	26,304	27,125	-3.0%
Gross profit	12,389	12,695	-2.4%
Gross profit margin	47.1%	46.8%	+0.3ppts
EBIT	5,418	5,507	-1.6%
EBIT margin	20.6%	20.3%	+0.3ppts
Net income	4,710	4,674	0.8%
Net income margin	17.9%	17.2%	+0.7ppts

Source: Barclays Research estimates

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Primary Stocks (Ticker, Date, Price)

Hengan International Group Co., Ltd. (1044.HK, 24-Mar-2015, HKD 87.50), Overweight/Neutral, J

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Asia ex-Japan Cosmetics and HPC

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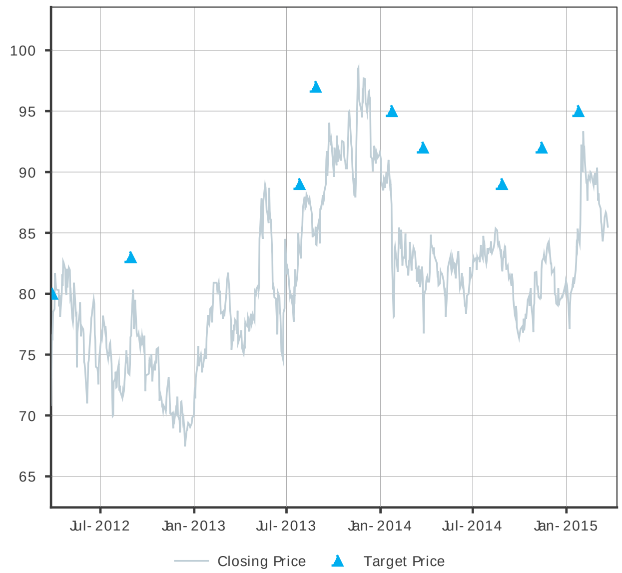
Hengan International Group Co., Ltd. (1044 HK / 1044.HK)

Stock Rating — Industry View

HKD 87.50 (24-Mar-2015) — **OVERWEIGHT** — **NEUTRAL**

Rating and Price Target Chart - HKD (as of 24-Mar-2015) — **Currency=HKD**



Source: IDC, Barclays Research

Link to Barclays Live for interactive charting

Date	Closing Price	Rating *	Adjusted Price Target
24-Jan-2015	85.35		95.00
13-Nov-2014	82.00		92.00
27-Aug-2014	82.30		89.00
25-Mar-2014	81.25		92.00
23-Jan-2014	87.35		95.00
27-Aug-2013	85.50		97.00
26-Jul-2013	83.95		89.00
29-Aug-2012	76.45		83.00
28-Mar-2012	76.60		80.00

Source: Thomson Reuters, Barclays Research

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*The rating for this security remained Overweight during the relevant period.

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Valuation Methodology: Our 12-month price target of HK$97 is based on a P/E of 25x 2015E EPS, which is the average Cosmetics and HPC trading multiple.

Risks which May Impede the Achievement of the Barclays Research Price Target: Key risks to the downside are rising over-capacity and a more competitive landscape in the Tissue space.

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