

Equity Research | China | Paper

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## Margins likely to stay more resilient than expected

- We expect Nine Dragons Paper (NDP) to achieve healthy unit dollar margin in 2H FY18, on higher selling prices. Over the mid-term, we believe NDP would benefit from rising bargaining power on market share gain, amid continuous supply reform. We think market is overly pessimistic about the margins pressure.
- We believe the new import quota system would lead the industry accelerate consolidation and favour large producer.
- Pegging to NDP's +1SD historical 5-yr PBR, we have revised down our price target to HKD14.0 (from HKD18.0), representing 1.4x our estimated FY19E book value, which implied 53.0% upside potential, hence reiterate Buy.

### Margins uptrend to stay on track amid re-emerging supply constraints.

Considering the higher average product prices realised in the first six month period, we expect the company to have achieved substantial unit dollar margins in the range of RMB687/RMB420 over the previous two six-month periods and an average of over RMB555 for the full year of FY18E. Meanwhile, we anticipate industry margins to remain on a sustainable uptrend considering the short-term support from major paper mills' maintenance plans over the summer period and mid-term outlook for the less-than-expected number of new containerboard projects scheduled to commence operation by the year-end, citing drag on progress due to certain environmental issues of respective projects. In addition, robust demand for quality waste paper materials is expected to continue to drive up the production costs of the paper mills, though the larger producers are expected to pass on the higher costs by hiking their product prices, which reaffirms an optimistic margin outlook, in our view.

**Beneficiary of rising supply shortage of waste paper.** The implementation of the new import quota system by the China Environmental Protection Department Solid Waste Center since this year has led to a substantial reduction in the scrap materials import YTD as compared to last year. According to industry feedbacks, the strict contamination requirement standards not being met by the majority, which contributed to the growing constraints on paper output as mills suspend production subsequent to depleting supplies.

**NDP's initiatives in vertical integration.** NDP implemented backward integration by acquiring an upstream fibre sourcing company in the U.S. with the aim of increasing access to a more secure channel for raw material supply in the long term. Management guided that at the current stage the newly acquired company would primarily serve the local market and would provide little benefit to the immediate shortage in its China operation. However, we believe further vertical extension of its production chain would benefit the company from a longer-term perspective as it could potentially be a platform for future development in recycled pulps in leading the company to become the first-mover in this area.

**Cautiously optimistic on FY19E outlook (ended Jun 2019).** According to the company's project development schedule, we foresee NDP to see modest sales volume growth going into FY19E, with the total annual capacity of linerboards from the 3PMs at the Quanzhou, Chongqing and Hebei bases to reach 1.4mn tons by end-18. Coupled with 1.85mtpa capacity to be added by mid-19, which would bring the total annual capacity to 17.28mtpa by end-FY19E, allowing the company to potentially become the largest producer in China on anticipation of capturing further market share gain going forward.

**Valuation near historical trough.** In terms of PER, NDP is trading at 5.2x/5.0x FY18E/FY19E, respectively, at the low-end of its historical forward PER range. Considering that the company's earnings outlook remains intact and it offers an attractive FY18E dividend yield of 6.1%, we believe the current valuation provides good entry opportunities given that the share price correction seems to have been overdone, in our view.

## Nine Dragons Paper (2689 HK)

### Buy

(unchanged)

<b>Price Target</b>	<b>HK\$14.0</b>
(Revision)	(N/A)
(upside)	(53.0%)

EPS revision	2018E	2019E
	(N/A)	(N/A)

Close price	HKD9.15
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Market cap.	HKD42,070 mn
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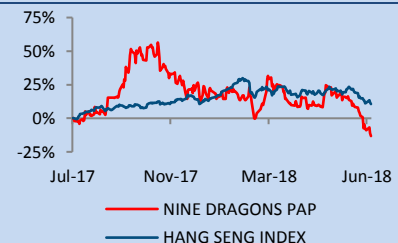
Free float	32.7%
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52-week range	HKD8.88 – 17.42
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3-mth ave. T/O	HKD159.0 mn
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Price as of 6 July 2018

### Stock rel HSI performance (%)



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**Income statement (RMB mn)**

Year end: Jun	2015	2016	2017	2018E	2019E
Revenue	30,093	32,093	39,155	50,143	53,277
COGS	(25,376)	(26,231)	(31,179)	(38,576)	(41,305)
<b>Gross profit</b>	<b>4,716</b>	<b>5,861</b>	<b>7,976</b>	<b>11,567</b>	<b>11,972</b>
Selling expenses	(679)	(736)	(838)	(922)	(964)
General and administrative	(918)	(1,048)	(1,142)	(1,129)	(1,181)
Other opex	148	253	565	565	591
<b>Operating profit</b>	<b>3,267</b>	<b>4,331</b>	<b>6,561</b>	<b>10,081</b>	<b>10,418</b>
Net interest expense	(1,324)	(2,706)	(1,242)	(1,249)	(1,196)
JVs and associates	39	42	116	116	122
<b>Pretax profit</b>	<b>1,982</b>	<b>1,667</b>	<b>5,435</b>	<b>8,948</b>	<b>9,344</b>
Taxation	(499)	(518)	(1,025)	(1,969)	(2,056)
Minority interests	(45)	(28)	(26)	(41)	(43)
<b>Net profit</b>	<b>1,438</b>	<b>1,122</b>	<b>4,384</b>	<b>6,938</b>	<b>7,245</b>
Net profit (adjusted)	1,352	2,894	4,783	6,938	7,245
<b>EBIT</b>	<b>3,175</b>	<b>6,118</b>	<b>7,050</b>	<b>10,156</b>	<b>10,497</b>
Depreciation & Amortization	(1,838)	(1,965)	(2,069)	(2,721)	(2,885)
<b>EBITDA</b>	<b>5,013</b>	<b>8,083</b>	<b>9,119</b>	<b>12,877</b>	<b>13,381</b>
Basic EPS (RMB)	0.29	0.62	1.02	1.49	1.55
Diluted EPS (RMB)	0.29	0.62	1.02	1.49	1.55
DPS (RMB)	0.07	0.13	0.30	0.48	0.50

**Cash flow statement (RMB mn)**

Year end: Jun	2015	2016	2017	2018E	2019E
<b>EBIT</b>	<b>3,267</b>	<b>4,331</b>	<b>6,561</b>	<b>10,081</b>	<b>10,418</b>
Depreciation & amortisation	1,838	1,965	2,069	2,721	2,885
Net interest	1,324	2,706	1,242	1,249	1,196
Taxes paid	(499)	(518)	(1,025)	(1,969)	(2,056)
Changes in working capital	2,058	1,389	(3,671)	152	(432)
Others	(2,383)	(3,323)	226	(2,382)	(2,271)
<b>Cash flow from operations</b>	<b>5,606</b>	<b>6,550</b>	<b>5,402</b>	<b>9,852</b>	<b>9,741</b>
Capex	(1,704)	(1,800)	(3,624)	(8,000)	(6,000)
Acquisitions	(80)	(38)	(44)	-	-
Disposals	15	16	70	-	-
Others	(419)	462	-	-	-
<b>Cash flow from investing</b>	<b>(2,188)</b>	<b>(1,361)</b>	<b>(3,166)</b>	<b>(8,000)</b>	<b>(6,000)</b>
Dividends	(408)	(392)	(643)	(2,219)	(2,318)
Issue of shares	-	-	-	-	-
Change in debt	(3,584)	(1,060)	(4,260)	-	(5,000)
Others	(16)	(46)	59	-	-
<b>Cash flow from financing</b>	<b>(4,007)</b>	<b>(1,497)</b>	<b>(4,844)</b>	<b>(2,219)</b>	<b>(7,318)</b>
<b>Change in cash</b>	<b>(589)</b>	<b>3,692</b>	<b>(2,609)</b>	<b>(367)</b>	<b>(3,577)</b>
Free cash flow	3,903	4,750	1,778	1,852	3,741

**Balance sheet (RMB mn)**

Year end: Jun	2015	2016	2017	2018E	2019E
Cash	7,311	11,002	6,473	6,106	2,529
Short term investments	-	-	-	-	-
Accounts receivables	6,749	5,552	6,620	7,794	8,281
Inventory	3,553	3,606	4,679	5,125	5,488
Other current assets	615	374	85	85	85
<b>Total current assets</b>	<b>18,228</b>	<b>20,535</b>	<b>17,857</b>	<b>19,110</b>	<b>16,383</b>
PP&E	45,011	44,861	46,415	51,694	54,810
Intangible Assets	252	245	231	231	231
Total investments	64	113	141	141	141
Other long term assets	1,479	1,538	1,523	1,523	1,523
<b>Total long term assets</b>	<b>46,806</b>	<b>46,757</b>	<b>48,310</b>	<b>53,589</b>	<b>56,705</b>
<b>TOTAL ASSETS</b>	<b>65,034</b>	<b>67,292</b>	<b>66,167</b>	<b>72,699</b>	<b>73,087</b>
Short term debt	12,188	11,993	12,116	12,116	10,023
Accounts payables	5,145	5,413	4,134	5,906	6,324
Other current liabilities	426	436	566	566	566
<b>Total current liabilities</b>	<b>17,759</b>	<b>17,842</b>	<b>16,816</b>	<b>18,588</b>	<b>16,913</b>
Long term debt	19,802	20,852	16,833	16,833	13,926
Deferred tax	1,912	2,176	2,433	2,433	2,433
Bonds payable	-	-	-	-	-
Other long term liabilities	35	-	-	-	-
<b>Total long term liabilities</b>	<b>21,749</b>	<b>23,029</b>	<b>19,266</b>	<b>19,266</b>	<b>16,359</b>
<b>TOTAL LIABILITIES</b>	<b>39,508</b>	<b>40,871</b>	<b>36,082</b>	<b>37,854</b>	<b>33,272</b>
Shareholders' Funds	25,227	26,074	29,749	34,468	39,395
Minority Interests	299	347	336	377	420
<b>TOTAL LIAB AND EQUITY</b>	<b>65,034</b>	<b>67,292</b>	<b>66,167</b>	<b>72,699</b>	<b>73,087</b>
Net cash / (debt)	(24,680)	(21,843)	(22,476)	(22,844)	(21,420)

**Key ratios**

Year end: Jun	2015	2016	2017	2018E	2019E
<b>Operating ratios</b>					
Gross margin	15.7	18.3	20.4	23.1	22.5
EBITDA margin (%)	16.7	25.2	23.3	25.7	25.1
Effective tax rate (%)	25.2	31.1	18.9	22.0	22.0
Revenue growth (%)	-	6.6	22.0	28.1	6.3
Net income growth (%)	-	114.1	65.3	45.1	4.4
EPS growth adj (%)	-	114.1	65.2	45.1	4.4
DPS growth (%)	-	85.8	130.9	58.3	4.4
<b>Efficiency ratios</b>					
ROE (%)	5.4	11.1	16.1	20.1	18.4
ROCE (%)	6.9	8.8	13.3	18.6	18.5
Asset turnover (x)	0.5	0.5	0.6	0.7	0.7
Op cash / EBIT (x)	1.7	1.5	0.8	1.0	0.9
Depreciation / CAPEX (x)	1.1	1.1	0.6	0.3	0.5
Accounts receivable days	84.1	70.0	56.7	52.5	55.1
Accounts payable days	72.2	73.5	55.9	47.5	54.0
<b>Leverage ratios</b>					
Net gearing (%)	97.8	83.8	75.6	66.3	54.4
Net debt / EBITDA (x)	4.9	2.7	2.5	1.8	1.6
Interest cover (x)	2.5	1.6	5.3	8.1	8.7
Current ratio (x)	1.0	1.2	1.1	1.0	1.0
<b>Valuation</b>					
PER (x)	26.8	12.5	7.6	5.2	5.0
EV/EBITDA (x)	13.3	10.2	7.5	5.1	4.8
PBR (x)	1.4	1.4	1.2	1.1	0.9
Dividend yield (x)	0.9	1.7	3.9	6.1	6.4

Source: Company data, Bloomberg, CSCI Research estimates

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## Company Rating Definition

The Benchmark: Hong Kong Hang Seng Index; Time Horizon: 12 months

<b>Buy</b>	12-month absolute total return: $\geq 10\%$
<b>Hold</b>	12-month absolute total return: $> -10\%$ but $< 10\%$
<b>Sell</b>	12-month absolute total return: $\leq -10\%$

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