

Texhong Textile

Leading R&D, star products

 Initial Coverage

Investment positives

We initiate coverage of Texhong Textile Company (02678) with a BUY rating and TP of Rmb14.01, based on 9x 2017e P/E (31% upside). **It is the largest core-cotton textile supplier; core-spun spandex materials are its high value-added key products, accounting for ~60% of its total revenue.**

Why BUY rating?

Yarn/fabric industry: garment consumers paying more attention to elegance, comfort and functionality. Faced with wider applications, core-spun spandex yarn and fabrics are star products with rich growth opportunities.

Competitive advantages: 1) Given its Rmb13bn 2016e sales, the company directly benefits from the economies of scales. 2) Leading R&D capability guarantees higher margin. 3) Plants are well diversified geographically, with production facilities located in the PRC/Vietnam accounting for 50%/50%, helping it to capture favorable policies and comparative advantages.

Rapid growth+rich opportunities. Judging from 20%/56% sales/net profit growth in 1H16, Texhong has benefited not only from rising cotton prices but also from the consumption upgrade. Vertical consolidation could become future's growth generator.

How do we differ from the market? R&D capabilities could serve as a strong entry barrier for Texhong against peers.

Potential catalysts: Positive outlook for the growth trend of cotton prices; 2H16 results to beat consensus expectations.

Financials and valuation

EPS is expected to be Rmb1.26, 1.43 and 1.62 in 2016/17/18, a CAGR of 36%. Unlike comparable peers, it is trading cheaply at single-digit forward P/E. With its R&D advantages and star products, its current valuation level could further improve.

Risks

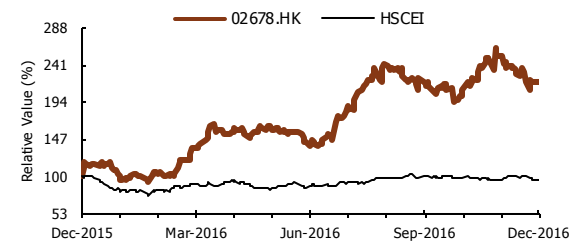
Fluctuations in cotton prices; weak demand for customer brands.

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Initiate with BUY

| | |
|-------------------------|----------------|
| Ticker | 02678.HK |
| CICC investment rating | * BUY |
| Last close | HK\$10.74 |
| CICC target | HK\$14.01 |
| 52wk price range | HK\$12.86~4.52 |
| Market cap (bn) | HK\$10 |
| Daily value (mn) | HK\$12.30 |
| Shares outstanding (mn) | 915 |
| Free float (%) | 100 |
| Daily volume (mn sh) | 1.09 |
| Business sector | Textiles |



| (Rmb mn) | 2014A | 2015A | 2016E | 2017E |
|----------------|--------|--------|--------|--------|
| Revenue | 10,470 | 10,575 | 13,300 | 15,747 |
| (+/-) | 27.2% | 1.0% | 25.8% | 18.4% |
| Net profit | 307 | 591 | 1,150 | 1,311 |
| (+/-) | -72.8% | 92.6% | 94.7% | 14.0% |
| EPS | 0.34 | 0.65 | 1.26 | 1.43 |
| BPS | 3.78 | 4.27 | 5.29 | 6.32 |
| DPS | 0.16 | 0.15 | 0.38 | 0.43 |
| CPS | 1.14 | 1.85 | 2.22 | 2.50 |
| P/E | 25.6 | 13.9 | 7.6 | 6.9 |
| P/B | 2.3 | 2.1 | 1.8 | 1.6 |
| EV/EBITDA | 9.8 | 6.5 | 4.7 | 4.2 |
| Dividend yield | 1.8% | 1.6% | 3.9% | 4.3% |
| ROAA | 3.4% | 5.8% | 9.2% | 9.0% |
| ROAE | 9.0% | 16.0% | 26.3% | 24.7% |

Source: Wind, Bloomberg, company data, CICC Research



Financial summary

| Financial statement (Rmb mn) | 2014A | 2015A | 2016E | 2017E | Financial ratios | 2014A | 2015A | 2016E | 2017E |
|-------------------------------|--------|--------|---------|---------|---------------------------|--------|-------|-------|-------|
| Income statement | | | | | Growth ability | | | | |
| Revenue | 10,470 | 10,575 | 13,300 | 15,747 | Revenue | 27.2% | 1.0% | 25.8% | 18.4% |
| COGS | -9,176 | -8,669 | -10,717 | -12,749 | Operating profit | -55.8% | 91.8% | 52.6% | 9.8% |
| Selling expenses | -352 | -369 | -437 | -520 | EBITDA | -38.6% | 60.9% | 43.6% | 11.2% |
| Administrative expenses | -328 | -381 | -452 | -536 | Net profit | -72.8% | 92.6% | 94.7% | 14.0% |
| Other ops income (expense) | 0 | 0 | 0 | 0 | Profitability | | | | |
| Operating profit | 600 | 1,150 | 1,756 | 1,929 | Gross margin | 12.4% | 18.0% | 19.4% | 19.0% |
| Finance costs | -249 | -419 | -395 | -377 | Operating margin | 5.7% | 10.9% | 13.2% | 12.2% |
| Other income (expense) | 0 | 0 | 0 | 0 | EBITDA margin | 9.5% | 15.2% | 17.3% | 16.3% |
| Profit before income tax | 355 | 736 | 1,365 | 1,556 | Net margin | 2.9% | 5.6% | 8.6% | 8.3% |
| Income tax | -48 | -147 | -218 | -249 | Liquidity | | | | |
| Minority interest | 0 | 2 | 4 | 4 | Current ratio | 1.76 | 1.22 | 1.35 | 1.45 |
| Net profit | 307 | 591 | 1,150 | 1,311 | Quick ratio | 1.10 | 0.81 | 0.93 | 0.96 |
| EBITDA | 998 | 1,605 | 2,304 | 2,562 | Cash ratio | 0.44 | 0.42 | 0.49 | 0.58 |
| Recurrent net income | 307 | 591 | 1,150 | 1,311 | Liabilities / assets | 62.2% | 65.5% | 64.4% | 62.6% |
| Balance sheet | | | | | Net debt / equity | 55.6% | 53.6% | 43.5% | 30.0% |
| Cash and bank balances | 1,094 | 1,940 | 2,547 | 3,383 | Return | | | | |
| Trade and bill receivables | 1,320 | 1,032 | 1,519 | 1,242 | RoA | 3.4% | 5.8% | 9.2% | 9.0% |
| Inventories | 1,636 | 1,893 | 2,217 | 2,882 | RoE | 9.0% | 16.0% | 26.3% | 24.7% |
| Other current assets | 335 | 762 | 816 | 987 | Per-share data | | | | |
| Total current assets | 4,385 | 5,627 | 7,099 | 8,494 | EPS (Rmb) | 0.34 | 0.65 | 1.26 | 1.43 |
| Fixed assets and CIP | 4,158 | 4,998 | 5,645 | 6,034 | BPS (Rmb) | 3.78 | 4.27 | 5.29 | 6.32 |
| Intangible assets and others | 596 | 776 | 920 | 1,012 | DPS (Rmb) | 0.16 | 0.15 | 0.38 | 0.43 |
| Total non-current assets | 4,754 | 5,774 | 6,565 | 7,047 | Cash flow per share (Rmb) | 1.14 | 1.85 | 2.22 | 2.50 |
| Total assets | 9,139 | 11,401 | 13,664 | 15,540 | Valuation | | | | |
| Short-term borrowings | 236 | 1,548 | 1,398 | 1,538 | P/E | 25.6 | 13.9 | 7.6 | 6.9 |
| Trade and bill payables | 1,666 | 2,295 | 2,990 | 3,297 | P/B | 2.3 | 2.1 | 1.8 | 1.6 |
| Other current liabilities | 589 | 783 | 862 | 1,031 | EV/EBITDA | 9.8 | 6.5 | 4.7 | 4.2 |
| Total current liabilities | 2,491 | 4,625 | 5,251 | 5,866 | Dividend yield | 1.8% | 1.6% | 3.9% | 4.3% |
| Long-term borrowings | 2,779 | 2,505 | 3,263 | 3,589 | | | | | |
| Total non-current liabilities | 3,193 | 2,837 | 3,553 | 3,870 | | | | | |
| Total liabilities | 5,684 | 7,463 | 8,804 | 9,735 | | | | | |
| Share capital | 94 | 94 | 94 | 94 | | | | | |
| Retained profit | 3,361 | 3,817 | 4,742 | 5,691 | | | | | |
| Equity | 3,455 | 3,911 | 4,837 | 5,786 | | | | | |
| Total liabilities & equity | 9,139 | 11,401 | 13,664 | 15,540 | | | | | |
| Cash flow statement | | | | | | | | | |
| Pretax profit | 355 | 736 | 1,365 | 1,556 | | | | | |
| Depreciation & amortization | 398 | 455 | 549 | 633 | | | | | |
| Change in working capital | 116 | 253 | -71 | -50 | | | | | |
| Others | 176 | 253 | 188 | 144 | | | | | |
| Cash flow from operations | 1,045 | 1,697 | 2,031 | 2,284 | | | | | |
| Capital expenditure | -607 | -935 | -1,185 | -1,010 | | | | | |
| Others | 22 | -184 | -150 | -100 | | | | | |
| Cash flow from investing | -585 | -1,119 | -1,335 | -1,110 | | | | | |
| Equity financing | 0 | 8 | 0 | 0 | | | | | |
| Bank borrowings | 216 | 842 | 608 | 466 | | | | | |
| Others | -502 | -582 | -697 | -804 | | | | | |
| Cash flow from financing | -285 | 268 | -89 | -338 | | | | | |
| Foreign exchange gain (loss) | 0 | 0 | 0 | 0 | | | | | |
| Net changes in cash | 175 | 846 | 607 | 836 | | | | | |

Source: Company data, CICC Research

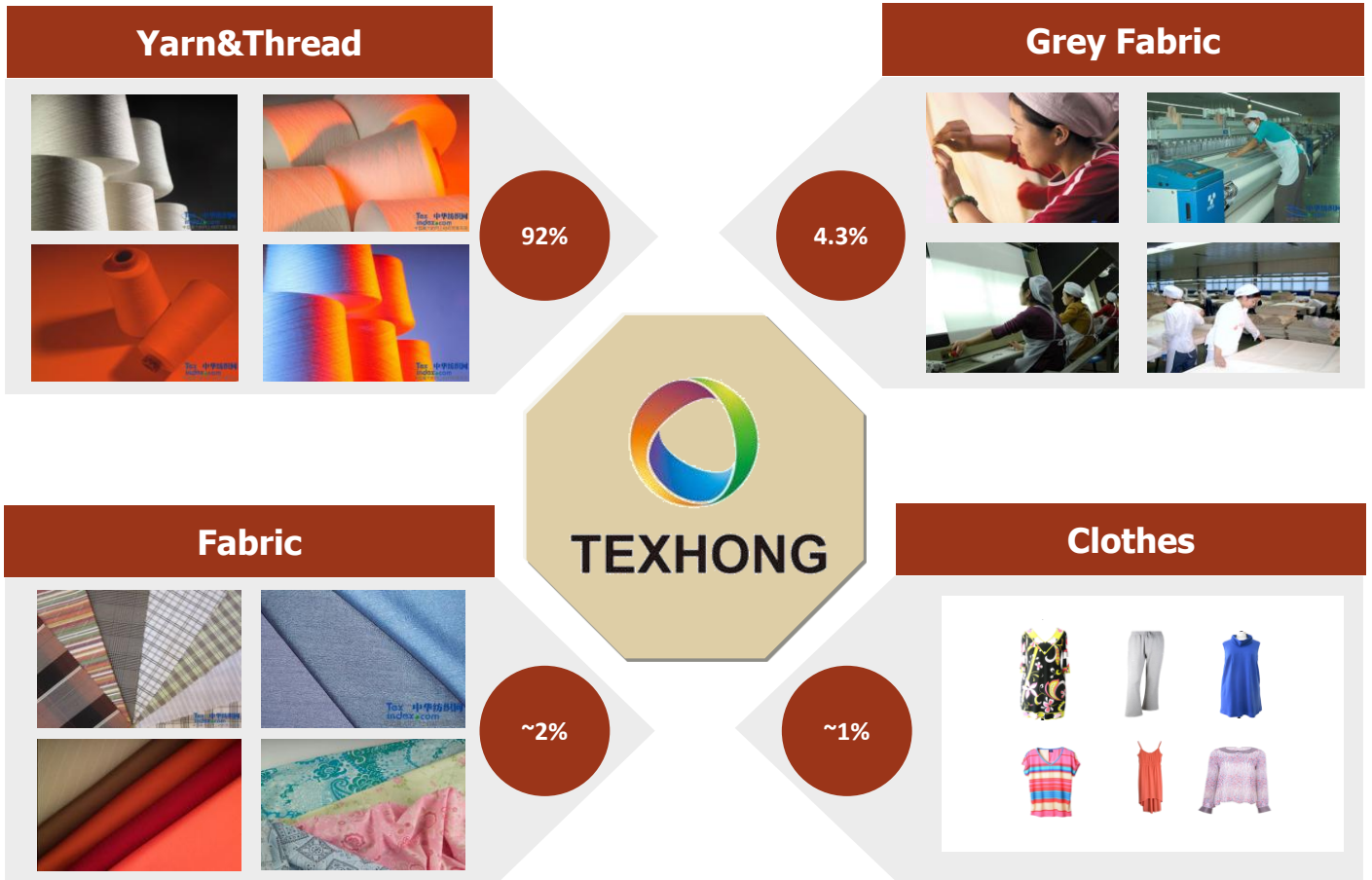
Company description

Texhong Textile is the largest core cotton textile suppliers which engaged in the production and distribution of quality yarn, grey fabrics and garment fabrics, especially of high value-added core-spun yarn and fashion cotton textiles. After the initial offering on HKEx in 2004, the Company has invested heavily in production capacity expansion and R&D. Currently its production facilities are mainly located in Mainland China and Vietnam, with its products widely used in high-tier branded apparels. The Company is now venturing into the downstream sector of the textile industrial chain.



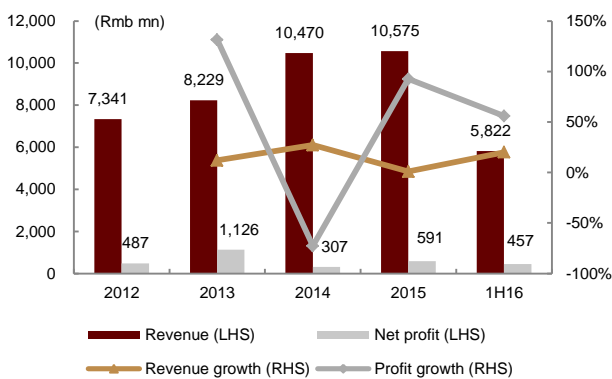
Company snapshot

Figure 1: Products of Texhong Textile and revenue contributions



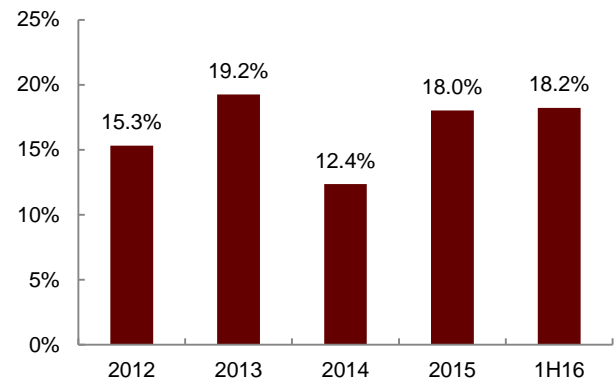
Source: Company data, CICC Research

Figure 2: 2012~1H16 revenue and net profit



Source: Company data, CICC Research

Figure 3: 2012~1H16 gross margin trend



Source: Company data, CICC Research



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Yarn & fabric industry: rich opportunities for high-tier products

Innovative technologies boosting bargaining power

From cotton to finished garments, the entire textile industrial chain involves multiple sections, starting from: 1) the manufacture of yarns, which are then 2) woven into fabrics; afterwards, those materials are 3) dyed and cut properly, and finally 4) embroidered and tailored. Judging from the competitive landscape, midstream players (weaving and dyeing factories) are relatively decentralized, **while upstream (yarn providers) and downstream (garment manufacturers) are experiencing a consolidation period, i.e. big names could emerge from both ends of the industrial chain.** As for now, and increasing number downstream garment-brand operators have realized the importance of textile industry clusters in mainland China, and as a result, 40% of imported apparels are rooted from PRC.

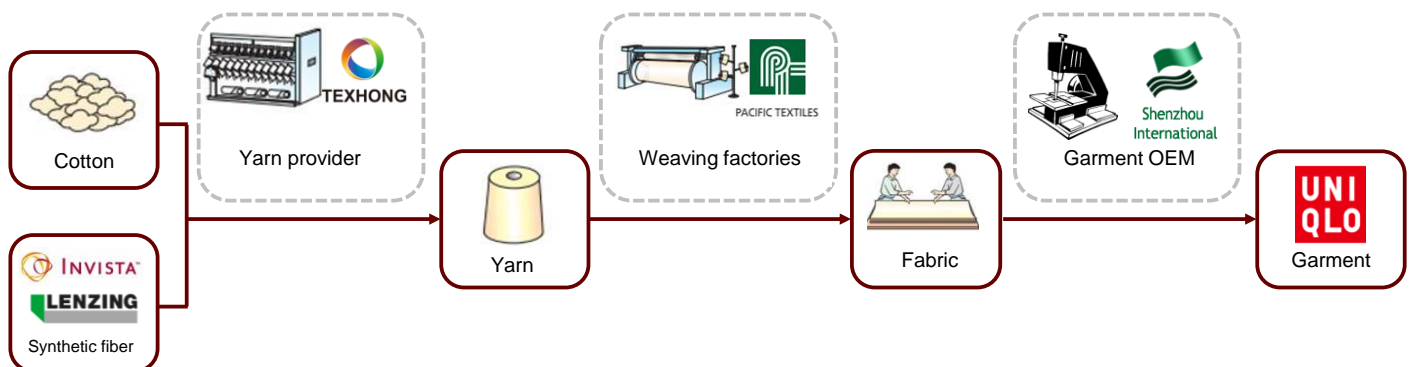
Yarn production section faced with a process of polarization. As for the entire sector, the boom period has passed and average players are haunted by excess capacity, while industry leaders could sustainably benefit from the economy of scales, thus a positive feedback could be realized with its growing production capabilities and customer base and strong players would become stronger via horizontal integration.

For yarn providers, huge synergies can be generated from cooperation with downstream brands and upstream suppliers:

- ▶ As upstream players of the textile sector, **leading yarn and fabric manufacturers could benefit from its experiences of cooperating with high-tier downstream customers;** thus, they are equipped with the ability to forecast the upcoming trends of the fabric industry with its insights into consumers' tastes.
- ▶ Product innovation is also rooted from frequently consulting suppliers on the latest fiber, spandex and other materials development and their applications. **Strategic relationships with renowned raw material suppliers help yarn and fabric producers developing new materials to build up its product inventory.**

Texhong Textile, which has continued focusing on the manufacture of yarns, lies on the upstream of the textile industry. Equipped with cutting-edge production technologies and valued customers, we expect a positive prospect for the textile giant.

Figure 4: Textile industrial chain overview-production process and typical players



Source: Company data, CICC Research



Spandex yarn and fabric: star products with strong demand

Weaving and knitting are two major textile technologies that feature different uses and properties. Woven fabrics are used in the production of shirts, jeans, khakis and jackets, while knitted fabrics are used in the manufacture of lingerie, sportswear and polo shirts. Woven garments lack elasticity compared to knitwear products. **The launch of spandex yarn added: 1) more appealing functions; and 2) wider application range to woven products.** For example, spandex yarn can provide denim with better flexibility, making jeans more comfortable. Its use has widened to the production of traditional knitwear products like high-tier T-shirts, polo shirts and socks. It has become a mature product with sustainable growth momentum.

- ▶ **Demand side: Top-tier garment material with appealing features.** Spandex is: 1) lightweight compared to rubber thread; 2) resistant to body oils, perspiration and lotions; and 3) retains its shape – i.e. soft and rubbery segments allow it to stretch up to 600% and then recover its original shape. Given its outstanding properties, blending spandex with other fabrics (esp. cotton) provides a higher level of comfort, durability and flexibility to garments in the practice of the fashion industry. Comparing to fabrics made entirely from spandex, products with cotton yarn added to the components are: 1) anti-allergic; and 2) easier to dye. It was first used in women's foundation garments and later introduced to other subsectors in the apparel industry. Spandex yarn and fabric face with strong demand from high-tier garment brands.
- ▶ **Supply side: Prices affected by fluctuations in crude oil prices.** Spandex prices, which are highly correlated with crude-oil prices, have a significant influence over the overall raw material costs. After peaking at ~Rmb80k at the beginning of 2011, the downward trend is maintained.

For Texhong Textile, spandex stretch yarn and spandex stretch fabrics are star products. The yarn is made by twisting textiles fibers (95~97% content) around a continuous strand of spandex (3~5% content) and concealing the core. The spandex core is the key to the higher elasticity of products. From the perspective of downstream customers – e.g., Uniqlo and some global sportswear brands – the yarn's high performance is the basis of innovations related to garment materials, contributing to both higher functionality and a more fashionable design. A higher portion of production capabilities are now utilized in the manufacture of spandex stretch yarns and fabrics.

Given its rich experience in the manufacture of spandex stretch yarn, **Texhong Textile could expand its business coverage along the textile-industrial chain and build a consolidated industry ecosystem eventually.**

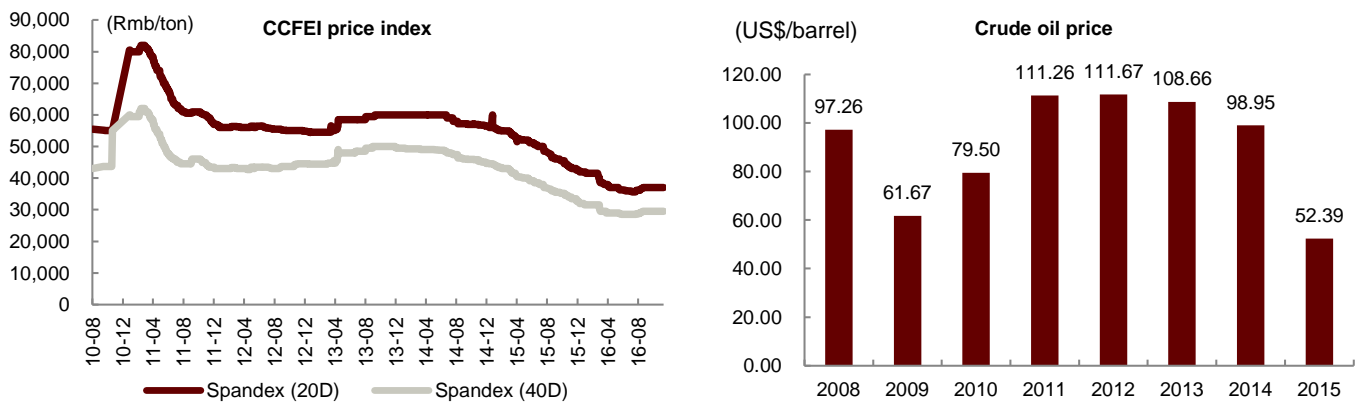


Figure 5: Applications of spandex yarn and fabric



Source: Official website of branded apparel retailers, CICC Research

Figure 6: Historical price trend of spandex and average crude oil price



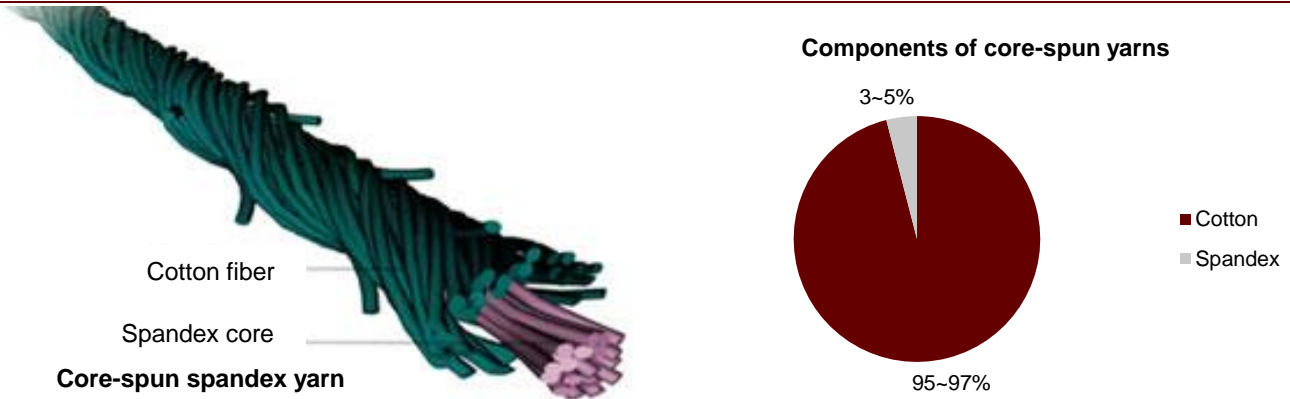
Source: Wind Info, CICC Research



Pro-cyclical players to benefit from the rising cotton prices

- ▶ Given the current upward trend of cotton prices, pro-cyclical textile companies, including Texhong Textile (as for its core-spun spandex products, synthetic fibers account for 3~5%, while cotton accounts for 95~97% of the total raw materials used), Luthai and Shenzhou International, has witnessed significant growth in their financial results.
- ▶ Although the government sell-off has increased slightly since July, we still see upside room in cotton prices. Over the medium-to-long term, the global inventory/consumption ratio for cotton has approached an inflection point, and cotton prices are likely to bottom out. Together with the existing imbalance between supply side and demand side, this suggests that downside room for cotton prices is limited for the next few months. We expect the price to remain stable with slight upside potential in 2017, assuming that the terminal demand level will not drop dramatically from the current situation.
- ▶ When the spread between domestic and overseas cotton price is reasonable, rising cotton prices are transferred to yarns. Pro-cyclical cotton-based textile companies may find it easy to transfer the rising cotton prices to the downstream, and ex-plant prices can rise alongside cotton prices. As cotton prices rise, the company is likely to benefit from expanding gross margin and accelerating revenue; after the expensive cotton is put into production, their revenue may rise further.

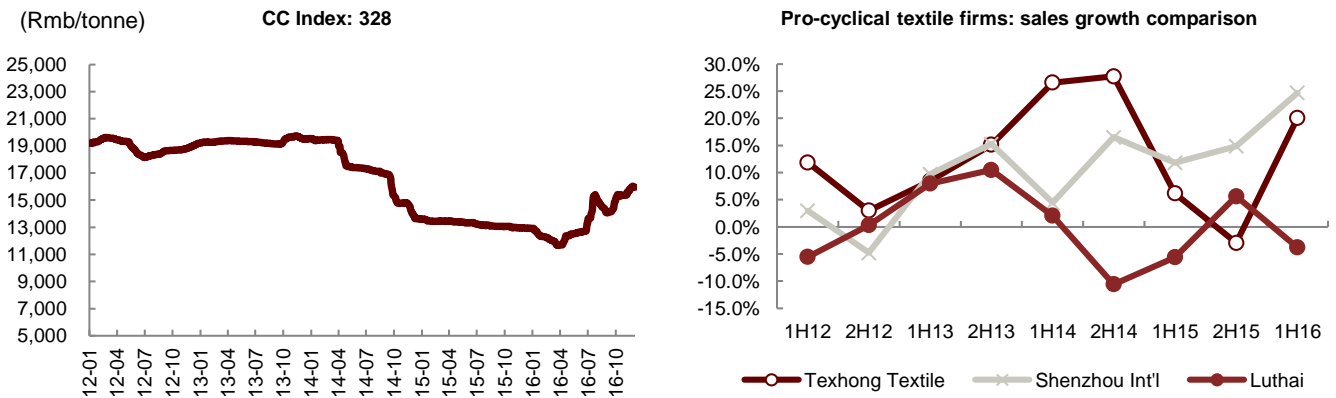
Figure 7: Components of Texhong Textile’s core-spun spandex yarn



Source: Wind Info, CICC Research

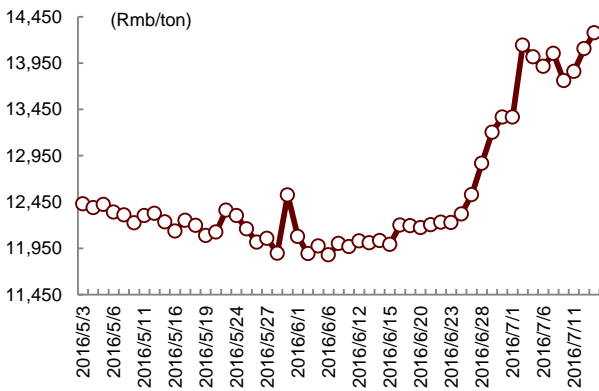


Figure 8: Trend of cotton price and pro-cyclical textile companies' revenue growth



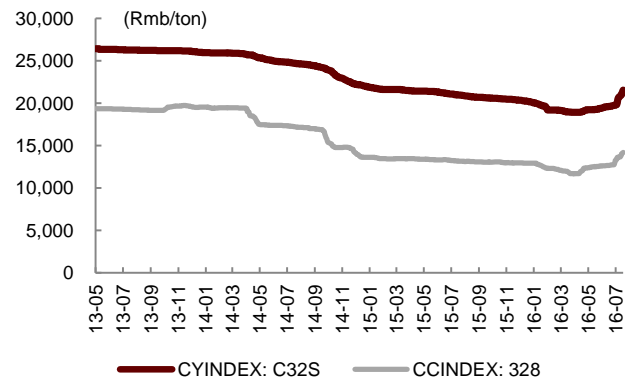
Source: Wind Info, CICC Research

Figure 9: ASP for domestic sell-off of cotton by government



Source: Shanghai International Cotton Exchange, Wind Info, CICC Research

Figure 10: Downstream yarns started raising prices



Source: Wind Info, CICC Research



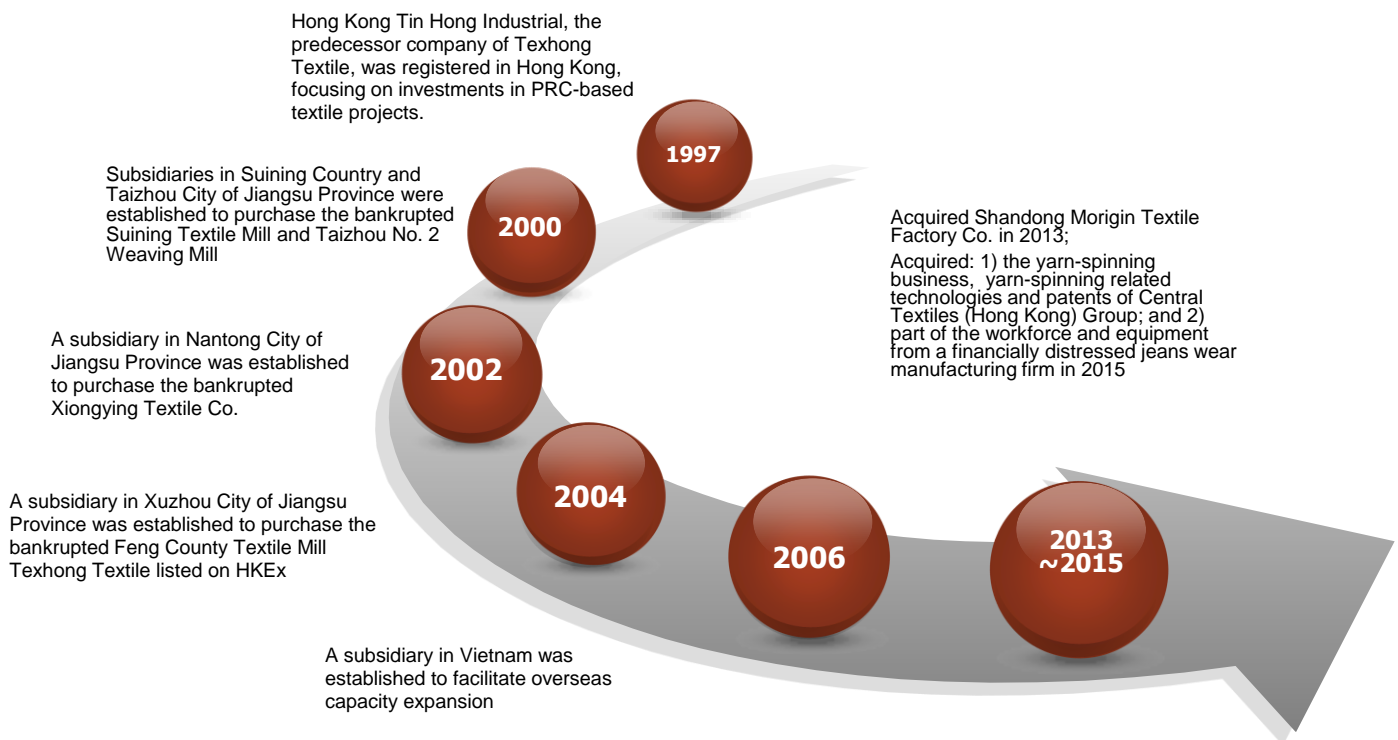
Texhong Textile: Largest core-cotton textile supplier

Company positioning and development history

Management positioned Texhong Textile as a leading manufacturer of high quality textile products, engaged in the production and distribution of quality yarn, grey fabrics and garment fabrics, especially of high value-added core-spun yarn and fashion cotton textiles. Its origin goes back to 1997, when its predecessor Hong Kong Tin Hong Industrial was established and focused on investing in PRC-based textile projects, and started production by renting looms from various textile mills. Since then and after its IPO on HKEx in December 2004, the company expanded its production facilities and strengthening its research and development arms. **Now, it is one of the largest core cotton-textile suppliers in the world.**

Hong Tianzhu, chairman and CEO of Texhong Textile, is the controlling shareholder of the company by holding controlling stakes in New Green Group (directly holds 42.9% of Texhong Textile's total shares outstanding) and in Trade Partners Investment (holds 16.6% shares). Mr. Hong founded the company and has over 20 years' experience in the textile industry. Widely known as being down-to-earth and dedicated to innovation, he is in charge of the company's overall development strategy.

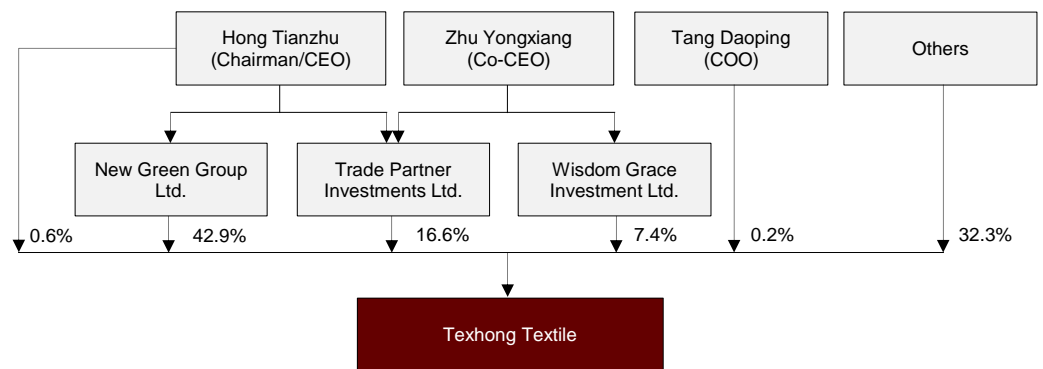
Figure 11: History and development of Texhong Textile



Source: Company data, CICC Research



Figure 12: Shareholding structure as of end-October



Source: Company data, CICC Research

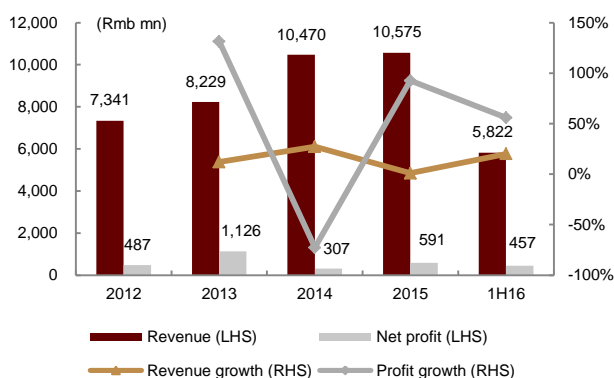
Outstanding profit growth driven by sales volume and cotton price

The annual sales and net profit of Texhong Textile have been volatile given the high dependence of textile companies' financial results on: 1) cotton prices; and 2) the FX market. **As of 1H16, Texhong Textile's revenue grew 20.1% YoY to Rmb5,822mn**, mainly driven by the sales volume growth under strong demand for the company's products; **and it also recorded a net profit of Rmb457mn, indicating a 55.9% YoY growth**, thanks to the 1.2ppt improvement in gross margin as a result of the drop in cotton cost.

The company generated >Rmb1bn net profit from January~October according to the latest positive profit alert, significantly surpassing its 2015 full-year net profit, thanks to strong sales volume and higher gross profit margin amid an upward trend in cotton prices.

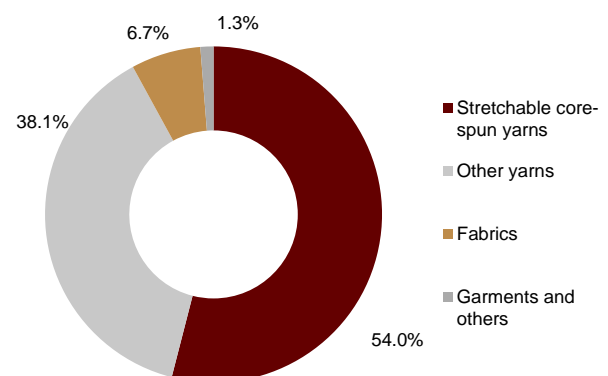
Yarn products still account for the largest portion of the company's total sales revenue. As for 1H16, yarns contributed 92.1% of the overall turnover (stretchable core-spun yarns/other yarns accounted for 54%/38.1%), while fabrics took 6.7% (grey fabrics/garment fabrics accounted for 4.4%/2.3%) of total sales. Since 2015, the company has engaged in the production of garments, which contributed 1.3% of total sales in 1H16.

Figure 13: 2012~1H16 revenue and net profit



Source: Company data, CICC Research

Figure 14: 1H16 revenue breakdown



Source: Company data, CICC Research



Clear capacity expansion strategy

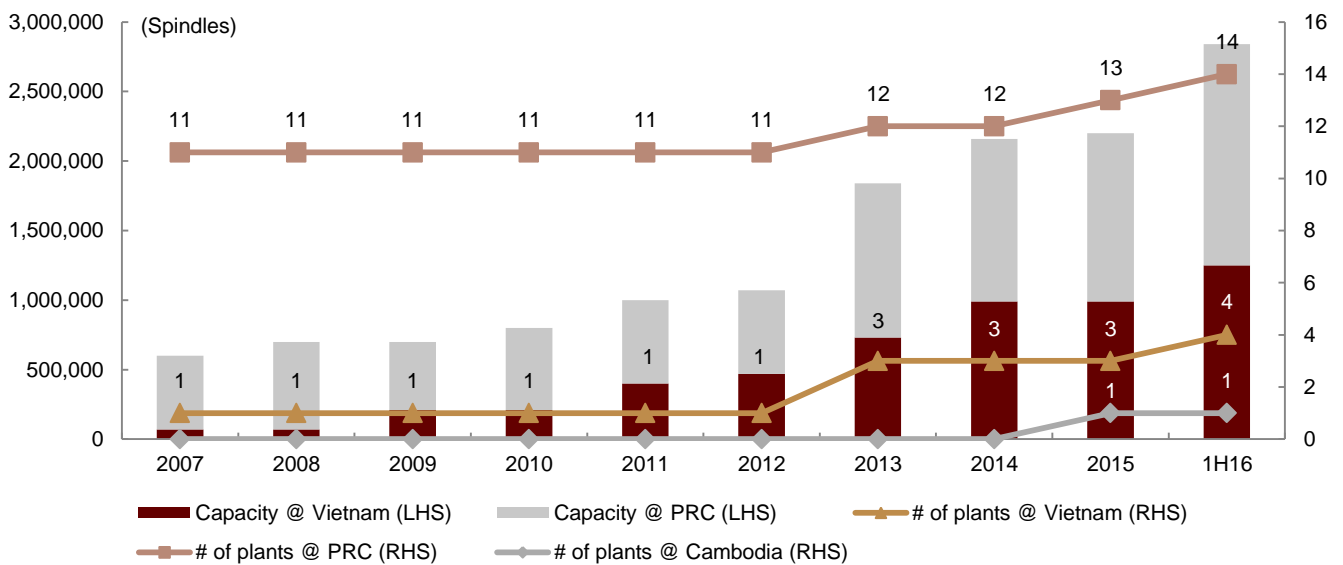
The development history of Texhong Textile can be divided into 2 phases:

- ▶ **From 2000~2004, the firm acquired bankrupt state-owned textile enterprises at low cost and upgrading the product facilities to ramp up its production capacity.** It acquired the fixed assets and factory premises of four SOEs that had been liquidated, namely: Tianzhu No. 2 Weaving Factory, Suining Cotton, Rudong Textile and Feng County Textile. The management team sent by Texhong Textile took control of the daily operations, aiming at improving the operating efficiency to turnaround their business.
- ▶ **Since 2006, the company has attached more importance to the capacity expansion in Vietnam** due to the labor cost advantages. The first subsidiary in Vietnam was established in October 2006, and we expect the plants in Vietnam would account for 50% of the company's total production capabilities.

As for now, plants in mainland China focus on product diversification and specialization, while those in Vietnam are direct beneficiaries of economies of scale and account for the largest share in its subsector globally.

At end-1H16, the Group had 14, 4 and 1 production bases in mainland China, Vietnam and Cambodia; respectively, **with total annual production capacity of about 2.84mn spindles.**

Figure 15: Production capacity expansion process: from 2007 to 1H16



Note: geographical distribution of production capacity for 2007~2012 were based on ex ante projections
Source: Company data, CICC Research



Future trend: Vertical consolidation along the industry chain

Currently the direct customers of Texhong Textile are non-branded garment factories. **According to management, the company is committed to building an integrated platform in Vietnam for the downstream industrial chain** by acquiring business, establishing JVs and recruiting suitable professionals, aiming at alleviating the fluctuation in its profitability caused by cotton priced through in-depth industrial development.

- ▶ **Feasibility & benefits:** Currently, capital expenditures are limited, allowing the company to invest heavily in vertical extensions along the industrial chain. The company is now venturing into making garments in an industrial park located in Vietnam. Later it plans to extend its business into the weaving and dyeing process. **An integrated textile ecosystem could contribute to higher gross margin via upstream/downstream consolidation.**
- ▶ **Schedule:** Construction of plants to form the platform comprising a downstream industrial chain (weaving, dyeing and garment manufacture) has been underway since 1H16, and equipment installations was generally completed by now. **We estimate that the garment manufacturing business will realize over Rmb100mn in 2017 and over Rmb1.0bn in 2018.** After completion, the weaving and dyeing plants would first sell products to downstream factories, and the company expects to directly communicate and cooperate with garment brands eventually.



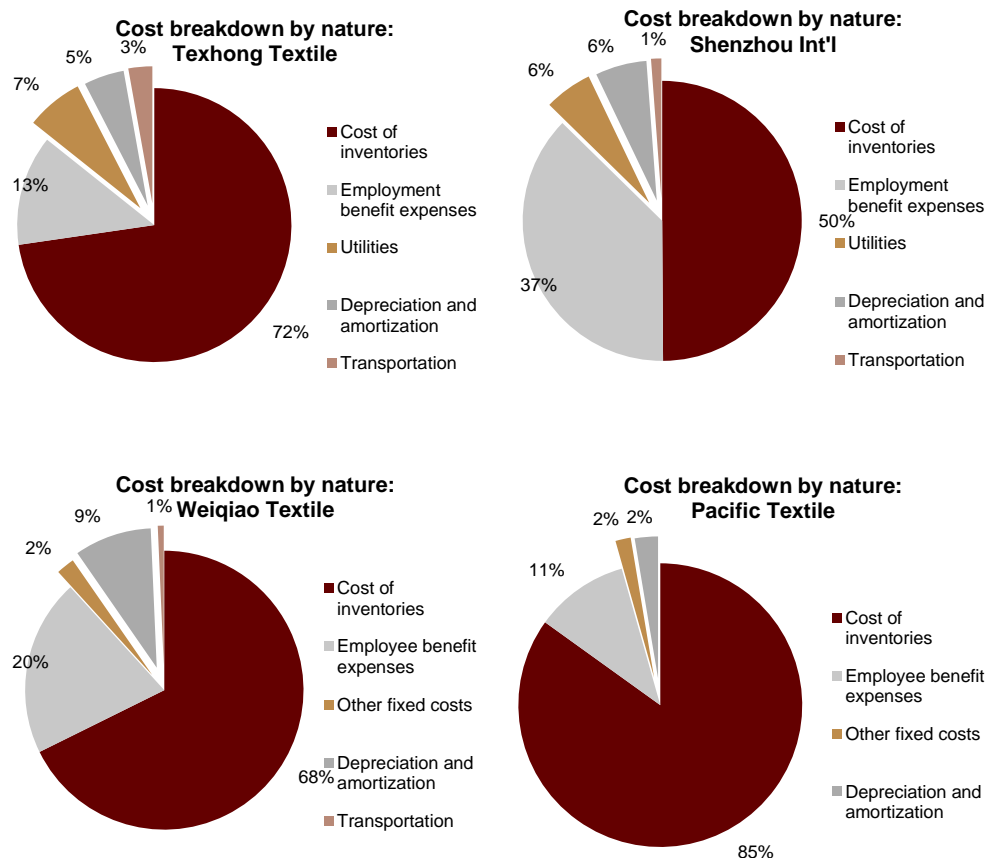
Core competitive advantages

Economies of scale: Lower unit cost

As one of the world's largest core cotton yarn suppliers with a share of ~30% in its subsector, Texhong Textile has invested heavily in PP&E over the past few years with its capex ranging from Rmb400~900mn. **Given the upward trend of cotton prices, the company could directly benefit from economies of scale by fully utilizing its operating leverage.**

Compared its peers, a cost breakdown analysis indicates that Texhong Textile's fixed costs account for a larger proportion in its cost structure. **If we regard expenditures in utilities, depreciation & amortization, transportation and others as fixed costs, Texhong Textile's would thus account for 14.3% of its total costs of sales and SG&A expenses vs. 12.7% at Shenzhou International's, 11.8% at Weiqiao Textile's and 4.4% at Pacific Textile's.** Thus, we expect the firm to benefit from the economy of scales, as fixed costs can be amortized more thoroughly with a larger production scale, leading to lower average unit cost. Given the pro-cyclical nature of the textile industry, leveraged companies could extraordinarily benefit from bullish market situation.

Figure 16: Cost breakdown analysis: Texhong Textile vs. comparable peers



Source: Company data, CICC Research



Leading R&D capabilities: revenue ramp-up and improved profitability

In 2007, Texhong Textile started centralizing its R&D resources from its headquarter and all PRC-based factories, and established a formal R&D center in Changzhou, which has kept developing and improving a wide variety of products in order to secure the company’s leading position in the sector and to meet the demand of quality customers for different high-end products.

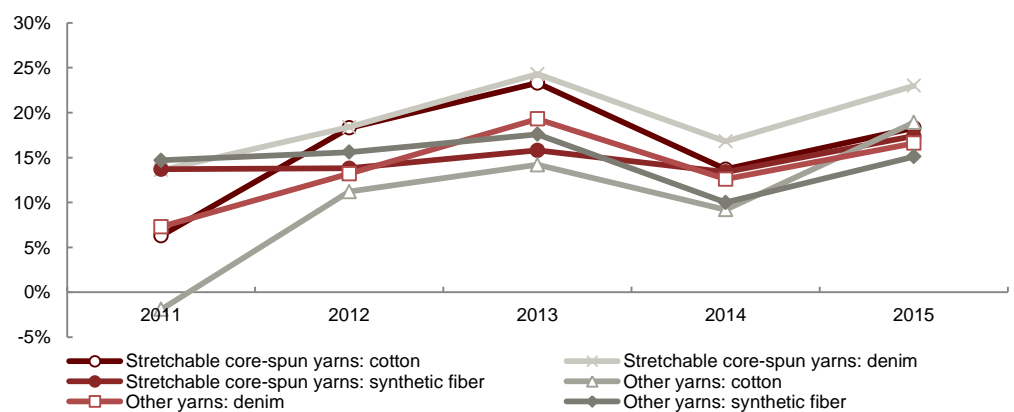
Apart from its individual efforts, cooperation with suppliers and customers along the industrial chain could also boost its R&D capabilities:

- ▶ **Downstream brands as fashion guidance:** As a bellwether in its sector, Texhong Textile has kept attending brand conferences with its clients such as Uniqlo, aiming at digging deeper into innovation with downstream fabric providers and garment manufacturers, and meeting the demand of quality customers for different high-end products. Customers frequently provide samples or ideas to the company to see whether manufacturing of certain types of fabric is feasible.
- ▶ **Upstream suppliers to trigger material innovation:** Texhong Textile has continued to strengthen the cooperation with: 1) INVISTA (an international core-spun spandex fiber manufacturer of LYCRA Brand); 2) Lenzing Fibers (the manufacturer of TENCEL Lyocell fiber/Modal fiber); and 3) Toray of Japan. Thus, the firm has established prolonged strategic partnerships and kept abreast of the latest development of raw materials, their usage and function.

Thanks to its R&D arms, product variety was guaranteed, so that Texhong Textile can effectively diversify the risk of fluctuation in raw material cost in over the long term. Following the successful launch of metallic-wire series textile products, the company launched core-spun textile products with polyester, nylon and polypropylene in 2007. In 2008, more than Rmb70mn of TVC and JC yarns were sold for specialized clothing needs for China Army.

Innovative products catering to specific demands enjoy extra pricing power when facing downside customers, thus boosting the company’s topline growth and gross margin. Over the past 5 years, the profitability trend of different products was upward despite the disturbance caused by raw material price fluctuation.

Figure 17: Gross margin trend by products



Source: Company data, CICC Research



Figure 18: Production and R&D facilities: infrastructure & software devices



Source: Company data, CICC Research

Capacity: Well diversified geographically-

As for now, 14, 4 and 1 plant(s) were located in Mainland China, Vietnam and Cambodia. **Thanks to the geographical diversification, Texhong Textile can benefit from supportive policies and comparative advantages in different areas as many as possible.**

Vietnam plants: Lower labor costs, taxes and tariffs despite emerging uncertainties related to TPP. Texhong Textile is among the pioneers that started building production facilities in Vietnam due to better cost efficiency. Thus the company can: 1) enjoy significant first-mover advantages with its initial investment in PP&E and rich experience of cooperating with local government, which act as entry barriers, helping Texhong Textile to maintain its cost advantage and abundant labor supply in Vietnam; 2) subsidiaries established in Vietnam are entitled to several years' income tax exemption and/or reductions, contributing to lower tax expenses for the company; and 3) yarns and fabrics produced in Vietnam and exported to other TPP participants could have enjoyed tariff exemptions were the agreement implanted. While the election of Donald Trump as the U.S. president could add uncertainty to the prospect, the international trades among FTA participants (Japan, South Korea and the EU) have already been exempt from tariffs or could enjoy a lower-tariff regime.

PRC-based plants: Beneficiaries of the Belt and Road initiative. Texhong Textile's mainland production facilities were mainly located in Shandong, Jiangsu and Zhejiang, while the company has attached more importance to the capacity ramp-up in Xinjiang since 2015, where favorable state policies were continually introduced thanks to the Belt and Road initiative. According to Xinjiang regional government, companies incorporated and mainly operating in Xinjiang could borrow at lower interest rates to finance its capital expenditures. They could conditionally benefit from transportation/utility/employee subsidies and government grants.



Figure 19: Geographical distribution of Texhong Textile's production facilities and headquarters



Source: Company data, CICC Research



Financial analysis and earnings forecast

Financial analysis

For comparison, we choose 7 textile manufacturers in mainland China or Taiwan as peers for Texhong Textile. Among all these firms, Eclat, Makalot and Shenzhou Int'l are garment OEMs (downstream); Luthai, Texwinca and Pacific textile mainly focus on the production of fabrics (midstream); and Weiqiao Textile engaged in the manufacture of cotton yarn, grey fabric and denim (upstream).

- ▶ **Profitability:** 1) Given that the company is positioned at the upstream of the textile industry, the gross margin is lower than that of fabric providers/garment OEMs, and more sensitive to fluctuations in cotton price. 2) Operating margin is also volatile due to dramatic rises and falls in other gains/losses following minor changes in SG&A expense ratio.
- ▶ **Working capital:** 1) The inventory situation remains healthy with the inventory-to-sales ratio staying at ~20% and inventory days at ~80 days. Robust sales volume growth accelerates its turnover. 2) As for accounts receivable, the company grants credit terms of <90 days to its customers in mainland China and <120 days to overseas ones. A/R turnover days remain at the industrial average (30~40 days), shorter than Shenzhou Int'l due to lower customer concentration.
- ▶ **Financial leverage:** Compared to its peers, Texhong Textile has been heavily using financial leverage to finance its investment in working capital and PP&E. From 2011~1H16, the debt-to-invested-capital ratio remained at >40%, significantly higher than the industrial average. While judging from its interest coverage ratio (4.1x in 2015), financial distress is unlikely to happen; besides, relatively high but reasonable leverage ratio guarantees a higher-than-average ROE level.

Figure 20: Peers comparison: profitability, working capital management and leverage as at 2015

| (as at end-2015) | Profitability | | Working capital management | | | Financial leverage | |
|------------------|---------------------|-------------------------|----------------------------|----------|----------|--------------------|-------------------------|
| | Gross profit margin | Operating profit margin | Inv. days | A/R days | A/P days | Net gearing ratio | Interest coverage ratio |
| Texhong Textile | 18.0% | 10.9% | 74.3 | 40.6 | 83.4 | 53.0% | 4.1x |
| Pacific Textile | 18.8% | 16.7% | 64.3 | 45.7 | 49.6 | 19.8% | 96x |
| Weiqiao Textile | 5.7% | 19.9% | 192.6 | 10.0 | 44.6 | 34.6% | 3.2x |
| Texwinca | 34.0% | 5.7% | 115.8 | 31.5 | 60.2 | 12.1% | 91.2x |
| Luthai | 29.7% | 13.6% | 147.0 | 21.5 | 25.4 | 10.5% | 47.7x |
| Eclat | 28.0% | 19.0% | 66.2 | 41.7 | 29.9 | 16.2% | - |
| Makalot | 23.6% | 11.3% | 60.4 | 13.3 | 32.5 | 2.5% | - |
| Shenzhou Int'l | 30.5% | 23.6% | 121.2 | 52.6 | 23.8 | 22.4% | 30.2x |

Source: Company data, CICC Research



Revenue and earnings forecast

We estimate that over 2016~18, **Texhong Textile's revenue will grow 25.8%, 18.4% and 15% YoY to Rmb13,300mn, Rmb15,747mn and Rmb18,102mn** and record net profit of Rmb1,150mn, Rmb1,311mn and Rmb1,482mn, an **EPS of +94.7%, 14% and 13% YoY to Rmb1.26, Rmb1.43 and Rmb1.62**. Key growth drivers include 1) capacity expansion; 2) higher gross margin; and 3) rising cotton prices.

Capacity expansion according to schedule

Texhong Textile's utilization rate has reached 100%; thus, production capability expansion is necessary with more orders being placed by customers. **An aggregate of ~3mn spindles are realized at end-2016, of which ~50% are in Vietnam** after the Xinjiang and Galaxy facilities in Northern Vietnam (totaling ~710,000 spindles) have begun full-scale operation. Besides, the company plans to spend ~Rmb30mn to acquire and upgrade a small yarn factory located in Guangdong Province, which will be upgraded to a planned capacity of 50,000 spindles, to cope with orders requiring prompt delivery.

According to the company, **targeted sales volume for 2016 and 2017 will be ~600,000 tonnes and ~690,000 tonnes of yarn** based on estimated production capacity.

Gross profit margin benefiting from high-end product mix

As mentioned above, the strategic partnership with fiber manufacturers helps the company utilize innovative fiber technology into the production of trendy functional yarns to cater for development in the differentiated high-end market. Currently, its product series was extended to high-tier woven yarn, knitting yarn and especially denim yarn after cooperating with Lenzing Fibers.

Thanks to its products keeping up with the latest fashion, Texhong Textile has relatively high pricing power against downside customers, contributing to its improving profitability. A diversified and high-tier product portfolio also makes the company more defensive against price fluctuations of raw materials. But according to the management, the gross profit margin of an upstream textile enterprise is unlikely to go beyond 20%.

Rising cotton price in China

Given the rising trend of cotton price in China, the selling prices of yarns are set based on the spot cotton price, while inventories used in production were procured at a lower cost 5~6 months earlier, resulting in higher ASP and lower unit cost of sales. Management says that the cotton-price factor will account for 20% of net profit for full-year 2016. We expect a temporary improvement in Texhong Textile's gross margin in 2016, which should revert to normal in 2017 with the cotton prices stabilized. Currently the cotton price is ~Rmb16,000; further room for rebound still exists (price once peaked at ~Rmb20,000 before). Thus, we assumed a 4% YoY growth in cotton price as the basic situation in 2017, leading to a 3.9% expected YoY growth in ASP.

Figure 21: 2017e sensitivity analysis: cotton price to revenue and net profit

| Cotton price +/- | ASP +/- | Revenue (Rmb mn) | YoY | vs. basic situation | Net profit (Rmb mn) | YoY | vs. basic situation |
|------------------|---------|------------------|-------|---------------------|---------------------|-------|---------------------|
| -4.0% | -3.8% | 14,620 | 9.9% | -7.2% | 1,191 | 3.5% | -9.2% |
| 0.0% | 0.0% | 15,202 | 14.3% | -3.5% | 1,253 | 8.9% | -4.4% |
| +4.0% | +3.9% | 15,747 | 18.4% | - | 1,311 | 14.0% | - |
| +8.0% | +7.8% | 16,468 | 23.8% | 4.6% | 1,378 | 19.7% | 5.1% |

Source: Company data, CICC Research



Figure 22: Key revenue assumptions

| (Rmb mn) | 2011A | 2012A | 2013A | 2014A | 2015A | 2016E | 2017E | 2018E |
|----------------------------------------------|--------------|--------------|--------------|---------------|---------------|---------------|---------------|---------------|
| Revenue | 6,873 | 7,341 | 8,229 | 10,470 | 10,575 | 13,300 | 15,747 | 18,102 |
| YoY | - | 6.8% | 12.1% | 27.2% | 1.0% | 25.8% | 18.4% | 15.0% |
| Cost of sales | -6,317 | -6,217 | -6,645 | -9,176 | -8,669 | -10,717 | -12,749 | -14,661 |
| Gross profit | 556 | 1,124 | 1,583 | 1,294 | 1,906 | 2,583 | 2,999 | 3,441 |
| Gross margin | 8.1% | 15.3% | 19.2% | 12.4% | 18.0% | 19.4% | 19.0% | 19.0% |
| Yarn | | | | | | | | |
| Revenue | 5,790 | 6,147 | 7,212 | 9,623 | 9,835 | 12,648 | 15,113 | 17,476 |
| YoY | - | 6.2% | 17.3% | 33.4% | 2.2% | 28.6% | 19.5% | 15.6% |
| Cost of sales | -5,308 | -5,134 | -5,719 | -8,403 | -8,025 | -10,154 | -12,202 | -14,122 |
| Gross profit | 481 | 1,013 | 1,493 | 1,220 | 1,810 | 2,494 | 2,911 | 3,355 |
| Gross margin | 8.3% | 16.5% | 20.7% | 12.7% | 18.4% | 19.7% | 19.3% | 19.2% |
| Stretchable core-spun yarns: cotton | 153 | 510 | 694 | 462 | 574 | 784 | 964 | 1,154 |
| Gross margin | 6.3% | 18.3% | 23.3% | 13.7% | 18.3% | 19.8% | 19.0% | 19.0% |
| Stretchable core-spun yarns: denim | 86 | 186 | 297 | 215 | 345 | 496 | 580 | 651 |
| Gross margin | 13.6% | 18.4% | 24.3% | 16.8% | 23.0% | 24.7% | 23.8% | 23.5% |
| Stretchable core-spun yarns: synthetic fiber | 86 | 82 | 116 | 93 | 133 | 189 | 210 | 239 |
| Gross margin | 13.7% | 13.8% | 15.8% | 13.4% | 17.4% | 19.4% | 18.4% | 18.4% |
| Other yarns: cotton | -10 | 50 | 122 | 164 | 328 | 459 | 531 | 603 |
| Gross margin | -1.9% | 11.2% | 14.2% | 9.2% | 18.9% | 20.4% | 20.0% | 19.9% |
| Other yarns: denim | 66 | 107 | 159 | 179 | 246 | 321 | 386 | 436 |
| Gross margin | 7.3% | 13.2% | 19.3% | 12.6% | 16.6% | 16.6% | 16.6% | 16.6% |
| Other yarns: synthetic fiber | 100 | 78 | 104 | 108 | 182 | 244 | 240 | 272 |
| Gross margin | 14.7% | 15.6% | 17.6% | 10.0% | 15.1% | 16.1% | 16.2% | 16.2% |
| Capacity (0,000 spindles) | 100 | 100 | 184 | 216 | 220 | 300 | 345 | 395 |
| YoY | - | 0.0% | 84.0% | 17.4% | 1.9% | 36.5% | 15.0% | 14.3% |
| Output (0,000 tonnes) | 18.98 | 24.29 | 28.41 | 43.16 | 47.69 | 60.00 | 69.00 | 76.86 |
| Utilization rate | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |
| Sales volume (0,000 tonnes) | 18.98 | 24.29 | 28.41 | 43.16 | 47.69 | 60.00 | 69.00 | 76.86 |
| YoY | - | 28.0% | 17.0% | 51.9% | 10.5% | 25.8% | 15.0% | 11.4% |
| ASP (Rmb/tonne) | 30,502 | 25,308 | 25,385 | 22,296 | 20,622 | 21,081 | 21,903 | 22,737 |
| YoY | - | -17.0% | 0.3% | -12.2% | -7.5% | 2.2% | 3.9% | 3.8% |
| Stretchable core-spun yarns: cotton | 34,415 | 27,598 | 27,598 | 24,325 | 22,453 | 23,576 | 25,344 | 27,245 |
| YoY | - | -19.8% | 0.0% | -11.9% | -7.7% | 5.0% | 7.5% | 7.5% |
| Stretchable core-spun yarns: denim | 30,794 | 25,503 | 25,655 | 23,919 | 22,862 | 23,091 | 23,552 | 24,023 |
| YoY | - | -17.2% | 0.6% | -6.8% | -4.4% | 1.0% | 2.0% | 2.0% |
| Stretchable core-spun yarns: synthetic fiber | 27,010 | 23,504 | 24,092 | 22,395 | 22,510 | 22,735 | 23,190 | 23,654 |
| YoY | - | -13.0% | 2.5% | -7.0% | 0.5% | 1.0% | 2.0% | 2.0% |
| Other yarns: cotton | 29,705 | 23,591 | 25,434 | 21,283 | 18,394 | 18,762 | 19,231 | 19,712 |
| YoY | - | -20.6% | 7.8% | -16.3% | -13.6% | 2.0% | 2.5% | 2.5% |
| Other yarns: denim | 27,839 | 22,355 | 21,576 | 19,684 | 17,753 | 17,931 | 18,199 | 18,472 |
| YoY | - | -19.7% | -3.5% | -8.8% | -9.8% | 1.0% | 1.5% | 1.5% |
| Other yarns: synthetic fiber | 26,557 | 22,837 | 22,739 | 20,447 | 20,336 | 20,458 | 20,765 | 21,076 |
| YoY | - | -14.0% | -0.4% | -10.1% | -0.5% | 0.6% | 1.5% | 1.5% |
| Grey fabrics | | | | | | | | |
| Revenue | 966 | 1,028 | 865 | 701 | 545 | 529 | 530 | 530 |
| YoY | - | 6.4% | -15.9% | -19.0% | -22.2% | -3.0% | 0.1% | -0.1% |
| Cost of sales | -912 | -942 | -800 | -652 | -481 | -463 | -461 | -461 |
| Gross profit | 54 | 86 | 65 | 49 | 64 | 66 | 69 | 69 |
| Gross margin | 5.6% | 8.3% | 7.5% | 7.0% | 11.7% | 12.6% | 13.0% | 13.0% |
| Sales volume (million meters) | 79.20 | 89.70 | 85.70 | 73.50 | 59.60 | 59.16 | 59.50 | 60.00 |
| ASP (Rmb/meter) | 12.19 | 11.46 | 10.09 | 9.53 | 9.15 | 8.95 | 8.90 | 8.82 |
| YoY | - | -6.0% | -12.0% | -5.5% | -4.0% | -2.2% | -0.5% | -0.9% |
| Garment fabrics | | | | | | | | |
| Revenue | 117 | 167 | 152 | 147 | 194 | 122 | 105 | 96 |
| YoY | - | 42.3% | -8.8% | -3.5% | 32.3% | -37.0% | -14.5% | -7.9% |
| Cost of sales | -97 | -141 | -127 | -122 | -160 | -100 | -86 | -79 |
| Gross profit | 20 | 26 | 25 | 25 | 34 | 22 | 19 | 17 |
| Gross margin | 16.8% | 15.6% | 16.2% | 16.9% | 17.5% | 18.0% | 18.0% | 18.0% |
| Sales volume (million meters) | 5.80 | 9.50 | 7.70 | 7.50 | 9.40 | 6.58 | 5.92 | 5.63 |
| YoY | - | 63.8% | -18.9% | -2.6% | 25.3% | -30.0% | -10.0% | -5.0% |
| ASP (Rmb/meter) | 20.20 | 17.55 | 19.74 | 19.56 | 20.65 | 18.58 | 17.65 | 17.12 |
| YoY | - | -13.1% | 12.5% | -0.9% | 5.6% | -10.0% | -5.0% | -3.0% |

Source: Company data, CICC Research



Figure 23: Income statement projection

| (Rmb mn) | 2011A | 2012A | 2013A | 2014A | 2015A | 2016E | 2017E | 2018E |
|---------------------------------|------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|
| Income Statement | | | | | | | | |
| Revenue | 6,873 | 7,341 | 8,229 | 10,470 | 10,575 | 13,300 | 15,747 | 18,102 |
| YoY | - | 6.8% | 12.1% | 27.2% | 1.0% | 25.8% | 18.4% | 15.0% |
| Cost of sales | -6,317 | -6,217 | -6,645 | -9,176 | -8,669 | -10,717 | -12,749 | -14,661 |
| Gross profit | 556 | 1,124 | 1,583 | 1,294 | 1,906 | 2,583 | 2,999 | 3,441 |
| Gross margin | 8.1% | 15.3% | 19.2% | 12.4% | 18.0% | 19.4% | 19.0% | 19.0% |
| Other income | 22 | 6 | 31 | 16 | 10 | 13 | 15 | 17 |
| Other gains & losses | -59 | -23 | 285 | -30 | -16 | 50 | -30 | -50 |
| Selling & distribution expenses | -152 | -203 | -234 | -352 | -369 | -437 | -520 | -615 |
| Administrative expenses | -209 | -227 | -308 | -328 | -381 | -452 | -536 | -634 |
| Operating profit | 158 | 677 | 1,357 | 600 | 1,150 | 1,756 | 1,929 | 2,159 |
| Operating margin | 2.3% | 9.2% | 16.5% | 5.7% | 10.9% | 13.2% | 12.2% | 11.9% |
| Share of result of a JV | 3 | 4 | 5 | 4 | 4 | 4 | 5 | 5 |
| Finance costs | -78 | -123 | -122 | -249 | -419 | -395 | -377 | -405 |
| Profit before taxation | 83 | 557 | 1,240 | 355 | 736 | 1,365 | 1,556 | 1,759 |
| Income tax expense | -22 | -71 | -114 | -48 | -147 | -218 | -249 | -281 |
| Effective tax rate | 26.6% | 12.8% | 9.2% | 13.6% | 20.0% | 16.0% | 16.0% | 16.0% |
| Profit for the year | 61 | 486 | 1,126 | 307 | 589 | 1,147 | 1,307 | 1,477 |
| Net income | 61 | 487 | 1,126 | 307 | 591 | 1,150 | 1,311 | 1,482 |
| YoY | - | 694.3% | 131.4% | -72.8% | 92.6% | 94.7% | 14.0% | 13.0% |
| Net margin | 0.9% | 6.6% | 13.7% | 2.9% | 5.6% | 8.6% | 8.3% | 8.2% |
| Noncontrolling interests | 0 | 0 | 0 | 0 | -2 | -4 | -4 | -5 |
| As a % of total profit | 0.0% | 0.0% | 0.0% | 0.0% | 0.3% | 0.3% | 0.3% | 0.3% |

Source: Company data, CICC Research

Figure 24: Statement of cash flows projection

| (Rmb mn) | 2011A | 2012A | 2013A | 2014A | 2015A | 2016E | 2017E | 2018E |
|--------------------------------------------------------------|-------------|-------------|-------------|--------------|---------------|---------------|---------------|---------------|
| Statement of Cash Flows | | | | | | | | |
| Cash Flow from Operating Activities: | | | | | | | | |
| Profit before taxation | 83 | 557 | 1,240 | 355 | 736 | 1,365 | 1,556 | 1,759 |
| Financial costs | 78 | 123 | 122 | 249 | 419 | 395 | 377 | 405 |
| Depreciation & Amortization | 176 | 205 | 268 | 398 | 455 | 549 | 633 | 712 |
| Change in fair value of derivative financial instruments | 39 | 20 | -12 | 3 | -6 | 0 | 0 | 0 |
| Gain on acquisition of a subsidiary | 0 | 0 | -265 | 0 | -69 | 0 | 0 | 0 |
| Share of result of a JV | -3 | -4 | -5 | -4 | -4 | -4 | -5 | -5 |
| (Gain) loss on disposal of PP&E | 2 | 4 | 11 | 2 | 4 | 0 | 0 | 0 |
| Amortisation of share option scheme | 0 | 0 | 0 | 0 | 10 | 0 | 0 | 0 |
| Changes in W.C. | -319 | 59 | -551 | 116 | 253 | -71 | -50 | -117 |
| Income tax paid | -100 | -55 | -88 | -78 | -112 | -218 | -249 | -281 |
| Operating cash flows | -36 | 924 | 729 | 1,045 | 1,697 | 2,031 | 2,284 | 2,500 |
| Cash Flow from Investing Activities: | | | | | | | | |
| Deposits for investment | 0 | 0 | 0 | 0 | -17 | 0 | 0 | 0 |
| Addition of PP&E | -421 | -572 | -936 | -607 | -935 | -1,185 | -1,010 | -1,054 |
| Purchases of land use rights | -39 | -84 | -32 | 0 | -171 | -150 | -100 | -100 |
| Proceeds from disposal of PP&E | 19 | 11 | 10 | 22 | 7 | 0 | 0 | 0 |
| Acquisition of a subsidiary | 0 | 0 | 16 | 0 | -2 | 0 | 0 | 0 |
| Investing cash flows | -441 | -645 | -942 | -585 | -1,119 | -1,335 | -1,110 | -1,154 |
| Cash Flow from Financing Activities: | | | | | | | | |
| Interests paid | -127 | -141 | -163 | -253 | -235 | -411 | -398 | -432 |
| Dividends paid | -199 | 0 | -326 | -232 | -143 | -225 | -362 | -411 |
| Placement of pledged bank deposits | 3 | 10 | -5 | -17 | -204 | -25 | -27 | -30 |
| Proceeds from capital injection by non-controlling interests | 0 | 0 | 0 | 0 | 8 | 0 | 0 | 0 |
| New bank borrowings raised (net) | 692 | -81 | 1,096 | 216 | 842 | 608 | 466 | 513 |
| Financing cash flows | 371 | -212 | 601 | -285 | 268 | -89 | -338 | -376 |
| Net increase in cash & cash equivalents | -106 | 67 | 389 | 175 | 846 | 607 | 836 | 970 |
| BB of cash & cash equivalents | 569 | 463 | 530 | 919 | 1,094 | 1,940 | 2,547 | 3,383 |
| EB of cash & cash equivalents | 463 | 530 | 919 | 1,094 | 1,940 | 2,547 | 3,383 | 4,353 |

Source: Company data, CICC Research



Figure 25: Balance sheet projections

| (Rmb mn) | 2011A | 2012A | 2013A | 2014A | 2015A | 2016E | 2017E | 2018E |
|---------------------------------------------|--------------|--------------|--------------|--------------|---------------|---------------|---------------|---------------|
| Balance Sheet | | | | | | | | |
| Current Assets: | | | | | | | | |
| Bank balances and cash | 463 | 530 | 919 | 1,094 | 1,940 | 2,547 | 3,383 | 4,353 |
| Pledged bank deposits | 32 | 22 | 27 | 44 | 248 | 272 | 300 | 330 |
| Derivative financial instruments | 0 | 0 | 13 | 0 | 61 | 61 | 61 | 61 |
| Other receivables, deposits and prepayments | 233 | 237 | 352 | 291 | 454 | 482 | 626 | 648 |
| Trade and bills receivables | 640 | 812 | 963 | 1,320 | 1,032 | 1,519 | 1,242 | 1,932 |
| Inventories | 1,289 | 1,422 | 2,280 | 1,636 | 1,893 | 2,217 | 2,882 | 2,982 |
| Total current assets | 2,657 | 3,023 | 4,555 | 4,385 | 5,627 | 7,099 | 8,494 | 10,306 |
| Non-current Assets: | | | | | | | | |
| PP&E | 1,992 | 2,229 | 3,804 | 4,158 | 4,998 | 5,645 | 6,034 | 6,390 |
| Land use rights | 186 | 265 | 395 | 385 | 552 | 691 | 779 | 865 |
| Interest in a JV | 47 | 51 | 56 | 60 | 64 | 68 | 73 | 78 |
| Deferred tax assets | 50 | 57 | 135 | 152 | 161 | 161 | 161 | 161 |
| Total non-current assets | 2,274 | 2,602 | 4,390 | 4,754 | 5,774 | 6,565 | 7,047 | 7,493 |
| Total assets | 4,930 | 5,625 | 8,944 | 9,139 | 11,401 | 13,664 | 15,540 | 17,799 |
| Current Liabilities: | | | | | | | | |
| Trade/bills payables | 502 | 865 | 2,010 | 1,666 | 2,295 | 2,990 | 3,297 | 3,934 |
| Other payables and accrued charges | 417 | 309 | 395 | 442 | 619 | 692 | 867 | 926 |
| Obligations under finance leases | 0 | 0 | 55 | 116 | 124 | 129 | 123 | 117 |
| Bank borrowings | 144 | 206 | 166 | 236 | 1,548 | 1,398 | 1,538 | 1,692 |
| Derivative financial instruments | 45 | 61 | 43 | 27 | 13 | 13 | 13 | 13 |
| Tax payable | -14 | 3 | 17 | 4 | 28 | 28 | 28 | 28 |
| Total current liabilities | 1,094 | 1,444 | 2,686 | 2,491 | 4,625 | 5,251 | 5,866 | 6,709 |
| Non-current Liabilities: | | | | | | | | |
| Obligation under finance leases | 0 | 0 | 179 | 338 | 236 | 194 | 184 | 175 |
| Bank borrowings | 1,712 | 1,564 | 2,623 | 2,779 | 2,505 | 3,263 | 3,589 | 3,948 |
| Deferred tax liabilities | 52 | 59 | 76 | 76 | 96 | 96 | 96 | 96 |
| Total non-current liabilities | 1,765 | 1,623 | 2,878 | 3,193 | 2,837 | 3,553 | 3,870 | 4,219 |
| Total liabilities | 2,858 | 3,067 | 5,564 | 5,684 | 7,463 | 8,804 | 9,735 | 10,928 |
| Equity: | | | | | | | | |
| Capital | 94 | 94 | 94 | 94 | 94 | 94 | 94 | 94 |
| Reserves | 1,978 | 2,464 | 3,286 | 3,361 | 3,817 | 4,742 | 5,691 | 6,762 |
| Non-controlling interests | 0 | 0 | 0 | 0 | 27 | 24 | 20 | 15 |
| Total equity | 2,072 | 2,558 | 3,380 | 3,455 | 3,939 | 4,860 | 5,805 | 6,871 |

Source: Company data, CICC Research

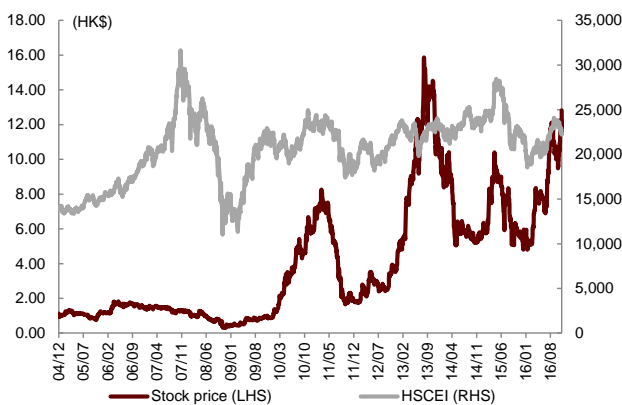


Valuation and investment recommendation

Texhong Textile has been trading at single-digit 1-year forward P/E since its IPO, while the historical P/E multiple of other comparable peers are in double digits. The cheap valuation was due to the fluctuations in financial results and the valuation discount that HK-listed industrial stocks historically suffer. The company's stock price has been volatile since listing, climbing rapidly in 1) March 2010~March 2011, 2) December 2012~September 2013, and 3) January 2016 until now; and it declined in 1) March 2011~November 2011, and 2) September 2013~May 2014. All these up-and-downs are driven by the interim/annual financial results, which are sensitive to cotton price fluctuations.

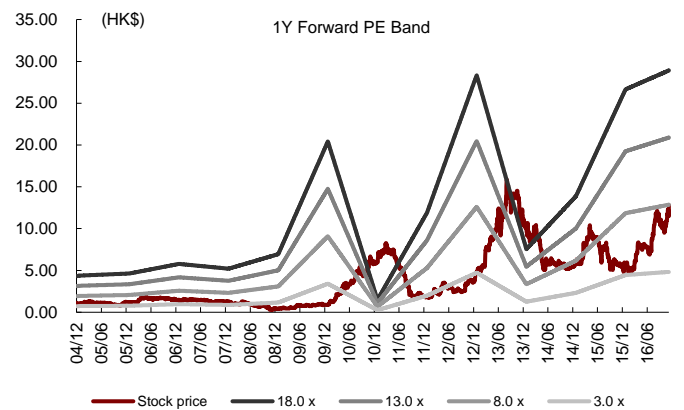
Excluding non-recurring shocks in net profit in 2008 and 2011, Texhong Textile's dividend payout ratio has remained at ~30%. **Given its inexpensive valuation, the high dividend payout could translate into an attractive dividend yield, perhaps hitting 3.6% for 2016.**

Figure 26: Historical stock price



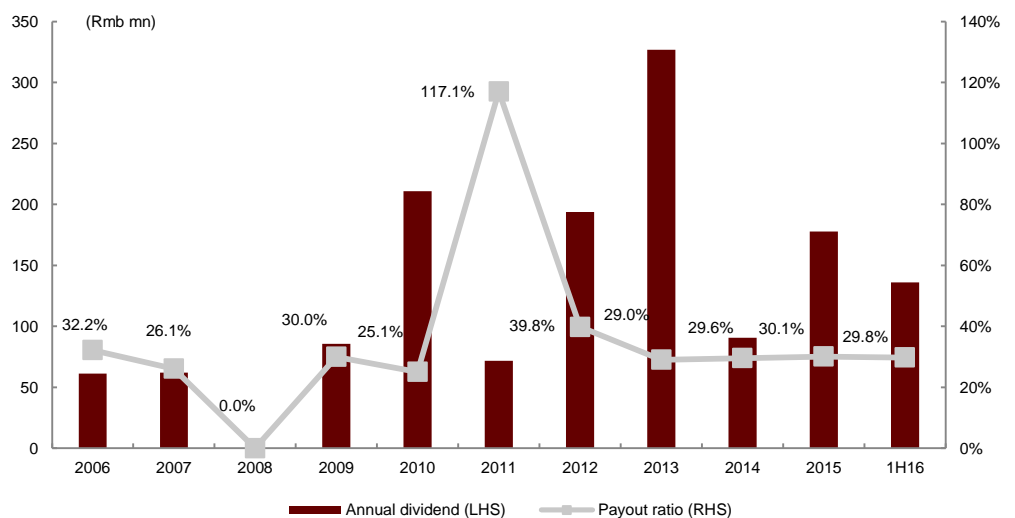
Source: Bloomberg, CICC Research

Figure 27: Historical P/E Band



Source: Bloomberg, company data, CICC Research

Figure 28: Dividend payout trend



Source: Company data, CICC Research



Initiate with a BUY rating, TP at HK\$14.01

We believe that Texhong Textile's future growth opportunities lie in: 1) product innovation, driven by its cutting-edge R&D capabilities; 2) rich production capacity to be realized by its geographically diversified production plants; and 3) vertical consolidation along the textile industry chain.

Listed apparel material providers are trading at 14/12x (Hong Kong listed), 15/14x (A-share listed) and 20/17x (Taiwan listed) 2016/17e P/E. **Texhong Textile, together with Best Pacific International** (intimate wear material producer) **and Shenzhou International** (garment OEM), **are typical companies featuring strong research and development arms along the textile industrial chain, and they should enjoy a valuation premium to their peers**, given that the production of garment materials is a technology-driven sector.

Given the advantage in R&D as well as its significant economy of scales effect, **we give Texhong Textile a 9x 2017e P/E multiple and a target price of HK\$14.01, implying 31% upside potential. Initiate with a BUY rating.**

Figure 29: Comparable valuations

| Ticker | Company | Price (local currency) | Mkt cap (mn) | Net profit (mn, report currency) | | | | | EPS (report currency) | | | P/E | | | 2015-17 Net profit CAGR | PEG | |
|-----------------------------------|--------------------|---------------------------|-----------------|----------------------------------|------|-------|------|-------|-----------------------|-------|-------|-------|-------|-------|----------------------------|-------|-------|
| | | | | 2015A | YoY | 2016E | YoY | 2017E | YoY | 2015A | 2016E | 2017E | 2015A | 2016E | | | 2017E |
| Hong Kong listed companies | | | | | | | | | | | | | | | | | |
| 2678.HK | Texhong Textile | 10.74 | 9,827 | 591 | 93% | 1,150 | 95% | 1,311 | 14% | 0.65 | 1.26 | 1.43 | 13.9 | 7.6 | 6.9 | 49% | 0.3 |
| 1382.HK | Pacific Textile | 8.75 | 12,656 | 1,126 | 5% | 1,201 | 7% | 1,297 | 8% | 0.78 | 0.83 | 0.90 | 11.2 | 10.5 | 9.8 | 7% | 1.5 |
| 2313.HK | Shenzhou Int'l | 47.25 | 66,103 | 2,355 | 14% | 2,954 | 25% | 3,481 | 18% | 1.68 | 2.11 | 2.49 | 23.5 | 20.0 | 17.5 | 22% | 1.1 |
| 2111.HK | Best Pacific Int'l | 6.98 | 7,178 | 342 | 39% | 425 | 24% | 511 | 20% | 0.33 | 0.41 | 0.50 | 21.0 | 16.9 | 14.0 | 22% | 0.9 |
| A-share listed companies | | | | | | | | | | | | | | | | | |
| 000726.SZ | Luthai A | 12.86 | 11,865 | 712 | -26% | 789 | 11% | 864 | 10% | 0.77 | 0.86 | 0.94 | 16.7 | 15.0 | 13.7 | 10.2% | 1.6 |
| Taiwan listed companies | | | | | | | | | | | | | | | | | |
| 1477.TW | Makalot Industrial | 121.00 | 24,066 | 2,159 | 27% | 1,712 | -21% | 1,709 | 0% | 10.86 | 8.61 | 8.59 | 11.1 | 14.1 | 14.1 | -11% | n.m. |
| 1476.TW | Eclat Textile | 331.50 | 89,169 | 4,174 | 39% | 3,579 | -14% | 4,466 | 25% | 15.52 | 13.31 | 16.60 | 21.4 | 24.9 | 20.0 | 3% | 6.2 |

Note: Highlighted companies are covered by CICC; other estimates are market consensus

Source: Company data, Bloomberg, Wind Info, CICC Research.



Risks

1. Fluctuations in cotton prices
2. Policy risks related to TPP
3. Production capacity ramp-up slower than expected
4. Sluggish demand for downstream brands.



Important legal disclosures

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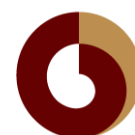
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