

Lee & Man Paper Manufacturing (2314 HK)

 Target price: **HKD9.50** (from HKD8.50)

 Share price (21 Aug): **HKD8.23** | Up/downside: **+15.4%**

 5 4 3 **2** 1
Outperform
 (unchanged)

Tissue paper business still delivering

- Tissue paper business shaping up to be a strong profit driver
- No new capacity additions announced; positive for industry dynamics
- Raising TP to HKD9.50; reiterating Outperform (2)

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What's new: As already indicated in its profit alert, Lee & Man (L&M) posted a record set of 1H17 results. While 2H17 looks on track for another set of strong results, we believe the visibility into 2018 is weakening. That said, the company's new tissue paper business is shaping up to be a potential long-term profit driver that can help reduce earnings volatility.

What's the impact: Tissue paper. We believe the biggest positive surprise in the 1H17 results was the strong profitability of the tissue paper business, which delivered a net profit per tonne of HKD964 (vs. HKD654 for 1H16). This is already close to the HKD1,000 per tonne target we expect the company to achieve over the long term under a bull-case scenario. However, we are still cautious whether this is a representative run-rate going forward since: 1) the volume in 1H17 remains very small (157k tonnes vs. the 795k tonnes in planned total capacity by end-2018), 2) almost all of the sales in 1H17 were still from one market (Chongqing, but L&M is starting to venture into Jiangxi and Guangdong), and 3) the company still supplied most of its bamboo pulp requirements via its own pulping machine in Chongqing, but it would need to buy externally going forward. Nonetheless, given the strong initial results, we continue to believe that the tissue paper business will remain margin-accretive over the long run and could eventually be a source of diversification for the company.

Containerboard. The net profit per tonne for containerboard in 1H17 was HKD782, a 45% YoY jump. While we believe a HKD700+ level is achievable in 2017, this is likely not sustainable in the long term, as its record results were due mainly to the concentrated and sharp price hikes over a short period of time. We note that China OCC prices have risen by c.20% since end-1H17, while international OCC prices have declined by c.10%. We believe a sizable swing factor in 2H17 profitability would be L&M's ability to shift its OCC mix towards more international OCC. Despite the record profitability, L&M did not announce new production capacities for either containerboard or tissue paper, which we believe is positive for the near-term sentiment on supply/demand dynamics.

What we recommend: We raise our 2017-19E EPS by 1-19% after adjusting our margin assumptions. We raise our 12-month target price to HKD9.50 (from HKD8.50), based on an unchanged 10x PER (roughly 10% below our target multiple for NDP) applied to the average of our now-revised 2017-18E EPS. We reiterate our Outperform (2) rating. Key risk: a sustained rise in raw-material prices.

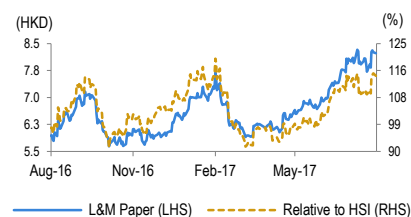
How we differ: Our 2017E EPS is largely in line with consensus, while our 2018-19E EPS are within 3% likely differing mainly on OCC assumptions.

Forecast revisions (%)

Year to 31 Dec	17E	18E	19E
Revenue change	1.8	3.6	4.7
Net profit change	18.9	5.5	1.1
Core EPS (FD) change	18.9	5.5	1.1

Source: Daiwa forecasts

Share price performance



12-month range	5.64-8.33
Market cap (USDbn)	4.76
3m avg daily turnover (USDm)	8.47
Shares outstanding (m)	4,520
Major shareholder	Lee family (68.0%)

Financial summary (HKD)

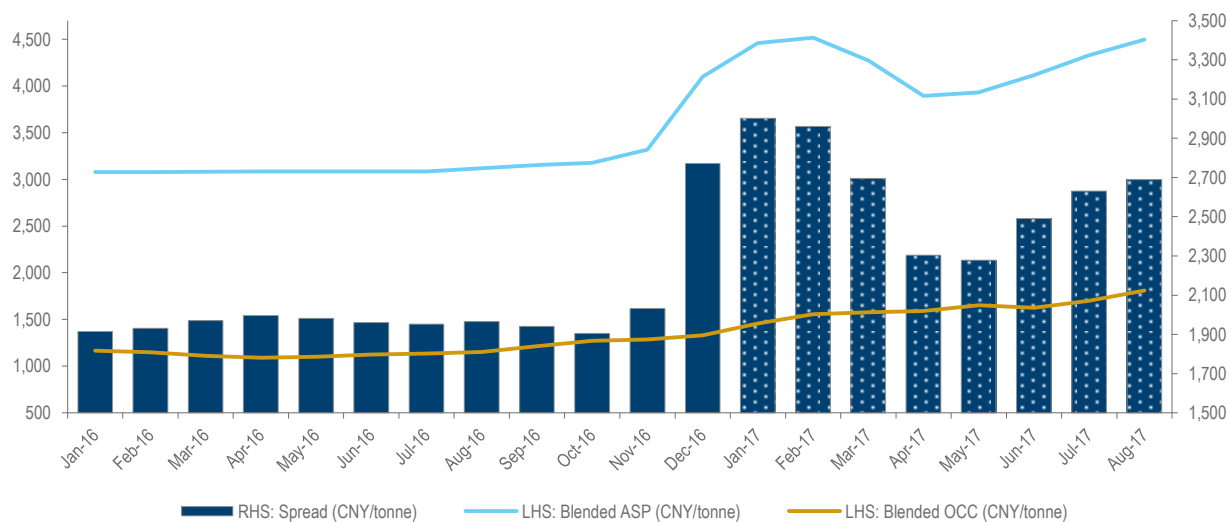
Year to 31 Dec	17E	18E	19E
Revenue (m)	25,661	29,418	31,715
Operating profit (m)	5,196	5,477	5,351
Net profit (m)	4,195	4,373	4,241
Core EPS (fully-diluted)	0.928	0.968	0.938
EPS change (%)	49.3	4.3	(3.0)
Daiwa vs Cons. EPS (%)	(1.3)	2.8	(3.2)
PER (x)	8.9	8.5	8.8
Dividend yield (%)	3.9	4.1	4.0
DPS	0.323	0.339	0.328
PBR (x)	1.9	1.7	1.5
EV/EBITDA (x)	8.3	7.7	7.5
ROE (%)	23.1	20.9	17.8

Source: FactSet, Daiwa forecasts

Lee & Man Paper: key changes to Daiwa forecasts

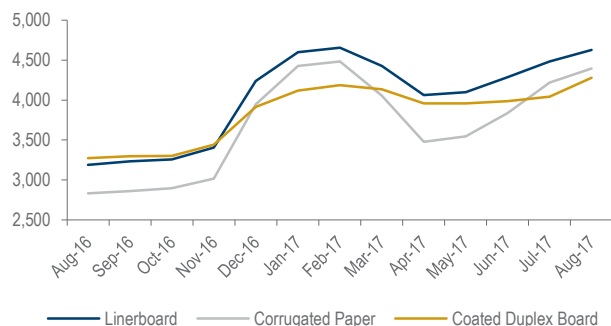
	New	2017E Old	Change	New	2018E Old	Change	New	2019E Old	Change
Containerboard sales volume (m tonnes)	5.5	5.5	1%	5.7	5.6	2%	6.1	5.8	4%
Containerboard ASP (HKD/tonne)	4,139	4,147	0%	4,323	4,330	0%	4,323	4,330	0%
Tissue sales volume (000s tonnes)	397	356	12%	676	582	16%	755	636	19%
Tissue ASP (HKD/tonne)	6,751	6,751	0%	6,886	7,089	-3%	7,024	7,797	-10%
Revenue:									
Linerboard + Testliner	19,774	19,218	3%	21,586	20,646	5%	23,283	21,534	8%
Corrugating medium	1,166	1,697	-31%	1,182	1,803	-34%	1,184	1,881	-37%
Coated duplex board	2,022	1,839	10%	1,997	1,832	9%	1,943	1,911	2%
Total Containerboard	22,963	22,754	1%	24,764	24,282	2%	26,410	25,326	4%
Tissue	2,682	2,405	12%	4,653	4,127	13%	5,305	4,959	7%
Total	25,661	25,200	2%	29,418	28,409	4%	31,715	30,285	5%
Gross profit	6,200	5,426	14%	6,761	6,486	4%	6,801	6,719	1%
Gross profit per tonne	1,042	927	12%	1,056	1,048	1%	991	1,036	-4%
Adj. operating profit	5,196	4,355	19%	5,477	5,148	6%	5,351	5,227	2%
Adjusted net earnings	4,195	3,528	19%	4,373	4,147	5%	4,241	4,193	1%
Adjusted Net Dollar Margin per Tonne	705	603	17%	683	670	2%	618	646	-4%

Source: Daiwa forecasts

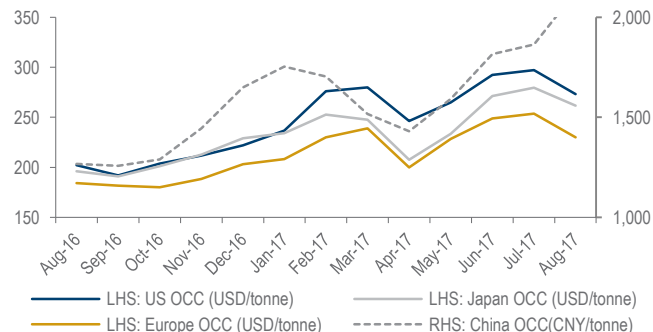
Daiwa's monthly spread simulation for packaging paper


Source: Daiwa estimates

Note: this simulation serves only as a proxy of the monthly movement of the spread between paper ASPs and OCC costs. August's simulations were based on available data until 18 August, 2017

1-year paper price trends in China in CNY/tonne (average)


Source: WIND, Daiwa

1-year-global OCC price trend (average)


Source: WIND, Daiwa

Financial summary

Key assumptions

Year to 31 Dec	2012	2013	2014	2015	2016	2017E	2018E	2019E
Total containerboard capacity (mmtpa)	4.59	4.91	5.23	5.23	5.23	6.03	6.03	6.43
Total tissue capacity (mmtpa)	0.00	0.00	0.00	0.14	0.36	0.69	0.80	0.80
Blended ASP (HKD/tonne)	3,546	3,435	3,377	3,239	3,258	4,314	4,593	4,621
Total COGS per tonne (HKD/tonne)	2,673	2,592	2,519	2,347	2,303	2,921	3,103	3,129
Total borrowing (HKDm)	9,074	10,959	12,861	14,262	13,547	14,500	16,000	17,000
Adj. net profit per tonne (HKD/tonne)	409	393	383	435	505	705	683	618

Profit and loss (HKDm)

Year to 31 Dec	2012	2013	2014	2015	2016	2017E	2018E	2019E
Linerboard + Testliner	9,418	13,166	13,237	13,576	14,334	19,774	21,586	23,283
Corrugating medium	1,073	1,356	1,547	1,547	1,240	1,166	1,182	1,184
Other Revenue	933	2,448	2,315	2,493	2,768	4,720	6,650	7,248
Total Revenue	11,424	16,970	17,099	17,616	18,342	25,661	29,418	31,715
Other income	263	370	410	418	528	613	599	612
COGS	(9,473)	(14,084)	(14,028)	(14,037)	(14,261)	(19,461)	(22,656)	(24,914)
SG&A	(660)	(934)	(1,039)	(1,069)	(1,127)	(1,617)	(1,883)	(2,061)
Other op. expenses	0	0	0	0	0	0	0	0
Operating profit	1,553	2,322	2,443	2,927	3,481	5,196	5,477	5,351
Net-interest inc./(exp.)	(58)	(139)	(198)	(145)	(149)	(206)	(271)	(303)
Assoc/forex/extraord./others	3	9	(36)	(32)	22	(18)	0	0
Pre-tax profit	1,498	2,192	2,209	2,751	3,354	4,972	5,206	5,048
Tax	(177)	(244)	(305)	(418)	(491)	(796)	(833)	(808)
Min. int./pref. div./others	0	0	0	0	0	0	0	0
Net profit (reported)	1,321	1,948	1,904	2,332	2,863	4,177	4,373	4,241
Net profit (adjusted)	1,317	1,940	1,940	2,364	2,841	4,195	4,373	4,241
EPS (reported)(HKD)	0.282	0.415	0.407	0.504	0.627	0.924	0.968	0.938
EPS (adjusted)(HKD)	0.281	0.413	0.414	0.511	0.622	0.928	0.968	0.938
EPS (adjusted fully-diluted)(HKD)	0.279	0.412	0.414	0.511	0.622	0.928	0.968	0.938
DPS (HKD)	0.102	0.123	0.141	0.160	0.205	0.323	0.339	0.328
EBIT	1,553	2,322	2,443	2,927	3,481	5,196	5,477	5,351
EBITDA	2,024	3,002	3,275	3,798	4,422	6,161	6,520	6,442

Cash flow (HKDm)

Year to 31 Dec	2012	2013	2014	2015	2016	2017E	2018E	2019E
Profit before tax	1,498	2,192	2,209	2,751	3,354	4,972	5,206	5,048
Depreciation and amortisation	471	680	833	871	941	965	1,043	1,091
Tax paid	(97)	(162)	(141)	(243)	(263)	(796)	(833)	(808)
Change in working capital	597	(1,280)	(256)	339	204	(1,359)	(1,222)	(464)
Other operational CF items	(137)	(158)	(103)	(175)	(315)	(71)	102	199
Cash flow from operations	2,333	1,272	2,541	3,542	3,922	3,711	4,297	5,066
Capex	(1,563)	(2,272)	(2,050)	(3,000)	(3,501)	(3,600)	(1,600)	(1,600)
Net (acquisitions)/disposals	0	0	0	0	0	0	0	0
Other investing CF items	(97)	(56)	(268)	14	(204)	(20)	110	10
Cash flow from investing	(1,660)	(2,328)	(2,318)	(2,986)	(3,705)	(3,620)	(1,490)	(1,590)
Change in debt	(510)	1,857	1,871	1,523	(619)	953	1,500	1,000
Net share issues/(repurchases)	0	0	0	0	0	0	0	0
Dividends paid	(244)	(578)	(660)	(739)	(934)	(1,462)	(1,531)	(1,484)
Other financing CF items	0	(184)	(111)	(411)	(199)	(216)	(281)	(313)
Cash flow from financing	(754)	1,094	1,100	372	(1,752)	(724)	(312)	(797)
Forex effect/others	7	15	(0)	(2)	(150)	0	0	0
Change in cash	(74)	53	1,322	926	(1,685)	(633)	2,495	2,680
Free cash flow	770	(1,000)	491	542	420	111	2,697	3,466

Source: FactSet, Daiwa forecasts

Financial summary continued ...

Balance sheet (HKDm)

As at 31 Dec	2012	2013	2014	2015	2016	2017E	2018E	2019E
Cash & short-term investment	657	711	2,033	2,959	1,274	641	3,136	5,815
Inventory	2,880	3,123	3,258	3,092	2,914	3,999	4,966	5,461
Accounts receivable	4,535	5,582	5,891	4,869	4,960	6,327	7,657	8,254
Other current assets	36	45	35	122	45	45	45	45
Total current assets	8,108	9,460	11,217	11,042	9,193	11,012	15,803	19,575
Fixed assets	18,790	20,830	22,465	23,351	24,312	26,947	27,504	28,013
Goodwill & intangibles	548	599	764	721	878	1,155	1,324	1,427
Other non-current assets	163	306	291	485	617	647	547	547
Total assets	27,609	31,195	34,737	35,599	35,000	39,761	45,178	49,562
Short-term debt	3,865	5,661	6,698	5,250	4,240	4,538	5,008	5,321
Accounts payable	3,309	3,165	3,262	3,043	3,549	4,265	5,152	5,665
Other current liabilities	87	83	357	156	174	174	174	174
Total current liabilities	7,261	8,909	10,317	8,449	7,964	8,978	10,334	11,161
Long-term debt	5,209	5,298	6,163	9,012	9,307	9,962	10,992	11,679
Other non-current liabilities	541	641	780	902	907	1,283	1,471	1,586
Total liabilities	13,011	14,848	17,260	18,363	18,177	20,223	22,797	24,426
Share capital	117	117	117	114	114	114	114	114
Reserves/R.E./others	14,481	16,229	17,360	17,122	16,709	19,424	22,267	25,023
Shareholders' equity	14,598	16,346	17,477	17,236	16,823	19,538	22,380	25,137
Minority interests	0	0	0	0	0	0	0	0
Total equity & liabilities	27,609	31,195	34,737	35,599	35,000	39,761	45,178	49,562
EV	45,616	47,446	48,026	48,503	49,472	51,059	50,064	48,384
Net debt/(cash)	8,416	10,249	10,828	11,304	12,273	13,859	12,864	11,185
BVPS (HKD)	3.113	3.483	3.734	3.728	3.681	4.323	4.951	5.561

Key ratios (%)

Year to 31 Dec	2012	2013	2014	2015	2016	2017E	2018E	2019E
Sales (YoY)	(22.4)	48.5	0.8	3.0	4.1	39.9	14.6	7.8
EBITDA (YoY)	(8.1)	48.3	9.1	15.9	16.4	39.3	5.8	(1.2)
Operating profit (YoY)	(5.1)	49.5	5.2	19.8	18.9	49.3	5.4	(2.3)
Net profit (YoY)	(3.5)	47.3	(0.0)	21.8	20.2	47.7	4.3	(3.0)
Core EPS (fully-diluted) (YoY)	(3.5)	47.9	0.5	23.3	21.6	49.3	4.3	(3.0)
Gross-profit margin	17.1	17.0	18.0	20.3	22.2	24.2	23.0	21.4
EBITDA margin	17.7	17.7	19.2	21.6	24.1	24.0	22.2	20.3
Operating-profit margin	13.6	13.7	14.3	16.6	19.0	20.2	18.6	16.9
Net profit margin	11.5	11.4	11.3	13.4	15.5	16.3	14.9	13.4
ROAE	9.4	12.5	11.5	13.6	16.7	23.1	20.9	17.8
ROAA	4.8	6.6	5.9	6.7	8.0	11.2	10.3	9.0
ROCE	6.6	9.1	8.5	9.5	11.3	16.1	15.1	13.3
ROIC	n.a.	8.3	7.7	8.7	10.3	14.0	13.4	12.6
Net debt to equity	57.7	62.7	62.0	65.6	73.0	70.9	57.5	44.5
Effective tax rate	11.8	11.1	13.8	15.2	14.6	16.0	16.0	16.0
Accounts receivable (days)	156.2	108.8	122.5	111.5	97.8	80.3	86.8	91.6
Current ratio (x)	1.1	1.1	1.1	1.3	1.2	1.2	1.5	1.8
Net interest cover (x)	26.6	16.8	12.3	20.2	23.3	25.3	20.2	17.7
Net dividend payout	36.2	29.6	34.7	31.7	32.7	35.0	35.0	35.0
Free cash flow yield	2.1	n.a.	1.3	1.5	1.1	0.3	7.2	9.3

Source: FactSet, Daiwa forecasts

Company profile

Lee & Man Paper (L&M) is China's second-largest paper producer in terms of production capacity. The company primarily produces linerboard, high-performance corrugating medium, and coated duplex board. In late 2014, it entered the tissue paper business. As of 30 June 2016, the aggregate design capacity of its paper machines was 5.63m tonnes.

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Disclosure of investment ratings

Rating	Percentage of total
Buy*	66.1%
Hold**	21.6%
Sell***	12.3%

Source: Daiwa

Notes: data is for single-branded Daiwa research in Asia (ex Japan) and correct as of 30 June 2017.

* comprised of Daiwa's Buy and Outperform ratings.

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