Daiwa Capital Markets

Sector

Consumer Discretionary / China
6 May 2013

The 10-second briefing

Production migration to ASEAN

- Drawn by low manufacturing costs and favourable tariffs, China's textile players are establishing production bases in Southeast Asia
- Upstream players look set to expand in ASEAN due to its improved infrastructure and supply chain, and lower cotton price
- We raise our target prices for Shenzhou International and Pacific Textiles, and initiate on Texhong Textile with a Buy (1) call

China Textile Sector

- **Positive** (unchanged)
- Neutral
- Negative

How do we justify our view?

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What's new

We believe the textile industry is going through a structural change, with the rapid rise in manufacturing costs in China putting pressure on companies to maintain their cost competitiveness by shifting production overseas. In this report we highlight the likely beneficiaries of production migration, favourable tariff treatment, and changing dynamics in the cotton market.

What's the impact

We believe it will be critical for textile companies to control their costs by gradually migrating their production bases to lower-cost regions or moving into the manufacture of higher value-added products. Eventually, we believe many of today's industry leaders will seek opportunities in Southeast Asia, in order to take advantage of lower manufacturing costs and tariffs.

Downstream players in the textile supply chain have been expanding in Southeast Asia for many years, paving the way for upstream players to step up their own manufacturing in the region. Southeast Asia is now an attractive option for upstream players (ie, spinners and fabric producers) to source cotton for less than they pay for domestic cotton, given the China government's price-support policy in its home market. The region's improving infrastructure and favourable tariff treatment only enhance its appeal for these companies.

What we recommend

We remain Positive on the China Textile sector.

We reiterate our Buy (1) call on Shenzhou International Group and raise our six-month target price to HKD27.8, on a new target PER of 14x applied to the average of our 2013 and 2014 EPS forecasts. Backed by strong demand from casual-wear clients such as UNIQLO and rising sales of its new polyester products, we forecast Shenzhou to return to earnings growth in 2013 (19% YoY). In addition, we believe the company is actively considering expanding its upstream capacity in Trans-Pacific Partnership (TPP) members such as Vietnam. Shenzhou is our top pick within the sector.

For Pacific Textiles, we raise our six-month target price to HKD11.0, on a new target PER of 14x applied to our 2014 EPS forecast (March year-end) but lower our rating to Outperform(2), given reduced upside to our target price on a six-month view. Still, we highlight Pacific Textiles as offering the most scope for expansion in Southeast Asia among our coverage universe, spearheaded by its joint venture in Vietnam. In our view, if the first phase of this expansion is successful, Pacific Textiles is likely to further increase its capacity in the region. We note, too, our view that Pacific Textiles is one of the best dividend-yield plays among our small-cap coverage.

We initiate on Texhong Textile with a Buy (1) rating and six-month target price of HKD11, based on a target PER of 10x applied to the average of our 2013 and 2014 EPS forecasts. The company, which has a strong presence in Vietnam, is set for 37% YoY growth in 2013 earnings, on our forecasts.

How we differ

We believe the market is under-estimating the cost pressures arising from production facilities in China, and hence may not be factoring into its forecasts the impact of migration to lower-cost regions.

Key stock calls

	New	Prev.
Texhong Textile (2678 HK)		
Rating	Buy	
Target	11.00	
Upside	▲ 21.5%	
Shenzhou International Group (2313 HK)		
Rating	Buy	Buy
Target	27.80	17.70
Upside	▲ 22.5%	
Pacific Textiles Holdings (1382 HK)		
Rating	Outperform	Buy
Target	11.00	9.50
Upside	▲ 11.3%	

Source: Daiwa forecasts.

- **Positive** (unchanged)
- Neutral
- Negative

How do we justify our view?

- Growth outlook
- Valuation
- Earnings revisions

Growth outlook

We believe textile companies in China, especially the upstream players, are actively seeking to mitigate pressure on their gross margins by expanding production capabilities in Southeast Asia. The region offers the potential for cost savings, as well as favourable tariff treatment on exports.

We forecast an earnings CAGR of 30% for Texhong over 2013-15, backed by increased production capacity and expansion in the company's gross-profit margin.

Shenzhou, Texhong Textile and Pacific Textiles: earnings

	Fiscal year-end	FY13E	FY14E	FY15E	CAGR (FY13-15E)(%)
Shenzhou (CNYm)	Dec	1,923	2,244	2,519	14%
Texhong (CNYm)	Dec	665	888	1,122	30%
Pacific Textiles (HKDm)	Mar	968	1,131	1,326	17%

Source: Daiwa forecasts

Valuation

Our six-month target price for Texhong is HKD11.00, based on a target PER of 10x applied to the average of our 2013 and 2014 EPS forecasts. Our target PER represents a 30% discount to the multiples of the company's regional peers, since Texhong's business model is more sensitive to fluctuations in cotton prices.

We reiterate our Buy (1) rating on Shenzhou. Our six-month target price is HKD27.8 (from HKD17.7), based on a new target PER of 14x applied to the average of our 2013 and 2014 forecasts (previously 10x our 2013 forecast).

Shenzhou and Texhong: PERs

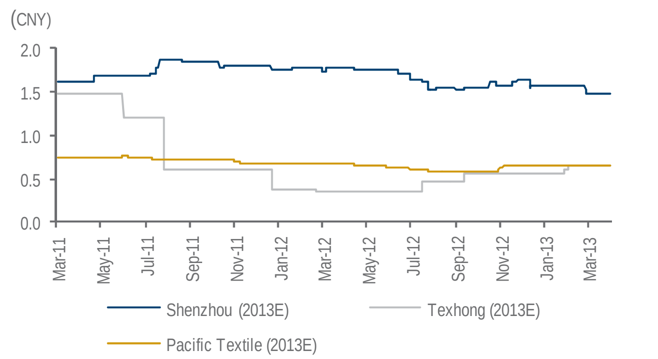
Source: Bloomberg

Earnings revisions

Our 2013 and 2014 earnings forecasts for Texhong Textile are respectively 14% and 25% higher than those of the Bloomberg consensus, as we are more positive than the market on both companies' sales-volume growth.

Our 2013 and 2014 EPS forecasts for Shenzhou are in line with the consensus figures. We believe the company will maintain its leading position in the sector (it is the largest vertically-integrated apparel maker in China) and continue to deliver strong earnings growth over our forecast horizon.

Shenzhou and Pacific Textiles: consensus earnings forecasts



Source: Bloomberg

Sector stocks: key indicators

		Share	Rating		Target price (local curr.)			EPS (local curr.)					
								FY1			FY2		
Company Name	Stock code	Price	New	Prev.	New	Prev.	% chg	New	Prev.	% chg	New	Prev.	% chg
Pacific Textiles Holdings	1382 HK	9.88	Outperform	Buy	11.00	9.50	15.8%	0.676	0.676	0.0%	0.789	0.789	0.0%
Shenzhou International Group	2313 HK	22.70	Buy	Buy	27.80	17.70	57.1%	1.475	1.512	(2.4%)	1.722	1.729	(0.4%)
Texhong Textile	2678 HK	9.05	Buy		11.00			0.752			1.004		

Source: Daiwa forecasts, share prices as of 3 May, 2013

Contents

Migration to ASEAN: the next wave

We believe it is inevitable that major China textile companies will shift some production to lower-cost countries. While this is a long-term structural shift, migration is being encouraged by the favourable international cotton price and attractive tariff treatment.

Setting their sights on Southeast Asia; expansion to continue

Looking to ASEAN

Just a few years ago, many textile companies considered China to be their primary production site, given the availability of labour at competitive costs, and proven supply chain and supporting infrastructure. But against a backdrop of rising labour costs and inflationary pressure, many companies have been gradually shifting production capacity overseas, with Southeast Asia being a primary destination.

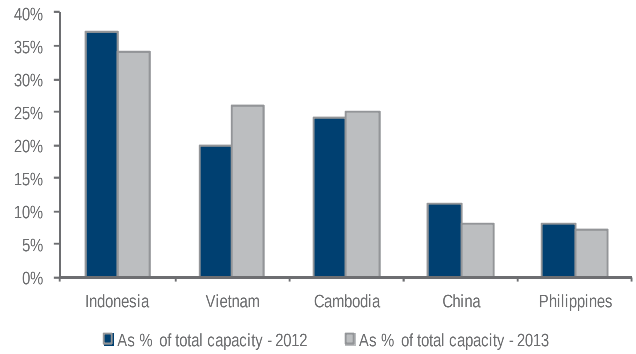
While some observers argue this shift is a temporary phenomenon that may not provide sustainable benefits, we see fundamental and structural drivers at play. It is important to understand that lower production costs are only one consideration in this migration. There are other strategic factors, such as favourable tariff conditions and reduced concentration of production in a single market.

Initially, it was the downstream garment companies (ie, Hansae, Makalot Industrial and Shenzhou International) that set up production facilities in Southeast Asia, primarily owing to the region's relatively low labour costs. According to a survey by the China Cotton Textile Industry Association, labour costs in China increased by around 10% in 2012 alone. Since downstream operations are not greatly reliant on infrastructure and utilities, and labour accounts for a relatively large proportion of their costs, these companies were naturally the first enter the Southeast Asia market.

Shenzhou has had downstream operations in Cambodia since 2005, and as part of the second phase of its development plans it recently opened a new garment factory in the country. Management expects to have some 10,000 people working in Cambodia by end-2013, of a total workforce of 51,400 as at end-2012.

Hansae has operated one of the largest downstream garment assembly plants in Vietnam since 2001, and in recent years has steadily expanded its capacity there, as well as moving into Indonesia (2005) and Cambodia (2007). Meanwhile, leading Taiwan downstream player Makalot now has major production sites in Vietnam, Indonesia, Cambodia and the Philippines.

■ Makalot Industrial: production capacity by location



Source: Company

Unlike the downstream garment manufacturers, midstream and upstream companies have not penetrated these regions to any great degree, mainly owing to concern over the standard of infrastructure and availability of utilities. Moreover, such a move by midstream and upstream players would require much greater capital investment than for the downstream garment assemblers.

However, based on our discussions with midstream and upstream players, we believe these companies are increasingly receptive to investing in Southeast Asia. Among the upstream players in the China textile sector, Texhong made its first investment in Vietnam in 2006 and is planning to construct a plant in northern Vietnam with an annual capacity of up to 400,000 spindles. In our midstream universe, construction work is under way on Pacific Textiles's joint-venture plant in Vietnam, and we see a high probability that Shenzhou will likewise invest in Vietnam.

Within the textile food chain, we see further opportunities for the midstream and upstream players to expand within Southeast Asia. In the face of rising operating costs and a shortage of labour in China, we believe further diversification of production into Southeast Asia is inevitable. Weak end-demand and industry consolidation have created a challenging business environment for textile and garment manufacturers in China, making migration to lower-cost regions an attractive proposition, particularly for the midstream and downstream manufacturers. Such a move should boost these companies' production capacity and sharpen their competitive edge, in our view.

Major textile players: production capacity by location

			*Production capacity								
Company	Bloomberg code	Headquarters	China	Vietnam	Indonesia	Cambodia	Philippines	Sri Lanka	Jordan	India	Bangladesh
Upstream											
*Weiqiao Textile	2698 HK	Shandong	100%								
*Texhong Textile	2678 HK	Shanghai	60%	40%							
Midstream											
*Pacific Textiles	1382 HK	Hong Kong	90%					10%			
Fountain Set	420 HK	Hong Kong	O		O			O			
*Texwinca	321 HK	Hong Kong	100%								
Downstream											
Makalot	1477 TT	Taiwan	11%	20%	37%	24%	8%				
Hansae	105630 KS	Korea	O	O	O	O					
Luen Thai	311 HK	Hong Kong	O			O	O				
*China Ting	3398 HK	Hong Kong	O								
Victory City	539 HK	Hong Kong	O		O	O			O		
*Win Hanverky	3322 HK	Hong Kong	85%	15%							
Vertical											
*Shenzhou Int'l	2313 HK	Zhejiang	85%			15%					
Eclat Textile	1476 TT	Taiwan	O	O		O					

*Source: Companies, *Daiwa estimates*

Note: the breakdown of Upstream, Midstream and Downstream is dependent on the major business of the companies.

Major textile players: gross-profit-margin comparison (%)

Company	Bloomberg code	FY10	FY11	FY12
Upstream				
Weiqiao Textile	2698 HK	16.1	1.8	6.8
Texhong Textile	2678 HK	23.9	8.1	15.3
Midstream				
*Pacific Textiles	1382 HK	20.8	18.0	17.1
**Fountain Set	420 HK	16.2	15.3	7.9
*Texwinca	321 HK	33.4	33.7	29.6
Downstream				
Makalot	1477 TT	16.2	16.8	16.2
Hansae	105630 KS	13.9	16.2	15.0
Luen Thai	311 HK	16.9	16.8	17.2
China Ting	3398 HK	31.2	31.1	29.9
*Victory City	539 HK	18.6	19.0	18.7
Win Hanverky	3322 HK	24.1	21.7	22.1
Vertical				
Shenzhou Int'l	2313 HK	29.9	28.8	28.5
Eclat Textile	1476 TT	20.3	22.1	25.4

Source: Bloomberg

*Note:*March year-end; ** August year-end*

Note: the breakdown of Upstream, Midstream and Downstream is dependent on the major business of the companies.

Major textile players: operating-profit-margin comparison (%)

Company	Bloomberg code	FY10	FY 11	FY 12
Upstream				
Weiqiao Textile	2698 HK	15.0	1.1	8.5
Texhong Textile	2678 HK	18.9	3.3	9.6
Midstream				
*Pacific Textiles	1382 HK	16.3	15.1	14.9
**Fountain Set	420 HK	3.9	5.3	-3.8
*Texwinca	321 HK	9.9	10.3	5.2
Downstream				
Makalot	1477 TT	8.9	9.4	9.1
Hansae	105630 KS	4.3	7.6	5.6
Luen Thai	311 HK	2.8	3.1	3.8
China Ting	3398 HK	13.5	9.6	7.6
*Victory City	539 HK	10.2	10.3	8.5
Win Hanverky	3322 HK	6.6	3.2	4.0
Vertical				
Shenzhou Int'l	2313 HK	23.8	23.5	22.8
Eclat Textile	1476 TT	9.6	12.5	15.9

Source: Bloomberg

*Note:*March year-end; ** August year-end*

Note: the breakdown of Upstream, Midstream and Downstream is dependent on the major business of the companies.

1. Manufacturing costs: key factor

Competitive labour costs in Southeast Asia

Labour is a significant component of textile companies' costs, given the labour-intensive nature of the business. This is especially the case for downstream garment manufacturers, where labour typically accounts for a relatively large proportion of costs. In this respect, China offered companies a competitive advantage, since downstream garment manufacturers could tap the country's sizeable and skilled workforce. We believe that having access to this pool of well-trained workers has enhanced the production efficiency of the downstream players.

But, a combination of rising inflation and increasing difficulty in recruiting skilled workers in recent years has prompted several companies to gradually shift production from China's coastal regions to inland provinces and, in some cases, further afield to Southeast Asia.

■ **Labour inflation in China – by year (%)**

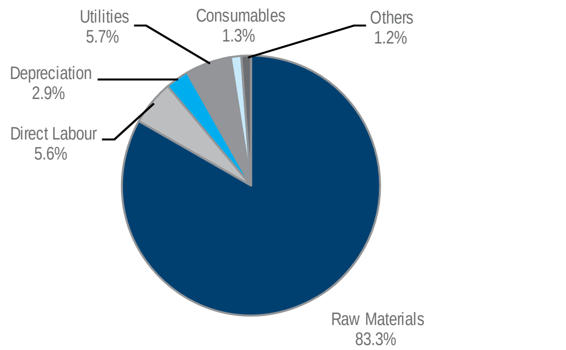
Source: CEIC, Daiwa

Moving production facilities to another area does not yield immediate benefits, however. According to our discussions with industry experts, it can take 6-12 months to recruit and train employees once a greenfield operation has been established. Thereafter, companies need to train middle managers in order to enhance the productivity of the overall workforce. In sum, we believe it can take 24 months or more to get a new factory operating at the desired productivity levels.

None of this is to say that China no longer offers a competitive advantage for textile companies. It still has a clear edge in infrastructure for textile production and access to raw materials through its well-developed supply chain.

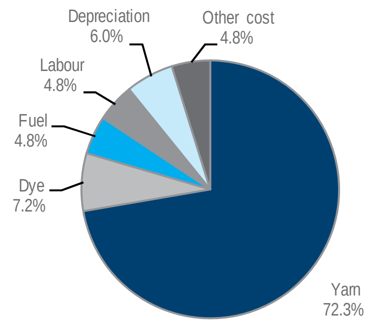
However, rising costs in China — for labour and more generally — are eroding this advantage. Based on *Doing business in 2012,* a report jointly published by International Finance Corporation and the World Bank, Vietnam and Cambodia have minimum wages of USD64.5/month and USD43.0/month, respectively — some 68% and 79% lower than China's USD204.2/month. While garment manufacturers typically pay more than the minimum wage, these figures underline the cost differential among these economies. Indeed, they are in line with our own research indicating that monthly wages in Southeast Asia are 50-80% lower than in China.

■ **Cost structure of typical upstream company - Texhong (2012)**



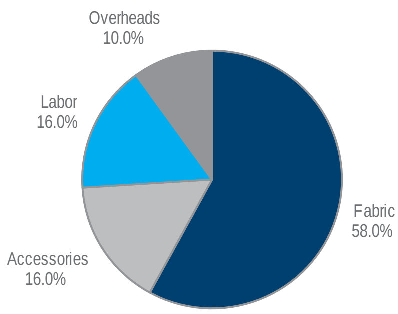
Source: Company

■ **Cost structure of typical midstream company – Pacific Textiles (2012)**



Source: Company

■ **Cost structure of typical downstream company – Makalot Industrial (2012)**



Source: Company

▪ Makalot: capacity and wage cost by production site

Site	Function	2013 capacity (dozen)	%	*Monthly wages (USD/person)	2012 total costs (USD/dozen)	2013E total costs (USD/dozen)
Taipei, Taiwan	Headquarters					
Indonesia	Factory	3,700,000	34%	250-300	14.7	15.1
Vietnam	Factory	2,900,000	26%	145-273	18.1	17.7
Cambodia	Factory	2,800,000	25%	74-158	13.4	14.3
China	Factory	820,000	8%	328-527	20.9	22.2
Philippines	Factory	780,000	7%	253-306	17.7	18.8

Source: Company
** Base salary of manufacturing workers*
Note: Dozen is Makalot's preferred measure of unit production

Well-developed supply chain

In our discussions with companies in the textile industry, one concern we heard several times was that Southeast Asia for now lacks an established supply chain. Whereas China has had a textile industry for many years, and with it a well-developed, sophisticated supply chain, Southeast Asia has been far behind in this respect.

The reality is that most downstream manufacturers looking to source key inputs for production have to import materials from China. Not only does this approach require an extended lead time, it also carries a cost penalty.

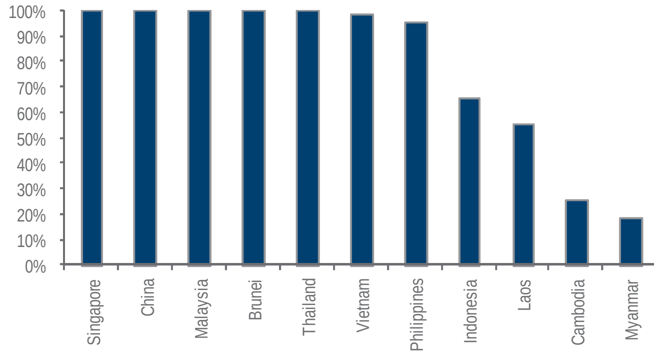
But there are signs of progress in the development of supply chains in some Southeast Asia countries. Many downstream operators have been doing business in the region for several years, and over time they have started developing their own supply sources. We believe that the recent decisions by Texhong Textile (upstream spinning mill) and Pacific Textiles (midstream fabric producer) to invest in Vietnam will only accelerate the development of the supply chain there.

Quality of infrastructure and utilities

Having access to established infrastructure and a reliable supply of utilities is critically important to the operations of upstream and midstream players in the textile industry. These companies' production facilities require a constant supply of water and electricity, and any interruptions to this supply can significantly reduce production yields and potentially damage the equipment. We believe this is a key reason for the historical reluctance of many upstream and midstream manufacturers to invest in Southeast Asia.

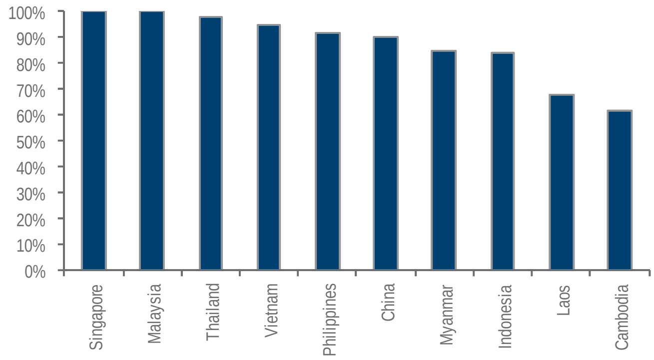
There is little to choose between the countries of Southeast Asia in terms of utilities costs alone. Indonesia and the Philippines stand out for their high water usage costs relative to the rest of the region. In terms of utilities costs, Vietnam has lower electricity costs than Cambodia and, indeed, most other Southeast Asian countries. Cambodia has the edge in terms of water costs, with an average cost of USD0.23/m3, compared with Vietnam's USD0.32-0.38/m3 and China's USD0.24-0.63/m3.

▪ Access to electricity as % of the population (2009)



Source: World Bank database, compiled by Daiwa

▪ Improved water source as % of population with access (2010)



Source: World Bank database, compiled by Daiwa

Logistics still a bottleneck in Southeast Asia

Textile companies must keep a keen eye on logistics costs — both for raw materials and finished goods — since the manufacturing process typically requires the involvement of several parties. Moreover, logistics have clear implications for delivery lead times for raw materials, work in progress (WIP), and end-products.

For example, delivery lead times are longer, and logistics expenses higher, if a company deliver its goods from, say, Vietnam to China, rather than producing and delivering within China alone. In order for overseas production to be economically viable, larger production volumes and lower production costs are required. If the profitability of products made in Vietnam is greater than for products made in China, overseas production would be a sound option.

On our analysis, China is still the most competitive country in terms of days taken to ship products for export. In China, the process takes 10 days, compared with 15-22 days for countries in Southeast Asia. As for the cost to export, Cambodia stands out as the most costly, likely because of the country's infrastructure constraints.

■ Labour costs: comparison

	Minimum wage (USD/month)	*Ratio of minimum wage to value added per worker	50-hour workweek allowed?	Maximum working days per week	Premium for night work (% of hourly pay)	Premium for work on weekly rest day (% of hourly pay)	Major restrictions on night work?	Major restrictions on weekly holiday work?	Paid annual leave (working days)
Vietnam	64.5	0.43	Yes	6.0	30	100	No	No	13.0
Indonesia	151.0	0.42	Yes	6.0	0	0	No	No	12.0
Cambodia	43.0	0.40	Yes	6.0	30	100	No	No	19.3
Philippines	192.5	0.64	Yes	6.0	10	30	No	No	5.0
Sri Lanka	40.2	0.12	Yes	5.5	0	50	No	Yes	14.0
Jordan	199.6	0.32	Yes	6.0	0	150	No	No	18.7
China	204.2	0.36	Yes	6.0	39	100	No	No	6.7

Source: Japan External Trade Organization (JETRO); Doing business 2012
Notes: As of December 2012; ratio to measure worker productivity*

■ Operating costs: comparison

	Inflation* (%)	Electricity (USD/kwh)	Water (USD/m3)	Tax paid	Time to export (days)	Cost to export (USD/container)
Vietnam	9.3	0.08	0.32-0.38	25%	21	610
Indonesia	4.3	0.08	1.06	25%	17	644
Cambodia	3.0	0.16	0.23	20%	22	755
Philippines	3.1	0.25	0.82	30%	15	585
China	2.4	0.08-0.11	0.24-0.63	25%	10	655

Source: Japan External Trade Organization (JETRO); Doing business 2012
** As of December 2012*

2. Tariffs matter

Another factor that we believe investors should pay close attention to is import and export tariffs, since these can have a big bearing on the profitability of textile companies exporting to developed markets such as the US, Japan and Europe.

Export tariffs are sharpening Southeast Asia's competitive edge

Cambodia is a popular choice for textile producers seeking an overseas production base, since tariffs on products exported from Cambodia to the European Union (EU) are waived. According to the terms of the EU's Generalized System of Preference (GSP), textiles and clothing products made in Cambodia and other developing countries receive preferential tariff treatment upon entry to the European market. Leading garment manufacturers such as Shenzhou, Makalot and Luen Thai have garment-manufacturing facilities in Cambodia. Not surprisingly, Shenzhou's plant in Cambodia mainly focuses on European clients such as Adidas and Puma. Vietnam is another preferred production site for companies, since products exports from the country to Japan receive favourable tariff treatment.

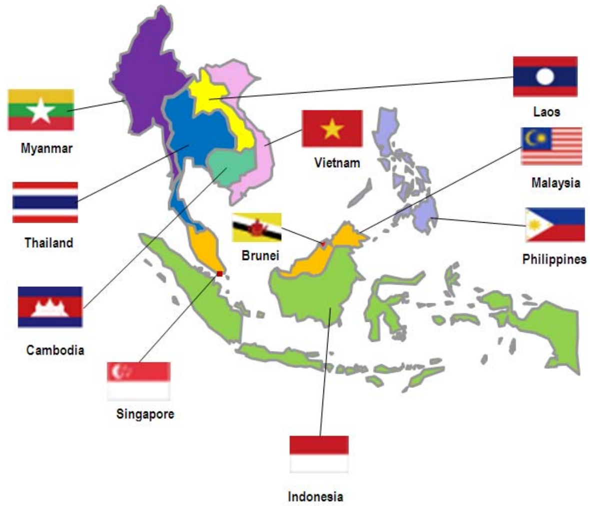
We believe this preferential treatment was a key factor in Pacific Textiles's decision to establish a joint venture in Vietnam. Pacific Textiles's largest customer is Japan's Fast Retailing (9983 JP, JPY36,000, Neutral [3]).

Low tariffs among members of China-ASEAN Free Trade Area and TPP

The ASEAN-China Free Trade Area (ACFTA), comprised of China and the six original members of the ASEAN Free Trade Area (AFTA), has been sharply reducing tariffs on exports. Since January 2010, the average tariff on exports between China and member states has been cut from 9.8% to 0-0.1%. ACFTA provisions call for zero tariffs among all member states by 2015.

The free trade area has essentially eliminated trade barriers between China and other ACFTA member states, in the process reducing costs for China textile companies with manufacturing facilities in countries such as Vietnam and Cambodia. Lower tariffs effectively reduce the cost of overseas expansion by bringing down the overall cost of shipping raw materials and production equipment to plants in Vietnam and other countries.

■ Member states of the ASEAN Free Trade Area (AFTA)



Source: Daiwa

■ ASEAN-China Free Trade Area preferential rate for original six members

	China-Asian Free Trade Area preferential tariff rate (%)			
Original tariff (%)	2005	2007	2009	2010
≥ 20%	20	12	5	0
15- 20%	15	8	5	0
10-15%	10	8	5	0
5-10%	5	5	0	0
≤ 5%	no change		0	0

Source: http://www.qgtong.com

Note: preferential rate applies between China and the original six members (Brunei, Indonesia, Malaysia, the Philippines, Singapore and Thailand). Zero tariffs for the four newer members (Cambodia, Laos, Myanmar and Vietnam) are targeted for 2015.

Meanwhile, the TPP is a free trade agreement among Australia, Brunei, Chile, Canada, Malaysia, Mexico, New Zealand, Peru, Singapore, the US, and, subject to final confirmation, Vietnam. The TPP is designed to further liberalise the economies of the Asia-Pacific region.

As part of the TPP, tariffs on textile products exported from Vietnam to the US are expected to drop from 17% to 0%, compared with a circa 4.5% tariff on exports of goods from China to the US currently.

Textile companies with factories in Vietnam or other membership states stand to benefit from such preferential treatment. But, in order to benefit fully, companies must meet certain obligations regarding the origin of raw materials. For final textile goods exported to the US, zero tariffs will apply only if the raw materials were produced in Vietnam or other TPP member countries. On our estimates, this requirement will mean that at least 80% of textile products made in Vietnam will not be eligible for zero tariffs. We will continue to monitor negotiations on the fine details.

■ Partial list of tariffs on textile-product exports to the US (2012)

Article	MFN	Rate of duty Special	Normal
Women's/Men's or boys' overcoats, carcoats etc	15.9%	Free (BH, CA, CL, CO, IL, JO, KR, MA, MX, OM, P, PE, SG) 8% (AU)	50%
Men's or boys' suits, ensembles, suit-type jacket etc	5.6%	Free(BH, CA, CL, CO, E*, IL, JO, KR, MA, MX, OM, P, PE, SG) 5% (AU)	45%
Men's or boys' suits, ensembles, suit-type jackets, blazers, trousers etc of cotton	13.5%	Free (BH, CA, CL, CO, IL, JO, KR, MA, MX, OM, P, PE, SG) 8% (AU)	90%
Men's or boys' suits, ensembles, suit-type jackets, blazers, trousers etc of other textile materials	14.9%	Free (BH, CA, CL, CO, IL, JO, KR, MA, MX, OM, P, PE, SG) 8% (AU)	72%
Women's or girls' suits,suit-type jackets, dresses, skirts etc of cotton	9.4%	Free (BH, CA, CL, CO, IL, JO, KR, MA, MX, OM, P, PE, SG) 8% (AU)	90%
Women's or girls' suits,suit-type jackets, dresses, skirts etc of cotton of other	5.6%	Free (BH, CA, CL, CO, E*, IL, JO, KR, MA, MX, OM, P, PE, SG) 5% (AU)	60%
Men's or boys' shirts, knitted or crocheted of cotton	19.7%	Free (BH, CA, CL, CO, IL, JO, MA, MX, OM, P, PE, SG) 8% (AU) 17.7% (KR)	45%
T-shirts, singlets, tank tops and similar garments, knitted or crocheted of cotton	16.5%	Free (BH, CA, CL, CO, IL, JO, MA, MX, OM, P, PE, SG) 8% (AU), 14.8% (KR)	90%
T-shirts, singlets, tank tops and similar garments, knitted or crocheted of man-made fibres	32%	Free (BH, CA, CL, CO, IL, JO, MA, MX, OM, P, PE, SG) 8% (AU), 28.8% (KR)	90%

Source: US International Trade Commission

Note: AU: Australia, BH: Bahrain, CA Canada, CL: Chile, CO: Columbia, IL: Israel, JO: Jordan, KR: Korea, MA: Morocco, MX: Mexico, P: Dominican Republic-Central America, PE: Peru, OM: Oman, R: Caribbean Basin Trade Partnership Act (CBTPA), SG: Singapore

Notes: MFN denotes duty for a Most Favoured Nation; Special shows the rate for the countries noted within the column; Normal is the regular rate of duty.

■ Partial list of tariffs on textile-products exports to China (2012)

Article	Most-favoured-nation rate of duty (MFN rate)	Non- MFN rate	Value-added tax
Pile fabrics,knitted or crocheted fabrics,warp knit fabrics and other textile materials	10-12%	70%-130%	17%
Men's or boys' overcoats,knitted or crocheted	18%	90%	17%
Overcoats,knitted or crocheted of wool or fine animal hair	25%	130%	17%
Women's or girls'overcoats,knitted or crocheted,wind-jackets etc	20%	130%	17%
Suits,jackets,trousers etc	16-25%	130%	17%

Source: http://www.qqtong.com

3. Increase in cotton prices: upstream players to benefit most

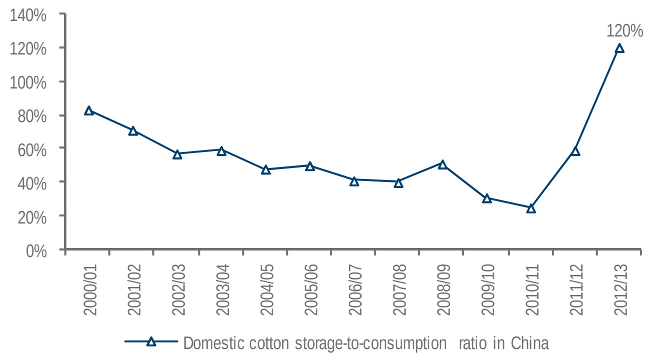
Within the textile-industry value chain, cotton is undoubtedly the raw material with the biggest bearing on overall costs. Thus, we believe it is important to understand and analyse each textile companies' approach to cotton procurement.

International or domestic?

The domestic cotton price has been higher than the international price since July 2011. The gap between the two has narrowed appreciably in recent months, with a floor price now effectively in place in China and the international price having risen.

The domestic cotton storage to consumption ratio has increased in recent years, suggesting that the supply of domestic cotton has been sufficient to meet domestic demand.

■ Domestic cotton storage-to-consumption ratio

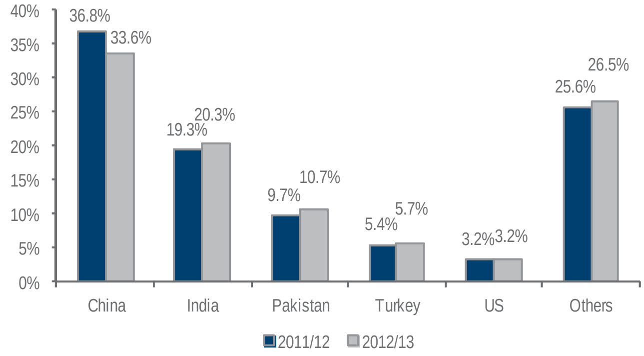


Source: cottonchina.org

The Zhengzhou grade-328 cotton price has been relatively stable since 2011 at CNY18,000/ton to around CNY19,000/ton. This stability is in line with the China government's intention to protect cotton farmers by setting a floor for the purchase price. According to the Chinese Cotton Association, the government has announced it will purchase cotton at a temporary price of CNY20,400/ton, with no limit on quantity, for 2013.

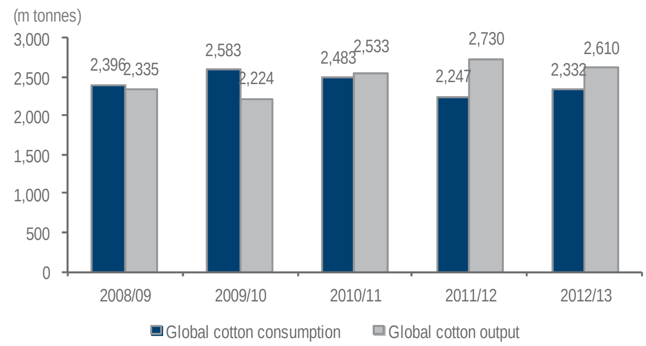
Considering these measures together with the high inventory levels, we expect the domestic cotton price to be relatively stable this year.

■ Geographical breakdown of expected cotton consumption



Source: USDA

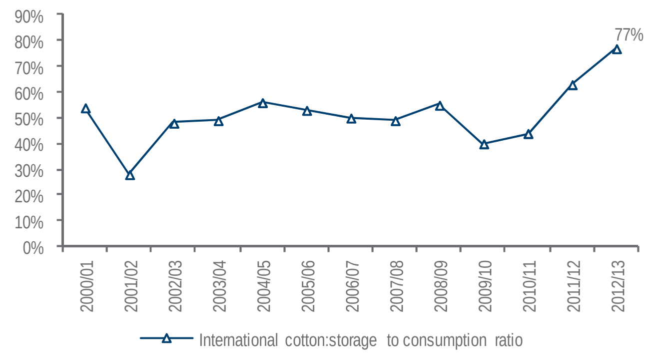
■ Expected global cotton output and consumption



Source: USDA

Meanwhile, the international cotton price has been rising, reaching CNY14,680/ton in mid-April, from CNY13,272/ton at end-March. We believe there have been a number of catalysts. First, according to a report by the US Department of Agriculture (USDA), the production area for cotton in the US is expected to total 10.026m acres in 2013/14, a decline of 18.6% YoY and 0.1pp lower than the USDA's estimate in February 2013.

■ International cotton: storage to consumption ratio



Source: USDA

In addition, the China government in late April introduced a quota on imported cotton, specifically for the processing trade, of 400,000 tons, in order to meet demand for lower-priced international cotton.

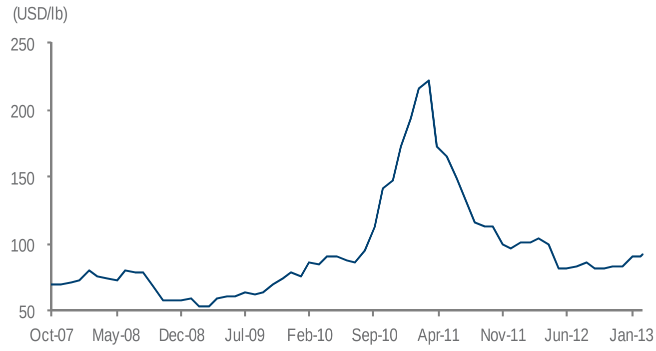
China's overall quota on cotton imports for 2013 stands 2.8m tons, including a proposed import quota of 1m tons which we expect to be approved in May. According to NDRC data, China's cotton import quota in 2012 was 894,000 tons. The increase in China's cotton import quota can be expected to have an impact on the international price in the short term.

In conclusion, assuming the domestic cotton price holds steady, we believe the price gap between domestic and international cotton is likely to narrow further in the future.

▪ China Zhengzhou grade-328 cotton price

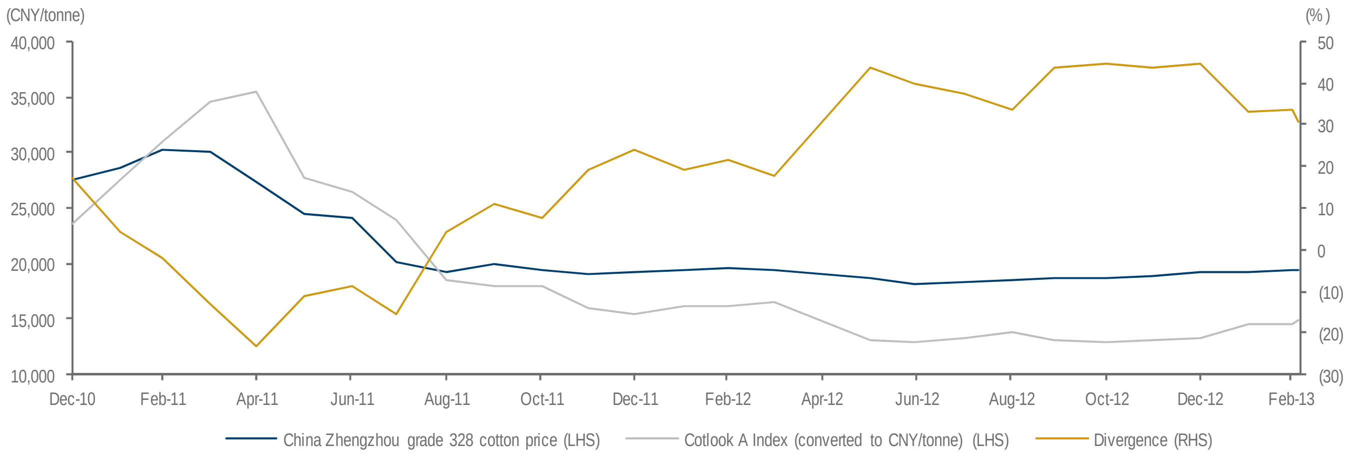
Source: Bloomberg

▪ Cotlook A Index



Source: Bloomberg

▪ Divergence of international and domestic cotton price



Source: Bloomberg

Conclusion: who stands to benefit the most from these conditions?

Given differences in the value chain among the downstream, midstream and upstream players, we think the spinners (yarn manufacturers) stand to be most affected by movements in the cotton price. Since spinners are part of the upstream segment, fluctuations in the cotton price have a direct impact on their margins. Considering the difference in timing between the cotton raw material being purchased and the final yarn being sold, spinners should experience incremental margin expansion if the cotton price were to be on an uptrend and their gross margin would be squeezed if the cotton price were to fall.

In the context of our view that the gap between the international and domestic cotton price is likely to narrow further, we highlight Texhong Textile as a key beneficiary by virtue of its production facilities in Vietnam.

Finally, we think Shenzhou stands to benefit from lower manufacturing costs and preferential tariff treatment for EU-bound exports from Cambodia. In addition, we think Pacific Textiles is likely to benefit the most from low tariffs, since more than 90% of its sales by volume are made to the US and Japan, exports to which are subject to favourable tariff treatment.

■ Textile companies: who benefits from what?

Ticker	Company	Production base migration	Low tariffs	Increase in cotton price
2313 HK	Shenzhou International	Current: 15% / Forecast: 20-25%	Benefits through EU exports (EU accounts for 21% of its sales by value)	Neutral
1382 HK	Pacific Textiles	Current: 0% / Forecast: 20%	Benefits through US and Japan exports (US & JPN sales account for 91% of its sales by value)	Neutral
2678 HK	Texhong Textile	Current: 50% / Forecast: 60-70%	Benefits through US and Japan exports (most sales go to China/Macau as indirect exports)	Positive

Source: Companies, compiled by Daiwa

■ Valuations: peer comparison

Company	BBG code	Share price 03-May-13 (local curr.)	Market cap (USDm)	Rating	PER (x) FY13E	PER (x) FY14E	PBR (x) FY13E	PBR (x) FY14E	EV/EBITDA (x) FY13E	EV/EBITDA (x) FY14E	Div. yield (%) FY13E	ROE (%) FY13E
Yarn												
CHINA TAIFENG BE	873 HK	1.98	255	NR	2.9	2.8	n.a.	n.a.	n.a.	n.a.	3.4	n.a.
WEIQIAO TEXTI-H	2698 HK	4.30	662	NR	9.0	8.7	0.3	0.3	n.a.	n.a.	3.5	2.9
* TEXHONG TEXTILE	2678 HK	9.05	1,032	Buy (1)	9.6	7.2	2.1	1.7	6.8	5.6	3.1	24.0
			Average:		7.1	6.2	1.2	1.0	6.8	5.6	3.4	13.4
Fabric												
*PACIFIC TEXTILES	1382 HK	9.88	1,839	Outperform (2)	14.6	12.5	3.3	3.0	8.8	7.7	7.2	23.5
*TEXWINCA HLDG	321 HK	8.95	1,573	Sell (5)	30.3	17.7	2.2	2.1	15.2	10.0	2.0	7.3
FOUNTAIN SET HLD	420 HK	1.10	171	NR	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
VICTORY CITY INT	539 HK	1.22	255	NR	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
			Average:		22.6	15.2	2.8	2.6	12.1	8.9	4.6	15.4
Garment												
*SHENZHOU INTL GP	2313 HK	22.70	3,891	Buy (1)	12.2	10.5	2.5	2.3	7.6	6.4	4.9	22.2
*TEXWINCA HLDG	321 HK	8.95	1,573	Sell (5)	30.3	17.7	2.2	2.1	15.2	10.0	2.0	7.3
GLORIOUS SUN ENT	393 HK	2.22	303	NR	13.1	11.1	1.0	0.9	n.a.	n.a.	6.3	7.5
WIN HANVERKY	3322 HK	1.02	167	NR	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
CHINA TING GROUP	3398 HK	0.50	134	NR	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
NIEN HSING TEXT	1451 TT	24.45	359	NR	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
TAINAN ENTERPRIS	1473 TT	36.80	183	NR	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
ECLAT TEXTILE CO	1476 TT	184.00	1,533	NR	18.9	14.8	5.8	4.8	13.6	10.7	3.3	33.3
MAKALOT INDUSTRI	1477 TT	125.50	693	NR	15.0	13.2	4.7	n.a.	12.0	n.a.	5.6	27.6
BOMBAY RAYON FAS	BRFL IN	236.35	592	NR	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
YOUNGONE CORP	111770 KS	41050	1,658	NR	19.6	19.1	n.a.	n.a.	n.a.	n.a.	0.5	19.0
HANSAE CO LTD	105630 KS	18,100	660	NR	11.6	10.2	2.4	2.0	9.5	7.4	0.6	22.9
			Average:		17.3	13.8	3.1	2.4	11.6	8.6	3.3	20.0

Source: Bloomberg, Daiwa forecasts*

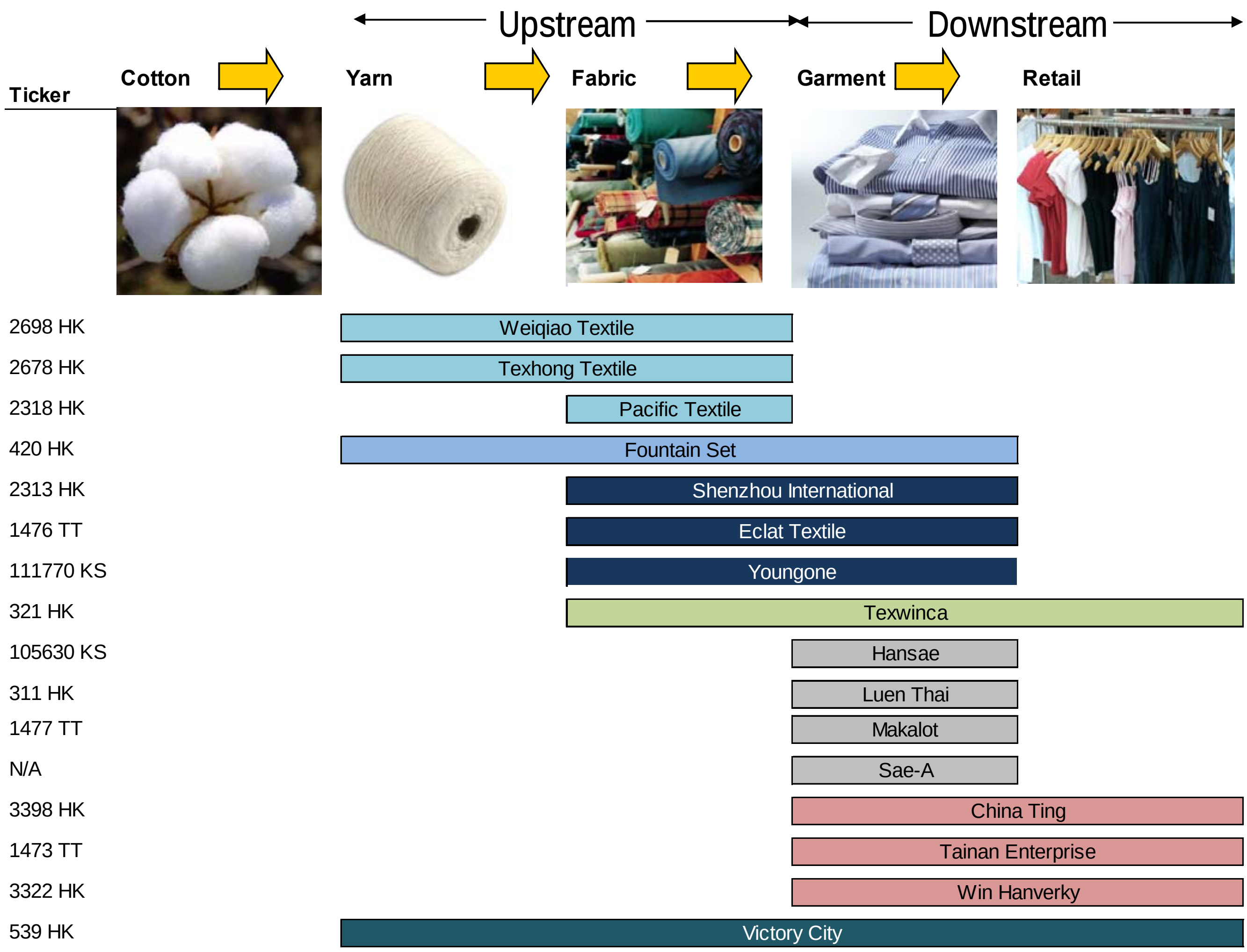
Appendix I: who's who in textiles

■ Textile industry ecosystem

Country	Company	Ticker	*Market cap (USDm)	Product line-up: Yarn	Fabric	Garment	Retail	Customers: Details	Location	**Major shareholder	
China	Weiqiao Textile	2698 HK	662	O	O	X	X	Itochu, Fountain Set, Texwinca, Nichimen, Marubeni	Shandong, China	Shandong Weiqiao Chuangye Group	62%
China	Texhong Textile	2678 HK	1,032	O	O	X	X	Zhejiang Limayunshan Textile, Yixing Lucky G, Toray International, Foshan Seazon Textile	China, Vietnam	Chairman	55%
China	Pacific Textiles	1382 HK	1,839	X	O	X	X	Liz Claiborne, UNIQLO, Triumph, Victoria's Secret, Marks & Spencer, Calvin Klein, Adidas, Nike, Aimer. Walmart, ANTA	Panyu, Guangdong, China; Sri Lanka; Bangladesh	Management	67%
China	Fountain Set	420 HK	171	O	O	O	X	GAP, Ralph Lauren, Marks & Spencer, JC Penny, Kohl's	Dongguan, Guangdong, China; Jiangyin, Jiangsu, China; Indonesia; Sri Lanka	Chairman	36%
China	Shenzhou Int'l	2313 HK	3,891	X	O	O	X	UNIQLO, Adidas, Nike, Puma	Ningbo, Zhenjian Province; Anhui, province, China; Cambodia	Ma Family	58%
China	Texwinca	321 HK	1,573	X	O	O	O	Walmart, JC Penny, PVH, Nike, Adidas, A&F,UNIQULO	Dongguan Guangdong province, China	Poon Family	54%
China	China Ting	3398 HK	134	X	X	O	O	Express, Macy's Michael Kors, Talbots, Guess, Ann Taylor, Ralph Lauren, GAP, A&F, Victoria's Secret, Ted Baker, BCBG, ESPRIT, Armani, ZARA, Marks & Spencer	Hangzhou, Zhejiang province, China	Longerview Investments Limited	71%
China	Victory City	539 HK	255	O	O	O	O	Forever 21, Calvin Klein, Walmart, Carter's Columbia, Kmart, DKNY, The North Face, ZARA, C&A, Semir, Yishion Jeans, Lining, 361 degree, Metersbonwe. Reebok	Xinghui, Guangdong province, China; Nanjing, China; Indonesia; Cambodia; Jordan	Pearl Garden Pacific Limited	23%
China	Luen Thai	311 HK	429	X	X	O	X	Adidas, Coach, ESPRIT, Fast Retailing, Limited Brands, Polo Ralph Lauren and Targus.	Dongguan, Guangdong province, China; Cambodia, Philippines, Saipan	Helmsley Enterprises Limited	63%
China	Win Hanverky	3322 HK	167	X	X	O	O	Y-3; Adidas; UMBRO; Nike; SLY; AZUL; Converse; Moussy; SHEL'TTER; Reebok	China; Vietnam; Cambodia (2013)	Quinta Asia Limite	59 %
Korea	Hansae	105630 KS	660	X	X	O	X	Target, Walmart, Holister, A&F, Limited, NY & Co., Federated, Kohl's	Vietnam, Central America, Indonesia, Cambodia, China	Hansae Yes24 Holdings and 8 others	59%
Korea	Sae-A	n.a.	n.a.	X	X	O	X	A&F, Adidas, BCBG, Carter's, GAP, UNIQLO, Walmart, Target, Tommy, Levi's, Mango	Guatamela, Nicaragua, Saipan, Indonesia, Vietnam	N/A	N/A
Korea	YoungoneCorp	111770 KS	1,658	X	O	O	X	VF, North Face, Nike, Lacoste, Patagonia, LL Bean, Land's End, VANS, BURTON, POLO Ralph Lauren, Calvin Klein, Timberland	Qingdao, China; Bangladesh, Vietnam, San Salvador	Youngone Holding	51%
Taiwan	Makalot	1477 TT	693	X	X	O	X	GAP, Kohl's, Target, JC Penney; Hanesbrands	Shanghai, China; Indonesia; Cambodia; Vietnam; Philippines	Management	55%
Taiwan	Tainan Enterprise	1473 TT	183	X	X	O	O	GAP, Mast, Macy's, Ann Taylor, Talbots, ESPRIT, Levis, Target, Sears	Cambodia; Indonesia; China; Taiwan	Yang Family	50%
Taiwan	Eclat Textile	1476 TT	1,533	X	O	O	X	Lululemon, Under Armour, Nike, Adidas	China, Vietnam, Cambodia	Chairman& Former chairman	11%

*Source: Companies, Daiwa compiled; * As of 03 May, 2013; **As of FY12*

■ **Textile/garment industry value chain**



Source: Companies, compiled by Daiwa

Appendix II: recent ASEAN policy announcements

■ **ASEAN: recent policy announcements**

Indonesia	Indonesia's Congress approved a new law for land acquisition in December 2011 which protects land providers' rights and improves the efficiency of land acquisition. The new law makes it easier for investors and land developers to acquire land.
	Indonesia may boost the average minimum wage by as much as 50% in 2013 as labour groups are calling for higher pay amid economic growth that has exceeded 6% for eight straight quarters.
Laos	Laos received approval to join the WTO in October 2012 as the 158th member.
	At the 9th Asia-Europe (ASEM 9) Summit, Laos signed at least 18 agreements and MoUs with other countries. These cover a wide range of topics, including agreements on financial assistance for various development projects, cooperation agreements on a Laos-China railway link, and a rail project from Savannakhet Province to the Laos-Vietnam border, as well as MoUs between Laos' Ministry of Foreign Affairs and ministries of other countries.
Malaysia	Malaysia intends to introduce rules for the governance of initial public offerings of business trusts as it seeks to extend a wave of share sales that saw the country surpass Hong Kong and Singapore for IPOs in 2012.
	Malaysia has announced further deregulation for its service sector and has so far attracted USD2.18bn of investments spanning 11 projects, ranging from the energy to property sectors. Malaysia will allow foreigners to own up to 70% of telecommunications network and service providers.
	Kuala Lumpur has become the world's fourth-largest centre for IPOs in 2012, overtaking financial hubs including London. Three of Asia's four largest first-time share sales in 2012 have come from Malaysia, which have raised a total of USD6.8bn.
	The prime minister has announced 20 projects under seven National Key Economic Areas, as well as the three Economic Corridors worth MYR26.09bn.
Myanmar	The EU approved a one-year suspension of sanctions against Myanmar in April 2012. The US suspended all economic sanctions on Myanmar in May 2012.
Philippines	The Department of Transportation and Communication (DOTC) aims to speed up work on public-private partnership (PPP) projects. The current PPP pipeline includes projects worth USD4.8bn.
	The Department of Energy (DOE) is setting up a one-stop-shop for investments.
Thailand	Thailand and South Korea have agreed to double their annual trade to USD30bn within the next 5 years, up from the 2011 level of USD13.9bn.
	Thailand increased its daily minimum wage to THB300 with effect from 1 January 2013.
*Vietnam	The minimum salary payable during probation periods or temporary reassignments will increase from 70% to 85% of the normal pay rate.
	Official observation of the Tet New Year holiday will increase from four to five days, increasing the number of days of paid public holidays from nine to 10 days.
	Maternity leave will increase from four to six months, with leave extended by an additional month per child in the event of multiple births.
	The maximum period for work permits for foreign workers will be reduced from three to two years. In most cases, work permits for foreign workers will now be required for short-term assignments (under 90 days), a change from the current code, which has no such requirement.
	Employers that outsource labor (i.e., employing temporary workers) and temp agencies will now be subject to rules and regulations, in contrast to the existing code, which does not address the subject. The changes would restrict the types of jobs that can be outsourced, limit the maximum duration of temporary employment to 12 months and require that temporary workers' pay equal permanent employees' wages if they have comparable duties and responsibilities.
Cambodia	Payment of Wages: Wages must be paid directly to the employee, unless agreed otherwise. Manual labourers must be paid at least twice per month, and their paydays must not be more than 16 days apart. Regular employees must be paid at least once per month. Any employee working on a commission basis must be paid at least every three months
	Salary Tax: a resident employee is taxed on both Cambodian and foreign sources, on an incremental scale with a maximum marginal rate of 20%. Non-resident employees pay tax solely on Cambodian income, at a flat rate of 20%.
	Normal working hours: Employees can work for a maximum of 8 hours per days, 48 hours per week; Overtime must be compensated at 150% of the employee's wages, if the overtime is completed before 10 pm. If the overtime is scheduled after 10 pm, on Sunday, or a public holiday, then the organization must pay 200% of the employee's wages. In any event, overtime is generally limited to 2 hours per shift.
	Maternity & Paternity Leave: expectant mothers are entitled to 90 days of maternity leave after one year of continuous service. There is no restriction on whether the leave must start before or after the birth. During the maternity leave period, the organization must pay 50% of the employee's average wage earned during the preceding 12 months. The payment should be made before the employee begins leave.

Source: Various websites, Daiwa's economics team

*Note: *Vietnam's new labour code came into effect on 1 May 2013*

Daiwa Capital Markets

Company

Consumer Discretionary / China
6 May 2013

The 10-second briefing

Shenzhou International Group
2313 HK

Target (HKD): **17.70 → 27.80**
Upside: **22.5%**
3 May price (HKD): **22.70**

Leader of the pack

- We expect sales growth across the various businesses to be more balanced over the next few years
- We expect Shenzhou to raise its dividend-payout ratio for the next few years on strong cash flow and a healthy balance sheet
- Our top pick in the sector; raising target price to HKD27.80 from HKD17.70; reaffirm Buy rating

1 **Buy** (unchanged)
2 Outperform
3 Hold
4 Underperform
5 Sell

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■ What's new
Unlike the market, which we believe has underestimated Shenzhou's dividend-payout ratio for the next few years, we think there is a high likelihood Shenzhou will actually increase its ratio from 2013, given its strong cash flow and healthy balance sheet. We also believe its earnings growth will accelerate in 2013-14 on expected benefits from its new synthetic product and the work it is doing with customer UNIQLO. Shenzhou remains our top sector pick.

■ What's the impact
We believe Shenzhou will be able to expand sales for key businesses in a more balanced fashion. Given strong demand from its casual-wear clients, such as UNIQLO, we forecast 15% YoY sales growth for its casual-wear business for 2013. We are also positive on the company's new products (synthetic fibre products and underwear line), which we think could be future revenue-growth engines.

Currently, most of Shenzhou's manufacturing capacity is in China. However, over the long term, we think Shenzhou will consider building upstream facilities in certain TPP countries, such as Vietnam, to benefit from favourable export tariffs.

■ What we recommend
We reiterate our Buy (1) rating and are raising our six-month target price to HKD27.80 (from HKD17.70), based on a new target PER of 14x (previously 10x) applied to the average of our 2013-14 EPS forecasts, to reflect the recent sector rerating. While we are cutting our 2013-14 earnings forecasts following the lower-than-expected 2012 numbers, given Shenzhou's competitive vertically integrated business model, we think the stock deserves to trade at least on a par with its regional peers. Also, given Shenzhou's strong cash flow and healthy balance sheet, we forecast it to raise its dividend-payout ratio to 60% from 2013 (versus 47% in 2012).

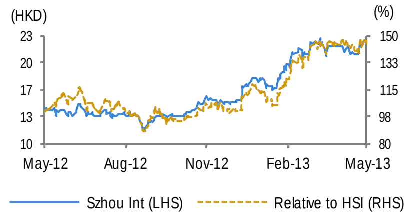
■ How we differ
Our 2013-15 EPS forecasts are largely in line with those of the Bloomberg consensus. However, we are more bullish than the market on Shenzhou's ability to pay out more dividends to its shareholders.

Forecast revisions (%)

Year to 31 Dec	13E	14E	15E
Revenue change	(5.0)	(1.5)	n.a.
Net profit change	(4.4)	(2.4)	n.a.
Core EPS (FD) change	(2.4)	(0.4)	n.a.

Source: Daiwa forecasts

Share price performance



12-month range	11.76-22.70
Market cap (USDbn)	3.81
3m avg daily turnover (USDm)	5.65
Shares outstanding (m)	1,303
Major shareholder	Ma Jianrong (58.4%)

Financial summary (CNY)

Year to 31 Dec	13E	14E	15E
Revenue (m)	9,994	11,733	13,293
Operating profit (m)	2,399	2,796	3,135
Net profit (m)	1,923	2,244	2,519
Core EPS (fully-diluted)	1.475	1.722	1.933
EPS change (%)	18.7	16.7	12.2
Daiwa vs Cons. EPS (%)	(0.7)	(2.9)	(3.0)
PER (x)	12.2	10.5	9.3
Dividend yield (%)	4.9	5.7	6.4
DPS	0.886	1.034	1.160
PBR (x)	2.5	2.3	2.0
EV/EBITDA (x)	7.6	6.4	5.6
ROE (%)	22.2	22.9	23.0

Source: FactSet, Daiwa forecasts

Financial summary

Key assumptions

Year to 31 Dec	2008	2009	2010	2011	2012	2013E	2014E	2015E
Output volume (m pieces)	134.5	160.1	169.7	207.0	215.3	236.8	267.6	294.3
ASP (CNY/piece)	34.0	36.0	37.8	42.0	40.4	41.2	42.8	44.1
Sales breakdown by products -Casual wear (%)	49.7	46.5	35.2	33.7	33.5	34.4	33.2	32.8
Sales breakdown by products -Sports wear (%)	42.3	42.3	50.2	54.7	55.9	55.0	51.5	50.0
Sales breakdown by products - Lingerie (%)	5.2	8.6	11.0	8.8	7.9	9.1	10.9	13.5
Sales breakdown by products - Other knitted products (%)	2.8	2.6	3.6	2.7	2.8	1.4	4.5	3.8

Profit and loss (CNYm)

Year to 31 Dec	2008	2009	2010	2011	2012	2013E	2014E	2015E
Casual wear Revenues	2,398	2,835	2,366	3,047	2,994	3,443	3,890	4,357
Sports wear Revenues	2,042	2,578	3,373	4,949	4,994	5,494	6,043	6,648
Other Revenue	382	680	980	1,047	949	1,057	1,799	2,289
Total Revenue	4,823	6,093	6,719	9,043	8,938	9,994	11,733	13,293
Other income	62	44	197	169	244	250	250	250
COGS	(3,674)	(4,159)	(4,713)	(6,442)	(6,393)	(7,066)	(8,272)	(9,372)
SG&A	(187)	(222)	(221)	(291)	(446)	(361)	(470)	(564)
Other op.expenses	(220)	(261)	(325)	(381)	(308)	(419)	(445)	(472)
Operating profit	804	1,495	1,656	2,100	2,035	2,399	2,796	3,135
Net-interest inc./(exp.)	(47)	(22)	(32)	(40)	(30)	(24)	(24)	(24)
Assoc/forex/extraord./others	0	0	0	0	0	0	0	0
Pre-tax profit	757	1,474	1,625	2,059	2,005	2,375	2,772	3,111
Tax	(57)	(220)	(352)	(355)	(384)	(451)	(527)	(591)
Min. int./pref. div./others	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)
Net profit (reported)	699	1,252	1,272	1,704	1,620	1,923	2,244	2,519
Net profit (adjusted)	699	1,252	1,272	1,704	1,620	1,923	2,244	2,519
EPS (reported)(CNY)	0.562	1.006	1.021	1.369	1.243	1.475	1.722	1.933
EPS (adjusted)(CNY)	0.562	1.006	1.021	1.369	1.243	1.475	1.722	1.933
EPS (adjusted fully-diluted)(CNY)	0.562	1.006	1.021	1.369	1.243	1.475	1.722	1.933
DPS (CNY)	0.176	0.308	0.306	0.405	0.579	0.886	1.034	1.160
EBIT	804	1,495	1,656	2,100	2,035	2,399	2,796	3,135
EBITDA	1,022	1,742	1,958	2,431	2,333	2,817	3,242	3,607

Cash flow (CNYm)

Year to 31 Dec	2008	2009	2010	2011	2012	2013E	2014E	2015E
Profit before tax	757	1,474	1,625	2,059	2,005	2,375	2,772	3,111
Depreciation and amortisation	218	247	302	331	298	419	445	472
Tax paid	(34)	(184)	(145)	(363)	(384)	(451)	(527)	(591)
Change in working capital	(166)	(440)	(999)	(419)	(151)	(273)	(557)	(499)
Other operational CF items	79	99	(4)	123	60	48	48	48
Cash flow from operations	854	1,194	778	1,733	1,828	2,117	2,182	2,541
Capex	(557)	(612)	(562)	(427)	(800)	(700)	(400)	(400)
Net (acquisitions)/disposals	1	(23)	(283)	3	0	0	0	0
Other investing CF items	(39)	(21)	(61)	(164)	159	0	0	0
Cash flow from investing	(595)	(656)	(907)	(588)	(641)	(700)	(400)	(400)
Change in debt	32	(135)	715	(185)	(458)	14	0	0
Net share issues/(repurchases)	0	0	0	0	950	0	0	0
Dividends paid	(187)	(220)	(384)	(382)	(505)	(755)	(1,154)	(1,347)
Other financing CF items	(47)	(22)	(32)	(24)	(30)	(24)	(24)	(24)
Cash flow from financing	(202)	(377)	299	(592)	(43)	(765)	(1,178)	(1,371)
Forex effect/others	0	0	0	0	0	0	0	0
Change in cash	57	162	171	553	1,145	652	604	769
Free cash flow	297	583	217	1,305	1,028	1,417	1,782	2,141

Source: FactSet, Daiwa forecasts

Financial summary continued ...

Balance sheet (CNYm)

As at 31 Dec	2008	2009	2010	2011	2012	2013E	2014E	2015E
Cash & short-term investment	365	446	752	1,347	2,275	2,903	3,484	4,229
Inventory	732	1,185	1,809	1,953	1,924	2,199	2,581	2,925
Accounts receivable	487	607	897	1,314	1,398	1,499	1,760	1,994
Other current assets	117	150	382	302	330	330	330	330
Total current assets	1,702	2,389	3,840	4,915	5,928	6,932	8,155	9,478
Fixed assets	2,480	2,915	3,470	3,522	3,853	4,216	4,167	4,091
Goodwill & intangibles	128	122	116	110	105	105	105	105
Other non-current assets	12	2	0	2	9	9	9	9
Total assets	4,321	5,427	7,425	8,550	9,895	11,262	12,436	13,683
Short-term debt	767	620	1,350	1,244	786	800	800	800
Accounts payable	287	386	487	491	397	500	587	665
Other current liabilities	320	449	681	702	590	677	674	671
Total current liabilities	1,374	1,455	2,518	2,437	1,773	1,977	2,061	2,136
Long-term debt	64	76	80	0	0	0	0	0
Other non-current liabilities	10	1	15	0	0	0	0	0
Total liabilities	1,448	1,532	2,612	2,437	1,773	1,977	2,061	2,136
Share capital	130	130	130	130	137	137	137	137
Reserves/R.E./others	2,731	3,753	4,670	5,949	7,951	9,119	10,209	11,380
Shareholders' equity	2,860	3,882	4,800	6,078	8,087	9,255	10,345	11,517
Minority interests	13	13	14	34	35	30	30	30
Total equity & liabilities	4,321	5,427	7,425	8,550	9,895	11,262	12,436	13,683
EV	23,946	23,730	24,158	23,398	22,013	21,394	20,813	20,068
Net debt/(cash)	466	250	678	(103)	(1,489)	(2,103)	(2,684)	(3,429)
BVPS (CNY)	2.298	3.118	3.855	4.882	6.206	7.103	7.939	8.838

Key ratios (%)

Year to 31 Dec	2008	2009	2010	2011	2012	2013E	2014E	2015E
Sales (YoY)	31.9	26.4	10.3	34.6	(1.2)	11.8	17.4	13.3
EBITDA (YoY)	67.4	70.4	12.4	24.2	(4.0)	20.7	15.1	11.3
Operating profit (YoY)	85.2	85.9	10.8	26.8	(3.1)	17.8	16.6	12.1
Net profit (YoY)	71.9	79.0	1.6	34.0	(4.9)	18.7	16.7	12.2
Core EPS (fully-diluted) (YoY)	71.9	79.0	1.6	34.0	(9.1)	18.7	16.7	12.2
Gross-profit margin	23.8	31.7	29.9	28.8	28.5	29.3	29.5	29.5
EBITDA margin	21.2	28.6	29.1	26.9	26.1	28.2	27.6	27.1
Operating-profit margin	16.7	24.5	24.6	23.2	22.8	24.0	23.8	23.6
Net profit margin	14.5	20.5	18.9	18.8	18.1	19.2	19.1	18.9
ROAE	26.2	37.1	29.3	31.3	22.9	22.2	22.9	23.0
ROAA	17.0	25.7	19.8	21.3	17.6	18.2	18.9	19.3
ROCE	23.0	36.1	30.6	30.9	25.0	25.3	26.3	26.7
ROIC	24.6	34.0	26.9	30.2	26.0	28.1	30.5	32.1
Net debt to equity	16.3	6.4	14.1	net cash	net cash	net cash	net cash	net cash
Effective tax rate	7.5	15.0	21.7	17.2	19.1	19.0	19.0	19.0
Accounts receivable (days)	30.8	32.8	40.9	44.6	55.4	52.9	50.7	51.5
Current ratio (x)	1.2	1.6	1.5	2.0	3.3	3.5	4.0	4.4
Net interest cover (x)	17.1	68.5	52.3	52.3	67.9	100.8	116.5	130.6
Net dividend payout	31.4	30.6	30.0	29.6	46.6	60.0	60.0	60.0
Free cash flow yield	1.3	2.5	0.9	5.6	4.4	6.0	7.6	9.1

Source: FactSet, Daiwa forecasts

Company profile

Shenzhou International Group (Shenzhou) is the largest vertically integrated player in China's garment business, which exports its products to Japan, Europe, United States and etc. And it is the largest textile/garment exporter in China.

Leader of the pack

New product lines should add revenue-growth momentum

Over the past five years, Shenzhou's sportswear business (in terms of sales) has been its fastest-growing business segment, recording a revenue CAGR of 34% over 2007-12. This segment has fuelled Shenzhou's business development, allowing it to become more than just a casual wear OEM player. Last year, sportswear sales accounted for 56% of its total revenue, due to rising orders from strategic customers such as Adidas, Nike and Puma. We forecast its sportswear sales to account for 55% of its total 2013 revenue, representing 10% YoY growth.

Its casual-wear business, however, has been expanding at a much slower pace over the past three years, as the company has experienced not only weaker-than-expected demand from the Japanese market (mainly casual wear), but has also put more resources into expanding its sportswear business.

Balanced sales growth for key segments

As the 2013 progresses, we expect sales growth for Shenzhou's various businesses to increase in a more balanced manner. Given the rapid expansion in sales for the company's sportswear business over the past few years, we expect sales growth to moderate. As Shenzhou is now one of the largest suppliers of apparel to the global sportswear brands, we believe the division is unlikely to replicate the 30-40% YoY sales growth it saw previously.

Meanwhile, we think Shenzhou will able to maintain stable revenue growth for its casual-wear businesses as we expect continued strong demand for apparel from its key client UNIQLO in Japan. UNIQLO plans to expand its presence outside of Japan, while other relatively new clients such as Abercrombie & Fitch and Calvin Klein have been added to its casual-ear portfolio.

■ Shenzhou: revenue breakdown by product

(CNYm)	2011	2012	2013E	2014E	2015E
Casual wear	3,047	2,994	3,443	3,890	4,357
Sports wear	4,949	4,994	5,494	6,043	6,648
Lingerie	799	702	912	1,277	1,788
Other knitted products	248	248	145	522	501
Total	9,043	8,938	9,994	11,733	13,293

Source: company, Daiwa forecasts

New products should fuel revenue growth

Shenzhou has been working on its polyester fabric since early last year. It has invested to build a new dedicated facility for this product at its headquarters in Ningbo (a large part of the CNY800m it incurred in capex for 2012), which started production in 4Q12. We believe this product will increase revenue in 2013 and 2014, and has a higher gross-profit margin compared with Shenzhou's traditional cotton-based apparel. Although this year is the first year the product will be commercially produced, we forecast sales of it to account for about 4% of total sales (we forecast total polyester fabric sales of CNY400m for 2013).

Based on our market research, we understand that Shenzhou is working closely with UNIQLO on the production of its AIRism products, a new underwear line that has been developed. According to Daiwa's Japan Specialty Retail analyst Yoshimasa Ikazaki, UNIQLO has an aggressive sales target for its AIRism brand over for the next few years, and the company believes it could be the next Heattech, one of UNIQLO's most successful products. For his latest sector update, see *Yen depreciation resulting in two-tiered earnings picture* (13 March 2013), and for more on Fast Retailing's (9983 JP, JPY36,000, Neutral [3]) UNIQLO operations (see page 24 of his sector update).

This new product line has the potential to be important to UNIQLO (in terms of revenue contribution), and we think it would be positive for Shenzhou as well. As the product cycle for the AIRism range is in the early stages of development, it is difficult for us to forecast the overall impact on Shenzhou's revenue, and whether it will actually be as big a success as the Heattech range. However, we do see this is as a positive development and hence we could we upside revisions to our revenue forecasts in the future.

Expanding the production base

Ningbo is still the main production base for Shenzhou, as not only is it home to its corporate headquarters but also houses most of the company's capacity for both upstream and downstream products. All of its upstream production plants are still in Ningbo, whereas the company has been expanding its downstream garment-making facilities into lower-cost areas, such as China's inner provinces and to lower-cost countries such as Cambodia.

As part of its capacity expansion plans, Shenzhou is now working on phase II of its plant in Cambodia, and phase II of its garment factory in Anqing, Anhui Province.

We believe Shenzhou's management will continue to increase its downstream garment-production facilities, as it increases production.

In terms of the company's upstream capacity expansion, we think it makes sense for Shenzhou to consider expanding into Trans-Pacific Partnership countries such as Vietnam because of the lower production costs and favourable tariffs. Currently, Shenzhou does not fully benefit from the tariffs awarded to TPP countries, as it sources its upstream products from China, despite having a downstream garment-making facility in Cambodia. However, if the company produces within the TPP region, it would benefit from the favourable export duties under the TPP agreement, which would have a positive impact on its business, because it would result in more volume orders. Thus, we would not be surprised if Shenzhou expands into Vietnam, which falls under the TPP agreement.

Paying more dividends

In April 2012, Shenzhou raised CNY1.2bn through a new share placement to enable it to invest in its polyester-fabric-making facilities. Within a year of the placement, the company paid back CNY755m to shareholders in dividends at the end of 2012. Also, we notice the company had a net cash position as at the end of last year.

■ **Shenzhou: net cash and dividend payout**

	2011	2012	2013E	2014E	2015E
Net cash (CNYm)	103	1,489	2,103	2,684	3,429
Net profit (CNYm)	1,704	1,620	1,923	2,244	2,519
Total dividend (CNYm)	505	755	1,154	1,347	1,512
Dividend-payout ratio (%)	30%	47%	60%	60%	60%

Source: company, Daiwa forecasts

Strong cash flow could support an increase in dividends

As we forecast Shenzhou's capex to decline to CNY700m in 2013 and CNY400m in 2014, we expect its free cash flow to increase over the same period. Thus, we think Shenzhou has the ability to pay out more dividends to its shareholders, supported by its strong cash flow.

In the past, even though the company had paid out a recurring dividend of about 30% of its total earnings, we forecast Shenzhou to raise its payout ratio to 60% over the next few years. According to our calculations, we forecast the total dividend to increase by 53% to CNY1.15bn for 2013 and 17% YoY, to CNY1.35bn, for 2014.

Valuation

We reiterate our Buy (1) rating and raise our six-month target price to HKD27.80 (from HKD17.70), based on a new target PER of 14x (previously 2013E PER of 10x) applied to the average of our 2013-14 EPS forecasts. We are increasing our target PER to reflect the recent sector rerating. We think the stock is still undervalued and we rate it as one of our top picks within the China textiles universe. Our new target PER is equal to the average 2013E PER of the company's Asia ex-Japan peers at current share prices (based on our and the Bloomberg-consensus EPS forecasts).

As the entire China sector has been rerated recently, on the back of stable earnings growth and strong cash flows of the textile companies, we believe Shenzhou deserves to trade at least at a par, if not at a premium, to peers, given that its vertically integrated business model tends to be more competitive.

As the company is adding new businesses to its portfolio, we believe its earnings-growth momentum will accelerate. We now forecast earnings growth of 19% YoY for 2013 (previously 14% YoY) and 17% YoY for 2014 (previously 14% YoY).

Some investors perceive the textiles sector to be a cyclical one, with the China companies involved in low-end manufacturing. These have been the main reasons why the sector has traded at relatively lower multiples in the past. However, we think the notion of being a cyclical sector is a misconception and that this does not apply to market leaders such as Shenzhou (we do not believe the market leaders are cyclical). Based on Shenzhou's past track record, the company has been able to maintain its gross-profit margin and has increased its dividend payout, regardless of the tough economic situation.

Risks

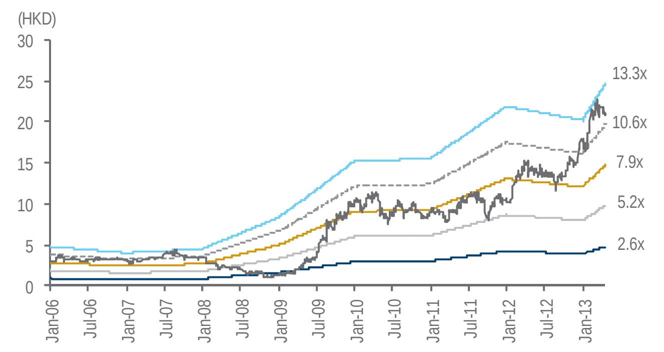
The main risks to our call would be significant fluctuations in the price of cotton, which would have a negative impact in Shenzhou's margins and profitability. Also, higher-than-expected increases in production costs such as labour, utilities could also be risks.

Peer valuation comparison

Company name	BBG code	Share price 03-May-13 (Local curr.)	Market cap (USDm)	Rating	PER (x) FY13E	PER (x) FY14E	PBR (x) FY13E	PBR (x) FY14E	EV/EBITDA (x) FY13E	EV/EBITDA (x) FY14E	Div. yield (%) FY13E	ROE (%) FY13E
*SHENZHOU INTL GP	2313 HK	22.70	3,810	Buy (1)	12.2	10.5	2.5	2.3	7.6	6.4	4.9	22.2
*TEXWINCA HLDG	321 HK	8.95	1,573	Sell (5)	30.7	17.9	2.3	2.1	15.4	10.1	2.0	7.3
*PACIFIC TEXTILE	1382 HK	9.88	1,820	Outperform (2)	14.6	12.5	3.3	3.0	8.8	7.7	7.2	23.5
*TEXHONG TEXTILE	2678 HK	9.05	1,032	Buy (1)	9.2	6.9	2.0	1.7	6.5	5.2	3.3	24.0
CHINA TAIFENG BE	873 HK	1.98	255	NR	2.9	2.8	n.a.	n.a.	n.a.	n.a.	3.4	n.a.
WEIQIAO TEXTI-H	2698 HK	4.30	662	NR	9.0	8.7	0.3	0.3	n.a.	n.a.	3.5	2.9
GLORIOUS SUN ENT	393 HK	2.22	303	NR	13.1	11.1	1.0	0.9	n.a.	n.a.	6.3	7.5
ECLAT TEXTILE CO	1476 TT	184.00	1,533	NR	18.9	14.8	5.8	4.8	13.6	10.7	3.3	33.3
MAKALOT INDUSTRI	1477 TT	125.50	693	NR	15.0	13.2	4.7	n.a.	12.0	n.a.	5.6	27.6
YOUNGONE CORP	111770 KS	41,050.00	1,660	NR	19.6	19.1	n.a.	n.a.	n.a.	n.a.	0.5	19.0
HANSAE CO LTD	105630 KS	18,100.00	661	NR	11.6	10.2	2.4	2.0	9.5	7.4	0.6	22.9
Average					14.2	11.6	2.7	2.1	10.4	7.9	3.7	19.0

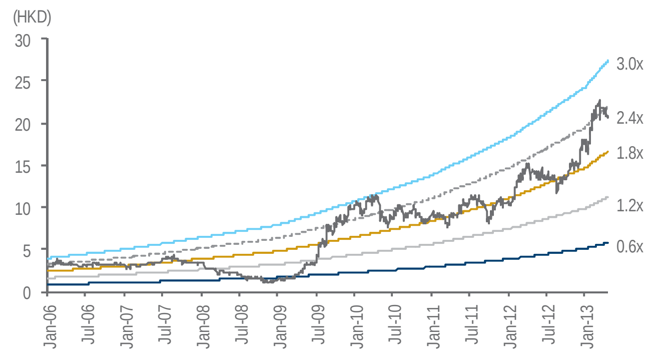
*Source: Bloomberg,*Daiwa forecasts*

Shenzhou: PER bands



Source: Bloomberg

Shenzhou: PBR bands



Source: Bloomberg

Shenzhou: Daiwa earnings-forecast revisions

	2013E			2014E		
	New	Previous	Changes (%)	New	Previous	Changes (%)
Output (m pieces)	237	235	1%	268	258	4%
ASP (CNY/piece)	41.2	43.7	-6%	42.8	45.0	-5%
(CNYm)						
Revenue	9,994	10,515	-5%	11,733	11,911	-1%
Gross profit	2,928	3,175	-8%	3,461	3,633	-5%
Operating profit	2,399	2,546	-6%	2,796	2,908	-4%
Net profit	1,923	2,010	-4%	2,244	2,300	-2%
EPS (CNYcents)	1.48	1.51	-2%	1.72	1.73	0%
Gross-profit margin	29.3%	30.2%	-0.9 pp	29.5%	30.5%	-1.0 pp
Operating profit margin	24.0%	24.2%	-0.2 pp	23.8%	24.4%	-0.6 pp

Source: Daiwa forecasts

The 10-second briefing

Pacific Textiles Holdings
1382 HK

Target (HKD): **9.50 → 11.00**
Upside: **11.3%**
3 May price (HKD): **9.88**

Look beyond China for long-term business growth

- The company is building a factory in Vietnam, which should lead to lower costs and favourable tariff treatment
- If the first phase of factory construction in Vietnam is successful, we expect further expansion
- Raising target price to HKD11.00, but downgrading to Outperform as we see less upside potential from current levels

1 Buy
2 Outperform (from Buy)
3 Hold
4 Underperform
5 Sell

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■ What's new
Given the recent rally in the share price (43.2% YTD), we are downgrading our rating because valuations now appear stretched. However, we still like the company because it has a superior operating track record and an attractive dividend yield, and we expect these features to be sustained over the long term. We also find the move into Vietnam appealing.

■ What's the impact
We like the company's decision to move into Vietnam, and expect this to sustain its business growth over the next few years. Pacific Textiles is working on phase I of its plant construction in Vietnam and aims to achieve annual sales volume of 50m lbs of fabric once construction is completed, expected in 2014. Management expects commercial operations at the Vietnam factory to start in 12-15 months. If phase I of the Vietnam operation is successful, we expect Pacific Textiles to add more capacity in the country, given the strategic value of its geographical location in terms of lower manufacturing costs and preferential tariffs for exports to the US under the terms of the TPP.

■ What we recommend
Given our confidence in the long-term revenue growth of the Vietnam factory/expansion plan, we are raising our target FY14E PER to 14x (from 12x), to reflect the recent sector rerating, and on a par with its regional peers. As such, we raise our six-month target price to HKD11.00 (from HKD9.50). However, we downgrade our rating to Outperform (2) from Buy (1), as we now see less upside potential from current levels.

Among its peers, Pacific Textiles stands out in terms of delivering consistent earnings growth, even in challenging times, and has maintained its dividend-payout ratio over the past 5-6 years. The risks to our call would include cotton-price fluctuations and a sudden decline in end demand, which would lead to a lower utilisation rate.

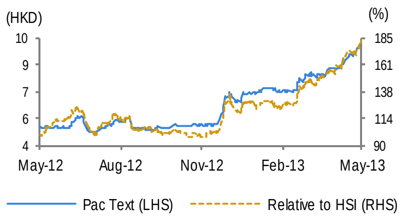
■ How we differ
We are more optimistic than the market about the company's overall output volume growth over the next few years. We are also more bullish on the company's dividend-payout ratio.

Forecast revisions (%)

Year to 31 Mar	13E	14E	15E
Revenue change	-	-	-
Net profit change	-	-	-
Core EPS (FD) change	-	-	-

Source: Daiwa forecasts

Share price performance



12-month range	4.74-9.88
Market cap (USDbn)	1.82
3m avg daily turnover (USDm)	0.92
Shares outstanding (m)	1,433
Major shareholder	Directors (67.4%)

Financial summary (HKD)

Year to 31 Mar	13E	14E	15E
Revenue (m)	7,038	8,076	9,610
Operating profit (m)	1,139	1,328	1,561
Net profit (m)	968	1,131	1,326
Core EPS (fully-diluted)	0.676	0.789	0.925
EPS change (%)	18.8	16.8	17.3
Daiwa vs Cons. EPS (%)	5.1	10.7	17.9
PER (x)	14.6	12.5	10.7
Dividend yield (%)	7.2	5.2	6.1
DPS	0.710	0.513	0.602
PBR (x)	3.3	3.0	2.7
EV/EBITDA (x)	8.8	7.7	6.7
ROE (%)	23.5	25.2	26.6

Source: FactSet, Daiwa forecasts

Financial summary

Key assumptions

Year to 31 Mar	2008	2009	2010	2011	2012	2013E	2014E	2015E
Output volume (m lbs)	155	157	196	209	155	176	213	253
ASP (HKD/lb)	27.6	30.1	30.0	34.3	41.5	40.0	38.0	38.0
Gross profit per unit (HKD/lbs)	4.5	4.4	6.2	6.2	7.1	7.4	7.1	7.1

Profit and loss (HKDm)

Year to 31 Mar	2008	2009	2010	2011	2012	2013E	2014E	2015E
Textiles Revenues	4,281	4,735	5,883	7,181	6,420	7,038	8,076	9,610
Other Revenue	0	0	0	0	0	0	0	0
Other Revenue	0	0	0	0	0	0	0	0
Total Revenue	4,281	4,735	5,883	7,181	6,420	7,038	8,076	9,610
Other income	58	59	68	87	99	90	100	100
COGS	(3,584)	(4,048)	(4,662)	(5,891)	(5,321)	(5,736)	(6,566)	(7,813)
SG&A	(352)	(320)	(320)	(285)	(236)	(253)	(283)	(336)
Other op.expenses	0	0	0	0	0	0	0	0
Operating profit	403	425	970	1,092	961	1,139	1,328	1,561
Net-interest inc./(exp.)	11	2	1	1	9	19	19	19
Assoc/forex/extraord./others	52	2	(3)	(16)	3	9	16	19
Pre-tax profit	465	429	969	1,078	974	1,167	1,362	1,598
Tax	(69)	(49)	(150)	(183)	(158)	(198)	(232)	(272)
Min. int./pref. div./others	(5)	(4)	(16)	(18)	77	0	0	0
Net profit (reported)	392	377	803	876	893	968	1,131	1,326
Net profit (adjusted)	392	377	803	876	815	968	1,131	1,326
EPS (reported)(HKD)	0.282	0.263	0.561	0.612	0.623	0.676	0.789	0.925
EPS (adjusted)(HKD)	0.282	0.263	0.561	0.612	0.569	0.676	0.789	0.925
EPS (adjusted fully-diluted)(HKD)	0.282	0.263	0.561	0.612	0.569	0.676	0.789	0.925
DPS (HKD)	0.145	0.150	0.520	0.330	0.700	0.710	0.513	0.602
EBIT	403	425	970	1,092	961	1,139	1,328	1,561
EBITDA	639	686	1,272	1,394	1,215	1,444	1,660	1,947

Cash flow (HKDm)

Year to 31 Mar	2008	2009	2010	2011	2012	2013E	2014E	2015E
Profit before tax	465	429	969	1,078	974	1,167	1,362	1,598
Depreciation and amortisation	236	261	302	302	254	305	332	386
Tax paid	(67)	(29)	(87)	(182)	(190)	(198)	(232)	(272)
Change in working capital	77	181	(347)	(680)	763	(574)	(276)	(429)
Other operational CF items	7	45	33	78	(229)	(30)	(44)	(49)
Cash flow from operations	719	887	870	596	1,572	669	1,143	1,235
Capex	(431)	(212)	(241)	(175)	(162)	(300)	(600)	(600)
Net (acquisitions)/disposals	1	(23)	(71)	(23)	100	0	0	0
Other investing CF items	0	0	(325)	208	117	0	0	0
Cash flow from investing	(429)	(234)	(636)	10	55	(300)	(600)	(600)
Change in debt	(270)	(236)	(285)	62	(9)	3	0	0
Net share issues/(repurchases)	1,796	0	0	0	0	0	0	0
Dividends paid	(873)	(150)	(673)	(444)	(846)	(1,017)	(735)	(862)
Other financing CF items	28	(12)	(9)	(31)	48	(1)	(2)	(2)
Cash flow from financing	681	(399)	(968)	(414)	(806)	(1,016)	(737)	(864)
Forex effect/others	0	0	0	0	0	0	0	0
Change in cash	971	254	(734)	192	820	(646)	(193)	(228)
Free cash flow	289	675	629	421	1,409	369	543	635

Source: FactSet, Daiwa forecasts

Financial summary continued …

Balance sheet (HKDm)

As at 31 Mar	2008	2009	2010	2011	2012	2013E	2014E	2015E
Cash & short-term investment	1,194	1,433	889	1,070	1,899	1,262	1,085	875
Inventory	993	762	1,174	1,501	903	1,267	1,534	1,922
Accounts receivable	609	600	789	1,110	927	1,126	1,333	1,586
Other current assets	35	18	66	46	144	529	576	671
Total current assets	2,832	2,813	2,918	3,728	3,872	4,183	4,527	5,054
Fixed assets	1,551	1,527	1,472	1,431	1,231	1,226	1,494	1,708
Goodwill & intangibles	0	0	0	0	0	0	0	0
Other non-current assets	20	45	267	141	258	268	284	303
Total assets	4,403	4,386	4,656	5,300	5,362	5,677	6,306	7,064
Short-term debt	275	284	73	174	0	50	50	50
Accounts payable	611	551	805	775	929	918	1,116	1,328
Other current liabilities	236	263	440	435	391	391	391	391
Total current liabilities	1,122	1,099	1,319	1,383	1,319	1,358	1,557	1,769
Long-term debt	394	120	1	0	47	0	0	0
Other non-current liabilities	1	5	17	29	33	33	33	33
Total liabilities	1,517	1,224	1,336	1,412	1,400	1,392	1,590	1,802
Share capital	1	1	1	1	1	1	1	1
Reserves/R.E./others	2,838	3,110	3,253	3,799	3,953	4,277	4,707	5,253
Shareholders' equity	2,840	3,111	3,254	3,801	3,955	4,278	4,708	5,255
Minority interests	46	50	66	87	7	7	7	7
Total equity & liabilities	4,403	4,386	4,656	5,300	5,362	5,677	6,306	7,064
EV	13,664	13,137	13,280	13,217	12,064	12,694	12,855	13,046
Net debt/(cash)	(526)	(1,029)	(814)	(896)	(1,851)	(1,212)	(1,035)	(825)
BVPS (HKD)	2.046	2.171	2.271	2.652	2.760	2.985	3.285	3.667

Key ratios (%)

Year to 31 Mar	2008	2009	2010	2011	2012	2013E	2014E	2015E
Sales (YoY)	1.8	10.6	24.3	22.0	(10.6)	9.6	14.7	19.0
EBITDA (YoY)	(26.8)	7.4	85.4	9.6	(12.9)	18.9	14.9	17.3
Operating profit (YoY)	(40.3)	5.5	128.2	12.6	(12.0)	18.5	16.6	17.6
Net profit (YoY)	(29.4)	(4.0)	113.3	9.1	(7.0)	18.8	16.8	17.3
Core EPS (fully-diluted) (YoY)	(45.4)	(7.0)	113.3	9.1	(7.0)	18.8	16.8	17.3
Gross-profit margin	16.3	14.5	20.8	18.0	17.1	18.5	18.7	18.7
EBITDA margin	14.9	14.5	21.6	19.4	18.9	20.5	20.6	20.3
Operating-profit margin	9.4	9.0	16.5	15.2	15.0	16.2	16.4	16.2
Net profit margin	9.2	8.0	13.7	12.2	12.7	13.8	14.0	13.8
ROAE	18.3	12.7	25.2	24.8	21.0	23.5	25.2	26.6
ROAA	10.5	8.6	17.8	17.6	15.3	17.5	18.9	19.8
ROCE	13.5	11.9	27.9	29.3	23.8	27.3	29.2	31.0
ROIC	15.1	16.8	35.4	33.0	31.6	36.5	32.6	31.9
Net debt to equity	net cash	net cash	net cash	net cash	net cash	net cash	net cash	net cash
Effective tax rate	14.7	11.3	15.5	17.0	16.2	17.0	17.0	17.0
Accounts receivable (days)	50.7	46.6	43.1	48.3	57.9	53.2	55.6	55.4
Current ratio (x)	2.5	2.6	2.2	2.7	2.9	3.1	2.9	2.9
Net interest cover (x)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Net dividend payout	51.2	57.1	92.8	54.0	112.3	105.0	65.0	65.0
Free cash flow yield	2.0	4.8	4.4	3.0	10.0	2.6	3.8	4.5

Source: FactSet, Daiwa forecasts

Company profile

Pacific Textiles Holdings manufactures customised knitted fabrics with a focus on complex, value-added fabrics. The company's products are used in a broad range of garments, such as men's, women's, and children's clothing, sportswear, swimwear, and innerwear. It works closely with many leading brands, including UNIQLO, Calvin Klein, Nike, Adidas, and Victoria's Secret, and has strong relationships with garment manufacturers.

Daiwa Capital Markets

Company

Consumer Discretionary / China

6 May 2013

The 10-second briefing

Texhong Textile

2678 HK

Target (HKD): **11.00**
Upside: **21.5%**
3 May price (HKD): **9.05**

Initiation: a good yarn

- Texhong's overseas production base gives it a competitive advantage over its upstream peers in China
- Its profitability should be boosted by the rising international cotton price
- We forecast a 2013-15 net profit CAGR of 30%; initiate with a Buy rating and target price of HKD11

1 **Buy** (initiation)
2 Outperform
3 Hold
4 Underperform
5 Sell

How do we justify our view?

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Investment case

We believe Texhong Textile (Texhong), which specialises in making high value-added yarns and fabrics, is a good proxy for the favourable structural changes we see in China's textile industry. We like the company's ability to source low-cost cotton from overseas at its established production base in Vietnam, but also expect it to benefit in terms of margins and earnings from an upward trend in the cotton price. We initiate coverage with a Buy (1) rating.

Catalysts

Texhong is able to buy more low-cost international cotton, as one of its production bases is in Vietnam. In our view, this gives the company a competitive advantage, enabling it to make its core products at a lower cost than its upstream competitors in China. We believe Texhong will continue to leverage on this advantage by expanding its capacity gradually in new locations such as North Vietnam, and it is also planning to enhance its product mix so as to increase its ASP. The current upward trend in the international cotton price should be a positive catalyst, as Texhong's earnings have a strong correlation with China and international cotton prices (a higher price enables it to enjoy higher ASPs and thus higher gross-profit margins).

We forecast the company to see a solid revenue CAGR of 24% for 2013-15, on planned capacity expansion in both Vietnam and China. For the net profit, we forecast strong growth of 37% YoY for 2013 and a 30% CAGR for 2013-15.

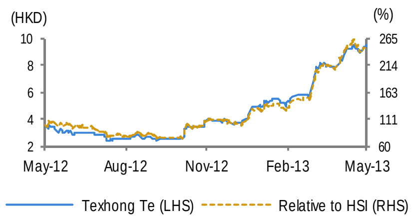
Valuation

We initiate coverage with a six-month target price of HKD11, based on the average of our 2013-14 EPS forecasts and a target 2013 PER of 10x, at a 30% discount to its regional peer group's average 2013 PER at the current share prices. As Texhong's business is sensitive to cotton-price fluctuations, we believe such a discount is warranted. Still, we believe Texhong has one of the best earnings-growth profiles in its peer group, and that the stock is undervalued at current levels.

Risks

We see the key risks to our rating, forecasts and target price as a decline in the international cotton price and sluggish economies in China and the Asia region.

Share price performance



12-month range	2.40-9.05
Market cap (USDbn)	1.03
3m avg daily turnover (USDm)	1.08
Shares outstanding (m)	885
Major shareholder	New Green Group Limited (42.4%)

Financial summary (CNY)

Year to 31 Dec	13E	14E	15E
Revenue (m)	9,364	11,691	14,418
Operating profit (m)	929	1,230	1,505
Net profit (m)	665	888	1,122
Core EPS (fully-diluted)	0.752	1.004	1.268
EPS change (%)	36.7	33.6	26.3
Daiwa vs Cons. EPS (%)	13.9	25.5	28.1
PER (x)	9.6	7.2	5.7
Dividend yield (%)	3.1	4.2	5.3
DPS	0.226	0.301	0.381
PBR (x)	2.1	1.7	1.4
EV/EBITDA (x)	6.8	5.6	5.1
ROE (%)	24.0	26.8	27.6

Source: FactSet, Daiwa forecasts

1 Buy (initiation)
2 Outperform
3 Hold
4 Underperform
5 Sell

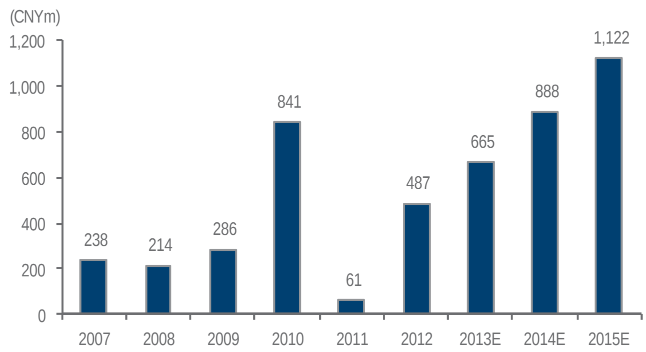
How do we justify our view?

- Growth outlook ✔✔✔✔✔
- Valuation ✔✔✔✔✔
- Earnings revisions ✔✔✔✔✔

Growth outlook ✔✔✔✔✔

We forecast Texhong's net profit to increase by 37% YoY for 2013 and at a CAGR of 30% over the 2013-15 period, on the back of enhancements to its product mix and expansion of its production capabilities and capacity to low-cost regions (such as North Vietnam). In addition, the continued upward trend we foresee in the international cotton price should enable the company to raise its ASP, boosting the company's earnings and net-profit margin over the next three years.

Texhong: net profit

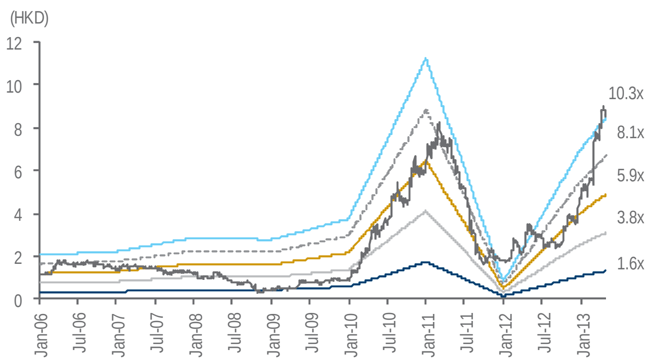


Source: Company, Daiwa forecasts

Valuation ✔✔✔✔✔

Our six-month target price of HKD11.00 is based on a PER of 10x applied to the average of our 2013 and 2014 EPS forecasts. Our target PER represents a 30% discount to the average 2013 PER of its Asia ex-Japan peers at the current share prices (based on our and the Bloomberg-consensus EPS forecasts). Our target price implies 22% upside potential, backed by the earnings' improvement we project for the next three years.

Texhong: PER bands

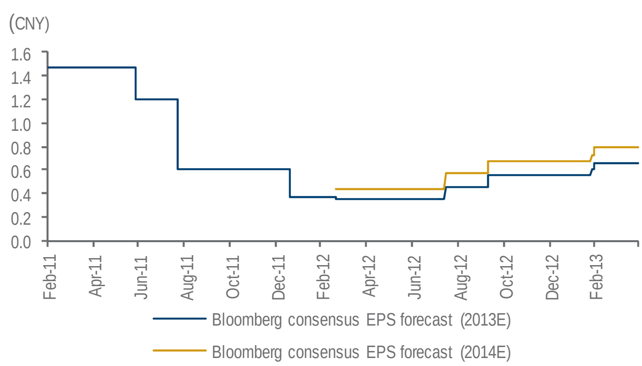


Source: Bloomberg

Earnings revisions ✔✔✔✔✔

Our 2013 and 2014 EPS forecasts for Texhong are 14% and 26%, respectively, higher than those of the Bloomberg consensus, reflecting our more positive outlook for the company's sales-volume growth. We expect strong sales-volume growth, which, along with the company's ability to source its main raw materials at lower prices, should enable it to deliver robust earnings growth.

Texhong: consensus EPS forecasts



Source: Bloomberg

Financial summary

Key assumptions

Year to 31 Dec	2008	2009	2010	2011	2012	2013E	2014E	2015E
Sales volume growth - stretchable core-spun yarns (YoY %)	n.a.	n.a.	(0.1)	3.0	44.8	33.3	30.0	26.7
Sales volume growth - other yarns (YoY %)	n.a.	n.a.	13.2	9.8	2.3	3.7	3.7	3.7
Sales volume growth - fabrics (YoY %)	n.a.	n.a.	(1.6)	(15.8)	16.7	15.0	16.0	17.0
Sales growth by products -stretchable core-spun yarns (YoY %)	(4.2)	7.0	36.4	24.3	18.9	32.0	28.0	25.0
Sales growth by products -other yarns (YoY %)	0.0	53.9	41.1	45.8	(16.2)	21.6	19.5	20.7
Sales growth by products -fabrics (YoY %)	(7.9)	(14.2)	19.2	2.0	10.3	20.0	20.0	20.0

Profit and loss (CNYm)

Year to 31 Dec	2008	2009	2010	2011	2012	2013E	2014E	2015E
Stretchable core-spun yarns/ Yarns	2,037	2,179	2,972	3,693	4,391	5,796	7,418	9,273
Other yarns	662	1,019	1,438	2,096	1,756	2,135	2,553	3,081
Other Revenue	1,039	891	1,062	1,083	1,195	1,434	1,720	2,064
Total Revenue	3,738	4,088	5,472	6,873	7,341	9,364	11,691	14,418
Other income	62	17	47	14	6	8	8	8
COGS	(3,279)	(3,487)	(4,163)	(6,317)	(6,217)	(7,871)	(9,748)	(12,021)
SG&A	(159)	(135)	(189)	(184)	(225)	(332)	(481)	(660)
Other op.expenses	(101)	(124)	(184)	(235)	(228)	(240)	(240)	(240)
Operating profit	261	359	982	150	677	929	1,230	1,505
Net-interest inc./(exp.)	5	(41)	(41)	(70)	(123)	(150)	(189)	(189)
Assoc/forex/extraord./others	(17)	0	9	3	4	4	4	4
Pre-tax profit	248	318	950	83	557	783	1,045	1,320
Tax	(34)	(32)	(109)	(22)	(71)	(117)	(157)	(198)
Min. int./pref. div./others	0	0	0	(0)	0	(0)	(0)	(0)
Net profit (reported)	214	286	841	61	487	665	888	1,122
Net profit (adjusted)	214	286	841	61	487	665	888	1,122
EPS (reported)(CNY)	0.242	0.323	0.951	0.069	0.550	0.752	1.004	1.268
EPS (adjusted)(CNY)	0.242	0.323	0.951	0.069	0.550	0.752	1.004	1.268
EPS (adjusted fully-diluted)(CNY)	0.242	0.323	0.951	0.069	0.550	0.752	1.004	1.268
DPS (CNY)	0.000	0.097	0.239	0.082	0.219	0.226	0.301	0.381
EBIT	261	359	982	150	677	929	1,230	1,505
EBITDA	357	482	1,127	327	881	1,149	1,450	1,725

Cash flow (CNYm)

Year to 31 Dec	2008	2009	2010	2011	2012	2013E	2014E	2015E
Profit before tax	248	318	950	83	557	783	1,045	1,320
Depreciation and amortisation	96	123	144	176	205	220	220	220
Tax paid	(26)	(25)	(81)	(100)	(55)	(117)	(157)	(198)
Change in working capital	25	(92)	(619)	(292)	63	(277)	(489)	(823)
Other operational CF items	30	44	75	96	154	146	185	185
Cash flow from operations	374	368	470	(36)	924	754	804	704
Capex	(336)	(129)	(349)	(460)	(656)	(706)	(774)	(824)
Net (acquisitions)/disposals	26	3	9	19	11	0	0	0
Other investing CF items	(19)	6	0	0	0	0	0	0
Cash flow from investing	(328)	(121)	(340)	(441)	(645)	(706)	(774)	(824)
Change in debt	204	(91)	279	692	(81)	1,232	0	0
Net share issues/(repurchases)	1	0	0	0	0	0	0	0
Dividends paid	(62)	(27)	(143)	(199)	0	(194)	(200)	(266)
Other financing CF items	(75)	(50)	(88)	(123)	(131)	(128)	(189)	(189)
Cash flow from financing	67	(168)	47	371	(212)	910	(389)	(456)
Forex effect/others	0	0	0	0	0	0	0	0
Change in cash	113	79	177	(106)	67	958	(359)	(576)
Free cash flow	39	239	121	(496)	268	49	29	(120)

Source: FactSet, Daiwa forecasts

Financial summary continued …

Balance sheet (CNYm)

As at 31 Dec	2008	2009	2010	2011	2012	2013E	2014E	2015E
Cash & short-term investment	335	408	605	495	552	1,489	1,129	553
Inventory	690	715	1,387	1,289	1,422	1,889	2,437	3,126
Accounts receivable	464	435	404	640	812	1,011	1,122	1,269
Other current assets	87	112	495	233	237	133	360	456
Total current assets	1,576	1,670	2,891	2,657	3,023	4,523	5,049	5,404
Fixed assets	1,584	1,590	1,950	2,177	2,494	2,876	3,326	3,826
Goodwill & intangibles	0	0	0	0	0	0	0	0
Other non-current assets	39	37	68	96	108	108	108	108
Total assets	3,199	3,298	4,909	4,930	5,625	7,506	8,483	9,338
Short-term debt	523	708	610	144	206	200	200	200
Accounts payable	631	511	859	502	865	1,204	1,404	1,443
Other current liabilities	243	292	552	448	373	250	388	398
Total current liabilities	1,396	1,510	2,021	1,094	1,444	1,654	1,992	2,041
Long-term debt	554	277	630	1,712	1,564	2,802	2,802	2,802
Other non-current liabilities	20	24	49	52	59	58	58	9
Total liabilities	1,971	1,811	2,700	2,858	3,067	4,514	4,853	4,852
Share capital	94	94	283	283	283	283	283	283
Reserves/R.E./others	1,134	1,393	1,926	1,789	2,275	2,708	3,347	4,202
Shareholders' equity	1,228	1,487	2,209	2,072	2,558	2,992	3,630	4,486
Minority interests	0	0	0	0	(0)	0	0	0
Total equity & liabilities	3,199	3,298	4,909	4,930	5,625	7,506	8,483	9,338
EV	7,060	6,894	6,943	7,666	7,519	7,814	8,174	8,750
Net debt/(cash)	742	577	635	1,360	1,218	1,513	1,873	2,449
BVPS (CNY)	1.389	1.680	2.497	2.342	2.892	3.382	4.103	5.070

Key ratios (%)

Year to 31 Dec	2008	2009	2010	2011	2012	2013E	2014E	2015E
Sales (YoY)	14.9	9.4	33.8	25.6	6.8	27.6	24.8	23.3
EBITDA (YoY)	2.2	34.9	133.8	(71.0)	169.8	30.3	26.2	19.0
Operating profit (YoY)	(5.4)	37.5	173.8	(84.7)	350.2	37.3	32.4	22.4
Net profit (YoY)	(9.9)	33.3	194.6	(92.7)	694.3	36.7	33.6	26.3
Core EPS (fully-diluted) (YoY)	(10.7)	33.3	194.6	(92.7)	694.3	36.7	33.6	26.3
Gross-profit margin	12.3	14.7	23.9	8.1	15.3	15.9	16.6	16.6
EBITDA margin	9.6	11.8	20.6	4.8	12.0	12.3	12.4	12.0
Operating-profit margin	7.0	8.8	18.0	2.2	9.2	9.9	10.5	10.4
Net profit margin	5.7	7.0	15.4	0.9	6.6	7.1	7.6	7.8
ROAE	18.6	21.0	45.5	2.9	21.0	24.0	26.8	27.6
ROAA	7.3	8.8	20.5	1.2	9.2	10.1	11.1	12.6
ROCE	12.1	15.0	33.2	4.1	16.4	18.0	19.5	21.3
ROIC	12.0	16.0	35.4	3.5	16.4	19.1	20.9	20.6
Net debt to equity	60.4	38.8	28.7	65.7	47.6	50.6	51.6	54.6
Effective tax rate	13.8	10.2	11.5	26.6	12.8	15.0	15.0	15.0
Accounts receivable (days)	40.5	40.2	28.0	27.7	36.1	35.5	33.3	30.3
Current ratio (x)	1.1	1.1	1.4	2.4	2.1	2.7	2.5	2.6
Net interest cover (x)	n.a.	8.7	24.1	2.2	5.5	6.2	6.5	8.0
Net dividend payout	0.0	30.0	25.1	118.0	39.8	30.0	30.0	30.0
Free cash flow yield	0.6	3.8	1.9	n.a.	4.2	0.8	0.5	n.a.

Source: FactSet, Daiwa forecasts

Company profile

Texhong Textile Group Limited (Texhong) manufactures yarns and grey fabrics, especially high value-added core-spun yarn textiles. The company's sales network includes Mainland China, Brazil, Turkey, South Korea and Bangladesh, and it had more than 1,600 customers as at end-2012. Texhong operates 11 production plants in China and one in Vietnam, with a total production capacity at end-2012 of over 1m spindles and 900 air-jet looms.

Benefiting from its low-cost production base

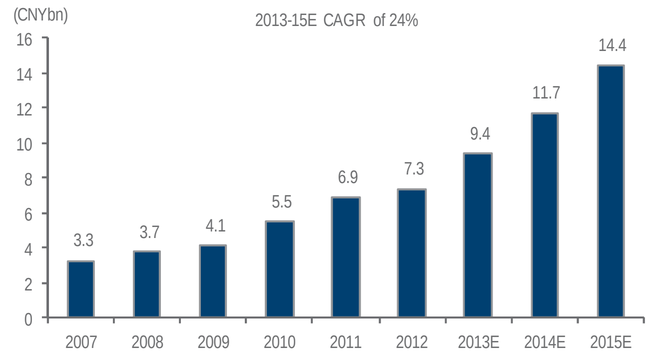
We believe Texhong is well-positioned strategically to source its key raw materials at lower prices compared to its China competitors, as some of its production facilities are located overseas.

Sustaining its competitive advantage via strategic location

Texhong is one of the leading upstream textile players in China, which is also its major market (Shanghai, Jiangsu Province and Zhejiang Province in particular). The company has an overseas production base, which allows it to benefit from low raw-material costs (it can source more cheaper cotton internationally than its peers) and tariffs.

The company is already reaping the benefits of its overseas production base, set up in Vietnam in 2006, as this enables it to source cotton from the international market at low cost. The price of cotton produced in China is much higher than the international cotton price due to the PRC Government's price-support policy. This enables Texhong to benefit from an arbitrage opportunity, using low-cost international cotton to make its textile products, then selling them at levels that are in line with the higher domestic cotton price. As long as the China cotton price remains higher than the international cotton price (which we expect to for the foreseeable future, as there are no plans currently to remove the China price-support policy), we believe this structural advantage over its domestic peers will remain a positive for Texhong's business growth and profitability in the coming years. Also, as the company plans to continue expanding its production facilities to low-cost regions within Southeast Asia over 2013-15, we expect it to be able to maintain solid top-line growth from an increase in production capacity.

■ Texhong: revenue



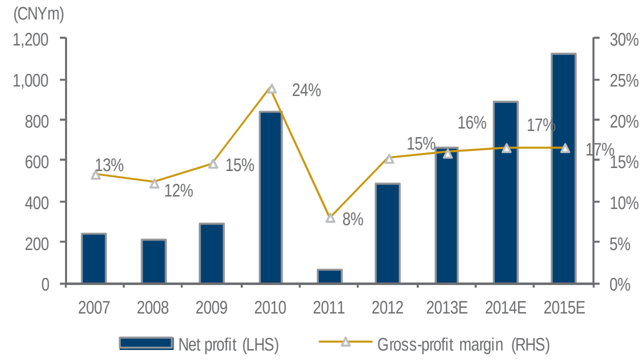
Source: Company, Daiwa forecasts

Texhong was one of the few textile companies in Asia ex-Japan to perform well financially in a tough operating environment for the textile industry in 2012.

For 2012, the company's revenue increased by a moderate 6.8% YoY to CNY 7.3bn, but its net profit rose eight-fold YoY to CNY487m, driven mainly by strong profit-margin expansion. Its gross-profit and net-profit margins rebounded by 7.2pp YoY to 15.3% and 5.7pp to 6.6%, respectively, due in part to the company's sourcing of international cotton at more favourable prices.

This recovery in the company's earnings for 2012 followed a substantial earnings decline in 2011, which was due to a sharp fall in China and international cotton prices. Last year's earnings recovery was aided by increased sales volumes, which, along with the company's flexibility to source lower-cost cotton internationally, helped it to improve profitability.

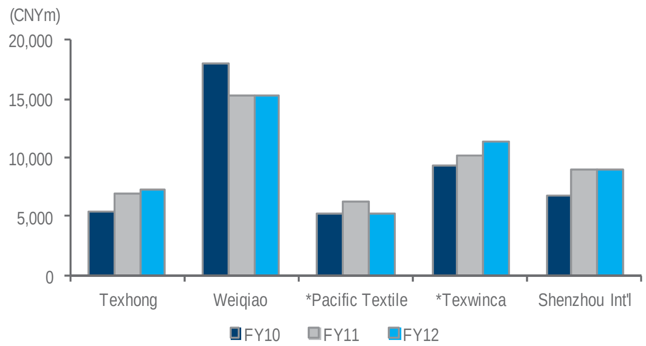
■ Texhong: net profit and gross-profit margin



Source: Company; Daiwa forecasts

We believe Texhong should be able to improve profitability further over 2013-15, on the back of the planned expansion to its production capacity and its increased focus on developing high-end, new products (such as non-Spandex core-spun yarns, knitted yarns using modal fibre, and viscose fibre), and thus we forecast a robust 30% earnings CAGR over the 2013-15 period. In our view, Texhong's key strength lies in the fact that it has a production plant in a low-cost country, Vietnam, and plans to expand into other markets, thereby enhancing its competitive edge over rival China textile companies over the long term.

■ **Texhong and China peers: sales comparison**



Source: Companies
*Note: * March financial year end*

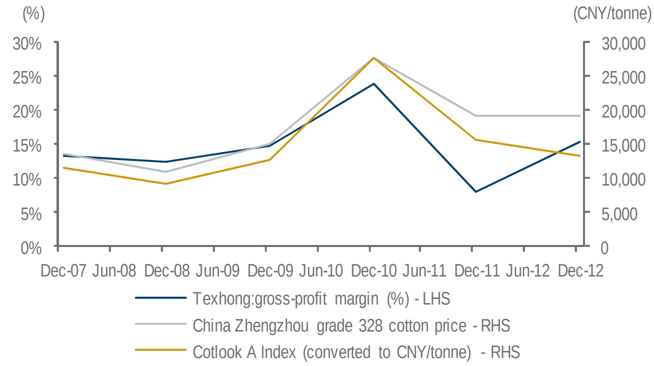
Cotton price is the key variable

Its earnings and share price are closely correlated with the cotton price

As an upstream player within the textile value chain, Texhong, like other spinners, relies heavily on raw materials, primarily cotton, given that the majority of its cost of goods sold comprises raw-material costs. Cotton accounts for more than 50% of the company's annual raw-material costs, and thus has a major influence on the trend in the company's gross-profit margin and bottom line.

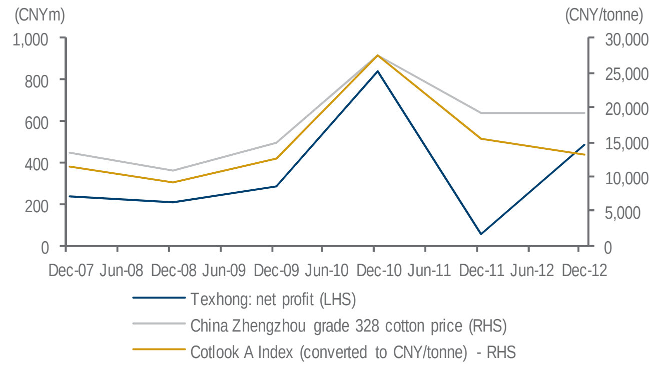
Since the selling prices of the final products from the spinners are set with reference to the spot price of the cotton crop in that particular year, cotton-yarn spinners typically benefit the most in terms of being able to set high ASPs when the cotton price rises, whereas their cotton inventory will generally have been sourced at a lower price prior to a spot-price rise. Our comparison in the charts that follow shows a close correlation between Texhong's gross-profit margin, net profit, and share price, with the movements in China and international cotton prices.

■ **Texhong: gross-profit margin vs. cotton price**



Source: Company, Bloomberg

■ **Texhong: net profit vs. cotton price**



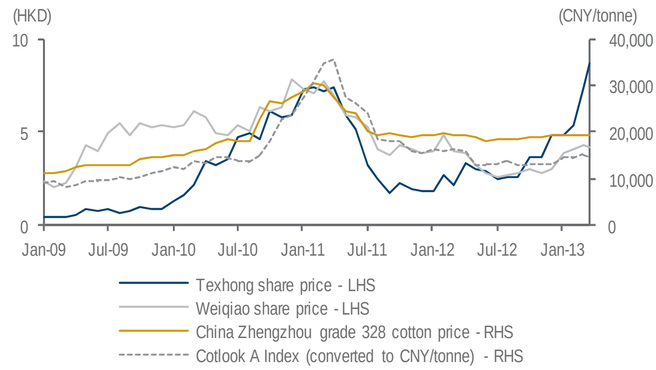
Source: Company, Bloomberg

International cotton price up modestly YTD

As discussed in the industry section of this report, the international cotton price has rebounded modestly year-to-date, which should have a positive impact on Texhong's gross-profit margin at least for this year.

In the following chart, we include Weiqiao Textile as it is one of Texhong's biggest competitors in China, and is also solely an upstream player.

■ **Texhong: share-price correlation with cotton price**

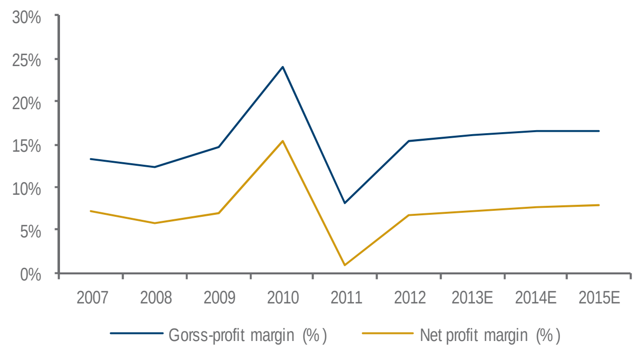


Source: Bloomberg

Texhong has been making efforts to reduce its exposure to cotton by increasing the use of other raw materials, such as synthetic fibre. Management has co-operation agreements with international companies that produce special fibres (cellulose-based Tencel, modal, and viscose), such as Invista (of the US), Lenzing (of China), and Toray (of Japan).

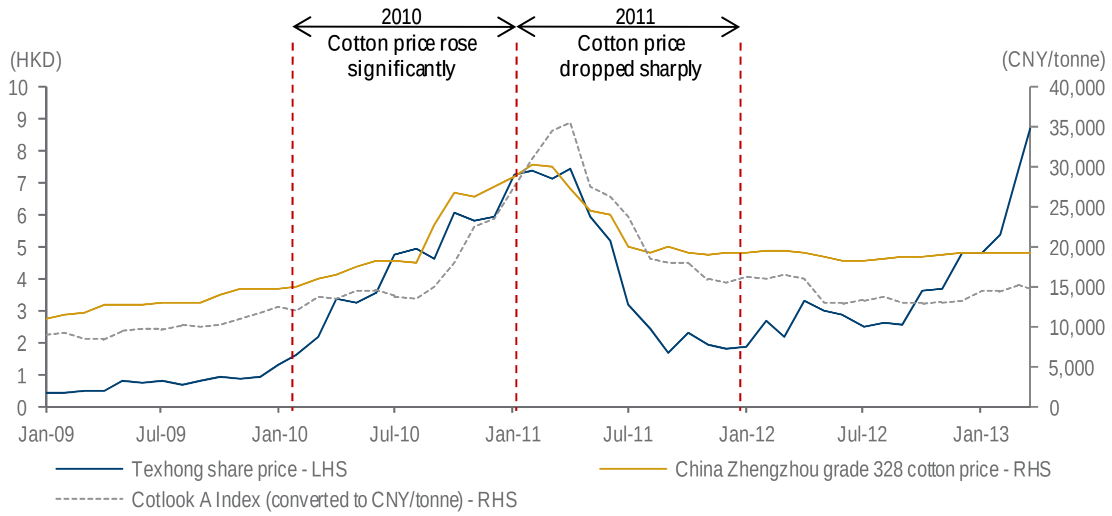
Thus, barring very sharp fluctuations in cotton prices, we expect further improvements in the company's gross and net-profit margins over 2013-15E.

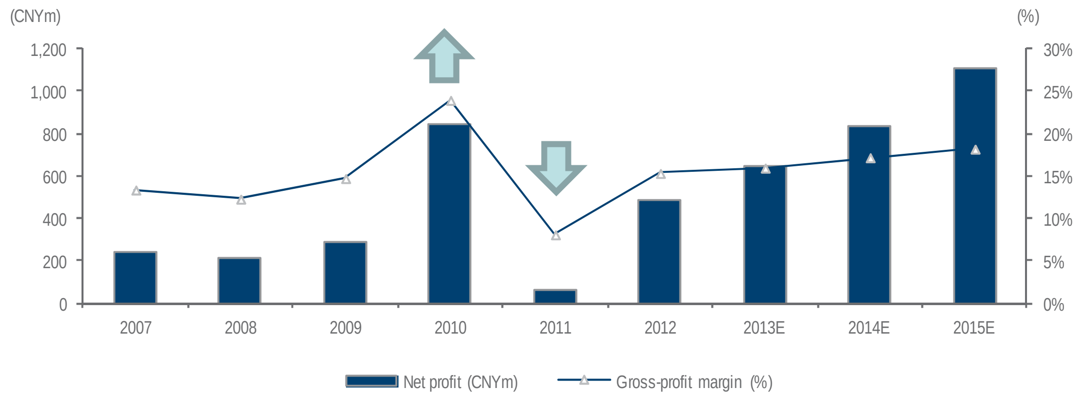
■ **Texhong: gross-profit and net-profit margins**



Source: Company, Daiwa forecasts

■ **Texhong: illustration of correlation of share price and net profit with cotton price**





Source: Bloomberg, Daiwa

Expansion plans

Geographical diversification: China and Vietnam

At present, Texhong has 12 production plants, of which 11 are in China (Xuzhou, Taizhou, Changzhou, and Nantong in Jiangsu Province, and Pujiang in Zhejiang Province) and one is in Vietnam (Dong Nai Province).

■ Texhong: production plants

Source: Company, compiled by Daiwa
*Note: * Work in progress*

In terms of production capacity, at the end of 2012 the company had a total of 1m spindles (more than 590,000 in China and over 400,000 in Vietnam) and 900 air-jet looms (in China). The overall utilisation rates were 100% in Vietnam and China (in terms of yarn products) for 2012.

Expansion: Vietnam, China, Uruguay, and Turkey

The company is working on establishing a new production plant in Vietnam's Quang Ninh Province, which borders China. The company expects the facility to be completed in 2014. About 400,000 spindles and 30 sets of open-end spinning machines are due be added to its total current capacity by the new plant.

Texhong benefits from a preferential tariff arrangement between China and Vietnam under the China-Asian Free Trade Area. This sees the tariffs on textiles exported between the two countries being close to zero. Also, as Quang Ninh Province borders China, the logistics expenses from the facility should be lower than the plant in Dong Nai.

In addition, the company expects 330,000 spindles to be added to its production base in Jiangsu Province, China, this year. Furthermore, a total of CNY400m will be invested to build a synthetic-fibre yarn factory in Uruguay that the company expects to be completed in 2014. This new plant is aimed at serving Texhong's existing client base in Brazil and also for entering the North America market, according to the company.

■ Texhong: production bases

Country	Area	Function	Note		
China	Jiangsu Province Zhejiang Province	Production bases and major markets	In the process of adding 330,000 spindles	Due to be completed in 2013	
Vietnam	Dong Nai	Production base	First overseas production base, built in 2006	Acquired another factory in March 2013	
Vietnam	Quang Ninh	Production base	Work started on the Quang Ninh facility in July 2012	Work on second phase started in 2013	
Uruguay	-	Production base	Synthetic-fibre yarn factory	Company expects construction to be completed in 2014	Plans to invest CNY400m
Turkey	-	Production base	Discussions are under way to acquire land and receive approvals.	Plans to acquire 200,000 sq m of land	Plans to invest USD4m

Source: Company, compiled by Daiwa

Focus on cost saving

Having a facility in Vietnam has allowed Texhong to enjoy reduced textile-export tariffs compared with other countries and competitive labour costs. It has also increased its flexibility with regards to sourcing low-priced cotton from overseas (there is a quota system on international cotton imports into China). Cotton, which is the key raw material for the company, accounted for 49% of its cost of sales for 2012. As Texhong continues to expand its production capacity, and with its ongoing cost-saving measures, we believe cost pressures are likely to be alleviated this year. Meanwhile, the Trans Pacific Partnership (TPP) agreement could be a catalyst for the future sales in North America over the long term. Under the TPP agreement, the tariffs on textile products exported from Vietnam to the US are due to drop from about 17% currently to 0% eventually.

Leveraging on low-priced international cotton

The major advantage Texhong has over other domestic upstream players is its ability to source cotton internationally. The company not only has an import quota of cotton as decided by the China Government (30,000-40,000 tonnes/year), but also can source cotton from other countries directly through its production base in Vietnam. About half of its production capacity is in the company's overseas factories, which can use cotton sourced from countries globally for production, while some of its domestic production capacity can use cotton from overseas through the import quota. As a result, more than 50% of Texhong's current production uses low-priced overseas-sourced cotton.

Unlike the other upstream players, Texhong has the flexibility to switch between sourcing international cotton and domestic cotton depending on the price. If the domestic cotton price fell, we believe the company could switch to use more domestic cotton instead.

■ **Regional textile players: gross-profit margin comparison (2010-12)**

	2010	2011	2012
Texhong	24%	8%	15%
Weiqiao	16%	2%	7%
*Pacific Textile	21%	18%	17%
*Texwinca	33%	34%	30%
Shenzhou International	30%	29%	28%

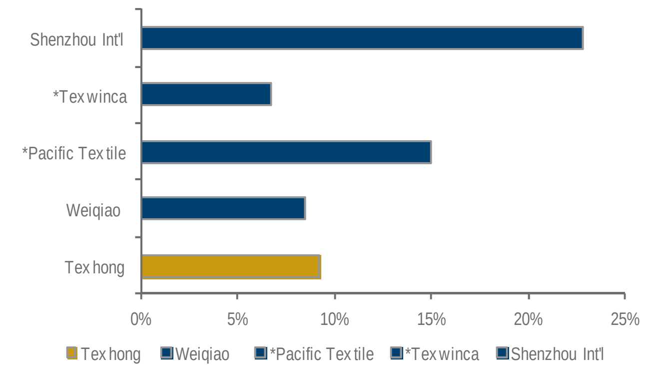
Source: Companies
*Note: *March financial year-end*

■ **Regional textile players: operating profit margin comparison (2010-12)**

	2010	2011	2012
Texhong	18%	2%	9%
Weiqiao	15%	5%	9%
*Pacific Textile	16%	15%	15%
*Texwinca	11%	11%	7%
Shenzhou International	25%	23%	23%

Source: Companies
*Note: *March financial year-end*

■ **Regional textile players: operating-profit margin comparison (2012)**



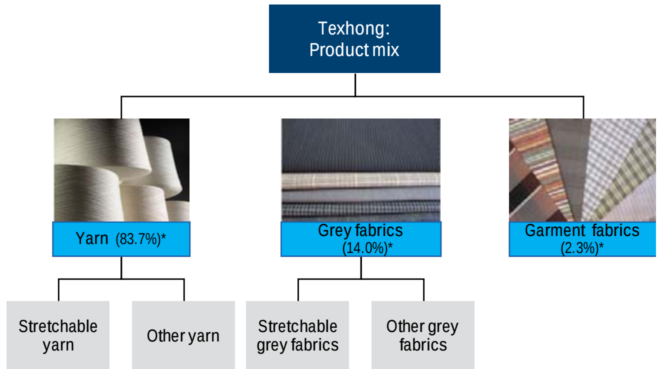
Source: Companies
*Note: *March financial year-end*

Product and client diversification

Major products

Texhong produces more than 1,500 types of yarn products and 2,700 types of fabric products. The company mainly focuses on manufacturing stretchable core-spun yarn and other yarns, with yarn products accounting for 83.7% of revenue for 2012.

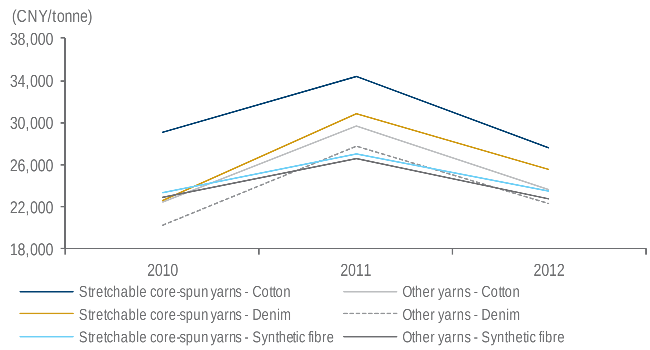
■ **Texhong: product mix (% of total revenue)**



Source: Company
*Note: *As of 31 December 2012*

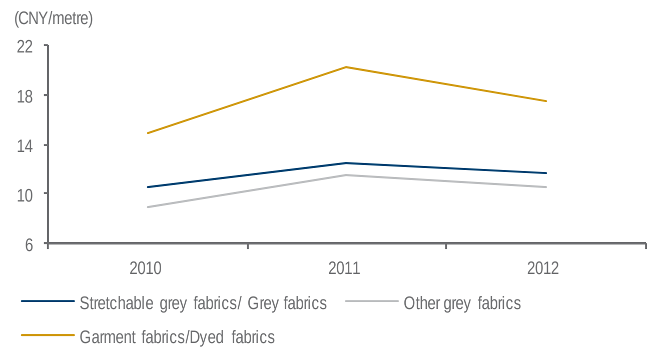
Among Texhong's yarn products, stretchable core-spun yarn (especially those products that use cotton as a raw material) has the highest selling price, while fabric products, such as garment fabrics and dyed fabrics have a lower ASP than stretchable grey fabrics. Management expects to increase the proportion of higher selling priced products in its product mix in order to improve the gross-profit margin.

■ **Texhong: product selling prices – yarns (CNY/tonne)**



Source: Company

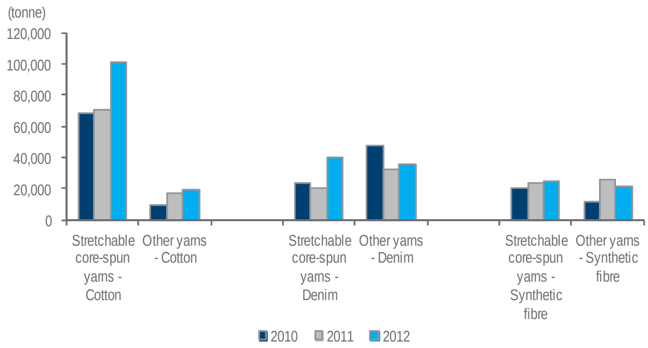
■ **Texhong: products selling price – fabrics (CNY/metre)**



Source: Company

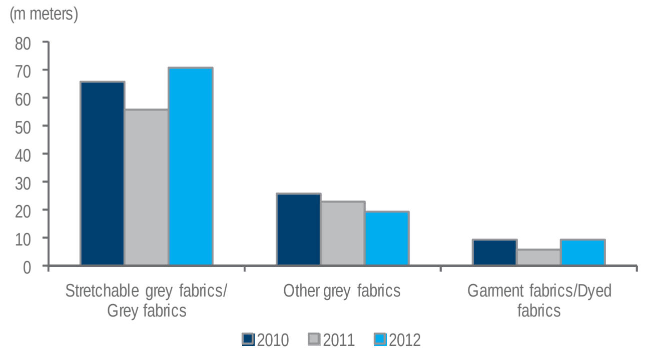
In terms of sales volume, about 68% of the company's yarn sales volume comes from stretchable core-spun cotton yarn, while the sales volume of stretchable grey fabrics accounts for 70% of total fabric sales volume. We believe it will continue to focus more on the high-margin products and work on developing high-end and new generation core-spun yarn products through its co-operation with special fibre producers such as INVISTA, Lenzing, and Toray, and improve the ASP of its value-added products.

■ **Texhong: products sales volume – yarns (tonnes)**



Source: Company

■ **Texhong: products sales volume – fabrics (m metres)**



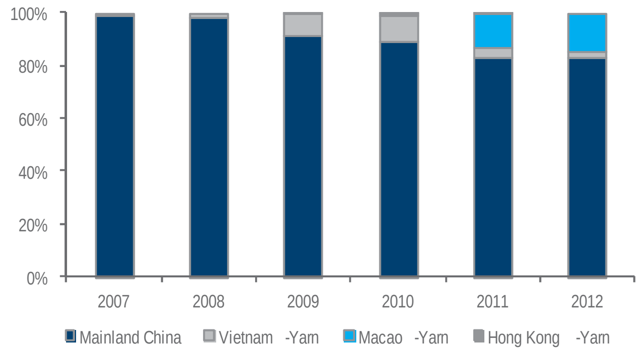
Source: Company

Major market and diversified clients base

Texhong's major market is Mainland China, which accounted for more than 80% of total 2012 turnover. Specifically, total sales to customers in Jiangsu and Zhejiang provinces respectively accounted for 59% and 60% of total sales for both 2011 and 2012.

In addition, the company continues to expand into Turkey, Brazil, Japan, Korea, Vietnam, and other markets. By the end of 2012, it had more than 1,600 customers (including about 1,400 from China), while revenue from its 10 largest customers accounted for only 19.8% of total revenue for the year.

■ **Texhong: revenue breakdown by region (2012)**



Source: Company

Company background and management

Texhong was established by Hong Tianzhu in 1997 and was listed in December 2004 in Hong Kong. Since establishing a production base in Vietnam in 2006, the company has enjoyed cost advantages over China competitors that only have production facilities in China, as Texhong can source cheaper cotton from overseas in Vietnam that is not subject to import tariffs. Chairman Hong and co-chief executive officer Zhui Yongxiang hold a combined shareholding of about 60% in the company.

■ **Texhong: shareholding structure**

Director	Percentage of ordinary shares (%)
Hong Tianzhu	51.9
Zhu Yongxiang	7.6

Source: Company
Note: As of 31 December 2012

■ **Texhong: management team**

Executive director	Position	Experience
Hong Tianzhu	Chairman and founder	Mr. Hong is the founder of the company and currently a vice chairman of the Hong Kong General Chamber of Textiles Limited. He has more than 20 years of experience in the textile industry.
Zhu Yongxiang	Co-chief executive officer	Mr. Zhu is responsible for the daily operation of the company. Prior to joining in 1997, he was an assistant to the general manager of Nantong No. 2 Cotton Textile Factory.
Tang Daoping	Chief operation officer and vice president	Mr. Tang is responsible for the operation of the company's yarn business. He has more than 27 years of experience in the textile industry, and joined Texhong in 1998 as a vice general manager.
Gong Zhao	Vice president	Mr. Gong is responsible for the operation of the company's grey fabric business. He has more than 27 years of experience in the textile industry and joined Texhong in 1998 as a vice general manager.

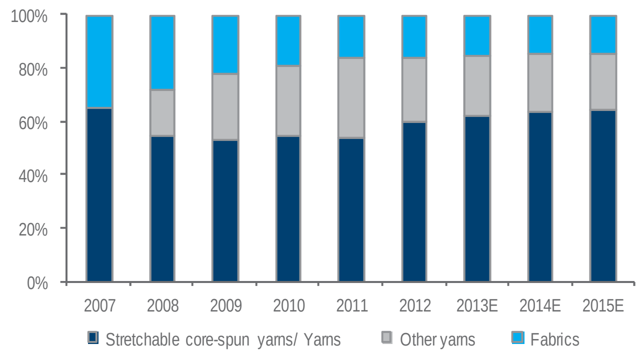
Source: Company

Financials

Resilient revenue growth

As at 31 December 2012, yarn products accounted for 84% of Texhong's total revenue. Specifically, stretchable core-spun yarn made up 60% of total 2012 revenue. We expect the company to continue to focus on the production of stretchable core-spun textile products over the next few years, due to the higher ASP these have compared with other products, and believe this will sustain future revenue growth. We forecast total revenue to rise by 28% YoY to CNY9.4bn for 2013, and at a CAGR of 24% for 2013-15.

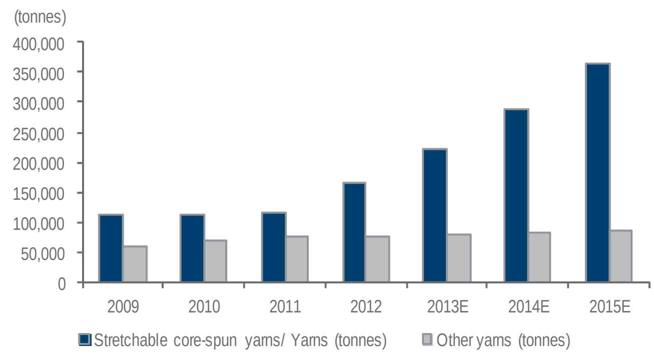
■ Texhong: revenue mix by product (%)



Source: Company, Daiwa forecasts

Due to sales-volume rises over the past few years, the company has continued to expand its production bases, both in inland China and overseas. The sales volume of its core product, stretchable core-spun yarn, rose by 45% YoY to 165,845 tonnes for 2012 from 114,502 tonnes for 2011, and we forecast it to increase at a CAGR of 28% over 2013-15.

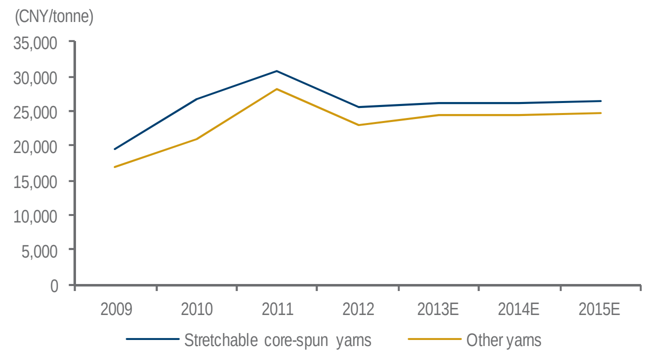
■ Texhong: sales volume of its core products (tonnes)



Source: Company, Daiwa forecasts

Texhong's ASP has a high correlation with the cotton price, as cotton is the key input for the company's products. Due to a decline in cotton prices over 2012, the ASP of yarn fell by 17% from CNY30,500 per tonne in 2011 to CNY25,308/tonne in 2012. Despite the ASP drop for 2012, the overall revenue of the company increased by 7% YoY, mainly driven by the improved sales volume of its products.

■ Texhong: ASP of major products (CNY/tonne)

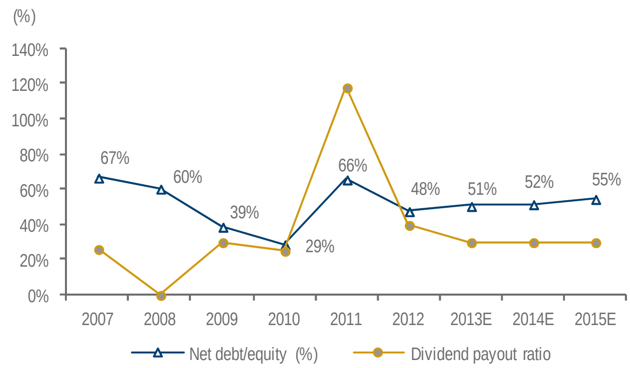


Source: Company, Daiwa forecasts

Improved balance sheet

At the end of 2012, the bank and cash balance of Texhong amounted to CNY530m (2011: CNY463m), while its net gearing improved to 48% for 2012 (from 66% for 2011). In April 2013, Texhong announced a plan to issue senior notes with a principal amount of USD200m (about CNY1.2bn) due in 2019, mainly to expand its business. We forecast the company's net-gearing ratio to be maintained at 50% over the next three years, which is at the high end of management's target. Meanwhile, we expect it to maintain a dividend payout ratio of at least 30% over 2013-15E.

■ Texhong: net debt-to-equity ratio and dividend-payout ratio (%)

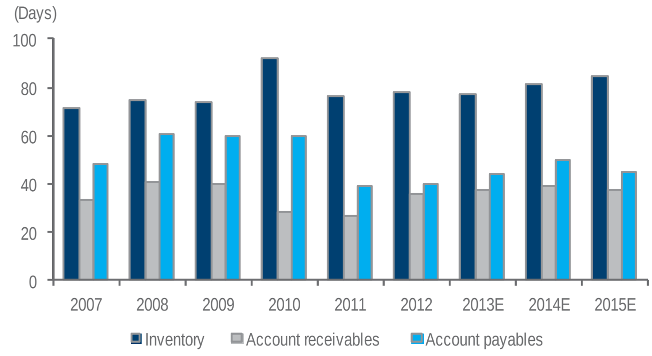


Source: Company, Daiwa forecasts

Working-capital management: increasing slightly but still better than peers

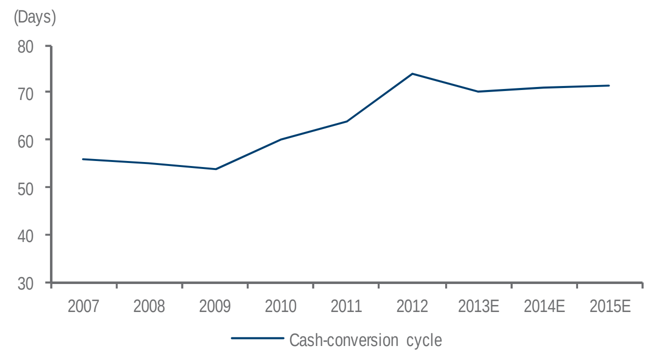
Texhong's cash-conversion cycle has been increasing since 2010, due to continuing operating expansion as well as increases in the prices of its raw production materials. Its inventory days increased slightly, to 78 days for 2012 from 76 days for 2011 on the back of a low cotton price. We believe the current rise in the international cotton price will benefit the company as it can continue to use low-priced cotton bought previously, while its selling price is benchmarked to the current sport price. Given that, we forecast the company's inventory days to increase slightly for 2013, which will lead to an increase in the cash-conversion cycle as well.

■ **Texhong: working-capital turnover days**



Source: Company, Daiwa forecasts

■ **Texhong: cash-conversion cycle**

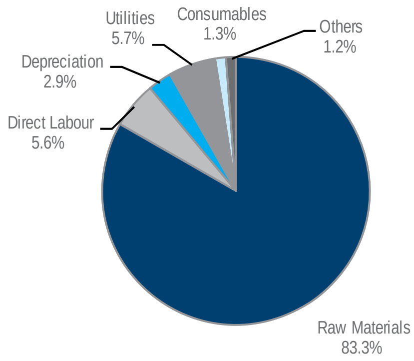


Source: Company, Daiwa forecasts

Cost structure

Raw materials account for more than 80% of the total cost of sales of Texhong, with the company's key raw-material component, cotton, making up about 50%. In the past, the company's earnings have been highly sensitive to fluctuations in the cotton price.

■ **Texhong: cost structure (2012)**

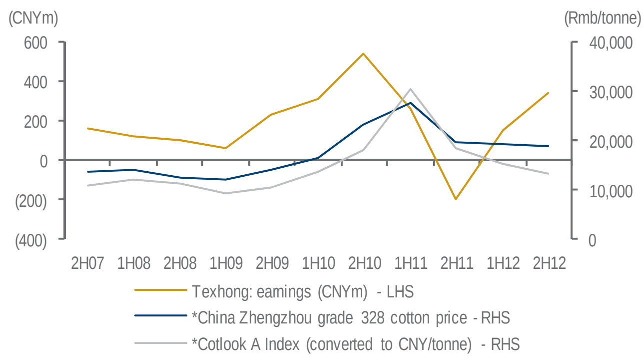


Source: Company

Cotton yarn is priced on a spot basis, and upstream spinners gradually adjust the selling price in order to offset the impact. Thus, it is difficult to analyse the sensitivity of the company's earnings to cotton-price movements. However, as we noted earlier in this report, spinners are affected by the low-priced cotton inventory they have, and this has a significant influence on their gross-profit margin.

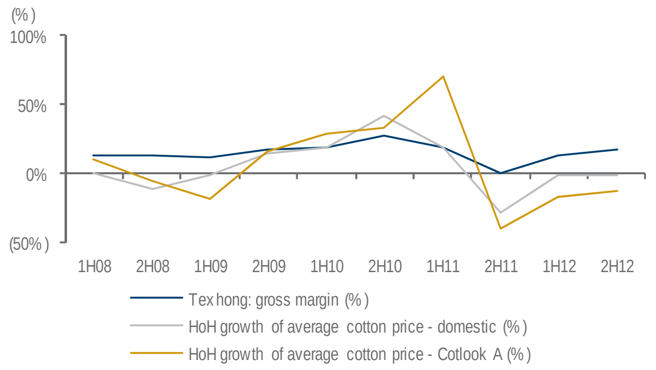
Hence, we look at the historical trend in order to have a better understanding of the magnitude of the earnings impact of cotton-price volatility. Based on the half-year numbers since 2H07, when cotton prices have been rising, Texhong's earnings increase rapidly. For instance, when the average China Zhengzhou grade cotton price rose by 18.4% HoH over 1H10 and 42.0% HoH over 2H10, the company's earnings accelerated by 32.7% HoH and 76.2% HoH for the respective periods. Meanwhile, if there is a significant fall in the cotton price, earnings would be negatively impacted to a large extent.

■ **Texhong: cotton price vs. earnings**



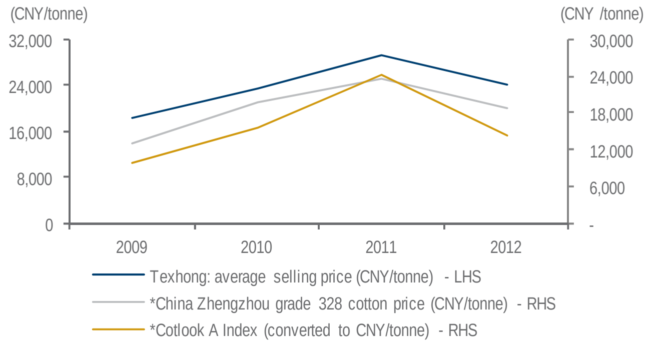
Source: Company, Bloomberg
*Note:*Average price of each half year*

■ Texhong: cotton price HoH changes vs. gross-profit margin (%)



Source: Company, Bloomberg
*Note:*average price of each half year*

■ Texhong: cotton price vs. ASP



Source: Company, Bloomberg
*Note:*Average price of each half year*

Valuation

We initiate coverage with a six-month target price of HKD11, based on a PER of 10x applied to the average of our 2013 and 2014 EPS forecasts. Our target PER is set at a 30% discount to the company's peers in the region, which is inline with the current discount. Given that Texhong's business is more sensitive to cotton-price fluctuations than its peers, we believe such a discount is warranted. However, given the strong 30% earnings CAGR we forecast for Texhong over 2013-15, we think the company has one of the best earnings-growth profiles among its peers, and hence we believe the stock is undervalued.

Risks

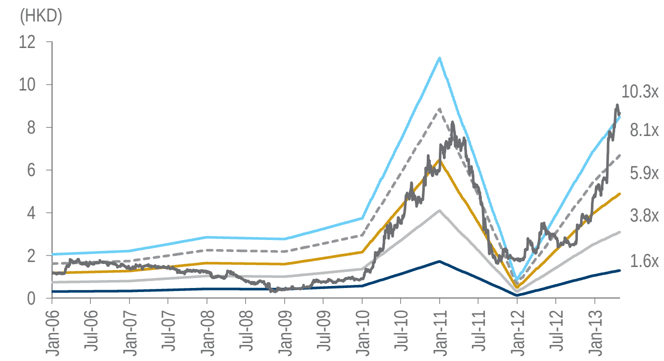
The key risks to our rating and target price include: 1) a significant decrease in the prices of cotton sourced overseas and domestically, 2) a deterioration in the economic environment, which could have an adverse effect on Texhong's financial performance, as fluctuations in the cotton price have a big effect on the company's earnings.

■ Peer valuation comparison

Company	BBG code	Share price 03-May-13 (local curr.)	Market cap (USDm)	Rating	PER (x) FY13E	PER (x) FY14E	PBR (x) FY13E	PBR (x) FY14E	EV/EBITDA (x) FY13E	EV/EBITDA (x) FY14E	Div. yield (%) FY13E	ROE (%) FY13E
*TEXHONG TEXTILE	2678 HK	9.05	1,032	Buy (1)	9.6	7.2	2.1	1.7	6.8	5.6	3.1	24.0
WEIQIAO TEXTI-H	2698 HK	4.30	662	NR	9.0	8.7	0.3	0.3	n.a.	n.a.	3.5	2.9
*SHENZHOU INTL GP	2313 HK	22.70	3,810	Buy (1)	12.2	10.5	2.5	2.3	7.6	6.4	4.9	22.2
*PACIFIC TEXTILE	1382 HK	9.88	1,820	Outperform (2)	14.6	12.5	3.3	3.0	8.8	7.7	7.2	23.5
*TEXWINCA HLDG	321 HK	8.95	1,573	Sell (5)	30.3	17.7	2.2	2.1	15.2	10.0	2.0	7.3
GLORIOUS SUN ENT	393 HK	2.22	303	NR	13.1	11.1	1.0	0.9	n.a.	n.a.	6.3	7.5
LUEN THAI HLDGS	311 HK	3.32	429	NR	8.6	7.1	1.2	1.0	n.a.	n.a.	3.5	14.0
VICTORY CITY INT	539 HK	1.22	255	NR	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
MAKALOT INDUSTRI	1477 TT	125.50	693	NR	15.0	13.2	4.7	n.a.	12.0	n.a.	5.6	27.6
YOUNGONE CORP	111770 KS	41,050.00	1,660	NR	19.6	19.1	n.a.	n.a.	n.a.	n.a.	0.5	19.0
HANSAE CO LTD	105630 KS	18,100.00	661	NR	11.6	10.2	2.4	2.0	9.5	7.4	0.6	22.9
Average					14.3	11.7	2.2	1.6	9.9	7.4	3.5	17.1

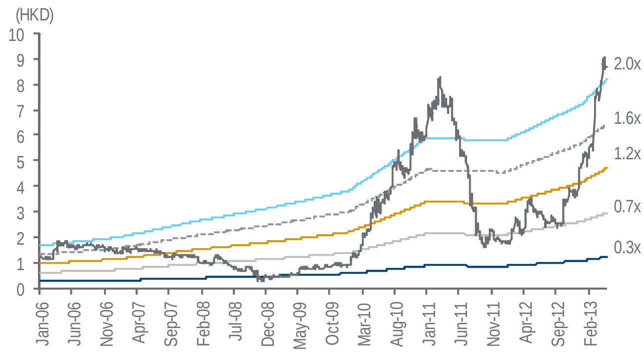
*Source: Bloomberg,*Daiwa forecasts*

■ **Texhong: PER bands**



Source: Bloomberg

■ **Texhong: PBR bands**



Source: Bloomberg

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"1": the security could outperform the local index by more than 15% over the next six months.
"2": the security is expected to outperform the local index by 5-15% over the next six months.
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"4": the security is expected to underperform the local index by 5-15% over the next six months.
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Additional information may be available upon request.

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If you decide to enter into a business arrangement with us based on the information described in materials presented along with this document, we ask you to pay close attention to the following items.

- In addition to the purchase price of a financial instrument, we will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction.
- In some cases, we may also charge a maximum of ¥ 2 million (including tax) per year as a standing proxy fee for our deposit of your securities, if you are a non-resident of Japan.
- For derivative and margin transactions etc., we may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements.
- There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
- There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by us.
- Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.
  *The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with us.

Corporate Name:	Daiwa Securities Co. Ltd.
	Financial instruments firm: chief of Kanto Local Finance Bureau (Kin-sho) No.108
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