Daiwa Capital Markets

Regional Textile Sector

Why the market may be overstating the impact of the Trans-Pacific Partnership on regional textile players with production facilities in Vietnam

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Special Report

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18 August 2016

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China Economy

What would a Trump presidency mean for China?

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The cherry on top

Ever since negotiations for the Trans-Pacific Partnership (TPP) kicked off in full force in 2013 (after Japan officially joined the negotiations), the trade deal has been regularly cited as one of the key reasons to invest in Asia textile stocks, particularly those with Vietnam exposure. Many investors cheered when the agreement was signed on 4 February 2016, but the excitement seems to have died down since then; and rightly so, in our view, given that the possibility of ratification before the end of 2016 looks increasingly slim. Recently, we have been asked by many investors what would happen if the TPP falls through.

At Daiwa, we are of the view that the TPP will not be passed anytime soon. Pin-pointing the timing is almost impossible, but if we were to speculate, we would expect a deal, if ever, to come into effect only after 2017; but even then, the deal would likely not be ratified in its current form.

Under this case, what would happen to the companies that have expanded so aggressively into Vietnam in anticipation of the TPP? How would their growth outlook change? Would these investments lower their return on invested capital? And why would they choose to invest in Vietnam in the first place?

In this special report, we attempt to answer these questions and highlight the company-by-company implications for Shenzhou International (2313 HK), Eclat Textile (1476 TT), Texhong Textile (2678 HK), Pacific Textiles (1382 HK), Best Pacific International (2111 HK), Makalot Industrial (1477 TT) and Texwinca (321 HK).

Our conclusion: the outlook for many of the textile companies under our coverage remains bright, irrespective of the TPP. Granted, the TPP would certainly accelerate the revenue and earnings growth of select textile companies, but we view it simply as a positive optionality.

The cherry on top, if you will.

John Choi, Regional Head of Small/Mid Cap Research

Chapter 1

The Trans-Pacific Partnership (TPP)

What exactly is the TPP?

An overview of the TPP

The Trans-Pacific Partnership (TPP) is a broad, multinational trade agreement involving 12 countries. The TPP started out as an expansion of the Trans-Pacific Strategic Economic Partnership Agreement (signed by Singapore, Brunei, New Zealand and Chile in 2005), when the US announced in February 2008 it would join the resulting negotiations. Subsequently, Australia, Peru, Vietnam, Malaysia, Mexico and Canada headed for the negotiating table, and in 2013 Japan became the 12th nation to enter the TPP negotiations.

The TPP is often viewed as a "landmark 21st Century agreement" due to its sheer size and scope — the 12 countries involved account for roughly 40% of global GDP or one-third of world trade, while the agreement also covers labour rules, environmental protection, copyright protection in addition to trade.

After over 40 rounds of negotiations over 7 years, the 12 countries reached an agreement on all aspects of the treaty and a final proposal was signed on 4 February 2016. However, like the North America Free Trade Agreement (NAFTA), the deal was negotiated in secret and details of the agreement were released only in November 2015. Given its complexity (the full text of the TPP spans over 6,000 pages of text broken up into 30 chapters), the TPP has garnered both criticism and praise, and has since been a constant topic of debate, particularly in US politics.

Trans-Pacific Partnership – 12 signatories

Source: Daiwa

According to the Office of the United States Trade Representative, the main purpose of the TPP agreement is to "promote economic growth; support the creation and retention of jobs; enhance innovation, productivity and competitiveness; raise living standards; reduce poverty in the signatories' countries; and promote transparency, good governance, and enhanced labor and environmental protections."

The key benefits of the TPP, as marketed by the TPP agreement, are claimed to be as follows:

- **Comprehensive market access.** The TPP eliminates or reduces tariff and non-tariff barriers across substantially all trade in goods and services and covers the full spectrum of trade, including goods and services trade and investment, so as to create new opportunities and benefits for participating countries' businesses, workers, and consumers. The TPP is said to eliminate over 18,000 tariffs across the 12 nations.

- **Regional approach to commitments.** The TPP facilitates the development of production and supply chains, and seamless trade, enhancing efficiency and supporting participating countries' goal of creating and supporting jobs, raising living standards, enhancing conservation efforts, and facilitating cross-border integration, as well as opening domestic markets.

- **Addressing new trade challenges.** The TPP promotes innovation, productivity, and competitiveness by addressing new issues, including the development of the digital economy, and the role of state-owned enterprises in the global economy.

- **Inclusive trade.** The TPP includes new elements that seek to ensure that economies at all levels of development and businesses of all sizes can benefit from trade. It includes commitments to help small- and medium-sized businesses understand the agreement, take advantage of its opportunities, and bring their unique challenges to the attention of the TPP governments. It also includes specific commitments on development and trade capacity building, to ensure that all parties are able to meet the commitments in the agreement and take full advantage of its benefits.

- **Platform for regional integration.** The TPP is intended as a platform for regional economic integration and is designed to include additional economies across the Asia-Pacific region.

Notably, several major Pacific-rim countries, including China and Russia, are not part of the TPP. Many market commenters have stated that this is a result of a geopolitical struggle in Asia between the US and China. President Obama has publicly expressed the US's desire to "write the rules of trade" in the region, instead of China. Other countries, such as Bangladesh, Colombia, India, Laos, the Philippines, South Korea, Taiwan, and Thailand, have hinted at or expressed interest in joining at a later date.

Who stands to benefit the most from the TPP?

We believe Vietnam would be one of the major beneficiaries of the TPP because:

1) **Vietnam is the fastest-growing country in terms of GDP growth, among the 12 TPP countries.**

2) **The US is already a major trading partner of Vietnam, and the TPP is its first free trade deal with the US.**

3) **The country's infrastructure and supply chains have improved dramatically over the past decade and it continues to benefit from lower labour costs than China.**

4) **Textiles and garments is a key export industry for Vietnam, and the protectionist measures on these goods have historically been quite high.**

Given the relatively small size of the Vietnam economy among the TPP countries (4^{th} smallest in terms of GDP) and the country's status as a major exporting nation (27^{th} largest export economy in the world), Vietnam is poised to be one of the major beneficiaries of the TPP, in our view. Specifically, we believe most of the incremental benefits to Vietnam would come from duty-free access to the US, as it currently does not yet have a free trade deal with the country, despite the US already being Vietnam's second-largest trading partner (behind only China).

We expect Vietnam's textile and garment industry to reap the most benefits, given it is one of Vietnam's most important sectors, contributing roughly 18% of Vietnam's export value, and roughly 15% of the country's GDP. The industry also employs over 2.5m people across more than 4,000 textile companies in the country. However, we note that Vietnam's garments and textile exports to the US are currently subject to a 17-30% taxation. If the TPP takes effect, this rate is expected to decline to 0%, and hence would be a huge boon to Vietnam's export volume to the US.

As a result, we believe the TPP would greatly accelerate Vietnam's trade momentum with major garment importers, but particularly the US. In fact, China is the only country that surpasses Vietnam in terms of net garment exports to the US, and Vietnam already runs a consistent trade surplus with most of the TPP nations, such as the US, Japan and Australia. The Eurasia Group (a consultancy firm) forecasts Vietnam to enjoy a 50% increase in apparel and footwear exports in 10 years if the TPP comes into effect.

Even without the TPP, we note that Vietnam's trade momentum with the US is already very strong. In recent years, the export value of Vietnam's textile and garment industry to the US has been growing at 12-13% per year, while the US's imports from all other countries increased only around 3%. This implies that Vietnam's market share in the US has been expanding rapidly. Additionally, exports from Vietnam still contribute only c.9% of the US's total garment and textile import value.

Given this fact, we believe textile and garment companies that have production facilities in Vietnam would be the first in line to reap the benefits of the TPP. In 2013, we highlighted that numerous regional textile players had accelerated the migration of their production facilities from China to ASEAN countries (see our report dated 6 May 2013 *Production migration to ASEAN*), driven primarily by labour cost inflation in China. Since then, we have continued to see an increasing number of companies setting up factories in Vietnam; and those that acted early are already reaping the benefits of Vietnam production, and have generally outperformed peers in terms of share-price gains.

We believe the following companies are the best-positioned to benefit from the TPP, upon its approval:

- Shenzhou International (2313 HK, HKD53.10, Buy [1])
- Eclat Textile (1476 TT, TWD379.50, Buy[1])
- Texhong Textile (2678 HK, HKD10.24, Buy [1])
- Pacific Textiles (1382 HK, HKD9.80, Outperform [2])
- Best Pacific International (2111 HK, HKD6.59, Buy [1])

See Sections 2 and 3 for more on these companies.

How the TPP could come into force

As described in Chapter 30 of the TPP, there are 3 pathways by which the TPP could come into force:

Pathway 1: Agreement by all 12 countries by 4 February 2018.

If all 12 original signatories ratify the TPP within 2 years of the TPP being signed (ie, by 4 February 2018), the TPP would come into force 60 days after the final 12th TPP country's ratification.

Pathway 2: At least 6 countries (including the US and Japan) ratify the agreement by the February 2018 deadline.

If all 12 countries have not ratified the TPP within 2 years of the TPP's signing (ie, by 4 February 2018), the TPP would come into force 60 days later if at least 6 of the original signatories that account for at least 85% of the combined GDP of the original signatories have ratified the agreement. This means that under this pathway, the TPP would come into effect by April 2018 at the latest.

Pathway 3: Postponed ratification.

If the TPP does not come into force under Pathway 1 or 2, it could come into force 60 days after at least 6 of the original signatories that account for at least 85% of the combined GDP of the original signatories ratify the agreement.

Note that for Pathways 2 and 3, the TPP agreement specifies that the 85% GDP threshold is calculated using 2013 figures from the International Monetary Fund. Based on those figures, we can conclude that the participation of the US and Japan is a must in order for the TPP to go through. The US and Japan alone contribute 60% and 18% of the total GDP of the 12 TPP nations, respectively, and hence if either country fails to ratify the agreement, it would be arithmetically impossible for the TPP to go through under the current terms (even if all countries ratify except for Japan, it would still only add up to 82% of total GDP). However, likewise, assuming the US and Japan ratify the agreement, we believe it would only be a matter of time before the TPP went through.

TPP: comparison of the member countries

Country	GDP in USDbn	% of total TPP nations GDP	Population (m)	GDP per capita (USD)
Australia	1,501	5%	23.29	64,464
Brunei Darussalam	18	0%	0.41	44,540
Canada	1,837	7%	35.10	52,345
Chile	277	1%	17.63	15,713
Japan	4,909	18%	127.33	38,552
Malaysia	323	1%	29.92	10,809
Mexico	1,262	5%	123.74	10,197
New Zealand	186	1%	4.48	41,541
Peru	202	1%	30.95	6,529
Singapore	302	1%	5.40	55,980
United States	16,663	60%	316.70	52,615
Vietnam	171	1%	89.69	1,902
Total of 12 TPP nations:	27,652	100%	804.62	34,366

Source: International Monetary Fund, Daiwa
Note: based on 2013 figures

When will the TPP be ratified?

The TPP is unlikely to be ratified in the near term

Given that the US alone makes up 60% of the GDP among the 12 TPP nations, we believe the passing of the deal through the US Congress is the decisive factor determining whether the deal will ultimately go through. In our view, knowing the significance of US ratification in the deal, a number of countries may not proceed with their own domestic ratification procedures, before receiving reasonable assurance that the US would obtain congressional approval. In particular, a number of TPP nations have already secured general government support and received feedback from the public, and as such, we believe there is relatively less resistance to the TPP in these nations than in the US. As a result, we contend that the probability of US ratification is directly correlated with the chance of the TPP coming into effect.

TPP: pathways to ratification and government support

	Pathway to ratification	Government support and current status
Australia	The TPP text was tabled in Parliament for 20 sitting days; presented to Parliament; Parliamentary vote by both the House of Representatives and the Senate.	Supportive. New prime minister, Malcolm Turnbull, called the trade deal "a gigantic stone for our future prosperity".
Brunei	Cabinet level meetings; to be reviewed by Legislative Council	Supportive.
Canada	Majority voting procedure in Parliament	New Prime Minister Justin Trudeau and his liberal government have not committed to the TPP publicly. But he is concurrently pushing for a Canada- EU trade deal.
Chile	Congressional ratification by committees and both houses.	President Michelle Bachelet stated the TPP would be sent to Congress for approval by the end of 2016. Chile is the only TPP member that has FTAs with all TPP members.
Japan	Lower House vote, then goes to Upper House, which has 60 days to vote on the bill or it returns to the Lower House.	The TPP is applauded by Prime Minister Shinzo Abe. The ruling coalition supports the deal and wants swift passage.
Malaysia	Parliament must pass legislation to give effect to the treaty, then proceed to ratification.	Despite Prime Minister Najib Razak being embroiled in corruption charges, the government is largely supportive.
Mexico	The Senate has exclusive power to approve treaties made by the president.	Very supportive government. Mexico already has FTAs with the largest TPP members (the US, Canada, Japan), and Mexican President Enrique Pena Nieto has actively defended NAFTA.
New Zealand	Final text presented to Parliament and referred to committee; minimum 15 sitting days, followed by vote on legislation.	Majority of the government supports the deal, but the Labour Party has vowed to vote against the TPP.
Peru	Ratification by Congress.	A generally supportive government for FTAs. Peru has signed 17 other FTAs in the past.
Singapore	Cabinet approval required and Parliament must vote on any legislative changes.	Favoured by Prime Minister Lee Hsien Loong, and his party has a large majority. Already has FTAs with most key TTP members.
US	Ratification by Congress. 90-day debate period followed by vote: no amendments can be added as the president has Trade Promotion Authority.	President Obama is a major proponent of the deal. But more importantly, both major presidential candidates oppose the deal.
Vietnam	The TPP needs to be verified by the Foreign Affairs Committee of the National Assembly. The National Assembly would then ratify the TPP by a resolution.	Highly supported by the socialist government. Scheduled to be put in front of Vietnamese lawmakers for ratification in October 2016.

Source: Daiwa, major news websites, The Economist Intelligence Unit

While the TPP is a signature deal for President Obama who has, as recently as in early September 2016, reiterated that he would do everything possible to get the TPP through Congress before he leaves office, we believe the chances are very slim. With the election season in full swing, Obama will likely make a push for the TPP during the lame duck session (ie, after the November election and before 3 January), but this strategy has already been met with a public backlash, even among Democrats. Some people believe Obama’s chances are favourable due to the fact that he won “fast track authority” for the deal in 2015, which forces Congress to only approve or deny the deal, but does not allow it to amend details of the agreement. However, we believe the fast track authority would in reality be of little value, amidst the growing aversion to the deal.

One of the major obstacles of obtaining ratification during the lame duck session is the stance of the 2 presidential front-runners. Both Hillary Clinton and Donald Trump have made rejecting the TPP a hallmark of their campaigns, but even if we assume the unlikely scenario of the TPP being passed during the lame duck session, we believe it is very likely that both would withdraw from the TPP immediately once they came into power, before even the TPP could come into effect.

For Donald Trump, we believe there is little doubt that he would throw out the TPP immediately if he is elected president. On a 7-point plan to change America’s “failed trade policies” released by Donald Trump in June 2016, the first on the to-do list was to “withdraw the US from the Trans Pacific Partnership”. He has also been very vocal throughout his campaign about the “disastrous” impact the deal would have on the US.

For Hillary Clinton, while she originally did support the deal when she was still Secretary of State, she has since changed her position and has repeatedly said that she would reject the deal “in its current form”. In our view, she would likely keep her word in rejecting the deal (since the TPP has also become a major talking point in her campaign), but her choice of words suggests that she could pass another version of the deal, after another round of negotiations.

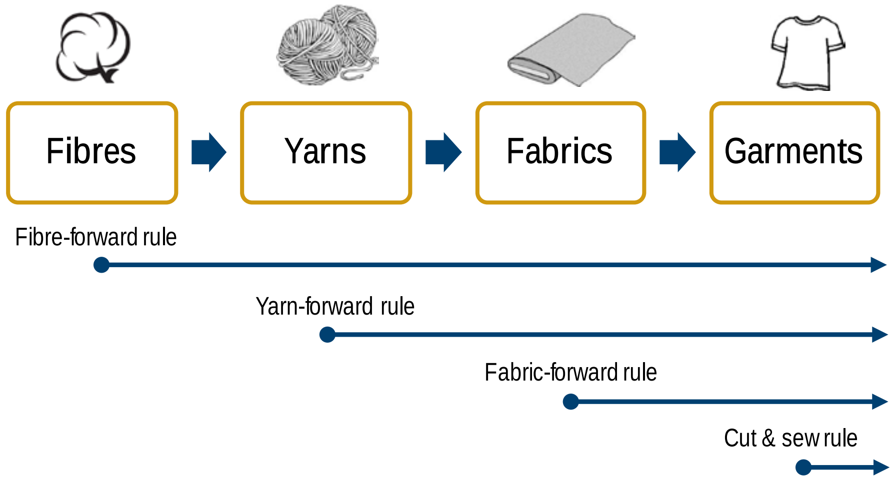
What this ultimately means is that, regardless of who becomes president, the TPP would likely not come into effect before 2018. Even if the TPP does go through in the future, it would likely not be in its current form, and many parts of the deal would be renegotiated.

Implications of the yarn-forward Rules of Origin

While we believe Vietnam would be a big winner under the TPP, one aspect that could limit the ability of the country to initially reap its full benefits is the Rules of Origin clause. This clause states that only products manufactured with raw materials sourced from and made in TPP countries can enjoy the duty-free benefits under the TPP. Since many goods go through numerous intermediary production stages, the rule is intended to ensure that the benefits of the TPP only apply to the 12 signatory countries rather than to other major textile countries such as China.

A Rules of Origin clause is quite typical among major free trade agreements (like NAFTA) and applies to a wide range of goods. For the textile industry in particular, there are different variants of the rule based on severity. The most common rule is the yarn-forward rule, which requires all textile manufacturing processes, starting from the spinning of yarns, to knitting/dyeing of fabric as well as the garment production, to all be done within TPP nations. While there are some FTAs that adopt the even stricter fibre-forward rule, which also requires the sourcing of fibres to be located within the FTA members, it is typically not the most practical, since cotton and other fibres are grown only in selective countries.

Different levels of Rules of Origin



Source: Daiwa

The TPP has adopted the yarn-forward rule, which may affect Vietnam, as the country's textile chain is significantly weighted towards garment production. However, we do note that there are exceptions to the rule:

1) If the weight of non-TPP originated material does not exceed 10% of the total weight of the goods, it would still qualify for TPP benefits.

2) Some apparel categories are exempt from the yarn-forward rule (such as bras and baby garments) and instead adopt a much more lenient cut & sew rule (the fibre, yarn and fabric can be sourced from any country while garment production has to be done within a TPP member country).

3) The TPP has a "short supply list" of yarns and fabric that are exempt from the Rules of Origin, meaning they can be sourced from any country. More than 194 different types of fibre and fabrics have made it to the list, most being niche and specialised materials. However, a significant portion of the short-supply list is temporary and only valid for 5 years, allowing time for the TPP member nations to ramp up their own production.

If the TPP goes through, we believe the yarn-forward rule would disproportionately benefit companies with strong and stable upstream yarn and fabric capacities. This is because despite the rapid growth of the Vietnam textile industry over the past decade, we estimate the country still imports 80-90% of the fabrics and materials it uses from China, South Korea and Taiwan. In terms of publicly listed yarn suppliers, Texhong Textile (2678 HK, HKD10.24, Buy [1]) and Bros Eastern (601339 CH, not rated), which both have sizeable established yarn facilities in Vietnam, should benefit. In terms of fabric suppliers, Pacific Textiles (1382 HK, HKD9.80, Outperform [2]) and Best Pacific International (2111 HK, HKD6.59, Buy [1]) are both rapidly ramping up production capacities in Vietnam.

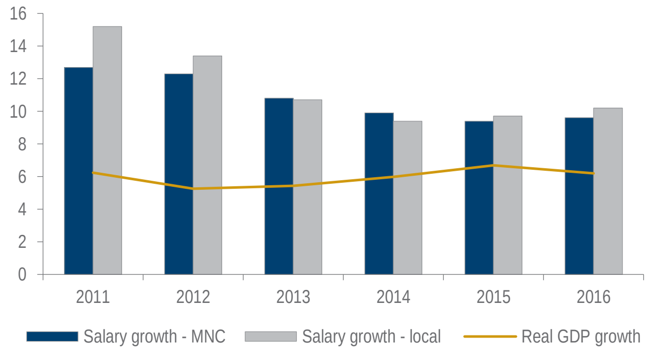
What if the TPP is scrapped/thrown out?

The TPP is often cited as having been the main driving force behind China textile companies' expansion into Vietnam in recent years. While we acknowledge that the TPP has been a consideration for a number of textile companies, we believe the migration would have taken place even in the absence of the TPP negotiations, as there are numerous benefits to manufacturing in Vietnam over the long term.

Lower labour costs

The biggest driver for the production migration to Vietnam, in our opinion, is the rising labour costs in China. Depending on the location and company, our discussions with numerous textile companies indicated that the all-in cost of a worker in Vietnam is still 40-60% cheaper than in China, and since garment production is often labour-intensive, the aggregate costs are significant to margins. While the average labour costs in Vietnam are rising rapidly (9-15% per year over the past 5 years), we believe this is an inevitable consequence of strong economic expansion, and note that China's average wage growth remains on a consistent 5-10% annual trajectory.

Vietnam: GDP vs. salary growth



Source: General Statistics Office of Vietnam, Mercer, Talentnet, VietnamNet

ASEAN: minimum wages as of 2014-15

Country	Minimum Wage (USD)
Myanmar	65 per month
Bangladesh	68 per month
Sri Lanka	50-53 per month for unskilled labour 60-72 per month for skilled labour
Cambodia	128 per month (garment and shoes industries)
Vietnam (Ho Chi Minh City & Hanoi)	156 per month*
Indonesia (Jakarta)	215 per month
Thailand (Bangkok)	9-10 per day
Philippines (Manila)	10-11 per day

Source: HKTDC, national bureaus, Daiwa
*Note: highest of the 2016 proposed range

Another area that companies consider when investing in Vietnam, but which is not reflected in the minimum wage level and is material to the overall cost of labour, is workers' skill and productivity level. On a sheer minimum wage comparison among ASEAN countries, Vietnam is far more expensive than Myanmar, Bangladesh or Sri Lanka. However, once productivity is taken into account, Vietnam labour becomes far more competitive.

Based on commentary from companies such as Shenzhou International and Makalot Industrial, Vietnam's workers in general (after their initial 1-2 years of training) are 80% as productive as workers in China. This compares with 50% for Myanmar and Bangladesh. We believe the work ethic of Vietnamese workers is high and close to that in China, which indirectly lowers the overall labour costs. We have also heard similar comments from non-apparel related companies operating factories in Vietnam, such as plush-toys maker Dream International (1126 HK, not rated). As a result, even without the TPP, we believe the cheaper but still productive labour force in Vietnam alone is already a strong enough incentive for many textile and garment players to relocate their production facilities to the country.

Supportive infrastructure and supply chains

One of the key impediments for companies considering expanding into Vietnam 5-10 years ago was the limited infrastructure and supply chain support in ensuring a smooth manufacturing process. Given that Vietnam has been among the fastest-growing economies in the world over the past decade, fuelled by foreign direct investment (FDI) and rising standards of living, we believe Vietnam's infrastructure (like ports and roads) has improved substantially, as well as its supply chain network (eg, growth of the upstream and downstream textiles industry). Even without the TPP, we believe Vietnam's infrastructure and supply chain would continue to be upgraded in tandem with its economic growth, hence benefitting manufacturers.

Tax incentives

To accelerate FDI in Vietnam, over the past decade, its government has offered aggressive tax incentives for companies investing in the country. All of the textile companies that we have spoken to said they had benefited from multi-year tax breaks or tax reductions. From what we have seen, a typical tax arrangement for companies is a tax break for the first 2-4 years (starting the first year of profitability), and half-tax rate for the next 5-10 years. In our opinion, these tax breaks can amount to substantial savings, and hence will likely remain a core attraction in investing in Vietnam, regardless of the TPP.

Comparison of Vietnam tax incentives

Company	Ticker	Tax exemption for the first X years:	Half tax rate for X years thereafter:
Shenzhou International	2313 HK	4	9
Regina Miracle	2199 HK	4	9
Best Pacific International	2111 HK	2	4
Eclat Textile	1476 TT	4	7
Texhong Textile	2678 HK	4	9

Source: Companies, Daiwa
Note: based only on the company's most favourable tax incentive received

Free trade agreements with almost every major country (except the US)

Another major driving force for factory migration to Vietnam, in our opinion, is the country's multiple free trade agreements. In short, Vietnam has already negotiated free-trade agreements with all of the major countries that it deals with, except for the US. Vietnam has 9 FTAs with major countries/regions which are in effect, and is negotiating 7 more (including the TPP and the Vietnam-Customs Union of Russia, Belarus, and Kazakhstan FTA that under ratification).

So, in the case of shipping to Japan, global brands that choose to manufacture garments in Vietnam, instead of China, do not have to pay a tariff of around 11-12% (Vietnam has already signed a Japan-Vietnam FTA). Additionally, Vietnam and the EU signed a new trade deal in early 2016 that would effectively open the door for Vietnam to 28 countries and 508m consumers.

Under the terms of the deal, which is expected to come into force in 2018, the EU would eliminate import duties on roughly 86% of all Vietnamese products, and importantly, tariffs for Vietnam-made textiles and footwear, would be cut to 0%. According to the Vietnam Textile and Apparel Association, Vietnamese garment and textile products are currently subject to an average EU import tariff of 11.7%.

Vietnam: free agreements

Free Trade Agreement	Status
ASEAN-Hong Kong, China Free Trade Agreement	Negotiations launched
Regional Comprehensive Economic Partnership	Negotiations launched
Vietnam-European Free Trade Association Free Trade Agreement	Negotiations launched
Vietnam-Israel Free Trade Agreement	Negotiations launched
Vietnam-European Union Free Trade Agreement	Signed but not yet in effect
Trans-Pacific Partnership (TPP)	Signed but not yet in effect
Vietnam-Customs Union of Russia, Belarus, and Kazakhstan Free Trade Agreement	Signed but not yet in effect
ASEAN Free Trade Area	Signed and in effect
ASEAN-Australia and New Zealand Free Trade Agreement	Signed and in effect
ASEAN-India Comprehensive Economic Cooperation Agreement	Signed and in effect
ASEAN-Japan Comprehensive Economic Partnership	Signed and in effect
ASEAN-People's Republic of China Comprehensive Economic Cooperation Agreement	Signed and in effect
ASEAN-[Republic of] Korea Comprehensive Economic Cooperation Agreement	Signed and in effect
Chile-Vietnam Free Trade Agreement	Signed and in effect
Japan-Vietnam Economic Partnership Agreement	Signed and in effect
Republic of Korea-Vietnam Free Trade Agreement	Signed and in effect

Source: Daiwa, Asian Development Bank

If the TPP is not ratified, there is another major FTA, the Regional Comprehensive Economic Partnership (RCEP), which is also significant for Vietnam. The RCEP has been negotiated in parallel with the TPP and is often viewed as an alternative to the TPP. The main differences between the RCEP and TPP are that:

1) The RCEP includes 16 countries vs. 12 countries for the TPP. RCEP is “led” by China (given its weight in global trade and GDP) while the TPP is led by the US.

2) The collective GDP of the countries involved in the TPP is around 40%, while for the RCEP it is 29%. However, the countries involved in the RCEP make up 12% of global trade, only 1% lower than the 13% for the TPP.

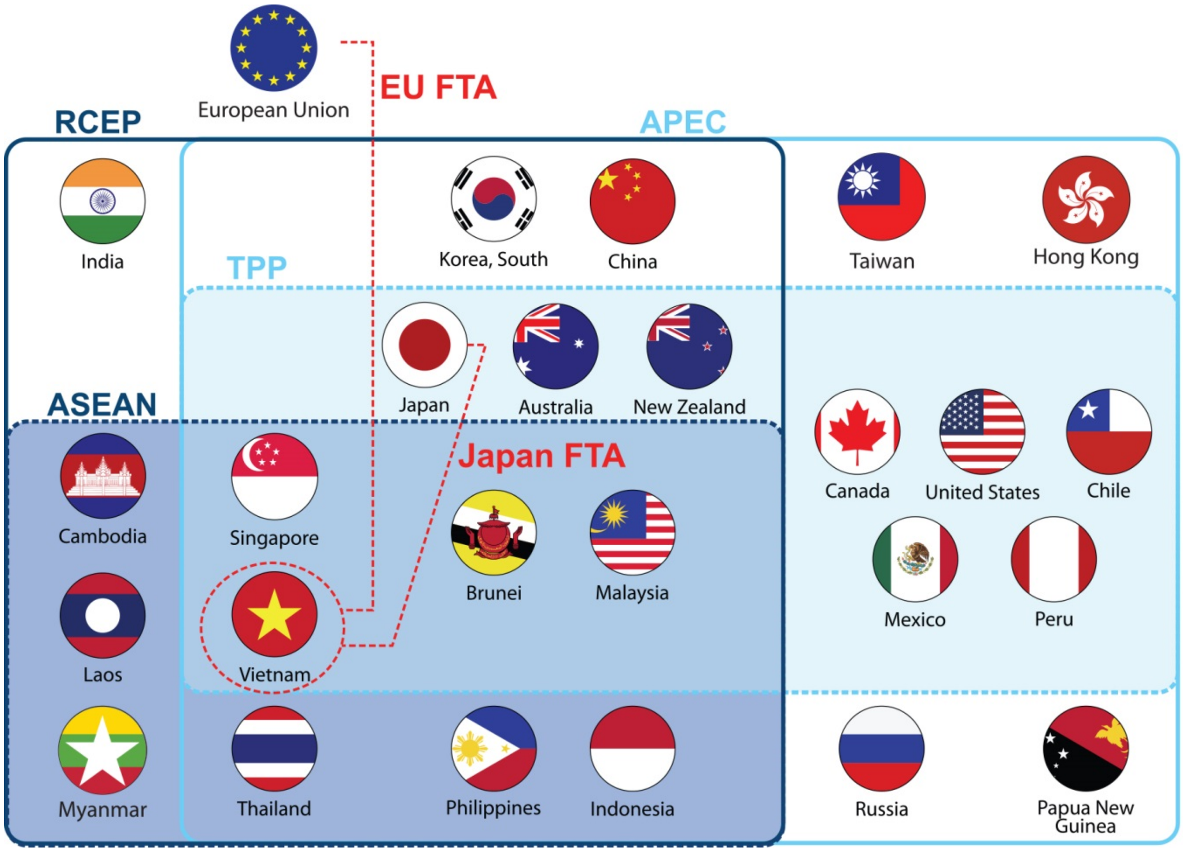
3) The TPP countries cover just over 10% of the world’s population, while the RCEP covers almost half of the world’s population.

Vietnam: TPP vs RCEP

Country	TPP	RCEP	Rank in Vietnam's exports	Rank in Vietnam's imports	Rank in FDI in Vietnam (% of total)
US	✓		1	7	7 (4.6%)
China		✓	3	1	9 (3.2%)
Japan	✓	✓	2	3	1 (15.0%)
Korea		✓	4	2	3 (12.7%)
Malaysia	✓	✓	5	8	8 (4.4%)
Thailand		✓	9	6	10 (2.7%)
Singapore	✓	✓	11	5	2 (12.8%)
Indonesia		✓	12	10	26 (0.14%)
Australia	✓	✓	7	13	21 (0.6%)

Source: Vietnam Industry and Trade Information Center

Vietnam: part of every major trade deal



Source: Daiwa

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Chapter 2

At a glance, who wins?

Our pecking order if the TPP is ratified

If the TPP goes through, we would be overweight on companies that:

- Already have sufficient production scale and a track record of producing in Vietnam.
- Those that have upstream and midstream capacity, such as spinning, knitting, dyeing but particularly weaving (and similarly avoid pure garment makers) capacity.
- Those with relatively large exposure to US customers and brands.
- Companies that are vertically integrated, and control as much of their own supply chain as possible.

Solely considering the above points (without considering current valuation), the top-5 regional textile companies we believe would benefit from the TPP are as follows:

1) Texhong Textile (2678 HK, HKD10.24, Buy[1])
2) Shenzhou International (2313 HK, HKD53.10, Buy[1])
3) Eclat Textile (1476 TT, TWD379.50, Buy [1])
4) Best Pacific International (2111 HK, HKD6.59, Buy[1])
5) Pacific Textiles (1382 HK, HKD9.80, Outperform [2])

Our pecking order if there is no TPP

If the TPP is scrapped, our view would not change materially. We would still favour the merits of having overseas capacity which could prepare companies for an eventual and necessary shift from primarily China manufacturing to that of a lower cost country. We would prefer companies that:

- Had production capacity in ASEAN countries. We note that countries like Vietnam and Cambodia still benefit from duty-free exports to Japan and Europe respectively.
- Had a solid track record of production in their home base, with a consistently high utilisation rate.
- Had some exposure to Europe and Japan customers that could allow them to benefit from duty-free exports.
- Were vertically integrated, and control as much of their supply chains as possible.

Solely considering the above points (without considering current valuations), our top-5 regional textile companies would be as follows:

1) Shenzhou International (2313 HK, HKD53.10, Buy [1])
2) Eclat Textile (1476 TT, TWD379.50, Buy[1])
3) Best Pacific International (2111 HK, HKD6.59, Buy[1])
4) Pacific Textiles (1382 HK, HKD9.80, Outperform [2])
5) Texhong Textile (2678 HK, HKD10.24, Buy[1])

Where are the factories located?

Vietnam: areas where textile companies from China, Korea and Taiwan invest

NORTH VIETNAM

Thai Binh
CN: TAL Group (private) - garment factory

Ninh Binh
TW: Eclat Textiles (1476 TT) - garment factory

Quang Ninh
CN: Texhong Textiles (2678 HK) - yarn facility

Vinh Phuc
CN: TAL Group (private) - garment factory

Hai Phong
CN: Regina Miracle (2199 HK) - lingerie garment facility
CN: Regina Miracle (2199 HK) - bra pads and functional sports garment facility
CN: Regina Miracle (2199 HK) - sports bras and functional sportswear garment facility

Hai Duong
CN: Best Pacific International (2111 HK) - elastic fabric and webbing facility
CN: Crystal Group (private) - Regent garment factory
CN: Pacific Textiles (1382 HK) (JV with Crystal Group) - fabric factory
TW: Makalot Industrial (1477 TT) - garment factory

Nam Dinh
CN: Jiangsu Yulun Textile Group (private) - yarn and garment factory
KR: Youngone (111770 KS) - garment factory

CENTRAL VIETNAM

Quang Nam
KR: Panko (private) - garment plant

SOUTH VIETNAM

Binh Duong
KR: KyungBang Group (000050 KS) - yarn factory
CN: Esquel Group (Private) - garment factory

Tien Giang
KR: Hansae (105630 KS) - garment factory

Ho Chi Minh City
CN: Shenzhou International (2313 HK) - garment factory (WorldOn)
TW: Sheico (private) - Forever Glorious garment factory
TW: Makalot Industrial (1477 TT) - garment factory
TW: Eclat Textiles (1476 TT) - garment factory
KR: Hansae (105630 KS) - garment factory
CN: Texwinca (321 HK) (JV with Megawell Industrial) - garment factory

Dong Nai
KR: Hyosung (004800 KS) - spandex factory
TW: Feng Tay (9910 TT) - shoe factory
TW: Formosa Taffeta (1434 TT) - woven fabric factory

Long An
TW: Formosa Taffeta (1434 TT) - woven fabric factory

Ba Ria-Vung Tau
TW: Feng Tay (9910 TT) - shoe factory
TW: Eclat Textiles (1476 TT) - Fabric factory

Tay Ninh
CN: Luthai Textiles (200726 CH) - yarn and fabric factory
CN: Bros Eastern (601339 CH) - yarn factory
CN: Nameson Holdings (1982 HK) - fabric and garment factory
CN: Shenzhou International (2313 HK) - fabric factory (Gain Lucky)

An Giang
CN: Luthai Textiles (200726 CH) - garment factory (planned)

Source: Compiled by Daiwa from various websites

Valuation metrics

	Source	Company name	Ticker	Last price	Market cap (US$m)	P/E Ratio LTM	P/E Ratio FY1	P/E Ratio FY2	P/B Ratio MRP	P/B Ratio FY1	P/B Ratio FY2	EV/EBITDA LTM	EV/EBITDA FY1	EV/EBITDA FY2	EV/Sales LTM	EV/Sales FY1	EV/Sales FY2	Div. yield (%) FY1	ROE (%) FY1
YARN SPINNERS																			
1	Daiwa	TEXHONG TEXTILE	2678 HK	10.2	1,168	10.1	7.9	6.8	1.8	1.7	1.4	6.0	5.2	4.2	1.0	1.0	0.9	3.8	23.1
2	BB	WEIQIAO TEXTI-H	2698 HK	5.6	855	5.6	4.9	3.7	0.3	0.3	0.3	1.5	2.4	1.8	0.5	0.5	0.5	7.1	6.7
					Average:	7.9	6.4	5.2	1.1	1.0	0.9	3.8	3.8	3.0	0.8	0.8	0.7	5.5	14.9
					Median:	7.9	6.4	5.2	1.1	1.0	0.9	3.8	3.8	3.0	0.8	0.8	0.7	5.5	14.9
FABRIC PRODUCERS																			
1	Daiwa	PACIFIC TEXTILE	1382 HK	9.8	1,828	12.9	14.1	12.8	4.3	4.3	4.3	10.2	10.3	9.5	2.0	1.9	1.8	7.1	30.8
2	Daiwa	TEXWINCA HLDG	321 HK	5.4	960	7.1	11.7	11.0	1.2	1.2	1.1	3.8	5.1	4.5	0.6	0.6	0.6	7.9	10.1
3	BB	FOUNTAIN SET HLD	420 HK	1.1	163	n.a.	n.a.	n.a.	0.4	n.a.	n.a.	n.a.	n.a.	n.a.	0.2	n.a.	n.a.	n.a.	n.a.
4	Daiwa	BEST PACIFIC INT	2111 HK	6.6	874	19.5	14.6	12.2	3.9	3.3	2.9	12.3	9.7	7.7	2.9	2.5	2.1	2.8	24.8
5	BB	VICTORY CITY INT	539 HK	0.4	152	3.5	n.a.	n.a.	0.2	n.a.	n.a.	5.3	n.a.	n.a.	0.7	n.a.	n.a.	n.a.	n.a.
					Average:	10.8	13.5	12.0	2.0	2.9	2.8	7.9	8.4	7.2	1.3	1.7	1.5	5.9	21.9
					Median:	10.0	14.1	12.2	1.2	3.3	2.9	7.7	9.7	7.7	0.7	1.9	1.8	7.1	24.8
GARMENT PRODUCERS																			
1	Daiwa	SHENZHOU INTL GP	2313 HK	53.1	9,579	23.8	22.3	18.8	4.8	4.3	3.8	16.1	14.0	12.0	4.5	4.7	4.1	2.6	22.2
2	Daiwa	TEXWINCA HLDG	321 HK	5.4	960	7.1	11.7	11.0	1.2	1.2	1.1	3.8	5.1	4.5	0.6	0.6	0.6	7.9	10.1
3	BB	REGINA MIRACLE I	2199 HK	10.4	1,642	24.7	21.6	16.0	4.8	4.0	3.3	16.5	13.0	10.1	2.5	2.2	1.8	1.1	20.2
4	BB	ECLAT TEXTILE CO	1476 TT	379.5	3,250	25.4	25.2	19.9	7.7	6.6	5.8	17.7	17.0	13.9	3.8	3.6	3.2	2.8	29.8
5	Daiwa	MAKALOT INDUSTRI	1477 TT	152.5	1,000	15.6	20.8	18.0	3.9	3.7	3.5	10.4	12.2	10.4	1.2	1.3	1.2	4.2	17.5
6	BB	NAMESON HOLDINGS	1982 HK	1.7	452	10.9	10.8	8.8	n.a.	2.4	2.2	9.0	7.3	6.0	1.5	1.3	1.2	3.4	27.7
7	BB	YOUNGONE CORP	111770 KS	38,200.0	1,527	12.1	10.7	10.0	1.4	1.3	1.2	7.7	7.1	6.7	1.1	1.0	0.9	0.5	12.7
8	BB	HANSAE CO LTD	105630 KS	27,650.0	998	10.6	11.9	10.2	2.5	2.2	1.8	7.0	7.4	6.5	0.7	0.7	0.6	0.9	20.0
					Average:	16.3	16.9	14.2	3.8	3.3	2.9	11.0	10.4	8.8	2.0	1.9	1.7	2.9	20.0
					Median:	13.9	16.3	13.5	3.9	3.0	2.7	9.7	9.8	8.4	1.4	1.3	1.2	2.6	20.1
CASUAL WEAR MANUFACTURERS & RETAILERS																			
1	Daiwa	TEXWINCA HLDG	321 HK	5.4	960	7.1	11.7	11.0	1.2	1.2	1.1	3.8	5.1	4.5	0.6	0.6	0.6	7.9	10.1
2	BB	GIORDANO INTL	709 HK	4.1	828	15.3	14.4	13.0	2.3	2.3	2.3	7.6	7.8	7.3	1.1	1.1	1.0	6.8	16.3
3	BB	BOSSINI INTL	592 HK	0.5	104	19.3	n.a.	16.5	0.8	n.a.	n.a.	n.a.	n.a.	n.a.	0.1	n.a.	0.1	n.a.	n.a.
4	BB	GLORIOUS SUN ENT	393 HK	1.1	218	14.1	n.a.	n.a.	0.7	n.a.	n.a.	10.9	n.a.	n.a.	0.4	n.a.	n.a.	n.a.	n.a.
5	BB	I.T LTD	999 HK	2.5	383	14.7	9.7	8.2	1.1	1.0	0.9	3.3	3.2	3.1	0.3	0.3	0.3	4.4	10.0
6	BB	BAUHAUS INTL HLD	483 HK	1.7	81	11.8	n.a.	n.a.	0.8	n.a.	n.a.	3.7	n.a.	n.a.	0.3	n.a.	n.a.	n.a.	n.a.
7	BB	ESPRIT HLDGS	330 HK	6.5	1,620	490.6	n.a.	39.8	1.1	1.1	1.1	n.a.	20.6	8.1	0.4	0.4	0.4	-	(2.0)
8	BB	CHINA OUTFITTERS	1146 HK	0.5	218	18.7	n.a.	n.a.	0.7	n.a.	n.a.	13.0	n.a.	n.a.	0.9	n.a.	n.a.	n.a.	n.a.
9	BB	METERSBONWE -A	002269 CH	4.1	1,555	n.a.	102.5	65.4	3.4	3.2	3.1	n.a.	23.0	20.1	1.8	1.8	1.7	n.a.	3.0
10	BB	ZHEJIANG SEMIR-A	002563 CH	10.6	4,287	19.8	17.4	14.5	3.1	2.8	2.5	n.a.	12.7	10.7	2.9	2.6	2.3	3.0	16.2
					Average:	67.9	31.1	24.1	1.5	1.9	1.8	7.1	12.1	9.0	0.9	1.1	0.9	4.4	8.9
					Median:	15.3	14.4	14.5	1.1	1.7	1.7	5.7	10.3	7.7	0.5	0.8	0.6	4.4	10.1
SPORTS WEAR MANUFACTURERS & RETAILERS																			
1	Daiwa	LI NING CO LTD	2331 HK	5.2	1,291	n.a.	25.6	14.2	2.6	2.3	1.9	17.2	9.0	5.4	1.2	1.2	1.1	-	11.2
2	Daiwa	ANTA SPORTS PROD	2020 HK	20.3	6,548	20.5	18.8	16.1	5.1	4.8	4.4	12.4	11.7	9.8	3.3	3.4	2.9	3.7	26.9
3	BB	CHINA DONGXIANG	3818 HK	1.5	1,092	7.3	10.8	11.3	0.8	0.7	0.7	8.2	10.9	10.2	4.6	4.3	3.9	5.5	6.8
4	Daiwa	XTEP INTL	1368 HK	3.7	1,048	10.5	10.0	9.1	1.4	1.4	1.3	4.8	4.7	4.1	0.9	1.0	1.0	5.0	14.0
5	BB	361 DEGREES	1361 HK	2.5	667	8.5	8.0	6.9	0.8	0.8	0.7	3.1	2.6	2.3	0.6	0.5	0.5	6.6	10.0
6	Daiwa	PEAK SPORT	1968 HK	2.5	773	13.3	12.0	10.9	1.1	1.0	1.0	4.0	2.6	2.4	0.8	0.8	0.8	5.8	8.7
					Average:	12.0	14.2	11.4	1.9	1.8	1.7	8.3	6.9	5.7	1.9	1.9	1.7	4.4	12.9
					Median:	10.5	11.4	11.1	1.2	1.2	1.1	6.5	6.8	4.7	1.0	1.1	1.0	5.2	10.6

Source: Daiwa forecasts, Bloomberg, Prices as of 26 September.

Chapter 3

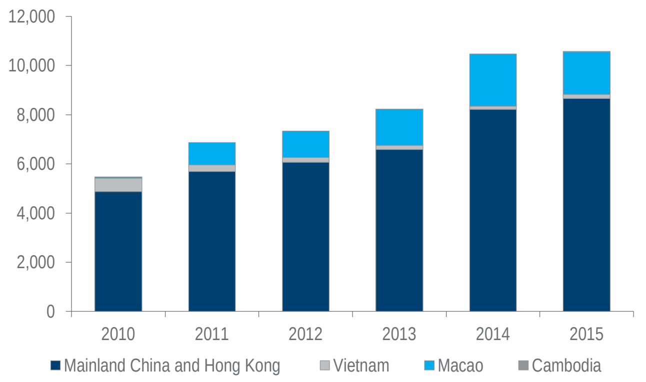
Detailed implications for regional textile companies

Upstream: Texhong Textile

Texhong Textile (2678 HK)

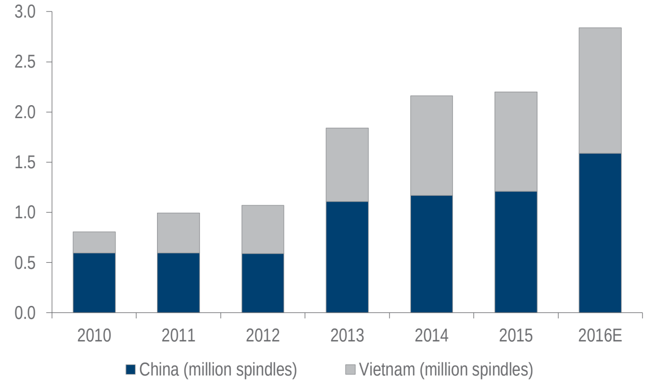
Market cap: USD1.2bn
Price (26 Sep 2016): HKD10.24
Target price: HKD15.60
Rating: Buy (1)

Texhong: revenue by geography (CNYm)



Source: Company, Daiwa
Note: Macao revenue is mostly from sales of yarn to Mainland China textile companies

Texhong: production capacity by geography



Source: Company, Daiwa
Note: Yarn spindle capacity only. Texhong also has minimal fabric and garment operations.

Exposure to ASEAN production

According to the General Statistics Office of Vietnam, there were 6.3m spindles in 2014/15, and this is expected to rise to 8.3m spindles by 2016/17. Given that Texhong had 1.25m spindles as of 30 June 2016, this implies that the company has a spindle market share of around 15-20%, which we believe is the largest in the country. Not only is Texhong the largest spinner in Vietnam, the company was also one of the first major textile companies to establish a presence in the country, having first started its expansion plan to Vietnam in November 2006, and hence is one of the longest running, and most experienced spinners in the country.

Texhong installed 260,000 new spindles in Vietnam during 1H16, which increased its spindle count in the country by 26%. As of 30 June 2016, the company had not announced any new yarn capacity expansion plan for 2H16 and 2017, but we would not rule out more investments in late 2017.

On the other hand, we believe the company will focus on expanding its downstream (fabric and garment) business in Vietnam, accelerating the process through working with third-party partners, establishing JVs as well as greenfield development. In 2015, the company set its sights on vertical integration and has since worked to establish its own downstream facility in Vietnam. We believe the benefits of this are 2-fold:

1) A diversification away from pure upstream operations could help reduce the company’s gross margin volatility. Upstream spinning businesses are typically much more sensitive to cotton and yarn price movements.

2) While Vietnam has benefited from an influx of investment activity for yarn spinning, woven fabric and fabric dyeing capacities have not seen an equivalent increase. Texhong’s downstream investment could capture a potential shortage of these capabilities, particularly if the TPP comes into force.

By early 2017, we expect the company to have an installed downstream capacity of 60m metres of grey fabrics, 40m metres of woven dyed fabrics and 7m pieces of trouser (denim) garments.

Impact of the TPP on the company

With the TPP, we believe management would accelerate its downstream expansion and increase its spindle count in Vietnam. We see Texhong as being a major beneficiary of the TPP on 2 counts:

1) **A key supplier of Vietnam-made yarns.** As mentioned above, the TPP's yarn-forward rule would require most apparel to use yarns spun within TPP member countries. The US is the only major cotton yarn producer among the TPP countries, but the geographic location and likely higher costs, mean that US yarns are not very competitive. Being the largest producer of yarns in the country, Texhong's yarns would likely be in high demand by mid and downstream customers, particularly those seeking yarns with consistent quality. While currently (as of 1H16) almost all of Texhong's yarns produced in Vietnam are shipped back to China for sale, we believe Texhong would shift some of its capacity to cater to domestic demand, which we expect would increase sharply if the TPP kicked in.

2) **Growing downstream business.** Even without the TPP, Vietnam is under-invested in mid-stream fabric production, particularly woven fabric. We believe Texhong's investment in downstream facilities would bear fruit if the TPP came into effect. In particular, the ramp-up of its downstream business could bring substantial revenue upside potential, as garments (the final product) typically have at least 5x higher selling prices than raw materials such as yarn. This ramp-up could lift revenue and earnings substantially.

However, even without the TPP, we note that there would likely be very little change to Texhong's strategy and outlook. This is because Texhong's original investment in Vietnam was mainly used to get around China's cotton import quota, and served as a way to partially arbitrage the lower international cotton prices vs. China cotton prices. We believe the status quo will unlikely change since: 1) China will continue to restrict the amount of international cotton imports for the foreseeable future, given it still has roughly 10m tonnes of cotton stockpile, and 2) as long as China continues to restrict cotton and subsidises its farmers, international cotton should remain cheaper than China's.

Revenue and earnings outlook

Despite the difficult environment for upstream players in 2014 and 2015, Texhong carried on with its aggressive capex expansion plans, namely increasing its spindles at its Vietnam plant, and launching a new production base in Xinjiang, China. This has allowed Texhong to increase its spindle count by 54% in 2.5 years, ending 1H16 with 2.84m spindles. We believe the company has only recently begun reaping the benefits of its expansion plans, aided by the stabilisation of cotton prices. The company's revenue rose by 20% YoY for 1H16 and we look for even faster growth in 2H16 of 28% YoY, driven by its higher spindle utilisation.

For 2017-18, we expect Texhong to continue to add yarn capacity, but at a slower rate (high single-digit to mid-teens percentage increase in spindles per year). On the other hand, we expect the company to focus more on its downstream expansion, and look for CNY300m of sales from garment production in 2017. Our forecasts do not explicitly account for a TPP scenario. If that happens, we believe there could be incremental or transferred spindle capacity in Vietnam (from its China plant) as well as more aggressive plans for weaving and dyeing facilities.

As Texhong is still primarily a yarn spinner, its gross margin is susceptible to swings based on cotton price movements. Our forecasts assume normalised gross margins of 18-19% throughout 2016-18, based on relatively stable cotton prices, but there could be upside if cotton prices continue to increase (from what we consider to be a relatively low base). As a result of the much higher spindle base in 2016E, and stronger yarn prices, we forecast Texhong's net profit to rise by 66% YoY for 2016, followed by 14-15% YoY growth for 2017-18.

Valuation

We reiterate our 12-month TP of HKD15.60, based on a target PER of 11x (0.5 sd above its average forward PER since 2014) and the average of our revised 2016-17E EPS. We reiterate our Buy (1) call as we believe Texhong has yet to see the full benefits of the upward-trending cotton-price environment. We are also positive on the company's vertical integration plan in Vietnam, which, if successful, could significantly improve Texhong's earnings visibility and margin volatility. Key risk to our call: a sudden drop in cotton prices.

Financial summary

Key assumptions

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Sales volume growth - stretchable core-spun yarns (YoY %)	3.0	44.8	12.2	19.8	7.4	37.0	21.7	4.3
Sales volume growth - other yarns (YoY %)	9.8	2.3	27.1	113.0	13.8	10.2	9.8	4.0
Sales volume growth - fabrics (YoY %)	(15.8)	16.7	(5.8)	(13.3)	(14.8)	11.5	2.6	5.0
Sales growth by products -stretchable core-spun yarns (YoY %)	24.3	18.9	12.5	8.2	1.2	36.1	22.7	6.4
Sales growth by products -other yarns (YoY %)	45.8	(16.2)	29.5	88.3	3.4	9.0	10.8	6.1
Sales growth by products -fabrics (YoY %)	2.0	10.3	(14.9)	(16.4)	(15.1)	15.0	4.4	7.1

Profit and loss (CNYm)

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Stretchable core-spun yarns	3,693	4,391	4,938	5,342	5,407	7,357	9,026	9,604
Other yarns	2,096	1,756	2,274	4,281	4,446	4,976	5,648	6,073
Other Revenue	1,083	1,195	1,017	847	722	830	866	927
Total Revenue	6,873	7,341	8,229	10,470	10,575	13,163	15,540	16,605
Other income	22	6	31	16	10	13	15	16
COGS	(6,317)	(6,217)	(6,645)	(9,176)	(8,669)	(10,724)	(12,636)	(13,523)
SG&A	(361)	(430)	(542)	(680)	(750)	(961)	(1,165)	(1,262)
Other op.expenses	0	0	0	0	0	0	0	0
Operating profit	217	699	1,072	630	1,166	1,491	1,753	1,836
Net-interest inc./(exp.)	(78)	(123)	(122)	(249)	(419)	(389)	(340)	(242)
Assoc/forex/extraord./others	(56)	(19)	290	(26)	(12)	115	(14)	6
Pre-tax profit	83	557	1,240	355	736	1,217	1,399	1,601
Tax	(22)	(71)	(114)	(48)	(147)	(231)	(252)	(288)
Min. int./pref. div./others	(0)	0	(0)	0	2	(5)	(15)	(20)
Net profit (reported)	61	487	1,126	307	591	981	1,133	1,293
Net profit (adjusted)	61	487	861	307	591	981	1,133	1,293
EPS (reported)(CNY)	0.069	0.550	1.273	0.347	0.668	1.109	1.280	1.461
EPS (adjusted)(CNY)	0.069	0.550	0.974	0.347	0.668	1.109	1.280	1.461
EPS (adjusted fully-diluted)(CNY)	0.069	0.550	0.974	0.347	0.668	1.108	1.280	1.461
DPS (CNY)	0.082	0.219	0.374	0.103	0.199	0.333	0.384	0.438
EBIT	217	699	1,072	630	1,166	1,491	1,753	1,836
EBITDA	393	904	1,340	1,028	1,631	1,999	2,330	2,446

Cash flow (CNYm)

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Profit before tax	83	557	1,240	355	736	1,217	1,399	1,601
Depreciation and amortisation	176	205	268	398	464	508	577	611
Tax paid	(100)	(55)	(88)	(78)	(112)	(231)	(252)	(288)
Change in working capital	(292)	63	(531)	122	323	(364)	(25)	(57)
Other operational CF items	96	154	(161)	284	286	384	334	235
Cash flow from operations	(36)	924	729	1,080	1,697	1,514	2,033	2,101
Capex	(460)	(656)	(968)	(607)	(1,106)	(1,600)	(700)	(500)
Net (acquisitions)/disposals	19	11	26	22	(12)	0	0	0
Other investing CF items	0	0	0	0	0	0	0	0
Cash flow from investing	(441)	(645)	(942)	(585)	(1,119)	(1,600)	(700)	(500)
Change in debt	692	(81)	1,096	216	842	547	(700)	(900)
Net share issues/(repurchases)	0	0	0	0	0	0	0	0
Dividends paid	(199)	0	(326)	(232)	(143)	(294)	(340)	(388)
Other financing CF items	(123)	(131)	(168)	(270)	(431)	(389)	(340)	(242)
Cash flow from financing	371	(212)	601	(285)	268	(137)	(1,380)	(1,529)
Forex effect/others	0	0	0	0	0	0	0	0
Change in cash	(106)	67	389	210	846	(223)	(46)	72
Free cash flow	(496)	268	(239)	473	591	(86)	1,333	1,601

Source: FactSet, Daiwa forecasts

Financial summary continued …

Balance sheet (CNYm)

As at 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Cash & short-term investment	495	552	946	1,138	2,188	1,965	1,919	1,991
Inventory	1,289	1,422	2,280	1,636	1,893	2,145	2,401	2,569
Accounts receivable	873	1,049	1,315	1,320	1,032	1,580	1,865	1,993
Other current assets	0	0	13	291	515	61	61	61
Total current assets	2,657	3,023	4,555	4,385	5,627	5,750	6,245	6,614
Fixed assets	2,177	2,494	4,199	4,542	5,549	6,642	6,765	6,654
Goodwill & intangibles	0	0	0	0	0	0	0	0
Other non-current assets	96	108	190	211	224	230	236	242
Total assets	4,930	5,625	8,944	9,139	11,401	12,622	13,246	13,510
Short-term debt	144	206	166	236	1,548	1,300	1,400	1,000
Accounts payable	920	1,174	2,405	2,107	2,913	2,895	3,412	3,651
Other current liabilities	31	64	115	147	164	164	164	164
Total current liabilities	1,094	1,444	2,686	2,491	4,625	4,360	4,976	4,815
Long-term debt	1,712	1,564	2,623	2,779	2,505	3,300	2,500	2,000
Other non-current liabilities	52	59	254	414	332	332	332	332
Total liabilities	2,858	3,067	5,564	5,684	7,463	7,991	7,808	7,147
Share capital	283	283	283	283	283	283	283	283
Reserves/R.E./others	1,789	2,275	3,097	3,171	3,628	4,314	5,107	6,012
Shareholders' equity	2,072	2,558	3,380	3,455	3,911	4,598	5,390	6,295
Minority interests	0	(0)	0	0	27	32	47	67
Total equity & liabilities	4,930	5,625	8,944	9,139	11,401	12,622	13,246	13,510
EV	9,272	9,125	9,746	9,775	9,787	10,556	9,912	8,953
Net debt/(cash)	1,360	1,218	1,844	1,877	1,865	2,635	1,981	1,009
BVPS (CNY)	2.342	2.892	3.821	3.905	4.421	5.197	6.093	7.116

Key ratios (%)

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Sales (YoY)	25.6	6.8	12.1	27.2	1.0	24.5	18.1	6.9
EBITDA (YoY)	(66.3)	129.9	48.2	(23.3)	58.7	22.6	16.6	5.0
Operating profit (YoY)	(78.8)	222.4	53.2	(41.2)	85.1	27.9	17.6	4.7
Net profit (YoY)	(92.7)	694.3	77.0	(64.4)	92.6	66.0	15.5	14.1
Core EPS (fully-diluted) (YoY)	(92.7)	694.3	77.0	(64.4)	92.6	66.0	15.5	14.1
Gross-profit margin	8.1	15.3	19.2	12.4	18.0	18.5	18.7	18.6
EBITDA margin	5.7	12.3	16.3	9.8	15.4	15.2	15.0	14.7
Operating-profit margin	3.2	9.5	13.0	6.0	11.0	11.3	11.3	11.1
Net profit margin	0.9	6.6	10.5	2.9	5.6	7.5	7.3	7.8
ROAE	2.9	21.0	29.0	9.0	16.0	23.1	22.7	22.1
ROAA	1.2	9.2	11.8	3.4	5.8	8.2	8.8	9.7
ROCE	5.9	16.9	20.4	10.0	16.1	17.3	18.9	19.6
ROIC	5.1	16.9	21.6	10.3	16.8	18.5	19.6	20.4
Net debt to equity	65.7	47.6	54.5	54.3	47.7	57.3	36.8	16.0
Effective tax rate	26.6	12.8	9.2	13.6	20.0	19.0	18.0	18.0
Accounts receivable (days)	47.1	47.8	52.4	45.9	40.6	36.2	40.5	42.4
Current ratio (x)	2.4	2.1	1.7	1.8	1.2	1.3	1.3	1.4
Net interest cover (x)	2.8	5.7	8.8	2.5	2.8	3.8	5.2	7.6
Net dividend payout	118.0	39.8	29.3	29.7	29.8	30.0	30.0	30.0
Free cash flow yield	n.a.	3.4	n.a.	5.9	7.4	n.a.	16.8	20.1

Source: FactSet, Daiwa forecasts

Company profile

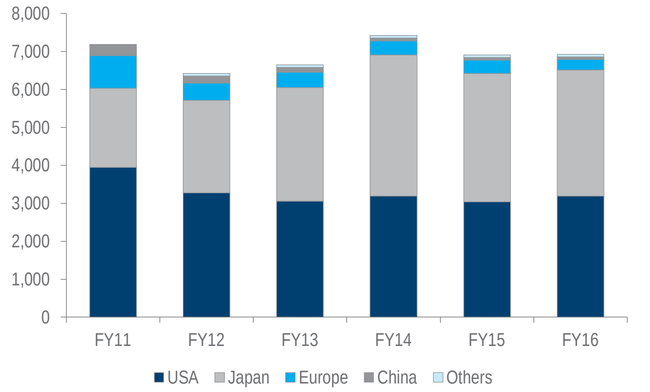
Texhong Textile Group Limited (Texhong) manufactures yarns and grey fabrics, especially high value-added core-spun yarn textiles. The company's sales network includes Mainland China, Brazil, Turkey, South Korea and Bangladesh, and it had more than 3,000 customers as at end-2014. Texhong operates production plants in China and Vietnam, with a total production capacity at end-2014 of over 2.16m spindles and 572 air-jet looms.

Midstream: Pacific Textiles

Pacific Textiles (1382 HK)

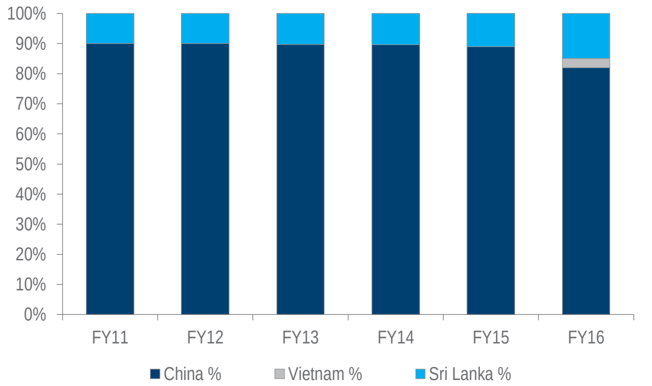
Market cap: USD1.2bn
Price (26 Sep 2016): HKD9.80
Target price: HKD11.30
Rating: Outperform (2)

Pacific Textiles: revenue by geography (HKDm)



Source: Company, Daiwa
Note: sales by end-buyer's (brand) country

Pacific Textiles: production capacity by geography



Source: Company, Daiwa

Exposure to ASEAN production

Pacific Textiles is one of the few China textile companies that has production capacity in Sri Lanka. The company has exposure through its 28.15% interest in Texture Lanka Jersey, a publicly listed company on the Colombo Stock Exchange. As at end-FY16 (March 2016), the company had 32m lbs of fabric capacity in Sri Lanka and 173m lbs of capacity at its main plant in Panyu, China.

In 2014, the company started expanding into Vietnam via a joint venture with Crystal Group, one of the largest privately owned textile and garment manufacturers in Asia. The JV, known as Pacific Crystal Textiles, is 71.25%-owned by Pacific Textiles, while the rest is owned by Crystal Group. The initial design capacity for the Phase 1 plant is 100,000 lbs per day (or roughly 3m lbs per year), which management expects to reach full utilisation by the end of 2016 (the facility reached 70,000 lbs per day by early September 2016).

Although management has not confirmed whether the company will proceed with a further expansion of its Vietnam facility, we believe the likelihood of a Phase 2 facility is very high. We understand that Pacific Textile's largest customer, UNIQLO, has expressed interest in obtaining additional capacity from Pacific Textiles, particularly since the ramp-up and quality of its Vietnam facility has been very smooth.

Impact of the TPP on the company

Pacific Textiles is a specialist in circular-knitted fabric. Its Vietnam facility focuses on weft knitting and fabric dyeing, both of which should be in high demand if the TPP comes into effect, as high-quality dyed fabric production is still in limited supply in Vietnam.

If the TPP does come through, we believe the company would almost certainly increase its production scale in Vietnam. Its duty free status with the US could provide a temporary boost to the order book from US mass market players (which has been under immense pressure since 2H FY16), but also attract new US brands (potentially higher end) as customers. Existing customers, such as L-Brands, for which Pacific Textiles has been a major supplier of lingerie fabric for its Victoria's Secret brand, and sportswear fabric for VSX and PINK brands, would likely request a larger allocation of Vietnam capacity.

While the TPP would likely be a net incremental positive for Pacific Textiles, there could also be a potential short-term negative impact on the company, as its China capacity (which is still 80% of the total capacity) would become less attractive to brand customers given the lack of duty-free market access. Hence, we would expect its customers, particularly those with strong sales in the US, to raise the pressure on Pacific Textiles to allocate Vietnam capacity to them, upon the TPP coming into force.

In reality, we have observed that requests from customers for more Vietnam capacity (rather than China) are already happening, even without the TPP's existence. At the moment, we believe these requests are primarily from its Japanese customers, such as UNIQLO, since Vietnam exports into Japan are duty-free, compared with the 12% tariffs levied if exported from China. As a result, we believe the TPP would have little impact on Pacific Textile's future direction, which would be to raise its Vietnam capacity.

Revenue and earnings outlook

On 15 September 2016, Pacific Textiles posted a profit warning stating that 1H FY17 (ending 30 September 2016) operating profit would decline by around 25% YoY. While we did expect 1H FY17 revenue to fall by a double-digit percentage YoY (*Order book to play catch-up in 2H FY17*) as a result of continued weakness in the US mass market brands, the decline in operating profit was slightly larger than we expected, suggesting possible margin compression. However, the company's anchor customer, UNIQLO (which makes up roughly half of Pacific Textiles' revenue), continues to be committed to Pacific Textiles and has indicated it is interested in more capacity.

We remain comfortable with our forecasts for the full-year 2016, as we expect the 2H FY17 order book to be stronger than the first half. For FY 2016, we look for adjusted net profit growth to be flat YoY (adjusted for HKD95m of one-off non-operating items in 2015). For FY 2017-18, we forecast 10-15% YoY growth in net profit, assuming Pacific Textiles continues to add capacity in Vietnam, irrespective of the TPP, which should be the primary driver of sales volume and earnings growth.

Valuation

We reiterate our 12-month target price of HKD11.30, based our average FY17-18E EPS and an unchanged target PER of 15x (in line with its peers' average trading multiple). Considering the expected strong 7%-plus dividend yield in FY18-19E, we reiterate our Outperform (2) rating. Key risk: a sharp fall in orders from its main customers.

Financial summary

Key assumptions

Year to 01 Apr	2012	2013	2014	2015	2016	2017E	2018E	2019E
Output volume (m lbs)	155	172	187	185	179	185	203	235
ASP (HKD/lb)	41.5	38.6	39.7	37.4	38.7	37.2	37.5	38.0
Gross profit per unit (HKD/lbs)	7.1	6.9	7.3	6.4	7.3	6.9	7.0	7.1

Profit and loss (HKDm)

Year to 01 Apr	2012	2013	2014	2015	2016	2017E	2018E	2019E
Textiles Revenues	6,420	6,649	7,423	6,907	6,928	6,877	7,628	8,919
Other Revenue	0	0	0	0	0	0	0	0
Other Revenue	0	0	0	0	0	0	0	0
Total Revenue	6,420	6,649	7,423	6,907	6,928	6,877	7,628	8,919
Other income	99	92	125	109	81	100	106	111
COGS	(5,321)	(5,468)	(6,062)	(5,729)	(5,625)	(5,597)	(6,202)	(7,251)
SG&A	(236)	(204)	(197)	(176)	(224)	(220)	(252)	(303)
Other op.expenses	0	0	0	0	0	0	0	0
Operating profit	961	1,069	1,289	1,111	1,159	1,159	1,280	1,475
Net-interest inc./(exp.)	9	15	7	13	4	(9)	(12)	(15)
Assoc/forex/extraord./others	3	26	16	96	131	36	37	38
Pre-tax profit	974	1,111	1,311	1,220	1,295	1,185	1,306	1,498
Tax	(158)	(186)	(197)	(150)	(172)	(154)	(170)	(195)
Min. int./pref. div./others	77	1	2	5	3	2	3	4
Net profit (reported)	893	925	1,117	1,075	1,126	1,033	1,139	1,308
Net profit (adjusted)	815	925	1,117	1,012	1,031	1,033	1,139	1,308
EPS (reported)(HKD)	0.623	0.644	0.773	0.743	0.778	0.714	0.787	0.904
EPS (adjusted)(HKD)	0.569	0.644	0.773	0.700	0.713	0.714	0.787	0.904
EPS (adjusted fully-diluted)(HKD)	0.569	0.644	0.773	0.700	0.712	0.714	0.787	0.903
DPS (HKD)	0.700	0.803	1.051	0.800	0.800	0.714	0.787	0.904
EBIT	961	1,069	1,289	1,111	1,159	1,159	1,280	1,475
EBITDA	1,215	1,259	1,448	1,262	1,314	1,349	1,494	1,702

Cash flow (HKDm)

Year to 01 Apr	2012	2013	2014	2015	2016	2017E	2018E	2019E
Profit before tax	974	1,111	1,311	1,220	1,295	1,185	1,306	1,498
Depreciation and amortisation	254	190	159	151	155	191	213	227
Tax paid	(190)	(139)	(196)	(236)	(172)	(154)	(170)	(195)
Change in working capital	763	(262)	27	117	(149)	86	(119)	(203)
Other operational CF items	(229)	(67)	29	(273)	(70)	(63)	(62)	(61)
Cash flow from operations	1,572	833	1,331	980	1,058	1,245	1,168	1,266
Capex	(162)	(113)	(262)	(418)	(350)	(500)	(300)	(300)
Net (acquisitions)/disposals	100	51	18	7	0	0	0	0
Other investing CF items	117	0	0	0	0	0	0	0
Cash flow from investing	55	(62)	(244)	(411)	(350)	(500)	(300)	(300)
Change in debt	(9)	0	0	1,085	(301)	0	0	0
Net share issues/(repurchases)	1	50	12	0	0	0	0	0
Dividends paid	(846)	(1,005)	(1,157)	(1,519)	(1,157)	(1,033)	(1,139)	(1,308)
Other financing CF items	48	14	8	4	4	(9)	(12)	(15)
Cash flow from financing	(805)	(942)	(1,136)	(429)	(1,454)	(1,043)	(1,151)	(1,322)
Forex effect/others	0	0	0	0	0	0	0	0
Change in cash	821	(171)	(49)	140	(746)	(297)	(283)	(357)
Free cash flow	1,409	720	1,069	562	708	745	868	966

Source: FactSet, Daiwa forecasts

Financial summary continued …

Balance sheet (HKDm)

As at 01 Apr	2012	2013	2014	2015	2016	2017E	2018E	2019E
Cash & short-term investment	1,899	1,797	1,778	2,028	1,452	1,156	910	592
Inventory	903	994	1,131	966	1,016	963	1,068	1,249
Accounts receivable	927	953	845	800	935	791	877	1,026
Other current assets	144	160	128	173	141	141	141	141
Total current assets	3,872	3,904	3,882	3,967	3,545	3,051	2,997	3,007
Fixed assets	1,231	1,159	1,237	1,410	1,560	1,870	1,956	2,030
Goodwill & intangibles	0	0	0	0	0	0	0	0
Other non-current assets	258	214	234	350	326	416	453	491
Total assets	5,362	5,277	5,353	5,727	5,431	5,337	5,406	5,528
Short-term debt	0	0	0	988	686	700	700	700
Accounts payable	929	783	839	747	783	672	744	870
Other current liabilities	391	428	469	341	436	436	436	436
Total current liabilities	1,319	1,211	1,309	2,076	1,906	1,808	1,881	2,006
Long-term debt	47	48	48	144	144	150	150	150
Other non-current liabilities	33	46	58	12	29	29	29	29
Total liabilities	1,400	1,304	1,415	2,233	2,080	1,987	2,059	2,185
Share capital	1	1	1	1	1	1	1	1
Reserves/R.E./others	3,953	3,964	3,934	3,495	3,359	3,359	3,359	3,359
Shareholders' equity	3,955	3,966	3,935	3,497	3,360	3,360	3,360	3,360
Minority interests	7	6	4	(2)	(8)	(10)	(13)	(17)
Total equity & liabilities	5,362	5,277	5,353	5,727	5,431	5,337	5,406	5,528
EV	12,138	12,280	12,305	13,112	13,366	13,643	13,849	14,125
Net debt/(cash)	(1,851)	(1,749)	(1,730)	(896)	(622)	(306)	(60)	258
BVPS (HKD)	2.760	2.762	2.722	2.417	2.323	2.323	2.323	2.323

Key ratios (%)

Year to 01 Apr	2012	2013	2014	2015	2016	2017E	2018E	2019E
Sales (YoY)	(10.6)	3.6	11.6	(7.0)	0.3	(0.7)	10.9	16.9
EBITDA (YoY)	(12.9)	3.6	15.0	(12.8)	4.1	2.7	10.7	13.9
Operating profit (YoY)	(12.0)	11.2	20.6	(13.8)	4.4	(0.1)	10.5	15.2
Net profit (YoY)	(7.0)	13.5	20.7	(9.4)	1.8	0.3	10.2	14.8
Core EPS (fully-diluted) (YoY)	(7.0)	13.3	19.9	(9.5)	1.8	0.3	10.2	14.8
Gross-profit margin	17.1	17.8	18.3	17.1	18.8	18.6	18.7	18.7
EBITDA margin	18.9	18.9	19.5	18.3	19.0	19.6	19.6	19.1
Operating-profit margin	15.0	16.1	17.4	16.1	16.7	16.8	16.8	16.5
Net profit margin	12.7	13.9	15.0	14.7	14.9	15.0	14.9	14.7
ROAE	21.0	23.4	28.3	27.2	30.1	30.8	33.9	38.9
ROAA	15.3	17.4	21.0	18.3	18.5	19.2	21.2	23.9
ROCE	23.8	26.6	32.2	25.8	26.3	27.6	30.5	35.2
ROIC	31.6	41.1	49.4	40.5	37.7	34.9	35.2	37.3
Net debt to equity	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	7.7
Effective tax rate	16.2	16.8	15.0	12.3	13.3	13.0	13.0	13.0
Accounts receivable (days)	57.9	51.6	44.2	43.5	45.7	45.8	39.9	38.9
Current ratio (x)	2.9	3.2	3.0	1.9	1.9	1.7	1.6	1.5
Net interest cover (x)	n.a.	n.a.	n.a.	n.a.	n.a.	125.9	108.3	99.8
Net dividend payout	112.3	124.6	136.0	107.7	102.8	100.0	100.0	100.0
Free cash flow yield	9.9	5.1	7.5	3.9	5.0	5.2	6.1	6.8

Source: FactSet, Daiwa forecasts

Company profile

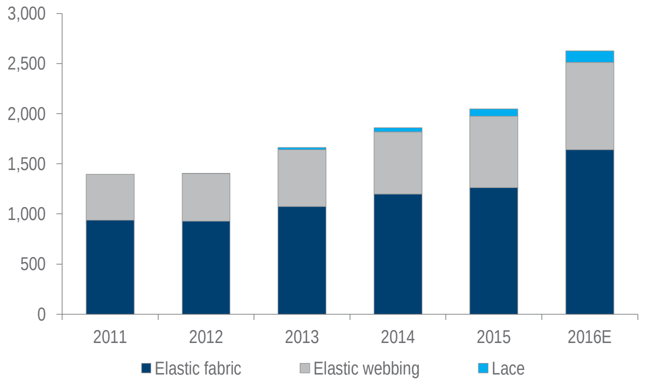
Pacific Textiles Holdings manufactures customised knitted fabrics with a focus on complex, value-added fabrics. The company's products are used in a broad range of garments, such as men's, women's, and children's clothing, sportswear, swimwear, and innerwear. It works closely with many leading brands,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

Midstream: Best Pacific International

Best Pacific International (2111 HK)

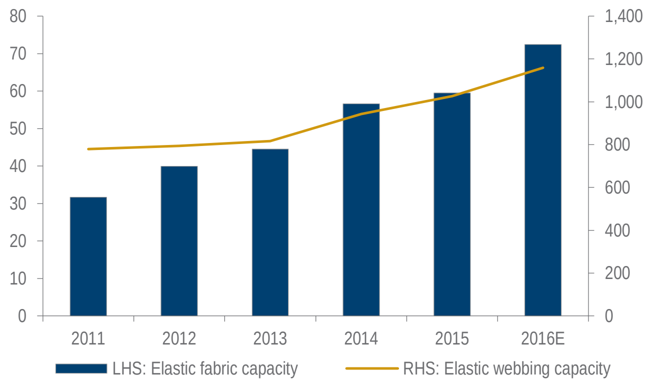
Market cap: USD0.6bn
Price (26 Sep 2016): HKD6.59
Target price: HKD8.40
Rating: Buy (1)

Best Pacific: revenue by geography (HKDm)



Source: Company, Daiwa
Note: sales by end-buyer's (brand) country

Best Pacific: production capacity by business (million meters)



Source: Company, Daiwa

Exposure to ASEAN production

Best Pacific has been a relatively slow mover in the Vietnam migration trend. The company only first announced plans to expand into Vietnam during its 1H15 results briefing, and is currently constructing its first factory in the Vietnam Singapore Industrial Park in Hai Duong, Vietnam. The company plans to build a second factory in the same location when it obtains authorisation from the government, which it expects at the end of February 2017. The total designed annual production capacity of the 2 Vietnam facilities is expected to add 25-30% incremental fabric and webbing capacity to the current capacity of 73m meters of elastic fabric and 1,136m meters of elastic webbing.

We expect the company's first Vietnam facility to begin production in mid-2017. We note Best Pacific's factories will be close to the factories of its largest downstream customer, Regina Miracle, located in the adjacent province of Hai Phong.

Impact of TPP on the company

While Best Pacific is only in the construction phase of its Vietnam expansion, the company would realistically have an operating fabric facility in Vietnam by the time, or if, the TPP comes into force. Given that the company's largest brand customer, Victoria's Secret, is US based, having a Vietnam facility could encourage the allocation of more orders.

In reality, we believe the company's initial expansion into Vietnam had little to do with the TPP. Rather, we believe Best Pacific's decision was largely motivated by Regina Miracle's Vietnam expansion plan, since that company is Best Pacific's largest downstream customer, and both companies are important partners of Victoria's Secret. Hence, even without the TPP, we believe Best Pacific's Vietnam expansion was necessary. Based on the fact that Regina Miracle's Vietnam plans seem to be more aggressive than Best Pacific's, we would not rule out further expansion plans by Best Pacific in the next 1-2 years.

Revenue and earnings outlook

In aggregate, Best Pacific's group production capacity is still relatively small, when compared with other listed players such as Pacific Textiles. As a result, we believe the company's future top-line growth will be partly dictated by its ability to ramp up capacity. On this front, the company is aggressively increasing its capacity concurrently in China and Vietnam, and hence should help set the path for accelerated growth in the near term.

We believe the key revenue growth driver for Best Pacific over at least the next 2-3 years is its sportswear business, which has seen sustained strong momentum. We note that the majority (60%) of its sportswear revenue in 1H16 (which made up 20% of total sales) was still attributable to only one customer, Victoria's Secret (including its VSX and Pink sub-brands). While Under Armour is the company's second largest sportswear customer, it only accounts for 4% of total sales, which we believe offers significant upside. The company also already has exposure to other top sports brands like Lululemon Athletica, Reebok, Adidas and the high-end 2XU brand, all of which contribute less than 1% of sales, but offer growth opportunities, in our view.

We look for a 21% revenue CAGR and a slightly faster 24% CAGR for earnings through 2018.

Valuation

We reiterate our Buy (1) call and our street-high 12-month TP of HKD8.40, based on a target PER of 17x, in line with the average trading PER of the company's regional textile peers, on our average 2016-17E EPS. With Best Pacific's industry-leading R&D capabilities and biggest runway for earnings growth among its peers, we believe the higher multiple is justified. The key risk: slower than-expected ramp-up of its sportswear business.

Daiwa Capital Markets

Financial summary

Key assumptions

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Elastic fabric sales volume (million meters)	23.2	22.5	27.5	32.4	33.1	43.1	53.6	61.2
Elastic fabric ASP (HKD/meter)	40.5	41.2	39.1	37.0	38.1	38.1	38.5	38.9
Elastic webbing sales volume (million meters)	525.8	521.0	608.4	642.6	769.3	947.7	1,005.0	1,080.0
Elastic webbing ASP (HKD/meter)	0.9	0.9	0.9	1.0	0.9	0.9	0.9	0.9
Lace sales volume (million meters)	0.0	0.0	1.2	2.5	4.5	7.3	10.9	14.9
Lace ASP (HKD/meter)	0.0	21.4	16.7	17.2	16.3	15.7	15.8	16.0

Profit and loss (HKDm)

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Elastic fabric	938	929	1,076	1,198	1,261	1,641	2,062	2,377
Elastic webbing	457	474	564	621	714	870	932	1,011
Other Revenue	0	1	20	42	74	115	172	238
Total Revenue	1,396	1,404	1,659	1,861	2,048	2,626	3,167	3,627
Other income	0	0	0	0	0	0	0	0
COGS	(948)	(955)	(1,137)	(1,292)	(1,368)	(1,721)	(2,091)	(2,399)
SG&A	(141)	(154)	(166)	(214)	(242)	(308)	(361)	(413)
Other op.expenses	(21)	(37)	(45)	(66)	(47)	(58)	(67)	(73)
Operating profit	285	259	312	289	391	540	648	741
Net-interest inc./(exp.)	(40)	(45)	(35)	(18)	6	(5)	(8)	8
Assoc/forex/extraord./others	(1)	26	25	33	18	30	34	38
Pre-tax profit	244	240	301	304	414	565	675	788
Tax	(38)	(42)	(57)	(57)	(72)	(99)	(118)	(138)
Min. int./pref. div./others	(26)	(23)	(30)	0	0	0	0	0
Net profit (reported)	180	174	215	247	342	466	557	650
Net profit (adjusted)	180	174	215	247	342	466	557	650
EPS (reported)(HKD)	0.240	0.232	0.286	0.270	0.336	0.455	0.544	0.636
EPS (adjusted)(HKD)	0.240	0.232	0.286	0.270	0.336	0.455	0.544	0.636
EPS (adjusted fully-diluted)(HKD)	0.240	0.232	0.286	0.269	0.332	0.452	0.540	0.630
DPS (HKD)	0.000	0.000	0.080	0.085	0.133	0.182	0.218	0.254
EBIT	285	259	312	289	391	540	648	741
EBITDA	346	344	416	405	513	715	898	1,003

Cash flow (HKDm)

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Profit before tax	244	240	301	304	414	565	675	788
Depreciation and amortisation	61	86	105	117	122	175	250	262
Tax paid	(19)	(64)	(42)	(37)	(72)	(99)	(118)	(138)
Change in working capital	(202)	74	(53)	19	21	(115)	(92)	(79)
Other operational CF items	61	35	35	30	60	11	11	(8)
Cash flow from operations	144	370	345	433	546	537	725	824
Capex	(139)	(142)	(217)	(185)	(239)	(863)	(488)	(152)
Net (acquisitions)/disposals	(60)	0	2	71	0	0	0	0
Other investing CF items	118	(83)	193	(632)	30	23	28	48
Cash flow from investing	(80)	(225)	(22)	(745)	(209)	(840)	(461)	(104)
Change in debt	66	59	(120)	(136)	(73)	239	100	100
Net share issues/(repurchases)	0	0	0	578	0	0	0	0
Dividends paid	0	0	(60)	(36)	(105)	(186)	(223)	(260)
Other financing CF items	(91)	(181)	(197)	(93)	(35)	(8)	(30)	(34)
Cash flow from financing	(25)	(122)	(376)	313	(212)	45	(152)	(194)
Forex effect/others	0	0	0	0	0	0	0	0
Change in cash	39	23	(53)	1	125	(258)	112	525
Free cash flow	6	228	128	248	307	(326)	236	672

Source: FactSet, Daiwa forecasts

Financial summary continued …

Balance sheet (HKDm)

As at 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Cash & short-term investment	126	149	98	745	870	612	724	1,250
Inventory	231	231	318	348	365	448	544	624
Accounts receivable	393	383	454	419	468	612	737	845
Other current assets	238	318	114	120	74	94	117	141
Total current assets	988	1,080	983	1,631	1,776	1,766	2,123	2,860
Fixed assets	758	890	1,033	1,106	1,035	1,699	1,925	1,812
Goodwill & intangibles	45	45	44	43	40	64	76	78
Other non-current assets	90	88	109	33	50	57	67	74
Total assets	1,882	2,103	2,169	2,813	2,901	3,585	4,190	4,825
Short-term debt	733	845	346	402	588	588	588	588
Accounts payable	206	243	310	357	389	448	544	624
Other current liabilities	454	358	198	154	172	248	311	369
Total current liabilities	1,392	1,445	853	912	1,149	1,284	1,444	1,582
Long-term debt	20	16	452	259	0	239	339	439
Other non-current liabilities	51	33	32	25	13	37	44	51
Total liabilities	1,463	1,495	1,337	1,196	1,162	1,560	1,827	2,072
Share capital	0	0	0	10	10	10	10	10
Reserves/R.E./others	361	527	725	1,607	1,729	2,015	2,353	2,743
Shareholders' equity	361	527	726	1,617	1,739	2,025	2,363	2,753
Minority interests	58	80	107	0	0	0	0	0
Total equity & liabilities	1,882	2,103	2,169	2,813	2,901	3,585	4,190	4,825
EV	7,536	7,644	7,658	6,768	6,570	7,067	7,055	6,629
Net debt/(cash)	627	712	700	(84)	(282)	215	203	(223)
BVPS (HKD)	0.481	0.703	0.967	1.771	1.705	1.980	2.310	2.692

Key ratios (%)

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Sales (YoY)	n.a.	0.6	18.2	12.1	10.1	28.2	20.6	14.5
EBITDA (YoY)	n.a.	(0.4)	20.9	(2.6)	26.5	39.3	25.6	11.8
Operating profit (YoY)	n.a.	(9.3)	20.6	(7.4)	35.3	38.1	20.1	14.4
Net profit (YoY)	n.a.	(3.2)	23.1	15.1	38.7	36.1	19.5	16.8
Core EPS (fully-diluted) (YoY)	n.a.	(3.2)	23.1	(6.1)	23.6	36.0	19.5	16.8
Gross-profit margin	32.1	32.0	31.5	30.5	33.2	34.5	34.0	33.8
EBITDA margin	24.8	24.5	25.1	21.8	25.0	27.2	28.3	27.7
Operating-profit margin	20.4	18.4	18.8	15.5	19.1	20.5	20.5	20.4
Net profit margin	12.9	12.4	12.9	13.3	16.7	17.7	17.6	17.9
ROAE	n.a.	38.5	34.0	20.2	20.4	24.8	25.4	25.4
ROAA	n.a.	8.7	10.0	9.9	12.0	14.4	14.3	14.4
ROCE	n.a.	19.6	20.1	14.8	17.0	20.8	21.1	21.0
ROIC	23.0	18.0	17.8	15.3	21.6	24.1	22.3	24.0
Net debt to equity	173.7	135.0	96.4	n.a.	n.a.	10.6	8.6	n.a.
Effective tax rate	15.5	17.6	18.8	18.7	17.3	17.5	17.5	17.5
Accounts receivable (days)	n.a.	100.9	91.9	85.5	79.0	75.0	77.7	79.6
Current ratio (x)	0.7	0.7	1.2	1.8	1.5	1.4	1.5	1.8
Net interest cover (x)	7.1	5.8	8.8	16.2	n.a.	107.0	85.6	n.a.
Net dividend payout	0.0	0.0	28.0	31.4	39.6	40.0	40.0	40.0
Free cash flow yield	0.1	3.3	1.9	3.6	4.5	n.a.	3.4	9.8

Source: FactSet, Daiwa forecasts

Company profile

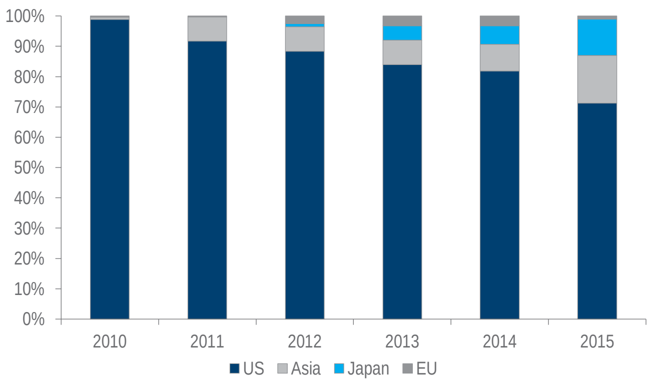
Founded in 2003, Best Pacific International is a leading global manufacturer of lingerie materials. The company produces elastic fabrics, elastic webbing and lace materials. Its major clients include some of the world's top lingerie brands, such as Victoria's Secret, Calvin Klein, Triumph and Wacoal. The company also supplies fabric for sports brands such as Lululemon Athletica and Under Armour.

Downstream: Makalot Industrial

Makalot Industrial (1477 TT)

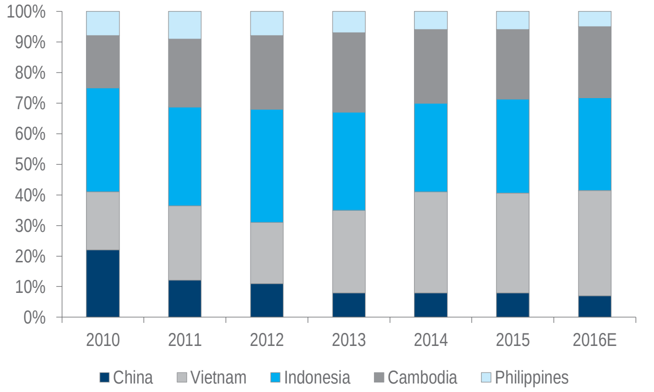
Market cap: USD1.0bn
Price (26 Sep 2016): TWD152.50
Target Price: TWD122.0
Rating: Underperform (4)

Makalot: revenue by geography



Source: Company, Daiwa
Note: Makalot discloses its revenue by end market.

Makalot: production capacity by geography



Source: Company, Daiwa

Exposure to ASEAN production

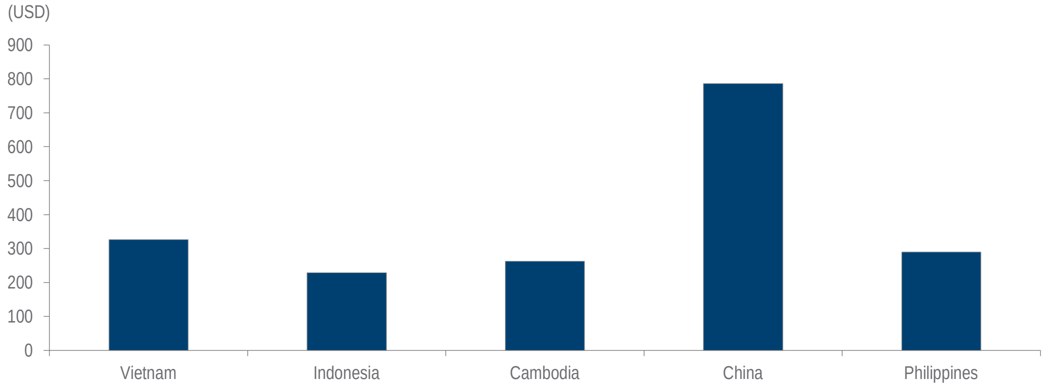
Makalot has 5 production bases, in Indonesia, Cambodia, Vietnam, China and the Philippines, and we believe this has enabled it to reduce the impact of rising labour costs in China. Makalot plans to further expand its capacity at its Indonesia, Cambodia and Vietnam plants in the next few years. In October 2013, the company took a 50% stake in Namtex, a Vietnam-based subsidiary of Tainan Spinning (Not rated), with a view to expanding into the dyeing and finishing process. This should also allow it to capitalise on the favourable tariff treatment for companies in Vietnam under the planned TPP, which would mean Makalot's customers pay zero import tariffs. Over the next 5 years, Makalot intends to allocate more orders to the Vietnam factory (which has been its largest production base since 2014, accounting for 34% of total capacity in 2016, up from 33% in 2015) given the favourable labour costs and potential TPP benefits.

Impact of the TPP on the company

If the TPP is ratified and implemented, we believe Makalot would speed up its expansion plans with Namtex, with a view to expanding into the upstream space, such as dyeing and finishing process. This move would likely have a positive impact on its gross-margin performance in the mid- to long- term due to its more integrated business model, rather than only being a garment manufacturer. Besides, the company would likely accelerate its Vietnam capacity expansion because, as at least 80% of its goods are exported to the US and US brands, its US clients would have the incentive to book Makalot's Vietnam capacity in advance for duty-free benefits, which would lengthen its order visibility and boost its order book. Even for its Japan client (GU, accounting for 15% of 2016E revenue), there would be 9% lower tariffs under the TPP framework.

If the TPP does not go ahead, we believe the impact on the company would be negative. In its space, too many of its peers, including those in China and Korea, have expanded their garment capacity in Vietnam in the past 2 years due to the potential TPP benefits, leading to price competition as a result of the subsequent oversupply in Vietnam. In turn, we have seen some brand clients move their orders to India and Bengal or other countries where labour costs are lower. If the TPP does not go through, OEMs would have likely have to take on more low-margin orders in order to fill their existing capacity in Vietnam. By extension, Makalot would likely have to supply some low-ASP/gross-margin orders, which would be negative for its overall gross margin. Besides, as Makalot would have no incentive to build further capacity in Vietnam, it would likely need to slow down its Vietnam capacity expansion and increase its capacity in other lower-labour-cost areas, such as in Indonesia and Cambodia.

Makalot: monthly wages per person in 2015 by production site



Source: Makalot, compiled by Daiwa

Revenue and earnings outlook

We forecast Makalot's revenue to decline by 3.0% YoY for 2016 and rise by 7.0% YoY for 2017, and its net profit to decline by 28.9% YoY and rise by 15.5% YoY over the same horizon. Note that our forecasts exclude the impact of the TPP. We see possible upside for Makalot if the TPP kicks in resulting from its rising bargaining power over brand clients and longer order visibility.

On the margin front, we forecast its gross margin to decline to 20.1% in 2016, from 23.6% in 2015, and then rise slightly to 20.6% for 2017, assuming stable cotton prices.

If the TPP comes into effect in 2018, we believe the company would see better bargaining power and greater order visibility, with a positive impact on its earnings. So far, Vietnam is the largest production base for Makalot, and we forecast it to account for at least 40% (up from 33% in 2015) of the company's total capacity by 2018. Still, the majority of the benefits would likely go to the brand names.

Valuation

We reiterate our Underperform (4) rating, and our 12-month TP of TWD122. Our TP is based on a PER of 15x applied to our 2016-17E EPS (basis unchanged), below the stock's past 5-year average PER of 18x (range of 11-29x). The key upside risk: better-than-expected sales growth from its main clients.

Financial summary

Key assumptions

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
ASP (TWD) (dozen)	1,853.4	1,732.2	1,704.2	1,800.3	1,800.3	1,746.3	1,746.3	1,746.3
Shipments (m dozen)	8.2	9.2	10.5	11.6	13.0	13.0	13.9	14.9
Consolidated gross margin (%)	20.9	19.9	19.9	21.7	23.6	20.1	20.6	21.1

Profit and loss (TWDm)

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
US	13,870	14,168	15,785	18,215	18,893	17,669	18,421	19,192
Japan	0	159	896	1,358	3,153	3,624	4,363	5,187
Other Revenue	1,253	1,540	1,230	1,316	1,313	1,359	1,454	1,556
Total Revenue	15,123	15,867	17,911	20,889	23,359	22,653	24,239	25,935
Other income	0	0	0	0	0	0	0	0
COGS	(11,966)	(12,712)	(14,344)	(16,362)	(17,847)	(18,101)	(19,247)	(20,464)
SG&A	(1,709)	(1,671)	(1,943)	(2,440)	(2,861)	(2,673)	(2,787)	(2,931)
Other op.expenses	0	0	0	0	0	0	0	0
Operating profit	1,449	1,484	1,624	2,087	2,650	1,879	2,205	2,540
Net-interest inc./(exp.)	(23)	(8)	(38)	(45)	(28)	(22)	(62)	(35)
Assoc/forex/extraord./others	(20)	(38)	61	52	69	28	34	34
Pre-tax profit	1,406	1,438	1,647	2,095	2,691	1,885	2,177	2,540
Tax	(293)	(261)	(304)	(389)	(514)	(351)	(405)	(472)
Min. int./pref. div./others	(2)	(1)	(1)	(0)	(18)	0	0	0
Net profit (reported)	1,111	1,175	1,342	1,705	2,159	1,535	1,772	2,068
Net profit (adjusted)	1,111	1,175	1,342	1,705	2,159	1,535	1,772	2,068
EPS (reported)(TWD)	6.639	6.887	7.716	9.268	10.898	7.451	8.604	10.038
EPS (adjusted)(TWD)	6.639	6.887	7.716	9.268	10.898	7.451	8.604	10.038
EPS (adjusted fully-diluted)(TWD)	6.375	6.634	7.382	8.959	10.663	7.333	8.468	9.879
DPS (TWD)	5.887	6.012	7.486	8.291	9.520	6.333	7.313	8.532
EBIT	1,449	1,484	1,624	2,087	2,650	1,879	2,205	2,540
EBITDA	1,632	1,677	1,827	2,347	2,955	2,296	2,648	3,011

Cash flow (TWDm)

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Profit before tax	1,406	1,438	1,647	2,095	2,691	1,885	2,177	2,540
Depreciation and amortisation	183	193	203	260	305	417	443	471
Tax paid	(293)	(261)	(281)	(337)	(452)	(351)	(405)	(472)
Change in working capital	(817)	878	(575)	(800)	933	1,180	189	230
Other operational CF items	(2)	17	(2)	72	100	30	51	25
Cash flow from operations	476	2,264	993	1,291	3,576	3,162	2,456	2,792
Capex	(394)	(252)	(3,238)	(470)	(766)	(803)	(771)	(771)
Net (acquisitions)/disposals	26	5	2	38	18	0	0	0
Other investing CF items	(9)	(2)	(144)	(99)	(33)	33	33	33
Cash flow from investing	(377)	(249)	(3,380)	(530)	(780)	(770)	(738)	(738)
Change in debt	139	353	1,183	(1,100)	(97)	1,197	(300)	(300)
Net share issues/(repurchases)	0	0	0	2,115	0	0	0	0
Dividends paid	(734)	(994)	(1,029)	(1,311)	(1,473)	(1,886)	(1,304)	(1,506)
Other financing CF items	0	4	18	(16)	19	0	0	0
Cash flow from financing	(595)	(637)	171	(312)	(1,551)	(689)	(1,604)	(1,806)
Forex effect/others	63	(43)	42	99	97	0	0	0
Change in cash	(433)	1,336	(2,175)	547	1,342	1,702	113	248
Free cash flow	83	2,012	(2,245)	821	2,811	2,359	1,685	2,021

Source: FactSet, Daiwa forecasts

Financial summary continued …

Balance sheet (TWDm)

As at 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Cash & short-term investment	2,039	3,378	1,181	1,702	2,967	4,669	4,783	5,031
Inventory	2,279	2,389	2,872	2,745	3,159	3,402	3,618	3,847
Accounts receivable	191	339	293	1,319	379	484	517	555
Other current assets	1,775	770	1,205	1,393	1,635	1,610	1,310	1,310
Total current assets	6,283	6,877	5,551	7,159	8,140	10,165	10,227	10,741
Fixed assets	964	1,014	4,121	4,368	4,613	4,788	5,125	5,134
Goodwill & intangibles	0	0	36	42	50	0	0	0
Other non-current assets	267	283	387	425	752	278	377	476
Total assets	7,514	8,174	10,095	11,994	13,555	15,231	15,729	16,351
Short-term debt	364	17	0	100	3	600	600	600
Accounts payable	1,199	1,278	1,448	1,457	1,718	3,125	3,442	3,815
Other current liabilities	1,436	1,416	1,562	2,060	2,513	2,152	2,166	2,153
Total current liabilities	2,999	2,712	3,010	3,616	4,234	5,877	6,208	6,569
Long-term debt	0	644	1,640	0	0	600	300	0
Other non-current liabilities	98	141	116	155	209	201	201	201
Total liabilities	3,097	3,497	4,765	3,771	4,443	6,678	6,708	6,770
Share capital	1,627	1,655	1,691	1,910	1,987	2,060	2,060	2,060
Reserves/R.E./others	2,783	3,010	3,609	6,298	7,067	6,435	6,903	7,464
Shareholders' equity	4,410	4,665	5,299	8,207	9,054	8,495	8,962	9,524
Minority interests	7	12	31	16	58	58	58	58
Total equity & liabilities	7,514	8,174	10,095	11,994	13,555	15,231	15,729	16,351
EV	29,743	28,706	31,900	29,825	28,504	27,999	27,586	27,038
Net debt/(cash)	(1,674)	(2,717)	459	(1,602)	(2,964)	(3,469)	(3,883)	(4,431)
BVPS (TWD)	27.101	28.193	31.344	41.428	45.701	41.242	43.513	46.238

Key ratios (%)

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Sales (YoY)	7.0	4.9	12.9	16.6	11.8	(3.0)	7.0	7.0
EBITDA (YoY)	5.4	2.7	9.0	28.4	25.9	(22.3)	15.3	13.7
Operating profit (YoY)	8.3	2.4	9.5	28.5	27.0	(29.1)	17.3	15.2
Net profit (YoY)	21.0	5.8	14.2	27.1	26.6	(28.9)	15.5	16.7
Core EPS (fully-diluted) (YoY)	20.4	4.1	11.3	21.4	19.0	(31.2)	15.5	16.7
Gross-profit margin	20.9	19.9	19.9	21.7	23.6	20.1	20.6	21.1
EBITDA margin	10.8	10.6	10.2	11.2	12.6	10.1	10.9	11.6
Operating-profit margin	9.6	9.4	9.1	10.0	11.3	8.3	9.1	9.8
Net profit margin	7.3	7.4	7.5	8.2	9.2	6.8	7.3	8.0
ROAE	27.1	25.9	26.9	25.3	25.0	17.5	20.3	22.4
ROAA	16.0	15.0	14.7	15.4	16.9	10.7	11.4	12.9
ROCE	32.9	29.3	26.4	27.3	30.4	19.9	22.4	25.3
ROIC	51.6	51.6	34.2	27.4	33.6	27.2	35.1	40.2
Net debt to equity	n.a.	n.a.	8.7	n.a.	n.a.	n.a.	n.a.	n.a.
Effective tax rate	20.9	18.2	18.5	18.6	19.1	18.6	18.6	18.6
Accounts receivable (days)	3.6	6.1	6.4	14.1	13.3	6.9	7.5	7.5
Current ratio (x)	2.1	2.5	1.8	2.0	1.9	1.7	1.6	1.6
Net interest cover (x)	63.1	192.8	42.8	46.8	95.7	87.2	35.8	73.6
Net dividend payout	88.7	87.3	97.0	89.5	87.4	85.0	85.0	85.0
Free cash flow yield	0.3	6.4	n.a.	2.6	8.9	7.5	5.4	6.4

Source: FactSet, Daiwa forecasts

Company profile

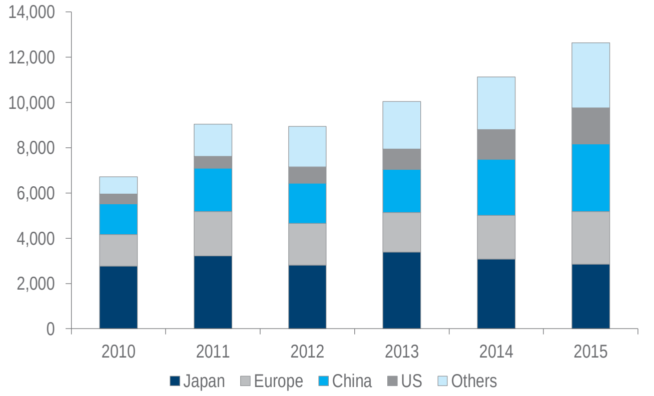
Makalot Industrial (Makalot) is a diversified garment manufacturer for brands and retailers globally. It not only produces apparel as an original equipment manufacturer (OEM), but is also an original brand manufacturer (OBM) with the launch of its FISSO brand in Taiwan and Mainland China in 2013.

Vertically integrated: Shenzhou International

Shenzhou International (2313 HK)

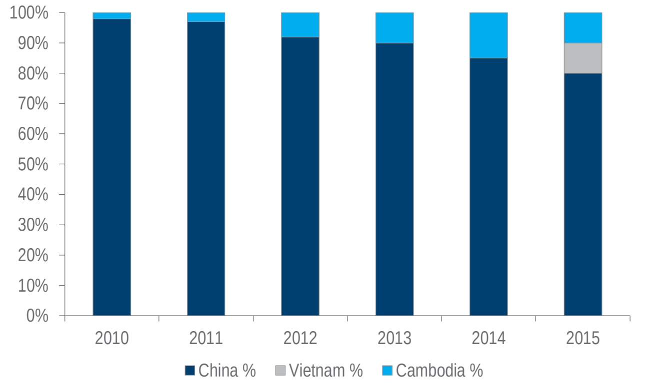
Market cap: USD9.6bn
Price (26 Sep 2016): HKD53.10
Target price: HKD61.00
Rating: Buy (1)

Shenzhou: revenue by geography in CNYm



Source: Company, Daiwa

Shenzhou: garment production capacity by geography



Source: Daiwa
Note: based on garment capacity only

Exposure to ASEAN production

Realising the significance of rising labour costs to its business, Shenzhou had the foresight to explore new manufacturing locations outside of China early, and commenced production of a garment factory in Cambodia in September 2005. While the factory was initially kept at a relatively small capacity, the company has, in recent years, expanded its scale to contribute roughly 13-14% of total garment capacity by mid-2016 and now employs over 11,000 workers in the country. The source of fabric for the Cambodia plant had been from Shenzhou's Ningbo plant for many years, before recently started to be supplied by its Vietnam fabric plant, which has helped improve its efficiency and cost structure (lower freight costs).

In 2013, Shenzhou started building a fabric facility in Vietnam, and commenced production at the plant in October 2014. Unlike in Cambodia, which has much more limited infrastructure and supply chain support, Shenzhou proceeded to develop its Vietnam production base to be vertically integrated, similar to its China base. Shenzhou has since constructed and commenced production of a garment plant in Vietnam and, as of mid-2016, has 6,000 workers in the country. By end-2016, the company aims to have 8,000 workers. The company has already made plans to continue to expand its garment scale, having already purchased the land-use rights for another facility. As in China, Shenzhou's vertical integration will be limited to just fabric and garment production, while yarns will be purchased from a third-party. At the moment, we understand that a major supplier of its yarns in Vietnam is Bros Eastern (management estimates that roughly 40% of Bros Eastern's Vietnam facility is dedicated to Shenzhou).

Impact of the TPP on the company

Shenzhou has long been the darling of the China textile stocks, having seen its share price more than quintuple in the past 5 years. In our opinion, its outperformance boils down to strong management execution and its vertical integration strategy. Of all the regional textile companies we have met, Shenzhou has the strongest track record in project execution, and its expansion into Vietnam was one of the smoothest we have seen. We note that Shenzhou first announced its decision to expand into the country (with a fabric factory) in mid-2013, but it was already producing by October 2014. When we visited the facility in early 2015, the factory appeared even more organised than its core facility in Ningbo. By the end of 2015, we estimate roughly 30% of the company's fabric production was done in Vietnam, up from around 6% in 2014.

With the TPP, we believe Shenzhou would be in a strong position to benefit, as it is one of the few major textile companies to have established a self-sustaining, vertically integrated production process in Vietnam. While other garment makers would likely rush to find a reliable fabric producer in Vietnam if the TPP comes into force (particularly one that has sufficient scale and uses Vietnam-spun yarn), Shenzhou should not have that problem since both its fabric and garment facilities have been operating smoothly. This could give it an opportunity to gain supplier market share for its core global brand customers (Nike, Adidas, Puma, UNIQLO).

Even without the TPP, we believe Shenzhou would still be much better off with manufacturing operations in Vietnam, due to:

1) **Lower wages.** Given the company's labour-intensive garment operations, Shenzhou benefits greatly from the much reduced wages in Vietnam compared to China. As of 30 June 2016, the company employed 76,360 staff group-wide, but we estimate that over 60% are still located in China. For comparison, the average wage cost for a worker in Shenzhou's Ningbo plant is around USD810, while in Vietnam and Cambodia it is USD420 and USD360, respectively.

2) **Lower tariffs for its second largest customer.** UNIQLO contributed roughly 30% of revenue to Shenzhou as of 1H16 (vs. Nike at 33%, Adidas at 21% and Puma at 9%), while Japan contributed 21% of total sales. Given the bulk of UNIQLO's shipments still go to Japan, the brand would likely prefer production to be done in Vietnam to enjoy tariff savings of 11-12%. With Vietnam covering exports to Japan, this complements the company's Cambodia production facility, which has duty-free status for exports to the EU (based on the EU's "Everything But Arms Scheme", which gives the 49 least developed countries, including Cambodia, duty-free exports on all products except arms and ammunition).

3) **Lengthy tax breaks.** Of all the regional textile players we cover, we believe Shenzhou was offered some of the best tax incentives for investment in Vietnam. If Shenzhou is able to maintain minimum annual revenue of USD500m within 3 years from the date of operations commencement, or employ more than 3,000 workers within 3 years, it would be subject to profit tax of 10% (vs. the typical 20% in Vietnam). Given that it already employs twice the required number, we believe the low profit tax rate is a given. Further, the company was offered a tax break for the first 4 years, and a half tax rate of 5% for the subsequent 9 years. Compared with the 25% corporate income tax rate in China, this is a big saving.

Revenue and earnings outlook

Shenzhou posted strong 1H16 results that beat even the most bullish street estimates. The company posted a 20% YoY increase in sales volume, together with a 5% increase in ASPs, due to an improving product mix. Despite Shenzhou's sizeable scale, we believe the company will continue delivering strong volume growth over the next 3 years (9-18% per year), as a result of: 1) the continuous ramp-up of its Vietnam garment facility, and 2) the continued automation of its manufacturing equipment, which already yielded a c.5% increase in volume growth during 1H16. We note that as of 1H16, the company's top-line growth remain constrained by its capacity.

On the earnings front, we revise up 2016-18E EPS by 1-3%, primarily on a lower blended income tax rate, as we expect its Vietnam tax incentives to become increasingly evident as its operations scale up. We now look for a 19% earnings CAGR from 2015 to 2018. While we forecast a record-high gross margin of 32.1% for 2016, we are cognizant that this may be a high base going forward, and hence have factored some downside into our estimates (particularly if cotton prices spike). For 2017 and 2018, we look for gross margins of 31.9% and 31.5%, respectively.

Our estimates do not take into account another round of Vietnam expansion, which we believe is likely if the TPP does go through. However, given Shenzhou's solid project execution capabilities, as well as its already sizeable Vietnam operations, we believe it is well placed to reap any positive optionality from the TPP. Moreover, we note that Nike recently became Shenzhou's largest revenue contributor, at 33% of revenue. Given that Nike's home market is the US, we would expect additional order allocations from Nike to Shenzhou if the TPP goes through.

Valuation

We raise our 12-month target price to HKD61 (from HKD57), based on the average of our revised 2016-17E EPS (previously 2016 only) and a target PER of 23x (previously 22x, now a 25% premium to the average trading PER of its regional peers). The expanded multiple reflects the Shenzhou's best-in-class execution, the continued strength of its order book and our view of the company's winning position regardless of the outcome of the TPP. We reiterate our Buy (1) call. The key risk: a slower-than-expected ramp-up of production in Vietnam.

Financial summary

Key assumptions

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Output volume (m pieces)	207.0	215.3	241.1	261.1	282.5	333.4	376.7	410.6
ASP (CNY/piece)	42.0	40.4	40.5	41.6	43.7	45.7	47.0	48.0
Sales breakdown by products -Casual wear (%)	33.7	33.5	28.6	24.5	27.5	25.0	24.0	23.0
Sales breakdown by products -Sports wear (%)	54.7	55.9	55.3	61.4	63.5	65.0	67.0	68.0
Sales breakdown by products - Lingerie (%)	8.8	7.9	13.7	13.0	8.1	9.5	8.5	8.5
Sales breakdown by products - Other knitted products (%)	2.7	2.8	2.3	1.1	0.9	0.5	0.5	0.5

Profit and loss (CNYm)

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Casual wear Revenues	3,047	2,994	2,872	2,724	3,476	3,898	4,355	4,640
Sports wear Revenues	4,949	4,994	5,561	6,830	8,028	10,134	12,158	13,718
Other Revenue	1,047	949	1,614	1,577	1,135	1,559	1,633	1,816
Total Revenue	9,043	8,938	10,047	11,132	12,639	15,590	18,146	20,174
Other income	169	204	262	295	237	451	471	496
COGS	(6,442)	(6,393)	(7,209)	(7,905)	(8,790)	(10,586)	(12,357)	(13,819)
SG&A	(291)	(382)	(454)	(598)	(695)	(850)	(1,043)	(1,166)
Other op.expenses	(381)	(371)	(469)	(458)	(626)	(727)	(709)	(761)
Operating profit	2,100	1,995	2,178	2,465	2,764	3,879	4,507	4,924
Net-interest inc./(exp.)	(40)	10	23	79	124	(118)	(121)	(106)
Assoc/forex/extraord./others	0	0	0	(1)	(1)	2	5	8
Pre-tax profit	2,059	2,005	2,201	2,543	2,887	3,763	4,391	4,826
Tax	(355)	(384)	(397)	(477)	(532)	(658)	(703)	(724)
Min. int./pref. div./others	(1)	(1)	(1)	(1)	(0)	(1)	(1)	(1)
Net profit (reported)	1,704	1,620	1,803	2,066	2,355	3,104	3,688	4,102
Net profit (adjusted)	1,704	1,620	1,803	2,103	2,429	3,104	3,688	4,102
EPS (reported)(CNY)	1.369	1.243	1.321	1.477	1.683	2.219	2.636	2.932
EPS (adjusted)(CNY)	1.369	1.243	1.321	1.503	1.736	2.219	2.636	2.932
EPS (adjusted fully-diluted)(CNY)	1.369	1.243	1.321	1.447	1.617	2.067	2.456	2.731
DPS (CNY)	0.405	0.579	0.604	0.789	0.896	1.220	1.450	1.613
EBIT	2,100	1,995	2,178	2,465	2,764	3,879	4,507	4,924
EBITDA	2,431	2,357	2,585	2,908	3,286	4,525	5,206	5,675

Cash flow (CNYm)

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Profit before tax	2,059	2,005	2,201	2,543	2,887	3,763	4,391	4,826
Depreciation and amortisation	331	362	407	443	522	647	699	751
Tax paid	(363)	(492)	(489)	(399)	(486)	(658)	(703)	(724)
Change in working capital	(419)	(213)	(380)	(592)	(716)	(594)	(843)	(669)
Other operational CF items	32	(38)	(30)	(77)	52	0	(0)	0
Cash flow from operations	1,641	1,625	1,709	1,918	2,259	3,157	3,544	4,183
Capex	(427)	(652)	(796)	(1,141)	(2,054)	(1,200)	(800)	(800)
Net (acquisitions)/disposals	3	1	(197)	(142)	(475)	0	0	0
Other investing CF items	(157)	197	133	(4,088)	1,135	0	0	0
Cash flow from investing	(581)	(455)	(861)	(5,371)	(1,395)	(1,200)	(800)	(800)
Change in debt	(185)	(458)	(786)	47	610	0	0	0
Net share issues/(repurchases)	0	940	1,217	0	0	0	0	0
Dividends paid	(382)	(540)	(755)	(825)	(1,104)	(1,254)	(1,707)	(2,029)
Other financing CF items	20	0	(20)	3,036	(15)	866	(640)	(400)
Cash flow from financing	(547)	(58)	(345)	2,257	(509)	(388)	(2,347)	(2,429)
Forex effect/others	0	0	0	0	0	0	0	0
Change in cash	513	1,111	504	(1,195)	355	1,569	397	954
Free cash flow	1,214	972	913	777	205	1,957	2,744	3,383

Source: FactSet, Daiwa forecasts

Financial summary continued …

Balance sheet (CNYm)

As at 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Cash & short-term investment	1,347	2,275	2,640	4,626	4,200	5,769	6,166	7,120
Inventory	1,953	1,924	2,425	2,607	3,233	3,586	4,173	4,640
Accounts receivable	1,314	1,398	1,375	1,643	2,002	2,339	2,722	3,026
Other current assets	302	330	553	1,433	1,477	1,477	1,477	1,477
Total current assets	4,915	5,928	6,993	10,309	10,912	13,170	14,538	16,263
Fixed assets	3,522	3,853	4,215	4,958	6,481	7,034	7,136	7,185
Goodwill & intangibles	110	105	102	103	109	109	109	109
Other non-current assets	2	9	8	573	860	860	860	860
Total assets	8,550	9,895	11,317	15,943	18,362	21,174	22,643	24,418
Short-term debt	1,244	786	0	47	657	1,420	1,000	800
Accounts payable	491	397	392	468	679	780	907	1,009
Other current liabilities	702	590	594	751	819	814	814	814
Total current liabilities	2,437	1,773	986	1,265	2,155	3,014	2,722	2,623
Long-term debt	0	0	0	2,865	3,117	3,220	3,000	2,800
Other non-current liabilities	0	0	0	2	0	0	0	0
Total liabilities	2,437	1,773	986	4,132	5,272	6,234	5,722	5,423
Share capital	130	137	142	142	142	142	142	142
Reserves/R.E./others	5,949	7,951	10,174	11,653	12,932	14,782	16,763	18,835
Shareholders' equity	6,078	8,087	10,316	11,796	13,074	14,924	16,905	18,977
Minority interests	34	35	15	16	16	16	17	17
Total equity & liabilities	8,550	9,895	11,317	15,943	18,362	21,174	22,643	24,418
EV	63,820	62,434	61,264	62,184	63,474	62,771	61,735	60,381
Net debt/(cash)	(103)	(1,489)	(2,640)	(1,715)	(426)	(1,129)	(2,166)	(3,520)
BVPS (CNY)	4.882	6.206	7.556	8.431	9.345	10.667	12.083	13.565

Key ratios (%)

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Sales (YoY)	34.6	(1.2)	12.4	10.8	13.5	23.3	16.4	11.2
EBITDA (YoY)	24.2	(3.0)	9.7	12.5	13.0	37.7	15.0	9.0
Operating profit (YoY)	26.8	(5.0)	9.1	13.2	12.1	40.3	16.2	9.2
Net profit (YoY)	34.0	(4.9)	11.3	16.7	15.5	27.8	18.8	11.2
Core EPS (fully-diluted) (YoY)	34.0	(9.1)	6.2	9.5	11.8	27.8	18.8	11.2
Gross-profit margin	28.8	28.5	28.3	29.0	30.5	32.1	31.9	31.5
EBITDA margin	26.9	26.4	25.7	26.1	26.0	29.0	28.7	28.1
Operating-profit margin	23.2	22.3	21.7	22.1	21.9	24.9	24.8	24.4
Net profit margin	18.8	18.1	17.9	18.9	19.2	19.9	20.3	20.3
ROAE	31.3	22.9	19.6	19.0	19.5	22.2	23.2	22.9
ROAA	21.3	17.6	17.0	15.4	14.2	15.7	16.8	17.4
ROCE	30.9	24.5	22.6	19.7	17.5	21.3	22.3	22.6
ROIC	30.2	25.5	24.9	22.5	19.8	24.2	26.5	27.7
Net debt to equity	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Effective tax rate	17.2	19.1	18.0	18.7	18.4	17.5	16.0	15.0
Accounts receivable (days)	44.6	55.4	50.4	49.5	52.6	50.8	50.9	52.0
Current ratio (x)	2.0	3.3	7.1	8.1	5.1	4.4	5.3	6.2
Net interest cover (x)	52.3	n.a.	n.a.	n.a.	n.a.	32.9	37.3	46.3
Net dividend payout	29.6	46.6	45.8	53.4	53.3	55.0	55.0	55.0
Free cash flow yield	1.9	1.5	1.4	1.2	0.3	3.1	4.3	5.3

Source: FactSet, Daiwa forecasts

Company profile

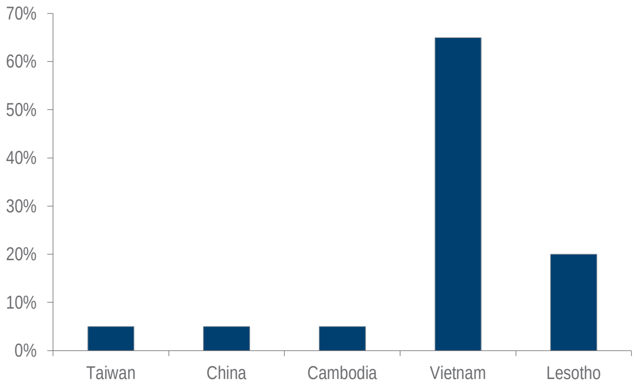
Shenzhou International Group (Shenzhou) is the largest vertically integrated player in China's garment business, and exports its products to Japan, Europe, and the United States. It is also the largest textile/garment exporter in China.

Vertically integrated: Eclat Textile

Eclat Textile (1476 TT)

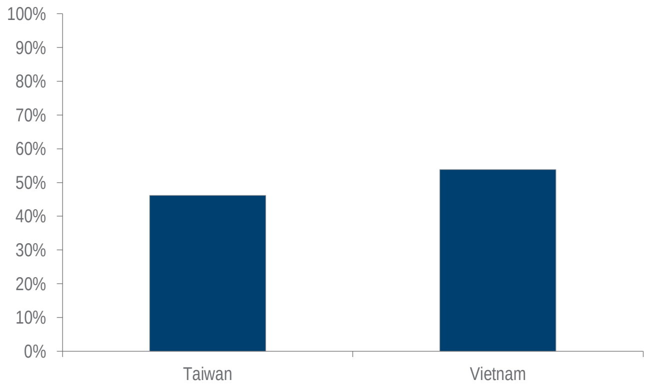
Market cap: USD3.1bn
Price (26 Sep 2016): TWD379.50
Target price: TWD418
Rating: Buy (1)

Eclat: production capacity by geography in 2015 (garment)



Source: Company, Daiwa

Eclat: production capacity by geography in 2015 (fabric)



Source: Company, Daiwa

Exposure to ASEAN production

Eclat has 15 garment production facilities globally, in Vietnam, China and Cambodia, as well as strategic outsourcing partners in South Africa, Vietnam, Cambodia, Taiwan and China. In terms of garment capacity distribution, Vietnam is the company's largest production site, accounting for 60-70% of its total capacity as at end-2015, followed by South Africa (10-20%), Cambodia, Taiwan and China. The company has over 10 years' production experience in Vietnam and targets to assign more production orders to its 4 plants there in 2016-17, eyeing potential benefits from the TPP, which would increase its bargaining power over its clients. Besides, Eclat plans to expand its Vietnam garment manufacturing capacity by 20% by 2017, and we expect the company to raise its internal-use fabric ratio (ie, fabric used for garment manufacturing vs. fabric sold to clients), which we think should boost profitability by 2017.

Impact of the TPP on the company

If the TPP goes ahead, we believe Eclat would be one of the major beneficiaries among Taiwan's textile players. The company already has more than 10 years' production experience in Vietnam, having suppliers locally (ie, yarn suppliers) and less execution risk regarding the learning curve as well as production management capability compared with new peers that have recently set up plants in Vietnam with a view to harnessing TPP benefits. Most of Eclat's clients are US based or export to the US, thus its clients would have the incentive to book Eclat's Vietnam capacity for fabrics and garments in advance. In addition, thanks to its vertically integrated model in Vietnam, we would foresee an improving gross margin trend as well as boosting of the order book in the mid to long term if the TPP comes into effect.

The company also plans to expand its internal garment capacity in Vietnam in 2017, and as such, we expect its internal-use fabric ratio to rise to 38% by end-2016, from 35% in 2015 and 32% in 2014, which should provide scope for gross-margin expansion and underpin Eclat's earnings growth prospects as well. However, the company said it will not further expand its Vietnam capacity after 2017 even the TPP is passed since Vietnam is already its largest production base (c. 50% of its total fabric capacity and 60-70% of its total garment capacity) and it would look for other cheaper labour cost areas.

If the TPP does not go ahead, Eclat would keep its garment capacity expansion plan on schedule (20% garment capacity expansion by 2017) based on its current order pipeline and visibility. The company has an advantage in terms of its fabric innovation, new product development and relatively integrated model, thus would be less affected by price competition locally. We believe Eclat will maintain its strategy of targeting the mid-high end products and sportswear segment compared to mass market products, and we see the financial impact of no TPP being limited.

Revenue and earnings outlook

We forecast Eclat's revenue to rise by 3.3% and 16.6% YoY for 2016-17E, and its net profit to decline by 3.0% YoY and rise by 26.9% YoY over the same horizon. Note that our forecasts do not include the TPP impact. We see possible upside for Eclat if the TPP kicks in given its rising bargaining power over brand clients and greater order visibility.

On the margin front, we forecast its gross margin to be on an upward trend over 2016-17E, rising from 28% in 2015, to 28.1% in 2016E, 28.5% in 2017E, and 28.7% in 2018, considering its new product launch schedule over 2016-17.

If the TPP comes into effect in 2018, we foresee a positive impact on Eclat's earnings. So far, Vietnam is the largest production base for Eclat and we forecast it will account for at least 70-80% of the company's total capacity (up from 60-70% in 2015) in 2018.

Valuation

We have a Buy (1) rating and 12-month target price of TWD418, based on the average of our 2016-17E EPS and target PER of 24x. Key risks: disappointing gross margin expansion on slower than-expected product launches or weaker ASP.

Financial summary

Key assumptions

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Garment revenue growth (YoY %)	32.7	45.8	35.4	10.6	21.4	0.0	14.2	11.3
Fabric revenue growth (YoY %)	15.5	2.6	30.7	23.6	24.3	9.0	20.4	19.6
Gross margin (%)	25.2	27.8	28.2	26.2	28.0	28.1	28.5	28.7

Profit and loss (TWDm)

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Garment revenue	6,110	8,907	12,059	13,333	16,191	16,191	18,497	20,587
Fabric revenue	4,525	4,643	6,069	7,503	9,326	10,165	12,235	14,633
Other Revenue	14	17	14	7	3	7	7	7
Total Revenue	10,649	13,566	18,142	20,843	25,521	26,364	30,739	35,228
Other income	0	0	0	0	0	0	0	0
COGS	(7,967)	(9,792)	(13,022)	(15,372)	(18,367)	(18,956)	(21,979)	(25,117)
SG&A	(1,181)	(1,484)	(1,727)	(1,857)	(2,187)	(2,188)	(2,336)	(2,677)
Other op.expenses	(53)	(57)	(102)	(107)	(128)	(137)	(138)	(141)
Operating profit	1,448	2,233	3,291	3,507	4,838	5,083	6,286	7,292
Net-interest inc./(exp.)	(27)	(24)	(17)	(25)	(26)	(21)	(20)	(19)
Assoc/forex/extraord./others	36	(13)	45	256	309	(95)	40	40
Pre-tax profit	1,457	2,197	3,319	3,738	5,121	4,967	6,306	7,313
Tax	(274)	(405)	(579)	(734)	(947)	(919)	(1,167)	(1,353)
Min. int./pref. div./others	0	(1)	(1)	(1)	0	0	0	0
Net profit (reported)	1,183	1,791	2,738	3,004	4,174	4,048	5,139	5,960
Net profit (adjusted)	1,183	1,791	2,738	3,004	4,174	4,048	5,139	5,960
EPS (reported)(TWD)	5.598	7.752	10.912	11.508	15.992	15.051	19.106	22.158
EPS (adjusted)(TWD)	5.598	7.752	10.912	11.508	15.992	15.051	19.106	22.158
EPS (adjusted fully-diluted)(TWD)	5.394	7.493	10.575	11.166	15.517	15.051	19.106	22.158
DPS (TWD)	3.000	5.324	7.000	8.000	10.500	10.535	13.374	15.511
EBIT	1,448	2,233	3,291	3,507	4,838	5,083	6,286	7,292
EBITDA	1,757	2,572	3,709	4,059	5,594	5,848	7,113	8,235

Cash flow (TWDm)

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Profit before tax	1,457	2,197	3,319	3,738	5,121	4,967	6,306	7,313
Depreciation and amortisation	310	338	418	552	756	765	826	942
Tax paid	(274)	(405)	(509)	(657)	(767)	(919)	(1,167)	(1,353)
Change in working capital	(311)	(462)	(744)	(489)	(564)	(590)	(751)	(772)
Other operational CF items	62	63	50	(0)	117	25	20	19
Cash flow from operations	1,243	1,732	2,534	3,144	4,663	4,248	5,235	6,150
Capex	(692)	(865)	(1,641)	(1,651)	(792)	(2,500)	(2,000)	(2,000)
Net (acquisitions)/disposals	(20)	(78)	(53)	10	11	0	0	0
Other investing CF items	(60)	(33)	0	(12)	(2)	0	0	0
Cash flow from investing	(772)	(976)	(1,693)	(1,652)	(783)	(2,500)	(2,000)	(2,000)
Change in debt	112	(100)	168	969	40	(13)	0	0
Net share issues/(repurchases)	0	1,000	0	0	0	2,560	0	0
Dividends paid	(399)	(634)	(1,230)	(1,757)	(2,088)	(2,740)	(2,834)	(3,598)
Other financing CF items	(7)	19	(24)	(13)	22	0	0	0
Cash flow from financing	(293)	285	(1,086)	(801)	(2,026)	(193)	(2,834)	(3,598)
Forex effect/others	(22)	37	(5)	(52)	(43)	0	0	0
Change in cash	157	1,078	(250)	639	1,811	1,555	402	552
Free cash flow	551	867	893	1,493	3,871	1,748	3,235	4,150

Source: FactSet, Daiwa forecasts

Financial summary continued …

Balance sheet (TWDm)

As at 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Cash & short-term investment	384	1,462	1,212	1,850	3,661	5,216	5,617	6,169
Inventory	1,919	2,461	3,233	3,099	3,563	3,822	4,431	5,064
Accounts receivable	1,221	1,741	2,295	2,788	3,109	3,527	4,112	4,713
Other current assets	203	249	239	328	339	0	0	0
Total current assets	3,727	5,913	6,979	8,065	10,672	12,565	14,161	15,946
Fixed assets	3,262	3,915	4,985	6,563	6,591	9,595	10,768	11,827
Goodwill & intangibles	115	134	24	23	22	22	22	22
Other non-current assets	214	115	558	274	397	383	383	383
Total assets	7,318	10,077	12,546	14,925	17,682	22,565	25,335	28,179
Short-term debt	1,174	1,116	1,330	2,229	2,227	2,229	2,229	2,229
Accounts payable	680	1,149	2,223	2,259	2,533	3,780	4,224	4,685
Other current liabilities	754	930	614	585	734	752	772	792
Total current liabilities	2,608	3,195	4,167	5,073	5,494	6,761	7,225	7,706
Long-term debt	63	24	0	74	89	74	74	74
Other non-current liabilities	181	204	262	300	325	300	300	300
Total liabilities	2,852	3,423	4,429	5,447	5,908	7,135	7,599	8,080
Share capital	2,112	2,460	2,509	2,610	2,610	2,690	2,690	2,690
Reserves/R.E./others	2,346	4,184	5,598	6,868	9,164	12,740	15,045	17,408
Shareholders' equity	4,458	6,645	8,107	9,478	11,774	15,430	17,735	20,098
Minority interests	8	9	10	0	0	0	0	0
Total equity & liabilities	7,318	10,077	12,546	14,925	17,682	22,565	25,335	28,179
EV	102,942	101,768	102,209	102,534	100,736	99,168	98,766	98,214
Net debt/(cash)	853	(322)	118	453	(1,345)	(2,913)	(3,314)	(3,867)
BVPS (TWD)	21.106	27.008	32.306	36.315	45.115	57.363	65.934	74.718

Key ratios (%)

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Sales (YoY)	24.7	27.4	33.7	14.9	22.4	3.3	16.6	14.6
EBITDA (YoY)	41.7	46.4	44.2	9.4	37.8	4.5	21.6	15.8
Operating profit (YoY)	52.4	54.3	47.3	6.6	38.0	5.1	23.7	16.0
Net profit (YoY)	54.8	51.5	52.9	9.7	39.0	(3.0)	26.9	16.0
Core EPS (fully-diluted) (YoY)	46.4	38.9	41.1	5.6	39.0	(3.0)	26.9	16.0
Gross-profit margin	25.2	27.8	28.2	26.2	28.0	28.1	28.5	28.7
EBITDA margin	16.5	19.0	20.4	19.5	21.9	22.2	23.1	23.4
Operating-profit margin	13.6	16.5	18.1	16.8	19.0	19.3	20.5	20.7
Net profit margin	11.1	13.2	15.1	14.4	16.4	15.4	16.7	16.9
ROAE	29.2	32.3	37.1	34.2	39.3	29.8	31.0	31.5
ROAA	17.6	20.6	24.2	21.9	25.6	20.1	21.5	22.3
ROCE	27.6	33.1	38.2	33.0	37.4	31.9	33.3	34.4
ROIC	23.9	31.3	37.3	31.0	38.7	36.1	38.0	38.8
Net debt to equity	19.1	n.a.	1.5	4.8	n.a.	n.a.	n.a.	n.a.
Effective tax rate	18.8	18.4	17.5	19.6	18.5	18.5	18.5	18.5
Accounts receivable (days)	39.5	39.8	40.6	44.5	42.2	45.9	45.4	45.7
Current ratio (x)	1.4	1.9	1.7	1.6	1.9	1.9	2.0	2.1
Net interest cover (x)	54.4	93.6	191.3	140.9	185.1	245.2	310.2	387.2
Net dividend payout	53.6	68.7	64.1	69.5	65.7	70.0	70.0	70.0
Free cash flow yield	0.5	0.8	0.9	1.5	3.8	1.7	3.2	4.1

Source: FactSet, Daiwa forecasts

Company profile

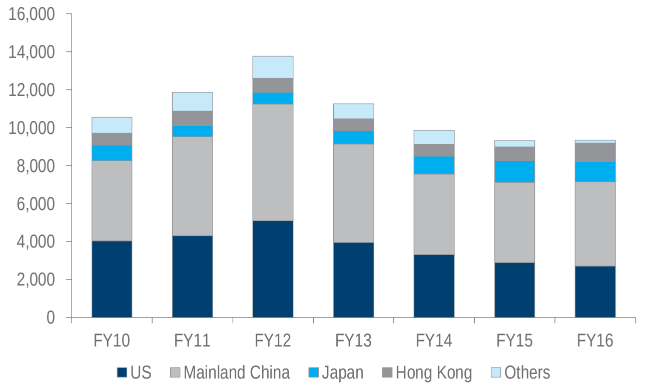
Eclat Textile (Eclat) is a technology-based Taiwanese textiles company that supplies functional and flexible knitwear fabrics, as well as sports apparel products, to a diversified client base. Its major clients include Nike, Gap (Athleta), Under Amour and Lululemon.

Vertically integrated: Texwinca

Texwinca (321 HK)

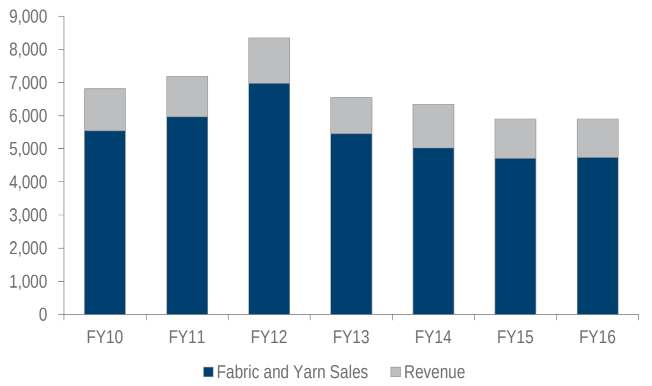
Market cap: USD0.96bn
Price (26 Sep 2016): HKD5.39
Target price: HKD5.20
Rating: Hold (3)

Texwinca: revenue by geography (HKDm)



Source: Company, Daiwa

Texwinca: manufacturing sales by type



Source: Daiwa
Note: excludes retail business sales; garment sales is 100% of associate sales

Exposure to ASEAN production

Texwinca has exposure to Vietnam only via an associate company, Megawell Industrial Limited, in which the company acquired a 50% stake for HKD150m in FY98. Megawell is a garment maker with factories in China and Vietnam. The company already had an established Vietnam facility when Texwinca acquired its 50% stake, and in this sense, Texwinca can be viewed as one of the first China textile companies with operations in Vietnam. However, we note that the company's business has been volatile over the past decade, and its top-line growth has been mild (revenue for the associate was HKD0.98bn in FY06 [ending 31 March] and HKD1.2bn in FY16).

Texwinca's main manufacturing business is largely dyed fabric production. Along with a minor dyed yarn business, a garment business via its 50% stake in Megawell and an extensive retail business, the company has a partial vertically integrated process. However, except for the garment factories owned by Megawell, all of Texwinca's other businesses are based in China.

Among our China textiles coverage, Texwinca is the only company that does not yet have confirmed expansion plans in Vietnam. However, we note that during the latest FY16 analyst briefing in June 2016, management did mention that it is officially carrying out due diligence and feasibility studies on expanding its presence in Vietnam. The company's stance on Vietnam remains cautious, and management said it will not be making any major investments, if it does choose to expand. In our opinion, this approach is over-conservative and has been one of the main reasons Texwinca's share price has underperformed its peers over the past 5 years.

Impact of the TPP on the company

Given Texwinca's minimal exposure to Vietnam, and the company's consistently slow and conservative stance, we believe the passing of the TPP would be incrementally negative for Texwinca. The passing of the TPP would likely accelerate Texwinca's plan for Vietnam expansion, but it would take at least 2 years for Texwinca to build a factory and commence production. While Megawell's Vietnam arm could benefit from the TPP, the scale would be too small to be material for Texwinca's group revenue, and it would also face the problem of sourcing Vietnam-made yarn and fabric. Furthermore, because Texwinca's customer base (for its manufacturing business) largely comprises US customers (around 70%), the passing of the TPP would further incentivise them to switch to a supplier with Vietnam production, in order to benefit from tariff benefits.

For Texwinca, we believe the better scenario would be the TPP falling through. Although a failed TPP would mean the status quo, it would keep the company's China production relatively competitive, in our view.

Revenue and earnings outlook

Texwinca's total revenue has slid continuously since it peaked in FY12, brought about by a combination of an aggressive restructuring of its retail business, and a relatively weak customer mix for its textiles business. Given that its retail business still makes up half of the group's total revenue, it should continue to play a key role in the group's top-line outlook. We believe most of the heavy lifting of its retail restructuring is complete, and the company already saw its revenue stabilise in FY16 (flat YoY). Going forward, we expect sales growth to remain positive, albeit at a low-single-digit percentage rate, driven by improving average sales per store (the company enlarged many of its stores and refreshed its brand image), while we would see upside to our forecasts if the company adds new incremental stores (we currently expect a continued gradual consolidation of stores).

We expect the company's top-line growth for FY17-19 to be primarily driven by its textiles business. As its customers are mainly US mass-market brands, the company has suffered alongside its customers, where the general demand for low-end mass-market private-label apparel has been weak since early 2016. We left our recent meeting with management with the view that the weakness has persisted, and hence we reduce our FY17-19E sales forecasts by 3-5%, after lowering our textile ASP and operating-margin assumptions. However, given the low base, we expect volume to pick up slowly from FY18E (3-5% growth per year). Our adjusted diluted EPS forecasts for FY17-19 are reduced by 11-14%.

Our estimates do not take into account the company's likely expansion into Vietnam, which would offer upside to our estimates. We note that Texwinca has plenty of cash and equivalents to fund any potential expansion into Vietnam internally (HKD2.8bn in net cash as of FY16).

As Texwinca recognised HKD665m in combined gains from disposal of trademarks and a subsidiary in FY16, the lack of these items in FY17 may cause headline net profit to see a 30% YoY decline. Excluding the impact of this, we look for core earnings to bounce off a low base in FY17 (up 7% YoY) on: 1) a continued improvement in the EBIT margin of its textiles business, backed by higher ASP prices from rising cotton prices, and 2) break-even for its retail business. We forecast a 10% adjusted net profit CAGR from FY16-19E.

Valuation

We lower our 12-month TP to HKD5.20 (from HKD6.20), derived by applying an 11x PER (about a 25% discount to its regional peers) to our revised FY17E EPS. The reduction in our target multiple reflects Texwinca's minimal ASEAN production exposure, as well as its lack of an expansion plan in Vietnam. We maintain our Hold (3) rating. The main downside risk to our call would be continued weakness in its textile business; the main upside risk would be a sudden rebound in its textiles sales volume.

Daiwa Capital Markets

Financial summary

Key assumptions

Year to 31 Mar	2012	2013	2014	2015	2016	2017E	2018E	2019E
Textile revenue growth YoY (%)	16.8	(21.7)	(7.9)	(6.1)	0.5	(2.9)	2.0	8.2
Number of retail outlets	3,827	3,658	3,085	2,924	2,743	2,713	2,703	2,693
Sales per retail outlet (HKDm)	1.8	1.5	1.4	1.5	1.6	1.7	1.7	1.8
EBIT margin - textile (%)	9.9	10.0	13.4	13.2	14.0	13.0	13.3	14.0
EBIT margin - retail (%)	2.3	(2.5)	(5.1)	0.3	(2.0)	0.0	0.2	1.0

Profit and loss (HKDm)

Year to 31 Mar	2012	2013	2014	2015	2016	2017E	2018E	2019E
Production, dyeing and sale of knitted fabric and yarn Revenues	6,976	5,460	5,026	4,718	4,741	4,602	4,692	5,075
Apparel retailing Revenues	6,766	5,768	4,816	4,591	4,592	4,584	4,704	4,843
Other Revenue	23	22	17	13	11	20	20	20
Total Revenue	13,766	11,251	9,860	9,322	9,343	9,206	9,417	9,938
Other income	161	304	144	101	80	51	51	51
COGS	(9,692)	(7,778)	(6,578)	(6,145)	(6,171)	(6,075)	(6,140)	(6,390)
SG&A	(3,300)	(3,239)	(2,938)	(2,602)	(2,673)	(2,574)	(2,684)	(2,830)
Other op.expenses	(15)	(2)	0	(14)	(13)	0	0	0
Operating profit	921	537	488	663	567	608	644	769
Net-interest inc./(exp.)	144	160	138	162	78	80	89	93
Assoc/forex/extraord./others	64	44	81	34	700	34	36	39
Pre-tax profit	1,128	740	707	858	1,345	722	768	900
Tax	(169)	(59)	(118)	(86)	(87)	(87)	(92)	(108)
Min. int./pref. div./others	(28)	53	79	1	(206)	(51)	(1)	(7)
Net profit (reported)	930	734	668	773	1,051	584	674	785
Net profit (adjusted)	930	734	649	773	592	635	674	785
EPS (reported)(HKD)	0.683	0.539	0.489	0.560	0.760	0.423	0.488	0.568
EPS (adjusted)(HKD)	0.683	0.539	0.475	0.560	0.428	0.460	0.488	0.568
EPS (adjusted fully-diluted)(HKD)	0.677	0.537	0.473	0.560	0.428	0.460	0.488	0.568
DPS (HKD)	0.500	0.400	0.483	0.560	0.620	0.425	0.390	0.455
EBIT	921	537	488	663	567	608	644	769
EBITDA	1,266	908	826	944	933	987	1,033	1,169

Cash flow (HKDm)

Year to 31 Mar	2012	2013	2014	2015	2016	2017E	2018E	2019E
Profit before tax	1,128	740	707	858	1,345	722	768	900
Depreciation and amortisation	345	371	339	281	366	379	390	400
Tax paid	(186)	(122)	(199)	(114)	(87)	(87)	(92)	(108)
Change in working capital	(34)	438	344	79	(264)	22	(32)	(88)
Other operational CF items	(304)	(459)	(225)	(239)	(778)	(114)	(124)	(131)
Cash flow from operations	948	967	965	865	582	922	909	973
Capex	(262)	(105)	(116)	(99)	(207)	(200)	(170)	(170)
Net (acquisitions)/disposals	22	112	145	260	23	0	0	0
Other investing CF items	(351)	(609)	1,238	(148)	23	(71)	(70)	(67)
Cash flow from investing	(591)	(602)	1,267	13	(161)	(271)	(240)	(237)
Change in debt	18	(97)	(1,639)	38	(1,064)	0	0	0
Net share issues/(repurchases)	3	47	69	(24)	0	0	0	0
Dividends paid	(762)	(504)	(684)	(705)	(801)	(456)	(568)	(575)
Other financing CF items	144	160	0	0	78	80	89	93
Cash flow from financing	(598)	(395)	(2,255)	(691)	(1,787)	(376)	(479)	(482)
Forex effect/others	68	49	(1)	(1)	0	0	0	0
Change in cash	(172)	19	(24)	186	(1,367)	275	190	254
Free cash flow	686	862	849	765	374	722	739	803

Source: FactSet, Daiwa forecasts

Financial summary continued …

Balance sheet (HKDm)

As at 31 Mar	2012	2013	2014	2015	2016	2017E	2018E	2019E
Cash & short-term investment	4,536	5,188	4,101	4,388	3,168	3,693	3,983	4,336
Inventory	2,713	1,992	1,898	1,867	2,047	2,015	2,037	2,120
Accounts receivable	1,087	935	890	917	698	687	703	742
Other current assets	2,388	1,582	447	518	725	797	877	965
Total current assets	10,724	9,696	7,336	7,690	6,637	7,193	7,600	8,163
Fixed assets	2,262	2,053	1,844	1,663	1,500	1,360	1,141	911
Goodwill & intangibles	33	33	33	33	33	33	33	33
Other non-current assets	417	530	513	613	1,154	1,120	1,125	1,131
Total assets	13,436	12,313	9,727	9,999	9,325	9,706	9,899	10,238
Short-term debt	3,193	3,283	1,502	1,748	530	530	530	530
Accounts payable	1,427	854	964	1,057	978	963	973	1,012
Other current liabilities	2,405	1,660	572	565	777	845	920	1,002
Total current liabilities	7,025	5,797	3,039	3,370	2,285	2,337	2,422	2,544
Long-term debt	413	225	367	158	313	313	313	313
Other non-current liabilities	112	121	134	151	166	166	166	166
Total liabilities	7,550	6,143	3,540	3,679	2,764	2,817	2,902	3,023
Share capital	68	68	69	69	69	70	70	70
Reserves/R.E./others	5,495	5,794	5,887	6,017	6,063	6,341	6,447	6,657
Shareholders' equity	5,563	5,862	5,956	6,086	6,132	6,411	6,517	6,727
Minority interests	323	308	231	234	429	480	481	488
Total equity & liabilities	13,436	12,313	9,727	9,999	9,325	9,707	9,900	10,239
EV	6,738	5,999	5,367	5,103	5,467	4,985	4,691	4,339
Net debt/(cash)	(930)	(1,679)	(2,232)	(2,482)	(2,325)	(2,850)	(3,140)	(3,493)
BVPS (HKD)	4.051	4.269	4.342	4.405	4.438	4.639	4.716	4.868

Key ratios (%)

Year to 31 Mar	2012	2013	2014	2015	2016	2017E	2018E	2019E
Sales (YoY)	16.1	(18.3)	(12.4)	(5.4)	0.2	(1.5)	2.3	5.5
EBITDA (YoY)	(24.3)	(28.3)	(8.9)	14.2	(1.2)	5.8	4.7	13.1
Operating profit (YoY)	(32.0)	(41.7)	(9.1)	35.9	(14.5)	7.3	5.8	19.5
Net profit (YoY)	(17.9)	(21.1)	(11.6)	19.1	(23.5)	7.3	6.2	16.4
Core EPS (fully-diluted) (YoY)	(18.8)	(20.8)	(11.8)	18.3	(23.5)	7.3	6.2	16.4
Gross-profit margin	29.6	30.9	33.3	34.1	34.0	34.0	34.8	35.7
EBITDA margin	9.2	8.1	8.4	10.1	10.0	10.7	11.0	11.8
Operating-profit margin	6.7	4.8	4.9	7.1	6.1	6.6	6.8	7.7
Net profit margin	6.8	6.5	6.6	8.3	6.3	6.9	7.2	7.9
ROAE	17.2	12.9	11.0	12.8	9.7	10.1	10.4	11.9
ROAA	7.2	5.7	5.9	7.8	6.1	6.7	6.9	7.8
ROCE	9.9	5.6	5.5	8.1	7.3	8.0	8.3	9.7
ROIC	16.0	10.5	9.6	15.3	13.1	12.9	14.3	17.9
Net debt to equity	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Effective tax rate	15.0	8.0	16.6	10.0	6.5	12.1	12.0	12.0
Accounts receivable (days)	26.9	32.8	33.8	35.4	31.5	27.5	26.9	26.5
Current ratio (x)	1.5	1.7	2.4	2.3	2.9	3.1	3.1	3.2
Net interest cover (x)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Net dividend payout	73.2	74.3	98.9	100.1	81.5	100.5	80.0	80.0
Free cash flow yield	9.2	11.6	11.4	10.3	5.0	9.7	9.9	10.8

Source: FactSet, Daiwa forecasts

Company profile

Texwinca's core businesses are textile manufacturing and apparel retailing. The US is the major market for the textile business, accounting for about 60% of that operation's turnover.

Daiwa
Capital Markets

Daiwa Capital Markets

Daiwa's Asia Pacific Research Directory

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