

# Hengan (1044.HK)

## Positive view on Ameba reform; expansion to beauty-care and upstream pulp businesses

China | Consumer | Company report

11 July 2018

### Investment Summary

- Regarding the recent trade disputes between China and USA, we expect that the Chinese government will pay more attention to the contribution of domestic demand to overall economic growth. With the increase in per capita income, it will help to boost the fast-moving consumer goods market growth, including the necessities market. As the market leader in paper towels and sanitary napkins industries in China, Hengan is expected to benefit from the trend.
- Facing intensified market competition and rising cost of raw materials (i.e. wood pulp), Hengan responded by launching new high-margin products, and implementing the “small sales team” operation model (also known as “Hengan’s Amoeba model”) in late April last year. The improvements of the financial figures like top line and expenses savings have been showed in the second half of last year. The improvements are expected to reflect in the whole year of 2018, to offset part of the impact from rising pulp cost on gross profit margin.
- Through the Amoeba model, the management team can also better understand the market situation, and observes that in addition to sanitary napkins and diapers products, there will be demands for other products. The management team has already repositioned the sanitary napkin business as premium personal hygiene business, and plans to launch new product categories such as cotton pads within this year. It also plans to strengthen the competitiveness of the e-commerce platform. We expect that these measures will help the growth of top line and controlling of expenses.
- Hengan has just announced the acquisition of the Finnpulp Oy, marking the expansion of its business to upstream pulp industry. The market has different views towards this action. We believe that the acquisition of upstream business will help Hengan to strengthen the mid- to long-term cost advantage and reduce the impact of pulp price volatility to gross profit margin. With an estimated total northern bleached softwood sulphate kraft pulp(NBSKP) production of 1.2 million tons, and eventually maximum holding of 49% of the share capital of Finnpulp, Hengan is expected to have approximately 600,000 tons of guaranteed supply from Finnpulp by 2021, which can fully fulfill previous yearly demand of 300,000 tons.
- In the past three years, Hengan’s dividend payout ratio was over 60%. The management team intends to maintain the dividend policy. We give Accumulate rating, a forecast price-earnings ratio of 21.1, and thus a target price of HKD80.5. (Closing price as at 9 July 2018)

### Accumulate

CMP HKD75.05

(Closing price as at 9 July 2018)

TARGET HKD 80.50 (+7.26%)

#### COMPANY DATA

O/S SHARES (MN) :	1206
MARKET CAP (HKDMN) :	90530
52 – WK LO/HI (HKD):	58.25/88.7

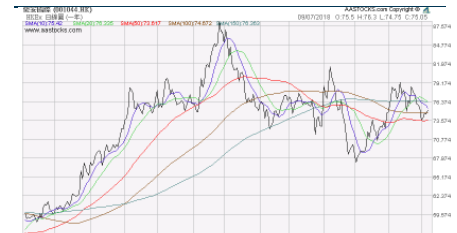
#### SHARE HOLDING PATTERN , %

Director Hui Lin Chit	20.09
Director Szeman Bok	19.43

#### PRICE PERFORMANCE , %

	1M	3M	1Y
Hengan	-3.04	-5.06	26.77
HSI	-7.65	-5.1	12.5

#### PRICE VS. HSI



Source: Phillip Securities (HK) Research

#### KEY FINANCIALS

RMB mn	FY16	FY17	FY18E	FY19E
<b>Net Sales</b>	19,277	19,825	21,808	22,898
<b>Net Profit</b>	3,597	3,794	3,915	4,196
<b>EPS, RMB</b>	2.97	3.15	3.25	3.48
<b>PER, x</b>	21.55	20.30	19.70	18.38
<b>BVPS, RMB</b>	12.18	13.56	14.66	15.85
<b>P/BV, x</b>	5.25	4.71	4.36	4.03
<b>ROE, %</b>	25.48	23.26	22.18	21.99

Source: Company reports, Phillip Securities Est.

Research Analyst

**Tracy Ku**

+852 2277 6516

tracyku@phillip.com.hk

## Business Overview

Established in 1985, Hengan is one of China's earliest manufacturers of sanitary napkin products. After years of development, Hengan's business can be roughly divided into four parts. The top three are personal hygiene products, including tissue paper, sanitary napkins and disposable diapers, which account for 47.4%, 35.2% and 10.1% respectively of the total revenue for 2017.

According to the management team, in terms of market share in mainland China in 2017, paper towels business accounted for around 20% , whereas sanitary napkins accounted for 27% to 28%. Hengan is the market leader for both industries. The market share of disposable diapers business accounted for single digit, which is mainly due to the dispersed market nature including foreign brands, but it is still the top leader among its mainland peers.

On March 13 2014, Hengan group and IBM signed a project contract to start "Third-wave" reform, which aimed at establishing Hengan's big data industry pattern.

In recent years, Hengan's revenue growths were only single digits. Last year's growth was only 2.8%. The management team has given this year's guidance as double-digit growth. The main driving factor is that the growth of paper towel business is accelerating. Considering the growth trend from the beginning of 2018, it has confidence to achieve the target.

The tissue paper business only increased by 3.6% last year, but it increased by more than 7% in the second half of the year, reflecting the results of amoeba reform, and the improvement of the overall sales channel.

We expect that the benefits from Amoeba model will be fully reflected in 2018, and the small team compliance rate is expected to increase from approximately 20% in 2017 to over 50% for this year. The benefits will be reflected as a result of accelerating growth of top line and reduction of operation expenses. Last year, less than 20% of Amoeba's units reached the sales target and this year we expect the ratio will increase to more than 50%.

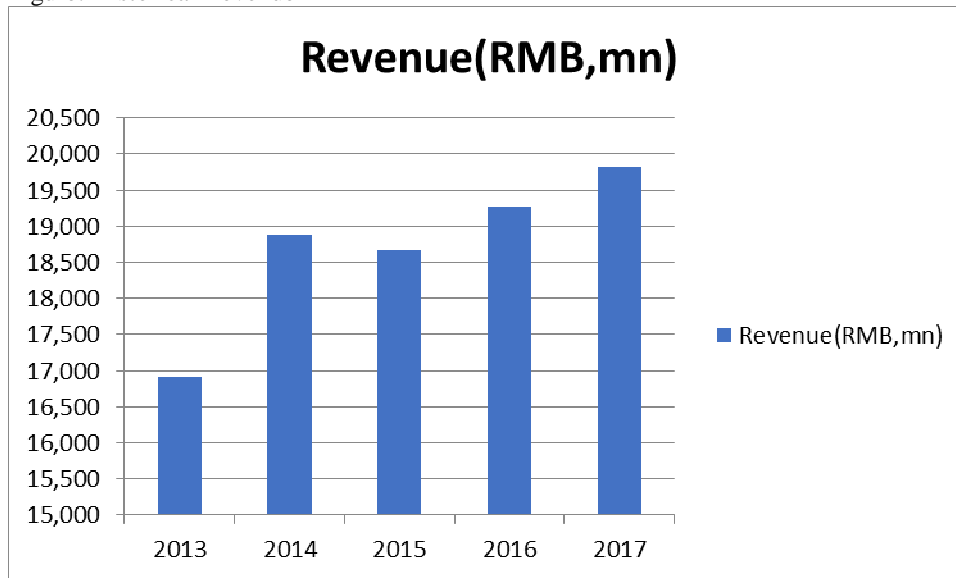
Besides, taking into account of the absorption of the releasing demand from industry consolidation, and the improvement of e-commerce channel, we believe that the double-digit growth target can be achieved. Tissue paper business will grow the fastest compared to other two main businesses.

We also expect that the main driver will be the sales volume growth. The overall selling price is expected to remain stable due to the launching of high-margin products. However, we also consider the intense competition in the industry, we expect that there will only be a low double-digit growth.

In terms of operating profit, there will still be new product promotion and branding investment this year. Therefore, it is believed that there is an opportunity to offset the improvement in the expense ratio brought by Amoeba reform. But if revenue can achieve double-digit growth, we believe that overall operation cost can be brought into control.

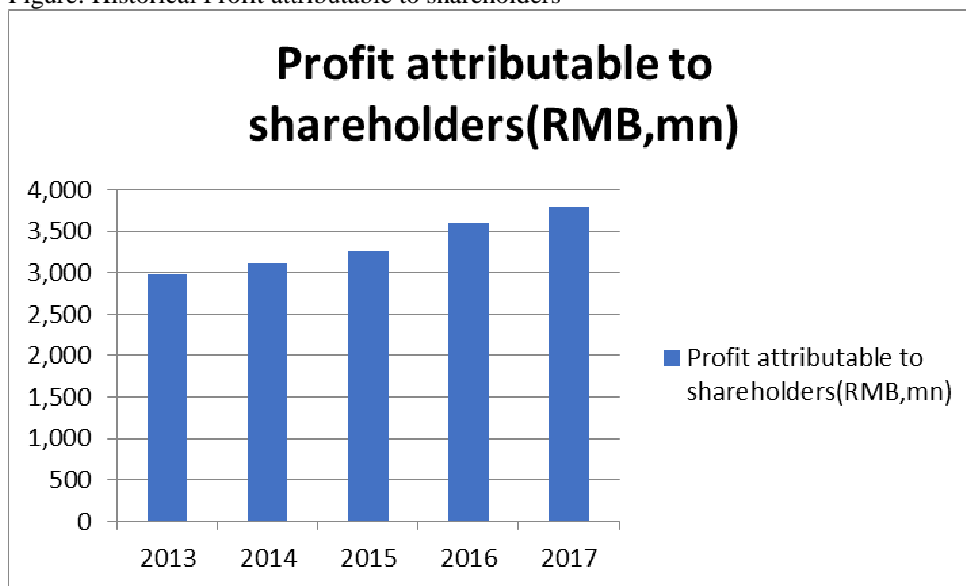
year	Company History
1985	Hengan Industrial Company Limited was established in 1985, as one of the pioneer enterprises produce sanitary napkin in China, with "Anle" sanitary napkins as its main product. In the end of 1980s, "Anle" sanitary napkin maintained the leading position of sanitary napkin market, which took 40% sanitary napkin market shares in China.
1991	Manufacturing facilities were built in strategic location throughout the nation, while our first branch company was established in Chongqing. By 2012, Hengan had built over 40 branch companies in 14 provinces/municipalities with total assets in excess RMB20 billion.
1993	"Anerle" brand sanitary with flaps launched as the upgraded sanitary napkin.
1996	Hengan started to operate "Anerle" brand baby diapers business.
1997	Tapped the household tissue paper industry by setting up Hengan Paper in Changde, Hunan.
1998	Hengan International Group listed on the Stock Exchange of HongKong.
2002	Thomas group of United States, one of the world famous management consulting companies, was engaged to help implementing full-scale management reforms at Hengan known as "Operation TCT", with the aim of fostering a top-tier PRC manufacturer of daily products and laying solid foundations for development in future century.
2004	Acquisition of Hong Kong Pharmicare Company Limited by Hengan Holdings.
2008	Hengan acquired Fujian Qinqin Foodstuffs company Limited; Booz consulting, another world famous management consulting companies, stationed Hengan group to drive our "Second-wave" reform which focused on target management.
2009	Full-scale implementation of the Performance Excellence System . Sales exceeding the benchmark of RMB10 billion.
2010	Implemented plants for the construction of Hengan Paper`s manufacturing bases in Chongqing and Wuhu of Anhui, aiming to increase the aggregate production capacity of its 5 principal bases of raw paper production to 0.9 million tons by 2012. Launched the infant and child products under the brandname of "Junichi" in joint venture with Junichi of Japan.
2011	Admission of Hengan International as a Hang Seng Index constituent stock on June 7th, 2011.
2013	In 2013, Hengan group`s sales proceeds reached 21.186 billion Hong Kong dollars, and taxed 1.2 billion yuan.
2014	On March 13, Hengan group and IBM signed a project contract to start "Third-wave" reform, which aimed at establishing Hengan`s big data industry pattern.

Figure: Historical Revenue



Source: Company, Phillip Securities

Figure: Historical Profit attributable to shareholders



Source: Company, Phillip Securities

**The price of raw wood pulp continues to be high, acquisition of upstream business help to combat**

Due to the the increase in wood pulp prices, the gross profit margin of tissue paper business dropped by 5 percentage points to 32.9% in last year. This also dragged the overall gross profit margin down 1.9 percentage points to 46.9%. We estimate that wood pulp prices will continue to rise this year. This will add pressure to the overall gross profit margin. The improvement bought from the launching of high GP-margin products may be fully offset. So we expect the GPM will drop a little bit compared to last year.

Hengan issued an announcement on April 23, announcing the acquisition of Fennpulp Oy. The initial investment consideration is 11,666,666 euros (equivalent to approximately RMB 90,461,700), which accounted for 36.46% of the enlarged

issued share capital. Hengan has the right to eventually increase the shareholding to 40 to 49% in 2019-2021.

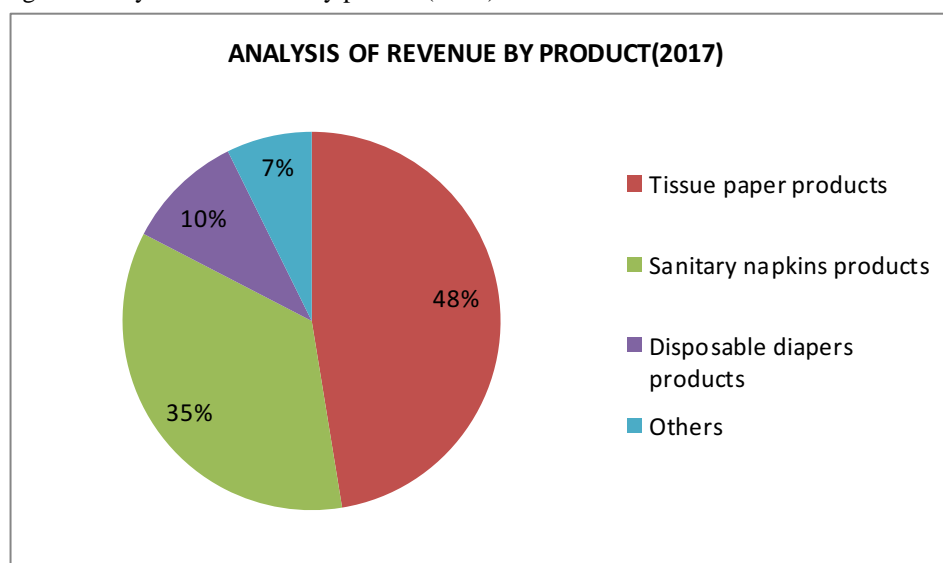
Finnpulp is currently engaged in planning and aiming to build a large-scale bioproduct mill in Kuopio, Finland. The target of the planned pulp mill is to produce approximately 1.2 million tons of NBSKP and other biological products each year. The project is expected to start this year and be completed in 2021.

We believe that the acquisition can provide Hengan with a stable supply of pulp at a stable cost. If Hengan eventually increase the shareholding to 49%, we expect to supply about 600,000 tons of wood pulp to Hengan by 2021.

According to the information given by the management team, Hengan`s historical demand for NBSKP is only 300,000 tons per year, future demand is expected to increase further. It also stated that the next step will be to take the role as a sales agent for Finnulp`s NBSKP production in Asia.

In addition to pulp products, Finnpulp will also have 10% to 20% biological products, which can replace coal mines as raw materials for power generation. Therefore, in terms of overall profit and operating efficiency, Finnpulp is believed to perform better than its ordinary peers. If we refer to the performance of its peer Mesta, the operating profit for 2017 and 2016 remained above 16%.

Figure: Analysis of Revenue by product(2017)



Source: Company, Phillip Securities

**Sanitary napkins repositioned as feminist personal care business, launching cotton pads and facial care mask products**

The high-GPM sanitary napkin business is the best performer among Hengan major business segments in recent years. Its revenue increased by 6.1% last year. It also eased the pressure of rising costs through product mix upgrading. The GPM was reminded flat at 72.2% y.o.y. We expect that this year`s sanitary napkin business revenue will maintain a steady growth, and GPM is expected to be maintained through the launching of high-GPM products.

The penetration rate of sanitary napkins in China market is already at a relatively high level. If Hengan`s business is limited to sanitary napkins in the future, it will be difficult to achieve higher growth. Therefore, Hengan has repositioned this business as a feminist personal care business.

From the perspective point of different markets in China, cities below 3rd tier are Hengan's relatively focused markets. In the future, as consumption upgrades will bring advantages, accompanying with Hengan's plan of launching of new brands and packaging. Its market share in 1st and 2nd tiers cities is expected to increase.

Hengan completed the acquisition of Wang-Zheng Berhad last year which is with developed distribution network in Southeast Asia market. According to management team, Hengan will launch cotton pad products to mainland market within this year marking the expansion of business to ladies' beauty products. It also plan to launch tampons, followed by facial care masks for the next step.

Wang-Zheng is currently the OEM supplier of cosmetic cotton pads for Watsons and Mannings in Singapore. The planned new products are aimed at female customers, which are the same as the original sanitary napkins. The related registration and study of distribution channels for cotton pads in China market are currently in progress.

### **Disposable diapers business expected to rebound this year, the proportion of special products in e-commerce platform planned to boost**

The revenue from diapers business dropped by 7% y.o.y last year. The keen market competition coupled with the increase in prices of raw materials and petrochemicals, and the unadjusted e-commerce price strategy, all helped to drive the GMP down 3.9 percentage points to 46.9%.

Since the second half of last year, Hengan has taken adjustment measures, including pricing adjustment of e-commerce products, and launching high-end and optimized products. The GMP during the period slightly improved comparing to the first half of the year.

The benefits of the strategic investment in e-commerce and maternity stores began to emerge. Diapers sales in both channels recorded significant growth. Sales from e-commerce channels reached a y.o.y growth of 70% and accounted for over 25% of the overall diapers sales in 2017.

According to the management team, the recovery trend of revenue for diapers has continued for Q1. New products with thinly design and strong water absorption are planned to launch within this year.

At present, high-end diaper market in China grow at a higher rate comparing to lower-end diapers, which implies that parents with growing purchasing power have high demand for the quality of products and low sensitivity to price. Hengan plan to continue to upgrade its products targeting high-end market but not mass market.

We expect that with the rapid growth of e-commerce platform sales, it will provide support for the overall sales of diapers in 2018. The revenue is expected to be stabilized and return to growth path.

Last year, Hengan's overall e-commerce turnover reached 2.02 billion yuan, rising by more than 80% y.o.y. Its contribution to the overall sales increased by 4 percentage points to 10%. Hengan's strategies include keep the same product prices online to be consistent with the offline ones, sometimes even more expensive; launch exclusive products for online channels.

According to the management team, the exclusive tissue paper products account for around 40 to 50% of overall tissue paper products on the ecommerce channels. The mainly difference is the packaging. For diapers, the exclusive ones account

for 30%, and sanitary napkins are about 30%. For the latter, most of the products are the same as the offline channels, but the prices are more expensive.

Hengan started strategic cooperation with the major e-commerce operators like Tmall and JD.com. It is expected to further strengthen the cooperation in product development, marketing and supply chain. The company's ultimate target is to boost the contribution of e-commerce business to the overall revenue.

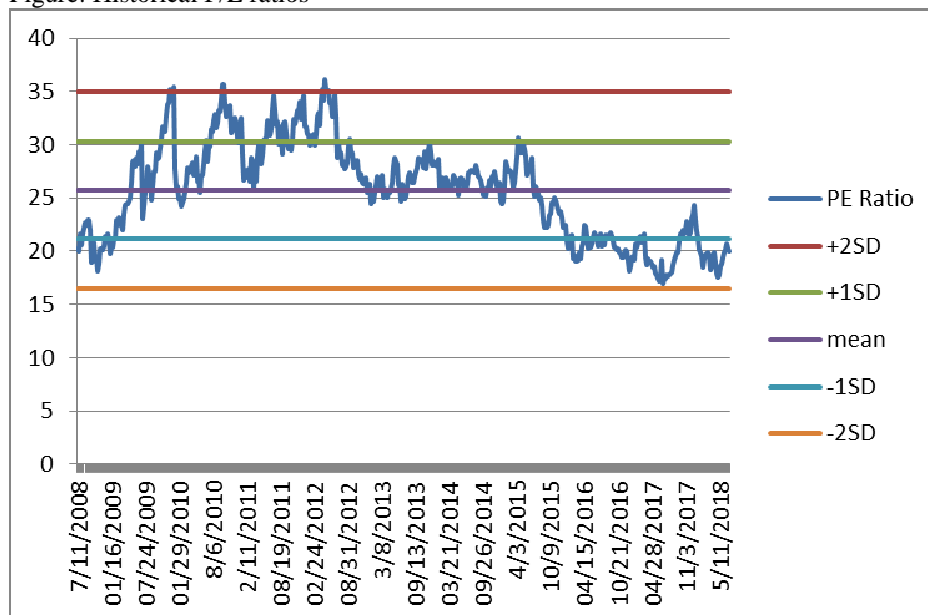
We expect the loss from e-commerce business to be narrow further and revenue will continue to grow at a high rate this year. The contribution of e-commerce business is expected to increase to about 15%.

### Investment Thesis, Valuation & Risk

**Our valuation model suggests a target price of HK\$80.5:** We expect that with the help to fast growing tissue paper business, Hengan's revenue will have a 10% increase this year. However, GPM this year is expected to decline slightly from last year due to the rising wood pulp price. But with the help of Amoeba model, the improvements are expected to reflect throughout the year. The operation expense to revenue ratio is expected to improve further.

We give Accumulate rating. Our forecast P/E is 21.1 times and the target price is HKD 80.5 . The risks that need to be watched include top-line growth rate missing from expectation, wood pulp prices fluctuating sharply, industry competition increasing significantly, and Ameba units missing sales target. (Closing price as at 9 July 2018)

Figure: Historical P/E ratios



Source: Bloomberg, Phillip Securities



## Financials

FYE	2015	2016	2017	2018E	2019E
<b>Valuation Ratios</b>					
Price to Earnings (P/E)	23.97	21.55	20.30	19.70	18.38
Price to Book (P/B)	5.18	5.25	4.71	4.36	4.03
<b>Per Share Data (RMB)</b>					
EPS	2.67	2.97	3.15	3.25	3.48
Book Value Per Share	12.35	12.18	13.56	14.66	15.85
Dividend Per Share	1.74	1.95	2.1	2.1	2.3
<b>Growth (%)</b>					
Revenue	2.6%	3.3%	2.8	10.0	5.0
Operating Income	7.0%	-3.0%	11.1	4.5	6.6
Net Profit	3.4%	10.3%	5.5	3.2	7.2
<b>Margins (%)</b>					
Gross Profit Margin	47.9	48.8	46.9	46.0	46.5
Operating Profit Margin	26.2	24.6	26.6	25.3	25.7
Net Profit Margin	17.7	19.5	19.2	18.0	18.4
<b>Key Ratios</b>					
ROE (%)	21.88	25.48	23.26	22.18	21.99
ROA (%)	10.02	11.02	9.77	9.68	9.44
<b>Income Statement (RMB,Mn)</b>					
<b>Revenue</b>	18,663	19,277	19,825	21,808	22,898
- Cost of Goods Sold	-9,723	-9,873	-10,526	-11,776	-12,250
<b>Gross Income</b>	8,940	9,404	9,299	10,031	10,648
-Operation Expenses	-4,598	-5,204	-5,183	-5,452	-5,724
<b>Operating Income</b>	4,888	4,743	5,272	5,510	5,875
<b>Pretax Income</b>	4,549	4,559	4,961	5,244	5,621
- Minority Interest	42	165	7	8	8
<b>Net Profit</b>	3,260	3,597	3,794	3,915	4,196

Source: Company, Phillip Securities (HK) Research Estimates

Exchange rate is one year HKD/CNY forward contract price on 9<sup>th</sup> July from Wind (Financial figures as at 9<sup>th</sup> July 2018)



**PHILLIP RESEARCH STOCK SELECTION SYSTEMS**

Total Return	Recommendation	Rating	Remarks
>+20%	Buy	1	>20% upside from the current price
+5% to +20%	Accumulate	2	+5% to +20% upside from the current price
-5% to +5%	Neutral	3	Trade within $\pm 5\%$ from the current price
-5% to -20%	Reduce	4	-5% to -20% downside from the current price
<-20%	Sell	5	>20% downside from the current price

We do not base our recommendations entirely on the above quantitative return bands. We consider qualitative factors like (but not limited to) a stock's risk reward profile, market sentiment, recent rate of share price appreciation, presence or absence of stock price catalysts, and speculative undertones surrounding the stock, before making our final recommendation

**GENERAL DISCLAIMER**

This publication is prepared by Phillip Securities (Hong Kong) Ltd ("Phillip Securities"). By receiving or reading this publication, you agree to be bound by the terms and limitations set out below.

This publication shall not be reproduced in whole or in part, distributed or published by you for any purpose. Phillip Securities shall not be liable for any direct or consequential loss arising from any use of material contained in this publication.

The information contained in this publication has been obtained from public sources which Phillip Securities has no reason to believe are unreliable and any analysis, forecasts, projections, expectations and opinions (collectively the "Research") contained in this publication are based on such information and are expressions of belief only. Phillip Securities has not verified this information and no representation or warranty, express or implied, is made that such information or Research is accurate, complete or verified or should be relied upon as such. Any such information or Research contained in this publication is subject to change, and Phillip Securities shall not have any responsibility to maintain the information or Research made available or to supply any corrections, updates or releases in connection therewith. In no event will Phillip Securities be liable for any special, indirect, incidental or consequential damages which may be incurred from the use of the information or Research made available, even if it has been advised of the possibility of such damages.

Any opinions, forecasts, assumptions, estimates, valuations and prices contained in this material are as of the date indicated and are subject to change at any time without prior notice.

This material is intended for general circulation only and does not take into account the specific investment objectives, financial situation or particular needs of any particular person. The products mentioned in this material may not be suitable for all investors and a person receiving or reading this material should seek advice from a financial adviser regarding the suitability of such products, taking into account the specific investment objectives, financial situation or particular needs of that person, before making a commitment to invest in any of such products.

This publication should not be relied upon as authoritative without further being subject to the recipient's own independent verification and exercise of judgment. The fact that this publication has been made available constitutes neither a recommendation to enter into a particular transaction nor a representation that any product described in this material is suitable or appropriate for the recipient. Recipients should be aware that many of the products which may be described in this publication involve significant risks and may not be suitable for all investors, and that any decision to enter into transactions involving such products should not be made unless all such risks are understood and an independent determination has been made that such transactions would be appropriate. Any discussion of the risks contained herein with respect to any product should not be considered to be a disclosure of all risks or a complete discussion of such risks.

Nothing in this report shall be construed to be an offer or solicitation for the purchase or sale of a security. Any decision to purchase securities mentioned in this research should take into account existing public information, including any registered prospectus in respect of such security.

**Disclosure of Interest**

Analyst Disclosure: Neither the analyst(s) preparing this report nor his associate has any financial interest in or serves as an officer of the listed corporation covered in this report.

Firm's Disclosure: Phillip Securities does not have any investment banking relationship with the listed corporation covered in this report nor any financial interest of 1% or more of the market capitalization in the listed corporation. In addition, no executive staff of Phillip Securities serves as an officer of the listed corporation.

**Availability**

The information, tools and material presented herein are not directed, intended for distribution to or use by, any person or entity in any jurisdiction or country where such distribution, publication, availability or use would be contrary to the applicable law or regulation or which would subject Phillip Securities to any registration or licensing or other requirement, or penalty for contravention of such requirements within such jurisdiction.

Information contained herein is based on sources that Phillip Securities (Hong Kong) Limited ("PSHK") believed to be accurate. PSHK does not bear responsibility for any loss occasioned by reliance placed upon the contents hereof. PSHK (or its affiliates or employees) may have positions in relevant investment products. For details of different product's risks, please visit the Risk Disclosures Statement on <http://www.phillip.com.hk>.

© 2018 Phillip Securities (Hong Kong) Limited

**Contact Information (Regional Member Companies)**

**SINGAPORE**

**Phillip Securities Pte Ltd**  
Raffles City Tower  
250, North Bridge Road #06-00  
Singapore 179101  
Tel : (65) 6533 6001  
Fax : (65) 6535 6631  
Website: [www.poems.com.sg](http://www.poems.com.sg)

**HONG KONG**

**Phillip Securities (HK) Ltd**  
Exchange Participant of the Stock Exchange of Hong Kong  
11/F United Centre 95 Queensway  
Hong Kong  
Tel (852) 22776600  
Fax (852) 28685307  
Websites: [www.phillip.com.hk](http://www.phillip.com.hk)

**INDONESIA**

**PT Phillip Securities Indonesia**  
ANZ Tower Level 23B,  
Jl Jend Sudirman Kav 33A  
Jakarta 10220 – Indonesia  
Tel (62-21) 57900800  
Fax (62-21) 57900809  
Website: [www.phillip.co.id](http://www.phillip.co.id)

**THAILAND**

**Phillip Securities (Thailand) Public Co. Ltd**  
15th Floor, Vorawat Building,  
849 Silom Road, Silom, Bangrak,  
Bangkok 10500 Thailand  
Tel (66-2) 6351700 / 22680999  
Fax (66-2) 22680921  
Website: [www.phillip.co.th](http://www.phillip.co.th)

**UNITED KINGDOM**

**King & Shaxson Capital Limited**  
6th Floor, Candlewick House,  
120 Cannon Street,  
London, EC4N 6AS  
Tel (44-20) 7426 5950  
Fax (44-20) 7626 1757  
Website: [www.kingandshaxson.com](http://www.kingandshaxson.com)

**AUSTRALIA**

**PhillipCapital Australia**  
Level 12, 15 William Street,  
Melbourne, Victoria 3000, Australia  
Tel (613) 96188238  
Fax (613) 92002272  
Website: [www.phillipcapital.com.au](http://www.phillipcapital.com.au)

**MALAYSIA**

**Phillip Capital Management Sdn Bhd**  
B-3-6 Block B Level 3 Megan Avenue II,  
No. 12, Jalan Yap Kwan Seng, 50450  
Kuala Lumpur  
Tel (603) 21628841  
Fax (603) 21665099  
Website: [www.poems.com.my](http://www.poems.com.my)

**JAPAN**

**PhillipCapital Japan K.K.**  
Nagata-cho Bldg.,  
8F, 2-4-3 Nagata-cho,  
Chiyoda-ku, Tokyo 100-0014  
Tel (81-3) 35953631  
Fax (81-3) 35953630  
Website: [www.phillip.co.jp](http://www.phillip.co.jp)

**CHINA**

**Phillip Financial Advisory (Shanghai) Co. Ltd**  
No 436 Hengfeng Road,  
Greentech Unit 604,  
Postal code 200070  
Tel (86-21) 51699400  
Fax (86-21) 63532643  
Website: [www.phillip.com.cn](http://www.phillip.com.cn)

**FRANCE**

**King & Shaxson Capital Limited**  
3rd Floor, 35 Rue de la Bienfaisance 75008  
Paris France  
Tel (33-1) 45633100  
Fax (33-1) 45636017  
Website: [www.kingandshaxson.com](http://www.kingandshaxson.com)

**UNITED STATES**

**Phillip Futures Inc**  
141 W Jackson Blvd Ste 3050  
The Chicago Board of Trade Building  
Chicago, IL 60604 USA  
Tel +1.312.356.9000  
Fax +1.312.356.9005