

# Nine Dragons Paper(2689.HK)

## Market leader position with great pricing power to effectively shifting the rising waste paper cost

China | Manufacturing | Company report

28 AUG 2018

### Investment Summary

- Regarding to the recent trade disputes between USA and China, we expect that China will intend to increase its support for domestic demand, in order to further boost its contribution to the overall economic growth and thus reduce its reliance on foreign trade. Packaging paper industry is highly related to fast moving consumer goods industry. We expect the growing trend of domestic consumer market will help to continue expand the demand for packaging paper products. Besides, fast-growing online shopping is also an important driving factor for the industry.

-In an effort to tighten control over solid waste imports, new regulations on the import of waste paper to China have been announced. In order to purchase cheaper import waste paper, companies need to obtain quotas granted by Ministry of Environmental Protection (MEP). Taking into account the lagging factors in the reaction cost of finished paper products, and the fact that large companies such as Nine Dragons can obtain lower-cost imported waste paper, we expect that the new policy will help accelerate industry consolidation and eliminate more small and medium-sized enterprises. Leading companies will have greater pricing power, which can help them to effectively shifting the cost of waste paper. Their profit margins are expected to be able to expand further.

-As the demand for packaging paper products is steady growing, new capacity or competitors continue to emerge. Nine Dragons has announced its plan for expanding 3.25 million tons of new capacity within the next two years. Luckily, these new capacity is mainly located outside the core area of the existing business and is expected to face less pressure for overcapacity.

- Due to the recent trade disputes between China and U.S., RMB exchange rate has fluctuated. As the size of debts of Nine Dragons in foreign currencies is limited, and there are quotas for imported waste paper, we expect the negative impacts of RMB depreciation to burdens of debt repayment and raw material cost are limited.

--The company has just announced positive profit alert for the year ended 30 June 2018. If the exchange losses on operating and financing activities were excluded, the profit attributable to equity holders is expected to increase not less than 60% y.o.y. The profit attributable to equity holders was RMB4765.3million if the exchange losses on operating and financing activities, and the gain from derivative financial instruments were excluded.

-FY 2017/18 annual result announcement is expected to be held in the coming September as previous years. In FY 2018/19, the restrictions on imported waste paper continued. Recently, the Ministry of Commerce announced that it will impose a 25% tariff on solid waste from the US from August 23. We expect that these factors will continue to add pressure on domestic waste paper price, and thus price of finished paper, but at the same time it will bring cost pressure to companies that have obtained import quotas such as Nine Dragons. However, it has just announced the acquisition of paper mills in the U.S. This upstream integration is expected to provide more secure material supply and offset some of cost pressure.

We expect the EPS for the two fiscal years from 2017 to 2019 to be RMB 1.63 and 1.71, respectively, and the corresponding P/E ratios are 4.88 and 4.65 times respectively. We give Buy rating, and target price of HK\$14.6, corresponding target P/E of 7.5 times. (current price as of August 24, 2018)

### BUY (Initially)

CMP HKD9.07

(Closing price at 24 August 2018)

TARGET HKD14.6 (+60.97%)

#### COMPANY DATA

O/S SHARES (MN) :	4674
MARKET CAP (HKDMN) :	43189
52 - WK LO/HI (HKD):	8.06/17.42

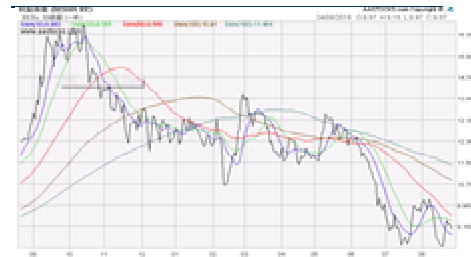
#### SHARE HOLDING PATTERN , %

Cheung Yan	66.42
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#### PRICE PERFORMANCE , %

	1 個月	3 個月	1 年
玖紙	-3.92	-27.2	-26.62
恒生指數	-3.46	-10.04	0.56

#### RETURN VS. HSI



Source: Aastocks, Phillip Securities

#### KEY FINANCIALS

RMB mn	FY16	FY17	FY18E	FY19E
<b>Net Sales</b>	32,093	39,155	54,423	59,909
<b>Net Profit</b>	1,122	4,384	7,631	8,015
<b>EPS, RMB</b>	0.24	0.94	1.63	1.71
<b>PER, x</b>	33.14	8.49	4.88	4.65
<b>BVPS, RMB</b>	5.66	6.44	7.59	8.79
<b>P/BV, x</b>	1.41	1.24	1.05	0.91
<b>ROE, %</b>	4.35	14.66	21.65	19.62

Source: Company, Wind, Phillip Securities Est.

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## Business Overview

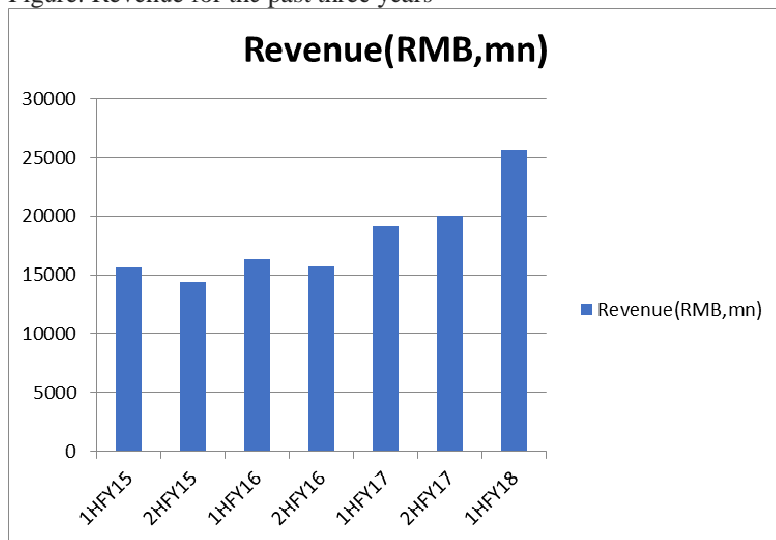
Founded in 1995, Nine Dragons is the world’s largest recoverd paper making group. It was listed on the Main Board of Hong Kong Stock Exchange on 3<sup>rd</sup> March, 2006. It is engaged in the production of linerboard, high perform corrugating medium, coated duplex board, printing and writing paper..

Its designed capacity in commercial production in packaging and recycled printing and writing paper as at 31 December 2017 was 13.7 million tpa, comprising 7.2 million tpa of linerboard, 3.4million tpa of high performance corrugating medium, 2.6 million tpa of coated duplex board and 0.5 million tpa of recycled printing and writing paper. Pm2(VN) at the Vietnam base commenced its commercial production in January 2018, adding an additional design and production capacity of 350,000 tpa for linerboard products, and lifting the design capacity in commercial production to 14.1 million tpa.

Revenue of FY2017 increased by approximately 22.0% y.o.y. Revenue of linerboard, high performance corrugating medium, coated duplex board and recycled printing and writing paper for FY2017 accounted for 49.9%, 23.1%, 20.8%.

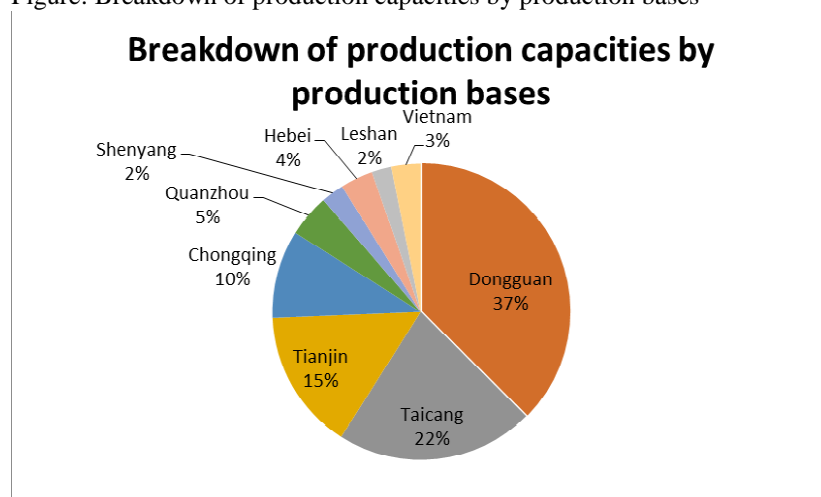
The majority of sales continued to be realised from the domestic market, which represented 95.6% of the total revenue, while the remaining revenue of 4.4% were sales denominated in foreign currencies which primarily represented sales made to foreign invested processing enterprises.

Figure: Revenue for the past three years



Source: Company, Phillip Securities

Figure: Breakdown of production capacities by production bases



Source: Company, Phillip Securities

- **Since the Lunar New Year Festival this year, the increase in prices has continued to pass on cost pressures:** After the Double-11 online shopping boom last October, the traditional peak season was below seasonality. We believed that this is mainly due to the impact of short-term waste paper price fluctuations. The market adopted a short-term wait-and-see attitude and waits for price stability or decline. In fact, after the Lunar New Year Festival this year, the market did experience an unusually strong off-season phenomenon. Paper-making companies rushed to increase prices to reflect rising paper costs.

According to the information provided by the management team, prices have been raised several times since the Spring Festival. The latest one was on May 10th. It raised kraftlinerboard 300 yuan per ton, corrugated cardboard 400 yuan, coated duplex board 200 yuan, coated linerboard 300 yuan, and 300 yuan for white top linerboard.

Although sales in 1H of FY2018 increased significantly by 34.1%, sales volume dropped by 10.7% to 6.3 million tons. One of the important factors for the increase in selling price was the fluctuations in raw material waste paper prices. Benefited from the increase in prices, the gross profit margin increased significantly by 6.2 percentage points to 24.5% during the period, and operating profit margin also rose by 3.26 percentage points to 16.76%.

- **The policy of importing waste paper is tilted towards large enterprises:** According to the management team, the targeted sales volume of FY2018 is 13 million tons, which is basically similar to the actual sales volume of 13.1 million tons for FY2017. This implies that the overall revenue of FY2018 will be mainly driven by price increases. We believe that as a leading industry player, Nine Dragons has the capacity of cost transfer, and thus its profit margin can be maintained or further expanded.

The domestic supply of waste paper in China is limited, so paper manufacturing industry were quite relied on the imported waste paper in the past. The imported ones are with cheaper price and higher quality.

However, in July last year, the mainland authority announced that they would restrict some of the solid waste imports from January 1 this year, causing large fluctuations in domestic and foreign paper prices.

The “Administrative Provisions on Environmental Protection for Waste Paper Import” was implemented by MEP in March 2018. It propose that companies

applying for importing waste paper quotas must have a production capacity of not less than 50,000 tons per year. Besides, the impurity ratio is reduced from 1.5% to 0.5%.

Recently, the Ministry of Commerce has announced the list of tariffs for U.S. imports. From 12:01 on August 23, solid wastes such as waste paper will be added 25% tariff.

According to the statistics of General Administration of Customs, the import volume of waste paper in the first half year was 7.1 million tons, a sharp drop of 52.5% y.o.y.

On August 6 this year, MEP announced the 17th batch of scrap materials import quotas. With a total quota of 588,671 tons of waste paper, Nine Dragons was the one who being granted for the largest volume. It was granted 355,963 tonnes of import quota, which accounted for 60.5% of the total quota.

According to management team, the formerly imported and domestic waste paper accounted for 60% and 40% respectively. Under the new policy, the ratio is expected to change to 40% and 60%. In the first half of FY2018, domestic waste paper accounted for approximately 57.3% of the company's total waste paper purchases.

We believe that the new policy is more friendly to large enterprises that can meet environmental protection requirements. This is reflected by the the annual productivity requirements of enterprises and the results of quota granted. We expect the new policy will help to speed up the pace of industry consolidation. Large companies like Nine Dragons are with greater pricing power, which will effectively shift the cost of waste paper.

**-New upstream acquisition help to secure best-cost material supply:** The company has just announced the acquisition of paper mills in the U.S. This upstream integration is still waiting for completion to take place. But if it is successful, it is expected to provide more secure material supply and bring efficient cost control effects to the company. The consolidation of the acquisition is a sum of USD175million, which will be satisfied through cash in hand and bank borrowing.

The mill in Rumford operates 3 paper production lines with a combined annual production of approximately 550,000tonnes. The mill has a combined annual pulping capacity of approximately 520,000 tonnes for kraft pulp, of which approximately 400,000 tonnes are for internal consumption and the rest of approximately 120,000 tonnes are for market.

The one in Biron operates 2 paper production lines, with a combined annual production of approximately 340,000tonnes.

**-Plan to expand production capacity help driving sales to maintain double-digit growth:** According to the management team, the Vietnam production base is mainly used to meet local demand. Taking into account the costs such as transportation fees and tariffs, the company has no plan to expand its export volume from Vietnam to China market. The China production base will continue to meet domestic production capacity.

Last year, Nine Dragons achieved sales volume of 13 million tons and its capacity utilization rate reached 92.86%, which is nearly full production. It has announced its plan for expanding 3.25 million tons of new capacity within the next two years. By the end of 2018, Quanzhou Phase II, Chongqing Phase III and Hebei Phase II

will be commenced production, with a total capacity increase of 1.4 million tons. By the end of June 2019, new production capacity in Shenyang, Dongguan and Quanzhou is expected to be commenced production, with an aggregate production capacity of 1.85 million tons.

We expect that the scale efficiency of the three smaller production bases in Quanzhou, Shenyang and Hebei Yongxin will be significantly improved by the time of commencement, which will further improve the profitability and cost optimization in these regional markets. The new capacity at Chongqing base can help to meet the additional market demand and further increase the scale of the production base.

Figure : Production expansion plan of Nine Dragon Paper

Production Base	Product	Design Capacity	Target Commencement Date
Quanzhou (Phase II)	Linerboard	350,000 tpa	Before end of 2018
Chongqing (Phase III)	Linerboard	550,000 tpa	Before end of 2018
Hebei (Phase II)	Linerboard	500,000 tpa	Before end of 2018
Shenyang (Phase II)	Linerboard	600,000 tpa	Before end of Jun, 2019
Dongguan	Linerboard	600,000 tpa	Before end of Jun, 2019
Quanzhou (Phase III)	Linerboard	650,000 tpa	Before end of Jun, 2019

Source: Company, Phillip Securities

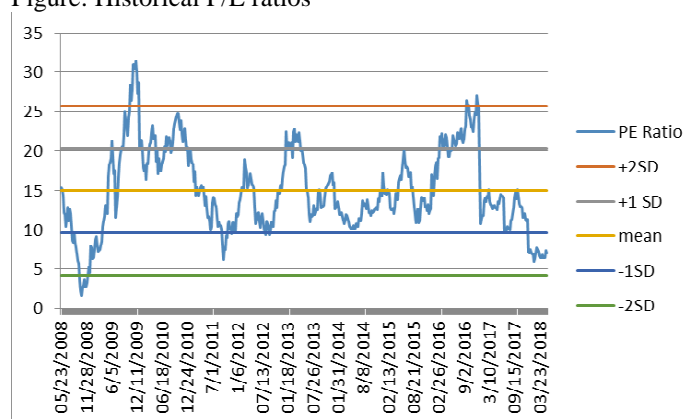
- **Entry barrier of the industry has been increased compared to the past (environmental protection requirements/financing environment), which limit new supply amount:** Given the improvement of environmental protection requirements by China government, it is difficult for the industry to acquire new land and grant approval for the construction of new plants. The existing small paper companies involuntarily reduce its production in order to meet environmental protection requirements. Nine Dragons` production plants have already met the national environmental protection requirements.

## Valuation and risk

We expect the EPS for the two fiscal years from 2017 to 2019 to be RMB 1.63 and 1.71, respectively, and the corresponding P/E ratios are 4.88 and 4.65 times respectively. We give Buy rating, and target price of HK\$14.6, corresponding target P/E of 7.5 times.

Investment risks include waste paper policy changes, domestic waste price drops dramatically, and import quota not granted. (current price as of August 24, 2018)

Figure: Historical P/E ratios



Source: Bloomberg, Phillip Securities

Figure: Peers' PE ratio comparison

	Market Price	PE Ratio
02689Nine Dragons Paper	9.07	5.47
02314Lee & Man Paper	7.40	5.71
02002China Sunshine Paper	1.62	2.91
01812ShandongChenming Paper	6.09	5.15
00731Samson Paper	0.52	3.03

Source: Bloomberg, Phillip Securities

## Financials

FYE	2015	2016	2017	2018E	2019E
<b>Valuation Ratios</b>					
Price to Earnings (P/E)	26.34	33.14	8.49	4.88	4.65
Price to Book (P/B)	1.46	1.41	1.24	1.05	0.91
<b>Per Share Data (RMB)</b>					
EPS	0.30	0.24	0.94	1.63	1.71
Book Value Per Share	5.47	5.66	6.44	7.59	8.79
Dividend Per Share	0.07	0.13	0.3	0.49	0.51
<b>Growth (%)</b>					
Revenue	4.02%	6.65%	22.01%	38.99%	10.08%
Gross Profit	-0.73%	24.28%	36.08%	56.93%	5.29%
Operating Income	-10.56%	33.66%	51.48%	62.90%	3.94%
Net Profit	-18.50%	-21.07%	283.65%	74.09%	5.03%
<b>Margins (%)</b>					
Gross Profit Margin	15.67%	18.26%	20.37%	23.00%	22.00%
Operating Profit Margin	10.77%	13.50%	16.76%	19.64%	18.54%
Net Profit Margin	4.84%	3.58%	11.26%	14.11%	13.46%
<b>Key Ratios</b>					
ROE (%)	5.71%	4.35%	14.66%	21.65%	19.62%
ROA (%)	2.24%	1.71%	6.66%	8.70%	7.88%
<b>Income Statement (RMB,Mn)</b>					
<b>Revenue</b>	30,093	32,093	39,155	54,423	59,909
- Cost of Goods Sold	-25,376	-26,231	-31,179	-41,906	-46,729
<b>Gross Income</b>	4,716	5,861	7,976	12,517	13,180
-Operation Expenses	-1,597	-1,784	-1,980	-2,395	-2,636
<b>Operating Income</b>	3,240	4,331	6,561	10,687	11,109
<b>Pretax Income</b>	1,955	1,667	5,435	9,596	10,079
- Minority Interest	45	28	26	45	48
<b>Net Profit</b>	1,412	1,122	4,384	7,631	8,015
<b>Net Profit(adjusted)</b>	1,351	2,894	4,783	7,631	8,015

Source: Company, Phillip Securities (HK) Research Estimates

Exchange rate (0.8784) is one year HKD/CNY forward contract price on 24<sup>th</sup> August from Wind  
(Financial figures as at 24<sup>th</sup> August 2018)

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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 ± 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

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