Da Nang Rubber JSC (DRC – HSX)

A Steady Growth through a Difficult Period

- **DRC has maintained steady growth through difficulties.**
- **Radial tire segment increases sharply in sales and its GPM will turn to positive from this year.**
- **Optimistic about the business outlook in the second half of 2017**

Outlook and Valuation:

Da Nang Rubber JSC (DRC – HSX) *is a leading domestic manufacturer in the tire and tube industry in Vietnam. In recent years, the company's new product - the Radial tire is still in the process of market penetration so that the result has not been as expected.*

In the short term, we think DRC is still experiencing the difficulty of the industry including the volatility of raw material prices, especially the radial tire sector with additional accelerated depreciation resulting in negative profit margins. However, considering better sales results and rubber price expected to be stable in the low price range, we believe that DRC's business performance will prosper quickly in the following quarters of 2017. Notably, based on the domestic and foreign consumption in the first six months as well as the existing orders, we estimate the output of radial tires will reach 100% of the first phase designed - capacity (equivalent to 300,000 tires), and this segment will return positive margins.

In addition, we find that DRC usually pays a high and regular annual dividend of VND2,000-3,000 per share, similar to many companies of Vietnam National Chemical Group (Vinachem). Vinachem has already planned for an IPO this year, but it is not yet known whether the Group will divest from DRC. We assess that a divestment will be unlikely in the near future. As a result, DRC cash dividend rate is likely to remain and can be lifted after the radial project has a steady return.

In line with more optimistic expectations of the company than our 2017 Strategic Report, the target price is revised to VND33,100 per share. We recommend investors should ***ACCUMULATE*** *this stock in the* ***LONG-TERM****.*

Key Financials

Y/E Dec (VND B)	FY2015	FY2016	1Q-FY17	FY2017E	FY2018F
Net Revenue	3,318	3,361	933	3,622	3,690
% change	2	1.3	18	7.8	1.9
PAT	416	395	71	336	406
% change	17.8	-5.0	-20	-15.0	20.9
PAT margin (%)	10.9	12.5	7.6	9.3	11.0
ROA (%)	13.2	13.3		10.3	12.1
ROE (%)	27.2	25.3		21.9	26.2
EPS (VND)	3,493	3,327		2,599	3,144
Book value (VND)	18,307	13,318		12,917	13,061
Cash dividend (VND)	3,000	2,800		3,000	3,000
P/E (x)	9.12	9.39		12.0	9.9
P/B (x)	1.6	2.3		2.4	2.4

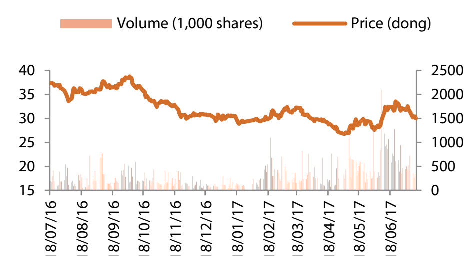
Source: DRC, RongViet Research estimated

ACCUMULATE

CMP (VND)	30,000
Target Price (VND)	33,100
Investment Period	**Long-term**

Stock Info

Sector	Automobile Parts
Market Cap (VND B)	3,611
Current Shares O/S	118,793,605
Beta	0.68
Free float (%)	33
52 Week High	38,800
52 Week Low	26,800
Avg. Daily Volume (20 sessions)	611,086



Performance (%)

	3M	1Y	3Y
DRC	3	-19	-2
VN30 Index	9	15	19
VN Index	7	16	29

Major Shareholders (%)

Vinachem	50.51%
Foreign Ownership	30.03%

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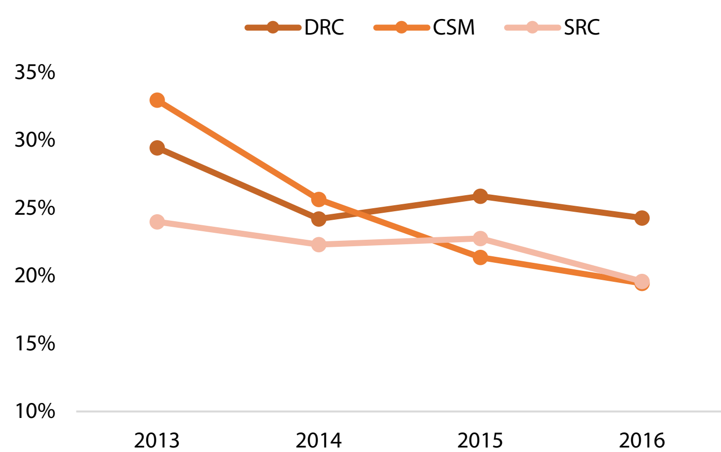
DRC – A Steady Growth through a Difficult Period

In 2016, competitive pressure weighs on Chinese tires that are priced at between 10% and 15% lower while dealer discounts are five to eight times higher than local tires, and larger foreign brands such as Michelin, Bridgestone have shifted to making inexpensive products. This harsh competition game has pushed domestic tire manufacturers to reduce their selling prices to maintain market shares. Besides, in mid - 2016, the price of natural rubber increased sharply. As a result, sales of domestic firms such as CSM and SRC dropped significantly in 2016, by 10% YoY and 5% YoY respectively. Meanwhile, DRC's revenue increased slightly by 1% YoY, and consumption increased significantly by 15% YoY. These growth rates are considered encouraging for DRC as they managed to maintain output growth in the context of domestic enterprises plunge when faced up with intense competition.

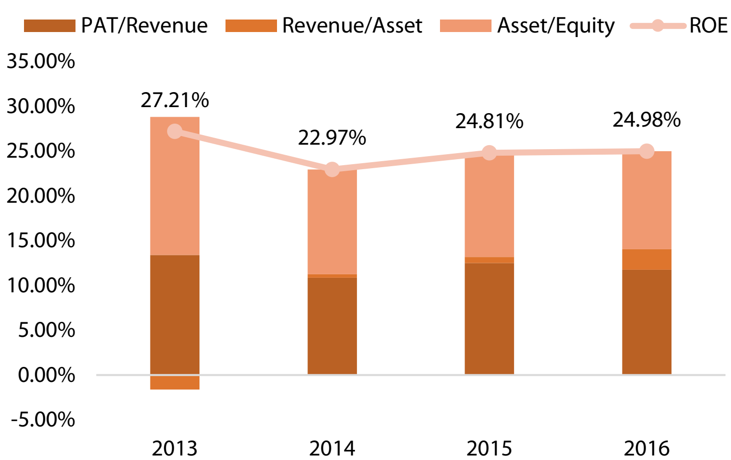
The results of the profitability assessment show that DRC is the most profitable company among three listed local manufacturers. Although the company's ROE fell in 2016, DuPont analysis shows the main reasons were lower ASPs due to competitive pricing and higher production cost, despite a significant increase in output. Furthermore, DRC's asset utilization ratio has shown a steady improvement.

Figure 1: ROE Comparisons in 2010-2016



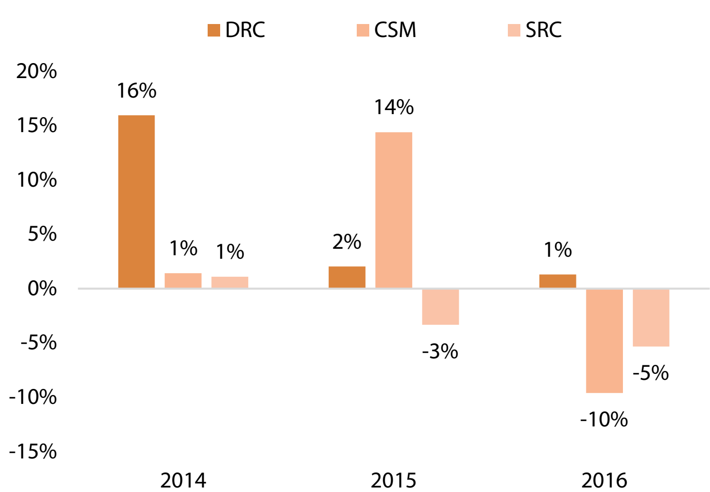
Source: DRC, CSM, SRC, RongViet Research

Figure 2: DuPont Analysis in 2013 - 2016



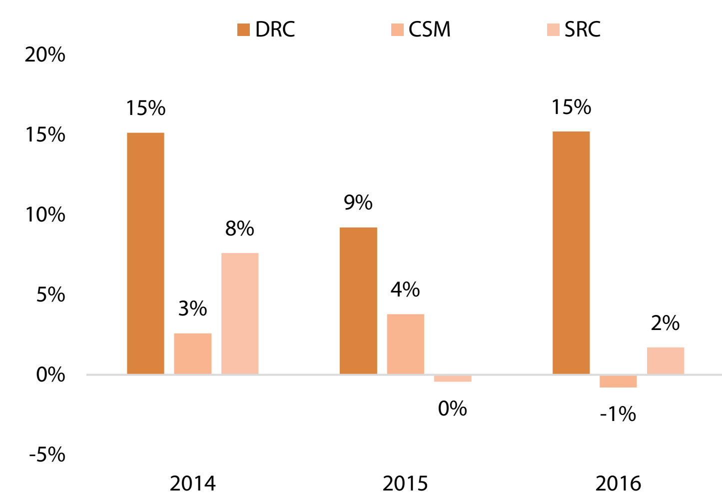
Source: DRC, RongViet Research

Figure 3: Revenue Growth Comparisons in 2014 - 2016



Source: DRC, CSM, SRC, RongViet Research

Figure 4: Sales Volume Growth Comparisons in 2014 - 2016



Source: DRC, CSM, SRC, RongViet Research

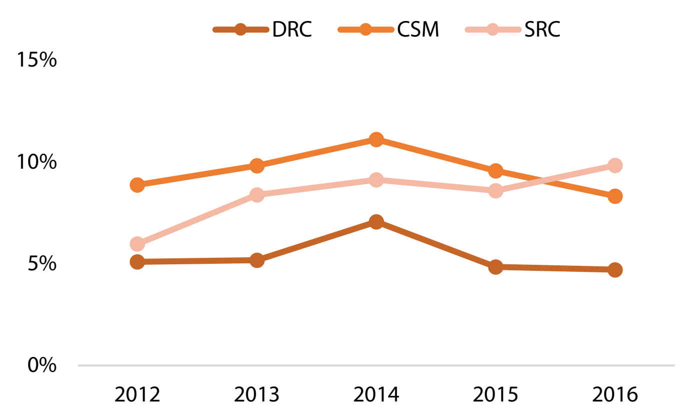
DRC's products are widely consumed domestically through 90 Tier 1 distributors and more than 2,000 Tier 2 Distributors but mainly focused in central Vietnam. However, in comparison, the number of DRC's agents is still less than CSM's. However, DRC, CSM, and SRC are all subsidiaries of Vietnam National Chemical Group; consequently, we consider it is possible for Vinachem to play a major role in coordinating, distributing market share and determining key products for each company to reduce competition. Additionally, when harsh competition in the tire replacement segment occurs, sales of CSM and SRC are likely to be severely impacted and reduced. Meanwhile, DRC has a significant advantage over its competitors as OEM and institutions consume 20-25% of their total output so DRC can sell even in the challenging periods.

Table 1: The Tier 1 Distributor Statistics

	Northen	Central	Southern	Total
CSM	27	34	100	161
SRC	66	19	17	102
DRC	16	55	19	90
Michelin	31	15	26	72
Kumho Tire	17	11	17	45

Source: RongViet Research

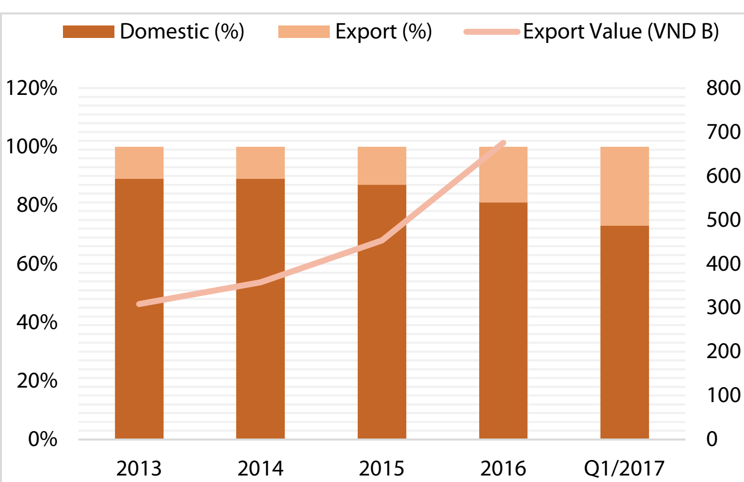
Figure 5: The SG&A to sales ratio Comparisons in 2013 - 2016



Source: DRC, CSM, SRC, RongViet Research

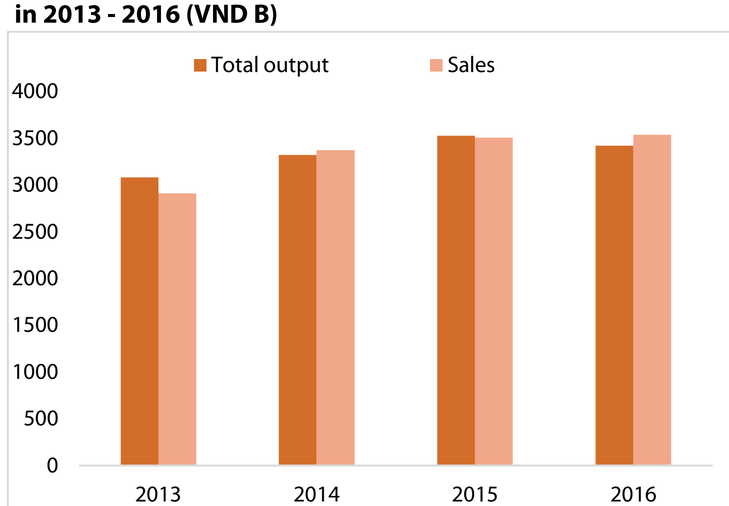
Automobile assemblers and large corporate clients, including Vinamotor, Truong Hai Auto, Hyundai Vina Motor, TMT, Vietnam National Coal - Mineral Industries Group, have regular demand. We consider that even though institutional clients have bargaining power, they bring DRC two advantages: (1) DRC's output is almost 100% consumed despite intense competition; (2) Average costs of sales are significant reduce compared to the distribution channel through agents. DRC is the most well controlled cost company of which SG&A to sales ratio is always a lot lower than CSM and SRC.

Figure 6: DRC's Exported Value and Proportion in Revenue



Source: DRC, RongViet Research

Figure 7: Total output (at current prices) and net sales of DRC in 2013 - 2016 (VND B)



Source: DRC, RongViet Research

DRC's products are mainly consumed in the domestic market (over 80% of revenue). Notwithstanding, we realize that the export value, as well as the proportion of export turnover in DRC's revenue structure, has gradually expanded over the years. DRC has exported to more than 35 countries around the world, mainly USA, India, South America, Africa, Europe, China and other Asian countries. In 2016, export turnover reached approximately USD30 million (+50% YoY), accounting for 19% of total revenue. With best efforts to improve product quality as well as to seek partners in potential markets, especially for radial tire products, we highly appreciate the export growth prospects in the future.

Radial Tire Segment's GPM Will Turn to Positive from This Year

DRC is the only firm among the local manufacturers selling well the all-steel radial tires

Radial tires are manufactured with the plies laid radially, which results in more advantages over bias tires (diagonal tires): better grip, easier handling, longer tread life due to less heat generated by the tire and better high-speed performance. As a result, the radial tire has been gradually replacing the diagonal tire in both passenger cars and trucks operated at high speeds.

Figure 8: DRC's Typical All – steel Radial Tires

Radial Tire 601

Radial Tire 721

Radial Tire 911

Source: DRC

Previously, Vietnam had to import 100% the all-steel radial truck tires. In 2013, DRC was the first domestic company to run an all - steel radial tire factory with the full designed capacity of 600,000 tires per year and the first stage of 300,000 tires per year. Only two domestic companies are currently producing radial steel tires, DRC and CSM (Southern Rubber JSC). Regarding CSM, despite the designed capacity of 1 million tires a year and the first phase has been operating (350,000 tires a year) since 2014, the production output is only 100,000 tires a year and still cannot proceed phase 2. Meanwhile, DRC sold 265,000 tires in 2016 and produced at 77% capacity of the first stage. According to our estimates, DRC will be fulfillment of Phase 1 this year. Phase 2, which will increase the total capacity to 600,000 tires per year, is under construction.

The Radial Project Updates

In 2015, DRC accelerated depreciation for its equipment of the Phase 1 radial plant from 15 years to 7 years, resulting in the negative gross margins of the radial segment in 2015 and 2016. Nevertheless, this change will help DRC reduce its depreciation burden in next few years and quickly increase this segment GPM. The company has planned to produce 276,000 tires in 2017 (equivalent to 92% of the design capacity of phase 1). Nevertheless, according to our latest update, DRC has manufactured 27,000 - 28,000 radial tires per month by the end of May and the first six-month output of 2017 has reached 170,000 tires. According to our estimates, DRC will reach 100% Phase 1 utilization this year.

They are currently building the second phase, adding equipment to increase its capacity. Phase 2 project will complete in 4Q2018 instead of 2Q2016. We think this progress schedule adjustment will temporarily reduce the depreciation pressure.

Table 2: DRC's Steel Radial Tire Project Evaluation

	Phase 1	Phase 2	Total
Initial investment outlay (VND billions)	1,710	705 *	2,415
Capacity	300.000 tires/year	300.000 tires/year	600.000 tires/year
Begin construction	2Q2011	2Q2015	
Complete construction	2Q2014	2Q2018	
Full capacity timing	2018	2021	
ROI			14%
IRR			16%
NPV			VND202 billion
Payback period (**)			7 years

*Source: RongViet Research estimate, * DRC; (**) since Q3 2013*

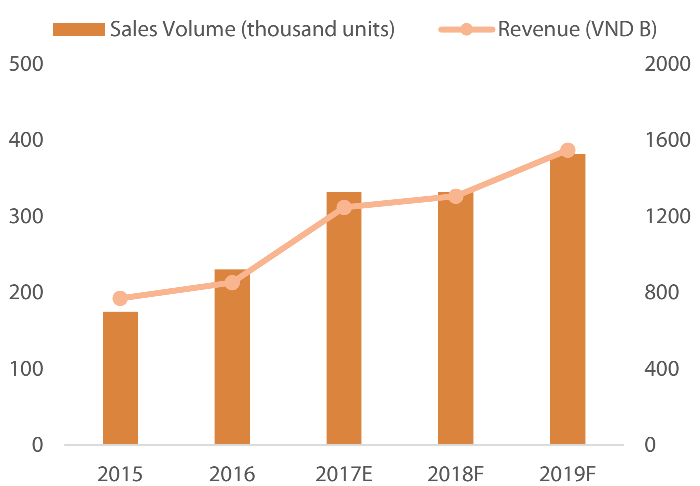
Table 3: Estimations of DRC's Steel Radial Tire Sales Volume and Net Cashflow

	2010	2011	2012	2013	2014	2015	2016	2017E	2018F	2019F	2020F	2021
Sales Volume				14.8	114.8	175.0	230.6	331.9	331.9	381.7	477.1	600*
NATCF	**-36.4**	**-192.8**	**-976.4**	**-407.9**	**298.3**	**501.1**	**410.1**	**-384.6**	**72.3**	**279.5**	**323.6**	**305.0**

*Source: RongViet Research estimate, *Full design-capacity*

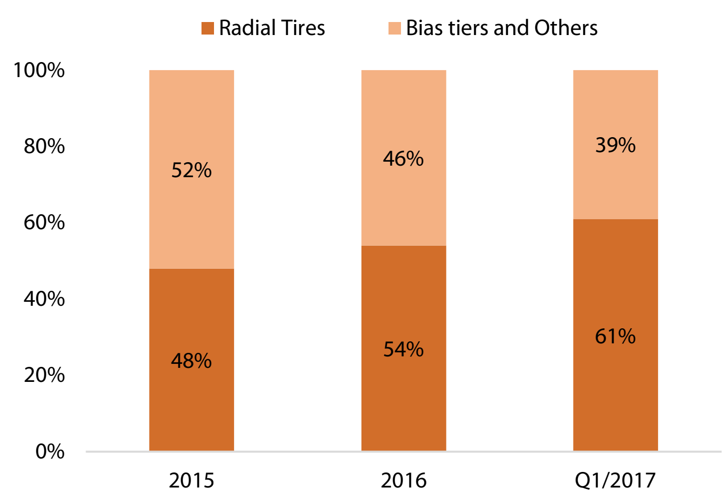
DRC radial tires have been manufactured by Sailun's Technology (China), so their quality was similar to same Chinese products. A DRC radial tire can only travel 80,000-90,000 kilometers while Maxxis or Goodyear one can extend to 120,000 kilometers. Therefore, DRC managed to reduce the price lower than other manufacturers to increase the market penetration and sales volume. Furthermore, the project cooperated with Black Donuts (a world leading company specializing in tire production consultancy) will be completed in October 2017, which is expected to enhance the quality of DRC's radial tires to meet customer requirements, orient to the export market as well as improve the price.

Figure 9: Revenue and Sales Volume of DRC' Radial Tire Forecasts



Source: DRC, RongViet Research estimate

Figure 10: Export Proportion of DRC by Product



Source: DRC, RongViet Research

Radial tires of DRC are mostly exported, while domestic consumption is mainly through dealers. At present, it is challenging DRC to sell radial tires in the local market because of direct competing against cheaper Chinese tires and other FDI firms. Specifically, local radial tire consumption in the first quarter of 2017 decreased significantly by 11% YoY. However, according to our update, some assemblers that are DRC's institutional customers are considering ordering DRC's products. THACO has been ordering DRC radial tires for assembling their heavy trucks since June this year.

In contrast, the radial tire exported volume is growing vigorously and gradually occupies a large share in the export revenue structure. Brazil was the largest export market in 2016 with 47,000 tires, and USD6.15 million revenue, equivalent 21% of total export value; followed by Thailand and Malaysia. It is worth noting that DRC began to export radial tires to the U.S market in August 2015. In the first quarter of 2017, the USA imported 5.500 DRC radial tires, valued at more than USD700,000 and became the second largest consumer market. The company has put high expectations on exporting radial tires to this market

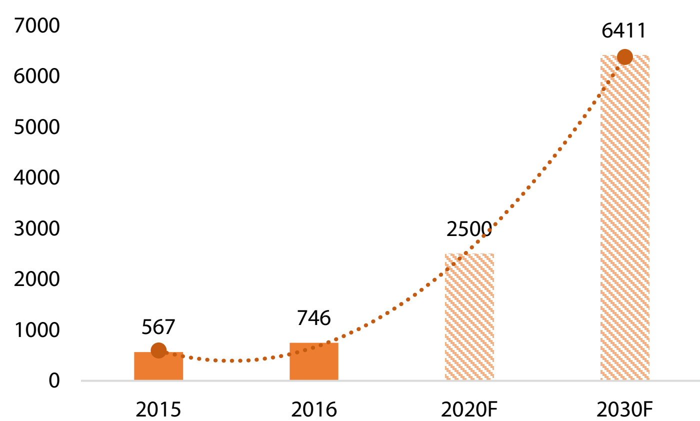
Besides, an opportunity for the DRC is that India is considering imposing anti-dumping duties on radial tires imported from China. India's imported tire demand is currently more than 40% while DRC is the only domestic company in Vietnam certified by ISI standard for radial tire products. DRC has exported 1,600 tires to this market in 1Q2017. This volume was not as large as expected, but we still hold the view that India will be a potential market.

Radial tires will be the key growth driver for DRC's revenue

At present, bias tires still account for a high proportion of DRC's revenue structure, but we notice a tendency in raising the percentage of radial tires. In the short term, this restructuring has not been strong because bias products are one of DRC's traditional products and consuming well in both the OEM and replacement segment while radial products are still in the process of penetrating the domestic market.

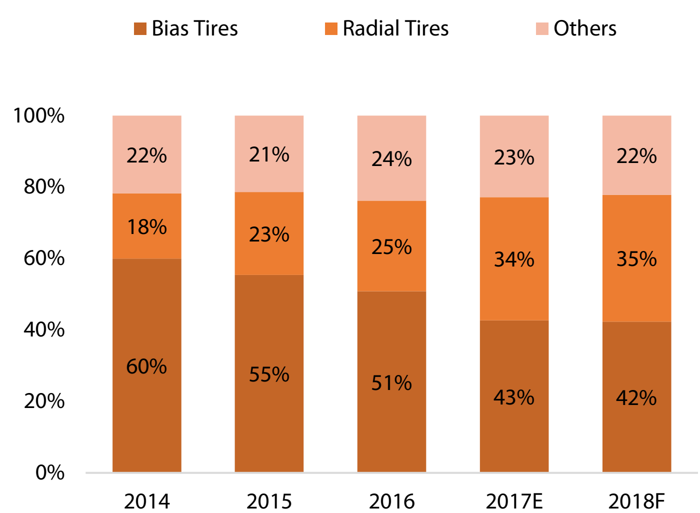
We hold the view that DRC's motorcycle and bicycle tire consumption will grow marginally in the next few years as the market for these two vehicles is almost saturated. In addition, bias tires have reached nearly full utilization, which will result in production growth of bias tires gradually leveled off. Meanwhile, a country with a low radial cannibalization like Vietnam and a rapid development of infrastructure will open up well as the concern of domestic truck assembly companies for this product of DRC, we now believe the radial tire segment will be the key driver in DRC's long-term growth prospect. We project that DRC's revenue will grow at CAGR of 9.41% from 2017 to 2020.

Figure 11: The Projection of Highway Length Completed in 2015 - 2030



Source: MT, RongViet Research

Figure 12: Revenue Breakdown by Segments



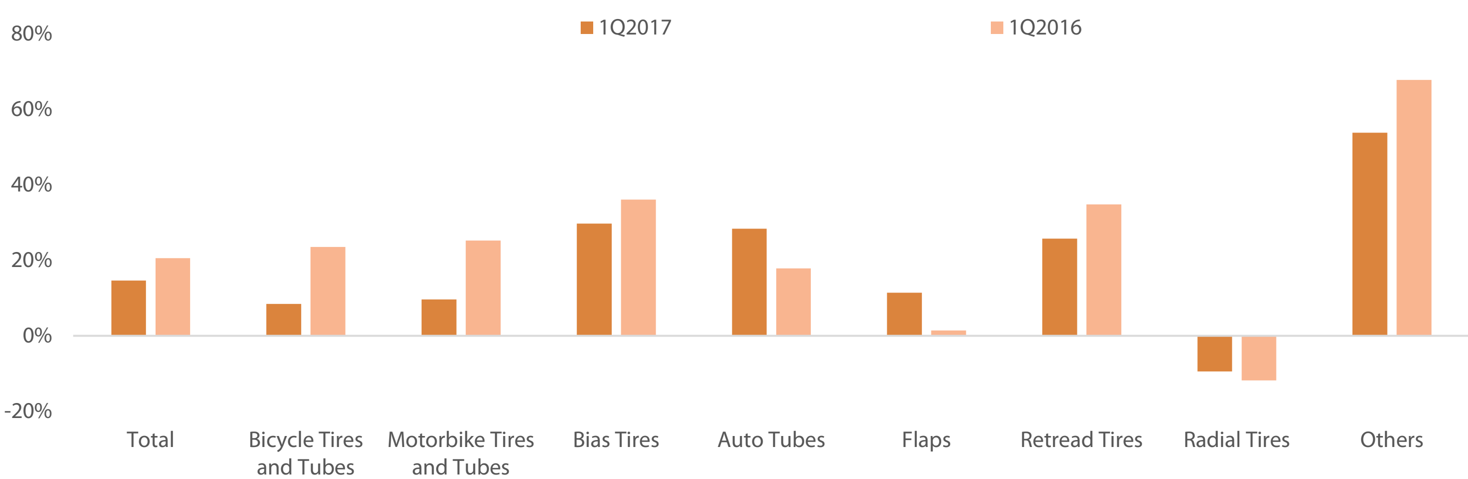
Source: DRC, RongViet Research

Q12017 Result Update: Input Prices Overtake Output Prices

In 1Q2017, DRC's revenue increased strongly by 20.7% YoY, reached VND900 billion. However, due to the sharp rise in rubber prices to the peak at the end of January, DRC's gross profit dropped significantly by 13.8%YoY, and PAT declined by 20.1% YoY. The company said even though they raised the selling price twice in 2017, up to 5% each time but could not be in line with the rise in input prices. Notwithstanding the higher sales volume and revenue, the GPM of many segments decreased compared to the same period of 2016, and the combined GPM is 14.7% YoY, down 590 basis points. DRC fulfilled only 84% of its first-quarter profit target and 16% of its full-year target, equivalent to the PAT of VND70.62 billion.

The radial tire segment has not reached break-even point yet due to the increase of input prices and the accelerated depreciation pressure; we find a positive signal is that output and sales are growing strongly over the same period and reached 55% YoY and 39% YoY, while gross margins also increased 2.39 percentage points.

Figure 13: GPM By Segments in 1Q2017 and 1Q2016

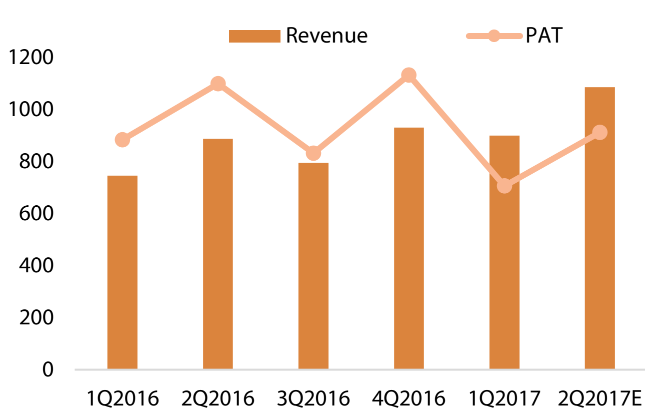


Source: DRC, RongViet Research

2017 Outlook: The "Euphoria" In the Business Result Will Come In the Second Half of Year 2017

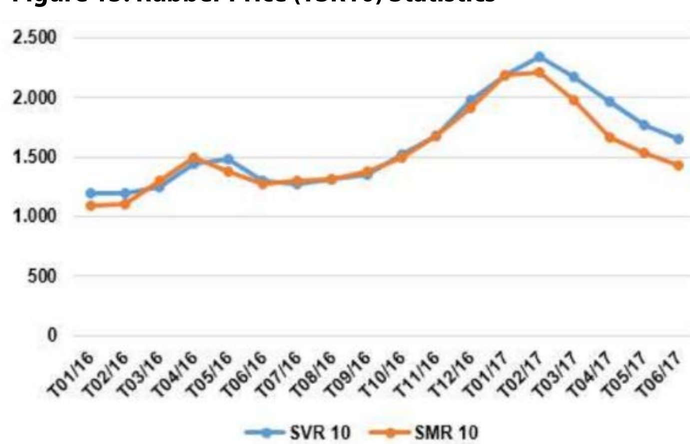
Since early February 2017, rubber prices have fallen sharply again as production in ANPRC member countries has recovered from natural disasters. However, DRC also said that there is a lag time between purchasing and putting on the line, we think business results in the second quarter in particular and in the first half of 2017 will improve, but not as good as the same periods last year.

Figure 14 : Quarterly Result (Unit: VND B)



Source: DRC, RongViet Research

Figure 15: Rubber Price (TSR10) Statistics



Source: VRA, RongViet Research

In the second half of 2017, we forecast it is unlikely that rubber prices could return to the peak at the beginning of the year. We based on (1) Thailand has begun to recover rubber production after floods, and the government would sell rubber from state stockpiles to boost the supply for export; (2) rubber farmers usually begin tapping from April so that the supply will increase then.

Benefiting from the lag time of the decrease in rubber prices as well as the recovery of sale prices, we expect that DRC's gross profit margin will improve significantly, resulting in the sharp increase in the second half of year's performance. Notably, estimated revenue and PAT of 2H2017 are VND1,876 billion (+ 8.7% YoY) and VND244 billion (+ 24.2% YoY) respectively.

Table 4: 2H2017 and 2017 Forecasts

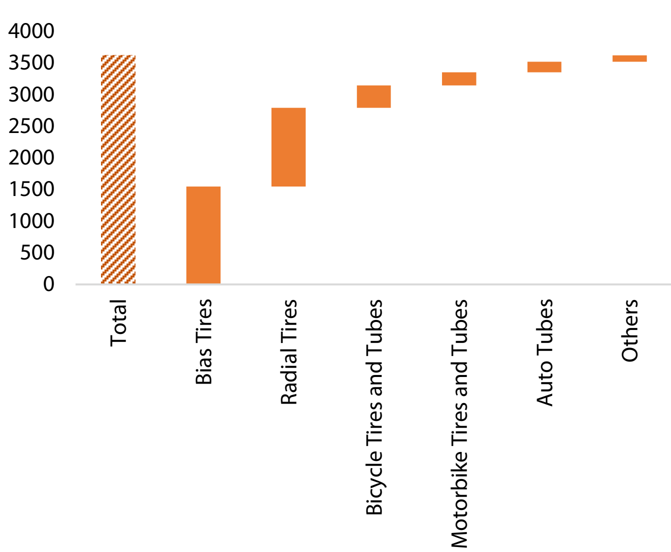
Particulars (VND B)	2H2017	+/-yoy	2017E	+/-yoy
Revenue	1876	+8.7%	3622	+7.8%
Gross profit	414	+20.8%	641	-8.5%
EBIT	330	24.0%	478	-11.9%
PAT	244	24.2%	336	-15.0%

Source: RongViet Research

Regarding DRC's 2017 outlook, we expect an improvement in the radial tire segment, which will be fulfillment this year of design capacity phase 1, equivalent to 300,000 tires. Although DRC's radial gross margin is still not as good as expected, the main reason supposes to be that the company accelerates depreciation of equipment as well as higher natural rubber prices in the previous year, resulting in a significant increase in the cost of goods sold. In the coming time, DRC will continue to recognize the output growth, which can lead to lower pressure in depreciation, combined with a slump in rubber prices that will help to improve this segment's GPM to 2.37%.

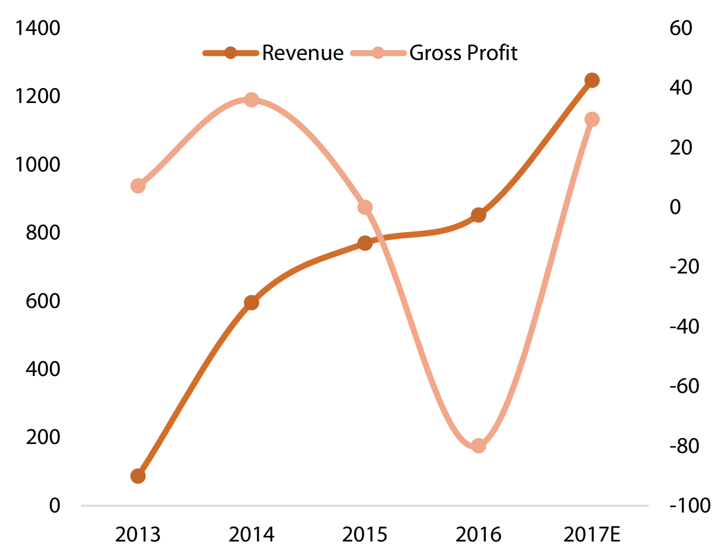
Our projection for the full fiscal year 2017 revenue is VND3,622 billion (+7.8% YoY) and PAT is VND336 billion (-15% YoY). Estimated 2017 EPS will be at 2,600 dong/share.

Figure 16: Revenue 's Projection by Segments



Source: RongViet Research

Figure 17: Revenue and Gross Profit Forecasts



Source: RongViet Research

Outlook and Valuation

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In the short term, we think DRC is still experiencing the difficulty of the industry including the volatility of raw material prices, especially the radial tire sector with additional accelerated depreciation resulting in negative profit margins. However, considering better sales results and rubber price expected to be stable in the low price range, we believe that DRC's business performance will prosper quickly in the following quarters of 2017. Notably, based on the domestic and foreign consumption in the first six months as well as the existing orders, we estimate the output of radial tires will reach 100% of the first phase designed -capacity (equivalent to 300,000 tires), and this segment will return positive margins.

In addition, we find that DRC usually pays a high and regular annual dividend of VND2,000-3,000 per share, similar to many companies of Vietnam National Chemical Group (Vinachem). Vinachem has already planned for an IPO this year, but it is not yet known whether the Group will divest from DRC. We assess that a divestment will be unlikely in the near future. As a result, DRC cash dividend rate is likely to remain and can be lifted after the radial project has a steady return.

In line with more optimistic expectations of the company than our 2017 Strategic Report, the target price is revised to **VND40,600 per share**. We recommend investors should **BUY** this stock in the **LONG-TERM** with 35% upside from the closing price on 13th July 2017.

Table 5: Valuation

Method	Price (VND)	Weight (%)	Weighted Price
FCFF	34,011	50	17,005
PE	35,995	50	17,997
Target Price		**100**	**33,141**

Source: RongViet Research

VND Billion

INCOME STATEMENT	2015	2016	2017E	2018F
Revenue	3,318	3,361	3,622	3,690
COGS	2,518	2,660	2,981	2,957
Gross profit	800	701	641	733
Selling Expense	77	85	103	105
G&A Expense	84	73	60	54
Finance Income	11	16	14	14
Finance Expense	124	83	75	89
Other profits	7	18	3	8
PBT	533	494	0	0
Prov. of Tax	117	99	420	508
Minority's Interest	0	0	84	102
PAT to Equity Shareholder	416	395	0	0
EBIT	639	543	336	406
EBITDA	848	775	478	574

Unit: %

FINANCIAL RATIO	2015	2016	2017E	2018F
Growth (%)				
Revenue	2.1	1.3	7.8	1.9
EBITDA	28.3	-8.6	-15.1	15.4
EBIT	11.3	-15.1	-11.9	20.0
PAT	17.8	-5.0	-15.0	20.9
Total Assets	0.2	-10.4	15.9	3.3
Equity	8.9	-5.4	-3.0	1.1
Profitability (%)				
Gross profit/Revenue	24.1	20.9	17.7	19.9
EBITDA/ Revenue	25.6	23.1	18.2	20.6
EBIT/ Revenue	19.3	16.1	13.2	15.6
Net margin	12.5	11.8	9.3	11.0
ROA	13.2	14.0	10.3	12.1
ROIC	28.1	27.3	22.0	24.4
ROE	24.9	25.0	21.9	26.2
Efficiency (%)				
Receivable Turnover	11.9	8.0	12.5	12.5
Inventory Turnover	3.2	3.5	3.3	3.3
Payable Turnover	6.0	8.5	5.9	6.7
Liquidity (%)				
Current	1.5	1.5	1.2	1.3
Quick	0.6	0.6	0.4	0.4
Solvency (%)				
Total Debt/Equity	62.1	57.2	78.6	87.6
Current Debt/Equity	26.6	32.5	37.8	36.9
Long-term Debt/ Equity	35.4	24.8	40.8	50.7

VND Billion

BALANCE SHEET	*2015*	*2016*	*2017E*	*2018F*
Cash and equivalents	240	51	107	80
Short-term investment	0	0	0	0
Receivables	278	419	290	295
Inventories	785	771	894	887
Other current assets	0	6	7	7
Tangible Fixed Assets	1,818	1,499	1,893	2,026
Intangible Fixed Assets	1	6	5	5
Long-term Investment	5	4	4	4
Other long-term assets	16	59	62	65
TOTAL ASSETS	**3,143**	**2,815**	**3,263**	**3,370**
Payables	420	312	507	444
Current Debt	446	513	580	572
Long-term Debt	593	392	626	787
Other long-term liabilities	11	16	16	16
Bonus Fund	0	0	0	0
TOTAL LIABILITIES	**1,470**	**1,233**	**1,728**	**1,819**
Owner's Equity	917	1,188	1,188	1,188
Capital	0	0	0	0
Retained Earnings	461	225	154	142
OCI	62	21	21	21
Investment Fund	233	149	172	201
TOTAL RESOURCES	**1,673**	**1,582**	**1,535**	**1,552**
Minority's Interest	**0**	**0**	**0**	**0**

CASH FLOW STATEMENT	*2015*	*2016*	*2017E*	*2018F*
Profit before tax	532	494	420	508
-Depreciation	284	245	179	185
-Adjustments	(816)	(740)	-	-
+/- Working capital	612	491	116	(163)
Net Operating CFs	**612**	**491**	**716**	**529**
+/- Fixed Asset	(44)	44	(97)	(120)
+/- Deposit, equity investment	(67)	(144)	-	-
Interest, dividend, cash profit received	-	-	-	-
Net Investing CFs	**(110)**	**(100)**	**(97)**	**(120)**
+/- Capital	83	274	-	-
+/- Debt	(107)	(133)	(168)	(169)
Dividend paid & other	(322)	(721)	(397)	(267)
Net Financing CFs	**(346)**	**(580)**	**(565)**	**(436)**
Beginning cash & equivalents	**85**	**240**	**54**	**107**
+/- cash & equivalents	156	(189)	53	(27)
Ending cash & equivalents	**242**	**54**	**107**	**80**

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Ratings / Return Potential	BUY	ACCUMULATE	NEUTRAL	REDUCE	SELL
Intermediate- term (up to 6 months)	>20%	10% to 20%	-5% to10%	-15% to- 5%	<-15%
Long-term (over 6 months)	>30%	15% to 30%	-10% to 15%	-15% to -10%	<-15%

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