


# HOA PHAT GROUP JSC (HPG – HSX)

## The Most Profitable Business Has Received the Highest Priority

| Particulars (VND bn) | Q1-FY17 | Q4-FY16 | +/- QoQ | Q1-FY16 | +/- YoY |
|---|---|---|---|---|---|
| Net revenue | 10,265 | 9,951 | 3% | 7,142 | 44% |
| PAT | 1,934 | 1,949 | -1% | 1,022 | 89% |
| EBIT | 2,251 | 2,312 | -3% | 1,244 | 81% |
| EBIT margin | 21.9% | 23.2% | -131bps | 17.4% | 451bps |

*Sources: HSG, RongViet Research*

**Q12017 Performance: The Undeniable Efficiency of the Market Leader**

- Steel volume 632,001 tons, +30%YoY.
- Construction steel prices increased 19.6% YoY.
- Slightly declined gross margin QoQ amid strong global steel price fluctuations thanks to the well-developed production complex.

**Q22017 Potential: Anticipating a New Input Price Hike**

Hai Duong Steel Complex is operating at full capacity and the steel business contributes over 80% net profit for HPG. Possessing the most upstream production mill, HPG is continuing to assert dominance in the domestic long steel market with no archrivals. However, the rainy season in Q2 is going to impact on HPG's steel sales and the iron ore and coking coal prices' peaking during the quarter may cause HPG's gross margin to deteriorate.

Our Q2 forecast includes a volume growth rate of 27% YoY, revenue growth rate of 28% YoY while we expect HPG's NPAT to be 23% lower YoY due to the effects of the input price change.

Dung Quat Steel Complex has started construction and the fact that the right issuance receives positive reaction from the market seems assuring for the progress. Nevertheless, HPG's resources are sufficient for the first phase of the project, which makes sure that Dung Quat's will start contributing to the group's performance in 2H2018.

***Valuation and Recommendation***: *While a strong capacity growth is not the spotlight for HPG in 2017, Hai Duong Steel complex will continue to be state-of-the-art in the domestic market and bring about a remarkable stability for the company's attractive gross margin. We maintain our positive point of view on the superior profitability of Hoa Phat's steel business, which is going to keep 2017 EPS stable in spite of the 20% dilution caused by the right issuance.*

*In a longer term, we expect that HPG's growth will be boosted by the operation of Dung Quat, a steel complex that will triple HPG's capacity. Using FCFF and P/E methods, we evaluate HPG price at* ***VND40,000/share****, which is* ***24.8%*** *higher than the closing price on 18th July 2017 and recommend to* ***BUY*** *the stock in the* ***INTERMEDIATE-TERM****. This target price is revised from that in our 2017 Strategy Report published on 15/03/2017 as the promising potential of the new steel project is included.*

## BUY

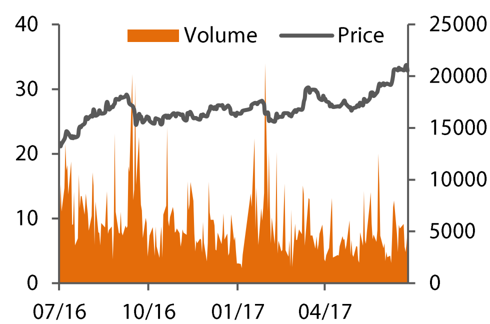
| | |
|---|---|
| CMP (VND) | 32,050 |
| Target Price (VND) | 40,000 |
| Investment Period | **Intermediate-term** |

**Stock Info**

| | |
|---|---|
| Sector | Basic materials |
| Market Cap (VND B) | 48,618 |
| Current Shares O/S | 1,516,947,138 |
| Beta | 1.32 |
| Free float (%) | 47.8 |
| 52 week High | 33,700 |
| 52 week Low | 21,150 |
| Avg. Daily Volume (20 sessions) | 4,441,639 |

| | FY2016 | Current |
|---|---|---|
| EPS | 4,470 | 5,565 |
| EPS Growth | 82.34 | 89.61 |
| Diluted EPS | 4,470 | 5,565 |
| P/E | 6.02 | 5.76 |
| P/B | 1.84 | 2.03 |
| EV/EBITDA | 3.95 | 4.72 |
| Cash dividend | 1,500 | - |
| ROE | 35.31 | 40.93 |

**Price performance**




**Major Shareholders (%)**

| | |
|---|---|
| Tran Dinh Long & wife | 32.80 |
| Dragon Capital | 7.65 |
| *Foreign ownership room (%)* | 15.04 |

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### Exhibit 1: Q1FY2017 Results

| Particulars (VND bn) | Q1-FY17 | Q4-FY16 | +/- QoQ | Q1-FY16 | +/- YoY |
|---|---|---|---|---|---|
| Net revenue | 10,265 | 9,951 | 3.2% | 7,142 | 43.7% |
| Gross profit | 2,463 | 2,639 | -6.7% | 1,431 | 72.1% |
| SG&A | 212 | 327 | -35.2% | 187 | 13.3% |
| Operating income | 2,397 | 2,652 | -9.6% | 1,432 | 67.4% |
| EBITDA | 2,492 | 2,569 | -3.0% | 1,451 | 71.7% |
| EBIT | 2,251 | 2,312 | -2.6% | 1,244 | 81.0% |
| Financial expenses | 112 | 101 | 10.9% | 94 | 18.8% |
| *- Interest Expenses* | 84 | 63 | 33.7% | 81 | 3.3% |
| Dep. and amortization | 241 | 257 | -6.3% | 207 | 16.3% |
| Non-recurring items (*) | | | | | |
| Extraordinary items (*) | | | | | |
| PBT | 2,243 | 2,253 | -0.4% | 1,211 | 85.2% |
| PAT | 1,934 | 1,949 | -0.8% | 1,022 | 89.2% |

*Source: HPG, RongViet Research*

### Exhibit 2: 1QFY2017 Performance Analysis

| Particulars | Q1-FY17 | Q4-FY16 | +/- QoQ | Q1-FY16 | +/- YoY |
|---|---|---|---|---|---|
| **Profitability Ratios (%)** | | | | | |
| Gross Margin | 24.0% | 26.5% | -253bps | 20.0% | 396bps |
| EBITDA Margin | 24.3% | 25.8% | -154bps | 20.3% | 396bps |
| EBIT Margin | 21.9% | 23.2% | -131bps | 17.4% | 451bps |
| Net Margin | 18.8% | 19.6% | -75bps | 14.3% | 453bps |
| Adjusted Net Margin | 18.8% | 19.6% | -75bps | 14.3% | 453bps |
| **Turnover *(x)** | | | | | |
| -Inventories | 3 | 3 | -0.2 | 4 | -0.5 |
| -Receivables | 16.8 | 17.9 | -1.1 | 17.2 | -0.4 |
| -Payables | 6 | 6 | 0.0 | 7 | -1.3 |
| **Leverage (%)** | | | | | |
| Total Debt/ Equity | 67.6% | 62.6% | 499bps | 59.8% | 781bps |

*Source: HPG, (*) Annualized turnover*

### Exhibit 3: Q2FY2017 Performance Forecast

| Particulars (VND bn) | Q2-FY17 | +/- QoQ | +/- YoY |
|---|---|---|---|
| Revenue | 10,287 | 0% | 28% |
| Gross profit | 2,061 | -16% | -20% |
| EBIT | 1,833 | -19% | -24% |
| NPAT | 1,558 | -19% | -23% |

*Source: HPG, RongViet Research*

## Updates:

### Updates on HPG's real estate projects:

*Mandarin Garden 2* (Hanoi) has a total investment amount of VND1,500 billion and is projected to contribute to HPG's results from 2018. This is a housing project of the mid-end segment as the estimated sales price is VND26 million/m2. 640 apartments started selling in Q3/2016 and will be handed over in late 2017, which is going to enable HPG to recognize incomes in 2018.

*70 Nguyen Duc Canh Apartment* (Hanoi) has a smaller scales (200 apartments) of a wider range of size (50 to 120 m2 per apartment), which shows that HPG is shifting their targets toward the middle income customers instead of the high-end segment as it did with Mandarin Garden 1. HPG is constructing the basements and estimates the handover time at late 2018. The project's average sales price is predicted to be lower than that of Mandarin Garden 2, which is considered attractive for its location and can help HPG to boost sales activities for the project.

*Yen My II Industrial Park* (Hung Yen province) is said to join the market during a high demand phase. The project is operated on an area of 169ha, divided into two phases. Phase I is going to lease out 107ha and occupying a total investment of VND630 billion. The estimated lease price can be USD65/m2 and the maximum fill rate is expected to be achieved within 4 years. Because the revenue is recognized once, the project is likely to pay a substantial contribution into HPG's real estate business results in 2018.

*Pho Noi North Residential Area* (Hung Yen province) is HPG's largest housing since Mandarin Garden 1 as the total area is 262ha, also divided into two phases. Phase I will cost HPG VND2,700 investment, selling two major housing types i.e. villas and apartments. The project is currently under clearance progress and as the most sizable one in HPG's pipeline, the contribution is also expected to be remarkable.

**HPG are making cautious movements regarding its agricultural business**. The company is operating two feed factories of 600,000 tons per year in total capacity in the North and another one in the South is scheduled for production test. The feeds are used as input for their farms, which are located near the factories where various animals are raised and bred. Hoa Phat's livestock include hogs, cows and hens, as they have been selling lean cows to slaughterhouses and are planning to introduce eggs and pork to the market in the near future. However, it should be noticed that HPG is cautious with the "1 million heads" target for their hog farms.

### Updates on Dung Quat Steel complex:

The 4-million-ton capacity steel mill when completing both phases will triple HPG's current output, which can also be inferred as an enormous improvement in earnings. We expect a significant growth in HPG's business results in 2019 when the company starts operating Dung Quat. We have projected a brief forecast on Dung Quat's performance and cash flow using HPG's details and the figures display a promising potential for HPG's long-term growth. In particular, Dung Quat will contribute over 1.7 million tons into Hoa Phat's output in 2019, which is around 30% of the total output, in 2021 the number is forecasted to double to 3.4 million tons, and Dung Quat would contribute over half of HPG's output. Regarding efficiency, phase I of the project is going to stabilise its gross margin of over 20%, similar to phase III of Hai Duong steel complex, while phase II is going to run at a lower margin because it will be the first time HPG produces flat steel. Nevertheless, HPG's overall gross margin can still be improved since 2019 because a large proportion of the HRC produced will be used in steel pipe production and allow this sector to capture higher added value for moving upstream. Regarding cash flows, we estimated that the NPV of the project is nearly VND12,500 billion under 11% WACC, equivalent to a thirteen-year IRR of 12.85%. Thus, for those who participated in the right issuance, cash flows from the project would add around 5,800 dong to the value of each pre-issue share.

The initiation of Dung Quat Steel Complex shows that Hoa Phat still prioritises their most profitable business. The project is expected to inherit HPG's experience regarding price monitoring as well as production and consumption management. As HPG is determined to avoid ownership dilution by issuing to current shareholders, the company's financial capability is highly respected as the project's borrowing proportion is only 50% of the total capex (most domestic steel producers use debt/asset ratio >70%). Importantly, the Ministry of transport has just recently announced the approval of Dung Quat Port into the Vietnam Central region's master plan for seaport until 2020, which is remarkably beneficial for the construction progress at Dung Quat as well as the operation in the future. It can be observed that their internal resources are sufficient and the market conditions are in favour of the two-billion dollar project. We consider that Hoa Phat has a reasonably appropriate timing for their largest project and maintain an optimistic view on the company's long-term potential.

**Table: Details on Dung Quat Steel Complex**

| Particular | Phase I | Phase II |
|---|---|---|
| **Capacity** | 2 million tons/year | 2 million tons/year |
| **Product mix** | 1 million tons rebar<br>1 million tons high-quality wire rod (for bolt & nail production) | 2 million tons HRC |
| **Targeted market** | Domestic<br>Exports | Internal consumption (for steel pipe production)<br>Domestic/exports |
| **Official operation** | 02/2019 | 08/2019 |
| **Capital** | VND20,000 billion Capex<br>VND6,000 Working Cap | VND20,000 billion Capex<br>VND6,000 Working Cap |
| **CapEx Funding** | 50% chartered capital-available<br>50% borrowing | 25% Share issuance<br>25% earnings in 2017-2018<br>50% borrowing |
| **Capex disbursement schedule** | N/A | 2017: VND3,200 billion<br>2018: VND4,200 billion<br>2019: VND12,000 billion<br>2020: VND600 billion |
| **Progress** | Paying clearance expense to Quang Lian (previous investor)<br>Constructing logistic infrastructure (ports) | |
| **Tax incentives** | 0% tax during first 4 years of positive taxable income<br>10% for the following 9 years. | |

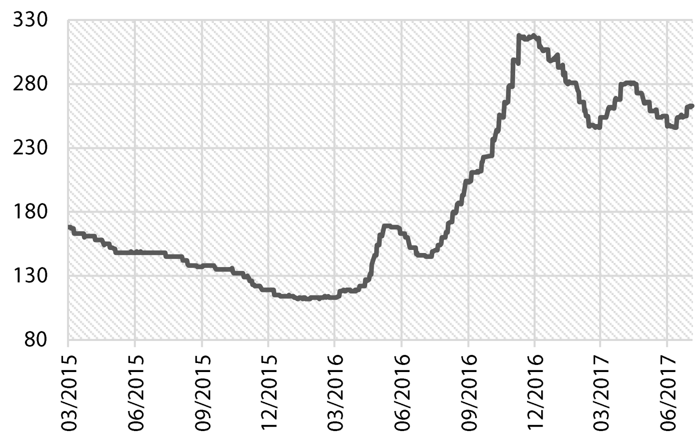
*Source: HPG, RongViet Research compiled*

## Appendix 1: The Steel Industry in Brief

**Figure 1: Iron Ore Price (USD per ton)**

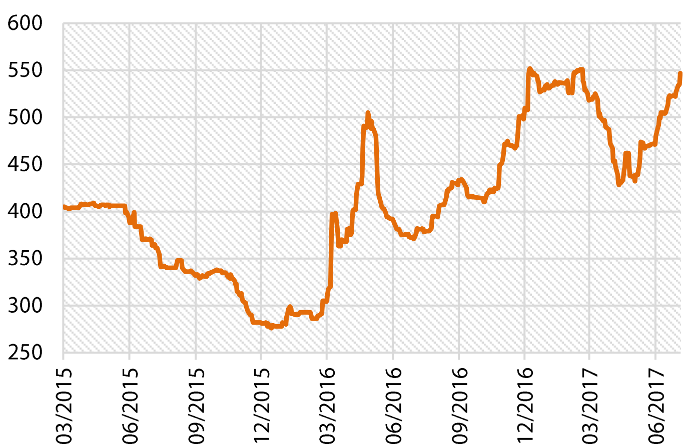

*Source: VSA*

**Figure 2: Coking Coal Price (USD per ton)**



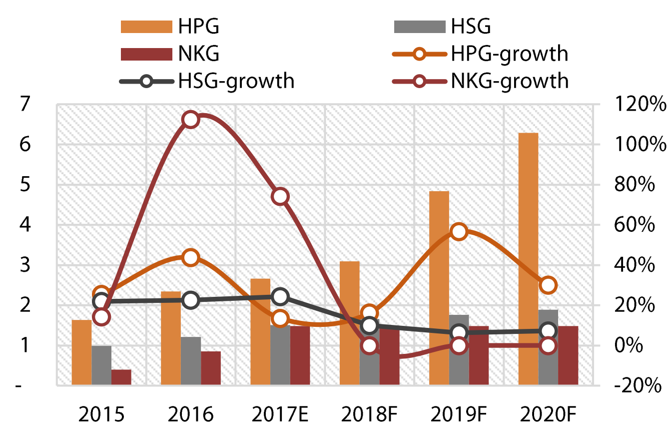

*Source: VSA*

**Figure 3: HRC  Price (USD per ton)**



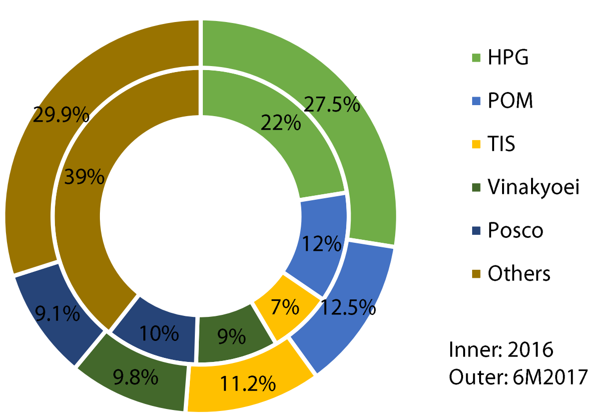

*Source: VSA*

**Figure 4: HPG, HSG and NKG' Capacity Expansions**



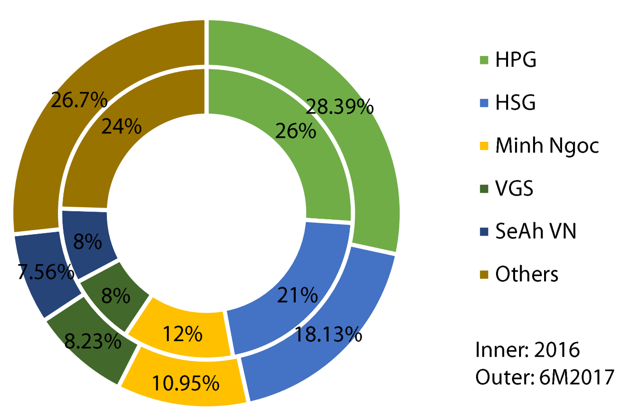

*Source: VSA*

**Figure 5: Construction Steel Market Share**




*Source: VSA*

**Figure 6: Steel Pipe Market Share**




*Source: VSA*

VND billion

| INCOME STATEMENT | FY2015 | FY2016 | FY2017E | FY2018F |
|---|---|---|---|---|
| Revenue | 27,453 | 33,283 | 40,212 | 50,897 |
| COGS | 21,859 | 24,533 | 30,649 | 39,752 |
| Gross profit | 5,594 | 8,751 | 9,564 | 11,145 |
| Selling expenses | 424 | 490 | 597 | 741 |
| G&A expenses | 761 | 405 | 344 | 361 |
| Financial income | 249 | 197 | 161 | 203 |
| Financial expense | 566 | 368 | 331 | 752 |
| Other income/loss | -101 | 17 | 17 | 17 |
| PBT | 3,990 | 7,702 | 8,470 | 9,510 |
| Tax expense | 485 | 1,096 | 1,252 | 1,617 |
| Minority interests | 19 | 4 | 4 | 5 |
| PAT | 3,485 | 6,602 | 7,214 | 7,889 |
| EBIT | 4,409 | 7,856 | 8,623 | 10,043 |
| EBITDA | 5,691 | 9,530 | 10,727 | 13,408 |

%

| FINANCIAL RATIO | FY2015 | FY2016 | FY2017E | FY2018F |
|---|---|---|---|---|
| **Growth** | | | | |
| Revenue | 7.6% | 21.2% | 20.8% | 26.6% |
| EBITDA | 7.0% | 67.5% | 12.6% | 25.0% |
| EBIT | 4.6% | 78.2% | 9.8% | 16.5% |
| PAT | 10.9% | 89.4% | 9.3% | 9.4% |
| Total assets | 15.5% | 30.1% | 38.3% | 43.3% |
| Total equity | 22.4% | 36.7% | 56.2% | 23.8% |
| **Profitability** | | | | |
| Gross margin | 20.4% | 26.3% | 23.8% | 21.9% |
| EBITDA margin | 20.7% | 28.6% | 26.7% | 26.3% |
| EBIT margin | 16.1% | 23.6% | 21.4% | 19.7% |
| Net margin | 12.7% | 19.8% | 17.9% | 15.5% |
| ROA | 13.7% | 19.9% | 15.7% | 12.0% |
| ROCE | 27.8% | 36.4% | 25.8% | 19.5% |
| ROE | 24.1% | 33.4% | 23.4% | 20.7% |
| **Efficiency** | | | | |
| Receivables turnover | 17.1 | 13.9 | 13.9 | 13.9 |
| Inventories turnover | 3.2 | 2.4 | 2.8 | 2.9 |
| Payables turnover | 6.2 | 4.0 | 4.8 | 5.3 |
| **Liquidity** | | | | |
| Current | 1.2 | 1.6 | 1.7 | 1.8 |
| **Solvency** | | | | |
| Total Debt/Equity | 47.5% | 32.7% | 24.7% | 49.7% |
| Current Debt/Equity | 42.3% | 27.8% | 19.6% | 17.4% |
| Long-term Debt/Equity | 5.1% | 4.9% | 5.1% | 32.3% |

VND billion

| BALANCE SHEET | FY2015 | FY2016 | FY2017E | FY2018F |
|---|---|---|---|---|
| Cash and cash equivalents | 2,373 | 4,559 | 6,037 | 7,447 |
| Short-term investments | 758 | 694 | 763 | 763 |
| Accounts receivable | 1,608 | 2,395 | 2,893 | 3,662 |
| Inventories | 6,937 | 10,247 | 10,797 | 13,651 |
| Other current assets | 239 | 289 | 346 | 416 |
| Property, plant & equipment | 12,579 | 13,799 | 23,806 | 38,552 |
| Acquired intangible assets | 255 | 257 | 254 | 251 |
| Long-term investments | 103 | 79 | 78 | 78 |
| Other non-current assets | 652 | 862 | 905 | 950 |
| **Total assets** | **25,504** | **33,180** | **45,880** | **65,768** |
| Accounts payable | 3,527 | 6,097 | 6,436 | 7,553 |
| Short-term borrowings | 6,117 | 5,488 | 6,037 | 6,641 |
| Long-term borrowings | 739 | 972 | 1,568 | 12,312 |
| Other non-current liabilities | 308 | 419 | 461 | 507 |
| Bonus and Welfare fund | 349 | 400 | 437 | 478 |
| Technology-science, dev. fund | 0 | 0 | 0 | 0 |
| **Total liabilities** | **11,040** | **13,376** | **14,939** | **27,490** |
| Common stock and APIC | 8,004 | 9,103 | 17,699 | 17,699 |
| Treasury stock (enter as -) | -1 | -1 | -1 | -1 |
| Retained earnings | 5,549 | 9,486 | 11,981 | 19,318 |
| Other comprehensive income | 0 | 0 | 0 | 0 |
| Inv. and Dev. Fund | 891 | 1,156 | 1,156 | 1,156 |
| **Total equity** | **14,444** | **19,745** | **30,835** | **38,172** |
| **Minority Interest** | **23** | **106** | **110** | **115** |

| VALUATION RATIO | FY2015 | FY2016 | FY2017E | FY2018F |
|---|---|---|---|---|
| EPS (dong) | 3,587 | 4,823 | 4,898 | 4,836 |
| P/E (x) | 3.7 | 3.4 | 6.7 | 6.8 |
| BV (dong) | 19,706 | 23,425 | 20,325 | 25,161 |
| P/B (x) | 0.8 | 1.1 | 1.6 | 1.3 |
| DPS (dong/cp) | 1,000 | 1,500 | 0 | 0 |
| Dividend yield (%) | 6.5% | 5.6% | 0 | 0 |

| VALUATION MODEL | Price | Weight | Average |
|---|---|---|---|
| FCFF | 40,898 | 50% | 20,449 |
| P/E | 39,186 | 50% | 19,593 |
| **Target price (dong/share)** | | **100%** | **40,000** |

| VALUATION HISTORY | Price | Recommendation | Period |
|---|---|---|---|
| 15/01/2016 | 21,833 | BUY | Long-term |
| 21/11/2016 | 31,250 | ACCUMULATE | Long-term |
| 15/03/2017 | 35,556 | BUY | Long-term |

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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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