

HOA SEN GROUP (HSG) - AGM NOTE HIGH VOLATILITY IN INPUT PRICES WREAKING HAVOC ON EARNINGS

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HSG held its AGM last month. HSG's poor performance in the previous fiscal year was one of the primary concerns expressed by its shareholders at the AGM.

After successfully surpassing its annual guidance in FY15-16, HSG unexpectedly failed to reach the target of VND1,650 bn in NPAT, although it was able to surpass its revenue target of VND23,000 bn in FY16-17. Management explained that the sharp increase in HRC input prices and rising interest expenses hurt HSG's profit margin. As a result, its net profit has been falling steadily for four consecutive quarters. In FY16-17, HSG recorded revenue of VND26,149 bn (+46.2% yoy) and NPAT of VND1,332 bn (-11.3% yoy).

FY16-17 revenue grew strongly on the back of solid volume growth of +25.5%, to touch 1.6 million tonnes. This included 1.15 million tonnes of galvanized steel (+32.8% yoy) and 375,000 tonnes of steel pipes (+8.1% yoy). This is a reflection of strong economic growth and robust construction activity.

However, high HRC input prices hurt profitability despite a recovery in ASPs. HSG's NPAT decline was largely attributable to the unexpected surge in HRC prices during the capacity expansion phase, which led to higher inventories and a surge in short-term working capital loans, both of which hammered margins. In FY16-17, the average HRC price (CFR ASEAN port) was US\$493.9 per tonne (+44% yoy). In Sep 2017, the HRC price reached US\$591.0 per tonne, the highest level since June 2012.

The average selling price (ASP) of galvanized steel recovered to VND16.6 million per tonne (+14.8% yoy), but this was still not enough to offset the significant increase in raw material prices. The company's gross margin declined to 16.9% in this fiscal year, dropping from the record level of 23.4% in FY15-16. HSG also experienced a rise in its leverage in FY16-17, as the price of HRC surged and capacity in the north was expanded. As of Sep 2017, HSG's total debt stood at VND11,856 bn (+105% yoy), and interest expenses increased by 131% yoy. HSG's net profit margin declined to 5.1% from 8.4% in previous fiscal year.

Key statistics

52w high (VND)	33,300
52w low (VND)	21,100
3m Avg daily volume (shares)	3,999,103
Market cap (VND bn)	9,030
Outstanding shares	349,992,883
Free float (%)	37
TTM P/E (x)	7.3
P/B (x)	1.8

Ownership (%)

Chairman & relating companies	62.97
Beira Limited	4.52
Vietnam Enterprise Investments Ltd.	2.81
Deutsche Bank AG London	2.02
Others	27.68

Source: VNDIRECT

Figure 1: HRC prices (CFR ASEAN port) (US\$/tonne)

	Average	Max	Min
FY15-16	343.1	437.0	274.0
FY16-17	493.9	591.0	410.0
Change %	44.0%	35.2%	49.6%

Source: VNDIRECT

Increased focus on the domestic market to combat rising competition. According to the company, the entry of new players into the galvanized steel industry has threatened the company’s leading position in the domestic market. For example, its main competitor, Nam Kim Steel, raised its capacity to 1.2 million tonnes in 2017 and plans to double this in the next five years. Meanwhile, other large players specializing in construction steel like Hoa Phat or Pomina have expressed interest in expanding into the galvanized steel segment. Specifically, Hoa Phat will run its first galvanized steel plant (400,000 tonnes pa of capacity) in the first quarter of 2018 and Pomina also has the same plan, and expects to complete the first phase of its plant (200,000 tonnes pa of capacity) at the end of this year.

As a result, HSG has to protect its market share in the near term through multiple measures including: (1) completing its investment plan in the North to raise its production capacity and ramp-up economies of scale; and (2) strengthening its distribution network with a target of 1,000 branches in the next two years. In FY17-18, HSG’s coated steel and steel pipes production capacity will rise by 680,000 tonnes (+32% yoy) and 295,000 tonnes (+39% yoy), respectively. We believe increasing competition will put pressure on HSG’s profit, especially as we expect that input prices will continue to remain high this year. However, we think that HSG’s leading position in the galvanized steel industry is a major advantage while most of its rivals are new entrants that are still in the early investment phase. In addition, buying HRC from Formosa and expanding its CRC production capacity in Hoa Sen – Nghe An plant will help HSG reduce its transportation costs in this fiscal year.

Figure 2: HSG’s steel production capacity (tonnes pa)

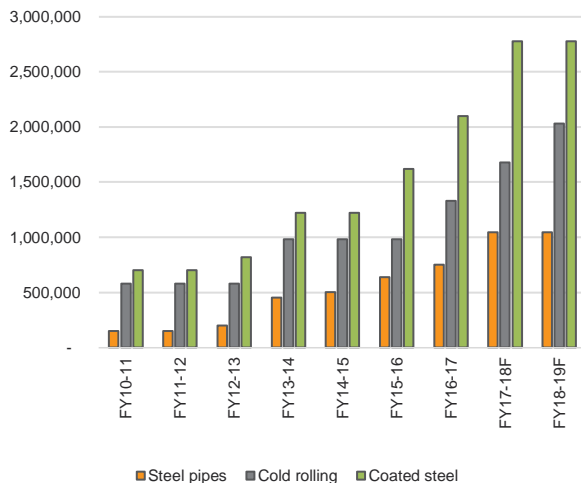
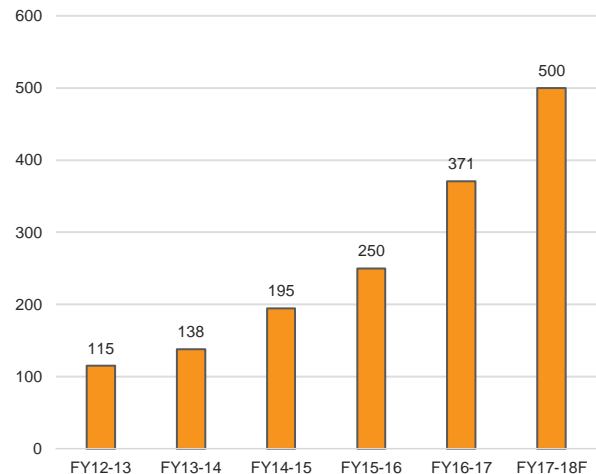


Figure 3: HSG’s retail branch count



Source: VNDIRECT

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Shareholders questioned management about their FY17-18 target of VND30,000 bn (+14.7% yoy) and net profit of VND1,350 bn (+1.4% yoy). According to shareholders, the target seems conflicted because earnings are projected to stay flat despite strong revenue growth. Management explained that the company has to accept lower margins in order to face the fierce competition. This target does not include the one-off financial gains of VND210 bn from divestment of its real estate properties. The company completed its divestment of Hoa Sen – Gemadep Port in 2017 and expects to record a profit after tax of VND100 bn this fiscal year. HSG is also selling another two real estate properties in HCMC (Tran Nao and District 9). The Tran Nao

project is valued at VND180 bn and could bring HSG an abnormal gain of VND110 bn this year. At the AGM, HSG's shareholders approved the cash dividend of VND1,000/share and 10% share bonus for FY16-17.

Disappointing earnings results in 1QFY17-18. At the end of January, the company disclosed its 1QFY17-18 results (from October to December 2017), which included revenue of VND7,887 bn (+36.8% yoy) and net profit of VND333 bn (-24.2% yoy). In 1QFY17-18, the average HRC price (CFR ASEAN port) was US\$562.7 per tonne (+21.1% yoy and 1.6% qoq). Gross margin declined to 15.0% (vs. 16.2% in 4QFY16-17) but the company cut SG&A costs in order to shield the impact of gross margin contraction on operating margins. The company's net profit margin stood at 4.2% this quarter, which was higher than the 4QFY16-17 net profit margin of 2.9%.

Lower transportation costs could offset elevated input costs into FY17-18. Due to favourable conditions in the global steel market, we think HRC prices will remain high this year. However, local galvanized steel manufacturers could diversify their input mix with Formosa's new supply (expected to double its HRC production capacity in May 2018). In addition, HSG will run its new cold rolling lines at full capacity (Hoa Sen – Nghe An plant) in this fiscal year. We expect that the new cold rolling line could reduce HSG's transportation costs of CRC from the South to the North.

We estimate that HSG will post a net margin of 4.2%, assuming HRC prices will stabilize at US\$580/tonne in FY17-18. We expect that HSG's revenue will grow by 32.2% yoy and earnings will rise by 9.0% yoy, not including the one-off financial income from the divestment of its real estate projects. We estimate that net profit will come in at VND1,602 bn in FY17-18 (+20.3% yoy), equivalent to EPS of VND 4,257.

We believe that the market has priced in the company's poor performance in FY16-17. Despite the increasing competition, we think the company will be able to protect its market share due to its strong distribution network and brand. Its current valuation, implying a forward P/E of 6.1x, looks attractive considering its leading position in the galvanized steel market in Vietnam. In addition, its regional peers are trading at a higher forward P/E multiple of 7.1x. However, we do not see any catalysts that would trigger a re-rating of the stock in the medium-term.

Figure 4: HSG's peer comparison

Company	Country	Market cap (US\$ mn)	TTM NPAT growth (%)	ROA (%)	ROE (%)	D/E (%)	TTM P/E (x)	P/B (x)	Forward P/E (x)
Jindal Stainless	India	731.3	na	0.7	na	295.6	44.6	2.3	10.7
Quingdao Hujintong Power	China	328.0	11.7	5.4	9.7	49.9	28.5	2.5	na
Nam Kim Steel	Vietnam	226.5	35.1	9.3	38.7	222.4	5.8	1.9	5.9
<i>Average</i>		<i>428.6</i>	<i>23.4</i>	<i>5.1</i>	<i>24.2</i>	<i>189.3</i>	<i>33.7</i>	<i>2.2</i>	<i>7.1</i>
<i>Median</i>		<i>328.0</i>	<i>23.4</i>	<i>5.4</i>	<i>24.2</i>	<i>222.4</i>	<i>28.5</i>	<i>2.3</i>	<i>8.3</i>
Hoa Sen Group	Vietnam	396.2	(32.4)	7.9	28.8	229.2	7.3	1.8	6.1

Source: Bloomberg, VNDIRECT

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RECOMMENDATION FRAMEWORK

Stock Ratings

Definition:

- Add The stock's total return is expected to reach 15% or higher over the next 12 months.
- Hold The stock's total return is expected to be between negative 10% and positive 15% over the next 12 months.
- Reduce The stock's total return is expected to fall below negative 10% over the next 12 months.

The total expected return of a stock is defined as the sum of the: (i) percentage difference between the target price and the current price and (ii) the forward net dividend yields of the stock. Stock price targets have an investment horizon of 12 months.

Sector Ratings

Definition:

- Overweight An Overweight rating means stocks in the sector have, on a market cap-weighted basis, a positive absolute recommendation.
- Neutral A Neutral rating means stocks in the sector have, on a market cap-weighted basis, a neutral absolute recommendation.
- Underweight An Underweight rating means stocks in the sector have, on a market cap-weighted basis, a negative absolute recommendation.

Country Ratings

Definition:

- Overweight An Overweight rating means investors should be positioned with an above-market weight in this country relative to benchmark.
- Neutral A Neutral rating means investors should be positioned with a neutral weight in this country relative to benchmark.
- Underweight An Underweight rating means investors should be positioned with a below-market weight in this country relative to benchmark.

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