

Hua Zhang (1673.HK)

Date: 9 March 2017

Company		Huazhang Technology
Stock Code		1673 HK
# of shares	(m)	600.6
Closing Price	(HK\$/share)	2.6
Mkt cap	(HK\$m)	1,561.7
FY16A EPS	(HK\$)	0.054
FY16A BVPS	(HK\$)	0.534
FY16A DPS	(HK\$)	0.040

Source: The company

- 1H FY17E net profit surged 153.1% YoY on 81.1% YoY increase in turnover.
- FY18F net earnings have potential to leap on margin enhancement and strong order growth.
- Expand GPM by vertical integration.
- Strong growth in EPC and environmental business is expected.
- Operating environment would become more favorable to the group.

Vigorous growth in 1H FY17E. Due to the substantial increase in contribution from EPC division, Huazhang Technology's unaudited net profit came into RMB14.3m, up 153.1% YoY for six months ended December 2016 (vs. HK\$6.9m, down 69.1% YoY for 1H FY16A). Revenue for the period reached RMB200.6m, up 81.1% YoY.

As of the end of December, the group had RMB62.1m net cash and RMB164.1m net current assets in hand. Its equity as of the end of December 2017 reached RMB278.9m.

As of the end of December 2016 value of the group's backlog increased 14.6% YoY to RMB245.1m. Among all, EPC contract value increased 9.7% YoY to RMB160.1m, or 65.3%.

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Potential surge in FY18F earnings. Based on the group's interim results figures and unfilled backlogs, we project the group's turnover and net earnings for FY17E to increase by 47.7% YoY and 43.7% YoY, respectively, to RMB517.0m and RMB43.6m. In our view, the group's net earnings for FY18F have potential to leap on margin expansion attributable to vertical integration, strong growth in revenue generated from EPC and environmental business due to resilient paper market in China and more stringent waste discharge, pollution control and energy consumption standards for papermaking industry.

Margin enhancement on vertical integration. Gross profit for the period increased 64.0% YoY to RMB47.8m, implying a GPM of 23.8%, vs. 26.3% for the corresponding period last year. In our view, the group's blended GPM would remain stable or ease slightly in FY17E, as proportion of contribution from EPC (engineering, procurement and construction management) division to the group's turnover is expected to expand further. GPM of the EPC division is estimated to be less than 20.0%, compared to around 25.0% commanded by industrial automation systems. In our view, GPM of the EPC has room to enhance. We estimate that a 1.0ppts increase in EPC division GPM would lift up the group's net earnings by 10.6%. Due to all of the components for the EPC project provided by the group are outsourced, GPM for such project are inevitably suppressed. As the group applies more self-develop/produced components into its EPC project, GPM would be enhanced. In fact, the group took first initiative of vertical integration in the end of 2016.

Acquiring headbox producers. In December 2016, the group announced that she has entered into a non-legal binding letter of intent with I3P vendors regarding potential acquisition of Hangzhou MCN Paper Tech (杭州美辰紙業技術有限公司) and Hangzhou Hao Rong Paper Tech (杭州豪榮科技有限公司). The target companies are engaging in the sales of headbox, which is an essential part of papermaking production line. It is a head tank which spreads the stock evenly along the width of the paper machine, accelerates the stock up to the machine operating speed and suspends the pulp fibers throughout the outgoing slurry. Hangzhou MCN Paper Tech and Hangzhou Hao Rong Paper Tech have patents and know-how in production of the headbox. If the acquisition be completed, Huazhang would possess one of the core technologies in paper making production line. More acquisitions of alike by the group can be expected, since management aims to develop a vertical integrated supply chain to boost GPM.

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Stern regulations create replacement demand and demand for environmental products. The Chinese government has imposed more stringent waste discharge standards and regulations on the paper industry in recent years. As a result, many papermaking production facilities which failed to comply with such standard have been shut down. For example, 200 paper production lines in China with annual production capacities of 1.67m tons in China had been closed in 2015. In addition, the government has required papermakers to adopt energy conservation measures that comply with “The standard of per unit energy consumption for manufacturing of pulp and paper” introduced in July 2016. The implementation of more severe waste discharge, pollution control and energy conservation standards by government bodies would increase Chinese papermakers’ capital expenditure for replacing its production facilities, and orders for the group’s EPC services and waste treatment systems are expected to increase accordingly.

Reflation in paper price. Between November 2016 to February 2017, price of newsprint rose about 40.0% to RMB5,300.0 per ton; of white card paper rose 30.0% to RMB6,500.0 per ton; of copperplate paper increased 26.0% to RMB6,300.0 per ton; of chip board increased 20.8% to RMB5,800.0 per ton; of uncoated paper rose 19.6% to RMB6,100.0; of kraftpaper rose 13.3%; of low density printing paper rose 11.1% to RMB6,000.0 per ton; of pure paper rose 8.3% to RMB7,800.0.

In February 2017, Shangdong Bohui Paper, Chenming Paper (1812 HK), APP-China, APP Gold Huasheng Paper, Shandong Sun Paper Industry announced price-hike. Shangdong Bohui Paper announced in February that prices for wood-free printed paper and minkdkal paper both adjusted upward by RMB500.0/ton. By the end of February 2017, some of the big boys in paper industry announced price-hike again. Prices of copperplate paper, white card paper and disposal food package board produced by papermakers in Shandong province were upwardly adjusted by RMB300.0 per ton; while price for white card paper produced by papermakers in Jiangsu province was hiked by RMB300.0 per ton.

Operating environment of China papermaking industry would remain prosperous between 2017 and 2018 on strong paper prices. Factors which support papers prices are expected to remain effective in the medium term:

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- China packaging material makers has been relying on imported waste paper as raw material. The sharp drop in import of waste paper in 2016 had boosted up raw material costs for domestic package material makers, and ultimately propelled the prices of that.
- Prices for both hardwood and softwood pulp have been trending up since October 2016, and the drop in CNY exchange rate has been further increasing pulp import cost for domestic traders, making domestic sales less lucrative and discouraging them to sell pulp at domestic spot market. Meanwhile, some of the traders have been stocking up pulp amid for better prices.
- Pulp imported from Chile accounted for around 15.0% among total import of that into China. The volcanoes explosion in pulp production region in Chile in January 2017 has disrupted pulp supply from there and boosted up the prices for pulp. By estimation, domestic prices for hardwood pulp and softwood pulp increased by 7.2% and 6.5%, respectively, to RMB5,124/ton and RMB5208/ton.
- Other costs elements of papermaking, including costs for labor, transportation, energy and other raw material are all on the uptrend. For example, a three-fold surge in latex price/ton has propelled offset printing paper prices by RMB200.0/ton.
- The implementation of new regulation on transportation and loading since October 2016 resulted in RMB300.0/ton increment in transportation costs.
- On expectation of further price hike, distributors and end-users have been stocking up paper, creating a shortfall of supplies.
- Many papermakers have been suffering lost for years. In order to resume their profitability, they hiked their products prices to pass on the increment in costs to their customers.
- Before 2016 when papers prices were relatively stable, many papermakers publishers, and printers kept low or even zero inventory in their warehouses to enhance their profitability and working capital. Starting from 2016 onward when papers prices started to pick up, end-users such as publishers and printers rushed to replenish their empty warehouse, which fuelled the paper price rally further.
- Since costs of funding are rising in China, papermakers are curtailing credit period granted to their customers.
- Starting from 2016, paper prices in Europe and North America started to pick up after being in the trough for past seven years. Major players in global

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papermaking industry included Smurfit Kappa, UPM, APP, International Paper has announced price hike in order to pass the upward pressure in COGS to end users.

- Competitions in China papermaking industry are expected to become more rational following consolidation in the industry.

Recycle sludge into energy. It is estimated that recycled paper plant with an annual capacity of 1m tons generates around 120,000 tons of recycled paper sludge per annum; and about 15m tons of sludge are generated nationwide every year in China from recycled paper production. In the past, recycled paper producers did not handle the sludge properly by dumping, burning or land filling, which would all cause secondary pollution.

In January 2017, the group entered into an agreement with Kun Sheng Machine Co., Ltd.'s ("Kun Sheng") regarding treatment of paper sludge and solid waste in the paper industry adopting refuse derived fuel technology. Under the agreement, the group would be the sole strategic partner of the Taiwanese company in paper industry. The refuse derived fuel technology is about converting waste into combustible fuel, and is very adaptive for papermaking mill with power generators and boilers. Such technology has been widely applied in many countries such as Japan and Israel. The group will introduce and promote solution applying refuse derived fuel technology in 2017. In March 2017, she has reached a refused waste derived fuel ("RDF") project agreement with Jiangsu Chamfor Paper Industry Co., Ltd., a paper manufacturer in the China, providing treatment of paper sludge and solid waste. This is the group's first RDF project since it signed a strategic cooperation agreement with Kun Sheng. It expected that it will be a new drive for the group.

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Research Note

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