

Van Shung Chong (1001 HK)

7 August 2014

From strength to strength

Listed in 1994, Van Shung Chong ("VSC") is well established in the steel trading business in Hong Kong and China. The company is a leading distributor of construction steel products in Hong Kong (with around 30% market share) and surface critical steel in Eastern China. At the same time, VSC is rapidly expanding its Building & Design Solutions business, that is more lucrative and involves distributing sanitary and kitchen ware brands in Hong Kong and China. The new management team is working to revitalise its business model through providing more value-added services to its customers.

- Demand for VSC's steel products to remain robust.** VSC is an active and significant player in the Hong Kong and Macau's construction steel market. It clearly benefits from the ongoing infrastructure investments including high-profile projects such as the Hong Kong-Zhuhai-Macau Main Bridge, the Hong Kong section of the Guangzhou-Shenzhen-Hong Kong Express Rail Link. VSC expects to see 20% volume growth in FY15.
- Centralized steel processing to improve efficiency.** Under IMDG, one key strategy is to adopt centralized steel processing which can: a) reduce dependency on what would be a labour intensive process; b) reduced worker accidents substantially; c) reduce the amount of scrap (by 5 to 10%); and d) achieve just-in-time delivery. The cost savings and added values are likely to be reflected in the segment's margin.
- Riding on increasing demand for luxury interior.** Given the rising demand for luxury lifestyle in mainland China and the high profitability of the BDS segment, VSC plans to set up more showrooms and A&D centres for the sub-dealers in mainland China. Two A&D centres are scheduled to be open in Wuhan and Changsha in 2H14 and one in Shanghai in 1H15. The BDS segment enjoys a 15% gross margin vs. 3-4% from IMDG.
- Valuation.** VSC currently trades at only 5.4x FY14 PE, which is attractively valued given the growing importance of the high-margin BDS segment within the sales mix.

Investment Summary

FY-end Mar 31	2010	2011	2012	2013	2014
Turnover (Rmb m)	3,252	4,208	4,432	3,761	3,849
Growth (%)	(30.2)	29.4	5.3	(15.2)	2.4
Net Profit (Rmb m)	75	31	6	72	104
Growth (%)	NA	(58.7)	(79.8)	1,039.6	44.8
EPS (Rmb)	0.19	0.07	0.02	0.17	0.25
Growth (%)	NA	(59.96)	(79.75)	1,039.98	44.12
PER (x)	7.2	18.0	89.0	7.8	5.4
OCF/Share (Rmb)	0.36	0.04	(0.41)	0.66	(0.46)
P/B (x)	0.9	0.9	0.8	0.8	0.7
EV/EBITDA (x)	5.8	9.2	34.1	5.8	14.7
DPS (Rmb)	0.06	0.02	0.02	0.05	0.07
Yield (%)	4.1	1.4	1.3	3.9	5.5

Source: Company data, CER estimate

Hong Kong / China / Industrial

NOT RATED

Share Price	Target Price	Upside / Downside
HK\$1.35	NA	NA

(as of 6 August 2014)

Jeff Wong

 (852) 2530 8306
 Jeff.wong@ebsecn.hk

52 Range (HK\$)	1.05-1.48
DVD yield %	5.52

Latest Key Data

FF no of shares (m)	239
FF (%)	57.33
FF market cap (HK\$ m)	323
12M daily turnover (HK\$ m)	1.39
12M volatility (%)	29.09
12M Hi/Lo (HK\$)	1.05-1.48
PEG FY13-15E (x)	NA
RoAE FY14 (%)	13.9
P/B FY14 (x)	0.7
Net debt/equity FY14 (%)	153.7

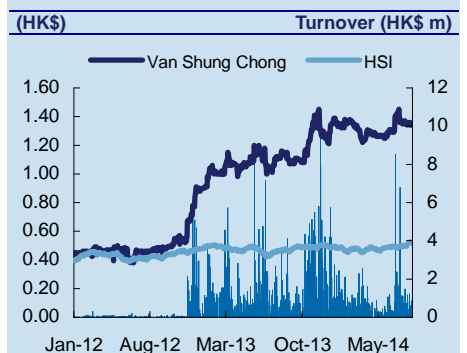
Performance (%)

	1M	YTD	12M
Absolute	(0.7)	(2.9)	16.4
Relative to HSCFI	(5.4)	(4.4)	2.6

Major Shareholders (%)

Mr. Andrew Yao & Associates	41.52
Public shareholders	58.48

Price Chart



Source: Bloomberg, CER estimates

Business Model

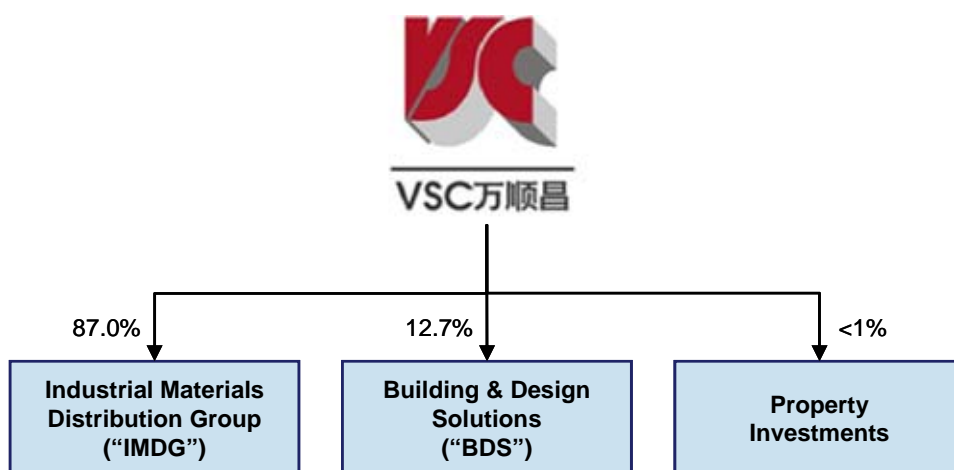
The company's business can be broadly classified into three segments.

The **Industrial Materials Distribution Group (“IMDG”)** is the single largest revenue contributor (FY14: 87% of sales) and it builds upon VSC's decades of procurement experience around the world and in China. VSC is one of the largest steel buyers in mainland China and has significant purchasing leverage.

IMDG's current scope of business includes mainly supply chain management, warehousing & inventory management and providing distribution and value-added solutions for the construction industry.

IMDG is also involved in distributing engineering plastics in Hong Kong and Southern China and this segment accounts for 11% of total sales in FY14. It currently plans to expand into Eastern China.

Figure 1: Major business segment of VSC



Source: Company data

The **Building & Design Solutions (“BDS”)** segment focuses on the distribution of international sanitary and kitchen ware products and it accounts for 13% of FY14 sales. VSC is one of the largest wholesale distributors in Hong Kong and China for TOTO, a renowned Japanese sanitary and bathroom fixtures brand. It also carries other reputable brands such as BAGNODESIGN, I-SPA and Rover.

Although this segment is relatively small in terms of total revenue, It enjoys a higher gross margin (15% vs. 3-4% from IMDG) and its future profitability is more promising than the traditional steel segment.

The **Property Investments** business (1% of FY14 sales) specializes in buying under-performing commercial buildings (including hotels) in strategic locations and converting them into high-end, high-yield investments through renovation and tenant profile restructuring. The following are two of the recent projects.

In December 2013, VSC purchased a 27-storey commercial building in Shanghai called the Central Park for Rmb 708m and it will be renovated into a Grade A office building complex.

In January 2014, VSC disposed Point Jingan, a Grade A office building, for Rmb653m (vs. Rmb420m when first acquired in 2008). With a 33% ownership, the company booked a gain of Rmb69m in FY14, which has been reflected in the P&L in FY14.

Demand for VSC's steel products to remain robust

VSC is an active and significant player in the Hong Kong and Macau's construction steel market. It clearly benefits from the ongoing infrastructure investments including high-profile projects such as the Hong Kong-Zhuhai-Macau Main Bridge, the Hong Kong section of the Guangzhou-Shenzhen-Hong Kong Express Rail Link and the Kai Tak Development Plan Stage One. VSC expects to see 20% volume growth in FY15.

The table below indicates the size of steel consumption for the ongoing infrastructure projects in Hong Kong.

Table 2: Steel consumption from infrastructure projects in Hong Kong

Duration	Projects	Est. Steel Consumption (tons)	Est. % of Tender Completed	Confirmed Supply by VSC
2010-20	Kai Tak Development Project	500,000	40%	25%
2011-17	Express Railway from HK to Mainland China	450,000	80%	38%
2012-17	HK-Zhuhai-Macau Bridge	250,000	70%	57%
2013-18	MTR Shatin to Central Link	300,000	40%	25%
2014-19	Tuen Mun to Airport Bypass Link	200,000	70%	100%
Total		1,700,000	59%	46%

Source: Company data

Over the longer term, the demand is well supported by the planned investments. Based on the 2014 policy address, future infrastructure investments will be focused on:

- Optimisation of public transportation system; in particular, five new railway lines will be completed over the next six years;
- New railway development beyond 2020, eg. South Island Line (West);
- Building new housing with a target of 470,000 units in 10 years; and
- Revitalisation of industrial buildings and redevelopment of old residential buildings.

Expansion to speed up following full control of BSC

The China contribution to IMDG is largely attributed to the Shanghai-based Bao Shun Chang ("BSC"), which became a wholly-owned subsidiary in October 2013. BSC specializes in the surface critical steel coil processing and distribution with 20 years of operating history. Having full control will help BSC expand more quickly in the automotive and home appliance industry. Demand for steel in the two sectors grew at 13.6% and 3.8% y/y respectively.

Centralized steel processing to improve efficiency

Under IMDG, one key strategy is to actively raise the overall efficiency of the value chain by introducing off-site automated centralized processing on its steel products.

Centralized processing has the advantages of: a) reducing dependency on what would be a labour intensive process (which is especially important given the recent shortage of labour in Hong Kong); b) reducing worker accidents

substantially; c) reducing the amount of scrap (by 5 to 10%); and d) achieving just-in-time delivery of tested and ready-to-use products. The cost savings and added values are likely to be reflected in the segment's margin.

In addition to centralized processing, VSC aims to expand its product base and client base, seeking also opportunities for export. Geographically, the company is focusing on the high-growth markets in Central, Southern and Northern China for future growth.

Riding on increasing demand for luxury interior

Under BDS, the company's goal is to provide value-added services to the distributors of sanitary and kitchen ware. Currently, there are two Architectural & Design (A&D) Centres in Hong Kong that were open to meet the needs of architects and designers. TOTO and BAGNODESIGN occupy 10,000 and 4,000 sq ft of floor space respectively.

The two centres can facilitate product testing and mock displays, as well as providing space and software solutions to the participants. At present, the A&D centres are self-sustaining units with high-profit margin.

Given the rising demand for luxury lifestyle in mainland China and the segment's high profitability, VSC plans to set up more showrooms and A&D centres for the sub-dealers in mainland China. Two A&D centres are scheduled to be open in Wuhan and Changsha in 2H14 and one in Shanghai in 1H15.

Table 3: Major BDS projects

Project	Location	Developer
Commercial		
Hoi Bun Road Project	Kwun Tong	Wheelock Properties
Sha Tsui Road Project	Tsuen Wan	K. Wah Properties
Wong Chuk Hang Project	Aberdeen	K. Wah Properties
Cheung Shun Street Project	Cheung Sha Wan	Luk Yeung Restaurant
Jardine House	Central	Hong Kong Land
City Plaza Three & Four	Taikoo Shing	Swire Properties
Residential		
Mount Nicholson Road Project	The Peak	Wheelock Properties
Tseung Kwan O Project (Lot 119)	TKO	Wheelock Properties
Tseung Kwan O Project (Lot 115)	TKO	K. Wah Properties
Yuen Long Project	Yuen Long	K. Wah Properties
Tanner Hill Estate	North Point	HK Housing Society
Hotel		
New World Hotel	Tsim Sha Tsui	
Hotel Nikko Phase III	Tsim Sha Tsui	
Intercontinental Hotel	Tsim Sha Tsui	
Disneyland Hotel	Discovery Bay	
Others		
Jockey Club	Sha Tin	
Central Police Station	Sheung Wan	
Court of Final Appeal	Admiralty	
HK International Airport	Lantau Island	

Source: Company data

To expand its geographical reach

Under BDS, the end-users are predominantly the interior design companies, property developers, hotels and individual customers. Currently, they can be reached via three different channels: wholesale to sub-dealers, direct supply to projects and new A&D centre for retail business.

In addition to expanding its customer reach through the channels above, VSC is also eyeing on around 90 cities that can be its potential customers over the long term. VSC will also introduce more new brands at the same time; the company is in talks with potential international sanitary ware suppliers at present.

Revitalized management team to drive changes

The executive team has a nice blend of veterans and new blood amid the continuing leadership of Chairman Mr. Andrew Yao and the appointment of the new CEO Mr. Frank Munoz (who also acted as non-executive director before assuming the role of CEO). The team is the driving force of the recent structural improvements of the company

Mr. Andrew Yao, Chairman and Executive Director of VSC, joined in 1992 and has over 21 years of experience in steel distribution. He is responsible for the company's overall strategy. He is also Deputy of the 12th National People's Congress of People's Republic of China.

Mr. Frank Munoz, CEO and Executive Director of VSC, has over 25 years of experience in steel processing and distribution. He was former President & CEO of Ryerson China and President of Ryerson Asia, as well as former Chairman of Tata Ryerson India Limited. He is responsible for formulating the corporate strategy and team building among management.

FY14 Results Review

FY14 (year-end: March) net profit rose 45% y/y to HK\$104m on the back of a 2.4% increase in revenue. For the construction steel business in Hong Kong, despite a 11% y/y decline in blended ASP, volume grew 30% y/y to 301.8k tons. EBITDA margin decreased 0.9%-pt to 8% due to higher freight charges. For the surface critical steel coil in China, volume sold was down 14.3% y/y to 165.5k tons (as a result of a disposal of an unprofitable China steel subsidiary during restructuring) while blended ASP improved slightly by 3.4% y/y.

FY14 gross margin improve slightly by 0.2%-pt to 9.6% following a more streamlined operation. Net margin was up 0.8%-pt to 2.7% and dividend payout remains at 30%.

Table 4: FY14 results summary

Year-end March HK\$m	2013	2014
Total sales	3,761	3,849
As % of sales		
Steel distribution	74%	76%
Building and design solutions	13%	13%
Plastic resins	13%	11%
Property investment	0.9%	0.4%
Other operations		
Revenue	3,761	3,849
+/-	-15.2%	2.4%
Cost of sales	(3,406)	(3,479)
Gross profit	355	370
Gross margin	9.4%	9.6%
Selling and distribution expenses	(31)	(54)
General and administrative expenses	(207)	(288)
SG&A per sales	6.3%	8.9%
Other gains – net	1	13
Fair value gain on investment properties	0	73
Operating profit	117	114
+/-	450.8%	-2.5%
EBIT margin	3.1%	3.0%
Finance income	1	3
Finance costs	(21)	(37)
Share of profits of associates – net	4	70
Profit before income tax	101	149
Income tax (expense)/credit	(29)	(45)
Effective tax rate	29.1%	29.8%
After-tax profit	71	105
Non-controlling interest	0	(1)
Net profit attributable to shareholders	72	104
+/-	1039.6%	44.8%
Net margin	1.9%	2.7%

Source: Company data

Valuation and Risks

Valuation

There do not exist many close comparables to VSC in the HK-listed universe in terms of its business exposure, market capitalization and profitability. Companies in steel trading such as Burwill and Kai Yuan, or in building & design such as JF Household Furnishings were loss making in the last reported financial year.

For steel trading, VSC enjoys a higher ROE than Golik (13.9% vs 10.7%), while VSC is trading at a slightly lower PE of 5.4x (vs Golik's 6.2x). For building & design, VSC is trading at a much lower PE than E.Bon's 22x, which is understandable given the BDS business is still relatively small in the sales mix. We note the E.Bon's ROE in FY14 was only 2.8%.

We note that VSC's net gearing (or net debt to equity) is at around 154%, which is due to increase in trade finance for Hong Kong Steel in order to lock-in low-price inventory. Another reason for the high gearing is the syndicated loan raised for acquisition of Shanghai-based Central Park. Net gearing is expected to be moderately lower over time as the benefits of restructuring begin to surface.

Risks

- Unexpected slowdown in the construction industry in Hong Kong or automobile industry in China may potentially affect the size of demand for steel products.
- Demand for high-end sanitary and kitchen ware products could face keen competition from other foreign or domestic brands in mainland China.

Table 5: Peer comparison

Company	Code	Curr	Price*	Mkt cap (US\$ m)	PER (x) 13A	P/B (x) 13A	Yield (%) 13A	ROE (%) 13A	Net gearing (%) 13A
Steel Trading									
Van Shung Chong*	1001 HK	HKD	1.35	73	5.4	0.7	5.5	13.9	153.7
Golik Holdings	1118 HK	HKD	0.91	66	6.3	0.6	4.4	10.7	38.1
Burwill Holdings**	24 HK	HKD	0.265	157	NA	0.8	0.0	NA	40.8
Kai Yuan Holdings**	1215 HK	HKD	0.137	226	NA	0.6	0.0	NA	-4.2
Weighted-average						5.8	0.7	1.3	12.4
Building and Design Solutions									
Van Shung Chong	1001 HK	HKD	1.35	73	5.4	0.7	5.5	13.9	153.7
E. Bon*	599 HK	HKD	0.66	26	22.0	0.6	4.5	2.8	6.2
JF Household Furnishings**	776 HK	HKD	14.24	528	NA	NA	0.0	NA	92.6
						9.7	0.7	0.8	11.0

Source: Bloomberg.

*Year end is Dec 31, except for VSC and E.Bon which both ended on Mar 31.

Hence, FY14 data from VSC and E.Bon are displayed under the 2013 actual data.

**These companies are loss making in their last reported financial year.

COMPANY DESCRIPTION

Van Shung Chong Holdings Limited is a leading distributor of construction steel products serving Hong Kong's construction market with a market share of around 30%. The company is also a major distributor of international sanitary and kitchen ware products, carrying reputable brands such as TOTO and BAGNODESIGN. It also invests in properties and operates finance businesses.

Profit & Loss (Consolidated)

FY-end 31 Mar (HK\$ m)	2010	2011	2012	2013	2014
Sales	3,252	4,208	4,432	3,761	3,849
Cost of sales	(2,953)	(4,019)	(4,261)	(3,406)	(3,479)
Gross profit	298	189	171	355	370
Other income	5	44	47	1	13
Operating expenses	(167)	(164)	(197)	(238)	(342)
Operating profit	136	70	21	117	114
Finance cost, net	(19)	(23)	(24)	(20)	(35)
Share of P/L of assoc. & JCE	(13)	7	8	4	70
Pre-tax profit	105	53	6	101	149
Tax	(22)	(14)	5	(29)	(45)
Minorities	(7)	(8)	(5)	0	(1)
Net profit	75	31	6	72	104
EBITDA	143	77	29	124	120
EBIT	136	70	21	117	114
EPS (HK\$)	0.19	0.07	0.02	0.17	0.25
DPS (HK\$)	0.06	0.02	0.02	0.05	0.07

Source: Company, CER estimates

Cash Flow (Consolidated)

FY-end 31 Mar (HK\$ m)	2010	2011	2012	2013	2014
Operating cash flow	146	15	(169)	274	(192)
Net profit	75	31	6	72	104
Depreciation & amortization	7	7	7	6	6
Change in working capital	17	36	(264)	216	(96)
Others	47	(59)	81	(20)	(205)
Investment cash flow	19	126	(5)	(38)	(886)
Net Capex	(8)	(2)	(6)	(24)	(5)
Disposal	0	0	0	1	0
Change in LT investment	26	125	0	(5)	(881)
Change in other assets	0	2	1	(10)	0
Free cash flow	164	141	(174)	236	(1,078)
Financing cash flow	(105)	180	(47)	(43)	986
Change in share capital	16	0	0	11	(1)
Net change in debt	(33)	18	(69)	(17)	670
Dividend paid	(13)	(22)	(9)	(18)	(26)
Net impact of exchange fluctuation	1	4	3	0	2
Net cash flow	59	321	(221)	193	(92)

Source: Company, CER estimates

Balance Sheet (Consolidated)

FY-end 31 Mar (HK\$ m)	2010	2011	2012	2013	2014
Total assets	1,444	1,838	1,790	1,779	2,653
Current assets	1,130	1,599	1,529	1,510	1,256
Cash & ST investments	161	486	267	460	371
Marketable securities & ST inv	0	0	0	0	0
Account & notes receivable	410	497	564	423	405
Inventories	246	390	397	366	333
Others	314	226	301	260	147
Non-current assets	314	239	261	269	1,397
LT investments	256	176	192	205	1,243
Net fixed assets	21	16	15	15	15
Others	36	47	54	50	139
Total liabilities	793	1,160	1,098	1,029	1,871
Current liabilities	789	1,159	1,097	1,028	1,197
Account payable	247	314	340	340	80
ST borrowings	410	600	654	581	1,010
Others	131	245	103	107	107
Non-current liabilities	4	2	1	1	674
Long-term debts	4	0	0	0	562
Others	0	2	1	1	112
Total equities	651	678	692	750	782
Shareholders' equity	621	645	659	715	781
Minority shareholders	30	33	33	35	0
Total liabilities + SH equities	1,444	1,838	1,790	1,779	2,653
Net cash / (debt)	(414)	(600)	(654)	(581)	(1,572)
Working capital	590	555	818	602	698
Total capital employed	1,065	1,278	1,346	1,331	2,353
Shareholders' equity + Minorities	651	678	692	750	782
Net gearing (%)	40.8	17.7	58.6	16.9	153.7

Source: Company, CER estimates

Financial Summary

FY-end 31 Mar	2010	2011	2012	2013	2014
Growth (%)					
Revenue	-30.2	29.4	5.3	-15.2	2.4
EBITDA	NA	-46.5	-62.6	330.9	-2.8
EBIT	NA	-49.0	-69.4	450.8	-2.5
Net profit	NA	-58.7	-79.8	1,039.6	44.8
EPS	NA	-60.0	-79.8	1040.0	44.1
Margins (%)					
Gross	9.2	4.5	3.9	9.4	9.6
EBITDA	4.4	1.8	0.6	3.3	3.1
EBIT	4.2	1.7	0.5	3.1	3.0
Net	2.3	0.7	0.1	1.9	2.7
Others (%)					
Effective tax rate	21.3	26.5	-79.0	29.1	29.8
Payout ratio	29.7	25.4	118.6	30.1	30.0
RoCE	12.1	4.8	1.0	10.0	13.3
Average RoE	13.0	4.9	1.0	10.4	13.9
Average RoA	5.6	1.9	0.3	4.0	4.7
Interest cover (x)	7.3	3.0	0.9	5.8	3.3

Source: Company, CER estimates

Everbright Research Limited Rating System

Buy	Expected to outperform the benchmark index by >15% over the next six months
Accumulate	Expected to outperform the benchmark index by 5 - 15% over the next six months
Hold	Expected to outperform or underperform the benchmark index by <5% over the next six months
Reduce	Expected to underperform the benchmark index by 5 - 15% over the next six months
Sell	Expected to underperform the benchmark index by >15% over the next six months

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Address: 17/F., Far East Finance Center, No. 16 Harcourt Road, Hong Kong.
Contact No.: (852) 2860-1101