HOA SEN GROUP (HSG VN)

BUY – TARGET PRICE VND39,000

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Massive capacity expansion that is credible

We are initiating coverage on Hoa Sen Group (HOSE:HSG), a steel company with the third highest market cap in its sector. Our valuation approach is based on the combination of multiples and discounted cash flow (DCF), targeting one-year price for HSG at VND39,000 (USD2.0), 65% above today's price. Our earnings forecast puts it has a 2010 PER of 5.9x, a 27% discount to the Vietnam steel average of 8.1x and 76% lower than its regional peers' 25.5x. Its 2010 PBR of 1.2x is a c. 30% discount to domestic and regional peers' 1.7-1.8x. Perhaps big bonus share issues so far this year ("dividends", totalling 2 new for 5 held) provide a "retail" explanation for this discount; more fundamentally, steel has had a tough few months of weak prices during 2Q (down c. 25%) and now the low rainy season.

HSG's main business (81% of sales) is flat steel, for which domestic production capacity can meet only 18% of domestic consumption at present. In 2009, HSG's steel sheets had a 29% market share in Vietnam (up to 34% in 5M2010). HSG's key advantage in this sector lies in its integrated production line. The raw material required is hot rolled coil (HRC), which is transformed to cold rolled coil (CRC) and then the final products. For HRC, Vietnam has to import 100% and for CRC, there have been only two domestic enterprises capable of manufacturing this product - HSG and unlisted Phu My Flat Steel (the same as HSG's size). At its current CRC capacity, HSG is able to internally source c. 60% of its CRC needs, and as its big new factory – representing a more than quadrupling of HSG's existing capacity - progressively reaches full operation by 2013, this ratio will rise to 100% and even allow CRC sales to external parties.

Sales from its own branches make up 66% of total sales, and its branch numbers will grow by 8% a year to 150 by 2015. This strong distribution network will make the ramping up of demand for its increasing production feasible, and also enables greater flexibility in its operations in response to changing market conditions. We like HSG management's plan to cover the whole process all the way from in-house CRC supply to directly delivering finished goods to customers in order to capture the fullest margin.

As for any steel company, we must acknowledge the vicissitudes of the steel market, both domestically and globally, which makes for uncertain and volatile pricing.

For the period 2010-13, we forecast that HSG will be able to achieve annual sales growth of 40% driven by sales from the new factory together with the growing distribution network. 2010 ROE and ROA are respectively estimated at 26% and 18%, levels that should rise in the coming years.

	2008	2009	2010E	2011E	2012E	2013E
Sales (VND bn)	2,716	3,262	4,657	7,346	10,463	13,160
EBITDA (VND bn)	343	757	1,014	1,617	2,448	3,042
Net income (VND bn)	82	460	401	835	1,473	2,003
Sales growth (%)	34.7%	20.1%	42.8%	57.7%	42.4%	25.8%
Net income growth (%)	-45.7%	460.0%	-12.8%	108.2%	76.3%	36.0%
ROE (%)	11.5%	51.2%	26.5%	35.6%	42.1%	38.2%
ROA (%)	13.8%	26.0%	18.5%	22.6%	26.2%	26.7%
EPS (VND)	1,439	8,062	3,999	6,405	8,688	9,091
BVPS (VND)	12,273	19,231	19,248	21,211	25,004	28,325
PER (x)	16.4	2.9	5.9	3.7	2.7	2.6
PBR (x)	1.9	1.2	1.2	1.1	0.9	0.8
EV/Sales (x)	1.2	1.3	1.0	0.8	0.6	0.4

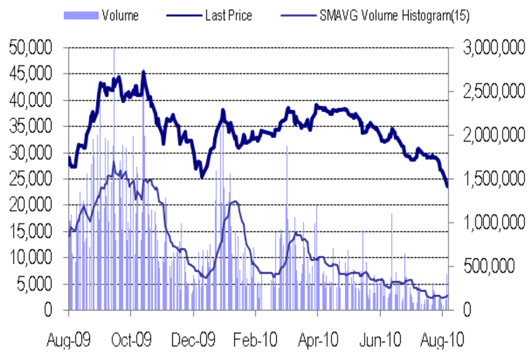
Source: HSG, Mekong Securities

Company Coverage

Recommendation: BUY	
	HOSE: HSG
	Steel sector
Price (VND)	**23,600**
Price target (VND)	**39,000**
Expected share price return (%)	65.5%
Expected dividend yield (%)	0.00%
Expected total return (%)	**65.5%**

Stock performance (%)	YTD	1m	3m	12m
Abs	-34%	-19%	-37%	-19%
Rel	-26%	-13%	-27%	-13%

Source: Bloomberg



Ownership Structure	11-Aug-10
Chairman	38.7%
Foreigners	19.1%
Others	42.2%

Stock Statistics	11-Aug-10
Bloomberg code	HSG VN
52-week range (VND)	23,600- 45,500
Shares O/S (m)	100
Mkt cap (VND bn)	2,367
Mkt cap (USD m)	142
Foreign room (%)	21.8%
Est. free float (m)	62
3m avg daily vol (shrs)	265,000
VND/USD	19,100
Index: VNIndex / HNX	463/139

Source: Bloomberg

HOA SEN - PHU MY PLANT

According to Vietnam Steel Association (VSA), domestic flat steel manufacturing for 2010 (1.1m tonnes; including HRC, CRC and steel sheets) can only meet 20% of total domestic consumption (6.0m tonnes), which has encouraged HSG to expand its current plant. Though industry capacity expansion plans for HRC and CRC seem to be aggressive, the feasibility of huge plants remains a big question. Three big projects for HRC might be halted by the Ministry of Trade and Industry (Ha Tinh Steel Complex – 4m tonnes/year, ESSAR VSC – 2m tonnes/year, Ca Na Ninh Thuan Steel Complex – 4.5m tonnes/year). Confirmed capacity expansion plans for HRC and CRC are as follows:

Table 1: Plants for CRC and HRC

	CRC	Capacity (tonnes/year)	HRC	Capacity (tonnes/year)
Current plants	Hoa Sen	180,000	Cai Lan Vinashin (for shipping industry only)	500,000
	Phu My Flat Steel	205,000		
	Posco Vietnam	1,200,000		
Coming plants	Hoa Sen (estimated)	600,000	Posco Vietnam	3,000,000
	Formosa Steel	120,000	VN Steel	2,000,000
	Sun Steel	120,000	Quang Ngai - Dung Quat	3,000,000
	Bach Dang	200,000		

Source: Decision 145/2007/QD-TTg, Mekong Securities

HSG's Hoa Sen - Phu My plant is expected to come into full operation in 2013, which comprises an integrated system for steel sheet production with value added services. Design capacity of this plant reaches 1,000,000 tonnes annually for CRC and 830,000 tonnes annually for various kinds of coated steel sheets (compared to current designed capacity of the existing plant in Binh Duong Province of 180,000 tonnes and 340,000 tonnes respectively). On a conservative perspective based on steel sheet demand and supply, we assume that utilization rate for steel sheets production is 50% and three production lines of CRC (200,000 tonnes/each) will be installed instead of five as planned. Regarding project financing, due to lack of data availability, we assume that financing by debt and equity is of equal proportion, with 100% of earnings in the coming three years being retained for the capex programme.

Table 2: Our financial assumptions on the new Hoa Sen – Phu My plant

	2010e	2011e	2012e	2013e
Net revenue	916,500	3,252,375	5,329,209	7,605,596
COGS	751,530	2,569,376	4,103,491	5,856,309
Gross Profit	164,970	682,999	1,225,718	1,749,287
S&A Expense	67,821	240,676	394,361	562,814
EBIT	**97,149**	**442,323**	**831,357**	**1,186,473**
% margin	11%	14%	16%	16%
Depreciation	132,900	217,440	301,980	386,520
EBITDA	**230,049**	**659,763**	**1,133,337**	**1,572,993**
Interest cost	42,270	42,270	42,270	42,270
Pre-tax income	54,879	400,053	789,087	1,144,203
Income tax	-	-	-	85,815
Net income	**54,879**	**400,053**	**789,087**	**1,058,388**
Financing				
Capex	704,500	704,500	704,500	704,500
Internal sources	352,250	352,250	352,250	352,250
New debt	352,250	352,250	352,250	352,250
ROE	10%	44%	63%	66%
ROIC	5%	22%	31%	33%

A "Porter 5" Analysis of HSG

Entry and exit barriers

In order to limit the overheated investment in the Vietnamese steel industry recently, the Ministry of Industry & Trade (MIT) has halted some ongoing steel projects deemed to be infeasible as well as withdrawn licenses of delayed ones. Entry barrier for a steel project is considered high because of the large amount of capital required (average of $12m for a 200,000-tonne CRC production line) together with fixed minimum designed capacity. Exit barriers for this industry, however, are high as well. Because plant and equipment required for manufacturing steel sheet are highly specialized, these assets cannot be easily sold to other industries. As a result, high exit barriers tend to hurt sector players like HSG when there is an imbalance between supply and demand (and when production is therefore well under capacity).

Supplier bargaining power

HSG imports HRC from big and prestigious suppliers mainly from Japan, Taiwan, and China (namely Shang-shing, Nippon Steel and BaoSteel). Supply for HRC is sufficient and stable whereas there is not much difference in quality, branding position and pricing policy among these suppliers. As a result, HSG can enjoy a wide variety of choices for suppliers. An unavoidable concern is that spot contracts signed with these partners depend on the movement of global steel prices, which can place HSG at mercy of high fluctuations in steel prices. HSG does not hedge its HRC or CRC purchases and has no plans to do so.

Customer bargaining power

The main client group of HSG at the moment is individual contractors, especially in suburban areas, which are less vulnerable to changes in prices than contracts for big construction sites. Moreover, their bargaining power is low. However, as steel products are becoming more standardized, individual customers have the power of switching to another brand without much switching cost. In order to give customers the best service and increase market share, HSG is continuously expanding its distribution network annually to take it closer to its customers. However, it is worth considering that HSG should diversify its targeted group of customers to big projects given that annual construction growth in Vietnam is set to be a rapid double-digit pace (in 1H2010, construction spending increased 27% YoY). HSG also plans to increase its export share to 20%-30% of total sales to avoid the risk of imbalance between steel supply and demand when many other big flat steel projects come into operation.

Threat of substitutes

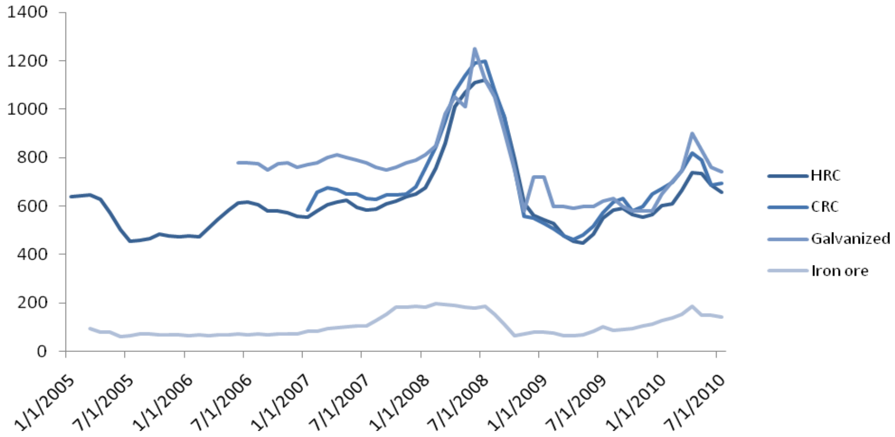
Coated steel sheets are of various usages in civil and industrial construction such as roofing systems, walling, doors, household appliances, etc. The main substitute for coated steel sheet is asbestos sheet. Coated steel sheet is favoured because of its better longevity, fire resistance, no health hazard, lightness (which means saving on structural cost), easiness for handling and fixing; whereas asbestos sheet is easily breakable, health hazardous, heavier and mediocre in fire resistance. Another kind of substitute for coated steel sheet is tile roofing. Tile roofing is sometimes preferred for its durability, aesthetics and heat reduction yet its cost is nearly double that of coated steel sheet. As a result, coated steel sheet seems to be a perfect and affordable choice for most customers.

Competitive rivalry within industry

Coated steel sheet accounted for 81% of 2009 HSG sales and nationwide market share of HSG in this category has increased from 29% in 2009 to 34% in 2010-to-date, far over that of its competitors. Together with HSG's strong strategy in brand positioning and branch expansion, we believe that market share of HSG will keep stable or rise further. Moreover, HSG is also a pioneer in technology innovation, evidenced by its newly installed hot dip galvanized steel sheet (HGI) and zinc aluminum alloy coated steel sheet (NOF), the first ever in Vietnam. These production lines help to deliver more durable and higher quality products at lower cost.

Global Steel Prices

Table 3: Global Steel Prices (USD/tonne), 2005-10



Source: Bloomberg, Mekong Securities

Steel prices have slightly increased since the beginning of 2009 when the global economy began to tentatively emerge from recession, and it is estimated that in the coming years steel prices will gradually recover thanks to increasing demand in construction and infrastructure, especially in developing countries. Moreover, the fact that China (which takes up of 30% of global steel consumption) has decided to reduce export subsidies for steel, together with the estimated rise of 30% in the forthcoming quarterly price negotiations for iron ore, could both point to forthcoming higher steel prices. The annual growth rate of steel prices globally since 2002 has averaged about 10%; based on a conservative perspective and cautious recovery of the world economy, we think that steel prices could rise at annual average of perhaps 5% over the next few years. However, such averages over the long term are typically achieved with much more volatile shorter term price progression.

Financials

HSG FINANCIALS MODEL	Price (VND):	23,600	Target (VND):	32,139	Mkt cap:	2,367,080	BUY		
Analyst	Duong Pham								
(VND mil except where stated)	2005	2006	2007	2008	2009	2010e	2011e	2012e	2013e
Steel sheet						4,656,225	7,345,433	10,461,540	13,158,492
Steel pipe						572	715	858	858
Plastic pipe and others						196	245	245	245
Total Net Sales	**749,774**	**1,111,197**	**2,015,691**	**2,715,755**	**3,261,921**	**4,656,993**	**7,346,393**	**10,462,643**	**13,159,738**
Sales growth (%)		*48.2%*	*81.4%*	*34.7%*	*20.1%*	*42.8%*	*57.7%*	*42.4%*	*25.8%*
CoGS ex-dep'n	672,236	912,069	1,619,538	2,141,604	2,267,734	3,298,114	5,186,177	7,240,873	9,143,712
Gross profit	67,549	185,766	350,755	481,598	881,431	1,071,108	1,763,134	2,720,287	3,421,532
Gross profit margin (%)	*9.0%*	*16.7%*	*17.4%*	*17.7%*	*27.0%*	*23.0%*	*24.0%*	*26.0%*	*26.0%*
SG&A	31,380	58,588	135,337	231,493	237,368	344,617	543,633	774,236	973,821
SG&A as % of sales	*4.2%*	*5.3%*	*6.7%*	*8.5%*	*7.3%*	*7.4%*	*7.4%*	*7.4%*	*7.4%*
EBITDA	**46,158**	**140,539**	**260,816**	**342,658**	**756,819**	**1,014,261**	**1,616,583**	**2,447,534**	**3,042,206**
EBITDA margin (%)	*6.2%*	*12.6%*	*12.9%*	*12.6%*	*23.2%*	*21.8%*	*22.0%*	*23.4%*	*23.1%*
EBITDA growth rate (%)		*204.5%*	*85.6%*	*31.4%*	*120.9%*	*34.0%*	*59.4%*	*51.4%*	*24.3%*
Depreciation	9,989	13,361	45,399	92,554	112,756	287,770	397,081	501,482	594,494
Bad debt provs, other costs (net)	0	0	0	0	0	0	0	0	0
Other Income (net)	340	4,337	(3,775)	(2,359)	16,591	15,000	90,000	75,000	75,000
Operating profit	**36,510**	**131,514**	**211,642**	**247,746**	**660,653**	**741,491**	**1,309,501**	**2,021,052**	**2,522,711**
Operating profit margin (%)	*4.9%*	*11.8%*	*10.5%*	*9.1%*	*20.3%*	*15.9%*	*17.8%*	*19.3%*	*19.2%*

Finance Income, net	(1,694)	(2,492)	7,565	(42,232)	(101,422)	-	-	-	-
Net interest expenses	15,369	20,131	51,689	109,267	73,681	307,909	406,675	429,035	356,893
Interest as % of avg net debt	*10.6%*	*7.0%*	*8.5%*	*12.3%*	*5.4%*	*14.9%*	*14.1%*	*12.5%*	*11.2%*
Interest cover (x)	*2.4*	*6.5*	*4.1*	*2.3*	*9.0*	*2.4*	*3.2*	*4.7*	*7.1*
Tax	-	4,310	16,395	14,142	25,733	32,519	67,712	119,401	162,436
Effective tax rate (%)	*0.00%*	*3.96%*	*9.79%*	*14.69%*	*5.30%*	*7.50%*	*7.50%*	*7.50%*	*7.50%*
Minorities	0	0	0	0	0	0	0	0	0
Net profit	**19,447**	**104,582**	**151,123**	**82,104**	**459,817**	**401,064**	**835,114**	**1,472,615**	**2,003,382**
Cash earnings	29,436	117,943	196,522	174,658	572,573	688,834	1,232,195	1,974,098	2,597,876
Number of shares (m)	12	25	57	57	57	100	130	170	220
EPS (VND)	**1,621**	**4,127**	**2,649**	**1,439**	**8,062**	**3,999**	**6,405**	**8,688**	**9,091**
EPS growth (%)		*154.7%*	*-35.8%*	*-45.7%*	*460.0%*	*-50.4%*	*60.2%*	*35.6%*	*4.6%*
Cash EPS (VND)	2,453	4,654	3,445	3,062	10,038	6,868	9,450	11,646	11,789

Key cashflow and balance sheet items	**2005**	**2006**	**2007**	**2008**	**2009**	**2010e**	**2011e**	**2012e**	**2013e**
Increase in working capital		-39,984	209,004	-247,092	60,125	579,364	1,035,669	1,132,059	998,225
Capex inc acquisitions		300,325	460,280	245,285	636,621	1,250,690	1,093,110	1,044,010	930,120
Other cashflow items		0	0	0	0	0	0	0	0
Free cash flow	**29,436**	**(142,397)**	**(472,763)**	**176,465**	**(124,173)**	**(1,141,220)**	**(896,584)**	**(201,971)**	**669,532**
Share issues (m)		133,400	316,985	0	0	432,615	0	0	0
Dividends paid	(23,514)	(124,510)	(87,617)	(117,630)	(88)	0	0	0	0
Increase in net debt		133,507	243,395	-58,835	124,260	708,605	896,584	201,971	-669,532
Net debt, end of year	**144,524**	**433,633**	**784,576**	**990,886**	**1,718,919**	**2,427,524**	**3,324,108**	**3,526,080**	**2,856,548**
Enterprise value	2,511,604	2,800,713	3,151,656	3,357,966	4,085,999	4,794,604	5,691,188	5,893,160	5,223,628
Shareholders' equity	**133,893**	**261,416**	**723,355**	**700,017**	**1,096,919**	**1,930,597**	**2,765,711**	**4,238,327**	**6,241,709**
BVPS (VND)	11,158	10,316	12,682	12,273	19,231	19,248	21,211	25,004	28,325

Net debt / equity (%)	*107.9%*	*165.9%*	*108.5%*	*141.6%*	*156.7%*	*125.7%*	*120.2%*	*83.2%*	*45.8%*
Net debt / EBITDA (x)	*3.1*	*3.1*	*3.0*	*2.9*	*2.3*	*2.4*	*2.1*	*1.4*	*0.9*
Total assets	**372,301**	**818,571**	**1,698,368**	**1,889,075**	**3,191,362**	**4,837,658**	**6,769,303**	**8,664,296**	**10,210,545**

Key return and valuation ratios	**2005**	**2006**	**2007**	**2008**	**2009**	**2010e**	**2011e**	**2012e**	**2013e**
ROE (%)	*14.5%*	*52.9%*	*30.7%*	*11.5%*	*51.2%*	*26.5%*	*35.6%*	*42.1%*	*38.2%*
ROA (%)	*9.8%*	*22.1%*	*16.8%*	*13.8%*	*26.0%*	*18.5%*	*22.6%*	*26.2%*	*26.7%*
ROIC (%)	*5.2%*	*12.9%*	*9.2%*	*5.2%*	*14.5%*	*14.2%*	*17.9%*	*21.6%*	*22.9%*
WACC (%)	*14.0%*	*13.7%*	*14.6%*	*14.1%*	*13.9%*	*14.3%*	*14.4%*	*15.1%*	*16.1%*
EVA (%)	*-8.8%*	*-0.9%*	*-5.4%*	*-8.9%*	*0.7%*	*-0.1%*	*3.5%*	*6.5%*	*6.7%*
PER (x)	*14.6*	*5.7*	*8.9*	*16.4*	*2.9*	*5.9*	*3.7*	*2.7*	*2.6*
EV/EBITDA (x)	*54.4*	*19.9*	*12.1*	*9.8*	*5.4*	*4.7*	*3.5*	*2.4*	*1.7*
EV/FCF (x)	*85.3*	*-19.7*	*-6.7*	*19.0*	*-32.9*	*-4.2*	*-6.3*	*-29.2*	*7.8*
PBR (x)	*2.1*	*2.3*	*1.9*	*1.9*	*1.2*	*1.2*	*1.1*	*0.9*	*0.8*
PSR (x)	*3.2*	*2.1*	*1.2*	*0.9*	*0.7*	*0.5*	*0.3*	*0.2*	*0.2*
EV/sales (x)	*3.3*	*2.5*	*1.6*	*1.2*	*1.3*	*1.0*	*0.8*	*0.6*	*0.4*
NOPAT	36,510	126,309	190,928	211,343	625,641	685,879	1,211,289	1,869,473	2,333,508

DCF Financial model	2005	2006	2007	2008	2009	2010e	2011e	2012e	2013e
FCF	46,498	(120,670)	(432,958)	305,704	41,651	(856,405)	(520,409)	194,886	999,657
Discount factor						1.00	1.14	1.32	1.53
Present value of given year's FCF						(856,405)	(454,830)	147,975	653,555
PV of FCF 2010-14						(509,705)			
Terminal growth rate						5%			
PV of terminal value						6,160,751			
DCF valuation per share (VND)						32,139			

Sensitivity Analysis

Terminal Growth Rate/Cost of Equity	3%	4%	5%	6%	7%
20.50%	15,500	19,400	23,800	28,900	35,100
19.50%	18,500	22,700	27,700	33,600	40,600
18.50%	21,800	26,500	32,000	38,800	47,000
17.50%	25,400	30,700	37,100	44,800	54,300
16.50%	29,500	35,500	42,800	51,800	63,000

Mekong Securities' Rating System

We currently use a three-tier recommendation system for the stocks in our formal coverage: BUY, HOLD, or SELL.

A **BUY** is applied when the expected total return over the next twelve months is at least 10%.
A **HOLD** is applied when the expected total return over the next twelve months ranges between -10% to 10%.
A **SELL** is applied when the expected total return over the next twelve months is -10% or worse.
These benchmarks are subject to change.

Expected Total Return (12 months) = [(Target Price - Current Price)/Current Price] + Forecast 12-month Dividend Yield.

Our Analyst's Methodology

Target price and expected total return
Initially, an analyst derives an expected 12-month target price using multiple valuation methodologies. Different valuation methods have been used, including, but not limited to, discounted free cash-flow and comparative analysis. The selection of methods depends on the industry, the company, the nature of the stock and other circumstances. Company valuations are based on a single or a combination of one of the following valuation methods: 1) **Multiple-based models** (P/E, P/cash flow, EV/sales, EV/EBIT, EV/EBITA, EV/EBITDA), peer-group comparisons, and historical valuation approaches; 2) **Discount models** (DCF, DVMA, DDM); 3) **Break-up value approaches** or asset-based evaluation methods; and 4) **Economic profit approaches** (Residual Income, EVA).

Valuation models are dependent on macroeconomic factors, such as GDP growth, interest rates, exchange rates, raw materials, on other assumptions about the economy, as well as risks inherent to the company under review. Furthermore, market sentiment may affect the valuation of companies. Valuations are also based on expectations that might change rapidly and without notice, depending on developments specific to individual industries.

Once analysts derive a risk-adjusted valuation for a company under review, its current market price is then compared with the target price to calculate an expected gain or loss. The one-year projected dividend yield, if any, is then added to the expected gain or loss to calculate an expected total return.

Disclaimer

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