KGI CHINA DEVELOPMENT FINANCIAL

China Sunsine Chemical Holdings Ltd (CSSC SP/CSSC.SI)

Accumulate at the trough

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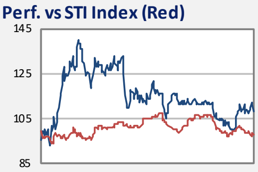
- We re-initiate with an OUTPERFORM rating. Our target price of S$1.40 is based on DCF model and an 11.6% required rate of return.
- We visited Sunsine's new insoluble sulphur production line located at Dingtao, Shang dong province, in addition to visiting its headquarters and the main plants at Shanxian, Shangdong. We observed that all the plants were running optimally.

Outperform - Re-initiation			
Price as of 10 Oct 19 (SGD)	1.09	**Performance (Absolute)**	
12M TP (S$)	1.40	1 Month (%)	3.8
Previous TP (S$)	-	3 Month (%)	0.0
Upside (%)	28.4	12 Month (%)	13.2
Trading data		**Perf. vs STI Index (Red)**	
Mkt Cap ($mn)	532		
Issued Shares (mn)	488		
Vol - 3M Daily avg (mn)	0.2		
Val - 3M Daily avg ($mn)	0.3		
Free Float (%)	38.0%		
Major Shareholders		**Previous Recommendations**	
Success More Group	60.1%		
Dimensional Fund Advisor	1.4%		



Financials & Key Operating Statistics

YE Dec (RMB m)	FY17	FY18	FY19e	FY20e	FY21e
Revenue	1695.9	3283.3	2925.0	3170.4	3569.1
PATMI	341.3	641.3	495.5	536.2	495.7
Core PATMI	341.3	593.3	495.5	536.2	495.7
Core EPS (RMB cents)	70.8	120.7	101.5	109.8	101.5
Core EPS grth (%)	48.6	70.4	-15.9	8.2	-7.5
Core P/E (x)	8.1	4.7	5.6	5.2	5.6
DPS (SGCents)	3.0	5.5	4.1	4.4	4.1
Div Yield (%)	2.7	4.9	3.6	3.9	3.6
Net Margin (%)	12.5	19.5	16.9	16.9	13.9
Gearing (%)	Net cash	Net cash	Net cash	Net cash	Net cash
Price / Earnings (x)	8.1	4.7	5.6	5.2	5.6
Price / Book (x)	10.2	4.8	5.3	4.6	4.1
ROE (%)	19.6	27.6	18.6	17.3	14.2

Source: Company Data, KGI Research

Benefiting from the long-term market consolidation. China accounts for 76% of the global rubber chemical production. In 2018, 47 producers supplied 90% of the output to China's market. China's industrial policies continue to promote market consolidation. We thus expect Sunsine, the largest rubber chemical producer in China, to benefit from the ongoing market trend.

High entry barriers reinforce segment integration. Branding recognition in the industry is important in establishing long-term and robust supply and trading relationships with the downstream customers. Furthermore, China's prolonged tightened domestic environmental protection policies have eliminated many companies who fail to meet the required criteria. Meanwhile, banks continue to restrict loans to the chemical industry, especially for capacity expansion.

Raw material prices at the cyclical bottom. The average selling price (ASP) of aniline collapsed after June 2018 and has reached a cyclical low. As a result, this has negatively impacted aniline producers who have high production costs, with many of them reporting thin margins or are even loss-making.

Sunsine has been improving its profitability. Historically, the company has managed to deliver stable profit margins of 20%+ GPM and 10%+ NPM on average. Over the past two years, its GPM and NPM improved to above 30% and 15% respectively. We expect Sunsine to further enhance its profitability given its dedicated environmental protection commitment and cost optimisation.

Clean balance sheet with a strong net cash position. Sunsine has managed to operate without debt since 4Q16. Moreover, its cash on hand reached RMB1.0bn in 2016, and most recently RMB1.17bn as of June 2019, equivalent to RMB2.39/share or S$0.46/share. Sunsine's strong net cash position is an additional competitive advantage, enabling the company to further gain market share by expanding its capacity at its own discretion, and mitigating any pressure from a potential liquidity crunch in the event of a market downturn.

Preparing for capacity expansion in the near term. The government has approved Sunsine's plans to add to another 20k tonnes of TBBS (Phase II) production, which is expected to be installed by the end of 2020. In addition, the company plans to acquire 680 mu of land, equivalent to 453.3k m^2, in the Shanxian Chemical Zone for future expansion. About 300 mu of this new land purchase, or an equivalent 200k m^2, is scheduled for another 60k tonnes of insoluble sulphur production lines.

Valuation & Action: Sunsine is currently trading at 5.6x 2019E PE, which we believe undervalues the group's dominant position and growth prospects. We expect Sunsine's performance to bottom out in 2020 as it continually increases its capacity and as ASPs recover. We re-initiate with an OUTPERFORM rating. Our target price of S$1.40 is based on DCF model with a required rate of return of 11.6%.

Risks: Main risks come from: 1) prolonged environment of low ASPs for both raw materials and end products, 2) unexpected surge of industry capacity in the short-term, and 3) an environmental protection inspection at the company that could result in a temporary reduction of utilisation rates.

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Company overview

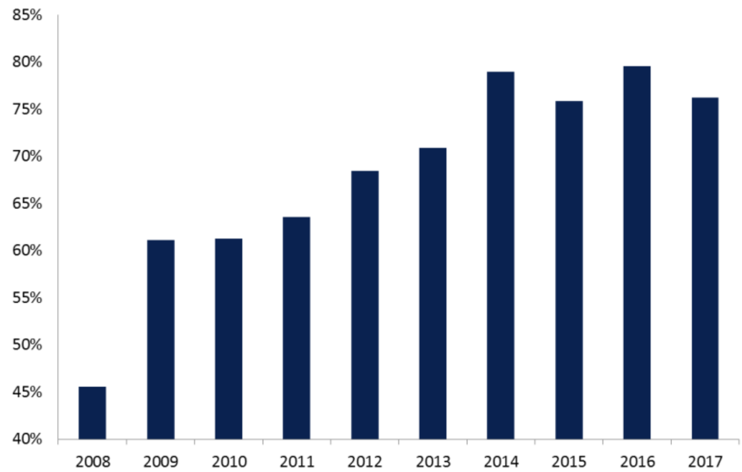
China Sunsine Chemical Holdings Ltd. (Sunsine) is a leading specialty chemical producer. It is the largest producer of rubber accelerators in the world and the largest producer of insoluble sulphur in the People's Republic of China.

- The production plants are located at Shangxian, Weifang, and Dingtao in Shangdong Province.
- As of December 2018, the overall capacity was at 172k tonnes, comprising 97k tonnes of rubber accelerators, 30k tonnes of insoluble sulphur, and 45k tonnes of anti-oxidant.
- It has more than 1,000 clients, majority of whom are tyre manufacturers. Currently, Sunsine is supplying two thirds of the global top 75 tyre makers such as Bridgestone, Michelin, Goodyear and Pirelli.

Investment thesis

A market leader benefiting from the long-term industry consolidation. China has been dominating the rubber chemical market in terms of production since 2009. In 2017, they were responsible for 76% of the 16mn tonnes of total global production, the other 24% coming from several major international players namely Flexsys, Lanxess, Agrofert Holding, Nocil, and Kumho Petrochemical. The near-reliance on China's supply has been due mainly to the improvement of clean production technology and synthesis technique, enhancement of product varieties, and proper establishment and standardisation of enterprise and production management.

Figure 1: China's market share of the global rubber chemical industry



Source: China rubber industry yearbook 2017-2018, KGI Research

According to the Rubber Industry Association Rubber Chemical Commission of the PRC, 47 members accounted for more than 90% of the production in the industry as of 2018. In terms of sales, 66.8% came from the top 10 producers, and 84.5% came from the top 20. In terms of production volume, 61.9% and 80.4% was from the top 10 and top 20 respectively. Therefore, the rubber chemical industry has significantly consolidated due mainly to the establishment of the new Environmental Protection Act in 2015. Small and medium producers with obsolete production techniques, singular product mix, and without standardised waste processing facilities have been phased out, benefiting market leaders.

The rubber chemical segment integration fits the national strategic purpose; hence, the central government will continue to maintain the current market status moving forward. In October 2014, the Rubber Industry Power Strategy forecasted total production and sales of 15mn tonnes (7% CAGR) and more than RMB25bn (6% CAGR) by the end of the 13th-Five-Year Plan (2015-2020); the figures are expected to grow to 20mn tonnes and more than RMB30bn by the end of the 14th-Five-Year Plan (2021-2025). Meanwhile, the segment integration (percentage of sales from the top 10 producers) will reach at least 70% and more than 3 enterprises with RMB2bn of sales will become the top 5 global producers by the end of the 13th-Five-Year Plan; the figures are targeted to increase to 80% and 4 respectively by the end of the 14th-Five-Plan.

Therefore, Sunsine takes a dominating role in the industry that controls the major supply globally, with the largest production scale and a relatively complete product mix.

Figure 2: Top 10 rubber chemical producers in China (as of Dec-18)

Name	Sales (RMB bn)	Production ('000 tonnes)
China Sunsine Chemical	3.5	154.0
Sennics	2.9	138.0
Yanggu Huatai Chemical	2.1	95.0
Kemai Chemical	2.1	80.0
Red Avenue New Materials	2.0	96.0
Hongsheng Chemical	1.3	12.5
Willing New Materials Technology	1.1	43.0
Stair Chemical & Technology	0.8	36.0
Sinopec Nanjing Chemical Industries	0.7	49.0
Chinasun Specialty Products	0.7	22.0

Source: rubberchem.com.cn, KGI Research

Figure 3: Ranking by product breakdown (as of Dec-18)

Rank	Rubber Accelerator	Anti-oxidant	Insoluble Sulphur
1	China Sunsine Chemical	Sennics	China Sunsine Chemical
2	Kemai Chemical	China Sunsine Chemical	Yanggu Huatai Chemical
3	Willing New Materials Technology	Kemai Chemical	Kailun Chemical

Source: rubberchem.com.cn, KGI Research

High entry barriers further leads to segment integration. There are three main barriers to entry for the industry.

First, branding recognition is important in establishing long-term and robust supply and trading relationships with the downstream customers, mainly the tyre and other rubber product manufacturers. Before tyre companies recognise the supplier, they will discreetly conduct due diligence on the suppliers regarding multiple aspects such as the product quality, production safety, and environment protection (EP). Global tyre companies will follow international standards such as the European Commission's Registration, Evaluation, Authorisation and Restriction of Chemicals. The recognition period will last for one to two years.

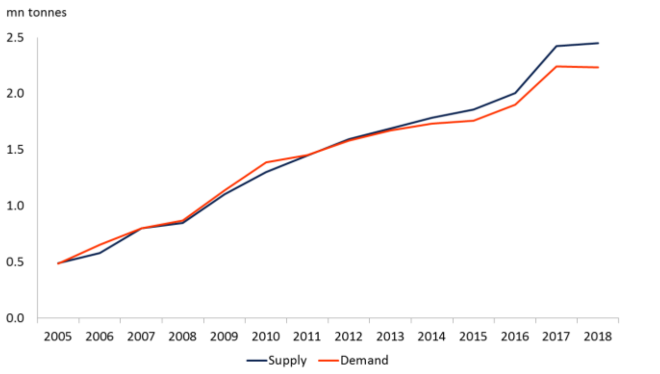
Second, prolonged tightened domestic environmental protection policies phase out companies who fail to meet the required criteria. The new Environmental Protection Act reinforces the regulation on air, water and solid waste treatment (3Ws). The production and processing of rubber chemicals inevitably generate the 3Ws, thus demanding companies to put more effort and capital on EP consistently. Accordingly, companies who fail to comply or cannot afford the costs have been forced to exit the market.

Lastly, every phase of the rubber chemical manufacturing requires enormous amounts of capital input, from product research and development to plant and facility built-up, even to marketing and technological innovations. Meanwhile, banks are also restricting loans to the chemical industry, especially for capacity expansion. Hence, insufficient funding support blocks new entrants.

Raw material price is at the cyclical bottom. Aniline, whose market topped in mid-2018 since the average selling price (ASP) of aniline peaked at over RMB12k/tonne in 1Q18, is one of the primary raw materials in the production of rubber chemicals. The strong demand in 1H18 also resulted in the 19.8k tonnes of aniline import in June 2018 since 2011.

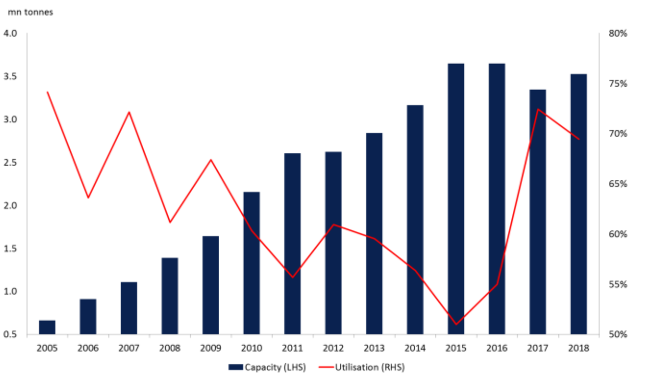
Additionally, although the market has had excess capacity, the sharp jump in utilisation over the past two years amid moderate capacity growth indicates that more rubber chemical producers have resumed their idled production lines. However, since the ASP of aniline nosedived after June 2018 reaching its cyclical low, aniline producers with high production costs are back to thin operational margins or even loss-making. The longer aniline price stays low, the more producers will halt production or even exit the market. Therefore, the low raw material prices are not sustainable. Aniline price saw a slight rebound in late August this year.

Figure 4: Aniline supply and demand dynamics



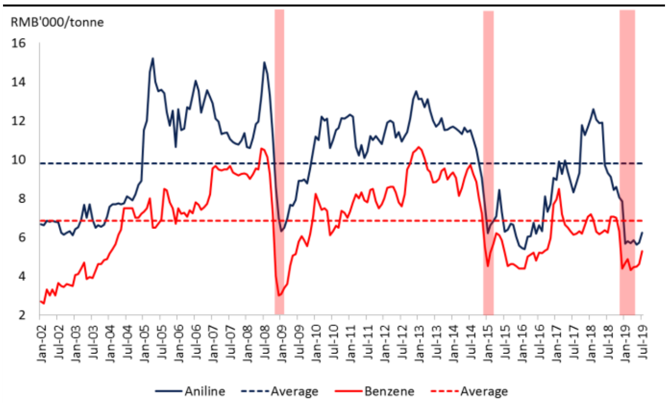
Source: chyxx.com, KGI Research

Figure 5: Utilisation rate surged in 2017 and 2018



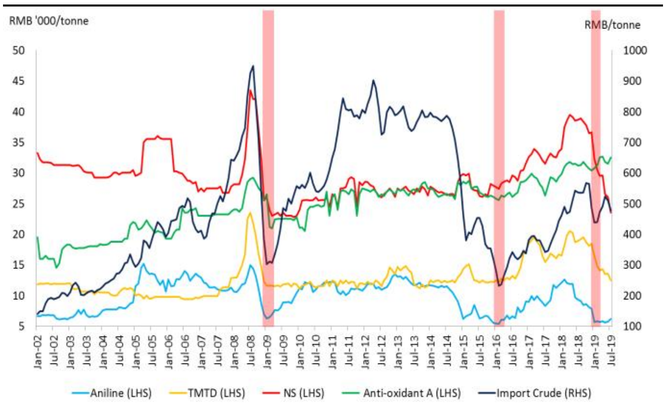
Source: chyxx.com, KGI Research

Figure 6: Aniline and benzene price movements



Source: CEIC, KGI Research

Figure 7: ASP is bottoming



Source: CEIC, KGI Research

Investment merits

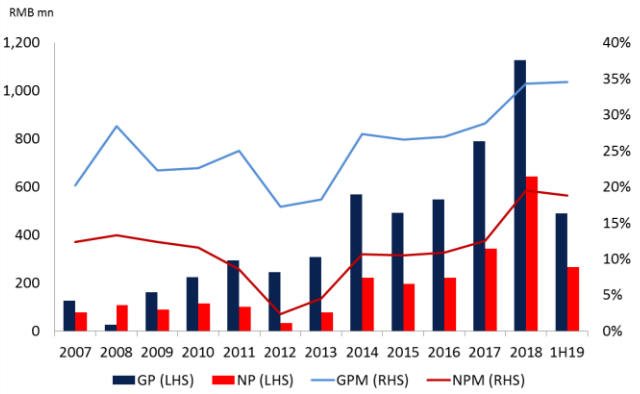
Improving robust profitability. Not only has Sunsine been leading the industry by taking up the largest market share, but it also maintains superior profitability. Historically, the company has managed to deliver stable profit margins with 20%+ GPM and 10%+ NPM on average.

The industry had a big turn in 2016 after the supply side reform – China deleveraged the industrial sector and curtailed overcapacities drastically. More importantly, China has also been implementing stricter environmental protection (EP) regulations. Consequently, a large number of plants, factories, and related companies were forced to shut down during that time.

Sunsine, however, survived and thrived owing to its dedicated EP commitment and its stringent pollution control long before. Furthermore, the company expanded its capacity (10k tonnes of each IS and TBBS) during 2016 and 2017, filling the supply gap. Thereafter, Sunsine reinforced its pricing bargain power. Over the past two years, its GPM and NPM were further lifted to above 30% and 15% respectively.

Compared to its peers' performance, Sunsine is taking the lead as well, its performance mainly attributable to its cost optimisation - the respective 20% and 80% of self-supplied electricity and steam for the main plant in ShanXian, Shangdong Province. Its quality scale and product mix also strengthens its competitiveness.

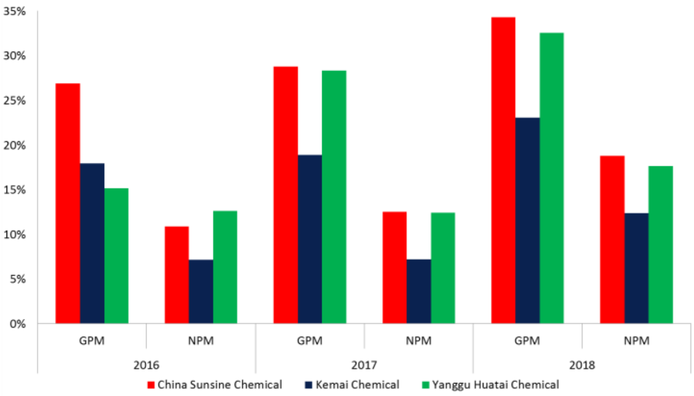
Figure 8: Sunsine's well-performed profitability



**Adjusted NPM was 18.1% after excluding one-time tax credit of RMB48mn in 2018*

Source: Company, KGI Research

Figure 9: Sunsine outperformed peers profitably

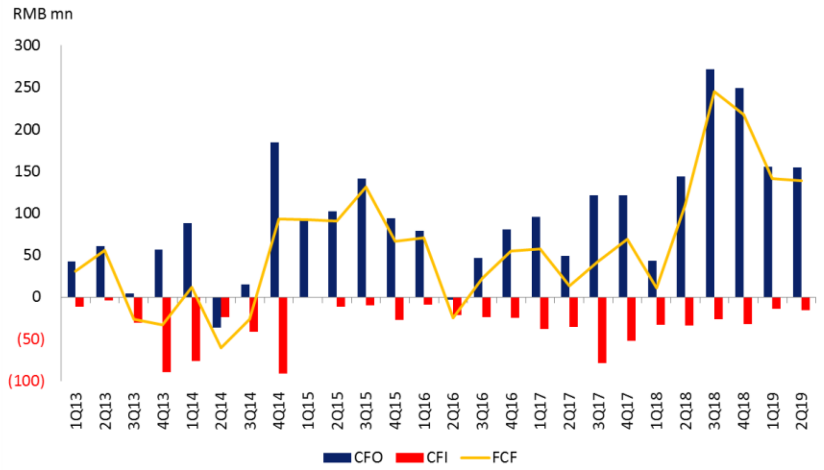


Source: Company, KGI Research

Clean balance sheet with a strong net cash position. Sunsine has managed to operate without debt since 4Q16. Moreover, its cash on hand reached RMB1.0bn in 2016, and most recently RMB1.17bn as of June 2019, equivalent to RMB2.39/share or S$0.46/share. The amassed war chest has been a result of positive free cash flow (FCF) generation. On average, the maintenance capex (bulk of the cash flow from investment, CFI) is RMB100mn to 150mn p.a. which is fully covered by cash flow from operation (CFO).

Meanwhile, its working capital is fully funded internally by cash. Although this is not an optimal working capital management structure, since the cost of internal funding is higher than the cost of debt, it could buffer the liquidity issues that are prevalent in the industry. Currently, Sunsine's peers are attempting to ramp up capacity in order to obtain more market share. However, funding is the one of the highest hurdles to overcome – domestic banks have been tightening the amount of credit released, especially for traditional manufacturing industries; not only will equity funding through an initial public offering take time, the amount raised is also subject to market sentiments. Therefore, Sunsine's strong net cash position shines through as an additional competitive advantage, enabling the company to further gain market share by expanding its capacity at its own discretion, and mitigating any pressure from a potential liquidity crunch in the event of a market downturn.

Figure 10: Increasing free cash flow



Source: Company, KGI Research

Preparing for capacity expansion in the near term. As of June 2019, the respective annual capacities are: 97k tonnes of rubber accelerator; 30k tonnes of insoluble sulphur; and 45k tonnes of anti-oxidant. Another 20k tonnes of TBBS (Phase II) is pending to be installed by the end of 2020, the approval of which has been granted. Sunsine will proceed with the Phase II project if the operation of Phase I (10k tonnes) runs smoothly. Additionally, the company plans to acquire 680 *mu* of land, equivalent to 453.3k m^2, located at Shanxian Chemical Zone for future expansion. About 300 *mu* of this land, or an equivalent 200k m^2, is scheduled for another 60k tonnes of insoluble sulphur production lines. The preliminary estimation of capex for facilities and construction is about RMB400mn; the capex for land is expected to be RMB45mn to 48mn based on the estimated price of RMB150k to 160k/mu.

We have listed Sunsine's peers' scheduled ramp-up of capacity below.

While investors may have concerns regarding the market's ability to absorb total production without putting more pressure on the ASP, we believe that this will not be a market-moving catalyst as it could take more than three to five years to see output from each of the new lines.

Yanggu Huatai has cancelled its plans for 10k tonnes of accelerator NS in April 2019, and the 15k tonnes of accelerator M could only be realised next year onwards.

Kemai's aggressive expansion plans also depend on the success of its IPO, which has already previously failed twice. Hence, there is no specific timeframe that the China Securities Regulatory Commission will approve it. Even if Kemai succeeds in its fund raising efforts, the new plants are still subject to approvals from various authorities, which could take an additoinal one to two years.

Essentially, competitiveness is dependent on the speed at which a company is able to shorten production times. As a result, we believe that the odds are in favor of Sunsine because capital is ready, it has a proven operating track record, and its relationships with the authorities are also well established.

Figure 11: Peers' planned capacity expansion (as of Jun-19)

('000 tonnes)	Rubber Accelerator	Anti-oxidant	Insoluble Sulphur
China Sunsine Chemical	TBBS: 20	N/A	60
Yanggu Huatai Chemical	M: 15 NS: 10, cancelled	N/A	10
Kelmai Chemical	TBBS: 30 CBS: 20	6PPD: 30	N/A

Source: Company, KGI Research

Assumptions and Valuations

We expect ASP to bottom out in 2020 amid the ongoing ramp-up of capacity. We derive a target price of S$1.40 based on a DCF model with a required rate of return of 11.6%. We re-initiate with an OUTPERFORM rating.

Figure 12: Assumptions and Valuations

	FY19e	FY20e	FY21e
Sales volume (tonnes)			
Accelerators	92,150	101,650	111,150
Insoluble Sulphur	31,800	31,800	31,800
Anti-oxidant	40,500	40,500	40,500
Realised ASP (RMB/tonne)			
Accelerators	21,736	21,931	23,201
Insoluble Sulphur	9,999	10,199	10,811
Anti-oxidant	13,550	13,821	14,512
Sales (RMB m)			
Accelerators	2,003	2,229	2,579
Insoluble Sulphur	318	324	344
Anti-oxidant	549	560	588

RMB mn	FY19e	FY20e	FY21e
Net income	495	536	496
Net capex	110	120	130
Chang in net WC	49	78	(37)
Change in borrowing	-	-	-
FCFE	336	338	402
Beta	1.35		
Required rate of return	11.6%		
Growth	0.5%		
FX (SGD/RMB)	5.10		
TP (SGD)	1.40		

Source: KGI Research

Key Risks

Risk	Remark
Market	
Raw materials and end products average selling prices remain weak	Earnings will decline and drag down growth driven by capacity expansion
Overall market capacity increases in the short term	Intensification of industry competition which could lead to a decline in profit margins
Policy	
Environmental protection inspection	Operation halt lowers utilisation and results in a decline in revenues and profits

Financial Summary

YE 31 Dec

INCOME STATEMENT (RMB m)	FY17	FY18	FY19e	FY20e	FY21e
Revenue	**2,738**	**3,283**	**2,925**	**3,170**	**3,569**
Cost of sales	(1,950)	(2,157)	(1,989)	(2,156)	(2,463)
Gross Profit	**788**	**1,126**	**936**	**1,015**	**1,106**
EBITDA	**567**	**809**	**703**	**757**	**805**
Depreciation & Amortisation	90	98	106	111	116
EBIT	**477**	**712**	**597**	**646**	**688**
Profit from Operations	**1,922**	**2,744**	**2,342**	**2,529**	**2,716**
Net Finance (Expense)/Inc	–	–	–	–	–
Profit before Tax	**477**	**712**	**597**	**646**	**688**
Income tax	(136)	(70)	(101)	(110)	(193)
PAT	**341**	**641**	**495**	**536**	**496**
PAT Normalized	341	593	495	536	496

BALANCE SHEET (RMB m)	FY17	FY18	FY19e	FY20e	FY21e
Cash and bank balances	500	1,039	1,327	1,670	2,078
Inventories	212	217	328	317	343
Trade receivables	638	691	624	739	711
Others	75	70	66	70	75
Current Assets	**1,425**	**2,016**	**2,345**	**2,796**	**3,208**
PP&E	662	691	688	698	713
Others	41	40	39	38	37
Non-current Assets	**703**	**731**	**727**	**736**	**750**
Total assets	**2,128**	**2,747**	**3,072**	**3,531**	**3,957**
Trade payables	71	63	62	68	74
Borrowings	–	–	–	–	–
Others	314	359	345	365	394
Current Liabilities	**385**	**422**	**407**	**433**	**468**
Bank loans	–	–	–	–	–
Non-current liabilities	–	–	–	–	–
Shareholders equity	1,742	2,326	2,665	3,098	3,489
Total Equity	**1,742**	**2,326**	**2,665**	**3,098**	**3,489**
Total Liabilities and Equity	**2,128**	**2,747**	**3,072**	**3,531**	**3,957**

CASH FLOW STATEMENT (RMB m)	FY17	FY18	FY19e	FY20e	FY21e
Profit before tax	477	712	597	646	688
Depreciation & non cash adjustments	90	98	106	111	116
Change in Working Capital	(83)	(2)	(49)	(78)	37
Income Tax Paid	(100)	(84)	(101)	(110)	(193)
Interest Paid	–	–	–	–	–
Others	2	(22)	(4)	(5)	(5)
CF from operating activities	**387**	**701**	**548**	**565**	**644**
Purchase/Disposal of PPE	(209)	(130)	(110)	(120)	(130)
Others	4	4	4	5	5
CF from investing activities	**(205)**	**(125)**	**(106)**	**(115)**	**(125)**
Dividends Paid	(47)	(59)	(136)	(106)	(111)
Debt Raised / (Repaid)	–	–	–	–	–
Equity Raised / (Bought Back)	86	(2)	(15)	–	–
Others	10	8	–	–	–
CF from financing activities	**50**	**(52)**	**(150)**	**(106)**	**(111)**
Net increase in cash & cash equiv.	231	523	292	344	408
FX effects	(9)	16	–	–	–
Beginning Cash	274	496	1,035	1,327	1,670
Ending Cash	**496**	**1,035**	**1,327**	**1,670**	**2,078**

KEY RATIOS	FY17	FY18	FY19e	FY20e	FY21e
Profitability					
Core EPS	70.8	120.7	101.5	109.8	101.5
Core EPS Growth (%)	48.6	70.4	(15.9)	8.2	(7.5)
DPS (SGD Cents)	3.0	5.5	4.1	4.4	4.1
Dividend Yield (%)	2.7	4.9	3.6	3.9	3.6
Profitability					
Gross margin	28.8%	34.3%	32.0%	32.0%	31.0%
EBITDA margin	20.7%	24.6%	24.0%	23.9%	22.5%
Net margin	12.5%	19.5%	16.9%	16.9%	13.9%
ROE	19.6%	27.6%	18.6%	17.3%	14.2%
ROA	16.0%	23.3%	16.1%	15.2%	12.5%
Financial Structure (x)					
Interest coverage	–	–	–	–	–
Total Debt/Equity	–	–	–	–	–
Net Gearing	Net cash	Net cash	Net cash	Net cash	Net cash

Appendix: Plant visit in September 2019

Figure 13: New IS production line with 10k-tonne capacity

Source: KGI Research

Figure 14: A corner of the 680 mu land in the fence

Source: KGI Research

Figure 15: One wrapped pack with 25 bags weighs one tonne

Source: KGI Research

Figure 16: Automatic wrapping line with a capacity of 33 to 40 tonne/day

Source: KGI Research

Figure 17: Hydrogen sulphide recycling facility

Source: KGI Research

Figure 18: Exhaust emission and treatment facility

Source: KGI Research

KGI's Ratings

Rating	Definition
Outperform (OP)	We take a positive view on the stock. The stock is expected to outperform the expected total return of the KGI coverage universe in the related market over a 12-month investment horizon.
Neutral (N)	We take a neutral view on the stock. The stock is expected to perform in line with the expected total return of the KGI coverage universe in the related market over a 12-month investment horizon.
Underperform (U)	We take a negative view on the stock. The stock is expected to underperform the expected total return of the KGI coverage universe in the related market over a 12-month investment horizon
Not Rated (NR)	The stock is not rated by KGI Securities.
Restricted (R)	KGI policy and/or applicable law regulations preclude certain types of communications, including an investment recommendation, during the course of KGI's engagement in an investment banking transaction and in certain other circumstances.

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