



May 22, 2014

Region | Paper

Nine Dragons (2689 HK)

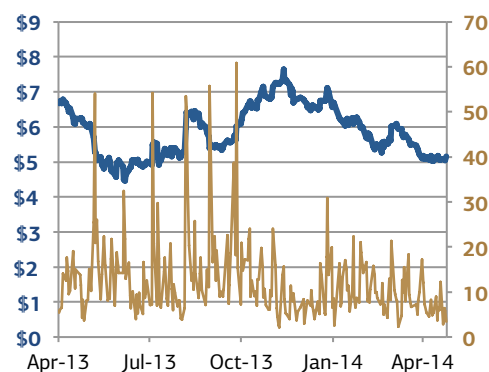


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Anne Stevenson-Yang
+86 139 1082 0535
anne@jcapitalresearch.com

Qin Shengxian
+86 186 0026 1068
qin@jcapitalresearch.com

Nine Dragons (2689 HK) one-year share price in HKD (blue) and volume (gold, in mln shares)



Source: Bloomberg, May 22, 2014

Nine Dragons (2689 HK)

Price	HKD 5.04
Rating	SELL
Price target	HKD 5.13
Difference	1.7%
Market Cap	HKD 23.5 bln
Simple Moving Avg.	6.6 mln
P/E	10.04x

Source: Bloomberg, May 22, 2014

+ Facing slowdown

China's paper industry continues weakening and Nine Dragons is paying the price. Both our checks and industrial data show that the company is facing lower demand and a drop in prices. Some distributors, sensitive to price fluctuations, have started switching brands.

+ High leverage ratio and USD debt

We believe Nine Dragons' high leverage will continue due to the weak demand, and we don't expect the industry to recover any time soon. Furthermore, by the end of 2013 55% of Nine Dragons' borrowings were in foreign currency, mostly USD. A continuing depreciation of the Renminbi would result in losses for Nine Dragons.

+ Closing coverage

The Nine Dragons share price fell below our price target of HKD 5.13 on May 21. We see little upside left in China's paper industry and believe it will keep slowing along China's economy. As we believe the stock is currently fairly valued, we are terminating coverage.

Nowhere to go

Nine Dragons is facing lower demand and falling prices in South and Northeast China.

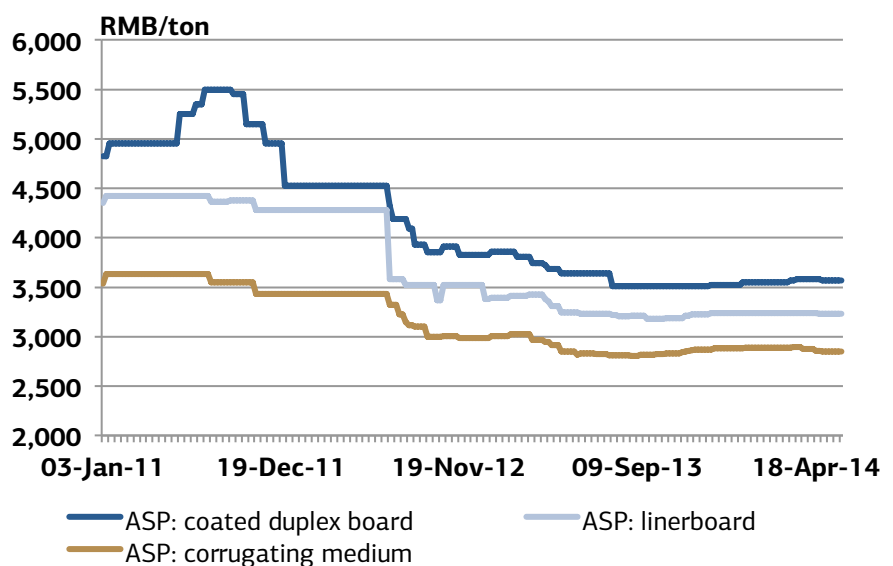
In early May, we conducted interviews with Nine Dragons distributors in several cities. In general, market demand for packaging paper continues to decline in 2014. According to distributors, YTD demand is down by 15-20% YoY in both South and Northeast China.

Distributors also told us that, in April, selling prices in the provinces of Guangdong and Liaoning fell again by RMB 50-100 per ton despite Nine Dragons' effort to raise prices after the Chinese New Year.

Industrial data from Wind confirms this murky picture. The ASPs of Nine Dragons' main products including linerboard, corrugating medium and coated duplex board are low compared with previous years. The data shows that prices in the South and the North of China have dropped by RMB 40-115 since the beginning of April, while prices in the East are more stable.

In addition to the weakening downstream market, and also in line with our previous findings, some distributors, who are sensitive to selling prices and care less about the paper quality, have stopped selling Nine Dragons' products and changed to other brands.

Chart 1. ASP of Nine Dragons' products



Source: Wind, J Capital Research

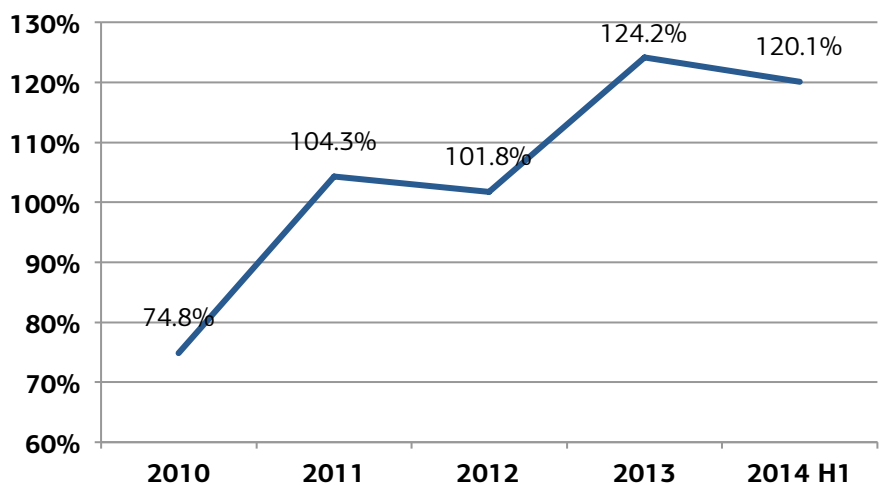
Nine Dragons not only has a high leverage ratio, but 55.1% of its total borrowings are in foreign currency, mostly USD.

Highly Leveraged

Nine Dragons continues having a high leverage ratio, despite a slight decrease to 102.1% at the end of CY 2013. In FY 2014 H1, Nine Dragons decreased its capital investment to RMB 1.5 bln, compared with RMB 2.9 bln in FY 2013 H1 and borrowed less to improve its financial position. However, given the industry's weakening demand, and without a strong industry recovery, we believe ND's leverage ratio will continue at a high level.

Additionally, at the end of 2013, 55.1% of the company's total borrowings were denominated in foreign currency, mostly USD. Because the yuan has been depreciating against the US dollar since the beginning of 2014, around 3% YTD, we believe the company will suffer a loss in FY 2014 H2. This contrasts with what happened by the end of December 2013, when along with the 2013 H2's appreciation of the yuan, the company booked a gain of RMB 150 mln for FY 2014 H1.

Chart 2. Net leverage ratio



Source: Company data, J Capital Research

Closing Coverage

Nine Dragons' share price fell to HKD 5.08 on May 21, below our price target of HKD 5.13. We see little upside left in the paper industry in the near term, and we think it may continue worsening along with China's slowing economy. As we believe the stock is currently fairly valued we have decided to terminate coverage.

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