

China / Hong Kong Company Update

Texhong Textile Group

Bloomberg: 2678 HK EQUITY | Reuters: 2678.HK

Refer to important disclosures at the end of this report

DBS Group Research . Equity

31 Aug 2022

BUY

Last Traded Price (30 Aug 2022): HK\$7.30 (HSI : 19,949)
Price Target 12-mth: HK\$10.70 (47% upside) (Prev HK\$23.80)

Analyst

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What's New

- 1H2022 earnings dropped 23%, in line with profit warnings; with weaker sales volume
- Weaker global demand outlook is expected to drag down GP margin from the record-high level
- However, with the higher proportion of downstream businesses, we expect a more consistent and stable normalised margin moving forward
- Revised down FY22/23F earnings by 30%/52% to reflect sales volume cut and lowered GP margin assumption; Maintain BUY with a lower TP of HK\$10.7

Normalized margin with better consistency

Investment Thesis

Growing downstream business with higher and more consistent GP margin Texhong's margins have always hinged on fluctuations in raw material prices. As such, its foray into the downstream garment fabric business is important in terms of margin stability. In 1H22, the higher proportion of downstream fabric business to total revenue has shared the pressure of raw material cost fluctuations faced by the yarn business. With the higher proportion of downstream (c.21%), which also considers as higher GP margin businesses (20-25%), we expect a more consistent and stable and even higher normalised margin moving forward.

Further expand its international presence to central America. While consolidating the supply chain in China market, Texhong has expanded its production line to Honduras, Central America. With existing production bases in China, Vietnam, Turkey, and Mexico, Texhong has increased its international presence and diversified its earnings risk away from China market focus.

Potential for spinoff of woven garment fabrics and Jeanswear operation businesses Texhong has been exploring the possibility of a spinoff and separate listing of the group's woven garment fabrics and jeanswear operation. The spinoff would benefit Texhong in terms of its valuation, business operation, and geographical advantage, and trigger a re-rating.

Valuation:

We maintain BUY with a lower TP of HK\$10.7, which is pegged to a lowered multiple of 6.4x FY22F PE. The PE multiple is based on the five-year average forward PE.

Where we differ:

We are more conservative on FY23F earnings versus consensus, where yarn business' GP margin will retreat to 16-17%. Sales volume will be under pressure by the weak demand outlook.

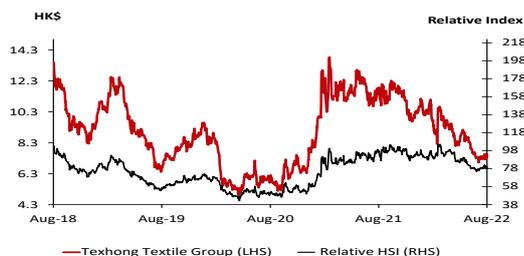
Key Risks to Our View:

Texhong's margins are highly dependent on cotton price movements. New forays into the downstream garment and fabric segment could be a new risk due to relative unfamiliarity.

At A Glance

Issued Capital (m shrs)	918
Mkt Cap (HKm/US\$m)	6,958 / 887
Major Shareholders (%)	
Hong (Tianzhu)	43.4
Trade Partner Investments Ltd.	16.5
Wisdom Grace Investments Ltd	7.4
Hui (Ching Lau)	7.0
Free Float (%)	25.7
3m Avg. Daily Val. (US\$m)	0.51
GICS Industry: Consumer Discretionary / Consumer Durables & Apparel	

Price Relative



Forecasts and Valuation

FY Dec (RMBm)	2020A	2021A	2022F	2023F
Turnover	19,577	26,521	26,092	24,369
EBITDA	1,782	4,364	3,395	2,884
Pre-tax Profit	681	3,340	2,215	1,613
Net Profit	517	2,685	1,804	1,276
Net Profit Gth (Pre-ex) (%)	(41.5)	419.3	(32.8)	(29.2)
EPS (RMB)	0.57	2.93	1.97	1.39
EPS (HK\$)	0.64	3.33	2.24	1.58
EPS Gth (%)	(41.5)	419.3	(32.8)	(29.2)
Diluted EPS (HK\$)	0.64	3.33	2.24	1.58
DPS (HK\$)	0.20	1.00	0.68	0.48
BV Per Share (HK\$)	9.76	12.46	13.85	14.85
PE (X)	11.4	2.2	3.3	4.6
P/Cash Flow (X)	1.8	3.4	1.6	2.6
P/Free CF (X)	2.2	nm	3.8	19.6
EV/EBITDA (X)	6.0	2.5	3.0	3.7
Net Div Yield (%)	2.7	13.7	9.3	6.6
P/Book Value (X)	0.7	0.6	0.5	0.5
Net Debt/Equity (X)	0.5	0.4	0.3	0.3
ROAE(%)	6.7	30.0	17.0	11.0
Earnings Rev (%)			(30)	(52)
Consensus EPS (RMB)			2.47	2.54
Other Broker Recs:		B:7	S:0	H:0

Source of all data on this page: Company, DBS Bank (Hong Kong) Limited ("DBS HK"), Thomson Reuters



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Texhong Textile Group

WHAT'S NEW

NDR takeaway: 1H2022 earnings dropped 23% y-o-y, in line with profit warnings

1H2022 earnings dropped 23% y-o-y to RMB992m, in line with profit warnings. The decrease in net profit was mainly due to the weaker yarn demand in 2Q2022, the decrease in production capacity after the sale of a yarn production facility in China, and a high comparison base, leading to the GP margin decreasing by 3.1ppt to 19.7%. Higher finance cost was also recorded of RMB175m, a 73% increase from 1H2021. Texhong's revenue increased by 3.9% to RMB13.0bn, thanks to the growth in its mid-downstream business, which offset the decrease in volume of its yarn business. The board declared an interim dividend of 38 HK cents per share, with the same payout ratio of 30% as previous years.

1HFY22 NDR takeaway

We hosted a Non-Deal Roadshow with Texhong's management on 30 August 2022. Here, we have listed out the key questions asked by investors.

What is the guidance on sales volume for FY22F? Texhong has guided down 20% of the sales volume from 880,000 tonnes (announced in Mar 2022) to 700,000 tonnes for the full year of FY22. In 1H2022, amid COVID-19 lockdown measures in China and the China property market crisis, paired up with the global interest rate upcycle environment, Texhong had achieved 320,622 tonnes in yarn sales volume. The lower full year guidance mostly adjusted for the worse than expected 1H performance. The management expects the overall weaker demand to linger and impact the sales volume in 2HFY22. However, 2HFY22 sales volume will be slightly better than in 1H, as demand has improved in August. September onwards is the industry's peak season, and therefore, the demand outlook for the yarn operation will improve h-o-h.

What is the company's focus in terms of product mix?

Texhong has been developing its mid-downstream businesses in the past years. The company has now put its focus on both the woven and knitted garment fabrics businesses. The grey fabrics operation will gradually shift supply for internal use only. The grey fabrics will be used for garment fabric production moving forward. At last, the company sold its 15 Jeanswear production lines to its JV partner Hualida Group at end-2021.

Knitted garment fabrics recorded a 6.6% GP margin in 1H22. What is the reason and what is the trend for this operation? The GP margin drop of knitted garment fabrics was mainly due to the new factory in Vietnam. The new factory is in the process of ramping up, and it takes time to see an improvement in the GP margin. Moreover, due to the lower demand in the overseas end market, orders are relatively low for the new factory. In the long run, management is confident about the Vietnam factory ramp-up. It is anticipated to ultimately improve its GP margin to 25-30%, when the new factory is mature and is operating smoothly. However, the GP margin in 2H2022 will likely stay at the current level amid weaker demand.

Adding on to that, what is the GP margin Texhong anticipated?

In terms of the yarn business, the normalised margin for Texhong is at 16%-17%, looking at previous years and excluding the effects of the US and China trade war and COVID-19 pandemic. Management believes that we can reference 2016-2018's GP margin level (average 17.5%) for the next couple of years. In terms of the garment fabrics business, woven garment fabrics have achieved its mid-term goal of 25% in 1H2022. Management expects the GP margin for the operation to improve to 25%-30% in longer term.

How much does Texhong hold in loans in terms of RMB and USD/HKD?

40% of the borrowings are in RMB and linked to the LPR, while the rest (60%) are USD and HKD borrowings. The significant increase in net finance cost was mainly due to the RMB depreciation. About 20% of the company's borrowings is on fixed interest rates.

What is the current stage of the potential spinoff?

Texhong has changed the proportion of the potential spinoff from all mid-downstream businesses, and it oversees yarn businesses (ex-China and Vietnam) to only cover woven garment fabrics and Jeanswear operations. The spinoff plan is currently being discussed with the HKEx and there is no timeline for it yet.

Texhong Textile Group

What is the capex for FY22? Management expects a total of RMB1-2bn in capex for FY22. The capex will be for improving old machinery and equipment for the yarn and garment businesses and purchases of new machines and equipment for the new Vietnam factory. However, management anticipates a control on capex in 2HFY22F and FY23F due to global economic uncertainties. We expect Texhong to further reduce its net gearing ratio to 0.3-0.4 in FY22 from FY21? and achieve more stable and low-risk profit growth.

What is the Central America plan? Texhong has expanded its business to Central America at Honduras to improve the global supply chain layout. The management saw the opportunity in Honduras, given that it is a key country for the garment industry in Central America. The pilot production base is expected to be built in 15-18 months and the new plant will have 100,000 spindles and two production lines for woven garment fabrics.

Our view

Weaker demand outlook is expected to drag down GP margin from the record-high level. Due to the rising interest rate environment, coupled with a weaker demand outlook, we believe the cotton price peaked in Apr 2022. Texhong's GP margin should see a downtrend moving forward. The recent extreme weather, coupled with lower crop yield, could pose a positive catalyst for cotton prices and therefore higher yarn price. But the weaker global demand for cotton should cap the upside of this potential impact. Overall, we expect the GP margin of the yarn business to gradually retreat to 17% in 2HFY22 and normalise at 16% in FY23F.

Downstream business contributes c.21% of total sales, while yarn business revenue drops 12% yoy. Yarn revenue was recorded at RMB9,241m, a 12% drop from the same period last year. It contributed 71% of total revenue in

1H2022, in contrast to 75% in 1H2021. The downstream business, including grey fabrics, garment fabric, and jeanswear (excl. trading business), has been gradually increasing its contribution to 21%. We reckon that the downstream business has a relatively stable GP margin in comparison to the yarn business, as the yarn GP margin is closely correlated to raw material price changes. With a higher proportion to total sales, and Texhong's key focus on garment fabrics, we expect the mid-downstream fabric business to help stabilise the GP margin moving forward.

Revised down FY22/23F earnings by 30%/52% to reflect a weaker demand outlook. We expect the volume of yarn sales to reach 700,000/750,000 tonnes in FY22/FY23F, 20% lower than our previous assumptions, to reflect the weaker demand outlook. This also translates to a 70%-80% utilisation rate in overall production capacity. We have also slightly revised down our GP margin assumption to reflect the potential cotton price and other raw material price downtrends. We revised down FY22/23F earnings by **30%/52%** to reflect weaker demand outlook.

Maintain BUY with lower TP of HK\$10.7. After rolling over to FY23F earnings, our new TP of HK\$10.7 is pegged to 6.4x FY22F PE, which is the five-year average forward PE. Although the stock is trading at 4.6x FY23F PE, close to -0.5std of its 5 years Mean PE, we think the stock pick has already factored in the lower GP margin. We believe the higher proportion of downstream businesses with more stable, and consistent GP margin will be recognized by investors and serve as a buffer for Texhong's long term GP margin and earnings. We recommend BUY with lower TP of HK\$13.56.

Company Background

Texhong Textile Group Limited (Texhong) manufactures and sells yarn and grey fabrics. The company's main focus is promoting and selling spandex stretch yarn and spandex stretch grey fabrics.

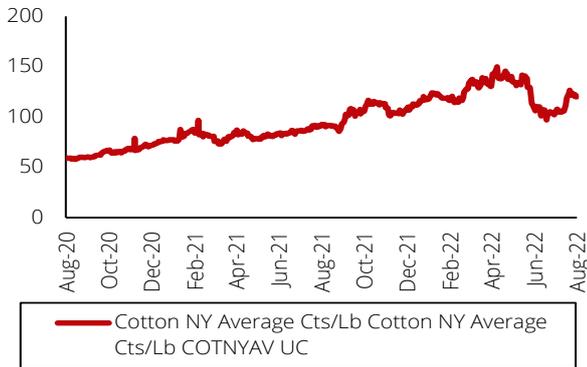
Texhong Textile Group
Interim Income Statement (RMBm)

FY Dec	1H2021	2H2021	1H2022	% chg yoy	% chg hoh
Revenue	12,526	13,995	13,021	3.9	(7.0)
Cost of Goods Sold	(9,674)	(10,995)	(10,453)	8.1	(4.9)
Gross Profit	2,853	2,999	2,568	(10.0)	(14.4)
Other Oper. (Exp)/Inc	(1,185)	(1,244)	(1,186)	0.1	(4.7)
Operating Profit	1,668	1,755	1,382	(17.1)	(21.3)
Other Non Opg (Exp)/Inc	0	0	0	nm	nm
Associates & JV Inc	(15)	54	(2)	86.6	(103.6)
Net Interest (Exp)/Inc	(22)	(101)	(175)	(697.7)	(73.7)
Exceptional Gain/(Loss)	0	0	0	nm	nm
Pre-tax Profit	1,631	1,709	1,205	(26.1)	(29.5)
Tax	(309)	(289)	(180)	(41.6)	(37.6)
Minority Interest	(34)	(22)	(32)	5.2	46.3
Net Profit	1,288	1,398	992	(23.0)	(29.0)
Net profit bef Except.	1,288	1,398	992	(23.0)	(29.0)
EBITDA	1,653	1,810	1,380	(16.5)	(23.8)
Margins (%)					
Gross Margins	22.8	21.4	19.7		
Opg Profit Margins	13.3	12.5	10.6		
Net Profit Margins	10.3	10.0	7.6		

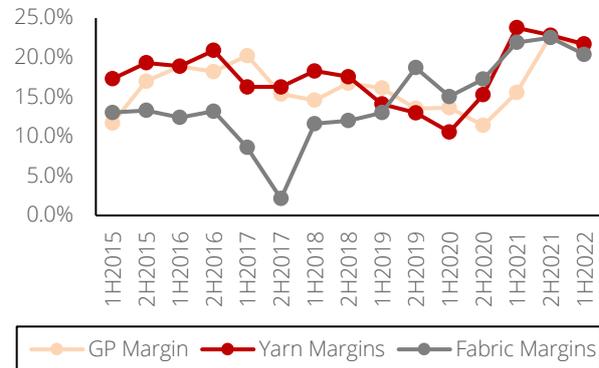
Source: Company, DBS HK

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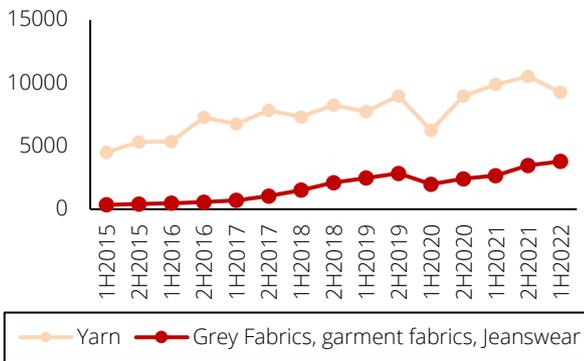
Due to the extreme weather, coupled with lower crop yield, cotton price has rebound from the recent drop in late June



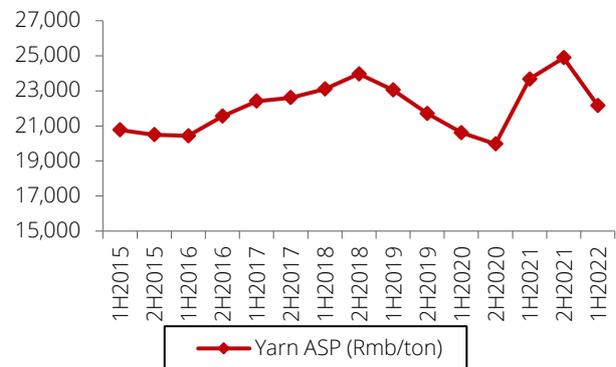
Mid-downstream fabric business will help stabilise GP margin moving forward as its % to total revenue increases



Texhong has been focusing on its mid-downstream business, which contributes 21% of total revenue



Yarn ASP dropped in 1H2022 due to weaker demand for yarn



Historical PE and PB band

Forward PE band (x)



PB band (x)



Source: Thomson Reuters, DBS HK

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Key Assumptions

FY Dec	2019A	2020A	2021A	2022F	2023F
Sales growth	14.9	(11.0)	35.5	(1.6)	(6.6)
Gross margin	13.6	13.8	22.1	18.5	16.3
Opex/Sales	(4.8)	(4.8)	(4.8)	(4.8)	(4.8)
Effective Tax Rate	(17.2)	(22.1)	(17.9)	(15.9)	(17.9)
Payout	30.3	30.8	30.3	30.3	30.3

Source: Company, DBS HK

Segmental Breakdown (RMB m)

FY Dec	2019A	2020A	2021A	2022F	2023F
Revenues (RMB m)					
Yarn	16,714	15,202	20,400	18,689	17,269
Grey fabrics	710	497	588	802	597
Garment fabrics	3,595	3,136	3,612	3,928	3,778
Jeans	983	680	672	766	634
Non Woven Fabrics	0	62	123	52	2,038
Trading	0	0	1,125	1,855	52
Total	22,003	19,577	26,521	26,092	24,369
Gross Profit (RMB m)					
Yarn	2,257	2,030	4,752	3,613	2,672
Grey fabrics	122	64	175	180	134
Garment fabrics	573	527	760	797	727
Jeans	53	37	89	88	116
Non Woven Fabrics	0	(34)	(15)	(21)	73
Trading	0	0	138	228	251
Total	3,006	2,624	5,900	4,885	3,972
Gross Profit Margins (%)					
Yarn	13.5	13.4	23.3	19.3	15.5
Grey fabrics	17.2	12.9	29.7	22.5	22.5
Garment fabrics	15.9	16.8	21.1	20.3	19.2
Jeans	5.4	5.4	13.3	11.5	18.2
Non Woven Fabrics	N/A	(54.4)	(12.4)	(41.5)	3.6
Trading	N/A	N/A	12.3	12.3	484.4
Total	13.7	13.4	22.2	18.7	16.3

Source: Company, DBS HK

Texhong Textile Group

Income Statement (RMB m)

FY Dec	2019A	2020A	2021A	2022F	2023F
Revenue	22,003	19,577	26,521	26,092	24,369
Cost of Goods Sold	(19,010)	(16,870)	(20,669)	(21,270)	(20,394)
Gross Profit	2,993	2,707	5,852	4,822	3,974
Other Opng (Exp)/Inc	(1,359)	(1,851)	(2,429)	(2,371)	(2,138)
Operating Profit	1,634	856	3,423	2,451	1,836
Other Non Opg (Exp)/Inc	0	0	0	0	0
Associates & JV Inc	28	45	40	15	15
Net Interest (Exp)/Inc	(548)	(220)	(123)	(251)	(238)
Dividend Income	0	0	0	0	0
Exceptional Gain/(Loss)	0	0	0	0	0
Pre-tax Profit	1,115	681	3,340	2,215	1,613
Tax	(192)	(151)	(599)	(351)	(288)
Minority Interest	(39)	(13)	(56)	(60)	(48)
Preference Dividend	0	0	0	0	0
Net Profit	884	517	2,685	1,804	1,276
Net Profit before Except.	884	517	2,685	1,804	1,276
EBITDA	2,521	1,782	4,364	3,395	2,884
Growth					
Revenue Gth (%)	14.9	(11.0)	35.5	(1.6)	(6.6)
EBITDA Gth (%)	(5.6)	(29.3)	145.0	(22.2)	(15.1)
Opg Profit Gth (%)	(13.7)	(47.6)	300.1	(28.4)	(25.1)
Net Profit Gth (%)	(24.0)	(41.5)	419.3	(32.8)	(29.2)
Margins & Ratio					
Gross Margins (%)	13.6	13.8	22.1	18.5	16.3
Opg Profit Margin (%)	7.4	4.4	12.9	9.4	7.5
Net Profit Margin (%)	4.0	2.6	10.1	6.9	5.2
ROAE (%)	12.4	6.7	30.0	17.0	11.0
ROA (%)	4.4	2.5	12.0	7.3	5.0
ROCE (%)	8.7	4.0	16.4	11.0	7.6
Div Payout Ratio (%)	30.3	30.8	30.0	30.3	30.3
Net Interest Cover (x)	3.0	3.9	27.9	9.8	7.7

Source: Company, DBS HK

Interim Income Statement (RMB m)

FY Dec	1H2020	2H2020	1H2021	2H2021	1H2022
Revenue	8,214	11,363	12,526	13,995	13,021
Cost of Goods Sold	(7,277)	(9,592)	(9,674)	(10,995)	(10,453)
Gross Profit	937	1,770	2,853	2,999	2,568
Other Oper. (Exp)/Inc	(620)	(1,231)	(1,185)	(1,244)	(1,186)
Operating Profit	317	539	1,668	1,755	1,382
Other Non Opg (Exp)/Inc	0	0	0	0	0
Associates & JV Inc	30	16	(15)	54	(2)
Net Interest (Exp)/Inc	(324)	104	(22)	(101)	(175)
Exceptional Gain/(Loss)	0	0	0	0	0
Pre-tax Profit	23	658	1,631	1,709	1,205
Tax	(4)	(146)	(309)	(289)	(180)
Minority Interest	(8)	(5)	(34)	(22)	(32)
Net Profit	10	507	1,288	1,398	992
Net profit bef Except.	10	507	1,288	1,398	992
Growth					
Revenue Gth (%)	(19.4)	(3.8)	52.5	23.2	3.9
Opg Profit Gth (%)	(60.5)	(35.3)	426.8	225.7	(17.1)
Net Profit Gth (%)	(97.8)	22.8	12,192.3	175.9	(23.0)
Margins					
Gross Margins (%)	11.4	15.6	22.8	21.4	19.7
Opg Profit Margins (%)	3.9	4.7	13.3	12.5	10.6
Net Profit Margins (%)	0.1	4.5	10.3	10.0	7.6

Source: Company, DBS HK

Texhong Textile Group

Balance Sheet (RMB m)

FY Dec	2019A	2020A	2021A	2022F	2023F
Net Fixed Assets	9,616	9,062	9,393	10,664	11,631
Invt in Associates & JVs	243	290	321	336	351
Other LT Assets	1,515	1,478	1,680	1,680	1,680
Cash & ST Invt	2,118	2,795	2,561	3,407	3,235
Inventory	5,100	3,796	7,152	5,633	5,401
Debtors	2,561	2,477	3,146	3,397	3,172
Other Current Assets	21	261	190	190	190
Total Assets	21,175	20,157	24,443	25,307	25,661
ST Debt	3,360	3,837	3,832	3,832	3,832
Creditors	3,834	3,464	5,480	4,602	4,413
Other Current Liab	390	709	778	1,340	1,030
LT Debt	4,925	3,226	3,383	3,383	3,383
Other LT Liabilities	567	448	369	369	369
Shareholder's Equity	7,473	7,863	10,038	11,159	11,964
Minority Interests	626	609	563	622	671
Total Cap. & Liab.	21,175	20,157	24,443	25,307	25,661
Non-Cash Wkg. Capital	3,459	2,359	4,230	3,278	3,321
Net Cash/(Debt)	(6,166)	(4,268)	(4,654)	(3,808)	(3,980)
Debtors Turn (avg days)	45.1	47.0	38.7	45.8	49.2
Creditors Turn (avg days)	81.3	83.3	82.6	90.5	85.0
Inventory Turn (avg days)	103.7	101.5	101.1	114.7	104.0
Asset Turnover (x)	1.1	0.9	1.2	1.0	1.0
Current Ratio (x)	1.3	1.2	1.3	1.3	1.3
Quick Ratio (x)	0.6	0.7	0.6	0.7	0.7
Net Debt/Equity (X)	0.8	0.5	0.4	0.3	0.3
Net Debt/Equity ex MI (X)	0.8	0.5	0.5	0.3	0.3
Capex to Debt (%)	23.4	9.3	31.0	30.5	27.7
Z-Score (X)	2.1	1.6	2.0	2.2	2.2

Source: Company, DBS HK

Cash Flow Statement (RMB m)

FY Dec	2019A	2020A	2021A	2022F	2023F
Pre-Tax Profit	1,115	681	3,340	2,215	1,613
Dep. & Amort.	859	881	901	929	1,033
Tax Paid	(165)	(177)	(480)	210	(598)
Assoc. & JV Inc/(loss)	(28)	(45)	(40)	(15)	(15)
(Pft)/ Loss on disposal of FAs	0	0	0	0	0
Chg in Wkg.Cap.	12	1,019	(2,009)	390	267
Other Operating CF	487	943	0	0	0
Net Operating CF	2,279	3,301	1,713	3,730	2,300
Capital Exp.(net)	(1,939)	(660)	(2,235)	(2,200)	(2,000)
Other Invt.(net)	(87)	24	92	0	0
Invt in Assoc. & JV	0	0	0	0	0
Div from Assoc & JV	0	0	0	0	0
Other Investing CF	87	59	(239)	0	0
Net Investing CF	(1,939)	(578)	(2,382)	(2,200)	(2,000)
Div Paid	(337)	(267)	(536)	(684)	(471)
Chg in Gross Debt	1,157	(1,222)	152	0	0
Capital Issues	0	0	0	0	0
Other Financing CF	(384)	(381)	875	0	0
Net Financing CF	436	(1,870)	491	(684)	(471)
Currency Adjustments	0	0	0	0	0
Chg in Cash	776	853	(178)	846	(172)
Opg CFPS (RMB)	2.48	2.49	4.07	3.65	2.22
Free CFPS (RMB)	0.37	2.89	(0.57)	1.67	0.33

Source: Company, DBS HK

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Target Price & Ratings History



S.No.	Date	Closing Price	12-mth Target Price	Rating
1:	7-Sep-21	HK\$10.94	HK\$20.00	Buy
2:	17-Mar-22	HK\$9.70	HK\$23.80	Buy

Source: DBS HK

Analyst: Byron Lam

Texhong Textile Group

DBS HK recommendations are based on an Absolute Total Return* Rating system, defined as follows:

STRONG BUY (>20% total return over the next 3 months, with identifiable share price catalysts within this time frame)

BUY (>15% total return over the next 12 months for small caps, >10% for large caps)

HOLD (-10% to +15% total return over the next 12 months for small caps, -10% to +10% for large caps)

FULLY VALUED (negative total return, i.e., > -10% over the next 12 months)

SELL (negative total return of > -20% over the next 3 months, with identifiable share price catalysts within this time frame)

*Share price appreciation + dividends

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