Company Visit Note

Huchems Fine Chemical Corp

- Huchems is a steady name in an unsteady environment. A revisit to Huchems reveals the company's defensive characteristics (dominant market position, recurring revenues, consistent cash flow generation and a strong balance sheet) are unchanged, while vertical integration and new initiatives have enhanced its margins and top-line prospects. FY07 net profit grew 87% on the back of 500bps operating margin expansion—12.5% from 7.2% in 2006. ROIC jumped to 25% from 14% in 2006.
- **Recent initiatives.** Huchems is building a 150,000 ton Mono Nitrate Benzene plant at a cost of W52B which the company expects to come on line in Jan 2009. Attributable revenues are ~W130B/annum or 43% of FY07 sales. Management expects Clean Development Mechanism business (emissions reduction) to produce ~W4.5B sales/annum from 2008-12. While this business accounts for less than 2% of FY07 sales, its contribution to operating profit is almost 10% owing to ~98% margin.
- **Future initiatives.** Without citing specific details, Huchems is considering a number of new growth initiatives such as expanding downstream in the polyurethane chain or entering into SE Asia's basic chemical market. Management indicated new businesses must adhere to a minimum ~12% operating margin hurdle rate in order to go forward.
- **Valuation and share price:** The stock has been a steady performer amid recent volatility, supported in part by net foreign buying. Based on consensus estimates the stock is trading between 12x-14x FY08E-09E EPS and 5x-6x FY08E-09E EV/EBITDA.

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Huchems Fine Chemical Corp (069260 KS), Financial data

	FY06	FY07	FY08E	FY09E
Sales(W B)	301	302	316	405
Operating profit (W B)	22	38	43	51
EBITDA (W B)	42	54	59	66
Net profit (W B)	15	28	33	39
EPS (W)	711	1,328	1,545	1,821
EPS growth (%)	82.8	86.8	16.3	17.8
ROE (%)	9.2	15.5	16.3	16.9
P/E (x)	30.2	16.2	13.9	11.8
P/B (x)	2.7	2.4	2.1	1.6
DPS (W)	260	490	N/A	N/A
Yield (%)	1.2	2.3	N/A	N/A

Source: Company, Quantiwise.

South Korea
Industrial Machinery

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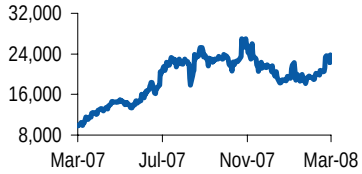
069260 KS, Not Covered
W21,500, Mar 17, 2008

One-year price performance
(Won)



Source: Datastream

Recent price performance

	1 Mth	3 Mths	1Yr
Absolute (%)	+7.5	+9.4	+106.7
Relative (%)	+15.7	+27.9	+87.5

Source: Quantiwise

Company data

52-wk range (W)	27,000 –10,400
Mkt cap. (W B)	458
Mkt cap. (US$ MM)	445
Common shares O/S (MM)	21.29
Free float common (%)	47
Foreign ownership (%)	3.0
Avg trading value (US$MM)	3.6
Exchange rate	W1,028/US$1
Kospi Index	1,574
Year-end	Dec

Source: Bloomberg, Company

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Post visit takeaways

Company Overview
Huchems is one of Korea's biggest fine chemical producers by capacity. The company was established in Sep 2002 after de-merging from Namhae Chemical (fertilizer and urea producer). Management cited undervaluation and shareholder maximization as the reasons for the split. Post-split, Korea's National Agricultural Cooperatives Federation (NACF) has retained its controlling 56% interest in Namhae Chemical partly due to strategic reasons, but reduced its ownership in Huchems from 56% to 10% in June 2006. NACF sold a 46% stake to a consortium of financial and strategic investors led by TaeKwang Industries and its CEO Mr. Park Yeon Cha, who is on Huchems's board of directors.

Defensive model
Huchems is Korea's dominant producer of dinitrotoluene (DNT), nitric acid and ammonium nitrate and toluidine used in the production of TDI and MDI, and in turn polyurethane, explosives, Styrofoam, dyes, paints and other non-durable consumer products. Huchems is either the sole producer or enjoys a dominant supplier position in its major product categories. These products are sold to domestic customers under long-term contracts with specified volume commitments. These captive, off-take contracts along with Huchems's dominant supplier positioning, close customer relationships (customers reluctant to switch based on price due to necessary re-testing, re-approvals) and capital intensity are key barriers to entry. Prices are determined using a cost-plus formula and are based on the price of feedstock (ammonia and toluene), exchange rates and transportation costs with a one to three month lag. Like most upstream chemicals, the price of ammonia (procured from Namhae Chemical) and toluene (procured from SK and GS Caltex) have risen due to robust supply/demand fundamentals and oil. The company also resells basic chemical products such as ammonia to third parties. While Huchems's model is relatively defensive, a key risk is unexpected production disruptions at its plants or at its customers. Sales and net profit fell a respective 10% and 46% in 2005 due to extended maintenance related turnaround at Korea Fine Chemical's TDI plant combined with a one-month shutdown at BASF's plant.

Outlook for TDI and MDI
According to *ICIS Chemical Business*, demand was healthy in 2007, driven by construction activity. Supply has been balanced, helped by exports to China, where supply was tight last year. New energy regulations should drive demand for insulation, especially in Central and Eastern Europe. Global demand for MDI is 7-8%/year, with the strongest growth of about 15%/year in China. Demand in the rest of Asia-Pacific is forecast above 8%/year. Europe will grow by 6-7%/year. Several projects are planned. In Europe, Borsodchem will build a 200,000 ton/year unit by 2011 and Bayer Material Science is studying a 400,000 ton/year plant by 2012-2013. More expansions are under way or proposed in China, India, Iran, South Korea, Portugal and the US. For TDI, the TDI market started to recover in 2006 after a long and low-priced market in 2005. More than 225,000 tons/year of capacity closed during 2005 in the U.S. at Bayer, Huntsman and Lyondell. Dow Chemical shut its plant in Italy, in August 2006. *ICIS Chemical Business* forecasts world demand to grow by 3-4%/year, with the strongest growth in Asia, mainly China. Western Europe will grow at GDP rates, but will be higher in Central/Eastern Europe and the Middle East/Africa. Supply in Europe is tipped to stay tight until 2011.

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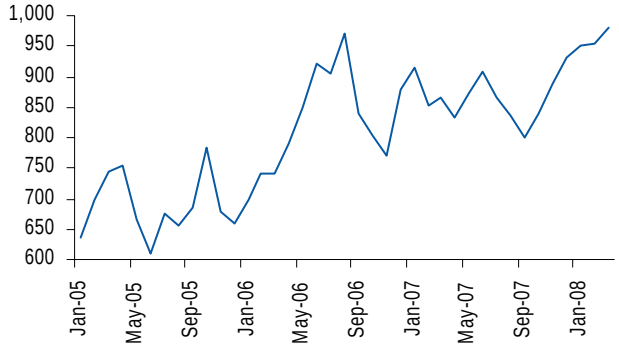
Table 1: Huchems Fine Chemical: Sales composition and market positioning

(Won in billion)

Product	Sales	% sales	Main customers	Share
Manufactured products				
DNT	125	41%	DC Chemical, Korea Fine Chemical	*100%*
Nitric acid	84	28%	POSCO, Rhodia Polyamaid, BASF, Kumho Mitsui, Hanwha	*80%*
Ammonium nitrate	19	6%	Hanwha, Korea Nobel Chemical	*95%*
Toluidine, others	6	2%	Hannam Industrial, Changjin Chemical	*60%*
Non-manufactured products for resale				
Ammonia	29	10%	Hanwha, BASF, Daesang, KEPCO	*10%*
Urea	16	5%	Dongwha Chemical, Hansol Chemical	*30%*
Methanol, etc	23	8%	Hansol Chemical, UNID, Foresco, Eagon Industrial	*10%*
TOTAL	301	100%		

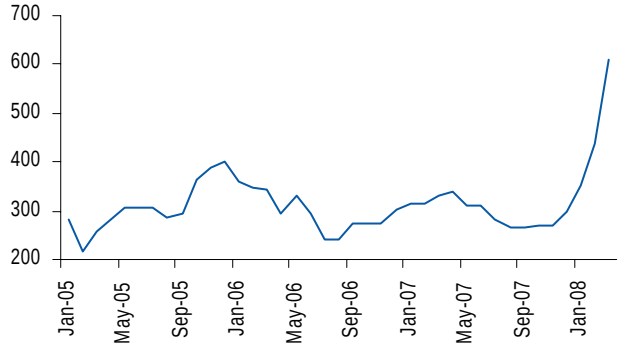
Source: Company

Figure 1: Toluene: Spot price
(US$/ton)



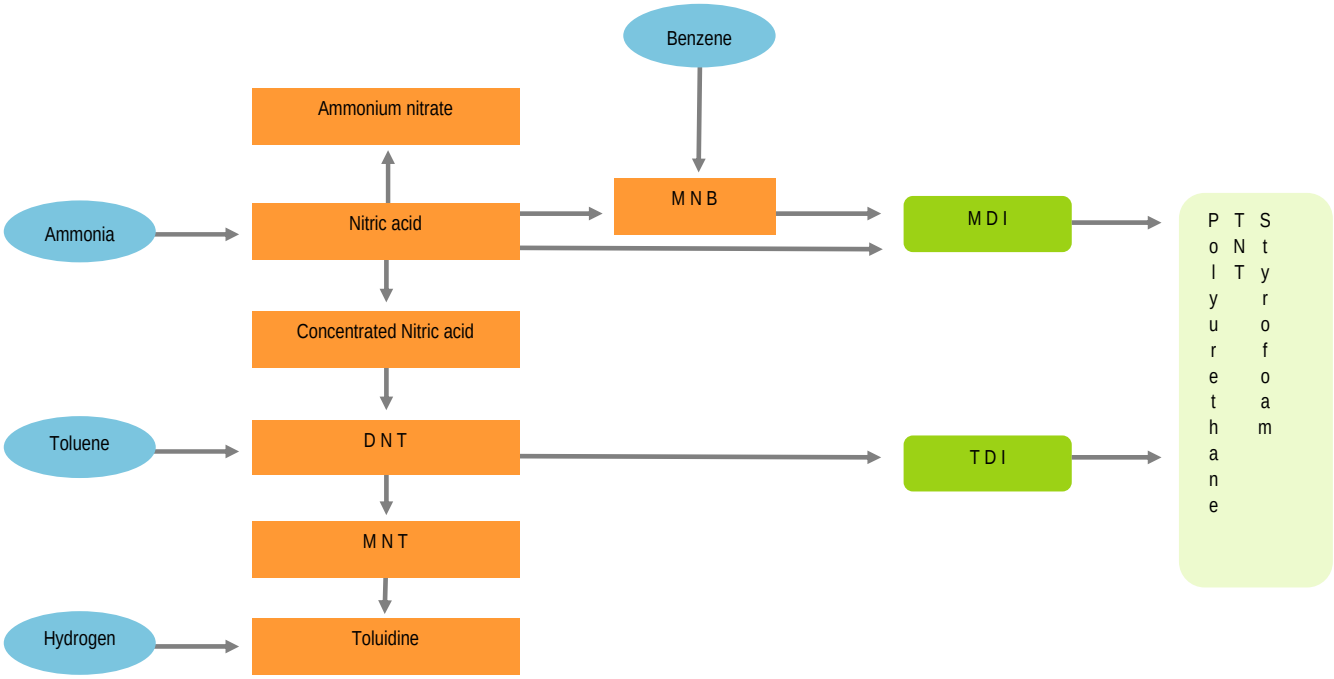
Source: Datastream

Figure 2: Ammonia: Spot price
(US$/ton)



Source: Datastream

Figure 2: Huchems Fine Chemical: Product flow chart (Orange boxes represents Huchems's capacities)



Source: Company

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Recent initiatives to boost margin and top-line prospects

- **Increased vertical integration yields W7 billion cost savings—**The addition of a diluted sulfuric acid concentration facility in 2006, which enables Huchems to reuse excess sulfuric acid during the production of DNT, is expected to result in annual cost savings of W7 billion or 2.3% gross margin improvement, according to the company. This combined with a roll-off in D&A are responsible for margin gains in FY07.

- **Mono Nitro Benzene Plant (MNB) to boost annual revs by W130 billion—** Huchems is building a plant capable of producing 150,000 ton/annum of MNB, a raw material for the production of MDI which is an intermediate product for polyurethane production, at a cost of W52 billion. The plant is expected to come on line in January 2009. The MNB will be supplied to Kumho Mitsui Chemicals under a minimum 15 year contract. Huchems estimates annual revenues of W130 billion with an operating margin of at least 10%.

- **CDM business to add W4.5 billion revs/OP per annum through 2012—**The Clean Development Mechanism (CDM) is a market based trading mechanism created by the Kyoto Protocol. Countries which have established an emissions reduction target under the Kyoto Protocol (Annex I countries such as in the EU) can contribute to the financing of projects in developing countries (non-Annex I countries such as Korea) which do not have a reduction target. The achieved emission reductions can be used by the Annex I country in order to meet its reduction target. The return of CDM investments depends on how emission permits are used by the investor. There are two basic options for the investor: 1) sell the emission permits to other companies or governments on international markets or 2) use the emission credits for offsetting emissions of own operations outside the CDM host country that are regulated by climate policies. In cooperation with Carbon of Austria, Huchems entered the clean development mechanism business in 2007. In exchange for the construction of a N2O reduction facility, Carbon will take a 75.9% stake in the project and proportionate annual income (estimated at W20 billion) until 2012. Under the agreement, Carbon will return the 75.9% stake to Huchems. Huchems currently has a 22.2% stake and the United Nations holds the remaining 2%.

Attractive financial characteristics

- **Net cash of W89 billion (18% of market cap)—**Huchems had W94 billion in cash and equivalents against debt of only W10 billion as of FY07.

- **Strong cash flow producer—**impressive working capital management (net working capital/sales has averaged less than 10% each of the past four years) combined with stable operating performance has translated into robust cash flow. Capex—W40 billion budgeted in FY08 for the MNB plant; maintenance capex is under W10 billion per annum.

- **Above average dividend payout—**36% of net profit

- **No non-core investments**

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Huchems Fine Chemical Corp: Financial summary

(Won in billion, year-end December)

Profit and Loss statement	FY04	FY05	FY06	FY07
Net Sales	306	276	301	302
Cost of Sales	265	245	258	242
Gross Profit	41	31	43	59
margin (%)	13.3%	11.3%	14.1%	19.7%
SG&A	19	19	21	22
EBITDA	43	33	42	54
margin (%)	13.9%	12.0%	14.0%	18.0%
Operating Profit	21	12	22	38
margin (%)	7.0%	4.4%	7.2%	12.5%
Non-operating items	0	(0)	(1)	2
Interest income	0	1	2	4
Interest expense	(1)	(0)	(0)	(0)
FX transaction	0	(0)	(0)	0
FX translation	0	(0)	0	0
Gain on equity method	0	0	0	0
Others	1	(1)	(3)	(1)
Pre-tax Profit	22	12	21	40
margin (%)	7.0%	4.4%	6.8%	13.2%
Income Taxes	6	4	5	12
Net profit	15	8	15	28
margin (%)	5.0%	3.0%	5.0%	9.4%
EPS (Won)	716	389	711	1,328

Balance sheet	FY04	FY05	FY06	FY07
Current Assets	96	103	117	154
Cash & equivalents	27	46	60	94
Receivables	46	36	41	42
Inventory	20	17	14	15
Others	2	4	2	4
Fixed Assets	131	117	104	97
Investment Assets	2	2	2	2
Tangible Assets	122	107	96	88
Others	8	8	6	8
Total Assets	227	220	221	251
Current Liabilities	53	47	43	53
Payables	26	37	31	22
Short-term Debts	13	0	0	10
Others	13	9	13	21
Non-current Liabilities	19	14	7	5
Long-term Debts	0	0	0	0
Others	19	14	7	5
Total Liabilities	71	60	51	58
Paid-in Capital	21	21	21	21
Capital Surplus	108	108	108	108
Retained Earnings	26	30	41	64
Shareholders' Equity	156	159	171	193

Cash flow	FY04	FY05	FY06	FY07
Operational cash flow	41	41	28	38
Net Profit	15	8	15	28
D&A	21	21	20	16
Severance provision	5	4	3	1
FX gains/losses	(0)	0	(0)	(0)
Chg in working capital	(2)	6	(13)	(8)
Others	1	2	2	(0)
Investment cash flow	(6)	(28)	(21)	(5)
Capex	(4)	(5)	(11)	(8)
Disposal of tangible assets	0	0	0	0
Chg of Intangible assets	0	0	0	0
Chg of Investment assets	0	(0)	(1)	1
Others	(1)	(23)	(9)	1
Financing cash flow	(16)	(17)	(4)	4
Chg in ST & LT debts	(12)	(13)	0	10
Change in Bonds	0	0	0	0
Right Issue	0	0	0	0
Dividend	(4)	(5)	(4)	(6)
Others	(0)	(0)	0	0
Net cash flow	19	(4)	4	38
Cash at beginning	8	26	22	26
Cash at end	26	22	26	64

Ratio Analysis	FY04	FY05	FY06	FY07
Growth Ratios				
Sales growth %	21.5%	-9.9%	9.1%	0.3%
Operating profit growth %	29.7%	-43.4%	79.2%	74.5%
Net profit growth %	14.7%	-45.6%	82.9%	86.7%
EPS growth %	14.7%	-45.7%	82.8%	86.8%
Profitability Ratios				
Gross margin %	13.3%	11.3%	14.1%	19.7%
EBITDA margin %	14.0%	12.0%	14.1%	18.0%
Operating margin %	7.0%	4.4%	7.2%	12.5%
Net margin %	5.0%	3.0%	5.0%	9.4%
Stability Ratios				
Total debt to equity %	8.1%	0.0%	0.0%	5.2%
Net debt to equity %	-9.5%	-29.0%	-35.1%	-43.2%
Current ratio %	182.3%	221.6%	269.9%	290.8%
Interest coverage	19.3	197.9	1317.0	194.4
Performance Ratios				
ROE %	10.1%	5.3%	9.2%	15.5%
ROIC %	9.5%	6.2%	14.0%	24.8%
Per Share Ratios				
EPS(Won)	716	389	711	1,328
BVPS (Won)	7,319	7,484	8,015	9,084
DPS (Won)	230	180	260	490

Source: Company