Hong Kong & China
Research

CAZENOVE

Initiation of coverage 19 April 2007

Luks Industrial Group

STOCK RECOMMENDATION **IN–LINE**		PRICE **HK$8.81**	
SECTOR **General industrials**		REUTERS CODE **0366.HK**	BLOOMBERG CODE **366 HK**
12 MONTH RANGE **HK$8.81 – 1.18**		MARKET CAPITALISATION **HK$4.5bn (US$579m)**	PRINCIPAL LISTING **HKG**
NEXT RESULTS DUE **October 2007 (H1)**	LAST RESULTS **16 April 2007 (FY)**	CHANGE IN STOCK RECOMMENDATION **n/a**	
		CHANGE IN EPS ESTIMATES **n/a**	

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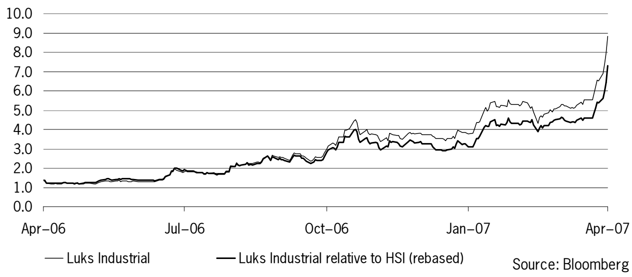
We initiate coverage on Luks Industrial Group (Luks) with an IN–LINE rating. Despite our positive assessment of Luks' Vietnamese operations (95% of revenue) and our forecast of a 555% increase in adjusted earnings between FY06 and FY09E, the recent spike (up 35% in one week/up 69% in one month) has pushed the share price above our fundamental fair value of HK$8.35.

However, we note that our **fair value is based on existing assets and confirmed expansion plans**. Management has ambitions to expand its presence in all three of its key businesses in Vietnam, giving **scope to add significant further value**. Its market experience and contacts, in this respect, are hidden assets **not captured in our fair value**. Currently Luks has three key businesses in Vietnam:

- **Cement**: At the end of 2006 cement capacity increased from 0.8m tonnes to 1.5m tonnes. Committed plans are in place to increase this to 3.0m tonnes by mid–2008. EBIT per tonne (US$11 in FY06) is above regional peers. Expansion to 5.0m tonnes is possible by 2010.
- **Property investment**: Luks owns the tallest office building in Vietnam, the Saigon Trade Centre. Positive rental reversions should underpin solid earnings growth during our forecast period. Management has ambitions to participate in further 'develop–own' projects in the office and serviced apartment sub–sectors.
- **Property development**: Luks has to date entered into two residential property development joint ventures with a total sellable floor area of 165,000 sqm. We estimate that these two projects will contribute net earnings of HK$311m. Management is in active discussions to secure additional land bank with an aim going forward of developing 100–150k sqm of residential space annually.

Share price performance



Source: Bloomberg

Share price (%)		**–1 mth**	**–3 mth**	**–12 mth**
Ordinary shares		+69	+134	+548
Relative to Hang Seng Index		+64	+135	+437
Average daily volume shares				2.6m
Hang Seng Index				20299.71
Year end: December	**2006**	**2007E**	**2008E**	**2009E**
Turnover (HK$m)	373.7	577.1	822.3	1,112.5
EBITDA (HK$m)	115.7	203.2	297.9	401.0
Earnings – reported (HK$m)	200.3	144.8	342.6	443.0
Earnings – adjusted (HK$m)	79.8	144.8	342.6	443.0
EPS – adjusted (HK$)	0.159	0.285	0.675	0.873
Growth (%)	+76	+79	+137	+29
DPS (HK$)	0.080	0.080	0.080	0.100
Growth (%)	0	0	0	+25
Div cover (x)	2.0	3.6	8.4	8.7
EV/EBITDA (x)	38.9	22.2	15.1	11.2
PER adj (x)	**55.3**	**30.9**	**13.1**	**10.1**
PBR (x)	3.7	3.4	2.8	2.2
EV/Sales (x)	12.0	7.8	5.5	4.0
Yield (%)	**0.9**	**0.9**	**0.9**	**1.1**
EBIT margin (%)	26.0	30.9	32.2	32.8
EBITDA margin (%)	31.0	35.2	36.2	36.0
Market cap:sales (x)	12.1	7.8	5.5	4.1
NAV per share (HK$)	2.1	2.4	2.7	3.3
ROE (%)	16.4	10.9	21.1	21.9
ROCE (%)	7.3	10.2	11.9	18.0
Interest cover (x)	24.7	6.8	5.5	13.0
Net debt/equity (%)	cash	22.5	29.2	cash

Source: Cazenove

1.0
Key points

1.1 Overview

Vietnam accounts 95% of revenue…earnings to expand 5.5x by FY09E

Vietnam, where Luks has had a presence since 1991, accounted for 95% of group revenue in FY06. While headline earnings in FY06 were distorted by investment property revaluations, underlying adjusted (operating) earnings still grew by a healthy 79%. With further expansion of the cement plant, the addition of property development in Ho Chi Minh City as a new earnings stream, and a positive rental reversion cycle for the group's investment property, the Saigon Trade Centre (the tallest building in Vietnam), we forecast earnings expansion of 5.5x between FY06 and FY09.

1.2 Valuation

fair value of HK$8.35 excludes further value accretive expansion

Our fair value of HK$8.35 reflects only the value of existing assets and firm expansion plans. Within this, cement which we have valued at US$140 per tonne of capacity (comparable to regional peers despite Luks achieving higher profitability per tonne, and arguably operating in a better macro environment) accounts for HK$5.48 (66%). The Saigon Trade Centre contributes a further HK$1.73 per share and the group's two residential property development joint ventures contribute a further HK$0.61. Vietnam in total accounts for HK$7.82 (94%) of our fair value. With a desire to increase its exposure to each of its three key divisions, combined with extensive market knowledge and contacts (hidden assets) as a result of the length of time it has operated in Vietnam, there is scope for further value creation to accrue going forward, resulting in upward revisions to our fair value once future investments are announced.

1.3 Cement

cement EBIT forecast to quadruple between FY06 and FY09E

Accounting for 73% of FY06 revenue and 66% of our fair value estimate, the cement operations (which are 100% owned) and are based at Hue in central Vietnam, are a key component of Luks. EBITDA and EBIT per tonne of capacity achieved in FY06 of US$13 and US$11 respectively compares favourably with regional peers. Capacity was expanded from 0.8m to 1.5m tonnes at the end of 2006 and the group now plans to expand this to 3.0m tonnes by mid–2008. We estimate that this together with efficiency/scale benefits should result in divisional EBIT roughly quadrupling between FY06 and FY09E. While new domestic cement capacity is being added industry wide, demand, driven by extensive infrastructure development, is forecast to continue to outstrip supply until at least 2009. In addition we believe the industry structure – c.75% of supply is controlled by state owned enterprises – should ensure healthy profit and return dynamics on a longer–term basis.

1.4 Property investment

40,000 sqm of HCMC office space out of a total pool of 350,000

The Saigon Trade Centre (STC), a 40,000 sqm office building that is 100% owned by Luks and located in the business district of Ho Chi Minh City (HCMC), is currently Vietnam's tallest building. With no foreign investment in property prior to 1985 and limited investment post Asian crisis until recently, HCMC faces a chronic shortage of international standard office space. Current stock is estimated at only 350,000 sqm. Whilst considerable of space is due for completion post 2008, demand stemming from financial institutions, foreign MNCs and upgrading by domestic corporates is expected to absorb this additional space. The net consensus is for continued rental increases in the next few years followed by stable rates going forward. Our DCF based valuation for STC is HK$1.73 per share based on the current starting office rent of US$29 psm and a 13% discount rate,

1.5 Property development

target of developing 100–150k sqm pa

In October 2006 Luks announced that it had entered into a mid to mass market residential development joint venture (70% owned) in HCMC. It followed this up in January 2007 by announcing that it had entered into a second residential development joint venture (90% owned) also in HCMC, but this time with a mid to high end focus. Combined equity investment in the two projects is US$22.6m for a floor area of 165,000 sqm, and we estimate that Luks' share of attributable profit should total US$40m. Management plans to continue building its land bank with an aim of becoming a developer with an annual release of 100–150k sqm of residential space.

1.6 Funding

We estimate, based on existing operations and committed expansion, that gearing will peak at 29% in FY08 and that existing unutilised banking facilities of HK$600m will be sufficient to fund the group's requirements. If however, Luks turns its ambitions to be a 100,000–150,000 sqm pa residential developer, and/or invests further in investment property, we believe that an equity fund raising exercise, in the absence of an asset disposal, would most likely become a necessity.

2.0
Valuation

our fair value is based on existing operations / committed expansion

The recent dramatic run up has resulted in the share price exceeding our fair value of HK$8.35. However, it is worth noting that our fair value only reflects our fundamental assessment of the value of existing operations and committed expansion plans (1.5m tonne cement plant and two residential property joint ventures).

Luks has ambitions to increase its exposure in each of its three core business segments

With a long track record of operating in Vietnam, and ambitions to increase its exposure in each of its three business segments (cement/property investments/property development) there is scope to potentially add significant further value as Luks deploys further capital into this high growth market. Our fair value clearly ignores the length of time it has been present in the market (16 years) and the intangible benefits – local knowledge and contacts – that result from this.

the value future expansion may create, and the value of local knowledge and contacts is not captured in our fair value

In addition, given investors' appetite for exposure to Vietnam, and the limited availability of investible pure plays, the resulting demand/supply imbalance could conceivably push the share price beyond fundamental valuations.

We would certainly look to buy into any weakness, which could emerge once the market wakes up to the fact that the jump in earnings from HK$22m in FY05 to HK$200m in FY06 was largely the result of investment property revaluations. We estimate core adjusted earnings, while still up a healthy 79% to HK$80m, were considerably lower than the reported headline figure.

2.1 Valuation summary

Fig 2.1 Fair value summary

Asset	Note	US$m	HK$m	HK$/share
Saigon Trade Centre, Vietnam	**DCF valuation**	**114**	**888**	**1.73**
HK & China investment property	Book value per 31.12.06 valuation	33	258	0.50
Total investment property		147	1,146	2.24
Property development, Vietnam	**Share of development profit**	**40**	**311**	**0.61**
Cement, Vietnam	**EV of US$140 per tonne of capacity**	**360**	**2,808**	**5.48**
Other	No value for TCM / Plywood	0	0	0.00
Enterprise fair value		547	4,265	8.32
Net cash / (debt)	As at December 2006	1	11	0.02
Equity fair value		**548**	**4,276**	**8.35**

Source: Cazenove

fair value of HK$8.35 – Vietnam accounts for 94%

Our fair value of HK$8.35 has been derived by valuing the group's key existing operations (Saigon Trade Centre, 1.5m tonnes of cement capacity, HK & China investment properties) along with our estimate of the value to be created by already disclosed expansion plans (1.5m tonnes of cement capacity/two residential property development joint ventures).

2.2 Cement

Cement accounts for the largest portion (66%) of our fair value at HK$5.48 per share. In valuing the cement operations capacity of 3.0m tonnes (1.5m current and 1.5m planned by mid–2008) we have referred to EV/tonne of capacity of other cement companies in the region. The average of our basket is US$137 per tonne of capacity.

Fig 2.2 Cement comparatives on a US$ per tonne of capacity basis

Company	Revenue	EBITDA	EBIT	EV
Lafarge Malaysia [LMC MK]	31	9	5	122
Siam City Cement [SCCC TB]	42	13	11	146
Indocement [INTP IJ]	41	8	6	144
Average	**41**	**11**	**8**	**137**
Luks Cement	**40**	**13**	**11**	

Source: Bloomberg, company reports, Cazenove

cement fair value of HK$5.48 based on EV/tonne of capacity of US$140

despite operating in a better macro environment/achieving higher profitability

Despite Luks operating in arguably a better macro environment – high growth combined with a favourable current demand/supply imbalance – we have erred on the side of caution and have used an EV/tonne of capacity of US$140 to value Luks' cement operations. In arriving at our fair value of US$360m (HK$2.8bn), we have netted off the cash costs that the group will incur in expanding its capacity to 3.0m tonnes.

Fig 2.3 Cement company PERs

Company name	Bloomberg code	Share price	Mkt cap (US$m)	PER 2006 (x)	PER 2007E (x)	PER 2008E (x)
Siam City Cement	SCCC TB	274	2,107	16.7	15.8	14.7
Hanil Cement	003300 KS	99700	807	12.3	14.8	13.7
Asia Cement	002030 KS	51800	263	13.3	21.4	17.2
Anhui Conch Cement	914 HK	32.05	5,913	103.4	38.9	27.2
YTL cement	YTLC MK	4.60	654	16.1	13.1	11.6
Lafarge Malaysian Cement	LMC MK	1.82	1,496	29.4	26.0	24.3
Holcim Indonesia	SMCB IJ	660	555	28.7	25.3	18.7
Indocement	INTP IJ	5400	2,006	33.5	20.3	15.8
Average				**30.2**	**21.3**	**17.9**

Source: Bloomberg

PER cross check suggests our valuation is reasonable

As a cross check, we have compared our implied FY08E PER of Luks' cement based on our valuation of US360m (HK$2.8bn) to the average PER of an enlarged basket of cement companies. Luks at an estimated 17.6x, is trading in line with the basket average of 17.9x.

2.3 Property investment

CB Richard Ellis valued the Saigon Trade Centre (STC) – Luks' only investment property in Vietnam – at US$82.2m as at 31 December 2006. We understand that in deriving its valuation that it used a DCF valuation method (there have been no office transactions in the market of A/B grade office space) using a starting current office rental rate of US$25 psm, and we estimate, based on our own modelling of the cash flows over the remaining lease life (36 years), a discount rate of 15%.

We understand current achieved office rental rates for STC average US$29 psm (high floors US$31/low floors US$27). Using this as a starting point and discounting the resulting cash flows at 13%, results in a valuation of US$114m. We have used this in our fair value working. For the HK & China investment properties, we have used the December 2006 valuation of HK$258m.

Saigon Trade Centre fair value of HK$1.73

Fig 2.4 Saigon Trade Centre valuation sensitivity

		STC office rent (US$ psm)				
		25	***27***	***29***	***31***	***33***
Discount rate (%)	***15%***	82	90	96	103	110
	14%	90	97	104	112	119
	13%	98	106	**114**	122	130
	12%	108	116	125	134	142
	11%	119	128	138	148	157

Source: Cazenove

2.4 Property development

We have cross checked, with international property consultants in Vietnam, the reasonableness of land costs, development costs and expected selling prices for Luks' two residential property development joint ventures. In deriving our fair value we have used Luks' share of expected net profits of US$40m as a proxy for the economic value added. Whilst we have not discounted the cash flow movements, we expect price increases to more than compensate for this.

2.5 Other

We have ascribed zero value to Luks' remaining operations – Traditional Chinese Medicine (TCM) and Plywood. Luks spent an estimated HK$300m in acquiring and developing the TCM business, If current clinical trials prove successful this could prove to be hidden assets. At this stage however, we would rather adopt a conservative approach.

3.0
Background

3.1 History

Founded in 1975, and listed on the Hong Kong Stock Exchange in 1987, Luks originally was a television manufacturer with plants in China. These operations were merged to form TCL in 1996. TCL was subsequently listed in 1999. Post listing, Luks completed the disposal of its television manufacturing business.

95% of group revenue from Vietnam in FY06

Luks first move into Vietnam was via the setting up of a television manufacturing plant in 1991. Following this, in 1992, Luks entered into two significant joint ventures. The first (75% owned) was to build an A–grade office building in Ho Chi Minh City – 'Saigon Trade Centre' – and the second (68% owned) was to construct a 600,000 tonne per annum cement plant in Hue. Both were completed in 1996 and Luks upped its stakes to 100% in the property and cement businesses in 2001 and 2005 respectively.

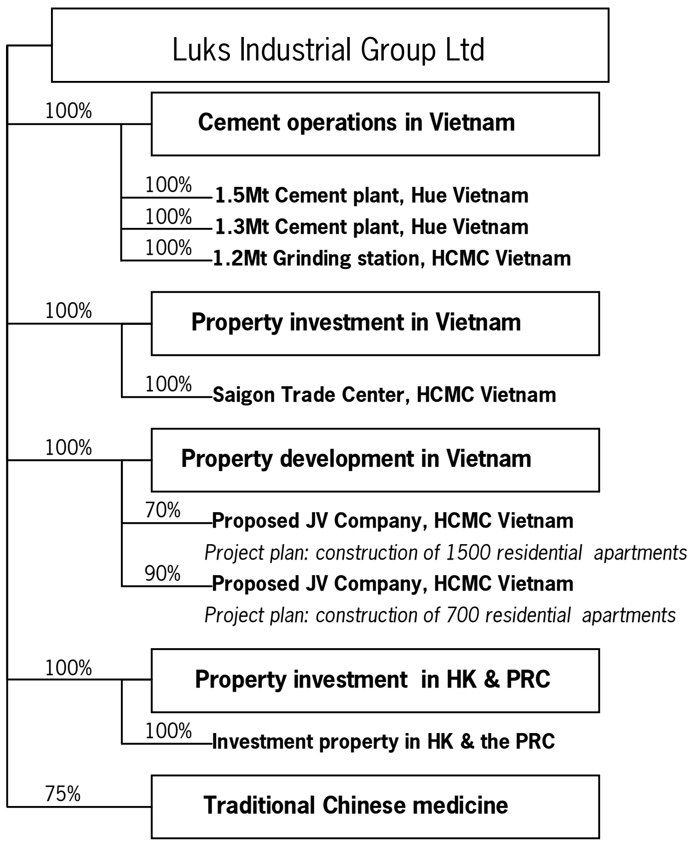
The cement plant capacity was increased to 800,000 tonnes in 2005 and to 1,500,000 tonnes in 2006. In 2006 the group also announced plans to increase capacity to 3,000,000 tonnes by mid 2008. In October 2006 Luks announced that it was setting up a residential development joint venture (70% owned), and followed this with the announcement in January 2007 of a second residential development joint venture (90% owned).

In FY06 Luks generated 95.3% of group revenue from Vietnam, with the cement operations contributing 73.5% and property investment 21.1%. Reflecting this geographical bias, the company has proposed a name change from 'Luks Industrial (Group) Limited' to 'Luks Group (Vietnam Holdings) Company Limited'. This name change will be voted on at the group's next AGM.

3.2 Organisational structure

three core divisions:
– cement
– property investment
– property development

Fig 3.1 Organisational structure



Source: Company

Notes: (1) targeted completion date: first half 2008; (2) JV company expected to be established before end 2007

3.3 Management

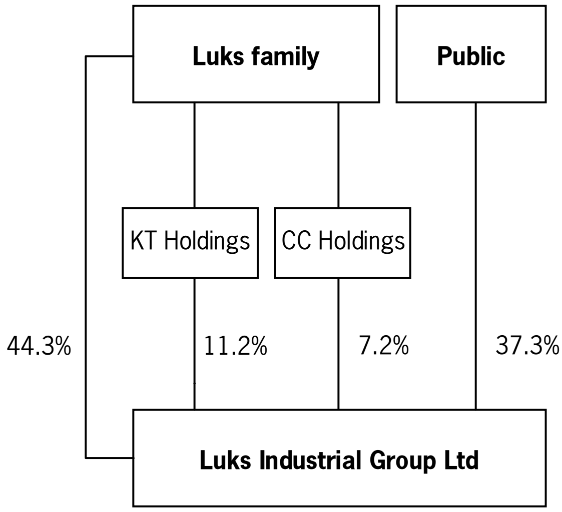
At the board level, aside from three independent non–executive directors and one executive director (Mr Martin Fan (41), the group financial controller who has been with the company for 16 years), all other posts are held by Luk family members: Mr Luk King Tin (70), founder, chairman and chief executive; Madam Cheng Cheung, Mr Luk King Tin's wife; Mr Luk Yan (43) and Mr Luk Fung (39), both sons of Mr Luk King Tin.

At the operational level, management has a wide range of experience. While the heads of both the group's cement and property operations in Vietnam are expatriates (Hong Kong Chinese), both have lived in the country for over ten years. Overall staff totals 910, mainly in Vietnam.

3.4 Ownership structure

Fig 3.2 Ownership structure

Luks family own 62.7%



Source: Company

3.5 Corporate governance

We are not aware of any action that has prejudiced the interests of minority shareholders during the group's long history as a listed company. The appointment of a big four auditing firm (Ernst & Young) also helps with credibility of the financials, although the audit opinion was qualified in both 2004 and 2005 because of an inability to substantiate the assumptions used to value the goodwill associated with the group's traditional Chinese medicine operations. This ceased to be an issue in 2006 with these assets having been written down to zero.

The only noteworthy issue on a corporate governance front is the fact that the Chairman and CEO roles are not split, with Mr Luk King Tin, the group's founder, holding both positions. According to the company, Mr Luk has no material interests aside from his shareholding in Luks Group.

3.6 Environmental issues

Clinker and cement carry numerous environmental concerns, from the consequences of quarrying to high dust creation and high energy usage (to fire kilns and cool down clinker). The use of alternative fuels is also limited due to occurrence and collection issues, with only about 3% of the group's energy needs coming from alternative fuels (rice husks/wood dust). That said, Luks operates the only cement plant in Vietnam, to our knowledge, with ISO 9001, ISO 14001 and ISO 18001 accreditation. There is a small provision in the company's accounts of HK$0.6m (2005 annual report figure) relating to environmental restoration, and signs of tree planting around the periphery of the quarry are in evidence.

4.0
Operational summary

4.1
Luks

Fig 4.1 FY06 revenue mix

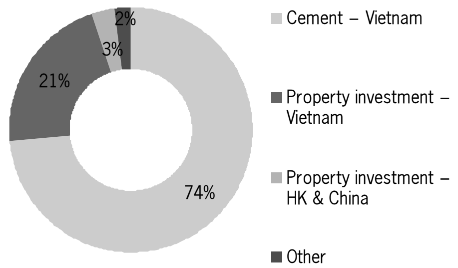
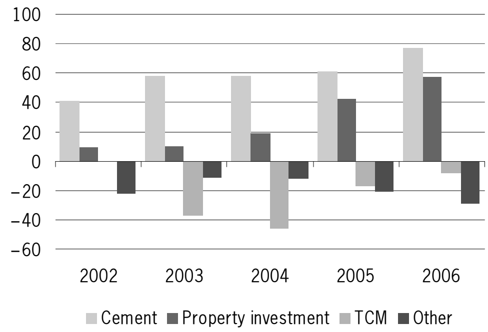


Fig 4.2 Adjusted divisional EBIT (HK$m)



Legend: segments listed clockwise from top
Source: Company / Cazenove

95% of revenue generated in Vietnam

73% of assets located in Vietnam

As at December 2006, 73% of Luks' assets were located in Vietnam. These assets generated 95.3% of total group revenue in FY06 – up marginally from 94.4% in FY05 and 93.2% in FY04. The Vietnamese cement operations were the largest contributor to revenue, accounting for 73.5% of group revenue in FY06, with the group's Vietnamese property investments (Saigon Trade Centre) accounting for a further 21.1%.

Fig 4.3 Asset base

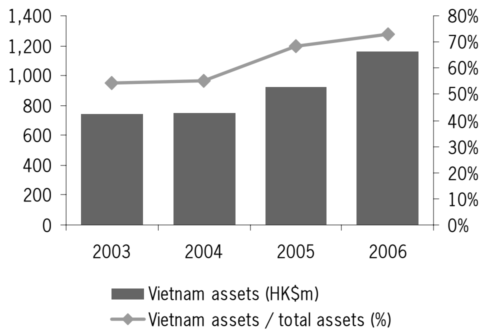
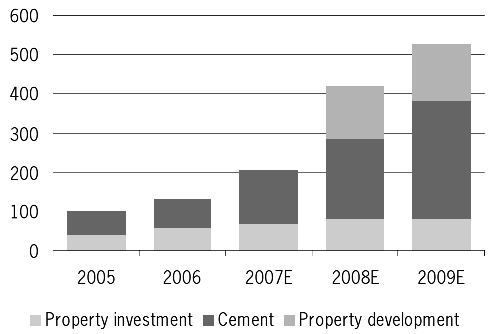


Fig 4.4 FY05–9E Vietnam adjusted EBIT



Source: Company / Cazenove
Note: net contribution figures for property development used in Fig 4.4

dramatic increase in profitability forecast due to new capacity and new earnings streams

In contrast to the group's other assets (namely Traditional Chinese Medicine), the Vietnamese operations of Luks (cement and property investment) have been consistently profitable. As discussed later in this report, we expect the expansion of cement capacity and the two property development joint ventures announced to date to lead to a substantial increase in the level of profit the group generates in Vietnam going forward.

4.2
Vietnam

With a large (84m) and young (69% < 35 year) population, a reasonably large natural resource base, a stable political environment and an increasingly pro–foreign business environment (accession of Vietnam to WTO in November 2006), Vietnam is increasingly being viewed as an attractive market, especially for those wishing to diversify their exposure to China.

Vietnam presents a positive macro backdrop for cement and property demand

The net result is that Foreign Direct Investment jumped sharply in 2006 and these substantial inflows of foreign capital are forecast to be an ongoing feature. This should help sustain high GDP growth, which has been above 8% in the past two years.

This economic environment provides a positive macro back–drop for the areas in which Luks operates –cement and property. In addition we would note post the Asian crisis, infrastructure and property investment fell sharply. The net result is that significant investment is needed to realise Vietnam's potential. Encouragingly this is now taking place, which should underpin rising cement demand. On the property front, the increased foreign presence in Ho Chi Minh City (HCMC) is driving up both office and residential property demand. In addition the property market in HCMC is benefiting from continued urbanisation, higher wages and population ageing.

robust GDP growth and rising GDP per capita

Fig 4.5 GDP growth (%)

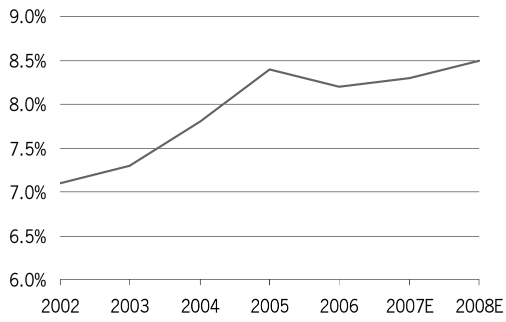
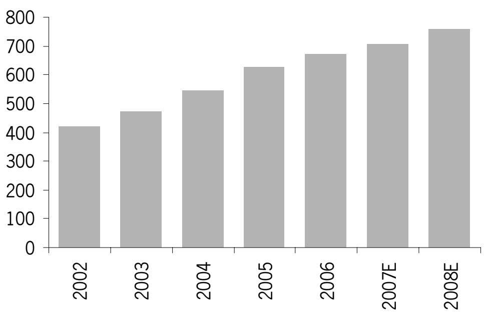


Fig 4.6 GDP per capita (US$)



Source: Asian Development Bank

increasing FDI and fixed asset investment

Fig 4.7 Fixed asset investment (VDN billion)

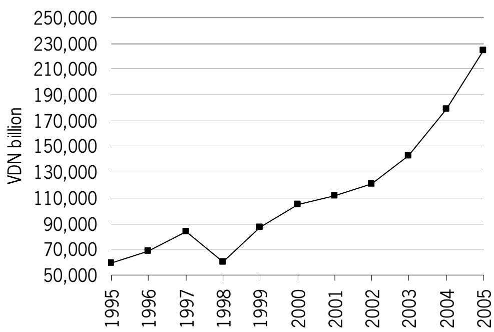
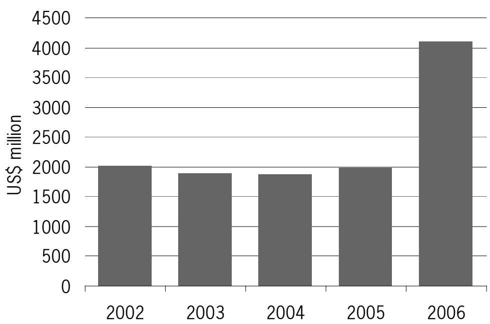


Fig 4.8 Foreign Direct Investment (US$m)



Source: Asian Development Bank

young population with rising income levels

Fig 4.9 Population age profile

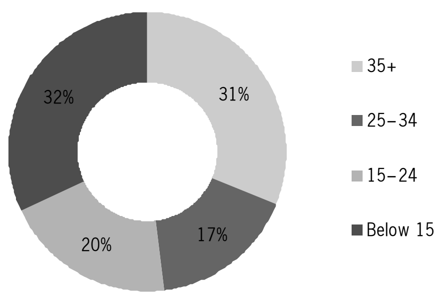
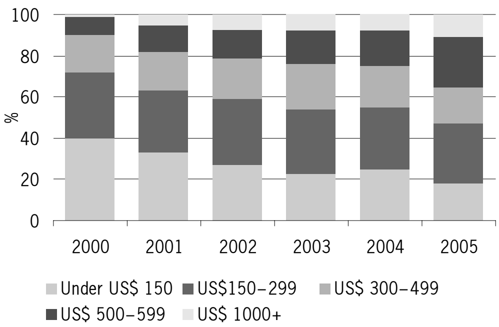


Fig 4.10 Income distribution



Legend: segments listed clockwise from top
Source: Asian Development Bank

5.0
Cement

5.1 Summary

Initially set up as a JV in 1992, Luks is now the only 100% foreign owned cement company in Vietnam. Based in Hue, it is the largest cement producer in the Central region. Its quarry, which is adjacent to its plant, covers 100 hectares and has estimated limestone reserves of 300m tonnes. It is the only cement producer in Vietnam, to our knowledge, to have attained ISO 9001, 14001 and 18001 (environmental) accreditation.

capacity to increase from 0.8m tonnes in mid–2006 to 3.0m tonnes by mid–2008

Cement production commenced in 1996, with an initial annual capacity of 0.6m tonnes. This was increased to 0.8m tonnes in 2005 and 1.5m tonnes in November 2006. Further expansion plans, including a cement grinding plant in the high growth market Ho Chi Minh City, which will take capacity to 3.0m tonnes by Q2 2008, have already been announced. Luks has also secured a ready mix concrete licence for 2.2m tonnes pa. Management is now evaluating the possible expansion of capacity to 5.0m tonnes by 2010, which would take its market share near to 10%.

In FY06, Luks sold 880,000 tonnes of cement at an average selling price (ASP) of US$40/tonne and achieved an EBIT of US$11.2/tonne – above our basket of region peers which achieved an EBIT per tonne of capacity of US$8.0. We are forecasting an increase in EBIT per tonne (US$12.4, US$13.2 and US$14.3 in FY07–9E, respectively) as economy of scale benefits, newer more efficient equipment and price increases offset higher input costs. The net result is that we forecast EBIT contribution will quadruple between FY06 and FY09E.

EBIT forecast to quadruple between FY06 and FY09E

Fig 5.1 Cement summary

Year end: December	FY04	FY05	FY06	FY07E	FY08E	FY09E
Capacity – period end	800,000	800,000	1,500,000	1,500,000	3,000,000	3,000,000
Capacity – average	800,000	800,000	887,500	1,500,000	2,250,000	3,000,000
Utilisation (%)	95%	98%	99%	93%	89%	90%
ASP (US$/tonne)	35.9	38.0	40.0	42.0	44.1	46.3
EBIT margin	27%	26%	28%	29%	30%	31%
EBIT (US$/tonne)	9.8	10.0	11.2	12.4	13.2	14.3
EBIT (HK$m)	57.7	60.8	77.0	134.9	205.5	301.6

Source: Cazenove

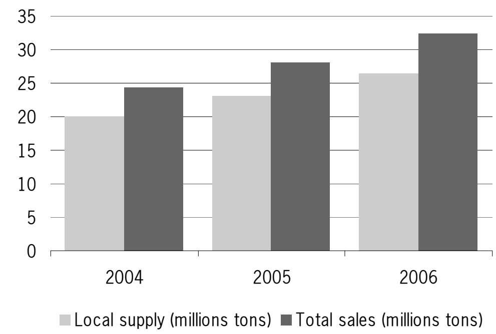
5.2 Industry overview

Demand
Intensive infrastructure and property development provide a positive demand backdrop for cement demand in Vietnam. According to the Vietnamese National Cement Association (VNCA), demand is expected to grow at a rate of c 12% pa. If this rate of growth were to materialise, then cement demand would increase from 32.5m tonnes in 2006 to roughly 50.0m tonnes by 2010. The Ministry of Construction forecasts a higher growth rate of roughly 15%.

positive demand/supply imbalance exists currently…

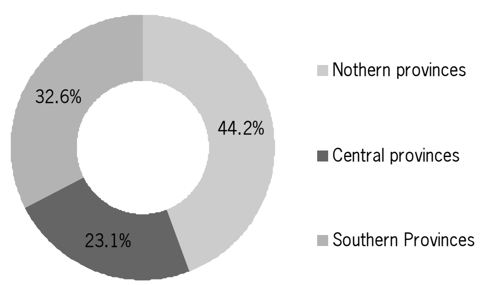
…and demand is forecast to grow at a rate of 12–15% pa

Fig 5.2 Domestic sales and supply



Source: VNCA

Fig 5.3 Geographic split of cement production



Legend: segments listed clockwise from top

Within the cement industry conventional wisdom is for demand to accelerate once GDP per capital reaches US$3,000 and to plateau when it exceeds US$15,000. In the key urban markets of Ho Chi Minh City and Hanoi, the US$3,000 threshold is rapidly approaching. Based on 2006 figures cement demand per capita in Vietnam is 0.4 tonnes. This compares to 1.0 tonnes per capita in China and an average in Europe of 0.6m tonnes (UK at 0.2m/Spain at 1.0m).

Supply

supply forecast to catch up with demand by 2009, but there is a long history of delays

Turning increasing demand into profit is dependent upon three factors: supply, pricing and input costs. Based on planned expansion, the consensus is for the current demand/supply imbalance, and resulting reliance on imports (largely from Thailand), to evaporate by 2009, and for a supply surplus to occur in 2010. We would note however that there is a long history of capacity expansion delays and that the most vocal voice in making these predictions, the VNCA, has a vested interest in painting a bearish picture given its linkage to roughly 75% of Vietnam's cement production capacity (c.55% pure domestic entities/c.20% JVs with foreign entities – Holcim and Lafarge from Europe, Taiheiyo of Japan, and Chinfun and Phuc Son of Taiwan). All the foreign JVs operate dry processes (more efficient) and have been granted approval for capacity expansion.

Costs

costs, particularly coal, are rising…

…but price rises should offset this

While the input cost environment is clearly bearish – removal of preferential coal pricing/higher electricity costs/higher oil costs – we believe that the VNCA will continue to push for price rises while at the same time lobbying for a reduction in the level of capacity approvals. Our view is based on our understanding that the domestic entities remain relatively inefficient (some wet cement) and have high debt levels to service (the result of purchasing expensive European equipment). Without this support the domestic entities would risk failure. In addition, cement prices in Vietnam still appear to be relatively low. In FY06 Luks achieved an ASP/tonne of sales of US$40. This compares to official cement rates of US$64/tonne in Malaysia (Malaysian Cement Association – Dec 06) and US$70/tonne in Thailand (Bank of Thailand – Jan 07).

Geology and Geography

supply concentrated in the North, with a resulting shortage in Southern Vietnam

Limestone is the principal ingredient in clinker production, which in turn is ground and mixed with additives to produce cement. Vietnam's limestone deposits stretch from the north to the centre of the country. With deposits of coal, (used to fire the incinerators used to produce clinker) mainly in the north of the country, most of Vietnam's clinker production capacity, and as a result cement production capacity, is located in that region. The net result is a supply surplus and keen pricing, in the north, but a supply shortage, satisfied by Thai imports, in the south. High freight costs combined with this demand/supply imbalance result in higher prices in the south.

5.3 Operational detail

Assets and capex

clinker capacity will continue to be located at Hue in Central Vietnam…

…but the next phase of expansion will include cement crushing and readymix concrete in HCMC

Currently all of Luks' assets are located adjacent to the site of its limestone quarry (100 hectares / 300m tonnes of estimated reserves) on the outskirts of Hue in Central Vietnam. While additional clinker capacity will continue to be located at Hue (access to limestone/economies of scale), Luks' most recent expansion plans include the setting up of a cement crushing plant on the outskirts of Ho Chi Minh City.

Fig 5.4 Luks: cement capacity (tonnes 000's)

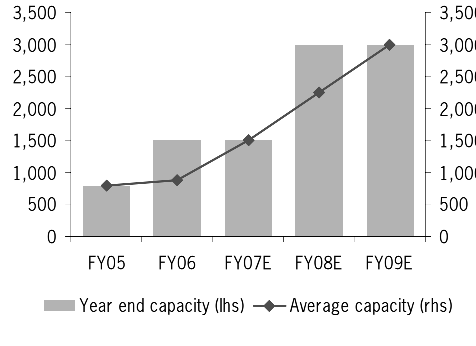
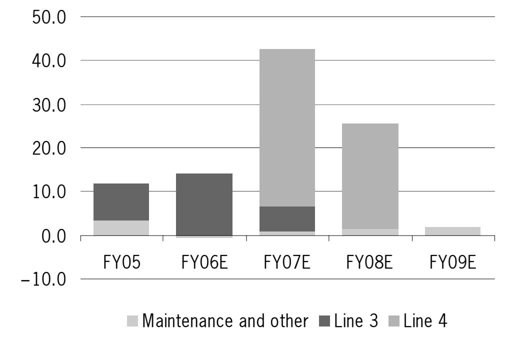


Fig 5.5 Luks: cement capex profile (US$m)



Source: Company

- Lines 1 & 2, Luks' 'old' plant has a cement capacity of 800,000 tonnes.
- Line 3, which was commissioned in November 2006, has a cement capacity of 700,000 tonnes. Equipment, sourced from China, cost US$10.7m and additional infrastructure and other related spend amounted to a further US$17.3m, bring the total cost per tonne to US$40.
- Line 4, which is scheduled to be commissioned in Q2 2008. will have a cement capacity of 1,500,000 tonnes. The equipment supply will cost US$25.6m (agreement already signed with a Chinese supplier) and management estimates spend on other items at US$34.4m, translating into an overall cost per tonne of US$40.

capacity expansion from 0.8m tonnes at mid–05 to 3.0m tonnes at mid–08 at a cost of US$40 per tonne

At a cost of US$40 per tonne of additional capacity, Luks is well positioned to generate a rapid payback on its investment. EBITDA per tonne in FY06 was US$13.5 and working capital requirements should be modest (overall group trade working capital to sales was only 6.5% in FY06). This low cost is made possible by the use of Chinese equipment, which we understand is priced at roughly one–third of a European line. With China the largest cement producer in the world (c. 45% of global supply) we do not believe credibility is an issue – indeed Luks' Lines 1 & 2 were also sourced from China and Lafarge uses Chinese equipment at its cement grinding plant in Ho Chi Minh City.

high capital costs for SOEs (c. 75% market share) should help underpin industry margins / returns

This capital cost element is also significant when considering overall pricing/industry profitability. We understand that the State Owned Cement Enterprises predominantly operate European equipment. In addition to placing a higher debt burden on these entities, which in turn needs financing, it also inflates the relative asset base when calculating acceptable cash returns. The net result, in our view, is that despite all the demand/supply noise, Luks should be well positioned to continue earning healthy returns on its investments.

Costs and profitability

As highlighted above, we see cost inflation as an unavoidable feature going forward, largely as a result of the Government's move to abolish the previous practice of preferential coal pricing for cement. We believe however, that the impact of cost inflation can be more than mitigated by resulting price rises, and in Luks' case increased efficiency (scale and newer plant). The net result is that we forecast margin expansion going forward.

Fig 5.6 Cost of goods sold breakdown

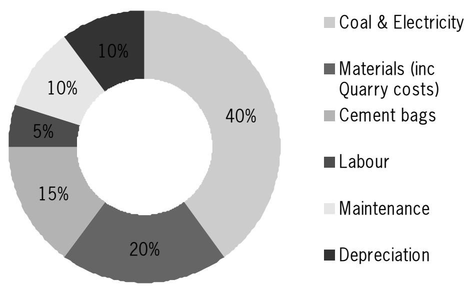
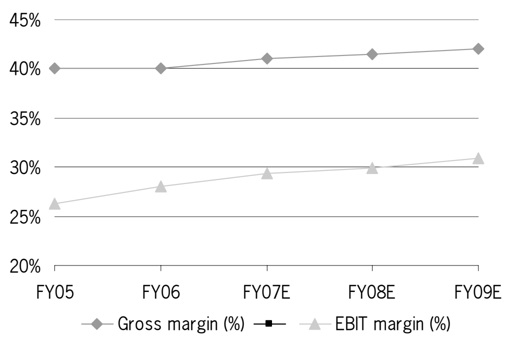


Fig 5.7 EBITDA and EBIT margins (%)



Legend: segments listed clockwise from top
Source: Company / Cazenove

coal and electricity account for 40% of costs

coal prices are expected to rise by 25% in 2006

Coal, used to fire the kilns for heating clinker up to 1,400°C, is the largest cost component. As a of result of cement's position as strategic industry, and as a result of substantial coal reserves in the country, preferential pricing has been a positive feature in Vietnam. However in January 2007 the Government gave the go ahead for negotiation between the largest users and Vietnam Coal and Minerals Group (VCMI) to establish reasonable prices. Luks estimates that coal prices, having already risen in FY06 will rise by a further 20–25% in FY07. Other costs, of which electricity is the next largest (used to power fans to cool the clinker), should only face modest inflation.

To counter rising input costs, and to avoid pure reliance on price rises for margin protection, Luks continues to focus on improved efficiency. These initiatives include:

- Increased scale – capacity will nearly quadruple by mid 2008.
- Improved equipment – of the resulting capacity, 75% will be newer and more efficient.

efficiency gains combined with rising prices should however result in solid, if not expanding, margins

- Introduction of a feed belt from the quarry to the plant – to reduce truck/handling costs.
- Introduction of higher value added product – ready mix in HCMC (2.2m tonne) licence.
- The possible building of its own coal fired power station.
- The use of extruders – these non–clinker items can account for c. 30% of cement volume, with pulverised fly ash (by–product of coal thermal power stations) a common extruder.

Credibility in Luks' ability to deliver is evidenced by the fact that its profitability per tonne of capacity, despite its small size, is already comparable or better than that of its regional peers.

Fig 5.8 Cement profitability comparison

Luks EBIT/tonne of US$11 v's our basket average of US$8

Company	Capacity (m tonnes)	Rev / tonne (US$)	Cost / tonne (US$)	EBITDA / tonne (US$)	D&A / tonne (US$)	EBIT / tonne (US$)
Lafarge Malaysia [LMC MK]	13.0	31	22	9	4	5
Siam City Cement [SCCC TB]	14.5	42	30	13	1	11
Indocement [INTP IJ]	16.5	41	33	8	3	6
YTL Cement [YTLC MK]	6.0	51	36	15	5	10
Average		41	30	11	3	8
Luks Cement		40	26	13	2	11

Source: Company reports/press releases/Bloomberg/Cazenove

Markets and distribution

To date, Luks' main market has been the Central region of Vietnam, where it is the largest player (the State Owned Enterprises are under represented here with a sub 10% market share), and where its 'KIM DINH' brand is well established. Product, principally in bags, is distributed via a network of local third party dealers, although some product is supplied directly to large scale projects and some product is shipped to Laos (seen as a long–term development market). The group's largest customer accounted for an estimated 33% of sales in FY04 and FY05. However, bank and property linked guarantees have resulted in minimal bad debt problems and overall group trade receivable days are a respectable 24 as at December 2006.

infrastructure projects in the Central region, where Luks is the biggest player, should support capacity expansion plans

The Central region is made up of the five provinces: Thua Thien – Hue, Quang Nam, Quang Ngai, Binh Dinh and the city of Danang, While not in the foreign media spotlight to the extent of Hanoi or Ho Chi Minh City, this area has been able to absorb all of Luks' production to date (there was virtually no inventory at the plant during our recent visit) and upcoming infrastructure projects should provide continued demand. Big projects include: the Hai Van Pass Tunnel, one of the biggest tunnel projects in South East Asia, linking Hue with Danang; the Danang – Quang Ngai highway, Chu Lai Open Economic Zone, modernisation of Danang International Airport and especially, Dung Quat Economic Zone with Vietnam`s first oil refinery in Quang Ngai province.

its new cement grinding facility in Ho Chi Minh City should provide it access to a new market

The establishment in Q2 2008 of a cement grinding plant (using clinker shipped by boat from its plant at Hue) with a capacity of 1.5m tonnes on a sixteen hectare site on the Saigon river on the outskirts of Ho Chi Minh City, will provide Luks with direct access to a new high growth market. Distribution, like in the Central region, will be predominately via established distributors. In this market, Luks is focusing on higher grade cements (ie with sulphate additives to combat water corrosion) as a differentiating factor. A brand launch aimed at the local distributors and major direct buyers has already taken place. In addition to cement sales, Luks will look to utilise its ready mix concrete licence in this market. Currently readymix is estimated to account for less than 30% of concrete usage, but as this market develops this is expected to trend up towards 70% – as is the case in more developed markets.

We would not discount the possibility of Luks setting up a second cement grinding plant on the Central coast to address the major infrastructure projects described above, and the follow on investment/development that will take place.

6.0
Property Investment

6.1
Summary

Saigon Trade Centre, 100% owned by Luks, is currently the tallest building in Vietnam

Luks developed and now owns 100% of the Saigon Trade Centre (STC), a grade A/B office and commercial building with 40,000 sqm GFA in District 1, HCMC's commercial centre. It is currently the tallest building in Vietnam, and a HCMC landmark. A 33 storey 50–year leasehold property with 36 years remaining, CB Richard Ellis valued the STC at US$82.2m as at 31 December 2006.

management is considering further investment in office and serviced apartments

Currently this is the group's only investment property in Vietnam, although management has expressed an interest in expanding its investment property portfolio in HCMC. If it were to do this, its preferred strategy would be the develop–own route, with a focus on office or serviced apartments (with sub–contracted management), as it sees these property asset categories as cheaper to develop than hotels and easier to manage than retail.

Outside of Vietnam, the group owns industrial and residential property in Hong Kong and China – a legacy of its previous life as an electronics manufacturer in these countries. We estimate these properties contributed 13% of the property investment division's revenue in FY06 and were valued by Vigers at HK$258m as at 31 December 2006.

6.2
Industry overview

HCMC is the commercial capital of Vietnam. With no direct investment foreign investment in real estate allowed prior to 1985 and a postponement/cancellation of investment post the Asian crisis, the net result is a limited supply pool of 'international standard' office space. The consensus amongst international property consultants in Vietnam is that there is currently only about 350,000 sqm of office space in HCMC, with the resulting demand/supply imbalance driving a doubling of rental rates in the past five years.

a severe office space shortage is driving improved occupany and rates in HCMC

However, construction work is now a very visible feature in central HCMC. Six key projects alone are estimated to add 227,000 sqm of additional supply by 2011. With 140,000 sqm of this space not scheduled to be available until after 2009, the general consensus however is that office rental rates will continue to trend upwards over the next few years.

Balancing the supply side of the equation, extra demand for international quality space is expected from financial institutions (following sector deregulation post WTO accession), the increased presence and expansion of MNCs and foreign companies, and a growing demand from Vietnamese companies as they upgrade to keep up with the rising standards of professionalism.

Fig 6.1 HCMC office stock

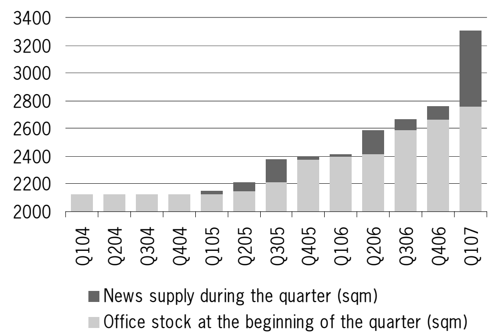
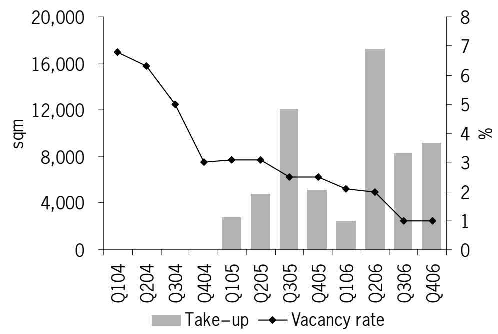


Fig 6.2 HCMC office take–up rate & vacancy rate



Source: CB Richard Ellis

new office space is being built, but the consensus is for rates to remain firm

The net result is that prime A/B grade office space rents are expected to remain firm even after the raft of new space is added to the market, but that rental rates of C and below grade space is likely to face downward pressure.

6.3 Operational detail

Fig 6.3 Investment property summary

Year ended: December	2002	2003	2004	2005	2006	2007E	2008E	2009E
STC GFA (sqm)	40,000	40,000	40,000	40,000	40,000	40,000	40,000	40,000
STC average rental rate (US$psm)	19.8	19.8	19.3	21.6	24.0	28.0	32.4	35.2
Occupancy (%)	52%	56%	64%	80%	90%	95%	95%	90%
STC rental income (US$m)	4.8	5.2	5.8	8.0	10.1	12.5	14.4	14.8
STC rental income (HK$m)	27.9	35.3	45.2	62.8	79.0	97.1	112.4	115.4
HK&China rental income (HK$m)	10.5	13.0	11.8	11.7	12.1	12.7	13.3	13.3
Total inv property rental income (HK$m)	38.5	48.3	57.0	74.5	91.1	109.8	125.7	128.7
Operating costs (HK$m)	–25.4	–34.7	–32.4	–30.9	–33.8	–36.5	–38.9	–40.7
EBITDA (HK$m)	13.1	13.6	24.6	43.5	57.3	73.4	86.8	88.1
Depreciation & Amortisation (HK$m)	–3.8	–3.2	–5.5	–0.9	–0.2	–0.2	–0.2	–0.2
EBIT – adjusted (HK$m)	9.3	10.3	19.0	42.6	57.1	73.2	86.6	87.9
Property revaluation (HK$m)	0.0	0.0	0.0	141.1	245.1	0.0	0.0	0.0
Other non–trading items (HK$m)	0.2	26.6	7.0	20.1	0.1	0.0	0.0	0.0
EBIT – reported (HK$m)	9.4	37.0	26.0	203.9	302.3	73.2	86.6	87.9

Source: Cazenove Note: STC = Saigon Trade Centre

Saigon Trade Centre has 36 years of its lease remaining

In 1992 Luks entered into a joint venture (75% stake) to build the Saigon Trade Centre. Construction was completed in 1996 and in 2001 Luks bought its partner's stake, taking its ownership to 100%. The 50–year lease on the building started in April 1993.

its tenant mix includes numerous blue chip name

Driven by a market supply/demand imbalance, occupancy has risen from 54% at the end of 2002 to 95% at the end of 2006. Tenants, of which there are 260 split roughly 95% international and 5% local, include such blue chip names as Standard Chartered, Prudential, Colgate Palmolive and Intel, amongst others. Leases range in length from two to five years, with the majority being towards the shorter–end of this range. Management of the property is carried out by Luks.

Improved occupancy, estimated at 90% in FY06 (86% at start /90% at mid year/95% at year end), and an 11% increase in achieved average rental rates, drove a 26% increase in revenue.

rental rates and occupancy have both been trending up

For FY07–9E we forecast rental revenue for STC to increase by 23%, 16% and 3% respectively. Behind this, we have assumed average occupancy rates of 95%, 95% and 90% respectively. In terms of rental rates, positive rental reversions, combined with firming rates (US$28 in FY06, US$33 in FY07E, US$36 in FY08E and US$36 in FY09E), we estimate will result in the average achieved rental psm increasing from US$24 in FY06 to US$35 by FY09E.

we are forecasting an increase in average rent psm from US$24 in '06 to US$35 by '09E.

Fig 6.4 STC occupancy (%)

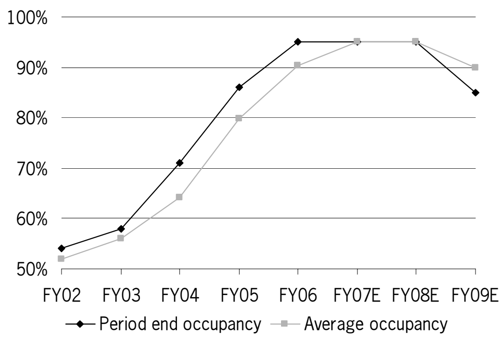
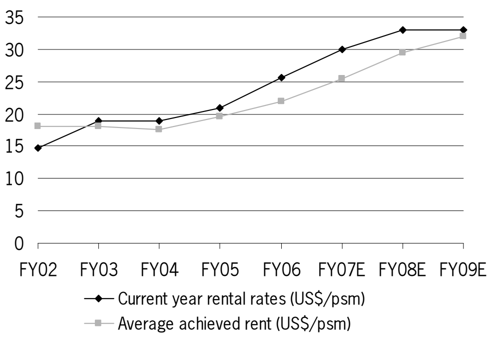


Fig 6.5 STC rental rates (US$/psm)



Source: Cazenove

rental rate used to value STC is 18% below that achieved currently

CB Richard Ellis valued the STC at US$82.2m (HK$641m) as at December 2006. With no secondary market transactions to benchmark a valuation against, we understand that DCF has been used as a valuation tool, with starting rental income of US$28 psm (US$27 for retail, US$25 psm for office, plus an additional 9% for parking space and other income). This is 18% lower than our estimated US$33 psm that STC will achieve on leases entered into in FY07E.

7.0
Property Development

7.1 Summary

two residential property development JVs announced to date

Luks has identified residential property development in HCMC as the third leg of its Vietnam strategy. In October 2006 it announced its first project (A) – a 70% owned JV that will develop 92,000 sqm of residential and commercial space. This was followed in January 2007 by the announcement of its second project (B) – a 90% owned JV that will develop 73,000 sqm of residential space.

with a floor area of 165k sqm these are expected to generate net profits of US$40m

Luks total investment in these two projects will total US$32.6m (US$22.6m equity/US$10.0m shareholder loan) and having checked the validity of Luks' assumptions (land cost/construction cost/selling price) with international property consultants based in HCMC, we estimate that the two combined will generate net profit attributable to Luks, based on current market selling prices, of US$39.9m. Construction of both projects is expected to start at the end of 2007, with sales and booking of profits spread between FY08 and FY10.

management aim to grow this business to a scale where it is developing 100,000 to 150,000 sqm annually

Building on its length of time in Vietnam and experience in the market, and the credos/local trust that ownership of the tallest building in HCMC brings, management aims to grow this business to a scale where it is developing 100,000 to 150,000 sqm per annum. We understand that discussions concerning the acquisition of further landbank to realise its ambition are ongoing. Any future expansion, which we view as both highly likely and most probably value accretive, has been ignored in deriving our forecasts and fair value, thereby providing future upside risk.

7.2 Industry overview

multiple factors driving new housing demand

Urbanisation, infrastructure development, a disproportionately high GDP per capita (estimated at US$1,800 in 2006 compared to a national average of US$672), a lack of housing inventory (estimated at c. 1m units for a population of 7m), the emerging availability of mortgages, income and purchasing power growth, stock market gains, positive demographics (young families seeking a home of their own) and an aspiration for a higher standard of living are all combining to fuel demand for new housing (ie real buyers with needs rather than just speculators) in HCMC.

supply increasing

but overall dynamics expected to remain positive

These dynamics, combined with an improving legal and regulatory framework, and difficulties for local developers to finance projects, has led to an increasing participation of foreign property developers in the market, including Keppel Land and other Singaporean companies. However, with limited development post the Asian crisis supply and demand dynamics still favour the developers, in our view. The Department of Planning & Supply estimate a demand for 103m sqm of residential property will be required by 2010 against a current supply of 53m sqm. According to CBRE Richard Ellis, only 32,228 condo units (read higher–end/prime location) will be completed between now and 2009. This should provide a positive backdrop for both prices and new developments yet to be announced.

7.3 Operational detail

A) 22,000 sqm site at An Lac Ward, Binh Chanh District, Ho Chi Minh City, Vietnam
Luks has entered into a 70:30 joint venture with the existing land owner to develop the site into a project with a total GFA of 115,000 sqm (ex basement) – 17.250 sqm of commercial areas, 74,750 sqm of residential and 23,000 sqm of public and ancillary facilities. Luks is contributing equity of US$14m to the JV and its partner, Thanh Phat, is contributing the land at a valuation of US$6m.

first site / JV:
–investment of US$14m
– selling price US$650
– net profit US$14m

The site, located beyond Chinatown, is roughly 45minutes from the CBD. Previously used as a factory, the site is in an industrial area that has been re–zoned for residential and commercial development. At one end of the road on which it stands is the new East–West Highway, which when completed should cut travelling time to the CBD by half, and at the other end is a Big–C hypermarket (a good sign that demographics/development potential is good).

The apartments will be pitched at the low to medium end of the market and management believes that comparable projects currently command selling prices of US$650 psm. Our cross–checks with international property consultants in Vietnam suggests that this price assumption is reasonable. The net result is an estimated attributable profit to Luks of US$13.9m (HK108m) using a simplistic calculation where funding costs are assumed to be covered by price increases.

second site / JV –investment of US$19m – selling price US$1050 – net profit US$26m

B) 9,935sqm site at Thao Dien Ward, District 2, Ho Chi Minh City, Vietnam
Luks has entered into a 90:10 joint venture with the existing land owner to develop the site into a project with a total GFA of 73,000 in apartment blocks of 22 to 24 floors. Luks is contributing equity of US$8.6m to the JV and its partner equity of US$0.9m, In addition, Luks is providing a shareholder loan to the joint venture of US$10m.

The site near to the second bridge is located in District 2, a popular higher–end residential area that is experiencing a lot of development activity as a result of its proximity to the CBD, international schools, clubs and its generally pleasant environs (lots of detached villas and plenty of greenery). Apartments on the third floor and above will have river views. Like site 1, site 2 is also currently an industrial site re–zoned for residential development and is also in reasonably close proximity to a hypermarket (Metro).

The apartments will be pitched at the medium to high end of the market and management believe that comparable projects currently command selling prices of US$1,050 psm. Our cross–checks with international property consultants in Vietnam suggests that this price assumption is reasonable. The net result is an estimated attributable profit to Luks of US$26.0m (HK203m) using a simplistic calculation where funding costs are assumed to be covered by price increases.

Fig 7.1 Property development summary

	Property A	Property B	A & B
Type	Residential mid to high end	Residential mid to mass market	
Location	Thao Dien Ward, District 2, HCMC	An Lac Ward, Binh Chanh District, HCMC	
Stake	90%	70%	
Land area (m2)	9,935	22,000	31,935
Sellable GFA (m2)	**73,000**	**92,000**	**165,000**
Land cost (US$/m2)	130	65	
Construction & other cost (US$/m2)	370	285	
All in cost (US$/m2)	**500**	**350**	
ASP (US$/m2)	**1,050**	**650**	
Profit (US$/m2)	**550**	**300**	
PBT (US$m)	40	28	67.8
Tax (%)	28%	28%	28%
PAT (US$m)	29	20	48.8
Construction commences	H2 07	H2 07	
Sale of units	H2 08	H2 08 / H2 09	
Completion of construction	H2 09	2009–10	
Attributable to Luks (US$m)	**26.0**	**13.9**	**39.9**
To be booked in FY08E	13.0	4.2	17.2
To be booked in FY09E	13.0	5.6	18.6
To be booked in FY10E	0.0	4.2	4.2
Equity investment (US$m)	8.6	14.0	22.6
Loan provided by Luks (US$m)	10.0	0.5	10.5
Capital invested	18.6	14.5	33.1
Post tax project return on capital	**140%**	**96%**	**121%**

Source: Cazenove

8.0
Other operations

8.1 Traditional Chinese Medicine

In January 2002 Luks acquired a 10% stake in Vigconic (VI) and purchased a further 65% stake in March 2003. VI is a Traditional Chinese Medicine (TCM) company focused on anti–ageing, with a main product code named VI–28.

HK$300m invested in TCM to date

Total investment to date is estimated at HK$300m, although the carrying value has been written–down to nil as at December 2006 (goodwill write–offs of HK$169m and HK$78m in FY05 and FY06 respectively).

losses reduced to sub HK$10m and now in clinical trial period

Operating losses, pre the goodwill write–offs, have acted as a drag on group earnings in recent years. Operating loss was HK$37m in FY03, HK$46m in FY04, HK$18m in FY05 and HK$8m in FY06. With the group's product in clinical trials, management expects spend going forward to be minimal, resulting in a sub HK$10m of operating loss per annum.

Three clinical trials are ongoing: University of Hong Kong, Beijing University and The Hong Kong University of Science and Technology. These are expected to complete by end 2008, this year and end 2008 respectively.

Management remains confident that the above trials will prove the efficacy of VI–28. If this confidence proves to be founded, management will then consider its options in terms of commercialisation – licensing/outright sale to an entity with distribution/sale in return for an equity stake in a partner with distribution.

ascribed zero value in our fair value working

At this stage, given the inherent uncertainties, we have continued to forecast a small loss for the TCM business and have ascribed it zero value in our fair value working.

8.2 Plywood

Luks Group owns 100% of Luks Timber (Vietnam). Revenue in the past three years has totalled HK$2.2m, HK$1.0m and HK$2.6m. As such it is essentially dormant. However, we understand that there may be some hidden value as this entity own, along with a JV partner, 20,000 sqm of land near to the airport. Currently used as a factory, we understand also that there is scope to apply for re–zoning. However, at this stage in our model and valuation workings we have omitted the group's 'plywood' assets.

9.0
Financial review and projections

9.1
Profit and loss account

Historic earnings have been distorted by property revaluation, goodwill write–downs (TCM) and other non–trading/abnormal items. FY06 reported earnings are a case in point with reported earnings up nine times, largely as a result of positive property revaluations (Vietnam up HK$164m /Hong Kong and China up HK$81m). With the goodwill of the TCM now written down to zero, adjustments for this should no longer be a feature going forward. Property revaluations will be.

non–trading items distort headline earnings...

Fig 9.1 Adjusted and reported earnings summary

Year ended: December	2002	2003	2004	2005	2006	2007E	2008E	2009E
Reported earnings (HK$m)	**52.4**	**20.2**	**30.6**	**22.2**	**200.3**	**144.8**	**342.6**	**443.0**
Property revaluation (HK$m)	–	–	–	141.1	245.1	–	–	–
TCM goodwill write–down (HK$m)	–	–	–	–169.0	–77.7	–	–	–
Other non–trading items (HK$m)	34.9	27.6	25.7	27.8	4.9	–	–	–
Deferred tax charge (HK$m)	–	–1.9	–1.8	–22.1	–51.7	–	–	–
Adjusted earnings (HK$m)	**17.4**	**–5.5**	**6.7**	**44.5**	**79.8**	**144.8**	**342.6**	**443.0**

Source: Cazenove

... but adjusted earnings still display improving trend

In arriving at an adjusted earnings figure, we have backed out the property revaluation, goodwill and other non–trading items. In addition we have added back the deferred tax charge as this largely relates to the property revaluations. The net result is a steadily improving net earnings profile driven by higher profitability of the group's Vietnamese operations and lower TCM losses.

Fig 9.2 Adjusted and reported EBIT summary

Year ended: December	2002	2003	2004	2005	2006	2007E	2008E	2009E
Cement (HK$m)	41.2	58.3	57.7	60.8	77.0	134.9	205.5	301.6
Property investment (HK$m)	9.3	10.3	19.0	42.6	57.1	73.2	86.6	87.9
Traditional Chinese Medicine (HK$m)	0.0	–36.8	–45.9	–17.6	–8.1	–5.0	–2.5	0.0
Other (HK$m)	–22.7	–11.6	–12.1	–20.6	–28.9	–25.0	–25.0	–25.0
Adjusted EBIT (HK$m)	**27.7**	**20.2**	**18.8**	**65.3**	**97.1**	**178.0**	**264.7**	**364.5**
Property revaluation (HK$m)	0.0	0.0	0.0	141.1	245.1	0.0	0.0	0.0
TCM goodwill write–down (HK$m)	0.0	0.0	0.0	–169.0	–77.7	0.0	0.0	0.0
Other non–trading items (HK$m)	34.9	27.6	25.7	27.8	4.9	0.0	0.0	0.0
Reported EBIT	**62.7**	**47.8**	**44.5**	**65.2**	**269.3**	**178.0**	**264.7**	**364.5**

Source: Cazenove

adjusted EBIT forecast to increase by 375% between FY06 and FY09E

cement division is the main driver of EBIT growth

Our forecast is for adjusted EBIT to increase by 368% (CAGR of 54%) between FY06 and FY09E. The principal driver of this growth is the cement division, where we expect EBIT to increase by 392% over the period to account for 85% of group EBIT by 2009E. This is the result of significant capacity expansion (average capacity up from 887,500 in FY06 to 3,000,000 in FY09E) and an increase in EBIT per tonne from US$11.2 in FY06 to US$14.3 in FY09E.

At the earnings level we forecast an even more dramatic increase (547% between FY06 and FY09E) as a result of the booking of property development profit. For the two projects announced to date, we have included only a net earnings contribution line in our consolidated P&L model,

Fig 9.3 Earnings break–down pre and post abnormal items and property development contribution

Year ended: December	2002	2003	2004	2005	2006	2007E	2008E	2009E
Pre–property dev (HK$m)	**17.4**	**–5.5**	**6.7**	**44.5**	**79.8**	**144.8**	**208.4**	**298.0**
Property dev (HK$m)	0.0	0.0	0.0	0.0	0.0	0.0	134.2	145.1
Adjusted earnings (HK$m)	**17.4**	**–5.5**	**6.7**	**44.5**	**79.8**	**144.8**	**342.6**	**443.0**
Abnormal items (HK$m)	34.9	25.7	23.9	–22.2	120.5	0.0	0.0	0.0
Reported earnings (HK$m)	**52.4**	**20.2**	**30.6**	**22.2**	**200.3**	**144.8**	**342.6**	**443.0**

Source: Cazenove

first time property: development profit driving even higher forecast earnings growth of 555%

Overall we are forecasting adjusted earnings growth of 77% in FY07E, 138% in FY08E and 30% in FY09E. We forecast the impact of higher interest costs, the result of debt funding of the group's capital contribution to its two property JVs and its continued cement capacity expansion capex, which erode part of the benefit of higher EBIT, will be offset by a low effective tax rate. Our forecast is for an effective tax rate of 8% in FY07E, 6% in FY08E and 13% in FY09E, compared to 13% in FY06. This low effective rate is the result of cement line 3 having a tax holiday for two years followed by two years at 7.5% tax rate, cement line 4 having a tax holiday for one year followed by a year at 14% rate, and Saigon Trade Centre income being taxed at 7.5% for FY07 and FY08.

forecast earnings growth of FY07E +81% FY08E +137% FY09E +29%

Fig 9.4 P&L summary

Year ended: December	2002	2003	2004	2005	2006	2007E	2008E	2009E
Revenue	**217.7**	**250.3**	**278.1**	**313.1**	**373.7**	**577.1**	**822.3**	**1,112.5**
Operating costs	–166.1	–182.9	–204.4	–227.9	–258.0	–373.8	–524.4	–711.6
EBITDA – adjusted	51.7	67.4	73.7	85.2	115.7	203.2	297.9	401.0
D&A	–23.9	–47.2	–55.0	–19.9	–18.6	–25.2	–33.2	–36.5
EBIT – adjusted	**27.7**	**20.2**	**18.8**	**65.3**	**97.1**	**178.0**	**264.7**	**364.5**
Net interest	–4.9	–8.3	–1.9	–3.1	–5.6	–21.0	–43.0	–21.0
JCE	1.4	–5.5	3.8	–3.3	–2.6	0.0	0.0	0.0
PBT – adjusted	24.3	6.4	20.7	58.9	88.9	157.0	221.7	343.5
Tax – ex def tax	–0.4	–0.3	–1.8	–11.2	–11.2	–12.3	–13.2	–45.5
MI	–6.5	–11.6	–12.2	–3.2	2.1	0.0	0.0	0.0
Earnings – adj pre prop dev	17.4	–5.5	6.7	44.5	79.8	144.8	208.4	298.0
Earnings – property dev	0.0	0.0	0.0	0.0	0.0	0.0	134.2	145.1
Earnings – adjusted overall	**17.4**	**–5.5**	**6.7**	**44.5**	**79.8**	**144.8**	**342.6**	**443.0**
Abnormal items inc def tax	34.9	25.7	23.9	–22.2	120.5	0.0	0.0	0.0
Earnings – reported	**52.4**	**20.2**	**30.6**	**22.2**	**200.3**	**144.8**	**342.6**	**443.0**

Source: Cazenove

Risks to our forecasts include: exchange rates (reporting currency of Hong Kong dollars, 90% of Saigon Trade Centre rents denominated in US dollars, no hedging instruments); the market price for cement; input costs for cement (coal, electricity, bags, oil, additives); rental rates for HCMC office property, and the sale prices of residential apartments, amongst others.

9.2 Balance sheet & cash flow

Fund raising risk? As at December 2006, Luks had a net cash position (including pledged and time deposits) of HK$10.8m – largely unchanged from the HK$12,0m of net cash at the start of the year. Gross debt at December 2006 stood at HK$116m and, we understand from our discussions with management that, the group has a further HK$600m of committed but un–drawn facilities.

starting net cash and available facilities should be sufficient to fund existing expansion

With lines 1,2 & 3 of the cement plant now in a cash generating phase, and the Saigon Trade Centre acting as a cash cow, we forecast that existing cash flow and bank facilities should be sufficient to fund current capex and investment plans.

- **capex** – the major spend should be the cement plant's fourth line, along with the cement grinding plant in HCMC, which is expected to cost US$60m (US$40/tonne – similar to line 3).
- **investment** – Luks is committed to investing US$23m of equity into its two residential development joint ventures and in addition is committed to providing a loan of US$10m to one of the joint ventures. Cash payback will be a feature, we estimate, of FY09 and FY10.

net gearing forecast to peak at 29% in FY08

Based on our forecasts, net gearing will peak at the end of 2008 at 29%. Assuming a cash float of HK$88m in that year (HK$90m in both FY05 and FY06), this equates to gross debt of HK$600m. Both net gearing and absolute gross debt are within management's comfort and available funding levels.

However, management has communicated a desire to increase the group's Vietnamese property exposure – both investment and residential. If deals to achieve this were to materialise it is possible, in our view, that further equity funding would be required.

further investment in Vietnamese property could, in our view, require additional equity funding

Fig 9.5 Net cash and net gearing profile

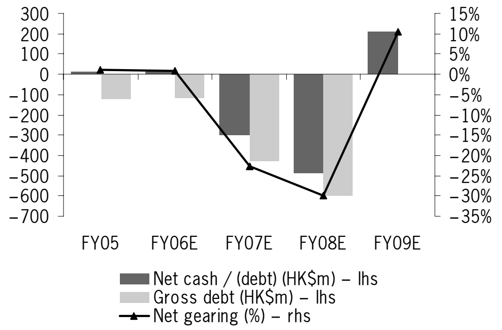
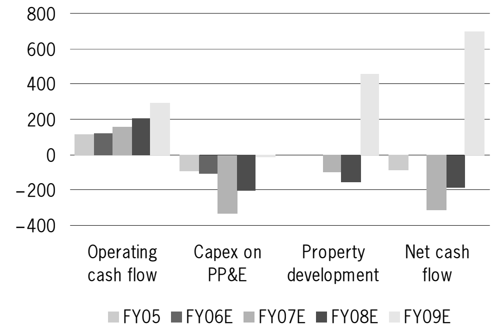


Fig 9.6 Cash flow summary (HK$m)



Source: Cazenove

working capital to sales ratio of 6.5% for FY06

Working capital. A positive supply/demand backdrop results in Luks selling virtually all of its cement production immediately. The net result is a low inventory ratio of 19 days. This, a healthy receivables ratio of 24 days and a payables ratio of 19 days, has resulted in an overall trade working capital to sales ratio of 6.5% for FY06. While relatively low, the scaling up of Luks' business will, we estimate, result in net working capital outflows of HK$7m, HK$22m and HK$27m in FY07–9E, respectively.

healthy inventory, debtors and receivables day ratios

Fig 9.7 Trade working capital

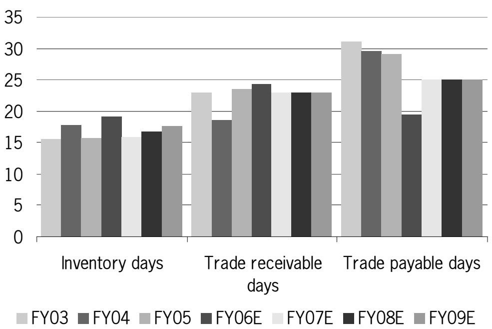
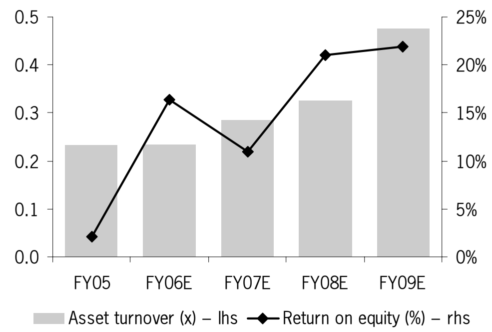


Fig 9.8 Return on equity



Source: Cazenove

business expansion cost likely to impinge dividend growth rate

Dividends. Despite the significant jump in headline earnings from HK$22m in FY05 to HK$200m in FY06, Luks kept its dividend payout unchanged at HK$0.08 per share (HK$0.03 interim/HK$0.05 final). This reflects both the non–cash nature of a significant element of the earnings (revaluation of property) and the need to maintain cash in the business for expansion. This later factor will, in our view, continue to impinge upon dividend growth in the next couple of years. As a result, we forecast an unchanged dividend payout in both FY07E and FY08E

Luks Industrial Group

Profit and loss account

Year end: December	2005	2006	2007E	2008E	2009E
Cement (HK$m)	231.7	274.6	458.7	688.1	975.3
Investment property (HK$m)	74.5	91.1	109.8	125.7	128.7
Other (HK$m)	6.9	8.0	8.5	8.5	8.5
Revenue (HK$m)	**313.1**	**373.7**	**577.1**	**822.3**	**1,112.5**
Cement (HK$m)	60.8	77.0	134.9	205.5	301.6
Property investment (HK$m)	42.6	57.1	73.2	86.6	87.9
Other (HK$m)	–38.1	–37.0	–30.0	–27.5	–25.0
EBIT (HK$m)	**65.3**	**97.1**	**178.0**	**264.7**	**364.5**
PBT – adjusted (HK$m)	58.9	88.9	157.0	221.7	343.5
Tax rate (%)	19%	13%	8%	6%	13%
Earnings – adj pre–prop dev (HK$m)	44.5	79.8	144.8	208.4	298.0
Prop dev earnings (HK$m)	0.0	0.0	0.0	134.2	145.1
Earnings – adjusted total (HK$m)	**44.5**	**79.8**	**144.8**	**342.6**	**443.0**
Earnings – reported total (HK$m)	22.2	200.3	144.8	342.6	443.0
EPS – adj pre–prop dev (HK$)	0.091	0.159	0.285	0.411	0.587
EPS – adj post–prop dev (HK$)	**0.091**	**0.159**	**0.285**	**0.675**	**0.873**
DPS (HK$)	0.080	0.080	0.080	0.080	0.100

Source: Company, Cazenove

Balance sheet

Year end: December	2005	2006	2007E	2008E	2009E
	HK$m	HK$m	HK$m	HK$m	HK$m
Property Plant & Equipment	375.4	460.2	771.1	939.2	919.7
Investment property	657.3	899.4	899.4	899.4	899.4
Intangible assets	93.6	15.8	15.8	15.8	15.8
Other non–current assets	44.0	41.3	137.2	425.1	110.3
Inventories	13.5	19.5	25.1	37.7	53.4
Trade receivables	20.1	24.9	36.4	51.8	70.1
Cash & equivalents	133.1	126.6	127.2	124.7	226.9
Trade payables	–24.9	–19.9	–39.5	–56.3	–76.2
Borrowings	–121.1	–115.8	–425.0	–600.0	0.0
Other net assets / (liabilities)	–129.2	–213.5	–204.0	–193.3	–180.5
Minorities	0.0	–2.1	–2.1	–2.1	–2.1
Shareholders' funds	1,046.1	1,220.8	1,326.2	1,626.4	2,021.4
Net cash / (debt)	12.0	10.8	–297.8	–475.3	226.9
Capital employed	1,167.2	1,338.7	1,753.2	2,228.5	2,023.5

Source: Company, Cazenove

Cash flow statement

Year end: December	2005	2006	2007E	2008E	2009E
	HK$m	HK$m	HK$m	HK$m	HK$m
EBIT	65.3	97.1	178.0	264.7	364.5
D&A	19.9	18.6	25.2	33.2	36.5
EBITDA	85.2	115.7	203.2	297.9	401.0
Working capital	29.4	16.5	–7.0	–21.9	–27.0
Other	6.3	0.0	0.0	0.0	0.0
Cash flow from operations	120.9	132.2	196.2	276.0	374.0
Interest	–6.0	–10.9	–26.0	–48.0	–28.0
Tax	–2.8	–3.0	–12.3	–13.2	–45.5
Capex (net)	–93.0	–107.9	–333.2	–201.3	–17.0
Business cash flow	19.0	10.3	–175.3	13.5	283.4
Acquisitions/disposals	–52.6	0.0	0.0	0.0	0.0
Other	8.8	5.3	–93.3	–151.0	463.7
Free cash flow	–24.8	15.6	–268.6	–137.5	747.1
Dividends	–39.3	–39.5	–40.0	–40.0	–45.0
Issue of shares	0.0	0.0	0.0	0.0	0.0
Other	–26.7	22.7	0.0	0.0	0.0
Net cash in / (out) flow	–90.7	–1.2	–308.6	–177.5	702.1
Closing net cash / (debt)	12.0	10.8	–297.8	–475.3	226.9

Source: Company, Cazenove

Key ratios

Year end: December	2005	2006	2007E	2008E	2009E
Interest cover (x)	10.5	24.7	6.8	5.5	13.0
Dividend cover (x)	1.1	2.0	3.6	8.4	8.7
EBITDA margin (%)	27.2	31.0	35.2	36.2	36.0
EBIT margin (%)	20.9	26.0	30.9	32.2	32.8
Revenue growth (%)	12.6	19.4	54.4	42.5	35.3
EPS growth (%)	469.1	75.7	79.1	136.7	29.3
Op cash/op profit (x)	1.9	1.4	1.1	1.0	1.0
Depn/capex (x)	0.2	0.2	0.1	0.2	2.1
Quick ratio (x)	1.0	0.8	0.8	0.8	1.8
ROE (%)	2.1	16.4	10.9	21.1	21.9
ROCE (%)	5.6	7.3	10.2	11.9	18.0
Net debt/equity (%)	cash	cash	22.5	29.2	cash
Working cap/sales (%)	–12.5	–14.9	–8.4	–3.3	0.0
Receivables days	23	24	23	23	23
Inventories turnover (x)	23	19	23	22	21
Asset turnover (x)	0.2	0.2	0.3	0.3	0.5
PER – adj(x)	97.2	55.3	30.9	13.1	10.1
EV/sales (x)	14.4	12.0	7.8	5.5	4.0
EV/EBITDA (x)	52.9	38.9	22.2	15.1	11.2
EV/EBIT (x)	69.0	46.4	25.3	17.0	12.4

Source: Company, Cazenove

Management	
Chairman & CEO	Luk King Tin
Executive Director & Financial Controller	Fan Chiu Tat, Martin
Executive Director	Cheng Cheung
Executive Director	Luk Yan
Executive Director	Luk Fung
Shareholder information (date) %	
Luk family	62.7%

Market information	
Estimated free float %	37.3%
Main listing(s)	Hong Kong
Average daily volume (3 months)	2.1m

Financial calendar	
Financial year end	December
Half year end	June
Reports & accounts	May
AGM	May

Source: Company, Bloomberg

Capital history – ordinary shares	
Number of shares (m)	512..4
Nominal value (HK$0.01)	0.01
Last issue/buyback	na

Seasonality %	Sales	Op profit
H2	52%	55%

Last property revaluation	31 December 2006

Business profile %	Sales	Op profit
Cement	73%	79%
Investment property	24%	59%
Traditional Chinese Medicine	1%	–8%
Other	1%	–30%

Geographical split %	Sales	Op profit
Vietnam	95%	na
Hong Kong	3%	na
China	2%	na

Source: Company

APPENDIX

IMPORTANT DISCLOSURES

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As at the disclosure date, the following applied:

- JPMorgan Cazenove Limited and/or an affiliate acted as a market–maker or liquidity provider in the securities of Luks Industrial (Group) Ltd.

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- No part of my compensation was, is, or will be, directly or indirectly, related to the expression of specific recommendations or views contained in this research.

Adrian Foulger.

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STOCK RECOMMENDATION DEFINITIONS

OUTPERFORM – the total return on the security is expected to outperform the relevant market index by 5% or more over the next six months.

IN–LINE – the total return on the security is not expected to outperform or underperform the relevant market index by 5% or more over the next six months.

UNDERPERFORM – the total return on the security is expected to underperform the relevant market index by 5% or more over the next six months.

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Our ratings are under constant review.

RECOMMENDATION HISTORY

12 months recommendation changes for Luks Industrial (Group) Ltd;
No changes in recommendation over the last 12 months.

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