

Paul Quah

paul.quah@cls.com
(852) 26008298

23 October 2007

Hong Kong Small Cap

Reuters 0366.HK
Bloomberg 366 HK

Priced on 22 October 2007
HK HSI @ 28,373.6

12M hi/lo HK\$16.50/3.10

12M price target HK\$13.00
±% potential +64%
Target set on 23 Oct 07

Shares in issue 573.2m
Free float (est.) 45.0%

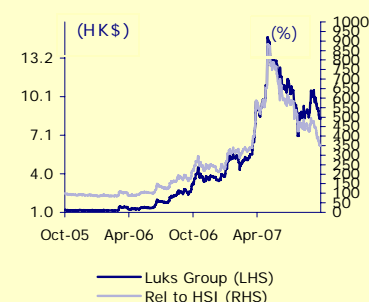
Market cap US\$586m

3M average daily volume
HK\$23.06m (US\$2.96m)

Major shareholders
Management 55.0%

Stock performance (%)

	1M	3M	12M
Absolute	(17.5)	(30.4)	151.4
Relative	(24.9)	(42.9)	60.5
Abs (US\$)	(17.1)	(29.8)	152.6



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Free option on Vietnam growth

HK listed Luks Group offers a rare and high quality exposure to Vietnam's rapidly growing economy. Luks owns the Saigon Trade Centre and the country's 6th largest cement plant. Recent non-stock specific price weakness presents a mispriced and compelling BUY opportunity at current levels, as investors effectively have a free call option on Vietnam growth on top of an established and cash generating Vietnam property/cement business. We initiate coverage with a BUY and price target of HK\$13.00 (64% upside).

The tallest building in Vietnam belongs to Luks

Luks wholly owns and operates the Saigon Trade Centre which is the tallest building in Vietnam at 34 storeys. The office building is enjoying 100% occupancy and we believe strong upside exist in rental growth with rental per sqm of US\$27 versus comparable rents of US\$35-40 per sqm currently.

Leverage to infrastructure growth

Luks cement operations is the nation's 6th largest, after doubling capacity in the last year. Luks has government approved plans to further double capacity over the next year in light of the shortage of domestic cement supply. Post a recent visit to the company's plant in Hue, central Vietnam, we are positive on its growth prospects and forecasting approximately 30% earnings cagr next 2 years.

More projects on the way...possible V-share listing

Luks management team is well entrenched in Vietnam having first entered the country in the early 90's. The company is on the lookout for more investments in the country. Interestingly Luks has plans to form 2 joint stock companies in Vietnam with the stated intention to list both these companies on the Vietnamese Stock Exchange in 3 years (by 2010).

Cheap on existing + free call option on Vietnam growth

Our fair value of Luks is HK\$13.00 implying 64% upside, comprising HK\$10.90 in existing high quality cash generative assets (property & cement), and HK\$2.10 in announced but yet to deliver projects. We see recent non-company specific share price weakness as a compelling BUY opportunity on two fronts: 1) Luks is cheap by HK\$3.00 versus existing and established operations (STC, cement and HK\$1.34 cash); 2) Investors have a free HK\$2.10 risk adjusted call option on future growth in Vietnam property and infrastructure.

Financials

Year to 31 Dec	05A	06A	07CL	08CL	09CL
Revenue (HK\$m)	313	374	519	637	775
Net profit (HK\$m)	60	59	153	258	555
EPS (HK¢)	12.3	12.0	28.5	45.0	96.9
CL/consensus(EPS%)	-	-	110	78	94
EPS (% YoY)	62.5	(2.6)	138.1	58.1	115.1
PEx (@HK\$7.92)	64.4	66.2	27.8	17.6	8.2
Dividend yield (%)	0.4	1.4	1.3	1.6	1.8
FCF yield (%)	3.5	0.7	3.9	(6.4)	13.8
ROAE (%)	5.70	5.20	9.20	11.80	21.90
Price/book (x)	3.7	3.2	2.2	2.0	1.6
Net gearing (%)	(1.14)	(0.88)	(37.43)	(4.74)	(11.59)

Source: CLSA Asia-Pacific Markets

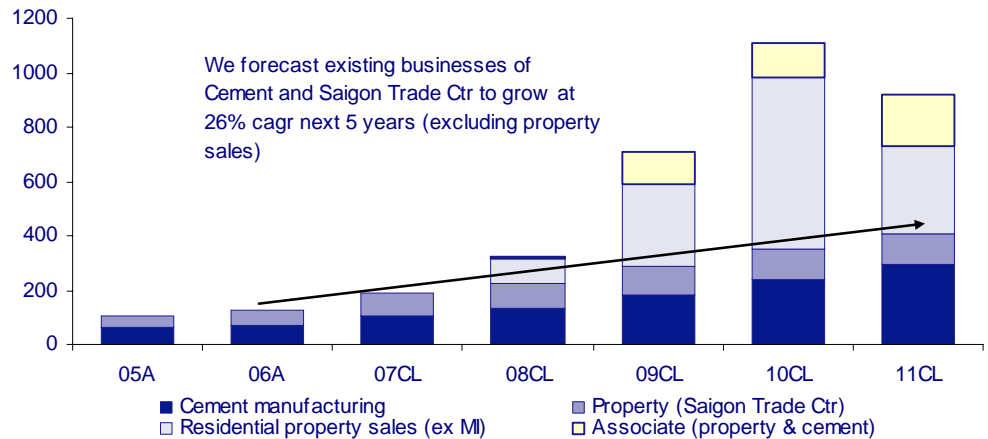
Existing operations in Vietnam are expected to grow at 26% cagr next 5 years

Leverage to Vietnam domestic growth

Luks Group's 2 key assets (100% owned) are growing strongly: 1) tallest building in Vietnam, Saigon Trade Ctr is enjoying 100% occupancy and seeing strong rental growth; 2) its cement operations have doubled capacity and likely to see more than 30% cagr next 2 years.

Figure 1

Existing businesses expected to grow 26% next 5 years



Source: CLSA Asia-Pacific Markets

Valuation

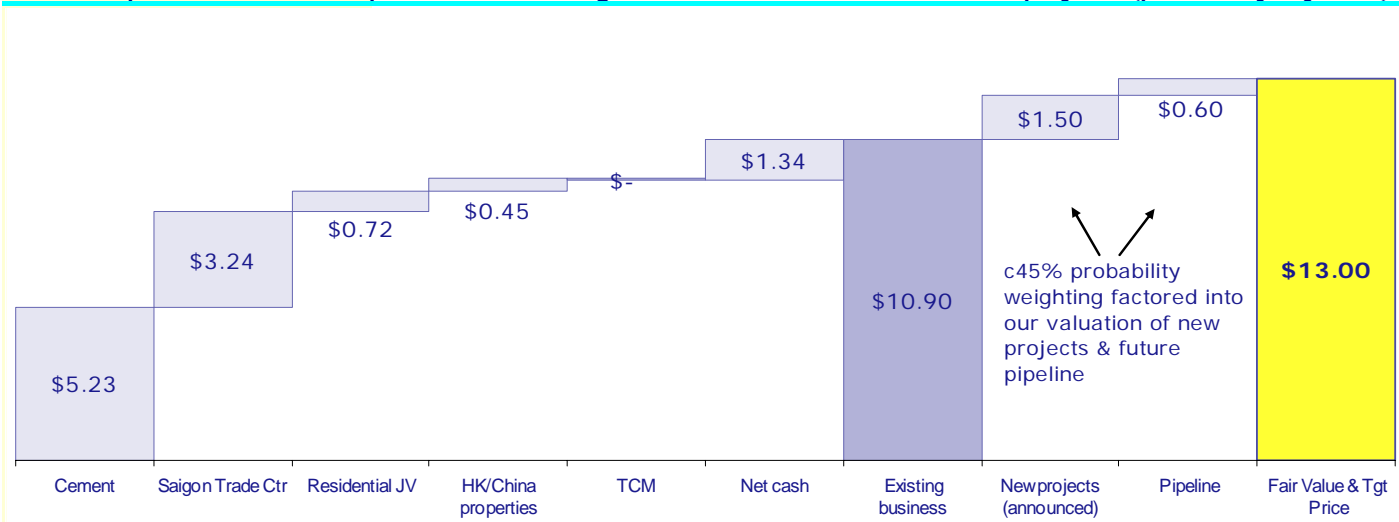
Our fair value and price target of Luks Group is HK\$13.00, derived by sum of the parts. The HK\$13.00 valuation comprises the value of the existing businesses at HK\$10.90, announced projects worth HK\$1.50 and future pipeline projects worth HK\$0.60.

Current share price present a free call option on Vietnam property and infrastructure growth

We believe the current share price presents a compelling investment opportunity. Essentially investors can buy Luks at a 39% discount to the valuation of the existing business which is cash generative and contains HK\$1.34 in net cash. In addition, investors are granted a free call option on future developments in Vietnam which have already been announced by the company, mainly in property and cement. We estimate this option to be worth HK\$2.10 per share which is already probability adjusted.

Figure 2

Luks Group – Our valuation captures both existing business and future value of new projects (probability adjusted)



Source: CLSA Asia-Pacific Markets

Figure 3

Sum of the parts valuation assumptions		Valuation approach	HK\$m	HK\$/shr
Existing business:				
Cement	DCF, implied EV/T: US\$138, 2.8MT		3,024	5.23
Saigon Trade Centre	NAV at 6.5% cap rate		1,872	3.24
Residential property JV	20% disc to DCF		418	0.72
Other properties	Reported book value		260	0.45
Chinese Medicine	DCF		-42	-0.07
Add: Net cash	FY07E		775	1.34
Sub-total (existing business)			6,307	10.90
Announced projects:				
CNS JV Cement, 45% interest	DCF, EV/T: US\$109, 50% probability		576	1.00
CNS JV Property, 30% interest	20% disc to DCF, 50% probability		47	0.08
Indochine JV Property, 95% interest	20% disc to DCF, 70% probability		246	0.43
Sub-total (existing business + announced projects)			7,183	12.40
Projects in the pipeline:				
Commercial/residential projects	20% disc to DCF, 30% probability		347	0.60
Total equity value			7,522	
No of shares & options (m)				579
Valuation per share				13.00
Current share price				7.92
Upside to valuation				64.2%

Source: CLSA Asia-Pacific Markets

Valuation scenarios

We find that Luks is currently trading at a 22% discount to our bear case valuation scenario and 52% discount to a bull case.

Figure 4

Valuation scenarios	Base case	Bull case (no NAV discount & no probability Weighting)	Bear case (zero value on new projects)
HK\$ per share			
Existing business:			
Cement	5.23	5.23	5.23
Saigon Trade Ctr	3.24	3.24	3.24
Residential property development	0.72	0.89	0.00
Other properties	0.45	0.45	0.45
Chinese Medicine	-0.07	-0.07	-0.07
Announced projects:			
CNS JV Cement	1.00	1.99	0.00
CNS JV Property	0.08	0.20	0.00
Indochine JV Property	0.43	0.80	0.00
Future pipeline:			
Commercial/residential projects	0.60	2.49	0.00
Net cash	1.34	1.34	1.34
Value per share	13.00	16.56	10.18
Discount to valuation	-39%	-52%	-22%

Source: CLSA Asia-Pacific Markets

Luks is preparing to deploy capital into property and cement projects in Vietnam

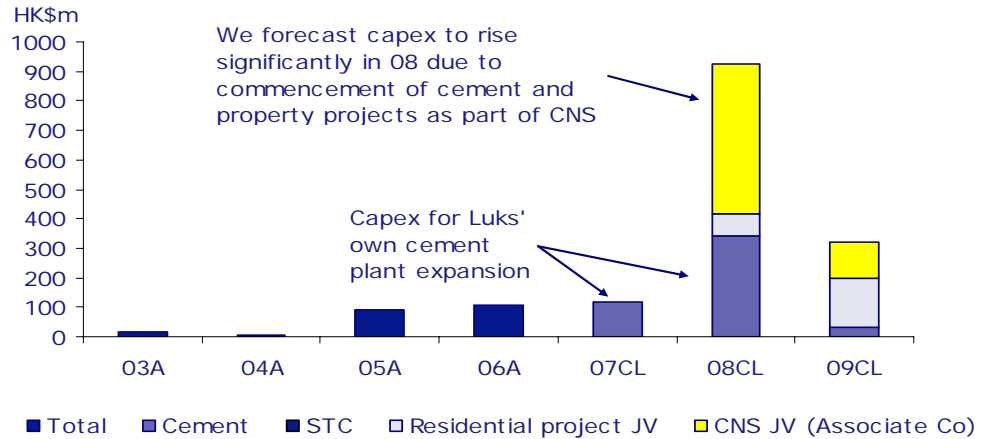
Luks is well funded from internal cash flows with the help of a capital raising earlier this year

We forecast strong ROCE increase on the deployment of capital next 2-3 years

Return on capital to accelerate

Figure 5

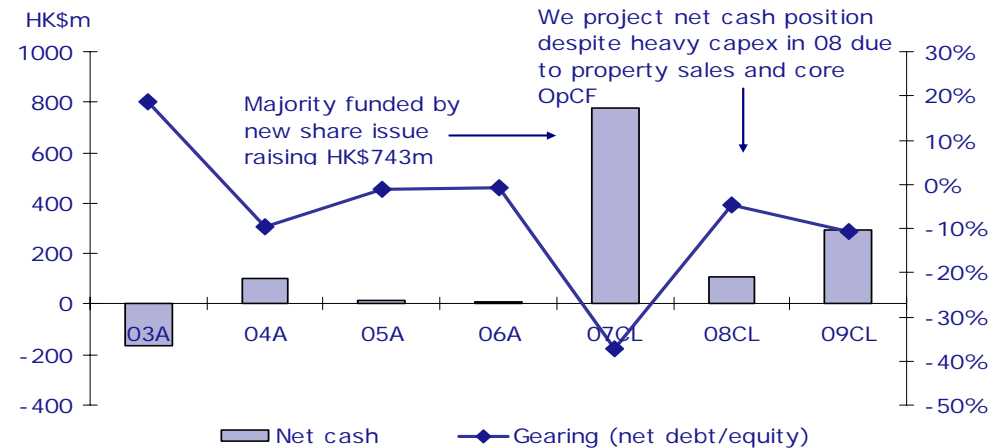
Large capex expected from 2008...



Source: CLSA Asia-Pacific Markets

Figure 6

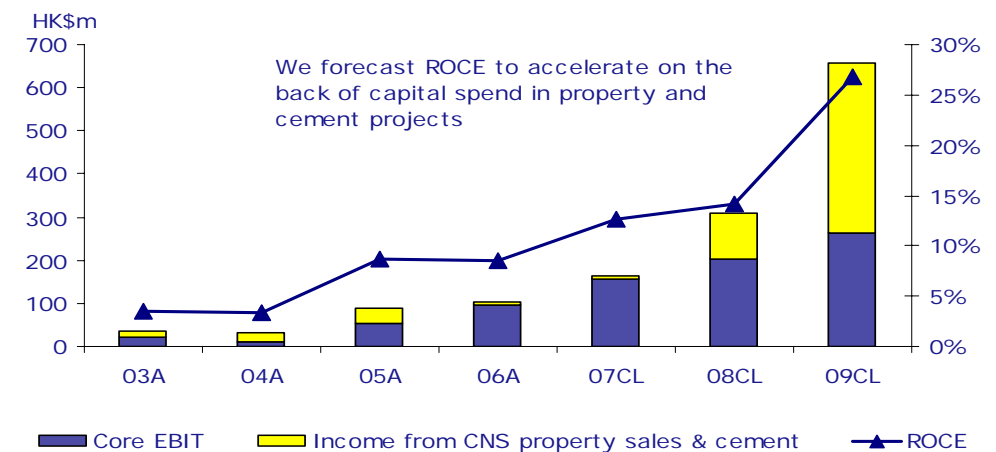
...but we still forecast a healthy balance sheet from internal funds and OpCF...



Source: CLSA Asia-Pacific Markets

Figure 7

The end result? ROCE to increase to >25% from <10% currently



Source: CLSA Asia-Pacific Markets

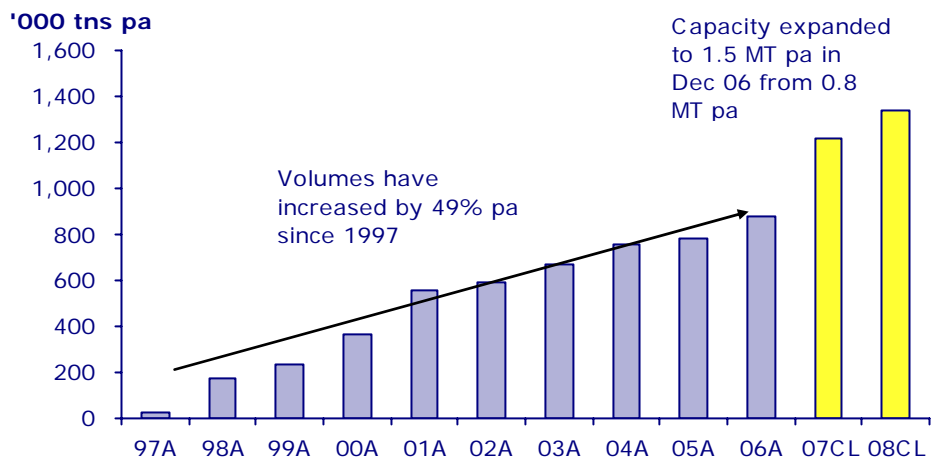
Business Segments

Cement operations

The key development in Luks cement manufacturing business is the recently-completed capacity expansion in December 2006, which takes its total annual production capacity to 1.5 MT, up from 800 thousand tonnes. Luks owns 100% of its cement plant, a business the company acquired in full from its JV partner in 2002. We understand this is the 6th largest cement plant in Vietnam and the largest in central Vietnam. The company also owns a limestone quarry with estimated reserves sufficient for 50 years or has a capacity of 3 MT a year.

Figure 8

Luks' cement volumes have steadily increased from day one, with more to come



Source: CLSA Asia-Pacific Markets, Company

Vietnam's cement industry

Management strongly believes that the cement manufacturing business in Vietnam is healthy, citing cement shortages in the country of roughly 5 MT in 2005 and in 2006. This follows demand estimates of approximately 32 MT annually (was 28 MT in FY05, up 14% YoY), with local supply only capable of satisfying 27 MT. The remaining 5 MT (mainly clinker) is imported, with Bangkok being a key exporter. In 2007, demand estimates by industry observers is around 36 MT and set to grow 20-25% pa post entry into WTO this year. We have seen a 49% volume cagr from Luks cement plant in Hue since 1997.

Whilst most of Luks competitors are indirectly state-owned (the Vietnam National Cement Corporation owns up to 70% of the market if one counts its numerous JVs), we do not see this as a risk to Luks for 2 reasons. Firstly, Luks has been established in Vietnam for a long time (since mid 90's) and secondly, Luks has close relationships with the provincial governments especially in Hue, where the company is a key contributor to the local industry. Recent events also confirm our view that Luks is allowed to operate and grow in line with its state-owned peers. For example, Luks approval to expand capacity was fast tracked by the VNCC and the company has also entered into a number of strategic JV's with state-owned enterprises to develop a number of cement and property projects.

The industry is also set up in such a way that new entrants require approval from the six ministries and the prime minister, which could prove difficult. To deal with the shortage in cement, the government is encouraging existing manufacturers to expand capacity instead of inviting new players. We

understand there are no subsidies or such support by the government other than supportive administrative processes for expansion. We also understand that the pricing environment has been stable and slightly up (3% in 2006 and 5–7% in 2007), as the government controls the prices of the VNCC given the interest of the government to see healthy construction levels. Any price increases requires governmental approval, the actual implementation of which is more difficult from what we gather.

Cement performance

In 1H07, Luks' cement volumes increased by 32% up from the 12.5% recorded in 2006. The strong growth in volumes reflect the increased capacity put in place at the end of 2006, which lifted capacity from 0.8 MT pa to 1.5 MT pa (production was constrained for most of 2006). Luks saw some price increases in the half which also helped drive Ebitda growth of 43%. Management is not seeing any pressure on the cost side. We note that around 41% of total cost of sales is represented by electricity and coal with cement GP margins around the 42% mark. 1H07 Ebitda margin of 36.4% was up from 34.7%. Longer term Luks is seeking to build its own power plant which should result in material cost saves (not factored in our forecast). Stronger volume growth is expected in 2H as the new capacity becomes more stable.

Figure 9

Luks cement performance and forecast

HK\$m	04A	05A	06A	07CL	08CL	09CL
Sales	212	232	275	395	502	628
Sales growth	8.9%	9.3%	18.5%	43.7%	27.3%	25.0%
Ebitda	75	78	93	143	188	236
Ebitda margin	35.4%	33.6%	33.8%	36.3%	37.5%	37.5%
Capex pa	6	112	114	120	341	31
Volume sold (tns)	757,000	782,000	880,000	1,218,700	1,523,375	1,904,219
Capacity (tns)	700,000	750,000	1,500,000	1,500,000	2,800,000	2,800,000

Source: CLSA Asia-Pacific Markets

Saigon Trade Centre

The Saigon Trade Centre (STC) is currently the company's only property exposure in Vietnam that is currently generating a revenue stream. Luks owns 100% of this property after acquiring its JV partner's (Ministry of Defence) 25% stake in 2001.

The property is located on 37 Ton Duc Thang Street which is right in the heart of the city near two major roads. The building at 33 storeys high is currently the tallest in Vietnam, is 40,000 sqm in saleable area and possesses a high quality tenant mix including Prudential, Thai Military Bank, Chase Manhattan Bank, Standard Chartered Bank, Colgate-Palmolive and Vietnam Airlines, Qantas etc. The building offers office space from 6th-30th floors; ground floor, 2nd-5th floor retail (bank branch on ground floor), roof top bar & restaurant, and basement car parking.

STC performance

The STC is currently enjoying an occupancy rate of 100% up from 95% last year. We find that the average rental per sqm achieved in 1H07 was US\$27/month up from US\$20-22/month last year. We believe there is room for significant upside to rentals post our discussion with Luks management in Vietnam and based on research by CB Richard Ellis (July 2007). The latter source suggests Grade A rentals could push through the US\$50 psm mark in 2007 from the average US\$39 psm level seen in 1Q07, before stabilising to the upper US\$40 psm range. CBRE also highlight that estimates of pent-up demand are in the 150-200,000 sqm range and is increasing.

Figure 10

Saigon Trade Centre performance and forecast						
HK\$m	04A	05A	06A	07CL	08CL	09CL
Sales	47	64	82	109	123	134
Sales growth	26.3%	34.6%	28.0%	33.3%	13.0%	9.4%
Ebitda	22	39	52	71	84	93
Ebitda margin	47.2%	60.8%	63.8%	65.4%	68.0%	69.0%
Occupancy	71%	86%	95%	100%	100%	100%
Rental (US\$/sqm/mth)	17	20	22	28	32	35
Rental growth	3.2%	14.0%	12.9%	26.6%	13.0%	9.4%

Source: CLSA Asia-Pacific Markets

Residential development

Luks announced in January 2007 the formation of 2 JVs with local partners to develop two residential properties for sale located in An Lac Ward, Binh Chanh District (115,000sqm GFA) and Thao Dien Ward, District 2 (73,000sqm GFA). We value the two JV's on a DCF basis taking into account land cost, construction cost and eventual sale price, discounted back to a present value basis. Our valuation of both projects for Luks is HK\$418m (HK\$0.72 ps) reflecting the company's 70% stake in An Lac and 90% stake in Thao Dien.

JV with CNS

Joint venture could lead to a listing in Vietnam

Luks entered into an MOU with CNS, a Vietnamese incorporated company which belongs to the Industry Department of Ho Chi Minh City on 18th May 2007. CNS is a company owned by the Industry Department of Ho Chi Minh City and is engaged in a number of industries such as mechanics, electronics, food processing, investment and operations of infrastructure projects in Vietnam. We value the CNS JV on the announced property and cement projects to be worth HK\$623m or HK\$1.08 per share.

The CNS agreement essentially involves setting up a cement and property business: Luks and CNS will form two joint stock companies to invest in cement and property projects in Vietnam. In addition, both parties will manage the joint stock companies with a view of listing both companies in the Vietnamese stock exchange in 3 years. Importantly for Luks the agreement sets out a rough plan to co-operate on other projects including: 1) investment in a thermal power plant, 2) construction of industrial zones, and 3) investment in an ecological resort.

Cement project

Luks and CNS will form a joint stock company to invest in cement projects in Vietnam, with Luks owning 45% of the business. The first project will involve the construction of a cement grinding factory with a 3 MT pa capacity, a new clinker production line of 1.25 MT pa capacity, and limestone mining rights. We are forecasting that this project will first come on stream only from June 2008 achieving 250,000 T in 2008 with full completion in 2 years or mid 2009.

Our valuation of the entire project is HK\$2.6bn, of which Luks 45% interest equates to HK\$1.15bn. For conservatism, given the relatively long dated completion of the project, we have assigned a probability factor of 50% into our valuation, or a valuation of HK\$576m (HK\$1.00 ps). The implied EV/ton is US\$109. In terms of P&L impact, this is expected to be reflected as a share of profit from associate companies.

Property project

Luks and CNS will form another joint stock company to invest and develop property in Vietnam, starting with an existing land plot with more to come going forward (from CNS). Our discounted NAV of the announced landbank measuring 18,300 sqm is HK\$311m, of which Luks 30% interest equates to HK\$93m. For conservatism, given the relatively long dated completion of the project, we have assigned a probability factor of 50% into our valuation, or a valuation of HK\$46.5m (HK\$0.08 ps).

JV with Indochine

Property development in District 9 HCMC

Luks wholly owned subsidiary Luks Land entered into a JV with Indochine, a Vietnamese incorporated company, to develop residential and commercial property in Vietnam on 29th August 2007.

The land, injected into the JV by Indochine, is located at Truong Thanh Ward, District 9, Ho Chi Minh City, Vietnam, measuring 159,737 sqm. The land relates to 3 sites: one at 38,983 sm, 68,796 sm and 51,958 sm which includes a 19,851 sm watercourse area. The estimated plot ratio is 1.05x, which suggest a GFA of 167,787 sm. Management has also indicated that the plot ratio could change (ie higher).

In terms of the JV agreement, Indochine contributes the land into the JV, and Luks in return essentially pays (to Indochine directly) the cost of gaining the approval from all relevant authorities for the investment to proceed (including permits etc) and compensation in removing the existing residents and structures on the land to get it ready for piling stage (estimated compensation rate is US\$93.89 psm). We are expecting construction to only begin from late 2009 as we believe the land approval/permit process is still a challenging and tedious task. In addition, we understand the land sites still require the basic infrastructure to be built including road, sewerage and electricity.

On arriving at our valuation we have incorporated a 20% discount to NAV. Our NAV is based on a DCF valuation of the project which we assume project construction from 2008 and completion by 2011. We have also forecast that a land and construction cost of US\$372 psm, or a total investment capex of US\$60m, double the US\$30m estimate given by the company. Our projected sale price of the property is US\$900 psm.

We are valuing the entire JV at HK\$370m, of which Luks's 95% interest equates to HK\$351m. We also assign a probability factor of 70% to account for some uncertainty which brings our valuation down to HK\$246m, representing (HK\$0.43 ps).

Traditional Chinese Medicine - written off

Luks traditional Chinese medicine business has been the only drag on the company's earnings, and has been largely phased out from the company after two significant write-downs in 2005 and 2006 (HK\$169m and HK\$78m). Going forward, losses are expected to be contained to HK\$5m by cutting down marketing and research and development expenses, but we understand there are a number of trials still ongoing. We have a negative HK\$0.07 ps valuation on this business.

Summary P&L forecast (HK\$m)

Year to 31 December	2005A	2006A	2007CL	2008CL	2009CL
Revenue	313	374	519	637	775
Operating Ebitda	73	115	194	257	315
Operating Ebit	53	97	156	201	262
Interest income	3	5	16	27	20
Interest expense	(6)	(11)	(9)	(16)	(20)
Other items	37	3	5	146	493
Profit before tax	87	94	168	357	755
Taxation	(23)	(37)	(15)	(59)	(136)
Minorities and other	(3)	2	0	(40)	(64)
Profit	60	59	153	258	555

Summary cashflow forecast (HK\$m)

Operating Ebit	53	97	156	201	262
Depreciation/amort	20	19	38	56	53
Working capital - trade	14	58	(6)	(7)	(9)
Other operating items	146	5	105	429	785
Operating cashflow	233	178	293	680	1,091
Net interest/taxes/other	(6)	(42)	(8)	(48)	(136)
Cashflow	227	136	285	632	955
Capital expenditure	(93)	(108)	(120)	(923)	(329)
Acq/inv/disposals	(47)	1	0	0	0
Free Cashflow	87	30	165	(292)	627
Ord div paid/Other items	(178)	(31)	600	(376)	(413)
Decrease in net debt	(91)	(1)	765	(667)	214

Summary balance sheet forecast (HK\$m)

Cash & equivalents	133	127	908	446	542
Debtors - trade	20	25	50	61	74
Inventories - trade	13	19	13	16	20
Other current assets	0	0	0	0	0
Fixed assets	400	482	565	1,432	1,707
Intangible assets	94	16	16	16	16
Other term assets	691	925	925	925	925
Total assets	1,351	1,594	2,477	2,896	3,285
Short-term debt	58	77	89	226	147
Creditors - trade	25	20	33	40	49
Other current liabs	85	112	112	112	112
Long-term debt/CBs	63	38	44	112	73
Other long-term liabs	73	127	127	127	127
Minorities/other equity	0	(2)	(2)	(2)	(2)
Shareholder funds	1,046	1,221	2,074	2,280	2,778
Total liabs & equity	1,351	1,594	2,477	2,896	3,285

Ratio analysis (HK\$m)

Revenue growth (%)	12.6	19.4	38.9	22.8	21.6
Op Ebitda growth (%)	11.6	57.2	68.2	32.7	22.4
Op Ebit growth (%)	347.3	82.5	61.1	29.0	30.3
Op Ebitda margin (%)	23.4	30.9	37.4	40.4	40.6
Op Ebit margin (%)	16.9	25.9	30.0	31.5	33.8
Net profit margin (%)	19.3	15.9	29.4	40.5	71.7
Dividend payout (%)	24.4	91.1	36.8	27.8	14.5
Tax rate (%)	26.8	39.0	9.0	16.5	18.0
Ebitda/net int exp (x)	25.2	20.7	(28.4)	(24.2)	
Net debt/equity (%)	(1.1)	(0.9)	(37.4)	(4.7)	(11.6)
Gross debt/equity (%)	11.6	9.5	6.4	14.8	7.9
Net debt/op Ebitda (x)	(0.2)	(0.1)	(4.0)	(0.4)	(1.0)
Gross debt/op Ebitda (x)	1.7	1.0	0.7	1.3	0.7
Return on equity (%)	5.7	5.2	9.3	11.9	22.0
ROCE (%)	8.8	8.9	12.9	20.0	32.7
Return on assets (%)	4.5	4.0	7.5	9.6	18.0

Source: CLSA Asia-Pacific Markets

Recommendation history - Luks Group (Vietnam Holdings) Company Limited 366 HK

Date	Rec level	Closing price	Target
23 October 2007	BUY	7.92	13.00

Source: CLSA Asia-Pacific Markets

Key to CLSA investment rankings: **BUY** = Expected to outperform the local market by >10%; **O-PF** = Expected to outperform the local market by 0-10%; **U-PF** = Expected to underperform the local market by 0-10%; **SELL** = Expected to underperform the local market by >10%. Performance is defined as 12-month total return (including dividends).

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08/03/2007