

Topic: Fujian Zhenyun Plastics Industry

Price Target: S\$0.77/share (Upside >300%)

(All calculations are denominated in SGD, based on 1 SGD : 4.89 RMB)

This report recommends a **STRONG BUY** on Fujian Zhenyun Plastics Industry (henceforth referred to as FJZY).

Background

1 Based on fundamentals, Fujian Zhenyun Plastics Industry (FJZY) is an extremely undervalued stock. According to its [quarterly report](#) (effective 30 June 2013), FJZY has a net asset value of \$1.19/share, with a strong net cash position of \$0.60/share¹. Furthermore, FJZY has been profitable since IPO in 2007. Despite the recent decrease in profitability, earnings are still positive at \$0.07/share¹ as of [2012](#).

2. As of 1st October 2013, the stock price is trading at only \$0.17/share. The huge price-value differential may be due to the following reasons, which can all be considered market inefficiencies:

¹ *Prior to adjustments for non-controlling interests.*

Possible reasons for extreme undervaluation

3. The price of FJZY nosedived following the release of a [disclaimer of opinion](#) on the 2009 financial statements by KPMG, as it was unable to verify transactions and balances with certain customers and suppliers. In response, [Deloitte & Touche](#) were appointed as special auditors and they have confirmed the [absence of foul play](#)² as follows:

² *"There are no other findings in their report in respect of the reliability or validity of documents relating to the Group's transactions with certain trade debtors and sales, trade creditors and purchases, inventories, and cash and bank balances in relation thereto that were covered by Deloitte's AUP."* – Deloitte

4. Yet, the assurance by Deloitte was fleeting as confidence in FJZY sank further after a series of high profile attacks by Muddy Waters LLC on fraudulent accounting practices by other S-chips. This may have cast a negative light on FJZY and turned away many potential investors.

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attack on
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5. Little attention has since been paid to this stock and there is not enough traction to pull the stock price from its doldrums. The board of directors, who owns over 70 out of the 115 million shares not listed in SGX, appears to be unconcerned about the share price. The directors do not have a plan to buy back the shares or sell their stakes.

Assessment of Key Risks

6. While the validity of FJZY's financial statements have been called into question, it is highly unlikely to manipulate its accounting figures due to the nature of assets held. Unlike the Chinese companies targeted by Muddy Waters LLC that revealed inflated earnings, revenues or plant assets, much of FJZY's estimated value is in cash (and audited by Deloitte). Further, [Mr. Lim Cheng Kee](#), an independent director, reassured shareholders in AGM 2012 that the cash is real. It is also reassuring to know that [Mr. Lim purchased FJZY's shares](#), although the amount is not a substantial one.

7. Over time, a stock price should converge towards its true value as sufficient investors begin to discover its true value. In the short term, a 3% dividend yield³ caps the downside risks while FJZY remains unloved⁴.

³ FJZY pays dividends annually. The yield is based on the stock price as of 1st Oct 2013.

⁴ A short-term risk-averse environment is expected amidst the negative news surrounding Blumont, Asiasons and LionGold Corp. However, FJZY differs from these as it is fundamentally undervalued.

Valuation

8. The target share price is conservatively estimated based on the biggest assets of FJZY:

a) **Net Cash (\$0.60/share)**: The greatest asset of the company is its cash. Yet, with no announced plans, inflation will erode the value of the cash over time. In addition, Deloitte pointed out a number of areas where FJZY's internal controls could be improved. Hence, a discount factor of 20% will be applied.

b) **Trade receivables (\$0.29/share)**: FJZY has extended generous credit terms to its customers, which saw its receivables balloon in recent years. It is plausible that not all receivables can be eventually collected. Hence, a discount factor of 30% will be applied.

c) **PPE + Inventory (\$0.37/share)**: The usual accounting valuation method of PPE is through the use of historical costs. Similarly, inventories are accounted at cost of goods in inventory. However, the true market value of this component is unclear. A conservative discount factor of 50% will be applied.

d) **NCI (\$0.10/share)**: Not all the assets declared in the FJZY group consolidated statements are owned by its shareholders. The amounts owned by the non-controlling interests should be subtracted.

9. The valuation does not factor FJZY's earnings. This very conservative position is adopted to reduce the likelihood of overestimating the price target because there are also hidden costs to doing business in China. FJZY stated in its 2012 annual report that it took a loan in order to maintain 'guanxi', or relationships.

Additional upsides for consideration

10. **Cash-rich companies can take advantage of opportunities in a downturn.** According to information shared by users on Next Insight, a resolution is passed in [FJZY's EGM on 10th May 2013](#) to *"provide for the expansion of the company's scope of business to include engaging in engineering works, design and installation of products. This change would enable the company to tender for a wider range of projects and improve its profitability."*

11. **FJZY's sales could grow.** It has been [sourcing for channels](#) to distribute its products beyond China. The company is also active in outreach to customers. For example, it [sources for customers through Facebook](#) and has an [up-to-date website](#) (verify with date of photos).

12. **FJZY is building up its reputation and credibility.** According to [information posted on SulekhaB2B](#), FJZY attained certifications in *"AS/NZS 1206; ISO 14001:2004; ISO 9001:2000; OHSAS 18001:1999; and is in the process of obtaining certifications for ASTM standards."* In addition, FJZY is [certified 'AAA'](#) by [中质信评估](#), a China Credit Quality Evaluation company.

Company Background

13. FJZY is based in China, and manufactures plastic pipes for water distribution, communications, gas and electrical cables.

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