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Shenzhen International: An emerging logistics play

Recommendation: BUY (initiating coverage) — **China Logistics**

Price	**HK$0.35**
Target price	HK$0.45 (+29%)
12 mth range	HK$0.23-0.43
Market cap.	US$517.5m
Daily t/o, 3 mth	US$1.7m
Free float %	46.1%
Ticker	0152.HK/ 152 HK

Year to Dec	Net profit HK$m	EPS HK$	EPS Δ%	P/E x	P/B x	EV/EBITDA x	Yield %	ROE %	ROCE %	N. Gear. %
04A	315.4	0.028	(8.2)	12.8	1.51	12.5	1.6	12.7	10.8	7.5
05A	360.3	0.032	13.8	11.2	1.28	11.6	1.6	12.5	10.6	22.2
06F	318.0	0.028	(11.3)	12.5	1.18	11.6	1.6	9.9	8.6	23.0
07F	413.1	0.036	29.9	9.6	1.08	8.8	2.1	11.7	10.0	20.1
08F	491.8	0.043	19.1	8.1	0.97	7.4	2.5	12.7	11.1	16.9

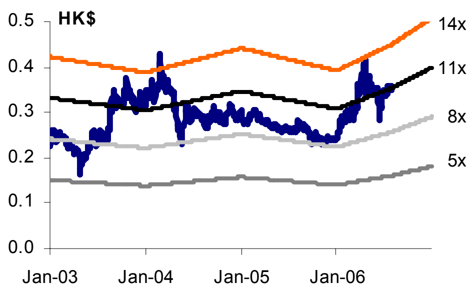
Relative to Hang Seng Index (1 mth, 3 mth, 12 mth): -3.8%, -5.5%, +17.0%
Actual price changes (1 mth, 3 mth, 12 mth): 0.0%, +4.1%, +32.1%
Consensus EPS (06F-07F): HK$0.025, HK$0.028

Key points:

- An emerging logistics conglomerate with interest in a number of multidisciplinary logistics assets, including 30.42% in Shenzhen Expressway (548 HK, HK$3.82, NR).
- "Green Lane" initiative is expected to give the company a competitive edge and drive logistics revenue at its new logistics park, which is strategically located in the heart of Shenzhen.
- Exposure to toll roads offers steady cash flow to fund M&A and restructuring activities.
- Interest in Shenzhen Expressway and China Southern Glass (200012 CH) alone is worth HK$0.28 per share, not to mention the value of its logistics assets. Initiate coverage with a BUY and target price of HK$0.45, based on our sum-of-the-parts valuation.

An emerging logistics conglomerate. Shenzhen International (SI) is an emerging integrated logistics conglomerate directly under the supervision of State-Owned Assets Supervision and Administration Commission (SASAC) of Shenzhen. The company has interest in a number of multidisciplinary logistics assets including logistics parks, consolidation centres, electronic logistics platforms, airlines, as well as toll expressways, through 30.42%-owned Shenzhen Expressway (548 HK, HK$3.83, NR) and 61.7%-owned Wuhuang Expressway. The company also has a 22.86% stake in China Southern Glass (CSG) (200012 CH), an industrial grade glass manufacturer listed in Shenzhen.

Chart 1: P/E bands



Source: SBI E2-Capital

New logistics park has geographical advantage. The company's new logistics centre, South China International Logistics Centre (SILC) is strategically located in the heart of Shenzhen. Surrounded by an extensive road network, SILC has multi access to sea (25km/20km to Yantian and Shekou ports), road (6km to Huanggang) and air (30km from Shenzhen Airport). SILC is one of six major logistics parks planned by the Shenzhen municipal government.

"Green Lane" model. SI plans to launch an integrated land-based feeder service in conjunction with Modern Terminals Ltd. (MT), a subsidiary of Wharf Holdings (4 HK, HK$28.95, NR). By forming a direct link between SILC and Kwai Chung ports, the "Green Lane" will dramatically shorten trucking time from Shenzhen to Kwai Chung. Due to congestion and duplicated customs procedures at Huanggang/Lok Ma Chau (LMC), the trip currently takes up to 3.5 hours. Green Lane will reduce the duration to around 30 minutes. This is achieved by shifting the customs functions at Huangang to SILC and eliminating the Hong Kong customs procedures at LMC. Once customs is cleared at SILC, the container is sealed using an electronic gateway, loaded onto the cross border truck and travels directly from the logistics park to Kwai Chung by road via a virtual "pipeline" route. On arrival, the container is transferred onto the ship for onward forwarding to overseas destinations. A dedicated channel will be set up at the Huanggang/LMC checkpoint to facilitate the feeder service to streamline the process and avoid queuing. To ensure security and increase transparency in the logistics process, all trucks within the pipeline will be tracked by GPS. The pipeline will be the first of its kind linking Kwai Chung ports to a major logistics park in China. Trial runs upstream of Huanggan/LMC has been completed and endorsed by the Shenzhen government in May 2006. The company and its partners are currently lobbying various Hong Kong government departments and trade associations and aim to launch the service by 4Q06.

Green Lane differentiates SILC. For manufacturers, freight forwarders and other logistics services providers to take advantage of the Green Lane, they must undertake all handling and consolidation activities within SILC. In effect, the Green Lane acts as a platform to funnel cargo and freight into SILC. The logistics centre derives revenue by offering value-added-services including 1) laden container services, 2) bonded warehouse services, 3) cargo transfer services and 4) storage and maintenance services for empty containers.

SILC bringing value to Hong Kong. At present, for a container from China traveling to North America and/or Europe, Kwai Chung enjoys a speed advantage over neighbouring ports such as Yantian, Shekou and Chiwan. The Green Lane will enhance this competitive advantage and maintain Hong Kong's status as the world's largest port by throughput. We expect beneficiaries will be port operators, shipping operators, freight forwarders and distributors. In our view, the Green Lane will enhance trucking as the preferred mode of transit from inland factories to Kwai Chung. Most outgoing container ships transit at a number of inland ports, with a final stop at Kwai Chung before departing for overseas destinations. Manufacturers prefer to take advantage of this transit arrangement for production purposes and use trucking to transit their goods to meet up with the container ship at Kwai Chung. For January-March 2006, re-exports through Hong Kong by sea amounted to a HK$161.3b market, up 3.3% YoY. The implementation of the Green Lane can further enhance Chinese manufacturers' production lead time and increase the attractiveness of Kwai Chung as the export port of call. In addition, we believe that time sensitive sectors such as express parcel delivery can also benefit from the streamlined processes offered by the Green Lane. To that extent, DHL has already indicated to set up a consolidation centre within SILC.

No substantial opposition from HK Government expected. Given the value that Green Lane can bring to Hong Kong's logistics value chain, we do not expect substantial opposition from the Hong Kong Government (Shenzhen Government had initially resisted the proposal as it wanted to foster its own local logistics industry). Moreover, this concept is not new to Hong Kong. MT operates a number of "inland gateways" at a number of upstream river ports in China while HACTL already has a dedicated green channel at Huanggang/LMC that links its Futian consolidation centre with its operations at the Hong Kong International Airport. However, even if SI cannot secure the relevant approvals from the Hong Kong Government, the company is still in a position to launch a modified Green Lane pipeline and offer significant time saving. This is because around 70% of the queuing and customs processing time occurs at the Huanggang side of the Huanggang/LMC checkpoint.

Huanggang/LMC is the key cross border checkpoint. Huanggang/LMC checkpoint is the main cross border exchange between Hong Kong and China, accounting for the 79.2% of total cross border container truck traffic. Container trucks movements at the Huanggang/LMC totaled 3.46m in 2005, down 6.3% YoY. Rising oil prices has forced manufacturers to opt for the cheaper but generally slower river barge transshipment to transit containers to Kwai Chung. However, we believe that the time and efficiency advantage offered by the Green Lane can reverse this trend, as trucking will become a more attractive option for those time sensitive and high quality goods. Moreover, trucking is more flexible than river barge as the sea mode of transport needs to stay moored until capacity space is sufficiently utlized before departing.

SWC impact factored into our estimates. The opening of the Shenzhen Western Corridor (SWC) will partially relieve traffic congestion at Huanggang/LMC and we have factored this into our estimates. According to various Government traffic studies undertaken during the design of the Deep Bay Link/SWC route, container truck traffic at the Huanggang/LMC checkpoint is projected to be around 2.8m in 2008. We currently estimate SILC to general 48k container movements that year, accounting for only 2% of total container truck movements at this checkpoint. This is a conservative estimate in our view given that the study at the time had not taken the additional container truck traffic that will be generated by the Green Lane initiative into consideration. Moreover, the fourth border crossing is mainly designed to accommodate the expected development in the western side of Pearl River Delta (PRD) and the additional traffic volume generated from this development. SWC will generate its own demand by making it more attractive for Chinese companies to set up manufacturing facilities on the western side of PRD and through modal substitution of river barge to trucking. Therefore, we are positive that SILC can still generate robust revenue growth even after the opening of the new cross border link. Our industry checks indicate that SWC is likely to be opened around mid-2007.

SI can capture the benefits from SWC too. SI will also benefit from the opening of SWC through its 20% interest in Shenzhen Western Logistics. The associate company owns a 400,000m^2 logistics park in the Qianhaiwan Logistics District. Qianhaiwan is strategically located at the first exit of SWC, adjacent to Dachan

Bay Terminal, which is currently under construction. Western Logistics will derive revenue from offering warehouse and value-added logistics services. The facility is under construction with the first phase (60,000m^2 warehouse logistics area) scheduled to be completed in July 2007. Western Logistics recorded revenues of HK$10.6m in FY12/05 from repairing and maintenance of empty container boxes.

Expressway assets an important part of portfolio. SI's stake in Shenzhen Expressway (SE) and Wuhuang Expressway is a key contributor to its portfolio. SE has 182.1km toll roads in operations with another 187.5km under construction. Key toll roads under SE's management include Meiguan Expressway, Jihe (East & West) Expressways and Shuiguan Expressway. The company is continuously improving the quality of its toll roads by acquiring good quality assets from Shenzhen Municipal Government while seeking to dispose of non-performing ones. It has demonstrated innovative initiatives by forming strategic partnerships with Yantian Port and Shenzhen Municipal Government to increase traffic on its Yanpai Expressway through joint promotions. In addition, SE is diversifying its revenue stream by broadening into construction management. We like SE as it is positioned to achieve long-term growth. The company recorded a net profit of RMB552.5m in FY12/05, up 33.2% YoY and we estimate earnings to jump 6.7%, 10.1% and 19.2% between FY12/06F to FY12/08F. As for Wuhuang Expressway, we conservatively estimate earnings to grow at low double digit percentage on an annual basis, in line with traffic volume and GDP growth in the Guangdong region.

Steady growth at Int'l Express Supervision Centre. We project SI's other key asset, Shenzhen Airport International Express Supervision Centre to record steady growth going forward. Shenzhen Airport is in the process of undertaking an RMB5.9b expansion and this should generate additional revenue opportunities for the consolidation centre through increased express freight volumes. Despite the huge growth potential of air cargo in China, we maintain conservative projections on this business given the Chinese government's priority to develop another airport, the Guangzhou Baiyun International Airport as outlined in the 11th Five Year Plan. Shenzhen Airport International Express Supervision Centre recorded a profit of HK$21.4m in 2005, up 51% YoY. Freight throughput increased 15.5% YoY to reach 171,000 tonnes. We project this business' bottom line to grow at around 15% over the next few years.

M&A/restructuring to refocus on logistics. SI presently plans a series of restructuring moves through increasing/decreasing equity holding in its assets. These include:

- Shenzhen South-China Int'l Logistics from 66.67% to 100%
- Shenzhen Western Logistics from 20% to 60%
- Shenzhen Expressway (548 HK) from 30.42% to 50%
- Dispose of the entire 22.86% interest in CSG (200012 CH)

These corporate actions will transform SI into a pure logistics play and increase return to shareholders. Management also indicated that they are exploring opportunities to acquire other logistics assets from its parent, though near term aim is to fully consolidate Shenzhen South-China Int'l Logistics and increase its stake in Shenzhen Western Logistics.

Net profit estimates. SI recorded a net profit of HK$360.3m in FY12/05. However, bottom line is projected to drop 11.7% YoY in FY12/06F to HK$318.0m (fully diluted EPS: HK$0.023) as the preceding year results were boosted by several one-off exceptional items. We expect an earnings rebound after the commencement of material contribution from South China Logistics. We project bottom line to surge 29.9% and 19.1% to HK$413.1m (fully diluted EPS: HK$0.030) and HK$491.8m (fully diluted EPS: HK$0.035) in FY12/07F and FY12/08F. The company aims to maintain a 20% dividend payout policy.

Initiate coverage with a target price of HK$0.45. In our view, SI is an undervalued play. The company's stake in Shenzhen Expressway and CSG alone is worth HK$0.28 per share on a fully diluted basis, not to mention the value of the company's logistics business. For the logistics business, we value SI's logistics subsidiaries (ex. Shenzhen Expressway) as a whole, given its focus on logistics and the synergies that are realized between the entities. Our sum-of-the-parts valuation yields a target price of HK$0.45, representing an undemanding 15x FY12/07F P/E. The valuation does not include any of the company's impending restructuring moves or further M&As, and we see the stock will warrant further re-rating on these announcements.

Corporate governance issues. SI is 41.9%-owned by SASAC of Shenzhen, through Shenzhen Investment Holding Corporation (SIHC). The holding company acquired the controlling interest in SI through a debt restructuring in 2000. Cheung Kong Group is a strategic investor in the company, with a 7.0% stake. The company issued a redeemable non-interest bearing CB with a face value of HK$330m to SIHC on 1 August 2002. The CB has a conversion price of HK$0.365 and will mature on 31 July 2007. The company raised further funds in January 2006 by issuing a CB with an aggregate amount of HK$600m. The bonds carries a yield of 3.95% p.a. and a conversion price of HK$0.341 per share on or before 24 Feb 2011. SI presently uses PricewaterhouseCoopers as its financial auditor after switching over from Ernst & Young in 2002.

Risk factors.

- Failure to secure relevant Hong Kong Government approvals relating to the Green Lane initiative;
- Execution risk associated with the Green Lane initiative;
- Changes in Chinese government regulations and economic policies; and
- Trade disputes between China and overseas countries.

Table 1: P&L

Year to Dec (HK$m)	2004	2005	2006F	2007F	2008F
Turnover					
Logistics related business	235.2	317.0	492.9	627.3	735.0
Property investments	18.9	-	-	-	-
	254.1	**317.0**	**492.9**	**627.3**	**735.0**
Cost of sales	(177.4)	(224.8)	(271.2)	(339.4)	(395.7)
Gross profit	76.7	92.1	221.7	288.0	339.3
Other revenues and gains	153.2	143.5	45.1	46.1	47.0
Selling and distribution costs	(14.8)	(14.4)	(17.7)	(20.1)	(24.3)
Administrative expenses	(65.3)	(77.2)	(98.6)	(87.8)	(97.0)
Other operating expenses	(27.2)	(8.2)	(26.7)	(7.7)	(8.0)
Operating profit	122.5	135.8	123.7	218.6	257.1
Finance costs	(2.5)	(25.8)	(51.2)	(48.7)	(46.2)
Share of profits and losses of jointly controlled entities	-	-	-	-	-
Share of profits of an associated	202.2	254.2	269.6	292.4	339.5
Profit before taxation	**322.2**	**364.2**	**342.0**	**462.3**	**550.3**
Taxation	(7.7)	(4.2)	(17.1)	(37.0)	(44.0)
Profit after taxation	**314.4**	**360.0**	**324.9**	**425.4**	**506.3**
Minority interests	0.9	0.3	(7.0)	(12.3)	(14.5)
Profit attributable to shareholders	**315.4**	**360.3**	**318.0**	**413.1**	**491.8**
% chg	*(6.9)*	*14.2*	*(11.7)*	*29.9*	*19.1*

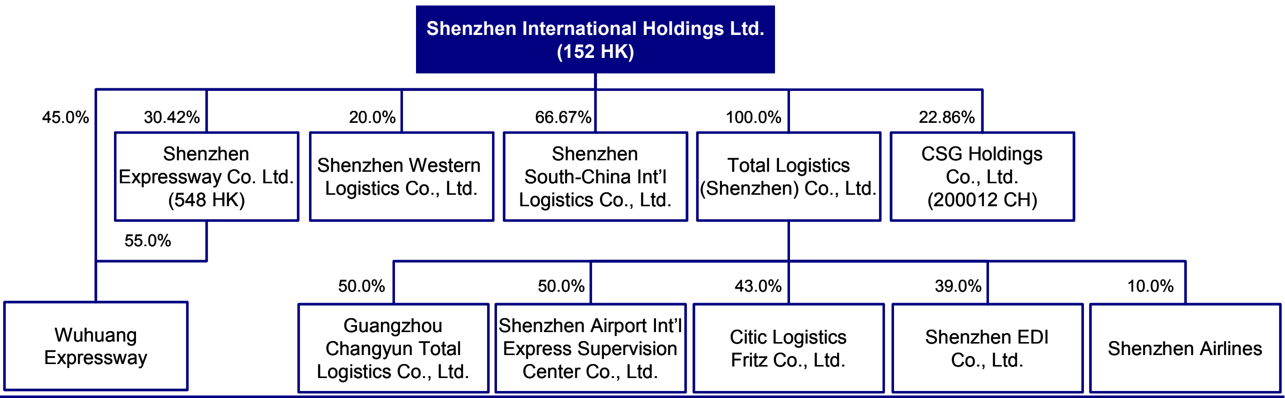
Source: SBI E2-Capital

Table 2: Sum-of-the-parts valuation

	% Holdings	Valuation method	(HK$m)	HK$/share
Logistics related business		12x adj. FY12/07F P/E	2,251.3	0.161
Shenzhen Expressway (548 HK)	30.42%	Mkt value	2,566.9	0.183
CSG (200012 CH)	22.86%	Mkt value	1,306.7	0.093
Add: Net cash			253.2	0.018
Less: Minority interest			(92.7)	(0.007)
Appraised NAV			**6,285.5**	**0.448**

Source: SBI E2-Capital

Chart 1: Organization structure



Source: Company data

P & L (HK$m)	04A	05A	06F	07F	08F
Year to Dec					
Turnover	**254.1**	**317.0**	**492.9**	**627.3**	**735.0**
% chg	*66.0*	*24.7*	*55.5*	*27.3*	*17.2*
Gross profit	76.7	92.1	221.7	288.0	339.3
EBITDA	333.4	399.9	408.4	533.0	631.9
Depre./amort.	(13.2)	(14.6)	(23.7)	(33.7)	(46.6)
EBIT	320.2	385.3	384.7	499.3	585.2
Net int. income/(exp.)	2.0	(21.0)	(42.6)	(37.0)	(34.9)
Exceptionals	-	-	-	-	-
Associates	202.2	254.2	269.6	292.4	339.5
Jointly-controlled entit.	-	-	-	-	-
Pre-tax profit	**322.2**	**364.2**	**342.0**	**462.3**	**550.3**
Tax	(7.7)	(4.2)	(17.1)	(37.0)	(44.0)
Minority interests	0.9	0.3	(7.0)	(12.3)	(14.5)
Net profit	**315.4**	**360.3**	**318.0**	**413.1**	**491.8**
% chg	*(6.9)*	*14.2*	*(11.7)*	*29.9*	*19.1*
Dividends	(57.2)	(62.5)	(63.6)	(82.6)	(98.4)
Retained earnings	258.2	297.8	254.4	330.4	393.5
EPS - Basic (HK$)	0.028	0.032	0.028	0.036	0.043
EPS - F.D. (HK$)	0.026	0.030	0.023	0.030	0.035
DPS (HK cents)	0.550	0.550	0.560	0.728	0.866
No. sh.s o/s (m) - W.A.	11,376.4	11,415.8	11,355.1	11,355.1	11,355.1
No. sh.s o/s (m) - Y.E.	11,376.4	11,355.1	11,355.1	11,355.1	11,355.1
No. sh.s o/s (m) - F.D.	12,280.5	12,319.9	14,018.7	14,018.7	14,018.7
Margins (%)					
Gross	*30.2*	*29.1*	*45.0*	*45.9*	*46.2*
EBITDA	*131.2*	*126.2*	*82.9*	*85.0*	*86.0*
EBIT	*126.0*	*121.5*	*78.0*	*79.6*	*79.6*
Pre-tax	*126.8*	*114.9*	*69.4*	*73.7*	*74.9*
Net	*124.1*	*113.7*	*64.5*	*65.8*	*66.9*

Balance Sheet (HK$m)	04A	05A	06F	07F	08F
Year to Dec					
Fixed assets	250.3	305.6	421.9	588.2	781.6
Intangible assets	(130.2)	659.7	644.0	628.3	612.6
Other LT assets	2,711.6	3,064.8	3,210.8	3,370.6	3,558.6
Cash	243.0	266.4	656.1	598.1	617.6
Accounts receivable	345.4	118.2	243.1	300.8	342.3
Other receivables	-	-	-	-	-
Inventories	-	-	-	-	-
Due from related co.s	-	-	-	-	-
Other current assets	0.1	53.8	53.8	37.7	26.4
Total assets	**3,420.2**	**4,468.5**	**5,229.7**	**5,523.6**	**5,939.1**
Accounts payable	(90.2)	(142.2)	(141.2)	(176.7)	(206.0)
Other payable	-	-	-	-	-
Tax payable	(16.4)	(19.1)	(20.8)	(24.5)	(28.9)
Proposed dividend	-	-	-	-	-
Due to related co.s	-	-	-	-	-
ST debts	(52.2)	(263.0)	(249.8)	(237.3)	(225.4)
Other current liab.	-	-	-	-	-
LT debts	(379.7)	(658.3)	(1,165.3)	(1,084.3)	(1,064.3)
Other LT liabilities	(166.0)	(214.1)	(219.5)	(224.9)	(230.6)
Total liabilities	**(704.4)**	**(1,296.6)**	**(1,796.5)**	**(1,747.7)**	**(1,755.2)**
Share capital	1,719.0	1,700.4	1,700.4	1,700.4	1,700.4
Reserves	925.6	1,399.1	1,653.5	1,984.0	2,377.5
Shareholders' funds	**2,644.6**	**3,099.6**	**3,354.0**	**3,684.4**	**4,077.9**
Minority interest	71.2	72.3	79.2	91.5	106.0
Total	**2,715.8**	**3,171.8**	**3,433.2**	**3,775.9**	**4,183.9**
Capital employed	3,147.7	4,093.1	4,848.3	5,097.5	5,473.6
Net (debt)/cash	(188.9)	(654.8)	(759.0)	(723.5)	(672.1)

Cash Flow (HK$m)	04A	05A	06F	07F	08F
Year to Dec					
EBIT	320.2	385.3	384.7	499.3	585.2
Depre./amort.	(22.2)	30.3	39.4	49.4	62.3
Net int. paid	2.0	(21.0)	(42.6)	(37.0)	(34.9)
Tax paid	(0.7)	(4.4)	(12.0)	(25.9)	(30.8)
Div. from associates	146.1	105.0	107.8	117.0	135.8
Gross cashflow	**445.4**	**495.2**	**477.3**	**602.8**	**717.6**
Chgs. in working cap.	(242.3)	279.3	(125.9)	(22.3)	(12.2)
Operating cashflow	**203.0**	**774.5**	**351.4**	**580.6**	**705.4**
Capex	(149.7)	(67.0)	(120.0)	(180.0)	(220.0)
Free cashflow	**53.3**	**707.5**	**231.4**	**400.6**	**485.4**
Dividends paid	(45.7)	(57.2)	(62.5)	(63.6)	(82.6)
Net distribution to MI	(0.5)	0.9	0.3	(7.0)	(12.3)
Investments	(36.9)	(595.9)	(350.0)	(40.0)	(40.0)
Disposals	40.9	1.8	3.0	3.0	3.0
New shares	-	-	-	-	1.0
Others	149.2	(523.1)	73.6	(257.6)	(303.1)
Net cashflow	**160.4**	**(465.9)**	**(104.1)**	**35.4**	**51.4**
Net (debt)/cash - Beg.	(349.3)	(188.9)	(654.8)	(759.0)	(723.5)
Net (debt)/cash - End.	(188.9)	(654.8)	(759.0)	(723.5)	(672.1)

Interim Results (HK$m)	04A	05A
Six months to June		
Turnover	**125.8**	**135.4**
% chg	*88.1*	*7.7*
Profit from operations	40.9	44.3
Interest expenses	(1.7)	(7.0)
Exceptionals		
Associates	103.3	96.4
Jointly-controlled entit.	-	-
Pre-tax profit	**142.5**	**133.7**
Tax	(1.0)	(1.0)
Minority interests	(0.2)	0.3
Net profit	**141.4**	**133.0**
% chg	*(53.3)*	*(6.0)*
Dividends	-	-
EPS (HK$) - W.A.	0.013	0.012
EPS (HK$) - F.D.	0.013	0.012
DPS (HK$)	-	-

Shareholding Structure	Shares o/s (m)	%
Shenzhen Investment	4,836.4	41.9
Cheung Kong (Holdings)	803.5	7.0
Deutsche Bank	579.7	5.0
Public	5,314.1	46.1
Total	**11,533.6**	**100.0**

Background

Shenzhen International Holdings is principally engaged in the provision of total logistics and transportation ancillary services. The company has a foothold in the four major subsector of the logistics industry, namely infrastructure, transportation systems, logistics and ancillary services.

Key Ratios (%)	04A	05A	06F	07F	08F
Net gearing	7.5	22.2	23.0	20.1	16.9
Net ROE	12.7	12.5	9.9	11.7	12.7
EBIT ROCE	10.8	10.6	8.6	10.0	11.1
Dividend payout	18.1	17.3	20.0	20.0	20.0
Effective tax rate	2.4	1.2	5.0	8.0	8.0
Net interest cover. (x)	na	18.3	9.0	13.5	16.8
A/R days	268.6	267.0	180.0	175.0	170.0
A/P days	108.8	188.6	190.0	190.0	190.0
Inventory days	-	-	-	-	-