

A dividend yield play for now

Hong Kong Logistics

Tradelink (536 HK, HK\$1.74)

Not Rated

B2G business model. Tradelink is electronic services provider for the logistics industry operating a business-to-government business model. The previously government owned company offers government-related trade declaration services including import and export trade declarations (TDEC), production notifications (PN), certificates of origin (CO) and dutiable commodities permits (DCP). In HKSAR, the logging of these notification by electronic means has been a compulsory requirement since 2000. Tradelink receives an annual registration fee from customers as well as a transaction fee for each transaction processed. The company currently has a customer base of over 54,000 users. In addition, Tradelink also operates a digital certification service called “Digi-Sign” and is the only private enterprise and one of only two entities in HKSAR to gain the status of “recognized certification authority” under the Electronic Transaction Ordinance. The other entity to offer such a service is the Hongkong Post.

Near monopoly position. Tradelink was the sole operator of government electronic trading services “GETS” in HKSAR prior to the government opening up the sector in 2003. Despite deregulation, entry barriers remain high as potential service providers are required to obtain a regulatory license from the government to operate GETS. To date, there are only 3 GETS providers in HKSAR and Tradelink continues to command a market share of over 90%. With a near monopoly position, Tradelink’s growth is tied strongly to the performance of the local economy.

Interim revenue up 2.7% YoY. Tradelink’s interim revenue edged up 2.7% YoY to HK\$120.7m while operating profit came in at HK\$55.7m, up 1.9% YoY. Operating margin was largely steady at 46.1% compared to 46.5% a year ago. Weighed down by a HK\$1.2m loss from the roll out of its new service Digital Trade and Transportation Network (DTTN), net profit contracted by 1.2% YoY to HK\$45.2m. The top line growth was slightly below our expectations given that HKSAR GDP rose 6.5% YoY for 1H 2006 while the Quantum Index for total exports and imports, measuring merchandise trade volume, were both up 10.1% YoY over the same period.

Table 1: Interim results

| Year to Dec | Turnover (HK\$m) | Operating profit (HK\$m) | Operating margin (%) | Profit before tax (HK\$m) | Net profit (HK\$m) | Basic EPS (HK cents) |
|-------------|---------------------|-----------------------------|-------------------------|------------------------------|-----------------------|-------------------------|
| 1H FY06 | 120.7 | 55.7 | 46.1 | 54.4 | 45.2 | 5.81 |
| 1H FY05 | 117.5 | 54.6 | 46.5 | 54.6 | 45.8 | 6.36 |
| YoY (%) | 2.7 | 1.9 | (0.4) | (0.3) | (1.2) | (8.6) |

Source: Company data

DTTN the company’s long term growth driver. Tradelink’s long term growth driver lies in DTTN, a B2B e-service platform for the logistics and supply chain industry. DTTN is the initiative of the Logistics Development Council (comprising both public and private sector participants) to improve HKSAR’s competitiveness and to transform HKSAR into the preferred regional e-logistics hub. The aim of DTTN is to provide a core messaging infrastructure to link up the various parties in the logistics value chain (such as buyers, sellers, freight forwarders and carriers) and offer integrated value added services such as distribution management, document exchange and transformation, together with other customer support and operations management. The logistics industry in HKSAR generates some 220m paper transactions per year and the company hopes to capture some 40% of this market in 5 years. The pilot phase of the DTTN is scheduled to be completed in 2H FY12/06. Though management indicated that the service will start generating revenue in 2H FY12/06, we estimate that the service is unlikely to reach breakeven until 2H FY12/07 at the earliest given ramp

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up and marketing expenses.

Strong balance sheet with 80% payout. The company has a strong balance sheet with HK\$377.0m (HK\$0.485 cash per share) with no debt. In addition, Tradelink has no bad debt as customers are required to submit a minimum deposit prior to using the company's services. This is evident by the low levels of trade receivables (HK\$23.9m, 19.8% of turnover) and short A/R turnover days of around 6 days. Management has indicated that they will maintain a 80% payout ratio in FY12/06 and 60% in the subsequent years.

Preliminary forecast and valuation. The use of electronic cargo manifest service for river and ocean carriers has become mandatory in since June 2006 and we expect this to contribute to the company's top and bottom lines in 2H FY12/06. We forecast that the company's FY12/06F net profit to reach HK\$94.3m (EPS: HK\$0.121), including a HK\$3.2m full year loss for DTTN. Upside to our estimates will come from a less than expected loss from DTTN roll out. The company trades at 14.4x or 11.2x ex-cash FY12/06F P/E and offers an attractive yield of 5.6%. In our view, the company will continue to be a dividend yield play for the foreseeable future until its DTTN services matures into a key growth driver for the company.

Corporate governance issues. Tradelink was listed on the HKEx in Oct 2005. The company has a strong and diverse shareholder base including Allianz AG (8.41%), HSBC (5 HK, HK\$139.40, NR), the HKSAR Government (7.80%) and JP Morgan Chase (4.83%). KPMG has been the company's financial auditor since listing.

Bidding for Hongkong Post's certification operations. The company has submitted a bid with a joint venture partner to operate the Certification Authority service of Hongkong Post. The result of the tender is expected to be announced in Oct 2006. We believe that a successful tender will provide further revenue growth and diversification for the company and would stimulate a re-rating of the stock price.

Table 2: P&L

| Year to Dec (HK\$m) | 03A | 04A | 05A | 1H 05A | 1H 06A |
|---|--------------|--------------|--------------|--------------|--------------|
| Turnover | 308.5 | 279.7 | 249.1 | 117.5 | 120.7 |
| Interest income | 4.0 | 5.1 | 8.1 | 4.5 | 3.5 |
| Other net loss | - | (4.3) | (1.2) | - | - |
| Staff costs | (87.2) | (83.0) | (80.1) | (36.5) | (38.4) |
| Depreciation | (40.8) | (25.5) | (15.6) | (7.2) | (7.7) |
| Impairment losses of investment in securities | (7.5) | (40.0) | - | - | - |
| Other operating expenses | (51.2) | (48.4) | (50.1) | (23.7) | (22.6) |
| Operating profit | 125.8 | 83.6 | 110.3 | 54.6 | 55.7 |
| Finance costs | - | - | - | - | - |
| Exceptionals | - | (0.1) | 0.3 | - | - |
| Share of profits/(losses) of an associate | (4.3) | - | (0.8) | - | (1.2) |
| Profit before taxation | 121.5 | 83.6 | 109.9 | 54.6 | 54.4 |
| Taxation | (23.8) | (20.6) | (18.5) | (8.8) | (9.2) |
| Profit after taxation | 97.7 | 63.0 | 91.4 | 45.8 | 45.2 |
| Minority interests | - | - | - | - | - |
| Profit attributable to shareholders | 97.7 | 63.0 | 91.4 | 45.8 | 45.2 |
| % chg | (14.4) | (35.6) | 45.1 | na | (1.2) |
| Dividend | (77.7) | (49.8) | (117.7) | (63.3) | (37.3) |

Source: Company data