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Other small/mid caps deliver higher yield — Hong Kong Logistics

Tradelink (536 HK, HK$1.54) — Not Rated

Since our previous report "a dividend yield play for now" (8th September 2006), we recently met with the management to get an update on the company's operations. Key takeaways are as follows:

GETS is still core cash cow. We found that Tradelink is still struggling to diversify revenues. Government Electronic Trade Services (GETS) remains the company's core revenue generator and cash cow. It comprises six main types of government related trade declaration services, including: 1) import and export trade declarations (TDEC); 2) production notifications (PN); 3) certificates of origin (CO); 4) dutiable commodities permits (DCP); 5) textiles trader registration scheme (TTRS) and 6) electronic cargo manifest (EMAN). In the HKSAR, logging of these notifications by electronic means has been a compulsory requirement since 2000. Tradelink was the sole service operator in the HKSAR before the government opened up the industry in 2003. Despite deregulation, entry barriers remain high, as service providers are required to obtain a regulatory license to operate, which are limited by the government. To date, the government has issued a second operating license for only three of the six services (TDEC, DCP and EMAN). Tradelink commands a market share of over 90% and with its near monopoly its growth is tied strongly to the performance of the local economy. It has a customer base of over 54,000 users, generating more than 17m transactions in 2006. The company charges a registration fee and a transaction fee of HK$0.50-12.50. Transaction fees makes up the bulk of its revenues, accounting for 90.7% of turnover in 1H FY12/06A, reaching HK$109.5m.

Trade transaction volume growth slowing despite strong GDP. According to HKSAR's Census and Statistics Department, Hong Kong's GDP grew 6.8% in the first three quarters of 2006 and is estimated to grow 6.5% for the full year. The growth was driven by the recovering world economy and continuing economic expansion. However, GDP growth is widely expected to moderate to between 5-6% in 2007 owing to a possible slow down in the US economy. After seasonal adjustments, total export expanded by 6.4% in 3Q 2006. Interestingly, trade transactions growth has been moderating from 7.3% YoY in 2004, to 5.1% in 2005. For the first 11 months of 2006, Hong Kong's trade transaction volume further slowed to a 3.4% YoY growth. Given that Tradelink's GETS service is more dependant on transaction volumes rather than GDP, the slowing growth may have a negative impact on Tradelink's revenues.

Limited advantage from GETS' "de facto" monopoly. With exclusive licenses for three of the six GETS services and 90%+ market share in the remaining three, Tradelink maintains a privileged status by virtue of its near monopolization of the industry. However, the company has limited ability to exploit this position in terms of pricing. Government approval is required for any price increase, while there is no set "floor price" limiting price decreases. Management stresses that though there is pricing pressure for the three services under competition, they are able to maintain prices at above competitors' rates without sacrificing significant market share.

Regulatory risk on the horizon. Being a government related service, GETS is subject to regulatory risk. The removal of textile quotas at the end of 2004 led to the abolition of textile registration (RTEL), a service offered by Tradelink under GETS at the time. As a result, transaction revenues fell 10.8% YoY in FY12/05A to HK$225.7m. On the flip side, management indicated that the government has made the submission of cargo manifest services by electronic means for river and ocean carriers mandatory since 16 June 2006. The company does not provide a breakdown for its GETS products; but we note through its IPO prospectus that EMAN revenues accounts for only 0.7% of overall transactions revenues in FY12/04A and in the first four months FY12/05. Therefore, this may have limited upside contribution to GETS. Tradelink's GETS license is due to expire at the end of 2008, and we expect the government to introduce more competition into the industry, especially by issuing an additional license for the three services (PN, CO, TTRS) currently offered exclusively by Tradelink.

Digi-Sign outlook: mixed news. Tradelink operates a digital certification service called "Digi-Sign". The company is the only private enterprise and one of only two entities in HKSAR (the other being Hong Kong Post) to gain the status of "recognized certification authority" under the Electronic Transaction Ordinance. The news for this service appears to be mixed. On one hand, the company was successful in signing up Taiwan's leading electronic services provider (Trade Van) and is currently in deep discussions with Netbay of Thailand to extend its services abroad. Offsetting this, our checks suggest that its bid to take over the operation of Hong Kong Post's digital signature services had been unsuccessful. Securing Hong Kong Post's operations and gaining sole provider status in HK would have enhanced Digi-Sign's credibility and facilitated potential service extensions overseas and into China. Tradelink is seeking mutual recognition of Digi-Sign with a similar service in Southern China to expand the service for its existing user base with Mainland operations.

Digi-Sign scalable but too small to drive growth. Digi-Sign is perhaps the company's most scalable and easiest to expand service but its revenue contribution is small at around 1% at the end of 1H FY12/06A, according to our estimates. Though growth of this segment will be robust in FY12/07, spurred by initial contribution by Trade Van, as well as continuing adoption from a tier one bank in Hong Kong, we estimate that Digi-Sign is a long way from becoming a key growth driver for Tradelink.

DTTN pilot phase completed, service launched. The pilot phase for Digital Trade and Transportation Network was completed in 2H FY12/06 and the company has begun charging for its services. DTTN is the HKSAR government's dedicated electronic initiative to bring Hong Kong's logistics sector into the 21st century and mark itself as the region's preferred e-logistics hub. The aim of DTTN is to provide a core messaging/interface infrastructure to link up the various parties in the logistics value chain and offer integrated value-added services such as distribution management, document exchange and transformation, customer support and operations management. The company aims to eventually capture 50% of this market, which generated some 220m paper transactions in 2002.

DTTN losses likely to rise, breakeven point some way off. Though DTTN has already signed on around 100 customers, we believe that usage is still very low. At this stage, Tradelink is focused on building the user community and driving usage volume. However, we note that the logistics industry is traditionally slow to adopt new processes/technologies. The service lost HK$1.2m in 1H FY12/06A. The management's reluctance to guide for the timing to reach breakeven point also suggests that earnings visibility is low.

Non-controlling stake limits Tradelink's aggressiveness to roll out DTTN. In our view, Tradelink may be very restricted as to how aggressively it can roll out DTTN. Despite having a 51% stake in DTTNCo., the company does not have any control of the subsidiary's board. We believe this is because the board is represented by interested parties along the logistics value chain (e.g. freight forwarders, carriers, industry associations etc), with no majority party. On one hand, the balanced board aligned the interests of all different parties to commit to the DTTN platform, but the offsetting disadvantage is that the setup may result in many stalemates during the decision making process. The results of DTTN are accounted for as an "associate company" in Tradelink's financial statement.

Preliminary net profit forecast. With only incremental gains likely in its core GETS, slowing trade transaction volume growth and small contribution from Digi-Sign, there is no clear avenue to drive Tradelink's top line. Though the business model is scalable (management does not foresee any significant increase in staff), margin expansion will be moderate as its already lean operating structure suggests limited scope to further squeeze out costs. Meanwhile, any margin gains will be partially eroded by continuing losses in DTTN. We estimate Tradelink's FY12/06F net profit at HK$94.1m, up 3.0% YoY, after allowing for a further HK$2.0m impairment charge for its interest in Oneport.

Losses in DTTN may force dividend policy change. In the company's IPO in 2005, management pledged to maintain a dividend payout of 80% for the first two years and 60% thereafter. Our interpretation is that the management had planned for DTTN to make a profit from the third year of Tradelink's listing (i.e. FY12/07). The company has strong cash flow generation (HK$55.3m in 1H FY12/06A, up 4.7% YoY) and low levels of accounts receivables (HK$23.9m) and should be able to maintain an absolute dividend payout if DTTN losses rise dramatically. Management has not ruled out the possibility of switching to an "absolute dividend" policy after the announcement of FY12/07 results in Mar 2007.

PCCW disposed of its 8.12% stake. In 13 Nov 2006, PCCW, the company's joint second largest shareholder at the time, disposed of its 8.12% stake in Tradelink at an average selling price of HK$1.50. We believe the stock's near-term upside may be influenced by this price.

Valuation. With its core GETS strictly a cash cow, longer-than-expected incubation period for DTTN and small contribution from Digi-Sign, the company does not have a clear growth driver that commands a premium valuation. Taking into consideration the possibility of a dividend policy change, we see the company in defensive mode and as a dividend yield play in the foreseeable future. Therefore, we believe yield will be a key valuation metric to support the stock's share price. In our view, the company should be valued against other high-yielding small to mid cap stocks, which despite offering superior bottom line growth and cheaper P/E multiple to Tradelink, can also deliver better yield. Tradelink is currently trading at 13x FY12/06F P/E, with an estimated 6.5% dividend yield. In our view, fair value on the counter should be in the region of 8.5% yield, implying 10x FY12/06F P/E.

Table 1: P&L

Year to Dec (HK$m)	03A	04A	05A
Turnover			
Transaction and handling fees	275.4	253.0	225.7
Annual subscription and registration fees	24.5	19.8	19.1
Training income	0.6	0.3	0.2
Sales of software and related installation	0.2	0.2	-
Others	7.8	6.4	4.0
	308.5	**279.7**	**249.1**
Interest income	4.0	5.1	8.1
Other net loss	-	(4.3)	(1.2)
Staff costs	(87.2)	(83.0)	(80.1)
Depreciation	(40.8)	(25.5)	(15.6)
Impairment losses of investment in securities	(7.5)	(40.0)	-
Other operating expenses	(51.2)	(48.4)	(50.1)
Operating profit	125.8	83.6	110.3
Finance costs	-	-	-
Exceptionals	-	(0.1)	0.3
Share of profits/(losses) of an associate	(4.3)	-	(0.8)
Profit before taxation	**121.5**	**83.6**	**109.9**
Taxation	(23.8)	(20.6)	(18.5)
Profit after taxation	**97.7**	**63.0**	**91.4**
Minority interests	-	-	-
Profit attributable to shareholders	**97.7**	**63.0**	**91.4**
% chg	*(14.4)*	*(35.6)*	*45.1*
Dividend	(77.7)	(49.8)	(117.7)

Source: Company data

Table 2: Valuation comparisons

Company Name	Stock Code	Country	Mkt Cap (US$m)	Price	Cur Yr PE (x)	Cur Yld (%)	Est Yld (%)
Electronic services							
Ninetowns	NINE US	CH	176.7	US$5.05	n/a	-	-
Trade-Van	6183 TT	TW	88.3	TW$14.65	n/a	4.6	-
Yellow Pages	YPG SP	SP	153.5	SG$1.25	15.7	5.2	6.9
Average					**15.7**	**4.9**	**6.9**
Small/mid caps							
ASM Pacific	522 HK	HK	2,334.8	HK$47.05	15.5	4.5	5.2
SaSa	178 HK	HK	467.6	HK$2.70	17.6	2.9	6.1
Karrie Int'l	1050 HK	HK	103.6	HK$1.96	5.2	7.5	11.4
Vtech	303 HK	HK	1,464.6	HK$47.80	9.3	7.1	8.5
Pacific Basin	2343 HK	CH	1,112.5	HK$5.57	8.0	-	11.0
Average					**11.1**	**5.5**	**8.5**
Tradelink	536 HK	HK	153.6	HK$1.54	13.0	5.1	6.5

Source: Bloomberg & SBI E2-Capital