Corporate Snippet

Fri, 18 Aug 2006

Kennedy Tsang
(852) 2533 3713
kennedytsang@softbank.com.hk

Positioning to tap Li & Fung

Hong Kong Logistics

IDS (2387 HK, HK$13.76)

Not Rated

Logistics-led business model. IDS is a member of the Li & Fung Group of companies, focusing on providing brand owners with integrated downstream distribution services in the Asia Pacific Region. The company has three core business segments namely: 1) logistics, 2) marketing and 3) manufacturing. IDS works with over 390 brand owners and retailers and specializes in the fast moving consumer goods (FMCG) and healthcare/pharmaceutical industries. The company was formed in 1999 when the parent group acquired the Asian marketing services and related business of UK-based Inchape.

Table 1: Business profile

Segment	Core Activities	Customers	Scale
Logistics	Ship, store, deliver	P&G, Unilever, Nike, Watsons, Timberland, Gillette, Johnson Diversey China, J&J, Philip Morris	>2,000 staff in 7 countries 55 DCs / depots (>450,000m2)
Marketing	Promote, bill, sell, collect	Philip Morris, Unilever, Pfizer, J&J, Abbott, Beiersdorf, Gillette	>2,000 staff in 8 countries
Manufacturing	Make, test, package	Pfizer, Nestle, J&J, Unilever, Fonterra	>900 staff in 3 countries

Source: Company data and SBI E2-Capital

Asset light model ensures scalability. Similar to stable mate Li & Fung (494 HK, HK$18.30, BUY), IDS operates an "asset light model" whereby it leases all of its hard assets such as distributions centers (DCs), depots and manufacturing facilities. This allows the business to be highly scalable, able to meet growing demands of its customers through both capacity and geographic expansion. The strategy also allows the company to enjoy strong ROAs and ROEs.

Table 2: ROA/ROE ratios

	01A	02A	03A	04A	05A
ROA (%)	3.0	0.8	2.3	3.3	3.9
ROE (%)	12.5	4.2	13.2	15.2	16.3

Source: Company data and SBI E2-Capital

Global trends facilitates growth. IDS is a prime beneficiary of several global trends. These include: 1) unbundling of downstream functions such as warehousing and distribution by MNCs to focus on brand management and product development, 2) global outsourcing trend of lower value functions such as logistics, manufacturing and below the line marketing, 3) growing consumerism in Asian economies and 4) globalisation trend as MNCs move production facilities to low cost economies in China and other parts of Asia.

Offering horizontal and vertical value chain. The company uses its logistics services as the front end platform to drive value for customers at both a horizontal and vertical level. At the horizontal level, after securing a customer's distribution contract, IDS then proceeds to increase its value proposition by offering additional warehousing and regional hubbing services. At the vertical level, IDS can offer to provide marketing/marketing services as well as extending service scope to other regional Asian countries after securing the logistics contract. For the customers it makes sense to engage IDS to manage both distribution and marketing functions as the company will have better visibility on inventory levels and sell through rates at point-of-sales, thus placing it in a better position to coordinate marketing campaigns. Through this process of value enhancement, IDS is able to integrate itself into the supply chain of the customers, which increases lock-in effect and dramatically raises switching costs.

Chart 1: Value chain model

Horizontal Value Chain

Vertical Value Chain

Service	**logistics:** distribution ➤ warehousing ➤ regional hubbing and export **marketing:** in-store marketing ➤ merchandising ➤ sales channel management ➤ bill collection
Functional	logistics ➤ marketing ➤ manufacturing
Geographical	Hong Kong ➤ China ➤ Thailand ➤ Singapore ➤ Malaysia

Source: Company data and SBI E2-Capital

FY12/06 interim results moderate. 1H FY12/06 results came in slightly below expectations. Turnover rose 26.2% YoY to US$467.5m, while net profit was up 15.8% YoY to US$8.5m with the aid of a US$3.7m tax credit (US$2.2m in 1H FY12/05). On a proforma basis, profit fell 7.1% YoY to US$4.8m, weighed down by a 51.6% YoY increase in corporate expenses. Management indicated that the additional corporate expenses were due to increased corporate finance activities and the setting up of a Regional Business Development (RBD) team to explore regional expansion opportunities. Logistics, marketing and manufacturing rose 8.3%, 32.1% and 15.2% to US$65.5m, US$339.2m and US$69.5m respectively. In our view, the company's turnover is not a good indicator of top line growth. As IDS is required to take "title" of the goods, actual "cost of goods" is included in the marketing revenues. Hence, revenue growth in this segment can be attributable to 1) organic growth in the business, 2) increased volume of goods handled and 3) increase in the value of goods. We prefer to focus on gross profit, which was up 11.9% to US$114.6m. IDS' logistics segment continues to be its core driver, with solid turnover growth and operating margin expansion to 9.0% (from 8.4%). Operating profit before corporate expenses rose 15.9% YoY to US$13.9m. On a geographical level, key growth regions were China, whose revenues surged 65.5% YoY to US$72.8m and the Philippines, where a full six month contribution from its new marketing operations drove revenues up 116.7% YoY to US$96.1m.

Table 3: Interim results

Year to Dec	Turnover (US$m)	Gross profit (US$m)	Gross margin (%)	OP before corporate expenses (US$m)	Net profit (US$m)	Basic EPS (US cents)
1H FY06	467.5	114.6	24.5	13.9	8.5	2.76
1H FY05	370.3	102.4	27.6	12.0	7.4	2.39
YoY (%)	*26.2*	*11.9*		*15.9*	*15.8*	*15.8*

Source: Company data

Enhancing customer base. The company had a strong 1H FY12/06 in terms of new contracts with 37 wins. These included P&G in Taiwan, Diageo in Singapore for regional hubbing and a manufacturing contract with Henkel, a German-based MNC, in Indonesia.

IDS announced M&As at last. During its IPO in Dec 2004, Management pledged to drive growth through organic expansion and selective M&As. The company was quiet on the latter in 2005 however, as it preferred to consolidate its regional business and expand into Philippines organically. It finally announced two acquisitions over the past two weeks. These included:

- Acquisition of Malaysian third party logistics (3PL) provider Sitt Tatt Logistics and two distribution centres (DCs) in Kuala Lumpur and Penang totalling 500,000sq ft for a total consideration of US$25.75m; and
- Signed MOU to acquire US based 3PL provider Impac Logistics for a consideration of US$35m, with additional earn out of up to US$7.5m. IDS is presently conducting due diligence on the said company.

Management indicated that both acquisitions would be a cash deal, funded through internal resources and bank financing, with no issue of new shares. At the end of 1H FY12/06, the company had net cash of US$10.7m, with US$46.0m of short-term debt. The acquisition of Sitt Tatt and the DCs is expected to be closed by 30 Sep and 31 Dec 2006 respectively. Meanwhile, due diligence on Impac Logistics is scheduled to be completed by the end of Sep 2006, with the acquisition deal closed by the end of Oct 2006.

Impac positions IDS to tap Li & Fung. We believe Impac will be an extremely good acquisition for IDS generating significant synergies. The target company will extend IDS' reach beyond Asia Pacific to the critical North American market. Impac has a strong focus in the garment industry allowing IDS to horizontally broaden into this sector. More importantly, the extension into this industry will open the door for IDS to tap the huge customer base of Li & Fung. Note that Li & Fung outsources all downstream distribution activities at present. Impac is not a 3PL services provider to Li & Fung currently, which indicates the tremendous scope for growth in this area. Impac is the key enabler to this strategy as it strengthens IDS' core competency in the area of export logistics. With last mile presence in the US, IDS is in a position to offer end-to-end supply chain solutions, a key requirement for many garment manufacturers and US retailers. Management indicated that Impac's 2005 turnover was just under US$50m and the target company enjoys similar margins to its incumbent logistics business.

Sitt Tatt brings scale to Malaysian operations. In a fragmented Malaysian market, Sitt Tatt will double the size of IDS' current operations and instantly transform the company into a market leader and provide it with scale to enhance profitability. The acquisition will also give IDS access into another new sector – electronics. Management indicated that it was necessary to purchase the DCs to consolidate supporting functions and adequately develop its logistics operations in this region. The company intends to dispose of the assets at a later date (most likely under a sell and lease back agreement) to maintain its asset light business model.

Preliminary forecast and valuation. Management aims to double the company's FY12/04 net profit to US$21.2m by the end of FY12/07. We estimate that with full year contributions from Sitt Tatt and Impac next year, the company is in a position exceeding this target and achieve a FY12/07 net profit of US$23.3m (EPS: US$7.53 cents). The counter trades at 23.4x FY12/07F P/E. The present valuation is reasonable given the growth opportunities available to IDS with its recent acquisition announcements, strong management and its value added business model. The stock may see further re-rating on further plans to enter Vietnam or Indonesia (logistics) either organically or through M&As.

Corporate governance issues. Li & Fung Group is IDS' largest shareholder, with a 51.12% stake. Other substantial shareholders include Matthews International Capital Management (7.14%), Brookeside Capital (5.01%) and INVESCO Asia (4.94%). The company has not further raised any fund through the equity market since listing in Dec 2004 and the prospectus indicated that it will maintain a dividend payout of no less than 50%. PricewaterhouseCoopers has been the company's financial auditor since listing.

Table 4: P&L

Year to Dec (US$m)	03A	04A	05A
Turnover			
Logistics	78.8	94.3	127.0
Marketing	424.1	379.9	575.9
Manufacturing	101.4	123.8	134.3
Inter-segment elimination	(12.4)	(13.1)	(15.7)
	591.8	**584.9**	**821.5**
Cost of sales	(448.6)	(419.8)	(604.6)
Gross profit	143.2	165.1	217.0
Selling and distribution costs	(104.9)	(122.1)	(168.3)
Administrative expenses	(31.4)	(30.3)	(32.7)
Core operating profit	6.9	12.7	16.0
Other operating gains/(expenses), net	6.2	0.6	3.0
Operating profit	13.1	13.3	19.0
Finance costs	(1.3)	(0.7)	(0.9)
Share of profits and losses of jointly controlled entities	-	-	-
Share of profits of an associated	-	-	-
Profit before taxation	**12.1**	**12.6**	**18.1**
Taxation	(2.9)	(1.1)	(3.8)
Profit after taxation	**9.1**	**11.6**	**14.3**
Minority interests	(0.8)	(0.9)	(0.9)
Profit attributable to shareholders	**8.4**	**10.6**	**13.3**
% chg	*181.3*	*27.2*	*25.3*
Dividend	(11.0)	(22.0)	(8.0)

Source: Company data