

Banking on rising economies of scale

China Logistics

GDNY Logistics (3399 HK, HK\$3.17)

BUY (unchanged)

Target price: HK\$4.6 (+45.1%)

Results review

- 1H FY12/06 sales beat our forecast with a 30.8% YoY increase to RMB2.2b but net profit rose only 10.3% YoY to RMB71.3m mainly due to the lead-time required to ramp up the new service zones. However, the results were inline with our forecast, note that it accounted for c.45% of our full-year earnings estimate. EPS amounted to RMB0.17. No interim dividend was declared.
- The interim results showed GDNY's dedication in growing its operation scale. Although the overall operating margin showed a drop of 1.2pcp YoY to 5.8%, but a growth of by 1.1% HoH.

Table 1: Sales breakdown by segments

RMBm	1H05	1H06	YoY %
Material procurement & logistics	1,278.1	1,642.5	28.5
Expressway services zones	120.9	150.7	24.6
Transportation intelligence services	72.6	170.4	134.7
Toll incomes	40.8	48.7	19.4
Coach business	129.6	131.5	1.5
Others	2.8	8.2	192.9
Sales	1,644.8	2,152.0	30.8

Source: Company data

Table 2: Overall margin trends

	1H05	2H05	2005A	1H06
Gross (%)	13.4	11.4	12.2	11.5
Operating (%)	7.0	4.7	5.5	5.8
Pretax (%)	6.3	4.6	5.2	5.5
Net profit (%)	3.9	2.7	3.1	3.3

Source: Company data

Table 3: Financial summary

Year to Dec	Net profit RMBm	EPS RMB	EPS Δ %	P/E X	P/B x	EV/EBITDA x	Yield %	ROE %	ROCE %	N. Gearing %
04A	108.8	0.260	73.7	12.7	1.22	6.1	n.a.	19.2	27.8	Cash
05A	136.6	0.327	25.6	10.1	1.17	6.3	2.3	16.1	20.7	Cash
06F	154.4	0.370	13.0	8.9	1.09	6.1	3.5	13.5	17.6	Cash
07F	199.1	0.477	29.0	6.9	0.91	4.8	4.5	14.4	19.4	Cash
08F	261.7	0.627	31.4	5.3	0.73	4.0	5.9	15.4	21.1	Cash

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Table 4: Operating profit margin breakdown by segments

Operating profit margin %	1H05	2H05	2005A	1H06
Material procurement & logistics	3.2	1.4	2.1	2.8
Expressway services zones	32.8	20.9	26.1	16.8
Transportation intelligence services	(4.4)	5.0	3.6	(1.4)
Toll incomes	76.5	83.8	80.3	79.5
Coach business	20.2	11.6	15.9	20.3

Source: Company data

Operation highlights

I) Material logistic services: Surprises on the top-line due to larger market share

Table 5: Volume of construction materials handled

	*2005A	1H06
No. of logistics projects handled	14	19
Total volume of material supplied (tonnes)		
- cement	2,200,000	460,900
- steel bars	655,000	385,800
- steel strand	23,000	7,000
- asphalt	130,000	28,800

* 1H05 figures are unavailable, we include FY12/05 figures as a reference

Source: SBI E2-Capital

- Sales were higher than expected with a 28.5% YoY increase to RMB1.6b, reflecting GDNY's ability to gain larger market share with the successful bid for the Guangzhou Rail Route 6 Project, Leshi Expressway Tender Section SX09, Guangzhou Dongsha to Xinlian Expressway Project and the station front construction of the newly established Wuhan to Guangzhou Passenger Line. The aggregated contract sum amounted to RMB600m for the period.
- Operating profit grew by a smaller rate of 14% YoY to HK\$46m. Both gross and operating margin showed a slight decline of 0.1pcp and 0.4pcp to 5.2% and 2.8% respectively. The decline was consistent with the required setup costs for additional warehouse, information infrastructure facilities in the transportation of asphalt. During the period, the Tiepeichang Central Warehouse, Sanshui Steel Bar, Steel Strand and Asphalt Warehouse, Guangzhou Municipal Huangpu Asphalt, asphalt warehouses in Maoming, Shantou, Haixinsha and Dongguan Xinsha Port were established. The set up of such facilities is vital for its future expansion in the transportation of higher-margin asphalt. It aims to grow the asphalt market outside the Guangdong Province to the Pan-Pearl River Delta area in the future. The asphalt market is enormous, as it is widely used for pavements and as a waterproof cement.
- The margin for material logistics services is relatively low and its growth relies heavily on volume. GDNY has achieved volume growth, and demonstrated that it has not been affected by the government's austerity measures in the PRC, since infrastructure projects are for public utility service. Apart from capturing a larger market share, it has also put effort in growing profitability, thanks to the transportation of higher-margin construction materials. The coal material logistics service has begun since 1H06.

II) Expressway service zones: Slower start at the beginning of the 11th Five Year Plan

Table 6: Service zone expansion plan

	2006F	2007F	2008F	2009F	2010F
New addition in the length of expressway in GD Province (km)	3,300	3,550	4,000	4,550	*5,500
No. of pairs of service zone in GD	55	60	69	80	100
GDNY's market share (%)	80	80	80	80	80
No. of service zones operated by GDNY	44	48	55	66	81
- annual net additions of service zones (pairs)	4	4	7	8	15

*5,500 km is the target of the 11th- Five Year Plan by the Guangdong Provincial Government

Source: SBI E2-Capital

- Sales were up 24.6% to RMB150.1m but operating profit was down 36% YoY to RMB25.4m. Both gross and operating margin declined 21.5pcp and 16pcp YoY to 32.4% and 16.8% respectively. We believe it was

mainly due to the lead-time for service zones to ramp up. New service zones normally require three to six months time to ramp up. There were 13 net additions in FY12/05A compared with 2 in 1H06. As a result, operating margin for FY12/06F is expected to normalize to c.21%.

- The total number of service zones grew from 40 pairs in FY12/05A to 42 pairs in 1H06, which was inline with our full-year forecast of 4 pairs in FY12/06. Although the pace of expansion seemed a bit slow at first the glance, we have already mentioned earlier that it was mainly due to a slower start at the beginning of the 11th Five Year Plan. The pace of service zone expansion follows the speed of expressway construction in the Guangdong Province. According to the 11th Five Year Plan (2006-2010), the total length of expressway should expand by another 5,000 km with one pair of service zones for each 50km of expressway. With a market share of 80% in Guangdong, the total number service zones operated by GDNY is estimated to expand to 80 pairs by 2010. For the 10th Five Year Plan (2000-2005), the length of expressway has expanded by 4,730km in 2005 from 200km in 2004, while the total number of service zones expanded from 27 pairs in 2004 to 40 pairs in 2005. The 13 pairs of net adds were mainly carried out towards the end of the 10th Five Year Plan. As a result, we have reason to believe the pace of new service zone addition will accelerate towards the end of the second 11th Five Year Plan.
- Apart from Guangdong, there is no concrete progress on expansion in Jiangxi. However, the Company has established a base in Nanchang to start the preliminary work on the service zone joint venture.

III) Coach business: Stable growth

- The cross-boarder coach business performed steadily despite higher fuel costs and restriction in the total number of shifts. Sales and operating profit rose slightly by 1.5% YoY and 2.2% YoY to RMB131.5m and RMB26.7m respectively.
- During the period, total passenger throughput rose 3% on average, with passenger load factor increase to c.38% from c.30% in FY12/05. The Group expects the total passenger throughput to be maintained at the FY12/05 level of 3.7m. The company is considers acquiring another domestic coaching business in the Pan-River Delta region in the medium-term.

IV) Tai Ping Interchange: Cash-generative

- The toll income segment reported good performance on the back of robust traffic growth with stable toll fees. Sales and operating profit rose 19.4% and 24% YoY to RMB48.7m and RMB38.7m. It remains a cash-generative business without any investment outlay required.

V) Intelligent Transportation Services (ITS)

- Sales surged 134.7% to RMB170.4m, mainly due to increase in the number of new projects and expansion into Guizhou, Qinghai, Henan, Hunan Province. However, this segment reported a loss of RMB2.42m (1H06: a loss of RMB3.2m), compared with an operating profit of RMB17m in FY12/05A. We attributed this to the costs involved in the development of new projects, including toll evasion prevention project and upgrading the HCS, HOS, HQS, HDS and OLS products.

Valuations

We think GDNY is increasingly focused on growing its operation scale in the material logistic segment in order to mitigate the impact from slower service zones uptake initially. We continue to favor the counter as we see opportunities to arise 1) once the operation in service zones is ramped up; 2) a strong net cash position of HK\$522m and 3) growth through potential acquisitions. We have revised up our sales forecast by 11-18% for FY12/06-07 to reflect the higher contribution from material logistics and ITS services but fine-tuned our earnings forecast based on lower margin. The Company has budgeted RMB200m as capex in FY12/06F. It has already spent RMB51m in 1H06. We maintain our BUY recommendation, with a revised target price of HK\$4.6, (prev. \$4.8) based on our blended P/E valuation. It is trading at 7.0x cum-cash and 4.0x ex-cash FY12/07F P/E.

Table 7: Blended P/E valuation

Sum-of-the-parts Valuation	EBIT FY12/06F (HK\$m)	Adj. Comparable P/E	HK\$m
Material procurement & logistics	88.8	8	710.2
Expressway services zones	61.7	10	617.0
Transportation intelligence services	18.2	5	91.2
Toll incomes	75.6	6	453.8
Coach business	46.2	3	138.5
Others	4.9	3	14.7
Enterprise value			2,025.3
Less debt:			(223)
Equity value			1,901.6
Value per share			4.6

Source: SBI E2-Capital

Disclosure of interests: SBI E2-Capital Securities acted as the Co-lead Manager/Underwriter of the IPO of Guangdong Nan Yue Logistics in Oct 2005.