

Consumer & Retail  
 Textiles, Apparel & Luxury  
 Goods  
 Equity – China

## Buy

Target price (HKD)	34.00
Share price (HKD)	32.00
Upside/Downside (%)	6.2

Performance	1M	3M	12M
Absolute (%)	6.5	25.7	30.0
Relative <sup>A</sup> (%)	7.0	21.1	4.9

Index<sup>A</sup> HSCEI

RIC 2313.HK  
 Bloomberg 2313 HK

Market cap (USDm) 5,772  
 Market cap (HKDm) 44,768

Enterprise value (CNYm) 36,447  
 Free float (%) 34

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# Shenzhou (2313 HK)

Buy: Widening the lead

- ▶ **2014 results were encouraging in demonstrating the group's ability to gain production share from its key customers**
- ▶ **We think contribution from Vietnam is on track with upstream production ramped up, downstream to start in 2H15e**
- ▶ **We establish a Buy rating and are setting a fair value target price of HKD34.0 (HKD30.0 previously)**

**Competitive advantages more apparent.** The group reported 2014 results which impressed not only due to accelerating sales growth (+17% yoy in 2H14, from +4% in 1H14) but also due to gross margin expansion (+0.7ppt yoy to 29.4% in 2014). There was some benefit in lower cotton prices which helped gross margin expand, but efficiency gains and higher utilization more than offset higher labour costs. The group is already the preferred supplier among many of its key brand customers, but its ability to improve efficiency and offer product innovation are key advantages that set it apart from competitors, in our view. As testament to this, the contribution from top 4 customers rose to 77% in 2014 from 75% in 2013.

**Vietnam expansion on track.** Shenzhou is the first of the textile companies under our coverage to begin production in Vietnam. The site, outside of Ho Chi Minh City, is the group's first upstream garment base to be located outside of Ningbo. We expect the upstream Phase I fabric capabilities to be fully ramped up soon, which should increase utilization in the Cambodia downstream facility and reduce lead time (another key advantage). As Phase I is completed, the group is on track to start its downstream operation in Vietnam by 2H15, which should further increase utilization from Vietnam upstream production and reduce production lead time. The earnings growth of 9% yoy that we forecast in 2015e should primarily be driven by additional capacity and higher operating efficiency.

**2014 results review.** The group reported FY14 net profit of RMB2,066m (+15% yoy) on an 11% increase in revenue. Earnings were 10% above our estimates, primarily due to higher sales, gross margin and other income. Management declared a final DPS of HKD1.00 (including HKD0.35 special dividend), which implies a total payout of 53% (2013: 46%).

**Establish a Buy rating with HKD34 fair value target price.** We establish a Buy rating and set a DCF-based fair value target price of HKD34.0 (HKD30.0 previously) on higher earnings estimates and a higher terminal growth rate. We raise our 2015-16e earnings by 10% and 7%, respectively, on better gross margin from higher efficiency and operating leverage. Key downside risks include slower-than-expected demand, a significant increase in raw material prices, and ramp-up delays or higher-than-expected start-up costs associated with the new Vietnam production.

## Financials & valuation

### Financial statements

Year to	12/2014a	12/2015e	12/2016e	12/2017e
<b>Profit &amp; loss summary (CNYm)</b>				
Revenue	11,132	12,415	13,598	14,716
EBITDA	3,033	3,394	3,758	4,155
Depreciation & amortisation	-443	-482	-512	-581
Operating profit/EBIT	2,591	2,912	3,246	3,574
Net interest	-46	-14	-14	-14
PBT	2,544	2,898	3,232	3,559
HSBC PBT	2,544	2,898	3,232	3,559
Taxation	-477	-543	-598	-658
Net profit	2,067	2,354	2,633	2,900
HSBC net profit	1,873	2,106	2,410	2,700

### Cash flow summary (CNYm)

Cash flow from operations	539	2,615	2,674	3,160
Capex	-1,085	-700	-600	-600
Cash flow from investment	-1,088	-655	-549	-540
Dividends	-1,105	-878	-982	-1,081
Change in net debt	4,092	-871	-1,184	-1,567
FCF equity	372	1,646	2,160	2,637

### Balance sheet summary (CNYm)

Intangible fixed assets	103	99	95	91
Tangible fixed assets	4,970	5,290	5,472	5,572
Current assets	8,038	9,404	11,017	12,827
Cash & others	1,428	2,252	3,436	5,003
Total assets	13,111	14,793	16,584	18,490
Operating liabilities	1,218	1,682	1,781	1,840
Gross debt	2,911	2,865	2,865	2,865
Net debt	1,483	612	-571	-2,139
Shareholders funds	11,796	13,045	14,736	16,582
Invested capital	10,465	10,859	11,367	11,647

### Ratio, growth and per share analysis

Year to	12/2014a	12/2015e	12/2016e	12/2017e
<b>Y-o-y % change</b>				
Revenue	10.8	11.5	9.5	8.2
EBITDA	15.9	11.9	10.7	10.6
Operating profit	17.2	12.4	11.5	10.1
PBT	15.6	13.9	11.5	10.1
HSBC EPS	12.7	9.0	14.4	12.0

### Ratios (%)

Revenue/IC (x)	1.2	1.2	1.2	1.3
ROIC	23.2	22.2	23.8	25.3
ROE	16.9	17.0	17.4	17.2
ROA	17.2	17.0	16.9	16.6
EBITDA margin	27.2	27.3	27.6	28.2
Operating profit margin	23.3	23.5	23.9	24.3
EBITDA/net interest (x)	65.3	237.0	262.4	290.1
Net debt/equity	12.6	4.7	-3.9	-12.9
Net debt/EBITDA (x)	0.5	0.2	-0.2	-0.5
CF from operations/net debt	36.3	426.9		

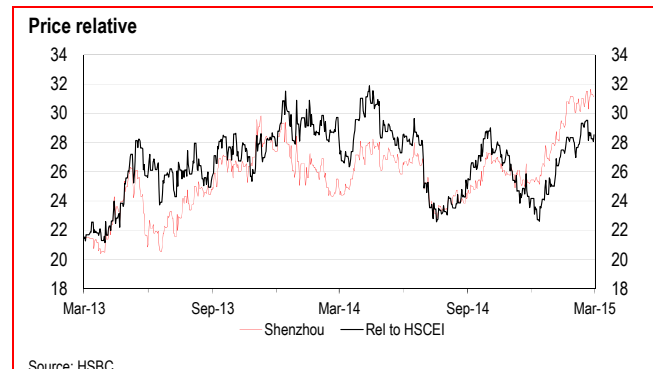
### Per share data (CNY)

EPS reported (fully diluted)	1.42	1.57	1.76	1.93
HSBC EPS (fully diluted)	1.29	1.40	1.61	1.80
DPS	0.79	0.63	0.70	0.77
Book value	8.43	9.32	10.53	11.85

### Valuation data

Year to	12/2014a	12/2015e	12/2016e	12/2017e
EV/sales	3.4	2.9	2.6	2.3
EV/EBITDA	12.3	10.7	9.4	8.1
EV/IC	3.6	3.4	3.1	2.9
PE*	19.9	18.2	15.9	14.2
P/Book value	3.0	2.7	2.4	2.2
FCF yield (%)	1.0	4.6	6.0	7.4
Dividend yield (%)	3.1	2.5	2.7	3.0

Note: \* = Based on HSBC EPS (fully diluted)



Note: price at close of 25 Mar 2015

## Valuation and risks

We use a DCF methodology to value Shenzhou as we think it is the best way to capture the incremental future free cash flow from the group's investments in Vietnam and other potential capacity expansion. We set a fair value target price of HKD34.0 (HKD30.0 previously) on higher earnings estimates and a higher terminal growth assumption. We raise our 2015-16e earnings by 10% and 7%, respectively, on better gross margin from higher efficiency and operating leverage.

Our DCF-based fair value target price of HKD34.0 is based on a WACC of 8.0% (7.8% previously) (using a risk-free rate of 3.5%, equity risk premium of 5.5% (6.0% previously) and beta of 1.0x and a terminal growth rate of 0.5% (0.0% previously)). We change our ERP to be consistent with our strategists' estimates but raise our WACC to reflect a lower percentage of debt in the group's capital structure. We also raise our terminal growth rate; we think the high efficiency and product technicality/innovation are key competitive advantages for the group and as such, should allow for production share gain from key brand customers. The DCF valuation implies a 2015e PE of 19.1x.

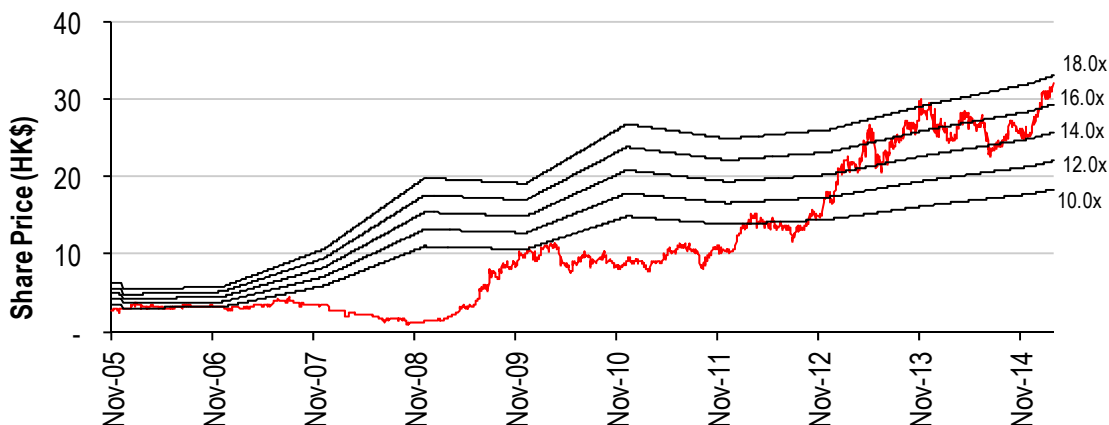
Key downside risks include slower-than-expected demand in volume or the sudden departure of key customers, a significant increase in raw material prices negatively affecting gross margin, and ramp-up delays or higher-than-expected start-up costs associated with the new Vietnam production.

**Shenzhou – New estimates vs old vs consensus, 2015-16e**

lin RMBm	2015e				2016e					
	HSBC Old	New	Cons	Diff'ce vs. old	Diff'ce vs. cons	HSBC Old	New	Cons	Diff'ce vs. old	Diff'ce vs. cons
<b>Revenue</b>	11,817	12,415	12,240	5.1%	1.4%	12,987	13,598	14,017	4.7%	-3.0%
<b>EBIT</b>	2,637	2,912	2,676	10.4%	8.8%	3,032	3,246	3,111	7.1%	4.4%
EBIT margin	22.3%	23.5%	21.9%	1.1ppt	1.6ppt	23.3%	23.9%	22.2%	0.5ppt	1.7ppt
<b>Net profit</b>	1,923	2,106	2,273	9.5%	-7.3%	2,270	2,410	2,633	6.2%	-8.5%
Net profit margin	16.3%	17.0%	18.6%	0.7ppt	-1.6ppt	17.5%	17.7%	18.8%	0.2ppt	-1.1ppt

Source: Bloomberg, HSBC estimates

**Shenzhou - 12-month forward PE band chart, Nov'05 to date**



Source: Thomson Reuters Datastream, HSBC

# Disclosure appendix

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### **From 23rd March 2015 HSBC has assigned ratings on the following basis:**

The target price is based on the analyst's assessment of the stock's actual current value, although we expect it to take six to 12 months for the market price to reflect this. When the target price is more than 20% above the current share price, the stock will be classified as a Buy; when it is between 5% and 20% above the current share price, the stock may be classified as a Buy or a Hold; when it is between 5% below and 5% above the current share price, the stock will be classified as a Hold; when it is between 5% and 20% below the current share price, the stock may be classified as a Hold or a Reduce; and when it is more than 20% below the current share price, the stock will be classified as a Reduce.

Our ratings are re-calibrated against these bands at the time of any 'material change' (initiation or resumption of coverage, change in target price or estimates).

Upside/Downside is the percentage difference between the target price and the share price.

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## Rating distribution for long-term investment opportunities

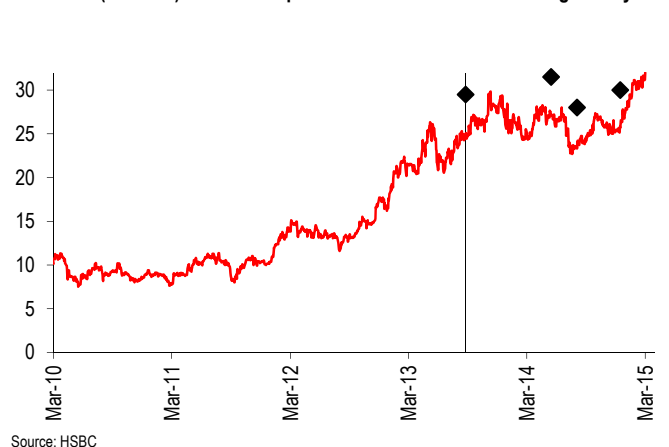
**As of 25 March 2015, the distribution of all ratings published is as follows:**

<b>Buy</b>	41%	(30% of these provided with Investment Banking Services)
<b>Hold</b>	39%	(28% of these provided with Investment Banking Services)
<b>Sell</b>	20%	(20% of these provided with Investment Banking Services)

For the purposes of the distribution above the following mapping structure is used during the transition from the previous to current rating models: under our previous model, Overweight = Buy, Neutral = Hold and Underweight = Sell; under our current model Buy = Buy, Hold = Hold and Reduce = Sell. For rating definitions under both models, please see “Stock ratings and basis for financial analysis” above.

## Share price and rating changes for long-term investment opportunities

Shenzhou (2313.HK) Share Price performance HKD Vs HSBC rating history



Recommendation & price target history

From	To	Date
N/A	Overweight	17 September 2013
Target Price	Value	Date
Price 1	29.50	17 September 2013
Price 2	31.50	08 June 2014
Price 3	28.00	27 August 2014
Price 4	30.00	07 January 2015

Source: HSBC

## HSBC & Analyst disclosures

### Disclosure checklist

Company	Ticker	Recent price	Price Date	Disclosure
SHENZHOU	2313.HK	32.00	25-Mar-2015	1, 5, 6, 7

Source: HSBC

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