COMPANY NOTE

Company Update

China | Conglomerates |

9 June 2015

Jefferies

EQUITY RESEARCH CHINA

China Merchants Hldgs Intl. (144 HK)
Solid Effort in Optimizing its Asset Portfolio

BUY
Price target HK$43.00
Price HK$31.15

Bloomberg: 144 HK
Reuters: 144.HK

Key Takeaway

We gain more insights in CMHI's latest plan to consolidate west Shenzhen port assets and expect positive synergies at the expense of a moderate earnings dilution. We also reiterate our positive view on the stock, as we believe CMHI's higher earnings growth potential from overseas acquisitions will begin to materialize and is not yet in the price.

In the process of merging west Shenzhen port assets. CMHI's Chairman, Li Jianhong, has recently revealed his plan to merge its west Shenzhen port assets by injecting Shekou port into Chiwan Wharf (000022 CH). West Shenzhen port in total accounted for 30% CMHI's core earnings in 2014.

Expect positive synergies. Before the merger, Shekou and Chiwan both were CMHI's subsidiaries, but those two ports operate separately. We expect positive synergies from the merger, including lower unit overhead and higher facility utilization. Management also expects higher bargaining power against the government, which should lead to improving efficiency of customs clearance (lower inspection rate, etc) to match that of Yantian port, so that its port tarriffs could catch up with that of Yantian (current tariff of west Shenzhen port is about 30% lower than Yantian). The detailed transaction analysis on Page 2&3.

Overseas acquisitions continue to move forward, reiterate our positive view. Chairman also revealed CMHI's plan to invest in Port of Klaipeda, a fast growing brownfield port on the Baltic Sea with 450K TEU annual throughput. Our recent company update also confirmed a solid pipeline for other overseas projects. We believe current midcycle valuation of 17x PE (fully diluted) has not yet reflected CMHI's potential to pursue inorganic earnings growth, not to mention Qianhai land. Reiterate Buy and price target of HK$43.

Valuation/Risks

Our 12M PT of HK$43 is derived from SOTP valuation. Key downside risks are a sudden slowdown in global trade and unfavorable progress in unlocking Qianhai's land value.

HKD	Prev.	2013A	Prev.	2014A	Prev.	2015E	Prev.	2016E
Rev. (MM)	--	7,758.0	--	8,257.0	--	9,120.0	--	9,918.0
Operating Profit	--	2,990.0	--	2,591.0	--	3,208.0	--	3,552.0
Core Earnings (MM)	--	4,008	--	4,849	--	5,504	--	6,057
Chg (% YoY)	--	18.8%	--	21.0%	--	13.5%	--	10.0%
P/B		1.6x		1.5x		1.4x		1.3x
BV/Share	--	19.30	--	20.35	--	22.13	--	23.59
Div. Yield		2.47%		2.47%		1.77%		2.47%
Dividend	--	0.77	--	0.77	--	0.55	--	0.77
EPS								
FY Dec	--	1.67	--	1.59	--	1.79	--	1.97
FY P/E		18.7x		19.6x		17.4x		15.8x

EPS forecast for 2015-16 are based on diluted share count due to Mandatory Convertible Securities.

Financial Summary

Book Value (MM):	HK$67,430.0
Book Value/Share:	HK$20.35
Net Debt (MM):	HK$9,150.0
Return on Avg. Equity:	7.8%
Net Debt/Capital:	13.6%
Long-Term Debt (MM):	HK$13,296.0
LTD/Cap:	19.7%
Cash & ST Invest. (MM):	HK$9,501.0

Market Data

52 Week Range:	HK$37.00 - HK$22.85
Total Entprs. Value (MM):	HK$85,342.9
Market Cap. (MM):	HK$76,192.9
Shares Out. (MM):	2,446.0
Float (MM):	1,193.1
Avg. Daily Vol.:	6,242,350

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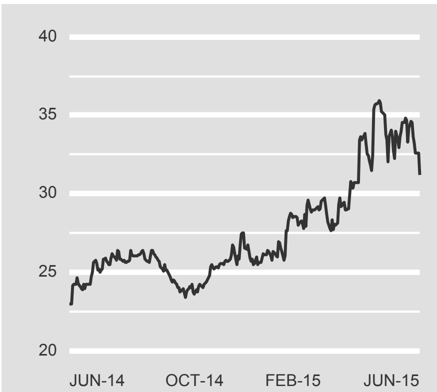
Price Performance



CMHI plans to merge west Shenzhen port assets

CMHI's Chairman, Mr. Li Jianhong, has revealed his plan to merge its west Shenzhen port assets during AGM. (Source: Aastock). This will be done by injecting Shekou port into listed Chiwan Wharf (000022 CH). Both are subsidiaries of CMHI.

5 years of consolidation came to an end

CMHI has steadily pushed forward the consolidation of west Shenzhen port assets since 2010. Previously, CMHI only directly operated Shekou port, of which it held an 80% stake. Another major player in west Shenzhen port, Chiwan Wharf (000022 CH), is a separate port operator, owned by Shenzhen Nanshan Group. CMHI own 37% of Nanshan Group, but does not have sufficient influence on Chiwan's operation. Shekou and Chiwan have their separate commercial development teams, clients and management teams.

In 2011, CMHI began to consolidate Nanshan including its port business (Chiwan Wharf), following entrusted 20% voting right of Nanshan from Guangzhou Guangye. In 2012, CMHI acquired 25% share of Chiwan Wharf from Nanshan, and turned it into a subsidiary. CMHI's last step is to inject all of its west Shenzhen port assets into Chiwan, and use it as the vehicle to control all west Shenzhen port assets. We expect CMHI will also buy the remaining minority stake in Shekou from MTL, and minority stake of Chiwan Container Terminal from Kerry Logistics.

Expect positive synergies

West Shenzhen port in total accounted for 30% of CMHI's core earnings in 2014, and it's the main "bread and butter" market for CMHI. However, in the past, the tariff rate for west Shenzhen port is 30% lower than east Shenzhen port, a.k.a. Yantian port, due to 1) poor waterway to the ports, 2) higher competition due to multiple operators in the area, and 3) relatively inconvenient custom clearance compared to Yantian.

The main objective for the merger is to tackle all three issues. Being the only operator in west Shenzhen port post the merger, CMHI can improve its bargaining power against the government in the respect of easing custom inspection procedures and improving the port supportive infrastructure, such as dredging the water to west Shenzhen port to accommodate larger vessels. By merging these two, which were run by separate management teams, CMHI can also remove the competition between the two ports, thus enhance the utilization of handling facilities as both ports can now share their spare capacity, i.e. berth, stack yard, etc, during peak period. Therefore, we expect CMHI should start to see positive synergies 12-24 months post the merger, driven by cost savings and improving pricing powers.

Scenario analysis suggests limited earnings dilution

In the near term, we expect small earnings dilution in light of the deal structure. We expect Shekou port will likely to be injected to Chiwan at 15x PE, in exchange of some new Chiwan shares (30x PE). For Chiwan (000022 CH) the benefit is more obvious, given that it issues shares at higher valuation to buy lower valued assets. For CMHI, our scenario analysis showed that its entitled earnings in west Shenzhen port could be changed from +5% to -16% immediately after the deal, which accounted for 2% to -5% of 2014 core earnings for the whole company.

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Table 1: Our base case assumes CMHI injects 100% stake of Shekou and Mawan at 15x PE, after acquiring remaining Shekou stake from MTL (no earnings dilution)

HK$mn	Equity stakes		2014 earnings attributable to CMHI	
	Before	After	Before	After
Shekou & Mawan	80%	73%	1,194	1,051
Chiwan	46%	73%	239	381
Total W. Shenzhen			1,433	1,432

Source: Jefferies estimates

Table 2: Bear case assumes CMHI inject its own 80% stake of Shekou and 70% Mawan at 15x PE (16% dilution to earnings of W. Shenzhen)

HK$mn	Equity stakes		2014 earnings attributable to CMHI	
	Before	After	Before	After
Shekou & Mawan	80%	70%	1,194	836
Chiwan	46%	70%	239	365
Total W. Shenzhen			1,433	1,202

Source: Jefferies estimates

Table 3: Bull case base case assumes CMHI injects 100% stake of Shekou and Mawan at 20x PE, after acquiring remaining Shekou stake from MTL (5% earnings accretion)

HK$mn	Equity stakes		2014 earnings attributable to CMHI	
	Before	After	Before	After
Shekou & Mawan	80%	77%	1,194	1,108
Chiwan	46%	77%	239	402
Total W. Shenzhen			1,433	1,510

Source: Jefferies estimates

Leveraging Qianhai land to gain favorable terms

Management indicated that they are deliberately slowing the negotiation process of Qianhai land with the government, in order to gain more benefits for their port operation in west Shenzhen areas. We expect those terms to include 1) gaining another piece of land near Dachan Bay area, 2) more government investment in expanding the waterway to west Shenzhen port, 3) taking over other port related assets owned by the government, 4) further easing the customs inspection process in west Shenzhen port to match that of Yantian, and 5) proper monetary compensation. Management believes those attached conditions will maximize the benefits from its Qianhai land compared to directly cash out the whole landbank to the government.

Overseas acquisitions steadily progressing forward

Our positive thesis on CMHI is mainly on its potential to grow inorganically supported by substantial cash on hand. We believe such earnings growth potential has yet to be reflected in current valuation. Over the past 2 years, CMHI has shown a solid record in overseas investment, with average ROIC (before tax) at 8%. We believe that large scale overseas M&As will be the key driver for its share price in the upcoming 12 months.

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Table 4: Overseas investment are all value accretive

Overseas project	Nature of project	EBIT (2014) (HK$mn)	Total Investment (HK$mn)	2014 ROIC	Guided project IRR (unlevered)
Nigeria TICT	Brownfield	240	1,194	20%	15%
Djibouti	Brownfield	176	1,434	12%	>12%
Terminal Link	Brownfield	385	3,875	10%	7.5%
Togo Lome	Greenfield	-80	2,325	-3%	12%
Colombo	Greenfield	0	3,875	0	11%

Source: Jefferies, company data
Note: for 2 green field project, we expect Colombo to generate HK$100mn net income in 2015, and Togo Lome to reach monthly breakeven by end of 2015.

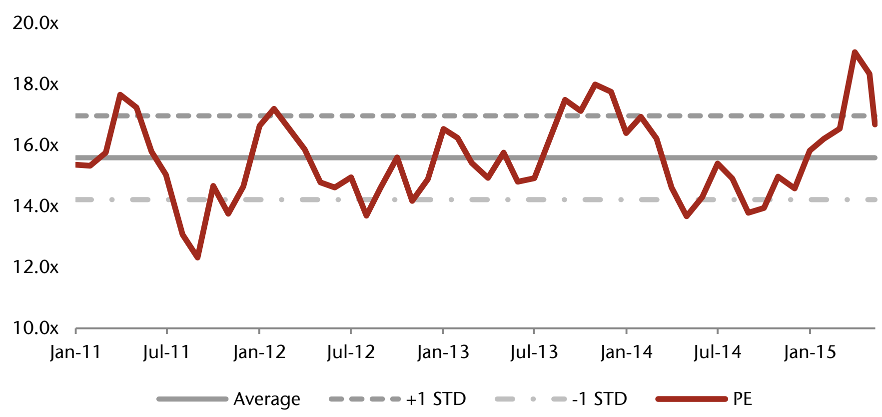
Recently, Chairman Li Jianhong also revealed to the public (Source: JOC) that CMHI is in discussions to invest in Port of Klaipeda in Lithuania, the largest container port in Baltic seas, with 450K TEU container throughput in 2014, and the gateway for China-Europe rail (part of one belt one road). CMHI also plans to take a minority stake of China Berlarus Industrial Park nearby, which could also help to feed up the volume at Klaipeda.

Separately, CMHI is also in discussion with Colombo port authority over the development of East Container Terminal to prepare for next phase expansion of current Colombo projects. Our recent update with management also confirmed a solid pipeline for other overseas projects.

Reiterate Buy with recent share price pull back

CMHI's share price has pulled back 13% from the recent peak in April, underperforming HSI (-5%), due to weak readings of China's export as well as weaker performance of red chip stocks in general. The share is currently trading at 17x 2015 PE (diluted), compared to its historical average of 16x since 2011, which we believe is not yet reflected its potential inorganic growth or value from Qianhai land, in our view. We reiterate our positive view on the stock.

Chart 1: CMHI - Valuation Range since 2011



Source: Jefferies estimates, company data, Bloomberg

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Table 5: Financial Summary

Profit & Loss				
HK$ mn	**2013**	**2014**	**2015E**	**2016E**
Revenues	7,758	8,257	9,120	9,918
Gross Profit	3,236	3,520	4,150	4,593
Depreciation	(1,224)	(1,687)	(1,747)	(1,807)
EBIT	2,990	2,591	3,208	3,552
Interest expense	(1,018)	(859)	(590)	(614)
Associates & JCEs	3,809	4,437	4,494	4,888
Exceptional gain	205	323	0	0
PBT	5,781	6,169	7,112	7,826
Tax	(842)	(1,151)	(1,067)	(1,174)
Minorities	(726)	(492)	(541)	(595)
Net profit (Reported)	4,213	4,526	5,504	6,057
Net profit (Core)	4,008	4,849	5,504	6,057
EPS (basic)	1.67	1.77	2.15	2.36
EPS (diluted)	1.67	1.59	1.79	1.97

Cash flow statement				
HK$ mn	**2013**	**2014**	**2015E**	**2016E**
Operating profit	2,990	2,591	3,208	3,552
Depr & amortization	1,224	1,687	1,747	1,807
Change in working cap.	(175)	445	(383)	(419)
Others	1,157	1,157	899	904
CF from operations	5,196	5,880	5,471	5,844
Capex	(3,485)	(3,644)	(4,000)	(4,000)
Disposal/ (purchase)	108	0	0	0
Investments	(5,436)	0	0	0
Free cash flow	1,711	2,236	1,471	1,844
Equity raised/ (repaid)	64	15,292	0	0
Debt raised/ (repaid)	7,781	(4,588)	(3,823)	0
Dividends paid	(1,005)	(1,971)	(932)	(2,337)
Others	(3,923)	665	(1,112)	(1,136)
Ending cash	3,205	13,114	8,922	7,382

Balance sheet				
HK$ mn	**2013**	**2014**	**2015E**	**2016E**
Cash	3,205	9,501	5,309	3,770
Receivables	1,627	3,693	4,062	4,469
Inventories	94	108	119	130
Net fixed assets	19,034	19,982	22,815	26,116
LT investments	41,942	44,139	47,041	50,197
Other long-term assets	22,413	24,430	24,430	24,430
Total assets	89,191	102,436	104,359	109,694
ST loans	2,339	5,357	5,357	5,357
Payables	2,204	4,412	4,410	4,408
Total current liabilities	4,752	10,365	11,581	13,223
Long term debt	24,541	13,296	9,473	9,473
Total liabilities	32,765	27,290	24,683	26,325
Shareholders' equity	48,599	67,430	72,014	75,733
Minorities	7,827	7,716	7,737	7,813
Total Liabilities and Equity	89,191	102,436	104,359	109,694

Ratio Analysis				
%	**2013**	**2014**	**2015E**	**2016E**
Gross margin	41.7	42.6	45.5	46.3
EBIT margin	38.5	31.4	35.2	35.8
Net profit margin	54.3	54.8	60.4	61.1
Revenue growth	(29.6)	6.4	10.5	8.7
EBIT growth	(13.9)	(13.3)	23.8	10.7
Net profit growth	10.3	7.4	21.6	10.0
Core growth	18.8	21.0	13.5	10.0
BVPS	19.3	20.4	22.1	23.6
Interest coverage (x)	2.9	3.0	5.4	5.8
Net debt to total capital	28.4	9.8	10.1	11.2
Net debt to equity	42.0	12.2	11.9	13.2
ROE	9.0	7.8	7.9	8.2
ROA	4.8	4.4	5.3	5.7

Source: Jefferies estimates, company data

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Company Description

China Merchants Holdings International Company Limited, through its subsidiaries and associated companies, operates container and cargo terminals, port transportation, and airport cargo handling. The company also manufactures containers through its associates.

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Other Companies Mentioned in This Report

- China Merchants Hldgs Intl. (144 HK: HK$31.15, BUY)
- Shenzhen Chiwan Wharf Hldg - A (000022 CH: NA, HOLD)

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