Company Report: Shenzhou International (02313 HK)

公司报告：申洲国际 (02313 HK)

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The Largest Vertically Integrated Knitwear Manufacturer in China, Initiate with "Buy"

中国最大的垂直整合针织服装制造商，首次给予“买入”评级

- **Shenzhou International is the largest knitwear manufacturer in China.** Shenzhou adopts a vertically integrated business model, including the design and production of fabrics (for self use only) and garment products (sold to clients). Currently Shenzhou has production facilities in China, Vietnam and Cambodia, therefore the US-Sino trade war has had limited impact on Shenzhou. Customer structure is stable with the top four clients (Nike, Adidas, Uniqlo and Puma) combined contributing around 80% of total revenue.

- **We forecast 2018-2020 basic EPS to be RMB3.096, RMB3.729 and RMB4.443, respectively (CAGR of 21.1%).** 1H18 revenue slightly missed but bottom line met expectations. Shenzhou's revenue is expected to grow at a CAGR of 16.0% during 2017-2020, driven by expansion of production capacity (2017-2020 CAGR of 13.6% in knitwear output) and increasing orders from clients. We forecast improving net margin in 2018-2020 driven by expected higher GPM, lower financial costs and lower effective tax rates.

- **Initiate with "Buy" and TP of HK$110.00.** Shenzhou has relatively high profitability due to its vertically integrated business model and its strong R&D ability. We expect Shenzhou to maintain strong growth momentum over the next few years. Our TP represents 31.3x, 26.0x and 21.8x 2018, 2019 and 2020 PER, respectively. **Risks:** 1) lower growth in global textile & apparel industry, 2) peer competition, 3) changing government policies, 4) increase in raw material prices and 5) unexpected fluctuations in exchange rates.

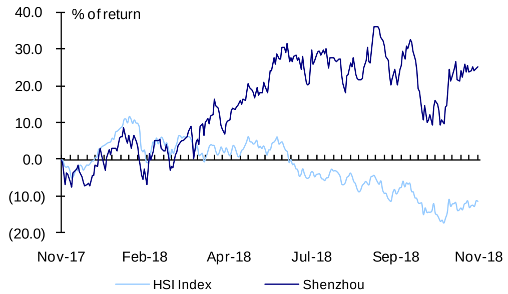
- **申洲国际是中国最大的针织服装制造商。**申洲采用了垂直整合的业务模式，包括设计和生产面料（仅供自用）及成衣产品（销售给客户）。目前公司在中国、越南和柬埔寨都拥有生产设施，因此中美贸易战对申洲影响有限。公司客户结构稳定，前四大客户（耐克、阿迪达斯、优衣库和彪马）合计约占总收入的 80%。

- **我们预测 2018-2020 年每股盈利分别为 3.096 人民币、3.729 人民币和 4.443 人民币（21.1%的年复合增长率）。**2018 年上半年收入略低预期但净利润符合预期。预期公司收入将在 2017-2020 年保持 16.0%的年复合增长率，主要由产能扩张（2017-2020 年针织品产能有 13.6%的年复合增长率）及客户订单增长所带动。我们预测 2018-2020 年净利率将持续改善，主要由预期更高的毛利率、更低的财务费用和更低的有效税率所带动。

- **首次给予“买入”评级以及 110.00 港元的目标价。**由于采用垂直整合的业务模式并且研发能力强，申洲拥有相对较高的盈利能力。我们预期申洲在接下来几年中将维持其强劲增长动能。我们的目标价分别相当于 31.3 倍、26.0 倍和 21.8 倍 2018 年、2019 年和 2020 年市盈率。**风险：**1) 全球纺织服装行业增速降低；2) 同业竞争；3) 政府政策变动；4) 原材料价格上涨；5) 汇率波动超出预期。

Rating:	**Buy** Initial
评级：	**买入** (首次覆盖)
6-18m TP目标价:	**HK$110.00**
Share price 股价:	HK$95.350

Stock performance
股价表现



Change in Share Price 股价变动	1 M 1 个月	3 M 3 个月	1 Y 1 年
Abs. % 绝对变动 %	13.6	(7.4)	27.1
Rel. % to HS Index 相对恒指变动 %	6.1	(1.3)	37.1
Avg. Share price(HK$) 平均股价（港元）	92.4	92.9	87.1

Source: Bloomberg, Guotai Junan International.

Year End 年结 12/31	Turnover 收入 (RMB m)	Net Profit 股东净利 (RMB m)	EPS 每股净利 (RMB)	EPS 每股净利变动 (△ %)	PER 市盈率 (x)	BPS 每股净资产 (RMB)	PBR 市净率 (x)	DPS 每股股息 (RMB)	Yield 股息率 (%)	ROE 净资产收益率 (%)
2016A	15,099	2,948	2.107	25.2	40.5	10.788	7.9	1.075	1.3	20.9
2017A	18,085	3,763	2.584	22.6	30.7	13.053	6.1	1.207	1.5	21.7
2018F	20,895	4,653	3.096	19.8	27.1	14.805	5.7	1.672	2.0	22.2
2019F	24,354	5,606	3.729	20.5	22.5	16.642	5.0	1.980	2.4	23.7
2020F	28,215	6,679	4.443	19.1	18.9	18.929	4.4	2.376	2.8	25.0

Shares in issue (m) 总股数 (m)	1,503.2	Major shareholder 大股东	Keep Glory Limited 46.6%
Market cap. (HK$ m) 市值 (HK$ m)	143,330.1	Free float (%) 自由流通比率(%)	48.1
3 month average vol. 3 个月平均成交股数('000)	3,592.9	FY18 Net gearing (%) FY18 净负债/股东资金 (%)	Net Cash
52 Weeks high/low (HK$) 52 周高/低 (HK$)	105.000 / 69.250	FY18 Est. NAV (HK$) FY18 每股估值（港元）	132.2

Source: the Company, Guotai Junan International.

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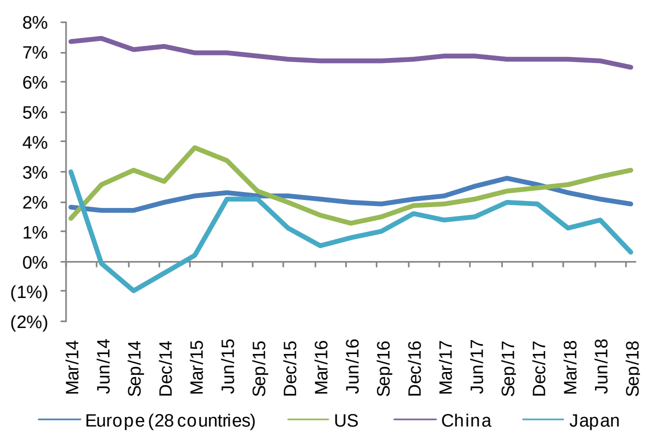
INDUSTRY ANALYSIS

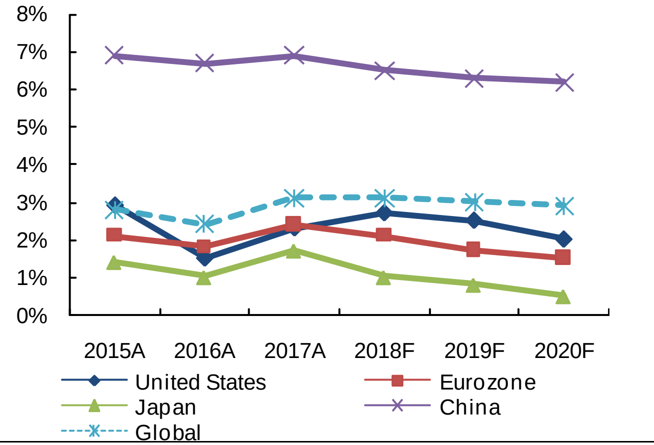
The economic environment in major countries and regions remained healthy in 1H18 but turned weak in 3Q18. The GDP of Europe (28 countries) in 3Q18 increased by 1.9% YoY, lower than the YoY growth rate of 2.1% in 1Q18 and 2.3% in 2Q18. GDP growth of Japan in 3Q18 was 0.3% YoY, which was also weaker than the first two quarters of 2018, mainly due to weak domestic consumption demand. However, the US economy remained very strong in 3Q18 with GPD growth reaching 3.0% YoY, the highest in the past 3 years. China maintained a much higher GDP growth rate than most other countries at 6.5% in 3Q18, slightly down from the YoY growth rate of 6.8% in 1H18. According to the World Bank, GDP of the Eurozone and US in 2019 is expected to grow YoY by 1.7% and 2.5%, respectively. The GDP of Japan is expected to grow by 1.0% YoY in 2018, and gradually slow down to 0.8% YoY and 0.5% YoY in 2019 and 2020, respectively, since consumption tax rate in Japan will be raised to 10% in October 2019. GDP of China during 2018-2020 is expected to grow YoY by 6.5%, 6.3% and 6.2%, respectively.

Figure-1: Quarterly Real GDP Growth in Major Countries & Regions (YoY)



Source: Eurostat, U.S. Bureau of Economic Analysis, National Bureau of Statistics of China, Cabinet Office of Japan, Guotai Junan International.

Figure-2: Annual Real GDP Growth in Major Countries & Regions and Forecasts (YoY)

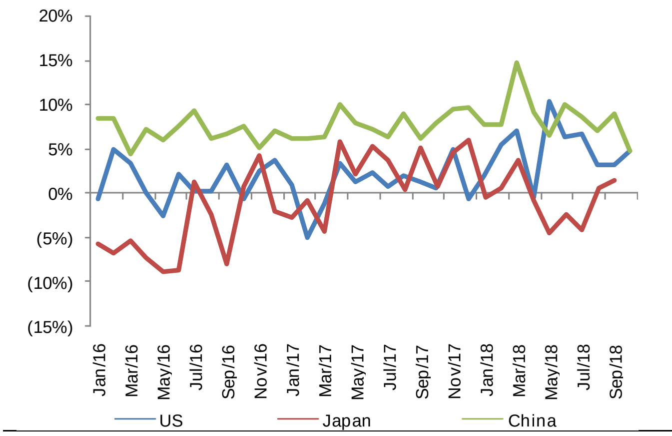


Source: World Bank, Guotai Junan International.

Retail sales of clothing and garments in major countries remained stable, with pockets of strong growth in 2018. According to the United States Department of Commerce, January to October 2018 accumulated retail sales of garment and accessories in the US recorded 5.0% YoY growth, which was much higher than the YoY growth rate of 0.9% for the full year of 2017, mainly due to recovery of the US economy. According to the Ministry of Economy, Trade and Industry of Japan, January to September 2018 accumulated retail sales of fabric, garments and accessories in Japan was slightly down 0.7% YoY due to weak domestic consumer sentiment and less tourists coming from China. According to the National Bureau of Statistics of China, January to October 2018 accumulated retail sales of garments, footwear, hats and knitwear in China grew by 8.4% YoY, which was higher than the YoY growth rate of 7.8% for the full year of 2017. The apparel industry in major countries remained healthy despite some slowdown, which increased uncertainty in the world economy, and is expected to remain positive growth during 2019 and 2020.

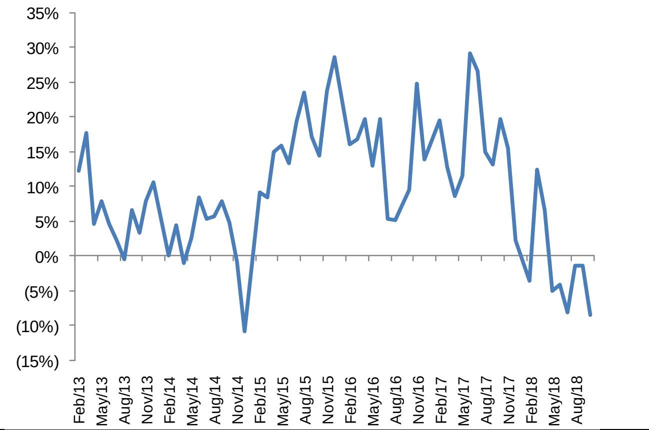
Sportswear sector in China underperformed in the first three quarters of 2018. Retail sales of sports and recreational articles in China grew at a CAGR of 16.8% during 2014-2017, while January to October 2018 accumulated retail sales dropped by 2.1% YoY, mainly due to relatively weak consumer sentiment and several months of extreme weather conditions in China this year. Sportswear sector in China may suffer from continued pressure over the next few months, but we still remain optimistic on this sector in the long run due to an increase in fitness awareness of Chinese people and supportive government policies.

Figure-3: Growth of Retail Sales of Clothing and Garments in Major Countries (YoY)



Source: United States Department of Commerce, Ministry of Economy, Trade and Industry of Japan, National Bureau of Statistics of China, Guotai Junan International.

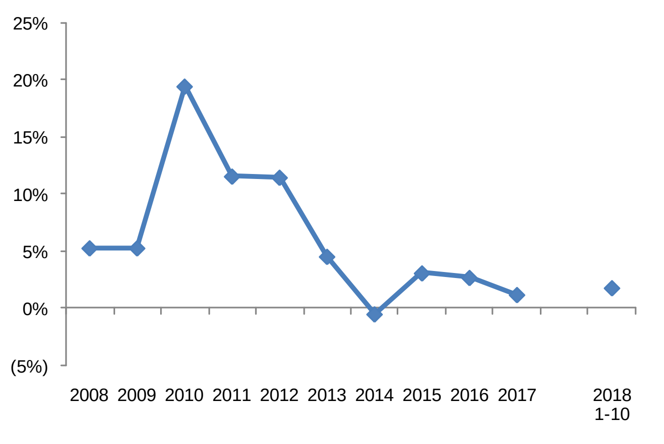
Figure-4: Growth of Retail Sales of Sports and Recreational Articles in China (YoY)



Source: National Bureau of Statistics of China, Guotai Junan International.

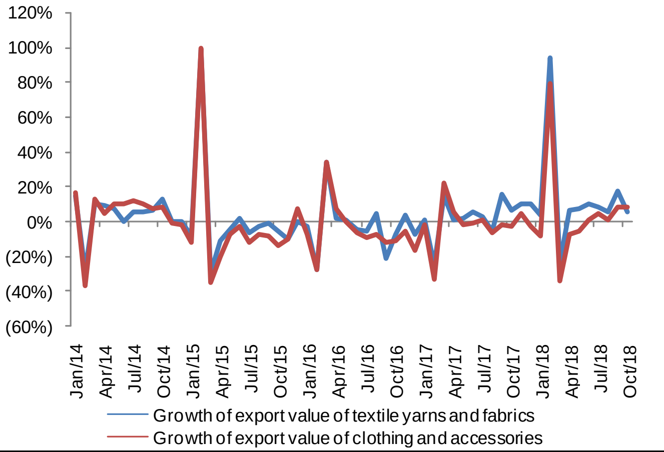
We expect the textile and garment industry in China to maintain stable growth during 2018-2020. The global textile and garment industry is going through a restructuring process. Due to increasing rental and labor costs and stricter environmental protection regulations, China has become less competitive in manufacturing textile and garment products. Therefore, low-end manufacturing has been transferring from China to Southeast Asian countries including Vietnam, Cambodia, Bangladesh, Indonesia, etc. According to the the National Bureau of Statistics of China, growth of fabrics production in China slowed down in the past few years, and January to October 2018 accumulated fabrics production grew by only 1.8% YoY. Whereas, those Southeast Asian countries are still weak in infrastructure and quality of labor. China, on the contrary, has already established a very complete and efficient industry chain, equipped with good infrastructure, advanced automation equipments and well-trained workers. Therefore, we believe that China will continue to be the most important manufacturing center for the global textile and apparel industry in the foreseeable future. Currently, China is still the largest exporter of textiles and garments, with total export value of textile and apparel products reaching around US$270 billion in 2017, far exceeding the export value of around US$170 billion in the European Union, which was the second largest. According to the General Administration of Customs of China, January to October 2018 accumulated export value of textile yarns and fabrics strongly increased by 9.9% YoY, while accumulated export value of clothing and accessories only grew by 1.2% YoY. The upstream category of the textile and apparel industry includes mainly raw materials including cotton, fiber, polyester chips, etc. Both domestic and foreign cotton price increased largely in 1H18 but has been dropping since due to ample inventory of both domestic and global cotton. As at 16 November 2018, the Cotlook A Index and the China Cotton 328 Index increased by 3.0% and -0.7%, respectively, since the beginning of 2018. Prices of other raw materials including fiber, MEG, PTA, polyesters, etc. increased significantly during August and September 2018 but have dropped back to normal, which relieved cost pressure on textile companies.

Figure-5: Accumulated Growth of Fabrics Production in China (YoY)



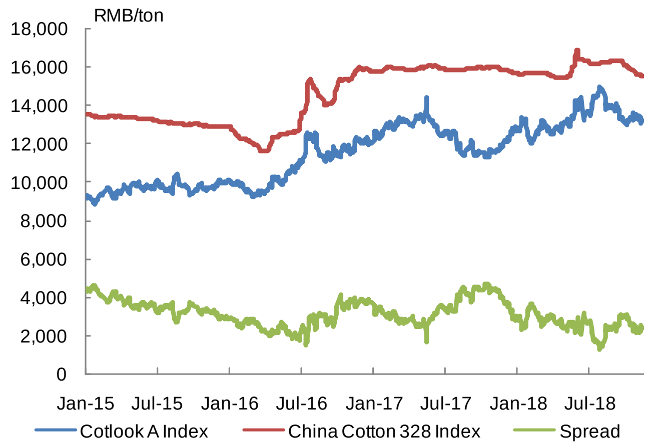
Source: National Bureau of Statistics of China, Guotai Junan International.

Figure-6: Growth of Export Value of Textile and Clothing in China (YoY)



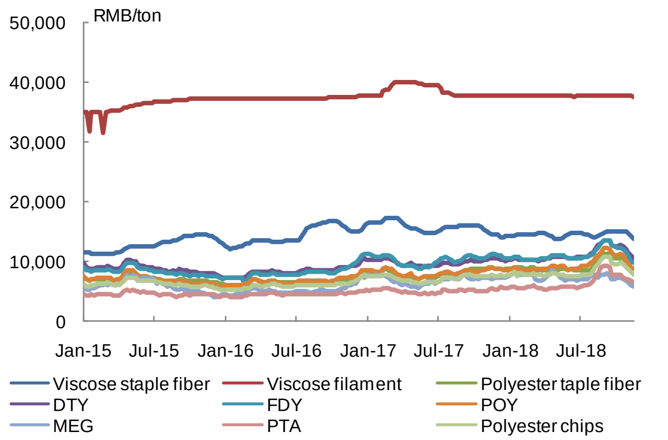
Source: General Administration of Customs of China, Guotai Junan International.

Figure-7: China Domestic and Foreign Cotton Price Indices



Source: www.cotlook.com, The China National Cotton Exchange, Guotai Junan International.

Figure-8: Market Prices of Major Raw Materials in Textile Industry in China



Source: www.sinotex.cn, Guotai Junan International.

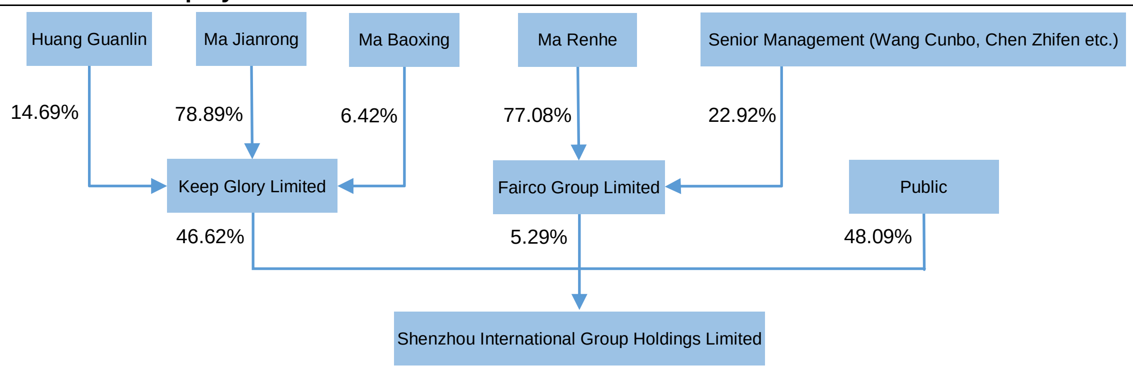
COMPANY ANALYSIS

Corporate Profile

Shenzhou International Group Holdings Limited ("Shenzhou" or "the Company") is the largest vertically integrated knitwear manufacturer in China. Shenzhou was founded in 1990 in China, and is principally engaged in the manufacturing of high-end knitwear on an OEM basis. The Company is also a knitwear garment manufacturing enterprise with the largest exporting amount of knitwear in China and ranked first among PRC garment exporting enterprises. The Company was listed on the Hong Kong Stock Exchange in November 2005 with the stock code of 02313 HK, and has been included in the Hang Seng Composite Index since 2010 and MSCI Index since 2013.

Concentrated and stable equity structure. The biggest shareholder of the Company is Mr. Ma Jianrong, who is the Company's chairman and Executive Director. Mr. Ma Jianrong is now holding 46.62% of Shenzhou's equity through Keep Glory Limited, a company also owned by Mr. Ma Baoxing (father of Mr. Ma Jianrong) and Mr. Huang Guanlin (brother-in-law of Mr. Ma Jianrong and CEO of Shenzhou), who are persons acting in concert with Mr. Ma Jianrong. Mr. Ma Renhe (cousin of Mr. Ma Jianrong) owns 5.29% of Shenzhou's equities through Fairco Group Limited, a company also owned by certain members of the senior management of the Company. The public shareholders held 48.09% of the Company's equities. The equity structure of Shenzhou is concentrated and stable, and the management team of the Company is stable and experienced in the textile and garment industry, which is conducive to the Company's long-term growth.

Figure-9: Shenzhou's Equity Structure

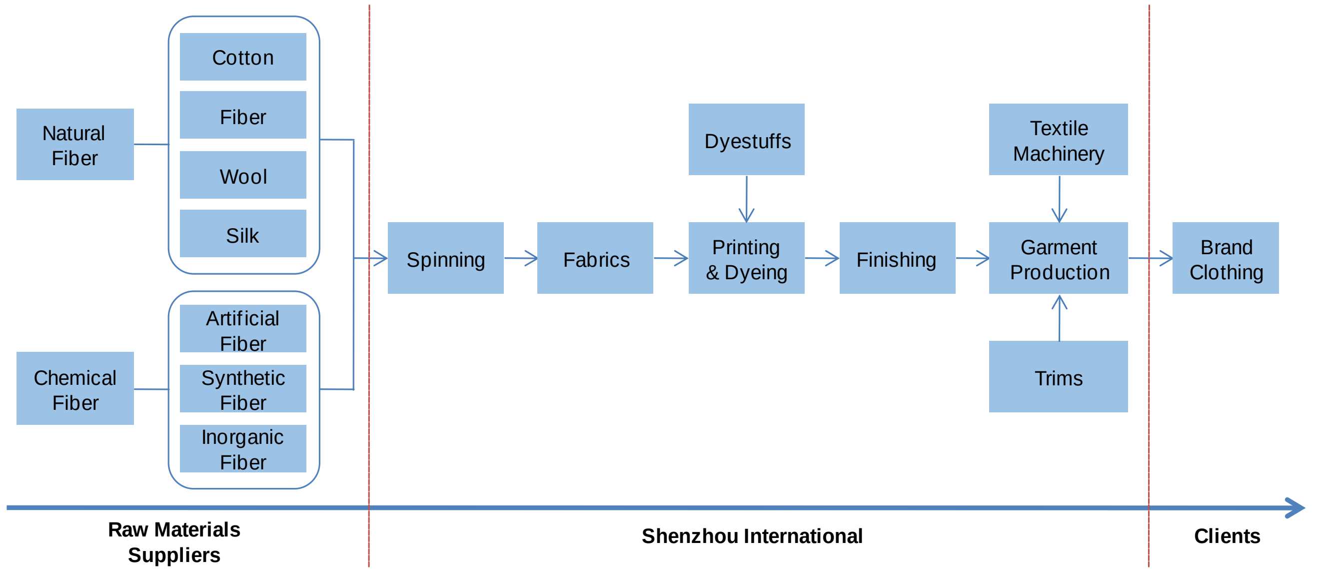


Source: the Company, Guotai Junan International.

Business Model

Shenzhou adopts a vertically integrated business model. The Company operates in the midstream (fabric production) and downstream (garment production) areas of the textile and garment industry chain. The fabric production procedure adopts an ODM model, which means that Shenzhou is able to conduct R&D and manufacturing by itself. The Company procures raw materials including cotton yarn, fiber, dyestuffs, trims, etc. from around 160 different suppliers, and then proceeds to the fabric manufacturing procedure including fabric weaving, dyeing and finishing, embroidering, and cutting and sewing. The fabrics manufactured by the Company are not sold, but will be entirely used for the Company's garment production. The garment production procedure adopts an OEM model, which means that Shenzhou does not own an apparel brand, but manufactures garment products according to client's requirements. The Company's garment products mainly include sportswear, casual wear and lingerie wear. By adopting the vertically integrated business model, the Company is able to effectively shorten production cycle and control production costs, which makes the Company the most competitive garment manufacturer in the industry.

Figure-10: Textile and Garment Industry Chain



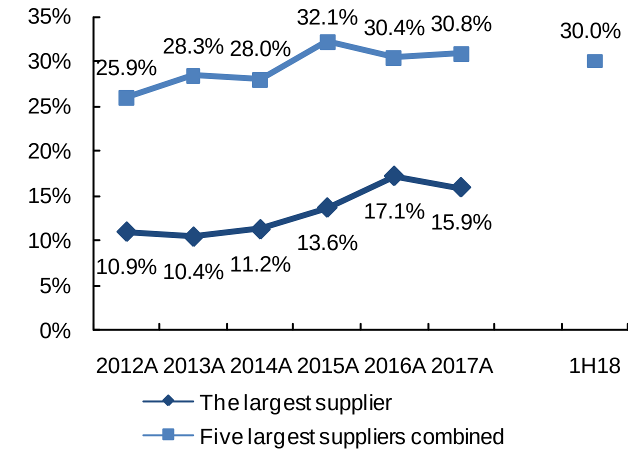
Source: Guotai Junan International.

Supply Chain Management

The Company procures raw materials from global suppliers. The materials procured mainly include cotton yarn, dyestuffs, trims, office supplies, fixed assets, equipment and spare parts, and canteen supplies. To ensure the efficiency of the procurement process, the Company formulates management documents such as "Procurement Control Procedures", which includes the criterion used for selecting suppliers. The Company had 160 raw material suppliers in 2017, among which 115 suppliers were located in China, accounting for 71.9% of the total number of suppliers, followed by Taiwan (6.3%), Korea (5.0%), Hong Kong (3.1%) and USA (2.5%). China will continue to be the largest supplier over the next few years. The five largest suppliers combined accounted for 30.0% of the Company's total procurement in 1H18, which was basically stable during the past three years.

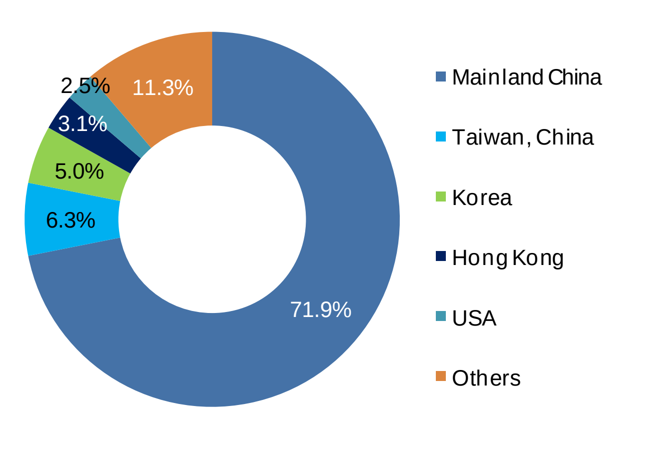
The Company's clients are mainly internationally and domestically renowned apparel and sportswear brands. The Company produces apparel products for international brands including Uniqlo, Adidas, Nike and Puma, and domestic brands in China including Anta, Li Ning and Xtep. The Company's sales to customers are highly concentrated, the five largest customers combined account for around 85% of the Company’s total over the past few years. The largest customer used to be Uniqlo, which has been replaced by Nike since 2014. Sales to Nike accounted for 29.1% of total sales in 2017, followed by Uniqlo (20.4%) and Adidas (20.0%).

Figure-11: Proportion of The Largest Supplier and Five Largest Suppliers Combined



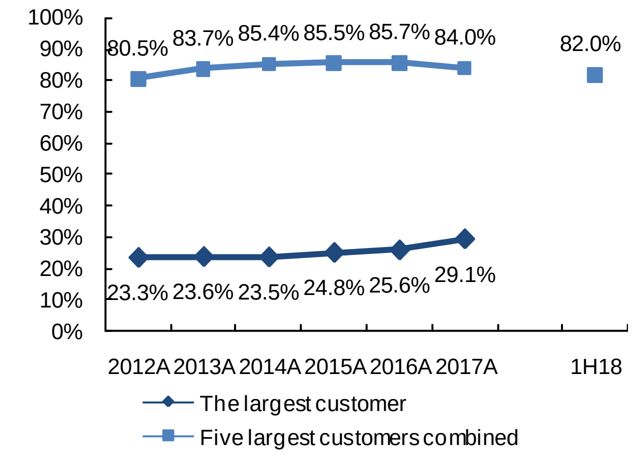
Source: the Company, Guotai Junan International.

Figure-12: Proportion of Purchases from Major Suppliers - by Region in 2017



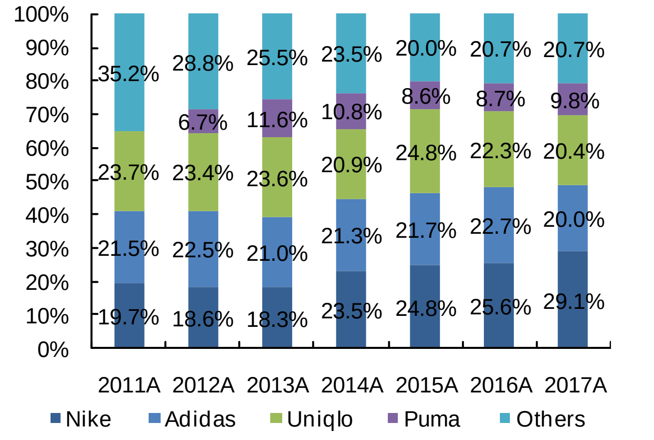
Source: the Company, Guotai Junan International.

Figure-13: Proportion of The Largest Customer and Five Largest Customers Combined



Source: the Company, Guotai Junan International.

Figure-14: Proportion of Sales to Major Clients



Source: the Company, Guotai Junan International.
Note: Puma was included in "Others" in 2011.

The Company mainly sells its products to Europe, Japan, USA and its own domestic market China. Shenzhou started its business in Japan and gradually established a good reputation with its first big client, Uniqlo. This reputation helped Shenzhou to gain huge sportswear clients like Nike and Adidas, and to expand its business to Europe and the US. In 2017, revenue from Europe, Japan and the US accounted for 22.3%, 17.3% and 12.9%, respectively, of total revenue. Mainland China has become the biggest market for the Company since 2015, mainly driven by the fast-growing sportswear industry in China. Revenue from mainland China accounted for 26.8% of total revenue in 2017.

Production Facilities and Operating Regions

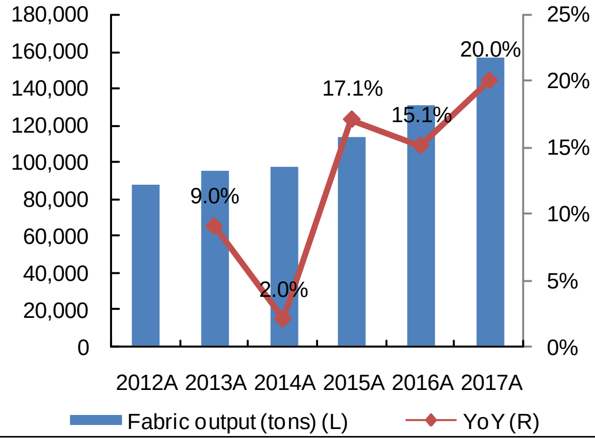
The Company has production facilities in China, Vietnam and Cambodia. The Company's production base in China is located in Ningbo Economic & Technical Development Zone. The Company established its first overseas garment factory in Cambodia in 2005, and continued to set up more garment factories in Quzhou and Anqing of China, Ho Chi Minh City of Vietnam and Phnom Penh of Cambodia. The Company also established sales offices or representative offices in Shanghai, Hong Kong and Osaka. As at 31 December 2017, the total area of the factories amounted to over 4,160,000 sq.m., which can produce over 350 million pieces of various kinds of knitwear every year. In 2017, the fabric output of the Company was 156,812 tons, representing an increase of 20.0% as compared to that of last year. The Group has over 77,100 employees globally as at 31 December 2017. On 17 September 2018, Shenzhou announced that it added new leased land in Cambodia with land area of 413,067 sq.m. for a leasing period of 50 years. The Company will also invest US$100 million to build a downstream garment production facility on that leased land to expand the Company's overall production capacity.

The US-Sino trade war has limited impact on Shenzhou. Currently, the Company's garment factories in Cambodia and Vietnam combined contributed around 25% of total garment output. Whereas, the Company's sales to the US only accounted for around 14% of total sales in 1H18, which means that demand from the US can be fully covered by the Company's factories in Cambodia and Vietnam, where tariffs are not impacted by the US-Sino trade war. In addition, the upstream fabrics needed by the factories in both Cambodia and Vietnam are completely sourced from the Company's fabric plant in Vietnam, and no imports from China are needed. Therefore, we don't expect Shenzhou to be seriously impacted by the US-Sino trade war.

Figure-15: Operating Regions of Shenzhou

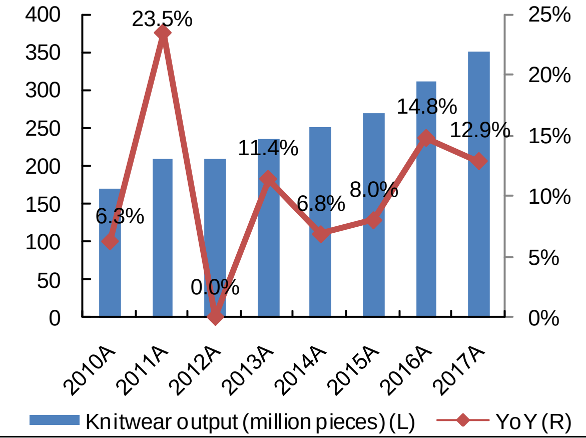
Source: the Company, Guotai Junan International.
Note: the orange color represents the production bases of Shenzhou in Ningbo; the pink color represents the sales offices of Shenzhou; the purple color represents the production bases located outside Ningbo.

Figure-16: Shenzhou's Fabric Output



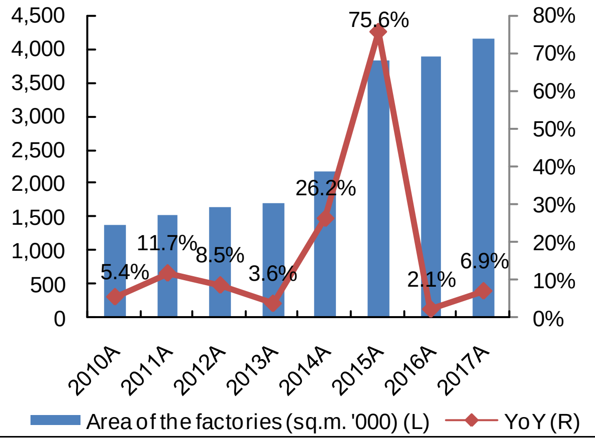
Source: the Company, Guotai Junan International.

Figure-17: Shenzhou's Knitwear Output



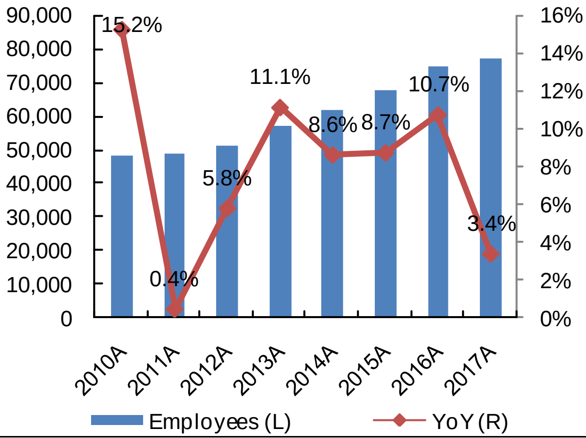
Source: the Company, Guotai Junan International.

Figure-18: Shenzhou's Factory Area



Source: the Company, Guotai Junan International.

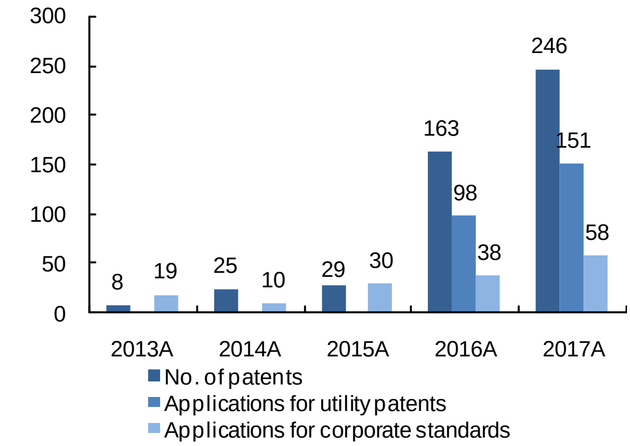
Figure-19: Number of Shenzhou's Employees



Source: the Company, Guotai Junan International.

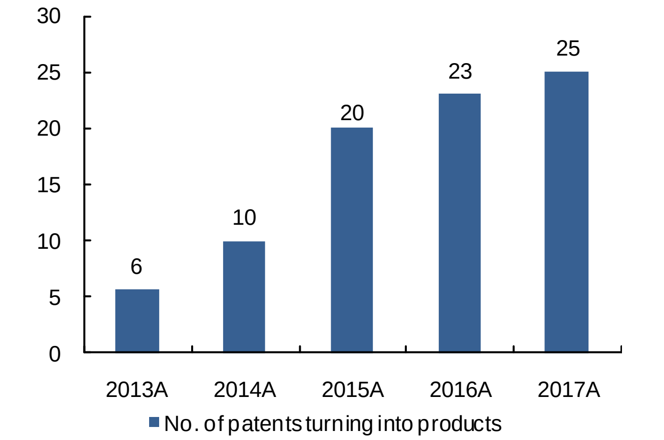
Shenzhou has very strong R&D capabilities. The Company invests heavily on R&D and innovation to keep its new products competitive compared to its peers. The Company has also adopted automation into its production facilities, which saves labor costs and improves production and management efficiency. The Company had 246 patents as at 31 December 2017, including 90 patents of new materials and fabrics and 156 patents for transformation and innovation of equipment and technique for production. In addition, the Company has made 151 applications for utility patents and 58 applications for corporate standards. The heavy investment in R&D enables the Company to develop high-quality fabrics and manufacture products with special techniques, like the Nike Flyknit. Shenzhou has established specially-designed factories for its major clients, Nike, Adidas and Uniqlo, in order to more efficiently manufacture their products that require difficult techniques. Currently around 70% of the Nike Flyknit fabrics are manufactured by Shenzhou.

Figure-20: Shenzhou's Patents



Source: the Company, Guotai Junan International.

Figure-21: Shenzhou's Patents that have Become Products



Source: the Company, Guotai Junan International.

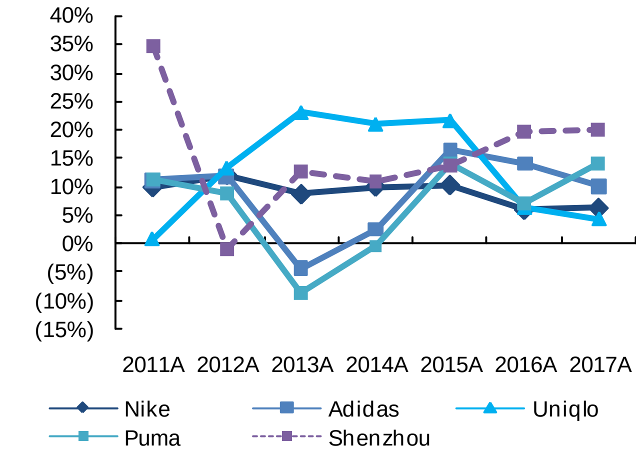
FINANCIAL ANALYSIS

Revenue

Revenue grew at a CAGR of 17.6% during 2014-2017. The Company's revenue grew very fast during the past few years, mainly driven by expansion of its production capacity and fast growth of its major customers. The Company's production capacity of fabrics and knitwear grew at a CAGR of 17.4% and 11.9%, respectively, during 2014-2017. Sales to the top four major customers combined grew at a CAGR of 19.0% during 2014-2017. The Company's top four customers (Nike, Adidas, Uniqlo and Puma) combined contributed around 80% of the Company's total sales over the past few years, so the Company's revenue growth was highly related to revenue performance of its major clients. The Company shifted its focus from casual wear to sportswear during 2013 and 2014, and benefited from strong growth in the global sportswear industry over the past few years. The Company's revenue from sportswear products grew at a CAGR of 20.8% during 2014-2017. Sportswear is now the biggest product category of the Company, which contributed 66.6% of total revenue in 2017, up from 55.3% in 2013. Revenue from casual wear products grew at a CAGR of 19.1% during 2014-2017, mainly driven by rapid growth of Uniqlo, which contributed around 80%-90% to the Company's total casual wear sales. In terms of region, mainland China has become the largest market for the Company with revenue contribution of 26.8% in 2017. Revenue from the European and USA markets in 2017 increased YoY by 20.1% and 51.0%, respectively, mainly driven by increasing demand for sportswear.

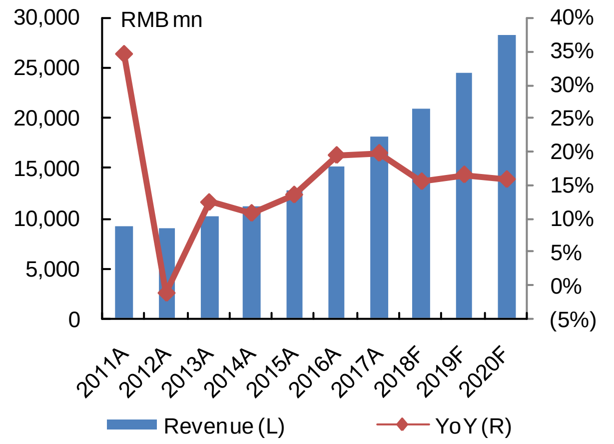
1H18 top line missed expectations. The Company's 1H18 revenue grew by 10.8% YoY to RMB9.16 billion, which was below market expectations due to the appreciation of RMB, which resulted in a 4% YoY decrease in ASP. Revenue from sportswear grew by 12.6% YoY and contributed 67.9% of total revenue. Nike continued to be the biggest client with revenue growing by 13.5% YoY. The five largest customers combined contributed 82% of the Company's total sales in 1H18.

Figure-22: Shenzhou's Revenue Growth Compared to Revenue Growth of Its Major Customers



Source: the Company, Guotai Junan International.

Figure-23: Shenzhou's Revenue and YoY Growth



Source: the Company, Guotai Junan International.

We forecast revenue to grow at a CAGR of 16.0% during 2017-2020. We forecast 2018-2020 total revenue to grow YoY by 15.5%, 16.6% and 15.9% to RMB20.89 billion, RMB24.35 billion and RMB28.22 billion, respectively. Revenue growth will be driven by both the expansion of production capacity and increasing orders from clients. The Company's daily average fabric output in Vietnam production base increased around 60% YoY to 190 tons in 2017, which was mainly driven by the operation of newly installed equipment in Vietnam fabric plants as well as increasing worker productivity, and is expected to increase to 300 tons by the end of 2018. The Company's production base in Ningbo is undertaking a renewal transformation program, which is expected to finish by mid-2018. The production capacity in Ningbo production base has been temporarily depressed by the transformation program, but will recover in 2019. We forecast the Company's 2018-2020 daily average fabric output to grow by 18.7%, 21.6% and 19.4% to 510 tons, 620 tons and 740 tons, respectively. The Company will continue to invest in garment production bases in overseas countries, which may also include Indonesia, Burma and other cities in Cambodia. The Company plans to build another factory in Vietnam in 2018 with a capacity of 10,000 workers, and to commence production in 2019. Besides, productivity of both domestic and overseas workers is continuously improving. The per capita Standard Allowed Hours (SAH) in mainland China, Cambodia and Vietnam improved YoY by 9%, 15% and 86%, respectively, in 2017. Therefore we forecast the Company's 2018-2020 knitwear output to grow by 13.0%, 13.3% and 12.0% to 395 million, 448 million and 502 million pieces, respectively, representing a CAGR of 13.6%. We expect orders from the Company's top-four customers to continue to grow fast during 2018-2020, mainly driven by strong demand for sportswear products in China, Europe and USA. The Company will also actively develop new customers in both mainland China and overseas markets.

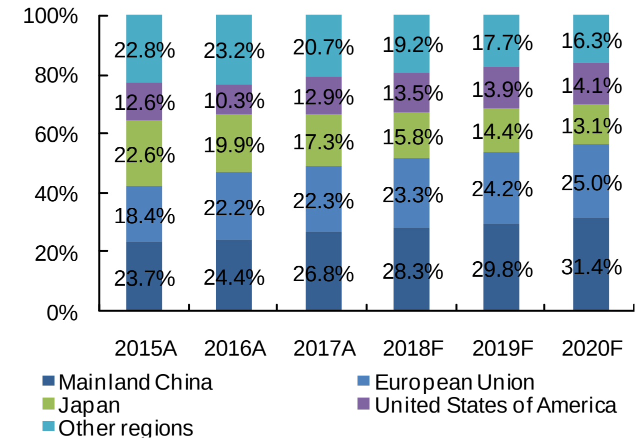
Table-1: Shenzhou's Production Capacity, Sales to Major Customers and Revenue Breakdown by Region

	2015A	2016A	2017A	2018F	2019F	2020F
Daily average fabric output (tons)	**311**	**358**	**430**	**510**	**620**	**740**
YoY	*17.1%*	*15.1%*	*20.0%*	*18.7%*	*21.6%*	*19.4%*
Knitwear output (million pieces)	**270**	**310**	**350**	**395**	**448**	**502**
YoY	*8.0%*	*14.8%*	*12.9%*	*13.0%*	*13.3%*	*12.0%*
- Mainland China	225	248	262	278	294	310
YoY	*3.7%*	*10.2%*	*5.8%*	*6.0%*	*5.7%*	*5.5%*
- Cambodia	37	47	53	69	86	104
YoY	*19.4%*	*27.0%*	*13.0%*	*30.0%*	*25.0%*	*20.0%*
- Vietnam	8	15	35	48	68	88
YoY	*300.0%*	*87.5%*	*130.0%*	*40.0%*	*40.0%*	*30.0%*
Sales to major customers (RMB mn)	**10,107**	**11,978**	**14,335**	**16,388**	**19,092**	**21,971**
YoY	*18.7%*	*18.5%*	*19.7%*	*14.3%*	*16.5%*	*15.1%*
% of total revenue	*80.0%*	*79.3%*	*79.3%*	*78.4%*	*78.4%*	*77.9%*
- Nike	3,140	3,869	5,256	6,439	7,791	9,310
YoY	*20.3%*	*23.2%*	*35.9%*	*22.5%*	*21.0%*	*19.5%*

- Adidas		2,738	3,422	3,609	4,006	4,607	5,229
	YoY	*15.7%*	*25.0%*	*5.5%*	*11.0%*	*15.0%*	*13.5%*
- Uniqlo		3,137	3,368	3,697	3,993	4,432	4,853
	YoY	*34.5%*	*7.4%*	*9.8%*	*8.0%*	*11.0%*	*9.5%*
- Puma		1,092	1,319	1,772	1,950	2,262	2,578
	YoY	*-9.3%*	*20.8%*	*34.4%*	*10.0%*	*16.0%*	*14.0%*
Total revenue (RMB mn)		**12,639**	**15,099**	**18,085**	**20,895**	**24,354**	**28,215**
	YoY	*13.5%*	*19.5%*	*19.8%*	*15.5%*	*16.6%*	*15.9%*
- Mainland China		2,996	3,690	4,845	6,070	7,527	9,221
	YoY	*20.4%*	*23.2%*	*31.3%*	*25.3%*	*24.0%*	*22.5%*
- European Union		2,320	3,356	4,031	4,595	5,492	6,535
	YoY	*20.2%*	*44.6%*	*20.1%*	*14.0%*	*19.5%*	*19.0%*
- Japan		2,860	3,004	3,129	3,304	3,486	3,660
	YoY	*-7.2%*	*5.0%*	*4.2%*	*5.6%*	*5.5%*	*5.0%*
- United States of America		1,589	1,548	2,338	2,864	3,480	4,141
	YoY	*22.2%*	*-2.5%*	*51.0%*	*22.5%*	*21.5%*	*19.0%*
- Other regions		2,876	3,502	3,743	4,061	4,369	4,658
	YoY	*23.2%*	*21.8%*	*6.9%*	*8.5%*	*7.6%*	*6.6%*

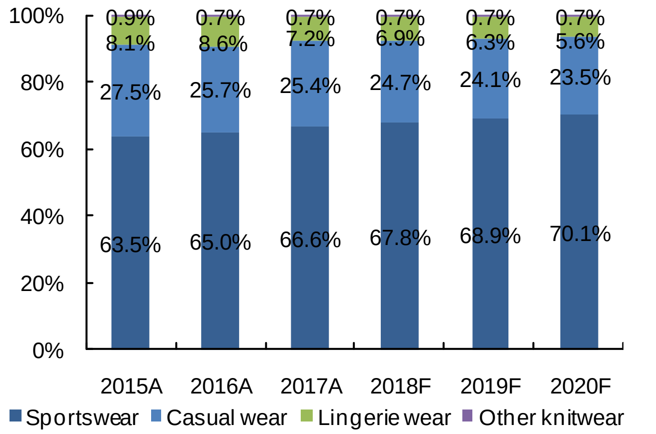
Source: the Company, Guotai Junan International.

Figure-24: Shenzhou's Revenue - by Region



Source: the Company, Guotai Junan International.

Figure-25: Shenzhou's Revenue - by Product



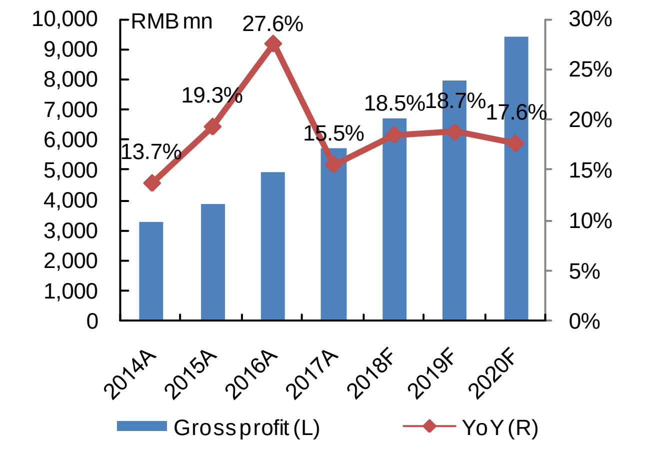
Source: the Company, Guotai Junan International.

Gross Profit & Gross Margin

Gross profit grew at a CAGR of 20.7% during 2014-2017. Growth in gross profit was higher than that of revenue, mainly due to improvement in GPM. The Company's GPM increased from 29.0% in 2014 to 31.4% in 2017, mainly driven by increase in productivity of the Company’s production bases and optimization of the Company's product mix. However, GPM in 2017 dropped by 1.2 ppt YoY due to negative impact from appreciation of RMB against USD and the increase of labor costs and price of raw materials. Normally, the Company negotiates with its suppliers to lock the purchase prices of raw materials in advance, and then negotiates order prices with its clients every quarter. This business model can help the Company to avoid impact to GPM to a large extent from the fluctuation of prices of raw materials. Overall GPM in 1H18 improved by 0.6 ppt YoY to 32.3%, mainly due to increased overseas production and continued improvement in productivity, but was partially offset by the appreciation of RMB.

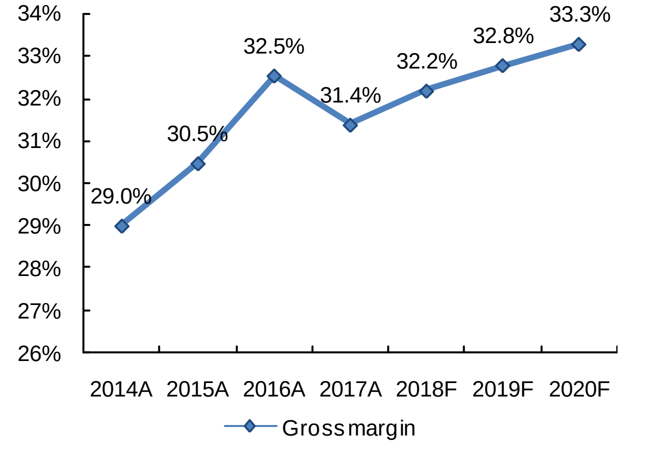
We forecast FY18-FY20 overall GPM to improve YoY by 0.8 ppt, 0.6 ppt and 0.5 ppt to 32.2%, 32.8% and 33.3%, respectively. The Company has been taking measures to improve productivity, including training and education for workers, enhancement of production automation and the implementation of information systems in production planning and operating control. The Company has implemented automation transformation to its production base in Ningbo, which will significantly improve domestic productivity in 2019 and 2020. The further application of automation can also lower labor costs and reduce material waste during production. We expect the Company's overall productivity to continue improving over the next few years, which will benefit overall GPM. Besides, the Company will continue to focus on R&D and innovation to maintain high quality and competitiveness of its products. Therefore, we expect the Company's GPM to slightly improve during 2018-2020.

Figure-26: Shenzhou's Gross Profit & YoY Growth



Source: the Company, Guotai Junan International.

Figure-27: Shenzhou's Overall Gross Profit Margin



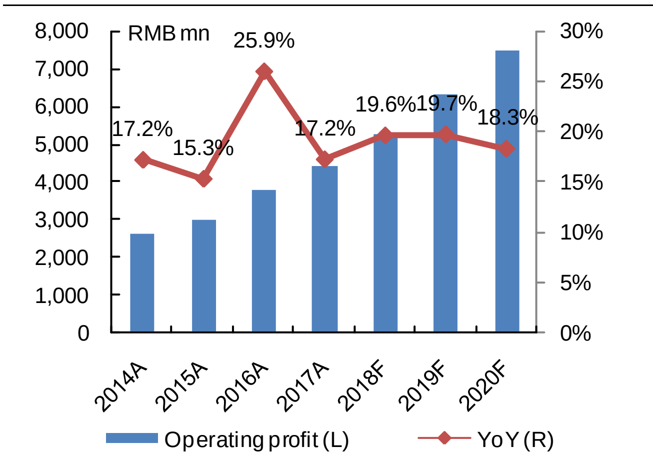
Source: the Company, Guotai Junan International.

Operating Profit & Operating Margin

Operating profit grew at a CAGR of 19.4% during 2014-2017. The Company's operating expenses are mainly selling and distribution expenses and administrative expenses. The Company's selling and distribution expenses grew at a CAGR of 23.7% during 2014-2017, and represented 2.6% of total revenue in 2017. Administrative expenses mainly include utilities expenses, office expenses, transportation expenses and other expenses. Administrative expenses grew at a CAGR of 15.8% during 2014-2017, along with expansion of the Company's production facilities. Total SG&A expenses accounted for 9.4% of total revenue in 2017, slightly lower than 9.6% last year. The Company's other income and other gains increased by 23.8% YoY to RMB572 million in 2017, representing 3.2% of total revenue, mainly due to increases in government grants and bank interest income. The Company received government grant in the range of 1.7%-2.4% of total revenue in the past eight years. Operating margin dropped by 0.5 ppt YoY to 24.4% in 2017, encumbered by decrease in GPM but partially offset by better control of expenses in 2017.

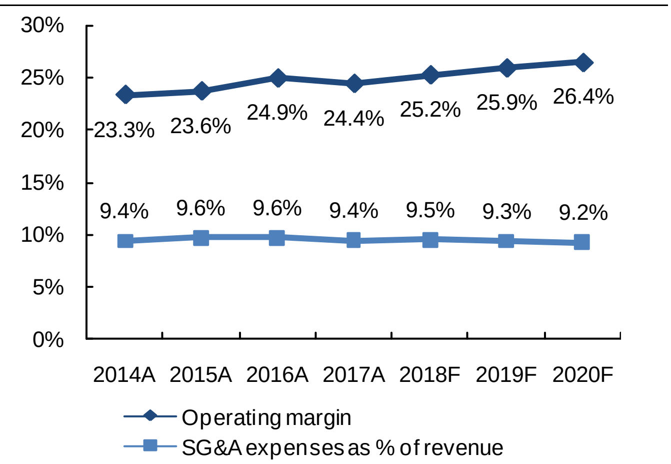
We forecast 2018-2020 operating profit to increase by 19.6%, 19.7% and 18.3% to RMB5.27 billion, RMB6.31 billion and RMB7.46 billion, respectively. We expect the Company to maintain effective cost control over the next few years in spite of the expansion of production facilities and employees. We forecast selling and distribution expenses and administrative expenses to grow at a CAGR of 16.3% and 14.7%, respectively, during 2017-2020. We forecast 2018-2020 total SG&A ratio to remain at the range of 9.0% to 9.5%. Therefore we forecast 2018-2020 operating margin to gradually improve YoY by 0.9 ppt, 0.7 ppt and 0.5 ppt to 25.2%, 25.9% and 26.4%, respectively.

Figure-28: Shenzhou's Operating Profit & YoY Growth



Source: the Company, Guotai Junan International.

Figure-29: Shenzhou's Operating Margin and SG&A Ratio



Source: the Company, Guotai Junan International.

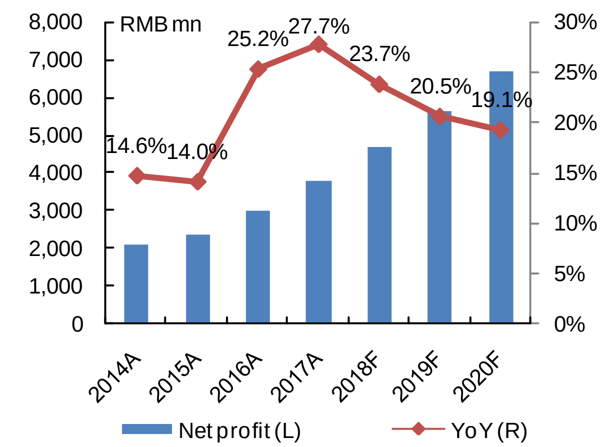
Net Profit & Net Margin

Finance costs are expected to be lower during 2018-2020. The Company's financial costs consist of interest expenses on convertible bonds and bank borrowings. On 18 June 2014, the Company issued convertible bonds which will be due on 18 June 2019, with the aggregate principal amount of HK$3.9 billion with a coupon rate of 0.5%. In June 2017, the convertible bonds together with accrued interest were converted into 87,199,985 shares at a conversion price of HK$37.50 per share and 17,022,412 shares at a conversion price of HK$37.01 per share. Therefore, interest expenses on convertible bonds dropped by 56.4% YoY to RMB42.1 million in 2017, and will be nil during 2018-2020. As a result, financial expenses plunged by 61.5% YoY in 1H18. The Company's balance of borrowings amounted to RMB2.13 billion, representing YoY increase of 71.6%, mainly raised to fund the expansion of overseas production capacity and the transformation of Ningbo production base. The effective interest rate of the Company's borrowings lies in the range between 2.5% and 3.0%. We expect the Company to gradually reduce its balance of borrowings during 2018-2020 considering its strong operating cash flow. Therefore, interest expenses on borrowings are also expected to be lower. We forecast 2018-2020 finance costs to decrease YoY by 49.3%, 1.8% and 5.0% to HK$62.3 million, HK$61.2 million and HK$58.1 million, respectively.

Effective tax rate is expected to gradually decrease during 2018-2020. The Company pays income tax for its business in mainland China, Hong Kong, Cambodia, Vietnam and Japan. The Company's subsidiaries in mainland China are subject to a tax rate of 25% on relevant assessable income. However, certain subsidiaries are qualified as "High-New Technology Enterprises", and are entitled to concessionary income tax rate at 15% for 2016-2018. The Company's subsidiaries in Cambodia are subject to a tax rate of 20%, while certain subsidiaries are entitled to an exemption from income tax for the first four profit-making years. The Company's subsidiaries in Vietnam are subject to a tax rate of 20%, while certain subsidiaries are entitled to a lower tax rate of 10%, and certain subsidiaries are entitled to an exemption from income tax for four years and 50% reduction for the nine years thereafter. The Company's effective tax rate during 2012-2016 remained stable within a range from 18% to 19%. However, effective tax rate in 2017 significantly decreased to 12.3%, mainly due to the commencement of operation of the newly established special fabric factory in Vietnam, which enjoyed an exemption from income tax, as well as a concessionary tax rate of 15% granted to one of the Company's subsidiaries in China. We believe that the Company's effective tax rate will continue to decrease due to more operations being commenced in Vietnam over the next few years, where effective tax rate is much lower than other regions. 1H18 effective tax rate dropped by 2.9 ppt YoY to 11.3%. We forecast 2018-2020 effective tax rate to gradually decrease to 10.8%, 10.3% and 9.8%, respectively.

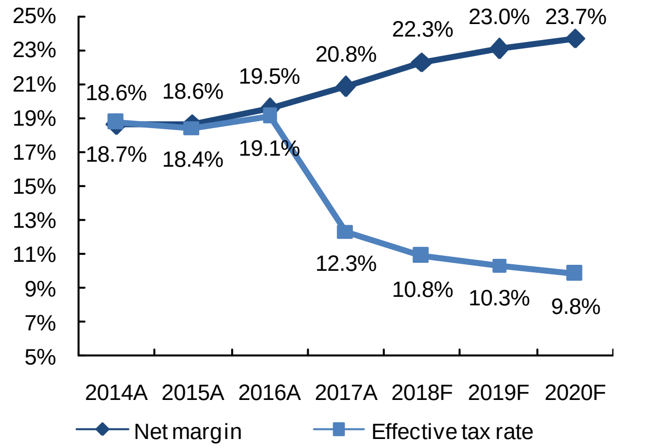
We forecast 2018-2020 net profit to grow YoY by 23.7%, 20.5% and 19.1% to RMB4.65 billion, RMB5.61 billion and RMB6.68 billion, respectively, representing a CAGR of 21.1% during 2017-2020. The Company's net profit grew at a CAGR of 22.1% during 2014-2017. 2017 net profit increased by 27.7% YoY to RMB3.76 billion, and net margin increased by 1.3 ppt YoY to 20.8% despite lower GPM, mainly benefiting from lower effective tax rate. 1H18 net profit increased by 21.1% YoY to RMB2.18 billion and net margin improved by 2.0 ppt YoY to 23.8%. We forecast 2018-2020 net margin to improve YoY by 1.5 ppt, 0.7 ppt and 0.7 ppt to 22.3%, 23.0% and 23.7%, respectively, mainly driven by expected higher GPM and lower financial costs and effective tax rates.

Figure-30: Shenzhou's Net Profit & YoY Growth



Source: the Company, Guotai Junan International.

Figure-31: Shenzhou's Net Margin & Effective Tax Rate

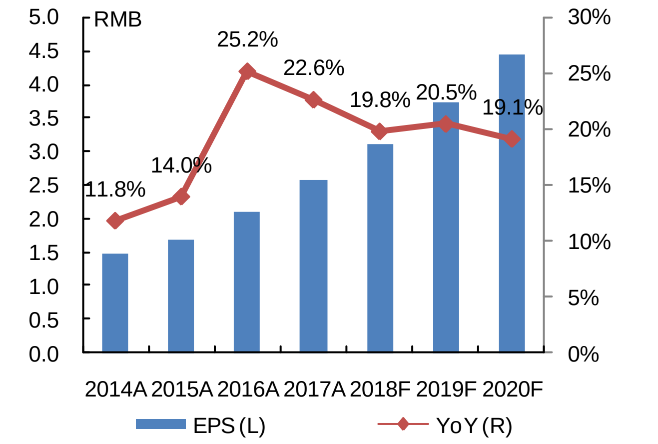


Source: the Company, Guotai Junan International.

EPS & Dividend

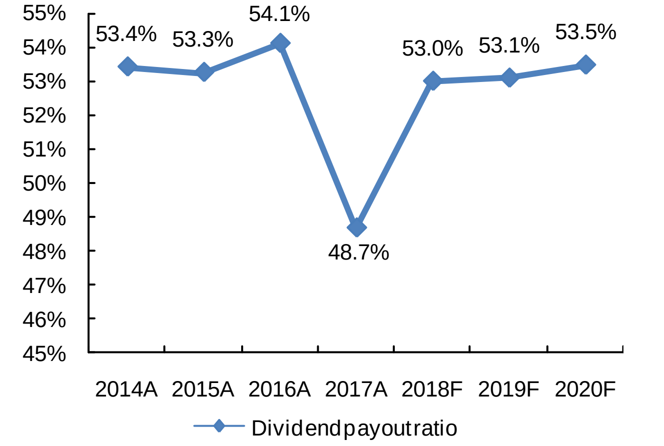
We forecast 2018-2020 basic EPS to be RMB3.096, RMB3.729 and RMB4.443, respectively, representing a CAGR of 21.1% during 2017-2020. The Company's 2017 EPS increased by 22.6% YoY, lower than the YoY increase of 27.7% in net profit, mainly due to the dilution of shares caused by the conversion of convertible bonds. During the past six years, the Company paid stable dividend with payout ratios in the range of 45%-55%. We believe that the Company will maintain similar payout ratios during 2018-2020 considering its strong cash flow and stable profitability. We forecast 2018-2020 dividend payment to be RMB2.47 billion, RMB2.98 billion and RMB3.57 billion, representing a payout ratio of 53.0%, 53.1% and 53.5%, respectively.

Figure-32: Shenzhou's EPS & YoY Growth



Source: the Company, Guotai Junan International.

Figure-33: Shenzhou's Dividend Payout Ratio

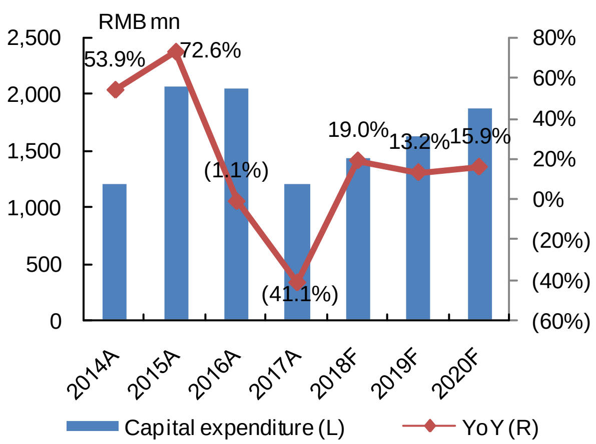


Source: the Company, Guotai Junan International.

Capital Expenditure

We forecast the Company's 2018-2020 capital expenditure to be RMB1.43 billion, RMB1.62 billion and RMB1.87 billion, respectively. The Company's capital expenditure is mainly related to the construction of production facilities in both China and overseas countries. The Company's capital expenditure was especially high in 2015 and 2016, exceeding RMB2.0 billion per annum, mainly due to the investment in Vietnam production facilities. Capital expenditure returned to RMB1.20 billion in 2017, in which approximately 55% was used for purchasing production equipment, approximately 37% for construction and acquisition of new plant buildings as well as prepayment for land lease, and the remaining balance for procurement of other fixed assets. The Company will continue to invest heavily in overseas production facilities over the next few years, including the new garment factory in Vietnam and the projected investment in Garment factory on the new leased land in Cambodia. Therefore we expect the Company's capital expenditure to remain high over the next few years.

Figure-34: Shenzhou's Capital Expenditure & YoY Growth

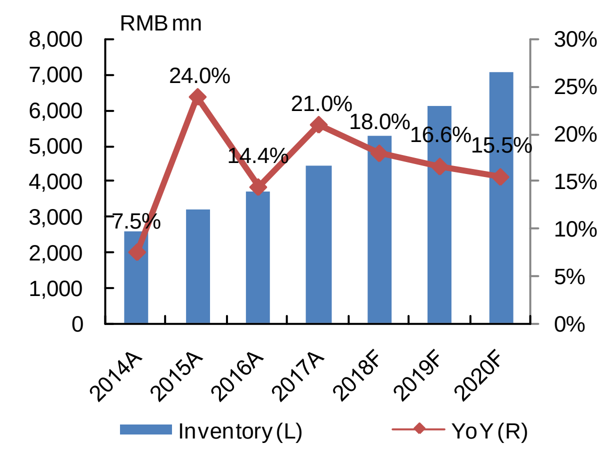


Source: the Company, Guotai Junan International.

Working Capital Management

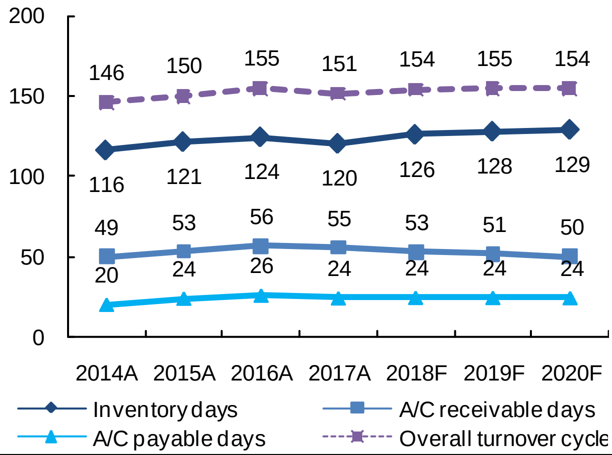
We expect the Company's working capital turnover cycle to remain stable over the next few years. The Company's Inventory balance grew at a CAGR of 19.8% during 2014-2017, which was slightly higher than revenue growth during that period. Increase in inventory was mainly due to the expansion of production capacities in both fabrics and garment products. Growth of raw materials and finished goods was especially fast, which grew at a CAGR of 41.5% and 20.8%, respectively, during 2014-2017. As a result, inventory turnover days increased from 116 days in 2014 to 120 days in 2017. We forecast the Company's inventory balance to grow YoY by 18.0%, 16.5% and 15.0% to RMB5.28 billion, RMB6.16 billion and RMB7.12 billion, respectively, representing a CAGR of 16.7% during 2017-2020, driven by expansion of production capacities. Therefore, we forecast 2018-2020 inventory turnover days to be 126 days, 128 days and 129 days, respectively. The Company's trade receivables turnover days remained stable at around 55 days over the past few years, which primarily benefited from the stable and concentrated customer structure. The Company's credit term with its customers is within six months. As at 31 December 2017, 96.2% of the Company's trade receivables were due within three months. We forecast 2018-2020 receivables turnover days to remain generally stable at 53 days, 51 days and 50 days, respectively. The Company's credit terms with its suppliers are normally within 40 days, and trade payable turnover days was around 24 days over the past three years. We forecast 2018-2020 trade payables turnover days to remain stable at 24 days. Based on our abovementioned estimates, we forecast 2018-2020 overall turnover cycle days to be 154 days, 155 days and 154 days, respectively.

Figure-35: Shenzhou's Inventory & YoY Growth



Source: the Company, Guotai Junan International.

Figure-36: Shenzhou's Working Capital Turnover Cycle



Source: the Company, Guotai Junan International.

ROA & ROE

We forecast 2018-2020 ROA to be 18.3%, 19.9% and 21.3%, respectively. The Company's ROA was above 20% during 2009-2011 but started to drop over the next few years, mainly due to lower net margins and asset turnover rates. ROA in 2017 increased by 1.3 ppt YoY to 20.8%, driven by higher net margin. We believe that the Company's ROA will continue to improve over the next few years, driven by enhancement in the Company's profitability.

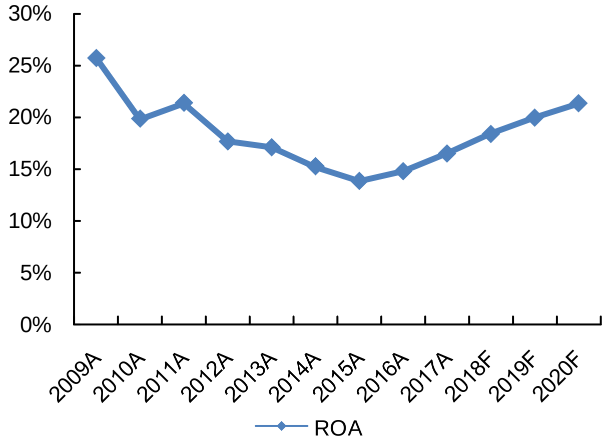
We forecast 2018-2020 ROE to be 22.2%, 23.7% and 25.0%, respectively. The Company's ROE in 2017 increased by 0.9 ppt YoY to 21.7%, mainly driven by improved net margin and was partially offset by decreased equity multiplier. We implement DuPont analysis on forecasted ROE. We expect asset turnover ratio to be higher during 2018-2020 due to forecasted strong growth in revenue, and net margin is also expected to improve, which will result in increases in forecasted ROE.

Table-2: DuPont Analysis on Shenzhou's ROE

	2014A	2015A	2016A	2017A	2018F	2019F	2020F
Net margin (net profit / revenue)	18.6%	18.6%	19.5%	20.8%	22.3%	23.0%	23.7%
Asset turnover (revenue / asset)	81.7%	73.7%	75.2%	78.8%	82.1%	86.4%	89.9%
Equity multiplier (asset / equity)	123.3%	137.9%	142.6%	132.2%	121.5%	119.3%	117.4%
ROE	18.7%	18.9%	20.9%	21.7%	22.2%	23.7%	25.0%

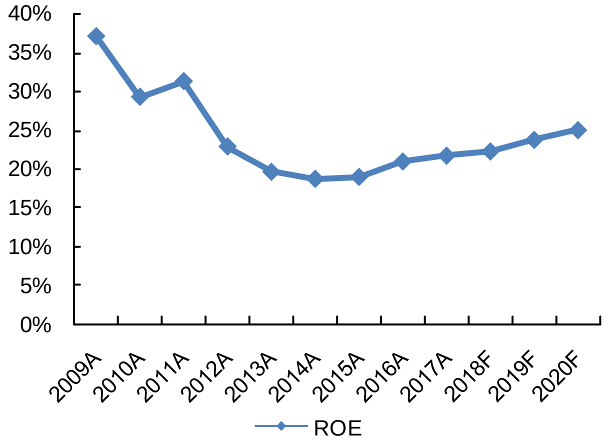
Source: the Company, Guotai Junan International.

Figure-37: Shenzhou's ROA



Source: the Company, Guotai Junan International.

Figure-38: Shenzhou's ROE



Source: the Company, Guotai Junan International.

Table-3: Key Financial Forecasts

HK$ mn	HISTORICAL			FORECASTS			YoY		
	2015A	2016A	2017A	2018F	2019F	2020F	2018F	2019F	2020F
Revenue	12,639	15,099	18,085	20,895	24,354	28,215	15.5%	16.6%	15.9%
Gross profit	3,849	4,909	5,671	6,719	7,978	9,384	18.5%	18.7%	17.6%
Operating profit	2,987	3,760	4,408	5,270	6,308	7,460	19.6%	19.7%	18.3%
Net profit	2,355	2,948	3,763	4,653	5,606	6,679	23.7%	20.5%	19.1%
Basic EPS (HK$)	1.683	2.107	2.584	3.096	3.729	4.443	19.8%	20.5%	19.1%
Gross margin	30.5%	32.5%	31.4%	32.2%	32.8%	33.3%	0.8 ppt	0.6 ppt	0.5 ppt
% SG&A of turnover	9.6%	9.6%	9.4%	9.5%	9.3%	9.2%	0.1 ppt	(0.2) ppt	(0.1) ppt
Operating margin	23.6%	24.9%	24.4%	25.2%	25.9%	26.4%	0.9 ppt	0.7 ppt	0.5 ppt
Net margin	18.6%	19.5%	20.8%	22.3%	23.0%	23.7%	1.5 ppt	0.7 ppt	0.7 ppt

Source: the Company, Guotai Junan International.

PEERS COMPARISON AND VALUATION

Major comparable peers are Yue Yuen (00551 HK), Texhong Textile (02678 HK), Pacific Textiles (01382 HK), Regina Miracle (02199 HK) and Stella Int'l (01836 HK). Most of these companies are engaged in manufacturing fabrics or garments, except for Yue Yuan, which manufactures only footwear products. Yue Yuan's business scale is around three times that of Shenzhou, but its revenue growth is forecasted to be in the low-single-digit percentages during 2018-2020, basically the slowest among all peers. Texhong Textile has similar business scale to Shenzhou, but mainly produces fabrics, which is in the midstream of industry chain. Therefore, Texhong's GPM and net margin are both significantly lower than Shenzhou. In spite of Shenzhou's relatively large business scale, its revenue is still expected to grow at a CAGR of 16.0% during 2017-2020, which makes Shenzhou very strong and competitive compared to its peers. Besides, Shenzhou has the highest gross margin and net margin among its peers, mainly due to its vertically integrated business model, which allows the Company to better control the industry chain.

Table-4: Peers Comparison on Key Financial Forecasts

	Stock	Revenue (RMB bn)			Gross Margin (%)			Net Margin (%)			ROE (%)		
Company	Code	2018F	2019F	2020F	2018F	2019F	2020F	2018F	2019F	2020F	2018F	2019F	2020F
Shenzhou	2313 HK	20.9	24.4	28.2	32.2	32.8	33.3	22.3	23.0	23.7	22.2	23.7	25.0
Yue Yuen	551 HK	65.9	68.2	71.4	25.0	25.6	26.0	3.7	4.3	4.6	8.4	9.8	10.6
Texhong Textile	2678 HK	18.9	21.6	23.8	16.6	16.8	17.0	7.0	7.3	7.5	21.1	21.7	21.7
Pacific Textiles*	1382 HK	4.9	5.8	6.2	15.5	17.5	18.1	12.2	14.3	14.6	22.8	27.0	28.2
Regina Miracle*	2199 HK	4.8	6.0	7.1	21.3	22.1	22.8	4.1	5.3	6.6	8.8	12.1	16.0
Stella Int'l	1836 HK	10.9	11.2	11.6	17.3	17.8	18.0	4.3	5.1	5.5	8.4	9.7	10.4
Texwinca Hldgs*	321 HK	6.8	7.9	8.3	30.7	30.2	30.4	3.6	4.0	4.6	5.7	6.6	7.9
Nameson Hldgs*	1982 HK	2.8	3.8	4.2	20.7	21.8	22.0	9.5	9.1	9.5	16.3	14.6	15.2
Simple Average		15.4	16.9	18.3	22.8	23.5	23.9	8.4	9.1	9.6	13.9	15.4	16.5
Weighted Average		26.3	29.1	32.3	28.6	29.2	29.7	16.3	17.1	17.7	18.5	20.1	21.3

Source: Bloomberg, Guotai Junan International.
** The financial year end of Pacific Textiles (1382 HK), Regina Miracle (2199 HK), Texwinca Hldgs (321 HK) and Nameson Hldgs (1982 HK) is not Dec. 31. For easier comparison with peers, "2018F" means FY19F and so on for the aforementioned companies.*

Our DCF model suggests an NAV of HK$132.16 per share. We have used the DCF model to evaluate the Company's business. We have forecasted the Company's free cash flow from 2018 to 2028 as well as the terminal value of cash flow afterwards. By discounting the FCFs and terminal value to present based on the assumptions shown in the table below, we arrive at an implied NAV of RMB174.8 billion, which is equivalent to HK$132.16 per share.

Table-5: DCF analysis for Shenzhou

WACC Calculation		NAV Calculation	RMB mn
Risk free rate	2.3%	PV of FCF	80,047
BETA	0.92	PV of terminal value	93,456
Market risk premium	10.9%	Enterprise value	173,503
Cost of equity	12.4%	- Net debt/(cash)	(1,520)
		- Preferred stock	0
Cost of debt	2.6%	- Minority interest	198
Effective tax rate	11.8%	Total NAV (RMB mn)	174,825
Cost of debt(after tax)	2.3%		
		Total shares (mn)	1,503
E/ (D+E)	91.7%		
D/ (D+E)	8.3%	**Total NAV per share**	
WACC	**11.5%**	RMB	116.30
Perpetuity growth rate	**3.0%**	HK$	132.16

Source: Bloomberg, Guotai Junan International.

Initiate with "Buy" investment rating and a TP of HK$110.00. The textile and garment industry is currently trading at 22.4x and 18.5x weighted average 2018 and 2019 PER, respectively. Shenzhou is currently trading at 27.1x 2018 PER, representing a 21.1% premium to industry average, and 22.5x 2019 PER, representing a 21.5% premium to industry average. Shenzhou is the largest knitwear manufacturer in China, and is expected to maintain its strong growth momentum over the next few years in spite of its relatively large business scale, mainly driven by expansion of production capacities in both domestic and overseas production bases. The Company enjoys relatively high profitability compared to its peers, which primarily benefits from its vertically integrated business model and efficient cost control measures. Furthermore, the Company has been investing heavily on R&D to keep its products competitive in the market and to sustain good relationship with major clients. We believe that Shenzhou will continue to grow fast and gain more market share over the next few years. We initiate with a TP of HK$110.00, which represents 31.3x, 26.0x and 21.8x 2018, 2019 and 2020 PER, respectively. Our TP represents 16.8% discount to our DCF derived NAV of HK$132.16 per share. Our TP also represents 15.4% upside potential, and therefore we give the Company a "Buy" rating.

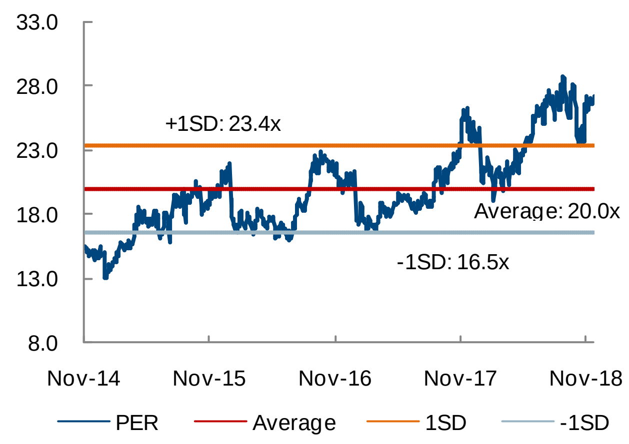
Table-6: Peers Comparison Table

Company	Stock Code	Currency	Last price	Market Cap HKD mn	PE(x) 17A	PE(x) 18F	PE(x) 19F	PE(x) 20F	PB(x) 17A	PB(x) 18F	PB(x) 19F	PB(x) 20F	ROE(%) 18F	D/Y(%) 18F	EV/EBITDA(x) 18F	Gross Margin(%) 18F	Operating Margin(%) 18F
Textile & Garment																	
Shenzhou	2313 HK	HKD	95.35	143,332	30.7	27.1	22.5	18.9	6.1	5.7	5.0	4.4	22.2	2.0	20.5	32.2	25.2
Yue Yuen	551 HK	HKD	23.35	37,749	9.5	14.0	11.9	10.6	1.2	1.1	1.1	1.1	8.4	5.8	7.7	25.1	5.6
Texhong Textile	2678 HK	HKD	9.56	8,747	6.6	5.9	4.9	4.3	1.2	1.1	1.0	0.8	21.1	5.1	4.7	16.6	9.7
Pacific Textiles*	1382 HK	HKD	7.75	11,210	11.6	15.2	12.0	11.2	3.5	3.3	3.2	3.0	22.8	6.0	10.6	15.5	13.8
Regina Miracle*	2199 HK	HKD	5.22	6,391	65.3	26.6	19.3	13.1	2.4	2.2	2.1	1.9	8.8	0.9	16.5	21.3	5.7
Stella Int'l	1836 HK	HKD	8.12	6,450	13.4	11.9	9.6	8.4	0.8	0.8	0.8	0.8	8.4	7.4	7.0	17.3	3.8
Texwinca Hldgs*	321 HK	HKD	3.19	4,408	9.2	14.5	12.3	10.3	0.8	0.8	0.9	0.9	5.7	8.5	7.1	30.7	5.1
Nameson Hldgs*	1982 HK	HKD	0.77	1,755	4.8	5.0	5.9	4.8	1.0	0.7	0.7	0.6	16.3	3.3	8.1	20.7	11.3
Best Pacific Int'l	2111 HK	HKD	2.10	2,182	7.1	8.0	6.4	6.3	0.9	0.9	0.8	0.7	11.8	2.5	5.7	25.7	11.9
Simple Average					17.6	14.3	11.6	9.8	2.0	1.9	1.7	1.6	13.9	4.6	9.8	22.8	10.2
Weighted Average					24.8	22.4	18.5	15.6	4.5	4.2	3.7	3.3	18.6	3.2	16.2	28.6	18.9

Source: Bloomberg, Guotai Junan International.

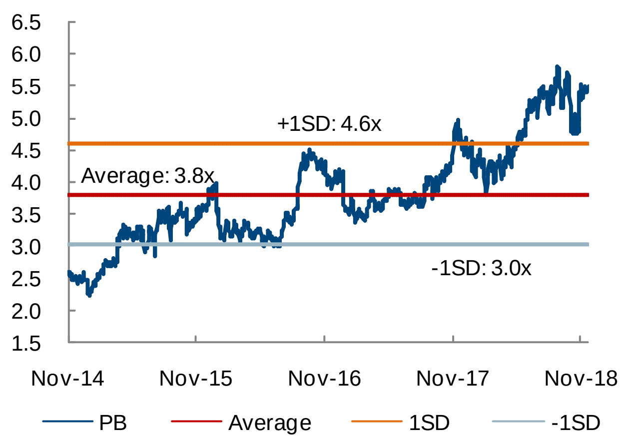
** The financial year end date of Pacific Textiles (1382 HK), Regina Miracle (2199 HK), Texwinca Hldgs (321 HK) and Nameson Hldgs (1982 HK) is not 31st December. For easier comparison with peers, "17A" means "FY18A" and "18F" means FY19F and so on for the aforementioned companies.*

Figure-39: Shenzhou's P/E Ratio (Next 4 Quarters)



Source: Bloomberg, Guotai Junan International.

Figure-40: Shenzhou's PB Ratio (Current Annual)



Source: Bloomberg, Guotai Junan International.

MAJOR RISKS

Industry risk

Growth of the global economy is expected to slow down over the next few years. There is a risk that the global textile and apparel industry may suffer from weaker market demand, especially in Europe and Japan, which may result in lower industry growth or even decline. If the downstream market is weak, the Company will receive less orders from its clients.

Competition risk

The textile and apparel industry is very competitive with a lot of well-performing companies. The industry chain has already been complete and mature after many years of development, so the industry barrier is relatively low, especially for lower-end manufacturing. In order to stay competitive in the market, Shenzhou must continuously invest in R&D to maintain its product differentiation and to lower down production costs.

Upstream risk

The textile and apparel industry is sensitive to changes in raw material prices. The raw materials include cotton, fiber, Mono Ethylene Glycol (MEG), Pure Terephthalic Acid (PTA), polyesters, etc. In case of significant increases in raw material prices, Shenzhou's profitability will suffer certain damage.

Regulatory & regional risk

Regulatory risk mainly refers to changes in government policies. Regulations on environmental protection in China is becoming more and more stringent, which raises environmental protection costs for the Company. Currently Shenzhou has moved its production capacity to Vietnam and Cambodia, and may continue to invest in other Southeast Asian countries including Indonesia and Bangladesh. Local governments of those countries normally provide supportive policies to encourage foreign investment, such as policies including tax reduction and exemption, rental discount, etc. There are risks that these supportive policies may be terminated before expiration due to certain reasons, for example, change of government, military coup, protests against Chinese investors, etc. Furthermore, some areas are prone to natural disasters such as floods, earthquakes, etc., which will affect the Company's local production operations.

Currency risk

Shenzhou's financial statements are presented in RMB, while sales of the Company are mainly settled in USD and the procurement mainly settled in RMB. Therefore, fluctuations in exchange rate, especially USD against RMB, has a certain amount of influence on the Company's costs and operating profits. The Company has adopted certain policies to hedge against the related exchange risks, including a certain amount of loans denominated in USD and HKD. Besides, the global layout of production sites of the Company should help to reduce impact of exchange rate fluctuations on its business.

US-Sino trade war

Currently, demand from the US can be fully covered by the Company's factories in Cambodia and Vietnam, where tariffs are not impacted by the US-Sino trade war. In addition, the upstream fabrics needed by the factories in both Cambodia and Vietnam are completely sourced from the Company's fabric plant in Vietnam, and no imports from China are needed. Therefore, we don't expect Shenzhou to be seriously impacted by the US-Sino trade war.

Financial Statements and Ratios

Income Statement

Year end 31 Dec (RMB m)	2016A	2017A	2018F	2019F	2020F
Total Revenue	15,099	18,085	20,895	24,354	28,215
Cost of Sales	(10,190)	(12,414)	(14,175)	(16,376)	(18,831)
Gross Profit	4,909	5,671	6,719	7,978	9,384
Other Income	462	572	581	666	749
Selling & Distribution Expenses	(354)	(470)	(554)	(638)	(740)
Administrative Expense	(1,103)	(1,231)	(1,422)	(1,628)	(1,856)
Other Expenses	(154)	(134)	(54)	(70)	(77)
Operating Profit	3,760	4,408	5,270	6,308	7,460
Finance Costs	(120)	(123)	(62)	(61)	(58)
Share of Profits of An Associate	2	4	4	4	4
Profit Before Tax	3,643	4,288	5,212	6,251	7,406
Income Tax	(695)	(528)	(564)	(645)	(727)
Profit After Tax	2,948	3,760	4,648	5,606	6,679
Non-controlling Interest	(0)	3	5	(0)	(0)
Shareholders' Profit / Loss	2,948	3,763	4,653	5,606	6,679
Basic EPS	2.107	2.584	3.096	3.729	4.443
YoY	25.2%	22.6%	19.8%	20.5%	19.1%

Cash Flow Statement

Year end 31 Dec (RMB m)	2016A	2017A	2018F	2019F	2020F
Profit Before Taxation	3,643	4,288	5,212	6,251	7,406
D&A	675	784	804	898	1,006
Other Adjustments	178	(39)	(145)	(170)	(188)
Changes in Working Capital	(842)	(730)	(1,065)	(1,150)	(1,226)
Interest Paid	(23)	(81)	(62)	(61)	(58)
Income Tax Paid	(570)	(533)	(558)	(641)	(721)
Cash from Operating Activities	3,061	3,689	4,186	5,127	6,219
Purchase of PP&E	(2,090)	(1,172)	(1,358)	(1,461)	(1,749)
Change in Structured Deposits	110	(1,050)	(525)	0	0
Change in Available-for-sale Investments	(2,320)	143	149	(57)	(288)
Other Investing Activities	1,813	352	142	(580)	(369)
Cash from Investing Activities	(2,487)	(1,727)	(1,593)	(2,098)	(2,407)
Dividends Paid	(1,254)	(2,484)	(2,020)	(2,844)	(3,241)
Other Financing Activities	907	888	(107)	(101)	(96)
Cash from Financing Activities	(347)	(1,596)	(2,126)	(2,945)	(3,337)
Net Changes in Cash	227	366	467	84	475
Cash at Beg of Year	1,816	2,105	2,471	2,938	3,022
Foreign Exchange Effect	62	(0)	0	0	0
Cash at End of Year	2,105	2,471	2,938	3,022	3,497

Balance Sheet

Year end 31 Dec (RMB m)	2016A	2017A	2018F	2019F	2020F
Property, Plant and Equipment	7,013	7,117	7,705	8,304	9,087
Intangible Assets	105	98	96	96	97
Long-term Deposites	850	650	650	1,300	1,650
Prepaid Land Lease Payments	923	957	995	1,114	1,196
Other Non-current Assets	89	65	62	69	89
Total Non-current Assets	8,981	8,887	9,507	10,882	12,119
Inventories	3,699	4,477	5,283	6,160	7,115
Trade and Other Receivables	2,653	2,815	3,209	3,626	4,061
Available-for-sale Investments	3,120	2,977	2,828	2,885	3,173
Structured Deposits	0	1,050	1,575	1,575	1,575
Other Current Assets	1,259	1,416	1,440	1,460	1,600
Cash & Cash Equivalents	2,105	2,471	2,938	3,022	3,497
Total Current Assets	12,835	15,206	17,273	18,729	21,022
Total Assets	21,816	24,093	26,780	29,610	33,141
Trade and Other Payables	758	873	1,013	1,163	1,325
Other Payables and Accurals	787	945	964	978	998
Interest Bearing Bank Borrowings	1,241	2,130	2,024	1,923	1,827
Other Current Liabilities	308	317	324	328	335
Total Current Liabilities	3,094	4,265	4,324	4,392	4,485
Convertible Bonds	3,410	0	0	0	0
Deferred Tax Liabilities	2	3	3	3	3
Total Non-current Liabilities	3,412	3	3	3	3
Total Liabilities	6,506	4,269	4,327	4,395	4,488
Share Capital	142	151	151	151	151
Reserves	14,951	19,470	22,104	24,866	28,303
Total Shareholders' Equity	15,093	19,621	22,255	25,017	28,455
Minority Interest	217	203	198	199	199
Total Equity	15,310	19,825	22,453	25,215	28,653

Financial Ratios

	2016A	2017A	2018F	2019F	2020F
Gross Margin (%)	32.5	31.4	32.2	32.8	33.3
Operating Margin (%)	24.9	24.4	25.2	25.9	26.4
Net Margin (%)	19.5	20.8	22.3	23.0	23.7
ROE (%)	20.9	21.7	22.2	23.7	25.0
ROA (%)	14.7	16.4	18.3	19.9	21.3
ROCE (%)	31.9	27.2	26.8	28.7	30.2
Payout Ratio (%)	54.1	48.7	53.0	53.1	53.5
Inventory Days	124.2	120.2	125.7	127.5	128.7
A/C Receivable Days	56.3	55.2	52.6	51.2	49.7
A/C Payable Days	25.7	24.0	24.3	24.2	24.1
Overall turnover cycle	154.7	151.4	154.0	154.5	154.3
Net Gearing (%)	Net cash	Net cash	Net cash	Net cash	Net cash
Current Ratio (x)	4.1	3.6	4.0	4.3	4.7

Source: the Company, Guotai Junan International.

Company Rating Definition

The Benchmark: Hong Kong Hang Seng Index

Time Horizon: 6 to 18 months

Rating		Definition
Buy	买入	Relative Performance>15%; or the fundamental outlook of the company or sector is favorable.
Accumulate	收集	Relative Performance is 5% to 15%; or the fundamental outlook of the company or sector is favorable.
Neutral	中性	Relative Performance is -5% to 5%; or the fundamental outlook of the company or sector is neutral.
Reduce	减持	Relative Performance is -5% to -15%; or the fundamental outlook of the company or sector is unfavorable.
Sell	卖出	Relative Performance <-15%; or the fundamental outlook of the company or sector is unfavorable.

Sector Rating Definition

The Benchmark: Hong Kong Hang Seng Index

Time Horizon: 6 to 18 months

Rating		Definition
Outperform	跑赢大市	Relative Performance>5%; or the fundamental outlook of the sector is favorable.
Neutral	中性	Relative Performance is -5% to 5%; or the fundamental outlook of the sector is neutral.
Underperform	跑输大市	Relative Performance<-5%; Or the fundamental outlook of the sector is unfavorable.

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