August 26, 2011

Dear clients and colleagues,

Global growth forecasts are being lowered in the backdrop of the current debt crisis. One bright spot, however, is that the IMF projects emerging economies will grow by 6½ percent this year (8 percent in emerging Asia).

China's had 230M middle-income residents in 2009 and this number is expected to grow to 700M by 2020 according to Euromonitor.

This week we profile Dah Chong Hong Holdings limited (1828 HK).

Business overview and history

Based in Hong Kong, Dah Chong Hong (DCH) is a leading business conglomerate that operates three businesses: Motor & Motor Related, Food and Consumer, and Logistics.

DCH began distributing motor vehicles in Hong Kong in 1962 and was the first Hong Kong automobile distributor to set up a foreign wholly-owned company in China. DCH currently represents 20 brands such as Acura, Audi, Bentley, Honda, Isuzu, MAN, Nissan and Opel through a network of 55 sales and service shops.

The conglomerate is a major player in Hong Kong and Macau, with market shares of 23% and 25%, respectively according to the Transport Department of Hong Kong.

DCH's Food & Consumer Product business accounted for 13% of its total profit in 2010. It distributes over 500 food products and 70 brands of fast-moving consumer goods, such as frozen meat from Tyson of the U.S. and Ferrero confectionery, to more than 20,000 outlets. It caters to the food service, retail and wholesale industries in the PRC, Hong Kong, Macau, Japan and Singapore. It also sells twenty electrical appliance brands.

The market

DCH operates in different markets, each with distinct dynamics.

In Hong Kong the market is mature and stable. In China, on the other hand, auto sales are expected to grow at 12% to 20M in 2011, and are expected to grow to 30M by 2020 as Chinese consumers experience salary growth and increased discretionary spending.

In 2010, passenger vehicle (PV) penetration in China was 4.5%, which was well below the global average of 15%, or 28% in Korea and 32% in Japan. This is even after selling more than 18.1M vehicles in 2010, compared with 11.7M cars sold in the U.S. The momentum in the premium segment is strong with dealers implying the limiting factor for luxury and premium car sales being volume allocated by the producers.

The China food market recorded a 22% CAGR in 2008-2010 on increasing consumption by households. Imports of select food categories like milk powder are benefiting from increased awareness about food safety issues.

Competitive advantages and competition

DCH has sold 58,833 cars in China out of the 18.1M cars sold in 2010, which represents around 0.3% of a market that's growing at double digits. By comparison, AutoNation sold 206,500 new cars and CarMax sold 263,000 last year in the U.S. In a growing market, stronger brands like DCH stand to increase penetration as markets consolidate in the future.

DCH's strong client relationship ensures a high level of recurring business. Over the past 50 years, it has built and developed a strong brand name and an integrated business platform that provides a range of comprehensive supply chain management services to its customers. The supply chain is supported by a strong logistics network and real time management system to cater to its multi-brand portfolio.

Growth strategy

DCH's exposure to Guangdong, one of the most affluent provinces in southern China with a low PV penetration rate of 5%, should provide the conglomerate with future growth. DCH's exposure to premium brands allows it to enjoy growth which is likely to continue as China's high-income population grows.

Dealer margins are higher while the drop-out rate is lower for high-end vehicles. DCH is also negotiating authorization for two more international premium auto brands and has appointed five Bentley dealerships in 1H11. It plans to open 10-15 sales and service shops in 2011.

DCH also stands to benefit from this large base of cars being sold, as the vehicles will need after-sales service in the near future, which should help generate higher revenue and margins.

Risks

Potential risks include government imposed restrictions on new car registrations, weakness in the Chinese economy and discontinuation of dealership/distributorship franchise from OEMs.

Market data

Market Cap $2.3B, P/E (2012) 9.8x, EV/EBITDA (2012) 6.6x, ROE 23%, dividend yield 2.7% and profit margin 4.4%. www.dch.com.hk

Valuation

We use a DCF model and derived a target price of $15.27.

Have a good weekend.

Regards,
The Global Alpha Team