February 2022
Equity Research
Sri Lanka

ACUITY
A joint venture of DFCC Bank and HNB

Expolanka Holdings PLC

EXPO

Amid record earnings and stock pullback,
we recommend to hold based on our medium term revenue outlook;
Reiterate at Neutral

Target price (12M, LKR) N/A
Neutral

Transportation | Reiterate Rating

Contents

Acuity: Stock Ratings Scale

Acuity rating	Sell	Underweight	Neutral	Overweight	Buy
Equivalent ratings	Strong Sell	Underperform Moderate Sell Weak Hold Reduce	Hold	Outperform Moderate Buy Accumulate Add	Strong Buy

Expolanka Holdings PLC	
1-week Trading Range (LKR)	314.50 to 345.50
Bloomberg Ticker	EXPO SL Equity
Market Cap (LKR Bn)	674.9
Market Cap (USD Bn)	3.4
Issued Quantity (Shares Mn)	1,954.9
52-week High (LKR)	405.00
52-week Low (LKR)	38.40
Financial Year End	31 March

Financial Year	FY2019/20	FY2020/21	9M FY2021/22
(LKR Mn except per share data)			
Revenue	103,246	218,375	452,111
Growth (Y-o-Y)	8%	112%	176%
Operating Profit	621	16,831	49,072
Growth (Y-o-Y)	-81%	2,609%	289%
Net Earnings	-737	14,830	41,388
Growth (Y-o-Y)	-151%	2,112%	272%
Diluted EPS (LKR)	-0.38	7.59	21.20

Summary

Based on the 3Q FY2021/22 earnings results, TTM revenues of EXPO stand at LKR 527 Bn (USD 2.63 Bn) with a seasonally adjusted revenue run rate of c. LKR 748 Bn (USD 3.7 Bn), which places the company amongst some of the larger freight forwarders in the world based on revenue and volumes. Management has executed well over the last few years through a combination of organic and inorganic growth as evidenced by revenue growth of EXPO exceeding its global peer set. Based on a three year forward revenue forecast using Monte Carlo simulations, we find that the stock is fully valued at current price levels. Therefore we reiterate our Neutral rating on the stock based on our medium term outlook, although we fully expect EXPO to report record earnings in the short term. Potential upside to our rating would be from continued inorganic growth which may enable EXPO to achieve revenue growth higher than our range estimates, sustained margins and from prolonged disruptions to global supply chains which would keep freight rates at elevated levels. Downside risks primarily emanate from faster pace of decline in global freight rates and lower volume growth than what we have modelled in our forecast.

Overview

Freight rates as measured by the WCI Composite Container Freight Benchmark and the Drewry Airfreight Average Rate have increased by 2.1x and 1.4x respectively in 2021. Over the same period, EXPO's TTM revenues have increased by 3.2x, indicating significant growth in volumes through well executed organic and inorganic growth.

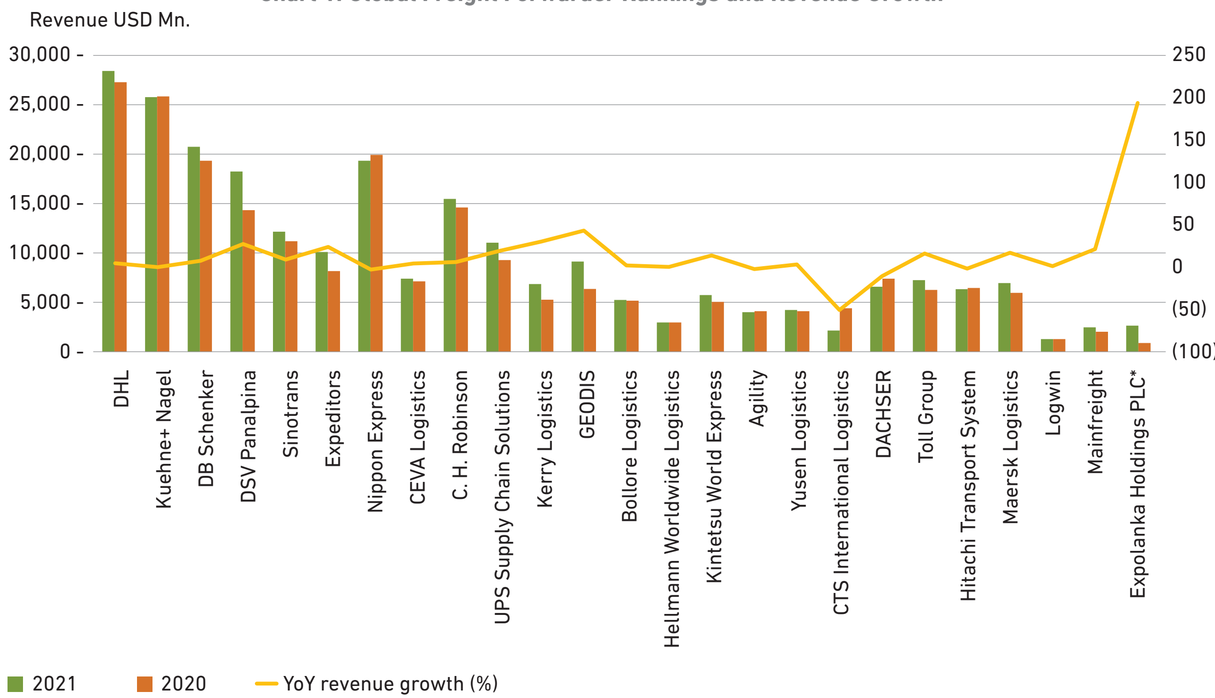
Table 1: Global Freight Forwarder Rankings and Revenue Growth

Armstrong & Associates: Top 25 Global Freight Forwarders List				
Rank in 2021	Provider	Gross Revenue (US$ Millions)* - As at Sep 2021	Gross Revenue (US$ Millions) - As at Sep 2020	YoY growth
1=	DHL Supply Chain & Global Forwarding	28,453	27,302	4.2%
1=	Kuehne + Nagel	25,787	25,875	-0.3%
2=	DB Schenker	20,761	19,349	7.3%
2=	DSV Panalpina	18,269	14,355	27.3%
3	Sinotrans	12,174	11,200	8.7%
4	Expeditors	10,116	8,175	23.7%
5	Nippon Express	19,347	19,953	-3.0%
6	CEVA Logistics	7,416	7,124	4.1%
7=	C.H. Robinson	15,490	14,630	5.9%
7=	UPS Supply Chain Solutions	11,048	9,302	18.8%
8	Kerry Logistics	6,867	5,274	30.2%
9	GEODIS	9,135	6,379	43.2%
10	Bolloré Logistics	5,265	5,180	1.6%

Armstrong & Associates: Top 25 Global Freight Forwarders List				
Rank in 2021	Provider	Gross Revenue (US$ Millions)* - As at Sep 2021	Gross Revenue (US$ Millions) - As at Sep 2020	YoY growth
11	Hellmann Worldwide Logistics	2,972	2,974	-0.1%
12	Kintetsu World Express	5,750	5,067	13.5%
13	Agility	4,018	4,122	-2.5%
14	Yusen Logistics	4,248	4,122	3.1%
15	CTS International Logistics	2,160	4,410	-51.0%
16	DACHSER	6,591	7,400	-10.9%
17	Toll Group	7,260	6,260	16.0%
18	Hitachi Transport System	6,346	6,472	-1.9%
19	Maersk Logistics	6,963	5,965	16.7%
20	Apex Logistics International	2,274		
21	Logwin	1,292	1,280	0.9%
22	Mainfreight	2,467	2,038	21.1%
	Expolanka Holdings PLC	2,651	900	194.5%

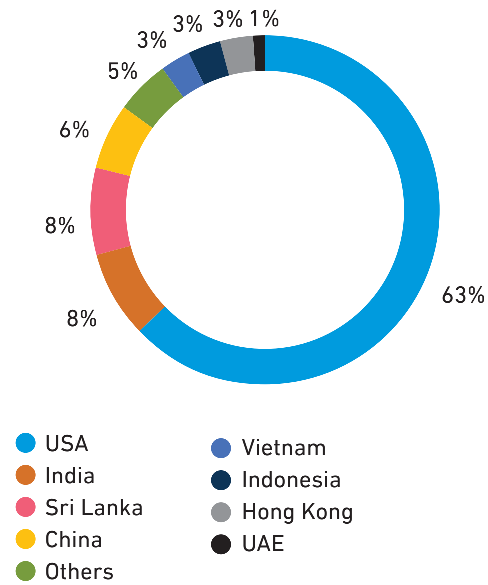
Given the current size of the company, industry rankings and geographic footprint, volume growth beyond these levels is likely to revert towards the industry mean in the absence of further inorganic growth.

Chart 1: Global Freight Forwarder Rankings and Revenue Growth



Source : Armstrong & Associates: Top 25 Global Freight Forwarders List

Chart 2: EXPO Geographic Revenue Breakdown in FY2021



Source: Annual Reports

Methodology and Data Sets

The purpose of this research note is to share our medium term revenue outlook for EXPO. This is not a detailed initiation report as we have not looked at all the other qualitative and quantitative factors that could impact the performance of EXPO. We believe the revenue outlook will be the primary determinant of EXPO's share price performance given the significant run up in the stock over the last two years based on reported revenue and earnings growth supported by both unprecedented industry tailwinds and internal growth.

The revenue of large and geographically diversified freight forwarders such as EXPO would theoretically be a function of the following variables (refer Table 2). Proxies for certain variables have very high dispersion based on historical data. From a long term stock valuation perspective, forecasting out this type of revenue beyond a very short time frame becomes increasingly problematic due to all the possible permutations and combinations arising from the interplay of multiple underlying variables.   We have therefore adopted a Monte Carlo simulation based methodology using 10,000 trials to model the forecast revenue of EXPO over a three year period. We have used appropriate data sets as proxies for certain variables along with our own assumptions as further elaborated.

Shipping and air freight rates are currently 2.7 standard deviations above average historic rates for both air and sea freight as measured by the Drewry Airfreight Average Rate and the WCI Composite Container Freight Benchmark respectively. Therefore we have modelled freight rates assuming a 25% drawdown in air freight prices and a 40% drawdown in sea freight prices at the end of three years. This would place shipping and air freight rates at slightly above one standard deviation from their respective historical averages to account for any lingering logistics and supply chain disruptions coupled with higher inflation globally. These assumptions would seem to be in line with industry opinion.

www.lloydsloadinglist.com/freight-directory/news/Freight-rate-normalisation-will-take-18-30-months/80330.htm
https://www.mckinsey.com/industries/travel-logistics-and-infrastructure/our-insights/when-are-shipping-rates-going-to-normalize

Table 2: Revenue Variables

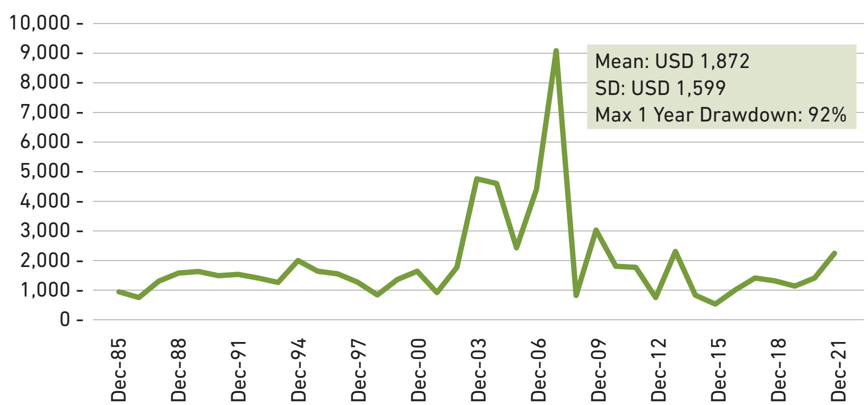
Variable	Proxy/ Forecast Assumption
Global air freight volume growth	Global air freight volume growth in Mn of MT shows stable growth except for drawbacks during periods of global economic downturns. We derive an average annual growth rate of 3.1% with a standard deviation of 7.4% as input values in our simulations.
Global sea freight volume growth	Likewise, global sea freight volume growth in Bn of MT shows very consistent growth except for short pullbacks during global economic downturns. We derive an annual average growth of 3.0% and a standard deviation of 3.1% as input values in our simulations.
Company outperformance/ underperformance relative to industry volume growth	This would be the primary company specific forecast assumption. We have assumed in our base case forecast that given its past track record of growth, EXPO would outperform the cumulative three year volume growth of the industry by 10 – 20 percentage points (15 – 25 percentage points in the bull case forecast) in our simulations.
Air freight price growth	Drewry Airfreight Average Rate would be the most suitable proxy for modelling air freight pricing levels. Given elevated pricing of air freight post pandemic, pricing levels as at end December 2021 is around 2.7 standard deviations above the mean. Therefore we have assumed a 25% drawdown in pricing levels within 3 years, thus reverting to around one standard deviation above the historical mean.
Sea freight price growth	The WCI Composite Container Freight Benchmark is a suitable proxy for modelling sea freight pricing levels. With elevated pricing of sea freight rates post pandemic, pricing levels as at end December 2021 is around 2.7 standard deviations above the mean. Therefore we have assumed a 40% drawdown in pricing levels within 3 years, thus reverting to around one standard deviation above the historical mean.
Depreciation rate of reporting currency against transactional currency	Based on historical data, we derive the average depreciation of the LKR against the USD over a three year period as 17.4% with a standard deviation of 9.1% as inputs in our simulations.

Correlation analysis of EXPO's revenue from 2012 to 2021 against our selected variables shows significantly high positive correlation. Shipping and air freight rates provide the highest explanatory power of EXPO's revenues with correlation coefficients over 0.9 whilst global volume growth also yields positive correlations. This leads us to believe that our revenue model should yield robust results.

Table 3: Correlation Matrix of EXPO Revenue from 2012 to 2021

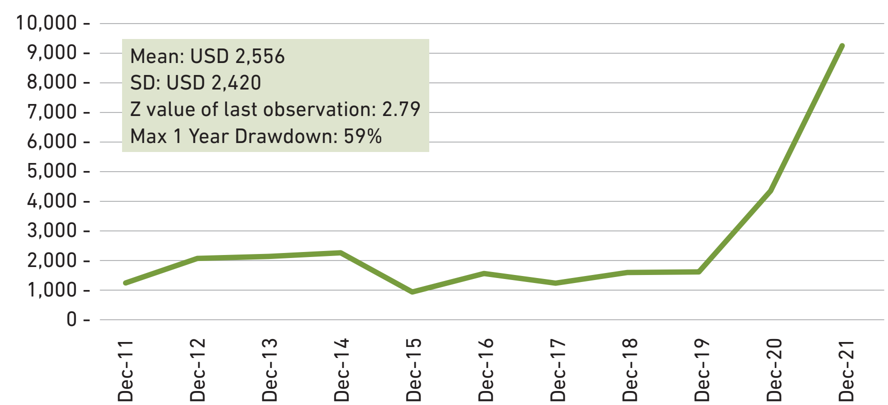
	EXPO Revenue	Drewry Air Freigh Avg Rate	WCI Container Freight Benchmark	Global Air Freight Volume	Global Sea Freight Volume
EXPO Revenue	1.00				
Drewry Air Freigh Avg Rate	0.91	1.00			
WCI Container Freight Benchmark	0.96	0.98	1.00		
Global Air Freight Volume	0.63	0.34	0.45	1.00	
Global Sea Freight Volume	0.49	0.25	0.32	0.92	1.00

Chart 3a: Baltic Dry Index Price in USD



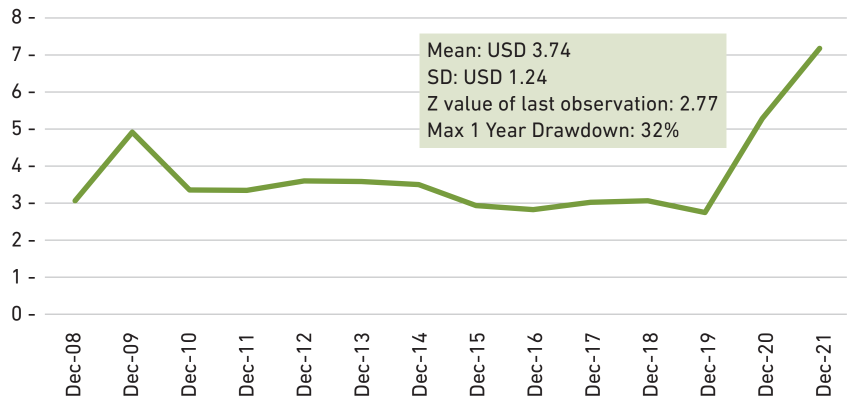
Source : Bloomberg

Chart 3b: WCI Composite Container Freight Benchmark USD per TEU



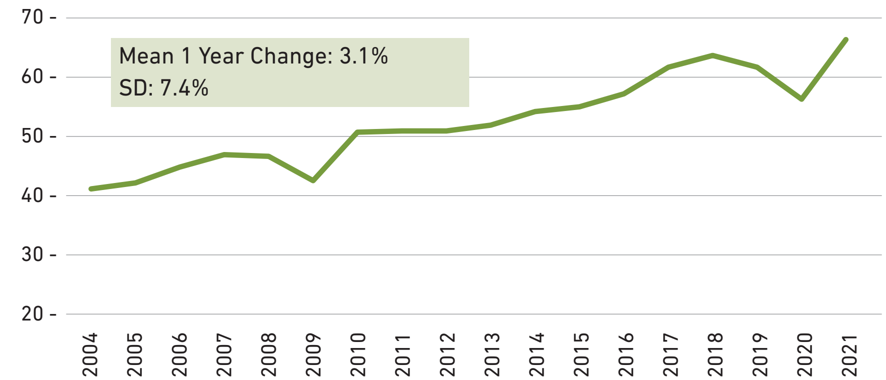
Source : Bloomberg

Chart 3c: Drewry Air Freight Avg. Rate USD per Kg



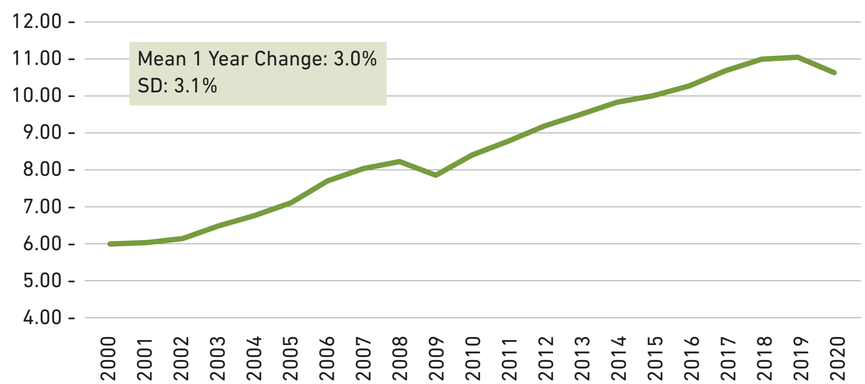
Source : Bloomberg

Chart 3d: Global Air Freight in Mn of MT



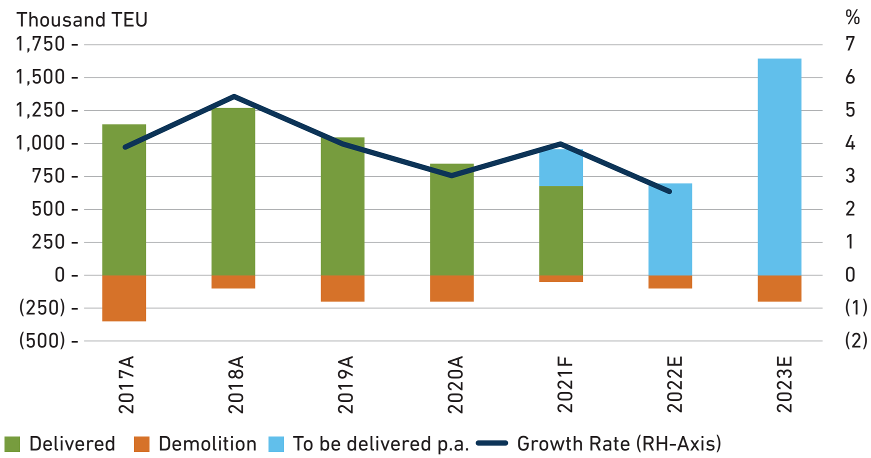
Source : Bloomberg

Chart 3e: Volume of Sea Freight in Bn of MT



Source : Statista

Chart 3f: Container Ship Fleet Growth 2017A-2023E



A: Actual, **F**: Forecast, **E**: Estimate

Source : BIMCO, Clarksons

Expectations of lower shipping charter rates is supported by the large number of container vessels due to enter service in 2023 and 2024.

Forecast Results

We have modelled EXPO's revenues three years forward as a function of the above variables and assumptions through a Monte Carlo simulation, where our primary assumption is that freight rates will revert to around one standard deviation above their historic averages. This yields the following results.

The mean revenue in year three is LKR 751 Bn with a standard deviation of LKR 82 Bn. The probability that annual revenues will be below LKR 700 Bn in year three is 27%, whilst the probability that annual revenues will exceed LKR 800 Bn is 26%. Hence there is a high likelihood that EXPO's annual revenues will fall within the LKR 700 Bn range three years from now, which does not represent a significant upside to the current seasonally adjusted revenue run rate of around LKR 748 Bn. For annual revenues to exceed the forecast levels there would need to be significant organic and inorganic growth beyond our estimated range to offset the anticipated decline in freight rates. We have also looked at more aggressive volume growth estimates for EXPO to account for possible inorganic growth, which forms our bull case forecast. The bull case forecast assumes that EXPO's three year volume growth will exceed the cumulative industry volume growth by 15 to 25 percentage points.

Table 4: Average Forecast Revenue in FY2024/25

	Base Case	Bull Case
Avg Annual Revenue (LKR Bn)	751	781
Standard Deviation (LKR Bn)	82	83
Probability of Revenue < LKR 700 Bn	c. 27%	c. 17%
Probability of Revenue > LKR 800 Bn	c. 26%	c. 40%

Our forecast which is based on a three year timeframe does not imply that EXPO's revenues and earnings will not improve in the near term if shipping and air freight prices remain at current elevated levels. We believe it's highly likely that EXPO will continue to report improved and record earnings through the remainder of 2022. However, given the high likelihood of a reversion to mean in global freight prices over the medium term coupled with the high correlation of EXPO's revenue to prevailing shipping and air freight rates, we believe markets will at some point discount for the potential impact from falling global freight prices once freight rates start to roll back. We believe our assumption of a pullback in shipping and air freight prices to around one standard deviation over historical averages over a period of three years is fairly conservative and leaves room to account for continued logistics and other pandemic related disruptions which are keeping freight rates at elevated levels.

Conclusion

We arrived at our three year price target range of LKR 380 to LKR 460 per share in our base case scenario (LKR 440 to 525 per share in our bull case) by applying net income margin assumptions based on current and historical margins and an exit P/E multiple range based around historical multiples from a global peer set adjusted for a discount for the Sri Lankan market. Our results indicate that the share is probably fully valued at current price levels leaving insufficient upside from a medium term perspective once we discount for the required return on equity. We reiterate our Neutral rating at this point given possible upside catalysts as detailed below.

Chart 4: Peer Set Historical P/E Ratios on TTM Earnings

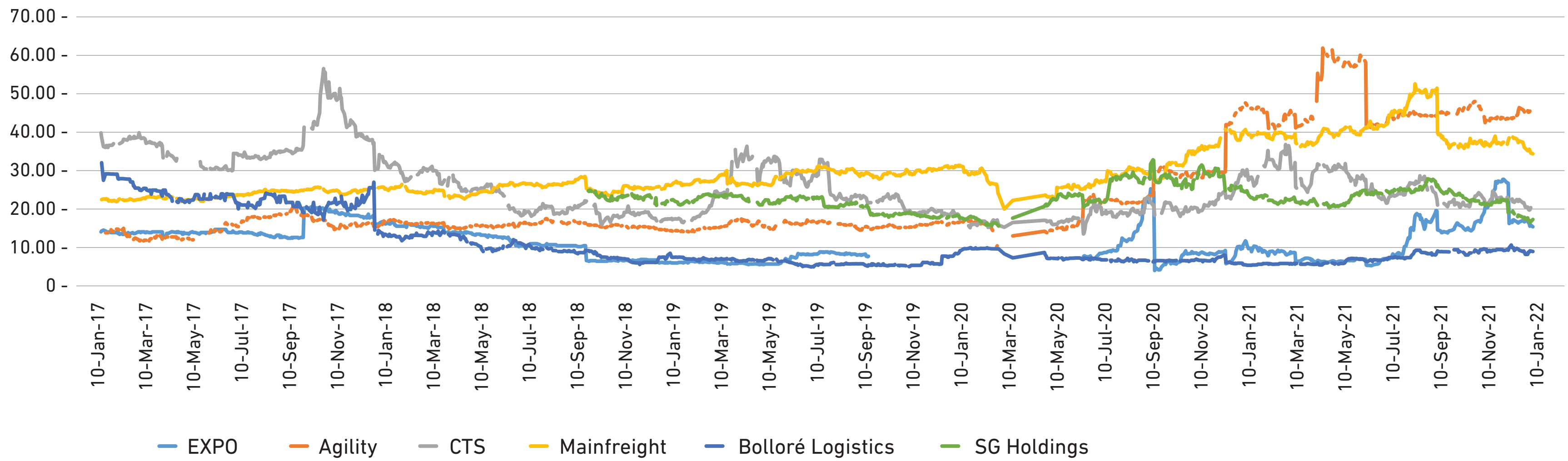


Table 5a: 36-month Target Price Range for Base Case

Avg. Revenue in FY2024/25 (LKR Bn)	751	751	751
Net Income Margin Assumption	8%	9%	10%
Exit P/E Assumption	10x	11x	12x
Market Cap (LKR Bn)	601	743	901
Target Price per Share (LKR)	310	380	460

Table 5b: 36-month Target Price Range for Bull Case

Avg. Revenue in FY2024/25 (LKR Bn)	781	781	781
Net Income Margin Assumption	9%	10%	11%
Exit P/E Assumption	10x	11x	12x
Market Cap (LKR Bn)	703	859	1,031
Target Price per Share (LKR)	360	440	525

Potential upside to our rating would be from continued inorganic growth which may enable EXPO to achieve revenue growth higher than our range estimates, prolonged disruptions to global supply chains which would keep shipping and air freight rates at elevated levels, higher sustained margins and/ or higher depreciation of the LKR against the USD. Downside risks emanate from faster pace of decline in global freight rates, margin compression or slower volume growth than what we have anticipated.

ACUITY
A joint venture of DFCC Bank and HNB

ACUITY Stockbrokers (Pvt) Ltd., (Company Reg: No-P.V.3310)
'ACUITY House', No. 53, Dharmapala Mw,
Colombo 03, Sri Lanka.
TEL: (+94) 112 206 206 | FAX: (+94) 112 206 298

Research Team

Shehan Cooray
(+94) 112 206 256
shehan@acuity.lk

Arun Sarweswaran
(+94) 112 206 251
arun@acuitystockbrokers.com

Jayden Muller
(+94) 112 206 253
jayden@acuitystockbrokers.com

Sales Team

Prashan Fernando
(+94) 112 206 222
prashan@acuitystockbrokers.com
(+94) 772250609

Kapila Pathirage
(+94) 112 206 227/228
kapila.p@acuitystockbrokers.com
(+94) 777660131

Naren Godamunne
(+94) 112 206 225
naren@acuitystockbrokers.com
(+94) 772250603

Dhammika Wanniarachchi
(+94) 112 206 229
dhammika.w@acuitystockbrokers.com
(+94) 771063754

Kumar Dias Desinghe
(+94) 814 474 443
hnbkandy@sltnet.lk
(+94) 777801713

Susil Fernando
(+94) 112 206 234
susil@acuitystockbrokers.com
(+94) 772432110

Auburn Senn
(+94) 112 206 239
auburn@acuitystockbrokers.com
(+94) 714943304

S. Vasanthakumar
(+94) 112 206 250/251
vasantha.k@acuitystockbrokers.com
(+94) 773613285

Prasanna Semasinghe
(+94) 814 474 443
hnbkandy@sltnet.lk
(+94) 773613284

Warana Sumanasena
(+94) 112206 231
warana@acuitystockbrokers.com
(+94) 719553617

Dinuk Subasinghe
(+94) 112206 237
dinuk@acuitystockbrokers.com
(+94) 775877878

Danuksha Koralage
(+94) 112206 233
danuksha@acuitystockbrokers.com
(+94) 777281221

Buddhenia Narangoda
(+94) 112206 248
buddhenia@acuitystockbrokers.com
(+94) 777453640

Disclaimer:

ACUITY

A joint venture of DFCC Bank and HNB