April 14, 2020

ZTO Express (NYSE: ZTO)

C1Q20: rebound, competition and consolidation

- The express delivery industry parcels grew 23% YoY in March, bringing C1Q20 full quarter to grow 3.2% YoY. Our tracking showed ZTO grew parcels by 9.2% YoY, with market share gaining 1.0ppt YoY and 0.3ppt QoQ;
- March marked the return to business as normal for T&D companies. Facing brightened outlook at home (pandemic) and success stories abroad (J&T), we believe the express delivery industry will put consolidation on hold, pick up price war again and mull about expansions overseas;
- We retain ZTO as our top pick with but with TP unchanged

BUY HOLD SELL

Target Price: US$28.0	Current Price: 27.20
RIC: (NYSE: ZTO)	BBG: ZTO US
Market cap (US$ mn)	21,269.00
Average daily volume (US$ mn)	52.9
Shares out/float (m)	575.8/N.A.

Source: Bloomberg, Blue Lotus (as of April 14, 2020)

Industry rebound strongly in March but ASP reversed trend

Our tracking data showed ZTO's C1Q20 parcel volume to be 2.41bn, up 9.2% YoY. After declining 10% YoY in January+February, industry parcel volume grew 23% YoY in March. Comparing to its T&D peers, ZTO resumed work earlier and suffered less in January+February, but its market shares actually declined in these two months, mainly, to SFE. ZTO's strong rebound in March might signal what will follow for its T&D peers while we expect SFE's March parcel market share to return to its pre-pandemic levels (~9%). We expect ZTO's parcel ASP to decline 11% YoY in C1Q20 (Exhibit 6).

Competition rising=consolidation delay=overseas expansion

The success of J&T Express in South East Asia and the launch of JTE (极兔) in Guangdong showed there were ample opportunities to be had in providing logistics service outside of China. However, we don't think JTE, which mostly composed of Oppo/Vivo distributors and Zhongyou Express (众邮), which inherited from UCE (优速) and has the backing of JD.com, will succeed given the enormous entry barrier today. The evident of the global pandemic only vindicated the importance of a comprehensive, flexible and low-cost logistic infrastructure. Chinese logistic company will view this opportunity as the same trend of global trade that has spurred the development of global express delivery Big Four: FedEx, UPS, DHL and TNT fifty years ago. The golden opportunity of expansion has just started, in our view. (TBC)

Key Changes

	New	Old	Diff
BLRI Recommendation	BUY	BUY	-
BLRI Target Price	US$28	US$28	-
2020E EPADS (US$)	6.90	7.80	(11.5%)
2021E EPADS (US$)	9.29	10.03	(7.4%)
2022E EPADS (US$)	12.89	12.56	2.6%

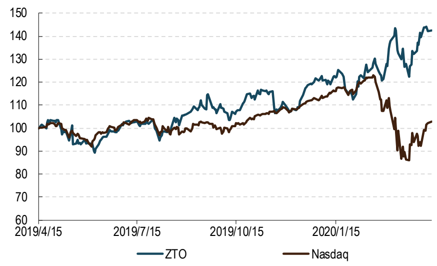
Source: Blue Lotus (as of April 14, 2020)

BLRI vs. The Street

No. of Bloomberg Recommendations	28
Target price vs. Bloomberg mean	(1.2%)
1-year-fwd EPADS vs. Bloomberg mean	(4.8%)
Bloomberg recommendation	4.76

Source: Bloomberg Recommendation, Blue Lotus (1=SELL,23=BUY) (as of April 14, 2020)

Price performance and volume data



Source: Bloomberg (as of April 14, 2020)

Research team

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Summary financial data

Highlights	2017A	2018A	2019E	2020E	2021E
Revenues (RMB mn)	13,060	17,604	22,110	24,615	39,792
Non-GAAP op. profit (RMB mn)	3,789	4,582	5,779	5,692	8,111
Non-GAAP EPADS (RMB)	4.89	5.60	7.58	6.90	9.3
P/E (non-GAAP)	39.0	34.0	25.1	27.6	20.5
Free cash flow yield (%)	(3.01%)	0.93%	1.81%	1.32%	3.67%

Source: Bloomberg, Blue Lotus (as of April 14, 2020)

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All prices are those current at the end of the previous trading session unless otherwise indicated. Prices are sourced from local exchanges via Reuters, Bloomberg and other vendors. Data is sourced from Bloomberg, Blue Lotus Capital Advisors Limited and subject companies. Consensus forward estimates are used in analysis. Past performance is not indicative of future results. Investors should consider this report as only a single factor in making their investment decision.

ZTO Express: Financial Summary

Fiscal year ends-31-Dec

Exhibit 1. Income statement

(RMB mn)	F2019A	F2020E	F2021E
Revenues	22,110	24,615	39,792
Cost of revenues	(15,489)	(17,698)	(29,996)
Gross profit	6,621	6,917	9,796
Gross margin	29.9%	28.1%	24.6%
SG&A	(1,546)	(1,950)	(2,585)
EBIT, non-GAAP	5,779	5,692	8,111
EBIT margin, non-GAAP	26.1%	23.1%	20.4%
Interest income/expense	585	550	-
Non-operating income, net	5,779	5,692	8,111
Profit or loss from equity investments	(12.0)	(12.0)	(6.0)
Foreign currency adjustment	13.3	(25.0)	-
Pretax (Loss)/income	6,745	5,960	8,213
Income taxes expenses	(1,078)	(736)	(1,232)
Net income, GAAP	5,667	5,223	6,981
Net income, non-GAAP	5,983	5,468	7,377
Net margin, non-GAAP	27.1%	22.2%	18.5%
Number of ADS, diluted	790	792	796
EPADS, non-GAAP	7.58	6.90	9.29

Source: ZTO Express, Blue Lotus (as of April 14, 2020)

Company Description

ZTO Express is China's leading delivery operator using the franchise model. In 2019, ZTO had 30K pickup outlets, 4.8K self-operated line-haul trucks, and 91 self-operated sorting hubs. In 2019, delivery, freight forwarding, and sale of accessories contributed 88%, 7.0%, and 4.5% of revenues. In 2019, ZTO's delivery market share (parcel) was 19.1%

Industry View

China delivery industry's parcel volume grew 24% YoY, reaching to 63 bn in 2019. We expect China's delivery industry's parcel volume to grow 21.0% YoY to 76.2bn in 2020, and CAGR from 2018-2020 is 22.3%.

Exhibit 2. Balance sheet

(RMB mn)	F2019A	F2020E	F2021E
Cash and cash equivalents	9,817	11,670	16,884
Restricted cash	590	657	1,062
Accounts receivable	487	542	877
Inventories	61	70	118
Advances to suppliers	446	497	803
Prepayments and other current assets	1,219	1,357	2,194
Amounts due from related parties	18	20	34
Current asset	17,926	20,102	27,261
Investment in equity investees	610	610	610
PPE	9,786	11,216	13,414
Total assets	36,814	41,502	52,452
ST bank borrowing	250	250	250
Accounts payable	1,564	1,770	2,970
Advance from customers	457	518	872
Income tax payable	376	418	676
Amounts due to related parties	195	217	350
Current liabilities	7,340	8,445	14,284
Additional paid-in capital	16,776	17,176	17,576
Retained earnings	16,723	21,946	28,928
Accumulated other comprehensive loss	(13,487)	(17,406)	(21,357)
Total equity	29,228	32,810	37,922
Total liabilities and equity	36,814	41,502	52,453

Source: ZTO Express, Blue Lotus (as of April 14, 2020)

Exhibit 3. Cash flow statement

(RMB mn)	F2019A	F2020E	F2021E
Net income/(loss)	5,667	5,223	6,981
Adjustment			
Depreciation and amortization	1,494	2,078	2,855
Loss on disposal of PPE	36	40	65
Change in working capital	1,103	850	4,299
Net cash used in operating activities	8,264	8,152	14,135
Purchase of property and equipment	(3,316)	(3,446)	(4,974)
Purchase of land use rights	(553)	(615)	(995)
Others	(1,686)	(2,115)	(2,654)
Net cash used in operating activities	(5,555)	(6,176)	(8,623)
Proceeds from capital contribution from shareholders	400	400	400
Proceeds from ST borrowing	-	-	-
Repayment of ST borrowing	-	-	-
Payment of dividends	(567)	(522)	(698)
Purchase of ordinary shares	-	-	-
Net cash used in financing activities	(167)	(122)	(298)
Net increase in cash and cash equivalents	2,542	1,854	5,214
Cash and cash equivalents, beginning of year	7,275	9,817	11,670
Cash and cash equivalents, end of year	9,817	11,670	16,884

Source: ZTO Express, Blue Lotus (as of April 14, 2020)

Can expansion be a driver for express delivery?

Alibaba/Cainiao has achieved lockdown in the express delivery industry against its competitors.

- **Investors seems not ready to accept the expansion story:** Since IPO, investors have focused on the topic whether (1) a collusive price environment can be maintained and, (2) Alibaba will assert an undue influence on China's express delivery industry. We argue that by now these two questions are no longer the right questions. But what constitutes the right questions? It is still unclear at best, unanswerable at worst. We would try to formulate an investment framework as below;

E-commerce and express delivery are the new gospels of global trade, this time from China.

- **Alibaba's investment seems to have bought it a series of veto rights**: In March 31, 2020, market rumoured that Alibaba/Cainiao had bought 5-10% of YUNDA (002120 CH, NR). If it is true, then Alibaba/Cainiao would have taken stakes in all T&D companies, including ZTO, YTO (600233 CH, NR), BEST (BSTI US, NR), YUNDA and Suning (002024 CH, NR), and achieved controlling stake in STO (002468 CH, NR). However, exactly what Alibaba/Cainiao has achieved through this array of minority investments is moot, in our opinion. Pinduoduo (PDD US, HOLD, US$35) still rose under the nose of Alibaba with supports from the express delivery industry, either publicly or secretly. We believe that Alibaba is determined to invest big and win big in logistics. But so far it has only bought a series of veto rights in these companies to lock Tencent/JD/PDD out. Going forward, we believe Alibaba/Cainiao's strategy is to egg on the competition between ZTO and YUNDA with Alibaba/Cainiao's investment as "wedding dowry". We, however, doubt this strategy will work, at least not until Alibaba/Cainiao can show it can run an operation profitability to gain market share in STO. Until that happens, the chance for the express delivery industry to collude is greater than it aligns with an external party. We believe this has become evident in the past few years;

- **What needs to happen for consolidation to occur**? We argue that despite Alibaba/Cainiao's successful investment in almost all express delivery companies, it only bought a veto right to lock competitors out of the industry. To influence the industry's decision to its favour, Alibaba/Cainiao needs to either demonstrate ability to run STO well, or significantly increase the portion of in-house direct GMV, or witnessing industry growth to slow down so that the companies will be seeking exits;

- **What prevents overseas expansion from becoming a major driver of the industry**? As Exhibit 5 shows, the entire SE Asia combined is ~40% of China's population and 20% of China's GDP. The market itself is big enough for immediate expansion but the future lies big in other developing economies like Latin America, India and Africa;

Both Lazada (Alibaba) and Shopee (SEA/Tencent) have established their own logistics operations but gradually both are outsourcing express delivery to external vendors.

- **In-house express delivery is enemy No.1 for express delivery companies in SE Asia**: We estimate the daily parcel volume of J&T Express is ~2.5mn for, giving it a market share of 1.3% if it were in China. J&T has the largest market share in Indonesia. However, if we count the entire SE Asia market, daily parcel volume is around 25-30mn, of which 1/3 belongs to Lazada (Alibaba) and Shopee (SEA/Tencent), 1/3 belongs to social commerce merchants on Facebook, LINE and Instagram and a small portion belongs to Amazon. Therefore, Parcel volume in SE Asia has already reached 13-16% of China's level. Perhaps reflecting the retrospective importance of express delivery, both Lazada (Alibaba) and Shopee (SEA/Tencent) have established express delivery operations in house (LGS and SLS);

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- **As market matures, in-house express delivery is unlikely to sustain**: Because express delivery is a scale driven business, it doesn't make sense to reject parcel pickup simply because it comes from a rival. We believe in the long run, both Lazada and Shopee will likely outsource their express delivery operations;

- **Smartphone plays an important role in pioneering logistic capability into the developing world**: J&T originated from a team from smartphone maker Oppo/Vivo. Its expansion back to China was also carried by Oppo/Vivo distributors. In Africa, Chinese smartphone maker Transsion builds its own factory and distribution hubs, especially in Ethiopia, thanks to its location as Africa's transportation hub;

Chinese business community has started to buy in the notion of Belt And Road Initiative to roll out a common market for Chinese goods.

- **New ways of achieving scalability exists outside of common markets**: China's big market is certainly one of the key determinants for the flourishing of express delivery industry. However, with global trade barriers on the rise, we should see a more fragmented global market, contrary to what Alibaba Chairman Jack Ma has envisioned and strived. We remain observant on whether China's Road and Belt initiative can lower the trade barriers and connect a common market under China's influence;

Chinese business community has started to buy in the notion of Belt And Road Initiative to roll out a common market for Chinese goods.

- **ZTO/COE business impacted by Chinese regulation**: ZTO's COE business illustrated the regulatory uncertainty surrounding the overseas expansion. To our understanding, ZTO's COE (China Oriental Express) business suffered two quarters of consecutive YoY revenue decline because Chinese Customs heightened the inspection ratio of imported parcels. As a result, many merchants cancelled their shipment or change merchandize origination from overseas address to domestic duty-exempt warehouses, cutting delivery fees payable to COE;

- **Freight forwarding is experiencing an e-commerce makeover**: The volatility experienced by COE overlooked the fact that e-commerce packages are replacing ocean liner containers as the carrying medium for commerce worldwide. Before the arrival of e-commerce, importers and exporters arrange bulk shipment via ocean liners. They then connect with offline distributors and retailers to distribute the goods. A freight forwarder like COE helped importers and exporters arrange cross-border logistics. After the arrival of e-commerce, consumers click and buy goods directly from the sites and apps of Amazon, eBay, Taobao/Tmall Global, or Lazada/Shopee. Their purchases are shipped via postal parcels if small or duty-exempt warehouses if large. The complicating factor is where the transaction is tariffed. Postal parcel, through the mechanism of Universal Postal Union (UPU), carries certain weight of duty-free allowance which is now being abused. In our view, postal parcel belongs to the primitive stage of e-commerce and will be replaced by duty-exempt warehouses in both import and export destinations when the volume justifies the infrastructure build. We expect ZTO/COE to register a (10)% YoY decline in revenue in C1Q20 but recovering to 1.5% YoY growth for 2020. From 2020 to 2023 we pencil in a revenue CAGR of 17%;

ZTO/COE will aggressively push into SE Asia in 2020, which we believe will kick in robust growth after C3Q20.

- **Cut short term but raise long term forecast for express delivery industry parcel volume**: We are cutting 2020's express delivery parcel volume growth from 21% to 18% YoY but we are raising 2020-2023 growth rate from 14% to 17% CAGR. We are cutting our 2020 express delivery ASP from (3.0)% to (3.1)% but keep the 2020-23 ASP growth rate at (3.0)% CAGR unchanged;

With pandemic induced new demand we expect the industry to resume its price war in 2020 and beyond.

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With PDD rising as a competition, the bargaining chip of Alibaba/Cainiao must center around enticement rather than punishment.

- **C1Q20 Bloomberg Consensus seems to be overly bearish, but stock price is not:** We forecast C1Q20 top line to decline 3.2% YoY and 35% QoQ to RMB4.44bn, 2.1% above consensus. We forecast non-GAAP EBIT to decline 21% YoY and 55% QoQ to RMB824mn, 51% above consensus. We forecast non-GAAP net income to be RMB801mn, 20% above consensus. For full year 2020, we forecast top line of RMB24.6bn, up 11% YoY and non-GAAP net income of RMB5.5bn, a decline of 8.6% YoY. We believe the global pandemic is short term negative but long-term positive for the express delivery industry and ZTO. It seems the market has already priced in the long-term benefits; (Exhibit 7)

- **ZTO is still our top pick in a price war scenario**: In our view, express delivery with its atomic-level C2C coverage and two-way traffic, has nature advantage over other forms of logistics. ZTO, as the cost and quality leader in express delivery, will steadily gain market share in a price intensive environment. We are raising ZTO's 2020 and 2023 parcel market share from 21.3% and 24.5% to unchanged and 26.3%, respectively. We believe ZTO's parcel market share will eventually top out at 1/3 of the market after Alibaba/Cainiao starting to intervene;

- **SFE launching a franchise delivery network will be the market's biggest wild card**: With YUNDA joining the club of Alibaba/Cainiao investees, the choice left for PDD and SFE will become narrower. Investors have feared that Alibaba/Cainiao will force its investee companies to shut out PDD, which we consider to be highly unlikely because the antitrust implications entailed. But what if Alibaba/Cainiao jointly direct their investees into expanding overseas? We believe both Alibaba/Cainiao and its investees, as well as the Chinese government, will be glad to see such happening. As a closed loop e-commerce + logistics conglomerate, we already know what JD.com will do. But what will SFE do? We believe SFE must expand its market share to keep the cost down. To do so SFE might have to launch another franchise network besides its in-house direct one. However, given SFE's historical records in this regard we cannot be optimistic its happening.

We believe SFE must aggressively pursue parcel market share but more haste can lead to more waste.

Exhibit 4. Cash position of express delivery

(RMB mn)	ZTO	SFE	YUNDA	YTO	BEST	STO
Cash and equiv.	16,360	11,252	1,612	3,478	2,138	2,703
ST invest.	0	0	0	0	1,196	0
LT debt	0	6,870	0	0	18	0
ST debt	0	8,250	910	2,720	108	1,269
Net cash	16,360	(3,868)	702	758	3,208	1,434

Source: ZTO, SFE, YTO, STO, BSTI, Blue Lotus (April 14, 2020)

Exhibit 5. Market characteristics of SE Asia countries

	Indone-sia	Malay-sia	Thail-and	Viet-nam	Phili-ppines	China
Population (mn)	274	33	69	99	109	1,400
GDP (US$ bn)	1,126	370	520	255	356	14,059
GDP per capital (US$ K)	4.11	11.35	7.51	2.59	3.27	10.04

Source: countrymeters.info, tradingeconomics.com (April 14, 2020)

Exhibit 6. China express delivery industry model by quarter

(mn or RMB mn)	1Q18A	2Q18A	3Q18A	4Q18A	1Q19A	2Q19A	3Q19A	4Q19A	1Q20E	2017A	2018A	2019A
Parcel Volume	9,920	12,163	12,656	15,974	12,143	15,610	16,150	19,610	12,530	40,060	50,712	63,513
YoY	*31%*	*25%*	*25%*	*26%*	*22%*	*28%*	*28%*	*23%*	*3.2%*	28.1%	26.6%	25.2%
Industry Revenue	127,140	147,360	150,130	179,210	154,300	185,380	187,440	222,690	153,400	495,710	603,840	749,810
YoY	*29%*	*23%*	*21%*	*17%*	*21%*	*26%*	*25%*	*24%*	*(0.6%)*	24.7%	21.8%	24.2%
Parcel ARPU	12.82	12.12	11.86	11.22	12.71	11.88	11.61	11.36	12.24	12.37	11.91	11.81
YoY	*(1.3%)*	*(1.5%)*	*(3.8%)*	*(7.2%)*	*(0.9%)*	*(2.0%)*	*(2.2%)*	*1.2%*	*(3.7%)*	(2.6%)	(3.8%)	(0.9%)
Parcel Volume (mn)												
ZTO	1,601	2,098	2,088	2,744	2,207	3,082	3,096	3,716	2,410	6,267	8,531	12,101
Best Inc.	938	1,336	1,496	1,868	1,398	2,049	2,241	2,438	NA	3,769	5,638	8,126
YTO	1,198	1,624	1,630	2,221	1,657	2,145	2,349	2,964	NA	5,102	6,673	9,115
SFE	915	942	945	1,049	976	1,045	1,224	1,590	NA	3,052	3,851	4,835
YUNDA	1,261	1,734	1,768	2,222	1,784	2,550	2,599	3,097	NA	4,696	6,985	10,030
STO	880	1,166	1,333	1,733	1,278	1,733	2,036	2,323	NA	3,898	5,112	7,370
Parcel volume market share												
ZTO	16.1%	17.2%	16.5%	17.2%	18.2%	19.7%	19.2%	18.9%	19.2%	15.6%	16.8%	19.1%
Best logistics	9.5%	11.0%	11.8%	11.7%	11.5%	13.1%	13.9%	12.4%	NA	9.4%	11.1%	12.8%
YTO	12.1%	13.4%	12.9%	13.9%	13.6%	13.7%	14.5%	15.1%	NA	12.7%	13.2%	14.4%
SFE	9.2%	7.7%	7.5%	6.6%	8.0%	6.7%	7.6%	8.1%	NA	7.6%	7.6%	7.6%
Yunda	12.7%	14.3%	14.0%	13.9%	14.7%	16.3%	16.1%	15.8%	NA	11.7%	13.8%	15.8%
STO	8.9%	9.6%	10.5%	10.8%	10.5%	11.1%	12.6%	11.8%	NA	9.7%	10.1%	11.6%
Others	31.5%	26.8%	26.8%	25.9%	23.4%	19.3%	16.1%	17.8%	NA	33.1%	27.5%	18.8%

Source: China Post Bureau, ZTO, BSTI, YTO, SFE, YUNDA, STO, Blue Lotus (April 14, 2020)

Exhibit 7. ZTO C1Q20 Preview

(RMB mn)	1Q20E	1Q20C	E vs Cons.	4Q19A	QoQ	1Q19A	YoY	2Q20E	2Q20C	E vs Cons.
Revenues	**4,430**	**4,341**	**2.05%**	**6,847**	**(35.3%)**	**4,574**	**(3.2%)**	**5,897**	**6,485**	**(9.07%)**
Cost of revenues	(3,328)			(4,850)	(31.4%)	(3,314)	0.4%	(4,076)		
Gross profit	1,102	881	25.0%	1,996	(44.8%)	1,260	(12.5%)	1,821		
Gross margin	24.9%	20.3%	4.57ppt	29.2%	(4.28ppt)	27.5%	(2.67ppt)	30.9%	31%	
SG&A	(598)			(392)	52.4%	(558)	7.2%	(428)		
Share-based compensation	(200)			(10.8)		(284)	(29.6%)	(15.0)		
EBIT, GAAP	624	231	170%	1,810	(65.5%)	760	(17.9%)	1,513	1,757	(13.9%)
EBIT margin, GAAP	14.1%	5.3%	8.77ppt	26.4%	(12.3ppt)	16.6%	(2.53ppt)	25.7%	27.1%	(1.43ppt)
EBIT, non-GAAP	824	545	51.2%	1,820	(54.7%)	1,044	(21.1%)	1,528	2,011	(24.0%)
EBIT margin, non-GAAP	18.6%	12.6%	6.05ppt	26.6%	(7.99ppt)	22.8%	(4.23ppt)	25.9%	31.0%	(5.10ppt)
Interest income/expense	100			148	(32.5%)	146	(31.7%)	150		
Profit or loss from equity				-		(6.40)		(5.61)		
Pretax (Loss)/income	708	586	20.8%	2,642	(73.2%)	874	(19.0%)	1,652	2,055	(19.6%)
Pre-tax margin	16.0%			38.6%		19.1%		28.0%		
Income taxes expenses	(106)			(331)	(68.0%)	(192)	(44.7%)	(198)		
Effective tax rate	15.0%			12.5%		22.0%		12.0%		
Net income, GAAP	601			2,317	(74.0%)	682	(11.8%)	1,454		
Net margin	13.6%			33.8%	(20.3ppt)	14.9%	(1.32ppt)	24.7%		
Net income, non-GAAP	801	669	19.7%	1,632	(50.9%)	966	(17.1%)	1,469	1,696	(13.4%)
Net margin, non-GAAP	18.1%	15.4%	2.67ppt	23.8%	(5.74ppt)	21.1%	(3.04ppt)	24.9%	26.2%	(1.24ppt)
EPADS (RMB), non-GAAP	1.02	0.82	24.1%	2.09	(51.2%)	1.23	(17.2%)	1.85	2.12	(12.6%)
Operating matrices										
Delivery parcels (mn)	2,443			3,692	(33.8%)	2,264	7.9%	3,901		
Delivery parcel ASP (RMB)	1.60			1.65	(3.5%)	1.79	(11%)	1.33		

Source: ZTO, Blue Lotus (April 14, 2020)

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