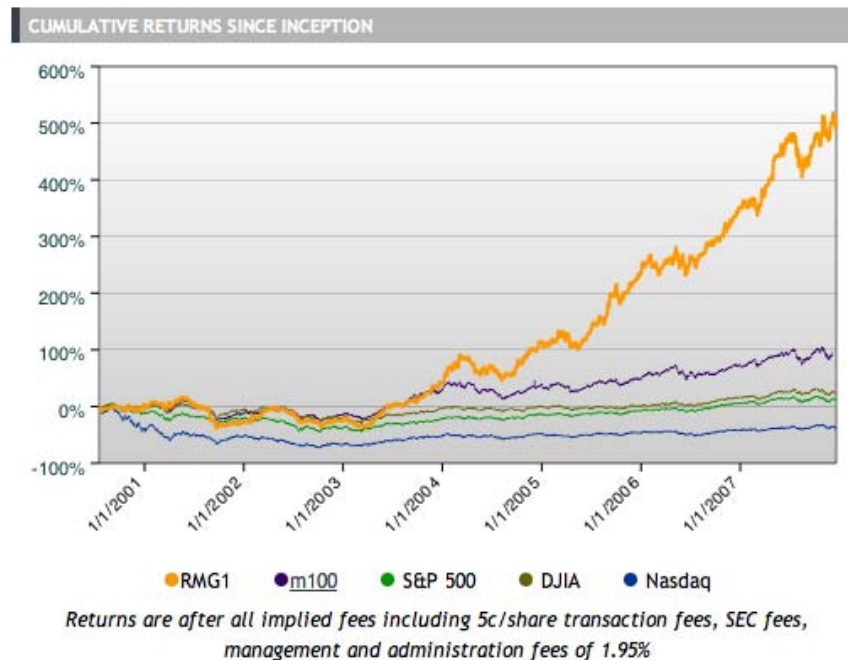


## Guanshen Railway and Novo Nordisk

These stocks were presented by Randolph McDuff to a gathering of the m100 held on October 6 and 7. Mr. McDuff is one of Marketocracy's top m100 members and the best performing mFOLIO master this year. Over the 6 plus years we've been tracking his performance his RMG1 portfolio has averaged over 27% a year and is up over 33% this year.



**RECENT RETURNS**

	12/20/07	MTD	QTD	YTD
<b>RMG1</b>	0.06%	0.22%	6.74%	33.34%
<b>S&amp;P 500</b>	0.49%	-0.47%	-4.21%	4.85%
<b>DOW</b>	0.29%	-0.94%	-4.68%	6.28%
<b>Nasdaq</b>	1.53%	-0.76%	-2.24%	9.34%

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For information about investing in a Marketocracy mFOLIO, [click here](#)

Guangshen Railroad (GSH) NYSE \$41.88

All amounts are expressed in US dollars. Guangshen railway reports in Chinese Yuan, which is converted at the rate of 1 Yuan = \$.1332 US

Shares outstanding: 141.7 million.

Total liabilities – short term assets (\$447 million)

Enterprise Value: \$6.38 billion

2006 EBITDA: \$161.3 million

2007 Forecast EBITDA: \$380 million

2008 Forecast EBITDA: \$420 million

Forecast 2007 closing EV/EBITDA: 16.5X

Forecast 2008 closing EV/EBITDA: 14.5X

**Guangshen Railroad (GSH) operates a railroad in the richest region of China.**

The population of Guangdong province is estimated at 110 million people. 2007 GDP in the province is estimated at \$3,800 US per person, roughly 55% higher than the national average. Economic growth in Guangdong has also historically surpassed the average growth of China. In 2006 Chinese GDP growth was 11.1%

GSH operates high speed and regular speed rail lines between Guangzhou and Shenzhen which total 147 km of track, stations and related infrastructure. A recent acquisition has added a further 334 km of regular speed line, making GSH a major trunk line operator in China. As GSH has invested heavily over the past decade to build state of the art infrastructure, its rail system is widely considered to be the most modern in all China.

Guangshen trunk lines connect with lines running to Beijing and also to Kowloon, Hong Kong.

GSH may set its own prices for high speed rail fares and is allowed to charge a premium of up to 225% of national price levels. The firm is also allowed to charge up to 150% of national price levels for freight. This provides GSH with the opportunity to increase operating income at levels that exceed inflation.

In 2006, GSH transported 51.9 million passengers. Over the past five years, passenger counts have increased by an average of 6% per year. The PRC presently owns 41% of the outstanding shares.

**A transformational acquisition, coupled with a recently completed expansion, should sharply accelerate growth in the near term.**

More than a doubling of revenue and EBITDA should occur. This will result from a highly accretive acquisition concluded early in 2007. A \$600 million expansion program of the Guangzhou-Shenzhen line has been brought on line, 6 months ahead of schedule.

**Guangshen recently purchased the Guanzhou-Pingshi railway for a bargain price.**

Effective January 1<sup>st</sup>, 2007, GSH became the owner of the Yangcheng Railway Company. This added rail lines from Guangzhou to Pingshi and related infrastructure. The rail lines will increase markedly, from 152 km to 481.2 kms. Whereas the Guanzhou-Shenzhen lines were predominantly passenger trains, the acquired businesses have a more balanced mix of freight and passenger revenues.

The total cost of this acquisition was \$1.343 billion US. According to first half results, it appears that this purchase was completed for roughly 7.6X EBITDA, *a considerable discount to recent US transactions.* The most recent North American rail transaction (CP purchase of DM&E) was priced at 19.7X EBITDA.

GSH will work to modernize the acquired operations. The firm also intends to increase passenger ticket prices at the new division.

Overall, this purchase appears to be *sharply accretive* to both the top and bottom line of GSH.

**Earnings in 2007 will gather steam with revenue from the new 4<sup>th</sup> line between Guangzhou-Shenzhen.**

This 4<sup>th</sup> line has been operational since April 8<sup>th</sup>, 2007. The 146.7 km corridor was completed a total cost estimated to be \$600 million U.S. This allows GSH to handle up to 19% more passengers between Guangzhou and Shenzhen, and considerably more freight.

**The six month 2007 financial report provides a glimpse of what may lie ahead.**

For the first half of 2007, revenue was \$611.2 million, up from \$230.5 million for the first half of 2006

In the first half of 2007, EBITDA rose to \$178.7 million US, up from \$84.1 million in the first half of 2006. On a per share basis, EBITDA was \$1.26 vs. \$.97

EPS was \$1.11 U.S. per share in 2006. For the first half of 2007, EPS was \$.70 per share.

GSH had completed a share issue early in 2007, to provide cash for the Yangcheng railway purchase. This increased the share count (YOY), from 86.7 million shares, to

141.7 million. This explains the discrepancy between the revenue and EBITDA growth on an absolute basis, vs. the per share numbers I have reported.

**Based upon the impressive financial results, investors might be surprised to know that the 6 month 2007 results were NEGATIVELY impacted by the transition.**

Schedule interruptions occurred at Guangzhou in the first four months of 2007, due to the final completion of the 4<sup>th</sup> line, which is adjacent to the first 3 lines. EBITDA margins for 2006 averaged 35.7% of revenues, while in the first half of 2007, EBITDA margins were just 28.7% of revenues.

The disruptions are now over, and 19% more high speed trains are operated daily. I predict very robust 2<sup>nd</sup> half 2007 comparisons

**A representative peer sample for appraisal does not exist.**

Guangshen primarily moves people, not freight, and is the only public railroad in China at present. North American rails that I follow (CP, CNI, KSU, BNI, U, NSC and CSX) are freight railways. The difference between a freight railway and a commuter railway lies in sensitivity to economic growth and changing commodity cycles. Consequently, one should be reluctant to use an “apples to apples” comparison when evaluating GSH to the North American rails.

There are also important balance sheet differences. The average North American railroad carries a significant amount of financial leverage (39%). GSH has a conservative balance sheet, and has only recently added a 6.5% debt component to its enterprise value. The debt was largely an assumption of liabilities with the Guangzhou-Pingshi line with some credit lines utilized to accelerate the opening of the 4<sup>th</sup> Shenzhen line. Management expresses some discomfort with leverage. It is likely that cash flow will be used towards an improvement in financial ratios over the next year.

### **Comparison**

GSH now sells for roughly 16.5X my estimated 2007 year end EV/EBITDA. I forecast that 2008 EBITDA could touch \$420-\$430 million, which prices the stock at 15.3-15.5X my 2008 EV/EBITDA estimate.

**CP:** 10.9X estimated 2007 EV/EBITDA. 10.4X estimated 2008 EV/EBITDA. EV is 35.3% debt. EBITDA margins were 33.2% of revenues.

**CNI:** 12.2X estimated 2007 EV/EBITDA. 11.6X estimated 2008 EV/EBITDA. EV is 30% debt. EBITDA margins were 43.5% of revenues.

**KSU:** 11.4X estimated 2007 EV/EBITDA. 10.8X estimated 2008 EV/EBITDA. EV is 46% debt. EBITDA margins were 27% of revenues.

**BNI**: 11.5X estimated 2007 EV/EBITDA. 10.8X estimated 2008 EV/EBITDA. EV is 40% debt. EBITDA margins were 28.8% of revenues.

**UNP**: 11.6X estimated 2007 EV/EBITDA. 10.9X estimated 2008 EV/EBITDA. EV is 39% debt. EBITDA margins were 27.3% of revenues.

**NSC**: 10.9X estimated 2007 EV/EBITDA. 10.4X estimated 2008 EV/EBITDA. EV is 40% debt. EBITDA margins were 34.6% of revenues.

**CSX**: 10.8X estimated 2007 EV/EBITDA. 10.4X estimated 2008 EV/EBITDA. EV is 40% debt. EBITDA margins were 31% of revenues.

Group average 2007 EV/EBITDA: 11.3X

Group average 2008 EV/EBITDA: 10.5X

Group average EBITDA margins: 32.2%

Recently, it was reported that Long Beach shipping statistics showed a 2.2% decline in tracking shipments YTD. To me, this suggests that consensus estimates for North American railroads may be optimistic.

North American railroads are well covered by Wall Street. They make excellent corporate clients, due to their leveraged balance sheets and hedging strategies on inputs.

### **Conclusion:**

Guangshen Railroad is more expensive than North American peers on an EV/EBITDA basis. Offsetting this premium valuation is the fact that GSH has just a fraction of the financial leverage of the more widely known counterparts. The company also has superior growth prospects in the near term to any other railroad that I follow.

Looking into 2008, as the simultaneous revenue accretion from the expansion and acquisition become evident, the shares of Guangshen may look increasingly desirable as a growth play on China. Should EBITDA margins revert to norm, my forecast may prove to be conservative.

I consider GSH to be an emerging growth investment nestled among cyclical peers. Guangshen is the 3<sup>rd</sup> largest holding in RMG#2, and I own shares personally.

**Novo Nordisk: (NVO \$120.04 on 10/03/07): High Quality Growth**

All amounts are expressed in US dollars, and are converted from Danish Krone to US dollars at the rate of 1 Krone = \$.1909 US

Shares outstanding (fully diluted) 320 million  
Current assets – total liabilities (est. on 09/30/07): \$1.7 billion.

Est. 2007 exit EV: \$36.5 billion  
Estimated 2007 EBITDA: \$ 2.53 billion.

Est. 2008 exit EV: \$35.3 billion  
Estimated 2008 EBITDA: \$ 2.9 billion

Estimated 2009 exit EV: \$34.0 billion.  
Estimated EBITDA: \$ 3.38 billion

Estimated 2007 exit EV/EBITDA: 14.4X  
Estimated 2008 exit EV/EBITDA: 12.2X  
Estimated 2009 exit EV/EBITDA: 10.06X

**Novo Nordisk is the world's leading pharmaceutical company specializing in diabetes care.**

NVO sells and produces a wide range of insulin and diabetes products and pharmaceuticals. Total market share on a global basis continues to grow.

Novo is also the world's leading producer of haemophilia inhibitors, the world's 2<sup>nd</sup> largest producer of human growth hormone and produces hormone replacement therapy drugs.

Market share in North America for insulin is presently estimated at 43%, and NVO holds a commanding 57% of the European insulin market. In international markets, NVO holds a 57% market share. In Japan and Australia, NVO's market share is 75%.

67% of sales were made outside of North America in the first half of 2007.

**By all accounts, revenues and margins are growing at an impressive pace.**

Revenues for the 1<sup>st</sup> half of 2007 were \$3.9 billion US; up by 9.1% over the same period for 2006. EBITDA was \$1.18 billion from regular operations. On a year over year basis, EBITDA grew by 12.9%. Margins for the first half of 2007 were 30.2%, and had grown to 31.5% in the second quarter of 2007.

Management of NVO notes that margins are likely to remain stable/improve for the balance of the year.

Novo anticipates that sales growth will accelerate for the latter half of 2007. Management targets 15% revenue growth for several years to come. I would note that management has historically exceeded targets handily.

**NVO has a blockbuster drug in the wings.**

Liraglutide is an insulin product now in late stage phase 3 testing. The drug triggers the release of insulin, and also reduces appetite.

There is a growing view that Liraglutide is statistically superior to insulin glitide (Lantus), both in terms of blood glucose control and weight loss. 4 separate phase three trials have clearly and definitively proven significant efficacy when compared to the present market leading drug.

Aside from the benefits of using Liraglutide vs. Lantus; it was also revealed Liraglutide's ability to control weight is such; Liraglutide is now enrolled in phase 2 trials as a weight loss drug.

Lantus is produced by Aventis-Sanofi. Global sales are of Lantus forecast to exceed \$2.8 billion US in 2007

Approval of Liraglutide for diabetes management should produce incremental revenues of \$1 billion + in short order and could rapidly displace Lantus. FDA clearance for use of Liraglutide as a weight management drug could propel sales 2-3X above this forecast.

Perhaps (at least partially) in anticipation of a potential FDA approval for Liraglutide within the next 12 months, NVO has elected to increase the number of US sales reps by 600 persons, or 46%.

The big loser will be Sanofi-Aventis upon rollout of Liraglutide.

**No weak points exist in the existing product profile.**

There are no major products scheduled to go "off patent within the next 5 years, and many of the products now selling are still ramping up in terms of sales. No major drug producer (that I am aware of), features such portfolio stability.

**I am pleased to report that Wall Street virtually ignores NVO in terms of research.**

Yahoo indicates that just 3 US brokerage firms cover Novo Nordisk, up from 2 a few months ago.

By way of comparison, SGP, a firm with only a slightly larger market cap, has 17 firms providing coverage. TEVA, a firm with a much smaller market cap, has a following of 23 analysts. LLY, a firm with a market cap about 65% larger than NVO, has a total of 19 analysts who cover the company.

**Some of Wall Street's indifference may be linked to an INTEGRATED investment banking model employed at most major investment firms.**

Wall Street has a marked preference towards providing coverage on US listed firms which can be "cross-sold" a variety of investment banking services. This includes M&A services, debt management services and/or equity undertakings. On occasion, major brokerage firms extend the courtesy of providing research on stocks that don't fit their revenue model, but which are included in major North American indexes.

Novo Nordisk meets none of those criteria. While the firm has a \$38 billion + market cap, US investment firms aren't interested in a debt free European company, not present in a North American index, which buys back stock using cash flow...rather than make acquisitions. When one combines the terms "European" & "debt free" with "non-acquisitive", it is almost assured that top drawer US research will be difficult to come by.

**The "politics" of Wall Street may also explain why US coverage on NOVO is limited.**

Novo Nordisk is the number #1 competitor for several US pharmaceutical firms considered to be core investment banking clients of leading brokerage firms (LLY, PFE & Sanofi-Aventis).

LLY used to be the world's largest producer of modern insulin, but lost this status to NVO roughly 2 years ago. PFE risks being displaced by NVO as the largest producer worldwide of human growth hormone. Sanofi's franchise may be in tatters upon release of Liraglutide. Public, positive coverage of NVO would be disruptive for these companies, in a myriad of ways.

The investment banking relationships that US firms have with NVO's large pharma competitors are strong. Even should brokerage analysts privately find NVO to be of their liking; it might be impossible for them to produce a report which would rate this company above peers.

Glowing appraisals of Novo Nordisk vs. important US clients could damage longstanding business relationships.

Consequently, in the various peer comparisons put forth, I believe that Novo's current and future prospects are generally talked "down" whereas US firms are generally talked "up".

**All this understatement makes Novo Nordisk a reasonably priced blue chip for the long term.**

Wall Street's tightening constraints, with respect to their research departments, create opportunities for those who understand the integrated research model.

Therefore, I can attest that NVO represents one of the highest quality "large" NYSE listed pharmaceutical companies in the world, with the absolute lowest profile on Wall Street.

**The ADR's will split 2 for 1 later this year.**

This may improve liquidity somewhat, and potentially lead to a wider investment following.

**I consider Novo Nordisk to be THE core holding among large cap pharmaceutical companies.**

Most US drug firms carry financial leverage. This leverage largely accounts for the reason that US firms sport a lower p/e ratio than NVO. Many pharmaceutical firms bury debt "off balance sheet" in the form of joint venture research partnerships.

Several important US drug companies have unquantified potential for liabilities, due to pending litigation. Legal costs eat up valuable cash flow, even when unfounded. I try to avoid "litigation heavy" stocks.

In contrast, Novo Nordisk sells for no more than the average large cap pharmaceutical firm on a forward EV/EBITDA basis. The company throws off a prodigious amount of cash and is litigation light. The balance sheet is flawless and the earnings quality is very high.

**Diabetes appears to be the fastest growing medical condition in the world today and represents an industry that I wish to participate in.**

If approved for diabetes care, Liraglutide has the potential to quickly increase NVO's annual revenues by at least 15%, and annual EBITDA by 23-25%. This would be over and above my existing forecast. I won't even hazard a guess as to how revenues might ramp up, if the drug is **ALSO** cleared for weight loss.

## **Conclusion**

Worldwide demand for insulin is expected to grow by 6%+ per year for many years to come, and I want to benefit from this trend. My preferred investment for participation in this business is NVO.

I consider Novo Nordisk to be a "best in class" company. The share price has demonstrated superior growth for the past 12 months. It now sells for an EV/EBITDA ratios similar to the average large pharma, in the near term. However, based upon its sturdy balance sheet, high quality portfolio and impressive growth outlook, I regard NVO as being attractively priced.

A potential rollout of Liraglutide within the next 24 months should render my forecast as being conservative.

Disclosure: I own shares personally, and NVO represents the second largest position of RMG#1.