

Natural Beauty Bio-Tech: Growth spurt

Recommendation: BUY (unchanged)

China Consumer

Price	HK\$1.87	Year to Net profit	EPS	EPS	P/E	P/B	EV/EBITDA	Yield	ROE	ROCE	N. Gear.	
Target price	HK\$2.86 (+52.9)	Dec	HK\$m	HK\$	Δ %	x	x	x	%	%	%	
12 mth range	HK\$0.82-2.15	05A	81.1	0.041	28.2	46.1	4.6	21.2	1.8	10.1	14.8	Cash
Market cap.	US\$479.49m	06A	123.2	0.062	51.9	30.4	4.1	17.6	2.1	14.3	20.1	Cash
Daily t/o, 3 mth	US\$0.21m	07F	172.1	0.086	39.7	21.7	4.2	13.6	6.0	19.2	23.7	Cash
Free float %	30.0%	08F	228.8	0.114	32.9	16.3	4.0	11.0	7.3	25.2	31.3	Cash
Ticker	0157.HK/0157 HK	09F	284.8	0.142	24.5	13.1	4.1	10.3	8.7	30.8	38.1	Cash

Relative to Hang Seng Index (1 mth, 3 mth, 12 mth): -20.8% -17.2%, +27.3%

Actual price changes (1 mth, 3 mth, 12 mth): -5.1%, +6.9%, +107.8%

Consensus EPS (07F-08F): HK\$0.083, HK\$0.096

Previous forecasts (07F-08F): HK\$150.2m (\$0.075), HK\$185.1m (\$0.093), HK\$218.3m (\$0.109)

Key points:

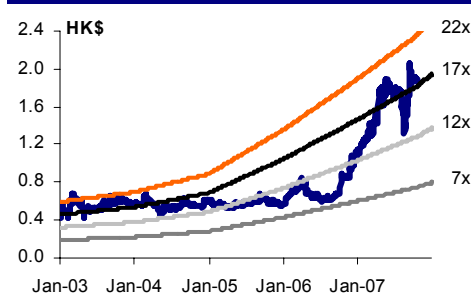
- Double-digit growth in average store sales in China in FY12/07F expected
- Fonperi, new product in Taiwan, set to capture 1.0-2.0% of the market in the next three years.
- New management team in Taiwan targets single-digit growth in sales in FY12/07F.
- Gross margin to widen further thanks to the introduction of high-end products.
- Payout ratio of 135.0% is well supported by net cash of more than HK\$500.0m (HK\$0.25 per share).
- Net profit to increase 14.5% in FY12/07F, 23.6% in FY12/08F and 21.3% in FY12/08F.
- Trading at only 16.3x P/E for FY12/08F and ex-cash P/E of 14.2x, based on our new profit estimates.
- Our new target price at HK\$2.86, from HK\$2.20, represents 52.9% upside potential.

Growth momentum intact. After a 50.4% net profit growth in 1H FY12/07A, Natural Beauty (NB) expects strong sales in 3Q FY12/07A. Its average store sales are expected to see double-digit growth in China and single digit growth in Taiwan in FY12/07A.

Strong growth from new products. NB's new brand, Fonperi, launched in April 2006, is sold at 1,100 retail outlets such as hypermarkets and drugstores as well as wholesalers in Taiwan. Since its launch, more than 116,000 Fonperi products have been sold for a total of HK\$5.4m. The company expects Fonperi's turnover to reach HK\$15.0m by end-2007 and the brand to capture 1.0 – 2.0% of Taiwan's retail skin-care market in the medium term. Operating profit in Taiwan reached HK\$17.7m, up 48.3%, in 1H FY12/07A. NB may introduce Fonperi to China in the near future. The operating margin of Fonperi products is expected to exceed the current 40.0% when the company achieves large economies of scale.

China - key driver. Accounting for 72.0% of the company's total turnover, China sales grew 22.5% in 1H FY12/07 and should see at least double-digit growth in the whole of 2007. In 1H07A, NB operated 1,710 stores in China. Its average sales per store reached HK\$82,000.0 in 1H (+13.9% YoY).

Chart 1: P/E bands



Source: SBI E2-Capital

Table 1: Average sales per store

Year to Dec	2003	2004	2005	2006	1H 2006	1H 2007	1H YoY (%)
China	122,000	133,000	139,000	148,000	72,000	82,000	13.9
Taiwan	175,000	237,000	259,000	220,000**	87,000	92,000	5.7
Total*	138,000	161,000	169,000	166,000	76,000	84,000	10.5

Source: Company data

*Does not include Hong Kong and Malaysia turnover

**Excluded 161 new retail outlets.

Table 2: Distribution channels

Six months to Jun	Franchisee owned spas	Entrusted		Self owned		Group Total	Retail channel	Grand Total
		Spas	Counters	Spas	Counters			
PRC	1,613	21	19	5	52	1,710	-	1,710
Taiwan	468	-	-	9	-	477	1,100	1,577
Others	51	-	-	1	-	52	-	52
Total	2,132	21	19	15	52	2,239	1,100	3,339

Source: Company data

Store revamp continues. The company renovated 1,646 franchised stores, or 83.9% of the total in Taiwan and 76.0% in China. The revamp enhanced the average sales per store by 13.9% to HK\$82,000.0 in China and 5.7% to HK\$92,000.0 in Taiwan. The average sales per store reached HK\$84,000.0, up 10.5% YoY, in 1H FY12/07A. Same store sales growth reached 14.0% in China and 6.9% in Taiwan. The remainder of the stores will undergo refurbishment soon to comply with the chain's uniform look.

Gross margin enhancement. NB has further improved its gross margins through 1) introduction of new high-margin products with higher ASPs and 2) cost savings from product repackaging which usually accounts of 30.0% of its cost of goods sold. Currently around 40.0% of all products have been repackaged. The company reduced the number of its package forms from over 200 to 24 for 314 products (204 China products and 110 Taiwan products). The exercise reduced and cost of packaging and improved the gross margin. The product-operating margin increased to 88.7%, up 4.3pcp. Management expects the overall gross margin to stay about 83.8% in FY12/07F.

Effective cost control. Despite increasing staff costs, other operational costs are under control. Advertising and promotional expenses accounted for 12.6% of total turnover in 1H FY12/07A, decreased from 14.1% in 1H FY12/06A and should be capped at below 20.0% of total turnover. Distribution costs accounted for 30.0% of total turnover in 1H FY12/07A and should stay at the current level of not more than 35.0%.

Vertical integrator. NB's business model is very fully integrated ranging from research and development, in-house production with production plants in Taipei and Shanghai with a total area of 7,866 sqm. More importantly they have taken over the operation of its warehouse, inventory and logistics management from China Post, which it used to collaborate with since 2005. Different from other cosmetic retailer brand, they distribute their products mainly through franchise network. NB also runs training and examination centers in China together with Ministry of Labour. Franchisees and beauticians are required to attend beauty and management courses for 1,200 hours. Frequent visits are paid to the franchise stores to ensure those stores are up to NB's standard.

Strong brand recognition. According to a 2005 Annual Report on Beauty Economy in China, the consumer recognition rate for NB's stores was 49.7%, ahead of other market leaders such as Shyenli (17.4%) and Beauty Farm (9.4%).

Table 3 : Retail competition

	Brands	Consumer recognition rate	Market shares 2005
High end department store brands	SKII	42.2	1.8
	Lancome	32.5	1.5
	Shiseido	27.8	1.1
	Estee Lauder	19.1	0.8
Mass hypermarket brands	Olay	36.6	15.7
	L'Oreal	30.4	3.5
	Clean & Clear – Johnson & Johnson	7.6	1.3
	Garnier Mini Nurse	15.7	2.1
Direct selling	Pone's	11.9	3.8
	Artistry – Amway	7.2	10.2
	Avon	27.8	6.8
Cosmetic drugstores	Mary Kay	6.1	4.5
	Aupres	15.5	5.8
	Dabao	13.5	3.6

Source: Company data

Strong financials. The group is in a net cash position of HK\$501.4m, up 40.7% from 1H FY12/06A. The dividend pay out is expected to exceed 100.0% in the next few years. We expect its future dividend payout ratio at 130.0% in FY12/07F, 120.0% in FY12/08F and 115.0% in FY12/09F.

1H FY12/07 results recap. Turnover grew 18.1% YoY to HK\$193.2m, pre-tax profit 31.1% (due to savings in other operating expenses) and net profit 50.4% to HK\$74.3m. An interim dividend of HK\$3.0 per share was declared and the proposed full-year dividend payout ratio reached 135% of EPS. Turnover from China increased 22.5% to HK\$139.3m on higher product sales and brand and image revamping. Net profit in China was HK\$70.6m, up 32.3%. Turnover in Taiwan rose 8.8% to HK\$50.6m, with HK\$5.4m generated by Fonperi. Net profit grew 64.3% YoY.

Margin improvement. The gross margin widened 5.1pcp to 83.6% and operating margin 5pcp to 49.6% as a result of better operating & marketing efficiency. The net margin improved 8.2pcp to 38.4% due to a 9.6% decrease in taxation expenses.

Table 4: Interim results

Six months to Jun	Turnover (HK\$m)	Gross profit (HK\$m)	Gross margin (%)	Pre-tax profit (HK\$m)	Tax rate (%)	Net profit (HK\$m)	EPS Basic (HK\$)
1H FY12/07A	193.2	161.9	83.8%	95.5	22.2	74.3	0.037
1H FY12/06A	163.6	128.8	78.7%	72.8	32.2	49.4	0.025
YoY (%)	18.1%	25.7%		31.2%	(31.1%)	50.4%	50.0%

Source: Company data

Table 5: Geographical turnover breakdown

Year to Dec (HK\$m)	1H 2006	% of sales	1H 2007	% of sales	Change (%)
PRC	113.7	69.5	139.3	72.1	22.5
Taiwan	46.5	28.4	50.6	26.2	8.8
Others	3.4	2.1	3.3	1.7	(2.9)
Total	163.6		193.2		18.1

Source: Company data

Table 6: Turnover breakdown by activity

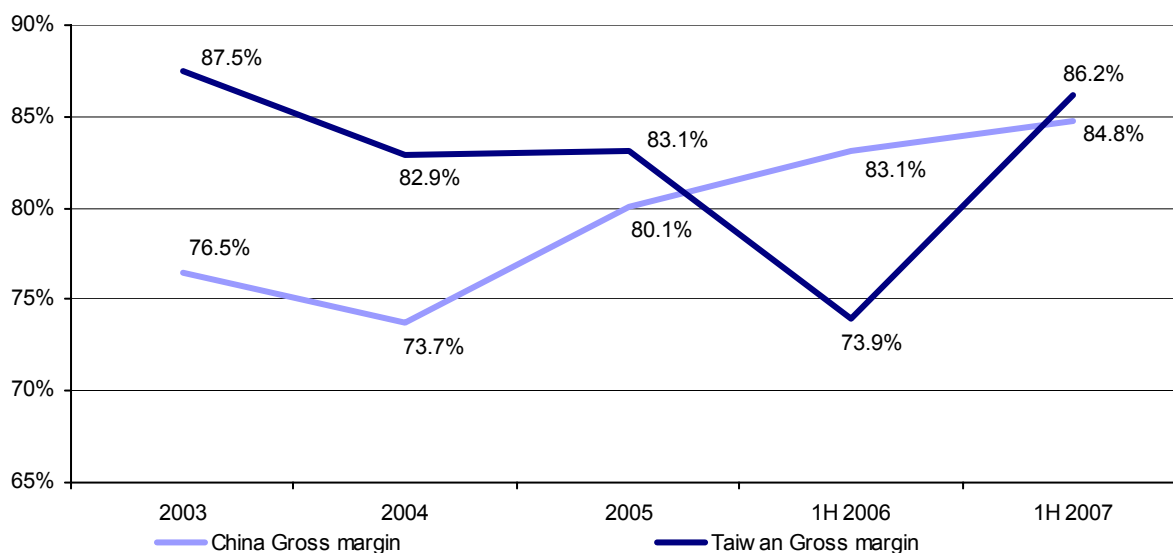
Year to Dec (HK\$m)	1H 2006	% of sales	1H 2007	% of sales	Change (%)
Product sales	153.0	93.5	182.0	94.2	19.0
Service income	8.3	5.1	9.1	4.7	9.6
Entrustment fee income	2.3	1.4	2.1	1.1	(8.7)
Total	163.6		193.2		18.1

Source: Company data

Table 7: Products turnover breakdown by region

Year to Dec (HK\$m)	1H 2006	1H 2007	Change (% YoY)
PRC	108.6	133.0	22.5
Taiwan	41.7	46.2	10.8
Others	2.7	2.8	3.7
Total	153.0	182.0	19.0

Source: Company data

Chart 2: Gross margin analysis

Source: Company data

Earnings revision. Given its strong sales growth in China and Taiwan, promising new products and fully vertically integrated business model, we expect NB's net profit to grow at a CAGR of over 29.0% in 2007-2009. We have increased our net profit estimate 14.5% to HK\$172.1m for FY12/07F, 23.6% to HK\$228.8m for FY12/08F and 21.3% to HK\$284.8m for FY12/09F.

Valuation. The counter is expected to trade at 16.3x FY12/08F P/E and ex-cash P/E of 14.2x based on our revised net profit estimate of HK\$228.8m. Our revised target price is HK\$2.86, based on 25.0x P/E for FY12/08F and 0.76x PEG.

Risks: 1) Execution risks in getting and keeping franchisees; 2) Major economic slowdown in China and Taiwan; and 3) Unexpected disasters like SARS in Hong Kong in 2003.

Table 8: Peer comparison

Name	Ticker	Year End	Price	Market cap (US\$m)	P/E (x) 1 yr fwd	P/E (x) 2 yr fwd	ROA (%)	ROE (%)	EBIT Margin (%)
Natural Beauty	157 HK	Dec	HK\$1.87	479.5	21.8	16.4	12.7	14.3	39.3
Fancl	4921 JP	Mar	JPY1,398	844.9	32.6	18.3	3.0	3.6	8.3
Shiseido	4911 JP	Mar	JPY2,680	9,799	33.0	30.2	3.6	6.6	7.2
Kose	4922 JP	Mar	JPY3,000	1,565.1	21.9	19.9	4.0	7.1	7.8
Mandom	4917 JP	Mar	JPY2,955	613.9	22.3	21.0	4.8	6.1	10.1
<i>Average</i>					26.3	21.2	5.6	6.2	14.5

Source: SBI E2-Capital, Bloomberg

P & L (HK\$m)	05A	06A	07F	08F	09F
Year to Dec					
Turnover	357.9	363.7	456.6	594.8	749.9
% chg	(0.1)	1.6	25.5	30.3	26.1
Gross profit	284.6	295.0	380.4	498.4	629.2
EBITDA	142.1	191.0	227.3	294.1	364.0
Depre./amort.	(25.6)	(20.8)	(18.3)	(15.9)	(16.9)
EBIT	116.5	170.1	209.0	278.2	347.1
Net int. income/(exp.)	3.3	4.3	5.2	7.3	7.6
Exceptionals	-	-	-	-	-
Associates	-	-	-	-	-
Jointly-controlled entit.	-	-	-	-	-
Pre-tax profit	119.8	174.5	214.2	285.5	354.7
Tax	(38.8)	(51.6)	(42.4)	(57.1)	(70.2)
Minority interests	0.1	0.4	0.4	0.4	0.4
Net profit	81.1	123.2	172.1	228.8	284.8
% chg	28.2	51.9	39.7	32.9	24.5
Dividends	(61.0)	(80.0)	(223.8)	(274.5)	(327.5)
Retained earnings	20.1	43.2	(51.6)	(45.8)	(42.7)
EPS (HK\$) - Basic	0.041	0.062	0.086	0.114	0.142
EPS (HK\$) - F.D.	-	-	-	-	-
DPS (HK\$)	0.033	0.040	0.112	0.137	0.164
No. sh.s o/s (m) - W.A.	2,000.0	2,000.0	2,000.0	2,000.0	2,000.0
No. sh.s o/s (m) - Y.E.	2,000.0	2,000.0	2,000.0	2,000.0	2,000.0
No. sh.s o/s (m) - F.D.	-	-	-	-	-
Margins (%)					
Gross	79.5	81.1	83.3	83.8	83.9
EBITDA	39.7	52.5	49.8	49.4	48.5
EBIT	32.6	46.8	45.8	46.8	46.3
Pre-tax	33.5	48.0	46.9	48.0	47.3
Net	22.7	33.9	37.7	38.5	38.0

Cash Flow (HK\$m)	05A	06A	07F	08F	09F
Year to Dec					
EBIT	116.5	170.1	209.0	278.2	347.1
Depre./amort.	25.6	20.8	18.3	15.9	16.9
Net int. paid	3.3	4.3	5.2	7.3	7.6
Tax paid	(39.2)	(44.2)	(62.3)	(39.5)	(64.4)
Dividends received	-	-	-	-	-
Gross cashflow	106.2	151.1	170.1	262.0	307.2
Chgs. in working cap.	1.2	(42.7)	42.4	(51.9)	(43.4)
Operating cashflow	107.4	108.4	212.5	210.0	263.8
Capex	(24.9)	(25.8)	132.7	(25.0)	(20.0)
Free cashflow	82.5	82.6	345.2	185.0	243.8
Dividends paid	(61.3)	(80.3)	(134.0)	(245.1)	(296.8)
Net distribution to MI	-	-	-	-	-
Investments	-	(0.4)	0.3	(0.6)	-
Disposals	2.1	0.1	-	-	-
New shares	-	-	-	-	-
Others	11.7	16.8	63.1	(79.2)	-
Net cashflow	34.9	18.7	274.7	(139.9)	(53.0)
Net (debt)/cash - Beg.	330.3	365.2	384.0	658.7	518.8
Net (debt)/cash - End.	365.2	384.0	658.7	518.8	465.8

Interim Results (HK\$m)	05A	06A	07A
Six months to Jun			
Turnover	163.1	163.6	193.2
% chg	8.1	0.3	18.1
Profit from operations	49.7	72.8	95.5
Interest expenses	-	-	-
Associates	(0.1)	0.0	0.0
Jointly-controlled entit.	-	-	-
Pre-tax profit	49.6	72.8	95.5
Tax	(17.2)	(23.4)	(21.2)
Minority interests	0.4	0.2	0.0
Net profit	32.8	49.4	74.3
% chg	5.0	50.7	50.4
EPS (HK\$) - Basic	0.016	0.025	0.037
DPS (HK\$)	0.013	0.020	0.050

Balance Sheet (HK\$m)	05A	06A	07F	08F	09F
Year to Dec					
Fixed assets	338.4	335.7	180.4	193.8	196.8
Intangible assets	0.9	-	0.7	0.7	0.7
Other LT assets	35.0	49.3	45.8	34.9	34.9
Cash and cash equiv.	365.2	384.0	658.7	518.8	465.8
Accounts receivable	77.9	86.0	67.8	95.2	120.0
Other receivables	63.6	79.2	58.3	108.8	137.2
Inventories	56.5	63.6	67.6	61.7	77.3
Due from related co.s	-	-	-	-	-
Other current assets	-	-	-	(0.0)	-
Total assets	739.5	768.9	1,079.2	1,013.8	1,032.7
Accounts payable	(16.6)	(16.6)	(13.0)	(14.3)	(18.0)
Other payable	(65.4)	(53.6)	(64.3)	(83.1)	(104.8)
Tax payable	(15.8)	(27.6)	(7.7)	(25.3)	(31.1)
Due to related co.s	-	-	-	-	-
ST debts	-	-	-	-	-
Other current liab.	(8.5)	(9.3)	(93.8)	(8.8)	(8.8)
LT debts	-	-	-	-	-
Other LT liabilities	(10.9)	(11.3)	(11.6)	(11.6)	(11.6)
Total liabilities	(117.2)	(118.5)	(190.3)	(143.1)	(174.3)
Share capital	200.0	200.0	200.0	200.0	200.0
Reserves	613.5	710.3	682.7	732.1	720.1
Shareholders' funds	813.5	910.3	882.7	932.1	920.1
Minority interest	6.8	6.4	6.0	5.7	5.3
Total	820.3	916.7	888.7	937.8	925.5
Capital employed	820.3	916.7	888.7	937.8	925.5
Net (debt)/cash	365.2	384.0	658.7	518.8	465.8

Shareholding Structure	Shares o/s (m)	%
Dr. Tsai Yen Yu	1,400.0	70.0
Keywise Capital	120.0	6.0
Public shareholders	480.0	24.0
Total	2,000.0	100.0

Background
Founded by Dr. Tsai Yen Yu in 1972, Natural Beauty is principally engaged in the manufacture and sale of skin, care, beauty and aroma therapeutic products and provision of skin treatments, beauty and spa services and skin care consulting and beauty training. Currently, the company operates 2,239 stores in Greater China. According to 2005 China Beauty Economy Annual Report, Natural Beauty is one of the top 10 most influential cosmetics brands in China with the highest consumer recognition rate of 49.7%. It was listed in Hong Kong in Mar 02.

Key Ratios	05A	06A	07F	08F	09F
Net gearing (%)	Cash	Cash	Cash	Cash	Cash
Net ROE (%)	10.1	14.3	19.2	25.2	30.8
EBIT ROCE (%)	14.8	20.1	23.7	31.3	38.1
Dividend payout (%)	81.4	64.9	130.0	120.0	115.0
Effective tax rate (%)	32.4	29.6	19.8	20.0	19.8
Net interest coverage (x)	na	na	na	na	Na
A/R turnover (days)	79.4	86.3	54.2	58.4	58.4
A/P turnover (days)	82.6	88.2	62.3	54.1	54.4
Stock turnover (days)	281.2	337.6	323.5	233.6	233.6

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