

Natural Beauty



BUY (unchanged)

Sustainable growth ahead

Key points:

- Net profit jumped 45.1% YoY to HK\$178.8m in FY12/07A, in line with our expectations.
- Gross margin widened on higher sales in China, with average sales per store up 19.0% in FY12/07A.
- Sales of Fonperi products in Taiwan reached HK\$15.4m after the line's launch in Apr 2007, with 3,744 POS at end-1Q FY12/08F, from 1,394 at end-FY12/07A.
- Aggressive expansion in FY12/08F, targeting 250 new franchise stores in China.
- Maintain BUY call with a target price of HK\$2.65, representing 41.0% upside potential.

FY12/07A results in line. Natural Beauty's (NB) FY12/07A results were in line with our expectations. Turnover was up 23.8% YoY at HK\$450.1m and net profit at HK\$178.8m, up 45.1% YoY. The gross margin widened 1.7pcp YoY to 82.8%. The net margin's 5.8pcp YoY expansion to 39.7%, ahead of our expectations, was boosted by a lower than expected effective tax rate of 14.0% (FY12/06A: 29.6%) as NB started to use tax breaks (under the 2 + 3 scheme) for one of its China subsidiaries.

Over 100.0% dividend payout. The final dividend of HK\$0.10 (final dividend: HK\$0.042, final special dividend of HK\$0.058) takes the total dividend for the year to HK\$0.15 (dividend: HK\$0.072 and special dividend: HK\$0.078). This represents a payout ratio of 167.8%. The company paid a special dividend in FY12/07A by returning cash proceeds from the disposal of its Taiwan property to shareholders.

Strong China performance. Revenue from China rose 32.0% YoY to HK\$316.8m, with the gross margin improving 2.6pcp YoY to 84.5%, due to: 1) strong China's GDP growth; 2) the company's successful rebranding campaign and 3) lower costs on the standardization of product packaging. NB's operating margin improved 1.0pcp YoY to 54.9% and net margin 12.7pcp YoY to 49.9%. In FY12/08F, NB plans to open 250 new franchise stores in China. However, we take this only as a rough estimate as we expect the company to focus on the "size" of franchises rather than their "number". NB plans to have more stores of around 300.0sqm or more to further leverage its operating scale. We expect this aggressive expansion and organic growth to help it maintain its growth momentum in China.

Taiwan - encouraging sales. Turnover increased 10.5% YoY to HK\$126.8m, helped by strong sales of NB's new Fonperi line (HK\$15.4m). The gross margin narrowed 1.9pcp YoY to 83.0% due to the lower (~70.0%) margin of the new line, compared with other NB products (~85.0%). Operating profit decreased 9.5pcp YoY to 35.3%, mainly due to initial Fonperi advertisement expenses. We expect the Taiwan business to be steady, growing at mid-to-high

China Retail

Mon, 14 Apr 2008

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Stock data

Price	HK\$1.88
Target price	HK\$2.65 (+41.0%)
12 mth range	HK\$1.23-2.77
Market cap.	US\$482.1m
Daily t/o, 3 mth	US\$0.12m
Free float %	29.6%
Ticker	157.HK/157 HK

Financial summary

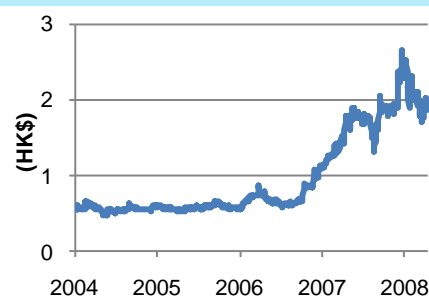
Year to Dec	06A	07A	08F	09F	10F
Turnover (HK\$m)	363.7	450.1	577.9	723.0	915.8
Net Profit (HK\$m)	123.2	178.7	225.1	268.2	340.9
EPS (HK\$)	0.062	0.089	0.113	0.134	0.170
EPS Δ%	51.9	45.1	25.9	19.1	27.1
P/E (x)	30.5	21.0	16.7	14.0	11.0
P/B (x)	4.28	4.13	4.40	4.42	3.55
EV/EBITDA (x)	17.6	14.5	11.7	9.3	7.0
Yield (%)	2.1	8.0	4.8	5.7	7.3
ROE (%)	14.6	20.0	25.5	31.5	35.7
ROCE (%)	14.5	19.9	25.3	31.2	39.7
N. Gear. (%)	Cash	Cash	Cash	Cash	Cash

Price Performance

	1 mth	3 mth	12 mth
Relative to HSI (%)	-4.2	-17.4	+1.9
Actual price changes (%)	+2.7	-24.2	+22.9

	08F	09F	10F
Consensus EPS (HK\$)	0.112	0.125	
Previous forecasts (HK\$m)	228.8	284.8	
Previous EPS (HK\$)	0.114	0.142	

Price Chart



single digits.

Fonperi - impressive start. NB's "Fonperi" brand was launched in Apr 2007 in Taiwan, with around 400,000 units sold in FY12/07A. The number of retail outlets distributing Fonperi is expected to reach 4,000 by end-FY12/08F, from 1,394 at end-FY12/07A and 3,744 at end-1Q FY12/08A. The rapid expansion and growing brand awareness of Fonperi should allow it to maintain its sales growth momentum. We expect revenue from Fonperi to double to HK\$30.0m in FY12/08F and underpin revenue growth in NB's Taiwan operations over the next two years.

Table 1: Final results

Year to Dec	Turnover (HK\$m)	Gross profit (HK\$m)	Gross margin (%)	Pre-tax profit (HK\$m)	Tax rate (%)	Net profit (HK\$m)	EPS Basic (HK\$ cents)
FY12/07	450.1	372.6	82.8	208.0	14.0	178.7	8.9
FY12/06	363.7	295.0	81.1	174.5	29.6	123.2	6.2
YoY (%)	23.8	26.3		19.2		45.1	43.5

Source: Company data

Table 2: Geographical turnover breakdown

Year to Dec (HK\$m)	2006A	% of the sales	2007A	% of the sales	Change (%)
PRC	240.0	66.0	316.8	70.4	32.0
Product sales	229.7	63.2	307.2	68.3	33.7
Taiwan	114.8	31.6	126.8	28.2	10.5
Product sales	97.4	26.8	118.1	26.2	21.3
Others	8.9	2.4	6.5	1.4	(27.1)
Product sales	7.4	2.0	5.1	1.1	(31.2)
Total	363.7		450.1		23.8

Source: Company data

Gross margin enhancement. NB's gross margin is improving thanks to: 1) strong sales in China of NB-1 series products, which have a higher margin and 2) cost savings from the standardization of product packaging. The company has now repackaged 363 products (out of about 700), which account for 70.0-80.0% of total sales. We expect its gross margin to improve to 83.8% in FY12/08F, 84.4% in FY12/09F and 84.5% in FY12/10F, mainly as a result of geographical mix changes and growing sales in China of higher-margin products (84.5% in FY12/07A) relative to Taiwan (83.0% in FY12/07A).

Solid growth in distribution network. The company opened 219 franchises in China and closed 103 in FY12/07A, bringing the total number of stores to 1,465. It has revised the number of stores in FY12/06A and FY12/07A and excluded 358 stores in China which had not completed closure procedures but had been inactive for one or two years. In Taiwan, 17 stores were opened and 70 closed in FY12/07A, bringing the total number to 457 stores. We forecast in FY12/08F a net increase of 220 stores in China and maintain the number of stores in Taiwan.

Store revamp almost completed. The company has essentially completed the renovation of its stores in China and Taiwan. The revamp, together with the company's new branding, has helped enhance its average sales per store by 19.0% YoY to HK\$225,000.0 in China and 4.5% YoY to HK\$230,000.0 in Taiwan. Blended average sales per store reached HK\$227,000.0, up 14.6% YoY in FY12/07A.

Table 3: Distribution channels *

At 31 Dec	2006A	Change	2007A	Change	2008F	Change
PRC	1,349	162	1,465	116	1,685	220
Taiwan	510	-26	457	-53	457	0
Others	51	11	53	2	53	0
Total	1,910	147	1,975	65	2,195	220

Source: Company data

* Note: Does not include retail outlets.

Table 4: Average sales per store

Year to Dec	2006A	2007A	2006A	2007A	Change (%)
	Average store	Average store	Average sales (HK\$)	Average sales (HK\$)	
PRC	1,268.0	1,407.0	189,000.0	225,000.0	19.0
Taiwan	523.0	483.5	220,000.0	230,000.0	4.5
Total*	1,791.0	1,890.5	198,000.0	227,000.0	14.6

Source: Company data

* Does not include Hong Kong and Malaysia turnover

Minor earnings revision and introducing FY12/10F estimates. We have made small adjustment to our forecasts, with net profit for FY12/08F and FY12/09F now estimated at HK\$225.1m (up 25.9% YoY) and HK\$268.2m (19.1% YoY), respectively (from HK\$228.8m and HK\$284.8m). We also introduce our FY12/10F estimates, with bottom line growth of 27.1% to HK\$340.9m. FY12/09F net profit growth is expected to moderate slightly YoY as the company's China subsidiary will be required to pay tax at half of the official rate after its tax holiday ends. Thus, we expect NB's effective tax rate to increase from 15.0% in FY12/08F to 20.0% in FY12/09F.

Maintaining our BUY call. We expect NB's net profit to grow at a CAGR of 23.1% in FY12/08F-FY12/10F. The counter is trading at an undemanding P/E of 16.7x FY12/08F, ex-cash P/E of 14.1x and 0.64x PEG, based on our net profit estimate of HK\$225.2m. Our target price is HK\$2.65, based on 21.0x ex-cash P/E for FY12/08F.

Table 5: Peer comparison

Name	Ticker	Price	Market cap (US\$m)	P/E (x)	P/E (x)	ROA (%)	ROE (%)	EBIT Margin (%)
				1 yr fwd	2 yr fwd			
Natural Beauty	157 HK	HK\$1.88	482.1	16.8	15.0	12.7	14.6	44.7
Shiseido	4911 JP	JPY2,535	10,209.7	30.1	28.2	3.6	6.6	7.2
Mandom	4917 JP	JPY3,020	716.0	21.4	20.0	4.8	6.1	10.1
Fancl	4921 JP	JPY1,365	941.0	22.5	20.9	3.0	3.6	8.3
Kose	4922 JP	JPY2,505	1,491.0	18.4	17.5	4.0	7.1	7.8
Avon	4915 JP	JPY137	78.7	n.a.	n.a.	-12.7	-23.8	-2.6
Estee Lauder	EL US	US\$45.44	8,789.6	19.2	17.1	11.4	31.8	10.7
Revlon	REV US	US\$0.96	490.8	n.a.	n.a.	-1.8	n.a.	8.9
Procter & Gamble	PG US	US\$70.18	215,978.8	20.1	18.0	7.4	16.1	20.2
Unilever	UL US	US\$33.77	102,150.3	15.3	14.2	n.a.	n.a.	n.a.
Colgate	CL US	US\$78.73	40,030.6	20.6	18.4	17.8	104.3	19.2
Average				20.5	18.8	5.0	18.5	13.5

Source: SBI E2-Capital, Bloomberg

Disclosure of interests: SBI E2-Capital Securities Ltd. acted as the bookrunner for Natural Beauty on November 28, 2007 for vendor share placement at HK\$1.91 per share for 94.47m shares.

P & L (HK\$m)	06A	07A	08F	09F	10F	Cash Flow (HK\$m)	06A	07A	08F	09F	10F
Year to Dec						Year to Dec					
Turnover	363.7	450.1	577.9	723.0	915.8	EBIT	170.1	201.3	256.4	327.4	418.4
% chg	1.6	23.8	28.4	25.1	26.7	Depre./amort.	21.9	17.5	19.8	21.0	22.0
Gross profit	295.0	372.6	484.4	609.9	774.1	Net int. paid	4.3	6.8	8.4	7.8	7.7
EBITDA	192.1	218.8	276.2	348.8	440.9	Tax paid	(44.2)	(52.2)	(33.6)	(48.7)	(72.8)
Depre./amort.	(21.9)	(17.5)	(19.8)	(21.0)	(22.0)	Dividends received	-	-	-	-	-
EBIT	170.1	201.3	256.4	327.8	418.9	Gross cashflow	152.1	173.4	251.0	307.4	375.3
Net int. income/(exp.)	4.3	6.8	8.4	7.4	7.2	Chgs. in working cap.	(42.6)	79.2	(17.0)	(105.5)	(50.6)
Exceptionals	-	-	-	-	-	Operating cashflow	109.6	252.5	234.0	201.9	324.7
Associates	-	-	-	-	-	Capex	(25.8)	(53.8)	(25.0)	(20.0)	(20.0)
Jointly-controlled entit.	-	-	-	-	1.0	Free cashflow	83.8	198.8	209.0	181.9	304.7
Pre-tax profit	174.5	208.0	264.8	335.2	426.1	Dividends paid	(80.3)	(140.0)	(254.0)	(190.4)	(150.2)
Tax	(51.6)	(29.2)	(39.7)	(67.0)	(85.2)	Net distribution to MI	-	-	-	-	-
Minority interests	0.4	(0.1)	0.0	0.0	0.0	Investments	(0.4)	0.3	0.0	-	-
Net profit	123.2	178.7	225.1	268.2	340.9	Disposals	0.1	157.7	-	-	-
% chg	51.9	45.1	25.9	19.1	27.1	New shares	-	-	-	-	-
Dividends	(80.0)	(300.0)	(180.1)	(214.5)	(272.7)	Change in loans	-	-	-	-	-
Retained earnings	43.2	(121.3)	45.0	53.6	68.2	Others	15.5	(12.0)	(0.1)	-	-
EPS (HK\$) - Basic	0.062	0.089	0.113	0.134	0.170	Net cashflow	18.7	204.8	(45.1)	(8.5)	154.5
EPS (HK\$) - F.D.	-	-	-	-	-	Net (debt)/cash - Beg.	365.2	384.0	588.7	543.7	535.2
DPS (HK\$)	0.040	0.150	0.090	0.107	0.136	Net (debt)/cash - End.	384.0	588.7	543.7	535.2	689.7
No. sh.s o/s (m) - W.A.	2,000.0	2,000.0	2,000.0	2,000.0	2,000.0	Interim Results (HK\$m)	06A	07A			
No. sh.s o/s (m) - Y.E.	2,000.0	2,000.0	2,000.0	2,000.0	2,000.0	Six months to Jun					
No. sh.s o/s (m) - F.D.	-	-	-	-	-	Turnover	163.6	193.2			
Margins (%)						% chg	0.3	18.1			
Gross	81.1	82.8	83.8	84.4	84.5	Profit from operations	72.8	95.5			
EBITDA	52.8	48.6	47.8	48.2	48.1	Interest expenses	-	-			
EBIT	46.8	44.7	44.4	45.3	45.7	Associates	0.0	0.0			
Pre-tax	48.0	46.2	45.8	46.4	46.5	Jointly-controlled entit.	-	-			
Net	33.9	39.7	38.9	37.1	37.2	Pre-tax profit	72.8	95.5			
						Tax	(23.4)	(21.2)			
						Minority interests	0.2	0.0			
						Net profit	49.4	74.3			
						% chg	50.7	50.4			
						EPS (HK\$) - Basic	0.025	0.037			
						DPS (HK\$)	0.020	0.050			
Balance Sheet (HK\$m)	06A	07A	08F	09F	10F	Shareholding Structure					
Year to Dec									Shares o/s (m)	%	
Fixed assets	335.7	222.6	227.7	222.2	224.7	Dr. Tsai Yen Yu			838.5	41.9	
Intangible assets	-	-	-	-	-	Dr. Su & Dr. Su			233.5	11.7	
Other LT assets	49.3	50.8	51.4	52.0	52.6	Martin Currie			174.1	8.7	
Cash and cash equiv.	384.0	588.7	517.2	504.6	684.9	Keywise Capital Management			161.5	8.1	
Accounts receivable	86.0	59.4	76.2	95.3	120.7	Public shareholders			592.4	29.6	
Other receivables	78.9	39.6	50.9	63.6	80.6	Total			2,000.0	100.0	
Inventories	63.6	71.0	85.6	103.5	129.7						
Due from related co.s	-	-	-	-	-	Background					
Other current assets	0.2	0.3	-	-	-	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 2,099 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.					
Total assets	769.2	1,032.3	1,009.0	1,041.2	1,293.2	Key Ratios	06A	07A	08F	09F	10F
Accounts payable	(16.6)	(21.8)	(28.0)	(35.0)	(44.4)	Net gearing (%)	Cash	Cash	Cash	Cash	Cash
Other payable	(53.6)	(68.5)	(87.9)	(110.0)	(139.3)	Net ROE (%)	14.6	20.0	25.5	31.5	35.7
Tax payable	(27.6)	(4.7)	(10.8)	(18.3)	(23.3)	EBIT ROCE (%)	20.5	23.2	29.8	39.1	44.4
Due to related co.s	-	-	-	-	-	Dividend payout (%)	64.9	167.9	80.0	80.0	80.0
ST debts	-	-	-	-	-	Effective tax rate (%)	29.6	14.1	15.0	20.0	20.0
Other current liab.	(9.3)	(9.8)	(9.8)	(9.8)	(9.8)	Net interest coverage (x)	na	na	na	na	na
LT debts	-	-	-	-	-	A/R turnover (days)	86.3	48.1	48.1	48.1	48.1
Other LT liabilities	(11.3)	(11.9)	(11.9)	(11.9)	(11.9)	A/P turnover (days)	88.2	102.6	109.3	113.1	114.3
Total liabilities	(118.5)	(116.7)	(148.4)	(185.0)	(228.7)	Stock turnover (days)	337.6	334.2	334.2	334.2	334.2
Share capital	200.0	200.0	200.0	200.0	200.0						
Reserves	678.7	709.6	654.5	650.2	858.6						
Shareholders' funds	878.7	909.6	854.5	850.2	1,058.6						
Minority interest	0.4	6.0	6.0	6.0	6.0						
Total	879.2	915.7	860.5	856.2	1,064.6						
Capital employed	879.2	915.7	860.5	856.2	1,064.6						
Net (debt)/cash	384.0	588.7	517.2	504.6	684.9						

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