

## China growth on track

## China Retail

## Natural Beauty (157 HK, HK\$0.63)

## BUY (unchanged)

### Target price: HK\$0.86 (+36.5%)

Although the weakening consumer sentiment has caused some hiccups in Natural Beauty's Taiwan market, we expect double-digit sales growth from the PRC market to make up the shortfall, leading to a largely flat top-line in FY12/06F. NB has delivered impressive margin growths in its FY12/05A results. We expect NB will continue to deliver remarkable margin improvements thanks to lower A&P expenses, product packaging costs, distribution costs and effective tax rate. We forecast a c.3% and 2.5% increase in gross and operating margins in FY12/06F. Major upside will come from an earlier-than-expected rebound in the Taiwan market and the recruitment of a new professional CEO.

**1) Centralizing A&P expenses for Taiwan and PRC.** Advertising and promotions are mainly conducted through T.V. commercials, magazines, outdoor advertising and sponsorship activities. NB has consolidated the T.V. commercials for both the Taiwan and PRC markets, which used to have two separate tailor-made commercials. We expect A&P expenses to account for less than 20% of total sales in FY12/06F, compared to 21.5% in FY12/05A.

**2) Reduced packaging costs.** NB carried out its product repackaging exercise, simplifying its package type from over 700 SKUs in more than 200 various forms to 24 standard forms only since Nov 2005. This has yielded significant savings in package costs, ranging from RMB0.06 to RMB12.14 per unit. NB expects to complete the product repackaging exercise by the end of 2006. Packaging usually accounts for 1/3 of COGS. We expect a c.3% gross margin improvement from this exercise in FY12/06F.

**3) Lower distribution costs.** NB will take over the operation of its warehouse, inventory and logistics management, from China Post which it used to collaborate with since 2005, as it will be more cost effective. By capitalizing China Post's expertise, NB has set up three logistics centers in Shanghai, Beijing and Guangzhou and they have been running smoothly. As a result, we expect distribution costs to account for 30.5% of total sales in FY12/06F, compared with 35.7% in FY12/05A.

### The major catalysts

**1) Store expansions on track.** Store expansion is on schedule to meet the 200 gross store opening target for 2006. By launching two large franchisee recruitment campaigns in Oct and Nov 2005, the total number of gross store openings in 1H FY12/06 reached 86. With 31 store closures, it represented a net addition of 55 stores. The pace of new store openings will accelerate in 2H06, due to seasonality factor. We expect a net addition of 125 stores for the full year 2006. Apart from new store openings, NB has been revamping stores in the PRC since 2005. It has completed revamping for 1,000 stores in 2005, with another 400-500 stores to

**Table 1: Financial summary**

Year to Dec	Net profit HK\$m	EPS HK\$	EPS Δ %	P/E x	P/B x	EV/EBITDA x	Yield %	ROE %	ROCE %	N. Gearing %
04A	63.3	0.032	16.8	19.9	1.58	6.9	4.0	8.2	12.7	Cash
05A	81.2	0.041	28.3	15.5	1.55	3.7	5.2	10.1	14.8	Cash
06F	91.2	0.046	12.3	13.8	1.45	5.3	5.9	10.8	15.4	Cash
07F	109.2	0.055	19.7	11.5	1.40	4.4	7.0	12.3	17.5	Cash
08F	124.9	0.062	14.4	10.1	1.36	3.7	8.1	13.7	19.4	Cash

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be completed in 2006. It will carry out the store revamping in Taiwan in 2006, which will drive sales further.

**Table 2: Store opening breakdown**

Year to Dec (HK\$m)	2003	2004	2005	2006F	2007F	2008F	2009F
<b>Avg no. of stores</b>							
The PRC	1,642	1,608	1,554	1,689	1,829	1,959	2,099
Taiwan	676	600	530	520	525	535	545
Others	-	-	40	40	40	40	40
Total	2,318	2,208	2,124	2,249	2,394	2,534	2,684
<b>net additions:</b>		<b>(110.0)</b>	<b>(84.0)</b>	<b>125.0</b>	<b>145.0</b>	<b>140.0</b>	<b>150.0</b>
<b>Avg. sales per store</b>							
The PRC	122,216	133,164	137,699	150,780	165,858	180,785	195,248
Taiwan	174,680	236,917	259,166	194,375	209,924	224,619	238,096
Others	n.a.	n.a.	166,075	207,594	249,113	293,953	346,864
Total	138,117	162,239	168,550	161,873	176,915	191,829	206,210
<b>Growth (%)</b>		<b>17.5</b>	<b>3.9</b>	<b>(4.0)</b>	<b>9.3</b>	<b>8.4</b>	<b>7.5</b>

Source: SBI E2-Capital

**2) Beefing up management team.** The market has placed certain discount to NB since it is viewed as a family-run business, headed by the founder, Dr. Tsai's family. NB is now recruiting a professional CEO and a few senior management positions from the China retail sector to beef up its team.

**Valuations.** We have fine-tuned our earnings forecasts based on improved margins. The expected flat top-line growth in FY12/06F is mainly due to lackluster performance in the Taiwan market. Dividend payout is expected to be maintained at >80%. We maintain our BUY recommendation with a target price of HK\$0.86, translating into 10.3x ex-cash (13.7x cum-cash) P/E FY12/07F, compared to 13.2x ex-cash (15.7x cum-cash) P/E for Sasa International (178 HK, HOLD, HK\$2.48).

**Table 2: P&L**

Year to Dec (HK\$m)	2004	2005	2006F	2007F	2008F
- Sales of goods	324.7	322.8	328.3	382.0	438.4
- Service income	28.3	29.8	30.3	35.3	40.5
- Entrustment fee income	5.1	5.3	5.3	6.2	7.1
<b>Turnover</b>	<b>358.1</b>	<b>357.9</b>	<b>364.0</b>	<b>423.4</b>	<b>486.0</b>
COGS	(82.3)	(73.3)	(63.6)	(69.8)	(80.1)
Gross profit	275.9	284.6	300.3	353.7	405.9
Other operating income	23.1	43.1	35.7	42.3	48.6
Distribution costs	(126.9)	(127.7)	(111.0)	(126.6)	(145.3)
Admin expenses	(63.9)	(62.0)	(63.0)	(73.3)	(84.1)
Other operating expenses	(8.8)	(18.2)	(31.1)	(39.8)	(46.1)
<b>Operating profit</b>	<b>99.4</b>	<b>119.9</b>	<b>130.9</b>	<b>156.3</b>	<b>178.9</b>
Finance costs	0.0	0.0	0.0	0.0	0.0
Exceptionals	0.0	0.0	0.0	0.0	0.0
Share of profit of an associate	(0.3)	0.0	0.0	0.0	0.0
<b>Profit before tax</b>	<b>99.1</b>	<b>119.9</b>	<b>130.9</b>	<b>156.3</b>	<b>178.9</b>
Taxation	(36.3)	(38.8)	(39.8)	(47.5)	(54.4)
Minority interest	0.5	0.1	0.1	0.4	0.4
<b>Net profit</b>	<b>63.3</b>	<b>81.2</b>	<b>91.2</b>	<b>109.2</b>	<b>124.9</b>
Dividends	(50.0)	(66.0)	(74.1)	(88.8)	(101.6)

Source: SBI E2-Capita