

Surprises on the upside

China Retail

Natural Beauty (157 HK, HK\$0.65)

BUY (unchanged)

Target price: HK\$0.93 (+43%)

Natural Beauty's (NB) 1H FY12/06 net profit beat our expectation, despite a largely flat sales growth. Sales and net profit were up 0.3% YoY and 52.3% YoY to HK\$163.5m and HK\$49.4m respectively. 1H06 net profit already represents c.54% of our full-year forecast, compared with an average of 45% to 50% in the past two years. EPS reached HK2.48 cents. DPS amounted to HK2 cents together with a special DPS of HK0.6 cents, representing a payout ratio of 80.2%.

Robust sales growth in the PRC market. The strong PRC performance was a result of the successful brand revamping exercise carried out in PRC since 2005. The PRC market has alleviated shortfall from Taiwan. Sales from Taiwan, which accounted for 28.4% of total turnover, dropped 24.8% YoY due to economic downturn and political instability. The fall was mitigated partly by a 16% YoY sales increase from the PRC market, which accounted for 69.5% of total. Other markets, including H.K. and Malaysia performed satisfactory with a 7.8% YoY increase in sales. They accounted for 2.1% of total sales.

NB continues to deliver impressive margin improvements. Gross profit margin was maintained at 78.7% but operating and net margin increased remarkably to 44.6% (1H05: 30.5%) and 30.2% (1H05: 20.1%), due to savings from distribution costs and overall improvement in operating efficiency, such as lower A&P expenses and product repackaging costs. Distribution costs as a percentage of sales decreased to 28.3% (1H05: 33.7%), while A&P expenses were reduced by HK\$5.9m to HK\$21.7m, thanks to centralizing A&P in both Taiwan and the PRC markets. On product repackaging costs, a total of 183 products were revamped by the end of June 2006. This successfully increased the product sales margins by 3pcp to 87%, compared with 84% in 1H05.

PRC tax refund. Apart from cost savings, the results were enhanced further by a tax refund of HK\$17.2m (1H05: HK\$12.2m) from PRC. Even we stripped out the tax refund, operating profit still grew by 48% YoY.

Table 1: Average store numbers

	1H06	1H05	YoY %
PRC	1,569.0	1,516.5	3.5
Taiwan	531.5	531.0	0.1
Others	2,100.5	2,047.5	2.6

Source: SBI E2-Capital

Table 2: Average sales per store

	(HK\$m)	1H06	1H05	YoY %
PRC		72,000	65,000	10.8
Taiwan		87,000	116,000	(25.0)
Others		76,000	78,000	(2.6)

Source: SBI E2-Capital

Expansion plan on track. Total number of stores in 1H06 reached 2,166 (PRC: 1,593; Taiwan: 527; Others: 46). We believe NB will meet its target of opening 200 franchisee stores in FY12/06F. Note that it has already

Table 3: 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	20.5	1.64	7.2	3.8	8.2	12.7	Cash
05A	81.2	0.041	28.3	16.0	1.60	4.0	5.1	10.1	14.8	Cash
06F	103.6	0.052	27.6	12.6	1.48	4.9	6.5	12.2	17.7	Cash
07F	124.2	0.062	19.9	10.5	1.43	4.0	7.8	13.9	20.0	Cash
08F	142.4	0.071	14.7	9.1	1.37	3.4	8.9	15.3	22.1	Cash

SBI E2-Capital is a dedicated small/mid cap investment banking/ stockbrokerage house. If you would like to access our research reports and know more about our services, please contact Raymond Jook, Head of Research, on (852) 2533 3715 or raymondjook@softbank.com.hk. Find our research on: sbie2capital.com, thomsononeanalytics.com and multex.com

Investors should assume that SBI E2-Capital is seeking or will seek investment banking or other primary businesses with the companies in this report.

Analyst certification: the views expressed in this report accurately reflects the analyst's personal views of the subject securities and that the analyst has not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report.

Disclaimer: the information and opinions in this report were prepared by SBI E2-Capital Securities Limited. SBI E2-Capital Securities Limited does not undertake to advise you of changes in its opinion or information. SBI E2-Capital Securities Limited and others associated with it may have positions in and effect transactions in securities of companies mentioned and may also perform or seek to perform investment banking services for those companies. This memorandum is based on information available to the public. No representation is made that it is accurate or complete. This memorandum is not an offer to buy or sell the securities mentioned.

achieved 86 new store openings in 1H FY12/06.

Recruiting professional management team. It will recruit a new CEO and two COOs, one for China and one for other markets by 2006.

Benefits from store revamping exercise in Taiwan are about to kick-in. The Group has just started its store revamping in Taiwan at the end of the first quarter and the effect is yet to be realized.

Earnings forecasts revised upwards. Inventory turnover showed an increase from 290 days in 1H05 to 309 days in 1H06 but it is expected due to the product repackaging exercise. AR turnover also rose to 77 days (1H05: 57 days) but it was matched by AP turnover, which rose to 80 days (1H05: 51 days). Based on higher operating margins, we have revised our earnings forecasts upwards by 13-14% for FY12/06F-08F. We expect solid growth from the PRC market to continue, while the rebound from Taiwan market can provide further upside. We maintain our BUY recommendation but have raised our target price to HK\$0.93 (from HK\$0.86), representing 15x FY12/07F P/E. NB was in a net cash position of HK\$260m.

Table 4: Earnings model

Year to Dec (HK\$m)	2004	2005	2006F	2007F	2008F
- Sales of goods	324.7	322.8	335.0	389.3	446.6
- Service income	28.3	29.8	30.9	36.0	41.2
- Entrustment fee income	5.1	5.3	5.5	6.3	7.3
Turnover	358.1	357.9	371.4	431.6	495.2
COGS	(82.3)	(73.3)	(68.6)	(75.5)	(86.6)
Gross profit	275.9	284.6	302.7	356.1	408.6
Other operating income	23.1	43.1	36.4	43.2	49.5
Distribution costs	(126.9)	(127.7)	(103.2)	(120.0)	(137.7)
Admin expenses	(63.9)	(62.0)	(76.5)	(88.9)	(102.0)
Other operating expenses	(8.8)	(18.2)	(8.5)	(9.9)	(11.4)
Operating profit	99.4	119.9	150.8	180.5	207.1
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
Profit before tax	99.1	119.9	150.8	180.5	207.1
Taxation	(36.3)	(38.8)	(47.3)	(56.6)	(65.0)
Minority interest	0.5	0.1	0.1	0.4	0.4
Net profit	63.3	81.2	103.6	124.2	142.4
Dividends	(50.0)	(66.0)	(84.2)	(101.0)	(115.8)

Source: SBI E2-Capital