

## Awaiting catalysts from the PRC market

## Hong Kong Retail

### Sasa (178 HK, HK\$2.75)

### HOLD (unchanged)

#### Target price: HK\$2.65 (-3.8%)

The Golden Week Holiday is coming to the end and the preliminary sales from Sasa came lower than expectation. Nonetheless, H.K. & Macau's total retail sales and same-store-sales (s.s.s.) boded well in \*Q2 FY3/07 with +9.8% YoY and +0.4% YoY. (ref: Table 2). The increase sales contribution from private labels and exclusive distributorship brands has raised its gross margin to 42% in Apr-Aug. (FY3/06A: 39.7%). We believe shorting pressure has been overdone regarding the clearance of SKII make-up and skincare products from their shelves previously, since SKII is just only one among 15,000 SKUs it carries. For its H.K. market, rental pressure has abated with positive s.s.s. growth for two consecutive quarters, compared with a negative growth in FY3/06A. However, we do not see a breakeven in the PRC market yet, which precludes it from the franchisee expansion plan. We expect Sasa's share price will remain range bound in the medium term.

#### Key takeaways from the meeting:

**Preliminary sales from Golden week holiday came lower than expect.** This year, the holiday was longer than before since it coincided with the Mid-Autumn Festival. Mainland tourists prefer taking longer trips to overseas instead of short ones to nearby countries, like H.K.. Besides, hotel room rates are exorbitant in the peak season. Nevertheless, overall customer traffic flow was similar to usual weekends.

**Benefits from further improvement in product mix.** In Q2 FY3/07, total retail sales and s.s.s. in H.K. and Macau recorded a mild growth of +9.8% YoY and +0.4% YoY compared with +13.4% and +1.7% in Q1. The average sales per transaction maintained strong with 12.2% YoY increase to HK\$252, compared to +9.9% in Q1. This showed that Sasa continued to benefit from an improvement in product mix. In Apr-Aug, the percentage of sales from brand management to total sales, which includes its private labels and exclusive distributorship rose from 30% in FY3/06A to c.33%. This has further improved its gross margin from 39.7% in FY3/06A to 42% in the same period.

**In-store services.** Sasa plans to utilize its existing retail platforms to cross-selling their products by providing in-store facial treatment in the PRC and nail-care services in H.K. These services are complementary in PRC but a fee is charged in H.K. This is an effective way to boost sales, especially in PRC since customers will usually buy their products after the service trial. For the H.K. market, nail bars are getting popular these days. The addition of nail-care services can provide another source of revenue with limited fix costs.

**Multi-branding strategy works well.** Regarding the clearance of SKII make-up and skincare products from retail stands, Sasa confirmed that sales for this brand has dropped substantially but the sales of other brands have increased as customers switched to buy other brands, thanks to Sasa's multi-branding strategy. The SKII brand is

**Table 1: Financial summary**

Year to	Net profit	EPS	EPS	P/E	P/B	EV/EBITDA	Yield	ROE	ROCE	N. Gearing
Mar	HK\$m	HK\$	Δ %	x	x	X	%	%	%	%
05A	202.1	0.155	30.4	17.8	3.9	11.0	6.2	22.9	24.9	Cash
06A	185.1	0.139	(10.0)	19.8	4.0	10.9	6.3	20.0	22.4	Cash
07F	208.5	0.156	12.3	17.6	4.1	10.9	6.4	22.7	24.4	Cash
08F	255.0	0.191	22.3	14.4	4.0	9.0	6.6	28.0	30.0	Cash
09F	286.4	0.215	12.3	12.8	3.9	7.8	7.4	16.9	30.0	Cash

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only one among 15,000 SKUs it carries in H.K.

**H.K. & Macau markets.** Two major issues baffling the H.K. market are rental costs and the sustainability of sales growth. In Q2, sales recorded a mild growth while rental cost showed a mild decline. In Apr-Sept, Sasa has renewed eight leases, rental cost increased by 22.6% YoY and total rental costs as a percentage of total sales rose to 10.5% compared with 9.6% in FY3/06A. The rapid increase was partly distorted by a low base since most of the leases were signed during the SARS outbreak. Other costs, including staff and A&P expenses remained stable. There are eight more leases to be renewed in FY3/07, Sasa expects rental costs to increase by 20-22% in FY3/07F. The problem of high rental costs will ease in FY3/08F with 18 leases to be renewed. We expect Sasa will benefit from lower rental costs, but will not be realized until FY3/08F.

**PRC market.** The total number of SKUs registered in the PRC has increased from 500 SKUs in FY3/06A to 700 SKUs up to Sept 2006. Sasa is on track to meet its target of 1,000 SKUs in FY3/07. Once it has achieved 1,000 registered SKUs, it will begin to launch the franchisee programs in PRC. However, there is no definite time frame for the franchisee plan. Currently, it carries 7,000 SKUs in PRC, which are not under its brand management. The 3<sup>rd</sup> Shanghai store with 1,000 sq. ft. was opened in Sept. The shop size is much smaller compared to 4,000 sq. ft for the existing two stores. Losses from the PRC market reached HK\$17.3m in FY3/06. We expect the PRC market still need some time to achieve a breakeven with the opening of the 3<sup>rd</sup> store.

**Valuation.** We like Sasa because 1) it is a very solid H.K. retail play with a multi-branding strategy; 2) it will benefit from lower rental costs in FY3/08F and 3) it enjoys a high average yield of 6%. However, we believe share price will remain range bound, unless the PRC market shows signs of a breakeven. We maintain our HOLD rating, with a target price of HK\$2.65, equivalent to 17x P/E in FY3/07F.

**Table 2: Retail sales performance**

Year to Mar	1Q06A	2Q06A	3Q06A	4Q06A	2006A	1Q07A	*2Q07A
<b>Hong Kong &amp; Macau</b>							
Retail sales YoY %	13	11.8	11.2	13.8	12.4	13.4	9.8
Same-store-sales YoY %	(1.3)	(6.9)	(6.5)	(0.9)	(4.0)	1.7	0.4
Average sales/ transaction (HK\$)	230	226	260	273	248	253	252
Total no. of transactions (m)	1.9	2.1	2.3	2.1	8.4	1.9	1.7
<b>Singapore</b>							
Retail sales YoY %	34.2	35.9	31.4	11.4	27.3	32.1	33.3
Same-store-sales YoY %	25.4	18.0	9.3	(1.4)	11.8	5.9	1.7
<b>Malaysia</b>							
Retail sales YoY %	20.7	29.9	25.3	13.8	22.2	17.4	20.4
Same-store-sales YoY %	8.6	15.0	23.5	16.4	16.2	13.9	12.7
<b>Taiwan</b>							
Retail sales YoY %	28.1	32.3	45.7	55.6	41.2	57.9	43.5
Same-store-sales YoY %	13.4	24.7	7.7	(2.9)	10.4	2.7	(12.1)

\* Q2 includes period from 1<sup>st</sup> July to 15<sup>th</sup> Sept, since whole-month data is not available yet.

Source: SBI E2-Capital