Corporate Snippet

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Losses from PRC market narrowing — Hong Kong Retail

Sa Sa (178 HK, HK$2.85) — BUY (upgraded from HOLD)

Target price: HK$3.60 (+20.8%)

1H FY3/07 net profit was in line with our expectations with a 11.1% YoY increase to HK$75m, while sales were slightly ahead of our estimates with a 14.6% YoY growth to HK$1,341m. Stripping out one-off items, recurring profits actually went up 14.5%. Basic EPS amounted to HK$0.056. Total DPS was maintained at HK$0.06, including a special DPS of HK$0.03. Payout ratio exceeded 100%. This set of good results was mainly driven by i) strong sales growth from overseas markets; ii) gross margin improvement due to higher contribution from own and exclusive distributed brands and iii) losses from the PRC market narrowed, together with a turnaround of its beauty services segment.

Table 1: Results highlight

6 months to Sept	Turnover (HK$m)	Gross profit (HK$m)	Gross margin (%)	Operating (HK$m)	Net profit (HK$m)	EPS (HK$)	DPS (HK$)
1H FY3/07	1,340.7	607.0	45.3	93.4	75.3	0.056	0.060
1H FY3/06	1,170.3	517.3	44.2	80.1	67.8	0.051	0.060
YoY (%)	*14.6*	*17.3*		*16.5*	*11.1*	*9.8*	-

Source: SBI E2-Capital

Strong overseas sales growth. Sales from retail and wholesale business rose 15.5% YoY in 1H FY3/07A. Sales of own brands and exclusively distributed products rose 22% YoY, which accounted for 31.7% of the Group's total retail and wholesale sales for the period, compared with a 29.1% in 1H FY3/06A. Sales growth was buoyed by overseas market, such as Singapore (+40.2%), Malaysia (+19%) and Taiwan (+47.4%). They altogether showed a net addition of 6 stores during the period. The domestic H.K. & Macau market also performed satisfactory with a 12.9% YoY increase in sales, despite only one net addition of store. Strong domestic consumption has mitigated the negative impact from a decline in the number of Mainland visitors.

Gross margin improvement in buffering higher operating costs. Overall gross margin improved by 1.1% to 45.3% (1H FY3/06A: 44.2%), mainly due to increased sales contribution from its own brands and exclusively distributed brands. As a result, despite higher operating costs such as shop rental and staff costs, overall operating margin still managed to edge up 0.1% to 7.0% (1H FY3/06A: 6.9%). Stripping out one-off items, overall net margin was maintained at 5.5%. During the period, there were two new exclusive brands namely, Methode Swiss and Beauty Formula being launched in China and the Company has secured exclusive distributorship for Natio from Australia and fragrances of Krizia and Sergio Tacchini.

Losses from the PRC market narrowed from HK$11.3m in 2H FY3/06 to HK$8.7m, reflecting a HK$2.6m operating profit contribution in 1H FY3/07A. The Group has just opened its third Shanghai "Sa Sa" in Sept 2006

Table 1: Financial summary

Year to Mar	Net profit HK$m	EPS HK$	EPS Δ %	P/E x	P/B x	EV/EBITDA x	Yield %	ROE %	ROCE %	N. Gearing %
05A	202.1	0.155	30.4	18.4	4.1	11.5	6.0	22.9	24.9	Cash
06A	185.1	0.139	(10.0)	20.5	4.1	11.4	6.0	20.0	22.4	Cash
07F	221.1	0.166	19.1	17.2	4.2	10.7	6.5	24.0	26.0	Cash
08F	269.1	0.202	21.7	14.1	4.2	9.0	6.7	29.3	31.6	Cash
09F	343.3	0.257	27.5	11.1	3.9	9.4	8.6	17.7	31.6	Cash

and set up a specialty counter in Seibu department store in Chengdu under its exclusive brand, "Suisse Programme" in April 2006. It has registered 550 SKUs during the period with another 200 SKUs in progress, compared with 500 SKUs in FY3/06A.

Outlook. We believe both H.K. and PRC markets are well on track to fuel Sasa's growth. H.K. economic growth continues with higher GDP, lower interest costs and mild inflation. Although both retail sales and same-store-sales in H.K. & Macau markets in Oct-Nov appeared to be rather weak at –1.8% and –2.2%, this was partly due to a higher comparison base. For the PRC market, we believe further losses are unlikely because i) unlike the previous two flagship stores in Shanghai with an average size of 4,000 sq. ft., the store size for the 3rd store is more reasonably at 1,000 sq. ft. with a comparatively lower setup costs. This means that future expansion strategy will be focused on smaller-sized shops.; ii) economies of scale can be achieved with more number of SKUs registered and ii) Sasa's PRC expansion strategy aims to increase the distribution channels for its exclusive brands by setting up beauty counters in department stores, in addition to selling them in Sa Sa stores. The setup cost for counters is much lower than standalone shops. It targets to increase the total number of POS up to 7, 20 and over 100 in FY3/07F, FY3/08F and FY3/11F respectively. When Sasa is able to achieve 800-1,000 SKUs, it will speed up the expansion of "Sa Sa" stores with an ultimate goal of rolling out a franchisee program.

Upgrade to BUY based on solid domestic growth and lower losses from the PRC. We have revised our earnings forecast upwards by 5%-7% for FY3/07-09F, based on higher gross margins. We think its high dividend payout policy of >100% will continue into FY3/07F, thanks to the solid cash position of c.HK$517m (c.HK$0.38/shs) and strong cash generating capability. We now upgraded our recommendation from HOLD to BUY, with a revised target price of HK$3.6, equivalent to 18x P/E or 0.9x PEG and a dividend yield of 6.8% in FY3/08F.

Risks. 1) Higher A&P expenses from the PRC market with the launch of beauty counters under its exclusive brands; 2) A setback in domestic and PRC economy; 3) Higher Euro and 4) A delay in the SKU registrations.