

Growing brand premium

China Retail

Prime Success (210 HK, HK\$5.08) BUY (upgraded from HOLD)

Target price: HK\$6.0 (+18%)

Results review:

In-line with our expectations. 1H FY12/06 sales and net profit were up 25% YoY and 39% YoY to HK\$1,441m and HK\$147.3m respectively. 1H earnings contributed c.43% of full-year forecast in FY12/06F, which was in-line with our expectations. EPS rose 34% YoY to HK9 cents. However, interim DPS has decreased to HK2 cents, compared with HK2.5 cents last year, as a result of reserving for its expansion purpose in Taiwan.

Margin expansions despite higher production costs. Despite higher production costs, overall gross and operating margins improved by 3% and 0.5% to 46.2% and 12% respectively in 1H06, thanks to the robust growth in OBM business and its flexibility in selecting higher-margin OEM orders, as well as tapping into different market segments for its branded business. The 63% surge in operating profit for the OBM business has mitigated the 35.7% decline for the OEM business.

Shoebox to achieve a breakeven in FY12/06F. Operating losses from Shoebox widened to HK\$4.4m from HK\$2.8m in FY12/05A due to the initial set-up costs, together with a pretty flat ASP. Nevertheless, PS has increased its stake in Shoebox by another 36% to 95% in September. It has opened 24 new shoebox stores in 1H06, bringing the total number to 99. PS is on track to meet its target of 150 stores by the end of 2006 and the pace of new shop openings from 2007 onwards will accelerate. Management is confident that Shoebox will achieve a breakeven in FY12/06F and expect to make profit from FY12/07 onwards.

Store expansions under Daphne will exceed its target. PS originally targets to add 400 POS under the Daphne brand each year up to 2010. However, it has already added 255 POS in 1H06. It is likely to exceed the annual target in FY12/06F.

Table 1: Interim results

Six months to Jun	Turnover (HK\$m)	Gross profit (HK\$m)	Gross margin (%)	Pre-tax profit (HK\$m)	Tax rate (%)	Net profit (HK\$m)	EPS (HK\$)	DPS (HK\$)
1H FY06	1,441	666	46.2	169.3	12.9	147	0.09	0.020
1H FY05	1,155	499	43.2	131.2	18.7	106	0.0674	0.025
YoY (%)	24.8	33.5		29.0		38.7	33.5	(20.0)

Source: Company data

Table 2: 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	176.2	0.113	109.0	44.8	14.9	32.1	0.6	37.6	38.3	Cash
05A	246.8	0.152	34.5	33.3	11.9	23.3	1.0	40.0	42.2	Cash
06F	341.9	0.209	37.0	24.3	8.8	16.5	1.2	41.6	45.6	Cash
07F	454.2	0.277	32.8	18.3	6.6	12.0	1.6	41.1	46.3	Cash
08F	589.1	0.360	29.7	14.1	4.9	9.0	1.8	39.6	45.5	Cash

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OEM business

- The OEM business was battered by higher production costs, with 3% YoY and 35.7% YoY drop in sales and operating profit to HK\$352m and HK\$45m respectively.
- Although PS has selectively pulled out resources to target at higher margin orders, such as Umbro, Aerosoles and Unisas, overall operating margin still dropped to 8.2% (1H05: 12.5%). However, the lackluster performance in its OEM business was completely offset by the OBM business, since it is highly flexible to switch its production resources to OBM business, which is more profitable.

Brand business**Table 3: OBM sales breakdown by brands**

(HK\$m)	1H05	1H06	YoY
Daphne	695.4	916.9	32
Adidas	66.0	113.8	73
Shoebox	31.5	58.6	86
Total	792.9	1,089.3	37

Source: SBI E2-Capital

Table 4: Operating profit breakdown by brands

(HK\$m)	1H05	1H06	YoY
Daphne	87.4	139.1	59
Adidas	4.0	7.9	99
Shoebox	(3.7)	(4.4)	n.a.
Total	87.7	142.6	63

Source: SBI E2-Capital

Table 5: OBM operating profit margin breakdown

%	1H05	1H06	YoY
Daphne	12.6	15.2	+2.6
Adidas	6	7	+0.9
Shoebox	(12)	(8)	n.a.
Overall operating margin	11	13	+2.0

Source: SBI E2-Capital

- Sales from the brand business continued to deliver impressive growth by increasing 37% YoY to HK\$1.1b, while operating profit increased by 63% to HK\$143m.
- The strong result was mainly driven by Daphne, with impressive operating margin improvement to 15.2% (1H05: 12.6%), thanks to an 8% ASP hike. Overall operating margin rose to 13.1% (1H05: 11.1%). For adidas Originals, operating margin improved slightly by 1pcp to 7%, despite a flat ASP. A new concept store will be rolled out under adidas Original, with a “Sports Casual” line. The ASP is expected to have little downward pressure going forward, since the Sports Casual line commands a lower ASP of RMB200/piece, compared with existing RMB500/piece.
- Total POS for the brand business increased to 1,893 as of June 2006, represented an addition of 284 POS in 1H06. POS under Daphne reached 1,698, represented an addition of 255 POS compared with its target of an addition of 400 POS for FY12/06. The management is comfortable to exceed the target in FY12/06F. POS under adidas Original reached 96, represented an addition of 5 POS. It will achieve 100 POS in FY12/06F.
- For Shoebox, PS has added 24 POS in 1H06, bringing the total number to 99 (FY12/05: 75 POS). PS is on track to meet its target of 150 stores by the end of 2006 and the pace of new shop openings from 2007 onwards will accelerate. The recent acquisition of another 36% stakes in Shoebox by PS proved management confidence over the performance of this bargain shoe segment. PS expects Shoebox to achieve a breakeven in FY12/06 and profit is expected to kick-in from FY12/07 onwards.
- Apart from the PRC market, PS has successfully brought Daphne to Taiwan with its first store opening in April 2006. It has set up 28 stores in Taiwan as of Sept, exceeding its full year target of 30 stores. Due to the overwhelming responses, PS revised its full-year target to 40 stores in 2006.

Outlook & valuations

- Going forward, we expect growing brand premium for Daphne. Although, losses from Shoebox will create a short-term overhang on its share price, we expect PS to gain from higher economies of scale once the bargain shoe shop model picks up.
- Apart from the retail business, growing brand premium has led PS to engage in brand licensing business under the “Daphne” brand to manufacturers for launching watches and eyewear products. The Daphne

watches have been launched since August 2006, while eyewear, mainly sunglasses will be launched in early 2007. Although, we do not expect material profit contribution from the brand licensing business, it has shown management's effort in exploring these business opportunities.

- Regarding its accounting policy of expensing its store renovation and investment costs instead of capitalizing it, the management is comfortable with existing accounting policy. We have fine-tuned our earnings forecast, reflecting higher operating margins from the brand business. PS is trading at 24x P/E FY06, compared to 18x industry average. We upgrade it from HOLD to BUY, with a revised TP of HK\$6.0 (previous TP: HK\$5.0), representing 22x P/E FY12/07F, compared to 12x industry average. We believe PS deserves to trade at a premium to its peers with higher brand premium.

Major risks. 1) Fluctuating tax rate. The strong 1H06 results was buoyed by a decline in effective tax rate. Effective tax rate for the period decreased substantially to 12.9% compared with 18.7% in 1H05A due to its shop portfolio expansion in different regions in PRC. Applying the same effective tax rate in 1H05A, earnings would have increased by 29% YoY instead. The average effective tax rate in the past years ranged between 18-24%. **2) Higher finance cost,** bank borrowings increased 3.3% from HK\$133m in FY12/05A to HK\$137.4m in 1H06A. However, finance cost for the period rose 20.3% reflecting higher interest costs. Its net cash position decreased to HK\$5.5m, compared with HK\$13.4m in FY12/05A as a result of the expansion.

Table 5: Peer comparison

Stock	Ticker	Currency	Market cap (US\$m)	FY06F P/E (x)	FY07F P/E (x)	ROA (%)	ROE (%)
Brand footwear							
Prime Success Int'l Group Ltd	210	HKD	1,066.7	24.0	17.9	20.27	39.84
Mirabell Int'l Hldgs Ltd	1179	HKD	80.9	8.1	7.0	11.16	15.24
Le Saunda Holdings	738	HKD	103.4	n.a.	n.a.	13.62	16.28
Hongguo International Hldgs	HGUO	SGD	170.4	16.0	12.0	17.03	24.69
China Hongxing Sports Ltd	CHHS	SGD	415.4	18.8	11.6	9.61	14.57
Average				16.7	12.1	14.3	22.1
OEM footwear							
Yue Yuen Industrial Hldg	551	HKD	4,828.1	13.9	12.1	10.24	16.8
Symphony Holdings Ltd	1223	HKD	226.2	8.0	7.2	12.98	18.62
Kingmaker Footwear Hldgs Ltd	1170	HKD	73.9	17.6	11.0	6.44	8.8
Average				13.1	10.1	9.9	14.7

Source: SBI E2-Capital