Corporate Snippet

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Visibility improves markedly — Hong Kong Textile

Top Form (333 HK, HK$1.39) — BUY (upgraded from HOLD)

Target price: HK$1.84 (+32%)

FY6/06 results were down, but we see light at the end of tunnel…

- FY6/06 net profit fell 37.3% to HK$115m, below our forecast of HK$127m. Turnover fell 2.6% to HK$1.43b. The shortfall was mainly caused by increased operating costs (air freight charges and over time pay) and inefficiency (i.e. production down time) as a result of disruption caused by the Sino-US and Sino-EU trade disputes last year. Full year dividend payout was 51% compared with 50% the year before (a total DPS of HK$0.055 cf. HK$0.085).
- The company made an operating loss of HK$6.5m for the branded business (cf. a loss of HK$5.6m in FY6/05) this year, almost all arising from the HK operation. As such, management finally decided to pull out its Meritlux branded business in HK in June and instead has opened four retail counters in Shenzhen.
- FY6/07 results are expected to improve on the back of 1) a more normal production environment and lower transport costs in the absence of trade dispute disruption; 2) lower quota costs (c.HK$22m in FY06) and more importantly 3) a maiden contribution from a new higher margin "beamless bra" or "sew free bra" product – accounting for an expected 10% overall sales in FY6/07 and increase to 30% in FY6/08 (no specific ASP is provided though). Management believes the company is the first in the marketplace that is able to produce this complex product on a mass scale. This new product will mainly target the up market in the US.
- Overall shipments are expected to rise 11.1% to 63m units in FY6/07 (c.17m shipped in 1Q FY6/07) cf. 56.7m (down 7.95% YoY) in FY6/06.
- ASP is expected to edge up to >US$3.28 in FY6/07 cf. US$3.01 in 1H 1FY6/06 and US$3.24 in 2H FY6/06.
- Gross margin is expected to improve 1-2% to 27-28% in FY6/07.

Major risks. 1) reduction of VAT rebates from 13% to 11% is likely to be implemented from 2007 onwards; 2) higher labour cost - minimum wage recently rose by 6% in Shenzhen and is likely to remain on the rise; 3) electricity shortage in Shenzhen; 4) pricing pressure on old products and 5) RMB appreciation.

Upgrade to BUY. It looks like the company will bottom out in the coming year. We have raised our recommendation from HOLD to BUY. We have upgraded our earnings forecast by c.9% for FY6/07-FY6/08. Our new target price of HK$1.84 is based on 12x FY6/07 P/E.

Table 1: Financial summary

Year to Jun	Net profit HK$m	EPS HK$	EPS Δ %	P/E x	P/B x	EV/EBITDA x	Yield %	ROE %	ROCE %	N. Gearing %
05A	183.1	0.170	16.5	8.2	4.5	5.8	6.1	47.9	54.7	Cash
06A	114.9	0.107	(37.3)	13.0	3.4	8.9	4.0	25.7	29.4	Cash
07F	165.1	0.153	43.8	9.1	3.2	6.4	5.7	32.9	37.6	Cash
08F	199.3	0.185	20.7	7.5	2.8	5.4	6.9	33.8	37.6	Cash
09F	226.8	0.211	13.8	6.6	2.3	4.8	7.8	32.7	36.4	Cash