

## Brighter future ahead

## Hong Kong Retails

### Bauhaus (483 HK, HK\$1.36)

### BUY (unchanged)

#### Target price: HK\$1.8 (+32.4%)

1H FY3/07A net profit came in 4% higher than our expectation to reach HK\$20.8m (+18.0% YoY), while sales came inline to reach HK\$219.5m (+21.5% YoY). EPS amounted to HK\$0.059. Interim DPS amounted to HK\$0.025, represented a payout of 42.4%. The good results was fuelled by 1) a strong retail market in H.K.; 2) sales rebound in Taiwan despite political instability; 3) a surge from wholesaling in Japan with the introduction of apparels into the Japanese market and 4) the management's ability and consistency in stringent cost control. As expected, gross margin declined by 1.6% YoY to 63.1% since sales contribution from wholesale and franchise operations rose to 16.7% of total sales in 1H FY3/07A, compared with only 14% in 1H FY3/06A. Operating margin declined by a lower extent of 0.3% YoY to 11.1% as overall operating expenses dropped by 1.5% YoY to 53.4% of total sales in 1H FY3/07A.

**Table 1: Result highlights**

6 months to Sep	Turnover (HK\$m)	Gross profit (HK\$m)	Gross margin (%)	Operating (HK\$m)	Net profit (HK\$m)	EPS (HK\$)	Interim DPS (HK\$)
1H FY3/07A	219.5	138.5	63.1	24.3	20.8	0.059	0.025
1H FY3/06A	180.7	116.9	64.7	20.7	17.6	0.054	0.025
YoY (%)	21.5	18.5	1.6	17.5	18.0	8.9	-

Source: SBI E2-Capital

#### Results review

- **Strong retail sales from H.K., despite keen competition.** Retail sales and same-store-sales in H.K. rose 14.5% YoY and 7% YoY respectively in 1H FY3/07A. The Group has reallocated some of the retail outlets to prime shopping areas and closed down shops in the 2<sup>nd</sup>-tier shopping areas where sales/rent ratio has not been optimised. It has just added a "TOUGH" shop in Causeway Bay and a "SALAD" shop in Tai Koo Shing. Total number of retail outlets reached 46 in 1H FY3/07A (1H FY3/06A: 42).
- **Sales rebound in Taiwan, despite political instability.** Retail sales and s.s.s. performed exceptionally well by rising 59.1% YoY and 27% YoY respectively in 1H FY3/07A. In stark contrast with other retailers who suffered a great setback in their sales as a result of the unstable political environment, Bauhaus was able to deliver strong growth as a result of the successful takeover of the Taiwan operation by the H.K. management team. Bauhaus has successfully replicated the H.K. management in its Taiwan operation and led to great improvement in operating efficiency. Total number of retail outlets reached 18 in 1H FY3/07A (1H FY3/06: 15).
- **Increase contribution from wholesaling in Japan.** Sales from wholesale operation rose 31.1% YoY to

**Table 2: 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	46.6	0.134	13.9	10.1	3.32	6.3	0.0	32.5	36.7	Cash
06A	50.9	0.145	8.1	9.4	1.64	7.5	7.9	24.7	27.1	Cash
07F	60.6	0.173	19.2	7.9	1.64	4.5	3.8	21.7	24.8	Cash
08F	74.1	0.211	22.3	6.4	1.32	4.8	4.7	22.8	26.3	Cash
09F	90.8	0.259	22.5	5.2	1.25	4.4	5.7	24.5	28.5	Cash

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HK\$23.6m mainly due to 69.8% sales increase from Japan. The Group has entered into a 5-year apparel distribution agreement with IMC, a major Japanese fashion retail chain to distribute “TOUGH” brand in Japan. Previously, the Group only sell its in-house brand name bags to the Japan market.

- **Both franchisee operations and self-owned store to fuel the PRC market growth.** Due to a low base, sales from franchise business in China rose 75.7% YoY to HK\$13m. It has franchise agreements with independent franchisees to operate 20 franchised stores in 1H FY3/07A (1H FY3/06A: 15) in the PRC and Macau. Apart from franchisee operations, the Group has turned a franchisee operation into a self-managed “TOUGH” retail outlet in Shanghai. Sales doubled after it took back the operations in the first month.

### Outlook

- **Increase in ASP** through 1) higher mark-up and 2) rollout of new concept stores. For the H.K. market, it has already increased the percentage of mark-up since Sept. The positive impact will be reflected in the Group’s 2H FY3/07 results. Besides, it has launched a new concept store “BAUHAUS ELITE”, targeting the high-end ladies fashion labels in Nov. The shop is located in the Harbour City, Tsim Sha Tsiu, which is a prime shopping area. The average ticket-price is as high as HK\$2,000-3,000. We believe it enables the Group to enjoy a higher gross margin going forward. It can also lessen the gross margin dilution of higher sales contribution from wholesale and franchisee operations.
- **Enhance brand equity with a new counter to be opened in the Sogo Department Store in Taiwan.** The Sogo Department Store is the most prestigious shopping mall in Taiwan with heavy traffic. Bauhaus can have higher brand recognition with the opening of this new store.
- **Further strengthening its regional development in Japan and the PRC.** The Group’s Japanese partner will open the first “TOUGH” apparel shop in 1Q 2007 in Omotesando, which is a prime high-end fashion district in Tokyo. For the PRC franchisee operation, it will open 6 “TOUCH” franchise stores in Beijing, Wuhan, Wenzhou, Cheugdu, Chongqing and Macau in 4Q 2006. For self-operated stores, it will open 2 “TOUGH” and 1 “SALAD” retail outlets in Shanghai in 1Q 2007. We believe it is well on track to meet its previous expansion target of 35 POS by the end of FY3/07. It aims to raise the total number of POS up to 80-100 by FY3/09F.
- **Rental costs to stabilize.** Total rental expenses rose 24% YoY, partly due to a lower base during the SARS period. In 1H FY3/07, the Group has renewed 12 leases out of the 18 leases to be renewed in FY3/07. Total rental expense was successfully kept in line with sales growth and was about 20.5% of total sales in 1H FY3/07A, compared with 20.1% in 1H FY3/06A. Although, the relocation of shops to prime shopping areas might increase the risks over higher rental, sales from these shops are expected to be much higher. So the overall sales/rental ratio should be able to maintain at c.20%.
- **Valuations.** Based on higher sales from Taiwan and higher operating margin, we revised our earnings forecast upwards by c.5-7% for FY3/07-09F. The Group remains in a net cash position of HK\$111m, or HK\$0.32/shs. We revised up our target price to HK\$1.8, representing an 8.5x cum-cash P/E and 7.0x ex-cash P/E in FY3/08F.

**Risks. Inventory risks.** Although inventory turnover was lowered from 235 days in 1H FY3/06A to 221 days in 1H FY3/07A, there was an increase in the provision of slow moving inventories of HK\$6.5m, compared with HK\$0.7m in 1H FY3/06A. In view of this, the Group is considering to change the stock order period from half-yearly to quarterly in order to have a more efficient control over their inventory.

**Table 3: No. of outlets**

Self-managed retail outlets	1H FY3/07A	1H FY3/06A	Net additions
H.K.	46	42	4
Taiwan	18	15	3
PRC	1	0	1
Franchise outlets			
PRC & Macau	20	15	5
<b>Total</b>	<b>85</b>	<b>72</b>	<b>13</b>

Source: SBI E2-Capital