I.T

Fri, 13 Feb 2009

In shape, but turbulences ahead

HOLD (from BUY)

Financial summary

Year to Feb	07A	08A	09F	10F	11F
Turnover (HK$m)	1,530.8	2,021.3	2,718.8	2,642.0	3,228.5
Net Profit (HK$m)	122.4	171.0	102.5	83.7	175.1
EPS (HK$)	0.118	0.160	0.089	0.066	0.138
EPS Δ%	0.1	36.0	(44.6)	(25.8)	109.2
P/E (x)	3.7	2.7	5.0	6.7	3.2
P/B (x)	0.55	0.38	0.35	0.31	0.27
EV/EBITDA (x)	55.7	43.0	19.7	20.3	19.5
Yield (%)	11.3	25.4	9.5	8.2	17.2
ROE (%)	15.6	16.7	8.0	6.4	12.6
ROCE (%)	17.3	19.6	7.3	7.2	13.5
N. Gear. (%)	Cash	Cash	Cash	Cash	Cash

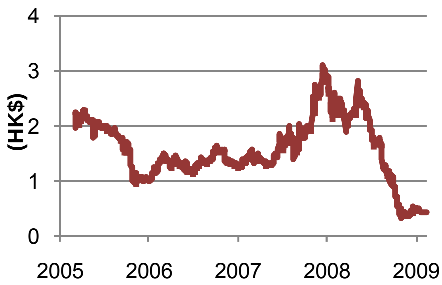
Source: SBI E2-Capital

Price Performance

	1 mth	3 mth	12 mth
Relative to HSI (%)	-4.2	+4.2	-65.3
Actual price changes (%)	-9.3	-1.1	-80.0

	09F	10F	11F
Consensus EPS (HK$)	0.140	0.158	0.205
Previous forecasts (HK$m)	183.5	240.1	322.4
Previous EPS (RMB)	0.172	0.225	0.302

Price Chart



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Ticker:	**999.HK**	12 mth range:	HK$0.30-1.83
Price:	**HK$0.44**	Market cap:	US$65.2m
Target:	**HK$0.48 (+9.1%)**	Daily t/o, 3 mth:	US$0.100m
		Free float %:	24.3%

Key points:

- Gloomy future despite better-than-expected sales growth
- Blended GP margin to contract 6.1pcp YoY in 2H FY02/09F
- Projects in Shanghai on track, with HK$100.0m capex in FY02/10F
- Taiwan's operations restructured, with GP margin ~63.0% in Jan
- We downgrade our target price from HK$1.80 (BUY) to HK$0.48 (HOLD), which represents 5.0x FY02/09F and 7.4x FY02/10F P/E

We met with the management to 1) discuss the current environment for retailers in Hong Kong and China; 2) clarify our earnings forecasts for the company.

Trying to beat Hong Kong's slowdown. The company's stepped up its marketing efforts in Nov 2008, which resulted in a 16.0% sales increase in Hong Kong (same-store-sales growth: ~ 8.0%) in Sep 08 - Jan 09. The blended gross margin shrunk around 6.1pcp YoY to 54.5% in 2H FY02/09. Amid the gloomy economic outlook, I.T. intends to focus on maintaining its existing operations in 2009 and may open several new stores, depending on favorable lease negotiations. Its operating margin in 2H FY02/09F might improve HoH given the booking in 1H of HK$13.6m in one-off marketing expenses related to its 20th anniversary and HK$13.8m in option expenses (around HK$7.0m in 2H and HK$7.0m in FY02/10F). The company is also strengthening its cost controls and has laid off about 90 employees (near 20% HK's total).

Treading cautiously in China. Expansion in the mainland has been streamlined into three main projects, two in Shanghai and one in Beijing. 1) The company is expanding its store at Shanghai's Grand Gateway (港匯廣場), which will triple in size to 2,000sqm by May. 2) For another Shanghai project, I.T. is using a new approach and leasing a whole building instead of floor space. It has signed an MOU with the local government and landlord of a 7,000sqm effective selling floor mart at Nanjing Road West (non-prime location), with plans to use ~70% fro its own portfolio and to lease the remaining 30%. This new business model will allow it to obtain longer leasing contracts at lower rates. Though the non-prime location should be a challenge, we are still positive on the project, given: a) the company's strong brand equity; b) its extensive product portfolio; c) similar successful experience in Hong Kong. The mart will be put into operation in early CY12/10 with expected HK$100.0m capex incurred in FY02/10F; 3) The last major plan for FY02/10F is to expand stores at Sanlitun (三里屯), Beijing.

Focus on izzue.com in Taiwan. The company has restructured its business in Taiwan, concentrating on its higher-margin izzue.com brand. The gross margin in January was about 63.0%.

Blurred outlook. Our view on operations in different geographic areas:

- Hong Kong – discretionary consumption might contract substantially in FY02/10F but the strong branding should help to limit a potential adverse impact from the weak economy (16.0% sales growth in Sep 08 – Jan 09 versus 2.2% in Hong Kong in Sep – Dec 08).
- China – consumption momentum is stronger than in Hong Kong, but the company has less brand equity in the

region. We agree with its cautious expansion plan.

Forecast adjustments and recommendation. We are still positive on the company's business model and management quality, but we adjusted our estimates (from 14 Oct 08 - "Not All Bad News") to factor in:

- FY02/09F: 26.8% YoY revenue growth in 2H FY02/09F, down from 30.3% in our previous forecast, with a 5.5pcp improvement in the operating margin from 1H FY02/09A, based on: 1) HK$28.5m advertising and marketing expenses, 50.0% of which are non-recurrent; 2) HK$7.0m related to option cost expenses; 3) layoffs in Hong Kong with lower staff cost growth to weigh for 14.2% of sales, from 15.7% in 1H FY02/09A.
- FY02/10F: 2.8% top line decline in FY02/10F (Hong Kong sales: -4.8% YoY; China: +4.2%) due to the dwindling local consumption (Hong Kong) and less spending on mid & high-end discretionary merchandise (China). The operating margin will narrow to 3.5% from 4.5% due to operating leverage from staff and rental expenses.
- FY02/11F: 22.2% increase in sales with 2.7pcp operating margin expansion for FY02/11F as the economy recovers.
- ~ HK$400m in cash reserves at end-Jan 2009, up from HK$148.8m at end-Aug 2008 mainly due to: 1) operating cash inflows related to its end of fall-winter collection; 2) a ~HK$130.0m loan from Standard Charter Bank and HSBC contracted in Oct 2008 (HIBOR + 0.5pcp).

Valuation. We cut our earnings forecasts by 79.0% for FY02/09F to HK$102.5m, 65.1% for FY02/10F and 45.7% for FY02/11F. Our theme for the consumer sector in 2009 is still to weight on staples. We think the counter lacks catalysts to trigger a re-rating but downside risks are limited given its strong balance sheet (around HK$270.0m net cash or HK$0.234 per share. Accordingly, we downgrade the counter from BUY to HOLD, with a target price of HK$0.48, which represents a 5.0x FY02/09F and 7.4x FY02/10F forward P/E.