

Water Oasis Group

Flowing with water

to summarize...

- WOG distributes skincare products and provides beauty services mainly in Hong Kong and China. It successfully introduced the US-originated H2O brand to Asia. After decade of development, H2O has become a well-known skincare name here.
- The company has H2O's distribution right in Hong Kong, China, Taiwan and Singapore, which also construct WOG's core operation and accounted for 58% of 1H FY09/11A total revenue.
- Since H2O business has achieved a certain scale, we expect future growth to come from the company's three new brands, Erno Laszlo, Glycel and JM Makeup.
- We appreciate the company's successful experiences in running H2O brand and held a positive attitude towards the three new brands, particularly the latter two, which are owned by the company itself.
- Revenue increased 16% in 1H FY09/11A to HK\$516m. Net profit, however, declined from HK\$24m to HK\$21m, which is partly due to recognition of deferred taxation from closure of Yves Rocher business.
- For 2H, we expect earnings to improve HoH from: 1) quit from the loss-making Yves Rocher business; 2) growth of other operations under a steady macro environment.
- The counter is trading at 13.1x historical P/E, which is in a deep discount against its two HK peers.

The company is a beauty specialist, exposing to both product distribution and beauty services. Water Oasis Group (WOG) markets and distributes skincare products. Starting with H2O in Hong Kong, now the company runs four brands, including H2O, Erno Laszlo, Glycel and JM. Meanwhile, it provides also beauty services under various names, Oasis Spa, Glycel, Aqua Beauty, Oasis Beauty, Oasis Homme and Oasis Medical. The two business segments, namely retail and services, accounted for 64% and 36%, respectively, of WOG's total revenue in 1H FY09/11A.

Ticker	1161 HK
Rating	Not Rated
Price (HK\$)	0.97
Target Price (HK\$)	n.a.
12m Price Range (HK\$)	0.94-1.53
Market cap. (US\$m)	95.0
Daily t/o (US\$m)	0.1
Free float (%)	30.1

Financial summary

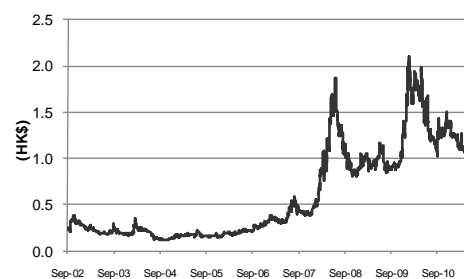
Year to Sep	08A	09A	10A
Turnover (HK\$m)	846.6	921.0	911.9
Net Profit (HK\$m)	71.2	81.0	59.2
EPS (HK\$)	0.197	0.110	0.079
P/E (x)	4.9	8.8	12.3
P/B (x)	2.0	2.0	3.1
EV/EBITDA (x)	4.6	4.4	5.5
Yield (%)	22.2	20.6	7.2
ROE (%)	39.4	44.1	24.9
ROCE (%)	32.9	35.0	18.0
N. Gear. (%)	cash	cash	cash

Source: SBI E2-Capital

	11F	12F	13F
Consensus EPS (HK\$)	0.093	0.11	-
Previous earnings (HK\$m)	-	-	-
Previous EPS (HK\$)	-	-	-

Price performance

Year to Sep	1m	3m	12m
Relative to HSI (%)	(7.8)	(11.2)	(44.6)
Actual price changes (%)	0.8	0.8	1.6



Source: Bloomberg

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Table 1. Product summary

Brands	Target market	ASP range	Products	Relationship
Retail				
H2O	Mid to mass market	HK\$70-520 for HK RMB90-600 for PRC	Skincare, body care and health supplements	WOG obtained HK distributorship early in 1998, which, later, was expanded to Taiwan, Singapore and the PRC.
Erno Laszlo	High-end market	HK\$330-2,280 for skincare HK\$360-890 for body care	Skincare, body care and cosmetics	Exclusive distributorship in HK & China was granted in 2009
JM Makeup	Mid to mass market	RMB49-140	make-up, skincare and accessories	It is WOG's own brand, which was introduced in 2010
Glycel	High-end market	HK\$380-1,800	Skincare	WOG acquired the trademark in 2010
Service				Description
Oasis Spa				Luxurious Spa targeting high-end customers
Glycel				Premium beauty centre offering treatments with Glycel products
Aqua Beauty				Premium beauty centre for Oasis Beauty VIPs
Oasis Beauty				Valuable services targeting mid-market customers
Oasis Homme				Offers services to male customers
Oasis Medical				Provides specialised medical beauty treatment and services

Source: Company data

Proven track record demonstrates the company's strength. We regard H2O as WOG's masterpiece, which made up 58% of the total revenue in 1H FY09/11A and demonstrates the company's core competitiveness i.e. the management's extensive understanding of the local skincare market and execution skills. H2O originated in the US and is a very first water-based skincare collection. WOG obtained its HK distributorship early in 1998 and expanded to Taiwan in 2000, the PRC in 2001 and Singapore in 2003. As end of May 2011, it operated total 304 H2O sales outlets, comprising 164 self-managed and 140 franchised (all in the PRC).

Table 2. H2O stores (May 2011)

	Hong Kong	PRC	Taiwan	Singapore	Total
Self-managed	19	130	14	1	164
Franchised	-	140	-	-	140
Total	19	270	14	1	304

Source: Company data

The company has been searching for the next "H2O". An apparent option for the company, in order to maintain a sound growth, especially after H2O reached a certain scale, is to duplicate its success in H2O and develop another line.

- ❑ WOG entered into agreement with Johnson & Johnson in Mar 2006 for distribution of Neutrogena products in China. The business performed well (161 stores at end-2008) until Johnson & Johnson decided not to renew the contract at expiry in Mar 2009 and get the distribution right back to itself.
- ❑ In Jul 2008, WOG signed shareholder agreements to form a JV with Yves Rocher, a leading French beauty brand, to sell the latter's products in the mainland. Outcome this time is a bit disappointing. WOG ceased all Yves Rocher operation in Mar 2011 as the business failed to meet expectation due to keen competition.
- ❑ Presently, WOG has three new brands in hand, including Erno Laszlo (exclusive distributorship agreement signed in Jun 2009 for HK & China), Glycel (acquired in May 2010) and JM Makeup (self brand launched in Apr 2010). They position differently and target on different customers (table 1).

As all the three brands are in their early stage, it is still too early to draw any conclusion, although we stay at positive side in view of WOG's track record. Particularly, we favour Glycel and JM Makeup, which are owned by the company and, therefore, better execution and motivation can be anticipated reasonably.

Sound growth was observed in 1H, although net profit was affected by stopping bleeding action. Revenue reached HK\$516m in 1H FY09/11A, up 16% YoY. Retail and services segments saw 4% and 47% growth, respectively, to HK\$330m and HK\$185m. Within the retail division, sales of H2O edged up 3% to HK\$299m. Blended gross margin enhanced 1.5pcps to 77.2%, which we largely attributed to the sales mix change. Operating expenses stayed relatively stable at 72.5% of total sales, compared with 72.1% the same period last year. Therefore, operating profit enlarged 23% to HK\$40m. However, net profit still dipped 13% to HK\$21m, which was mainly due to recognition of deferred taxation associated with Yves Rocher, resulting tax expenses surging from HK\$8m to HK\$21m.

Table 3. Sales by products

Six months to Mar	10A		11A		YoY sales growth
	Turnover (HK\$ m)	Number of outlets	Turnover (HK\$ m)	Number of outlets	
Retail	318.5	361	330.1	361	3.6%
H2O	289.3	274	299.4	298	3.5%
Yves Rocher*	17.7	85	10.5	-	(40.7%)
Erno Laszlo	5.4	2	8.8	4	63.0%
JM Makeup	-	-	0.4	16	n.a.
Glycel	-	-	7.9	3	n.a.
Service	125.7	22	185.4	28	47.4%
Oasis Spa	15.1	2	18.5	3	22.5%
Glycel	-	-	29.2	4	n.a.
Aqua Beauty, Oasis Beauty, Oasis Homme	78.7	18	86.2	18	9.5%
Oasis Medical	14.2	2	31.5	3	121.8%

Source: Company data

Note:

* Operation ceased in Mar 2011.

Table 4. P&L

Year to Sep (HK\$ m)	08A	09A	10A	1H 10A	1H 11A
Turnover	846.6	921.0	911.9	444.3	515.5
Changes in inventories of finished goods	(193.0)	(234.8)	(217.4)	(108.2)	(117.7)
Gross profit	653.6	686.1	694.5	336.1	397.8
Other income	3.4	13.8	3.2	1.7	4.0
Other gain and losses	1.1	(1.4)	44.1	15.2	12.2
Staff costs	(224.0)	(243.0)	(255.1)	(123.6)	(151.3)
Depreciation of PP&E	(22.5)	(25.2)	(27.3)	(13.9)	(14.0)
Other expenses	(311.2)	(328.2)	(385.1)	(182.6)	(208.3)
Profit from operations	100.4	102.1	74.2	32.8	40.4
Finance costs	(0.1)	(1.0)	(2.9)	(0.4)	(3.0)
Profit before taxation	100.3	101.2	71.3	32.4	37.5
Income tax expenses	(22.1)	(17.7)	(13.9)	(8.0)	(20.6)
Profit for the period	78.2	83.4	57.4	24.3	16.9
Attributable to:					
Owners of the Company	71.2	81.0	59.2	24.2	21.1
Non-controlling interests	6.9	2.4	(1.8)	0.1	(4.3)
EPS - Basic (HK\$)	0.197	0.110	0.079	0.033	0.028
EPS - Diluted (HK\$)	0.195	0.110	0.077	0.032	0.027
Proposed DPS (HK\$)	0.215	0.200	0.070	0.030	0.030
Proposed dividend	79.1	73.9	53.5	22.9	22.9

Source: Company data

HoH improvement is anticipated. Following the closure of loss-making Yves Rocher in 1H, we think it is fair to expect some improvement of the retail segment in the second half. As 26 out of total 28 beauty services centres are located in Hong Kong, the local environment certainly matters. So far, we see little chance of a sudden turnaround of Hong Kong economy. Therefore, the services segment may retain its strong performance in 2H. We are looking for ~HK\$60m net profit for the full FY09/11F.

Valuation seems undemanding compared with peers. The stock is trading at 13x historical P/E. Based on the expected HK\$60m, FY09/11F P/E multiple will stay at the same level, which is in a deep discount against its peers. There are two other HK-listed cosmetics distributors, **Sa Sa (0178 HK, HK\$4.76)** and **Bonjour (0653 HK, HK\$1.26)**. The former is priced at 22x FY03/12F P/E (historical: 21x) based on market consensus while the latter at 16x FY12/11F (historical: 19x).

Table 5. Valuation matrix

Company	Ticker	Fiscal year end	Market cap (US\$m)	Historical PER (x)	1-year PER (x)	2-year PER (x)	P/BV (x)	ROE (%)
WOG	1161 HK	09/2010	95.0	13.1	10.3	8.7	3.1	28.1
Sa Sa	0178 HK	03/2011	1,711.5	21.4	22.0	17.7	11.9	32.9
Bonjour	0653 HK	12/2010	475.7	19.1	15.6	12.6	17.5	105.7

Source: Bloomberg

Risks. The company has some non-operation items (e.g. fair value adjustment of CB and investment properties) in its P&L, which may materially affect final earnings number.

Table 6. Key financials

Year to Sep (HK\$ m)	08A	09A	10A
Revenue	846.6	921.0	911.9
Gross profit	653.6	686.1	694.5
Operating profit	100.4	102.1	74.2
EBITDA	121.9	127.2	101.0
Net profit	71.2	81.0	59.2
EPS (HK\$)	0.197	0.110	0.079
Fixed assets	119.4	116.2	44.0
Inventories	65.9	99.8	71.5
Receivables	116.0	112.1	131.1
Payables	98.2	113.3	132.3
Cash	141.4	145.8	217.5
Short-term debt	44.8	42.2	39.6
Long-term debt	0.0	0.0	39.4
Shareholders' fund	180.7	183.7	237.3
Total equity	189.4	196.6	249.4
Net cash from operating activities	134.7	87.4	106.1
Net cash used in investing activities	(137.5)	(3.9)	(57.9)
Net cash from financing activities	(21.5)	(79.1)	23.5
Net change in cash and cash equivalents	(24.3)	4.4	71.7

Source: Company data

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