

Royale Furniture Holdings Limited

Enjoys a premium brand recognition

to summarize...

- Royale Furniture engages in manufacturing and the sales of home furniture business in Mainland China.
- The group has attained a well recognized brand "Royal Furniture" since their sponsorship of the Beijing Olympic Game in 2008.
- For 1H FY12/10A result, the group's turnover recorded an YoY increase of 54% to HK\$545.1m from HK\$354.5m in 1H2009. Profit attributable to equity holders increase 175% YoY to HK\$60.0m from HK\$21.9m in 1H FY12/09A.
- Sales from franchisee represented 87.1% of the total sales, an increase from 80.5% in 1H2009. Revenue from self-operating stores represented 12.9% of the total sales, a decrease from 19.5% in the previous year, on sales channel mix changes
- Going forward, the company will continue to capture the fast growing market of the low-tier cities, third, fourth and beyond. The group will establish logistic hubs across China to improve distribution efficiency.
- Our target price of HK\$3.16 representing 14.0x current year forward PE and 9.75x for 2011 forward P/E

Description: Royale Furniture engages in manufacturing and the sales of home furniture business in Mainland China. It's sales of home furniture business operates in two segments, the self-operating shops segment and the franchise operation segment. As of June 30th, 2010 the group's sales channel comprised of 100 self-operating shops and 1,538 franchise outlets. The group has a diversified product portfolio that can satisfy a wide range of customer demands. It's product mixture range from practical to high-end sophistication, and a well balance of mixture between the traditional Chinese to the Modern Western.

Table 1. 1H FY12/10A results

6 months to June	Turnover (HK\$m)	Gross Profit (HK\$m)	Gross margin (%)	Pre-tax profit (HK\$m)	Tax rate (%)	Net profit (HK\$m)
1H FY10	545.1	159.4	29.3	69.9	3.2	60.0
1H FY09	354.5	112.5	31.7	24.1	4.8	21.9
HoH(%)	53.7	41.7		20.0		173.9

Source: Company data

Group History: The group was officially established in 1997 in the Pearl River Delta. The group originally engaged in manufacturing of wooden panel furniture, and later expanded into the production of solid wood furniture and upholstery products. It's main production facility is in Guangzhou Shitan and have other smaller plants with total size of approximately 300,000 square meters, employing over 4,000 workers. In 2002, the group was listed on the Main Board of Hong Kong Stock Exchange. During the 2008 Beijing Olympics Game, the group was selected as the official home furniture exclusive supplier for the Games in which they produced 23,259 set of bedroom furniture and 14,000 set of sofas.

Brand Recognition: Since their sponsorship of the Beijing Olympic Game in 2008, the group has attained a well recognized brand: "Royal Furniture", which projects a premium quality image with affordable price range that can fit a wide range of market

Ticker	1198 HK
Rating	BUY
Price (HK\$)	2.85
Target Price (HK\$)	3.16
12m Price Range (HK\$)	1.01-3.15
Market cap. (US\$m)	210.4
Daily t/o (US\$m)	0.5
Free float (%)	55.5

Financial summary

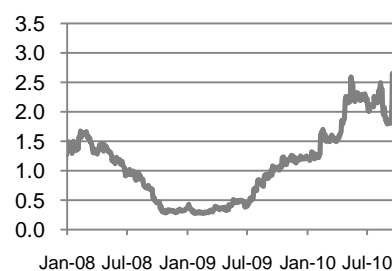
Year to Dec	07A	08A	09A	10F	11F
Turnover (HK\$m)	651.0	790.9	688.4	919.1	1,128
Net Profit (HK\$m)	50.4	(89.5)	130.5	114.0	163.3
EPS (RMB)	0.170	(0.29)	0.295	0.226	0.324
P/E (x)	16.7	-	9.7	12.6	8.8
P/B (x)	1.58	2.00	2.04	1.64	1.32
EV/EBITDA (x)	10.2	-	6.5	7.8	5.9
Yield (%)	1.3	0.8	3.5	2.7	3.9
ROE (%)	14.8	-	24.4	16.4	18.9
ROCE (%)	17.5	-	27.5	19.2	22.7
N. Gear. (%)	Cash	Cash	Cash	Cash	Cash

Source: SBI/Bloomberg

1H09 figures have been adjusted to reflect the reclassification of non-core product income

Price performance

Year to Dec	1m	3m	12m
Relative to HSI (%)	3.4	17.1	118.3
Actual price changes (%)	10.5	35.7	133.6



Source: Bloomberg

SBI Research Team

(852) 2533 3700
sbiresearch@sbie2capital.com

sector demands. The success of its brand recognition led them to winning the bid for the exclusive supplier in home furniture for the 26th Summer Universiade Game to be held in Shenzhen, China in 2011. With this mandate, the group is currently working along with the Universiade official to develop suitable products that will meet the standard set for the event.

Business Model

High-Tier vs. Low-Tier Cities: The group’s sales growth strategy targets high-tier and low-tier cities. In the high-tier cities which includes first and second tier cities, the group’s focus is on their self-operating stores with larger selection of furniture that offers well diversified products lines. This which can accommodate sophisticated tastes of customers in a progressive modern cities. In the low-tier cities which includes third, fourth tier or beyond, the group rely on sales channel of its franchisees. The group works closely with franchise operators to promote more affordable and practically series that can fit the demand of the customers. Going forward, low-tier cities penetration will serve as a growth driver, where the group plans to continuously sign up new franchisees.

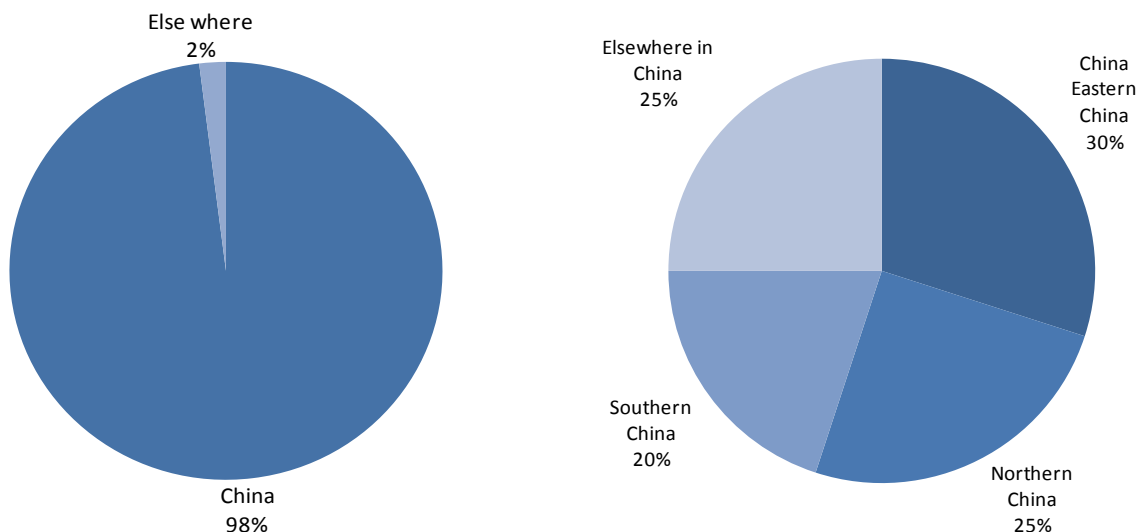
Going forward: The company plans to continue to capture the fast growing market of the low-tier cities, third, fourth and beyond. The group will establish logistic hubs across China to increase improve distribution efficiency. Their plan is to partner with regional logistic companies to establish an efficient supply chain that will target reduction of transportation costs and delivery time. The initial step in the plan is to pilot it in a few selected region by the end of 2010. Upon successfully implementation and satisfying result, the model will then expand and implement in more regions and eventually covers all strategic regions throughout China by the middle of 2011. Also the group will continue to leverage on its brand recognition by looking for overseas ODM project opportunities and continue to sponsor large events that can secure sizeable bulk orders, such as the Beijing Olympic Game in 2008 and the Universiade Shenzhen in 2011.

Latest Reported Financials

Interim Result: For the six months period ended on June 30th 2010, the group’s turnover recorded an YoY increase of 54% to HK\$545.1m from HK\$354.5m in 1H2009. Gross profit had a YoY increase of 42% to HK\$159.4m from HK\$112.5m in 1H2009. Gross profit margin dropped 2.4pcp from 31.7% in 1H2009 to 29.3%. The decline was largely due to increase in raw material cost. Selling and distribution cost as a percentage of revenue decrease to 11.1% from 15.5%, and the administrative expenses as of percentage of revenue decreased to 6.9% from 9.9%. Net profit margin increase 5.9pcp to 12.4% from 6.5% in 1H2009. Profit attributable to equity holders increase 175% YoY to HK\$60m from HK\$21.9m in 1H2009. The increase in profit was largely due to increase in gross profit and operating leverage.

Sales Breakdown: The group derived 30% of its sales from Eastern China region, 25% from Northern China, 20% Southern China and 25% from all other regions combined. Revenue from self-operating stores totaled HK\$70.5m a 1.9% yoy increase from HK\$69.2 in 1H2009. Sales from self operating store represent 12.9% of the total sales, a decrease from 19.5% in the previous year. Revenue from franchise totaled HK\$474.6m, a 66.3% yoy increase from HK\$285.3m in 1H2009. Sales from franchisee represents 87.1% of the total sales, an increase from 80.5% in 1H2009. The gross profit margin from self-operating store increase slightly from 46.9%to 47.7%, while gross profit margin from franchise store decreased from 28% to 26.5%.

Graph 2. Sales breakdown by geographic region

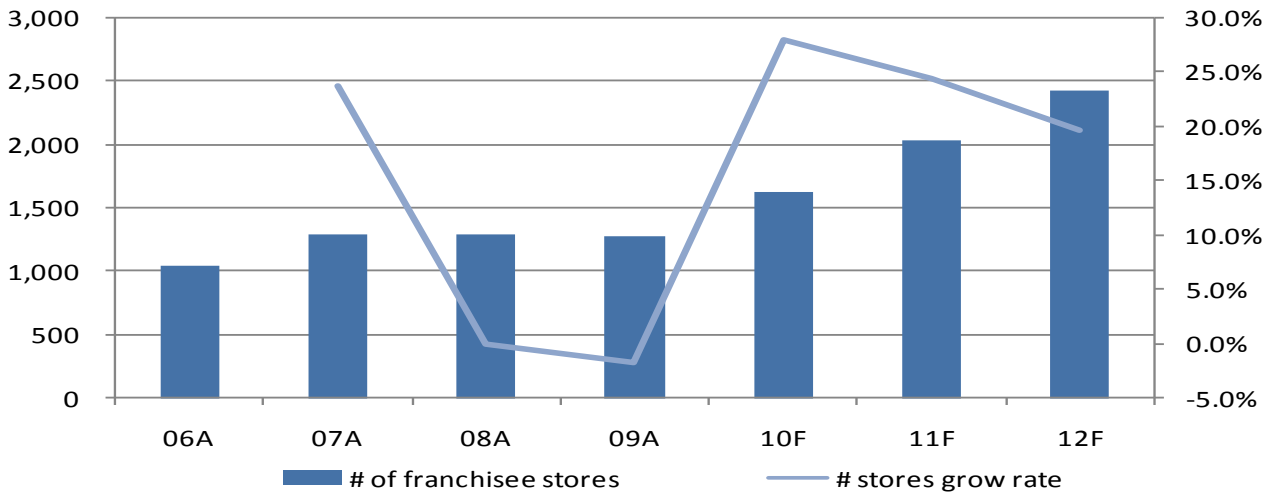


Source: Company

Future Expectation

Signing on new franchise and setting up self operating shops: The group has 1,538 franchisee stores and 100 self-operating stores at the end of June 2010. For the full year 2010, the group expects to increase the number of franchisee store to 1,638 and increase the number of self-operating stores to 105. For the franchisee stores, the number of stores fluctuates from year to year. For the year 2010, the group target to have 1,638 franchise stores, and thereafter increase the number of franchisee stores by 400 each year. At this rate, the total number of franchisee store will be 2,038 by the end of 2011, and 2,438 by the end of 2012.

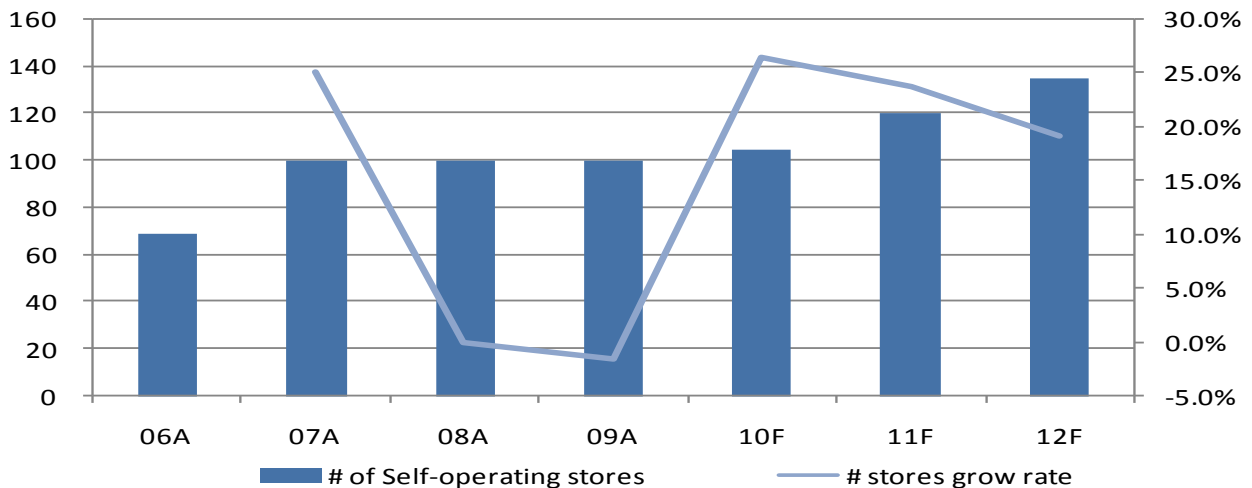
Chart 1. Number of franchisee shops and growth rate



Source: Company

For the last few years, the number of self operating stores has been steady at 100, Going forward the group will plan to add fifteen self-operating stores each year, bring the total number of self operating stores to 120 for 2011 and 135 for 2012.

Chart 2. Number of self-operating stores and growth rate

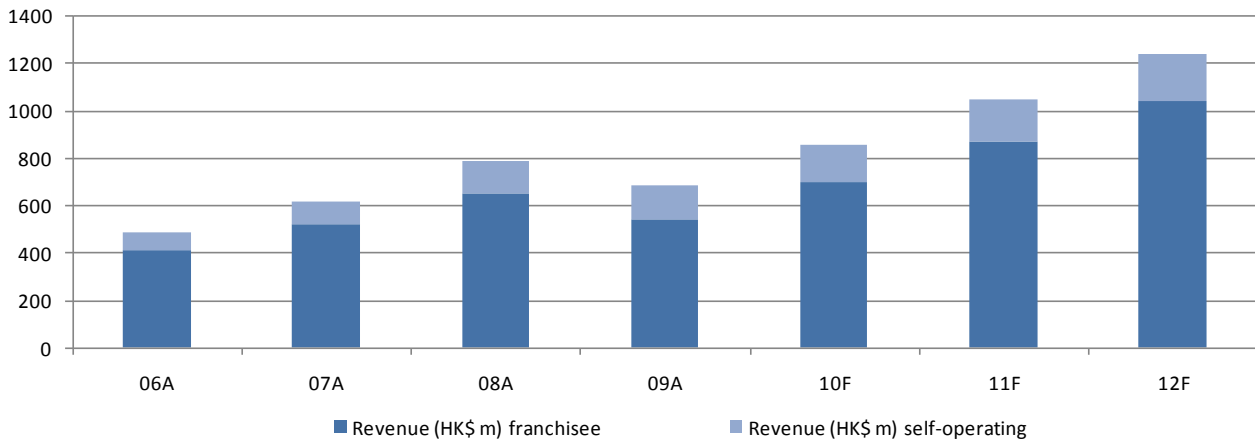


Source: Company

Increase in revenue expected: We estimate the average revenue from a single franchise stores from 2006 to 1H2010 is roughly around HK\$466 thousand. Given the number of franchisee shop targeted by the group, we estimate that the revenue from franchisee shop will be roughly HK\$762.6m for 2010, HK\$948.8m for 2011 and HK\$1,135.0m for 2012.

Average revenue from self operating shop fluctuates during earlier years for the group. Assuming the group had adjusted their operational efficiency in the self operating shops. We will use the average revenue from a single self-operating shop in 2009. The average revenue from a single self operating store is around HK\$1.49m. Given the number of self-operating shop targeted by the group, we came up with estimates for self-operating shop of HK\$156.5m for 2010, HK\$178.9m for 2011 and HK\$201.2m for 2012. Putting together the revenue between franchisee store and self operating shops, our revenue forecast for the group in 2010 is HK\$919.1m, HK\$1,127.7m for 2011 and HK\$1,336.3m for 2012.

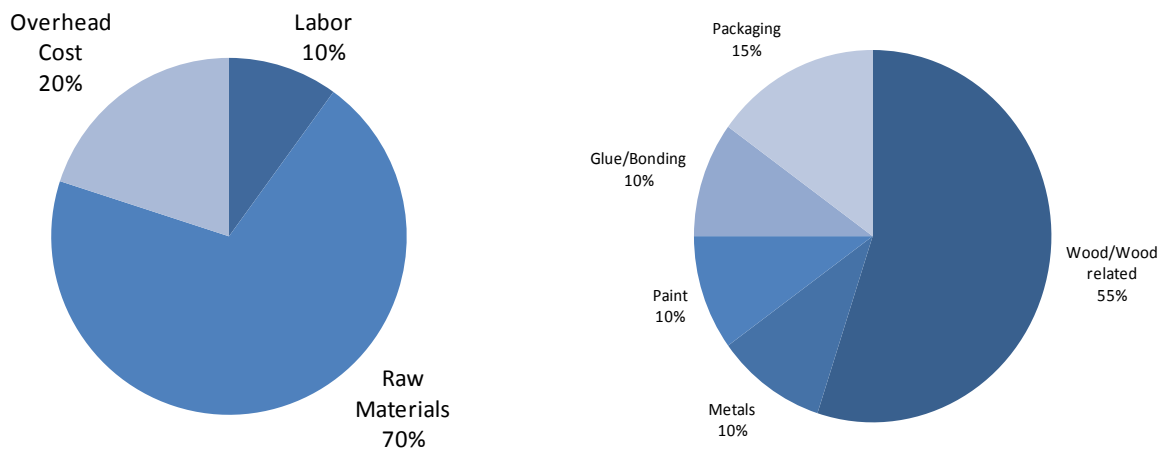
Chart 3. Revenue from franchisee stores and revenue from self-operating stores



Source: Company

Cost Structures: The cost of sales for the group are made up of 70% in raw materials, 20% in overhead cost and 10% in labor. Among the raw materials cost, wood and wood products, such as particle board made about 55% of the raw material cost. Packaging made up about 15% of the cost, glue and bonding materials made up 10% of the cost, paint made up about 10% of the cost and metals used made up about 10%. During the last few years, the group saw an increase in cost of materials, thus it is reflected in the decrease in gross margin over the years.

Graph 2. Cost breakdown for cost of sales (Left) Breakdown of raw materials cost (right)



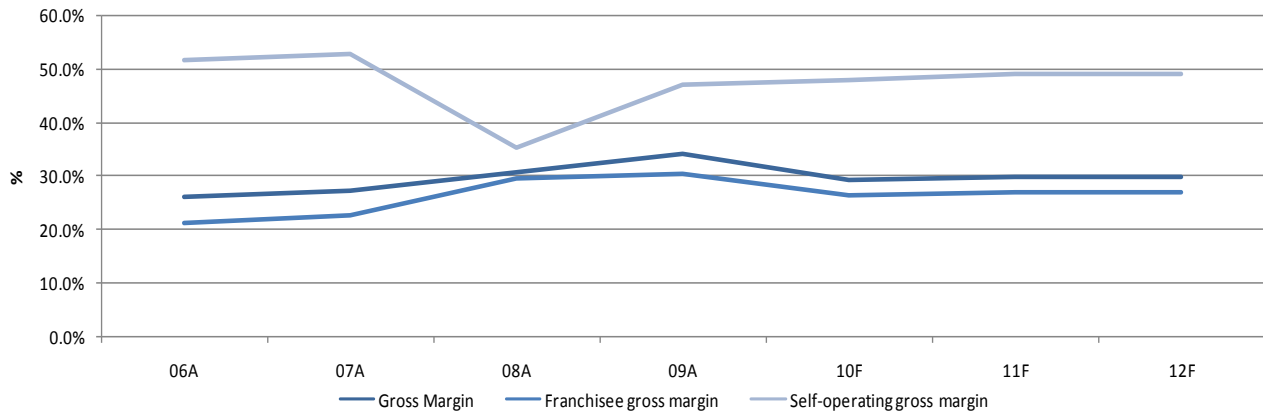
Source: Company

Margin trended down but should stabilize: From 2006 to 2009, the gross margin of the group have shown an upward steady trend, from 26.1 in 2006 to 34.2 in 2009, however due to increase in raw material costs, gross margin decrease to 29.3% in the first half of 2010. For the remainder of 2010, the group sees the gross margin to remain at the current level. However, the group feels that the gross margin should rebound slightly to around 30% for 2011 and 2012.

When decomposing the gross margin into franchise stores and self operating stores, we find that the decrease is largely due to decrease in gross margin of the franchisee stores. For the first half 2010, the franchisee gross margin decrease to 29.3% from previous year of 31.7%. However the self-operating store had an increase in gross margin. From 46.9% in 1H2009 to 47.7% in 1H2010. In fact, according to the group, they're foreseeing an increase in margin for their self-operating store, because of the improvement in efficiency and operation

they have made to their self operating shops. The group feels that the gross margin for the self operating shop should rebound to 48% for 2010 and 49% for 2011 and 50% for 2012.

Chart 4. Gross margin for the group, franchisee stores and self operating stores

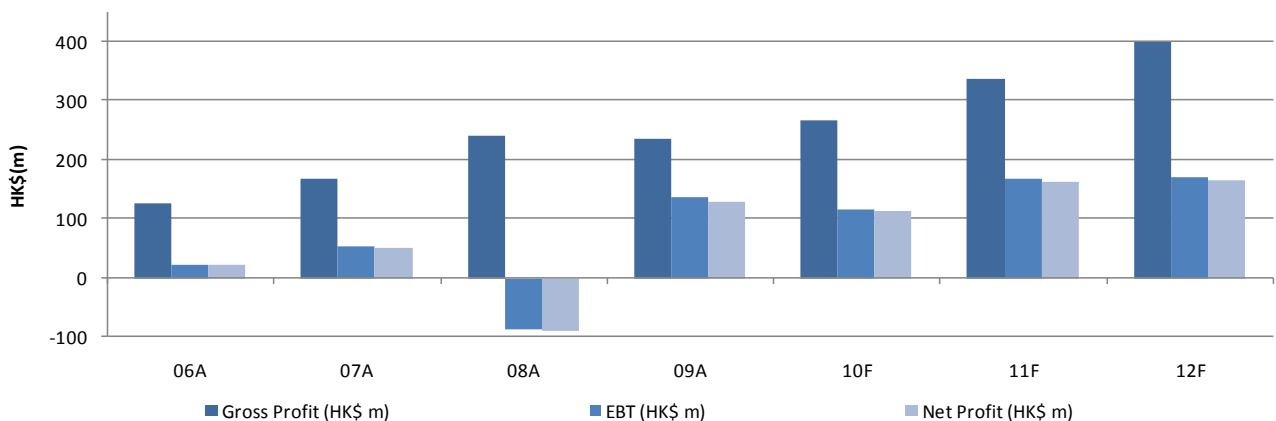


Source: Company

Profit forecast: Using margin guidance we are estimating that the gross profit for the group to be HK\$268.8m for 2010 and HK\$338.3m for 2011 and HK\$400.9m for 2012. For the first half of 2010 the group shows 12.8% EBT margin and a net profit margin of 12.4%. The group expects the selling distribution expense and administration cost to remain stable to a slight decrease, thus we feel comfortable using 12.8% as our EBT margin forecast. The effective tax rate will see a slight increase, however the group is taking measure to structure in a tax efficient way, thus we will use 12.4% as our net profit margin for our forecast. Using these assumptions and our net profit forecast is HK\$114.0m for 2010, HK\$163.3m for 2011 and HK\$165.7m for 2012.

Our net profit forecast for 2011 taking into consideration of one time gain from the Shenzhen Universiade Event. We estimate the event will bring in roughly the same amount as the Beijing Olympic but should cost no more than half of Beijing Olympic sponsorship. Using average gross margin between self operating store and franchisee we estimate a onetime gain of roughly HK\$23.5m for 2011.

Chart 5. Gross Profit, EBT and Net Profit forecast



Source: Company

Valuation and our view: Royal Furniture is currently trading at 12.6x current year forward P/E and 8.8x 1 year forward P/E. Our target price of HK\$3.16 representing 14.0x current year forward PE and 9.75x 1 year forward P/E. We believe the growth in sales of home furniture depends largely on the sales growth of the properties market, since purchases of home furniture follows naturally after purchasing of a new property. The Chinese government has introduced austerity measures that are largely targeting the sales growth of the property market, thus resulted in a decline of property sales across China. If the government's policy is to continue to cool off the property market, this can result in a large negative effect to the home furniture sales. However, the government's austerity measure in the past have particular targeted towards the first and second tier cities, the measure was not intended for the properties sales of in the low-tier cities, thus the effect on potential home buyers in the lower tier city tend to be minimal. Given that Royale Furniture's target growth are in the low-tier cities, the austerity measure may not be significantly affected by the continuation in the cool down of the property sector. Also the Chinese government policy will tend to continue to provide incentive for rural-to-urban migration, this in turn can be positive for low-tier cities property sales growth, thus potential benefit in furniture sales.

Table 2. Assumption and Forecast

	06A	07A	08A	09A	Estimates 10F	Estimates 11F	Estimates 12F
# of stores							
Franchisee stores	1,050	1,300	1,300	1,278	1,638	2,038	2,438
Self-operating stores	69	100	100	100	105	120	135
Gross margin (%)	26.1	27.4	30.6	34.2	29.3	30.0	30.0
Franchisee stores	21.1	22.6	29.5	30.5	26.5	27.0	27.0
Self-operating stores	51.7	52.8	35.2	46.9	48.0	49.0	50.0
Revenue (HK\$ m)							
franchisee	409.4	518.5	649.8	539.4	762.6	948.8	1,135
self-operating	79.7	96.5	141.1	149.1	156.5	178.9	201.2
Revenue (HK\$ m)	489.1	615.0	790.9	688.4	919.1	1,127.1	1,336.3
Gross profit (HK\$ m)	127.6	168.2	241.9	235.4	268.8	338.3	400.9
EBT (HK\$ m)	23.4	54.4	(87.2)	137.2	117.6	167.8	171.0
Net profit (HK\$ m)	23.1	52.3	(89.5)	130.5	114.0	163.3	165.7

Source: Company and SBI E2-Capital

Table 3. Valuation comparison

Company name	Ticker	Mkt cap (US\$m)	Last Price (Local)	His P/E (x)	1-Yr P/E (x)	2-Yr P/E (x)	PB (x)	Est ROE (%)
HK-listed								
Fava International	8108 HK	37.4	0.17	-	-	-	0.8	-
Hing Lee HK	396 HK	37.4	1.46	13.7	-	-	1.1	8.1
JF Household Furn	776 HK	50.5	1.77	14.8	-	-	2.0	13.2
Kasen Int'l Hldgs	496 HK	252.1	1.70	7.0	11.2	3.8	0.8	6.8
Samson HLDGS	531 HK	543.2	1.39	12.3	9.0	8.5	1.0	7.4
Man Wah Holdings	1999 HK	1267.5	10.18	12.0	11.3	8.9	6.4	62.0
Average				11.9x	10.5x	7.1x		
China-Listed								
Guangdong Yihu	600978 CH	864.3	6.71	19.7	18.1	14.8	2.2	10.7
Markor International	600337 CH	606.8	9.27	78.4	44.1	29.9	3.5	3.3
Average				49.1x	31.1x	22.4x		

Source: Bloomberg

Table 4. Historical P & L

Year to Dec (HK\$m)	FY07A	FY08A	FY09A	1H09A*	1H10A
Revenue	651.0	790.9	688.4	354.5	545.1
Cost of sales	(446.8)	(549.1)	(452.9)	(242.0)	(385.7)
Gross profit	168.2	241.8	235.4	112.5	159.4
Other income	54.6	59.8	62.3	2.0	7.9
Selling and distribution expenses	(97.9)	(195.1)	(105.9)	(54.9)	(60.4)
Administrative expenses	(63.2)	(68.3)	(57.2)	(35.4)	(37.8)
Other expenses	(6.9)	(10.9)	(2.6)	0.0	0.0
Finance costs	(1.9)	(3.2)	(1.2)	(0.3)	(2.2)
Share of Profit of associates	1.5	0.4	3.4	0.3	3.0
Profit before tax	54.4	(87.2)	134.2	24.1	69.9
Income tax expense	(2.1)	(2.3)	(3.7)	(1.2)	(2.2)
Net profit	50.4	(89.5)	130.5	21.8	60.0

Source: Company data, SBI E2-Capital

* Figures have been adjusted to reflect the reclassification of non-core product income

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