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First Read: Fragmented and pricey — China Consumer

Embry Holdings (1388 HK) — Not Rated

Company profile. Founded in 1970's, Embry is a multi-branded H.K. lingerie manufacturer and retailer. Its production is based in Shenzhen and Changzhou with 5,000 skilled workers responsible for sketching and manufacturing of lingerie. It has a total of 1,080 outlets in both China and H.K., which consist of 64 self-operated stores and 1,016 concession counters. It carries its own brands, namely Embry Form, Fandecie, Comfit and Liza Cheng (LC) with ASP ranging from RMB100 to RMB1,800. The LC brand was introduced in 2H06. Apart from its own brands, its OEM and wholesale segment accounted for c.9% of total sales in 1H06. China is Embry's major market, accounting for 84% of 1H06 sales, followed by H.K. with 13%. According to the China Industry Research Center, Embry Form captured 12.4% of China's market share based on lingerie sales value in 2005, the largest on a national level, followed by Triumph and Maniform. The top ten best selling brands in China accounted for 67% of total market share in China.

Table 1: Point of sales

As at Oct 31, 2006	Retail stores	Concessions
PRC and Macau	49	987
HK	15	29
Total	**64**	**1,016**

*Source: Company data; *including 2 in Macau*

Table 2: Current production capacity

Locations	Units (a basic feature brassiere)	Usage
Shenzhen	6.6m	R&D + Production
Changzhou	5.2m	Production
Total current capacity	**11.8m**	

Source: Company data

Table 3: Expected production capacity by 2008

Location	Units (a basic feature brassiere)	Usage
Shandong	11.9m	Production
Current + expected capacity	23.7m	

Source: Company data

Table 4: Offer statistics

Price range	HK$2.86-3.62
No. of shares offered (new shares)	100m
Fund raised:	HK$286-362m
Offer P/E (FY12/06F F.D.)	14.88-18.80x
FY12/05A net profit	HK$44.4m
FY12/06F net profit	HK$77m
Market cap	US$147-186m
IPO open	5 Dec
IPO close	8 Dec
Listing	18 Dec

Source: Company data

Strong demand for lingerie in China. According to "The Industry Research Report of China: Underwear Industry 2006", by China Industry Research Center, cotton underwear sales are expected to grow 20% p.a. in the next ten years.

Subdued sales growth. Embry experienced slower sales growth compared with the +20% p.a. growth of the cotton underwear industry in China. Embry's sales actually slowed down from 18% in 2004 to 8.1% in 2005, despite the fact that it captured the largest market share in China in 2005. Sales growth remained subdued at 8.2% in 1H06.

Earnings growth from margin improvement. Despite weak sales growth, Embry showed a remarkable gross, operating and net margin improvement at 2.1%, 6.4% and 4.7% points in 1H FY12/06A compared with that of FY12/05A. Management attributes these to 1) higher ASP from the launch of its functional "Comfit" series; 2) lower raw material costs; 3) higher utilization rate; 4) enhanced operating efficiency and 5) the introduction of a new ERP system in 2003 to facilitate its supply chain management. However, we believe the major swing factor is selling and distribution expenses. Selling and distribution expense has declined from 56.9% in FY12/05A to 52.5% in 1H FY12/06A as a percentage of sales. The margin improvement has led to a substantial improvement in net profit in 1H FY12/06 (see table 6). According to management, net profit is expected to rise by c.70% YoY to HK$77m in FY12/06F and is expected to increase by another 30% in FY12/07F as a result of organic growth.

Expansion plans. On the retail side, Embry expects to add 300 outlets by 2007 in addition to its existing 1,080 POS (point of sales). On the production side, Embry expects to establish another factory in Shandong with an annual production capacity of 11.9m standard product units, almost doubling its existing production capacity. The new plant is expected to commence operation by 2008. The total capex for this expansion amounts to HK$66m.

Our read:

- **Competition is intense and Embry does not have superior operating efficiency.** The market widely expects Embry to command a higher margin than OEM lingerie manufacturers since it carries its own brands. Although Embry's gross margin is very high at 75% compared to Top Form's (333 HK) 30%, which is mainly an OEM manufacturer, Embry's operating margin of 10.2% is comparatively lower than Top Form's 15.7% in FY12/05A. In 1H FY12/06A, Embry's operating margin did improve remarkably to 16.6%. Management attributes the improvement to better economies of scale and the launch of more new product lines. Going forward, any further expansion in margin will be the key to Embry's future success.

- **Execution risk on POS expansion.** Apart from margin improvement, Embry's total number of POS has been maintained at around 1,000 in the past three years (2003-2006). We are concerned about the execution risk of the planned addition of 300 POS in 2007 as the company has never done such fast pace expansion before.

- **Fragmented China lingerie market.** Overall we see 1) the lingerie market in China is fragmented and Embry does not possess a dominant market position, even though it captured the largest market share; 2) brand awareness is low in China and 3) competition is intense and Embry does not have superior operating efficiency. We see inventory control and logistics management will be the key to its success. Inventory turnover days maintained at around 120 days in the past three years. A&P expenses accounted for 3% of its total sales, while R&D accounted for only 1%.

- **Valuation on the high side.** The valuation of lingerie comparables, such as Brazin Ltd., Calida, Delta Galil, Hanesbrand, Maidenform, Tefron, Wacoal and Warnaco, ranges between 13.1x to 19.4x FY12/07F, while Top Form only trades at 11x FY6/07 P/E. Embry's offer valuation looks a bit on the high side at nearly 19x FY12/06 P/E when compared to its peers and other China consumption plays with similar size. Although it is in a net cash position, net cash was reduced from HK$131m in FY12/04 to HK$16m in 1H FY12/06A. One positive point is that, there is no direct listed comparables for Embry in H.K. It will draw some attraction from the market.

Table 5: Peer valuation comparisons

Stock	Ticker	Mkt cap (US$m)	P/E (x) 06A	P/E (x) 07F	Operating margin (%)	ROA (%)	ROE (%)
Top Form	333 HK	240.1	16.3	11.2	**9.96	15.96	25.66
Wacoal	3591 JP	1,800.2	n.a.	n.a.	6.8	1.6	1.8
Brazin Ltd.	BRZ AU	161.5	15.3	13.1	2.41	4.18	14.43
Calida	CALN SW	143.2	*21.0	18.4	5.21	5.77	8.8
Delta Galil	DELT US	185.0	n.a.	n.a.	(4.12)	(7.19)	(17.93)
Hanesbrand	HBI US	2,315.2	n.a.	14.4	9.69	7.07	11.06
Maidenform	MFB US	469.5	*20.4	18.7	8.77	(3.39)	(28.73)
Tefron Ltd.	TRF US	224.2	*12.5	n.a.	9.5	1.75	6.49
Warnaco	WRNC US	1,167.4	*24.9	19.4	6.74	4.38	8.61
Average			**18.4**	**15.9**	**6.1**	**3.4**	**3.4**

** Represents FY2005 figures*

*** Operating margin for Top Form is disrupted by the Sino-US & EU trade disputes in 2005/2006. Normally, operating margin is around 15%.*

Source: SBI E2-Capital & Bloomberg

Table 6: Financials

Year to Dec (HK$m)	2003	2004	2005	1H05	1H06
Turnover	429	508	550	290.2	314.1
Operating profit	22	56	56	n.a.	52.1
Net profit	15	45	46	n.a.	40.3
YoY % change					
Sales (%)	*n.a.*	*18.4*	*8.3*	*8.2*	*n.a.*
Operating profit (%)	*n.a.*	*154.5*	*0.0*	*n.a.*	*n.a.*
Net profit (%)	*n.a.*	*200.0*	*2.2*	*n.a.*	*n.a.*
Margins (%)					
- Gross	*73.0*	*75.4*	*75.1*	*n.a.*	*77.0*
- Operating	*5.1*	*11.0*	*10.2*	*n.a.*	*16.6*
- Net	*3.5*	*8.9*	*8.4*	*n.a.*	*12.8*
Current ratio (x)	5.4	7.0	3.7	n.a.	4.1
Gearing ratio	Net cash	Net cash	Net cash	n.a.	Net cash
ROE (%)	4.3	11.0	15.7	n.a.	22.2
Effective tax rate (%)	30.8	21.0	19.0	n.a.	n.a.

Source: Company data

Table 7: Use of proceeds

	HK$m
Expand 300 new retail outlets in PRC & H.K.	75
A&P expenses on Embry Form, Fandecie & Comfit	75
A&P expenses on LC products	15
Production capacity expansion	66
Product development	22
ERP & IT system upgrade	18
General working capital	29

Source: Company data