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## Growth momentum intact

## China Retail

## Natural Beauty (157 HK, HK\$1.75)

## BUY (unchanged)

Target price: HK\$2.20 (+25.7%)

Table 1: Review of 2006 operations

| HK\$m                         | 2005         | 2006         | YoY (%)     | Remarks  |
|-------------------------------|--------------|--------------|-------------|--|
| Sales                         |              |              |             |  |
| - PRC                         | 213.9        | 240.0        | 12.2        | 162 new stores   |
| - Taiwan                      | 137.4        | 114.8        | (16.4)      | 135 new stores; affected by economic recession                                       |
| - Others                      | 6.6          | 8.9          | 34.2        |  |
| <b>Total sales</b>            | <b>357.9</b> | <b>363.8</b> | <b>1.6</b>  | <b>Strong China sales offset decline in Taiwan</b>                                   |
| Gross profit                  | 284.6        | 295.1        | 3.7         | Successful brand revamp boosts sales margin  |
| Other income                  | 43.1         | 47.3         | 9.7%        | Boosted by a tax refund of HK\$26.5m in China  |
| Distribution & admin. expense | (189.6)      | (160.8)      | (15.2)      | Stringent cost controls  |
| Other operating expenses      | (18.2)       | (6.9)        | (62.2)      | Inventory provision of HK\$7m charged in FY12/05A from product repackaging exercise  |
| <b>Operating profit</b>       | <b>119.8</b> | <b>174.5</b> | <b>45.6</b> | <b>Centralized advertising for China and Taiwan improves operating efficiency</b>    |
| Finance costs                 | -            | -            | -           | Net cash position of HK\$356.2m  |
| PBT                           | 119.8        | 174.5        | 45.6        |  |
| Taxation                      | (38.8)       | (51.6)       | 33.0        | Effective tax planning in China; lower effective tax rate of 29.6% (FY12/05A: 32.4%) |
| <b>Net profit</b>             | <b>81.1</b>  | <b>123.2</b> | <b>52.0</b> | <b>Beat our estimates</b>  |
| Basic EPS (HK\$)              | 0.041        | 0.062        | 51.9        |  |
| Interim DPS (HK\$)            | 0.009        | 0.014        | 55.6        |  |
| Special interim DPS (HK\$)    | 0.004        | 0.006        | 50.0        |  |
| Final DPS (HK\$)              | 0.020        | 0.030        | 50.0        |  |
| Final special DPS (HK\$)      | -            | 0.013        | -           |  |
| <b>Total DPS (HK\$)</b>       | <b>0.033</b> | <b>0.063</b> | <b>89.4</b> | <b>Total payout raised to 101%</b>   |

Source: Company data, SBI E2-Capital

Table 2: Financial summary

| Year to Dec | Net profit HK\$m | EPS HK\$ | EPS Δ % | P/E x | P/B x | EV/EBITDA x | Yield % | ROE % | ROCE % | N. Gearing % |
|-------------|------------------|----------|---------|-------|-------|-------------|---------|-------|--------|--------------|
| 05A         | 81.1             | 0.041    | 28.2    | 43.2  | 4.30  | 19.5        | 1.9     | 10.1  | 14.8   | Cash         |
| 06A         | 123.2            | 0.062    | 52.0    | 28.4  | 3.87  | 15.1        | 3.7     | 14.3  | 20.2   | Cash         |
| 07F         | 150.2            | 0.075    | 21.9    | 23.3  | 3.71  | 12.6        | 3.5     | 16.3  | 22.9   | Cash         |
| 08F         | 185.1            | 0.093    | 23.2    | 18.9  | 3.52  | 10.2        | 4.3     | 19.1  | 26.9   | Cash         |
| 09F         | 218.3            | 0.109    | 18.0    | 16.0  | 3.33  | 10.3        | 5.1     | 21.4  | 30.1   | Cash         |

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## Results review

- ❑ **Strong China sales growth.** Natural Beauty (NB) reported 52.0% YoY rise in net profit to HK\$124m in FY12/06A, beating our estimates by 18.0%, largely due to its better sales margin, higher operating efficiency, tax refund in China and lower effective tax rate. However, sales, up 1.6% YoY at HK\$363.7m, came marginally below our forecast, as a 16.0% YoY sales drop in Taiwan offset a 12.2% YoY rise in China and 34.2% YoY increase in other markets.
- ❑ **Lower COGS and product enrichment.** The benefits of its brand revamp in China since 2005, such as improved operating efficiency, have been fully reflected in this set of results. On the product repackaging front, NB has simplified its packaging forms from more than 200 to 24, lifting the profit margin in China to 85.4% in FY12/06A (FY12/05A: 85.1%) since product packaging costs accounted for one-third of COGS. It also launched anti-allergy, pore refining series and six kinds of health supplements under the premium “NB-1 Family” line during the period. We believed lower COGS and continual product enrichment helped boost the gross margin by 1.6pcp to 81.1% in FY12/06A.

**Table 3: Operating margin breakdown by market**

| %      | 2005 | 2006 | YoY (%) |
|--------|------|------|---------|
| PRC    | 40.0 | 53.9 | 13.9    |
| Taiwan | 36.3 | 44.8 | 8.5     |

Source: Company data, SBI E2-Capital

- ❑ **Operating profit margins in China and Taiwan improved significantly** in FY12/06A. (refer: table 3) as centralized advertising for China and Taiwan lowered ad expenses.

**Table 4: Average number of stores**

|        | 2005    | YoY (%) | 2006    | YoY (%) |
|--------|---------|---------|---------|---------|
| PRC    | 1,533.5 | 4.8     | 1,626.0 | 6.0     |
| Taiwan | 530.0   | 13.2    | 603.5   | 13.9    |
| Total  | 2,083.5 | 6.0     | 2,275.0 | 9.2     |

Source: Company data, SBI E2-Capital

**Table 5: Average sales per store**

| HK\$   | 2005    | YoY (%) | 2006    | YoY (%) |
|--------|---------|---------|---------|---------|
| PRC    | 139,000 | 4.5     | 148,000 | 6.5     |
| Taiwan | 259,000 | 9.3     | 190,000 | (26.6)  |
| Total  | 169,000 | 5.0     | 160,000 | (5.3)   |

Source: Company data, SBI E2-Capital

- ❑ **More benefits from brand revamp.** Aggressive store expansion partly offset the decline in the company’s overall average sales per store, undermined by Taiwan’s economic recession (table 5). The average sales per store in China rose 2.0pcp from 4.5% in FY12/05A, thanks to the brand revamp exercise, but dropped from 10.8% in 1H FY12/06A. We expect revamp benefits in China to taper off in FY12/07F since NB has already completed the exercise in 1,066 out of its 1,707 stores in the country, but we see more positives in Taiwan, where the exercise has just started.

**Table 6: Sales breakdown by activities**

| HK\$m       | 2005  | 2006  | YoY (%) |
|-------------|-------|-------|---------|
| Products    | 322.8 | 334.6 | 3.6     |
| Services    | 29.8  | 24.5  | (17.9)  |
| Entrustment | 5.3   | 4.7   | (10.5)  |

Source: Company data, SBI E2-Capital

- ❑ **Decline in service and entrustment income.** Despite a 3.6% YoY increase in product sales, service income fell 17.9% YoY and entrustment income 10.5% YoY. The decline in service income came from a HK\$2.7m drop in service income from the closure of two spas in China and Hong Kong and a HK\$2.5m decline in the Taiwan market as a result of recession. However, management fees from franchisees increased 5.1% YoY to HK\$8.5m with 162 net additions in franchisee owned stores. The drop in entrustment income was mainly due to the expiry of certain entrustment arrangements in FY12/06A. The number of entrusted spas declined from 28 in FY12/05A to 24 in FY12/06A.

**Outlook**

- ❑ **New products in Taiwan to revive sales.** In 2007, the company plans to establish in Taiwan 1,300 retail POS in 2007 (in hypermarkets and drugstores such as Carrefour, Watsons, Jusco, Geant, COSTCO and RT-Mart) for its newly launched (April 2007) brand “Fonperi”, a series of DIY personal care products targeting the young age group. NB’s newly recruited COO estimates Taiwan’s skin care product market at NT\$5b/year and the company aims to capture c.1.0-2.0% of it by end-2007 with the help of Fonperi.
- ❑ **Aggressive store expansion in China.** NB added 162 new stores in China, up 23 from FY12/05A, and 400 are planned in FY12/07F. We consider the expansion aggressive and include net additions of only 229 in our FY12/07F forecast.

**Valuation.**

- ❑ **Reiterate BUY.** We believe that the company’s earnings growth momentum remains intact in China and we expect its brand revamp to continue generating cost savings. If the Taiwan market bottoms out, it should significantly boost NB’s profitability. We revise our earnings forecast upwards by an average of 24.5% for FY12/07F to FY12/08F. Our target price is lifted to HK\$2.2 (from HK\$1.2) based on 1x PEG in FY12/08F and a three-year (06-09) CAGR of 21.0%. We reiterate our BUY rating. NB is in a net cash position of HK\$356.2m or HK\$0.18/shs. Capex is budgeted at HK\$35.0m in FY12/07F.

**Risks:** 1) **Tighter working capital cycle:** inventory turnover rose from 275 days in FY12/05A to 314 in FY12/06A. The company aims to keep it under 260 days. AR turnover increased 12 days to 69, while AP days rose 21 days to 87. Cash conversion cycled is shortened by c.30 days. 2) **Economic slowdown in China.** 3) **Failure in new product launches in Taiwan.**