

Stella International



BUY (unchanged)

Steady strides

Key points:

- Top and bottom line in good shape.
- Output from Vietnam suppliers affected by strikes.
- Healthy retail expansion.
- Long-term prospects unchanged.
- Earnings forecast cut for FY12/08F.
- Maintain BUY.
- Lower target price at HK\$17.12.

1H FY12/08A review. Revenue rose 18.3% YoY to US\$493.7m, with the gross margin widening to 23.6% from 23.1%.

- ❑ ODM division – turnover grew 16.7% to US\$482.3m, comprising a 3.6% increase in the sales volume and 13.6% in ASP. The shipment volume was below the company's growth target of around 10.0% mainly due to capacity constraints, especially an unexpected strike at contractual manufacturers in Vietnam in April. The gross margin narrowed 0.3pcp to 22.3% due to higher manufacturing overheads.
- ❑ Retail division – turnover surged 196.7% to US\$11.4m, on a 41.7% hike in same-store-sales (SSS) (around 30.0% from the sales volume and 10.0% from ASP). The store-level operating margin improved by 8.1pcp to 13.4%. The company opened 47 new stores (Stella Luna: 20, What For: 27) during the period bringing the total to 130 (Stella Luna: 93, What For: 37) at end-June.

The blended operating margin narrowed by 0.6pcp to 12.5% due to a 46.5% increase in SG&A, mainly for 1) retail network expansion; 2) brand building; 3) labor training. The net margin shrunk 0.8pcp to 11.3%. Net profit increased 10.8% to US\$55.6m.

Recent developments.

- ❑ April – over 1,000 workers at Stella's contracted suppliers went on strike to protest against long hours and poor working conditions, affecting Stella's production, mainly for low-margin private label products. The company has scaled down its FY12/08 capacity increase from about 10.0% to 5.0 – 6.0%.
- ❑ June – Stella opened 27 new What For stores in 1H, and cut its original target of 80 in FY12/08F to 70, partly due difficulties related to the Beijing Olympic Games.
- ❑ July – the company agreed with Deckers to establish a 49:51 JV in China to wholesale and retail Deckers's UGG Australia brand. Up to two stores will be opened in FY12/08.

Forecast adjustments and valuation.

Top line. We expect only a minor impact from the lowered full-year manufacturing capacity and What For store expansion targets, given limited contributions from private label products and green retail stores. Hence we only fine tune our top-line forecast.

Hong Kong Industrials

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Stock data

Price	HK\$13.50
Target price	HK\$17.12 (+27%)
12 mth range	HK\$1094-18.80
Market cap.	US\$1,404.0m
Daily t/o, 3 mth	US\$1.5m
Free float %	30.3%
Ticker	1836.HK/1836 HK

Financial summary

Year to Dec	06A	07A	08F	09F	10F
Turnover (US\$m)	779.3	937.21	1,114.71	1,320.81	1,557.3
Net Profit (US\$m)	91.4	114.7	128.6	150.1	172.6
EPS (US\$)	0.156	0.165	0.159	0.185	0.213
EPS Δ %	6.8	5.8	(3.7)	16.7	15.0
P/E (x)	11.7	11.0	11.4	9.8	8.5
P/B (x)	2.42	2.01	1.78	1.69	1.59
EV/EBITDA (x)	14.3	11.4	10.5	8.6	7.1
Yield (%)	-	0.3	0.9	1.0	1.1
ROE (%)	22.4	19.6	16.5	17.7	19.2
ROCE (%)	21.9	18.7	14.6	16.8	19.2
N. Gear. (%)	Cash	Cash	Cash	Cash	Cash

Price Performance

	1 mth	3 mth	12 mth
Relative to HSI (%)	-2.1	+26.4	-12.2
Actual price changes (%)	-2.2	+4.8	-13.1

	08F	09F	10F
Consensus EPS (US\$)	0.170	0.197	0.222
Previous forecasts (US\$m)	145.3	165.1	185.9
Previous EPS (US\$)	0.180	0.204	0.230

Price Chart



Gross margin. We expect the gross margin of the ODM segment to shrink due to higher-than-expected manufacturing overheads in 1H FY12/08A and the strike in Vietnam, implying a thinner margin from contractual manufacturing agreements.

Earnings. The company expects operating losses from the retail segment to be larger than expected due to brand building expenses. It also increased overall staff training expenses in 1H FY12/08A and considering the footwear industry's heavy reliance on labor, we expect this trend to continue. Overall, we cut our net profit estimate for FY12/08F from US\$145.3m to US\$128.6m.

Table 1: Forecast adjustments for FY12/08F

(US\$m)	New	Old	Change	Main reasons
Turnover	1,114.7	1,121.3	(0.6)	
ODM	1,087.8	1,094.3	(0.6)	Lower output from Vietnam contractual suppliers
Retail	26.9	27.0	(0.4)	Less new stores for What For
Gross profit	265.2	277.3	(4.4)	
ODM	247.8	257.0	(3.6)	Higher manufacturing overhead and procurement expenses for products from Vietnam suppliers
Retail	17.5	20.3	(14.0)	Lower-than-expected gross margin in 1H
Other income	25.3	25.3	0.0	
Selling and distribution costs	(53.7)	(46.1)	16.3	More marketing expenses for retail segment
Administrative expenses	(62.4)	(60.6)	3.1	More expenses for staff training
Research and development costs	(39.3)	(39.5)	(0.6)	In line with top line growth
Share of results of an associate	0.0	0.0		
Finance costs	(0.4)	(0.4)	0.0	
Profit before tax	134.8	156.0	(13.6)	
Income tax expense	(6.3)	(10.7)	(40.9)	Lower-than-expected effective tax rate in 1H
Profit for the period	128.5	145.3	(11.6)	
Attributable to:				
Equity holders of the Company	128.6	145.3	(11.5)	
Minority interests	(0.1)	0.0		Minority shareholder owns 30.0% interest in Stella's retail operation in Thai

Source: SBI E2-Capital

Valuation. With sharp hikes in long-term interest rates, we employ a new discount rate of 12.53% (4.53% risk-free rate plus 8.0% risk premium) in our DCF model instead of the old 11.15% (3.15% + 8.0%) and derive a fair price of HK\$17.12.

Recommendation. We see Stella as a leading footwear manufacturer, who will benefit from: 1) expansion of its major clients, mostly tier-one brands; 2) contraction of Europe's footwear manufacturing industry, which will increase outsourcing to OEM companies; 3) production shift from South America (Brazil) to Asian countries. Also, Stella's foray into the retail market will bring in some extra momentum. The company's bottom line will grow at a CAGR of 14.6% from FY12/07A to FY12/10F, according to our estimates. We maintain our BUY recommendation with a new target of HK\$17.12 based on the fair value.

P & L (US\$m)	06A	07A	08F	09F	10F	Cash Flow (US\$m)	06A	07A	08F	09F	10F
Year to Dec						Year to Dec					
Turnover	779.3	937.2	1,114.7	1,320.8	1,557.3	EBIT	89.3	109.5	113.8	142.4	172.4
% chg	16.5	20.3	18.9	18.5	17.9	Depre./amort.	13.0	15.3	20.2	21.8	25.3
Gross profit	165.7	221.0	265.2	332.5	409.4	Net int. paid	4.4	9.8	20.9	21.5	22.7
						Tax paid	0.0	0.0	(7.7)	(6.3)	(13.9)
EBITDA	102.3	124.8	134.0	164.1	197.8	Dividends received	0.2	0.1	0.0	0.0	0.0
Depre./amort.	(13.0)	(15.3)	(20.2)	(21.8)	(25.3)	Gross cashflow	106.8	134.7	147.3	179.3	206.5
EBIT	89.3	109.5	113.8	142.4	172.4	Chgs. in working cap.	(55.2)	(78.7)	(29.6)	(34.4)	(39.5)
Net int. income/(exp.)	4.4	9.8	20.9	21.5	22.7	Operating cashflow	51.6	56.0	117.6	144.9	167.0
Exceptionals						Capex	(22.1)	(24.2)	(37.3)	(35.9)	(29.1)
Associates	0.0	(0.1)	0.0	0.2	0.4	Free cashflow	29.5	31.9	80.4	109.0	138.0
Jointly-controlled entit.						Dividends paid	(21.8)	(122.7)	(34.6)	(107.2)	(117.6)
Pre-tax profit	93.6	119.2	134.8	164.1	195.6	Net distribution to MI					
Tax	(2.3)	(4.6)	(6.3)	(13.9)	(22.8)	Investments					
Minority interests	0.0	0.1	0.1	(0.0)	(0.1)	Disposals					
Net profit	91.4	114.7	128.6	150.1	172.6	New shares	0.0	444.6	0.0	0.0	0.0
% chg	7.0	25.5	12.1	16.7	15.0	Others	2.8	(20.4)	1.4	0.2	0.2
Dividends	(21.8)	(251.2)	(34.6)	(107.2)	(117.6)	Net cashflow	10.5	333.3	47.2	2.0	20.6
Retained earnings	69.6	(136.5)	94.0	42.9	55.1	Net (debt)/cash - Beg.	63.2	73.7	407.0	454.2	456.2
						Net (debt)/cash - End.	73.7	407.0	454.2	456.2	476.8
EPS (US\$) - Basic	0.156	0.165	0.159	0.185	0.213	Interim Results (US\$m)	06A	07A			
EPS (US\$) - F.D.	0.156	0.165	0.159	0.185	0.213	Six months to Jun					
DPS (US\$)	-	0.038	0.128	0.141	0.154	Turnover	352.2	417.3			
No. sh.s o/s (m) - W.A.	585.0	693.9	809.3	809.3	809.3	% chg		18.5			
No. sh.s o/s (m) - Y.E.	585.0	809.3	809.3	809.3	809.3	Profit from operations	42.7	52.3			
No. sh.s o/s (m) - F.D.	585.0	693.9	809.3	809.3	809.3	Interest expenses	(0.0)	(0.1)			
						Associates	0.0	0.0			
Margins (%)						Jointly-controlled entit.					
Gross	21.3	23.6	23.8	25.2	26.3	Pre-tax profit	42.7	52.2			
EBITDA	13.1	13.3	12.0	12.4	12.7	Tax	0.0	0.0			
EBIT	7.0	11.7	10.2	10.8	11.1	Minority interests		0.0			
Pre-tax	12.0	12.7	12.1	12.4	12.6	Net profit	42.7	52.3			
Net	11.7	12.2	11.5	11.4	11.1	% chg		22.3			
						EPS (US\$) - Basic	0.071	0.086			
						DPS (US\$)		0.038			
Balance Sheet (US\$m)	06A	07A	08F	09F	10F	Shareholding Structure					
Year to Dec									Shares o/s (m)	%	
Fixed assets	144.6	158.2	175.2	189.4	193.1	Cordwalner Bonaventure Inc.			564.3	69.7	
Intangible assets	9.5	10.4	10.2	10.2	10.4	Others			245.0	30.3	
Other LT assets	0.6	1.2	0.0	0.0	0.0	Total			809.3	100.0	
Cash	73.7	407.0	454.2	456.2	476.8	Background					
Accounts receivable	128.0	174.1	207.1	245.4	289.3	Established in 1982, Stella International is a Taiwan-based footwear manufacturing company. Products include men's casual, men's fashion, women's casual, women's fashion, etc. Production facilities are located in China and Vietnam with effective capacity totaling 45.0m pairs in 2007. The company commenced its own retailing operation in 2006 and owns two brands (Stella Luna and What For) now. It listed in Hong Kong exchange in Jul 2007.					
Other receivables						Key Ratios	06A	07A	08F	09F	10F
Inventories	77.9	97.9	116.4	138.0	162.7	Net gearing (%)	Cash	Cash	Cash	Cash	Cash
Due from related co.s	78.7	7.1	7.1	7.1	7.1	Net ROE (%)	22.4	19.6	16.5	17.7	19.2
Other current assets	50.1	0.8	0.8	0.8	0.8	EBIT ROCE (%)	21.9	18.7	14.6	16.8	19.2
Total assets	563.0	856.7	971.1	1,047.1	1,140.2	Dividend payout (%)	23.8	219.1	26.9	71.4	68.1
Accounts payable	(105.6)	(115.6)	(137.4)	(162.9)	(192.0)	Effective tax rate (%)	2.4	3.9	4.7	8.5	11.7
Other payable						Net interest coverage (x)	na	na	na	na	na
Tax payable	(3.0)	(7.7)	(6.3)	(13.9)	(22.8)	A/R turnover (days)	56.9	58.8	62.4	62.5	62.7
Due to related co.s	(15.1)	0.0	0.0	0.0	0.0	A/P turnover (days)	45.8	43.1	41.4	41.5	41.6
ST debts						Stock turnover (days)	42.6	44.8	46.0	47.0	47.8
Other current liab.	0.0	(0.3)	(0.3)	(0.3)	(0.3)						
LT debts											
Other LT liabilities											
Total liabilities	(123.7)	(123.6)	(144.1)	(177.1)	(215.2)						
Share capital	0.0	10.4	10.4	10.4	10.4						
Reserves	439.3	722.6	816.6	859.5	914.6						
Shareholders' funds	439.3	733.0	827.0	869.9	924.9						
Minority interest	-	0.1	0.0	0.1	0.1						
Total	439.3	733.1	827.0	869.9	925.1						
Capital employed	439.3	733.1	827.0	869.9	925.1						
Net (debt)/cash	73.7	407.0	454.2	456.2	476.8						

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