

# Stella International



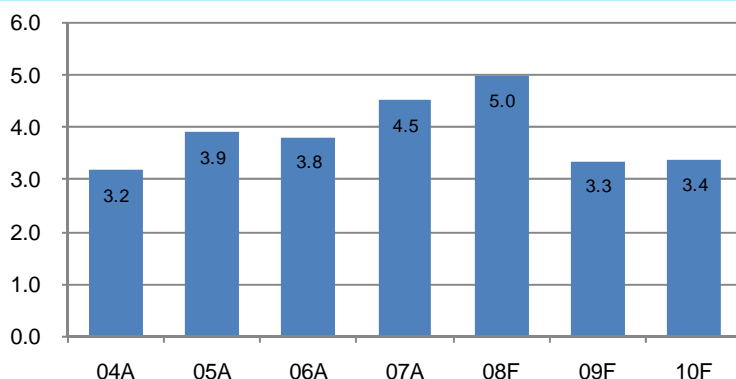
## Waiting for Christmas

### Key points:

- Forecast cut to reflect weak macros, especially in the US and Europe.
- Protection from its reputation for quality work.
- Downside risk limited by net cash HK\$3.42 per share at end-September.
- Target price cut to HK\$7.36 from HK\$17.12.
- Recommendation to be reviewed after Christmas retail figures become available.

**Pending ODM orders.** Most customers, though still optimistic, are waiting for Christmas sales figures before deciding their procurement volumes in 2009, the company said. In our view, the footwear market in the US and Europe will contract substantially given the current recession and, especially, weak consumer confidence. The two regions accounted for 89.1% of Stella's sales in 1-3Q FY12/08A. Still, the company's reputation for quality work, especially its R&D ability, differentiates it from other players and should offer some protection during the downturn. We expect its shipment volume to drop 8.6% YoY in FY12/09F and unit gross profit to shrink because: 1) the company needs to reduce prices to gain sufficient orders; 2) consumption is shifting to less-profitable mid & low-end products. We expect the segment to recover after 2009.

**Chart 1: Unit gross profit for ODM division (US\$/pair)**



Source: Company data, SBI E2-Capital

**Vietnam.** After Vietnam's nationwide strike in April / May, the company raised local wages by over 20.0% (local currency mean). However, the impact will be moderate thanks to VND depreciation against the US\$ (down 5.6% since start of the year), according to the management. Stella will continue expanding in Vietnam to balance its overall production costs (costs in Vietnam are 30% lower than in China).

**No impact of new export policy.** In the RMB4.0tr stimulus package, the Chinese government intends to raise VAT rebates to labor-intensive industries including footwear manufacturing. However, the policy will not influence Stella's operations as the company has been exempted from VAT.

**BUY (unchanged)**

### China Industrials

Mon, 01 Dec 2008

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### Stock data

Price	HK\$6.12
Target price	HK\$7.36 (+20%)
12 mth range	HK\$5.80-17.98
Market cap.	US\$629.2m
Daily t/o, 3 mth	US\$0.9m
Free float %	38.7%
Ticker	1836.HK/1836 HK

### Financial summary

Year to Dec	06A	07A	08F	09F	10F
Turnover (US\$m)	779.3	937.2	1,096.2	903.1	947.3
Net Profit (US\$m)	91.4	114.7	122.1	28.7	29.8
EPS (US\$)	0.156	0.165	0.151	0.036	0.037
EPS Δ%	6.8	5.8	(8.6)	(76.5)	3.6
P/E (x)	5.0	4.7	5.1	21.8	21.0
P/B (x)	1.03	0.85	0.82	0.92	1.03
EV/EBITDA (x)	6.0	4.6	4.1	13.0	11.9
Yield (%)	-	1.9	2.1	2.1	2.1
ROE (%)	22.4	19.6	16.3	4.0	4.6
ROCE (%)	21.9	18.7	16.4	3.4	4.0
N. Gear. (%)	Cash	Cash	Cash	Cash	Cash

### Price Performance

	1 mth	3 mth	12 mth
Relative to HSI (%)	-14.6	-25.5	-22.3
Actual price changes (%)	-5.8	-50.6	-60.6

	08F	09F	10F
Consensus EPS (US\$)	0.156	0.163	0.186
Previous forecasts (US\$m)	128.6	150.1	172.6
Previous EPS (US\$)	0.159	0.185	0.213

### Price Chart



**Slowing retail sales.** Stella had 164 stores in September, comprising 106 Stella Luna (91 in China, 13 in Thailand, one in Taiwan and one in Macau) and 58 What For (57 in China and one in Macau). It plans to open 20 more in 4Q and 80 (close 10 old stores) in 2009. According to the company's study, China's consumption level can support around 150 Stella Luna stores and much more What For ones. Same-store-sales (SSS) growth slowed from 41.7% in 1H FY12/08A to 22.4% in 3Q. Although China's domestic consumption is still strong (up 22.0% in Oct), we expects SSS growth to weaken as spending is moving to staples. We estimate that the segmental turnover will increase 29.7% in FY12/09F, driven by the company's enlarged retail network, while the business will remain in the red till 2011.

**3Q results highlights.** Turnover increased 16.4% to US\$331.8m, of which US\$325.1m came from ODM (13.7% YoY) and the remainder from retail (up 94.6%). Other income, mainly interest and rental income, fell from US\$6.9m a year earlier to US\$1.7m. As a result, net profit edged up merely 1.3% to US\$41.5m.

**Forecast adjustment.** We slashed our forecast to reflect a potential market contraction. The new fair value of the counter is HK\$9.20 per share, comprising HK\$5.78 from its ODM and retail operation and HK\$3.42 from its balance sheet (US\$377.5m net cash at end-Sep). We set our target price at HK\$7.36, representing a 20.0% discount to the fair value. We will review our estimates and recommendation after Christmas when the outlook is clearer.

**Table 1: Forecast adjustments**

Year to Dec (US\$m)	08F	09F	10F	Note
<b>New forecasts</b>				
Turnover	1,096.2	903.1	947.3	
ODM	1,069.3	868.3	898.3	Assume 18.9% drop in shipment volumes and 10.7% in ASP in FY12/09F due to the weak market. Recovery in FY12/09F.
Retail	26.8	34.8	49.0	Sales to stay driven by retail network expansion
Operating profit	128.8	29.8	30.9	Operating profit to plunge due to shrinking gross margin and fixed part of operating expenses
ODM	202.2	106.2	107.4	
Retail	(1.4)	(4.4)	(2.5)	
Unallocated expenses, net	(72.0)	(72.0)	(73.9)	Higher unallocated expenses in FY12/08F due to less-than-expected interest and rental income. Lower estimates for FY12/09F and FY12/10F with expectations of better cost control
Net profit	122.1	28.7	29.8	
<b>Old forecasts</b>				
Turnover	1,114.7	1,320.8	1,557.3	
ODM	1,087.8	1,258.9	1,451.7	
Retail	26.9	61.9	105.6	
Operating profit	134.8	164.1	195.6	
ODM	203.3	235.1	271.4	
Retail	(8.3)	4.1	15.9	
Unallocated expenses, net	(60.2)	(75.2)	(91.7)	
Net profit	128.6	150.1	172.6	

Source: SBI E2-Capital

### Risks.

- ❑ Retail figures, especially during Christmas in the US and Europe will materially affect the company's sales in 2009.
- ❑ Forex rate fluctuations, especially the VND/US\$ rate.
- ❑ Workforce issues - China's new labor law may make it more difficult to introduce unpopular measures or lay off workers to reduce costs during the downturn.

Table 2: P&amp;L

Y/F 31 Dec (US\$m)	06A	07A	08F	09F	10F
Revenue	779.3	937.2	1,096.2	903.1	947.3
Cost of sales	(613.7)	(716.1)	(839.0)	(737.3)	(768.6)
Gross profit	165.7	221.0	257.2	165.8	178.8
Other income	15.0	15.9	10.5	9.5	9.2
Selling and distribution costs	(31.7)	(38.5)	(49.5)	(49.7)	(52.1)
Administrative expenses	(28.9)	(45.8)	(56.5)	(59.6)	(67.0)
Research and development costs	(26.4)	(33.0)	(32.9)	(36.1)	(37.9)
Share of results of an associate		(0.1)	(0.1)	0.1	0.4
Finance costs	(0.1)	(0.3)	(0.4)	(0.3)	(0.3)
Profit before tax	93.6	119.2	128.4	29.7	31.0
Income tax expense	(2.3)	(4.6)	(6.3)	(1.0)	(1.2)
Profit for the period	91.4	114.6	122.1	28.7	29.8
Attributable to:					
Equity holders of the Company	91.4	114.7	122.1	28.7	29.8
Minority interests		(0.1)	0.0	(0.0)	(0.0)
EPS - Basic (US\$)	0.156	0.165	0.151	0.036	0.037
Proposed DPS (HK\$)		0.900	1.000	1.000	1.000

Source: Company data, SBI E2-Capital

P & L (US\$m)	06A	07A	08F	09F	10F	Cash Flow (US\$m)	06A	07A	08F	09F	10F
<b>Year to Dec</b>						<b>Year to Dec</b>					
<b>Turnover</b>	<b>779.3</b>	<b>937.2</b>	<b>1,096.2</b>	<b>903.1</b>	<b>947.3</b>	EBIT	89.3	109.5	122.3	24.3	25.7
% chg	16.5	20.3	17.0	(17.6)	4.9	Depre./amort.	13.0	15.3	20.5	21.8	24.5
Gross profit	165.7	221.0	257.2	165.8	178.8	Net int. paid	4.4	9.8	6.1	5.2	4.9
						Tax paid	0.0	0.0	(7.7)	(6.3)	(1.0)
EBITDA	102.3	124.8	142.8	46.2	50.3	Dividends received	0.2	0.1	0.0	0.0	0.0
Depre./amort.	(13.0)	(15.3)	(20.5)	(21.8)	(24.5)	<b>Gross cashflow</b>	<b>106.8</b>	<b>134.7</b>	<b>141.3</b>	<b>45.1</b>	<b>54.2</b>
EBIT	89.3	109.5	122.3	24.3	25.7	Chgs. in working cap.	(55.2)	(78.7)	(41.3)	(58.5)	92.6
Net int. income/(exp.)	4.4	9.8	6.1	5.2	4.9	<b>Operating cashflow</b>	<b>51.6</b>	<b>56.0</b>	<b>100.0</b>	<b>(13.5)</b>	<b>146.8</b>
Exceptionals						Capex	(22.1)	(24.2)	(60.2)	(25.8)	(22.9)
Associates	0.0	(0.1)	(0.1)	0.1	0.4	<b>Free cashflow</b>	<b>29.5</b>	<b>31.9</b>	<b>39.8</b>	<b>(39.3)</b>	<b>123.9</b>
Jointly-controlled entit.						Dividends paid	(21.8)	(122.7)	(93.4)	(107.2)	(103.8)
<b>Pre-tax profit</b>	<b>93.6</b>	<b>119.2</b>	<b>128.4</b>	<b>29.7</b>	<b>31.0</b>	Net distribution to MI					
Tax	(2.3)	(4.6)	(6.3)	(1.0)	(1.2)	Investments					
Minority interests	0.0	0.1	(0.0)	0.0	0.0	Disposals					
<b>Net profit</b>	<b>91.4</b>	<b>114.7</b>	<b>122.1</b>	<b>28.7</b>	<b>29.8</b>	New shares	0.0	444.6	0.0	0.0	0.0
% chg	7.0	25.5	6.5	(76.5)	3.6	Others	2.8	(20.4)	1.4	0.2	0.2
Dividends	(21.8)	(251.2)	(93.4)	(107.2)	(103.8)	<b>Net cashflow</b>	<b>10.5</b>	<b>333.3</b>	<b>(52.1)</b>	<b>(146.2)</b>	<b>20.4</b>
Retained earnings	69.6	(136.5)	28.7	(78.5)	(74.0)	Net (debt)/cash - Beg.	63.2	73.7	407.0	354.9	208.6
						Net (debt)/cash - End.	73.7	407.0	354.9	208.6	229.1
EPS (US\$) - Basic	0.156	0.165	0.151	0.036	0.037	<b>Interim Results (US\$m)</b>	<b>06A</b>	<b>07A</b>			
EPS (US\$) - F.D.	0.156	0.165	0.151	0.036	0.037	<b>Six months to Jun</b>					
DPS (US\$)	-	0.115	0.128	0.128	0.128	<b>Turnover</b>	<b>352.2</b>	<b>417.3</b>			
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 (%)	21.3	23.6	23.5	18.4	18.9	Jointly-controlled entit.					
Gross	13.1	13.3	13.0	5.1	5.3	<b>Pre-tax profit</b>	<b>42.7</b>	<b>52.2</b>			
EBITDA	7.0	11.7	11.2	2.7	2.7	Tax	0.0	0.0			
EBIT	12.0	12.7	11.7	3.3	3.3	Minority interests		0.0			
Pre-tax	11.7	12.2	11.1	3.2	3.1	<b>Net profit</b>	<b>42.7</b>	<b>52.3</b>			
Net	779.3	937.2	1,096.2	903.1	947.3	% chg		22.3			
						EPS (US\$) - Basic	0.071	0.086			
						DPS (US\$)		0.038			
<b>Balance Sheet (US\$m)</b>	<b>06A</b>	<b>07A</b>	<b>08F</b>	<b>09F</b>	<b>10F</b>	<b>Shareholding Structure</b>					
<b>Year to Dec</b>								<b>Shares o/s (m)</b>	<b>%</b>		
Fixed assets	144.6	158.2	180.9	184.8	183.2	Cordwalner Bonaventure		564.3	70.5		
Intangible assets	9.5	10.4	27.1	27.0	27.1	Others		235.6	29.5		
Other LT assets	0.6	1.2	0.0	0.0	0.0	<b>Total</b>		<b>799.9</b>	<b>100.0</b>		
Cash	73.7	407.0	354.9	208.6	229.1	<b>Background</b>					
Accounts receivable	128.0	174.1	203.7	301.0	189.5	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						<b>Key Ratios</b>	<b>06A</b>	<b>07A</b>	<b>08F</b>	<b>09F</b>	<b>10F</b>
Inventories	77.9	97.9	114.5	112.9	99.7	Net gearing (%)	Cash	Cash	Cash	Cash	Cash
Due from related co.s	78.7	7.1	21.8	0.0	0.0	Net ROE (%)	22.4	19.6	16.3	4.0	4.6
Other current assets	50.1	0.8	0.8	0.8	0.8	EBIT ROCE (%)	21.9	18.7	16.4	3.4	4.0
<b>Total assets</b>	<b>563.0</b>	<b>856.7</b>	<b>903.6</b>	<b>835.2</b>	<b>729.3</b>	Dividend payout (%)	23.8	219.1	76.5	373.0	348.5
Accounts payable	(105.6)	(115.6)	(135.2)	(150.5)	(118.4)	Effective tax rate (%)	2.4	3.9	4.9	3.3	3.9
Other payable						Net interest coverage (x)	na	na	na	na	na
Tax payable	(3.0)	(7.7)	(6.3)	(1.0)	(1.2)	A/R turnover (days)	56.9	58.8	62.9	102.0	94.5
Due to related co.s	(15.1)	0.0	0.0	0.0	0.0	A/P turnover (days)	45.8	43.1	41.7	57.7	51.8
ST debts						Stock turnover (days)	42.6	44.8	46.2	56.3	50.5
Other current liab.	0.0	(0.3)	(0.3)	(0.3)	(0.3)						
LT debts											
Other LT liabilities											
<b>Total liabilities</b>	<b>(123.7)</b>	<b>(123.6)</b>	<b>(141.8)</b>	<b>(151.8)</b>	<b>(120.0)</b>						
Share capital	0.0	10.4	10.4	10.4	10.4						
Reserves	439.3	722.6	751.4	672.9	598.9						
<b>Shareholders' funds</b>	<b>439.3</b>	<b>733.0</b>	<b>761.7</b>	<b>683.3</b>	<b>609.3</b>						
Minority interest	-	0.1	0.1	0.1	0.1						
<b>Total</b>	<b>439.3</b>	<b>733.1</b>	<b>761.9</b>	<b>683.4</b>	<b>609.4</b>						
Capital employed	439.3	733.1	761.9	683.4	609.4						
Net (debt)/cash	73.7	407.0	354.9	208.6	229.1						

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