Corporate Snippet

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Sales dilution despite margin improvement — China Retail

Prime Success (210 HK, HK$6.74) HOLD (downgraded from BUY)

Target price: HK$6.0 (-10.9%)

Results review

- Prime Success' (PS) net profit rose 15.0% YoY in FY12/06A to HK$291.6m, 13.7% below our forecast and much lower than the consensus forecast of HK$349m. Sales rose 17.9% YoY to HK$3.1b and operating profit 23.9% YoY to HK$400.6m. EPS amounted to HK$0.178 and DPS to HK$0.045, representing a payout of 25.3% (FY12/05A: 31.8%) or a dividend yield of 0.7%.
- The results shortfall was mainly due to 1) falling sales and shrinking operating margins in the OEM segment due to higher production costs; 2) lower same-store sales for Daphne as rapid store expansion resulted in sales dilution due to new stores; 3) start-up losses in Taiwan and 4) higher effective tax rate of 24.6% (FY12/05A: 19.8%).
- Overall gross margin widened 1.5pcp YoY to 45.1% as the gross margin of the branded business widened about 10.0pcp YoY to 54%, offsetting a 5.2pcp drop in the OEM operating margin. The overall operating margin improved c.0.7pcp YoY to 13.0%, due to a 2.8pcp YoY improvement in the operating margin of the branded business and a tax refund of HK$8.9m on reinvestment.

Operations review

Branded business

Rapid network expansion in China but sales diluted due to new stores

- Sales grew 26.8% YoY to HK$2.3b thanks to the addition of 597 POS, bringing the total to 2,206 in FY12/06A. Operating profit surged 57.6% YoY to HK$330.2m thanks operating margin expansion for Daphne (from 13.0% in FY12/05A to 16.5% in FY12/06A) and narrowing losses from Shoebox.
- The number of new POS for Daphne beat the target by c.100, with a total of 495 net additions in FY12/06A. Sales and operating profit for Daphne rose 25.8% YoY and 59.5% YoY to HK$2.0b and HK$326.8m, respectively. However, sales from existing stores were diluted as same-store sales growth slowed to c.3% YoY during the period, compared with a high single digit growth in FY12/05A.
- Sales for Shoebox surged 89.6% YoY to HK$142.6m, supported by 89 new POS. The total number of POS reached 164 by the end of 2006, while same-store sales rose c.5% YoY. Operating losses narrowed from HK$4.4m in 1H FY12/06A to HK$0.2m in 2H.
- Adidas Originals delivered a stable performance with an addition of 13 POS to a total of 104 in FY12/06A. Sales and operating profit rose 8.9% YoY and 8.1% YoY to HK$193.8m and HK$8.0m, respectively, while

Table 1: 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	254.6	0.157	38.7	42.9	14.8	29.7	0.9	40.1	45.5	Cash
06A	291.6	0.178	13.4	37.9	11.2	23.7	0.9	34.2	43.4	Cash
07F	341.9	0.209	17.3	32.3	9.3	19.5	1.2	31.5	43.7	Cash
08F	418.6	0.256	22.4	26.4	7.6	15.9	1.3	31.7	44.7	Cash
09F	500.6	0.306	19.6	22.1	6.3	13.6	1.2	31.3	43.4	Cash

the operating margin was flat at 4.1%. Same-store sales rose c.12%.

Taiwan- start-up losses

- Since its foray into the Taiwan market in April 2006, total number of POS reached 30 at end-2006. The overall operating environment is challenging amid Taiwan's sluggish economy and the operation remained in the red due to start-up costs. The exact amount of losses was not disclosed.

OEM business- higher production costs

- Sales dipped 2.3% YoY to HK$776.8m, while operating profit plunged 38.1% YoY to HK$69.9m mainly due to rising production costs (labour and raw material) amid rising oil prices. Nonetheless, the value of export orders on hand was >HK$200m as of end-2006.

Outlook

- **Rapid POS expansion despite sales dilution**. PS aims to maintain its rapid branded retail network expansion despite sales dilution from new stores, adding 700 (Daphne: +400; Shoebox: +200; adidas Original: +100) POS in FY12/07F, and eventually bring the total number of POS to 5,000 by 2010. However, we are concerned about the sustainability of this expansion strategy because, apart from sales dilution, competition is getting keener and good store locations with heavy traffic are more difficult to come by.
- **Product mix enhancement**. The company will enhance its product mix by adding a premium brand, "Daphne Diamond", this year. The ASP for Daphne Diamond is RMB200/pair higher than that of Daphne.
- **OEM environment remains tough**. We expect the operating environment to remain challenging, since oil prices are expected to stay high and labour costs are under upward pressure. We expect top-line growth to slow down in FY12/07F and margin pressure to continue although PS switched from lower-margin orders from Payless and Target to higher-margin orders from Aerosoles with higher ASPs.
- **Enhanced logistics management**. By end-2007, the company plans to build a logistics centre in Chengdu, bringing the total number to six, including the recently launched centres in Beijng and Shenyang, which helped to cut the average inventory turnover by 9 to 147 days in FY12/06A.

Valuation

- With the aggressive store expansion, we expect PS can still sustain its top-line growth but at a slower rate going forward due to the dilution of sales to new stores. However, its bottom-line growth will be affected by losses from the Taiwan market and margin pressure in the OEM business. We have cut our earnings forecast by c.26% on average for FY12/07F-08F based on lower same-store sales growth and shrinking OEM margins. We downgrade the counter from BUY to HOLD, with the target price maintained at HK$6.0, translating to 1x PEG in FY12/09F.