

Dance with Giants

Not Rated

Summary. Pou Sheng's (PS) Turnover rose 74.7% in 3Q FY09/08A to US\$251.4m. The gross margin narrowed 2.0pcp to 34.6%. Net profit surged 296.5% to US\$26.7%. Excluding a US\$10.1m one-off gain from fair value changes on options, the company's bottom line grew 145.8% to US\$16.6m. Our view towards PS includes mainly:

- Market with a strong organic growth momentum.
- Extensive sales network and close relations with top brands.
- Potential acquisition of a regional joint venture (RJV).
- Reliance on three brands.
- Short-term margin pressure.

High demand. China's sportswear product market expanded rapidly over the last four years and we expect it to remain robust despite the country's possible economic slowdown in the short term. The industry's positive long-term outlook (20.0–25.0% CAGR for the next five years) is intact, in our view.

Extensive sales network. The company's most precious asset, its sales network, is expanding on schedule, with the total number of outlets up from 6,797 at end-March to 7,533 at end-June, comprising 4,368 directly-operated (2,409 by PS and 1,959 by RJV) and 3,165 indirectly-operated (2,394 under PS and 771 under RJV).

Close relations with top brands. We regard PS as a retail extension of brands as it usually works closely with them on planning and execution. The company is a key distributor of Adidas, Nike and Lining, contributing around 28.0%, 20.0% and 40.0%, respectively, of their total sales in China. PS is also the exclusive licensee of Converse in China.

Potential acquisition of RJV. The company has reached call option agreements with 18 of its total 22 RJVs, giving it the right to acquire remaining stakes in them at discount valuations (around 15.0 – 25.0%) to PS's prevailing one during the acquisition. In 1-3Q FY09/08A, contributions from associates and jointly controlled entities totaled US\$11.9m, or 20.4% of the company's EBIT.

Reliance on three brands. Adidas, Nike and Converse represent around 75.0% of PS's total revenue. After the end of its exclusive licensee agreement with Converse in 2008, PS will become the brand's exclusive distributor in China from 2009 to 2011. We think this shift will adversely impact PS' growth, especially in FY09/09F.

Short-term margin pressure. The gross margin narrowed 2.0pcp to 34.6% due to disappointing sales during the Beijing Olympic Games. PS piled up inventories before the games in anticipation of high demand for athletic products. However the market was very quiet, leaving the

China Consumer

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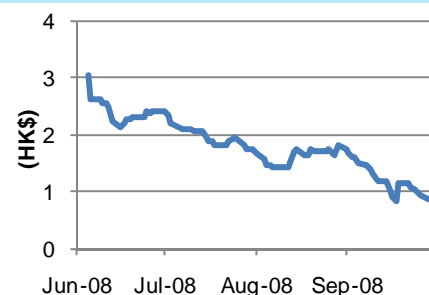
Stock data

| | |
|------------------|-----------------|
| Price | HK\$0.95 |
| Target price | n.a. |
| 12 mth range | HK\$0.75-3.05 |
| Market cap. | US\$435.6m |
| Daily t/o, 3 mth | US\$1.1m |
| Free float % | 24.7% |
| Ticker | 3813.HK/3813 HK |

Financial summary

| Year to Sep | 05A | 06A | 07A | 08F | 09F |
|--------------------|-------|-------|--------|-----|-----|
| Turnover (US\$m) | 207.2 | 373.0 | 555.9 | | |
| Net profit (US\$m) | 3.3 | 11.4 | 31.9 | | |
| EPS (US\$) | 0.012 | 0.033 | 0.024 | | |
| EPS Δ % | | 170.5 | (26.7) | | |
| P/E (x) | 10.0 | 3.7 | 5.0 | | |
| P/B (x) | 1.47 | 1.16 | 1.16 | | |
| EV/EBITDA (x) | 30.9 | 12.2 | 6.7 | | |
| Yield (%) | n.a. | n.a. | n.a. | | |
| ROE (%) | 14.7 | 38.6 | 36.5 | | |
| ROCE (%) | 8.4 | 23.4 | 21.4 | | |
| N. Gear. (%) | 143.7 | 51.5 | 41.6 | | |

Price Chart



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company with large inventories. This margin pressure is expected to persist until Mar 2009.

Corporate governance. The business was established in 1992 by Yue Yuen (0551 HK, HK\$20.25, NR), which is a leading sportswear manufacturer in China. PS was spun off and listed in Hong Kong in Jun 2008 via a global offering of 946.9m new shares at HK\$3.05 each. Yue Yuen remains the company's controlling shareholder with a 55.7% stake.

Valuation. The counter is trading at 6.1x one-year forward P/E multiple, which makes it the cheapest stock among HK-listed athletic product companies.

Table 1: Peer comparison

| Company name | Ticker | Fiscal Year end | Mkt Cap (US\$m) | His P/E(x) | Curr-Yr Fwd P/E(x) | Nxt-Yr Fwd P/E(x) | ROE (%) |
|------------------|----------------|-----------------|-----------------|-------------|--------------------|-------------------|-------------|
| Xtep | 1368 HK | 12/2007 | 548.5 | 11.3 | 7.9 | 5.2 | 95.0 |
| Anta | 2020 HK | 12/2007 | 1,440.0 | 12.6 | 12.2 | 8.9 | 24.5 |
| Li Ning | 2331 HK | 12/2007 | 1,721.4 | 19.3 | 16.9 | 12.7 | 30.1 |
| Pou Sheng | 3813 HK | 09/2007 | 435.6 | n.a. | 6.1 | 5.8 | 36.5 |
| China Dongxiang | 3818 HK | 12/2007 | 1,718.5 | 13.1 | 12.3 | 9.8 | 23.6 |
| Nike | NKE US | 05/2008 | 33,842.6 | 18.6 | 16.9 | 15.0 | 25.4 |
| Adidas | ADS GR | 12/2007 | 4,870.0 | 12.9 | 12.5 | 10.6 | 18.8 |

Source: Bloomberg

Table 2: P&L

| Year to Sep (US\$m) | 05A | 06A | 07A | 1-3Q 07A | 1-3Q 08A | 3Q 07A | 3Q 08A |
|--|---------|---------|---------|----------|----------|--------|---------|
| Revenue | 207.2 | 373.0 | 555.9 | 379.1 | 671.0 | 143.8 | 251.4 |
| Cost of sales | (128.4) | (233.8) | (354.9) | (239.9) | (426.3) | (91.1) | (164.4) |
| Gross profit | 78.8 | 139.2 | 201.0 | 139.2 | 244.7 | 52.7 | 87.0 |
| Other income and gain | 6.1 | 8.8 | 14.2 | 13.3 | 21.3 | 4.2 | 5.7 |
| Selling and distribution costs | (56.9) | (84.6) | (118.8) | (83.4) | (167.9) | (31.5) | (64.4) |
| Administrative expenses | (17.8) | (31.3) | (37.4) | (27.2) | (39.9) | (10.2) | (8.7) |
| Other expenses | | | | | (5.5) | 0.0 | (5.5) |
| Fair value changes on derivative financial instruments | | | 18.2 | 0.0 | | | |
| Share of results of associates | 0.1 | 0.1 | 1.0 | 5.3 | 0.6 | 2.7 | |
| Share of results of jointly controlled entities | 3.0 | | 15.9 | 0.0 | 6.6 | | |
| Interest on bank borrowings wholly repayable within five years | (1.8) | (3.8) | (3.7) | (3.5) | (12.7) | (1.1) | (4.3) |
| Profit before taxation | 8.3 | 28.3 | 58.4 | 39.3 | 79.2 | 14.6 | 19.0 |
| Taxation | (2.3) | (7.3) | (14.5) | (10.5) | (10.8) | (4.9) | (1.2) |
| Profit for the year | 6.0 | 21.0 | 43.9 | 28.9 | 68.4 | 9.7 | 17.8 |
| Attributable to: | | | | | | | |
| Equity holders of the Company | 3.3 | 11.4 | 31.9 | 21.7 | 60.8 | 6.7 | 16.6 |
| Minority interests | 2.7 | 9.6 | 12.0 | 7.2 | 7.7 | 3.0 | 1.2 |

Source: Company data