

Hembly: Retail to drive growth

Recommendation: BUY (unchanged)

China Consumer

Price	HK\$4.20	Year to Net profit	EPS	EPS	P/E	P/B	EV/EBITDA	Yield	ROE	ROCE	N. Gear.	
Target price	HK\$5.90 (+31.1%)	Dec	HK\$m	HK\$	Δ %	x	x	x	%	%	%	
12 mth range	HK\$1.94-7.00	05A	58.2	0.230	88.5	18.3	5.1	11.0	n.a.	56.7	19.9	104.5
Market cap.	US\$152.2m	06A	78.1	0.309	34.2	13.6	2.7	7.5	2.8	31.7	13.9	44.9
Daily t/o, 3 mth	US\$0.35m	07F	104.9	0.371	20.2	11.3	2.4	5.9	2.8	25.0	12.7	26.1
Free float %	19.0%	08F	162.7	0.576	55.1	7.3	1.9	3.1	2.8	29.2	16.5	53.1
Ticker	3989.HK/3989 HK	09F	250.5	0.886	53.9	4.7	1.4	1.9	2.8	34.5	21.5	48.8

Relative to Hang Seng Index (1 mth, 3 mth, 12 mth): -12.9%, -35.8%, +29.4%

Actual price changes (1 mth, 3 mth, 12 mth): -12.5%, -21.1%, +101.0%

Consensus EPS (07F-08F): HK\$0.43, HK\$0.64

Previous forecasts (07F-09F): HK\$127.9m (\$0.504), HK\$168.6m (\$0.665), HK\$206.6m (\$0.814)

Key points:

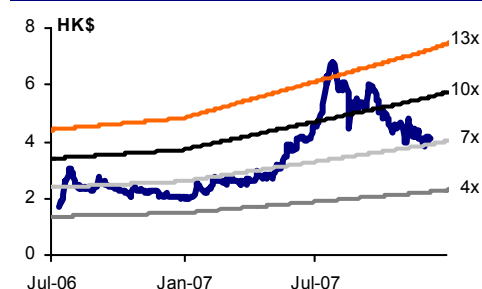
- 72 new stores to open by end-FY12/07F, 198 in FY12/08F and 640 in FY12/09F.
- Retail and distribution to be future growth key driver and turnover to rise about 30.0% in FY12/07F, 200.0% in FY12/08F and 90.0% in FY12/09F.
- New partnerships in D&R expected to contribute significantly to Hembly in FY12/08F.
- SCM segment turnover to increase about 40.0% YoY in FY12/07F, 30.0% in FY12/08F and 20.0% in FY12/09F.
- Sergio Tachini (ST) to drive supply chain management (SCM) growth, with sales to reach HK\$150.0m in FY12/07F and HK\$300.0m in FY12/08F.
- Net profit to grow at a three-year (2006-2009) CAGR of 47.5%.
- Target price revised upwards to HK\$5.9 (from HK\$4.5) based on the sum-of-parts method.

Distribution & Retail (D&R)

□ **More stores.** At the beginning of Sep 2007, Hembly had 88 self-owned stores (20 Lotto, 23 Stonefly, 45 Sisley) and 82 franchised stores (60 Lotto and 22 Stonefly). The company will open 72 new stores by end-FY12/07F (49 self-owned and 23 franchised), 198 in FY12/08F (48 self-owned and 150 franchised) and 640 in FY12/09F (more than 400 franchised). Its capital expenditure will reach HK\$160.0m in FY12/07F and HK\$190.0m in FY12/08F. In Sep 2007, Hembly covered more than 30 cities in China. It plans to open more department store outlets.

□ **D&R future growth driver.** We expect D&R turnover to increase about 30.0% in FY12/07F, 200.0% in FY12/08F and 90.0% in FY12/09F, contributing about 11.0% of total sales in FY12/07F, close to our previous forecast. We expect D&R to account for about 20.0% of total turnover in FY12/08F and 30.0% in FY12/09F. As a result, the overall gross margin will widen from 35.5% in FY12/06A to more than 38.0% in FY12/09F, mainly due to a higher D&R gross margin.

Chart 1: P/E bands



Source: SBI E2-Capital

Table 1: Growth potential

Growth rate(%)	FY12/07F	FY12/08F	FY12/09F
Distribution and retailing	30.0	200.0	90.0
Manufacturing and sales	40.0	30.0	20.0

Source: Company data

- **Improving D&R.** Turnover rose 16.1% YoY to HK\$30.3m in 1H FY12/07A and operating profit HK\$2.3m as a result of Lotto's and Stonefly's rising same-store sales (up 20.0% and 15.0%, respectively). The gross margin of the D&R segment widened to 51.8% from 40.0%, thanks to an increase in the distribution of Lotto products. Lotto's gross margin improved from 37.7% to 55.1% on the increasing number of self-managed stores with higher margins. Stonefly broke even in 1H FY12/07A after abandoning its apparel sales and focusing on footwear. Its gross margin narrowed to 45.7% from 48.3% due to a higher proportion of lower-margin products.

Table 2: No of outlets

	2006A		September 2007A		2007F		2008F	
	Self - owned	Franchise	Self - owned	Franchise	Self - owned	Franchise	Self - owned	Franchise
Stonefly	22	12	23	22	35	25	35	65
Lotto	11	54	20	60	40	80	60	190
Sisley	-	-	45	-	60	-	80	-
Moschino	-	-	-	-	2	-	10	-
Sub-total	33	66	88	82	137	105	185	255
Total		99		170		242		440

Source: Hembly

- **New partnerships.** In Jun 2007, the company signed an exclusive 10-year distribution contract with Moschino and in July an agreement for the lease and conditional purchase of the Bond Street Business with Mariella, Italian high-end customer brand. The moves highlight the company's increased focus on high-end high-margin products.
- **Sisley.** Established in 1968, Sisley is engaged in the design of apparel for men, women and children. The collections include sporty and casual wear, formal and elegant dresses. The brand is sold at 850 outlets throughout the world. In Sep 2006, it set up a 50:50 JV with Benetton Group S.p.A. and acquired distributor exclusivity in China. On 1st Aug 2007, Benetton's 45 directly managed stores were transferred to the joint venture, which is expected to contribute to Hembly in FY12/08F.
- **Moschino.** Created in 1983 by Franco Moschino, Moschino is engaged in the design and manufacture of fashion for men and women. It has three collections, "Moschino", "Moschino Cheap & Chic" and "Moschino Jeans". Within five years, the company plans to open 30 Moschino shops in China. By end-2007, two flagship stores will be opened. Moschino is expected to contribute significantly to Hembly in FY12/08F.

Table 3: Turnover breakdown

(HK\$m)	1H FY12/06A	% of total	1H FY12/07A	% of total	% change
Manufacturing and sales	236.5	90.1	337.1	91.8	42.5
Distribution and retailing	26.1	9.9	30.3	8.2	16.1
Total	262.6		367.4		39.9

Source: Company data

Supply Chain Management

- **Strong SCM growth.** Turnover rose 42.5% YoY to HK\$337.1m in 1H FY12/07A on higher orders from Europe and accounted for 91.8% of total revenue. Operating profit rose 43.5% YoY to HK\$72.9m. Gross margin narrowed to 34.6% from 35.6%, as a result of the appreciation of the RMB. SCM growth is expected to reach approximately 40.0% in FY12/07F, 30.0% in FY12/08F and 20.0% in FY12/09F, with ST sales as a main driver. We have cut our ST sales forecast to HK\$150.0m in FY12/07F, HK\$300.0m in FY12/08F and HK\$390.0m in FY12/09F.
- **Growth in Europe.** In 1H FY12/07A, sales reached HK\$252.4m in Europe (74.9% of total manufacturing revenue), HK\$64.7m in China (19.2%) and HK\$20.0m (5.9%) in other countries. Revenue from Europe increased on higher orders from existing customers and an enlarged customer base. Europe accounted for 68.7% of total turnover in 1H FY12/07A and we expect European sales to grow 20.0-25.0% in FY12/07F, excluding ST.

Interim results recap. The company's net profit rose 30.3% YoY to HK\$45.6m in 1H FY12/07A on the back of a 39.9% turnover growth to HK\$367.4m. Turnover of the SCM segment (91.8% of the total) increased 42.5% to HK\$337.1m and of the retail and distribution business 16.1% to HK\$30.3m. An interim dividend of HK\$0.03 per share was proposed.

Table 4: 1H FY12/07A results

Year to Dec	Turnover (HK\$m)	Gross profit (HK\$m)	Gross margin (%)	Pre-tax profit (HK\$m)	Tax rate (%)	Net profit (HK\$m)	EPS Basic (HK\$)
1H FY12/07A	367.4	132.4	36.0	53.3	14.6	45.6	0.180
1H FY12/06A	262.6	94.6	36.0	40.9	10.8	35.0	0.194
YoY (%)	39.9	40.0		30.3	35.2	30.3	(7.2)

Source: Company data

Margins. The overall gross margin remained stable at 36.0% in 1H FY12/07A. The operating margin narrowed to 18.5% from 19.4% a year ago, mainly due to a 57.0% increase in administrative expenses to HK\$55.5m, as a result of one-off listing-related expenses (the company listed in July 2006). We expect the gross margin to narrow in FY12/07F to about 34.3% as a result of the impact of RMB appreciation on costs and to widen to 36.8% in FY12/08F on higher contributions from higher-margin D&R activities.

Risk. 1) Rising raw material prices. 2) Increased labor costs. 3) Pricing pressure from RMB appreciation. 4) Textile trading regulatory changes. 5) Forex rates.

Valuation. Based on our current model, the company is trading at P/E of 11.3x for FY12/07F and 7.3x for FY12/08F. We retain our BUY call and are fine-tuning our FY12/07F earnings estimates to factor in the withdrawal of one of its SCM client, Morgan, which went bankrupt in 1H FY12/07A. We expect net profit to grow at a three-year CAGR of 47.5% in 2006-2009. Using the sum-of-the-parts method, our target price is raised to HK\$5.9 from HK\$4.5, which represents 10.2x P/E in FY12/08F and is based on an earnings multiple of 8.6x for the SCM business and 22.5x for the D&R business.

Table: Peer comparables

Quote	Name	Market cap. (US\$m)	P/E (x)		PEG (%)	ROE (%)	Net gearing
			1-yr fwd	2-yr fwd	1-yr fwd		
Apparel manufacturers							
321	Texwinca	983.3	10.6	9.0	0.68	20.4	26.4
393	Glorious Sun	647.9	16.3	14.9	1.13	16.0	Cash
311	Luen Thai	127.2	5.6	n.a.	n.a.	1.2	Cash
2313	Shenzhou International	561.9	8.4	6.9	0.40	20.7	8.0
928	Tack Fat	275.8	6.0	4.9	n.a.	26.1	35.0
3398	China Ting	524.7	8.8	7.5	0.49	25.2	Cash
518	Tungtex	89.8	n.a.	n.a.	n.a.	18.3	Cash
Average			9.3	8.6	0.68	15.4	-
Footwear retailers							
210	Prime Success	1,211.6	24.7	19.1	0.85	33.8	3.4
1179	Mirabell	168.2	13.2	13.2	n.a.	12.3	Cash
738	Le Saunda	98.2	n.a.	n.a.	n.a.	16.4	Cash
Average			19.0	16.2	0.85	20.8	-
Apparel retailers							
2331	Li Ning	3,595.2	61.6	42.5	1.57	23.0	Cash
589	Ports	1,932.8	41.3	31.7	1.24	30.4	Cash
375	YGM Trading	104.1	28.9	5.9	n.a.	16.8	Cash
130	Moiselle	80.3	n.a.	n.a.	n.a.	24.0	n.a.
608	High Fashion	114.5	n.a.	n.a.	n.a.	11.4	31.1
Average			43.9	26.7	1.41	21.1	-
Total average retailers			33.9	22.5	1.22	21.0	-

Source: SBI E2-Capital, Bloomberg

P & L (HK\$m)	05A	06A	07F	08F	09F
Year to Dec					
Turnover	427.8	611.7	887.3	1,349.0	1,868.7
% chg	46.5	43.0	107.4	52.0	38.5
Gross profit	142.1	219.9	304.0	496.2	727.6
EBITDA	82.2	121.4	159.0	238.4	350.5
Depre./amort.	(6.8)	(10.9)	(14.2)	(23.0)	(31.2)
EBIT	75.4	110.6	144.8	215.5	319.2
Net int. income/(exp.)	(11.8)	(19.8)	(21.4)	(21.7)	(17.4)
Exceptionals	-	-	-	-	-
Associates	-	-	-	-	-
Jointly-controlled entit.	-	-	-	-	-
Pre-tax profit	63.6	90.8	123.4	193.7	301.8
Tax	(5.1)	(13.3)	(18.5)	(31.0)	(51.3)
Minority interests	(0.3)	0.6	-	-	-
Net profit	58.2	78.1	104.9	162.7	250.5
	88.5	34.2	34.3	55.1	53.9
Dividends	-	25.3	33.3	33.3	33.3
Retained earnings	58.2	103.4	138.3	196.1	283.9
EPS (HK\$) - Basic	0.323	0.357	0.371	0.576	0.886
EPS (HK\$) - F.D.	0.230	0.309	0.371	0.576	0.886
DPS (HK\$)	n.a.	0.118	0.118	0.118	0.118
No. sh.s o/s (m) - W.A.	180.0	218.6	282.6	282.6	282.6
No. sh.s o/s (m) - Y.E.	180.0	218.6	282.6	282.6	282.6
No. sh.s o/s (m) - F.D.	252.9	252.9	282.6	282.6	282.6
Margins (%)					
Gross	33.2	35.9	34.3	36.8	38.9
EBITDA	19.2	19.9	17.9	17.7	18.8
EBIT	17.6	18.1	16.3	16.0	17.1
Pre-tax	14.9	14.8	13.9	14.4	16.2
Net	13.6	12.8	11.8	12.1	13.4

Cash Flow (HK\$m)	05A	06A	07F	08F	09F
Year to Dec					
EBIT	75.4	110.6	144.8	215.5	319.2
Depre./amort.	6.8	10.9	14.2	23.0	31.2
Net int. paid	(11.8)	(19.8)	(21.4)	(21.7)	(17.4)
Tax paid	0.7	0.7	(9.9)	(17.4)	(30.2)
Dividends received	-	11.7	11.7	11.7	11.7
Gross cashflow	82.9	133.8	149.2	221.0	320.3
Chgs. in working cap.	(78.3)	(119.7)	(59.9)	(189.7)	(215.7)
Operating cashflow	4.6	14.1	89.3	31.3	104.5
Capex	(75.3)	(61.5)	(160.0)	(190.0)	(140.0)
Free cashflow	(78.0)	(76.6)	(82.6)	(175.7)	(59.5)
Dividends paid	-	(7.6)	(33.3)	(33.3)	(33.3)
Net distribution to MI	-	-	-	-	-
Investments	(3.0)	(2.5)	-	-	-
Disposals	0.6	1.1	-	-	-
New shares	31.0	106.0	-	-	-
Others	(0.1)	(20.5)	141.9	8.6	15.7
Net cashflow	(49.4)	(0.1)	26.0	(200.4)	(77.2)
Net (debt)/cash - Beg.	(105.6)	(155.0)	(155.1)	(129.1)	(329.5)
Net (debt)/cash - End.	(155.0)	(155.1)	(129.1)	(329.5)	(406.7)

Interim Results (HK\$m)	05A	06A	07A
Six months to Jun			
Turnover	165.2	262.6	367.4
% chg	n.a.	59.0	39.9
Profit from operations	30.3	50.9	68.1
Interest expenses	(4.8)	(10.0)	(14.8)
Associates	-	-	-
Jointly-controlled entit.	-	-	-
Pre-tax profit	25.5	40.9	53.3
Tax	(2.5)	(4.4)	(7.7)
Minority interests	(0.0)	(1.5)	-
Net profit	23.0	35.0	45.6
% chg	n.a.	52.1	30.5
EPS (HK\$) - W.A.	0.192	0.194	0.180
DPS (HK\$)	-	0.030	0.030

Balance Sheet (HK\$m)	05A	06A	07F	08F	09F
Year to Dec					
Fixed assets	121.7	175.1	229.2	348.6	426.3
Intangible assets	-	-	-	-	-
Other LT assets	35.3	70.0	91.6	139.3	170.4
Cash	84.6	238.4	290.6	102.8	38.6
Accounts receivable	93.4	187.9	218.8	332.6	460.8
Other receivables	47.3	58.2	67.6	102.7	142.3
Inventories	69.2	107.3	155.7	236.7	327.8
Due from related co.s	32.4	7.4	22.9	22.9	22.9
Other current assets	1.4	10.4	3.7	3.7	3.7
Total assets	485.4	854.8	1,080.2	1,289.4	1,592.8
Accounts payable	(43.2)	(58.6)	(87.3)	(127.6)	(170.8)
Other payable	(34.0)	(28.8)	(55.7)	(81.5)	(109.1)
Tax payable	(2.8)	(10.5)	(8.6)	(13.6)	(21.1)
Due to related co.s	(5.0)	(13.0)	(6.1)	(6.1)	(6.1)
ST debts	(191.6)	(288.2)	(311.3)	(320.6)	(330.2)
Other current liab.	(9.3)	(0.1)	(2.2)	(2.2)	(2.2)
LT debts	(48.0)	(105.3)	(108.5)	(111.7)	(115.1)
Other LT liabilities	(2.6)	(5.2)	(5.2)	(5.2)	(5.2)
Total liabilities	(336.5)	(509.6)	(584.9)	(668.5)	(759.7)
Share capital	0.0	25.3	25.3	25.3	25.3
Reserves	148.3	319.9	470.0	595.6	807.8
Shareholders' funds	148.3	345.2	495.3	620.9	833.1
Minority interest	0.7	0.0	-	-	-
Total	149.0	345.2	495.3	620.9	833.1
Capital employed	388.6	738.7	915.0	1,053.2	1,278.4
Net (debt)/cash	(155.0)	(155.1)	(129.1)	(329.5)	(406.7)

Shareholding Structure	Shares o/s (m)	%
Mr. Ngok Yan Yu	*151.8	53.7
Keywise Capital	22.6	8.0
Value Partners	22.0	7.8
Ward Ferry Management	17.3	6.1
New World Development	15.2	5.4
Public	53.7	19.0
Total	282.6	100.0

* 50.0m shares have been pledged to OZ Management

Background
Established in 2000 as a garment trader, Hembly has quickly evolved into a one-stop Supply Chain Management (SCM) services provider on apparel products and fashion accessories to international brand names, such as Benetton, Lotto, Lafuma and Quiksilver. It has expanded downstream into the retail and distribution of apparel and footwear market in the PRC through joint ventures with Lotto, Stonefly and Sisley and through an exclusive distribution contract with Moschino.

Key Ratios	05A	06A	07F	08F	09F
Net gearing (%)	104.5	44.9	26.1	53.1	48.8
NET ROE (%)	56.7	31.7	25.0	29.2	34.5
EBIT ROCE (%)	25.8	19.6	17.5	21.9	27.4
Dividend payout ratio (%)	0.0	32.4	31.8	20.5	13.3
Effective tax rate (%)	8.0	14.6	15.0	16.0	17.0
Net interest cover. (x)	6.4	5.6	6.8	9.9	18.3
A/R days (days)	91.8	115.4	109.5	97.6	101.4
A/P days (days)	51.5	49.1	47.4	47.6	47.7
Inventory days (days)	62.2	82.2	82.3	84.0	90.3

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