

Hembly: The retail segment is set to fly

Recommendation: BUY (unchanged)

China Consumer

Price	HK\$2.61	Year to	Net profit	EPS	EPS	P/E	P/B	EV/EBITDA	Yield	ROE	ROCE	N. Gear.
Target price	HK\$3.90 (+49.4%)	Dec	HK\$m	HK\$	Δ %	x	x	x	%	%	%	%
12 mth range	HK\$1.74-3.19	04A	30.9	0.122	21.6	21.4	8.3	13.9	n.a.	74.6	24.7	185.7
Market cap.	US\$84.8m	05A	58.2	0.230	88.5	11.3	3.2	6.4	n.a.	56.7	25.1	104.5
Daily t/o, 3 mth	US\$0.06m	06F	75.7	0.299	30.1	8.7	3.3	4.6	3.4	43.2	21.5	71.0
Free float %	35.4%	07F	117.3	0.464	54.9	5.6	2.6	3.1	5.3	51.4	25.7	67.5
Ticker	3989.HK/3989 HK	08F	151.7	0.600	29.3	4.4	1.8	2.8	6.9	48.6	30.2	31.3

Relative to Hang Seng Index (1 mth, 3 mth, 12 mth): +4.9%, +8.7%, n.a.

Actual price changes (1 mth, 3 mth, 12 mth): +6.1%, +16.5%, n.a.

Previous forecasts (06F-07F): HK\$75.6m (\$0.299), HK\$112.1m (\$0.443), HK\$150.7m (\$0.596)

Key points:

- Outsourcing from European customers accelerates further, benefiting the Supply Chain Management (SCM) segment with increasing order size from current customers.
- Margin improvement with new premium brand customers under SCM.
- Shipments for the spring-summer 2007 season under SCM up c.30% YoY.
- The Retail & Distribution (R&D) segment broke even in FY06F, with a total of 129 retail outlets – 30 under Sisley, 65 under Lotto and 34 under Stonefly.
- R&D's contribution to grow from c.10% of total sales in FY06F to c.18% in FY07F.
- Potential acquisitions and strategic alliances with branded customers.
- Target price revised up to HK\$3.9 from HK\$3.4, representing 8.4x FY12/07F P/E.

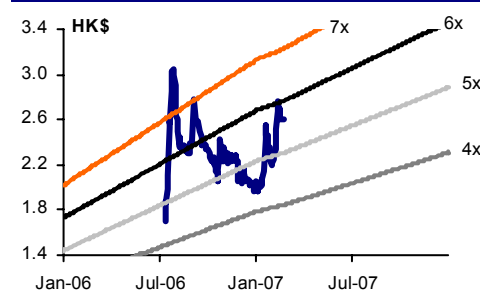
Supply Chain Management.

- ❑ **Increased orders from existing customers.** Outsourcing by European countries is gathering pace, benefiting Hembly directly with at least a 30% YoY increase in sales to existing customers in FY06F.
- ❑ **New premium brand customers.** Hembly has added several premium brand customers including Hugo Boss, D&G, DKNY Jeans, See By Chloé and Burberry Kids, which together represent c.7-10% of total sales. The cost of goods sold has been lowered due to an increase in the proportion of domestic sourcing instead of direct overseas imports. These two factors boosted the gross margin of the SCM segment. We are revising up our gross profit margin estimates for the SCM segment by 3.8% to 35.8% (FY12/05A: 33.1%) in FY12/06F.
- ❑ **Strong order book.** Hembly has two major shipments a year, the spring-summer and autumn-winter season. The current spring-summer 2007 shipments are up c.30%, which has ensured earnings sustainability in 1H FY07F.

Retail & Distribution

- ❑ **R&D segment to break even in FY06F.** We expect the segment to break even mainly thanks to the contribution of the Lotto JV, which should completely offset a slight loss by the Stonefly JV due to inventory write-offs incurred after it discontinued its retail of apparel at the beginning of 2006 to focus on shoes.
- ❑ **Contribution from Sisley to be included in FY07F.** In Sept 2006, Hembly has formed a 50%-owned JV with Benetton Group S.p.A., which will receive the 30 Sisley outlets in China. Sales from Sisley will not be

Chart 1: P/E bands



Source: SBI E2-Capital

booked in until FY07F. The JV plans to open not less than 150 Sisley outlets over the next five years. Sales per Sisley shop are HK\$300,000-400,000 per month.

Table 1: Number of retail outlets

Brands	2005A		2006A		2007F	
	Self-owned	Franchisee	Self-owned	Franchisee	Self-owned	Franchisee
- Stonefly	18	6	22 (28)	12 (10)	35	20
- Lotto	-	5	11 (9)	54 (59)	40	80
- *Sisley	-	-	30 (44)	-	67	-
Sub-total	18	11	63 (81)	66 (69)	142	100
Total		29		129 (150)		242

* The JV for the exclusive distribution and retail under "Sisley" was just formed in Sept 2006.

Figures in () are the total number of retail outlets planned during its IPO period

Source: SBI E2-Capital, Company data

- ❑ **Slow re-registration of Sisley.** The retail expansion seems to be slower than planned during the company's IPO. Since Stonefly and Lotto progressed as expected (refer to Table 1), we found that the major discrepancy came from Sisley, with the re-registration of the 30 outlets transferred to the JV with Benetton Group taking longer than expected. Nonetheless, Hembly expects to bring the number of Sisley outlets to 67 in FY07F.
- ❑ **Strong sales growth.** Apart from inorganic growth, both Lotto's and Stonefly's sales per shop have shown increases of 10% to 15% YoY in FY12/06F. We expect the R&D segment's sales contribution to grow from c.10% in FY12/06F to c.18% in FY12/07F.

Financial Highlights

Table 2: Profit & Loss

Year to Dec (HK\$m)	04A	05A	06F	07F	08F
- Supply Chain Management	283.1	412.0	538.3	694.3	817.2
- Retail & Distribution	8.8	15.8	60.0	153.6	240.1
- Royalties	0.1	0.2	0.2	0.3	0.3
Turnover	292.0	427.8	598.5	848.2	1057.6
% chg	11.4	46.5	39.9	41.7	24.7
Gross profit	79.9	142.1	216.7	322.0	411.4
EBITDA	40.0	79.4	111.2	157.4	195.3
Depre./amort.	(2.3)	(6.2)	(7.8)	(10.1)	(11.3)
EBIT	37.7	73.2	103.4	147.3	184.0
Net int. income/(exp.)	(3.8)	(9.6)	(17.5)	(14.5)	(12.5)
Exceptionals	0.3	0.0	0.0	0.0	0.0
Associates	0.0	0.0	0.0	0.0	0.0
Jointly-controlled entit.	0.0	0.0	0.0	0.0	0.0
Pre-tax profit	34.3	63.6	85.9	132.7	171.5
Tax	(3.4)	(5.1)	(9.6)	(14.9)	(19.2)
Minority interests	(0.0)	(0.3)	(0.6)	(0.6)	(0.6)
Net profit	30.9	58.2	75.7	117.3	151.7
% chg	21.6	88.5	30.1	54.9	29.3

Source: SBI E2-Capital

Table 3: Interim results highlights

Year to Jun	Sales (HK\$m)	Gross profit (HK\$m)	Gross margin (%)	Pre-tax profit (HK\$m)	Tax rate (%)	Net profit (HK\$m)	EPS (HK\$)	DPS (HK\$)
1H FY12/06A	262.8	94.6	36.0	40.9	10.8	35.0	0.194	0.030
1H FY12/05A	165.2	57.6	34.9	25.5	9.8	23.0	0.192	-
YoY (%)	59.1	64.3		60.4		52.3		

Source: Company data

Valuation.

Table 4: Sum-of-The-Parts valuation

(HK\$m)	2007F Net profit (HK\$m)	Target P/E (x)	Valuation
- Supply chain management	110.4	10.6	1,170.5
- Retail & distribution	7.4	17.7	131.4
Valuation	117.8		1,301.9
Less Debt			(315.2)
Equity value			986.7
Value per share (HK\$)			3.9

Source: SBI E2-Capital

- **Margins improvement.** While we are keeping our sales and net profit forecast largely unchanged, we have revised up the gross and operating margin estimates for FY06F-08F by an average of 2% and 1% respectively to reflect the addition of premium brand customers under the SCM segment and the maiden profit contribution of the R&D segment, compared with our previous breakeven projections in FY07F. As a result, our operating profit estimates were lifted by an average of 7.4% for FY/06F-08F. However, we are keeping our net profit forecast largely unchanged because of an increase in finance costs.
- **Target price revised up.** We have revised our target price up to HK\$3.9 from HK\$3.4 based on the sum-of-the-parts valuation. We apply an earnings multiple of 10.6x for the SCM segment and 17.7x for the R&D segment in FY12/07F. The SCM earnings multiple was derived from the industry average of sourcing and apparel manufacturing, while the R&D earnings multiple was derived from the industry average of China retail. (refer to table 5)

Table 5: Peer comparisons

Quote	Name	Market cap. (US\$m)	PE (x)			P/B (x)	ROA (%)	ROE (%)	Operating Margin (%)	Yield (%)
			2005	2006F	2007F					
Sourcing agents										
494	Li & Fung	8,694	33.2	27.9	22.1	14.2	13.5	38.1	3.3	2.2%
915	Linmark	86	8.0	6.1	5.1	0.6	6.7	14.9	3.9	7.1%
			20.6	17.0	13.6	7.4	10.1	26.5	3.6	0.0
Average			516.7	17.0	13.6	7.4	10.1	26.5	3.6	4.7%
Apparel manufacturers										
393	Glorious Sun	487	15.1	14.0	12.3	2.2	7.5	15.5	8.0	3.9%
311	Luen Thai	169	13.1	5.5	5.3	6.2	3.4	6.7	3.8	0.0%
928	Tack Fat	195	10.0	5.6	5.1	1.8	7.4	17.4	15.5	3.5%
448	Hang Ten	93	6.3	n.a.	n.a.	12.1	11.1	21.3	7.5	1.2%
3398	China Ting	442	6.6	8.4	7.2	1.2	25.1	40.5	23.5	5.9%
Average			10.2	8.3	7.5	4.7	10.9	20.3	11.6	2.9%
Apparel retailers										
2331	Li Ning	1,176	39.0	35.1	26.2	7.9	12.2	17.2	11.0	0.8%
589	Ports	929	37.2	31.5	24.5	9.3	19.0	23.0	21.8	1.5%
375	YGM Trading	132	6.4	5.2	3.8	1.7	17.6	25.5	13.0	6.4%
608	High Fashion	62	7.1	n.a.	n.a.	0.7	4.6	10.0	2.1	5.5%
3322	Win Hanverky	872	n.a.	19.1	16.5	n.a.	20.7	60.5	18.0	
Average			22.4	22.7	17.7	4.9	14.8	27.2	13.2	3.6%

Source: SBI E2-Capital

Risks: 1) Termination of JV; 2) Slower pace of retail expansion and 3) Long cash conversion cycle.

Disclosure of interests: SBI E2-Capital Securities Ltd. acted as the Sole Bookrunner, Lead Manager and Underwriter for the Hembly IPO (77.28m shares at HK\$1.70) on July 12, 2006.

P & L (HK\$ m)	04A	05A	06F	07F	08F	Cash Flow (HK\$ m)	04A	05A	06F	07F	08F
Year to Dec						Year to Dec					
Turnover	292.0	427.8	598.5	848.2	1,057.6	EBIT	37.7	73.2	103.4	147.3	184.0
% chg	11.4	46.5	39.9	41.7	24.7	Depre./amort.	2.3	6.2	7.8	10.1	11.3
Gross profit	79.9	142.1	216.7	322.0	411.4	Net int. paid	(3.8)	(9.6)	(17.5)	(14.5)	(12.5)
						Tax paid	(9.6)	(0.3)	(4.9)	(7.6)	(9.8)
EBITDA	40.0	79.4	111.2	157.4	195.3	Dividends received	-	-	-	-	-
Depre./amort.	(2.3)	(6.2)	(7.8)	(10.1)	(11.3)	Gross cashflow	27.1	70.1	89.1	135.6	173.3
EBIT	37.7	73.2	103.4	147.3	184.0						
Net int. income/(exp.)	(3.8)	(9.6)	(17.5)	(14.5)	(12.5)	Chgs. in working cap.	(21.8)	(47.6)	(27.8)	(63.0)	(52.9)
Exceptionals	0.3	-	-	-	-	Operating cashflow	5.3	22.5	61.3	72.6	120.3
Associates	-	-	-	-	-						
Jointly-controlled entit.	-	-	-	-	-	Capex	(29.3)	(75.3)	(65.8)	(25.8)	(19.7)
Pre-tax profit	34.3	63.6	85.9	132.7	171.5	Free cashflow	(9.1)	(40.7)	7.6	53.8	103.7
Tax	(3.4)	(5.1)	(9.6)	(14.9)	(19.2)						
Minority interests	(0.0)	(0.3)	(0.6)	(0.6)	(0.6)	Dividends paid	-	-	(22.7)	(35.2)	(45.5)
Net profit	30.9	58.2	75.7	117.3	151.7	Net distribution to MI	-	-	-	-	-
% chg	21.6	88.5	30.1	54.9	29.3	Investments	-	(3.0)	-	-	-
						Disposals	0.3	0.6	-	-	-
Dividends	-	-	22.7	35.2	45.5	New shares	0.0	31.0	131.4	-	-
Retained earnings	30.9	58.2	98.5	152.5	197.2	Others	(43.7)	(37.4)	(104.9)	(46.2)	(2.8)
						Net cashflow	(52.5)	(49.4)	11.4	(27.6)	55.4
EPS (HK\$) - Basic	0.172	0.323	0.346	0.464	0.600						
EPS (HK\$) - F.D.	0.122	0.230	0.299	0.464	0.600	Net (debt)/cash - Beg.	(53.1)	(105.6)	(155.0)	(143.7)	(171.3)
DPS (HK\$)	n.a.	n.a.	0.090	0.139	0.180	Net (debt)/cash - End.	(105.6)	(155.0)	(143.7)	(171.3)	(115.9)
No. sh.s o/s (m) - W.A.	180.0	180.0	218.6	252.9	252.9						
No. sh.s o/s (m) - Y.E.	180.0	180.0	252.9	252.9	252.9	Interim Results (HK\$ m)	05A	06A			
No. sh.s o/s (m) - F.D.	252.9	252.9	252.9	252.9	252.9	Six months to June					
						Turnover	165.2	262.8			
Margins (%)						% chg	n.a.	59.1			
Gross	27.4	33.2	36.2	38.0	38.9						
EBITDA	13.7	18.6	18.6	18.6	18.5	Profit from operations	30.3	50.9			
EBIT	12.9	17.1	17.3	17.4	17.4	Interest expenses	(4.8)	(10.0)			
Pre-tax	11.8	14.9	14.4	15.7	16.2	Associates	-	-			
Net	10.6	13.6	12.7	13.8	14.3	Jointly-controlled entit.	-	-			
						Pre-tax profit	25.5	40.9			
Gross margin breakdown (%)	04A	05A	06F	07F	08F	Tax	(2.5)	(4.4)			
Sales of apparel & accessories	26.9	33.1	35.8	37.3	38.0	Minority interests	(0.0)	(1.5)			
Distribution & retailing	41.6	36.4	40.0	41.0	42.0	Net profit	23.0	35.0			
Royalty fee income	n.a.	n.a.	n.a.	n.a.	n.a.	% chg	n.a.	52.3			
Balance Sheet (HK\$ m)	04A	05A	06F	07F	08F	EPS (HK\$) - W.A.	0.192	0.160			
Year to Dec						DPS (HK\$)	-	0.030			
Fixed assets	50.6	121.7	139.3	151.4	158.0						
Intangible assets	-	-	-	-	-	Shareholding Structure					
Other LT assets	21.5	35.3	40.4	43.9	45.8						
Cash	32.3	84.6	228.8	143.9	160.7						
Accounts receivable	60.3	93.4	117.6	166.7	207.8						
Other receivables	14.1	47.3	42.7	60.5	75.4						
Inventories	28.2	69.2	68.7	97.3	121.4						
Due from related co.s	38.1	32.4	28.1	28.1	28.1						
Other current assets	3.1	1.4	1.5	1.5	1.5						
Total assets	248.2	485.4	667.1	693.3	798.7						
Accounts payable	(16.6)	(43.2)	(39.0)	(53.7)	(66.0)						
Other payable	(26.8)	(34.0)	(39.3)	(54.2)	(66.5)						
Tax payable	(0.1)	(2.8)	(4.7)	(7.3)	(9.4)						
Due to related co.s	-	(5.0)	(3.8)	(3.8)	(3.8)						
ST debts	(114.7)	(191.6)	(284.1)	(244.5)	(220.0)						
Other current liab.	(9.6)	(9.3)	(2.2)	(2.2)	(2.2)						
LT debts	(23.2)	(48.0)	(88.4)	(70.7)	(56.6)						
Other LT liabilities	(0.1)	(2.6)	(2.6)	(2.6)	(2.6)						
Total liabilities	(191.0)	(336.5)	(464.1)	(439.0)	(427.2)						
Share capital	3.0	0.0	252.9	252.9	252.9						
Reserves	53.9	148.3	0.0	0.8	118.0						
Shareholders' funds	56.9	148.3	202.4	253.7	370.9						
Minority interest	0.3	0.7	0.6	0.6	0.6						
Total	57.2	149.0	202.9	254.3	371.5						
Capital employed	195.1	388.6	575.4	569.5	648.1						
Net (debt)/cash	(105.6)	(155.0)	(143.7)	(171.3)	(115.9)						
						Key Ratios	04A	05A	06F	07F	08F
						Net gearing (%)	185.7	104.5	71.0	67.5	31.3
						NET ROE (%)	74.6	56.7	43.2	51.4	48.6
						EBIT ROCE (%)	24.7	25.1	21.5	25.7	30.2
						Dividend payout ratio (%)	0.0	0.0	30.0	30.0	30.0
						Effective tax rate (%)	9.9	8.0	11.2	11.2	11.2
						Net interest cover. (x)	10.0	7.6	5.9	10.1	14.7
						A/R days	82.5	91.8	91.8	83.4	88.1
						A/P days	44.9	51.5	47.4	32.1	41.5
						Inventory days	43.7	62.2	65.9	57.6	61.8

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