

## Hembly: Earnings-accretive deal

**Recommendation: BUY (unchanged)**

**China consumer**

Price	HK\$3.90	Year to Net profit	EPS	EPS	P/E	P/B	EV/EBITDA	Yield	ROE	ROCE	N. Gear.	
Target price	HK\$4.50 (+13.3%)	Dec	HK\$m	HK\$	Δ %	x	x	x	%	%	%	
12 mth range	HK\$1.74-3.95	05A	58.2	0.230	88.5	16.9	4.7	8.5	n.a.	56.7	25.1	104.5
Market cap.	US\$126.84m	06A	78.1	0.365	58.5	10.7	2.5	5.7	3.0	31.7	19.2	44.9
Daily t/o, 3 mth	US\$0.37m	07F	127.9	0.504	38.3	7.7	2.2	3.4	3.9	32.2	20.1	57.1
Free float %	40.2%	08F	168.6	0.665	31.8	5.9	1.7	2.4	5.1	33.0	21.8	56.7
Ticker	3989.HK/3989 HK	09F	206.6	0.814	22.6	4.8	1.4	2.0	6.3	32.0	22.6	43.2

Relative to Hang Seng Index (1 mth, 3 mth, 12 mth): +32.3%, 42.4%+, -)

Actual price changes (1 mth, 3 mth, 12 mth): +31.8%, +48.2%, -)

Previous forecasts (07F-08F): HK\$117.3m (\$0.464), HK\$151.7m (\$0.600)

### Key points:

- H4T grants Hembly three-year option to acquire the Sergio Tacchini (ST) business in Europe at nil consideration is cost-free.
- Hembly will become the sole supplier to ST, we expect this will enhance EPS by 8.4% in FY12/07F and 10.5% in FY12/08F.
- Fall-winter 2007 shipments under SCM remain robust, up c.30-40% YoY.
- Slower-than-expected contribution from retail & distribution (R&D), with Sisley stores factored in in 2H FY12/07F.
- Lower effective tax rate of 11% expected on a proposed tax write-back in FY12/07F.
- We estimate Hembly's net profit to grow at a three-year (2006-2009) CAGR of 38%.
- Target price revised upwards to HK\$4.5 (prev. HK\$3.9) based on DCF valuation.

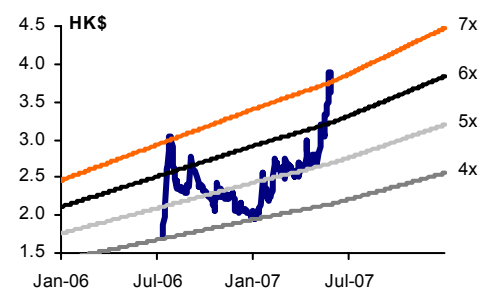
**Option to acquire ST.** Hembly announced on 25<sup>th</sup> May that H4T S.R.L., a private and wholly owned company by its chairman Mr. Ngok, acquired Sergio Tacchini S.p.A (ST). Subsequently, H4T granted Hembly a three-year option to acquire Mr. Ngok's interest in ST.

**EPS accretive.** ST is a customer of Hembly and accounted for c.2.5% of the group's total sales in FY12/06A. With Mr. Ngok's acquisition of ST, Hembly is expected to become ST's sole supplier. Hembly's sales to H4T are estimated at HK\$267.5m in 2H FY12/07F, HK\$362.9m in FY12/08F and HK\$415.7m in FY12/09F, representing a significant boost of 22.9% in FY12/07F and 35.4% in FY12/08F to the group's top-line. We estimate Hembly's EPS enhancement at 8.4% in FY12/07F and 10.5% in FY12/08F because of lower gross margins earned from ST (average c.25%, compared with c.33-35% from Hembly's SCM customers). Based on ST's significant top-line contribution in the coming years, we forecast that Hembly's gross margin will narrow to 32.7% (from 37.8%) in FY12/07F and 32.0% (from 38%) in FY12/08F.

**Option dilemma.** Since ST is currently in the red, we believe Hembly faces a dilemma as exercising the option would mean additional financing for the transaction and risks from exposing the group to managing wholesale and retail operations in Europe, which is different from its goal to expand downstream in China. According to the management, H4T paid c.HK\$300m for ST, which includes ST's brand equity, property in Milan, two warehouses in Bellinzago and Novarese and distribution network.

**ST background.** Established in the 1960s, ST is engaged in the manufacturing of clothing and footwear for sport and leisure, especially tennis and sailing outfits under the brand name of "ST" and "Sergio Tacchini". It has 200

**Chart 1: P/E bands**



Source: SBI E2-Capital

sales points mainly in Italy, France and Spain with branch offices in France, Spain, Belgium and Hong Kong. It also owns a number of licences for the use of the brand in core goods and accessory product lines, such as fragrances, eyewear and leather goods. Currently around 75% of its total production is sourced in the Far East. The company also owns a building in Milan and two warehouses in Bellinzago and Novarese. Amid keen competition, ST has suffered losses since 2003 and liquidated some of its chains of single-brand directly-managed shops set up between 1997 and 2002 in Italy. It has also cut down its workforce.

**Slow contribution from R&D.** We expect the R&D segment to contribute c.11.2% of total sales in FY12/07F, against our previous forecast of 18%, because the 35 Sisley stores will not be included until 2H FY12/07F due to slow re-registration of previous franchisees into Hembly. The Group aims to bring the total number of Sisley shops to 67 in FY12/07F, focusing in Shenzhen, Guangzhou and Shanghai. Lotto's sales remain strong, while sales from Stonefly are a bit lackluster.

**Table 1: Retail network expansion plans**

Brands	FY12/06	FY12/07F	FY12/08F
- Stonefly	34	55	70
- Lotto	65	120	250
- Sisley	30	67	82
Total POS	129	242	402

Source: SBI E2-Capital, Company data

**Valuation.** We have revised our earnings forecast up 9-11% for FY12/07F-08F and introduced FY12/09F forecast. We expect Hembly's net profit to grow at a three-year CAGR of 38% (2006-2009). Based on our DCF valuation, our target price is raised to HK\$4.5 from HK\$3.9, which represents 8.7x P/E in FY12/07F. We cross checked our analysis by using the sum-of-the-parts method, which suggests a fair value of HK\$7.7, based on an earnings multiple of 10.5x for the SCM business and 15.0x for the D&R business. We believe the DCF valuation better reflects Hembly's intrinsic value in the current market and reiterate our BUY recommendation.

**Table 2: DCF model**

Capital structure	
- Debt %	20.0
- Equity %	80.0
WACC %	17.0
Risk free rate %	5.3
Equity risk premium %	8.3
Cost of equity %	20.1
Cost of debt %	5.8
Terminal growth rate %	1.0
Tax rate %	17.5
DCF valuation (HK\$m)	1,306.5
Less: Net debt (HK\$m)	(155.1)
Equity value (HK\$m)	1,151.5
<b>Per share value (HK\$)</b>	<b>4.5</b>

Source: SBI E2-Capital

**Table 3: P&L**

Year to Dec (HK\$m)	05A	06A	07F	08F	09F
- Supply Chain Management	283.1	412.0	551.9	946.3	1106.8
- Retail & Distribution	8.8	15.8	59.4	120.0	240.1
- Royalties	0.1	0.2	0.4	0.5	0.8
Turnover	292.0	427.8	1066.8	1347.7	1579.6
% chg	11.4	46.5	149.4	26.3	17.2
Gross profit	79.9	142.1	356.2	450.0	533.1
EBITDA	40.0	80.0	170.3	217.5	261.1
Depre./amort.	(2.3)	(6.8)	(8.4)	(12.9)	(15.7)
EBIT	37.7	73.2	161.9	204.6	245.4
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	144.4	190.1	232.9
Tax	(3.4)	(5.1)	(15.9)	(20.9)	(25.6)
Minority interests	(0.0)	(0.3)	(0.6)	(0.6)	(0.6)
Net profit	30.9	58.2	127.9	168.6	206.6
% chg	21.6	88.5	63.7	31.8	22.6

Source: SBI E2-Capital

**Risks.** 1) Higher interest costs; 2) Longer cash conversion cycle with higher receivable turnover; 3) Retail expansion risks.

**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)	05A	06A	07F	08F	09F
<b>Year to Dec</b>					
<b>Turnover</b>	<b>427.8</b>	<b>611.7</b>	<b>1,066.8</b>	<b>1,347.7</b>	<b>1,579.6</b>
% chg	46.5	43.0	149.4	26.3	17.2
Gross profit	142.1	219.9	356.2	450.0	533.1
EBITDA	80.0	119.4	170.3	217.5	262.1
Depre./amort.	(6.8)	(10.9)	(8.4)	(12.9)	(16.7)
EBIT	<b>73.2</b>	<b>108.5</b>	<b>161.9</b>	<b>204.6</b>	<b>245.4</b>
Net int. income/(exp.)	(9.6)	(17.7)	(17.5)	(14.5)	(12.5)
Exceptionals	-	-	-	-	-
Associates	-	-	-	-	-
Jointly-controlled entit.	-	-	-	-	-
<b>Pre-tax profit</b>	<b>63.6</b>	<b>90.8</b>	<b>144.4</b>	<b>190.1</b>	<b>232.9</b>
Tax	(5.1)	(13.3)	(15.9)	(20.9)	(25.6)
Minority interests	(0.3)	0.6	(0.6)	(0.6)	(0.6)
<b>Net profit</b>	<b>58.2</b>	<b>78.1</b>	<b>127.9</b>	<b>168.6</b>	<b>206.6</b>
% chg	88.5	34.3	63.8	31.8	22.6
Dividends	-	25.3	38.4	50.6	62.0
Retained earnings	58.2	103.4	166.3	219.2	268.6
EPS (HK\$) - Basic	0.323	0.357	0.504	0.665	0.814
EPS (HK\$) - F.D.	0.230	0.365	0.504	0.665	0.814
DPS (HK\$)	n.a.	0.118	0.151	0.199	0.244
No. sh.s o/s (m) - W.A.	180.0	218.6	253.7	253.7	253.7
No. sh.s o/s (m) - Y.E.	180.0	218.6	253.7	253.7	253.7
No. sh.s o/s (m) - F.D.	252.9	214.2	253.7	253.7	253.7
<b>Margins (%)</b>					
Gross	33.2	35.9	33.4	33.4	33.7
EBITDA	18.7	19.5	16.0	16.1	16.6
EBIT	17.1	17.7	15.2	15.2	15.5
Pre-tax	14.9	14.8	13.5	14.1	14.7
Net	13.6	12.8	12.0	12.5	13.1

Cash Flow (HK\$m)	05A	06A	07F	08F	09F
<b>Year to Dec</b>					
EBIT	73.2	108.5	161.9	204.6	245.4
Depre./amort.	6.8	10.9	8.4	12.9	16.7
Net int. paid	(9.6)	(17.7)	(17.5)	(14.5)	(12.5)
Tax paid	(0.3)	(6.7)	(8.0)	(10.5)	(12.8)
Dividends received	-	-	-	-	-
<b>Gross cashflow</b>	<b>70.7</b>	<b>98.4</b>	<b>145.1</b>	<b>192.8</b>	<b>237.0</b>
Chgs. in working cap.	(47.6)	(117.1)	(172.0)	(107.6)	(89.7)
<b>Operating cashflow</b>	<b>23.1</b>	<b>(18.7)</b>	<b>(26.8)</b>	<b>85.2</b>	<b>147.3</b>
Capex	(75.3)	(61.5)	(90.0)	(90.0)	(60.0)
<b>Free cashflow</b>	<b>(40.7)</b>	<b>62.8</b>	<b>(106.4)</b>	<b>3.7</b>	<b>93.9</b>
Dividends paid	-	(7.6)	(38.4)	(50.6)	(62.0)
Net distribution to MI	-	-	-	-	-
Investments	(3.0)	(2.5)	-	-	-
Disposals	0.6	1.1	-	-	-
New shares	31.0	106.0	-	-	-
Others	(37.4)	(159.9)	43.2	(20.8)	(19.3)
<b>Net cashflow</b>	<b>(49.4)</b>	<b>(0.1)</b>	<b>(101.5)</b>	<b>(67.7)</b>	<b>12.6</b>
Net (debt)/cash - Beg.	(105.6)	(155.0)	(155.1)	(256.6)	(324.3)
Net (debt)/cash - End.	(155.0)	(155.1)	(256.6)	(324.3)	(311.6)

Interim Results (HK\$m)	05A	06A
<b>Six months to Jun</b>		
<b>Turnover</b>	<b>165.2</b>	<b>262.8</b>
% chg	n.a.	59.1
Profit from operations	30.3	50.9
Interest expenses	(4.8)	(10.0)
Associates	-	-
Jointly-controlled entit.	-	-
<b>Pre-tax profit</b>	<b>25.5</b>	<b>40.9</b>
Tax	(2.5)	(4.4)
Minority interests	(0.0)	(1.5)
<b>Net profit</b>	<b>23.0</b>	<b>35.0</b>
% chg	n.a.	52.3
EPS (HK\$) - W.A.	0.192	0.138
DPS (HK\$)	-	0.030

Balance Sheet (HK\$m)	05A	06A	07F	08F	09F
<b>Year to Dec</b>					
Fixed assets	121.7	175.1	183.4	238.5	269.4
Intangible assets	-	-	-	-	-
Other LT assets	35.3	70.0	73.3	95.3	107.7
Cash	84.6	238.4	163.1	108.0	133.6
Accounts receivable	93.4	187.9	327.8	414.1	485.3
Other receivables	47.3	58.2	101.6	128.3	150.4
Inventories	69.2	107.3	187.2	236.4	277.1
Due from related co.s	32.4	7.4	28.1	28.1	28.1
Other current assets	1.4	2.8	1.5	1.5	1.5
<b>Total assets</b>	<b>485.4</b>	<b>847.2</b>	<b>1,065.9</b>	<b>1,250.2</b>	<b>1,453.1</b>
Accounts payable	(43.2)	(58.6)	(106.3)	(134.3)	(156.6)
Other payable	(34.0)	(28.8)	(73.1)	(92.4)	(107.7)
Tax payable	(2.8)	(10.5)	(7.9)	(10.4)	(12.8)
Due to related co.s	(5.0)	(13.0)	(3.8)	(3.8)	(3.8)
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)	(2.6)	(2.6)	(2.6)
<b>Total liabilities</b>	<b>(336.5)</b>	<b>(509.6)</b>	<b>(615.8)</b>	<b>(678.1)</b>	<b>(731.0)</b>
Share capital	0.007	25.3	25.3	25.3	25.3
Reserves	148.3	319.9	424.3	546.2	696.2
<b>Shareholders' funds</b>	<b>148.3</b>	<b>345.2</b>	<b>449.6</b>	<b>571.5</b>	<b>721.5</b>
Minority interest	0.7	0.0	0.6	0.6	0.6
<b>Total</b>	<b>149.0</b>	<b>345.2</b>	<b>450.1</b>	<b>572.1</b>	<b>722.1</b>
Capital employed	388.6	738.7	869.8	1,004.4	1,167.4
Net (debt)/cash	(155.0)	(155.1)	(256.6)	(324.3)	(311.6)

Shareholding Structure	Shares o/s (m)	%
Mr. Ngok Yan Yu	101.8	40.1
New World Development	30.2	11.9
Credit Suisse Group	23.6	9.3
Evolution Capital	10.3	4.1
Credit Suisse Group	9.4	3.7
Public	78.4	30.9
<b>Total</b>	<b>253.7</b>	<b>100.0</b>

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.

Key Ratios	05A	06A	07F	08F	09F
Net gearing	104.5	44.9	57.1	56.7	43.2
NET ROE	56.7	31.7	32.2	33.0	32.0
EBIT ROCE	25.1	19.2	20.1	21.8	22.6
Dividend payout ratio	0.0	32.4	30.0	30.0	30.0
Effective tax rate	8.0	14.6	11.0	11.0	11.0
Net interest cover. (x)	7.6	6.1	9.3	14.1	19.6
A/R days	91.8	170.1	166.2	159.5	73.4
A/P days	51.5	76.6	69.5	66.5	30.5
Inventory days	62.2	82.2	75.6	86.1	89.6

---

SBI E2-Capital is a dedicated small/mid cap investment banking/ stockbrokerage house. Find our research on: [sbie2capital.com](http://sbie2capital.com), [thomsononeanalytics.com](http://thomsononeanalytics.com), [factset.com](http://factset.com) and [multex.com](http://multex.com)

**SBI E2-Capital stock ratings:**

**STRONG BUY** : absolute upside of >50% over the next three months

**BUY** : absolute upside of >10% over the next six months

**HOLD** : absolute return of -10% to +10% over the next six months

**SELL** : absolute downside of >10% over the next six months

Investors should assume that SBI E2-Capital is seeking or will seek investment banking or other related businesses with the companies in this report.

**Analyst certification:** The views expressed in this report accurately reflect the analyst's personal views of the subject securities and that the analyst has not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report.

**Disclaimer:** This research report is not an offer to sell or the solicitation of an offer to buy or subscribe for any securities. The securities referred to in this report may not be eligible for sale in some jurisdictions. The information contained in this report has been compiled by the Research Department of SBI E2-Capital Securities Limited ('SBI E2-Capital') from sources that it believes to be reliable but no representation, warranty or guarantee is made or given by SBI E2-Capital or any other person as to its accuracy or completeness. All opinions and estimates expressed in this report are (unless otherwise indicated) entirely those of SBI E2-Capital as of the date of this report only and are subject to change without notice. Neither SBI E2-Capital nor any other person, accepts any liability whatsoever for any loss howsoever arising from any use of this report or its contents or otherwise arising in connection therewith. Each recipient of this report shall be solely responsible for making its own independent investigation of the business, financial condition and prospects of the companies referred to in this report. SBI E2-Capital and their respective officers, directors and employees, including persons involved in the preparation or issuance of this report, may from time to time (1) have positions in, and buy or sell, the securities of companies referred to in this report (or related investments); (2) have a consulting, investment banking or broking relationship with any company referred to in this report; and (3) to the extent permitted under applicable law, have acted upon or used the information contained or referred to in this report including effecting transactions for their own account in an investment (or related investment) in respect of any company referred to in this report, prior to or immediately following its publication. This report may not have been distributed to all recipients at the same time. This report is issued only for the information of and may only be distributed to professional investors and dealers in securities and must not be copied, published, reproduced or redistributed (in whole or in part) by any recipient for any purpose. This report is distributed in Hong Kong by SBI E2-Capital. Any recipient of this report who requires further information regarding any securities referred to in this report should contact the relevant office of SBI E2-Capital located in such recipient's home jurisdiction.

Copyright © SBI E2-Capital Securities Limited 2007. All rights reserved.

---