OTO Holdings

Attractive valuation for entry

Established since 80s, OTO is engaged in sales and distribution of relaxation and wellness products under the 'OTO' brand in the Hong Kong, Macau and China regions. Key principal business activities include 1) market research and products design and development (R&D) 2) advertising and promotion and 3) retailing and brand management. Manufacturing, packaging and productions processes are outsourced, via OEM & ODM, to manufacturers in China, Korea, Taiwan and Japan regions. Sales and distribution is mainly via self-operate retail outlets and consignment counters. OTO's business model is simple and asset slight. It sales result was adversely affected by key retail store relocation during FY03/12A and FY03/13F.

Ticker	**6880 HK**
Rating	**Not Rated**
Price (HK$)	0.62
Target Price (HK$)	-
12m Price Range (HK$)	0.4 – 0.75
Market cap. (US$m)	25.4
Daily t/o (US$m)	0.1
Free float (%)	34.9

Investment summary

- Well-known local brand is trading at 9% discount to HK$0.68 net cash per share.
- Expect profit normalization in FY03/14F from stores relocation and redecoration.
- Sales channel diversification since 2002 to B2C business, increasing sales via B2C enhances OTO's earning visibility.
- China sales amount might reach 50% of group turnover within 3 years; low CAPEX suggests potential payback in 3 months, under our assumptions.

Financial summary

Year to March	**10A**	**11A**	**12A**	**13F**	**14F**
Turnover (HKm)	289.3	209.4	245.7	266.0	340.6
Net Profit (HKm)	69.1	37.2	15.2	7.8	34.0
EPS (HK)	0.22	0.12	0.05	0.02	0.11
P/E (x)	2.87	5.33	13.00	25.32	5.82
P/B (x)	2.09	1.55	0.74	0.72	0.64
EV/EBITDA (x)	1.19	2.11	(1.08)	(1.12)	(0.75)
Yield (%)	-	-	-	-	-
ROE (%)	101%	33%	8%	3%	12%
ROCE (%)	120%	40%	11%	4%	14%
N. Gear. (%)	N. Cash	N. Cash	N. Cash	N. Cash	N. Cash

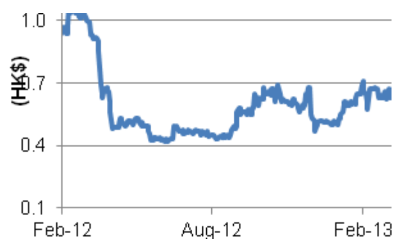
Source: SBI E2 Capital/Bloomberg

	11F	**12F**	**13F**
Consensus EPS (HK)	-	-	-
Previous earnings (HKm)	-	-	-
Previous EPS (HK)	-	-	-

Established local brand is trading at below book. OTO brand is a well-known local relaxation brand, has been presence in Hong Kong over 20 years. Pursuant to 1H FY03/13A financial result, OTO had total net cash of HK$216.8m and total net equity of RMB265.0m, equivalent to per share value of HK$0.68 and HK$0.83 respectively. In our view, net cash per share HK$0.68 would be a floor price of OTO's valuation. The current price HK$0.62 represents 9% and 26% discount of the net cash and net equity value per share.

Price performance

Year to March	**1m**	**3m**	**12m**
Relative to HSI (%)	2.9	(6.8)	23.1
Actual price changes (%)	0.0	17.0	33.6



Source: Bloomberg

Potential profit normalization from key retail store relocation. OTO's Hong Kong sales were adversely impacted by key store relocation during the period 2H FY03/12A and 1H FY03/13A. For 2H FY03/13A, Hong Kong retail sales continuously affected by sales loss arise from existing store relocation (Harbour City in TST, Telford Plaza in Kowloon Bay) as well as store redecoration (Time Square in CWB). Sales loss from TST store relocation was estimated to be HK$12.5m, i.e. roughly 10% of forecast turnover, while new stores sales in Olympian City and East Point City (TKO) were yet to pick up. Hence, we do not expect to see a notable rebound in 2H FY03/13F.

China story; China sales might account up to 50% of group sales within 3 years. OTO engaged in China market since 2011 after listing on HKEx. Number of selling points has reached 64.Retail network covers 1-2 tier cities, including Chengdu, Shanghai, Beijing and Shenzhen. Turnover from China region has reached HK$21.2m in 1H FY03/13A as compared to HK$20.0m in FY03/12A. Retail outlets expansion via consignment counters enable relatively low cost and quick expansion. We expect China selling points will reach up to 70 in FY03/13F, 110 in FY03/14F and 136 in FY03/15F.

Our view and valuation. OTO is currently trading undervalue. Net cash value HK$0.68 would be a good floor price of company valuation, and seeks for potential upside on 1) profit normalization in FY03/14F; 2) China expansion and 3) new key relaxation products to be success. However, we expect FY03/13F result would be continuously distorted by the sales loss from store relocation and redecoration along with incremental expansion expenses.

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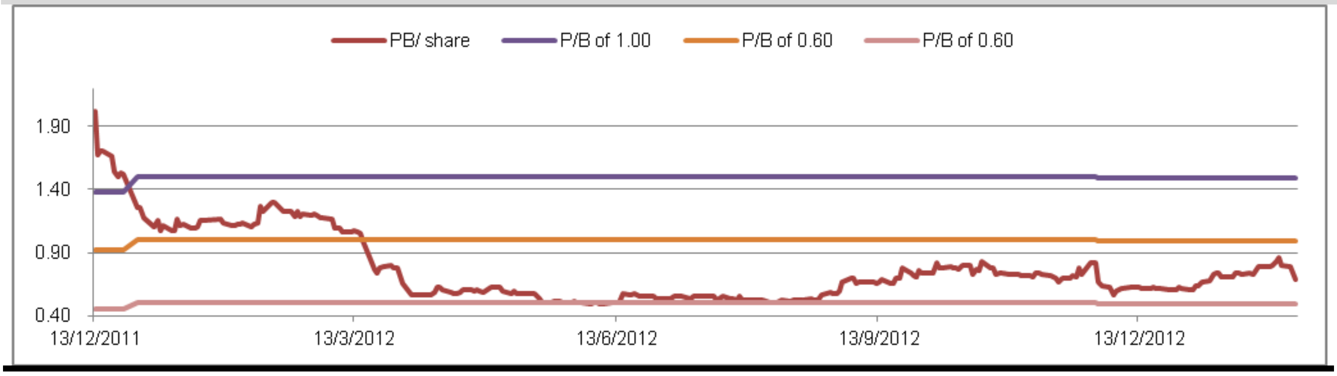
Investment thesis

Cash rich established brand is trading at below book value. OTO brand is a well-known relaxation and wellness retailer in Hong Kong. Under the international accounting standard, the value of self-developed brand is not recognized in the book value. Based on the latest 1H FY03/13A financial report, OTO had total asset value of HK$299.8m and net equity of RMB264.5m. The total asset value consisted HK$270.7m of current assets (90% of total asset), of which HK$227.9m (84% of total current assets) was cash or cash equivalent. Given the total borrowing of HK$11.1m, OTO had a net cash position of HK$216.8m. The current price HK$0.62 per share implies a market value of HK$198.2m, i.e. market is pricing OTO at 9% discount of company's net cash value and 26% discount of its book value (which does not reflect the value of the OTO brand). Illustration 1 shows OTO's P/B band since the listing:

Illustration 1. Historical PB band



Source: SBI E2-Capital

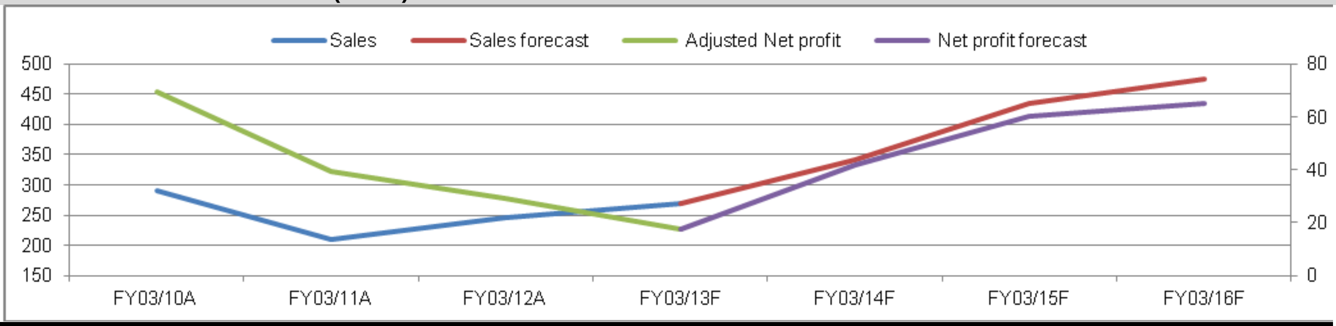
Potential Profit normalization in FY03/14F from stores relocation and redecoration. In 2H FY03/12A and 1H FY03/13A, Hong Kong turnover has dropped by 4% and 11% HoH to HK$98.2m and HK$87.8m. The decrease in Hong Kong sales was mainly attributable to the Harbour City and Grand Century Place store relocation during the period. They were closed at the end of year 2011 and the beginning of the year 2012. The estimated sales loss from Harbour City was roughly HK$12.5m for half year, while new stores sales (Olympian City and East Point City) were yet to pick up. Hence, stores relocation combining with sluggish consumption sentiment and China expansion expenses led 2H FY03/12A and 1H FY03/13A profit to drop by 55% and 45% HoH to HK$8.8m and HK$4.8m. For 2H FY03/13F, despite TST store location has secured at Star House to replace the Harbour City store. Star House store was yet to commence operation. It is expected Star House store to be opened in the mid of April in 2013F. Yet, Time Square store was redecorated while Telford store was closed and seeking for seeking for relocation in 2H FY03/13F. Therefore, store relocation and redecoration issue will continue to impact on 2H FY03/13F and FY03/13F result. In our view, Hong Kong store relocation has mostly completed by FY03/13F. Hence, we expect to see a rebound in Hong Kong region performance in FY03/14F. Table 1 shows the financial summary in half year period from 2H FY03/12F to 1H FY03/13F.

Table 1. Historical sales breakdown

HK$m	1H FY03/11A	2H FY03/11A	1H FY03/12A	2H FY03/12A	1H FY03/13A
Sales	100.0	109.4	118.2	127.5	124.3
- Growth rate		9.3%	8.1%	7.9%	-2.5%
Hong Kong	87.5	96.3	101.9	98.2	87.8
- Growth rate		10%	6%	-4%	-11%
Net profit Adjusted for Listing expenses	18.6	21.3	19.4	8.8	4.8
- Growth rate		14%	-9%	-55%	-45%
Adjusted net profit margin	19%	19%	16%	7%	4%

Source: SBI E2-Capital

Illustration 2. Our sales forecast (HK$m)

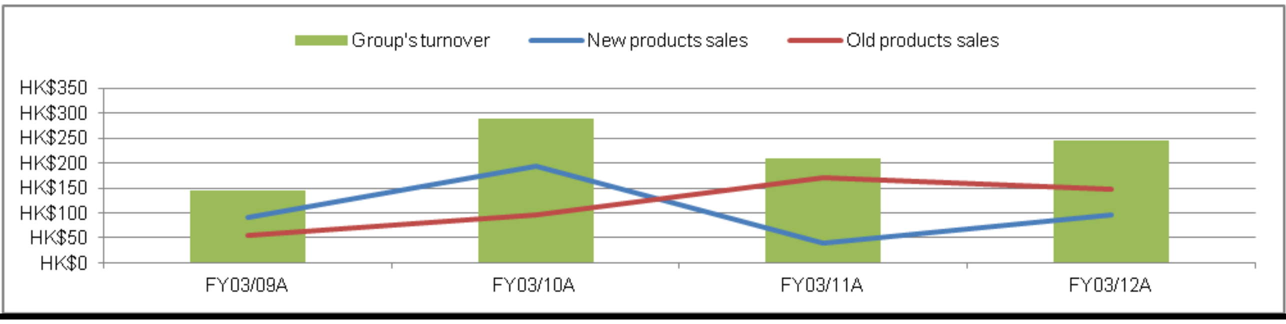


Source: SBI E2-Capital

Betting on potential success of new product to be launch. Typically, relaxation products have a relatively short product life cycle, for around a year. Company launches up to 10 ~ 15 new products per annum. New products sales often denote large part of group sales. For instance, two key relaxation products (KRP) were launched in FY03/10A, namely Power Tap and e-Lux, had led sales to a record high of HK$289.3m, up by 101% YoY. During the period, new products sales was accounted for 87% of group turnover, in particular, sales of Power Tap and e-Lux accounted for 84% sales new product sales which amounted to HK$162.2m. In contrary, new products sales in FY03/11A was substantially lower by ~80% YoY, causing overall sales dropped by 28% YoY while new product sales in FY03/12A were yet to form a turnaround. In our view, potential success of new products sales would be the prospect earning upside on top of profit normalization and China sales growth for FY03/14F and onwards:

Table 2. New products sales and overall sales

HK$m	FY03/09A	FY03/10A	FY03/11A	FY03/12A
Key relaxation products (KRP)	e-Bliss	Power Tap; e-Lux	Cruncher; Power Repose	e-Cuddle; Master Sense Massage
KRPs sales (HK$m)	n.a	162.2	34.1	n.a
Number of new products launched	13	12	10	7
New products sales (HK$m)	90.3	192.5	38.9	97.2
Group Turnover	144.2	289.3	209.4	245.7
% of group sales	63%	87%	19%	40%



Source: SBI E2-Capital

Sales channel diversification enhances OTO's earning visibility. Majority of OTO's sales turnover is contributed by business to customer (B2C) sales, which accounted for 91%, 86%, 86% and 79% of group turnover from FY03/09A to FY03/12A. B2C sales often rely heavily on consumer preference; hence sales cannot easily forecast and measure. The particularly common issue for Hong Kong B2C business are the incremental increase in rental expense and other operation expense, such as wages and marketing, which has led to lower industry profit margin (i.e. greater earnings volatility). To diversify earnings from B2C sales, OTO has engaged in B2B sales to, 1) corporate clients since 2002 and 2) overseas market since 2005. Despite lower in profit margin from B2B sales at between 30%~55% as compared to retail sales up to 80%, bulk sales via B2B ensures sales volume and forward sales order can reasonably foresee. Yet, products for B2B sales are often customized, hence pricing and profit margin can be managed in certain extend. In comparison, B2C business gross profit margin was ~75% adding 20% staff cots, 28% rental expenses and 8% marketing and other related expenses, net profit margin often fall below 20%. Hence, expending presence on B2B business would enhance OTO's earning visibility and lower the reliance on new products sales. We expect to see a stable grow in OTO's B2B segment. Table 3 shows percentage of B2B sales to the group which indicates an overall uptrend of B2B sales turnover from 9% of group turnover in FY03/09A to 21% in FY03/12A, dollar amount increased from HK$13.6m to HK$52.5m.

Table 3. B2C & B2B sales result

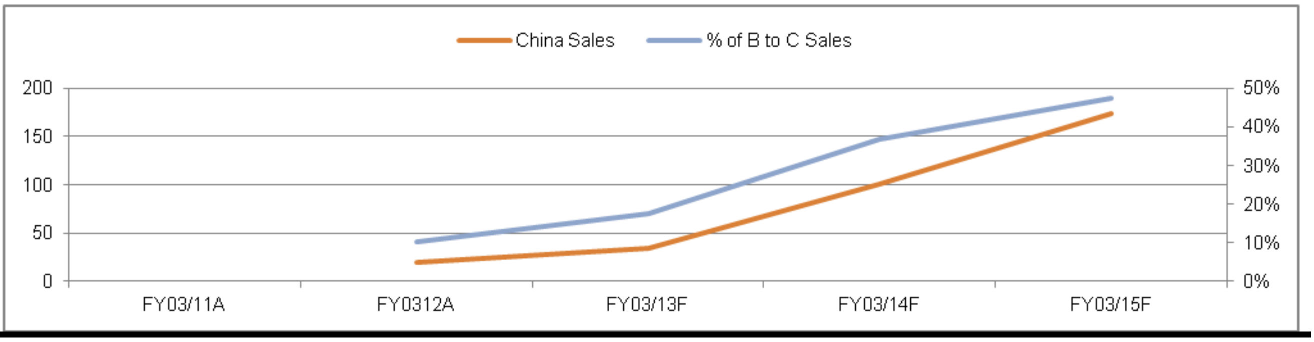
	FY03/09A	FY03/10A	FY03/11A	FY03/12A
B2C sales (HK$m)	130.7	247.3	180.7	193.1
B2B sales (HK$m)	13.6	41.9	28.7	52.5
B2C % of total sales	91%	86%	86%	79%
B2B % of total sales	9%	14%	14%	21%

Source: SBI E2-Capital

China story; payback in 3 months if 4 items sold per day. OTO has engaged in China market since 2011 after listing on HKEx. Number of selling points has reached 64 in China. Retail network covers key 1-2 tier cities, including Chengdu, Shanghai, Beijing and Shenzhen region. Turnover from China region has reached HK$21.2m in 1H FY03/13A as compared to HK$20.0m in FY03/12A. Retail outlets expansion is mostly via consignment counter at renowned shopping mall while retails are located in central shopping/business district mainly for marketing purpose. CAPEX for a new consignment counter open is relatively low at around RMB100,000 to RMB200,000 per store. If we assume average 4 products were sold per day, investment payback period can be less than 3 months. Yet, the low CAPEX expansion reduces the capital commitment and requirement. Low cost expansion also enables selling points to be relocated without substantial costs. Apart from typical retails sales, online sales and B2B sales would be a good China business opportunity that OTO is yet to exposure. In our view, China market would be the key long term growth thesis. If we compare the average number products sold per day between China and Hong Kong market, average number of product sold per day in China (1.9 item/day) was substantially lower than Hong Kong (8.1 item/day). The difference between two regions might suggest a good growth potential in the China market. Management targets to open up to 200 retail outlets by the end of 2016. We expect number of domestic selling points could reach up to 70 in FY03/13F, 110 in FY03/14F and 136 in FY03/15F. Table 4 shows OTO's China historical performance and our projection for the next three years:

Table 4. 3 years China Sales points and turnover projection

China Market	FY03/11A	FY0312A	FY03/13F	FY03/14F	FY03/15F
Retail Store	0	1	4	9	11
Consignment counter	14	33	66	101	125



Source: SBI E2-Capital

Business Analysis

Asset slight model; outsourced production for product variation. OTO is positioned at the front and the end of the value chain. Business activities focus on product development, market research (R&D), sales and distribution. The manufacture procedure is outsourced via OEM & ODM to 17 manufactures. Key long-term suppliers include Easepal (蒙发利, 002614 CN), who is the largest OEM and ODM supplier of relaxation and wellness products in China. OTO offers wide range of products. OEM/ ODM of manufacturing allow better management flexibility on costs, capital and working capital. Self-produced might limit the product variation by technique, available machine and skilled labours, while it might add burden on capital commitment and induce higher exposure on incremental increase of wages expenses. Furthermore, OTO has a long-term relationship with key manufacturers, which allows higher flexibility on working capital management. Inventory procurement is made in bulk and delivered in tranches. It takes around 75 days from order to first deliver, while payment is made upon delivery by bank transfer or credit appliance with a credit period up to 60 days. Manufacturers tend to produce volume exceed first tranche order demand, while the exceed inventories are stocked at manufacturers' warehouse and can be delivered upon request, hence, lower burden on OTO's warehouse and enhance OTO's operating cash flow cycle. In terms of retailing, sales turnover is mainly derived from B2C via self-operated retail store and consignment counters. Retail outlets are leased from landlord with relatively low CAPEX costs.

Table 5. Working Capital and financial ratio

HK$m	FY03/09A	FY03/10A	FY03/11A	FY03/12A
Sales	144.2	289.3	209.4	245.7
COGS	39.9	85.7	63.8	82.3
Inventory	4.8	5.3	6.9	7.2
Inventory Turnover(days)		11	19	33
Trade payable (days)		21	35	31
Trade receivable (days)		14	26	31
Total Asset	72.0	161.0	172.1	304.7
Total Current Asset	50.5	137.5	148.9	280.0
Cash	33.7	114.2	114.6	237.1
Total Equity	41.9	95.0	128.2	266.9
Net cash from operating activities	20.2	76.2	22.4	8.5
CAPEX	0.3	0.7	2.1	2.2

Source: SBI E2-Capital

Sales breakdown by: 1) region, 2) distribution channel. Engaged in China market since listing, OTO's China retail business is at relatively early stage. Historical results mostly reflect Hong Kong and Macau performance. Turnover from China represents 7% and 14% of group sales in FY03/12A and 1H FY03/13A respectively. Yet, majority of B2C income is derived from Hong Kong retail sales representing over 80% of sales income. Reliance on Hong Kong & Macau sales has decreased in recent years, due to increase in sales via corporate and international sales and China expansion as opposed to sales loss due to key Hong Kong sales outlet relocation. Table 10 shows an overall decrease trend in OTO's Hong Kong & Macau region retail business since FY03/10A. The decrease in sales via B2C channel has led to an overall decline of group profit margin. OTO adopts cost plus pricing strategy. Retail price is set at roughly 4x of cost of inventory procurement, i.e. ~75% gross margin. Sales via B2B, products are often customized and are sold in bulk with a bulk discount; hence B2B has a lower profit margin between 30% and 55%. Consequently, proportionate increase in sales via B2B channel led to the decrease in gross profit margin. Gross profit margin dropped from 72% in FY03/09A to 65% in 1H FY03/13A.

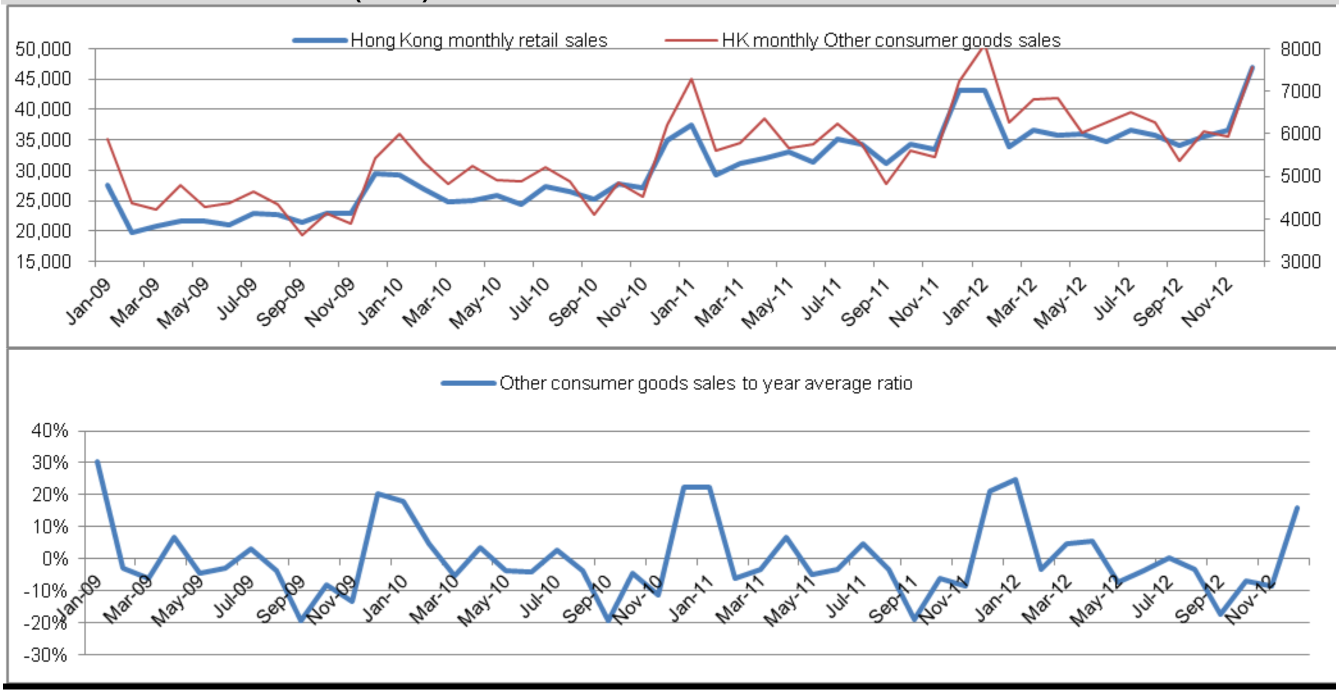
Table 6. Sales breakdown

HKm	FY03/09A	FY03/10A	FY03/11A	FY03/12A	1H FY03/13A
B2C					
- Retail Store	66.7	129.5	90.7	90.4	38.4
- Hong Kong & Macau*	66.7	129.5	90.7	89.4	37.5
- China*				1.0	0.9
- Consignment Counter	59.7	103.7	78.4	91.3	54.8
- Hong Kong & Macau*	59.7	103.7	78.4	72.3	34.6
- China*				19.1	20.2
- Roadshow	4.2	14.1	11.6	11.4	2.6
Corporate sales	8.4	33.7	16.6	22.8	14.3
International Sales	5.2	8.2	12.2	29.7	14.1
% of sales via B2C	90.6%	85.5%	86.3%	78.6%	77.1%
% of sales via B2B	9.4%	14.5%	13.7%	21.4%	22.9%
Gross profit margin	72.4%	70.4%	69.5%	66.5%	66.6%

*Source: SBI E2-Capital; *assumption made based on average retail to consignment store ratios 1.2:1*

Hong Kong sales in FY03/12A & 1H FY03/13A underperformed the market. Illustration 3 shows Hong Kong monthly total retail sales and other consumer goods sales from the Jan 2009 to Dec 2012. Total Hong Kong retail sales shows a stable uptrend from 2009 to 2012 at a CAGR of 17%. January and December sales are typically the peak retail season in Hong Kong while sales during September and November tend to below the year average. Since OTO's historical sales results were mainly derived from Hong Kong retail sales, Hong Kong retail sales is a good indicator to assess OTO performance. Comparing the industry trend to OTO's Hong Kong sales, as shown in illustration 3, FY03/11A & FY03/12A performance were in contrary to the market uptrend, while per stores sales figures, illustrated in table 10, also suggests sluggish sales after FY03/10A. It is because sales were affected by store relocation, meanwhile there were no new outstanding products launched. New products sales only accounted for 40% of total income in FY03/12A, as compared to 63% and 87% in FY03/09A and FY03/10A.

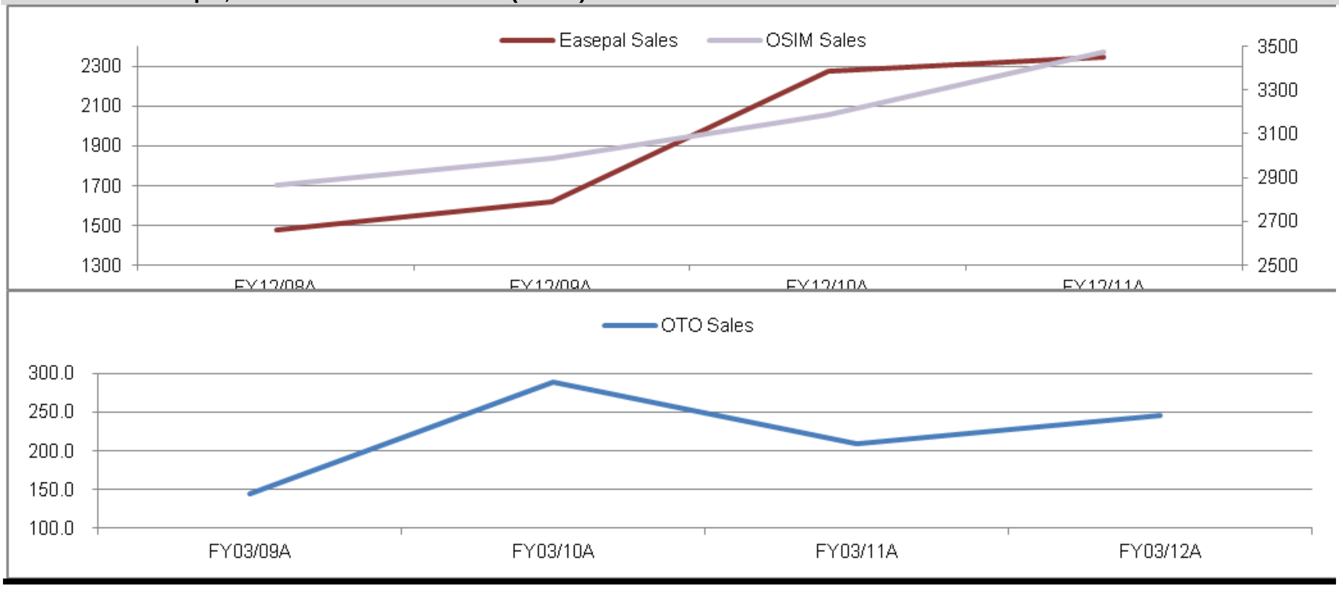
Illustration 3. Market sales market (HK$m)



Source: SBI E2-Capital

Peers comparison. Easepal (蒙发利, 002614 CN), who is the China largest OEM and ODM suppliers of relaxation and wellness products and one of OTO's supplier, whose shares are listed on Shenzhen exchange. Easepal is also engaged in sales of relaxation products under its own brands, OGAWA, Easebonny and COZZIA, in domestic and overseas market. Easepal's financial result is a good dynamic valuation to the relaxation goods industry. OSIM (O23.SGX) is the leading retailer of the relaxation and wellness products in the Asia Pacific regions. OSIM has strong presence in Hong Kong and has engaged in the China market since 2005. OSIM operates 267 number of stores in China. Yet, its North Asia sales, cover regions includes Japan, China, Hong Kong and Korea, are comparable to OTO. As shown on FY12/12A result, Easepal and OSIM have shown an overall similar growth trends from FY08/12A to FY12/12A. Particularly, OSIM North Asia regional sales increased by 15% 15% and 6% YoY from FY12/09A to FY12/11A.

Illustration 4. Easepal, OSIM and OTO sales trend (HK$m)



Source: SBI E2-Capital

Table 7. Selling outlets comparison

OTO	FY03/10A	FY03/11A	FY03/12A
Turnover (HK$m)	289	209	246
Number of outlets	31	33	47
OSIM	FY12/09A	FY12/10A	FY12/11A
North Asia turnover (S$m)	259	298	317
Number of outlets located in North Asia	301	385	385

*Source: SBI E2-Capital; OTO, OSIM, *SGD to HKD: 1: 6.26861585*

Table 8. Turnover, profit and margin comparsion

OTO	FY03/10A	FY03/11A	FY03/12A
Turnover chg YoY	101%	-28%	17%
Gross Profit chg YoY	95%	-28%	12%
Net profit (net of listing expenses) chg YoY	352%	-43%	-26%
Gross profit margin	70%	70%	67%
Net Profit margin (net of listing expenses)	24%	19%	12%
OISM	FY12/09A	FY12/10A	FY12/11A
Turnover chg YoY	4%	7%	9%
Gross Profit chg YoY	5%	11%	15%
Net profit chg YoY	-125%	104%	38%
Gross profit margin	63%	65%	69%
Net Profit margin	5%	10%	12%

Source: SBI E2-Capital, OTO, OSIM

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Domestic expansion analysis, targeted to open up to 200 retail points by 2016. OTO has sales point coverage in Shanghai, Chengdu, Shenzhen and Guangzhou region. Total sales points have reached 64. It is targeted to open up to 200 retail points by the end of 2015 at retail stores to consignment stores ratio of 1:9. China expansion is mainly via consignment counters at renewed shopping mall, while retails stores are to be located in key shopping districts to enhance brand awareness. Expansion via consignment counters enables quickly ramp up sales network at relatively low cost. Rent payment is often charged as a percentage of the turnover. Rental rate is between 25% and 28% of sales. Initial CAPEX mainly consists of the decoration cost, around RMB100k to RMB200k per outlet. If we assume 1) CAPEX of RMB150,000/ store, 2) total year fixed OPEX of RMB234,000 (including staff cost & other operating fixed expenses) and 3) flowing expenses at 58% of overall sales (including rental expense, sales commission etc), cash earnings would be breakeven if 33 products sold per month at average price RMB1,400 per item, while CAPEX would payback in year if 59 products were sold per month and payback in three months if 120 products were sold per month. Assuming 3 products were sold per day, IRR of new consignment counter would be 438% with a payback period of 166 days. Table 10 shows the assumption and result of our hypothesis.

Table 9. Sales breakdown to number of product sold per day

Number of product sold per day		FY03/09A	FY03/10A	FY03/11A	FY03/12A	1H FY03/13A
Retail Store	- HK & Macau *	8.5	20.3	10.9	11.5	10.0
	- China*				1.9	2.2
Consignment Counter	- HK & Macau *	8.1	16.3	8.3	7.3	6.8
	- China*				1.5	1.9
Overall B2C						
- Hong Kong & Macau *		8.3	18.3	9.5	9.1	8.1
- China*					1.5	1.9
Number of retail outlet						
Retail stores	- HK & Macau	16	16	15	14	14
	- China*				1	2
Consignment Counter	- HK & Macau	15	17	18	19	19
	- China*	0	0	14	33	45
ASP Assumption (HK$)		1,348	1,091	1,472	1,472	1,472

*Source: SBI E2-Capital; *assumption made based on average retail to consignment store ratios 1.2:1*

Table 10. Retail analysis per new consignment counter opening

Assumptions			
Number of sales staffs	2~3	Other flowing expense cost	2% of turnover /month
Wages/ month	RMB7,000	Rental Expense	26% of turnover/month
Other fixed expense cost/ month	RMB2,000	Gross Margin	70%
ASP / product	RMB1,400	ETR	18%
CAPEX/ store	RMB150,000	Discount Rate	20%

Result:	Number of products sales/ month
Operating breakeven	33
CAPEX breakeven	59
NPV breakeven	36
Payback Period (60 products sales/month)	353 days
Payback Period (90 products sales/month)	166 days
Payback Period (120 products sales/month)	109 days

Source: SBI E2-Capital

Impact on OTO as a result of China expansion 1) Change in earning seasonality 2) Key risks associated with China market. Sales of relaxation and wellness products are closely link to gale. Hong Kong relaxation sales is peak during Father's and Mother's day in May and June (1H of OTO's fiscal year), and in December and Jan (2H of OTO's fiscal year) during the Xmas holiday and New Year holiday. As a result of China market diversification, seasonality will weigh more on 2H of the fiscal year. Peak season in the domestic market are typically in Jan/ Feb around Chinese New Year and in Oct during the National Holiday (2H of OTO's fiscal year). Under the population aging, urbanisation and increase in average income per capita, China relaxation and wellness market outlook is positive. Since low entry barrier of the industry, competition is intense and fragmented. Domestic market competitors include local brand as well as international brand from Japan, US, EU, and other ASIA pacific areas. Price varies substantially depending on brand from hundreds to thousands. Competitors include established international high-end brands; Sanyo, Fuji, Panasonic, OSIM, Family and local brand include Ospirit, OGAWA, Brother, iRest, KangTai, Omron, Shouken, Comia etc. Market competition might lead to prolonged price and marketing completion to erode industry earning profitability, as well as surplus supply. In terms of financial ratios, China expansion might lead to increase in trade receivable days and inventory turnover days. Sales turnover via consignment counters in shopping mall usually receives at the monthly settlement day, while cash receive from settlement often takes more than 30 days. Yet, OTO has set four warehouses located in ChengDu, Beijing, Shanghai and Shenzhen regions as a logistical centre to cope with China expansion for the nearby outlets. Consequently, it will increase the inventories turnover day ratios.

Key expanses items analysis. Rental, wages and marketing expenses are the major three cost elements for B2C retail operator; they are accounted for ~40% to 50% of group sales.

- **Rental costs**. Rental contract can generally distinguish into three types; 1) fixed payment, 2) percentage of turnover or 3) hybrid of both. Retail store rent is typically charged at a fixed amount per month whereas consignment counter and roadshow counters rent are typically charged at a fixed rate of turnover or hybrid of both. The rental payment rates for consignment counters at shopping malls are similar to Hong Kong and China at around 25% to 28% of turnover. In terms of retail rent contract, lease contract tends to be fixed for a specified period, lease terms are subjected to renew as the fixed period expiry. Lease payment tends to be fixed for 2 years. Rent fee varies depending on location. The average rent payment per store for the FY03/11A, FY03/12A and 1H FY03/13A were around HK$130k, HK$150k and HK$170k per month respectively, representing an increase of 10% to 15% per annum. The increase was largely due to most lease contracts were being renewed during FY03/12A and 1H FY03/13A. We expect average fixed lease payment increase at 5~10% per annum. Minimum lease payment accounted in average 23% of retail stores sales, while it varied between 22% and 28% during the traceable period. Total lease payment was accounted for 15% group sales.
- **Wage expenses.** Wages expense is the second largest operating expense item after rent. Substantial portion of staff costs are allocable to frontline sales. Package for frontline sales is a basic salary plus commission basis. The gross commission fee to sales is around 7.5% of outlet sales income. Basic salary was around HK$10,000 in Hong Kong, while around HK$6,000 in China. As a result of China expansion, total number of staffs increased by 71% from 103 to 176, of which number of retail staff has increased by 78% from 69 to 123 from FY03/09A to FY03/12A. China retail outlet requires around 2 – 3 additional sales staffs per new store open. Staff costs to sales ratios during the traceable period were 14%, 14%, 15% and 19% from FY03/10A, FY03/11A, FY03/12A and 1H FY03/13A orderly. The increase in 1H FY03/13A was largely due to China expansion, while new store sales in China were yet to pick up.
- **Marketing expense.** OTO was relative conservative on marketing expenditure. Marketing budget is tightly control between roughly 6% and 7% of sales. OTO's marketing strategy is more focused on printed ads, e.g. bill board, magazine or leaflet and audio ads, instead of heavily spend on expensive TV advertising campaign.

B2C earning sensitivity on change of rental and wages expenses. Since rental, wages and marketing expenses are mostly attributable to the B2C business (Retail store, consignment counter and roadshow counter), we have further breakdown and examined the earning sensitive of Hong Kong & Macau retail business. Based on the average traceable data for OTO's Hong Kong retails business, COGS, rent, staff and marketing cost accounted for roughly 73% of sales. The increase in rental and wages expenses often is major concern for retailers. We have examined OTO earning sensitivity on change in the rent and staff costs. The result shows 5%, 10% and 15% increase in rental payment would lead to 5%, 11% and 16% decline in cash profit; whereas 5% increase in wages expense would lead to up to 3% decrease in net cash profit. If we assume 5% increase in staff costs and 10% increase in rent payment, net cash profit would drop by up to 13%.

Table 11. Earrings sensitivity to changes in 1) rental and 2) wages expenses

HK$m	Average	Rent + 5%	Rent + 10%	Rent +15%	Wages + 5%	Rent +10%; Wage +5%
B2C sales	100%	100.0%	100.0%	100.0%	100.0%	100.0%
Expenses:						
COGS (~28% of sales)	28%	28.0%	28.0%	28.0%	28.0%	28.0%
Rent	26%	27.2%	28.5%	29.8%	25.9%	28.5%
Staff	13%	12.5%	12.5%	12.5%	13.2%	13.2%
Marketing	6%	6.3%	6.3%	6.3%	6.3%	6.3%
Other costs	3%	3.0%	3.0%	3.0%	3.0%	3.0%
EBITDA	24%	23.0%	21.7%	20.4%	23.6%	21.1%
TAX	4%	4.1%	3.9%	3.7%	4.3%	3.8%
FCF	20%	18.8%	17.8%	16.7%	19.4%	17.3%

Source: SBI E2-Capital

Our financial projection

Sales assumption. Our projection model is sales point driven based on the assumption of average product sold per day per store. ASP is base on the average historical result while number of stores is based on the average projected number of store between beginning and closing of the financial year. Table 16 shows our number of store assumption in China and Hong Kong & Macau regions. Table 17 shows our projection on average number of product sold per day per store. The decline sales per store from 1H FY03/13A (1.9 item per day) to FY03/13A (0.8 item per day) were largely due to the majority of new stores were opened in late 2H. For Hong Kong & Macau market, we expect no major change in the total number of stores, while any change would be largely due to sales outlet relocation. For China market, company is targeted to open up to 200 sales points by end of 2016. We model to be achieved 200 sales outlets by the end of FY03/17; at pace, 70 outlets in FY03/13F, 110 in FY03/14F, 136 in FY03/15F, 175 in FY03/16F and 200 in FY03/17F. We expects to China sales volume will gradually pick up. Our model assumption is relative conservative, average number of item sales via consignment would reach 1.5 per day in FY03/14F and further to 2 per day in FY03/15F and onward. Table 12 shows our five years forecast on the group revenue.

Table 12. Key model assumption on number of outlets in Hong Kong & Macau and China

Number of outlets	FY03/13F	FY03/14F	FY03/15F	FY03/16F	FY03/17F
Number of Retail store					
HK& Macau	15	15	15	15	15
China	4	9	11	15	20
Number of Consignment Counter					
HK & Macau	19	19	19	19	19
China	66	101	125	160	180

Source: SBI E2-Capital

Table 13. Key model assumption on number of items sold per day in Hong Kong & Macau and China

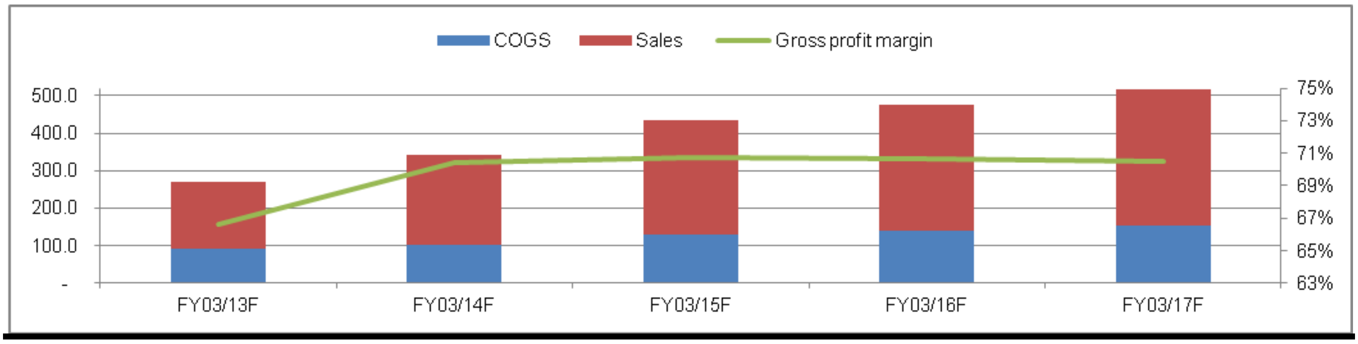
Number of item	FY03/13F	FY03/14F	FY03/15F	FY03/16F	FY03/17F
Retail store					
HK& Macau	7	9	10	10	10
China	2.5	2.5	2.5	3	3
Consignment Counter					
HK & Macau	9	8	9	9	9
China	0.8	1.5	2	2	2

Source: SBI E2-Capital

Table 14 shows our five years forecast on COGS. We expect gross profit margin would be around rebound to average 70~71% in coming years. Increase in gross profit margin mainly reflects the proportionate increase in sales via B2C business as a result of China B2C business expansion. We expect the increase would be limited by increase in sales via international and corporate. The lower profit margin in FY03/13F was largely due to higher portion of earnings would be delivered by lower margin B2C sales and decrease in Hong Kong retails sales.

Table 14. Our sales, COGS and gross profit margin for the next five years

HK$m	FY03/13F	FY03/14F	FY03/15F	FY03/16F	FY03/17F
Sales	266.04	340.64	434.65	475.37	517.17
COGS	(88.27)	(100.83)	(127.40)	(139.62)	(152.44)
Gross profit margin	67%	70%	71%	71%	71%



Source: SBI E2-Capital

Rent, staff, and marketing expenses projection. We expect an overall uptrend in rental expenses. Rental expenses are modelled in two methods; 1) fixed payment and 2) percentage of revenue. The Hong Kong retail store fixed rent payment would be the key parameter to impact on the minimum lease payment, which we model fixed rent grow rate at around 5 to 10% per annum. As for percentage of revenue, increase in floating rent would be largely due to the increase via domestic consignment counters. The rate is expected to be around 28% to 29% of sales. Similar to rental assumption, staff costs are partly linked to sales plus a fixed salary. The majority of incremental staff costs would drive from increase in the number of frontline sales as well as increase in administrative staffs due to China expansion. We expect to see a decrease trend in the average staff cost per head in three to four years due to increasing portion of staff from lower wages rate Chinese workers. The average wages would pick up as a result of expansion ramp up coupled with increasing wages rate in China. In terms of market expenses, our projection on marketing expenses is based on a fixed percentage to B2C sales ratio at 8%. Table 15 show our financial projection summary for the next five years.

Table 15. our financial projection summary for next 5 years

HK$m	FY03/13F	FY03/14F	FY03/15F	FY03/16F	FY03/17F
Revenue	266.0	340.6	434.6	475.4	517.2
Other income	5.6	7.1	9.0	9.8	10.6
COGS	(88.3)	(100.8)	(127.4)	(139.6)	(152.4)
Gross profit	183.4	246.9	316.2	345.5	375.4
Staff cost	(52.0)	(61.4)	(70.7)	(84.3)	(89.0)
Rental expense	(67.3)	(82.2)	(107.9)	(117.4)	(130.0)
Market Expense	(19.1)	(24.8)	(33.2)	(36.9)	(40.2)
Other expenses	(32.7)	(34.4)	(39.1)	(41.1)	(43.1)
EBITDA	12.3	44.2	65.3	65.8	73.0
Depreciation and amortization	(2.6)	(3.1)	(3.5)	(3.8)	(4.1)
EBIT	9.7	41.0	61.8	62.0	68.9
Finance cost	(0.5)	(0.5)	(0.5)	(0.5)	(0.5)
EBT	9.3	40.5	61.3	61.5	68.4
Tax	(1.4)	(6.5)	(9.8)	(9.8)	(11.0)
Net profit	7.8	34.0	51.5	51.7	57.5
% of Sales					
Revenue	100%	100%	100%	100%	100%
Gross profit	69%	72%	73%	73%	73%
EBITDA	5%	13%	15%	14%	14%
EBIT	4%	12%	14%	13%	13%
EBT	3%	12%	14%	13%	13%
Net profit	3%	10%	12%	11%	11%

Source: SBI E2-Capital

CAPEX. OTO is a retailer and brand manager, hence no heavy burden on capital expenditure. Majority of CAPEX is divided from 1) decoration cost for new store opening 2) existing store redecoration and 3) store relocation. In particular, China sales expansion is mostly via consignment, which the cost of refurbishment is relative low. We expect CAPEX of around RMB100,000 to RMB200,000 per new consignment counter, while CAPEX for new retail store would be up to RMB350k. Since some of the decoration items are portable, CAPEX might be even lower for store relocation to the nearby area. Table 16 shows our CAPEX forecast in relation to new stores open for the next five years.

Table 16. CAPEX projection

Net increase of outlets point per year	FY03/13F	FY03/14F	FY03/15F	FY03/16F	FY03/17F
Retails Store					
- Hong Kong	1	0	0	0	0
- China	3	6	3	2	5
Consignment counters					
- Hong Kong	0	0	0	0	0
- China	43	34	23	27	20
CAPEX for new stores opening (HK$m)	7.8	6.9	4.4	4.6	4.5

Source: SBI E2-Capital

Table 17. Financial position projection

HK$m	FY03/13F	FY03/14F	FY03/15F	FY03/16F	FY03/17F
PPE	15.2	19.9	20.8	21.6	22.0
Investment property	6.7	6.7	6.7	6.7	6.7
Other Fixed Assets	14.1	13.1	13.1	13.1	13.1
Total Fixed Assets	36.0	39.7	40.6	41.4	41.8
Inventories	12.1	16.6	20.9	23.0	25.1
Investments at fair value through P&L	1.9	1.9	1.9	1.9	1.9
Total trade receivable	32.8	42.0	53.6	58.6	63.8
Other Current Assets	1.6	1.6	1.6	1.6	1.6
Cash and Cash equivalent	225.7	245.1	285.6	332.1	384.7
Total Current Assets	274.1	307.2	363.6	417.2	477.1
Total Trade Payable	19.3	22.1	27.9	30.6	33.4
Bank borrowings	13.8	13.8	13.8	13.8	13.8
Other Current Liabilities	2.0	2.0	2.0	2.0	2.0
Total Current Liabilities	35.2	37.9	43.7	46.4	49.2
Non Current Liabilities	0.2	0.2	0.2	0.2	0.2
Total Equity	274.8	308.8	360.3	412.0	469.5

Source: SBI E2-Capital

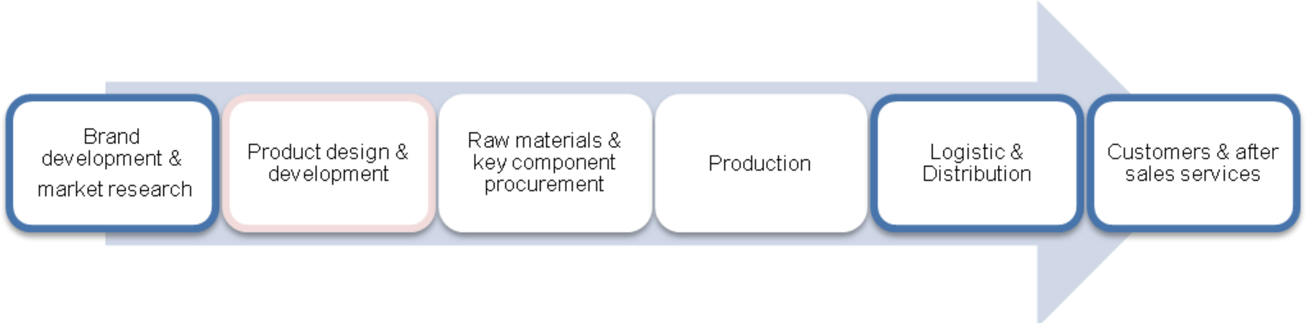
Our view and valuation

OTO is currently trading at under cash value. Given low cost of expansion and quick repayment period, cash level would be relatively stable despite expect decline of bottom-line result. In our view, net cash value HK$0.68 would be a good floor price of company valuation, and investor would be seeking for potential upside on 1) profit normalization in FY03/14F; 2) China expansion and 3) new key relaxation products to be success. For FY03/13F result, we expect roughly 50% drop in net profit YoY leading to a forward PE of 25.3x. OTO is currently trading at market capitalization value of HK$198.2m, implies a 12A PE of 13.0x. As compared to downstream supplier, Easepal (002614 CN), trading at 12A PE of 91.9x on Shenzhen stock exchange and retail peer, OSIM, is trading at 12A PE of 16.5x.

Background Information

Simple business model; OTO holdings is engaged in products design, brand building and retailing. Established since 80s, OTO is engaged in sales and distribution of relaxation and wellness products under the 'OTO' brand in the Hong Kong, Macau and China region. Key principal business activities include 1) market research and products design and development (R&D) 2) advertising and promotion and 3) retailing and brand management. Manufacturing and packaging process are outsourced, via OEM & ODM, to manufacturers in China, Korea, Taiwan and Japan regions. Sales and distribution is mainly via self-operate retail outlets and consignment counters. Products mainly design and develop via in-house R&D team/ third party design house or co-develop with ODM manufacturers. In Jan 2011, OTO has engaged an external Holland design house to strengthen the semblance of the product design. OTO's business model is simple and asset slight. Illustration 5 highlights the OTO's business position in the value chain:

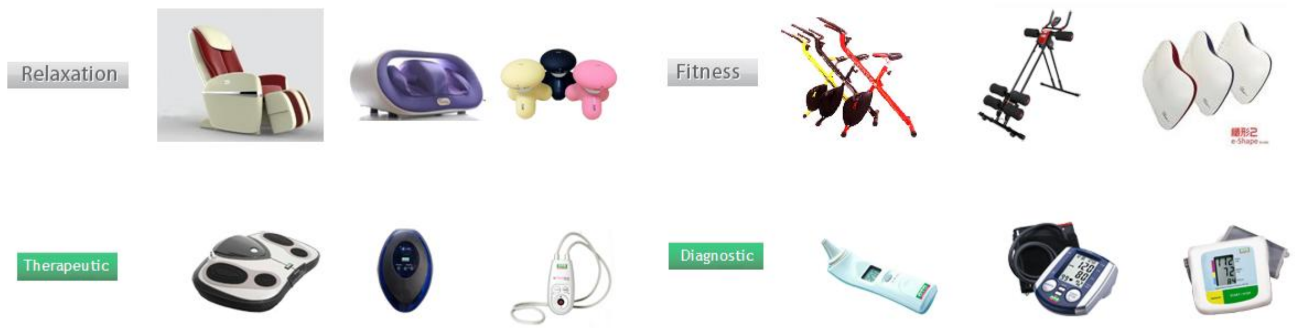
Illustration 5. OTO's business model position



Source: SBI E2-Capital

What does OTO offer? OTO offers comprehensive relaxation, health and wellness products to ease the modern day living tension. OTO's products are varied in size, type and feature. OTO's products can be categorized according to its function into four types; 1) relaxation, 2) Fitness, 3) Therapeutic and 4) Diagnostic. Relaxation products, targeted customer age group between 30 and 60, are the key sales contributor of group earnings accounted for 77% of company's turnover in 1H FY03/13A. For example, relaxation products include massage chair (OTO Weekend Rossi), foot massage products (OTO Power Flex) and shoulder massage products (OTO Power Tap). Sales of relaxation products are mainly via retails outlets. In terms of fitness, therapeutic and diagnostic products, products are often tailor made for corporate or international sales. For instance, customized exercise bike as a welcome gift for new customer of bank or tailor-made therapeutic and diagnostic products for professional union (e.g. nursing union). They represented 17%, 4% and 2% of 1H FY03/13A sales respectively.

Illustration 6. OTO's business model position



Source: SBI E2-Capital

Sales Channels & profit margin. As a typically retailer, majority of OTO's sales income are divided from retails store and consignment counters, representing ~80% to 85% of group's turnover. Pursuant to the latest data, OTO has operated 31 numbers of retails and consignment outlet in the Hong Kong and Macau regions, and 63 numbers of sales points in the Mainland China. Sales via retails/ consignment usually have a higher gross margin between 70% and 75%. Retail price is set via cost plus at ~4x of finished goods procurement costs. B2B sales via corporate sales or international sales often have a lower profit margin between 30% and 50%, since sales often in bulk along with bulk discount.

Table 18. Sales Channels & profit margin

Channel	% of group sales	Margin
Retails Store	30%~45%	70%~75%
Consignment counters	35%~40%	70%~75%
Roadshow counters	2%~6%	70%~75%
Corporate sales	6%~12%	45%~55%
International sales	3%~12%	25%~40%

Source: SBI E2-Capital, OTO prospectus

Disclosure of interests: SBI E2-Capital Financial Services Limited acted as placing agent for OTO Holdings Limited (stock code: 6880) in October 2012.

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

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