ERATAT LIFESTYLE: Higher selling prices, higher gross margins going forward

Written by Leong Chan Teik
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Eratat CFO Ken Ho speaking with investors after the Q&A session yesterday. Photo: Leong Chan Teik

AS ERATAT LIFESTYLE transitioned from focusing on sportswear to casual wear over the past year, it raised its average selling prices (ASPs) to distributors - but this was not enough to cover the higher cost of better quality raw materials used.

A key reason: Eratat was in the midst of establishing its brand in casual wear, and ASPs did not rise as fast to cover the increase in cost of sales.

Hence, the drop in its gross margin from 30.6% in 1H last year to 26.5% in 1H this year.

The story is set to change, though.

Responding to questions on the fall in margins, Eratat CFO Ken Ho yesterday told investors at a CIMB lunchtime presentation that gross margins and ASPs will go up from 2H of this year.

Eratat VP for investor relations Kellyn Tan. Photo: Leong Chan Teik

This is likely to lead to what investors love most in businesses: net profit growth.

Already, Eratat has an order book of RMB500 million for delivery in the 2H of this year, which is a 12% year on year increase, so an increase in gross profit margins is likely to generate net profit growth.

This will come as cheerful news for shareholders, who have seen a 23% drop in net profit in the 1H of this year to RMB46.7 million.

The RMB46.7 million, however, puts Eratat ahead of its Singapore-listed peers China Hongxing Sports, which raked in RMB38.8 million, and China Sports (RMB39.1 million).

The latter two are facing intense competitive pressure in the sportswear industry where consumers have a relatively low inclination to pay up for pricey sportswear - but that is not the case for casual wear.

Here are some of the highlights of the Q&A session after the corporate presentation by Kellyn Tan, VP for investor relations of Eratat, which currently has 1,400 retail outlets in China.

Q: Why don't you increase your gearing to increase your working capital?

Ken Ho (CFO): Yes, we don't have any bank borrowings at the moment. In China, borrowings are on a short-term basis usually. They are renewed yearly but you have to repay everything first.

Loans are subject to government monetary policy and this will place a borrower at risk. We don't want to put ourselves in that position. And we can't borrow from Singapore banks as there are restrictions on transferring and using the money in China.

	Stock price	1H revenue (RMB'000)	1H net profit (RMB '000)	Market cap (S$'m)	PE (trailing)
Eratat Lifestyle	18 c	417,991	46,721	75	3.9
China Hongxing	16.5 c	1,008,175	38,783	462	35
China Sports	10.5 c	688,188	39,140	101	5.7

With rising brand equity and a switch to casual wear, Eratat is enjoying higher profits than its peers which are into sportswear.

Q: Why are you not selling your products in cities such as Shanghai and Beijing?

Ken: We are not in Tier-1 cities. We are in Tier 2 and 3 cities (chiefly in the provinces of Hebei, Fujian, Guangdong and Shanxi). We are planning to move into malls of Tier 1 cities such as Shanghai.

For that, our selling price has to be at least RMB300 per piece to sell to consumers looking for premium products.

Q: Are your sales recognized at the point of selling to distributors, or when they sell to consumers?

Ken: It is when the products are out of our factory. They are non-returnable. They are based on orders the distributors had placed at our trade fair. We then make to order and we don't keep stock.

ERATAT	
52-week high/low	30 c/ 12 c
Stock price	18 c
No. of shares	414,912,514
Market cap (S$'m)	74.7
Annualised EPS (S$)	0.0533
Dividend FY10	RMB0.0466 (book close mid-Sept 2010)
Dividend yield	5.4%
PE ratio	3.4

The distributors' orders are non-cancellable. But we work with them to create awareness of our products and help them choose good locations for their stores.

Q: How many retail outlets do you intend to open in the next 5 years?

Ken: We don't have a fixed number. It depends on how many good locations our distributors can get. We would rather have quality and be able to operate for at least five years, instead of opening and closing stores frequently, which would cause the brand image to suffer.

We want our distributors to own more of the stores, instead of third-party retailers, so the distributors can better manage inventory risk, for example.

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