

Eratat Lifestyle Limited

Do You Want to Miss This Ride?

We left Eratat Lifestyle Limited's trade fair feeling optimistic about its order book for the 2011 Autumn/Winter season, which will be finalized about a month from now. The visit also showed us that Eratat is on track in executing its articulated strategy to raise brand value. During the visit, we felt positive investor interest in this counter, which is a confidence booster. **Maintain Increase Exposure view based on an intrinsic value of S\$0.480.**

Key Developments:

Trade Fair Garnered Positive Response: Feedback we obtained suggested that the trade fair was more impressive than that last year. Consequentially, we felt that Eratat's Autumn/Winter 2011 order book (when finalized) may place upward pressure on our forecasts.

ERATAT PREMIUM: In fact, we have already seen the financial success of the PREMIUM label, whose average orders per store was 56% higher than the CLASSIC series for 1H FY11, despite a late mid-season launch for the former.

We see this as a much more astute move to grow sales and profits compared to pushing distributors to open more outlets than they can manage.

From a longer term point of view, the PREMIUM label seems like a pre-emptive strike to capture high end market share as more consumers join the high income segment in both the 1st tier and 2nd tier cities.

Allaying Concerns: With its Annual Report due to be out over the next two weeks, Eratat's audit should be nearing formal completion. With no announcements thus far over any audit issues, we see little cause for concern over Eratat's cash balances at the moment.

Investor Interest: Eratat offers an attractive mix of strong growth prospects and undemanding valuation at the moment. As the company continues to reach out to more investors, including institutions, we see increased participation by investors as a potential share price catalyst.

Increase Exposure

- Intrinsic Value S\$0.480
- Prev Close S\$0.225

Main Activities

Eratat Lifestyle Limited is principally engaged in the design, manufacture and distribution of lifestyle fashion footwear, and the design and distribution of lifestyle fashion apparel under its well-established proprietary brand "ERATAT".

Financial Highlights

(Y/E Dec) RMB m	FY10	FYE10	FY11F
Revenue	898.7	787.6	1127.2
Gross Profit	258.5	237.4	349.4
Earnings	96.6	111.4	156.4
EPS (RMB cts)	23.3	26.8	37.7

[^]FYE10F data are based on the nine month period ended Dec 2010. Eratat changed its financial year end from Mar to Dec in May 2010.

Source: Company, SIAS Research

Key ratios (FY11F)

PER	3.1
P/BV	0.6
Return on Common Equity	22.5%
Gross Debt to Common Equity	0%
Current ratio	8.1

Source: SIAS Research

Indexed Price Chart

Green (FSSTI)
White (ERATAT)



Source: Bloomberg

52wks High-Low S\$0.270 /S\$0.120
Number of Shares 414.9m
Market Capitalization S\$93.4m

Analyst:

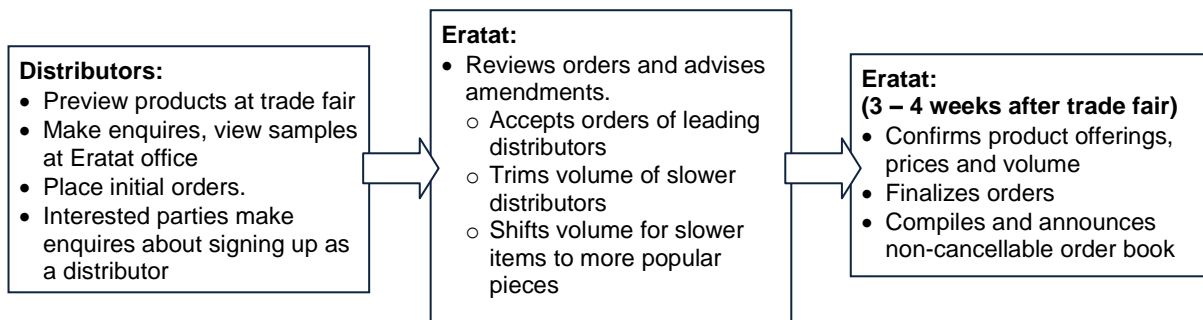
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Autumn/Winter 2011 Trade Fair

Event in Brief: We visited Eratat's 2011 Autumn/Winter Season trade fair on 31 March 2010, in Jinjiang City, Fujian Province, PRC, where the company is also headquartered at. The event was almost three hours long and consisted of a panel discussion among experts on the domestic fashion industry, as well as a fashion parade showcasing 180 of Eratat's newest products from both the PREMIUM and CLASSIC series.

Significance: Eratat trade fairs are important events where distributors converge to preview the next season's offerings. A successful fair raises the interest of distributors, who will be drawn to either order more goods subsequently or sign up as an Eratat merchant, in the case of new distributors.

Figure 1: Behind the Scenes after the Trade Fair



Source: Company, SIAS Research

Just a Recap: Eratat organizes at least two trade fairs a year – one for each half yearly season. This year, the company had an additional fair in February for the ERATAT PREMIUM Summer Series following the launch of this new range. For the 2011 Spring/Summer season, the company has already garnered a confirmed order book of RMB517m to be recognized over 1H FY11. **Eratat's Spring/Summer order book suggests sales growth of 33.2% season-on-season for ERATAT brand products.**

Positive Interest Felt: Visitors we spoke to felt that the trade fair (and the products showcased) was more impressive than that of last year. The trade fair ended with warm rounds of applause from the audience.

At Eratat's office the next morning, the "model store" was packed with distributors looking through product samples. Several groups had also congregated at the lobby, making enquiries and being attended to by company representatives. These sights, combined with the strong 1H FY11 order book, suggest that our FY11F forecasts risk further upward adjustments in the quarters to come.

Larger Objective behind Branding Efforts: Upfront, the ERATAT PREMIUM label is intended to help the company penetrate into top tier malls and cities and win the consumer dollar of high income earners. From the panel discussion, we realized that this label is a **pre-emptive move** to capture future growth from the entire Chinese market.

Rising consumer sophistication was a recurring theme during the discussion. We saw that consumers in the 2nd and 3rd tier cities will eventually demand for as much as their 1st tier city peers in terms of branding and design.

This means that a) the space for high end clothing will continue to grow and b) a successful premium label will help raise the perceived value of the ERATAT CLASSIC category for the increasingly urbane mass market.

Figure 2: Illustrative Product Changes and Developments across Time



Existing Collections

ERATAT CLASSIC: 

- Comprises of the existing three series: a) Stylish Lifestyle, b) Life Fashion and c) Celebrity series. The Travel Lifestyle series was discontinued in 2011 in favor of the remaining three more distinctive series.
- Targets the mass market.
- Carried at 1,150 retail points, of which 930 are specialty stores and shop-in-shops as of Dec 2010.
- Spring/Summer 2011 order book of RMB477m.

ERATAT PREMIUM: 

- A high end men's wear series of full range of apparel, shoes and bags.
- Targets high income earners (Capturing new price range of up to RMB7,000 per piece for the Summer Series. Some items from the Autumn/Winter series may be priced higher).
- To be carried at 50 planned new shops in Anhui, Guangdong, Henan, Shandong, Shanxi and Zhejiang in 1H 2011 via six distributors. Several new shops will also be opened in Shanghai by May 2011 in Tier-1 shopping malls.
- Summer 2011 order book of RMB40m (compiled following mid season trade fair in February)

Source: Company, SIAS Research

Will ERATAT PREMIUM Work?: ERATAT PREMIUM will have its own brand identity. In our previous update report, we have mentioned that it will have its own logo and retail frontage design. The value of this “sub-brand” is demonstrated by the impressive order book of RMB40m obtained following the February ERATAT PREMIUM (Summer 2011) trade fair. The quantum of orders obtained per each planned ERATAT PREMIUM stores is 56% higher than that of the CLASSIC specialty stores and shop-in-shop outlets.

Figure 3: Order Book Analysis

Series	Order Book (RMBm)*	Specialty Stores / Shop-in-Shop	Orders / Store (RMB'000)
CLASSIC	477	930 [^]	513
PREMIUM	40	50 ^{**}	800

*Pertains to Spring/Summer 2011 Collection for CLASSIC and mid-season Summer 2011 Collection for PREMIUM series respectively.

**Planned number of outlets for PREMIUM series by end 1H FY11.

[^]Excludes 220 retail counters to be gradually replaced by specialty stores.

Source: Company, SIAS Research

Figure 4: PREMIUM Label Product and Packaging

An ERATAT PREMIUM label 12cm x 10cm wallet retailed at RMB318 and its accompanying red velvet pouch, box and cover.



The matching 26cm x 22cm paper bag that came with it.

These exhibits showcase how PREMIUM label products will be retailed differently from the CLASSIC series.

Source: Company, SIAS Research

“You Choose Me, I Choose You.”: Reference materials given out at the trade fair also showed that it is not easy to be an Eratat distributor/retailer. Interested parties have to make a formal written application and undergo at least three rounds of stringent checks before they are approved to start operations.

Assessments will include applicants’ financial strength, business competence and fit with Eratat’s strategic direction and business objectives. More in-depth studies will also include on-site surveys of planned retail locations and business financial plans and analyses. This ensures that the distributors appointed are of quality, and that retail operations are sustainable in the long run.

Wrap-Up of Recent Concerns

Safeguards: We heard from the management that the legal representatives of Eratat's operating entities are the CEO Mr. Lin Jiancheng himself and his mother-in-law, who had helped him start the company. As such, the risk of a (external) legal representative turning "rogue" is reduced. We understand that the company is currently considering SGX's guidance for S-chips regarding legal representatives.

In response to investor queries, the CFO Mr. Ken Ho reassured us that he reviews the monthly bank statements and reconciles them to the accounts. As a final control, Mr. Lin the CEO approves all payments, which are processed in batches. Mr. Ho also shared with us that the Audit Committee had instructed the internal audit team to focus on bank balances and large cash movements last year as a precautionary measure. No negative findings were noted.

Finally, we were told by Mr. Ho that the company's auditors have already completed the annual audit. **The fact that NO announcements concerning the audit have had to be made thus far says a lot about the status of the company.**

The Intuition behind Funding Needs: The crux of the issue is that Eratat has to pay suppliers 70% to 80% of its orders as deposit, which is an industry norm to ensure timely delivery, while extending credit to distributors. Its working capital needs will most likely have been increased by the new ERATAT PREMIUM line. Additional capital will allow the company to expedite growth, which may potentially offset the dilutive impact of new shares.

Investor Interest is Back?: At the trade fair, there were several fund managers among the audience. Accordingly, not all of them are from Singapore based funds. We understand that the company has the intention to increase investor relation activities targeting institutional investors. Eratat currently trades at 4.2x 9M Apr-Dec (FYE10) EPS and 3.0x FY11F EPS, which we view to be very attractive compared to HK/China listed peers transacting at much higher multiples. As such, we will not be surprised to see Eratat gaining more attention from professional funds in the future.

Should Eratat's current P/E multiple be successfully re-rated upwards by the market, this should put away concerns by investors who felt that the company might place out new shares too cheaply.

Ultimately, we find Eratat's growth prospects and attractive valuation enticing. **Maintain Increase Exposure based on an intrinsic value of S\$0.480.**

Shots from the Trade Fair and Office Visit

Figure 5: CEO Mr. Lin Addressing the Audience. (Theme of Trade Fair in the Background)



Source: Company, SIAS Research

Figure 6: Panel Discussion – ERATAT PREMIUM Designer Seated Extreme Right



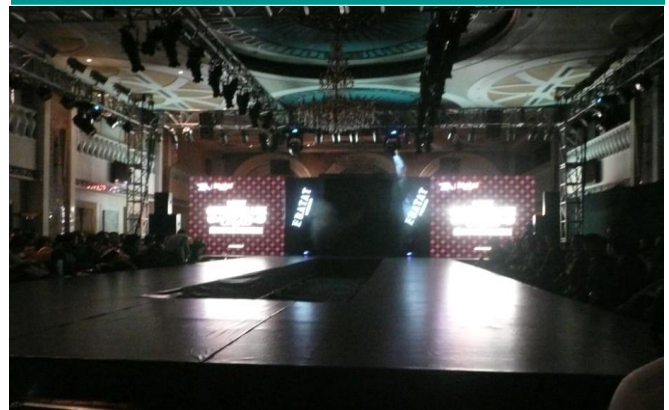
Source: Company, SIAS Research

Figure 7: The Occasional Caucasian Model to Give a European/Cosmopolitan Flair



Source: Company, SIAS Research

Figure 8: The Stage Just Before the Show – There were about 300 People in the Audience



Source: Company, SIAS Research

Figure 9: ERATAT CLASSIC Series



Source: Company, SIAS Research

Figure 10: The End of The Trade Fair



Source: Company, SIAS Research

Figure 11: Next Day At the “Model Store”



Source: Company, SIAS Research

Figure 12: Apparel on Display



Source: Company, SIAS Research

Figure 13: Visitors Browsing Through Display Items



Source: Company, SIAS Research

Figure 14: Bags and Shoes on Display



Source: Company, SIAS Research

Figure 15: Mr. Lin Showcasing a New Jacket



Source: Company, SIAS Research

Valuation and Forecasts

Figure 16: Economic Profit Valuation Model

RMB m	FY11F	FY12F	FY13F	FY14F
Revenue	1,127.2	1,296.3	1,490.8	1,788.9
EBIT	210.6	234.4	269.5	323.5
Tax on EBIT	-54.7	-58.7	-67.5	-81.0
NOPLAT	156.0	175.7	202.0	242.5
Invested Capital	626.0	765.2	922.0	1,293.7
% of Debt	0.0%	0.0%	0.0%	0.0%
% of Equity	100.0%	100.0%	100.0%	100.0%
WACC (%)	13.8%	13.8%	13.8%	13.8%
Capital Charge	86.6	105.9	127.6	179.1
Economic Profit	69.3	69.8	74.4	63.4
Terminal Value				546.3
Discount Rate	0.88	0.77	0.66	0.58
Present Value	60.9	53.8	48.8	36.6
Book Value	626.0	Risk Free Rate		2.5%
Explicit Value	200.1	Beta		1.4
Terminal Value	314.9	Market RP		8.4%
Value of Equity	1141.1	Cost of Equity		13.8%
Number of Shares (m)	414.9	Cost of Debt		0.00%
Value per share (RMB)	2.750	LT Growth		2.0%
Value per share (S\$)	0.532	RMBSGD Rate		0.1936
Expanded Shares o/s (m)	538.5	(conversion of warrants)		
Add cash per share (S\$)	0.069	(from exercise of warrants)		
Value per share (S\$)	0.480			

Source: SIAS Research

Figure 17: Financial Forecasts and Estimates

RMB m	FY08	FY09	FY10	FYE10	FY11F	FY12F	FY13F	FY14F
Revenue	453.0	777.3	898.7	787.6	1127.2	1296.3	1490.8	1788.9
Gross Profit	131.7	234.0	258.5	237.4	349.4	388.9	447.2	536.7
Operating Profit	81.7	145.9	131.5	150.2	210.6	234.4	269.5	323.5
Net Profit	70.2	125.9	96.6	111.4	156.4	176.2	202.5	243.0
Attributable to Shareholders								
Total Current Assets	127.4	392.2	511.3	629.8	761.0	925.2	1281.7	1502.3
Total Non-Current Assets	80.7	99.0	95.8	92.1	98.0	104.3	124.6	143.8
Total Current Liabilities	44.4	47.4	73.1	95.9	93.9	107.5	112.5	136.1
Total Non-Current Liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total Equity	163.7	443.7	534.0	626.0	765.2	922.0	1293.7	1510.0
Cash from Operating Activities	10.3	7.0	30.0	2.9	5.2	176.3	39.9	154.0
Cash from Investing Activities	-45.4	-21.5	-1.9	-0.3	-10.0	-10.0	-25.0	-25.0
Cash from Financing Activities	36.3	164.8	-6.3	-19.3	-17.2	-19.4	169.2	-26.7
Net Change in Cash	1.2	150.3	21.8	-16.7	-22.0	146.9	184.1	102.2
Inventory Days	18	10	9	12	15	15	15	15
Receivable Days	39	52	76	94	115	115	115	115
Payable Days	17	11	17	24	25	25	25	25
Return on Common Equity	72.3%	41.5%	19.8%	25.6%	22.5%	20.9%	18.3%	17.3%
Return on Assets	41.2%	36.0%	17.6%	22.3%	19.8%	18.7%	16.6%	15.9%
Gross Debt / Common Equity	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Current Ratio	2.9	8.3	7.0	6.6	8.1	8.6	11.4	11.0
EPS (RMB cents)	24.2	30.8	23.3	26.8	37.7	42.5	37.6	45.1
BV / Share (RMB cents)	39.5	106.9	128.7	150.9	184.4	222.2	240.3	280.4
PER	4.8	3.8	5.0	4.3	3.1	2.7	3.1	2.6
P/BV	2.9	1.1	0.9	0.8	0.6	0.5	0.5	0.4

^ROE and ROA are annualized figures in FYE10. FYE10F EPS is for the period Apr to Dec 2010. FYE10F PER is based on 9M EPS. We assume the conversion of outstanding warrants in FY13F. Receivable days are based on the net AR balances – adjusted to exclude 17% VAT on sales which is recorded as part of accounts receivable.

Source: Company, SIAS Research

Rating Definition:

Increase Exposure – The current price of the stock is significantly lower than the underlying fundamental value. Readers can consider increasing their exposure in their portfolio to a higher level.

Invest – The current price of the stock is sufficiently lower than the underlying fundamental value of the firm. Readers can consider adding this stock to their portfolio.

Fairly Valued – The current price of the stock is reflective of the underlying fundamental value of the firm. Readers may not need to take actions at current price.

Take Profit – The current price of the stock is sufficiently higher than the underlying fundamental value of the firm. Readers can consider rebalancing their portfolio to take advantage of the profits.

Reduce Exposure - The current price of the stock is significantly higher than the underlying fundamental value of the firm. Readers can consider reducing their holdings in their portfolio.

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