Eratat Lifestyle Limited

Strong Growth Revisited

Increase Exposure

- Intrinsic Value S$0.325
- Prev Close S$0.180

Eratat Lifestyle Limited's (Eratat) 2Q FY11 PATMI grew by 95.6% YoY to RMB53.0m as higher apparel sales led to a 5.6% points increase in gross margin. Trading at just 0.59x P/BV and 2.6x trailing 12 month earnings, our analysis suggests that Eratat is severely undervalued in a situation where its risks have been substantially priced in, while its growth is being heavily discounted by the market. ***Maintain Increase Exposure based on an intrinsic value of S$0.325***

Key Developments:

PATMI to hit RMB183.4m in FY11F: Eratat's 2Q results gave us more visibility on its margins following higher apparel sales and the introduction of ERATAT PREMIUM, leading us to raise our forecasts for the year.

Entry into Shanghai: Eratat opened 50 new ERATAT PREMIUM stores in other provinces and 11 in Shanghai. Accordingly, Eratat's presence in Shanghai – a top tier China city – can help attract better distributors and lower barriers of entry to tier-1 malls in other cities for distributors.

Steep Discount to Book: Currently, Eratat's discount to book value translates to a) the write-off of more than 60% of its trade receivables and b) the discounting of all future growth to zero value. We believe that its share price is excessively depressed. At the moment, this value will most likely be unlocked as the company continues to show results.

Receivables: The turnover of Eratat's receivables should pick up as the company's product portfolio stabilizes, removing the need to incentivize distributors. Moreover, the company's high working capital needs relative to its cash balance implies that it has been collecting back its receivables – otherwise, it would have already run into funding issues.

Valuation Adjusted: To better reflect the higher required rate of return placed on Eratat, we raised our estimated cost of equity on the company to 19.1%, which reduced our intrinsic value on the counter to S$0.325 despite higher forward profit forecasts.

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	1092.5
Gross Profit	258.5	237.4	354.3
Earnings	96.6	111.4	183.4
EPS (RMB cts)	23.3	26.8	42.4

^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	2.3
P/BV	0.5
Return on Common Equity	25.7%
Gross Debt to Common Equity	0%
Current ratio	9.5

Source: SIAS Research

Indexed Price Chart

Green (FSSTI)
White (ERATAT)

Source: Bloomberg

52wks High-Low	*S$0.270 /S$0.145*
Number of Shares	*474.9m*
Market Capitalization	*S$85.5m*

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Results Overview

Profit Beat Expectations: Eratat's 1H FY11 PATMI came up to 57.8% of our full year forecast, which was higher than expected. Revenue was largely in-line taking into account the RMB550m order book for 2H FY11 and an est. RMB20m in 3rd party footwear sales. The outperformance in profitability was largely driven by lower than expected operating expenses as the company spent less on marketing costs. Earlier this year, Eratat had opted to sponsor Season 2 of the Judose Challenge competition, which had saved the company the set-up costs of a new show.

What to Expect for 2H? We now expect 2H FY11F sales to come in at RMB570m (RMB550m from order book + RMB20m of 3rd party footwear sales). We did not factor in any mid-season restocking orders to be conservative. This is because the ERATAT PREMIUM autumn/winter range is new to the market and Eratat has in 2011 streamlined its distribution base to 12 key top-performing distributors.

Profit Forecasts Raised: We adjusted our forecast gross margins to obtain a higher gross profit of RMB354.3m for the whole year, versus RMB349.4m previously. FY11F PATMI is raised to RMB183.4m (previously RMB156.4m) to factor in the lower than expected operating expenses.

Figure 1: Results Analysis

	1H FY11	FY11F (prior)	% of FY11F (prior)	FY11F New	FY11F 2H New	2H 2010	Growth (F)	Remarks
Revenue	522.5	1127.2	46.4%	1102.5	570.0	550.4	3.6%	1H FY11 + 550m order book + est. 20m 3rd party footwear = 1,092.5m
Gross Profit	168.9	349.4	48.3%	354.3	185.4	172.5	7.5%	1H FY11 + 550m x 24% (share of PREMIUM products) x est. 40% + 550m x 76% x est. 31% + 20m 3rd party FW x 15% = 354.3m.
Op Expenses	-47.5	-138.4	34.4%	-106.4	-58.8	-58.8	0.0%	Expect flat in 2H; fell by just RMB0.5m in 1H 2011
Tax	-30.9	-54.7	56.5%	-64.5	-33.5	-29.3	14.3%	@ 26% effective tax rate
PATMI	90.4	156.4	57.8%	183.4	93.0	84.3	10.4%	
			Diff				**Chg**	
Gross Margin	32.3%	31.0%	1.3%	32.4%	32.5%	31.3%	1.2%	
Net Margin	17.3%	13.9%	3.4%	16.8%	16.3%	15.3%	1.0%	

Source: Company, SIAS Research

To See More Sustainable Growth Rates: Our model and assumptions gave a forecast profit growth of just 10.4% YoY in 2H FY11. Variances against our forecast will depend on a) the volume of restocking orders and b) the actual gross margin obtained by Eratat from the PREMIUM series in the autumn/winter season.

What's Next? The high growth of >90% that we have seen thus far is less likely to be revisited as Eratat nears the completion of its move up the value chain from sportswear to casual apparel and now high-end fashion wear. The next step is to expand quality distribution channels and to fine-tune Eratat's product segments – e.g. gradually move the casual fashion wear series up the value chain nearer to the PREMIUM range. We are assuming a more reasonable bottom-line growth of 15% from 2012 to 2014, based on Eratat's current product series and distribution network.

Eratat's entry into Shanghai tier-1 malls with its PREMIUM series has, according to the management, raised its profile within the apparel industry. We understand that Eratat's brand presence in Shanghai is by itself advertising and can potentially attract better distributors. Barriers of entry to tier-1 malls in other cities have also been lowered:

A) Other mall operators will be more receptive towards carrying the Eratat brand (over other brands) and

B) Relationships with several tier-1 mall operators have been established. Eratat can work with them to help distributors tap onto these operators' presence in other provinces.

Eventually, the stabilization of Eratat's product mix and retail formats will also mean that it no longer has to extend long credit terms to distributors to encourage them to take up its new products (and recommended retail formats), leading to a reduction in receivable turnover days. Nonetheless, we maintain our forecast AR turnover days of 120 over our forward horizon of up to 2014.

Trade Receivables Mirroring Increase in Revenue: Trade receivables increased by 24.0% from RMB374.6m in 1Q 2011 to RMB464.6m in 2Q 2011. The increase is in tandem with the 25.3% quarter-on-quarter growth in revenue. Trade receivable turnover days rose by 7 to 113 days quarter-on-quarter mainly because 0.6% more of total trade receivables were between 61 to 90 days old. The more critical 91 to 120 days age bracket actually saw a 0.8% point decrease in terms of percentage of total account receivables.

Figure 2: Trade Receivables

RMB m	Trade Receivables	Revenue	AR Days
1Q 2011	374.7	231.9	106.0
2Q 2011	464.6	290.6	113.0
Change	89.9	58.6	7.0
Change %	24.0%	25.3%	6.6%

AR Ageing				
RMB m	1-60 Days	61-90 Days	91-120 Days	
1Q 2011	178.8	92.5	103.3	a
	47.7%	24.7%	27.6%	b
2Q 2011	222.5	117.4	124.6	c
	47.9%	25.3%	26.8%	d
Change				
RMB m	43.7	24.9	21.3	c-a
% points	0.2%	0.6%	-0.8%	d-b

Source: SIAS Research

Other Receivables increased by RMB95.1m from RMB76.9m at end Dec 2010 to RMB172.0m at end Jun 2011 as the payment of trade deposits to OEMs for the higher value autumn/winter season series took place before the end of the second quarter. Year-on-year, the increase was a smaller RMB58.3m mainly the result of the RMB81.5m YoY growth in apparel orders. We do not see this set of receivables as a concern.

Eratat as an Undervalued Counter

Receivables Risk has already been More Than Priced In: Based on a share price of S$0.180, Eratat is trading at 0.59x its equity per share, or a RMB322.4m discount to equity. This discount in turn represents 69.4% of total trade receivables of RMB464.55m as of end Jun 2011. Trade receivables that are older than 60 days only total to RMB242.0m. In a nutshell, Eratat's share price, at S$0.180, has already factored in substantial receivables write-offs.

Even Its P/E Is Too Low: At S$0.180, Eratat's market capitalization will be S$85.5m, which works out to 2.6x trailing 12-month PATMI of RMB174.7m. Suppose we expense away all of Eratat's receivables that are more than 90 days old, we still end up with an adjusted trailing 12-month profit of RMB50.1m or S$9.4m. Attach a subjective 10x P/E multiple to that, we still obtain a hypothetical market capitalization of S$94.0m (+10.0% from S$86.0m).

By virtue of the steep discounts, we can also assert that Eratat's share price has already priced in some of the alternate risk of distributors being discontinued, especially if they are unable to sell Eratat's products, leading to a decline in sales for the company.

What About its Cash? – Another fear plaguing S-Chips: While we are not in a professional position to perform a bank verification of Eratat's cash balances, Eratat's cash balance is not suspiciously high. In fact, it is sufficient for less than a quarter's expenses and trade deposits. Eratat's working capital ex-cash adds up to RMB511.0m at the end of 2Q FY11 when it raised just RMB61.6m from the equity markets this year. Given its high working capital needs, it would have run into funding issues without a) a comfortable cash balance and b) cash collection from distributors.

So what if it's Cheap? The only issue we cannot resolve is how this value can be unlocked. Possible scenarios include a) sustained earnings growth amidst improving investor sentiment towards S-Chips, b) corporate actions such as a dual-listing or a "delist and relist elsewhere" exercise.

Based on what we understand, the management finds the cost and effort of maintaining a dual-listing prohibitive given its current size and potential funds raised. They also find a privatization exercise too risky at the moment as they would be cut off from an available source of financing. Such moves will probably take place at a later stage of the company's growth.

Our Valuation: At this juncture, we view Eratat more as a value, rather than a growth counter, as its high growth has repeatedly been heavily discounted by the market. We raised our subjective beta on Eratat to 2.0x (previously 1.2x). This in turn raises Eratat's cost of capital to 19.1%/year, almost twice the market required return. Our higher required rate of return consequently reduced our intrinsic value on Eratat to S$0.325.

We emphasize that this is a move to align our valuation to its prevailing risk premium and will be adjusted as sentiment improves. We note that our updated FY14F profit stands at RMB278.7m versus RMB243.0m previously.

Figure 3: Economic Profit Valuation Model

RMB m	FY11F	FY12F	FY13F	FY14F
Revenue	1,092.5	1,256.4	1,444.8	1,661.6
EBIT	247.2	284.3	326.9	376.0
Tax on EBIT	-64.5	-74.1	-85.2	-97.9
NOPLAT	182.7	210.2	241.7	278.0
Invested Capital	626.0	839.9	1,014.9	1,413.7
% of Debt	0.0%	0.0%	0.0%	0.0%
% of Equity	100.0%	100.0%	100.0%	100.0%
WACC (%)	19.1%	19.1%	19.1%	19.1%
Capital Charge	119.3	160.1	193.4	269.4
Economic Profit	63.4	50.1	48.3	8.6
Terminal Value				51.4
Discount Rate	0.92	0.77	0.62	0.52
Present Value	58.1	38.6	29.9	4.5
Book Value	687.6	Risk Free Rate		1.8%
Explicit Value	131.1	Beta		2.0
Terminal Value	26.7	Market RP		8.8%
Value of Equity	845.4	Cost of Equity		19.1%
Number of Shares (m)	474.9	Cost of Debt		0.00%
Value per share (RMB)	1.780	LT Growth		2.0%
Value per share (S$)	0.334	RMBSGD Rate		0.1876
Expanded Shares o/s (m)	598.5	(conversion of warrants)		
Add cash per share (S$)	0.062	(from exercise of warrants)		
Value per share (S$)	0.325			

^Book value of RMB626.0m as of end 2010 + Net Proceeds from Placement.

Source: SIAS Research

Quick Takeaways from Site Visit

We recently had the opportunity to visit three of 11 ERATAT PREMIUM outlets in Shanghai. As at June 2011, there were 50 ERATAT PREMIUM shops spread out in key cities in Zhejiang, Guangdong, Henan, Shandong, Anhui and Shanxi. In Shanghai, we understand that the distributor intends to open another seven ERATAT PREMIUM outlets within this year, bringing the total in Shanghai to 18.

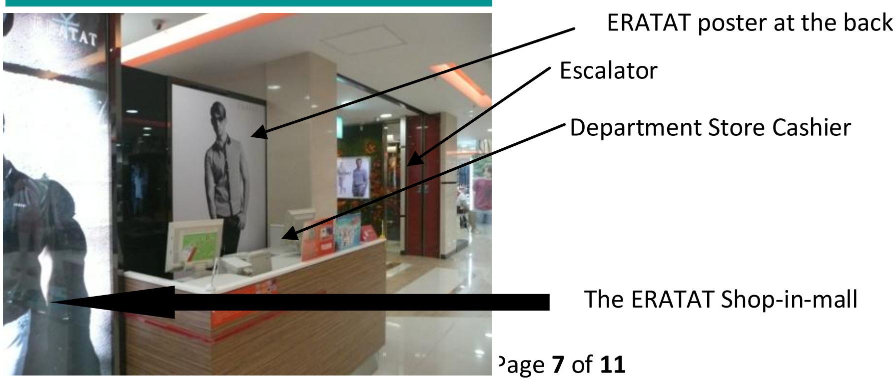
- **Execution of the "PREMIUM" Vision:** We noted that the three outlets are all located in modern large shopping malls. Two of the outlets are located at or in close proximity to the major shopping belts of Huaihai Road and Nanjing Road. The crux of the issue is that the Eratat brand is now placed side by side other major fashion apparel brands at top tier malls, which raises consumer perception of the brand. In contrast, the CLASSIC series had come across as less sophisticated.

- **The Importance of Distributors:** Eratat shares the same distributor in Shanghai as Hangzhou. Our conversations during the site visit suggests that the distributor was able to secure desirable locations at shopping malls as he was previously a senior executive with a leading domestic sports brand and has the network to reach out to targeted shopping mall operators.

- **Why the High Working Capital Needs:** We also understand that the capital allocated for each outlet is about RMB2m to RMB5m (depending on size and location), inclusive of working capital. To set up 18 outlets in a year will require the distributor to provide capital of at least about RMB36m. As such, it makes sense for Eratat to be selective about its distributors (chop those underperforming ones) and extend credit to retained distributors.

- **Good "In-Mall" Locations:** Not only are the shops located at high end shopping malls, they occupied attractive spots within the malls too. The shops we saw were usually located close to escalators where human traffic is higher. A shop-in-shop at a department store is located right next to the store cashier, which also carries an ERATAT ad at the back, giving good brand visibility.

Figure 4: Visible "In-Mall" Location



Source: SIAS Research

Location of Outlets Visited By Order

1) "Shop-in-mall" in New World Department Store <新世界百货> at the Paris Spring Shopping Mall <巴黎春天> located in the Baoshan District of Shanghai.

   New World Department Store China Limited (NWD) has close to 40 department stores in 17 cities in China. In Beijing and Shanghai, NWD has about 15 stores. Eratat can work with its distributors to penetrate through NWD's existing network and also continue leasing space at new NWD stores – thus riding on NWD's growth.

Figure 5: Shopping Mall Frontage

Source: http://www.nwds.com.hk

FYI: We were greeted by several OSIM massage chairs placed just meters away, facing the entrance when we entered this mall.

Figure 6: "Shop-in-Mall"

Source: SIAS Research

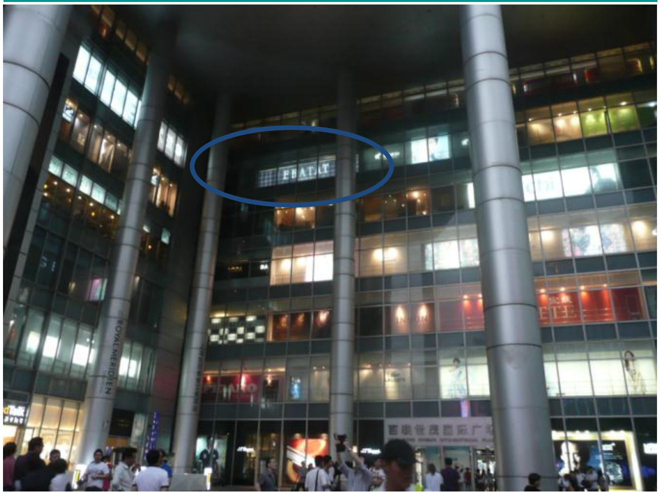
2) Shop at "Sun Moon & Light Central Plaza" <日月光中心广场> located at Xujiahui Road <徐家汇路> in the heart of Shanghai.

   This mall was officially opened in 2010. It is situated less than two kilometers away from the Huaihai Road shopping belt. The Xujiahui Road vicinity is also considered a rather prime area. According to the management, this is another shopping mall chain (from Taiwan) that the company can leverage on to grow its distributors' network.

3) Shop at "Bailian Shimao International Plaza" <百联世茂国际广场> located at Nanjing Road Pedestrian Street <南京路步行街>。

   This mall is located at the prime Nanjing Road area. As such, obtaining retail space at this mall is unlikely to be easy. Moreover, the distributor managed to get space for the ERATAT logo to be displayed from the street level (See Figure below).

Figure 7: View from Outside the Mall



Source: SIAS Research

Figure 8: View of Street where Figure 7 Picture was Taken

Source: SIAS Research

Figure 9: Financial Forecasts and Estimates

RMB m	FY09	FY10	FYE10	FY11F	FY12F	FY13F	FY14F
Revenue	777.3	898.7	787.6	1092.5	1256.4	1444.8	1661.6
Gross Profit	234.0	258.5	237.4	354.3	407.4	468.6	538.8
Operating Profit	145.9	131.5	150.2	247.2	284.3	326.9	376.0
Net Profit	125.9	96.6	111.4	183.4	210.9	242.4	278.7
Attributable to Shareholders							
Total Current Assets	392.2	511.3	629.8	839.8	1034.0	1437.2	1690.8
Total Non-Current Assets	99.0	95.8	92.1	88.5	85.8	82.5	79.3
Total Current Liabilities	47.4	73.1	95.9	88.4	104.9	105.9	125.0
Total Non-Current Liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total Equity	443.7	534.0	626.0	839.9	1014.9	1413.7	1645.1
Cash from Operating Activities	7.0	30.0	2.9	37.5	210.7	80.3	253.5
Cash from Investing Activities	-21.5	-1.9	-0.3	-0.5	-0.5	-0.5	-0.5
Cash from Financing Activities	164.8	-6.3	-19.3	30.4	-35.9	156.4	-47.4
Net Change in Cash	150.3	21.8	-16.7	67.4	174.3	236.3	205.7
Inventory Days	10	9	12	15	15	15	15
Receivable Days	52	76	94	120	120	120	120
Payable Days	11	17	24	25	25	25	25
Return on Common Equity	41.5%	19.8%	25.6%	25.0%	22.7%	20.0%	18.2%
Return on Assets	36.0%	17.6%	22.3%	22.2%	20.6%	18.4%	16.9%
Gross Debt / Common Equity	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Current Ratio	8.3	7.0	6.6	9.5	9.9	13.6	13.5
EPS (RMB cents)	30.8	23.3	26.8	41.2	44.4	51.0	58.7
BV / Share (RMB cents)	93.4	112.4	131.8	176.8	213.7	236.2	274.9
PER	3.1	4.1	3.6	2.3	2.2	1.9	1.6
P/BV	1.0	0.9	0.7	0.5	0.4	0.4	0.3

^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.

IMPORTANT DISCLOSURE