Sun Art Retail Group Limited

FY14 Result - SSS Continues to Deteriorate; Feiniu Investment Likely to Drag Earnings Further

Underweight

6808.HK, 6808 HK

Price: HK$6.96

▼ **Price Target: HK$6.00**
Previous: HK$7.30

China
Consumer

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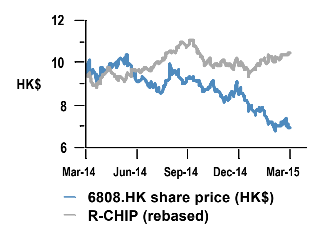
Sun Art reported 2H14 NPAT 4.5% below JPMf. SSSG continued to deteriorate (4Q14 -6%) with Jan + Feb 2015 negative. Furthermore, we continue to worry about the negative impact of e-commerce investment on earnings.

- **Weaker than expected FY14 result.** 2H14 NPAT of RMB1,198m was 4.5% below JPMf with stronger than expected gross margins offset by lower than expected sales, operating cost growth and e-commerce investment. We reduce our earnings forecasts by 5%/11% for FY15/FY16 respectively following this result.
- **SSSG continues to deteriorate.** SSS declined 1.6% in FY14. We estimate SSS declined ~6% in 4Q14 (v 3Q14 -1%). Management remained cautious with respect to outlook, noting SSS in January + February 2015 continuing to be negative with pre-paid card sales over Chinese New Year declining ~19%.
- **We continue to worry about the negative impact of e-commerce investment on earnings.** The company previously disclosed that it expected e-commerce losses to have ~3-4% negative impact on FY14 earnings. In actual fact, e-commerce had ~5-6% drag on FY14 earnings, missing guidance. The company has consistently under-guided with respect to the negative drag on earnings from e-commerce investment and we are worried about continued upside risk to the level of capex and opex investment for e-commerce. Management noted it will invest more into e-commerce in FY15 relative to FY14. We interpret management comments to mean that the company does not expect e-commerce investment to have more than ~10% drag on earnings in FY15. We are worried e-commerce investment may represent larger than ~10% drag on earnings.
- **Remain cautious on Sun Art.** (1) We see limited upside risk to consensus forecasts in the short term; (2) Over the longer term, we believe there is downside risk to group operating margins in a number of areas: (i) store productivity reduction as e-commerce and alternative formats gain market share, and (ii) downside risk to rental income.

Price Performance



	YTD	1m	3m	12m
Abs	-10.3%	3.1%	-21.3%	-26.3%
Rel	-15.5%	-1.3%	-26.2%	-37.2%

Sun Art Retail Group Limited (Reuters: 6808.HK, Bloomberg: 6808 HK)

Rmb in mn, year-end Dec	FY13A	FY14A	FY15E	FY16E	FY17E
Revenue (Rmb mn)	86,195	91,855	98,305	105,887	117,762
Net Profit (Rmb mn)	2,775	2,908	2,960	2,948	3,133
Diluted EPS (Rmb)	0.29	0.30	0.31	0.31	0.33
Recurring EPS (Rmb)	0.29	0.30	0.31	0.31	0.33
DPS (Rmb)	0.28	0.16	0.16	0.21	0.22
Revenue growth (%)	10.7%	6.6%	7.0%	7.7%	11.2%
Net Profit growth (%)	15.2%	4.8%	1.8%	(0.4%)	6.3%
Recurring profit growth	15.2%	4.8%	1.8%	(0.4%)	6.3%
EPS growth (%)	15.2%	4.8%	1.8%	(0.4%)	6.3%
ROE	15.6%	15.1%	14.4%	13.3%	13.3%
ROA	5.9%	5.7%	5.4%	4.9%	4.8%
P/E (x)	19.3	18.5	18.1	18.2	17.1
P/BV (x)	2.9	2.7	2.5	2.4	2.2
EV/EBITDA (x)	14.5	13.5	12.6	12.1	11.2
Dividend Yield	5.0%	2.8%	2.8%	3.7%	3.9%

Source: Company data, Bloomberg, J.P. Morgan estimates.

Company Data	
Shares O/S (mn)	9,540
Market Cap (Rmb mn)	53,674
Market Cap ($ mn)	8,561
Price (HK$)	6.96
Date Of Price	02 Mar 15
Free Float(%)	-
3M - Avg daily vol (mn)	7.52
3M - Avg daily val (HK$ mn)	56.16
3M - Avg daily val ($ mn)	7.2
R-CHIP	4657.10
Exchange Rate	7.76
Price Target End Date	31-Dec-15

See page 14 for analyst certification and important disclosures, including non-US analyst disclosures.

Key catalyst for the stock price:	Upside risks to our view:	Downside risks to our view:
Upcoming quarter result releases and any indication that on trends with respect to sales and margins	(1) Any upturn in the food and general merchandise retail environment in China; (2) Any change in consumer behaviour such that foot traffic for hypermarkets improve; (3) Any weakness in the growth of e-commerce in China; (4) Better than expected gross margin expansion; (5) Improvement in staff productivity such that cost increase pressure is mitigated.	(1) Further weakness in the food and general merchandise retail environment in China (2) Further loss in hypermarket's market share to other retail format (e-commerce, convenience store and traditional channels) (3) Larger than expected pressure on operating margins.

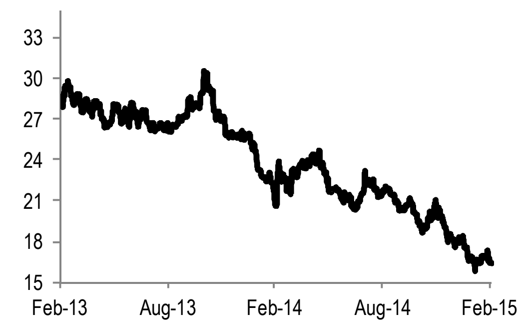
Key financial metrics	FY14A	FY15E	FY16E	FY17E
Revenues (LC)	91,855	98,305	105,887	117,762
Revenue growth (%)	7%	7%	8%	11%
EBITDA (LC)	6,533	6,909	7,155	7,670
EBITDA margin (%)	7%	7%	7%	7%
Tax rate (%)	28%	28%	28%	28%
Net profit (LC)	2,908	2,960	2,948	3,133
EPS (LC)	0.30	0.31	0.31	0.33
EPS growth (%)	5%	2%	0%	6%
DPS (LC)	0.16	0.16	0.21	0.22
BVPS (LC)	2.06	2.24	2.39	2.54
Operating cash flow (LC mn)	5,622	7,651	8,947	7,449
Free cash flow (LC mn)	-338	1,961	2,496	1,683
Interest cover (X)	NM	NM	NM	NM
Net margin (%)	3%	3%	3%	3%
Sales/assets (X)	1.79x	1.79x	1.77x	1.81x
Debt/equity (%)	4%	4%	4%	4%
Net debt/equity (%)	-26%	-28%	-31%	-30%
ROE (%)	15%	14%	13%	13%
Key model assumptions	**FY14A**	**FY15E**	**FY16E**	**FY17E**
Sales growth	6.6%	7.0%	7.7%	11.2%
Gross Margins	22.9%	23.8%	24.1%	24.3%
EBIT Margins	4.3%	4.1%	3.8%	3.6%

Source: Company and J.P. Morgan estimates.

Valuation and price target basis

Our Dec-15 price target of HK$6.0 is based on based a target P/E of ~16x and our earnings forecasts for the year ending Dec-16. Our target P/E is in line with the average one-year forward trading multiple for international food retail names and has reduced slightly to be in line with trading multiples of international peers.

Sun Art 1 year forward PE



Source: Bloomberg, Company and J.P. Morgan estimates.

Sensitivity analysis	EBITDA		EPS	
Sensitivity to	FY15E	FY16E	FY15E	FY16E
100bps decrease in SSSS	-2.8%	-3.1%	-4.6%	-5.6%
10bps decrease in Gross margin	-1.4%	-1.4%	-2.3%	-2.6%
10bps decrease in EBIT Margin	-1.4%	-1.4%	-2.3%	-2.6%

Source: J.P. Morgan estimates.

JPMe vs. consensus, change in estimates

EPS (RMB)	FY15E	FY16E
JPMe old	0.33	0.35
JPMe new	0.31	0.31
% chg	*-4.8%*	*-10.9%*
Consensus	0.31	0.34

Source: Bloomberg, J.P. Morgan estimates.

Comparative metrics

	CMP	Mkt Cap	P/E		EV/EBITDA		P/BV		YTD
	LC	$Mn	FY15E	FY16E	FY15E	FY16E	FY15E	FY16E	Stock perf.
Wumart	5.7	944.7	12.9	11.2	3.3x	2.8x	1.4x	1.4x	-14.3%
CRE	16.4	5,127.1	50.8	32.6	7.0x	5.4x	0.8x	0.8x	1.1%
Lianhua	3.7	527.0	42.2	25.5	N/A	N/A	1.0x	0.9x	-6.2%
Dairy Farm	8.7	11,817.6	21.7	19.7	13.7x	12.6x	0.3x	0.3x	-2.9%
Woolworths	29.3	28,747.3	14.7	14.6	8.4x	8.2x	3.3x	3.1x	-4.5%
Carrefour	29.8	24,496.2	17.2	15.2	6.7x	6.1x	2.2x	2.0x	17.7%
Tesco	245.2	30,650.9	23.3	23.0	9.6x	9.0x	1.4x	1.3x	29.7%
Wal-Mart	83.9	270,522.3	16.8	17.0	8.7x	8.6x	3.2x	3.0x	-2.3%
Kroger	71.2	34,957.7	21.0	19.1	9.1x	8.6x	6.1x	5.2x	11.1%

Source: Bloomberg, Company and J.P. Morgan estimates. Prices are as of March 2, 2015.

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Main points

Sun Art continued to report a relatively weak result.

- FY14 turnover RMB91,855m (JPMf RMB92,497m), up 6.6% yoy (JPMf +7.3%). Supermarket sales grew 6.2% (JPMf +6.9%) while rental income grew 21.6% (JPMf +22.4%).
- FY14 supermarket SSSG was -1.6% (JPMf -0.8%). We estimate this implies 2H14 SSSG of -3.3% (JPMf -1.6%) and 4Q14 SSSG of -5.7% (JPMf -2.3%), representing a further deterioration relative to 1H14 (flat) and 3Q14 (-1.0%).
- FY14 reported gross profit RMB20,998m (JPMf RMB21,044m), implying reported gross margin of 22.86% (JPMf 22.75%). Supermarket gross margins increased ~100bps to 20.51% (JPMf 20.39%).
- FY14 EBIT RMB3,927m (JPMf RMB4,033m), implying EBIT margin of 4.28% (JPMf 4.36%).
- FY14 NPAT RMB2,908m, (JPMf RMB2,964m, Bloomberg consensus RMB2,954m), up 4.8% yoy (JPMf 6.8%). 2H14 NPAT was RMB1,198m, ~4.5% lower than JPMf and Bloomberg consensus.
- Final dividend of HK16cps declared, in line with JPMf (HK16cps) and above consensus (HK14cps).

Table 1: Sun Art - Profit & Loss Statement

	Actual 1H13	Actual 2H13	Actual FY13	Actual 1H14	Actual 2H14	Actual FY14	JPMf 2H14	JPMf FY14
Supermarket sales	43,420	40,538	83,958	46,690	42,446	89,136	43,069	89,759
Rental income	1,095	1,142	2,237	1,348	1,371	2,719	1,390	2,738
Total turnover	44,515	41,680	86,195	48,038	43,817	91,855	44,459	92,497
% Growth	*12.9%*	*8.4%*	*10.7%*	*7.9%*	*5.1%*	*6.6%*	*6.7%*	*7.3%*
COGS	-35,284	-32,298	-67,582	-37,515	-33,342	-70,857	-33,939	-71,454
Gross profit	9,231	9,382	18,613	10,523	10,475	20,998	10,521	21,044
Gross margin	*20.74%*	*22.51%*	*21.59%*	*21.91%*	*23.91%*	*22.86%*	*23.7%*	*22.75%*
Other income & gains (ex interest income)	181	133	314	197	166	363	150	347
CODB	-7,279	-7,835	-15,114	-8,416	-9,018	-17,434	-8,941.1	-17,357.1
CODB/Turnover	*16.4%*	*18.8%*	*17.5%*	*17.5%*	*20.6%*	*19.0%*	*20.1%*	*18.8%*
EBIT (excludes interest income)	2,133	1,680	3,813	2,304	1,623	3,927	1,729	4,033
EBIT margin	*4.79%*	*4.03%*	*4.42%*	*4.80%*	*3.70%*	*4.28%*	*3.9%*	*4.36%*
EBIT growth	*12.0%*	*25.0%*	*17.4%*	*8.0%*	*-3.4%*	*3.0%*	*2.9%*	*5.8%*
FX gains/losses	0	0	0	0	0	0	0	0
Net interest	158	163	321	184	107	291	174	358
Equity accounted profit	0	0	0	0	0	0	0	0
PBT	2,291	1,843	4,134	2,488	1,730	4,218	1,903	4,391
Income tax expense	-621	-571	-1,192	-699	-477	-1,176	-571	-1,270
Non-controlling interests	-94	-73	-167	-79	-55	-134	-78	-157
NPAT	1,576	1,199	2,775	1,710	1,198	2,908	1,254	2,964
NPAT growth	*14.8%*	*15.7%*	*15.2%*	*8.5%*	*-0.1%*	*4.8%*	*4.6%*	*6.8%*
DPS (HKc)	0.0	28.0	28.0	0.0	16.0	16.0	16.0	16.0

Source: J.P. Morgan estimates, Company data.

In the sections below, we detail issues raised by this result.

Issue #1 – SSSG continued to deteriorate

- Our estimate of the trend in Sun Art SSSG (based on company half-yearly disclosure) is detailed in the table below. We estimate that 4Q14 SSSG deteriorated further to -6%.

Table 2: Sun Art - Quarterly SSSG History

	1Q13	2Q13	3Q13	4Q13	1Q14	2Q14	3Q14	4Q14
SSSG	3.0%	5.3%	1.0%*	-1.1%*	1.1%*	-1.5%*	-1.0%*	-5.7%

Source: J.P. Morgan estimates, Company data. December year end. * Estimates based on company disclosures during conference call

- The company attributed the slowdown in SSSG to the following factors:
    - Slower growth in the overall consumer market.
    - More diversified consuming channels available to customers.
    - Lack of new stimulus for spending, particularly after the expiration of the government subsidy granted to energy-saving home appliances in Jun-13.
    - Weakness in pre-paid card sales. During the 2014 mid-Autumn festival, total pre-paid card sales declined ~25% (~23% decline on same store basis).
    - Calendar shift in Chinese New Year, which likely negatively impacted 4Q14 sales.
- Looking into FY15, management remained cautious with respect to SSSG outlook.
    - Management noted that SSSG for January + February 2015 remains in negative territory. This is somewhat concerning given the later Chinese New Year should have arguably boosted consumption (as many retailers complained that the earlier Chinese New Year in 2014 negatively impacted January + February 2014 sales combined).
    - Pre-paid cards sales continued to be negatively impacted by anti-corruption measures. The company disclosed pre-paid card sales over Chinese New Year declined ~19% (~17% decline on same store basis).

Table 3: Sun Art - Prepaid Card Balances

RMBm	Jun-11	Dec-11	Jun-12	Dec-12	Jun-13	Dec-13	Jun-14	Dec-14
Advance receipts from customers	4,205	5,949	5,649	7,207	7,268	8,080	7,440	7,774
Sales	33,712	32,828	38,469	37,467	43,420	40,538	46,690	42,446
% Sales	12.5%	18.1%	14.7%	19.2%	16.7%	19.9%	15.9%	18.3%

Source: Company reports.

Issue #2 – We continue to worry about e-commerce investment

Comments at 1H14 result

- At Sun Art's 1H14 result, management provided the following commentary with respect to the company's investment outlay in *Feiniu.*
    - The company expects to invest ~RMB500m into the business initially with this capex not yet spent. The company believes this investment should satisfy capacity needs over the next couple of years.
    - Losses for Feiniu in *1H14* were less than 3% of group earnings. For FY14, the company expects the impact to be ~3-4% of earnings. Over the medium

term, the company hopes to control Feiniu losses such that it will never be greater than 10% of group earnings.

Updated comments at FY14 result highlight e-commerce investment is moving faster than expected

- We believe the company made a number of comments during its FY14 briefing suggesting that e-commerce investment is moving faster than our own expectations:
  - The company stated that although net profit increased RMB100m to RMB3,042m in FY14 (representing 3.4% growth yoy), the increase in profit for 2014 over 2013 would be ~8.9% excluding losses incurred by *Feiniu* (Sun Art's e-commerce venture). This implies ~RMB162m losses associated with *Feiniu*. Hence, *Feiniu* losses represent ~5.3% of FY14 earnings. We note this is above previous company guidance of ~3-4% losses.
  - The company expects its initial RMB500m investment to be able to adequately fund *Feiniu* in FY15. However, the company expects *Feiniu* to require ongoing rounds of capital injection at a later date.
  - The company indicated that it will invest more into e-commerce in FY15 relative to FY14. Our interpretation from company commentary is that the company's plan is that e-commerce investment will not represent more than ~10% drag on earnings for FY15. We originally did not expect ~10% drag on earnings to be incurred in FY15 but thought it was more likely in FY16.
- We have previously stated our view that we believe there is upside risk to capex expenditure required if Sun Art were to expand its e-commerce business. We note that international retailers are spending or planning to spend significant capex (in dollar terms) into e-commerce and omnichannel retailing.

Table 4: International Department Store E-commerce Capex

Kohl's	Expect 2014 capital expenditure to be ~US$725m. Indicated largest percentage total investments in capex are in technology with largest percent by far in omni-channel and personalization (comments at Feb 2014)
Debenhams	Guiding to £130m capex for FY15. Of this, ~33% relates to group systems investment and ~3% to logistics (comment at Oct 2014)
Macy's	Historically spent ~20% of capex into online investment. Will increase investments on online and omnichannel infrastructure with its annual US$1 billion plus capex budget (comment at Aug 2014)
M&S	The transformation programme has completed after capex hikes in recent years (£738m in FY12, £821m in FY13). Noted that ~50% capex spent on infrastructure development and ~25% spent on initiatives to support the company's multi-channel strategy. Planned capex is £500m to £550m per annum over the next three years. (comment at Nov 2014)
Nordstrom	Plan to spend US$3.9bn in capex over next five years. Of this 31% relates to e-commerce and technology investments, including initiatives to improve e-commerce delivery and fulfillment, online and mobile experience and personalization (comments at Dec 2014)
Sak's	Expect to spend C$320m p.a. over three years for Hudson's Bay and Sak's. Sak's planned to spend ~$70m to develop omnichannel in 2013 (comments at Apr 2014)
Walmart	Investments in e-commerce and digital initiatives are expected to range between $1.2 and $1.5 billion in FY16 (12 months ended Jan-16), up from approximately $1.0 billion estimated for FY15 (comments at Oct 2014)

Source: Company reports; Bloomberg.

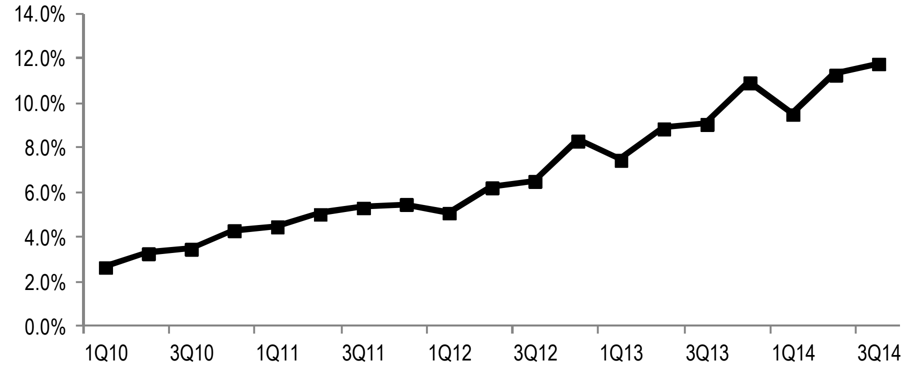
- We believe the company's experience to-date with respect to start-up costs associated with e-commerce supports our view. We are worried that as e-commerce grows, the company will need to invest more into the business, which in turn will negatively impact return on capital metrics and margins. We are worried that losses associated with e-commerce will grow to become more than ~10% drag on the company's earnings.

Issue #3 – We continue to worry about the threat of e-commerce growth

We remain worried about the growth of e-commerce and its impact on store productivity

- E-commerce has gained significant market share over recent years in China. By our calculations, e-commerce penetration has reached ~8-9% of total retail sales in China in 1Q14, up from ~2% at the start of 2010.

Figure 1: China E-Commerce Sales as % Corresponding Retail Sales



Source: J.P. Morgan estimates, iResearch, National Bureau of Statistics. Numerator = total e-commerce sales as estimated by iResearch. Denominator = Total China retail sales less automobile and petroleum sales for designated entities as estimated by National Bureau of Statistics. The NBS data only disclose sales by category for designated entities. Designated entities are defined as those entities with annual sales over RMB5m or with over 60 employees.

- As we discussed in our report *Reviewing Longer Term Threats Posed by the Growth of E-Commerce* (dated 24 September 2013), we believe e-commerce will continue to gain market share going forward for the following reasons:
  - Growth of the mobile web and associated blurring of lines between what is classified as online and offline purchasing.
  - Social networking innovation driving a richer online shopping experience.
  - Personalisation driving a richer online shopping experience.
- With average Sun Art hypermarkets ~9,000-10,000sqm, we worry that as e-commerce penetration grows, this will mean that more store space gets made redundant, which in turn has a negative impact on store productivity.

Issue #4 – We continue to worry about future prospects for rental income

Rental income represents a material proportion of Sun Art's earnings and has been growing strongly over recent years

Sun Art's rental business represents a material proportion of group earnings

- The average size of Sun Art's complexes is ~28,000sqm.
  - In the Sun Art prospectus, the company disclosed that the average size of a hypermarket within its complex was ~8,880sqm
  - In the Sun Art prospectus, the company also disclosed that the average size of retail galleries (representing the area of the hypermarket complex that Sun Art subleases to retail/restaurant tenants) within the complex is ~4,000-6,000sqm.
  - The remainder of the complex represents car park, warehouses, etc.

- This implies space used to generate rental income represents ~30% of the shopping area within a Sun Art shopping complex.

Table 5: Sun Art - Average Size of Complex by Region (Sqm)

	Dec-11	Jun-12	Dec-12	Jun-13	Dec-13	Jun-14	Dec-14
Eastern China	30,084	30,116	29,914	29,685	29,462	29,346	29,800
Northern China	25,289	25,289	25,795	25,516	25,263	25,263	25,251
North East China	26,502	26,502	27,645	27,741	27,262	27,262	27,330
Southern China	25,591	25,518	24,624	24,510	24,742	24,818	24,639
Central China	26,397	26,039	26,515	26,199	26,982	26,982	26,918
Western China	30,849	28,531	30,906	30,740	29,532	29,532	28,945
Group Average	28,128	28,030	28,000	27,787	27,636	27,591	27,628

Source: J.P. Morgan estimates, Company data.

- Given that retail gallery space does represent a sizeable portion of the total space within the Sun Art complex, we would expect rental income to also represent a sizeable proportion of group income.
- The company does not separately disclose all of the operating costs associated with the company's rental business. Hence, it is difficult to obtain an accurate understanding of how much rental income actually contributes to total group profitability.
- In the table below, we detail our estimates of "partially-costed" EBIT for Sun Art's rental business. This estimate is based on the company's disclosure of lease expenses and depreciation and does not include all operating costs associated with the company's rental business.

Table 6: Sun Art - Estimate of Partially-Costed EBIT (RMBm)

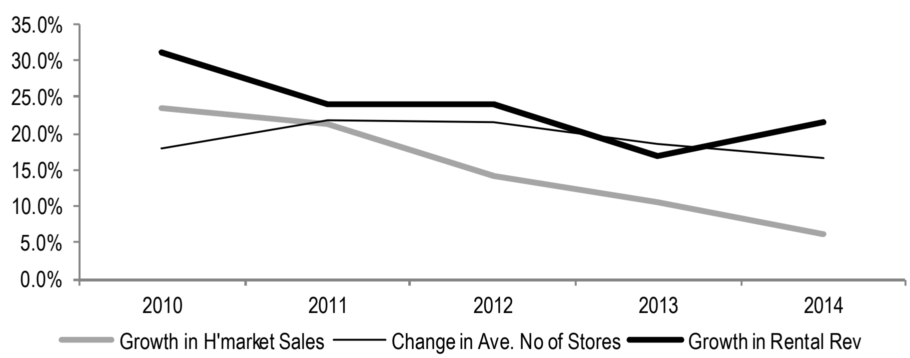
	2010	2011	2012	2013	2014
Rental income	1,244	1,544	1,915	2,237	2,719
Lease expenses	(159)	(200)	(255)	(325)	(367)
Operating expenses on investment properties	(23)	(34)	(47)	(52)	(68)
Depreciation	(221)	(282)	(312)	(380)	(433)
Partially-costed rental EBIT	841	1,028	1,301	1,480	1,851
Total group EBIT	2,424	2,814	3,248	3,813	3,927
As % Total group EBIT	34.7%	36.5%	40.1%	38.8%	47.1%

Source: J.P. Morgan estimates, Company data.

Rental revenue has been growing strongly over recent years

- As can be seen in the figure below, rental revenue growth for Sun Art has been higher than hypermarket revenue growth over recent years.

Figure 2: Sun Art - Rental Revenue Growth



Source: Company data, J.P. Morgan.

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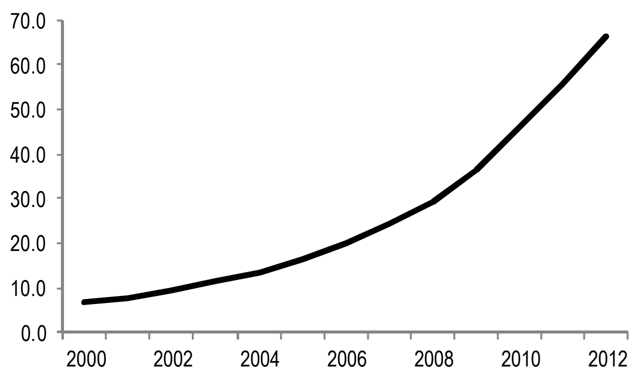
We believe there is downside risk to rental revenue growth over the medium to longer term

- Over the next three years, Sun Art's rental revenue growth should be supported by the company's store growth plans, with the company having secured 162 sites to open complexes.
- Nevertheless, we believe downside risk to rental revenue growth does exist for the following reasons:
  - Chinese hypermarkets in general have been experiencing reduction in traffic.
  - Ongoing threats to hypermarket foot traffic posed by the growth of e-commerce.

Chinese hypermarkets have been experiencing a reduction in traffic

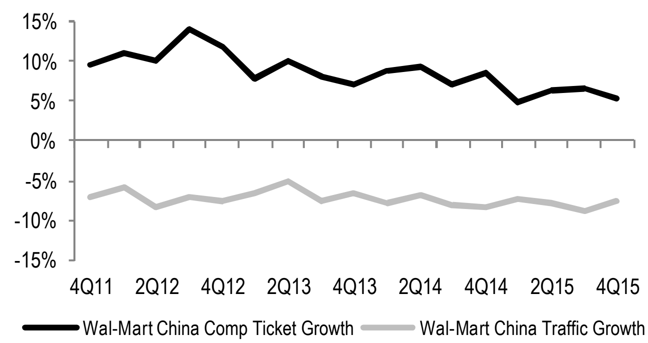
- Over recent years, hypermarkets in China have experienced consistent decline in traffic, with average basket sizes increases to offset this decline in traffic. In the figure below, we highlight the trend in traffic and average basket size as reported by Walmart for its China business. We believe this is representative of the trend as seen by Chinese hypermarket operators in general.
- Hypermarket operators have attributed this decline in traffic to a move away from traditional daily shopping to larger consolidated shopping trips as car ownership has increased.

Figure 3: China Car Ownership per 1,000 Population



Source: CEIC.

Figure 4: Walmart China - Average Comp Ticket Growth v Traffic Growth



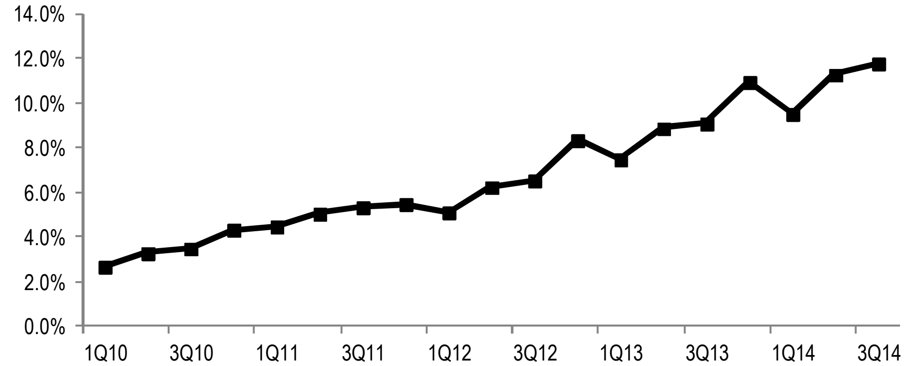
Source: Company reports. January year end.

- Historically, retailers/restaurants have placed their stores within retail galleries of hypermarket complexes to benefit from the traffic that hypermarkets generate. We believe the current traffic trend experienced by hypermarket complexes does negatively impact the proposition offered to tenants and could have a negative impact on rental renewals over the medium to longer term.
- Sun Art's rental agreements are typically only for one year in length and are fixed in nature. Hence, the level of certainty with respect to longer term rental income going forward is relatively low. We recognised that Sun Art noted its traffic only declined ~3% in 1H14, which is better than that of peers. Nevertheless, we note this traffic figure is still declining and we note the trends in other more developed markets for the hypermarket format is continued traffic decline.

Ongoing threats to hypermarket foot traffic posed by the growth of e-commerce

- E-commerce has gained significant market share over recent years in China. By our calculations, e-commerce penetration has reached ~8-9% of total retail sales in China in 1Q14. We believe this growth is also having a negative impact on traffic for hypermarket operators such as Sun Art.

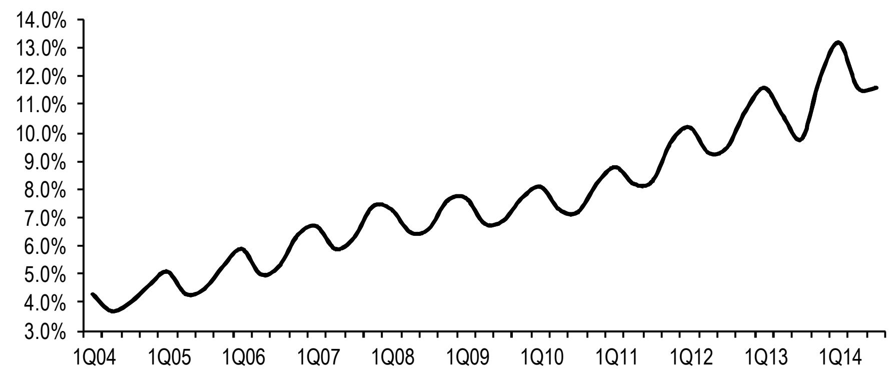
Figure 5: China E-Commerce Sales as % Corresponding Retail Sales



Source: J.P. Morgan estimates, iResearch, National Bureau of Statistics. Numerator = total e-commerce sales as estimated by iResearch. Denominator = Total China retail sales less automobile and petroleum sales for designated entities as estimated by National Bureau of Statistics. The NBS data only disclose sales by category for designated entities. Designated entities are defined as those entities with annual sales over RMB5m or with over 60 employees.

- As comparison, e-commerce penetration in the US is estimated to be ~11-12% (after excluding for categories where a majority of product sold is done offline such as food, petrol, motor vehicles). However, it has taken China ~4 years to move from ~2% e-commerce penetration to ~10% e-commerce penetration, something that took the US over 10 years to achieve.

Figure 6: US E-Commerce Sales as % Corresponding Retail Sales



Source: comScore. E-commerce sales as a proportion of total retail sales excluding sales for the following categories: Motor Vehicle & Parts Dealers, Food & Beverage Stores, Gasoline Stores, Food Services & Drinking Places and Fuel Dealers.

- As e-commerce continues to take market share, we believe this may have a further impact on traffic for hypermarket complexes. In turn, this could have a negative impact on the hypermarket operator's ability to charge ever-increasing rents.

In addition, we highlight risks associated with the Sun Art plaza concept

- The company disclosed that its Ningbo Sun Art Plaza shopping centre which was owned and operated was completed and opened during 2014. Similar to the Auchan Suzhou shopping centre, total GFA of the Sun Art Plaza is ~170k sqm and is higher than an average Sun Art complex.

- Currently, the company has no intention to significantly develop and roll out a big format shopping centre. The reason why the Ningbo Plaza was developed was due to the acquisition of a large piece of land at a low price which allowed

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the company to experiment. The company indicated that if the Ningbo experiment is successful, there are some plans to develop one plaza every year or two.

- While we are not averse to experimentation, we note capex for the Ningbo complex is ~RMB1bn, which is significant. We were previously worried about the company's exposure to a large amount of store space and potential impact of negative rental reversions. With an additional shopping mall format, we think this adds risk with respect to rental income.

Issue #4 – Gross margins continued to increase in FY14

- Sun Art continued to report improving gross margins. At the headline level, gross margins increased 127bps in FY14.
- Supermarket gross margins increased ~100bps in FY14 as a result of:
    - Merchandise mix shift away from lower gross margin categories.
    - Common purchasing consolidation with company disclosing common negotiations now representing 43.8% of buying turnover (v ~40% previously disclosed).
    - Improving economies of scale. For example, we note that the RT Mart Central DC in Chibi, Hubei commenced operations in Oct-14 and now serves ~30 stores. We have previously stated our view that a Sun Art DC will likely become margin accretive when supporting over 20 stores (with capacity of ~50 stores).

Table 7: Sun Art – Summary Historical Financials

RMBm	1H12	2H12	FY12	1H13	2H13	FY13	1H14	2H14	FY14
Supermarket sales	38,469	37,467	75,936	43,420	40,538	83,958	46,690	42,446	89,136
Rental income	947	968	1,915	1,095	1,142	2,237	1,348	1,371	2,719
Turnover	39,416	38,435	77,851	44,515	41,680	86,195	48,038	43,817	91,855
Other income & gains	153	141	294	181	133	314	197	166	363
Hypermarket sales growth	*14.1%*	*14.1%*	*14.1%*	*12.9%*	*8.2%*	*10.6%*	*7.5%*	*4.7%*	*6.2%*
Rental income growth	*26.8%*	*21.5%*	*24.0%*	*15.6%*	*18.0%*	*16.8%*	*23.1%*	*20.1%*	*21.5%*
COGS	-31,350	-30,351	-61,701	-35,284	-32,298	-67,582	-37,515	-33,342	-70,857
Reported gross profit (Turnover less COGS)	8,066	8,084	16,150	9,231	9,382	18,613	10,523	10,475	20,998
As % Turnover	*20.46%*	*21.03%*	*20.74%*	*20.74%*	*22.51%*	*21.59%*	*21.91%*	*23.91%*	*22.86%*
S'mkt gross profit (s'mkt sales less COGS)	7,119	7,116	14,235	8,136	8,240	16,376	9,175	9,104	18,279
As % Supermarket sales	*18.51%*	*18.99%*	*18.75%*	*18.74%*	*20.33%*	*19.50%*	*19.65%*	*21.45%*	*20.51%*
CODB (including depreciation)	-6,315	-6,881	-13,196	-7,279	-7,835	-15,114	-8,416	-9,018	-17,434
As % Turnover	*16.02%*	*17.90%*	*16.95%*	*16.35%*	*18.80%*	*17.53%*	*17.52%*	*20.58%*	*18.98%*
EBIT (exclusive of interest income)	1,904	1,344	3,248	2,133	1,680	3,813	2,304	1,623	3,927
As % Turnover	*4.83%*	*3.50%*	*4.17%*	*4.79%*	*4.03%*	*4.42%*	*4.80%*	*3.70%*	*4.28%*
Operating profit (as reported)	2,037	1,481	3,518	2,298	1,849	4,147	2,495	1,738	4,233
As % Turnover	*5.17%*	*3.85%*	*4.52%*	*5.16%*	*4.44%*	*4.81%*	*5.19%*	*3.97%*	*4.61%*

Source: Company reports. December year end.

- While management indicated that the company still wanted to maintain price leadership, we are worried that the company continues to place pressure on suppliers in order to generate gross margin expansion. We have previously obtained feedback from channel checks indicating that suppliers are now beginning to prefer alternative channels such as e-commerce for sales growth. We are hence worried about the sustainability of ongoing growth in gross margins as it could drive suppliers away from the hypermarket channel.

Earnings revisions

- We have updated our earnings forecasts detailed in our table below. Key changes to our earnings forecasts are as follows:
  - We reduce our sales growth forecasts to reflect lower than expected sales growth in 2H14 and the start of 2015.
  - Increased gross margin assumptions to reflect better than expected gross margin expansion in FY14.
  - Assumed increased cost investment associated with e-commerce hence leading to reduced operating margin assumptions.

Table 8: Sun Art - Changes to Estimates

RMBm, %

	Old			New			% Change		
	FY14	FY15	FY16	FY14	FY15	FY16	FY14	FY15	FY16
Turnover	92,497	102,946	116,451	91,855	98,305	105,887	-0.7%	-4.5%	-9.1%
Turnover growth	7.3%	11.3%	13.1%	6.6%	7.0%	7.7%			
Gross profit	21,044	23,729	27,038	20,998	23,416	25,546	-0.2%	-1.3%	-5.5%
Gross margin	22.8%	23.0%	23.2%	22.9%	23.8%	24.1%			
EBIT	4,033	4,366	4,812	3,927	4,056	4,049	-2.6%	-7.1%	-15.9%
EBIT margin	4.36%	4.24%	4.13%	4.28%	4.13%	3.82%			
Operating profit (as reported)	4,405	4,642	4,951	4,233	4,333	4,331	-3.9%	-6.6%	-12.5%
Operating profit margin	4.76%	4.51%	4.25%	4.61%	4.41%	4.09%			
NPAT	2,964	3,111	3,308	2,908	2,960	2,948	-1.9%	-4.8%	-10.9%
NPAT growth	6.8%	5.0%	6.3%	4.8%	1.8%	-0.4%			
Diluted EPS (RMB cps)	31.1	32.6	34.7	30.5	31.0	30.9	-1.9%	-4.8%	-10.9%
DPS (HKcps)	16.0	17.0	21.0	16.0	16.0	21.0	0.0%	-5.9%	0.0%

Source: J.P. Morgan estimates, Company data.

Investment Thesis, Valuation and Risks

Sun Art Retail Group Limited *(Underweight; Price Target: HK$6.00)*

Investment Thesis

We believe Sun Art does benefit from its leading competitive position, strong execution and strong management team. Nevertheless, we remain cautious as: (1) We see limited upside risk to consensus forecasts in the short term; (2) Over the longer term, we believe there is downside risk to group operating margins in a number of areas: (i) store productivity reduction as e-commerce and alternative formats gain market share, (ii) downside risk to rental income.

Valuation

Our Dec-15 price target of HK$6.0 is based on based a target P/E of ~16x and our earnings forecasts for the year ending Dec-16. Our target P/E is in line with the average one-year forward trading multiple for international food retail names and has reduced slightly to be in line with trading multiples of international peers.

Risks to Rating and Price Target

Upside risks to our view include: 1) any upturn in the food and general merchandise retail environment in China; 2) any change in consumer behaviour, such that foot traffic for hypermarkets improves; 3) any weakness in the growth of e-commerce in China; 4) better-than-expected gross margin expansion; and 5) improvement in staff productivity, such that cost increase pressure is mitigated.

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Sun Art Retail Group Limited: Summary of Financials

Income Statement

Rmb in millions, year end Dec	FY13	FY14	FY15E	FY16E	FY17E
Revenues	86,195	91,855	98,305	105,887	117,762
% change Y/Y	10.7%	6.6%	7.0%	7.7%	11.2%
Gross Profit	18,613	20,998	23,416	25,546	28,597
% change Y/Y	15.3%	12.8%	11.5%	9.1%	11.9%
Gross margin	21.6%	22.9%	23.8%	24.1%	24.3%
Other operating income	314	363	363	363	363
EBITDA	6,034	6,533	6,909	7,155	7,670
% change Y/Y	16.0%	8.3%	5.8%	3.6%	7.2%
EBITDA Margin	7.0%	7.1%	7.0%	6.8%	6.5%
EBIT	3,813	3,927	4,056	4,049	4,264
% change Y/Y	17.4%	3.0%	3.3%	(0.2%)	5.3%
EBIT Margin	4.4%	4.3%	4.1%	3.8%	3.6%
Net Interest	321	291	255	260	326
Share of JVs	-	-	-	-	-
Other non operating income	0	0	0	0	0
Earnings before tax	4,134	4,218	4,311	4,309	4,590
% change Y/Y	17.9%	2.0%	2.2%	(0.0%)	6.5%
Tax	(1,192)	(1,176)	(1,207)	(1,206)	(1,285)
as % of EBT	28.8%	27.9%	28.0%	28.0%	28.0%
Minorities	(167)	(134)	(144)	(154)	(172)
Net income (reported)	2,775	2,908	2,960	2,948	3,133
% change Y/Y	15.2%	4.8%	1.8%	(0.4%)	6.3%
Recurring Net Income	2,775	2,908	2,960	2,948	3,133
% change Y/Y	15.2%	4.8%	1.8%	(0.4%)	6.3%
Diluted EPS	0.29	0.30	0.31	0.31	0.33
% change Y/Y	15.2%	4.8%	1.8%	(0.4%)	6.3%
Recurring EPS	0.29	0.30	0.31	0.31	0.33
% change Y/Y	15.2%	4.8%	1.8%	(0.4%)	6.3%

Cash flow statement

Rmb in millions, year end Dec	FY13	FY14	FY15E	FY16E	FY17E
PBT	4,134	4,218	4,311	4,309	4,590
Depr. & amortization	2,221	2,606	2,853	3,106	3,406
Change in working capital	2,121	1,487	1,669	2,707	731
Tax & Other	189	(1,379)	168	186	178
Cash flow from operations	7,306	5,622	7,651	8,947	7,449
Capex	(6,845)	(5,750)	(5,506)	(6,263)	(5,531)
Sale of assets	-	-	-	-	-
Acquisition of subsidiaries/intangibles	0	0	0	0	0
Other	903	1,860	0	0	0
Cash flow from investing	(5,942)	(3,890)	(5,506)	(6,263)	(5,531)
Equity raised/(repaid)	0	0	0	0	0
Debt raised/(repaid)	0	507	0	0	0
Dividends paid	(919)	(2,261)	(1,227)	(1,526)	(1,717)
Other	69	0	0	0	0
Cash flow from financing	(850)	(1,754)	(1,227)	(1,526)	(1,717)
FX gain/(loss)	-	-	-	-	-
Net change in cash	514	(22)	918	1,157	200
Ending cash	6,271	6,249	7,167	8,324	8,524
DPS	0.28	0.16	0.16	0.21	0.22

Balance sheet

Rmb in millions, year end Dec	FY13	FY14	FY15E	FY16E	FY17E
Cash and cash equivalents	6,271	6,249	7,167	8,324	8,524
Accounts receivable	3,411	3,902	4,095	4,547	4,947
Inventories	11,268	11,161	12,824	13,140	15,408
Others	1,173	131	131	131	131
Current assets	22,123	21,443	24,217	26,142	29,011
Goodwill	-	-	-	-	-
Intangible assets	108	133	133	133	133
Long term investments	-	-	-	-	-
Net fixed assets	26,953	30,062	32,715	35,872	37,997
Other assets	723	799	305	305	305
Total Assets	49,910	52,443	57,376	62,458	67,452
Liabilities					
Short-term loans	391	898	898	898	898
Trade & other payables	29,611	30,424	33,456	36,931	40,331
Others	364	512	536	568	575
Total current liabilities	30,366	31,834	34,890	38,397	41,803
Long-term debt	0	0	0	0	0
Others	113	25	25	25	25
Total Liabilities	30,529	31,909	34,965	38,472	41,878
Minorities	633	861	1,005	1,159	1,331
Shareholders' equity	18,748	19,673	21,406	22,828	24,244
BVPS	1.97	2.06	2.24	2.39	2.54

Ratio Analysis

Rmb in millions, year end Dec	FY13	FY14	FY15E	FY16E	FY17E
Gross margin	21.6%	22.9%	23.8%	24.1%	24.3%
EBITDA margin	7.0%	7.1%	7.0%	6.8%	6.5%
Operating Margin	4.4%	4.3%	4.1%	3.8%	3.6%
Net margin	3.2%	3.2%	3.0%	2.8%	2.7%
Recurring net profit margin	3.2%	3.2%	3.0%	2.8%	2.7%
Sales growth	10.7%	6.6%	7.0%	7.7%	11.2%
Net profit growth	15.2%	4.8%	1.8%	(0.4%)	6.3%
Recurring net profit growth	15.2%	4.8%	1.8%	(0.4%)	6.3%
EPS growth	15.2%	4.8%	1.8%	(0.4%)	6.3%
Interest coverage (x)	NM	NM	NM	NM	NM
Net debt to equity	(30.3%)	(26.1%)	(28.0%)	(31.0%)	(29.8%)
Sales/assets	1.8	1.8	1.8	1.8	1.8
Assets/equity	265.6%	266.4%	267.3%	270.9%	276.0%
ROE	15.6%	15.1%	14.4%	13.3%	13.3%
ROCE	14.9%	14.3%	13.6%	12.7%	12.6%

Source: Company reports and J.P. Morgan estimates.

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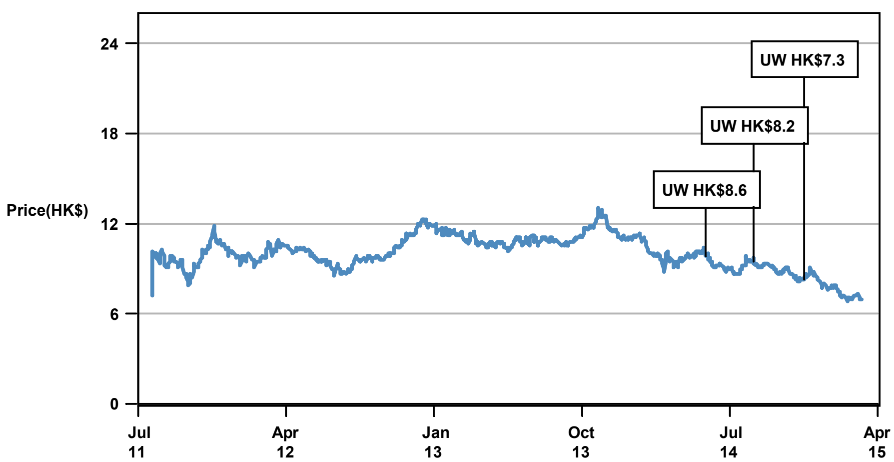
Sun Art Retail Group Limited (6808.HK, 6808 HK) Price Chart



Date	Rating	Share Price (HK$)	Price Target (HK$)
15-May-14	UW	9.93	8.60
14-Aug-14	UW	9.44	8.20
13-Nov-14	UW	8.30	7.30

Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.
Initiated coverage May 15, 2014.

The chart(s) show J.P. Morgan's continuing coverage of the stocks; the current analysts may or may not have covered it over the entire period.
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	Overweight (buy)	Neutral (hold)	Underweight (sell)
J.P. Morgan Global Equity Research Coverage	45%	43%	12%
IB clients*	56%	49%	33%
JPMS Equity Research Coverage	45%	48%	7%
IB clients*	75%	67%	52%

*Percentage of investment banking clients in each rating category.
For purposes only of FINRA/NYSE ratings distribution rules, our Overweight rating falls into a buy rating category; our Neutral rating falls into a hold rating category; and our Underweight rating falls into a sell rating category. Please note that stocks with an NR designation are not included in the table above.

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