

March 10, 2015

Cosmo Lady Holdings Company

Aggressive Push for Growth; Execution Is Key

Industry View
In-Line

Stock Rating
Overweight

We think Cosmo Lady is on track for strong growth in 2015, supported by a solid supply chain, improving IT system, and a multi-brand strategy. The aggressive use of working capital in 2014 adds pressure on cash flow, but we expect improvement in 2015. Remain OW.

Off to a good start in 2015: SSSG in the first two months reached positive double digits, according to management. Excluding one-off benefits from a later Chinese New Year in 2015, broadened product offerings in men's underwear and the higher-end line of the "Secret" brand should continue to drive SSSG re-acceleration in 2015, in our view.

During the results briefing, management remained upbeat on the expansion plan of adding 1,200 stores for the main Cosmo brand and 200-300 stores for each new brand (Free Day, Ordifen) in 2015. eCommerce development continues to track ahead of our expectation as Cosmo deepens its partnerships with the major online platforms and extends into more categories.

More clarity on 2014 operating cash outflow: Cosmo invested heavily into growth by increasing its net working capital by RMB507M in 2014. Cosmo made higher rental prepayment (mostly 12 months) for most of its retail stores to capture more favorable lease terms (around 8-10% discount). Our channel checks with several major pedestrian street retail chains indicate that while the practice is common, many retailers tend not to adopt it nowadays, given a lower degree of flexibility in operation and the uncertainties in the street retail landscape. In addition, the trade-related cash cycle also lengthened by 13 days, to 62 days, in 2014. We see higher risks to cash flow from this aggressive approach by Cosmo, but still within manageable limits.

We believe that Cosmo's channel control capabilities are much better than most of its peers have; therefore, it can afford to trade some cash flow in the near term in exchange for a faster pace of market share gain.

We also think operating cash flow should improve in 2015 as the cash cycle normalizes. Execution remains key.

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Cosmo Lady Holdings Company (2298.HK , 2298 HK)

Hong Kong/China Discretionary / China

Stock Rating**Overweight****Industry View****In-Line**

Shr price, close (Mar 9, 2015)

HK\$5.22

52-Week Range

HK\$6.10-3.17

Sh out, dil, curr (mn)

1,500

Mkt cap, curr (mn)

Rmb6,322

EV, curr (mn)

Rmb6,032

Avg daily trading value (mn)

HK\$18

Fiscal Year Ending	12/13	12/14e	12/15e	12/16e
ModelWare EPS (Rmb)	0.20	0.23	0.29	0.38
Prior ModelWare EPS (Rmb)	-	-	-	-
Consensus EPS (Rmb)\$	-	0.23	0.29	0.37
Revenue, net (Rmb mn)	2,916	3,887	5,024	6,507
EBITDA (Rmb mn)	383	561	766	1,022
ModelWare net inc (Rmb mn)	296	438	562	717
P/E	-	18.5	14.3	11.2
P/BV	-	4.1	3.0	2.5
RNOA (%)	57.0	65.0	56.6	54.1
ROE (%)	48.8	63.7	25.5	27.2
EV/EBITDA	-	13.8	7.9	5.8
Div yld (%)	-	1.7	2.1	2.6
Leverage (EOP) (%)	(42.2)	(58.3)	(51.7)	(48.8)

Unless otherwise noted, all metrics are based on Morgan Stanley ModelWare framework
 \$ = Consensus data is provided by Thomson Reuters Estimates
 e = Morgan Stanley Research estimates

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Analysis

Dissecting operating cash flow

2014 operating cash flow was -RMB54M (vs. our estimate of +RMB343M), mainly reflecting the increase in net working capital (up RMB507M vs. our estimate of up RMB97M). We think the aggressive usage of working capital could enable Cosmo Lady to push for faster growth, but also leaves less flexibility in its operations.

Exhibit 1: Operating Cash Flow, 2014 Actual vs. Our Estimates

Operating cash flow	2013A	2014A	2014E	2014 Diff.	Note
Net income	276	425	405	20	
Depreciation and amortization add-back	30	38	43	(4)	
Finance income	(5)	(12)	(8)	(4)	
Finance costs	1	0	0	0	
(Increase)/decrease in net working capital :	(92)	(507)	(97)	(410)	
Trade receivables	8	(110)	(35)	(75)	TR Days down from 22D in 2013 to 21D in 2014 (vs. MSe: 18D)
Deposits, prepayment and other receivables	(23)	(234)	(30)	(203)	Mainly due to higher prepaid rental expenses and VAT recoverable
Inventory	(104)	(234)	(137)	(97)	Inv Days up from 72D in 2013 to 78D in 2014 (vs. MSe: 74D)
Trade payables	(18)	51	57	(6)	TP Days down from 45D in 2013 to 37D in 2014 (vs. MSe: 39D)
Accruals and other payables	46	20	49	(29)	Mainly due to lower receipts in advance from customers
Other operating cash flow items	8	2	0	2	
Cash flow from operations	218	(54)	343	(397)	

Source: Company data, Morgan Stanley Research (E) estimates

Key items to note:

1. Trade receivable days were at 21 in 2014 (vs. our estimate of 18). The aging profile deteriorated moderately as TR due within 30 days accounted for 54% of total in 2014 (vs. 71% in 2013). The general credit terms with franchise customers are 60-90 days. If we look at the percentage of TR due within 90 days, that remains fairly stable at 94% in 2014 (vs. 95% in 2013).
2. Deposits, prepayment and other receivables caused the biggest delta vs. our forecast. According to management, the increase of RMB234M in 2014 stemmed mainly from higher prepaid rental expenses (roughly RMB150M) and higher VAT recoverable (roughly RMB60-70M). In 2H14, Cosmo took a more aggressive approach towards retail store expansion. In order to negotiate for better rental rates (roughly 8-10% discount), Cosmo decided to pay 12 months of rental in advance for most of the new self-operated store openings and for store renewals in 2014. In some cases, Cosmo was also able to get better locations by paying the landlords 12 months in advance.
3. Inventory days went up from 72 days in 2013 to 78 days in 2014. This is higher than our estimate of 74 days; we were expecting improvement in like-for-like inventory turnover days in both retail and wholesale, while the actual inventory turnover days were rather flattish YoY in 2014. We think there is still room for improvement in 2015 as Cosmo upgrades its information system across the supply chain.

Exhibit 2: Aging Analysis of Trade Receivables

Trade Receivables, Gross	2013A	2014A
– Within 30 days	124	154
– Over 30 days and within 60 days	33	89
– Over 60 days and within 90 days	7	21
– Over 90 days and within 180 days	8	13
– Over 180 days and within 360 days	1	3
– Over 360 days	0	3
Total	173	282
Mix %	2013A	2014A
– Within 30 days	71%	54%
– Over 30 days and within 60 days	19%	32%
– Over 60 days and within 90 days	4%	8%
– Over 90 days and within 180 days	5%	5%
– Over 180 days and within 360 days	0%	1%
– Over 360 days	0%	1%

Source: Company data, Morgan Stanley Research

Exhibit 3: Aging Analysis of Trade Payables

Trade Payables	2013A	2014A
– Within 30 days	52	22
– Over 30 days and within 60 days	69	94
– Over 60 days and within 90 days	52	69
– Over 90 days and within 180 days	36	63
– Over 180 days and within 360 days	11	22
– Over 360 days	0	1
Total	219	270
Mix %	2013A	2014A
– Within 30 days	24%	8%
– Over 30 days and within 60 days	32%	35%
– Over 60 days and within 90 days	24%	25%
– Over 90 days and within 180 days	16%	23%
– Over 180 days and within 360 days	5%	8%
– Over 360 days	0%	0%

Source: Company data, Morgan Stanley Research

Other key takeaways from the analyst briefing

1. Online sales: Cosmo Lady's online sales showed strong performance. During the March 8 Women's Festival on Tmall, Cosmo Lady ranked #2 in terms of traffic, #5 in terms of volume and #9 in terms of sales value. The company plans to add more categories and drive higher spending per customer as it captures a strong base of online intimate wear shoppers.
2. Guidance on 2015 capital expenditure: Rmb150~200M.
3. 2015 network expansion plan: Cosmo management indicated a similar pace of store openings for its main Cosmo brand, i.e. +1,200 stores, with a target mix of 20% self-operated stores vs. 80% franchisee stores. It will also push for store growth for new brands.
4. 2015 SSSG: The company seeks to maintain/improve its SSSG in 2015 from the single-digit level achieved in 2014 (+2.5% in 2014, by our estimate). SSSG in the first two months of 2015 was encouraging, recording double-digit growth, benefiting from a later Chinese New Year in 2015 vs. 2014.

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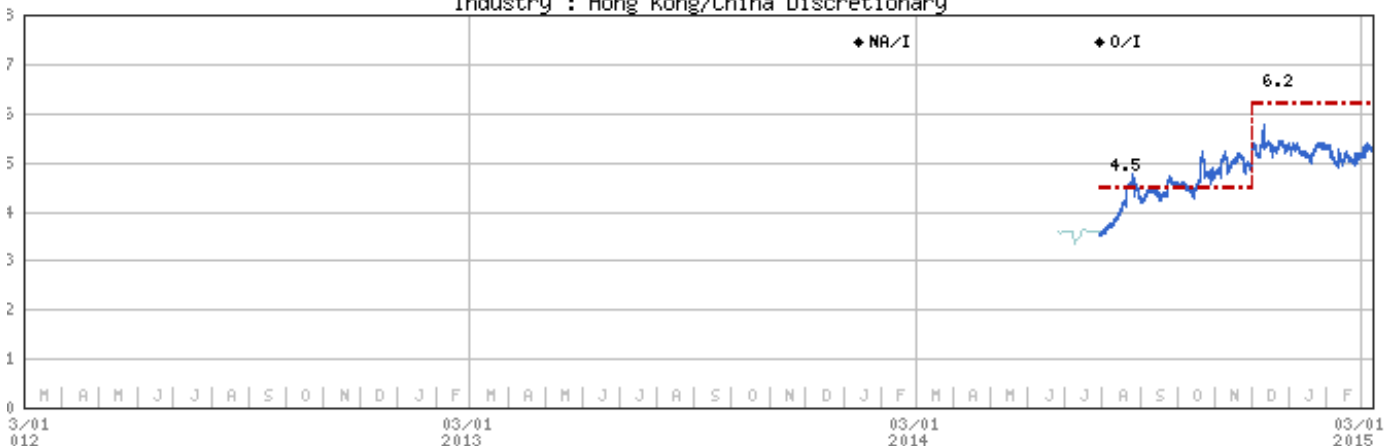
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INDUSTRY COVERAGE: Hong Kong/China Discretionary

COMPANY (TICKER)	RATING (AS OF)	PRICE* (03/09/2015)
Gu, Robby		
Cosmo Lady Holdings Company (2298.HK)	O (07/30/2014)	HK\$5.22
Esprit Holdings (0330.HK)	U (12/19/2012)	HK\$7.67
Giordano International (0709.HK)	U (11/24/2014)	HK\$3.69
Global Brands Group Holding (0787.HK)	U (12/09/2014)	HK\$1.24
Goodbaby International Holdings (1086.HK)	O (08/12/2014)	HK\$2.55
Li & Fung Ltd (0494.HK)	U (12/09/2013)	HK\$8.08
Samsonite International (1910.HK)	O (08/29/2013)	HK\$25.65
Lin, Robert		
Belle International (1880.HK)	E (05/22/2013)	HK\$8.23
Daphne International Holdings (0210.HK)	O (08/21/2014)	HK\$1.89
Golden Eagle Retail Group Limited (3308.HK)	E (11/23/2012)	HK\$9.55
Intime Retail (Group) (1833.HK)	O (03/21/2013)	HK\$4.81
New World Department Store China Limited (0825.HK)	E (08/12/2014)	HK\$1.93
Parkson Retail Group Limited (3368.HK)	E (02/24/2014)	HK\$1.63
Springland International Holdings (1700.HK)	O (01/31/2011)	HK\$2.46
Sun Art Retail Group Limited (6808.HK)	U (06/19/2014)	HK\$6.43
Lui, Edward		
ANTA Sports Products (2020.HK)	E (05/26/2013)	HK\$16.50
Chow Sang Sang Holdings International (0116.HK)	E (11/26/2013)	HK\$17.82
Chow Tai Fook Jewellery Group Ltd. (1929.HK)	E (02/27/2015)	HK\$8.71
Hengdeli Holdings Ltd. (3389.HK)	E (01/02/2013)	HK\$1.40
Li Ning (2331.HK)	U (07/19/2011)	HK\$3.40
Luk Fook Holdings (International) Ltd. (0590.HK)	E (02/27/2015)	HK\$23.55

Stock Ratings are subject to change. Please see latest research for each company.

* Historical prices are not split adjusted.