

Consumer & Retail  
Textiles, Apparel & Luxury  
Goods  
Equity – China

## Overweight

Target price (HKD)	3.80
Share price (HKD)	2.61
Potential return (%)	45.6

Note: Potential return equals the percentage difference between the current share price and the target price

Performance	1M	3M	12M
Absolute (%)	0.0	-21.4	-32.0
Relative <sup>A</sup> (%)	3.0	-22.9	-37.2

Index<sup>A</sup> HANG SENG INDEX

RIC	1368.HK
Bloomberg	1368 HK

Market cap (USDm)	732
Market cap (HKDm)	5,685

Enterprise value (CNYm)	3,199
Free float (%)	25

Note: (V) = volatile (please see disclosure appendix)

13 March 2015

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# Xtep Int'l (1368 HK)

OW: Investing for the race ahead

- **A&P expenses were higher than we expected in 2014 but we think these investments should support sales growth**
- **Future trade fair orders for 3Q15 continued to show growth and there is potential upside from replenishment orders**
- **Remain OW but lower our DCF-based TP to HKD3.8 (from HKD4.5) on a higher tax rate and lower EBIT margin**

**Sales momentum encouraging.** Sales rose 10% yoy in 2014, which was 9% above our estimate. This outperformance was thanks to replenishment orders (growing at a high single digit rate) during the season but also rapid growth from Xtep Kids and e-commerce. The sell-through trend is also very healthy, as 4Q14 SSSG grew at a mid-single digit rate (faster than the flat reported trade fair orders). So even though 3Q15 future trade fair orders were reported at only a low single digit growth rate, we think there is room for upside from replenishment orders thanks to the group's flexible ordering system.

**Investing now for future growth.** Admittedly A&P expenses were higher than we were expecting in 2014, but these investments should enhance the brand image and boost growth in other brands (e.g., Xtep Kids, e-commerce). A&P expenses rose by 28% yoy but the increased spending was for: 1) increased marathon sponsorships, 2) more marketing initiatives for Xtep Kids (e.g., sponsored cartoon series), and 3) upgrading to "Xtep 7<sup>th</sup> generation" stores. These should help sales and profitability; for example, the proportion of functional products has increased to c40% in 2014 (2013: c30%) and footwear (especially running) grew rapidly at 35% yoy, with gross margin at 42.1% (+1.2ppt). So we are already seeing the benefits from past investments in the running category and would expect the new spending to support sales growth. The A&P to sales ratio did increase to 13% in 2014, but this is within the 11-13% historical range and should payoff in sales growth.

**2014 results review.** The group's 2014 net income declined by 21% yoy to RMB478m on 10% yoy growth in sales. Net income was 20% below our estimate and 16% below consensus; sales and gross margin beat our estimates but net income was lower due to higher operating expenses (particularly A&P, AR write-off) and a higher effective tax rate.

**Valuation and risks.** We maintain our OW rating but lower our DCF-based TP to HKD3.8 (from HKD4.50) on a higher tax rate and lower EBIT margin given higher opex investments. Our target price implies 11.2x 2015e PE. Downside risks include lower-than-expected sales from intensified competition and/or unsuccessful brand positioning; higher-than-expected operating expenses or effective tax rate.

## Financials & valuation

### Financial statements

Year to	12/2014a	12/2015e	12/2016e	12/2017e
<b>Profit &amp; loss summary (CNYm)</b>				
Revenue	4,778	5,137	5,512	5,769
EBITDA	867	1,076	1,104	1,151
Depreciation & amortisation	-58	-53	-62	-71
Operating profit/EBIT	809	1,023	1,042	1,081
Net interest	-38	-27	-31	-31
PBT	770	997	1,011	1,049
HSBC PBT	770	997	1,011	1,049
Taxation	-284	-370	-367	-380
Net profit	478	619	636	661
HSBC net profit	478	619	636	661

### Cash flow summary (CNYm)

Cash flow from operations	210	552	580	707
Capex	-106	-150	-150	-150
Cash flow from investment	-538	-150	-150	-150
Dividends	-288	-295	-314	-324
Change in net debt	740	-106	-116	-233
FCF equity	21	402	430	557

### Balance sheet summary (CNYm)

Intangible fixed assets	60	60	60	60
Tangible fixed assets	857	954	1,043	1,122
Current assets	6,947	7,210	7,490	7,805
Cash & others	3,137	3,243	3,359	3,592
Total assets	7,864	8,225	8,593	8,987
Operating liabilities	1,194	1,222	1,261	1,310
Gross debt	1,839	1,839	1,839	1,839
Net debt	-1,298	-1,404	-1,520	-1,753
Shareholders funds	4,700	5,024	5,347	5,683
Invested capital	3,535	3,761	3,976	4,089

### Ratio, growth and per share analysis

Year to	12/2014a	12/2015e	12/2016e	12/2017e
<b>Y-o-y % change</b>				
Revenue	10.0	7.5	7.3	4.7
EBITDA	-9.0	24.2	2.6	4.3
Operating profit	-9.7	26.6	1.8	3.7
PBT	-10.7	29.4	1.4	3.8
HSBC EPS	-21.1	25.8	2.8	3.9

### Ratios (%)

Revenue/IC (x)	1.6	1.4	1.4	1.4
ROIC	16.9	17.6	17.2	17.1
ROE	10.4	12.7	12.3	12.0
ROA	6.7	8.0	7.9	7.8
EBITDA margin	18.1	20.9	20.0	20.0
Operating profit margin	16.9	19.9	18.9	18.7
EBITDA/net interest (x)	22.6	40.5	35.2	36.8
Net debt/equity	-27.6	-27.9	-28.3	-30.7
Net debt/EBITDA (x)	-1.5	-1.3	-1.4	-1.5
CF from operations/net debt				

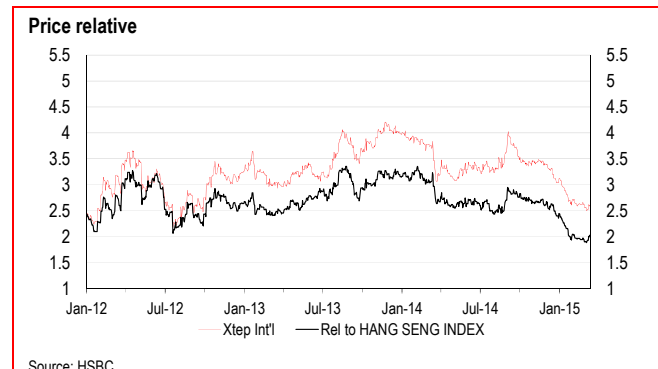
### Per share data (CNY)

EPS reported (fully diluted)	0.22	0.27	0.28	0.29
HSBC EPS (fully diluted)	0.22	0.27	0.28	0.29
DPS	0.13	0.14	0.15	0.15
Book value	2.16	2.31	2.45	2.61

### Valuation data

Year to	12/2014a	12/2015e	12/2016e	12/2017e
EV/sales	0.7	0.6	0.6	0.5
EV/EBITDA	3.8	3.0	2.8	2.5
EV/IC	0.9	0.9	0.8	0.7
PE*	9.7	7.7	7.5	7.2
P/Book value	1.0	0.9	0.9	0.8
FCF yield (%)	0.5	8.7	9.3	12.1
Dividend yield (%)	6.2	6.7	6.9	7.2

Note: \* = Based on HSBC EPS (fully diluted)



Note: price at close of 12 Mar 2015

## Valuation and risks

We lower our DCF-based target price to HKD3.8 (from HKD4.5) on a higher effective tax rate and lower EBIT margin starting in 2016e from higher opex investments. We were previously expecting a higher degree of operating leverage beyond 2015e as sales continues to recover but now think higher A&P spending will be needed for the brand to continue gaining market share. So we have revised our estimates to account for a 1.0pp deterioration in EBIT margin in 2016e (compared to a 0.5pp deterioration previously). Our target price implies 11.2x 2015e PE, which is approximately in-line with the group's historical average of 10.2x since Jun-08.

Our DCF-based target price of HKD3.8 is based on a cost of equity of 10.1% (10.7% previously), beta of 1.2, risk-free rate of 3.5%, equity risk premium of 5.5% (6.0% previously) and terminal growth rate of 0.4%. We change our ERP to be consistent with our strategists' estimates. For the beta of 1.2, we use a 1.2 sector beta and a company-specific beta of 1.0. The sector beta takes into account the limited barriers to entry in the sector, meaning the current growth rates for the company should not prove sustainable. This is the sector beta we use for the sporting goods industry in Europe and the US (Nike, adidas and Puma). Under our research model, for stocks without a volatility indicator, the Neutral band is 5ppts above and below the hurdle rate for China stocks of 9.0%. Our target price implies a potential return of 45.6%, above the Neutral band; therefore, we rate the stock Overweight. Potential return equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated.

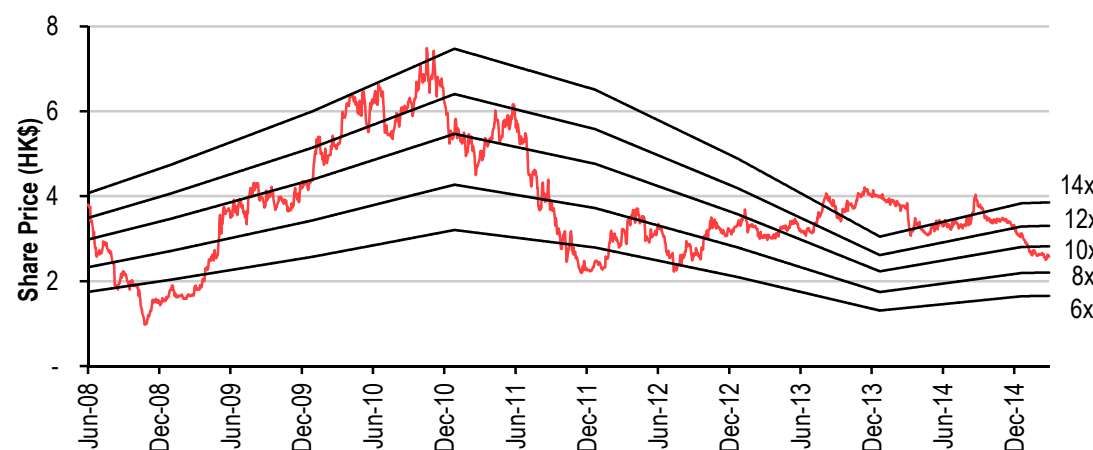
Downside risks include lower-than-expected sales from intensified competition and/or unsuccessful brand positioning, and higher-than-expected operating expenses and effective tax rate that might result in lower-than-expected net margin.

Xtep - Old vs new vs consensus estimates, 2015-16e

	HSBC		2015e	Diff. vs.		HSBC		2016e	Diff. vs.	
	Old	New	Cons.			Old	New	Cons.		
Revenue	4,708	5,137	4,708	9.1%	9.1%	5,069	5,512	5,087	8.7%	8.3%
EBIT	917	1,023	890	11.6%	15.0%	964	1,042	932	8.1%	11.9%
EBIT margin	19.5%	19.9%	18.9%	0.5ppt	1.0ppt	19.0%	18.9%	18.3%	-0.1ppt	0.6ppt
Net profit	615	619	610	0.6%	1.4%	643	636	655	-1.0%	-2.9%
Net profit margin	13.1%	12.0%	13.0%	-1.0ppt	-0.9ppt	12.7%	11.5%	12.9%	-1.1ppt	-1.3ppt

Source: Bloomberg, HSBC estimates

Xtep - 12-month forward PE band chart, Jun'08 to date



Source: Thomson Reuters Datastream, HSBC

# Disclosure appendix

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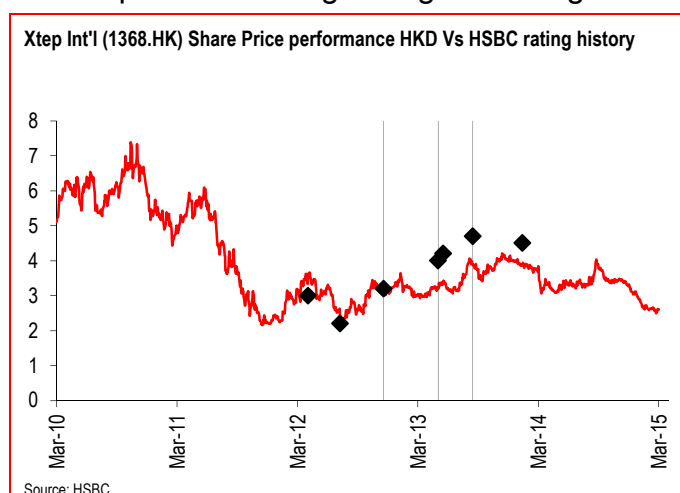
\*A stock will be classified as volatile if its historical volatility has exceeded 40%, if the stock has been listed for less than 12 months (unless it is in an industry or sector where volatility is low) or if the analyst expects significant volatility. However, stocks which we do not consider volatile may in fact also behave in such a way. Historical volatility is defined as the past month's average of the daily 365-day moving average volatilities. In order to avoid misleadingly frequent changes in rating, however, volatility has to move 2.5 percentage points past the 40% benchmark in either direction for a stock's status to change.

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## Share price and rating changes for long-term investment opportunities



### Recommendation & price target history

From	To	Date
Underweight (V)	Neutral (V)	28 November 2012
Neutral (V)	Overweight (V)	12 May 2013
Overweight (V)	Overweight	25 August 2013
Target Price	Value	Date
Price 1	3.00	13 April 2012
Price 2	2.20	19 July 2012
Price 3	3.20	28 November 2012
Price 4	4.00	12 May 2013
Price 5	4.20	28 May 2013
Price 6	4.70	25 August 2013
Price 7	4.50	23 January 2014

Source: HSBC

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