

## Wumart Stores (1025 HK)

### Neutral (V)

Target price (HKD)	6.50
Share price (HKD)	5.60
Potential return (%)	16.1

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

Dec	2014a	2015e	2016e
HSBC EPS	0.37	0.37	0.38
HSBC PE	12.2	12.1	11.9
<b>Performance</b>	<b>1M</b>	<b>3M</b>	<b>12M</b>
Absolute (%)	-0.7	-24.1	-31.7
Relative <sup>a</sup> (%)	1.2	-26.3	-44.7

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

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Downgrade to N(V): cash flow disappointment overshadows strength in earnings

- ▶ **2014 recurring profit 18% better than our estimate, beat on SSSG and consolidated GPM**
- ▶ **Zero dividend was a negative surprise; we expect lower cash flows to be generated from operations**
- ▶ **Downgrade to N(V) from OW(V), lower DCF-based TP to HKD6.5 (from HKD7.7)**

**2014 results were better than expected.** Wumart's FY same-store sales growth (SSSG) was 4.4%, much higher than 0.9% in 1H, thanks to its "low price strategies" implemented from May. Strong suppliers income and rental income offset the negative impact from lowering prices, leading to a 40bp y-o-y expansion in consolidated GPM to 21.2%. Operating profit declined 6.4% y-o-y, as SGA still grew faster at 20% y-o-y than 15.7% growth in consolidated GP. Thanks to lower tax rate, FY recurring net profit grew 2.1% y-o-y to RMB476m, a big improvement from 10% decline in 1H14 and 18% better than our estimate. However, after Wumart booked RMB143m impairment loss from loss-making and closed stores, the reported net profit showed a decline of 14% to RMB395m.

**Zero dividend in 2014 was negative surprise.** Despite the strength in operating results, Wumart for the first time since its listing paid zero dividends (69.8% payout in 2013), justified by its decline in operating cash flow and the plan to increase capex. Its 2014 operating cash flow fell 35% y-o-y to RMB958m due to the decline in OP and the drop in prepaid card sales. Capex in 2015e should increase to RMB600-700m from RMB400m as it plans to open 20 big stores, up from 16. The zero dividend was a negative surprise to us as we upgraded the stock to OW(V) in August 2014 based on dividend yield and cash flow yield. We assume the dividend payout will return to 35% in 2015 and forward, as OP cash flow resumes positive growth from the 35% decline in 2014; but visibility is low.

**We turn more cautious on future cash flows.** Our previous forecasts on cash flow are optimistic as prepaid cards sales will remain weak: the new card sales declined by 11% in 2014 y-o-y and the card used in total sales declined to now 20% from 25% a year earlier. With the government's continued focus on constraining extravagant spending, we now expect customer prepayments to remain flat due to weak prepaid card sales (versus in line with sales growth previously). Offsetting this, better-than-expected 2014 core earnings have led us to raise our 2015 earnings forecast 16%. Net-net, we have cut our FY15 and FY16 OP cash flow forecasts by 25% each, resulting in a cut to our **DCF-based target price to HKD6.5** (from HKD7.7) and **downgrade to N(V)**. The change to our target price are due to the cuts we've made to our earnings and OP cash flow forecasts.

<sup>a</sup> Index	HSCEI
Index level	11,566
RIC	1025.HK
Bloomberg	1025 HK

Source: HSBC

Enterprise value (RMBm)	3,739
Free float (%)	42
Market cap (USDm)	923
Market cap (HKDm)	7,175

Source: HSBC

## Financials & valuation

### Financial statements

Year to	12/2014a	12/2015e	12/2016e	12/2017e
<b>Profit &amp; loss summary (RMBm)</b>				
Revenue	21,638	24,271	26,953	29,778
EBITDA	1,079	1,115	1,155	1,191
Depreciation & amortisation	-444	-479	-514	-548
Operating profit/EBIT	635	636	641	643
Net interest	19	19	24	30
PBT	557	666	676	683
HSBC PBT	664	666	676	683
Taxation	-140	-166	-169	-171
Net profit	395	477	484	490
HSBC net profit	476	477	484	490

### Cash flow summary (RMBm)

Year to	12/2014a	12/2015e	12/2016e	12/2017e
Cash flow from operations	958	1,092	1,146	1,218
Capex	-400	-650	-651	-652
Cash flow from investment	-638	-640	-641	-642
Dividends	0	-143	-145	-147
Change in net debt	560	-328	-385	-460
FCF equity	840	527	586	663

### Balance sheet summary (RMBm)

Year to	12/2014a	12/2015e	12/2016e	12/2017e
Intangible fixed assets	872	867	863	861
Tangible fixed assets	3,633	3,875	4,082	4,255
Current assets	6,708	7,469	8,291	9,204
Cash & others	2,188	2,610	3,089	3,645
Total assets	12,175	13,173	14,199	15,283
Operating liabilities	7,311	7,859	8,428	9,051
Gross debt	1,060	1,154	1,249	1,345
Net debt	-1,128	-1,456	-1,840	-2,300
Shareholders' funds	3,781	4,116	4,455	4,797
Invested capital	1,714	1,742	1,719	1,625

### Ratio, growth and per share analysis

Year to	12/2014a	12/2015e	12/2016e	12/2017e
<b>Y-o-y % change</b>				
Revenue	14.6	12.2	11.1	10.5
EBITDA	-3.2	3.4	3.6	3.1
Operating profit	-6.4	0.2	0.8	0.2
PBT	-22.3	19.6	1.5	1.1
HSBC EPS	2.1	0.3	1.5	1.1

### Ratios (%)

Year to	12/2014a	12/2015e	12/2016e	12/2017e
Revenue/IC (x)	15.0	14.0	15.6	17.8
ROIC	33.0	27.6	27.8	28.8
ROE	12.7	12.1	11.3	10.6
ROA	3.6	3.9	3.7	3.5
EBITDA margin	5.0	4.6	4.3	4.0
Operating profit margin	2.9	2.6	2.4	2.2
Net debt/equity	-28.3	-33.6	-39.2	-45.4
Net debt/EBITDA (x)	-1.0	-1.3	-1.6	-1.9

### Per share data (RMB)

Year to	12/2014a	12/2015e	12/2016e	12/2017e
EPS reported (diluted)	0.31	0.37	0.38	0.38
HSBC EPS (diluted)	0.37	0.37	0.38	0.38
DPS	0.00	0.11	0.11	0.11
Book value	2.94	3.20	3.46	3.73

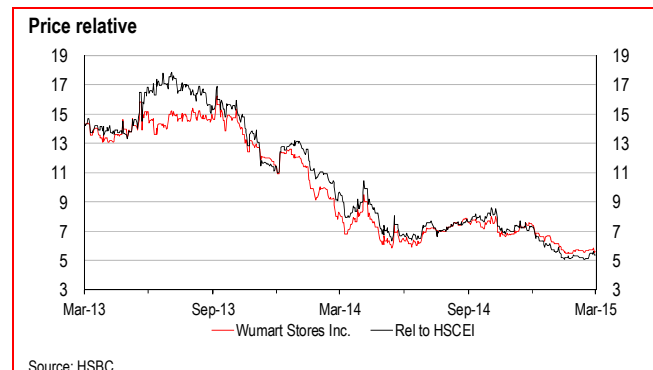
### Key forecast drivers

Year to	12/2014a	12/2015e	12/2016e	12/2017e
Effective OFA growth %	9	6	4	4
Same-store sales %	4	3	3	3
Consolidated gross margin %	21	22	22	23
Effective tax rate %	25	25	25	25
Dividend payout ratio %	0	30	30	30

### Valuation data

Year to	12/2014a	12/2015e	12/2016e	12/2017e
EV/sales	0.2	0.2	0.1	0.1
EV/EBITDA	3.7	3.4	2.9	2.5
EV/IC	2.4	2.1	2.0	1.8
PE*	12.2	12.1	11.9	11.8
PB	1.5	1.4	1.3	1.2
FCF yield (%)	16.2	10.1	11.2	12.6
Dividend yield (%)	0.0	2.5	2.5	2.5

\*Based on HSBC EPS (diluted)



Note: Priced at close of 12 March 2015

# Cash flow disappointment overshadows strength in earnings

- ▶ 2014 recurring profit 18% better than our estimate, beat on SSSG and consolidated GPM
- ▶ Zero dividend was a negative surprise; we expect lower cash flows to be generated from operations
- ▶ Downgrade to N(V) from OW(V) with new DCF-based TP HKD6.5 (old HKD7.7)

## Wumart: Changes to our earnings forecasts

RMBm	2H14e	2H14a	Change	2014e	2014a	Change	2015e old	2015e new	Change	2016e old	2016e new	Change	2017e new
Sales	9,367	9,690	3%	18,579	18,902	2%	20,395	21,113	4%	22,207	23,348	5%	25,691
Other revenue (suppliers income, rental income from sub-leasing)	941	1,514	61%	2,162	2,735	27%	2,437	3,158	30%	2,724	3,605	32%	4,087
Operating Revenue	10,308	11,205	9%	20,741	21,638	4%	22,831	24,271	6%	24,931	26,953	8%	29,778
Gross profit	1,163	953	-18%	2,064	1,854	-10%	2,284	2,102	-8%	2,518	2,360	-6%	2,637
Consolidated gross profit	2,105	2,467	17%	4,226	4,589	9%	4,721	5,260	11%	5,242	5,965	14%	6,724
Total operating expenses	(2,088)	(2,135)	2%	(3,996)	(4,043)	1%	(4,520)	(4,723)	5%	(5,086)	(5,435)	7%	(6,203)
Rental cost	(569)	(618)	9%	(1,090)	(1,140)	5%	(1,257)	(1,370)	9%	(1,434)	(1,606)	12%	(1,849)
Staff cost	(781)	(735)	-6%	(1,477)	(1,431)	-3%	(1,744)	(1,721)	-1%	(2,056)	(2,060)	0%	(2,450)
Operating profit	95	213	124%	517	635	23%	515	636	24%	499	641	29%	643
Profit before tax	143	135	-5%	564	557	-1%	576	666	16%	569	676	19%	683
Net profit	98	88	-10%	404	395	-2%	413	477	16%	408	484	19%	490
Recurring net profit	98	169	73%	404	476	18%	413	477	16%	408	484	19%	490
<b>Key drivers:</b>			<b>Change</b>			<b>Change</b>			<b>Change</b>			<b>Change</b>	
SSSG	1.1%	7.8%	6.7ppt	1.0%	4.4%	3.4ppt	2.0%	3.0%	1.0ppt	2.0%	3.0%	1.0ppt	3.0%
Effective floor area growth (%)		8.4%		7.7%	9.1%	1.4ppt	5.1%	6.4%	1.3ppt	4.2%	4.2%	0.0ppt	4.1%
Staff costs to Revenue ratio	7.6%	6.6%	-1.0ppt	7.1%	6.6%	-0.5ppt	7.6%	7.1%	-0.5ppt	8.2%	7.6%	-0.6ppt	8.2%
Merchandise sales / OP Rev	90.9%	86.5%	-4.4ppt	89.6%	87.4%	-2.2ppt	89.3%	87.0%	-2.3ppt	89.1%	86.6%	-2.4ppt	86.3%
Direct sales margin	12.4%	9.8%	-2.6ppt	11.1%	9.8%	-1.3ppt	11.2%	10.0%	-1.2ppt	11.3%	10.1%	-1.2ppt	10.3%
Staff costs / OP Rev	7.6%	6.6%	-1.0ppt	7.1%	6.6%	-0.5ppt	7.6%	7.1%	-0.5ppt	8.2%	7.6%	-0.6ppt	8.2%
Rental costs / OP Rev	5.5%	5.5%	0.0ppt	5.3%	5.3%	0.0ppt	5.5%	5.6%	0.1ppt	5.8%	6.0%	0.2ppt	6.2%
Effective tax rate	28.4%	29.1%	0.7ppt	25.0%	25.1%	0.1ppt	25.0%	25.0%	0.0ppt	25.0%	25.0%	0.0ppt	25.0%
Consolidated gross margin	20.4%	22.0%	1.6ppt	20.4%	21.2%	0.8ppt	20.7%	21.7%	1.0ppt	21.0%	22.1%	1.1ppt	22.6%
Operating margin	0.9%	1.9%	1.0ppt	2.5%	2.9%	0.4ppt	2.3%	2.6%	0.4ppt	2.0%	2.4%	0.4ppt	2.2%
Net profit margin (/ OP Rev)	0.9%	0.8%	-0.2ppt	1.9%	1.8%	-0.1ppt	1.8%	2.0%	0.2ppt	1.6%	1.8%	0.2ppt	1.6%
Recurring net profit margin (/ OP Rev)	0.9%	1.5%	0.6ppt	1.9%	2.2%	0.2ppt	1.8%	2.0%	0.2ppt	1.6%	1.8%	0.2ppt	1.6%
<b>YoY %</b>													
Sales	10.2%	14.0%		9.4%	11.3%		9.8%	11.7%		8.9%	10.6%		10.0%
Consolidated GP	11.1%	30.2%		11.3%	20.9%		11.7%	14.6%		11.1%	13.4%		12.7%
Operating profit	-46.3%	20.5%		-23.8%	-6.4%		-0.4%	0.2%		-3.1%	0.8%		0.2%
Net profit	-17.9%	-25.9%		-11.9%	-14.0%		2.1%	20.9%		-1.1%	1.5%		1.1%

Source: Company data, HSBC estimates

## Wumart: DCF valuation (RMBm)

**NPV of cash flows** **3,920**

Net cash (debt)	2,825
Equity value	6,745
Number of shares (m)	1,288
<b>Value per share (RMB)</b>	<b>5.2</b>
– HKD : RMB	1.24
<b>Target price (HKD)</b>	<b>6.5</b>

	Explicit 2015	Explicit 2016	Explicit 2017	Semi explicit 2018	Semi explicit 2019	Semi explicit 2020	Semi explicit 2021	Semi explicit 2022	Semi explicit 2023	Semi explicit 2024	Semi explicit 2025	Terminal
<b>Free cash flow calculation</b>												
Sales	24,271	26,953	29,778	31,267	32,830	34,472	36,195	36,195	36,195	36,195	36,195	
Sales growth	12%	11%	10%	5%	5%	5%	5%	0%	0%	0%	0%	
EBIT	636	641	643	587	525	454	376	274	173	72	72	
EBIT margin	2.6%	2.4%	2.2%	1.9%	1.6%	1.3%	1.0%	0.8%	0.5%	0.2%	0.2%	
NOPAT	477	481	482	440	394	341	282	206	130	54	54	
Depreciation	479	514	548	548	548	548	548	548	548	548	548	
Gross cash flow	956	995	1,030	989	942	889	830	754	678	602	602	
Less minority interest EBITDA	42	44	46	44	42	39	37	33	30	27	27	
Increase in working capital	262	347	471	–	–	–	–	–	–	–	–	
Change in WC as a % of inc sales	1.1%	1.3%	1.6%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	
Maintenance capex	350	350	350	400	400	400	400	400	400	400	400	
<b>Free cash flow</b>	<b>773</b>	<b>828</b>	<b>899</b>	<b>545</b>	<b>500</b>	<b>450</b>	<b>393</b>	<b>321</b>	<b>248</b>	<b>175</b>	<b>175</b>	<b>1,436</b>

Year	1	2	3	4	5	6	7	8	9	10	11	11
WACC	11.00%											
<b>PV of cash flow</b>	<b>697</b>	<b>672</b>	<b>657</b>	<b>359</b>	<b>297</b>	<b>240</b>	<b>189</b>	<b>139</b>	<b>97</b>	<b>62</b>	<b>56</b>	<b>456</b>
<b>NPV of cash flows</b>	<b>3,920</b>											
Number of shares (m)	1,288											
Long-term growth rate	0%											

**WACC calculation**

Cost of equity	11.75%
Cost of debt	6.0%
Tax rate	25.0%
Target equity ratio	90%
Target debt ratio	10%
Risk-free rate (Rf)	3.5%
Equity risk premium	5.5%
Sector beta	1.0
Specific beta	1.5
<b>WACC</b>	<b>11.0%</b>

Source: Company data, HSBC estimates

## Valuation

Though there are fluctuations in earnings resulting from investing in new stores and variations in SSSG assumptions, cash flows from existing stores continue to have high visibility. As a result, we set our target price for Wumart based on DCF.

Our DCF approach combines our earnings model and EBITDA estimates with our assumptions on depreciation, working capital, taxes, and debt levels. We explicitly estimate minority interest EBITDA and then strip this out of consolidated operating earnings. We model cash flows and EBITDA explicitly up to 2017, after which we build in semi-explicit cash flow estimates running off a sales growth assumption and a profitability metric through to 2025. After this stage, we move to a terminal valuation phase. Our DCF assumptions include a 5.5% China equity risk premium and a 0% terminal growth rate, while Wumart has a 6% cost of debt and a target 10:90 debt-to-equity ratio, yielding a cost of capital of 11.0%.

Our new DCF-based target price is HKD6.5 (was HKD7.7). The lower target price results from the cuts to our FY15 and FY16 operating cash flow estimates (by 25% for each year).

Under our research model, the Neutral band for volatile stocks equals the local market hurdle rate set by HSBC's Global Equity Strategy team (8.5% for Hong Kong-traded stocks), plus or minus 10ppt. Our target price implies a potential return of 16%; we therefore downgrade our rating on the shares to Neutral(V) from Overweight (V). Potential return equals the percentage difference between the current share price and the target price, plus the forecast dividend yield when indicated.

**Downside risks to our rating and estimates** include aggressive pricing strategies that do not lead to market share gains and faster than- expected cost appreciation. **Upside risks** to our view include (1) a sector re-rating driven by a pick-up in inflation or a normalization in demand following the government's curb on extravagant spending; (2) improvement in the OP cash flow situation; and (3) resumption of dividend payout.

# Disclosure appendix

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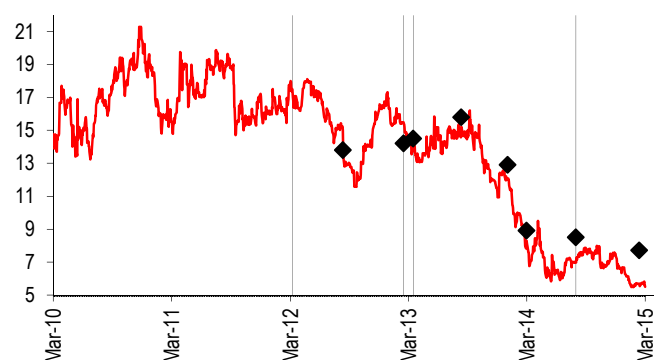
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Overweight (Buy)	41%	(30% of these provided with Investment Banking Services)
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## Share price and rating changes for long-term investment opportunities

Wumart Stores Inc. (1025.HK) share price performance HKD vs HSBC rating history



Source: HSBC

### Recommendation & target price history

From	To	Date
Neutral (V)	Underweight (V)	20 March 2012
Underweight (V)	Underweight	26 February 2013
Underweight	Neutral	27 March 2013
Neutral	Overweight (V)	11 August 2014
Target price	Value	Date
Price 1	13.80	22 August 2012
Price 2	14.20	26 February 2013
Price 3	14.50	27 March 2013
Price 4	15.80	22 August 2013
Price 5	12.90	13 January 2014
Price 6	8.90	12 March 2014
Price 7	8.50	11 August 2014
Price 8	7.70	22 February 2015

Source: HSBC

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