

Li Ning Co., Ltd.

## 2014 results in line; expect losses to narrow

Li Ning reported a 2014 net loss of RMB781m, in line with our estimate and Bloomberg consensus, as well as the profit warning announced in January. Gross margin was relatively flat y/y at 44.6% despite a higher proportion of direct sales and new products. Management said it is optimistic that the company will reverse losses by 2015 and the company has made positive changes such as lowering account receivable provisions and clearing obsolete inventory. However, we believe Li Ning will continue to face challenges such as controlling operating expenses and cash usage with an expanding direct-retail network. We raise our 2015E and 2016E earnings by 9.4% and 5.5%, respectively, to reflect our expectation for better sales data and reduced marketing expenses, but remain EW as we believe investment in the transformation plan will take time to filter through to earnings. We lower our PT 23% to HK\$3.56 to reflect the higher number of shares outstanding.

**Sales showing signs of improvement but margin improvement could be tricky:** 1) trade fair orders recorded five consecutive quarters of growth up to 3Q15, with the latest season seeing high teens growth y/y; 2) SSS recorded mid-single-digit growth in 4Q14; 3) while a greater percentage of sales coming from the direct-retail operation should help sales growth and gross margins, we expect the positives to be offset by higher overhead cost pressure, and the sports life segment could face intense competition from both local and international brands; 4) management's focus will likely be on supply chain management (operating a demand-driven model with faster market-response), and "lifestyle" concept products that appeal to younger customers.

**2014 review:** 1) sales increased 16% y/y to RMB6.7bn (up 23% in 2H14); 2) gross margin was relatively flat y/y at 44.6%; 3) the percentage of receivables over 180 days accounted for 26% of total AR (flat y/y); 4) there were a total of 5,626 stores at end-2014 (-4.9% y/y); and 5) Lin Ning has been appointed interim CEO.

**Earnings and PT revisions:** We raise our 2015E/2016E earnings by 9.4%/5.5% to reflect our expectation for better sales data and reduced marketing expenses, but lower our PT to HK\$3.56 from HK\$4.60 to reflect a higher number of shares outstanding. Our new PT is based on a target P/B of 2.5x now applied to our 2015 BVPS estimate.

### 2331.HK: Financial and Valuation Metrics EPS CNY

FY Dec	2012	2013	2014	2015	2016
EPS	-1.88A	-0.27A	-0.50E	-0.11E	0.21E
Previous EPS	-1.88A	-0.31A	-0.64E	-0.15E	0.25E
P/E	N/A	N/A	N/A	N/A	14.0

Source: Barclays Research.

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PLEASE SEE ANALYST CERTIFICATION(S) AND IMPORTANT DISCLOSURES BEGINNING ON PAGE 5.

Stock Rating **EQUAL WEIGHT**  
Unchanged

Industry View **NEUTRAL**  
Unchanged

Price Target **HKD 3.56**  
lowered -23% from HKD 4.60

Price (18-Mar-2015) HKD 3.62  
Potential -2%  
Upside/Downside  
Tickers 2331 HK / 2331.HK

Market Cap (USD mn) 879  
Shares Outstanding (mn) 1885.21  
Free Float (%) 80.06  
52 Wk Avg Daily Volume (mn) 5.7  
52 Wk Avg Daily Value (USD mn) 2.98  
Dividend Yield (%) N/A  
Return on Equity TTM (%) -31.61  
Current BVPS (CNY) 1.42

Source: Thomson Reuters

Price Performance Exchange-HK  
52 Week range HKD 5.70-2.67



[Link to Barclays Live for interactive charting](#)

### Asia ex-Japan General Retail

Vineet Sharma, CFA

+852 2903 4609

v.sharma@barclays.com

Barclays Bank, Hong Kong

Emily Huang

+886 2 663 84692

emily.huang@barclays.com

BCSTW, Taiwan

Ally Wang

+852 2903 4261

ally.wang@barclays.com

Barclays Bank, Hong Kong

Asia ex-Japan General Retail Industry View: NEUTRAL

## Li Ning Co., Ltd. (2331.HK)

Stock Rating: EQUAL WEIGHT

Income statement (CNYmn)	2013A	2014E	2015E	2016E	CAGR	Price (18-Mar-2015)	HKD 3.62
Revenue	5,824	6,728	7,339	8,481	13.3%	Price Target	HKD 3.56
EBITDA	24	-328	77	753	216.4%	<b>Why Equal Weight?</b> We expect the company to turn profitable in 2016 on aggressive inventory clearance and channel restructuring. While we expect top-line growth to occur and gross margins to be strong, it will likely take time to turn profitable as the company is still in the investment phase of its transformation plan.	
EBIT	-169	-529	-136	529	N/A		
Pre-tax income	-317	-665	-176	489	N/A		
Net income	-392	-781	-172	325	N/A		
EPS (reported) (CNY)	-0.27	-0.50	-0.11	0.21	N/A		
Diluted shares (mn)	1,455	1,564	1,564	1,564	2.4%		
DPS (CNY)	0.00	0.00	0.00	0.00	N/A		

Margin and return data						Average	Upside case	HKD 4.22
EBITDA margin (%)	0.4	-4.9	1.0	8.9	1.4	Our upside case incorporates faster sell-through and inventory clearance, and better-than-expected cost control. We apply a P/B multiple of 4.5x.		
EBIT margin (%)	-2.9	-7.9	-1.9	6.2	-1.6			
Pre-tax margin (%)	-5.4	-9.9	-2.4	5.8	-3.0			
Net margin (%)	-6.7	-11.6	-2.3	3.8	-4.2			
ROIC (%)	-7.2	-20.9	-3.2	14.1	-4.3	<b>Downside case</b> <span style="float: right;">HKD 3.01</span>		
ROA (%)	-6.5	-13.0	-2.9	5.3	-4.3	Our downside case incorporates worse same-store sales growth and prolonged channel revamp for its distributors. We apply a P/B multiple of 1.0x.		
ROE (%)	-18.2	-33.7	-9.2	16.7	-11.1			

Balance sheet and cash flow (CNYmn)						CAGR	Upside/Downside scenarios
Tangible fixed assets	1,142	1,233	1,171	1,153	0.3%	Price History Prior 12 months	
Intangible fixed assets	381	446	390	333	-4.3%	Price Target Next 12 months	
Cash and equivalents	1,281	1,031	597	894	-11.3%	High	Upside
Total assets	6,017	6,040	5,742	6,441	2.3%	5.70	
Short and long-term debt	846	1,227	1,227	1,227	13.2%		
Net debt/(funds)	-435	196	630	333	N/A		
Other long-term liabilities	1,107	1,191	1,191	1,191	2.5%		
Total liabilities	3,125	3,867	4,055	4,388	12.0%		
Shareholders' equity	2,892	2,169	2,038	2,404	-6.0%		
Change in working capital	566	-27	-138	-85	N/A	Current	Target
Cash flow from operations	-14	-220	67	506	N/A	3.62	3.56
Capital expenditure	-94	-150	-150	-150	N/A		
Free cash flow	-107	-370	-83	356	N/A	2.67 Low	3.01 Downside

Valuation and leverage metrics						Average
P/E (reported) (x)	N/A	N/A	N/A	14.0	14.0	
EV/EBITDA (x)	248.4	-20.5	93.5	9.2	82.6	
FCF yield (%)	-2.0	-6.5	-1.5	6.3	-0.9	
EV/sales (x)	1.0	1.0	1.0	0.8	1.0	
P/BV (x)	1.6	2.3	2.6	2.2	2.2	
Dividend yield (%)	0.0	0.0	0.0	0.0	0.0	
Total debt/capital (%)	6.9	19.1	19.5	19.0	16.1	
Net debt/EBITDA (x)	-18.3	-0.6	8.2	0.4	-2.6	

Selected operating metrics	2013A	2014E	2015E	2016E
Total stores (branded Li Ning)	5,915.0	5,626.0	6,026.0	6,276.0
New stores added	-519	-289	400	250
Inventory turnover days	104	109	122	119
Account receivable days	89	71	66	64
Payment days	106	92	90	88
Promotion ratio	24.2	18.8	15.5	12.1

Source: Company data, Barclays Research  
Note: FY End Dec

Note: The numbers for 2014 remain our estimates or are preliminary headline numbers pending the release of the full set of actual results by the company.

## Earnings revisions

We raise our earnings estimates by 9.4% for 2015 and 5.5% for 2016 to reflect our expectation for better sales data and lower marketing expenses.

FIGURE 1

### Li Ning – Revisions to Barclays estimates

RMB mn	2014A	2015E	2016E
<b>Old estimates</b>			
Sales	6,318	7,082	8,199
Gross profit	2,837	3,204	3,767
Operating profit	-587	-153	489
Pre-tax profit	-673	-203	459
Net profit	-797	-188	307
<b>New estimates</b>			
Sales	6,728	7,339	8,481
Gross profit	3,004	3,323	3,902
Operating profit	-529	-136	529
Pre-tax profit	-665	-176	489
Net profit	-781	-172	325
<b>Change</b>			
Sales	6.1%	3.5%	3.3%
Gross profit	5.6%	3.6%	3.5%
Operating profit	11.0%	12.9%	7.5%
Pre-tax profit	1.3%	15.6%	6.1%
Net profit	1.9%	9.4%	5.5%

Source: Company data, Barclays Research estimates

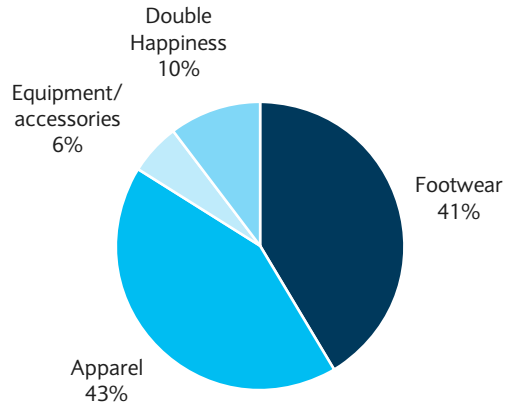
## Valuation

We lower our price target to HK\$3.56 from HK\$4.60 as a result of adjusting for a higher number of shares outstanding (1,885mn, from 1,455m as of end-2014). Our new price target of HK\$3.56 is based on a target P/B multiple of 2.5x (unchanged) now applied to our 2015 BVPS estimate of HK\$1.14 (previously on 2014E BVPS). We use P/B as our valuation methodology as we forecast the company to turn profitable only in 2016. Our target multiple of 2.5x is based on China retail companies' trading average.

## Risks

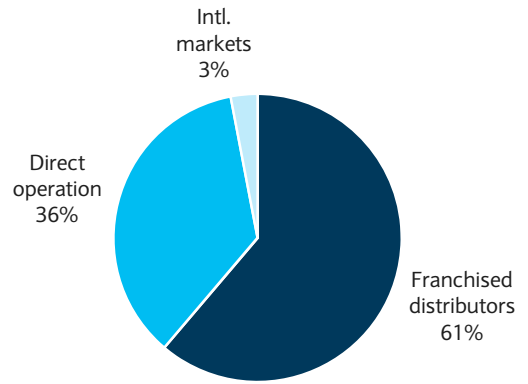
Key downside risks include: 1) execution on the company's transformation plan; 2) a prolonged period for distributors to adopt the new format; and 3) the time needed to translate the change to financials. Key upside risks include: 1) faster-than-expected sell-through; and 2) better-than-expected cost control.

FIGURE 2  
Sales by brand and category as at end-2014



Source: Company data, Barclays Research

FIGURE 3  
Sales by channel as at end-2014



Source: Company data, Barclays Research

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Li Ning Co., Ltd. (2331.HK, 18-Mar-2015, HKD 3.62), Equal Weight/Neutral, J

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CJ O Shopping (035760.KQ)	E-Mart (139480.KS)	Esprit Holdings Limited (0330.HK)
Golden Eagle Retail Group Ltd. (3308.HK)	Gome Electrical Appliances (0493.HK)	Gourmet Master (2723.TW)
GS Home Shopping (028150.KQ)	GS Retail (007070.KS)	Hyundai Department Store (069960.KS)
Hyundai Home Shopping (057050.KS)	Jubilant Foodworks (JUBI.NS)	L'Occitane International (0973.HK)
Li & Fung Limited (0494.HK)	Li Ning Co., Ltd. (2331.HK)	Lifestyle International Holdings Ltd. (1212.HK)
Lotte Shopping (023530.KS)	Luk Fook Holdings (International) Limited (0590.HK)	Page Industries (PAGE.NS)
Parkson Retail Group Ltd. (3368.HK)	PRADA S.p.A. (1913.HK)	President Chain Store (2912.TW)
Sa Sa International (0178.HK)	Samsonite International (1910.HK)	Shinsegae (004170.KS)
Titan Industries (TITN.NS)	Trinity Ltd. (0891.HK)	Wowprime (2727.TW)

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**Li Ning Co., Ltd. (2331 HK / 2331.HK)**  
**HKD 3.62 (18-Mar-2015)**

Stock Rating  
**EQUAL WEIGHT**

Industry View  
**NEUTRAL**

**Rating and Price Target Chart - HKD (as of 18-Mar-2015)**

Currency=HKD



Date	Closing Price	Rating	Adjusted Price Target
14-Aug-2014	4.32		4.18
24-Mar-2014	5.09		4.54
13-Aug-2013	4.60	Equal Weight	4.27
06-Jul-2012	4.06	Underweight	2.25

Source: Thomson Reuters, Barclays Research

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**Valuation Methodology:** Our 12-month price target for Li Ning of HK\$3.56 is based on a target P/B of 2.5x applied to our 2015 BVPS estimate of HK\$1.42. We use P/B as a valuation methodology as we forecast the company to turn profitable only in 2016. Our target multiple of 2.5x is based on China retail companies' trading average.

**Risks which May Impede the Achievement of the Barclays Research Price Target:** Key downside risks to our investment thesis and price target for Li Ning include: 1) execution on the company's transformation plan; 2) a prolonged period for distributors to adopt the new format; and 3) the time needed to translate the change to financials. Key upside risks include: 1) faster-than-expected sell-through; and 2) better-than-expected cost control.



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