

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

Neutral (V)

Target price (HKD)	4.20
Share price (HKD)	4.04
Potential return (%)	4

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

Performance	1M	3M	12M
Absolute (%)	25.1	39.5	-24.9
Relative ^A (%)	26.0	32.8	-41.4

Index ^A	HSCEI
RIC	2331.HK
Bloomberg	2331 HK

Market cap (USDm)	982
Market cap (HKDm)	7,616

Enterprise value (CNYm)	6829
Free float (%)	61

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

19 March 2015

Catherine Chao*

Analyst
 The Hongkong and Shanghai Banking Corporation Limited
 +852 2996 6570
 catherinefchao@hsbc.com.hk

Erwan Rambourg*

Analyst
 The Hongkong and Shanghai Banking Corporation Limited
 852 2996 6572
 erwanrambourg@hsbc.com.hk

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Li Ning (2331 HK)

N(V): Race to recovery not over yet

- ▶ **FY14 results missed on a lower gross margin and higher finance costs**
- ▶ **Although the sales outlook is better than we had previously expected, we think the group will not breakeven in 2015**
- ▶ **Maintain N(V) but lower our DCF-based TP to HKD4.2 (from HKD4.72, adjusted for the share offer) mainly due to the dilution from the convertibles**

2014 results miss. Although the FY14 reported net loss of RMB781m appeared to be in line with consensus, and better than our estimate, the core earnings loss of RMB805m missed our estimate of RMB589m. Sales were better than expected but the gross margin disappointed due to higher COGS (labour cost pass-through) and higher finance costs also weighed. No dividend was declared for FY14 (FY13: HKD0.0).

High execution risk. Management wants to regain market share this year through product adjustments (with a focus on the lifestyle category and key sports like basketball) and channel expansions. The group has a target of adding 500 stores this year (mostly in wholesale), which will result in the first net openings since 2011. However, we are concerned that the wholesale channel may not be ready for such aggressive expansion with high channel inventory (8 months compared to 4-5 months for peers), a sell-through rate of only 72%, and little improvement in AR (26% of receivables still over 180 days due). With future trade fair orders averaging mid- to high-teens growth in 9M14, and only a +10% store expansion, a high-single- to-low-double-digit SSSG (an acceleration from the mid-single-digit rate in 4Q14) is implied to meet such an order growth rate. We think this is an aggressive target given the wholesale channel condition.

Loss likely to continue in 2015. While the sales recovery is encouraging, we think it could be challenging for the group to breakeven in 2015. Operating expenses were cut by RMB200m in 2014 but many are fixed costs (e.g. A&P sponsorships, rental/staff costs from self-operated stores) which limit further reduction. We are forecasting a net loss of RMB169m in 2015, which is lower than consensus (net profit of RMB48m). We are more sceptical than management on sales growth – we forecast 14% sales growth and believe it would need to accelerate to 20% for the group to breakeven.

Maintain N(V) rating but lower TP mainly on share count. We lower our TP to HKD4.2 (from HKD4.72, adjusted for the share offer) mainly to reflect the dilution from the convertibles, as well as lower estimates and a slightly higher WACC. Key upside/downside risks include changes in the consumption environment, the pace of distribution channel reform and inventory clearance, and the level of operating expenses and working capital. **Catalysts:** quarterly operating updates (resuming this year), TPG/GIC CB conversion.

Financials & valuation

Financial statements

Year to	12/2013a	12/2014e	12/2015e	12/2016e
Profit & loss summary (CNYm)				
Revenue	5,824	6,728	7,659	8,632
EBITDA	24	-330	175	569
Depreciation & amortisation	-193	-198	-195	-196
Operating profit/EBIT	-169	-529	-20	372
Net interest	-92	-82	-48	-41
PBT	-317	-665	-105	292
HSBC PBT	-317	-665	-105	292
Taxation	-42	-79	-26	-93
Net profit	-392	-781	-169	160
HSBC net profit	-883	-805	-149	180

Cash flow summary (CNYm)

Cash flow from operations	-120	-374	-59	239
Capex	-99	-150	-150	-100
Cash flow from investment	-325	-150	-150	-100
Dividends	0	0	0	-25
Change in net debt	-1,092	729	-1,545	-114
FCF equity	356	-584	-171	178

Balance sheet summary (CNYm)

Intangible fixed assets	381	446	398	348
Tangible fixed assets	1,674	1,631	1,635	1,588
Current assets	3,962	3,963	5,351	5,779
Cash & others	1,281	1,031	2,177	2,291
Total assets	6,017	6,040	7,384	7,715
Operating liabilities	2,079	2,345	2,467	2,625
Gross debt	1,046	1,525	1,125	1,125
Net debt	-235	494	-1,051	-1,165
Shareholders funds	2,684	1,952	3,336	3,472
Invested capital	2,657	2,663	2,741	2,800

Ratio, growth and per share analysis

Year to	12/2013a	12/2014e	12/2015e	12/2016e
Y-o-y % change				
Revenue	-12.8	15.5	13.8	12.7
EBITDA		-1489.6		224.8
Operating profit				
PBT				
HSBC EPS				
Ratios (%)				
Revenue/IC (x)	2.2	2.5	2.8	3.1
ROIC	-4.4	-20.0	1.4	10.4
ROE	-41.1	-34.7	-5.7	5.3
ROA	-4.2	-10.8	-1.1	3.0
EBITDA margin	0.4	-4.9	2.3	6.6
Operating profit margin	-2.9	-7.9	-0.3	4.3
EBITDA/net interest (x)	0.3		3.7	13.7
Net debt/equity	-8.1	22.8	-29.3	-30.9
Net debt/EBITDA (x)	-9.9	-1.5	-6.0	-2.0
CF from operations/net debt				
Per share data (CNY)				
EPS reported (fully diluted)	-0.27	-0.50	-0.08	0.07
HSBC EPS (fully diluted)	-0.57	-0.48	-0.05	0.10
DPS	0.00	0.00	0.00	0.03
Book value	1.85	1.25	2.05	1.84

Valuation data

Year to	12/2013a	12/2014e	12/2015e	12/2016e
EV/sales	1.0	1.0	0.7	0.6
EV/EBITDA	256.1		30.4	9.2
EV/IC	2.3	2.6	1.9	1.9
PE*				33.7
P/Book value	1.8	2.6	1.6	1.8
FCF yield (%)	5.6	-9.2	-2.7	2.8
Dividend yield (%)	0.0	0.0	0.0	0.8

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



Note: price at close of 19 Mar 2015

Valuation and risks

We lower our DCF-based target price to HKD4.2 (from HKD4.72, adjusted for the share offer) mainly to reflect the dilution from the convertibles, as well as lower estimates and a slightly higher WACC. We lower our 2015-16 earnings estimates to account for a lower-than-expected gross margin after the 2014 results missed in this regard.

Our target price of HKD4.2 is based on a WACC of 9.6% (previously 9.4%) using a risk-free rate of 3.5%, an equity risk premium of 5.5% (previously 6.0%), and a beta of 1.3x. We lower our ERP to be consistent with our equity strategists' estimates but this is more than offset by the lower percentage of debt in the capital structure (25% vs 36% previously) and hence our WACC increases. We assume a terminal growth rate of 0.5%. We use a DCF valuation method to value Li Ning as the near-term earnings momentum is likely to stay weak and volatile due to heavy investment in A&P and it is more appropriate to use DCF to capture future free cash flow.

Under our research model, for stocks with a volatility indicator, the Neutral band is 10ppts above and below the hurdle rate for Hong Kong stocks of 9.0%. Our target price implies a potential return of 4.0%, within the Neutral band; therefore, we reiterate our Neutral (V) rating. Potential return equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated.

Key upside risks:

- ▶ A stronger consumption environment and a faster-than-expected distribution channel reform and inventory clearance, leading to higher-than-expected sell-through and network expansion
- ▶ Lower-than-expected operating expenses (particularly lower A&P spend or higher impairment reversals) that might result in a higher-than-expected net margin

Key downside risks:

- ▶ Lower-than-expected sell-through of products, leading to lower sales and a deterioration of gross margin from higher retail discounting
- ▶ Higher-than-expected operating expenses
- ▶ Higher working capital spending needed, which may put additional pressure on cash flow

Li Ning - HSBC change vs. old, and vs. consensus, 2015-16e

CNYm	2015e				2016e					
	HSBC Old	New	Consensus	Difference vs. old consensus	HSBC Old	New	Consensus	Difference vs. old consensus		
Revenue	7,152	7,659	7,356	7.1%	4.1%	8,080	8,632	8,330	6.8%	3.6%
EBIT	28	(20)	145	nm	nm	399	372	512	-6.8%	-27.2%
EBIT margin	0.4%	-0.3%	2.0%	-0.6ppt	-2.2ppt	4.9%	4.3%	6.1%	-0.6ppt	-1.8ppt
Net profit	(103)	(149)	48	45.2%	nm	205	180	327	-11.9%	-44.8%
Net profit margin	-1.4%	-2.0%	0.7%	-0.5ppt	-2.6ppt	2.5%	2.1%	3.9%	-0.4ppt	-1.8ppt

Source: Bloomberg, HSBC estimates

Disclosure appendix

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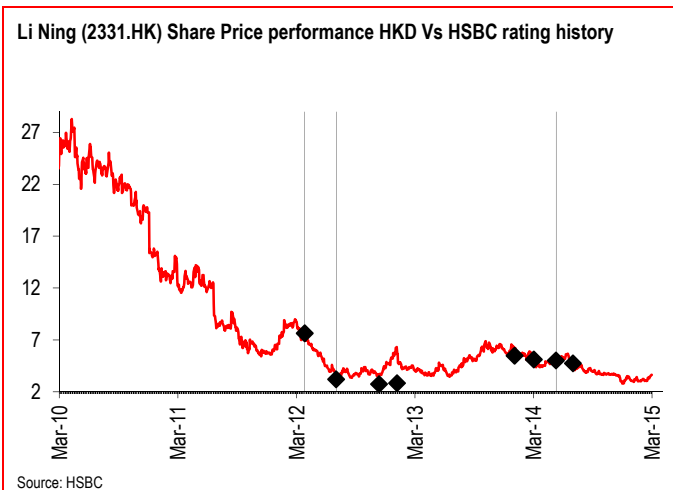
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Share price and rating changes for long-term investment opportunities



Recommendation & price target history

From	To	Date
Underweight (V)	Neutral (V)	13 April 2012
Neutral (V)	Underweight (V)	19 July 2012
Underweight (V)	Neutral (V)	27 May 2014
Target Price	Value	Date
Price 1	7.62	13 April 2012
Price 2	3.18	19 July 2012
Price 3	2.72	28 November 2012
Price 4	2.81	22 January 2013
Price 5	5.45	20 January 2014
Price 6	5.08	20 March 2014
Price 7	4.99	27 May 2014
Price 8	4.72	18 July 2014

Source: HSBC

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Issuer of report

The Hongkong and Shanghai Banking Corporation Limited

Level 19, 1 Queen's Road Central
Hong Kong SAR

Telephone: +852 2843 9111

Fax: +852 2596 0200

Website: www.research.hsbc.com

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