

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

Buy

Target price (HKD)	24.30
Share price (HKD)	18.92
Upside (%)	28.4

Performance	1M	3M	12M
Absolute (%)	-6.8	-6.6	4.8
Relative ^A (%)	-7.2	-12.1	-20.4

Index^A HSCEI

RIC 1836.HK
 Bloomberg 1836 HK

Market cap (USDm) 1,937
 Market cap (HKDm) 15,030

Enterprise value (USDm) 1,747
 Free float (%) 61

23 March 2015

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Stella (1836 HK)

Buy: Picking up the pace

- ▶ **After a tough year in 2014, the outlook is improving for this year for both sales and gross margin**
- ▶ **For the manufacturing business, gross margin should benefit from higher utilization and improved efficiency**
- ▶ **We establish a Buy rating and set a target price of HKD24.3**

Volume acceleration. Management guidance for this year's production orders is maintained to be at a high-single digit growth rate for 2015e, an acceleration from 5% yoy volume growth in 2014. The group is gaining orders from several factors, including increased proportion of production from existing customers, ramping up select new customers, and winning share away from other factories as brand customers look to consolidate their supplier network. As the group is ramping up production, working capital was higher (particularly inventory to prepare raw materials accordingly) but we believe this level should normalize after the initial stocking is completed into 2015e.

Gross margin improvement likely. Labor costs continue to bring pressure, particularly in China, where additional benefits (housing allowance, social security) are being mandated. However, higher utilization from more volume should help achieve leverage on overhead and other fixed costs. In addition, the group has been concentrating on building up the overall production efficiency so incrementally this helps to offset the higher labor costs. We expect OEM gross margin will continue to improve, from 17.9% in 1H14 and 18.6% in 2H14 to 19.0% in 2015e. Hence, we think the stock could re-rate on the positive earnings momentum, with core earnings growth acceleration from 4% in 2014 to 17% in 2015e.

2014 results review. FY14 net income came in at USD121m (-2% yoy) on 8% yoy sales growth. Sales were already known and operationally, core earnings were in-line but reported earnings missed our estimate by 6% due to one-off impairments. Management declared a final DPS of HKD0.55, implying a full-year payout of 72% (2013: 79%, including special dividends).

We establish a Buy rating. We set our PB-based target price at HKD24.3, which implies 16.4x 2015e PE. Downside risks include lower manufacturing orders and lower-than-expected cost savings and efficiency from production relocation. **Catalysts:** 1Q15 sales update (to be released in April) and higher guidance from brand customers.

Financials & valuation

Financial statements

Year to	12/2014a	12/2015e	12/2016e	12/2017e
Profit & loss summary (USDm)				
Revenue	1,663	1,769	1,842	1,899
EBITDA	177	208	230	248
Depreciation & amortisation	-40	-44	-48	-52
Operating profit/EBIT	137	164	182	196
Net interest	3	2	3	4
PBT	136	166	186	200
HSBC PBT	136	166	186	200
Taxation	-16	-20	-23	-25
Net profit	121	147	164	176
HSBC net profit	125	147	164	176

Cash flow summary (USDm)

Cash flow from operations	59	207	206	208
Capex	-79	-55	-50	-50
Cash flow from investment	-77	-53	-47	-46
Dividends	-97	-103	-115	-123
Change in net debt	117	-51	-45	-39
FCF equity	-28	154	159	162

Balance sheet summary (USDm)

Intangible fixed assets	0	0	0	0
Tangible fixed assets	386	397	399	397
Current assets	793	839	893	952
Cash & others	132	183	228	267
Total assets	1,186	1,244	1,299	1,356
Operating liabilities	234	247	254	260
Gross debt	0	0	0	0
Net debt	-132	-183	-228	-267
Shareholders funds	952	996	1,045	1,098
Invested capital	814	806	810	824

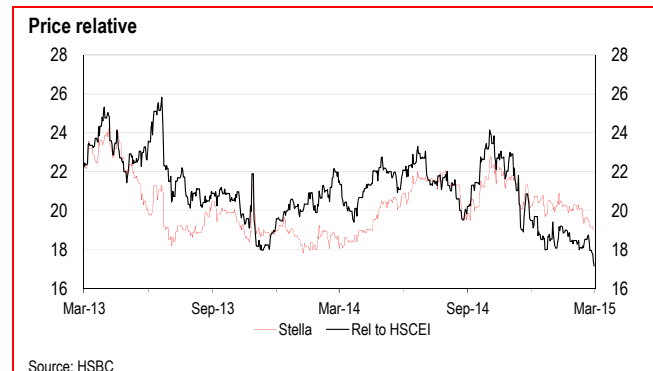
Ratio, growth and per share analysis

Year to	12/2014a	12/2015e	12/2016e	12/2017e
Y-o-y % change				
Revenue	7.9	6.4	4.1	3.1
EBITDA	6.6	17.8	10.7	7.4
Operating profit	5.2	19.4	11.4	7.5
PBT	-1.1	22.4	11.7	7.7
HSBC EPS	4.3	16.9	11.5	7.5
Ratios (%)				
Revenue/IC (x)	2.2	2.2	2.3	2.3
ROIC	16.3	17.8	19.8	21.0
ROE	13.3	15.1	16.1	16.4
ROA	10.2	12.0	12.8	13.2
EBITDA margin	10.6	11.8	12.5	13.0
Operating profit margin	8.2	9.2	9.9	10.3
EBITDA/net interest (x)				
Net debt/equity	-13.8	-18.4	-21.8	-24.3
Net debt/EBITDA (x)	-0.7	-0.9	-1.0	-1.1
CF from operations/net debt				
Per share data (USD)				
EPS reported (fully diluted)	0.15	0.18	0.21	0.22
HSBC EPS (fully diluted)	0.16	0.18	0.21	0.22
DPS	0.11	0.13	0.15	0.16
Book value	1.20	1.25	1.32	1.38

Valuation data

Year to	12/2014a	12/2015e	12/2016e	12/2017e
EV/sales	1.1	1.0	0.9	0.9
EV/EBITDA	10.2	8.4	7.4	6.7
EV/IC	2.2	2.2	2.1	2.0
PE*	15.4	13.2	11.8	11.0
P/Book value	2.0	1.9	1.9	1.8
FCF yield (%)	-1.5	8.0	8.3	8.4
Dividend yield (%)	4.5	5.3	6.0	6.4

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



Note: price at close of 20 Mar 2015

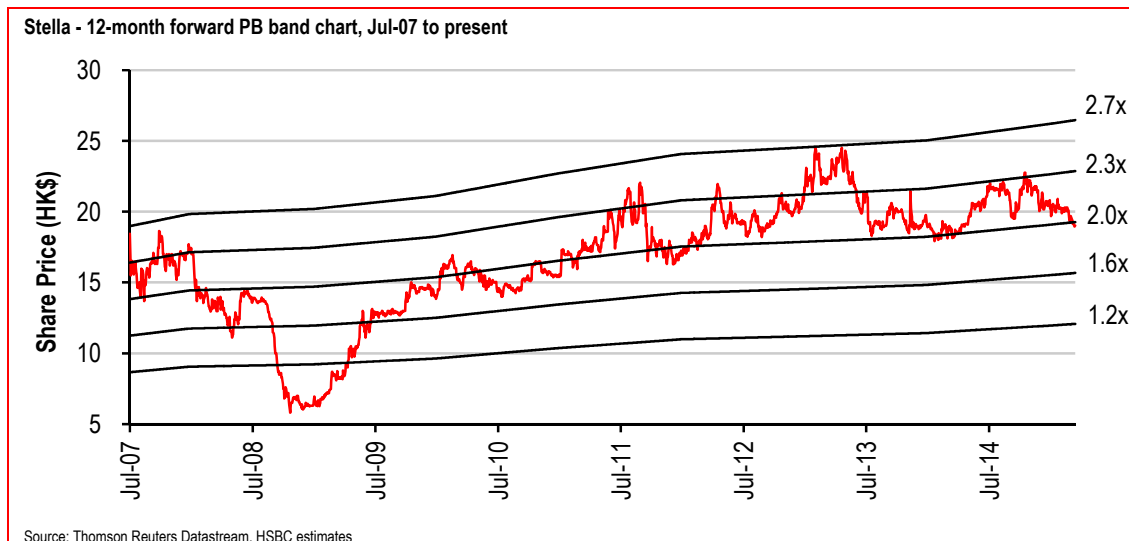
Valuation and risks

Our PB-based target price of HKD24.3 implies a 2015e PE of 16.4x. We slightly lower our earnings estimates by 5% and 4% in 2015-16e to account for lower other income (assuming similar level to 2014) and for a higher effective tax rate (higher proportion of production from inland China).

We use a PB methodology to value Stella as: 1) it is asset rich, and 2) historically, earnings have been volatile, and we prefer to focus on longer-term growth. It is also consistent with the methodology we use for Stella's closest peer, Yue Yuen.

Our target PB multiple of 2.5x 12-month forward PB represents 1.5 standard deviations above the group's historical average trading level since listing in July 2007. We think using 1.5SD above the historical average PB multiple is appropriate given the expected ROE recovery starting in 2015e. We cross reference our target multiple against a Gordon growth model. We assume a COE of 9.0% (previously 9.5%), a WACC of 9.0% (previously 9.5%), a 2015e ROE of 15% (previously 16%) and a terminal growth of 5%, which results in a PB multiple of 2.4x, approximately in-line with the target PB used to derive our target price. We lower our COE to be consistent with our strategists' estimates.

Key downside risks include lower-than-expected orders from brand customers, higher-than-expected wage inflation, lower-than-expected cost savings from shifting production outside of Guangdong, and lower-than-expected SSSG in the retail segment.



Stella - changes vs old vs consensus estimates

In USDm	2015e				2016e					
	HSBC Old	New	Consensus	Difference vs. old consensus	HSBC Old	New	Consensus	Difference vs. old consensus		
Revenue	1,771	1,769	1,780	-0.1%	-0.6%	1,845	1,842	1,909	-0.2%	-3.5%
EBIT	168	164	163	-2.3%	0.5%	186	182	183	-2.0%	-0.4%
EBIT margin	9.5%	9.2%	9.1%	-0.2ppt	0.1ppt	10.1%	9.9%	9.6%	-0.2ppt	0.3ppt
Net profit	155	147	152	-5.1%	-3.1%	171	164	170	-4.3%	-3.7%
Net profit margin	8.7%	8.3%	8.5%	-0.4ppt	-0.2ppt	9.3%	8.9%	8.9%	-0.4ppt	0.0ppt

Source: Bloomberg, HSBC estimates

Disclosure appendix

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From 23rd March 2015 HSBC has assigned ratings on the following basis:

The target price is based on the analyst's assessment of the stock's actual current value, although we expect it to take six to 12 months for the market price to reflect this. When the target price is more than 20% above the current share price, the stock will be classified as a Buy; when it is between 5% and 20% above the current share price, the stock may be classified as a Buy or a Hold; when it is between 5% below and 5% above the current share price, the stock will be classified as a Hold; when it is between 5% and 20% below the current share price, the stock may be classified as a Hold or a Reduce; and when it is more than 20% below the current share price, the stock will be classified as a Reduce.

Our ratings are re-calibrated against these bands at the time of any 'material change' (initiation or resumption of coverage, change in target price or estimates).

Upside/Downside is the percentage difference between the target price and the share price.

Prior to this date, HSBC's rating structure was applied on the following basis:

For each stock we set a required rate of return calculated from the cost of equity for that stock's domestic or, as appropriate, regional market established by our strategy team. The target price for a stock represented the value the analyst expected the stock to reach over our performance horizon. The performance horizon was 12 months. For a stock to be classified as Overweight, the potential return, which equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated, had to exceed the required return by at least 5 percentage points over the succeeding 12 months (or 10 percentage points for a stock classified as Volatile*). For a stock to be classified as Underweight, the stock was expected to underperform its required return by at least 5 percentage points over the succeeding 12 months (or 10 percentage points for a stock classified as Volatile*). Stocks between these bands were classified as Neutral.

*A stock was classified as volatile if its historical volatility had exceeded 40%, if the stock had been listed for less than 12 months (unless it was in an industry or sector where volatility is low) or if the analyst expected significant volatility. However, stocks which we did not consider volatile may in fact also have behaved in such a way. Historical volatility was 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 had to move 2.5 percentage points past the 40% benchmark in either direction for a stock's status to change.

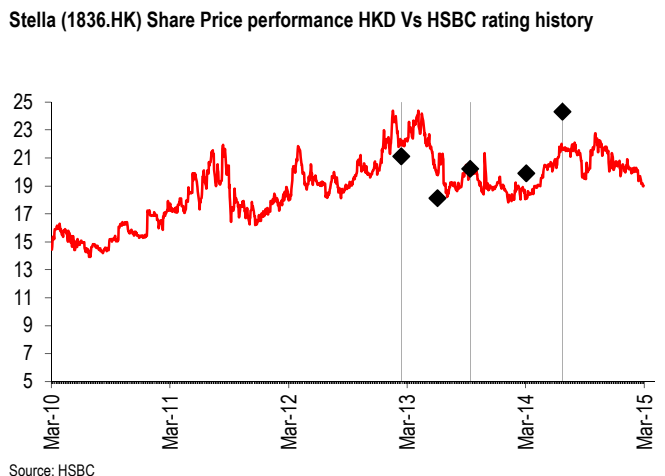
Rating distribution for long-term investment opportunities

As of 22 March 2015, the distribution of all ratings published is as follows:

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For the purposes of the distribution above the following mapping structure is used during the transition from the previous to current rating models: under our previous model, Overweight = Buy, Neutral = Hold and Underweight = Sell; under our current model Buy = Buy, Hold = Hold and Reduce = Sell. For rating definitions under both models, please see “Stock ratings and basis for financial analysis” above.

Share price and rating changes for long-term investment opportunities



Recommendation & price target history

From	To	Date
N/A	Underweight	04 March 2013
Underweight	Neutral	02 October 2013
Neutral	Overweight	13 July 2014
Target Price	Value	Date
Price 1	21.10	04 March 2013
Price 2	18.10	23 June 2013
Price 3	20.20	02 October 2013
Price 4	19.90	24 March 2014
Price 5	24.30	13 July 2014

Source: HSBC

HSBC & Analyst disclosures

Disclosure checklist

Company	Ticker	Recent price	Price Date	Disclosure
STELLA	1836.HK	19.02	20-Mar-2015	7

Source: HSBC

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