

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

## Buy

Target price (HKD)	1.90
Share price (HKD)	1.46
Upside/Downside (%)	30.1

Performance	1M	3M	12M
Absolute (%)	10.6	5.0	-6.4
Relative <sup>A</sup> (%)	11.7	0.0	-17.1

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

RIC   3818.HK  
 Bloomberg                               3818 HK

Market cap (USDm)                       1,042  
 Market cap (HKDm)                       8,083

Free float (%)                               47

**26 March 2015**

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# China Dongxiang (3818 HK)

Buy: Back in the game

- ▶ **2014 results were boosted by a one-off disposal gain but the core sportswear business is showing improvement**
- ▶ **Improving margins and stabilizing retail network indicate better prospects for the Kappa brand in China**
- ▶ **We establish a Buy rating on the stock and set a fair value target price of HKD1.90 (from HKD1.82)**

**Encouraging turnaround in Kappa.** For the first time, sales for the Kappa brand in China have shown signs of stabilizing. Sales were flat and the group opened net 126 stores in 2H14 (both in self-operated and wholesale), which represents the first time each metric has stopped decreasing since 2010. In addition, gross margin for the core Kappa brand improved by 3.3ppt to 60.5%, which may be partly attributable to a higher proportion of self-operated stores but wholesale store productivity has also increased in 2H14. We think this indicates a turnaround in the core sportswear business.

**Recovery in profitability.** We are forecasting core earnings to grow by 39% yoy to USD32m in 2015e, but admittedly this is from a low base where core net margin is still only 2.4%. But we think EBIT margin is likely to improve from 6.1% in 2015e to 10.3% in 2017e, the highest profitability level since 2011.

**Upside potential from investments.** In addition to the core business, the company has made a number of investments that could provide earnings upside. If we account for income from financial assets, then reported net margin would be boosted to 13.1% in 2015e to 14.5% in 2017e. Available-for-sale financial assets represent 50% of current market cap. Cash and equivalents represent 83% of current market cap, so the stock is trading well below the value of its assets.

**Alibaba stake sale helped group achieve significant net profit.** The group reported 2014 net income of RMB915m (+335% yoy) on a 11% decline in sales. As indicated in a positive profit alert in Dec-14, the increase was thanks to disposing part of their stake in Alibaba (BABA US). Excluding one-off gains and income from financial assets, core earnings declined by 63% yoy to USD23m.

**Establish Buy rating with 30% upside.** We set a fair value PB-based TP of HKD1.90 (from HKD1.82). We raise our target price on a higher 2015e BVPS but offset by a slightly lower target multiple of 0.87x 2015e PB (from 0.95x) due to a lower ROE assumption. Downside risks include slower-than-expected sales per store, higher-than-expected operating expenses, and a lower-than-expected return on investments.

## Valuation and risks

We set a fair value target price of HKD1.90 (HKD1.82 previously). We use the ROE-implied PB method to value China Dongxiang and as we think the company's near-term earnings are weak and free cash flow is volatile but its large cash balance and the value of its assets should provide a floor to valuation.

We raise our EBIT estimates by 55% and 22% for 2015-16e, respectively on higher sales and operating leverage, but lower our net profit estimates by 8% and 7%, respectively, on lower income from financial assets.

Please refer to the following table for a summary of the assumptions used to derive our PB-based target price of HKD1.90. For the beta of 1.3, we use a 1.2 sector beta and a company-specific beta of 1.1. The sector beta takes into account the limited barriers to entry in the sector, meaning the strong growth rate for the company in the past should not prove sustainable. This is the sector beta that we use for the sporting goods industry in Europe and the US. We lower our WACC assumption based on a lower ERP (5.5% versus 6.0% previously) to be consistent with our strategists' estimates. We use a long-term ROE assumption of 10% (previously 11%) given the increased uncertainty on the recovery pace and lower earnings estimates. This ROE is below the peak 20% level reached by the company in 2008-10.

### China Dongxiang – Target price calculation

PB-ROE method	old	new
LT ROE	11%	10%
Growth	5%	5%
WACC	11.4%	10.8%
<b>Target PB multiple</b>	<b>0.95</b>	<b>0.87</b>
2015e BPS	1.90	2.19
<b>PB based value per share</b>	<b>1.82</b>	<b>1.90</b>

Source: HSBC estimates

Downside risks include slower-than-expected sales per store, higher-than-expected operating expenses, and a lower-than-expected return on investments

### China Dongxiang - Change vs old vs consensus estimates, 2015-16e

In RMBm	2015e					2016e				
	HSBC Old	New	Cons	Diff'ce vs. old	vs. cons	HSBC Old	New	Cons	Diff'ce vs. old	vs. cons
Revenue	1,251	1,305	1,504	4.3%	-13.3%	1,387	1,445	1,672	4.2%	-13.6%
EBIT	51	80	133	55.2%	-39.9%	105	129	169	22.1%	-23.9%
EBIT margin	4.1%	6.1%	8.8%	2.0ppt	-2.7ppt	7.6%	8.9%	10.1%	1.3ppt	-1.2ppt
Net profit	186	171	259	-8.3%	-34.0%	219	204	298	-6.6%	-31.5%
Net profit margin	14.9%	13.1%	17.2%	-1.8ppt	-4.1ppt	15.7%	14.1%	17.8%	-1.6ppt	-3.7ppt

Source: Bloomberg, HSBC estimates

## Financials & valuation

### Financial statements

Year to	12/2014a	12/2015e	12/2016e	12/2017e
<b>Profit &amp; loss summary (CNYm)</b>				
Revenue	1,262	1,305	1,445	1,569
EBITDA	125	109	158	191
Depreciation & amortisation	-29	-29	-29	-29
Operating profit/EBIT	96	80	129	162
Net interest	-14	22	21	22
PBT	975	241	289	323
HSBC PBT	975	241	289	323
Taxation	-62	-72	-87	-97
Net profit	915	171	204	228
HSBC net profit	23	32	65	89

### Cash flow summary (CNYm)

Cash flow from operations	1,545	176	208	217
Capex	-20	-30	-30	-30
Cash flow from investment	-1,674	-30	-30	-30
Dividends	-154	-646	-131	-151
Change in net debt	-678	500	-47	-35
FCF equity	633	7	39	48

### Balance sheet summary (CNYm)

Intangible fixed assets	248	234	220	206
Tangible fixed assets	83	98	112	127
Current assets	5,931	5,451	5,527	5,603
Cash & others	5,326	4,825	4,872	4,908
Total assets	11,309	10,829	10,906	10,982
Operating liabilities	939	937	942	944
Gross debt	0	0	0	0
Net debt	-5,326	-4,825	-4,872	-4,908
Shareholders funds	10,340	9,865	9,937	10,014
Invested capital	-3	20	44	84

### Ratio, growth and per share analysis

Year to	12/2014a	12/2015e	12/2016e	12/2017e
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#### Y-o-y % change

Revenue	-10.7	3.4	10.8	8.5
EBITDA	19.6	-13.1	45.0	20.9
Operating profit	26.6	-17.1	61.5	25.6
PBT	254.6	-75.3	19.8	11.9
HSBC EPS	-63.8	39.0	105.2	36.9

#### Ratios (%)

Revenue/IC (x)	4.1	150.4	45.0	24.5
ROIC	33.5	753.9	310.3	191.9
ROE	0.2	0.3	0.7	0.9
ROA	9.1	1.4	1.7	1.9
EBITDA margin	9.9	8.4	10.9	12.2
Operating profit margin	7.6	6.1	8.9	10.3
EBITDA/net interest (x)	9.1			
Net debt/equity	-51.4	-48.8	-49.0	-48.9
Net debt/EBITDA (x)	-42.5	-44.3	-30.8	-25.7
CF from operations/net debt				

#### Per share data (CNY)

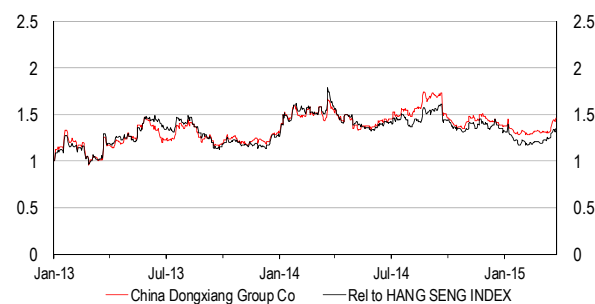
EPS reported (fully diluted)	0.16	0.03	0.04	0.04
HSBC EPS (fully diluted)	0.00	0.01	0.01	0.02
DPS	0.12	0.02	0.03	0.03
Book value	1.82	1.74	1.75	1.77

### Valuation data

Year to	12/2014a	12/2015e	12/2016e	12/2017e
EV/sales	-3.1	-2.6	-2.4	-2.2
EV/EBITDA	-31.0	-31.1	-21.8	-18.2
EV/IC		-169.7	-77.6	-41.5
PE*	290.0	208.7	101.7	74.3
P/Book value	0.6	0.7	0.7	0.7
FCF yield (%)	44.0	0.5	2.7	3.3
Dividend yield (%)	9.9	1.8	2.2	2.4

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

### Price relative



Source: HSBC

Note: price at close of 25 Mar 2015

# Disclosure appendix

## Analyst Certification

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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.

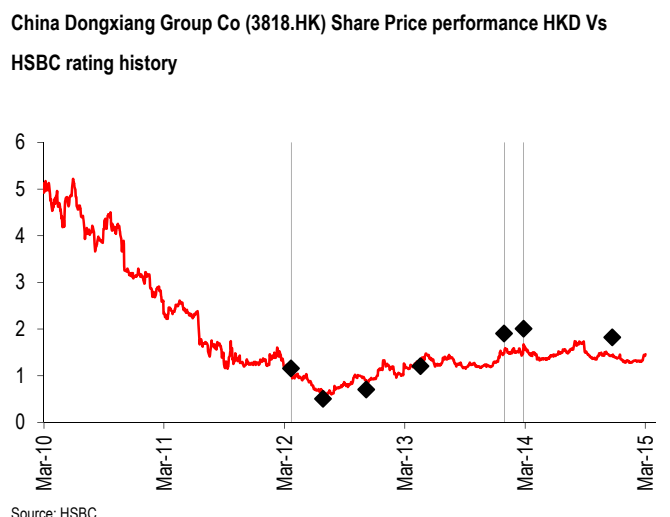
## Rating distribution for long-term investment opportunities

As of 25 March 2015, the distribution of all ratings published is as follows:

<b>Buy</b>	41%	(30% of these provided with Investment Banking Services)
<b>Hold</b>	39%	(28% of these provided with Investment Banking Services)
<b>Sell</b>	20%	(20% of these provided with Investment Banking Services)

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
Underweight	Underweight (V)	13 April 2012
Underweight (V)	Overweight (V)	20 January 2014
Overweight (V)	Overweight	20 March 2014
Target Price	Value	Date
Price 1	1.15	13 April 2012
Price 2	0.50	19 July 2012
Price 3	0.70	28 November 2012
Price 4	1.20	12 May 2013
Price 5	1.90	20 January 2014
Price 6	2.00	20 March 2014
Price 7	1.82	15 December 2014

Source: HSBC

## HSBC & Analyst disclosures

### Disclosure checklist

Company	Ticker	Recent price	Price Date	Disclosure
CHINA DONGXIANG GROUP CO	3818.HK	1.46	25-Mar-2015	7

Source: HSBC

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