

Key Takeaways

Cosmetic Health Care Sector

8 Jul 2008

Water Oasis (1161.HK)

Water Oasis distributes skin-care and body-care products and provides beauty services. 74% of 1H08 revenue was from product sales and the rest from beauty services. Water Oasis is the exclusive distributor of ~H2O plus products in Hong Kong, Macau, Taiwan, the PRC and Singapore and was granted exclusive distributorship of Neutrogena products in PRC department stores in 2006.

Although product sales are very profitable (gross margin 70%-plus), the company generated an operating margin of only 10.7% and a net margin of just 8.7% in 1H08 due to high operating leverage (staff and rental costs made up 46% of sales). Nonetheless, expanding the retail network can help increase economies of scale and improve overall profitability, and margins have risen since FY06. Earnings visibility is high, even though the market is fragmented, as skin-care products have a relatively long life span. These products also benefit from high customer loyalty, which offers greater pricing power. Water Oasis has raised product prices 10% in Hong Kong and the PRC to offset rising costs.

Key concerns would be the smooth execution of store roll-out, one of the company's main earnings drivers. Inflation woes in China could erode purchasing power and hit its product and beauty-services sales. There is also competition from parallel imports, which may divert sales to small cosmetics stores.

Key takeaways

- Strong sales momentum from China expansion**

Rising purchasing power in China has led to strong demand for reputable beauty products. Sales of cosmetics products are set to grow from RMB38.7bn in 2006 to over RMB80bn in 2010. Water Oasis' distributorship of renowned beauty product brands in China can help it maintain decent sales growth (43% yoy in 1H08) on the back of rising demand. For May 2008, all its ~H2O plus stores had achieved double-digit same-store-sales growth (11% for self-managed stores and 27% for franchisees).

Although China is the company's largest revenue source, it still plans to expand geographically. It aims to increase the number of Neutrogena outlets from 119 at end-2007 to 160 at end-September 2008 and the number of ~H2O plus stores from 164 at end-2007 to 185 at end-September 2008. This should be achievable, as many department stores have aggressive expansion plans for their sales networks and are also using the franchise model (minimal capex).

Figure 1: Earnings Summary

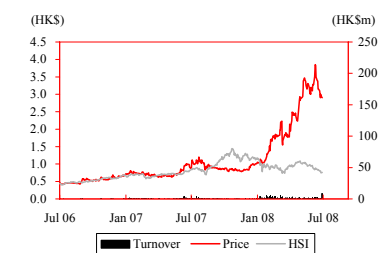
Year ending 30 Sept	FY04	FY05	FY06	FY07
Net profit – HK\$m	1.7	12.8	13.6	40.7
Net-profit growth – %	N/A	653.4	6.6	199.4
EPS – HK cents	0.5	3.7	4.0	11.7
EPS growth – %	N/A	635.2	6.5	194.2
P/E – X	591.2	80.4	75.5	25.7
DPS – HK cents	1.0	6.5	8.0	15.0
Dividend yield – %	0.3	2.2	2.7	5.0
BVPS – HK	0.5	0.5	0.4	0.5
P/B – X	6.4	6.5	6.8	6.2
Op. cash flow per share – HK cents	11.2	13.6	11.7	19.1
Free cash flow per share – HK cents	(5.1)	4.0	4.7	15.0
Free-cash-flow yield – %	(1.7)	1.3	1.6	5.0
Net debt per share – HK cents	(18.1)	(20.2)	(38.1)	(46.5)
Net debt/ price – %	(6.1)	(6.8)	(12.9)	(15.8)
Issued shares – millions	333.8	342.1	342.2	348.2

Sources: Bloomberg and Sun Hung Kai Financial

HSI **21,913**
 HSCEI **11,712**

Performance (%)	1m	3m	12m
HSI	(10.2)	(9.9)	(2.7)
HSCEI	(13.3)	(11.2)	(7.6)

Water Oasis - Price vs. HSI, Share Data



Price – HK\$	2.90
HSI	21,913.06
52W high/low (HK\$)	3.98/0.71
Shares in issue – millions	366.08
Market cap – HK\$m	1,061.62
3M avg. turnover – HK\$m	1.11
Major shareholders – %	
Hitchin Trading Limited	24.13

Sources: Bloomberg and Sun Hung Kai Financial

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■ **Competitive edge – strong brand portfolio and niche products**

To ease its heavy sales exposure to ~H2O plus (80-90% of product sales), Water Oasis has diversified its brand portfolio by winning exclusive rights to distribute Neutrogena skin-care products in PRC department stores.

It also recently added a French brand, Yves Rocher, to its portfolio. It has sole distributorship of Yves Rocher products in the mainland. This brand targets a demographic somewhere between Neutrogena and ~H2O+, and is expected to commence operations at department-store counters in September. Water Oasis is also developing a domestic brand (Jimmy Doll), focusing on the mass market, which should mitigate the risk of losing exclusive distributorship for ~H2O plus. Nonetheless, management is not particularly concerned about this as it has already gained a strong foothold in China, which offers it bargaining power when negotiating for renewal. With a strong brand name, it can also get favorable lessee terms and locations in department stores.

Water Oasis is working with supplier ~H2O plus L.P. to develop new products specifically for its target demographic. These niche products should help it compete with international brand names and increase customer loyalty.

Figure 2: Water Oasis – from single brand to multi-brand strategy



Source: The Company



Figure 3: Water Oasis - establishing a strong foothold in China, increasing bargaining power



Source: The Company

- High earnings visibility.** As mentioned in our strategy report (*Slowing Growth Momentum Calls for Careful Stock Picks*, published on 26 June), we prefer Chinese consumer companies not subject to price controls, that do not suffer directly and significantly from raw-material price rises and are not affected by rising rental rates in China.

Under an inflationary and regulated environment, owning a valuable business franchise (that can pass through rising costs) is crucial for solid earnings. We believe high customer loyalty and longer product life spans (i.e. sales do not rely on new products being rolled out at higher ASPs) can improve earnings visibility, by allowing product price hikes without losing customers. Cosmetics have no impact on the CPI, and so are not subject to price controls. Last, but not least, as a wholesaler, Water Oasis does not directly suffer from rising raw-material prices. It raised product prices 10% in Hong Kong and the PRC at end-2007 and by a similar amount in Taiwan this year.

Though the company may suffer from rising rental rates (19% of 1H08 sales, the second largest expense) in China, its strong brand name offers some bargaining power on rental terms.

- Attractive yield and cash rich**

As the company consistently generates positive cash flow and free cash flow, it has distributed over 100% of earnings since FY05 (excluding special dividends declared). The stock generates 5% historical dividend and free-cash-flow yields. This plus the net-cash position (16% of its market cap) offer some downside protection amid a volatile market.

Valuation

Water Oasis is down 25% from its peak of HK\$3.98 on 19 June, in line with the fall in Chinese consumer plays on concerns about a slowdown in national consumer spending. The stock trades at 25X historical earnings, generating 5% historical dividend and free-cash-flow yields. The current valuation represents a 37% P/E premium to peer Natural Beauty, which derives most of its revenue from China and from skin-care-product distribution. Indeed, Water Oasis trades at the highest P/E in the sector, although it also generates the highest dividend and free-cash-flow yields. The stock could therefore prove appealing on a yield basis.

Figure 4: Peer comparison

Company	Stock code	Share price (HK\$)	Market cap (HK\$m)	Ytd change (%)	Gross margin (%)	Operating margin (%)	Net margin (%)	ROAA (%)	ROAE (%)
Water Oasis	1161.HK	2.95	1,079.9	204.1	77.8	6.3	7.2	11.2	25.6
Natural Beauty	157.HK	1.63	3,260.0	(34.3)	82.8	39.2	39.7	17.6	20.0
Modern Beauty	919.HK	2.70	1,953.5	(27.8)	97.0	33.1	28.9	21.7	59.7
Average				(4.6)	85.9	26.2	25.3	16.8	35.1

Company	Dividend-payout ratio (%)	Net debt/equity (%)	Dividend yield (%)	FCF yield (%)	FY1 EPS growth (%)	FY2 EPS growth (%)	FY0 P/E (X)	FY1 P/E (X)	FY2 P/E (X)
Water Oasis	131.0	Net cash	5.0	5.0	N/A	N/A	25.7	N/A	N/A
Natural Beauty	167.9	Net cash	2.9	4.6	22.2	23.6	18.3	14.8	12.3
Modern Beauty	84.7	Net cash	4.3	2.5	15.8	13.8	11.0	9.5	8.2
Average	127.9		4.1	4.0	19.0	18.7	18.3	12.1	10.2

Sources: Bloomberg and Sun Hung Kai Financial

Figure 5: Water Oasis – 1H08 results highlights

HK\$'000	1H07	1H08	Yoy %	SHKF Comments
Sales	278,142	398,267	43.2	Driven by the addition of 60 outlets, bringing the total from 293 at end-September 2007 to 353 at end-March 2008, plus rising same-store-sales growth and average transaction value.
COGS	(67,125)	(94,678)	41.0	
Gross profit	211,017	303,589	43.9	
Operating expenses	(203,064)	(273,562)	34.7	
Operating profit	12,057	42,528	252.7	6.3-ppts margin expansion through greater cost efficiency and the Taiwan and Singapore businesses turning profitable.
Profit before tax	12,057	42,528	252.7	
Tax	(1,951)	(7,779)	298.7	
Profit for the period	10,106	34,749	243.8	
Attributable to				
Equity holders	9,359	32,637	248.7	
Minorities interests	747	2,112	182.7	
EPS – HK cents	9.1	2.7	235.4	
DPS – HK cents	10.0	5.0	100.0	Payout ratio consistently over 100% since FY04.

Sources: The Company and Sun Hung Kai Financial

Key investment negatives

- **Not being able to attract franchisees would hit revenue growth.** Sales growth hinges on increasing the number of outlets as well as organic growth through same-store-sales growth. The company operates stringent controls over franchise partners to ensure high quality.
- **Loss of exclusive distributorships.** ~H2O plus distributorship rights will expire in seven years and Neutrogena distributorship will expire in 2009, though this will be renewable for a further three years thereafter. Nonetheless, given the company's strong foothold in China's cosmetics market, it has greater bargaining power for renewing distribution rights.
- **Weakening economic prospects** may have a negative impact on sales as consumers rein in spending on discretionary products and services. The company suffered losses in FY03 due to the SARS outbreak and the weaker Hong Kong economy at the time (61% of sales were from Hong Kong in FY03). But the current downturn in sentiment may have less impact on its Neutrogena product lines as these are priced at RMB24-299 (vs. RMB90-600 for ~H2O plus).
- **Execution risks in new business.** The company has expanded into distributing beauty equipment, medical beauty (such as laser, whitening and Botox treatment), floral arrangement and advertising in FY08. These new businesses make up less than 10% of sales.
- **Share placements could exert pressure on stock price.** The company has a concentrated shareholder base. A small number of shareholders held 91.62% of the issued shares at March, and management has indicated that they will dispose of some shares to strategic investors if conditions are appropriate, though they are in no rush to do so.
- **High operating leverage.** Water Oasis has significant exposure to the retail rental market. Profitability may be hit by rising rentals. Rentals expenses made up 19% of 1H08 sales.
- **Competition from parallel imports** bearing the ~H2O plus brand name or forgeries.
- **Keen competition in beauty services.** Entry barriers for this industry are very low. Beauty services made up 26% of 1H08 sales.
- **Low liquidity** (three-month average turnover is HK\$1m) and small market cap vs. other Chinese consumer names (HK\$1.1bn vs. peer **Natural Beauty's (157.HK)** HK\$3.2bn).

Company Background



- Water Oasis distributes skin-care and body-care products and provides beauty services (beauty salon and spa). 74% of 1H08 revenue was from product sales and the rest from beauty services. It is the exclusive distributor of ~H2O plus products in Hong Kong, Macau, Taiwan, the PRC and Singapore (a seven-year agreement was renewed in 1H08). It has also won exclusive distributorship of Neutrogena products in PRC department stores in 2006, with three-year exclusive rights renewable for a further three years thereafter. ~H2O plus products are priced at RMB90-600 in the PRC market (HK\$70-520 in Hong Kong) and aimed at unisex consumers aged 20-40. Neutrogena products are priced at RMB24-299 and targeted at women aged 18-35. The company operates one beauty-services center in Beijing and is expected to add one more in July.
- Customers include retail consumers who purchase skin-care products at retail outlets or who receive spa services at spa centers, as well as its franchisees. Products are purchased from suppliers ~H2O Plus, L.P. and Johnson and Johnson. Under its distributorship agreement with ~H2O plus, Water Oasis pays a percentage royalty on the gross receipts for ~H2O plus products in addition to inventory cost, but has no such arrangement with Johnson and Johnson.
- To maintain strong sales momentum (17% p.a. in FY04-07), the company is expanding its China retail network. Prospects are bright in the PRC cosmetics industry, fuelled by rising household incomes and purchasing power leading to increased demand for quality products. Sales of cosmetics products are expected to top RMB80bn in 2010, from RMB39bn in 2006. 48% of 1H08 sales were from China and the largest source of revenue. The company aims to increase the number of Neutrogena outlets from 119 at end-2007 to 160 at end-September 2008 and the number of ~H2O plus outlets from 164 outlets at end-2007 to 185 at end-September 2008. Rolling out new outlets will be a key earnings drivers. Water Oasis uses the franchise format (it has 74 ~H2O Plus franchise stores and 56 Neutrogena franchise stores) in addition to self-managed stores. The company receives a one-off franchisee fee of RMB20,000-30,000, while franchisees bear all the decoration costs and upfront costs. Franchisees also have to purchase products from the company, which means they assume the inventory risk. This reduces Water Oasis' capex while allowing it to maintain rapid geographical expansion. A wide distribution network should mean greater bargaining power when renewing its distributorship deal.
- To reduce its heavy exposure to ~H2O plus, the company added Neutrogena to its portfolio in 2006 and Yves Rocher this year. It is also developing a domestic brand (Jimmy Doll).
- Due to its strong balance sheet (debt free) and cash generating business, Water Oasis has maintained over a 100% dividend-payout ratio since FY04. Skin-care products have high customer loyalty, and together with its strong brand name this should allow it to pass on rising costs, improving earnings visibility. Indeed, the company raised its ~H2O plus product prices 10% in Hong Kong and the PRC at end-2007.

Figure 6: Water Oasis – Brand summary

	~H2O plus	Neutrogena	Yves Rocher
Customers	Unisex, aged 20-40	Female, aged 18-35	N/A
Product price range	HK\$70-520 for Hong Kong RMB90-600 for PRC	RMB24-299	Women and men
Product range	Skincare and body care	Skincare	Skincare, fragrance and body care and cosmetics
Distributorship terms	Sole in Hong Kong, PRC, Macau and Singapore	Sole in PRC department stores	Sole in China and Taiwan

Sources: The Company and Sun Hung Kai Financial

Figure 7: Investment Highlights for Water Oasis

 Key investment positives	 Key investment negatives
<ul style="list-style-type: none"> ▪ Strong industry prospects in China. Sales of cosmetics products are expected to top RMB80bn in 2010, from RMB39bn in 2006. Beauty services in China also offer great growth potential. It has exclusive distribution rights for ~H2O plus in China and won Neutrogena distribution rights for PRC department stores in 2006. It also has two beauty centers in China (PRC market made up 48% of 1H08 sales). ▪ Strong industry growth from rising real disposable incomes and mainland demand for quality beauty products (China's urban real incomes grew 12.4% in 2007). ▪ Strong top-line growth from store roll-outs in China. It aims to bring the number of Neutrogena outlets from 119 at end-2007 to 160 at end-September 2008, and the number of ~H2O plus outlets from 164 at end-2007 to 185 at end-September 2008. ▪ Fast expansion in China with minimal capex. The company uses a franchise format (74 franchisees for ~H2O plus and 56 for Neutrogena) in addition to self-managed stores. Decoration costs and upfront costs are borne by franchisees. ▪ Franchisees also have to buy products from the company, minimizing inventory risk (i.e. this is transferred to franchisees). ▪ Economies of scale from network expansion can help improve profitability. Margins have risen since FY06. ▪ A wide distribution network offers greater bargaining power for distributorship renewal. ▪ Reducing its reliance on a single brand (80-90% of product sales are from ~H2O plus). It added Neutrogena in 2006 and will add another French brand, Yves Rocher, this year. It is working with its majority shareholder to develop a cosmetics brand in China, targeting to launch in early 2009. ▪ Generous dividend payout on the back of a strong balance sheet (net cash makes up 10% of its market cap). It has paid out over 100% of earnings since 2004. ▪ Strong brand name offers competitive advantage through favorable rental terms and better shop locations in department stores. ▪ Wide range of services, from luxury high-end, mid- and mass-market beauty services for men and women. ▪ The company's beauty school can supply a steady stream of professional beauticians. ▪ High customer loyalty offers greater pricing power. Skin-care products are not as affected to rapidly shifting fashion cycles as other cosmetics products, and therefore have longer life spans. The company has raised product prices 10% in Hong Kong and the PRC at end-2007. ▪ Niche product advantage. The company has worked with supplier ~H2O plus L.P. to develop a range of products specifically for Asian demographics (vs. international brands that focus on western demographics). These niche products can help lock in customers. ▪ Not affected by government-policy intervention. Skin-care products are consumer staples, but do not affect the CPI and are hence unlikely to be hit by price caps in the PRC. 	<ul style="list-style-type: none"> ▪ Growth hinges on expanding the number of outlets. The company operates stringent controls over its franchise partners to ensure high quality. ▪ Weakening economic prospects may have a negative impact on sales as consumers rein in spending on discretionary products and services. The company suffered losses in FY03 from the SARS outbreak and weak economy in Hong Kong at the time. ▪ Execution risks in new business. The company has expanded into distributing beauty equipment, medical beauty services (such as laser, whitening and Botox treatments), floral arrangement and advertising in FY08. ▪ Share placements could exert pressure on the stock price. The company has a concentrated shareholder base, with six shareholders holding 91.62% of the issued shares in March. ▪ High operating leverage. It has a significant exposure to the retail rental market. Profitability may be hit if retail rentals rise (19% of 1H08 sales and the second largest expense item). ▪ Competition from parallel imports bearing the ~H2O plus brand name or forgeries. ▪ Keen competition in beauty services, where entry barriers are very low. ▪ Low liquidity and small market cap vs. other Chinese consumer names.

Source: Sun Hung Kai Financial

Figure 8: Water Oasis - Profit and Loss Statement

Year ended 30 Sep, HK\$ m	FY04	FY05	FY06	FY07	FY04-07 CAGR (%)
Revenue	357.6	413.9	484.0	593.4	17.6
COGS	(93.4)	(99.0)	(106.8)	(131.5)	13.3
Gross profit	264.1	314.8	377.2	461.9	19.0
Operating expenses	(263.8)	(323.3)	(369.0)	(423.7)	15.3
Other operating income	2.0	2.6	5.4	12.3	77.0
Operating profit	3.6	17.9	13.6	52.7	N/A
Finance expenses	0.0	0.0	0.0	0.0	N/A
PBT	3.6	17.9	13.6	52.7	N/A
Tax	(1.7)	(4.7)	(0.7)	(10.2)	296.9
Net profit	1.7	12.8	13.6	40.7	N/A
EPS – HK cents	0.5	3.7	4.0	11.7	N/A

Sources: Bloomberg and Sun Hung Kai Financial

Figure 9: Water Oasis - Balance Sheet

Year ended 30 Sep, HK\$ m	FY04	FY05	FY06	FY07	FY04-07 CAGR (%)
Cash and securities	79.0	85.7	130.3	161.9	19.8
Accounts receivable	25.2	31.8	39.7	58.0	26.0
Inventory	31.1	35.2	45.3	49.6	10.8
Other current assets	27.3	20.9	35.0	54.9	36.2
Total current assets	162.6	173.5	250.4	324.5	21.1
Net fixed assets	78.7	118.9	33.4	26.1	(5.3)
Other long-term assets	18.8	17.1	45.8	49.5	31.4
Total assets	260.0	309.4	329.5	400.0	19.0
Short-term debt	2.0	2.0	0.0	0.0	N/A
Accounts payable	6.6	11.3	6.2	3.0	(6.4)
Other current liabilities	76.8	120.6	170.4	226.3	45.4
Total current liabilities	85.4	133.9	176.6	229.4	43.2
Long-term debt	16.7	14.8	0.0	0.0	N/A
Other long-term liabilities	1.2	3.1	0.7	0.9	(5.9)
Total liabilities	103.3	151.8	177.3	230.2	42.6
Shareholders equity	156.9	157.4	151.4	167.2	3.9
Minorities	(0.2)	0.2	0.8	2.6	63.7
Total equity and liabilities	260.2	309.2	328.7	397.4	18.8

Sources: Bloomberg and Sun Hung Kai Financial

Figure 10: Water Oasis - Key Ratios

Year ended 30 Sep	FY04	FY05	FY06	FY07	FY04-07 CAGR/ average (%)
Growth ratios					
Revenue growth – %	15.3	15.8	16.9	22.6	17.6
EBIT growth – %	N/A	401.4	(24.2)	287.8	145.0
Net-profit growth – %	N/A	653.4	6.6	199.4	188.3
EPS growth – %	N/A	635.2	6.5	194.2	184.3
Profitability ratios					
Gross margin – %	73.9	76.1	77.9	77.8	76.4
Operating margin – %	1.0	4.3	2.8	8.9	4.3
Net margin – %	0.5	3.1	2.8	6.9	3.3
ROAA – %	0.7	4.5	4.3	11.2	5.2
ROAE – %	1.1	8.1	8.8	25.6	10.9
Other ratios					
Capex/sales – %	15.2	8.0	5.0	2.4	7.6
Capex/depreciation – %	351.3	198.4	117.3	64.0	182.8
Operating expenses/sales – %	(73.8)	(78.1)	(76.2)	(71.4)	(74.9)
Net debt/equity (net cash) – %	(38.5)	(43.8)	(86.1)	(96.9)	(66.3)
Inventory/sales – %	8.7	8.5	9.4	8.4	8.7
Effective tax rate – %	46.9	25.9	5.4	19.3	24.4
ROAA component analysis					
Revenue/average assets – %	155.6	145.4	151.5	162.7	153.8
COGS/average assets – %	(40.7)	(34.8)	(33.4)	(36.0)	(36.2)
Gross profit/average assets – %	114.9	110.6	118.1	126.6	117.5
Operating expenses/average assets – %	(114.8)	(113.6)	(115.5)	(116.2)	(115.0)
Other operating income/average assets – %	0.9	0.9	1.7	3.4	1.7
Operating profit/average assets – %	1.6	6.3	4.3	14.5	6.6
Finance expenses/average assets – %	0.0	0.0	0.0	0.0	0.0
PBT/average assets – %	1.6	6.3	4.3	14.5	6.6
Tax/average assets – %	(0.7)	(1.6)	(0.2)	(2.8)	(1.3)
Net profit/average assets – %	0.7	4.5	4.3	11.2	5.2
ROAE component analysis					
Revenue/average equity – %	237.9	263.4	313.5	372.5	296.8
COGS/average equity – %	(62.2)	(63.0)	(69.2)	(82.5)	(69.2)
Gross profit/average equity – %	175.8	200.4	244.3	290.0	227.6
Operating expenses/average equity – %	(175.6)	(205.7)	(239.0)	(266.0)	(221.6)
Other operating income/average equity – %	1.3	1.7	3.5	7.7	3.6
Operating profit/average equity – %	2.4	11.4	8.8	33.1	13.9
Finance expenses/average equity – %	0.0	0.0	0.0	0.0	0.0
PBT/average equity – %	2.4	11.4	8.8	33.1	13.9
Tax/average equity – %	(1.1)	(3.0)	(0.5)	(6.4)	(2.7)
Net profit/average equity – %	1.1	8.1	8.8	25.6	10.9

Sources: Bloomberg and Sun Hung Kai Financial

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