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Commerce & Industry

## Pacific Textiles (1382): Steady Growth & Attractive Dividends

Author(s): Kwok Yat Sing (SFC CE NO:ARR940)

Pacific Textiles, a textile manufacturer, posted its annual results for the year ended 31<sup>st</sup> March 2009. Revenue was HK\$4,735M, up 10.6% YOY but gross profit decreased by 1.4% YOY, to HK\$687M. Operating profit was HK\$425M, up 5.5% YOY but reported net profit fell by 4% YOY, to HK\$377M. Excluding disposal and fair value and impairment gains/losses as well as provision for bad debts, recurring net profit arrived at HK\$382M, up 12.1% YOY. The company proposed to declare a final dividend of HK\$0.12/share, up 60% YOY.

The moderate revenue growth was primarily attributable to rising average selling price (ASP) per pound of its products (FY09: HK\$30.1; FY08: HK\$27.6) but stagnant sales volume (FY09: 157.2M pounds; FY08: 155M pounds). As such, revenue grew by 10.6% YOY, to HK\$4,734.8M. Owing to surging cotton prices in 1HFY09, gross margin was under pressure and gross profit arrived at HK\$687M, down 1.4% YOY, despite revenue growth. With well costs controlled measures implementation and decreased customer claims during the review period, operating profit went up by 5.5% YOY, to HK\$425.1M. Although effective tax rate was 11.4%, down 3.4% points YOY, the company recorded less non-recurring gains than previous year (FY09: HK\$1M; FY08: HK\$50.7M). Therefore, reported net profit was HK\$376.5M, down 4% YOY. Excluding non-recurring items, recurring net profit actually went up by 12.1% YOY, to HK\$381.5M. **Notably, the recurring net profit growth was wholly attributable in strong recovery in 2HFY09. Recurring net profit in 2HFY09 soared by 1.33 times YOY, to HK\$199.9M (1HFY09: HK\$181.6M, down 28.6% YOY).**

### ACCUMULATE and HIGH RISK

With an expectation on slight gross margin improvement in FY10E because of lower raw material costs, stable ASP and sales volume growth, **the company's recurring net profit for FY10E might arrive at HK\$399.7M, up 4.8% YOY and further increase by 13% YOY, to HK\$451.6M in FY11E.**

At **HK\$2.31/share**, the company trades at a **historical FY09 recurring P/E of 8.8x** and **prospective FY10E and FY11E recurring P/E of 8.4x and 7.4x**, respectively. In view of slightly undemanding valuation and attractive prospective dividend yield (6.5%), we maintain **ACCUMUALTE and HIGH RISK** on this counter. **This counter is not suitable for conservative investors. Risk-taking investors who consider this counter may prefer accumulating the share at price weakness and should limit exposure to no more than 3% of portfolio.** Major risks are rebounding raw materials costs and higher-than-expected effective tax rate.

Earnings Forecast

HK\$ M	FY11E	FY10E	FY09
Sales Volume (M pounds)	180.0	165.0	157.2
ASP (HK\$/pound)	31.0	30.0	30.1
Revenue	5,580	4,950	4,735
Reported Net Profit	452	400	377
Recurring Net Profit *	452	400	382
Reported Diluted EPS (HK\$)	0.31	0.27	0.26
Recurring Diluted EPS (HK\$)	0.31	0.27	0.26
DPS (HK\$)	0.18	0.15	0.15
Reported P/E (HK\$2.31)	7.4	8.4	8.9
Recurring P/E (HK\$2.31)	7.4	8.4	8.8

Source: Company's results, Quam estimates

\* Exclude disposal and fair value and impairment gains/losses & provision for bad debts

Income Statement

HK\$ M	2H	1H	2H	1H	FY09	FY08	FY09 / FY08
	FY09	FY09	FY08	FY08			
Sales Volume ( <sup>'000</sup> pounds)	71,800	85,400	73,200	81,800	157,200	155,000	1.4%
Sales ASP (HK\$/pound)	30.3	29.9	26.9	28.2	30.1	27.6	9.1%
<b>Revenue</b>	<b>2,183</b>	<b>2,552</b>	<b>1,975</b>	<b>2,305</b>	<b>4,735</b>	<b>4,281</b>	<b>10.6%</b>

COGS	(1,835)	(2,213)	(1,717)	(1,867)	(4,048)	(3,584)	13.0%
<b>Gross Profit</b>	<b>348</b>	<b>338</b>	<b>258</b>	<b>438</b>	<b>687</b>	<b>697</b>	<b>-1.4%</b>
Other revenue	27	31	27	31	59	58	1.3%
Distribution expenses	(71)	(78)	(90)	(91)	(150)	(181)	-17.2%
Administrative costs	(80)	(90)	(85)	(86)	(171)	(171)	-0.2%
<b>Operating Profit</b>	<b>224</b>	<b>201</b>	<b>111</b>	<b>292</b>	<b>425</b>	<b>403</b>	<b>5.5%</b>
Finance income, net	2	0	4	7	2	11	-83.6%
Share of associates	1	1	1	(0)	1	1	60.6%
<b>Core Profit before tax</b>	<b>226</b>	<b>202</b>	<b>116</b>	<b>299</b>	<b>428</b>	<b>415</b>	<b>3.3%</b>
Other gains/losses	0	1	43	7	1	51	-98.0%
Income tax	(27)	(22)	(30)	(39)	(49)	(69)	-29.0%
<b>Profit after tax</b>	<b>200</b>	<b>181</b>	<b>130</b>	<b>267</b>	<b>381</b>	<b>397</b>	<b>-4.1%</b>
Minority interests	(5)	1	(1)	(3)	(4)	(5)	-13.3%
<b>Reported Net Profit</b>	<b>195</b>	<b>182</b>	<b>128</b>	<b>264</b>	<b>377</b>	<b>392</b>	<b>-4.0%</b>
<b>Recurring Net Profit *</b>	<b>200</b>	<b>182</b>	<b>86</b>	<b>254</b>	<b>382</b>	<b>340</b>	<b>12.1%</b>
<b>Gross Margin</b>	<b>16.0%</b>	<b>13.3%</b>	<b>13.1%</b>	<b>19.0%</b>	<b>14.5%</b>	<b>16.3%</b>	
<b>Operating Margin</b>	<b>10.3%</b>	<b>7.9%</b>	<b>5.6%</b>	<b>12.7%</b>	<b>9.0%</b>	<b>9.4%</b>	
<b>Reported Net Margin</b>	<b>8.9%</b>	<b>7.1%</b>	<b>6.5%</b>	<b>11.4%</b>	<b>8.0%</b>	<b>9.2%</b>	
<b>Recurring Net Margin</b>	<b>9.2%</b>	<b>7.1%</b>	<b>4.4%</b>	<b>11.0%</b>	<b>8.1%</b>	<b>8.0%</b>	

Source: Company's results

\* Exclude disposal and fair value and impairment gains/losses & provision for bad debts

## Business Review

Revenue was HK\$4,734.8M in FY09, up 10.6% YOY and the growth was mainly attributable to the rise in ASP (HK\$30.1, up 9.1% YOY). The surging cotton prices in 1HFY09 had a negative impact on the gross margin and gross profit declined by 1.4% YOY, to HK\$687M. Distribution costs decreased by 17.2% YOY, to HK\$149.9M because of a significant reduce of customer claims and administrative expenses remained steady during the review period. Therefore, operating profit arrived at HK\$425.1M, up 5.5% YOY. Although effective tax rate fell by 3.4% points YOY, to 11.4%, the company recorded less non-recurring gains than previous year (FY09: HK\$1M; FY08: HK\$50.7M). Therefore, reported net profit dropped by 4% YOY, to HK\$376.5M. Excluding non-recurring items, recurring net profit was HK\$381.5M, up 12.1% YOY. **Notably, the recurring net profit growth was wholly attributable in strong recovery in 2HFY09. Recurring net profit in 2HFY09 soared by 1.33 times YOY (1HFY09: HK\$181.6M, down 28.6% YOY), to HK\$199.9M because of gross margin improvement.**

## Segment Review

### Geographical turnover

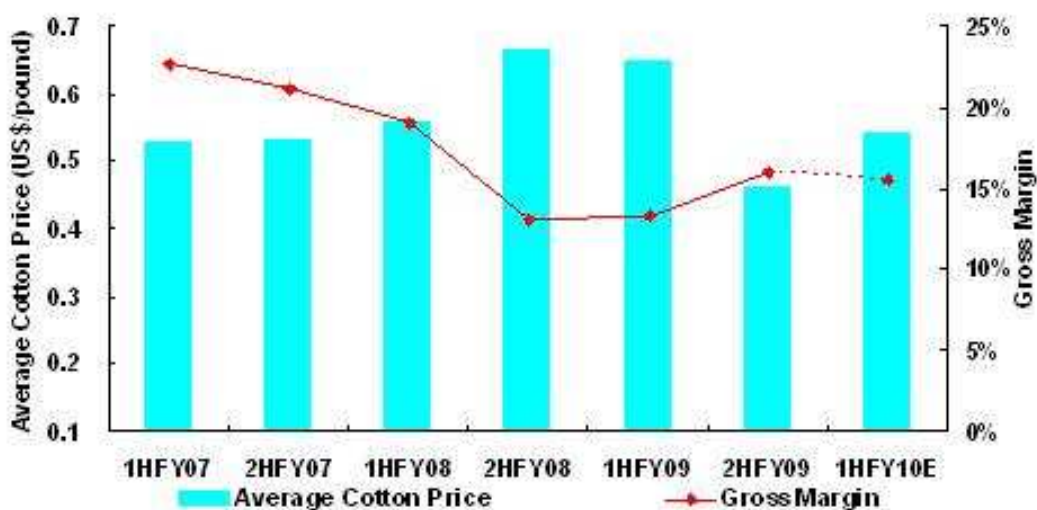
HK\$ M	2H	1H	2H	1H	FY09	FY08	FY09 / FY08
	FY09	FY09	FY08	FY08			
<b>Segment Revenue</b>							
China	627	673	422	628	1,300	1,050	23.8%
South East Asia	467	530	523	543	997	1,066	-6.5%
Hong Kong	374	490	376	416	864	792	9.1%
Sri Lanka	463	447	345	365	910	710	28.1%
Others	253	412	310	353	664	663	0.2%

Source: Company's results

Segment revenue from China and Sri Lanka recorded satisfactory 23.8% and 28.1% YOY growth, to HK\$1,299.8M and HK\$909.7M, respectively. The sales growth in Sri Lanka was attributable to the increased production capacity. We expect these two regions to continue to post stable performance in FY10E and FY11E. Moreover, the establishment of Bangladesh's plant in 2011E might further enhance the company's sales to Japan and EU markets because of the absence of tariffs and quota restrictions for goods exporting to these markets from Bangladesh.

## Expectation on FY10E gross margin improvement

### US middling grade average cotton price vs. Gross Margin



Source: Bloomberg, Quam estimates

Observed from the graph above, we could see that gross margin was highly negatively correlated to the movement of average cotton price. Gross margin improved as a result of a HOH fall in cotton price, vice versa. **Despite the fact that 1HFY10E gross margin might fall on a HOH basis, we expect the corresponding gross margin to be much higher than that of 1HFY09 but FY10E gross margin might improve only slightly because of the recent cotton price rebound.**

### VAT rebate rate on exporting textiles and garments

Commencement Date	VAT rebate rate
13-Oct-03	13%
15-Sep-06	11%
1-Aug-08	13%
1-Nov-08	14%
1-Feb-09	15%
1-Apr-09	16%

Source: The Ministry of Finance, China

The table above presents the VAT rebate rate adjustments on exporting textiles and garments in China. The company will be entitled a VAT rebate if the raw materials in use for production have been charged VAT before and the finished goods were exported to foreign countries from China. **The latest VAT rebate rate on exporting textiles and garments is 16%, up from 11% in July 2008.** The benefits will be wholly captured in FY10E and FY11E and further increase competitive power against industries from other countries, ceteris paribus.

### Strong customer portfolio

The company's major clients are Calvin Klein, Marks & Spencer, Triumph, UNIQLO and ANTA Sports. These industry-leading companies might gain market share from recent industry consolidation and further promote Pacific Textiles sales orders in the long run.

### Healthy Financials

As at 31<sup>st</sup> March 2009, Pacific Textiles was in a net cash position with cash and cash equivalents of HK\$1,431.7M (FY08: HK\$1,175.5M) and total borrowings and finance lease obligations of HK\$405.5M (FY08: HK\$671M). Net cash inflow before financing activities soared by 117.1% YOY, to HK\$655.5M. Shareholders' equity was HK\$3,111M, equivalent to HK\$2.14/share. Financials remained healthy.

### Key financial data

Price: \$2.31 (at 23<sup>rd</sup> July 2009)

12 month H/L: HK\$2.44 / HK\$0.44

Share O/S: 1,453.7M

Market cap: HK\$3,358.1M

FY10E Recurring Diluted EPS: HK\$0.27

FY10E DPS: HK\$0.15

FY10E Recurring P/E: 8.4x

FY10E Yield: 6.49%

BV pre share: HK\$2.14 (at 31<sup>st</sup> March 2009)

P/B: 1.08x

FY09 ROE: 12.1%

Major shareholders: Far East Asia Limited (27.98%); Silver Bay International Holdings Limited (11.94%); Fifth Element Enterprises Limited (6.98%); Hollywood Pacific Limited (6.98%); Top Strong Holdings Limited (6.98%)

Disclosure: Kwok Yat Sing (ARR940), the author of this document declares that as of the date of the publication of this report, he does not hold an interest in HK stock 1382.