

OVERWEIGHT

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China sportswear sector

Overweight, Anta is our top pick for 2011

*We have overweight rating for sportswear sector for 2011 though selling pressure emerged recently due to disappointing China Dongxiang's 2Q11 order value growth as we think the problem is company specific and attributable to its branding and promotional strategy. We prefer brands with comparatively effective promotional campaign and strong presence in second and third-tier cities with pricing strategy suitable for this market. We select **Anta (2020 HK)** as our top pick given the branding effect brought by COC sponsorship and its mass-market pricing for second and third-tier cities. We also have buy rating for **Xtep (1368 HK)** given the Company's efficient entertainment marketing strategy in addition to sports event sponsorship to complement its fashionable focus. Both Anta and Xtep have over 80% of revenue generated from second and third-tier cities. For **Li Ning (2331 HK)** and **China Dongxiang (3818 HK)**, we think their sales performance is unlikely to be exciting in 2011 and downgrade these two counters to **HOLD**.*

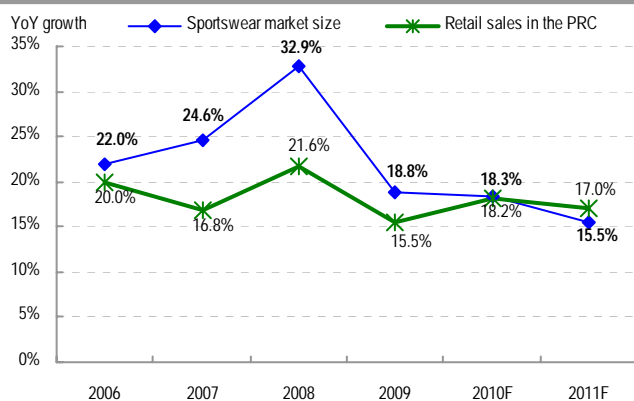
- ◆ **Slower sportswear market growth in 2011.** With slower PRC GDP estimated growth of 8.8% in 2011 compared with approximately 10.0% in 2010, sportswear market is expected to grow 15.5% in 2011, slower than approximately 18.3% in 2010 and we think Anta and Xtep will outperform the sportswear market growth based on 10.1% and 11.6% store growth rate respectively in 2011 and strong SSSG underpinned by their brand equity and promotional activities.
- ◆ **Surging cost—ongoing concern for sportswear companies and distributors.** With the surging labour and raw material cost, margin of sportswear companies are likely to be affected in 2011. We think sportswear companies with higher brand awareness are better positioned to achieve stable GPM or GPM expansion given their ability to raise ASP. The rising rental cost and labour cost on the other hand have created pressure for distribution channels and lowered their profitability.
- ◆ **Urbanization—key driver for economic growth going forward.** It is expected that urbanization rate will exceed 50% in 2012 as more rural population migrates into cities given government's effort on job creation in urban areas under the 12th Five Year Plan. The increasing urbanized population, with associated increasing disposable income per capita, will serve as the key growth driver for PRC economy and sportswear products. Under this trend, we think mass-market sportswear brands with well-established distribution network in second and third-tier cities will be major beneficiaries given the trade up consumption pattern associated with income increase to switch from basic products to branded sportswear products.
- ◆ **Increasing store efficiency will underpin growth going forward.** We think future growth of sportswear companies will be determined by store operating efficiency, or same store sales growth, which is highly correlated with brand value and brand promotional activities.
- ◆ **OVERWEIGHT rating for the sector, we prefer those with mass-market focus and strong presence in second and third-tier cities.** We prefer brands with comparatively effective promotional campaign as well as strong presence in second and third-tier cities with pricing strategy suitable for this market. We have selected Anta as our top pick within the sportswear sector in 2011 given the Company's sponsorship for COC, which further promotes its brand across the nation and its mid-end pricing strategy to target the mass market. We also have **BUY** rating for **Xtep (1368 HK)** given the Company's efficient entertainment marketing strategy in addition to sports event sponsorship to complement its fashionable focus.

Sportswear market to grow 15.5% in 2011

Overall sportswear market is likely to grow slower in 2011 compared with 2010. Boosted by the strong nominal GDP growth of CAGR 19.7% between 2005 and 2008, the size of PRC sportswear market has more than doubled from RMB50bn in 2005 to RMB101bn in 2008, representing a CAGR of 26.4%. The yearly growth rate of sportswear market peaked in 2008, in line with the effect of Beijing Olympic. With slower PRC GDP growth of 8.8% in 2011 estimated against approximately 10.0% in 2010 amid the transition from export-driven economy to one more relying on domestic consumption, which could take several years, the retail sales sector including sportswear market is expected to experience slower growth in 2011. Euromonitor estimates PRC sportswear industry to grow at a CAGR of 16.6% between 2009 and 2012.

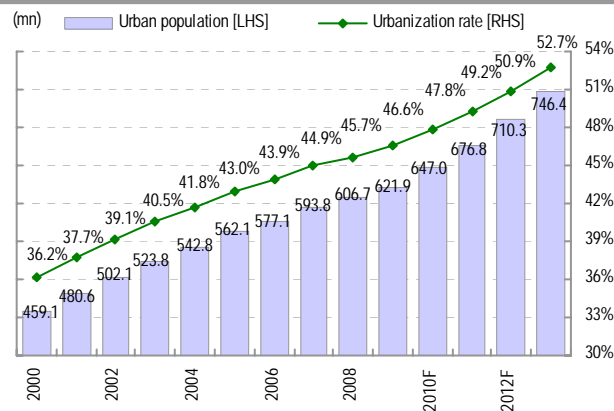
Yet, its growth rate will continue to outpace GDP growth, in our view. Currently, the PRC sports sector contributes over 0.5% of total GDP, but it is still far less than approximately 2.0% in the US. Given strong government support, the growth of sportswear market, in our view, will continue to outpace GDP growth going forward. According to *Guidance to Accelerate the Development of Sports Industry* issued by General Office of the State Council, the PRC government aims to build a strong domestic sportswear industry to compete in the international arena by 2020.

Figure 1: Sportswear market is estimated to grow 15.5% in 2011



Source: Historical retail sales data by NBS, projected retail sales data by Core Pacific - Yamaichi, sportswear market data by Euromonitor Report

Figure 2: Urbanization rate is estimated to exceed 50.0% by 2012



Source: Historical data by NBS, Projected data by Frost & Sullivan

Increasing urbanization—key driver for economic growth amid transforming economy.

In 2009, urbanization rate in the PRC was 46.6% with rural population of 712.9mn. It is expected that urbanization rate will exceed 50% in 2012 as more rural population migrates into cities given government's effort on job creation in urban areas under the 12th Five Year Plan. The increasing urbanized population, with associated increasing disposable income per capita, will serve as the key growth driver for PRC economy and domestic demand going forward, including sportswear products.

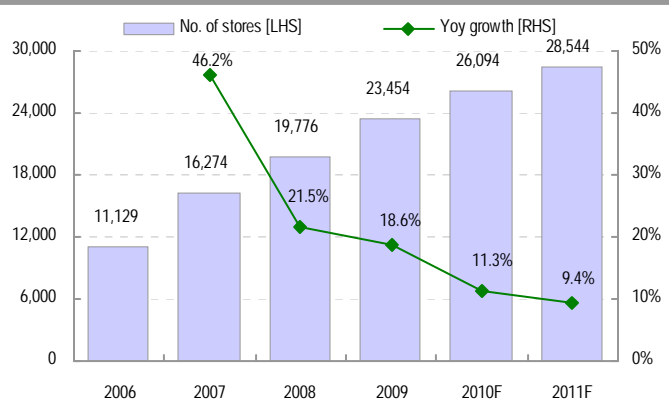
Mass-market brands with established distribution network in second and third-tier cities will be the major beneficiaries.

The demand boosted by accelerating urbanization and increasing disposable income per capita, in our view, will most likely benefit mass-market sportswear brands given the trade up consumption pattern associated with income increase to switch from basic products to branded sportswear products. Under such scenario together with relatively saturated market in first-tier cities, we think mass-market brands with well-established distribution network in second and third-tier cities, where economic growth outpaces that of first-tier cities, will be major beneficiaries.

Future growth hinges on SSSG

Expansion of distribution network was once the major growth driver for the sportswear industry. Between 2006 and 2009, the total number of stores for the four major brands of the sportswear companies that we cover increased from 11,129 to 23,454, representing CAGR of 28.2%, which has largely supported the growth of sportswear companies. The combining revenue of the four major brands grew at a CAGR of 54.2%, from RMB5,455mn in 2006 to RMB19,986mn in 2009. However, as the comparison base becomes higher, the store growth rate inevitably slows down. In addition, distributors of certain brands are facing problems of either excess inventory or lower profitability resulted from cost increase, and these issues could result in more cautious and selective store opening by those distributors. Consequently, we estimate store addition rate of the four major brands to grow 9.4% in 2011, lower than 11.3% in 2010.

Figure 3: Growth of stores of the four companies we covered



Source: company data and Core Pacific - Yamaichi estimates

Table 1: A&P as % of revenue, SSSG and % of stores linked to ERP/MIS

A&P	2006	2007	2008	2009	2010F	2011F
Anta	8.3%	12.4%	13.8%	12.7%	14.5%	14.0%
CNDX	8.1%	6.5%	7.7%	8.9%	8.6%	8.5%
Li Ning	16.4%	16.0%	17.5%	15.4%	16.3%	16.1%
Xtep	8.6%	5.6%	9.1%	11.8%	12.0%	12.3%

SSSG	1Q09	2Q09	3Q09	4Q09	1Q10	2Q10	3Q10
Anta	HSD	HSD	MSD	HSD	low teen	low teen	HSD
CNDX	6.0%	2.0%	-11.0%	1.0%	4.0%	0.4%	4.7%
Li Ning	SD	-SD	-8.2%	3.8%	5.0%	4.2%	4.0%
Xtep	2.0%	5.0%	6.0%	HSD	MSD	HSD	DD

Current prortion of stores linked with ERP or MIS			
Anta	CNDX	Li Ning	Xtep
50.0%	45.0%	90.0%	55.0%

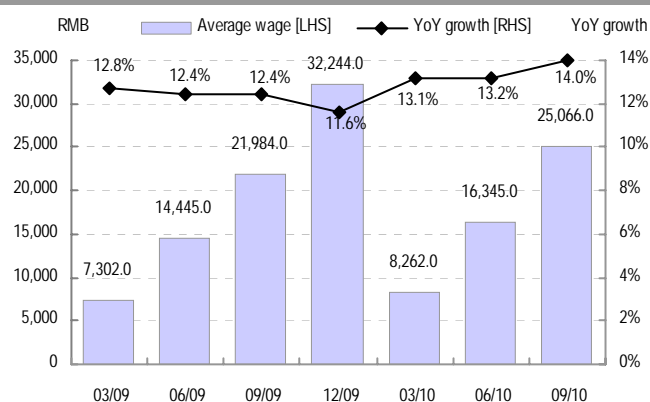
Source: company data and Core Pacific - Yamaichi estimates

Increasing store efficiency will underpin growth going forwards. As store expansion rate slows down, we think future growth of sportswear companies will be determined by store operating efficiency, or same store sales growth, which is highly correlated with brand value and brand promotional activities. That is, the better the SSSG, the higher the order value growth and subsequent replenishment orders. In the case of Kappa, which has fashion appeal but incurred the lowest A&P expenses as a percentage of revenue comparing with peers, has experienced gradual decline of SSSG since 1Q09 and eventually resulted in excess inventory within distribution channels which in turn saw a mere 2.8% yoy order value growth in 2Q11 sales fair. The Company started using media advertisement since Jan2010, but the effect on retail sales was slower than expected.

ERP is the key to monitor inventory levels within distribution channels. As the majority of stores of sportswear brand companies are operated by distributors or sub-distributors, the access to real time information regarding the sales performance and inventory level is critical for sportswear brand companies to make judgment on market demand accurately. However, currently, no one enterprise within our coverage has 100% ERP or MIS coverage for its distribution network.

Surging cost—concern for sportswear companies as well as distributors. In line with economic recovery, the growth of average wage in the PRC has accelerated since the beginning of 2010, with accumulated average wage year to date growing 14.0% yoy, which combined with raw material cost increase, pressures the profit margin of sportswear companies. We think sportswear companies with higher brand awareness are better positioned to achieve stable GPM or GPM expansion given their ability to raise ASP. The rising rental cost and labour cost on the other hand have created pressure for distribution channels and lowered their profitability. In the case of Li Ning, who offered the least wholesale discount, has proposed to increase wholesale discount by 3.0% from 2011.

Figure 4: YTD accumulated average wage rose by 14.0%



Source: NBS and Core Pacific - Yamaichi

Table 2: Wholesale discount, store growth in 2011 and order value growth

	Anta	CNDX	Li Ning	Xtep
Current wholesale price as % of retail price	42.0%	47.0%	50.0%	40.0%
Store growth in 2011	10.1%	7.7%	7.6%	11.6%
1Q11 order value growth	23.0%	11.8%	11.8%	23.0%
2Q11 order value growth	21.0%	2.8%	13.0% *	25.0%

* Core Pacific - Yamaichi estimates

Source: company data and Core Pacific - Yamaichi estimates

Mixed performance of sportswear companies. In the sportswear market, mid to high-end brands such as **Li Ning (2331 HK)** and **Dongxiang (3818 HK)** reported slower revenue growth in 1H10 compared with order value growth recorded in 1Q10 and 2Q10 sales fairs, while mass-market brands such as Anta and Xtep reported 1H10 revenue growth similar to that of order value growth. In addition, Li Ning and Dongxiang's order value growth in 1Q11 as well as their SSSG were also lower compared with **Anta (2020 HK)** and **Xtep**.

OVERWEIGHT rating for the sector; prefer those with mass-market focus and strong presence in second and third-tier cities. With the increasing cost pressure within distribution channels, we prefer brands with comparatively effective promotional campaign as well as strong presence in second and third-tier cities with pricing strategy suitable for this market. We have selected Anta as our top pick within the sportswear sector in 2011 given the Company's sponsorship for COC, which further promotes its brand across the nation and its mid-end pricing strategy to target the mass market. We also have buy rating for Xtep given the Company's entertainment marketing strategy in addition to sports event sponsorship to complement its fashion focus. Regarding Li Ning, the sales performance in 2011 is unlikely to be exciting given uncertainty associated with distribution channel reformation. For Dongxiang, we lower our estimate of order value growth rate in 3Q11 and 4Q11 sales fairs to single digit given excess inventory within distribution channel and slower than expected effect of increasing promotional effort on retail sales performance.

Table 3: Sector valuation (as at 30 November 2010)

Company	Bloomberg code	Rating	Price (HK\$)	Mkt cap (HK\$m)	PER (x)			PEG 10-12E	PBR (x)			Yield (%)	
					09	10F	11F		09	10F	11F	10F	11F
Sportswear sector													
Anta	2020 HK	BUY	14.48	36,110	24.9	22.2	17.4	0.8	6.1	5.4	4.7	2.8	3.5
Li Ning	2331 HK	HOLD	20.45	21,513	19.4	16.2	14.9	1.2	6.4	5.4	4.7	2.5	2.7
China Dongxiang	3818 HK	HOLD	3.47	19,662	11.6	11.2	10.7	2.6	2.3	2.2	2.0	5.4	5.6
Xtep	1368 HK	BUY	6.77	14,732	19.1	16.7	14.4	0.9	4.1	3.8	3.2	3.9	4.5
	<i>adjusted</i>				<i>19.6</i>	<i>17.1</i>	<i>14.5</i>						
361 Degree	1361 HK	NR	6.44	13,321	12.4	11.0	9.3	0.5	3.3	2.8	2.3	3.1	3.9
Peak	1968 HK	NR	5.65	11,853	14.0	12.9	10.3	0.5	3.5	2.8	2.4	2.6	3.0

Source: Data for 361 Degree and Peak by Bloomberg, others by Core Pacific-Yamaichi