

# OSIM International (OSIM SP)

Share Price: SGD1.36

MCap (USD): 757M

Singapore

Target Price: SGD1.49 (+10%)

ADTV (USD): 2M

Consumer Disc.

# HOLD

 (Unchanged)

## Tea Leaf Readings

- We hosted a post-results briefing, where management advised clients to stay the course and ride out downturn.
- Management suggested TWG could turn profitable next year due to the build-up in HK and acceleration of franchising.
- Reiterate HOLD. Short-term still grim, but 3Q15 likely the trough for 2015. A risk is the loss of TWG shareholding fight.

## What's New

We hosted a post-results management briefing at TWG Republic Plaza, the first TWG Tea store in Singapore. Highlights below:

- OSIM will keep its retail network intact in order to ride the recovery. It can do this as it has a flexible cost structure where rents and staff costs adjust to slower sales. *Our analysis suggests that same-store sales are more than covering rentals in Singapore and HK, the two most expensive cities in Asia.*
- Expensive chairs outsold smaller massage items in 3Q15 and the share of total OSIM sales rose to 70% from 60-65%. *We are encouraged by this as it suggests OSIM is not losing market share. Further, it also suggests each store can still sell 1-2 high-end chairs a week, which is encouraging in a downturn.*
- TWG could turn profitable next year, with HK store-count building up rapidly, and franchising accelerating. *We are optimistic on franchising, a low-cost but highly profitable way of expanding TWG's reach. The Middle-east looks especially promising, while distributorships in the US, Canada, and Australia could be converted to franchises.*
- Judgement for OSIM vs. Murjani will be known by early 2016. *We would expect legal costs to have peaked in 2015, unless OSIM loses the Singapore case. The worst case scenario is a sell-back of the 16.3% stake. But it would have be a price proportionate to the investments put in by OSIM.*

## What's Our View

Reiterate HOLD. Near-term outlook still poor, but 3Q15 should have been the trough for this year. We see a risk from the loss of TWG shareholding fight.

FYE Dec (SGD m)	FY13A	FY14A	FY15E	FY16E	FY17E
Revenue	647.6	691.1	598.1	656.5	775.1
EBITDA	136.2	151.6	93.6	119.6	137.5
Core net profit	98.2	102.8	62.8	76.3	87.1
Core FDEPS (cts)	12.5	12.3	7.5	9.8	11.2
Core FDEPS growth(%)	11.2	(1.3)	(39.0)	30.2	14.2
Net DPS (cts)	6.0	6.0	6.0	6.0	6.0
Core FD P/E (x)	10.9	11.0	18.1	13.9	12.1
P/BV (x)	3.6	2.4	2.8	2.4	2.2
Net dividend yield (%)	4.4	4.4	4.4	4.4	4.4
ROAE (%)	42.0	29.0	15.4	19.5	20.4
ROAA (%)	17.1	13.4	7.8	9.9	10.6
EV/EBITDA (x)	11.8	8.8	9.9	7.1	5.9
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash

## Key Data

52w high/low (SGD)	2.17/1.36
3m avg turnover (USDm)	2.0
Free float (%)	35.1
Issued shares (m)	779
Market capitalization	SGD1.1B
Major shareholders:	
-SIM CHYE HOCK	62.4%
-Templeton Asset Management Ltd. (Hong	2.4%
-Western Asset Management Co. Pte Ltd.	1.4%

## Share Price Performance



	1 Mth	3 Mth	12 Mth
Absolute(%)	(16.3)	(17.1)	(26.3)
Relative to index (%)	(22.1)	(10.1)	(20.5)

## Maybank vs Market

	Positive	Neutral	Negative
Market Recs	0	5	3
	Maybank Consensus		% +/-
Target Price (SGD)	1.49	1.46	2.4
'15 PATMI (SGDm)	56	60	(7.0)
'16 PATMI (SGDm)	76	75	1.8

Source: FactSet; Maybank

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We hosted a post-results tea session with OSIM, represented by CFO Peter Lee and Corporate Developments Manager Juan Chow Yee. The following issues were discussed.

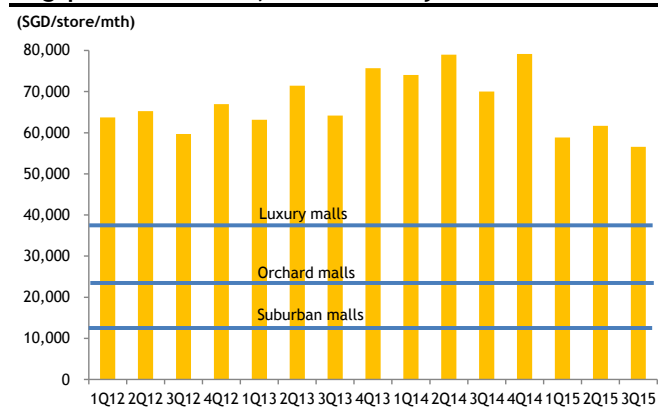
### Staying the course

OSIM is waiting for market conditions to improve. Management assured that revenue will improve along with market conditions as long as it stays the course in the following areas:

1) **Maintain a visible ground presence.** Management ruled out indiscriminate store closings just to bring operating costs down. While it will continue to close underperforming stores, it will also open new ones as it needs to maintain its ability to launch new products and perform effective marketing. A sufficiently effective network of stores is critical to be able to take advantage of the recovery when it comes.

*Our comments: Will OSIM be able to maintain this strategy? For now, we believe it can. Same-store sales have fallen significantly this year but our analysis suggests that revenue per store was still above Singapore and HK retail rental costs in 3Q15. Most of OSIM's stores are in suburban areas. Some are in central locations such as ION and MBS in Singapore, and Causeway Bay and Pacific Place in HK, but they are not prime lots. OSIM has 26 stores in Singapore. However, they are unlikely to be paying top dollar for the premium stores - the ION store is on 4F while the MBS store is in B2. Similarly, it has 29 stores in HK, of which two are in Causeway Bay. One however is part of the SOGO Department Store, while the other is on the 9th floor of Times Square. It will also be helped by the fact that retail rents are coming down in both Singapore and HK.*

**Figure 1: OSIM same-store sales still more than covering Singapore rental costs, even at luxury malls ION and MBS**

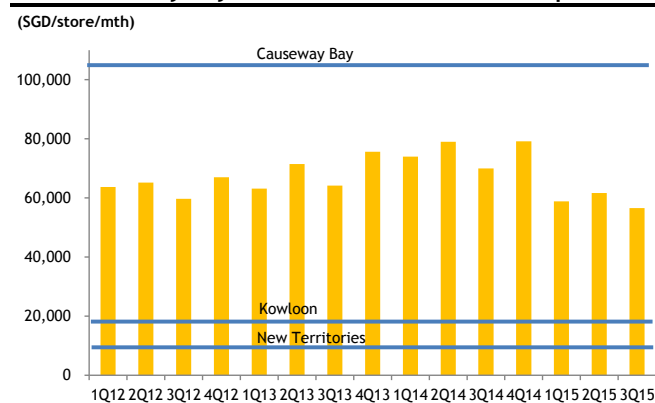


Source: Maybank Kim Eng estimates

For Singapore, we assumed SGD15 psf/mth for suburban malls, SGD30 psf/mth for Orchard Road malls and SGD50 psf/mth for luxury malls. We assumed HKD85 psf/mth in the New Territories, HKD135 psf/mth in Kowloon, and HKD850 psf/mth in Causeway Bay. OSIM's store sizes range from 500 sf to 1,000 sf. We assumed an average store size of 750 sf.

Note: OSIM has never divulged their same-store sales. The above charts are based on our own estimations.

**Figure 2: OSIM same-store sales also covering HK rental costs, even Causeway Bay as 2 stores there are in non-prime lots**

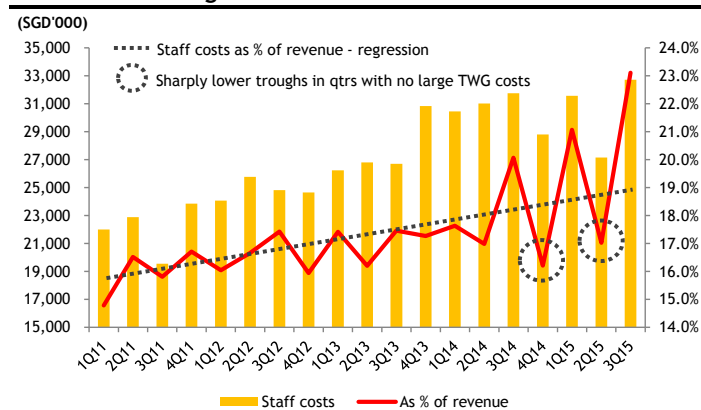


Source: Maybank Kim Eng estimates

2) **Maintain a flexible cost structure.** Further, OSIM structures its store rentals with fixed and variable elements where rents adjust to lower sales. Similarly with staff cost, where 30% comes from commissions. But the savings are masked by the cost of TWG’s expansion, which is a strategic one independent of market conditions.

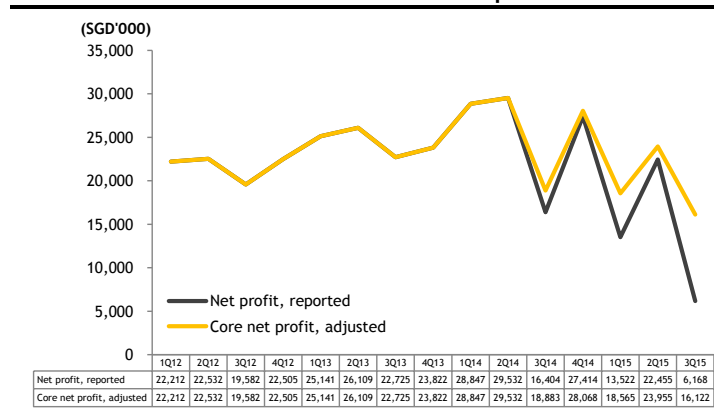
*Our comments:* This appears to have occurred, as shown in Figure 3, which shows higher volatility in 3Q14-3Q15 around the staff cost regression line. The sharply-higher peaks were caused by higher TWG-related costs and the sharply-lower troughs in quarters of low TWG costs were likely caused by the lower variable staff costs. In stripping out the TWG staffing costs, we also concluded that OSIM’s profits, while still down, were much less volatile without TWG’s expansion (Figure 4). We conclude that OSIM has been affected by poor market conditions, but not to an extent where we would expect the company to sink into losses. This could alleviate worst-case investor concerns.

**Figure 3: Lower variable staff costs partially masked by TWG-related new hirings...**



Source: Company data, Maybank Kim Eng estimates

**Figure 4: ...but we conclude that OSIM’s earnings would have been much less volatile if not for TWG’s expansion costs**



Source: Company data, Maybank Kim Eng estimates

### Selling more big chairs than small items

Management made the interesting point that, in current difficult times, chairs actually outsold small massage products. In 3Q15, chairs accounted for almost 70% of OSIM massage product sales, up from 60-65% before.

*Our comments:* This runs counter to the conventional thinking that cheaper products sell better during a downturn. From a sales-person’s perspective, however, we can see why. Basically, he or she just needs to make 1-2 sales of the higher-priced chairs a week vs as many as 21 a week of the cheapest handheld massager. Effort-wise, selling chairs would also be more intense per prospect, but would need fewer prospects, which is encouraging given the downturn. This also suggests that OSIM is not losing market share, despite weaker markets.

**Figure 5: Granular look at same-store sales from an OSIM sales-person’s perspective**

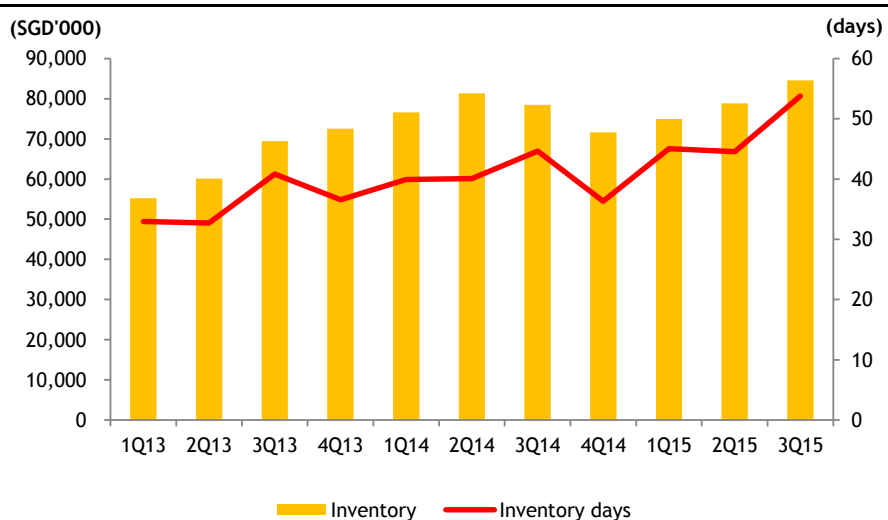
3Q15 same-store sales (per store per mth)	SGD56,597	Chairs	Small items
Split between chairs & small items		70%	30%
Revenue per store per mth from		SGD39,618	SGD16,979
- No of uInfiniti chairs needed per store per mth, @ SGD7,599		5.2 (1-2 a week)	
- No of uMagic chairs needed per store per mth, @ SGD5,499		7.2 (1-2 a week)	
- No of uDiva Classic chairs needed per store per mth, @ SGD1,999		19.8 (5 a week)	
- No of uPhoria leg massagers needed per store per mth, @ SGD799			21 (5 a week)
- No of uHip hip massagers needed per store per mth, @ SGD359			47 (12 a week)
- No of uPamper handheld massagers needed per store per mth, @ SGD199			85 (21 a week)

Source: Company data, Maybank Kim Eng estimates

### No alarming trend for inventory

Inventory has risen from 45 days in 3Q14 to 54 days in 3Q15. However, management did not view this with concern as it is driven by TWG's expansion in North Asia, where it now has more corporate-owned stores and warehouses. OSIM has traditionally been conservative with its provisioning for obsolete stock; 50% of the value of massage products over a year old is provided for, with even more conservative provisioning of 180 days for China. All stocks are current and fully provided for. With the impending launch of a new mid-range chair in 1Q16, management believed all old stocks will be cleared by then. Even products sold during warehouse sales are above cost.

Figure 6: Inventory days rising



Source: Company data

### TWG expansion to continue

TWG today is profitable at the EBITDA level, and at the net level only if legal fees of SGD7m in 9M15 are not included. However, it plans to continue its expansion in North Asia, with general managers already hired for HK and China. Management alluded to the possibility that TWG could contribute some profits in 2016.

**(1) Hong Kong:** Since the trademark case with Tsit Wing Group was settled earlier this year, it is full steam ahead. TWG has added two new stores in Pacific Place and Harbour City in HK, adding to the first store in the IFC Mall. In 4Q15, it will open 1 more store in HK and its second store in Macau. Over time, TWG is likely to want to secure locations near the Venetian and Sands as well, since it is aligned with Sands in Singapore. According to management, HK can be profitable today although they have said before that they will likely only be happy when the number of TWG stores hit 4-5 in any particular location.

*Our comment:* This may be a positive development to look forward to next year, as a turnaround to profitability in HK could help to offset TWG's bleeding in North Asia.

**(2) Legal suits:** The Singapore suit against the TWG co-founder Manoj Murjani ended in September, and OSIM incurred SGD4m in legal costs in 3Q15. A judgement is expected in early 2016. The trademark appeal

against Tsit Wing Group in HK will be heard in Jan 2016, but will be a relatively short 3-day hearing.

*Our comment: In this context, we would expect legal costs to be over the hump in 2015, unless OSIM loses the Singapore case. The absolute worst-case scenario could involve returning the stake and/or share of revenue/profits to Mr Murjani. The brand itself should stay with TWG, but the ownership stakes could shift. OSIM should still retain majority ownership as we understand that Mr Murjani is basically arguing for the court to reverse the stake increase from 53.7% to 70%, effected in Jan 2014. However, it may not come to this.*

*As we understand it, the original 2011 agreement specified OSIM's rights to take over more equity if performance targets were not met. In addition, the other co-founder - current TWG President Mr Taha Bouqdir - did not object, hence OSIM could point to this as confirmation of its legal rights. We think it is likely the court will also consider the investments that OSIM has put in since then. OSIM should argue that without them investing to build up TWG, it will not be as big as it is today. The worst case scenario, in our estimation, is that the court may require OSIM to sell back the 16.3% stake to Mr Murjani at a certain price. But it would have a price that is proportionate to the investments and effort that OSIM has put in to build up TWG after it took over the stake.*

### Franchising the next major step

Franchisees currently own and operate more than 100 of the 546 OSIM stores, and 29 of the 49 TWG stores (52 planned by end-2015). However, franchisees currently contribute less than 5% of group revenue as OSIM only accounts for raw material and product sales to them and not the entire retail revenue, while franchisees pay their own capex and operating costs.

However, there are plans to beef up the TWG franchise business, starting with the Middle-east next year. In addition, OSIM plans to convert distributors to franchisees, currently in countries such as the USA, Australia and Canada, which are committed to delivering on defined expansion plans. There are also plans to appoint more OSIM franchisees in the USA and other countries.

*Our comments: More franchisee-run stores will allow TWG to expand revenue without having to spend a lot on capex, and could moderate its expansion costs in North Asia, which will involve corporate-owned stores instead of franchisees. OSIM has mentioned before that it wants to expand into a minimum of 10 major cities in China. It currently has 3 stores in Shanghai and 1 in Guangzhou. Beijing, Shenzhen, Nanjing and Chengdu are also on the agenda.*

**Figure 7: TWG stores around the world, as at end-3Q15**

Owned no. of stores	20.0	Franchisee-run no. of stores	29.0	Distributor-run no. of stores	18.0
Singapore	9.0	Thailand	6.0	Australia	6.0
China	4.0	Philippines	5.0	USA	6.0
Hong Kong	3.0	Malaysia	5.0	Morocco	2.0
Taiwan	3.0	Korea	4.0	Canada	1.0
Macau	1.0	Japan	3.0	UK	1.0
		UAE	3.0	Germany	1.0
		Indonesia	2.0	Portugal	1.0
		Cambodia	1.0		

Source: Company data, Maybank Kim Eng

## Upcoming product launches

OSIM currently has two high-end chairs - the ulnfiniti at SGD7,599 and the ulnfiniti Luxe at SGD7,999. It intends to cycle out the ulnfiniti next year as the customer experience with the Luxe has been proven to be better. It will only launch a new high-end chair in 2017.

4Q15 will see the following products launched:

- uCrown 3 head massager - bringing back a new version of the uCrown 2 last launched in 2009;
- uGallop 2 - bringing back the equestrian core exerciser;
- uPamper 2 handheld massager - replacing current SGD199 uPamper;
- uDiva Classic - a lower priced massage sofa at SGD1,999 compared to the SGD2,699 uDiva currently on sale.

*Our comments: Management also alluded to another new chair in 1Q16 but did not reveal its target segment. Usually, there is a 2-year cycle for new chairs except for massage sofas, which have seen a new model every year since the product was introduced in 2013. Therefore, it is unlikely to replace the mid-range SGD5,499 uMagic that was only launched in 2Q15 after a delay. It may be a replacement for the SGD1,499 uChill office massage chair, which we think has not sold well.*

## Re-embracing stars as part of a core marketing strategy

OSIM plans to bring back celebrity endorsements in 2016 after deciding not to use them in 2015. A major entertainment star was promised. Its marketing platform will still however embrace online marketing.

## Corporate vs personal investments - who decides?

This year, new investments by OSIM in two listed companies came to light. In June, it invested in 8.8% of Trek 2000, the inventor of the ThumbDrive USB drive and Flucard WiFi SD card. In July, Fujian-based shoemaker China Sports International announced that OSIM had acquired 9.3% of its shares back in 2014. Most recently, OSIM's founder Mr Ron Sim has also emerged as an anchor investor in high-end seafood restaurant chain Jumbo Seafood in its upcoming IPO. Questions were asked of the rationale and decision-making process behind these three investments, with one fund manager expressing that OSIM should have taken a stake in Jumbo instead of Mr Sim.

Management explained that Trek had certain technologies that OSIM could utilise in its products at a future time, while China Sports had certain technologies in its shoes that OSIM was interested in, such as breathable soles and materials. As for the decision-making process, OSIM has a 5-member investment committee headed by Mr Sim that evaluates all investments. The ultimate decision, however, is made by the board. OSIM is also given first choice at all investments that present themselves to the company. In Jumbo's case, the board decided against an investment by OSIM.



FYE 31 Dec	FY13A	FY14A	FY15E	FY16E	FY17E
<b>Key Metrics</b>					
P/E (reported) (x)	10.1	10.5	19.2	13.0	11.4
Core P/E (x)	10.0	10.4	17.0	13.0	11.4
Core FD P/E (x)	10.9	11.0	18.1	13.9	12.1
P/BV (x)	3.6	2.4	2.8	2.4	2.2
P/NTA (x)	12.1	4.1	5.3	4.2	3.5
Net dividend yield (%)	4.4	4.4	4.4	4.4	4.4
FCF yield (%)	9.1	8.0	4.8	2.5	6.8
EV/EBITDA (x)	11.8	8.8	9.9	7.1	5.9
EV/EBIT (x)	13.1	10.3	13.0	8.8	7.3

**INCOME STATEMENT (SGD m)**

Revenue	647.6	691.1	598.1	656.5	775.1
Gross profit	455.1	486.3	429.0	466.1	554.2
EBITDA	136.2	151.6	93.6	119.6	137.5
Depreciation	(13.7)	(21.8)	(22.2)	(23.0)	(27.1)
Amortisation	0.0	0.0	0.0	0.0	0.0
EBIT	122.5	129.8	71.3	96.6	110.4
Net interest income / (exp)	(0.4)	1.5	1.5	0.0	0.0
Associates & JV	2.9	1.0	1.7	2.0	2.3
Exceptionals	(0.9)	(0.7)	(7.0)	0.0	0.0
Other pretax income	0.0	0.0	0.0	0.0	0.0
Pretax profit	124.9	132.3	74.5	98.6	112.7
Income tax	(27.6)	(30.1)	(20.1)	(21.7)	(24.8)
Minorities	(0.0)	(0.0)	1.3	(0.7)	(0.8)
Perpetual securities	0.0	0.0	0.0	0.0	0.0
Discontinued operations	0.0	0.0	0.0	0.0	0.0
Reported net profit	97.4	102.2	55.8	76.3	87.1
Core net profit	98.2	102.8	62.8	76.3	87.1

**BALANCE SHEET (SGD m)**

Cash & Short Term Investments	290.9	456.4	376.4	370.5	428.9
Accounts receivable	42.3	43.5	41.0	54.0	63.7
Inventory	72.5	71.6	65.5	89.9	106.2
Property, Plant & Equip (net)	25.2	36.4	39.2	36.2	29.1
Intangible assets	189.9	180.6	175.6	170.6	165.6
Investment in Associates & JVs	18.5	18.4	20.1	22.0	24.4
Other assets	40.8	45.4	40.9	42.9	47.1
<b>Total assets</b>	<b>680.0</b>	<b>852.5</b>	<b>758.7</b>	<b>786.2</b>	<b>865.0</b>
ST interest bearing debt	154.6	17.2	15.0	16.4	19.4
Accounts payable	101.6	96.5	81.9	71.9	84.9
LT interest bearing debt	0.1	168.3	170.0	170.0	170.0
Other liabilities	80.0	79.0	68.0	75.0	88.0
<b>Total Liabilities</b>	<b>336.0</b>	<b>360.5</b>	<b>335.1</b>	<b>333.2</b>	<b>362.7</b>
Shareholders Equity	271.2	438.4	375.8	407.1	448.0
Minority Interest	72.7	53.6	47.8	46.0	54.3
<b>Total shareholder equity</b>	<b>343.9</b>	<b>491.9</b>	<b>423.6</b>	<b>453.0</b>	<b>502.3</b>
Perpetual securities	0.0	0.0	0.0	0.0	0.0
<b>Total liabilities and equity</b>	<b>680.0</b>	<b>852.5</b>	<b>758.7</b>	<b>786.2</b>	<b>865.0</b>

**CASH FLOW (SGD m)**

Pretax profit	124.9	132.3	74.5	98.6	112.7
Depreciation & amortisation	13.7	21.8	22.2	23.0	27.1
Adj net interest (income)/exp	0.4	(1.5)	(1.5)	0.0	0.0
Change in working capital	1.9	(16.0)	(3.9)	(48.4)	(15.0)
Cash taxes paid	(29.2)	(26.0)	(13.4)	(26.7)	(34.9)
Other operating cash flow	(11.8)	(1.7)	(1.7)	(2.0)	(2.3)
Cash flow from operations	100.1	108.9	76.3	44.6	87.6
Capex	(10.5)	(23.6)	(25.0)	(20.0)	(20.0)
Free cash flow	89.5	85.3	51.3	24.6	67.6
Dividends paid	(36.2)	(47.6)	(47.0)	(47.2)	(86.4)
Equity raised / (purchased)	(7.4)	(12.0)	(38.0)	0.0	0.0
Perpetual securities	0.0	0.0	0.0	0.0	0.0
Change in Debt	4.5	134.0	(0.5)	1.5	3.0
Perpetual securities distribution	0.0	0.0	0.0	0.0	0.0
Other invest/financing cash flow	6.9	(0.3)	1.5	0.0	0.0
Effect of exch rate changes	5.8	0.8	(14.3)	15.2	74.3
Net cash flow	63.0	160.2	(47.0)	(5.9)	58.4

FYE 31 Dec	FY13A	FY14A	FY15E	FY16E	FY17E
<b>Key Ratios</b>					
<b>Growth ratios (%)</b>					
Revenue growth	7.6	6.7	(13.5)	9.8	18.1
EBITDA growth	7.6	11.3	(38.3)	27.8	14.9
EBIT growth	6.2	6.0	(45.0)	35.5	14.2
Pretax growth	8.8	5.9	(43.7)	32.4	14.3
Reported net profit growth	12.0	5.0	(45.4)	36.7	14.2
Core net profit growth	10.1	4.7	(39.0)	21.5	14.2
<b>Profitability ratios (%)</b>					
EBITDA margin	21.0	21.9	15.6	18.2	17.7
EBIT margin	18.9	18.8	11.9	14.7	14.2
Pretax profit margin	19.3	19.1	12.5	15.0	14.5
Payout ratio	44.6	46.1	84.5	57.4	50.3
<b>DuPont analysis</b>					
Net profit margin (%)	15.0	14.8	9.3	11.6	11.2
Revenue/Assets (x)	1.0	0.8	0.8	0.8	0.9
Assets/Equity (x)	2.5	1.9	2.0	1.9	1.9
ROAE (%)	42.0	29.0	15.4	19.5	20.4
ROAA (%)	17.1	13.4	7.8	9.9	10.6
<b>Liquidity &amp; Efficiency</b>					
Cash conversion cycle	(38.6)	(25.1)	(18.5)	27.5	59.3
Days receivable outstanding	22.4	22.3	25.4	26.0	27.3
Days inventory outstanding	118.1	126.7	146.1	146.9	159.8
Days payables outstanding	179.1	174.1	190.0	145.4	127.8
Dividend cover (x)	2.2	2.2	1.2	1.7	2.0
Current ratio (x)	1.4	3.7	3.7	4.1	4.1
<b>Leverage &amp; Expense Analysis</b>					
Asset/Liability (x)	2.0	2.4	2.3	2.4	2.4
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash
Net interest cover (x)	nm	na	na	nm	nm
Debt/EBITDA (x)	1.1	1.2	2.0	1.6	1.4
Capex/revenue (%)	1.6	3.4	4.2	3.0	2.6
Net debt/ (net cash)	(136.2)	(270.9)	(191.4)	(184.1)	(239.5)

Source: Company; Maybank



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