

ESTHETICS INTERNATIONAL GROUP <i>Initial Coverage</i> Stock Code: 5081	Price:	RM0.985
	Market Capitalisation:	RM118.2m
	Board:	Main Board
	Sector:	Trading/Services
	Recommendation:	Buy

KEY STOCK STATISTICS

	2005	2006F
EPS (est)	10.4	12.3
P/E (est)	9.5	8.0
Dividend/Share	6.0	9.0
NTA/Share (RM)	0.74	0.83
Book Value/Share	0.74	0.83
Issued Capital (mil shares)	117.8	120.0
52-weeks Share Price Range	RM0.93 - RM1.37	
<u>Major Shareholders</u>	<u>%</u>	
Li mYee Soon	25.1	
Melissa Chen	22.4	

PER SHARE DATA

YE 30 Jan	2003	2004	2005	2006F
Book value (RM)	0.55	0.67	0.74	0.81
Cash Flow (RM)	0.14	0.14	0.12	0.14
Earnings (sen)	12.0	12.1	10.4	12.3
Gross Dividend (sen)	-	2.5	6.0	9.0
Payout Ratio (%)	-	15.4	35.3	43.7
PER (x)	8.2	8.1	9.5	8.0
P/Cash Flow (x)	7.0	7.0	8.5	7.1
P/Book Value (x)	1.8	1.5	1.3	1.2
Dividend Yield (%)	-	2.5	6.1	9.1
ROE (%)	21.7	19.7	15.8	15.9
Net Gearing (%)	net cash	net cash	net cash	net cash

P&L ANALYSIS (RMm)

YE 30 Jan	2003	2004	2005	2006F
Revenue	65.57	62.59	80.66	96.24
Operating profit	19.30	17.87	19.72	23.81
Depreciation	(2.25)	(2.17)	(2.33)	(2.63)
Net interest income	0.46	0.53	1.23	0.87
Exceptional items	-	-	-	-
Pre-associate profit	17.51	16.22	18.62	22.05
Associates	(0.22)	(0.19)	(0.89)	(0.80)
Pretax profit	17.30	16.04	17.73	21.25
Taxation	(5.65)	(4.33)	(5.46)	(6.37)
Minorities	(0.03)	(0.02)	(0.06)	(0.06)
Net profit	11.61	11.69	12.22	14.82
Operating margin (%)	29.4	28.6	24.4	24.7
Pretax margin (%)	26.4	25.6	22.0	22.1
Net margin (%)	17.7	18.7	15.2	15.4
Effective tax rate (%)	32.7	27.0	30.8	30.0

1 Investment Highlights / Summary

Esthetics International Group is a leading provider of professional skin care services in Malaysia. Its competitive edge lies in its exclusive distributorship rights for Dermalogica range of products as well as skin therapy and beauty equipment. Leveraging on experience gained over the years, EIG successfully launched its in-house brands of cosmetics and body wellness products. In the financial year ended Jan 2005, in-house brands accounted for 13% of revenue from the Group's distribution activities. With earnings projected to grow at a healthy 17% p.a. in FY06-07, EIG's PERs would improve from 9.6x to an attractive 8.1x and 6.7x for the 2 years. Potential capital appreciation of 28% coupled with high net dividend yield of 6.5% suggest total returns of 34.5%. **BUY.**

2 Background

- Corporate Profile*

Has Dermalogica distributorship rights for Malaysia ... EIG's foray into the skin care business started when Melissa Chen, its co-founder, set up her first skin care centre Head To Toe Beauty Care Centre ("HTTBC") at Imbi Plaza, Kuala Lumpur in 1984. In 1989, Esthetics Group managed to secure its first exclusive distributorship to distribute Dermalogica range of professional skin care products in Malaysia. The business arrangement with Dermalogica Inc, USA ("DI") also entitles the Group to use the Leonard Drake mark for its professional skin care services centres.

Melissa Chen and her co-founders established their first professional skin care centre known as Leonard Drake Professional Skin Care Centre ("LDPSC") in Bangsar, Kuala Lumpur in 1992. As at end-March 2005, the Group has 16 Professional Skin Care Centres and 2 kiosks located in prominent shopping centres. It also has 300 appointed local dealers who independently own skin care centres.

... and regional countries. EIG has further secured the exclusive distributorships for Dermalogica for Thailand, Singapore, Indonesia, Vietnam, Brunei, Cambodia, Hong Kong and Philippines. In addition

to the Dermalogica range of skin care products, the Group has secured exclusive distributor rights for the following:

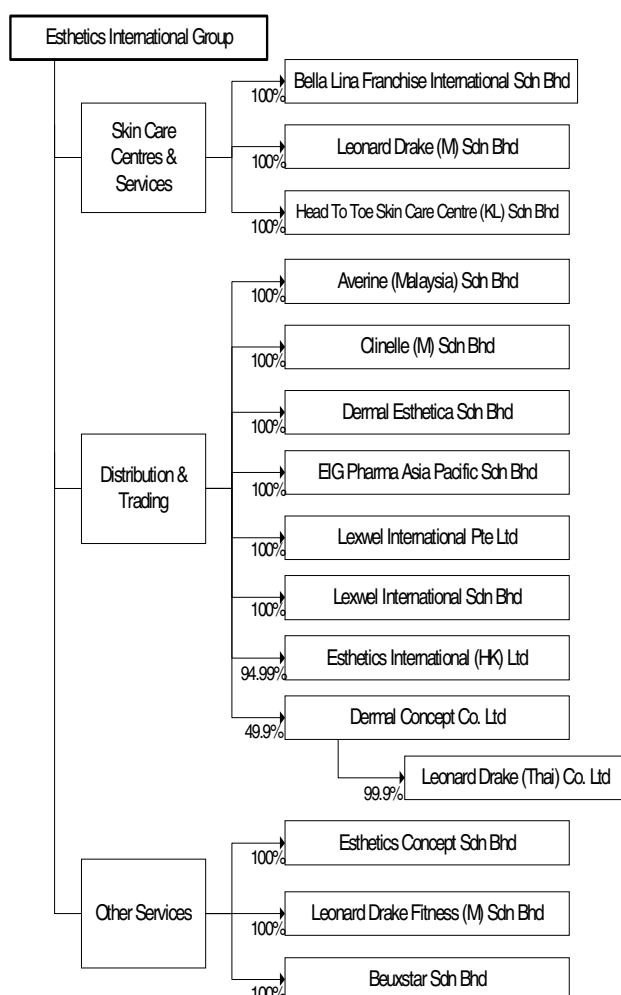
- Eve Taylor (London) Ltd for its range of aromatherapy products in 1992;
- Nemectron GmbH for its range of Electro-Cosmetic (Beauty) Equipment in 1993;
- Weyergans High Care AG for its range of beauty equipment in 2003;
- Danycare Medical Beauty GmbH for its range of medical products in 2003; and
- Ros's Esthetica Y Electromedicina for its range of beauty equipment in 2003.

Has since introduced 4 in-house brands. EIG has also launched four in-house brands of products - Averine range of cosmetics (re-launched in 2001), Eflim range of slimming products for external application only (2001), Bioxil range of whitening and firming essence (2002), and Clinelle range of cosmeceutical products (2003).

● Corporate Structure

Please see chart below

GROUP STRUCTURE



● Business

EIG has two core activities. EIG's operations can be broadly categorised into two segments:

- professional skin care & wellness services ("Professional Services"); and
- distribution of skin care & wellness products ("Products/Trading").

Both core activities of Professional Services and Products/Trading complement each other. Professional Services comprises professional services rendered and related sales in respect of skincare and fitness programmes undertaken by its wholly-owned subsidiaries Leonard Drake (Malaysia) Sdn Bhd ("LDM") and Belle Lina Franchise International Sdn Bhd ("BLFISB"). Products/Trading comprises the distribution of skincare products and beauty equipment undertaken by Dermal Esthetica Sdn Bhd ("DESB"), Esthetics International (HK) Ltd ("EIHK"), and Clinelle (M) Sdn Bhd ("CMSB").

Dermalogica its main revenue earner. Although EIG has expanded its portfolio of franchises, the Dermalogica franchise remains the Group's most important. About 80% of EIG's revenue is contributed by its Leonard Drake centres and sales of Dermalogica products.

In terms of the split between Professional Services and Products/Trading, approximately 40% of EIG's turnover comes from the provision of services while the sale of products account for a bigger 60% of revenue. However, margins earned from provision of Professional Services are higher than margins earned by its Products/Trading division.

Professional Services division ... Currently, EIG has 16 corporate owned Leonard Drake Professional Skin Care Centres and 2 Dermalogica kiosks or Dermalogica Consultation Centre. The centres are located in prominent shopping centres in Klang Valley (16 centres) and Penang (2 centres). It also has 8 corporate owned Belle Lina centres - 7 in the Klang Valley and 1 in Kota Bahru.

EIG's professional skin care services are mainly facial skin care therapy and body care therapy. Its facial skin care therapy includes preventive and corrective facial programme, eye care treatment, decollate facial programmes, non-surgical face lifting, and advanced acne management. As for body care/wellness, EIG offers bath therapy, body wraps and scrub, breast care, stress reduction therapy, pressure therapy, spot trim and fit programme, and body waxing.

... to tap new market segments ... Management sees opportunities for growth in new market

segments such as the bumiputeras and male market. The Group has about 26,000 active customers of which less than 10% are Malay clients and less than 5% are males. EIG is currently doing a concept study for the set-up of a professional skin care centre for men. A new name is likely to be adopted and if all goes well, the Group would establish 2 professional skin care centres for men in 2005. One of its competitors, Bella Skin Care Sdn Bhd has 6 centres for men and these are said to be doing well. Dermalogica products are suitable for the Malay market as they are alcohol-free.

... via opening of new centres, ... To tap these new segments as well as expand its market reach, EIG plans to establish at least 3 new corporate owned centres, one Leonard Drake centre in Suria KLCC that will be its flagship store with 5,000 sq ft of space, and two Belle Lina centres (one each in Shah Alam City Centre and Lot 10). The Group would also set up 4 Dermalogica Consultation Centres, one each in Sogo Shopping Complex, Bukit Raja, Shah Alam and The Curve in FY06.

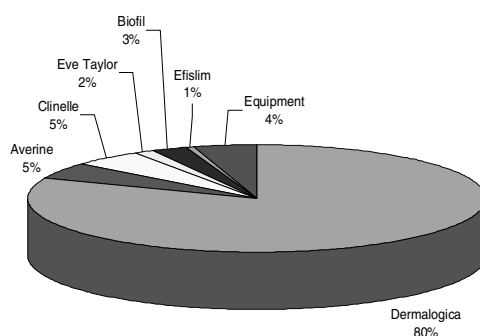
In total, the 3 new corporate owned centres and 4 consultation centres or kiosks would require investments of RM2.0m. At the same time, the Group also has plans to refurbish 12 of its existing Leonard Drake centres at an estimated cost of RM1.0m.

... obtained approval for own franchise scheme. To promote its own Belle Lina range of products, EIG will introduce a new skin care and wellness chain under its own trade name, *Belle Lina, Oasis of Wellness* as a franchise concept. The Group has obtained approval from Franchising Department of Ministry of Entrepreneur Development in December 2004 and the franchise scheme would be launched in early 2QFY06. Management targets to have 7 franchised centres in FY06 and increasing to 13 in FY07 and 19 in FY08. EIG would receive franchise fees in the immediate term but revenue from this home-grown franchise would include royalty and product sales over the longer term.

Management has ambitious plans for its Belle Lina franchise. It intends to introduce the franchise to Singapore, Hong Kong and Thailand while for Vietnam, Indonesia and Philippines master franchisors would be appointed.

Products/Trading division ... EIG's distribution activities are carried out by wholly-owned subsidiaries DESB and EIHK. Since 1989, DESB has been an exclusive distributor of Dermalogica skin care products for Malaysia, Hong Kong, Singapore, Thailand, Indonesia, Philippines, Vietnam, Cambodia and Brunei. Currently, it carries

BREAKDOWN OF PRODUCT REVENUE (FY05)



Source: EIG

more than 165 products under the Dermalogica range of products.

DESB also distributes EIG's in-house brands Averine, Eflislim and Biofil. The company also acts as the exclusive distributor for Eve Taylor aromatherapy and essential oils for facial and other applications, and various brands of professional skin care and body therapy equipment. Equipment carried include Radiancy (US), Novalight (US), Omnilight (US), Dany Care (US), Weyergan (Germany), Nemectron GmbH (Germany), and Ros's Esthetics (Spain).

... supported by large base of dealers and overseas distribution network. Besides distributing to EIG's Leonard Drake centres, DESB also sells its products through a network of about 300 dealers who own professional skin care centres in Malaysia. It is estimated that there are some 5,000 independent dealers in the skin care industry.

The Group's overseas distribution network is undertaken by 95%-owned EIHK, which is responsible for distribution of Dermalogica products in Hong Kong, and 49.9%-owned DCCL, which takes care of Thailand. For Singapore, Vietnam, Cambodia, Indonesia and Philippines, EIG has appointed overseas sub-distributors. In these regional markets, the same strategy of using dealers is adopted. Currently, it has 150 dealers in Hong Kong, 250 in Thailand and 115 in Singapore.

Distribution business would be key revenue driver. Management is optimistic its Products/Trading division would achieve strong sales growth over the next 12 months. Unlike the provision of professional services, which can be constrained by time required for each treatment, equipment capacity, and number of trained staff, revenue from distribution of skin care and wellness products would be boosted by EIG's strategies to start its own franchise, expand its network of new professional skill care centres, recruit more dealers as well as

foray into new segments such as the men and bumiputera markets.

Also going into the mass market. To further broaden its earnings base, EIG is working on plans to venture into the middle-income and mass retail market segments. Its first step in that direction is the introduction of its in-house brand “*Clinelle*”, a range of cosmeceutical products with advanced formulation. Clinelle is now sold in major pharmacies such as Guardian, Vital Care Pharmacies, Watsons stores, Jusco outlets and independent pharmacists outlets.

Another area that EIG is planning to venture into is the direct selling business of wellness products. We have not factored into our forecast any revenue from this new business activity. Inclusion of this new source of revenue would be made once operations commences and more operational details are available.

3 Valuation

To arrive at our fair value for EIG, PE valuation would be used as the yardstick. Besides a comparison against current market PER, we would also benchmark the stock against Eng Kah Corporation. Although not directly comparable, Eng Kah would provide an indication of industry’s growth prospects and market’s valuation of this sector. Eng Kah is an OEM of colour cosmetics and personal care products for multi-national corporations. It is, however, not involved in the distributions activities.

COMPARATIVE VALUATION

	Eng Kah	Esthetics
Share Price (RM)	5.40	0.985
Market Cap (RMm)	217.7	118.2
Ave Daily Vol (mil)	0.009	0.017
P/E FY04 (x)	15.6	9.4
P/E FY05F (x)	12.9	8.1
P/NTA (x)	2.5	1.3
Yield (%)	1.9	9.1

4 Earnings Outlook

FY06 earnings to rise 17.5%. For FY ending January 2006, we expect EIG to improve its net profit by a healthy 17.5% to RM14.8m. This would be supported by a 19.3% increase in revenue to RM96.2m, lifted mainly by the Group’s Products/Trading division. Margins are expected to be stable at 24.7% as we do not expect any major changes in product costs.

In FY05, EIG’s net profit grew a modest 4.4% to RM12.2m despite a robust 28.9% jump in revenue to RM80.7m. This was mainly because the Group did not fully passed on higher product costs from DI. As a result,

its operating margin contracted to 24.4% from 28.6% in FY04.

5 Recent Developments

Setting infrastructure for direct selling business. Incorporated Lexwel International Pte Ltd in Hong Kong (February 2005) and Lexwel International Sdn Bhd (March 2005) with the intention to carry out direct selling of personal healthcare and skin care products. Lexwel has submitted an application to the Ministry of Domestic Trade and Consumer Affairs for the issuance of a Direct Selling Licence. It is EIG’s plans to use the Hong Kong unit to enter into China.

Secured new distributorships for equipment. In March 2005, the Group expanded the range of skin care therapy equipment in its portfolio. DESB signed a Distributorship Agreement with Radiancy Asia Pte Ltd for the exclusive rights to distribute selected Radiancy products in Malaysia for 3 years to 30 March 2008. These products are for skin photo rejuvenation, acne phototherapy and photo epilation.

In the same month, EIG Pharma Asia Pacific Sdn Bhd signed an International Distributor Agreement with American Medical Bio Care Inc (“AMBC”) for the exclusive rights to distribute AMBC’s fluorescent pulsed light technology systems for treatments of pigmented and vascular lesions of the skin, wrinkles, skin laxity, acne, permanent reduction of hair and tattoo removal to the medical/dermatologist market in Malaysia.

6 Investment Risk

Skin care industry is very competitive. In Malaysia, as in any parts of the world, competition in the skin care industry is intense. The domestic market is highly fragmented with many players in each of the three main segments i.e. mass market, premium brands and professional skin care products.

KEY PLAYERS IN PROFESSIONAL SKIN CARE SECTOR

Professional skin care services	Distributors to professional skin care centres
Clara International Beauty Group Sdn Bhd	Clara International Beauty Group Sdn Bhd
Esthetics International Bhd	Esthetics
Beaubelle Worldwide Sdn Bhd	Beaubelle Worldwide Sdn Bhd
JF Beauty Group Sdn Bhd	JF Beauty Group Sdn Bhd
PT Mustika Ratu Sdn Bhd	PT Mustika Ratu Sdn Bhd
Excellent Combination Sdn Bhd	Excellent Combination Sdn Bhd
Clarins Sdn Bhd	Societe Francaise De Cosmetiques Sdn Bhd
Adonis Beauty Consultants Sdn Bhd	Menard Cosmetics (M) Sdn Bhd
Bella Skin Care Sdn Bhd	Sky Resources Sdn Bhd
CN Health and Beauty Group Sdn Bhd	
Tung Pao Sdn Bhd	

Source: EIG prospectus

Having been in the industry for more than 16 years, EIG has learnt to not only cope but thrive despite the competition. Management attributes this to the Group's ability to establish a good reputation for the Leonard Drake centres and Dermalogica products.

Renewal of Dermalogica franchise. EIG's current distribution rights from DI is for 10 years and will expire in 2012 with an option to extend for another 5 years. Non-renewal of this franchise would certainly hurt EIG's prospects. However, we believe the Group would be able to remain a distributor of Dermalogica products for a long time to come. Our optimism is backed by EIG's 16 years relationship with DI. Furthermore, being the only DI distributor that has contracts to distribute to more than one country is also testament of EIG's ability to deliver results.

7 Balance Sheet

As at 31 January 2005, EIG had net cash of RM32.9m. Given its planned capital expenditure of RM7.0m in FY06, we foresee the Group remaining in a net cash position by end-January 2006.

BALANCE SHEET AND OTHER FINANCIAL DATA (RMm)

YE 30 Jan	2003	2004	2005
Total assets	61.0	77.2	103.9
Fixed assets	21.5	25.8	30.4
Current assets	39.3	51.4	73.6
Intangibles	-	-	-
LT assets	21.7	25.8	30.4
Current liabilities	(7.3)	(11.7)	(14.0)
LT liabilities	(0.1)	(0.2)	(0.6)
Minorities	-	0.1	0.2
Share capital	0.7	48.3	60.0
Reserves	52.8	16.9	29.2
Shareholders' Funds	53.5	65.2	89.2

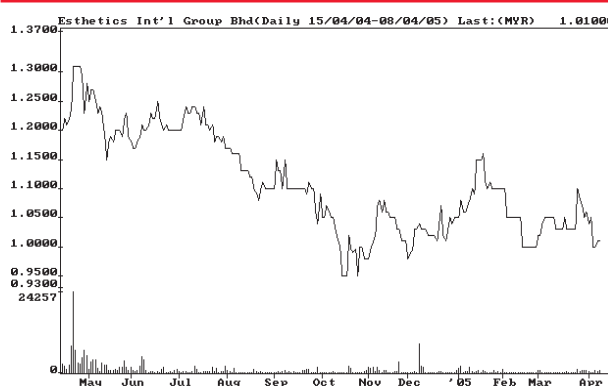
Source: EIG

8 Recommendation

Target price of RM1.26. At RM0.985, EIG shares are trading at 8.1x its CY05 EPS of 12.2 sen and 6.7x CY06 EPS of 14.7 sen. This is sharp discount to current market PER of 13x.

Pegging EIG's CY05 EPS at 10.3x, which is a 20% discount to Eng Kah's (RM5.40) current valuation of 12.9x, we arrive at a fair value of RM1.26. This suggests potential upside of 28%. The directors have made known its intentions to distribute between 30%-50% of EIG's net profit to shareholders. Based on our projected gross dividend of 9 sen per share (net: 6.48 sen) or payout of 38%, net dividend yield is an attractive 6.5%. We rate EIG a **Buy**.

PRICE CHART



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For AmResearch Sdn Bhd


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