

Recommendation: **BUY**

Stock Code: 5081

Bloomberg: EIG MK

Price: MYR0.87

12-Month Target Price: MYR1.00

Date: July 5, 2005

Board: Main

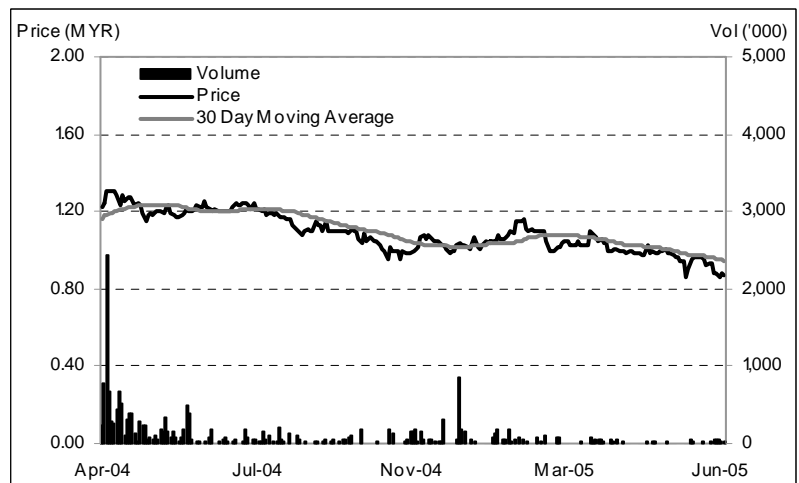
Sector: Trading / Services

GICS: Consumer Staples / Personal Products

Market Capitalization: MYR115.2 mln

Summary: Esthetics International Group (EIG) is the exclusive distributor of several brands of professional skincare and beauty products in Malaysia and parts of Asia, with the most well-known brand being Dermalogica. EIG also provides professional skincare and beauty services via the operations of Leonard Drake and Belle Lina Skincare Centres in and around the Asian region. EIG was listed on the Bursa Malaysia Main Board in Mar. 2004.

Analyst: Hoe Lee Leng, CPA



Highlights

- EIG's strategy of increasing reliance on its strong distribution channel is, we believe, the key to its future success.
- Although EIG is likely to incur startup-losses for its new product launches and new outlet operations for the initial period, we believe expansion of its product distribution channels would also expand operating profit margins for its product trading division, especially from the franchising operations.
- Given this scenario, we have forecast EIG to record a three-year net profit CAGR of 13.4% p.a.

Investment Risks

- EIG operates in a very competitive environment, due to the ease of entry and low capital requirement. EIG's main competitors are companies like Clara International, Thalgo, and to a certain extent bigger names like Estee Lauder and Clarins, which set up standalone retail units.
- EIG's overseas operations, we believe, may be difficult to manage efficiently from Malaysia, given the diversity of cultures, operational structures and government regulations.

Recommendation

- We initiate coverage on EIG with a Buy recommendation and an upside potential of 14.9% to our 12-month target price of MYR1.00. Our target price is based on a 30% discount to the consumer sector PER. We believe EIG should trade at a discount to the sector due to the tight liquidity of its shares and its small free float of only 25%.
- We believe EIG's strong distribution system and established brand name via its Leonard Drake corporate outlets would enable it to see through its expansion plans successfully while remaining a step ahead of its competitors.
- We expect EIG to remain in a net cash position over the next few years, given its relatively strong operating cashflow of between MYR5-7mln p.a.
- Based on EIG's recently announced dividend policy - to distribute between 30%-50% of its net profits for at least the next two years - we have forecast EIG's net dividend payout at an average of 40% p.a. over the next few years. This translates to net dividend yields of between 5%-6.6% p.a.

Key Stock Statistics

	2005	2006F
FY Jan.		
EPS (sen)	10.2	11.1
PER (x)	8.5	7.9
Dividend/Share (sen)	6.0	6.0
NTA/Share (MYR)	0.72	0.84
Book Value/Share (MYR)	0.72	0.84
Issued Capital (mln shares)	120.0	
52-week Share Price Range (MYR)	0.805 - 1.25	
Major Shareholders:	%	
Lim Yee Soon	25.1	
Melissa Chen	22.4	

Per Share Data

	2003	2004	2005	2006F
FY Jan.				
Book Value (MYR)	NA	NA	0.72	0.84
Cash Flow (sen)	NA	NA	12.1	13.3
Earnings (sen)	NA	NA	10.2	11.1
Dividend (sen)	NA	NA	6.0	6.0
Payout Ratio (%)	NA	NA	42.4	39.0
PER (x)	NA	NA	8.5	7.9
P/Cash Flow (x)	NA	NA	7.2	6.5
P/Book Value (x)	NA	NA	1.2	1.0
Dividend Yield (%)	NA	NA	6.9	6.9
ROE (%)	NA	NA	14.1	13.3
Net Gearing (%)	NA	NA	0.0	0.0

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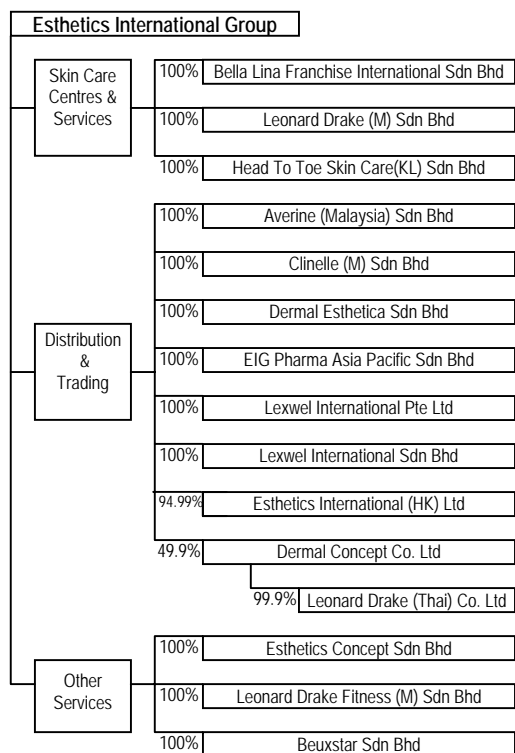
Background

Corporate Profile

EIG was founded by its major shareholder and CEO Melissa Chen. It provides professional skin care services and distributes beauty products. The company started with a skin care centre, Head To Toe Beauty Care Centre in 1984. In 1989, it secured the exclusive distributorship rights for Dermalogica Incorporated, USA's (DI) range of professional skincare products in Malaysia. EIG has since secured exclusive distributorships from DI for Thailand, Singapore, Indonesia, Vietnam, Cambodia, Hong Kong and Philippines. Its business arrangement with DI also entitles it to use the Leonard Drake (LD) trademark, which originated from U.S. It now has 18 professional skin care centers under the LD name, and two kiosks located in shopping centers in Penang and the Klang Valley. It also has over 300 appointed dealers, including 120 overseas dealers. Currently, EIG has a strong customer base of 26,000.

Besides DI, EIG has exclusive distributor rights for various international brands of professional skin care and beauty equipment and owns four in-house brands, including Averine (cosmetics).

Corporate Structure



Source: Company data

Business

EIG's operations are divided into two divisions namely professional services and distribution of products/trading. The professional services division contributes about 40% of group revenue, while distribution/trading contributes the remaining 60%. The majority (80%) of distribution/trading revenue comes from the sale of the DI range of products, which consists of 165 different products. Averine, its in-house brand, is the next best seller, with 138 types of products, contributing 5%-6% to the distribution/trading division.

The business arrangement with DI is a simple one. For example, DI gives EIG an annual target of purchases, (which grows at a rate of 8% p.a.). If EIG is unable to meet the target in the first year, the target is cumulated for the next year. However, if EIG exceeds the target (which has been the case most of the time), the target is maintained at 8% growth p.a. from the original sales value. DI sets a base export price for their products (in US\$), and each country is allowed to set its own market price thereafter.

DI usually raises its base export prices every 18 months by about 3% each time, but this is not across the board for all products. EIG usually does not pass down all the additional costs to its customers as often, but may do so once in three years. In fact, prices for its professional services have not been raised for the past three years.

EIG's contract with DI is usually for a period of 10 years, with the last renewal being in May 2002. The contract is extendable for another five years subject to terms and conditions.

EIG's dealers are trained extensively at an in-house training center by a central trainer from the U.S. Most of the dealers (including the independent ones) only sell EIG's range of products exclusively.

The in-house ranges of products, which attract a better sales margin than DI's products, are usually manufactured overseas and packed locally. EIG exports these in-house brands to countries like Singapore, Indonesia, Hong Kong, Thailand, Vietnam, Brunei and even the United Kingdom. Out of its total sales, 80% is from the domestic market and 20% from exports.

Earnings Outlook

Going forward, EIG has a few main strategies to expand its business. Firstly, it intends to expand its products and services to tap into the new "wellness" revolution in the market. This could see it exploring potential businesses like vitamins, cosmetic dermatology, cosmetic plastic surgery and other possibilities. EIG has plans to launch two new in-house brands for nutritional products this year, namely Vitwell and Inner Treats. EIG's strategy is to try to launch at least two in-house brands every year.

Secondly, EIG intends to increase its customer base by focusing on men, which is a relatively untapped segment of the market. This currently comprises less than 10% of EIG's clientele. EIG plans to establish two men skin care centers in 2005. We believe this could succeed, as there are already competitors in the marketplace doing relatively well.

Thirdly, it intends to expand regionally and locally. In Malaysia, it intends to open six new corporate outlets in 2005/2006 and refurbish 12 existing centers, all of which is expected to cost around MYR2-3 mln. Given that it usually only takes between six to nine months to reach breakeven point for these outlets (depending on the size and location), we believe the new outlets will be profit-generating within a year. Regionally, EIG plans to either appoint new dealers or open new corporate outlets. EIG plans to open a new Leonard Drake outlet each in Hong Kong and Thailand in 2005, estimated to cost another MYR2-3 mln.

Fourthly, EIG intends to set up its own franchising system under the trademark of "Bella Lina, Oasis of Wellness", which will exclusively distribute EIG's products. EIG has already obtained the necessary approvals from authorities to launch the franchising scheme and is targeting seven local franchisees by end-2005. In addition to revenue from product sales, EIG will be able to obtain both franchise fees and royalty

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income from its franchisees. The cost of franchise fees is estimated at between MYR30,000-40,000. Besides Malaysia, EIG plans to set up the franchise system in Singapore, Hong Kong and Thailand while for Vietnam, Indonesia and Philippines, master franchisors would be appointed. Currently, EIG has seven Belle Lina outlets in Malaysia, but these are corporate outlets and not franchised outlets.

All in, EIG's strategies are focused on making the most of its strong distribution channel, as it believes distribution rather than manufacturing is the key to its future success. This will result in a higher revenue and profit contribution coming from EIG's product trading division and lower contributions from the professional services division. We estimate revenue from EIG's professional services division to reduce to 35% (from 40%), while revenue from the product trading division should increase to 65% (from 60%) over the next few years. Given EIG's strong distributorship network and highly trained professional staff, we believe this strategy is positive for EIG for the medium to long term.

Although EIG is, in our view, likely to incur startup-losses for its new product launches and new outlet operations for the initial period, we believe expansion of its product distribution channels would also expand operating profit margins for this division, especially from the franchising operations. We have imputed a rise in operating profit margins from 13.1% in FY05 to 14%-14.5% over the next few years, as a result of this. Operating profit margins for the professional services division is estimated to be unchanged at 25%-26% p.a. Given this scenario, we have forecast EIG to record a three-year net profit CAGR of 13.4% p.a.

EIG expects to spend about MYR7.5 mln in capital expenditure (capex) for FY06, MYR2.5 mln of which is for its new corporate office. The remaining MYR5 mln is for the building of new corporate outlets. Some MYR4 mln of this capex will be funded from EIG's remaining IPO proceeds and the rest from EIG's internal funds. As at Apr. 2005, EIG had net cash of MYR28.7 mln, of which approximately MYR9 mln are proceeds from its IPO, which has yet to be utilized.

We expect EIG to remain in a net cash position over the next few years, given its relatively strong operating cashflow of MYR5-7 mln p.a. EIG has recently announced a new dividend policy - to distribute between 30%-50% of its net profits for at least the next two years. As such, we have forecast EIG's net dividend payout at an average of 40% p.a., which translates to net dividend yields of between 5%-6.6% over the next few years.

Valuation

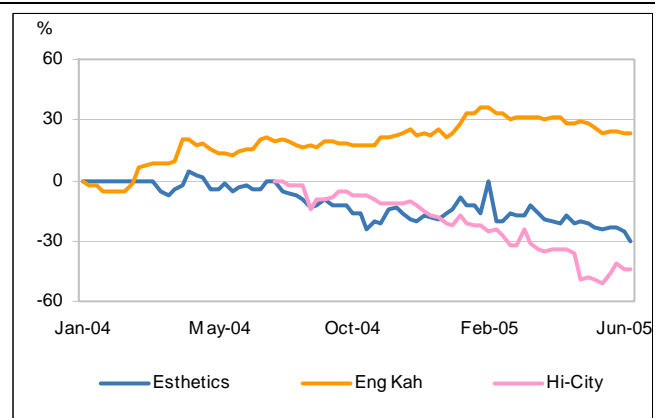
EIG's PER valuation is at 8.6x CY05 earnings, which is a substantial discount to the consumer sector PER of 14x, but similar to comparative company Hi-City BioScience's FY04 PER. Our target price is based on a 30% discount to the sector CY04 PER. The discount reflects the stock's small free float of 25% and low liquidity. Our 12-month target price is therefore, based on a PER of 9.8x and includes our estimated net DPS assumption for FY05 of 4 sen, bringing it to MYR1.00/share.

Comparative Valuation

	EIG	Eng Kah	Hi-City
Share Price (MYR) @ Jul. 1, 05	0.87	3.40	0.40
Mkt. Cap (MYR mln)	104.4	205.7	32.0
Ave. Daily Vol. ('000)	19	20	64
PER FY04 (x)	NA	14.8	8.5
PER FY05 (x)	8.5	NA	NA
P/NTA	1.2	1.8	0.7
Yield (%)	6.9	2.4	3.8

Source: Bloomberg, Company data

Relative Share Price Performance of Comparables



Source: Bloomberg, S&P Equity Research

Recent Developments

Part of EIG's IPO proceeds is to be used for building a new MYR10 mln corporate office with warehousing and logistics facilities in Shah Alam. The building is already constructed and EIG plans to move in by Sep. 2005. EIG intends to dispose off its existing head office in Petaling Jaya, which is said to be worth close to MYR5 mln.

EIG is in the midst of setting up the infrastructure needed to expand its business further using the direct selling business forum and has recently set up subsidiaries in Hong Kong and Malaysia for this purpose. Management expects this business to commence in Jul./Aug. 2005. However, in 1QFY06, we expect EIG to incur some start-up losses with regards to this new operation at least for the first six months.

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Profit & Loss

FY Jan. / MYR mln	2004	2005	2006F	2007F
Revenue	NA	80.7	92.0	105.4
Operating Profit (EBIT)	NA	20.7	24.1	27.6
Depreciation	NA	2.3	2.7	2.8
Interest Expense	NA	0.0	0.0	0.0
Pretax Profit	NA	17.7	19.4	22.4
Effective Tax Rate (%)	NA	30.8	31.0	31.0
Net Profit	NA	12.2	13.3	15.4
Operating Margin (%)	NA	25.7	26.2	26.2
Pretax Margin (%)	NA	22.0	21.0	21.3
Net Margin (%)	NA	15.2	14.4	14.6

Source: Company data, S&P Equity Research

Balance Sheet

FY Jan. / MYR mln	2003	2004	2005
Total Assets	NA	NA	103.9
Fixed Assets	NA	NA	30.4
Current Assets	NA	NA	73.6
Other LT Assets	NA	NA	0.0
Current Liabilities	NA	NA	19.2
LT Liabilities	NA	NA	0.8
Share Capital	NA	NA	60.0
Shareholders' Funds	NA	NA	84.0

Source: Company data, S&P Equity Research

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Glossary

Strong Buy: Total return is expected to outperform the total return of the KLCI or KL Emas Index respectively, by a wide margin over the coming 12 months, with shares rising in price on an absolute basis.

Buy: Total return is expected to outperform the total return of the KLCI or KL Emas Index respectively, over the coming 12 months, with shares rising in price on an absolute basis.

Hold: Total return is expected to closely approximate the total return of the KLCI or KL Emas Index respectively, over the coming 12 months with shares generally rising in price on an absolute basis.

Sell: Total return is expected to underperform the total return of the KLCI or KL Emas Index respectively, over the coming 12 months and share price is not anticipated to show a gain.

Strong Sell: Total return is expected to underperform the total return of the KLCI or KL Emas Index respectively, over the coming 12 months by a wide margin, with shares falling in price on an absolute basis.

S&P 12 Month Target Price – The S&P equity analyst's projection of the market price a given security will command 12 months hence, based on a combination of intrinsic, relative, and private market valuation metrics.

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