February 17, 2012

Dear clients and colleagues,

At a time when many consumer goods struggle with weak demand, luxury is hotter than ever. The global luxury market is expected to reach a new record high of nearly $240B in 2011. Many luxury goods companies announced impressive Q4 sales growth with even more confidence for 2012 thanks to new riches from emerging markets.

LVMH reported 20% sales growth for Q4, luxury division of PPR (owner of Gucci) +22%, Coach + 15%, Fossil +19%, Michael Kors +56%, and Burberry +30%.

Emerging markets are experiencing structural growth, which may last for decades. New riches show increasing appetite for expensive bags, perfumes, champagnes, shoes and watches, regardless of the global market turmoil and austerity measures that limit the budget of ordinary households. Certain segments of the industry are particularly booming, such as handbags, men's fashion, shoes and watches.

Even during the crisis, the manufacturing sales of luxury handbag and Small Leather Goods (SLGs) in China grew 20%/8.3% in the 2008/2009. According to Frost & Sullivan, this market is expected to achieve a 20% CAGR between 2010-15E., faster than the 10% level expected for the matured footwear and textile OEM industries in China. Our latest addition in the portfolio, Sitoy, is well positioned to ride the luxury boom.

Sitoy Group Holdings Ltd. (1023 HK – HK$2.82)
www.sitoy.com

Business Overview
Sitoy is the world's largest luxury handbag and SLGs maker. It has been a reliable outsourced manufacturer in China for many well-known international brands such as Coach, Fossil, Prada, Lacoste, and Michael Kors.

The company was founded in the 1970s, and went public in December 2011. It has five factories in China, 7 retail stores, and 14,700 employees. 68% of revenue is from North America, 17% Europe and 15% Asia.

Management
Management is very experienced and stable. The founding family (Yeung) still controls the business, with 74.8% of ownership. Prada, a major client of Sitoy, bought 20% of the total shares offered at the IPO and holds 4.9% of ownership.

Market Data
market cap HK$2.9B (US$368M), net debt US$2M, expected dividend yield 4.1%, p/e (12/2012): 7.1x, ev/ebitda (12/2012) 6.0x, gross margin 22%, operating margin 14%, profit margin 12%.

Target Market

The global luxury handbag and SLGs outsourced manufacturing market is expected to increase from US$3.8B in 2010 to US$6.8B in 2015, representing a CAGR of 12.1%, according to Frost & Sullivan. The market grew a CAGR of 7.3% in 2006-2010.

This production of luxury handbag/SLG is also shifting to China. China currently accounts for 40% of global production and is expected to reach 60% by 2015.

Competitive advantages

- Leading industry position: Sitoy has 5% market share globally and 12% in China.
- Excellent track record: short production lead time and superior craftsmanship.
- Outstanding ODM with value-add research and design capacity.
- Gaining trust from customers: It supplied 15% of Coach's handbags in 2011 vs. 8% in 2009.

Competition

The two other major players are also from China, namely Simone with 4.5% global market share and Yamani 3.0%.

Growth strategy

- More diversified customer base.
- Develop retail business: to open 100 retail stores in China by 2014, selling TUSCAN handbag, a high-end fashion brand of Italian origin.

Risks

- High sales concentration: Coach accounts for 53.2% of Sitoy's total sales. Top 5 customers account for 82.4%.
- Execution risk in the early stage of retail business.
- Higher labor cost: Production is concentrated in Guangdong province in China where labor shortage is getting severe.

Investment Theme

- Strong demand for luxury goods, especially from emerging countries.
- Increasing production shift of luxury goods to China.

Valuation

Target price = HK$5.5, using DCF model at growth rate of 18% for the next 7 years, 4% at maturity, risk premium of 11%, and payout at maturity of 55%.

Have a nice weekend.
The Global Alpha Team