STANDARD &POOR'S

Degem

Recommendation: **HOLD**

Stock Code: **7119** Bloomberg: **DGEM MK** Price: **MYR1.09** 12-Month Target Price: **MYR1.12** Date: **August 17, 2006**

Board: Main

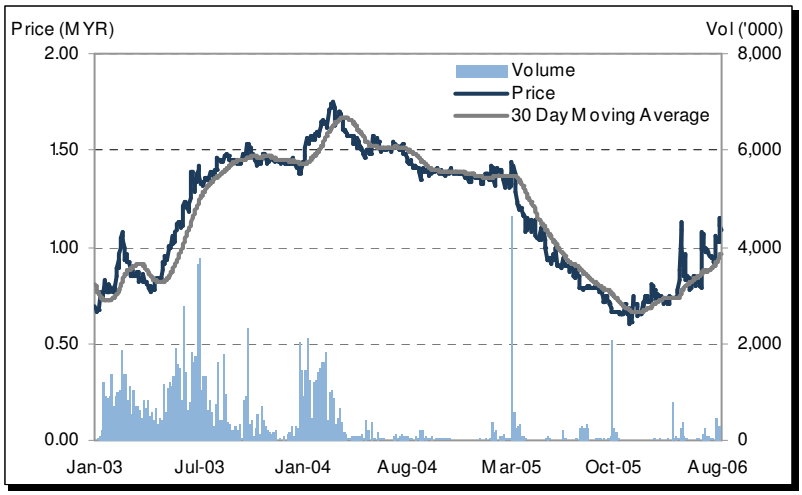
Sector: Consumer Products

GICS: Consumer Discretionary / Apparel, Accessories & Luxury Goods

Market Capitalization: MYR146.0 mln

Summary: Founded in 1982, Degem is a leading jeweler in Malaysia focused on the domestic trading and manufacturing of diamonds, gemstones, pearls, white gold and platinum jewelry. Degem was listed on the Second Board in Oct. 2001, and was transferred to the Main Board in June 2003.

Analyst: Alison Seng



Results Review & Earnings Outlook

- Degem reported a 2Q06 net profit of MYR4.33 mln (+192.2% YoY0 driven by revenue of MYR39.04 mln (+49.9% YoY) and an exceptional gain from the disposal of assets amounting to MYR2.49 mln. Stripping out the one-off gain, recurring net profit in 2Q would be MYR1.84 mln (+24.1% YoY).
- The results were better than expected with revenue and recurring net profit in 1H06 making up 58% and 76% of our original full year forecasts.
- Stronger demand for jewelry both at home and abroad bolstered sales in 1H06. Reported operating profit margin in 1H06 (based on recurring earnings) was 10.1% vs. 10.5% in 1H05 with lower operating costs largely offsetting the fall in gross profit margins. Degem also benefited from the streamlining of its operation after disposing two non-performing PYT outlets recently to focus on building the DeGem and Diamond and Platinum (D&P) brands.
- In our view Degem appears optimistic about achieving a net profit of MYR10 mln (inclusive of exceptional gain) in 2006. It expects earnings to normalize after a dismal 2005. It has plans to increase its overseas exposure. Given the good performance in 1H06, we believe that Degem's profit target is achievable. We have raised our net profit forecasts for 2006 and 2007 by 20% and 30.5% after adjusting our sales forecasts and margin assumptions. We have also raised our forecasts for further out years.

Recommendation & Investment Risks

- We maintain our Hold recommendation. We raise our 12-month target price to MYR1.12 from MYR0.87 after an earnings revision. We are encouraged by the better operating results and optimistic that Degem would perform better after the restructuring. Degem has closed its second last PYT outlet and plans to switch its last PYT store to a DeGem store. It also plans to invest in a factory and wholesale division in the Middle East and to expand its distribution network to some Asian countries.
- On 7 Aug., Degem declared a special interim dividend of 16.5 sen gross (or 11.88 sen net) to be payable on 8 Sep. 2006. We believe this special payout is a result of proceeds from the sale of the PYT outlets. We do not expect any additional dividend payout in 2006.
- Our target price is based on DCF analysis. Key assumptions in our DCF calculation are 2006-2010 FCF CAGR of 8.4%, terminal growth rate of 3% (unchanged) and a WACC of 9.6% (vs. 9.8%). Our target price includes projected net dividend of 12 sen for 2006.
- Risks to our recommendation and target price are Degem's failure to expand its business domestically due to the difficulty in securing good shopping mall locations in Malaysia and delays in its overseas expansion.

Key Stock Statistics

FY Dec.	2005	2006F
EPS (sen)	3.5	7.5
PER (x)	31.6	14.5
Dividend/Share (sen)	2.5	16.5
NTA/Share (MYR)	0.76	0.70
Book Value/Share (MYR)	0.82	0.76
Issued Capital (mln shares)	134.0	
52-week Share Price Range (MYR)	0.59-1.22	
Major Shareholders:	%	
Legion Master Sdn. Bhd.	51.7	
Employees Provident Fund	11.2	

Per Share Data

FY Dec.	2003	2004	2005	2006F
Book Value (MYR)	0.70	0.72	0.82	0.76
Cash Flow (sen)	11.7	9.8	4.9	8.9
Earnings (sen)	10.4	8.4	3.5	7.5
Dividend (sen)	2.5	3.0	2.5	16.5
Payout Ratio (%)	17.3	27.4	52.3	158.4
PER (x)	10.5	13.0	31.6	14.5
P/Cash Flow (x)	9.3	11.1	22.4	12.2
P/Book Value (x)	1.6	1.5	1.3	1.4
Dividend Yield (%)	2.3	2.8	2.3	15.1
ROE (%)	15.8	11.5	4.5	9.5
Net Gearing (%)	15.0	25.2	25.5	35.2

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Quarterly Performance

FY Dec. / MYR mln	2Q06	2Q06	% Change
Revenue	39.0	26.1	49.9
Operating Profit (EBIT)	NA	NA	NA
Depreciation	-0.4	-0.6	-34.5
Net Interest Income / (Expense)	NA	NA	NA
Pre-tax Profit	5.5	2.4	135.3
Net Profit	4.3	1.5	192.2
Operating Margin (%)	NA	NA	-
Pre-tax Margin (%)	14.2	9.0	-
Net Margin (%)	11.1	5.7	-

Source: Company data

Profit & Loss

FY Dec. / MYR mln	2004	2005	2006F	2007F
Revenue	135.3	108.2	133.0	140.8
Operating Profit (EBIT)	17.8	9.2	15.9	14.3
Depreciation	-1.8	-1.9	-1.9	-2.4
Net Interest Income / (Expense)	-1.5	-1.2	-2.0	-2.3
Pre-tax Profit	16.2	8.0	14.0	12.0
Effective Tax Rate (%)	24.4	41.3	28.0	28.0
Net Profit	10.6	4.6	10.0	8.7
Operating Margin (%)	13.1	8.5	12.0	10.2
Pre-tax Margin (%)	12.0	7.4	10.5	8.5
Net Margin (%)	7.8	4.3	7.6	6.1

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.
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