

Board: Main

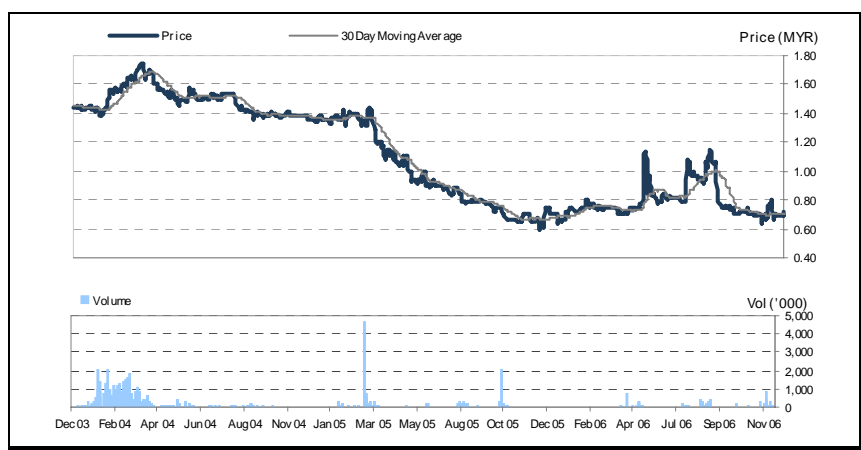
Sector: Consumer Products

GICS: Consumer Discretionary/Apparel, Accessories &amp; Luxury Goods

Market Value - Total: MYR95.8 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. Listed in Oct. 2001, it was transferred to the Main Board in June 2003.

Analyst: Alison Seng



## Results Review &amp; Earnings Outlook

- Fueled by robust consumer spending and supported by increased promotion and marketing efforts, Degem's 3Q06 revenue grew 11.3% YoY to MYR33.4 mln, in line with our expectations. Net profit, which came in at MYR3.2 mln, up 109.6% YoY, was better than expected due to higher-than-expected margins.
- Degem has coped well in spite of firm commodities prices with gross profit margin improving to 36.9% in 3Q06 (vs. 34.8% in 3Q05). Operating cost was kept under control, declining by 9.8% YoY to MYR7.1 mln despite the higher revenue. This contributed to a better pre-tax profit margin of 15.5% in 3Q06 (vs. 7.9% in 3Q05).
- Degem believes that the recent restructuring exercise, in which it disposed some non-performing assets and streamlined its existing operations, will have positive impact on its profitability.
- We have lifted our 2006 and 2007 net profit forecasts by 8.2% to MYR10.9 mln and 11.9% to MYR9.7 mln respectively after updating our margin assumptions. 2006 net profit includes a one-off gain from the disposal of fixed assets and inventories amounting to MYR2.3 mln. We have also adjusted our capital expenditure and working capital requirements, which appeared conservative.

## Recommendation &amp; Investment Risks

- We have lowered our 12-month target price to MYR0.84 from MYR1.12 after updating our valuation parameters. We are upgrading our recommendation to Buy from Hold. Following the recent share price correction, there is a potential upside of 18% to our target price.
- Degem's earnings are normalizing following poor performance in 2005. We are optimistic that the restructuring will help the company focus on strengthening the Degem and Diamond and Platinum (D&P) brands to enhance its profitability.
- Our target price is based on DCF analysis. Key assumptions include: 2006-2010 FCF CAGR of 4.7% (8.4% previously), terminal growth rate of 3% (unchanged) and WACC of 9.5%-10.4% (vs. 9.6% previously). Our target price included a projected net DPS of 3.8 sen over the next 12 months. Our original target had included an 11.9 sen special net dividend already paid out in Sep.
- Trading at 2007 PER of 9.8x based on the forecasted EPS of 7.2 sen, valuation is not demanding compared with its historical median PER of about 13x.
- Risks to our recommendation and target price include failure to secure good shopping mall locations for future store expansion in Malaysia and unsuccessful overseas expansion.

## Key Stock Statistics

FY Dec.	2005	2006E
Reported EPS (sen)	3.5	8.1
PER (x)	20.7	8.8
Dividend/Share (sen)	2.5	16.5
NTA/Share (MYR)	0.76	0.71
Book Value/Share (MYR)	0.82	0.76
No. of Outstanding Shares (mln)	134.0	
52-week Share Price Range (MYR)	0.64 - 1.15	
Major Shareholders:	%	
Legion Master Sdn. Bhd.	51.7	
Employees Provident Fund	8.7	

## Per Share Data

FY Dec.	2003	2004	2005	2006E
Book Value (MYR)	0.70	0.76	0.82	0.76
Cash Flow (sen)	11.7	9.8	4.9	7.5
Reported Earnings (sen)	10.4	8.4	3.5	8.1
Dividend (sen)	2.5	3.0	2.5	16.5
Payout Ratio (%)	20.7	27.4	52.3	193.5
PER (x)	6.9	8.5	20.7	8.8
P/Cash Flow (x)	6.1	7.3	14.7	9.5
P/Book Value (x)	1.0	0.9	0.9	0.9
Dividend Yield (%)	3.5	4.2	3.5	23.1
ROE (%)	15.8	11.5	4.5	7.8
Net Gearing (%)	15.2	25.4	25.7	36.7

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**Quarterly Performance**

FY Dec. / MYR mln	3Q06	3Q05	% Change
Reported Revenue	33.4	30.0	11.3
Reported Operating Profit	NA	NA	NA
Depreciation & Amortization	-0.4	-0.5	-7.5
Net Interest Income / (Expense)	NA	NA	NA
Reported Pre-tax Profit	5.2	2.4	>100
Reported Net Profit	3.2	1.5	>100
Reported Operating Margin (%)	NA	NA	-
Reported Pre-tax Margin (%)	15.5	7.9	-
Reported Net Margin (%)	9.5	5.1	-

Source: Company data

**Profit & Loss**

FY Dec. / MYR mln	2004	2005	2006E	2007E
Reported Revenue	135.3	108.2	133.0	140.8
Reported Operating Profit	17.8	9.2	17.3	15.8
Depreciation & Amortization	-1.8	-1.9	-1.8	-2.3
Net Interest Income / (Expense)	-1.5	-1.2	-2.1	-2.5
Reported Pre-tax Profit	16.2	8.0	15.1	13.3
Effective Tax Rate (%)	24.4	41.3	28.0	27.0
Reported Net Profit	10.6	4.6	10.9	9.7
Reported Operating Margin (%)	13.1	8.5	13.0	11.2
Reported Pre-tax Margin (%)	12.0	7.4	11.4	9.4
Reported Net Margin (%)	7.8	4.3	8.2	6.9

Source: Company data, S&amp;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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For residents of Malaysia. All queries in relation to this report should be referred to Alexander Chia, Lee Leng Hoe or Ching Wah Tam.

## Recommendation and Target Price History

Date	Recommendation	Target Price
New	Buy	0.84
17-Aug-06	Hold	1.12
22-Jun-06	Hold	0.87
1-Mar-06	Strong Sell	0.40
5-Jan-06	Strong Sell	0.45

