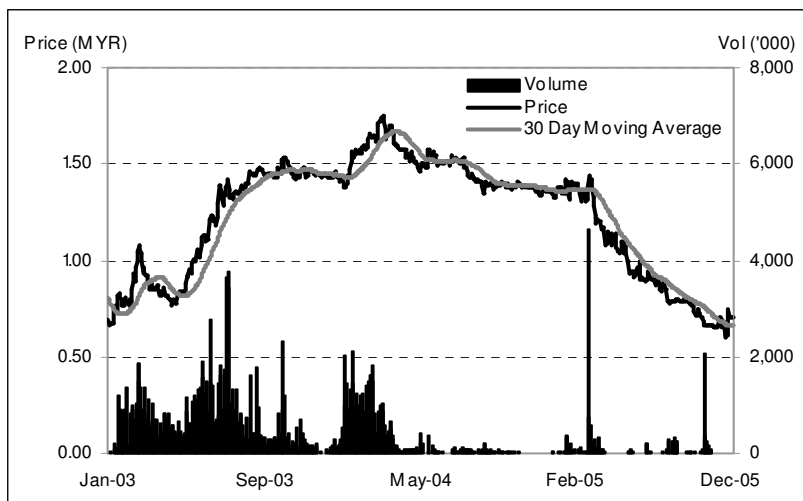


Board: Main**Sector:** Consumer Products**GICS:** Consumer Discretionary / Apparel, Accessories & Luxury Goods**Market Capitalization:** MYR96.5 mln

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

Analyst: Alison Seng**Highlights**

- Degem posted a 49.3% YoY drop in 9M05 net profit to MYR4.9 mln on the back of lower revenue and weaker margins. Revenue for 9M05 fell by 12.9% YoY to MYR82 mln due to stiffer competition while EBIT margin fell to 9.9% from 15.2% a year ago.
- We forecast net profit to fall by 35.7% YoY to MYR6.8 mln in 2005. We expect modest rebounds in earnings in 2006 and 2007 as Degem opens more outlets and consolidates its business operation to achieve greater efficiency.

Investment Risks

- Our analysis and forecasts carry a higher degree of uncertainty than normal because our attempts to meet with Degem's management to obtain additional information prior to preparing this report were unsuccessful.
- Risks to our recommendation and target price include stronger-than-expected demand for Degem's jewelry leading to higher growth in revenue and recovery in margins.

Recommendation

- We initiate coverage on Degem with a Strong Sell recommendation and a 12-month target price of MYR0.45. In our opinion, the competitive pressure in the crowded jewelry industry in Malaysia would continue to suppress earnings. We are also concerned that weaker consumer sentiment due to higher fuel prices will impact discretionary spending.
- Our target price is derived using discounted cash flow (DCF) analysis. We have discounted Degem's future cash flow at a WACC of 9.6% and assume FCF CAGR of 2.0% (2005-2010) and terminal growth of 0%. The conservative assumptions are due to Degem's poor earnings track record in 2004 and 2005.
- Degem currently trades at 2006 PER of 13.1x. Our target price implies a 2006 PER of 8.2x on EPS forecast of 5.5 sen, which in our view is fair given our expectations of modest earnings growth and the low estimated ROE of 6.4% in 2006.

Key Stock Statistics

FY Dec.	2004	2005F
EPS (sen)	7.9	5.1
PER (x)	9.1	14.1
Dividend/Share (sen)	3.0	1.9
NTA/Share (MYR)	0.76	0.78
Book Value/Share (MYR)	0.76	0.84
Issued Capital (mln shares)	134.0	
52-week Share Price Range (MYR)	0.59 - 1.53	
Major Shareholders:	%	
Legion Master Sdn. Bhd.	55.0	
Employees Provident Fund	11.3	
Diamond Landmark Sdn. Bhd.	6.9	

Per Share Data

FY Dec.	2002	2003	2004	2005F
Book Value (MYR)	0.61	0.70	0.76	0.84
Cash Flow (sen)	10.4	11.7	9.8	6.8
Earnings (sen)	9.3	10.4	7.9	5.1
Dividend (sen)	0.0	2.5	3.0	1.9
Payout Ratio (%)	0.0	17.3	25.8	27.4
PER (x)	7.7	6.9	9.1	14.1
P/Cash Flow (x)	6.9	6.1	7.3	10.6
P/Book Value (x)	1.2	1.0	0.9	0.9
Dividend Yield (%)	0.0	3.5	4.2	2.7
ROE (%)	15.1	15.8	11.5	6.5
Net Gearing (%)	10.5	15.0	25.2	21.5

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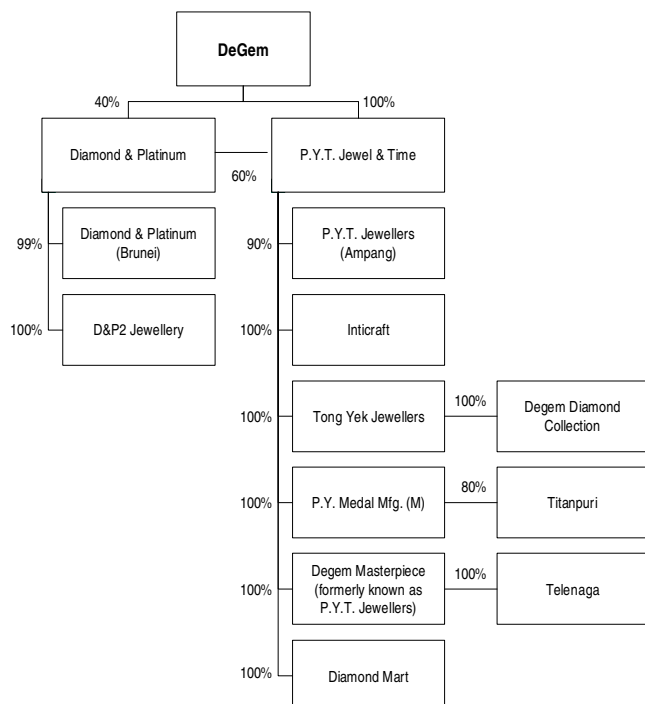
Background

Corporate Profile

Degem manufactures and trades gold, diamonds, gold medals and badges and also manages and develops property. Jewelry trading and manufacturing are its principal activities. In 2004, jewelry trading made up 98.5% of total revenue. Since its inception, Degem now has approximately 20 retail outlets in Malaysia.

Degem started off as Thye Loong Goldsmith, which was founded by Managing Director Choong Kai Sun in 1982. Apart from Chong Kai Sun, his siblings Choong Kai Soon, Choong Kai Fatt and Choong Khoi Onn are also directors of the company and they assist Chong Kai Sun in managing the daily operations of the company. Degem's largest shareholder, Legion Master – collectively owned by the siblings -- holds a 55% stake in the company.

Corporate Structure



Source: Company data

Business

Degem operates an integrated jewelry business. Its major business segments are trading and manufacturing. Trading is the most substantial contributor to revenue. In FY04, revenue from the trading division accounted for 98.5% of group sales. Its manufacturing division supplies jewelry exclusively to its retail outlets.

It has a factory in Selangor that occupies floor space of 5,040 sq. ft. Degem sells its products mainly through three retail arms comprising PYT Jewellers, Diamond & Platinum (D&P) and Degem. Based on information from its 2004 annual report, Degem has four PYT stores, 11 D&P outlets and three DeGem showrooms.

PYT stores are located in shophouses in the suburbs and cater to the high-end market. D&P caters to the mid- to lower-end market and targets the trendier and younger consumers. Its outlets are found in major shopping centres. Degem, which emphasizes high-end fashion and branding, started operating in late 2003 to broaden Degem's earnings base.

Degem's outlets are mostly located in the Klang Valley, where there is a higher concentration of potential clients. In 2002-2004, new outlets outside of Klang Valley such as in Penang and Johor Baru also commenced operation. Degem sells its diamond jewelry under its own brand names of Rembrandt Collezione and Happy Eight.

Degem's products are customized mainly for the domestic market. However, apart from aiming to establish a presence in all major cities in Malaysia, Degem is also looking to expand into other overseas markets e.g. Vietnam.

Earnings Outlook

In 2004, Degem recorded an 18.7% increase in revenue to MYR135.3 mln but net profit fell by 19.6% to MYR10.6 mln due to weaker margins. EBIT margin fell to 13.1% from 17.9%, reflecting higher start up costs and promotional expenses incurred by its newly opened DeGem stores. In addition, it incurred MYR1.2 mln in professional fee charges arising from the exercise of its Islamic Note Facility and the acquisition of the remaining 40% of D&P.

In 2005, its performance worsened with cumulative 9-month net profit halving to MYR4.9 mln and revenue declining 12.9% YoY to MYR82 mln. Degem attributed the poor performance to stiff competition and weaker consumer spending.

We doubt that there was significant improvement in sales and profitability in the final quarter of 2005 given the competitive landscape. We forecast 2005 net profit to decline by 35.7% on the back of a 16.3% dip in revenue and lower margins. We expect EBIT margin to fall to 9.7% in 2005 versus 13.1% in 2004.

Going forward, we have assumed that EBIT margin remains stable at 9.7% over the next two years. We forecast revenue and net profit to improve modestly after 2005 as Degem consolidates its business operation. We have assumed an effective tax rate of 28% for 2005 onwards.

Valuation

We initiate coverage on Degem with a Strong Sell recommendation and a 12-month target price of MYR0.45. We are concerned that the competitive pressure in the crowded jewelry industry in Malaysia would continue to suppress earnings. We are also concerned that weaker consumer spending due to high fuel prices will impact discretionary spending.

Our target price is derived from discounting Degem's future cash flow at a WACC of 9.6% and assumes FCF CAGR of 2.0% (2005-2010) and terminal growth of 0%. Our conservative growth rate assumptions are due to Degem's poor earnings track record in 2004 and 2005.

Degem currently trades at 2006 PER of 13.1x. Our target price implies a 2006 PER of 8.2x. In our view, the valuation is fair given our expectations of modest earnings growth and the low estimated ROE of 6.4% in 2006.

Degem's closest comparable is Poh Kong (PKH MK, Hold), the largest jewelry retailer in Malaysia. 2005 was a poor year for Degem, affected by weaker sales from strong competition and rising operating costs. Although smaller in operations and earnings base, Degem has better margins and lower gearing compared to Poh Kong. Trading liquidity of Degem is also higher than Poh Kong. Having said that, Degem's valuation of 13.1x 2006 earnings appears to be stretched versus Poh Kong's CY2006 PER of 7.3x.

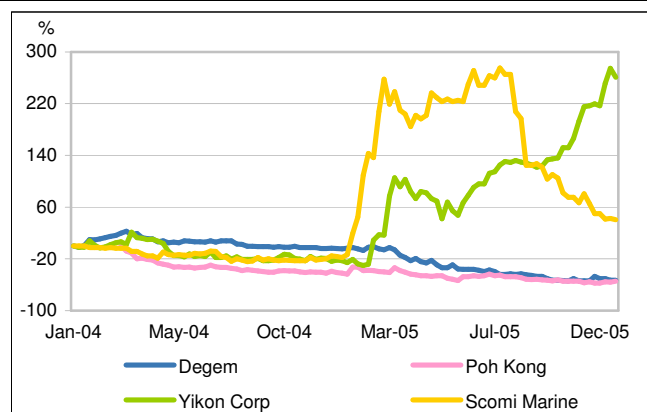
Meanwhile, we do not think that other jewelry companies such as Yikon (YCB MK, Not Ranked) and Scomi Marine (SMB MK, Not Ranked) are good comparables to Degem. Yikon operates a predominantly export driven business in gold jewellery and Scomi Marine, (formerly known as Habib), has diversified into marine coal transportation and gas and oil businesses.

Comparative Valuation

	DGEM	PHK	SMB	YCB
Share Price (MYR) @ Jan. 04, 06	0.72	1.12	1.01	4.82
Mkt. Cap (MYR mln)	96.5	129.4	593.8	196.9
Ave. Daily Vol. ('000)	90	16	564	4
PER FY03 (x)	6.9	2.8	2.5	274.2
PER FY04 (x)	9.1	3.7	2.5	99.4
P/NTA	0.9	0.6	0.8	4.3
Yield (%)	4.2	4.5	2.5	0.0

Source: Bloomberg, Company data

Relative Share Price Performance of Comparables



Source: Bloomberg, S&P Equity Research

Recent Developments

Apr. 05: Degem acquired the remaining 40% stake in Diamond & Platinum for MYR14.4 mln, funded by the issuance of 8 mln new Degem shares and cash of MYR2.28 mln.

Profit & Loss

FY Dec. / MYR mln	2003	2004	2005F	2006F
Revenue	114.0	135.3	113.3	121.5
Operating Profit (EBIT)	20.5	17.7	11.0	11.8
Depreciation	-1.6	-1.8	-2.3	-2.6
Net Interest Income / (Expense)	-1.3	-1.5	-1.4	-1.4
Pretax Profit	19.4	16.2	9.6	10.4
Effective Tax Rate (%)	23.8	24.4	28.0	28.0
Net Profit	13.1	10.6	6.8	7.4
Operating Margin (%)	17.9	13.1	9.7	9.7
Pretax Margin (%)	17.0	12.0	8.4	8.5
Net Margin (%)	11.5	7.8	6.0	6.1

Source: Company data, S&P Equity Research

Balance Sheet

FY Dec. / MYR mln	2002	2003	2004
Total Assets	113.8	142.2	174.6
Fixed Assets	23.3	26.0	26.2
Current Assets	90.4	116.2	148.4
Other LT Assets	0.0	0.0	0.0
Current Liabilities	26.9	42.7	70.1
LT Liabilities	5.8	6.0	1.5
Share Capital	42.0	63.0	63.0
Shareholders' Funds	77.5	88.2	96.0

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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