INITIATION REPORT

08 Mar 2011

Degem Bhd		***Market Price:***	*RM1.04*
		Market Capitalisation:	*RM139.4m*
		Board:	*Main Market*
Recommendation:	*Hold*	***Sector:***	*Consumer Products*
Target Price:	*RM1.11*	***Stock Code/Name:***	*7119 / DEGEM*

Analyst*: Edmund Tham*



Source: Degem annual report

BACKGROUND

Degem Berhad was first listed on the local stock exchange under the Second Board during October 2001. Subsequently, the company transferred to the Main Board of Bursa Malaysia during June 2003. The company is one of the 3 gold and/or jewellery companies listed on Bursa Malaysia.

"Focus on fine jewellery"

The group's core businesses are in manufacturing, retailing, design and distribution of fine jewellery. Its core brands are "Degem" and "Diamond & Platinum".

Degem has a seasoned management team with more than 30 years of experience in the industry. The management team is spearheaded by 4 brothers from the Choong family. They are Mr Paul Choong Khoi Onn, Mr Choong Kai Soon, Mr Choong Kai Fatt and Mr Choong Kay Cheong.

"Experienced management team"

Currently, the group has spread its wings regionally. For its Malaysian operations, the group has 5 Degem outlets while it has 11 Diamond & Platinum outlets. Regionally, the group has expanded to Brunei (1 Diamond & Platinum outlet), Indonesia (1 Degem outlet in Jakarta) and Hong Kong (1 distribution centre).

"Expanding regionally"

Currently, the group's business is focused on a mixture of precious metals with diamonds and precious stones. This is to capture both the middle and upper class markets and also the young and trendy market. The management also focuses on design and craftsmanship excellence, strong brand name maintaining a strong operating margin. Four characteristics known informally as the "4 Cs" are now commonly used as the basic descriptors of diamonds and gemstones: carat, cut, colour, and clarity. The group has retail outlets in key shopping and prestigious areas such as Bangsar, The Gardens (Midvalley), Pavilion and 1Utama.

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The group's **Degem** stores are more upmarket and focus on the boutique concept with a personalised customer service. Degem is also the exclusive distributor of the Lazare brand.

Meanwhile, the group's **Diamond & Platinum** (D&P) retail stores cater more for the entry level, youthful and mass market segments. It has a wide range of trendy and ready to wear designs. D&P stores also sell the Estrella diamond brand.

"A major jewellery manufacturer"

The group's wholly-owned Inticraft SB is involved in the jewellery manufacturing business segment. Inticraft is one of the largest licensed jewellery manufacturing companies in Malaysia. Their production team consists of 11 innovative designers and 68 skilled craftsmen. The company has a maximum production capacity of 3000 units per month, and presently the output is around 80% of that amount.

PERFORMANCE – FY10

4Q/ 31 Dec	4Q10	4Q09	yoy %	3Q10	qoq%
Rev (RMm)	59.7	46.9	27.3	44.1	35.4
EBIT (RMm)	6.9	4.3	58.6	4.1	69.5
NPAT (RMm)	5.1	4.0	25.8	2.8	81.0
EPS (sen)	3.8	3.0	25.8	2.1	81.0

12M/ 31 Dec	FY10	FY09	yoy %
Rev (RMm)	185.3	189.4	(2.2)
EBIT (RMm)	18.6	19.3	(3.8)
NPAT (RMm)	13.0	15.3	(15.3)
EPS (sen)	9.7	11.4	(15.3)

"Strong Q4 performance"

Degem recorded a strong financial performance during its 4Q/FY10 ended 31st December 2010. The strong top-line performance was likely due to the better sales volumes during quarter, when there were the major Hari Raya Aidilfitri and Christmas festivals. Furthermore, a number of working population tended to get their bonuses during the year end period.

Nevertheless, despite of the group's strong Q4 performance, the previous quarters during the year were not as productive in terms of the sales revenue generated.

For its full-year FY10 (ended 31st December 2010) revenues, the group recorded revenue of RM185.3 million, which was slightly lower than the revenue of RM189.4million achieved during its FY09. This reflected a decrease in revenue of 2.2% y-o-y.

The group's FY10 net profit after minority interests and foreign exchange translations amounted to RM13.0 million. This was 15.3% lower than the comparative net profit recorded during its FY09.

During the group's strong 4Q/FY10, the group recorded revenue of RM59.7 million, which was 27.3% higher than the revenue recorded in its 4Q/FY09. For 4Q/FY10, the group's net profit after tax and foreign exchange translation of RM5.1 million was 25.8% better than the comparable net profit of RM4.0 million recorded during 4Q/FY09.

Even comparing q-o-q versus the preceding 3Q/FY10, the group's 4Q/FY10 results were stronger. The group's 4Q/FY10 revenue of RM59.7 million and net profit of RM5.1 million was 35.4% and 81.0% higher than the corresponding figures in the group's 3Q/FY10.

OUTLOOK/CORP. UPDATES

The domestic economy has been growing at a reasonable rate during the past year and we expect the group's revenues to grow in tandem during the year 2011, as well.

"Domestic economy still growing well"

The latest available Malaysian economic data revealed reasonably positive growth rates in y-o-y percentage terms. Malaysia had reported a very respectable 4Q/2010 GDP growth of +4.8% (+7.2% for full year 2010 GDP), stable 4Q/2010 unemployment rate of 3.2% and manageable CPI of 2.4% (January 2011). Meanwhile, Bank Negara Malaysia (BNM) had last reaffirmed its accommodative overnight policy rate (OPR) of 2.75% in January 2011.

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"Active share buy-back programme"

Degem's management actively practises share buy-backs. During the latest quarter (4Q/FY10), the group repurchased 99,700 of its issued ordinary shares from the open market at an average price of RM1.07 per share. The total consideration paid for the repurchase including transaction costs was around RM107,120 and this was financed by internally generated funds. As at 31st December 2010, a total of 1,934,800 shares repurchased were held at a total cost of around RM1,914,356. The shares repurchased are being held as treasury shares. Degem's management plans to use the treasury shares for future share dividends or to be sold for profits when the market timing is right.

VALUATION

Degem's management has not proposed its dividend rate for FY10 at the time of this report. Its last dividend paid out was the 4% gross dividend per share (DPS) on its shares of par value RM0.50 for its FY09. We expect that Degem would be able to meet or better this dividend rate.

"Dividend rate to be maintained or bettered"

With a relatively weak adjusted beta of 0.32 to the KLCI, Degem has underperformed the KLCI this year (by -7.14% vs. +0.34% year-to-date (YTD)). Recently, equity markets have been impacted by the political unrest and upheavals in a number of Middle East and North African nations. Furthermore, Degem is not a particularly large market-cap stock, and this may put a dampener on its market visibility and trading volume.

Based on our forecast of Degem's FY11 EPS and estimated P/E of 10 times, we set a **FY11-end Target Price (TP) of RM1.11.** This TP represents a 6.7% upside from its current market price. Our TP for Degem reflects a P/BV of 0.9 times over its FY11F BV/share.

Meanwhile, the domestic "Clothing & Accessories" sector's average P/E and P/BV is 7.7 times and 0.75 times, respectively. We find that Degem's P/E and P/BV valuations are not among the most undemanding within its sector, domestically.

"Focus on fine jewellery – a double edged sword?"

Degem's management has focused on the diamond and gemstone fine jewellery segment. The fine jewellery segment appears to provide higher profit margins than gold products per se, as they are not any "association price guidelines", unlike that for yellow gold products. However, we believe that the demand for fine jewellery could be more susceptible to the volatility in economic conditions and hence consumer optimism and buying sentiment.

Degem's management appears conservative in terms of its cash management and gearing levels. We find that its dividend payouts are quite consistently within the 10-20% range, while its ROE of 8-11% is quite reasonable. The group has decided to expand regionally, and we see this as a beneficial move in the long term, given the expected growth in GDP and population, especially within the ASEAN region.

"Hold Call for now"

While Degem is well managed and sound fundamentally, at the moment we are recommending just a Hold Call for now. We would like to see more **sustained revenue and earnings growth** before we consider upgrading our recommendation to a Buy Call.

The group also faces general operating risks from fluctuating raw material and foreign exchange rates, amidst competition from its peers. Going forward, the group's upside would be largely dependent on its management's marketing and growth strategy, and also on the overall economic conditions.

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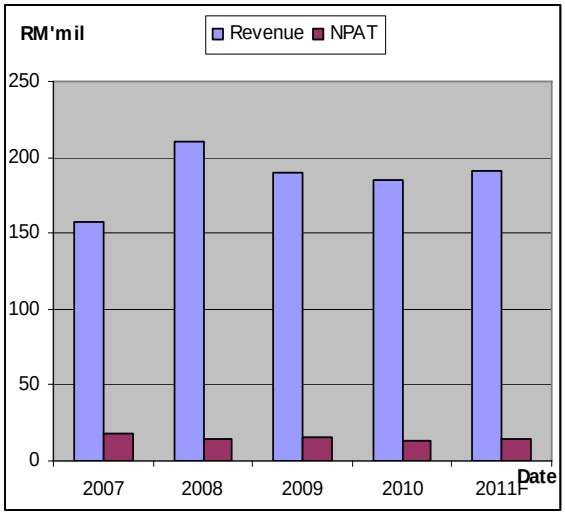
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Degem: 6-month Share Price



Source: NextView

Degem's Revenue and Net Profits (2007-2011F)



Source: Degem

KEY FINANCIALS

Key Stock Statistics	2011F
EPS (sen)	11.1
P/E (x)	9.4
Dividend/Share (sen)	2.0
NTA/Share (RM)	1.25
Book Value/Share (RM)	1.25
Issued Capital (mil shares)	134.0
52-weeks share price (RM)	0.93 – 1.22
Major Shareholder:	%
Legion Master S/B*	51.7

**Legion Master is controlled by the Choong family*

Per Share Data	2008	2009	2010	2011F
Book Value (RM)	0.99	1.08	1.15	1.25
Earnings (sen)	10.7	11.4	9.7	11.1
Dividend (sen)	2.5	2.0	2.0	2.0
Payout Ratio (%)	17.5	13.1	15.5	13.5
PER (x)	9.7	9.1	10.8	9.4
P/Book Value (x)	1.1	1.0	0.9	0.8
Dividend Yield (%)	2.4	1.9	1.9	1.9
ROE (%)	10.9	10.6	8.4	8.9
Net Gearing (cash) (x)	0.08	0.06	0.04	0.01

**50 sen par value*

P&L Analysis (RM mil)	2008	2009	2010	2011F
Year end: Dec 31				
Revenue	209.8	189.4	185.3	191.2
Operating Profit	21.7	23.5	23.0	25.1
Depreciation	(2.1)	(3.1)	(2.2)	(2.3)
Interest Expenses	(1.7)	(1.3)	(1.5)	(1.7)
Pre-tax Profit	20.0	22.2	20.5	22.4
Effective Tax Rate (%)	29.2	30.8	34.4	31.5
Net Profit	14.4	15.3	13.0	14.9
Operating Margin (%)	10.4	12.4	12.4	13.1
Pre-tax Margin (%)	9.5	11.7	11.0	11.7
Net Margin (%)	6.8	8.1	7.0	7.8

Listing of Degem's retail store locations:

Brand	Location
Degem:	
	Bangsar Baru (HQ)
	Pavilion
	The Gardens
	1Utama
	Ampang Point
	Ngee Ann City (Singapore)
	New outlet (Singapore)
	Grand Hyatt (Jakarta)
Diamond & Platinum:	
	Mid Valley
	Sungei Wang
	Sunway Pyramid
	1Utama
	The Curve
	SACC Mall (Shah Alam)
	AEON Bukit Tinggi (Klang)
	AEON Tebrau City (JB)
	Queensbay Mall (Penang)
	Gurney Plaza (Penang)
	Ipoh Parade (Ipoh)
	Abdul Razak Complex (Brunei)

Source: Degem annual report/website

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