



MALAYSIA EQUITY

Investment Research

Daily News

CONSUMER

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Stock Profile/Statistics

Bloomberg Ticker	DGEM MK
KLCI	1230.96
Issued Share Capital (m)	134.00
Market Capitalisation (RMm)	131.99
52 week H L Price (RM)	1.58 0.82
Average Volume (3m) '000	4.93
YTD Returns (%)	-0.22
Net gearing (x)	0.21
Altman Z-Score	3.33
ROCE/WACC	0.77
Beta (x)	1.32
Book Value/share (RM)	0.84

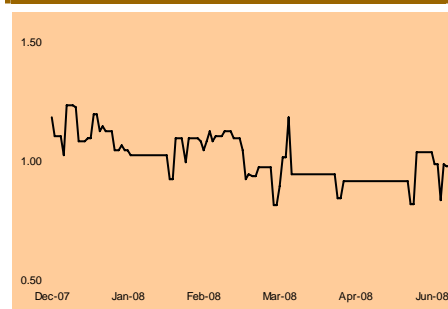
Major Shareholders (%)

Legion Master Sdn	51.72
Diamond Landmark	7.82
M Taib Hasan Bin	2.24

Share Performance (%)

Month	Absolute	Relative
1m	7.07	11.79
3m	5.91	1.63
6m	-12.83	-3.56
12m	-19.56	-15.78

6-month Share Price Performance



Company Update

Private Circulation Only

Degem

BUY	Maintain
Price	RM0.99
Target	RM1.70

A Diamond in the Rough

Despite fewer outlets compared to its rivals, Degem fares better in terms of earnings, underscoring its operational efficiency. As the jewellery industry is very much into the volume game now on the back of rising raw materials prices, the group is seeking more opportunities locally and overseas. Going forward, we put Degem under review due to inflationary pressure and project EPS CAGR of 16% over the next two years. Target price of RM1.70 is derived based on 9.0x FY09 EPS.

Degem is different. Degem adopts a slightly different business model in comparison to Tomei and Poh Kong, as it emphasizes very much on the boutique concept with personalized services serving the middle to high end market. Compared to Tomei (~40%) and Poh Kong (~75%) where the bulk of their revenues are generated from gold, 75% of Degem's sales are attributed to Diamond related jewellery. As such, Degem is less likely to be affected by surging gold prices and is also in the comfort zone especially where fashion trends are more inclined towards diamond than gold.

Re-rating catalysts. To cope with the rising raw material prices and intense competition, the group is expanding into China, Hong Kong and Singapore with the option to venture into new markets in the future. Hong Kong remains the key overseas contributor (70% of its foreign sales in 1Q08) as the sales in Hong Kong are normally in bulk through the wholesales business model. While this would depress margins slightly, the group could save a lot in terms of operational costs. Management also hinted that the group is in the midst of negotiations with a local party for another new business venture. We view this positively as this could potentially be an additional revenue stream for Degem.

Spared from the rising material costs. Degem's margins have been hovering between 34%-40% despite rising cost of materials. This can be explained by the higher sales volume and its ability to price its products at a decent premium to reflect the quality and value added services offered. However, we expect raw materials cost will continue to grow that will partially offset higher sales volume.

Maintain BUY. We maintain our forecast with CAGR EPS of 16% for FY08-FY10, pending the opening of outlets officially and outcome possible new venture with a local party. Maintain BUY with a target price of RM1.70 based on average peers PE, 9x FY09 EPS.

FYE Dec (RMm)	FY05	FY06	FY07	FY08f	FY09f
Turnover	108.2	143.9	157.9	179.6	201.5
Net Profit	4.6	13.8	17.8	19.1	24.9
% chg YoY	-56%	199%	29%	8%	30%
Consensus	-	-	-	22.2	23.3
EPS (sen)	3.4	10.3	13.3	14.3	18.6
DPS (sen)	2.5	19.0	2.5	3.5	4.5
Div Yield	1.8%	13.8%	1.9%	2.6%	3.4%
ROE	4.2%	13.1%	14.8%	14.0%	15.9%
ROA	2.8%	7.5%	9.0%	9.2%	10.7%
PER (x)	21.5	7.2	5.6	6.9	5.3
P/BV (x)	1.2	1.3	1.1	1.0	0.8
EV/EBITDA (x)	8.4	7.5	0.8	1.0	0.8

KEY HIGHLIGHTS

Better margins despite the lack of scale. In terms of the number of outlets, Degem with a total of 18 outlets does not have the distribution reach of its rivals, Poh Kong and Tomei which have ~90 and ~42 outlets respectively. However, this is not a stumbling block as the group's earnings and operating margins are comparable or better than that of its rivals. Group earnings grew 29% yoy in FY07 versus Poh Kong (-29.2% yoy) and Tomei (-53.4%). We attribute the robust performance to the combination of its well-established brand equity, strong emphasis on premium product quality as well as personalized customer service. The fewer retail outlets meant lower operational costs, mitigating downside margin risks.

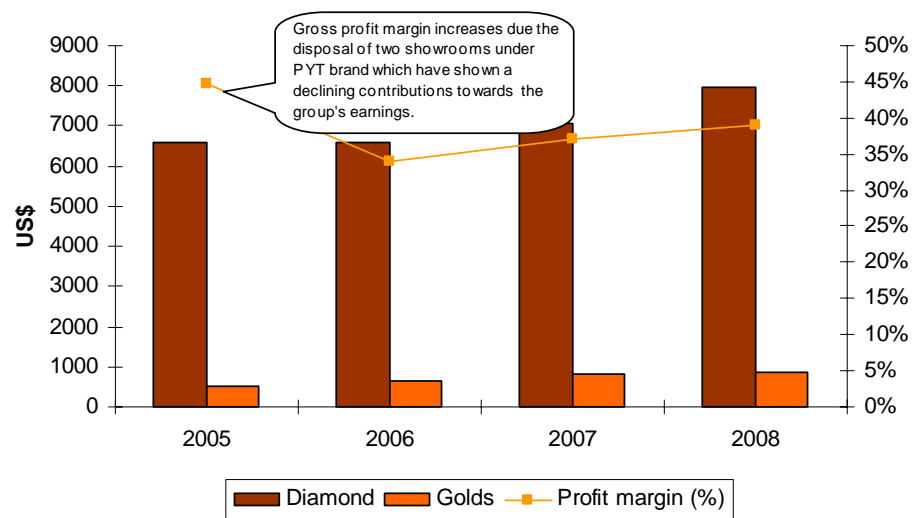
Table 1: FY07 financial results of DeGem and peers

	Revenue (RMm)	Net profit (RMm)	EBITDA margin (%)	2007 PER (x)	ROE (%)
DeGem	157.94	17.76	17.20	5.6	14.80
Tomei	223.78	12.31	7.88	7.32	12.66
Poh Kong	414.24	18.4	9.65	10.65	8.36

Source: OSK Research

Looking into the Chinese market. Management has plans to open 2 outlets in Hong Kong and 1 in Beijing next year in a bid to penetrate into the huge Chinese market. The outlets will carry a different brand name to reflect the focus on the high-end market. As Degem's balance sheet remains healthy with net gearing at a nominal 0.18x, additional borrowings should not be an issue. We expect revenue contribution (40% in FY07) from Hong Kong will increase by 3% and 4% in FY08 and FY09 respectively with the opening of the outlets. For Singapore, due to the satisfactory performance of its business, the group will be opening a full-fledged sales outlet in Marina Bay (Floor space rental S\$90 psf) by this year. We view the overseas ventures positively in light of the high purchasing power of these countries. While details remain sketchy, Degem is in talks with a local party that could potentially be positive to earnings in the near future.

Margin pressure mitigated by higher volumes. Margin- wise, the rise in raw material prices in particular gold may exert some pressures on margins to a certain extent. However, the increase is still within the cost escalation factor (shown in Figure 1) driven by continuous growth of its market share due to its unique and trend-driven designs, exclusive distributorships of Lazare and Fabergé brands as well as its overseas endeavours which increases sales volume. Degem's sales are more services driven, contrary to that of rivals which face higher operating costs due to extensive sales branches. The escalating prices of gold which contribute less than 10% of total revenues is unlikely to affect group's earnings but would spur demand as it could act as a hedge against inflation. The depreciation of the US\$ would not affect DeGem substantially due to the natural hedge provided by overseas sales denominated in US\$ and US\$ raw material purchases. Nevertheless, we remain cautious on creeping inflationary pressures due to the recent electricity tariff and petrol price hike that could take a toll on retail earnings over the medium-term.

Figure 1: Prices of raw materials and gross profit margin of Degem

Source: OSK

FYE Dec (RMm)	FY05	FY06	FY07	FY08f	FY09f
Turnover	108.2	143.9	157.9	179.6	201.5
EBITDA	19.1	21.1	27.2	28.9	36.3
PBT	8.0	17.2	22.7	24.4	31.6
Net profit	4.6	13.8	17.8	19.1	24.9
EPS	3.4	10.3	13.3	14.3	18.6
DPS	2.5	19.0	2.5	3.5	4.5
Margin					
EBITDA	17.6%	14.7%	17.2%	16.1%	18.0%
PBT	7.4%	11.9%	14.4%	13.6%	15.7%
Net Profit	4.3%	9.6%	11.2%	10.6%	12.3%
ROE	4.2%	13.1%	14.8%	14.0%	15.9%
ROA	2.8%	7.5%	9.0%	9.2%	10.7%
Balance sheet					
Fixed asset	20.7	20.8	20.6	20.1	19.5
Current Assets	133.3	148.4	163.4	176.2	198.8
Total Assets	166.9	182.5	196.3	208.1	232.9
Net Current Assets	111.3	108.5	124.0	139.7	160.1
LT Liabilities	0.9	2.6	2.5	2.6	2.5
Shareholders Funds	109.8	105.3	120.2	136.2	156.6
Net Gearing (%)	26%	25%	18%	21%	18%
Cash Flow					
PBT	8.0	17.2	22.7	24.4	31.6
Change in Working Capital	-4.0	4.5	-13.4	-26.5	-24.4
Operating Cashflow	0.2	-1.0	6.3	-5.2	2.8
CAPEX	0.1	4.8	0.4	0.4	0.4
FCF	0.2	0.9	6.7	-4.8	3.2

OSK Research Guide to Investment Ratings**Buy:** Share price may exceed 10% over the next 12 months**Trading Buy:** Share price may exceed 15% over the next 3 months, however longer-term outlook remains uncertain**Neutral:** Share price may fall within the range of +/- 10% over the next 12 months**Take Profit:** Target price has been attained. Look to accumulate at lower levels**Sell:** Share price may fall by more than 10% over the next 12 months**Not Rated:** Stock is not within regular research coverage

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