

28 February 2019

Consumer Cyclical | Health & Beauty

Best World (BEST SP)

Buy (Maintained)

Going Back To Fundamentals; Maintain BUY

Target Price (Return) SGD2.95 (+15%)
 Price: SGD2.56
 Market Cap: USD1,031m
 Avq Daily Turnover (SGD/USD) 12.8m/9.5m

- **Maintain BUY with higher TP of SGD2.95** from SGD2.13, 15% upside and 3% FY19F yield. Best World's 4Q18 results beat our as well as consensus' estimate. For the full year, core PATMI grew 15% YoY to SGD63.9m.
- **4Q18 results were above expectations.** Sales from all markets came in above our expectations, while the franchise business model in China achieved stronger margins. During the briefing, management said it still expects 50% YoY growth in end-consumer demand for the China market. As such, we remain confident of its growth prospects in the near term. We raise our FY19F-21F earnings by 8-14% on the back of higher revenue and margin assumptions.
- **Share price has been on a rollercoaster ride in the last month.** Over-exuberance in the market resulted in its share price soaring 24% in the first two weeks of February over no apparent news, before collapsing on concerns raised in the *Business Times* article, [Sales of DR's Secret in China: Best World's best-kept secret?](#) (page 3). We note that Best World has issued a statement to clarify the issues raised. It is also looking to engage an independent review to address the relevant concerns. We believe the move towards greater transparency will build greater confidence among the investment community.
- **Going back to fundamentals.** Since the share price has now retraced to a more reasonable level, we see value emerging, given the strong growth prospects in its China franchise business. We raised our TP to SGD2.95 on the back of stronger earnings growth as well as a higher target P/E multiple of 18x in our blended valuation methodology (page 2) to reflect increased clarity in the franchise business' margins.
- **Stay safe, stick to fundamentals.** While we are confident of the near-term earnings prospects, we caveat investors to avoid chasing share price when valuation runs way too high. Unlike a usual retail business, Best World's direct selling model and franchise model operate largely by "social selling". This business model itself innately has limited visibility in end-consumer demand. Key risks include overstocking of inventories by franchisees and inability to track sudden drop in end-consumer demand.

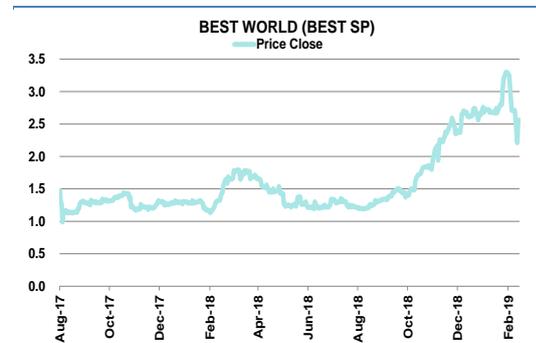
Analyst

Juliana Cai
 +65 6232 3871
juliana.cai@rhbgroup.com



Share Performance (%)

	YTD	1m	3m	6m	12m
Absolute	(2.7)	(4.5)	11.9	109.2	78.7
Relative	(8.6)	(6.0)	6.7	108.5	86.9
52-wk Price low/high (SGD)	1.14 - 3.33				



Source: Bloomberg

Forecasts and Valuation	Dec-17	Dec-18	Dec-19F	Dec-20F	Dec-21F
Total turnover (SGDm)	214.8	266.3	471.1	561.8	647.8
Recurring net profit (SGDm)	55.7	63.9	97.0	117.5	139.2
Recurring net profit growth (%)	61.0	14.8	51.8	21.2	18.5
Recurring P/E (x)	31.6	27.5	18.1	15.0	12.6
P/BV (x)	13.6	10.1	7.9	6.3	5.0
P/CF (x)	30.8	11.7	21.7	14.2	11.5
Dividend Yield (%)	1.3	2.3	2.8	3.3	4.0
EV/EBITDA (x)	23.3	16.4	11.2	8.8	7.1
ROE (%)	43.0	42.0	43.6	41.8	39.7
Net debt to equity (%)	net cash				
Interest coverage (x)	n.a	n.a	n.a	n.a	n.a

Source: Company data, RHB

Figure 1: 4Q18 results summary

FYE Dec (SGDm)	4Q18	3Q18	4Q17	QoQ (%)	YoY (%)	Comments
Revenue	127.7	92.1	71.5	38.7	78.6	Revenue growth was largely driven by the commencement of franchise model in China in end 2Q18. On top of volume growth, ASP was higher per unit product under the new franchise model.
Gross profit	99.8	77.3	47.7	29.1	109.2	The higher ASP per unit product brought about higher gross margins in 3Q18 and 4Q18. We expect gross margins to be in the range of 75-80% going forward.
<i>Gross margin (%)</i>	78.2	83.9	66.7			
Distribution	(40.8)	(32.7)	(13.6)	24.8	199.0	Distribution cost increased YoY due to the change in business model.
<i>% of revenue</i>	(32.0)	(35.5)	(19.1)			
Admin	(19.5)	(16.5)	(12.3)	17.6	58.6	Driven by higher management fee for its China franchise business.
EBIT	39.1	35.6	20.1	10.0	95.1	
<i>EBIT Margin (%)</i>	30.7	38.6	28.1			
Pretax profit	39.4	35.8	20.1	10.3	95.8	
Net Profit	28.0	29.8	21.7	(5.8)	29.5	Included in 3Q18 was SGD9m of one-off fees.
Recurring PATMI	28.1	20.9	21.8	34.6	28.9	
<i>Net margin (%)</i>	22.0	22.7	30.5			

Source: Company, RHB

Valuation

We raised our TP to SGD2.95 based on our blended valuation methodology. As highlighted in our initiation report [Best World : Put Your Skin In The Best Game; Initiate BUY](#) (23 Oct 2018), we think its share price is likely to re-rate upon more clarity about its earnings prowess in China following 3Q18 and 4Q18 results. Our TP is now based on the average of 18x target P/E and DCF valuation. Our 18x target P/E is based on peer average and is also in line with Best World's 5-year average P/E. Our WACC assumption for DCF valuation also includes additional country risk premium to account for its exposure to the China market. Our new TP implies 15% upside from current levels.

Figure 2: TP derivation

DCF valuation			
(SGD m)	FY19F	FY20F	FY21F
Net Income	97.0	117.5	139.2
+ Non-Cash Charges	7.4	10.0	10.9
+ Fixed Capital Investment	-20.5	-10.5	-5.5
+ Change in net working capital	-21.8	-2.5	5.1
+ Change in debt	-2.0	0.0	0.0
FCFE	60.0	114.5	149.6
Terminal Value			1501.2
PV	60.0	103.1	1338.2
Total discounted FCFE	1501.4		
Value/Share (SGD)	2.73		
Cost of equity	11.1%		
Risk free rate	2.8%		
Beta	1.1		
Market return	9.5%		
Country risk premium for China exposure	0.8%		
Terminal growth	1.0%		
Relative valuation			
Target P/E	18x		
FY19F PATMI (SGD m)	97.0		
EPS (SGD)	0.18		
Value/share (SGD)	3.18		
RHB TP (average of DCF and relative valuation)	2.95		

Source: RHB

Understand The Business Before Investing

Uncovering the secret. Best World's share price took a plunge on 18 Feb on concerns highlighted by the *Business Times* article, [Sales of DR's Secret in China: Best World's best-kept secret?](#). Some of the key contentions raised include:

- i. The business model in China;
- ii. Best World's limited direct selling licence in China;
- iii. Ability to track sales;
- iv. Reconciliation of sales figures to underlying consumer demand.

Greater confidence instilled after *Business Times* article. We believe management has adequately addressed the confusion with regards to change in its business model in China in its [clarification announcement](#) dated 23 Feb. We would also like to reiterate that while the company has limited direct selling licence in China, it was selling into the China market via import agents prior to 2Q18 and is selling into China through its franchisee after 2Q18. Its franchise licence applies to the whole of China and encompasses the sale of skincare products.

We came out more confident of the group's corporate governance after this saga. In order to assure the investment community, the group is willing to incur additional professional costs to engage an independent reviewer to address concerns raised with regards to its business validity. With regards to the inability to locate franchisees in China mentioned in the article, the group now maintains an updated list of its franchisees on its website.

During the analysts' briefing, management also mentioned that the group is working with its franchisees to collate its end-consumer numbers in China. Once compiled and verified, the group would publish these figures quarterly, similar to the direct selling membership numbers it provides. We believe this increase in transparency would bode well for investor confidence in the long run.

However, some innate risks are unavoidable... Nonetheless, we agree with the *Business Times* article that tracking sales and the underlying consumer demand for this company remain challenging. However, this is the innate risk of the business model. As previously highlighted in our initiation report, unlike traditional retailers, Best World's distributors and franchisees sell largely through the sharing of product usage experiences. There is therefore limited visibility on sales growth and the inventory floating on trade.

Best World also has limited control over sales efforts and purchases made by its distributors and franchisees. Inventory build-up by distributors or franchisees could occur without the group or investment community being aware of it, posing risks to sudden earnings decline.

... but relatively lower risk in the new franchise model. The change from export model to franchise model in China, however, would mitigate this risk to a certain extent. As opposed to the export model where import agents get credit terms from the group, the group operates on cash-before-delivery terms with its franchisees. There is therefore a lower risk of inventory build-up by the franchisees as they have to pay cash up front before purchasing and there is no return policy for unsold goods. As such, moving forward, we believe there would be better correlation between sales figures recorded by the group and the underlying demand of end-consumers.

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KUALA LUMPUR

RHB Research Institute Sdn Bhd
Level 3A, Tower One, RHB Centre
Jalan Tun Razak
Kuala Lumpur 50400
Malaysia
Tel : +603 9280 8888
Fax : +603 9200 2216

JAKARTA

PT RHB Sekuritas Indonesia
Wisma Mulia, 20th Floor
Jl. Jenderal Gatot Subroto No. 42
Jakarta 12710
Indonesia
Tel : +6221 2783 0888
Fax : +6221 2783 0777

HONG KONG

RHB Securities Hong Kong Ltd.
12th Floor, World-Wide House
19 Des Voeux Road
Central
Hong Kong
Tel : +852 2525 1118
Fax : +852 2810 0908

BANGKOK

RHB Securities (Thailand) PCL
10th Floor, Sathorn Square Office Tower
98, North Sathorn Road, Silom
Bangrak, Bangkok 10500
Thailand
Tel: +66 2088 9999
Fax :+66 2088 9799

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**RHB Research Institute Singapore
Pte Ltd.**
10 Collyer Quay
#09-08 Ocean Financial Centre
Singapore 049315
Tel : +65 6533 1818
Fax : +65 6532 6211