Far Eastern Department Store (2903 TT)

HOLD

Retail

Initiation

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Recommendation

HOLD

Date:	October 17, 2005
Share Price (NT$):	16.65
Price Target (NT$):	17.71
Percent Change:	6.37%
52-wk range (NT$):	13.32-21.4
TWSE:	5826.27

Company Data

Capital Size (NT$):	10.36bn
Market Cap (NT$):	17.25bn
Market Cap (US$):	515.76mn
Issuing Shrs:	1.04bn
Outstanding Shrs:	973.60mn
PER ('06E):	25.23x
PBR ('06E):	0.94x
Foreign Ownership:	16.03%
Major Shareholder:	Group Related: 30.21%

Performance	1-m	3-m	6-m
Absolute	(3.76)	1.59	24.83
Relative to TAIEX	(0.87)	9.24	24.98

Key Changes	Current	Prev.
Recommendation	HOLD	NA
Price Target (NT$)	17.71	NA
'06 Revenue (NT$ bn)	19.89	NA
'06 Gross Margin (%)	22.50	NA
'06 Oper. Margin (%)	4.00	NA
EPS (NT$)	0.66	NA

Price Catalysts (+,-)

(-) Premature China harvest expectation

(-) Continuing hypermart investment loss

Related Research

PSC (2912 TT)	Aug. 08, '05

Long Road Ahead

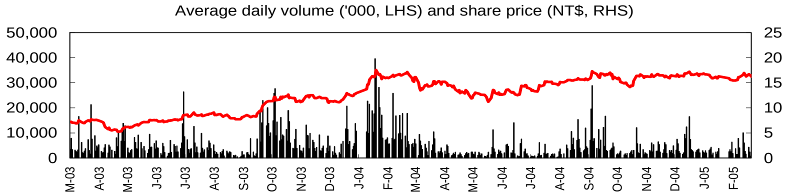
- **FEDS' core business is improving.** Through recent store remodeling and image re-positioning, Far Eastern Department Store (FEDS) has successfully corrected the slipping sales trend and enhanced its operating margin. For the first nine months of this year, the top line growth was 7.2% under severe industry competition and a lukewarm economy. We expect the improvements to continue through 2007 via the repositioning effect and the new opening in the prime Hsinyi district, scheduled in 2007.

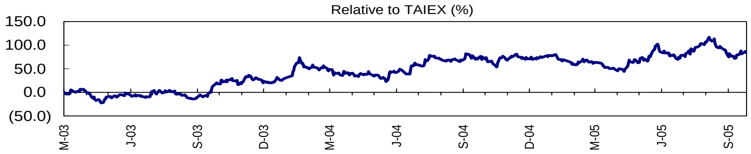
- **Department store market is reshuffling.** With the changing shopping patterns and sprouting larger new stores, we believe Taiwan's department store market will be dominated by fewer chained operators, such as FEDS and Shin Kong Mitsukoshi, who are backed by strong financial support to enable large-scale operation.

- **Premature China harvest theme.** FEDS had benefited from the China market for NT$150.6mn and NT$54.5mn respectively in 2004 and 1H05 through its SoGo holding. Nevertheless, FEDS' China expansion plan is still at full-speed to push for the opening of another 14 stores by 2010 under a high-competitive environment due to recent deregulation of China's retail market. Therefore, we think the China harvest theme is still premature.

- **Local hypermart investment might continue to drag down net earnings.** FEDS recorded an investment loss of NT$356 in 2004 and NT$300mn in 1H05 from its 50% stake hypermart investment, Géant. We expect the hypermart industry rivalry to become increasingly severe for Géant, after Carrefour has acquired Tesco's local operation to extend its dominating market share in Taiwan.

- **HOLD with a target price of NT$17.71.** We price the share based on its fundamental outlook and conclude a target price of NT$17.71 that equals to 1.0 x PBR of our 2006 estimated BV of NT$17.71; Hence, we derived a HOLD rating with 6.37% upside potential.



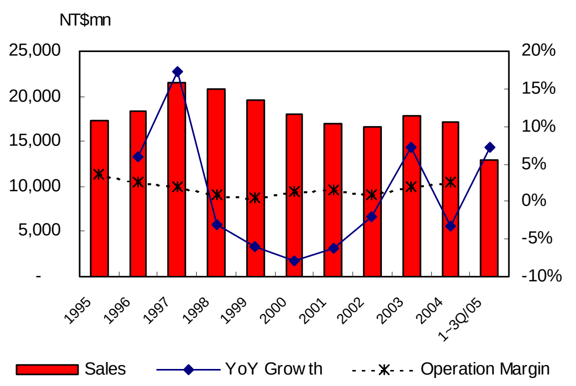


Investment Keynotes

Company core operation

Far Eastern Department Store (FEDS), a Far Eastern group's retailing arm, is one of the oldest local department store chains and the only listed department store chain in Taiwan. FEDS currently owns nine stores island-wide. Through recent store remodeling and image re-positioning, the 39-year-old retail giant has successfully corrected the slipping sales trend and enhanced its operating margin. For the first nine months of this year, the top line growth was 7.2% under server industry competition and a lukewarm local economy.

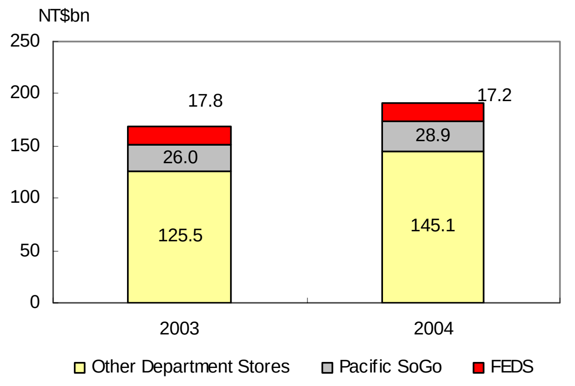
Figure 1: FEDS Sales and Operating Margin Trends



Source: Company data; MasterLink Securities

In 2002, the FEDS and its related subsidiaries together acquired 43.2% of Pacific SoGo Department Stores (SoGo), which owns the most profitable department store in downtown Taipei and six other locations in Taiwan. SoGo recorded net sales of NT$28.9bn in 2004. The two department store chains collectively accounted for 24.1% (FEDS 9.0%; Pacific SoGo 15.7%) of Taiwan's total department store turnovers, or NT$46.0bn, in 2004, ranked number 2 after Shin Kong Mitsukoshi Department Store.

Figure 2: FEDS and SoGo Market Share



Source: Company data; MasterLink Securities

We estimate SoGo's revenue to continue to exceed FEDS' for the next two years. This will be mainly due to the grand opening of the new store in 2006, the BR4 project, and a strong customer base established through advantageous store locations. For FEDS, the operations should continue to improve via repositioning the existing stores and opening a new store in 2007 in Taipei's shopping flagship district, the Hsinyi district.

Figure 3: FEDS and SoGo Store Number in Taiwan

	SoGo	FEDS
Current	7	9
2006 (E)	8	9
2007 (E)	9	10
2008 (E)	10	11

Source: Company, MasterLink Securities

Department store industry overview

In spite of a soft economy, Taiwan's shoppers have shown increasing appetites for high-priced imported boutique goods, which have triggered the opening of various new department stores with better amenity layouts and larger floor areas. This has also led to an increasingly vigorous department store industry in recent years. As witnessed in Figure 4, the sector sales has been moving in line with the assorted retailer market since 2000, except for the SARS-affected 2003. The sector has even outperformed in 2004 with 12.9% growth, versus the 7.0% increase for the overall assorted retailers' revenue.

Figure 4: Taiwan Assorted Retailer Market Size

(NT$bn)	2000	2001	2002	2003	2004
Total Assorted Retailers' Revenue	569.5	592.8	622.9	644.7	690.0
Growth	8.9%	4.1%	5.1%	3.5%	7.0%
Total Department Store Revenue	148.8	154.7	172.4	169.3	191.1
Growth	8.7%	4.0%	11.4%	-1.8%	12.9%
Market Share	26.1%	26.1%	27.7%	26.3%	27.7%

Source: MoEA, MasterLink Securities

With the changing shopping patterns and the sprouting of larger new stores, we believe Taiwan's department store market will be dominated by fewer chained operators, such as FEDS and Shin Kong Mitsukoshi who are backed by strong financial support to enable large-scale operation.

China operation

FEDS is exposed to China's department stores operation through its acquisition of SoGo in Taiwan. SoGo has entered the China market since 1993 and currently operates a total of ten stores in five different cities under Pacific Department Stores (PDS). On the other hand, the first store under Far Eastern Department Store targeting higher-end consumers has just had its grand opening early 2005 in Chongqing with another 100%-invested store due by 1Q06 in Tiainjin.

PDS recorded a total revenue of NT$12.6bn with NT$1.9bn operation earnings and NT$626.0mn net earnings (5.0% net margin) in 2004, and NT$282.4mn net earnings for 1H05. Accordingly, FEDS had benefited from the China market for NT$150.6mn and NT$54.5mn, respectively in 2004 and 1H05.

Figure 5: 2004 PDS Operation Result

Store Location	# of Stores	FEDS Ownership	Revenue NT$mn	Operating Earnings	Net Earnings
Shanghai	3	19%	6,965.0	1,596.2	465.5
Chengdu	2	26%	2,729.6	114.1	88.0
Chongqing	2	26%	1,734.3	253.4	169.4
Beijing	1	14%	1,207.4	(87.6)	(86.9)
Total	8		12,636.4	1,876.1	636.0

Source: Company, MasterLink Securities

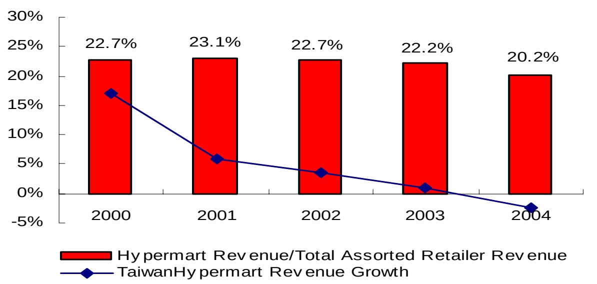
With China completely open its retail market to foreign operators; FEDS is pushing the China expansion plan at full-speed to occupy market shares. The company is aiming for a total of 25 stores, or 14 more locations, over 8 cities by 2010. We estimate that a total of NT$3.2bn funding is required to accomplish this mission.

We visited the company's China office early October and received message of intensive industry competition from the existing and new players. Although the latest economic cool-down policy raising self-funding requirement from 5% to 30% for new big-scale shopping mall projects was intended to reduce competition, we are worried that the determined new players are those with great financial strengths who are tougher to compete with and will impact FEDS' current China operation and prolong the new investment's payback period. FEDS estimated the accumulated net loss for a new store should be within NT$100mn during the first three years to reach breakeven in the forth year.

Hypermart investment

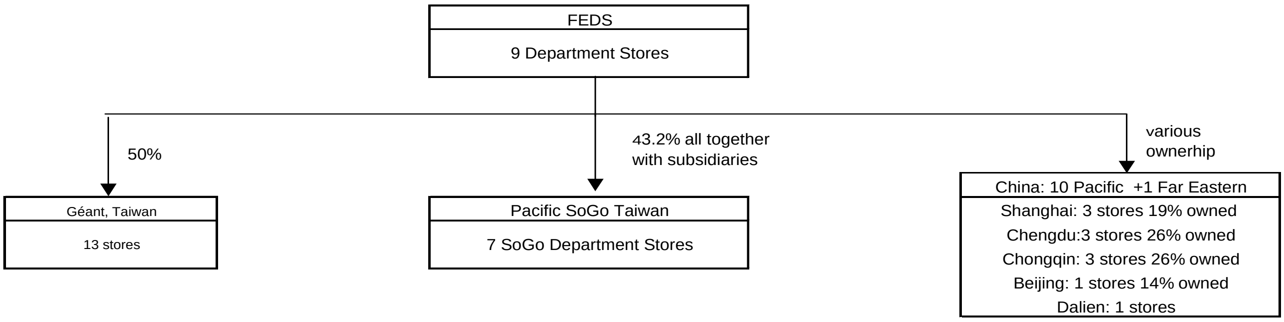
FEDS also invested 50% of a joint venture with the Casino Group in France to operate a hypermart chain, Géant, in Taiwan which currently has 13 locations and made NT$14.9bn sales in 2004, ranked number three and 10.7% of local hypermart share. Owing to intensive peer competition and falling sector revenue, Géant generated a net loss of NT$712mn (NT$356 booked by FEDS) in 2004 and NT$600mn (NT$300mn booked by FEDS) in 1H05, thus dragging down FEDS's L/T investment income. Even though FEDS is anticipating its hypermart business to turn profitable by 2008 when the store locations reach 20, we believe the industry rivalry will become increasingly severe for Géant after Carrefour has acquired Tesco's local operations to extend its dominating market share to 40% or 42 store locations out of the total 105 hypermart stores in Taiwan.

Figure 6: Taiwan Hypermart Market Trend



Source: MoEA, MasterLink Securities

Figure 7: FEDS' Retailing Empire



Source: Company, MasterLink Securities

Earning Forecasts

We estimate even under suppressing competition; FEDS' sales will increase stably through the gaining of more market share. We also tilt up the gross margin and operating expense slightly for higher sales on better-margin goods and rising operating costs. We, however, anticipate a lower China operation contribution as two new stores, in Chongqing and Chengdu, just began operations in 2005, and Géant should continue posting losses in 2006. Lastly, we do not project any land sales in 2006 as the one NT$450mn transaction in 2005, although it is highly possible due to funding needs for the expansion. Based on the assumptions above, FEDS should post a weaker net income in 2006 versus 2005, regardless an increase of operating income by 33.7%. Our EPS forecasts for 2005 and 2006 are NT$0.89 and NT$0.66, respectively.

Risk Factor

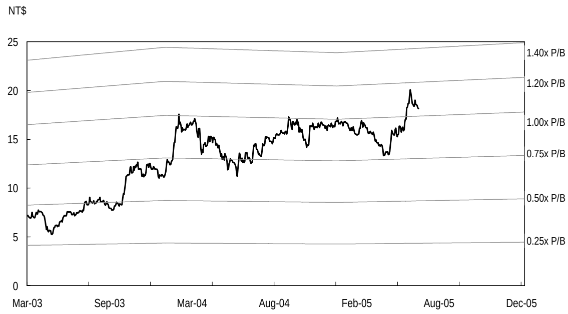
In addition to Géant's sustaining loss, our major concern for FEDS is its ambitious expansion plan, particularly in the China market. We think China's strong economic boom and recent deregulation of domestic retail industry will lend to a highly competitive department store industry. Nevertheless, riding on PDS' 13-year China experience, we expect FEDS' new ventures in China to skip some operational risks and shorten the payback period, compare with other concurrent new players.

Valuations and Recommendation

HOLD with a target price of NT$17.71

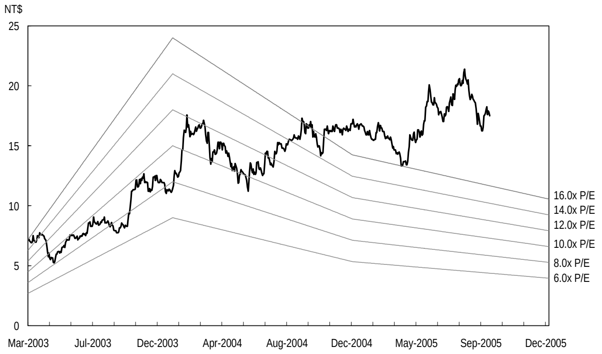
Owing to the recent hype on China harvest theme, which we believe is premature, the company's share price shot up to a valuation new high of 1.20x one-year-forward–looking PBR. We think, as the company is at the midst of its expansion phase from all aspects, the valuation based on its fundamental outlook should be conservative. We, therefore, conclude a target price of NT$17.71 that equals 1.0 x PBR of our 2006 estimated BV of NT$17.71 and derive a HOLD rating with 6.37% upside potential.

Figure 8: FEDS P/B Band



Source: TEJ; MasterLink Securities

Figure 9: FEDS P/E Band



Source: TEJ; MasterLink Securities

FEDS Key Ratios					NT$mn
Year to December	2002	2003	2004	2005E	2006E
Net Sales Grwoth	-2.12%	7.21%	-3.39%	8.30%	7.00%
Gross Margin	20.23%	20.71%	21.16%	21.70%	22.50%
Operating Income Margin	0.83%	2.04%	2.63%	3.20%	4.00%
Operating Income Growth	-47.26%	163.37%	24.30%	31.83%	33.74%
EBT Margin	-3.12%	2.20%	9.11%	5.39%	3.75%
EBT Growth	-734.17%	-175.53%	300.67%	-35.93%	-25.52%
Net income Margin	-3.32%	1.70%	8.62%	4.96%	3.45%
Net income Growth	-6027.37%	-154.88%	390.22%	-37.72%	-25.52%
ROAA	-1.86%	0.93%	4.33%	2.53%	1.78%
ROAE	-3.68%	1.99%	9.00%	5.28%	3.81%
Inventory T/O (days)	8	6	5	6	6
AR T/O (days)	24	9	10	10	10

FEDS P&L					NT$mn
Year to December	2002	2003	2004	2005E	2006E
Net Sales	16,569	17,763	17,161	18,585	19,886
Cost Of Goods Sold	(13,217)	(14,085)	(13,529)	(14,552)	(15,412)
SG&A	(3,214)	(3,315)	(3,180)	(3,438)	(3,679)
Operating Income	138	363	451	595	796
Net Investment Income	(533)	(66)	1,321	(45)	(60)
Other Non-Operating Income (net)	(121)	93	(209)	452	10
Pre-Tax Income	(517)	390	1,563	1,002	746
Income Tax Expense	33	88	84	80	60
Net Income	(550)	302	1,480	921	686
EPS(NT$)	(0.55)	0.31	1.50	0.89	0.66
DPS(NT$)	0.00	0.25	0.60	0	0.00
Payout Ratio	0.00%	75.76%	37.74%	0.00%	0.00%
Common Stocks	10,001	9,870	9,870	10,364	10,364

FEDS Balance Sheet					NT$mn
Year to December	2002	2003	2004	2005E	2006E
Cash & Equivalent	213	166	434	1,794	1,450
Receivable	1,097	439	482	491	525
Inventories	298	237	189	224	238
Long-term Investment	6,891	8,762	10,002	11,401	11,341
Total Fixed Assets	18,985	21,758	22,251	23,368	24,346
Other Assets	3,738	2,287	1,358	876	877
Total Assets	31,222	33,651	34,716	38,153	38,776
Current Liab.	7,099	7,715	7,546	8,301	10,477
L-T Liabilities	9,498	10,289	9,946	12,180	9,941
Common Stocks	10,001	9,870	9,870	10,364	10,364
Capital & Legal Reserve	7,154	6,747	6,747	6,839	6,907
Retained Earnings	(411)	297	1,485	1,229	1,846
Adjustment	(2,120)	(1,268)	(878)	(760)	(760)
Total Equity	14,625	15,646	17,224	17,672	18,358
Total Liab. & Equity	31,222	33,651	34,716	38,153	38,776
BV(NT$)	14.62	15.85	17.45	17.05	17.71

FEDS Cashflow					NT$mn
Year to December	2002	2003	2004	2005E	2006E
Net Income	(550)	302	1,480	921	686
Depreciation& Amortization	451	432	433	439	509
Net Working Capital Change	(436)	253	(571)	5	78
Other	756	781	(797)	175	143
Operating Cashflow	222	1,769	544	1,540	1,417
Sale (Purchase) of L-T Inv.	(955)	(1,136)	239	(1,444)	-
Sale (Purchase) of F.A.	(4,224)	(1,422)	(1,486)	(1,416)	(1,488)
Other	1,283	1,372	367	420	(1)
Investment Cashflow	(3,896)	(1,186)	(879)	(2,439)	(1,489)
Dividend Paid	(194)	-	(243)	(592)	-
Debt Change	3,893	1,531	130	2,851	(272)
Other	(295)	(2,159)	715	-	-
Financing Cashflow	3,403	(629)	603	2,259	(272)
Total Cash Change	(271)	(46)	268	1,359	-344

MasterLink Securities – Stock Rating System
BUY: Total return expected to appreciate 10% or more over a 3-month period.
HOLD: Total return expected to be between 10% to –10% over a 3-month period.
SELL: Total return expected to depreciate 10% or more over a 3-month period.

Additional Information Available on Request