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## Challenger Technologies Ltd

Singapore

18 Mar 2005

### Recommendation:

# BUY

Previous call: Nil

### Price

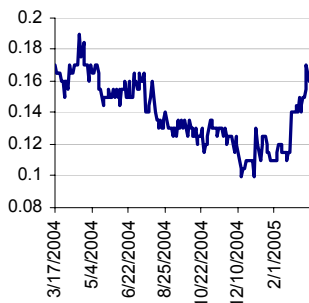
**Previous close** :S\$0.160  
**Target**  
**-Cum-dividend** :S\$0.230  
**-Ex-dividend** :S\$0.205

### Share Statistics

Shares	153.5m
Market Cap.	\$24.6m
Trailing PER	8.6x
Forward 2005 PER	8.9x
Forward 2006 PER	8.8x
P/NTA	1.7x
52-week Price Range	\$0.10-\$0.19
52-week PER Range	5.4x-10.2x
Listing Bourse	SGX Sesdaq
Major Shareholders	Mr Loo Leong Thye (42.80%) Mr Ng Leong Hai (24.64%) Mdm Ong Sock Hwee (9.13%)

Source: Bloomberg; Phillip Securities Research

### Price Chart



### Company Profile

Challenger Technologies Ltd is a retailer of IT products, which has two superstores and two small format outlets in Singapore. Challenger

### Pay \$12.5m for a business that generated \$3m cash a year

The group's retail business is by and large a cash business where walk-in customers pay cash for products. The combination of cash receipt, low inventory days of around 36 days and 30-60 days credit by suppliers allow the company to generate cash consistently. The cash flows from operations for the FY2002, FY2003 and FY2004 are \$1.98m, \$3.04m and \$3.75m. Sitting in its balance is about \$12 million cash, net of debt. At the current share price (market cap of \$24.6 million), one is effectively paying \$12.6 million for the cash generative business.

### High dividend payout ratio

The company has consistently pay out a substantial proportion of her profit, even before it was listed. Its first post-IPO gross dividend is 3.7 cents (interim and final), which represents a dividend yield of 23% based on the previous close. The current year's dividend is unusually high because the group is attempting to utilize the S44 credit. We expect dividend to remain high for the next two years as there is balance in the S44 credit. Even after the S44 credit is fully utilised, we still expect dividend payout to be high. The IPO proceeds are sufficient for business expansion and working capital needs. Hence, the group should *able* to pay out all of its earnings.

### Be a co-owner; Buy for Dividend

And the management is *willing* to pay dividends. The owner-operators (who own more than 75% of the group) derive their main rewards from dividends. At the current price, we believe the stock offer attractive annual dividend yield. Being a stable cash-generating business, Challenger can be fairly valued using the discounted cash flow model. We derived a fair value of \$0.230. We initiate coverage with a BUY call.

### Key Financial Data

(Financial Year Ended 31<sup>st</sup> December)

	FY04	FY05F	FY06F
Turnover (\$ m)	75.5	69.8	71.9
EBIT (\$ m)	3.1	3.4	3.5
Net Profit (\$ m)	2.9	2.7	2.8
Net Profit Margin (%)	3.8	3.9	3.8
ROE (%)	19.7	20.3	20.9
EPS (cents)	1.87	1.80	1.83
P/E (x)	8.55	8.87	8.77
Book value per share (cents)	9.5	9.0	8.9
P/Bk (x)	1.68	1.77	1.79
FCF per share	2.1	1.4	1.6
P/FCF (x)	7.68	11.26	9.77
Gross Dividend per share (cents)	3.7	2.5	2.5
Gross Div Yield (%)	23.1	15.6	15.6

## Company Profile

### Background

#### **Core Business: IT Retailer**

Challenger Technologies Ltd is primarily an IT retailer, deriving 93.9% of her revenue and all her profit from this business segment. The company purchases IT and related products (such as computers, PDA, digital cameras, MP3 players, software etc.) from IT vendors and sells them at her two Challenger Superstores (located at Funan The IT Mall and DBS Tampines Centre) and two small format outlets to walk-in customers. With over 60,000 members under its Minus10 program, there is a substantial number of repeat customers among its clientele. All four stores are profitable for FY2004. The Group also provides after sale IT services to customers, whether or not they have purchased the products from Challenger. Customers will be charged a servicing fee depending on the complexity of the IT problems.

**Table 1: What Challenger sells**

Product Category	Products	Notable Vendor
Accessories	Bag, cleaner, filter	Dicota, Targus, Fellowes
Data Communication	Modem, Network	D-Link, Linksys
Desktop	PC, Monitors, LCD	Acer, Compaq, HP, BenQ, LG, Samsung
Home entertainment	CD, DVD players	Shinco, Enzer
Imaging and video	Digicam, videocam, webcam	Casio, Olympus, Nikon, Canon, Sony
Input devices	Keyboard, joysticks, mouse	Logitech, Microsoft
Media	Floppy, hard disk, memory card, USB drive	Seagate, Western Digital, Maxtor, Kingston, SanDisk
Mobile computing	Laptop, PDA	Acer, Compaq, Fujitsu, HP, Palm, Toshiba
Multimedia	MP3 players, soundcard, graphic, speaker	Creative, Apple iPod, Altec Lansing
Office equipment	Projectors	Benq, Brothers, HP, InFocus, Sharp
Printing devices	Printer, Scanner, All-in-one	Brothers, Canon, Epson, HP, Lexmark, Minolta, Samsung
Software	Entertainment, Education, Business, Utilities	Microsoft, Symantec, Adobe
Supplies	Toners, cartridges, labels	HP, Canon, Epson, Lexmark, Brothers

Source: Company, Phillip Securities Research

The company operates in a fragmented and competitive IT retail space where competitors range from the sole proprietors in Sim Lim Square to the online store like Dell to the large IT retailers like Harvey Norman, Courts and Best Denki.

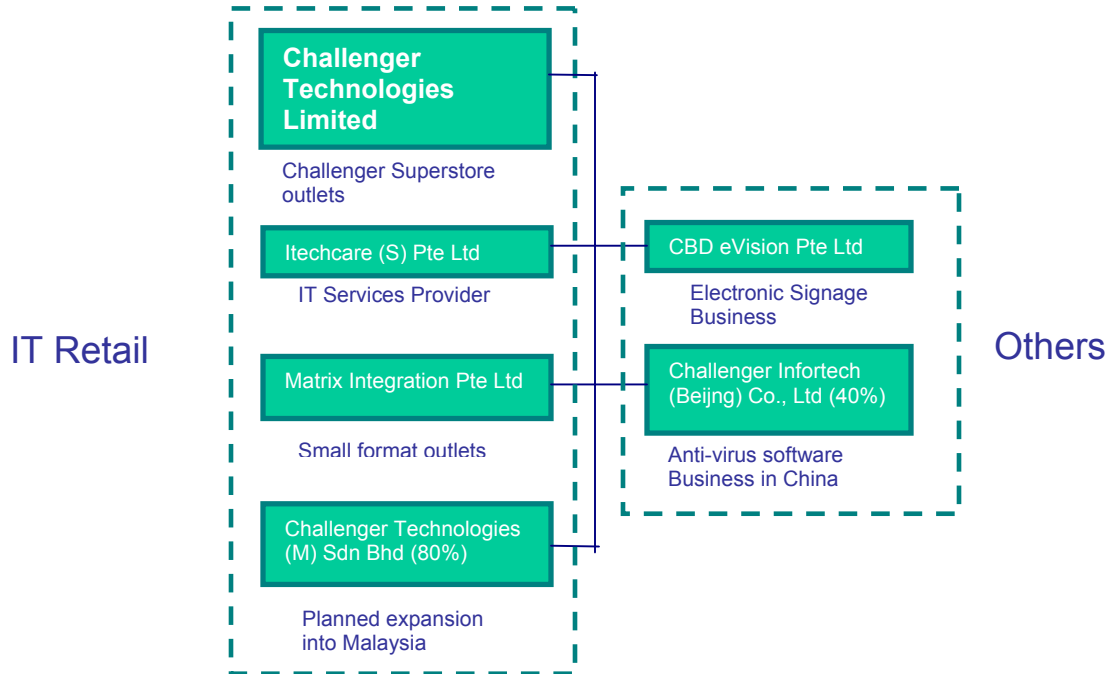
#### **Other Businesses**

Under the electronic signage services business, the Group design and fabricate electronics signage for owners of commercial buildings, financial institutions and hotels on a project-by-project basis. This business contributes 1.5% of the Group's FY2004 revenue and suffered a small loss of \$0.16m.

Under the office supplies business, the Group distributes office supplies to corporate customers and statutory boards in Singapore. The Group entered the business by acquiring OA Supplies Pte Ltd in April 2004. This business contributed 4.8% of Group's FY2004 revenue. The group intends to dispose of this loss-making subsidiary because the subsidiary's management decides to venture into non-office supplies business.

In July 2004, the Group invested in a 40% stake in a Beijing-based anti-virus software provider, Challenger Infortech (Beijing) Co., Ltd. The exposure is limited to the initial investment. No further cash injection is planned.

**Figure 1: Company Structure**

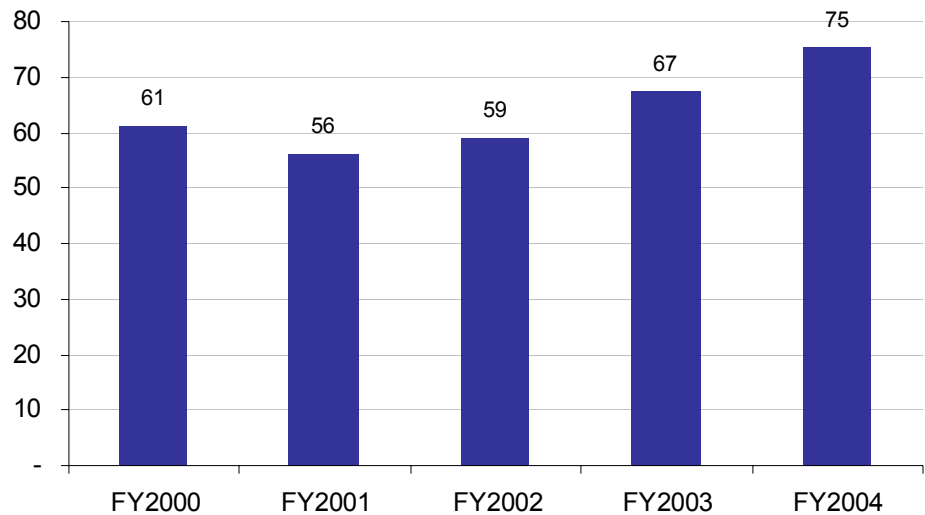


## Financials

### Sales and profit

The company derives her income from purchasing IT and related products and selling them at a profit to walk-in customers.

**Figure 2: Sales Trend**

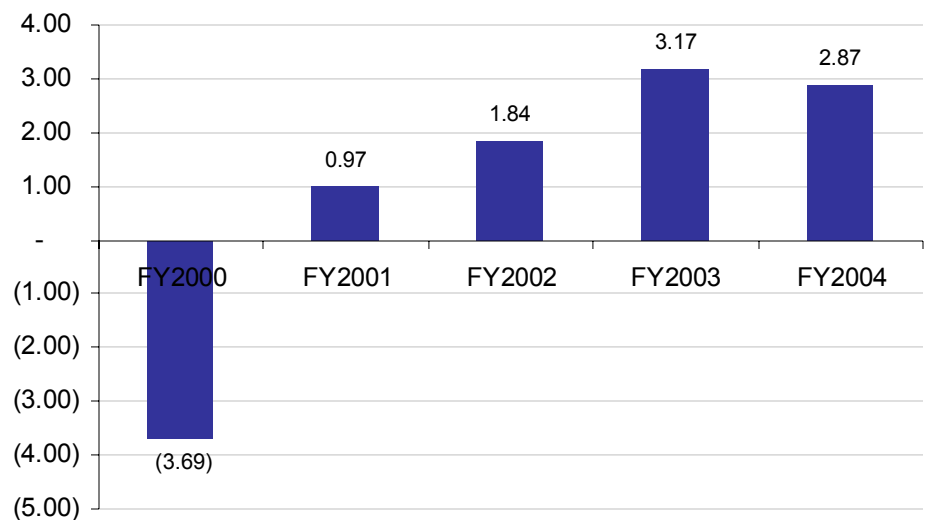


Source: Company, Phillip Securities Research

\*FY2004 include turnover of \$3.7 m from office supplies business which will be disposed of

The retail business is relatively a stable business. Challenger's growth and decline in sales have generally tracked the country's GDP growth rate.

**Figure 3: Profit Trend**



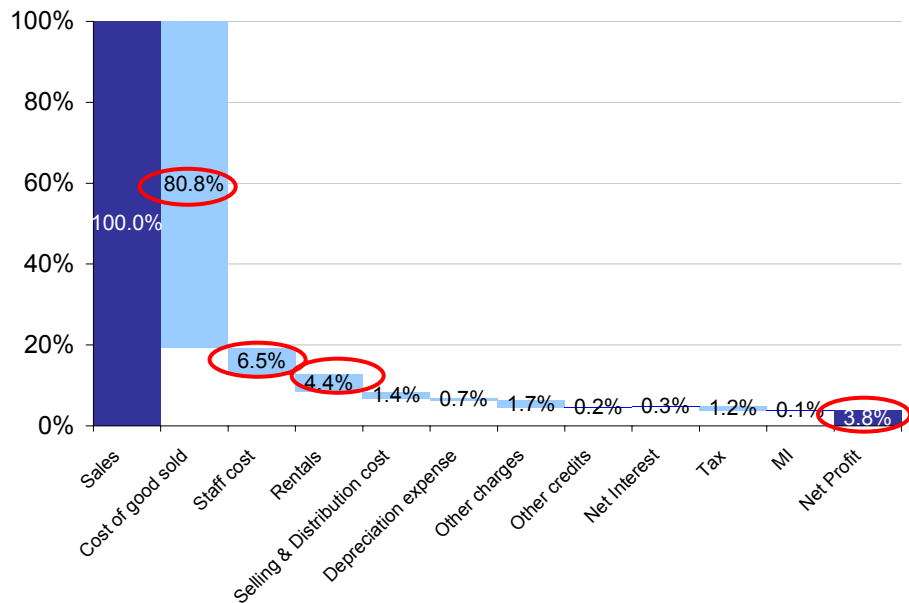
Source: Company, Phillip Securities Research

The company suffered losses in FY2000 because of its high operating cost to cater to its regionalization plans (which did not take off successfully). There were also other costs incurred such as loss on disposal of subsidiary, loss on disposal of equipment and bad debts written off. Profitability subsequently recovered as the company streamlined to focus on the Singapore market.

**Cost drivers**

Challenger’s key to profit is managing her key cost drivers: inventory, staff cost and rental. Controlling these costs are the major challenges faced by the company.

**Figure 4: Breakdown of FY2004 Profit & Loss**



Source: Company, Phillip Securities Research

**COGS**

Challenger has consistently achieved 18-20% gross margin Channel checks indicates that a single-digit to low-teen % mark-up by retailers for (generally higher-value) IT products are common. Mark-up for accessories and software range from 20% to 50%. Challenger is able to generate a gross margin higher than its listed peers because of its higher mix of IT accessories.

Challenger has its strong bargaining power because of volume purchase. In addition, by abhorring the extension of credit to customers, it pocket another 3-5% margin that would otherwise have gone to the finance company or credit card firms. As a result of its short cash conversion cycle, it is able to pay vendors promptly and get further discount, which further adds to the gross margin. We believe that the company is able to maintain its gross margin.

**Rental**

Rental is a major fixed cost of the business. Challenger signs three-year lease for her outlets at Funan The IT Mall and DBS Tampines Centre. At Funan, her rentals are affordable because of her strategy to locate at the top floor. Rentals are lower there because human traffic flow is supposedly lower and Challenger is willing to occupy the entire floor. However, with her lease at Funan up for renewal this August and a landlord in the shape of CapitalMall Trust, we still expect the rental expense to creep up.

**Staff Cost**

Staff cost is another major cost driver for the IT retailer, as it is for most corporations. Challenger incorporates a high variable component for its sales staff, with low fixed based, so that salaries are highly correlated to performance.

The increase in the foreign worker levy is not expected to have a material impact on the company who employs about 33 foreign employees.

### Strong cash flow

The working capital is by-and-large financed by suppliers as goods are sold on cash terms, while suppliers grant credits of 30-60 days.

### No gearing

The company has been in net cash position for the past five years.

## So, what's different about Challenger?

### Run by owner-operator: strong focus on bottom-line

Mr Loo Leong Thye, Mdm Ong Sock Hwee and Mr Ng Leong Hai who collectively own more than 75% of the company are owners-operators of Challenger. The CEO, Mr Loo's monthly salary is \$18,000, while that of Mdm Ong is \$8,000. Their rewards come from incentive bonuses (which are based on group profits) and dividends as major shareholders. Hence, there is a strong focus on profitability by the owners-operators and the principal-agency problem is minimal.

The company does not have any share option scheme. Mr Loo, Mdm Ong and Mr Ng do not receive any director fees. Only the independent directors are paid.

**Table 2: Comparison of Margins**

Ratio	Challenger	Courts	Pertama
Gross margin	19.2	9.9	9.5
Net margin	3.8	(0.1)	2.1

Source: Bloomberg, Phillip Securities Research

\*Based on respective 2004 financial year-end figures

### Unique inventory control systems

In Challenger, buyers (staff in-charge of what products to bring in) are measured on the gross profit generated by the products they bring in. A key aspect of the controls systems is the inventory write-offs against a buyer's P&L as a result of inventory aging.

Inventory aging is done monthly. Inventory not sold within 90 days will trigger monitoring by the management. Inventory is 50% written off if not sold within 6 months and fully written off after a year.

Unlike most other retailers, not only is buyer rewarded to bring in products that generate sales, they are penalised for bringing in slow-moving products. The results are evident as the company enjoy consistently high inventory turn compared to its peers

**Table 3: Trend of Inventory Turn**

Ratio	2001	2002	2003	2004
Inventory Turn	9.3	9.7	8.9	10.2
Inventory Days	39	37	40	36

Source: Company, Phillip Securities Research

**Table 4: Comparison of Inventory Management**

Ratio	Challenger	Courts	Pertama
Inventory Turn	10.2	7.2	7.0
Inventory Days	36	51	52

Source: Bloomberg, Phillip Securities Research

### Sales staffs are empowered: think about profitability

Sales staff measured on gross profit and not just sales figure. Sales staff would not be fixated on selling single product range for the sake of meeting sales target. In this way, the sale staff are empowered and motivated to provide solutions (not just products) to customers. The incentive systems for sale staff is also structured such a way that the variable component exceeds that of the fixed component when targets are met.

### Cash business

Challenger's retail business is by and large a cash business where walk-in customers pay cash for products. The company does not offer hire purchase and limits its interest-free credit card instalment plans to 12 months. While sales growth may be restricted as result, we are of the opinion that profitability and cash flow are preserved. Instalment plans lower profitability by up to 5% as a result of financing cost.

The combination of cash receipt, low inventory days of around 36 days and 30-60 days credit by suppliers allow the company to generate cash consistently.

**Table 5: Summary of operational differences**

Area	Challenger	Industry common practices
Principal-agency problem	Unlikely	Likely
Inventory control	Merchandisers measured on profitability generated by goods they purchased; write-offs affect profitability	Merchandisers measured on sale or profitability generated by goods they purchased; write-offs do not affect performance measure
Sales management	Sales staff measured on profitability generated by the goods they sell	Sales staff measured on sales figure/volume
Cash flow management	Mostly cash term; Credit card instalments only up to a year	Cash term; Hire purchase; Credit card instalments up to 36 months

## Is the 21% dividend yield for real?

### Yes, high payout because of S44 credit

Challenger announced a two-tier final gross dividend of 3 cents (the Group paid an interim gross dividend of 0.7 cents). At the current price of 16 cents, dividend yield is 18.8%, which is way above the usual dividend yield. Currently the stock is still cum-dividend. The stock will go ex-dividend on 15 April 2005.

The total interim and final net dividend payout of \$4.5m is more than the FY2004 pre-tax profit. The company is paying out the amount because there is substantial balance in the Section 44 credit and there is sufficient cash to run the business. The dividend is paid out from retained earnings and not from the IPO proceeds, which are budgeted for expansion plans. The Group will have cash holding of about \$8 million, after the dividend payout.

After this round of payout, the balance in the S44 credit is equivalent to what has been utilized this year. That means that potentially, there may be another bonus payout in the current financial year.

### Company is willing to pay dividend

Challenger's retail business will be a stable one that generates cash. Her expansion and regionalisation plans (see below) do not entail large cash layout. Her current cash holding likely exceeds what is required to fuel the plans. That means that the company has cash to pay dividends. More importantly, the management believes in rewarding the shareholders through dividends and has a record of doing so.

**Table 6: Dividend Records**

Ratio	Pre-IPO			Post-IPO
	2001	2002	2003	2004
Pre-tax Earnings (\$'000)	1,357	2,190	4,024	3,715
Free cash flow (\$'000)	1,532	1,828	3,777	3,198
Dividend (\$'000)	1,586	2,808	1,699	4,544

Source: Company, Phillip Securities Research

## Potential Growth Drivers

### New outlets in Singapore

Challenger will continue to have its primary focus on the local retail market. Where opportunity arises (right location at the right rental rate), it will open new stores with size similar to that of the Tampines branch. It has previously experimented with small concept stores at Sim Lim and found them not to be profitable.

### Regional drive

Challenger is looking to expand regionally. Prior to IPO, it had attempted to break into the Brunei, Indonesia and Thailand markets without success. Since then, it has gone back to the drawing board to fine-tune its regionalization plan. The current model it plans to adopt is the franchise model. This model will limit its capital exposure and leverage on the knowledge of the local management. The group has incorporated an 80%-owned subsidiary, Challenger Technologies (M) Sdn Bhd, in Malaysia for this purpose.

### Other Businesses

The electronic signage business has streamlined its supply chain and secured cheaper source for its supplies. With its domain knowledge and lower cost, it is expected to return to profitability. Upside surprise will come from major new project work, if any.

## Valuations & Recommendation

### Buy for Dividend; Target price of \$0.23

At the current price, we believe the stock offer attractive annual dividend yield. Being a stable cash-generating business, we believe Challenger can be fairly valued using the discounted cash flow model. We derived a fair value of \$0.230 (cum-dividend).

**Table 7: DFC Model**

In \$'million	Cum-dividend	Ex-dividend
NPV of FCF	4.42	4.42
NPV of terminal value	19.00	19.00
Add: Cash, net debt	11.79	7.29
Total Equity value	35.21	31.35
No. of shares (million)	153.5	153.5
Value per share (in S\$)	<b>0.230</b>	<b>0.205</b>

Source: Company, Phillip Securities Research

#### Assumptions

WACC	12.3%
Rf	3.2%
Rm	9.2%
Assumed Beta	1.0
Ke	12.3%
We	100%
Terminal growth rate	0.5%

### An alternative simple valuation

The company has 7.7 cents of cash, net of debt, per share as at 31 Dec 04. At the current share price of 16 cents, one is essentially paying 8.3 cents for a business that has generated operating cash flow of 1.3 cents, 2.0 cents, and 2.4 cents for the FY2002, FY2003 and FY2004.

#### Peer Comparison

Company	Px S\$	Mkt Cap S\$m	Hist PE (x)	Dividend yield (%)	P/Bk (x)	P/FCF (x)
Challenger	0.16	24.6	8.55	23.1	1.68	7.7
Courts	0.56	90.1	-51.2	25.5*/3.3	0.61	63.4
Pertama	0.29	69.3	8.35	4.0	0.83	-20.0

\*including special dividend



Signed

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