China | Consumer

Nu Skin Enterprises Inc. (NUS US)

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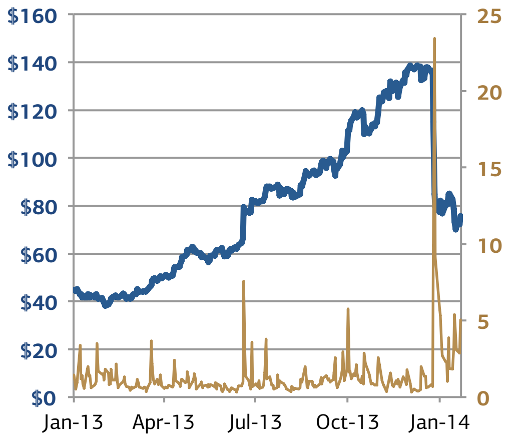
They'll get over it

Nu Skin Enterprises Inc. (NUS US) one-year share price in USD (blue) and volume (gold, in mln shares)



Source: Bloomberg, February 12, 2014

Nu Skin Enterprises (NUS US)

Price	USD 75.75
Rating	**BUY**
J Cap Target Price	**USD 91**
Difference	**26%**
Market Cap	USD 4.5 bln
Simple Moving Avg.	3,21 mln
P/E	15.49x

Source: Bloomberg, February 12, 2014

+ No obvious effect from regulatory attack

We believe that Nu Skin will likely find an arrangement with Chinese authorities that will permit the company to continue operating smoothly in China. The sale of TR90, the company's hottest product now, will likely be impacted. But activity was brisk at Nu Skin's pick-up points in Beijing and Guangzhou, which we visited following the New Year's holiday. In Beijing, the store has moved to a new space roughly four times the size of the old store and was full on February 8 with sales executives picking up products, and in Guangzhou as well, sales executives claimed there was no regulatory interference.

+ H1 impact

The company is currently not accepting new sales executives, and company associates believe this situation will continue for a month or two. Sales meetings and conventions are likely to be delayed, as the company will be careful to seek approval ahead of time—a requirement that is sometimes ignored.

+ The real risk

We believe the risk to Chinese sales is a potential collapse in interest rates and the domestic money market. Before that happens, we believe Nu Skin will continue seeing its highest growth in China.

+ PT USD 91; valuation: BUY

Our analysis of the business leads us to suspect that a significant portion of Nu Skin China's revenue derives from investment in China's high-return money market. As a result, we think that an imminent financial crisis will hit Nu Skin China hard. However, at the current share price, deleting half of China sales and figuring on negative growth in 2014 still bring us to a share price of about USD 100 on a DCF basis and USD 91 at 12x 2014 forward earnings. We believe that the current regulatory clouds over the company will clear, and the chances of a price rebound for the stock seem high. We recommend buying Nu Skin.

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Nothing money won't cure

Nu Skin China has been under a cloud ever since the People's Daily on January 15 alleged a "suspected illegal pyramid scheme" and Xinhua reported an investigation by the State Administration for Industry and Commerce (SAIC). Nu Skin canceled its Q4 call pending clarification of the China problems.

We have not determined whether an investigation is ongoing. However, Nu Skin sales executives say that the SAIC officials in January came and went. Sales appear to be booming, with the Beijing store having moved into a space nearly four times as large and other stores seeing volumes significantly increased year on year. Based on the fairly low bureaucratic level of the attack plus experience of other companies in the industry, we believe that Nu Skin will succeed in finding a workaround, which generally entails a charitable donation or funding to support consumer awareness.

Nu Skin sales executives insist that nothing has changed.

We do believe that the China business may see lower growth and lower profit in 2014 as a result: Nu Skin's LTO sales will likely come under tighter scrutiny, and bureaucratic accommodations to be made may be costly. However, we do not believe that Nu Skin China will lose its license, and consequently, we think the USD 55 decline in share price is excessive.

Q4 results

Nu Skin announced Q4 revenue at USD 1.075 bln, ending the year with 49% revenue growth. Greater China is now half of the company's total revenue. Limited Time Offer revenue is about 35% of China revenue, and we believe the LTO sales, which are for product carried in without formal approval, will be impacted by the current regulatory scrutiny on Nu Skin China.

Sales conventions may be curtailed, given that they are politically sensitive events that can too closely resemble religious revival meetings for the taste of government authorities. In normal times, companies do not always seek prior approval for these meetings, but the current atmosphere of caution indicates that Nu Skin will be crossing all this for the time being, and that will slow conventions.

Nu Skin China appears to have misrepresented an online sales promotion as a "convention," conveying the idea that regulatory

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approval had been granted. On January 31, Nu Skin's share price rose on news published by Benzinga that China's Ministry of Commerce had granted the company permission to hold its "2014 EXPO." That Expo meeting, however, is a small, routine promotional event attracting a few dozen attendees; it is not a 10,000-plus convention. Furthermore, the notice makes it appear that the event will be an online promotion for which no regulatory approval is needed.

NUS depends heavily on its LTO sales, which accounted for 34% of its Greater China revenue in 2013 Q3.

Nu Skin depends heavily on its LTO sales periods, during which it sells the newest products, which the company portrays as being in limited supply. The principal LTO product in the last 12 months has been AgeLoc TR90, a product that is not licensed for sale within China. That means that TR90 must be purchased online, through the Nu Skin internal ordering system, and then picked up offshore or else delivered by express mail from overseas. As of 2013 Q3, the LTO sales made up 34% of the Greater China revenue, which in turn was fully half of worldwide revenue.

We believe that the LTO sales could be impacted, as Nu Skin may need to apply for product registrations before TR90 is brought into China in quantity.

We have long held reservations about this company's China business. Our primary research indicates that inventory movement, store visits, and import records do not support the sales levels reported. We find Nu Skin's small loans activities and charitable contributions troubling, and we find evidence that capex may have been overstated. Nu Skin does not adequately explain how it makes hard currency available to Chinese sales executives who make purchases via the LTO program.

We do, however, see very fast growth in sales executive count, and domestic financial filings indicate high cash holdings.

Financial investments would resolve many of the inconsistencies in Nu Skin's financial filings and business operations, and we hypothesize that a significant portion of the China business actually consists of financial investment returns. If that is the case, then Nu Skin China is highly vulnerable to a potential financial crisis.

Even eliminating China sales, however, would leave Nu Skin with a valuation higher than its current USD 75.5. For that reason, we think Nu Skin is a BUY.

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Valuation

We assume that Nu Skin China's growth will be halved in 2014 and fall further in 2015, recovering to 5% growth. We assign the company terminal growth of 2%. On a DCF basis, with a WACC of 8.7, Nu Skin is worth USD 106 per share. Given the difficulty of assessing future growth, we prefer to value the company at 12x forward earnings, which is typical for direct-sales companies. On that basis, Nu Skin is worth USD 91.

Risks

On the downside, Nu Skin China could see its license revoked, leading to a fall in revenue for 2014 of roughly 35%, given that most of Greater China sales are ultimately destined for the mainland.

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Table 1. Income Statement

USD mln	2010	2011	2012	2013e	2014e	2015e
Revenue	1,537	1,744	2,170	3,236	4,045	3,842
Cost of sales	(272)	(323)	(353)	(527)	(607)	(538)
Gross profit	1,265	1,421	1,817	2,709	3,438	3,304
Selling expenses	(646)	(751)	(970)	(1,537)	(1,922)	(1,825)
General and administrative expenses	(401)	(436)	(505)	(635)	(793)	(754)
Restructuring charges						(1,825)
Total operating expenses	(1,048)	(1,188)	(1,476)	(2,172)	(2,715)	(2,579)
Operating profit	217	234	341	537	723	725
Other income (expense), net	(9)	(7)	4	(8)	(8)	(8)
Income before provision for income taxes	208	227	345	529	715	718
Provision for income taxes	(72)	(73)	(124)	(190)	(256)	(257)
Tax rate	34%	32%	36%	36%	36%	36%
Net income	136	153	222	340	459	461
Dividend (USD m)	31.19	36.62	48.48	74.28	100.37	100.69
Proposed Dividend per share (USD/share)	0.5000	0.5900	0.8000	1.2258	1.6563	1.6615
Basic earnings per share (USD/share)	2.180	2.470	3.660	5.608	7.577	7.602
Diluted earnings per share	2.110	2.380	3.520	5.392	7.286	7.309
Beg. weighted Av No of Shares (m)	63	62	62	61	61	61
New shares issued	-1	0	-1	0	0	0
End. weighted Av No of Shares (m)	62	62	61	61	61	61
Fully diluted weighted Av No of Shares (m)	65	65	63	63	63	63
Payout ratio		24%	22%	22%	22%	22%

Source: Company filings

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