JCAP

September 29, 2014

China | Direct Sales

Nu Skin Enterprises (NUS US)

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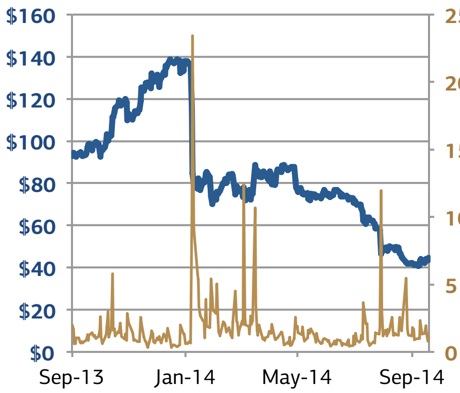
Nu Skin Enterprises (NUS US) one-year share price in USD (blue) and volume (gold, in mln shares)



Source: Bloomberg, September 29, 2014

Nu Skin Enterprises (NUS US)

Price	USD 44.53
Rating	**NOT RATED**
Price target	—
Difference	—
Market Cap	USD 2.6 bln
Simple Moving Avg.	1.3 mln
P/E	7.44x

Source: Bloomberg, September 29, 2014

No sign of life

+ Imports at a trickle

After finding in August that Nu Skin's China factories were idle, we looked at the company's imports of finished and semi-finished products to package for sale in the stores. We found that the total value of imports from May through July was less than USD 60,000. Comments from sales executives suggest that they are not selling off the large China-based inventories. In fact, we think Nu Skin China is simply not selling much at all.

+ Debt payments in doubt

Already in breach of debt covenants, Nu Skin has now upped interest it must pay in order to extend a USD 50 mln revolving credit facility from September 4 to December 3—despite claiming USD 285 mln in cash. Current portions of debt amount to roughly USD 100 mln. Nu Skin has said it would make a quarterly dividend payment of about USD 20 mln in September, but to do so, it would probably have to breach covenants again.

+ Valuation: NOT RATED

We have ended our formal coverage of Nu Skin and no longer maintain a target price.

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Is it about the crackdown?

Nu Skin's business in China in 2014 has all but ground to a halt. We do not believe that the political and regulatory attack on the company's China operations, which began in January, is ultimately responsible. Nu Skin has been through this sort of scrutiny before, paid a fine, and moved on. The problem looked to have been resolved when the company paid about half a million dollars in fines in February. Furthermore, many other direct-sales companies that are technically in violation of regulations are operating unmolested.

Has Nu Skin China been paying commissions out of cash contributions from new sales executives?

We believe instead that the attack was a catalyst for a collapse in what may have characteristics of a financial pyramid: new sales executives were being induced to join based on promised rewards out of proportion to the company's actual profitability.

Now, as the end of September draws near, Nu Skin must pull off the near impossible and generate enough cash to permit payment of a promised dividend. Bank covenants set requirements for operating cash flow before dividends may be paid. Given that the China business has no pulse, we cannot think our way through to how Nu Skin might be able to make a dividend payment without breaching the covenant.

Import volumes

Over the summer, we checked Nu Skin's China-based factories several times and found them idle. To confirm our view that very little product is selling in China, we sought Customs data to identify imports to Nu Skin China, whether of product intermediates or of finished products for resale. We found that Nu Skin China is recorded as having imported less than USD 60,000 worth of products between May 1 and July 31 this year. By contrast, in 2012, when Greater China's full-year sales of USD 571 mln were less than half of the expected 2014 level, quarterly import values amounted to about USD 500,000. In other words, imports for the May through July period were about one-tenth of the amounts recorded in 2012, when sales were lower.

The stores we have checked have been very quiet, and sales executives chatting on WeChat say that sales are very low.

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The Shanghai factory rented from Dexin as it was on August 26 at about 3 pm. Photo by J Capital | August, 2014.

Some Nu Skin products have been popping up for sale on Taobao but also not selling on those channels, at least according to the publicly visible sales counters.

Above: screenshot of Nu Skin bag and Nu Skin Galvanic Body Spa for sale on Taobao, with counter showing that 0 sales have been made of the Body Spa and one sale of the bag, which retails for about USD 2.20. Below, TR 90 on sale, also with no takers. Screenshots from Taobao | September 26, 2014.

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One of the attractions of the Nu Skin network for would-be salespeople in China is that, unlike many MLMs, Nu Skin does not pressure its distributors into carrying a lot of inventory. They are more likely to take orders from their network before making purchases in order to minimize their liabilities. That characteristic may keep too many Nu Skin products from floating around on Taobao.

Juggling debts

Nu Skin recently paid more to extend its debt facility by three months, to December 3.

On August 15, Nu Skin agreed to up the interest it owes to Bank of America in return for extension of a USD 50 mln credit facility to December 3 instead of September 4.

On September 2, fund manager and blogger John Hempton disclosed that the May amendment to Nu Skin's debt facility, in which JP Morgan agreed to extend the term of the debt, had been signed by one Richard M. Nixon for JP Morgan. Nu Skin subsequently stated that the signature was a typographical error and that Richard M. Hixson had signed. This strange story suggests, at a minimum, haste in preparing the documents. It is hard to imagine that a banker named Richard M. Hixson would not be sensitive to a misspelling of his name to double as the infamous U.S. president.

That odd irregularity played a minor note in the dissonant chord

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that is Nu Skin's cash management. The company overall conveys an impression of scrambling for cash.

Where's the cash?

Nu Skin claims to have USD 285 mln in cash, of which about USD 88 mln is in China and not easily accessible. And yet the company breached a debt covenant and took two three-month loans totaling USD 50 mln then extended for three months:

> "As of March 31, 2014, we were in violation of our restricted payments covenant under our amended and restated credit agreement, dated as of May 25, 2012. . . "

Despite its cash problems, Nu Skin is planning to make capital expenditures of about USD 40 mln in 2014 H2.

In spite of these cash problems, the company has said it would pay a quarterly dividend in September, amounting to about USD 20 mln, and make capital expenditures of about USD 40 mln in the second half to expand corporate facilities in Provo, China, and South Korea, and upgrade stores in China. Given that debt covenants restrict Nu Skin's dividend payments unless the company generates positive operating cash flow after capital expenditures, and given the negative operating cash flows of USD 185 mln in the first half, Nu Skin would probably be in violation of debt covenants (again) if it paid the dividend.

Insider sales

CEO Truman Hunt. General Counsel Matthew Dorney, and Chairman Steven Lund cashed in shares in August and September as they frequently do. Hunt sold 19,487 shares for USD 44.72 each.

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