

GOBI

HOLD Rating at a Target Price
of MNT

Sep 10, 2019

General

Ticker:	GOV
Industry:	Cashmere
Current Price:	MNT 280.23
Target Price:	MNT 367.18
Market Cap:	MNT 219 billion

Key Statistics

52 Week Range:	275.79- 35,180.00
Daily Range:	280.00-283.80
Shares Outstanding:	780,112,500

Figure 1. Stock Price History



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Introduction

Gobi Joint Stock Company (“Gobi” or the “Company”) is the largest vertically integrated manufacturer of cashmere products in Mongolia. Currently, the Company is listed on the Mongolian Stock Exchange (MSE) Top 20 Index and has a 71.3% share of the domestic cashmere market and a 2% share of the global cashmere garment market. Gobi’s current operations include the knitting, weaving, sewing, and manufacturing of Gobi brand clothing and other white-label cashmere products.

Investment Overview - Key Recent Developments

- **Acquisition of Goyo Cashmere:** In June 2019, Gobi announced that it had completed the acquisition of Goyo Cashmere, the second largest cashmere producer in Mongolia. The acquisition allowed Gobi to cement its title as the leading cashmere producer in Mongolia.
- **Stock split by 1-to-100:** In October 2018, the Company announced its decision to split its stock during its general meeting with a 99.99% approval rating. The stock split will help the Company bring down the price of its shares and increase equity liquidity.
- **Intensive Expansion:** In November 2018, the Company opened the “Galleria Ulaanbaatar” center in the heart of the capital city. Also known as the world’s largest cashmere store, the store offers both Gobi and Goyo products. The Company also started the operation of its 6,690 m2 knitting and sewing plant. The plant will only supply Gobi and Goyo as the companies push to secure more lucrative positions in the cashmere production value chain.
- **Operational Scale-Up:** Between FY14-FY18, Gobi grew its revenue at an average CAGR of 27%. In addition, EBITDA and net profit margins have increased steadily over the past 5 years.

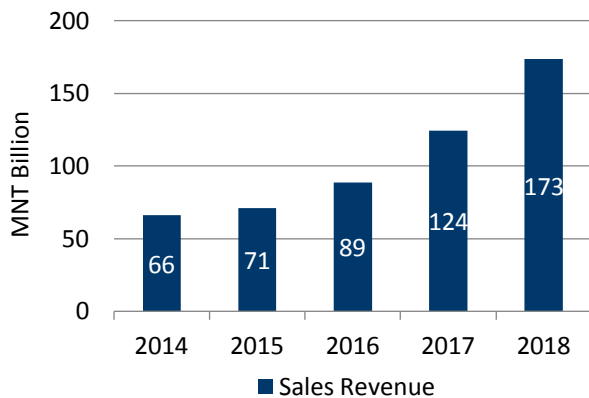
Figure 2. Key Historical Financials

MNT million	2014A	2015A	2016A	2017A	2018A
Income Statement					
Revenue	65,935	71,211	88,674	124,425	173,439
EBITDA	16,546	21,643	29,843	35,573	40,329
Net profit	10,492	10,748	16,139	17,503	17,764
Balance Sheet					
Total assets	99,978	122,761	135,872	180,729	248,608
Total liabilities	47,435	54,286	50,074	79,016	130,954
Shareholder’s equity	52,543	68,475	85,799	101,713	117,654
Ratio Analysis					
Revenue growth	-	8%	25%	40%	39%
Gross margin	33%	39%	41%	41%	41%
EBITDA margin	25%	30%	34%	29%	23%
Current ratio	3.50	2.8	2.2	2.5	1.4

Company Overview

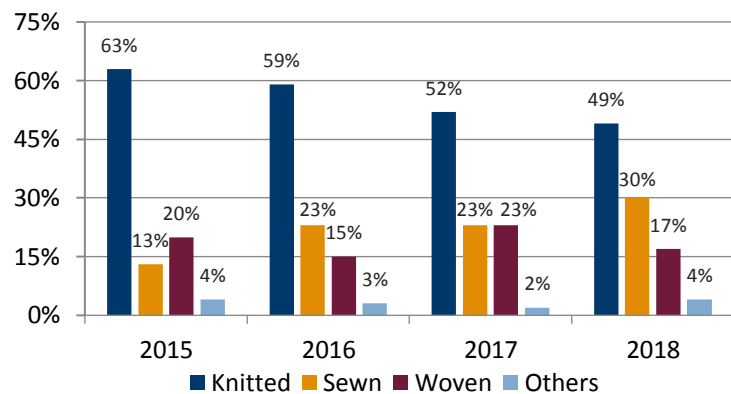
Founded in 1981, Gobi was established in a joint effort by the Mongolian and Japanese governments to start producing cashmere goods using local raw cashmere. In 2007, FCI LLC, a subsidiary company of Tavan Bogd LLC, bought a 73.45% stake in Gobi Cashmere at an auction, privatizing the state-owned company. Since then, the company has continued to improve its production quality and efficiency, and ultimately become one of the largest cashmere companies in not only Mongolia, but the world as well. Today, Gobi offers finished cashmere garments such as sweaters, cardigans, coats, shawls, and suits. The Company also offers tailoring and dry-cleaning services. All products are knitted, woven, or sewn. The company currently employs over 2,700 workers.

Figure 3. Sales Revenue of Gobi



Source: Gobi Annual Report

Figure 4. Breakdown of Sales Revenue by Product types



Source: Gobi Annual Report

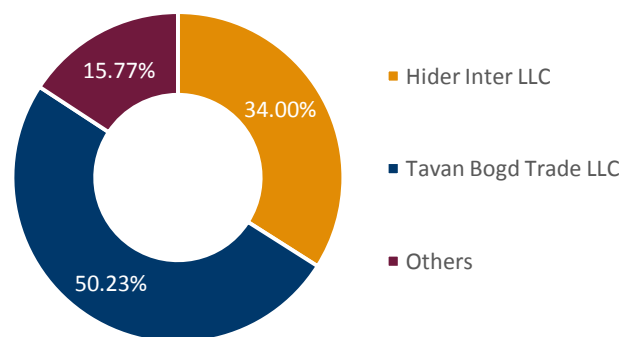
Acquisition of Goyo Cashmere

Established 1993, Goyo Cashmere is the second largest cashmere manufacturer in Mongolia, with a domestic cashmere market share of 13.6%. In 2017, Tavan Bogd Group, the largest shareholder in Gobi Cashmere, acquired Goyo Cashmere and invested USD 35 million (MNT 87.5 billion) to increase the company's export/production capacity and overall product quality. Consequently, Goyo Cashmere's production increased 5-fold and its employee count increased 3-fold during FY2018. The company was then 100% acquired by Gobi Cashmere in June 2019, creating one of the largest cashmere companies in the world. It is important to note that prior to the 2019 acquisition, Goyo Cashmere was seen as a primary competitor of Gobi Cashmere in the domestic market. Thus, the acquisition allowed Gobi Cashmere to reduce competition, increase economies of scale, and benefit from other post-merger synergies.

Ownership Structure

The major shareholders of Gobi are Tavan Bogd Trade LLC, with a 50.23% stake, and Hider Inter Ltd, with a 34.00% stake. Hider Inter LLC is a Japanese investment firm owned by Mr. Hideo Sawada, who is the president of H.I.S Co., Ltd. Tavan Bogd Group's former subsidiary, an investment company – FCI LLC, previously owned 28.59% of the stake prior to its acquisition by Tavan Bogd Group's acquisition. This acquisition made Tavan Bogd Group the most influential shareholder in the Company, with a total stake of 50.23%. In total, these 2 major shareholders control 84.23% of the equity ownership in Gobi.

Figure 5. Gobi Ownership Structure



Source: Gobi Annual Report

Market Overview

Cashmere Market – Moderate Growth Outlook

Overview

In 2018, the cashmere industry in Mongolia grew by 35% YOY, reaching a total market cap of MNT 1 trillion. This amounted to production of 9,500 tons of cashmere in 2018, or 40% of global cashmere production. Gobi has been a leader in cashmere manufacturing for over a decade as a result of the Company’s consistent investment in perfecting its operational capacity. In November 2018, the Company opened the “Galleria Ulaanbaatar” center in the heart of the capital city. The store offers both Gobi and Goyo products. The Company also started the operation of its 6,690 m2 knitting and sewing plant. Moreover, the recent “Cashmere Program” launched by the government to raise the quality of Mongolian raw cashmere is likely to benefit Gobi Cashmere’s supply chain management.

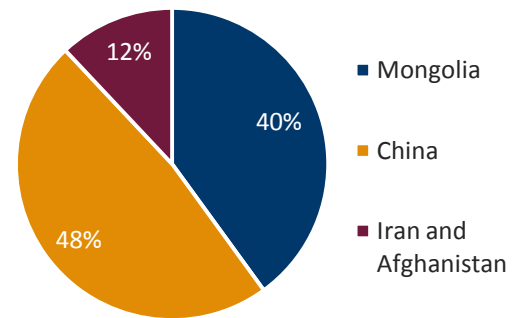
Domestic Market

After the Goyo Cashmere merger, Gobi cemented its title as the dominant cashmere producer in Mongolia. Together, the merged company now accounts for over 80% of the domestic market. In 2018, Gobi’s domestic sales revenue reached MNT 111.9 billion, a staggering 50% y-o-y increase. A breakdown of the domestic sales shows that 50% of the buyers were Mongolian consumers, while the remainder consisted of tourists mainly from South Korea, China, Japan, and Russia. To further domestic sales, the Company recently opened the largest cashmere shop in the world at Galleria shopping center in an urban neighborhood of Ulaanbaatar.

International Branches

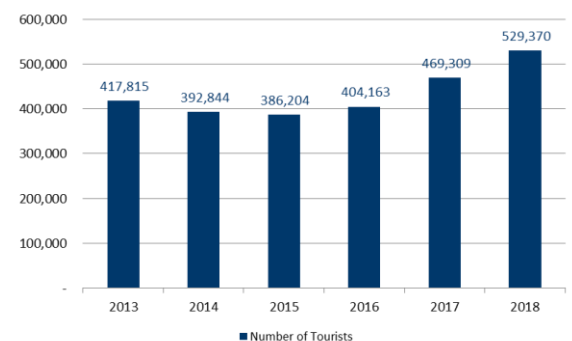
Gobi now plans on expanding its export business and increasing its international presence. Currently, the Company has 61 franchise stores and five retail branches in 40 major cities throughout 13 countries. In 2018 alone, Gobi added eight franchises and four pop-up stores in cities such as Istanbul, Toronto, Chicago and Saint Petersburg. This feat shows the Company’s attempt to break into the Western markets, where cashmere goods are seen as exotic and luxurious. Gobi’s total 2018 export revenue was MNT 61.6 billion, a 23% increase YOY.

Figure 6. World cashmere production market share



Source: MOFA

Figure 7. Number of tourists entering Mongolia



Source: National Statistics Office

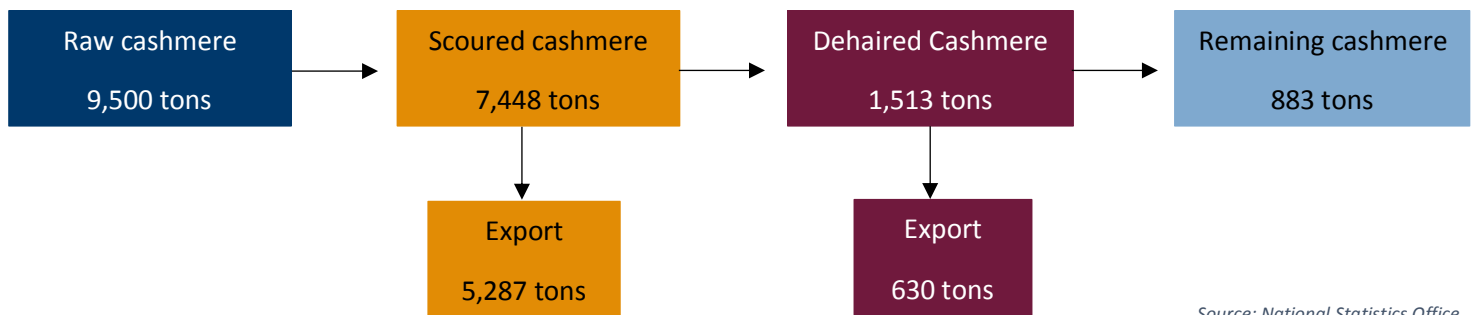
Figure 8. Location of Stores by Country



Export Market

In 2018, 91% of the total cashmere produced in Mongolia was exported out of the country at the processing stage. Note that raw cashmere is first washed, dehaired, then processed. Around 5,287 tons of washed cashmere were exported to China and 630 tons of dehaired cashmere were exported to countries like Italy, Germany, England, and China. The remaining 9% stayed in Mongolia for later stages of the production chain. A total of 293,000 cashmere garments were exported in 2018, the majority of which were produced by Gobi. The Company also exports white-label garments, products made for other manufacturers, and generated USD 25 million from 171 clients in 31 countries in 2018.

Figure 9. Overview of the cashmere processing stages

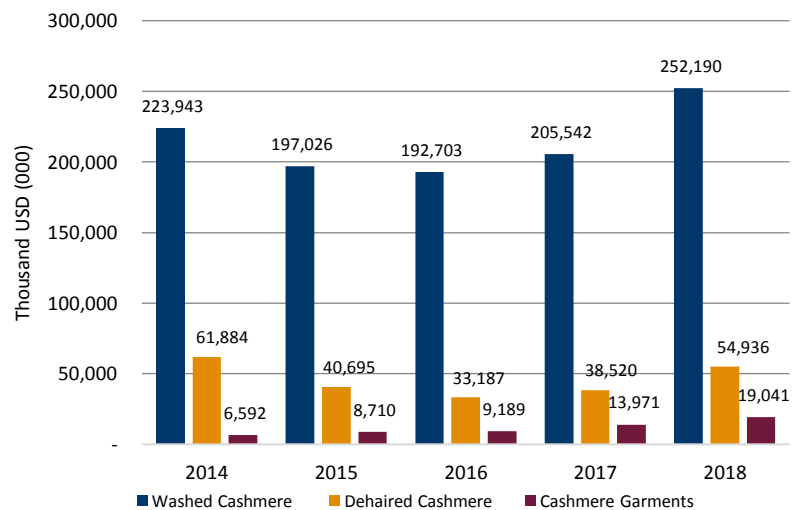


Source: National Statistics Office

Cashmere Program 2018-2021

The Government of Mongolia (GoM) has been promoting efforts to increase exports of cashmere garments, the final product of the cashmere value-added chain, as opposed to washed and dehaired cashmere. The largest such initiative is the “Cashmere Program,” which was passed in February 2018 with the aim of encouraging cashmere processing plants to move up the value chain and produce garments. Under the program, the GoM provided financial support to cashmere processing plants, from which Gobi and Goyo received MNT 48 billion and MNT 30.3 billion in 2018, respectively. This program aims to increase export revenues and the competitiveness of Mongolian cashmere goods in foreign markets, ultimately allowing the Mongolian economy to diversify away from the volatile mining industry.

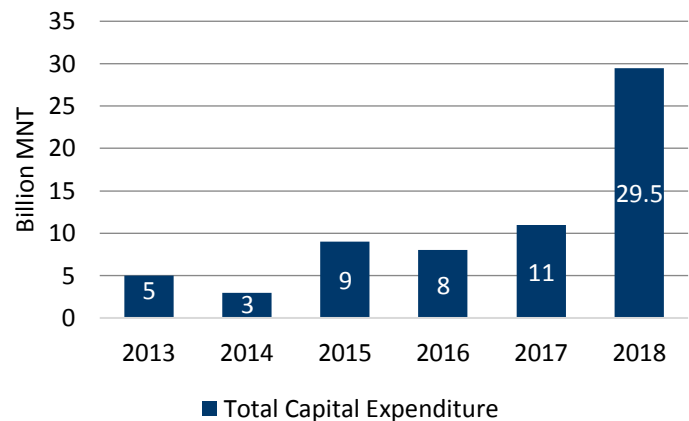
Figure 10. Total value of cashmere exports



Intensive Expansion

Gobi received priority financial support from the GoM, through which the Company was able to expand its capacity, purchase the latest quality control equipment and advance its export market. A breakdown of their capital expenditures in 2018 shows that 51% of their spending was on new equipment and 43% was on construction of infrastructure and stores (including the construction of Galleria and its new processing plant). According to Gobi management, Gobi is unlikely to incur major additional CAPEX in the foreseeable future.

Figure 11. Total Capital Expenditure



Valuation

From our valuation analysis, we reached a 12-month target share price for Gobi of MNT 367.18. We reached this target share price through a (1) Implied EBITDA Multiple Method, (2) Implied Perpetuity Growth Method, (3) Comparable Companies Method. Note that we did not conduct a precedent transaction analysis due to the lack of M&A activities and information available in the industry.

We primarily used Gobi's historic and forecasted production and revenue targets to derive our financial forecasts and expected future cash flows. Additionally, we adjusted our forecasts to account for Gobi's merger with Goyo Cashmere. After adjusting for post-merger synergies, we determined the NPV of these future cash flows using a discount rate we deemed appropriate for Gobi after considering the Company's beta, historic return on debt, and CAPM. We then utilized the relevant EBITDA multiples method and perpetuity growth method to determine the terminal value of The Company.

For the comparable companies analysis, we used a set of seven peer companies' EV/EBITDA multiples to calculate Gobi's target price. It should be noted that because Gobi is the only cashmere producing company actively traded on the Mongolian Stock Exchange, we were unable to perform a comparable analysis within the Mongolian cashmere industry, so we sourced comparable companies from countries with similar economic environments, business models (vertically integrated), target customers (middle-to-higher income), market capitalizations and other qualitative factors. The implied share price of each three method were averaged to reach the target price.

EV (Enterprise Value) Calculation

MNT Million	2015A	2016A	2017A	2018A	2019E	2020E	2021E	2022E
Sales income	71,211	88,674	124,425	173,439	200,046	234,290	268,534	302,778
Gross profit	27,938	36,219	50,544	71,292	80,921	95,487	109,384	123,416
<i>margin, %</i>	39%	41%	41%	41%	40%	41%	41%	41%
EBITDA	21,643	29,842	35,573	40,329	57,958	67,047	73,465	81,901
<i>margin, %</i>	30%	34%	29%	23%	29%	29%	27%	27%
EBIT	17,634	25,307	29,939	33,770	51,087	59,849	65,924	74,001
Tax	(2,905)	(4,997)	(5,939)	(5,484)	(12,771)	(14,962)	(16,480)	(18,500)
Plus: Depreciation	4,008	4,535	5,634	6,559	6,871	7,199	7,541	7,901
Less: CAPEX	(26,356)	(38,732)	(25,999)	(31,184)	30,007	35,144	40,280	45,417
Less: Changes in NWC	(2,361)	6,969	24,111	(28,948)	49,340	14,114	14,894	14,735
Unlevered Free Cash Flow	(9,979)	(6,917)	27,745	(25,287)	64,520	31,056	31,598	32,720
WACC					17.0%	17.0%	17.0%	17.0%
Discount Period					1.0	2.0	3.0	4.0
Discount Factor					0.85	0.73	0.62	0.53
NPV of Free Cash Flow					66,729	79,273	82,320	84,162
Terminal Value – EBITDA Multiple Method								440,791
Terminal Value – Perpetuity Growth Method								310,560
Implied Terminal EV – EBITDA Multiple Method								582,486
Implied Terminal EV – Perpetuity Growth Method								444,320

1. EBITDA Multiple Method

Implied EBITDA Multiple (MNT million)	
Enterprise Value ("EV")	581,100
Less: Total Debt	255,121
Plus: Cash and Cash Equivalents	3,993
Equity Value	331,359
Outstanding Shares	780,112,500
Equity Value per Share (MNT)	424.76

2. Perpetuity Growth Method

Implied Perpetuity Growth (MNT million)	
Enterprise Value ("EV")	444,320
Less: Total Debt	255,121
Plus: Cash and Cash Equivalents	3,993
Equity Value	193,193
Outstanding Shares	780,112,500
Equity Value per Share (MNT)	247.65

3. Comparable Companies Method

Comparable Companies	Identifier	Country	Price /Earnings	Price /Sales	Net Debt /EBITDA	EBITDA /EV
High Fashion International Limited	608-HK	Hong Kong	13.0	0.2	13.3	5.8
Gokaldas Exports Limited	532630-IN	India	15.7	6.8	12.7	5.9
Kewal Kiran Clothing Limited	532732-IN	India	15.3	2.4	10.8	-0.3
Brunello Cucinelli S.p.A.	BC-IT	Italy	39.87	3.65	21.50	0.25
Cia. Hering	HGTX3-BR	Brazil	20.68	3.37	18.41	-1.11
Far East Knitting & Dyeing Industries Limited	FEKDIL-BD	Bangladesh	11.92	0.73	6.06	-0.61
Thai Wacoal Public Company Limited	WACOAL-TH	Thailand	16.60	1.23	18.83	1.45
Mean			19.0	2.6	14.5	1.6
Median			15.7	2.4	13.3	0.2

EBITDA Multiple Valuation (MNT million)

Gobi 2018 EBITDA	40,329
times: EBITDA Multiple	x 14.5
Enterprise Value ("EV")	585,897
Less: Total Debt	255,121
Plus: Cash and Cash Equivalents	3,993
Equity Value	334,769
Outstanding Shares	780,112,500
Equity Value per Share (MNT)	429.13

Valuation Summary – Target Price

Valuation Approach	Weight	Price (MNT)
Implied EBITDA Multiple Method	33.33%	424.76
Perpetuity Growth Method	33.33%	247.65
Comparable Companies Method	33.33%	429.13
Target Price per Share		367.18

Investment Risks

1. Regulatory Risk

Given the strategic importance of cashmere industry, Government of Mongolia has long subsidized cashmere production and exports to improve cashmere quality and strengthen global competitiveness. With the most valuable nation brand, Gobi Cashmere has generally favorable regulatory environment. However, the recent merger with Goyo may draw attention of domestic regulators and put the company under public scrutiny, potentially leading to imposition of measures such as excise taxes and anti-monopoly cost controls. Although there has not been cost imposition precedent on major monopoly companies in Mongolia and we find no indication of such measures in the near term, MICC advises its clients and investors to be cautious about the potential regulatory risk in the long run. In the short run, Gobi Cashmere has insurance in place to hedge against certain types of political risks such as political instability and changes in foreign trade policies.

2. Macroeconomic Risk

Over a third of Gobi's sales revenue is generated in foreign markets, highlighting the company's exposures to both foreign and domestic macroeconomic risks. Gobi's foreign export creates further sales opportunities as the company has sought the benefits of market diversification. Currently with total of 65 stores across 13 countries, Gobi has reduced its exposure to fluctuations in single markets. In terms of domestic sales, healthy economic growth alongside the government's attempt to diversify into the agricultural industry have been leading factors in Gobi Cashmere's sales growth. Given the sustained economic recovery from the previous recession, domestic sales are expected to show continued growth in the near term. However, the company has long been exposed to seasonal risk as nearly half of the total domestic sales is from tourists during travel season. Although the number of tourists has grown in the past three years, longer time horizon does not indicate a sustained growth pattern. Therefore, MICC advises its clients to exercise caution. Concerning foreign exchange fluctuations, Gobi hedges against exchange rate risks through foreign sales. Effectively two thirds of total sales are made in foreign currency as the company transfers exchange rate risk to foreign buyers.

3. Management risk

Gobi has been investing heavily to expand its operational capacity in recent years. However, the company has relied largely on debt financing to achieve this. Although its operational performance has been sustainable and efficient, as evidenced by the 20% growth in revenue, the company has ultimately increased its exposure to short-term revenue fluctuations that affect its earning power and ability to make dividend payments. The company plans on using debt to further finance in its operations, thus raising additional concerns.

4. Foreign Exchange Risk

A final risk we believe to be worth considering is Gobi's exposure to foreign exchange fluctuations. Gobi's debts are mainly denoted in foreign currencies, thus the MNT's depreciating trend against the USD and EUR increases the Company's interest and principal payment burdens. This is alarming as the company has significant liability commitments in the near future, making it difficult to predict the Company's future financial health.

Conclusion

Since 1981, Gobi has been a major player in the Mongolian and, increasingly, international cashmere markets, controlling 73.1% of the domestic market and 2% of the international market. The Company has successfully and sustainably grown its revenues in a market poised for continued growth. Based on the Company's historical and predicted future performance, we believe Gobi has a promising future in which it will continue to capitalize on opportunities around the world and move up the value-added chain of cashmere production. Furthermore, we believe the future success of Gobi will benefit the entire Mongolian economy as the country aims to minimize its reliance on revenues derived from the mining industry. However, the success of the company is not risk-free. The Company may face risks stemming from regulators, macroeconomic trends, management, or changes in exchange rates.

ABOUT MICC

Mongolia International Capital Corporation (MICC) was established in 2005 as the first investment banking firm in Mongolia. Mongolia's rapid economic development and favorable financial environment present unique prospects for investment opportunities and growth potential for companies. In order to enable our clients and investors to take full advantage of these opportunities, MICC offers investment banking, asset management, securities underwriting and brokerage services. In addition, we conduct periodic macroeconomic research, develop analyses of domestic industries and review equities listed on the Mongolian Stock Exchange.

MICC continues to make history in the Mongolian financial sector. We serve leading companies in the mining, manufacturing, financial, retail trade, airline and construction sectors, and prize our close and long-standing working relationships with our clients. Our goal is to assist both local and international companies realize their strategic goals by offering innovative and efficient financing solutions.

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