MICC

Equity Research

GOBI

MONGOLIAN CASHMERE

ACCUMULATE

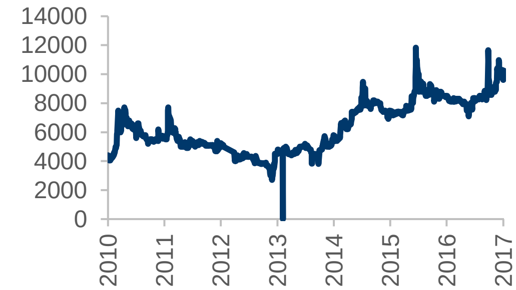
February 17, 2017

General (MNT)	
Ticker:	GOV
Current price:	10,970
Price target:	13,176
Market Cap:	86 billion

Key Statistics	
52 week price range:	MNT6925-11830
% 52 week high:	93%
Estimated perpetuity g:	6%
Estimated exit multiple:	5.70

Trading Statistics	
Shares outstanding:	7,801,125
Avg volume (3m):	977
Institutional ownership:	84.1%
Insider ownership:	1.58%

Figure 1. Stock Prices, 2010-2017



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Investment Summary

Modest Outlook for next 12 months

- **Aggressive marketing and new product design**

Gobi JSC aims to expand its global market share through franchising and penetrating luxury garment market. The Company began a ground-up restructuring in 2015 that included changes to management philosophy, product design, and human resources. To stay competitive in the global market, Gobi has conducted aggressive marketing campaigns and invested in new product line development. Gobi is also branding itself as an environmentally conscious company, introducing Eco collections like Organic Cashmere and Light Cashmere.

- **Historical performance indicates stable operations**

Gobi continues to finance working capital through short-term loans. Gross sales CAGR from FY12-FY15 is 15%. EBITDA margins increased modestly over the past 4 years, as Gobi demonstrated effective management during difficult economic times. The Company revalued its assets in 2015, which was reported in the income statement and increased net income from MNT10 billion to MNT17 billion.

- **However, given strong competition and increased expenses, income margins are expected to shrink**

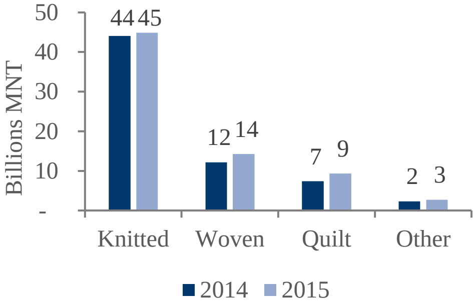
All cashmere companies are highly dependent on the availability of raw materials. Driven by local and Chinese demand, prices are expected to go up in the near term. In addition, domestic consumer purchasing power has decreased in light of recent macroeconomic slowdown. If Gobi's large marketing and production investments do not result in significantly higher sales, MICC expects its margins to shrink given rising COGS.

Figure 2. Historical Financial Performance

(millions MNT)	FY12	FY13	FY14	FY15	Q2FY16
Net sales	40,827	48,758	65,935	71,211	25,065
Cost of sales	29,710	32,514	44,275	43,273	15,456
Opex	3,417	3,609	5,323	11,669	4,475
Other	1,506	371	852	2,474	1,366
EBITDA	8,449	11,716	16,710	17,691	5,790
Net profit	5,251	7,103	10,492	17,024	3,162
Total liabilities	30,767	38,161	47,435	54,286	60,641
Total capital	36,938	43,066	52,543	68,475	70,545

Business Overview

Figure 3. YOY Comparison of Sales Breakdown

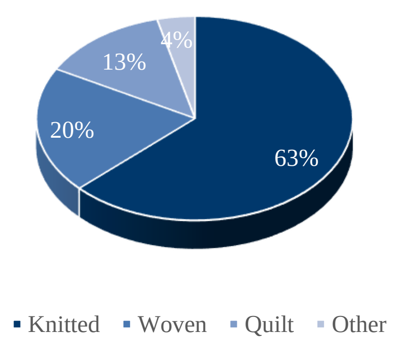


- **Company History**

Gobi was founded in 1981 with Mongolian and Japanese government co-financing to manufacture 100% pure cashmere. In 1993, the Company was partially privatized, listing 26.55% of its equity on the Mongolian Stock Exchange. The remaining 73.45% of its shares were sold to Tavan Bogd and Japanese investors. Today, Gobi has become the largest vertically integrated cashmere producer in Mongolia and one of the five largest in the world. The Company has four factories: primary processing, spinning, knitting and weaving. The company has a capacity to produce 1100 tons of raw cashmere, 30 tons of woven cashmere and 210 tons of combed cashmere per annum.

- **Revenue Streams**

Figure 4. Sales Breakdown by Product Type, 2015



Employing over 1,000 employees, the Company exports its products to 200 companies in 40 countries and operates 51 branch stores in major cities across the world, namely London, Berlin, Prague, Moscow, New York, Brussels, Milan, Tokyo, Paris, Seoul and recently Georgetown. Coats, scarves, throws, and blankets constitute the Company's most popular offerings. To expand its product offerings and embrace a more environmentally friendly image, Gobi introduced 20 brands and collections, including Organic Mongolian Cashmere, Yama Cashmere, Gobi-Mazaalai Collection, Basic Collection, Baby Camel Wool and Summer Light Cashmere. The management seeks to increase sales exports share in coming years through active marketing and a higher-end product mix.

Figure 5. Exports and Local Sales Breakdown

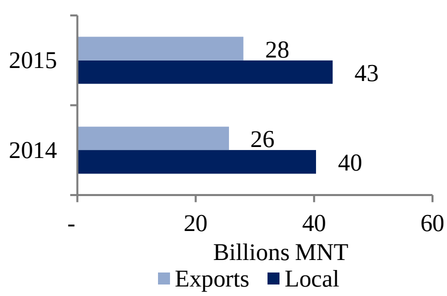


Figure 6. International Branches

Management and Governance

Management

Gobi has 10 members on the Board of Directors and 8 executive officers in the management team. The management team is led by Mr. Baatarsaikhan, the CEO and a small shareholder.

Figure 7. List of Major Shareholders

Major shareholders	Shares (thous)	Ownership percentage
Hide Inter LLC	2,652.3	34.0%
FCI LLC	2,230.0	28.6%
Tavan Bogd Trade LLC	1,239.8	15.9%
Ulemj Ikh LLC	439.8	5.6%

- **Baatarsaikhan Tsagaach – CEO**

Following graduation from the Electrical Engineering University of Japan, Mr. Baatarsaikhan held executive positions at Tavan Bogd, Tavan Bogd Trade LLC, Juulchin LLC, MIAT and Palace Hotel. He was appointed CEO of Gobi in 2008 and overseen the company's successful expansion efforts. Mr. Baatarsaikhan has a seat on the Board of Directors and holds 0.01% (500) shares of Gobi.

- **Davaa Naranbaatar – General Director**

Mr. Davaa graduated from the Institute of Commerce and Business with an economics major and joined Tavan Bogd Cosmetics LLC as a manager. He held various positions at Tavan Bogd Cosmetics from 2002 to 2008 and joined Gobi in 2008 as the Sales Director. Mr. Davaa was then promoted to General Director in 2009 where he has overseen the company's international expansion.

Gobi does not release information on Individual salaries and compensation. However, in 2015, the Board of Directors and management were paid in total MNT102 million and MNT 657 million respectively, near identical to their 2014 compensation.

Figure 8. Management's Share Holdings

Management	Shares	Ownership
Khulan D	122,473	1.57%
Baatarsaihan D	500	0.01%
Khurelbaatar D	48	0.0006%

Corporate Governance

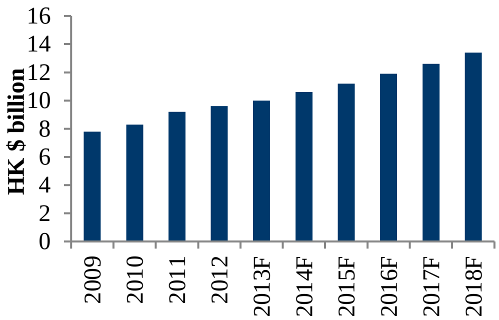
The Company's board consists of three designated committees: compensation, audit and nomination. Board members are nominated and elected by shareholders on a cumulative voting basis. Committees are appointed by the board members and directly report to the board. Audit committee oversees the operations of internal audit department, as well as external audit team. The board is comprised of qualified and independent members, who hold management level roles at other organizations or have expertise in the relevant area.

Industry Overview

- **Overview**

According to Bain and Company's 2015 "Luxury Goods Worldwide Market Study," cashmere constitutes €4 billion of the total €60 billion luxury garment industry. As a luxury item, the demand for cashmere is closely correlated with macroeconomic conditions. Global demand has rebounded from 2008 and is predicted to experience strong growth through the end of the decade. Mongolia provides an estimated 25% of the global supply of cashmere and is renowned for its high quality fibers. However, only approximately 30% of its supply are actually processed by Mongolian companies. The vast majority of cashmere is sold with relatively little value-added processing to Chinese manufacturers.

Figure 9. Historical and Forecasted Raw and Processed Cashmere Prices



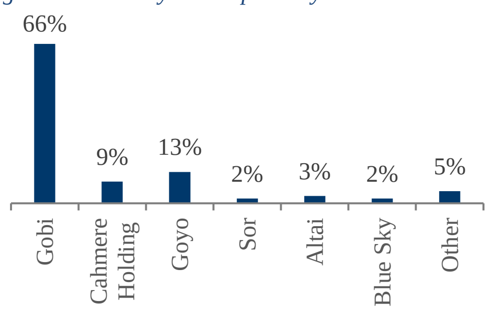
Source: U.S. Census Bureau, 2012 IPSOS Industry Report

- **Strategic Positioning**

Gobi Cashmere stands apart as an industry leader largely for its completely vertically integrated production line ("From Goat to Coat"), strong brand presence, and operation of international branch stores. Within Mongolia, it has captured an estimated 66% of total market share through marketing initiatives and cost competitiveness. Economies of scale improve Gobi's efficiency and gives it an edge over other domestic firms. Gobi's investment in international branding and expansion also allow it to capitalize on the global growth in demand. It has begun designing product lines specifically for foreign markets and has franchised over 50 international branches in upscale markets in Germany, the United States and the Japan. Especially given its dominant Mongolian market share, Gobi enjoys a strong strategic position.

- **Competition**

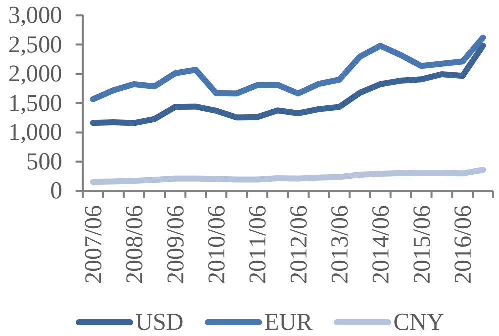
Figure 10. Industry Participants by Market Share



Source: MICC Analysis

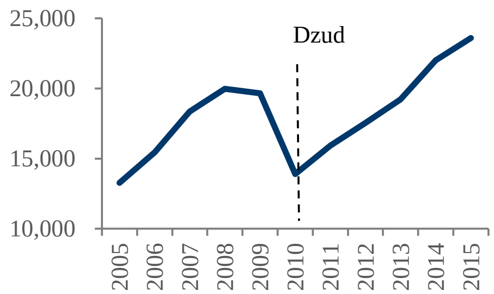
Even still, domestic competitors like Altai Cashmere and Goyo Cashmere have also invested heavily in raw cashmere processing and begun international exports to upscale markets in the United States and Europe. These brands are not globally represented by physical stores, but instead maintain distribution partnerships with international retailers. As Gobi expands, it will face direct competition from more established international cashmere brands and retailers. Gobi's offerings are price-wise most directly comparable to the cashmere line of J.Crew and Uniqlo. Gobi offers a much more specialized brand than most international companies. In addition to Gobi's focus on new product development, MICC also expects that the Mongolia Textile Institute's new "Mongolian Noble Fiber" standard will elevate the global profile of Mongolian cashmere. These standards will further differentiate companies like Gobi from other western offerings, helping them in foreign markets.

Figure 11. MNT Exchange Rate, 2007 - 2016



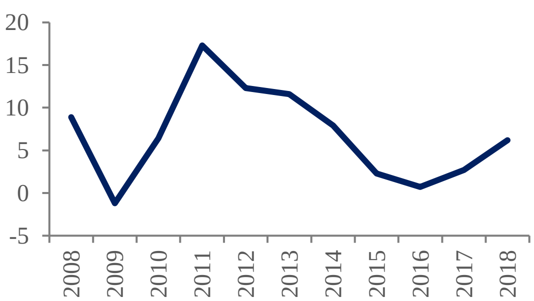
Source: Bank of Mongolia

Figure 12. Goat Headcount



Source: National Statistics Office

Figure 13. GDP Growth 2008 – 2018F



Source: World Bank

Upside

- **Exchange Rate Depreciation**

Continued MNT depreciation has made Gobi's garments more competitive on the international markets. As Gobi continues to expand overseas and receive a greater proportion of its sales overseas, the weak tugrik will allow it to capture market share quickly.

Downside

- **Supply Chain Reliability**

Maintaining a steady supply of raw cashmere is the single greatest challenge facing Gobi cashmere. Due to the seasonality of cashmere wool harvesting, the Company's year-long supply must be purchased all at once. This dynamic creates a bottleneck where suppliers are often unable to procure the desired quantity of cashmere — Gobi is a well-established player which currently minimizes this risk. A more pertinent threat is the devastating winter Dzud disaster that can kill millions of goats and imperil the steady supply of cashmere.

- **Domestic Economic Conditions**

The domestic market continue to provide the majority of Gobi's sales. The Mongolian economy has cooled considerably from its 2012 peak GDP growth of 17.5%. While Gobi's sales have grown during the slowdown, luxury garments like cashmere are price elastic and susceptible to macroeconomic swings. Furthermore, Gobi borrows at a low, government sponsored 8% loan. If this program is discontinued, Gobi will have to finance its working capital at the current high market rates.

- **Competitor Expansion**

The international and domestic expansion of established Mongolian competitors like Buyan, Goyo, and Altai Cashmere are another risk. These companies have invested heavily in processing technology and now claim to be vertically integrated. These firms could capture additional domestic market share and threaten Gobi's market dominance.

- **Poor Results from Marketing Campaign**

Gobi launched an expensive 2015 marketing campaign in 2015 as part of its efforts to expand globally and maintain domestic market share. Yet sales grew only modestly between 2014 and 2015, suggesting that this large expenditure may not have moved the needle substantially. It is difficult to judge the long term implications of Gobi's efforts and more time is required before assessing whether they have successfully penetrated foreign markets.

- **Changing Consumer Preferences**

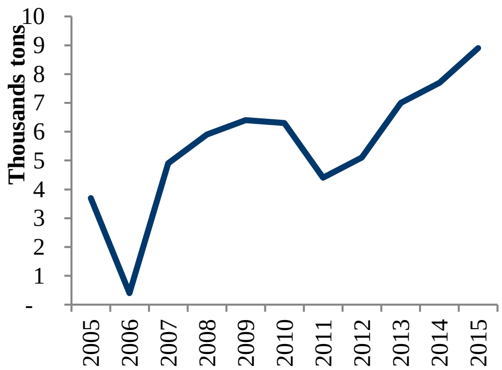
Other luxury fibers threatens Gobi's continued success. Alpaca, yak, and vicuna wool are considered by many designers to be new "soft gold" fibers that are enticing alternatives to cashmere. These fibers appeal to alternative customer preferences and may steal global market share from cashmere garment makers

Recent News

"Gobi will dominate the market of cashmere coats by 2020" ~ Director of Local Sales, Budkhuu Ts
Icon.mn, 31 August 2016

The management saw an untapped opportunity in the cashmere coat sector and set a goal to produce 100,000 coats (ten times more than current production) by 2020. Apart from increasing the production, the Company will create 200 new jobs, which will increase the number of employees to 1,515. Based on the R&D results, Chinese visitors heavily purchased cashmere coats (3-5 per person) as a gift or for personal use. This number is expected to increase in coming years. In addition, Gobi will engage in online retail shopping and make the shipment available worldwide, starting from Germany. Regarding the design, Gobi is cooperating with Lapine and Aldex, top leading manufacturing companies of Japan.

Figure 14. Total Mongolian Cashmere Production (Raw and Processed)



Source: National Statistics Office

"Gobi's net sales increased by 30.5 percent"
Ubinfo.mn, 29 July 2016

First half of 2016 reported gross sales of MNT25.06 billion and net sales of MNT3.16 billion, an increase of 11.3% and 30.5% compared to the same period in the previous year. The Company's working capital increased to MNT86.1 billion, of which approximately 78% is contributable to the purchase of raw materials. In 2016, Gobi purchased 450 tons of raw cashmere, which was 10% more than 2015 and twofold more than five years ago. In line with market demand and trend, the Company is planning to inject MNT22 billion in five years period.

"Mongolian cashmere industry in the first three quarters"
Theubpost.mn, 24 November 2016

Compared to 2014, first three quarters of 2015 saw a 10% drop in cashmere exports, which valued at 25 million in 2015. However, total volume increased by 3.2% and reached 398.4 tons, of which 74% was exported to Italy, 12% to UK, 8.5% to China and 1.1% to Japan. As part of EPA, Mongolian and Japanese governments signed an agreement stating that cashmere exports will be free of tariffs.

Financial Analysis

- **Sales**

Gobi Cashmere has reported consistent growth from 2012 to 2015, driven largely by their global expansion and growing domestic market dominance. 56% of sales revenue was derived from local sales, with the remaining 44% from exports. Gobi's costs remained relatively constant, as the gross profit margin grew from 27% to 39% over the same period.

However, signs of trouble emerge domestically and with overall cost containment. From 2014 to 2015, gross profit margins on exports increased 7%, but actually decreased 5% domestically. Domestic production costs rose at a faster rate than domestic sales. The company benefitted from the MNT's currency depreciation in foreign markets like the United States, which made Gobi cashmere more competitive with rival brands and propelled sales growth. Yet Mongolian GDP growth plummeted from 7.9% in 2014 to 2.3% in 2015, depressing local cashmere sales. Furthermore, MICC estimates that in the next 4 years, buoyed by global cashmere demand, the price of raw cashmere will continue to put upward pressure on Gobi's COGS. Gobi has also embarked upon an expensive branding marketing campaign, spending 408% more on distribution and marketing costs in 2015 than in 2014. The increased advertising budget only corresponds with an 8% increase in sales.

MICC predicts future sales growth to experience a slightly lowered 9% CAGR through 2019. Global demand will still drive healthy increases in exports, but domestic conditions will prove a more difficult sales environment. The economy is still experiencing relatively sluggish growth, but the main obstacle will be an increasingly competitive domestic cashmere garment market.

Figure 15. Sales and COGS, 2014-2015

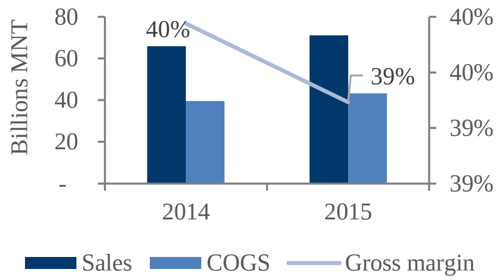
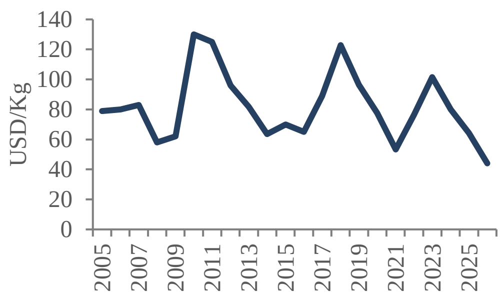


Figure 16. Cashmere Prices 1990-2026F

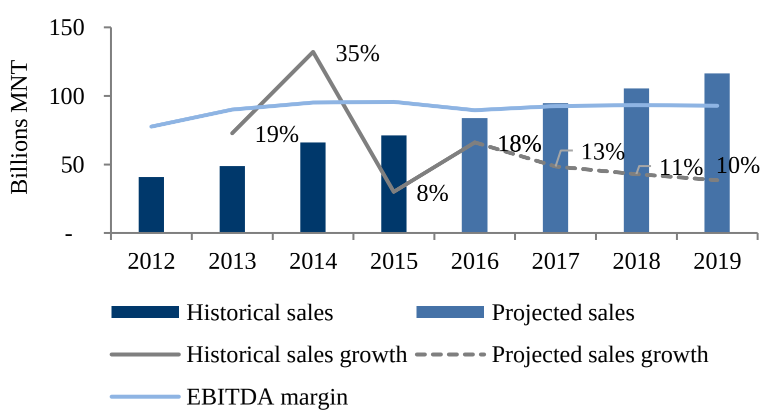


Source: Mongolian Commodities Exchange, Alibaba, and MICC analysis

Figure 17. Profitability Ratios

	2012	2013	2014	2015
Gross profit	27%	33%	33%	39%
EBITDA	21%	24%	25%	26%
Net income	13%	15%	16%	24%

Figure 18. Historical and Projected Sales Growth



- **Liquidity**

Since 2012, Gobi has nearly tripled the cash on its balance sheet, growing from nearly MNT6 billion to MNT18 billion in 2015. However, this growth in cash on the balance sheets is not driven by a positive net operating cash flow, but rather by loan financing. Indeed, Gobi's liabilities have increased nearly six fold in the past 4 years to MNT30 billion by the end of 2015.

Figure 19. Solvency Ratios

	2012	2013	2014	2015
Current Ratio	7.99	9.43	3.50	2.77
Quick Ratio	3.61	4.05	1.09	1.25
Solvency Ratio	0.18	0.20	0.23	0.32
D/C Ratio	0.45	0.47	0.47	0.44
Interest Ratio	4.09	5.69	5.54	4.38

Based on the credit statistics Gobi has actually improved its ability to satisfy its debt obligations. Though the current ratio has dropped by more than half since 2012, to 2.77, it's still well above the rule of thumb value of 1.0. The interest coverage ratio has remained consistent indicating that Gobi can continue to service its debt. Gobi is conservative when it comes to its capital structure, keeping its leverage less than equity investments. Moreover, the PPE revaluation in 2015 decreased the debt/capital ratio in 2015, rather than an overall decrease in debt or a new capital injection.

- **Cash Flow**

The Company's operating cash flow fluctuates widely year to year. But, between 2012 and 2015, Gobi generated little to no cash inflow from operations. Gobi is investing heavily in asset purchase as part of its rapid growth strategy. The combination of a sustained negative operating cash flow and large asset expenditures have made financing working capital difficult. The Company obtains loans with a 3-8 year maturity and an interest rate of 6-8%. This trend is expected to continue in coming years, unless Gobi increases its profit margin or decreases its costs.

Figure 20. Gobi's Stock Ratios

	2012	2013	2014	2015
EPS	673	910	1,345	2,182
P/E	6	5	5	4
Earnings yield	18%	19%	19%	26%
Book value per share	4,735	5,520	6,735	8,778
Price to book value	0.79	0.86	1.07	0.95
Dividend per share	125	130	140	140
Dividend yield	3.3%	2.7%	1.9%	1.7%
Dividend payout	0.19	0.14	0.10	0.06

- **Share Performance**

In line with earnings growth, earnings per share have increased from MNT673 to MNT2, 182 in the four year period and the P/E ratio stayed relatively stable until 2015. The PPE revaluation drove the 2015 drop in P/E ratio. Gobi's reliance on debt financing over equity is the primary explanation for its lower P/E ratios. Lastly, the dividend yield has been steadily dropping due to rapid growth and increased investment opportunities. Dividend payout ratio is expected to drop so long Gobi expands its operations. Thus, for growth-focused investors, Gobi appears to be a strong addition to investment portfolios.

Valuation

- **Comps**

Gobi is the only cashmere producing company that is actively traded on the Mongolian Stock Exchange. Therefore, we were not able to perform comparative analysis within cashmere industry. In addition, M&A activities do not happen often enough to perform precedent transaction analysis. Consequently, we used discounted cash flow (DCF) analysis.

Compared to Darkhan Nekhii, Gutal and Mongol Nekhmel—three other retail companies traded on the MSE, Gobi has higher EPS and lower P/E (except for Mongol Nekhmel). In other words, Gobi is more profitable than these companies but its share is undervalued. However, Gobi's market to book value ratio falls below Gutal and Mongol Nekhmel. Low market to book ratio can be contributable to high assets or low share prices. A comparison to the major cashmere company Brunello Cucinelli SpA reinforces the notion that Gobi is relatively undervalued. In particular, Gobi has a much lower P/E and price to book value than a relatively successful, high-end European cashmere company.

Figure 21. Companies in the Retail Industry

	Darkhan Nekhii	Gutal	Mongol Nekhmel
Share price	19,100	12,600	4,800
Outstanding shares	1105479	1618684	474164
Net income (mln)	957	1965	263
Owner's equity (mln)	34988	7877	688
Book value per share	31,650	4,866	1,451
Price to book value	0.60	2.59	3.31
EPS	866	1,214	(555)
P/E	22	10	(9)

Figure 19. Brunello Cucinelli Comparison

	Gobi	Brunello Cucinelli
Share price (MNT*)	10,970	56,889
Outstanding shares	7,801,125	68,000,000
Net income (mln)	17,024	87,103
Owner's equity (mln)	70,544	502,895
Book value per share	8,778	7,650
Price to book value	1.25	7.44
EPS	2,182	1,242
P/E	5.0	45.8

*MNT: EURO as of 1.16.17 was calculated as 2643

- **DCF**

M&A activities do not happen often enough to perform precedent transaction analysis. Consequently, MICC used a discounted cash flow (DCF) analysis.

To forecast future earnings, the MICC team met with the management to confirm proprietary estimations of future earnings and production volumes. While the Gobi management team declined to comment on our analysis, we believe that revenue predictions are consistent with the current market consensus. In addition, the regression analysis suggested comparatively lower BIAS, MAD, MSE and MAPE than moving average and exponential forecasting techniques.

Regarding the beta of the Company, we were not able regress it against MSE Top-20 Index due to less frequent trading activities. Compared to MSE Top-20, Gobi is not traded daily. Even though if we use ARCH model to correct the interval effects, the results would have produced large biases.

Furthermore, implied enterprise value of the Company is obtained through EBITDA multiple and Perpetuity growth models. It's the average of two. Exit multiple is assumed to be 5.7, whereas perpetuity growth rate is 6.0%. These assumptions are made based on the long-term inflation forecasts, as well as the company characteristics.

- **Sensitivity Analysis**

Given +/- 1% change in cost of equity, target price per share deviates by 7-11%.

Figure 22. Target Price Sensitivity

Cost of equity	Target price per share
22%	9,915
21%	10,608
20%	11,372
19%	12,221
18%	13,177
17%	14,264
16%	15,522
15%	17,007
14%	18,802

Figure 21. Valuation

Implied Equity Value('000):	102,791,536
Outstanding shares	7,801,125
Implied Fair Value	**13,177**
Current Market Value	**10,970**

- **Recommendation**

Gobi still leads the Mongolian cashmere manufacturing industry and its international expansion will greatly insulate it from domestic economic conditions — especially as other Mongolian companies develop more competitive garment offerings. Gobi has credibility for shareholders and distributed dividends for last six years consecutively. For these reasons, we recommend an **ACCUMULATE**.

Figure 23. Sensitivity Analysis

Enterprise Value

WACC \ Exit Multiple	4.7	5.2	5.7	6.2	6.7
16.6%	162,217,494	166,110,733	170,003,971	173,897,210	177,790,449
17.1%	157,962,257	161,789,413	165,616,569	169,443,724	173,270,880
17.6%	153,994,830	157,757,299	161,519,767	165,282,236	169,044,705
18.1%	150,281,731	153,980,874	157,680,017	161,379,160	165,078,303
18.6%	146,794,735	150,431,879	154,069,022	157,706,166	161,343,310

Implied Perpetuity Growth Rate

WACC \ Exit Multiple	4.7	5.2	5.7	6.2	6.7
16.6%	3%	5%	6%	6%	7%
17.1%	4%	5%	6%	7%	8%
17.6%	4%	5%	6%	7%	8%
18.1%	5%	6%	7%	8%	8%
18.6%	5%	6%	7%	8%	9%

Implied Equity Value

WACC \ Exit Multiple	4.7	5.2	5.7	6.2	6.7
16.6%	103,489,262	107,382,501	111,275,740	115,168,979	119,062,218
17.1%	99,234,026	103,061,182	106,888,337	110,715,493	114,542,649
17.6%	95,266,598	99,029,067	102,791,536	106,554,005	110,316,474
18.1%	91,553,500	95,252,643	98,951,786	102,650,928	106,350,071
18.6%	88,066,504	91,703,647	95,340,791	98,977,935	102,615,078

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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