

May 10, 2011

# Deér Consumer Products

(DEER-NASDAQ)

Leisure

**Stock Rating:** Outperform(S)  
**Industry Rating:** Market Perform

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## In-Line Quarter, Full Year on Track

### Event

DEER reported first quarter results, which were roughly in line with expectations. 1Q11 EPS were \$0.17, a penny below our \$0.18 estimate and a penny ahead of Street consensus of \$0.16. The company reported EPS of \$0.12 in the year-ago period.

### Impact

DEER's business continues to perform well, with expansion in both the domestic and export sides of the business.

### Forecasts

The company maintained full-year guidance of \$1.08-\$1.12. Our EPS estimates are unchanged. We currently expect the company to report EPS of \$1.15 in 2011 and \$1.35 in 2012.

### Valuation

At a current valuation of 6.6x our 2012 EPS estimate of \$1.35, the company trades at a very attractive price, which is a discount to its Chinese peers (~15x). Our 12-month price target of \$15 represents an 11x multiple on our 2012 EPS estimate of \$1.35. Risks to this target include poor retail takeaway of Deér-branded products or the loss of a major retail account.

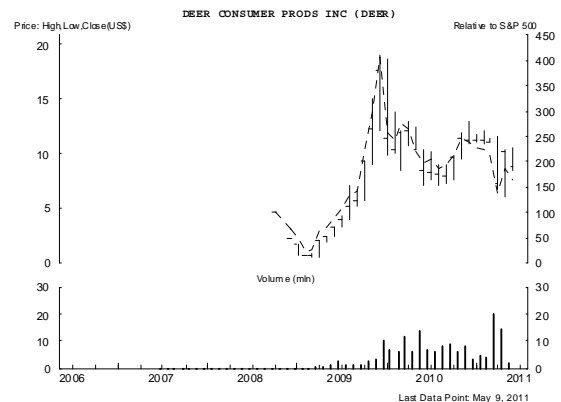
### Recommendation

We continue to rate DEER share **OUTPERFORM (S)**.

### Securities Info

<b>Price (9-May)</b>	<b>\$8.82</b>	<b>Target Price</b>	<b>\$15</b>
52-Wk High/Low	\$13/\$6	Dividend	\$0.20
Mkt Cap (mm)	\$296	Yield	2.3%
Shs O/S (mm, BASIC)	33.6	Float O/S (mm)	17.0
Options O/S (mm)	na	ADVol (30-day, 000s)	667

### Price Performance



### Valuation/Financial Data

(FY-Dec.)	2009A	2010A	2011E	2012E
EPS Pro Forma	\$0.53	\$0.90	\$1.15	\$1.35
P/E			7.7x	6.5x
First Call Cons.			\$1.09	\$1.28
EPS GAAP	\$0.53	\$0.90	\$1.15	\$1.35
FCF	-\$0.04	-\$1.38	\$0.57↑	\$0.34↓
P/FCF			15.5x	25.9x
EBITDA (\$mm)	\$15	\$38	\$48	\$60
EV/EBITDA			2.5x	2.0x
Rev. (\$mm)	\$81	\$176	\$227	\$269
EV/Rev			0.5x	0.4x

Quarterly EPS	1Q	2Q	3Q	4Q
2010A	\$0.12	\$0.18	\$0.28	\$0.33
2011E	\$0.17A	\$0.21↓	\$0.36↑	\$0.41↑

Balance Sheet Data (31-Dec)		
Net Debt (\$mm)	-\$178	Total Debt/EBITDA
Total Debt (\$mm)	\$55	EBITDA/IntExp
Net Debt/Cap.	nm	Price/Book

Notes: All values in US\$.

Source: BMO Capital Markets estimates, Bloomberg, FactSet, Global Insight, Reuters, and Thomson Financial.

### Changes

**Annual FCF**  
 2011E \$0.48 to \$0.57  
 2012E \$0.34 to \$0.34

**Quarterly EPS**  
 Q2/11E \$0.22 to \$0.21  
 Q3/11E \$0.35 to \$0.36  
 Q4/11E \$0.39 to \$0.41

## Investment Conclusion

We rate shares of Deér Consumer Products **OUTPERFORM (S)** with a price target of \$15. We believe DEER, a Chinese maker of home appliances, has one of the more compelling business models and growth stories in the consumer products industry. DEER employs a two-pronged business model that includes a stable, lower-margin third-party manufacturing export business, which generates an attractive free cash flow, combined with a high-margin branded business in its domestic China markets that offers significant opportunities for growth.

At a current valuation of 6.6x our 2012 EPS estimate of \$1.35, the company trades at a very attractive price, which is discount to its Chinese peers (~15x). Given the company's expected 22% annual EPS growth rate over the next two years, we believe shares are worth more, and place a target of \$15, or 11x our 2012 EPS estimate of \$1.35. This is a discount to China-based peers that trade on the Chinese exchanges. We recognize the fact that it may take time for this multiple expansion to occur, as the US market does not currently appear willing to award shares of China-based, US-listed companies with appropriate market multiples.

## Key Points

DEER reported first quarter results, which were roughly in line with expectations. 1Q11 EPS were \$0.17, a penny below our \$0.18 estimate and a penny ahead of Street consensus of \$0.16. The company reported EPS of \$0.12 in the year-ago period. Included in the results was an unanticipated \$1 million gain from the provincial Chinese government, rewarding the company for being a large employer in the Yangjiang region. Excluding this gain, EPS would have been \$0.15. The company reaffirmed its full-year guidance of sales between \$200 and \$220 million (+14% to +25%) and EPS in the range of \$1.08 and \$1.12 (+20% to +24%). Our 2011 sales and EPS estimates are \$227 million (+29%) and \$1.15 (+28%), respectively. We expect the company to grow sales another 18% in 2012 to \$269 million and EPS by 17.5% to \$1.35.

Revenues grew 45% to of \$34.7 million, just ahead of our \$34 million expectation (+42%), and the Street's \$33.2 million expectation (+39%). Sales in the domestic China market grew by 141% as the company continues to aggressively penetrate that market. Management indicated that it is "experiencing strong customer product re-ordering from existing customers." This is a positive development, as the vast majority of the domestic China sales growth to this point had come from channel fill. In our recent visit to China, we were impressed by the breadth and depth of the Deér-branded product available at retail in the Shenzhen region. Consumer takeaway, though, was much more difficult for us to observe and gauge. Management's comments are encouraging, but we look forward to our next opportunity to better scout this retail takeaway for ourselves.

Sales to export markets grew a robust 11%, with strong growth in emerging market regions: Middle East & Africa +39%, Asia (ex China) +31%, South America +15%. Europe grew 6%, while sales to North America declined 40%. The company cited a desire to concentrate on higher margin businesses with better pricing power in less stagnant markets, and thus claims to

have turned away some North American business as a result. However, the company recently closed major deals to supply appliances to two yet to be named North American brands. These products began shipping in 2Q, and management promised to reveal their identities on the next earning conference call.

Gross margin declined 10 basis points to 28.7%. This was 250 basis points (bp) below our 31.3% expectation. We had anticipated higher margin given the fact that domestic China sales carry higher margins and are growing more quickly than the lower margin export business. An increase in volumes should have also driven leverage over fixed costs. Management commented that commodity cost increases did not have had a big impact on margin in the quarter. However, the labor component was said to have increased 10%, and contributed to 150 bp of margin pressure. We have moderated our margin assumption going forward.

Operating expense grew more than we had modeled, but we actually view this positively. Selling expense grew to \$2.6 million, an increase of \$1.2 million, or 83%. As a percentage of sales, selling expense increased to 7.5% from 6.0%. The increase was due to the hiring and training of sales promoters to work in retail stores in order to show customers, first hand, the benefits of DEER's products. Recall that many of DEER's products are relatively new and underpenetrated in the China market. During our store tours, we saw very few competitive offerings in the blender, juicer, and chopper segments, for instance, (unlike the rice cooker, hot water kettle, and steamer segments which are intensely competitive). These promoters will be trained to extol the virtues of blended fruit drinks, margaritas, and other western-style concoctions. We are comfortable with rising levels of selling expense in order to build brand awareness and to ensure adequate retail takeaway, as we believe a key risk to the DEER story is that once the channel-fill to retailers is complete, DEER products do not perform well with consumers, and these products are then delisted.

The company's balance sheet appears to be in good shape. The company ended the quarter with \$28 million in cash and \$5 million in short-term debt. The company's net cash position represents \$0.70 per share. Accounts receivable grew by 135% to \$46 million from \$19.6 million a year ago. Given that domestic China sales grew by 141%, we think this A/R growth is easily explainable by the longer collection terms in the China market. DEER's collection terms for its two largest China customers is 180 days from the close of the billing cycle, which is 30-45 days after the products are delivered. Other domestic customers pay 30-90 days after the close of the billing cycle. Conversely, export products are sold under letters of credit, prepaid arrangements, or on short credit terms. Export-related receivables are, on average, collected in less than three months. At the end of 1Q11, 73% of DEER's accounts receivable were from domestic China customers. Inventory appears in good shape, growing 38% to \$29 million from \$21 million, representing 95 days of inventory on hand compared to 104 days in 1Q10.

**Deer- Quarterly Income Statement**

(Millions, except per-share data)

	2010				2011				2012E				
	2007	2008	2009	Q1	Q2	Q3	Q4	2010	Q1	Q2	Q3	Q4	2012E
<b>Net Revenues</b>	\$33.5	\$43.8	\$81.3	\$23.9	\$34.5	\$55.3	\$62.2	\$175.8	\$34.7	\$44.0	\$73.0	\$75.3	\$227.0
Cost of Sales	26.2	34.1	61.2	17.0	24.6	39.4	44.3	125.3	24.7	31.2	51.6	52.0	159.6
<b>Gross Profit</b>	7.2	9.7	20.2	6.9	9.9	15.8	18.0	50.6	10.0	12.8	21.4	23.3	67.4
Selling	1.5	2.9	3.6	1.4	1.8	2.8	3.2	9.2	2.6	3.1	5.0	5.0	15.7
G&A	1.8	2.6	2.4	0.7	1.1	1.5	1.3	4.6	1.2	1.5	1.9	2.0	6.6
<b>Operating Profit</b>	3.9	4.2	14.2	4.8	7.0	11.6	13.5	36.8	6.1	8.2	14.5	16.3	45.1
Interest	0.1	0.3	0.0	(0.1)	(0.2)	(0.2)	(0.0)	(0.5)	(0.1)	(0.1)	(0.1)	(0.2)	(0.4)
Financing Costs	0.0	0.2	0.2	0.0	0.0	0.0	0.1	0.1	0.0	0.0	0.0	0.0	0.0
Other exp (inc)	(0.2)	(1.0)	(0.5)	0.0	0.1	0.7	0.3	1.2	(0.8)	0.0	0.0	0.0	(0.8)
<b>Pretax Income</b>	4.0	4.7	14.5	4.8	7.1	11.0	13.1	36.0	7.0	8.3	14.5	16.5	46.4
Income taxes	0.6	1.3	2.1	0.8	1.1	1.7	2.0	5.6	1.2	1.2	2.2	2.5	7.1
<b>Net Income</b>	\$3.4	\$3.4	\$12.4	\$4.0	\$6.0	\$9.3	\$11.0	\$30.3	\$5.8	\$7.1	\$12.4	\$14.0	\$39.2
Diluted Shares Outst.	NM	16.7	23.2	33.8	33.7	33.6	33.9	33.7	33.9	34.1	34.3	34.6	34.2
<b>Diluted EPS</b>	NM	\$0.20	\$0.53	\$0.12	\$0.18	\$0.28	\$0.33	\$0.90	\$0.17	\$0.21	\$0.36	\$0.41	\$1.15
<b>Margin Analysis</b>													
Revenue	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
<b>Gross Margin</b>	21.6%	22.1%	24.8%	28.8%	28.7%	28.7%	28.9%	28.8%	28.7%	29.1%	29.3%	30.9%	29.7%
Selling	4.5%	6.5%	4.4%	6.0%	5.3%	5.0%	5.1%	5.2%	7.5%	7.0%	6.8%	6.6%	6.9%
SDG&A	5.3%	5.9%	2.9%	2.8%	3.2%	2.7%	2.1%	2.6%	3.6%	3.4%	2.6%	2.6%	2.9%
<b>Operating Margin</b>	11.7%	9.7%	17.5%	20.0%	20.2%	21.0%	21.7%	21.0%	17.6%	18.6%	19.8%	21.7%	19.9%
<b>Pretax Margin</b>	12.1%	10.6%	17.8%	20.0%	20.7%	19.9%	21.0%	20.5%	20.2%	18.9%	19.9%	21.9%	20.4%
Tax Rate	15.2%	27.9%	14.6%	15.7%	15.5%	15.9%	15.7%	15.7%	17.3%	15.0%	15.0%	15.0%	15.3%
<b>Net Margin</b>	10.2%	7.7%	15.2%	16.9%	17.5%	16.8%	17.7%	17.3%	16.7%	16.1%	16.9%	18.6%	17.3%
<b>Percentage Change</b>													
Revenue	15.3%	30.8%	247.8%	125.0%	108.2%	108.2%	90.8%	116.2%	45.1%	27.7%	32.1%	21.0%	29.1%
<b>Gross Profit</b>	34.7%	25.2%	75.9%	61.6%	63.0%	63.0%	50.8%	60.1%	30.9%	22.7%	25.9%	22.9%	25.0%
Selling	56.4%	88.0%	678.9%	150.1%	187.1%	187.1%	87.4%	157.7%	83.3%	70.3%	81.4%	58.4%	71.6%
SDG&A	0.0%	43.5%	(7.2%)	81.7%	35.1%	244.7%	70.4%	91.7%	83.8%	37.7%	28.3%	48.0%	44.4%
<b>Operating Income</b>	99.9%	8.1%	235.7%	209.0%	159.1%	111.2%	159.0%	199.0%	27.7%	17.4%	24.8%	21.2%	22.4%
<b>Pretax Income</b>	69.3%	15.4%	391.8%	223.6%	128.1%	95.1%	144.8%	283.3%	46.3%	16.4%	32.1%	25.0%	28.3%
<b>Net Income</b>	70.8%	(1.9%)	268.5%	251.1%	124.7%	87.7%	145.4%	165.1%	43.5%	17.3%	33.4%	27.2%	29.3%
<b>EPS</b>	NM		264.2%	126.1%	55.7%	53.9%	69.1%	165.1%	43.0%	16.0%	30.5%	24.7%	27.1%

Source: BMO Capital Markets estimates and corporate reports.

**Deer- Quarterly Segment Breakdown**

(Millions, except per-share data)

	2010E				2011E				2012E				
	Q1A	Q2A	Q3A	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2012E
OEM	\$9.3	\$9.3	\$3.0	\$3.5	\$11.5	\$2.0	\$3.0	\$3.0	\$3.0	\$1.5	\$2.5	\$2.5	\$9.0
ODM	31.4	57.8	15.5	20.1	29.0	22.9	87.4	100.3	100.3	19.5	26.3	38.3	116.0
Total Export	\$41.7	\$67.0	\$17.5	\$23.1	\$32.0	\$26.4	\$98.9	\$111.3	\$111.3	\$21.0	\$28.8	\$40.8	\$125.0
Domestic	\$2.0	\$14.3	\$6.4	\$11.4	\$23.3	\$35.8	\$76.9	\$115.7	\$115.7	\$18.5	\$23.0	\$46.0	\$143.5
<b>Total</b>	<b>\$43.8</b>	<b>\$81.3</b>	<b>\$23.9</b>	<b>\$34.5</b>	<b>\$55.3</b>	<b>\$62.2</b>	<b>\$175.8</b>	<b>\$227.0</b>	<b>\$227.0</b>	<b>\$39.5</b>	<b>\$51.8</b>	<b>\$86.8</b>	<b>\$268.5</b>
<b>Percentage Change</b>													
OEM	NA	(10.8%)	88.7%	20.0%	11.1%	16.7%	24.2%	(4.3%)	(16.7%)	(25.0%)	(16.7%)	#####	(18.2%)
ODM	NA	84.3%	189.4%	80.3%	38.2%	12.7%	51.4%	14.7%	13.9%	12.9%	14.1%	15.9%	15.7%
Total Export	NA	60.6%	172.7%	69.2%	35.1%	13.2%	47.6%	12.5%	12.6%	9.0%	10.6%	13.2%	12.3%
Domestic	NA	598.8%	1304.8%	579.5%	706.8%	285.4%	437.2%	50.5%	58.8%	20.1%	27.8%	24.3%	24.0%
<b>Total</b>	<b>NA</b>	<b>85.8%</b>	<b>247.7%</b>	<b>125.0%</b>	<b>108.2%</b>	<b>90.8%</b>	<b>116.2%</b>	<b>29.1%</b>	<b>32.1%</b>	<b>13.9%</b>	<b>17.6%</b>	<b>18.8%</b>	<b>18.3%</b>
<b>Percent of Total</b>													
OEM	23.7%	11.4%	8.4%	8.7%	5.4%	5.6%	6.5%	4.8%	4.1%	3.8%	4.8%	2.9%	3.4%
ODM	71.6%	71.0%	64.9%	58.3%	52.4%	36.8%	49.7%	44.2%	45.2%	49.4%	50.7%	44.1%	43.2%
Total Export	95.3%	82.4%	73.2%	67.0%	57.8%	42.4%	56.3%	49.0%	49.3%	53.2%	55.6%	47.0%	46.6%
Domestic	4.7%	17.6%	26.8%	33.0%	42.2%	57.6%	43.7%	51.0%	50.7%	46.8%	44.4%	53.0%	53.4%
<b>Total</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>

Source: BMO Capital Markets estimates and corporate reports.

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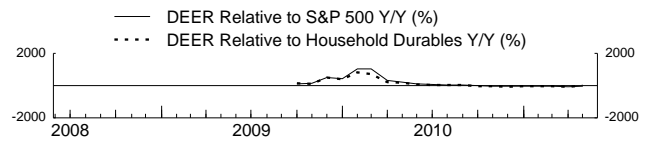
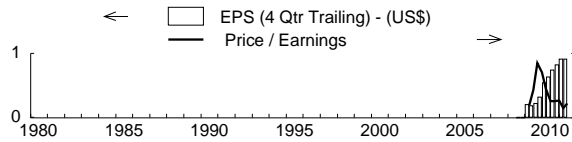
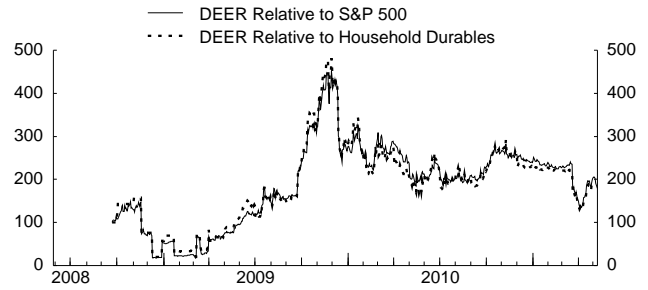
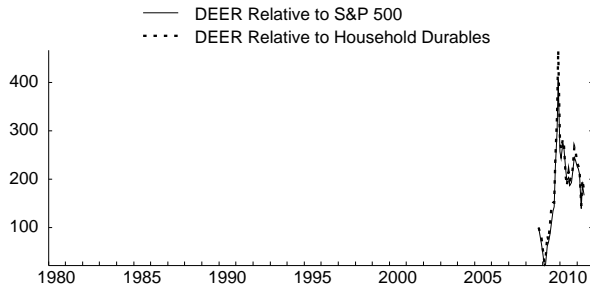
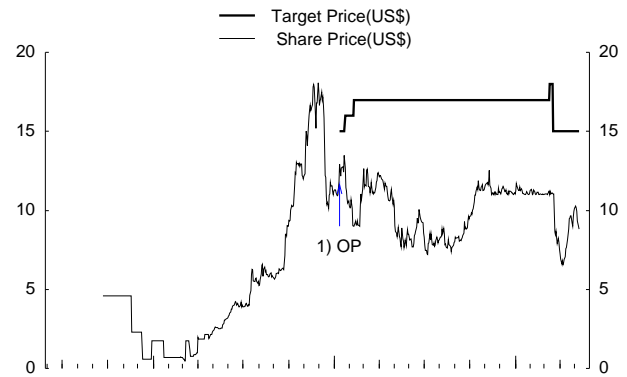
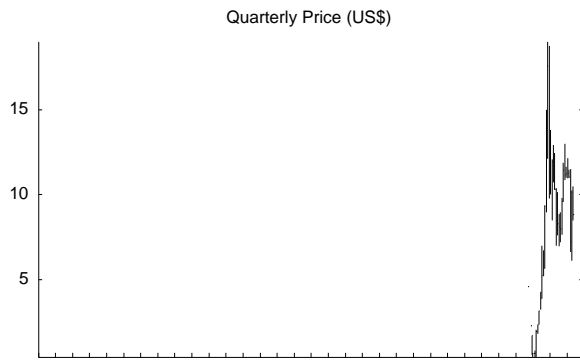
**Deer- Summary Cash Flow Statement**

(Millions, except per-share data)

	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011E</u>	<u>2012E</u>
Net Income	\$2.0	\$3.4	\$3.4	\$12.4	\$30.3	\$39.2	\$47.9
Depreciation/Amortization	0.6	0.8	1.2	1.4	1.6	3.1	4.0
Other Noncash Charges	(0.0)	(0.1)	0.4	0.3	0.3	0.0	0.0
Changes in Working Capital	<u>(1.8)</u>	<u>(3.7)</u>	<u>(1.9)</u>	<u>(13.8)</u>	<u>(21.2)</u>	<u>(18.6)</u>	<u>(29.0)</u>
<b>Operating Cash Flow</b>	<b>\$0.8</b>	<b>\$0.4</b>	<b>\$3.0</b>	<b>\$0.4</b>	<b>\$11.1</b>	<b>\$23.8</b>	<b>\$23.0</b>
Capital Expenditures	(1.5)	(2.1)	(4.2)	(4.3)	(15.1)	(11.6)	(11.0)
Other	<u>0.2</u>	<u>(0.6)</u>	<u>0.3</u>	<u>0.2</u>	<u>(42.3)</u>	<u>7.4</u>	<u>0.0</u>
<b>Free Cash Flow</b>	<b>(\$0.5)</b>	<b>(\$2.2)</b>	<b>(\$0.8)</b>	<b>(\$3.7)</b>	<b>(\$46.3)</b>	<b>\$19.6</b>	<b>\$11.9</b>
Financing & Acquisitions							
Sale of Common Stock	\$0.0	\$0.0	\$0.0	\$81.5	\$6.6	\$0.0	\$0.0
Repurchase of Common Stock	0.0	0.0	0.0	0.0	(6.9)	0.0	0.0
Debt Borrowings (Repayments)	0.7	2.7	2.2	(1.2)	0.0	(5.0)	0.0
Dividends	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	<u>0.1</u>	<u>0.5</u>	<u>(0.1)</u>	<u>0.0</u>	<u>1.2</u>	<u>(12.9)</u>	<u>0.0</u>
Net Financing Activity	<u>\$0.7</u>	<u>\$3.2</u>	<u>\$2.1</u>	<u>\$80.3</u>	<u>\$0.9</u>	<u>(\$17.9)</u>	<u>\$0.0</u>
<b>Net Change in Cash</b>	<b>\$0.2</b>	<b>\$0.9</b>	<b>\$1.3</b>	<b>\$76.6</b>	<b>(\$45.4)</b>	<b>\$1.7</b>	<b>\$11.9</b>
Cash at Beginning of Year	\$0.4	\$0.6	\$1.5	\$2.8	\$79.3	\$34.0	\$35.6
Cash at End of Year	\$0.6	\$1.5	\$2.8	\$79.3	\$34.0	\$35.6	\$47.6
Operating Cash Flow Per Share	NM	NM	\$0.18	\$0.02	\$0.33	\$0.69	\$0.65
Free Cash Flow Per Share	NM	NM	(\$0.05)	(\$0.16)	(\$1.38)	\$0.57	\$0.34
EBITDA Per Share	NM	NM	\$0.33	\$0.68	\$1.14	\$1.41	\$1.68

Source: BMO Capital Markets estimates and corporate reports.

### DEER CONSUMER PRODS INC (DEER)



DEER - Rating as of 18-Sep-08 = NR

Date	Rating Change	Share Price
1 11-Jan-10	NR to OP	\$11.79

Last Daily Data Point: May 9, 2011

**Important Disclosures****Analyst's Certification**

I, Gerrick L. Johnson, hereby certify that the views expressed in this report accurately reflect my personal views about the subject securities or issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this report.

Analysts who prepared this report are compensated based upon (among other factors) the overall profitability of BMO Capital Markets and their affiliates, which includes the overall profitability of investment banking services. Compensation for research is based on effectiveness in generating new ideas and in communication of ideas to clients, performance of recommendations, accuracy of earnings estimates, and service to clients.

**Company Specific Disclosure**

Disclosure 9: BMO Capital Markets makes a market in this security.

**Methodology and Risks to Our Price Target/Valuation**

**Methodology:** This target represents a 17x multiple on our 2011 EPS estimate.

**Risks:** Risks to this price target include an inability to bring new products to market on a timely basis.

**Distribution of Ratings (March 31, 2011)**

Rating Category	BMO Rating	BMOCM US Universe*	BMOCM US IB Clients**	BMOCM US IB Clients***	BMOCM Universe****	BMOCM IB Clients*****	Starmine Universe
Buy	Outperform	34.2%	15.2%	38.6%	39.2%	48.5%	53.1%
Hold	Market Perform	62.9%	12.5%	58.6%	56.8%	49.0%	41.3%
Sell	Underperform	2.9%	13.3%	2.9%	4.1%	2.5%	5.5%

\* Reflects rating distribution of all companies covered by BMO Capital Markets Corp. equity research analysts.

\*\* Reflects rating distribution of all companies from which BMO Capital Markets Corp. has received compensation for Investment Banking services as percentage within ratings category.

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We use the following ratings system definitions:

OP = Outperform - Forecast to outperform the market;

Mkt = Market Perform - Forecast to perform roughly in line with the market;

Und = Underperform - Forecast to underperform the market;

(S) = speculative investment;

NR = No rating at this time;

R = Restricted – Dissemination of research is currently restricted.

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