QKL Stores
First Quarter 2011 Earnings Conference Call
May 16, 2011

Operator: Please stand by. Good day and welcome to the QKL Stores first quarter 2011 Earnings Conference Call. I would note that today's call is being recorded.

At this time I'd like to turn the conference over to Mr. Bill Zima of ICR. Please go ahead, sir.

Bill Zima: Thank you everyone and welcome to QKL Stores first quarter 2011 Conference Call. On our call today is Mr. Zhuangyi Wang, Chairman and Chief Executive Officer; Mr. Alan Stewart, Chief Operating Officer; Mr. Jerry Chan, Chief Financial Officer, and Mr. Mike Lee, Investor Relations Officer.

Before we begin, I would like to remind everyone that except for historical information, statements made during this conference call are forward-looking and made pursuant to the Safe Harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements involve known and unknown risks and uncertainties which may cause the Company's actual results in future periods to differ materially from forecasts of their expected results. Those risks include, among other things, a competitive environment in the industry in general and in the Company's specific market areas, inflation, changes in the cost of goods and services, and economic conditions in general and in the Company's specific market area. Those and other risks are more fully described in the Company's filings with the SEC.

Mr. Wang and Mr. Stewart will discuss highlights of the Company's business during the first quarter, and Mr. Chan will provide an update on the Company's financial highlights followed by a question and answer session.

With this said, I would now like to turn the call over to Mr. Wang. Please go ahead, sir.

Zhuangyi Wang: (Chinese spoken)

Translator: Thank you, Bill.

Zhuangyi Wang: (Chinese spoken)

Translator: Good day everyone.

Zhuangyi Wang: (Chinese spoken)

Translator: I would like to thank everyone for taking the time to join us for today's conference call.

Zhuangyi Wang: (Chinese spoken)

Translator: We made a lot of progress in the first quarter with our store opening activity.

Zhuangyi Wang: (Chinese spoken)

Translator: The opening of the six new stores in the first quarter was our most active store openings in a quarter to date.

Zhuangyi Wang: (Chinese spoken)

Translator: We have since opened another five stores in April which brings us close to completing our plans to open a total of 12 new stores for the year.

Zhuangyi Wang: (Chinese spoken)

Translator: While this has resulted in higher than average levels of pre-opening expenses, but believe we are setting the stage for an increase of top and bottom line growth in the coming quarter.

Zhuangyi Wang: (Chinese spoken)

Translator: We finished the first quarter operating a total of 49 stores, compromised of 33 supermarkets, 13 hypermarkets and three department stores.

Zhuangyi Wang: (Chinese spoken)

Translator: As our new store opening clients grow for the remainder of the year, particularly in the second half, we expect our profitability to improve and will benefit from our new store sales, increase the same store sales at existing stores, and reduced store openings and promotional expenses.

Zhuangyi Wang: (Chinese spoken)

Translator: We were also pleased with the improvement of our operating cash flows in the first quarter due to a reduction in inventory after the patron's New Year's season and a decrease in other receivables attributable to cash recovery from our vendors after the busy holiday season.

Zhuangyi Wang: (Chinese spoken)

Translator: We are pleased with our execution in the first quarter and we remain focused on like-minding profitability for our shareholders.

Zhuangyi Wang: (Chinese spoken)

Translator: At this time I would like to turn the call over to our Chief Operating Officer Mr. Alan Stewart and Mr. Jerry Chan, our Chief Financial Officer, who will discuss the company's first quarter financial highlights as well as our strategic initiatives.

Alan Stewart: Thank you, Zhuangyi, and thank you everyone for joining our call today. I believe our store opening execution in the first quarter was solid and we are setting the stage for increased top and bottom line growth in the coming months. As part of this effort, we remain highly focused on ensuring solid revenue and margin performance within our existing store locations as we add new stores.

Looking first at our existing stores, our same store sales were approximately 84.1 million in the first quarter of 2011 and an increase of 8.5 from 77.5 million in the first quarter of 2010. This reflected the growth of 34 comparable stores. The drivers of this gross were due to company management have rich retail knowledge and experiences. Nowadays, retailers in China really face tough competition and fighting with competitors, not only in China as well as from abroad. With this thought in mind, we did price investigation against competitors every week for non-food and grocery products, and every day for our fresh products. Also, we developed all sorts of promotion activities to attract more customers to our stores. Besides, our merchandising group established long-term cooperation relationship with farmers and resource suppliers which ensure our stores can always provide customers the freshest product with low cost.

As of March 31, 2011, we operated 33 supermarkets, 13 hypermarkets and three department stores. The average size of our supermarkets is approximately 2,500 square meters in sales area, while our hypermarkets typically average approximately 4,500 square meters in sales area. Each of these store concepts are supported by our two distribution centers. Under our expansion plan, we opened six new stores in the first quarter of 2011 that have in the aggregate approximately 34,000 square meters of space. We opened an additional five stores in the month of April for an aggregate of 46,000 square meters of space. For the remainder of the year we expect better than our 12 new stores that we promised you for 2011.

We continue to believe that there are significant expansion opportunities in small and medium-sized cities in northeast China, many of which do not contain modern supermarket chains. The demand for supermarkets is likely to grow significantly over the next several years in our region as it continues to experience urbanization. As we evaluate growing our store presence and top line opportunities, we continue to identify ways in which we can enhance our gross profit margin, reduce operating expenses, and improve overall profitability.

In terms of our initiatives to grow gross profit margin first, we believe our full year of gross margin trends can gradually increase from current levels as we reduce supply costs, focus on the merchandise with higher margins such as foods we prepare ourselves—that would be the bakery and flower and things like that—and private label merchandise. We also expect to benefit from greater sales of non-food items, a larger size store format and bulk buying power. As we open more and more stores in northeast China, QKL will have better relationships with the key suppliers in terms of increasing marketing income and lowering cost of merchandise.

Second, we believe we will continue to increase same store sales at our older stores through better seasoned management, higher basket sales and better promotions, enhancements of our customer loyalty program and our fresh food offering. As it relates to our initiatives to reduce operating expenses, we have a number of initiatives in place. This includes improvements to our logistics and information systems to support our stores, the opening of our second DC is contributing to our logistics and overall efficiency. For example, at the end of the first quarter we ran 4,500 SKUs out of our new DC, and at the end of the first quarter we were nearly 30% increased compared to the end of last year.

We're also doing our best to keep labor costs in line with growth through hiring more part-time job workers in the store during the high-peak season, reduce the labor drain in low season. Such endeavors further strengthen our overall financial performance and market position.

Further, as our new store opening plans slows for the remainder of the year, particularly in the second half, we'd like to emphasize that we expect our profitability to improve as store opening and promotional expenses are reduced. Overall, we continue to believe that 2011 will be a record year for QKL stores in terms of revenue and profit.

At this time, I'll turn over the call to Jerry Chan, QKL Stores Chief Financial Officer, who will review our financial results for the first quarter. Jerry?

Jerry Chan: Thank you, Alan. Revenue in the first quarter of 2011 increased 24.1% to 101.3 million from 81.6 million in the first quarter of 2010. Revenue performance reflects the growth of 34 comparable stores which are stores that have been opened (unintelligible) January 1, 2010. As well, that's when the opening of 15 new stores since January 1, 2010. Same store sales were approximately 84.1 million in the first quarter of 2011, an increase of 8.5% from 77.5 million in the first quarter of 2010. The 15 new stores opened since January 1, 2010, contributed approximately 17.2 million in the first quarter of 2011.

Gross profits increased 24.6% year-over-year to 18.1 million compared to 40.5 million in the past year previous. Gross margin for the first quarter of 2011 was 17.9% compared to 18.5% in the first quarter of 2010. The increase in gross profit primarily attributable to the increase in net sales over the prior year period.

Operating expenses including selling and G&A increased by 16.2% to 14.7 million compared to 9.0 million in the prior year period. This was primarily a result of additional salaries, (unintelligible) and the routine expenses, hiring of employees and other operating costs related for the company's increased full-time over the past year as well as some of the opening expenses from six new stores opened in this 2011 first quarter.

(Inaudible) income 3.4 million or 3.3% of sales from 5 million or 6.7% of total sales in the first quarter of 2010. First quarter 2011 (inaudible) income was approximately 2.6 million or (unintelligible) dollars per share compared with 11.9 million or $3.39 a share for the same period in 2010. Excluding changes in the (unintelligible), taxed income for the three months ended March 31, 2011 was 2.6 million or (unintelligible) per diluted share compared to 4.1 million (unintelligible) in the prior period year.

As of March 31st, 2011, the company had 41.1 million in unrestricted cash compared to 46.5 million as of March 31, 2010 and no debt or (inaudible). As of March 31, 2011, the company operates 49 stores totaling (unintelligible) compared to 28 stores totalling 164,000 square meters in the prior year period. We opened six new store locations in the first quarter of 2011.

The number of weighted average shares outstanding in (inaudible) of EPS excluding the value of the warrant decreased 8.2% to 37 million in the first quarter 2011 from 40.4 million in the first quarter 2010.

Net cash provided by operating activities for 2011 first quarter was 25.5 million compared to 1.5 million in the prior year period. The increase in cash provided by operating activities primarily attributable (inaudible) net cash (inaudible) decrease of inventories and decrease of (inaudible). A decrease of inventories was caused by reducing the inventory on-hand after the

Chinese New Year season. The decrease of other receivables is largely attributable to the recovery of money (unintelligible).

Capital expenditures in the first quarter were 1.9 million. We expect our cap ex spending to trend in the 2.2 million range in quarter two and move lower into the 0.5 million range for the 2011 third and fourth quarters as our store openings trend close.

(Unintelligible), we plan to open 12 new store locations comprised of hypermarkets, supermarkets and department stores, having an aggregate of approximately 70,000 square meters of space. Of this total, 11 stores have been already opened through the first four months of the year, and we expect the other one store location to open by the second quarter.

This concludes our prepared remarks for today. We appreciate you listening to our call and look forward to providing you with updates to our business in the weeks and months ahead.

Operator, we are now ready to take some questions.

Operator: Thank you. Ladies and gentleman, at this time if you would like to ask a question, please press star, one, on your telephone. If you're joining us using a speaker phone, we ask that you please release the mute function to allow your signal to reach our equipment. Once again, that is star, one, please.

And we'll go first to Jodi Dai with Global Hunter Securities.

Jodi Dai: Hi, this is Jodi. Congratulations on a good quarter. The first question is in regard to your plans of new stores to open for the remaining of the year. Now that you guys have over $40 million on your cash balance, I wonder if there is any possibilities or any color you guys could share with us on the number of the new stores to open. Thank you.

Jerry Chan: Hi Jodie. So we do not have any more locations under construction right now at QKL (inaudible) but we expect that we will open more by the end of the year. I will say two to three stores from here.

Jodi Dai: Okay, that's helpful. Thank you. And then secondly, I wonder, other than the potential new stores, what's your cap ex plan for the rest of the year?

Jerry Chan: Our cap ex mainly relates to our new store openings and of course we do have some renovations for our existing stores so as to restructure our old stores and for this one we estimate that that maybe that will be about 0.5 million per quarter.

Jodi Dai: Three point five million per quarter?

Jerry Chan: No, 0.5 million.

Jodi Dai: Okay, thank you. And, lastly, I wonder, SG&A during the first quarter is a little bit higher than I expected, which I believe reflects the higher expenses associated with the new store opens. I wonder how should we model it for going forward or how much of this quarter's expense won't occur in the future quarters and how much will stay? Thanks.

Jerry Chan: Yes, we understand that we had significant increase in our operating expense due to increasing the store counts and special and some expenses such as stock costs, rental and pre-opening expenses. In response to the question, the opening costs of the operating expense for this quarter is $2.2 million US. So in the second quarter we expect to see high salary expenses as well because of the pre-opening expenses for five to six new stores April to June. However, we expect the (inaudible) expenses not continuated in the remaining year because we do not expect there will be still pre-opening expense for the second half period.

Alan Stewart: Also Jodi—this is Alan—the pressure on the gross profit will relax a little bit. When you're opening up this many stores, you know, 11 stores, and actually we've got a 12th one that's just ready to open, you have a lot of pressure on the gross profit to get the stores open and you have probably about a nine gross for the first month for those stores. So that gross takes away from the total and that's, you know, 12 stores against still a small base. So now we are over that and we can start enjoying those little better gross profit.

Jodi Dai: Okay, thanks for that color, very helpful. And lastly if I may, I wonder if you guys are just in general getting any shares from wet markets and how do you usually compete with them? Thanks, I'll jump back to the queue.

Alan Stewart: Maybe I can answer that. So when you go into a new location, we compare our prices on a daily basis for what we call the top 160 very important products. So we have what we call an EDLP, everyday low price, and we go into the wet markets and make sure that we are equal to or lower than the wet market, and sometimes that's difficult because as you know the wet market does not have to pay taxes. We have to pay taxes. But we will lower our margins and make sure that we can drive the customer away from the wet market. The wet market also the government is helping a little bit because of the security and the safety in a wet market, the pricing is a negotiable item in the wet market in many cases where it's a set price in the QKL store, and the safety of the product also is a main concern to the customer. So, in some cases it's easy to drive that customer away, especially a younger customer. So, it's not too hard but you have to invest in the pricing in order to do that.

Jodi Dai: Okay, very helpful, thank you.

Operator: Once again ladies and gentleman, star, one, please for a question or comment today.

And once again that is star, one, please. We'll go to Mickey Straus with Straus Asset Management.

Mickey Straus: Oh hi. I wanted to get a better handle on the selling expense increases started in the fourth quarter and obviously much greater even this quarter, and why we've had almost a doubling of selling expenses over the last year when revenues are only up 25%.

Alan Stewart: Jerry, do you want to answer that or do you want me to?

Jerry Chan: Alan, you go ahead, (inaudible).

Alan Stewart: Mickey, we haven't talked to you for a while. Essentially when you're opening up stores, the labor is the main issue. We're trying to hire in a marketplace, we put in about 11 existing people from our existing base stores. The rest of the help is all hired on a local basis and you are aware, we are going down into Liaoning, into Jilin provinces, which is a distance from Daqing. We've had to put together a regional team, both for merchandising and for the operations. Once that has been done, which is done, we now have the whole base, so we can open up stores without any additional operating people or merchandising people, and I can tell you that's a huge expense. One, from the standpoint of we bring on brand new program so there's a whole training that's required, but also the investment and just physical numbers of people to get that all done. I would tell you, you know, the whole global area from the north Russian border in Manchuli down to (inaudible) in Liaoning or we're into next to the North Korea border, that's all been covered now with people and that has all been done essentially this last year. That's a huge cost that will not be repeated, but it will stay there and now as you start filling in the stores, your overhead, your people within the stores will start getting reduced. We've got labor percentages that are too high in these new stores, and we're in the process of making sure those get back, but you first have to take care of the stores, and so we know that we've got extra labor in the stores, we know we had to put the people in in the regions, but that's an expense that you have to suffer.

Mickey Straus: So if we go out 12 months, what should selling expense be as a percent of sales and once you're more stable?

Alan Stewart: I'm not sure that I can give you an exact number but I will tell you that from the headquarters cost, you will not increase that headquarters cost. From the store, if we put in another 10 or 12 stores and this, you know, forget about the ones we've already put in, but if you look down another 12 months, 15 months, you're going to reduce your headquarters overhead considerably and also you'll have a year of experience in your general management in stores. So, you know, I haven't put all the numbers together but I know the budget is showing that there is considerable improvement in the percentage.

Jerry Chan: The opening expense for this quarter I have mentioned is around $2.2 million US, and for the next quarter, this will be approximately 2 million something because we opened five to six stores in the second quarter. And in the third quarter or fourth quarter, it depends on when our new stores will open and now that we're developing very significant demand for pre-opening costs in the third quarter or fourth quarter.

Mickey Straus: And all of those pre-opening costs are in your selling expense category or are they spread throughout the income statement?

Alan Stewart: Yes, most of them are—go ahead.

Mickey Straus: Most of them are in the selling expense category I guess.

And then as you know, Alan, you've been talking for some time about the distribution center helping your gross margins by as much as 200 basis points. Last year didn't happen because you didn't open on time and you weren't able to renegotiate your contracts. Why aren't we seeing a gross margin improvement at this point and/or when should we?

Alan Stewart: I think that you are seeing it. What you don't see is the diminution of the gross profit as a result of opening all these stores and a dropping gross for 30 days at 9% instead of 17. As the pressure of opening up the new store lets up, then you go back to your 17's and so you're going to start seeing that.

Mickey Straus: How about 18 or 19?

Alan Stewart: Yes. I think you're going to see your 18s.

Mickey Straus: Can I interrupt, Alan? If you took the I think the 34 stores that are in your cost base, what are the gross margins of those stores versus a year ago as opposed to all the new stores which I understand would have much lower gross margins as you promote and as you open, but can you say that the 34 stores had a very nice margin increase?

Alan Stewart: (Unintelligible) gross profit, yes. Jerry, do you have that? I don't have that in front of me, but do you have that for the 34 stores, the gross profit?

Jerry Chan: I will try to calculate the (unintelligible) for the gross profit of these 34 stores.

Alan Stewart: What we'll do, Mickey, is we'll get back to you.

Mickey Straus: Yes, I think it's important. It just shows the difference between the two because it's understandable you'd have low gross margins on the new stores, but not on the old stores if in fact you're operating, you know, efficiently. Okay, well that's all I had. Thank you.

Alan Stewart: Okay thanks, Mickey.

Operator: Next we'll hear from Howard Zhou with Roth Capital Partners.

Howard Zhou: Good evening, just a few quick questions. First of all, on the operating expense, do you not see, I mean, is there any increasing pressure on the starting cost and the rentals that you see?

Alan Stewart: Let me just take a shot and then Jerry you can chime. Clearly the rental costs are going up slightly but they are going up. And the locations that we're picking up I think are better locations and at the same time, some of these are larger locations. So I think you're going to see that over the next several years. I think that the rest of the issues are all controllable. There is nothing you can do about the rent.

Howard Zhou: Yes, okay. So what about employee counts? This is widely reported that there is salary increase in China across their industry. I was just wondering how would that affect your business?

Alan Stewart: Zhuangyi took care of most of that this last year. We raised wages both in management, some in the store, I mean in the office. We did cut back some numbers of people to control part of that cost increase but I would say unilaterally we went across the board and picked up wages and got them into what we considered market. We don't have near the pressure of wages that you have in the south part of China.

Howard Zhou: Okay, that's good. This could fall under you gross margin; I'm just wondering if you can share some color in terms of the potential gross margin in the second half. I understand the first half because of the new store openings, the margin has been capped at 18% range. So, would it become more optimistic into the second half, are you still looking at 18% or maybe a little more positive on the gross margin?

Alan Stewart: (Unintelligible) and I'm speaking probably out of turn but I think that in the low 18, you should be able to attain that.

Howard Zhou: Okay, low 18. And, cost sales came in at 8.5% in the first quarter. Are you comfortable to maintain the similar same store gross for next three quarters?

Alan Stewart: You know, part of that's going to depend on inflation. As you know, inflation is a fringe to our retail business in particular. I watched the government and all of a sudden we were buying vegetables at a higher price, now the—the customer backed off. And now the government is saying supermarkets, help the farmers. The farmers are starting to starve to death because nobody wants to buy their product. So it's feast or famine. I think that clearly the government's going to back off a little on the inflation. That will have some bearing on the same store sales. But I don't see that it's going to happen drastically and so you're probably still going to be in the 7 to 10 range.

Howard Zhou: Okay. And lastly, on the cap ex, you had 1.9 million to purchase some equipment in the first quarter. Did that fully reflect the cost, the cap ex you spent on the new stores opened in the first quarter and second quarter, or there will be some remaining in the coming quarters?

Alan Stewart: I think that again—I'll step up on it. When you're opening up stores, you try to get clean cutoffs, but I would say it is impossible. And so you have some stuff that was probably spent in the fourth quarter of last year for stuff coming into the opening of the first quarter and there will also be some lag from the first quarter into the second quarter and Jerry tried to tell you those what those numbers, 1.9 and then 2.0. You know, you open up a store in January and in some cases you really don't have to pay for that until let's say even the first part of April. So you're liable to get some, and Jerry I think does a good job of cutoffs, but it's not a perfect world out there. So, just know that there is some pre- expenses that are sometimes while the store's under construction before it's opened. You end up having to put deposits down on the rest and sometimes if we can stretch it, we try not to pay the vendor for stuff and lag it out two to three months if we can do it but we do try to reflect by quarter but it's not perfect.

Howard Zhou: Yes, in this case. All right. That's all. Thank you for taking my questions.

Alan Stewart: Thanks for your release, by the way, Howard.

Operator: And once again, star, one, please, and we will go back to Jodi for a follow-up question.

Jodi Dai: Hi. This is still Jodi. Thanks for taking my follow-up. First of all, I know last month I visited your new distribution center in Harbin, which I think was pretty impressive. I wonder if you guys can share some colors on the current utilization at the center, and then I have a follow-up.

Alan Stewart: Mike or me, it doesn't make any difference. We've got about 4,500 SKUs in there. It will hold 6,000, so you've got still some capacity, Jodie.

Jodi Dai: Okay. So, my follow-up is in regards to your plans on use of cash on hand. Would you consider to do the release, another new distribution center or how do you plan to use the cash for the rest of the year?

Alan Stewart: Let's me answer on this. The DC is—easily you can go out to 100 plus stores. We designed it for 200. The inside capacity you can handle 200 stores. The problem will be that at the front end when you're trying to move that many trucks up against the dock, we can go to 24-hour shifts and we can use the same stop and move to a lot more stores. So it makes no sense at this point to open a second distribution center. It's just a matter of picking out the logistics in there. So, I wouldn't expect that you're going to see any money put into a dry DC. I think Zhuangyi has plans in the future to put in a cold chain warehouse, which makes lots of sense, but you have to have that they are very expensive and you have to have lots of volume running through there.

Jerry Chan: Just like Alan said, we believe that this DC in Harbin can support more than 100 stores. Now we only have 78 people using the system to support all the stores, and receive the stores in those locations and maybe more than 10 stores in one week and then next week we rotation to the other, you know, 10 more stores, and it looks like we're doing that all right and more and more SKUs coming in and we also do a random check of the inventory and also monitor the moving state of the SKUs.

Jodi Dai: Okay. So any color on the use of cash?

Alan Stewart: I think as Jerry said earlier, there will be some remodels, but the rest will be saved for opening the new stores.

Jodi Dai: Okay. Great, that's all my questions. Thanks.

Operator: And at this time there are no further questions. I'll turn the conference back over to Management for any additional or closing comments.

Alan Stewart: Let me just comment. We appreciate everybody listening to our presentation and it was nice to hear from Mickey; I haven't heard from him for a while so—and Howard, thank you for your release, I think it was right on point. So, we look forward to hearing from you later.

Operator: And that does conclude our conference. We thank you all for joining us today.