QKL Stores
Second Quarter 2011 Results Conference Call
August 15, 2011

Operator: Please stand by as we are about to begin. Good day and welcome to the QKL Stores Second Quarter 2011 Earnings conference call. Today's conference is being recorded.

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

Bill Zima: Thank you everyone and welcome to the QKL Stores Second 2011 Earnings conference call. On our call today is Mr. Zhuangyi Wang, Chairman and Chief Executive Officer; Mr. Jerry Chan, Chief Financial Officer; Miss Xishuang Fan, Chief Operating Officer; Mr. Mike Li, Investor Relations Officer.

Before we begin, I would like to remind that except for historical information statements made during this conference call are forward looking 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 forecasted and their expected results.

Those risks include, among other things, the competitive environment in the industry in general and in the company's specific market areas, inflations, changes in the costs of goods and services, 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. Li will discuss the highlights of the company's business during the second quarter. 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: Good evening. I would like to thank everyone for taking the time to join us for today's conference call. We continue to make meaningful progress with our store opening activities in the second quarter.

In our expansion plan we opened five new stores in the second quarter, bringing our store opening total to 11 stores in the first half of 2011. We now currently operate 32 supermarkets, 15 hypermarkets and four department stores in northeastern China and Inner Mongolia, totaling 259,000 square meters of space.

We expect to modify our store opening plan in the second half of the year, and currently plan to open an additional two to three new locations for the remainder of the year. This slow down in new store activity should result in lower operating expenses when compared to the second quarter. We continue to benefit from a strong overall balance sheet. Our cash balance remains healthy and we do not carry any debt. We will preserve our cash to focus primarily on new store openings, the opening of a new DC we will discuss further, and store remodel activity. We remain focused on building a large regional footprint of highly efficient, profitable supermarket and hypermarket locations and remain very encouraged with our opportunities ahead.

At this time, I would like to turn the call over to Mr. Mike Li and to Mr. Jerry Chan who will discuss the company's second quarter operational results and financial highlights with you. Thank you.

Mike Li: Thank you John and thank you everyone for joining our call today.

The second quarter was a period in which we focused on further expansion of our business while also improving efficiency at the same time. As part of this effort we remain highly focused on ensuring solid revenue and margin performance within our existing store location, as well as adding new stores.

Looking first at our existing store, our same store sales were approximately US$67.3 million in the second quarter of 2011 and that's an increase of 7.6% from 62.5 million in the second quarter of 2010. This reflected the growth of 33 comparable stores. We carefully monitored the pricing of our local competitors to ensure that our products are competitively priced in their markets and were also involved in store promotional activity to draw a broader group of customer to our stores.

As of June 30th, 2011 we operate 32 supermarkets, 16 hypermarkets and four department stores. The average size of our supermarkets is 2,100 square meters in sales area, while our hypermarkets typically average approximately 4,700 square meters in sales area. The performance of our existing stores opened for more than a year continue to show stable growth profit margins of 17.8%, which helps support the ramp up period of our newer stores, which does typically take longer to ramp to profitability. In the last 12 months, we have opened 18 new stores, many of which are located in remote areas and require higher marketing incentives to attract the customers. For many of the residences located near our newly opened stores it typically takes longer for them to understand the modern grocery store format.

While our average sales per square meter are lower compared to our mature store our new stores have very strong growth capabilities. As we execute our new store market initiatives we are confident that our store will be more widely understood and accepted by local consumers over time.

As well our store openings plan modifies from the first half of the year we believe that preliminary store opening expenses will decrease in the coming quarter as our total store sales rise, labor and utilities costs stabilize and new store marketing expenses (inaudible). We continued to focus on controlling our costs in all areas of our business. As part of this effort we monitored the performance of each of our stores to evaluate any room for improvement. Any store that do not meet a certain performance benchmark over period of time will be closed. In the third quarter, we closed three stores.

These three stores were closed because they were not performing well as we expected when compared to other mature stores and with their leases, contracts, due to expire in the second quarter, we will not renew. As related to our future store opening plan, we plan to open two to three additional stores this year. Many of the new stores are opening in the near coming quarter will be in the Liaoning province, which will have more merchandise resources in our other two operating provinces Heilongjiang and Jilin. In Liaoning we have already assembled a regional team both for merchandising and operations. Having this team in place will allow us to open up additional stores without adding a large number of new hires.

In order to further improve our distribution network in Liaoning Province. We're planning on opening a new 19,000 square meter distribution center in Shenyang City, which will serve as a central location for our existing and future stores in Liaoning Province. We plan on opening this DC in this December at a total cost of over, approximately over US$1 million.

As QKL expands its market presence in northeast China we are uniquely positioned against our local competitors through our large in-store product offerings, strong supplier relationships, efficient distribution network and state-of-the-art IT system. We are comfortable with our opportunities in the second half of the year and believe we will see an improvement in operating expenses and profit growth for the coming quarter.

For the remaining two quarters of 2011, we believe our gross margin will remain stable in the 17% to 18% range. Operating expenses as a percent of total revenue will move back into 14% to 15% range and will return to profitability with net income as a percent of total revenue in the 2% to 3% range.

At this time, I will turn it over the call to Jerry Chen, our Chief Financial Officer who will review the financial results for the second quarter, Jerry.

Jerry Chan: Thank you Mike.

Revenue in the second quarter of 2011 increased 26.3% to US$83.5 million, from 66.1 million in the second quarter of 2010. Revenue performance reflects the growth of 33 comparable stores, which are stores that have been opened for a least one year before the beginning of the comparison period, or by April 1, 2010. As well as sales from the net opening of 18 new stores since April 1, 2010.

Same store sales of approximately 67.2 million in the second quarter of 2011, an increase of 7.6% from 62.5 million in the second quarter of 2010. The 18 new stores opened since April 30, 2010 generated approximately 14.1 million in the second quarter of 2011.

Gross profit increased 26.1% year-over-year to 14.6 million compared to 11.6 million in the prior year period. Gross margin for the second quarter of 2011 remained set (sp?) at 17.5%, an increase in gross profits are primarily attributable to the increase in net sales compared to the second quarter of 2010.

Operating expense increased 66.1% to 14.7 million compared to 8.8 million in prior year period. This was primarily a result of additional salaries, rent and utility expense also the hiring of more employees and operating costs related to the company's increased store count over the past year, as well as from pre-opening expense from five new stores opened in the second quarter of 2011.

The company reports a net loss of approximately $32,000 or -$2.001 per diluted share compared with net income of 2.1 million or $0.05 per diluted share for the same period in 2010. The decrease was due to higher selling expense related to new stores opening and higher staff costs in second quarter of 2011.

As of June 30, 2011 the company has US$36.0 million in unrestricted cash compared to 17.5 million as of December 31st, 2010 and no debt or bank loans.

The number of weighted average shares outstanding and a combination of diluted EPS, excluding the fair value of warrants increased 25.3% to 25.8 million in the second quarter of 2011 from 39.9 million in the second quarter 2010. The decrease is due to the fact that 7.3 million preferred stocks were not included in the combination of diluted net earnings per share as their effects would have been anti-dilutive since the company had a net loss in the second quarter of 2011.

Net cash provided by operating activities for the six months ended June 30, 2011 and 2010 were 26 million and 5.3 million respectively. The increase in cash provided by operating activities for the six months ended June 30, 2011 compared to the same period in 2010 primarily reflects net cash inflow caused by the decrease of inventories and decreased of other receivables and decrease of advances to suppliers. The decrease of inventories was caused by reducing the inventories on hand after the peak Chinese New Year season and the decrease of other receivables is largely attributable to the repayment of money from vendors.

Cap expenditure in the second quarter of 5.9 million, we expect our cap ex spending to trend lower into the 2 million range for the 2011 third and fourth quarter and our store opening to trend much lower than past quarters.

This concludes our prepared remarks for today. We appreciate your listening to our call and look for 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 sir. The question and answer session will be conducted electronically. If you'd like to ask a question you may do so by pressing the star key followed by the digit one on your touchtone telephone. If you are using a speaker phone please make sure that your mute function is turned off to allow your signal to reach our equipment. Once again, please press star, one on your touchtone telephone to ask a question and we'll pause a moment to assemble the queue.

And we will hear first from Jodi Dai with Global Hunter Securities.

Jodi Dai: Hi, thanks for taking our questions. Zhuangyi, Mike and Jerry (inaudible). Hi, so my first question is in regards to your same store sales during the quarter, it came in seems like closer to the lower end of your normal range, I was wonder what factors impacted the same store sales and what do you guys expect in the second half?

Mike Li: Jodi, I think the same store sales, or the dropping of the same store sales is mainly because of the more competition in Daqing area. We have, we operate 51 stores and one third of them is in our, 18 new stores are not operating more than one year and we have about 20 stores in Daqing area, so we have new (inaudible) coming in and the new (inaudible) of the city and also a new (inaudible) department store with a supermarket on the west (inaudible) of the city. That is really hurting us, but we were trying to make more promotional activities to draw the customer back. They were not, the customer were driven by price of course but also curiosity and make them always (inaudible) around in the new store, in the new shopping malls. But we are confident that we can have that momentum revived and we should have at least 8% same store sales in the future.

Jodi Dai: Okay thanks, that's helpful. And so secondly, I think you guys mentioned about a new Distribution Center in Shenyang. This is good news, I was wondering, could you remind us how much you spend for the first Distribution Center in Harbin and how many stores this new center in Shenyang will support?

Mike Li: I think we spent slightly over US$1 million for the Harbin DC and we believe we probably will spend the same equal or slightly higher than the Harbin DC for the Shenyang Distribution Center because the rent is slightly higher and so we have to retrain the staff and buy the (inaudible), buy the forklift and also you know they say, high duty shelves and also we have to implement a system. We plan to open that late December just before the winter comes.

Jodi Dai: So, I would imagine it would support just as much stores as the old center?

Mike Li: Yes, I think that DC, that 19,000 square meters DC will support at least 30 store, 30, 40 store.

Jodi Dai: Okay thanks and lastly before I jump back to the queue I was wondering so with the new Distribution Center construction in the pipeline, I was wondering what your cap ex plans for the second half of this year, thank you?

Jerry Chan: Okay, for the cap ex for the second half of this year, Distribution Center cost of around (inaudible) and we also have some cap ex related to the new store opening and it will consist of about 3 to US$5 million depending on the speed of our new store openings. So, I think the cap ex for the second half of this year will be around five to US$8 million depending on our speed of the opening new stores (inaudible) we have some remodeling of our old stores.

Jodi Dai: Thanks.

Operator: And ladies and gentlemen as a reminder that is star, one on your touchtone telephone if you would like to ask a question. And we will hear next from Howard Zhou with Roth Capital Partners.

Howard Zhou: Hey good evening, everyone, (inaudible). Just a few questions for you; firstly could you provide a bit more color on the performance of your new stores, recall you opened 18 since April last year. So how would you grade their performance, did it meet your original expectations?

Mike Li: It's not reaching (inaudible) expectations, those stores are all opened in small, emerging cities or small towns. It takes longer to (inaudible) a customer (inaudible) understand our (inaudible) modern store format and we are on the right track, we believe their future growth will be great.

Howard Zhou: Okay, got it. And then looking ahead to 2012 how many new stores do you plan to open right now? And also, do you think you have sufficient capital to support that kind of expansion?

Mike Li: (Inaudible) trying to open another 20 stores in 2012 and we are really finding the new locations in the three provinces right now. I think more than 10 of them already signed. We think we have (inaudible) enough money to open those new stores one, based on our healthy cash flow and also we can get higher lines from the local banks.

Howard Zhou: Okay, just curious, out of the 20 planned stores have you signed any lease yet? And also you mentioned potentially to be some debt borrowing; do you have any secure credit facility available?

Mike Li: Howard, you repeat again?

Howard Zhou: My question is first for the 20, you said you plan to open 20 new stores next year, have you signed any lease on them yet? The second question is: you mentioned that you probably will borrow some money from (inaudible) in addition to your internal cash, so have you secured any credit facility from bank yet?

Mike Li: Currently we have, already have 100 million RMBs committed from the (inaudible) Bank. That's about US$15 million. And yes.

Howard Zhou: Yes, I'm sorry go ahead.

Mike Li: And also I think we have already about 10 new leases for the next year already committed.

Howard Zhou: I'm sorry, ten new leases?

Mike Li: Yes, I mean location leases.

Howard Zhou: So officially signed, or just a oral commitment?

Mike Li: No, it's already signed.

Howard Zhou: Okay, ten, ten already signed?

Mike Li: Yes.

Howard Zhou: Okay, third question, moving on to the margin side, appreciate if you could provide some insight in terms of how we should model for your operating expenses? And given current inflationary environment do you see inflation a concern to your business and, in terms of the rental and salary have you seen any significant increase year-over-year?

Mike Li: I think inflation is there and (inaudible) help the retailer a lot. We found out that the customer, they were buying substitutes in the store trying to avoid the higher, increased cost of their products. But, so we believe that our same store sales will go up and the margin, you know, we should automatically pass the margins, pass the increased costs to our customer, but at the same time we're trying to get the new market, get the new store become profit and we feel in a period of pre-openings and give away a lot. But the overall gross margin should be stable or slightly going up.

Howard Zhou: Okay and then just one quick last question is could you tell us how many warrants are still outstanding there?

Mike Li: You mean warrants, right?

Howard Zhou: Yes.

Mike Li: We have slightly over 11 million warrants.

Howard Zhou: Okay, thank you for taking my questions.

Operator: And we will go next to James Fold with Fold Corporation.

James Fold: Good evening. Did I hear that you had closed three stores to date and I'd be curious if that is the case, where those stores are located?

Mike Li: Yes we closed three stores, one in Harbin, one in (inaudible), one in (inaudible). The Harbin store and the (inaudible) store are not performing very well, I mean they were making money at a store level but after the expenses of that quarter they become lost. That's lots of period of time and we do not see any good things about the two stores so we decide to close that. And in the (inaudible) store, it's a good location but it's just not our strategy. It's very small, very tiny it's only 400 space, it's like a convenience store. The three all, the contracts are all expired so we decide not to renew again.

James Fold: Are there any other stores that you're planning to close in the future?

Mike Li: Not for this year.

James Fold: Thank you very much.

Operator: And ladies and gentlemen as a reminder, that is star, one if you would like to ask a question. And we'll pause a moment to assemble the queue. And we have a follow-up question from Jodi Dai with Global Hunter Securities.

Jodi Dai: Hi, thanks for taking my follow ups. I was wondering because you guys mentioned during the quarter you saw increased amount of competition in the comparable stores and you also mentioned that the newer stores, the location for the newer stores is in the more remote areas and takes longer and more expense for the customers, to educate the customers, so I was wondering so for next year for the new stores, what's your strategy in choosing locations? Would you be more focused on, in the areas of more matured, with more matured customer base or maybe continue to find new locations in the remote areas? Thank you.

Mike Li: Yes, Jodi I think (inaudible)you saw the locations in the (inaudible) city and (inaudible) and they were performing well but they were matured stores. Since the current new stores have not been (inaudible) remote area but they were really (inaudible) small town or small city and they have great potential to become a good store even same store sales more than 10% after operating for seven, eight years. And, but it's just to start very hard, those customer were, in that kind of city they do not understand what is supermarket or what is the shopping idea in the supermarket. So it takes longer than (inaudible) city, that's what we face, I mean the problem we are facing right now. And I think we feel more than 50% of market share in (inaudible) city if we just have Walmart (inaudible) coming in, already there and also some local, I mean national competitors very strong but we have the (inaudible) brand already set up (inaudible) a long time ago, so that time will revive. People here (inaudible) they have curiosity, they want to shop in the new shopping area or shopping mall, they're trying to experience the new thing. So when they found out it's purely same product and same price or even we can provide a lower price they must come by to check out store. It's just a short period of time and we believe we can be a dominant position in (inaudible) city. But that is not only the strategy part, we will maintain a share in (inaudible) keep calculating the outside market share.

Jodi Dai: Okay. So, would you say the average spending levels for your newer stores is at about the same levels with the older comparable stores? The spending levels for the areas?

Mike Li : Yes, I think it's going up, but it's not dramatically, you know, the steel price going up so your shelving will go up and also the labor but it's not very high, not very obvious. But the rent in (inaudible) province is apparently slightly higher than (inaudible) province.

Jodi Dai: Okay thank you.

Operator: And our next question comes from Peter Siris with Hua Mei.

Peter Siris: Peter Siris. Mike, Jerry, Zhuangyi. I'm going to, I have a couple of questions. Let me first start with the Distribution Center. Mike, I didn't completely understand, the Distribution Center in Shenyang in how big compared to the Distribution Center in Harbin?

Mike Li: I will say it's half of the Harbin DC.

Peter Siris: Because the Harbin DC I think could handle like 150 to 200 stores, right?

Mike Li: Yes. If we operate several kinds of IT and equipment it can easily handle 150 stores.

Peter Siris: But you said the Distribution Center in Shenyang would cost the same as the Distribution Center in Harbin, even though it's only half the size?

Mike Li: They were functional same, (inaudible) DC but it's very hard to ship merchandise to Liaoning province from Harbin. It's not that efficient.

Peter Siris: I understand that, the question I'm asking is the cost, why is that Distribution Center, which is half the size costing the same as the Harbin Distribution Center? That was my question.

Mike Li: I think the field price go up for the past two years and high (inaudible) shelving is going up and also we have to implement a new software and also the rent is slightly higher than the Harbin DC. That's an approximate number, it's not finalized.

Peter Siris: Okay, I want to go back to the problem or the issue with the new stores that, those stores those stores are being opened in new areas and sort of country level cities as opposed to fill in stores. So how long do you think those stores are going to take to reach good profitability?

Mike Li: I think it's two to three years (inaudible).

Peter Siris: Okay so now following up on the last question, the new stores that you're going to open next year, are those also going to be in small markets?

Mike Li: I think so, that's how it's planned to be, open the stores in Tier three, Tier four city.

Peter Siris: So I love the stores in the Tier three, Tier four cities, I guess the question I had is, are we going to be looking at basically breakeven earnings for the next couple of years that you open all these stores or what's, you know, what should we be looking for in terms of earnings as you open stores in new markets?

Mike Li: I will translate for Mr. Wang. Mr. Wang explained the next half probably going to be stabilized this year because we opened new stores and they will not become mature so quickly to ramp up the profitability. So we believe the margin, the profit won't be much more better than this year. John believes when we have more and more comparable stores as a big block of the total store comps (sp?) then we will worry about margin. Don't worry about the (Inaudible) margin and net profits when we open 10 or 20 store.

Peter Siris: So is there a way to look at what the existing stores earned this year versus what the new stores cost you to open and operate?

Mike Li: I think we could know that.

Peter Siris: I mean it's fine with me if you open stores that are going to give us long-term growth, but investors look at also at earnings and you know, it's very hard to figure out what the earnings are here, I mean it's easy to see what the earnings are but it's hard to see what the earnings power is when you're opening all these stores so quickly.

Mike Li: Yes, Peter let me translate. Mr. Wang explained that it just takes about three years to make this company become bigger profit. To translate we are just facing the problem of climbing, you will find the new stores are not profit as you expected and also you are trying to get market share because some of (inaudible) take it, it's revenue and the margin and net profit, it's a revenue and net profit gain but we have to balance it and also, John said we could likely mention now that our old store performing as well as the new store performing to understand the format.

Peter Siris: Mike, but here's my point. I love these new stores, I visited many of them, I think that long term it will give you a blocking position in (inaudible) and this will be a great investment for you. I'm all for this, and I understand that small stores in new markets take longer to ramp up. I'm trying to understand what the earnings power of the company is going to be two to three years from now?

Mike Li: I think the new store will have to open, the performance for the next two years is a lot of element, we have to see how the, how quick the new stores become profit and I can't answer you this question right now. Maybe Jerry and I go back and work on the guidance and get back to you. But it's very hard to play a number here.

Peter Siris: Okay, well I just suggest for the future that maybe you guys could try to help us understand the model a little better.

Mike Li: Okay, maybe in the future we will provide performance of old stores and performance of the new stores.

Peter Siris: Great thanks.

Operator: And with no further questions at this time I would now like to turn the call back over to management for any final remarks.

Mike Li: Thank you all for participating on today's conference call. We look forward to providing you with additional updates on our business in future, thank you.

Operator: And that does conclude today's conference. We thank you for your participation.