QKL Stores, Inc.
Third Quarter 2011 Earnings
November 14, 2011

Operator: Good day, and welcome to the QKL Stores Third Quarter 2011 Earnings Conference Call. Today's conference 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 the QKL Stores Third Quarter 2011 Earnings Conference Call. On our call today is Mr. Zhuangyi Wang, Chairman and Chief Executive Officer; Mr. Jerry Chan, Chief Financial Officer; Ms. Fan, Chief Operating Officer; and Mr. Mike Li, 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 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 and the industry in general and in the Company's specific areas; inflation; changes in the cost 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 third 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: (Mandarin spoken)

Mike Li: Thank you, good evening.

Zhuangyi Wang: (Mandarin spoken)

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

Zhuangyi Wang: (Mandarin spoken)

Mike Li: Our third quarter results generally met our levels of expectations.

Zhuangyi Wang: (Mandarin spoken)

Mike Li: The total store sales were strong in the third quarter, increasing 26.5% to 82.1 million, from 64.9 million in the third quarter of 2010.

Zhuangyi Wang: (Mandarin spoken)

Mike Li: Of the 33 stores opened at least one year, we achieved same store sales growth of 9.3% on sales of US$67.5 million.

Zhuangyi Wang: (Mandarin spoken)

Mike Li: This store growth was also driven by in-store promotional events, such as store anniversary celebrations.

Zhuangyi Wang: (Mandarin spoken)

Mike Li: Such activity allowed us to increase our membership club, it continues to grow and now has (inaudible) over 650,000 members.

Zhuangyi Wang: (Mandarin spoken)

Mike Li: It is worthwhile to point out that 62% of QKL stores total revenue was derived from members of our customer club. This is our highest level yet and highlights the loyalty of our growing consumer base.

Zhuangyi Wang: (Mandarin spoken)

Mike Li: While we were active with the level of promotional activities among our existing store opened at least one year, the growth margin performance of these stores was a respectable 18%.

Zhuangyi Wang: (Mandarin spoken)

Mike Li: Our older stores outperformed our younger stores opened less than a year.

Zhuangyi Wang: (Mandarin spoken)

Mike Li: Many of our new store locations are in new markets, which typically take longer, on average, to ramp up sales and profit. Through our sales and marketing efforts, we believe our market share will build over time as the smaller market consumer becomes more educated and increasingly understands our product quality, assortment and the benefits of our modern grocery store concept. As this occurs, we expect these locations to become more productive and generate benefits from higher levels of sales, gross margin and profit.

Zhuangyi Wang: (Mandarin spoken)

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

Mike Li: Thank you, John, and thank you, everyone, for joining our call today. As of September 30, 2011, we operated 32 supermarkets, 16 hypermarkets, four department stores and two distribution centers, one in Daquing and one in Harbin. The average size of our supermarkets is 2100 square meters in sales area, while our hypermarket typically averages approximately 4700 square meters in sales area. The performance of our existing stores opened for more than a year continues to show stable gross profit margins of 18%, which helps to support the ramp-up period of our newer stores, which typically take longer to reach profitability. In the first nine months this year, we have opened 13 new stores, with approximately 98,600 square meters of space, in aggregate.

We had some notable accomplishments in the third quarter. We started construction of our new Shenyang distribution center in the third quarter and we are going to open this new Shenyang distribution center in late November. This 9,000 square meter facility, which houses non-food and grocery products, will serve as a central location for our two existing stores, as well as future stores in Liaoning Province. This new DC has a budget of (inaudible) or slightly less than US$800,000 (ph). We believe this new DC has the potential to support 30 to 40 stores in Liaoning Province and the Jilin Province in the future.

We opened up two new stores in the third quarter and did not close any stores. The first store is a 15,000 square meter hypermarket in Da'an, which is in the Jilin province. The second store opened is a 6,600 square meter supermarket in Zhalannuoer County, Inner Mongolia. Approximately 20 of our 53 total stores have been opened less than a year. The sales contribution of these new stores was less expected in the third quarter, with an average gross margin in the 13 to 14% range.

Given that most of our selling expenses are fixed or semi-fixed costs, including utility expenses, store rental and labor costs, our operating margin turned out higher than expected. We remain focused on providing value-added promotional programs to further boost the sales performance of the newer stores. For example, we have planned—we have 13 store anniversary events planned in the fourth quarter, which entails a number of expenses, and there will be a great marketing event, promotional catalogs and activities throughout Christmas sales and New Year sales. As we continue to run promotions, we will appropriately monitor the expenses of each promotion to ensure a favorable return.

When comparing our operating expenses in the third quarter over the prior year, there was an increase in preliminary expenses that were offset by the increase in inflation and from higher employee expense. We have (inaudible) compensation levels of certain store employees to enormously improve our competitiveness of our pay packages.

With respect to our pricing strategy, we are not preparing to raise prices for our customers in the fourth quarter. This said, we have a number of exciting marketing initiatives planned for the Christmas and New Year holidays. This includes a series of promotional (inaudible) that will run from early December to early January.

We will continue to carefully monitor the performance and efficiency of each and every one of our stores. In the fourth quarter, we believe our gross profit margins will be in the range to 17 to 17.5%, and selling expenses for sales will be in the range of 14.5% to 15%.

We plan to open one more store by the end of December, which will bring our total store count for 2011 to 14 locations. The new store we intend to open is in Zhaoyuan (ph), located in Daqing. The floor space of this new location is expected to be approximately 2400 square meters. We do not plan on any store locations closing in the coming quarter.

As we slow the pace of our store openings and remodels, and largest costs related to the DC (inaudible), we expect our cap ex in Q4 to be lower than the prior quarter. For the fourth quarter, we expect cap ex to be in the range of US$2-3 million, compared to US$2.7 million in the 2011 third quarter.

Our balance sheet is strong, with a strong cash position, low-level debt and a healthy flow of cash from operations. We continue to make meaningful progress with our store operations and believe this will result in a business that will result in greater sales and profit over time.

At this time, I will turn the call to Jerry Chan, our Chief Financial Officer, who will review the financial results for the third quarter. Jerry.

Jerry Chan: Thank you, Mike. Revenue in the third quarter of 2011 increased 26.5% to $82.1 million, from $64.9 million in the third quarter of

2010. Revenue performance reflected the growth of 33 comparable stores, which are stores that have been open for at least one year before the beginning of the comparison period, or by July 1, 2010, as well as sales from the opening of 20 new stores since July 1, 2010. Same-store sales were approximately 67.5 million in the third quarter of 2011, an increase of 9.3% from the 61.7 million in the third quarter of 2010. The 20 new stores opened since July 1, 2010 generated approximately 14.6 million in the third quarter of 2011.

Gross profit increased 25.7% year-over-year to 14.2 million, compared to 11.3 million in the prior year period. Gross margin for the third quarter of 2011 was 17.3%, slightly decreased from 17.4% in the prior year period. The increase in gross profit was primarily attributable to net sales increased by 17.2 million in the third quarter of 2011, compared to the third quarter of 2010.

Operating expenses increased 54.7% to $15.4 million, compared to $9.9 million in the prior year period. This was primarily a result of additional salary, rent and utility expenses, and the hiring of more employees, also other operating costs related to the Company's increased store count over the past year, as well as from pre-opening expenses from two new stores opened in the third quarter of 2011.

The Company reported a net loss of approximately $0.8 million or $0.03 per diluted share, compared with net income of $1.0 million or $0.03 per diluted share for the same period in 2010. This decrease was due to higher selling expenses related to new stores opening and higher staff costs in the third quarter of 2011.

As at September 30, 2011, the Company had $28 million in unrestricted cash, compared to $17.5 million as of December 31, 2010. The Company had $3.1 million short-term bank loans as of September 30, 2011, compared with no debt or bank loans as of December 31, 2010.

The number of weighted average shares outstanding used in the computation of diluted EPS, excluding the fair value of the warrants, decreased 19.2% to 31.1 million in the third quarter 2011, from 38.5 million in the third quarter of 2010.

Net cash provided by operating activities for the nine months ended September 30, 2011 and 2010 was 47.4 million and 7.3 million, respectively. The increase in cash provided by operating activities for the nine months ended September 30, 2011, compared to the same period in 2010, primarily reflects net cash inflow caused by the increase in accrued expenses, decrease of inventories and decrease of other receivables. The increase in accrued expenses was in line with our increase in operating expenses due to inflation and new store openings. The decrease of inventories was caused by reducing the inventory on hand after the peak Chinese New Year season at the beginning of this year and the decrease of other receivables is largely attributable to the repayment of money from vendors.

Cap ex expenditure in the third quarter was (inaudible) million. We expect our cap ex spending to trend lower into the 2 to 3 million range for the 2011 fourth quarter, because our store openings trend much lower than cost per quarter.

This concludes our prepared remarks. We appreciate your 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. The question and answer session will be conducted electronically today. 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're using a speaker phone, please make sure your mute button is turned off to allow your signal to reach our equipment. Once again, it is star, one for questions, and we'll pause for just a moment to assemble the queue.

We'll take our first question from Liv Pierce, Roth Capital Partners.

Liv Pierce: Good evening. Thank you for taking my questions. One of the things that I was curious about is if you could break apart the membership growth that you're seeing at new stores versus comp stores, and then the revenue from the membership that you're seeing in each of those buckets. I think you gave total revenue from membership, but I'm wondering if we could kind of get a greater picture, a better picture from the new stores. Thanks. I have some additional questions, but let's start with that.

Mike Li: Hi, Liv. I think the membership for the new stores is relatively low, because when we have a new store open, usually we'll help the customer around that area to apply membership for QKL, but sometimes they are not aware of the importance of having the membership card with QKL, so (inaudible) enough interest to apply one. But, when we open the store, they find out they get membership price, you know, (inaudible) items at a lower price than compared with the regular price in the store, they know the importance to have a membership card in their wallet if they, you know, visit the store or twice a week or three times a week. So, the number that we have in our membership in the new stores is really growing slowly, not—I will say they will start at 30% or 40% and the number will go up, let's say, three quarters in a row to 60% or 70%.

Liv Pierce: Okay. So, Mike, maybe another way to look at it is let's talk about the stores that were opened in fiscal '10 and how those stores are performing, in terms of reaching mature store productivity and what's the membership look like in those stores? If you could help us see how the ramp, you know, what kind of ramp we should be expecting, I think that would be immensely helpful.

Mike Li: Yes. I'm sorry, I don't have the information at hand. Jerry and I have to go back and look into those memberships, you know, the information in the new stores, but I will say they were not high as mature store.

Liv Pierce: Okay. Remind me how many stores you opened in fiscal '10. I believe it was maybe nine stores, right?

Mike Li: Right, we opened nine stores last year.

Liv Pierce: Right, okay. So, let's just talk revenue and margin from those stores. From a revenue perspective, how are those stores ramping?

Mike Li: You mean the nine stores we opened last year?

Liv Pierce: Right, right.

Mike Li: Maybe Jerry can find you the information about the nine stores we opened last year later.

Liv Pierce: Okay, or maybe we can talk about that off line. Do you have plans or can you give us some guidance on new store openings for next year? I'm not sure if you've already given that or not.

Mike Li: We plan to open 10 stores in 2012.

Liv Pierce: Okay, which is down … (cross talking).

Mike Li: We have enough cash to do that because of our cash flow generated from the operations, and also the credit line from the bank.

Liv Pierce: Okay. Then, Mike, what's the breakdown of these stores? Are they going to be primarily grocery, hyper? What's the distribution between your … (cross talking).

Mike Li: Most of them should be hypermarkets and supermarkets.

Liv Pierce: Okay. The department stores as a group, how are they performing versus the grocery hypermarket?

Mike Li: You mean the difference between the hyper and super?

Liv Pierce: No, no, no, the department stores, I think you only have four department stores opened and just how is their performance? I realize it's a smaller component of your business, but just how that … (cross talking).

Mike Li: Yes, I think maybe (inaudible), we have three stores in that city, two supermarkets, one department store. The department store is not, you know, ticking up a lot, but one of the grocery stores in the other, you know, basement, in the other ground floor of the department store, we make some change for that store. We lowered the price nature. Because when we opened it, we initially planned to make a higher end store, grocery store, in the nice department store, but we found out it's not right, so we were trying to change the pricing nature of that store and hoping that store will come back quickly. The other one, we still have some, you know, competition across the street, but I do not believe it is a competition problem, rather than the customers', you know, buying habits.

Liv Pierce: Okay. Then, finally, and then I'll get back in the queue, can you talk to us about what events, like give us a little more color on the events that you're planning? Are these events that you've done before and the customers recognize? Just, I think, any kind of color would be helpful. Thanks.

Mike Li: I'm sorry, Liv, would you please repeat again?

Liv Pierce: Sure. You said you've got several events planned from December through early January, you know, just a little more information about what type of events. Are they events that you have done before so the customer is familiar with them? Are they new events? Are they events that competitors do? I'm just trying to see perhaps what you're point of view is going to be, you know, differential and the value. Thanks.

Mike Li: Right. As you know, we have one Carrefour open earlier this year in Daquing, and we have another local competitor (inaudible) that has another store in the west of the town, of the city of Daquing, so we have awareness of the, you know, fear, competition in Daquing City, because we have most of our old stores in Daquing. That's why we have planned nine store anniversaries in the first quarter, most of them in Daquing City or Daquing area. But I think that's the reason, to drive the same-store sales going up. So, we're trying to do the same thing in the Q4. We've planned 13 store anniversary events in the fourth quarter, I would say in November and December, and that's a very big event. I mean, two or three stores maybe do it at the same time. Also, we have catalogs related to the Chinese New Year, not Chinese New Year, just New Year and Christmas holidays. Usually, we sell, you know, four weeks in advance, three weeks in advance, two weeks in advance of the holiday different items, different merchandise, maybe, you know, battings, ribbons, you know, non-food, four weeks, three weeks ago, before the holidays, and prepare other merchandise two weeks, and we will focus to sell the customer fresh, mainly fresh, one week or, you know, three/five days in advance of the holidays. Most of the key catalogs, we already planned and already have the merchandise fixed in our catalogs, and we will run that from early December to early January, four or five weeks in a row.

Liv Pierce: Okay, all right. That's helpful. I'll get back in the queue. Thank you so much and good luck.

Mike Li: Thanks for calling.

Operator: As a reminder, if you'd like to ask a question on today's call, it is star, one. If you're using a speaker phone, please make sure your mute button is turned off to allow your signal to reach our equipment. Once again, that is star, one for questions.

We'll take our next question from Peter Siris, Huamei 21st Century.

Peter Siris: (Mandarin spoken)

Zhuangyi Wang: (Mandarin spoken)

Peter Siris: Mike, Jerry, how you guys doing?

Mike Li: Hi, how are you are?

Zhuangyi Wang: (Mandarin spoken)

Mike Li: Zhuangyi says you are coming to China.

Peter Siris: No, I was in China, but he wasn't around, so I missed him, but I'll come back.

Mike Li: (Mandarin spoken)

Zhuangyi Wang: (Mandarin spoken)

Mike Li: We welcome you, old friend.

Peter Siris: (Mandarin spoken). I want to ask about the strategy of opening all these stores in the sort of far-away places that are taking longer to ramp up. What's the strategy, you know, why are you opening your stores in

Inner Mongolia and all these far-away regions, when they seem to hurt short-term profits?

Mike Li: I think we were not trying to open the store far away from our, you know, headquarters at Daqing. It just happened, the location. We still believe those stores, you know, in a bad location or in a remote area, they were just like other, you know, tier-four, tier-five cities, they just need time to get used to the new concept of market—I mean, the customer has to, you know, understand for a while, then they will realize the importance of the (inaudible), and we have to convince them price, offer them everything. So, it takes time, but … (cross talking).

Peter Siris: No, I understand, Mike. I understand, but the question I'm asking, or maybe I'll it differently. The question I'm asking is this. If you open more stores in your core areas, those stores would do better faster. So, there is obviously a strategy of opening stores in, you know, more far-away areas, and I want to understand what the—and you know when you open these stores that they're going to take longer to ramp up. So, the company's made a decision to have lower short-term profits in exchange for having more geographic diversity, and I'm curious, I want to understand what the strategy is there.

Mike Li: I think our strategy is not trying to open the store far away from our headquarters. I think the strategy is we're trying to have new stores in the—we'd rather have new stores in a brand new market, brand new city (inaudible), instead of, you know, more penetration in existing markets.

Peter Siris: No, I understand that, Mike, but I'm asking why do you think that's the right strategy. That's what I'm asking.

Mike Li: Because we think the opportunities in the tier-four, tier-five cities are very urgent. We have to have them in the near one, two years to capture the market.

Peter Siris: Because if you don't get there, then somebody else will?

Mike Li: Yes, we believe that, or there will be some, you know, existing company in the tier-four, tier-five city growing bigger.

Peter Siris: So, as you get the—how much lower are the margins for—in these tier-four, tier-five cities, are the margins lower or are the costs higher, because the sales haven't ramped up fast enough?

Mike Li: I think the margin is low. First, for the pricing strategy, we had to lower the price a little bit, because we marked, you know, different prices in different cities for one item. If you were in a tier-five city, we have to lower the (inaudible) price a little bit. The second is we have promotions and a series of catalogs to increase the sales to make, you know, customers feel we are the cheapest store in the city. So, that will lower our gross margin. For the new stores, we just calculated, you know, 20 stores we operated less than year, our average margin is 13.5 to 14%.

Peter Siris: That's a pretty dramatic difference. Do you expect those stores to go back to the 17 or 18% margin as they mature?

Mike Li: Yes, yes. Yes, we believe they will be the key driver for our Company in the future, but it takes longer than we expected.

Peter Siris: One more question. By opening stores in all these tier-four and tier-five cities, do you think that this gives you the ability to discourage other competitors from coming into the market or does this give you long-term extra, you know, buying power, marketing power? What's the long-term strategy?

Mike Li: I think that's right, because in the northeast part of a China, the international players, the international market, they all focus on the tier-three cities, tier-two, tier-three cities, and we're trying to widen the competition, so we opened stores in tier-three, tier-four and tier-five, and in the tier-three cities we might have, you know, Wal-Mart or Carrefour operate in the same market, just like Daquing, but we're really trying to beat them with more volume, more sales volume, especially in the fresh department, and we're trying to operate more flexibly in the fresh area. In the tier-four and tier-five cities, there's no way for the international market to come in. There will be some existing chains, you know, five stores in one city, or eight stores in one area in Heilongjiang or Jilin province, but we're trying to have a better look store to compare with them, and also we're trying to have more variety and a cheaper price to compete with them. So, that's our strategy to find a location.

Peter Siris: And when will we see—I mean, I think the strategy on a long-term basis makes a lot of sense to me. The question I want to know is when are we going to start to see profit from all these stores that you've opened?

Mike Li: Usually, it takes one year to one-and-a-half years to, you know, ramp up the sales and profit, but the tier-four, tier-five city store, I would say takes longer, maybe two to three years.

Peter Siris: And your store opening plan for the next 12 months is going to be what?

Mike Li: Ten, 10 stores.

Peter Siris: Mostly in … (cross talking).

Mike Li: Most of them in brand new markets. One of them is in Daquing, we already signed.

Peter Siris: Great. Thanks and I look forward to coming and visiting.

Mike Li: Yes, yes, you're welcome.

Operator: As a reminder, it is star, one if you'd like to ask a question on today's call. Please remember, if your phone is on mute, please turn your mute button off to allow your signal to reach our equipment. Once again, that is star, one for questions.

We'll take our next question from James Fuld, who's a private investor.

James Fuld: Good evening, nice to hear your voices. Can you tell me why there are 31 million shares and how the preferred share count is calculated?

Jerry Chan: You mean the basic accounting share number?

James Fuld: The basic number of shares has been reduced to 31 million from 38.

Jerry Chan: This is because (inaudible) basically, we have 31 million shares for the last quarter and we have also around 6.9 million of preferred stock to be convertible into the common stock, and that's why we have (inaudible) million common stock in the (inaudible) quarter of 2010. However, for this quarter, because we had a net loss (inaudible), the dilutive effect of the preferred stock, it had to be added for (inaudible). That's why we only count the 31 million ordinary shares in the computation of our EPS.

James Fuld: When does that conversion feature cease? When must the shareholder convert?

Jerry Chan: Can you repeat the question?

James Fuld: Yes. There are 6.9 million convertible preferred shares. Is there a time limit for when they must convert? Can they be redeemed at all at any time?

Jerry Chan: No, that's not happening for us, because (inaudible) converting into our common stock (inaudible).

James Fuld: For next year, you've said you're going to open 10 new stores. Can you give us an idea as to capital expenditures required for those 10 stores?

Mike Li: The capital expenditure for each store is around US$1.5-2 million, and for 10 stores, I think it's approximately US$18 million.

James Fuld: Thank you, and one last question. The 33 comp stores, can you tell me how many square meters those add up to?

Mike Li: I'm sorry, we can't tell you the numbers right now. Maybe I'll send you later.

James Fuld: That would be great. Thank you very much.

Mike Li: Yes, thank you.

Operator: As a reminder, it is star, one for questions. At this time, we have no further questions in the queue. I'd like to turn the conference back over to management for any additional or closing 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. Thanks.

Operator: This concludes today's conference. We thank you for your participation.