QKL Stores, Inc.
Fourth Quarter 2010 Earnings Conference Call
March 31, 2011

Operator: Good day, everyone, and welcome to today's QKL Stores Fourth Quarter 2010 Earnings Conference Call. Today's call is being recorded.

I would now like to turn the conference over to Mr. Bill Zima, ICR. Please go ahead, sir.

Bill Zima: Thank you, everyone, and welcome to QKL Stores Fourth Quarter 2010 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 Li, Investor Relations Officer, who will translate for Mr. Wang.

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 respective results. Those risks include, among other things, the 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 fourth 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.

Zhuangyi Wang: (Mandarin spoken)

Mike Li: Thank you, Bill. Good day, everyone.

Zhuangyi Wang: (Mandarin spoken)

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

Zhuangyi Wang: (Mandarin spoken)

Mike Li: We were pleased with our fourth quarter results, which exceeded our internal projections and resulted in the following sequential improvements over the third quarter.

Zhuangyi Wang: (Mandarin spoken)

Mike Li: Our gross margin performance exceeded 18%, as we benefited from healthy same store sales.

Zhuangyi Wang: (Mandarin spoken)

Mike Li: And also contributed due to the larger store format of many of our stores and our new distribution center.

Zhuangyi Wang: (Mandarin spoken)

Mike Li: We finished the year operating a total of 43 market locations; that's 29 supermarkets, 11 hypermarkets and three department stores.

Zhuangyi Wang: (Mandarin spoken)

Mike Li: As we enter 2011, we believe the northeast China region will continue to benefit from solid economic growth, increased urbanization and growing levels of disposable income, which bodes well for our existing retail stores and new stores we plan on opening.

Zhuangyi Wang: (Mandarin spoken)

Mike Li: We have already opened six new stores in the first quarter and plan to add 12 new store locations for an aggregate total of approximately 70,000 square meters of space in 2011.

Zhuangyi Wang: (Mandarin spoken)

Mike Li: We believe our full year gross margin trends can gradually increase from current levels as we benefit from greater sales of non-food items, a larger size store format, bulk buying power, greater private label sales and the opening of our second distribution center.

Zhuangyi Wang: (Mandarin spoken)

Mike Li: We also will continue to focus on minimizing our expenses to generate additional profit growth opportunities.

Zhuangyi Wang: (Mandarin spoken)

Mike Li: As we continue to benefit from solid sales within our existing store locations and our new stores come on line, and continue to do so in the coming months, we expect to see significant increases to our revenues and profit.

Zhuangyi Wang: (Mandarin spoken)

Mike Li: We believe our initiatives will position QKL Stores as the market leader in the northeast of China and that 2011 will be our best year yet.

Zhuangyi Wang: (Mandarin spoken)

Mike Li: We believe QKL will be the best year in 2011.

Zhuangyi Wang: (Mandarin spoken)

Mike Li: At this time, thanks for all your help and I would like to turn the call over to our Chief Operating Officer, Mr. Alan Stewart, and Mr. Jerry Chen, our Chief Financial Officer, who will discuss the Company's fourth quarter financial highlights, as well as our strategy initiatives.

Alan Stewart: Thank you, John, and thanks everyone for joining our call today. 2010 was an eventful year for QKL Stores and we finished the year with a larger number of stores and a solid revenue growth, when compared to 2009. I believe our execution in the fourth quarter was solid and we are setting the stage for increased top and bottom line growth in the coming year. At the same time, we remain focused on striking the right balance of ensuring that new stores are brought on line, while also ensuring solid revenue and margin performance within our existing store locations.

Along with same store sales performance with our existing stores, we saw a nice bounce back from our third quarter performance with a 9% growth, when compared to the prior year. This reflected the growth of 31 comparable stores. The drivers of this growth were due to better seasoned management, higher basket sales and better promotions.

At the end of 2010, we operated 29 supermarkets, 11 hypermarkets and three department stores, with two distribution centers, one for groceries and non-food and the other for fresh. We ended the year with 43 locations, closed two stores in 2010, due to the expiration of lease contracts. The aggregate square meter total of our 43 supermarket and hypermarket locations at year end totaled 226,000 square meters. Of the nine new store locations added in 2010, two were supermarkets and six were hypermarkets, which is in line with our trend to open more larger box hypermarket stores which generate more volume and higher margin, on average, when compared to our smaller supermarkets. Our new stores continue to come on line in a more orderly fashion. In the fourth quarter, we opened up five new store locations.

Making improvements to our logistics and information systems to support our supermarkets is critical to our success. The opening of our new distribution center earlier in 2010 was instrumental in moving forward with our store opening plans. We are running more of our grocery and non-food items through this new facility, which has facilitated our store opening plan, while also contributing to the improved gross margins that we experienced in the fourth quarter. At the end of 2010, we had a total of approximately 3,500 SKUs in the warehouse, up from 3,000 in quarter three. We intend to add another 1,000 SKUs, bringing the total to 4,500 for storage by the end of 2011's first quarter. Thus far, in 2011, we opened up another six locations, and we have another six stores that we expect to be opened by the end of the second quarter. This allows us to easily meet our revised projection of 12 new stores and 70,000 additional square meters of retail space.

As we continue to increase our overall store base, we are analyzing their performance to ensure the expenses are minimized and profit margins are optimized. We are closely monitoring the performance in our stores to ensure that all points of execution are achieved. This is measured in several ways, including private label performance, a broader SKU assortment, an actively growing customer rewards program, and keeping labor costs in line with our growth. These endeavors should further strengthen our overall financial performance and market position.

Our geographic expansion remains in the three northeastern provinces and Inner Mongolia, where there is an emerging market for our retail operations and where competition is limited. It also benefits from rapid economic growth, urbanization and increasing disposable income.

Decreasing our product costs related to origin sourcing, further maximizing our distribution centers, expanding our private label sales and improving our customer loyalty program are core areas in which overall profitability can grow. Additionally, the offering of more self-prepared foods, like the bakery and flour, and more private label goods which have higher gross margin will allow us to increase the overall profit margin.

Through the execution of the preceding initiatives, we believe that 2011 can be a record year for QKL Stores.

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

Jerry Chan: Thank you, Alan. Revenue in the fourth quarter increased 17.3% to $85.8 million for the three months ended December 31, 2010, from $73.2 million for the three months ended in the same period of 2009. The 31 comparable stores, which are stores that have been open for at least one year, generated sales of approximately $73.8 million in the fourth quarter of 2010, an increase of 8.7%, compared with $67.4 million in the fourth quarter of 2009. Same store sales increase reflects the opening of 12 new stores since October 1, 2009. These 12 stores generated approximately $12.5 million of sales in the fourth quarter of 2010, compared to $2.3 million for the three new stores opened in the fourth quarter of 2009. The number of stores, including supermarkets, hypermarkets and the department stores, at the end of the fourth quarter was 43, compared to 36 in the prior year's period.

Gross profit increased 18.6% year-over-year to $15.4 million, compared to $13.0 million in the prior year period. The increase in gross profit was primarily attributable to the increase in the net sales over the prior year period. Our gross profit also benefited from our new distribution center that enables us to purchase larger orders from vendors at lower prices and thus reduces our cost of goods sold. Gross profit for the fourth quarter of 2010 was 18.0%, compared to 17.8% for the fourth quarter of 2009.

Our fourth quarter operating income decreased to $2.8 million, or 3.2% of sales, from $3.4 million, or 4.6%, in the fourth quarter of 2009.

Selling expenses increased by 31.7% to $10.5 million or 12.3% of total revenue in the fourth quarter, from $6.1 million or 11.0% of total revenue in the prior year period.

General and administrative expenses increased to $2.1 million, or 2.5% of net sales, from $1.6 million, or 2.2% of net sales, in the prior year period.

Operating expenses increases were primarily a result of additional salary, rent and utility expenses, also the hiring of more employees and other operating costs related to the Company's increased store count over the past year.

Fourth quarter net income was approximately US$2.4 million, compared with $12.1 million for the three months ended December 31, 2009. Excluding changes in the fair value of warrants, adjusted net income for the three months ended December 31, 2010, was $2.4 million, or $0.06 per diluted share, compared to $2.6 million, or $0.07 per diluted share, in the previous prior year.

As of December 31, 2010, the Company had $17.5 million in unrestricted cash, compared to $45.9 million as of December 31, 2009, and no debt or bank loans.

The total inventory position at the end of the fourth quarter was $44.5 million, compared to $24.7 million at the end of December 2009.

Looking at our full year 2010 results, net sales increased by $50.8 million, or 20.5%, to $298.4 million, from $247.6 million for fiscal 2009. Gross profit was increased by 9.3 million, or 21.2%, to 52.9 million, or 17.7% of net sales, in fiscal 2010, from 43.6 million, or 17.6% of net sales, in fiscal 2009. The change in gross profit was primarily attributable to the increase in the full year net sales.

The provision for income tax was 3.4 million in full year 2010, compared with 3.8 million in full year 2009. Excluding the impact of changes in the fair value of warrants, our effective rate was 26.0% for fiscal 2010 and 2009.

Net income was 17.4 million in fiscal 2010, compared to a net loss of 24.6 million in fiscal 2009. Excluding changes in the fair value of warrants, adjusted net income for fiscal 2010 decreased 11.3% to 9.6 million, or $0.24 per diluted share, from 10.8 million, or $0.34 per diluted share, for fiscal 2009.

Looking ahead to the full year 2011, we plan to open 12 new store locations, comprised of hypermarkets, supermarkets and department stores, having in the aggregate of approximately 370,000 rentable space. Of this total, six stores have already opened in 2011 first quarter and we expect the other six store locations to open by the second quarter.

This concludes our prepared remarks for today. 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. If you would like to ask a question, please 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 your mute function is turned off to allow your signal to reach our equipment. Once again, if you would like to ask a question, please press star, then one.

We'll take our first question from Howard Zhou with ROTH Capital Partners.

Howard Zhou: Hello, everyone. Congratulations on the strong quarter. My first question is regarding cash spending. It looks like you spent over 20 million on acquisitions in the first quarter; you bought the operating rights of seven stores. I'm just curious to how long, on average, are these operating rights you bought; and, also, could you provide some color on why you want to buy instead of leasing; and looking forward, what is your plan in terms of acquisitions for 2011?

Jerry Chan: First, actually, Howard, the operating right is just to buy out the former player, but we'll have 15-year to 20-year contract, and these contracts are with the developer or landowner. Also, when we see this location, it's located on the center of a business street of a county level city, and in the county level city in the northeast of China, the businesses are very concentrated, it's just 1,000 meters away from south to west for this street. Usually, you have one location at different sites. In the business street, you dominate the market share. Clearly, that's why we, you know, buy the former player out instead of trying to leasing another one, because there's no alternative to lease another one on the same street, in the same, you know, business environment.

Howard Zhou: Okay, and should we expect more acquisitions to come in 2011?

Jerry Chan: For this 2011 store, we don't have any business acquisition right now, for the 12 stores.

Howard Zhou: Okay, okay. Secondly, there was a significant increase in inventory and other receivables, so could you comment on the sharp increase in working capital and what should we expect for the next few quarters?

Operator: Thank you. Once again, if you would like to ask a question, please press star, then one.

Howard Zhou: Hello?

Jerry Chan: Yes, hello.

Howard Zhou: Hello? Can you hear me?

Operator: Yes, sir, your line is open.

Howard Zhou: Yes, I just asked a second question. Do you have to repeat it or you already got it?

Jerry Chan: I already got it, yes.

Howard Zhou: Okay.

Jerry Chan: This year, in terms of our current working capital, because, first of all, the increase in other receivables, which is a result from increased loans to the vendors to ensure we keep a level of merchandise through the peak Chinese New Year season, and also we have the increased inventory because we have more stores this year, and the restocking inventory for our new stores opened in January 2011, and remember that we have five new stores in early 2011, so that's why we consume a lot of working capital.

Howard Zhou: Okay. So, would it be reasonable to assume at least the working capital will come down in the next few quarters?

Jerry Chan: Yes, I think so, because most of the working capital, the loans to the vendors will be returned in the second quarter or in the third quarter, so that our working capital will be increased or our cash will increase again.

Howard Zhou: Yes. More importantly, I just want to know, do you think that you would have enough cash to support the planned store opening, like 12 stores for this year?

Jerry Chan: Yes. Howard, the six stores we opened in January into March, actually, a lot of the expenses has already accrued in the fourth quarter of last year, and on top of the six, six more stores are under construction. I believe some of the pre-opening expense, you know, like travel expense, is already highlighted in the fourth quarter of last year.

Howard Zhou: Okay.

Jerry Chan: So, we have enough for the 12 stores this year.

Howard Zhou: Okay, that's good to know. Then, lastly, just a final question, could you talk about the trend of your same store sales and the gross margin, what should we look for in 2011?

Alan Stewart: Yes, Howard, the trend is going to be positive, there's no question about that. You also have to understand that the stores that were opened in the fourth quarter came into Chinese New Year. That's the best time to open up stores, because you get an influx of people coming into the stores. So, the stores that opened in the fourth quarter were essentially all profitable in the Chinese New Year and will continue to be profitable as we're coming into the second quarter. I think that the trend so far—and I know you visited a couple of the stores very early in their openings, but the stores are coming on well, they have better trained people, because we have a bigger base now to draw personnel from.

Howard Zhou: Okay, that's helpful. It answered it very well, thank you. I will now go back to the queue. Thank you.

Operator: Thank you. Once again, as a reminder, if you would like to ask a question, please press star, then one. We will pause for just a moment.

As a final reminder, if you would like to ask a question, please press star, one.

It appears there are no further questions at this time. I would like to turn it back over to you for any closing or additional remarks.

Alan Stewart: Let me just say thank you for joining us. I know it's early in the morning, but we do appreciate it, and the numbers are out on the wire already. We look forward to providing some first quarter guidance in the next few weeks and I think everybody will be pleased with it.

Operator: Thank you. That does conclude today's presentation. Thank you for your participation.