

# Chow Tai Fook Jewellery [1929.HK]

## Q4 FY2018 Performance Confirms its Leading Role. Upgrade to BUY.

Chow Tai Fook Jewellery (CTF) reported encouraging Q4 FY2018 operating figures (covering Jan-Mar 2018) after market close on 16 Apr 2018. The Company had good retail sales performance in both mainland China, and HK/Macau (RSV up 13% & 11% YoY, respectively). The figures were better than Q3 FY2018, suggesting CTF has resumed its growth momentum in the HK/Macau segment. We expect the positive momentum to continue, especially for HK/Macau. We lift our earnings forecast for FY19E/20E by 5%/9%, respectively. Our new earnings forecast implies an EPS CAGR of 25.7% in FY2017-FY2019E. We also raise our TP from HK\$9.20 to HK\$11.10, as our target FY2019E PER is raised from 20x to 23x after considering the macro-environment, peer performance and stronger EPS growth outlook. We believe CTF, as the leader in the Chinese jewellery segment, with a much bigger scale than its listed peers, now deserves a higher premium. We upgrade our rating from HOLD to BUY, as we expect there to still be trading opportunities within a 12-month horizon.

### Investment Highlights

- Growth Momentum Resumed in Hong Kong & Macau.** CTF reported 11% YoY growth in Retail Sales Value (RSV) for the region in Q4 FY2018, which was notably better than Q3 2018 (+0% YoY). We believe the reasons behind the increase are that (1) CTF stopped conducting big sales during Jan-Mar 2018; (2) there was a strong contribution from mainland Chinese visitors, as the percentage of retail sales transacted in UnionPay/RMB jumped from 42% in Q3 FY18 to 51% in Q4 FY18; and (3) local consumer purchases increased during the CNY period. The region also reported strong same store sales growth (SSSG) of 17% during the quarter, which we believe shows good progress in store network optimization.
- Mainland China: So Far So Good.** The Mainland China segment, which has been the largest segment for CTF, continued to report double-digit RSV growth for five consecutive quarters, driven by both new store additions (+17 during the quarter) and improved performance for existing stores (SSSG: +7% in Q4 FY18). Notably, the RSV YoY growth for the e-commerce segment moderated to 38% during the quarter, but we do not believe this is a major setback for the Company, due to CTF's premium position.
- We Expect Gold Product Sales to Improve.** Gold products did better than gem-set jewellery during the period, as mainland China and HK/Macau recorded 14%/18% SSSG, respectively, for gold products. We expect this momentum to continue at least for a while, as we expect the increasing inflation risk in both markets to prompt more investors to buy more gold products.
- We Now Believe CTF Deserves a Higher Valuation. Upgrade to BUY.** We lift our earnings forecast for FY19E/20E by 5%/9%, to HK\$0.48/HK\$0.54, respectively. Our new earnings forecast implies an EPS CAGR of 25.7% in FY2017-FY2019E. We also raise our TP from HK\$9.20 to HK\$11.10, as our target FY2019E PER is raised from 20x to 23x. Our argument for a higher multiple is as follows: (1) we expect the gold price, which is likely to be ignited by inflation risk, to support segment performance; (2) unlike the previous boom, which was hit by the anti-corruption campaign, we believe this growth is more healthy and sustainable, driven mainly by consumption upgrades; and (3) the 23x FY19E PER implies a <1x PEG ratio, assuming a FY2017-FY2019E EPS CAGR of 25.7%.

Year ended 31 March	FY2016	FY2017	FY2018E	FY2019E	FY2020E
Turnover (HK\$m)	56,592	51,246	56,631	64,198	70,469
Net profit (HK\$m)	2,941	3,055	4,068	4,834	5,437
Net margin	5.2%	6.0%	7.2%	7.5%	7.7%
Basic EPS (HK\$)	0.29	0.31	0.41	0.48	0.54
Change	-46%	4%	33%	19%	12%
PER (x)	33.2	31.9	24.0	20.2	17.9
Yield (%)	8.2%	5.2%	2.5%	2.5%	2.8%
PBR (x)	2.7	3.0	3.2	3.0	2.7

Sources: Company, CGIS Research

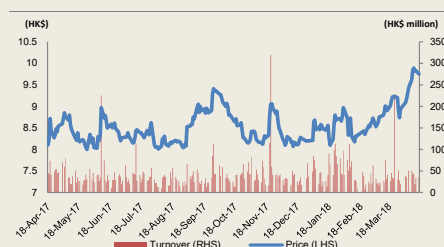
## China Consumer Sector Luxury

# BUY

Close: HK\$9.75 (April 16, 2018)

Target Price: HK11.10 (+13.8%)

### Price Performance



Source: Bloomberg

Market Cap	US\$12,420m
Shares Outstanding	10,000m
Auditor	Deloitte
Free Float	10.7%
52W range	HK\$7.79-10.06
6M average daily T/O	US\$5.86m
Major Shareholding	CTF Holding (89.34%)

Sources: Company, Bloomberg

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## Key financials

Profit & loss (HK\$m)	FY2016	FY2017	FY2018E	FY2019E	FY2020E	Cash flow (HK\$m)	FY2016	FY2017	FY2018E	FY2019E	FY2020E
<b>Total revenue</b>	<b>56,592</b>	<b>51,246</b>	<b>56,631</b>	<b>64,198</b>	<b>70,469</b>	Net profit before tax	3,936	4,378	5,454	6,482	7,289
COGS	(40,950)	(36,283)	(40,208)	(45,581)	(50,033)	Depreciation and amortisation	915	868	689	781	857
<b>Gross profit</b>	<b>15,641</b>	<b>14,963</b>	<b>16,423</b>	<b>18,617</b>	<b>20,436</b>	Change in working capital	8,946	1,460	(3,049)	(4,156)	(3,452)
Other income	306	330	233	245	271	Other operating cash flow	100	(487)	(1,025)	(1,173)	(1,322)
Selling and distribution cost	(9,197)	(8,011)	(8,604)	(9,417)	(10,180)	<b>Operating cash flow</b>	<b>13,897</b>	<b>6,220</b>	<b>2,069</b>	<b>1,934</b>	<b>3,372</b>
Administrative expenses	(2,427)	(2,296)	(2,128)	(2,372)	(2,583)	CAPEX	(1,046)	(1,240)	(1,498)	(1,322)	(1,276)
Other operating expenses	(51)	(215)	(237)	(269)	(295)	Proceeds from disposals	20	6	-	-	-
<b>Operating profit</b>	<b>4,273</b>	<b>4,770</b>	<b>5,687</b>	<b>6,804</b>	<b>7,649</b>	Other investing cash flow	(18)	87	(474)	24	15
Net financial expenses	(88)	(97)	(234)	(322)	(359)	<b>Investing cash flow</b>	<b>(1,045)</b>	<b>(1,147)</b>	<b>(1,972)</b>	<b>(1,298)</b>	<b>(1,261)</b>
Other gains and losses	(249)	(295)	-	-	-	Net proceeds from borrowings	(969)	(4,135)	1,024	1,193	989
<b>Profit before tax</b>	<b>3,936</b>	<b>4,378</b>	<b>5,454</b>	<b>6,482</b>	<b>7,289</b>	Share issue	-	-	-	-	-
Tax expenses	(957)	(1,227)	(1,258)	(1,495)	(1,682)	Dividends paid	(6,582)	(5,148)	(6,320)	(2,429)	(2,568)
<b>Profit after tax</b>	<b>2,979</b>	<b>3,151</b>	<b>4,195</b>	<b>4,986</b>	<b>5,607</b>	Interest paid	(257)	(251)	(313)	(347)	(374)
Minority interests	(38)	(96)	(128)	(152)	(170)	Other financing cash flow	(200)	(238)	(0)	-	-
<b>Net profit</b>	<b>2,941</b>	<b>3,055</b>	<b>4,068</b>	<b>4,834</b>	<b>5,437</b>	<b>Financing cash flow</b>	<b>(8,008)</b>	<b>(9,771)</b>	<b>(5,610)</b>	<b>(1,582)</b>	<b>(1,953)</b>
Basic EPS (HK\$)	0.29	0.31	0.41	0.48	0.54	Forex adjustment	(321)	(392)	-	-	-
Diluted EPS (HK\$)	0.29	0.31	0.41	0.48	0.54	<b>Net change in cash</b>	<b>4,524</b>	<b>(5,090)</b>	<b>(5,512)</b>	<b>(946)</b>	<b>158</b>
Total DPS (HK\$)	0.80	0.51	0.24	0.24	0.27	<b>Free cash flow</b>	<b>12,036</b>	<b>4,670</b>	<b>1,587</b>	<b>816</b>	<b>2,553</b>

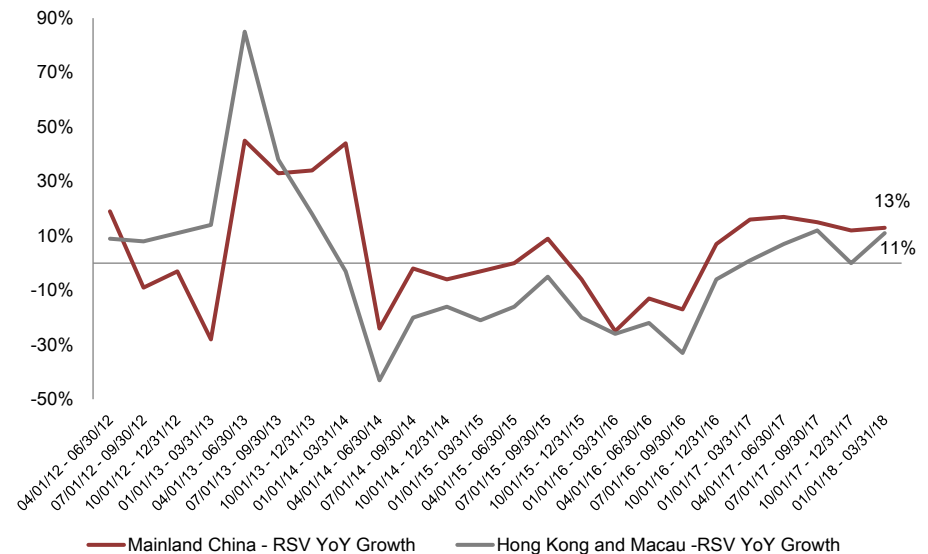
Balance sheet (HK\$m)	FY2016	FY2017	FY2018E	FY2019E	FY2020E	Key ratios	FY2016	FY2017	FY2018E	FY2019E	FY2020E
Cash and cash equivalents	13,001	7,943	2,431	1,485	1,643	Revenue growth	-12.0%	-9.4%	10.5%	13.4%	9.8%
Inventories	31,377	29,259	32,477	36,816	40,412	Gross profit growth	-18.0%	-4.3%	9.8%	13.4%	9.8%
Trade and other receivables	4,605	5,057	5,596	6,362	6,995	Operating profit growth	-38.4%	11.6%	19.2%	19.6%	12.4%
Other current assets	22	9	9	11	12	Net profit growth	-46.1%	3.9%	33.1%	18.8%	12.5%
<b>Total current assets</b>	<b>49,005</b>	<b>42,269</b>	<b>40,513</b>	<b>44,674</b>	<b>49,062</b>	Gross margin	27.6%	29.2%	29.0%	29.0%	29.0%
Property, plant and equipment	4,750	4,666	5,476	6,016	6,435	Operating margin	7.6%	9.3%	10.0%	10.6%	10.9%
Prepaid land lease payments	212	185	185	185	185	Net margin	5.2%	6.0%	7.2%	7.5%	7.7%
Deposits paid for acquisition of	133	53	53	53	53	ROA	5.4%	6.4%	8.7%	9.4%	9.7%
Other non-current assets	638	398	475	549	606	ROE	8.4%	9.6%	13.8%	15.1%	15.6%
<b>Total assets</b>	<b>54,737</b>	<b>47,571</b>	<b>46,702</b>	<b>51,476</b>	<b>56,341</b>	Net debt to equity	Net Cash	Net Cash	20.2%	24.2%	17.8%
ST borrowings	7,320	6,193	5,362	6,079	8,773	Quick ratio	0.9x	0.8x	0.5x	0.4x	0.4x
Trade and other payables	4,336	5,693	6,292	7,132	7,829	Current ratio	2.6x	2.7x	2.5x	2.5x	2.2x
Gold loan	6,513	3,216	3,570	4,046	4,442	Interest coverage ratio	48.3x	49.4x	24.3x	21.1x	21.3x
Other current liabilities	595	686	833	973	1,083	<b>Key assumptions</b>	<b>FY2016</b>	<b>FY2017</b>	<b>FY2018E</b>	<b>FY2019E</b>	<b>FY2020E</b>
<b>Total current liabilities</b>	<b>18,764</b>	<b>15,788</b>	<b>16,057</b>	<b>18,231</b>	<b>22,126</b>	Jewellery POS	2,180	2,260	2,400	2,458	2,514
LT borrowings	600	600	2,100	2,100	-	Mainland China	2,057	2,125	2,270	2,327	2,382
Other non-current liabilities	562	512	553	596	625	HK, Macau and others	123	135	130	131	132
<b>Total liabilities</b>	<b>19,926</b>	<b>16,900</b>	<b>18,709</b>	<b>20,927</b>	<b>22,752</b>	Watch POS	125	121	121	121	121
Common stock	10,000	10,000	10,000	10,000	10,000	<b>Total POS</b>	<b>2,305</b>	<b>2,381</b>	<b>2,521</b>	<b>2,579</b>	<b>2,635</b>
Reserves	24,904	21,799	19,546	21,952	24,821	<b>SSSG</b>					
<b>Shareholders' equity</b>	<b>34,904</b>	<b>31,799</b>	<b>29,546</b>	<b>31,952</b>	<b>34,821</b>	Mainland China - Jewellery	-10%	-5%	8%	10%	8%
Minority interests	846	703	830	982	1,152	HK, Macau and others	-22%	-12%	10%	12%	8%
<b>Total equity &amp; liabilities</b>	<b>55,675</b>	<b>49,402</b>	<b>49,086</b>	<b>53,860</b>	<b>58,725</b>						
Net cash / (net debt)	5,081	1,151	(5,031)	(6,694)	(7,130)						
Basic BPS (HK\$)	3.57	3.25	3.04	3.29	3.60						

Sources: Company, Capital IQ, CGIS Research estimates

## Investment Thesis—Fundamentals Intact

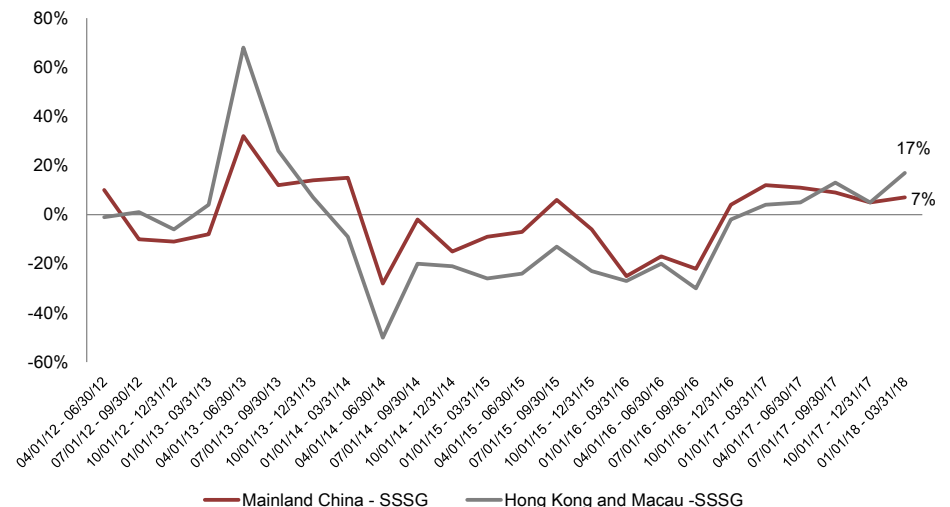
The Q4 FY2018 (Jan-Mar 2018) results reported by CTF generally showed good performance in both mainland China and Hong Kong/Macau. We believe the mainland China performance is more important, as we estimate it will account for >60% of CTF's revenue for FY2018E. However, Hong Kong/Macau cannot be overlooked, as it is still an important part of the Company's revenue and subject to higher operating leverage in the near term. Hong Kong has higher fixed costs due to high rental expenses, but we expect cost reductions and positive sales growth to help overall earnings.

**Figure 1: Retail Sales Value (RSV) YoY Growth—Mainland China and HK/Macau**



Sources: Company, CGIS Research

**Figure 2: Same Store Sales Growth (SSSG)—Mainland China and HK/Macau**

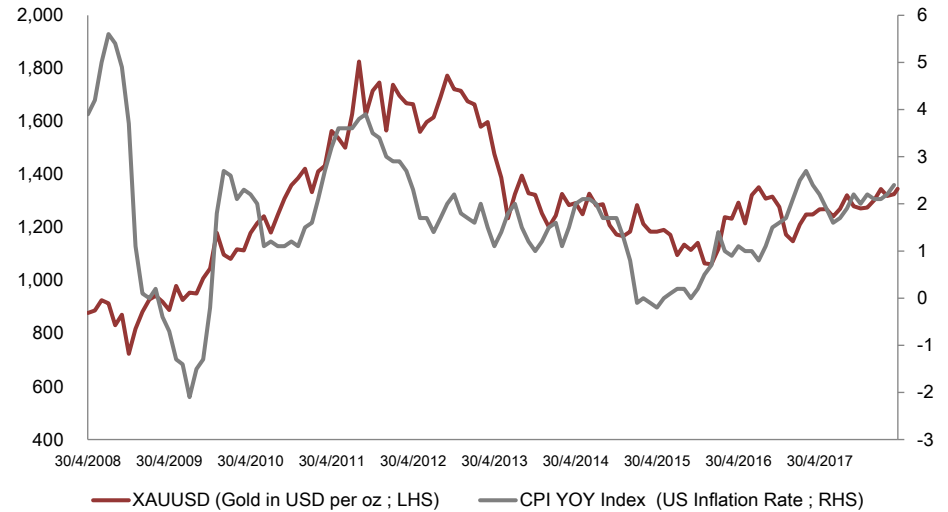


Sources: Company, CGIS Research

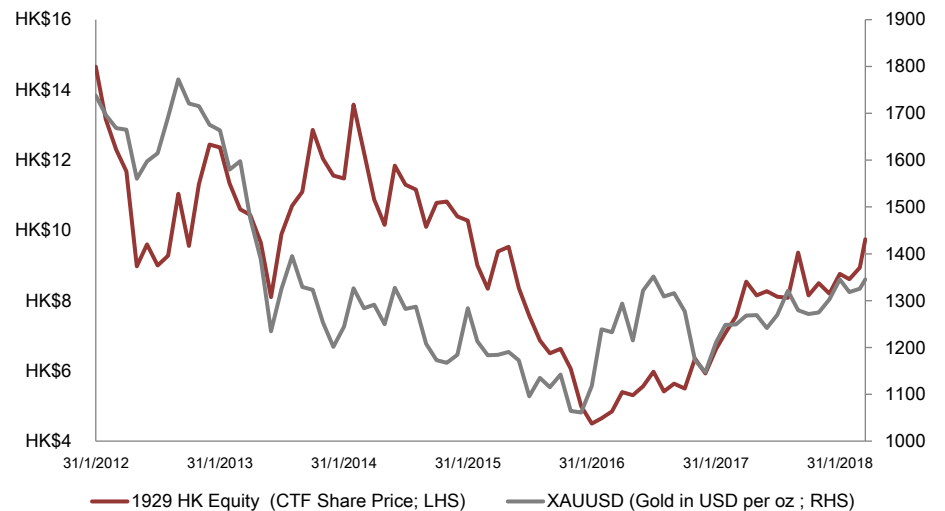
**Figure 3: RSV Growth & SSSG for the Past 8 Quarters**

	04/01/16 - 06/30/16	07/01/16 - 09/30/16	10/01/16 - 12/31/16	01/01/17 - 03/31/17	04/01/17 - 06/30/17	07/01/17 - 09/30/17	10/01/17 - 12/31/17	01/01/18 - 03/31/18
Mainland China - SSSG	-17%	-22%	4%	12%	11%	9%	5%	7%
Hong Kong and Macau -SSSG	-20%	-30%	-2%	4%	5%	13%	5%	17%
Mainland China - RSV YoY Growth	-13%	-17%	7%	16%	17%	15%	12%	13%
Hong Kong and Macau -RSV YoY Growth	-22%	-33%	-6%	1%	7%	12%	0%	11%

Sources: Company, CGIS Research

**Figure 4: Gold Price and US Inflation**


Sources: Bloomberg, CGIS Research

**Figure 5: CTF Share Price and Gold Price**


Sources: Bloomberg, CGIS Research

## Valuation: We Are Now More Positive

We lift our earnings forecast for FY19E/20E by 5%/9% to HK\$0.48/HK\$0.54, respectively. The HK/Macau region performed slightly better than we expected, and we see the positive momentum continuing, as the HKD/RMB exchange rate is expected to be favourable for CTF.

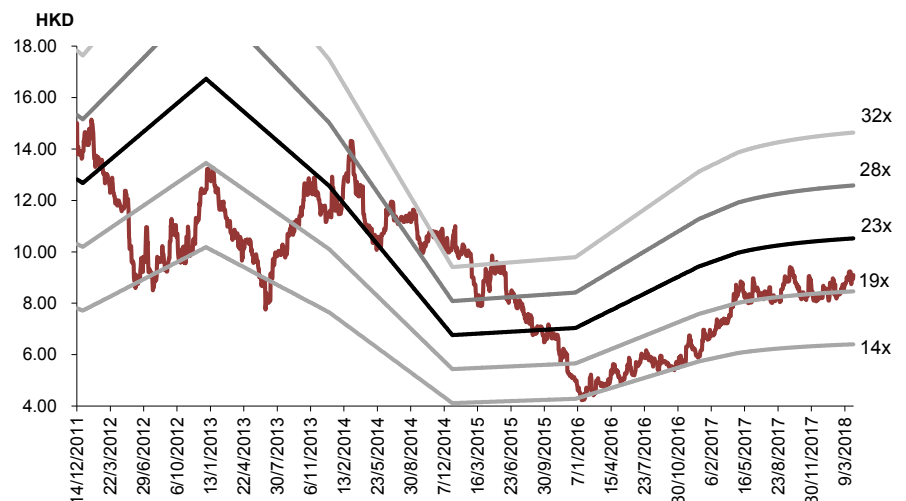
Our new earnings forecast implies an EPS CAGR of 25.7% in FY2017-FY2019E. Accordingly, we raise our TP from HK\$9.20 to HK\$11.10, and our target FY2019E PER from 20x to 23x.

## Why We Are Turning More Bullish

Previously, we were conservative on CTF's target multiple, but we are now more comfortable with CTF trading at a higher premium. Our argument for a higher multiple is based on the following:

- (1) We expect the gold price, which is likely to be ignited by inflation risk in the US and China, to support segment performance (refer to Figure 4 & Figure 5);
- (2) We believe that unlike the previous boom, which was hit by the anti-corruption campaign, this growth is more healthy and sustainable, driven mainly by consumption upgrades; and
- (3) Our 23x FY19E PER target implies a <1x PEG ratio, assuming a FY2017-FY2019E EPS CAGR of 25.7%.

Figure 6: PER Band of CTF



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BUY : share price will increase by >20% within 12 months in absolute terms

SELL : share price will decrease by >20% within 12 months in absolute terms

HOLD : no clear catalyst, and downgraded from BUY pending clearer signal to reinstate BUY or further downgrade to outright SELL

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