

Luk Fook Holdings [590.HK]

Need Further Catalysts after Mixed Q4FY18 Results. Maintain HOLD.

The Q4 FY2018 (Jan-Mar 2018) operating figures reported by Luk Fook show a mixed picture. For the HK/Macau region, the Company is a beneficiary of Hong Kong's retail market recovery. SSSG during the period was +18%, driven by both gold products and gem set jewellery. Luk Fook also benefited from more mainland Chinese tourist arrivals in HK. The growth was in line with the industry average. However, mainland China was still somewhat weak, as SSSG was mildly negative for two consecutive quarters. While Luk Fook attributed this to the high base effect, we believe it continued to face keen competition from its peers. For March and early-April, its Hong Kong/Macau business continued to improve, and we expect the momentum to continue, as we expect consumers to buy more gold products for inflation protection. We expect Luk Fook to continue to benefit from consumption upgrades and business expansion in mainland China, but it will take time for the Company to prove itself as an obvious market gainer in the current cycle, especially in China. We maintain our HOLD rating, as we believe another re-rating in the near term is unlikely. Overall, we slightly lift our EPS forecast for FY19E/20E by 4.1%/4.3% to HK\$2.04/HK\$2.24 to reflect the positive outlook for its HK/Macau operations, and lift our TP to HK\$33.6, based on 15x FY19E PER (its average level).

Investment Highlights

- Overall SSSG Supported by Strong HK/Macau Performance.** Overall SSSG for Luk Fook in Q4 FY2018 was +16%, attributable to strong HK/Macau SSSG of +18%, driven by both gold and gem set jewellery sales (both recorded SSSG of +19%). The Company suggested the good performance was driven by increasing tourist arrivals from mainland China, and noted that March was better than both Jan and Feb, suggesting a proven recovery in the local retail market.
- Mainland China: Still under Pressure.** The performance in mainland China continued to be under pressure for two consecutive quarters. Luk Fook reported -2% SSSG in Jan-Mar 2018, although the March performance turned better. Management attributed this to (1) the high base effect in FY17, resulting in a weaker growth rate for FY18, (2) keen competition, especially from some of its peers, and (3) likely cannibalization from the HK/Macau region. On the bright side, store expansion was better than expected. With franchisees opening more stores than originally expected, the total number of stores in mainland China reached 1,561 (157 self-operated and 1,404 licensed) by the end of March. The Company is also considering revising upwards its store opening plan for FY19E.
- Yet to Show Signs of Solid Market Outperformance.** From a top-down perspective, Luk Fook should be a beneficiary of HK's retail recovery and consumption upgrades in China. It should also benefit from gold product demand, triggered by inflation concerns. However, we have become more hesitant about expecting Luk Fook to become an outperformer in the current cycle. Apart from keen competition from Chow Tai Fook [1929.HK; BUY], we are more wary of competition from local brands targeting the mass market. For example, Chow Tai Seng [002867.CH; NR] posted strong earnings growth thanks to its franchising model. This could pose a threat to Luk Fook, which has a similar business model.
- Another near term re-rating unlikely. Maintain HOLD.** We slightly lift our EPS forecast for FY19E/20E by 4.1%/4.3% to HK\$2.04/HK\$2.24, and our latest TP to HK\$33.6, based on 15x FY19E PER. We believe the recent rally already reflects Luk Fook's good performance in Hong Kong. More catalysts, especially evidence of better performance in mainland China, are needed for another re-rating.

| Year ended 31 March | FY2016 | FY2017 | FY2018E | FY2019E | FY2020E |
|---------------------|--------|--------|---------|---------|---------|
| Turnover (HK\$m) | 14,031 | 12,807 | 14,181 | 15,741 | 17,124 |
| Net profit (HK\$m) | 959 | 1,017 | 1,197 | 1,314 | 1,418 |
| Net margin | 6.8% | 7.9% | 8.4% | 8.4% | 8.3% |
| Basic EPS (HK\$) | 1.63 | 1.73 | 2.04 | 2.24 | 2.42 |
| Change | -40.6% | 6.3% | 17.7% | 9.8% | 7.9% |
| PER (x) | 19.1 | 18.0 | 15.3 | 13.9 | 12.9 |
| Yield (%) | 3.5% | 3.7% | 3.7% | 3.7% | 3.7% |
| PBR (x) | 2.1 | 2.0 | 1.9 | 1.8 | 1.7 |

Sources: Company, CGIS Research

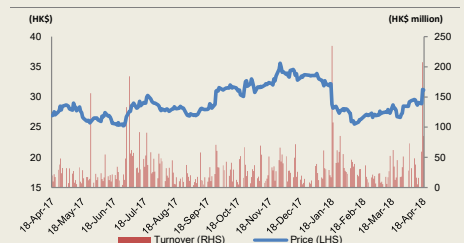
China Consumer Sector Luxury

HOLD

Close: HK\$31.15 (April 18, 2018)

Target Price: HK\$33.6 (+7.87%)

Price Performance



Source: Bloomberg

| | |
|----------------------|------------------------------|
| Market Cap | US\$2,330m |
| Shares Outstanding | 587.1m |
| Auditor | PwC |
| Free Float | 54.7% |
| 52W range | HK\$24.62-35.60 |
| 6M average daily T/O | US\$4.02m |
| Major Shareholding | Luk Fook Control (39.89%) |

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 |
|-------------------------------|---------------|---------------|---------------|---------------|---------------|-------------------------------|----------------|----------------|--------------|--------------|--------------|
| Total revenue | 14,031 | 12,807 | 14,181 | 15,741 | 17,124 | Net profit before tax | 1,161 | 1,250 | 1,470 | 1,614 | 1,738 |
| COGS | (10,777) | (9,530) | (10,512) | (11,742) | (12,839) | Depreciation and amortisation | 136 | 131 | 142 | 157 | 171 |
| Gross profit | 3,254 | 3,277 | 3,669 | 3,999 | 4,284 | Change in working capital | 898 | (534) | (638) | (731) | (648) |
| Other income | 139 | 176 | 177 | 192 | 207 | Other operating cash flow | (132) | (127) | (286) | (313) | (332) |
| Selling and distribution cost | (1,982) | (1,994) | (2,220) | (2,402) | (2,562) | Operating cash flow | 2,063 | 720 | 688 | 728 | 929 |
| Administrative expenses | (149) | (155) | (166) | (184) | (200) | CAPEX | (113) | (168) | (136) | (142) | (152) |
| Other operating expenses | (51) | (14) | (15) | (17) | (18) | Proceeds from disposals | 1 | - | - | - | - |
| Operating profit | 1,212 | 1,289 | 1,445 | 1,588 | 1,711 | Other investing cash flow | 726 | (240) | 33 | 34 | 36 |
| Net financial expenses | 28 | 15 | 24 | 26 | 27 | Investing cash flow | 614 | (408) | (103) | (108) | (116) |
| Other gains and losses | (79) | (54) | - | - | - | Net proceeds from borrowings | (977) | (477) | 47 | 58 | 52 |
| Profit before tax | 1,161 | 1,250 | 1,470 | 1,614 | 1,738 | Share issue | - | - | - | - | - |
| Tax expenses | (200) | (223) | (261) | (287) | (305) | Dividends paid | (648) | (646) | (690) | (675) | (675) |
| Profit after tax | 961 | 1,027 | 1,209 | 1,328 | 1,432 | Interest paid | (14) | (9) | (9) | (8) | (9) |
| Minority interests | (3) | (10) | (12) | (13) | (14) | Other financing cash flow | (29) | 0 | - | (0) | 0 |
| Net profit | 959 | 1,017 | 1,197 | 1,314 | 1,418 | Financing cash flow | (1,668) | (1,131) | (652) | (626) | (632) |
| Basic EPS (HK\$) | 1.63 | 1.73 | 2.04 | 2.24 | 2.42 | Forex adjustment | (22) | (13) | - | - | - |
| Diluted EPS (HK\$) | 1.63 | 1.73 | 2.04 | 2.24 | 2.41 | Net change in cash | 987 | (832) | (67) | (5) | 181 |
| Total DPS (HK\$) | 1.10 | 1.15 | 1.15 | 1.15 | 1.15 | Free cash flow | 1,858 | 451 | 682 | 901 | 1,064 |

| Balance sheet (HK\$m) | FY2016 | FY2017 | FY2018E | FY2019E | FY2020E | Key ratios | FY2016 | FY2017 | FY2018E | FY2019E | FY2020E |
|---------------------------------------|---------------|---------------|---------------|---------------|---------------|-------------------------|---------------|---------------|----------------|----------------|----------------|
| Cash and cash equivalents | 2,430 | 1,862 | 1,795 | 1,790 | 1,970 | Revenue growth | -11.9% | -8.7% | 10.7% | 11.0% | 8.8% |
| Inventories | 6,345 | 6,973 | 7,721 | 8,570 | 9,323 | Gross profit growth | -15.1% | 0.7% | 12.0% | 9.0% | 7.1% |
| Trade and other receivables | 215 | 217 | 236 | 255 | 270 | Operating profit growth | -38.7% | 6.4% | 12.1% | 9.9% | 7.7% |
| Other current assets | 338 | 360 | 360 | 360 | 360 | Net profit growth | -40.6% | 6.1% | 17.7% | 9.8% | 7.9% |
| Total current assets | 9,328 | 9,411 | 10,112 | 10,974 | 11,923 | Gross margin | 23.2% | 25.6% | 25.9% | 25.4% | 25.0% |
| Property, plant and equipment | 604 | 564 | 558 | 543 | 523 | Operating margin | 8.6% | 10.1% | 10.2% | 10.1% | 10.0% |
| Land Use Rights | 215 | 248 | 248 | 248 | 248 | Net margin | 6.8% | 7.9% | 8.4% | 8.4% | 8.3% |
| Prepaid land lease payments | 122 | 121 | 121 | 121 | 121 | ROA | 9.0% | 9.5% | 10.5% | 10.8% | 10.8% |
| Other non-current assets | 359 | 315 | 331 | 341 | 350 | ROE | 11.1% | 11.5% | 12.8% | 13.1% | 13.2% |
| Total assets | 10,627 | 10,659 | 11,370 | 12,226 | 13,165 | Net debt to equity | Net Cash | Net Cash | Net Cash | Net Cash | Net Cash |
| ST borrowings | 400 | - | - | - | - | Quick ratio | 1.5x | 1.3x | 1.1x | 1.0x | 1.0x |
| Trade and other payables | 892 | 1,005 | 1,112 | 1,235 | 1,343 | Current ratio | 5.3x | 5.9x | 5.7x | 5.6x | 5.6x |
| Gold loan | 311 | 437 | 484 | 542 | 594 | Interest coverage ratio | N/A | N/A | N/A | N/A | N/A |
| Other current liabilities | 554 | 152 | 178 | 196 | 211 | Key assumptions | FY2016 | FY2017 | FY2018E | FY2019E | FY2020E |
| Total current liabilities | 1,757 | 1,594 | 1,775 | 1,972 | 2,148 | Self-operated POS | 168 | 200 | 225 | 245 | 265 |
| LT borrowings | - | - | - | - | - | Mainland China | 105 | 133 | 157 | 177 | 197 |
| Other non-current liabilities | 104 | 105 | 116 | 123 | 129 | HK, Macau and others | 63 | 67 | 68 | 68 | 68 |
| Total liabilities | 1,861 | 1,699 | 1,891 | 2,095 | 2,277 | Licensed POS | 1,260 | 1,296 | 1,404 | 1,484 | 1,564 |
| Common stock | 2,553 | 2,553 | 2,553 | 2,553 | 2,553 | Total POS | 1,428 | 1,496 | 1,629 | 1,729 | 1,829 |
| Reserves | 6,121 | 6,301 | 6,807 | 7,447 | 8,190 | SSSG | | | | | |
| Shareholders' equity | 8,674 | 8,853 | 9,360 | 9,999 | 10,743 | Mainland China | -8.0% | -5.0% | 9.5% | 8.0% | 6.0% |
| Minority interests | 95 | 107 | 119 | 132 | 146 | HK, Macau and others | -20.0% | -20.0% | 8.0% | 7.0% | 6.0% |
| Total equity & liabilities | 10,629 | 10,659 | 11,370 | 12,227 | 13,165 | Gold & Platinum | -20.0% | -25.0% | 10.0% | 7.4% | 6.4% |
| Net cash / (net debt) | 2,030 | 1,862 | 1,795 | 1,790 | 1,970 | Gem-set jewellery | -24.0% | -6.0% | 9.3% | 9.3% | 7.2% |
| Basic BPS (HK\$) | 14.89 | 15.21 | 16.09 | 17.20 | 18.48 | | | | | | |

Sources: Company, Capital IQ, CGIS Research estimates

4Q FY2018 SSSG: A Mixed Picture

As Figure 1 suggests, overall SSSG for Luk Fook reached +16% during Q4 FY2018 (Jan–Mar 2018), driven mainly by the solid performance of the HK/Macau region. However, mainland China continued to be under pressure, as it reported negative SSSG for two consecutive quarters, suggesting a lingering effect from its peers' promotion campaigns.

In a side-by-side comparison with Chow Tai Fook, Luk Fook had a similar performance in the Hong Kong/Macau market, but underperformed significantly in mainland China. We also suspect Luk Fook underperformed its A-share-listed peer Chow Tai Seng. The aggressive PRC-based Chow Tai Seng targeted a 20-30% increase in both revenue and net profit for 2018. As it planned to increase promotion and expansion after its IPO in Apr 2017, it may continue to put pressure on Luk Fook.

Figure 1: Luk Fook's SSSG Performance

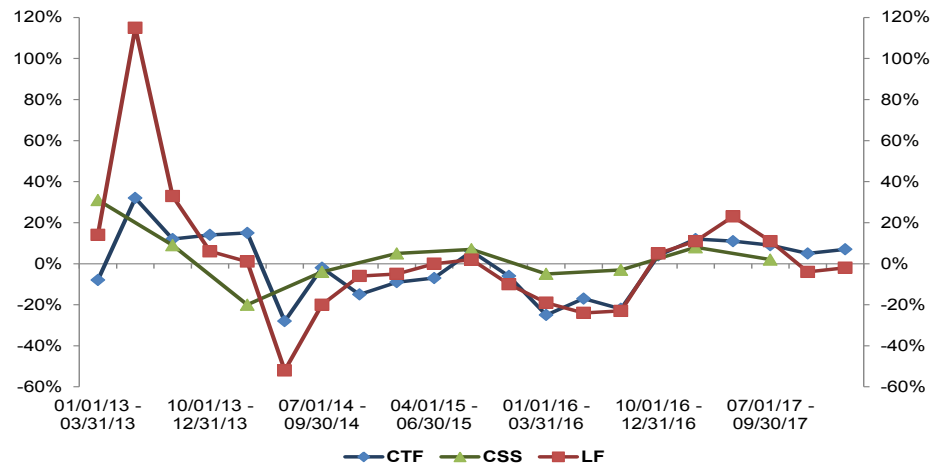
| Period | 4Q FY2016 | 1Q FY2017 | 2Q FY2017 | 3Q FY2017 | 4Q FY2017 | 1Q FY2018 | 2Q FY2018 | 3Q FY2018 | 4Q FY2018 |
|------------------------------|-------------------------|-------------------------|-------------------------|-------------------------|-------------------------|-------------------------|-------------------------|-------------------------|-------------------------|
| Date | 01/01/2016 - 03/31/2016 | 04/01/2016 - 06/30/2016 | 07/01/2016 - 09/30/2016 | 10/01/2016 - 12/31/2016 | 01/01/2017 - 03/31/2017 | 04/01/2017 - 06/30/2017 | 07/01/2017 - 09/30/2017 | 10/01/2017 - 12/31/2017 | 01/01/2018 - 03/31/2018 |
| Overall | -27% | -24% | -37% | -10% | 2% | 5% | 17% | 1% | 16% |
| Gold | -28% | -26% | -47% | -11% | -1% | 5% | 21% | -3% | 16% |
| Gold (by weight) | -25% | -30% | -55% | -19% | -5% | 5% | 25% | -9% | 5% |
| Gem-set jewellery | -25% | -19% | -14% | -4% | 11% | 9% | 16% | 10% | 18% |
| Mainland China | -19% | -24% | -23% | 5% | 11% | 23% | 11% | -4% | -2% |
| Gold | -27% | -29% | -30% | 2% | 16% | 32% | 19% | -2% | -1% |
| Gold (by weight) | -29% | -37% | -43% | -13% | 8% | 26% | 23% | -4% | -2% |
| Gem-set jewellery | 8% | -8% | -3% | 20% | 6% | 10% | -2% | -7% | -2% |
| Hong Kong & Macau | -28% | -24% | -39% | -11% | 1% | 3% | 18% | 1% | 18% |
| Gold | -28% | -25% | -49% | -12% | -5% | 0% | 21% | -4% | 19% |
| Gold (by weight) | -24% | -29% | -57% | -20% | -8% | 0% | 26% | -9% | 8% |
| Gem-set jewellery | -27% | -20% | -14% | -5% | 12% | 9% | 18% | 11% | 19% |

Sources: Company, CGIS Research

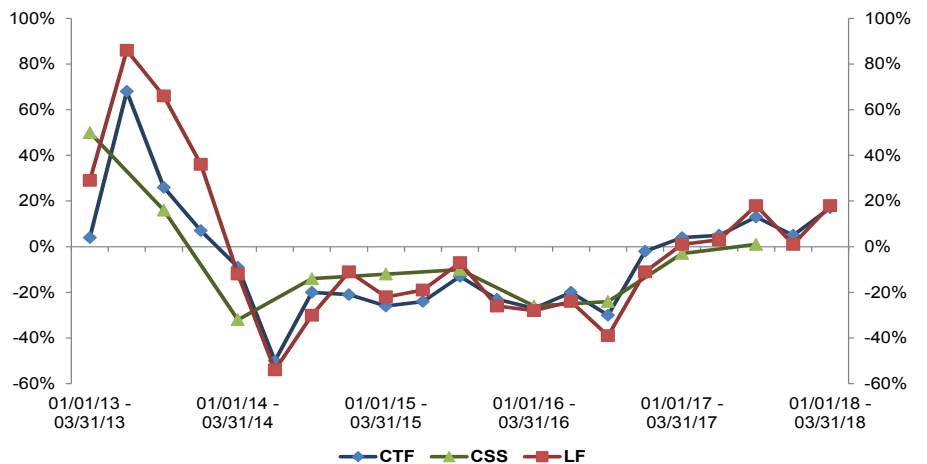
Figure 2: SSSG Performance: Chow Tai Fook vs Luk Fook

| Jan - Mar 2018 | Chow Tai Fook | Luk Fook |
|--------------------------|---------------|----------|
| SSSG - Overall | | |
| Mainland China | 7% | -2% |
| Hong Kong and Macau | 17% | 18% |
| SSSG | | |
| Gem-set jewellery | | |
| Mainland China | -8% | -2% |
| Hong Kong and Macau | 16% | 19% |
| Gold product | | |
| Mainland China | 14% | -1% |
| Hong Kong and Macau | 18% | 19% |

Sources: Company, CGIS Research

Figure 3: Mainland China SSSG of the Three HK-based Retailers


Sources: Company, CGIS Research estimates for Chow Sang Sang

Figure 4: Hong Kong & Macau SSSG of the Three HK-based Retailers


Sources: Company, CGIS Research estimates for Chow Sang Sang

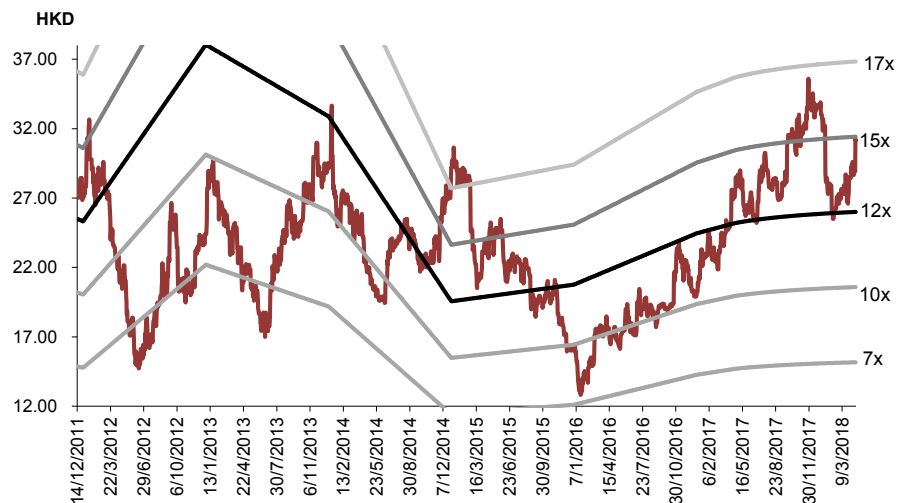
Our concern about competition from Luk Fook's peers intensified after the release of the Q3 & Q4 FY2018 operating figures. In the previous uptrend, Luk Fook was an outperformer among the three leading Hong Kong-based jewellery retailers. We expected Luk Fook to be an outperformer again in the current recovery cycle, as we believed Luk Fook's mass market-oriented positioning would benefit from healthier demand after the central Chinese government initiated anti-graft campaign started in 2013. However, Luk Fook showed brief outperformance in mainland China for two quarters in 2017. We expect it to take some time for the market to see Luk Fook's efforts to regain growth momentum in mainland China.

Valuation: Waiting for Further Catalysts

We have slightly revised our EPS forecast for FY19E/20E by 4.1%/4.3% to HK\$2.04/HK\$2.24 after the release of the latest operating figures. Accordingly, we lift our latest TP to HK\$33.6, based on 15x FY19E PER. We maintain our target FY2019E PER of 15x, as we believe a further re-rating is unlikely at this moment. While its Hong Kong/Macau segment has performed well, its mainland China business is still under pressure, as we explained previously.

Unless the Company proves itself with surprisingly strong FY2018 earnings (released in June 2018) and/or Q1 FY2019 operating figures (released in July 2018), we believe another rally in the near term is unlikely, especially since the Company's share price already recovered after the market anticipated good operating performance for Luk Fook's Hong Kong business. We therefore prefer to recommend staying on the sidelines and maintain our HOLD rating.

Figure 5: PER Band



Sources: Bloomberg, CGIS Research

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Explanation on Equity Ratings

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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