

Chow Tai Fook Jewellery [1929.HK]

D/G to HOLD—Wait to See How It Bets on China's Mass Market

CTF reported FY18 EPS of HK\$0.409, up 34% YoY, which is in line with our forecast. In the years ahead, we believe CTF will continue to enjoy growth in both major markets. For mainland China, instead of having a rapid SSSG, we believe the driver will be store expansion. We believe FY19E will be the most aggressive year for CTF in recent years, as we estimate that it will add around 340 stores. In HK, we believe mainland tourists will continue to drive retail sales, but operating leverage will be limited as rental savings are near the finale. We leave our earnings forecast mostly unchanged after the results. CTF will continue to distribute special dividends in FY18, and this will allow it to pay an attractive 5.1% dividend yield. However, we believe this special dividend financed by debt will raise the concern about sustainability, as the Company will be in a net debt position in FY19E. Our TP of HK\$11.10, based on 23x FY19E PER, remains unchanged, and we lower our rating to HOLD, as we see limited upside. After the recent rally, we believe it's time to take profit, as the current valuation of 22.9x FY19E PER does not look very attractive based on 18%/15% EPS growth in FY19E/FY20E.

Investment Highlights

- FY18 EPS Up 34% YoY, in line with Forecast.** Revenue of HK\$59,156m was higher than our forecast, partly due to higher revenue from the jewellery trading business. This dragged down the GPM for FY18 from 29.4% to 27.4%, in addition to factors such as a changing product mix and hedging losses (vs. a hedging gain in FY17). Meanwhile, savings in Hong Kong and Macau rental expenses and staff costs (selling and distribution costs up merely 2% YoY) led to high EPS growth of 34% vs. revenue growth of 15%.
- Mainland China: Aggressive Store Expansion in FY19E.** Mainland China continues to be a revenue driver, as it contributed revenue of HK\$36.8bn, up 19% YoY. As the Company expects the SSSG to slow down to the low single digits, the expansion focus will be on store numbers. We expect the POS addition for FY19E to be ~340, which will make FY19E the most aggressive year for CTF in terms of store openings in recent years. This is part of CTF's focus on the mass market and multi-brand strategy.
- Hong Kong: Favoured by Tourists But Rental Reversion Coming to an End.** While the improving environment in the HK & Macau segment helped drive the overall net margin to 6.9%. (FY17: 6.0%), we believe the upside for FY19E will be limited. While we expect HK retail to continue to grow >10%, this will be partly offset by limited rental savings. As the retail environment has improved, CTF has experienced smaller rental reductions for its stores. Combined with store expansion (target of 5 in FY19E), we believe the margin expansion will not be that dramatic. At this point, we expect the overall NPM to improve by less than 50bps to 7.3% in FY19E.
- Sustainability of the Special Dividend a Concern.** For three consecutive years, CTF has distributed a special dividend. With a special DPS of HK\$0.30, total DPS is HK\$0.57, implying a pay-out ratio of 139.2%. This special dividend is financed by debt and will eventually put CTF into a net debt position. CTF management targets its net gearing ratio to reach 20% in FY19E, which will make CTF the only major company in the jewellery sector in a net debt position.
- D/G to HOLD.** We leave our earnings largely unchanged after the results announcement. We believe the recent rally has already factored in most of the recent positives. With EPS growth of 18%/15% for FY19E/FY20E, we see limited room for CTF's PER multiple to rise significantly from the current level of 22.9x. Therefore, we leave our TP of HK\$11.10 unchanged.

Year ended 31 March	FY2016	FY2017	FY2018	FY2019E	FY2020E
Turnover (HK\$m)	56,592	51,246	59,156	66,148	73,782
Net profit (HK\$m)	2,941	3,055	4,095	4,841	5,584
Net margin	5.2%	6.0%	6.9%	7.3%	7.6%
Basic EPS (HK\$)	0.29	0.31	0.41	0.48	0.56
Change	-46%	4%	34%	18%	15%
PER (x)	37.7	36.2	27.1	22.9	19.8
Yield (%)	7.2%	4.6%	5.1%	2.6%	3.0%
PBR (x)	3.1	3.4	3.2	3.2	3.0

Sources: Company, CGIS Research

China Consumer Sector Luxury

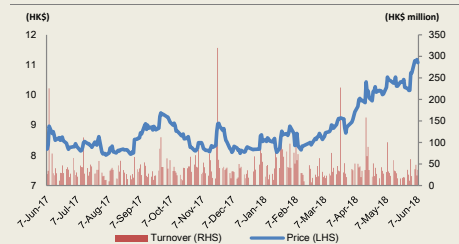
HOLD

(Downgrade from BUY)

Close: HK11.08 (June7, 2018)

Target Price: HK11.10 (+0.18%)

Price Performance



Source: Bloomberg

Market Cap	US\$12,420m
Shares Outstanding	10,000m
Auditor	Deloitte
Free Float	10.7%
52W range	HK\$7.69-11.54
6M average daily T/O	US\$5.46m
Major Shareholding	CTF Holding (89.34%)

Sources: Company, Bloomberg

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Key financials

Profit & loss (HK\$m)	FY2016	FY2017	FY2018	FY2019E	FY2020E	Cash flow (HK\$m)	FY2016	FY2017	FY2018	FY2019E	FY2020E
Total revenue	56,592	51,246	59,156	66,148	73,782	Net profit before tax	3,936	4,378	5,832	6,625	7,643
COGS	(40,950)	(36,283)	(42,943)	(47,645)	(53,144)	Depreciation and amortisation	915	868	532	595	664
Gross profit	15,641	14,963	16,213	18,502	20,637	Change in working capital	8,946	1,460	(2,302)	(2,995)	(3,941)
Other income	306	330	408	408	452	Other operating cash flow	100	(487)	2,782	(1,331)	(1,524)
Selling and distribution cost	(9,197)	(8,011)	(8,239)	(9,394)	(10,233)	Operating cash flow	13,897	6,220	6,844	2,895	2,842
Administrative expenses	(2,427)	(2,296)	(2,682)	(2,512)	(2,766)	CAPEX	(1,046)	(1,240)	(1,084)	(1,720)	(3,206)
Other operating expenses	(51)	(215)	(48)	(54)	(60)	Proceeds from disposals	20	6	-	-	-
Operating profit	4,273	4,770	5,653	6,951	8,030	Other investing cash flow	(18)	87	(473)	79	57
Net financial expenses	(88)	(97)	(163)	(325)	(387)	Investing cash flow	(1,045)	(1,147)	(1,557)	(1,641)	(3,149)
Other gains and losses	(249)	(295)	342	-	-	Net proceeds from borrowings	(969)	(4,135)	2,907	1,219	1,429
Profit before tax	3,936	4,378	5,832	6,625	7,643	Share issue	-	-	-	-	-
Tax expenses	(957)	(1,227)	(1,629)	(1,656)	(1,911)	Dividends paid	(6,582)	(5,148)	(7,950)	(4,302)	(3,128)
Profit after tax	2,979	3,151	4,203	4,969	5,732	Interest paid	(257)	(251)	(244)	(405)	(444)
Minority interests	(38)	(96)	(108)	(128)	(148)	Other financing cash flow	(200)	(238)	(0)	-	-
Net profit	2,941	3,055	4,095	4,841	5,584	Financing cash flow	(8,008)	(9,771)	(5,287)	(3,488)	(2,143)
Basic EPS (HK\$)	0.29	0.31	0.41	0.48	0.56	Forex adjustment	(321)	(392)	-	-	-
Diluted EPS (HK\$)	0.29	0.31	0.41	0.48	0.56	Net change in cash	4,524	(5,090)	1	(2,233)	(2,449)
Total DPS (HK\$)	0.80	0.51	0.57	0.29	0.34	Free cash flow	12,036	4,670	2,710	1,393	3,503

Balance sheet (HK\$m)	FY2016	FY2017	FY2018	FY2019E	FY2020E	Key ratios	FY2016	FY2017	FY2018	FY2019E	FY2020E
Cash and cash equivalents	13,001	7,943	7,944	5,711	3,262	Revenue growth	-12.0%	-9.4%	15.4%	11.8%	11.5%
Inventories	31,377	29,259	34,929	38,358	42,785	Gross profit growth	-18.0%	-4.3%	8.4%	14.1%	11.5%
Trade and other receivables	4,605	5,057	6,410	7,098	7,875	Operating profit growth	-38.4%	11.6%	18.5%	23.0%	15.5%
Other current assets	22	9	28	32	35	Net profit growth	-46.1%	3.9%	34.0%	18.2%	15.4%
Total current assets	49,005	42,269	49,312	51,199	53,958	Gross margin	27.6%	29.2%	27.4%	28.0%	28.0%
Property, plant and equipment	4,750	4,666	5,341	6,465	9,007	Operating margin	7.6%	9.3%	9.6%	10.5%	10.9%
Prepaid land lease payments	212	185	190	190	190	Net margin	5.2%	6.0%	6.9%	7.3%	7.6%
Deposits paid for acquisition of	133	53	28	28	28	ROA	5.4%	6.4%	7.4%	8.3%	8.8%
Other non-current assets	638	398	382	422	473	ROE	8.4%	9.6%	12.3%	14.3%	15.3%
Total assets	54,737	47,571	55,252	58,304	63,655	Net debt to equity	Net Cash	Net Cash	Net Cash	16.9%	19.7%
ST borrowings	7,320	6,193	5,823	6,461	9,306	Quick ratio	0.9x	0.8x	0.7x	0.6x	0.4x
Trade and other payables	4,336	5,693	8,359	9,346	10,425	Current ratio	2.6x	2.7x	2.4x	2.2x	1.9x
Gold loan	6,513	3,216	5,335	5,917	6,600	Interest coverage ratio	48.3x	49.4x	34.6x	214x	20.7x
Other current liabilities	595	686	1,202	1,352	1,544						
Total current liabilities	18,764	15,788	20,719	23,076	27,876						
LT borrowings	600	600	2,100	2,100	-						
Other non-current liabilities	562	512	653	681	728						
Total liabilities	19,926	16,900	23,472	25,857	28,604						
Common stock	10,000	10,000	10,000	10,000	10,000	Key assumptions	FY2016	FY2017	FY2018	FY2019E	FY2020E
Reserves	24,904	21,799	23,423	23,962	26,419	Jewellery POS	2,180	2,260	2,454	2,799	2,965
Shareholders' equity	34,904	31,799	33,423	33,962	36,419	Mainland China	2,057	2,125	2,324	2,664	2,829
Minority interests	846	703	674	802	950	HK, Macau and others	123	135	130	135	136
Total equity & liabilities	55,675	49,402	57,570	60,621	65,973	Watch POS	125	121	110	110	110
Net cash / (net debt)	5,081	1,151	21	(2,850)	(6,045)	Total POS	2,305	2,381	2,564	2,909	3,075
Basic BPS (HK\$)	3.57	3.25	3.41	3.48	3.74	SSSG					
						Mainland China - Jewellery	-10%	-5%	0%	5%	3%
						HK, Macau and others	-22%	-12%	10%	10%	8%

Sources: Company, Capital IQ, CGIS Research estimates

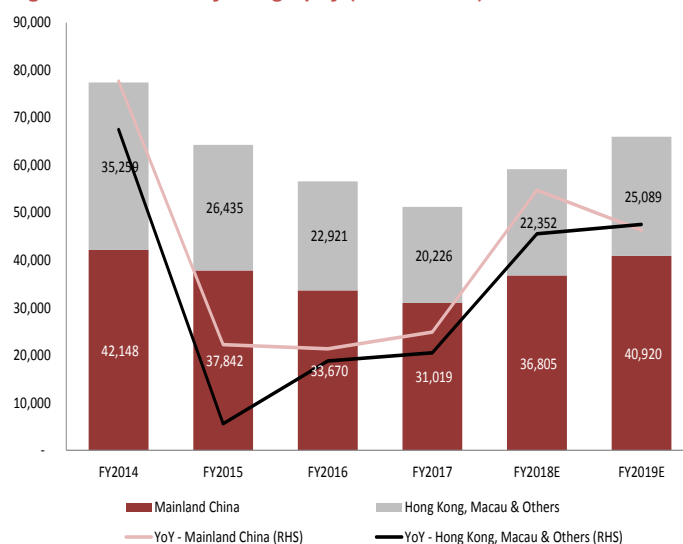
FY2018 Results Review

Figure 1: FY2018 Results Review

Unit: HK\$m	FY2017	1H FY18	2H FY18	FY2018	FY18 vs FY17	Note
Revenue	51,245.5	24,754.3	34,402.1	59,156.4	15.4%	Higher than expected due to jewellery trading
Cost of goods sold	(36,282.8)	(17,588.6)	(25,354.4)	(42,943.0)	18.4%	
Gross profit	14,962.7	7,165.7	9,047.7	16,213.4	8.4%	Lower GPM due to: (1) product mix - more gold product sales and trading; (2) impairment of gem inventory; (3) hedging
Other income	329.5	186.1	221.8	407.9	23.8%	
Selling and distribution costs	(8,011.3)	(3,683.1)	(4,555.6)	(8,238.7)	2.8%	Savings in HK & Macau staff cost and rental expenses
General and administrative	(2,296.0)	(1,203.9)	(1,477.7)	(2,681.6)	16.8%	
Other gains and losses	(285.8)	111.0	231.4	342.4	N/A	
Other expenses	(214.5)	(24.2)	(23.9)	(48.1)	-77.6%	
Share of results of associates	(9.6)	—	—	—	—	
Interest income	140.0	43.9	36.4	80.3	-42.6%	
Finance costs	(236.6)	(91.6)	(152.1)	(243.7)	3.0%	
Profit before taxation	4,378.4	2,503.9	3,328.0	5,831.9	33.2%	
Taxation	(1,227.3)	(674.7)	(953.9)	(1,628.6)	32.7%	
Profit for the year	3,151.1	1,829.2	2,374.1	4,203.3	33.4%	
Profit for the year attributable to:						
Shareholders of the Company	3,055.3	1,779.1	2,315.8	4,094.90	34.0%	
Non-controlling interests	95.8	50.1	58.3	108.4	13.2%	
EPS (HK\$)	0.306	0.178	0.23	0.409	33.7%	In-line with CGIS forecast
Total DPS (HK\$)	0.51	0.12	0.45	0.57	11.8%	Special DPS of HK\$0.3 declared

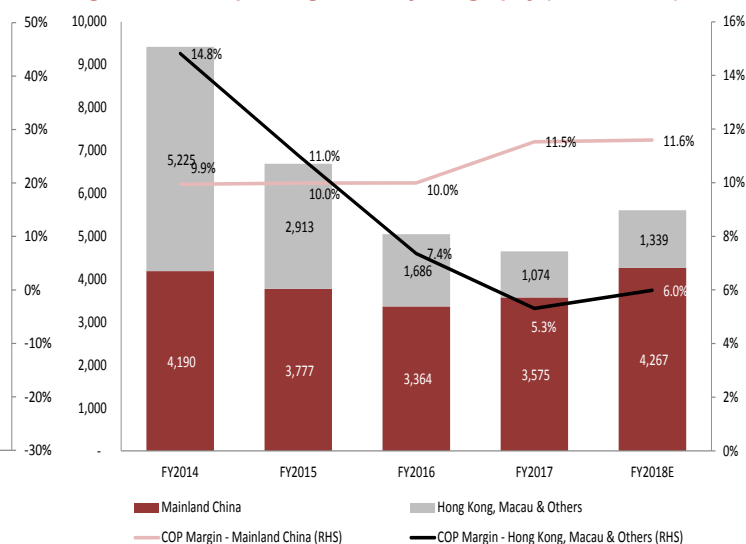
Sources: Company, CGIS Research

Figure 2: Revenue by Geography (Unit: HK\$ m)



Sources: Company, CGIS Research estimates

Figure 3: Core Operating Profit* by Geography (Unit: HK\$ m)

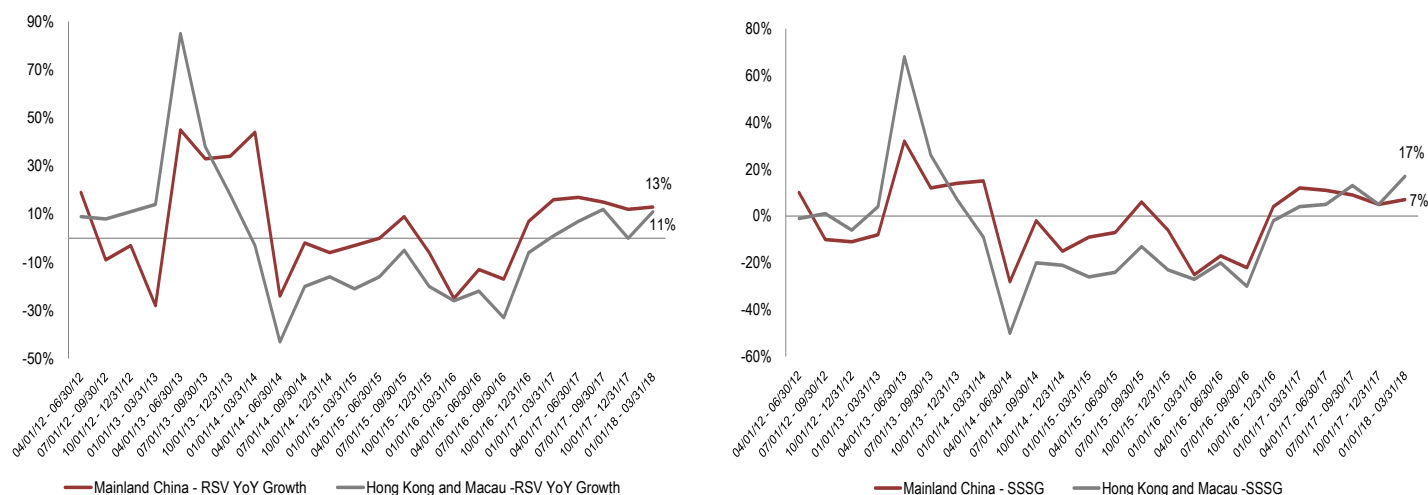


Sources: Company, CGIS Research

*without unrealized hedging gain on gold, other gains and losses, other expenses, share of results of associates, finance income & expenses

FY2018 Results Review (Continue)

Figure 4: Retail Sales Value YoY Growth (Left) and SSSG (Right) —Mainland China / HK & Macau



Sources: Company, CGIS Research

Figure 5: POS Network Breakdown by Geography

POS Network	FY2015	FY2016	FY2017	FY2018
Mainland China	2,124	2,179	2,246	2,449
Hong Kong	93	89	83	80
Macau	19	20	19	19
Taiwan	16	23	22	22
Korea	1	4	5	7
Japan	-	-	-	2
Malaysia	1	1	2	2
Singapore	1	1	1	1
United States	2	2	3	3
TOTAL	2,257	2,319	2,381	2,585

Sources: Company, CGIS Research

Figure 6: Revenue & Product Mix Breakdown

Unit: HK\$m	FY2014	FY2015	FY2016	FY2017	FY2018
Revenue by Segment					
Retail	67,179	54,661	48,326	43,613	48,729
- Hong Kong and Others	35,077	25,961	21,853	19,299	20,633
- Mainland China	32,102	28,699	26,473	24,314	28,096
Wholesales	10,228	9,616	8,266	7,633	10,428
- Hong Kong and Others	182	473	1,068	927	1,719
- Mainland China	10,046	9,143	7,198	6,705	8,708
Total Revenue	77,407	64,277	56,592	51,246	59,156
Product Mix					
Gem-Set Jewellery	21%	27%	27%	25%	24%
Gold Products	61%	53%	55%	57%	59%
Platinum/Karat Gold Products	13%	14%	12%	12%	11%
Watches	4%	5%	5%	6%	6%

Sources: Company, CGIS Research

Figure 7: POS Network by Brand

POS by brand	Chow Tai Fook Jewellery	CTF Watch	Hearts On Fire	Monologue	SOINLOVE	Total
Mainland China	2,317	106		6	9	11
Hong Kong	78	2		-	-	-
						2,449
						80

Sources: Company, CGIS Research

Key Takeaways and Our View

Mainland China: CTF management mentioned that in FY2019E, its target is to open ~300 CTF core brand stores, ~20 stores for Monologue and ~20 stores for SOINLOVE. Monologue and SOINLOVE are new brands introduced to capture millennial consumption demand.

Therefore, we expect a net POS addition of 340 stores to be achieved in FY2019E. This number is higher than what we previously expected. We believe this aggressive number is partly due to the slowdown in SSSG. Management currently targets low to mid single-digit SSSG for FY2019E.

We believe this is in line with the general industry pattern and the correct approach. Some peers, like Lao Feng Xiang, have experienced weaker SSSG, but we believe CTF can counter this by appealing to younger consumers.

Hong Kong & Macau: While Hong Kong retail sales are recovering, management acknowledged the concern about CTF's regional sales underperforming overall jewellery retail sales in Hong Kong, and does not expect the per store productivity to recover to the level before the industry downturn started in 2014. It expects the driver to be healthier consumer demand instead.

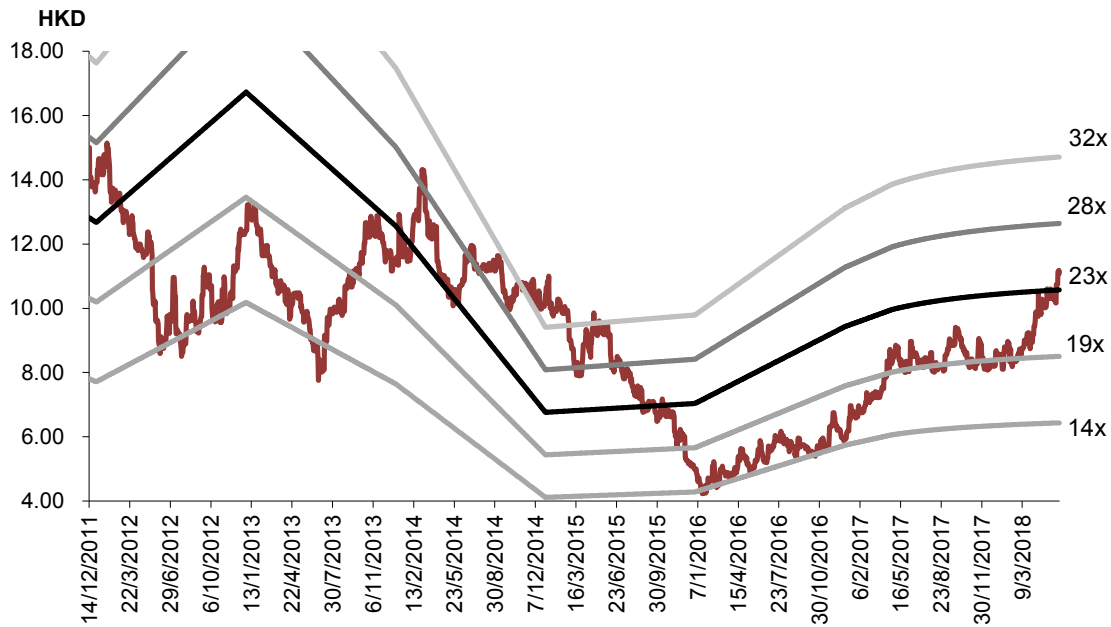
Financials: Revenue in FY2018 was higher than we expected, partly because of the jewellery trading business (HK\$1,144m in FY18 vs. HK\$352m) and wholesale business, both of which have a lower GPM.

For special dividends, our concern relates to the deteriorating FCF. As a full cash flow statement is not yet available, we estimate that FCF in FY2018 was HK\$2,710m, lower than FY2017's HK\$4,610m.

We expect FCF to continue to deteriorate in FY2019E due to working capital needs, especially inventory, given the Company's rapid expansion in China, as well as CAPEX of ~HK\$1.5bn.

Valuation

Figure 8: PER Band



Sources: Bloomberg, CGIS Research

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- 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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