# Luk Fook (590): Attractive Valuation on China Expansions

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Luk Fook, a jewellery retailer and wholesaler in Hong Kong and China, posted its annual results for the year ended 31st March 2010. Revenue was HK$5,386M, up 36% YOY on satisfactory same store sales (SSS) growth in HK, self-owned stores expansions in China as well as growing wholesaling business. Gross profit rose 48% YOY, to HK$1,294M, which was mainly attributable to sales growth and strong gross margin improvement in the first half. Gross profit growth surpassed rising staff costs and rentals and operating profit reached HK$657M, up 1.1x YOY. Such increase was then partially offset by non-recurring loss and a rise in effective tax rate. Reported net profit soared 93.2% YOY, to HK$532M. Excluding non-recurring items, recurring net profit was HK$551M, up 100.8% YOY. The company proposed to declare a final dividend of HK$0.28/share (FY09: HK$0.12), bringing the total dividend for the year to reach HK$0.43/share, up 152.9% YOY.

**Strong SSS Growth in 1QFY11 & Continuous Expansions in China**

- Gross margin improvement in the first half as well as strong sales growth in the second half promoted earnings growth.
- HK & Macau retailing markets accounted for an approximately 70% of the company's total revenue in FY10, posted a 40% SSS growth in 1QFY11 (April – June 10), which was due to the outbreak of H1N1 influenza last year. China retailing market also reported a 20% SSS growth in 1QFY11 (1).
- However, management also guided that such high growth in 1QFY11 is not expected to be maintained and SSS growth might achieve 10% in 2HFY11. We believe such target is achievable.
- As at 31st March 2010, the company had 36 & 483 self-owned & licenses shops in China. The company expects to open 100 new stores in China, of which 10-20 are self-owned stores.

**ACCUMULATE, MEDIUM RISK** (read footnote)

**Therefore, we expect the company's recurring net profit for FY11E to be HK$676.5M, up 22.7% YOY and further increase 18.7% YOY, to HK$802.9M in FY12E.** At **HK$12.44/share**, the company trades at a **historical FY10 recurring P/E of 11.1x** and **prospective FY11E and FY12E recurring P/Es of 9.1x and 7.6x** respectively.

- Valuation is not demanding on increasing contribution from Chinese visitors as well as China market.
- We maintain ACCUMUALTE and MEDIUM RISK (read footnote) ratings on this counter. Exposure to this counter should not be excessive.
- Major risks are lower-than-expected wholesaling business growth and gross margin improvement. Short-term fluctuation of gold and platinum prices is a concern.

Earnings Forecasts

| HK$ M | FY03/12E | FY03/11E | FY03/10 | FY03/09** |
|---|---|---|---|---|
| Revenue | 7,710 | 6,573 | 5,386 | 3,959 |
| Reported Net Profit | 802.9 | 676.5 | 531.6 | 275.2 |
| Recurring Net Profit * | 802.9 | 676.5 | 551.1 | 274.5 |
| Reported EPS (HK$) | 1.63 | 1.37 | 1.08 | 0.56 |
| Recurring EPS (HK$) | 1.63 | 1.37 | 1.12 | 0.56 |
| DPS (HK$) | 0.63 | 0.53 | 0.43 | 0.17 |
| Reported P/E (HK$12.44) | 7.6 | 9.1 | 11.5 | 22.3 |
| Recurring P/E (HK$12.44) | 7.6 | 9.1 | 11.1 | 22.3 |

Source: Company's results & Quam estimates
* Exclude foreign exchange and fair value gains/losses
** Company's restated results

Income Statement

| HK$ M | 2HFY10 | 1HFY10 | 2HFY09** | 1HFY09** | FY10 | FY09** |
|---|---|---|---|---|---|---|
| | Mar-10 | Sep-09 | Mar-09 | Sep-08 | Mar-10 | Mar-09 |
| **Revenue** | **3,298.8** | **2,087.6** | **2,144.5** | **1,814.7** | **5,386.4** | **3,959.2** |
| COGS | (2,530.6) | (1,562.3) | (1,647.0) | (1,438.3) | (4,092.9) | (3,085.3) |
| **Gross Profit** | **768.2** | **525.3** | **497.5** | **376.4** | **1,293.5** | **874.0** |
| Other income | 23.7 | 20.2 | 11.0 | 17.3 | 43.9 | 28.2 |
| Operating costs | (372.7) | (307.7) | (324.2) | (263.0) | (680.3) | (587.2) |
| **Operating Profit** | **419.2** | **237.8** | **184.3** | **130.7** | **657.1** | **314.9** |
| Finance income, net | (1.2) | (2.0) | 0.0 | (3.6) | (3.2) | (3.6) |
| Share of associate | 1.1 | 1.3 | (0.8) | 2.0 | 2.3 | 1.2 |
| **Core Profit before tax** | **419.1** | **237.1** | **183.5** | **129.0** | **656.2** | **312.6** |
| Other gains/losses | (14.8) | (7.1) | (1.0) | 4.4 | (21.9) | 3.4 |
| Tax | (57.2) | (40.4) | (29.2) | (8.6) | (97.5) | (37.8) |
| **Profit after tax** | **347.1** | **189.7** | **153.4** | **124.8** | **536.7** | **278.2** |

| | | | | | | |
|---|---|---|---|---|---|---|
| Minority interests | (3.9) | (1.2) | (1.3) | (1.8) | (5.1) | (3.1) |
| **Reported Net Profit** | **343.2** | **188.4** | **152.1** | **123.0** | **531.6** | **275.2** |
| **Recurring Net Profit *** | **356.8** | **194.3** | **155.6** | **118.9** | **551.1** | **274.5** |
| | | | | | | |
| **Gross Margin** | **23.3%** | **25.2%** | **23.2%** | **20.7%** | **24.0%** | **22.1%** |
| **Operating Margin** | **12.7%** | **11.4%** | **8.6%** | **7.2%** | **12.2%** | **8.0%** |
| **Recurring Net Margin** | **10.8%** | **9.3%** | **7.3%** | **6.6%** | **10.2%** | **6.9%** |

Source: Company's results & Quam estimates
* Exclude foreign exchange and fair value gains/losses
** Company's restated results

Segment Results

| HK$ M | 2HFY10 | 1HFY10 | 2HFY09** | 1HFY09** | FY10 | FY09** |
|---|---|---|---|---|---|---|
| | Mar-10 | Sep-09 | Mar-09 | Sep-08 | Mar-10 | Mar-09 |
| **No. of Stores** | | | | | | |
| HK | 31 | 31 | 30 | 30 | 31 | 30 |
| China | 36 | 32 | 19 | 17 | 36 | 19 |
| Macau, Canada & US | 6 | 7 | 7 | 6 | 6 | 7 |
| Total Self-Owned Stores | 73 | 70 | 56 | 53 | 73 | 56 |
| PRC & Canada Licensee Shops * | 484 | 438 | 401 | 368 | 484 | 401 |
| **Segment Revenue** | | | | | | |
| Retailing - HK | 2,003 | 1,271 | 1,401 | 1,203 | 3,274 | 2,604 |
| Retailing - Macau | 304 | 201 | 158 | 110 | 505 | 268 |
| Retailing - Overseas | 12 | 11 | 15 | 11 | 23 | 26 |
| Retailing - the PRC | 187 | 102 | 108 | 70 | 289 | 177 |
| Wholesaling | 696 | 426 | 394 | 352 | 1,122 | 746 |
| Licensing | 96 | 77 | 68 | 69 | 174 | 138 |
| Total | 3,299 | 2,088 | 2,145 | 1,815 | 5,386 | 3,959 |
| **Segment Results** | | | | | | |
| Retailing - HK & Macau & overseas | 267 | 121 | 142 | 48 | 388 | 190 |
| Retailing - the PRC | 27 | 12 | 5 | 4 | 39 | 9 |
| Wholesaling | 79 | 64 | 15 | 58 | 143 | 73 |

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|---|---|---|---|---|---|---|
| Licensing | 60 | 48 | 40 | 50 | 108 | 90 |
| Total | 433 | 245 | 201 | 161 | 678 | 363 |
| **Segment Margin** | | | | | | |
| Retailing - HK & Macau & overseas | 11.5% | 8.2% | 9.0% | 3.6% | 10.2% | 6.6% |
| Retailing - the PRC | 14.5% | 11.7% | 4.6% | 5.9% | 13.5% | 5.1% |
| Wholesaling | 11.4% | 15.0% | 3.8% | 16.6% | 12.7% | 9.8% |
| Licensing | 61.9% | 62.6% | 57.8% | 72.7% | 62.2% | 65.3% |
| Total | 13.1% | 11.7% | 9.4% | 8.9% | 12.6% | 9.2% |

Source: Company's results

* 1 in Canada only

** Company's restated results

**Notes on Rating**

Accumulate: The share is undervalued and investors may accumulate on weakness to secure more unrealized value. However, if investors already own excessive holdings of this stock, then they might have to reduce their holdings. Despite having the same rating of "accumulate", some stocks might have higher unrealized value than others.

Hold: The share is priced close to its value. If investors own excessive holdings of this stock, then they might have to reduce their holdings. Despite having the same rating of "hold", some stocks might have higher unrealized value than others.

Reduce: The share is not attractively priced and investors should reduce their exposures

Low risk: Earnings predictability is high. Investors may own relatively high exposures of the share.

Medium risk: There is a certain degree of earnings predictability. Investors may own controlled exposures of the share. However, if investors own excessive holdings of this stock, then they might have to reduce their holdings.

High risk: Earnings predictability is low. Exposure should be strictly controlled. If investors own excessive holdings of this stock, then they should reduce their holdings.

Disclosure: Chan Hing, Angus (AVO463), the author of this document declares that as of the date of the publication of this report, he does not hold an interest in the stocks mentioned in the article.