

Luk Fook: Well-executed PRC expansion

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Recommendation: Not Rated

Hong Kong Retail

Price	HK\$2.44	Yield (3/06A)	5.7%
12 mth range	HK\$1.02-2.55	ROE (3/06A)	13.9%
Market cap.	US\$154.1m	Net gearing (3/06A)	Cash
No. shares o/s	492.5m	Net debt/sh. (3/06A)	Cash
Daily t/o, 3 mth	<US\$0.54m	BV/sh. (3/06A)	HK\$1.47
Free float %	47.5%	Consensus EPS	
Major shareholder	Luk Fook (Control) Ltd. – 47.5%	- 3/07F	HK\$0.350
Ticker	0590.HK/ 590 HK	- 3/08F	HK\$0.400

Key points:

- Targets c.20% annual point-of-sales (POS) expansion in FY3/07F-08F in the PRC.
- Although top-line growth from HK retail in FY3/08F is expected to be slower than in FY3/07F, lesser rental pressure and higher PRC retail contributions will fuel bottom-line growth
- Beneficiary of RMB appreciation.
- High yield at 5.7% with generous payout of 50%.
- Luk Fook (LK) captured c.10% of China's jewellery retail market according to our estimates.

Well-executed PRC expansion. With the rapid pace of its franchisee expansion, we believe LF's China expansion plan is gaining momentum. As of today, LF has c.250 franchised stores in the PRC, about 30 more than in Sept 2006. Its presence in the PRC market is wider than we thought. Apart from the first tier cities, such as Shanghai, Beijing and Guangzhou, the company has ventured into Xijiang and Inner Mongolia. We attributed this to its franchisee mode of expansion, which allows widespread market penetration within a short period of time. LF targets c.20% annual POS expansion for the next few years in the PRC market. Although, China accounted only for c.5% of its sales, it contributed c.30% of its net profit in 1H FY3/07A.

Good licensing model. In the PRC, franchisees currently source c.50% of their products from LF, with the company collecting a wholesale margin of c.8% on average. For products sourced from suppliers designated by LK, it will charge the franchisees a fee for its quality control and consultancy services. On top of these, LF will also collect c.10% of their sales as royalties.

Retail rentals peaked in 3Q 2006. Usually, one-third of LF's stores are subjected to lease renewal every year. Leases renewed as of today have shown increases of 10-20%. Recently, a lease was renewed with a 8% increase in rent only. Although, the management expects a milder increase in HK retail sales in FY3/08F compared with 21% registered in 1H FY3/07A, we believe lower rental pressure and higher PRC retail contributions will fuel the bottom-line growth.

Valuation. LF targets an annual POS expansion of 20% in PRC. Capex is budgeted at HK\$30-40m with c.50% for store renovation and the rest for expanding its factory's production capacity. The company is in a net cash position of HK\$113.4m or HK\$0.23/sh as of 30 September 2006. It targets a payout of c.50%. Dividend yield is on the high side compared with peers (ref: table 2). It is trading at a consensus ex-cash and cum-cash P/E of 5.5x and 6.1x respectively for FY3/08F, compared with the industry's average of 12.2x.

1H FY3/07A results review. After a dismal FY3/06A, LF saw a turnaround in 1H FY3/07A with sales up 72% and net profit 1.9x, mainly due to 1) strong growth in the HK economy; 2) successful re-branding since Sept 2005; 3) the traditional good-for-marriage year; 4) a substantial increase in the quantity of gold jewellery items purchased by the Group from retail customers and then resold to gold merchants in view of the drastic surge in gold prices; 5) a

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substantial increase in its franchisee contributions and 6) lower rental pressure. Excluding gold resales, sales would have increased by c.25% YoY only. The HK market contributed >95% of its retail sales in 1H FY3/07A. Operating margin widened by 3.7% to 7.5% in 1H FY3/007A.

Table 1: Interim results

6 months to Sept	Turnover (HK\$m)	Gross profit (HK\$m)	Gross margin (%)	Operating (HK\$m)	Net profit (HK\$m)	EPS (HK\$)	Interim DPS (HK\$)
1H FY3/07A	1,404.0	264.4	18.8	104.6	85.5	0.173	0.070
1H FY3/06A	816.4	185.6	22.7	30.8	29.7	0.061	0.030
YoY (%)	72.0	42.4		239.6	188.3	185.3	133.1

Source: SBI E2-Capital

Table 2: Peer comparisons

Stock	Ticker	Curr	Share price (HK\$)	Market cap (US\$m)	P/E (x) 1-yr Fwd	P/E (x) 2-yr Fwd	Operating margin (%)	ROA (%)	ROE (%)	Yield (%)
Hang Fung Gold	870	HKD	1.25	129.0	6.6	5.5	6.0	6.2	13.2	3.2
Chow Sang Sang	116	HKD	4.95	378.9	10.2	9.0	3.6	7.1	9.2	3.4
Luk Fook	590	HKD	2.38	154.1	7.0	6.1	5.6	11.1	13.9	5.7
Tse Sui Luen	417	HKD	0.84	22.3	n.a.	n.a.	3.6	(5.8)	(21.0)	-
Xinyu Hengdeli	3389	HKD	6.65	1,032.0	41.0	29.1	15.1	11.0	24.7	0.8
Dickson	113	HKD	8.89	338.6	14.0	11.5	8.1	10.5	15.4	4.6
Oriental Watch	398	HKD	1.62	58.2	n.a.	n.a.	4.0	6.7	8.8	3.7
Stelux	84	HKD	0.64	75.6	n.a.	n.a.	7.0	11.8	23.3	6.3
Ming Fung	860	HKD	0.34	30.4	n.a.	n.a.	17.6	14.1	23.3	2.9
Average					15.8	12.2	7.8	8.1	12.3	3.8

Source: SBI E2-Capital

Table 3: P&L

Year to Mar (HK\$m)	02A	03A	04A	05A	06A
Turnover	1,478.8	1,461.8	1,598.1	1,961.7	2,126.3
% chg	(7.9)	(1.2)	9.3	22.8	8.4
Gross profit	316.1	304.4	345.9	416.0	462.9
EBITDA	91.9	69.5	105.0	165.3	178.2
Depreciation & amortization	(15.4)	(12.9)	(12.3)	(12.7)	(19.0)
EBIT	76.5	56.6	92.7	152.6	159.2
Net int. income/(exp.)	2.0	0.9	0.2	(0.3)	(0.5)
Exceptionals	0.0	0.0	0.0	0.0	0.0
Associates					
Jointly-controlled entit.					
Pre-tax profit	78.5	57.5	92.9	152.3	112.4
Tax	(13.9)	(9.8)	(14.8)	(25.1)	(15.9)
Minority interests	(0.4)	(0.3)	(1.1)	(1.2)	(0.8)
Net profit	64.2	47.4	77.0	126.0	95.7
% chg	(9.9)	(26.3)	62.5	63.7	(24.0)
Dividends	(35.4)	(28.5)	(33.7)	(58.3)	(48.8)
Retained earnings	28.8	18.9	43.3	67.7	46.9
EPS (HK\$) - Basic	0.138	0.100	0.161	0.261	0.197
EPS (HK\$) - F.D.	0.135	0.098	0.158	0.258	0.195
DPS (HK\$)	0.075	0.060	0.070	0.120	0.100

Source: SBI E2-Capital

Company background. Established in 1991 and listed on the HK Stock Exchange in 1997, LF is principally engaged in retailing and wholesaling of gold and gold jewellery mainly in HK, China and Macau. To boost production efficiency, it has established its own production base in Panyu, Guangzhou, which supplies c.15% of its sales, while the rest is outsourced. Products are sold under its own brands, namely “Luk Fook” and “ICE g.”. In 1H FY3/07A, its retail and wholesale accounted for c.45.7% and c.54.0% of total sales and c.50.3% and c.47.6% of its operating profit respectively. Around 50% of its retail sales came from mainland tourists. Currently, the company

operates 25 shops in HK, mainly on high-street level. It has 250 POS under franchisee operations in the PRC. It hedged c.50% of its gold inventory.