

Hang Fung Gold: Hidden value to be unleashed

Recommendation: BUY (initiating coverage)

Hong Kong Retail

Price	HK\$1.59	Year to Net profit	EPS	EPS	P/E	P/B	EV/EBITDA	Yield	ROE	ROCE	N. Gear.	
Target price	HK\$2.3 (+44.7%)	Mar	HK\$m	HK\$	Δ %	x	x	x	%	%	%	
12 mth range	HK\$0.87-1.52	05A	107.2	0.189	59.9	8.4	1.08	7.51	2.4	13.9	9.9	83.9
Market cap.	US\$157.8m	06A	129.7	0.170	(9.9)	9.3	1.07	6.26	2.5	13.2	10.2	41.5
Daily t/o, 3 mth	US\$0.9m	07F	162.1	0.209	23.0	7.6	0.98	5.36	2.6	13.6	11.7	59.7
Free float %	49.7%	08F	210.1	0.271	29.6	5.9	0.86	5.18	3.4	15.7	12.4	58.9
Ticker	870.HK/870 HK	09F	273.9	0.354	30.4	4.5	0.75	4.29	4.5	17.8	15.4	50.6

Relative to Hang Seng Index (1 mth, 3 mth, 12 mth): +32.3%, +35.8%, +12.7%

Actual price changes (1 mth, 3 mth, 12 mth): +35.9%, +45.9%, +50.0%

Consensus EPS (07F-08F): HK\$0.196, HK\$0.235

Key points:

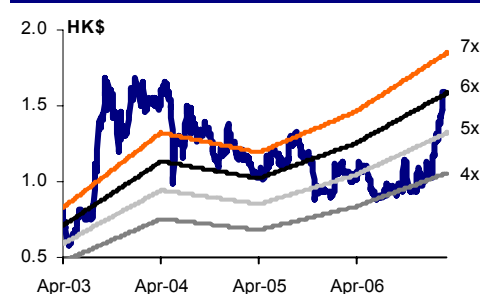
- Retail contribution to grow to c.50% in FY3/07F.
- The Gold Palace – a popular tourist attraction.
- 100 POS to be added in each of the next two years (2007-2008).
- Hidden value of HK\$295m (HK\$0.38/shs) in Gold Exhibits on gold price surge.
- Gains from Gold Exhibit disposals, with lower depreciation expenses, improve operating margins and ROE.
- Net gearing lowered to 41.5% (prev. 66.6%) in FY3/06A with the convertible bond issues.
- Investment in gold exhibits capped at HK\$100m.
- Target price set at HK\$2.3, based on 8.5x FY3/08F P/E.

□ **Increasing contributions from brand retailing.** Retail sales is expected to grow c.40% YoY in FY3/07F and contribute c.50% of the total sales in the year, from c.41% in FY3/06A, which will benefit the Group's gross margin as gross margin for the retail segment can be 30-40% higher than wholesale. HFG operates 118 retail outlets in China, mainly in 40 first and second-tier cities with 76 self-owned stores and 42 franchisees. It also operates 13 self-owned stores and six tourism exhibition halls in Hong Kong. It aims to add a total of 200 POS in the next two years (2007-2008), with 100 POS being added every year.

□ **Rising tourist travel.** Its exhibition halls in Hong Kong, covering a total area of 100,000 sq.ft., attract over 7,000 visitors daily, enjoying rental advantage of c.4% of total sales. The Gold Palace has become a popular tourist attraction since its first rollout in 2006. HFG is expected to benefit from the rising purchasing power of China's middle class and RMB appreciation.

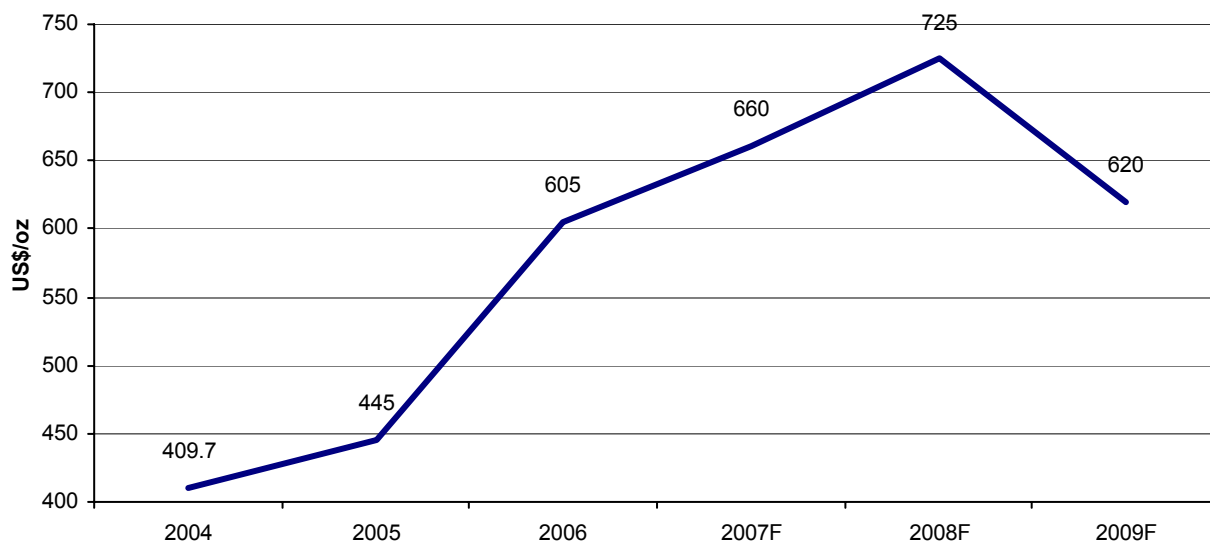
□ **Hidden value in Gold Exhibits on gold price surge.** HFG's Gold Exhibits, built from 2001 to 2006, contain a total of 5.5 tonnes of solid gold. The average price of gold has risen from US\$274/oz in 2001 to US\$465/oz in 2006 (refer to chart 2), representing an increase of 69.7% or a five-year CAGR of 11.1%. According to our estimation, the rise has created a hidden value of HK\$295m (HK\$0.38/shs) in HFG's book, since the company capitalized the Gold Exhibits as assets. According to the London Bullion Market Association, the average price of gold should rise 9.1% to US\$660/oz in 2007 and peak at US\$725/oz in 2008, which will further boost the hidden value of the Gold Exhibits.

Chart 1: P/E bands



Source: SBI E2-Capital

Chart 2: Gold price



Source: London Bullion Market Association, SBI E2-Capital

Table 1: Portfolio of Gold Exhibits

	Year of establishment	Cost (HK\$m)	Market value (HK\$m) (18th Jan 2007)	Estimated gain on disposal (HK\$m)
Gold Kuan Yin	2000/01	13.4	31.1	17.7
Gold Zodiac	2000/01	6.9	16.2	9.3
Gold Washroom	2000/01	64.2	134.2	69.9
Gold Windmill	2003/04	3.9	6.0	2.1
Gold Carriages (x 2)	2004/05	106.1	155.5	49.3
Gold Palace	2005/06	399.8	546.3	146.5
Others		0.5	0.6	0.2
TOTAL		594.9	889.9	295.0

Source: SBI E2-Capital

- **Planned disposal of Gold Chariot.** The hidden value of the Gold Exhibits can only be unlocked upon disposal, which will lead to 1) one-off revaluation gain; 2) lower depreciation expenses and 3) rental expenses on the lease back of the sold Gold Exhibits. The degree of improvement in the operating profit margin will depend on the yield of asset leaseback. HFG plans to dispose of one of its two Gold Chariots in 2007, which have a total market value of HK\$155.5m and are expected to generate a disposal gain of HK\$20m each. According to our estimation, the move would lower depreciation expense by c.HK\$5.3m annually. Assuming a leaseback yield of 6.5%, HFG would incur rental expenses of c.HK\$5.1m and thus, the net benefit would be HK\$200,000.
- **A turning point if committed to dispose its gold assets.** As of 30th Sept 2006, the Gold Exhibits accounted for c.90% of its PPE (HK\$748m). On average, depreciation expenses of >HK\$100m are incurred every year. Although the impact of Gold Chariot disposal is small, we believe that if HFG sells more of its Gold Exhibits and limits new investments, it can boost its operating profit margin substantially. The disposal of its “Gold Wong Tai Temple” in April 2006 generated a gain of HK\$32.8m, and a leaseback yield is c.7%.

Financial Highlights

Table 2: Profit & Loss

(HK\$m)	05A	06A	07F	08F	09F
Year to Mar					
- Whole & distribution	1,596.5	1,690.6	1,775.1	1,863.9	1,957.1
- Brand retailing	970.2	1,189.5	1,665.2	2,414.6	3,139.0
Turnover	2,566.7	2,880.0	3,440.3	4,278.5	5,096.0
% chg	24.1	12.2	19.5	24.4	19.1
Gross profit	902.6	950.3	1,023.9	1,325.0	1,625.9
EBITDA	257.0	271.6	369.4	399.5	481.0
Depre./amort.	(120.5)	(111.8)	(158.6)	(134.2)	(115.2)
EBIT	136.6	159.8	210.8	265.3	365.9
Net int. income/(exp.)	(26.3)	(49.9)	(39.9)	(56.7)	(61.6)
Exceptionals	3.1	28.2	3.8	24.7	-
Associates	-	-	-	-	-
Jointly-controlled entit.	-	-	-	-	-
Pre-tax profit	113.4	138.2	174.8	233.3	304.2
Tax	(6.2)	(8.4)	(17.5)	(23.3)	(30.4)
Minority interests	-	-	-	-	-
Net profit	107.2	129.7	157.3	210.0	273.8
Net profit (pre-exceptionals)	110.6	112.7	171.3	211.1	304.2

Source: SBI E2-Capital

Table 3: Interim results

Six months to Sep	Turnover (HK\$m)	Gross profit (HK\$m)	Gross margin (%)	Pre-tax profit (HK\$m)	Tax rate (%)	Net profit (HK\$m)	EPS (HK\$)	DPS (HK\$)
1H FY07	1,522.7	448.8	29.5	58.5	11.1	52.0	0.0682	0.015
1H FY06	1,361.2	423.4	31.1	48.4	5.8	48.4	0.0669	0.010
YoY (%)	11.9	6.0		13.9		7.5	1.9	50

Source: Company data

Valuation.

HFG is currently trading at 8.1x FY12/07F P/E, compared to an industry average of 16.7x on jewelers and luxury goods retailers. We believe it will continue to benefit from China's middle class rising consumption power in the long term, with near term catalyst from gold asset disposals. We initiate coverage with a BUY rating and a target price of HK\$2.3, representing 8.5x FY12/08F P/E.

Table 3: Peer comparison

Stock	Ticker	Currency	Price (HK\$)	Market cap (US\$m)	P/E (x) 1-yr Fwd	P/E (x) 2-yr Fwd	Operating Margin (%)	ROA (%)	ROE (%)	Yield (%)
Jewelers										
Hang Fung Gold	870	HKD	1.59	156.8	8.1	6.8	6.3	6.2	13.2	2.5
Chow Sang Sang	116	HKD	5.73	453.8	11.8	10.4	3.6	7.1	9.2	3.0
Luk Fook	590	HKD	2.8	180.0	8.5	6.5	5.5	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	-
Luxury goods retailers										
Xinyu Hengdeli	3389	HKD	6.6	1,006.5	40.3	28.3	15.1	11.0	24.7	0.8
Dickson	113	HKD	9.79	393.1	15.0	12.3	8.1	10.5	15.4	4.2
Oriental Watch	398	HKD	1.82	64.2	n.a.	n.a.	4.0	6.7	8.8	3.3
Stelux	84	HKD	0.61	78.1	n.a.	n.a.	7.0	11.8	23.3	6.6
Ming Fung	860	HKD	0.51	46.5	n.a.	n.a.	16.1	12.5	20.5	2.0
Average					16.7	12.9	7.7	7.9	12.0	3.5

Source: SBI E2-Capital

Risk. 1) Slower-than-expected retail expansion; 2) Slowdown in consumption growth in China; 3) High gearing; 4) Dilution from the exercise of CB, but the impact will be offset by earnings growth and 4) New investment in Gold Exhibits.

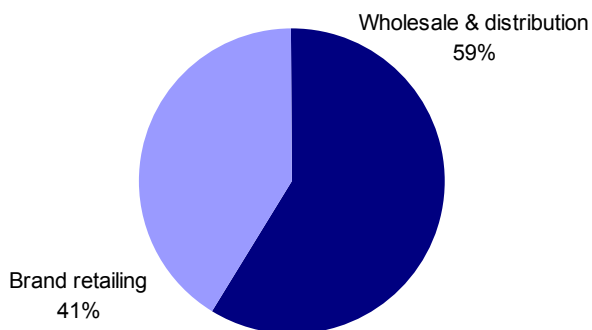
Corporate governance. 1) PricewaterhouseCoopers has been the auditor since 2002; 2) Management indicated

that dividend payout will be c.20% per year going forward. 3) The founder and chairman of the Group, Mr. Lam Sai Wing, does not have any side-business other than HFG.

Share placement history. 1) In Nov 2006, Goldman Sachs arranged a HK\$240m convertible bond issue (21.44% of enlarged issued share capital) with a conversion price of HK\$1.136/shs expiring in 2011; 2) One for three rights issue of 186.9m shares at HK\$1.01/shs in Apr 2005 and 3) Placement of 72.5m shares at HK\$1.31 in Sept 2003.

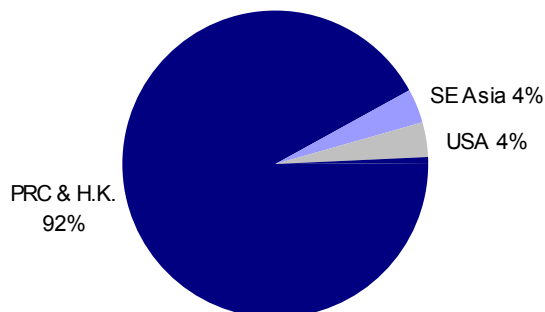
Company background. Set up as an OEM gold and jewellery manufacturer in 1979 and listed on the HK Stock Exchange in 1999, Hang Fung Gold (HFG) has diversified into retail selling products under three proprietary brands, “3D-GOLD”, “La Milky Way” and “Modeo” (acquired in 2005). It also distributes “BLITA” and “Swiss Horn” watch products. It retails in China, Hong Kong and Macau, with wholesale operations in the U.S., Europe, SE Asia and China. Currently, it has 118 stores in the Mainland in 40 first and second-tier cities, including 76 self-owned stores and 42 franchisees. It operates 13 self-owned stores and six exhibition halls in Hong Kong. China and Hong Kong remain its largest market, accounting for 91.7% of total sales in 1H FY3/06A. Over 70% of its gold wholesales are hedged and are therefore immune to gold price fluctuations.

Chart 2: sales by segment



Source: Company data

Chart 3: sales by country



Source: Company data

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