

Larry Jewelry International Company Limited

Growth Engine restarted...

Key Investment Themes

- Larry Jewellery is a prestigious jewellery player with strong brand equity, focusing on high-end market.
- Cooperation with Oriental Watch provides a low risk low cost means for expansion.
- Launching of high ticket item will boost ASP and margin
- Initiatives has been taken by management to optimize the operation
- Expected to return to profit in this fiscal year
- Gearing ratio will drop substantially following the fund raising exercise in 2Q
- Set to benefit from the rapid growth in high-end jewellery market in Greater China and South East Asia region

Photo Set 1. Larry Jewelry's products



Source: Company data

Investment story. As a prestigious player with strong brand equity, Larry Jewellery is set to benefit from the rapid growth in jewellery market in Greater China and Asia Pacific region. Posted as a high-end fine jeweler, Larry is unique, compared to its peers whose focus on mass market. Thanks to its excellent design, authentic quality and superior craftsmanship, the jeweler has developed a client base of rich family customers of generations, enjoying high customer loyalty.

Management team of the jeweler has been taking initiatives to resume growth momentum in the business, such as network expansion via cooperation with Oriental Watch, launching of high ticket and limited edition items, increase publicity of the brand, revitalize brand image and reformation of operation.

Last fiscal year earmarked the restructuring stage for the group and it reported a net-loss, due to non-recurring accounting charges. We expect the group to return to profit and resume growth momentum from this year on, on full year contribution from jewellery retail operations, margin enhancement, substantial lower finance cost and double digit growth in turnover due to higher ASP and expansion in sales channel. Further, the group financial position would be more vigorous following the fund raising exercise in 2Q FY12F, with net gearing ratio drop to 6% from more than 100%, by estimation.

Going forward, we expect to see an escalation in the group's ROE. Unlike its listed peers, earnings base of the group is still relative small, implying a high growth potential. We expect the group to outperform its peers, in terms of ROE and earnings growth onward.

Major competitive advantage: Brand equity of Larry Jewellery. Established in 1967, Larry Jewelry is a renowned brand in Asia Pacific for its unsurpassed mastery in fine jewelry design, extraordinary craftsmanship and authentic quality. It is a true fine jeweler in high-end jewelry market in Asia Pacific with a strong threshold of rich family customers of generations. It is one of the three

Please refer to important disclosures at the end of this report

| Ticker | 8351 HK |
|------------------------|-----------|
| Rating | BUY |
| Price (HK\$) | 0.73 |
| Target Price (HK\$) | 1.05 |
| 12m Price Range (HK\$) | 0.43-1.95 |
| Market cap. (US\$m) | 80.9 |
| Daily t/o (US\$m) | 0.3 |
| Free float (%) | 93.46 |

Financial summary

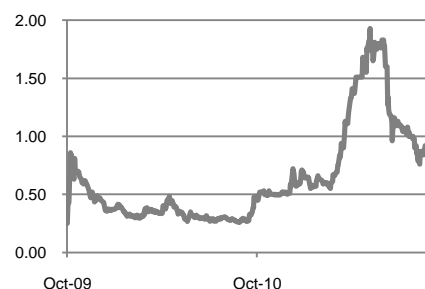
| Year to Dec | Mar. 11A | Dec. 11A |
|--------------------|----------|----------|
| Turnover (HK\$m) | 48.7 | 204.0 |
| Net Profit (HK\$m) | (19.4) | (74.5) |
| EPS (HK\$) | (0.029) | (0.086) |
| P/E (x) | - | - |
| P/B (x) | 5.14 | 3.89 |
| EV/EBITDA (x) | - | - |
| Yield (%) | - | - |
| ROE (%) | - | - |
| ROCE (%) | - | - |
| N. Gear. (%) | Cash | 102.8 |

Source: SBI E2-Capital

| | 11A | 12F |
|----------------------|-----|-----|
| Consensus EPS (HK\$) | - | - |
| Previous EPS (HK\$) | - | - |

Price performance

| Year to Dec | 1m | 3m | 12m |
|--------------------------|-------|-------|--------|
| Relative to HSI (%) | 0.8 | (4.7) | (37.3) |
| Actual price changes (%) | (1.4) | 4.3 | (47.5) |



Source: Bloomberg

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jewelers in HK recognized by De Beers to sell Forevermark diamonds, while the other two are Chow Sang Sang and Chow Tai Fook. In addition, Larry is an exclusive distributor for top-selling Lazare jewelry in Singapore, and the group obtained the distribution right of Lazare jewelry in Hong Kong in February 2012. Larry Jewelry has won numerous award and recognition for its superior product design and craftsmanship as well as premium customer services.

Market position of Larry Jewellery. Larry's ASP in 2011 was around HK\$75,000, or at least five times higher than its Hong Kong listed peers. Thus, in the pricing spectrum, Larry's position is high-end jeweler, slightly below the multinational top-tier jewelers such as Van Cleef & Arpels, and Bulgari.

In addition, unlike its peers whose focus on the mass market in Greater China selling mass-produced jewellery, Larry put a great emphasis on design, quality and highly customized services. All of its products are handcrafted in Hong Kong and Singapore, which makes Larry a true fine jeweler. In fact, its jewellery workshop in Hong Kong is located in central. Its experienced sales team offered VIP prime services and expert grade consultancy services to its customers. Thus, Larry is focusing on the high-end customer segment. Over years, Larry has successfully developed a clientele of rich family customers of generations. Thanks to its brand heritage, customer loyalty to Larry is high.

Table 1. Achievements

| Year | Achievements |
|------|---|
| 1986 | De Beers 1986 Diamond International Awards (Milan, Italy) |
| 1997 | Silver Award in Brooch Category in the International South Sea Pearl Jewellery Design Competition Bronze Award in Bangle Category in the International South Sea Pearl Jewellery Design Competition |
| 1998 | The only pioneer-jeweler selected by the Singapore Tourist Board in the Singapore Gold Circle (SGC) Scheme 1 |
| 1999 | Gold Award in Brooch Category in the International South Sea Pearl Jewellery Design Competition 7 Silver Award in Pendant Category in the International South Sea Pearl Jewellery Design Competition |
| 2001 | Tourism Host Award from Singapore Tourism Board |
| 2003 | Bronze Award in Ring Category in the International South Sea Pearl Jewellery Design Competition. Two Merit Awards in Brooch Category in the Hong Kong Jewellery Design Competition. Merit award in Other Category in the Hong Kong Jewellery Design Competition |
| 2005 | Tourism Host Award from Singapore Tourism Board SuperBrands 2004/2005 National Model Company in Singapore by SPRING |
| 2007 | Excellent Service Award 2007 From Singapore Tourism Board |
| 2008 | Best Local Jewellery 2008 by Singapore Tatler |
| 2011 | 10 Years Quality Tourism Services Merchant Recognition |
| 2012 | Capital Entrepreneur Award |

Source: Company data

Revitalization of the operation. Previous management team of Larry had run the business prudently; they did not make any drastic move or expanded the operation aggressively, until the new management stepped into the office. The new management will focus on enhancing return on shareholder equity, higher growth and higher margin; it targets to increase the turnover and ASP by double digit growth rate, and boost up the group's blended margin by another 2%-3% (GPM in FY10A: ~25%; FY11A~30%). Means to the goals include change in client mix, expansion in sales network, launching high value items, adopting flexible pricing strategy, intensive promotion and marketing event and brand revitalization; reformation in remuneration system , extending the store opening hour, as well as improvement in economy of scale.

Change in client mix. Approximately 39% of Larry's customers are from Hong Kong, 54% are from South East Asia and around 7% are from Mainland China. Compared to other HK-listed jewelers with over 60% of their customers from Mainland China, proportion of Mainland Chinese clients in the group's clientele is low. The group aims to tap the fast expanding Mainland Chinese clientele by launching more marketing/promotion events and advertising campaign, introduction of designers/celebrity collaboration series and cooperation with Oriental Watch (398 HK).

Photo Set 2. Larry Jewelry stores in Singapore



Source: Company data

Shops in prime locations. Currently, Larry Jewelry has six shops in the most popular shopping districts in Hong Kong and Singapore. In Hong Kong, Larry's shops are located in Central, Causeway Bay, TST and Pacific Place (Admiralty). Larry's shops in Singapore are located in Paragon and ION Orchard, the two renowned shopping malls in Orchard Road, the retail and entertainment hub of Singapore which target up-market shoppers.

Photo Set 3. Larry Jewelry stores in Hong Kong



Source: Company data

Bloom of POS. We expect the group's sales networks to expand in the relative fast pace starting from 2012 onward, as the group and Oriental Watch (398 HK) entered into the cooperation agreement in March 27. Under the terms of the cooperation, both parties agreed that initially, Larry Goods will be sold in specific section of the Oriental Watch's two-storey flagship shop in 100 Queen's Road, Central, Hong Kong, and upon achieving satisfactory results, the sales channel of Larry would be expanded to other retail outlets of Oriental Watch as may be agreed between the parties. Currently, Oriental Watch operates 12 stores in Hong Kong, 2 stores in Macau, 90 stores in China and 2 stores in Taiwan. It is expected that sales of Larry's goods at Oriental Watch outlets will be incepted in 2Q12.

Expansion in safe mode. In our view, the cooperation between Larry and Oriental Watch would expand Larry's sales network in efficient and cost saving manner. By our estimation, the capital expenditure for opening up a standalone jewelry store is about HK\$40m, and most of the expenditure goes to inventory. In addition the jeweler has to assume high rent should the store is located in popular shopping district, not to mention that good location in popular district has become rare in town. Under the cooperation mode between Larry and Oriental Watch, Larry immediately has access to shop floor space in prime location of popular shopping district in town. Rental and decoration expenses should be limited as Larry just occupies a section in Oriental Watch shop floor space.

Reach to Mainland clientele. Since its establishment in 1961, Oriental Watch has become one of the largest watch retailers in Greater China region renowned for its reputation, credibility, and scale. The luxurious watch retailer carries around hundred world prestigious brands, in particular the world famous Swiss brands like Rolex, Tudor, Piaget, Vacheron Constantin, Audemars Piguet, IWC, Parmagiani, Jaeger-LeCoultre, Girard Perregaux, Longines and Omega. Oriental Watch's major clientele is wealthy Mainlander who can afford luxurious watch. Unlike Larry, whose major customers are wealthy family/high net-worth individual from Hong Kong and South East Asia, more than 70% of Oriental Watch customers are Mainlanders. With outlets in Oriental Watch shops, Larry has the reach of Mainland Chinese customers. Further, leveraging on Oriental Watch's information on its clientele, including spending power, preference and behavior, Larry would not necessary need to test the market by stocking variety of jewelry. This will reduce the risk of overstocking and reduce the cost of inventory. As mentioned, Oriental Watch has 90 stores in China. Potentially, if the HK cooperation model is proven to be successful, the cooperation mode could be stretch into Oriental Watch sales network in Mainland China, providing a low risk and low cost mean for Larry to expand into first-tier cities in China.

Boost up ASP. In 2011, ASP of Larry's products was HK\$75,000. Thanks to the increase in price of products, Larry's product ASP reached HK\$82,000 in February 2012. We expect that Larry's products ASP to increase further, due to launching Lazare Diamond in Hong Kong and introduction of designer and celebrity collaboration series.

Distribution of Lazare Diamond. Larry Jewelry has been the exclusive distributor of Lazare Diamond in Singapore since 1989. Currently, sales of Lazare Diamond accounted for about 30% of the group's sales in Singapore. Thanks to its solid relationship with Lazare, it won the distribution right of Lazare Diamond in Hong Kong in February of this year. Currently, Given its solid relationship with Lazare, we do not rule out the possibility that Larry win the distribution right of Lazare Diamond in Greater China in the future.

Photo Set 4. Lazare Diamond



Source: Company data

The world's most beautiful diamond. Founded in 1903, Lazare Kaplan International has become the premier diamond-cutting company in the world. Its tradition of excellence gives those who buy a Lazare Diamond the confidence of possessing "The world's most beautiful diamond". Each Lazare Diamond is cut to very strict standards that are more stringent than what other calls "ideal" proportions. When a diamond is ideally cut, light rays from all sides are bent towards the center of the stone and are reflected back through the top in a blaze of light. The proportions Lazare used for its ideal cut diamond create the optical balance of brilliance, scintillation and fire-the three optical properties that contribute to a diamond's unique beauty. Currently, In Japan alone, Lazare has 200 boutiques there, and the Lazare ring is perceived as the most wanted ring for wedding couples in Singapore and Japan.

Photo Set 5. Lazare Diamond



Source: Company data

High ASP, high profitability. Thanks to its high brand awareness for its superior quality and high value, respective ASP and gross profit margin of Lazare Diamond is estimated to be at least 30% and 2% higher than generic diamond. Thus, we expect that the inception in sales of Lazare Diamond in Hong Kong will provide a boost to the group's sales and ASP, starting from FY12F. Management expects sales from Lazare Diamond would account for 10%, 20% and 30%, respectively, of the Hong Kong office revenue in FY12, FY13 and FY14.

Designer and celebrity collaboration series. The launching of designer and celebrity collaboration series would also uplift ASP and sales, as well as increase publicity of Larry brand. Since products in the collaboration series are expected to be limited edition, designed by or associated with famous designers/design units and celebrities, the perceived value of such items should be higher than generic products in same quality. This allows management to mark up the price for such products.

Intensive promotion and marketing campaign. To boost sales and increase publicity of Larry brand, the group will launch a series of promotion events in 2012 as follow:

| Month | Promotions |
|-----------|--|
| February | Launch of Lazare Diamond in Causeway shop in Hong Kong; Valentine promotion. |
| March | Bridal Collection & Promotion |
| April | Diamond Month Promotion |
| May | Diamond Month Promotion |
| June | 45th Anniversary Activities |
| July | 45th Anniversary Activities |
| August | 45th Anniversary Activities |
| September | Autumn Special Event |
| October | Autumn Special Event |
| November | Christmas/ New Year Promotion/Sales Event |
| December | Christmas/ New Year Promotion/Sales Event |

Source: Company data

The Diamond Month promotion in April and May would be the signature events in this year, according to the management of the company. The events will be held in both Singapore and Hong Kong. The events are consisted of catwalk show, exhibition, auction and party. A giant diamond with 26 carat would be displayed in the exhibition as well.

Revitalize the brand. Further, to revitalize the Larry brand, a new advertising campaign would be incepted. Image and renovation of the Hong Kong stores will be upgraded, in order to provide a high-end and customized shopping atmosphere for customers. Management intends to boost up the A&P budget to 4-5% of its turnover from 1% in the past.

Photo Set 6. Unify store image and new advertising campaign



Source: Company data

Modification in pricing strategy. Until the new management team taking over the office, Larry Jewelry adopted the cost plus model to price its products, which is all-in historical cost plus a fixed margin of about 25% +. In such pricing mode, selling price failed to reflect the change in value of raw material (gem stone, diamond and gold). Now, management team is adopting a pricing strategy which is sensitive to change in cost of raw material and demand for particular jewelry items, with the aid of the upgraded inventory management system. The upgraded IMS also allows management keep track on the movement and storage of inventory instantly, ensure the safety of the valuable inventory. In our view, a more flexible pricing strategy will also shorten the inventory turnover from 12 months to less than 9 months.

Improvement in economy of scale. In the past, the Singapore office and the Hong Kong office procured raw material such as precious metal, diamond and gem stone separately, resulted in less discount offered by suppliers, higher logistic costs and deficiency in resource allocation, such as overlapping of purchase. Now, since the Singapore office and the Hong Kong office procure collectively, the group can enjoy higher discount offered by suppliers due to bulk purchase, logistics costs are contained and resources are allocated in a more efficient manner. The cost containment from group procurement is expected to increase the group's blended margin by at least 1%.

Reformation of reward system. Management is reforming frontline staffs' remuneration package from fixed salary basis to more performance oriented. This will provide incentives to frontline staffs to achieve more sales.

Extension in store opening hour. Previously, the shop opening hours of Larry shop is from 10:00am to 7:00pm, and the management is extending the shop opening hours gradually. Management targets to move the shop closing time from 7:00pm to 9:00pm.

A hub of talents. The group's business plan would be executed by management team consisted of experts in the area of marketing, finance, and other fields:

Table 3. Management team

| Name | Position | Description |
|---------------|--------------------|--|
| Joe Chan | Chairman | <ul style="list-style-type: none"> ☐ Over 20 years of advisory and trading experience at leading financial institutions ☐ Joined Morgan Stanley London, Paris & Hong Kong, 1988–1996, as the head of non-Japan Asia equity trading operation, head of bond trading in Paris and head of French Franc and ECU denominated bond trading in Paris & London ☐ Founded Galaxy Asset Management (H.K.) Limited in 1998 and is currently a Managing Director and Chief Investment Officer |
| Pauline Tsang | Executive Director | <ul style="list-style-type: none"> ☐ Over 8 years of experience in the accounting and finance area ☐ Joined Deloitte Touche Tohmatsu in 2002 and worked her way to senior auditor in the assurance and advisory business area ☐ Joined the Research and Strategy Group at Citi Private Bank in 2007 |
| Iris Chung | Head of Retail | <ul style="list-style-type: none"> ☐ Over 20 years of experience in marketing and retail operations ☐ Joined the Swire Group in the 90s as Group Management Trainee and worked as the Advertising & Promotion Manager & Merchandising Manager for both Marathon Sports and The Athlete's Foot ☐ Worked for Coca Cola China as Marketing Director for Hong Kong and Macau regions ☐ Group CEO of Just Gold and spokesperson for the Company and icon for the brands ☐ Launched Just Diamond in 1994 and steered Just Gold to China in 2002 ☐ Was awarded "The 100 Most Outstanding Woman Entrepreneurs in China 2006" |
| Teddy Luk | CFO | <ul style="list-style-type: none"> ☐ Over 15 years of experience in finance operation and M&A ☐ Joined the corporate finance team at Arthur Andersen in the 90s, advising clients on fund raising, strategic planning and M&A ☐ Associate director of PricewaterhouseCoopers corporate finance service line focusing the retail sector. ☐ CFO of a HKEx listco and the VP Finance and Business Development for a MNC's operations in China |

Source: Company data

Five months contribution from Larry in FY11A. The financial year end date of Larry Jewelry International has been moved from 31 March to 31 December commencing from the financial period ended 31 December 2011. Accordingly, the FY11A reporting covered the nine months period from 1 April 2011 to 31 December 2011. In addition, the acquisition of Sharp Wonder (whose own the retail operations of Larry Jewellery) was completed in July 2011. Thus, retail operations of Larry Jewellery provided five months contribution only to the group in FY11A.

Results for FY11A. For the year ended March 2011, the group's turnover increased by about 3% to HK\$48.6m. Since its gross profit dropped by 30.3% YoY to HK\$13.3m, the group reported a net loss of about HK\$19.3m. Almost all of the income reported by the group for the 12 months period ended March 2011 was generated from the legacy jewellery wholesale business, Eternity Jewellery.

For the nine months ended December 2011, the group reported a turnover of about HK\$204m, due to the contribution of Larry Jewellery. The group reported a net loss of about HK\$74.5m, mainly due to non-recurrent and one off charges of about HK\$50m, collectively, plus high financing costs:

1) In accordance with accounting standards, the inventories of Sharp Wonder as at 19 July 2011 were revalued at the fair market value, representing a 17.9% increase over their historical costs. Thus, as at the reporting date of 31 December 2011, an amortization of about HK\$21.3m was charged against the value of Sharp Wonder's inventory. Such charges were included in the group's COGS. In addition, the

group made a provision of about HK\$5m for inventory of Eternity's wholesale business, and such charges were also included in the COGS, by our estimation. As a result, the group's gross profit margin was dragged to 17.3. If the aforementioned charges had not been included into the COGS for the period, the group's gross profit margin would have been about 30%, by our estimation.

- 2) For the period, the group incurred a cost of about HK\$15.8m associated with various transactions and acquisitions.
- 3) HK\$5.1m of amortization was charged against the goodwill of Parkwell Asia, the company which the group acquired in September 2011.
- 4) A provision of HK\$3.1m for the closure of Macau retail business under Eternity.
- 5) 799.7% surge in distribution costs to HK\$34.9m, mainly attributed to the operating costs of the Larry's retail operations acquired during the reporting period and the marketing expense for promoting the brands.
- 6) 108.1% increase in administrative expenses to about HK\$59m, due to expansion of operation following the acquisition of Sharp Wonder, costs for opening new store and costs for completing the acquisitions and capital raising exercises.
- 7) A substantial increase in finance costs of about HK\$17.4m.

Core operation: proven track record. The group's core operation's Larry Jewellery did perform well in last year. For the 12-month ended December 2011, Larry Jewellery saw its turnover, gross profit and net profit increased 7.8% YoY, 19.5% YoY and 63.6% YoY, respectively, to HK\$435.9m, HK\$126.6m and HK\$36.5m. The surge in Larry's 12-month results was mainly attributable to the increase in ASP to HK\$75,000, and we estimate that Larry's bottom line is very sensitive to the change in ASP and blended margin. Turnover and net profit CAGRs of Larry between 2009 and 2011 were 15.6% and 93.7%, respectively. Meanwhile, its gross profit margin increased from 25.4% to 29.0%. In January and February, Larry Jewellery's turnover was up about 8% and 10%, respectively.

Turnaround in FY12F. We expect the group to return to profit in FY12F, as:

- 1) Larry's Jewellery will provide full year contribution to the group.
- 2) Expansion in sales network and extended store opening time will boost up revenue.
- 3) Higher ASP.
- 4) Margin enhancement on bulk purchase result in lower procurement cost, higher ASP and improved inventory management.
- 5) Substantial saving of finance cost.
- 6) Amortization charges against inventory are expected to drop substantially.

Target Price and Valuation. We are in the process of revising our financial model and target price, and this report serves as an interim update on the business operations. Our back of pad calculation estimate for the group's net earnings is in the region of HK\$46m in FY12/12F and HK\$80m in FY12/13F.

Equity financing in FY11A. To finance the acquisition of Sharp Wonder Group (at the consideration of HK\$400m, of which HK\$250m in cash and HK\$150m in promissory notes) and provide capital to its operation, the group raised HK\$354.4m in last year. Of which, HK\$173.4m was raised via equity financing, as follows:

| Table 4. Fund raising activities | |
|----------------------------------|---------------------------------------|
| Dates | Activities |
| March 2011 | issued 64.5m shares at HK\$0.553 each |
| April 2011 | issued 26m shares at HK\$0.553 each |
| August 2011 | issued 61.8m shares at 0.75 each |
| September 2011 | issued 72.7m shares at HK\$0.75 each |
| December 2011 | issued 30.7m shares at HK\$0.76 each |

Source: Company data

Debt level in FY11A. As of the end of December 2011, the group had gross debt and net debt of HK\$322.0 and HK\$198.7m, respectively. Its debt to asset ratio and net gearing ratio were 68.0% and 102.8%, respectively. The group's gross debt were consisted of :

- 1) one-year term bridge loan of HK\$125m from a financial institution which bear an annual interest rate of 15%.
- 2) promissory notes with a principal amount of HK\$150m as part of the consideration of the acquisition of the Sharp Wonder Group. The promissory notes bear interest at 3.5% per annum.
- 3) In July 2011, an aggregate principal amount of HK\$54m of the convertible notes were issued to the placees with the conversion price of HK\$1.50 per conversion share, which bear interest at the rate of 2% per annum and will be redeemed by the Company in July 2014 at 120% of its principal amount. The effective interest expenses of the CB is 18.9% per annum. HK\$5m of the convertible had been redeemed. Thus, we estimate the outstanding amount of such CB is HK\$49m currently.
- 4) In September 2011, a zero coupon convertible notes in the principal amount of HK\$2m were issued, as a part of the consideration for the acquisition of the Parkwell Group. The CB bears no interest and were issued with the conversion price of HK\$1.00 per conversion share

and will be redeemed by the group in September 2014 at 100% of its principal amount. The effective interest expenses of the CB is about 6.3% per annum.

Finance cost for the period was HK\$17.4m or 8.7% per annum, equivalent to 49% of the group's gross profit of HK\$35.2m for the period.

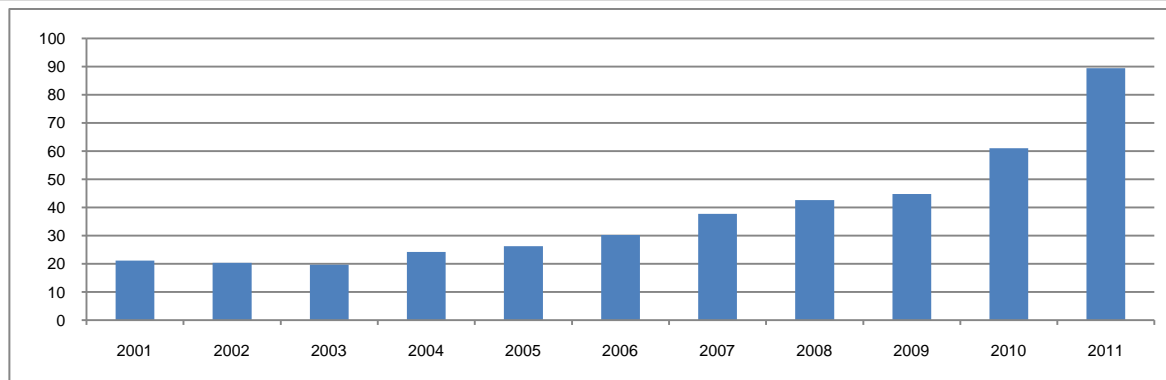
Better financial fitness. In March of this year, the group issued a 2-year term CB with annual coupon of 3% and exercise price of HK\$0.8 each and raised HK\$54.5m. Further, in the same month, the group announced to raise HK\$180m by issuing 233.8m shares at HK\$0.77 each under special mandate to be sought at SGM. Among all, the group had entered into a subscription agreement with Lico Consultancy to which Lico Consultancy conditionally agreed to subscribe for 150.7m shares at HK\$0.77 for a total cash consideration of about HK\$116m. Following the issuance of CB and new shares, the group will raise HK\$234.5m, and its net debt will drop to about HK\$22.7m, representing a net gearing ratio of about 6%. We expect that some of the proceeds from the recent fund raising will be used to repay debt, in particular the debt with high interest rate. Further, the group is seeking for low rate loan facility from banks in Hong Kong. Thus, we expect the group all-in finance cost will drop to 4.5% from 8.7% in FY12F, representing a saving of at least HK\$8m, which is equivalent to about 22% of Larry Jewelry's net earnings reported in FY11A.

Share capital. As of the end of FY11A, the group had about 864.9m shares outstanding. Including the share options and CBs, the number of fully diluted shares of the group is 1,044.9m shares. If we include the 233.8m new shares which are expected to be issue in the near term, the total number of fully diluted shares would be 1,278.7m.

Jewellery retailing: a high growth industry. Between 2001 and 2011, value of retail sales of jewellery, watches and clock and valuable gifts in Hong Kong increased at a 10 year CAGR of 15.5%, from about HK\$21.2b to HK\$89.4b. In 2011, value of retail sales of jewellery, watches and clock and valuable gifts increased by 46.6% YoY, from about HK\$61.0b to HK\$89.4b. Excluding watches and clock and valuable gifts, value of retail sales of jewellery in Hong Kong between 2006 and 2011 increased at a 5-year CAGR of about 24.0%, from HK\$23.1b to about HK\$68.0m, according to Frost & Sullivan Research.

Mainlander the big spender. The influx of Chinese tourist since the launching of individual traveling scheme in 2003 has been the major driving force of the growth in value of retail sales of jewellery, watches and clock and valuable gifts. Between 2006 and 2011, number of tourists to Hong Kong and Macau increased at a 5-year CAGR of 8.2%, from 47.2m to about 70.0m. Meanwhile, visitors from China increased at a 5-year CAGR of 11.6%, from 25.5m to about 44m. During the period, value of retail sales of jewellery, watches and clock and valuable gifts increased at a 5-year CAGR of 24.2%.

Chart 1. Value of retail sales of jewellery, watches and clock (HK\$ billion)



Source: Hong Kong Census and Statistics Department

Growth momentum remains strong. Organic growth in Hong Kong jewellery market is projected to be strong, at 5-year CAGR of 35.1% projected by Frost & Sullivan Research. The growth of the jewellery industry in Hong Kong is driven by the increase in domestic consumer demand and rising number and affluence of Chinese tourists, benefiting from affinity for designs and quality from the consumer base.

Drivers of growths. Retail value of jewellery market in China has been increasing alongside with the rise in disposable income level and increase in affluence of Chinese people. Between 2006 and 2010, value of jewellery market in China increased at a 4-year CAGR of 29.1%, from HK\$108.9b to HK\$302.2b. In our view, besides the increase in Mainlander affluence and disposable income level, unique consumer behavior of Chinese consumers and low jewellery possession rate in China will be drives of demand growth:

Low jewellery possession rate. In 2009, the jewelry pre-capita consumption of the world was about US\$47.0, according to Frost & Sullivan Research. Meanwhile, jewelry pre-capita consumption in US, EU, Japan and Hong Kong were about US\$260.0, US\$214.0, US\$81.0 and US\$97.0, respectively. Compared to aforementioned region, jewelry pre-capita consumption in China in 2009 was about US\$20.0 only. Given the increase in affluence in the country, we expect that jewelry pre-capita consumption in China will eventually reach the world level, or even surpass it.

Event-driven jewellery purchase. Event-driven purchases are an important driver of jewellery retail sales in Greater China due to Chinese tradition of jewellery gift giving at ceremonial and festive event such as weddings and new born arrivals. It is worth to note that

Chinese people often plan discretionary celebration such as weddings around dates delineated by various system of almanac and auspicious beliefs. These related purchases are non-cyclical and generally inelastic to economic conditions and commodity prices. It is estimated in 2010, over 30% of the Chinese population was at the marriages age of 20 to 39, and the number of registered marriage in China is projected to increase at a CAGR of 9.2% between 2010 and 2015.

Cultural significance of jewellery. For Chinese, gold, diamond and other gem stone products carry a cultural connotation that represents eternity, dignity, prosperity, blessing and fortune. The durability and tangibility of gold, diamond and other gem stone products carry pragmatic and sentimental value as both preservation and transfer wealth across generations. Growth in Chinese demand for jewellery is expected to be strong, on the cultural foundation of wealth accumulation and conservatism.

Demand for authentic jewellery. Lucrative jewellery market in China has attracted fraudulent retailers selling imitable jewellery that is misrepresented as real products made from precious metals and stones. With rising education level, increasing sophistication and increase in affluence of Chinese customers, demand for authentic and genuine jewellery products with strong design elements is rising; and jewellery retailers with trustworthy brand, especially the jewelers in Hong Kong, are gaining market share and experience strong repeating purchase. Many consumer surveys have demonstrated that Hong Kong is a first choice of Mainland Chinese for jewellery purchasing.

Increasing demand for products with strong designed elements and brand identity. Due to media influence and increase in disposable income level, Chinese consumers' perception of jewellery products has expanded beyond the value of the raw materials. They are demanding jewellery with strong designed element, self-expression function and association with their life-style. This industrial trend provides opportunities for jewelers with strong brand identity and design capability.

Desire to purchase and own higher value jewellery products. For many Chinese consumers, the first jewellery purchase is typically gold products. As discretionary income increase in China, many consumers are seeking to purchase higher price jewellery products items such as diamond.

Price spectrum in jewellery retail industry in Hong Kong. According to Frost & Sullivan Research, in 2010, retail value of jewellery market in Hong Kong and Macau was about HK\$62.0b. Mass luxury (jewellery products with price greater than HK\$2,000 and less than HK\$100,000) accounted for 53.8% of retail value in 2010, while high-end products (price greater than HK\$100,000) and low-end products (price less than HK\$2,000) accounted for 38.6% and 7.6% of the retail value, respectively.

Market segmentation. Players in the Hong Kong jewellery retail market can be classified by local/regional brand and multinational brand as well as by price. Van Cleef & Arpels, Cartier, Bulgari, Tiffany and Tesiro are multinational brand, while Chow Sang Sang, Chow Tai Fook, Lukfook, 3D-Gold, King Fook, Seng Feng and TSL are local or regional jewelers focusing on Greater China Market. Almost all of the local/regional players are focusing on mass luxury market. The number of jewellery POS in Hong Kong and Macau were estimated to be 900, by Frost & Sullivan, with stand-alone branded stores and stores in shopping malls representing the dominant sales channel by number of POS, at 56.8% and 40.2%, respectively.

Table 5. Peers GP Margin

| Company name | Ticker | GP Margin (%) |
|---------------------|---------|---------------|
| Chow Tai Fook | 1929 HK | 28.3 |
| Chow Sang Sang | 116 HK | 19.7 |
| TSE SUI LUEN | 417 HK | 51.3 |
| Hong Kong Resources | 2882 HK | 23.3 |
| King Fook | 280 HK | 28.0 |
| Tiffany & Co. | TIF US | 59 |
| Signet Jeweler | SIG US | 38.3 |
| Su-Raj Diamonds | SURJ IN | - |
| Verite | 9904 JP | 49.2 |

Source: Bloomberg

According to Frost & Sullivan, in 2010, Chow Tai Fook accounted for 20.1% of jewellery market in Hong Kong and Macau, by retail value. Meanwhile, Chow Sang Sang, Lukfook, Mabelle, Cartier, Tiffany & Co, King Fook, Seng Feng, CSS and Qeelin accounted for 8.7%, 7.3%, 3.9%, 2.8%, 2.2%, 2.0%, 1.6%, 1.5% and 1.5%, respectively. Again, The top four jewelers are all local/regional players focusing on mass luxury market. Even Tiffany & Co, which is a multinational brand are focusing on mass luxury market.

Table 6. Peers

| Company | Ticker | FY end | Market cap (US\$m) | Historical PER (x) | 1-year PER (x) | 2-year PER (x) | P/BV (x) | ROE (%) |
|---------------------|----------------|---------|-----------------------|-----------------------|-------------------|-------------------|----------|---------|
| <u>Jewelry</u> | | | | | | | | |
| CHOW TAI FOOK JE | 1929 HK Equity | 03/2011 | 15,384.6 | 12.00 | - | 18.5 | 13.8 | 36.4 |
| CHOW SANG SANG | 116 HK Equity | 12/2011 | 1,732.2 | 19.96 | 12.4 | 10.4 | 8.7 | 18.2 |
| TSE SUI LUEN JEW | 417 HK Equity | 02/2011 | 177.7 | 6.59 | 7.6 | - | - | 24.5 |
| HONG KONG RESOUR | 2882 HK Equity | 03/2011 | 113.6 | 0.45 | 20.0 | - | - | 5.7 |
| KING FOOK HLDGS | 280 HK Equity | 03/2011 | 55.2 | 0.99 | 13.4 | - | - | 3.5 |
| <u>Watch</u> | | | | | | | | |
| EMPEROR WATCH & JEW | 887 HK Equity | 12/2011 | 1,042.2 | 1.21 | 12.5 | 10.6 | 8.4 | 20.5 |
| ORIENTAL WATCH | 398 HK Equity | 03/2011 | 240.7 | 3.29 | 8.2 | 6.1 | 5.4 | 13.5 |
| SINCERE WATCH | 444 HK Equity | 03/2011 | 109.3 | 2.09 | 8.0 | - | - | 27.6 |
| <u>Fashion</u> | | | | | | | | |
| PRADA | 1913 HK Equity | 01/2012 | 16,698.0 | 50.90 | 29.5 | 23.3 | 18.7 | 28.5 |
| JOYCE BOUTIQUE | 647 HK Equity | 03/2011 | 127.0 | 0.61 | 6.0 | - | - | 23.4 |
| MILAN STATION | 1150 HK Equity | 12/2011 | 102.0 | 1.18 | 15.3 | 11.8 | 8.4 | 47.8 |

Source: Bloomberg

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