OVERWEIGHT

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Hong Kong retail sector

Increasing integration with Mainland supports growth

In 2010, the strong rebound of the Hong Kong economy with improving employment condition has spurred private consumption and retail sales in Hong Kong. In addition, the strong inflow of PRC tourists and their increasing consumption power also support the growth of Hong Kong retail sales. The value of total retail sales in Hong Kong increased by 18.3% over a year earlier to HK$263,057mn for the ten months ended 31Oct2010. With further improvements in unemployment rate and economic condition expected, we estimate Hong Kong retail sales to grow 12.0% in 2011. We have ***OVERWEIGHT*** *rating for the Hong Kong retail sector due to increasing integration between Mainland and Hong Kong which could trigger more tourist inflow from PRC and benefit Hong Kong from their increased spending. In particular, we favour those with high exposure to the Mainland. Our top pick for Hong Kong retail sector is* ***Luk Fook (590 HK)*** *as weakening US dollar could trigger higher demand for gold and rising disposable income could increase demand for jewelry. As at 30Sep2010, Luk Fook had a total of 646 retail outlets globally with 607 in the PRC.*

- **Strong rebound of Hong Kong economy in 2010.** Though the risks of a relapse into recession in the US and Europe remain, the tilt of balance of global economy landscape towards the East, especially the Mainland China, has resulted in faster economic growth in the emerging Asian economies in 2010 compared with the West. In line with increasing integration with Mainland, Hong Kong real GDP grew 7.1% yoy for the nine months ended 30Sep2010.

- **Increasing economic ties with Mainland.** While external demand could remain weak compared with the level before the global financial crisis, and the advanced economies are still the main driving force for the final demand in global trade, we think the increasing integration between Hong Kong and Pearl River Delta will continue to support the economic growth of Hong Kong. In 2011, we estimate Hong Kong real GDP to grow 4.3%.

- **Unemployment rate is estimated to trend down further in 2011.** We expect the continuous economic growth will drag down Hong Kong unemployment rate to 4.0% in 2011, which could continue to support the growth of private consumption and retail sales. However, the proposed imposition of minimum wage could result in job cuts and higher-than-expected unemployment rate.

- **PRC tourists—another Hong Kong retail sales growth driver.** In addition to domestic private consumption, Hong Kong retail sales sector is largely underpinned by the strong inflows of tourists, especially from PRC. For the ten months ended 31Oct2010, the number of total tourist arrivals increased by 24.7% to 29,434,487. Among the total, 64.0% are from Mainland China and arrivals from Mainland grew 29.4% for the ten months ended 31Oct2010 to 18,845,025. Their consumption power has also increased due to appreciation of RMB and increasing disposable income per capita.

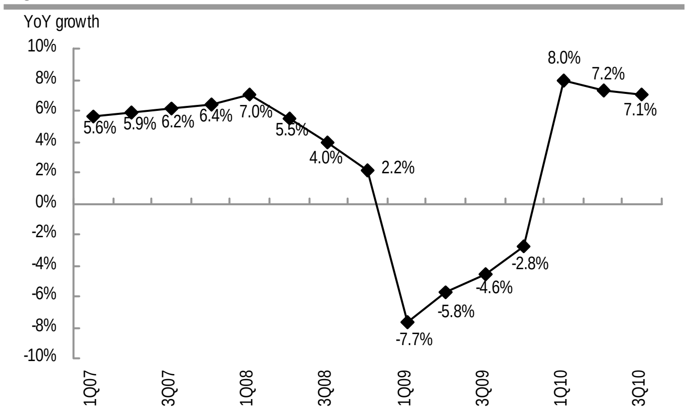
- **OVERWEIGHT rating for Hong Kong retail sector.** With the increasing integration between Mainland and Hong Kong, the expansion of domestic economy, increasing inflow of PRC tourists as well as their rising disposable income and weak US dollar, we have overweight rating for Hong Kong retail sector. In particular, we favour those with high exposure to the Mainland. Our top pick for Hong Kong retail sector is **Luk Fook (590 HK)** as weakening US dollar triggers demand for gold and rising disposable income could increase demand for jewelry. As at 30Sep2010, Luk Fook had a total of 646 retail outlets globally with 607 in the PRC.

Strong rebound in 2010, further growth in 2011

Hong Kong GDP grew 7.1% yoy for the nine months to 30Sep2010 in real terms. Though the risks of a relapse into recession remain in the US and Europe, the tilt of balance of global economy landscape towards the East, especially the Mainland China, has resulted in faster economic growth in the emerging Asian economies in 2010 compared with the West. In line with increasing integration with Mainland, the robust economic growth of China in 2010 served as the basis for strong economic recovery of Hong Kong, with Hong Kong real GDP growth of 7.1% yoy for the nine months ended 30Sep2010. Among GDP components, private consumption accounted for 62.3% of total GDP and grew 5.7% yoy for the nine months ended 30Sep2010. Hong Kong GDP is estimated to grow 6.5% in 2010 by HK SAR government.

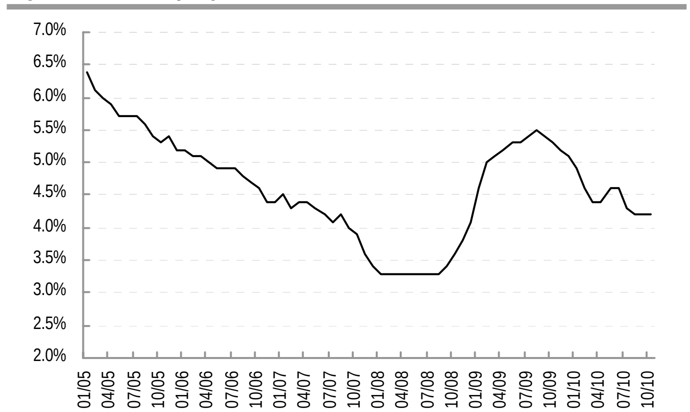
Increasing integration with Mainland China lays a solid foundation for future growth. In the medium term, external demand could remain weak compared with the level before the global financial crisis, and the high unemployment rate in various advanced economies together with global trade imbalance could lead to protectionist against products exported from China and Hong Kong. Given the advanced economies are still the main driving force for the final demand in global trade, their slower growth could drag down external trade of Hong Kong and its GDP growth. However, the PRC's shift towards domestic-consumption driven economy and the increasing integration between Hong Kong and Pearl River Delta , which is a national strategy endorsed by the central government, will continue to support the economic growth of Hong Kong in our view. The construction of Hong Kong-Zhuhai-Macau Bridge and the Hong Kong-Guangzhou Express Rail Link will enhance the inflows of PRC tourists and economic cooperation between Mainland and Hong Kong. In 2011, we estimate Hong Kong real GDP to grow 4.3%.

Figure 1: **Resilient economic rebound in 2010**



Source: Hong Kong Census and Statistics and Core Pacific-Yamaichi

Figure 2: **Unemployment rate trended down to 4.2%**



Source: Hong Kong Census and Statistics and Core Pacific-Yamaichi

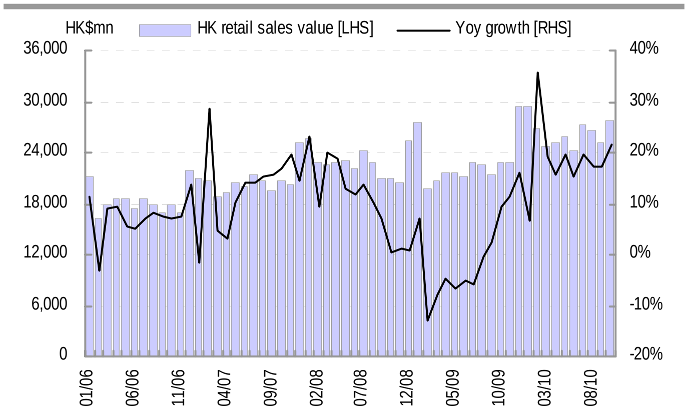
Unemployment rate is estimated to trend down further in 2011. Riding on the economic growth, for the third quarter ended 30Sep2010, total employment increased to 3,531,400, a new high since early 2009, and unemployment rate was further pushed down to 4.2%. The improving employment condition led to further improvements in consumption spending; private consumption grew 5.7% yoy for the third quarter ended 30Sep2010. We expect the continuous economic growth will drag down Hong Kong unemployment rate to 4.0% in 2011, which could continue to support the growth of private consumption and retail sales. However, the proposed imposition of minimum wage could result in job cuts and higher-than-expected unemployment rate. According to Hong Kong Census and Statistics Department, in the first half of 2010, the poverty rate was 18.1% or 126 million people living in low income / poor families, for the highest number ever.

CPI to surge to 4.0% in 2011. The strong rebound of Hong Kong economy did not result in uncontrollable inflation year to date. Overall consumer prices rose by 2.6% in October 2010. However, going forward, inflation is likely to step up as a result of higher import prices amid a weaker US dollar and elevated global food and commodity prices. In addition, the new round of quantitative easing of the US could trigger further capital inflows into the region and push up Hong Kong inflation. For 2011, we estimate Hong Kong composite CPI to surge to 4.0%.

PRC tourists—another Hong Kong retail sales growth driver. Hong Kong retail sales has benefited from the recovering economic condition and associated lower unemployment rate and higher private consumption. In addition to domestic private consumption, the Hong Kong retail sales sector is largely underpinned by the strong inflows of tourists, especially tourists the PRC. For the ten months ended 31Oct2010, the value of total retail sales in Hong Kong increased by 18.3% over a year earlier to HK$263,057mn while the number of total tourists arrival increased by 24.7% during the same period to 29,434,487. Among the total tourist numbers, 64.0% are from Mainland China and tourists from Mainland grew 29.4% for the ten months ended 31Oct2010 to 18,845,025.

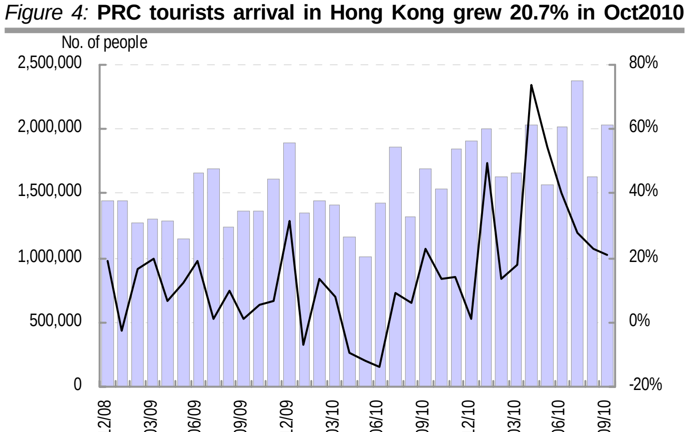
Spending power of PRC tourists has increased in accordance with increasing disposable income per capita and weaker US dollar to which Hong Kong dollar is pegged. Year to date, RMB has appreciated against the US dollar by more than 2.0% and we expect it to further appreciate by 3.1% in 2011. The appreciation of RMB, together with increasing disposable income per capita of PRC household has in general increased PRC tourists spending on shopping in Hong Kong. From Jan2010-Jun2010, shopping expenditures accounted for 76.2% of total overnight PRC tourist spending, which grew 41.9% to HK30,887.7mn. In our view, Hong Kong retail sales could continue to benefit from the strong inflows of PRC tourists brought by increasing integration between Hong Kong and Mainland as well as increasing disposable income per capital of PRC household and appreciation of RMB. We estimate Hong Kong retail sales to grow 12.0% in 2011.

Figure 3: **Hong Kong retail sales value grew 21.6% in Oct2010**



Source: Hong Kong Census and Statistics and Core Pacific-Yamaichi

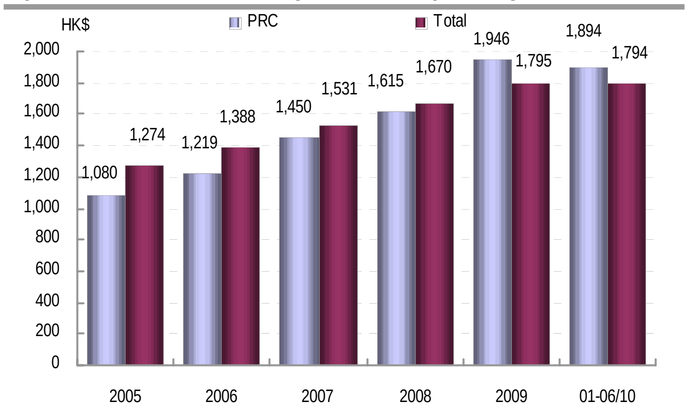
Figure 4: **PRC tourists arrival in Hong Kong grew 20.7% in Oct2010**



Source: Hong Kong Tourism Board and Core Pacific-Yamaichi

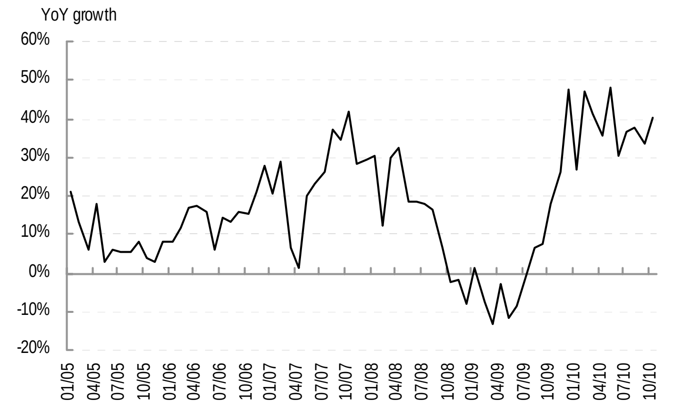
OVERWEIGHT rating for Hong Kong retail sector. With the increasing integration between Mainland and Hong Kong, the expansion of domestic economy, increasing inflow of PRC tourists as well as their rising disposable income and weak US dollar, we have overweight rating for Hong Kong retail sector. In particular, we favour those with high exposure to the Mainland. Our top pick for Hong Kong retail sector is **Luk Fook (590 HK)** as weakening US dollar could trigger demand for gold and rising disposable income could increase demand for jewelry. As at 30Sep2010, Luk Fook had a total of 646 retail outlets globally with 607 in the PRC.

Figure 5: **Per diem overnight visitor spending**



Source: Hong Kong Tourism Board and Core Pacific-Yamaichi

Figure 6: **Hong Kong jewelry retail sales yoy growth**



Source: Hong Kong Census and Statistics and Core Pacific-Yamaichi

Table 1: **Sector valuation (as at 30 November 2010)**

Company	Bloomberg code	Price (HK$)	Mkt cap (HK$mn)	PER (x) 09	PER (x) 10F	PER (x) 11F	PBR (x) 09	PBR (x) 10F	PBR (x) 11F	Yield (%) 10F	Yield (%) 11F
Cosmetics and personal care											
Sa Sa	178 HK	9.11	12,721	29.1	26.0	20.8	9.7	8.3	7.2	2.9	3.6
Bonjour	653 HK	1.50	4,422	23.6	22.4	17.4	21.4	16.7	12.5	4.0	4.6
L'OCCITANE	973 HK	20.95	30,942	32.5	29.6	24.1	59.0	50.7	43.6	0.1	0.1
Watch and jewelry											
Emperor Watch and Jewellry	887 HK	1.18	6,678	23.1	26.2	15.9	3.3	2.9	2.5	1.9	8.9
Hengdeli	3389 HK	5.05	22,120	38.4	31.6	26.1	4.7	4.3	3.8	0.8	1.0
Luk Fook	590 HK	26.30	12,953	19.5	18.5	15.2	6.1	4.8	3.9	2.2	2.7
Chow Sang Sang	116 HK	18.40	12,455	17.9	19.4	16.1	2.4	2.2	2.0	1.8	2.2
Department store											
Lifestyle	1212 HK	19.92	33,445	25.3	27.5	24.0	4.8	4.3	3.8	1.4	1.6
Aeon	984 HK	15.90	4,134	18.2	14.5	13.1	3.2	2.9	2.6	3.5	3.8
Apparel and accessories											
Giordano	709 HK	4.80	7,172	16.2	15.7	14.3	3.2	3.1	2.9	4.7	5.2
I.T	999 HK	7.15	8,545	25.4	24.5	20.0	5.0	4.3	3.7	1.8	2.2
Oriental Watch	398 HK	5.12	2,149	13.3	12.5	10.4	1.3	1.2	na	1.5	1.8

* *For Sa Sa, L'Occitane, Luk Fook and I.T., PER and PBR ratio refers to 10, 11E and 12E, as the financial year of Sa Sa, L'Occitane and Luk Fook ended 31Mar while financial year of I.T ended on 28Feb*

* *For Sa Sa, L'Occitane, Luk Fook and I.T., yield refers to 11E and 12E, as the financial year of Sa Sa, L'Occitane and Luk Fook ended 31Mar while financial year of I.T ended on 28Feb*

Source: Bloomberg