



Trough of Retail is Approaching

In brief

The retail industry in Hong Kong is facing cold winds from the North. The number of PRC visitors has decreased from 47.2 million in 2014 to 45.8 million in 2015. The visitors' number has a further drop of 10.6% in the first half in 2016, compared with 2015 first half.

Value index of retail sales of clothing, jewelry and department stores has continued decreasing for 18 months since December 2014. Let's have a look at how the market views the prospects of the Hong Kong retail industry.

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Peak to the Trough

Hong Kong retailing market is commonly known as largely dependent on PRC visitors in recent years. We have measured and tested some correlations between the performance of some Hong Kong listed players (such as Chow Tai Fook, Luk Fook and SaSa) and the number of PRC visitors to substantiate the relationship in between.

Correlation measures the strength of the linear relationship between two random variables, i.e. number of PRC visitors and revenue of selected retail companies in this case. Correlation ranges from -1 to +1. If correlation equals to +1, the random variables have perfect positive correlation. This means that a movement in one random variable results in a proportional positive movement in the other relative to its mean.

By comparing the historical sales data of the listed companies and number of PRC visitors for the same period, we observed that there is positive relationship between the Hong Kong retail revenue and the number of PRC visitors. As demonstrated in Figure 1 below, most of the correlation coefficients of the selected companies are over positive 0.9, which indicate a strong positive correlation between the two variables.

Since the first introduction of The Individual Visit Scheme (“IVS”) on 28 July 2003, the number of PRC visitors increased from 8.5 million in 2003 to 47.2 million in 2014 with annual CAGR of 17%. The portion of PRC visitors over total visitors to Hong Kong increased from 5% in 2003 to 78% in 2014 (Figure 2).

The rising trend of PRC visitors boosted the Hong Kong retail market, especially clothing, jewelry, cosmetics, electronic products and medicine products which are some of the favorites of PRC tourists. The related retail companies, such as SaSa, Chow Tai Fook, Bossini, focused on IVS customers and were highly benefited from the trend. The retail revenue rebounded from the trough of 172.9 billion in 2003 to the peak of 493.4 billion in 2014.

However, the music stopped on 13 April 2015, when the Central Government announced the adjustment on “multiple-entry” IVS for permanent residents of Shenzhen to “one trip per week” to prevent mainlanders from over-purchasing daily necessities, like milk powder, in Hong Kong. In addition, the Chinese Central Government launched certain anti-corruption campaign, which is believed to significantly lower Chinese visitors’ spending. These turning points triggered the collapse of rapid growth trend on PRC visitors as well as the Hong Kong retail market.

According to the Hong Kong Census and Statistics Department, value index of retail sales started to decrease in the early 2015. The decline accelerated in 2016. The value of sales of jewelry, watches and clocks, and valuable gifts, clothing, footwear and allied products, electrical goods and department stores recorded double digit drop in the first half in 2016.

This decreasing trend matches with the decline in PRC visitors. Based on the data from the Hong Kong Tourism Board, number of PRC visitors in the first five months in 2016 was 17.2 million which was one-tenth less than same period of previous year. (Figure 3)

Retail companies were seriously affected by the decrease in PRC visitor number and their spending. Some of the listed retail companies has recently issued profit warning announcements, such as Chow Tai Fook, Luk Fook and SaSa. Some of their profits decreased by around 35% to 50% and some of them even turned into loss making.

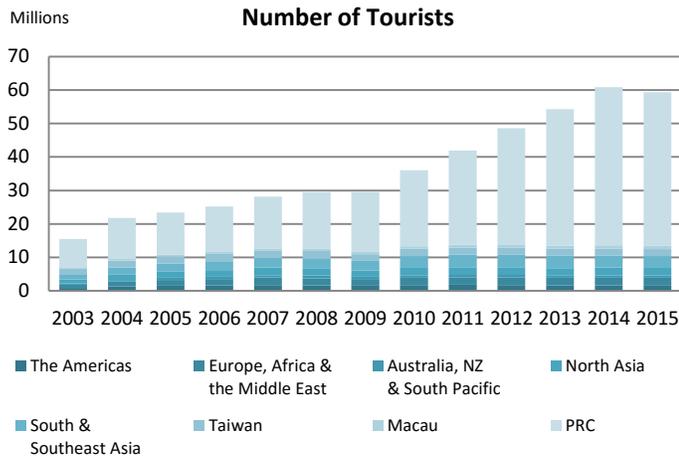
The negative prospects were also reflected in the stock prices and the market capitalization of these listed companies. For example, the share price of SaSa as at 30 June 2016 was HKD3.04 which is only one-third of the historical highest price in 2013 of HKD9.12. (Figure 4)

Figure 1: Correlation of Number of PRC Visitors and Revenue of Retail Companies

Companies	Stock code	Business	Correlation Coefficient PRC visitors & Revenue from HK (2010-15)
Chow Tai Fook	SEHK:1929	Jewelry	0.92
Lok Fook	SEHK:590	Jewelry	0.96
Sa Sa	SEHK:178	Cosmetics	0.99
Loccitate	SEHK:973	Cosmetics	0.97
Bossini	SEHK:592	Clothing	0.99
IT	SEHK:999	Clothing	0.93
Samsonite	SEHK:1910	Consumer goods	0.99
Lifestyle intl	SEHK:1212	Department store	0.94

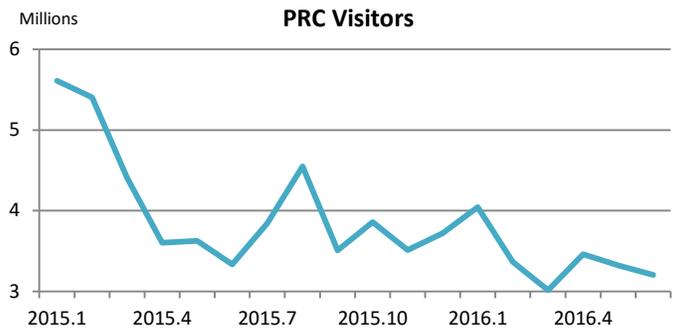
Source: Bloomberg, Hong Kong Tourism Board, AVISTA Research

Figure 2: Number of Tourists in 2013-2015



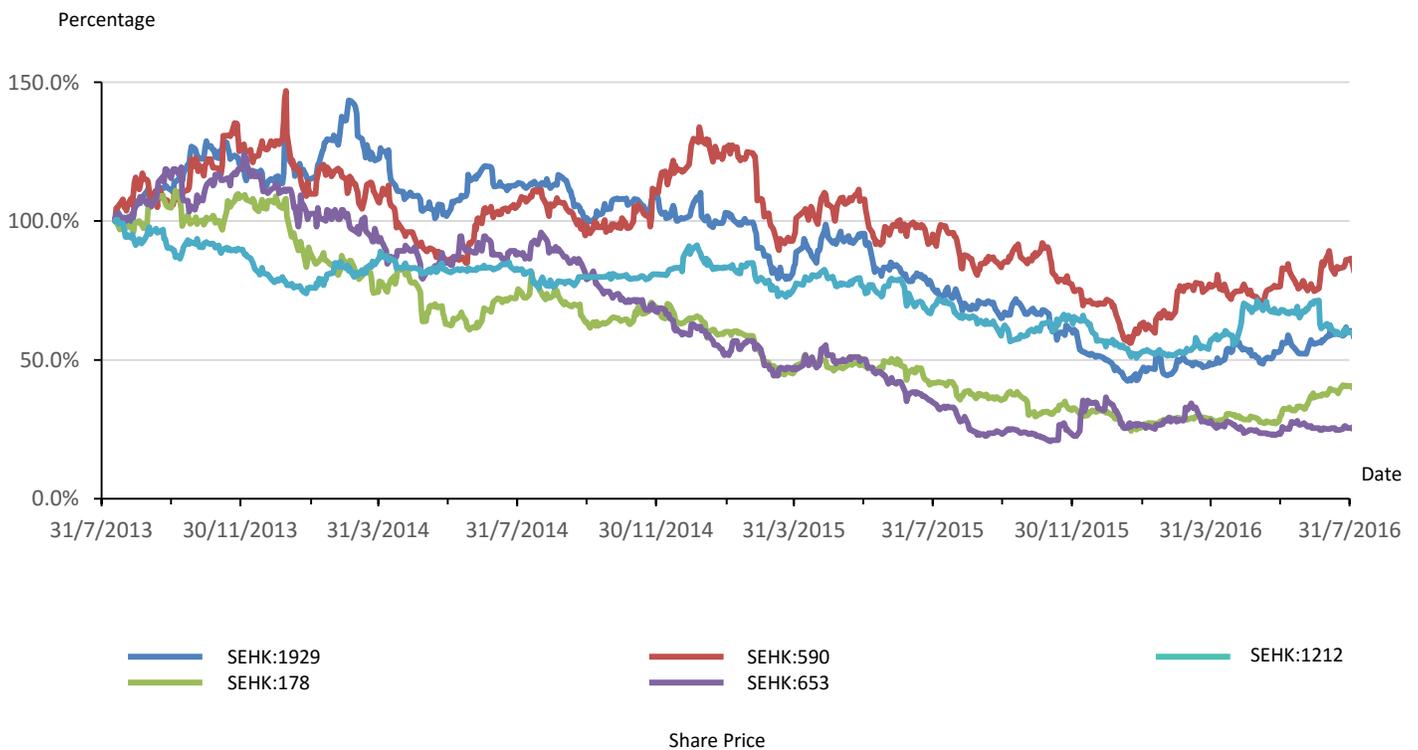
Source: Hong Kong Tourism Board

Figure 3: Number of PRC visitors (Jan 2015 – Jun 2016)



Source: Hong Kong Tourism Board

Figure 4: Peer Companies Stock Price



Source: S&P, Capital IQ, AVISTA Research

Policies and Political

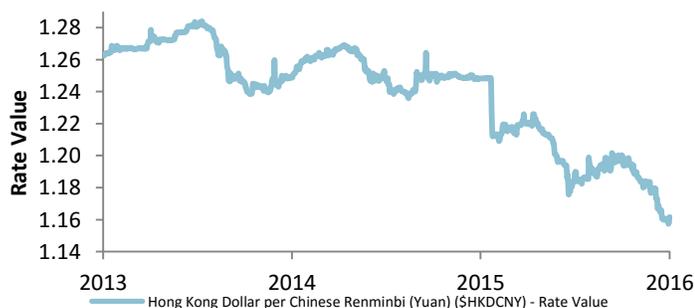
Despite the sluggish performance of retail industry, it appears that favorable policies are not likely to be imposed in near future. From the press release by the Hong Kong Government in May 2016, the Government has no revival of PRC visitor plan nor any plans to the relax the IVS arrangement to resume “multiple-entry” IVS, as it is well understood among the society that the overwhelming visitors have exerted pressure on society’s atmosphere and affect citizen’s daily lives.

Furthermore, there were numerous protests against PRC tourists and local government in these years, notably the “Mong Kok civil unrest” in February 2016 and the “Umbrella Movement” in 2014. These social instabilities may have created a negative image for Hong Kong as a destination for tourists especially mainlanders. From political prospective, it is unfavorable to the rebound of retail industry, especially PRC visitors-oriented companies.

Currency Trends

Apart from the sentimental political environment in Hong Kong as suggested, the fluctuation of Chinese Yuan against HKD and other neighbor countries also affected local tourism and retail sector. Ever since the leader of PRC has decided to allow Renminbi (“RMB”) to depreciate in order to support its economic slowdown, it has a negative impact on retail companies in Hong Kong. Since January 2014, RMB has dropped by a cumulative 9.4% against HKD over these two years (Figure 5). In particular, RMB fell by 2.9% since the start of 2016 to its lowest against HKD over the last four years.

Figure 5: HKD/ CNY 5 Year Exchange Rate



Source: Hong Kong Tourism Board

According to Mr Charles Ng, the Honorary President of Hong Kong Inbound Tour Operators Association, hotel and retail sectors have offered more than 5% discounts, hoping to cancel out the effect of the depreciating RMB value and to attract more customers. However, if the depreciation of RMB persists, the discount may not be able to offset the impact of currency movements to PRC visitors.

A Small Turning Point

On the other hand, there is a positive sign for the retail industry. In recent weeks, neighbor countries’ currencies including Japanese yen and South Korean won have rapidly strengthened, despite the fact that yen has sharply depreciated in mid-2014 which brought in a lot of PRC visitors to buy luxury products in Japan instead of Hong Kong (Figure 6). One RMB can now exchange for only 15 yen, compared with 19 yen at the beginning of 2016. This is likely to reduce the attractiveness to shop in Japan. According to an article in South China Morning Post (“SCMP”), data from the Japan Tourism Agency, an official government department, showed that even though the number of PRC tourists has increased, spending per person dropped 23% in Q2 comparing to Q1 2016. SCMP also mentioned an economist from Credit Suisse suggested that “the discount PRC visitors are getting from spending in Japan is narrower. There may be chance to lure back some PRC tourists”. Nonetheless, PRC tourists may still not opt for Hong Kong as their destination since they are having more choices to travel compared to the last decade. Countries including but not limited to Japan, U.S. and South Korea have relaxed their visa requirements, aiming to attract more PRC visitors (Table 1). These measures have been a huge

success. For example: in another article in SCMP the approved U.S. visa application for business and tourist travel between October and March increased by 55% compared with same period one year before.

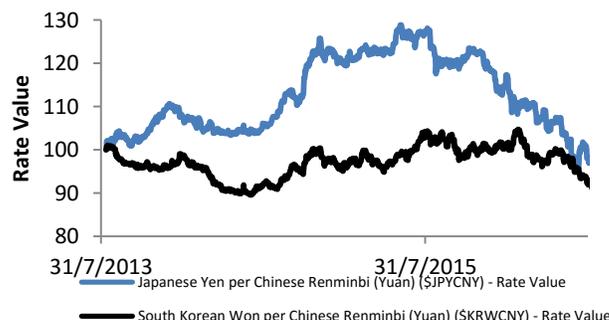
Chinese Import Policies

Another factor that significantly affects the Hong Kong retail industry is the structural change in China economy, which is now promoting the focus on domestic consumption. The PRC government launched several measures to reduce the price of foreign goods sold domestically. Starting from June 2015, the authorities reduced tariff imposed on foreign-made consumer goods like bags and clothing by 50% for 14 categories of goods (Table 2). These policies reduce the price gap between the goods in Hong Kong and those in China, which in turn reduce the incentives for PRC citizens to purchase in Hong Kong.

Trough Is Approaching

Due to the structural change of China’s economy, the RMB may have potential to drop in an expected manner and authorities would continue to boost its domestic consumption. These policies appear to be unfavorable to the retail sector in Hong Kong. Furthermore, the restriction on IVS and the unstable political environment in Hong Kong may further create negative factors towards the Hong Kong retail market. Going forward, it may be time for the Hong Kong market players to construct strategies to diversify its target customers and reduce reliance on PRC visitors in order to survive in the hard time.

Figure 6: Currency of CNY against JPY and Won



Source: Hong Kong Tourism Board

Table 1: Different countries' visa requirement for mainlanders

Countries	Requirement	
	In the past	2015
United States	<ul style="list-style-type: none"> One year tourist and business visa 	<ul style="list-style-type: none"> Ten year tourist and business visa
Japan	<ul style="list-style-type: none"> Three year visa 	<ul style="list-style-type: none"> Five year visa Lower minimum income requirement
South Korea	<ul style="list-style-type: none"> One year and three year visa 	<ul style="list-style-type: none"> Five year multiple entry visa Monthly salary over 5000 ¥
Thailand	<ul style="list-style-type: none"> No on-arrival visa and no free visa application during certain period 	<ul style="list-style-type: none"> On-arrival visa Free visa application from Aug to Nov
France	<ul style="list-style-type: none"> Visa process time up to 8 weeks 	<ul style="list-style-type: none"> Visa process time within 48 hours

Source: South China Morning Post

Table 2: China's Tariff rates import goods before and after 1 June 2015

Categories	Tariff rates	
	2015 rate (%)	Starting from 1 June (%)
Cosmetics and Skin Care Products	6.5	2.0
Shoes	24.0	12.0
Fur Clothing	23.0	10.0
Men and Women's Suits and Outerwear	17.5	10.0
Kashir wool, knitted and crocheted items	14.0	7.0
Diapers	7.5	2.0

Source: HKTDC

Table 3: Peer Companies Evaluation

Company	Ticker	Ccy	Mkt Cap	PE	PE	PE	EBITDA Margin	EBITDA Margin
			(HKD in million)					
			2016 (Est)	2015	2016 (Est)	2017 (Est)	2016(Est)	2017 (Est)
Chow Tai Fook	SEHK:1929	HKD	59100	15.27	20.07	18.62	10.02	9.77
Luk Fook Holdings	SEHK:590	HKD	11272.47	7.88	11.76	12.19	9.59	9.63
Sa Sa International	SEHK:178	HKD	9688.64	12.85	24.92	24.35	7.40	7.76
Bonjour Holdings	SEHK:653	HKD	1194.4	48	34.50	17.25	4.57	5.21
Lifestyle intl.	SEHK:1212	HKD	17211.78	8.71	10.92	9.57	46.33	44.20

Source: Bloomberg, AVISTA Research

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