

CHINA
DEVELOPMENT
FINANCIAL

Tactical Play: US Luxury Market

(LVMHF US, TPR US, CPRI US, PPRUF US)

LVMH's share price rally signals buoyant luxury consumption by the Chinese

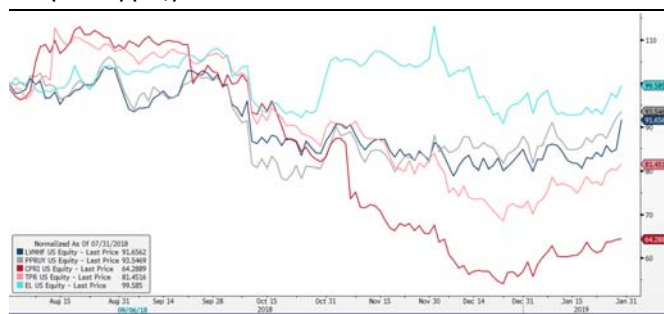
Geraldine Wong / 62 6202 1193 / Geraldine.wong@kqi.com

- LVMH's one day share price rally of 8.1% could see spillover to other luxury stocks.
- Slowdown in luxury expenditure by the Chinese seems unlikely from both a purchasing power and a consumer sentiment standpoint.
- The purchasing power of an average Chinese consumer will get a boost from new tax laws which came into effect as of 1st January 2019.
- Consumer sentiments remains surprisingly strong with 46% of consumers cited to increase luxury expenditure within the next 12 months.

Event. We issued a tactical play strategy on trade war events and resilient Chinese luxury consumption, leveraging on US luxury stocks. Share prices of some of the biggest global luxury houses declined by 30-40% from Sep 18 to Jan 19. Past headwinds to hit the luxury sector included:

- US-China trade war tensions
- Apple's revenue cuts (that blamed weakening Chinese consumption)
- China's worse than expected trade data
- Weak results posted by major US retailers (such as Macy's)

Figure 1: 6M normalized price movements of LVMH (LVMHF US), Kering (PPRUF US), Estee Lauder (EL US), Michael Kors (CPRI US) and Tapestry, Inc. (TPR US) (US\$)



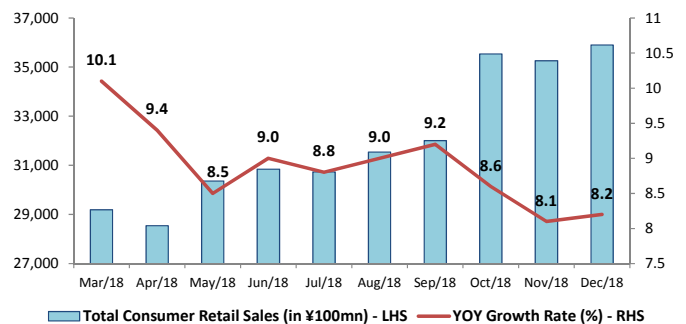
Source: Bloomberg, KGI Research

As discussed in our earlier report, the share price dip could not be supported by fundamental reasoning, with both luxury consumption and top line growth going strong for luxury houses.

Chinese consumption holding up (for now). While YoY retail consumption growth did decline from double digits in early 2018, the month of December continued to post expenditure growth of about 8% YoY. Macroeconomic risks dented the Chinese stock markets in 2018 where the Shanghai composite suffered negative one year returns amounting to -24.6%. This, however, was not heavily reflected within retail and luxury consumption. Wages also showed signs of immunity to wider market risks. According

to the National Bureau of Statistics, urban and rural per capita disposable income increased 5.6% YoY and 6.6% YoY to reach ¥ 39,251 and ¥ 14,617 in 2018.

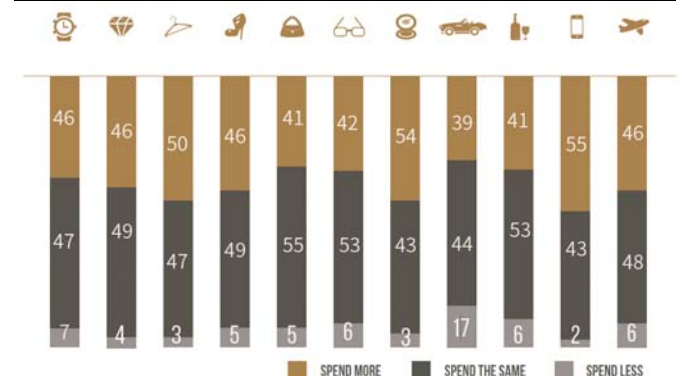
Figure 2: Total monthly retail sales on consumer goods and corresponding YOY growth rate



Source: National Bureau of Statistics, KGI Research

According to the China Luxury Forecast (CLF) report released earlier this month, 46% of Chinese respondents are planning to spend more on luxury goods, with only 6% planning to cut luxury expenditure in the next 12 months. The top three luxury segments to anticipate growth was reported to be electronics, beauty & cosmetics and garments. China's slowdown may be affecting big ticket items such as luxury automobiles, but impact did not seem to hit smaller ticket luxury goods.

Figure 3: CLF Survey Results, Mainland China: 'Are you willing to spend more or less on luxury in the next 12M compared to the past 12M?'



Source: CLF 2019, KGI Research

LVMH's Earnings Rally. LVMH's share price rallied about 8.1% on 30th of January, after posting record breaking results for FY2018. Operating profits increased 20% YoY while net profit was up 14% YoY. Revenue growth was led by 'Asia ex Japan' which was up 29% YoY in 2018, signaling buoyant demand for luxury goods.

Impact on Individual Income Taxes. The National People's Congress in China revised individual income tax (IIT) laws that will bring about significant changes in the purchasing power of an average Chinese consumer. As of 1st of January 2019, new monthly tax brackets introduced will prioritize tax reductions for low to middle income earners. Standard tax deductions will be increased from ¥ 42,000 per year to ¥ 60,000 per year. An estimation by Ernst & Young showed that a taxpayer with gross monthly wage of ¥ 60,000 will see a 16% reduction in monthly tax burden. That figure grew to 71% for an individual earning ¥ 10,000 a month.

Figure 4: A comparison between PRC's new and old IIT law

Old Tax Bracket (¥)	New Tax Bracket (¥)	Income Tax Rate (%)
Up to 1,500	Up to 3,000	3%
1,500 - 4,500	3,000 - 12,000	10%
4,500 - 9,000	12,000 - 25,000	20%
9,000 - 35,000	25,000 - 35,000	25%
35,000 - 55,000	35,000 - 55,000	30%
55,000 - 80,000	55,000 - 80,000	35%
Over 80,000	Over 80,000	45%

Source: KGI Research

A Want And A Need Now? Chinese consumers now indicate that the reason behind their luxury spending is to reflect their taste and improved life quality more so than to showcase an improved social status. A purchasing power boost from the new tax regulations will likely benefit the mass affluent, the consumer group that will most likely increase their luxury consumption going forward.

Figure 5: CLF Survey Results, Mainland China: 'What is the reason for your luxury purchase?' (%)



Source: CLF 2019, KGI Research

Crème de la Crème. Constant brand innovation, trend setting initiatives and uniqueness to detail set winning brands apart from the rest of the lot. Brand stickiness seems to be easing with noticeable yearly changes to top brand rankings across the various luxury segments. A safer bet would be to go with luxury houses with diversified brands and segments to decrease seasonality preferences for individual brand.

Figure 6: Top winning brands by product category

Category	Top Winners
Watches	Cartier, Rolex, Omega
Jewelry	Cartier, Dior, Chanel
Clothing	Hermes, Gucci, Dior, Chanel
Leather goods and Handbags	Hermes, Gucci, Coach
Beauty and Cosmetics	Estee Lauder, Chanel, Lancome

Source: CLF 2019, KGI Research

Optimizing the sales formula. Top information sources for brand awareness remains to be traditional media sources, social media as well as celebrity endorsements. Surprisingly, Chinese ecommerce sites such as JC.com and TMall (a China based ecommerce B2C website operated by Alibaba Group) received more online orders for luxury items than the official website of individual brand. With Chinese New Year just around the corner, brands with greater consumer visibility may be in a better position to reap benefits from festive sales by having the right strategy mix – active client engagements, festive product offerings, and presence on various distribution channels to optimize online views.

Tactical Play. China and US trade talks last week would likely resume in mid-February after Chinese New Year. The 90-day trade war truce deadline would then require a deal to be reached by 1st March 2019.

Criminal charges pressed by US against Huawei and Huawei CFO's arrest warrant would continue to remain as the elephant in the room. Consensus is that both China and US will try to reach an agreement before the deadline and prioritize short term economic stability over the longer term issue involving intellectual property rights. That issue may potentially be deferred for resolution in the future.

Exit Strategy. We reiterate events and dates that investors should pay close attention to for this tactical play. Following LVMH's results rally, a few other luxury brands will be posting results for the past financial quarter sometime early February 2019.

These include:

1. Capri Holdings (CPRI US) – 6th February, 3Q19 Results
2. Tapestry Inc (TPR US) – 7th February, 2Q19 Results
3. Kering SA (PPRUF US) – 12th February, FY2018 Results

As a short-term trade, investors could take profit after announcement of positive results, or wait on favorable news regarding festive spending over Chinese New Year in the coming week (4th Feb – 10th Feb). Market volatility can be expected closer to the 1st of March, when a deal is expected to be made between China and US. A second wave of volatility can be expected around end of March when Brexit formally commences.

Notwithstanding this tactical call, there could be sufficient catalysts to hold these luxury stocks for a longer investment horizon if the trade war deal concludes on a positive note. Analysis of industry data shows that luxury spending may no longer be reserved for the wealthier consumers, but may now constitute a social norm. We anticipate greater consumption by the mass affluent due to raising wages, greater disposable income from the new tax laws and a pursuit of goods to reflect higher living quality.

From a macro view, a more favorable RMB/USD exchange rate and capital flows back into the Chinese market would help cushion downside risks for luxury expenditure.

Company	Bloomberg Ticker	Currency	Price	Mkt Cap (USD\$m)	Total Returns YTD	Total 1 YR Returns	5 YR historical P/E (x)	P/E (x)	12M Return Potential	Est Forward Rev Growth (% YOY)	Net Gearing (%)
Diversified segments											
Salvatore Ferragamo SpA	SFER IM	EUR	17.61	3,402	-0.3%	-21.6%	24.9	30.4	(3.2%)	(3.8)	11
LVMH Moet Hennessy Louis Vuitton	LVMHF US	USD	321.00	163,249	8.4%	4.3%	19.7	22.4	11.5%	4.8	32
PRADA SpA	1913 HK	HKD	27.05	8,822	4.8%	-17.5%	28.1	36.4	16.6%	3.9	35
Cie Financiere Richemont SA	CFR SW	CHF	69.24	39,982	9.9%	-21.6%	27.6	13.8	17.8%	22.3	56
Capri Holdings Ltd	CPRI US	USD	42.48	6,382	12.0%	-35.6%	15.9	9.2	43.2%	9.3	43
Tapestry Inc	TPR US	USD	38.71	11,218	14.7%	-15.2%	18.1	14.3	31.4%	5.5	49
Hermes International	RMS FP	EUR	524.80	63,420	8.3%	19.8%	35.8	41.3	(8.5%)	6.6	1
Burberry Group PLC	BRBY LN	Gbp	1,825.00	9,836	5.2%	16.5%	22.4	22.9	2.1%	(1.1)	2
Kering SA	PPRUF US	USD	496.71	62,724	6.9%	8.8%	26.5	25.5	18.8%	(13.2)	44
HUGO BOSS AG	BOSS GY	EUR	63.50	5,117	17.8%	-12.3%	20.3	20.4	14.7%	0.8	14
Diversified segments					9%	-7%	24	24	14%	3.53	29
Jewelry and Watches											
Tiffany & Co	TIF US	USD	88.73	10,816	10.2%	-15.1%	21.0	18.6	20.3%	5.7	31
Chow Tai Fook Jewellery Group	1929 HK	HKD	6.83	8,705	4.6%	-13.7%	19.0	16.0	8.5%	8.1	39
Pandora A/S	PNDORA DC	DKK	282.70	4,770	6.6%	-48.4%	19.2	6.0	22.3%	(1.5)	84
Swatch Group AG/The	SWGAY	USD	14.33	15,809	-1.7%	-36.5%	22.2	17.9	31.2%	2.9	0
Jewelry and Watches					5%	-28%	20	15	21%	3.80	38
Apparels											
Lululemon Athletica Inc	LULU UW	USD	147.81	19,358	21.5%	89.0%	30.8	44.9	8.9%	21.9	-
Ralph Lauren Corp	RL UN	USD	116.14	9,342	12.3%	3.7%	18.2	17.2	11.3%	0.2	17
G-III Apparel Group Ltd	GIII US	USD	34.87	1,721	25.0%	-6.6%	20.4	13.4	31.6%	8.0	35
Ted Baker PLC	TED LN	Gbp	1,870.00	1,092	20.6%	-36.3%	28.5	15.8	11.2%	2.5	57
PVH Corp	PVH US	USD	109.11	8,263	17.4%	-29.6%	15.5	11.7	24.1%	5.9	56
Apparels					19%	4%	23	21	17%	7.70	33
Alcohol											
Diageo PLC	DGE LN	Gbp	2,913.00	92,235	4.2%	17.4%	21.2	24.3	2.5%	2.2	85
Brown-Forman Corp	BF/B US	USD	47.25	22,499	-0.7%	-12.1%	29.8	29.7	8.0%	3.8	194
Constellation Brands Inc	STZ US	USD	173.66	32,901	8.0%	-19.8%	27.6	20.4	21.3%	5.7	127
Pernod Ricard SA	RI FP	EUR	145.40	44,177	1.5%	14.9%	24.3	24.4	(1.8%)	(1.4)	51
Marie Brizard Wine & Spirits S	MBWS FP	EUR	2.48	80	-5.7%	-80.1%	-	-	2.8%	(8.4)	39
Remy Cointreau SA	RCO FP	EUR	102.20	5,961	3.3%	-2.9%	37.7	34.8	6.6%	3.0	33
Davide Campari-Milano SpA	CPR EU	EUR	7.88	10,471	6.6%	25.5%	25.5	22.9	(9.9%)	(6.7)	67
Marie Brizard Wine & Spirits S	MBWS FP	EUR	2.48	80	-5.7%	-80.1%	-	-	2.8%	(8.4)	39
Alcohol					4%	-5%	23	21	17%	5.88	58

KGI's Ratings

Rating	Definition
	KGI Securities Research's recommendations are based on an Absolute Return rating system.
BUY	>10% total return over the next 12 months
HOLD	-10% to +10% total return over the next 12 months
SELL	<-10% total return over the next 12 months

Disclaimer

This report is provided for information only and is not an offer or a solicitation to deal in securities or to enter into any legal relations, nor an advice or a recommendation with respect to such securities. This report is prepared for general circulation. It does not have regard to the specific investment objectives, financial situation and the particular needs of any recipient hereof. You should independently evaluate particular investments and consult an independent financial adviser before dealing in any securities mentioned in this report.

This report is confidential. This report may not be published, circulated, reproduced or distributed and/or redistributed in whole or in part by any recipient of this report to any other person without the prior written consent of KGI Securities. This report is not intended for distribution and/or redistribution, publication to or use by any person in any jurisdiction outside Singapore or any other jurisdiction as KGI Securities may determine in its absolute discretion, where the distribution, publication or use of this report would be contrary to applicable law or would subject KGI Securities and its connected persons (as defined in the Financial Advisers Act, Chapter 110 of Singapore) to any registration, licensing or other requirements within such jurisdiction.

The information or views in the report ("Information") has been obtained or derived from sources believed by KGI Securities to be reliable. However, KGI Securities makes no representation as to the accuracy or completeness of such sources or the Information and KGI Securities accepts no liability whatsoever for any loss or damage arising from the use of or reliance on the Information. KGI Securities and its connected persons may have issued other reports expressing views different from the Information and all views expressed in all reports of KGI Securities and its connected persons are subject to change without notice. KGI Securities reserves the right to act upon or use the Information at any time, including before its publication herein.

Except as otherwise indicated below, (1) KGI Securities, its connected persons and its officers, employees and representatives may, to the extent permitted by law, transact with, perform or provide broking, underwriting, corporate finance-related or other services for or solicit business from, the subject corporation(s) referred to in this report; (2) KGI Securities, its connected persons and its officers, employees and representatives may also, to the extent permitted by law, transact with, perform or provide broking or other services for or solicit business from, other persons in respect of dealings in the securities referred to in this report or other investments related thereto; and (3) the officers, employees and representatives of KGI Securities may also serve on the board of directors or in trustee positions with the subject corporation(s) referred to in this report. (All of the foregoing is hereafter referred to as the "Subject Business".)

However, as of the date of this report, neither KGI Securities nor its representative(s) who produced this report (each a "research analyst"), has any proprietary position or material interest in, and KGI Securities does not make any market in, the securities which are recommended in this report.

Each research analyst of KGI Securities who produced this report hereby certifies that (1) the views expressed in this report accurately reflect his/her personal views about all of the subject corporation(s) and securities in this report; (2) the report was produced independently by him/her; (3) he/she does not carry out, whether for himself/herself or on behalf of KGI Securities or any other person, any of the Subject Business involving any of the subject corporation(s) or securities referred to in this report; and (4) he/she has not received and will not receive any compensation that is directly or indirectly related or linked to the recommendations or views expressed in this report or to any sales, trading, dealing or corporate finance advisory services or transaction in respect of the securities in this report. However, the compensation received by each such research analyst is based upon various factors, including KGI Securities' total revenues, a portion of which are generated from KGI Securities' business of dealing in securities.

Copyright 2019. KGI Securities (Singapore) Pte. Ltd. All rights reserved.