

# CTGDF (601888 CH)

## Management initiatives may not fully dispel uncertainty over the planned margins recovery; down to HOLD

4Q21 tourist traffic (+63% QoQ) **recovered as we expected**, and so was CTGDF's rally, before the shares plunged further for the quarter's aggressive discounts that subsequently prompted a 10% cut in our 2021E earnings. CTGDF management pledged to uphold better margins for 2022 through disciplined promotions and a committed price collusion with other Hainan duty-free operators. That said, Hainan's 100bn sales target looks to be a setback that could again drag CTGDF into the unhappy paradox between profitability and growth, particularly considering the current fluid travel outlook. Separately, the rising contribution from lower-margin businesses (e-commerce and duty-paid) could also manifest into a disruptor to management's plan. The path to GPM recovery looks bumpy to us, and to reflect the augmenting ambiguities, we downgrade CTGDF to **HOLD** on a 29% cut in our 2022E earnings on back of a 7.3pp cut in GPM. At c.10% below consensus, our 2022E net profits reflects 1) a troughed GPM from 4Q21, which, however, remains lacklustre into 2022E, and 2) a relatively flattish EBIT margins to showcase management's execution efficiency to mitigate the stagnant GPM trajectory. Meanwhile, we also lower our target multiple to 36.5x end-22 P/E (from previously 49.0x) which is now rebased to -1sd below its 3-year average. We trim our TP to RMB 212 from RMB 350.

### Major earnings assumptions:

- We cut 14% of our 2022E revenue to RMB98bn, which mainly comprises RMB11bn contribution from Sunrise Shanghai/ Shanghai Airports, and RMB80bn from Hainan offshore operations. For the latter, the amount would account for 80% of Hainan's target, largely in line with CTGDF's market share on the island.
- We lowered our 2022E GPM to 31.6% (from 38.9%) based on 34% for duty-free business and 26% for duty-paid business. We still assume cosmetics/ apparels to offer the highest GPM with the former at 40%+, followed by watches/ jewelry at 30%+, while electronics offer the lowest at c10%. Cosmetics/ perfume will contribute to c50% of the sales mix, followed by c20% of electronics, and the remaining from watches/ alcohol/ leather goods.
- Any supportive policies announcement, especially the easing of China's zero-covid policy, represent upside risks to our rating/ TPs. In particular, we consider the relaxation on the purchase of imported necessities for Hainan residents a trump card to help achieve the 100bn target.

### Earnings summary

(YE 31 Dec)	FY19A	FY20A	FY21E	FY22E	FY23E
Revenue (RMB mn)	48,612	52,597	67,670	98,392	138,324
YoY growth (%)	3.4	8.2	28.7	45.4	40.6
Net income (RMB mn)	4,632	6,140	9,592	11,346	16,571
EPS (RMB)	2.4	3.1	4.9	5.8	8.5
YoY growth (%)	50.3	32.6	56.2	18.3	46.1
Consensus EPS (RMB)	n.a	n.a	4.9	6.4	9.5
P/E (x)	n.a	n.a	38.3	32.4	22.2
P/B (x)	n.a	n.a	12.7	10.0	7.7
Div Yield (%)	n.a	n.a	0.8	1.0	1.4
ROE (%)	23.3	27.5	33.2	31.0	34.6
Net gearing (%)	52.4	54.6	45.2	36.5	36.5

Source: Company data, Bloomberg, CMBIGM estimates

**HOLD (Down)**

Target Price	RMB212
(Previous TP)	RMB350)
Up/Downside	+12.6%
Current Price	RMB188.3

### China Consumer Sector

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#### Stock Data

Mkt Cap (RMB mn)	369,330
Avg 3 mths t/o (RMB mn)	2,159
52w High/Low (RMB)	403.8/185.1
Total Issued Shares (mn)	1,952.4

Source: Bloomberg

#### Shareholding Structure

China Travel Group	53.3%
HKSC	9.6%
CSFC	3.0%

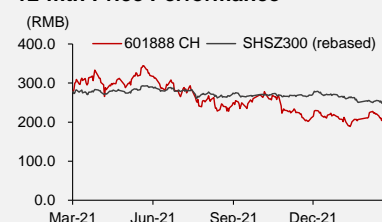
Source: Bloomberg

#### Share Performance

	Absolute	Relative
1-mth	-10.3%	-5.3%
3-mth	-11.2%	-0.4%
6-mth	-38.2%	-13.8%

Source: Bloomberg

#### 12-mth Price Performance



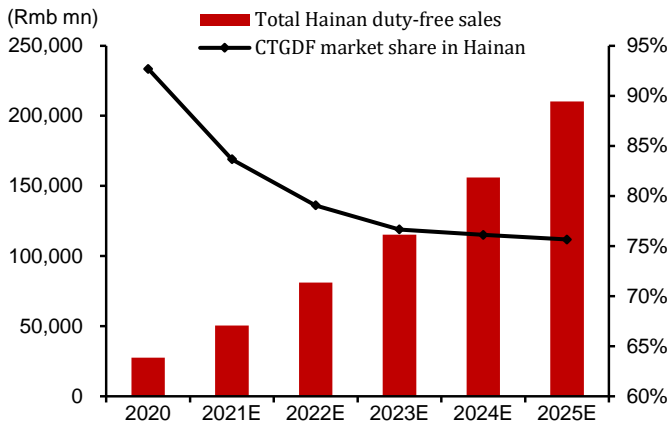
Source: Bloomberg

#### Auditor: PricewaterhouseCoopers

#### Related Reports

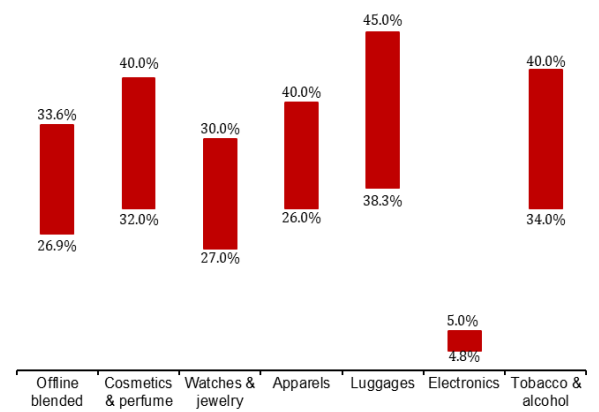
1. ["CTGDF \(601888 CH\) – At near term trough; Shares likely mean-revert on sequentially better 4Q tourist traffic; Initiate at Buy"](#) – 15 Sep 2021

**Figure 1: CTGDF's market share in Hainan**



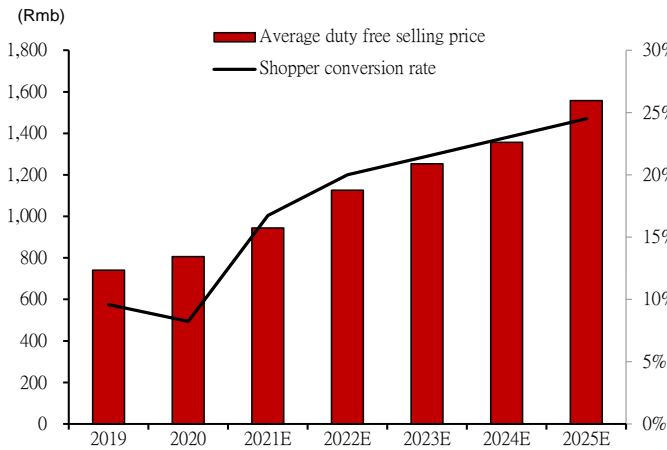
Source: Hainan government, CMBIGM estimates

**Figure 2: Offline GPM range for major products**



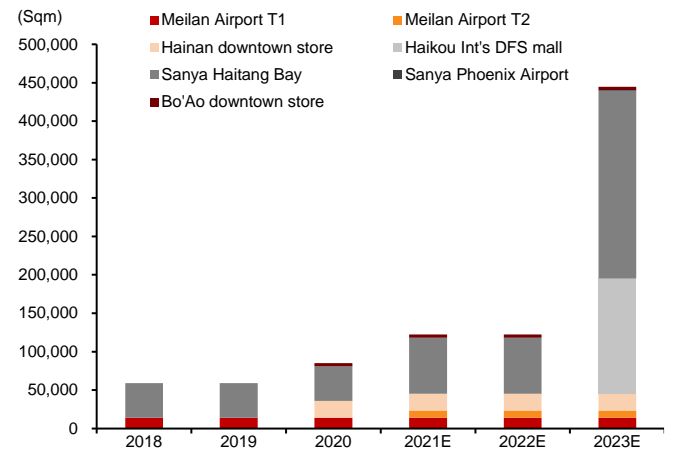
Source: CMBIGM estimates

**Figure 3: DF spending/ shopper conversion rate**



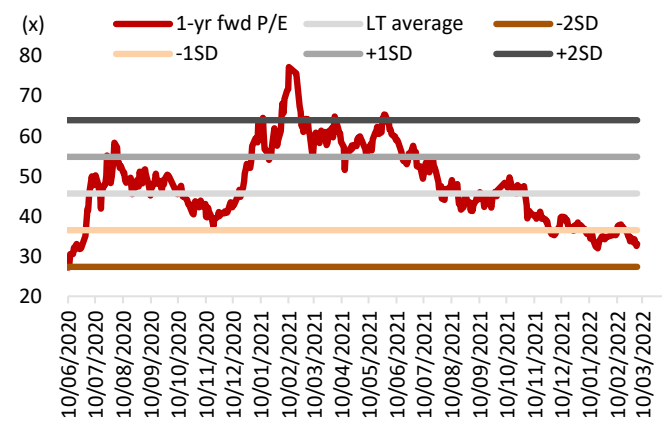
Source: Wind, CMBIGM estimates

**Figure 4: CTGDF retail space expansion in Hainan**



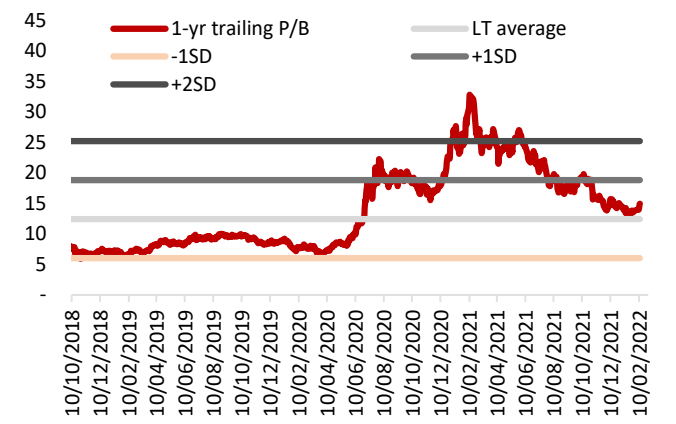
Source: Company data, CMBIGM

**Figure 5: 12M forward P/E band**



Source: Company data, Bloomberg, CMBIGM estimates

**Figure 6: 12M trailing P/B band**



Source: Company data, Bloomberg, CMBIGM estimates

## Expansion of Haikou/ Sanya Duty-free complex is crucial to sustain CTGDF's leadership in Hainan

- Following the favorable tax policy for tourists leaving Hainan to enjoy duty-free shopping, Hainan's core duty-free sale channels have been captured by CTGDF through the establishment of offshore duty-free stores throughout the island. In 2014, its Sanya International Duty-Free Complex, the first integrated travel retail complex in China, and the largest single duty-free store in the world in terms of total sales area according to Frost & Sullivan, commenced business with more than 70,000 sq m of sales area. CTGDF also operates duty-free stores with easy access in downtown Haikou and the area of Boao Forum for Asia. To stay in line with its marketing and promotion strategy, it has set up experience centers designed for different locations such as resorts, scenic spots, and outlets in Hainan to let travelers experience the products in person while offering the pick-up service when they depart Hainan. Together with two major airports in Hainan, it has successfully set up a well-rounded duty-free retail network.
- CTGDF's offshore duty-free stores offer Chinese tourists who usually visit overseas duty-free stores another option. In 2020, in view of the favorable government policies and COVID-19 pandemic which caused significant decrease in international travel activities, its sales from offshore duty-free stores recorded a strong improvement. In 2018, 2019 and 2020, the revenue generated from offshore duty-free stores were RMB8,010.4mn, RMB13,249.6mn and RMB29,961.9mn, with a CAGR of 93.4%.
- In response to the "duty-free shopping plus premium hotel" project, expansion of Sanya International Duty-Free Complex is expected. The duty-free shopping area has been under construction since Mar 2021 and is foreseen to be completed in 2023 with an estimated GFA of 76,500 sq m. For hotel area, its construction is targeted to start in Dec 2021 and to commence operations in 2026 with an estimated GFA of 96,000 sq m. We believe the expansion of Haikou/ Sanya Duty-free complex is crucial to sustain CTGDF's leadership in Hainan (currently 80%+ market share).

**Figure 7: Exterior of Phase I of Sanya International Duty-Free Complex (Frontal View)**



Source: Company data, CMBIGM

**Figure 8: Exterior of Phase II of Sanya International Duty-Free Complex**



Source: Company data, CMBIGM

## We expect more supportive policies to come

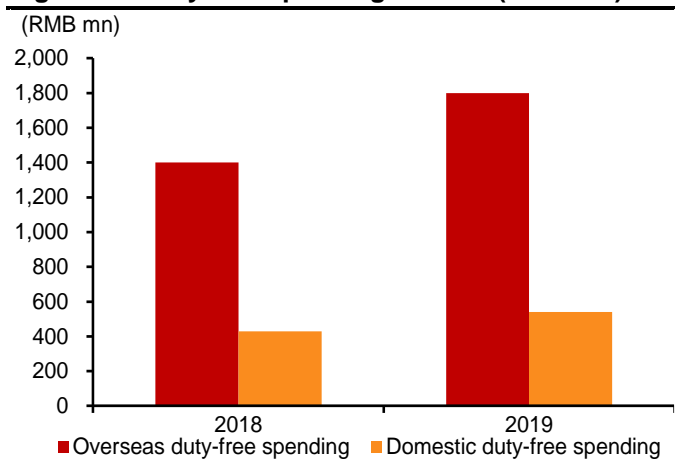
- To revive the duty-free market that has been significantly hit by COVID-19, the Chinese government enacted a series of policies to promote the growth and development of the duty-free industry including measures to encourage offshore duty-free shopping and the development of integrated travel retail complex and downtown duty-free stores.

**Figure 9: List of historical favourable policies that promote the duty-free market**

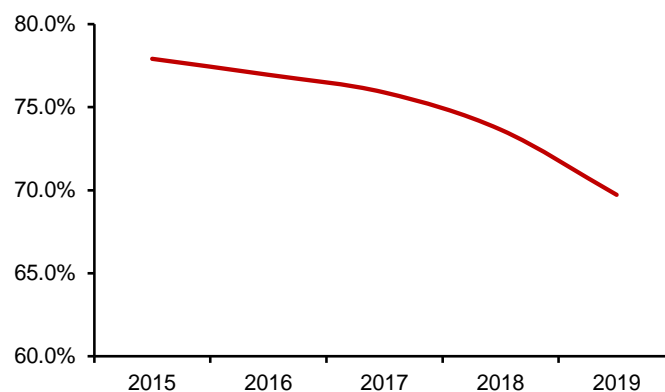
Time	Key message
April 2011	<ul style="list-style-type: none"> <li>• The official launch of preferential tax policy for travellers leaving Hainan to enjoy duty-free shopping</li> </ul>
November 2012	<ul style="list-style-type: none"> <li>• The increase in duty-free spending allowance (from RMB5,000 to RMB8,000)</li> <li>• The expansion of product category list (from 18 to 21 items)</li> </ul>
March 2015	<ul style="list-style-type: none"> <li>• The expansion of product category list (from 21 to 38 items)</li> </ul>
February 2016	<ul style="list-style-type: none"> <li>• The approval of non-Hainan residents making duty-free purchases multiple times in a year with annual exempted tax value of up to RMB16,000</li> <li>• The approval of duty-free stores operating online shopping platforms</li> </ul>
December 2018	<ul style="list-style-type: none"> <li>• The increase in offshore duty-free shopping allowance (from RMB16,000 to RMB30,000)</li> <li>• The cancellation of limits on the number of purchases</li> </ul>
June 2020	<ul style="list-style-type: none"> <li>• The announcement of favourable corporate tax policies for registered companies in Hainan and companies operating in encouraged industries (lower rate of 15% or exempted)</li> <li>• The announcement of favourable individual income tax policies for talents and those in short supply (the part of tax burden above 15% would be exempted)</li> <li>• The increase in annual purchase cap (from RMB30,000 to RMB100,000)</li> <li>• The expansion of product category list (from 38 to 45 items)</li> <li>• The cancellation of the maximum purchase price of RMB8,000 per item</li> </ul>
November 2020	<ul style="list-style-type: none"> <li>• The announcement of a set of measures for the customs supervision of zero tariff raw and auxiliary materials imported into the Hainan Free Trade Port</li> </ul>
December 2020	<ul style="list-style-type: none"> <li>• The approval of establishment of six new duty-free stores in Hainan</li> <li>• The announcement of the List of "Zero Tariff" Vehicles and Yachts in the Hainan Free Trade Port</li> </ul>
February 2021	<ul style="list-style-type: none"> <li>• The launch of mail services, instead of picking up the goods at the airports and train stations</li> <li>• The announcement of the Negative List on "Zero Tariff" Policy for importing self-use production equipment into Hainan Free Trade Port</li> </ul>
April 2021	<ul style="list-style-type: none"> <li>• The announcement of further relaxation on market access in major industries such as healthcare and finance</li> </ul>

Source: Government websites, CMBIGM

- We await relaxation on purchase of imported necessities for Hainan residents**  
 The next supportive policy announcement, according to the Chinese government in December 2020, relates to allowing duty-free shopping for Hainan onshore residents (without departing Hainan), which we believe could be a pilot program ahead of the tax exemption initiative for Hainan by 2025. According to Wind, there are about 10mn local residents in Hainan. Assuming an annual luxury/ leisure spending of RMB1,000 per capita that CTGDF could capture, we estimate the relaxation, should it realize, would represent a RMB10bn addressable market that CTGDF could explore.
- Domestic consumption repatriation**  
 The 14th Five-Year Plan promotes a new development pattern that centers on the domestic consumption circulation along with the co-development of an international circulation. The policy emphasizes the central role of the domestic consumption and seeks to improve the efficacy and efficiency of the circulation with the aim of bringing back overseas spending to sustain domestic economic growth. According to CTGDF, total overseas duty-free spending by China tourists reached approximately RMB1.8tn in 2019, with Korean Duty-free (KDFS) contributing to RMB1tn, 55% of the total. These compare to only RMB54bn domestic duty free spending. Assuming 10% of the spending will be redirected to the domestic market, we estimate this could boost the market size of the latter by 33%.

**Figure 10: Duty-free spending 2018/19 (RMB mn)**

Source: Wind, UNWTO, CMBIGM

**Figure 11: c70% luxury spending made in overseas**

Source: Company data, CMBIGM

In fact, with the relaxation of duty-free policy since Jul 2020, the total imports of consumer goods grew 8.2% YoY to RMB1.6tn, according to the China Custom. Jewelry and cosmetics offered the fastest growth of 30%, followed by suitcase of 20%. This translated to RMB33bn duty-free spending for Hainan for the same year, despite travel restrictions amid the pandemic. Given the ambition of reshaping Hainan to be a tax-free port by 2025, domestic duty-free sales will remain a channel to repatriate overseas consumption back to China.

**Figure 12: Tax summary for imported products to China**

Product Category	Minimum Tariff	GST	VAT
Wine	20%	10%	13%
Tobacco	10%	46%	13%
Handbags/ Luggage	10%	N/A	13%
Watches	11%	20%	13%
Jewellery	17%	5%	13%
Make-up	5%	15%	13%
Perfume	5%	15%	13%

Source: China Customs, State Taxation Administration, CMBIGM

## An aggressive online strategy

CTGDF took the initiative to develop its online platform. It takes full advantage of the rise of online shopping and creates a consistent customer engagement from the moment a trip is planned and the moment the traveler returns home. The international travel restrictions since early 2020, as a result of the COVID-19 pandemic has accidentally accelerated the launch of the initiative. Of note, CTGDF has been fully engaged in online sales and marketing through multiple online channels since Feb 2020 with new functions that include, but not limited to the followings:

### ■ Personalized product recommendations

Personalized product recommendations were made to customers based on their browsing and purchase histories. CTGDF also organized livestreaming shows to enable direct interaction between customers and KOLs.

### ■ Customer services and customer loyalty program

The Company provided online chats and hotline support to respond to customer enquiries. An integrated customer loyalty program based on membership points was also created via WeChat app.

Figure 13: Screenshots of the cdf membership club's WeChat mini-app

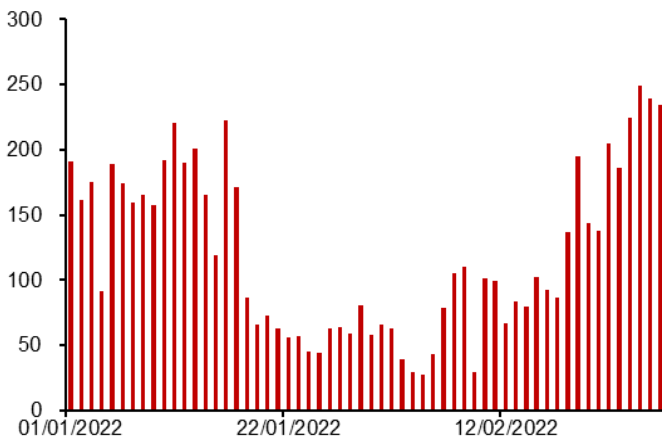


Source: Company data, CMBIGM

## LNY tourist traffic recap

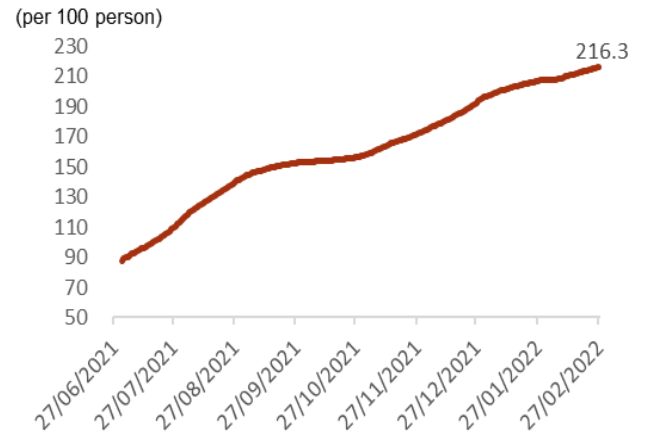
- Touristic visitations/ revenue during 2022 LNY (1.31-2.6) still slightly declined by 2%/ 3.9% YoY. It recovered to 73.9%/ 56.3% of 2019 level, but was still relatively low amid the major national holidays since Mid-Autumn and National Day in Oct 2020, though higher than 2021 full year levels of 51%/ 54%. This is likely because China has been normalizing the opening of touristic attractions, with over 70% of A-rated attractions in the countries opened during LNY.
- The covid situation has been well managed in China, where the covid control policy tends to become more flexible in order to minimize unnecessary hurt to traffic flow and the economy. The surprising conditional approval of covid-19 drug by CFDA on 11 Feb 2022 also reflected China's willingness to accelerate the recovery process. We see scope for tourist traffic to trough in 2022.

**Figure 14: Daily no. of Covid cases in China**



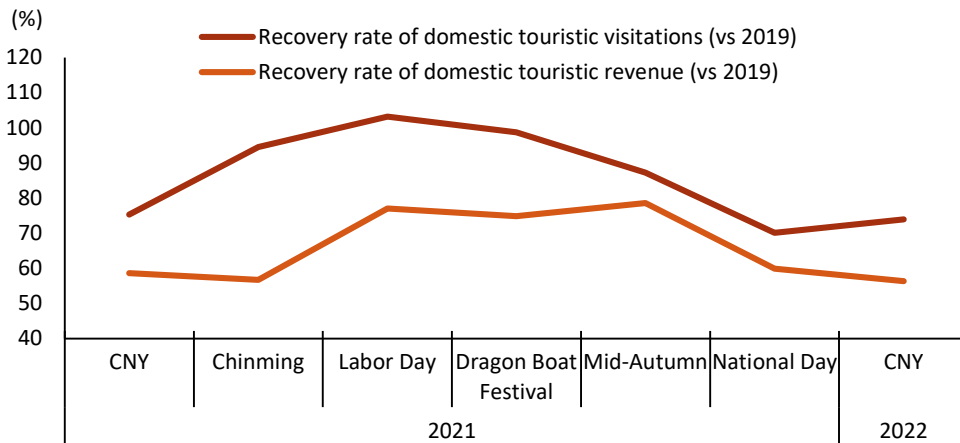
Source: Wind, CMBIGM

**Figure 15: China's vaccination rate (Feb 27)**



Source: Wind, CMBIGM

**Figure 16: Recovery rate vs 2019 during major national holidays since 2020**

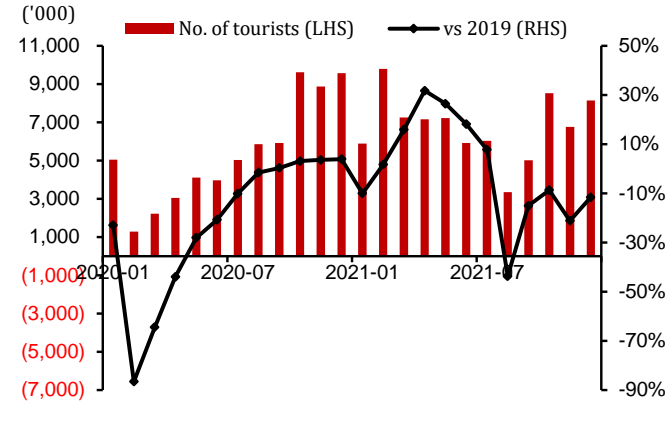


Source: Wind, CMBIGM



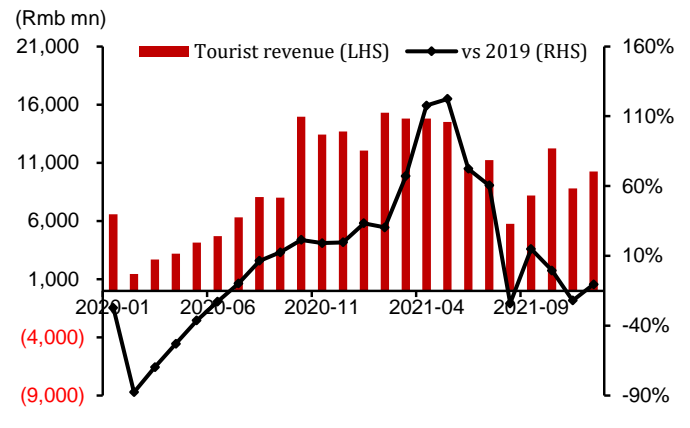
■ Tourism and duty-free shopping in Hainan maintained strong momentum throughout the LNY holiday (1.30-2.6) although China has maintained its zero-covid policy so far. For instance, touristic revenue and no. of tourists in Hainan came in at RMB753mn/ 5.4mn, when the no. of travelers at Haikou Meilan Airport increased 56.4% YoY and flight bookings to Hainan grew 40%+ on Ctrip.com. During 30 Jan - 5 Feb, the 10 duty-free stores in Hainan recorded sales value/ no. of shoppers/ no. of units purchased/ spending per shopper of RMB1,980mn/ 278k/ 1.65mn/ RMB7,127, +144%/ +128%/ +143%/ +125% YoY, respectively.

**Figure 17: Hainan travel recovery vs 2019**



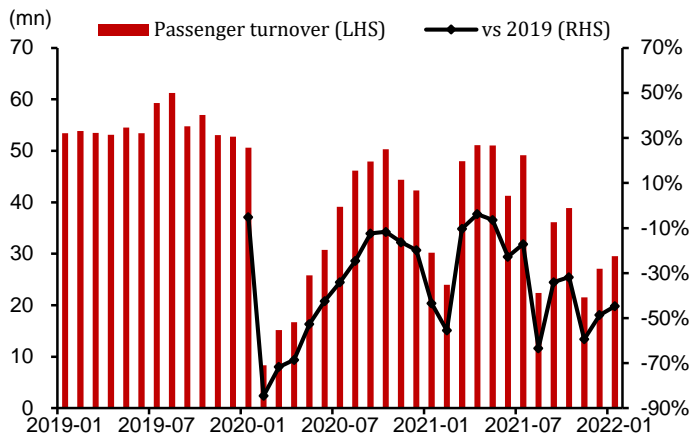
Source: Wind, CMBIGM

**Figure 18: Hainan tourists spendings vs 2019**



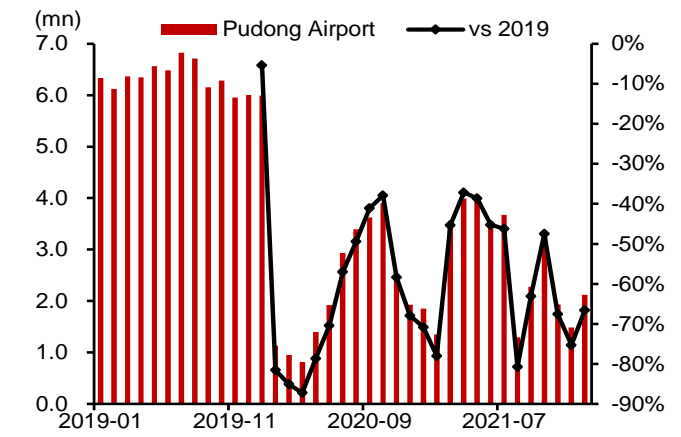
Source: Wind, CMBIGM

**Figure 19: Sanya airport monthly passenger turnover**

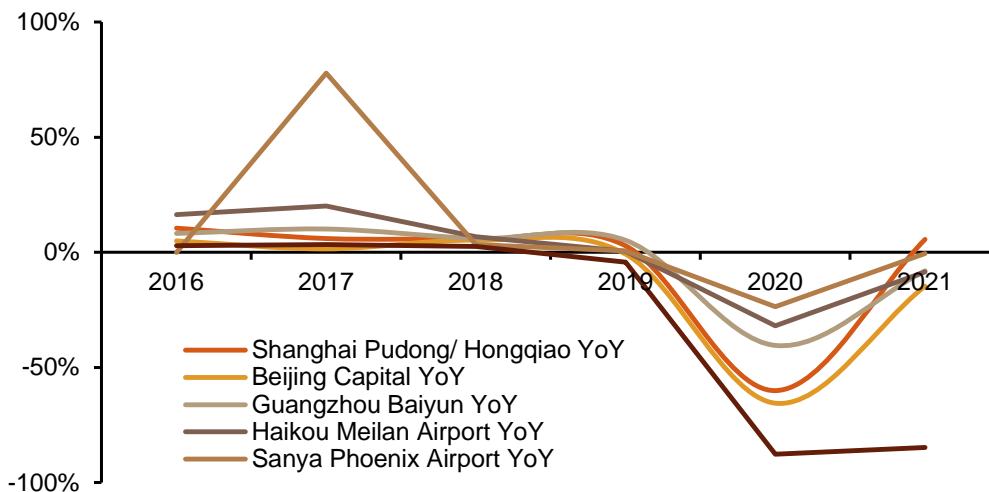


Source: Wind, CMBIGM

**Figure 20: Pudong airport passenger turnover**

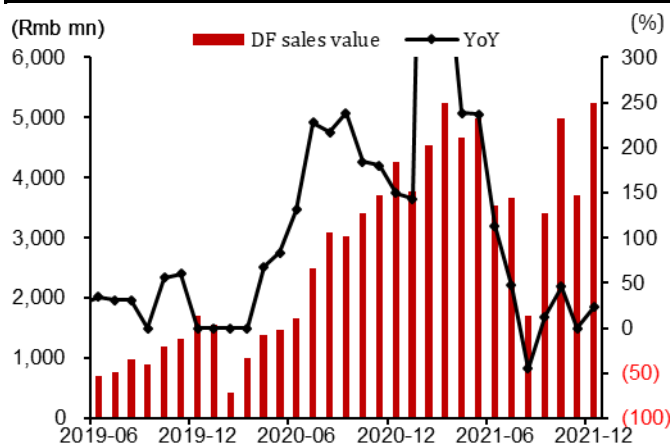


Source: Wind, CMBIGM

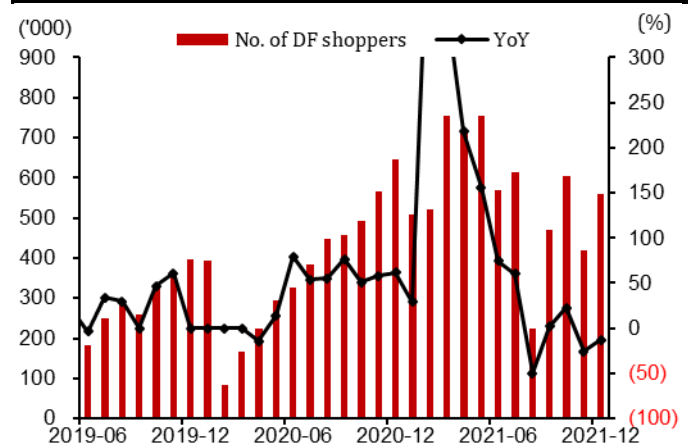
**Figure 21: Passenger turnover among major airports in China**


Source: Wind, CMBIGM

- On the other hand, in January, passenger flow has recovered to 70%+ vs 2019 in both Sanya Phoenix and Haikou Meilan Airports, the two major airports in Hainan. Sanya Phoenix has also exceeded 2019 level in terms of no. of flights (Meilan at c.92% vs 2019). Tourist spendings/ visitations in Hainan grew 22.0%/ 13.1% YoY and 62.6%/ 1.66% vs 2019. Duty free revenue kept tracking brightly, with sales value/ no. of shoppers/ spending per shopper of RMB5,822mn/ 980k/ RMB5,940, +43.8%/ +40.2%/ +2.9% YoY.

**Figure 22: Hainan monthly duty free revenue**


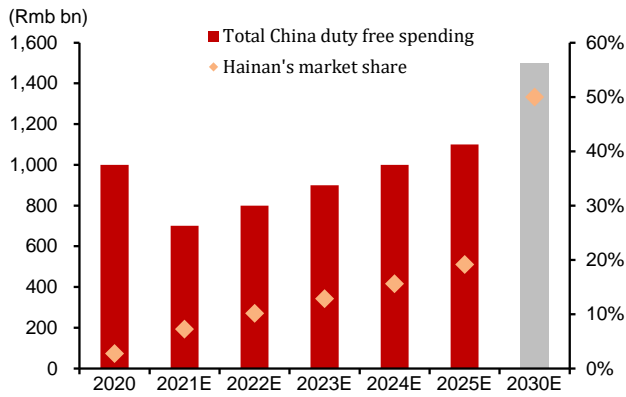
Source: Wind, CMBIGM

**Figure 23: No. of duty free shoppers to Hainan**


Source: Wind, CMBIGM

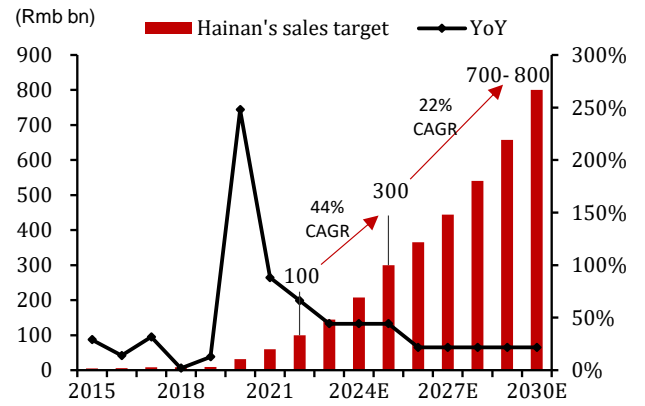
- Hainan province targeted to achieve RMB100bn sales in 2022E, RMB300bn in 2025E and RMB700-800bn in 2030E, which imply a 65%+ YoY growth in 2022E, a 44%+ CAGR in 2023E-25E and a 21%+ CAGR in 2026E-30E. Its 2025 target implies a nearly five-fold growth potential vs RMB60.2bn revenue in 2021. Longer term, we think CTGDF would likely be the major beneficiary from the expansion of Hainan duty free market, given a 80%+ estimated market share on the Island.

**Figure 24: China Duty free spending market size**



Source: Government websites, CMBIGM

**Figure 25: Hainan's target for duty-free operators**



Source: Hainan government, CMBIGM

## Financial Summary

### Income statement

YE 31 Dec (RMB mn)	FY19A	FY20A	FY21E	FY22E	FY23E
<b>Revenue</b>	<b>48,612</b>	<b>52,597</b>	<b>67,670</b>	<b>98,392</b>	<b>138,324</b>
Duty-paid sales	1,149	19,708	20,693	29,518	36,897
Duty-free sales	45,818	32,361	46,977	68,874	101,42
<b>Gross profits</b>	<b>24,825</b>	<b>21,376</b>	<b>23,120</b>	<b>31,092</b>	<b>47,767</b>
D&A	(408)	(516)	(542)	(577)	(612)
Selling expense	(15,536)	(8,847)	(6,090)	(7,379)	(13,41)
Administration expense	(1,628)	(1,637)	(2,030)	(2,657)	(4,150)
Other operating expense	(483)	(568)	(1,316)	(2,417)	(3,554)
<b>EBIT</b>	<b>6,771</b>	<b>9,809</b>	<b>13,141</b>	<b>18,062</b>	<b>26,033</b>
<b>EBITDA</b>	<b>7,179</b>	<b>10,325</b>	<b>13,684</b>	<b>18,639</b>	<b>26,645</b>
Finance costs, net	(4)	545	92	106	112
Non-operating	581	(676)	761	(750)	(700)
Total investment gains/(los	60	(7)	740	10	10
<b>Pre-tax profit</b>	<b>7,407</b>	<b>9,672</b>	<b>14,734</b>	<b>17,428</b>	<b>25,455</b>
Income tax	(1,801)	(2,335)	(3,389)	(4,009)	(5,855)
Less: Minority interests	(975)	(1,197)	(1,753)	(2,074)	(3,029)
<b>Net profit</b>	<b>4,632</b>	<b>6,140</b>	<b>9,592</b>	<b>11,346</b>	<b>16,571</b>

### Cash flow summary

YE 31 Dec (RMB mn)	FY19A	FY20A	FY21E	FY22E	FY23E
<b>Net income</b>	<b>4,632</b>	<b>6,140</b>	<b>9,592</b>	<b>11,346</b>	<b>16,571</b>
D&A	408	516	542	577	612
Change in working capital	(562)	(2,888)	(4,945)	(8,091)	(8,084)
Others	(1,356)	4,435	706	1,733	2,679
<b>Net cash fr. operating act.</b>	<b>3,121</b>	<b>8,202</b>	<b>5,896</b>	<b>5,565</b>	<b>11,779</b>
Capex & investments	(1,498)	(1,234)	(1,467)	(1,409)	(1,221)
Associated companies	(500)	(1,542)	-	-	-
Others	336	337	338	339	340
<b>Net cash fr. investing act.</b>	<b>(631)</b>	<b>(3,814)</b>	<b>(1,675)</b>	<b>(1,412)</b>	<b>(1,224)</b>
Equity raised	-	-	-	-	-
Change of Debts	3	255	-	-	-
Dividend paid	(1,618)	(1,658)	(3,050)	(3,608)	(5,270)
Others	(113)	20	(51)	(93)	(279)
<b>Net cash fr. financing act.</b>	<b>(1,729)</b>	<b>(1,383)</b>	<b>(3,101)</b>	<b>(3,701)</b>	<b>(5,548)</b>
<b>Net change in cash</b>	<b>761</b>	<b>3,005</b>	<b>1,119</b>	<b>452</b>	<b>5,006</b>
Cash at the beginning of the year	11,059	12,032	14,706	15,825	16,277
Exchange difference	85	(331)	-	-	-
<b>Cash at the end of the year</b>	<b>11,906</b>	<b>14,706</b>	<b>15,825</b>	<b>16,277</b>	<b>21,284</b>
Less: pledged cash	504	50	-	-	-

### Balance sheet

YE 31 Dec (RMB mn)	FY19A	FY20A	FY21E	FY22E	FY23E
<b>Non-current assets</b>	<b>8,442</b>	<b>10,948</b>	<b>12,821</b>	<b>13,666</b>	<b>14,288</b>
Fixed asset	1,632	1,591	1,758	1,903	2,025
Prepaid lease payments	357	357	357	357	357
Interest in JV	254	254	254	254	254
Other non-current assets	6,199	8,747	10,452	11,152	11,652
<b>Current assets</b>	<b>22,246</b>	<b>30,971</b>	<b>38,482</b>	<b>49,778</b>	<b>65,892</b>
Cash	11,906	14,706	15,825	16,277	21,284
Account receivable	800	129	166	241	338
Prepayments	381	256	256	256	256
Other current assets	9,159	15,881	22,236	33,005	44,014
<b>Current liabilities</b>	<b>7,961</b>	<b>15,661</b>	<b>17,508</b>	<b>20,661</b>	<b>23,884</b>
Borrowings	224	417	417	417	417
Obligations under finance	3,537	4,327	6,174	9,327	12,550
Other payables	2,729	7,246	7,246	7,246	7,246
Tax payables	1,471	3,671	3,671	3,671	3,671
<b>Non-current liabilities</b>	<b>415</b>	<b>79</b>	<b>79</b>	<b>79</b>	<b>79</b>
Borrowings	-	-	-	-	-
Deferred income	97	74	74	74	74
Others	319	5	5	5	5
<b>Minority Interest</b>	<b>2,421</b>	<b>3,871</b>	<b>5,266</b>	<b>6,917</b>	<b>9,327</b>
<b>Total net assets</b>	<b>22,310</b>	<b>26,179</b>	<b>34,116</b>	<b>43,504</b>	<b>57,216</b>
<b>Shareholders' equity</b>	<b>22,310</b>	<b>26,179</b>	<b>34,116</b>	<b>43,504</b>	<b>57,216</b>

### Key ratios

YE 31 Dec	FY19A	FY20A	FY21E	FY22E	FY23E
<b>Sales mix (%)</b>					
Duty-paid sales	2.4	37.5	30.6	30.0	26.7
Duty-free sales	94.3	61.5	69.4	70.0	73.3
<b>P&amp;L ratios (%)</b>					
Gross margin	51.1	40.6	34.2	31.6	34.5
Operating margin	13.9	18.6	19.4	18.4	18.8
Pre-tax margin	15.2	18.4	21.8	17.7	18.4
Net margin	9.5	11.7	14.2	11.5	12.0
Effective tax rate	(24.3)	(24.1)	(23.0)	(23.0)	(23.0)
<b>Balance sheet analysis</b>					
Current ratio (x)	0.5	0.5	0.4	0.3	0.3
Net receivable days	6.0	0.9	0.9	0.9	0.9
Net payable days	54.3	50.6	50.6	50.6	50.6
Inventory turnover days	124.1	172.8	172.8	172.8	172.8
Net debt to equity (%)	52.4	54.6	45.2	36.5	36.5
<b>Returns (%)</b>					
ROE	23.3	27.5	33.2	31.0	34.6
ROA	15.1	14.6	18.7	17.9	20.7
Dividend yield	0.4	0.5	0.8	1.0	1.4
<b>Per share</b>					
EPS (RMB)	2.4	3.1	4.9	5.8	8.5
DPS (RMB)	0.7	1.0	1.6	1.8	2.7
BVPS (RMB)	10.2	11.4	14.8	18.7	24.5

Source: Company data, CMBIGM estimates

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