

LEVEL 7 ASSESSMENT SPECIFICATION



Student name:	Tong Ho Yan	Student ID number:	2019397
Programme:	MBA		
Module:	Finance for Business Managers		
Module code:	HKBM7008	Contribution to Overall Module Assessment (%):	100%
Lecturer:	Dr Katherine Mo	Internal Verifier:	Dr Arion Wong
Assignment Title:	Assignment 1	Word count (or equivalent):	5,000 words +/- 10%
Submission deadline:	23 August 2021	Return date of provisional marks & written feedback:	Within 10 days after submission
Submission method:	All written assessments, where practical and possible, must be submitted via Turnitin unless otherwise instructed by the Lecturer. (Please DO NOT put this assessment specification into Turnitin or it will match many similarities with other students' submissions.) Alternative submission method (if applicable): Late submission of the assessment will result in a late penalty mark. Penalties for late submission: Up to one week late, maximum mark of 50%. Over one week late, 0%. Only the Extenuating Circumstances Panel may approve a change to submission dates.		
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Total word count: 4,720

Executive Summary

This report studies the financial performances of Luk Fook Holdings (International) Limited in comparison with another two companies in the same industry. Luk Fook is one of the leading fine jewelry companies focusing on retail, wholesale, design and production. It is a listing company having a global distribution network with over 2,000 stores worldwide. In recent years, the overall economy has been affected by the COVID-19 pandemic, influencing the retail industry by decreasing the number of tourists, and the social distancing measures have decreased the demand of jewelry products drastically. In addition to that, the increase in gold price and raw materials have also influenced the jewelry industries.

An evaluation of the corporate governance and structure of Luk Fook has revealed its corporate stability and strong governance, although there are still areas of improvement in terms of its dual role of Chairman and CEO; as well as increasing the diversity of the Board of Governors. The financial analysis in comparison with the other two companies, Chow Sang Sang and Tze Sui Lun, showed that Luk Fook has great corporate strategies in financial control and has strong paying debt ability and low level of liability as compared to other two. In terms of operational efficiency, it has a short collection period in comparison but the days sales in inventory has been extended during the pandemic year.

An appraisal exercise is done in this report to evaluate the financial feasibility for the Group's future project, which is to open additional 300 stores in Mainland. With some assumptions made, the NPV, IRR, ARR of the project proposed was calculated.

Discussion on how to raise funds for investment project is also carried out and it is concluded that the best way to raise funds during this period of time is through bank loans due to the low interest rate and strong financial ability from the Group.

Last but not least, recommendations for auditing performance have been made. These include reviewing the direct cost; the creditor's performances; the inventories control; and the structural of corporate governance. These recommendations are suggested to be carried out per each quarter within a year.

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1. Company Background

Luk Fook Holdings (International) Limited ('Luk Fook') was established in 1991 by a group of jewellery specialists who had a unique market sense and passion to engage in the industry. The group has outstanding performances in sourcing, designing, wholesaling, trademark licensing and retailing of a variety of gold and platinum jewellery and gem-set products. Over the years the Group has developed a corporate vision of 'Brand of Hong Kong, Sparkling the World', it also has a structured and comprehensive corporate environment, social and governance policy and is actively engaged in promoting environmental protection, contributing to the society, and providing a caring corporate culture. Its branding theme of 'Love is Beauty' builds a warm and sincere brand image and strengthening customer's emotional attachment to the brand through quality products and excellent customer service programmes.

Luk Fook has a global distribution network with 2,284 shops worldwide, including 146 self-operated shops across Hong Kong, Macau, Mainland, Singapore, Malaysia, Cambodia, Philippines, United States, Canada and Australia, and 2,138 licensed shops in Mainland, Philippines and Cambodia. There are three sub-brands operated from the Group, which are 'Goldstyles', 'Dear Q', and '3D GOLD', accounting 82 shops in Mainland (Luk Fook, 2021, Pg. 3).

In addition to retail business, in 2003, the Group set up a large-scale jewellery processing plant in Nansha, Guangzhou, enabling a stable supply chain and quality assurance. It enables the Group to be competitive within the distribution network. Its high-quality standard is supported by the ISO 9001 Quality Management Systems and ISO 14001 Environmental Management System certifications in 2008 and 2009

respectively. In 2013, the Group set up the Victoria Gemological Institute Limited, which is accredited in jewellery authentication and professional training.

The Group was listed on the Main Board of the Stock Exchange of Hong Kong Limited in May 1997 (Stock Code: 0590). It has around 5,900 employees in total of which over 72% is based in Mainland; 21% in Hong Kong; and around 6% in Macau. The organizational structure shows that over 90% of the workforce are senior officer or below and the highest percentage of workforce by age is from 30-39 years old (Luk Fook, 2021, Pg. 88-89).

2. Business Overview and challenges

Hong Kong's jewellery industry is classified into two sectors in general. They are fine jewellery or jewellery made of precious metals, and imitation jewellery (Man, 2020). Luk Fook is classified as the former sector.

In 2020, the Covid-19 pandemic has had a powerful effect on the global jewellery market. It was estimated that the personal luxury goods market would shrink by 20-35% worldwide in 2020 and that it would take two to three years for the industry to recover to pre-crisis levels (Man, 2020). In Hong Kong, the number of tourists was severely affected by the travel restrictions set by the Hong Kong Government and the social distancing measures has reduced the number of shoppers and events requiring the purchase of jewelry. According to Hong Kong Tourism Board (2021), the number of tourists decreased by 99% in the first half of 2021. This has resulted a 36.8% drop in total retail business for Luk Fook in the previous financial year (Luk Fook, 2021, Pg 14).

Besides the pandemic, several factors have also contributed to the business challenges in the jewellery industry. A survey conducted by the Hong Kong Trade and Development Council (2020) showed that fluctuations of global economy; price fluctuation of raw materials; increase in operating costs and fluctuating exchange rates have been rated as the four biggest challenges facing the industry (Man, 2019). There is also a shift of the selling pattern to e-commerce for the jewellery industry.

In summary, the jewellery industry is facing macro and micro environmental challenges and corporations are required to be innovative to sustain businesses.

3. Corporate Governance, Internal Control and Risk Management

Corporate governance creates a solid organization structure that clarifies roles, reporting lines and delegation of responsibilities (Sarbah and Xiao, 2015). Good corporate governance generates goodwill and confidence from investors. The Corporate Governance by Luk Fook emphasizes on integrity, transparency, accountability, and independence, as well as safeguarding the shareholder's value and interest.

Table 1 shows the Return on Assets and Return on Equity for Luk Fook. Birken (2021) stated that an ROA of over 5% indicates a good ratio. Although the ROA of Luk Fook dropped to 6-7% in 2019 and 2020 (Luk Fook, 2020; Luk Fook, 2021), it remained as a good ROA level indicating the Group makes good use of its assets to generate income. The ROE level is best to compare with other companies in the same industry and detailed analysis will be shown in Section 4.4.

Table 1. ROA and ROE of Luk Fook from 2018 to 2020

	2020	2019	2018
Return on Assets (ROA after tax)	7%	6%	10%
Return on Equity (ROE after tax)	9%	8%	14%

Source: Compiled by the author

3.1 Corporate Structure

The Group is led by a Chairman who oversees the Board of Directors in setting strategic directions and risk management. The management team and the four distinctive committees governing risk management, audit, remuneration, and nomination, are supervised under the Board of Directors.

The Group has applied the principles and complied with all code provisions by the Corporate Governance Code and Corporate Governance Report. However, there is one exception to the compliance to the code provision A.2.1 (Hong Kong Exchanges and Clearing Limited, 2011), that is the group shares the same Chairman and Chief Executive Officer, Mr. WONG Wai Sheung. The Group explained that in view of the increasing trend of business deriving from the Mainland market, it is believed that Mr. WONG Wai Sheung being the Chairman and the CEO of the Company will further enhance the business development of the Group in the Mainland market due to its norms on “status parity” when future business negotiations are conducted in Mainland. On this subject, there has been debate on whether separation of the Chairman and CEO should be adopted by listed companies. Some believes that the separation increases the board’s independence from the management leading to better monitoring and oversight; other believes the ‘unity of command’ enabling clear lines of authority for effective management (Tonello, 2011). Wijethilake_and

Ekanayake (2020) stated that CEO duality exerts a negative effect on firm performance when the CEO is equipped with additional informal power. Conversely, CEO duality exhibits a positive effect on firm performance when board involvements are high. However, Duru et al. (2016) argued that CEO duality has statistically significant negative impacts as duality might reduce firm performance through managerial entrenchment, it can provide benefits to the firm in the presence of board vigilance. There are also believes that the decision by the firm to appoint their CEOs as the Chairman is determined by the firms' operating environment and that there is no evidence to suggest the CEO-chairs use their dual power to detriment of shareholders (Ghosh et al., 2015). As such, it is recommended that the Group should regularly review the dual role and have an independent review on this for the benefit of the Group.

3.2 Committee Structure

With reference to the Financial Report (Luk Fook, 2021), there were regular meetings for the Board of Directors and Committees. All Directors attended the meetings in 2020/2021 Financial Year. In addition, there was also ongoing development for the Directors with specific training on regulatory development, director's profession or duties or other relevant topics. Four separate committees work together and report to the Board of Directors.

The Remuneration Committee is responsible for making recommendations to the Board on the Company's policy, structure, and packages for all remuneration of directors, senior management and staff. The salary adjustment and discretionary bonus are usually recommended by the committee; The Audit Committee was

responsible for reviewing the Group's interim and annual financial statement, reviewing the internal audit programme, financial control, internal control and risk management system, as well as the Company's policies and practices. The Group recognizes the importance of external auditors as a separate role of the management, who would select appropriate external auditors for auditing and attesting to the Group's Financial statement, and the Audit committee would be overseeing the whole process. There are regular audits that cover a wide range of aspects including the adequacy of resources, staff qualifications and experience, training programmes or accounting.

A Nomination Committee was established to make recommendation to the Board on the structure, size and composition of the Board, and to review the retirement and rotation plan of the directors. There is a Nomination Policy for appointing or reappointing the directors of the Company and to assess the candidates based on several selection criteria set by the policy. This can ensure the quality of Board of Directors entering to the Board level. There was a clear election record indicating the responsibility and delegation of the Board of Directors and there was no financial, business, family or other connected relationship between members of the Board, this is an important highlight to show the independence of the role for each Board member. The Group recognizes the necessity of diversity at the Board level thus a report of demographics of the Board member is listed in the Annual Report (Luk Fook, 2021). The Board is composed of members with different professionals, including financial or other industries, public service, government bodies or charities. However, it is recommended that the Board should have a Board Diversity Policy ensuring the diversity of the Board is met and be consistent over the years (HKEX,

2020).

The Risk Management Committee plays a key role in reviewing the Company's compliance to rules and working with the management team to risk assess new projects. The Risk Management is systemic and disciplined with a clear framework in place. There is a clear policy for the disclosure of inside information with close regard to the Guidelines on Disclosure of Inside Information issued by the Securities and futures Commissions. In terms of shareholder's rights, there are numbers of procedures for shareholders to convene a Special General Meeting and putting forward proposals at a general meeting. The Board maintain ongoing communications with shareholders to provide transparency and engagement. The shareholders are allowed to require Board's attention by writing or can make proposals at the annual AGM. Finally, a dividend policy is in place and having considered certain criteria, the Group sets to distribute 40-45% of its annual net profits as dividends to shareholders,

In summary, the Corporate Governance Structure is solid and compliant to the best practice. Although they chose to have a dual role of the CEO and the Chairman, literature reviews show both pros and cons of the dual role and there is no evidence to show that the dual role will be detrimental to the overall governance of the corporation. However, the Board should review the dual role regularly and independently assess the performance for the benefit of shareholders. It is also recommended that the Group should develop a Board Diversity Policy to ensure the diversity is maintained within the Board level.

4. Financial analysis

A three-year financial analysis for Luk Fook is carried out and compared with two other local jewellery brands, Chow Sang Sang Holdings International Limited ('CSS') and Tse Sui Luen Jewellery (International) Limited ('TSL'). A simple comparison of the background of three companies are shown in Table 2. It is shown that Luk Fook is the newest company of all, and it only entered to the stock market in 1997. It has the most store distribution and is heavily invested in the Mainland market. The total sales and gross profit in 2020/21 Financial year were the middle amongst the three. A more detailed financial comparison will be carried out later in this section.

Table 2. Comparison of company profile

	Luk fook	CSS	TSL
Founding year	1991	1983	1960
Year entered to stock market	1997	1973	1987
Financial year	1 st Apr- 31 st Mar	1 st Jan-31 st Dec	1 st Apr- 31 st Mar
Stock Code	0590	0116	0417
Stock Value¹	17.51	9.19	1.36
Total Stores:	2,284	748	Over 480
- HK	- 47	- 65	
- Mainland	- 2,212	- 653	
- Macau	- 13	- 4	
- Others	- 12	- 26	
Sub-brands	- Goldstyles - Dear Q - 3D GOLD	- Promessa - Oasis - Emphasis - Marco Bicego - Mintygreen	N/A
Total sales in 2021 (HK\$M)	\$8,861	\$15,032	\$2,391
Gross Profit in 2020 (HK\$M)	\$2,632	\$4,154	\$1,148

Note 1: for the period of 2020/21 Financial Year, monthly averaged of the adjusted close value (Appendix 1)

Source: Compiled by the author

4.1 Income Statement Analysis

Hong Kong's economy was negatively impacted by a series of events such as social unrest and Covid-19 pandemic since 2019. These events have severely impacted the number of tourists in Hong Kong as described in section 2. Table 3 highlights the income statement analysis for the three companies in the past 3 fiscal years. All three companies' revenue and profit decreased since 2018 (Luk Fook, 2019,2020,2021; Chow Sang Sang, 2019,2020,2021; Tze Sui Lun 2019,2020,2021) and TSL even resulted in profit loss since 2019. In terms of percentage of revenue loss, Luk Fook has a total revenue loss of 44% since 2018/19, whereas CSS and TSL have 20% and 35% decreased since 2018 respectively. However, in comparison to the total profit loss, Luk Fook has 32% decreased in profit while CSS and TSL have 46% and 181% loss respectively as compared to 2018. This reflected that Luk Fook has a successful overall financial crisis management and measures were in place to retain profit during the financial crisis.

Table 3. Income statement comparison

	Luk Fook (LF) HK\$'000				Chow Sang Sang (CSS) HK\$'000				Tze Shui Lun (TSL) HK\$'000			
	2020/21	2019/20	2018/19	Average	2020	2019	2018	Average	2020/21	2019/20	2018/19	Average
Revenue	8,861,335	11,233,771	15,859,990	11,985,032	15,032,420	17,736,226	18,806,342	17,191,663	2,648,600	2,913,827	4,064,920	5,562,427
Cost of Sales	(6,229,020)	(7,910,751)	(11,826,154)	(8,655,308)	(10,877,614)	(12,958,750)	(14,175,208)	(12,670,524)	(1,688,883)	(1,765,431)	(2,445,558)	(3,454,314)
Gross Profit	2,632,315	3,323,020	4,033,836	3,329,724	4,154,806	4,777,476	4,631,134	4,521,139	959,717	1,148,396	1,619,362	2,108,113
Profit before income tax	1,255,437	1,091,061	1,806,363	1,384,287	920,920	883,291	1,322,651	1,042,287	(1,011)	(60,028)	99,442	(61,039)
Income tax expenses	(236,303)	(223,409)	(302,708)	(254,140)	(376,456)	(239,758)	(310,394)	(308,869)	(43,078)	(29,726)	(45,275)	(72,804)
Profit of the year	1,019,134	867,652	1,503,655	1,130,147	544,464	643,533	1,012,257	733,418	(44,089)	(89,754)	54,167	(133,843)

Sources: Compiled by the author

4.2 Bankruptcy Index (Altman Z-Score)

In order to review the overall performance of a company, an Altman Z-Score could be used. It was first set up in 1968 by Professor Edward Altman to depict the likelihood of bankruptcy of a company (Hayes et al., 2010). A Z-Score lower than 1.81 indicates a strong likelihood of bankruptcy whereas a score of greater than 2.99 indicates a less likelihood. The Z-score is calculated based on the financial indicators in Table 4.

Table 4. Financial indicators for the bankruptcy ratio

	Luk Fook (LF)				Chow Sang Sang (CSS)				Tze Shui Lun (TSL)			
	HK\$'000				HK\$'000				HK\$'000			
	2021/20	2020/19	2019/18	Average	2020	2019	2018	Average	2021/20	2020/19	2019/18	Average
Net Current Assets	8,785,954	8,007,643	8,684,355	8,492,651	9,276,077	8,197,939	8,651,062	8,708,359	1,116,326	1,078,473	826,970	1,007,256
Total Assets	14,512,039	13,925,048	14,423,572	14,286,886	16,826,467	16,236,438	13,838,036	15,633,647	2,531,020	2,708,915	2,457,147	2,565,694
Retained earnings	8,771,915	7,818,955	7,964,520	8,185,130	11,849,755	10,463,026	10,249,578	10,854,120	879,911	837,918	1,023,611	913,813
EBIT	1,226,588	1,027,986	1,840,616	1,365,063	1,008,784	972,453	1,359,642	1,113,626	49,411	3,320	149,802	67,511
Stock ¹ value (HKD)	18	20	24	21	8	10	13	11	1	1	2	1
Number of stock	587,107	587,107	587,107	587,107	169,359	169,359	169,359	169,359	249,182	249,182	248,552	248,972
Total Liabilities	3,187,815	3,512,937	3,860,656	3,520,469	4,807,353	5,604,053	3,419,099	4,610,168	1,589,064	1,808,828	1,371,437	1,589,776
Sales	8,861,335	11,233,771	15,859,990	11,985,032	15,032,420	17,736,226	18,806,342	17,191,663	2,648,600	2,913,827	4,064,920	3,209,116

Note 1: for the period of 2019/2020 Financial Year, monthly averaged of the adjusted close value (Appendix 1)

Sources: Compiled by the author

Using the above figures, a Z Score can be derived through a formula:

Z score = $1.2A + 1.4B + 3.3C + 0.6D + 0.999E$, where A = working capital/ total assets;

B= retained earnings/total assets; C=EBIT/total assets; D= (stock value x total

number of stock)/ total liabilities; and E= Sales/ total assets (Hayes et al., 2010).

Table 5. Z Score and indicators

	LF				CSS)				TSL			
	HK\$'000				HK\$'000				HK\$'000			
	2021/20	2020/19	2019/18	Average	2020	2019	2018	Average	2021/20	2020/19	2019/18	Average
A	0.61	0.58	0.60	0.59	0.55	0.50	0.63	0.56	0.44	0.40	0.34	0.39
B	0.60	0.56	0.55	0.57	0.70	0.64	0.74	0.70	0.35	0.31	0.42	0.36
C	0.08	0.07	0.13	0.10	0.06	0.06	0.10	0.07	0.02	0.00	0.06	0.03
D	3.23	3.38	3.69	3.43	0.29	0.30	0.67	0.42	0.14	0.19	0.34	0.22
E	0.61	0.81	1.10	0.84	0.89	1.09	1.36	1.11	1.05	1.08	1.65	1.26
Z-Score	4.40	4.55	5.23	4.73	2.91	2.98	3.87	3.25	2.21	2.10	3.05	2.45

Source: Compiled by the author

Table 5 shows the Z-score of Luk Fook in the past 3 fiscal years as compared to the other two competitors. Luk Fook's average Z-score (4.73) is the highest amongst the three whereas Tze Shui Lun has the lowest (2.45). All three companies have an average Z-Score above 1.81 indicating that are not likely to bankrupt. Both Luk Fook and CSS have the Z-score above 2.99, showing that have even less likelihood of bankruptcy.

4.3 Paying Debt Ability

Table 6 shows a comparison of the paying debt ability of Luk Fook and the other two competitors. The current ratio measures a company's ability to pay short-term obligations or those due within one year. Taking the average from the past three years, Luk Fook has the highest current ratio, indicating that it has the highest ability to pay debts. The quick ratio measures the capacity to pay its current liabilities without needing to sell its inventory or obtain additional financing. Luk Fook's quick ratio appears to be in a decent position to cover its current liabilities.

Table 6. Analysis of the paying debt abilities

	Luk Fook				CSS				TSL			
	2020/21	2019/20	2018/19	Average	2020	2019	2018	Average	2020/21	2019/20	2018/19	Average
Current Ratio	3.98	3.61	3.34	3.64	3.54	2.97	3.97	3.49	2.01	1.95	1.61	1.86
Quick Ratio	1.50	1.15	0.83	1.16	1.14	0.82	1.41	1.12	0.90	0.67	0.55	0.71
Cash Ratio	1.20	0.88	0.56	0.88	0.45	0.11	0.45	0.34	0.34	0.30	0.19	0.28
Total Debt Ratio	0.22	0.25	0.27	0.25	0.29	0.35	0.25	0.29	0.63	0.67	0.56	0.62
Debt/Equity Ratio	0.03	0.34	0.37	0.24	0.40	0.53	0.33	0.42	1.69	2.01	1.26	1.65
Long Term Debt Ratio *	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.46	0.63	0.00	0.36
Equity Multiplier (EM)	0.14	1.34	1.37	0.95	1.40	1.53	1.33	1.42	2.69	3.01	2.26	2.65
Time Interest Earned	42.52	16.30	53.74	37.52	11.48	10.91	36.76	19.71	0.98	0.05	2.97	1.34

Note *: Long term debt with interest bearing

Source: compiled by the author

The average cash ratio for the three companies are all below 1 in the past three fiscal years, indicating that their abilities to cover its short-term obligations using only cash and cash equivalents is low. However, all three companies have shown increased in cash ratio in the most recent financial year. This may be a result of decreased liabilities or increased in cash flow reserve as a responsive measure to the economic decline. With regards to the total debt ratio, all three companies remain a ratio below one and TSL has the highest total debt ratio of all, meaning that it has a higher degree to use its debt to finance its assets. Luk Fook has the lowest average total debt ratio, indicating that only 25% of its assets is financed by the creditors. The debt-to-equity ratio of TSL remains above one in the past three years and Luk Fook as the lowest ratio of all. This reflects TSL has a higher use leverage to its shareholders, posing a greater risk. CSS remains in the middle for many of the ratio and it has an equity multiplier of 1.4. This indicates that it has a higher level of debts, than Luk Fook but it is lower than TSL. With regards to the Time Interest

Earned (TIE), Luk Fook has an outstanding ratio of 37.52 in average, representing it has a high ability to pay off its debts as well as having remains to invest in the business. It has high profit before income tax as compared to the finance cost. In summary, Luk Fook's paying debt ability is the highest amongst the three and it remains abundant in cashflow to manage its liability.

4.4 Profitability Assessment

As according to Table 3, the average total revenue of CSS (\$17,192 million) in the past three fiscal years was the highest amongst the three companies. However, Luk Fook resulted in the highest in the profit of the year, having \$1,130 million in average. Table 7 highlights the ratio of the profitability, it shows that the average gross profit margin of Luk Fook and CSS are both 26%, whereas Luk Fook has a net profit margin on 10%. This has resulted in a higher overall net profit of Luk Fook. TSL, on the other hand, has a highest gross profit margin (38%) but a lowest Net Profit Margin (2%). This has affected its overall performance and indicating that the Group needs to review on its operating cost to increase the net profit. The return on assets and equity of Luk Fook are both the highest amongst the three. This highlights that Luk Fook better utilizes its assets in terms of profitability and it has a higher profitability in relation to shareholder's equity. In summary, the profitability of Luk Fook is satisfactory within the industry.

Table 7. Comparison of the profitability ratio

	Luk Fook				CSS				TSL			
	2020/21	2019/20	2018/19	Average	2020	2019	2018	Average	2020/21	2019/20	2018/19	Average
Gross Profit Margin	28%	27%	25%	26%	28%	27%	25%	26%	36%	39%	40%	38%
Net Profit Margin	12%	8%	9%	10%	4%	4%	5%	4%	2%	0%	4%	2%
Return on Assets (ROA after tax)	7%	6%	10%	8%	3%	4%	7%	5%	-2%	-3%	2%	-1%
Return on Equity (ROE after tax)	9%	8%	14%	11%	5%	6%	10%	7%	5%	10%	-5%	3%

Source: compiled by the author

4.5 Operational Assessment

Table 8 shows the operational performances of all three companies. As described earlier, the overall economy in Hong Kong was impacted since 2019 due to various factors. This has resulted in the overall decline in the inventory turnover across the industry. Another reason contributing to the slow inventory turnover was also because of the increased in gold and platinum price overall that will delay the buying from customer (Luk Fook, 2021). The average inventory turnover for Luk Fook was the slowest amongst the three and it has the highest number of days' sales in inventory. The Group needs to reduce the inventory turnover by introducing more sales activities through the retail or e-commerce channels.

Luk Fook has a high receivable turnover of 41.42 in average with an average collection period of 9.1 days. Although it is shown to be rather effective amongst the three companies, Luk Fook data showed that the average collection period (days) was longer in the recent financial year. This needs to be reviewed by the group and to evaluate the reason of delay.

Table 8. Operational ratio analysis

	Luk Fook				CSS				TSL			
	2020/21	2019/20	2018/19	Average	2020	2019	2018	Average	2020/21	2019/20	2018/19	Average
Inventory Turnover (Times)	0.85	1.05	1.27	1.06	1.24	1.45	1.90	1.53	1.38	1.21	1.70	1.43
Days' Sales in Inventory (Days)	429.02	347.58	287.70	354.77	294.43	251.60	191.87	245.96	264.57	300.56	214.36	259.83
Receivables Turnover (Times)	31.95	48.57	43.73	41.42	22.82	30.31	18.47	23.87	22.81	37.46	27.44	29.24
Average Collection Period (Days)	11.42	7.52	8.35	9.10	15.99	12.04	19.76	15.93	16.00	9.74	13.30	13.01
Creditors' ratio/Period of credit received from trade creditors (Days)	59.90	32.66	30.12	40.89	21.83	18.56	16.43	18.94	33.58	50.80	33.51	39.29
Operating Period (days)	440.45	355.09	296.04	363.86	310.43	263.64	211.63	261.90	280.57	310.30	227.66	272.85
Cash Period (days)	380.55	322.43	265.93	322.97	288.59	245.08	195.20	242.96	247.00	259.50	194.15	233.55

Source: compiled by the author

4.6 Stock Market Assessment

All three companies have shown decreased in market capitalization and PE ratio in the last three years although Luk Fook remains the highest in both as compared to the other two companies. CSS's PE ratio remains stable and less fluctuated in the past three years despite the economical downturn. This may be a benefit to the investors for long term investment.

Table 9. Stock market assessment

	Luk Fook				CSS				TSL			
	2020/21	2019/20	2018/19	Average	2020	2019	2018	Average	2020/21	2019/20	2018/19	Average
Market Capitalization	10,282,005	11,859,561	14,249,087	12,130,218	1,390,437	1,664,799	2,279,572	1,778,270	216,788	339,793	469,544	342,042
PE Ratio	10.09	13.67	9.48	11	2.55	2.59	2.25	2	(4.92)	(3.79)	8.67	(0.01)
Market to book ratio	0.10	1.14	1.35	1	0.12	0.16	0.22	0	0.23	0.38	0.43	0.35

Source: compiled by the author

The book-to-market ratio determines the market value of a company relative to its actual worth. Kenton (2019) stated that if the ratio is above 1, the stock is undervalued, whereas if it is less than 1, the stock is considered overvalued. A high ratio is preferred by value managers who interpret it to mean that the company is a value stock. With

reference to Table 9, Luk Fook has an average of 1 in the market to book ratio meaning that from the investor point of view it is attractive to invest as compared to the other two companies.

5. Investment Project Appraisals

In the 2020/2021 Financial Report, the Group stated the target of additional 300 or more Luk Fook Licensed Shops in Mainland in the upcoming year. A licensed shop is different from a self-operated shop, where by definition means 'any business, organization, or individual that has been granted legal permission by another entity to engage in an activity' (Segal, 2019). Luk Fook mainly operates in China based on licensed shop as it fits into their urbanization strategies by having more departmental stores or shopping malls in rural cities. An appraisal exercise is going to be done in this section, highlighting various financial indicators to evaluate the feasibility of the project.

5.1 Cost and Profit Estimation

Table 9 predicts the cost of the project based on the recent financial report and some assumptions. It is estimated that the total estimated cost to open 300 stores in China is \$251 million.

Table 10. Cost estimation for the project

Project: To open 300 Luk Fook Licensed Shop in Mainland			
Items	HK\$'000	Justification	Source
Cost of Sales	6,229,020		Annual Report, 2021 (Pg. 173)
Finance Costs	28,849		Annual Report, 2021 (Pg. 173)
Total Estimated Cost	6,257,869		
Percentage of Total Estimated Cost to Total Revenue	71%	Total Revenue: \$8861335	
Total revenue from retail and licensing in China	2,608,000		Annual Report, 2021 (Pg. 21)
Total estimated cost in China	1,851,680	71% of the total China revenue and licensing in China	
Total estimated cost per shop (Mainland) ¹	837		
Total estimated cost for the project	251,132	300 stores in total	

Note 1: Total 2,212 stores in Mainland

Source: compiled by the author

The sales projection is based on the current straight-line depreciation rate in 5 years. Since the Group has not had positive sales growth rate in recent years, a reference of 8.2% has been taken for prediction (Zheng, 2021).

Table 11. Basic information for sales projection

Items		Source
Depreciation (HK\$'000)	92,596	Annual Report 2021 (Pg. 253)
Depreciation for furniture, fixtures, computer equipment, plant and machinery	5 years	Annual Report 2021 (Pg. 192)
Sales growth rate (%)	8.2%	Zheng (2021)
EBITDA (%)	15%	
Operating period (days)	417.6	
Tax rate	25.0%	PWC (2019)

Source: compiled by the author

Table 12. Sales and revenue projection

Item	HK\$'000	Justification	Source
Total Group Revenue	8,861,335		Annual Report 2021 (Pg. 173)
Total revenue from retail and licensing in China	2,608,000	60% of total Group Revenue	Annual Report 2021 (Pg. 21)
Revenue per shop in Mainland	1,179	2,121 stores	
Predicted sales in new project	353,707	300 stores	
Profit of the year	1,019,134	12% of total revenue	Annual Report 2021 (Pg. 173)
Predicted profit in China	312,960	As above, profit of the year is 12% of total revenue, thus predicted as 12% of total Mainland revenue	
Net increase in cash and cash equivalent	701,482	8% of Total group revenue	Annual Report 2021 (Pg. 179)
Predicted cashflow in China	208,640	As above, net cashflow is 8% of total group revenue, thus predicted as 8% of the China Revenue	

Source: compiled by the author

Table 13. Computing profit

	Year #				
	1	2	3	4	5
Sales ¹ (HK\$'000)	382,711	414,093	448,049	484,789	524,542
EBITDA (HK\$'000)	57,407	62,114	67,207	72,718	78,681
Depreciation (HK\$'000)	18,519	18,519	18,519	18,519	18,519
EBIT (HK\$'000)	38,887	43,595	48,688	54,199	60,162
Tax cost ² (HK\$'000)	9,722	10,899	12,172	13,550	15,041
Profit (HK\$'000)	29,166	32,696	36,516	40,649	45,122

Note 1: Last year sales from Mainland X (1+growth rate)

Note #: Extended calculation to 20 years is shown in Appendix 2

Note 2: Tax rate as 25%

Source: compiled by the author

The estimated profit for the first-year accounts for 9.32% of the actual Group's net profit in 2020/21. Due to COVID-19, the number of inventory turnover days was 429 days in 2020/21 financial year, this has affected the calculation of the expenditure

based on the inventory turnover days. In addition, there is insufficient China data to support for the project forecast. With reference to the positive net cash flow for the Group, the prediction for the first year cashflow is therefore predicted as 9.32% of the actual Group's net cashflow from China, which is \$19 million.

Table 14. Cashflow calculation

Cashflow calculation	Year [#]				
Items	1	2	3	4	5
EBITDA (HK\$'000)	57,407	62,114	67,207	72,718	78,681
Expenditure ¹ (HK\$'000)	28,241	30,557	33,062	35,774	38,707
Tax expense (HK\$'000)	9,722	10,899	12,172	13,550	15,041
Cashflow (HK\$'000)	19,444	20,658	21,973	23,395	24,934

Note 1: Estimated based on the cashflow projection with growth rate as 8.2%.

Note #: Extended calculation to 20 years is shown in Appendix 2

Source: compiled by the author

5.2 The NPV, IRR and ARR

The Net Present Value (NPV) for the project is presented in Table 14. Since the initial set up cost is high, the project is reassessed and extended to 20 years to look at the NPV. The Interest rate used in the NPV calculation is 7% which is the ROA of the Group in 2020/21 Financial Year. The NPV derived from Table 14 is \$106 million. A positive NPV indicates that the discounted present value of all future cash flows related to the project is positive, in other words, attractive to invest (Fernando, 2021). Therefore, this project to open 300 stores in China is positive to move forward. The Internal Rate of Return (IRR) of this project is 10.88%, meaning that the discount rate that sets NPV to zero is 10.88%. The account rate of return (ARR) of this project is 34.58%, with an expected payback period of 9.66 years or 9 years and 8 months.

Table 14. NPV, ARR, IRR

	HK\$'000			HK\$'000	
Year	Cashflow	Cumulative Net Cashflow	Year	Cashflow	Cumulative Net Cashflow
0	(251,132)	(251,132)			
1st year	19,444	(231,688)	11th year	37,209	49,027
2nd year	20,658	(211,030)	12th year	39,881	88,908
3rd year	21,973	(189,057)	13th year	42,771	131,679
4th year	23,395	(165,662)	14th year	45,899	177,578
5th year	24,934	(140,728)	15th year	49,283	226,861
6th year	26,599	(114,130)	16th year	52,944	279,805
7th year	28,400	(85,730)	17th year	56,906	336,712
8th year	30,349	(55,380)	18th year	61,193	397,904
9th year	32,458	(22,922)	19th year	65,831	463,736
10th year	34,740	11,818	20th year	70,850	534,585
NPV	106,396				
IRR	10.88%				
ARR	34.58%				

Source: compiled by the author

6. Fund-raising Management

Luk Fook's capital management objectives are to safeguard the ability to provide returns for shareholders, benefits for other stakeholders, and to maintain an optimal capital structure to reduce the cost of capital (Luk Fook, 2021). In terms of raising funds for new projects, the Group has options to do this via the retained earnings, issue of new shares or obtain new bank borrowings.

Luk Fook has abundant retained earnings and cashflow. As according to the Group's Annual Report 2020/21, the net cash was \$3,546 million. This includes the bank borrowing of \$526 million and \$1,983 million of gold loans. If the Group was to invest on a project costing 3% of total assets (\$14,512 million) this would cost \$435 million, which is enough for the group to cover from its net cashflow. However, the

disadvantage of that would be the reserves will be reduced by 12%. Given the economy is still being unstable by the Covid-19 pandemic, with the boarder remains closed for travelers, the Group is best to retain the cashflow for financial risk management.

Another way is to issue new shares, there are a total of 800 million of authorized shares of Luk Fook and only 587 million have been issued (Luk Fook, 2021). This shows that the Group has capacity to issue more new shares to attract investors. This is an effective way to raise funds, but the Group will also have to share the profits with the investors should there be any. The Group's Dividend Policy sets out that the Group intends to distribute 40% to 45% of its annual net profits as dividends to shareholders, although it is set with terms and conditions applied, this will overall reduce total amount of profit to the Group.

Alternatively, the Group may consider borrowing money from bank for further investment. With reference to the Annual Report 2020/21, the interest rates of the bank borrowing ranged from 0.73%– 0.75% per annum, this is lower than the rate (2.37%- 2.89%) as compared to 2020. With the lower interest rate, it is reasonable for the Group to borrow money for a one-off investment. The only concern would be the Group will increase the liabilities and the overall investment cost is increased. However, given that the interest rate is low and the Group has great paying debt ability, it is the most suitable fund-raising method under this economy and overall situation for the Group.

7. Audit planning

With reference to the financial analysis in section 4. A few areas of improvements can be identified for Luk Fook, and the following audit plan is recommended to the Group.

First quarter- Direct Cost Management

As the Gross Profit Margin of the Group was low (Table 7), the Group needs to review the overall cost of sales to see if they can increase the Gross Profit Margin. It is recommended that the staff cost, and the overall cost of the licensing business should be reviewed in the first quarter.

Second quarter- Inventory and supply chain management

As the number of Days' Sales in Inventory reached over 400 days due to the pandemic, the Group must review the channels of sales and to promote faster turnover of goods. There is also a need to review the supply chain management and to have a market research on the consumer behavior. Shortening the inventory days will increase the overall revenue and with the additional cost control, these will benefit the overall profit for the Group.

Third quarter- Credit and debt collection

An audit for creditors and the debt collection period from suppliers should be carried out for tighter cashflow control. A performance evaluation for the suppliers can be done which includes the purchasing process, delivery of supplies, payment due date, etc.

Forth quarter- Corporate governance structure

A review of the corporate governance structure in particular of the dual role of the Chairman and the CEO needs to be reviewed by the Nomination Committee.

8. Conclusion

The overall background and performance of Luk Fook can be concluded as outstanding within the industries. Its investment on Mainland market and control on profit margin has shown positive outcomes in terms on the overall profit of the Group. It has a bigger vision on expanding further in the Mainland market, although the investment project appraisals were calculated based on the estimated figures, the Group has abundant net cash flow and low interest loan opportunities to raise funds for future investment projects. In terms of future planning, the Group needs to review further on its cost, debt collection period and find innovative solutions to reduce the days sales in inventory to increase the revenue and profit.

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Appendix 1
Stock Value of Luk Fook (2018-2021)

Date	Open	High	Low	Close	Adj Close	Volume
01/04/2018	28.5	34	27.6	33.0	28.6	28780232
01/05/2018	32.95	36.15	32	35.8	31.0	16238385
01/06/2018	35.75	37.75	29.2	32.5	28.2	21826031
01/07/2018	32.45	33	26.8	27.9	24.2	31144713
01/08/2018	28	28.85	25.8	27.3	23.7	19855857
01/09/2018	27.4	28.2	25.05	27.3	24.1	10034867
01/10/2018	27.25	27.95	23.65	25.9	22.9	14926116
01/11/2018	25.7	27.3	22.5	22.9	20.2	16452180
01/12/2018	23.1	23.95	20.9	22.4	19.8	22195220
01/01/2019	22.35	22.9	21.5	22.8	20.6	20481413
01/02/2019	23.25	26.35	22.75	26.4	23.9	12377536
01/03/2019	26.4	27.3	25.15	26.5	24.0	8243099
01/04/2019	26.6	29.65	26.4	28.1	25.5	12181443
01/05/2019	28.1	28.5	24.95	25.2	22.8	7475431
01/06/2019	25.2	25.9	23.35	24.5	22.2	7135938
01/07/2019	24.5	25.2	22.65	23.7	21.5	10616064
01/08/2019	24.55	24.55	18.58	19.6	17.8	19241296
01/09/2019	19.52	23.15	19.1	19.7	18.4	12364065
01/10/2019	19.68	21.5	19.1	20.9	19.5	12478182
01/11/2019	20.75	22.6	20.2	21.8	20.4	7600868
01/12/2019	21.7	22.7	19.94	22.5	21.0	14599309
01/01/2020	22.45	24.3	20.95	21.2	20.3	9608038
01/02/2020	20.9	21.85	18.96	19.0	18.2	9884947
01/03/2020	19	19.5	12.06	15.6	15.0	16756588
01/04/2020	15.7	17.26	14.6	16.6	15.9	12054870
01/05/2020	16.56	16.9	13.2	13.6	13.0	11595958
01/06/2020	13.62	17.18	13.42	16.8	16.1	20870207
01/07/2020	16.78	17.26	15.4	16.6	15.9	20691575
01/08/2020	16.6	18.56	16.28	17.3	16.6	12431565
01/09/2020	17.26	20.8	17.16	18.7	18.5	12175133
01/10/2020	18.74	20.5	18	18.9	18.7	9475579
01/11/2020	19	21.15	18.5	19.6	19.3	12268025
01/12/2020	19.5	19.8	18	18.6	18.3	8093281
01/01/2021	18.56	18.76	16.7	16.8	16.8	9074146

01/02/2021	16.88	22.1	16.74	19.7	19.7	15940662
01/03/2021	19.8	22.3	18.96	21.4	21.4	14188269

Average: 17.51

Appendix 2

Cashflow calculation for Investment Project Appraisal

Cashflow calculation	Year				
Items (HK\$'000)	1	2	3	4	5
EBITDA	57,407	62,114	67,207	72,718	78,681
Expenditure ¹ (predicting growth rate as sales growth rate 8.2%)	28,241	30,557	33,062	35,774	38,707
Tax expense	9,722	10,899	12,172	13,550	15,041
Cashflow	19,444	20,658	21,973	23,395	24,934

Cashflow calculation	Year				
Items (HK\$'000)	6	7	8	9	10
EBITDA	85,133	92,114	99,667	107,840	116,683
Expenditure ¹ (predicting growth rate as sales growth rate 8.2%)	41,881	45,315	49,031	53,052	57,402
Tax expense	16,653	18,399	20,287	22,330	24,541
Cashflow	26,599	28,400	30,349	32,458	34,740

Cashflow calculation	Year				
Items (HK\$'000)	11	12	13	14	15
EBITDA	126,251	136,604	147,805	159,925	173,039
Expenditure ¹ (predicting growth rate as sales growth rate 8.2%)	62,109	67,202	72,712	78,675	85,126
Tax expense	26,933	29,521	32,321	35,351	38,630
Cashflow	11	12	13	14	15

Cashflow calculation	Year				
Items (HK\$'000)	16	17	18	19	20
EBITDA	187,228	202,581	219,192	237,166	256,614
Expenditure ¹ (predicting growth rate as sales growth rate 8.2%)	92,106	99,659	107,831	116,673	126,241
Tax expense	9,722	10,899	12,172	13,550	15,041
Cashflow	19,444	20,658	21,973	23,395	24,934