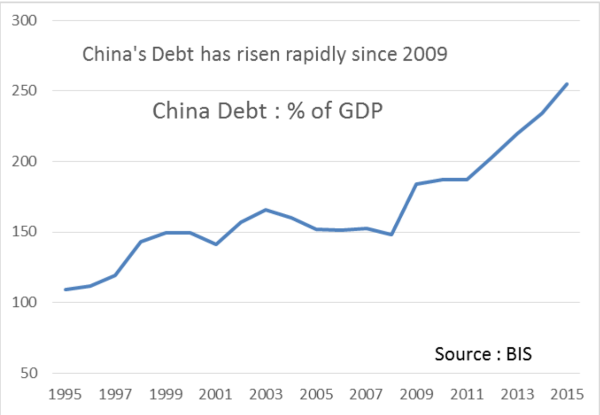
Newsletter for September 2016

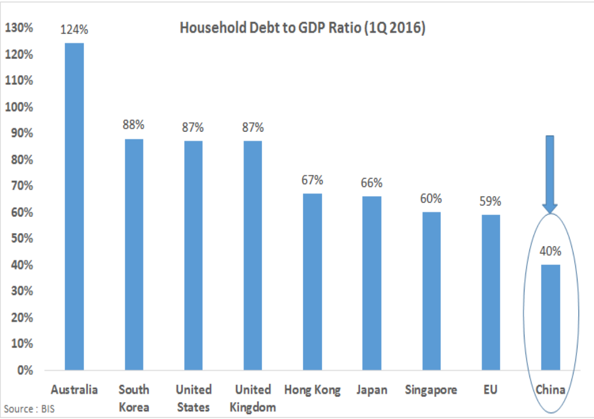
China Consumer: From Penetration to Premiumization

In our past write ups we have introduced investors to the concept that while China goes through its structural macroeconomic adjustment phase, there are newer and more exciting opportunities emerging in tertiary sectors which throw up interesting investment opportunities, we called it "The other China no one talks about".

In this piece we are looking at trends in the Consumer space where we are actively invested.

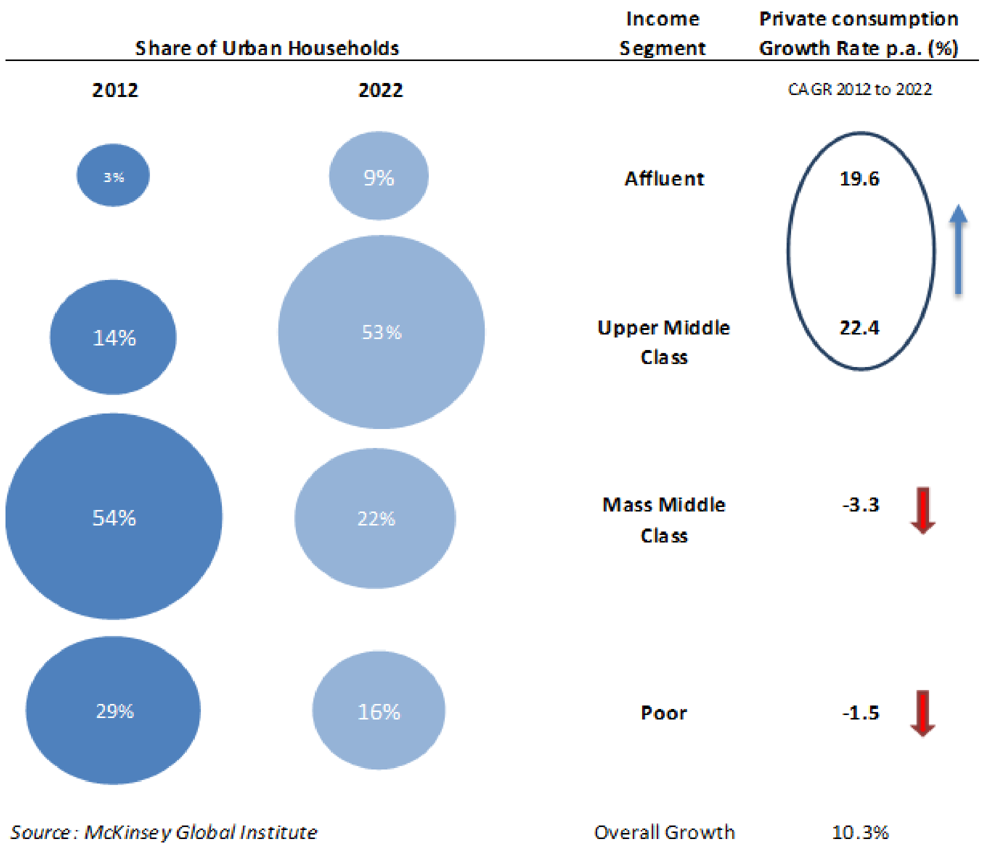
To recap, China is going through a macroeconomic adjustment phase as it transitions to a lower growth, middle income economy. This adjustment is complicated by the socio-economic structure and the past growth model which was heavily investment driven and which in the recent past depended on taking on more and more debt to produce a diminishing rate of incremental output. Consequently, we are now faced with a debt overhang which is going to weigh heavily on investment activity and future growth. On this parameter, China seems a lot like the Western world where we are seeing growth struggle due to leverage overhang, as elaborated by us in "Macro Thesis underpinning our Investment Views".



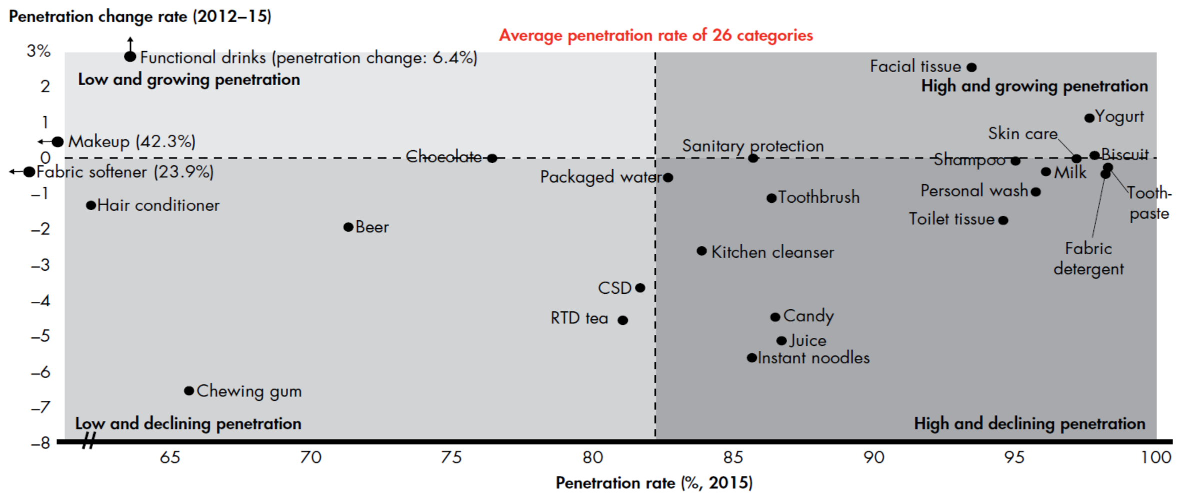


While China goes through its deleveraging cycle, there is a segment of the economy where leverage is low in absolute terms as well as relative to the world - the Chinese consumer.

In addition to being underleveraged, the profile of the Chinese consumer is changing. The chart below shows the rising proportion of upper middle class and affluent consumers in China, who are driving growth at the top end of the consumption pie at a faster pace.

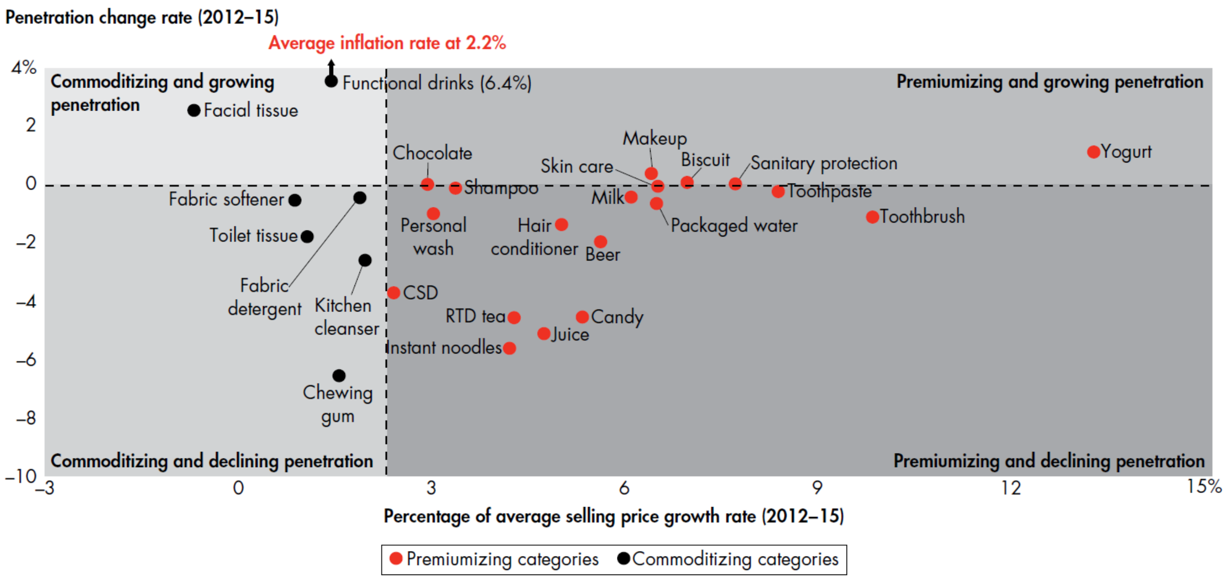


China's move from a closed economy to an open one over the last twenty years has been a story of penetration. As penetration reaches saturation levels, closer to that of developed markets, the growth story is likely to shift towards satisfying the aspirational customer who is looking to upgrade. The chart below shows how consumer categories in China are reaching saturation with plateauing penetration.



Notes: Penetration refers to total number of category buyers of total households population x100%; the penetration change is calculated by subtracting 2012 penetration rate from 2015 penetration rate
Sources: Kantar Worldpanel; Bain analysis

The chart below shows how as penetration saturates, categories which are premiumizing are seeing growth.



Notes: We used 2.2%, the geometric average inflation rate from 2012 to 2015, as the threshold; categories with price growth of more than 2.2% in 2012–15 are defined as "premiumizing" categories
Sources: Kantar Worldpanel; Bain analysis

So what we have in China now is an underlevered, aspiring consumer who is already upgrading. From experiencing new categories for the first time, thus driving penetration, the story has now shifted to the new consumer, who is ready to spend more to experience premium products and services.

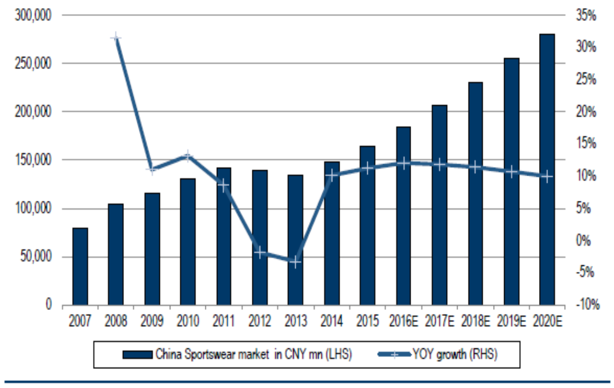
What does this mean for investors? It means that consumer companies which have a premiumization strategy or are selling to the aspiring consumer have a business model which can continue to deliver growth.

Our investment strategy in China is to look for companies that have a business strategy to target this changing trend in China, that can deliver high single digit growth and that are generating excess free cash flow which can be paid back as dividends or used to acquire complementary businesses in the home market or overseas to satisfy the needs of the new China.

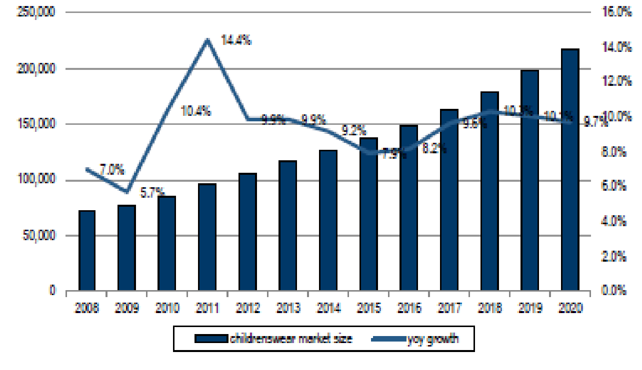
When we analyse recent trends in the consumer space, what stands out is the surprisingly poor performance shown by a lot of Staples, i.e. companies selling day-to-day categories like noodles, beverages, etc. In the first half of 2016, many of them reported double digit volume decline, unusual for an emerging market. The key reason for that is high penetration and lack of differentiation in their product strategies.

On the other hand, we have been drawn to the Sportswear & Apparel segment, where rising incomes and middle class aspiration towards a higher quality, healthier lifestyle is helping the innovative players to build strong brands and robust business models. We expect them to continue to deliver consistent growth while generating stable cashflows. These companies have good dividend yields, keep rewarding shareholders with special payouts and have the capacity to drive growth by capitalizing on both organic and inorganic opportunities.

The sportswear market is forecasted to decelerate to 8% while children's wear is forecast to continue robust growth at 10% CAGR from FY15-20.

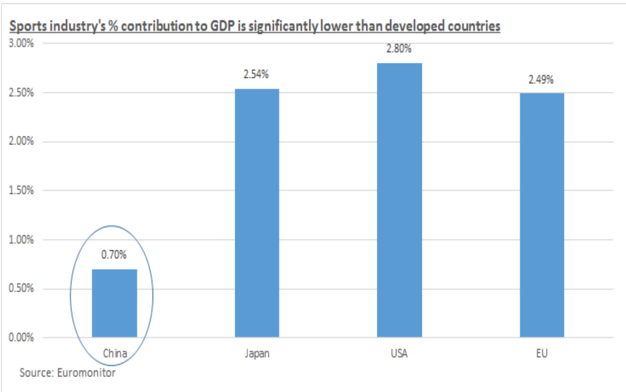


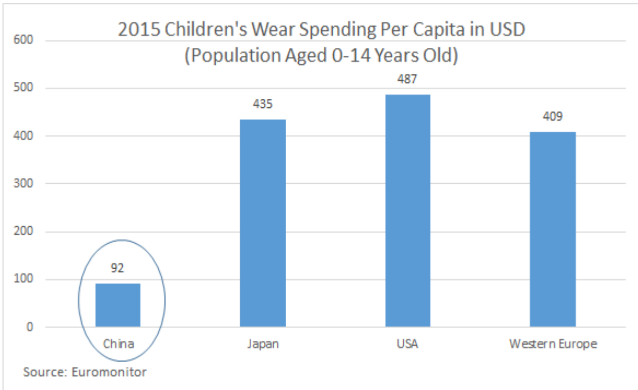
Source: Euromonitor, Credit Suisse estimates



Source: Euromonitor

Growth in sports and children's apparel is being driven by Chinese consumers catching up with the Western world in terms of lifestyle.





Government policies are encouraging these industries and organized players with strong brands reap the benefits.

Chinese government targets to grow sports industry to RMB 7tn by 2025, implying a 15% CAGR

	2015 Actual	2020 Target	2025 Target
Sports industry (value in RMB billion)	1.76	3.0	7.0
% of GDP	0.7%	1.0%	2.0%
Sports service as a % of total sports industry	20%	30%	50%
Sports participation (Estimated billions of people)	0.4	0.435	0.5
Sports area per capita (in sq m)	1.6	1.8	2.0

Source: General Administration of Sports of China, Credit Suisse

Premium branded players have gained market share in past five years

	2010	2015	% change
Nike	12.1	17.5	5.4
Adidas	9.5	16.0	6.5
Anta	8.5	9.9	1.4
Xtep	5.1	5.3	0.2
Li Ning	9.7	5.5	-4.2
361 degrees	6.0	3.9	-2.1
Peak	4.7	2.3	-2.4
Kappa	3.9	0.7	-3.2
Others	40.5	38.9	-1.6

Source: Euromonitor

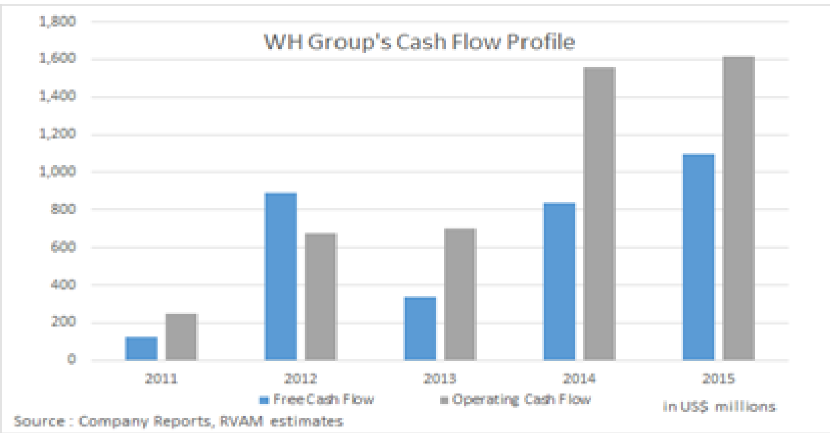
We have been highlighting an emerging theme in Asia for some time - as growth slows, capex requirements for businesses reduce and the focus shifts towards managing cashflows.

One of our strongest ideas in the consumer space in China, which nicely fits our thesis, is surprisingly in the Staples space, where a lot of companies are reporting poor numbers. This is one of the largest pork manufacturers in the world. More details in the box below:

W.H. Group (WHG, 288.HK) is the largest pork and packaged meat processing company in the world. The company has grown over time by consolidating in its home market China and becoming vertically integrated across global locations through its acquisition of Smithfield in the USA. It now controls the entire pork production and marketing chain, from rearing hogs to selling branded processed and packaged meat in the U.S. and China. It does this by having world-scale manufacturing operations, an established portfolio of brands and a large global distribution network.

The company listed in the HK Exchange in 2014 and since then has reported steady and growing revenues and profits, regardless of the vagaries of the hog market or pork price volatility, due to its integration across the total value chain. The business has low capital intensity and generates growing free cash flow which thus far has been used to reinvest in the business and to pay down debt. As a result it could be in the enviable situation of being almost debt-free about three years from now. WHG is a typical example of a company that is benefitting from the premiumization trend in a fully penetrated industry (pork), as it introduces branded packaged products from its stable in the U.S. to its customer base in China, thus opening up new growth avenues.

For a company with such attributes (now a Fortune 500 company) and an integrated model that smoothens out the volatility of the earnings and cashflows, its stock trades at extremely undemanding valuations in our view. It has been one of our strongest ideas for over a year now. We like it for the steady earnings growth and the free cash flow it will generate over the next few years. The FCF yield of 8.5% on a 1-year forward basis is particularly appealing. It would not surprise us at all if this stock were to re-rate upwards to reflect the true strength of the business, from its current year estimated Price to Earnings (P/E) ratio of 12.6x.



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