China Update

ASPOMA

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Feedback on End of November China Trip

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During our November trip to China we reserved some time to get a first-hand impression of the current developments in the wider real estate sector and the consumer and services sectors.

We met among others with KWG, a Guangzhou based listed property developer, several non-listed property developers in central China's Henan province and several building materials suppliers including Liansu, China's biggest listed piping company. In the consumer and services sectors we had discussions with Belle International, China's largest retailer of women shoes, and several private retailers and producers of cosmetics, baby nutrition/care products and healthcare related products. We also met with 51jobs, China's leading recruitment services provider, to review the company's business strategy and operations.

In short, in the real estate sector, a two-year-effort by the Chinese Government to bring the real estate market under control is eventually showing the intended impact. The coming months will no doubt be highly challenging as prices and volumes in the physical market will continue to fall; however, the current cleansing process should provide the basis for a (more) sustainable development going forward. Social housing start-ups and commercial real estate will help to ensure a single digit growth in overall construction activity. Issues at listed developers often highlight underlying strategic and operational deficiencies which come to fore in current market conditions.

We made similar observations in the consumer and services sectors: Companies with good business models, positioning and execution are well placed to continue to thrive irrespective of potentially tighter consumer budgets and more scrutinizing consumer demand. Me too players run a high risk – or already show – signs of stress.

For details please refer to the following paragraphs.

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Real estate and construction material sectors

We met with:

- KWG – a Guangzhou based listed property company which mainly targets the mid to high end client segment in prime locations of tier 1 cities (2.7x '12E P/E, 23% '11/'12 EPS growth (all consensus estimates), 3.6% dividend yield, market cap HKD 7.2bn)
- Non-listed local private property developers based in central China's Henan province focusing on the mid to low end client segments
- Liansu – China's biggest listed piping company (5.6x '12E P/E, 17% '11/'12 EPS growth (all consensus estimates), 3.6% dividend yield, market cap HKD 9.8bn).

Overall, financing conditions are extremely tight. This is reflected not only in higher down payment requirements for mortgages and higher mortgage rates but also in very tight bank lending to property developers. Overall, new loans to developers were just RMB 10bn in Q3 vs. RMB 168bn in Q1 and social housing projects got the most part of the new loans. Average cost of official bank loans (if available at all) increased from 7.4% in Q2 to 7.8% in Q3. New flow of shadow bank financing fell near to zero from RMB 1trn in the previous quarter. Reports of price cuts by developers have been picking up (MOHURD statistics suggest that the ASP is down 16% in Oct vs. Jan but still up slightly yoy). None of the developers we met expect that policymakers will lift restrictive housing policy soon (earliest in Q3 2012). Developers are very cautious in terms of land acquisitions but believe that there is definitely a limit for price declines due to concerns about a negative price spiral, negative wealth effects and a detrimental impact on local government land sales and financing.

Notably, there is a big difference in term of micro situation in tier 1 cities and Henan – Henan is a less developed central China province with a low urbanization rate of 37% vs. China's average of 50% and a higher expansion speed of major cities. Henan also benefits from the relocation of production and manufacturing facilities from costal region to central China. Besides this, the governor of Guangdong province (No1 ranked in terms of GDP in China) will become the governor of Henan province which will help to attract more multinationals to the region (already seen ZTE, Foxconn etc. announced).

Although ASP/sqm has been rising from RMB 3700 to RMB 6700 in the last 4 years, it is much lower than the ASP of RMB 25k to 45k/sqm in coastal provinces. Affordability in terms of asp/income ratio has, however, not changed that much as official statistics show a salary growth of around 20% p.a. and grey income is believed to have grown at a speed of 2-3x the official rate for professionals like doctors and teachers. Demand is still strong and developer's GP margins are still at 60-70%.

KWG Porperty

Listed companies like KWG will miss their initial sales target for 2011 by 10-15% but valuations have already corrected substantially; KWG for example is trading at a discount to NAV of 60-70% based on internal calculations which assume a 5-10% yoy ASP decline (too optimistic?).

Liansu

Building material makers like Liansu (piping) have not seen a slowdown yet. Although distributor financing conditions have worsened, margins have been stable so far due to price hikes achieved in the last quarter and lower input cost, which were neutralized by increasing financing cost.

Companies in the building materials sector pointed out that historically a slowdown in property sales had lagged effects on the supply chain as developers normally cut back on the acquisition of new land rather than halting projects under construction. This is also reflected in the recent completion data which are still trending up (housing starts have been strong in 2010 and the normal completion period is 18-24 months). With land acquisitions having dropped since the beginning of the year and property sales having started to slow since July, there is a high probability that market driven property investment will start to decline in the coming quarters. On the other hand, social housing starts have been around 3mn units in 2010 and 10mn in 2011 which means overall construction activity could still show single digit growth until 2013.

Liansu is expecting to achieve 20% growth both at the revenue and EPS level for 2012 (slightly above market consensus of 17%), given its strong market positioning and further consolidation of the sector. The stock is trading at 5.6x '12E P/E (consensus estimates).

Consumer and services sector

We met with:

- Belle International – China's largest retailer of women shoes (20.0x '12E P/E, 22% '11/'12 EPS growth (consensus estimates), 2.0% dividend yield, market cap HKD 128.4bn)
- 7 Days Group – one of the top 3 budget hotel chains in China (20.4x '12E P/E, 51% '11/'12 EPS growth (consensus estimates), 0.0% dividend yield, market cap USD 692.8mn)
- 51jobs – China's leading recruitment services provider (17.0x '12E P/E, 14% '11/'12 EPS growth (consensus estimates), 0.0% dividend yield, market cap USD 1.2bn)

Belle

In non-sports women shoes Belle expects stable 15-20% yoy growth in most sales regions. ASP has been increased by 3-5% in the last quarter in order to compensate the raising raw material and labour cost. Labour cost increases averaged 10-15% but have been compensated by productivity gains and better process and supply chain management. As a result margins have been stable. With regards to future growth Belle plans to expand in the men and kids segments as well as accessories. The company also sees plenty room to grow geographically but will focus on centrally located shopping malls. Belle feels well positioned to obtain attractive locations as the company is a good tenant for shopping mall operators. In sport shoes Belle only distributes Adidas and Nike and both brands are doing well. However, Belle did mention that domestic brands are struggling due to oversupply, lack of differentiation, fast store expansion in the past and poor supply chain management.

Currently, Belle's manufacturing facilities are all running at full capacity, however, if global and domestic sentiment worsen due to continued government tightening policy, sales growth could see a temporary slow-down as happened in 2008/2009 for one or two quarters – but should recover very quickly, as overall disposable income is still growing.

Belle is also looking to acquire Italian based manufacturing facilities – "made in Europe" is generating very high demand growth rates and higher margins. Plans to add more US/European manufactured/ originated products were also mentioned by other Chinese retailers we talked to during our trip in the areas of cosmetics, baby nutrition and baby care products and generally healthcare related products.

7 Days Group

The company targets young, low budget leisure and low budget business travellers. Its occupancy rate has been stable at around 80-85% and its new hotels opening target of 30-40% yoy growth is on track. 7 Days Group expects to benefit from lower business travel budgets and leisure related travel is generally seen as a structural growth area. The company implemented very strict cost controls – rental cost have been stable but labour cost have been increasing by 10-15% p.a. and utility cost by 5-10%. 70% of a hotel manager's compensation is directly linked to sales, earning and membership acquisition. Promotion cost to sales is stable although supply is increasing and the top 3 budget hotel chains are in door by door competition in many locations.

Overall, the budget hotel sector continues to experience high growth and, so far, there are no signs of irrational pricing behaviour of the competitors.

51 Jobs

The company reported business as usual and is seeing no indications for a slow-down. The major growth constraint is a lack of sufficiently trained sales professionals. Office worker related demand has been very stable so far and is still showing a 20%+ yoy growth. The company believes that this is due to the service sector being a structural growth area which is less impacted by the Government's tightening in the real estate and also manufacturing and export related sectors. Generally, on-line job searching and recruiting is replacing the traditional media – which is very positive in terms of operating cost, efficiency and expansion potential for the sector. The company also highlighted that HR outsourcing services are a structural growth area as most of the businesses are getting bigger and require more professionally managed HR functions.