July 18, 2011

Dear clients and colleagues,

Many of you are familiar with China's new growth model after the financial crisis: to shift the engine from export to more domestic consumption for a more sustainable growth. In the Twelfth Five-Year Plan, this long-term goal remains intact. This week we would like to introduce some new initiatives to encourage the domestic consumption and present a consumer stock recently added to our portfolio – Stella International.

Income targets

According to the Plan, China will accelerate to form an orderly pattern of wage and income distribution, promote the reasonable and rapid growth of the salaries of employees, restrain and gradually reduce unreasonable wage gap and realize no arrears of wages of employees, especially the migrant workers' wage.

In the next five years the average income per capita is expected to increase over 7% annually. This goal looks achievable if we consider the substantial room for urbanization and the fact that in the past five years annual income per capital grew over 12% annually for both urban and rural areas.

Consistent with the major theme of the Plan to promote economic equality, China also aims to raise the minimum wage standard by at least 13% on average annually. As a result the minimum wage standard in most parts of China will reach more than 40% of the average income of employees in urban areas.

In Q1 2011, 13 out of China's 34 provinces and municipalities raised the minimum wage by 22.6% on average. Currently, the city with the highest monthly minimum wage standard in China is Shenzhen at 1,320 yuan (US$200) following a 20% increase effective from April 1, 2011.

Other major targets

Several other targets in the Plan will impact the consumption. For example, annual GDP growth 7%; urbanization rate to reach 51.5%; job creation 45 million; inflation at or below 4% per year; 36 million units of low-income housing; 357 million people covered by urban pension and all rural residents covered by rural pension; and 70% of medical bills covered by national health insurance.

Individual tax reform

On June 30, 2011, China announced tax reforms to be effective in September 2011. The new rules will raise minimum income tax threshold and simplify tax code in order to increase the purchasing power of consumers, lessen inflationary burden of lower income earners, and boost domestic consumption over the long term. Key impacts are as follows.

1) Minimum tax threshold for individual's monthly wage will increase to 3,500 yuan from the current 2,000 yuan. Income tax brackets will be reduced to seven from current nine.

2) Individuals with average monthly income less than 12,500 yuan will enjoy about 4-6% in tax savings.
3) Individual Industrial and Commercial Households will enjoy about 7-10% in tax savings.
4) Under the new tax policy, an estimated 7.7% of total population would be required to file tax versus 28% previously (or 24 million tax filers, down from 84 million).

Import Tariffs Cut Expected

According to China Daily (June 20, 2011), the English-language newspaper regarded as the advocate for the government, China will soon slash import duties on high-end consumer goods. Current duties are very hefty. Prices of 20 luxury brands of watches, suitcases, clothes, liquor and consumer electronics in China are 45% higher than those in Hong Kong, 51% higher than in US, and 72% higher than in France. With the new taxes, duties on imported cosmetics, milk powder, watches, clothes, suitcases and shoes are expected to be reduced or even scrapped entirely.

New Chinese consumer stocks in the portfolio

From 2005 to 2010, China's retail sales grew at a CAGR of 18%. We are very bullish on China's consumption uptrend and added three Chinese stocks in our portfolio last month. Stella International is a manufacturer of high-end footwear (see details below). Simcere Pharma Group is a Chinese manufacturer and supplier of branded generic pharmaceuticals. Dah Chong Hong is a conglomerate specialized in motor vehicle distribution and dealership business in mainland China.

Stella International (1836 HK – HK$20.05)
www.stella.com.hk

Business Overview
Stella International is a leading OEM for the top global shoe brands. Revenue in 2010 reached US$1.3B and its annual manufacturing capacity is about 50 million pairs. North America and Europe are Stella's two largest markets, accounting for 55% and 28% of revenue respectively. China is catching up, currently at 8%.

Stella's client base includes six of the world's top ten casual footwear companies, namely, Clarks, Deckers, ECCO, Rockport, Timberland and Wolverine, as well as leading companies in fashion footwear, such as Cole Haan, Kenneth Cole, Guess and Nine West. The Company also designs, develops and manufactures footwear for several high-fashion brands such as Celine, Donna Karan New York, Emilio Pucci, Givenchy, Loewe, Marc by Marc Jacobs, Guess, Marciano, Alejandro Ingelmo, Paul Smith, Sigerson Morrison, Alexander Wang and Via Spiga.

With OEM as the main revenue stream, in 2006 Stella entered high-end fashion footwear retail market in China to leverage its manufacturing expertise. Now it has over 300 retail stores under its own brands Stella Luna and What For.

History

The company was founded in 1982 in Taiwan to produce women's low-end footwear US retail customers. It started China operations in 1991 and has gradually moved up the value chain. Besides mainland China, it also has factories in Vietnam and Indonesia. The company went public in 2007.

Management

Management is very experienced and stable. Three founders of the company still lead the firm. Insiders hold a total of 48% ownership. No stock option has been issued. 2,500 employees are shareholders.

Market Data

market cap HK$16B (US$2.0B), net cash US$364M, div yield 4.1%, ev/t12 sales 1.3x, ev/t12 ebitda 11.4x, p/e (12/2012) 12.4x, ev/ebitda (12/2012) 7.8x, gross margin 21.9%, operating margin 11.4%, profit margin 9.4%, 1-year return 48%.

Target Market

Stella's addressable market is focused on manufacturing in Europe and retail in China.

In Europe, over 450 million pairs of shoes are produced each year, mainly in Italy, Spain, and Portugal. In China, Stella has only over 300 retail stores. The number of middle-income and affluent consumers in tiers 1 and 2 cities is expected to grow at 7% annually from 2010 to 2020. CLSA forecasts that China will become the world's largest market for luxury goods by 2020.

Competitive advantages

- Manufacturing expertise: Over the past 30 years, Stella accumulated rich industry experience.
- Solid business relationship with diversified clientele.

Competition

The footwear manufacturing market is very fragmented. Stella's main competitors are from both Europe and Brazil.

In Europe, high labor cost and retiring experts have been forcing manufacturing to shift to China, Brazil and other developing countries. Brazil's footwear export volume has been declining due to strong Brazilian Real and higher labor cost than in China.

Growth strategy

- Expand capacity: Stella plans to increase the production capacity from the current 50 million pairs per year to 70 million by 2014.
- Increase retail distribution: By 2014 the company aims to have 300 Stella Luna stores and 800 What For stores. Revenue contribution from retail business is expected to reach 20% from the current 5%.

Risks

- Margin pressure due to rising labor and raw material costs
- Weak consumer demand due to economic slowdown.
- Yuan appreciation

Investment Theme

Stella benefits from renewed consumer demand from the global economic recovery. In the longer term, the consumer boom in China will help the company to capitalize on the growing enthusiasm for quality fashion footwear.

Valuation

Target price = HK$40, using DCF model at growth rate of 15% for the next 7 years, 6% at maturity, risk premium of 9%, and payout at maturity of 70%.

Have a good week.

The Global Alpha team