COMMENTARY

May 23rd, 2014

Dear clients and colleagues,

Personal Consumption is the largest part of the economy. In the US, it is more than 70% of the total, dwarfing investment and government expenditures. In China, government estimates put it at 36%, although that number is probably more than 50% if the same methodology was used as in the US. Regardless of the number, consumption in China has been increasing at more than 10% in the last few years and should continue at a strong rate for many years to come, driven by rising income and better social programs.

We believe the reason why investors are attracted to emerging markets is the rise of more than 2 billion new consumers reaching middle class, in China and other emerging economies.

Global and International small caps are one of the best asset class to be exposed to the consumer. The MSCI small cap index weight is more than 20% and close to 30% if we include healthcare.

One company, in our portfolio since 2011 is ideally positioned to benefit from the consumer sector, both in developed as well as emerging markets. We met them again during our recent visit to China. The company is Stella International.

Stella International (1836 HK – HK$20.55)
www.stella.com.hk

Business Overview
Established in Taiwan in 1982, Stella International is a leading developer and manufacturer of top quality, high-end footwear. They offer a one-stop shop that combines design, development and manufacturing (ODM for Original Design Manufacturer). In 1991, the company relocated production to China and in 1998, opened its first factory in Vietnam.

Stella 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, Guess, Jones Group, Kenneth Cole and Michael Kors. The company also design, develop and manufacture footwear for several high-fashion brands such as Alexander Wang, Armani, Bally, Balmain, Givenchy, Kenzo, Marc Jacobs, Miu Miu, Paul Smith, Prada, etc.

In 2006, the company began its retail operation in China through its own brands Stella Luna, What For, JKJY by Stella and a joint-venture brand, Pierre Balmain. The first non-Asian store opened in 2009 (Dubai) and in 2012, the company opened its first Paris store.

GLOBAL ALPHA

Target Market

As a leading ODM (Original Design Manufacturer), Stella's market is the premium, leather based footwear market. The addressable market is around 500 million pairs of shoes per year. It is worth noting that Italy still produces around 200 million pairs per year, while Spain produces around 100 million pairs. With a production of around 50 million pairs in 2013 and plans to increase to 70 million pairs in 5 years, the company still has lots of growth potential.

On the retail side, the Chinese premium footwear market is estimated at more than US$10 Billion annually and the company captured less than 1% of that market which is growing at more than 10% per year.

Management

The founders are still managing the company and together with around more than 1000 employees own about 40% of the company, ensuring long term sustainability. The most recent executive to join the company, the group CFO, joined 8 years ago.

Competition

Stella is the largest company in the industry, but it is a very fragmented industry and the company has less than 10% of the addressable market.

Competitive advantages

- One stop shop. The company has 300 shoes development teams with more than 2600 design technicians, producing more than 10 000 specific shoe designs for their customers.
- Manufacturing flexibility. Average order size is less than 1000 pairs.
- Expertise in leather sourcing and manufacturing.
- Financial strength, no debt and more than US$200 million in cash.
- Diversified production base, owned factories in China's Guangdong province and Indonesia and production facilities in Inner China and Vietnam.

Growth strategy

- Benefit from outsourcing trend in luxury brands by deepening existing relationship and pursuing new ones. For example, Tory Burch is a new client that will start in the fall of 2014.
- Ramp-up factories in Inland China and Indonesia, capacity to increase by about 10% per year for next 5 years.
- Enter leather goods (hand bags) market, a higher margin market and leverage existing customer relationships.
- Increase brand awareness to expand retail business.

Risks

- Rising labor costs. Labor turnover. Unstable labor supply
- Retail expansion yet to be proven.

Market Data

Market Cap HK$16 325 (US$2 105), Net cash US$278 m, P/E (2015) 13.9x, ev/sales (2015) 1.0x, ev/ebitda (2015) 8.9x, dividend yield 4.1%, insider and employee ownership 46%

Global small cap companies are not always known by name. But they almost always touch our daily lives in an important way. For Stella, have a look at the shoes you are wearing or look at the table below and it is highly probable they would have been made by Stella. Soon, the handbag you carry may also be made the Company. And in the future, you may even buy a pair of Stella Luna shoes. You may already have noticed Gisele Bundchen, Blake Lively or Jennifer Lawrence wearing Stella Luna pour Anthony Vaccarello on the red carpet this season.

But again, should we call it a small cap company? With 77 000 employees and sales exceeding US$1.5 Billion, coming 80% from outside China and no customer more than 10% of sales, is it really risky?

At the same time, one would argue that Stella can still be 10 times bigger in the future, an argument that can hardly be made for most mega cap companies.

Have a nice week.

The Global Alpha Team

Source: Stella Investor fact sheet