HARGREAVEHALE

INVESTMENT BULLETIN

Little Emperors

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It is hard not to cry, skimming through the UK Comprehensive Spending Review. The idea that private sector growth can more than compensate for contraction in the public sector is hopeful to say the least. It is true that this happened during the fiscal rebalancing in the four years to 1999, but at the time private sector activity still accounted for some 60% of GDP. Now thanks to a bloated public sector it is back to around 50%. In order to create 2.5m private sector jobs, in order to persuade somebody to actually start or invest in a startup you are going to need significantly lower sterling, much lower corporation tax and you need to cut the costs of being in business. You have to reduce your unit costs of production to that of the global competition. Many of our costs are entirely self imposed and that is the tragedy. Independent "think tank" Open Europe suggests, based on 2300 of the UK Government's own impact assessments, that regulation has cost the UK economy £176 billion since 1998, roughly equivalent to the country's entire budget deficit. Hacking this lot back against well dug in vested interests looks like a task which is more than Hercules himself could manage.

It is one thing cutting back on social spending and another trying to free up the supply side of the economy so that the UK private sector's costs can become competitive globally. And back in the 1990's the UK Banks were in a position to lend money with loan books rising at 5% to 6% a year. Now their balance sheets are shattered and bank lending is shrinking at an annualised rate of 6% to 7%. They are going to limp along for years, until Central Banks create new engines of lending growth by dividing up “casino" banks from lending banks and recognising bad debts in the process. Again, such a move would represent a serious challenge to powerful vested interests. All this means that the target growth rates of GDP envisaged by the Spending Review of 2% to 3% are likely to prove unrealistic. Already the British Chamber of Commerce is forecasting Q3 growth of 0.5% down from 1.2% in the previous quarter. If we are talking about this sort of growth rate going forward, then it will be impossible for the Government to meet its deficit reduction targets by 2014. More to the point, the economy will need further sterling depreciation, more bank note printing and serious tax rises or hacking into waste, which could be politically highly unpopular. The figures do not add up.

Fortunately UK investors remain in a very privileged position. They do not have to buy into the story of a cyclical recovery in the UK domestic economy. This is particularly the case if they make the judgement that printing notes or a second wave of quantitative easing (QE2) is unlikely to be inflationary in the short term because the unreformed banks are unable to utilise this expanded monetary base to lend. The need to hedge against UK inflation via indexed linked gilts, or domestic property/housebuilders/retailers etc is much diminished. Better to hedge against relative Sterling weakness going forward by buying UK Corporates with global product bases or overseas companies.

Of course, there are serious pitfalls in overseas markets. Things seem to be hotting up in currency markets as all the beautiful notes printed by the Anglo Saxon Central Banks to inflate away debt, fly across the world into stronger Brazilian or Asian currencies, possibly triggering the beginnings of a trade war.

It all really started with the Brazilians desperate to head off currency inflows. First they imposed a 2% tax on such inflows, most recently this has been upped to 4%. Next, the Japanese made a public statement to the effect that they would fight with their reserves against any further strengthening of the Yen against the Dollar. Public statements from the Japanese Central Bank are rare, the sort of thing that happens every decade, so the markets tend to take such things seriously. Of course, the Japanese are very cross with the Koreans currently hosting the G20 summit. The US dollar has fallen 12.8% so far this year against the Yen but is only down 4.8% against the Korean currency, the Won. This has meant that South Korean companies have the pricing advantage over the Japanese when it comes to supplying the US with automobiles, electronics, ships etc. Not much love lost.

In front of the G20 summit, the Chinese have been as per usual busily strengthening their own currency. This tactic has certainly worked in the past and might still do but the Japanese are now starting to get very cross. Recently the Japanese prime minister stated: “I want South Korea and China to take responsible actions within common rules”. Things don't seem to be getting much better at the G20 conference this weekend. Lee Myung-Bak, the South Korea President hosting the conference was quoted as saying to Central Bank leaders that unless they agree a common statement of intent: "We may not operate bus, train or aeroplane services to take you back home". This was presumably an attempt at a joke, but when the US Treasury Secretary made his normal pre summit statement that he "guaranteed US policy is not to weaken the dollar, on the contrary it is to strengthen the dollar", this was presumably not meant to be treated as a joke, but in all probability was.

Investors in "emerging" markets have to be of the opinion that currency wars will not lead to real trade wars. Statements coming out of G7 or G20 meetings are often difficult to interpret, and as a result the language of these statements is widely known as "Central Banker's Esperanto”. In the US Congress, the message, particularly pre elections is easier to understand. Politicians have been shouting for tariffs on Chinese imports to the US “to protect US jobs". It is conveniently forgotten that the imposition of such tariffs would merely have the longer term effect of increasing imports from countries such as Vietnam, Thailand and South Korea.

There are few signs yet that current pressures are likely to lead to trade wars. There are some indicators however that the conversation is changing away from currencies towards specific trade cap commitments, allowing surpluses and deficits on current accounts to be no more than 4 per cent of gross domestic product. By way of example, China's current account surplus was 5.9% in 2009 compared with 10.6% two years earlier. By contrast, the US had a current account deficit of 3 per cent last year. Exceptions would be made of countries which had to import large quantities of raw materials, a friendly gesture by the US towards the Chinese. Indeed there are some suggestions that whilst a lot of noise passes between the two countries in terms of trade rhetoric, the US and China in reality have a number of common interests.

The first relates to the Dollar/Yuan peg. The lower the dollar, the more competitive the Chinese currency is in relation to Europe and Brazil, and Asian

competition such as the Yen. And of course a significant proportion of Chinese exports to the US, are actually manufactured by plants in China owned by US multinationals who can pay higher dividends to US shareholders as a result of much lower labour costs.

A true confrontation leading to a trade war therefore seems somewhat far fetched certainly in the immediate future. If anything there have been some encouraging signs of the opening up of free trade. When China joined the World Trade Organisation (WTO), there were around 7000 items subject to tariff arrangements, the highest rates being on luxury items which averaged around 25% going up in some cases to 100%. Now tariffs on luxury handbags and watches range between 10% and 30%, on cosmetics 10%, whisky 10% and China remains committed to reducing them further or eliminating them entirely as part of its obligations to the WTO.

And this process of elimination of tariffs is still continuing regardless of currency wars. The momentum is still there. For example it has recently been agreed that all tariffs on goods traded between Korea and the EU will be eliminated by June 2012. Last year Korea was Asia's fourth largest economy and two way trade between Korea and the EU was worth 5.76 billion Euros.

So on balance it looks as though the immediate currency tensions can be dealt with. Investors also have to take note of the malign impact of huge capital inflows from the West on local economies in Asia and South America, creating property and equity bubbles which burst unexpectedly. Again, it does appear that local Central Banks, having suffered in the past are reacting much quicker than before. The imposition of capital controls via import taxes in Brazil is a case in point. And of course China wants to be in control of its own bubbles.

The Chinese currency is not convertible and capital inflows for ”investment purposes" remain under the microscope. The Chinese Central Bank is acting as Central Banks should. Interest rates were raised 25 basis points last week to 5.56%, a pre-emptive move to curb inflation running at 3.6%. Third quarter growth was 9.6% and consumers are feeling quite good too with retail sales in September up 18 per cent. With real interest rates of 2% it does not yet feel like a bubble or certainly a bubble in its early stages. It should have a number of years still to run particularly if it suits the Chinese Government to allow the currency to rise to reduce import costs and develop internal infrastructure with less overall reliance on export markets.

And here might lie the opportunity for UK based investors. We have mentioned China's continuing commitments to the WTO of lowering import tariffs on luxury goods. This is of interest to investors in the context of the recent announcement that China has replaced the US to become the world's largest luxury goods consumer after Japan. Within two years China will probably be the world's largest market for the West's luxury brands, with demand rising by 25% to 30% each year. It is this demand statistic which is of interest.

This is because the Chinese have been quite slow to develop their own domestic brands. There have been some brand successes, such as Shanghai Tang and LaVie but these have been directed at foreigners. Some jewellery brands such as

Tse Sui Luen and Chow Tai and Goldlion, but their influence on the market has been minimal. It is the big western brands which control the market.

This has long been recognised by stockmarkets and as a result most brand names are trading on high multiples in recognition of the growth to come. For example, Richemont which controls Cartier, Purdey, Vacheron, Van Cleef, Piaget and Dunhill is trading on a prospective PER of 20. LVMH which has recently taken a stake in Hermes and controls Christian Dior, Dom Perignon, Henessy, Krug and Givenchy is trading on a prospective PER of 22.PPR which has 100% of Gucci is trading on a prospective PER of 17.

But what is expensive in the context of exploding consumer demand? After all, China is creating about 35m middle class consumers every year and shopping malls are increasingly being dominated by western brands such as Cartier, Louis Vuitton etc. All the evidence seems to suggest that managements are somewhat behind the curve seeking to catch up and deal with exploding demand. Looking at a segmental analysis of Burberry's revenues shows that Asia Pacific sales are forecast to grow from £240 m last year to £352 m in 2011. In the first half of the year to March 2011, Asia Pacific sales were ahead by 37%, whilst European sales are increasingly dominated by Far Eastern buyers. L'Oreal's sales profile is changing rapidly. Sales growth from Europe is negligible when adjusted for inflation, whilst Asia Pacific sales excluding Japan were up 14.8% in the first half. Sales from Brazil, Argentina, Mexico and Columbia are growing at 19.7% from a much lower base. In China, L'Oreal is market leader in the luxury skin care market with a 16% market share and should deliver 15% to 20% grow going forward as it ramps up its position in tier 3-5 cities. In this connection, it is worth remembering that China now has 151 cities with populations greater than one million compared with the US which has just 9 cities in such a category.

In constructing a long term portfolio, it is probably well worth paying up and buying into market leaders such as LVMH or Richemont. Shorter term and with a higher risk profile because it has yet to establish itself in global markets to the same extent is Mulberry. Mulberry is UK Aim listed with a current market capitalisation of £313m. This may well appear expensive in relation to historic profits of £6m. It has a yield of below 1%. It has a product range of luxury handbags which it is developing into a range of leather products for men and women. Thus it is in product terms relatively early stage. It is experiencing supply chain pressures because of the sharp global demand for its products. All of this should be enough to put off investors given the market capitalisation. But the prize for getting it right is sizeable, because sales are growing off a small base. Last year, for example, for the year to March 2010, sales were £72m and are forecast to rise to £108m in the current year and £130m in 2010. Last year 29% of sales, retail and wholesale were from Asia, and these revenues are expected to increase at rapidly going forward. As the company stated in its Report and Accounts: "it is clear that our best selling products in our home market have equal appeal internationally". Here the 58% shareholding owned by Christina Ong is of critical importance. One of the richest families in Asia, the Ongs are in the pole position in relation to financing wholesale and retail distribution in the Far East. Analysts' estimates of the profits profile of Mulberry has recently been increased from last years £6.1m to £13m in the current year and £18m in 2011/12.

A recent Microsoft survey of luxury online advertising suggests that Asian consumers are much more alert to the opportunity to buy luxury fashion online. In answer to the question, “Would you like to see more advertising of luxury goods online?” 64% of Asian consumers agreed or completely agreed. By contrast, 31% of European consumers agreed. In answer to the question: “the internet is a great way to stay up to date with luxury brands, 72% of Asian consumers said yes and only 57% of their European counterparts agreed. This has interesting implications for Italian quoted online fashion retailer YOOX (higher risk), currently capitalised at around 500m Euros.

At present, whilst almost all major fashion brands have an on line presence, only around one third are actively exploiting e-commerce as a means of selling to customers. A number of brands are happy to outsource such e-commerce and YOOX has established on average five year contracts with a number of important Italian brands including Giorgio Armani, Valentino, Dolce & Gabana and Marni. These contracts are based on around 40% of revenues to YOOX, whose website offers product some of which is not actually available in retail stores. This business is growing rapidly. Euro ebitda in calendar 2010 is forecast at 14.3 million rising to forecasts of 22.6 million next year and 32.5 million in 2012. The scope for the business is interesting because online sales represents just 1% of all sales. For example, Valentino’s has Euro 3 billion of sales with less than 1 per cent being online. Online sales as a percentage of total sales are forecast to rise to 15% by 2015, so the growth of traffic going forward is considerable. If you look at the values being attributed to ASOS, in ebitda terms, or the price which Richmont recently paid for rival Net-a-Porter, equivalent to over three times sales and the longer term price potential of YOOX group could be interesting.

UK investors have plenty of scope to invest in global opportunities. They should be benefitting from what is known as the “Little Emperor" phenomenon. The most brand conscious of all China's consumers are the "Little Emperors", the generation which is the result of the one child policy enforced by the Chinese Authorities. These children typically have six sources of disposable income with parents and grand parents all contributing to this one child's every need. The breeding ground for luxury brands.

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