Global emerging markets

by **PIETER HUNDERSMARCK** and **GAVIN JOUBERT**

***PIETER HUNDERSMARCK** joined Coronation in November 2007 as a member of the emerging markets research team. Prior to joining Coronation, he spent two years in Corporate Finance at ABN AMRO bank.*

***GAVIN JOUBERT** is head of the Coronation Global Emerging Markets team and has 14 years' investment experience. He has managed a wide range of South African equity and balanced portfolios and currently co-manages Coronation's range of Global Emerging Market funds.*

China represents the single largest country exposure in the Coronation Global Emerging Markets (GEM) Fund and makes up 32% of the portfolio. We are frequently asked if we are worried about China – specifically about the sustainability of the Chinese economy and whether there is a property bubble. The answer is that both issues do worry us. On the first point we don't believe that the current consumption of commodities by China is sustainable, and as a result we believe that current commodity prices are in many cases unsustainable at current levels (iron ore and copper in particular). This consumption of course, through infrastructure spend, makes up a large part of the Chinese economy and we would therefore naturally expect China's infrastructure spending to moderate. In terms of a property bubble, we do believe that there is a property bubble in certain of the larger cities (Shanghai in particular), but we don't believe that it is a nationwide issue. Partly because of these concerns we don't own any Chinese commodity companies, banks or property companies.

We certainly don't believe that the Chinese economy will continue to grow at 10% p.a., as it has over the past 30 years. However, even an average annual growth rate of 5% to 6% over the next five years would make it one of the healthiest economies in the world, and would provide a nice tailwind for consumer businesses in China. At the same time, we believe that the mix of the Chinese economy over time will shift, with infrastructure and exports becoming smaller and consumption becoming bigger. We also hold the view that in 5 and 10 years' time the average Chinese individual will spend a lot more on cars, clothes and food than he or she does now. Today, China already contributes 40% of the group revenue of KFC (owned by YUM! Brands); more cars are sold in China than in the US (China is Rolls Royce's single largest market); Apple already generates 12% of its revenue from the country and yet only 1% of Chinese mobile subscribers have an Apple iPhone, and the list goes on. The key point is that already the Chinese consumer is a significant force, and it is the Chinese consumer that attracts us. We spend a large amount of time researching Chinese consumer stocks, valuing these businesses and investing in those that are trading well below what we think they are worth.

So while we do have concerns about China, we believe the prospects for many Chinese consumer companies over the next several years are extremely promising. Importantly, we also believe the valuations of a number of Chinese consumer companies are very attractive. Our entire 32% exposure is invested in Chinese consumer companies across a range of very different industries, with the common thread that they all sell goods to consumers in China. We are invested in the second largest local supermarket retailer; a high-end clothing retailer; two car manufacturers (including the only BMW China joint venture); the second largest beer company; three consumer-focused internet companies; a department store; two Macau casino operators; a branded food and beverage company, and a ladies footwear retailer named Daphne.

Daphne

The ability to invest with a long-term time horizon, beyond the noise of the short term where the majority of market participants spend their time, is one of the anchors to our investment philosophy. Because we look out over long time periods we aim to identify and invest in businesses that can survive the test of time – ideally ones that have a leading position in a promising business space, a growing business value, have enduring competitive advantages, a clear strategic focus, a robust balance sheet, and above all an attractive valuation.

Many of these attractive qualities can be found in Daphne. Established in 1987 as a family owned shoe manufacturing company, today it is the market leader in affordable branded ladies fashion shoes in China, with 4 000 outlets under its *Daphne* brand and 1 300 outlets under its *Shoebox* brand. Unlike other Chinese-listed companies that focus on mid- to high-end footwear, Daphne competes in the mass-market segment with its *Daphne* brand (72% of sales and 84% of operating profit (EBIT)) and the low-end family segment with its *Shoebox* brand (21% of sales and 18% of EBIT). Today the company is still controlled by the original founding family.

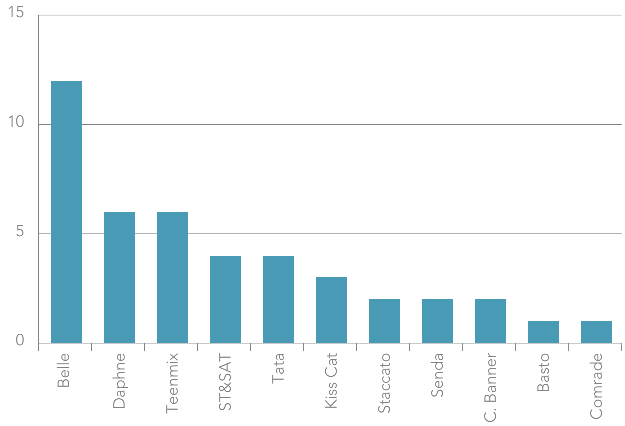
The size of the business opportunity facing Daphne is significant. In 2010, Daphne sold about 26 million pairs of shoes. Assuming no repeat purchases by the same customers, Daphne is presently only serving 26 million customers, or about 8% of the total addressable urban Chinese female population (of about 300 million). More importantly, it is highly likely that its target market (young, middle class working women) will buy more than one pair of shoes a year. As such, Daphne is still only scratching the surface of arguably the largest shoe market in the world.

Daphne's competitive position within the shoe market is strong. It owns two powerful brands – the *Daphne* brand is ranked no. 2 by market share and *Shoebox* is no. 1 in the lower income category. Daphne's competitive arena is highly fragmented, and consists mainly of unbranded and/or unlisted regional players with presence in either mid- or high-tier cities. Daphne has extensive nationwide coverage of cities from tier 1 all the way through to tier 6 cities. By casting its net wide, Daphne has gained first move advantage into the lowest-tier cities where there are few mass market aspirational brands.

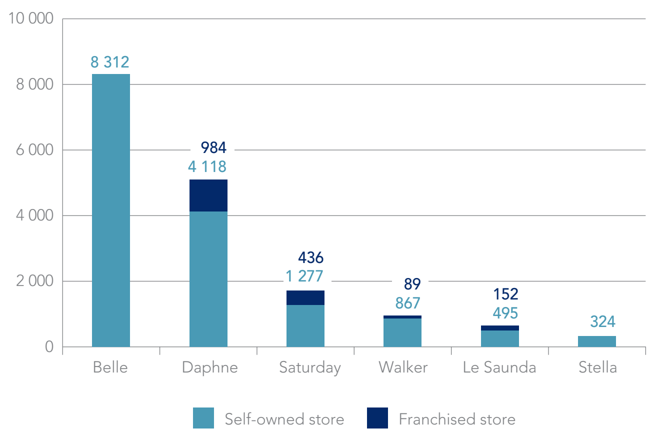
Daphne produces the vast majority of products at its own manufacturing facilities, from where they are shipped to its retail distribution network. This sales network allows Daphne the leverage against suppliers for bulk buying and better rental contracts than peers. The low cost production model and management pedigree of building and maintaining market leading brands makes Daphne a powerful force in the retail shoe market.

Daphne market share and network size

DAPHNE RANKS NUMBER 2 BY BRAND MARKET SHARE IN CHINA, 2009



SECOND LARGEST FOOTWEAR SALES NETWORK



Source: BAML

Despite their high market share in the formal retail market, both the *Daphne* and *Shoebox* brands are underpenetrated in China, with *Shoebox* (1 300 stores) the least penetrated of the two. The company is well funded, with over 15% of its market capitalisation in cash and zero debt, and is poised to expand its network strongly in the coming years. Each year, for the next five years, Daphne plans to roll out approximately 500 *Daphne* stores, 300 *Shoebox* stores and 150 of its newly acquired mid-tier brands. This store rollout will allow the *Daphne* brand to deliver nearly 20% revenue growth in our view, from a combination of 14.5% space growth and same-store-sales-growth (SSSG) of 6% on a normalised basis, while the *Shoebox* brand will expand space by 30% and will see 9% SSSG, leading to just under 40% revenue growth.

With 19% and 13.5% operating margins for the *Daphne* and *Shoebox* brands respectively, Daphne enjoys the second highest profitability among listed ladies footwear companies in China. The company earns these margins on the lowest average selling prices in the peer group, which further speaks to its low-cost business model. We believe these margins have room to expand as the business matures, selling prices increase ahead of inflation, and scale advantages are further defined.

In summary, Daphne offers us an attractive opportunity to invest in a well-run, growing, branded Chinese consumer company that will benefit from the consumption shift taking place in the Chinese economy over the next decade. We believe the business is worth in excess of HK$13, versus a share price of just over HK$8 today. At a 10.4x rolling forward price earnings multiple (and 9x forward when accounting for the cash), we believe the opportunity is very attractive. Daphne is a 2.5% position in Coronation's GEM funds.