China’s need for higher consumption

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Amélie Thévenet examines the growth dynamics of Chinese consumer spending and discusses the need for China to accelerate its rebalancing towards a domestic-focused, consumption-led economic model. If they can achieve that, then the benefits for domestic companies – already fast-growing businesses – should be significant.

The Chinese consumer is the most important thing in the world economy, said Jim O’Neill, former Goldman Sachs Chief Economist and coiner of the term ‘BRIC’, earlier this year. That is a comment that underlines the pivotal role that Chinese spending power now plays on the global stage.

For many international companies, the bulk of sales growth comes from their Chinese/Asian divisions. Swiss luxury goods conglomerate Richemont already generates 22% of global sales from China and Hong Kong alone, with the rest of Asia adding another 16%. Asia is also the fastest-growing region for sales.[1] Likewise, the Greater China region is by far Nike’s fastest-growing geography (triple the growth of its core North American market), representing 16% of global sales.

Nike, Inc.	**Revenue (USD, millions)**		
Division	**12m ending 31.05.2019**	**% of Total**	**YoY % Growth**
North America	15,902	41%	7%
EMEA	9,812	25%	6%
Greater China	6,208	16%	21%
Asia Pacific & LatAm	5,254	13%	2%
Other	1,941	5%	-3%
Total	**39,117**	**100%**	**7%**

Source: Nike, ‘Fiscal 2019 Fourth Quarter and Full Year Results’ to 31.05.2019

Arguably, the growth profile of these international companies is hampered by exposure to their mature legacy markets in the West. Domestic Chinese companies, by contrast, are naturally a purer play on the theme, and with a domestic market that is so strong the trade war need not stand in the way of their medium-term growth. In the sportswear sector for example, Anta and Li Ning, the two largest domestic brands, have seen their consolidated sales increase by 35% and 33% YoY respectively in the first six months of 2019. The trade war, which is a headwind for so many companies, may in fact benefit these companies as the mood in China shifts towards a preference for domestic goods for patriotic reasons encouraged by the government.

How to spend it

That is only part of the story, however. As the Chinese economy slows, so too has the pace of household expenditure growth – albeit less so than other parts of the economy such as manufacturing and exports that are more impacted by the trade war.

[1] Source: Richemont, FY19 Annual Results presentation

China's per capita household expenditure has more than doubled in the past 10 years, but the pace of growth has slowed

Source: CEIC

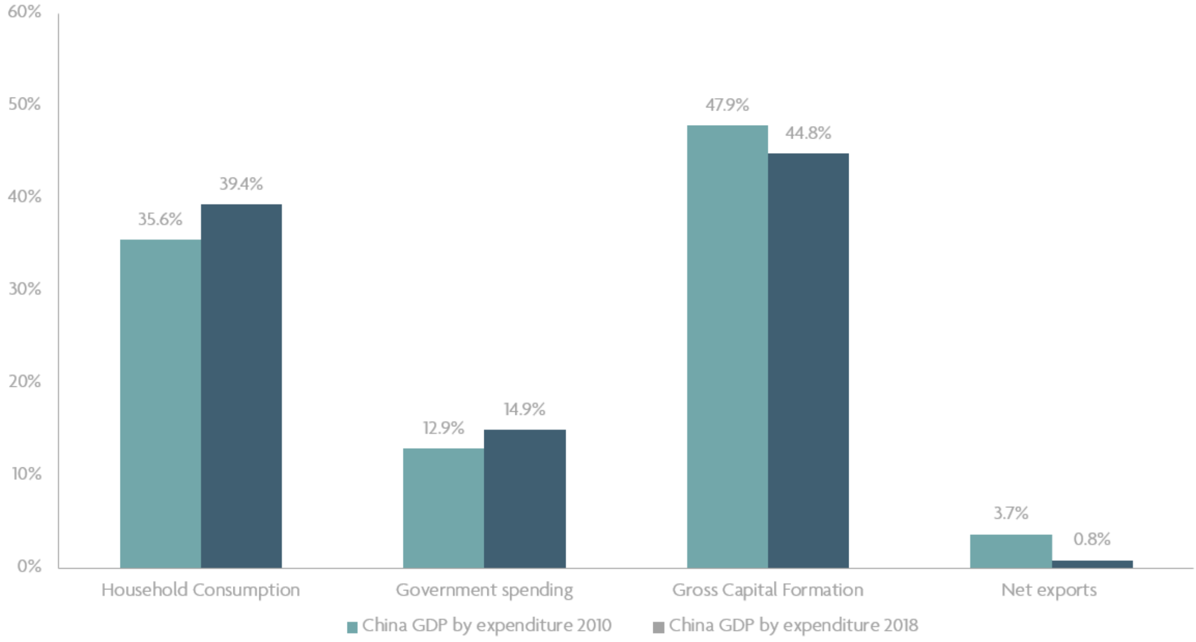
The Chinese government seems to recognise the need to rebalance its economy into a more domestic-focused, consumption-led model. Some progress has already been made on that front and the trade war may even provide an incentive for them to accelerate that plan, since domestic consumption is easier for them to stimulate than other measures that are more at the mercy of international markets and cross-border trade.

The scope to increase expenditure and consumption is significant. In common with many other Asian and Middle Eastern countries, China's savings rate is high at 45.7%. The trend is downwards (in 2010 China's savings rate was 51.5%) but if that reduction can be accelerated it could be dramatic given the size of the domestic Chinese market. Achieving Western levels of savings rate may be unrealistic, but if China can get anywhere near the 27.0% level of neighbouring Japan in future the impact should be significant.

Country/Region	Gross Savings Rate
Macau	67.1%
Qatar	62.2%
Ireland	57.5%
Luxembourg	52.4%
Nepal	51.7%
Brunei	49.4%
UAE	48.3%
Singapore	47.7%
China	45.7%
Mongolia	43.8%
Japan	27.0%
UK	17.5%
United States	17.3%

Source: CEIC

The gradual process of rebalancing China's economy towards consumption has already begun, but arguably needs to accelerate



Source: CEIC

Key areas of opportunity

Greater spending by Chinese consumers would have a knock-on impact on many areas of the market, leaving plenty of room for active investors to seek out the most appealing opportunities and areas where the positive change potential has so far gone underappreciated.

As shown in the table below, there are a few powerful trends in the consumer space in China.

Net % of consumer survey respondents in China who plan to increase consumption in the next 12 months (May 2019 survey)

Sport/Body exercise/Gym	18%
Education	17%
Domestic or outbound traveling	16%
Medical/Healthcare	12%
Food and beverage items	10%
Daily necessities	10%
Cosmetics and skincare	9%
Clothes and wearables	6%
Elderly-care service	6%
Telecom/Mobile phone/Telecom services	5%

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Chinese consumers are becoming more health conscious, which means that they are spending more on sport-related items and health food supplements. It is estimated that the scale of sports industry will exceed RMB5 trillion by 2025.[2] Education is also an area where parents spend a lot and is very resilient to economic downturn, especially in after-school tutoring.

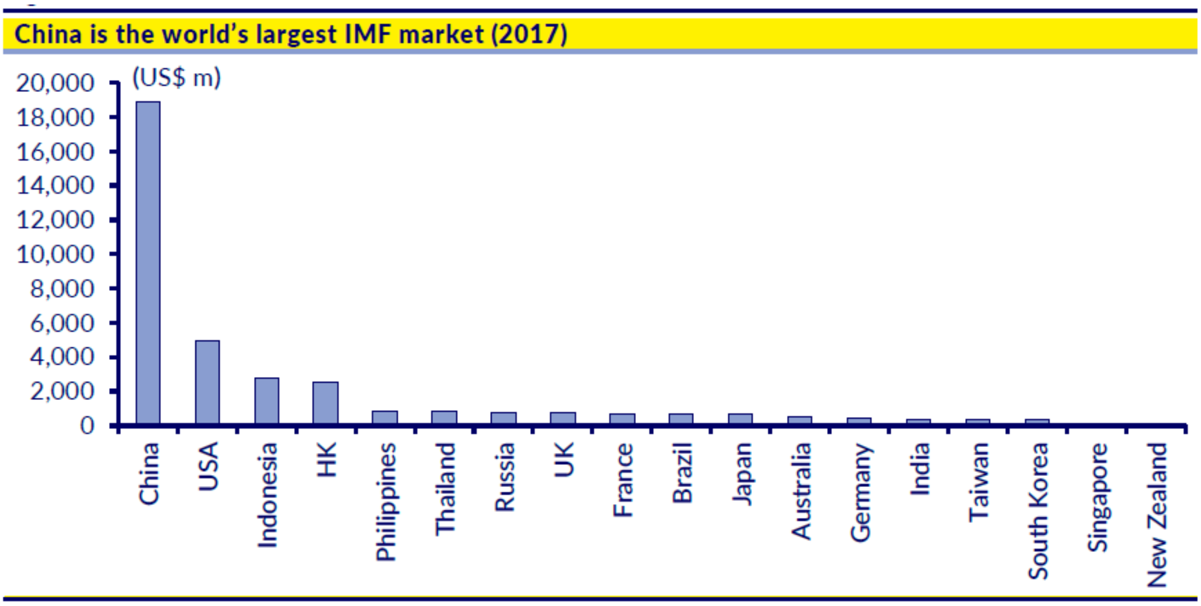
In my view, Chinese consumer companies are well placed to cater to these consumption needs, although it is important to be selective – for example, in food, beverages and cosmetics Chinese consumers tend to favour foreign brands which they still trust more.

Li Ning – a sportswear domestic champion

Appetite for foreign goods was resilient to the practical and political effects of the trade war, although the longer and more bitter the dispute with the US becomes the more likely it is that there will be a patriotic shift towards domestic Chinese brands. I see sportswear company Li Ning as well placed to benefit from any such shift, as it has already launched a new product line that plays up the patriotic side of being Chinese. Even aside from that, Li Ning is in my view well placed to benefit from future increased consumption of sportswear goods, and the ongoing operations restructuring ensures a healthy increasing cash flow generation (operating cash flow increased by 107% in H1 2019)

Health and Happiness – providing adult and baby nutrition

Owing to safety and sanitation scares in the past, Chinese consumers still trust foreign brands more when they buy infant milk formula.



Source: Euromonitor, CLSA

Health & Happiness (H&H), a Hong Kong based company, is particularly well placed as they are a Chinese company, but they source key raw ingredients from France and the US for their premium infant milk formula (IMF), and from Australia for their adult health supplements. They have a deep understanding of the domestic market and command 5.5% market share of the Chinese IMF market, which I expect to rise as they are exposed to the premium market which is growing faster. They have an internationally diverse management team which I view as a key asset to succeed in their industry in the long run.

[2] Source: Li Ning, 2019 Interim Results presentation

New Oriental Education – after-school tutoring

New Oriental Education is one of the leaders in private after-school tutoring in China, and also provides language training and test preparation courses. Education is one of the most resilient household expenditures in China, as parents want the best education possible for their children. Even in lower tier cities, families do choose to pay for after-school tutoring in the hope that their children would get into the best universities. New Oriental Education has an increasing presence in after-school tutoring, both offline where they are one of the two leaders, and online to capture the rural markets. Despite being one of the largest providers, and growing revenues at above 30% YoY, they only have 2% market share as the industry is very fragmented. We expect that the K12 offline business should grow at a rate close to 40% during the company’s financial year ending May 2020, driven by capacity expansion and rising fees, as well as higher retention and capacity utilisation.

An engine of change

The Chinese consumer continues to wield power over global consumption trends. While there is a slowdown in Chinese consumption growth, the long-term trends of household consumption growth in China are very resilient and, in my view, there are attractive opportunities in pockets of the sector where growth potential is higher. The Chinese government is keen to boost private consumption and reduce the household saving rates – I believe it is reasonable to expect that they will support consumption with ad hoc measures should the slowdown be more pronounced and focus on rebalancing the economy away from too much reliance on infrastructure spending and industrial growth.

Furthermore, aspirations of Chinese consumers are changing as they focus on a healthier lifestyle. The younger generation seeks different experiences through travel and entertainment rather than accumulating foreign luxury goods. While some trends evolve, some trends remain ever more powerful, like spending on children’s education. Overall, the growing power of Chinese consumers will remain an important engine of change delivering potentially attractive investment opportunities for the Jupiter Global Emerging Markets team.

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