

All Eyes on China's Domestic Consumption

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China is the biggest retail market in Asia (ex-Japan) and the fourth largest globally (the same size as the United Kingdom). Rapid GDP growth, the rise of the middle-class and disposable income has kept China the fastest growing consumer market in the world.

During the peak of the equities cycle in 2007, Chinese discretionary consumer names were trading at 32x forward price to earnings (FDPE) and staples were trading at over 35x FDPE. Until this August, China's consumer confidence remained high. Snowstorms, earthquakes and floods didn't manage to dampen the consumer's spirits. But consumer confidence took a nosedive right after the Olympics. Currently, the discretionary and staple names are trading at 10x FDPE and 17x FDPE and the street has started to aggressively cut earnings projections on consumer companies.

It seems like the greatest consumerism story has turned sour overnight. During my recent trip to China, I met with 13 consumer companies. All of whom said that the economy has deteriorated much faster than they expected, but they still believe China's domestic demand should be insulated from the external slowdown. I disagree with them slightly. It may be true for consumer staples, but China's demand for discretionary consumer goods does correlate highly with the global environment. Most of China's consumption power resides in tier 1 cities and the coastal regions. These regions' net wealth is still highly dependent on foreign investments and external demand.

The hype towards the Olympic Games has masked the economic slowdown. Chinese consumers' net wealth has taken a further dent from falling house prices and stock markets. Macro analysts still expect house prices to fall 20-30% before demand returns. The A-share market has lost more than 60% YTD. CPI is expected to drop below 1% in 2009 and wage inflation will also slow down in 2009. The government's policies are not enough to resurrect domestic consumer confidence. The loan interest subsidies for small and medium enterprises and relaxed second-home mortgage policies will have little impact on the economic fundamentals. Rental returns on properties have declined to below 2% at current market prices, which is way below bank deposit rates. Relaxing second-home mortgages will not encourage investors to return to an unattractive market as people are still waiting for the housing markets to bottom out. Therefore, consumer confidence is likely to stay low in 2009 and will only recover when the global economy recovers.

The top-line growth for consumer companies may not be stellar in 2009, but the demand has not come to a complete halt and certainly is not going into negative growth territory. The savings rate is still very high and consumer taste upgrading continues. Demand in the vast inland cities is still robust. Same-store-sales growth in the coastal regions could still reach low teens in 2009 through a better product mix and promotions. Better cost management, lower wage pressure and a relaxed credit environment will help to maintain net margins.

We now believe current stock valuations though, have discounted too much risk in 2009 earnings. Given the long term urbanisation story in China, consumer companies are very attractive for patient investors and now is a much better entry point than last year!