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FOR PROFESSIONAL INVESTORS ONLY

J O Hambro Capital Management Group

A View From Asia

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Phoenix – a mythical, beautiful, lone bird, which lives in the Arabian Desert for 500 or 600 years and then sets itself on fire, rising renewed from the ashes to start another long life: a symbol of immortality

2018 caught me completely on the wrong foot. Going into the year, our screens for cash flow and profit growth in Asia looked strong while price-to-book valuations were below long-term mean valuations. In 2017, China had embarked on two distinct but structurally important policy initiatives. I expected both to result in better cash flows for 'old corporate China' and a relatively sounder financial system, which had been plagued with high indebtedness.

Production curbs

Efforts to deal with persistent pollution in many Chinese cities led to a curb in production, and, in many cases, shutdowns of inefficient steel/cement factories and coalmines. Because of the subsequent reduction of supply, commodity prices climbed, leading to better profits and cash flows for the surviving companies. This, in turn, meant that the banking system in general had fewer non-performing loans. Their customers, the very same 'old corporate China', were highly indebted and in poor financial shape prior to the benefit they raked in from higher pricing power as a result of capacity shutdowns. Simultaneously, a clampdown on shadow banking and peer-to-peer lending by the authorities moderated the rate of loan growth. With valuations nowhere near bull market peaks, I was quite sanguine about markets.

The strength of the US dollar, whether from rising rates or tighter liquidity, started to have an impact on markets. However, it was probably the hardening of the US's stance towards China which rapidly changed the outlook. I did not anticipate that the tensions would precipitate and devolve into a strategic adversarial relationship in a matter of months. Starting the year with a bullish bent of mind meant that the pain has been severe.

Changes for a changed outlook

In light of the changed outlook, from mid-year onwards I made several changes to the portfolio, recognising that the current political environment is likely to persist and hence it is difficult to expect a return to business as usual. It might be prudent to assume that trade tensions will persist, even if temporary truces are declared. They are unlikely to alter trade and investment patterns. The two subjective rules we have tried to run on stocks we own are: (a) does the business have an ability to help import substitution; and (b) if a business has seen tough times for whatever reason in the past few years, can the turnaround be sustained over the medium term?

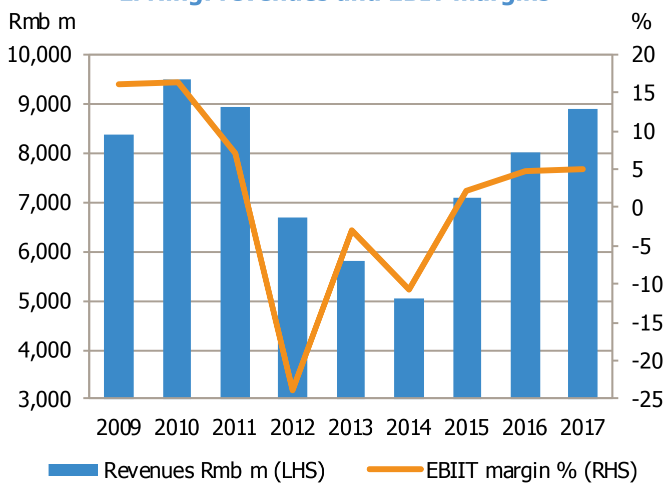
The ups and downs of Li Ning

Li Ning (LN) is a stock that meets both these criteria. At the start of this millennium, LN was one of the local, budding businesses that wanted to build a brand and take advantage of rising consumer incomes in China. Those heydays when China joined the World Trade Organization and growth in emerging markets (EM), especially BRIC countries, was the rage, almost all entrepreneurs in EM, China included, extrapolated growth for decades to come. The then impending 2008 Olympics in Beijing was supposed to be the crowning glory for companies like LN. Indeed, the sky was the limit.

Alas, brand building and retailing are two of the most difficult tasks for any business, especially in a hyper-competitive Chinese market. If you have read Phil Knight's autobiography 'Shoe Dog', you will know exactly what I mean. Today, Nike is not only perceived as (but also proven to be) a slick and well-oiled marketing machine. With almost flawless brand resonance, R&D supporting its products and near perfect execution, the company deserves its esteemed status. Yet reading Knight's tale, we learn how, until the late 1990s, there were several occasions when Nike was running a hand to mouth existence, borrowing money when struggling with cash flow problems and facing many a near-death experience.

LN, too, thought it had a right to win the Chinese market and expanded aggressively across China. Though its brand had some resonance with customers, in hindsight it was more a distribution push (getting the product as widely available as possible) rather than the genuine pull of its brand, which drove sales. After the Olympics, facing the financial crisis in 2008, the firm found itself in dire shape. Revenue contracted and operating de-leverage crushed margins.

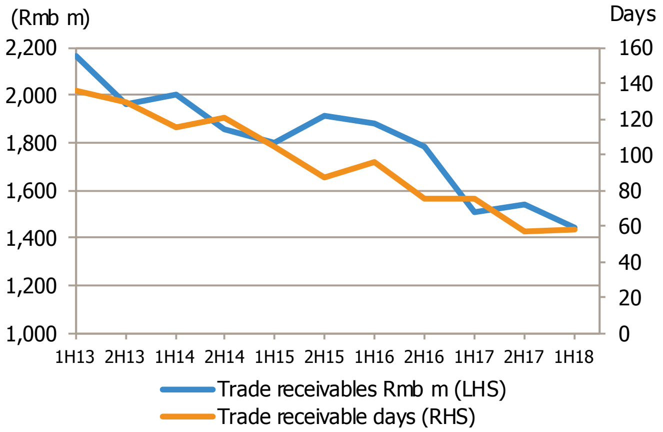
Li Ning: revenues and EBIT margins



Source: CLSA and Li Ning company reports.

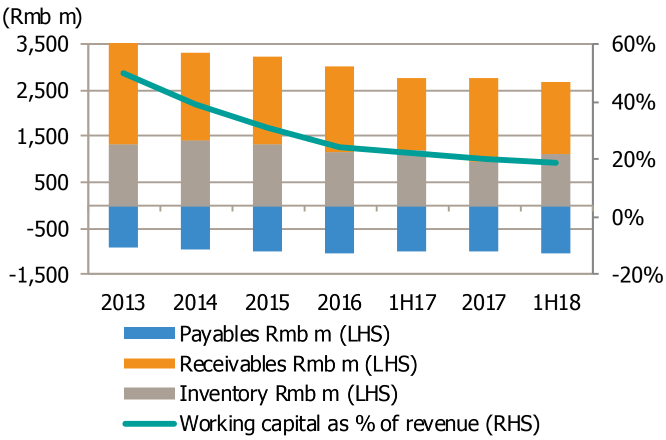
Subsequently, the rise of e-commerce and the structural headwind of reorganising the business to deal with the new buying patterns was an added challenge. Investing in the brand and reinforcing it was important, but more critical was the need to right-size its balance sheet, particularly working capital. You can see from the following charts that the company has successfully managed to deal with its bloated working capital situation in the past three years. Not only have days of working capital fallen over time, but even the absolute amount of working capital has been brought under control, which I find admirable.

Li Ning: trade receivables and trade receivable days



Source: CLSA and Li Ning company reports.

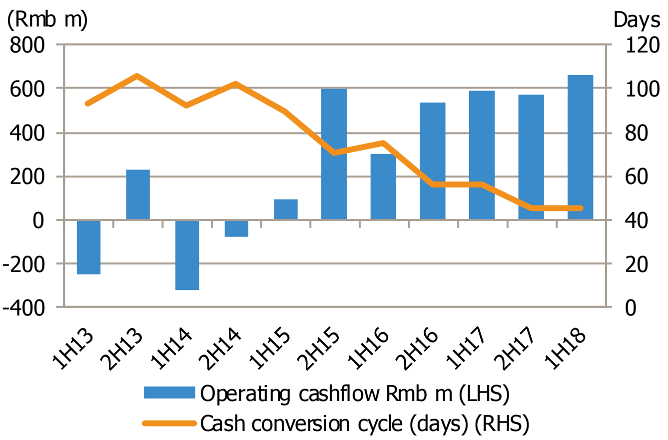
Li Ning: payable/receivable/inventory/WC



Source: CLSA and Li Ning company reports.

Over the past 18-24 months, revenue have started to rebound as LN has intensified its focus towards R&D and new product introductions. So far, in 2018, every quarterly update reported demand up by high teens to low 20s percentages, an encouraging trend. Along with better sales, the focus on managing working capital has resulted in a dramatic turnaround in free cash flow generation.

Li Ning: operating cashflow/cash conversion cycle



Source: CLSA and Li Ning company reports.

Li Ning: doing the right thing

If trade barriers do persist or intensify and the Chinese government (for the sake of argument) were to impose tariffs on Nike or Adidas, consumers in China will unlikely roam around barefoot. They will look for alternatives, and LN will be one of those alternatives. I agree that the perception and possibly the quality of LN's shoes and apparel might not match that of Nike's, but the very fact that the business is in much better shape today, gives LN the firepower to reinvest in quality and branding. Retailing is a hard business. As with Nike, even the best firms today have had rocky periods in the past. So far, LN seems to be doing the right things. Perhaps the situation as it unfolds on the macro side could assist it in gaining share and help propel the company out of the rubble it found itself in not too long ago.