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FOR PROFESSIONAL INVESTORS ONLY

# A View From Asia

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## Shifting sands

Luckin Coffee (LC), self-described as 'China's fastest growing, tech-enabled coffee brand', filed for listing in the US. Akin to Uber and Lyft, LC loses a lot of money but that is where the similarity ends. LC is not a business that has the usual characteristics of achieving scale in a short period. Rapid scale usually happens from network effects or for firms selling digital products/services. Yet, in China, this conversion of online to offline business and attempts to scale are relatively mundane for a start-up. The key ingredients required are: plentiful venture capital funding; catching the eye of one of the established platforms like Alibaba or Tencent to get them to invest in you (they fear you might turn into a competitor); and ambition to dominate one aspect of commerce with the objective of attacking adjacent domains and becoming a platform of some sort thereby accumulating customer data. Making money is optional.

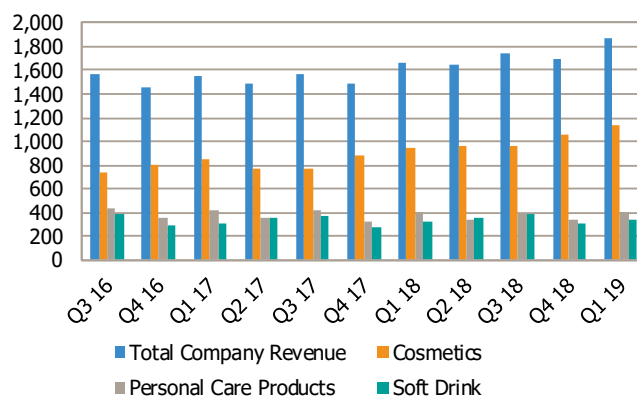
Founded in mid-2017, LC has grown from one store to 2,380 stores as of March 2019. Admittedly, 91% of its stores are just for picking up orders with almost no seating facility. LC provides convenience of ordering via an app, offers choice of delivery by third party or self-pick-up from a nearby store and payment is online. Currently in 28 cities, LC wants to expand throughout China with locations in office buildings, commercial establishments and university campuses.

LC's turnover in the year ended December 2017 was approximately US\$32,000. In 2018, it skyrocketed to US\$125.5m and in Q1 2019 to US\$71.3m. Losses outpaced revenue growth. From a loss of US\$56,000 in 2017, to US\$241.6m in 2018, to US\$82.4m in Q1 2019. It last raised capital in December 2018 at a valuation of US\$2.9bn. I only cite these numbers to present an example of the immense disruption we witness in China across several industries. It requires a constant state of alertness to changes in distribution platforms, technology solutions, competition and much more. Finding truly entrenched businesses with longevity is difficult. Which is why we expounded on the condiments industry in China on our quarterly call. It is one industry where we have a high degree of confidence of a long-term moat for its key participants.

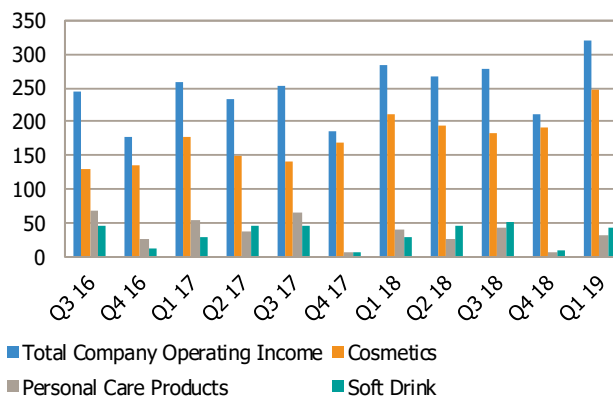
Let me cite another industry where there is almost constant change on churn: cosmetics. We own one name, Korean-listed LG Household and Healthcare (LGHH). I started buying LGHH in Q1 2018 when the stock sold off on concerns over deterioration of relations between China and South Korea. Late in 2017, the Chinese government banned group travel by Chinese citizens to South Korea. LGHH owns several cosmetic brands and the Chinese are

its largest customer base. The impact on sales was real but I reasoned that these diplomatic events are usually temporary in nature. LGHH's products had not changed, nor the desire of the Chinese consumers to buy them. Fast-forward a year, tensions have subsided and things are almost back to normal between China and South Korea. Q1 2019 results for LGHH were indeed very good. Cosmetics (60% of consolidated revenues) grew 20.3% and hit US\$1bn quarterly revenue for the first time. Its best-selling premium brand, 'The History of Whoo', grew an impressive 36%. This is not just commendable on its own merit but remarkably so in light of the big shifts in advertising channels, impact of key influencers and distribution channels for cosmetics in China.

## Looking prettier: LGHH Revenue breakdown



## Operating Income breakdown



Source: Bloomberg.

China is now the epicentre of and global leader in social commerce. Best defined as a confluence of social media interaction amongst friends, influencers and fans, the growth in social commerce is impressive. This is enabled



by the large online platforms, online payment mechanisms and super-fast delivery infrastructure. The first wave of disruption in cosmetic retailing, shifted business away from physical department and speciality stores to online stores of Alibaba's Tmall, Jumei or JD.com. In the past year or so, companies such as Xiaohongshu (an unlisted social media and e-commerce platform) Bytedance (an unlisted operator of TikTok short video format) and IQiyi (a NASDAQ-listed video entertainment provider) are just three of several that have jumped into the fray of selling cosmetics and apparel. These companies are not retailers in the traditional sense; they are platforms for Key Opinion Leader (KOLs), referred to as influencers in the West. The platforms derive a percentage of revenues from any sale over their platform by influencers while also generating advertising revenues.

KOLs have fan followings that run into several thousands and some in the millions. Either they are celebrities in their own right or they provide advice on beauty and make-up. Not just content with making money from advertising revenues, KOLs either recommend brands/products or launch their own brands to sell to their fans. As a result, there is almost a seismic shift taking place, particularly at the mid-to-low end of the market, where customers are willing to accept newer products on the recommendation of KOLs.

LGHH has some luck on its side. Ever since they started the cosmetics and skin care business, they focused on the high end of the market. It is an uphill task to build a following for any brand, let alone a premium offering. However, that has helped them withstand many of these technology-enabled shifts in China. Its Korean competitor, Amorepacific, has suffered a severe slowdown in the past 2-3 years. Amorepacific was reliant on mid-to-low end brands – a strategy that seemed to work well until 2017 or so. As these social commerce-enabling platforms have gained prominence, there is a

proliferation of brands, especially at the low-to-mid price segment. Consumers are willing to spend a bit of money on experimenting, especially if their trusted celebrity or KOL assures them that she/he recommends it. At the premium end, tried and tested brands, especially foreign-owned brands from Estee Lauder, L'Oreal, Shiseido and LGHH continue to retain their hold. In an ever-changing market, it is prudent to assume this can change. LGHH is promoting two more brands that are currently small but still positioned as premium brands to cultivate options for growth. I do think that the premium end resonates differently than 'fast fashion' cosmetics or apparel. Perhaps not everything is susceptible to disruption by throwing money and promising convenience.

## JOHCM Asia Ex Japan Fund

### 5 year discrete performance (%)

#### Discrete 12-month performance to:

	30.04.2019	30.04.2018	30.04.2017	30.04.2016	30.04.2015
A USD Class	-8.07	6.30	21.59	-12.82	13.31
Benchmark	-4.04	23.94	21.18	-18.56	17.90
Relative return	-4.20	-14.23	0.34	7.06	-3.89

#### Past performance is no guarantee of future performance.

Source: JOHCM/MSCI Barra/Bloomberg, NAV of Share Class A in USD, net income reinvested, net of fees as at 30 April 2019. The A USD Class was launched on 30 September 2011. Benchmark: MSCI AC Asia ex Japan NR (12pm adjusted). Performance of other share classes may vary and is available on request.

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