Victoire

Alma Victoire Asia SMID Equity Fund

Quarterly Report - 3Q18

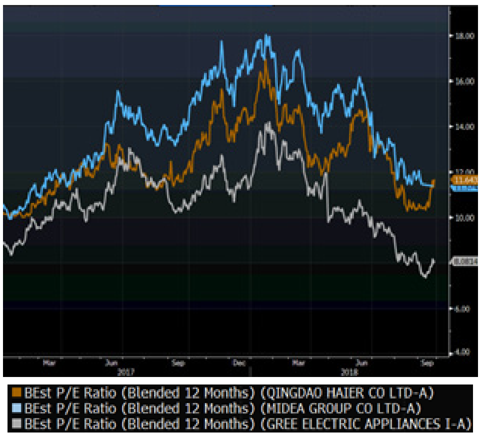
Chinese Home Appliances: Picking the Baby from the Bathwater

The property sector in China has been severely punished of late due to continued tightening measures by the government to curb prices: from tighter credit on developers to home purchase restrictions on buyers, and more recently, banning corporate purchases of residential properties and setting price caps on new homes. Consequently, Chinese real estate developers have corrected some 30-40% year-to-date, as investors flee the sector fearing an imminent and painful downturn. As fundamental long-term value investors, we have always been attuned to gaining exposure to the structural rise in Chinese consumption but struggled to reflect this on our Fund due to the high valuation that national brands historically commanded. And although larger real estate developers with national presence have often traded at deeply discounted valuations (4-6x P/Es), we have been reluctant to invest in them. This is because as prudent investors, we have never been able to get past the sector's aggressive leverage, heavy working capital burden and opaque accounting practices. However, with the recent sell-off in Chinese equities and especially in the Chinese developers, value started to emerge in some interesting pockets of consumption plays in China. With their fortunes perceived as being tied to home sales, Chinese appliance and home furnishing makers have been dragged down along with the real estate sector and have recently shown up in our stock selection screen.

Debunking the Myth

Seeing several of these branded appliance and home furnishing makers pop up in our screen immediately triggered our interest. Afterall, it is not often we find Chinese consumer companies with well-known national brands trading within our valuation parameters. They are direct beneficiaries of higher wage growth, upgrade from basic to higher valued-added features, and better design/aspiration demand of a large burgeoning Chinese middle class – effectively, long-term structural plays on Chinese consumption. Yet, the common market perception that these companies' sales are highly correlated to property sales resulted in a sharp selloff and de-rating of the sector recently.

12-Month Forward Price/Earnings Valuation:

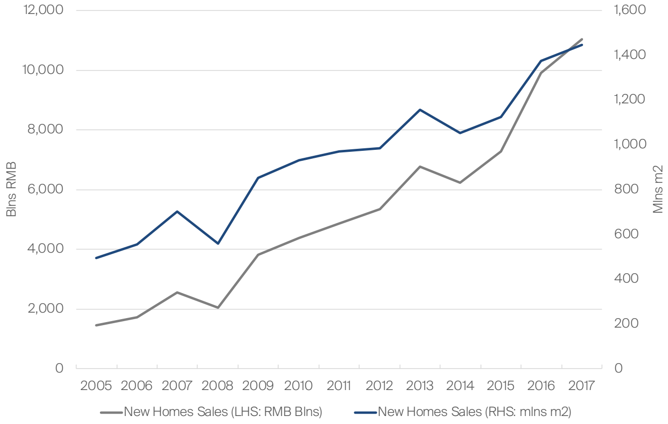


Source: Bloomberg

Victoire Asia Investments Limited
Suite 2006, Sunlight Tower
248 Queen's Road East
Wan Chai, Hong Kong
Phone: + 852 3116 6138
vair@victoireinvest.com
www.victoireinvest.com

With the new home sales in China reaching new historical highs, it is not hard to see the risk of being either at, or close to a cyclical peak, especially considering the current policy tightening measures.

New Homes Sales in China:



Source: National Bureau of Statistics

Admittedly, we recognize that there should be some linkage in demand for these products to new home sales, and that investors' fears are not entirely unjustified. But we would argue that the degree of such link is not as strong as it is generally perceived, given some local features of the Chinese property market and other drivers at play (i.e. product extension, increased penetration in less mature appliance categories, product functionality upgrades etc.). Historical growth patterns between new home vs appliance sales show that the link is not as strong as generally perceived:

Appliances vs New Home Sales in China:

Annual Growth Rates yoy growth	Appliances Sales RMB	New Homes Sales RMB	New Homes Volume Mlns m2
2009	27%	87%	53%
2010	53%	15%	9%
2011	19%	11%	4%
2012	-9%	10%	1%
2013	18%	27%	18%
2014	14%	-8%	-9%
2015	-16%	17%	7%
2016	3%	36%	22%
2017	48%	11%	5%
1H18	28%	15%	3%

Source: National Bureau of Statistics, Victoire Asia. Appliance sales calculated from aggregation of domestic sales of top 3 Chinese appliance brands (Haier, Midea and Gree which account for ~70-80% of market across major product categories).

We believe that the key to debunking the notion of high correlation between new homes and appliances sales is to recognize that a significant portion of new property unit sales in China is attributable to investments rather than genuine demand for new housing. The fluctuation in new home sales in a typical housing cycle is mostly attributable to the speculative (i.e. investments) rather than the non-speculative component of demand (i.e. real demand from new home formations, upgrades, structural urbanization etc.). We would argue that these non-speculative/real demands mentioned are

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more stable and sustainable. In China, it is primarily this non-speculative portion of new housing units that supports the current sales base of the appliances industry, since most units sold for investment purposes are customarily delivered, kept in bare shell format and not fitted with appliances and home furnishings.

Now, what constitutes investment vs real demand for new homes? Such information is nearly impossible to quantify, but there are a few reference points we can anchor our analysis on to determine a proxy for real vs speculative demand. Considering the current annual volume of new home sales is estimated at around 14 million units:

- This represent about 1% of the population, twice of China's low annual population growth rate of 0.5%.

- This figure is about 25% higher than the approximately 11 million first-time marriages registered annually (basis for new home formation).

- The full paid property purchases is estimated to be around 25% of volume, this should be a good proxy for investment demand, as second home leverage restrictions and current credit tightening measures have made it increasingly difficult for most individuals to speculate.

While the current level of residential new home sales is well above level supported by real demand, it is not a given that an imminent property market correction is upon us. Some analysts and most developers continue to make positive cases for the sector, arguing that despite this seemingly high volume of new home sales, total demand (investment + new home formation) is well supported and currently outstrips supply. The argument is that developers have purposefully curbed supply by rationing their landbanks in hope of gaining better margin in the future. On the pricing front, they make the case that the current "reported" market prices understate the true market prices, as many secondary home transaction prices are under-reported to the local government to appear that the price curb measures are working. Regardless whether the property market will stay robust or about to enter a downturn, any eventual downward correction should be mostly borne by investment demand. Hence any downward pressure on home appliances and furnishing industry should be limited, considering the demand drivers for these products should remain well supported by more resilient real housing demand.

Another margin of safety to consider is that whilst reported contracted sales have grown considerably over recent years, actual housing units delivered have been rather stagnant. The result is an increasing gap in units sold vs delivered as illustrated below.

Growing Divergence in Contracted vs Completed Units:

	FY2006	FY2007	FY2008	FY2009	FY2010	FY2011
Contracted Sales Volume (mlns m2)	554	701	559	853	931	970
Growth %, YoY	*12%*	*27%*	*-20%*	*53%*	*9%*	*4%*
GFA Completed (mlns m2)	455	498	477	577	612	717
Growth %, YoY	*4%*	*10%*	*-4%*	*21%*	*6%*	*17%*

	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017
Contracted Sales Volume (mlns m2)	985	1,157	1,052	1,124	1,375	1,448
Growth %, YoY	*99%*	*18%*	*-9%*	*7%*	*22%*	*5%*
GFA Completed (mlns m2)	790	787	809	738	772	718
Growth %, YoY	*81%*	*0%*	*3%*	*-9%*	*5%*	*-7%*

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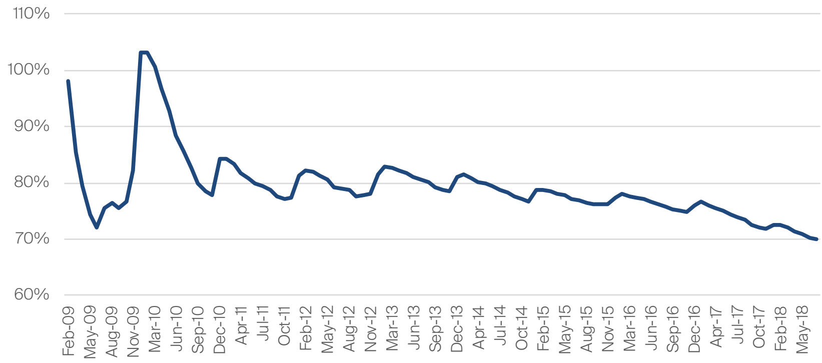
Cumulative Contracted vs Completed Units:



Source: National Bureau of Statistics, Victoire Asia. Cumulative contracted over completed units, both measured in gross floor area (m2). Contracted units led by 12-months.

In the worst case, we can read this delay in completion as a sign that developers, with their leveraged balance sheets and facing tighter liquidity conditions, may be struggling to deliver previously sold units. The silver lining is that unless we see significant rise in default from buyers (unlikely given the restrictive loan-to-value of 70% for mortgages in China), delivered units should rise in the next few years even if contract sales stagnate, thus providing further support for appliances and home furnishing demand.

The Case for Chinese Home Appliances

We see many positives in our thesis for these Chinese home appliance makers. First, the market has already priced in an imminent downturn in the property market, hence significantly de-rated the home appliances industry to valuations that we now find attractive. Secondly, even if the scenario of a housing market downturn materializes, we see most of the downside risk tied to housing units sold for investment purposes, which should have limited consequences to the demand for home appliances. Interestingly, in a housing market downturn, price correction typically acts as a deterrent to investment demand while providing an element of support and stimulus to real demand. This is also well aligned with the direction and objective of policy makers, who want to see a stabilization or gradual decline in property prices to improve affordability of housing for the social benefit of the masses. Finally, there is the fact that when we invest in appliance makers, we undertake an exposure to businesses that are inherently safer due to their more stable cashflow/earnings profile, healthier working capital dynamics, more transparent financials and stronger balance sheets.

Out of the few consumer names captured by our screen, only 3 appliance makers (Midea, Gree, Hangzhou Robam) and 1 custom home furnishing manufacturer (Suofeiya) proved to be interesting enough to warrant further research and due diligence. Upon concluding our researches, we opted to establish positions only in Midea and Hangzhou Robam, as they offered the best combination of valuation and earnings growth dynamics, as well as other qualitative considerations such as well-known brand equity, strong market share positions in their respective products and well-positioned for upgrade trends. We passed on Gree and Suofeiya. On Gree, we could not gain comfort over an unresolved conflict of interest risk with its CEO after her initial but failed attempt to get Gree to takeover an EV battery company (Gree's board did not approve the transaction). We suspect she pledged

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her holdings in Gree and invested in the loan proceeds in the EV battery company. Suofeiya, despite being an excellent and extremely profitable business, is still heavily dependent on the primary property market (i.e. fitting and furnishing of new homes). We see the risk that this market may be structurally challenged on its current high margin, as property developers in China increasingly look to boost their own margins by offering fully furnished units. Finally, from a portfolio risk management perspective, there was an explicit consideration on limiting exposure of highly correlated names under the same thematic drivers.

In conclusion, while property developers are subject to real estate investment demand, which can be highly volatile, home appliances makers enjoy a more stable and sustainable demand from new home formation. In addition, those with stronger brands can further boost growth through increased penetration in certain less mature product lines (i.e. air conditioners, air purifiers, home filtration systems etc.), also by market share gains, achieving higher ASP from product upgrades/innovation and extending their product portfolios. Given the superior characteristics of these strong national brands that arguably can be sustained for generations, leading appliance brands in China have historically been traded at high multiples and at a considerable premium to the market. With their current valuations being dragged down by concerns in the property market, we see this as a great opportunity to invest in these businesses for the long-term.

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