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October 30, 2014

Unilever China

Are Weak Earnings Systemic or Company Specific?

Unilever China's Earnings Drop - Is this a Unilever or China Problem?

What caused Unilever's 20% drop in third quarter earnings in China? Is this a systemic problem or another example of weak execution by multinationals in China?

When Unilever said sales fell 20% in the third quarter, it blamed a slowdown in emerging markets, particularly China. The news was a shock as it followed double digit growth in 2013 and seemed to highlight a problem for multinationals – consumer and other – in China.

In its statement, Unilever blamed "de-stocking." "Emerging market growth remained weak with flat volumes. Within this there was a sharp slow-down in China. In China the impact of the sharp market slow-down has led to trade de-stocking across the distribution channels. This resulted in a decline in our underlying sales of around (20)%," the company said. But Unilever's statement didn't really address the causes for the slowdown apart from pointing its finger at the economy.

The reasons for the decline may be more complicated than simply a slowing economy. In general, we believe foreign multinationals are currently faced with four reasons for what appears to be widespread earnings declines:

1. **The economy.**

2. **Weak multinational execution.**

3. **Rising domestic competition.**

4. **Subtle anti-foreign attitudes.**

Economy. This is the most obvious reason given the continued slowdown in GDP growth. The new normal (according to the PBOC's chief economist) is now 7.3%, down from 7.5% just earlier this year. Nationally, FMCG growth recovered to 6.9% in the third quarter, higher than both Q2 (4.7%) and Q1 (4.6%,) a promising rebound in the second half of the year, according to a survey by Kantar Worldwide. But retail sales have steadily fallen month-on-month from 12.5% in May to 11.6% in September. This compares with 13.3% growth in September 2013.

Multinationals' Surprisingly Weak Sales in China. The second– and perhaps larger reason – is weak execution in China by the multinationals. Recent sales numbers (first half or third quarter) were weaker than in earlier periods. But they still varied quite widely, suggesting that multinational consumer success in China is a function of both execution and general economic growth.

For example, Honda its sales forecast for China by 100,000 vehicles due to slowing growth.

Samsonite, whose China sales account for 10% of the total, posted first half sales growth there of 8.1%. Richemont's Asia/Pacific sales rose 36% (no breakdown for China), lower than earlier periods. The company blamed a weak performance by the Cartier watch brand, which suffered from low demand and overstocked retailers particularly in the Asia Pacific region where Richemont earns 40% of its sales. Sales were lower in Hong Kong, Macau and mainland China, Richemont said. Even Procter & Gamble, where emerging markets account for 39% of revenue, said global third-quarter sales were up a relatively lackluster 2%, although there was no China breakdown. Nestle admitted in its first half results that "China is challenged but fundamentals are improving."

Burberry's growth has slowed in China but remains strong, rising 20% but down from the previous 30% growth. "In Q2 we still saw high single digit (sales) growth in Asia, and from the Chinese, in China and when they were traveling," said CEO Angela Ahrendts."We still saw good growth from (the) Chinese. It just wasn't double digit as it had been in previous quarters. We believe that will probably be outperformance compared to our peers."

Walmart's China sales in the second quarter of this year grew 1.1 percent, but same-store sales, a key figure of revenue from stores open at least a year, fell 1.6 percent. David Cheesewright, who heads the international division at Walmart, acknowledged at its recent investor conference that China remained tough even after 17 years.

How are the domestic consumer brands doing? Also mixed to down. Hop Hing Group, which sells Dairy Queen and Japanese noodles in northern China, reported a reasonable 5.6% first half revenue growth. During the "Golden Week" holiday in October, sales to Mainland Chinese tourists in Hong Kong remained unchanged as the number of transactions attributable to them increased by over 10% and was offset by a drop of over 10 per cent in their average spending. The results may have been skewed by the Hong Kong demonstrations. Fast foods company Tsing Yi (322 HK) reported a 2% drop in Q2 sales.

Domestic consumer companies overall appear to have miscalculated growth. The average inventory days among consumer products companies listed in Shanghai now stands at 200 for beverages, nearly 900 for spirits, and close to 600 for retailers.

Do Multinationals "Get" China? As important as a slowing economy, there have been significant execution problems by the multinationals. Let's look at Uniliver Unilever, in May this year, launched its Lifebuoy soap, whose main competitor is Safeguard in P&G and Dettol, made by RB Plc of the U.K. This was Lifebuoy's second attempt to enter the Chinese personal care market. The second time around, at the start of 2014 Unilever invested a huge amount of money in online and offline promotion, as well as channel promotion.

The relaunch failed for two reasons. First, the FDA said that the chemical component Triclosan involved in the common antibiosis products may have potential harm to hormone secretion. FDA also managed to stop any personal care involving Triclosan from further sales. Lifebuoy had to modified its ingredients just one month after entering China, which was in June this year. The concerns and potential further regulation may account for part of the sales drop. Second, P&G launched a series of promotions in personal care products right before the launch of Lifebuoy, which provided additional pressure on Unilever's sales.

Domestic Competitors Gaining Share. Another factor that has contributed to the lackluster China results for the multinationals is growing market share and aggressive price-cutting by domestic competitors. Some of this may reflect the slower economy. But some is a rising sophistication among domestic brands. One prime example is the Xiaomi mobile phone company. Samsung has lost its lead as the top mobile phone brand to Xiaomi, which has been willing to accept thin margins on the hope of selling services in the future. In reaction, Samsung is expected to cut its prices by 20%, according to the Wall Street Journal.

Another example is Whirlpool. It bought a majority stake in a former Sanyo joint venture with a domestic manufacturer, Hefei. However, this aggressive expansion by Whirlpool into the Chinese market comes just as retail sales slow and domestic competitors are cutting prices. Competitors Gree and Medea are both reducing prices by up to 20%. Multinationals are scrambling to grow sales and margins at a time when domestic competitors are fighting for share.

Anti-foreign Attitudes. This more difficult to prove. A survey by the American Chamber of Commerce in Beijing accused Chinese anti-monopoly regulators of targeting foreign companies while turning a blind eye to state-owned enterprises. Antitrust laws enacted six years ago to ensure healthy competition in the Chinese market are conversely being used to concentrate power in state enterprise. The legislation gives the nation's "administrative monopolies" a "privileged role," said the chamber, which serves as a nongovernmental organization representing U.S. business interests.

These accusations pertain mainly to the large state companies – such as China Mobile and the energy companies – that were selected by Beijing under the previous administration to become dominant in their selected industries. These industries include energy, telecommunications and banking. The point is elaborated in the book "No Ancient Wisdom" by former Amcham China Chairman James Mcgregor, who argues that state capitalism is hurting foreign companies. China has lodged high profile allegations against western companies such as Microsoft and pharmaceutical firm GSK. These ostensibly have an economic purpose but may reflect a subtle form of economic nationalism.

The consumer area has been relatively untouched by Beijing's dominance, mainly because consumer companies have fewer employees than a capital intensive industrial company. However, although Beijing may keep its distance at times, local Provincial governments often support their state favorites over other provinces and foreign multinationals. One example cited in the book "Beyond the Middle Kingdom" by academic Scott Kennedy, is the auto industry. Geely Auto, for example, is headquartered in Hangzhou, Zhejiang Province, and receives favorable treatment from its home Province against multinationals, many of whom have yet to turn a profit in China. Tesla, as another example, faces opposition in China against start up electric auto companies backed by Provincial governments, which have completely separate policies from Beijing.

Conclusion. Slower economic growth, and tightened fiscal Provincial revenue, may reduce local subsidies for auto and other companies, making the competitive environment more hospitable for multinationals. Nonetheless, the key point is that execution – along with demographics and economic factors – must be taken into account when analyzing the strategy of global multinationals fighting for market share and profits in China.

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