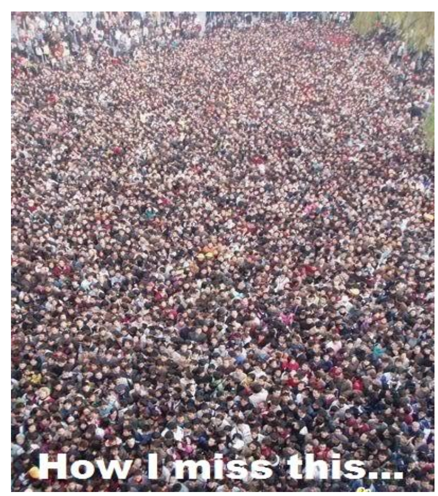
<u>**Emerging Markets Illustrated**</u> October 11, 2013

Jamie Dimon has warned investors and employees alike at JPM that the bank, after handing over $920,000 to settle the "London Whale" hedging case may be liable for another $11 bn in fines. He is understandably a bit busy now negotiating with the **US Attorney General, the Justice Department, the SEC, the NY Attorney General** and even **the Department of Housing and Urban Development**. He is not alone. Everyone in banking is firmly living in an era of the back office taking over the front office while litigation and compliance costs continue to rise. A falling tide imperils all boats and I have also been instructed that the format of *Emerging Markets Illustrated* must move with the grim times. Henceforth, EMI will appear in email format with a new disclaimer. (The twisted content, however, will remain unchanged).

Ruminations

China's "Golden Week" passed in a thick brown haze without much incident. It is interesting to see how far and wide China's new found influence is spreading as the US gov't has apparently decided to adopt the same holiday. The major difference is here in the US, of course, only gov't employees get the holiday. The rest of us have to work. Markets are understandably nervous as the idiocy in Washington represented by the Republican Party and their shadowy moneyed supporters destroy any vestiges of support that party once held with thinking hominoids. There will be no "default" and anything to the contrary is just noise. I see the whole thing as an embarrassing buying opportunity if markets falter here.



It is Nobel Prize season, the only time of year people look up "**Sweden**" on a map. If you glance at historical Nobel Prize winners, for its population China is severely underrepresented. I think this may change as news brought to me by the always funky SCMP proclaims "*Sprite is the best cure for a hangover, Chinese researchers claim*." Apparently, the scientists analyzed 57 different non-alcoholic drinks to learn how they affect the production of an enzyme called ALDH, which is responsible for breaking down the alcohol in the body into harmless substances. They found some herbal teas, especially those with hemp seeds, actually prolong a hangover! Stay away from that. More intriguingly, it was discovered that the liquid chemical dump known as “Sprite”, or “Xue Bi” in Chinese and manufactured by the Coca-Cola Company actually stimulates ALDH production.

I remember once at a particular forum asking globe-trotting chef and gonzo food critic, **Anthony Bourdain**, “*What’s the best cure for a hangover?*” His answer: “*Do ya really want to know? Two joints and a Coke*.” Well, he was close. China’s scientists will have the final say and Nobel nominations will be sure to follow.

Alibaba is creating a new retail landscape in China and altering how brands position themselves in that fast changing market. We will look at an example of this below but first the upcoming Alibaba IPO will not only be very interesting for what it reveals about the company itself but the ironies already apparent in their chosen listing destination. While democracy is non-existent in China and only a watered-down version is mouthed in Hong Kong it is Hong Kong, rather than that “bastion of democracy” the US, where “one share one vote” is practiced. Jack Ma is keen to sell shares but won’t let go of control and he has been sent packing. All this despite a potential valuation of $60 bn and the fact Alibaba would have been the largest IPO in HK since **AIA** in 2010. So far this year IPOs in HK have raised $7.9 bn, just ahead of the $7.3 bn raised in Sao Paulo. A hot IPO is sorely needed in HK to rekindle animal spirits in the market but **Charles Li**, head of the HKSE and the SAR’s gallant guardian of governance, has quite rightly decided not to pimp standards by taking the long view of building HK into a respectable and world class market. It wasn’t that long ago in Hong Kong that insider trading was not even illegal. Hats off to Mr. Li despite all the predictable local flak he has been taking.

Research

"(In Napoli where love is king
When boy meets girls here's what they say),
When the moon hits your eye
Like a big pizza pie, that's amore
When the world seems to shine
Like you've had too much wine, that's amore."

– **Dean Martin**

You see an attractive woman, tastefully attired at a party wearing just the right amount of makeup; not too much and not too little. Everyone is ignoring her. You move in.

This is a similar story. Here we have the dominant cosmetics brand in Korea with a **durable competitive advantage**, which is still taking local market share and now entering China in a big way, selling at record low valuations after being sold off 27% this year on what appears to me to be a genuinely solvable issue.

Amorepacific (090430 KS), Korea's number-one cosmetics company is a $5 bn market cap company that trades US$11 mn a day; a solid, liquid, mid-cap company not without some quiet charm.

Durable Competitive Advantage:

Amore has the highest gross margins of any mid-size to large cap company in Korea. Amore's GMs of 71% dwarf those of competitor **LGH&H (051900 KS)** at 53%. Net income growth has averaged 9% over the last five years. Those spectacular margins and the steady growth Amorepacific enjoys has led to the company's 35% market share in the domestic cosmetic and skin care market.

Amore is also consistently the most profitable and the clear leader among the other girls at the ball. Pre-tax income has grown at a 28% CAGR over the last 5 years. Free cash flow is always positive and the company has zero debt. They don't need debt and are self-financing.

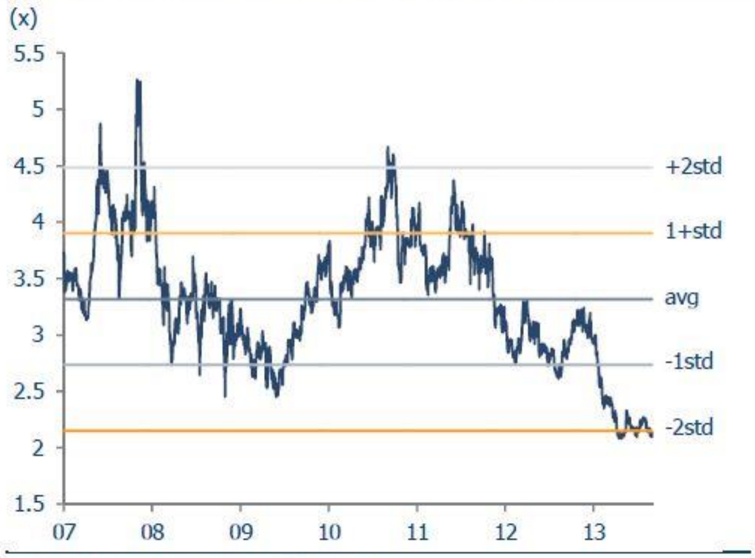
Pure retained earnings have been growing at an amazing 75% CAGR over the last five years and book value per share continues to grow at 20% CAGR. Clearly, the company is doing something right and consistently grows value for shareholders.

Historical Low Valuation:

Of the 32 analysts who follow the stock, 25% have a Hold rec and two have an actual Sell rec, which is amazing for a Korean company as bad news and bad views are not tolerated well there.

While analyst **Yumi Park** has a Hold rec on the stock in her report, "*Waiting for the Right Entry Point*" (here) she writes, "*Based on a P/B valuation, Amorepacific looks cheap, trading at a 12M P/B of 2.2X, the historical bottom valuation*."

Figure 6 Amorepacific's 12-month forward P/B



Source: Datastream, Mirae Asset Research

This is two standard deviations below historical average for the stock *and* is happening while the Bloomberg peer index is trading at a one standard deviation *above* its historical range.

Figure 8 Bloomberg World Cosmetics & Personal care Index 12-month forward P/B

Source: Bloomberg, Mirae Asset Research

The divergence is clear but will it continue? <u>I think not for the following reasons</u>.

Amorepacific is a strong brand and is the clear industry leader. I would not underestimate brand loyalty and I know I don't change my cosmetic preferences easily (soap and a towel). Customer preference and loyalty to the brand will continue to provide momentum while the company sorts out its current solvable problem.

That problem is domestic consumers have been trading down during a period of slow economic growth. Also, 30% of cosmetics sales (which are 85% of total revenues) are derived from pesky door-to-door (D2D) saleswomen pushing creams and lotions onto harried Korean housewives. This sales channel has been eroding as more consumers shop at department stores and on the internet.

However, outside of D2D Amore continues to enjoy sales growth that is outperforming the market, ie, they are still taking market share. Despite lackluster department store numbers overall in Korea, Amore has been gaining market share in that channel (18% Q313 vs. 16% Q212). Duty-free store sales and online and specialty store sales are also doing well. JPM estimates specialty store OPM will jump to 11.5% this year vs. just 9% last year due to strong growth and better product mix.

The company also has plans to reverse sales declines in the D2D business by expanding the range of lower price point products and adding health supplements to the mix. Amore will also launch a new brand exclusively designed for the D2D channel next year.

Amore uses its high end brand “**Sulwhasoo**” with a focus on traditional organic herbal cosmetics to penetrate foreign markets. The company has even opened the **Amorepacific Spa** in trendy Soho (NYC) where, I am told, I can get a full “**Brazilian Bikini Wax Service**” for 75 bucks. Hmmm. No thanks.

The China Angle

Another reason to take a long-term positive view of Amore’s outlook is China. Women in China value healthy looking skin almost as much as a wealthy husband and Amorepacific’s sales there are growing at 30% pa. Analyst Yumi Park forecasts the overseas operation while loss making now will break even this year. China generates over 60% of overseas sales and growth is expected to continue at a 30% CAGR.

According to Euromonitor, the skincare portion of cosmetics accounts for 40% of China’s total cosmetic market and is growing at 13% CAGR while in Korea market growth is slower – but still exceeds that of GDP – at 5.5%. As of 2Q, Amore operated almost 4,200 sales counters in China and spends 30% of sales there on AP, vs. just 12% in Korea. This is to be expected as the company builds its brand in the world’s largest cosmetic market.

The China Strategy

China, as any three-year old knows, is not an easy place to do business. Labor costs have shot up and competition is fierce. What is Amorepacific’s strategy in China and how are they doing compared to the competition?

Actually, they seem to be doing really well as a look at their brand positioning on the internet reveals. Soon-to-list Alibaba is the dominant B2C player in China and owns the ubiquitous “TMall” consumer internet site. Multinationals have found TMall a good platform to penetrate logistically tricky 3rd and 4th tier cities in China and it is estimated sales on TMall are growing at 70% pa. As retail in China is extremely fragmented and few players have reached national scale, many brands are finding it easier to just go directly to the consumer and TMall allows them to do this.

Both Amorepacific’s *Laneige* and LG H&H’s *Face Shop* have their own TMall sites. However, Amorepacific’s site garners the highest rankings and sits on the top page:

October 1st – Cosmetics hits top page of TMALL, with Amorepacific’s Laneige getting good exposure

Source: Alibaba/CLSA

Recognizing that China is the land of fakes and probably the first country to even have fake pilots, Amorepacific is tackling the counterfeit threat head on with a specific education campaign: “NO NO NO!”

Source: Alibaba/CLSA

Mirae earnings forecast for Amorepacific is for 9% sales growth and flat OP FY13 and for 10% revenue CAGR for the period of FY12-15. JPM estimates a 1% change in domestic cosmetic sales equates to a 7.5% change in EPS. Any improvement in the D2D channel with new product release not far away will have an immediate impact on earnings and expectations.

Q3 results are to be announced November 14. Also to be announced are conclusions and strategy going forward to address and fix current issues. I would expect some good news here and investor sentiment to improve in the run-up to the meeting.

The time to buy a blue chip industry leader is when they stumble and are facing an issue that is fixable. If the stock is also trading at a record low valuation then downside is even more protected.

My view: now is the time to accumulate Amorepacific, a damsel in distress but still the prettiest girl at the dance, a fallen star before the rebound.

The Last Page

I found this on Craigslist:

LARGE HOUSE! LOTS OF ROOM! RECENTLY OPEN!

So my roommates all left because of a job thing and I need to make rent. I really think this place is great and I've been living here for a while (incumbency FTW!). I don't want to leave but the utilities are a real b!tch to afford on your own. Some facts about the digs:

It's about 775,000 square feet. Yeah, it's big, I know. But don't let the size alone fool you! It's cozy too--lots of individual rooms!

Location, location, location. It's close to everything you could possibly want. The Botanical Gardens (they're temporarily closed, but don't let that stop you); the metro, and plenty of bars. The bars are important, because what else are we gonna do?

It's historic too! It was built in like 1800 something. Don't ask me the specifics, there's a plaque somewhere. Let's just say it's pretty sweet. There are plenty of cool things inside, like a giant statue of King Kamehameha I. It makes for weird midnight runs to the bathroom, but whatever.

Wanna know more just ask!

About you: Must be LGBT friendly. Must not be a Republican. Don't be racist. Don't hate women. Must think poor Americans are people.

- *cats are OK - purrr*
- *dogs are OK - wooof*
- *Location: Capitol Hill*
- *it's NOT ok to contact this poster with services or other commercial interests*

Cheers.

Derek Hillen, CAIA
Mirae Asset Securities

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