

JESA INVESTMENT & MANAGEMENT CO. LTD.

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NEWS FROM JESA! China can build Rome in two weeks

By Saro Capozzoli, Founder and GM of JESA Investment & Management Co., Ltd

Anyone who visited Shanghai in different times has surely noted the fast growing rate of building construction and infrastructure development. It is not a news the concern, luckily far from being a reality, about a Dubai-style real estate bubble. An evaluation of Economist Intelligence Unit applies models of population and incomes in China's cities to prove the demand for housing in the next decade, which is growing so quickly that of course a correction in the next years will be anyway short-lived. What is astonishing about the evaluation is that **China**, at the current rate of construction, **can build a city of the size of Rome in only two weeks**.

The development is also pushed by the trend, supported by local regulations, to replace buildings dated back to 1950s and 1990s with new ones in compliance with local safety and energy consumption needs.

These are factors that play against an imminent bubble. China's urban population will continue to grow till 2039 (between 2011 and 2020 will increase 26.1%); urban disposable income in the same period is expected to reach about 7.500

USD; residential floor per head has doubled in the last 10 years and will increase from 30 sqm in 2008 to 41 sqm by 2020 (already high for international standard considering the level of income).

This housing boom, with a faster pace in the West regions brings many opportunities for investors in different sectors such as building materials, furniture, cars (home owners in more affordable satellite towns rely more on cars as mean of transportation), whose cumulative value is expected to reach RMB 75 trillion within 2020. This trend will also affect the demand of steel and energy (about 40%), putting increasing pressure on global markets.

ITALIAN VERSION

Chiunque abbia visitato Shanghai in tempi diversi ha sicuramente notato la velocità di sviluppo e costruzione delle infrastrutture e dei palazzi. Non sono certo una novità le preoccupazioni, fortunatamente infondate, di una bolla speculativa stile Dubai. Una valutazione dell' Economist Intelligence Unit applica modelli relativi alla popolazione e al reddito nelle città cinesi per confermare la domanda immobiliare nei prossimi 10 anni, la cui crescita attuale subirà, sì correzioni nei prossimi anni, ma di breve durata.

Quello che è impressionante della valutazione è che **la Cina**, all'attuale velocità di costruzione, è **in grado di costruire una città delle dimensioni di Roma in due settimane**. Questo trend di sviluppo è spinto anche dalla necessità (supportata da leggi locali) di sostituire palazzi risalenti al periodo dagli Anni '50 agli anni '90, con edifici che rispettino le norme di sicurezza e risparmio energetico. I seguenti fattori giocano contro ad una imminente bolla. La popolazione urbana è in continuo aumento fino al 2039 (tra 2011 e 2020 crescerà del 26.1%); il reddito medio della popolazione urbana raggiungerà circa 7500 USD; la superficie residenziale pro-capite si è duplicata negli ultimi 10 anni e aumenterà da 30 mq a 41 mq entro il 2020 (valori alti per la media internazionale se comparati al reddito pro-capite).

Questo boom immobiliare, che ha una crescita più veloce nelle province occidentali, rappresenta molte opportunità per gli investitori di diversi settori quali materiali edili, arredamento, auto (proprietari di immobili in insediamenti urbani limitrofi alle grandi città utilizzeranno prevalentemente auto come mezzo di trasporto), il cui valore atteso raggiungerà i 75 trillioni di RMB entro il 2020. Tale trend influenzerà anche la domanda di acciaio ed energia (circa del 40%).

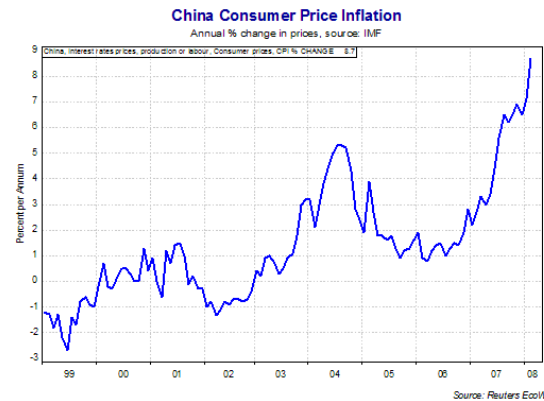
Inflation: the main problem in actual Chinese economy

Chinese economy is often hit by inflation: during the Mao Zedong period was caused by the lack of goods inside the economic planning, called economic decline inflation; also after 80's with the public reforms, inflation has shown itself as problem.

Without exception, all inflation is due to the fact that there is more currency in the market than they're worth the goods. The market, therefore, automatically scales in the relationship between the two to create the aggregate value of money, which thus equals the total value of goods. This means that the price of goods increases. If we want to expose this theory with less technical words we can say: "When there's so little money and goods, the goods become more expensive". It's the typical Keynesian mechanism.

Thanks to policies of openness in place since 1979, multinational corporations have invested heavily in China in the nineties, attracted by the rapid industrial growth and cost-competitive workforce. China is now the first country in the world as recipient of foreign direct investments:

more than half of the 500 largest companies in the world are present in the Pearl River Delta. Chinese participation in international trade increases every year: in 2003 the volume of commercial transactions was about U.S. \$ 851.2 billion.



Producer prices has increased by 7,2 % in 2010. It was the strongest increase since September 2008. The Chinese government has tried to increase the interest rate and raise the minimum reserve to face this problem: Bank of China has in fact the intention to bring lending rates and deposit on a year to to 5.81 and 2.75 per cent. Over the same period the previous year's foreign investments have risen to the equivalent of 6.9 billion dollars, making totalizing in the first two months of 2008, an increase of 75% to 18.1 billion dollars.

Foreign direct investments in China in February showed an increase of 38%, fuelling concerns about the growth of liquidity and inflation. This move, unfortunately, has not had desired effects, in fact Zhōngguó Rénmín Yínháng (The central Bank of China) has been forced to grant loans for over than 7950 billion Yuan, more the expected sum of 7500 that the Chinese Government has planned. In 2010 in stem to face Real estate speculation and counter the inflation, The People's Bank of China raised 3 times its base rate using a monetary tightening by raising in arc of 2010, six times the ratio of reserve requirements. Obviously that impact was not the expected, in fact the biggest problem remained intact, which is too high a flow of investment, especially in real estate, where speculation is now skyrocketing.

Monetary reserves continue to raise reaching the amount of 2850 billion USD and this worries US government, since most part of this reserves are held in \$, representing a big slice of the entire American public debt. Also the part of European public debt is raising. According to current estimations China detains about 7,3 % of the European public debt, about 600 billion €, including Spanish public debt bought with the intention of help distressed Countries.

To avoid raising in real estate market Chinese Government tried to introduce a luxury real estate duty but all without effects.

Nowadays the main problem is not that Chinese economy is not able to produce goods, the main problem is that most of the **goods** producers are exporting to Europe or USA, so there is a mismatching between the internal demand and the increase in investments (**money**), attracted by the low costs and the policy of Chinese Government.

Everyone says that China is the world's factory, but its capacity is not addressed to the internal market. On the contrary, pointing to the richer Western markets. If we measure it for its domestic market, we can say that China simply has too much surplus production. This allow a small minority of population to gain ever greater prosperity using low-cost labour in China and approach high-income markets of the West to secure huge profits.

A really big part of Yuan on the domestic market is used to buy foreign currency, and this makes the Chinese reserves of foreign currency the largest in the world. Surplus money is also used to buy assets such as real estate to preserve the value of purchase, and this brings back money to

the domestic money market. So while the real purchasing power of money is lost, the money stays within the country. This accounts for the potential, and growing inflation.

First of all China must stimulate the internal demand trying to reduce the mismatching between different social classes and increase the power of purchase of the biggest part of population with the intent of reduce difference between goods and money. In fact as is showed in the following table China's GDP is about 10% of Italian's one and half of Malaysian's one.

**GROSS DOMESTIC PRODUCT PER PERSON
IN 2009 (in €)**

Luxemburg	105.918
Italy	35.435
USA	45.934
France	42.413
Malaysia	6.950
China	3.735

Source: International Monetary Fund, World Economic Outlook Database, October 2010

In a situation like this, the government should use the foreign currency that has to absorb the excess Yuan, as it should try to soften the

restrictions imposed on foreign goods seeking to enter China. The only right way to solve the problem of inflation is to reduce the movement of the Yuan and to support the flow of external goods. Instead, the Chinese government is doing exactly the opposite. It does not allow a free exchange of foreign currency and softens the restrictions imposed on foreign goods that want to enter China. In this way, most of the products of foreign companies in the country will have no market, or are faced with an already glutted market.

Only departing from this China will be able to solve the problem.

Chinese Luxury Market: how to ride the new trends.

For all the international luxury firms China has nowadays an allure more powerful than ever in the past.

The first reason is for sure the double-digit economic growth, which is gradually encouraging consumers to move away from the saving culture of older generations and "enjoy life today", pushing up the demand for pricey prod-

ucts. Indeed, according to Goldman Sachs' prediction, China's consumption of luxury goods and services will account by 2015 for more than 20 percent of a global market worth totally more than US\$ 80 billion a year, overtaking in value the US and second only to Japan.

Secondly, it's remarkable the apparent stability of this growth rate. Even during the financial crisis in 2009, sales of luxury goods rose by 16 percent, of course down from the 20 percent growth of previous years, but far better than the performance noticed in the others major luxury markets.

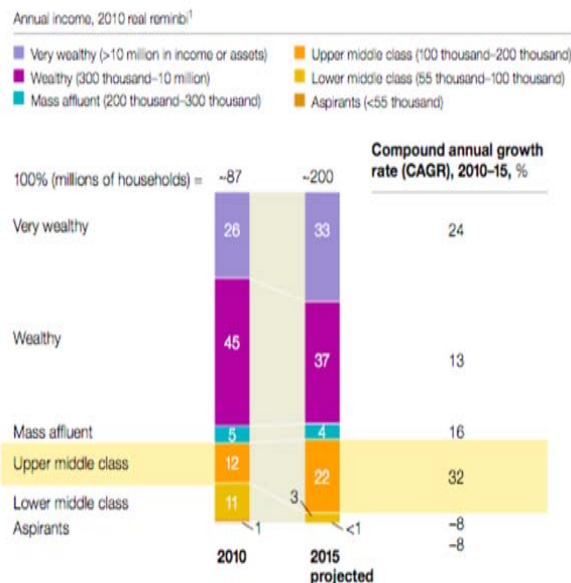
Furthermore Italian brands are particularly well placed to benefit from this expansion, as the "Made in Italy" label holds great cachet among China's burgeoning middle class.

Despite this euphoric climate the situation is rapidly evolving and new important dynamics and challenges must be taken into account in order to avoid risky scenarios.

A recent McKinsey's research shows that while wealthy and very wealthy households (with annual income higher than 300,000 renminbi) in the next five years will continue to be the major consumer of luxury products, China's upper middle class (annual income between 100,000

and 200,000 renminbi) will be the biggest new opportunity.

Share of luxury-goods consumption in China by household income, %



¹In Dec 2010, 1 renminbi = \$0.15.

In fact its number is expected to grow of almost six times, from 13 million in 2010 to 76 in 2015, with a overall share of 22% on the whole market. Besides this remarkable shift in the target customer for future luxury products, it is perceptible also a change in the kind of belonging that will be the new "object of desire" for Chinese customers. Interest is moving beyond handbags, je-

welry, fashion and following the European trend, it will involve higher spending on luxury services and experiences, like spa or expensive wellness activities.

Another important dynamic is related to the level of sophistication of Chinese customers. Thanks to access to the Internet and foreign media, increased freedom to travel and the experience of overseas education, they have become more discerning and savvy about the relationship between quality and price. In 2008 only two of five people in China realized that in the mainland prices were at least 20 percent higher than they were for example in Hong Kong. By 2010, 66 percent did.

The last factor concerns the results of the old battle that international luxury companies have been fighting against counterfeit goods in China. The mainland's desire for status has always been the drive factor for the luxury market.

"In China you wear wealth on your sleeve", said Chadha and Husband, authors of "The cult of luxury brand". Indeed the tradition of *guanxi* is the single biggest factor spurring the growth of luxury in China, still according to the authors. Besides these certainties, researches show that

consumers increasingly want the real thing, mainly because they felt sure that their friends would spot a counterfeit.

In this evolving landscape luxury-goods companies must take care of these dynamics, in order to fully understand the direction in which the market is moving.

The "land rush" to establish luxury stores in China has been remarkably intense in the past years, with a sharp expansion rate. The reason is that in the luxury category, early entry does seem to provide huge benefits. For top fashion brands, entering in advance in the market means creating a highly loyal customer base, who returns to the stores an average of nine times per year.

Louis Vuitton, consistently rated Asia's favorite brand, is a perceptual example of this phenomenon. The French brand was a first mover, opening its first point of sale in China in 1992, and it has been profitable from its first year, with annual growth of almost 50 percent.

Nevertheless the land rush in China's luxury market is coming to an end. Competition is becoming much more intense and companies need smart decisions in their pursuit of brand leadership. We have identified two main success

factors, critical in order to success in the future Chinese luxury market.

The first one is the **level of service**. According to a recent opinion pool, two out of three consumers are disappointed with the indifferent attitudes of salespeople. Many Chinese tourists spend more on luxury items in a single trip to Hong Kong than they do in an entire year in the mainland. It's not just price that drives these purchases, in fact consumers cite authenticity, wider selection and above all better service as reasons for shopping away from home.

The in-store experience is by far the most important factor driving purchasing decisions in this market, so training and bringing staff up to internationals level is crucial in order to compete in this new market.

Secondly, conducting rigorous **quantitative analysis** to determine the right footprint for the brand will be crucial to avoid huge mistakes. Some companies seem to have conducted in the past very little market analysis and now find themselves with empty retail stores. The previous race for point-of-sale locations will come to an end. All brands should have clear goals and targets for each city, based on strong data on

current demographics, evolution of wealth, points of sales owned by competitors and possible available partners.

The bottom line is that Chinese market present a huge opportunity for innovative luxury firms that have well-positioned brands, with a clever strategy able to satisfy the needs of this new demanding customer base.

Notice for Italian Tax Payers

Invitation to donate part of the taxes for an association that takes care of medical treatments for immigrants without medical rights in Italy and for the start up of an hospital in Rwanda

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