

Asia: Cutting Through the Noise Series

Issue V – In With the New

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Key Takeaways:

- As old-economy industries lose competitiveness and generate weaker profits, China is shifting from exports to consumption.
- Despite China's low average income, the country's upper middle class already shows characteristics of developed market (DM) economies like the US.
- Conditions are ripe for new business models to take hold.
- Asia's nascent middle class is in the early stages of a multi-decade run, with China taking off from a low base.
- Companies and investors targeting China's swelling middle-income segment may encounter a relatively benign competitive landscape and considerable upside from the blossoming new economy.

China in Transition

Amid the expansion of China's consumer class, companies developing new business models and pursuing innovation are well-positioned to seize a once-in-a-generation opportunity.

In the coming year, China's cyclical industries are likely to show increasing weakness as the government reduces stimulus and reins in excess liquidity. Meanwhile, technological advances and business innovation appear to be on the verge of radically changing the composition of China's economy. As easy growth opportunities dissipate, the government and industry leaders are displaying a growing willingness to break from their traditional ways, which should hearten stock market participants. Currently, the performance of H-shares is hinting at the true potential of new business models, with Tencent and industries outside of materials, property, and industrials standing out as components of the new economy.

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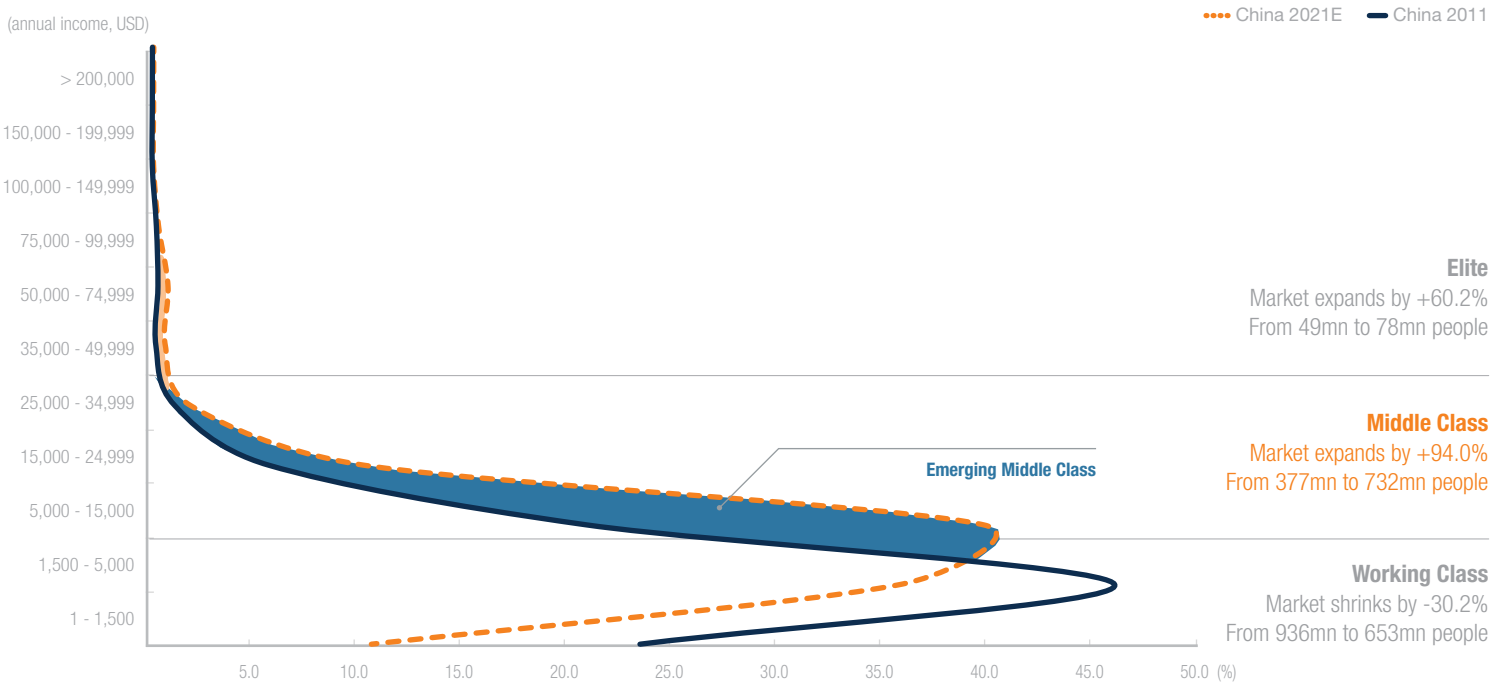
Three Kingdoms

The viability of new business models in China is contingent on the expansion of the country's consumer class. Currently, China's GDP per capita stands at USD 8,000, which, upon first glance, appears too low to support significant growth in new consumer industries.¹ However, in our view, treating China's consumers as one homogenous spending class is not a valid approach, given the sheer

size of the population and the sharp differences between the patterns displayed in each income bracket. Rather, in order to pinpoint key determinants and meaningful trends, it is necessary to first divide Chinese households into three distinct classes, or "kingdoms." And a close examination of these three kingdoms indicates that the country's income trends are in fact supportive of economic transition.

China's Three Disparate Income Classes

Source: Based on Mirae Asset Daewoo estimates (United Nations)



Starting at the top, China is home to around 50 million people—roughly equivalent to the size of Korea's entire population—earning more than USD 35,000 annually.² This is the income group that is conspicuously buying brand-name goods at luxury stores around the world. However, while this group is certainly the most visible, our research indicates that the focus of China's policies for the next five years will be on helping the working-class population enter the ranks of the middle class (those earning between USD 5,000 and USD 35,000).

The working class—the more than 900 million Chinese earning less than USD 5,000 annually—is decidedly discontent, and efforts to improve this group's lot are already underway. For example, the government is currently reforming its hukou (residency permit) system as a means of reducing inequality and labor discrimination against

migrant workers while improving access to education, healthcare, and financial services. Moreover, the government is aiming to provide more affordable housing and raise the minimum wage, all while pushing through an aggressive anti-corruption campaign. Collectively, these moves will drive upward social mobility for nearly one billion people, the impact of which cannot be overstated.

We project that China's middle class will grow from 377 million in 2011 to 732 million in 2021, showing an incremental increase easily surpassing the entire population of the US.³ This represents a historic step-change in the spending power of the Chinese consumer, who in addition to enjoying income growth, is also less indebted than his or her developed market (DM) peers.

¹ World Bank (2017)

² Mirae Asset Daewoo (2017)

³ Mirae Asset Daewoo (2017)

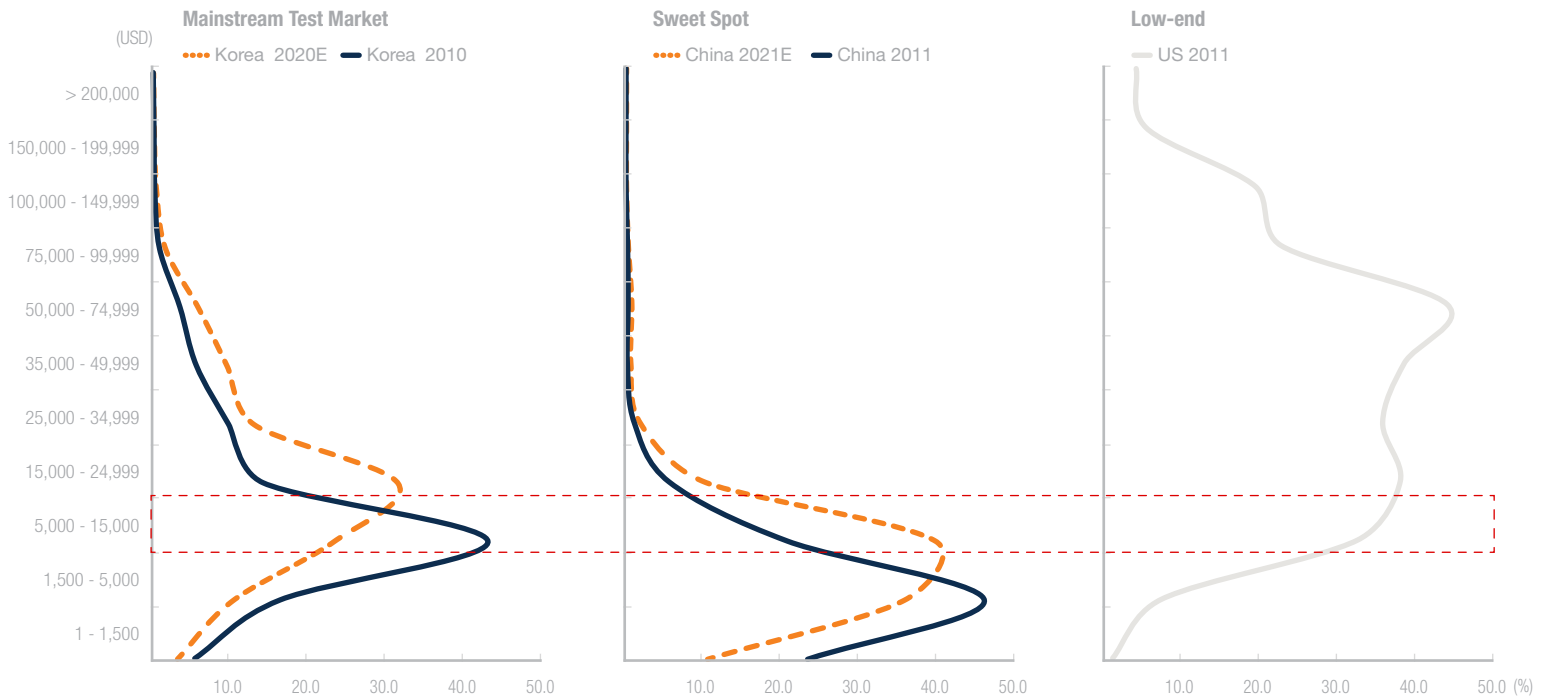
Serving the Sweet Spot

Zooming out to a comparison between US and Korean income charts and our three kingdoms chart underscores the importance of price point and target markets for companies entering China. In

particular, we believe that an analysis of China's USD 5,000-15,000 bracket illuminates the ways in which companies can leverage the country's growing middle class.

Income Chart for 3 Disparate Economies

Source: Based on Mirae Asset Daewoo estimates (United Nations)



Not only does the middle class display the greatest propensity for development, it is also the least competitive from a market entry perspective. In the upper-tier segment (over USD 35,000), market entrants run into a plethora of high-end global brands, while the low-end space is filled with mainland players unafraid of engaging in costly price wars. In light of these conditions, we believe that the ballooning middle class is the sweet spot for companies developing new business models and pursuing innovation. More specifically, we believe the USD 5,000-15,000 sub-category holds the key, as its occupants are starting to expand beyond staples to discretionary goods, such as basic cosmetics and portable electronics.

The New Chinese Consumer Class

For the most part, since the global financial crisis, Asia has suffered from stagnant global growth and Chinese imbalances. Nevertheless, opportunities are emerging as China endeavors to transform its economy by establishing a robust consumer class that can sustain growth without debt-fueled stimulus. While the general perception is that China is already a major consumption economy, our three kingdoms analysis suggests that there is still plenty of room to run for the country's middle class.

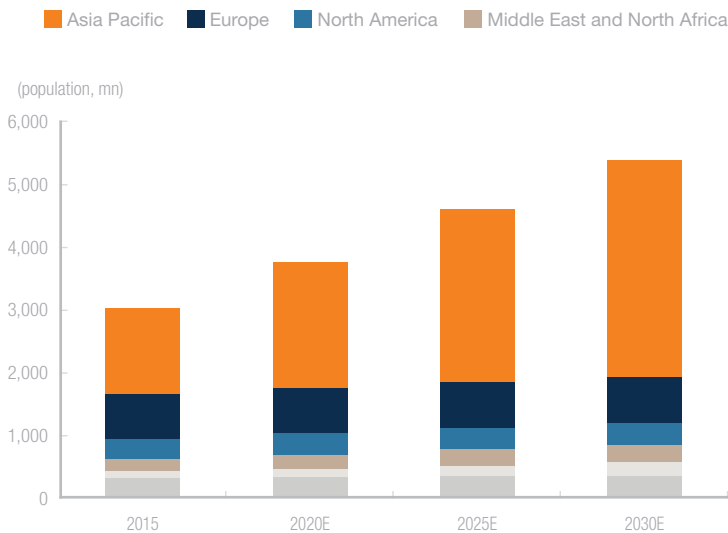
More broadly, China is, along with India, the muscle behind Asia's ongoing middle class upswing. And with prudent policymaking and

some structural changes, we believe that emerging markets (EMs) will overtake DMs in the middle class on the back of Asia's high-charged advance. In our view, the development of transparent, effective, and performance-driven financial infrastructure, as well as improved productivity of capital, will be particularly integral to fostering the innovation necessary to tap into the growth of the middle class. While trusting governments to formulate responsible policies based

on a long-term vision has led to numerous disappointments over the past five years, we believe that, going forward, we will see concerted efforts by policymakers and industry leaders to reignite growth by pursuing reform and innovation. Investors would be well-advised to position themselves to take advantage of the opportunities that are expected to arise out of the changes ahead.

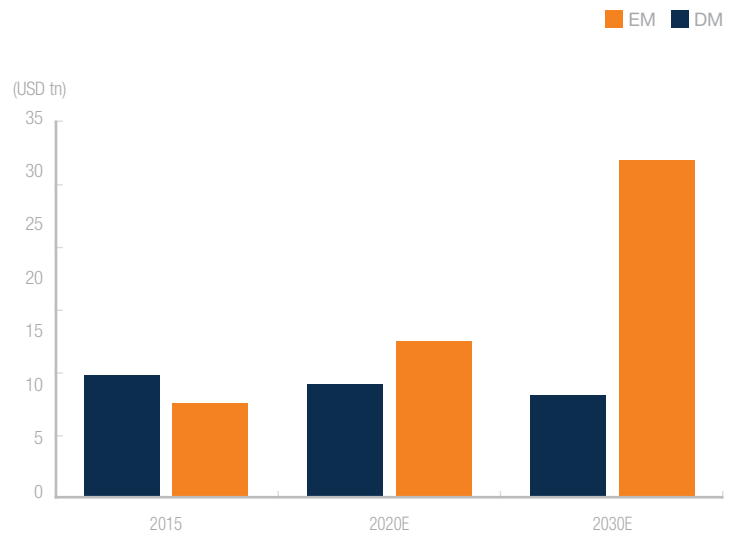
Asian Middle Class is Only Growth Segment

Source: Brookings Institution (2017)



EM Middle Class Set to Overtake DM Peers

Source: Brookings Institution (2017)



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