Chinese and Starbucks Late Stage Growth Obesity

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August 26, 2008

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The pessimist is the optimist who has seen the future.
- Alexander Katsenelson (my older, wiser brother).

What do Starbucks and China have in common? A lot! Both got us hooked on consumption: one of fancy, expensive caffeinated liquids; the other on cheap foreign made goods. Both have defied the conventional wisdom – they grew faster and longer than common sense told us was possible. They also share another striking commonality: both are suffering from late stage growth obesity (LSGO).

The Starbucks story

With the beautiful benefit of hindsight we know what happened to Starbucks – it grew too fast, opened too many stores, and sacrificed its own standards to meet unrealistic targets. The company first claimed that it only had a few hundred stores that it needed to close, and then the few hundred spilled into six hundred. Weak consumer spending will likely push Starbucks to re-examine its store count again, doubling or tripling the store closures.

Starbucks percentage of new stores growth in 2007 was only slightly lower than it was in 1999. But in 1999 it had 2,000 stores; in 2007 it was pushing a 10,000 company owned stores mark. Let's put this in perspective: in 1999 Starbucks opened 447 stores - 1.8 stores per working day; in 2007 that number more than tripled to 1,403 stores a year - 5.5 stores per working day. At this level of growth physical limitations come in: there is only so much real estate that fits a company's criteria at a certain point in time. Management started sacrificing on the quality of their decisions, compromises were made that were unthinkable several years before. Stores were opened too close to each other or on the wrong side of the street, expensive leases were signed, they even hired baristas that would have fit in better at McDonalds – you get the idea.

Unfortunately the present and the future will pay for the decisions of the past: stores will need to be closed, long-term leases terminated, charges taken,

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corporate costs created in hopes of high growth eliminated, and corporate culture of partnership strained by barista layoffs.

Starbucks needs to go on a permanent growth diet (at least in the US), and realize that it has the metabolism of a 37 year old and can digest fewer new stores. By tightening its standards for opening new stores the company will be on the way to recovery, though at slower growth. Starbucks is blessed with financial strength, capable management and unbelievable brand. If management admits to themselves that the heydays of growth are behind, recovery should be fairly painless. Starbucks generates tremendous operating cash flows, which in the past were completely consumed by opening new stores. If the company were to go on the LSGO diet, its capital expenditures would decline and free cash flows balloon – the value unlocked.

But this discussion is not about Starbucks, it is about what is taking place in China.

The Great China story

The benefit of hindsight that provides clarity in analysis of Starbucks today is not there for China, at least not yet. But if you were to open your mind and look past today's cheery newspaper headlines you'd see that China is suffering from a severe case of LSGO.

Ten for ten. Since 1998 its GDP has grown at about a 10% annual real growth rate, and its economy more than tripled in size (in real terms). There were no recessions, just expansion – the Chinese miracle growth? The origins of China's tremendous growth are well known: large population migrating from low (farming) to higher productivity (manufacturing) activity, cheap labor, a capitalism-friendlier communist government, and insatiable demand from the US and the rest of the developed world for cheap goods.

Unlike Starbucks – a private enterprise that has free market principles deeply inbred in its DNA - China is a communist country. Though it is moving towards free market capitalism, it is not there yet. The rule of law is weak, the country infested with corruption, and due to central planning and tight government control of the banking system capital is often allocated based on cronyism (or political relationships) not merit.

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Prolonged high growth in this environment results in inefficiencies that are compounded year after year. In other words, though the growth is high, the quality of growth is low, thus asset allocation decisions are likely to be poor. The ten year super-high growth marathon put China at high risk, actually more likely of a certainty, of a severe case of LSGO.

From today's perch we can only guess of the consequences of LSGO, but we'll gain that clarity after the fact – a luxury we don't have. Newspapers that are praising the Chinese growth miracle today will write exposes on what went and is going wrong in China.

I have absolutely no facts to back up what I am about to say, but it is not hard to imagine future stories about poverty stricken farmers that moved to big cities for a better life and found despair; or that inland migration (from farming to factories) only brings a onetime productivity jump as poorly educated farmers-turned-factory-workers add little to productivity improvements afterwards; or how weak and debt ridden the financial system is; or the devastating impact that pollution has on health and productivity; or how the biggest shopping mall in the world, that happens to be in China, is almost completely empty.

Oh wait, the story about the shopping mall is not a figment of my imagination (I am not that good) but has already taken place. In 2005 NY Times ran an article titled China, New Land of Shoppers, Builds Malls on Gigantic Scale, it talked about the biggest shopping mall in the world that happened to be in Dongguan, China. The article said:

> "Not long ago, shopping in China consisted mostly of lining up to entreat surly clerks to accept cash in exchange for ugly merchandise that did not fit. But now, **Chinese have started to embrace America's modern "shop till you drop" ethos** and are in the midst of a buy-at-the-mall frenzy…. **by 2010, China is expected to be home to at least 7 of the world's 10 largest malls**… Already, **four shopping malls in China are larger than the Mall of America.** Two, including the South China Mall, are bigger than the West Edmonton Mall in Alberta, which just surrendered its status as the world's largest to an enormous retail center in Beijing." (emphasis added)

Fast forward three years and you find a very different story: the biggest mall in the world - the South China mall, with space for fifteen hundred stores, only has a dozen stores open for business – it is empty. Shoppers never materialized. Billions of dollars have been wasted.

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Analyzing the Chinese economy while it is growing at superfast rates is like analyzing a credit card company or a mortgage originator during an economic expansion – all you see is reward – the growth. But the defaults – the risk – are masked by a healthy economy and constantly increasing new business that is profitable at first. The true colors of that growth only appear after the economy slows down and new accounts mature. (In fact, the banks or credit card companies in the U.S. that showed the lowest loan growth during last expansionary cycle have a lot fewer credit problems than those that did – U.S. Bank Co comes to mind here.)

The consequences of LSGO are likely to be very painful for China. As of today we don't know how much of the recent growth came from wasteful, unproductive growth. Only after a slowdown will the true problems surface.

The Speed. What makes things even worse is that China cannot afford a slow down. I discussed this in the past but it is worth repeating. The Chinese economy is like the bus from the movie "Speed". In the movie the bus is wired by a villain (played by Dennis Hopper) with explosives, and will explode if its speed drops below 50 miles per hour. The Chinese economy has 1.3 billion unsuspecting people on board. It could blow if economic growth drops below its historical pace.

A combination of high financial and operation leverage sprinkled with past high growth rates will send this economy into a severe recession if growth rates slow down. Let me explain:

High operational leverage. China has become a de facto manufacturer for the world. With the exception of food products, it is difficult finding a product that was not, at least in part, manufactured in China. Industrial production accounts for 49% of GDP, double the rate of most developed nations (i.e. industrial production for the United States is 20.5 % of GDP, UK 18.2% , and Japan 26.5%).

Chinese miracle growth is largely driven by the manufacturing sector; historically its industrial production grew at a faster rate than GDP. The manufacturing industry is very capital intensive. Building factories requires a large upfront investment. High commodity prices and rapid wage inflation has driven those costs up. Once a factory is built the costs of running it are to a large degree independent of the utilization level – they are fixed – a classical definition of operational leverage. On top of these factors, laying-off workers is a politically sensitive process in China, which creates another layer of fixed costs.

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High financial leverage. Debt is the instrument of choice in China. Due to a lack of equity-fund- raising alternatives (their stock market is very young), bank debt and underground finance companies that charge very high interest rates are the predominate sources of capital in China – this generates a great degree of financial leverage. (Though according to my friend Bill Mann, The Motley Fool's advisor of Global Gains newsletter, a frequent visitor to China, state owned enterprises are much more leveraged than private enterprises.)

Total operational leverage. Large piles of debt (financial leverage) combined with high fixed costs (operational leverage) create a very high total operational leverage.

Total operational leverage in China is elevated further as factories are built to accommodate future demand – this is a classical byproduct of LGSO. It is a human tendency to draw straight lines and thus making linear projections from the past into the future. During the fast growth period the angle of the straight lines is tilted upward, causing an over investment in fixed assets, as inability to keep up with demand may cause manufacturers to lose valuable customers. (Fear of over investment is overrun by fear of losing customers.)

This type of thinking results in tremendous overcapacity when demand cools. Here is an example: let's say a company saw demand for its widgets rise 10% year after year. It builds a new factory to accommodate future demand, let's say five years. It will likely model a 10% annual increase in demand as well. But what if demand comes in at 6% a year over the next five years? This will translate into overcapacity - not 4% but 20% (4% per year times five years). Suddenly you don't need to build factories or add capacity for awhile.

This greatly leveraged growth is terrific as long as the economy continues to grow at a fast pace: sales rise, costs rise at a slower rate (in large they are fixed) - margins expand - the beauty of leverage. However, leverage is not so sweet and soft when sales decline. Overcapacity is a death sentence in the manufacturing (fixed costs) world. As companies face overcapacity or slowdown in demand, they try to stimulate sales by cutting prices, which in part lead to price wars (similar to what we observed in the U.S. between Sprint, MCI and AT&T in the long distance business during the mid 90s) and to a fatal deflation. Sales decline, costs remain the same – margins collapse.

The weakness in the US and European economies will temper demand for Chinese made goods. China is already showing first signs of slow down - inflation is increasing and rate of real growth is decreasing.

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ADVISOR PERSPECTIVES

It gets worse: high commodity prices

Chinese demand for stuff (oil, metals, machinery etc…) has a tremendous impact on commodities, driving their prices many fold. High (and rising) commodity prices are negative for developed world economies but they are catastrophic to developing economies – they bring comparatively higher inflation and often stagflation. Here is why:

Inflation is sourced from two broad categories: commodities (stuff) and wages. Emerging markets are twice as cursed when it comes to inflation:

1. Commodity prices (less shipping costs and government controls – the Chinese government limits price increases on certain commodities, but we know that doesn't work in the long-term) are the same around the world. Thus the U.S. and China will see a similar increase in commodity prices (at least in dollar terms). But the commodity component represents a larger portion of the total product cost in China than in the U.S., as wages in China are a less significant component of a total cost. For instance, bread baked in the U.S. and China will require the same amount of wheat and wheat will cost as much. But baker wages will be significantly larger in the U.S. than in China and will result in a much higher cost of the finished product. Therefore, a spike in wheat prices will have a larger impact on the loaf of bread in China than in the US.

2. Wage inflation: the US and Europe have little wage inflation, as rising unemployment has diminished the already weak bargaining power of the labor force, keeping wages in check. Economic expansion has put significant upward pressure on wages inflation in China (and India as well).

In combination, these two factors were responsible for inflation in high single digits in China, double the rate of inflation in the U.S.

China is not the cheapest place in the world to manufacture, not anymore. To its benefit, cheaper countries (Singapore, Vietnam etc…) are not big enough to steal a significant amount of capacity and the US in many cases doesn't have the needed infrastructure to bring manufacturing back. Appreciation in the renminbi and high oil prices (which are driving shipping rates up, placing a significant premium on the distance factor) are making Chinese produced goods even less attractive. Something has to give: either the U.S. will consume less or China will keep prices low to stimulate the demand, swallowing the loss, or a combination of both.

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It gets even worse…

I constantly catch myself wanting to say "the story only gets worse", but unfortunately it does. The US and Europe can cope with energy and food inflation a lot better than China and other developing nations, as we spend a lot less on food and energy as a percent of our income and have a lot more discretionary income. (Just take a look at magazine section in the book store. There is probably a fishing magazine for the left handed fishermen.)

Though the Chinese consume a lot less gasoline than Americans. They don't have as many cars and don't drive as much, but they do have stomachs – they eat. High energy prices have translated in food inflation that in China runs in the high teens. The average American family spends only 15% of their household budget on food, whereas the Chinese spend 37% . Maybe this is one of the reasons their shopping malls are empty. People that pay high gasoline prices but are full don't riot, but hungry people do. The current situation raises political risk in China and also the chances that government (social) intervention will rise. This also puts in doubt the significant development of a Chinese middle class, at least in the near future.

When I wrote an article for Financial Times in May discussing risks in stuff stocks (commodities, energy and industrials) I called today's environment "a global commodity bubble". I was imprecise, after a conversation with the brilliant Ed Easterling of Crestmont Research (by the way, Ed wrote "Unexpected Returns" - a must read) and reading a wonderful interview with James Montier by Kate Welling, I'd like use James' more precise definition of today's environment: a "global growth expectations" bubble. After all, it is the supply demand (to a large degree) that was responsible for this unprecedented growth in "stuff", shifting the mentality of the market into "this time is different" gear. It is not.

In the past "stuff" stocks were cyclical, their margins played a very predictable foxtrot of bouncing together with the whims of the US economy. Today they are behaving if as Google is their middle name – their sales are climbing in double digits, margins keep expanding and now they are called "growth" stocks. They are not. It is just Chinese late stage growth obesity, which has disproportionately impacted the demand for stuff, creating an expectation that the "growth story" will continue forever. Nothing is forever. Starbucks discovered that and so will China. China is likely to have a bright future, but it doesn't consist of straight to the sky growth trajectories.

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Implications. Demand for commodities will decline, while more supply from past investments (there is a significant lag) will be coming to the market – they'll come crushing down to earth. Companies that make *stuff* will suffer, their margins are at multi-multi-multi-year highs, margins pendulum will swing the other way, to the other extreme. Suddenly they won't appear to be as cheap. (Take a look at my January Barron's article in which I discuss the risk in corporate margins and May Financial Times article which explores China and stuff stocks.)

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