

# FCL*Capital*

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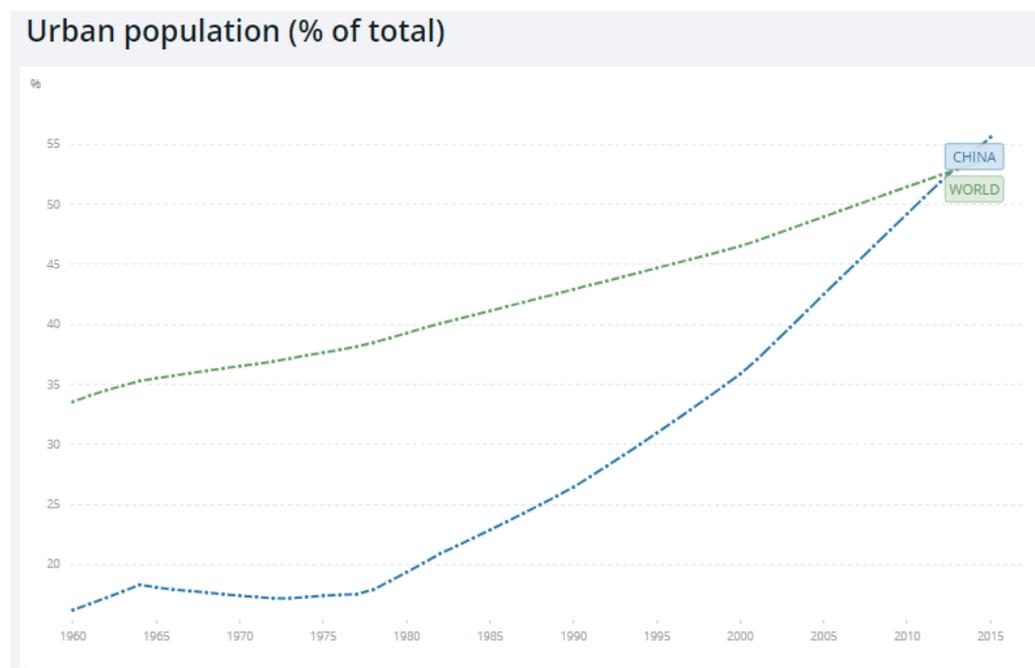
## Thesis: Long on Anta Sports Products Ltda.

### 1) The Opportunity

Since 1979, when the initial economic reforms that set in motion the planet's most extraordinary economic rise in history began, the Chinese development model, it is now widely accepted, followed a few delineated waves, or to put it better, a few patterns:

- First a massive reallocation of resources, including people, following the first reforms that made the country welcoming to foreign capital that would bring knowledge and money and take advantage of the country's cheap labor force. This first wave unleashed humankind's fastest migration from the countryside, usually from inland central areas of the country to the cities situated in the eastern coast - like Shanghai, Beijing and Shenzhen. As a consequence the country's urbanization ratio recently surpassed 50% and it is still climbing

**Chart 1: China urbanization ratio**



Source: World Bank

- A second wave began when Chinese companies in possession of this recently acquired know how from years of partnerships and joint ventures with foreign investors began doing it alone, creating their own brands, practices and services. It is widely reported in western media that foreign (i.e. Western) brands enjoy a premium because of their reputation, safety and status but there are also widespread evidences within china that this premium, while real, is gradually eroding.
- Finally, the future seems to be shown by companies like Alibaba, Tencent and YY. Where Chinese players themselves acquire enough resources and leadership to not follow anymore and instead become leaders in the 21st century in new fields like AI and mobile internet.

So, as fiduciaries of a BRIC-centric global equity fund, how do we profit from the most important economic transition ever experienced in this planet? Once the cheap labor arbitrage play no longer works the most obvious way to “play China” would seem to be to invest in one of their “BAT” (Baidu, Alibaba, Tencent) internet companies. But this is old news and exceptional ideas rarely come from obvious places.

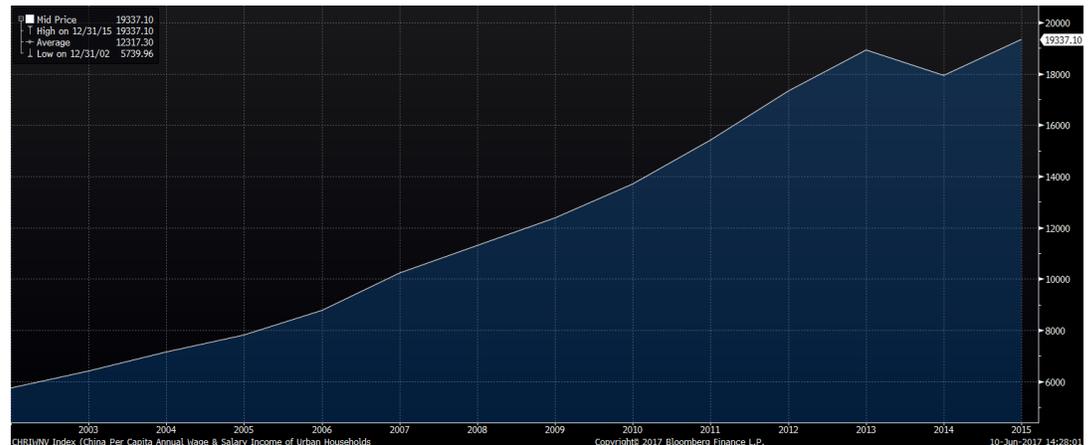
Instead, we tried to immerse ourselves into a new way of thinking. A country of 1.3 billion people, getting richer and more urban. New aspirations and desires. How to profit from this and most importantly how to find something that not many people have seen?

A richer and more urban population eats differently<sup>1</sup>, saves money differently, has fun in different ways and wants to live a different life.

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<sup>1</sup> Something we explored in our Minerva thesis as seen in previous letters

## Charts 2: China average income in urban households:



Source: Bloomberg

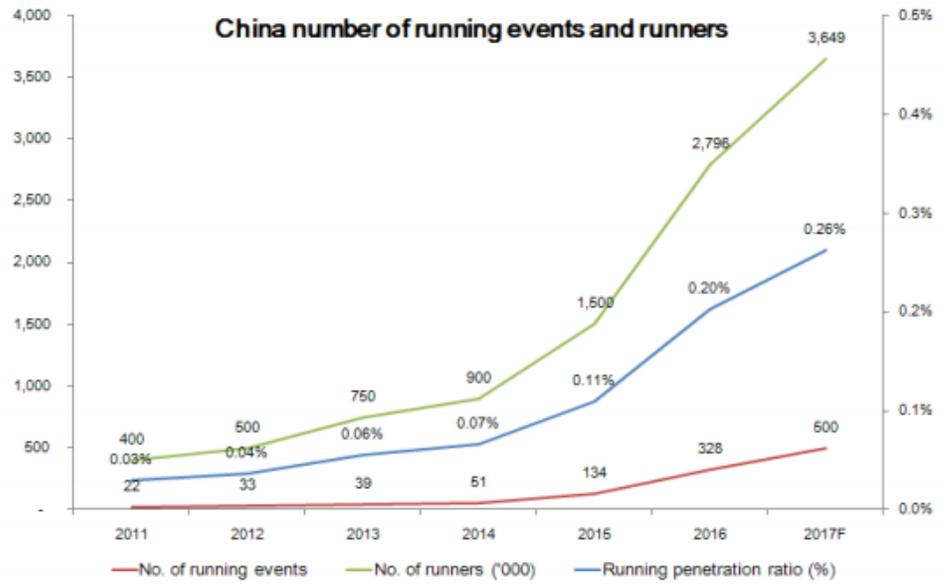
After a few months of digging into china and reading everything we could; from Chinese people dating habits to their love for live entertainment, we came across a report that showed that for the first time, just like it previously happened in the rich world, income and calorie intake in china “diverged”<sup>2</sup>.

Or to put in simpler terms, in a country where it was tragically common for hundreds of millions of people to experience hunger and days without food the first ones who got rich also got fat. As the decades went by and a new, urban generation began to form, habits and a consciousness more similar to the rich world took form: affluent people that, compared to their poorer countrymen, were more health conscious, globally minded and preoccupied about quality of life.

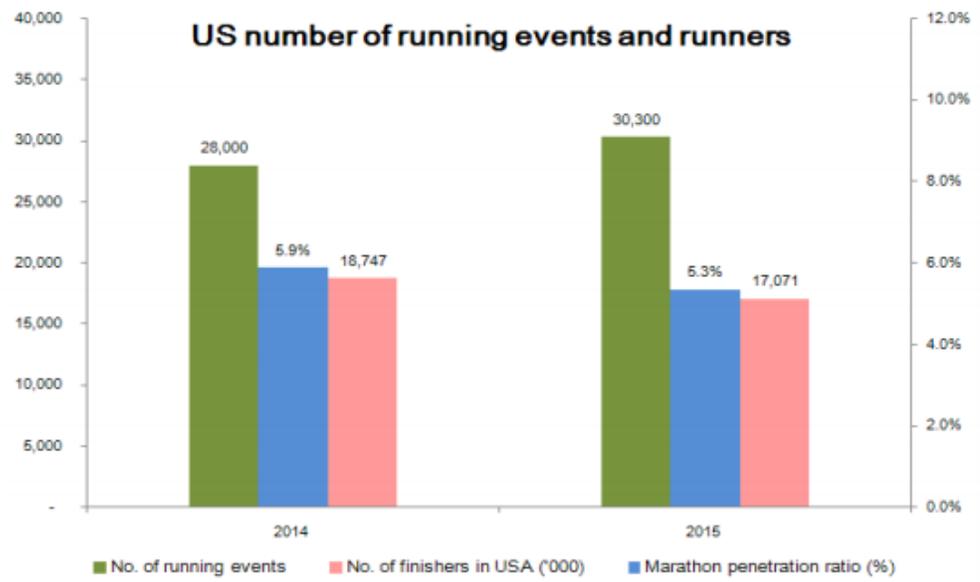
Then we began to think about new habits that Chinese *millennials* could form. The rise of china was not only about smartphone penetration and new apps: it was about massive urban construction , new parks, new standards of living, and a different diet that while less healthy would also lead to a new desire of building and cultivating healthy habits.

<sup>2</sup> <https://www.ft.com/content/110b5f88-468b-11e7-8519-9f94ee97d996?emailId=593a7080ee8a3600044d3135&segmentId=2597e9a1-8d0d-61e4-8734-bd027f30ddc9>

**Chart 3**



**Chart 4**



Anta was founded in 1994 by a young man named Ding Shizhong in the city of Jinjiang in Fujian province. Initially the idea, similar to the ones from so many Chinese entrepreneurs at the time, was to build things that had inferior quality but also were a lot cheaper than similar goods from the west. In other words, taking advantage of the fact that people for the first time had the desire to acquire new things and were starting to have some income. Entrepreneurs started recreating cheaper versions of foreign goods. Also, according to most accounts, the purpose of Ding Shizhong was simply “to ease his family’s financial burden”<sup>3</sup> selling shoes that were initially made by his father at home. In other words, an amazing entrepreneurial story that, if had came from an American or European, would be celebrated across the globe.

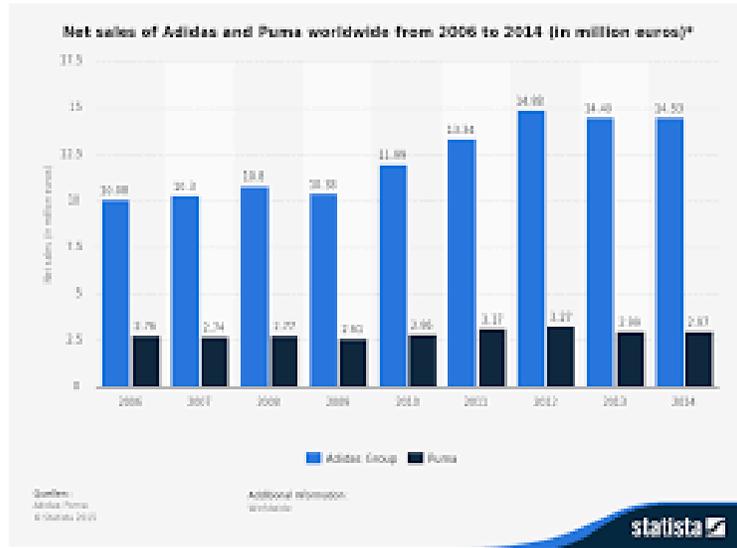
It was around that time that hundreds of millions of Chinese people had heard about the two major global sports brands and could for the first time, if not acquire them, at least desire them: Nike and Adidas products.

Anta was one among hundreds of local brands that were created to target a niche in this market and especially a share of the lower income buyers in second and third tier Chinese cities: while urbanites in Shanghai could acquire brand new Nike shoes the people in smaller cities would probably have to get by with one of the cheaper Chinese versions.

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<sup>3</sup> <http://www.cnbc.com/2016/08/05/how-ding-shizhong-made-a-business-out-of-his-love-for-shoes.html>

**Chart 5: Chinese sports market billions**



From those humble beginnings, Anta grew. Today, it is the third largest sports company in China behind Nike and Adidas and by far the largest one among native Chinese firms. It dresses the Chinese Olympic team and sponsors global sports stars.

**Charts 6: Anta Chinese Volleyball Delegation**



Chart 7: Clay Thompson

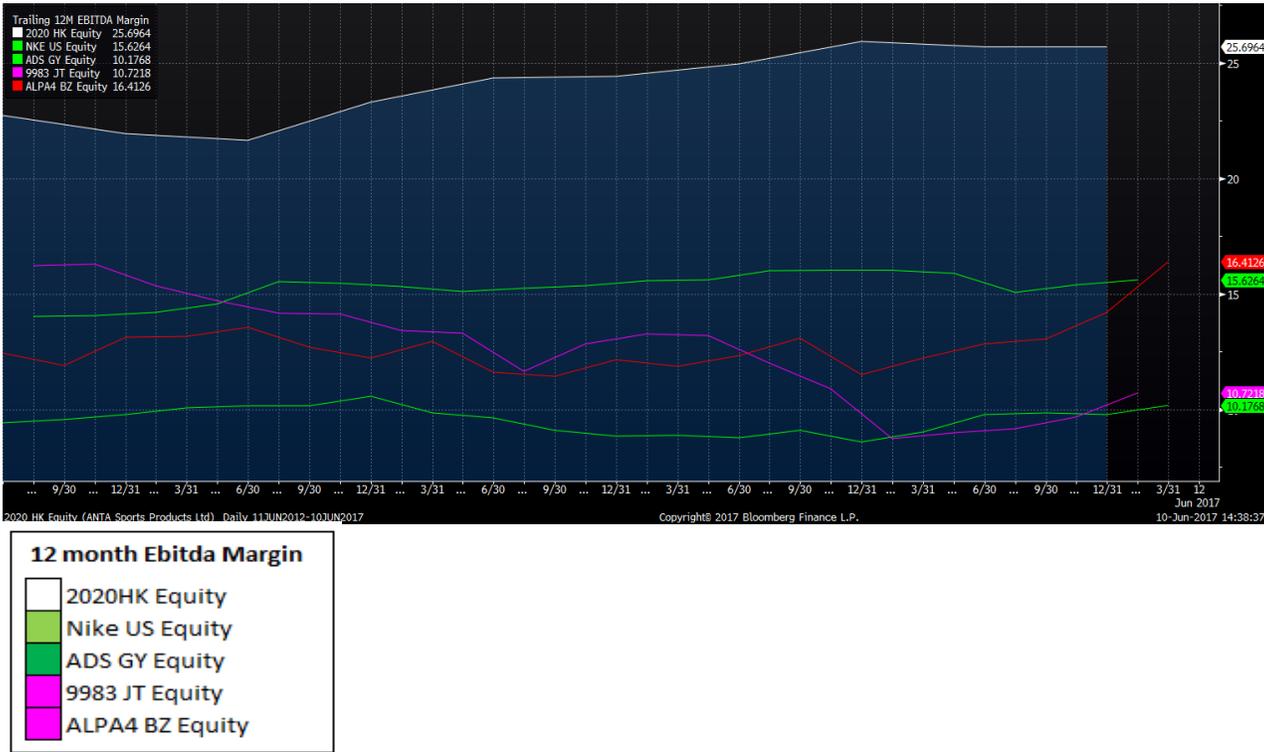


## 2) The products

Anta's products are still cheaper than international competitors. Nowadays typical Anta shoes sell for around half the price of similar Adidas or Nike shoes for example. Although harder to quantify, we do think the quality gap is, if not totally gone, rapidly declining. Gradually Anta's products are seen not only in second and third tier cities but also in the major Chinese coastal cities. Its brand and desirability factor, while having some way to go, is clearly closing in on foreign rivals.

After a quick internet search in some basic websites Anta's products, seem to be well regarded and with rising customer satisfaction while its own branded products traditionally sell for around half the price of Adidas and Nike. With that said, Anta enjoys greater Ebitda margins with its lean structure, single country focus and control of different levels of production.

**Chart 8: Trailing past 5 years Ebitda margin: Anta, Nike, Adidas, Alpargatas, Fast Retailing**



But there's more to the Anta story: not satisfied with just competing with international brands from a low cost position, Anta began to compete with them head on: in 2009 Fila, a premium Italian brand was struggling in China and Anta bought the brand's Chinese rights.

Since then Anta was responsible for reviving Fila's fortunes in China and the brand now has more than 100 FILA stores and more than 30 FILA KIDS stores in the country.

Subsequently, Anta also bought Descente's rights in China, an important Japanese sports shoes company's and its ambitious founder doesn't hide the intention to expand in the outdoor wear sector, which would put the company on a collision course (or possibly agreement?) with companies like Timberland.

This "brands management" model was successfully explored by a Brazilian company we held in our portfolio many years ago called Alpargatas. This shows the advantages of running a BRIC fund: models and successful formulas while different from place to place bear some resemblance.

Anta however enjoys a lot more flexibility, scale and ambition than Alpargatas ever did: it combines efficient production, its own brands and exclusive rights to important foreign brands in a market several times larger than Brazil and growing quickly.

## Chart 9: price comparison - Anta vs Nike vs Adidas

Brand	Model	Original Price (¥)	Current Price (¥)	618 Price (¥)	Shipping	Monthly Sales	Cumulative Reviews	Send Points
ANTA	安踏男鞋气垫鞋运动鞋男夏季2017新款透气休闲鞋官方旗舰店跑步鞋夏季跑鞋 MAX 缓震舒适,网面透气	369.00	249.00	206.00	广东广州 至 杭州 快递: 0.00	-	-	-
Nike	耐克官方 NIKE FLEX TRAINER 7 女子训练运动鞋 898479 非凡,灵活 驾驭高强度训练 轻盈透气	499.00	499.00	449.00	上海 至 杭州 快递: 0.00	1579	1244	249
adidas	adidas 阿迪达斯 三叶草 男女 经典鞋 ZX RACER adidas is all in	699.00	359.00	258.00	杭州	613	1320	179

Chart 10: Anta portfolio of products



**3) The numbers**

Anta finds itself facing a multi decade growth opportunity. It is only scratching the surface of where its shoes and sports clothes may reach since there are multiple layers of opportunities ahead:

- The Chinese population is urbanizing, adopting western habits and seeing its income rise fast
- Anta has been improving its products and seeing its quality gap both real and in perception terms shrink when compared to the global players.
- Once it reaches sufficient clout and scale Anta may decide to go abroad and compete with foreign brands at their home turf. This is certainly not in our projections but is a possible optionality for the next decade.

Overall, we think Anta's higher margins and faster growth should justify a premium to the western brands that operate mostly in mature markets.

But let's look at the numbers:

**Chart 11**

Company	Market Cap USD MM	EV/Ebitda	P/E 2017(E)	Avg past 3 year sales growth
Anta	7.86	12.00	18.29	22.40%
Fast Retailing	35.93	17.05	34.04	16.28%
Nike	87.82	15.80	22.05	8.57%
Adidas	39.55	15.54	27.07	10.92%
Alpargatas	1.77	9.79	13.48	5.94%

As we can see Anta, not only maintains higher margins but also trades at cheaper levels and has enjoyed a higher level of growth in the recent past, furthermore, it is also likely to maintain this higher growth in the future.

Since Anta grows so much faster than its international rivals and enjoys higher margins we decided that an EV/Ebitda or simple P/E comparison wouldn't be adequate. Instead, we think the fairest measure to compare this diverse group of peers is the PEG ratio.

With PEG, we take into account not only the companies price to earnings but also its growth potential. In this case, since we won't try to guess the future, we simply took the average past 3 years sales growth from a Bloomberg terminal and used it to divide each company's estimated 2017 PE.

**Chart 12: PEG Ratio: (2017 Price/Earnings ratio divided by past 3 years average sales growth)**

<b>Fast Retailing</b>	2.09
<b>Nike</b>	2.57
<b>Adidas</b>	2.47
<b>Alpargatas</b>	2.26
<b>Peers average</b>	2.34
<b>Anta</b>	0.81

**Anta Upside:  $2,34 / 0,81 = 188\%$  or a target price of HK 66.96 per share**

It seems a too good to be true opportunity. There is only one card left for a bear to play the China card. This is after all a Chinese company. It probably has poor corporate governance and risks that developed companies don't experience, right? There must be, after all, a reason why Anta is that cheap.

Well, this is the topic of our next section.

#### **4) Corporate governance**

Even with the fact that this house runs a BRICs global fund we haven't and don't plan on making investments in inland Chinese stock markets for the near future. We share many of the global investors concerns not only about corporate governance rules, but even more importantly, we have additional concerns regarding the ability to put money in and out of the country. As fiduciaries of our

investors' capital, we worry about government interference, and that puts us away from this market. At least for the time being.

So our Chinese bets tend to come basically from Chinese companies listed either in US markets as most tech Chinese companies are, or, most obviously, in Asia's financial center, Hong Kong.

While we agree with the market's concerns when it comes to inland Chinese markets, we judge that most of the discount of Hong Kong stocks to be based more on unfamiliarity than real and honest concerns about governance per se..Hong Kong shares most of the basic standards of developed markets - it is rapidly becoming one of finance's three major global hubs itself- and in some cases even surpasses its developed peers.

It is funny to see how fast many investors quickly forgot the Alibaba saga: we are fans and enthusiasts of Alibaba, but it is a very documented fact that Jack Ma, its brilliant founder, first wanted to list it in Hong Kong and tried to convince the Stock Exchange to change its rules and allow it to have disproportionate voting power for its shares. Hong Kong Stock Exchange did not budge and with the pressure having no effect, Jack Ma opted to list it in New York instead. So as in many things about the West's views of China, there is myth and there is reality when it comes to concerns about Asian markets corporate governance.

And there's more: Hong Kong allows the possibility of short selling, it is open, transparent, it adopts common law for resolution of disputes, it is Asia's undisputed financial center and its rapidly evolving infrastructure makes some investors refer to Hong Kong as one of the three parts of finance's "triple crown", alongside New York City and London, referring to the three major financial markets, one for each time zone.

Having founded the company in 1994, Anta's founder listed it on Hong Kong stock exchange in 2007. We haven't had a chance to speak with the founder and don't know why he chose to list it there since Chinese inland markets were already developing. Maybe

because he already had global ambitions, maybe to signal good corporate governance. Either way, it is a very auspicious sign.

We do try to be a little more strict and cautious with Anta than we would be with, say, a Swiss or American company. Familiarity plays a role and this house is no more immune to the so called “home bias”. That being said, we do not see why Anta should have a major discount when compared to peers, since it is listed in a developed market that is in many ways even more strict than New York or London.

## 5) Risks

We do not see too many risks into our thesis and most importantly, we don't see unbearable risks - the ones that this house is not willing to incur as fiduciaries of our investors capital.

The main ones we can think of are:

**- Foreign brands in China (Nike and Adidas) may not only maintain but also expand their brand premium compared to Anta.**

Mitigating factor: Anta does not completely overlap with its international competitors with a stronger presence still felt in second and third tier cities. All in all, we don't see any reason why a Chinese company, more attuned to Chinese tastes and preferences and more in touch with the growing Chinese middle class cannot close the quality gap at least as perceived by the Chinese markets against its rivals.

## **- New domestic rivals could enter the market.**

Mitigating factor: The way we see it is really the opposite: as it has usually occurred, after a “gold rush”<sup>4</sup> the natural evolution of a new industry after a couple of decades is survival of the fittest and consequently, consolidation. Once a new opportunity was spotted in the 1990’s, it was natural that many entrants would try their luck. Now a new road ahead seems to be already taking place.

Two listed medium sized, very interesting Chinese companies come to our mind and could, in our opinion, be acquired by Anta: the shoe makers, 361 degrees (1361:hk) and Xtep (1368:hk).

Either way, we foresee a path of consolidation and rising barriers to entry not the other way around. Chinese sportswear market is now several times larger than 20 years ago and on its way to surpass America’s market. The capital and knowledge now required are far different than it once was the case when Anta’s founder’s father was making shoes at home in 1994.

## **- Delisting in Hong Kong and worsening of corporate governance**

Mitigating factor: While corporate governance is meant to be constantly monitored and we certainly act this way when it comes to our investments, we don’t see a rational reason why Anta’s billionaire founder would change the course of his leadership and promote significant changes in its governance structure.

Once again, Hong Kong’s laws and regulations certainly act as a buffer and the gradual internalization of the Chinese economy makes it likely that over time best practices become more and more ingrained by Chinese entrepreneurs who are, after all, already among the planet’s best.

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<sup>4</sup> Car makers in the early 20th century and computer makers in the 1980s come to mind

## **6) The future: A leading brand serving what will soon be the planet's most powerful middle class.**

As many value investors hurtfully learn, it is better to buy a great company at a fair price than an average company at a low price. And what constitutes a great company? Formidable investors in the past century of Dodd and Graham tradition, have made their contributions and put it better than us: a “moat” that keeps it protected from new entrants, like hard to replicate distribution channels would be a great start, also maybe a powerful brand that is gradually becoming more powerful, a large and fast growing underserved market, an unique position in the supply chain that makes it ready for new horizons and also, if possible, a fair price.

Anta is really in the bull's eye of investment ideas in our opinion, reuniting all these characteristics in a single, promising company led by a fantastic entrepreneur that is only getting started.

From its base of second tier cities it is fast conquering of Chinese metropolis with its FILA stores, from its humble beginnings it is becoming a brand easily recognized and familiar to China's vast middle class.

We see a promising road for Anta with multiple optionalities: buying smaller Chinese rivals like 361 and Xtep, making new agreements with foreign brands, and decreasing the premium currently enjoyed by Adidas and Nike inside the Chinese territory.

All in all, we see it as reminiscent of Amazon in the early 21st century or Apple in 2010, a company holding promise and being disregarded by its bears as eccentric and lacking appeal.

In our opinion, however, to use an obvious metaphor since it is a company that designs running shoes, Anta not only has a bright future and is a company designed for a 21st century portfolio, but also, yes, enjoys a clear road ahead, perfect for a wise investor to put its running shoes on and jump ahead.

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