Sector Report

Consumer brands

All subsectors

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LE LOTUS BLEU

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Structural and substitution drive Chinese Consumer

- Even though we are long-term optimistic on the rise of Chinese consumer brands, we believe short-term optimism is misplaced. Chinese underconsumption is only half true. It only occurs in categories associated with development stages;
- We suggest investors to focus on two themes: (1) structural changes led by China's transition to an older and more affluent society, (2) substitution and globalization that can break the ceiling for valuation;
- Our TOP PICKS are Li Auto, Atour, Luckin, FUTU, BEKE and Miniso.

Chinese underconsumption is a myth

China's personal consumption over GDP isn't low by global standards if we compare apple to apple. The underconsumption only holds true in sectors serving an older and richer population, which are small today but will grow into in due course. China's consumption levels in most main-stay category/sectors aren't low.

Theme No.1 is thus to invest in these new sectors

An obvious winner is FUTU, taking advantage of rising affluence and global asset allocation, and KE Holdings, benefiting from rising liquidity of residential properties. But Miniso also signifies the export of Chinese lifestyle elsewhere.

Theme No.2…who substituting who makes all the differences

A salient fact about Consumer is that its businesses employ very different physical, chemical or biological processes and serves mutually exclusive populations. Cross sector entry is difficult and market ceiling is a winner's curse. Substituting multinational corporations (MNC) is an inevitable step for growing and presages global competitiveness. We argue that technology advancement, import revitalization, concentrated segmentation are three ways employed following successful domestic substitution (国产替代) to brings local champions one step up into greater success. We suggest investors to look for these upgrade cases.

No easy routes but focus the right segments lessens the difficulty

Out-spend MNC's entire budget isn't feasible. But focusing on the right segments and making smart decisions on R&D and/or marketing can achieved the goal. We believe such is also the only way to identify true winners in Consumer.

Key financial of stock mentioned

	Revenues			Non-GAAP op.profit			Non-GAAP NI		
(Rmb mn)	2021	2022E	2023E	2021	2022E	2023E	2021	2022E	2023E
Li Auto Inc.	45,287	94,758	130,373	(1,602)	4,568	11,082	21	3,649	9,845
Atour Lifestyle	2,148	2,217	3,756	196	291	808	130	218	663
Luckin Coffee	7,965	13,293	19,600	(236)	1,776	3,616	(2)	1,048	2,879
Miniso Inc.	10,086	11,103	14,391	882	1,840	2,234	723	1,517	1,818
FUTU Holdings	7,115	7,523	9,888	3,183	3,537	4,526	2,909	3,065	3,960
KE Holdings	81,302	60,645	71,983	1,203	722	8,031	2,843	1,825	7,849

Source: Blue Lotus, Bloomberg (As of March 17, 2023). * Miniso report periods are FY22, FY23, FY24

BUY UR SELL

Top picks

	Ticker	Rating	Target
Li Auto Inc.	LI US	BUY	US$40
Atour Lifestyle Holdings	ATAT US	BUY	US$36.5
FUTU Holdings	FUTU US	BUY	US$51
Luckin Coffee Inc.	LKNCY US	BUY	US$40
Miniso Inc.	MNSO US	BUY	US$24
KE Holdings	BEKE US	BUY	US$20

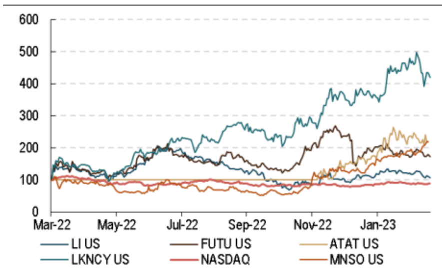
Source: Blue Lotus (as of March 17, 2023)

Stocks mentioned

Name	Ticker	Rating	TP	Current price	FY23 TP PE
NIO Inc.	NIO US	SELL	US$8	US$21.98	NM
Xpeng Inc	XPEV US	SELL	US$8	US$8.33	NM
Nayuki	2150 HK	SELL	HK$3.1	HK$7.95	40x
ANTA	2020 HK	NR	NR	HK$102.1	NR
BYD	1211 HK	NR	NR	HK$205.4	NR
Li Ning	2331 HK	NR	NR	HK$58.5	NR
Shanghai Jawha	600315 SH	NR	NR	RMB29.3	NR

Source: Blue Lotus, Bloomberg (as of March 17, 2023)

Price performance and volume data



Source: Bloomberg (as of March 17, 2023)

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See the last page of the report for important disclosures

Li Auto Inc.: Financial Summary

Fiscal year ends-31-Dec

Exhibit 1. Income statement

RMB mn	2022A	2023E	2024E
Total sales/revenues	45,287	94,758	130,373
Cost of sales	(36,496)	(74,324)	(100,387)
Gross profit	8,790	20,434	29,986
Gross margin	19.4%	21.6%	23.0%
SG&A expenses	(5,665)	(8,107)	(10,430)
R&D expenses	(6,780)	(10,601)	(12,385)
Operating profit - GAAP	(3,655)	1,726	7,171
Operating income - non-GAAP	(1,602)	4,568	11,082
Interest income	976	1,147	1,735
Interest expense	(106)	(1,924)	(1,924)
Pre-tax profit	(2,159)	949	6,981
Income taxes	127	(142)	(1,047)
Net profit / (Loss) - GAAP	(2,032)	806	5,934
Net profit / (Loss) - non-GAAP	21	3,649	9,845
EPADS (RMB)	(2.09)	0.83	6.11
EPADS – fully diluted (RMB)	(2.09)	0.83	6.11

Source: Li Auto Inc., Blue Lotus (as of March 17, 2023)

Company Description

Li Auto, founded in 2015, designs, develops, manufactures, and sells premium smart electric SUVs. LI strategically focuses on the SUV segment within a price range of RMB 200k to RMB 500k. LI is the first to successfully commercialize EREVs in China. LI started volume production of Li ONE in November 2019 and delivered 133k units Li ONE, L9 and L8 in 2022.

Industry View

China's new-energy vehicle sales volume increased by 96.3% in 2022, due to better market acceptance of EVs and favorable EV policies, including national EV subsidy and purchase tax exemption. We expect the growth rate to reach 30% in 2023, which will inevitably lead to divergence in the industry.

Exhibit 2. Balance sheet

RMB mn	2022A	2023E	2024E
Cash and equivalents	40,418	63,879	101,342
Net receivables	48	471	1,053
Inventory/stocks	6,805	12,818	21,535
Other current assets	1,690	1,690	1,690
Net PP&E/Fixed assets	11,188	13,727	17,096
Net intangibles	833	683	683
Total investments	1,484	1,584	1,684
Other long-term assets	6,040	6,040	6,040
Total assets	86,538	118,924	169,155
Accounts payable	20,024	52,821	97,117
Short-term debt and current portion of long-term debt	391	391	391
Other current liabilities	6,958	6,958	6,958
Current liabilities	27,373	60,169	104,466
Total long-term liabilities	13,979	13,979	13,979
Total liabilities	41,352	74,148	118,445
Total common equity	44,859	43,586	49,520
Minority interest	328	328	328
Total shareholder's funds/equity	45,186	44,776	50,710
Total liabilities and equity	86,538	118,924	169,155

Source: Li Auto Inc., Blue Lotus (as of March 17, 2023)

Exhibit 3. Cash flow statement

RMB mn	2022A	2023E	2024E
Income pre-preferred share dividends	(2,032)	806	5,934
Depreciation and amortization add-back	898	1,522	1,758
Net loss/(gain) on asset sales	-	-	-
Accounts receivable	72	(423)	(582)
Inventory	(5,187)	(6,013)	(8,717)
Accounts payable	10,648	32,796	44,297
Other operating cash flow items	2,875	-	-
Cash flow from operations	7,380	30,612	44,615
Capital expenditure	(5,128)	(5,128)	(5,128)
(Acquisitions)/divestitures	1	1	1
Investments	(100)	(100)	(100)
Other investment cash flow items	863	-	-
Cash flow from investing	(4,365)	(5,227)	(5,227)
Increase/(decrease) in long-term debt/convertible bond	-	-	-
Share repurchase/issue (change in common stock)	-	-	-
Increase/(decrease) in preferred shares	-	-	-
Other financing cash flow items	(106)	(1,924)	(1,924)
Cash flow from financing	5,639	(1,924)	(1,924)
Total cash flow	9,925	23,461	37,463
Cash at beginning of the year	30,493	40,418	63,879
Cash at the end of the year	40,418	63,879	101,342

Source: Li Auto Inc., Blue Lotus (as of March 17, 2023)

Atour Lifestyle Holdings Limited: Financial Summary

Fiscal year ends-31-Dec

Exhibit 4. Income statement

(RMB mn)	2021A	2022E	2023E
Net revenues	**2,148**	**2,217**	**3,757**
Total hotel operating costs	(1,420)	(1,406)	(2,329)
Other operating costs	(163)	(166)	(266)
Gross profit	**565**	**644**	**1,162**
Selling and marketing expenses	(124)	(115)	(220)
General and administrative expenses	(197)	(211)	(249)
Technology and development	(52)	(65)	(110)
Pre-opening expenses	(18)	0	0
Other operating income	22	37	38
Share based compensation	0	0	(188)
Operating profit, GAAP	196	291	620
Operating profit, non-GAAP	**196**	**291**	**808**
Interest income	7	12	12
Interest expense	(8)	(6)	(6)
Other income, net	0	(4)	0
Gain from ST investment	9	9	8
Pre-tax profit	204	302	634
Income tax expense	(64)	(85)	(159)
Net income, GAAP	140	216	476
Net income attributable to shareholder, GAAP	130	218	476
Net income attributable to shareholder, Non-GAAP	**130**	**218**	**663**
GAAP diluted EPADS (RMB)	1.21	1.52	3.32
Non-GAAP diluted EPADS (RMB)	1.21	1.52	4.63

Source: Atour Lifestyle Holdings Limited (as of March 17, 2023)

Company Description

Atour Lifestyle Holdings Limited, which started operating in 2013, is the largest upper midscale hotel chain in China in terms of room number, operating 96% of hotel under manachised model and 4% as self-operated. As of September 30, 2022, it has operated 880 hotels with 102k rooms, covering 151 cities in China.

Industry View

We expect the lodging industry to grow at 5-yrs CAGR of 4.4% over 2021-2026E to reach RMB911bn, where the hotel industry to grow at 5-yrs CAGR at 5.6% to RMB749bn in 2026E. We expect the chain hotel ratio by room number to increase from 34% in 2021 to 48% in 2026E. We expect the hotel chains industry revenue to grow at 5-yrs CAGR of 10% to Rmb680bn in 2026E, where the upper midscale hotel chains to grow at 5-yrs CAGR of 22% to reach RMB170bn in 2026E, outpacing the overall hotel chains growth.

Exhibit 5. Balance sheet

(RMB mn)	2021A	2022E	2023E
Cash and cash equivalents	1,039	1,460	2,595
Accounts receivable net	100	111	188
Prepayments and others	167	158	250
Amounts due from related parties	52	49	75
Inventories	59	69	121
Total current assets	1,416	1,848	3,229
Property and equipment net	439	445	510
Operating lease right-of-use assets	0	2,070	2,070
Other non-current assets	390	415	445
Total non-current assets	829	2,930	3,025
Total assets	**2,245**	**4,778**	**6,255**
Operating lease liabilities, current	0	346	346
Accounts payable	161	185	341
Deferred revenue	234	246	417
Salary and welfare payables	95	111	188
Accrued expenses	447	443	751
Other current liabilities	114	153	226
Total current liabilities	1,051	1,484	2,270
Total non-current liabilities	629	2,573	2,766
Total liabilities	1,681	4,057	5,035
Total equity	**565**	**720**	**1,209**
Total liabilities and equities	**2,245**	**4,778**	**6,255**

Source: Atour Lifestyle Holdings Limited (as of March 17, 2023)

Exhibit 6. Cash flow statement

(RMB mn)	2021A	2022E	2023E
Net income	140	216	476
Adjustments:			
Depreciation and amortization	94	107	124
Gain from ST investment	(9)	0	0
Net loss on disposal of property and equipment	2	0	0
Net loss on disposal of intangible asset	0	0	0
Allowance for doubtful accounts	3	3	3
Deferred income tax expense (benefit)	(9)	0	0
Changes in working capital	197	83	660
Net cash used by operating activities	**418**	**409**	**1,263**
Net cash used in investing activities	**(42)**	**40**	**(128)**
Net cash used by financing activities	**(161)**	**(28)**	**(0)**
Net increase in cash	206	421	1,135
Cash at the beginning of the period	833	1,039	1,460
Cash at the end of the period	1,039	1,460	2,595

Source: Atour Lifestyle Holdings Limited (as of March 17, 2023)

Luckin Coffee Inc.: Financial Summary

Fiscal year ends-31-Dec

Exhibit 7. Income statement

(RMB mn)	2022A	2023E	2024E
Net revenue	**13,293**	**19,600**	**25,454**
Operating expenses	(2,363)	(2,859)	(3,524)
Operating income	1,156	2,987	4,859
Operating margin	8.7%	15.2%	19.1%
S&M	(570)	(785)	(1,018)
G&A	(1,460)	(1,963)	(2,444)
Non-GAAP operating income	**1,776**	**3,616**	**5,644**
Non-GAAP operating margin	13.4%	18.4%	22.2%
Interest income	85	100	110
Other income, net	61	0	0
Pre-tax profit	1,127	3,065	4,947
Income tax benefit/(expense)	(639)	(774)	(1,237)
Net (loss)/income	488	2,290	3,710
Net margin	3.7%	11.7%	14.6%
Non-GAAP net income/(loss)	**1,048**	**2,879**	**4,475**
Non-GAAP net income/(loss) per ADS — Diluted (RMB)	3.32	9.12	13.91

Source: Luckin Coffee Inc. (as of March 17, 2023)

Company Description

Luckin Coffee is one of the largest coffeehouse chains in China that offers freshly brewed coffee, tea and food. As of C4Q22, the company operates 5,652 stores in ~50 top tier cities, and 2,562 partnership stores in ~200 lower-tier cities.

Industry View

We expect China's coffee market to grow from RMB110bn in 2021 to RMB240bn in 2026 at the 5-year CAGR of 16.9%. Among that, freshly brewed coffee will grow at 19.0% CAGR, outpace the instant coffee and ready-to-drink coffee at 5.5% and 8.0% CAGR respectively in 2022-2025.

Exhibit 8. Balance sheet

(RMB mn)	2022A	2023E	2024E
Cash and cash equivalents	3,534	4,575	7,274
Restricted cash	44	44	44
Accounts receivable, net	59	115	162
Receivables from online payment platforms	152	383	472
Prepaid expenses and other current assets, net	1,078	1,927	2,221
PPE	2,004	2,751	3,414
Other non-current assets, net	328	392	509
Deferred tax assets, net	208	1,568	2,036
Operating lease right-of-use assets	2,004	2,751	3,414
Total assets	**10,480**	**15,792**	**21,140**
Accounts payable	441	647	820
Accrued expenses and other current liabilities	1,375	2,651	3,205
Deferred revenues	97	198	231
Operating lease liabilities	881	1,375	1,707
Non-current liabilities	1,024	1,375	1,707
Mezzanine equity:	1,578	1,578	1,578
Additional paid-in capital	16,037	16,037	16,037
Total liabilities and equity	**10,480**	**15,792**	**21,140**

Source: Luckin Coffee Inc. (as of March 17, 2023)

Exhibit 9. Cash flow statement

(RMB mn)	2022A	2023E	2024E
Net (loss)/income	488	2,290	3,710
Adjustments:			
Foreign exchange loss/ (gain), net	(11)	0	0
Loss on disposal of property and equipment	0	0	0
Depreciation and amortization	420	517	652
Impairment of long-lived assets	222	40	20
Share-based compensation expenses	(398)	(589)	(765)
Accounts receivable	(20)	(56)	(47)
Inventories	(613)	(455)	(331)
Receivables from online payment platforms	20	(231)	(89)
Prepaid expenses and other current assets	(34)	(850)	(294)
Cashflow from operating activities	**20**	**2,135**	**4,095**
Purchases of property and equipment	(798)	(1,117)	(1,375)
Cash received from disposal of PPE	1	1	1
Cashflow from investing activities	**(798)**	**(1,116)**	**(1,373)**
Cashflow from financing activities	**(2,276)**	**0**	**0**
Net change in cash and cash equivalents	(2,977)	997	2,700
Cash, cash equivalents, and restricted cash at beginning of years	6,555	3,578	4,575
Cash, cash equivalents, and restricted cash at end of years	3,586	4,590	7,298

Source: Luckin Coffee Inc. (as of March 17, 2023)

Miniso Group: Financial Summary

Fiscal year ends-30-Jun

Exhibit 10. Income statement

(RMB mn)	FY2022	FY2023E	FY2024E
Revenue	10,086	11,103	14,391
Cost of sales	(7,016)	(6,968)	(9,101)
Gross profit	3,070	4,135	5,291
Other income	26	30	32
Selling and marketing expenses	(1,442)	(1,701)	(2,192)
General and administrative expenses	(816)	(693)	(895)
Other net income	24	46	(40)
Operating profit	882	1,840	2,234
Net finance costs	33	95	93
Profit before taxation	907	1,935	2,328
Income tax expense	(267)	(474)	(582)
Net income	640	1,461	1,746
Non-GAAP net income	723	1,517	1,818
Non-GAAP diluted EPADS (RMB)	2.10	4.43	4.93

Source: Miniso Group (as of March 17, 2023)

Company Description

By offering lifestyle products at affordable price, MNSO has become the largest chain value retailer in China, with a quickly expanding global presence, and recorded total GMV of RMB19 bn in FY2022. As of C3Q22, MNSO has established a total of 5,405 stores across 99 countries, with 3,378 in Mainland China and 2,027 in the overseas market.

Industry View

China's branded variety retailer (BVR) sector, the major retailing model offering value products in China, has witnessed the highest growth rate in the lifestyle market despite its small scale. We expect China's BVR sector to grow at a CAGR of 15% in 2023-26, which outpaced that of the overall lifestyle product market.

Exhibit 11. Balance sheet

(RMB mn)	FY2022	FY2023E	FY2024E
Cash and cash equivalents	5,348	6,626	8,484
Restricted cash	32	32	32
Inventories	1,188	1,317	1,720
Trade and other receivables	1,056	1,065	1,380
Total current assets	8,073	9,487	12,065
Property, plant and equipment	420	493	562
Right-of-use assets	2,343	2,429	2,496
Intangible assets	44	34	23
Other non-current assets	404	404	404
Total non-current assets	3,210	3,360	3,484
Total assets	**11,282**	**12,847**	**15,549**
Loans and borrowings	0	0	0
Trade and other payables	3,073	3,082	3,833
Other current liabilities	715	856	1,002
Total current liabilities	3,789	3,939	4,836
Loans and borrowings	7	7	7
Other non-current liabilities	459	498	548
Total non-current liabilities	466	505	554
Total liabilities	4,254	4,444	5,390
Total common equity	7,027	8,403	10,159
Non-controlling interests	(4)	10	45
Total shareholders' equity	7,032	8,394	10,114
Total liabilities and equity	**11,282**	**12,847**	**15,549**

Source: Miniso Group (as of March 17, 2023)

Exhibit 12. Cash flow statement

(RMB mn)	FY2022	FY2023E	FY2024E
Net income	640	1,461	1,746
Adjustments for:			
Depreciation and amortization	390	486	548
Others	(99)	3	0
Fair value changes of paid-in capital	0	0	0
Equity-settled share-based expenses	83	53	150
Income tax	267	474	582
Changes in working capital:			
Inventories	308	(129)	(403)
Trade and other receivables, prepayments	(190)	(8)	(315)
Contract liabilities	86	151	168
Trade and other payables and accruals	180	9	750
Restricted cash	(29)	0	0
Income tax paid	(230)	(474)	(582)
Cashflows from discontinued operations	0	0	0
Net cashflow from operating activities	**1,407**	**2,025**	**2,644**
Net cashflow from investing activities	**(2,126)**	**(747)**	**(785)**
Effects of exchange rate changes	30	0	0
Net increase in cash and cash equivalents	(1,453)	1,278	1,859
Cash and cash equivalents at beginning of year	6,771	5,348	6,626
Cash and cash equivalents at end of year	**5,348**	**6,626**	**8,484**

Source: Miniso Group (as of March 17, 2023)

Futu Holdings Limited (NASDAQ: FUTU)

Fiscal year ends-31-Dec

Exhibit 13. Exhibit 1. Income statement

(HKD mn)	2021A	2022E	2023E
Total revenues	**7,115**	**7,523**	**9,888**
Brokerage commission	3,913	3,936	4,126
Interest income	2,518	3,197	5,092
Other income	684	390	670
Cost of revenue	(1,206)	(911)	(1,534)
Brokerage commission and handling charge expenses	(572)	(353)	(499)
Interest expenses	(377)	(171)	(295)
Processing and servicing costs	(257)	(388)	(740)
Gross profit	**5,909**	**6,612**	**8,355**
Total operating expense	(2,726)	(3,076)	(3,829)
Research and development	(805)	(1,247)	(1,520)
Selling and marketing	(1,392)	(998)	(1,158)
General and administrative	(529)	(831)	(1,150)
Operating profit	**3,183**	**3,537**	**4,526**
Others, net	2	(319)	(100)
Pre-tax income	3,185	3,217	4,426
Income tax expense	(375)	(367)	(664)
Net income	2,810	2,850	3,762
Net income attributable to shareholder	2,810	2,850	3,762
Non-GAAP Net income	**2,909**	**3,065**	**3,960**

Source: Futu Holdings Limited, Blue Lotus (as of March 17, 2023)

Company Description

FUTU is an advanced technology company that provides its clients a fully digitalized brokerage platform. Its advanced features and community spirit helped to accumulated high quality users, whose average age is 35, with high earnings. FUTU currently operates in four regions, including mainland China, HK, United States, and Singapore. By 3Q22, FUTU accumulated ~1.4mn paying clients, and serves 19.2mn users. We estimate that FUTU's paying clients will grow at 3-yr CAGR of 12% to reach 2.1mn by 2025.

Industry View

The global online security trading market has increased from US$66tn in 2017 to US$144tn in 2021, with online penetration at 53.2%. Mobile internet development/ retail investor participation/ demanding on high quality investor community and products are the main contributors to the extending online retail investor base.

Exhibit 14. Exhibit 2. Balance sheet

(HKD mn)	2021A	2022E	2023E
Cash and restricted cash	4,557	5,730	5,030
Cash held on behalf of clients	54,734	51,572	60,438
Term deposit	2	-	-
Loans and advances	29,587	29,881	34,101
Receivables	10,397	8,379	9,721
Interest	51	51	51
Prepaid assets	18	18	18
operating lease	244	244	244
Other assets	1,950	1,820	1,820
Total assets	**101,539**	**97,695**	**111,422**
Amounts due to related parties	87	96	155
Payables:	67,177	60,392	70,070
Interest	15	15	15
Short-term borrowings	6,357	4,611	4,815
Securities sold to repurchase	4,468	4,468	4,468
Operating lease	261	261	261
Accrued expenses and others	2,187	2,187	2,187
Total liabilities	**80,553**	**72,031**	**81,970**
additional paid in capital	17,936	17,936	17,936
other comprehensive loss	76	76	76
Accumulated deficit	4,152	7,652	11,440
Treasury stock	(1,179)		
Total equity	**20,986**	**25,664**	**29,452**
Total liabilities and equity	**101,539**	**97,695**	**111,422**

Source: Futu Holdings Limited, Blue Lotus (as of March 17, 2023)

Exhibit 15. Exhibit 3. Cash flow statement

(HKD mn)	2021A	2022E	2023E
Net (loss)/income	2,810	2,850	3,762
Adjustments for:			
Depreciation and amortization	36	45	59
Expected credit loss	3	-	-
Loss from equity investments	-	-	-
Impairment from equity investment	-	-	-
Foreign exchange gains	(138)	-	-
Share-based compensation	99	214	198
Realized gain from financial securities	-	-	-
Deferred income tax expenses	(21)	(12)	(16)
Amortisation of right-of-use assets	84	-	-
Changes in operating assets:	(13,354)	1,725	(5,562)
Changes in operating liabilities:	16,493	(6,776)	9,736
Net cash generated from operating activities	**6,012**	**(1,954)**	**8,177**
Gain from PPE	(70)	(76)	(80)
Gain from financial securities	(1,170)	-	-
Placement of term deposit	277	-	-
Net cash used in investing activities	**(964)**	**(76)**	**(80)**
Net cash from financing activities	**10,554**	**-**	**-**
Exchange loss	167	40	69
Net increase in cash	15,770	(1,990)	8,165
Cash at beginning	43,522	59,292	57,302
Cash at end	59,292	57,302	65,467

Source: Futu Holdings Limited, Blue Lotus (as of March 17, 2023)

KE Holdings Inc.: Financial Summary

Fiscal year ends-31-Dec

Exhibit 16. Income statement

(RMB mn)	2021A	2022E	2023E
Revenue	**81,302**	**60,645**	**71,983**
Cost of Goods Sold	(64,933)	(47,349)	(53,333)
Gross profit	**16,369**	**13,296**	**18,650**
Sales and marketing	(4,309)	(4,411)	(4,679)
General and administrative	(8,924)	(7,227)	(5,903)
R&D expense	(3,194)	(2,639)	(2,623)
Operating profit, GAAP	(806)	(980)	5,446
Share based compensation	(1,538)	(1,190)	(2,159)
Amortization of intangibles	(470)	(512)	(425)
Operating profit, non-GAAP	**1,203**	**722**	**8,031**
Others	2,496	1,322	1,280
Earning before tax	1,690	341	6,726
Taxation	(1,665)	(1,302)	(1,682)
Net income, GAAP	**24**	**(960)**	**5,045**
Net income, non-GAAP	**2,843**	**1,825**	**7,849**
Number of ADS diluted	1,183	1,201	1,214
EPADS, non-GAAP (RMB)	**2.40**	**1.51**	**6.46**

Source: KE Holdings, Blue Lotus (as of March 17, 2023)

Company Description

KE Holdings Inc. ("Beike") is the leading integrated online and offline platform for housing transactions and services in China. Beike's business ranges from existing and new home sales, home rentals, to home renovation, real estate financial solutions, and other services. In 2021, Beike generated a GTV of RMB3,853bn and facilitated over 2.2mn housing transactions on platform. Beike's existing home transaction services revenue and new home transaction services reached RMB31,948mn and RMB46,476mn in 2021, representing 39.6% and 57.5% of total net revenue, respectively.

Industry View

China has the largest housing market in the world in terms of the GTV and number of transactions of existing and new home sales and home rentals in 2021, according to the CIC Report. The total existing and new home sales and home rentals market reached RMB25.0tn in 2021 from RMB0.5tn in 2000 and is expected to further grow at a CAGR of 5.2% to RMB31.4tn by 2025, we estimate.

Exhibit 17. Balance sheet

(RMB mn)	2021A	2022E	2023E
Cash, cash equivalents and restricted cash	26,732	23,241	32,562
Short-term investments	29,403	29,403	29,403
ST financing receivables	702	787	2,075
Account receivables, net	9,325	8,664	9,998
Amounts due from related parties	591	505	585
Loan receivables from related parties	43	32	38
Prepayments and others	3,130	2,244	3,167
Total current assets	69,926	64,876	77,828
Property and equipment	1,972	2,318	2,752
Right-of-use assets	7,244	7,694	8,171
Other noncurrent assets	21,177	21,395	21,667
Total assets	**100,319**	**96,283**	**110,418**
Account payable	6,009	5,027	5,645
Employee compensation payable	9,834	6,065	7,774
Customer deposits payable	4,181	4,043	5,999
Other current liabilities	8,328	8,245	10,133
Total current liabilities	28,936	23,672	29,967
Long term borrowings	-	-	-
Total liabilities	33,263	26,039	32,964
Total liabilities and shareholder equity	**100,319**	**96,582**	**110,716**

Source: KE Holdings, Blue Lotus (as of March 17, 2023)

Exhibit 18. Cash flow statement

(RMB mn)	2021A	2022E	2023E
Net income	(525)	(960)	5,045
Depreciation of property and equipment	880	676	760
Amortization of intangible assets	491	347	427
Other provisions and deferred taxes	1,178	(130)	(107)
Share based compensation	1,538	1,190	2,159
Change in working capital	32	(5,318)	3,110
Net cash in operation activities	**3,595**	**(4,195)**	**11,393**
Purchase and redemption of ST investments	(9,876)	-	-
Purchase of PPE and intangibles	(1,430)	(1,044)	(1,257)
Financing receivables originated and collected	3,313	(153)	(1,417)
Loans to and from related parties	(6)	11	(6)
Net cash in investment activities	**(24,884)**	**(1,208)**	**(2,702)**
Proceeds and repayment of ST borrowings	260	(260)	-
Proceeds and repayment of LT borrowings	-	-	-
Net cash in financing activities	**(1,074)**	**1,913**	**630**
Net increase in cash and cash equivalents	(22,806)	(3,490)	9,321
Cash and cash equivalent at beginning	49,537	26,731	23,241
Cash and cash equivalent at end	26,732	23,241	32,562

Source: KE Holdings, Blue Lotus (as of March 17, 2023)

Opportunities are in structure and substitution

The investment opportunities to Chinese consumption sectors are mainly from structural and substitutional angles.

Our analysis found China's consumption level is no longer low by global standards. After adjusting apple-to-apple, China's retail sales as percentage of GDP stood at 38%, actually higher than 37% for the US and 28% for Japan. We found, however, this doesn't mean China's consumption is saturated, but only means the composition of consumption is different. Chinese consumptions are robust on daily essentials but low on healthcare, financial and professional services.

China's consumer spending isn't as low as one thinks

According to National Bureau of Statistics, China's social retail sales amounted to Rmb44.1tn in 2021, representing 39% of China's nominal GDP. This social retail sales, while well quoted, doesn't include the following household expenses:

China's social retails sales do not include healthcare, rental, education, financial services, etc. while other countries do.

- **Healthcare consumption expenditure**, which in 2021 was estimated to be Rmb4.2tn (*Source: NHC*), of which ~45% was paid by the consumers out-of-pocket. China's retail sales figure only includes the cost of medicine while the US retail sales figure includes medicine *and* patient/elderly care. The latter is actually quite sizable in the US but minuscule in China at the present time. Please refer to Exhibit 1 of our digital healthcare system initiation <*Early stage calls for prudence*>, September 15, 2021, for comparative figures;
- **Rental and utility expenditure**, which in 2021 was estimated to be Rmb2.2tn (*Source: CIC*). Please refer to Exhibit 17 of our Beike initiation <*Meet, work and live in Beike*>, March 5, 2021, for details. Both US and Japanese consumption data include rental and utility;
- **Education services expenditure,** which in 2021 was estimated to be Rmb7.4tn, of which 17% was paid by consumers out-of-pocket**.** Please refer to Exhibit 5 of our K12 education initiation <*Piling up critical stepstones for a great nation*>, July 6, 2018, and college education initiation <*Focus on undergraduate and geographic coverage*>, April 12, 2019, for comparative figures. Again, US personal consumption includes education services;

We found the statement that Chinese under-consumes is not true.

- **Financial services expenditure**, which includes brokerage commission totalling Rmb0.5tn in 2021 (*Source: SAC*), insurer premium totalling Rmb4.5bn (*Source: IAC*) and asset managers' management fees totalling Rmb0.1tn in 2021 (*Source: WIND*). In US personal consumption expenditure this is classified as financial services;
- **Professional services expenditure**, which includes personal accounting expenses (negligible) and real estate brokerage service which in 2021 totalling Rmb0.34tn (*Source: Blue Lotus*). Please refer to our Beike initiation for comparative figures;
- **Recreational, entertainment and cultural services expenditure**, which in 2021 was estimated to be Rmb11.9tn, of which 50-60% was paid by consumers out-of-pocket (*Source: Blue Lotus*);
- **Used motor sales expenditure,** which in 2021 was estimated to be Rmb1.1tn (*Source: CADA*). Used car sales is included in US personal consumption but excluded from Chinese retail sales.

The above consumption expenditures are included by various degrees in various countries. Therefore, to make our comparisons apple-to-apple, we first remove the above categories (the China Standard). The result is shown in Exhibit 19. It shows that China's retail sales over GDP (adjusted) stood at 38%, behind India's 54% but above US's 37% and Japan's 28%, suggesting that China actually over-consumes.

The statement that China under-consumes depends on inclusion of certain retail categories that China does under-consume.

We then include the above categories (the non-China standard), China's adjusted retail sales over GDP became 42%, comparing to 67% of US and 52% of Japan, in 2021, suggesting China under-consumes.

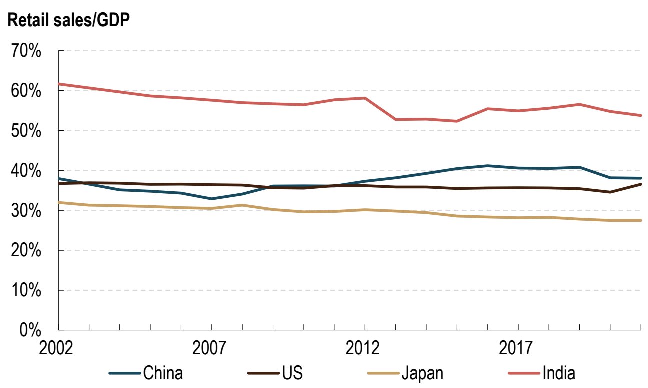
Therefore, the statement of China under-consuming depends on the inclusion of certain consumption categories that China indeed under-consumes. These consumptions are mostly related to a more affluence and older society, into which China will grow soon.

China's low consumption level is due to structural underspending

India's high consumption level hints that a country's consumption over GDP is highly correlated with its development status. We found it true. If only daily essentials are counted as consumption, then a developing country will have an abnormal high level of consumption over GDP (Exhibit 20). If a middle-income country includes cars and homes as consumption, their consumption level will appear high, too. Then, if a high-income country includes healthcare, financial services and professional services as consumption, their consumption levels over GDP will move further higher. But in fact, their consumption level might be similar.

Low, mid- and high-income countries have different meanings of consumption.

Exhibit 19. Retail sales over GDP comparison, adjusted



Source: NDS, BEA, ESRI, BPS, India Budget, Blue Lotus (as of March 17, 2023)

Exhibit 20. Retail sales over GDP in certain categories, 2021

	Cosmetics	Apparel	New car	Dining	Food	Beverage
China	0.9%	3.1%	**3.8%**	4.1%	5.5%	0.6%
US	0.3%	2.0%	1.6%	4.5%	4.1%	0.5%
Japan	0.7%	1.8%	2.7%	2.9%	7.7%	1.0%
S. Korea	1.6%	2.6%	2.5%	4.4%	5.5%	0.7%
Mexico	0.7%	1.4%	2.4%	1.3%	**15%**	1.9%
India	2.4%	4.5%	1.0%	1.6%	**18%**	0.1%
Indonesia	0.1%	1.9%	1.8%	5.0%	**22%**	2.2%

Source: NBS, BEA, ESRI, KOSIS, INEGI, METI, Blue Lotus (as of March 17, 2023)

Affordable essential in China is a legacy by the socialist regime

Exhibit 20 breaks out the categorized retail sales over GDP of different countries. We use GDP as a common denominator to remove the impact of different definitions of what constitute a retail sales or domestic consumption.

As it shows, the reason that India's consumption over GDP is so high is because it spends a significant portion, 18%, of its GDP on food. The same observation exists in Mexico and Indonesia.

China's consumption levels of new car and dining are relatively high by global standards.

In China's case, none of the investigated categories are below peer countries as percentage of GDP.

A major contributor of China's consumption over GDP is new car sales, which at 3.8%, is significantly higher than other countries, which partially explained why used car sales is under-developed in China. Also, China's dining expense stood out even though its food consumption as GDP was relatively low versus. peers. China's consumption of cosmetics and non-alcoholic beverages are lower than some countries like India, Indonesia and Mexico but aren't low comparing to India and South Korea. A masculine definition femininity might explain the former and prevalence of tea drinking might explain the latter.

While budget composition and cultural factors can be behind many consumption differences, we know Chinese aren't under-spenders as they are pictured to be.

This data confirmed that Chinese hasn't underspent in consumption, as a whole, comparing to other countries. In 2021, Americans spent US$246bn on used car sales (1.1% GDP), US$2.5tn on healthcare, US$1.3tn on financial services and US$211bn on professional services, US$2.8tn on rental and utilities, all of which were included in the US personal consumption according to definition by BEA but not in China's social retail sales by the definition of NBS.

Economic structure and demographics are factors No.2 and No.3

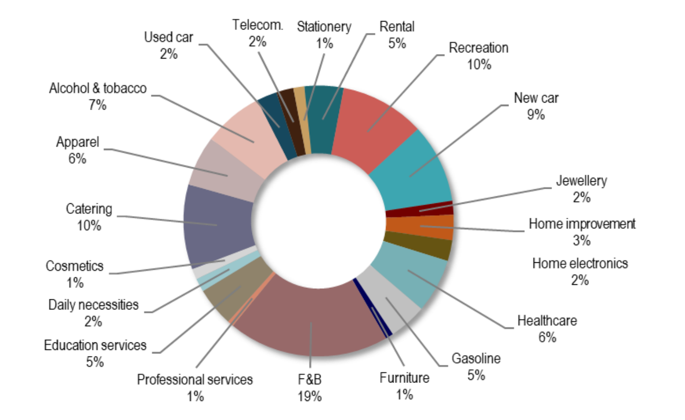
For example, the relatively high percentage of food and beverage consumption in Japan and Korea reflects the price of grocery there to be much higher than agricultural states like U.S. and China. The relatively low consumption level of cars over GDP in Mexico probably reflects the abundant supply of cheap US-exported cars in that country. Mexico's high level of beverage consumption likely reflects the success of US soft drink giants there. Lastly, Japan's relatively low consumption level as GDP is probably a result of its demographic profile.

China's future growth in consumption will likely happen in new categories instead of in existing categories.

Service, especially for the rich and old, is what China under-consumes

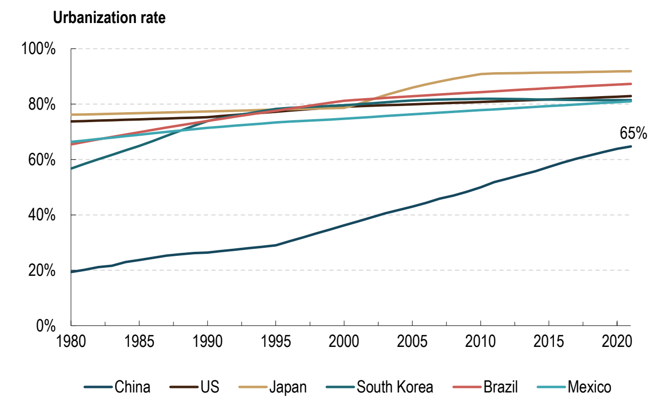
Exhibit 21 reconstructs China's consumer spending by taking into account of service sales, which NBS undercounts in its definition of social retail sales. Service sales amounted to Rmb6.8tn in 2021, adding on top of Rmb39.4tn consumer goods as defined by NBS. We can see that Chinese consumers spend ~11% of its expenditure on new and used cars, ~6% on healthcare (out of pocket) and ~10% on homes (rental, utility, home improvement, etc.). Other service components, such as financial and professional services, has been minuscule for Chinese but substantial for Americans. Home improvement is also a small category for Chinese but a big one for Americans. The same is for elderly care.

Exhibit 21. Consumption breakdown, China, total-Rmb48.5tn



Source: NBS Blue Lotus (as of March 17, 2023)

Exhibit 22. Urbanization comparisons, China vs. developed



Source: NBS, WorldBank, Blue Lotus (as of March 17, 2023)

We believe China's future consumption growth will likely take place in new categories as the country's development status, economic structure and demographic profile evolve.

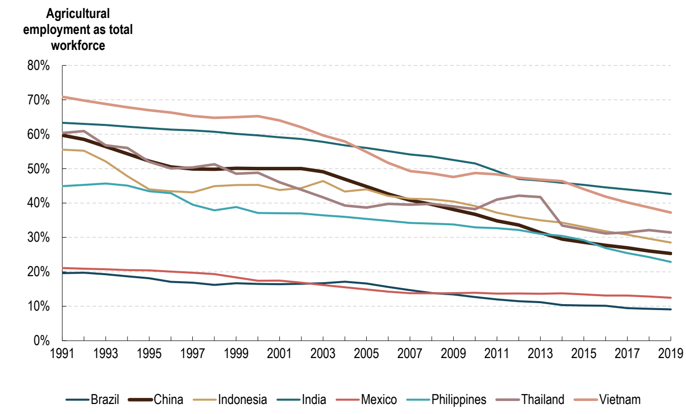
Urbanization is a driver, but must be conditioned on jobs

According to World Bank, China's urbanization level is still below global levels (Exhibit 22). The theory goes that an urban resident consumes more than a rural one because he/she relies more on the social division of labors.

The theory of urbanization driving consumption must rest on division of labor, not on domicile of abode.

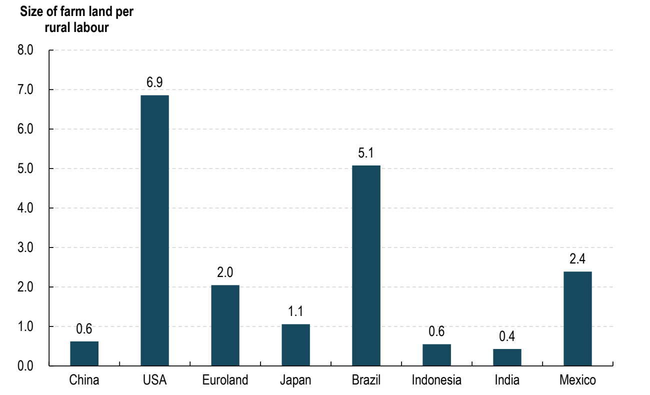
We buy this theory, on the condition that the displaced rural labor does find a paying job in the urban.

Exhibit 23. Agricultural employment as total workforce



Source: WorldBank, Blue Lotus (as of March 17, 2023)

Exhibit 24. Average lot size of arable land



Source: NBS, WorldBank, Blue Lotus (as of March 17, 2023)

Urbanization's benefit to consumption must condition on job creations

China agricultural employment as total workforce is smaller than percentage of residents living in rural areas, suggesting the room for further urbanization isn't as great as one expects.

The definitions of urbanization by World Bank vary from country to country. But in China the official definition is actually the domicile of abode, or *Hukou* (户口). This is not a meaningful definition of urbanization, in our view. The correct definition, in our view, should be residents employed by non-agricultural sectors. In China's case, this ratio was ~25%, close to 35% by the domicile of abode but still lower (Exhibit 23), suggesting less room for urbanization than pictured to be.

So, roughly a quarter of China's labour force, ~279mn people, engages in agricultural work. This is in-line with the world average of 27%, and much higher than Brazil (9%) and Mexico (12%). As Exhibit 23 shows, China started at an agricultural workforce composition similar to Thailand and Indonesia in 1991. It ended at about the same levels in 2019 as these two countries. Is there something wrong? How did China rise in global manufacturing in the past few decades with still so many residents working in agriculture?

The reasons we explored point to the pace of urbanization will stay slow in the coming years. In our view, China's slow pace of urbanization can be attributed to the following reasons:

- **Chinese government has always encouraged the retention of agricultural population:** This is evident in various policies executed at the village and township level to slowdown rural migration to the cities, for the purpose of social stability;

The fragmentation of China's agricultural production is a result of Agricultural Production Subtracting Policy introduced in 1982.

- **Fragmentation of China's agricultural industry:** China pursued soviet style, collective communes in the 1950-80's, but there weren't enough urban jobs, at the time, to absorb not only the excess rural labours, but even the baby boomers at cities. As a result, massive number of idled rural labours resulted and Chairman Mao had to initiate a campaign called "Go up to mountains and down to countryside" (上山下乡). In 1982, acknowledging its failure, Chinese government reversed course and introduced subcontracting (包产到户) of agricultural productions to individual households. This, in our view, directly resulted in the fragmentation of China's agricultural production today. As Exhibit 24 shows, Average farming area per rural labour was only 0.6 acres. China's agricultural labour density is ~1/3 of EU, ~1/2 of Japan and 1/10 of US, at a level comparable to India and Indonesia, where a substantial portion of rural labours are tied to agricultural work, in low productivities;

Globally agricultural work doesn't need so many labors.

- **China has discouraged agricultural economy of scale:** According to China's 3rd agricultural census, 98% of China's agricultural entity and 90% of agricultural labour force were independent farmers, typically a single family. This means that *despite* China's rapid rise in global manufacturing, China still has excess labour in its farmland. This is actually the case around the globe, too, only that China had a solution by absorbing them into export factories;

An effective urbanization to consumption must be the migrated person finds a higher paying job.

- **China has actively tackled migration labour issues:** A large influx of rural labour has migrated to cities in the past decades and contributed to China's rise as a global manufacturing powerhouse. However, state policies have *not* encouraged such migration. Chinese government at various level has tried to maintain and improve living standards for rural migrant labours. Without such measures, urbanization could have happened at a faster pace, possibly with social illnesses, such as ghettoization and underground crime. The fact that no such social illness existed in a large scale actually pointed to China's intended control of urbanization pace.

We see no reason why China will reverse its slow urbanization policy

The question is, can China's urban centres absorb more, or fewer rural labours going forward? The answer depends whether urban can pay a higher wage than staying in rural can provide. There are positives and negatives. First the positive,

E-commerce platforms are enabling foodstuff supply chain companies which we believe overtime will blur the boundary between agricultural and industrial productions.

- **Agricultural-industrial complex blurs the line between agricultural and industrial work:** One of the main driving forces of lifting rural labour to urban while remaining living in rural area is the integrated agricultural industrial complex, enabled by e-commerce and O2O platforms like Meituan and Pinduoduo. Using demand pooling made possible by these platforms, new kind of foodstuff supply chain companies emerged, creating non-farming jobs. Leaders in this space include Lehe (乐禾), WJH (望家欢), Meicai (美菜) and Haidilao-affiliated Shuhai (蜀海), as well as prefabricated food producers like WZX (605089 CH, NR) and WJD (王家渡). Jobs created by these enterprises convert workers into de factor urban residents, who consume more but stay in rural areas;

- **The negative factors are also plenty, including:**

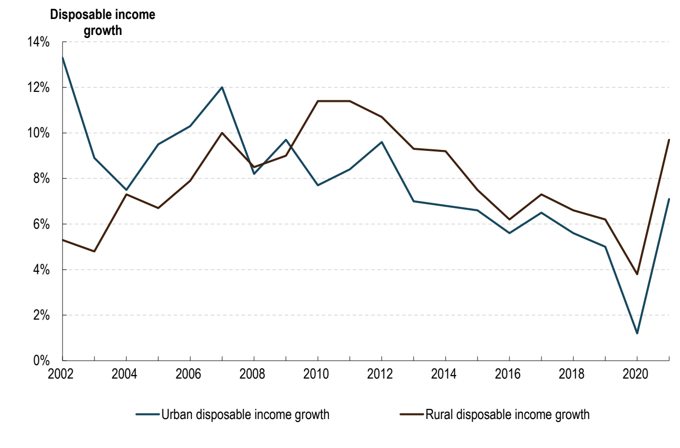
  – **Out shifting of manufacturing jobs due to Sino-US trade war**: Export has been the main game changer of China's rural economics. Collectives and automation are actually becoming feasible, leading to more rural labour joining urban, but such process is disrupted by the trade war;

  Service job, especially low end, tends to create less consumption power than manufacturing job.

  – **Rural disposable income has been growing faster than urban since 2010**: As shown in Exhibit 25, rural disposable income has persistently outgrown urban in the past decade, reflecting government's persistent effort at subsidizing rural population, which resulted in rural disposable income growing from 1/3 of urban in 2010 to 40% of urban in 2021. This gap, in our view, will further narrow as we expect the Chinese government to continue to act to counter the population flow to urban to maintain social stability;

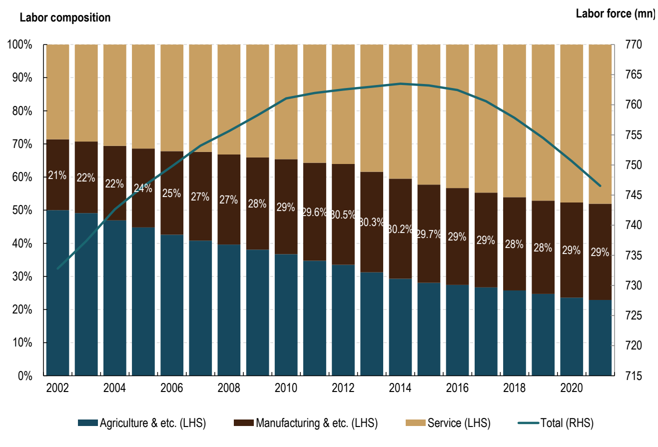
  – **Service jobs will replace manufacturing as the main driver for migrant employment**: As Exhibit 26 shows, China's manufacturing jobs as percentage of total peaked at 2012 (31%). Manufacturing job contribution to total labour force stabilized in recent years, thanks to government efforts, but the absolute size of China labour force has started to steadily decline since 2015. Going forward we believe the gravity pull will be service jobs gaining further weight over manufacturing. Service jobs, however, tend to create less wealth multiplying effect and thus less consumption power than manufacturing jobs, as various literatures have shown.

Exhibit 25. Disposable income growth, urban vs. rural



Source: NBS, Blue Lotus (as of March 17, 2023))

Exhibit 26. China's labour force and composition



Source: NBS, Blue Lotus (as of March 17, 2023). Agriculture & etc.=Agriculture, forestry, livestock farming & fishing; Manufacturing & etc.=Manufacturing & mining,

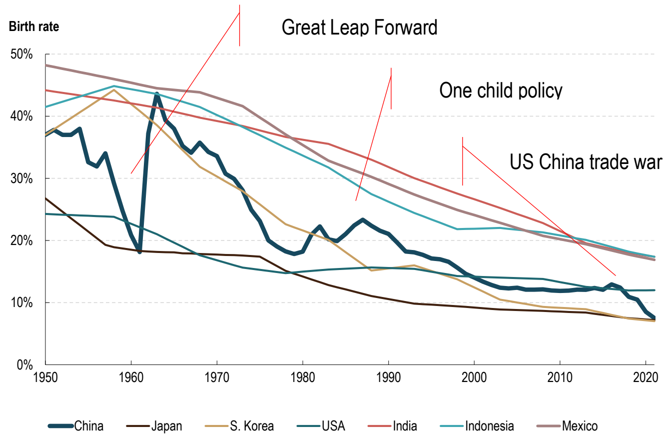
Population aging is a major threat to consumption

China is becoming like Japan in terms of median age by 2030, which will have major implication on consumptions.

The low consumption level of Japan (Exhibit 19) after removing elderly care shows the future for China. In 2022, China's median age stood at 38.4, comparing to 38.5 for U.S., 48.6 for Japan, 43.2 for S. Korea, 31.1 for Indonesia, 29.3 for Mexico and 28.7 for India. According to United Nations Development Programme (UNDP), China's median age is expected to reach 47.1 by 2030, similar to the level of Japan today, which represents a major threat to China's consumption down the road.

According to NBS, China's birth rate decelerated sharply from 2018 onwards to hit a new low of 7.5% in 2021 (Exhibit 27). The US-China trade war coincided with this pivotal change, further compounding on a series of policy changes that increase the uncertainty of future generations.

Exhibit 27. Birth rate comparison



Source: NBS, UNBP, Blue Lotus (as of March 17, 2023)

Exhibit 28. China's pension asset vs. the world

(US$ tn)	China	U.S.	Japan	Korea	India
National	1.38	2.85	1.97	0.56	0.07
Employer	0.65	23	1.10	0.19	0.01
Individual	0.02	14	0.75	0.14	0.004
Total	2.05	39	3.82	0.89	0.09
Population >65 (mn)	201	54	36	8.5	91
Pension per senior (US$ K)	10	722	107	105	1.0

Source: MOHRSS, SSA, BOJ, GPIF, PFA, NPFA, KOSIS, NPS, Blue Lotus (as of March 17, 2023)). Exchange rate assumptions, US$1=Rmb6.8=JPY137=KRW1,333= INR80

Housing policy shift complicates consumption decisions

We believe another major headwind against consumption is the shift in housing policy, since 2018, which drastically alter the return expectation of residential housing.

China's pension fund has been new and underfunded. Many treat an ever-appreciating housing market as their pension. Such assumption is no longer valid.

Despite rapid progress over a short time, China's elderly safety net is still substantially smaller than that of the developed countries. As Exhibit 28 shows, the size of China's public and private pension funds in 2021 was only Rmb13.3 tn. On a per-above-65-person basis, China's pension per senior was only ~US$10K, roughly 1.4% of U.S., 9.3% of Japan, 9.5% of Korea, but ~10x of India, suggesting this mainly a development stage problem.

The reasons why such might be could be:

- **Short history**: China's pension system only established itself in 2000 (national), 2004 (employer) and 2022 (individual) while some of the U.S. state pension funds dated back to the 19th century;
- **Narrower investment scope**: Chinese national pension's investment scope broadened to include stocks in 2015 with a 30% investable upper limit, while the US public pension fund can invest up to 47% in equities, including non-US equities;
- **Low participation and contribution limit**: As Exhibit 28 shows, the majority of US retirement funds are held in individual IRA and 401K accounts, in which the account holders enjoy tax breaks by investing in the mutual fund industry. The return of U.S. retirement accounts essentially becomes a market return. The Chinese version of 401K and IRA, individual retirement account, was introduced only in 2022 and is now capped at Rmb12K a year, which is minuscule as a start.

Currently China only allows annual cap of Rmb12K investing in the Chinese version of 401K/IRA per person.

From 2016-21, S&P returned 16.3% annualized and CSI returned 8.3%, while U.S. public pension 10.9%, China public pension 6.5% while average U.S. mutual fund returned 7.7%.

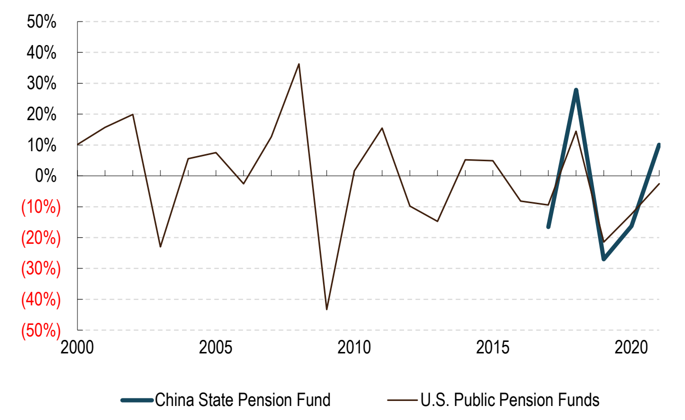
Exhibit 29 shows the relative return over index of China's national pension fund versus historical return of US public pension funds. It shows that over the five years in which it disclosed data and by investing in domestic Chinese assets only, China's national pension fund actually generated similar return as the U.S. public pension funds in the comparable period. However, as aforementioned, 95% of the U.S. pension assets are held in 401K and IRA accounts, which generate mutual-fund-type of returns. From 2016-21, S&P returned 16.3% annualized and CSI returned 8.3%, while U.S. public pension retuned 10.9%, China public pension 6.5% and average U.S. mutual fund 7.7%. Judging from this limited data, it appears that the bigger nest egg of US retiree is a result of wider participation and longer investment horizons, instead of superior investment return.

Nevertheless, because of the smaller nest eggs saved for retirement, many Chinese families treat the rising property market as their de facto pension fund. This assumption has proven untrue in 2020 and will likely deter the will of consumption of Chinese consumers.

Chinese households are more vulnerable and less diversified.

As Exhibit 30 shows, Chinese households hold more of their assets in real estate, which constituted 40% of their total assets in 2019, versus 26% in the US. In 2020 and 2021, China's residential housing price rose by high single digits while 2022 declined by low single digit. So, the composition didn't change radically. Further, US households hold more debt securities and defined benefit entitlements than Chinese households. Overall, the two countries' household net worth is about equal in size but with the Chinese households more vulnerable to stock market gyrations and real estate depreciations than their US counterparts. Lastly, while Chinese households do hold more in deposits, if we add defined benefit entitlements and other financial assets as high safety assets, Chinese household's nest eggs aren't bigger or even securer than their US counterparts.

Exhibit 29. Investment return from pension funds, vs. index



Source: SSF, Blue Lotus (as of March 17, 2023), Index of China=CSI 300, Index of US=S&P

Exhibit 30. US and China household balance sheet

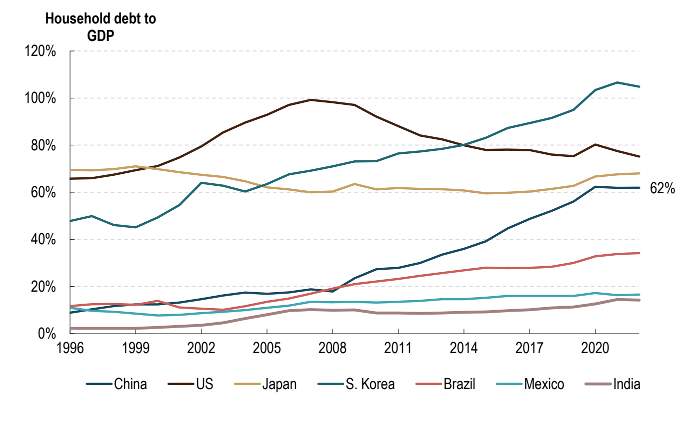
(scale to 100)	US	China
Total assets	100	100
Financial assets	66	57
Deposits	**11**	**21**
Stock: Direct holding	15	30
Stock: Indirect holding (mutual fund)	7.6	3.3
Debt security: Direct & Indirect	**5.7**	**0.7**
Defined benefit entitlements (pension)	**11**	**0.0**
Other financial assets	16	2.3
Real estate	**26**	**40**
Consumer durables	4.7	2.4
Other non-financial assets	3.2	0.6
Total liabilities	12	10.9
Mortgage	7.6	7.8
Credit card	2.9	1.3
Other liabilities	1.4	1.8
Net worth	88	89

Source: Fed Reserve, CNBS/NIFD (2019), Blue Lotus (as of March 17, 2023)

Household debt rose to all-time high, hindering consumption

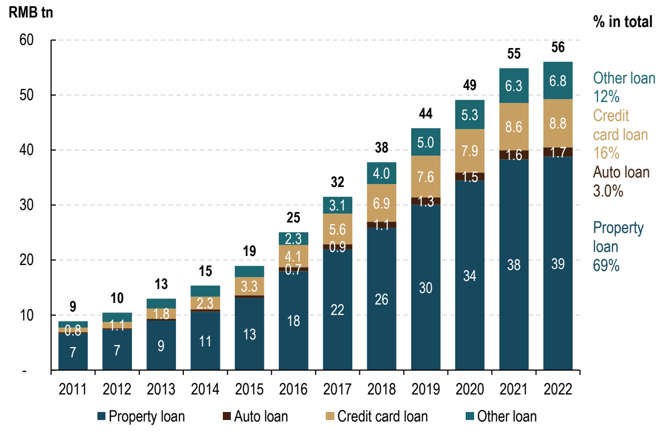
Because of rising mortgage costs (Exhibit 32), the burden of Chinese households' mortgage debt has kept climbing to 62% of GDP in 2022 (Exhibit 31). While this is still low by developed market levels, it is much higher than Brazil, Mexico and India.

Exhibit 31. Household debt to GDP



Source: NBS, WorldBank, Blue Lotus (as of March 17, 2023)

Exhibit 32. Composition of household debt, China



Source: NBS, WorldBank, Blue Lotus (as of March 17, 2023)

Studies by IMF showed that rising household debt can boost short term but at the expense of long term economic growth. Countries with less external debt and floating exchange rates, and which are financially more developed, are better placed to weather this trade off. The question is whether China can do so. We believe that with the rising trade tensions with the Western bloc, Chinese consumers aren't in a safe mode to weather this consequence and hence they will likely underspend to protect their retirement nest eggs.

Top pick for structural demand growth: FUTU, BEKE

FUTU and BEKE cater to the structural demand driver of Chinese consumption.

The BUY case on FUTU (FUTU US, BUY, US$51) rests on the globalization of assets held by Chinese households. The investment case of FUTU has some short-term challenges due to regulation, but we believe the benefits of FUTU's existence benefits Rmb's globalization and China's overseas investment. This is not lost in the mind the Chinese authorities, in our opinion. The clarification of the legal status of FUTU's service over the past two years significantly released the potential regulatory risk and the stock is now attractive in valuation.

The BUY case on BEKE (BEKE US, BUY, US$19) rests on the overall circulation ratio of Chinese residential assets remains far below the world's average, thus will go up over time. A big chunk of China's housing stock, mainly in the forms of rural homestead (宅基地) and urban shared-equity housing (小产权房), has not legally entered the circulation. We believe in the long-run, housing value is the ballast stone of China's residential wealth whose stabilization means a great deal to consumption.

Substitution must be sustained and profitable

As incremental demand growth in China's consumer sector becomes hard to attain, growth must increasingly come from market share shifts. Yet there are good and bad shifts, as well as sustained and transient shifts. We divide substitution growth into (a) domestic substitution of imported/MNC brands, (b) technology advancement leading to market share shuffles, (c) ideas from import revitalizing domestic sector, (d) cross-sector syndication regrouping consumer preferences.

Number wise consumer stocks constitute ~1/4 in China and ~1/2 in Hong Kong stock markets.

Alcohol & tobacco is the best for long-term investors

We count a total of 1,672 consumer stocks listed in China (968), Hong Kong (657) and US ADR (47) with a combined market capitalization of Rmb34.4tn at the point of this report. We exclude the pharma/biotech/biopharmas but include the gasoline stocks. We also removed the dual and triple listings.

Total market size of the consumer industries was Rmb47.8bn in 2021, giving it a price over market size, sort of a price to sales ratio, of 73%. Consumer is a big sector, with the number of stocks constituting ~1/4 of all the listed stocks in China and almost half in Hong Kong.

Sectors with market cap over market size bigger than 73% are Alcohol & tobacco, Home appliance & electronics, and Services. These sectors are concentrated in nature with fewer players controlling big market shares. The majority of industry sales are captured by the listco.

Alcohol & tobacco has market cap over market size bigger than average and market size per stock bigger than average. Growth can be achieved through year-after-year price increases.

In particular, Alcohol and tobacco also has a big market size per listed stock, which means each listed company covers a big market size. Combining these two angles together, Alcohol & tobacco seems to be the best sector for long-term investors because it is concentrated and large. The reason behind is simple. Alcohol & tobacco is basically a resource-driven consumer sector. Growth can be achieved through year-after-year price increases.

Exhibit 33. Chinese consumer stocks at a glance

	Market cap (Rmb bn)			Total market Cap (Rmb bn)	Total # of stocks	Market size 2021 (Rmb bn)	Market cap/ Market size	Market cap %	Market size %	Market size per listed stock
	A share	H share	ADR							
Food & catering	1,889	1,514	191	3,416	244	13,587	**26%**	9.9%	30%	**55**
Alcohol & tobacco	5,040	560	27	5,472	50	3,294	**166%**	16%	7.2%	**66**
Apparel/Cosmetics/ Personal Care	1,098	1,056	106	2,219	280	6,349	**35%**	6%	11%	**23**
Healthcare services***	1,476	342	-	1,791	91	5,862	**31%**	4.8%	6.3%	**64**
Home appliance & electronics	3,136	1,227	-	4,363	322	2,511	**174%**	13%	5.5%	**7.8**
Auto, parts & gas	6,187	2,285	373	3,219	231	8,117	**40%**	9%	17%	**35**
Housing service *	794	1,428	165	2,222	146	3,563	**62%**	6%	8%	**24**
Services **	1,774	8,660	4,930	11,836	308	4,530	**261%**	34%	16%	**15**
Total	21,395	17,072	5,791	34,538	1,672	47,813	**73%**	100%	100%	**28**

Source: Bloomberg, Blue Lotus (As of March 17, 2023) *Incl. rental, renovation, utility and brokerage. **Internet, education and travel, ***Mostly hospitals

Food & catering has a big market size but few listco's

Food & catering is the best for short term investors because it is dispersed (-) but each listed stock covers a big market size.

On the other hand, Food & catering seems to be a sector very suitable for speculators. Its market size over market cap in 2022 was only 26%, suggesting a very dispersed market yet each listed company covers Rmb55bn of addressable market, meaning successful companies have a lot of upside potential. Contrary to Alcohol & tobacco, entry barrier and upside ceiling to the Food & catering sector are both very low.

Exports broaden the horizons for product-based consumer sectors

Both IT/electronics and Services sectors have lopsided size of companies. At one hand, export boosts the market value of very large companies, At the other hand, many small listco's exist.

Home appliance & electronics have a market cap over market size of 174%. Not only because this sector is relatively concentrated, thank to economy of scale, but also because it exports a lot. Companies like MIDEA (000333 CH/000527 CH, NR) derives ~40% of its revenues from overseas and Haier (600690 CH/6690 HK, NR), Luxshare (002475 CH, NR) and GREE (000651 CH, NR) derived 50%, 90% and 15% of revenues from overseas in 2021. The presence of export opens up the market cap upside for large companies in this sector. But the sector also contains many small companies, so market size for every listed stock was only Rmb7.8bn.

While it is not the case in Auto, parts & gasoline right now, the Auto sector also has the potential to boost its market cap through export. Currently the market cap of the Auto sector was only 40% of its domestic market size, but each stock covers Rmb35bn of domestic market. This means companies in this sector are still being valued for its domestic addressable markets. The entry barrier to the Auto, parts & gasoline sector is significantly higher than the home appliance & electronics sector.

A similar angle exists on the Apparel/Cosmetics/Personal Care because today its export contribution is also very small, leading to the sector's market cap over market size at 35%. Each listed company covers Rmb23bn of market, below the average of Rmb28bn, suggesting the entry barrier is low.

Ceiling is the most important definition of a consumer stock

Services, which consist of Travel, Education, Games, TV/Film/Video and Financial & Professional services, bear resemblance to IT/electronics in that it has both big and small companies. It has companies that have pricing power and companies that do not. In 2022, each listed consumer stock oversees ~Rmb15bn of the market.

What growth investors look for is the potential for small companies to grow to big ones in a given sector. This is especially important for the Consumer sector because cross entering is usually difficult.

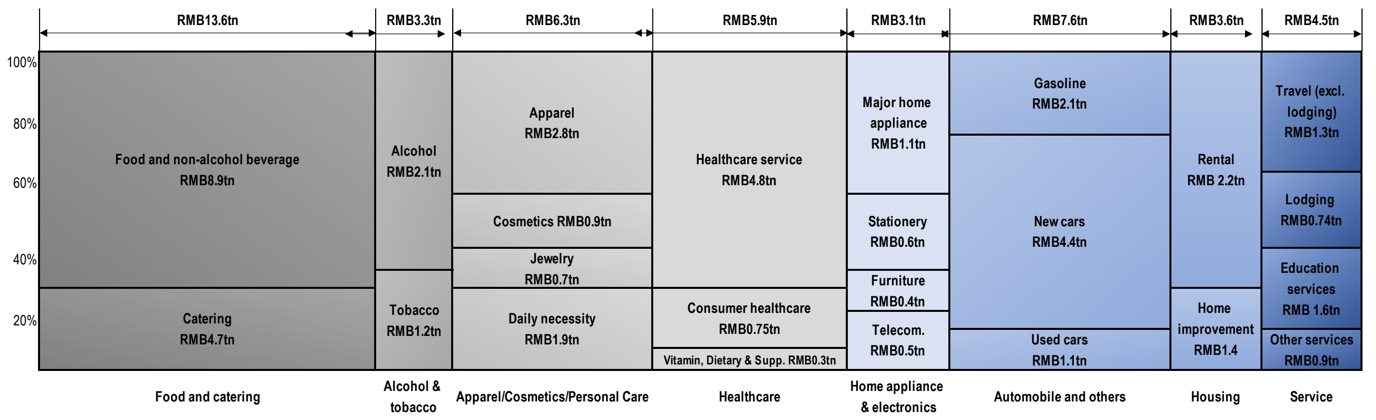
Exhibit 34 shows the relative size of consumption in China's overall pie of Rmb48tn. We believe ceiling is the most important definition of a consumer stock. This is because the consumer sector is very big and diverse, encompassing totally different physical, chemical or biological processes and targeting totally different age, gender and cultural groups. Cross entering different consumer sectors tend to be difficult, if not being very difficult.

Because of this, we focus our research on (1) identifying the ceilings, (2) examining possible ways of breaking the ceilings and (3) comparing the sustainability and profitability of the breakthroughs.

Exhibit 37 shows the subsector and sub-subsector of China's Food and Beverage sector, which consists of 2 sectors, 5 subsectors, 13 sub-subsectors, 45 sub-sub-subsectors and more than 100 products. Products are constantly invented and reinvented, and companies can choose one or several as their main businesses. The fact that consumer products typically employ completely different physical/chemical/biological processes is evident in Food and Beverage sectors. More often than not, companies cannot outgrow their products or sub-sub-subsectors. In developed countries, cross sub-sub-subsector growth is typically achieved via acquisitions.

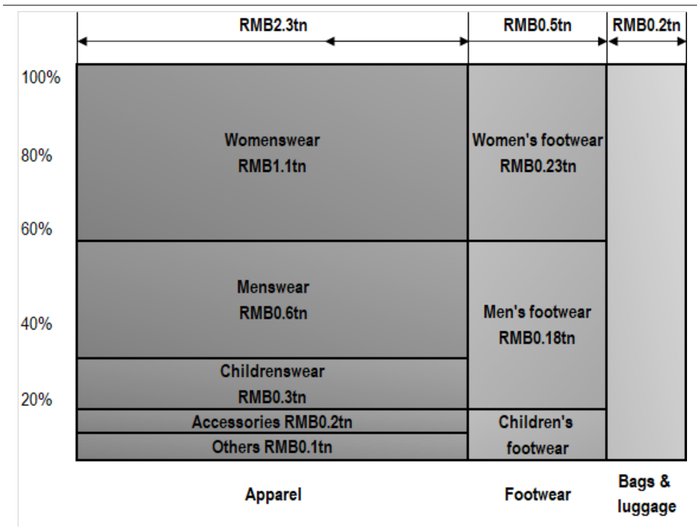
Apparel, hats, shoes and luggage consists of 7 sectors, including (1) Formal attires, (2) Functional attires, (3) Children's attires, (4) Underwear, (5) Winter attires, (6) Fast fashion, (7) Shoes, bags and accessories and (8) Apparel outsourcing, and 12 subsectors, which divide the above by Men, Women, Sports & Outdoor, Professional, etc. (Exhibit 35).

Exhibit 34. China's consumer industries at a glance in 2021, total Rmb48tn



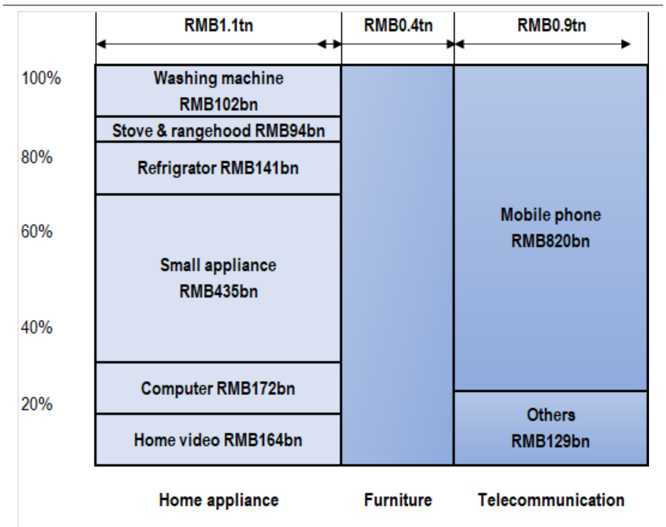
Source: NBS, Euromonitor, CIC, Blue Lotus (as of March 17,2023)

Exhibit 35. Subsectors of Apparel, shoes, hats and luggage



Source: NBS, Euromonitor, CIC, Blue Lotus (as of March 17,2023)

Exhibit 36. Subsectors of Home appliance, electronics & 3C



Source: NBS, Euromonitor, CIC, Blue Lotus (as of March 17,2023)

In home appliance, electronics and 3C products, the industry's typical breakdown consists of (1) White electronics (Kitchen & Bath), (2) Black electronics (Audio & Video), (3) 3C (Computer, Communication, Small Consumer) electronics and (4) Environmental (Air conditioner & heater), with numerous products underneath (Exhibit 36). Blue Lotus's 2019 initiation of Viomi Technology

<*Strengthening beachhead is key*> discussed Viomi's attempt in using Internet-Of-Things (IOT) as a change agent to shuffle the White electronics subsector.

Exhibit 37. Sector, subsector and leading player of China's food and beverage sector

Category	Sector	Subsector	Sub-sub-sector	Product categories	Market size 2022 (Rmb bn)	Top players
Food & Beverage Product	食品 (Food)	Staples & Seasoning (主食和调味品)	Staple food (主食)	Rice, Noodle, Processed meat (加工肉), Cereal (麦片),Process vegetable and fruit (加工果蔬)	474	Tingyi Holdings (康师傅), WH Group(万洲), Yihai Kerry (金龙鱼)
				Baked goods (烘焙)	263	Dali Food (达利食品), Toly Bread (桃李面包), Panpan (盼盼食品), Orion (好丽友)
			Edible oil (食用油)	Corn, Canola (芥花), Subflower (葵花), Peanut (花生), Soybean (大豆), Rapeseed (菜籽), Olive (橄榄)	117	Yihai Kerry (金龙鱼), China National Cererals, Shandong Luhua Peanut Oil, Xiwang (西王)
			调味品 (Seasoning)	Salt, Sugar, Soysource, Vinegar	173	Haitian (海天), Lee Kum Kee (李锦记) , Laoganma (老干妈)
		RTD meals and soups (即食速冻食品及汤料)	Normal temperature RTD meal	Instant noodles (速食面), hot pot, congee	134	Tingyi Holdings (康师傅), JML (今麦郎), Uni-president China (统一)
			Deep frozen RTD meal	Dumplings (饺子，汤圆), Buns (馒头)	176	Sanquan (三全), Synear (思念), General Mills (湾仔码头)，Yinlu (银鹭)
		Dairy (乳制品)	Baby food (婴儿食品)	Milk powder (奶粉), Supplment food (辅食)	200	Feihe Dairy(飞鹤), Nutricia(纽迪希亚), Junlebao (君乐宝)
			Butter and Cheese (黄油和奶酪)	Butter, Cheese	16	Milkground (妙可蓝多),Milkana (百吉福).Yili(伊利)
			Liquid milk (液态奶)	Fresh milk (常温白奶), Pasteurized milk (巴氏奶)	261	Yili, Mengniu (蒙牛),Want Want (旺旺), Bright Dairy(光明)
			Yogurt and sour milk (酸奶)	Yugurt, milk drink	139	Yili, Mengniu, Bright Dairy
			Plant based milk (植物奶)	Soybean milk (豆奶), Coconut milk (椰奶)	41	Yangyuan Zhihui（养元智汇),Coconut Palm，Chengde Lolo （承德露露), Dali
		Snacks (零食)	甜食(Confectionery)	巧克力(Chocolate confectionery)	22	Mars Food, Ferrero, Nestle, Godiva
				糖果(Surgar confectionery)	60	Strong Food (喜之郎),Want Want, Hsu-Fu-Chi (徐福记)
				口香糖 (Gum)	13	Wrigley Confectionery, Mondelez China, Ferfetti Van Melle
			Ice cream (冰激凌)	Ice cream, Sorbet (雪酪), Gelato (意式冰淇淋), Frozen Yogurt (酸奶冰淇淋)，Frozen Custard (奶冻)	52	Yili, Wall's China (和路雪),Mengniu, Nestle
			Savory snacks	Cued meat (肉脯), Seeds (种子), Nuts (坚果), Soybean (辣条)，Dry fruit & vegi (脱水果蔬), pop corn (爆米花),Potato Chips (薯片)	276	PepsiCo China, Want Want, Pingping Food (平平食品), Three Squirrels （三只松鼠), BCW (百草味), LPPZ (良品铺子)
		Fresh food (生鲜)	Egg (鸡蛋)	Raw egg, preserved egg (皮蛋/咸蛋)	153	Deqingyuan (德青源), Sun Daily (圣迪乐), Charoen Pokphand Group (正大集团)
			Fish & seafood (海鲜)	River and sea, Fish, Crab, Shrimp, etc	487	Zhangzidao (獐子岛), Sino-Ocean (远洋集团), Mingzhu (明珠集团)
			Fruit (水果)	Apple, Orange, Watermelon, etc	1,328	Pagoda (百果园),Meituan, Dingdong Maicia, Freshippo
			肉(Meat)	Pork, Beef, Lamb	1,364	WH (万洲), Yurun Food (雨润食品), Wens Foodstuff (温氏股份)
			淀粉根(Starchy roots)	Potatoes, Yams	215	
			蔬菜(vegetable)	Green leaves	583	Yinlong Agriculture (银龙农业)
	Beverage (饮料)	Alcoholic beverage	Chinese Spirits	Maotai-flavor liquors, Luzhou-flavor liquor, Fen-flavor liquor, rice-flavor liquor	1,100	Kweichow Moutai (贵州茅台),Wuliangye(五粮液),Yanghe (洋河)
			Beer (啤酒)	Ale, Lager and Hybrid	668	China Resources Beer (华润啤酒),Tsingtao Brewery (青岛啤酒), Yanjing Brewery (燕京啤酒)
			Grape and rice wine (葡萄酒和米酒)	Grape wine, Rice wine	317	Guyue Longshan (古越龙山),Zhangjiagang Brewery (张家港酿酒),Changyu Pioneer Wine （张裕)
		Non-Alcoholic Beverages	Bottled water (瓶装水)	Minery, Distill	226	Nongfu Spring (农夫山泉),China Resources C'estbon Beverage (华润怡宝),Ganten Industry (景田食品),Tingyi Holdings
			Carbonated (碳酸饮料)	Fruit, Non-fruit	108	Coca-Cola, Tingyi Holdings, Genki Forest (元气森林)
			Juice (果汁)	Orange, Apple	73	Coca-Cola, Tingyi Holdings, Huiyuan Beverage (汇源果汁)
			RTD Coffee (即饮咖啡)	Domestic, imported	12	Nestle, Tingyi Holdings, Wei Chuan Foods (味全食品)
			RTD tea (即饮茶)	Green, Puer, Red, White	111	Tingyi Holdings, President Enterprises (统一),Jiaduobao (加多宝)
			Functional drink (功能饮料)	Energy, Sports	66	Red Bull, Eastroc Beverage (东鹏饮料), Dali Food
Food & Beverage Services	FSR (正餐)	Chinese cuisine (中餐)	Hot pot	Beijing hotpot, Chongqing hotpot, Cantonese hotpot	3,989	Haidilao (海底捞), Xiabuxiabu (呷哺呷哺), Little Sheep (小肥羊), DLS (东来顺), Xibei (西贝), Jiumaojiu (九毛九), QJD (全聚德), Outerback,Tony Roma
			Roast poultry (烤鸭)	Beijing Roast Duck, Guangdong roast poultry		
			Vegetarian	Vegetarian		
			Other Chinese Cuisine	Sichuan cuisine, Cantonese cuisine, etc		
		Non-Chinese cuisine (非中餐)	Japanese	Sushi, Sukiyaki, Yakiniku, Shabushabu	685	
			American	Steak, Rib		
			European	Italian, French		
			South Asia	Indian, Pakistan		
			Southeast Asia	Thailand, Singapore, Indonesia, Vietnanmese		
	QSR (快餐)	Chinese QSR	Rice dishes	Open kitchen stir fry (明档现炒), Steam dishes	774	Laoxiangji (老乡鸡), ZLMLT (张亮麻辣烫),Kungfu (真功夫), Hefu Noodle (和府餐饮), Country Style Cooking (乡村基), Tai-Hing (太兴), 小女当家, Zkingfu (真功夫), HFLaomian (和府捞面)
			Noodle dishes	Ramen (拉面), Laomian (捞面), Shaved (刀削面)		
			Poultry dishes	Fried chicken, Steamed chicken, Roasted poultry		
		Non-Chinese QSR	Chicken dishes	Chicken dishes	326	Yum China, McDonald's, Hua Lai Shi (华莱士), Dicos (德克士), Restaurant Brand International, Genki (元气寿司), Saizerya
			Pizza	Pizza		
			Burger	Fried chicken, pizza, burger, etc		
	Street food & drink stalls (街头餐饮)	Street coffee	Street coffee	Latte, Black, Cappuccino, Mocha, Espresso, etc	108	Starbucks, Luckin, Costa (Coca cola)
		Street tea	Street tea	Milk tea, fruit tea, etc	139	Mixue (蜜雪冰城), Guming (古茗), Shuyi (书亦)

Source: Blue Lotus (As of March 17, 2023)

But technology advancement can break the ceiling of automobile

In automobile, market shares held by Chinese brands had gone up and down, but the last three years we have seen rapid pick up of Chinese Electronic Vehicle (EV) makers in the mid-to-high-end segment so that the share gain no longer confines to the low and ultra-low end (Exhibit 38). After breaking the 50% unit volume share in 2022, C1Q23 unit market share held by Chinese brands again stayed above 50%. Export of made-in-China passenger vehicles grew 57% YoY in 2022, driven by

Generational technology change often brings disruptive change to consumer products. But the winners win with their supply chains.

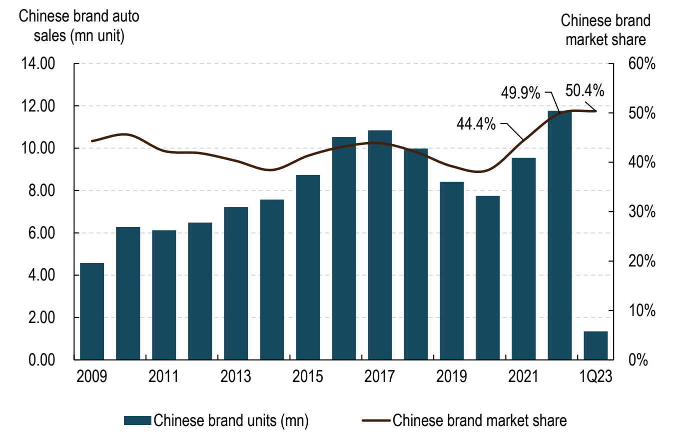
1.2x growth of EV exports, on the back of 1.1x growth in 2021 (*Source: CAAM*). Blue Lotus Auto Analyst Simon Liu believes Chinese brands will break 60% domestic unit share by 2025.

Sustained technology-led market share shuffle often carries supply chain implications.

Generational technology change often brings disruptive change to the landscape of consumer products. The rise of Apple and its dominant share in the global communication device market is attributable to the rise of smartphones over feature phones, culminating the fall of Nokia and Ericsson. It is also inseparable from the supply chains of semiconductor and software foundation built in the vicinity of Apple, again at the expense of other global competitors. What makes the difference in the case of Chinese EV are the rise of the battery supply chain and China's EHV (Extreme-High-Voltage) national power grid. Such development makes Chinese EV brands' success within China highly predictable.

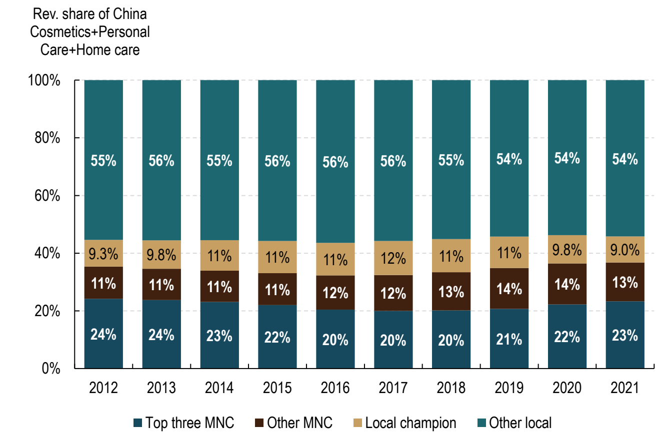
However, whether the EHV infrastructure can transplant outside of China and whether Chinese EV can overcome global trade barriers to become global remain to be seen. Prior to the rise of China's EV industry, Huawei led China's efforts in shuffling the smartphone industry by leveraging a relatively small disruptive change of photo image processing but was blocked by the U.S. trade censors on the ground of its non-consumer business. Alternative energy development routes also exist outside of EHV power grids. On the positive side, the Sino-US trade war made China no choice in expanding its domestic technology abroad.

Exhibit 38. Chinese brand automobile unit sales and market share



Source: CAAM, Blue Lotus (As of March 17, 2023)

Exhibit 39. Chinese cosmetics, personal care and home care revenue market share



Source: Euromonitor, Blue Lotus (As of March 17, 2023), Top 3 MNC=P&G, Unlever, L'Oreal, Estee Lauder, Other MNC=Shiseido, LVMH, Amore, LG, Colgate, J&J. Local champion= Pehchaolin, Jala, Jawha, Blue Moon, Nice

Domestic substitution and import revitalization happen on Luckin

As note in our Luckin initiation <*The golden opportunity is for Luckin itself to miss*>, Luckin's success is both a result of domestic substitution of Starbucks and revitalization of an industry by an imported item, coffee.

Global minded Chinese consumer company must zero in on global supply chains.

- **Domestic substitution**: Starbucks, upon entering China, occupied the premium market position of high-end, high price and coffee+food+space. This market skimming strategy, however, overlooked China's low caffeine consumption level and the advantage held by coffee over tea in caffeine in-take. Equipped with mobile Internet order taking and payment flows, Luckin leveraged on the mistakes made by Starbuck to reinvent the street drink coffee business;

- **Import revitalization**: China's caffeine consumption level has long been low with the main source of caffeine from tea. The idea of coffee drinking was introduced by Starbucks but was popularized by Luckin. Following Luckin's success, new competitions from the angle of food provision focused on western bakery as the second import revitalization idea. As we wrote in the Luckin initiation, domestic substitution doesn't mean Chinese cuisine substitute Western cuisine. It means Chinese company substituting Western company. In this regard, Japanese snack food companies offered a good point of reference. Local champions like Lotte (004990 KS, NR), Morinaga (2201 JP, NR), Calbee (2229 JP, NR) and Ezaki Glico (2206 JP, NR) sell chocolate, potato chips, chewing gums and ice creams to achieve dominant market share at home. We believe that one must realize that modern Western foods aren't just Western foods but are modern foods, too. Modern foods consume almost unlimited amount of protein versus traditional foods which contains large quantity of starch. In our view, the failure of some Chinese snack companies to scale up their business is a result of small and ancient supply chain footprint. These supply chains are no longer relevant to the modern life.

Leading consumer companies nurture their own supply chain.

Fusion idea drives new innovation: the case of Atour Lifestyle

The market share evolution in Cosmetics & Personal Care again illustrated the opportunity lied in structural change of China's Consumer Sector.

We believe global minded Chinese consumer companies must be mindful of global supply chains. Luckin benefits from the global supply chain of coffee, which is more standardized, transparent and global in nature than the tea supply chain, leading to the coffee supply chain prevailing the tea supply chain. As Luckin entering the bakery business, it will join the western bakery supply chain, which again enjoys these advantages over the Chinese bakery industry. As leading player in the coffee supple chain, Luckin can, to a certain degree, win by default.

Also benefiting from a supply chain once dominated by multinational companies (MNC) is the lodging industry. China benefits greatly from the global supply chain of lodging in manpower, business process and supply network. Atour transplanted the management philosophy of leading Internet companies to the managing of critical human capital in the business of hotel management, leading to superior customer satisfaction to its rivals.

Both domestic and MNC can offer vital idea of fusion to reinvent the consumer industry.

Cross fertilization happens both ways. In the street drink industry, introductions of dairy products (Western), fresh fruits (Taiwan) and coffee (Western) techniques have repeatedly revitalized the tea industry, and then through competition, to the coffee industry. We notice that imports have been a constant source of new ideas in cross-fertilizations in today's increasingly intertwined world. While imports have often been the original inspiration, domestic innovation does spur afterwards to lead to further innovation down the road. To balance China's rapid Westernization in the recent past, traditional Chinese elements have caught the *en vogue* to become a constant source of new ideas.

But for the innovation to stick, it must (1) meet consumer's mainstream needs, (2) be also supply chain sound. Street drink tea's reliance on the fresh fruit supply chain has brought about margin headaches as the reliance on fruit freshness can weight on the cost.

Globally, Environment-Social-Governance (ESG) concepts have also infiltrated the China Consumer Sectors. At this point, supply chain constraints are ESG's main inhibitor.

MNC's flawed model doesn't relieve its challenger's challenges

Domestic substitution, meaning Chinese brands gaining market share over foreign brands, has been hailed as a national progress by the nationalist audiences. In our opinion, from the viewpoint of promoting sustained local employment, domestic substitution is arguably pursued, explicitly or implicitly, by a lot of governments worldwide. Hence, it is likely to continue. However, the sustained phenomenon of domestic substitution in China also highlights the management dilemma of the multinationals, which some solve better than others. In the end, achieving balanced growth by a multinational corporation (MNC) is itself complex and challenging.

MNC's focusing on revenue optimization typically have succession issue while MNC's focusing on cost optimization typically lose market share.

The essence of the MNC business model is to use the smallest number of SKU's to hit the broadest possible markets. This is not the only way of globalization, but a dominant way, if not the American way. However, a centrally managed MNC cannot simultaneously optimize revenue and cost. Maximizing revenue means giving subsidiaries autonomy which complicates the SKU's. Optimizing cost means to cut SKU's which loses local consumer appeal.

Dilemma in core competency adds on the dilemma on talent retention. Talent loss has been a persistent hassle for MNC's. Some MNC's, especially European, have opted for decentralized management of their subsidiaries but succession often becomes a problem when the decentralized management forms a fiefdom of individuals that must be planned for succession. The solution of the American MNC's is to promote within from unified ranks of employees but it inevitably led to loss of talent when some subsidiaries get promoted more than the others.

These dilemmas, coupled with China's market size, pose serious challenges to MNC's management. For MNC's, China is their largest or second largest market. But can China team exert their proportional influence to the global team? If not, employee turnover or employee mediocrity can result. We have seen similar problems exist in all walks of consumer and healthcare sectors.

We see American MNC's being more centralized and thus cost focused while European MNC's being more decentralized and thus more revenue focused.

The same dilemma also applied to the Chinese Internet sector in the early days and was amplified by the access to the US capital market. The eventual outcome is MNC's exiting the China Internet space altogether. But will this repeat in all consumer sectors?

What drives follow-on growth following MNC's exit?

Exhibit 39 shows it is not always the case that following the rise of local champions, the next step is MNC's quick exit of the market. The evolution of MNC brands in Cosmetics & Personal Care Sector, for example, is typical in a sector without generational technology changes. Two of the old three, Procter & Gamble and Unilever, gradually lost market shares but a number of new, more specialized MNC brands, liked Estee Lauder, Shiseido and Amore Pacific, gained market share to maintain the overall MNC market share constant. Further, the long-term market No.2, cosmetic brand L'Oreal took the market change to overtake No.1 Procter & Gamble in 2019.

In Cosmetics & Personal/Home Care, MNC brands have long occupied a stable market share of ~1/3, although the composition of this 1/3 changed.

Behind such change lies also the phenomenon of higher growth in new subsectors like Color Cosmetics and Fragrance, strongholds of L'Oreal, Estee Lauder, etc., over old subsectors like Skin Care, Bath & Shower and Oral Care, strong holds of P&G and Unilever. MNC leaders tend to teach local champions and it was the old leaders that face local competition first. As Chinese becoming more affluent, makeups experienced faster growth than maintenances. But what is interesting is that the local champions of this sector had stagnant market share growth in the past few years, which suggests that local champions also have a substitution pecking order in place.

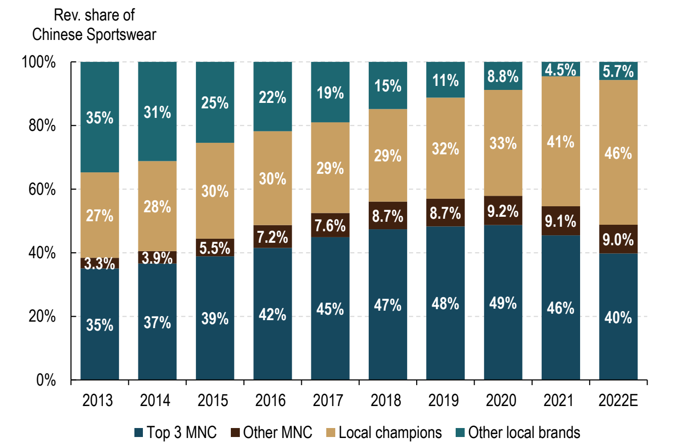
To gain further market share over MNC, local champions must focus on the basics of sales marketing and R&D. Choosing segment and sticking to character also worked.

The story in sportwear is somewhere in between. MNC brands gained market share until 2020 but local champions gained market share too. The whole market consolidated with smaller players being the first to exit. Within local champions, ANTA first scaled up from 7.3% market share in 2013 to 20.4% in 2022 on successful acquisition, sponsorship marketing and R&D. Then Li Ning scaled up from 6% market share in 2018 to 10.4% in 2022 mainly on betting on the right segment and riding the "Xinjiang Cotton" incident. In the "Xinjiang Cotton" incident, Chinese consumers viewed their country being ill-treated and supported local brands that used Xinjiang cotton and publicly displayed such message. This shows that having an "ESG" character can substantiate a brand. Other MNC brands bifurcated. New Balance lost market share while Skechers gained. New entries like Lululemon, PUMA and Under Armour also gained.

What account for the difference?

We believe the difference is simply that Chinese challengers must mitigate their weaknesses in sales marketing and R&D to their global peers after scoring the initial victory often on manufacturing cost and MNC missteps. Local champions that successfully did that go one step up. If they learn to do it outside of China, they go two steps up. For different industries the importance of sales marketing and R&D vary. In the Cosmetics sector, for example, Estee Lauder can win market share with below average R&D expenditure. While in the Personal Care and Home Care sector, R&D probably has more bang for the buck.

Exhibit 40. Chinese sportswear revenue market share



Source: Euromonitor, Blue Lotus (As of March 17, 2023), Top 3 MNC=Nike, Adidas, Skechers, New Balance, Other MNC=Lululemon, VF, Puma, Underarmor, ASICS. Local champion=ANTA, LINING, Xtep, 361Degrees, PEAK, Blue Lotus (2022/6/30)

Exhibit 41. R&D cost as percentage of revenues

	2017	2018	2019	2020	2021
Jahwa	2.5%	2.1%	2.3%	2.0%	2.1%
Blue Moon	1.2%	1.0%	1.0%	0.9%	0.7%
P&G	2.9%	2.9%	2.7%	2.5%	2.5%
L'Oreal	3.4%	3.4%	3.3%	3.4%	3.2%
Estee Lauder	1.4%	1.3%	1.5%	1.5%	1.6%
Shiseido	5.4%	5.8%	5.8%	4.3%	3.5%

Source: Shanghai Jahwa, Blue Moon, P&G, L'Oreal, Estee Lauder, Shiseido, Blue Lotus (As of March 17, 2023)

Focusing on the right segment with the right R&D and marketing

Besides generational technology change offering leapfrog opportunities, sub-sector focus can also neutralize the resource superiority of the MNC's.

Needless to say, Chinese companies with their smaller revenue footprint pale in comparison in absolute amount of their budget to MNC peers. In Personal/Home Care, we saw almost all Chinese local champions focus on herbal ingredients to differentiate, an obvious misstep by P&G and Unilever. This sheds another light on the R&D cost angle, the challenger can amass local strength in a sub-sector that out-spends the MNC's. In fact, every success by local champions can be attributed to amassing resources in a segment that MNC overlooked or underspent.

On the other hand, in sectors with relatively standardized attributes, such tactics do not work. In the case of EV, Volkswagen has an R&D budget twice as big as Toyota, GM and FORD, which in turn have R&D budget 2-3x of Tesla, 6-7x of BYD and 10-15x of Nio and Li Auto. In the case of Nio and Li Auto, the only way to grow is to incur losses to bring the volume up (Exhibit 42). Still, EV as a subsector of automobile has been beyond reach and underestimated by traditional carmakers for extended period of time, giving Nio, Li, Xpeng and Tesla room to grow.

Exhibit 42. R&D cost as total revenue of auto makers

	2017	2018	2019	2020	2021
BYD	3.6%	4.1%	4.6%	4.9%	3.8%
Toyota	3.8%	3.6%	3.5%	3.7%	4.0%
Tesla	11.7%	6.8%	5.5%	4.7%	4.8%
GM	5.0%	5.3%	5.0%	5.1%	6.2%
Ford	5.5%	5.5%	5.2%	6.1%	6.0%
VW	5.7%	5.8%	5.7%	6.2%	6.2%
Li Auto	NA	NA	411.1%	11.6%	12.2%
NIO	NA	80.7%	56.6%	15.3%	12.7%

Source: Company data, Blue Lotus (As of March 17, 2023)

Exhibit 43. R&D cost per vehicle sold of auto makers

(US$)	2017	2018	2019	2020	2021
BYD	1,528	1,390	1,769	2,536	1,566
Toyota	867	890	876	930	1,070
Tesla	13,355	5,948	3,653	2,985	2,770
GM	1,528	1,657	1,616	1,840	2,763
Ford	1,211	1,371	1,374	1,696	1,928
VW	1,309	1,347	1,395	1,597	1,877
Li Auto	NA	NA	174,269	4,890	5,267
NIO	NA	51,096	31,232	8,251	7,284

Source: Company data, Blue Lotus (As of March 17, 2023)

Step-wise down market not always work, but Miniso does

China's intention of focusing on manufacturing to grow itself out of Middle-Income-Trap suggest its merchandise price level likely won't go up anytime soon.

Step-wise down market means exporting to a market with lesser a development stage. Such tactic, which is a reversal of domestic substitution, is often not sustainable, in our view. There has also been a lack of success by Chinese companies pursing this go-to market strategy.

But we don't consider Miniso as practicing step-wise down market and won. Miniso's overseas stores are typically located in high-end shopping malls and its merchandise gross margin and ASP are higher than China's. We believe Miniso is arbitraging between China's developed country lifestyle and its developing country price level in certain product categories like apparel, cosmetics, electronics and accessories. At this point we don't see the window of this arbitrage closing anytime soon.

The maturing of franchising environment a plus for locals

The successes of Luckin, Atour and Mixue, as well as business cases of a range of retail brands, suggest that franchising, once a death trap for brands, finally started working in China. We attribute this to several factors:

- General improvement of legal, commercial and tax environment in China;
- Mobile Internet enabled segregation of workflows, leading to simple, short-chained and widely participated business steps that can be effectively policed by SaaS tools;
- Wide-spread user of mobile and centralized payment tools that eliminates embezzlement and corruption;
- Successful and wealthy entrepreneurs who can benefit from sustainably honest relationships.

Franchising is a battleground that MNC's are at a disadvantage.

In our view, the maturing of franchising environment is positive for local champions (but not all locals) at the expense of MNCs. It allows local champions to mitigate their lack of funds to quickly ramp up their businesses. It leverages local champions' local understanding in handling labor and franchisee relations at an affordable cost, over MNC's myriad layers of controls.

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