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BTN Thursday Thoughts

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I have money, you have money; so we are friends.

-Chinese Proverb

Is the Chinese Consumer Back?

When we wrote about Tiffany (TIF- 4/28/2018) we noted that earnings quality has been very strong. There are times when gold or diamond prices are rising rapidly that can skew margins up. This is due to very slow inventory turn moving low cost finished goods through Cost of Goods Sold, along with price hikes implemented to buy higher cost raw materials that will become finished goods later. That really is not happening now as diamond prices have been largely flat for 5-6 years – here is a graph showing 12 years of diamond pricing. Gold has been fairly flat too.

Tiffany may be benefitting from a return of spending from the Chinese. In 2013 into 2014, the Chinese government imposed several rules to limit foreign exchange and currency movement by citizens. This was done to retain more foreign currency reserves in China. It was also done to protect against graft and corruption. The latter meant that fewer people wanted to be seen showing off a new watch, jewelry, or visiting casinos and taking extravagant vacations. This type of foreign travel allowed the Chinese to essentially spend via credit cards and have it converted into HK dollars or other currencies and effectively move money out of China and out of Chinese control. They could also buy foreign currency while overseas. The same thing could happen if they bought HK stocks - it created assets in HK dollars.

These controls are not gone now. In fact, the Chinese government still has a $50,000 cap on foreign exchange purchases by citizens per year. It recently changed the limits on how much foreign currency can be purchased while overseas. Previously, the limit was Rmb100,000 per account. Now it is Rmb100,000 per individual. That is still a sizeable amount of money, and it does appear that the fears of being suspicious about large luxury purchase are fading.

Moreover, many of the wealthier Chinese already have money in foreign banks and non-Chinese credit cards where they are can escape these rules. Those with businesses that generate sales and profits overseas can also establish cash outside China and keep it there. We found a good article in Finews.Asia describing how the Swiss banks have been catering the wealthy Chinese to hold overseas profits and HK stocks and the banking business is growing.

When these currency controls and graft suspicions first went into effect, the impact on the growth for jewelry and other luxury sales was immediate:

Year-over-Year Change in Retail Sales for Jewelry and Similar Products

	2012	*2013*	*2014*	*2015*	*2016*	*2017*
China	16.0%	25.8%	-1.7%	7.3%	0.0%	5.6%
Hong Kong	7.7%	22.9%	-13.7%	-15.6%	-17.2%	5.2%

The China figures include retail sales in China related to gold, silver, and jewelry and come from the National Bureau of Statistics of China. The Hong Kong figures represent sales of jewelry, watches, clocks, and valuable gifts and come from the Hong Kong Census and Statistics Department.

This flows with what people would expect - sales within China are not subject to the currency controls and therefore fell but did not crater. However, sales in Hong Kong, where foreign exchange is more likely to be involved, fell rapidly and kept falling. Bain & Company did a 2017 study on luxury goods sales worldwide. That would include clothes, shoes, cognac, purses, as well as jewelry and watches. They found they could break growth into four time-periods over the last couple of decades:

	1994-2007 EM grows	*2008-2009 Fin. Crisis*	*2010-2014 China Spree*	*2015-2016 Reboot*
CAGR Luxury Goods	7%	-5%	9%	-1%
% Luxury Good Brands with positive Growth	85%	35%	95%	50%

In good times, Bain found that almost all luxury brands enjoy growth. In weak times, people become more selective. It appears that this market is turning around. The National Bureau of Statistics of China saw gold, silver, and jewelry sales rise 5.6% in 2017, and are up 7.5% through April 2018. The Hong Kong stats saw 5.2% growth in 2017 and 22% in the 1Q of 2018. In our view, it also appears to be broad-based.

We looked at several areas that would be impacted by Chinese consumption and all seem to be reporting rising demand. Let's first look at foreign travel by the Chinese:

# in millions	*2011*	*2012*	*2013*	*2014*	*2015*	*2016*	*2017*
# Chinese Outbound Trips	70	83	98	107	117	122	131
Y/Y growth	22%	18%	18%	9%	9%	4%	7%

We are using stats from the China National Tourism Administration. The forecast is for growth to accelerate again by 10% in 2018. Relaxing the visa process to make it easier for Chinese citizens to enter more countries has also played a role, and that trend continues. We have seen spending figures from multiple sources and they vary by wide margins. We only found numbers from the China NTA for 2014-17. Others come from the UN and travel organizations. The consensus is that the Chinese spend more than other group in total and per capita. There are more middle-class Chinese traveling which is pressuring the per capita figures, but the overall growth in spending appears to be established too by several sources. The China NTA reported 5% growth in USD spending by outbound tourists in each of the last two years.

We should also point out that the growth in Chinese travel to certain markets has been even more pronounced:

# in millions	*US*	*Singapore*	*Japan*
2010	0.8	1.2	1.4
2017	3.2	3.2	7.4

Las Vegas Sands (LVS) breaks out a few areas that would appeal to the Chinese visitor – retail sales at its high-end stores and baccarat play in Las Vegas. We looked at trailing twelve month sales per square foot for Shoppes at Marina Bay Sands in Singapore and Shoppes at Venetian in Macao. The sales figures have started to rebound strongly:

	Marina Bay Sands	*Venetian*
1Q18	$1,719	$1,591
4Q17	$1,590	$1,389
3Q17	$1,506	$1,357
2Q17	$1,482	$1,340
1Q17	$1,431	$1,330
4Q16	$1,383	$1,326
3Q16	$1,396	$1,359
2Q16	$1,334	$1,359
1Q16	$1,334	$1,428
4Q15	$1,361	$1,469
3Q15	$1,383	$1,540
2Q15	$1,393	$1,578
1Q15	$1,409	$1,636
4Q14	$1,426	$1,673

In both cases, decay stopped in 2016 and the results jumped 20% in 1Q18. Remember these are trailing 12-month totals so the gain in 1Q is even more pronounced.

On Baccarat in Las Vegas, Las Vegas Sands went from double-digit growth in certain quarters such as 72% in 4Q13 and even a 37% increase in 3Q14 to three years of y/y declines for every quarter between 2015-17. Double-digit rates of decline hit all but one period between 4Q15 and 1Q17, and that was a 9% drop in 1Q16 so there were no good signs in the trend. The rate of decay slowed in 2017 and in 1Q18, the company saw a 33.8% increase in Baccarat play. The company is even looking to expand the number of junket facilities to cater to very high-end gamblers after 1Q18 results, and it continues to add more high-end hotel rooms.

Looking at Tiffany's sales for the last few years, it appears they are again benefiting from the Chinese spending on jewelry (as noted above) and the foreign travel growth. 1Q18 results saw a broad-based gain in areas impacted by the Chinese. The company raised guidance from 4Q results to 1Q results:

Outlook	*4Q17 call*	*1Q18 call*
Comp sales	low-mid single digit	mid-high single digit
EPS range	$4.25-$4.45	$4.50-$4.70
Cash from Ops	$660mm	$700mm

TIF's breakdown of growth makes it sounds like the Chinese are back at Tiffany's. Comps grew 9% in the Americas in 1Q18. A big reason given was higher spending by local and foreign tourists. Comps were up 9% on constant currency in the Asia/Pacific region too, attributed to higher spending in Greater China and local and foreign tourist spending. Comps in Japan rose 9% on constant currency with foreign tourist spending being a key. This makes sense given the accelerating growth in Chinese outbound tourism and the big growth to the US, Singapore, and Japan.

There was a start to this trend in 4Q17 with 5% comp growth in the Americas and 13% in Asia Pacific with strong growth from Mainland China. Before that, the strong growth in Mainland China was being offset by weakness in local buying in places like Hong Kong, Korea and lower spending by foreign tourists:

Comps	*4Q15*	*1Q16*	*2Q16*	*3Q16*	*4Q16*	*1Q17*	*2Q17*	*3Q17*
Americas	-8%	-9%	-8%	-2%	-3%	-4%	-1%	1%
Asia/Pac	8%	-12%	-9%	-10%	-1%	-2%	-7%	2%
Japan	9%	5%	-5%	1%	12%	-1%	9%	0%

In Asia/Pacific, TIF was calling out strong Mainland China sales since late 2015, but also noting those were being offset by big declines in Hong Kong with some quarters dampened by Singapore as well. This corresponds very well with what the jewelry spending has been as reported in the Chinese and Hong Kong stats earlier. Sales in both the Americas and Japan have been reported as weak partially due to lower spending by foreign tourists for much of this late 2015-2017 time frame too.

In our opinion, there should be some broad-based pent-up demand after several years of weaker sales for luxury goods to the Chinese. They are accelerating their travel as well, which could bode well for this to impact many areas of consumer spending – hotels, clothing, luggage, whiskey, in addition to jewelry and casinos. The Bain study predicts the luxury market will remain more selective with about half the group enjoying growing sales and the rest losing market share. We will point out that that when growth in this area has accelerated in the past, the percentage of brands seeing growth is over 80%.

We would also point out that many people who shop while on vacation tend to do it in brick and mortar stores. Anecdotally, we saw the shopping district in Auckland, NZ after Christmas with tourists waiting in line outside to get into stores like Prada, Louis Vuitton, Coach and even Adidas as well as jewelry stores. The amount of decay in Hong Kong jewelry, watches, and valuable gifts sales since 2013 is still 37% after the 5% rebound in 2017. That bodes well for this growth to continue. It does appear that the fear of being suspected of graft and other criminal activity by wearing expensive jewelry in China has passed and they are spending again.

Always keep in mind, much of what started the drop-off was China cracking down on keeping foreign currency in its country. Those rules have not changed. Should Chinese outflows start to accelerate again they could tighten the limits further.

Sealed Air (SEE) Review

We reviewed Sealed Air's (SEE) recent results and noted a few items of concern that warrant attention going forward:

- Accounts receivable adjusted for securitized receivables jumped by over 2 days in the 3/18 quarter.

- Other receivables also increased disproportionately to sales growth. While the largest component of other receivables is VAT (value-added tax) receivables, it also includes amounts related to advances and vendor rebates, indicating that profits in the 3/18 quarter could have benefitted from the timing of recognition of those amounts. We are currently not overly concerned by the movements in receivables, but they warrant scrutiny in future quarters for continued increases.

- Accounts payable growth has outstripped growth in cost of sales in the last two quarters. The company noted in its 10-K that cash flow has benefitted from its structured payables programs, although it gives no details regarding them. A structured payable program allows a company's vendors to sell amounts it has invoiced the company to third-party financial institutions, which allows the company to delay payment of these payables. This makes these cash flows much more like short-term debt than traditional trade payables. Therefore, an increased use of structured payables could be viewed as an artificial benefit to operating cash flows. Regardless of the extent to which SEE has used such programs, the benefit to cash flows from rising payables seem unlikely to continue at its recent pace.

Receivables Rose After Adjustment for Securitization

At first glance, SEE's trade receivables balance appears to be under control, with the 3/18 accounts receivable days of sales actually down by 2 days from the year-ago period:

	3/31/2018	*12/31/2017*	*9/30/2017*	*6/30/2017*	*3/31/2017*	*12/31/2016*
Sales	$1,131.0	$1,227.8	$1,131.3	$1,070.3	$1,032.2	$1,101.4
Trade Receivables	$465.1	$552.4	$540.5	$310.3	$450.5	$460.5
Trade Receivables Days	37.5	41.1	43.6	26.5	39.8	38.2

Note that SEE sold its Diversey business late in the 3/17 quarter and accounted for its results as discontinued operations. Therefore, the above amounts do not include the results of Diversey, but we cannot get comparable data prior to the 12/16 quarter for a longer-term analysis of receivables.

*Also note that the company acquired Fagerdala in Singapore on 10/2/2017. According to the 3/18 quarter 10-Q, the preliminary purchase price allocation assigned a value of $22.4 million to Fagerdala's trade receivables. Our calculation of DSO (receivables*91.25/quarterly sales) utilizes quarterly sales. Since the 3/31 quarterly sales figure would have included a full quarter of Fagerdala's revenues, the DSO amount would not have been skewed by a partial quarter of sales from the acquired company, and the comparison to the year-ago quarter would have only been impacted to the extent that Fagerdala's DSO level was different than that of SEE's core business. This was likely an immaterial impact.*

While trade receivables look benign on the surface, SEE has an accounts receivable securitization program it utilizes for short-term financing. Under this arrangement, it periodically sells receivables to participating banks which are used as collateral against short-term financing to SEE. Trade receivables used as collateral are reclassified from "trade receivables" to "prepaid expenses and other assets" on the balance sheet. Therefore, we must add these securitized amounts back in to the company's trade receivables balance for the purpose of analyzing trends in the origination of receivables:

	3/31/2018	*12/31/2017*	*9/30/2017*	*6/30/2017*	*3/31/2017*	*12/31/2016*
Trade Receivables	$465.1	$552.4	$540.5	$310.3	$450.5	$460.5
Securitized Receivables Balance	$91.4	$0.0	$0.0	$195.1	$30.0	$0.0
Adjusted Trade Receivables	$556.5	$552.4	$540.5	$505.4	$480.5	$460.5
Adjusted Trade Receivables Days	44.9	41.1	43.6	43.1	42.5	38.2

We can see that after adding back the securitized amounts, the company's 3/18 adjusted trade receivables days of sales actually rose by 2.4 days over the year-ago quarter after rising almost 3 days year-over-year in the 12/17 quarter. Given the company's strong sales growth in recent quarters, this by itself is not overly alarming.

However, there is another component to receivables to analyze as well. In addition to trade receivables and securitized receivables, SEE also reports "other receivables" on its balance sheet. According to the company, the largest component of other receivables is VAT (value-added tax) receivables, but also include advances and deposits as well as vendor rebate receivables. The below table adds other receivables into the calculation of DSOs for the last eight quarters:

	3/31/2018	*12/31/2017*	*9/30/2017*	*6/30/2017*	*3/31/2017*	*12/31/2016*
Adjusted Trade Receivables	$556.5	$552.4	$540.5	$505.4	$480.5	$460.5
Other Receivables	$99.3	$90.2	$81.7	$77.3	$73.7	$72.7
Adjusted Trade+Other Receivables	$655.8	$642.6	$622.2	$582.7	$554.2	$533.2
Adjusted Trade+Other Receivables Days	52.9	47.8	50.2	49.7	49.0	44.2

We can clearly see the disproportionate increase in other receivables which has led to an increase in adjusted DSO of almost 4 days over the 3/17 quarter. We admit that the nature of other receivables makes them not completely comparable to trade receivables. Nevertheless, the disproportional increase leaves open the possibility that the 3/18 quarter artificially benefitted from the timing of receipt of rebates and advances. As with the increase in adjusted trade receivables, we are not immediately alarmed by the increase, particularly given the reshuffling after the Diversey divestiture potentially created noise in the comparisons. Nevertheless, these trends deserve attention in the next couple of quarters. Continued disproportionate increases in adjusted trade receivables or other receivables should be viewed with increased concern.

Accounts Payable Increasing

SEE's cash flow has benefitted from an increase in accounts payable in recent periods. The following table shows accounts payables days of sales (accounts payable*91.25/quarterly cost of sales) for the last six quarters:

	3/31/2018	*12/31/2017*	*9/30/2017*	*6/30/2017*	*3/31/2017*	*12/31/2016*
COGS	$757	$852	$769	$726	$697	$738
Accounts payable	$730	$724	$778	$647	$581	$539
Accounts payable DSPs	88.0	77.5	92.3	81.3	76.1	66.6

Days payable have increased much faster than sales in the last two quarters. SEE's 10-Q filing for the 3/18 quarter mentions rising payables as being a positive factor on cash flow growth but stops short of giving color on it. However, the company stated in its 2017 10-K that working capital was impacted by "an increase in accounts payable reflecting higher days payable **outstanding consistent with utilization of structured payable arrangements as well as other initiatives for longer payment terms**…" A structured payable program allows a company's vendors to sell invoices from SEE to designated third-party financial institutions which the company can then pay at a later date. This essentially allows a company to delay paying its suppliers. However, such an arrangement closely resembles short-term financing rather than traditional trade payables. Cash flows from short-term financing would flow through the financing section of the cash flow statement. Thus, an increasing use of a structured payable facility could be viewed as an artificial benefit to operating cash flows. Regardless of how much SEE is utilizing structured payables, it has clearly gone a long way in milking cash from its payables to the benefit of cash flow and it is unlikely it can continue this pace for long.

A Note on Prepaid Expense Increases

We noted a disproportionate jump in SEE's "prepaid expenses and other current assets" account in the 3/18 quarter. However, as noted above, this account includes trade receivables that have been pledged as collateral in the company's accounts receivable securitization program. The following table adjusts for these amounts and shows an adjusted prepaid days of sales calculation (adjusted prepaid expenses*91.25/quarterly sales):

	3/31/2018	*12/31/2017*	*9/30/2017*	*6/30/2017*	*3/31/2017*	*12/31/2016*
Prepaid Expenses	$195.0	$33.9	$63.6	$251.9	$95.8	$54.5
Securitized Receivables Balance	$91.4	$0.0	$0.0	$195.1	$30.0	$0.0
Adjusted Prepaid Expenses Balance	$103.6	$33.9	$63.6	$56.8	$65.8	$54.5
Adjusted Prepaid Days of Sales	8.4	2.5	5.1	4.8	5.8	4.5

We see that even after the adjustment for securitized receivables that the prepaid expense account jumped dramatically. Management noted in the 10-Q and the call that it made a $45 million royalty pre-payment in the 3/18 quarter which was recorded in prepaid expenses. This more than accounts for the observed increase in prepaids, so this is not a concern.

Disclosure

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