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The People's Outback

"Huge downward pressure," Premier Wen Jiabao's memorable weekend appraisal of the balance of forces in the Chinese economy, is a judgment that logically ought to fall on China's principal economic satellites as well as on the People's Republic itself. Reading the premier's remark, we thought of Australia. Following is a bearish update, macro and micro, on the People's Outback.

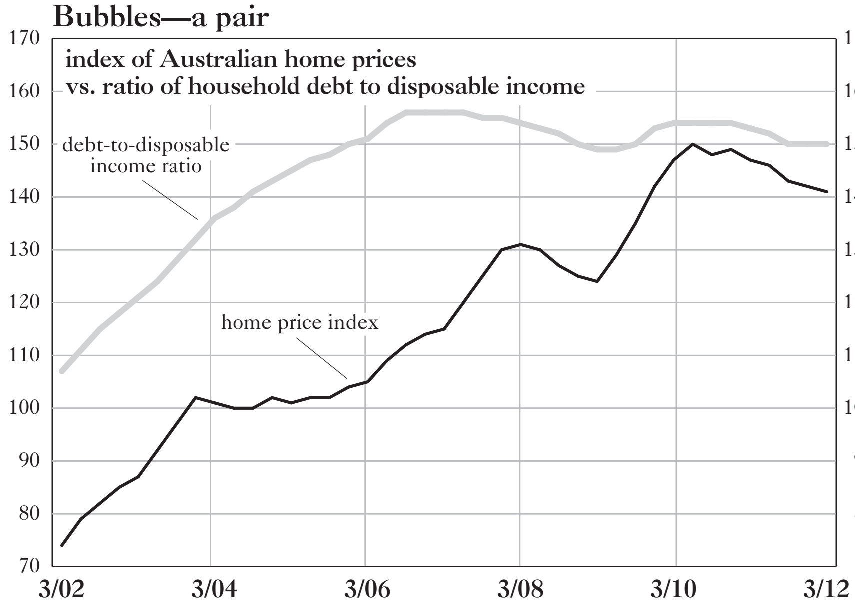
According to the 2011 Australian census, Mandarin is the second most-spoken language Down Under, with native Australian still holding the lead. Chinese banks are ramping up their lending in Australia while Wayne Swan, the Australian treasurer, is petitioning Beijing to make the Aussie dollar directly convertible into the renminbi. By the numbers, Australia's economy is fairly booming—growth in the March quarter ran at a 5.3% annualized rate—but it's a China-centric kind of boom, heavily concentrated in mining investment.

Before homing in on an Australian company that seems especially exposed to Chinese disappointment, a word or two on what may have driven Premier Wen into the camp of the China bears. These pages have faithfully reported on empty Chinese apartment towers, rising Chinese coal mountains and profitless Chinese steelmaking. Now add to the list unsold Chinese toiletries and slumping Chinese shoe sales. "Nielsen data for March/April suggest Chinese consumers are cutting back on staples such as shampoo, toothpaste and razor blades," reports Goldman Sachs in a July 3 note. "In the short term, these changes have resulted in slowing revenues and higher inventory levels across the industry with some of our competitors reporting significant revenue declines," Nike's chief financial officer, Donald W. Blair, warned dialers-in on a June 28 earnings call.

As the Chinese 99% is doing without, so, too, evidently, is the Chinese 1%. "Hong Kong's stores recorded a year-on-year fall in May watch sales for the first time since 2009, as wider retail sales slowed in Asia's shopping Mecca," China's *Economic Observer* reported on July 5. As noted in the June 15 issue of this publication, China accounts for 30% of Swiss watch sales and 27% of Richemont's top line.

Because East or West, the knee bone is connected to the thighbone, trouble in the astoundingly investment-heavy Chinese economy is reaching the producers of China's capital equipment, including Zoomlion (*Grant's*, May 18) and Sany. The People's Republic's top construction equipment maker, Sany is slashing payrolls in response to plunging sales. "Layoffs [in China's machinery industry] have never happened in the last 10 years, even during the down cycles in 2005 and 2008," Barclays analyst Victoria Li was quoted as saying in the July 5 *Financial*

Bubbles—a pair



sources: Reserve Bank of Australia, Australian Bureau of Statistics

Times. "Definitely, this down cycle is much tougher than before."

All of which leads the inquiring mind back to Australia, whose prodigious growth owes less to the direct export of commodities to China than to the fast-paced build-up of the infrastructure to make such shipments possible (*Grant's*, June 3, 2011). "At first glance," notes a Goldman Sachs analysis of Australia's first-quarter GDP figures, "the National Accounts data would appear to show that the Australian economy is now booming; however, more than half of the 1.8% surge in domestic demand in the quarter was due to a 50% surge in engineering construction in [Western Australia], which makes up just 1.7% of GDP. Indeed, our estimate is that the non-mining economy expanded by just 0.8% year-over-year compared to a [real] 31% year-on-year surge in the mining and mining-related sectors (approximately 15% of the economy)."

So Australia's is a patchy, eccentric economy, a feast-and-famine affair. Residential real estate has, until lately, shared in the feasting. Between March 2002 and March 2012, house prices in Australia's eight principal cities jumped by 89%, but the market peaked in June 2010 and the average price has subsequently fallen by 6%. Aussie consumers, even more heavily encumbered than Americans, have caught the thrift bug—Australia's savings rate jumped to 9.3% in March of this year from 3% in September 2006. Partly in consequence, construction not related to resource extraction is registering year-over-year real declines on the order of 7% to 8%.

Down Under is no destination for seekers of low rents. According to a canvass of English-speaking markets by the eighth Annual Demographia International Housing Affordability Survey, Australia has five of the world's 15 most expensive Anglophone cities. "There were no affordable markets [median house price to income of less than three times] in Australia in 2011," quoth the survey, "and the overwhelming majority of markets were severely unaffordable [median house price to income of greater than 5.1 times]."

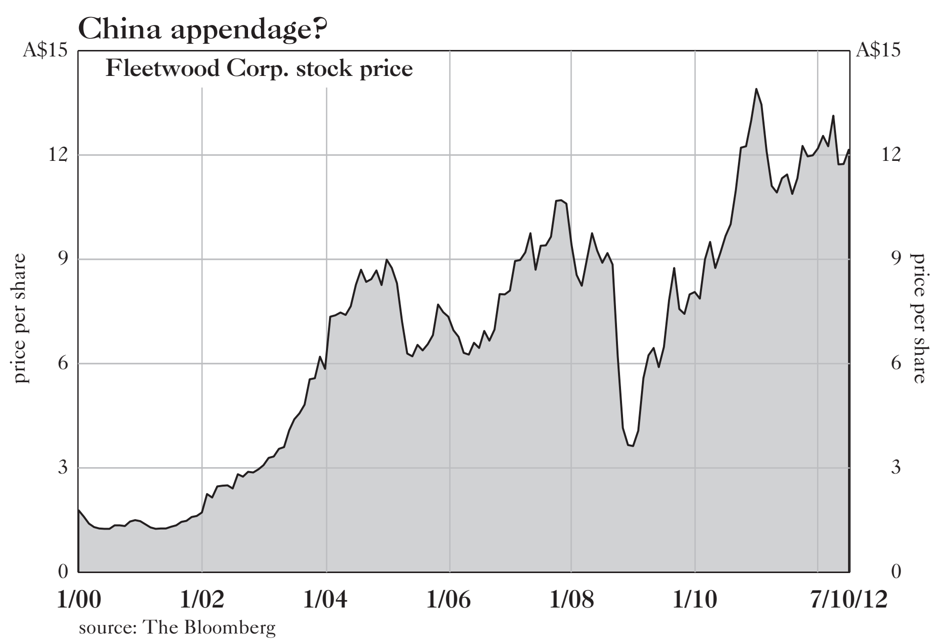
Bearish, therefore, we remain on the China-Australia axis. How to implement the idea?

Fleetwood Corp., FWD on the Sydney Stock Exchange, features the right kind of exposure to the wrong kind of markets. What it lacks, unfortunately, is the wrong kind of management. The Fleetwood balance sheet holds 22 Australian cents a share of net cash, and the stock yields 8 ½%. Better by far from the bear's perspective would be an overleveraged company yielding nothing. But facts are facts. The field of Australian public companies engaged in the manufacture of recreational vehicles and manufactured housing earmarked for the China-dependent Aussie mining sector comprises FWD alone.

The name—Fleetwood—may conjure happy memories for the American bear. California-based Fleetwood Enterprises, overleveraged maker of both RVs and manufactured houses, filed for bankruptcy in 2009. Be warned, however, that unleveraged FWD is a different breed of cat. Australia's Fleetwood recreational-vehicle sales—and margins, too—have long been dwindling. As recently as the fiscal year ended June 2005, the RV division generated 64% of sales and 71% of earnings before interest and taxes. "Subsequently," observes colleague Evan Lorenz, "sales have stagnated and earnings have collapsed. Though the spate of poor RV results has rather surprised the Australian analytical community, they have run true to form with the mid-2000 American experience. Anxious and encumbered consumers are poor prospects for writing a big check for a Coromal Caravan or a Windsor camper.

"Compare and contrast," Lorenz continues, "Fleetwood's manufactured accommodation segment. Between fiscal 2005 and fiscal 2011, revenues trebled to A$292.2 million from A$94.6 million, while EBIT margins more than doubled to 20.9% from 9.5%. To draw a bead on just how dependent Fleetwood has become on its China-anchored mining business, strip out a subsidiary named RBR, which makes manufactured structures not destined for booming Western Australia. Excluding RBR, Fleetwood's pre-fab housing business generated A$173.4 million in turnover and an EBIT margin of no less than 28.8% in fiscal 2011.

"While analysts anticipate softness in the just-ended fiscal year—flat earnings and a 6% dip in revenues is the consensus view—they have high hopes for the future. The composite prediction features revenue growth of 9.8% and earnings growth of 14.1% in the three years to 2015. Here at *Grant's*, we are sitting half a world away from the action. Fleetwood's management declines to talk (the company's in a quiet period, it says), and we've had no bet-



ter luck reaching the sell side. Nor can we even vouch for the fact that there's stock to borrow, though short interest in FWD amounts to just 0.2% of the float. What one can reasonably infer," Lorenz says, "is what the bulls are thinking. What they collectively seem to reason is that China and Australia will land softly, if at all."

Grant's respectfully begs to disagree.

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