THE STRAITS TIMES

Premium

Looking for growth stocks in unusual places

PUBLISHED 3 HOURS AGO

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West China Cement, HKBN and China Everbright Greentech are among companies that enjoyed growth rates of between 25 and 50 per cent last year.

One might assume that these are high-technology or new economy stocks favoured by the market.

In fact, they operate in relatively traditional industries, yet are capable of delivering high sustainable growth rates. These companies could be considered "neo classical" growth stocks.

There are three structural factors underlying growth in these shares, which suggest that their rise is not simply driven by a cyclical recovery or a temporary surge in earnings:

1. THE INDUSTRY IS UNDERGOING STRUCTURAL CHANGE

At first glance, the Chinese cement industry is past its heyday, with demand declining as Chinese infrastructure build-outs slow down and the property sector starts to decelerate following a decades-long construction boom.

Yet, cement firms in China have been delivering consistent growth in earnings over the past few years and earnings are expected to be stable. How did this come about?

Much like when investor Warren Buffett bought into the railroad and airline industries in the United States, the Chinese cement industry has been undergoing structural change.

It has become a consolidated oligopoly in the past few years, with small and inefficiently run players exiting the industry, following the tightening of environmental efficiency standards. Cement factories are being shuttered and production halted, resulting in a continuous decline in the supply of cement.

The result is an industry where pricing is back to reasonable levels and industry players are no longer incentivised to compete aggressively. Now that supply is more evenly matched with demand, most cement players are enjoying growing levels of profitability.

Further, with a ban on new cement supply, this stable and profitable situation is likely to continue into the foreseeable future.

Annual earnings growth of select stocks

Companies	2017	2018	2019 (estimated)
A – Cement, China	Large	56%	51%
B – Telco, Hong Kong	10%	12%	41%
C – Environment Management, China	46%	37%	25%

Note:
- This is calendarised data of adjusted net income for companies A and C, and adjusted earnings before interest, taxes, depreciation and amortisation for company B.
- Company A is West China Cement, company B is HKBN Ltd and company C is China Everbright Greentech.

Sources: BLOOMBERG CONSENSUS, PHILLIP CAPITAL
SUNDAY TIMES GRAPHICS

2. EXISTING OPERATORS ARE NOT SERVING CUSTOMERS WELL OR HAVE AN INEFFICIENT STRUCTURE

Most people view fixed telecommunications (voice and broadband) as a boring, steady business, more so in developed, mature Hong Kong.

Yet, the No. 2 broadband player in Hong Kong has been delivering significant earnings growth, and it aims to continue growing at over 20 per year annually for the next couple of years. How did it do this?

When broadband operator HKBN entered the market, the incumbent was earning high profits providing fixed-line services to residential customers in Hong Kong and thus, less willing to innovate and roll out the high-speed connections consumers demanded due to the risk of cannibalising their existing offerings.

HKBN entered the market to address these unmet demands, rolling out fibre coverage aggressively to residential customers. Its high speeds, quality of customer service and attractive prices made it the go-to provider for broadband in Hong Kong.

It gradually edged out the larger incumbent, resulting in it having over 35 per cent market share of broadband today.

Just as important to its success was a culture of shared prosperity. Most of HKBN management are expected to fork out significant sums of their own money to invest in the company, greatly motivating them to do well, aligning their interests with those of shareholders and creating an entrepreneurial, go-getter culture that could never be matched by the incumbent.

Today, HKBN is expanding its offerings into mobile, content and wholesale. Its culture, customer focus and management incentives are likely to sustain its growth into the future.

3. DEMAND GROWTH IS BEING DRIVEN BY POLICY CHANGE AND BARRIERS TO ENTRY ARE HIGH

Demand for environmental services in China is growing due to a legacy of pollution as a result of breakneck industrial growth. This has provided some companies, which have relevant expertise, the opportunity to take advantage of a sea change in environmental policies in China.

Hazardous waste treatment is less discussed, but is probably one of the most profitable sectors in environment management in China. Hazardous waste output from factories is largely untreated or incorrectly treated.

DBS estimated in 2018 that hazardous waste treatment operating capacity was less than 20 per cent of actual waste generated, leaving significant room for growth in treatment.

This sector also has large barriers to entry - besides technology, only select companies have relationships with local governments enabling them to secure prime sites at industrial areas.

And once a company establishes a foothold in an area, it will essentially be the sole provider of hazardous waste treatment services, an enviable position to have in any industry.

Driven by environmental needs, policy support and strong entry barriers, companies in this sector are expected to enjoy a multi-year tailwind of growth and profitability.

These structural factors are not unique to the stocks discussed. There are many examples from around the world of companies that have benefited from similar trends.

While finding such stocks is never easy, owning a handful of these less-known growth shares may prove to be quite profitable.

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Annual earnings growth of select stocks