

Implications of China's Changing Labour Market

March 9 2010

Recent labour shortages in China's light manufacturing bases highlight the change in China's migrant workers' mindsets and the growing need for factory automation. We see little impact on the listed companies as they are already paying above-average wages and almost 100% of their workers returned after the February holiday. However, many smaller manufacturers could be affected again in 2010 as they may have to pay 20-50% higher wages to attract employees.

Migrant Workers: More Demanding

- More Employment Opportunities in Inner China
- Factories on the Coast Have to Pay Premium
- Little Short-Term Impact on Listed Companies
 - Already Paying 25-50% Above Average
 - Plus Benefits, Incentives, Law Compliance
 - Only 3-5% Wage Increase Planned for 2010
 - Close to 100% Workers Return After Holiday
- Smaller Factories Need to Increase Wages
 - Still Unable to Raise Export Selling Prices

Implications for the Industry

- More Factory Closures Ahead
- Impact on Garments Rather than Fabrics
- Factories Relocating Inland but Not Abroad
 - South East Asia Not As Efficient as China
 - Now Trade to EU, US Quota Free
- Higher Demand for Machines, Factory Automation

Demand: China Strong, Export Stronger

- Chinese Garment Sales Strong
 - Above 20% yoy Growth Since April 2009
 - Clothing Among Bestsellers During Spring Festival
- Export Demand Higher Since Oct/Nov
 - Still Volatile, Short Lead Times

Companies: Tom Form Revisited

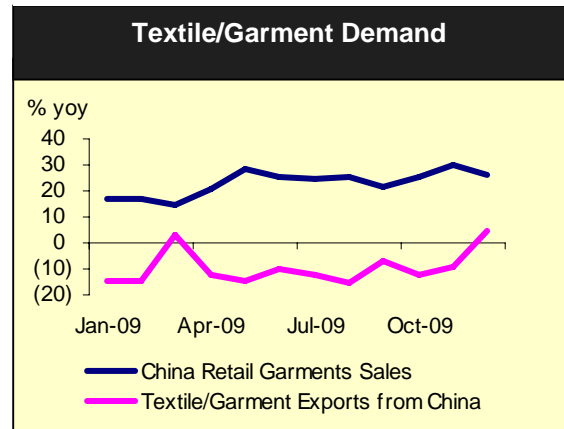
- Top Form: Expanding Again, Buy
- Texwinca: Strong 2HMar10, Buy
- China Ting: Stronger Retail, Buy

Listed Companies Above Average

Textile and Garment Wages		
Company	Rmb/month	% Difference
Texwinca	2,000-3,000	40-50
nearby factories	1,500-2,000	
China Ting	1,700	30-40
nearby factories	1,000-1,200	
Top Form	2,300	25-30
nearby factories	1,800	

Sources: Companies, Research-Works

China Strong, Exports Strengthening



Source: CEIC

Buy Recommendations

- *Texwinca*
- *China Ting*
- *Top Form*

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Recent serious labour shortages in China's light manufacturing bases in Guangdong and Zhejiang highlight some significant structural changes affecting the country's textile and garment industry. We believe that these trends are relevant for light manufacturing overall in China.

Impact of the Chinese Labour Market Changes on the Textile and Garment Industry

- We believe that the short-term **impact of the labour shortages on the listed companies could be minimal**, as they already pay above-average wages. Garments are the more labour-intensive segment (labour cost can reach 20% of costs), while textiles rely more on machinery (labour is typically only 5-7% of costs).
- Smaller, unlisted manufacturers may have to increase wages and benefits to attract workers. This could increase their labour cost by as much as 50% and inevitably **force more factories to close**. This would increase the pricing power of the large suppliers in the industry: just as with Texwinca in dyed fabrics.
- As there are now more employment options for migrant workers closer to home (central and western China), **it could be more difficult for companies to retain workers** for long periods of time.
- This could lead to a new wave of factory **relocations to central and western China**.
- **Demand for higher-end equipment, including factory automation products is likely to strengthen**. This kind of investment could help factories increase efficiency and reduce labour intensity.

Many factories reported problems with finding sufficient labour following the February Chinese New Year holiday. However, it seems to us that this was caused **not so much by the actual lack of workers but rather by an important change in their mindsets**. Now that attractive jobs are available closer to their homes in inland China, migrants are demanding higher wages in the coastal regions to compensate for the hardships of migration.

This trend has the most negative impact on manufacturers who pay below-average wages. **Listed companies we spoke with saw close to 100% of their employees returning from the Spring Festival in February**. That is, we believe, because these companies pay above-average wages and are fully-compliant with the labour law in China.

Factories that have been paying close-to-minimum wages may now need to increase salaries to attract workers: **basic wages at those companies may have to rise as much as 50%** to "catch up" with the larger employers. Meanwhile most listed companies plan only about a **3-5% wage increase** in 2010.

If smaller manufacturers are indeed forced to increase wages significantly in the first half of 2010, we would likely see **further factory closures**. From our research we conclude that **most exporters, especially in the garment segment, are unable to increase selling prices** despite the increases in raw material and labour costs. Export orders, although higher in volume terms since November, are volatile and the lead time is still very short. Selling prices have stabilised but costs are growing.

Wages at Textile/Garment Factories: Listed vs Unlisted			
Current Average Monthly Wages		Rmb/month	Increase Needed (%)
Texwinca	knitted fabric factory worker	2,000-3,000	
unlisted companies in Guangdong		1,500-2,000	40-50
China Ting	garment factory worker	1,700	
unlisted companies in Zhejiang		1,000-1,200	30-40
Top Form	brasserie factory worker	2,300	
unlisted companies in Jiangxi		1,800	25-30

Excluding benefits or bonuses. Sources: Companies, Research-Works Estimates

Just How Serious Are The Shortages?

Some of the recent labour shortages were magnified by seasonal factors. Chinese New Year is the only time during the year when migrant workers travel back home, so some production disruptions are inevitable. Also, this is the change of the fashion season from winter to summer, so retailers are rushing the fabric and garment suppliers to speed up deliveries. Export demand has been stronger since November, but most **manufacturers cut their labour force in 2009**.

China's Trade Share: Still Growing

Despite the headwinds experienced by most Chinese textile and garment makers in 2009, **China keeps gaining market share in its key textile and garment export markets**. Its share of US textile and garment import value expanded by 4% in 2009 to 39%. China also expanded its share of Japan's textile and garment imports, where it has been a dominant supplier in recent years with 70-80% of the market. We estimate that China's share of the EU's textile and garment import value was flat in 2009. These three markets took about 48% of China's textile and garment exports last year.

China's Share of Textile and Garment Imports

% by Value	2007E	2008E	2009E
EU	32	35	35
Import Value (US\$bn)*			100
US	34	35	39
Import Value (US\$bn)*			81
Japan	70	77	79
Import Value (US\$bn)*			25

* Estimated EU, UK and Japan textile and garment import value in 2009.

Sources: CEIC, CNEX, US Department of Commerce, Research-Works

We expect China's growth in world textile and garment trade to continue in 2010. Some China-based garment companies, which set up facilities in South East Asia after 2005 to avoid quotas and rising costs in China, tell us that their future expansion will concentrate in China. Thailand, Vietnam or the Philippines cannot match China in terms of overall efficiency, infrastructure or volume.

Please note that the **textile and garment quotas to the US** expired at the end of 2009, while EU trade has been quota-free since the end of 2008. Considering the low trade volumes and western customers' preference for low-price items, we do not expect new trade disruptions in the near future.

Chinese Domestic Demand: Strong

We believe that China's domestic demand for textiles and clothing has been relatively strong in the first two months of 2010.

Garment retail sales have grown above 20% yoy every month since April 2009.



Source: CEIC

Notably, **garments were among the best-selling items during the week-long Chinese New Year**. The sales value of clothing grew 17.7% compared with the 2009 holiday: this was the second best-selling item after jewellery and gold, which increased 19.1% yoy. Discounting has also seemingly eased in recent months.

The strong domestic demand should support manufacturers with some domestic exposure as well as the companies with retail networks in China. We think that both Texwinca and China Ting have seen strength in their retail operations since October 2009.

Textile Machinery: Strong Asian Demand

We note the **strong increase in China's textile machinery exports** in December (up 51% yoy) and January (47% increase yoy). Most China-made textile equipment is exported to the lower-end Asian markets including India, Pakistan and South East Asia.

The recent pick up in Chinese textile equipment exports highlights the fact that the rest of Asia is also benefiting from stronger global demand for clothing and textiles. **Yarn and fabric-making equipment**, mostly going to **India and Pakistan**, should be the main contributor to China's textile machinery exports by value.



Companies: Three Buys

Top Form: Revisited

We would like to draw investors' attention to a former sector favourite, **Top Form International (333 HK)**. The company has been off the radar screens since its production was seriously disrupted by the "bra wars" and the return of quotas in 2005.

Net profit peaked in 2005. The company lost HK\$13mn in the FYJune09. **However, it seems that Top Form's business turned around during the July-December 09 half. We expect it to deliver strong second half results for January-June 2010.**

In recent years Top Form has focused on **improving its production efficiency** (the company managed to increase average selling prices as it was **closing down inefficient capacity and selecting higher gross margin orders**). Top Form also closed its loss-making lingerie retail business in China.

Despite the tough last four years, Top Form remains the world's largest OEM bra supplier. It sells to the likes of Warnaco, Maidenform, Etam, VDV and H&M. The company has production facilities in China (some 60% of capacity), Thailand and the Philippines.

The company's **order book is filled until June 2010**. It plans to **expand capacity 20% during the next two years**. A lot still depends on export demand but the risk to Top Form delivering strong June 2010 annual results seems limited.

The company had minimal bank borrowings and net cash of HK\$207mn in Dec09. The management indicated that Top Form could re-enter Chinese retail through a local brand acquisition.

The company's market capitalisation is still below US\$100mn but **we believe that investors should put Top Form on their radar screens**. 2010 results are expected to be announced in September 2010. We forecast net profit of HK\$60mn in FYJun10 and HK\$81mn in FYJun11. Top Form is trading at 11 x June 2010 PE.

Texwinca: Still Strong

The positive surprise from our recent call with Texwinca's management is that **the company managed a double digit fabric selling price increase** in recent months. The adjustment to the average selling price should help Texwinca maintain margins in the second half, Sept09-Mar10, despite higher labour and raw material costs.

The company continues to have **15-20% annual capacity expansion** in dyed knitted fabric. The management believes that it can continue expanding in Guangdong and has no plans of setting up facilities elsewhere. We believe that Texwinca is now **the largest single-location dyed knitted fabric supplier in the world**. It is definitely the leader in China.

Texwinca's retail performance has also improved in the second half: the company has achieved **double digit same store sales growth since November**. Retail operating margin is expected to increase as the company's stores offer smaller discounts.

The main risk in our view is the increase in cotton prices. The company says it is now purchasing cotton at prices 12-13% higher than in 2009. It has so far managed to increase selling prices in line with the cost increases, perhaps because of the limited supply as many of its competitors reduced capacity in recent years. **We maintain our Buy recommendation on Texwinca.**

China Ting: Stronger Retail

While it seems to us that China Ting's OEM business is still affected by the global downturn, **the company's retail seems to be doing better**. It has been able to increase retail selling prices in China in 2009 and improve operating profitability as it reduced its department counters and focused on independent stores.

The management mentioned that it expects to see some positive developments in its wool business this year. Also, we expect that **the company could be regaining its OEM pricing power** in the second half of the year.

We expect China Ting's 2009 EPS to fall 5-10% but increase 10-15% in 2010 and about 20% in 2011. The company is trading at 11 x 2009 PE, Buy.



STOCKS



Textile Valuations													
	Y/E	Mkt Cap (bn)	US\$ (mn)	% Free Float	Price 8 Mar	EPS (% chg)				PER x			
						08A	09E	10E	08**	09E	10E		
Hong Kong		HK\$										HK\$	
China Ting*	Dec	2.9	372	28.8	1.4	(36.3)	(8.4)	12.8	11.4	10.7	9.5		
Fountain Set*	Aug	1.0	133.0	55.0	1.3	87.6	nm	na	nm	nm	na		
Luen Thai	Dec	0.9	115	22.3	0.9	(7.7)	na	na	9.3	na	na		
Pacific Textiles	Mar	7.4	949.0	31.3	5.1	(7.1)	79.6	12.0	12.7	11.0	9.8		
Shenzhou Intl	Dec	13.2	1,700	28.5	10.6	69.7	47.0	37.9	11.6	12.9	9.3		
Texhong	Dec	1.9	250.8	26.3	2.2	(11.1)	na	na	11.2	na	na		
Texwinca*	Mar	10.1	1,300	41.2	7.6	(7.2)	21.8	8.2	11.3	9.6	8.8		
Top Form	Jun	0.7	84.5	44.2	0.6	nm	nm	35.1	nm	11.0	8.1		
Victory City*	Mar	2.1	273	49.3	2.0	(38.4)	(13.6)	29.7	8.3	7.8	6.0		
Weiqiao Textile*	Dec	2.3	295.2	95.5	5.5	(67.9)	4.5	15.3	8.1	10.6	9.2		
Win Hanverky	Dec	1.7	221	34.1	1.4	(88.7)	na	na	72.7	na	na		
China A Shares		Rmb										Rmb	
Black Peony	Dec	12.2	1785.4	32.1	15.3	(94.7)	nm	15.5	32.7	25.8	28.1		
Jiangsu Hongdou	Dec	2.9	426	53.1	6.8	(41.2)	na	na	87.5	na	na		
Jiangsu Sunshine	Dec	11.8	1724.3	76.4	6.6	2.4	na	na	103.9	na	na		
Jiangsu Skyrun	Dec	3.7	541	60.0	7.2	2.4	na	na	74.2	na	na		
Luthai Textile B	Dec	7.4	1080.1	67.5	11.0	(16.7)	(11.7)	na	22.4	20.7	na		
Shanghai Dragon	Dec	4.4	648	100.0	10.4	10.3	na	na	217.4	na	na		
Youngor	Dec	32.8	4,802	64.3	14.7	220	5.4	(9.6)	27.8	43.8	21.8		
Veken	Dec	2.0	298	100.0	6.9	(36.0)	na	na	nm	na	na		
India		Rs										Rs	
Alok Industries	Mar	14.7	323.6	61.5	24.3	(44.2)	na	na	6.5	na	na		
Arvind Mills	Mar	8.1	178	60.5	35.7	nm	(144.6)	22.4	na	17.4	14.2		
Bombay Dyeing	Mar	21.0	461.3	58.5	543.5	(417.2)	nm	267.2	(10.8)	46.8	12.8		
Gokaldas	Mar	5.4	119	5.1	157.1	(92.8)	na	na	155.6	na	na		
Himatsingka Seide	Mar	4.3	95.3	43.6	44.1	na	nm	na	142.0	3.8	1.0		
Raymond Ltd	Mar	14.0	308	46.8	228.1	nm	nm	12.8	nm	18.2	16.1		
Taiwan		TW\$										TW\$	
Nien Hsing	Dec	10.6	331.7	72.0	17.9	nm	na	na	8.6	na	na		
Makalot	Dec	10.3	325	81.0	67.4	(75.1)	211.0	12.0	34.5	11.1	9.9		
Korea		KRW										KRW	
Basic House	Dec	152.9	134.9	42.0	7330	(36.5)	na	na	na	na	na		
Handsome	Dec	326.3	288	61.0	13250	(1.7)	102.6	(41.6)	5.5	4.0	6.8		
Youngone	Dec	415.0	366	75.0	32350	4.6	136.2	3.0	10.1	21.5	20.9		
Japan		JPY										JPY	
Wacoal	Mar	158.6	1,754	84	1,106	4.6	(57.1)	51.8	49.0	70	46		

Companies with March and June year ends appear in the column for the previous year, eg. FY March 09 in the 08 column. All others appear in their calendar years, eg. August 09 in 09 column.

* Research-Works Estimates. Rest Bloomberg

** Trailing PE, Bloomberg Estimate

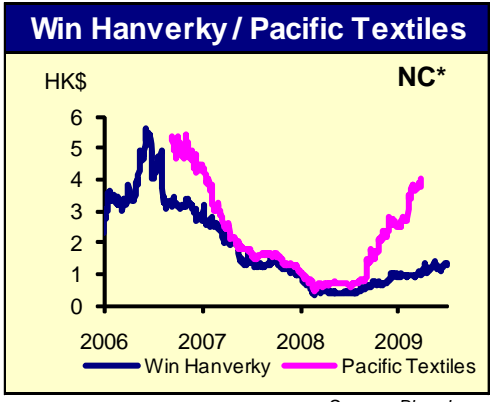
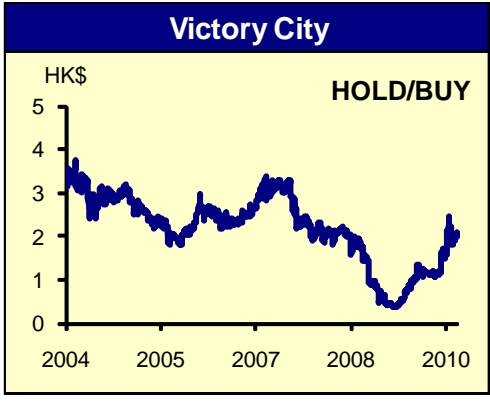
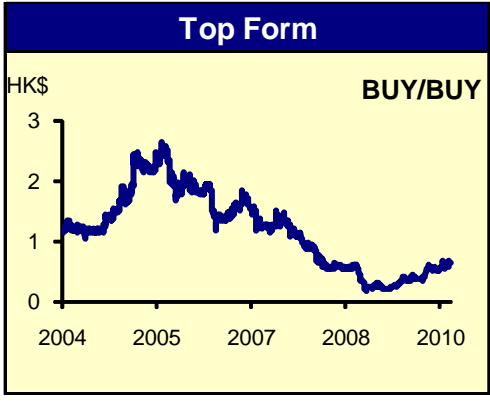
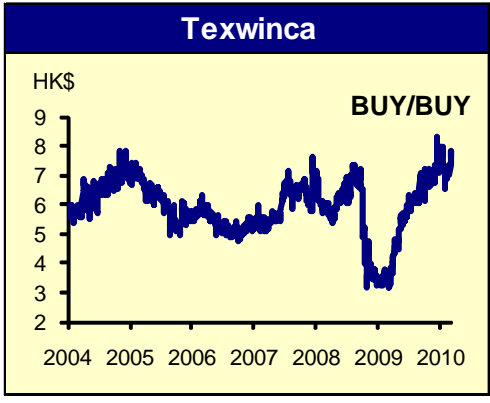
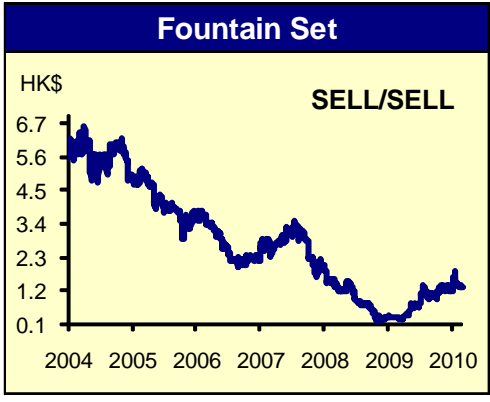
NB China A Share free float is listed shares as % of total shares: Source Reuters



Share Prices and Performance for Textile Companies									
% chg at Mar 8	Segment	Ticker	Price	1 Week	1 Mth	3 Mths	6 Mths	12 Mths	24 Mths
Hong Kong			HK\$						
China Ting	Garments/Retail	3398 HK	1.4	0.7	7	8.7	3.8	236.6	na
Fountain Set	Fabrics	420 HK	1.3	(0.8)	0.0	(6.5)	18.2	372.7	(9.1)
Luen Thai	Garments	311 HK	0.9	0.0	9.8	3.4	18.4	130.8	8
Pacific Textiles	Fabrics	1382 HK	5.1	(0.4)	4.3	3.6	105.6	na	na
Shenzhou Intl	Garments	2313 HK	10.6	(1.7)	14.2	4.7	40.6	579.5	292.6
Texhong	Yarns/Fabrics	2678 HK	2.2	31.7	74.6	147.2	171.6	388.9	122.2
Texwinca	Fabrics/Retail	321 HK	7.6	3.0	5.9	5.3	8.2	131.9	25.2
Top Form	Underwear	333 HK	0.6	(4.7)	8.9	10.9	64.9	206.5	7.0
Victory City	Fabrics/Garments	539 HK	2.0	(0.5)	7.0	25.0	70.9	471.4	(1.7)
Weiqiao Textile	Yarns/Fabrics	2698 HK	5.5	(0.2)	9.3	0.2	(1.1)	188.5	(45.6)
Win Hanverky	Sportswear	3322 HK	1.4	3.8	18.4	16.4	48.4	229.3	na
Avg				2.8	14.5	19.9	49.9	300.8	49.9
Hang Seng Index				0.7	8.5	(3.9)	0.6	77.9	(5.8)
China A Shares			RMB						
Black Peony	Denim	600510 CH	15.3	9.4	18.9	16.2	65.3	166.4	81.5
Jiangsu Skyrun	Garments	600981 CH	7.2	(2.2)	3.2	2.6	6.6	47.1	(36.7)
Luthai Textile B	Fabrics	200726 CH	11.0	(4.0)	2.1	(8.0)	18.0	55.6	na
Shanghai Dragon	Underwear/Home	600630 CH	10.4	3.3	9.2	(2.1)	17.9	22.0	(30.6)
Youngor	Garments	600177 CH	14.7	(3.5)	1.2	(0.9)	15.9	62.7	(30.1)
Veken	Home Textiles	600152 CH	6.9	(0.6)	7.1	(0.7)	35.8	76.6	(30.0)
Avg				0.4	7.0	1.2	26.6	71.7	(9.2)
Shanghai A Share Index				(1.0)	4.1	(7.3)	4.2	39.2	(29.0)
India			Rs						
Alok Industries	Fabrics	ALOK IN	24.3	3.4	(4.9)	13.6	7.3	81	(54.6)
Arvind Mills	Denim	ARVND IN	35.7	3.9	0.1	(2.5)	4.8	217.3	(12.0)
Bombay Dyeing	Textiles	BD IN	543.5	3.7	4.8	35.2	45	344.4	(8.8)
Gokaldas	Garments	GEXP IN	157.1	0.7	1.7	2.6	19.1	196.7	(21.9)
Himatsingka Seide	Silk/Home Textiles	BD IN	44.1	16.1	12	8.5	17	137.5	(39)
Raymond Ltd	Fabrics	RW IN	228.1	6.1	3.0	17.7	25.1	221.9	(23.3)
Avg				5.6	2.8	12.5	19.9	199.8	(26.6)
Sensitive Index				4.5	7.7	(0.4)	6.4	106.1	7.4
Taiwan			TW\$						
Nien Hsing	Denim	1451 TT	17.9	4.1	10	5.6	9.8	136	(14.6)
Makalot	Garments	1477 TT	67.4	10.9	16.6	14	8.7	150	0
Avg				7.5	13.4	9.9	9.3	142.6	(7.3)
Taiwan TaieX Index				2.2	7.3	(0.3)	5.9	66.4	(9.2)
Korea			KRW						
Basic House	Casual Wear	084870 KS	7,330	(0.4)	2.1	36.5	16	383.8	13.6
Handsome	Garments	020000 KS	13,250	(3.3)	(4.3)	(14.8)	6.9	69.4	19.4
Youngone	Sportswear	009970 KS	32,350	8.0	5.7	1.9	47.0	111	84.5
Avg				1.4	1.2	7.9	23.3	188.2	39.2
KOSPI Index				3.8	6.5	1.6	2.1	56.8	(0.6)
Japan			JPY						
Wacoal	Underwear	3591 JP	1,106	1.0	7.7	8.6	(3.7)	1.1	(25.7)
NIKKEI 225 Index				3.7	6.0	4.0	1.5	47.0	(17.5)

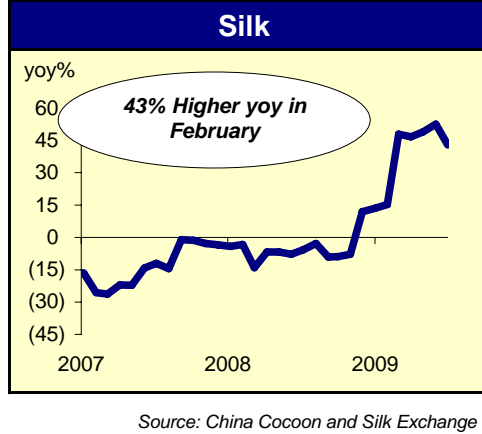
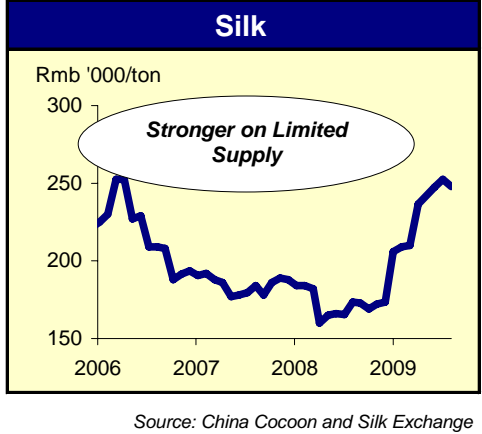
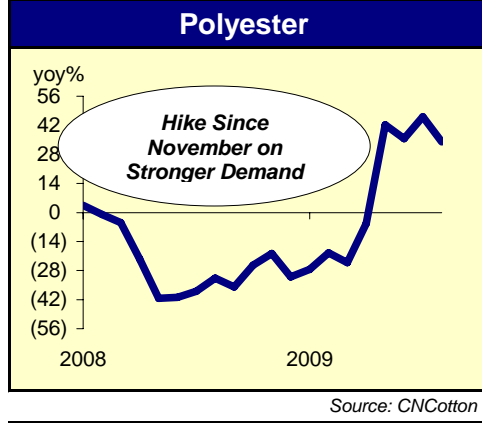
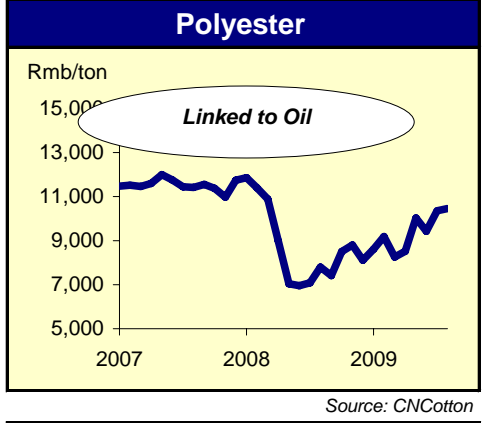
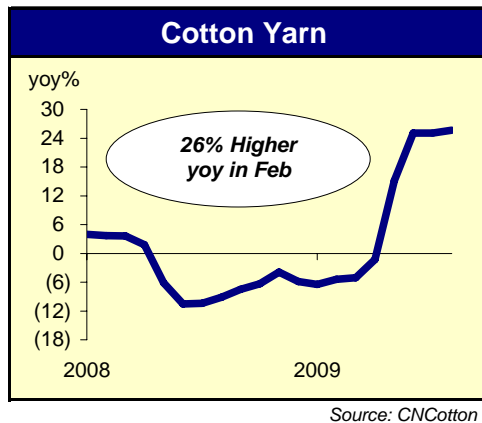
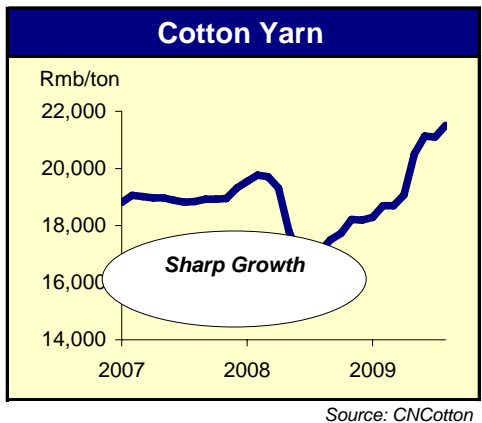
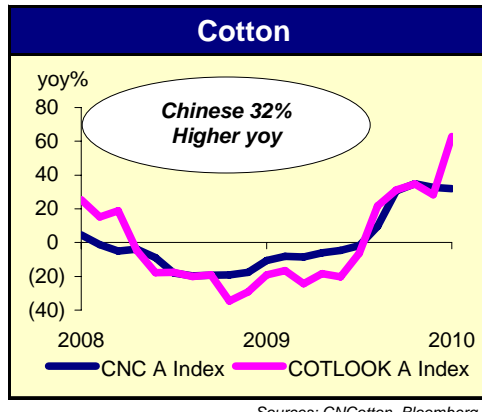
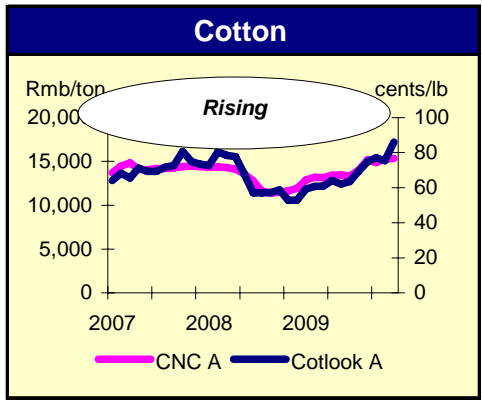
Source: Bloomberg

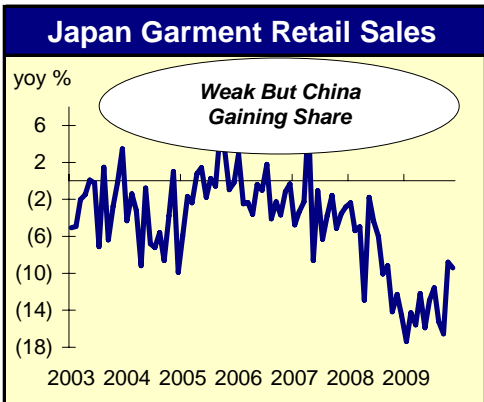
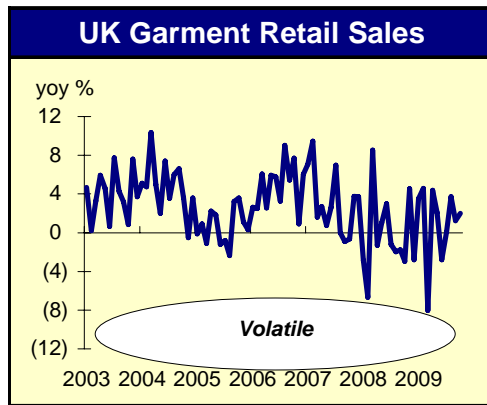
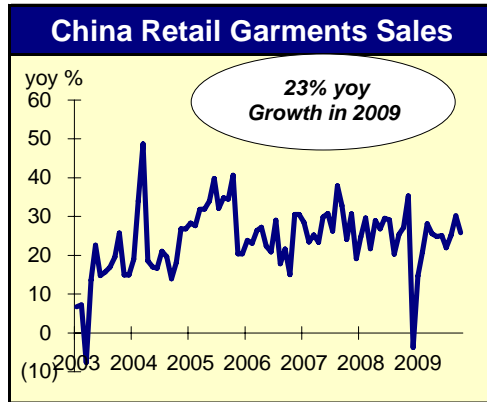
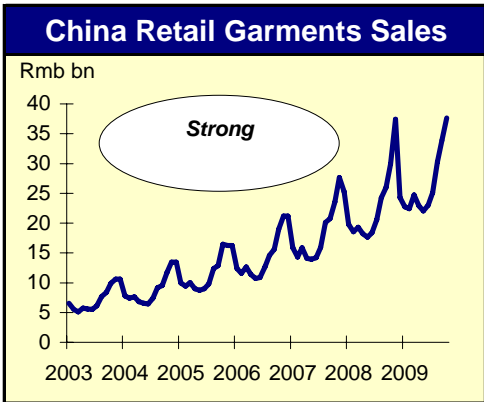
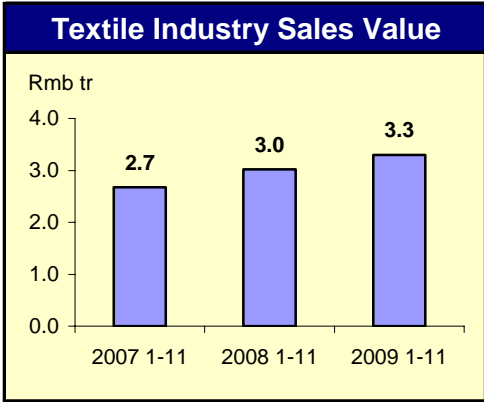
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Source: Bloomberg

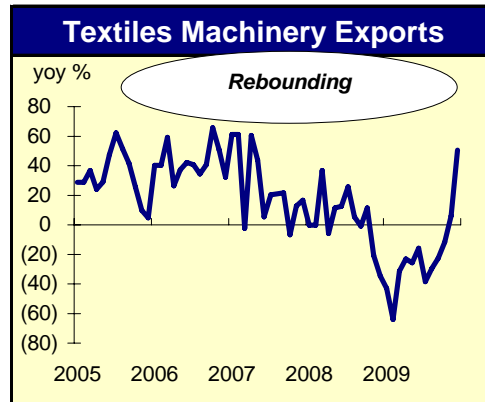
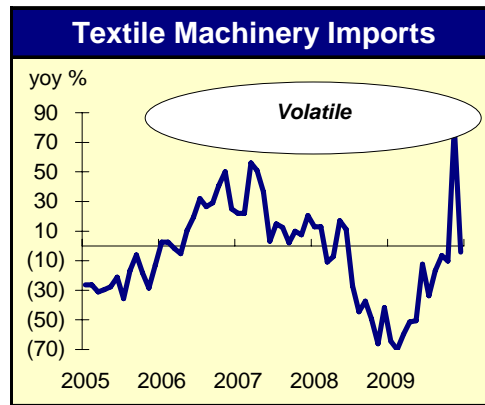
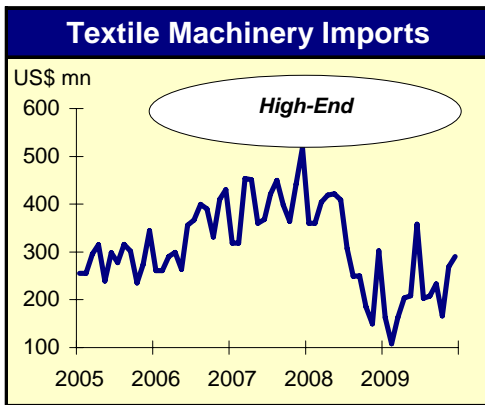
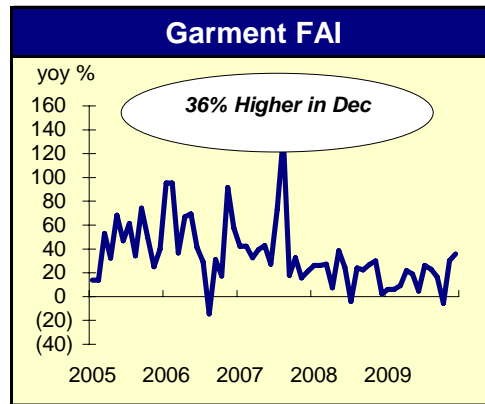
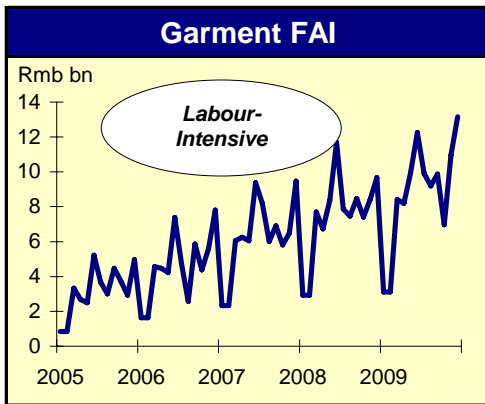
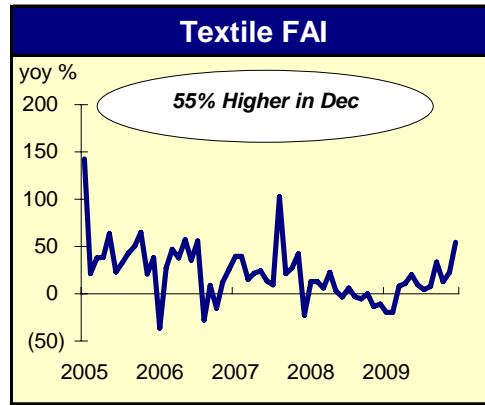
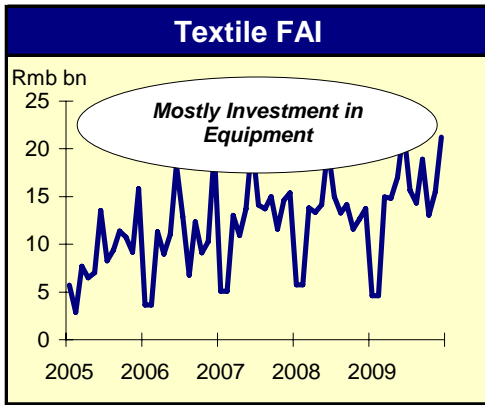
Note: All recommendations are on a one and two-year view.
NC* Not Covered





* Department Stores

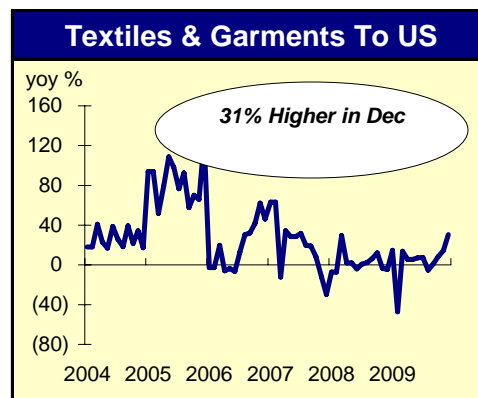
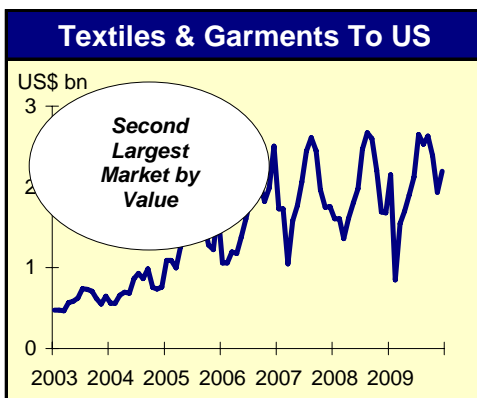
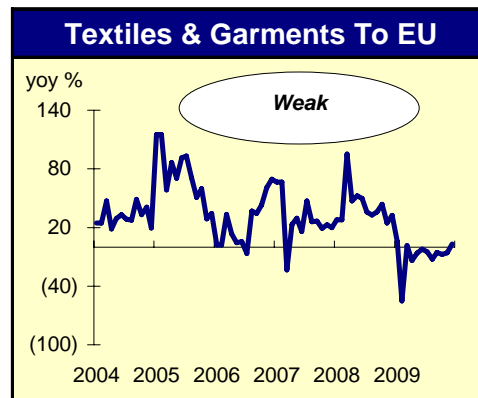
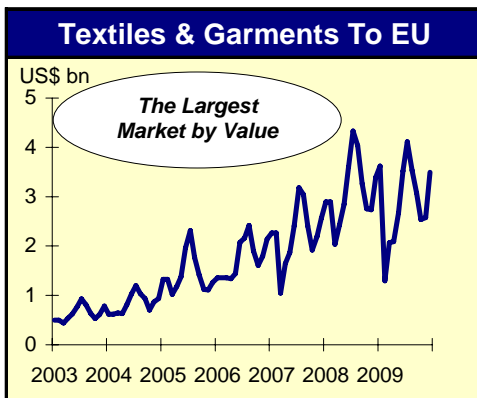
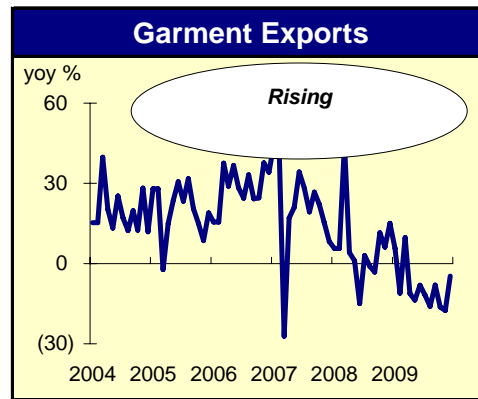
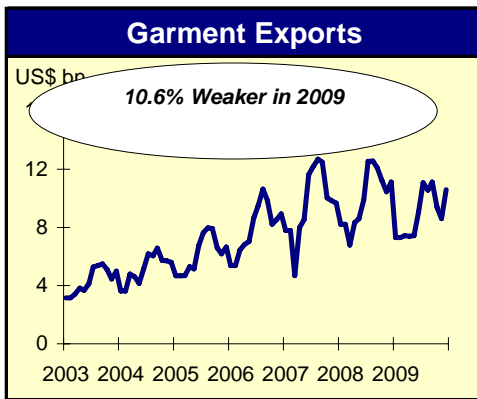
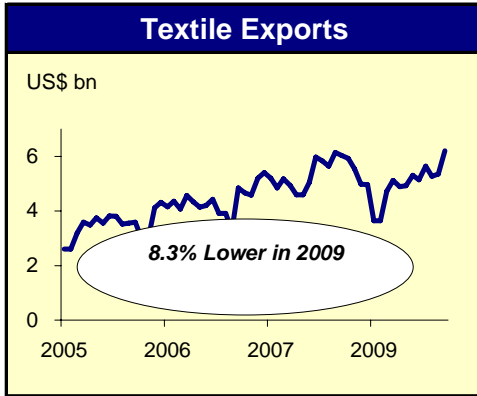
Source: CEIC



* Incl. Garment, Footwear and Headgear manufacturing

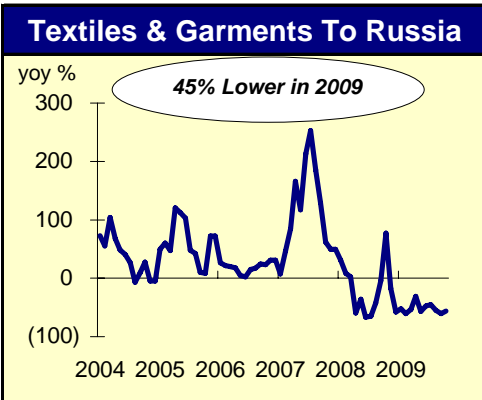
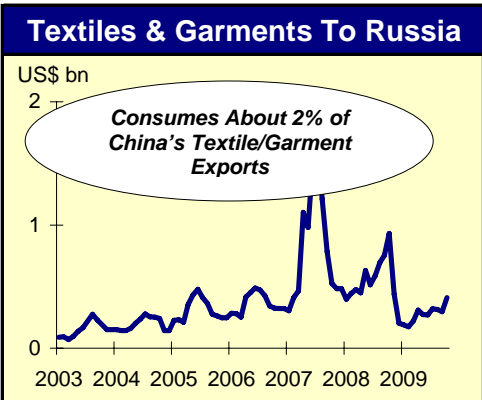
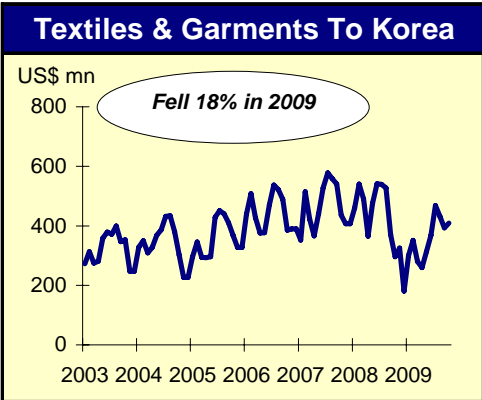
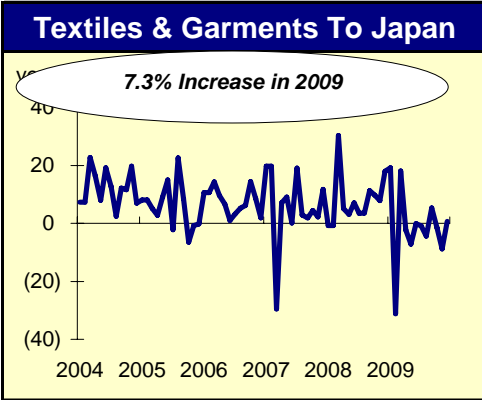
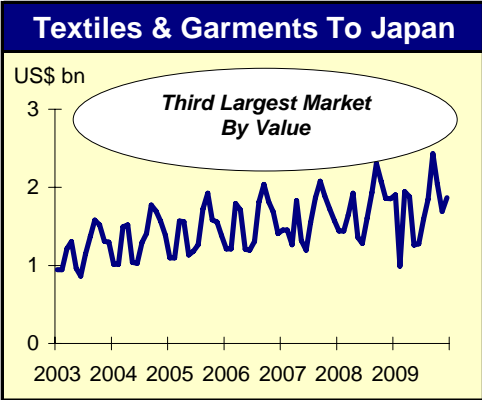
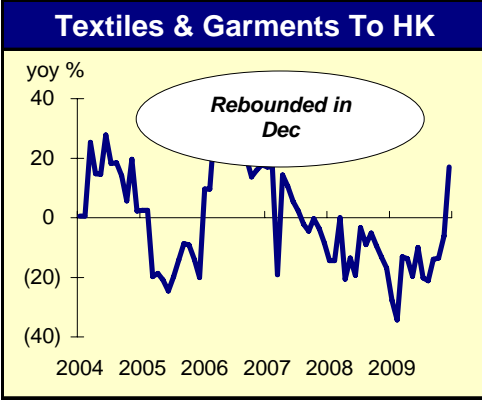
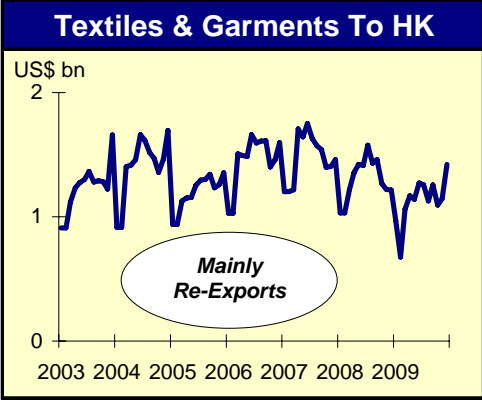
Source: CEIC

EXPORTS



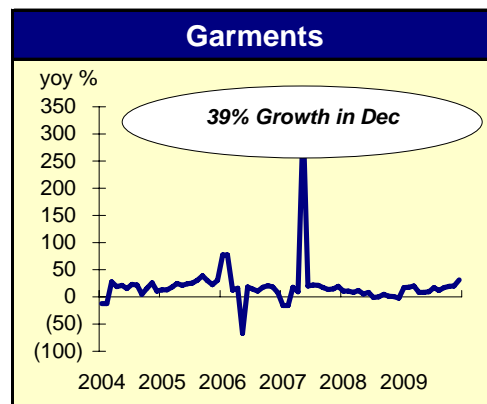
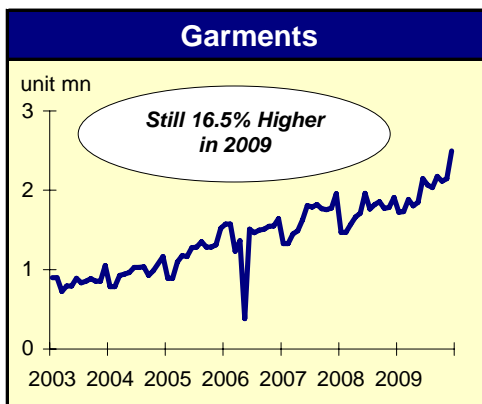
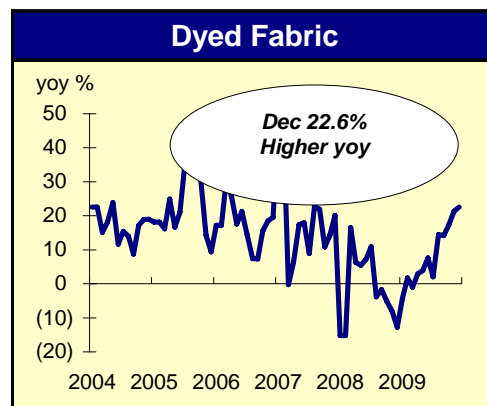
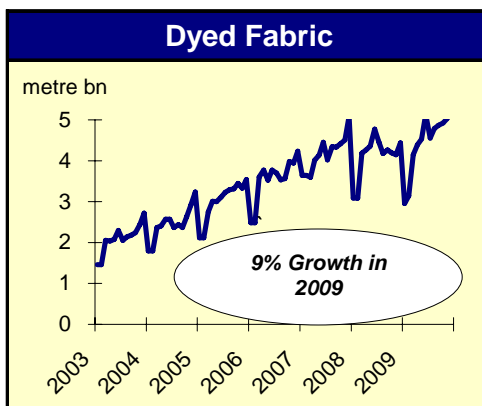
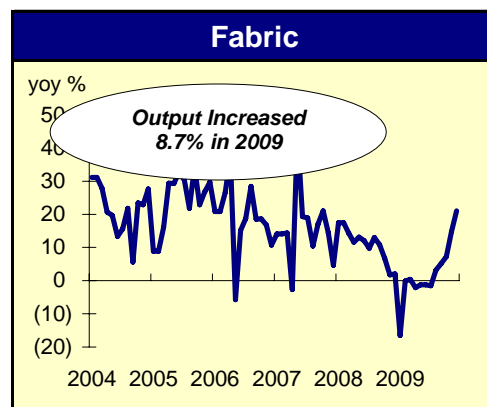
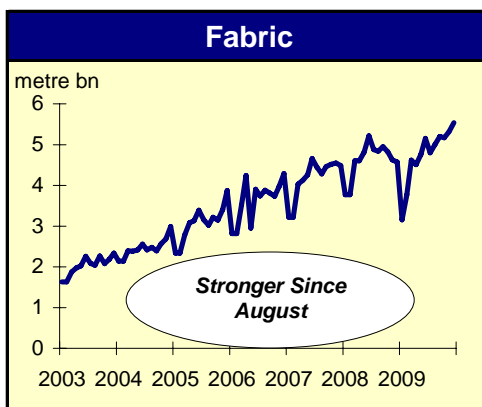
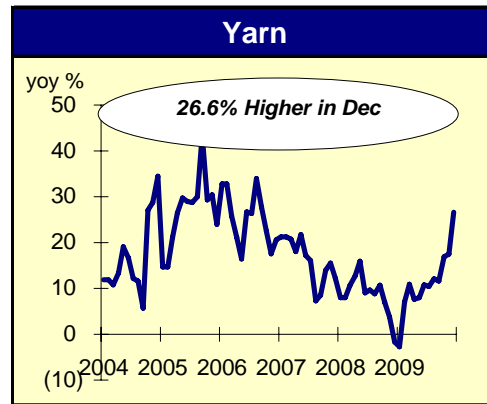
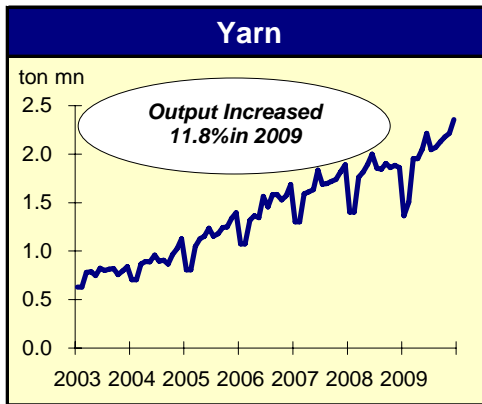
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EXPORTS



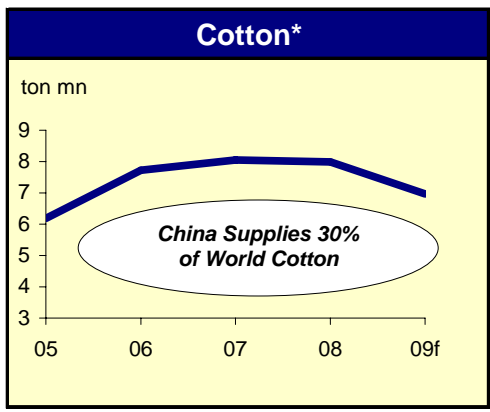
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PRODUCTION

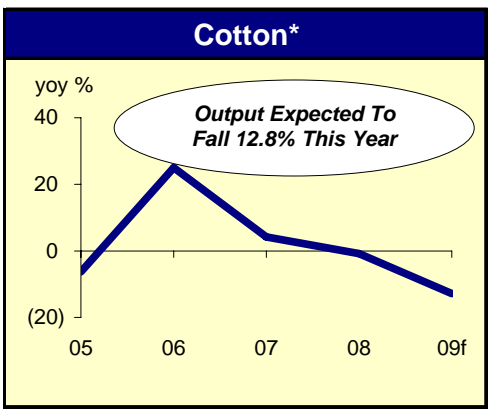


Source: CEIC

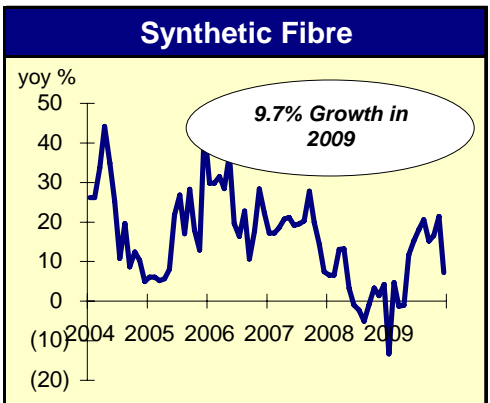
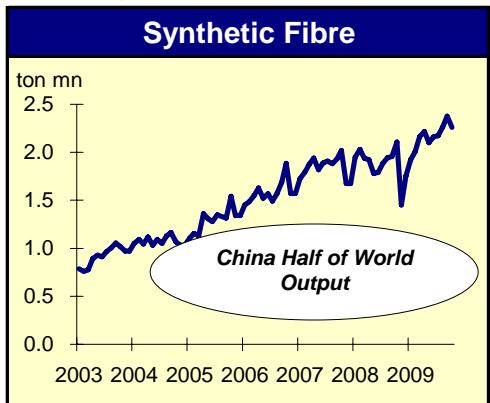
PRODUCTION



* YE 31st August



Source: USDA PSD



Source: CEIC

All Data Is For China Up To December, Unless Otherwise Stated
NB When we talk of highs we exclude Jan/Feb numbers that are distorted by the changing Lunar New Year holiday

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