Old is the new young

Dirk van Vlaanderen - Associate Portfolio Manager

"Keeping dry is an imperative in the beginning and in the twilight years of life. The design, comfort and fit of modern diapers (locally, more popularly referred to as nappies) have improved dramatically since the first commercial disposable ones produced in the 1970s. This has resulted in a global industry worth over $60 billion with attractive growth prospects."

Old is the new young

We analyse the global opportunities for the baby and adult incontinence diaper markets and outline how Ontex, the largest European producer of private label nappies with a growing global presence in the category, is well positioned to benefit from market trends.

Booming market dynamics

The baby care and adult incontinence segments are two of the most attractive in terms of growth outlook in the broader personal care product market. Development in these categories is underpinned by long-duration structural trends of population growth, an ageing population, increasing urbanisation, rising income per person and the increasing penetration of the formal retail sector, particularly in emerging markets.

Baby care is expected to increase at 3.3% per annum for the next five years mainly due to growth in emerging markets where population expansion rates remain relatively high. As shown below, the two largest producers of branded nappies - Procter & Gamble, producer of the ubiquitous Pampers brand and Kimberly-Clark, the manufacturer of Huggies - account for 45% of the global market share. Other large branded regional players include Essity (Europe), Unicharm (Asia) and Ontex (Latin America).

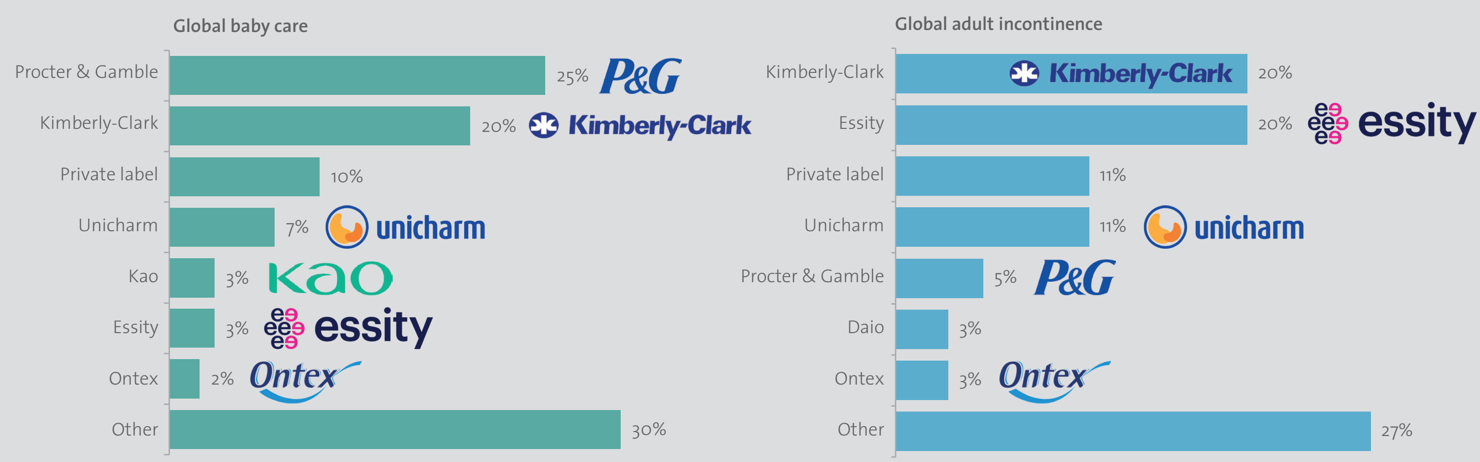
Private label brands contribute 10% to the global market and have been gaining significant share from the branded players over the last 15 years, particularly in Europe, off the back of the growth in the hard discount retail channel.

Innovation in the baby care nappies category has centred on improvements in materials to ensure greater absorbency (dryness) and comfort. In recent years, there has been a trend towards "baby pants" for toddlers, a convenient form of protection while potty training, which has extended the time children spend in the category.

Adult incontinence, although the smaller in absolute market size, is currently expected to grow at twice the rate of baby care, or 6.6% per annum. This is due to the ageing populations in emerging and developed markets. The global population of adults over 65 years of age is expected to grow by 3.5% per annum to 2030. Kimberly Clarke and Essity are the two largest branded players globally in adult incontinence products, with around 40% of the global market share between them.

Adult incontinence products are sold through institutional (hospitals and old-age homes) and retail channels. The retail channel is growing strongly as manufacturers continue to invest in brand awareness to help overcome some of the negative perceptions of the product and ensure greater availability.

Global baby care and adult incontinence retail diaper market shares (2017)



Source: Euromonitor, UBS analysis

Innovation in the category has centred around absorption, comfort, and specifically, on creating a thinner and less conspicuous product without compromising on effectiveness.

Ontex uses Europe as a springboard to the world

Ontex began 30 years ago as a small, family-owned producer of adult incontinence products for the institutional healthcare market in Europe. Expansion into adjacent categories, such as baby care and feminine hygiene products, and various acquisitions across several geographies, has seen the shape and footprint of the group change dramatically over the years.

Prior to 2015, Ontex was mainly a European-based manufacturer of retailer-branded baby care, feminine care and adult incontinence products benefitting from the aggressive share gains that the hard discounter own-brands won at the expense of branded competitors. Today, Ontex is the largest producer of retailer brands across all three product segments in Europe - more than twice the size of its nearest competitor.

With significant scale and expertise in retailer brands in Europe, the group then expanded internationally into the branded space. Two large acquisitions in the branded baby care and adult incontinence segments - Mexico (2016) and Brazil (2017) - materially shifted the group's geographic exposure with 27% of revenues now generated in these two Latin American markets.

Ontex is currently the #1 player in adult incontinence products in Mexico and Brazil, and the #2 and #3 manufacturer in baby care in these markets respectively.

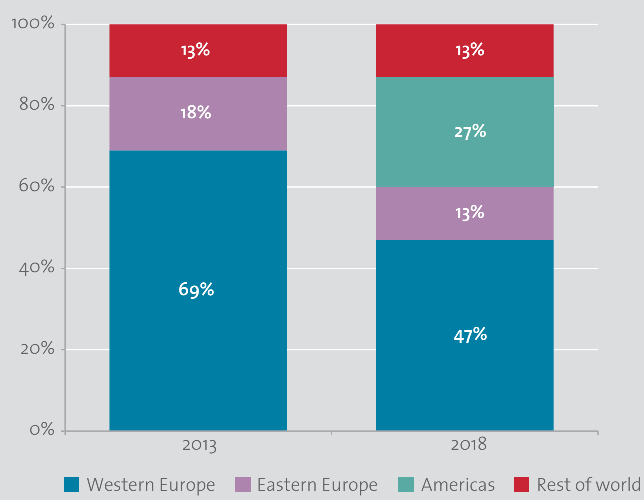
As indicated below (left), Eastern Europe now accounts for 13% of revenue where Ontex is strongly positioned in Poland, Turkey, the Czech Republic and the Balkans. The rest of the world division makes up 13% of revenue where Ontex has strong positions in baby care: Ethiopia (#1 position and 45% market share), Pakistan (#2 position and 12% market share) and Algeria (#3 position and 19% market share).

A perfect margin storm

The last two years have seen significant pressure on Ontex's profitability, with operating profit margins (profitability of the company before interest and taxes) contracting from 10.4% down to 7.7% in 2018 (left chart on following page). The primary reasons for this are:

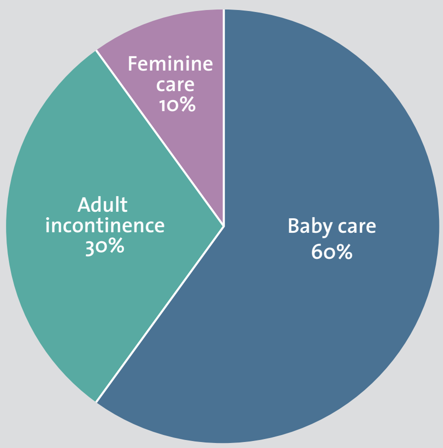
- **Input costs:** After a fairly benign input cost environment for several years, 2017 saw the start of rampant inflation in the majority of Ontex's main inputs (below right), which increased on average by over 20% in US dollars.
- **Adverse foreign exchange rates:** With most input cost denominated in US dollars, the sharp devaluation of some emerging market currencies (especially the Brazilian real

Ontex revenue by region



Source: company presentations

Ontex revenue by product type (2018)



Source: company presentations

and Turkish lira) and the relative strength of the US dollar versus the euro, has resulted in a further margin squeeze. Ontex has struggled to raise prices sufficiently in local currency to offset the currency weakness.

- **Brazilian troubles:** After acquiring Hypermarcas' hygiene division in Brazil in 2017, the economy began to struggle and, combined with competitive pressures, resulted in the baby care market showing negative growth. At the same time, Ontex discovered that profits had been overstated by the previous owner. While a turn-around of the business is underway, we estimate that Brazil has resulted in group margins being 1% lower than they otherwise would have been.

Despite significant group cost savings programmes and price increases to offset these pressures, margins still contracted to 7.7% in 2018 and are likely to do so further to 7.0% in 2019 (below left). We do, however, expect the Brazilian margins to recover over time and for some of the cyclical input cost pressures to reverse. This, combined with the Transform2Grow programme discussed below, should see Ontex margins normalising significantly higher in the years ahead.

Taking Ontex to the next level

The company recently announced a new strategy - Transform2Grow - which will be implemented over the next three years.

It seeks to:

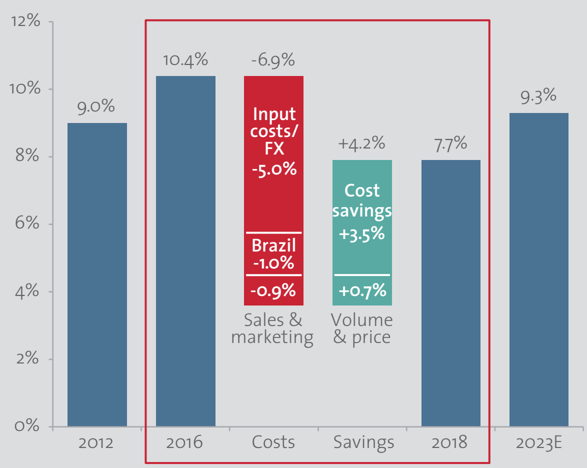
- **Boost operational efficiency** - by optimising the existing manufacturing footprint through factory rationalisation and cost savings. Further improvements to transport, warehousing and procurement will lower costs and reduce working capital.
- **Improve commercial capability** - by focusing capital expenditure and resources on high-growth segments (baby pants, adult pants and light incontinence products), sharpening the focus on innovation and leveraging group-wide skills.

The plan is expected to deliver an incremental 1.25% - 1.75% to operating profit margins by 2021 and underpins the margin recovery we expect to see from the business in the next few years.

Investing in the demographic dividend

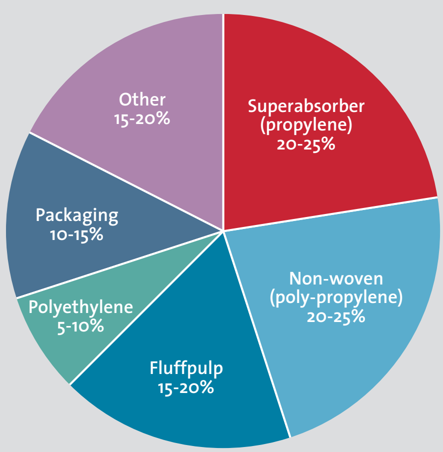
The structurally favourable demographic trends support an increasingly robust demand for baby care and adult incontinence products and Ontex is well positioned to continue to benefit from this growth. While margins are currently low, we see a path to recovery through the self-help measures discussed, resulting in significantly higher earnings and shareholder returns. As such, we own Ontex shares on behalf of our clients. UP

Ontex margin pressures and outlook



Source: company reports, Kagiso Asset Management estimates

Estimated breakdown of input costs (2016)



Source: Deutsche Bank, company data

Kagiso Asset Management (Pty) Limited

Fifth Floor MontClare Place
Cnr Campground and Main Roads
Claremont 7708

PO Box 1016 Cape Town 8000

Tel +27 21 673 6300 Fax +27 86 675 8501

Email info@kagisoam.com

Website www.kagisoam.com

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Footnote: 1 Annualised (ie the average annual return over the given time period); 2 TER (total expense ratio) = % of average NAV of portfolio incurred as charges, levies and fees in the management of the portfolio for the rolling three-year period to 30 June 2019; 3 Transaction costs (TC) are unavoidable costs incurred in administering the financial products offered by Kagiso Collective Investments and impact financial product returns. It should not be considered in isolation as returns may be impacted by many other factors over time including market returns, the type of financial product, the investment decisions of the investment manager and the TER. This is also calculated on the rolling three-year period to 30 June 2019; 4 Source: Morningstar; net of all costs incurred within the fund and measured using NAV prices with income distributions reinvested; 5 Source: Kagiso Asset Management; gross of management fees; 6 Median return of Alexander Forbes SA Manager Watch: BIV Survey; 7 Median return of Alexander Forbes Global Large Manager Watch.