

## **20/20 View on a Niche Franchise**

The business model of a contact lens vendor echoes the unique qualitative and quantitative characteristics of a franchise. Contact lens has become a consumer staple product, a daily necessity that will be replenished by wearers, translating into a stable recurrent sales base for the vendor. The global contact lens market has evolved into an oligopolistic landscape with the top four players accounting for 96% market share; 43% for Johnson & Johnson, 25% for CIBA, 18% for Cooper and 10% for Bausch & Lomb. **Economies of scale** has been reached in the past decades by these 'oligopolists', creating a strong entry barrier for new players. **Manufacturing know-how** is also difficult to duplicate as experienced optical engineers are not easy to find, providing further obstacle to new or small players, and widening the so-called 'moat' that adds difficulty to new comers. This environment has nurtured an unregulated oligopolistic operating environment with so far, limited price war, preserving attractive gross return for the dominant players.

Contact lens has evolved into a daily necessity for many users in the developed parts of the world, much like our shampoo and toothpaste. As such, unlike luxury and discretionary consumer items, demand for contact lenses is resilient during economic downturn. The **recession proof nature** is well evidenced by the +4% revenue growth in 2009, during which the global economy was hit hard by the financial crisis where many cyclical and discretionary consumer products experienced sharp contraction in sales, let alone growth.

According to Wikipedia, as at the end of 2012, world near-sighted population reached 1.7bn, and among them, 133mn people, or 8%, wear contact lenses. Cooper, the world's third largest contact lens brand, estimates that the global contact lens market will grow at a CAGR of 6% from 2011 to 2016.

Growth expectations are even stronger in the emerging economies, including China. According to Wikipedia, around 31% of China population, i.e. 400mn people, is near-sighted, higher than global average of 25%. However, China's contact lens penetration is only 5%, lower than global average of 8% and far below 20%-30% for developed countries. We believe contact lens penetration is highly correlated with GDP per capita. Driven by rising affluence, China's contact lens penetration is likely increase to 6%-7% in five years from 5% in 2012.

In addition to increasing number of contact lens users, another growth driver is the migration to short-term wear (daily/monthly) from long-term wear (semi-annual/annual) for convenience and health purpose; as short-term wear lenses are more gas permeable and better for the eyes. Currently only 10% of contact lens users in China wear daily disposable contact lenses, which is far below global average of 40%. Although the cost per year of daily wear is 5 times that of monthly wear and 10 times that of annual wear, the trend is firmly on a migration towards short-term lens in tandem with growing affluence level. This provides clear margin-expansion opportunity for lens manufacturers which are in the short-term wear categories.

China's contact lens market size amounted to US\$370mn in 2012. Driven by increasing contact lens users and migration to short-term wear, we expect the market to grow >15% CAGR in coming years. Similar to the global market, China's contact lens market is highly concentrated with the top four players accounting for 82% market share (Hydron: 28%, Johnson & Johnson: 27%, Bausch & Lomb: 21%, Weicon: 6%). That said, given the rising affordability and brand awareness, we believe there is still room for further industry consolidation. Well established brands are likely to gain more market share.

Coloured contact lens is designed to change the appearance of the eye. These lenses may also correct refractive error. The ability to change one's eye colour is increasingly popular and common amongst Asians, propelling the colour lens market to grow even faster than the overall contact lens market in Asia. According to GfK, a market research organization, demand for colour lens surged in Korea, Singapore, China and Malaysia, by 18%-37% from July 2011 to June 2012, outpacing the overall contact lens demand growth. In Japan, many of the colour contact lens vendors are cosmetics brand companies. Much like mascara or lipstick, or eye shadow, we believe colour contact lens as an aesthetic product is here to stay.

The fast-growing color lens market gives an advantage to large manufacturers. Generally, top contact lens vendors have highly automated machines to produce large volume of contact lens, but the use of such machines is more restrictive in colour lens manufacturing due to the complexities in colour lens manufacturing. Established manufacturers who have achieved scale, **and** can run a labour intensive manufacturing line, are heavily sought after by contact

lens brand owners. In order to tap into the fast-growing colour lens market and expand their product portfolio, more and more contact lens brands are outsourcing colour contact lens manufacturing. This creates a virtuous circle for colour contact lens manufacturers to gain further scale and bigger share of the manufacturing pie.

Another contact lens type which is increasingly popular is silicone hydrogel. Silicone hydrogel lenses have higher oxygen permeability than traditional HEMA (2-hydroxyethyl methacrylate) material. According to Contact Lens Spectrum, Silicone hydrogel lenses are very popular in the US with 65% penetration rate. However, the reverse is true in Asia. According to GfK, silicone hydrogel lenses made up only 15% of total value of six Asian contact lens markets (China, Malaysia, South Korea, Taiwan, Hong Kong and Singapore) due to silicone hydrogel lenses' higher price points. With rising affluence, we believe more and more Asian consumers will use silicone hydrogel lenses, making these premium lens products one of the key growth drivers for the contact lens industry in the foreseeable future.

We are optimistic about the earnings capabilities of contact lens manufacturers and brand owners, particularly those who can tap into the growing China market in the coming years. The key players in the contact lens continuum are set to generate superior shareholder's return.

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