Client Update
August 2020

FSSA
INVESTMENT MANAGERS

Asian Equity Plus / Asia Pacific All-Cap Update

Quality companies should emerge stronger after a crisis

Broadly, we believe quality companies, led by effective management teams operating dominant franchises, are best placed to weather the challenges in an uncertain world. Since the establishment of this team more than three decades ago, the Asia Pacific region has witnessed numerous crises, but we have seen quality companies emerge from such events even stronger than before. While every downturn is different, this principle remains central to our investment philosophy and underpins our stock selection in the region.

As bottom-up investors, we focus primarily on company fundamentals – but we cannot ignore the changes in consumer behaviour as a result of Covid-19. We believe it is important to continue to challenge our assumptions to avoid falling into complacency. With this in mind, we have attempted to identify portfolio holdings that are likely to emerge with a stronger business post-Covid; and those that could face structural challenges ahead.

In our view, Shiseido and Tencent belong to the former category, while Trip.com and Link REIT probably belong to the latter. At Shiseido, the impact of Covid-19 has been significant. Around 40% of revenue comes from Chinese tourists (and they tend to be the ones that buy the more expensive products), who have not travelled overseas since international borders closed in the first quarter of this year. While no one knows when travel and tourism might resume, Shiseido has used the downturn as an opportunity to address various issues that should help to improve profitability in the long run.

The new CFO, who joined last year from Coca Cola Icecek in Turkey, has a special interest in improving efficiencies and information technology (IT). Sales and marketing expenses are under scrutiny and IT systems are in the process of an upgrade to provide more visibility on Shiseido's different brands and channels. We believe this level of granular data and analytics should lead to an acceleration in brand consolidation/divestment, with a greater focus on the prestige channel where profitability is higher.

There is already a recovery underway at Shiseido. Online sales have accelerated due to Covid-19 and a digital transformation is in progress, with a global IT platform ("One Shiseido") and the launch of different e-commerce channels among the key priorities in the company's medium-term plan to 2023. Meanwhile, China is perhaps a month ahead of the rest of the world in terms of containing the virus, which is encouraging for the company's China sales. With all this combined, we believe there is a case for Shiseido's operating margins to expand – and its business should be much stronger than before.

At Tencent, strong growth from its games segment was widely expected, as people stayed at home. Although this is likely to normalise post-Covid (time spent on games will naturally fall off when people return to work), our impression is that Tencent's overall ecosystem has strengthened and the addressable market has expanded, which bodes well for more sustainable growth levels over the longer term.

WeChat now has more than a billion monthly active users (MAUs), 20 million official accounts, 50 million payment merchants, 150,000 developers and 800 investee companies. In the recent results announcement, the management highlighted the importance of Tencent's role in "keeping users connected, informed and entertained" during Covid-19.

The pandemic has helped to grow new user acquisitions in online games, as well as in strategic areas such as cloud, education and healthcare. Subscriptions to videos and music has also grown (though the payment ratio is still low at 20% and 5% respectively), and Tencent Meeting has been a sweeping success, becoming China's equivalent to Zoom.

In contrast, the impact of Covid-19 on Trip.com, an online travel agency (OTA), could not be more different. International travel has come to a standstill, with travel restrictions and quarantine measures to reduce the spread of the virus. Trip.com's 1H20 revenue declined significantly and operating profit margins have been under pressure amid the challenging environment.

Globally, only a few countries have reopened their borders since Covid-19. The vast majority of the world is still closed to international visitors and is likely to remain so for at least the remainder of the year. Within China and on the domestic front, there are signs of normalisation and a recovery underway; but for Trip.com it is mostly taking place in the short-haul travel segment (within the same city/province) and on lower-priced ticket sales. Overall, we believe the global travel and tourism sector is unlikely to recover to previous levels for quite some time.

Link REIT has performed phenomenally well since listing 15 years ago and has been a major contributor to performance over the years. Up until the outbreak, Link REIT's operations had been extremely resilient, even with the ongoing protests in Hong Kong over the past year.

Recent performance has been less than stellar, as its underlying tenants – restaurants and retailers – have been hugely impacted by coronavirus lockdowns. During the protests, Hongkongers were at least still eating out and shopping for groceries (though luxury retail and large discretionary items were weaker). Now, major shopping areas and restaurants have all largely emptied.

The pandemic has made rent negotiations impossible, as tenants have been reluctant to commit to terms with such uncertainty ahead. In addition, the company has provided HKD80m rent relief to its smaller tenants (1.4% of its annual distribution of HKD5.6bn), which has dented profitability.

With organic growth under pressure, we have been disappointed to learn that Link REIT has been looking at overseas acquisitions to meet its target income growth. It recently spent AUD683m (USD469.5m) to buy an office building in Sydney with a yield of just 3.9%. While there is a positive spread vs. the short-term financing rate, the return on investment is rather poor – especially when compared to China Resources Land, which generates a much healthier 15-20% yield on cost on its shopping malls.

With little visibility on the development of a vaccine, or when the pandemic might end, we believe that both Trip.com and Link REIT are likely to struggle to perform. They are relatively small positions in the Asian Equity Plus strategy; and we do not own them at all in the Asia Pacific All-Cap strategy.

Performance review

Year-to-date, the Asian Equity Plus and Asia Pacific All-Cap strategies have fallen in absolute terms and slightly underperformed their benchmarks. Over longer time periods, both strategies have delivered reasonable performance on an absolute basis. Portfolio turnover remains low, at about 10%-20%, and has been over the past many years.

While our short-term performance is disappointing, given that we expect to preserve capital and perform better in falling markets, Covid-19 has up-ended all the usual conventions. Value stocks that were previously defensive, such as higher-yielding stocks CK Hutchison and Oversea-Chinese Banking Corporation (OCBC), have not helped to protect capital; while technology and internet stocks, such as Tencent and Alibaba, have become the new defensive play due to large-scale lockdowns and people having to stay at home.

Both technology and China were notable in their strong performance over the last six months. China is among the best-performing stock markets globally, as the country faced Covid-19 early on and has managed to keep the number of cases largely under control. Conversely, our high exposure to India (circa 22% before the market falls), hurt performance, with Indian banks in particular weakening due to concerns about the impact of the coronavirus on the economy.

Of the two strategies, Asia Pacific All-Cap has lagged Asian Equity Plus due to its exposure to small caps. While the top 10 positions of both strategies are similar, the tail of the All-Cap strategy includes several smaller companies that hurt performance, such as Take Solutions, BFI Finance, Astra Otoparts, Hemas and Benext Group (formerly named Trust Tech).

Portfolio changes

Despite the turmoil, we remain largely comfortable with the quality of our holdings. Year-to-date and through the market volatility, we have adopted a "buy on dips" strategy. Our view is that franchise values in the long run should have very little to do with whether there is a pandemic today or whether this year's profit has been wiped out. There are of course some exceptions – especially when balance sheets are under stress. But, virtually all of our investee companies have strong balance sheets and we believe they should continue to grow over the longer term.

We therefore added to most of our bank holdings when they corrected sharply. As share prices reached historic lows, our view was that much of the bad news (such as the potential rise in non-performing loans) should be in the price. This has resulted in a largely flat exposure to banks, at around 20% (or 22% if we include AIA Group, an insurance company).

More than half of this exposure is to Indian financials. Pre-Covid, there were signs of exuberance in the sector – the market cap of Indian financials was close to China's, while the valuation for Bajaj Finance was more than 10x book – and in hindsight, we should have trimmed earlier. But, after the recent decline, Indian banks traded at levels not seen since the Asian Financial Crisis. We thought they looked attractively valued – particularly the high-quality private banks that we favour, such as HDFC Bank and ICICI Bank.

Another conscious portfolio decision was to add to our consumer staples exposure, which includes Vinamilk, Dairy Farm, Godrej Consumer Products, Vitasoy and Haw Par. While consumer staples companies are typically defensive in downturns (they are seen as bond proxies, with a hedge on rising inflation), they have not performed well in the current climate. The difference this time is that Covid-19 has disrupted demand with retail store closures and stay-at-home guidelines.

However, we believe these policies should be short-lived and, as interest rates have plummeted (the US Federal Reserve has

forecasted rates to remain close to zero until 2022), we believe there is a case for consumer stocks to be rated more highly on a discounted cash flow (DCF) basis.

Looking beyond the pandemic to 2025, we sought to identify companies that still offered decent growth potential and had become more attractively valued due to the falling market. In particular, a number of portfolio holdings in India and Southeast Asia were trading at trough valuations. This exercise resulted in top-ups in Bank Central Asia (BCA), BDO Unibank, OCBC, ICICI Bank, Concepcion and BFI Finance.

To fund various purchases, we reduced our exposure to healthcare and exporters. Our experience from the SARS period in 2003 suggested that there was a negative correlation between healthcare and the overall market. We reduced CSL, Resmed and Cochlear on this basis. For Cochlear, we were fortunate to have met the company just before it had a precautionary equity placement. On exporters, we reduced Techtronic, TSMC and Samsung Electronics, although they have performed quite defensively to date.

More recently, we trimmed our exposure to China by reducing ENN Energy, Shanghai International Airport and Yum China. Our China weighting had increased quite considerably over the last 6-12 months as, in addition to a buoyant stock market, we had also initiated several new positions, such as China Resources Land and Tencent.

Outlook

The outlook is likely to remain uncertain until such time that either a vaccine or treatment for Covid-19 is found. However, Asian corporate balance sheets are strong; and most of our investee companies are in a net cash position, which should help to cushion shorter-term cash flows. As quality growth stocks became cheaper, we consolidated our strategies into higher-conviction names and bought companies on our watch-list that were more reasonably priced.

The coordinated central banks' response to the pandemic has been a continuation of aggressive monetary policies. At a time when there is little growth globally, this has led to increased demand for long-dated "quality" growth. Markets have rebounded quickly and in some regards, valuations have become irrelevant. The recent craze for technology and biotech initial public offerings (IPOs) could be a warning sign – investors are once again behaving irrationally, putting capital into companies with no revenue or even with huge losses.

But, predicting market movements has never been our strength. As always, we continue to focus on our bottom-up investment approach, seeking quality companies to invest in for the long term. The companies in our strategies are led by high quality stewards, and are typically market leaders with significant competitive advantages. We believe there is plenty of scope for these businesses to grow over the next 3-5 years.

Source: Company data retrieved from company annual reports or other such investor reports. Historical valuations and ratios sourced from Bloomberg. As at 31 July 2020

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