FSSA
INVESTMENT MANAGERS

Asian Growth Update

"Freedom is always the freedom to think otherwise."
Rosa Luxemburg

Overview

In our last client update, written through the depths of Covid-despair, we observed that real life and the world of markets are seldom so intimately entwined. With markets swinging violently to the downside on a riptide of fear, it was clear even then that activity was being driven by short-term anxiety rather than a real evaluation of Asia's longer-term value-accretion prospects.

As we all know, markets are highly effective discounting machines. When all are fearful and the headlines are unrelentingly negative, there is a reasonable chance that much of the downside has already been reflected. It seems easy with the benefit of hindsight, but so went 2020. Indeed, the obverse now looks the greater risk given current levels of market enthusiasm.

We have previously argued that the world has moved ten years into the future in just the last ten months. In many ways that seems to be increasingly true. The triumph of the technology sector, as well as the "new normal", are obvious truisms. In hindsight, though, they are just the latest iterations of this modern age of accelerated disruption. After all, this region has latterly very much been at the forefront of such change.

For those that persist in reading the runes, as well as according to most weighty and expert analysis, things undoubtedly look very challenging. We have all seen the dystopian zombie movies. Rolling lockdowns, monetary profligacy, rising deficits, unprecedented debt burdens, social dislocation and a supposed new cold war all weigh heavily on the outlook. Then there are higher valuations in an environment of persistently lower (zero) interest rates.

We have no macro view, other than to suspect that it is probably quite sensible to lean against unbridled optimism when things are generally so uncertain. Global valuations are, without question, quite bubbly, but at the same time, we all know that these things can roll on. In particular, the current output gap means that inflation may well remain subdued, though current economic and monetary conditions are without modern precedent.

With the rollout of vaccines, it seems reasonable to assume that the world will become less abnormal in time (six months?). Along the same line, in time-honoured fashion, nobody would be particularly surprised either if markets sold off on the actual arrival of better times compared with the mere future expectation of improvement. There is, as usual, plenty to worry about.

In the meantime, we continue to do more of the same; that is, to focus intently on the quality of the management teams and franchises of the companies that we own, and to care about balance sheets. Above all, just as we did not get mired in pessimism in March 2020, so today we need to ensure that we do not get too carried away and that we continue to pay sensible valuations.

Portfolio activity

While we have always characterised our portfolios as herbaceous, meaning that something should always be blooming irrespective of the market season, portfolio activity in the first half of 2020 was higher than usual. As Covid roiled markets and companies almost irrespectively we were able to effectively rotate some of our portfolio holdings.

From a top-down view, we moved funds from companies that proved more resilient and defensive into the beaten and economically sensitive. We did this across the portfolio, adding and trimming broadly across existing holdings. In hindsight, this has proven helpful to returns in the second half, and subsequent portfolio activity has been quite subdued.

In particular, we added a number of internet companies such as JD.com, Tencent and Seek, alongside a number of more economically cyclical companies like Fanuc in Japan and Voltas in India. We have followed all of these companies for some time, and the indiscriminate sell-off provided an attractive entry point.

We detailed the investment case for these internet companies in our last June write-up. Their subsequent

strong earnings growth has compounded returns, while their price-to-earnings ratios (PER) have expanded in response to their market share gains. It seems likely that these gains (as customers have been forcibly transitioned from physical to virtual worlds) will prove to be sustainable. Such behaviour, as we have all experienced, has become normalised.

For our other existing portfolio holdings, the Covid-panic saw us sell the likes of a resilient utility like Hong Kong & China Gas or the Taiwanese Uni-President consumer group, while adding to the Indian banks in general. We took the opportunity to add a couple of battered travel-related companies as well, namely Shiseido and Shanghai International Airport (SIA).

New positions

In some ways, the travel-related companies are the outliers, because their businesses have been smashed and they remain beleaguered. Buying them inevitably means taking a view on the degree of macro travel-recovery; but on the other hand, both companies are well capitalised and conservatively managed, and the rebound will largely be determined in China and by Chinese tourists.

We have some confidence about that. A sharp rebound, as well as continuing secular growth in China leisure travel, seems like a reasonable assumption. In that respect, both Shiseido and SIA are well positioned. At the same time that we added Shiseido, we sold out of AmorePacific Group.

AmorePacific was a relatively small position, with Shiseido clearly a much better and more established global brand. We believe Shiseido will recover faster, while we were very frustrated at our inability to engage effectively with AmorePacific. In meetings, and more formally by letter, we raised a number of concerns around their capital discipline, as well as the need for a greater focus on e-commerce. Perhaps, rather unsurprisingly, they were disinterested; though this is not untypical in Korea. Recently, there has been talk that reform may now be starting.

Shiseido

Shiseido is similarly in need of an overhaul, but the process is already underway. Shiseido is Japan's leading cosmetics company and while they have a global presence, they have mostly struggled outside Japan, other than in China. Indeed, despite their high gross margin (of circa 80%), with relatively high fixed costs Covid has hit the company hard. Though the recovery has already started, the business is expected to be cumulatively loss-making in 2020.

The China business nonetheless remains very strong, accounting for an even higher 30% of total group sales in fiscal year (FY)20. Chinese tourists normally account for a sizeable portion of Shiseido's Japan revenue and its travel sales, with some of that business transferred to onshore China duty-free. On a normalised basis and in aggregate, China probably already accounts for more than 40% of group profits.

Unfortunately, their US and European businesses are both loss-making and the overall group's operating margin has been, on a normalised basis, only 10%. By comparison, the likes of L'Oréal and Estee Lauder have high-teens margins and even LG Household & Health Care (LG H&H) in Korea is 15%. To be fair, Shiseido is equally profitable in the Japan market, with the China margin at low-teens.

The opportunity lies in their renewed and far more pronounced emphasis on improving the operating margin, with the appointment of a new ex-Coca Cola CFO joining the CEO who is from Coke too. The new CFO is specifically focused on improving efficiency and their IT systems, alongside a review of their existing businesses from a return on investment (ROI) point-of-view.

Shiseido looks expensive on forward multiples, with a historic FY19 PER of 37x. However, the reinvigoration of the management team, as well as a specific focus on margin and a likely recovery in the China business, underpin our confidence. Though the shares have rebounded from their March lows, we would expect a more normal environment to provide something of a fillip.

Shanghai International Airport (SIA)

We have owned Shanghai International Airport (SIA) before, selling it on an earlier substantial re-rating, as it became a favourite of foreign investors. Just as for Shiseido, Covid has resulted in operating losses for FY20 and the overall business, including associates, is barely likely to break even despite some offset from domestic travel.

SIA is a Chinese State-Owned-Enterprise (SOE), which in our experience usually implies inefficiency, conflicts of interest and policy-driven management decisions, but at the same time confers the backing of the government in times of hardship. In any case, SIA has a strong balance sheet with net cash, irrespective of the mid-2019 sizeable expansion in capacity.

The new satellite terminal has doubled retail space. Surprisingly, the project was finished on time, as well as under budget, with capacity at their Pudong airport increased to 80m passengers a year. On the other hand, given the state-owned nature of the asset, periodically there is speculation around the injection of Shanghai's old (Hongqiao) airport, as well as the runways, which are held separately.

SIA is positively exposed to a resumption of international travel, with the segment accounting for 50% of revenues.

With new capacity, as well as revised revenue-sharing terms with duty-free operators, we expect earnings to rebound beyond FY19's historic level. The market PER, looking out to FY22, is 25x which remains at around the prior average level.

Voltas

In India, we added Voltas, which is India's largest air-conditioning company. We remain positive on the prospects for long-term domestic economic growth in India. The Tata Group owns Voltas, with similarly owned Tata Consultancy Services (TCS) remaining one of the largest holdings in the strategy. While the forward valuation looks quite demanding, at circa 35x PER to end-of-year 2022, the potential for growth and company transformation seems quite high.

As India grows richer, demand for air-conditioning is likely to enjoy strong tailwinds, with China (as usual) highlighting the potential. Furthermore, in the shorter term, the geopolitical fall-out between India and China (in the Himalayas) has boosted sales with restrictions on China imports. The company believes that growth should be able to compound at 12-15% for the next few years.

Air-conditioner penetration in India is just one-tenth that of China, at about 6% vs. 65%. Competition has increased, but the threat of onshore Chinese production has clearly been deferred. The air-conditioning business is dealer, service and reputation driven, which also provides some barriers to entry. Additionally, the group is moving into white goods (washing machines and refrigerators), with the late-2018 formation of a joint venture with Turkey's Arcelik.

This seems like a sensible diversification given their strong brand reputation, as well as existing distribution channels. In addition, the company is showing better capital management, with a recent decision to split out their projects division, (mechanical engineering/installation business in the Middle East). Returns and the track record for this business, as for their competitors, have been poor. Otherwise, the business is net cash and we should see returns, as well as growth, rebounding in the next few years.

Adding & trimming

While we added substantially to the Indian banks in general, with the group collectively trading at 15-year lows, we sold out of Singapore's Oversea-Chinese Banking Corporation (OCBC). OCBC is clearly a well-run bank and even now it is trading at just above book value for 10-12% return on equity (ROE), but we believe the Indian banks have a much better growth trajectory. Though the bulk of the Indian population is now banked, the publicly-owned banks remain constrained capital-wise, while competition has clearly abated.

A number of the more aggressive Indian private banks (Yes Bank in particular) have pulled back significantly as some of them were somewhat over-extended into this downturn. The non-bank finance companies, (NBFCs), have become less pushy too and this should underpin growth, as well as margins, for the remaining private banks. HDFC Bank, Housing Development Corporation, Kotak Mahindra Bank and Axis Bank remain among our largest holdings.

In China, though we added Zhejiang Supor less than a year ago, we exited the position on growing fears of rising e-commerce competition. Just as China has jumped to the future in e-commerce, so the power and resilience of brands has come under growing pressure, as competitors are able to go straight to customers. With our increase in e-commerce exposure, as well as feedback in meetings with these businesses, we became less confident about the outlook for manufacturers. We were able to sell at a modest profit.

Taiwan Semiconductor (TSMC) remains our biggest position, despite a modest trim, with the company continuing to execute flawlessly. Nobody does it better, it seems, with Samsung Electronics (SEC) the closest in terms of technology but always a competitor to any outside customer. We still consider TSMC to be one of the world's finest businesses and, like TCS, it gives us broad exposure to the increasing tech-intensification of our daily lives. Though it should rightly be considered cyclical, the forward PER (going into a smartphone upcycle) is still 25x FY21.

The economic rebound in China has also propelled the performance of the Japan-listed capital goods manufacturer, Fanuc. We added significantly on the Covid-dip, while trimming defensive Japanese consumer company Unicharm. Overall, our consumer companies, such as Uni-President and Unicharm, broadly and unsurprisingly, have held up well.

Fanuc

Essentially, Fanuc provides exposure to the automotive and technology manufacturing sectors, in particular smartphones and computers. Sales growth and the recovery have been strong, with the company being the largest industrial robot supplier to China. The tailwinds should remain in place, with the secular growth of automation as China gets older and richer. Fanuc already derives 30% of sales directly in China.

The company was already in a downturn before Covid, after a moderation in China's capital investment cycle. A resumption of growth, plus normalisation after Covid, means that the group should benefit from additional cyclical growth tailwinds in the next few years. Anticipating this, the shares have performed well and now trade on a forward 2023 PER of 32x.

In the same vein, we have seen a strong rebound at Mediatek, with the group now again approaching previous PER highs. Like Fanuc, we believe earnings still have potential for positive revision, with the group just entering the growth phase of the new 5G-chip cycle. 5G-chip demand should double (200m to 400m units) in the current year, while the competition intensity should remain manageable (SEC, Qualcomm and Mediatek are the entire market).

Mediatek's absolute forward PER is not unreasonable, but we need to remember that their mission as a fast-follower is to seek out big pools of profit and then, through their participation, make them disappear. The group has a fortress balance sheet, but it is a necessary bulwark against tougher times. Mediatek remains a top holding in the fund.

Smartphones & 5G

We have had less good fortune with Taiwanese smartphone lenses maker Largan, and it has been one of the more substantial detractors from overall performance. We believe the issue has been the prolonged transition from 4G to 5G phones. Meanwhile, they have a net cash balance sheet and the prospective PER is now a lowly mid-teens. We have added, though have yet to see any benefit.

We also own small positions in acoustics and lenses manufacturer AAC Technologies, and equipment manufacturer ASM Pacific. We trimmed both positions early in the year and together they now account for just 1% of the portfolio. We expect them to benefit from a pick-up in the 5G cycle.

At the margin, we trimmed Cognizant on a sharp rebound in performance, with the Asian Growth strategy otherwise having decent exposure to IT Services via TCS and Tech Mahindra. We added slightly to China Mengniu Dairy and Midea as well. Mengniu continues to deliver in respect of higher margins, while Midea's valuation is still a very reasonable 21x PER FY22.

Update on valuations

Look-through valuations have generally escalated, with an assumption that corporate earnings will normalise over the next two years. Prior to Covid in February 2020, the Asian Growth strategy was valued at circa 23x PER and was trading at about a 20% premium to the 10-year median valuation.

At that time, we felt that the valuation was justified by the portfolio median ROE of 17%. By contrast, the Asia Pacific market index was comparatively valued at 13x PER with an ROE of just 10%. We have always believed that you get what you pay for.

With a total expected annual portfolio return of 8-10% (although a reminder that is not guaranteed), assuming earnings growth of 6-7% and a coupon of 3%, by comparison to other asset classes globally we felt that Asia looked comparatively attractive. Irrespectively, as we subsequently found out and have come to expect periodically from emerging markets, at the March market-nadir the portfolio PER valuation slumped to just 17x.

Following the subsequent rebound, on our best estimates we believe the portfolio PER valuation today is more like 28x. That looks expensive, in an absolute sense and certainly by comparison to history, but earnings have been squashed and everything generally has been bid up. As a comparison, looking out 12 months, the market index PER has been similarly boosted to 17x while the ROE is still 10%. The differential in favour of our portfolio remains very much the same and may even have expanded.

While the market's sustainable growth rate is likely to be somewhat lower, the portfolio ROE has improved with our changes, edging up to circa 18%. The top ten holdings' ROE is slightly higher at 21%, which account for about 43% of the portfolio.

In a world where governments everywhere remain committed to doing "whatever it takes" in terms of maintaining zero interest rates and injecting liquidity, the higher portfolio valuation does not seem unreasonable. Indeed, in contrast to the alternatives, you could even regard it as comparatively attractive.

The higher ROE underscores the implicit quality of the portfolio, which in our experience has always proven to be by far the most important factor in respect of protecting capital when markets trade at elevated levels. We think this was proven yet again in the Covid sell-off, with the portfolio ultimately rebounding strongly. Meanwhile, we faced no emergency calls for cash or any heart-stopping moments in terms of the underlying resilience of our holdings.

Company updates

JD.com has continued to execute very well and while the growth rate has begun to moderate on a high base, the group believes that there is still plenty of potential. Indeed, when we added JD.com and last wrote about the company, we were attracted by their asset-heavy Amazon-like direct sales approach, in contrast to Alibaba's third-party dependent platform model.

As we argued earlier, China is in many ways ahead of the rest of the world and while their e-commerce penetration is now amongst the highest, the overall competitive environment is benign. Off-line retail is much weaker, with

e-commerce players being the only pan-national retail as opposed to the dying physical retailers of the West. China has jumped straight to the future.

To that end, the e-commerce players have started to add physical retail to their business (omni-channel), particularly in grocery, whereas things have been exactly the other way around in the more developed world. This is one reason why innovation has been greater in China. On the other hand, perhaps the regulatory risks (as we are seeing with Alibaba) are greater as well. We still do not own Alibaba.

JD.com has performed strongly, with the shares almost doubling over the last 12 months. When we first added the company, the forward PER multiple was circa 20x, but today it is more like 30x looking out to FY22. On the other hand, the business is professionalising, the founder has stepped back and the group has successfully taken advantage of capital markets to the benefit of shareholders. Earlier in 2020, they bought back shares (USD2bn), whereas latterly they have been spinning off subsidiaries (JD Health) at high valuations.

The group is targeting a mid-to-high single-digit profit margin, with the net margin moving from 0.7% to 2.2% in the last couple of years. This seems quite reasonable. The group is still net cash, while only 10% of profits are exposed to the Variable Interest Entity (VIE) structure. By contrast, Tencent's VIE exposure is 40-50%, though our holding in the group has remained small at just 1-2%.

Seek

As we noted last time too, we established a position in the Australia-listed online recruitment company, Seek. Seek has a leading market share in Australia, as well as in Hong Kong, Singapore and Malaysia. Besides that, they control Zhaopin, (61% stake), which is one of the leading recruitment sites in China. Asia cumulatively accounts for circa 40% of earnings, with China specifically at 10-15% of group profits.

There has lately been some controversy around Zhaopin, with a short-seller report highlighting the industry-wide issue of fraudulent job postings. This looks to us a bit like the e-commerce companies' inflation of gross merchandise value (GMV) figures. We had a good look at the allegations and engaged with the company. We found their response very reassuring, with no attempt to obfuscate. In our dealings with the management, we have found the alignment, as well as their long-term thinking, to be generally very good.

The shares have performed well, though again earnings have been eviscerated by the contraction in economic activity. That said, the historic FY19 PER is now 51x, but the underlying net profit margin was then 16% compared to a stated 12% after write-offs and losses. Moreover, the group has a long-term aspirational target of more than doubling sales in the next five years. With an economic rebound and a normalisation in margins, growth should be strong, but the FY24 PER multiple is still a high 32x.

Mistakes & Dairy Farm

Dairy Farm has continued to be a laggard and remains one of the top detractors from performance. We have met with the company, as well as their largest and non-listed associate, several times in the last 12 months. The story is unchanged. The part of the business that was most problematic (Southeast Asian grocery) has turned around, in part helped by Covid, but there has been an underlying business transformation as well.

We believe this to be encouraging, as the other main businesses (7-11, Mannings retail drugstores and Maxim's restaurants) are still struggling with rolling Covid lockdowns. While 7-11 is just about operating at break even, Mannings profits have collapsed and Maxim's losses are material. The group is backed by Jardine Matheson, so there is no balance sheet risk, and we expect the company to be a prime beneficiary of normalisation.

We think the valuation is attractive on a look-through basis, with a PER of about 13x, but the shares are relatively illiquid. We do not expect them to bounce before a material earnings improvement is more visible. The way things are going, that might not be until the second half of 2021 and so the company is likely to remain a drag. That said, we are confident about their strategy, the management and their business franchises, as well as their eventual recovery.

Outlook & conclusion

"The most contrarian thing of all is not to oppose the crowd, but to think for yourself." **Peter Thiel**

The biggest risk, looking forward, must be complacency. Markets have moved from extreme fear to full-on elation in less than nine months. This is disconcerting and there are plenty of signs of hubris, excess and pro-cyclical thinking, from SPACs[1] to the absolute conviction that central banks have got our backs. Client tolerance for relative underperformance, despite strong absolute gains, has also declined. These are all, in our experience, general signs that we should be rather careful.

Despite these issues and elevated share prices, most investors are unable to step away, while the arguments

[1] Special Purpose Acquisition Companies or "blank cheque companies" are shell companies with no commercial operations. Their purpose is to raise capital through IPOs purely to acquire other existing companies.

for Asia and the relative valuation attractions are already well known. In the meantime, all we can do is lean against such enthusiasm, make sure that we do not get too carried away, and ensure that the portfolio is at least well diversified (herbaceous) ahead of any changes in the market climate.

We still care about balance sheets, which was helpful in Q1 2020 when markets fell away. While those share-price moves were absolutely gut-wrenching, we never had to worry about the solvency of the underlying businesses, and so we were able to add broadly to some of the biggest fallers. This is never easy to do, but probably impossible if you begin to worry that the company may not survive.

We are still focused on absolute returns and happy that the overall portfolio has not lagged the market by too much, despite being very different to the major Asia index. We think our divergence from the index matters increasingly, because if the tide does go out, the impact of passive strategies could bring quite a crunch to index holdings. This is another reason why we bother to invest bottom-up and seek the best company opportunities, irrespectively.

As we concluded last time, we travel hopefully, but nonetheless keep carefully feeling for the stones as we progress. We wish you the best of health and, dare we say it, lots of luck in the year ahead.

With thanks and as usual, we welcome your comments and feedback.

Source: Company data retrieved from company annual reports or other such investor reports. As at 31 December 2020.

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