FSSA Investment Managers

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Client Update
Focused on the fundamentals

March 2025

Our Asian equity strategies delivered reasonable returns in 2024, and our long-term track record remains solid. Despite the prevailing uncertainty and an uneven recovery across the region, our portfolio holdings were generally resilient. Even with a slowdown in China, concerns about geopolitics, and election upsets around the world, there were pockets of growth to be found.

While we do not try to predict macro events or political outcomes, we can comfortably say we expect the year ahead – like last year – to continue to be underpinned by uncertainty. US policy under President Trump and his "America First" mindset is likely to be highly chaotic (as we have already seen) and have far-reaching consequences – and not just on China-US relations. But as markets whipsaw in response to the headlines, we see opportunity amid the turbulence.

As we have discussed in the past, one of our core investment beliefs is that quality companies should outperform in the long run. In our experience, the most successful businesses are the ones with solid corporate governance, an attractive franchise with secular growth opportunities and strong competitive advantages, and sound financials. This conviction underpins our philosophy and has remained steadfast in the decades we have been investors.

And so, rather than worry about trade wars and tariffs, we have redoubled our efforts on bottom-up fundamental company analysis. While there are plenty of things to worry about, we believe companies with effective management teams and proven track records will find ways to grow sustainably through the cycles. The best companies will rise to the challenge (and many have already diversified their supply chains and customer base).

Ultimately, our priority is to grow our clients' capital over the long term, while taking a balanced view of the risks. As share prices fall, we can add to quality companies at lower valuations, which in turn provides a greater "margin of safety" and bodes well for our longer-term returns.

Meeting companies is central to our process

We spend the majority of our time meeting companies and have taken advantage of the proximity and travel links across Asia to forge deeper relationships with management teams over time. Last year, as our analysts travelled around the region, we visited India and Taiwan three times apiece and spent time in China every month or two. We highlight our key observations from these trips in the sections below.

These face-to-face meetings and in-country research trips are an invaluable part of our investment process. Not only do they entail candid discussions about the company's business model, growth strategy and the direction of travel, but we also gain a deeper understanding of the longer-term challenges and opportunities the business might face in the future. These meetings inform our views on a company's quality and whether there is good alignment with the management as minority shareholders.

From our research, we select just 40-45 companies for our Asian equity portfolios, while our watch list typically comprises 160-180 companies. That might not seem like much, but very few companies have the right ingredients to succeed in the long run, in our view. We do not believe that every business has a price; and being disciplined in our process means we avoid companies where there are red flags on governance, concerns about sustainability, or if stakeholders have been treated badly – irrespective of the growth opportunity or valuations.

Finally, as we are bottom-up and benchmark-agnostic investors, we do not have to own any companies unless they meet our quality criteria. Our investment approach allows us to go wherever the best opportunities are, meaning our Asian equity portfolios represent our best ideas across the region.

Pockets of growth in China

As noted in our China update last September, there has been a broad market shift in recent years, due to China's slowing economy and the property market downturn. Cheap cyclicals and state-owned companies performed well in this environment, while the quality growth companies in our portfolios (even those with attractive dividend yields) struggled.

During our trips to China, we were slow to appreciate the extent of the weakness and its impact on the consumer companies in our portfolios. Belatedly, we recognise that our assumptions about spending patterns – that people will upgrade to better-quality and more premium products as their incomes rise – isn't likely to happen in a deflationary environment. We consolidated our exposure to consumer companies and sold out of China Resources Land (property developer with a portfolio of shopping malls).

Looking ahead, near-term weakness aside we believe there are reasons to be optimistic on China. We expect there to be less focus on regulations this year, as the government introduces policies to stimulate the economy and promote growth. And with the China 10-year government bond yield at 1.6%,[1] the earnings yield gap is widening. As a result, the companies in our portfolio with a 5%+ free cash flow yield have become more attractive.

If we look five or 10 years into the future, we still believe that companies with strong brands will outperform others as people choose to upgrade certain goods and services – albeit on a more selective basis than before. This should benefit the likes of Anta Sports and China Resources Beer. We also note that Chinese consumers have been focused on gaining experiences, and both domestic and international travel has risen. And to offset weakness in the domestic market, Chinese companies have been expanding overseas – both in terms of relocating production facilities and finding overseas customers. These structural growth trends remain firmly in place, and the derating over the past few years means that the risk/reward looks attractive. We have found ample opportunities to add on weakness to our portfolio companies in China, such as Netease, Shenzhou International and Shenzhen Mindray.

Even amid the decline there were pockets of growth. Both Tencent and Midea – top holdings across our Asian equity portfolios – generated strong performance last year. Tencent, which we have owned for many years, executed well on multiple fronts. New game approvals have picked up, while its high-margin businesses such as video accounts and mini-shop e-commerce services have been growing strongly. There appears to be no sign of complacency, and the company has continued to develop new functions within WeChat to improve monetisation rates and enhance the quality of the franchise.[2]

Tencent reported healthy net profits and sustained improvements in its gross margin and has proven its ability to deliver growth despite the weak economy. The management is confident that profitability will improve further as the business mix leans towards higher-margin services. In addition, Tencent bought back more than HKD 100bn of shares in 2024 (double the size of its share repurchases in 2023), which combined with a healthy dividend payout should provide a boost to shareholder returns. We added to our position as we think it is still reasonably valued on mid-teens forward price-to-earnings.[3]

Midea, which had suffered from rising raw material prices, weak demand and inventory destocking in previous years, executed well, nonetheless. Domestically it is ranked no. 1 or no. 2 in every major home appliance category and has benefitted from a shorter upgrade cycle and growing replacement demand. Despite uncertainties around China's property market and the broader economic outlook, Midea is guiding for high single-digit growth in home appliances in the domestic market. This seems reasonable, and the government's trade-in subsidies should provide some support too.

Despite its large scale, Midea's efficient operations are profitable and highly cash-flow generative. Last year Midea reported resilient earnings results, with export demand offsetting the weakness at home. While Trump's presidential win has raised concerns about its overseas business (due to the threat of higher tariffs), North America makes up just 7% of its total revenue from home appliances (2023 figures). More than 20% comes from Asia (ex-China), Europe, the Middle East and Africa, and others.

Moreover, its global supply chain is well diversified with around 20% of its appliance production capacity located outside of China, and a target to increase this to 30%. It already has 17 overseas research and development (R&D) centres, 22 overseas manufacturing plants and more than 35,000 of its employees are outside China. We think

[1] Source: Factset, as at 17th February 2025.
[2] Source: All company data herein retrieved from company annual reports or other such investor reports. As at 17th February 2025 or otherwise noted.
[3] Source: Financial metrics and valuations are from FactSet and Bloomberg. As at 17th February 2025 or otherwise noted.

Midea should be able to manage higher tariffs, if they materialise, by passing through the costs to consumers or by moving its production to a friendlier base country.

In summary, despite the slowdown in the economy, we have found that there are still attractive investment opportunities in China, especially if one takes a longer-term view. We also believe well-managed businesses will eventually become stronger and more resilient after challenging periods, as they adapt and strengthen their franchises. This often leads to market share gains and usually translates into solid returns in the long run, once their strong fundamentals are fully appreciated by the market.

Positive reforms; but India's banks face headwinds

Last year we visited India three times, including just after the general election in June. While the results were considered disappointing by some (Prime Minister Narendra Modi secured a third term, but his party failed to win an outright majority), one thing we don't worry about in India is the politics. Over the years, India has had many different governments and political parties, some of which were ousted within weeks, while others lasted for more than 10 years. Despite all the political complexities, India has continued to evolve and move forward.

Initiatives like the Goods and Services Tax (GST), which simplified the collection of state and local taxes, Unified Payments Interface (UPI), which brings together multiple bank accounts in a single mobile application, and Aadhaar, India's digital identification number for individuals, have clearly helped to improve efficiency. While the decade before Covid saw a period of slow growth in India, these reforms are starting to reap rewards and should underpin India's structural growth.

In contrast to the China market, India has performed well in recent years; but some pockets of the market are now expensively valued. We reduced consumer companies like Colgate-Palmolive (India) and Godrej Consumer Products, as both were trading on 50-60x price-to-earnings. We believe there is a long runway of growth ahead for both companies, given the low per capita consumption rates and low selling prices in India. But although their longer-term investment cases are still intact, we have been leaning against expensive valuations to avoid getting carried away by the froth.

However, on a bottom-up basis, India remains one of the most attractive markets in Asia to find investment ideas. In our Asian equity portfolios, two of the top 10 positions are the leading private-sector banks in India, HDFC Bank and ICICI Bank. With their superior deposit franchises and given the dominance of inefficient state-owned banks in the Indian banking industry, we believe they can continue to gain market share while maintaining attractive returns on assets.

ICICI Bank has been among the top contributors to performance over the past few years and continues to report strong results across its business. We have owned the bank for more than five years, after witnessing positive changes in its management and culture. While the bank's aggressive growth-at-any-cost culture had kept us away in the past, Sandeep Bakhshi's appointment as CEO led to a more long-term oriented, conservative and risk-aware mindset. The results are evident in the bank's performance, and it now boasts industry-leading asset quality and growth metrics.

In our meeting with the CEO of ICICI Bank, he touched upon how the reforms have led to improvements in its business processes. For example, in the past, loans to small and medium-sized enterprises were essentially loans against property because there was no information about the borrower's cash flows. Now, its credit officers can pull up GST filings, credit bureau scores, and information from Aadhaar and real estate documents in its review process, which means they can be more selective in their loan offers.

With its cost of funds advantage, ICICI Bank's loan growth is well balanced – it is not being forced to grow the risky parts of its loan book to manage net interest margins (as those borrowing on the interbank market might do). Mr Bakhshi is thinking about the potential risks and what the bank needs to do to stay ahead of them. Throughout, ICICI Bank's performance has been consistent despite all the noise. It remains a significant holding, though we have taken steps to control the position size. We believe valuations are fair for a market leader.

HDFC Bank is another core holding in our Asian equity portfolios. It is the largest private-sector bank in India, with over 10% market share in loans and deposits, and the management has a track record of managing risks prudently over three decades. As a result, the bank has maintained industry-leading return on assets across economic cycles.

We have owned the bank for many years and have long admired the management team, and the way it has pursued growth in a countercyclical and conservative manner. Over the past year, performance has lagged peers for a number of reasons, but we think the problems are temporary.

HDFC Bank's merger with parent company Housing Development Finance Corp (mortgage lender) in recent years should lead to a stronger financial conglomerate and be accretive to returns over time. However, the integration between two large and complex financial institutions has taken longer than expected. The group also gave out aggressive growth guidance, which inevitably led to market disappointments when those targets weren't met.

Since then and after meeting with the management, expectations have been re-set and predictability of earnings is coming back. HDFC Bank has given up market share in unsecured lending over the last three years, which has contributed to its slower earnings and derating. But the velocity of growth in this segment of the market was worrying — the bank often saw the same customers asking for additional loans after 3-6 months, which clearly rang alarm bells.

While it would have been easier for HDFC Bank to grow unsecured lending (with higher net interest margins) aggressively at a time when deposits were weak, true to form it has chosen to act countercyclically, which we believe will serve them well in the coming periods. HDFC Bank is now starting to see better quality customers come back, while other banks are dealing with higher credit costs amid tighter liquidity conditions in the system. Smaller banks and non-bank finance companies have grown much faster in unsecured loans and are therefore likely to be more vulnerable as the tide turns.

Given HDFC Bank's scale, we expect growth to slow from the previous 20%+, but we still believe it is one of the best quality companies to own in Asia. It remains among the top holdings in our Asian equity portfolios.

However, we are cognisant of the risks, as the banking industry in India appears to be facing several headwinds. During our meetings in India, there was mention of the regulator putting pressure on what banks can charge their customers, while increased regulatory intervention on compliance and technology means higher costs. Net interest margins are likely to moderate from the current high levels, while credit costs could rise from extremely low levels. We also discussed the headwinds for banks' share of gross domestic product (GDP) to sustain at current levels. All of this suggests that the runway for growth which the industry enjoyed in the past may be tougher to achieve going forward.

But if the outlook is to become more challenging over the next five years, there are advantages to holding the biggest and the strongest banks in the country. All the above considerations could lead to further consolidation in the banking sector, as smaller players find it harder to bear the higher costs and at the same time lose income streams. And we still expect new profit pools to emerge over time, even if the growth opportunity may not be as predictable as before. With this in mind, we are comfortable owning both ICICI Bank and HDFC Bank as long-term core holdings.

Mahindra & Mahindra (M&M), the Indian conglomerate, also added to performance amid a turnaround in the group's performance. Following a successful engagement with the group chairman, the appointment of CEO Anish Shah in 2021 perhaps marked the turning point for the group. After he took over the reins, most of the executive board was replaced, and international talent was hired to fill the gaps. He set out clear return-on-capital requirements across the group's businesses and took swift decisions on non-core or poor-quality ones, leading to a dramatic improvement in the group's financial performance.

After exiting 15 businesses over the past three years, M&M is shifting into growth mode again. The group has increased its focus on its core businesses — automotive, farm, financial services and IT services — which have long track records of profitable operations and the opportunity to scale up significantly in the coming years.

The management are now clear about where they have the right to win — categories with a good growth runway, and where M&M has scale and can do very well. But the nature of these businesses and the historical issues mean that results won't happen in a straight line. On the other hand, having met the management repeatedly in recent years, we believe the direction of travel is positive.

What's behind Taiwan's AI-mania?

Our team members visited Taiwan three times in 2024. From those company meetings, it is not hard to see why there is so much excitement around Artificial Intelligence (AI). When we met with Taiwan Semiconductor Manufacturing (TSMC), for example, the management set forward a vision for the future: "ubiquitous computing", where all kinds of devices are connected and continuously collect, transmit and process data. In this world, older technology nodes still have their place, while newer devices will rely on cutting-edge technology to continually learn and iterate. This was a popular idea; and many of the people we spoke to expect to see some kind of decentralised AI model (where data and processes are distributed across a network of entities) by 2026/27.

TSMC, a core holding in our Asian equity portfolios, has been a major beneficiary of AI advancements. Revenue and profits are expected to continue to grow due to the "extremely robust" demand from AI, while sectors like robotics are expected to push semiconductor needs even higher. In fact, demand has been so strong that it has become a "seller's market", such that customers are willing to pay up to secure supply. TSMC's cutting-edge 3nm technology is the most advanced in the industry, and it has been able to raise prices steadily over the years — an indication of its strong competitive moat.

TSMC's success is partly due to its operational excellence, but the most critical point in the investment case, in our view, is its pure-play foundry business model. As it doesn't compete with its clients at the technology front-end, its customers don't have to worry about intellectual property transfer. On the flip side, TSMC gains exposure to the latest technology trends and doesn't have to worry about tech obsolescence. This strengthens TSMC's economic resilience and reinforces its leading position within the ecosystem.

Over the past 12 months, TSMC has been one of the top contributors to performance. It is now the biggest company in Taiwan — and Asia — and among the top 10 largest in the world. Despite its asset intensive nature, TSMC has maintained attractive returns on equity, while profitability is near record highs driven by operating leverage and higher utilisation rates. Its customer concentration is the highest it has ever been, reflecting the concentrated nature of the tech industry. But while the management are still very confident, we worry that the whole industry is getting carried away with the AI-hype. Accordingly, we have trimmed our position, though it remains a significant holding across our portfolios.

TSMC is not the only company to benefit from AI-mania — Taiwanese technology companies have generally re-rated. From chip-designers to equipment-makers and testing apparatus companies, the broad feedback was that AI had become the main growth driver for their businesses, while everything else is slowing. Other than TSMC, we own two integrated chip designers, both of which performed well last year. Mediatek is a leading provider of smartphone chips globally, while Realtek focuses on mass-market connectivity solutions, such as Wi-Fi, Ethernet and Bluetooth. Both companies should benefit from the broadening use of AI from cloud computing to on-device AI agents.

We have been following Mediatek for many years and have witnessed its performance through the cycles. Throughout the ups and downs in its history, its talented engineers and well-aligned management team usually find a way through to the next “big thing”. From optical drives for computers to scan CDs, it entered the smartphone supply chain with 2G modem chips and benefited from technology upgrades each year — until it collapsed in 2015-17 amid a price war with low-cost Chinese competitors.

Looking beyond the short-term weakness and collapse in share price, we initiated a position in 2016, anticipating that the company would right itself as it had done in the past.

In 2018 Rick Tsai joined Mediatek from TSMC and focused on getting the basics right again. We believe Mediatek has been transformed under his leadership into a better-quality company. He has tightened execution, with steadier margins, on-time launches of 5G and Wi-Fi 7 products and numerous global partnerships (e.g., Nvidia in auto; Meta in smart glasses; small projects with Google; and an application-specific integrated circuit (ASIC) project with a hyperscaler). It is not dissimilar to what TSMC is known for, i.e., steadily pushing the edge of technology with the help of a diverse range of partners.

While Mediatek’s expertise lies in low-power, connectivity (5G modems) and multimedia chips, it has been investing in research and development (R&D) in new areas. The management recognises that they must diversify the business to grow. The company plans to push into higher-end flagship products in the near term and, overall, become a more international company. While it is too early to see results, we expect earnings growth to accelerate to the low teens if successful.

Realtek, on the other hand, is not a high-end chip design company, but it has a good track record of growth. Over the last 10 years, revenue has grown at around 13% compounded annually in US dollars.

While wireless technology is relatively mature and seemingly commoditised, there does seem to be some differentiation between providers. With rising competition from Chinese chip designers who often undercut on price, Realtek is starting to focus more on value-added products and has targeted applications with higher tech requirements, such as Edge-AI devices and AI glasses. We are optimistic that Realtek will be able to fend off the competition with higher barriers to entry as it moves up the value chain, and that margins should improve due to the product mix.

Clearly, there is a lot of hype around AI and its use-cases, and we still have many questions about its future. The amount of investment into AI has been staggering, and as we saw recently, the potential for cheaper models to disrupt the industry could upend all expectations. For now, we are waiting for signs of more predictable and sustained earnings to emerge from the rest of the pack. Similar to the mobile phone era we suspect that the majority of the AI profit pool will accrue to just a handful of players, but it is not yet clear who the long-term winners will be.

Outlook

The uncertainty that was prevalent across Asian and global markets in 2024 looks set to continue into the new year. With Mr Trump’s election win in the United States, the consensus is that US policy will be negative for emerging markets — and the president has already announced a flurry of executive orders and increased trade tariffs. But instead of trying to second-guess geopolitics or macro policy, we continue to focus our efforts on finding high-quality companies to invest in for the long term.

We expect there may be volatility in the near term as companies — and investors — recalibrate to the new norm. But we are optimistic that we can continue to deliver decent returns for our clients in the long run. On a weighted average basis, our holdings are generating returns on equity of around 19%, while earnings should grow at a low- to mid-teens rate over the coming years. Portfolio valuations are hovering around 18x price-to-earnings and 6-7% free cash flow yield, which we believe is reasonable for the expected growth.