FSSA Investment Managers

Client Update
FSSA Asian Growth

May 2022

> *"The past is terrible, the present is catastrophic. Thank goodness we don't have a future."*
>
> *Armenian proverb*

Catastrophe-times

This time a year ago, we made the observation that it felt like madness to remain optimistic, or even constructive, about investing successfully in the face of such relentlessly grim news-flow. The same is true today, but with extra bells and whistles. The only good news, if you can see it as such, is that markets are materially cheaper.

Many people seem to think that money management is about predicting the future. But even with the gift of perfect foresight, the subsequent market reaction to news is often far from obvious. Far more relevantly for our clients, we think asset management is about building portfolios that don't blow up when bad things happen. We try to do that by investing in the highest quality companies that we can find (quality of management as a key signifier and return-on-equity being the most familiar data heuristic), with an emphasis on preserving capital through these worst-of-times.

Unsurprisingly, the future has always somehow taken care of itself. As horrendous as the news in the real-world sounds, it has been compounded in market-land with equities exiting what has in hindsight been a golden period for investors. Quiescent inflation, ever-lower rates and money-printing have been powerful tailwinds for ever-higher valuations for well over a decade.

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Tailwinds to headwinds

Looking out, by contrast we now seem to be facing a more challenging era of general economic adversity and a reversion to mean valuations, along with gathering negative headwinds. Much of the news seems reminiscent of the rather grey 1970s, when politics and inflation concerns similarly dominated the headlines and equities generally struggled.

Typically, such an environment means slower growth, lower multiples and a need for greater discernment when it comes to company selection. Perhaps today's investors have little experience of such conditions. Those of us who can remember such times were probably still at school. A greater appreciation of risk seems warranted, with an approach more focused on not losing, rather than just thinking about winning.

For Asian investors, this may sound pedestrian and dull. But in an age of higher inflation (transitory or not), we think that eking out an annual high single-digit to low double-digit rate of absolute return would be a decent outcome. Most of that return should, in our view, continue to be driven by underlying earnings growth, underpinned by an annual portfolio yield now approaching 3%.

And of course, if the world does indeed prove to have a future, a re-rating on any subsequent optimism would further bolster returns. Over any reasonable time-frame, this would not be a shabby outcome. Moreover, in today's world the alternatives to high-quality equity do not seem entirely obvious to us.

Such bigger decisions, thankfully, lie outside of our remit. That said, despite the growing cacophony of negativity we continue to believe, with some degree of confidence, that the companies we own on behalf of our clients are worth substantially more than the market is pricing in today and even in — dare we say it — three, five and ten years into the future.

Portfolio activity

Given our long-established philosophy and approach to investing, despite the world turning somersaults our activity levels have remained normally subdued. In our last write-up, the emphasis was on sales in better conditions and after four disposals (with no new purchases) the number of holdings in the strategy stood at 38. This time around, it has been more balanced, with the market providing greater opportunities to buy.

We added three new names and materially boosted two smaller holdings into major positions. We added Colgate-Palmolive and Mahindra & Mahindra in India as well as China Resources Beer (CR Beer) in China. We added significantly to Nippon Paint in Japan and Jardine Cycle & Carriage in Singapore. The total number of holdings is now 37, while the top 10 companies account for roughly 42% of the portfolio (from 47% previously).

Arguably, the portfolio has become slightly less concentrated, but we have made an effort to recycle capital, adding and trimming to company holdings at both ends of the spectrum as markets have rotated. Though we again completely disposed of four more companies, two were straightforward divestments, being President Chain Stores (PCS) and Unicharm of Taiwan and Japan respectively.

We have owned both companies for many years, with PCS (operating Taiwan 7-11) held for over a decade. Along with Unicharm, a consumer goods company (diapers and feminine hygiene products), they have proven their defensive qualities in these more difficult times. Given that other companies have fallen more sharply, we took profits on relatively high multiples to fund our new purchases.

JD.com & Tencent

Otherwise, we sold Tencent and JD.com, thus removing our exposure to China's e-commerce sector. We disposed of Tencent, a small holding, almost a year ago without significant portfolio cost. JD.com, on the other hand, was only sold in the last few months and at a loss.

This is disappointing, as the company has been owned for less than three years and was originally bought at the beginning of Covid. We were optimistic about its prospects in our last write-up. However, of late JD.com was keeping us up at night and our view has become more mixed. We read their latest annual report, which helped but was not entirely reassuring.

Our original view on JD.com was that the company's governance and alignment were improving from a low base, while the valuation was attractive given the superior growth outlook. The variable interest entity (VIE) structure, accounting for just 10-15% of profits, was less onerous than at peers, and we noted the (perhaps overly) cheery expectation for continued linear growth.

The annual report confirmed that there has indeed been some governance improvement, but it seems to be driven mostly by the Hong Kong secondary listing. On the other hand, China's regulatory environment has become less clear, while the increased complexity of the group structure has exacerbated the original alignment issues. Meanwhile, in common with many other internet companies, the founder has stepped aside and is now chairman.

In the meantime, the group has been adept at raising capital, successfully taking advantage of generally high valuations. This has been both good and bad. On the one hand, they have been able to raise substantial funds and have expanded greatly, but this has diluted our interest at the group level and expansion and start-up losses for its new businesses have risen significantly.

In addition, we believe the competitive environment has become tougher. E-commerce penetration in China is already at high levels. There is always the possibility, as we are seeing around the world, that Covid has pulled forward some demand as well. Irrespective of these growing concerns, you could perhaps argue that they are now well discounted.

JD.com attractively priced?

Indeed, growth expectations for JD.com remain quite optimistic (high-teens revenue CAGR[1] over the next three years), with adjusted net profit to grow from USD 2.2bn in fiscal year (FY)22 to USD 5.5bn in FY25. That may even be achievable, but given the uncertainty we concluded that the potential risks seem quite high versus the opportunity, despite the lower implied PER-multiple[2].

Many analysts around the world still look at such growth companies on a non-GAAP[3] basis, removing costs like share-based compensation from their profit estimates. In buoyant times, nobody looks too carefully at growth estimates, especially when the going is good. But in the current environment, our view is that the market is likely to focus more intently on the real underlying valuation. On that basis, we felt that the group is probably more expensive than is generally appreciated. On a cash-flow basis too, slower growth could mean a significant reversal in free cash-flow.

For JD.com, like most retailers, much of its positive cash-flow (80%) is the result of a mismatch between payments to suppliers (on credit terms of up to 90 days), versus customers paying in cash at the time of purchase. As we have seen with other companies, if sales slow the negative impact on working capital can be substantial.

Putting all of this together, we concluded that other companies look comparatively more straightforward, though this was not without vigorous debate within the team. Some colleagues continue to place credence in JD's economic moats and its ability to gain share in the industry, and it remains a holding in some portfolios. Moreover, as a team we continue to engage with JD.com on the various concerns raised above – and as we often say, it is about travelling and not arriving.

For the Asian Growth portfolio, in China we initiated a new position in China Resources Beer and added substantially to Japan-listed Nippon Paint. We have known both of these companies for a long time, but hitherto had felt that they were both rather expensive.

China beer

China Resources Beer (CRB) is the largest beer company in China, with around 31% market share. The Chinese beer market is now quite consolidated, with just five operators.

After CRB, Tsingtao and Anheuser-Busch InBev each hold 23% and 19% share, with the top three together sharing 75% of the market. This is good and competition appears rational and measured.

China is (as usual) quite different to global markets, with beer volume having been in decline since 2014. Historically, beer was watery and cheap, with the average selling price and profitability being just a half and a third of the levels of global beer companies respectively. As Chinese GDP and the middle class cohort have grown, so the opportunity has been about premiumising, modernising and improving unit economics.

While sales progress has therefore been quite tepid, margins and profitability have improved substantially as the beer businesses consolidated their breweries (CRB still have 60) and improved returns. CRB's share of premium sales has grown rapidly in recent years and is now just under 20% of turnover, helped in part by a 2019 merger with Heineken China. Heineken now owns 21% of the business.

Reading the CRB annual report, it is all about quality growth and a clear focus on profitability. Although the company is a State-Owned Enterprise (SOE), which increasingly is no bad thing in these times, China Resources businesses have typically been well run, with returns comparable to private enterprises.

[1] Compound annual growth rate
[2] Price-to-earnings ratio multiple
[3] non-Generally Accepted Accounting Principles

CRB's CEO is well rewarded — he has a marketing background and has been at the company since 2001. He is a hands-on leader with a clear strategy that he is implementing in a systematic way. The group has a strong balance sheet with net cash, and cash-flow generation is strong. In the shorter term, investors are worried about higher input prices (50% of beer's cost-of-goods-sold consists of packaging like aluminium cans). This has temporarily depressed the share price, to our benefit.

In the past, beer companies have been able to pass on costs through higher average selling prices, in common with most consumer goods companies. The gross profit margin of circa 40% should limit the impact on net profit. Though we have followed the company for a long time, it has been rather highly rated in the last decade.

Now, using relatively undemanding assumptions alongside a PER-multiple of 25x, we see decent upside to our valuation as well as opportunity for a solid and dependable real rate of return. We have started with a small position, given rolling Covid-concerns; but as a traditionally persistent business, it will be an easy one to add to on any shorter-term disappointment.

...and paint

We have discussed Nippon Paint before and even owned it previously, though with a key issue being the complicated structure and questions around alignment and control. The group is Asia's largest paint company, with half of profits being from China. Despite the name and geographical spread of the business, the company is now fully controlled by a Singaporean family.

Over the last sixty years the Wuthelam group, owned by the Goh family, built the ex-Japan business through a joint venture with the Japanese parent. We anticipated that the ownership structure would be cleaned up, with the direct interest in the Asia ex-Japan businesses swapped by the Goh family for a larger holding in Nippon Paint at the Japan parent company level.

That transaction was finally completed in January 2021 with some boardroom drama, giving the Goh family 59% direct control of the entire business. The deal meant that alignment between the owners, shareholders and the business is now much clearer — and better, in our view. The business is professionally managed and is now run collectively as one group, including Japan.

With all of the uncertainty, Nippon Paint's share price has performed rather poorly in the last year or two, with the change lately being compounded by a host of headwinds, from rising input and materials prices to a weak China property market. Price competition in the China paint market has latterly been brutal and seems rather unsustainable. The group's results seem likely to remain under pressure for some time, but paint is a business with high return characteristics and consumer-business-like metrics.

We think the cash-flows are attractive and believe the company should be materially larger in a decade. Meanwhile, in March 2022 the group reiterated their commitment to their mid-term strategy with relatively positive views on both growth and margins. Today, China's paint market is dominated by business-to-business activities, as well as new-build construction activity.

We expect that the overall China market will end up like most others, with repainting activity driven by consumers. The margin, cash-flow and profitability implications of such a shift are significant. Although we expect profits to remain under pressure, with even just a double-digit net margin rate (in line with prior expectations), there should be significant upside. On that basis we have added into share-price weakness, with the group now forming a 3% holding.

ASEAN[4] exposure

For quite some time, as China's markets levitated we noted the extent to which ASEAN has been left behind. The problem has been the relative lack of growth alongside a limited opportunity set. We have discussed Jardine Cycle & Carriage (JC&C) before; and we have owned a small position in it for the best part of a decade. It has done little for the strategy, until now. Today, it is a top ten position.

ASEAN has perked up considerably in the last six months in both an absolute and relative sense. Strategically, many businesses have begun to diversify production away from China, with Vietnam being the most obvious beneficiary. Additionally, the recent pick-up in commodity prices (and an inflationary outlook) has been beneficial for countries like Indonesia and Malaysia (as both countries are resource-rich with crude and palm oil).

JC&C's major asset is Astra International, Indonesia's largest manufacturer and retailer of vehicles. We have always liked Astra, but the performance has been lacklustre for many years. Besides economic recovery, we expect many of the underlying businesses to perform materially better as the region exits Covid. Astra accounts for around 80% of JC&C's overall valuation. Astra itself is a conglomerate, with interests in heavy equipment (Komatsu), plantations and even small mining operations (coal and gold).

The coal interests are being diluted in terms of its earnings contribution, with no further capital commitment being made. ESG[5] arguably remains something of an overhang, but the group has always been clear about the

[4] Association of Southeast Asian Nations
[5] Environmental, social and governance

need to balance the global (and Western) emphasis on environmental targets with the country's longer-term social and development needs and goals. We believe the direction of travel is positive.

Indeed, Jardine's general attitude to ESG has transformed in the last couple of years, with generational change at the top of the company and a pronounced effort to improve governance. Rather handily, JC&C's other main asset is a 27% interest in Vietnam's largest privately-owned business (Thaco), which is similarly a conglomerate (the largest motors manufacturer and retailer in the country) with property interests.

Otherwise, the group holds an 11% stake in Vinamilk (Vietnam's largest dairy company) in which we own a small position directly, as well as 25% of listed Siam City Cement in Thailand. The group still owns the original Singapore (and Malaysia's) Mercedes dealership too. Recent results from the broader group, driven by Astra, have been encouraging and we expect profits to rebound strongly.

JC&C is a holding company with USD 1.5bn of debt, which suggests that there may be (and the company has been clear about this) some form of capital raise in the next couple of years. Despite that, we have added materially to the position in the last six months. Although the company has perked up, we still believe it to be attractively valued, trading just above book value with a PER of circa 10x. The yield is 5%.

In India, we bought toothpaste

Our overall exposure to India has remained high at over 30% of the strategy and as noted we have added Colgate-Palmolive (India) and Mahindra & Mahindra (M&M). These new purchases were funded to some extent by trimming Housing Development Corporation and HDFC Bank — the two companies have finally announced their merger and our combined holding (at 11%) was too large.

Just as for our new China names, we have followed both companies closely for many years (having owned M&M in the past). Colgate is an extremely profitable company, but has latterly been struggling with growth. As a consequence, at least until recently, the share price (unlike that of most consumer companies) has been rather pedestrian. Nonetheless, we believe that the group's business prospects are improving and consider toothpaste to be a resilient category. For some time, we thought that one of the main problems with the company was the never-ending parade of expat CEOs, who only ever stay for three years before they rotate out to a bigger job with the multinational parent.

This has held back consistency and longer-term strategic thinking, in our view. In recent times, Colgate has lost out as the likes of locally-based Patanjali has shifted the market-place towards natural products. We have long believed that a more local leadership team would help. That said,

Colgate's market share remains over 50% and returns are still impressive.

We were therefore quite encouraged when a new CEO, an Indian national, arrived two-and-a-half years ago and jolted the business with plans for expansion into personal care (with the Palmolive brand), alongside a more aggressive push for growth. Last year, we initiated a relatively small position. And then, just as we might have expected, in March 2022 the group announced that the CEO was moving to a bigger group job in America. This looked like more of the same.

However, his replacement will be a female executive hired locally from Hindustan Unilever, where she had most recently been running the home care business after 23 years with the group. It is another change, but perhaps it marks a break with the past. We remain hopeful that the new strategy might even be accelerated.

Strategically, the Palmolive household business has been neglected in the past, while the parent has decided to focus more resources into India. In that sense, we suspect that the market should be encouraged by this lateral and local hire, but of course nobody likes uncertainty.

Meanwhile, like so many businesses, in the short term margins have and will be further eroded by input price increases. But this is another high-margin business (70% gross) and these pressures should, in time, be passed onto customers. We expect more of a leadership-growth mindset in future, while the valuation is attractive by comparison to the rest of the consumer sector. We have added to our holding.

...and engineering

Mahindra & Mahindra (M&M) is a well-known Indian conglomerate, with a long and storied history. We have always had high regard for the family and their history of shareholder returns alongside strong governance. We used to own M&M and have directly owned Tech Mahindra (a major driver of overall group value) for the last decade. Though M&M's recent share-price gains may look impressive, the resurgence in the valuation only marks a return to where the group was trading three years ago.

The previous collapse in the valuation reflected not only its poor shorter-term numbers, with their core tractors and motors businesses both hard hit by Covid, but also broader market concerns around the group's capital allocation. In fact, we have actively engaged with the group for some time about group-bloat, with growing evidence of "diworsification" alongside its lack of capital discipline and inadequate focus on returns.

The CEO has now been changed and the message appears to have been received. In fact, the process provides a good example of what can sometimes be achieved on the back of a significant decline in value, when coupled with active engagement and the longer-term interests of an aligned family. This is one reason why we have always liked the combination of an engaged family acting as long-term stewards of value, who are at the same time willing to step back and engage professional managers to run the business.

There is much that remains to be done, but the group is still not expensive, in our view. We believe that there is significant upside compared with fairly limited expectations. We see distinct signs of recovery in the auto business, while the management are now committed to quite ambitious targets. We started with a small position and have since scaled it up to 3%.

Some trims... and portfolio metrics

We referred earlier to topping and tailing our company holdings as the markets have rotated, taking profits on a number of positions to fund our new investments. In particular, we trimmed Seek, Voltas, Tech Mahindra and Taiwan Semiconductor (TSMC).

They have fallen since, but their valuations are still some way above their historic averages. That said, TSMC remains the largest holding in the strategy, while the others are now reduced to circa 1% each. We discussed the portfolio look-through valuations in the last update and they remain broadly unchanged.

The strategy appears to be roughly 10% cheaper now, in terms of PER, while the portfolio return-on-equity (ROE) remains at 19% (with the top 10 at 22%) compared with a market PER of circa 13x and ROE of 12%. We believe the strategy is now slightly more attractively priced in comparison to the market.

This is important, because we believe that persistency of profit (in some businesses rather than others), balance sheets (for obvious reasons) and the sagacity of management teams will be what helps to protect returns in a more difficult environment. These are the factors that, in our mind, drive quality.

Creturns. And, as part of our investment process and embedded sustainability analysis, we have always believed that quality is synonymous with good ESG practices as well. We believe good people (and companies) do good things and vice-versa. These are the businesses that we want to own.

As for inflation, it will clearly hurt in the shorter term; but we take some comfort in the fact that the look-through gross margin for the strategy is 40%, compared to 26% for the market. The net margin of 20% is twice that of the market, which again provides some proof that we are, generally speaking, invested in better-quality (and more profitable) businesses.

Composite Performance (to 30 April 2022)

12m Rolling discrete periods	30 Apr 2022	30 Apr 2021	30 Apr 2020	30 Apr 2019	30 Apr 2018
FSSA Asia Pacific Select Composite	-8.8	36.8	-4.7	2.5	19.5
MSCI AC Asia Pacific ex Japan Index	-13.1	48.9	-8.3	-2.5	20.3

These figures refer to the past. Past performance is not a reliable indicator of future results. For investors based in countries with currencies other than USD, the return may increase or decrease as a result of currency fluctuations.

The strategy performance figures is the weighted average performance of FSSA IM's funds that contribute to the strategy in question, is based on monthly performances and are net of a default annual management fee of 0.85%.

Source: MSCI / First Sentier Investors (UK) Funds Limited. Since inception performance figures have been calculated from 30 September 2004 – 30 April 2022.

Country exposure

We have said before that the MSCI categorisation of companies can often be misleading. With our investment process, we invest from the bottom up, company by company, with no regard for the index. As a consequence, we sometimes categorise our holdings on an economic exposure basis, which for instance means that we own Nippon Paint, Fanuc and Shiseido for exposure to China's paint, machine tools and cosmetics markets respectively.

Today, from an MSCI point of view it looks as if we have only a 5% exposure to China. While this might make our clients very happy, considering the news-flow, it is somewhat misleading per the examples above. We have always argued that it is better to look at our company holdings on a Greater China basis, including Hong Kong and Taiwan. It is not entirely correct, with the likes of TSMC being truly global, but it is certainly less wrong, in our view.

Adding in the China economic exposure of the strategy's Japan names, we believe that the country exposure to China is more correctly just over 42%. India is another interesting case in point. We have discussed the global information technology (IT) services companies (Tech Mahindra and Tata Consultancy) before — Cognizant is the same but it just happens to be listed in America.

For the sake of clarity, although our Indian country exposure looks to be 35% of the strategy (including Cognizant), by removing the IT services companies the weighting to domestic India is more like 25%. Of course, this remains significant and we have increased our exposure somewhat in the last six months. As we remarked earlier, even though things are looking up for ASEAN, our economic exposure only adds up to a 12% weighting. Japan (outside China) is otherwise 3%, Korea is 4% and Australia is 1%.

...and sector weightings

The sector breakdown is similarly often a matter of confusion. Last time we discussed the reasons we considered businesses like Jardine Matheson, Techtronic, Voltas and Shanghai International Airport to be consumer-driven companies on the basis of their real economic exposure (and not industrial companies, per MSCI). Today, we would add Jardine Cycle & Carriage to that list. With the additions of Colgate-Palmolive (India), China Resources Beer and perhaps even conglomerate Mahindra & Mahindra, the broad consumer-exposure of the strategy has expanded further to 38% (from 33%). Per the official index categorisation, it has edged up from 25% to 26%.

Our IT exposure has dropped slightly to 29%, with hardware still occupying the biggest share (TSMC, Mediatek, Largan and Advantech) at 14%. IT services account for a further 10% of the strategy, while the e-commerce platform share (Naver and Seek, categorised by MSCI as Communication Services) has fallen to just 5% with the sale of Tencent. JD.com, although an e-commerce platform, was previously and quite reasonably categorised as a consumer company.

Exposure to the Financials sector has fallen slightly, from 25% to 22% with the reduction to the HDFC group. The "others" category has risen from 5% to 8% — and besides Central Pattana (Thai shopping centres), now includes Indocement, Nippon Paint and Fanuc. Central Pattana is a consumer rather than a property company, but we will stick with the relevant Materials and Industrials labels for the latter three businesses.

Laggards & mistakes

We have already written about JD.com, but in a sense everything has lagged because the value of the portfolio has fallen. In our view, the key factor should be to differentiate between a permanent loss of capital and quotation losses. The sell-off has to date been indiscriminate and has gathered momentum.

In a general sell-off, as we have experienced before, in the early days we typically struggle along with everybody else as all companies are marked down together. But in the months that follow, we would expect quality companies to bounce back more quickly as things shake themselves out.

In terms of attribution, the biggest performance detractors over any meaningful timeframe are still Dairy Farm and Largan. Dairy Farm is executing as expected and while we think there has been a significant improvement

to the business, the impact of Covid has been utterly overwhelming. Our estimation of what the company is worth is still substantially higher than the current share price. Though Dairy Farm has been painful, it does not keep us up at night.

Meanwhile, Largan is a much smaller position, with its superior economics for now being overwhelmed by the decline of the smartphone market. It is valued as a manufacturing rather than a technology company today. We still anticipate recovery.

Outlook & conclusion

> *"More than any other time in history, mankind faces a crossroad. One path leads to despair and utter hopelessness. The other, to total extinction. Let us pray we have the wisdom to choose correctly."*
>
> *Woody Allen*

Woody Allen gave this speech to a graduating class in America ... in 1979. Last time I checked, collectively we are all still here. The future turned out to be perhaps not so bad. Some would disagree and things seem particularly bad at the moment for obvious reasons, while it is sad too how we humans go on to make the same mistakes over and over again.

Mark Twain's aphorism about history often rhyming rather than repeating reflects the same sentiment. The one constant is us and, despite all the talk about progress, it is pretty clear from recent events that we are much the same as we always have been. So much for peace in our time and the belief that we had all learnt from history that war doesn't pay and such ideology always leads to misery.

Financial markets are similarly renowned, perhaps to an even greater extent, for their endlessly repeated patterns of enthusiasm and despair. It is because of us again – the human condition being driven by that age-old see-saw of greed and fear. Despite our supposed sophistication, even now *progress is cumulative in science and engineering, but (remains) cyclical in finance*, so the well-known financial thinker and writer James Grant wrote.

Although these observations might seem rather depressing, in a sense they suggest grounds for hope with the key thing being not to get too carried away. The world continues to turn. What we are currently living through in real life – and the markets to a significant extent – is nothing new even in recent modern times. Those of us who are old enough can indeed remember such things.

All we can do is recognise and acknowledge these things, and resolve to hunker down, focus on capital preservation, invest in the best and highest quality companies that we can find, and thereby endure these challenging times. That is what we are endeavoring to do. With thanks to our clients, as always, for your concurrent fortitude and patience.

Source: Company data retrieved from company annual reports or other such investor reports. Financial metrics and valuations are from FactSet and Bloomberg. As at 30 April 2022 or otherwise noted.

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