Client Update
June 2020

FSSA INVESTMENT MANAGERS

Asian Growth Update

***"Without art, the crudeness of reality would make the world unbearable."* George Bernard Shaw**

All of us have been brutally confronted by a new reality in the last few months. It has certainly been crude, with financial markets swinging around on a riptide of greed and fear, as we the participants have vacillated between elation and despair. It is not surprising. Life and the world of markets are seldom so intimately entwined.

Our last client letter concluded that investment is best practised as a synthesis of science and art, or more practically, as a melding of the actual numbers with a world of future possibilities. The last few months have very forcefully demonstrated that trade-off, with a yawning gap between visibly-collapsing short-term earnings numbers and the longer-term imaginary promise of a better world.

In every crisis, there is always opportunity, or so we are repeatedly told. It doesn't feel like it, but that's the point – it never does. It is a poor comparison, in spite of all the spurious Covid-war-talk, but as Winston Churchill famously said: "*If you're going through hell, keep going.*" And so, like most other people with day jobs, we have soldiered onwards.

As we moved through March's financial-panic lows into April's money-propelled buying frenzy and May's putative new Cold War, we have gathered our courage and looked resolutely towards the horizon. We have taken great comfort in the quality of the companies that we own and in particular their balance sheets. The other totem has been our past collective experience, with the firm having now successfully and surprisingly regularly navigated a series of supposedly one-off economic catastrophes.

No matter how grim reality seems, over time and looking back, corporate value has still compounded strongly and long-term client returns have remained healthy. Moreover, given our resolute client base, such times (when they are comfortably receding in the rear-view mirror) have indeed given us opportunities to do the right things.

In recent months, the triumph of the technology sector has become a truism, with e-commerce, online services and cashless transactions replacing the more traditional options. Socially, it has seen the rise of working-from-home. Culturally and more broadly, you could argue that in the future everything will be local rather than global and virtual instead of physical. *Globalisation is dead*, so the argument goes.

But, most of these supposedly seismic shifts in the way we now live are nothing but an acceleration of what was already happening. Artisanal food offerings and craft breweries have, after all, become commonplace and are just the latest and another evolution of the capital model. An abundance of online entertainment, streaming services, food-apps and e-retailers have long-signalled the death of cinemas and shopping centres.

These things have been well reflected in markets, from the rise of Tencent, Naver, Alibaba and JD.com at the more ethereal end of the spectrum, to the likes of Mediatek, ASM Pacific and Largan through the physical presence of the magical smartphone. Taiwan Semiconductor (TSMC) and Samsung Electronics (SEC) have long been regarded as the Asian meta-plays on all such things.

As for our Asian portfolios, broadly (and with only a few exceptions), Covid-19 has, as you would expect, had a severe and wide-ranging impact on all companies. To that extent, the fact that a company might make losses for a quarter-or-two arguably matters far less than usual, as all businesses are facing the same sorts of pressures. Earnings estimates, despite being slashed, are probably still lagging reality.

Market volatility and uncertainty will no doubt persist. Our investment process suggests that the only sensible thing to do is to look through these events and stay true to what we tell everybody we do: that is, to take a longer-term view and remember that quality always matters far more than valuation. So far, so good. The bigger danger, we think, is that if we diverge from our philosophy and experience, we will get caught up in the general hysteria, news-flow and short-term noise.

If we behave in such a way, we believe that we are far more likely to make short-term decisions that we will later come to regret. Now, perhaps more than ever, we are thinking three-to-five years out and wondering what the world will look like. Of course, it is a work of imagination, but we believe it will probably be fine; in which case, it is the same old message as usual. Double down on quality, with a particular emphasis on balance sheet strength and cash flow. Then, buy the best franchises.

Furthermore, what are the alternatives to high quality equity this time around? Cash, gold, or property? But, the "everything bubble" has meant that prices for all assets were already broadly elevated going into this crisis. In addition, it would appear that the massive and rapid response from central banks globally has effectively put a bid under all asset prices.

To that point, the real difference this time may well be a significant future expansion of government as well as bureaucracies, with a sharply higher level of interference in business in general. In fact, you can surely count on it. We would argue though, that this too was happening already.

As many have noted, the problem with a "just-in-time" and a most efficient approach to life generally is that there is no slack built into the system. As we go back to the future with the likes of compulsory healthcare, benefits and holiday leave, working capital and taxes will increase and labour costs will surely rise, as the focus shifts to redundancy and resilience.

For now, it is easy to see and focus on the deflationary impact of what is going on, but in the longer term, many of these changes will have inflationary implications, from both a supply and demand-side point of view. We have not had to worry about such things for the last twenty-to-thirty years.

Governments will legislate on these issues; and we believe the surveillance state will grow as well. Power is often a one-way ratchet – and it has been surprising to see just how easily and quickly state-power has expanded. Given the apparent abject policy failure in the West, it does not seem that fanciful to suggest that China's economic model, with its state-owned enterprises and bigger government, might well, in time, come to be regarded as the better system.

You can easily imagine how, in the future, local laws and nationalist regulations will seek to protect the likes of local pharmaceutical companies, while a fixed percentage of GDP could be spent on disease prevention and the stockpiling of personal protective equipment (PPE), food and so on. This is redundancy rather than efficiency, but it will cost more and marks a profound shift in the economic mores.

As we talk to companies, we realise that even now (after several months), few seem to know anything much at all. Ironically, the news seems to be getting worse as lockdowns roll off around the world, with companies now right-sizing to reflect the new economic reality. The monetary infusion will soon start to roll off too, let alone a second wave of infection.

That is why we focus most intensely on the quality of management and business franchises. After we have comforted ourselves that the companies we own have the balance sheets to survive and that their businesses will remain relevant (some businesses are clearly going to disappear), we believe that in three years' time positive results should typically follow.

An update on valuations

Despite the rather extreme price volatility, we remain broadly relaxed about our portfolio holdings. Little has changed in this regard, even though some of the declines have been sizeable. Our belief is that prices have fallen more than longer-term business prospects have been eroded – which means there have been and perhaps still are opportunities out there.

Earlier this year, in a pre-Covid world, the price-to-earnings ratio (PER) valuation for our Asian portfolios was roughly around 23x, which is about 20% above the 10-year median valuation. That is at the upper end of the range, but seemed relatively justifiable with a buoyant median return on equity (ROE) ratio of 17%, in a world drowning in free money with a virtually zero cost of capital.

To put things in perspective, today the PER valuation (assuming normalised earnings) is more like high-teens (maybe 18-19x), which is now modestly below the 10-year median. On the other hand, the historical ROE has risen a bit to 18% (this will likely fall this year – but we are looking two-to-three years through for a recovery), with some recent new portfolio additions as we took advantage of the sell-off.

We have rotated capital from companies that have held up extremely well, or switched between companies that have fallen equally, but where we judge the prospects to be better. At present, it goes without saying that all earnings forecasts are even more a work of art than usual. The only thing that most people can agree on is that they are mostly wrong. That is true, but we have always worked on the basis that it is far better to be roughly right rather than precisely wrong.

When all there is, is hysteria and miasma, a theoretical framework can perhaps provide some basis for making a helpful stab at where valuations might lie. Given the portfolio valuation figures above, in a more normalised environment the inverse of the PER implies an earnings yield of around 4-5%. Assuming cash flow is the same would imply a similar cash flow return as well (although, generally it isn't, given capital expenditure).

Despite the daily emotional drama of stock markets, share prices are theoretically the net present value (NPV) of these future cash flows. Yes, valuations can deviate from the fundamentals for long periods, but eventually the numbers should triumph. On that basis, if an entire year of earnings were wiped out, the intrinsic value of our Asian portfolios should theoretically fall by say 5%. Clearly, this calculation is entirely wrong, but it does put some context around the sharp down-draft that we have seen in share prices.

With the more pessimistic estimates arguing that we are going to see two-to-three (or maybe even three-to-four) years of past GDP progress destroyed as economies rebase, you can get some idea of the potential impact on the intrinsic value of share prices. Put the other way around, with the 20-25% decline in some markets, share prices are already discounting a pretty severe outlook.

The bounce in prices is therefore not difficult to explain, unless you believe that the potential for all businesses (and the whole world) has more permanently eroded. It could be, but we believe this dystopian scenario to be unlikely. It is another truism of NPVs and discounted cash flows (DCFs) that most of the value lies far off in the future and long beyond the impact of this virus. Anyone calculating such figures knows that the fudge-factor is usually found in the terminal value.

Alternatively, the markets might be reflecting on the levels of debt in the system and indeed the very survival of some businesses. That seems fair. But, Asian corporate balance sheets are generally strong, as there has been no pillaging of balance sheets to buy back shares, per US companies, and most of our portfolio companies are in a net cash position.

Portfolio activities

Despite our high levels of enthusiasm about the companies we own, we have been more active than usual over the last six months, as we have taken advantage of the at times indiscriminate nature of the sell-off. We do not anticipate such activity levels to continue and believe portfolio turnover will decline from here.

We initiated a number of new positions, these being Central Pattana, China Resources Land, Vitasoy, Zhejiang Supor and Vinamilk. Thankfully, after we added through the March panic, they have all held up quite well. In recent weeks, we have added small positions in Tencent, Seek and JD.com as well.

With the latter additions, one could perhaps usefully quote Keynes in respect of changing one's mind when the facts change, as well as note how slow we have been to catch up with the rest of the world. That is fair and some will wonder whether this signals a market-top for internet companies. We hope not and do not think so. After all, many of these businesses are just consumer companies in another guise – and those have always been the core of our portfolios.

That said, we have in the past struggled with some aspects of these new-economy companies, from their business models to governance and valuations. It seems obvious though, that this virus should, as we noted above, result in permanent changes in the way the world works and plays. We have known it for some time and the prospects of these companies have clearly improved, while our research efforts have allayed some of our previous concerns. Recent results from these companies have perhaps further proved the point.

In terms of funding these additions, we have now sold out of Newcrest significantly, as well as a number of companies that have held up well, particularly Pigeon and Daikin in Japan. To that point, we have also trimmed the likes of Taiwan Semiconductor (though it remains our largest position), Naver and Oversea-Chinese Banking Corporation (OCBC).

We switched to companies such as Dairy Farm, Brambles, AmorePacific Corporation, Universal Robina Corp (URC) and Largan. We also sold out entirely of CK Hutchison and added to CK Asset, with the Li Ka-Shing family adding much more significantly to the latter.

New positions

We have met Central Pattana and Vitasoy many times over the years, always liking these businesses, but usually baulking at the valuations. In hindsight, we should have just bought them; meanwhile, the March share-price weakness reduced their valuations to below-average levels. We consider them to be superior businesses.

Central Pattana (CPN) is a 40-year old business, with the group dominating the retail shopping mall sector in Thailand. The company has many of the qualities that we typically look for in a business. It is owned by a reputable and trustworthy family (50%-plus shareholding), but run by professionals; and it has a strong franchise, as well as a good long-term value-compounding track record. The balance sheet is in decent shape, with gearing of circa 50%, while the valuation now seems quite reasonable.

The group runs 34 malls, with 15 of these in Bangkok. The rest, bar one in Malaysia, are spread out across Thailand. We believe it is a good proxy for the emerging middle classes and, in particular, growing rural consumption. That said, around half of group sales are generated in Bangkok, with the company accounting for around 20% of Thai retail sales. The group has a long and impressive history of growth, with same-store-sales even now increasing by around 2-3% a year.

CPN is valued at around 1.5x book, with property companies more typically trading at a discount to asset value. Occupancy for the malls is at 92%, while around one-third of sales come from food and beverages (F&B). Although the coronavirus has affected the business, with tourism usually accounting for 15-20% of total sales, we expect this to be transient. The group has proven resilient to challenges (political dissent and bombings in Bangkok) in the past.

Vietnam Dairy Products, better known as Vinamilk, is a business we have looked at quite closely in the past and have met with a few times. Portfolio holding Jardine Cycle & Carriage has been a shareholder since mid-2017 with an 11% stake. Lately, Vinamilk's share price has been subdued and a slowdown in growth provided us with an opportunity to add.

Vinamilk was founded in 1976, listed in 2006 and, although a state-owned enterprise, has been managed by the same CEO since 1992. Madam Mai Kieu Lien has managed the privatisation and engagement with the state extremely well. The group is run like a private company and returns have been fabulous, with the company compounding at a mid-20s rate. Indeed, the high operating margin (22%), buoyant ROE (still 36%) and absolute scale of the company (USD8.6 billion market cap), are factors that have deterred us in the past.

The group is much more profitable than our other dairy holding, China Mengniu, with the main explanation being a dramatic difference in sales and marketing costs. While we expect Mengniu's margins to rise (still circa 6%), on looking more closely at Vinamilk and the industry structure, we believe that the latter's profitability should be sustainable. The current multiple has now contracted to a seemingly attractive 20x. We believe the growth rate is likely to reaccelerate, with returns recovering to a double-digit rate.

In an industry that has suffered a mixed reputation in recent years, Vinamilk has been focused on product quality from the start, with the company importing milk powder from the West. In addition, they established their own herds/farms in 2006 to provide fresh liquid milk, with 35% now internally sourced. Financially, the balance sheet has mostly remained net cash, with strong free cash flow. Shareholder alignment is positive as the state needs funds, with 80% pay-out. The current yield is around 4%.

Zhejiang Supor is new, in terms of coverage and research. We initiated a small position and added to it on weakness. In China, the company is the market leader in cookware and second in small kitchen appliances. It is 81%-owned by the French-listed SEB group, whose brands include Moulinex, Krups, Rowenta and Tefal. Their latest 2016 acquisition, WMF, originated in Germany and is a market leader in professional cookware and coffee machines.

Supor has the rights to all of these consumer products, with the exception of the business-to-business range (professional coffee machines). There is no royalty charged by SEB and the parent has made an effort to concentrate all of their China business within the locally-listed company. The rights to the WMF brand in China were injected into Supor in 2017 at book value.

Whilst we know that past performance is not an indicator of future performance, Supor's capable professional management team (incentivised by restricted shares) have driven excellent past performance. Sales growth has averaged 23% per annum over the past 14 years (only one year of declining sales, in 2012), with ROE averaging 17% and return on capital employed (ROCE) at 33%. Even during the 2008/09 financial crisis, Supor proved to be resilient, maintaining double-digit growth and stable margins.

Supor's balance sheet is strong (net cash of USD400 million) and the company generates good free cash flow. We believe overall market growth should remain healthy (high single digit), as per capita sales value of small kitchen appliances is only USD4 in China, compared to USD20 in the US, Japan and Korea.

While all seemingly positive, there was one key hurdle to overcome: Supor's former owner and chairman was reported to have bribed a senior government official in 2007 to facilitate SEB's takeover of Supor. After much deliberation, we believed the incident to be an isolated case, rather than a reflection of a generally corrupt corporate culture.

We have talked to former Supor employees and they have witnessed significant changes in terms of environment, social and governance (ESG) procedures ("like heaven and earth") brought about by SEB. We were also reassured by the fact that SEB is considered a beacon of ESG in its industry and, as a subsidiary of SEB, Supor would be subject to the same high standards as the parent.

New purchase China Resources Land (CR Land) is 61%-owned by China Resources Holdings (CR Group) and is a strange hybrid; that is, a commercially operated state-owned company. The company dates back to 1994 and was listed in 1996, while the holding company, CR Group, has a long illustrious history dating back to pre-revolution 1948.

CR Land is a state-owned enterprise, but as one of the oldest "red-chips", it has a long history of operating commercially and to high standards. In fact, the parent company has, since the mid-2000s, a track record of injecting land into the listed entity at favourable prices as they scaled-up the company. This process is mostly complete and CR Land is now the tenth-largest developer in China.

At the end of 2018, CR Land had 51 malls in operation, with a total floor area of 92 million square feet. They have another 52 malls under development, with total space projected to double. Contrary to the experience of the West and despite high e-commerce penetration in China, the business has continued to see strong double-digit same-store-sales growth. Rental income has compounded at 19% over the last four years.

Over the shorter term, Covid-19 has clearly affected discretionary spending in China and management have tempered expectations with a rather cautious outlook for 2020.

However, recurrent income is expected to grow to around one-third of profits (from 20% now) in the next five years. The business trades at a modest premium to book, but at around 40% discount to revalued asset value, reflecting the scope for value accretion at the newly-opened malls as they mature. On balance, we believe the risk/reward seems reasonable.

Back in Hong Kong, we initiated a position in Vitasoy, which will be a familiar name to anybody who has spent time in this city. The company dates back to 1940 and is a well-known local brand. Originally focused on soymilk, the portfolio has since expanded to include a broad range of drinks, particularly ready-to-drink lemon tea.

These days, China accounts for 70% of sales and more like 75% of group profits. The founding Lo family still control 30% of the business, but it has been professionally managed for over a decade.

We added when the shares corrected sharply on a short-term slowdown in growth. But, China's growth rate was and remains sustainably in the mid-teens, while the outlook for plant-based and non-dairy drinks in China, like the rest of the world, looks positive. The group continues to expand, with a new factory expected to open in mid-2020, and the absolute scale of the company (market cap of USD4 billion) seems small compared to the opportunity on a five-to-ten year view. The company has a net cash balance sheet, which is reassuring too.

Besides Tencent (which we have long owned in our China portfolios), we added JD.com and Seek as new positions. JD.com is a Chinese e-commerce retailer and Amazon-like in owning the bulk of its own infrastructure rather than just facilitating third-party sales. The company is still growing strongly at 15% per annum top-line, with significant ongoing investment.

Like many Chinese internet companies, there are issues with dual share classes (the founder controls 78% of the votes with 15% ownership), a variable interest entity (10% of profits), and the usual dilution on the issuance of shares as compensation to employees (about 1% a year). On the other hand, the company generates good cash flow, is profitable, and has a growth trajectory that suggests that the forward PER could fall to 20x in the next few years.

Seek is less controversial, being listed in Australia (its core market). It has built leading positions in Hong Kong, Singapore and Malaysia through its purchases of JobsDB and JobStreet (both major online recruitment businesses in Southeast Asia) and controls China's leading online recruitment company, Zhaopin, with a 61% stake. We believe the China business alone could be multiple times larger as it benefits from the network effect. Together, these Asian markets now comprise 58% of consolidated sales.

The company is not without its challenges, with net gearing of 83%; but it is highly cash generative and we thought the shares offered decent value after being battered in the first quarter.

Company performance update

Even before the recent weakness, we were conscious of owning too many banks. We sold Kasikornbank, DBS Bank and Public Bank in the last twelve months (pre-Covid), but in hindsight, we could have reduced further. We still have exposure to OCBC, HDFC Bank, Kotak Mahindra Bank, Bank Central Asia (BCA), Housing Development Corporation and Axis Bank. All of them, in common with banks around the world, have fallen sharply.

HDFC Bank in particular has seldom been cheaper. The absolute valuation-low in the last 15 years was 2.4x Price-to-Book (P/B) in March 2009, while the long-term growth in book and ROE has been around 20%. At these levels, you do not have to torture the data to get decent upside. Overall, we believe that the secular growth story for strong Indian private banks still has much further to run.

The parent Housing Development Corporation has fallen too; but when we wrote the fiscal year (FY) 19 annual report review, it was clear that they had already pulled back on non-banking financial company (NBFC) troubles, as well as reiterated their core philosophy and processes. We believe they should be well positioned for a downturn, having raised capital in 2018, monetised its subsidiaries and booked excess provisions for possible problem loans in the future (Tier 1 is at 17.3%). Looking forward, there should be less competition; and we believe the group looks attractively valued on a sum of the parts basis.

Kotak Mahindra Bank (KMB), on the other hand, is reassuringly expensive, which perhaps again proves the point about quality, with the bank having held up far better than peers despite the starting point. That makes it optically expensive, with KMB now trading at 4x book. In the last decade it has ranged up to 5x P/B (end-2019), with a low of 1.5x at '09 GFC-lows and an average of 3.8x P/B over the last decade.

Mr Kotak's stake has been diluted from 30% to 29%, with a need to reach 26% by August per the Reserve Bank of India (his voting rights have already been capped at 15%). With banks, it is all about the track record; and with his name on the door, we are reassured that he looks at everything three-times over. The bank is well capitalised, with a Tier 1 ratio of 20% after the latest USD1 billion capital raise.

Elsewhere in India, we own a number of the Information Technology (IT) Services companies, with Tata Consultancy Services (TCS) still among our largest holdings. They all face shorter-term headwinds, but we see the sector as a key beneficiary of the ever-greater digitalisation of society. We have always been attracted by the fact that, while banks spend 5-6% of revenues on technology, for businesses in general the spend is more like 1-2%. It is not hard to believe that this will change markedly in the next decade.

In the shorter term, for all of these IT companies and for US-listed Cognizant in particular, the challenge is their heavy exposure to financial services. Cognizant trades at a discount (15x PER) and is a turnaround story, with a new CEO, Brian Humphries. Such things are never easy, even in the best of times. Still, we have met the CEO and we liked him; and his view (and our impression) is that Cognizant has been undermanaged for a significant number of years.

Godrej Consumer Products has latterly been something of a quandary for the team. We have always liked the growth story for Indian consumer companies, but Godrej's recent results and capital allocation (many acquisitions in lots of geographies) have been a bit of a struggle. The balance sheet seems fine, but the complexity and FX-mix could provide some challenges. Core net profits have been flat for the last three years.

On the other hand, its Indonesia business looks good, Africa should improve from a low base and raw materials tailwinds should help underpin margins. The operating margin at 19% is positive, the ROE is decent and longer-term returns have been good. With a lacklustre update on March 2020 quarter's sales, the market has probably already reflected much of the weakness, while trading normalisation should hopefully see a strong recovery in revenues and growth.

Asean still tough

We own very little in Asean, where markets have been doing an imitation of the AFC/GFC[1] and zombie apocalypse all rolled into one. BCA in Indonesia is absolutely fine; on the other hand, Indocement has halved in the last few months, but it has positive net cash, is controlled by Heidelberg of Germany and pays a decent dividend. Indocement is now trading on an enterprise value (EV) of about USD80 per tonne, a significant 40-50% discount to replacement cost. These are already cycle-low valuations and we have added to it.

It is not hard to see growth reaccelerating, in our view. The Indonesian cement market has consolidated, with just two companies controlling 75% of output, (Semen: 50% and Indocement: 25%). Long-term growth has been mid-teens, albeit slower in recent years due to China imports, falling prices and soft demand.

Mistakes?

Jardine Cycle & Carriage is another company that has struggled and is essentially trading at 20-year lows. The group has held up better than underlying Astra (thanks to Indonesian ETFs, no doubt), but the Indonesian business is still about 65% of the valuation. Who knows when Indonesia will improve, but it would be surprising if it doesn't, given the scale of the country.

The other big assets are Vinamilk, Thaco and the Singapore Motors business, which account for about 10%, 8% and 7% of the valuation respectively. The current sum of the parts valuation is unimpressive, with the group trading at just a 6% discount after the decline of Astra.

Meanwhile, it is complicated at Jardine Matheson, with the conglomerate owning 85% of Jardine Strategic, which in turn owns 58% of Jardine Matheson. The revalued net asset valuation (RNAV) has shrunk to USD50 per share (which is about the current share price), reflecting the broad contraction in valuations, particularly for Jardine Strategic.

Conglomerates are out of fashion, it would seem, and Jardine Matheson has sadly proven to be an exceptional value trap in the last decade. That said and given where we are, we like the business-mix and in particular believe that Dairy Farm and Astra are probably very attractively valued.

Indeed, Dairy Farm has had an awful time, as we wrote in our last update. Yet, the problem-part of the business has continued to improve and one would expect the group to be a prime beneficiary of normalisation and recovery. The shares have halved and now seem attractive. Their 20% stakes in Yonghui and Robinson Retail together account for half the market cap, with the shares accordingly trading on our estimates at an FY19 core PER of 13x.

According to the 1Q20 update, profits will be down again, with 7-11, Maxim's and the health and beauty businesses (Mannings and Guardian) all feeling the lockdown impact. Maxim's has been hit particularly hard, with Dairy Farm's share of profits amounting to USD80 million last year compared to USD100 million in FY18. If Maxim's were to be valued on the same multiple as Café de Coral, (and we believe Maxim's is a better business), it would be worth USD2 billion and another third of market cap. On the other hand, IKEA is doing better, as are supermarkets.

Looking out three years, the core business is now trading at 13x PER (or 9x if we assume that the supermarket business recovers to a 3.5% margin). The point being that the core business is very cheap, but it will take a leap of faith and confidence that things will get back to the way they used to be. Around the world, these types of businesses command high multiples; at Dairy Farm, there is a strong CEO whom we believe is doing the right things to underpin longer-term sustainable growth.

North Asia is moderately better

Our relatively modest Japanese holdings have performed well, particularly by comparison. Fanuc is absolutely fine, which says something about the franchise and their positioning. Profits and margins had already fallen by 25% on the auto and smartphone downturn, before the virus stopped the world.

Yet, profitability (margin) was still in the teens and they have a fortress balance sheet with USD5 billion net cash. It looks like the group will continue to be profitable for calendar 2Q20 (it has not made losses in the last twenty years), when one might assume profits should bottom.

China is 25% of sales, where demand remains "firm", with the rest of Asia another 20%. In 2008/09 profits declined 70%, but recovered to beyond the prior peak within four short years. While recent results confirm that the current year will not be a wash-out, profit does seem likely to decline again (but not by so much) to March 2021. Irrespectively, we believe a rebound should follow thereafter (if you believe in the capital cycle and auto/tech in particular).

At LG Chemical (which has also turned into a hand-sanitizer play), the fundamental chemicals business has held up much better than we might have expected (7% earnings before interest and taxation (EBIT) growth in FY19), while the restructuring of the LG Electronics-related businesses has returned the materials business

[1] Asian Financial Crisis / Global Financial Crisis

to profit. Together these businesses have offset the losses (and provisions) elsewhere, as the Electric Vehicle (EV) related division has ramped up capacity.

Overall, FY19 profits fell sharply, but the market has looked through to a rebound. EV battery inflection is expected and capacity should increase from 70 to 120 gigawatts (GW) by end 2021. Although the chemicals margin is likely to moderate, a lower-priced naphtha (oil-related) should help. The shares trade on a FY21 PER of 20x, which means there is a great deal of good news already reflected in the price.

Back to technology and despite many company meetings, Largan Precision remains something of a mystery wrapped in an enigma, but its long-term track record, profitability and returns give us confidence. Guidance (1Q20) was unsurprisingly subdued in terms of upcoming new projects and models, but capital expenditure was maintained and the balance sheet was better viz. working capital. FY19 ended with net cash of USD3 billion (20% of market-cap).

The upcoming 5G and technology wave has only been strengthened, in our view, by everything that is going on; and in that sense Largan's recent de-rating looked like an opportunity. Recessionary conditions may see some trading down in terms of favouring the mass-market, but the company has pushed ahead with its free-form and highly-complex multi-piece lenses. We assume growth will come back, particularly when looking out three years, which should provide reasonable upside, along with the security of their balance sheet.

Mediatek is another technology play that has done well, with the added frisson of growing US-China disenchantment. It has the strong balance sheet (USD5 billion, 20% of market cap), proven management and decent long-term track record that we usually look for, as well as 5G and always another new-new thing around the corner.

Despite being a bleeding-edge technology company, it ticks all of our boxes, soothes our neuroses and gives us mostly restful nights. Still, Qualcomm (though American) should never be underestimated and there is always the clear and present threat of new competition from the People's Republic of China (PRC).

The group's growth segment (chips for the likes of Alexa, Google Home, gaming, cloud, Artificial Intelligence and Virtual Reality applications) should benefit from growing tailwinds and overall growth should continue to be double-digit. That said, the stock has done relatively well and is now trading at 25x historic PER and maybe 20x forward (towards the top-end of its recent 10-year range), while the ROE at 8-9% is only half the level it was 6/7 years ago.

China white-goods manufacturer and exporter Midea Group has performed well too, which has been positively surprising, given all the concerns about competition, discounting and price cuts. The recent FY19 results and 1Q20 figures were reassuring, with the group commenting that production costs are now the lowest in recent years, in terms of raw materials and efficiency cost-down.

The group appears to have gained market share, particularly online. Inventories have declined and the group expect margins to remain stable. Overseas orders are rebounding quickly, with the company still expecting export share to increase further, from 42% of sales in FY19 to 50% in the next three years. That said, with air-conditioners at 43% of sales, competition will remain tough and the property market slowdown in China is an obvious headwind.

The consensus view is that the biggest will get bigger, with Midea likely to emerge as a relatively stronger business. That seems reasonable. The balance sheet is net cash, at USD6 billion, or 10% of the market cap. We believe the group should continue to grow earnings reasonably strongly.

Hong Kong & China Gas also performed surprisingly well, given how little growth there has been. FY19 results were poor and the group is quite highly geared too, with net debt to equity of 50% and borrowings of HKD4 billion. Then, there are the risks around policy and pricing; and their New Energy division is hurting in light of recent oil price movements (it is a high-oil-price proxy business).

Every time we look at it, we are concerned all over again, particularly on such expensive valuations. We have been trimming, with opportunities to add to other companies with better prospects.

Outlook and conclusion

"Change, change, change; aren't things bad enough already?" **Lord Palmerston**

We have never, in these parts, thought that much of Lord Palmerston's views after he long ago dismissed Hong Kong as: "*A barren rock with nary a house upon it. It will never be a mart for trade.*" While we know just what he means in respect of the rapidity of change, such extreme sentiments, as Hong Kong has always proven, should always be called into question.

That has certainly been our experience of markets over the last six months. While there has been plenty going on, nothing has been keeping us awake at night. Although, if truth be told, some of the share-price moves have been quite stomach-churning. Thankfully, the underlying performance of the real businesses represented by these flashing electronic blips has been much steadier.

Over the longer term, as you may note from the recent portfolio changes, we remain focused on growth in an absolute return sense, believing that the best way of achieving such a goal is to run a diversified portfolio of high quality companies. Our portfolios have always been built company by company and from the bottom up, with little regard for index positioning.

Although quality companies initially fell by almost as much as the indebted, the badly managed and the over-stretched, this is what typically happens in financial panics, as well as at the front-end of broad sell-offs. But, as time rolls on, investors predictably return to their senses, markets shake themselves off and the more durable franchises run by proven management teams with sensible capital structures tend to recover much more quickly.

We believe that the process has already begun, with many of our portfolio holdings recovering lost ground in recent weeks. But, the divergence between stock markets and the real economy has again raised cries of "*this time it's different*", which by implication suggests that the bounce is not sustainable. We are not so sure and dare to think that it might well be. However, we acknowledge that the market remains highly skittish and may test new lows. We travel hopefully, but nonetheless keep feeling for the stones as we go.

As for Covid-19, everybody knows how seriously Asia has been treating the virus issue. We appear to be exiting the worst of the economic lockdowns here, but we believe that the rest of the world will get to where it needs to as well. In Hong Kong, we have had some prior experience with SARS, but regardless, we believe people globally will in general do the right thing – despite the familiar arguments about Asian social cohesion versus liberal Western ways.

Meanwhile, as we all adjust to the new normal, we wish all of our clients and readers the best of health and luck in the months ahead.

As always, we would welcome your comments and feedback.

Source: Company data retrieved from company annual reports or other such investor reports. Historical valuations and ratios sourced from Bloomberg. We have renamed "FSSA Asia Pacific Equities Client Letter" to "FSSA Asian Growth Update". All views and opinions are those of FSSA Investment Managers. As of 3 June 2020 or otherwise stated.