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Notes from the Road: China, Taiwan, and Korea Takeaways

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Executive Summary

- Over the course of two weeks in June 2023, we met with 40 companies in China, Taiwan, and Korea and attended the JP Morgan China Summit and the Macquarie Asia Tech Tour. These trips are hugely beneficial to our investment processes.
- China is open, which is great to see in person. The recovery has been slower than expected, and while World Bank still forecasts 5% GDP Growth in 2023 and we expect our portfolio companies to deliver solid double-digit earnings growth for the year, it is a step down from earlier expectations. Chinese companies were guiding for a second half recovery, especially in the sectors of consumer, service sectors, EVs and travel in China.
- Taiwan has been a bright spot thus far into 2023 EM in terms of performance, especially led by the IT sector rebound. And while the global economic conditions are still weak, our management teams showcased deep industry expertise, entrepreneurial spirit, and a commitment to shareholder returns, bolstering our long-term investment confidence.
- Korea remains impressive how they have been able to innovate, move up the tech value chain, and build around the strength of their large corporations (Samsung, LG, and SK Hynix). The current economic environment feels sluggish, but we found many small cap companies with strong growth trajectories and attractive valuations.
- All three of these markets feel under-owned and inexpensive. Market Cap to GDP of China is now 1x compared to Japan at 7x, for example. We found many quality companies trading at 30-60% discounts to their US counterparts, which we view as a tremendous opportunity.

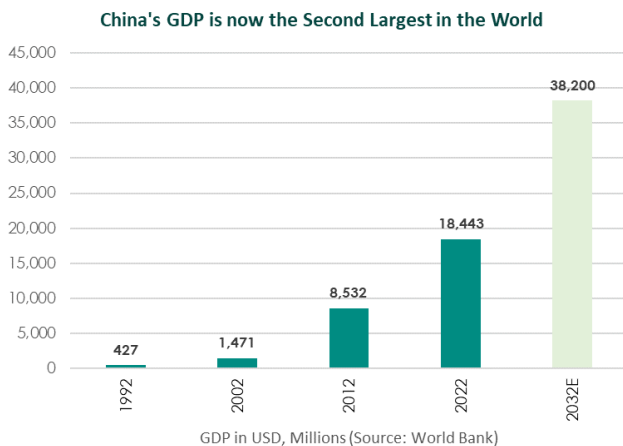
China: Reopening is slower than expected, but areas of optimism



JAMES FLETCHER, CFA
Founder & Portfolio Manager

Takeaways:

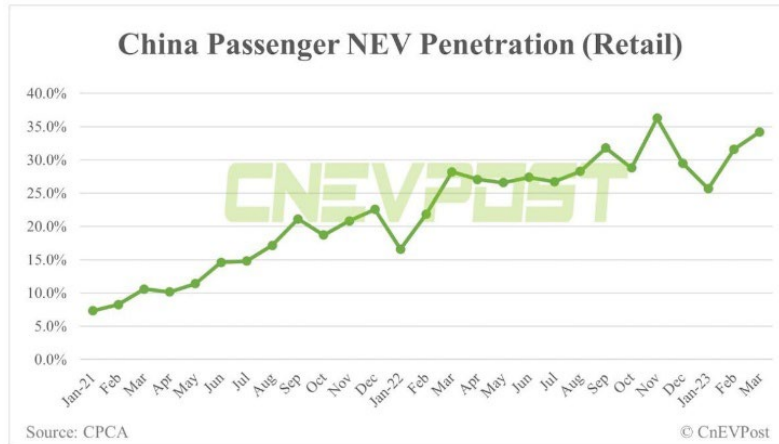
China has over 1.4 billion people, which supports the world's 2nd largest economy, and it is open! Really you have to see it to believe it. In Shanghai, restaurants are bustling, new EVs are everywhere, and JP Morgan just hosted their largest China conference ever with over 3,000 attendees. Tim Zhang and I met with portfolio companies, watchlist companies, did site visits, and attended the JP Morgan China Summit.



The first thing that we noticed being back in China was the 180-degree opening. Entry into the country was seamless, no one mentioned COVID, and few people even wore masks. People are busy at malls, restaurants, and back at work.

New technologies are booming. 30% of cars sold in China in 2022 were EVs, making it the largest EV market in the world, and you see new EVs everywhere. Not just Tesla, new models from BYD, Xpeng, Li Auto and Nio fill the roads, it looks like a glimpse of what roads will look like in the US in 3-5 years. From 2020-2022, EV Penetration grew from 5% to 30% in China.

There is also a lot of excitement around Chinese development of AI, solar, robotics, and companies like Bristol Meyers, L'Oréal, Bain, and others highlighted companies are doubling down on China as their largest offshore R&D hub. From what we heard, multinationals are not pulling out of China, especially with regards to high end R&D and manufacturing, as they still see China as a large and growing customer base in the second largest economy in the world, so can't afford to stop investing despite the geopolitical tensions.



Recovery is happening but still lacks confidence. After years of COVID, geopolitics, property market weakness, lower stock markets, and policy uncertainty, consumers are still tentative and private investment has been slow to come back. However, we believe that the World Bank’s target of 5% GDP growth in 2023 is still attainable. After our meetings, we updated our portfolio company’s expected earnings growth for 2023 from 28% to 22%, still solid but had some downgrades given that 2Q remains weak and recovery is expected to be back end loaded for the year.

Geopolitical tensions are the big question, but some positive signs. Presentations by Henry Kissinger, Condoleezza Rice, Zhu Min, Jake Sullivan, Huang Yiping, and Jamie Dimon, were encouraging as they all pointed to the fact that dialogue is happening again and that in the end, collaboration is in everyone’s best interests. That being said, the trend of “derisking” and “decoupling” of supply chains between China and the West remains an ongoing theme, we heard those terms frequently during the conference.

JP Morgan China Summit Takeaways:

- There were 3,000 people in attendance at the Conference, of which 1,200 were investors, the largest China Summit in the past 20 years. **Of the 1,200 investors, only approximately 50 were from the US.** I remember attending this conference four years ago and roughly a third of the investors were from the US. My view is this indicates a bearishness from the US currently in China.
- JPM kicked off the summit with a live poll of the audience: **1) Which asset class will do better on a 3-year view? 34% said EM Equities, 24% Gold, 13% DM Equities;** 2) What is most likely to trigger the next market crisis? 71% said geopolitics; 3) What will make you add to your China investment? 41% said an improvement in US-China relations, 33% said China’s macro recovery in 2H23.
- Robin Li, CEO of Baidu said that with **Generative AI, “10k engineers will be able to do the work of 50k engineers previously”.** Mr. Li also made the point that the Chinese are very good at developing applications around platforms (WeChat, Didi, Meituan) and he expects that will be the case for AI applications as well.
- Zhu Min, of China Center International Economic Exchange emphasized that China’s new growth model will be consumption, high-end manufacturing, energy transition and renewables. This overall shift will shift to lower but better-quality growth over the long run.

- **In 2022, 64% of global renewable energy installations in the world came from China.** China added 141GW renewable capacity in 2022 and plans to add another 160GW in 2023 according to International Renewable Energy Agency.
- Jamie Dimon, CEO of JP Morgan, is bullish on the US, thinks America will be just fine through a mild recession or mild bank failures this year, and is also bullish on continuing to invest in China, as AsiaPac led by China, remains its fastest growing region.
- Sunny Sui of Jaguar Microsystems made the point that **Chinese self-sufficiency of semiconductors has risen from 11% in 2014 to 17% in 2021**, showing progress but is still very far away from being able to split their supply chain from the West. Leading edge is still challenging for China Semiconductors. What a future may entail would be two platforms (China and West) with different IP, but different divisions of companies (like ASML, NVIDIA and Qualcomm) being able to sell to both markets, but with separate platforms.
- A full technology decoupling between the US and China would be a 5% hit to overall global GDP, according to IMF Director Steven Barnett.
- **Market Cap / GDP is 1x in China / HK, compared to Japan at 6x GDP.** We see this is a tremendous, long-term opportunity for investors in China.
- **Youth unemployment (ages 16-24) has risen to 20% in China**, and especially weakness in the Digital Economy as big tech companies are slowing hiring. Companies may be waiting for targeted stimulus measures in the 2H of the year.
- **BYD made the point that EVs are the future, reaching 35% of new cars sold in China during the first quarter of 2023 and taking off quickly in other markets (like Thailand).** BYD's latest models are super high end \$150k all the way down to the Seagull which has 300-mile range and costs only \$11k.
- **China ESG funds are now 1% of total AUM and the 39% Independent Board ratio has been rising.** China was also the fastest growing over the past five years for PRI Signatories, according to JP Morgan's ESG Team.



Insightful Panel with Henry Kissinger, Condoleezza Rice and Mary Erdos at the JP Morgan China Summit

Site Visit: Universal Vision Eye Hospital in Pudong, China

One insightful visit to highlight is that we took the opportunity to tour an eye hospital of a portfolio company, Universal Vision Biotechnology, in Pudong area of Shanghai. Universal Vision operates 40 eye clinics throughout Taiwan and China.

We were greeted by a cheerful and experienced staff. The head doctor, Dr. Teo has worked at the clinic for seven years. She said that she chooses to work at Universal Vision because of their high-quality standards and exceptional brand reputation. In her view, Universal Vision pays their staff better than the market average and provides the best quality services to their customers. As a result, there is very little staff turnover and she said everyone enjoys working there. The other staff we spoke with reiterated this.

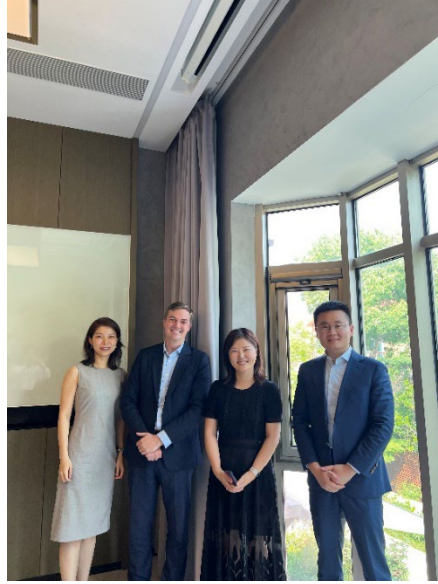
The equipment at the eye hospital seemed to be top notch. They purchase European equipment and maintain clean, hygienic standards and service the equipment regularly according to Dr. Teo. Everything we observed was orderly, efficient, and adhered to high standards.

Dr. Teo commented that business is ok, but the weak economic conditions still in China has kept customers from making major purchases like Lasik eye surgeries. Currently they are doing 2-3 Lasik surgeries per week, which is below the 4-5 surgeries per week they were seeing before the pandemic. Relative to peers, she commented that although more eye clinics are opening in China, few have the strong brand perception and high-quality standards of Universal Vision. As a result, she was not worried about competitors.

Overall, we left the visit feeling optimistic about the company culture, the company's brand reputation for quality and the long-term growth potential for eye clinic growth in China.



James visits Universal Vision Biotechnology Eye Hospital in Pudong, China with Head Doctor, Dr. Teo



Pictured: Tim and James in Shanghai, Visiting East Jade Asset Management, Visiting BYD EV Dealership



Pictured: Tim and James in Shanghai, attending the JP Morgan China Summit

Taiwan: Excellent and pragmatic management teams bolster our long-term investment confidence



TIM ZHANG, CFA
Research Analyst

Takeaways:

Taiwan has over 23m people that support the world's 21st largest economy. Taiwan's economy is driven by its strong tech sector ecosystem and entrepreneurial culture, and although 2022 was a difficult year for the tech industry, the rebound in 2023 has been strong. It is impressive to step back and look at the strong long-term investment returns for the county's tech sector, led by TSMC and supported by numerous innovative and well-run businesses.

Taiwan's Tech Industry has had a total return of 12.5% p.a. over the past 10 years, and has recovered strongly in 2023 (MSCI Taiwan IT)



During our recent trip to Taiwan, we had the opportunity to visit eight companies, including five portfolio companies, and attend Macquarie's Asia Tech Tour. Over the trip, we were also able to conduct some casual interviews with locals, such as taxi drivers and retail store salespeople, to gauge their confidence in Taiwan's economy.

This trip reinforced our confidence in our Taiwanese holdings, with notable companies like Chief Telecom and Voltronic showcasing strong market positions and expansion plans. The global economic conditions and high base effect pose challenges in 2023, but we maintain a positive long-term outlook for our portfolio companies that continue to grow their earnings and cash flows. Our interactions with management teams highlighted their expertise, entrepreneurial spirit, and focus on shareholder returns.

2023 is expected to be challenging due to the global economic situation as well as the high base in 2022. Inflation has raised operating expenses, making it difficult for businesses to recruit and retain employees who have higher salary expectations. Downturns in downstream industries have led to reduced business activity and demand, putting pressure on companies. Additionally, the high base effect from strong performance in 2022 poses challenges for sustaining growth and profitability in 2023.

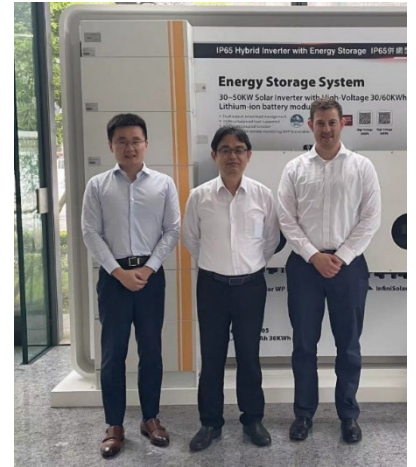
Our long-term confidence in Taiwanese holdings is strengthened. The management teams we met have impressed us in three ways:

- 1) They possess deep industry expertise and a cautious approach to expansion, prioritizing returns, and profitability. They are committed to long-term growth despite short-term challenges.
- 2) The management teams exhibit exceptional entrepreneurial spirit, as seen in the Chairman of Sporton forgoing salary and bonus in favor of annual dividends, aligning interests with other shareholders.
- 3) Our Taiwanese companies prioritize shareholder returns, with an average dividend payout ratio exceeding 70% in fiscal year 2022. We anticipate this high level of dividend payout to continue based on our meetings with them.

Meeting Takeaways: Chief Telecom and Voltronic. We met with Tim Chiang, Vice President of Chief Telecom, who expressed confidence that the annual revenue growth could reach 15% to 20% during 2024e-2026e. This exceeded our expectations of it doubling the internet data center (IDC) capacity by FY24e will contribute to accelerating its annual revenue growth from high-single-digit (2018-2022) to low-teens (2024e-2026e). Additionally, we gained greater confidence in its IDC business's pricing power, as the contracts entitle the company to pass on cost inflation, including labor, utilities, and rental expenses, to its clients.

During our meeting with Louis Wang, CFO of Voltronic, we found that while he maintained a conservative (unchanged) tone regarding the 2023 guidance, we deepened our understanding of Voltronic's company culture, competition strategy, and long-term growth potential, which helped to increase our long-term investment confidence. The company's culture focuses on product differentiation and R&D efforts, allowing them to effectively compete with international giants like Huawei, resulting in gross profit margins that surpass those of their larger competitors.

Watchlist Company Highlight. We met with a company that manufactures and distributes energy drinks and healthcare products primarily in Taiwan. Through interviews with local consumers and a meeting with the company's GM Office Director, we were impressed with the company's strong market share and positive brand reputation. We were impressed by the Director's openness and transparency in communication and the company's planned growth in Taiwan and overseas.



Pictured: Tim and Benjamin in Taiwan, visiting Chief Telecom, Visiting Voltronic



Pictured: Tim visiting Chailease, visiting the watchlist company

Korea: A standout market in terms of tech, innovation and low valuations



BENJAMIN SAIN

Senior Research Analyst

Takeaways:

At the end of May, we embarked on our trip to Korea, a vibrant country with around 51m people that supports the world's 10th largest economy¹. Over the course of a week, we visited 20 companies speaking with management and making site visits. This trip helped deepen our knowledge and understanding of our holdings and uncovered promising new investment opportunities. Being on the ground helps us understand the country's culture – all of which play a role in helping us understand and frame an investments risk and return characteristics.

Korea itself has a unique culture, with strong Chinese, Japanese and even US influences. The country is well educated, has strong family values, and is very competitive. While the economy faces long-term uncertainties around demographics, more recently the company has struggled with high interest rates and a slow-down in the semiconductor industry. Semiconductors account for roughly 20% of the country's exports – of which memory accounts for nearly 65%. This semi-cycle, which initially led Korea's economy to an 11yr high in 2021, stalled and then fell in 2022, leading overall GDP to decline by 0.4% in Q4 2022². Though we've seen a bit of stability in Q1 2023 the overall economy seems to be holding its breath for a strong turn-around in the latter half of the year. Results of this cycle were seen by us first-hand. Traveling to and from meetings, the skyline was filled with idle cranes and construction activity was low.

Overall, throughout our meetings in Korea, we came away with some general observations:

- **Korea felt cheap**, meaning the dollar seemed to go far and the company stock valuations tended to be below historical five-year averages as well as global peers.
- **The business cycle is turning negative**, and you could see this in several areas:
 1. The skyline was riddled with cranes but didn't see much actual construction happening.
 2. Most companies had expressed concern with turnover in the past, but some are now starting to limit their hiring.
 3. Speaking with the local brokers, the job market is weak and getting weaker.
- **Korea is very much still vertically integrated with the country's largest companies** (SK Hynix, Samsung, and LG). A lot of the "China + 1" supplier shift has gone to SE Asia. Korean supply chains remain very much vertically integrated within themselves. **What is impressive is the degree of automation and premiumization** within the Korean system of the past five years across industries.

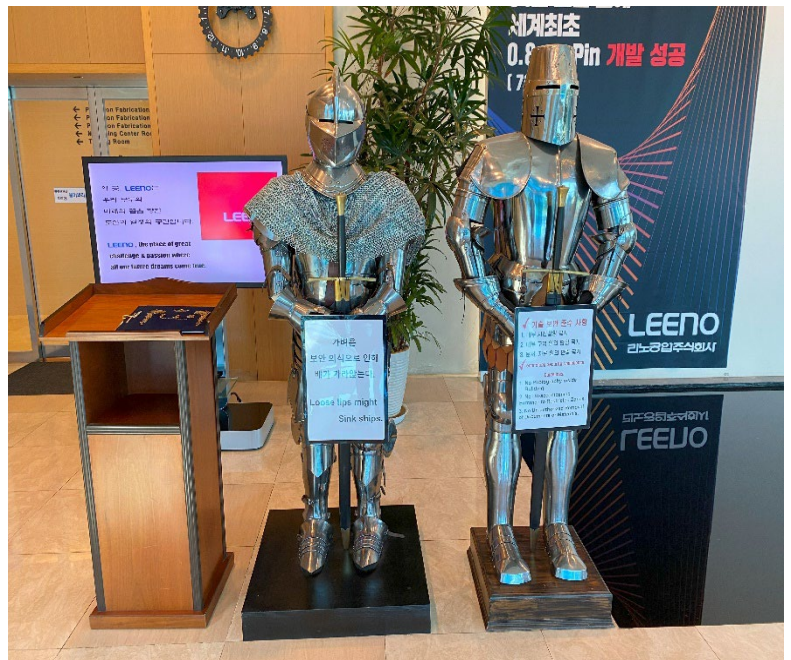
¹ World Bank

² Reuters.com

- **Most of the companies are beginning to integrate ESG** but they are still far behind their western counterparts.
- There were **Pro-USA demonstrations** going on in the city (it was their Memorial Day week) and overall consensus towards America/Americans seemed positive.

Meeting Takeaway: Channels Checks for Tokai Carbon. As economic cycles will continue, we strive to find companies where competitive dynamics persist. One such company is Tokai Carbon Korea (TCK), one of our current investment holdings. While we were unable to meet with the management team during our trip, we had a very productive meeting with their key competitor (the “Company”). Tokai Carbon is the market leader in producing silicon carbon rings (SiC) used in the manufacturing of semiconductors. As the industry has moved to more corrosive processes, the rings which hold the semiconductor wafer needs to be more resistant, thus many of the large manufacturers of semiconductor manufacturing equipment (like Lam Research and Applied Materials) have moved to using SiC rings. TCK is the leading producer of these rings with close to 90% market share. However, in 2021, TCK lost a patent battle allowing other competitors to enter the market. Part of the concern was that TCK would quickly lose market share. We believed that there would remain significant barriers to entry and scale which would support TCK. Our conversation with the Company confirmed this. Over the past two years, while the Company has been able to enter and claim about 10% of the market, we believe further share gains will be more limited. First off, the Company’s main customer is Tokyo Electric – a major supplier of semiconductor manufacturing equipment. Along with being a core customer, Tokyo Electric (TEL) is also one of the Company’s major shareholders, controlling about 14% of shares. This puts the Company in an interesting position and somewhat at odds with other customers as TEL issues pressure to ensure their own supply capacity. So far, the inroads into SiC have been exclusively with TEL. Secondly, to start supplying other competitors with SiC rings, the Company will need to go through a qualification period that can take 1-2 years. This process hasn’t even started. Finally, to gain share, the Company is having to price their products at a significant (~20%) discount to TCK. For these reasons, we feel that our assessment of TCK is correct – they are a high-quality company that benefits from significant barriers to entry. TCK will continue to control the majority of the market during its initial phase of adoption and as the cycle in semiconductors turns positive. We expect to see a return to double-digit growth and TCK continuing to capture the lion’s share of economic profits.

Watchlist Company Highlight: We had the opportunity to meet with a firm that manages the country’s only neutral internet exchange (IX) and provides data center and cloud network services to both local and global customers. We highlighted this company for its strong fundamentals and being very similar to another one of our Taiwan holdings, Chief Telecom. As a neutral IX, it is able to attract large multi-national customers with lower costs and service optionality vs. competitors’ networks which force customers into using their own connections and protocols. As data proliferation, transmission, and the use of cloud services increases, it should be a direct beneficiary. We’re also excited as the company plans to expand capacity (by nearly 300%) which we believe will drive growth over the next 2-5 years.



Pictured: Benjamin and James in downtown Seoul, Korea and Two statues outside of Leeno's headquarters tell employees and investors that they take their trade secrets seriously.



Benjamin and James climbed the Bukhansan Mountain peak, a 2,750 feet summit, and download two weeks worth of meetings.

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