Asian monthly roundup

November 2017

- Upbeat earnings growth help push Asian stocks higher
- US Federal Reserve keeps policy unchanged but hints of another rate hike
- China's party congress concludes with largely anticipated outcomes
- Japan's ruling coalition retains majority after landslide victory
- We introduced Renesas Electronics and Shionogi & Co, added to our Aberdeen Global – China A Share Equity Fund, and divested JR East

A steady stream of upbeat corporate earnings propelled Asian equity markets higher in October. Renewed optimism regarding the prospects for US tax reform and recovering oil prices also bolstered sentiment. Brent crude broke above US$60 per barrel amid expectations that production cuts by major suppliers are helping to rebalance the market. However, gains were curbed after the US Federal Reserve left rates on hold and reinforced expectations of a December rate hike.

Politics dominated regional newsflow, notably China's 19th National Congress, which delivered few surprises. Most investors expected President Xi Jinping to use the event to demonstrate his power and they were not disappointed: his vision of the future for the country is now enshrined in the constitution as part of its guiding ideology. Strong leadership can provide a stable platform from which to pursue economic and financial market reforms. With specific growth targets removed, we can expect more emphasis on quality of growth in pursuit of supply-side reforms, a more equitable wealth distribution and possibly greater financial stability.

With that in mind, we have been adding to our position in the **Aberdeen Global – China A-Share Equity Fund**, which offers an interesting selection of mainland companies that are poised to capitalise on rising domestic consumption and other positive structural trends in the economy. The fund's underlying holdings, such as Hangzhou Hikvision (a leading producer of video surveillance products), Han's Laser Technology (the biggest maker of industrial laser equipment) and Kweichow Moutai (a leading distillery brand and a wide domestic business moat) have been delivering healthy growth; we expect their robust fundamentals to continue supporting the momentum in earnings.

Meanwhile, tensions between China and South Korea appeared to ease, as both nations agreed to restore ties after a year-long standoff over the THAAD missile system. This bodes well for Korean companies with exposure to China, such as **AmorePacific**, as they have been hurt by the backlash.

In Japan, Prime Minister Shinzo Abe's gamble on an early election paid off when his ruling coalition retained its two-thirds parliamentary majority. But the result was more a reflection of an opposition in disarray than a resounding endorsement of his economic and constitutional policies. The moment Tokyo governor Yuriko Koike declined to participate in a head-to-head leadership race, the contest was over. Predictably, the stock market has since rallied in anticipation of continued monetary and fiscal stimulus and the prospect of further downward pressure on the yen. Bank of Japan governor Haruhiko Kuroda is expected to be reappointed when his term ends next April. While domestic spending has accelerated and there are tentative signs that wage growth is firming, our views are unchanged: Abenomics amounts to printing money and has failed to lift inflation. Structural reform is what's required to turn the economy around, yet this is a challenge to vested interests. Still, we are optimistic on equities because many companies are well positioned to benefit from industry trends, such as autonomous driving, and their management are paying increasing attention to governance.

Elsewhere, Indian equities recovered strongly from the previous month's losses, driven by the government's plan to recapitalise state-owned banks. Not surprisingly, shares of public-sector lenders, which we do not hold, rallied on the news as investors rotated out of their private-sector peers like **Kotak Mahindra Bank**, **HDFC Bank** and **HDFC**, despite those companies reporting solid earnings. This may dampen short-term performance, but we think our holdings are backed by solid fundamentals and are better capitalised and managed than most of the state-owned banks. Overall, credit growth has been anaemic in recent years, partly due to bad debt and depleted capital, which have crimped the lending ability of state-owned banks. We do think that the recapitalisation plan gives these lenders some breathing room to shore up their capital, absorb losses and clean up their balance sheets, instead of incurring huge haircuts through the fire sale of stressed assets. Recapitalisation should ideally be accompanied by improvement in credit risk management and better operating efficiencies. It could encourage banks to lend again, kickstart the capex cycle and benefit the broader economy.

However, resolving the significant amount of non-performing loans in the system will be challenging and could take years. In addition,

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overcapacity in certain sectors has hampered a recovery in credit demand. We continue to favour private-sector banks that have a proven track record of efficient operations, sustainable growth and managing credit risks.

Stocks in Malaysia fizzled after the euphoria over the budget faded. Prime Minister Najib Razak had filled the budget with bumper subsidies and grants ahead of a general election that must be held by next August. In Indonesia, stocks failed to sustain their gains after the parliament approved the populist budget, which comes well ahead of the 2019 presidential election.

Outlook

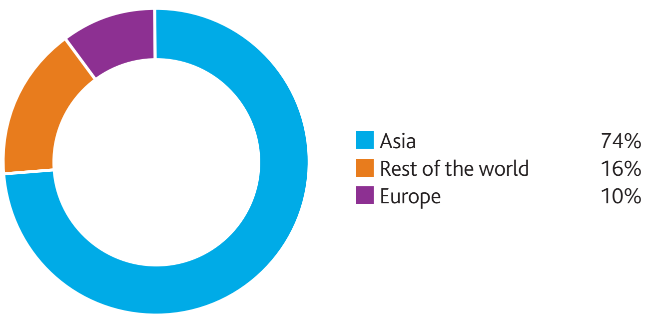
Asian markets continue to enjoy a sweet spot of improving growth prospects and favourable external conditions: corporate earnings have been improving amid growing evidence of a synchronised worldwide recovery. Global financial conditions remain easy because of extremely accommodative monetary policies, with the US Federal Reserve raising rates gradually and continued quantitative easing in Japan. Hence we have seen strong performance this year. With many countries expected to enjoy sustained economic growth into the next year, this should benefit our holdings.

Results season begins in earnest

The third-quarter earnings season got off to a good start, with better-than-expected results from most of our holdings. Here are a few key ones.

HSBC

Q3 profits by geography



Source: Company data, Q317

HSBC posted its first quarterly results since Mark Tucker took over as the bank's first external chairman. Notably, its focus on Asia paid off: the bank made more than 70% of its third-quarter profits from the region, even as costs rose owing to business expansion. While it may be premature to assess the impact of Tucker's leadership, investors will watch for signs of how he and the next chief executive, John Flint, will shape strategy. Currently the chief executive of retail banking and wealth management, Flint will take over as CEO from February 2018. We take a positive view of Flint's appointment. He has experience across the group in key segments, and has spent a great deal of time in Asia. His appointment signals continuity rather than transformation. Hence, we expect the bank to remain focused on deepening ties to Asia, strengthening wealth and retail franchises, as well as technology.

Samsung Electronics

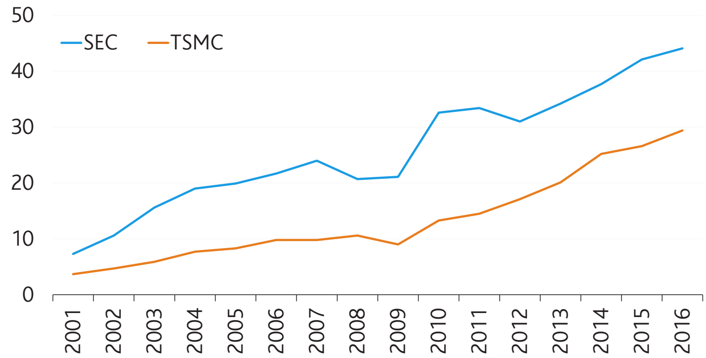
Samsung Electronics (SEC) rewarded shareholders with its biggest ever dividend payout on the back of another quarter of record profits, thanks to increasing demand for its memory chips. In view of future needs, SEC plans to almost double its capex to 46.2 trillion won (US$41 billion) this year from 2016, with the bulk on expanding its memory chip facilities.

As part of a leadership reshuffle, SEC made a break from tradition by separating the roles of chairman and chief executive officer. Chief financial officer Lee Sang-Hoon is stepping up to helm the board. Three experienced lieutenants will take the reins at its core divisions of semiconductors (Kam Ki-Nam), mobile phones (Koh Dong-Jin) and consumer electronics (Kim Hyun-Suk). We view the latest developments positively, following the unexpected announcement earlier in October that CEO and vice-chairman Kwon Oh-Hyun will step down in March next year, even as group scion Lee Jae-Yong remains behind bars with a ruling on his appeal expected only early next year. We have been engaging with management on the need for a new CEO and an independent director since Kwon's decision.

Despite lingering short-term uncertainty, we think Samsung remains well positioned over the longer term. It has made strides in becoming more institutional, which we have witnessed in holding the company for over 10 years. The latest changes at the top point to its deep and experienced bench strength, which allows talent development at its globally competitive business divisions. Its latest results also show that it remains a highly profitable cutting-edge leader in technology.

SEC and TSMC's growth trajectory – both have enjoyed solid growth over the past decade

Annual revenue (US$bn)



Source: Bloomberg, October 2017

TSMC

Investors will also be looking for hints on leadership strategy at TSMC, after founder Morris Chang announced his retirement in 2018. Under Chang's 30 years in charge, **TSMC** (one of our core holdings) has grown into the world's biggest foundry chipmaker, with a market capitalisation of around US$210 billion. We think it will be business as usual for the group, given that succession plans have been laid out years ago. His handpicked successors, Mark Liu and C.C.Wei, have risen through the ranks in tandem – from senior vice-presidents to chief operating officers to co-CEOs in 2013. After Chang retires, Liu will be the new chairman and Wei the sole CEO. We view this as a much cleaner leadership structure, with clear lines of responsibility for both, guided by an experienced board of directors and capable senior executives.

The leadership change comes at a time when TSMC is seeking to diversify its customer base, by moving into sunrise industries, such as artificial intelligence and autonomous driving, as traditional demand drivers, such as the PC, TV and smartphone markets mature. That said, TSMC has a good record in strategy execution, supported by a robust balance sheet and good cash generation that enables it to keep on investing in cutting-edge technology and innovation. It has laid out a five-year roadmap for making the most advanced chips, announcing in late September that it would build the world's first 3nm wafer fab in Taiwan. TSMC's share price is trading near all-time highs, reflecting investors' confidence in its long-term growth prospects and earnings potential. We share their confidence.

Elsewhere in the region…

Encouraging results from our Japanese holdings so far have reflected more on the fundamental improvement in their businesses and less on the impact of the weaker yen. **Fanuc** lifted its full-year earnings forecast after first-half results beat market expectations on the back of brisk sales. Notably, China's push to upgrade its manufacturing sector is boosting demand for the company's factory-automation systems. But management is more cautious about its robomachine business as it believes that demand related to smartphones and IT tends to be cyclical. **Shin-Etsu Chemical**'s PVC business helped support earnings, while **Chugai Pharmaceutical**'s good performance was partly due to demand from parent company Roche, which is rebuilding its inventory. Retail conglomerate **Seven & i Holdings** was aided by its mainstay convenience store business and cost cuts.

Among our A-share holdings, earnings were robust across the board, which suggest that profitability could have bottomed. Generally the consumer-related holdings fared well, with growth in both volumes and price driving earnings momentum. Chinese banks saw a rebound in operating profits and higher fee income, while asset quality also improved.

Likewise, results from our bank holdings in India and Indonesia mostly met our expectations. Indian lenders, **HDFC Bank** and **Kotak Mahindra Bank**, were bolstered by higher net interest income, while asset quality was good and non-performing loans negligible. **Bank Central Asia** benefited from robust loan growth. Overall, the key metrics were stable non-performing loans, lower write-offs, improving net interest margins, and room for further reduction to deposit rates following the central bank's policy rate cuts in the previous months.

CDL bids for full control of M&C Hotels

City Developments (CDL) mounted a takeover bid for Millennium & Copthorne Hotels (M&C). CDL, which indirectly owns 65.2% of M&C, is offering 552.5p in cash for each share it does not hold. This offer represents a premium of 21.4% over M&C's closing price on Oct 6, valuing the company at £1.8 billion. Both CDL and M&C belong to billionaire Kwek Leng Beng's Hong Leong group.

We have stated publicly that the offer significantly undervalues M&C's assets, as have three other investors: Fidelity International, International Value Advisers and MSD Partners. Although we think it has been challenging for M&C, given a revolving door of upper management appointments and a lack of clarity on strategy, the company still boasts an impressive portfolio of high-quality assets in prime locations, such as London, New York and Singapore. Significantly, M&C stopped valuing its hotels publicly from 2014 onwards, when a change in disclosure rules freed the company from doing so. We see a lot of hidden value as a result. The 2014 valuation implied an NAV of 820p and analysts have estimated the current NAV at £10.50 or £11. We think that a bid price of 750p-800p would be more reasonable to reflect this valuation. Since the CDL announcement, M&C's share price has risen to about 612.5p, suggesting that the market is expecting a revised offer.

CDL's share price also had a good run. The company has not only benefited from news of the potential privatisation of M&C, but also gained from the Singapore government's move to selectively tweak property curbs for the first time since 2009, and a wave of collective sales in the city state. Altogether, the narrowing of CDL's valuation gap presented us the opportunity to take some profits last month.

What we have been busy with…

Besides the portfolio transactions mentioned earlier, we continued to take profits from the **Aberdeen Global - Indian Equity Fund**, as the Indian market has been one of the stronger performing markets in Asia this year.

We also pared the position in **Swire Pacific** after a stock price run-up year-to-date, which has led to a narrowing of the discount at which the company trades to its intrinsic value.

In Japan, we initiated positions in semiconductor maker **Renesas Electronics** and pharmaceutical company **Shionogi & Co**, while exiting rail operator JR East. Renesas has a leading position in chips used in the auto industry, which appears on the cusp of a long-term shift to electric vehicles and self-driving technology. Tightening emissions regulations and a need for cars with better energy efficiency underlie these trends. Formed through the merger of semiconductor operations of several Japanese conglomerates, Renesas has undergone an operational restructuring and is leaner as a result. Shionogi engages in the research and development of infectious diseases, particularly HIV, as well as the treatment of pain and symptoms affecting the central nervous system. More than a decade after restructuring its R&D division, the company has a robust pipeline, with a sizeable proportion of its projects either in-house or co-developed. It is also supported by a solid balance sheet.

We sold JR East following a run-up in valuations. While the company enjoys steady growth, the outlook for its core domestic rail operations is muted. To mitigate this, JR East has been developing its growing real estate portfolio, and seeking opportunities overseas. But it may take some time before any potential benefits can be realised. Hence, we divested the position in view of more attractive opportunities elsewhere.

We also took profits from **Chugai Pharmaceutical**. The drugmaker continues to perform well, supported by solid results from its existing portfolio, market optimism on its pipeline, and positive news flow regarding the potential of its haemophilia drug, ACE910.

The companies highlgihted are owned in various Aberdeen portfolios.

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