

The Long View: Notes from the Road in Taiwan

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The Janus Henderson Global Emerging Market (GEM) Equities Team recently visited Taiwan, a country that has been a source of high-quality companies over the years. Here the team examines key findings, risks and opportunities from the trip.

Recently, the team visited Taiwan, a country that we have found to consistently be a source of high-quality companies over the years we have been visiting. Taiwan sits in an interesting strategic position given its proximity to, as well as its economic and political ties with, China, a short distance away across the Taiwan Strait. The country has had a long history of involvement in global commerce. The name “Taiwan” comes from the location of a commercial outpost of the Dutch East India Company. Today, Taiwan has a population of approximately 23 million people and is a global hub for high-tech manufacturing.

Self-governed Taiwan, however, has never been formally declared independent from China, and in January 2019 Chinese President Xi Jinping stated Taiwan must and will be reunited with the mainland. This complicated relationship casts a shadow over many of the Taiwanese companies that we have spoken to.

On-the-Ground Research

The finance industry is not short of conferences, and many company representatives that we have the opportunity to meet often travel to

visit investors. We believe that seeing a company in situ is important for the many clues this provides in terms of the culture of the business.

On a previous trip, we noticed a digital board showing how many restaurants a franchise company was opening, giving us a clue that this business valued growth above everything else – a red flag, in our experience. This company did not make it onto our list to revisit.

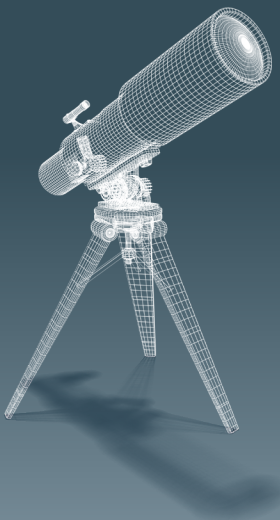
As a team, we invest using a bottom-up approach, judging each company on its individual merits as opposed to taking a view on a broad theme or conviction on a particular macroeconomic outcome, such as interest rates or currencies behaving in certain ways. We find forecasting these kinds of outcomes very difficult at best and instead choose to uncover companies with strong long-term records, with the kind of owners that we believe to be properly aligned with us as minority shareholders.

Understanding How and Where Companies Operate

To better understand companies, it is helpful to study the context in which they operate. Taiwan stands out on a number of measures, such as tertiary education and foreign reserves. There is a premium on education, and Taiwan has done a good job of moving up the complexity spectrum as lower-skilled work



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has moved over the years to mainland China. A large majority of those leaving high school go on to third-level education, and approximately 25% of the bachelor's degrees awarded are in engineering, as Taiwan has some of the world's most successful engineering companies.

One example of this prowess is Taiwan's domination of the world of high-end bicycles. Two companies, Giant and Merida, have come to occupy this position through a combination of long-term thinking and good strategic decisions. When China moved into low-end bicycle manufacturing in the 1980s, both Merida and Giant decided that rather than compete on the basis of cost, they would compete on quality. The conservative balance sheet employed by Merida then put it in a position to buy a stake in Specialized when the U.S. bicycle and component manufacturer encountered financial troubles in 2001. Today, that stake delivers around 20%-30% of Merida's pre-tax income and places it at the forefront of innovation in electric-assisted bicycles.

Long-Term Tailwinds Await Those with Patience

It has not been an easy few years for the bike companies due to flagging demand, particularly in China, partly due to the growth in rental bike companies that we have written about in the past. This has tested our resolve but underlines the importance of owning high-quality businesses. We think the long-term demand for high-end bicycles should increase alongside the growing middle class in emerging markets. As leisure time increases and, hopefully, pollution abates, there should be a significant growth in interest in cycling as a leisure pursuit. This is a long-term secular trend, and we believe that patience will be rewarded.

Conservative Nature

We have seen time and again how strong balance sheets have given good companies the opportunity to make strategic acquisitions at a time when others that live beyond their means are forced to sell. Net cash balance sheets (those businesses with more cash than debt) are a feature of many of the companies that we met on our trip and

highlights the conservative nature of the country. We met with one of the Taiwanese banks, which typically have very low leverage, and came to understand that the regulator in Taiwan is, in part, the source of this conservatism.

The reason for these large capital buffers and the sixth-largest foreign currency reserves in the world seems to be explained by the fact that Taiwan has no safety net. Due to historical claims that mainland China makes on the country, it has managed to prevent Taiwan's membership in many global organizations that might act as a backstop in the event of a crisis, such as the International Monetary Fund. It would appear that Taiwan understands a banking crisis could drive the country into the hands of China.

Keeping It in the Family

Taiwan also has many family-run companies that are having to deal with, or have dealt with, the challenge of succession. The influence of the Japanese, who occupied the country for 50 years, can still be seen in the history of many of the companies we visited, which have borrowed many of the techniques that made their manufacturing some of the highest quality in the world. In several of the companies that we visited, where succession has taken place, many of the new generation have been educated in the U.S. This brings a different style of thinking and, in some instances, a different emphasis in strategy. We noted several examples of companies that were now focused more on building brands on top of existing excellence in manufacturing or distribution.

Assessing the People Behind a Business

We view the assessment of people as a key part of the investment process, and understanding the intergenerational changes is important in determining whether the underlying quality of a company is changing. At Uni-President, we met with the Chairman, Alex Lo, a family member by marriage, who took over from the founder in 2013 and is now responsible for running a conglomerate that stretches from manufacturing noodles in Taiwan to 7-Eleven in the Philippines.

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Uni-President's most significant component by value is the largest and most successful convenience store chain in Taiwan under the 7-Eleven brand. This has reinvented itself several times to redefine what convenience stores are. Although it started as a simple retailer in 1978, as the concept became saturated, the company redefined its purpose to include feeding the people that came into its stores, making its addressable market not just people looking to shop but also people looking to eat.

Over time, the company also expanded into services including bill payments and, most recently, became a provider of logistics services to the rapidly growing eCommerce market in Taiwan. Customers selling items peer to peer can simply drop a package off in one 7-Eleven and have it picked up by the recipient in another, once again redefining its addressable market. This allows us to participate in the growth of online retailing without trying to pick a disruptive winner or paying inflated valuation multiples.

Understanding the Quality of the Company

Uni-President also has a significant presence in China, having invested and opened its first manufacturing plant in the mainland in 1992. We look for references that help us understand the quality of the company, and here we found a number of successful joint ventures, including 7-Eleven and Starbucks. The company has also extended its food manufacturing and convenience stores into mainland China and has gradually been growing these with a focus on the long term, as demonstrated by their decision to focus more on building brands than fighting price wars. Given the restrictions around investing in Chinese consumer-related companies, many of which are listed only in tightly controlled mainland China markets, Uni-President gives us the opportunity to invest alongside an owner with a long track record whose company is exposed to the growth of consumption in China. We also like that the business has deliberately chosen to grow profitably, rather than quickly, by making decisions that result in long-term payoffs.

Sustainability is Becoming a Competitive Advantage

Building brands is one example of these decisions, and managing the rate of growth of their convenience stores to establish a localized and scalable model is another. We also spent some time talking about various aspects of sustainability. What was striking is the realization that sustainability could become a competitive advantage. For example, changing the kind of packaging products use from plastic to paper, wood or metal would not only be better for the environment but would differentiate their product from their competitors, and put them in a place where consumer trends would come to them. We believe that lasting change comes about when the business "does well by doing good."

A cautionary tale made us consider the risks posed by online retail to consumer-related businesses. Due to a relatively minor incident, a Taiwanese coffee shop with a presence in China found that its products were pulled from the delivery services that Chinese people are increasingly reliant on. This, in turn, had a profound and immediate effect on sales. This made us think more broadly about the risks that concentrated distribution in some of the countries we invest in could have, particularly where it could allow the State to hold companies ransom.

Risk-Aware Approach

More broadly, we continue to think about the risks posed to the companies that we own and recognize that the tense relationship between China and Taiwan has the potential to cause disruption. What we have learned over many years, however, is that by backing high-quality, resilient businesses with managers and owners who have demonstrated integrity over long time periods, we believe we can reduce the risk to our investments from events that we can neither predict nor control and ultimately grow capital over time.



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