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Asia from the bottom up

March 2017

Company research lies at the heart of what we do in Aberdeen. Last year, our fund managers attended 1,746 meetings with 881 companies as part of their coverage of the Asia Pacific region.

Meetings may take Aberdeen fund managers to all corners of the region – from China's prosperous coastal cities, to the high-tech corporate campuses of central India; from call centres in the Philippines' southern islands, to modern dairy farms in Vietnam.

These meetings are crucial because they form the basis of our investment process: they allow us to engage with management teams as part of a continuous review of existing investments; they also enable us to check out potential new ones.

Along the way we've built up, for want of a better term, a 'bottom-up' view of the region, synthesising hundreds of conversations involving company executives and government officials, with our own observations.

That's why we can say with some confidence that earnings growth will rebound this year despite caution over Donald Trump's protectionist instincts. This recovery will be driven by some of the most battered sectors such as energy, materials and commodities. But even earnings from consumer discretionary businesses are expected to benefit.

That said, cost pressures are rising even as companies continue to focus on improving efficiencies, cash flow and balance sheet strength. While discretionary purchases are returning, consumer spending, as a whole, remains soft.

Here's a quick whistle stop tour of the region:

China

There are signs of recovery and this has led to rising optimism. But this is really a tale of two economies: the 'new' – e-commerce, tourism, consumption – and the 'old' – steel, coal, shipbuilding.

There's a lot of excitement around 'new economy' companies but there are also signs of capacity constraints (e.g. Beijing Capital International Airport). Costs, especially labour costs, are rising although this may help deter new entrants and quicken consolidation. We're seeing a small rebound in discretionary consumer spending, but this is strictly on a province-by-province, city-by-city basis. Gone are the days when everyone rode a rising tide – stock picking is crucial.

There are signs of improvement in the 'old economy' but it's far from a full-blown recovery. Stability has been achieved through stimulus and government intervention, rather than market forces. Overcapacity remains a serious issue and consolidation is sorely needed. There has been progress on reforms but the pace has disappointed. The effects of ending the One Child Policy in late 2015 trickled through to property developers (as some families upgraded their homes) and dairy companies (more babies consume more milk powder). However, developers are telling us that demand is now waning again.

India

Corporate earnings growth is relatively high compared to the rest of the region, but has been sluggish in recent years, despite Narendra Modi becoming prime minister in 2014. While reforms have been making progress at the federal and state levels, and economic conditions have improved, we're still waiting to see evidence of top-line revenue growth and private capital expenditure.

A crucial election victory this month in India's most populous state, Uttar Pradesh, gave Modi's party a convincing mandate to push ahead with its reform agenda. However, companies face headwinds from, amongst other things, US plans to restrict the entry of skilled foreign workers (affecting Indian IT companies with US operations such as TCS and Infosys) and curbs on short-term growth after New Delhi's decision last November to withdraw and replace almost 90 per cent of cash in circulation. Companies are still reluctant to invest, preferring instead to pay down debt and pare costs.

Demand for consumer goods is coming back on a selective basis: small items are moving faster than big ones; online more than bricks and mortar; north faster than south. For example, Hero MotoCorp has reported a rebound in the sale of motorbikes. However, higher commodity prices are hurting profit margins. There are also big differences between well-run private sector companies and lower quality state-owned enterprises, so-called public sector undertakings. For example, banking is one industry where innovative private sector lenders (e.g. Kotak Mahindra) can boast about having fewer non-performing loans and taking market share from state counterparts.

Australia/New Zealand

Last year's rebound in commodity prices threw a lifeline to companies such as Rio Tinto and BHP Billiton and helped avert recession in Australia. However, company executives are cautious because they are all too aware of the role of Chinese government stimulus in supporting prices. That's why they haven't changed their iron ore forecasts, are noncommittal on capital expenditure and remain focused on cost cutting.

Banks have voiced concerns about property prices, especially on the popular east coast where many of the big cities are located: Commonwealth Bank of Australia is watching Brisbane closely and has tightened its lending criteria. New Zealand's Fletcher Building, a construction products company, has expressed worries about Western Australia – the state most associated with the mining boom – where residential demand has plummeted. Meanwhile, retail has benefited slightly from rising prices but companies such as Woolworths, a supermarket, must contend with intense competition – both online and foreign.

In New Zealand, the big drivers of growth are tourism and immigration. Tourist numbers are expected to grow to 1 million a year (compared with a population of 4 million) within four years, while the population is growing at 2 per cent per annum. This is expected to benefit companies such as the aforementioned Fletcher Building (which has a pipeline of infrastructure projects for the next three years), Auckland International Airport and Air New Zealand.

The Exporters – Japan, Korea and Taiwan

US protectionism is an obvious concern, especially since policy unpredictability makes planning so difficult. Japanese companies are assessing their options although the outlook may not be so dire for automakers because some 80 per cent of Honda cars sold in the US are made there; the corresponding numbers for Toyota and Nissan are 60 and 65 per cent respectively. Taiwanese contract manufacturer Hon Hai Precision Industry has announced plans to spend some US$7 billion to build a plant in the US, while Taiwan Semiconductor Manufacturing Company is considering moving production to the US, even though TSMC would lose the competitive advantages of Taiwanese engineering and vendor ecosystem.

The trend towards automation is a big theme in global manufacturing: there's a real possibility that US companies forced to relocate production back home may simply invest in automation (rather than hire more Americans) to keep costs in check. Meanwhile, Chinese manufacturers are increasingly turning to industrial robots as a tighter jobs market pushes up labour costs. This would benefit Japanese companies such as Fanuc, Keyence and Nabtesco that either make industrial robots or manufacture critical components for them.

With regards to technology, we have the most exposure to Taiwan and Korea – more specifically TSMC and Samsung Electronics. They have been very much the out-performers within their respective home markets thanks to an improving capital expenditure cycle within some of their divisions, as well as the fact they have first-mover advantage in many areas of new technology. Semiconductors have been a bright spot for Samsung in particular. Samsung also boasts the biggest global market share in NAND and DRAM memory.

Asean – Malaysia, Thailand and Indonesia

It's been a pretty tough operating environment over the past couple of years. One consistent theme across many of these markets has been weak consumer spending. This has impacted shopping mall operators in Malaysia. In Thailand, high household debt, especially in more rural areas, coupled with the period of mourning that followed the death of King Bhumibol Adulyadej last November, weigh on consumer sentiment.

Commodity prices, the recent rebound notwithstanding, have affected Indonesia and Malaysia. Indonesia sells coal while Malaysia has a big oil and gas industry. Companies in the oil services sector (e.g. Bumi Armada) tell us that they are still hunkered down for what they call the 'long winter' and don't anticipate any meaningful improvements in orders for some time.

The region's banks, with the exception of the Philippines where lenders see 12 – 15 per cent loan growth, tell us their growth expectations are pretty subdued. For example, the Singapore banks (e.g. DBS and OCBC), which have operations throughout the region, only expect 3 – 5 per cent loan growth. The same would be true in Malaysia, Thailand and Indonesia.

However, infrastructure spending is cause for optimism. In Thailand, companies are bidding for projects and contractor backlogs have doubled. In Malaysia, demand for infrastructure projects including urban rail networks and intercity railways and motorways, is at an historic high. In Indonesia, lending by state-owned banks to the construction sector is picking up: Bank Negara Indonesia reports infrastructure loan growth of 47 per cent year-on-year, albeit from a low base.

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