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PODCAST TRANSCRIPT

TALKING RESEARCH – ON THE ROAD IN TAIWAN AND CHINA

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Katie:
Hello and welcome to Talking Research. My name is Katie Boyce, I'm an investment writer at Walter Scott, and this podcast is an opportunity to



DES ARMSTRONG
Investment Manager

hear first-hand from members of our Research team.

Today I'm delighted to be joined by investment managers Des Armstrong



TOM MIEDEMA
Investment Manager

and Tom Miedema. Des and Tom are both, dare I say it, veterans of the team, having joined Walter Scott back in 2004 and 2007 respectively. They're both currently members of the Americas

team but, over the course of their long careers at the firm, as is traditional for everyone in Research, they've rotated through all three regions: Americas, EMEA and Asia. And today they're here to talk about Asia.

Tom, Des, welcome!

Tom:
Hi, Katie.

Des:
Hi, Katie.

Katie:
Thank you both very much for joining me today to chat about your recent trip to Taiwan and China which, given the ongoing headlines around geopolitical tensions and, of course, the end of China's strict zero-Covid policy, was a particularly timely visit. Des, maybe you could kick off with a bit of context to the trip?

Des:
Yeah, delighted to do so. Firstly, it was a week in Taiwan and then a week in Shanghai in China. The visit to China really was the main reason why we wanted to get out to Asia. It's obviously been a closed shop for a very long time, being something of an information vacuum. When you read the headlines in the Western media, they're quite extreme. So, we felt it was important to get out there and, as much as anything, for it to be a country visit. But, obviously, while we're there, to meet with all the companies we can. And then, in the case of spending time in Taiwan, the man on my right, Tom here has been talking a lot about TSMC and about the importance of the semiconductor industry.

Katie:
And you've both visited China many times before but, clearly, given the pandemic, this was the first time for quite a few years. So maybe you could give us a few thoughts on what's changed? Did it feel different to your previous trips?

Tom:
I think overwhelmingly the sense was of normalcy, normality, the same as we'd seen before. I had, for the last time, been there in 2019, both in Taiwan and in China, and been reading the same headlines that everyone else is reading, expecting things to have changed materially. Actually, on the streets, facing the companies, just traveling through the countries, it felt like it has always felt. We've done this for a very long time. However, clearly the economy is not firing on all cylinders. There are plenty of problems in China today.

Des:
Yeah, the optimism in Shanghai wasn't quite what it was when I visited in 2017. We spoke to people on the street, the restaurateurs, and they said there had been quite a departure of a lot of the expat community. We'd also seen some of the urban elites within China move to the likes of Singapore and what have you, so that's having an impact for sure. But, look, in terms of the economic vibe, it was still very strong. Also, there was no signs of social stress.

You're reminded how digitised that economy is out there, how well things work. It was very pleasing from that perspective to see the economic vibe still holding up. Certainly, there was a big disconnect between how the situation is portrayed in the Western press versus what it's like on the ground.

Katie:
Tom, you lived in Taiwan. It's an interesting place. It's been at the heart of ongoing geopolitical tensions between the US and China – but it's a small island. Why is it such a globally significant place?

Tom:
It's quite an amazing success story, to be honest. Taiwan is a very small island with a small population and very little in the way of natural resources, so they have no natural right to be where they are. It's a success story that's really been driven by the people and the

entrepreneurs that have led it forward over the last couple of decades. As you mentioned, I lived there in 2004-2005, so two years there and I've visited many, many times since. And I'll be back again in a few weeks' time to see family over there.

In terms of why it's successful and why people know Taiwan, clearly there's a long history of the politics between Taiwan, China and the US. And there's the strategic importance of the Taiwan Strait, of trade, on the military, the positioning in the Pacific that it has. But I think the key reason that we all know now why Taiwan is so important is the tech industry. TSMC is at the centre of that. But there's a whole ecosystem that's been developed over multiple decades.

When I was living there, Taiwan was very important. But, after the last two decades, TSMC is now the global leader in semiconductor technology and it's just become incredibly strategic. It's not just TSMC but many other components as well, which are critical to global supply chains.

Katie:
Because TSMC really is incredibly important to Taiwan, isn't it?

Des:
Morris Chang, the founder of TSMC, has had a remarkable impact on that country. And when you're there, obviously, like I said earlier, it was my first time, you really just get an insight into the impact that TSMC has had on that industrial complex and just how important economically that company is.

Katie:
It's a company that we at Walter Scott know very well and have done for a long time. What were the key takeaways from your meeting with the business?

Tom:
We talked a lot about geopolitics and supply chains, and they're incredibly aware of what's going on. Clearly, they



spent a lot of time thinking about this. But ultimately, what they are thinking about is how best to serve their customers. It's a business that's always put their customers first. And what the customers are looking for is the fastest computing power that they can get, the lowest power consumption for the chips that they're buying, and the lowest cost.

Today, the factor of geopolitically diversified supply is also becoming important. TSMC is building in Arizona, they're building in Japan, they'll potentially be building in Europe, so providing customers some flexibility in terms of where the chips are manufactured. Their focus is very much on technology. As much as possible, they'd like to stay away from politics and focus on delivering each new generation of technology. This year they'll be delivering what's called three nanometer technology, and in 2025, all being well, they'll deliver the two nanometer node. And, if they remain the leader in delivering those technologies against the likes of Samsung and Intel, then that's what's going to be most important for ensuring the position of TSMC, and potentially even Taiwan.

Des:

And they didn't say this specifically in the meeting but, the inference from the conversations that we were having was that that's their best way of defending themselves from this geopolitical risk. That's how they navigate this challenging time, which is to remain technologically relevant. And it's very obvious, compared to their peers, that they are just a number of generations ahead from a technological standpoint.

Tom:

I think one of the interesting things we talked about in the meeting as well is people focus on building elsewhere and view it as a potential negative or a higher cost or kind of inflationary burden for their cost base. But I think what's also interesting is that, when you look at the statistics, TSMC last

year was 8% of Taiwan's GDP, it was 13% of Taiwan's exports. They employ a massive quantity of the engineering graduates that are coming out of Taiwan's best universities. And so, TSMC was, to some extent, outgrowing Taiwan. Diversification makes a lot of sense for the company too. Perhaps the geopolitics has accelerated this process, but it was certainly something that I think was ultimately inevitable, that would have to happen anyway.

Katie:

And, beyond TSMC, you met with other semiconductor businesses out there too?

Tom:

To be honest, you could spend two weeks in Taiwan just covering companies involved in this area in some way or another. We met with a whole host of different companies. Companies like ASE, which does the back-end packaging for semiconductors; UMC, which used to be TSMC's great rival, is still involved in the foundry business, but has a different kind of niche; companies like Global Unichip that help customers on the design side of the chip (and they actually sit across the road for TSMC). There are many examples of companies that are very important in the whole ecosystem. We should think about it very much as an ecosystem rather than just TSMC, with all providing, I think, some interesting insights in terms of what's happening in this space.

Des:

And, to be clear, it wasn't just all semiconductor electronic companies we met with. There were a number of interesting consumer names that we met with too. The likes of Great Tree and President Chain and what have you were the other meetings that we had that kept us sane.

Katie:

On the electronics and semiconductor industry, Tom, earlier this year you visited the US and, in fact, we chatted

on this podcast about supply chains and geopolitics. How has this trip informed your thinking with that Asian perspective?

Tom:

I think, for the most part, it confirmed a lot of what we were talking about and that we took away from the US. I mean, if anything, it was even more complex than I realised. And being complex was one of the takeaways from the first trip. The more you dig, the more you find out and the more layers there are to this onion that is the supply chain. I think the main takeaways remain very similar, that the world is on a clear path to de-risking/decoupling in terms of supply chains. That seems very inevitable. It's difficult to imagine anything that's going to derail that trend, but it's going to be very hard.

Katie:

And it sounds from some of the things you've both been saying within the team that it's not just America necessarily pushing this. Chinese companies are well aware of it and they are working towards that, too. Perhaps you could say a bit more about that?

Des:

At the meetings we had, the engagement with all the companies, this was not obviously new news to them. Many of their customers had been speaking with them. And, yes, there is a geopolitical consideration here, which I think is forcing their hands in many ways. So, we're starting to see the beginnings of new investment going into the likes of India and other parts of south-east Asia and also Mexico. But also I think there's an awareness that there was an over-concentration of their supply chain in China. Clearly, that awareness has come around from the extended lockdowns that happened in China.

But I think Tom's absolutely right about the complexity associated with this, it's going to be incredibly difficult to try and recalibrate these supply



chains overnight. And it's going to be difficult, I think, to very quickly try and duplicate what China has been able to build over 20 years, in terms of the quality of its manufacturing output, the value add that it has there, the efficiency, the flexibility. So yeah, it's going to be quite a messy divorce over time, I think.

Tom:

I was going to say that we'll also see this coming in multiple phases. The initial phases were publicly seeing TSMC making big investments, and the world is very aware of that Foxconn building in India. But these are the kind of stage one investments. But, behind those, in terms of all the suppliers of components, the broader supply chain, the ecosystems, that's going to take multiple years in multiple stages and probably more subsidies and more efforts to really de-risk the whole way through. This is going to be a decades-long process.

Des:

And that's what we were trying to get out of the trip, which was to see the nuance within the headlines that we are reading, and I think that's a great example of it.

Katie:

Because here in the UK, and certainly in the US, what we read and we hear about China and the economy more broadly tends to be very doom and gloom: regulation, property's a concern, youth unemployment, the possibility of deflation. But, having been there, does it feel like an economy that's struggling? What's your take?

Tom:

Broadly, it feels like an economy that's doing okay. It's not very strong, the consumer is weak, those problems are real. The real estate is a big part of the economy. There are big problems there. And the government seems to be very committed to not restimulating and, having learned lessons of the past, not just pushing that kind of whole industrial economy, including

real estate, to create another bubble and then suffer the consequences of that. We've seen with the regulatory impact when you had multiple years and a lot of pain worn by the internet companies, this is a government that's very willing to take pain for a long time, even if that means slower economic growth, to get the outcome that they want. I'd back them to continue down the path, not do the kind of old stimulatory measures, and therefore it will take longer to recover.

But there are certain aspects of the economy that are doing very well. The consumer is saving money at the moment, is a bit nervous, but I think the consumer economy will come back. Service industries are probably going to come back and do okay. And parts of the economy like renewables, electric vehicles, the battery supply chain, there are still a lot of areas of investment as well. So, there are pockets of strength in about what is undoubtedly a weaker economy at the moment.

Des:

And that's a great example of where China's getting it right. You look at the EV penetration in China, it's 30, 35% levels. Arguably, we're seeing a shakeout in the EV industry because there's an overcapacity there. The government now is removing those subsidies. We met with NIO, which is very much seen as the Tesla of China. But it's in a position where it has now established quite a dominant network of charging across the entire country. And so it's a great example, I think, of where China is leading relative to the rest of the world.

I would argue that one of the bigger challenges that China is facing is youth unemployment. When we were there, it was actually graduation week, and so there's over 11 million graduates looking for jobs and there aren't that many of them at the moment. One in five people are unemployed right now, I think in the ages of between 18 to 25, so that is a headwind.

But when you spend time on the streets – East Nanjing Road, we were lucky enough to connect with a retail expert that walked us down all the different department stores there – you continue to see the consumption story unfolding. There's no getting away from that. But, also, you see how distressed some of the companies are in terms of the ability to sell to the consumers. One of the shops we walked past had a 90% off promotion. It's not often that you see that. So yeah, I think there's a fragility there in the consumer as well that needs to be recognised, too.

Katie:

And from 90% reductions to the other end of the spectrum... You visited Hang Lung's major mall in Shanghai, Plaza 66.

Tom:

I hadn't been to Plaza 66 for five years or so, and it had changed quite dramatically. It used to be a very quiet mall. You'd go there and you basically wouldn't see that many people. The footfall was very low, but the sales were through the roof, so it was an incredibly productive mall. But most of that productivity was ultra-VIPs doing very discreet shopping within the stores. Now, when we went back, Des and I were surprised at just how lively their mall was. I mean, it wasn't packed, but it had a really good feel to it, lots of people moving around.

We got a tour from the leasing manager of Hang Lung who talked to us through the dynamics of the customer that they've seen there. They had more customers in the main mall, a much younger customer base than they previously experienced, but very engaged with luxury fashion. And they developed a different platform for the VIPs. The mall itself has a VIP area, but also, within the stores, there are certain floors for your LV [Louis Vuitton], for your [Christian] Diors, for your Hermès, to serve that VIP customer with very unique bespoke experiences. They actually set up entire rooms just



for one visit from one customer, with products that they know that customer will like. Luxury is still alive and well in China, but it's clear the dynamics are slightly changing. Hang Lung's pretty confident that, even as China opens up, they'll retain that customer who's become very accustomed to shopping in China.

The excess that we saw in the past isn't quite there. But then still, you get some stories of pretty excessive behaviour. One of the homeware retailers that we saw still has a client that comes in and buys brand new sheets every day – high-end Egyptian cotton. So this client is spending hundreds of thousands a year on bedding.

Des:

One of the other opportunities we had to meet outside the corporate network was an individual that worked for the Chamber of US Business [Commerce] and he was giving us insights into the health of the foreign business community, obviously through the lens of US corporates. And there's undoubtedly been a departure of some of the entrepreneurs from China. But, in terms of the multinationals, all are still there. All are reasonably optimistic about the end demand in terms of that marketplace for the long term but are having to obviously navigate quite a challenging political environment. I think many of the corporates that we met with were working hard to better establish relationships with local government, to ensure that they can manage through some of the tricky experiences they are having as a result of the politics in the country.

Katie:

As visitors to China, who've been there before, did it feel different from a Western perspective? Is there a kind of anti-Western rhetoric?

Des:

The insight I could maybe give on that is when we're looking at the experience that Nike and Adidas have

had in China. So the Better Cotton Initiative sensitivity that happened has been an issue for Western companies that have businesses in China. That seems to have worked its way through. If anything, the nationalism that came from that situation turned into something of a fashion trend itself. It's like a 'Buy China' type of narrative, but that's kind of, as all fashion trends do, washed out. The likes of Nike and Adidas start to see improved demand levels but they've had to adapt. Like I said before, it's very much a local strategy that they're employing now in China, as opposed to trying to maybe import more of US and European cultural identities. I think that trend will continue as we go forward.

Tom:

In terms of nationalistic feeling or anti-Western sentiment, certainly I've experienced that in China previously but, on this trip, I was really surprised. The reception that we got certainly was very positive on the street, around the hotel. There are clearly far fewer foreigners now in Shanghai than there were. But actually, if anything, I felt a warmer welcome than usual, just speaking to people in all different settings.

Katie:

Talking about being there in China, after the experience of the pandemic, everyone was grounded, you couldn't travel, and yet, at the time, you were still speaking to companies, you were still getting a good grip on things. But it's presumably good to be back on the road? Where do you find the greatest value in research trips?

Des:

This is one of the best research trips I've done in terms of just getting that benefit of the country visit. As we've spoken about, it was just important, given the information vacuum we felt we're in, to get out there. And one of the big takeaways was this huge disconnect between how life is being portrayed in Western media to what it's actually like

on the ground. The corporates we met with are fully cognisant of the challenges that they're facing longer term but are adapting and have been for quite some time. You get the insight into whether or not the likes of the people in Taiwan are preparing for war.

Katie:

Are they?

Des:

They're definitely not. That wasn't the vibe that we got whatsoever. The Taiwanese have a very high quality of life. I think they're very pragmatic people. I think the chance of them pushing for independence from a political standpoint is very low. But never say never. And then, life on the streets in Shanghai, from my personal experience, that has to be, from an economic standpoint, one of the most vibrant cities I've ever been in – and that continues to be the case today.

Tom:

I think, on the company side, we very firmly believe that meeting companies on their turf, seeing the assets, touring the factories, getting in the offices, it's just incredibly important. We obviously did a lot of preparation work before going out there and meeting companies in China. When you step into some offices and you meet some people, you immediately get a strong feel of what that company is about, sometimes positive, quite often negative.

Des:

Do you want to give the example of how we were received by Hikvision? I think his opening statement was "why are you guys here?"

Katie:

Remind us, Hikvision is... ?

Tom:

Surveillance equipment. They're a leader in surveillance cameras. They've now applied that to multiple different areas like industrial, in the home, but they are on the entity list in the US, so very restricted in what business they can do today. The week that we were there, the



UK government decided to remove all Hikvision equipment from government buildings in the UK. It's had a lot of negative press, had a tough couple of years and so I think they were delighted to see us, some foreign investors, and gave us a wonderful tour of their exhibition centre. But, as Des said, they were immediately asking the question as to why are you here? Is it still possible for you to invest in us?

Des:

Also, I think it was obvious from the meetings we had that there was a huge amount of value-add being generated in corporate China. The companies

like Montage, WuXi, Cathay Biotech, Putailai (the batteries materials company), Tofflon, these are all sort of great examples of not just great Chinese companies, but global leaders in what they do. The idea that China doesn't have a role to play in the future, I think, is too black and white.

Katie:

That seems a sensible place to wrap up. As you say, as the second biggest economy in the world, China as a manufacturing powerhouse is not going away. It's likely to be there for a long time to come. Ditto Taiwan with its electronic prowess.

Des, Tom, thank you very much for your time. Thank you for your excellent insights. Sounds like it was certainly a busy couple of weeks, and I'm sure you've got plenty of analysis to follow up on.

To our listeners, thank you very much for your time today. We hope you enjoyed hearing these insights from Des and Tom. With trips planned to California, Spain and plenty of others in the pipeline, we look forward to sharing further updates with you very soon. Until then, thank you and goodbye.

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