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FOR PROFESSIONAL INVESTORS ONLY

J O Hambro
Capital Management Group

A View From Asia

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Counterintuitive: contrary to an intuitive belief or to common-sense expectations

For our quality growth businesses, we look for amongst other things, a couple of financial metrics: the ability to generate free cash flows over time and consistently high returns on assets (ROA). These criteria would normally preclude asset-intensive cyclical industries from our screening process. It is not difficult to extrapolate the pernicious effect on cash flow and ROAs from aggressive capital investments, especially in today's environment. The current economic recovery is over a decade long. Debt as a percentage of GDP has increased substantially (especially in China) and now weighs on future demand. Trade disputes, protectionism and geopolitical rivalries have increased uncertainty. Technological change is upending many industries – autos being a poster child. In short, estimating future demand is very challenging for many industries.

Yet I have recently increased our weightings in Taiwan Semiconductor (TSMC). The world's largest independent foundry manufacturing silicon wafers clearly operates a very capital-intensive business. Besides, the semiconductor industry has always been cyclical. During upturns, TSMC must ensure it has adequate production capacity to meet demand. But during downturns, it has to deal with excess capacity and high fixed costs associated with its manufacturing facilities. Annual commitments of billions of dollars on R&D and manufacturing capacity leave little room for error.

Fabless companies like Qualcomm always relied on foundries to manufacture chips. They focused on innovating design and functionality while foundries focused on manufacturing. A perfect division of expertise allowed for faster innovation in technology over the years. Even AMD, which makes CPUs and GPUs (processors), decided to focus just on chip design. In 2008, it spun off its chip manufacturing capability into a newly-formed foundry company called Global Foundries.

The irony, even in a world awash with cheap capital, is that not every semiconductor manufacturing firm can keep up on this capex treadmill. Two of TSMC's competitors, UMC and Global Foundries, have recently announced their decision not to compete in advanced manufacturing processes. AMD had struggled for years against Intel. In 2018, AMD decided to move all its CPU and GPU manufacturing to TSMC and away from Global Foundries. Thanks in large part to TSMC's capabilities, AMD has recently started taking share away from Intel.

In my view, the long-awaited consolidation in the foundry business is finally upon us. Once formidable competitors now accept they cannot match TSMC's scale and R&D efforts. This is reflective of the rapidly rising barriers to entry around TSMC's business. Supply of advanced foundry manufacturing capabilities is far more concentrated.

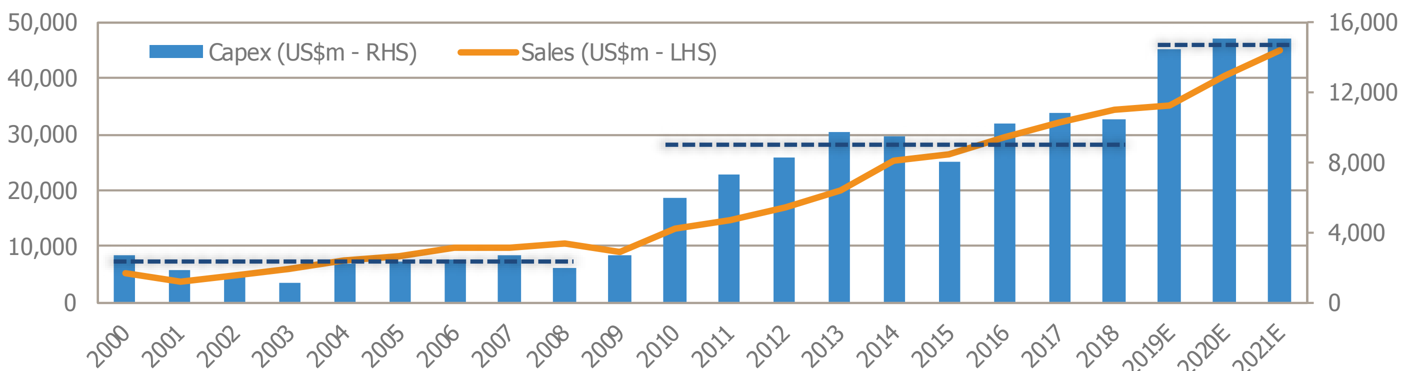
Just this quarter, TSMC announced that it will increase its capex spend to US$14-15bn per annum, compared to its earlier expectation of US$10-11bn. That is a substantial increase and raises a critical question: will there be enough demand in the years ahead given the challenges I laid out above? For this, we must look at the history of TSMC's capital spend decisions.

As you can see in the chart at the bottom of the page, there have been three distinct phases where TSMC has substantially raised its capex:

- 2000-2009: TMSC's average annual capex hovered around US$2.5bn
- 2010-2015: it upped its capex to US$8bn p.a.
- 2016- 2018: capex increased to average US$10bn p.a.
- 2019 onwards: TMSC has guided for US$14-15bn p.a.

In 2008-9, the decision was driven by introduction of the iPhone. In 2015-16, the rise of social media and spreading connectivity across the world boosted demand even further. TSMC's recent decision to raise capex in 2019 is predicated on its expectation of the arrival of 5G computing. A proliferation of sensors and devices will multiply the need for silicon chips. It is difficult to predict how strong demand will be and how soon it reflects in sales. Yet with consolidation in foundry supply, my view is that TSMC remains a standout winner in this industry. The capital intensity required is now a barrier to entry, and TSMC stands to benefit disproportionately in the future. With expected earnings growth, I think markets will re-rate TMSC's price-to-book and price-to-earnings multiples to levels that reflect a more stable quality business as opposed to a cyclical one. The risk in owning the stock has materially reduced, hence my decision to increase the weightings in our portfolio.

Taiwan Semiconductor Manufacturing Company: seeing a bright future



Source: Bloomberg.

JOHCM Asia Ex Japan Fund

5 year discrete performance (%)

Discrete 12 month performance (%):

	30.11.19	30.11.18	30.11.17	30.11.16	30.11.15
A USD Class	11.60	-21.47	25.90	6.70	-8.32
Benchmark	8.13	-9.87	35.17	7.22	-10.65
Relative return	3.20	-12.88	-6.86	-0.49	2.61

Past performance is no guarantee of future performance.

Source: JOHCM/MSCI Barra/Bloomberg, NAV of Share Class A in USD, net income reinvested, net of fees as at 30 November 2019. The A USD Class was launched on 30 September 2011. Benchmark: MSCI AC Asia ex Japan NR (12pm adjusted). Performance of other share classes may vary and is available on request.

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