GIB ASSET MANAGEMENT

On the road: Engagement in action

Value unlock in Korea & Taiwan

Rabbits, Hidden Treasure & Winds of Change

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Our Active Engagement approach leans on identifying hidden value in businesses and using the tool of Engagement to unlock and drive its greater market recognition. Two markets stand out with an abundance of potential material engagement outcomes – Korea and Taiwan.

In our inaugural Engagement trip after COVID restrictions were lifted, we walk through our work with a series of portfolio companies. We focus on the way we hope to deliver change, how we believe these changes can manifest and the impact of such enhancements to propel forward returns for our investors.

As we enter the Year of the Rabbit in the new Chinese Lunar Year, astrologists point to a year blessed with 'wealth, partnership and successes'. An auspicious and apt backdrop for our portfolio wide approach to friendly Active Engagement.

Gong hei fat choy!

Korea and Taiwan: Darkened clouds but reasons for optimism?

As internal team discussions go, this was an easy one. After a two year hiatus when company engagement was limited to targeted Zoom calls and opportunistic meets in London, Asia is now open for business. Amid accelerated COVID re-openings, management teams keen to re-connect with investors and a flurry of Investor Days – our main preoccupation was to determine which markets to focus on first.

Korea and Taiwan stood out, despite only contributing 25% of our invested capital. Both represented priority markets for our inaugural Engagement trip with each of our nine companies blessed with significant engagement latency. We believe that both markets are potentially misunderstood too. Despite brimming with companies leading globally on innovation, IP and scale driven cost structures, investors have been sceptical. Moreover, this region has had historically troubled relationships with the more 'active' investor as is testament to the legacy of failed Korean activist campaigns.

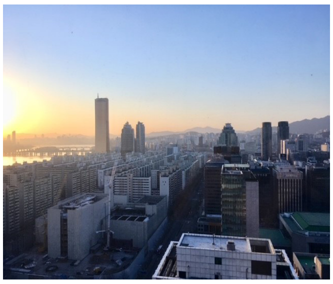
Taiwan has been a major underperformer in Asia through much of 2022. Valuations have compressed materially in the midst of rising geopolitical risks, semiconductor cycle concerns and softening demand from global end markets. Continued global concerns about inflation and the varying depth of recessions are relevant – Taiwan remains an export oriented market.

Taipei 101, Taiwan

As a result, the TAIEX fell nearly 27% over 2022[1], materially more than the wider Emerging Markets index. Valuation multiples crumbled by more than 30%. Much of this was shaped by deteriorating investor appetite as foreign investors sold more than $30bn last year vs. net selling of $12.2bn in 2021 and $17.7bn in 2020. Following such a challenging period, it's unsurprising that contrarians are re-examining the longer term fundamentals in the context of undemanding valuations. The market's trailing price/earnings ratio is two standard deviations below its five year average. Cash health is strong with Taiwan's dividend yield leading most markets across Asia. Not only does this provide downside support and offer a defensive angle for investors, it is also an important Engagement lever for us. In particular, thoughtful Capital Allocation plans can help reinforce a number of semiconductor companies' competitive advantages through talent retainment, as we discuss later.

A thousand miles north over the East China Sea, similar compelling valuations are aplenty in **South Korea.**

Investors here have long debated whether much of the market represents an opportunity of unwinding 'trapped' shareholder value or if attention should be quickly shifted elsewhere. Handicapped by the much discussed 'Korea Discount', listed businesses have historically traded at steep discounts to global peers as a consequence of sub-optimal corporate governance, unfriendly shareholder protection and inefficient capital allocation. Much blame has been apportioned to the convoluted 'Chaebol' structure (family-run business groups that play a central role in the economy) despite recent evidence pointing to more material valuation discounts beyond this enclave[2]. But something is amiss. The economy continues to perform reasonably well – operating profit has increased more than 50% over the prior seven years, GDP growth rate is expected to accelerate, external vulnerability is low with twin fiscal and current account surpluses whilst foreign exchange reserves are high and growing[3]. The country has one of the lowest debt to GDP ratios globally and sovereign credit ratings measure Korea favourably against the majority of OECDs[4] .



Sunrise in Seoul

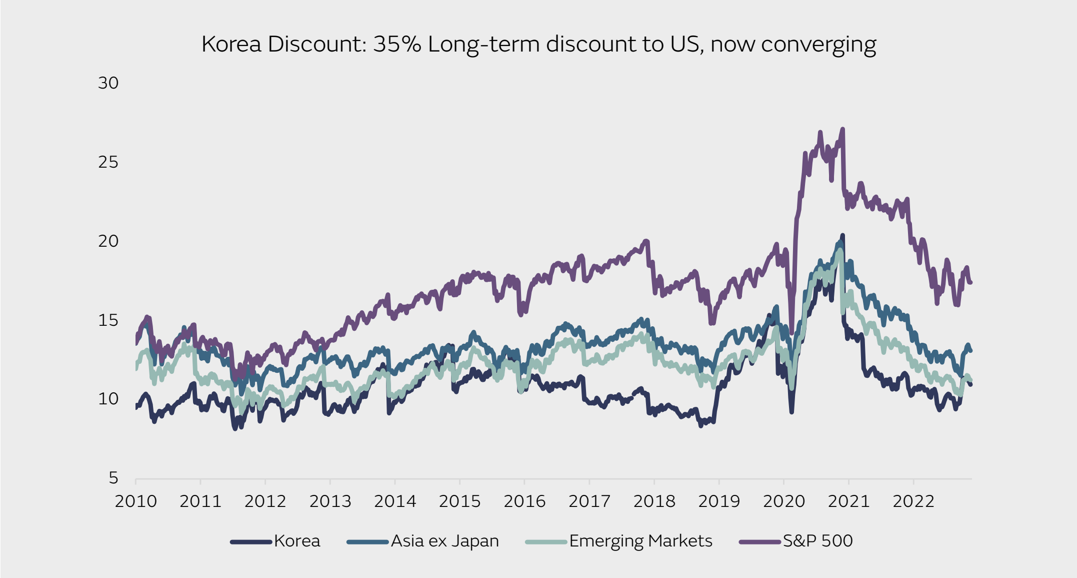
[1] https://focustaiwan.tw/business/202212310003
[2] The Korea Discount and Chaebols", Ducret and Isakov (2019)
[3] Bloomberg (2023)
[4] Ibid

The corporate sector has given rise to true global champions – the country has ranked first on a number of innovation indices over the last decade with leading competitive positions in semiconductors, consumer electronics, automotive and healthcare.

However, market valuations continue to imply that these corporate fundamentals are aggressively discounted by a lofty 'Korean' cost of capital in the face of a higher perception of associated risk. There have been some efforts to address this. Recent government administrations have promoted a 'fair economy' through the appointment of former shareholder activists into important regulatory positions. Their purview has centred on monitoring and blocking unfair transactions for the exclusive benefit of majority shareholders. The frequency of circular holding structures has since significantly reduced. The much vaunted 'Korean Stewardship Code' was implemented in 2016 with a focus on improved corporate governance, a drive to give greater recourse to institutional investors and mechanisms to improve majority/minority investor alignment. The Korean National Pension Service, armed with more than $700bn[5] of assets, was quick to adopt the code. But whilst the headlines appear rosy, the view on the ground is more realistic.

Companies have found further advantages through a stickier and more diversified shareholder base, global partnership opportunities, an improved international network, enriched reputations with customers and suppliers, greater liquidity and internal access to a wider pool of talent.

Some companies have sidestepped these pressures and continue to operate in outdated ways where investors rightly question the risk of expropriation of cash. But others have changed – attracted by the carrot of a lower market implied cost of capital and higher valuation multiples as business practices and governance structures are rewarded by the wider market. These companies have found further advantages through a stickier and more diversified shareholder base, global partnership opportunities, an improved international network, enriched reputations with customers and suppliers, greater liquidity and internal access to a wider pool of talent. Competitive advantages are enhanced and management incentive programs kick in.



Source: Bloomberg as at January 2023

Our engagement philosophy: what can the future hold?

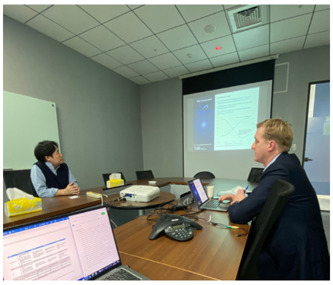
It feels remiss to focus just on the challenges, rather than the solutions that many businesses have in hand through the power of change. Our investment approach has long focused on investing exclusively in emerging market companies for which potential change through engagement is central to the investment thesis. This focus on 'change' is critical. Not only does it imply a business is underestimated, and hence undervalued, but it is also impossible to replicate through passive strategies since they are by nature backward looking. This leads us to seek high quality companies that are undervalued – not because of core fundamental deficiencies, but due to a deficit in terms of governance, capital allocation, disclosure, their approach to material environmental issues and strategic urgencies which are fixable. Once alignment is in place, corporate decision making is more straightforward with inherent incentives to unlock value through such enhancements. Our experience has shown that size doesn't matter – it is the power of ideas rather than the muscle of voting power that matters most.

But the method of engagement matters. Aggressive activism framed by litigious threats, hostility and short termism have largely been ineffective in Taiwan and Korea. Cultural differences, less legal shareholder protection, tightly held ownership and fewer potentially supportive private fund managers blunt the effectiveness of such methods. As we've outlined before[6], our approach to friendly Active Engagement differs. It is instead defined by initially seeking friendly partnership with management teams. Our interactions begin with humility whilst we employ a significantly longer term horizon with an unswerving ambition to first improve alignment. As a result, our interactions with portfolio companies are not shaped around public shareholder letters and shaming. Instead our conversations are private and supportive, communicated through our bespoke 'Engagement Value Creation' presentation decks, recurring open discussions and whitepapers.

Over the course of our trip, we presented to six portfolio companies (two in Korea and four in Taiwan). Our meetings typically last a few hours and involve an operational update with management teams in their offices followed by our presentation to management and Board members in which we walk them through our suggestions for further value creation. Our 'Engagement Value Creation' presentation decks showcase our previous work with portfolio companies, introduce a number of steps that we believe can unlock significant shareholder value, outline the likely impact this can have on the businesses' return profile and introduce comparisons with peer companies (both in emerging and developed markets) that can act as a reference. We stress we are on the same side as our portfolio companies. Our Engagement Action Points aim to provide helpful, material and actionable suggestions that lean on our prior experience and outside perspective.

A number of our investors have found it useful to go through these presentations with us – we would encourage you to reach out if of interest.

In total our trip covered over **30 Action Points** which focus on two key outcomes with a ~40%/60% split: (i) improving businesses' compounding power; and (i) reducing their market implied cost of capital. Levers to achieve these outcomes range widely, including measures to enhance Governance, improve Strategic Capital Allocation, Disclosure and Investor Relations, and introduce our material Sustainability framework to each company. A combination of higher incremental returns alongside a lower implied cost of capital will drive higher economic value added (EVA), and in turn justify a valuation multiple re-rating.



*Engagement in action:
Company meeting in Taiwan*

[5] https://www.reuters.com/markets/funds/skoreas-huge-pension-fund-local-force-driving-won-lower-2022-07-20/
[6] https://gibam.com/insights/engagement-in-emerging-markets-introducing-a-new-normal-of-active-management

I. Compounding Power: Unlocking value through an improved free cash flow profile

This first category of value unlock concentrates on helping portfolio companies improve their compounding power through establishing a pathway to higher Return On Invested Capital (ROIC). This is typically shaped by providing suggestions on strategic capital allocation (dividend policy formalisation, buyback programs, accretive M&A), readdressing their reinvestment strategy, driving operational improvements and aligning incentive structures with minority investors through the inclusion of ROIC as a guiding KPI. Rather than raiding companies of cash, we seek to formalise a capital allocation strategy that balances the needs of reinvestment with capital efficiency.

This leads us to seek high quality companies that are undervalued – not because of core fundamental deficiencies, but due to a deficit in terms of governance, capital allocation, disclosure, their approach to material environmental issues and strategic urgencies which are fixable.

1. Capital returns to augment returns and reinforce competitive advantages

Three of our companies in Taiwan in the semiconductor value chain represented good opportunities for value creation through more efficient capital allocation. Whilst the semiconductor industry has seen a sharp de-rating on account of slowing end market demand and inventory pressures, our three portfolio companies (asset-light semiconductor IC design businesses) are backed by strong balance sheets with significant cash piles. As we argued before[7], we believe that companies can opportunistically deploy cash to buyback shares to drive a higher book value per share. Not only would this be accretive from a capital deployment perspective, it would further calm markets that insiders view the businesses as being fundamentally undervalued. On top of this, the recent geopolitical concerns in Taiwan have created uncertainty surrounding many of these businesses' main competitive advantage – their talent. Anecdotally, Chinese chip IC design companies have been seeking to lure Taiwanese talent to develop their own nascent industry, with proposed salaries as much as 60% higher than existing levels. Were this 'brain drain' to accelerate, it would rapidly deteriorate the competitive positions of a number of our semi IC design and IP companies.

As a result our suggestions to three portfolio companies was to i) embark on an inaugural buyback program of material size; and ii) use the acquired shares to initiate a KPI linked, share option incentive scheme to bolster talent retention. Having ownership in the business rather than being mere employees, naturally inculcates a greater sense of belonging, pride and crucially, commitment. We referenced the case study of TSMC, who recently successfully introduced a well-structured share based incentive programme (with a three year vesting period). These suggestions were met well, with one company since announcing their first ever buyback programme to take advantage of these opportunities. Their share price responded favourably.

2. A wider Capital Allocation vision: balancing accretive M&A and reinvestment needs

Two portfolio companies in Korea have valuations dampened by market scepticism of the durability of their return profile.

[7]https://gibam.com/insights/moral-hazard-the-cfo-put-and-how-active-engagement-helps

Engagement in action: Post meeting in Seoul

For one - a leading internet platform with services offered across advertising, gaming and content - optically high valuation multiples are at risk if return on incremental invested capital deteriorates. This is particularly important for long duration investments, such as this, where a near term focus on profitability must be balanced alongside reinvestment to achieve scale. As such, our engagement Action Points focus on recommendations to introduce a longer term Capital Allocation vision with ROIC focused KPIs that are integrated with management's variable compensation. Our proposals include framing a wider platform monetisation strategy, delivering cost efficiencies across the business, introducing a progressive formal dividend policy and articulating an M&A programme (with transparent IRR targets and target areas) to neutralise concerns of a misallocation of resources.

Another Korean holding, a leader in the semiconductor equipment manufacturing value chain, has seen a high market implied cost of capital emerge due to investor concerns of 'capex creep' – capex overspend in order to cement strong relationships with key customers. This has damaged the predictability of their future free cash flow streams. We encouraged the company to develop a publicly available five year Capital Allocation vision. We suggested including a framework to balance capacity expansion, debt reduction, accretive inorganic growth and a formal dividend policy which will provide an inbuilt safety valve for dilutive capital allocation. This would directly address a key investor concern for a business with market leading competitive advantages but handicapped valuations which we believe are fixable.

3. Improved remuneration incentives: aligning management teams to the metrics that matter most

Engagement in action: "Mirimiri!"

A number of our Action Points for our Korean and Taiwanese companies focused on revamped remuneration metrics to align management teams in an improved way. As discussed above, introducing KPIs that linked ROIC to further share option grants and variable compensation can be helpful to reduce the risk of dilutive capital allocation decisions. Whilst such incentive structures might be common place in the developed world, many companies in emerging markets have primarily focused on revenue growth and balance sheet expansion. This can be fruitful in the throes of a fully-fledged investment cycle, but less so as capital cycles peak and balance sheet repair is required.

Improved incentives are another lever to unlock value in companies where holding company discounts are emerging. Our Korean internet portfolio company has more than 60% of its value attributed to its investment portfolio where a number of subsidiaries remain unlisted. Net asset value (NAV) reporting and disclosure is patchy, incentives are misaligned with a focus purely on NAV growth rather than an acknowledgment of a rising discount to NAV. Their wider approach to optimising for an improved NAV per share through buybacks is unclear. Our engagement solves these inefficiencies through developing a clear framework to build NAV per share. This should include an IRR-linked investment policy to compound NAV over time alongside a buyback programme to drive an accretion in NAV per share and magnify returns on NAV. We are leaning on our historical work with a peer company, who successfully implemented such changes, to help formulate a three step process to unlock holdco value for our Korean business too. The impact of successful implementation can be particularly material.

II. Cost of Capital: Unlocking value through better perception and lower risk

The second category of value unlock involves working alongside our portfolio companies to drive lower their market implied cost of capital. This in turn can result in a higher justified valuation multiple. In particular, we focus on integrating our material Sustainability framework, improving disclosure & reporting standards, cultivating culture fit and institutionalising investor relations. Whilst these might seem cosmetic to developed market investors, such improvements are material in the emerging world. Local language reporting, absent IR, minimal disclosure, non-existent sell side coverage and limited Sustainability understanding are untapped opportunities given the lack of experience and access to third party help.

1. Governance enhancements: a key source of returns

Whilst this might seem cosmetic to developed market investors, such improvements can be material in the emerging world.

Tailored governance enhancements formed a bulk of our cost of capital Action Points across all six portfolio companies in Taiwan and Korea. In particular, our suggestions pointed to an improvement in Board independence and diversity, steps to address related party transaction risks at one of our Korean businesses (leaning on prior successful engagement in both India and Turkey), and suggested methods for how four companies could mitigate the rising wave of regulatory worries. Strong governance provides a foundation for better decision making. However, empirical evidence points to the strongest outperformance not coming from already good companies getting a little better, but instead previously poorly ranked businesses getting significantly better[8]. This is why our bespoke governance engagement work is so important, and crucially, a significant source of latency for the portfolio looking ahead.

2. Our Sustainability Framework: business critical introduction and integration

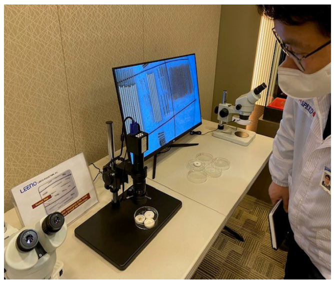
As discussed before[9], material Sustainability enhancements through engagement have proven to be a valuable source of returns. Steering clear of greenwashing, our engagement approach seeks to help portfolio companies improve on their Sustainability standing and address the most relevant and material Sustainability risks and opportunities. Not only does this reinforce competitive advantages and introduce businesses to new growth opportunities, it also reduces perceptions of risk and can reduce the cost of capital through attracting a wave of sizeable sustainability focused investors.

Our three step Sustainability engagement process involves the following 3 steps: i) develop a full stakeholder led Materiality Matrix; ii) introduce a Sustainability strategy through an ambitious long term plan that draws on the conclusions from the prior step and; iii) reinforce these KPIs through linkages in executive compensation. Each portfolio company is different though and at varying stages in their own journey, hence a bespoke set of suggestions trumps any one size fits all approach.

We accelerated such work with four companies in Taiwan and one in Korea. The Taiwanese businesses – who are leading players across the semiconductor design and manufacturing value chain – are surprisingly lowly ranked by most ESG rating agencies.

[8] https://gibam.com/insights/engagement-in-emerging-markets-introducing-a-new-normal-of-active-management
[9] https://gibam.com/insights/active-engagement-activism-our-roadmap-for-driving-more-impactful-change

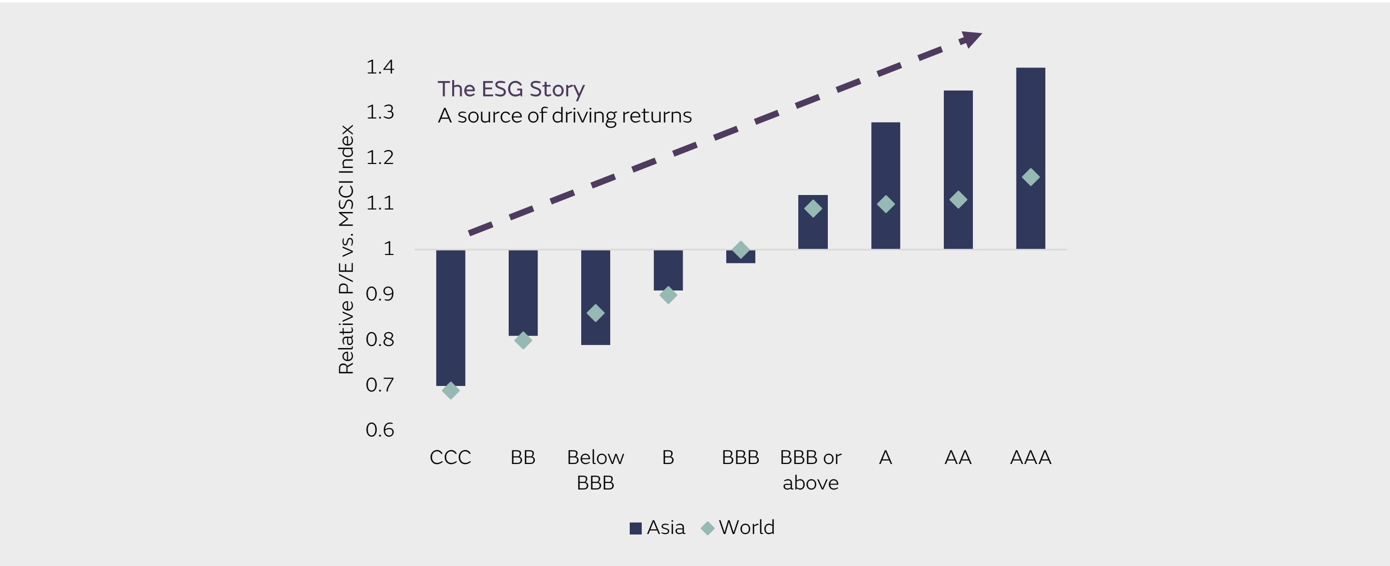
This is not due to any sinister carbon emissions contribution, but rather due to inadequate reporting disclosure. Our engagement with each sought to rectify this, and indeed we pointed to another portfolio company in the same sector from Korea which had made material improvements in this regard. That Korean business had seen a number of ESG rating improvements, inclusion in new indices, had attracted positive sell side coverage and as a result, a lower market implied cost of capital. Again, this highlights the inbuilt latency in the portfolio today as the opportunity for improvements ahead remain.



Engagement in action: At a R&D centre - Busan, Korea

Pressure for Sustainability improvements is not only being demanded from investors like ourselves, but from global value chains too. Many of these businesses supply chips to leading consumer electronics and automotive brands internationally – Apple, Dell and Volkswagen for example. They too require sustainability enhancements since their value chains are being forensically assessed, so any resistance for change in Taiwan can represent a material business risk.

During the trip, it was pleasing to hear the progress of one our portfolio companies in the Taiwanese semiconductor IP space. Following our recommendations a year ago, they have since introduced an executive committee with explicit ESG reporting targets alongside oversight of medium and longer term goals for the company. Many companies across emerging markets suffer from low ESG rating scores due to limited internal efforts to disclose any sustainability-related actions and initiatives. This is an exciting engagement opportunity for us. As businesses embark on this rating transition, statistical and empirical evidence point to the positive impact this can have on a lower cost of capital and subsequent valuation multiple re-rating.



Source: Jefferies, Factset alpha tester, MSCI

3. Institutionalising Investor Relations: reducing friction for investors

Two of our portfolio companies in Taiwan and one in Korea are underselling their businesses. Whilst their sharp focus on strategic positioning and operational excellence is commendable, a deficiency in laying out the company's vision and facilitating investors to do their job has driven a mispricing. This can be unlocked. Our work with these three businesses focuses on introducing English reporting, articulating a clear five year vision, encouraging them to disclose financial information to data platforms, driving sell side understanding and coverage, and showcasing their market leading capability through Investor Days. Much of the discussion with our portfolio companies is to assuage fears that such practices won't be giving away the company's secrets, but instead highlight the attractive investment opportunity for the wider market.

The impact of such engagement success can be significant. For example, the Korean business – a market leader in the semiconductor equipment manufacturing value chain – trades at a 75%[10] discount to its peers despite market leadership, accelerating sector tailwinds and clear competitive advantages. Its financial metrics (gross margins, return on equity and return on invested capital) are superior to peers which implies its discounted valuations are explained by a relatively high cost of capital. Our work is to address this and much can be attributed to a lack of English reporting, non-existing financial disclosure, zero sell side coverage whilst their progress on Sustainability is in its infancy. Our presentation to the company focused on how these enhancements represent easy wins, with convergence to peer multiples implying a 4x return. We were encouraged with their ambition and intent to see these changes come through.

Engagement in action:
Production line tour - Anseong, Korea

2023: An auspicious start with wider emerging markets optimism abound

Whilst we are pleased with the results so far – there remains much more to do. We continue to be excited about the hidden value that exists in our portfolio and the engagement steps ahead to unlock it. Our team have a busy period ahead - travelling to present our 'Engagement Value Creation' decks to other portfolio companies in Indonesia, Vietnam, India and China over the next few weeks.

This inbuilt portfolio wide latency, alongside the increasingly attractive wider Emerging Markets opportunity, has the potential to be an exciting foundation for strong forward returns to come.

Cái yuán gun gun!

[10]GIB AM analysis, 2023

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