



THE LONG VIEW

# Notes from the Road - South Korea & Taiwan

In his interesting 2022 book *Chip War*<sup>1</sup>, economic historian Chris Miller notes that Taiwan provides 37% of the world's new computing power each year and that two Korean companies produce 44% of memory chips.

Both countries' position in the global supply chain has increased markedly in importance in recent years and success in areas such as semiconductor manufacturing has spawned new generations of companies that have become global leaders within their niches. We recently spent time visiting over 30 companies throughout both countries and came away impressed at the innovation and leadership we saw – outside the technology sector as well as within it. Here we share some of these insights, shining a light on great businesses that caught our attention and giving cause for optimism when looking at the investment opportunities available in East Asia.

## SOUTH KOREA

Our focus in South Korea tends not to be on the big names. The local economy is dominated by large family-controlled conglomerates known as 'Chaebols'<sup>2</sup>. The 10 largest of these groups today make up almost 60% of the country's GDP<sup>3</sup>. These companies' growth has been impressive, but has also led to sprawling corporate entities with interests in many disparate sectors, which are often difficult for outside investors to pick apart – for example, Samsung started as an exporter of dried fish in the late 1930s. Cross-shareholdings are a common feature, too, used to protect a family's controlling influence. Their success has also been helped by close relationships with the ruling powers, which have historically allowed them to retain their positions of dominance. Governance and treatment of minority shareholders have sometimes been questionable, with the current heads of the two largest groups, Samsung and SK, having spent time in prison for financial crimes related to bribery and embezzlement<sup>4</sup>.

Although this backdrop may suggest our time and resources could be better spent elsewhere, it is far from painting a full picture of the investment opportunity. If one looks beyond the behemoths, there are many businesses exposed to strong structural growth trends where no compromising on either quality or alignment is necessary.

South Korea's chip-building evolution over the past 30 years has created scale for local specialist equipment suppliers to blossom into global leaders. Take the examples of three companies we visited on our trip, which specialise in inspection and testing equipment – **Koh Young Technology**, **Park Systems** and **Leeno Industrial**. All three started without ownership ties to Chaebols or government and are still run today by their founders, who own significant stakes. Other common characteristics include being global market share gainers in their niches, selling 'high-value-add' products (as is demonstrated by strong gross margins) and having robust balance sheets capable of withstanding downturns.

We were particularly keen to visit Leeno Industrial, having built up our knowledge of the company from afar over the past few years. Leeno sells precision testing equipment, primarily for use with integrated circuits, and most of its sales come via exports. Core to its competitive advantage is the ability to mass-produce tiny testing pins to exacting specifications, which are then used by customers to probe chips for quality assurance.

To get there, we took the excellent high-speed rail to Busan, South Korea's second-largest city. Our train ride down was rewarded with an illuminating tour of Leeno's production lines and a better appreciation of their vertical integration in machinery and the level of customisation required for each customer order.





Another area where innovation has been allowed to prosper is in video gaming. Interestingly, the Chaebols attempted to dominate this market too in the early 1990s, through distribution of Japanese consoles and games – **Samsung** partnered with **Sega**, and **Hyundai** with **Nintendo**. This left a gap for independent players to emerge with localised content for the Korean market. **Nexon**, which is currently held by the strategy, is a pioneer in online multiplayer games dating back to its 1996 title *Kingdom of the Winds*, which is still played online today. The company has created tremendous IP since then. *Dungeon & Fighter* was launched 18 years ago and has generated over \$22 billion in gross revenue, making it one of the most successful video game titles in history and even earning several billion dollars more than the box office takings for the Star Wars and Harry Potter series<sup>5</sup>. The company is listed in Japan but the bulk of its developers are based in South Korea, as is the majority of revenue. What marks it apart from peers is its diversification of revenue streams across multiple enduring titles, lowering the risk that any one game fails to deliver.

On this trip, we had the chance to meet many of their Korean listed peers, including **NCSOFT**, **Pearl Abyss** and **Krafton**. All three of these companies are finding it challenging to follow up on a single successful title and thus remain highly dependent on a risky revenue stream. Whilst one of their 'shots on goal' may pay off, we prefer the surety of Nexon's model and resilient free cash flow. Perhaps the strongest endorsement we received was from the investor relations representative at another game developer professing his passion for *MapleStory*, one of Nexon's long-running titles!

South Korea's inclusion in MSCI's Emerging Market Index has long been a source of debate. Other index providers such as FTSE Russell and S&P Dow Jones consider it a developed market, which is no major surprise given its real GDP per capita surpassed that of Japan in 2018<sup>6</sup>. Just after we returned from this trip, MSCI announced that Korea was still falling short on several market accessibility issues in their view, which would prevent an upgrade in classification. Issues flagged range from the ease of currency trading for overseas investors to the fact that Korean companies disclose dividend amounts after the ex-date of the dividends, which differs from international standards<sup>7</sup>. MSCI did note, however, that improvements are being made with respect to treatment of foreign shareholders and this is something we saw on the ground. A few companies we met, including **Naver**, the dominant internet search company in South Korea, committed to cancelling treasury shares and returning cash to shareholders. English-language information disclosure, another issue for MSCI, is also increasing. We have little idea if or when MSCI will upgrade South Korea but, regardless, it is a market in which we believe a keen focus on governance will help avoid mistakes.



## TAIWAN

Best-in-class global franchises are also found in Taiwan. Whereas Korea embraced the Chaebol system Taiwan encouraged the formation of small and medium enterprises, particularly those with an export focus. For a relatively small country of 23.6 million people, it has a deep pool of listed companies and has always proved a fruitful source of ideas for the strategy. Living in the shadow of mainland China has helped forge resilient businesses and management teams with sensible attitudes towards financial risk that chime well with our approach. Balance sheets with large reserves of cash and little debt were a common feature of the businesses we met.

**Nien Made**, a family-run leader in custom window coverings, had more than 10% of its market capitalisation in net cash<sup>8</sup> and exemplified this conservative approach.

The realignment of global supply chains also came up in many conversations. A desire to source key components closer to home for many countries is being driven by issues experienced during the Covid-19 pandemic as well as rising geopolitical tensions between the United States and China.

**Taiwan Semiconductor Manufacturing Company (TSMC)** is at the crux of this discussion, being the largest outsourced manufacturer of computer chips and one of the world's largest companies, with a market capitalisation of over \$400 billion. Whereas TSMC's investment in new fabrication facilities in the United States and Japan has been well documented, it was interesting to hear how other Taiwanese companies are dealing with these shifts.

**Advantech**, a supplier of embedded computers that help automate factories, is looking to double its US sales capacity as its end customers 'onshore' more production. In the case of **Delta Electronics**, a leading supplier of power and thermal management technologies, we were told that all their incremental investment is now outside their largest market, China, as they follow their customers to SE Asia, India and North America. Importantly, many of these shifts are creating incremental demand for their products and management see this as a continuation of the company's expertise spreading globally.

**MediaTek**, which designs chipsets for smartphones and other connected devices, recently announced a partnership with **Nvidia** to create chips for the next generation of cars in a further example of the recognition of Taiwanese IP.

We also spent time with consumer companies that have become leaders in their field. Taiwanese companies dominate the global market for mid and high-end bicycles. This dates to the 1970s and their ability to respond quicker than peers to win large orders from the big US brands during a boom in cycling<sup>9</sup>. **Giant Manufacturing** and **Merida Industry** remain at the forefront of the industry today. Although they are based close together in the city of Taichung, the difference in style of headquarters is striking. Giant, the larger of the two by market capitalisation, had moved to a new purpose-built tower since we last visited, complete with adjacent cycling culture museum. In contrast, every square metre at Merida HQ is used, with management's offices adjacent to the production lines and warehouses. We were told that during peaks in demand even the staff car park is commandeered for finished bikes waiting to be shipped out. Merida has historically had to be more frugal as it sells fewer of its own-brand bikes and thus has lower revenue and profits, instilling a strict discipline on costs. The real value of the company, however, comes from its stake in Specialized, a high-end brand sold mostly in Europe and the United States.

## LESSONS FOR THE ROAD AHEAD

Research trips are helpful for building further knowledge of existing holdings and generating new ideas, but they also help us avoid mistakes. In both Taiwan and South Korea we came across companies that would fail to meet our expectations for alignment. We saw companies who were competing directly with their customers, shareholders' funds being spent on lavish offices and complicated ownership structures that leave minority investors open to abuse. In one case a listed subsidiary was being charged well above market rent by its parent company for its key facility. All this serves as a timely reminder that integrity matters when seeking to avoid permanent loss of capital and travelling in-country can be another powerful line of defence in our investment approach. However, as we have detailed above, there is plenty of cause for optimism and further reasons to believe that the best companies in emerging markets are among the best companies anywhere in the world.

## SOURCES

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# Contacts

## SKERRYVORE

45 Charlotte Square, Edinburgh EH2 4HQ

clients@skerryvoream.com

### Ian Tabberer

Portfolio Manager

Ian.Tabberer@skerryvoream.com

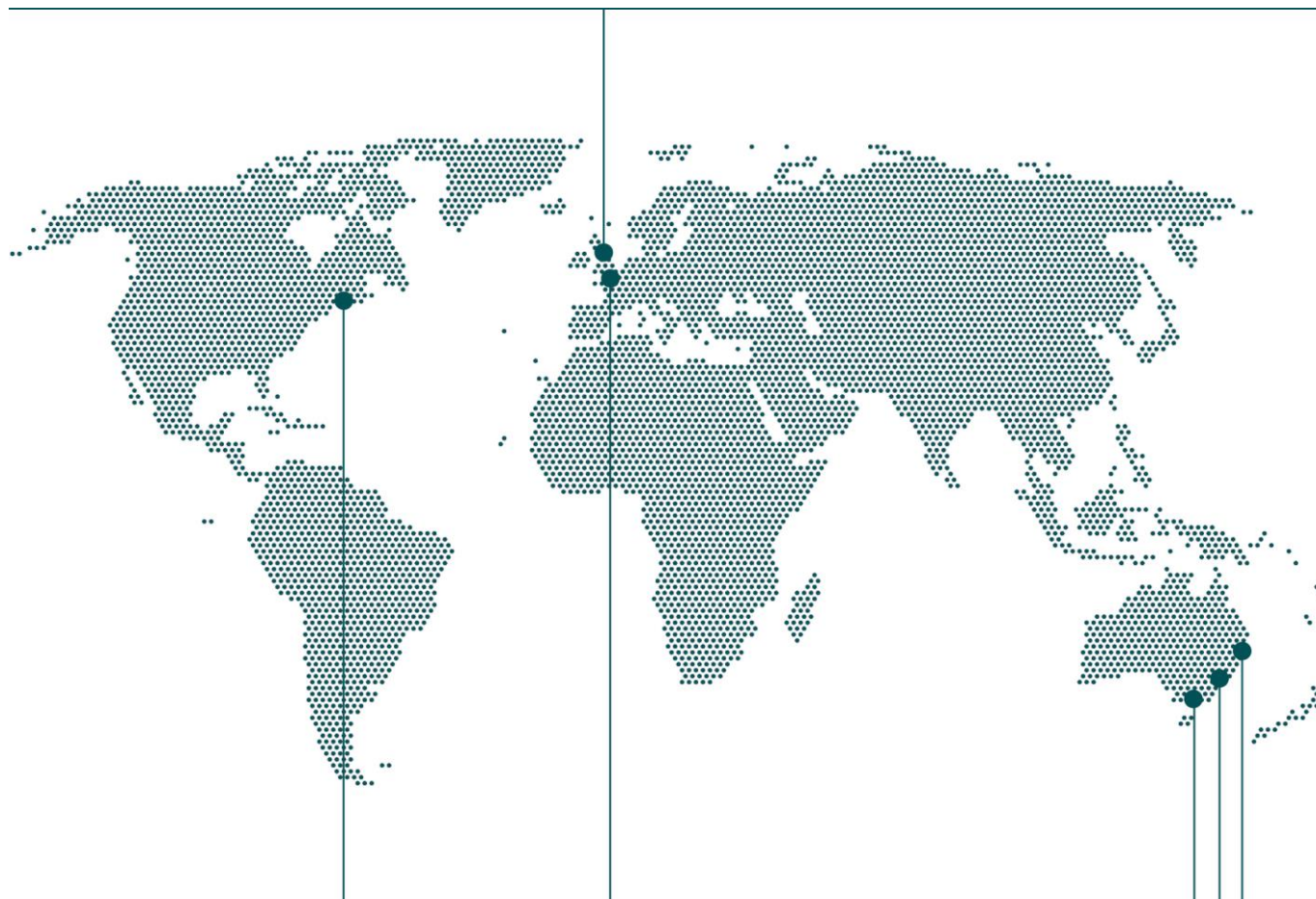
+44 (0) 131 202 3074

### Sarah Monaco

Investment Director

Sarah.Monaco@skerryvoream.com

+44 (0) 131 202 3070



## BFM GROUP

### BENBRIDGE - UK

108-110 Jermyn Street, London SW1Y 6EE

IR@bennbridge.com

### BENBRIDGE - US

260 Franklin St, 16<sup>th</sup> floor, Boston MA 02110

us.inquiries@bennbridge.com

## BENNELONG - AUSTRALIA

Level 26, 20 Bond Street, Sydney NSW 2000

Bennelong House, 9 Queen Street  
Melbourne VIC 3000

Level 37, Riparian Plaza, 71 Eagle Street  
Brisbane QLD 4000

Level 1, 81 Stirling Highway, Nedlands  
Perth WA 6009

client.experience@bennelongfunds.com



SKERRYVORE

Tel: +44(0) 131 202 3070

Email: [clients@skerryvoream.com](mailto:clients@skerryvoream.com)

[www.skerryvoream.com](http://www.skerryvoream.com)



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