2021 Mid-Year Pan-Asian Equity Market Review: EVs and 5G two big growth opportunities

Longlead Capital Partners

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Mid-Year Pan-Asian Equity Market Review: EVs and 5G two big growth opportunities

- Pan-Asian economic growth expectations across the region have been revised upwards
- A long/short approach to equity investing has advantages as at these times divergent performance between companies and sectors proliferates which boosts alpha opportunities.
- There remain areas of opportunity on the long side where strong growth is likely to continue in the second half with two of these being the growth of electric vehicles and 5G telecommunications.
- EV sales grew by 40% last year despite the pandemic, and this growth has accelerated in the early part of 2021. The low level of current penetration also suggests a long runway for significant growth in the future.
- Longlead's mapping of the supply chain in Asia exposed to the EV thematic has identified more than 100 companies with a collective market cap of more than US$2 trillion

August 2, Sydney: As 2021 progresses much has changed in the Pan-Asian investment landscape. On the positive front economic growth expectations across the region have been revised upwards from the levels expected at the beginning of the year on stronger demand for goods and services driven by the reopening of economies across the globe as well as unprecedented fiscal and monetary stimulus programs. This has driven material upwards revisions to company earnings expectations in countries such as Korea, Taiwan, Japan, Singapore, and Australia.

Counterbalancing this has been negative revisions to earnings expectations in China and Hong Kong. These latter two country's trends are attributable to the combined effects of early policy normalisation and an intensified regulatory drive in China coupled with cost inflation running hotter than original expectations in many sectors. The other notable change to the landscape is the emergence and spread of the Delta COVID variant which is presenting as a new challenge from a public health control perspective in many countries and is elongating the pandemic reopening pathway, potentially requiring even larger fiscal stimulus programs.

Equity market performance across Pan-Asia in 2021

Equity market performance across Pan-Asia in 2021 has broadly followed these diverging earnings trends. Equities have performed well in countries where earnings expectations have continued to improve such as Taiwan, Korea and Australia and have fallen in China and Hong Kong since February where the opposite has eventuated.

As we look ahead, individual country purchasing manager indexes (PMIs) provide a forward-looking lens on how these dynamics are evolving from here. In China and Hong Kong, PMIs have fallen from their peak in the first quarter which is indicative of slower growth in the second half of 2021. Even in countries like Taiwan and Australia that have materially exceeded original economic growth expectations, PMIs are now retracing but are doing so from a high base and remain at levels signalling slower but still robust growth. This dynamic is not limited to Asia with the same trends evident in the US and is indicative of peak growth having passed as economies have cycled the initial impacts of the COVID pandemic early in 2020. While these indicators are normalising now, corporate earnings growth remains the base case albeit at a decelerating pace.

The importance of these dynamics for equity markets is two-fold. First there is a clear relationship between forward earnings expectations and leading activity indicators like the PMI. When PMIs indicate expansion, earnings expectations typically rise and vice versa. Second, there is also a broad relationship between P/E ratios and PMIs. As economies accelerate, market multiples expand and as they slow multiples typically contract. This multiplies the effect of the business cycle on share prices. Demonstrated by the divergence between the equity market trends of countries across Asia in the first half of the year, the path of earnings expectations matter to equity market performance and with the current PMI indicators, it is reasonable to expect aggregate earnings growth expectations to slow and multiples to potentially contract resulting in lower aggregate equity returns through the remainder of 2021 across the region.

But conditions are always evolving and it is necessary to ask what could surprise. In China, despite the recent concerns over a regulatory crack down on sectors such as the Internet, property services and education that has resulted in widespread foreign investor selling of China equities, we note that the drag from policy normalisation on the corporate sector may move to a more neutral stance in the second half and help to stabilise earnings expectations.

The recent surprise reserve ratio cut by the Peoples Bank of China is indicative of such an intent. If further drag from macro tightening is removed late in the year, a return to earnings expectations growth in China in the fourth quarter, supported by strong export demand from reopening economies and faster fiscal spending from the China government, is a possibility that we are monitoring as it would support a potential rebound in China equities. This seems a low probability scenario at a time like now when China equities are falling rapidly, however investors need to be alive to just such a possibility given the speed with which rebounds have appeared in many markets since COVID appeared.

The recent rebound in the copper price which is typically sensitive to such trends also points to a potential stabilisation in China growth expectations ahead. When we separate the recent regulatory surprise from the macro indicators, China was first to rebound from the initial impacts of the pandemic, the first economy to pass peak growth and normalise policy and when stabilisation eventuates is a potential source of surprise, with expectations and equity prices low moving into the remainder of the year. While regulatory risk remains high however, investing in China equities requires a highly selective approach.

Given these macroeconomic trends a long/short approach to equity investing has advantages as at these times divergent performance between companies and sectors proliferates which boosts alpha opportunities. Even in a slowing growth environment there remain areas of opportunity on the long side where strong growth is likely to continue in the second half with two of these being the growth of electric vehicles and 5G telecommunications.

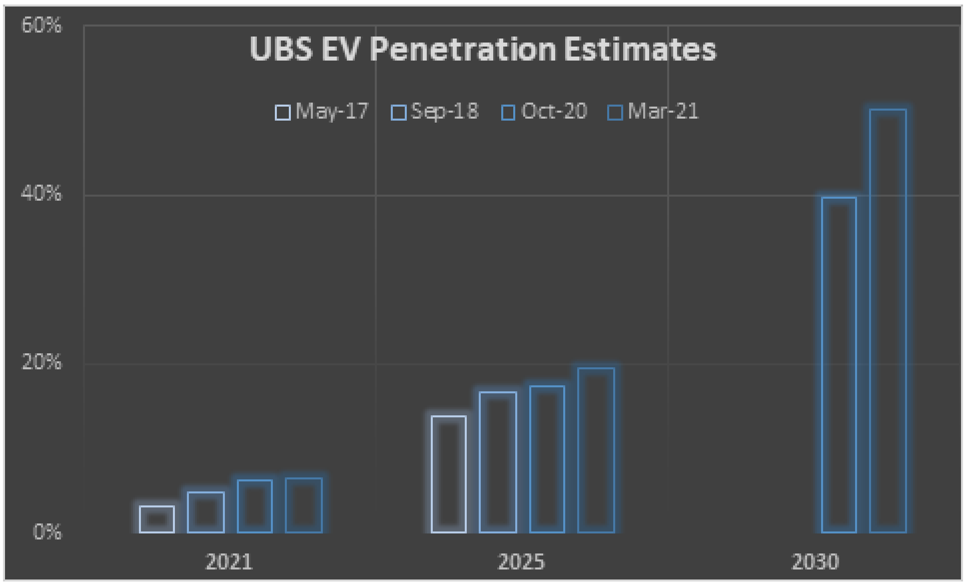
Electric Vehicles: 100 companies in supply chain identified with a collective market cap of more than US$2 trillion

The global automobile fleet is moving from technology fuelled by internal combustion engines to electric vehicles ("EVs") powered by lithium-ion batteries. This is an enormous, structural growth opportunity that will play out for the next decade and beyond.

Historically, EVs have been a market characterised by hype and hope. Fifteen years after Tesla launched its Roadster, total EV sales represented fewer than 5% of all cars purchased globally in 2020. However, the market has grown steadily off a low base during that time, and now appears to be at an inflection point. EV sales grew by 40% last year despite the pandemic, and this growth has accelerated in the early part of 2021.

The low level of current penetration also suggests a long runway for significant growth in the future. In seeking to understand the investment implications and opportunities, several features stand out.

The first of these is that despite widespread agreement that EVs represent a large and rapidly growing opportunity, **the market has repeatedly and consistently underestimated the rate of change and the speed at which EVs are being adopted**. Near-term expectations of growth are being revised upwards as the industry faces greater-than-expected demand, but so too are longer-term projections. A review of the EV penetration estimates from UBS shows a consistent increase in its expectations for EV adoption:



Between October 2020 and March 2021, UBS, increased its expectation for 2021 EV demand by 7%, 2025 demand by 15% and 2030 demand by 30%. UBS isn't alone. Virtually every broking firm, research house, automotive maker and market participant has had to steadily increase their expectations of EV adoption, and the rate of this increase has only accelerated in recent periods. Based on the experience of a country like Norway, an early adopter of EV which grew penetration from less than 6% in 2013 to 56% in 2019, today's estimates are likely to prove conservative. What this means from a stock valuation perspective is that current-published market expectations in sell side research probably underestimate the rate of adoption and revenue growth for companies exposed to this sector, and that this discrepancy is more pronounced the further out you look.

The second aspect that stands out is that the story of **EV adoption is very much an Asian-centric one.** Previous technology paradigm shifts typically had their origins in developed markets such as US (software) or Europe (clean energy). By contrast, as much as people immediately think "Tesla" when invoking electric vehicles, the five largest manufacturers of EV batteries are all located in Asia, spread between China, Korea and Japan. This is significant, as this is where the intellectual property largely resides. While the raw materials are extracted from all over the world, they are processed into refined materials and components are designed and manufactured in factories in Asia, with China alone representing 60-80% of the chemical processing, component manufacturing and a large percentage of battery cell production. On the demand side, China remains the largest market for EVs globally, larger than both the European Union (outside of a brief period in late 2020) and orders of magnitude larger than the US.

The third aspect of the EV thematic is its size and complexity**. Longlead's mapping of the supply chain in Asia exposed to the EV thematic has identified more than 100 companies with a collective market cap of more than US$2 trillion**. By value, these are broadly evenly split between the automotive manufacturers and parts suppliers on the one hand, and the battery manufacturers and associated supply chain on the other.

Longlead's preferred exposures are those where we expect both top line growth as the industry shifts to EVs, and for this to translate into increased earnings power, which we do not expect to be the case for all industry participants. These largely fall into three categories.

1. The first of these are automotive manufacturers whose product portfolios are likely to see them gain market share as the vehicle market becomes electrified. Companies like **Hyundai Motor Group** in Korea and **Li Auto** (listed in the US but selling EVs into the Chinese market) both fit into this category.
2. The second category is the manufacturers of the batteries themselves, where a small group of companies like **LG Chem** and **SK Innovation** in Korea, **Panasonic** in Japan and **CATL** in China hold a high percentage of the global share of batteries and have recently reached or are about to reach inflection points in their earnings due to improving scale.
3. The third area is in segments of the supply chain where we have identified bottlenecks, either in the procurement or processing of materials or due to IP or cost advantages which are likely to confer increasing market share and earnings over time. These include the producers of lithium chemicals such as **Ganfeng Lithium** in China, where the market has entered into a phase of shortages much faster than expected, and where the end-demand is largely driven by EV adoption. Other areas include the manufacturers of battery separators, where participants such as **Yunnan Energy** in China and **SK IE Technology**, a recent IPO in Korea, have clear cost and intellectual property advantages that should enable them to grow at above-market rates for a sustained period of time.

The area is not without risks. In the short-term, many companies exposed to the EV industry will experience strong top line growth buoyed by the tailwinds of EV adoption. However, this manifests itself in high valuations and the creation of expectations of future earnings which may not be met. EV adoption is reliant in part on falling prices for both batteries and vehicles to make them affordable to consumers. This is likely to impact the earnings opportunity of companies in the supply chain without a clear cost or technology advantage who will see their margins impacted as the industry matures. The vehicle manufacturers are accelerating this process by in-sourcing technology to enable them to reduce unit costs and differentiate versus competitors. The sector is also seeing rapid technology change. In particular, the batteries used to propel EVs are likely to gradually switch from the current paradigm of lithium-ion batteries to solid state batteries which theoretically offer higher energy density and therefore better driving range. This will likely displace some of the beneficiaries of the current wave of lithium-ion adoption and create a new cohort of winners and losers. The rapidly changing dynamics of EV adoption create a favourable opportunity set for the Fund to benefit from this emerging dispersion.

5G Telecommunications: significant technological change is presenting opportunities

Another area where significant technological change is presenting opportunities for the firm is in 5G. "5G" stands for "fifth generation" and refers to the technology standard for mobile networks that are being deployed throughout the globe today.

Every few years, the technology standards underpinning mobile networks are upgraded, necessitating upgrades to the networks themselves as new network equipment is deployed to take advantage of the upgraded capability of the new network standards. 3G deployment, which occurred during the mid-to-late 2000s, allowed higher speed data transmission over mobile networks, while 4G enabled videos to be streamed on mobile devices. 5G networks offer the promise of greater bandwidth, higher speed and lower latency services, which will in theory open up mobile networks to perform a range of use cases that they were previously not suited to.

From an investment perspective, 5G has rolled through the market in three phases, each of which has had a different group of beneficiaries. The first phase involved the building of the networks, which meant deploying hard assets such as fibre optic cable, base stations and antennas. This was a boon to the companies building the networks but came at the cost to the network operators. At the time, the operators were facing declining earnings from their existing 4G networks, with mobile companies across the globe resorting to price-based competition to win market share in mature, saturated markets. As such, the added cost of building expensive networks that they were yet to monetise was particularly painful, with many operators around the region experiencing declining cash flow and falling dividends. This ultimately gave way to the second phase, which is where we are now. Many operators have built their 5G networks to a point where they are deploying large numbers of users onto them, and these users are in turn paying higher prices to access the high speeds offered by 5G. Investors were initially sceptical of investing in the industry after years of declining earnings, which has created opportunities in companies like **Telstra** in Australia and **SK Telecom** in South Korea. These companies have passed the peak of their 5G capex and are seeing accelerating revenue and earnings as they add valuable 5G users to their customer base. The early phase of a new mobile network deployment typically favours market leaders like Telstra and SK Telecom, as we believe they have the best networks, the strongest balance sheets and the greatest ability to deploy the new generation quickly and to benefit from its adoption. At the same time, the firm sees opportunities to bet against companies in countries where the deployment of 5G is less advanced, competition or regulatory intervention is driving down 4G prices, and capex is yet to peak.

The vast majority of 5G users today are consumers. For these users, 5G is in practice largely "4G plus", with the primary benefit being the ability to perform existing use-cases at higher speeds, rather than enabling something fundamentally new. However, 5G will transition over the next few years from 4G plus to millimetre wave ("mmwave"), which will allow even faster speeds and lower latency as the 5G networks start accessing much higher frequency spectrum than is used today. As this happens, 5G will enter its third phase. mmwave will allow companies to run use cases that require enormous quantities of data in a single location, enabling use cases like greater factory automation and remote health care. The potential opportunity here is substantial, with many network operators estimating that the advent of mmwave will create much larger revenue pools than those of consumer 5G. These use cases are still being commercialised, so it's not clear today who the beneficiaries of this increased technological capability will be. We will continue to closely follow this space to enable us to understand the opportunity set that inevitably arises from this changing environment.

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Attributed to Andrew West, Managing Director at Longlead Capital Partners.

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Longlead Capital Partners is a specialist Pan-Asian long-short equity manager that focuses on identifying investment opportunities inside the rapidly changing business environments that are unique to Asia and was founded in 2014 by Tim Campbell & Andrew West. Longlead operates investment strategies that target absolute returns with low correlation to equity markets using fundamental bottom up stock selection. The team which is situation in Singapore and Australia utilises an "on the ground" research model that leverages insights obtained from a broad universe of companies right across the region.

Dr Andrew West is a Managing Director and co-founder of Longlead based in Longlead's Sydney office. Andrew has two decades of experience in investment and financial analysis across hedge funds, private equity, and academic research and holds a 1st class honours degree in Commerce and a PhD in Economics (Finance) from the University of Sydney.