Taiwan: setting the bar high

Notes from the road

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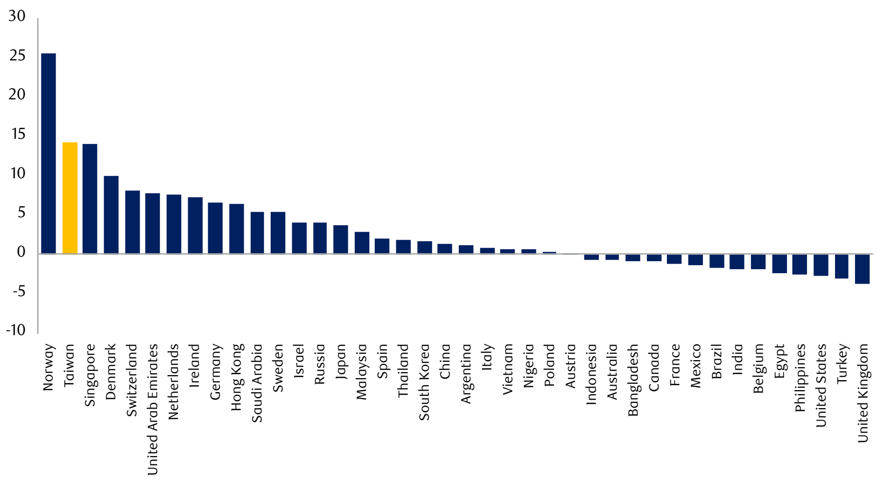
"Over the last twenty years, Taiwan's current account surplus has increased from 2% to 14% of GDP, the second highest in the world and a reflection of the country's competitiveness."

When I first visited Taiwan several years ago, I wouldn't have assumed that it has a higher GDP per capita than that of my native Italy, or that it features in the top ten countries in the world on a variety of metrics, such as global competitiveness and digital innovation[1].

Over the last twenty years, Taiwan's current account surplus has increased from 2% to 14% of GDP, the second highest in the world (Exhibit 1) and a reflection of the country's competitiveness, which is built on innovation, manufacturing excellence and, most importantly, trust.

These statistics stand in stark contrast to the impression given during the drive from Taoyuan International Airport to the city of Taipei, where 649,300 buildings (roughly 70% of the city's total) are more than 30 years old[2]. The pace of development has been limited, with only 25,000 buildings (less than 3%) completed in the last five years[3]. Interestingly, even though over 20% of the population is aged 65 or over, many of these old residential buildings do not have elevators, which is creating a problem for the fast-ageing population. As much as I consider frugality a quality in assessing the management of the companies we invest in, I had meetings with CEOs in buildings that certainly did not live up to the strength of the franchises they manage!

Exhibit 1: Current account % of GDP by country



Source: Bloomberg, as at 2023.

[1] IMD, World Economics Forum, World Digital Competitiveness ranking 2023.
[2, 3] Taipei housing difficult for aging society: experts - Taipei Times.

Taipei was developed as the Chinese arrived from the mainland in the 1950s and 60s, when they thought their stay would be temporary. The idea was to return to mainland China and, that being the case, aesthetics and durability were not considered important. Taiwan was also still relatively poor at that time.

Following a very busy week meeting twenty-four corporates, a few questions spring to mind on my return to London.

Firstly, given that half of Taiwan's population lives in Taipei, the country's main business, financial, and technological hub, will the city ever receive a true facelift and catch up with the country's industrial status? Secondly, given Taiwan's dominant position in many industries' global supply chains, can the country improve or even just maintain its status from here? Thirdly, the Information Technology sector has performed very strongly over the last 18 months, but can this continue throughout 2024 and beyond? Taiwan accounts for around two-thirds of the IT sector's market cap in emerging markets ("EM"), and during my week there, I spent a significant amount of time going back and forth to Hsinchu, Taiwan's equivalent of Silicon Valley, where I met with many of the key players in this industry.

Will Taipei ever get a facelift?

This first question is the easiest to answer, as it is already happening. In fact, quite a few of the corporates I met are in the process of relocating to new headquarters. Management remains frugal, an aspect we appreciate, but the decision to move to newer buildings is a strong sign of confidence and it is positive for employees. This process had started a few years ago, just before Covid, but the overhaul is becoming more noticeable: I witnessed new, sleek residential and office buildings, commercial centres, and recreational parks. Roads and bridges have also started to replace old infrastructure, and cranes and construction sites are in abundance. Examples are the Taipei 101 tower and new financial centre, high-end shopping malls, and the residential buildings around the tower, where my hotel was located. In a sense, the Taipei 101 tower represents the growing confidence of Taiwan.

Will Taiwanese corporates be able to maintain their competitive positions within global supply chains?

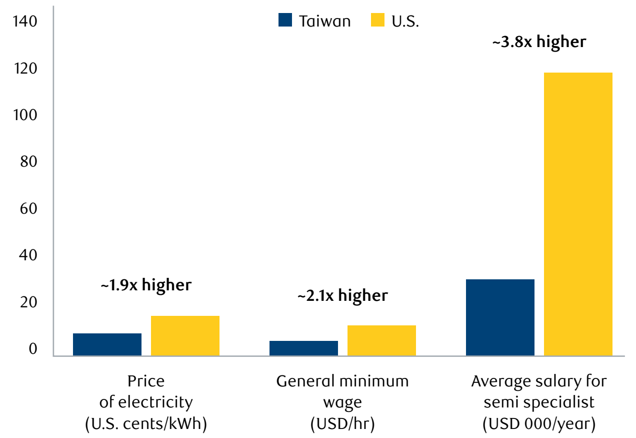
In terms of this second question, Taiwanese corporations are in a difficult situation, which is paradoxically the curse of their success. Over the last decade, Taiwan has become an indispensable part of global supply chains in many industries. However, this importance has resulted in threats and pressure (primarily from U.S. and European customers) for companies to reduce that reliance, and where that is not possible, to reduce the risks associated with such unavoidable dependency. These include geopolitical and reputational (as they pertain to ESG) risks.

Taipei at night.

Such companies are having to balance the demands of their various stakeholders, from the short-term interests of many investors, who often tend to focus on next quarter's earnings, to those of their customers.

With regard to geopolitical risk, many Taiwanese corporations have been under pressure to diversify their manufacturing and, as a result, they have invested in capacity in Southeast Asia and the U.S.. Productivity and cost structures in these regions tend to be less competitive than in Taiwan and China (Exhibit 2), which dilutes returns. Thus far, Taiwanese firms have managed to maintain profitability during the transition to higher value-added products, although it is difficult to imagine future improvements, given the obstacles and the levels reached.

Exhibit 2: Key operating expenses comparison – U.S. versus Taiwan



Source: Goldman Sachs, as at 2023.

Measuring, reporting, and improving ESG indicators also has a cost, and from what I heard during my meetings in Taipei, this is frequently not fully passed through, posing a barrier to further profitability improvements. For example, Taiwan's energy matrix is heavily dependent on fossil fuels. In 2023, approximately 80% of Taiwan's electricity generation and over 95% of its energy consumption came from these fuels[4]. The government has set an ambitious plan targeting 20% of energy from renewables by the end of 2025, increasing to 40% by 2030[5], but progress so far has been slow. Until the country's efforts in green infrastructure begin to deliver results, corporates don't have much choice but to pay higher prices for renewable energy, buy carbon credits and/or invest at a cost in their own off-grid renewables.

A positive aspect of Taiwanese corporations, many of which are still family owned, is their long termism. They are willing to sacrifice short-term profit by acting in a way that – while not generating returns for years – should improve their franchises over time. This 'crossing the river by feeling the stones' approach to business has laid the foundations for Taiwan's success, and it remains unchanged, giving me confidence that the country will successfully overcome these hurdles.

Where are we in the tech cycle?

Answering the third question, the outlook for the IT sector requires the balancing of short- and long-term factors. Despite the strong structural forces that are likely to support its growth in the long run, the sector will remain cyclical, with peaks and troughs caused by inventory adjustments, demand, valuations, and investor positioning. The discussions I had with numerous CEOs reinforced my conviction that this cycle seems extended and may not be too far from its peak. There are three key reasons for this view:

Firstly, demand is narrower and weaker compared to other cycles. It has become clearer following this trip that AI is the primary driver of this current cycle in terms of real, incremental demand; however, AI is estimated to account for less than 10% of the sector's revenues[6]. It also became clearer during meetings with key players that the 'cannibalisation' between AI and basic servers will continue in 2024, and that this wasn't just a short-term forced budget adjustment in 2023; for the time being, it is a capital allocation decision. While consumer electronics demand is recovering, it is being driven by inventories. This follows the rapid de-stocking of the previous two years, which has been larger than in previous cycles. However, 'real' demand from consumers remains modest.

Secondly, the length and magnitude of equity gains is already well above the average gain recorded in all upcycles during the last 20 years. Typically, upcycles for semiconductors last around 12.5 months, with an average equity gain of 75%. Tech stocks bottomed out in the third quarter of 2022, which means we have already seen about 15 months of gains, resulting in a 124% increase in the SOX share price (a global index composed of semiconductor companies) from the trough[7]. By these measures alone, this cycle looks mature. At the same time, sales and EPS growth for the sector have only recently (as of the fourth quarter of 2023) turned positive.

Thirdly, the valuation of the EM IT Sector is now above the long-term average, given the strong performance.

Tech stocks generally peak and trough two quarters before earnings do. On balance, we must also acknowledge that, just as investors discounted the bottom much earlier this time, or one year before the bottom in earnings, they may also discount the peak in earnings earlier than in the past. In that case, while it is certainly difficult to perfectly time the cycle, our team's research suggests that at this time we would be inclined to reduce exposure during periods of strength. This is particularly true when we consider that this cycle may be weaker than previous ones.

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Overall, my visit inspired confidence that Taiwan will be able to maintain its competitive position in global supply chains, given that the strong ecosystem it has built over decades would be difficult to replicate in terms of reliability, competitiveness, trust, and integrity. This is especially true with regard to technology supply chains, where Taiwanese corporations have created a significant and enduring advantage. Nonetheless, the performance of associated shares appears to be extended in the short term.

Meanwhile, I'm looking forward to my next visit to the country, when I'm sure that more firms will have relocated to newer premises.

[4, 5] taipower.com.tw, as at August 2023.
[6] IDC, as at 2023.
[7] Bloomberg, as at 2024.

Authors


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Guido is a portfolio manager and head of research for the RBC Emerging Markets Equity team at RBC GAM. Guido is currently responsible for research in Taiwan and Central and Eastern Europe. Prior to joining the organization in 2010, Guido worked as an emerging markets portfolio manager and also as an equities analyst at a U.K.-based asset management firm, specializing in global emerging market strategies. He had previously worked at a global asset management firm as a securities analyst, where he progressed to become a junior portfolio manager. Guido began his career in the investment industry in 1998 as an equity and derivatives trader in Italy.

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