COMMENTARY

September 16, 2021

Dear Clients and Colleagues:

We recently launched our Emerging Markets (EM) Small Cap fund. Comprised of over 11,000 companies, the EM Small Cap universe presents plenty of very sound investment ideas. One of the main challenges we have encountered since launching the fund more than a month ago has been the strong Chinese government regulations in various sectors, mainly technology and education. While we do not have investments in these sectors in China, we have seen a climate of increasing uncertainty in other economic sectors.

From a local perspective (which can differ from Western perspective), Chinese policy-makers are aiming for common prosperity, which fundamentally entitles a policy shift towards reducing wealth inequality. The concept is not new; it has been a long-term goal of the Chinese government that has become more relevant recently. The Central Party and State Council jointly announced the plan on June 10, establishing Zhejiang province as the pilot zone. The 14th five-year plan (2021-2025) called for an "action plan" to be fully implemented by 2050 to become an advanced, modern economy. Among common prosperity goals are narrowing the income gap, tackling the increasing real estate prices, promoting higher household income growth, increasing public services, such as healthcare and education, and improving living conditions of rural residents, among many others. These common prosperity initiatives will likely rebalance the economy from investments to consumption, targeting the mid-low-income population. Moreover, the state's role in public and private sectors is likely to become more relevant.

It is worth noting that the Chinese government seems to have downplayed the importance of paying too much attention to short-term growth. They indeed have a short-term buffer, considering the 2021 GDP target is "above 6%", and the country is likely to grow in the range of 8% this year.[1] The current outlook is more focused on solving structural problems, which may have short-term collateral consequences, but the vision is to improve the long-term perspective. Indeed, President Xi has emphasized a couple of times that the aforementioned long-term goals are not just an economic objective, they are about the Party's "governing foundation". The foregoing is still interesting, since, as previously mentioned, the Western vision is often different. Billions of dollars have been lost in market capitalization of Chinese assets, driven by strict regulatory policy in the after-school tutoring

[1] www.dw.com

sector, together with anti-monopoly and cybersecurity rules in the internet sector. The government has also tightened property policies. Currently a blanket of uncertainty persists regarding "which sector will be regulated next". For example, almost one month ago, a state media article equated the gaming industry, which has many companies that trade on the stock market, to “opium”. Although the government quickly quashed this article and there were no official statements, it caused a rapid slump of shares linked to the gaming sector, reflecting the prevailing nervousness among investors. The government recently released new regulations for the industry, including limiting the amount of time children can play video games to three hours a week, and last week state media mentioned that companies should avoid the sole focus of pursuing profit, in order to prevent minors from becoming addicted to games. This sentiment led to another round of losses in gaming-related stocks.

Again, different perspectives come into play. We believe China is trying to improve its society in the long term, but are not very concerned about the effect this may have on investors in the short term. The question then is; how can we better cope and adjust to these policies for the benefit of our clients? China accounts for around 10% of the MSCI EM Small Caps index, making it an important investment for our fund. Our approach to this new environment is to understand the domestic perspective and invest in companies/sectors that are subject to less regulation and more likely to benefit from the new trends that we see emerging in the future. Each scenario presents a new opportunity and the trends include:

- greater self-reliance on government-fostered technology (semiconductors, artificial intelligence);
- renewable energy;
- fitness;
- consumption favouring local brands/companies; and
- manufacturing industry and robotics for products designed mainly to support and strengthen the Chinese economy.

In manufacturing and robotics, Estun Automation (002747 CH) is one of our key holdings. The company is the largest domestic industrial robot-maker in China and one of the best-positioned stocks in the A-share Small-Cap automation sector. Estun also produces several key components itself, which gives the company a strong competitive advantage in relation to competitors who rely on external suppliers. For example, Estun is one of the few robot-makers that can manufacture servo systems and controllers in-house. It has also managed to gain cutting-edge technologies, like robot 3D vision and micro-servos via a number of acquisitions. In short, Estun has the capabilities to manufacture almost all of the core parts it needs, with the exception of reducers, although they still procure the basic mechanical parts and semiconductor chips. They also have production plants across the globe. The two key plants are UK-based Trio, acquired in 2017, a top 10 global player in motion control systems, and Germany-based Cloos, acquired in 2019, making the brand a cutting-edge welding robot. In light of this, supply chain management has become a key issue for Estun.

The latter is definitely a big advantage. For industrial automation, all the key core technology is in upstream components, like servos, motion control systems, and reducers. Thus, without access to upstream components, a company is merely one of many system integrators, which face a significantly lower entry barrier, intense competition, and lower margins. In fact, now that the Estun brand is better known, more external system integrators are starting to integrate Estun's robots into their product portfolio, which is why Estun shifted resources away from their system integration department. Back in 2019, the revenue contribution of industrial robot manufacturing and sales, and system integration sub-segments was 50:50, but from 2020 onward, it's been skewing towards robot sales. As of the first half of 2021, the proportion has shifted to 80:20 for sales of robots to system integration.

Nowadays, Estun's main end markets are lithium-ion batteries, computers, communications, and consumer electronics (known as the 3C industry in China) applications, solar, welding robots (primarily for heavy machinery), and metal forming (processing). Smaller, fast-growing contributors include woodwork, home appliances, and packaging. Meanwhile, the core markets for the Cloos robot brand are medium- and heavy–plated 6-axis welding robots. Currently, this brand is gaining market share in China's heavy machinery segment. Cloos is also developing their medium-plated welding robots, which are commonly used in heavy-duty trucks.

Industry-wise, according to the MIR database, a Chinese based, high-end, hardware-focused research, the China automation market size grew 26.9% year over year to approximately RMB153 billion in the first half of 2021.[2] The market is continuously experiencing robust demand from new-economy manufacturers, notably industrial robots, electric vehicle batteries, wind turbines/solar panels, as well as 3C and logistics, and some of the more niche markets (e.g., tobacco, wood engraving), which are dominated by Japanese players. However, this represents a huge upside potential for players like Estun, who are narrowing their technology gap with international peers. Moreover, machine exports drove some of the automation demand in the first half of 2021. Estun (and peers like Innovance) have

[2] https://mp.weixin.qq.com/s/Q3Dm_n2D9Kd9nx832wpy1w

experienced continuous market share gains. The company is also well positioned to maintain its domestic industrial robot leadership position, especially in 4-axis and 6-axis industrial robots, which contributed to approximately 85% of their shipment volume in the first half of 2021.

Estun's focus on the new-economy manufacturers, coupled with their expected market share gains, should ensure a secular growth trend in the long term. Although there has been plenty of uncertainty around the Chinese economy since the start of the second half of 2021, we continue to view industrial automation (IA) demand as among the highlights of local dynamics, given the favourable demand outlook and strong policy support for an industrial upgrade. Estun is a perfect example of a company that can position Chinese automation, robotics, and industrialization on par with the leading international players. We believe the company will get ongoing government support for achieving these targets in the mid/long term, so the company is unlikely to be exposed to any material regulation risk. In light of its quarterly politburo meeting outlining the drive to "encourage enterprise to scale up technological upgrade investment", we expect the manufacturing industry to step up investing pursuit of robotization.

Estun has experienced short-term pressure driven by COVID-19 in China (primarily in Nanjing and Jiangsu, Estun's headquarters and production base) and lower-than-expected results in Q2 2021 are likely to remain so for the rest of the year. The difficult quarter was driven by:

- price hikes of parts, base metals and chips;
- Estun prioritizing market share over margins in 2021; and
- hikes in raw material transportation fees.
- the delayed shipping of Trio motion controllers

We feel this situation is temporary and expect margin reversal from next year (or before), driven by ongoing operating leverage, improvements in internal cost control, and more import substitution from domestic parts. In fact, in their Q2 earnings results conference call, the company maintained 2021 revenue guidance of RMB 3.5-4.0 billion, with its 2021/22/25 industrial robot sale targets of 10k/15k/50k units unchanged. Estun management also expects profit margin to rise notably as its business expands.

Despite the short-term headwinds, we hold a positive view toward Estun, as we believe in the sustainability of industrialization and automation, on the back of a solid secular growth trend in the coming years in China. As the local market leader, Estun is now already directly competing with big foreign players, like Japan-based FANUC. Their acquisition of Cloos has significantly contributed to the positioning and diversification of Estun's robots in China. We expect Estun's market share to increase from 3-4% to approximately 10% by 2025, meaning Chinese factories will increasingly shift to domestic rather than foreign brands. We believe Estun has the potential to emerge as one of the leading industrial robot manufacturers globally. This could be a similar story to other emerging domestic players in China, such as excavators, where domestic market leader Sany holds an approximate 25% market share.[3]

As bottom-up investors, fundamentals drive our stock selection. We look for companies growing faster than their industry, with good margins and cash flows. We also need to understand local dynamics and invest accordingly. China's recent policies are a good example of a divergence in timing and perspectives between local interests and foreign investors, as detailed above. The road has been bumpy, but opportunities are also emerging, especially in small-cap companies, that will likely have more room to grow in the long run. Government-encouraged manufacturing and robotics companies also present good opportunities in this scenario, which supports our preference for our holding Estun.

Have a great day.

The Global Alpha team

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[3] www.sanyglobal.com