Baillie Gifford™

Short Briefings on Long Term Thinking – Episode 36

December 2023

Beyond China: south-east Asia's next export stars

Your capital is at risk.

Malcolm Borthwick (MB): The family-owned Danish toymaker Lego has turned to Asia for its first carbon-neutral factory. It's investing over $1bn in the solar-powered plant, which will start moulding its plastic bricks next year. But what may surprise you is that that facility isn't in China, but Vietnam.

China is no longer the world's factory floor. Soon it will count for less than half of the US's low-cost imports from Asia, for the first time in more than a decade. Geopolitical tensions and China's move up the value chain are creating opportunities for emerging countries in south-east Asia. Countries such as Thailand, Malaysia, Vietnam and Indonesia.

Welcome to *Short Briefings on Long Term Thinking*. I'm Malcolm Borthwick, managing editor at Baillie Gifford. And I'm joined by Ben Durrant. He's an investment manager in the Pacific Fund, Pacific Horizon Investment Trust and our Emerging Markets Equity Team. Ben has recently returned from south-east Asia. And over the next 20 minutes or so, we will discuss the opportunities being created by the rise of these new export champions.

But first, a quick reminder. As with all investments, your capital is at risk and your income is not guaranteed.

Ben, it's great to have you on *Short Briefings on Long Term Thinking*. Welcome to the programme.

Ben Durrant (BD): Hi, Malcolm. Thanks.

MB: So, it's quite an expansive question to start with Ben, but why has China been so successful as a low-cost exporter for the past three or four decades?

BD: Sure. It's the key question, Malcolm. And it's a really complex one. But I think it's one to really think about maybe what the reasons are, because then we can apply that to much of the rest of south-east Asia, understanding what may be successful and where may not be successful as a result. If we look at China, and as well as Japan and Korea, and Taiwan in the past, there's three key things that we see.

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The first is agricultural land reform, which isn't what you'd expect, perhaps. But what that does is it really lets the country produce an economic surplus by the farmers working hard in a labour-intensive way to deliver that kind of output.

The second is export-led manufacturing. Labour-intensive. And you want the test from other countries and companies: do they want to buy the stuff you're selling because that then leads to a helpful feedback loop that then encourages the companies that are successful to get more capital and the companies that aren't successful to rethink what they're doing.

The final aspect, and this is what China really excelled at, was focusing their resources, particularly capital, on the industries that are working. And that involves hard trade-offs. Because you need to avoid consumption today. You need to have low-interest rates. You need to save a lot of money but not really get paid for it so that the companies that are investing can afford to borrow that money. And China through its controlled political and banking system did a fantastic job at that. Now an enormous amount of that was misallocated or wasted, but plenty of it went to the right places.

MB: And going back to one of your earlier points Ben about land reform. I think that's really interesting because we don't often think of land reform being the genesis of change.

BD: No. It's the crucial first step though. we're indebted to the likes of Joe Studwell, who's written a great book called How Asia Works, and we're fortunate to have on the board of our investment trust, who has done a lot of work exploring this. But what it means is that you can encourage the population to really work hard and invest in their land. Whereas if you have that more feudal system people work for, essentially to meet rent payments and nothing more, and you don't create that surplus. There are plenty of other examples of countries that have tried to do the other steps to build the big factories without land reform. And generally speaking, it hasn't worked.

MB: And one of the other really interesting things is the motivation behind why a lot of US and other international companies relocated manufacturing to China in the late 1970s was low-cost labour.

BD: China's labour was incredibly cheap. It had an income per head about the level of Afghanistan. However, it had a very good quality labour force and the perspective that they had some very middle-income levels of social indicators. They had a life expectancy about 20 years longer than Afghanistan, for example. And so you have this enormous untapped population that essentially was just held back by the civil war in China, then the Great Leap Forward, the Cultural Revolution. So, when this potential was finally unleashed, then I think you saw enormous things happen. And by virtue of the sheer size of the country, once that snowball got going, it went an awful long way.

But the cost of labour did rise and now the likes of Bangladesh, Vietnam are far cheaper places to work, to employ people. And so you've actually seen some great Chinese businesses moving their factories outside of China themselves already. And so it was coming to a natural end in that respect. And there were of course events as well. Covid revealed the errors of having single points of reliance in a company's supply chain. And geopolitics is certainly changing the game in a difficult way from China because a lot of those more intellectual property-intensive companies are now struggling to export and instead of shifting towards import substitution, which has been a much tougher thing to achieve we've seen in the past.

But nonetheless, China's still the world's largest exporter, and will remain that way for the foreseeable future. But when we look for export growth, we expect much that to be based elsewhere. And for China themselves, they're trying to shift more towards a consumption led economy, which is the natural thing to do, but doesn't involve a fundamental restructuring of that economy.

MB: And we'll go deep into some of these countries in more detail shortly but why is south-east Asia so well placed to benefit from that move by China, away from low-cost manufacturing?

BD: I suppose it's in the simplest sense of that word 'placed'. You're on the same geographic supply lines there. You're on the same shipping lines across the Pacific. And so that makes you a natural contender, as opposed to the likes of Brazil for example.

The next step is that you have similar starting points in terms of economies, you have relatively cheap labour, you have abundant labour, and you also have governments that have that strong degree of political control that are willing to enact these kinds of policies. We've looked at plenty of these and south-east Asia has always had an enormity of promise. And sometimes that hasn't really followed through. The likes of India, for example, or Indonesia has always been a tomorrow's success story. But perhaps that's changing because geopolitics has given them another roll of the dice in short. There are also just these Chinese companies that are building facilities elsewhere in south-east Asia. They're not going to go and build them in Ecuador, for example. And so, I think is just the natural next step.

MB: You're just back from Vietnam and visiting a few other countries in the region. Your colleague Roddy Snell describes Vietnam as the greatest structural growth opportunity in Asia over the next decade. Why is that?

BD: It's because it's got the same three building blocks. It's almost the unintended consequence of being a communist state is that you can then enact land reform which makes you a great capitalist nation, but it's combining those two. It's this weird dichotomy this unusual marriage, but it works really well. And Vietnam is intriguing because it has shown it can enact the same policies. It also has lower cost labour than China does now – about half the cost. And from a geopolitical perspective, it's everyone's friend. We're seeing Chinese Korean and American companies, all big investors and factories there.

And this isn't us seeing an undiscovered truth here, but it's evident in the numbers. Exports are up ninefold over the last 13 to 14 years. And there are still a few trillion dollars of Chinese exports that naturally move there over time. While they've seen a tougher time over the past year given some of the global economic swings, industrial park developers we met spoke about really strong interest from companies looking to set up facilities there. And again, there's an intriguing contrast when we look at the population a bit like China. While relatively low wage, they've got a good life expectancy still, and also a great education. If you look at standardised education testing, they outscore the UK quite comfortably, for example, which isn't what people expect.

MB: It's a very vibrant, innovative economy, isn't it?

BD: It is yes. Some of that's still tucked away deep within multinationals who have subsidiaries there.

So, we're already investors in Vietnam's largest exporter, that's Samsung Electronics. And Samsung are building a dedicated port there, which shows you quite how committed they are to it in the long term. But you really see that drive to succeed when you speak to people there. And that's one of the fun things about going to visit countries in person as well. It's not conversations just with CEOs. It's conversations with taxi drivers as well. And you get a feeling for who's feeling positive about their economy or not. And plenty of people complain, but there are some countries where people generally speaking are far more optimistic and enthusiastic about their prospects. And Vietnam is certainly one of those.

MB: And there are a number of companies you visited when you were over there. A number of retailers banks, steel companies. But it's a seafood company that caught my imagination. Vinh Hoan. Tell me more about them.

BD: It's a great business in a tough industry. We're talking about exports. Traditionally you think okay, clothing or maybe you think electronics but here we're talking about frozen fish fillets. But it's a fantastic business. I've been to their offices a few times in Saigon, but they haven't yet made the pilgrimage their fish farms on the coast yet. So, they're the world's largest exporter of catfish. It's technically pangasius but it doesn't really roll off the tongue. But it's a great example. Firstly, it was circular economy. They use all of the wastewater and products go back in to produce fertiliser for their crops, then they go and are used to feed the fish themselves. It's also a fantastic lesson in marketing. So I think it makes the industry pretty special. Actually. Nobody in the west is particularly fond of the idea of eating catfish, even though it's a perfectly fine of a bit of a generic white fish. And so, the industry renamed it Bassa.

So, if you've ever gone to a restaurant and an unnamed white fish or gotten one of those meal delivery kits from Gousto, or HelloFresh, the white fish you've cooked with isn't Cod but it's Bassa, and most likely bred, processed and frozen in Vietnam before being shipped all around the world.

MB: And what's the investment case for Vinh Hoan from here as a growth stock?

BD: It's a great question. Catfish isn't the typical Baillie Gifford investment. There are a few things. They're just the best operators in a pretty tough industry. We think that they are lower cost. And we think they are higher quality as well. And so, they can build more capacity and people will continue to buy what they sell. And actually, rising trade standards are a real beneficiary for them as well. The United States has put plenty of anti-dumping bans on other manufacturers, other countries that they think aren't doing a good job in this industry. Whereas Vinh Hoan has avoided all of those. And then fundamentally, it is one of the cheapest, healthiest proteins that there is. And so, you see replacement of the very vulnerable but brand name fish for fish like this, which we think can be grown in a sustainable way. And we think that Vinh Hoan is very well placed to continue to do that.

MB: And you didn't just meet companies in Vietnam, did you? As part of your research process you like to look at other opinion formers and different sources, don't you?

BD: So one of the real benefits is that you speak to companies and then you speak to another company and say: "So what about those guys?" That's valuable. If you can take it a step further and get the other stakeholders involved, that's really useful. Journalists are always a fantastic source of information. Just going and speaking to them off-the-record, because they are fantastic at digging up sources. But as always, with newspapers, they're incentivised to report on events rather than trends. And it's us that really care about trends rather than anything else. And so they've got far more colour on that. In Vietnam, there's an unusual situation where much of the local journalist community is controlled or at least influenced by the Communist Party. But actually speaking to some of the foreign journalists there to understand what's going on, to have them interpret what the media are saying and aren't saying is really valuable there.

And I think so much of that just doesn't get reported. Vietnam is a pretty small place in economic terms. None of this makes the front page of the *FT* ever really. And so understanding what's going on there is really useful. One of the other people we spoke to – and this is not just the content of the meeting, but the very fact that we had the meeting I think is telling in of itself – we had a couple meetings with members of the Vietnamese Communist Party in relatively senior roles in the economic planning side of things, who were willing to meet with us, a few foreign investors, to really explain what they thought was going on in the country and genuinely listen to us which I thought was surprising. While the country is often superficially compared to China, you never get that openness to conversation with foreign investors from the Party there.

MB: There's often a temptation, I think, to group countries together, whether it's south-east Asia or other regions, but the countries themselves are pretty different. Let's move on to Indonesia because the growth story there is different. And it's also interesting in terms of how they're moving up the value chain in certain industries.

BD: Yeah. Indonesia is geographically blessed. It's one of the largest producers of practically anything you care to point out be it from rubber, rice, coconuts, or in the ground, you've got bauxite, copper, nickel. The problem, of course, there is you've got the resource curse, whereas they've always exported that and never really been able to benefit really from the value that they have. And that has made it an easy life for many of the rich and powerful there without benefiting the enormous population that Indonesia has.

Jokowi has done something interesting – the current Indonesian President – in trying to take advantage of that resource abundance, particularly in nickel, and forcing companies not just to mine an export but actually to process more in-country. People thought it wouldn't work at all. They thought no, no one will just melt will do this. They'll just go elsewhere. But actually, you're finding the Chinese in particular, are making enormous investments in nickel processing there to refine the nickel into something that could first be used for stainless steel. But now even more intriguing me refining it to an even higher level. So that you can use that nickel to make batteries. And then you got the likes of Hyundai Motors that have built a car factory in Indonesia itself to produce electric vehicles there. My colleague Grace was there a few months ago. And the big question, of course, is, how does that then affect the rest of the economy? You've got these industrial parks that are the size of cities. Some that are larger than Edinburgh. But these are in islands far east of the country and a lot of that is on very generous tax terms, for example. So some people benefit but not hundreds of millions of people. But I think in time, there is a real potential that you strengthen the currency as a result, and you also through tax revenue and just by encouraging manufacturing clusters, start to do something intriguing there.

And so, we're hopeful that Indonesia is actually having a chance to take a turn for the better. The beneficiary of geopolitics and people trying to build separate supply chains. And also a big beneficiary of renewable energy demands. We're real enthusiasts for some of the changes that you're seeing in the world. I think that people fundamentally underestimate the resource intensity of electrifying the world turning everything to electric vehicles, for example, and a lot of what we need for that currently resides deep under Indonesia, at the moment. So if they can extract, refine and sell that back to the world, and I think there's something special potentially there.

MB: And you mentioned clusters there. And nickel being a cluster in Indonesia. Well, what about Malaysia? There are also clusters of expertise there as well.

BD: Malaysia is a funny one, in that it's never really met that broad based export potential, but in the same way, you can see the results of industrial policy. They've been very strong in chip outsource testing and assembly. A lot of the world's chips, about 16 per cent or so are, are actually assembled in Malaysia. But maybe a more unusual one is rubber glove manufacturing. Malaysia originally just through virtue of having the right resources, natural rubber, started manufacturing rubber gloves. And then it became an export industry and then government targeted [it]. So now about two-thirds of the world's rubber gloves are made in Malaysia. That's about 240 billion gloves a year.

It's been one where when you get to sufficient scale, no one can really compete with you. And so that's why they've managed to be for many decades, the world's leader in rubber glove manufacturing despite China's evident strengths and capabilities to be able to do it in the past. That's changed slightly as a result of Covid because rubber glove demand was pretty slow and steady until of course, the pandemic where unmet demand was enormous and so the Chinese set up factories in the mainland there and have since completely changed the face of that industry to Malaysia's loss, it feels at the moment. I went to visit some of these companies there to understand is this a fantastic capital cycle opportunity when you've got companies that have great scale and currently going through a demand dip, do you buy them? But it feels like the industry is structurally changed, unfortunately.

MB: And what about Thailand? What type of companies did you visit in Thailand and why?

BD: Yeah, Thailand's an unusual one. Its big market is big export is tourism. You've got white sand beaches, surrounded by palm trees, but you obviously can't export that. So you bring that you bring the consumer there. The challenge with that, of course, is that tourism is a services-based industry, and you don't have the same productivity gains. So Thailand, similarly, has never really been able to build a big export base. They have an auto industry. It's fine but it's not something you can invest in as they're all foreign owned. And so we look mainly at the banks, the retailers there, understanding what the scope for growth is things that benefit the broader population.

There's one that really caught my eye, a rural lender that provides capital to those that don't have it and really need it in Thailand. It's grown tremendously quickly over the last five years or so. And typically speaking, when we see a bank or a lender that's growing quickly, we throw up our arms in despair because we're seeing disaster coming. As the well-worn phrase goes, it's very easy to get money out, it's much more difficult to get it back. And so I really wanted to go and understand what was going on there in person because only so much you can understand from reading their financial accounts.

So I met with the son of the founding couple, who is the successor for the business, to really understand the lending culture the ethos of management, which is one of the toughest bits when it comes to really assessing the investment case for a business like this. We had a good conversation. I don't know if I learned anything unique from what he said. But the most insightful thing for me wasn't what was said, but rather some of the smaller aspects. So for context, this man's family is worth a couple billion dollars. But he was wearing the classic $10 Casio digital watch and, even more telling, he was using a pretty mid-end Samsung phone with a very cracked-up screen. Now, maybe that tells you he's frugal or just very careless. But there's certainly some kind of insight there about the attitude that this man had, who will be running the business for the next 30, 40 years. And I thought that actually, no, there's maybe something more to this business that we might have thought.

MB: Someone who's well-grounded?

BD: Exactly. Yeah, exactly.

MB: So we've looked at Indonesia, Malaysia, Thailand and Vietnam. Moving into that area of low-cost manufacturing that China is exiting partly. But how can these countries in themselves move up the value chain and maybe move away from low-cost manufacturing?

BD: There's a couple things that really matter. Firstly, you want to own your own companies or at least have some kind of reasonable degree of control of them, because then you can benefit from the profits of those and reinvest that profit in further businesses. The second aspect is just controlling the supply chain. In you're originally the assembler, but then you can provide some of the lower-cost components and you can provide some of the more advanced components like that. China really blazed the trail here in encouraging or forcing intellectual property transfer. I don't know if that can happen again. I think certainly countries are more wary about that. But you're seeing it happen inherently as people learn by doing. And then as people's education levels increase, you start seeing higher value contributions there. You can look at the IT services business, for example.

India's great success as an industry there. You have the likes of FPT in Vietnam, that originally did something similar but far more basic for often Japanese companies. But then as they do that more, they start to do more advanced coding. And that's just a natural process, I think. In a way it's forced. As your income levels rise, your currency gets stronger. You can't afford just to do the simple error check, and you need to do more. But I think you just rely on human innovation. And if you have the incentive by owning those businesses and being able to profit from it, generally speaking, it tends to happen.

MB: And there are a lot of opportunities within Baillie Gifford in US equities, UK equities, Europe, wherever you want to see your interest. Why are you specifically interested in emerging markets?

BD: I think it's absolutely fascinating, because you can invest across the entire spectrum of an industry, and essentially you get to travel through time. You can invest in countries that were exactly the same as another country was 100 years ago, and you can see different perspectives. And from the perspective of an equity market investor, there's always something that's in vogue and always something that's out of vogue. And you can't ignore the macro, which is tricky, but it does give you a whole other lens to it. So I think it's the world's most dynamic region. The majority of GDP growth will come from Asia over as far forward as you care to look this century really. And that isn't reflected in stock markets. And so, I think that there is an enormous opportunity there. And being discerning and understanding where it comes from, is the big challenge. But intellectually, I think it's extremely rewarding and hopefully from a shareholder perspective, it is rewarding and future as well.

MB: And interestingly, you mentioned that you can't avoid the macro and at Baillie Gifford, we’re bottom-up investors. But do you take into account the macro, maybe more than a lot of other investment teams within Baillie Gifford?

BD: You can't afford to completely ignore it because if you look back to the origins of the Asian financial crisis, for example, any good investment case in Indonesia or Thailand was completely swamped by currency devaluation at that point in time. The flip side, of course, is an enormous tailwind as well. In contrast to the Asian Financial Crisis, you now have a far stronger set of economies. And so when you see the world beset by fear and uncertainty over the last couple of years, actually Asia has done remarkably well. Whereas if you roll back 25 years ago, you'd expect a crisis at this point in time. So I think you need macro to give you context to those individual company investment cases. And also, as we were discussing, you need to understand if there's a broader economic support. For example, in Vietnam, we wouldn't buy a bank anywhere, but we’d buy a bank where you see that broader macro supports. So I think it's absolutely essential. It is the final touch, generally speaking, on how we build our portfolios. They are first and foremost, the best companies, the fastest-growing companies we can find that attract valuations, but then we need to put the macro into consideration as well.

MB: We always end the podcast by asking you what book you're reading at the moment. Ben what book you're reading at the moment?

BD: So I've recently finished How the World Really Works by Vaclav Smil. So he's the generalist’s generalist. He's a fantastic man. He's written probably 70-odd books. His work in particular on energy, and the practical steps needed for any energy transition are absolutely fascinating. But this book, How the World Really Works, is a masterpiece and it manages to cover the fundamental processes that shape human life in an accessible but thorough way, in just a few hundred pages. It goes through the four pillars of modern civilization: ammonia, steel, concrete and plastics. And I don’t think many of us think much day-to-day about all these aspects and how our world operates. And in a world so dominated by internet companies, advertising, social media, it’s a really important and refreshing reminder of how the world actually does work. And I think one that everybody would benefit from reading.

MB: That’s a great book recommendation to end *Short briefings on long term thinking,* Ben. Thanks for joining us.

BD: Thank you.

MB: And thanks to you listeners for investing your time in Short Briefings on Long Term Thinking. You can find all our episodes at bailliegifford.com/podcasts. Or subscribe at Apple Podcasts, Spotify and on other platforms. And if you enjoyed listening, why not check out the article The Indonesian companies powering the green transition by Ben’s colleague, Roddy Snell which we’ve linked to in our show notes. Goodbye.

Show notes

China became known as the world's factory thanks to it offering companies a way to manufacture all kinds of goods at a high quality and relatively low cost. But in recent years, south-east Asian nations, including Vietnam and Indonesia, have begun challenging it for that status. Baillie Gifford investment manager Ben Durrant recently returned from a tour of the region. He discusses some of the long-term growth opportunities he unearthed on his trip.

Background
Ben Durrant invests on behalf of the Pacific Horizon Investment Trust, the Pacific Fund, and our Emerging Markets Equity Team.

In this latest episode of *Short Briefings on Long Term Thinking*, he explores the factors that led China to become the world's leading exporter and how its move up the value chain is now creating opportunities for other south-east Asian countries to grasp.

Durrant reviews some of his most memorable encounters in Vietnam, Indonesia, Malaysia and Thailand and reveals which growth companies excited him the most. They include businesses using mined metals to make car batteries, banks serving populations with growing spending power and, perhaps surprisingly, one of the world's leading catfish exporters.

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The Indonesian companies powering the green transition
Ben Durrant LinkedIn page
How Asia Works
How the World Really Works
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Baillie Gifford International LLC is wholly owned by Baillie Gifford Overseas Limited; it was formed in Delaware in 2005 and is registered with the SEC. It is the legal entity through which Baillie Gifford Overseas Limited provides client service and marketing functions in North America. Baillie Gifford Overseas Limited is registered with the SEC in the United States of America.

The Manager is not resident in Canada, its head office and principal place of business is in Edinburgh, Scotland. Baillie Gifford Overseas Limited is regulated in Canada as a portfolio manager and exempt market dealer with the Ontario Securities Commission ('OSC'). Its portfolio manager licence is currently passported into Alberta, Quebec, Saskatchewan, Manitoba and Newfoundland & Labrador whereas the exempt market dealer licence is passported across all Canadian provinces and territories. Baillie Gifford International LLC is regulated by the OSC as an exempt market and its licence is passported across all Canadian provinces and territories. Baillie Gifford Investment Management (Europe) Limited ('BGE') relies on the International Investment Fund Manager Exemption in the provinces of Ontario and Quebec.

Israel

Baillie Gifford Overseas Limited is not licensed under Israel's Regulation of Investment Advising, Investment Marketing and Portfolio Management Law, 5755-1995 (the Advice Law) and does not carry insurance pursuant to the Advice Law. This material is only intended for those categories of Israeli residents who are qualified clients listed on the First Addendum to the Advice Law.

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