Notes from the Road: Semiconductors, Real Estate, and the Japanese Consumer

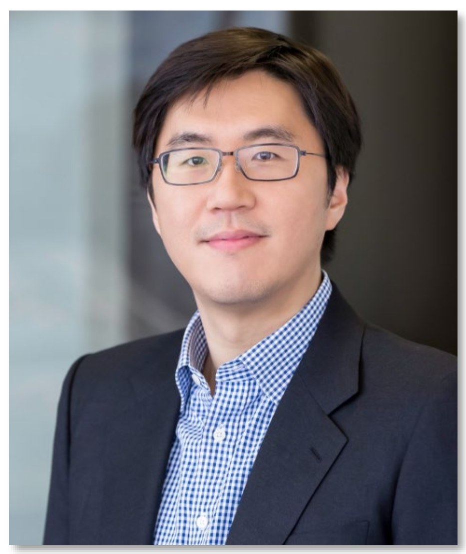
December 2023

Recent research travel took Causeway analysts to Silicon Valley, London, Tokyo, and across China and Hong Kong. Here are highlights of what we learned. We invite our clients to contact us for detailed discussions on any of these subjects.

Brightening Outlook for Semiconductors

Brian Cho, Fundamental Portfolio Manager

Coverage: Technology, Communication Services



I visited Silicon Valley to meet with semiconductor companies, from equipment and component manufacturers to suppliers of central processing units (CPUs), graphic processing units (GPUs), memory, and hard disk drives (HDDs).

The AI race is intensifying: Nvidia is doubling the pace of its artificial intelligence (AI) chip launches and integrating the latest memory technology into its servers for higher compute capacity. We expect key competitors to follow suit.

Increased AI usage requires more compute power, which requires more memory. While we continue to view this as a cyclical industry, we expect durable, multi-year demand growth for memory manufacturers.

Hard disk drive and memory manufacturers should benefit from shortages: Production capacity for HDDs and memory was cut substantially over the last two years, from 25 to 40% across manufacturers. Demand is recovering for the data centers, PCs, and smartphones that use these components.

We think end-customers—and the market—are underestimating the degree of undersupply and the time it will take to restore sufficient capacity. Supply of HDDs and memory may fall short of 2024 demand, even if sluggish, favoring their manufacturers. We also note these two industries have largely consolidated over the past decade, and industry participants have demonstrated business discipline in the current cycle.

Shallow downcycle for overall equipment spend: China's semiconductor manufacturing is buoying overall equipment spending. China's spending levels may be peaking but, in my view, should not decline precipitously, given China's ongoing domestic capacity additions to increase self-reliance. For the next upcycle, technology transitions, such as a new transistor architecture, should support complex semiconductor manufacturing.

Real Estate: Differentiated Markets

Conor Muldoon, Fundamental Portfolio Manager

Coverage: Financials, Materials, Real Estate

I spent a week in London meeting with real estate investment trusts (REITs). Here are some insights on real estate segments in the UK and US.

UK Office and Retail: Old office stock appears distressed, exemplified by a £100 million bid for a building that sold in 2015 for £260 million. London office properties benefit from a diverse occupier base, but valuations may continue to decline as rental growth is offset by rising cap rates (a property's net operating income/market value). Tenant preferences are growing increasingly distinct: for quality or new buildings, prime city locations and, in retail, parks over indoor malls.

UK Logistics: Occupier demand for warehouses, data centers, and transport businesses has normalized after the strong Covid period. London logistics pricing is robust due to supply constraints and demand for priority delivery. Transaction volume has declined due to a spike in interest rates, with buyers and sellers still wide apart on valuations. Many companies expressed the desire to be well-capitalized for future purchases during the upcycle.

US Residential: The outlook varies across regions: rental income pressure is anticipated in the Sunbelt for the next few years due to unprecedented new supply levels. Demand is weak in San Francisco and Seattle but so far resilient in Southern California, although non-paying tenants and high levels of bad debt are challenging Los Angeles markets. Despite positive renewals, new lease rates are expected to decline while various factors like client selection and property location and type contribute to the market dynamics.

US Shopping Centers: There has been a decade without new supply in US shopping centers and current high cap rates are deterring new development. Anchor tenants, mainly grocery stores, often pay rents 30-40% below market. Smaller shops generally have high occupancy and pay close to market rates. In many instances, cash conversion (cash flow/net rental income) and tenant sales have remained strong, with current tenants interested in adding space.

US Hotels: A recovery in group travel continues, but 2023 levels are still 10% below those of 2019. Leisure rates are substantially above 2019 levels but are expected to gradually decline, partially offset by a recovery in international tourism. Activity from frequent business travelers remains below pre-Covid levels, so this segment may be more resilient in an economic downturn.

China Real Estate

David Khoo, Research Analyst

Coverage: Financials, Real Estate

I traveled through Singapore, Hong Kong, Shenzhen, and Guangzhou for company meetings and property tours. These themes emerged from my research.

Chinese retail landlords are adjusting to changing consumption patterns: Mass-market consumers have been more cautious, focusing on value, and shifting towards experiential purchases like dining and entertainment. To continue attracting shoppers, many landlords are changing the tenant mix and shrinking individual store sizes to broaden variety. Such repositioning can be dilutive to returns, but the properties I toured have largely completed the adjustment process.

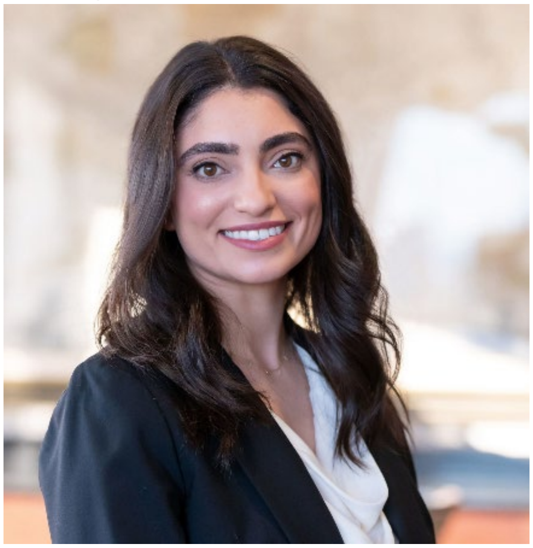
Retail supply is relatively disciplined in Singapore and Hong Kong: To manage land constraints, urban planners generally match new supply of non-discretionary retail to new residential estate developments, which limits the cannibalization of existing properties. Properties with direct connections to public transportation have a material competitive advantage.

Mixed bag for Hong Kong real estate companies: Residential prices are down and office properties oversupplied, but balance sheets are generally conservative with low—and declining—leverage. Equity valuations have derated significantly, creating investment opportunities in quality assets that may outperform over a longer-term horizon.

Excess liquidity in Singapore and Hong Kong: High interest rates have not only reduced demand for new borrowing but also incentivized debt repayments. Given the competition for quality borrowers, many companies have been able to reduce credit spreads for refinancings.

Japan's Shifting Consumer Sector

[Claudia Crivello, Fundamental Research Analyst]
Coverage: Consumer



I spent a week in Japan meeting with cosmetics, food & beverage, and retailing companies. I also had a chance to visit many of the retail store formats in Japan. These are my key takeaways.

The Japanese economy has continued to benefit from reopening: Japan was one of the last developed markets to open from Covid lockdowns, at the end of 2022. Many companies reported tourist levels reaching or surpassing pre-Covid levels, although the mix includes fewer Chinese tourists. As for domestic consumers, their purchasing is bifurcated between luxury and value (down-traded) goods over mid-priced products.

Consumer companies are increasing prices for the first time in decades: Sales volumes are holding up under these increases and some companies are considering additional price raises to help offset cost inflation, particularly given a weaker yen. After years of stagnant pricing, future price increases could become an attractive driver of future top-line growth for companies.

Some companies are raising wages but lowering headcount: Because of inflation, many companies have increased wages. The Japanese government and major labor unions plan to meet regarding a mandatory wage increase in 2024. But some companies plan to reduce headcount to offset rising employment costs, a practice rarely exercised by Japanese companies.

Japanese cosmetics companies are selling less to Chinese customers. The economic slowdown in China, below-average Chinese travel, and concerns over treated waste-water release from the Fukushima nuclear power plant have depressed sales of Japanese cosmetics to Chinese customers. Some cosmetic companies (along with other consumer packaged goods companies) are rethinking long-term investments in China.

Convenience stores and drugstores are gaining share from supermarkets and department stores. Japanese shoppers are prioritizing price and convenience, favoring these store formats. Convenience store food sales are strong, and drugstore companies are using profits from high margin segments to subsidize lower prices on products that compete with supermarkets. General home and apparel retailers are ceding share to specialty retailers.

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