CERNO CAPITAL

TM Cerno Pacific

UCITS Regional Equity Portfolio

Q3 2020

Investment Objectives

The Cerno Pacific portfolio is a geographically specific fund, which invests primarily across the Pacific area but also the wider emerging markets. The fund's objective is to produce capital growth over the long term through a focus on companies that are judged to be innovators or are beneficiaries of innovation through their products, services or business models. The optimal route to access the full benefit of innovation is likely to be, directly or indirectly, in the form of equity, which will be the predominant asset class in the portfolio. The manager takes an active approach to currency exposures and may hedge where deemed appropriate.

Fund Data

NAV/Share	£17.57
Fund Size (£mn)	£37.1mn
Currency Share Class	GBP (Base)
ACD	Thesis Unit Trust Mgt
Custodian	Northern Trust
Legal Structure	OEIC (UCITS)
Inception Date - Fund	Jan 2017
Inception Date - Strategy	Oct 2009
Saving Structures	SIPPs & ISAs
Share Type	Acc & Inc

Q3 20 Investment Report

Fund Activity

Performance commentary and position changes during the quarter

Disco – The Art of Precision

Supplier of semiconductor equipment

Nihon M&A Center – Friendly Matchmaker

Specialist M&A advisory boutique focusing on SME succession

Fund Managers

Fay Ren - Co Manager
ren@cernocapital.com

Michael Flitton - Co Manager
michael@cernocapital.com

Fund Activity

The fund delivered 9.6% in Q3 vs 4.1% for the Asia Pacific comparator index. This takes performance for the year to 36.4% against 4.4% for the market.

During the quarter TSMC was the primary contributor, rising 44% (in US$) and contributing 1.8%. Most of the move occurred in a short window in July and reflected the pivot in the competitive environment in the company's favour. As we reflected in our missive at the time, Intel visits the confessional, the admission by Intel of the need to outsource chip production to stay competitive de facto confirms TSMC's overwhelming leadership position in logic semiconductors. TSMC's accelerating advantages over Intel formed the core of our thesis when we initiated our position in 2018. Still, the size of the market's reaction was a surprise, with TSMC +24% in two days and Intel down 18%. Alongside TSMC, Nidec and Alibaba also contributed over 1% each to fund gains. Nidec rose as investors began to anticipate an improved outlook for global auto production. Alibaba meanwhile recovered from the headwinds of US-China trade tensions as the secondary listing took off in Hong Kong. Year to date, all but three current positions have contributed positively to the portfolio.

Q3 saw a more diverse environment for stocks than the broadly rising tide in Q2. Bilibili (-42bps contribution) was pulled down by the broad Nasdaq de-rating, despite improving monetisation and prospects for user growth. Resmed (-34bps contribution), a global leader in respiratory care, delivered disappointing results as headwinds emerged from lower diagnosis rates in sleep apnoea. Other detractors included Sunny Optical (21bps).

Currencies were broadly neutral in Q3. We continue to hedge KRW and TWD exposure with a long position in JPY. This position also benefits from declining risk appetite, which remains a threat to global markets into US election season. Sterling was a broad headwind, rising 4% over the quarter.

Technology continued its outperformance in Q3 within Asia Pacific. From August however, we began to see the first noticeable signs of sector rotation with Industrials, and to a lesser extent Materials, performing strongly. Since the beginning of August Industrials are up 8%, against 3% for Technology. This move in stocks tied to economic recovery reflects the widening gap between Asia's trajectory during the pandemic, and the Western developed world. The fund performed well despite these headwinds, which we expect to be a continuing feature into 2021.

Movement in the portfolio was higher compared to Q2. Two stocks were sold: Trip.com, the leading online travel agency in China and ASM Pacific, a producer of electronics back end equipment. For Trip.com the visibility on the return of international travel, to which they have a high exposure, has fallen materially. The competitive environment in China is also in flux as Meituan Dianping looks to muscle into new markets. ASM on the other hand made way for a new addition, Disco, which is also in the semiconductor space. We are cognisant of sector concentration and feel that the 20% we hold is an appropriate limit. Both stocks remain on the approved list for future investment. Alongside Disco, Nihon M&A Centre also entered the portfolio. Nihon offers boutique advisory services to SMEs in Japan, and elsewhere. We discuss both new additions in further detail in the following pages.

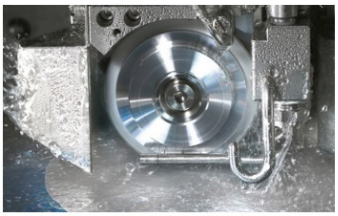
- Michael Flitton

Disco – The Art of Precision

Perhaps more than any other country, the term *precision* is most closely associated with Japan. As Simon Winchester comments in *Exactly*[1] , 'this is a country known for its rigorous appreciation of the perfect, both today and in antiquity'. This heritage has led to a natural accumulation of Japanese companies within the semiconductor equipment supply chain.

Disco was founded in 1937 as Dai-Ichi Seitosho Company. The business was originally focused on abrasive wheel manufacturing for industry. In 1950 the group produced a revolutionary abrasive wheel just 1.2mm wide. In turn this enabled the manufacture of individual electricity meters for peoples' homes. The path of high precision was set and as the semiconductor industry took off in the lats 50s Disco built on its skill set to expand into cutting tools for dicing the new chips of the future.

Sixty years on and Disco still offers just three services enshrined in the company's slogan: *kiru-Kezuru-Migaku* or Cutting, Grinding and Polishing.



Source: Company website

This commitment to high precision excellence in a narrow skill set has helped the company establish a dominant position in a critical slice of semiconductor production. Across its product offering Disco holds an 80-90% market share. The group's position will be difficult to assail. The engineering expertise required to deliver accuracy of cutting to within 1/1000th of a millimetre is not easily replicated. Given the continual gains required in the industry Disco also spends heavily on R&D to improve its offering. Finally, the criticality of its service to the success of the end product means reliability is the key parameter for its customers, rather than lower prices from potential new entrants.

The accelerating animosity between China and the US places Japanese suppliers of semiconductor equipment in an advantageous position. They appear uniquely placed to supply both sides. This may change, but as it stands their addressable markets have expanded through this turbulence.

Disco's existing market dominance leaves little room for future market share gains to drive growth. Nevertheless, we believe prospective growth is well underpinned. Aside from the structural drivers for increased semiconductor demand, the evolution of processing gains is moving towards emphasis on packaging and architecture, rather than scaling. This trend means higher intensity of grinding and dicing and a larger potential market for Disco.

- Michael Flitton

[1]Exactly – How Precision Engineers Created the Modern World

Nihon M&A Center – Friendly Matchmaker

29 years ago, Yasuhiro Wakebayashi & Suguru Miyaki, a pair of Japanese travelling salesmen spotted a problem during their business trips across the country. The two men sold computers to accounting agencies and regional financial institutions, and through their interaction, realised that many small business owners (who were clients of those financial institutions) were struggling with succession. That was well before Japan's aging demographic became a well-documented issue.

Nihon M&A Center (NMA) was their solution. The company was established in 1991 with the aim to match SMEs (small & medium enterprises) buyers and sellers, typically running between 10-100 employees in size, leveraging relationships with their national network of accounting firms and banks to join the dots. The SME market is shunned by big banks and major M&A brokers as they tend to pursue low volume high value deals involving larger corporates. NMA takes the opposite approach, driving high volumes and low deal sizes. It completed 885 deals in total in FY2019, averaging 2.4 deals per day, doubling from just 4 years ago, whilst managing a still lucrative operating margin of 44%.

The high deal success rate of NMA stems from their strong brand, niche focus (less competition & quicker turnaround), large network covering 90% of Japan's financial institutions to provide stable deal sourcing (the only firm with national coverage), highly optimised proprietary database & human capital, and importantly their positioning as the 'friendly broker' offering a much needed service for both buyers and sellers.

This segment of the M&A advisory market offers a great deal of opportunity. SMEs (<500 employees) represent over 85% of total enterprises in Japan, of which there are c.4 million small businesses whose owners are over the age of 60 and c.2 million with owners over 70, according to SME Agency. The Japanese government estimates that around half of them will have no successor, recognising this as an increasingly urgent issue hampering employment and productivity should those businesses be forced into closure. The auto components industry, for instance, already faces a severe supplier shortage problem where specialist offerings provided by small suppliers prove difficult to replace. NMA targets specifically a universe of around 120k profitable enterprises with no clear succession plans. Its pipeline remained robust even during the worst months of COVID-19 outbreak earlier this year, having grown 19% YoY in the latest quarter with an order backlog of c.1600 deals despite sharply fewer face-to-face meetings. The company turned to virtual channels to educate CEOs, highlighting the heightened health risks on succession given the virus. There is also the additional task of convincing older generations to overcome the psychological cultural taboo of selling their business rather than take the (supposedly) dignified route of 'sinking with the ship'.

Source: Internet

The company has identified a gap in the market that lines itself up well for future growth given the structural underlying supply-demand dynamics. The M&A business is subject to macroeconomic cycles, and the profitable SME sector will inevitably attract more competition over time. However, we still expect NMA's dominant position to remain in place hinged on its defensive network and superior expertise, as well as active investments to expand adjacent offerings and geographies.

Setting an example for their clients, Mr. Wakebayashi (77) and Mr. Miyaki (68) have begun their own internal succession process, gradually building employee stakes for an appointed group of mid-level managers who will one day take over the reins on their departure.

- Fay Ren

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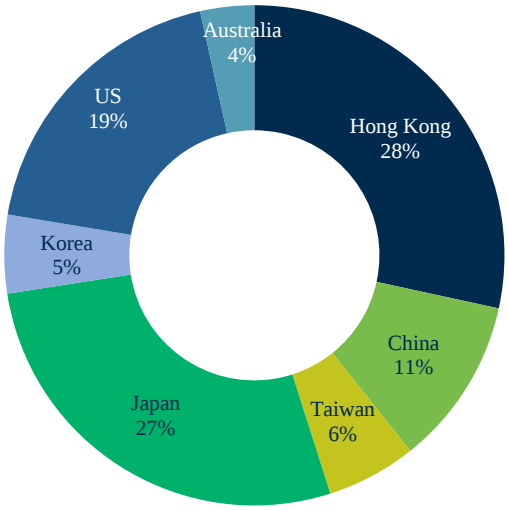
Top 10 Holdings

Tencent	5.4%
TSMC	5.2%
Wuxi Apptec	4.8%
Kingdee	4.6%
Samsung Electronics	4.5%
Nidec	4.3%
Alibaba	4.3%
Tokyo Electron	4.1%
Hangzhou Tigermed	3.9%
Shenzhen Mindray	3.7%

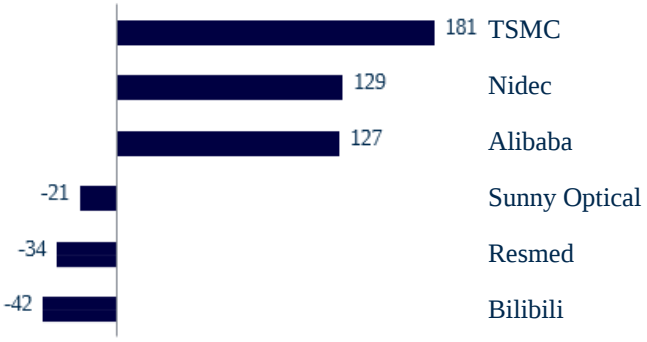
Geographic Allocation (Ex Cash)



Allocation by Sector

Information Technology	30%
Health Care	21%
Industrials	16%
Customer Discretionary	14%
Communication Services	14%
Cash	5%

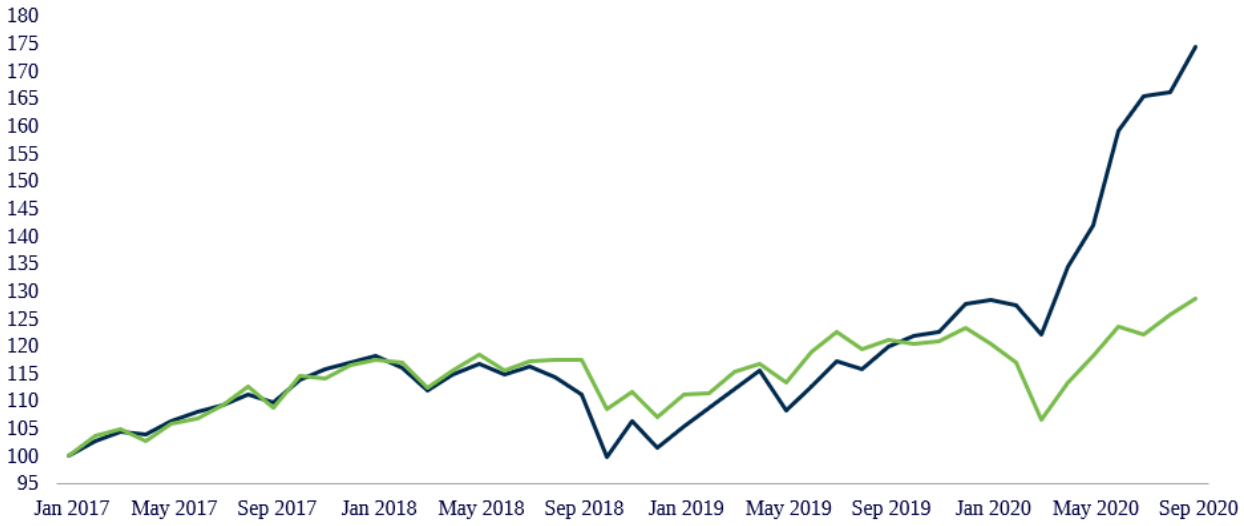
Top/Bottom Quarterly Contributors (bps)



Track Record

Year Ended	Sep 2020	Sep 2019	Sep 2018	Since Inception*
Fund (Class B)	+45.3%	+8.0%	+1.3%	+75.7%
MSCI AC Asia Pacific	+6.3%	+3.1%	+8.1%	+28.8%

**Inception as a UCITS: 27 January 2017*



- TM Cerno Pacific (Class B) - MSCI AC Asia Pacific Index

Performance is based on a Net Asset Value (NAV) price basis with income reinvested, net of fees. Past performance is not a guide to future performance.

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Key Fund Information

Ongoing Charges	Class A Management Fee 1.00% Allocated manager's Fees 0.14% Other Fees (Inc running costs) 0.54% OCF 1.68% Class B Management Fee 0.75% Allocated manager's Fees 0.14% Other Fees (Inc running costs) 0.54% OCF 1.43%
Counterparties	Authorised Corporate Director: Thesis Unit Trust Management Trustee: NatWest Trustees Custodian: Northern Trust Auditor: Grant Thornton UK LLP
Contact	Tom Milnes 0207 036 4126 tom@cernocapital.com

Fund Codes

	ISIN:	SEDOL:	Bloomberg:
A Acc	GB00BDCJ9Z32	BCDJ9Z3	TMCPEAA LN
B Acc	GB00BDCJB138	BDCJB13	TMCPEBA LN

Cerno Capital Partners LLP 34 Sackville Street, London, W1S 3ED Telephone: +44 (0) 207 036 4110 Website: cernocapital.com