



What's Become of Asia's Small Caps?

Seven years ago, Asia's smaller companies had rallied hard out of the Global Financial Crisis. Earnings momentum was strong and the risk appetite among investors was hearty. Fast forward to today, and interest in Asia's small caps—as well as its performance as an asset class—is decidedly more mixed. Risks are perceived to have risen and skepticism returned with cries of “we can't trust the numbers.” So it may be opportune, therefore, to reassess what has changed in this time and evaluate what lies ahead for Asia's smaller companies. Despite the noise and volatility of the sector, there continue to be many opportunities within this universe for us, as active managers, to identify quality companies at attractive prices.

What Has Changed?

Change is a constant, and in the past seven years it has been extreme. Some industries and companies in Asia are now almost unrecognizable. At an asset class level, we have observed four notable changes: heightened volatility, more “punishing” markets, increased scarcity of growth and a larger investable universe.

- ✿ **Volatility has long been a common feature for small companies**—This has predominantly been a function of its thin liquidity and perceived lower predictability (and higher risk) of earnings. Most of the heightened volatility since about 2009 is due to external shocks, the latest example being the surprising outcome of the Brexit referendum. We take the glass half full approach to such volatility and external shocks. We have confidence in the quality-focused nature of our investment philosophy where companies are characterized by strong products, management and balance sheets and in many cases display an ability to adapt to the evolving times and to continue to grow through the cycles. We view volatility as presenting opportunities.
- ✿ **Markets have arguably become more punishing**—Let's take valuations as an example. Previously, cheap valuations typically sufficed to provide share price support. So a high-flying stock market darling, that might have stumbled, would find share price support and be given a chance to prove itself. In recent years, however, we have seen investors become less willing to give the benefit of the doubt and more willing to sell regardless of price and valuation levels. This mentality has undoubtedly been fueled by a rising output of short-seller reports that, through some successful bets, have managed to heighten investor anxiety and foster a wider trend of “sell first, ask questions later.” This raises the need to be even more disciplined in our company analysis. It also highlights how a low multiple does not necessarily signify value; that value can simply end up being a value-trap. This notion is starkly evident in the discounted cash flow intrinsic value formula that illustrates that value is inextricably linked to cash flows and to the growth of those cash flows. Intrinsic value is very sensitive to growth. While we believe that earnings growth is the key driver of stocks over the long term, this assumes that one does not overpay on entry. Our desire to avoid earnings downgrades explains our preference for companies with higher proportions of recurrent and/or more predictable cash flows.
- ✿ **The new global regime of lower nominal GDP growth makes the search for growth companies more challenging**—While challenging, this is not terribly concerning to us. First, we still believe it is possible, with some commitment to hard work, to sort the wheat from the chaff to find growth names. Second, the corollary to a lower aggregate group of growth names is that those pockets of growth that do exist become a scarcer resource and, hence, more “valuable” (in the sense that investors become more willing to bid them up). Obviously, the risk is that valuations paid for growth become excessive. Certainly, low interest rates have exacerbated the picture, pushing up valuations across the board even against a backdrop of fading growth. While we see pockets of over-valuation in small caps, the landscape does not appear egregious. And we have a valuation approach that aims to distinguish between the quality and sustainability of individual growth names.
- ✿ **The investable universe has grown.** The remit alone for the Asia small cap universe, excluding Japan and Australia, (under US\$3 billion market cap) stands at 15,592 stocks—a massive number and much higher than the universe was three years ago (13,227 stocks). Compare that to 10,660 stocks seven years ago. To put this in context, there have been just 1,368



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companies brought public in the U.S. since 2009. Granted a bigger universe does not automatically equal a proportionate increase in quality companies. However, through a deliberated screening process and our bottom-up fundamental analysis, the net impact of a greater universe is in our view translating into a larger pool of growth stocks from which to pick. Particularly encouraging is that 58% of the new Asia listings since 2009 are services, consumption and industrial-related names. In addition, the opening of the China A-share market to foreign investors has brought in a massive new set of companies into our small cap universe, providing not only some exciting new stories but also portfolio diversification benefits. We have made scores of trips into various (and sometimes) obscure cities of China with the aim not just of gathering information and meeting A-share companies but also growing comfort levels to investing in what is a new market to us.

What Hasn't Changed?

Fortunately, the variance in quality in the small-cap indices across Asia hasn't changed. Such variance in quality typically reflects itself in share price performance. Using Hong Kong's small-cap universe (firms under US\$3 billion market cap) as an example, our work shows that over the long term (three years), higher quality companies—defined simplistically here as firms in the top decile for return on equity (ROE)—significantly outperformed bottom decile ROE companies. In our view, this dispersion—which illustrates that small caps are not a homogenous, inter-correlated asset class—is unlikely to diminish and highlights the critical importance of stock selection and indeed of active management.

Let's answer the “change” bit of this question first. What has not changed is the characteristics that we seek (and believe make a good investment) in a small company. Our mandate is to invest in companies with wide and sustainable moats. Our belief, well-supported by history, is that such companies will—even in tough times—continue to grow. We believe buying these at the right valuations can provide a solid risk-return profile.

A solid management team is also a major focus of ours. Measuring competency is somewhat subjective, but a key feature here—in addition to assessing capital allocation, accountability and alignment of compensation schemes with minority shareholders—would be an analysis of operational expertise. Much of this analysis would revolve around margin volatility. We like to see not just historical delivery of low volatility margins but also an ability to scale those margins over time. Obviously, this hinges not just on management but also on a business's products or services, its pricing power and its ability to manage costs. Pricing power—especially in this deflationary environment—is a chiefly attractive characteristic.

Another important part of the search process is filtering out undesirable characteristics, such as lack of transparency and “creative” accounting. We favor simplicity, predictability and evidence of a willingness to invest for the long term. So when we see features such as related party transactions or creative accounting, our default reaction is to take heightened care. This is especially the case where related parties are customers and/or distributors of that company.

We dislike companies on the basis of their lack of differentiation and cyclical/low earnings predictability. In addition, a common feature of companies we tend to prefer is low leverage. Some may argue that this no longer makes sense with the cost of debt now so low. But in this volatile world, we do not want to be stuck with situations where debt-funded expansions or acquisitions hit a snag—triggering cuts in dividends or a drop in the reinvestment rate.

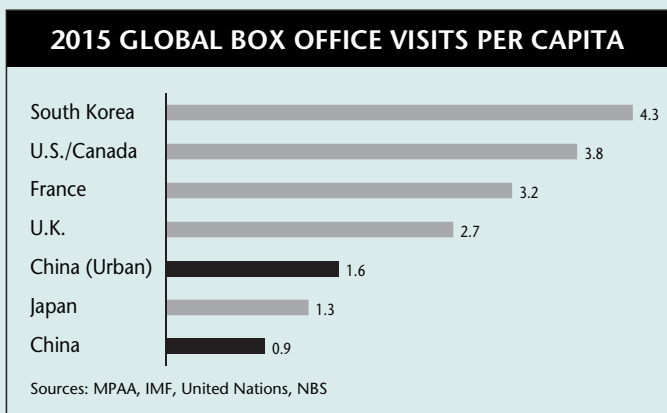
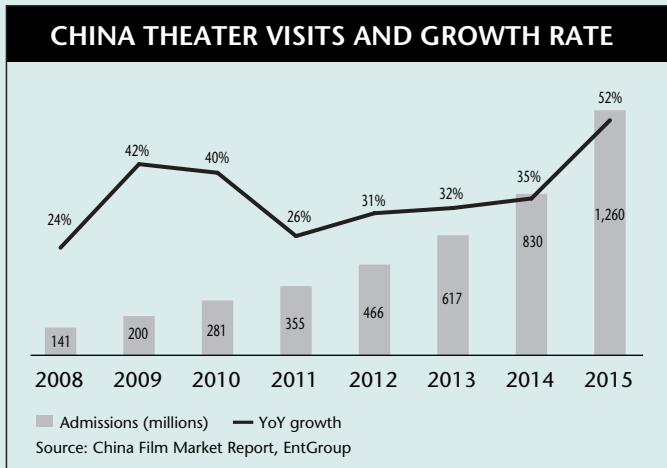
Asia's middle class is continuing to expand, and we continue to favor asset-light, service-oriented sectors and consumer firms with strong brands in industries such as sportswear, leisure, consumer banking, cosmetics, travel, e-commerce and health care. It is worth noting, however, that despite our bias toward branded companies, we do see quite compelling opportunities in service and cost-focused original equipment manufacturers (OEMs) throughout Asia. A common trait among certain OEMs is a propensity to migrate production into lower cost regions such as Vietnam and Cambodia. Exposure to these export-focused, U.S. dollar earners also provides added portfolio diversification.

What Lies Ahead

Taking advantage of a more affluent consumer base, and the need to offset higher wages (a by-product of rising affluence), Asian markets have been seeing the development of more lifestyle-related sectors.

One such sector is that of the film industry. Box office revenues in China, for instance, compounded at 34% (between 2010 and 2015) to US\$6.6 billion. Over the same period, the global box office compounded at just 4%. What's more, China is expected to soon surpass the U.S. as the world's largest box office market. More liberal access to content and investment in content production have also helped feed an appetite for more films. China's previous quota limit set on imported Hollywood movies was relaxed in 2012, lifting the limit from 20 to 34 a year. While China's per capita visits to cinemas has surged, the prevailing ratio—just 0.9 in 2015 versus 4.3 and 3.8 for South Korea and North America, respectively—coupled with hopes of further relaxation on imported content, may spell a rosy outlook for China's overall movie sector.

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Amid Asia’s shift from simple subsistence to having the desire (and means) to indulge, attitudes toward personal health awareness and well-being have also changed accordingly. There is now an increased desire and propensity to exercise. This itself is driving a boom in sports viewership and sports-related industries, ranging from apparel and footwear brands to tech-related health gadgets. Chinese companies have been committing significantly to television rights for high profile soccer and basketball games, and acquiring both minority and majority stakes in European soccer teams and sporting events.

Another obvious lifestyle trend—one that is already advanced in the developed world—is evident in improving dietary habits. Admittedly, China has had its share of widespread food scandals—from tainted baby milk powder to vegetables and meat laced with perilously high levels of pesticides and antibiotics. But there has also been a general trend of better awareness over the benefits of eating healthier. For instance, we see a shift in consumption to things like healthier dairy and plant-based (soy and coconut) beverages, away from carbonated drinks. We see surging

consumption of (and proliferation in companies producing) health supplements, vitamins and other products deemed beneficial to internal health such as probiotics. This is evident across Asia. There are extremes to be found in certain countries like South Korea, which itself is fueling the skin care, hair care and body care industries. South Koreans also have a famous obsession for improving “outward appearances” and among the highest rates of plastic surgery in the world. In our work, we are finding an increasing number of Asian-listed companies that are seeking not only to cater to these rising trends within the region, but also to the same trends in the developed world.

As in the developed world, higher standards of living, greater affluence and longer life expectancies themselves can also have negative side effects. An obvious case is a growing prevalence of lifestyle diseases such as heart disease and diabetes. According to a 2016 World Health Organization report, China in 2014, which accounted for 19% of the global population, had 110 million adult diabetics, or more than 30% of the world’s diabetic population. This equates to a prevalence rate of approximately 10%, versus less than 1% in 1980. Out of China’s diabetics, the vast majority suffered from Type 2 diabetes, which is mostly caused by unhealthy lifestyles and obesity as opposed to Type 1 diabetes, which is diagnosed primarily in children and young adults and typically regarded as congenital or hereditary. We see a rising number of highly innovative, quality-focused, cost competitive manufacturers of devices from pace makers to blood glucose monitoring systems that have grown to meet these domestic and global (hence export opportunity) trends.

Finally, we are encouraged to constantly be discovering not only corporate mindsets that are more open to change but also actual rapid change itself in terms of things like automation and industry structures.

Given the urgency for firms to offset rising wages, investment in automation has been impressive, particularly in China. A decade ago, abundant and cheap labor coupled with long paybacks was such that Chinese manufacturers were unwilling to invest in automation. By contrast, today, we see the desire to invest in automation, and furthermore, a willingness to pay a premium for the best imported equipment (robots, software, 3D printers etc.).

While markets will always be fluid and risks will continue to exist, we believe there is still abundant scope for bottom-up active investors, even for those with high hurdle requirements, to find compelling opportunities in Asia’s smaller companies.

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