



Matthews Asia Perspective

China's Small Companies Win Through Innovation



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Smaller companies typically do not have much capital to compete with their larger peers. A way to win against bigger companies, therefore, is through sustainable innovation. This could be a technology innovation that results in an intellectual-property moat or a business-model innovation where the smaller company has figured out a better way to do business.

Riding a wave of innovation, China's smaller companies are poised to come into their own as investment opportunities in 2018. 2017 was undoubtedly the year of Chinese large-cap technology stocks, thanks to the performance of several large internet companies. Many other opportunities may be available this year further down the market-capitalization scale, however, if investors are willing to look.

About three years ago, for example, mobile phones featured just one camera lens. Today, new smartphones offer multiple lenses to enable users to shoot 3D selfies. As demand for consumer-driven applications in technology devices grows among millennials, we see opportunity in Chinese small-cap companies that manufacture modules for smartphones, as well as those that innovate to make handsets thinner and lighter and with a longer battery life. In addition, semiconductors will be an important structural growth area for China as it tries to become self-sufficient in semiconductor production.

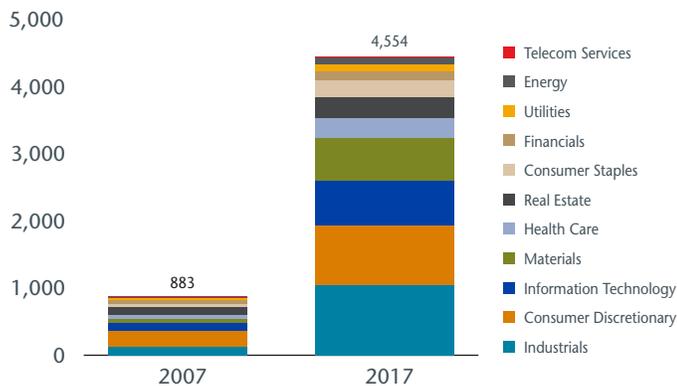
There are many small-cap opportunities beyond technology. China's continuing reforms could create healthy prospects in 2018 for several sectors within the country's small-cap universe. We believe sectors such as industrial automations, health care and consumer discretionary are among the most attractive from a secular growth perspective. Supply-side reform is happening in certain sectors such as materials and energy. Consider the Chinese government's stricter stance toward cleaning up the environment. The country is still powered by dirty coal, so the government has been stringent on the use of coal lately in order to clean up the air and water.

We also believe China will be a powerhouse in global health care, for example, whether in pharmaceuticals drug discovery or diagnostics. In the past, the Chinese have been known to take a copycat approach and this has included Western drugs. The government now is trying to steer companies away from that mentality and has launched initiatives to foster innovation.

Authorities in China's Jiangsu province, for example, have greenlighted a program of genetic sequencing that will see them build a genetic database of Chinese residents. A focus of the program is to identify genes linked to cancer and rare and chronic diseases. In my view, this initiative will change the health care landscape within 10 years because this abundance of data will open up opportunities for innovation in the pharmaceutical industry. We already have seen some Chinese gene synthesis companies develop cancer drugs that offer high cure rates.

Overall, we believe small cap companies in China are at the forefront of the country's economic shift away from fixed asset investments (such as manufacturing, infrastructure and real estate) and toward innovation, consumption and services. The amount of innovation developing in the more entrepreneurial regions is promising and smaller Chinese companies are tapping into it. They tend to thrive mostly in productivity- and value-enhancing industries such as automation, health care, e-commerce and education.

China's Small Company Universe is Expanding for Foreign Investors



Includes all companies domiciled in Hong Kong, Macau and mainland China with market cap of US\$50MN to US\$3BN. 2007 figures do not include companies listed on the Shanghai or Shenzhen exchanges as they were generally not available to foreign investors at that time.

Sources: FactSet Research Systems and Bloomberg as of 31 December 2017

China provides a broad investment universe for stock pickers: over 4,500 companies with a market cap of less under US\$3 billion, which we define to be small cap, are domiciled in China. These companies provide opportunities for higher growth at lower valuations because they are less well known. This

allows active managers like us to uncover high-quality companies with good corporate governance at lower valuations. In a market that is relatively uncovered by the sell-side research community, we aim to identify quality businesses run by disciplined management teams that can grow sustainably and survive over a full market cycle.

We are focused on seeking innovative and capital-efficient, small companies that possess sustainable, quality earnings streams, strong cash flows and good balance sheets. The Matthews China Small Companies Fund aims to provide investors with exposure to a growing universe of small companies that account for an increasingly meaningful share of China's economic growth and access to private sector entrepreneurialism and transformational areas of China's economy. The portfolio invests in asset-light businesses with low leverage. These companies tend to have faster average earnings growth and higher-than-average return in invested capital compared with the overall China small-cap equity market.

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