Asia Insight
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Scouting for Growth-Oriented Companies

Asian growth is more widely accepted today than it was when Matthews first launched its Asia ex-Japan growth strategy in September 1994. Beyond the headline GDP growth figures, companies in some of the region's bigger economies have grown earnings per share, in local currency terms, significantly faster than their U.S. counterparts over a 20-year period. There have been other shorter periods when Asian growth may have appeared to be faltering, but over longer time horizons, it is clear that the region has managed to sustain a robust pace of economic growth.

Over the next decade, we believe that Asia's outperformance relative to the rest of the world will continue. The region's growth drivers are likely to continue to evolve, as they have in the past. For instance, the recent drop in export-related demand is likely to accelerate the shift toward domestic consumption in countries like China. That growth, in turn, will prove to be more sustainable, though rates are likely to be more modest compared to recent growth. As investors in Asian growth, our efforts are firmly focused on understanding companies and the industries in which they operate. There are no surefire templates, and in fact, maintaining a rigid checklist with which to evaluate companies can be an exercise in futility. In constructing our portfolios, we have found it helpful to assess the interaction of the following three variables to understand the long-term prospects of an investment: the quality of a business, management team strength and the price at which an investment is available.

Defining Growth

We have a broad definition of what constitutes growth without being constrained by any specific numbers. "Real" growth and economic progress, which enhances people's lives, is more desirable than growth that is unsustainable over longer periods. In the year leading into the Asian financial crisis of the late 1990s, it seemed that a combination of easy capital and delusions of endless prosperity were influencing corporate behavior in many parts of Asia. In the mid 1990s, GDP growth in Thailand accelerated to a pace of 10% led by a spike in fixed asset investment. It culminated, however, in a collapse in real estate prices, which have yet to fully recover on an inflation-adjusted basis. In the late 1980s, Taiwan experienced a similar situation with the growth cycle typified by asset appreciation and property markets that seemed to rise endlessly. Invariably, such cycles lead to bloated balance sheets at the corporate level and a fall in efficiency measures such as asset turnover. They also indicate that growth rates are unlikely to persist. What is likely to be more sustainable is "organic growth" such as that exemplified by new markets like India's telecommunications industry, which began taking shape less than 10 years ago.

Identifying the right business with sustainable growth characteristics is vital, and can at least partly offset potential missteps in the investment process. In spite of the region's noteworthy growth of the last decade, only a few companies in Asia ex-Japan have been able to post at least 10% annual sales growth (not compounded) consistently, which underscores the difficulty of assessing the competitive advantages surrounding a particular business—whether it is branding, production costs, technological edge or distribution networks. As their sales grew, many of these companies generated significant wealth for their shareholders. In our experience such competitive advantages often manifest themselves in businesses that are able to grow without necessitating multiple injections of capital. Therefore, it is often more rewarding to consider companies that grow at a measured pace for several years, rather than ones that blaze the charts over shorter time horizons only to fizzle out later.

When examining the suitability of a business, industry structures that are conducive to expanding profitability can also provide a cushion to management teams. The point is best exemplified by comparing investing in commodities with investing in the consumer sector. When it comes to commodities, there are vagaries of cyclicality and the timing of inflection points in commodity prices. Beyond this, the specter of government interference is particularly pronounced in Asia. The threat of rising inflation can provoke governments to cap rising commodity prices, forcing companies to subsidize the consumer in domestic markets. An investment in Asian commodity companies is somewhat akin to writing a call option with a much higher downside, and a relatively contained upside.

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In contrast, we believe the simplicity and recurring nature of consumer businesses are desirable characteristics. Compared to the consumer sector, the semiconductor industry, for example, requires skilled management and proprietary technology just to stay afloat. No doubt there are excellent semiconductor companies, but the challenge of pushing the cost or technological curve year after year can be exacting, and it becomes imperative to identify the right management teams capable of staying ahead of the curve.

The Integrity Check

As minority investors, the risk of investing in firms with mediocre or misaligned management teams can be exaggerated. This can be particularly true in industries that are more dependent on good management. A big source of frustration can revolve around a misalignment between the motives of a company's founding owners and its minority shareholders. The development of Asia's capital markets and the increasing use of equity markets as a source of finance are fostering a better understanding of minority rights, but the risks of stepping on governance-related minefields are real. There is no better alternative than continuous meetings with management teams, and cross-checks with their peers, suppliers and customers to gain insight into the integrity of a firm's managers. We look for positive signs such as a dividend policy, independent board and professional management. Yet, instances of corporate fraud will continue to test the resolve of Asian investors unless a culture of corporate governance starts to take hold.

In our experience, one of the best times to assess management teams is during tough economic environments. The ability to guide a company through troubled waters with honest and open communication is the hallmark of a seasoned management team. Instances of outright fraud can be limited by focusing investments in businesses that are inherently more transparent, such as those in the services sector where capital requirements are limited and entrepreneurial zeal, rather than political connections, affect long-term success more.

The Price is Right

While attempting to value a company, it is important to keep an open mind. We are disciplined in our approach of exploring the intrinsic value of a business, rather than fixating on a specific multiple such as price to earnings ratio (P/E). If a firm's business model and management team are identified correctly, the burden of being precise with valuation is at least partly diminished since the rate of return on the investment will be supported by long-term earnings growth. Nonetheless, we try not to overpay, whether it is for earnings, cash flow or production output.

In our investing process, it is rare to select stocks simply because of low valuations. One potential challenge is overemphasizing the valuation risk, and underestimating the risk to business fundamentals. It is much more critical to understand the economic progress that is possible, and a confirmation that improvements are taking place.

In the region, and particularly in Asia ex-Japan, the economic tailwinds from broad-based wealth creation set the foundation for a fertile environment within which to scout for growth-oriented companies. However, growth investing doesn't necessarily mean glamour investing in the "industries of the moment." We find that a disciplined approach is necessary to generate long-term capital appreciation in the sometimes volatile markets of Asia. We continue to focus on identifying companies that have durable competitive advantages and can sustain high levels of profitability, revenue and earnings growth over the long term. We don't try to time market cycles because, in our view, that can hurt performance. Despite some near-term challenges, we believe Asia is entering a phase in which economic growth may moderate. However, profitability levels should improve, and seeking exposure to growing earnings streams will be rewarding for investors willing to withstand the region's inevitable ups and downs.

Sharat Shroff, CFA
Portfolio Manager
Matthews International Capital Management, LLC

This month Asia Insight focuses on the topic of growth in Asia, and features a conversation with the following Matthews Asia Funds Portfolio Managers:

- **Taizo Ishida**, Matthews Asia Pacific Fund and Matthews Japan Fund
- **Lydia So**, Matthews Asia Small Companies Fund and Matthews Asian Technology Fund

Our regular country updates are available on our website at matthewsasia.com.

Investing for Growth Roundtable

The information below does not constitute a recommendation to invest in any sectors mentioned.

Q: How do you assess growth in Asia?

A: Lydia So: I see growth in three categories. There is secular growth, which we see when increased wealth among a population leads to more demand for products and services that enhance their living standards. In Asia, we see a lot of this first category and it's the most obvious type of growth. Second, there is growth that comes about through innovation such as new products and the introduction of new business models. We're seeing this more and more in Asia in industries such as technology and health care. I favor these first two categories. The third category is growth that is cyclical in nature, which may, for example, be an industry that is recovering and growing again.

A: Taizo Ishida: It's helpful to identify companies that are utilizing proven business models that we've seen work before, let's say, 20 years ago in a more developed country. The notion of growth and value is a bit intertwined for me since I look for growth at attractive valuations. I'm always more interested in finding growth in overlooked sectors where the growth is less obviously identified. You don't pay as much for those companies.

We have a discipline of looking at a company and comparing it to what similar companies have done in bigger economies. Then we assess how big we think it should be in 10-years time. That sort of discipline helps so that you don't pay too much attention to high rates of short-term growth. The more you stretch out the time horizon of your investment the more you start to take a different approach to growth.

Q: What other parameters are important to consider?

A: Lydia So: There are many things that we consider. On the macro level, you need to look at growth by putting it into context in terms of a country, industry or company's stage of development. You can't just look at growth in a vacuum. On a company level, a strong balance sheet and cash flow in particular help us feel confident that a company can grow in a sustained manner. A company's ability to grow without diluting the cash flow to shareholders is key. A lot of people think of growth in terms of sales or in terms of profits but what's really important is sales per share or profits per share. We look at a company's ability to fund the growth internally. That sort of profile gives you a bit more comfort.

Q: Are you also finding business models that you haven't seen in bigger economies?

A: Taizo Ishida: Yes, in Asia we often find business models that you don't see anywhere else. You think you've seen it all, and then you come across a business model you haven't seen before. Those are areas that are really fascinating, but we need to be very careful in assessing the real value of these particular businesses.

But in our search we still maintain a bias toward companies that are relatively low on debt. Ultimately, growth is a series of investment opportunities, whether it's new products or building new capacity.

Q: Can you give an example of a growth opportunity you are excited about?

A: Lydia So: At this juncture it's really interesting because the economies are emerging from a downturn, and bad times really weed out the weaker players. For example, it's been a terrible time for airlines but I know of an in-flight catering company which, during the downturn, has acquired other firms. Now they can position themselves for the upturn and they are supplying services to non-aviation businesses such as resorts in Singapore and also catering to hotel employees in Macau. While other firms are still struggling, this company is a good example of one that is able to leverage its strong balance sheet to weather the turbulence and keep growing.

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