Asia Insight
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All Things Great and Small

Since we launched the Matthews Asia Small Companies Fund one year ago this month, investors have witnessed nearly frozen credit markets, diminishing export figures and high profile corporate failures in the U.S. and Europe. World economies limped along as the West cut spending, and commodity prices corrected sharply as global demand contracted.

Amid the chaos, how were small companies in Asia coping? While the region itself wasn't suffering from the same weak balance sheet as the West, nor was it immune to the global economic shocks. Asian exports fell month after month following the worst of the crisis. News of hordes of Chinese migrant workers left unemployed after factory closings made headlines even in the West. Not surprisingly, small-cap stocks suffered greater sell-offs than did their large counterparts because of extreme risk-aversion and concerns over funding in a tightened credit environment. Indeed, some companies that had borrowed money for expansion or mergers and acquisitions during better times suddenly found themselves skirting bankruptcy.

When an accounting scandal involving a mid-size Indian IT services firm was uncovered, investors began to second-guess the integrity of some smaller companies in what they had considered to be a professional market backed by the highest return on equity in the region. There was reason to be skeptical elsewhere in Asia, too. In South Korea, small export-oriented companies suffered losses after buying a kind of currency hedge, known as a KIKO (Knock-In Knock-Out) contract, without fully understanding its risks. In Hong Kong, some companies incurred trading losses when derivatives they held plummeted in value. In this climate, many shied away from small companies, wondering about untested management and fearing the possibility of more ugly "unknowns."

But then came glimmers of optimism: China signed a massive US$586 billion stimulus package; global financial markets started to stabilize; and India's markets rebounded after an election victory of the ruling Congress Party allowed the introduction of reforms to stimulate economic growth. As confidence crept back so did capital flows. Regional trading activity among foreign investors has turned from net sales in 2008 to net purchases year-to-date.

Small-cap companies have actually rallied more strongly than large caps since the distressed levels seen in March. The MSCI All Country Asia ex Japan Small Cap Index rose 68% from March to August, outperforming the MSCI All Country Asia ex Japan Large Cap Index by 21 percentage points. Initial Public Offerings (IPOs) also improved with restored liquidity and risk appetite—more than 130 small companies have listed since January this year.

Over the past five years, more than 2,000 new small companies in various industries have raised more than US$120 billion through IPOs. Of those, consumer-related companies account for almost a quarter, and capital raised was typically used to expand capacity, sales networks and distribution channels. Companies are also spending more on brand building. The new focus on domestic demand may prove an important structural change in the environment for small companies. For many, it will be easier to thrive in their home markets, unshackled from the domination of multinationals—it is these long-term strategic considerations that are important, rather than a fixation on short-term earnings momentum.

The True Picture

What's important to note is that the stock prices of small companies tend to be more volatile—they are more severely punished for their mistakes, but generally more richly rewarded when investor confidence returns. This cyclicality can be intimidating—worse, it can lead to investors taking too short-term a view.

As long-term investors in Asia, we believe in looking beyond short-term "noise" and focusing on the structural changes taking place in the region's markets and economies. We see Asia shifting away from economies dominated by government-owned entities and embracing deregulation and competition to drive economic efficiency. These changes are apparent in the Indian government's encouragement of competition in India's telecommunication space as well as in reforms to China's banking sector.

To be sure, Asia has had its fair share of past crises—the Asian financial crisis of 1997–98 led to wide swings in currencies and asset values. The region has also seen a long process of deleveraging corporate balance sheets and even epidemics

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such as the SARS outbreak. But the underlying economies have adapted to these cycles, and average household incomes in the region have risen. As wages among Asian consumers continue to grow over time, the desire to improve living standards will also develop and, we believe, the goods and services of small entrepreneurial firms will rise with demand. It is this growing domestic consumption and entrepreneurialism that should be one of the important growth drivers in the Asia ex-Japan region.

What is particularly encouraging about the growth we are seeing is the overall evolution of the consumer experience in China's growing middle class. Currently, China's private consumption as a percentage of GDP is about 40%, compared to 70% in the U.S. To put things into perspective, China now has more than 600 million mobile phone subscribers and has surpassed the U.S to become the largest automobile market in the world, with 10 million vehicles projected to be sold this year. China's consumption market is massive and has been growing at 15% annually in nominal terms. This size and growth attracts local entrepreneurs. Businessmen, who had been focused on making products cheaply for foreign brand names to sell in the U.S., and who effectively had their margins controlled by the larger U.S. entity, have learned the value of brand equity. They have also learned of the huge growth potential within their home market, and are setting their sights on building domestic brands.

Another source of quality growth we are observing throughout the region is rising competitiveness and technological know-how. This is apparent particularly in India's pharmaceutical sector. The sector started off with reverse engineering in the 1990s. Talented management teams have steered some companies to become world class competitors in the generic drugs space. India now claims the largest number of FDA-approved manufacturing facilities outside the U.S. And within India's domestic market, pharmaceutical companies are also ramping up to meet domestic demand, which has been growing at 12%.

Factors that are driving growth in the small-cap universe include:

- A deepening of capital markets, which can help small firms be less reliant on bank loans
- Focus on domestic markets by smaller companies in industries that are still in the early stages of development, especially in sectors such as consumer goods and services, health care and technology
- A new culture of entrepreneurs with a competitive drive, seeking profits (compared to the old state-owned enterprises) which should mean more accountability to shareholders

Looking Ahead

The recent sharp market rallies have prompted questions over whether stock prices have run ahead of fundamentals. It is still unclear as to how long it will take for the global economy and corporate earnings to fully recover. There are some concerns that China's massive surge in loan growth could eventually lead to non-performing loans in the banking systems followed by monetary tightening policies. Can small companies be hit hard again if faced with scarcity of capital and a potential for fleeing liquidity?

We believe the merits of investing in Asia's small companies remain attractive. While we don't expect smooth sailing, there is no reason to believe the secular growth trends cannot continue over the long run. We believe that more small to medium enterprises will continue to surface, expanding the investability and diversity in the universe. In an encouraging sign, China is planning to launch the Growth Enterprise Market (GEM) board in its Shenzhen A-share market next month. Chinese securities regulators have reported that the GEM would be designated to small companies and focus on six sectors this year—including new energy, bio-pharmaceuticals and information technology. This development highlights the burgeoning number of small-to medium-size enterprises and the importance of expanding financing channels for them. In many parts of Asia, there are already separate boards designated for small companies within established stock exchanges.

Admittedly, not many small companies are on their way to becoming the next blue-chip in their industry. For those companies that do not have quality, sustainable business models or strategies to tackle changing competitive landscapes, their abilities to endure will be questioned. This recent downturn has been a true test of management strength and sound business models. We are happy to see quality companies standing up to the challenges and emerging to capture growth opportunities in the years ahead.

Lydia So
Portfolio Manager
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This month Asia Insight focuses on the topic of small companies in Asia, and features a conversation with the following Matthews Asia Funds Portfolio Managers:

- **Noor Kamruddin**, Matthews Asia Small Companies Fund and Matthews India Fund
- **Michael Han**, CFA, Matthews Korea Fund

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

Investing in Asian Small Companies Roundtable

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

Q: Can you give an example of small companies in Asia bettering competition?

Noor Kamruddin: In India, the banking sector has grown. Bank assets there total about US$1 trillion while GDP is also at about US$1 trillion. Meanwhile, credit card users as a percentage of the total population are at about 1.8% in India—much lower than the U.S.—and mortgage penetration as a percentage of GDP is only 7% compared to 80% in the U.S.

Small private banks are improving services for clients, and this has ignited competition among government-owned banks. Whereas before, you might have had to wait in several different lines to take care of your different banking needs, now they are putting in place single-service windows for better efficiencies. We're also seeing faster turnaround times for loans.

So there's a lot of room for growth for financials in India. Unlike the U.S. where financials are mostly large-cap firms, we can find blue chip financials in Asia that are still small.

Michael Han: Small banks in Korea also have their advantages. While commercial banks are subject to political intervention, small regional banks in Korea tend to have better operating metrics, better net interest margins and better returns on equity.

Q: Do you see differences in the small companies of Asia compared to those elsewhere?

Noor Kamruddin: The main difference is small companies in the U.S. tend to be in new and emerging fields. These can be your Internet start ups or other technology sector companies that may require US$10 million to US$25 million up-front for new ideas—with the hit-or-miss ratio of success being quite high. The small companies we look at in Asia, by comparison, are in sectors with more stable, proven business models. For example, the up-and-coming small health care companies are not developing new drugs but working mostly on generics or consumables. The tech companies are also different in that they are more service oriented. The number two tissue paper company in China and the number one paint company in India, for example, are both small-cap firms. There are some new innovative companies, but they are prudent with capital.

The largest differences in the sector weightings of the MSCI All Country Asia ex Japan Small Cap Index and the Russell 2000 Growth Index are in health care, IT and financials. The Russell Index has a 20% weight in health care and a 26% weight in technology, whereas the MSCI Index only has 4% in health care and 19% in IT.

Q: How do you assess management for smaller companies?

Michael Han: We usually look at all the same things—head room, competitive advantage and business model. But the business model matters a lot with small companies. With Korean small companies, we try to figure out whether the chaebol companies (family-owned conglomerates) will try to jump into the same space.

We look for companies that aren't just a supplier of components for a bigger foreign company that can grow only so much.

I'm not looking for pure growth in my approach to small companies; growth is not the number one criteria. I try to look for solid business models and good ideas. In my case, for Korea, we look at markets for industries that are going to be around for a while like brokerages or education companies or travel services. We assess good market share and competitive advantages.

Noor Kamruddin: I'd say the general process is the same but there are fewer reports and less analyst coverage for the smaller companies. This can be good because sometimes these companies can go unnoticed by other people so that you can snatch them up for cheap. But then some companies may have their annual reports only in Korean, for example, so you have to know the language and do your due diligence.

Q: What structural changes do you see in Asia now that are supporting growth for these new companies?

Michael Han: The deepening of capital markets and corporate debt markets are helping small companies be less dependent on banks. Better governance is also increasingly important in supporting new ventures.

Korean exporters have enjoyed a re-rating of their market status because they have very strong balance sheets. If they were second-tier companies before, their strong balance sheets have bumped them up.

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