Asset allocators, fund managers and even company management teams are often guilty of simplifying the opportunity set in Asia to the extreme. Investor presentations are frequently littered with headline-grabbing statistics, including numbers such as the expected proportion of global GDP to come from the region by 2050, or the total size of the middle class by 2020. To confuse matters further, these big picture musings frequently use arbitrary timescales, alongside often far-reaching assumptions. Although these metrics can provide some perspective, they do not tell the full story.

As Asia specialists, we at Matthews are well-versed in the macroeconomic attractions of a region that doubtless has some economies well-placed for long term, structural growth. However, market and economic history tell us that there is little correlation between GDP growth and equity market returns. Rather, it is corporate profitability that is the primary driver to concern ourselves with. Economic growth in Asia provides corporations with opportunities to enhance earnings, book value and cash flow, but only certain companies have the ability to take advantage of this and create value for shareholders through economic cycles.

At Matthews, we often talk about investing in “quality” companies with “economic moats” as we believe these entities are best-placed to succeed over the long term in Asia. After all, we are investing our shareholders’ capital to own part of a business, not speculating on the near-term movements of share prices. In our February 2014 issue of Asia Insight What Defines Quality, we addressed a number of areas that help define a “quality” business, including track records, incentive structures, capital structure and return generation. An important facet is finding those companies with high and sustainable returns that are derived from a real competitive advantage, or as Warren Buffett referred to in Berkshire Hathaway’s 1995 Annual Report “economic castles protected by unbreachable moats.” These moats enable a company to survive and thrive as decades pass, creating economic value along the way through generating returns ahead of their cost of capital.

But what exactly is an economic moat? And how are these derived? Whilst cultural and economic differences create nuances across geographies, competitive moats tend to be derived from the same general sources. Pat Dorsey’s The Little Book that Builds Wealth describes these well as broadly falling within four categories:

1. The Network Effect
2. Intangible Assets
3. Cost Advantages
4. Switching Costs

The first of these, the “Network Effect,” revolves around the premise that the value of a company’s service increases for both new and existing users as more people use it, such as online tools like social networks. “Intangible Assets” involve the benefit of patents, brands, licenses, et al., that may prohibit copycats and build trust, experience or prestige in the minds of consumers. “Cost Advantages” are found in firms that have a structurally lower cost base than peers, enabling them to offer customers a lower price. Lastly, “Switching Costs” involves those situations where a customer changing providers would be too expensive or particularly disruptive.

How are Moats Achieved?

All of these premises may be common sense investing for most people, so we need to go further and understand how moats were actually achieved historically. Additionally, what is the direction of an economic moat—is it widening or is it being eroded as economic textbooks suggest is likely to occur over time?

Performing this form of analysis in Western markets is tricky enough. But it is fair to say that the history and width of economic moats in Asia is open to even greater deliberation in many cases given ownership structures, a historical lack of standardized accounting, crony capitalism, protectionist policies and weak transparency in subsidy and tax regimes.

For example, the Economist magazine’s Crony Index study suggests that approximately 50% of the wealth of Asia’s billionaires has been derived from sectors that are prone to crony capitalism. These kinds of businesses may
“Buffet spoke of ‘economic castles protected by unbreachable moats.’ These moats enable a company to survive and thrive as decades pass, creating economic value along the way through generating returns ahead of their cost of capital.”

optically have high returns, but, as bottom up investors, it is important for us to understand if the business is generating its wealth through a real competitive advantage, or if it is through governmental relationships that may change over time with incumbents, as markets liberalize and as the rule of law becomes better enforced. In Asia, there has historically been a strong propensity for firms to put capital to work in conjunction with the national goals of governments, as well as rampant instances of bribery. Indonesia, Thailand, the Philippines and India rate particularly poorly on Transparency International’s Corruption Perceptions Index. One may even include the oft well regarded Hong Kong government that has enabled a small clutch of property tycoons to control the incredibly limited supply of housing in the city state. Ultimately, “rent-seeking”* derived from political connections cannot be counted upon as a guaranteed structural economic moat for businesses over the longer term, as witnessed by prior failures of these systems in other geographies throughout history, with popular discontent often eventually influencing public policy. The expected, and entirely necessary, path of structural reform to enhance productivity across parts of Asia will make this misallocation of resources ever harder to justify, otherwise growth inevitably sputters.

Another overstatement of return profiles often found in Asia is through the existence of trade restrictions and protectionist policies. Time and again we see “walled gardens” protecting incumbents from foreign competition and forcing an improvement in the value proposition to customers. These industries range widely and include areas such as mining, cigarettes, health care, telecom, technology, and even retail in geographies such as India, through the limitation of foreign ownership in subsidiaries.

Arguably, the greatest culprit of all within unsustainably high returns, and hence economic moats across the region, comes from subsidy regimes in place, particularly in China. There is some debate amongst economists as to the efficacy of such policies with a small number arguing that they can help create growth but most believe that they create activity instead of outcomes. What is clear at an individual company level is that these should not be relied upon as consistent sources of profits. Broadly speaking, competition in China is frequently undermined by distortions in areas like the cost of capital, the price of land, the price of power and outright cash subsidies dished out to certain industries.

The largest misallocation of resources that can be seen is through the financial system within the Communist state, as banks have an imposed maximum deposit rate that they can offer to their customers. This mechanism ensures that the savers in Chinese society essentially subsidize industry (and inherently state-owned enterprises) with cheaper interest rates than they should receive.

During the Party’s third plenary session last year, one of the key focal points of reform over the coming decade was financial liberalization, including the loosening of this mechanism, amongst others, and encouraging foreign competition (today, only ~2% of banking sector assets are held at foreign banks). The impact on bank return on equity (ROE) is obvious. Although high today, banks will no longer be guaranteed a cheap funding base to boost these returns. In addition, they will likely have to pay for deposit insurance and may even be forced into more realistic reporting of their non-performing loans. Further, the favored lending rates to state-owned enterprises should also come under pressure. If so, SOE return profiles may drop, particularly in light of the excess capacity that this form of cheap credit tends to create.

China’s domestic auto industry is a prime example of this kind of overcapacity as governmental subsidies and cash flow from foreign joint venture partners encourage failing domestic brands (which continue to lose market share) to expand their offerings in the hope of building a national champion. Interestingly, despite being a member of the World Trade Organization (WTO), China has only disclosed its subsidies once since joining the WTO in 2001. This is despite there being a requirement to disclose these once every two years.

Compounding these challenges is also a mentality that has pervaded in many parts of Asia for decades. That is, the model of being a manufacturing center focused on tangible assets and ignoring the building out of intangible assets through research and development and advertising and promotion to help innovate and create brands, and earn the trust of consumers. This is highlighted to a slightly worrying extreme in Interbrand’s 2013 evaluation of the World’s most valuable brands, where only 10 of the top 100 brands globally originated from Asia. We should remember that of our four sources of economic moats above, all are helped by these important investments, amongst other factors.

*When corporations or countries extract resources for their own economic gain without reciprocating benefits back to society.
“...it is fair to say that the history and width of economic moats in Asia is open to even greater deliberation in many cases given ownership structures, a historical lack of standardized accounting, crony capitalism, protectionist policies and weak transparency in subsidy and tax regimes.”

Whilst this may have been an acceptable position historically, as Asia continues to develop, it is important that governments and companies in the region adapt to future changes, including social media, better-educated populations, increasing labor and capital costs, and greater competition from Western multinationals. All of these factors may meaningfully impact the returns that businesses can generate, where previous winners will no longer be able to just “stick to their knitting” and not adapt to incoming and improving foreigners. As an example of this, China’s child nutritional products industry is still dominated by foreign players despite attempts by Chinese firms to build a local champion. In fact, as one passes through the Hong Kong airport, instead of hearing warnings about drug trafficking over the tannoy, reminders to all travelers entering China are provided regarding the two-tin limit on infant formula. This is quite an example of brand, prestige, and safety that foreign companies have managed to create, albeit local companies have partially manufactured their own downfall by destroying consumers’ confidence in their safety after repeated scandals.

There is some evidence that many Asian companies do seem to be recognizing these challenges. Not only do we consistently hear more companies talking of real brand building, but there has also been a tangible increase in research and development (R&D), with China leading the way having increased domestic expenditure on R&D by about 21% per annum between 2000 and 2010.

Of course, spending on R&D and advertising are, by themselves, no certainty in being able to build an economic moat, nor increase an existing moat’s longevity. The real key is how this capital is spent and how willing are businesses to harness the vast pool of improving young talent across the region? We have to ask ourselves are companies now trying harder to innovate, and are they aware of disruptive innovators that frequently come into industry and upset the apple cart? It is important for Asian companies to continue down this newer path of differentiated, sought after offerings, whether it be engineering excellence in infrastructure development, superior service in retail, class leading innovation in healthcare, or just plain good value for customers. These steps will help them continue to create value through governmental changes, reform agendas, increasing labor costs and across economic cycles, especially as we see improvements in the rule of law and patent protection. This is particularly true in an age where global supply chains exist and integrated media provides a more level playing field for new players. Further, past missteps of Western companies entering Asian markets with the hubris of no localization strategy look to be in decline as these entities better target some of their greatest opportunities for growth. Rarely do we see such mistakes today as, for example, Best Buy’s miserable venture into China during the 2000s, where they rolled out the American model of big box stores, only to be swept aside by local competition.

It is within this backdrop that fundamental analysis is key. The opportunity set of true value creators in Asia is large, and likely to continue to grow given improving education standards, supportive domestic environments and a strong entrepreneurial spirit. At Matthews we try to understand an industry’s structure, meeting regularly with company management, their suppliers, their customers and even their peers. These are all vital cogs in getting behind the history of a moat, its size and its likely longevity, allowing us our best chance to understand true intrinsic value creation.

Kenneth Lowe, CFA
Portfolio Manager
Matthews Asia

**Regional Share of Worldwide R&D Expenditure: 1996 and 2011**

<table>
<thead>
<tr>
<th>Region</th>
<th>1996: US$522 billion (total world spending)</th>
<th>2011: US$1.4 trillion (total world spending)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asia/Pacific*</td>
<td>19%</td>
<td>40%</td>
</tr>
<tr>
<td>North America</td>
<td>39%</td>
<td>30%</td>
</tr>
<tr>
<td>Europe</td>
<td>26%</td>
<td>20%</td>
</tr>
<tr>
<td>Rest of World</td>
<td>16%</td>
<td>5%</td>
</tr>
</tbody>
</table>

*Asia/Pacific includes China, Taiwan, Japan, South Korea, Singapore, Malaysia, Thailand, Indonesia, Philippines, India, Pakistan and Sri Lanka

Source: Science and Engineering Indicators Digest 2014
Disclosure and Notes
As of July 7, 2014, accounts managed by Matthews Asia had not held a position in Best Buy Co., Inc.

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