Matthews Asia

Matthews Asia Perspective

The Case for Value Investing in Asia

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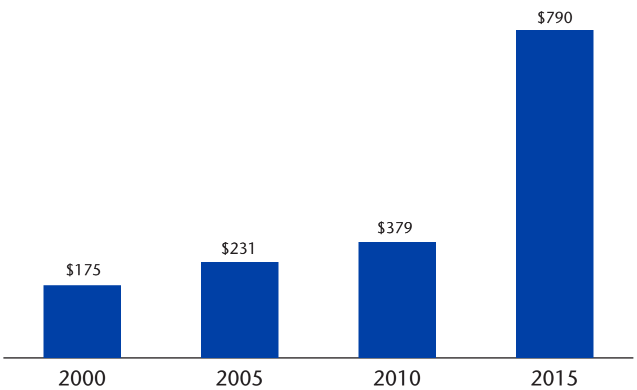
When considering Asia, investors typically think of growth and conjure up images of a bustling Asian metropolis. Indeed, Asia excluding Japan, led by China, notched one of the fastest growth periods in history over the past few decades and lifted hundreds of millions of people out of poverty. Not surprisingly, then, most Asia-focused investment strategies tilt toward growth. We believe the time is ripe, however, for a value-oriented investing strategy in Asia to shine. After all, what if you could buy growth at a discount?

Value investing in Asia, which is still one of the fastest growing regions globally despite the recent slowdown, is not an oxymoron. The common definition of value investing is to buy undervalued companies at a discount to a conservatively estimated intrinsic value. The idea of buying a dollar's worth of intrinsic value at seventy cents or less while that value continues to grow is as applicable in Asia as elsewhere. Value investors want to buy growth—the faster the growth, the better—but only at a substantial discount.

Two key conditions are now in place for a value-oriented investing strategy in Asia. First, the slowdown in Asia in recent years has led to a compression of earnings multiples in the valuation of many companies in the region. Many of these same stocks used to be growth darlings trading at a highflying multiple that is the bane of value investors. But many now trade at no higher than a mid-teen P/E ratio while still generating double-digit profit growth, albeit not growing as fast as before. In some cases, a drop in the valuation multiple has gone ahead of deceleration in earnings growth. Thus a meaningful discount has emerged between the share price and a conservatively estimated value of the business. This presents opportunities to value investors that were not as readily available earlier.

Corporate governance is another key condition. Though progress in this area often feels like a case of two steps forward and one step back, corporate governance has significantly improved across Asia in the two decades since the Asian financial crisis in the late 1990s. Many Asian companies are either state-owned enterprises or family controlled. Thus investors have been rightfully concerned about how minority shareholders are treated. A key metric is the return of cash to shareholders. Though this metric still leaves a lot to be desired in some countries, it clearly has been moving in the right direction as the payout ratio and buyback levels are higher now than ever for all major Asian markets. A case in point is a major electronics company in South Korea that has been conducting multiple rounds of share buybacks recently. This would have been unthinkable a decade ago. Furthermore, more and more companies in the region are engaging in shareholder-friendly moves to unlock value by doing spin-offs, de-mergers, or selling off non-core assets. In 2015, for example, a prominent Hong Kong-based conglomerate announced it would be split into a property entity and a non-property entity. This was hailed by the market as a value-enhancing corporate move. Overall, better corporate governance leads to higher chances for value stocks to shrink or close the valuation discount.

Figure 1. Value of M&As, Investments, Spin-Offs, and Buybacks in Asia ex-Japan ($ bn)



Note: Asia ex Japan is target or seller (criteria filter in Bloomberg search)
Source: Bloomberg; January 13, 2017

The Asia (ex-Japan) market actually never lacked undervalued stocks. Most of them, however, are undervalued for a reason. It may be because the business has not been growing and has no sustainable growth prospects, corporate governance is poor, management has questionable characters or a shady past, business quality is mediocre, or its financial numbers are too good to be true. Due to the less developed nature of its economy and market, Asia is full of such land mines if one blindly invests in statistically cheap companies. We believe quality of the underlying business and its management should be considered first and foremost in a value investing strategy in Asia, even more so than when investing in the United States or Europe.

Why do we believe such a value investing strategy could work in Asia? It is for the same reasons it has been working well over a long period of time in the United States and Europe. Markets everywhere inevitably go through cycles driven by human psychology such that, in market dislocations, share prices are pushed to levels that are way above what they are worth on the upside and, likewise, pushed way below what they are worth on the downside. Therein is opportunity. Value investors typically react to bad news. Bad news could happen at company, industry or country level. This often leads share prices to decline and hit bargain levels. A key question for value investors becomes: Is the bad news more than discounted in the share price? This is as relevant in Asia as in any other market.

Make no mistake, growth-oriented investing in Asia continues to make sense and satisfy the needs of many investors. Vast pockets of strong growth remain in the region, such as in India, Vietnam and Indonesia. The Asia (ex-Japan) region overall, however, has felt the impact of China's slowdown in recent years. Given this backdrop, we believe now is the time to consider value investing in Asia, a strategy that has worked well over the long run in the United States and Europe.

Disclosure and Notes

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