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Matthews Asia

Matthews Asia Perspective

Asia's Small Companies Go Big

Reflections on a Decade of Small-Cap Investing

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Fueled by greater connectivity, robust digital ecosystems and the growing purchasing power of millennial consumers, small companies often have the most attractive growth potential in Asia. As we celebrate the 10th anniversary of the Matthews Asia Small Companies Strategy on September 15, 2018, it's a natural time to reflect on changes we've seen across the region. Today, the most creative new companies in Asia can find their ideal consumers more quickly and grow at scale faster. In addition, many small companies in Asia tend to focus on domestic markets, insulating them to a degree against global macro concerns such as trade skirmishes and currency fluctuations. And finally, the universe of small companies in Asia continues to expand, opening opportunities for investors to gain exposure to a diverse range of businesses.

Digital and Physical Connectivity Scales Up Growth

Connectivity in Asia today has at least two dimensions. The first is greater access to mobile phones and the internet. Consumers in Asia use mobile phones to make dinner reservations, buy airplane tickets and even schedule doctor's appointments. The ubiquity of mobile phones has encouraged leapfrogging, meaning the absence of an older technology allows for faster adoption and integration of a newer one. Leapfrogging through the use of mobile technology has occurred in areas as diverse as microfinance and quick service restaurants. Small companies are tapping the power of mobile connectivity for instant access to customers. The second dimension is greater access to the physical infrastructure required to connect cities, markets and customers. This infrastructure can include highways, rail lines, airports and seaports. Infrastructure investments allow for greater regional integration of supply chains, as well as faster delivery times to reach customers. Both of these forms of connectivity—digital and physical—have greatly expanded over the past decade, creating a more level playing field for smaller companies.

Millennial Spending Power on the Rise

In the U.S. and Europe, digital platforms such as Google Play service and Apple's App Store allow small companies to sell products online to the coveted demographic of millennial consumers immediately, without building brick-and-mortar stores first. A similar trend is happening across Asia, with digital platforms taking on an even greater scale and presence in everyday life. Millennials represent a prime customer base because they are likely to spend more online than older consumers and they tend to be more comfortable with digital platforms, although digital purchases are occurring across all demographics in Asia. The ability to access millennials quickly didn't exist a decade ago. Today, small companies in Asia are able to quickly scale up sales by targeting millennials through digital platforms.

An Expanding Universe

Asia's small companies, excluding Japan, now represent more than 8,000 publicly listed stocks, ranging from US$100 million to US$3 billion in market capitalization. We are also seeing greater diversity of consumer companies in Asia, in sectors such as technology, financials and health care. The basic thesis of investing in small caps in Asia is similar to investing in small caps everywhere: Smaller company stocks tend to be inefficiently priced because there are so many of them and not many sell-side brokers cover the universe.

Fundamental Research is Key

As the universe of small companies expands, an active approach to security selection can add value through proprietary, boots-on-the ground research. While the size of the universe creates more hidden gems to uncover, it also creates more companies to avoid. Smaller companies can be prone to poor governance, unfair treatment of minority shareholders and occasional, though rare, cases of fraud. A core tenant of our risk-management approach is, "when in doubt about a company, avoid investing in it." If we have questions we can't answer about a company's business model or concerns we can't assuage about a management team, we steer clear of the company's stock.

As active managers, we can be highly selective and invest in considerably less than 1% of the overall universe of small companies in Asia today. The best-managed small companies feature strong management teams, transparent business models, robust corporate governance and fair treatment of all shareholders. These companies represent a great diversity of business opportunities and return drivers. Worldwide, small-cap investors tend to look for growth and diversification via differentiated portfolio exposures. Asia's small-cap stocks have the potential to deliver these sought-after investment qualities by tapping into the growth potential of some of the world's fastest-growing economies.

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