



SMALLER COMPANIES

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# Innovation ignites alpha in Asia

DISCOVER THAT SMALL CAP SPARK

Small companies provide an opportunity to invest in Asia's innovation edge and entrepreneurial spirit at an early stage.

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## Overview

- Educated workers, evolving capital markets and a vast consumer market have helped create a robust innovation ecosystem that nurtures both small and large companies across markets and sectors in Asia.
- Finding innovative companies early in their lifecycle can add alpha to portfolios – a bottom-up and active process is key to idea generation and risk management.
- Our showcase of innovative smaller companies highlights the depth and diversity of opportunity.

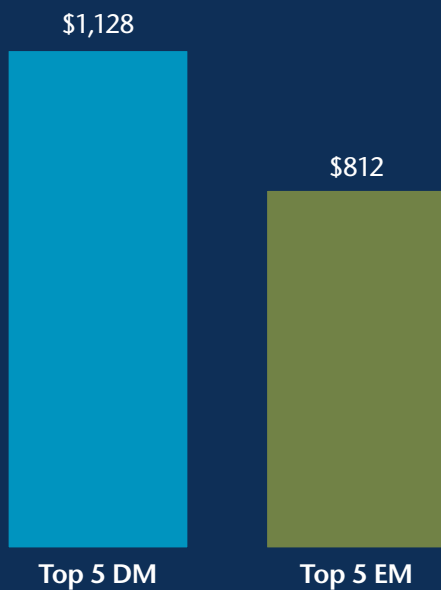
At its best, innovation can drive rapid revenue growth, superior competitive positioning and create an economic moat for businesses. Within the innovation cycle, there is a key component. Smaller companies are often both the source of innovation and the bridge that enables emerging and fast-growing countries to transition to higher-value added economies and compete at a bigger scale.

Many smaller companies, which we generally define as US\$1-5 billion in market capitalization, operate in nascent and fast-growing industries. In some countries, they may lack access to capital which can make them more competitive, innovative and capital-efficient than their larger peers.

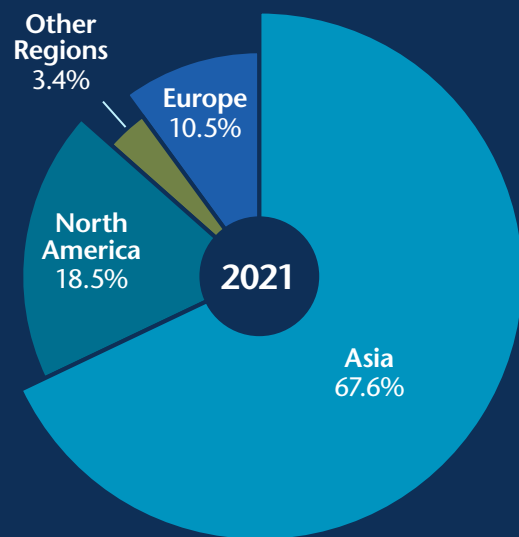
In Asia, the innovative potential of smaller companies has changed dramatically in the last decade thanks mainly to three developments: the growth of a large, highly educated, well-trained workforce, with more engineers, PhDs, and filed patents than any other region; the entrenchment of a sizable venture capital and public equity markets; and the emergence of Asia as the world's largest addressable consumer market. These three factors have supported a strong R&D spend that has helped create a robust innovation ecosystem in Asia that nurtures both small and large companies across markets and sectors.

**Figure A: Strong R&D Spend Drives a Robust Innovation Ecosystem in Asia**

2022 R&D SPEND – US\$ BILLIONS



PATENT APPLICATIONS BY REGION



Note: R&D Chart: Developed Markets (DM) includes U.S., Japan, Germany, France and U.K. Emerging Markets (EM) includes China, India, South Korea, Russia and Brazil.

Sources: Statista; data as of December 2020. Patent Application from World Intellectual Property Organization (WIPO) Database, December 2022

As this ecosystem has evolved, so too have investment opportunities. For example, secular opportunities in sophisticated industries, from automation and digitalization to entertainment and healthcare, are set to supersede growth from high-volume basic industries. In our view, investors can capture these secular growth trends most effectively by gaining exposure to innovative small-cap companies that will come to dominate these new industries.

## Teeming with growth

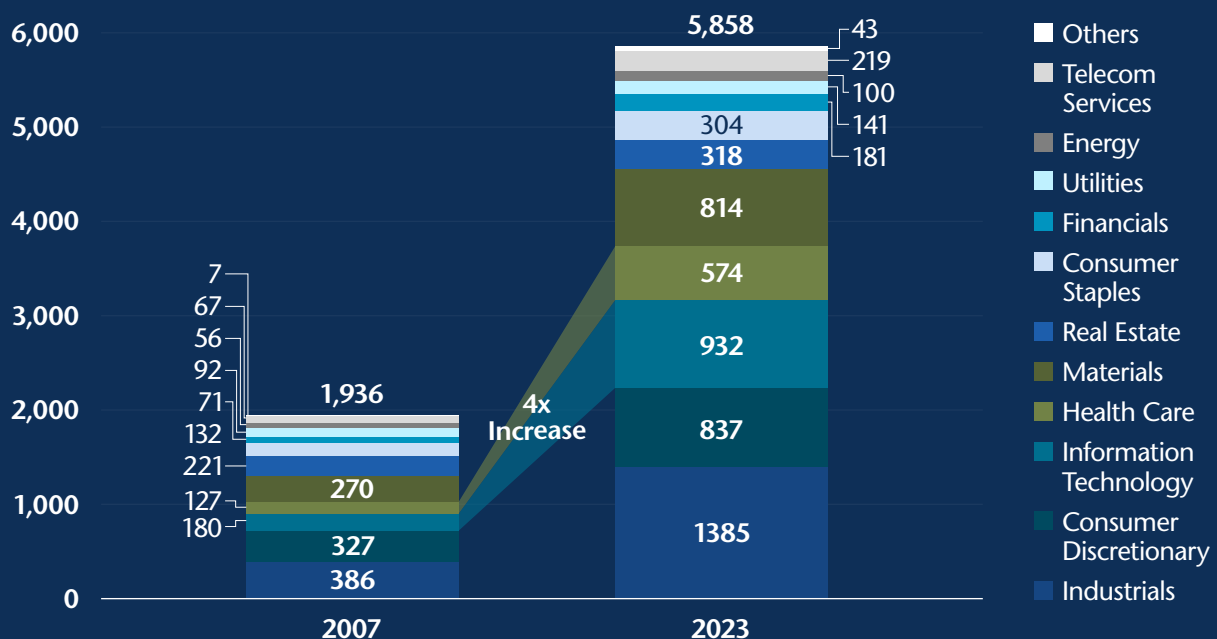
Small companies have always been an integral part of the Asia's economy and as capital markets have deepened, the investment universe has grown considerably. A significant proportion of this growth has come from China. Between 2007 and 2022 the number of Chinese small caps surged, most notably in the innovative sectors of information technology, from 180 to 932, and healthcare, from 127 to 574 (see Figure B). In these two sectors, the universe has nearly twice the number of growth stocks than the MSCI China Index.



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**Figure B: China's Small Company Universe is Expanding for Foreign Investors**



Includes all companies domiciled in Hong Kong, Macau and mainland China with market cap of US\$50MN to US\$5BN. 2007 figures do not include companies listed on the Shanghai or Shenzhen exchanges as they were not available to foreign investors at that time.

Source: Bloomberg; data as of March 31, 2023

In many ways China is a natural home for small cap opportunities. Among urban employment, 88% work in small, privately-owned, entrepreneurial companies and China's small-cap universe has grown to become one of the largest globally, with over 5,000 companies.<sup>1</sup>

1. CEIC, as of October 27, 2021

## Small-cap specialisms

While innovative small caps can be found across all sectors and industries in Asia, they tend to reflect the different stages of development of the various economies. For example, in South Korea, Hong Kong and Singapore, we see innovation driven by aging populations, in areas such as biopharma and factory automation. In countries like India, Indonesia and Bangladesh, we find innovation among small companies providing both basic banking and private banking services.

In China, smaller companies benefit from the tailwinds of seemingly unstoppable trends, such as Chinese consumer upgrades and hyperconnectivity (see Figure C). These trends are associated with income growth, technology, manufacturing, and energy self-sufficiency, as well as market share opportunities and gains in complex supply chains previously dominated by foreign players.

### Figure C: Potential Unstoppable Trends in China Today

Evolving trends give rise to innovation in small companies



#### CONTINUED CUSTOMER UPGRADES

- Rising demand for quality products & services



#### HYPER-CONNECTIVITY AND INDIGENOUS TECH INNOVATION

- Data and semiconductors
- Productivity tools and software



#### INVESTING IN LONGEVITY

- Next generation drug manufacturing
- Robotics and automation



#### A GREENER CHINA

- Carbon Neutrality 2060
- Energy self-sufficiency plans

The statements above are based on the beliefs and assumptions of our portfolio management team and on the information currently available to our team at the time of such statements. Although we believe that the expectations reflected in these statements are reasonable, we can give no assurance that these expectations will prove to be correct.

## Managing risk and reward

Over the past decades, we have witnessed many innovative companies rewarded for the product and service ideas that are meeting the new demands of a region of rising wealth in Asia.

Innovation, however, can also bring challenges as it sometimes captures investor interest on the basis of little more than speculation and excitement. We take the associated risks seriously and view our in-depth due diligence process as a key component of our ability to mitigate risk. We stick to a consistent philosophy and strategy, keeping in close communication with companies and remaining resolute amid short-term volatility.

In our experience, finding innovative companies early in their lifecycle can be a critical source of alpha; we often establish contact long before an IPO and the company potentially entering an exponential growth phase as getting to know company management has been a key part of our investment process.

We believe a bottom-up process is particularly suited to Asian small caps. This involves visiting companies on-the-ground – headquarters, factories, stores, and talking to management, suppliers and customers – as well as investigating financials.

In an economic downturn or when financial conditions tighten, small companies generally find it harder to access capital compared to large companies. Seeking small companies with strong balance sheets, superior cash generation capabilities and low leverage ratios can effectively address these potential funding challenges and underlines the importance of fundamental research.

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## Forward looking exposure

We believe small companies provide an opportunity to invest in Asia’s innovation edge and partner with minority shareholder-friendly entrepreneurs at early stages. Yet the region’s benchmarks do not adequately reflect its potential. As active investors focused on Emerging Markets and Asia, we believe they are too backward-looking. Many of the exciting trends we see today will be reflected in the major regional benchmarks only in years or decades to come.

## Figure D: Big Ideas From Small Companies



### Biotech

A Chinese biotech company recognized that antibody-based therapeutics could potentially treat disease. Today it is a leader in cell therapy and immuno-oncology. The company created a hugely innovative process to treat a deadly form of cancer that involves extracting, modifying, multiplying, and reinserting immune cells, and has entered a licensing agreement with a global pharma giant.



### Integrated Device Manufacturer (IDM)

When one of China's largest semiconductor companies started out it created a virtual IDM business model that set it years ahead of its competitors. This enabled the company to collaborate with semiconductor foundries, fabless companies and outsource semiconductor assembly and test (OSAT) houses to solve challenges in technology, manufacturing and business. Today it has industry-leading process technology to design innovative designs mixed-signal and analog power management integrated circuits that are used in industrial, consumer, computing and communications.



### Microfinance

An Indian microfinance and mortgage lender launched a series of digital initiatives to capitalize on the growth of smartphone penetration in India's rural areas. The initiatives included completely paperless and contactless account opening process, and upskilling customers to increase adoption of digital banking. They translated into tremendous growth for the company, which continues to expand its footprint.



### EV Batteries

South Korea's largest producer of cathodes for EV batteries was born out of the vision to develop eco-friendly core materials and parts to improve air quality. The cathode is the single most expensive component of a battery cell, and cathode materials, such as lithium, nickel and cobalt, are the core materials that determine a battery's voltage, energy density, lifespan, output. The company develops next-generation materials that addresses volume limitations and cost competitiveness.



## Renewables and Robotics

This Chinese company makes both EV auto parts (electric drives) and robotics components (RV reducers), benefitting from secular penetration opportunities in both electric vehicles and factory automation in China. As a key supplier to a tier one EV Original Equipment Manufacturer (OEM), the company's EV business has grown steadily. More recently, the company made a breakthrough in RV reducers, which are a major component in robots. Given China's aging demographic shifts and increasing wages, more robotics and automation solutions are used in today's factories. Across both areas of the business, localization opportunities give Chinese manufacturers in complex manufacturing a chance to move up the value chain and take market share from foreign counterparts.



## Complex Manufacturing

This Chinese industrial company is a leading provider of complex equipment, process systems and digitalized engineering solutions. Initially it provided core pressure equipment and integrated solutions to mainly the oil and gas chemical industry, but in recent times has successfully broadened out to pharmaceuticals, power battery raw materials, electronic chemistry and other fields. The company focuses on continuous innovation in complex manufacturing to serve different downstream industries in large scale projects, successfully being amongst the first Chinese players to break into an arena historically dominated by western world competitors.

Investments involve risk. Investing in international, emerging and frontier markets may involve additional risks, such as social and political instability, market illiquidity, exchange-rate fluctuations, a high level of volatility and limited regulation. Additionally, investing in emerging and frontier securities involves greater risks than investing in securities of developed markets, as issuers in these countries generally disclose less financial and other information publicly or restrict access to certain information from review by non-domestic authorities. Emerging and frontier markets tend to have less stringent and less uniform accounting, auditing and financial reporting standards, limited regulatory or governmental oversight, and limited investor protection or rights to take action against issuers, resulting in potential material risks to investors. Investing in small- and mid-size companies is more risky than investing in larger companies as they may be more volatile and less liquid than large companies. Pandemics and other public health emergencies can result in market volatility and disruption.

## Definitions

**Alpha** Alpha, a commonly quoted indicator of investment performance, is defined as the excess return on an investment relative to the return on a benchmark index.

**Leverage ratio** A leverage ratio is any one of several financial measurements that look at how much capital comes in the form of debt (loans) or assesses the ability of a company to meet its financial obligations.

**MSCI China Index** The MSCI China Index is a free float-adjusted market capitalization-weighted index of Chinese equities that includes China-affiliated corporations and H shares listed on the Hong Kong Exchange, and B shares listed on the Shanghai and Shenzhen exchanges.

It is not possible to invest in an Index.

**Holdings are subject to change.** As of 8/31/2023, accounts managed by Matthews Asia held positions in Legend Biotech, Silergy, Bandhan Bank, Ecopro BM, Zhejiang Shuanghuan Driveline and Morimatsu International. This information is presented solely for illustrative purposes and is not representative of the results of any particular security or product.

Matthews China Small Companies Fund holdings as of 8/31/2023. Current and future holdings are subject to change and risk.

Matthews Asia Small Companies Fund holdings as of 6/30/2023. Current and future holdings are subject to change and risk.

Matthews Asia Innovative Growth Fund holdings as of 8/31/2023. Current and future holdings are subject to change and risk.

Matthews Asia Sustainable Future Fund holdings as of 6/30/2023. Current and future holdings are subject to change and risk.

Matthews India Fund top ten holdings as of 6/30/2023. Current and future holdings are subject to change and risk.

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