Asia ex-Japan Smaller Companies

Attractive valuations backed by significant growth potential

July 2019

HSBC Global Asset Management

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An exciting opportunity

The Asia ex-Japan small-capitalization (small-cap) universe represents an exciting opportunity for investors to gain exposure to a dynamic and diversified set of smaller companies in Asia. Relative to the US and European small-cap markets, Asia ex-Japan small caps is a considerably deeper, yet demonstrably less efficient, market given its lower levels of sell-side coverage (refer Exhibit 3) and more limited information flow. This provides great opportunities for active managers to find alpha. Investing in the Asia ex-Japan small-cap universe will enable investors to access niche business models and get greater exposure to companies benefiting from growing domestic consumption in Asia. While volatility is higher relative to the large-capitalization (large-cap) space, returns for small caps in Asia have proven to be more attractive over time and, in our view, investors should consider a higher allocation to Asia ex-Japan small caps within a broader equity portfolio.

The Asia ex-Japan small-cap universe consists of companies listed in markets including China, India, Hong Kong, Korea, Taiwan, Thailand, Singapore, Malaysia, Indonesia and the Philippines. There is no universal definition of what constitutes a small cap. Market capitalization limits for small caps such as less than USD2 billion or USD5 billion are often quoted, but, in practice, a smaller company is relative to each market. For example, a USD5 billion market cap may be considered small for the Hong Kong market, but in the Indonesian market, it may be considered mid-cap. MSCI has taken the approach of classifying companies in the bottom 14% of market cap in each of the constituent index countries as small cap, subject to minimum liquidity and free-float requirements. The MSCI AC Asia ex Japan Small Cap Index - the most widely followed benchmark for small caps in Asia - consists of over 1,400 stocks (as of June 28, 2019).

Large caps and small caps in Asia

Key differences

Exposure to higher-growth sectors

When comparing the large- and small-cap indices in Asia ex-Japan, one of the key differences is the significant weighting of Financials relative to other sectors in the large-cap index. This reflects the dominance of banks, insurance companies and real estate companies in the large-cap space. In contrast, the smaller companies index has a more balanced representation of stocks across sectors. The two sectors with the largest weightings (Information Technology and Consumer Discretionary) represent less than 31% of the small-cap index, while for the large-cap index, the two largest sectors (Financials and Technology) represent over 40% of the index (Exhibit 1).

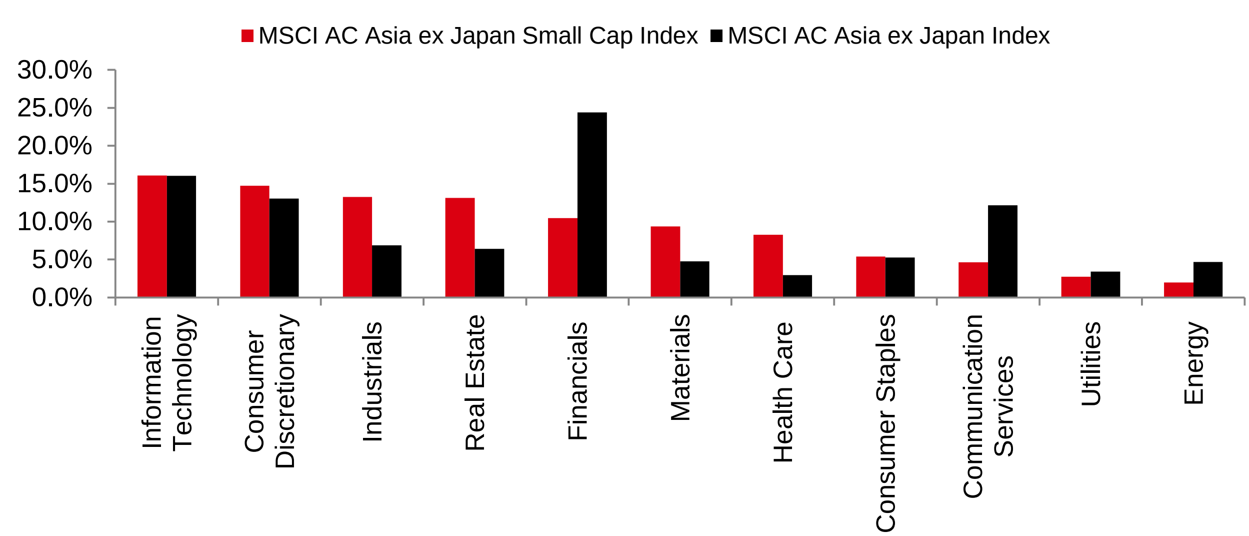
Perhaps more importantly, the sector exposure chart also highlights that the small-caps index generally has greater exposure to the "new economy" of Asia – companies in sectors that are benefiting from rising domestic consumption and/or that are associated with innovation—specifically, the higher exposure to the consumer sectors (discretionary in particular), Industrials (primarily domestic names), Health Care and Information Technology (large weighting, similar to that in the large-cap index). At the same time, the small-cap index has less exposure to "old economy" sectors such as Financials and Communication Services.

"Pure plays" and niche business models

The result of the more-balanced sector exposure within small caps is investors having the opportunity to invest in a broader set of companies. Indeed, the small-cap universe offers exposure to companies in specialized industries not available in the larger-cap universe, given the more narrow focus of many smaller-cap companies. An example is the Auto sector in Asia, where the large caps are represented mainly by auto equipment manufacturers and auto assemblers while the small caps are mainly comprised of auto parts manufacturers providing niche or high-tech components. Similarly, we see this in the Technology sector where large-cap names are largely represented by assemblers while small-cap players are often niche parts suppliers.

The benefit of investing in these niche businesses is that they are often "pure plays" in a particular market and have simpler and more easily understandable business models. While this may leave a company more exposed to specific (e.g., potentially negative) market trends, the greater focus of these companies on their core businesses often means they can be more successful in finding ways to innovate and stay competitive. At the same time, we often see a better alignment of interests in smaller companies where the management tends to have a higher level of ownership compared to that of larger companies. With more "skin in the game," management teams are potentially more focused on delivering performance and returns.

Exhibit 1: Asian large cap versus small cap sector exposure



Source: HSBC Global Asset Management, data as of May 31, 2019.

Large caps and small caps in Asia

Key differences (cont'd)

Diversified exposure, high active share[1] portfolios

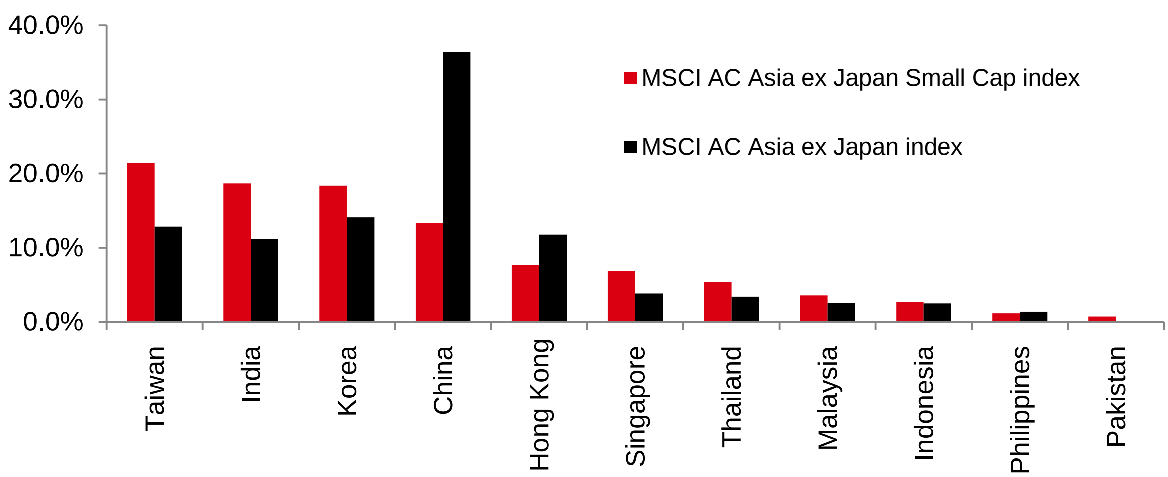
In addition to offering a better diversification profile from a sector perspective, the small-cap universe is better diversified on a single-stock basis. Specifically, the top ten stocks in the MSCI AC Asia ex Japan Index make up around 28% of the market cap of the Index while in contrast, the top ten names in the small-cap index represent only 4% of total market cap (MSCI data, as of June 28, 2019).

As a result, Asia ex-Japan small-cap funds generally have a much higher active share(1) versus their reference benchmarks relative to larger-cap funds. It also means that small-cap fund managers can generally be more benchmark agnostic than large-cap managers, who are often forced to own mega-cap stocks in order to avoid excessive benchmark risk. Given the sheer size of the universe of small caps (and specifically the Asia ex-Japan Small Cap Index, which has over 1,400 names as of June 28, 2019), a small-cap portfolio will generally reflect only ideas of the highest conviction of a small-cap manager.

For country composition, the small-cap index is quite similar to that of a large-cap peer in that the largest weightings in both indices are represented by China, Taiwan, India, Korea and Hong Kong; whereas Philippines, Indonesia and Pakistan are the three smallest weightings in both indices (Exhibit 2).

Asian small caps, as represented by the Asia ex Japan Small Cap Index, also offer better diversification benefits across geographies. The Asia ex Japan Index, representing Asian large caps, is heavily concentrated in the Greater China region (China, Taiwan, Hong Kong), at 61.1% of the total index weight, with China alone taking up 36.4% (Exhibit 2). The Greater China region and China itself only account for 42.5% and 13.3%, respectively, of the Asia ex Japan Small Cap Index, which comparatively provides more access to other fast-growing regions in Asia, south and southeast Asia specifically.

Exhibit 2: Asian large-cap versus small-cap country exposure



Source: MSCI, Bloomberg as of end of May 2019. Active share is a measure of the percentage of stock holdings in a portfolio that differ from the benchmark index.

Key features of Asia ex-Japan small-cap stocks

Lack of coverage and attractive valuations

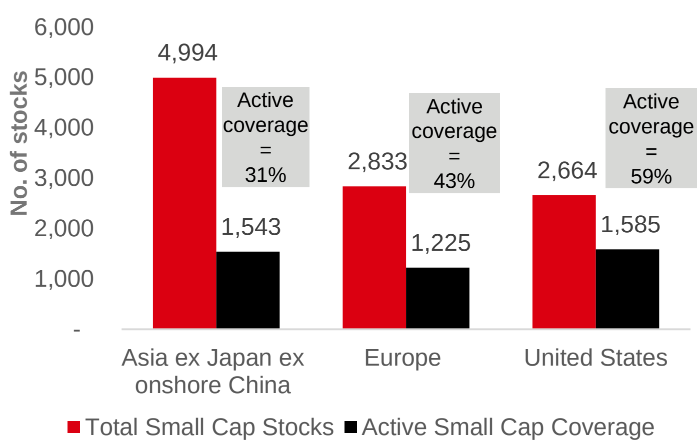
Too many stocks, too little coverage

With over 1,400 stocks in the small-cap index, the Asian small-cap asset class provides a fertile ground for active management and alpha generation. The lower level of liquidity in small-cap names often results in wider bid-ask spreads and higher share price volatility. This “excess volatility” often means that small-cap stocks will undershoot or overshoot their fair value, providing investors with opportunities to buy stocks cheaper and increase the likelihood of delivering excess returns as stock prices revert to a level closer to their fair value.

The Asian small-cap market is also relatively inefficient compared to the developed small-cap markets given its thinner sell-side coverage (Exhibit 3). The Asian small-cap universe is very under-researched, with only 31% of the roughly 5,000 companies in the investible universe (those with a market cap of USD100 million-USD5 billion) being covered by three or more sell-side analysts. In other words, 69% of this universe has leas than two sell-side analysts covering the stock. The key reason for the relatively thin coverage is the sheer size of the universe as well as under-investment by sell-side firms where coverage of small caps is often not profitable.

The 31% sell-side coverage for Asia small caps compares to 43% for European small caps and 59% for US small caps. Thinner coverage means that information on the company is disseminated less frequently, while earnings revisions may be irregular or imprecise. This asymmetry provides opportunities for well-resourced buy-side investment teams to obtain an informational advantage.

Exhibit 3: Active coverage of small caps by region



Source: Macquarie, data as of March 2019

Attractive valuations

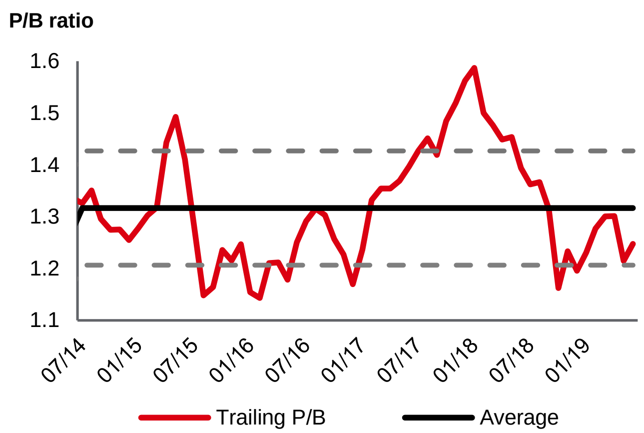
In terms of valuations, Asia ex-Japan small caps look inexpensive compared to small caps in the US and Europe. Using leading market indices as a proxy, Asia ex-Japan is trading materially cheaper on both a P/B and a P/E basis, despite expectations for similar profitability potential (i.e., return-on-equity (ROE)) going forward. Additionally, the strong valuation and profitability credentials are being offered with relatively low average debt-to-equity. Asia ex-Japan small caps are also trading at a lower-than-average P/B ratio from a historical perspective (5-year rolling).

Exhibit 4A: Valuation against other markets

	MSCI Asia ex Japan Small Cap	MSCI Europe Small Cap	Russell 2000
P/B	1.2x	1.7x	2.1x
P/E (CY 2019 Est)	13.6x	16.6x	25.2x
ROE (CY 2019 Est)	7.5%	8.5%	4.9%
Debt/Equity	93.2%	119.0%	121.9%

Source: Bloomberg, data as of June 2019

Exhibit 4B: Valuation against time (5-year rolling)



Source: Bloomberg, HSBC Global Asset Management, data as of June 28, 2019

Key risks of investing in small caps

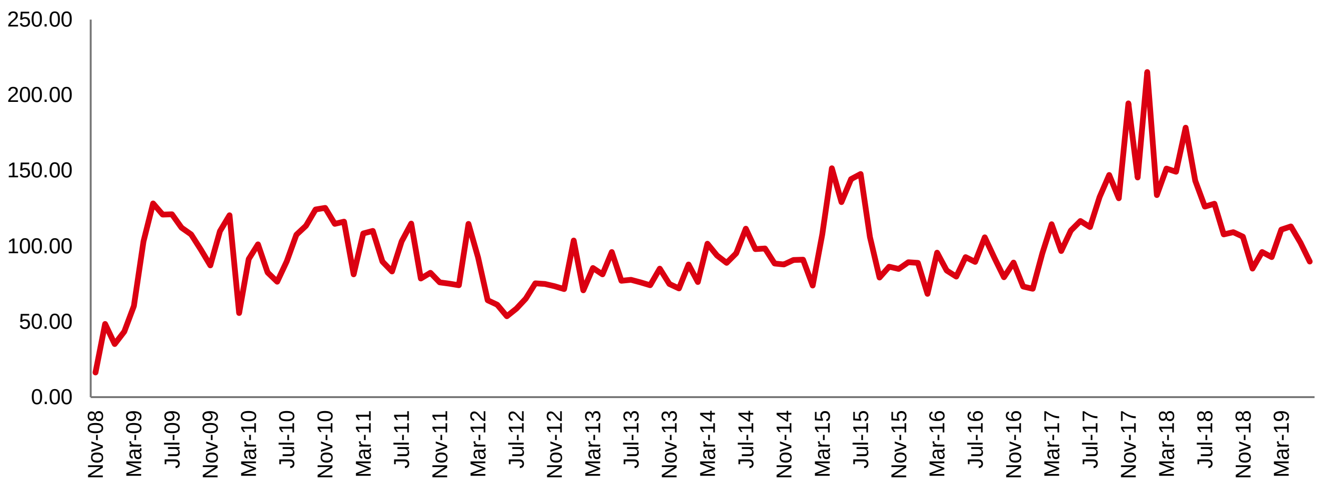
Company-specific and liquidity risks

The key risk for small caps is clearly company-specific risk. As noted previously, sell-side coverage of small caps is quite thin in Asia and, therefore, it is imperative that small-cap fund managers have a robust investment process and are properly resourced to do their own due diligence on companies. Beyond stock-specific risk, small-cap investors also need to be very mindful of liquidity.

Liquidity describes the degree to which a stock can be quickly bought or sold in the market without affecting the stock's price. Liquidity of small-cap stocks is very sensitive to changing risk appetite, above and beyond the outlook for a company specifically. Improving liquidity, which is often the result of increased broker coverage of stocks or increasing investor appetite for equities in general, can provide re-rating potential for small caps and act as a tailwind to boost performance. At the same time the “drying up” of liquidity, which can be driven by a “risk off” environment, can have the opposite effect.

Exhibit 5 shows the monthly turnover of the MSCI Asia ex Japan Small Caps Index constituents (in aggregate) and the extent of its variability. Monthly liquidity peaked at USD215 billion of turnover in January 2018, only to decline to USD90 billion in June 2019. As part of a robust risk framework, screens may be used to better manage liquidity risk in a portfolio – for example, minimum daily turnover (typically USD1 million average daily turnover) or minimum market cap (i.e., USD100 million). Assessment of liquidity is crucial when selecting stocks and building portfolios. The attractiveness of a stock with significant upside potential in terms of fundamentals should be balanced by an assessment of its average liquidity when it comes to determining the weighting of the stock in a portfolio, or whether to include the stock into the portfolio at all.

Exhibit 5: MSCI Asia ex Japan Small Cap Index monthly turnover



Source: MSCI, Bloomberg, data as of June 2019. Past performance is no guarantee of future results.

Asia ex-Japan: Still the world's growth engine

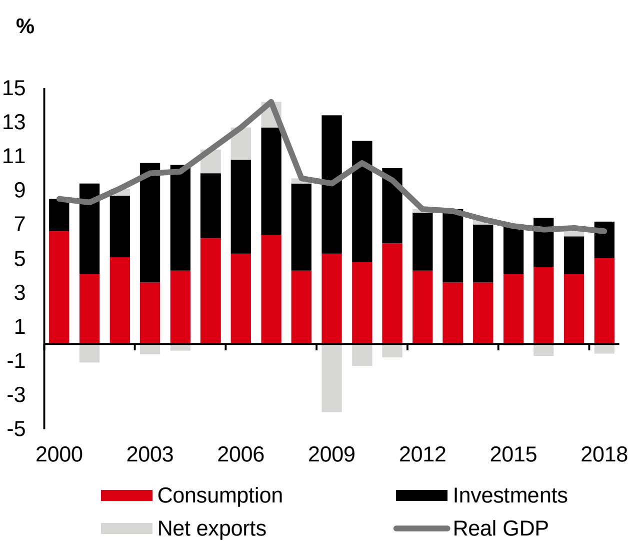
Roaring tiger, soaring dragon

China – ascending economic superpower

In second place and closing in fast, China's economy (measured as gross domestic product (GDP) in US dollars) is now two-thirds the size of the world's leading economy, that of the United States, and more than doubles the size of Japan's economy, which is the world's third largest at the moment. Many believe that China will overtake the US in GDP within the next two decades. In fact, if measured on a purchasing power parity (PPP) basis, China's GDP, according to the IMF, has already surpassed that of the United States by almost 30%. Simply put, China's economy is large and is still growing fast, making it a vast hunting ground for promising small caps.

Rebalancing of the Chinese economy is progressing gradually, with consumption replacing investment as the main engine of economic growth over the past few years. Certain sectors, such as Consumer Discretionary, should benefit from China's expanding urban middle class. Consumption-driven industries and companies tend to have sizeable representation in the small-cap universe.

Exhibit 6: China GDP growth breakdown



Source: CEIC, Bloomberg, HSBC Global Asset Management, data as of December 31, 2018. Past performance is no guarantee of future results.

Including China A-shares in major indices

2018-19 marked a watershed moment in the evolution of Chinese asset markets. In June 2018, MSCI began to include China A-shares into its global equity indices for the first time and then further increased the inclusion factor in 2019. This historical development is in part a result of China's steady efforts to reform its financial markets, as well as its eagerness to open up these markets to global investors. We believe China will continue to make incremental changes to liberalize its markets and its efforts will be recognized through greater inclusion in due course. An increased inclusion of China A-shares into major indices would induce greater buying power in the China A-share market.

Exhibit 7: China A-share inclusion timeline

Period	Inclusion factor	MSCI action on China A shares
June 2018-Sept 2018	5%	◆ Partial inclusion of China A large cap shares in two phases (implemented)
May 2019	10%	◆ Increase inclusion factor of China A large cap shares ◆ ChiNext large cap shares are eligible for inclusion beginning May 2019
Aug 2019	15%	◆ Increase inclusion factor of China A large-cap shares, including ChiNext shares
Nov 2019	20%	◆ Increase inclusion factor of China A large-cap shares, including ChiNext shares ◆ Add China A mid cap shares, including ChiNext shares, with 20% inclusion factor

Source: MSCI timeline, as of July 2019

Asia ex-Japan: Still the world's growth engine

Roaring tiger, soaring dragon (cont'd)

Stock Connect

In November 2014, China launched the Shanghai-Hong Kong Stock Connect, which allows foreign investors to trade in a range of onshore stocks (A-shares) via the Hong Kong Stock Exchange and onshore investors in China to invest in the offshore Hong Kong equity market via the Shanghai Stock Exchange. The Stock Connect program was subsequently extended to the Shenzhen Stock Exchange two years later at the end of 2016. Assuming the definition of small cap to be any stock with market capitalization less than USD5 billion (or roughly CNY35 billion), there are 600 small-cap stocks on the Shenzhen Stock Exchange and 440 on the Shanghai Stock Exchange that are accessible to foreign investors via Stock Connect (HKEX, as of 15 July 2019).

India – the awakening giant

Despite the recent blip, India is still one of the fastest-growing economies in the world. While it has been held back for decades by the lack of constructive government policies, India has, in recent years, undertaken meaningful reforms to promote development and growth. India's ruling party, the Bharatiya Janata Party (BJP), made some strides during its first term in power (2014 – 2019) to initiate and implement economic reforms in areas such as infrastructure, housing, tax and banking.

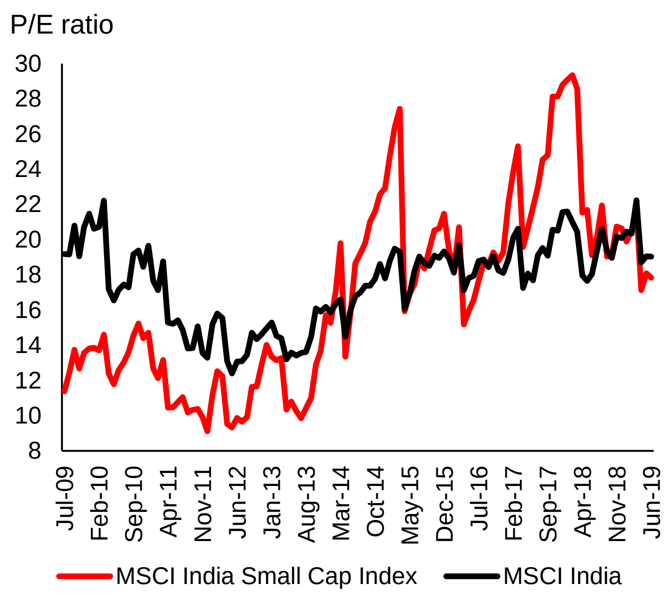
BJP's landslide victory in May 2019

The implications of BJP's landslide second-term victory is two-fold. Firstly, it is a manifestation of the public's approval of policies and reforms the BJP implemented during its first term. Secondly, BJP now has a clear mandate to build upon its previous policies and reforms with more force and conviction. This view was reaffirmed when th e Modi government 2.0 announced its first budget in July, which sought to build on many of the government's previously initiated reforms to revive private investment and support sustainable long term economic growth.

Small caps and pricing inefficiencies

The Indian equity market, like most of its emerging market peers, is less efficient than those of developed markets, granting a significant informational advantage to well-resourced active managers looking for bargains. As in other markets, small caps tend to be even less efficient, and, therefore, more volatile than large caps. Valuations could fluctuate wildly and deviate from stock fundamentals. Plotting the 12-month forward-looking P/E ratio, one can see that investor valuations of Indian small caps has been very volatile across time, even more so than their valuation of Indian large caps (Exhibit 8).
Incidentally, Indian small caps have been trading at a discount to large caps on a P/E basis over the past few months (as of June 2019), a relatively rare phenomenon in recent years. Heightened volatility in the Indian small-cap universe sometimes offers great opportunities to buy into under-valued stocks.

Exhibit 8: Erratic valuation: Indian equities



Source: Bloomberg, data as of June 2019. Past performance is no guarantee of future results.

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