A big comeback: Rising fortunes of Asia's small caps

Examining seven key developments expected to provide momentum to Asia's small caps

October 2022

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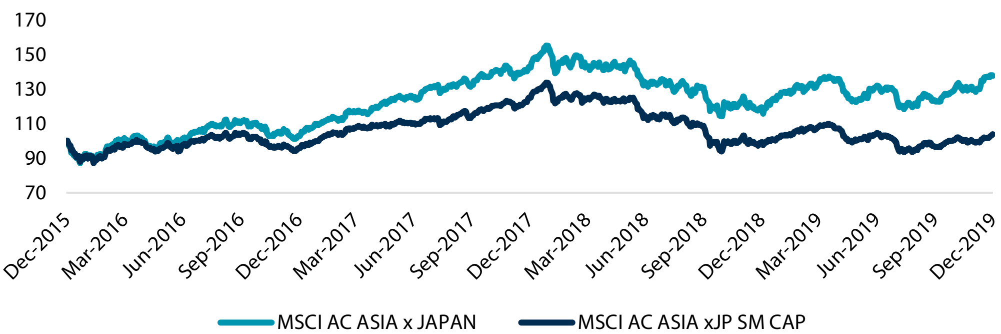
Introduction

After spending almost a decade in the shadows of their larger counterparts, Asia's smaller companies are being viewed in a new light. Factors that had weighed on these businesses are now turning into tailwinds, and we have identified seven key developments which should provide momentum for the asset class. Nikko Asset Management's Senior Portfolio Manager for Asian Equity, Grace Yan, examines these drivers and looks at how investors can benefit from exposure to the region's small-cap stocks.

To understand why investor attention shifted away from smaller companies, we first need to look at the evolving relationship with their larger counterparts. Between 2006 and 2010, smaller companies led the rally that unfolded in the wake of the global financial crisis. This was in line with expectations, given that smaller names often have healthier balance sheets, higher growth profiles, and greater agility than larger businesses. Consequently, they tend to recover first.

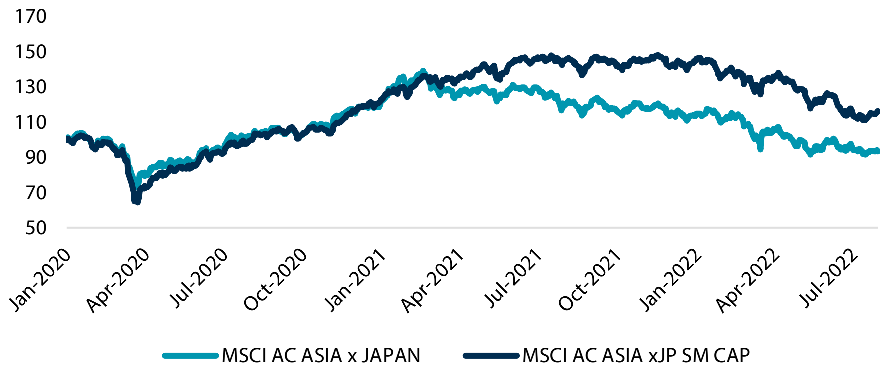
Small caps then moved broadly in line with the wider market until exchange-traded funds (ETFs) began their rise to prominence. From 2015 to 2019, we witnessed significant inflows into passive vehicles, most of which were concentrated in large-cap stocks. As such, smaller companies failed to benefit from the substantial growth of these funds – for example, the iShares Asia ex-Japan Small Cap ETF was terminated in 2015. In tandem, there were other overarching trends, such as the rise of mega-cap stocks and the commoditisation of sectors such as consumers and tech, which also proved unhelpful for smaller companies.

Chart 1: MSCI AC Asia ex Japan Index, Asia ex Japan Small Cap Index (2015-2019)



Source Bloomberg July 2022

Chart 2: MSCI AC Asia ex Japan Index, Asia ex Japan Small Cap Index (2020 onwards)



Source Bloomberg July 2022

However, the past two years have seen several market developments converge, with previous headwinds now becoming tailwinds for small caps. We have identified seven key drivers behind this change in sentiment, such as an evolving regulatory environment, the shift in focus among ETFs toward smaller companies, increasing personalization, changing consumer trends, friendshoring due to US-China rivalry, the advent of the fifth industrial revolution and lastly beneficiaries of environmental, social, and governance (ESG).

Chart 3: Seven key drivers behind change in sentiment towards Asian small caps

The regulatory climate—a reversal of fortunes

The first of these supporting elements is the growing regulatory oversight of larger companies with a significant market share or dominant positions in Asia and globally. These businesses now face greater scrutiny over issues such as data privacy and restrictive market practices, and regulators are trying to temper these firms' dominance with moves such as anti-monopoly legislation. For example, South Korea became the first country to pass a so-called anti-Google law that bans the search giant from forcing its payment systems onto content providers. This allows smaller companies to transact directly with end-users and places them on a more level playing field with their larger counterparts.

ETF focus shifting to small caps

As noted, passive investing has dominated fund flows and led to the outperformance of large-cap names. Yet, given the evolving investment landscape, we think this trend has reached an equilibrium. It's estimated that around 39% of global assets under management are invested in large-cap-focused passive funds, which contrasts with 33% invested

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in small caps. In the emerging market segment—most of which is represented by Asia—this figure drops to a mere 13% invested in smaller companies. [1]

Passive investing has inflated the size of large caps and made their share prices more volatile due to regular index rebalancing. This polarity creates pressure and intensifies the need for more symmetry, which should prove beneficial for small-cap names.

Meanwhile, the rise of retail investors empowered by social media on commission-free trading platforms underscores the need for active investing and diversification within the ETF space. At the start of 2021, US retail investors saw an opportunity to challenge institutional hedge funds that had been shorting the share price of meme stocks such as Gamestop, assuming they would fall further. In Gamestop's case, these market participants, coordinating through social media, propped up its share price, forcing the hedge funds to cover their short positions. The result was a widely publicised price crash.

Indeed, at one point, Gamestop represented 20% of the SPDR S&P retail index. Passive investors would have been severely burned if they were invested in the ETF when its price collapsed. This highlights the need for diversification and an active investment strategy. Looking ahead, we believe that interest in active investing will increase as investors become more aware of the risks associated with a passive approach. Such a shift would be beneficial for small caps as they have the potential to trade closer to their intrinsic value with increased coverage.

Moving from commoditisation to personalisation

In response to the trend toward more personalised mass-manufactured goods, there is a rising demand for more bespoke and innovative products. This is where smaller companies could shine and prove that it does not take a large company to drive change. A point demonstrated by small businesses that specialise in emerging technologies, such as 3-D printing, which has the potential to reshape multiple sub-industries, including healthcare, industrial design and manufacturing. Currently, there are nearly 600 companies in the region using 3D-printing technology, 95% of which are unlisted start-ups. [2]

MZs as a new pillar of consumption

Millennials and Gen Z (MZ), being digital natives, are expected to be the new driving force of consumption. By 2025, it is estimated they will account for half of the consumers in Asia Pacific. As well as being comfortable with the online consumption of goods and services, the MZ generation is also mindful of social justice and climate change while desiring uniqueness and personalisation. Companies that deliver products that meet this fast-changing demand will succeed. For instance, some cosmetic brands are demonstrating this ability.

One example is Yatsen Holding Limited, a US dollar (USD) 600 million company in China that took advantage of online marketing and fast production times to drive sales; and Clio Cosmetics Co Limited, a USD 200 million South Korean cosmetic company focusing on "must have" products. Driving both companies' success is the fact they are small, nimble, able to identify trends and launch unique products to capture customers' interest.

In Clio's case, the company's management quickly realised that online was the primary channel used by the MZ generation. It was one of the first South Korean businesses to close its physical stores in China and focus on KOLs (key opinion leaders) and internet marketing. It also responded to evolving trends with innovative products like a cleansing foam that removes micro-fine dust – a big issue given pollution levels in some cities. And with the onset of the pandemic, Clio developed a mask-proof foundation that swiftly became a must-have item. In other developments, Clio identified the demand for vegan skincare and launched its Goodal (a combination of "good" and "all") skincare brand featuring natural ingredients. This product also chimes with the MZ generation's focus on eco-friendly packaging.

In contrast, we have seen larger companies that are slow to respond to the changing operating environment suffer as a result. The relatively small size of these firms, coupled with an ability to identify trends and create unique products that capture the imaginations of their customers, form the basis of their success.

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[1] JP Morgan, Morningstar, 2022

[2] https://www.crunchbase.com/hub/asia-pacific-3d-printing-companies

"Friendshoring" due to US-China rivalry

Competition between the world's largest economies extends beyond raw measures of goods sold. Concerns about data security and privacy issues are resulting in growing protectionism. In turn, this leads to a decoupling of technical standards on both the hardware and software fronts and increased demand for localisation. We see increased localisation on the back of rising protectionism and concerns over data security and privacy issues too.

So-called friendshoring, or the sourcing of materials and manufacturing from "friendly" nations, is an increasing trend supporting smaller local companies. Both the US and China are investing heavily to gain an advantage, and these investments should be positive for small caps as they can benefit from an increase in domestic capital-expenditure.

Andes Technology Corp is a USD 542 million Taiwanese company underpinned by this development. The company builds on the RISC-V[3] platform and sells software solutions to its clients. Given US-China relations, there is an increasing need to move away from the ARM (advanced RISC machine) and Intel infrastructure and reduce any dependence on US companies. Chinese vendors are looking for an alternative solution, and this provides the opportunity for small companies like Andes to gain market share.

The fifth industrial revolution

Reaching the next stage of industrial development means harnessing evolving technologies surrounding artificial intelligence (AI) and Big Data. Nowhere are these opportunities more abundant than in China, which accounts for three-quarters of the world's AI patents.[4] Commercialising these ideas presents smaller companies with a vast opportunity. At the same time, because the regulatory framework remains pliable (as these new sectors emerge), smaller companies will find themselves on a more even playing field with large caps. They will also have the upper hand because they are not restricted by legacy systems or old technology. This means they can exploit smart tech and deliver innovative products with greater personalisation while incurring lower costs.

For example, larger companies like Uniqlo and Zara have historically dominated the apparel space, making it challenging for smaller companies to compete. However, new companies like SHEIN are gaining market share with the emergence of big data and the internet. SHEIN was only founded in 2008 but has grown significantly. The company was originally a platform that sold only clothes, but its founder saw an opportunity whereby the firm could design its own labels and accessories based on big data.

The key differences between SHEIN and its peers are:

1) Low cost: The company buys directly from suppliers, which reduces the number of supply-chain layers.

2) Influencer marketing: SHEIN leveraged off the internet with Instagram, TikTok and various platforms to promote its products and used big data to analyse user interest and demand.

3) Real-life user reviews or key opinion customers: The platform encourages users to post pictures of themselves in the clothes they buy. This helps eliminate concerns about the quality and fit of the garments. Having real people with various body shapes model the clothes gives an additional layer of comfort.

These tech developments make it easier for disrupters and agile smaller companies to flourish. The acorns of today could become the oak trees of tomorrow.

A boost from ethical investing

As demand for sustainable investing rises, it is expected to drive more companies to embrace such principles in their operations. At first glance, this trend seems to favour large companies, given their ample budgets and greater access to expert guidance. However, in their rush to establish their ESG credentials, some larger names have also come under scrutiny for greenwashing, particularly in areas of their extended business operations that find it challenging to meet the necessary standards. In contrast, smaller companies have an advantage when adapting to the changing ESG landscape, as they are closer to their customers and have a tighter focus on business lines.

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[3] RISC-V: An open standard instruction set architecture (ISA) provided under open source licenses (RISC stands for "reduced instruction set computer")
[4] World Intellectual Property Organization, 2021

At the same time, smaller companies can respond more flexibly to new business opportunities. An example is CTCI Corp, a USD 1.1 billion provider of engineering, procurement, and construction services in Taiwan. Its management identified that green energy would be a growing trend in the 2020s and made a concerted effort to embrace the shift toward environmentally friendly power sources. With the increasing focus on carbon neutrality, CTCI also saw a need to convert existing facilities to reduce carbon emissions and growing demand for new facilities built with carbon-friendly materials. As a smaller company, CTCI's willingness to change direction is reflected in its order book, with more than 70% of its pipeline in green energy, low carbon and environmental-protection projects.

The benefits of diversification

From an investment perspective, the very nature of being exposed to the small-cap market provides other benefits, in our view. First, the size of this universe can help spread a portfolio's risk while improving its defensiveness through diversification. At the same time, more than 50% of these companies are not covered by any sell-side analysts. This can give conscientious stock-pickers who conduct their own research and due diligence a significant advantage. Finally, the structure of these businesses is also favourable. More than half of Asian small caps are controlled by their founders and management, who have a personal stake in the success of their businesses. This aligns the interests of the key stakeholders with that of the investor.

Overall, we expect these characteristics, coupled with the seven trends discussed, to support the outperformance of this asset class in the years ahead.

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