FOR INVESTMENT PROFESSIONALS ONLY. NOT FOR FURTHER DISTRIBUTION.

T.RowePrice®
INVEST WITH CONFIDENCE

PRICE POINT
March 2016

Timely intelligence and analysis for our clients.



Eric Moffett
Portfolio Manager, Asia Opportunities Equity Strategy

Asian Equity

APPLYING A QUALITY INVESTMENT DISCIPLINE TO THE HIGH-GROWTH ONLINE ECONOMY IN ASIA

EXECUTIVE SUMMARY

- Weakening global growth and China's economic slowdown, in particular, has hurt sentiment toward Asia in recent years. However, despite the challenges, Asia ex Japan remains one of the fastest-growing and dynamic regions in the world, a market underpinned by significant structural advantages.
- The long-term, secular trends that have fueled Asia's rapid growth over the last decade are well known: accelerated urbanization, rising wealth, improving living standards—these are just some of the compelling growth drivers that make Asia ex Japan such an exciting investment area.
- The burgeoning Asian middle-class consumer is one secular force that is probably still only in its early stages. Home to the world's two most populous countries, it is no wonder that Asia ex Japan remains a major driver of change in the global economy.
- The boom in technologies that are disruptive to traditional businesses is one example, with Chinese consumers central in establishing this behavioral shift. What's more, the potent force of Chinese demand is driving rapid innovation and evolution within the e-commerce space. China leads the world in the development of online-to-offline (O2O) commerce—a rapidly expanding model utilizing the efficiency of online platforms to access offline opportunities.
- In this Price Point, Eric Moffett, portfolio manager for the T. Rowe Price Asia Opportunities Equity Strategy, explains why investing in high-quality companies benefiting from powerful secular trends remains the key to capturing the region's considerable growth potential.

When asked about their investment strategy, many portfolio managers tend to cite a similar core focus—something to the effect of investing in "quality companies." However, while this certainly has a reassuring ring to it, rarely is the statement followed up with an explanation as to what actually makes a quality company.

WHAT IS A "QUALITY" COMPANY?

Most would generally agree that there are a number of core financial parameters that are prerequisite characteristics of quality: steady, consistent earnings growth; high returns on equity; cash flow generative; and low debt relative to assets. Where the assessment of quality becomes a little more subjective, however, is in relation to those characteristics that cannot be gleaned from financial statements. Indeed, it is arguable that these nonfinancial attributes are perhaps most relevant in determining just how sustainable a company's quality is likely to be. In this way, management ability, shareholder focus, competitive advantage, and industry/thematic influences are all vital considerations.

The concept of investing in quality companies is certainly not a new one. In the 1930s, revered investor Ben Graham, widely considered to be the father of value investing, stressed the importance of investing in high-quality companies as a prerequisite to delivering superior long-term performance. Underpinning this belief was Graham's observation that, over time, the largest losses came not from investing in high-quality companies at seemingly high prices, but from investing in lower-quality companies at prices that appear to offer good value. Importantly, he observed that quality was the most important attribute over time, with such companies outperforming over the long term due, in large part, to their superior resilience during periods of market stress.

VALUATION REFLECTS QUALITY…ULTIMATELY

Valuation is an important element of quality investing. Ultimately, valuation is a reflection of quality, and so it is not unreasonable to expect those companies with many or all of the characteristics described above to command a premium price. At first glance, they might appear relatively expensive, but given their quality, it is more a case of being appropriately priced.

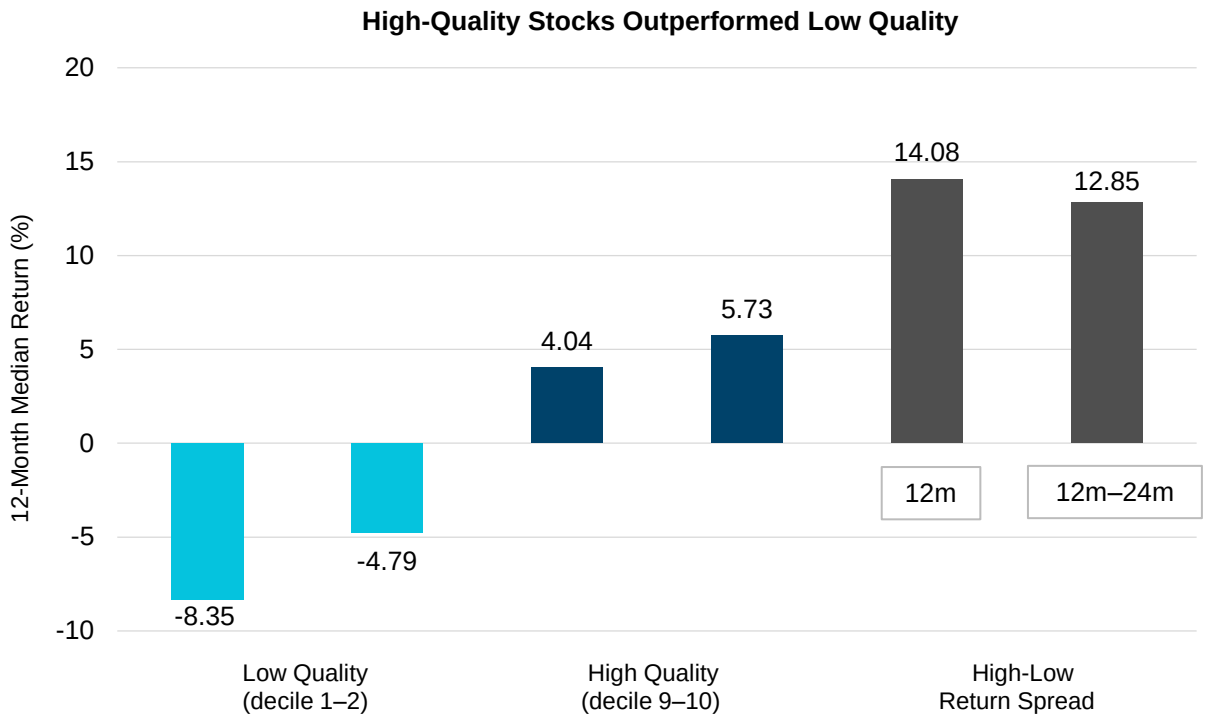
The valuation question is particularly relevant within the Asia ex Japan context. A large, diverse, and multifaceted region, Asia offers a rich opportunity set, with a great many high-quality companies to be found. However, for many investors in the region, there remains an all-pervading mentality that growth is everything, trumping all else as the principal indicator of a company's quality. Any company displaying near-term growth must be good quality, so these names are seized upon by investors, with the effect of pushing multiples higher. This short-term mentality, however, is fraught with potential danger, principally, that it generally fails to consider the sustainability of the growth over the longer-term. Growth in itself is not enough to warrant higher prices; this can be highly cyclical and potentially erratic and uncertain. For long-term investors, quality companies are those that can deliver sustainable, multiyear growth—indicating a robust business model throughout the economic cycle—and as such, deserving of a higher price. This appears to be confirmed by the chart analysis below. In Figure 1, we ranked by quality Asia ex Japan's 500 largest companies each month during the period December 31, 1995 to December 31, 2015, and then measured how they performed.

AT THE HEART OF QUALITY ARE ROBUST FINANCIALS

Fundamentally, equity markets are driven by corporate profitability, so a demonstrated history of superior and sustainable profitability is a hallmark of a company quality. In this regard, measures such as high returns on invested capital and high returns on equity are important features. How profitable a company is shows just how successfully it generates returns on investments made in the business. The more profitable, the greater the ability to reinvest in the business, pay out dividends, or buy back company shares. Businesses that persistently deliver high returns on capital are also better placed to withstand any adverse conditions, such as increased competition, rising costs, or falling sales. Meanwhile, a track record of consistent, low-volatility earnings is another key indicator of quality. A company with a volatile earnings history is less predictable and, thus, a riskier long-term proposition. In contrast, consistent, low-volatility earnings suggest a robust business model with pricing power through the economic cycle and, therefore, are less likely to disappoint investors and hurt the value of the stock.

It is no great revelation to suggest that a strong balance sheet is advantageous to a company's long-term prospects. The healthier the balance sheet, with low debt relative to assets and ample operational cash flows, the greater the ability to withstand adverse conditions or unexpected challenges. Relatively modest leverage (debt/equity) and healthy interest coverage (earnings/interest expenses) are two key ratios that imply a sound balance sheet and an appropriate capital structure.

Figure 1: **Assessing the Impact of Quality on Performance**



Past performance is not a reliable indicator of future performance.

Source: T. Rowe Price. Data from December 1995 to December 2015.

Largest 500 companies by market capitalization assessed each month; companies are assigned a score on each measure, data are then equal-weight aggregated, and companies are ranked and assigned to one of 10 groups; performance relative to other groups over the next 12 months is then measured.

QUALITY BEYOND THE FINANCIAL STATEMENTS

As touched on earlier, it is not only financial metrics that are relevant in determining the quality of a business. An assessment of company management, for example, is a key consideration. The experience, track record, and motivation of a company's decision makers, in the end, have a major bearing on its overall performance. Management determines the strategic vision of the company and the path to delivering that vision. In this way, meeting with management teams is an essential part of gaining a comprehensive understanding of a business. This primary interaction provides important insights into growth targets, financing plans, capital structure suitability, approach to leverage, capital allocation plans, any potential opportunities or headwinds, as well as many others, all of which are fundamentally important to making a call on quality.

How effectively management allocates capital plays a large role in determining a company's success. This is a decision that is open to a great deal of subjectivity—from reinvesting in the business, to strengthening the balance

sheet, to financing acquisitions, to rewarding management, to paying shareholder dividends or buying back shares. While not yet common practice among companies in Asia, from an investor perspective, allocating capital to pay dividends, or to buy back shares, is certainly an attractive company feature, as it shows a clear alignment with shareholder interests.

Indeed, the level of importance a company assigns to shareholders is essential knowledge. Ideally, management will also be owners of the business and, thus, have a vested interest in the company's success. The management team's incentive structure, for example, should be achievable over a multiyear time frame, thereby encouraging a commitment to building long-term business success. Too often, management teams are rewarded for hitting short-term earnings targets. Not only do such goals fail to encourage long-term loyalty, but they invariably result in the business being skewed toward hitting these short-term targets, and this may not always be in the best, long-term interests of the company or its shareholders. In the end, the actual amount of compensation paid to management is perhaps less relevant than the path to achieving it. Ideally, what investors want is a management team that is successful in creating shareholder value over time, and those that can deliver this should expect to be appropriately rewarded.

In the end, however, perhaps the single most defining attribute of quality companies is their clear competitive advantage. Experienced management, strong financials, robust capital structure—all these are essential components, but their impact is diluted greatly if there is limited opportunity for superior, sustainable growth in the first place. In this way, a clear competitive advantage stands as the single most influential factor on a company's long-term performance. History shows that, in most cases, it takes companies years, if not decades, to establish a clear competitive edge. However, once such an entry barrier around the business is established—what Warren Buffett calls "moats"—it tends to endure over multiple business and economic cycles.

THE POTENT AND DISRUPTIVE INFLUENCE OF THE ASIAN CONSUMER

The long-term, secular trends that have fueled Asia's rapid growth over the last decade are well known: improving living standards, accelerated urbanization, greater intra-regional trade, and rising household wealth. These are just some of the ongoing drivers of growth that continue to exceed those of the developed world. This is what makes Asia ex Japan such an exciting investment area—a region underpinned by powerful secular forces, yet one that is also still developing, allowing early adoptive, innovative companies to build commanding positions in exciting, early-stage growth markets.

The burgeoning Asian middle-class consumer is one secular force that is probably still only in its early stages. It is of little surprise that the world's two most populous countries, China and India, are proving hugely influential in driving disruptive change in the global economy. China's rising middle class is expected to more than double in size by the end of the next decade, while some predict that India's middle class may more than quadruple over the same period, given the lower base from which it is starting. Real wage growth and improving standards of living are driving an exciting, broad-based shift in consumer tastes and daily spending habits. Consumers are buying better-quality, slightly more expensive daily items than they used to, and this is evident in everything from diapers to food products to apparel. The knock-on effect of this demand has been the sharp growth in e-commerce. What's more, Asia is leading innovation and evolution in this space, rapidly expanding in the area of online-to-offline (O2O) commerce—a model utilizing the efficiency of online platforms to access offline opportunities.

DRIVING THE SHIFT IN CONSUMER SPENDING PATTERNS

Historically, consumers were drawn to e-commerce primarily for reasons of competitive pricing. However, other factors, such as fast delivery, improved features and functionality, as well as wider product ranges, are now attracting a whole new wave of online consumers. The explosion of e-commerce in Asia is being driven by the fact that it is bridging the gap between what people want and what people can get offline. Mobile Internet penetration in China, for example, is among the highest in the world, effectively opening up a world of consumer opportunities, especially for those who live outside major urban areas. Although global e-commerce sales

continue to grow at a healthy pace, Asia's growth eclipses that of the rest of the world. China's market has been growing at a pace of more than 70% annually since 2009, and China officially overtook the U.S. in 2013 as the world's largest e-commerce market. Some estimates suggest that, by 2020, it may be as large as that of the U.S., Japan, the U.K., Germany, and France combined.[1]

Of course, newer entrants in Asia will encounter certain challenges, such as logistics and payment services, if they wish to secure their long-term survival in this competitive arena. This is particularly the case for companies operating in less mature e-commerce markets, where rapid growth is putting significant strain on the underdeveloped infrastructure network. Even in the more established e-commerce markets like China, companies still face issues, such as a lack of quality warehousing space and poor delivery coverage in smaller cities or rural areas. Meanwhile, in India, payment constraints are an issue for the e-commerce sector. India is still a largely cash-based economy, and credit card penetration remains low. Many consumers simply do not have the ability to pay for goods online. Given these barriers to entry, the large, established Internet companies, particularly in China, with their existing infrastructure and large customer bases, have quickly secured dominant positions in the high-growth e-commerce industry. What's more, Chinese Internet companies also have an inherent advantage in the form of the "Great Firewall," a tool used by the Chinese government to regulate the Internet, and which bans or discourages a number of large global Internet firms from operating there.

THE NEW BIG THING—O2O

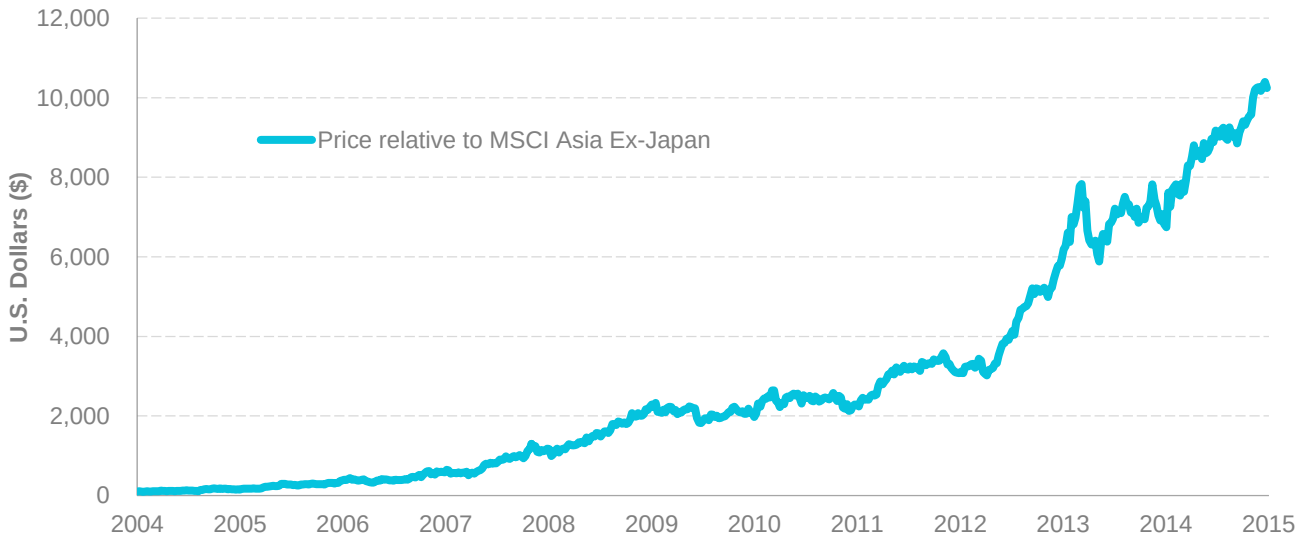
From a position of strength, these Internet companies are driving innovation and creating new growth opportunities. Nowhere is this trend more evident than in China, where the boom in O2O commerce has been made possible by the dominance and brand power of the country's Internet giants. Leveraging their substantial existing customer bases, names like Tencent, Alibaba, and Baidu have aggressively branched out into more traditionally offline business models and services, penetrating deeper into the everyday lives of Chinese consumers and creating new and lucrative monetization of "user clicks."

Indeed, Tencent, one of China's dominant Internet firms and leading provider of online entertainment via its mobile and PC platforms, is a company that ticks all of the "quality" boxes described earlier. The company is a major beneficiary of China's rising consumer wealth, as well as broadening Internet penetration, particularly mobile access with China now one of the largest market for smartphones. While it began purely as an online gaming company, leveraging a customer base of more than 800 million users, Tencent has now established a strong foothold in the rapidly expanding O2O commerce space, successfully integrating gaming, social media, and e-commerce to create a full user interactive experience. Over the past decade, a strong and professional management team has been very successful in monetizing opportunities and reinvesting to build new capabilities, offer broader services, and so attract a growing portion of consumer spending. Unlike some competitors that are effectively run as a one-man show, Tencent adopts a team management approach and, despite having grown into a large, successful firm, management maintains the startup spirit to be hungry, innovative, and entrepreneurial. Against a backdrop of generally weaker investor sentiment toward Asia ex Japan in recent years, the growth shown by Tencent during this time (Figure 2) is particularly noteworthy and a testament to the company's quality.

Financial theory tells us that long-term growth is unsustainable; that exceptional company performance is only ever a short-term anomaly; and that soon enough, exceptional performance becomes average performance. However, in the broad and diverse Asia ex Japan region, we continue to find exceptions to this rule, those rare but real examples of quality companies boasting the necessary traits to overcome the forces of mean reversion. And in owning these outstanding companies for the long term, investors are aligned with the powerful compound earnings growth that they can deliver.

[1] Source: Remarkety, as of September 2015.

Figure 2: Quality in Focus—Tencent Holdings Ltd.



- Leading provider of online entertainment through its movie and PC community platforms.
- The dominant social platform in China, Tencent boasts a user base of over 800 million and is the proxy to fast-growing online entertainment demand.
- The company appears well positioned to benefit from movie internet penetration and is executing faster than expected on mobile monetization.
- High-quality management team demonstrates strong execution in monetization and focused on the user experience.
- While not cheap, valuations are attractive given the growth and quality of the stock.

Sources: T. Rowe Price and MSCI as of December 2015.

These statistics are based on the company discussed and are not a projection of future performance.

The specific securities identified and described above do not necessarily represent securities purchased or sold by T. Rowe Price. This information is not intended to be a recommendation to take any particular investment action and is subject to change. No assumptions should be made that the securities identified and discussed above were or will be profitable.

MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed, or produced by MSCI.

INVEST WITH CONFIDENCE®

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

To learn more, please visit troweprice.com.

Important Information

This material, including any statements, information, data and content contained within it and any materials, information, images, links, graphics or recording provided in conjunction with this material are being furnished by T. Rowe Price for general informational purposes only. The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request. It is not intended for distribution to retail investors in any jurisdiction. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price. The material does not constitute a distribution, an offer, an invitation, recommendation or solicitation to sell or buy any securities in any jurisdiction. The material has not been reviewed by any regulatory authority in any jurisdiction. The material does not constitute advice of any nature and prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. Past performance is not a reliable indicator of future performance. The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The views contained herein are as of March 2016 and may have changed since that time. Unless indicated otherwise the source of all market data is T. Rowe Price.

Australia - Issued in Australia by T. Rowe Price International Ltd (ABN 84 104 852 191), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. T. Rowe Price International Ltd is exempt from the requirement to hold an Australian financial services licence in respect of the financial services it provides in Australia. T. Rowe Price International Ltd is authorised and regulated by the UK Financial Conduct Authority under UK laws, which differ from Australian laws. For Wholesale Clients only.

Canada - Issued in Canada by T. Rowe Price (Canada), Inc. T. Rowe Price (Canada), Inc. enters into written delegation agreements with affiliates to provide investment management services. T. Rowe Price (Canada), Inc. is not registered to provide investment management business in all Canadian provinces. The investment management services provided by T. Rowe Price (Canada), Inc. are only available for use by Accredited Investors as defined under National Instrument 45-106 in those provinces where it is able to provide such services.

DIFC - Issued in the Dubai International Financial Centre by T. Rowe Price International Ltd. This material is communicated on behalf of T. Rowe Price International Ltd by its representative office which is regulated by the Dubai Financial Services Authority. For Professional Clients only.

EEA - Issued in the European Economic Area by T. Rowe Price International Limited, 60 Queen Victoria Street, London EC4N 4TZ which is authorised and regulated by the UK Financial Conduct Authority. For Professional Clients only.

Hong Kong - Issued in Hong Kong by T. Rowe Price Hong Kong Limited, 21/F, Jardine House, 1 Connaught Place, Central, Hong Kong. T. Rowe Price Hong Kong Limited is licensed and regulated by the Securities & Futures Commission. For Professional Investors only.

Japan - Issued in Japan by T. Rowe Price International Ltd, Tokyo Branch (KLFB Registration No. 445 (Financial Instruments Service Provider), JIAA Membership No. 011-01162), located at GranTokyo South Tower 7F, 9-2, Marunouchi 1-chome, Chiyoda-ku, Tokyo 100-6607. This material is intended for use by Professional Investors only and may not be disseminated without the prior approval of T. Rowe Price International Ltd, Tokyo Branch.

Singapore - Issued in Singapore by T. Rowe Price Singapore Private Limited, No. 501 Orchard Rd, #10-02 Wheelock Place, Singapore 238880. T. Rowe Price Singapore Private Limited is licensed and regulated by the Monetary Authority of Singapore. For Institutional and Accredited Investors only.

Switzerland - Issued in Switzerland by T. Rowe Price (Switzerland) GmbH ("TRPSWISS"), Talstrasse 65, 6th Floor, 8001 Zurich, Switzerland. For Qualified Investors only.

USA - Issued in the USA by T. Rowe Price Associates, Inc., 100 East Pratt Street, Baltimore, MD, 21202, which is regulated by the U.S. Securities and Exchange Commission. For Institutional Investors only.

T. ROWE PRICE, INVEST WITH CONFIDENCE and the Bighorn Sheep design are, collectively and/or apart, trademarks or registered trademarks of T. Rowe Price Group, Inc. in the United States, European Union, and other countries. This material is intended for use only in select countries.