FSSA Investment Managers

Client Update

Japan equities: Renewed optimism after visiting companies

May 2023

> *"For reasons I have never understood, people like to hear that the world is going to hell."*
>
> *Historian Deirdre McCloskey*

In the past 12 months, global investors have worried about a "regime change" in the long-term inflation outlook, as well as the heavy rotation away from technology companies after the Covid optimism reversed. Media headlines are filled with alarming terms like the banking crisis, stagflation, higher for longer, and so forth. Pessimism is what sells newspapers and the reason such headlines are a compelling read.

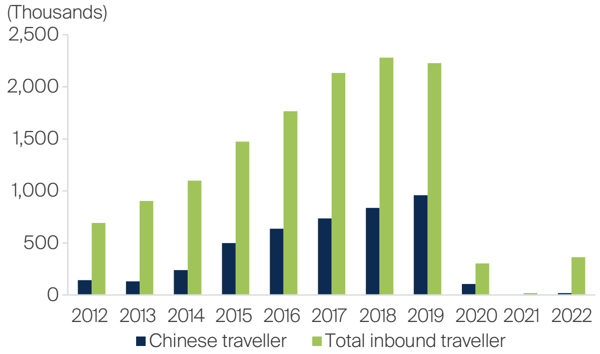
However, our dozens of meetings with companies during our latest trip to Japan projected renewed optimism about their business outlook and competitive strengths. A few core observations stood out – the rebound in consumer demand, the secular trend of digital transformation, and adapting to a slowdown in the global economy.

Post-Covid rebound is taking shape, positive for consumer companies

Less than 12 months ago, one could easily take a photo in Arashiyama (a popular tourist spot in Kyoto) without a single pedestrian in the background. Now, most hotels have been fully booked at record-high prices.

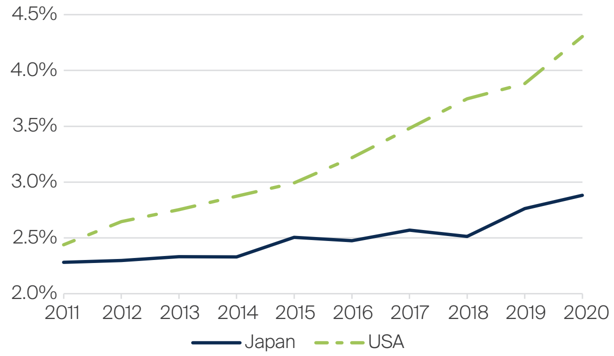
The rebound in domestic consumption started to gather pace when Japan's border reopened in October 2022, and we see plenty of scope for it to continue. According to the Japan National Tourism Organisation, the number of foreign visitors has only recovered to 66% of 2019's level, and Chinese tourists, previously the biggest growth engine of inbound consumption, are still down by 89% compared with pre-Covid.

Inbound tourists to Japan



Source: Japan Tourism Agency, as of April 2023.

ICT spending as % of GDP



Source: Japan's Ministry of Internal Affairs & Communications, as of 2020.

The government lifted mask requirements from mid-March and will downgrade Covid's classification to a "common infectious disease" from May. These policy relaxations should benefit consumer-related industries that were heavily affected, such as drug stores, cosmetics brands and chain restaurant operators.

One likely beneficiary from the re-opening is Shiseido, Japan's leading cosmetics company. It used to generate more than 30% of its revenue from China's onshore shops combined with Japan's inbound Chinese tourists. During the pandemic, the company streamlined its brand portfolio by disposing of loss-making brands in the US/Europe and selling low-margin businesses (such as personal care). We think Shiseido will emerge stronger and achieve higher margins than before the pandemic.

Food & Life Companies, which runs the largest conveyor belt sushi restaurant chain under the Sushiro brand, has seen its same-store sales growth (SSSG) gradually recover from last year's public relations crisis around misleading advertisements. Recently the CEO sounded confident that the overseas business would surpass its mid-term plan, driven by the fast expansion of its Greater China business. This would imply more than 130% growth from fiscal year (FY) 2022 to FY2024 for the company's overseas revenue. Its selling price in China is at least 70% higher than in Japan while the operating cost is lower, so we expect the company's profit to grow faster than its revenue as the business scales up overseas.

Digital transformation remains a robust driver

Our latest meetings with large Japanese corporations reaffirmed that the structural trend of digital transformation (DX) is intact. DX involves adapting processes and customer experiences via digital technologies to meet changing business needs. Japan's spending on information and communication technology (ICT) as a percentage of GDP has trended up only mildly in the past decade, and lagged the US by a wide margin.

Historically Japanese companies considered information technology (IT) spending to be a part of maintenance costs, and only spent on the back-office systems. However, their awareness of DX has increased and the pace of investment should accelerate, making it one of the biggest secular drivers in Japan in the next 5-10 years. According to International Data Corporation (IDC)[1], the consulting market in Japan is expected to grow at an 8.8% compound annual growth rate (CAGR) in 2022-2026 and the IT services industry may grow by 3.4% CAGR. The market for DX-related services is expected to grow much faster at 30.1% CAGR in 2020-2025.

The first stage of DX is to improve a company's labour productivity by upgrading its IT systems. A 2022 government survey[2] showed that 63% of companies still used patchy legacy systems (defined as more than 10-20 years old and written in old languages that young engineers are unfamiliar with). This has become a drag on management and business operations. The second stage of DX is when a company transforms its business model to running on a digital platform. Therefore in the long term we believe DX will benefit not only IT services and software companies, but also consulting and project management services providers.

Despite rising interest rates in the US and a slowing global economy, most blue-chip companies we met are committed to making long-term investments. And this has been reflected in the latest financial results of our portfolio holdings. IT services firms like Baycurrent Consulting and Shift have delivered more than 30% revenue growth and over 50% profit growth in their latest results. Rakus, a leading domestic Software-as-a-Service (SaaS) provider, has consistently grown by over 30% year-on-year (YoY) with high visibility. In our latest meeting with the CEO of GMO Payment Gateway, he was highly confident of achieving the company's mid-term plan one year earlier and still commits to 25% annual profit growth.

After the market's rotation into value in early 2022, we believe that the de-rating in these quality growth companies is unjustified considering their high earnings visibility, long growth runway and decent margins and return on equity (ROE). Any further share price corrections triggered by macro sentiment would only make these investments more attractive, in our view.

[1] Sources: https://www.idc.com/getdoc.jsp?containerId=prJPJ49649322 and https://www.idc.com/getdoc.jsp?containerId=prJPJ49137922
[2] Source: https://juas.or.jp/library/research_rpt/it_trend/

Global weakness is a short-term headwind for companies exposed to demand outside Japan

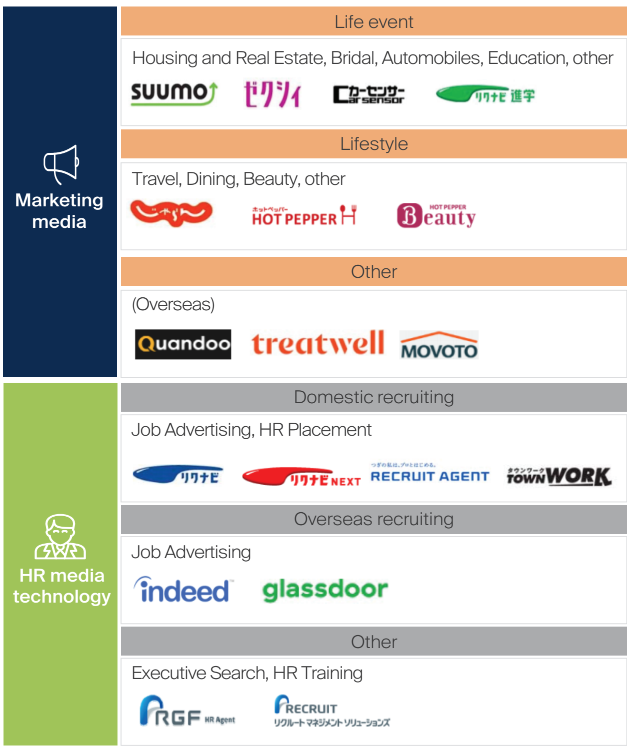
Despite the slowing global economy, Japan's domestic economy has been fairly resilient. Investors often have the misperception that Japan is highly cyclical and export-driven, but 80% of Japan's GDP comes from domestic consumption, making it fairly sheltered from external macro headwinds.

That said, we met a few Japanese companies with large overseas exposure, and they expressed concerns about slowing demand and margin pressure, perhaps driven by the tighter monetary policy in Western economies.

In the recruitment industry, one of our large positions is Recruit Holdings, a leading human resources and marketing media company. It owns US-based Indeed, the world's largest job search engine. In hindsight, we should have trimmed more decisively in late 2021 when hiring demand was at the peak in the US. We had underestimated Covid's distortion of the labour market.

However, as long-term investors we think Recruit Holdings is a high quality company. It has a balanced portfolio of cash-cow and high-growth businesses supported by its renowned entrepreneurial culture. The stock is trading near historical troughs at 20x price-to-earnings ratio (PER). Besides, the profitability of its domestic media solution business (22% of the total revenue) has yet to recover, with the earnings before interest, taxes, depreciation and amortisation (EBITDA) margin at 14% vs 24% before Covid. More recently, the management of its subsidiary Indeed announced a 15% reduction in its labour force, as part of its initiatives to streamline costs.

Recruit Holdings has a balanced portfolio of brands



Source: FSSA Investment Managers, April 2023.

Growth could become a bigger concern than inflation

Recently, Indeed's CEO Chris Hyams expressed concern that job openings are likely to drop to pre-pandemic levels or even lower. We believe this upcoming weakness in the US job market will bring about softer inflation and wage growth, which runs counter to the consensus view of inflation being "sticky".

To us, it looks like things are reverting to pre-pandemic conditions. Goods demand has weakened, while supply chain bottlenecks are clearing up. Global manufacturing companies have expanded capacity with more to come, which may lead to oversupply in many areas.

Our recent observations in Japan support this view. Domestic consumer and retail companies say raw material costs have peaked, and companies such as Kobe Bussan and Ajinomoto expect better gross margins later this year. And it now appears that weakness in the Japanese yen peaked last November.

Inflation may also soften in other major countries. Based on what Recruit's CEO said about the US job market, wage growth and services inflation may be the next to normalise. We expect investors will soon worry more about growth than inflation. After all, the pandemic has not altered the world's structural growth slowdown and deflationary forces – ageing population, financialisation and evolving technology.

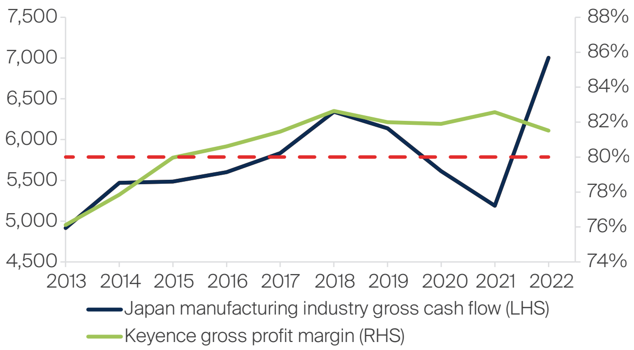
Hence, we will stay invested in the types of companies that we have always preferred – those with strong balance sheets, cash flow generation, pricing power, and are able to grow through innovation, geographical expansion, and industry consolidation.

For example, one of our key holdings in the semiconductor industry is Lasertec, a global leader of mask blanks and photomask inspection systems used in the semiconductor production process. Lasertec's resilience stands out in the industry, thanks to its near-monopoly on extreme ultraviolet lithography (EUV) technologies, which account for more than 80% of its orders. It also has high sales visibility – its estimated June 2023 backlog can cover revenue in the next two years – and managed to increase average selling prices (ASPs) for its latest products. The company's quality markers, including its monopolistic global market share, high return on capital employed (ROCE), and earnings visibility in a down cycle give us confidence as long-term shareholders.

Other major holdings which have shown resilience in their fundamentals include Keyence and Hoya. As the largest global vision sensor and machine vision vendor, Keyence has proven its strength in different parts of the cycle. The management announced last year that it would raise the dividend per share (DPS) by 50%, based on investors' feedback.

There are a few key reasons for its superior profitability metrics and steady long-term returns. Firstly, Keyence's production is fabless (meaning it does not own factory plants), so its resources are concentrated in research and development (R&D) and sales and marketing. Due to its low fixed cost structure, Keyence generates high returns on invested capital and earnings are typically resilient during a downturn. Secondly, Keyence's direct sales model (as opposed to a distributor sales model) enables the company to benefit from a virtuous feedback loop with its clients, which allows for fast innovation in product design.

Keyence has shown resilient margins across cycles



Source: Company data, Statistics Bureau of Japan as of April 2023.

Hoya, a leading manufacturer of lenses and related optical products, demonstrated impressive cost control ability amid the industry slow down by cutting "every type of cost that you can imagine" and preserving high operating margins amid the recent difficult times. The company has a strong profit-centric culture and consistent track record. It should benefit from the secular growth trend in the IT segment where it has a near-monopoly in certain materials, such as EUV mask blanks used in the production of semiconductors, and glass substrates used in Hard Disk Drives (HDD). Hoya generates 40-50% operating margins on these products, as there is virtually no competition.

Although Lasertec, Keyence and Hoya trade at higher valuations vs the market and their peers, their ROCE and growth are significantly higher, backed by strong management, robust business models and innovative cultures. They represent the type of quality companies that we like to back in the long term.

By contrast, despite Japanese banks having a strong run in the past 12 months, we are not tempted to chase this sector. Japan is still an over-banked society with weak loan demand and extremely low net interest margins, so we believe there are better opportunities elsewhere. Even if new Bank of Japan governor Kazuo Ueda stops the existing policies of yield curve control (YCC) and negative interest rate policy (NIRP), there may be a limited earnings impact on Japanese banks. Overall we expect monetary policy to remain accommodative while inflation stays benign.

Portfolio update

Since our last client update from end-June 2022 through to March of this year, the key performance contributors in the FSSA Japan Equity strategy included Baycurrent Consulting, Keyence and Lasertec. We added to Baycurrent as it was sold off last year due to a growth-to-value style rotation and concerns about the global economy recession. Despite the uncertain global macro outlook, we had conviction in its growth and earnings resilience. We were rewarded after the company delivered strong financial results in line with our expectations — over 30% revenue growth, driven by the corporate Japan's commitment to DX investments. Keyence and Lasertec also rebounded in the past six months thanks to their resilient and strong growth compared with peers.

The top detractors included MonotaRO (an industrial supplies business), Olympus (the largest medical equipment company in Japan) and Nihon M&A Center (a leading mergers and acquisitions intermediary firm focused on serving small and medium-sized enterprises in Japan). The share price of MonotaRO fell due to lower-than-expected revenue growth, as a result of weaker demand from domestic manufacturing companies who were less confident about the future. Olympus pulled back due to concerns about the strong Japanese yen (it is highly sensitive to currency fluctuations) and the US hospital budget, which may be affected by the upcoming recession. Nihon M&A Center continued its correction due to weaker revenue growth, as the company is undergoing a transformation after the accounting irregularities uncovered in Dec 2021.

We added to Nihon M&A Center on share price weakness. While the financial impact of the errors was not significant and the company took proactive measures to address the issue, we were disappointed as shareholders. In response, we held an engagement meeting with the CEO followed by a letter with suggestions related to governance. The management listened to our advice and actively took a series of countermeasures. They believe that the recent earnings slowdown, caused by the incident, helped them reflect on the weaknesses of its business process and growth strategies. We expect the company to emerge stronger by reorganising management incentives, using more digital tools to improve productivity and eliminating wasteful spending internally.

With regard to new initiations, we purchased a few companies which we used to own or were on our watch list, after their valuations appeared attractive. For example, we bought Terumo, one of the strongest medical technology companies in Japan with a global franchise in cardiovascular products. It has a stable growth profile while its new business cooperation with CSL for blood plasma collection systems should bring a profitable long-term revenue stream. Its share price corrected meaningfully due to temporary factors such as lower procedure volumes (a result of the pandemic), high raw material costs and logistics costs.

Another new holding is Nomura Research Institute (NRI), which declined as a result of style rotation and concerns about its overseas business. We thought this was a good chance to rebuild a position. We believe NRI is the most prestigious think tank and IT solutions provider in Japan with leading brand recognition and a quality talent pool. We believe the structurally growing digital transformation (DX) trend in Japan will support NRI's long term growth.

We also initiated a position in Makita, one of the leading global power tool brands. Makita has strong brand recognition among professional users and faced severe industry headwinds last year, such as the end of the Covid boom for do-it-yourself (DIY) power tools, weakening construction demand, supply chain disruption along with excess channel inventories, and yen depreciation. Makita is mitigating this by producing less volume and normalising inventories, after which we believe it can recover and grow steadily.

We trimmed and sold out of a number of stocks due to valuation concerns, such as Unicharm, Shift, Kotobuki Spirits and Japan Elevator Services. We had been trimming S-Pool throughout the past few years as the stock performed well, and sold our remaining holdings at the beginning of 2023, as we believe changing regulations will pose headwinds for the company's special needs employment business. We also trimmed our position in SMC due to its record-high profitability in conjunction with its aggressive capacity expansion in the next 2-3 years. Unfortunately, cyclical companies often make the mistake of expanding in good times.

Conclusion

2022 was a challenging year for the FSSA Japan Equity strategy performance both due to things we never owned, like banks and commodities-related companies, and what we have owned since inception — quality franchises that generate higher growth and returns over the long term.

Despite the market's concerns around higher interest rates, inflation and slower economic growth, the companies most out of favour were those with net cash balance sheets, strong pricing power, high margins and ROCE. The market focused on their higher relative valuation in the near term, while their strong earnings and balance sheet resilience amid a potential global recession was completely ignored. After the recent de-rating, we think the investment appeal of our portfolio companies has only grown.

As usual, we would like to conclude by thanking our clients for your trust and support.

Source: Company data retrieved from company annual reports or other such investor reports. Financial metrics and valuations are from FactSet and Bloomberg. As at April 2023 or otherwise noted.

[1] If the materials will be made available in other locations, seek advice from Regulatory Compliance.