FSSA
Investment Managers

Fund Manager Q&A

Japan – Land of Hidden Gems (Part 2)

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Sophia Li, Portfolio Manager, joined FSSA Investment Managers as a graduate in 2009 and has developed an extensive coverage of companies in North Asia. Sophia manages the team's Japan equity strategies and is the lead manager of the FSSA Japan Equity Strategy.

The Japan equity market has been quite volatile in recent months. How do you manage against these risks in the portfolio?

We do not see short-term market volatility as a kind of risk. Instead, we define risk as the permanent loss of client capital – and to protect against that risk, we believe the most important thing we can do is maintain the discipline to stick to our rigorous bottom-up stock selection process.

Recent market volatility has been driven in part by concerns about global inflation. For companies to make it into our portfolio, we require them to have a dominant franchise or strong pricing power, so they should continue to perform well even in a high inflation environment. We also require businesses to be highly defensive, with the ability to produce medium-to-long-term secular growth.

The portfolio is invested in a combination of both domestic Japanese companies and Japanese companies with global franchises (those with high overseas exposure). The global companies should perform well in a global recovery, while the purely domestic companies should be able to deliver sustainable earnings growth and remain resilient during an economic downturn.

How does the team define overvalued? Are there any examples where you have divested based on valuations?

We conduct a fair market value (FMV) exercise for each company in our portfolio (including those on our watch list), calculating the annualised return and dividends on a three-to-five year basis. As a rule of thumb, we require more than a double digit return to invest in a company – and for those that comes with higher risk, we would require even higher returns to compensate. If a business generates a negative return in our FMV calculations, we consider it to be overvalued.

We used to own a company called Hoshizaki Electric, a domestic leader in commercial fridges and freezers for restaurants in Japan. When we invested in the company, it had only limited sell-side coverage. The valuation was reasonable at about 20x price-to-earnings (P/E) ratio.

However, over the years it re-rated far more quickly than its earnings growth, and after conducting more detailed due diligence, we found that the company did not have much substance to its overseas expansion story. There were also some concerns with the new management. As a result, we completely disposed of the stock not long after.

Did the Covid-19 sell-off last year present any good accumulation opportunities for the portfolio?

With hindsight, the market crash early last year did indeed present great opportunities for global investors to buy companies in Japan. We picked up mainly two types of companies.

The first was what we believed to be Covid beneficiaries — not just temporarily, but goods and services that should benefit from the structural changes brought forward by the pandemic. For example, Japanese consumers and corporates can be quite conservative, and the pandemic had accelerated the digitalisation of their behaviours. Beneficiaries of this changing behaviour included companies in the digital payments (GMO Payment Gateway), e-commerce (M3 and Shift) and Software-as-a-Service (Rakus) sectors.

The other type of companies were the ones that we believed would be affected by the pandemic in the short term (in terms of their valuation) but, given their strong franchises, should be able to rebound in the next one or two quarters. Examples include Recruit Holdings, which we believed should benefit from the economy re-opening, and a hidden gem called Kotobuki Spirits, which sells souvenir sweets mainly to domestic and inbound tourists in Japan.

Kotobuki Spirits generated decent return-on-equity (ROE) and profit margins even before the pandemic. We believe after the pandemic is over, both margins and ROE should improve due to a series of cost reduction activities over the past 12 months. We also believe they are well prepared for demand to recover post the pandemic.

Do you see any opportunities in the small- to mid-cap segment?

In our view, there are quite a lot of opportunities in this space, mainly because of the lack of analyst coverage. These smaller companies tend to have slightly higher price volatility in the short term, given the higher participation from retail investors. However, we believe that in the long run they can generate good returns for global investors.

Every year we host around 250 to 300 meetings with companies and more than half of them are with new companies. Hence, we are quite optimistic about the opportunity set in the small- to mid-cap sector.

Do you see any opportunities in the Electric Vehicle (EV) market in Japan?

We have been looking for investment opportunities in the Electric Vehicle (EV) sector for about four years, but have struggled to find any well-managed and relatively pure businesses that can benefit from this sector. We also do not want to chase after “hot themes” just for the sake of it, as it would compromise our investment philosophy.

We have a position in a company called Nidec, which produces servo motors, but across all industries and not just EV. Although we believe its EV traction motors may hold some promise, this line of business is still very small. Today, it accounts for just 1% of the company’s revenue. That said, we believe it will grow quickly and by 2025, we believe it could account for 15% of revenue as EV penetration continues to rise.

Environmental, Social and Governance (ESG) analysis is central to the team’s investment philosophy. How has the Japan strategy evolved over the years from this perspective?

ESG has always been an integrated part of our investment process, ever since the team was first established. But it has been a journey, and our process has indeed evolved over the years.

As a team, we do not invest in any industries or companies that cause direct harm to the environment or to society; and we value the quality of the management and corporate governance above a company’s franchise or growth prospects. In the early days, we would apply this lens as a form of risk management. However, over the years, we started to identify companies that are able to transform environmental and social risks into opportunities.

For example, we own a number of companies in the portfolio that are committed to providing products and services to small and medium sized enterprises (SMEs) in Japan, which are usually at a disadvantage compared to large enterprises due to their size. Rakus’s corporate mission for example, is to provide affordable services to SMEs.

We have also been expanding our risk metrics from mainly corporate governance to include environmental and social risks.

In our view, one of Japan's biggest weaknesses is gender diversity. Since last year, we have started to hold annual engagement meetings with investee companies. The meetings last around 60 to 90 minutes and we would discuss all the key and material issues of their businesses, defined according to the Sustainability Account Standards Board (SASB).

We would also encourage them to disclose more information – the lack of information disclosure has been a particular problem with mid- to small-cap companies in Japan. Through our engagement efforts, we are happy to see that some management are quite open-minded and are making progress. That said, given that "slow and steady" is really the name of the game in Japan, we will continue to engage with companies patiently and monitor the progress.

Are there any past company engagements that you could share?

A few years ago, Fast Retailing (Uniqlo) had an issue on labour protection with one of their previous suppliers in Indonesia. We engaged with them on their supply chain management processes, especially on their lack of a grievance system (which had been adopted by global peers such as H&M and Zara). Fast Retailing did not have such a system back then.

We introduced Fast Retailing to a company called Elevate, a supply chain solutions provider, which carried out a consultation. As a result, Fast Retailing improved their grievance system and now are currently in discussions on whether they should introduce proper surveys and assessment tools for the system.

What are your thoughts on sector rotations in the Japanese market? Are you ever tempted to buy some of the cheaper stocks with lower-quality growth prospects?

In the past, we were tempted; and we purchased companies that were cheap by compromising our standards on quality. However, in hindsight, these were not good purchases and we actually lost money on them.

As a team, we have a relatively long-term investment horizon of at least three-to-five years if not more. However, lower-quality companies tend to generate mediocre returns over the cycle and when something goes wrong, we find it very difficult to muster enough conviction to add on weakness. It turns out that these companies are cheap for a reason.

We have learnt our lesson; and will not be tempted to chase sector rotations in future cycles. In fact, we do not take any macro view – when we invest in a company, we look for businesses that can generate sustainable returns and growth that is unrelated to the macro environment.

Many companies in the portfolio are in a net cash position. 18 months into Covid, how has this benefitted them?

From our observations, when markets crash, companies with strong balance sheets tend to have the benefit of the doubt from investors and are usually more resilient.

Many companies, especially Software-as-a-Service (SaaS) companies, took the opportunity during the pandemic to reinvest into their businesses. They called 2020 a "once in a lifetime opportunity" for them to increase market penetration, and invested massively during the year to promote their services.

Meanwhile, companies like Japan Elevator Service and Shift made quite a few merger and acquisition (M&A) deals over the past 12 months or so. The smaller players were struggling because of the pandemic and were keen to sell their businesses.

Japanese SMEs have a structural succession issue. In the next five years or so, more than 70% of the SME founders in Japan will retire and many will struggle to find a successor. This crisis presents a great opportunity for industry leaders with ample cash on their balance sheet to consolidate the market.

Source: Company data retrieved from company annual reports or other such investor reports. Financial metrics and valuations are from FactSet, Lipper and Bloomberg. As at 31 July 2021 or otherwise noted.

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