Fund Manager Q&A

Japan – Land of Hidden Gems (Part 1)

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Sophia Li
Portfolio Manager

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.

What are some of the biggest misconceptions about Japan?

Strategists often argue that Japan is perhaps the most cyclical market amongst the major global economies, with profits highly correlated to global trade. We disagree. It is true that many of the large index constituents are companies with high overseas exposure or are highly sensitive to forex fluctuations. However, in our view, Japan's economy is actually very defensive and mainly driven by domestic demand. Japan's exports account for less than 20% of GDP – far lower than that of Germany or South Korea where more than 40% of GDP is derived from exports.

Another misconception about Japan is that the ageing population and prolonged deflationary environment means that there are few quality companies that can deliver high growth and returns. We disagree with that notion too. Especially from a bottom-up perspective, our view is that Japan has a deep investment universe with many high-quality companies that are focused on delivering sustainable growth and returns and are uncorrelated to the global macro environment.

Why should investors consider Japan?

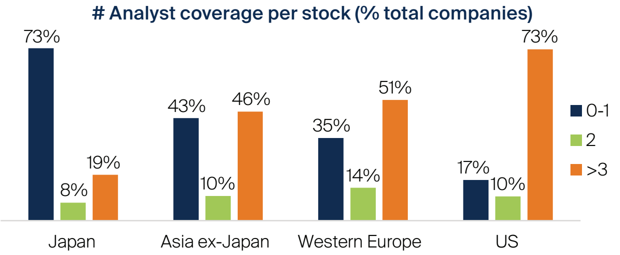
Firstly, in our view, you can find a large number of companies in Japan which have strong global franchises and dominant market share in secular growth industries such as factory automation, machine vision, medical equipment and semiconductors.

Secondly, we see strong Japanese consumer brands benefitting from the favourable demographics in Asia, which accounts for more than 60% of the global population. Not to mention the rising number of middle-income families in Asia with increasing consumption power.

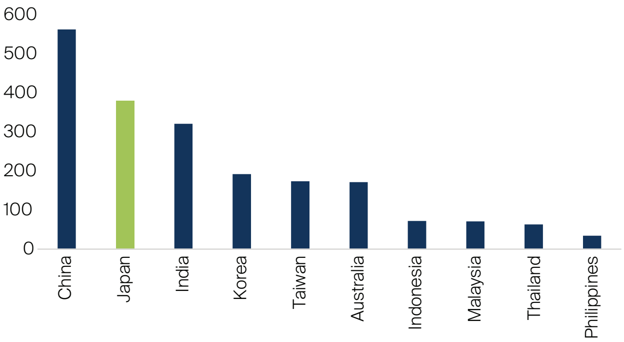
Thirdly, we believe there are even more investment opportunities among the purely domestic Japanese companies. We tend to find hidden gems in the underpenetrated and emerging industries in Japan – such as e-commerce, digital payments and Software-as-a-Service (SaaS). They are often under-researched by the market and our view is that this is what really makes Japan an interesting investment destination.

If you look at the chart below, more than 70% of the listed companies in Japan are covered by only one analyst, or none at all. In addition, if we look at the number of 10-baggers in Japan (defined as stocks that have delivered returns of more than 10 times the amount of its initial investment over the past 10 years) it is second only to India and is far higher than China or other Asian countries. We believe this proves that the market efficiency mechanism has not broken down in the way that people might think.

Under-researched



Number of ten-baggers from 2011



Calculation period is from August 2011 to August 2021 (minimum USD 500mn market capitalization). Numbers may not add up to 100% due to rounding.
Source: Bloomberg & Jefferies, data as at 15 July 2020.

To us, the investment case for Japan has nothing to do with the macro environment. Rather, we seek to back a set of globally-competitive companies and local domestic disruptors that can win market share from complacent incumbents. As such, we believe Japan is a perfect market for bottom-up active investors like FSSA who have a different, contrarian perspective to deliver active returns.

What sets FSSA's Japan strategy apart from peers?

First of all, as we adopt a benchmark agnostic investment philosophy, our strategy usually has a high active share, ranging historically between 70% to 90%. In addition, we define risk as the permanent loss of capital, rather than deviation from the benchmark or short-term volatility of stock performance.

As bottom-up investors, the FSSA Japan strategy is built company by company, from the bottom up and with little regard for index positioning. This results in a focused portfolio of around 40 to 45 high-conviction stocks. As a team, FSSA believes that what we don't own is just as important as what we do own. As such, we do not invest in industries that cause direct harm to society or the environment. Nor have we invested in companies with structural problems, or companies that are driven purely by global macro cycles.

We are long-term investors and have an investment horizon of around three-to-five years, if not more. Our investment philosophy is to identify high-quality companies that can deliver sustainable investment returns and growth that is uncorrelated with the macro environment. Once we have built sufficient conviction, we aim to buy them at sensible prices and hold for the long term.

How does a stock make it into the portfolio?

We evaluate companies based on three aspects: the quality of its franchise and management, and sustainability of growth.

Firstly, in terms of the franchise, we look for companies that have a dominant market share in niche industries that can gradually make inroads into associated markets.

In addition, we prefer companies that adopt an asset-light business model, which in our view is a key factor in delivering high return on invested capital (ROIC) and strong earnings resilience during an economic downturn. We also prefer to invest in companies that have a continued ability to innovate, so that they can disrupt the industry incumbents and win market share.

In terms of management, in Japan we look for distinctive leaders, rather than those with typical management characteristics. Conventional Japanese corporates usually have a slow and stubborn corporate culture, where promotion is based on seniority and an employee's ability to conform, rather than their actual performance. In our view, this may partially explain why their corporate performance has been struggling since the economic bubble burst.

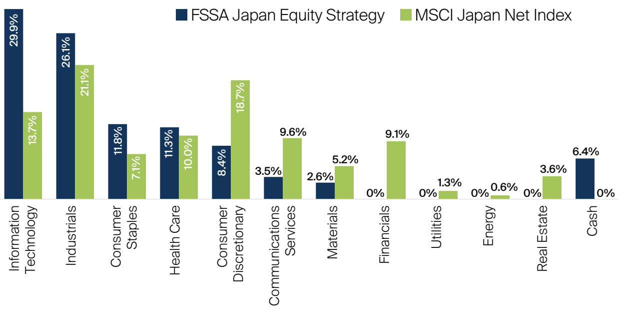
Instead, we back management who are open-minded and motivated, who have a speedy decision-making process and can rectify mistakes quickly, and can adjust their strategy according to the fast-changing external environment.

Lastly, we focus on the sustainability of a company's growth. We try to identify structural trends in Japanese corporate and consumer behaviour, and look for the best investment opportunities that we believe should most benefit from those secular drivers. We look for innovative companies, in terms of business models or new product launches, as this helps them gain market share from incumbents. This is especially important because Japan is already a mature economy where most industries are quite saturated. We also like defensive and sticky business models that can generate revenue on a recurring basis.

How is the strategy positioned today?

As you can see from the slide below, we have very limited exposure to sectors such as financials, utilities and real estate, which in our view have structural issues and low growth opportunity.

Sector breakdown – Japan Equity Strategy
as at 31 March 2021



Source: First Sentier Investors. Numbers may not add up due to rounding.

While it may look like we have a high exposure to Industrials, more than 90% of this segment are companies in the commercial service industries, which includes mergers and acquisitions (M&A) advisory, recruitment services and e-commerce. For example, Recruit Holdings is in the recruitment business, while Benefit One is in the business process outsourcing (BPO) services sector. Both are categorised as Industrial companies. In reality, these companies are very defensive in terms of their business model.

Recruit owns Indeed, one of the largest job search engines in the world, and the business has been growing by more than 25% in the past five years. We believe growth will continue to be strong, mainly driven by the recovery of job markets in the United States and other developed markets.

Recruit also owns a number of leading marketing media portals in Japan, such as Jalan.net (a travel information and accommodation booking site) and Hot Pepper Gourmet (an online restaurant review and booking site). We believe these businesses should recover when the economy starts to reopen by the second half of this year.

Our highest exposure is to Information Technology (IT), which mainly reflects our long-term positive view on the factory automation, semiconductor production equipment (SPE) and software sectors in Japan.

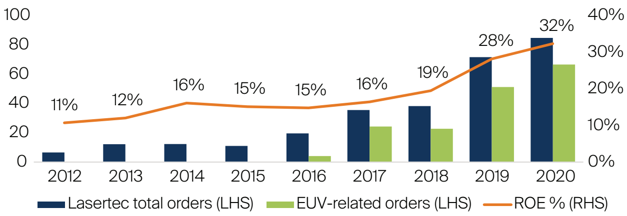
Could you share some company examples from the Information Technology sector?

Over the past 12 months we have established new positions in the SPE market, as the strategic value of semiconductors has been increasing dramatically. We believe that the semiconductor supply chain will increasingly be localised in each of the major global economies (such as the US and Europe), rather than just in Taiwan or Korea.

As production technology continues to advance, we believe capital expenditure intensity will also rise. These tailwinds should benefit companies in the SPE market, of which Japan is a global leader.

We believe that Lasertec, one of the largest SPE companies in Japan, should benefit from these structural tailwinds. It is a global leader and has almost a monopolistic market share in Extreme Ultra Violet (EUV) mask blanks and photomask inspection systems.

EUV equipment order growth and ROE trend



Source: Gartner, Alliance Bernstein, Company data by the end of DecFY2020.

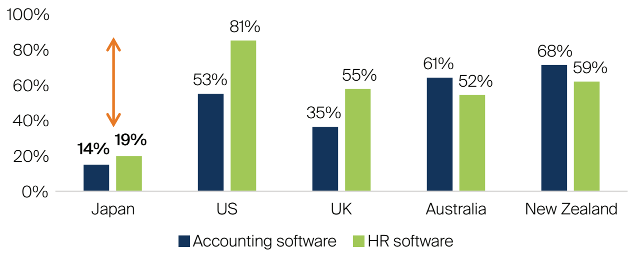
We believe Lasertec (along with ASML, a European-based company) is one of the largest beneficiaries of the increasing adoption of EUV technology in advanced semiconductor manufacturing processes. The company is run by professional management and has a strong research & development (R&D) culture. As a result, it has been able to launch new products ahead of the competitors. Both return on equity (ROE) and operating margin is top notch within the industry and, based on our estimates, we would expect the ROE to rise to above 40% in the foreseeable future.

We also own companies in the Software-as-a-Service (SaaS) and IT services industries. We firmly believe that Japanese corporates have been under-investing in IT for years (particularly software) and they may soon face the so-called "2025 Digital Cliff" — a shortage of human resources in IT.

We invested in Rakus more than four years ago — back then it was still a "hidden gem" without any analyst coverage. Today, Rakus is one of the largest cloud services companies in Japan, providing affordable SaaS to small and medium-sized Japanese enterprises (SMEs), many of which have very low IT literacy.

As you can see from the chart below, the SaaS penetration rate in Japan is still very low compared to the US, the UK or Australia. Hence, we believe there is still a long runway for growth and we believe companies such as Rakus will continue to deliver strong and long-duration growth by gaining market share in Japan's large IT spending pool (which is estimated to be as much as USD100 billion).

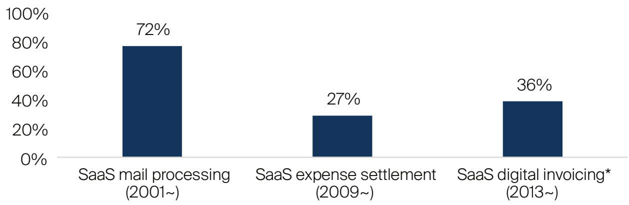
SaaS penetration rate in Japan is still relatively low



Source: Company data (as at March 2020), Daiwa (published in April 2020).

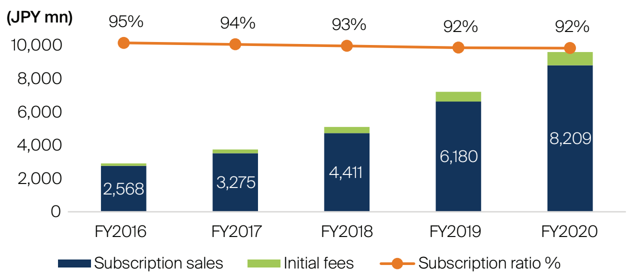
Additionally, Rakus has a leading market share in niche applications such as expense settlement and digital invoicing systems. The company's market share has been very stable and more than 90% of their revenue is generated on a recurring basis, which should prove to be highly defensive during an economic downturn.

Rakus builds high share in niche domains and expands footprint



* Market size based on Infomart and Rakus software revenues

Subscription-based cloud business secures recurring income



Source: Company data (as at March 2020), Daiwa (published in April 2020).

The portfolio has relatively high exposure to consumer companies. Could you share some examples?

We own mainly two types of companies in the Consumer Staples sector: strong Japanese consumer brands and Japanese specialty retailers.

Shiseido, for example, is one of the strongest consumer brands in Japan, with more than 20% market share. It generates a large part of earnings from overseas countries like China, which has strong demand for premium cosmetics. Another example is Unicharm, which has a dominant market share in baby and adult diapers as well as sanitary napkins, across all major Asian countries including at home in Japan.

Meanwhile, Japanese specialty retailers provide high-quality products at affordable prices. Examples include Fast Retailing and Kobe Busan. Fast Retailing, which runs the Uniqlo brand, is a global company which generates more than half of its earnings from overseas markets. With their scale, they are able to leverage strong, diverse supply chains and have developed a robust product development capability.

Kobe Busan is a leading discount retailer in Japan, selling grocery products at prices that are 30% to 40% cheaper than other retailers in Japan. Despite the continuous Quantitative Easing (QE) in Japan (which is intended to be inflationary), Japanese consumers still have a strong deflationary mindset and are becoming even more cost-conscious — which has benefitted discount retailers like Kobe Busan.

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.