FSSA Investment Managers

Client Update

FSSA Japan Equities

October 2021

Overview

In our last client update in February 2021, we discussed the reasons we resisted the temptation to switch into pure cyclicals and so-called "value" stocks[1] — even though we had anticipated a sector rotation in the market (the TOPIX subsequently peaked in March 2021). When there is a rise in inflation from very depressed levels it usually favours value and cyclicality, as pricing power returns to sectors that had been under pressure, no matter how temporary the effect. As such, since the Covid vaccine breakthrough last November, a number of lagging sectors, such as mining, commodities, shipping and banks, enjoyed a strong rally to which our Japan strategy had virtually no exposure.

Given the commoditised nature of these businesses, and their less attractive outlook and long-term growth sustainability compared to the companies in our portfolio, it is hard to call investments in these securities anything more than a macro trade. Nevertheless, not owning them does not mean that the FSSA Japan Equity strategy is not positioned for the global recovery that is being supported by rising vaccination rates and economic re-openings.

> In fact, we have added meaningfully to a number of holdings during the period in review, including leading semiconductor equipment manufacturers, Human Resources (HR) service providers and factory automation vendors. These companies should all benefit from an upturn in activity.[2]

In the meantime, we also took advantage of the market's behaviour to add to portfolio holdings as they became cheaper, including Software-as-a-Service (SaaS) companies, internet service providers and others.

> As we have discussed in previous letters, we do not seek out companies with a low price-to-earnings (PER) valuation; rather, we look for companies with certain characteristics that indicate a superior franchise.

In light of the concerns about global cost inflation, we believe companies with a dominant market share, strong pricing power and a continual ability to innovate (either in terms of product or business model) should be able to protect client capital better. We also require businesses to be defensive, with the ability to produce medium-to-long-term secular growth regardless of the prevailing macro situation. Companies with an asset-light business model, a high proportion of recurring revenue, the ability to create new avenues of growth and a cash-rich balance sheet tend to be less prone to an economic shock, in our experience.

> Most importantly, underpinning all of these factors we look for a strong corporate culture and team of people — which, in our view is the ultimate source of a company's lasting competitive advantages.

[1] Defined as having a low stock price relative to the 12-month earnings per share (EPS)

[2] Certain statements, estimates, and projections in this document may be forward-looking statements. These forward-looking statements are based upon FSSA's current assumptions and beliefs, in light of currently available information, but involve known and unknown risks and uncertainties. Actual actions or results may differ materially from those discussed. Readers are cautioned not to place undue reliance on these forward-looking statements. There is no certainty that current conditions will last, and FSSA undertakes no obligation to correct, revise or update information herein, whether as a result of new information, future events or otherwise

Considering these factors makes it easier to add to portfolio companies when they are sold off amid sector and style rotations. To us, short-term market volatility is not a "risk", but an opportunity to add to high-quality companies at more attractive valuations.

After struggling in the first quarter of 2021, the performance of the FSSA Japan Equity strategy recovered at the start of Q2 and has further strengthened in the past few months. There are several reasons for the improvement. Firstly, the companies that we own have been delivering consistently strong revenue/profit growth and in many cases have beaten expectations. Secondly, some of the "hidden gems" in our portfolio are increasingly being appreciated by the market. There is nothing more satisfactory than for us to see the investment cases of our investee companies being recognised by a broader base of investors. Lastly, due to the surging fear of Covid variants and growing concerns about stagflation and Fed tapering, global investors are becoming more worried about the sustainability of the economic recovery and the ability for cyclical companies to pass on inflation pressures to end-customers.

> We believe that it is the quality of the business and the people, and not optically cheap valuations, which will navigate investors through these unchartered waters.

In the following note, we will first discuss the investment cases for two of our top holdings, which we have been adding to over the period and represent two key investment groups in the portfolio — global niche market dominators positioned in industries of secular growth; and domestic disruptors positioned in under-penetrated industries. We then follow on with an overview of our environmental, social and governance (ESG) activities in Japan.

Tapping into a decade-long tailwind

The strategic value of semiconductor chips has increased significantly in the past three years. They are used in millions of everyday products, ranging from smartphones and consumer electronics, to hyper-scale data centres and automobiles. With ever-increasing computing requirements, along with demands for energy efficiency and portability, the entire semiconductor industry has been advancing towards smaller-sized chips in a process called miniaturisation.

ASML, a Dutch holding company that makes equipment to imprint circuits onto chips using Extreme Ultraviolet (EUV) light (a process called lithography) has developed cutting-edge technology that has shrunk the smallest size of the pattern that can be created on a semiconductor wafer. We believe the semiconductor industry is at the beginning of a new era where EUV becomes indispensable as the main technology for chip manufacturing over the next decade.[3]

The adoption of EUV technology has been slowly building momentum. In 2019, Taiwan Semiconductor (TSMC) revealed an aggressive EUV adoption plan for the mass production of its 5nm[4] chips. In January 2021, it announced an unprecedented medium-term capital expenditure (capex) plan of USD 100bn from 2021 to 2023. Following that, Intel announced plans for a USD 20bn investment to build two leading-edge semiconductor-manufacturing facilities ("fabs") in the US and another USD 85bn to be invested in Europe over the next decade. This will lift its total capex to over USD 25bn a year, up from an average of USD 15bn a year from 2018 to 2020.

We believe that a leading Semiconductor Production Equipment (SPE) Company in Japan is one of the key beneficiaries in this world of increasing technology use. Similar to ASML's monopolistic position in EUV lithography machines, this Japanese SPE company has 100% market share of EUV-related inspection systems for three of the largest global chipmakers. By our estimates, EUV-related equipment accounted for approximately 53% of its total revenue and 70% of its total orders in the fiscal year (FY) ending June 2021.

> In our view, this SPE Company possesses a key quality to look for when investing in Japan, Shokunin Kishitsu, which can be translated literally into the "Craftsman's Spirit" or devotion to the mastery of a skillset (though the true meaning goes far beyond that).

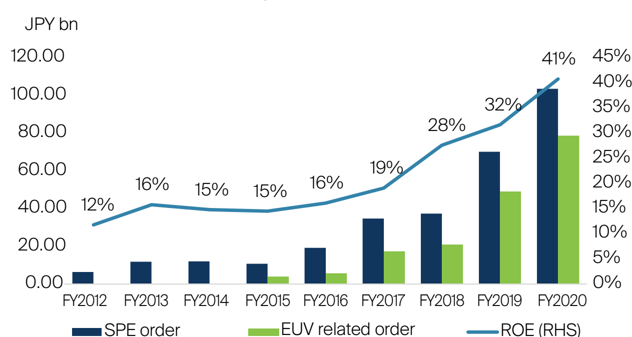
Maximising financial return is never the top of its agenda. Instead, the company has a genuine passion for "creating unique solutions" and fostering long-term partnerships with customers, which is the core of its corporate mission. The company is also highly profitable, though this is simply an outcome of its actions rather than a purpose. It walks a "narrow path" by placing a razor-sharp focus on what it is best at, then, after securing a globally-dominant market position it gradually expands into areas adjacent to its core products. It is commendable too that despite its monopolistic position, it charges a fair price for its products to maintain long-term partnerships with customers. Long before anyone believed in the widespread adoption of EUV technology, and while overseas competitors turned away from EUV due to the "unjustifiable financial return", this SPE company quietly made consistent investments into this area, resulting in its global monopolistic status today.

[3] For illustrative purposes only. Reference to the names of each company mentioned in this communication is merely for explaining the investment strategy and FSSA does not necessarily maintain positions in such companies. Any fund or stock mentioned in this presentation does not constitute any offer or inducement to enter into any investment activity nor is it a recommendation to purchase or sell any security.

[4] nm or nanometre = one billionth of a metre

Sales at the SPE Company have grown at 36% CAGR[5] for the past five years. Growth further accelerated to 65% year-on-year in FY2020 and, despite the company's conservative culture, the management guided for over 40% order growth in FY2021. Additionally, its asset-light business model means that its financials have been more resilient than peers during down-cycles. In FY2020, the company recorded operating profit margins (OPM) of 37% and return on equity (ROE) of 41%[6]. Because of these characteristics, this SPE company has displayed a more stable growth profile than the overall semiconductor industry, which tends to be highly cyclical.

EUV equipment order growth and ROE trend



Source: Company data, as at 30 June 2021

One of the key risks for this company is competition. However, we believe that its solid research and development (R&D) culture (more than 70% of employees are engineers) and its attractive product pricing will prove to be a high barrier to entry.

Disrupting the IT services industry

In Japan's JPY 16trn information technology (IT) market, software testing accounts for around 33% of the total. But the outsourcing ratio for software testing is extremely low — just 1% — as companies in Japan have historically preferred to develop software systems from scratch. As these systems grow and become more complex, it becomes increasingly difficult for third parties to test the system.

> The founder of this IT Services Company tapped into this untouched market by providing testing services more efficiently and cheaper than the original in-house software developers — many of whom lack the motivation or the quality assurance knowledge to carry out the testing themselves.

At the same time, Japanese companies' IT departments often have a shortage of skilled engineers who can keep up with the latest technology and implement new projects. As a result, the entire process is delegated to external systems integrators and IT consultants who control the core system and are locked into subordinate vendors with costly long-term contracts.

This multi-subcontracting structure is starting to change, thanks to the growing area of digital transformation (DX). Corporate management are becoming more hands-on with new technology implementation, and have been looking at ways to improve project governance by separating the vendors responsible for planning, development and quality assurance. Meanwhile, systems integrators started to focus on maximising the value from their existing engineers, which led them to relinquish the testing work given the growing shortages of IT engineers in Japan. According to a 2019 survey by the Ministry of Economy, Trade and Industry (METI), the gap between demand and supply of IT professionals in Japan is expected to swell to over 545,000 by 2030 (accounting for about 45% of the total number of IT engineers in Japan today).

Having built trusted relationships with clients since 2014 through its software testing business, this IT Services Company aspires to revolutionise Japan's IT industry in its attempts to overturn the multi-subcontracting structure explained above. The management has introduced more value-added services, including consulting and software development, and tried to become a tier-one IT Services Company, which has allowed it to raise the unit price of its engineers continuously. As a result, its highly skilled engineers enjoy the fastest wage growth in the industry, of around 10% a year. Its performance-based compensation structure has enabled the company to attract top-tier talent from other firms where salary growth is capped, while the favourable work environment has led to a lower attrition rate of 8% compared to the industry average of 11-15%.

To meet the growing demand for its services, this IT Services Company has been hiring 1,500 engineers a year, with plans to accelerate the pace to 8,000 engineers a year by FY2030.

> We believe this should significantly boost sales — its recently announced mid-to-long-term plan is to reach JPY 300bn in sales in 10 years' time, a 26% CAGR from the current year.

The management also has plans to grow the business with a disciplined approach to acquisitions, as it expands into new service areas and acquires additional talented engineers. The management only consider companies in non-redundant service areas, prime vendors with an extensive client base, firms with an immediate profit contribution above goodwill, and those with a low acquisition price. It has acquired 5-6 companies each year since 2019 and successfully integrated them into the group.

[5] Compound annual growth rate
[6] Past performance is not indicative of future performance.

The senior management are directly involved in the company's critical operations and we believe they are doing the right things to grow the business sustainably. The CEO aims to reform the industry by removing the need for inefficient layers of subcontracting and at the same time improve the work environment for IT engineers in Japan. Meanwhile, the Vice President hails from Keyence — a company renowned for its salespeople — and is regularly on the sales floor to train employees with new techniques. He initially joined as an independent director and was appointed Vice President two years later, as enhancing the company's sales capabilities was deemed a key priority to achieve Shift's long-term vision.

Moreover, the profile of this IT Services Company's independent directors reflects a willingness by the management to listen to different opinions, a distinct advantage we have observed among successful smaller Japanese companies. The five independent directors have served as C-suite executives in diverse industries ranging from finance to IT services, thus providing the company with insights into investor communications, business strategy, and IT industry trends. These high-calibre directors have been driving board meeting reforms and have become increasingly more vocal following the company's transition to an audit and supervisory committee board structure since 2019. With these factors combined, we believe that this IT Services Company has ample long-term growth potential ahead of it.

ESG in Japan

In October 2020, Prime Minister Yoshihide Suga pledged that Japan would undertake to reach net-zero greenhouse gas (GHG) emissions by 2050, leading to a rise in the number of Japanese companies following suit. By the end of April 2021, nearly 40% of all constituents in the Nikkei 225 composite had committed to net-zero goals — a doubling of the number of companies with such pledges from the end of 2020[7].

Meanwhile, recent revisions to Japan's Corporate Governance Code, combined with proposed reforms at the Tokyo Stock Exchange (which will see the market restructured in April 2022 into three new market segments: the Prime Market, the Standard Market and the Growth Market), suggest that the emphasis on environmental, social and governance (ESG) issues is growing.

To be included in the Prime Market, companies must adhere to higher levels of corporate governance compared to the rest of the market, with minimum standards relating to the independence of the board, English-language disclosure, and climate-related disclosure in line with the Taskforce for Climate-related Financial Disclosures (TCFD).

While global companies in Japan already adopt best practice on disclosure, many domestic-focused companies are lagging in the ESG rankings, as third-party data providers have penalised the latter with lower ratings — ostensibly because of poor disclosure.

However, the ratings should not be taken entirely at face value, in our view, due to a number of concerns on the inconsistencies in the scope of coverage, the rating methodology and weighting, and the final ratings for the same company across different data providers.

> Instead of relying on inconsistent ratings, we have taken our bottom-up investment approach and applied it to ESG, conducting a series of dedicated ESG engagement sessions with portfolio companies over the past year.

Through our meetings, we formed views on which companies have a corporate mission aligned to ESG values and others that seemed to be only paying lip service. Encouragingly, most Japanese companies we met acknowledged the importance of ESG and their senior executives actively sought investor advice on establishing a basic ESG framework. Thus, to help companies still at the nascent stage of their ESG journey, we highlighted best practices we had come across at other companies, discussed GRI[8] vs. SASB[9] reporting standards, and offered our views on how to identify key materiality issues for their businesses.

Most importantly, we came to realise that the lack of disclosure and the absence of established ESG classifications in Japan did not necessarily mean that ESG was missing from Japanese companies' values. In fact, our portfolio companies are often the ones tackling structural problems in Japan head on.

One example is a Special Needs Employment Services Provider that helps companies hire disabled workers, as required by law. Its focus on service quality, amid the challenges associated with a high churn rate of disabled employees, has helped this company build a strong reputation in this area and contributed to its sustainable profit growth. Additionally, the company has started a carbon-credit trading and consulting business, which will educate Japanese companies and help them meet the requirements of ESG disclosure.

Most companies we met with seem to have the necessary ESG-related risk management measures in place. For instance, the IT and software companies we talked to over the past year have already obtained data

[7] https://asia.nikkei.com/Business/Business-trends/Almost-40-of-Nikkei-225-companies-pledge-net-zero-emissions

[8] Global Reporting Initiative

[9] Sustainability Accounting Standards Board

protection certifications and adhere to strict security and compliance protocols.

With each engagement activity, we improved our understanding of our portfolio companies' core fundamentals, reinforcing the belief that ESG research is an integral part of the overall investment process. For instance, we gained insights into rising engineer unit prices at an IT Services Company and its systematic "Top Gun" training program while talking about its firm-wide employee engagement initiatives. On another company's product recall issue, we were reassured on its quality control capabilities after the company appointed a new global head of quality assurance, noting that it had taken concrete measures to address the problem.

Portfolio metrics and conclusion

As noted, we have been adding to our highest conviction holdings amid the market weakness, which we believe should continue to improve the quality of the portfolio. At the end of August 2021, the portfolio's weighted average return on capital employed (ROCE) and return on equity (ROE) was 47% and 19% respectively. This compares to ROCE of 7% and ROE of 9% for the MSCI Japan at the end of August 2021.

The concentration of companies in the portfolio with firm pricing power and asset-light business models means that the strategy's profitability metrics are much higher than the corresponding benchmark – average gross profit margin (GPM) and operating margin of our portfolio companies have been consistently above 45% and 19%, respectively, compared to 29% and 9% for the MSCI Japan. These quality ratios have been maintained since inception of the strategy.

While the average price-to-earnings ratio (PER) of the portfolio is not cheap, it is mainly the result of our focus on high-quality growth stocks. Many of these companies have been re-rated during the pandemic, thanks to their sustained earnings growth and robust franchises. Moreover, a number of companies in the portfolio are positioned in highly under-penetrated industries and have been investing heavily to raise awareness of their services and solidify their leading market position. Our exposure to these types of companies has artificially lifted the near-term PER of the overall portfolio as their profitability will only normalise after 3-5 years.

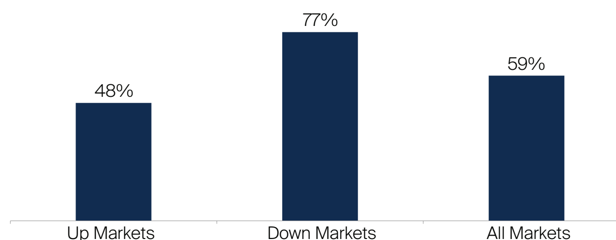
Meanwhile, the pandemic has negatively affected the short-term earnings of portfolio companies that rely on inbound tourists (for example, cosmetics companies). However, we believe these companies have outstanding franchises and the long-term sustainability of their businesses remains strong. We believe they should be quick to rebound once travel resumes. Moreover, Covid has served as an accelerator for them to push forward their transformation plans. For example, one cosmetics company recently announced the disposal of three non-performing brands in the US. Combined with other restructuring measures already taken would eliminate more than JPY 20bn of losses, based on 2019 financials.

Lastly, we would like to cite a parable from the late Philip Fisher, an infamous long-term stock investor, in relation to the objective of our strategy – which is to preserve and grow our clients' capital in the long run. Because of our unique investment approach and the nature of the companies that we invest in, there has been, and will be in the future, sharp short-term volatility in the strategy's relative performance from time to time. Historically, our performance has lagged mostly in a typical up-market, while demonstrating the ability to preserve capital in down-markets. As the chart below shows, since inception the FSSA Japan Equity strategy has outperformed 77% of the time in down-markets, 48% in up-markets and 59% of the time when calculated across all market conditions. Paraphrasing the words of Mr Fisher:

> "One might build a splendid restaurant business with a high-priced menu; or by selling the best possible meals at the lowest price; or by making a success of Hungarian, Chinese or Italian cuisine. Each would attract a following. However, with all his skill, he could not possibly build up a clientele if one day he served the costliest meals, the next day low-priced ones, and then without warning served nothing but exotic dishes."

By this standard, just as a restaurant self-selects a certain kind of clientele, we hope that over time the FSSA Japan Equity strategy will attract similar-minded and long-term oriented investors.

Outperformance of the FSSA Japan Equity strategy under different market conditions



These figures refer to the past. Past performance is not a reliable indicator of future results. For investors based in countries with currencies other than USD, the return may increase or decrease as a result of currency fluctuations. All performance data for the FSSA Japan Equity Fund Class III (Accumulation) USD. Source for Fund – Lipper IM / First Sentier Investors (UK) Limited. Performance data is calculated on a gross of fees basis and includes income reinvested net of withholding tax. Months of outperformance vs benchmark (Since inception to 01 July 2016: MSCI Japan Index gross. From 01 July 2016 to date: MSCI Japan Index net). Source for benchmark – MSCI. Since inception performance figures have been calculated from 02 February 2015 – 31 August 2021.

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

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