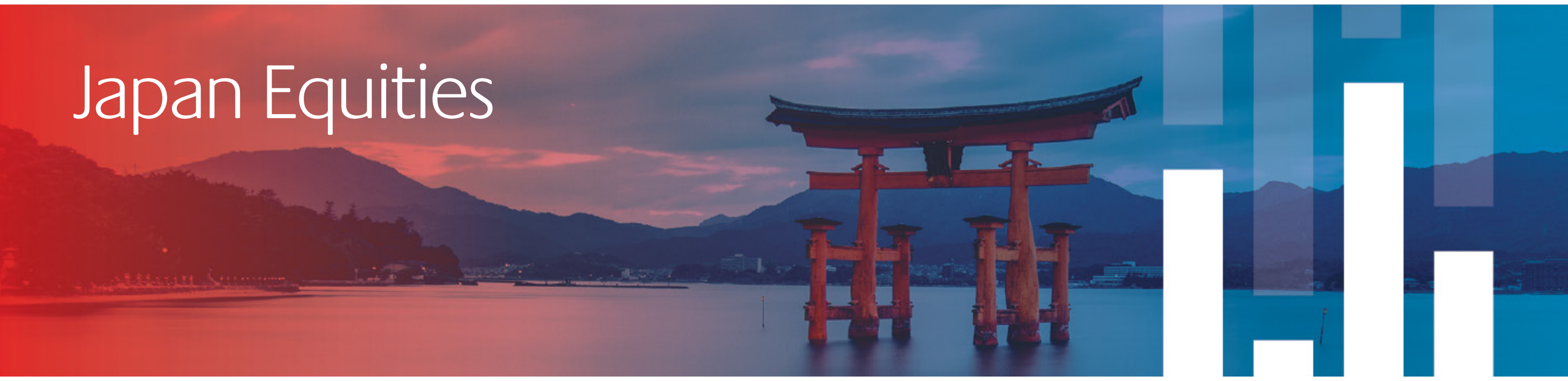
Client Update
May 2020

Japan Equities



The Japan equity market underwent significant volatility in the first quarter due to the coronavirus pandemic and concerns about its impact on the global economy. The sell-off was indiscriminate and across all sectors, with little differentiation between the higher quality, well-managed companies that we own and their less attractive peers.

Although it was frustrating to see the widespread market carnage and the impact on our short-term performance, the panic-selling created an opportunity for us to add to our conviction stocks at attractive valuations. Since then, some of our holdings have subsequently rebounded (although it is too early to call an end to the coronavirus market panic).

After every crisis in Japan's history – including the Global Financial Crisis (GFC) in 2008 and the Tōhoku earthquake and tsunami in 2011 – the behaviours of consumers and corporations fundamentally changed. In light of the current global health crisis, we tried to envision any positive developments that might arise from the situation and sought to identify companies that could benefit.

For example, the percentage of workers equipped with remote-working capabilities in Japan is currently below 20%[1]. We believe this will inevitably rise, leading to higher expenditure on technology-related goods and services. As we adapt to the new norms of social distancing measures and travel restrictions, the use of e-commerce, digital payments, telemedicine, cloud services, virtual and online entertainment, and online education platforms have accelerated – and are likely here to stay.

In the midst of such uncertainty, we believe our Japan portfolio is well-positioned. Our investment approach is inherently conservative and more than 80% of our portfolio companies have a secure net cash position. In a world awash in high levels of debt, we believe these companies should offer a reasonable amount of downside protection.

A large portion of the portfolio is invested in purely domestic companies with higher visibility with regards to demand. This includes drugstores and discount food retailers offering daily necessities, software and technology solutions providers operating a recurring revenue model, and online platforms in e-commerce and digital payments. We believe they should remain resilient in the event of a global recession.

Among our portfolio holdings with high overseas exposure, we have invested in leading Asian consumer franchises, global medical equipment manufacturers, factory automation companies, and other technology leaders. They are all high-quality companies with dominant market share in their respective niche industries and reinforced by solid balance sheets.

Despite shorter-term disruptions, we remain confident that our portfolio companies can bounce back from adversity and become even stronger after the crisis.

Adding to high conviction companies

Earlier this year and in anticipation of a sharp slowdown, we evaluated our portfolio holdings, looking for companies that we believe should remain relatively defensive. We took advantage of the market volatility to consolidate the portfolio into higher conviction ideas and purchase companies on our watch list that had become more reasonably valued.

Among the companies we added to were Welcia, Japan's largest drugstore operator, and MonotaRO, Japan's largest maintenance, repair and operations (MRO) e-commerce platform. Both companies proved to be highly defensive and benefited from increased demand for hygiene and healthcare products amid coronavirus concerns. Notwithstanding the temporary sales boost, we believe the long-term investment case for both companies – as the leading players in their respective industries – remains intact.

Welcia's business model is bearing fruit and its performance is starting to diverge from competitors. Welcia offers one-stop solutions for consumers, with a particular focus on dispensary/pharmacy services (a sizeable market worth JPY7.5 trillion[2]). While its drugstore peers dismissed the idea of dispensing prescriptions due to high initial costs, Welcia made upfront investments and has become one of the largest dispensaries in the country.

Although Welcia's market share of the prescription drug market by revenue is still 2%, it has only recently started to benefit from the change in consumer behaviour and the increased use of dispensaries near their homes. This trend is in accordance with government policies to promote the use of community-based healthcare (as opposed to hospitals and clinics); therefore, we believe there is still room to grow. Around 7% of the JPY6.5 trillion[3] drugstore market is prescription sales, of which

[1] Source: Ministry of Internal Affairs and Communications (MIC): *2018 Communications Usage Trend Survey (Company Edition)*
[2] Source: Ministry of Health, Labour and Welfare: *2018 Trends in Dispensing Medical Expenses*
[3] Source: Ministry of Economy, Trade and Industry: *Preliminary Report on the Current Survey of Commerce, March 2020*

Welcia already takes a 31% share. We believe Welcia should continue to gain share in a consolidating market, due to its strong brand and established infrastructure.

At MonotaRO, we believe there is still a long runway of growth ahead, as it continues to gain market share in the fragmented MRO industry. Compared to 30% e-commerce penetration in the overall business-to-business (B2B) market, e-commerce penetration in the MRO segment is only 10%[4]. We believe the pandemic will likely accelerate the shift towards online purchases, particularly when factoring in economies of scale and the benefit of lower procurement costs. Amazon has proven to be less of a competitive threat than previously anticipated, as MonotaRO holds a stronger presence in the B2B sector.

We also topped up our position in OBIC, Japan's largest enterprise resource planning (ERP) systems provider, which we wrote about in detail in a previous note. OBIC has been resilient in the current market environment and has performed steadily in previous downturns. Operating profit has grown consistently for the last 22 years, including the GFC and the Tōhoku earthquake periods.

Recurring revenue businesses have continued to grow, with cloud services and on-premises support accounting for 39% of sales and 48% of operating profit. With more people working from home, we expect cloud-based services to become an increasingly larger business.

Similarly, we took advantage of market weakness to add to Benefit One, which provides membership benefits (such as travel management and healthcare) to corporate clients. The majority of Benefit One's revenue is recurring and has grown by around 11% a year for the last five years.

Despite the short-term sell-off, we believe the longer-term investment case for Benefit One remains solid and the company could become much bigger in five years' time. While Japanese companies and government entities have traditionally provided welfare services for their employees in-house, Benefit One has become a major outsourced supplier of value-add services to the employee, while also saving costs for the employer. In addition to fringe benefits, the CEO has communicated his vision for newer platform businesses, such as payment settlements and healthcare.

We also added to GMO Payment Gateway, the largest online payment processing company in Japan. GMO Payment's driven and capable management team is headed by President Mr Ainoura and Vice President Mr Muramatsu, former CEOs of Card Call Service and Payment One – the two companies that merged 14 years ago to form GMO Payment. As a growth-oriented company focused on sustainable growth over the medium to long term, the management are committed to delivering 25% compounded annual profit growth over the next five years.

One of the key risks for GMO Payment is if its biggest clients start to process payments in-house after reaching a certain scale. This was the main reason behind GMO Payment's revenue slowdown in 2019, as companies like Rakuten and Mercari shifted some of the services previously provided by GMO to an internal division.

However, we believe there is still plenty of room for GMO Payment to grow, as e-commerce penetration in Japan is only 7%[5] of retail sales. With more offline retailers and consumer brand companies launching e-commerce portals, we believe GMO Payment is well-positioned to capture the market, due to its extensive experience and track record in the payments industry.

The emergence of cashless payment transactions could be another growth driver for GMO Payment. Japan's cashless payment penetration is relatively low at 18%[5] compared to countries such as South Korea (95%), the UK (67%) and the US (44%). Recent policies, such as merchant subsidies and consumer rewards programs (which have been primary catalysts in other nations), are expected to accelerate the pace of transition. This could open doors to larger addressable markets, such as the offline cashless payment (JPY300 trillion) and the public tax/utilities market (JPY100 trillion).

New positions

As bottom-up investors, we do not rely on benchmark indices or sectors to construct portfolios. Investment ideas are generated by meetings with company management, followed by detailed fundamental research and analysis on companies we might want to invest in. The recent market volatility allowed us to buy high quality stocks on our watch list that we had followed for some time, but were too expensively valued in the past.

Among the new positions was Hoya, a leading manufacturer of lenses and related optical products. Having observed its performance over time, we increasingly appreciated its corporate philosophy of being a "*big fish in a small pond*" and its strong focus on corporate governance and shareholder returns. Unusual in a Japan context, Hoya has a strong profit-centric culture and its track record has been consistently good.

Over the past 10 years, total shareholder return was 78% of free cash flow after acquisitions (Hoya's policy is to return all excess free cash flow to shareholders after budgeting for capital expenditures and acquisitions), or 73% as a proportion of net income. On top of that, Hoya has JPY290 billion net cash on its balance sheet (or 9% of market cap). The board believes this is too high, which means we should probably expect to see share buybacks in future.

[4] Source: Ministry of Economy, Trade and Industry: *2018 Infrastructure Development for a Data-Driven Society in Japan (Market Research on Electronic Commerce)*
[5] Source: GMO Payment Gateway, February 2020

Hoya's business can be categorised into two major divisions: Life Care and Information Technology (IT). In the IT segment, which focuses on glass-related products used in the technology manufacturing process, Hoya has developed a near monopoly in certain materials, such as Extreme Ultraviolet (EUV) mask blanks used in the production of semiconductors, and glass substrates used in Hard Disk Drives (HDD).

Hoya generates 40-50% operating profit margin (OPM) on these products, as there is virtually no competition. As semiconductor leaders Taiwan Semiconductor (TSMC) and Samsung start to migrate their chip production to more advanced and smaller nodes, we believe that average selling prices (ASPs) for Hoya's EUV products should rise. Hoya expects to double the capacity of both products over the next few years.

We also purchased Olympus, the largest medical equipment company in Japan with 70% global market share in gastrointestinal endoscopes[6]. Despite its strong franchise, we have been concerned in the past with its complacent culture and low profitability. However, we believe there are positive changes underway: Olympus has replaced the majority of its senior leadership team with externally-hired managers, which should bring fresh new perspectives, as well as the ability to make drastic changes where it is needed.

The executive management team now consists of five key people in CxO[7] leadership positions, thus streamlining the decision-making process. In addition, the core Medical business has been restructured and simplified from five divisions into two, with Endoscopic Solutions managed from Japan and Therapeutic Solutions to be managed from the US.

After the reorganisation, Olympus' strategy has refocused on strengthening its leadership in gastrointestinal endoscopes. It is investing in China, where the overall penetration of gastrointestinal endoscopy is low, by increasing its training programs to resolve the bottleneck of insufficiently qualified doctors (China has only 22 endoscopists per million people, compared to 250 per million in Japan[8]). Chinese government policies to promote endoscopic diagnosis support its penetration into mid-tier hospitals, which should increase demand for Olympus' products exponentially.

In addition, Olympus has committed to controlling costs in order to improve margins and profitability. The majority of Olympus' consolidated profit comes from its Endoscopic Solutions segment, which generates around 29% OPM. However, Olympus' consolidated OPM is only 9% - much lower than global peers (Medtronic, Stryker and Johnson & Johnson all generate OPM above 20%).

Olympus aims to improve its OPM to 20% by fiscal year (FY) 2023. We continue to monitor the progress, as we believe that there could be considerable upside if Olympus can execute its transformation plan. While it is early days and there is still much to be done, we believe the direction of travel is encouraging. The position is a relatively modest one, though we have been adding on weakness.

What we sold and lessons learned

We sold Relo Group and BeNEXT to make room in the portfolio for the companies mentioned above. Both companies had been pursuing lower quality growth, in our view, with overseas acquisitions diluting earnings and distracting management from the main local business.

Relo Group is a leading corporate services company, providing leased housing, global relocation services and fringe benefits. We initially bought Relo for its recurring revenue model, which offers stable earnings growth and downside protection during economic downturns, as demonstrated during the GFC.

However, we started to question the investment case amid signs that the company had bigger ambitions for its global relocation services. In particular, Relo's large overseas acquisition in 2019 of a global relocation business caught our eye. The purchase price was expensive at 139x price-to-earnings ratio (PER) and it led to a spike in Relo's financial leverage. Like many Japanese companies who remain passive investors of their overseas purchases, Relo's culture did not seem globally-savvy enough to transform the acquired business.

As such, we had been reducing our position in Relo since last year, in favour of Benefit One. As the coronavirus started to spread, our portfolio review led us to completely sell out of Relo as we considered the impact of a recession on its global relocation business – and, given that better-quality companies could be purchased at bargain prices amid the market sell-off.

Similarly, BeNEXT's overseas acquisitions have been a major concern on profitability. We initially believed that BeNEXT, which primarily dispatches engineers in Japan (88% of operating profit), should benefit from increasing labour shortages in this particular sector.

In hindsight, we should have exited this position when we noticed BeNEXT's longer-term ambitions on making overseas acquisitions. Instead, we held on to it because of its cheap relative valuation, even though we increasingly had concerns about the quality of its business. Similar to Relo, Covid-19 aggravated the risks of BeNEXT's overseas exposure (Nissan Motor in the UK) and its

[6] Source: Olympus, November 2019
[7] C-level corporate executives
[8] Source: Olympus, November 2019

manufacturing staff dispatching business, both of which are macro-sensitive.

Among engineering dispatch companies, we have greater conviction in TechnoPro, with its longer-term mindset (the company trains its engineers in more advanced skills) and its higher exposure to IT engineers (50% in headcount terms, compared to BeNEXT's 20% mix), where demand has been resilient and growing rapidly.

Both Relo Group and BeNEXT seemed to be cheaper than peers, which initially gave us comfort as lower valuations provide a greater 'margin of safety'. However, as we subsequently realised, optically-cheap companies do not necessarily protect capital.

Most investors look at companies in a much too simplistic way: growth vs value. However, in reality, all investors should be looking for value; that is, to buy companies where the market value is below intrinsic value. But, a lower price-to-earnings ratio (PER) or price-to-book (P/B) valuation, based on 12-month earnings or book value, does not mean that a company is cheap, nor that there is more value to realise compared to companies at a higher PER or P/B. The issue with these ratios is that they cannot capture a company's long-term profit/cash flow growth, nor its resilience during economic recessions.

We look at valuations from a more holistic perspective and believe that quality companies can justifiably command a premium – particularly those that have these three qualities concurrently: 1) high return on invested capital; 2) strong and sustainable growth; and 3) high earnings visibility, supported by a strong franchise and management team.

Our portfolio holdings generate 37% weighted average ROIC, indicating that these companies have higher profits that can either be reinvested for long-term growth or be returned to shareholders. We also believe companies with a high-calibre franchise or management team warrant a lower discount rate (cost of capital) because earnings visibility is higher. As such, the best-performing companies in the current down-market have typically had higher valuations relative to the market – which is what we have experienced in our Japan portfolio.

Interestingly, for some of our high-conviction holdings, it is difficult to pinpoint a single numerical value based on today's business. These companies evolve over time, as the management invent new business lines to grow earnings. For example, M3 started by offering pharmaceutical marketing services (information on drugs that is emailed to doctors). However, 20 years later, its services include contract research, job placement and medical records software. The pharmaceutical marketing segment now accounts for only 16% of M3's consolidated sales.

As part of our investment approach, we are disciplined in conducting regular fair market valuation reviews; however, our conviction in a company's franchise, management and sustainability of growth plays an equally important role in our holistic investment decision-making process.

Performance review

The top contributors to performance year-to-date are the same companies that we had added to during the sell-off – MonotaRO, GMO, Welcia, OBIC and M3. Though they were sold off along with the market, they subsequently rebounded, as investors realised there should be little negative fallout from the coronavirus. Out of the companies that performed poorly – BeNEXT, Fast Retailing, Recruit Holdings, SMS and Workman – we sold BeNEXT, as mentioned earlier, but we remain long-term owners of the rest and have been adding on weakness.

Workman and Fast Retailing (UNIQLO) specialise in selling quality, affordable clothing. They were highly defensive during previous economic recessions as their stores attracted price-conscious customers. However, Covid-19 has particularly affected discretionary retailers due to a weaker consumer appetite and widespread store closures. Even so, while these short-term disruptions undoubtedly affect earnings, they are temporary in nature and, in our view, do not affect the long-term investment case.

We believe the Workman Plus brand should continue to strengthen, as affordable, functional apparel continues to grow in popularity among deflationary-minded Japanese consumers. Fast Retailing, led by a passionate and visionary founder, has a strong franchise supported by solid brand equity and a decent growth outlook both domestically and overseas. Both companies generate the highest ROIC among industry peers – Workman's ROIC is 34%, while Fast Retailing yields 38% ROIC, indicating a strong foundation for sustainable growth.

Despite being recruitment-related businesses, Recruit Holdings and SMS proved to be resilient in previous economic downturns relative to competitors. SMS only hires nurses and careworkers – roles that enjoy strong demand irrespective of the economic cycle, due to Japan's ageing population and labour shortages in the care sector.

Recruit Holdings is not only a recruitment company, it also runs various online media portals – the equivalent of Yelp (online local business reviews) and Expedia (online travel agency) in Japan. The marketing media business accounts for 38% of earnings before interest, tax, depreciation and amortisation (EBITDA), online job advertising and recruitment accounts for another 38%, and the general staffing business is around 24%.

Due to Covid-19, most job interviews have been delayed or cancelled – companies do not want to host face-to-face meetings and they have been reluctant to shift the process completely online. In addition, restaurants and the travel industry were hard hit, which affected Recruit's business as well.

However, SMS and Recruit are both leading franchises operated by capable management. We believe SMS will likely remain a key beneficiary of structural labour shortages in the niche care sector; and Recruit's asset-light model, entrepreneurial culture and track record of achieving a leading market share in its domain bodes well for future growth. As consolidation in each industry accelerates due to Covid-19, we believe stronger companies such as SMS and Recruit should increase their leadership over peers.

Last words

In the throes of a downturn, pessimism is abound, which is understandable and expected. But the Chinese word for "crisis" (危機), which consists of two letters with opposite meanings – danger and opportunity – suggests that we should look at the status quo from another perspective. Likewise, great investors in history exploited market volatility in a downturn, which ultimately generated superior returns.

We have two observations on the companies that have been resilient (so far) during Covid-19. The first type are those that have already built a dominant franchise and are best positioned in a Darwinian world, where survival of the fittest is the name of the game. The other type are those leading the disruption in their respective industries, either by innovating or helping others adopt better business processes. Regardless of the type, capable management, whether charismatic or visionary, is indispensable to creating successful companies.

It is the darkest nights that produce the brightest stars; and our findings remind us that our investment philosophy of focusing on high-quality companies with strong franchises, financials and management is for the benefit of long-term returns and in the best interest of our clients, especially during times of turmoil. As we stay true to our colours, we will continue to invest in companies that we believe can spot and grasp opportunities in the midst of a crisis.