Searching for sustainable returns in Japan

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The First State Japan Equity Strategy invests in a concentrated portfolio of high-quality companies with strong management teams, dominant franchises and conservative financials. As long-term, conservative investors, we seek to invest in companies that have high return on invested capital, strong and sustainable growth, and high earnings visibility.

A large portion of the portfolio is invested in domestically-focused companies that have high visibility with regards to demand. This includes drugstores and discount 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.

The remainder of the portfolio is invested in leading Asian consumer franchises, global medical equipment manufacturers, factory automation companies, and other technology leaders. Though they have high exposure to overseas markets, they are all high-quality companies with a dominant market share in niche industries and are supported by solid balance sheets.

Despite the perception that there is no growth in Japan, our core portfolio holdings have been able to adapt and grow despite economic headwinds, and have delivered sustainable earnings growth and attractive shareholder returns. In this update, we aim to address some of the most common investor concerns about Japan equities and highlight the opportunities for sustainable growth in this market.

Economic growth is not a requirement for corporate growth

Theoretically, a fast-growing economy bodes well for corporate earnings and stock prices, and vice versa. Because of this, investors often cite Japan's weak economy and deflationary environment as reasons they have been reluctant to invest in Japan. However, the data suggests that these concerns may be unfounded. Although Japan's nominal GDP has grown by just 4% since the late '90s peak, Japan Inc's corporate profits have grown by 180% over the same period.

With our bottom-up and research-driven investment approach, we have found that Japan contains many "hidden gems" – companies that are able to grow strongly, despite the macro backdrop. How is this possible? Our research indicates that high-quality franchises that are dominant in niche sectors can sustain strong and consistent earnings growth without relying on leverage or macro conditions. Often, these companies incorporate some combination of the following characteristics: innovation, disruption, overseas expansion and a strong focus on return on invested capital.

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Even in declining sectors, there are singular companies that have beaten the odds and delivered steady returns for investors. One such example is specialty furniture retailer Nitori, the largest furniture brand in Japan. Weak domestic consumption and deflationary price expectations might reasonably challenge any domestically-focused retailer. However, Nitori has continually innovated – from product design to new store formats – to secure new areas of growth.

Nitori's vertically-integrated business model means that it manages the entire supply chain, with product sourcing from Southeast Asia, domestic distribution centres that cover every corner of Japan, and direct management of its bricks-and-mortar stores and its e-commerce business. This enables the company to offer high-quality furnishings that are much cheaper than peers and generates higher gross profit margins.

Nitori's track record speaks for itself and by any standard measure, the company would be considered a remarkable success story. Book value and dividends per share have grown by more than 20x over the past two decades, while sales and profits have grown for 32 consecutive years – despite no growth in the furniture and home furnishings market in Japan. Long-term shareholders have been rewarded handsomely.

Fast Retailing is another example of a Japanese company that has delivered excellent compounded growth for investors. Despite Japan's weak economy, Fast Retailing has delivered more than 20% compound annual profit growth over the past 20 years. The company behind UNIQLO, the casual-wear brand offering functional apparel and basic wardrobe staples, has turned deflation – a significant headwind for the retail industry – into a tailwind.

Fast Retailing provides high quality and functional yet low-cost unisex clothes, catering to all genders and age groups. Though its designs are simple and timeless, UNIQLO brings continual innovation to its product offering, making incremental improvements over time.

The company's ethos is based on the guiding principles of its founder and president, Mr Tadashi Yanai, who believes that *"God is in the details"*. This reflects the Japanese conviction that skillful execution – with a sharp focus on perfecting the small things – should eventually accumulate into a leading competitive advantage over time.

As Akio Nitori, founder and chairman of Nitori, reportedly said, *"Economic growth is never a part of our growth assumptions."* This supports our view that *there are no sunset companies, only sunset industries.* We believe that successful investing in Japan is about seeking out these "hidden gems" in a large and deep universe, rather than simply buying the index. As a highly under-researched market, we believe that Japan offers the perfect opportunity for bottom-up active investors to generate alpha.

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Niche industries can provide a favourable competitive landscape for sector leaders

While the potential for outsized profits and strong sales growth usually attracts new entrants to an industry, our observations from spending time in Japan and talking to company management teams suggest that the younger generation prefer to work at steady jobs in large corporations rather than take the risk of launching new businesses. Due to the low growth economy, Japanese society has perhaps become even more conservative and focused on stability than ever before.

Additionally, the size of Japan's venture capital industry is tiny (less than 1% of China's) and there is little support for fledgling young businesses. As a result, new companies must build a profitable business model almost immediately to generate cash flow and sustain growth levels. There is no "free money", which reduces the incentive to burn cash in order to capture a share of the market.

Negligible entrepreneurship, particularly in sectors where the market size is small (and thus potential rewards are lower), along with an underdeveloped private capital market, means that in niche sectors with just one or two dominant companies, the leading franchises tend to maintain their market position as there are no significant rivals to compete with. This can lead to sustainably high returns for investors in those companies.

In our Japan portfolios, we own a few companies, such as Benefit One and S-Pool, that benefit from this kind of competitive landscape – we refer to them as *the only fisherman in a vast blue ocean*. Benefit One is Japan's largest provider of corporate welfare services, a highly scalable, recurring revenue business. The company has few competitors and generates an extraordinary 70% return on invested capital.

While fringe benefits are typically only provided to permanent workers in large corporations, we expect small-to-medium sized companies (which employ 70% of Japanese workers) to increasingly start offering them as well – thus expanding the potential market size. Benefit One aims to become a "one-stop shop" solutions provider to increase its value to clients, bundling together business travel management and healthcare programs with its core fringe benefit services.

Benefit One's operating profit has grown 10x over the past 15 years. We believe this could accelerate further, as the company enhances its information technology (IT) systems, digitalises its services, scales the business and improves margins and profitability. As an asset-light business, Benefit One does not need much capital to grow, while its already-large size and the "network effect" acts as a natural barrier to other entrants.

Another company that fits into this category is S-Pool, which provides special needs employment services. S-Pool stands for *Solutions, Systems, Staff, Society and Sharing,* which represents the company's core beliefs and corporate philosophy. The company leases and manages farmland where its client's disabled employees can cultivate vegetable crops. Alongside the philanthropic nature of the business, S-Pool generates a healthy 39% return on invested capital, thanks to high barriers to entry and a niche market with few competitors.

In Japan, the law stipulates that 2.2% of most companies' overall headcount must be filled with persons with disabilities. However, there are several challenges to meeting this quota. While people with physical rather than mental disabilities are easier to place into jobs, around 35% are already employed – which means a relatively smaller pool of candidates. On the other hand, only 6% of people with learning or mental disabilities are employed, but there are relatively few roles that are suitable – and as much as 50% of those that find work end up leaving within the first year.

As such, out of 90,000 domestic companies that are subject to the Act of Employment Promotions of Persons with Disabilities, around 50% are non-compliant. S-Pool's long track record in the special needs employment sector places it at the forefront in this niche area. Its unique farming model is built upon years of accumulated experience, resulting in increased employee motivation and an extremely high 93% retention rate. Around 30% of corporate clients are recurring, which attests to the high level of client satisfaction too.

Similar to Benefit One in the fringe benefits sector, S-Pool faces no major competitive threat for its special needs employment services. Demand is defensive and both local governments and blue-chip companies have benefitted from S-Pool's expertise. S-Pool's model proves that companies that provide social benefits for the betterment of society do not necessarily need subsidies – and could even be attractive to investors if executed well.

Unique business models – "Only in Japan"

Tourists who have visited Japan would most likely agree that it is a country like no other. Those who have yet to be introduced to this unique country may find aspects of its inimitable culture and customs unfamiliar, perhaps even inscrutable. From an investment perspective, this same unfamiliarity with the Japan market – with dissimilar investment opportunities compared to other equity markets – could present investors with considerable challenges.

We believe that a deep knowledge of the local market and an understanding of the cultural and societal aspects of Japan are critical in the research and analysis of Japanese companies – especially if there are no direct Western parallels to draw a comparison. As a team, we spend most of our time visiting companies and carrying out research trips to the countries where we have made investments (though we have temporarily moved to "virtual meetings" due to Covid-19). We have found that the Japan market contains businesses that are uniquely Japanese.

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For example, M3 is a global leader in online medical-related services. The company launched its pharmaceutical marketing services (information on drugs emailed to doctors) around 20 years ago and has since expanded its business areas to include contract research, job placements and medical records software. There is no Western company equivalent that provides similar services to M3.

One of the main reasons for M3's success is its huge following among doctors (around four million subscribers globally), which puts the company in a position to transform the sales process of pharmaceutical and medical products.

While Japanese drug companies spend the majority of their annual marketing budgets on sales representatives and related commissions, just 2% is allocated to online marketing. On the other hand, doctors spend twice as much time collecting materials on the internet (using informational sources like M3) compared to the time they spend talking to pharma reps. We believe this represents a huge market potential for M3.

Doctors benefit from having reliable and trusted information at their fingertips, which saves time that could be better utilised elsewhere (for example, by seeing more patients). Drug companies benefit by using "pay-for-performance" services to promote products directly to doctors on M3's medical platform, which reduces the costs of hiring traditional medical representatives.

M3 has no direct equivalent that investors could compare to, which makes it a challenge to understand the market and long-term growth opportunity. Only after meeting with management multiple times (and with different team members, to gain fresh perspectives) did we start to grasp the enormity of its potential, which eventually resulted in a purchase of the company's shares.

Katitas, which buys old homes or auctioned-off houses, remodels them and then sells them on to new or first-time buyers at a reasonable price (usually at a 50% discount to new properties), is also unique to Japan. In the past, houses in Japan were not built to last for more than 30 years – they were constructed quickly and cheaply to serve a growing population after the Second World War. As a result, many have fallen in value over time, while those left vacant are often neglected or abandoned by their owners.

There are currently more than 8.4 million vacant properties *("akiya")* around Japan – one out of every seven properties – and this has been rising steadily over the past five decades. Katitas, which means "adding value" in Japanese, has created an entirely new market from this previously untouched segment, with a clear value proposition that not only provides quality and affordable homes, but also contributes to the revitalisation and redevelopment of local regions in Japan.

Established for more than 20 years, Katitas has accumulated years of experience in buying the right properties at a low price and renovating at a reasonable cost. As such, we believe Katitas is well positioned in a niche market – and there are no sizeable competitors in this space. Though the company is still relatively small with a market cap of just USD1.9 billion, we would expect it to grow considerably larger in the years to come.

More than a box ticking approach is needed in Japan

At FSSA, we seek to invest in quality companies, as defined by the strength of their management, financials and franchise. Our investment approach remains the same, irrespective of which market we look at. However, Japanese management philosophy is quite different to the Western style of management; and some of the key "quality" aspects that investors typically focus on may not apply.

For example, global investors often look for management to be financially aligned with minority shareholders. This usually helps to ensure that the executives managing a company act in the best interests of shareholders, by optimising capital allocation and making strategic decisions to maximise long-term shareholder returns.

However, some of the best Japanese companies do not prioritise shareholders' returns – their first priority is to take care of their stakeholders, after which financial performance is assumed to follow. There are many examples of good managers and leaders in Japan that are motivated by a deeper purpose rather than purely financial incentives.

Pan Ning, the CEO of Fast Retailing's China business is a typical example of this viewpoint. Mr Pan is credited for building the China business from scratch; but he receives no stock-based compensation and owns few shares in the company, even though the Greater China region is the company's biggest growth driver outside of Japan.

UNIQLO is consistently ranked the No. 1 apparel brand in China and the business is highly profitable, despite its strategy of looking after its stakeholders first. Instead of maximising profits, the management try to take a balanced approach, sharing profits with both consumers (through low product prices) and suppliers.

We spent time with the management of Fast Retailing/UNIQLO to understand how they could produce quality apparel at such competitive prices, without introducing operational risk or infringing on human rights. The company responded that UNIQLO has around 500 Chinese factory suppliers, but only around 200-300 unique items, which has helped to enhance manufacturing efficiencies and reduce unnecessary costs.

Each supplier is put through a strict evaluation process, but once they have been approved, they are treated like family members instead of being squeezed on margins. While UNIQLO had previously used a third-party agency to rate the quality of suppliers, the company has since moved to an in-house team of textile professionals, who visit suppliers on a weekly basis to monitor compliance and quality standards.

Keyence Corp is another example of a company that may seem unattractive at first glance. Due to its conservative approach, Keyence holds around 85% of its balance sheet in cash and government bonds, yet its dividend distribution payout ratio is a paltry 18.4%. Investors point to this inefficient capital allocation and cash hoarding policy as signs that the company has little regard for shareholder returns.

Keyence is at the forefront of the automation industry with its sensors, laser markers and machine vision systems. Despite the "low" rating, Keyence has delivered excellent capital growth for investors. The company generates stable free cash flow and high returns on invested capital; and both sales and net profit per employee are among the highest in the industry.

There are a few key reasons for its superior profitability metrics and long-term steady returns. Firstly, Keyence's production is fabless (meaning it does not own factory plants) and its resources are concentrated in research and development (R&D), and sales and marketing. Due to its low fixed cost structure, Keyence generates high return on invested capital and earnings are typically resilient during a downturn. This also enhances its long-term competitiveness.

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. Its extremely capable and technical sales consultants often design products to meet a client's requirements before the client even knows what they need! This strong ability to innovate on product design translates into high (more than 80%) gross profit margins for the company.

While Keyence's total shareholder returns has been constrained by its capital management, it has still delivered an attractive 13% compound annual growth rate over the past 30 years, the equivalent of its book value per share with dividends reinvested. Additionally, there are encouraging signs that minority shareholders' concerns are being heard, with the dividend payout – while still relatively low – increasing from 5.8% in FY2018 to 18.4% in FY2020.

An ageing population is no barrier to growth

It is no secret that Japan has one of the oldest populations in the world, as defined by the proportion of people aged 65 and over. In 2019, the United Nations published a report that predicted that Japan's over-65 year olds would rise to 38% of the total population by 2050, up from 28% today[1]. This will have wide-ranging implications on the labour force and productivity, healthcare resources and costs, as well as savings and investments.

Japan's demographic "time bomb" has been well signalled for some time, which has allowed the government and the private sector to plan for a future with fewer workers and more retirees. Moreover, this is happening not only in Japan; the challenges associated with an ageing population are being confronted all over the world and Japan's experience may well prove useful to other countries in the future.

Although an ageing population could be considered detrimental to economic growth and productivity (all things being equal), sectors that tackle the issues head on can be a good hunting ground for sustainable investment returns. Automation and technology firms have been obvious beneficiaries, as companies seek to automate processes and replace labour-intensive functions with machines.

In fact, Japan is among the leading countries for automation – Japanese companies make more than 50% of all industrial robots and computer-controlled systems globally. Companies like Keyence and SMC Corp have been at the forefront of the industry, with high levels of profitability, superior returns on invested capital and healthy balance sheets. Over the past 10 years, Keyence and SMC Corp have delivered total returns of 23% and 15% compounded annual growth respectively.

Nihon M&A Center, a specialist corporate finance intermediary that facilitates the sale of small to medium-sized enterprises/companies (SMEs) to third parties, is another example of how Japan's ageing population can provide attractive and sustainable investment returns.

Historically, as SME owners neared retirement age, the usual succession route was to pass the business on to family members or relatives. However, as the younger generation have increasingly chosen to pursue other interests, it has become common to find a third party to take over the reins instead – thus, demand for specialist consultants such as Nihon M&A began to grow.

According to Nihon M&A, the potential market size is substantial. There are around 600,000 SMEs (excluding micro-enterprises with less than 10 employees) in Japan. Of these, around 30% are profitable and 65% of those do not have a successor – which implies that 120,000 business owners might want to sell their business when they retire in the future.

Nihon M&A is the absolute leader in this niche area, with 19% estimated market share based on deal volume, followed by M&A Capital Partners, Strike and Yamada Consulting (with 6%, 5% and 2% market share respectively). The remaining 68% of the market consists of numerous unlisted players handling much smaller deals (which means that there is no customer overlap with the four main listed M&A intermediaries).

Investment banks have not entered the SME market, given the smaller deal size; and Japanese security companies and mega banks have found it marginally more cost effective to refer SME deals to specialist consultants such as Nihon M&A. As a result, Nihon M&A has little competition in this space; and sales have compounded by 20-25% over the last 10 years.

We believe the SME M&A market should prove to be resilient in an economic downturn, as SME owners tend to focus on securing a buyer that will take care of their legacy and employees, rather than on obtaining the highest valuations; therefore, we believe Nihon M&A should continue to find a steady market for their services.

[1] World Population Prospects 2019, United Nations

The mythical correlation between Japan equities and a weak JPY

Foreign investment into Japan equities tends to be highly correlated with movements in the Japanese yen (JPY). Global investors typically buy Japan equities when the JPY is weak and sell when it is strong. Underlying these fund flows is the assumption that a weaker currency should mean stronger exports and higher overseas profits; therefore, a weaker JPY should mean that Japanese companies would perform well.

However, exports comprise just 16% of Japan's total GDP (compared to 22% for China and 46% for Korea). On the other hand, personal consumption forms 60% of Japan's GDP. This suggests that the correlation between corporate profit and foreign exchange should be much lower than global investors expect.

In addition, the historical data show that strong corporate profits have correlated with a stronger yen in at least six earnings cycles, while a weaker yen has done little to drive corporate profits. Since 1997 (at Japan's peak GDP), the Japanese yen has cumulatively strengthened by 16% against the US dollar, while Japanese corporate profits have risen by 180%. This is because Japan's trade balance – not financial flows – is the key driver for the JPY.

Nonetheless, the Japanese yen's status as a "safe haven currency" can add to the volatility of the Japan equity market. Investors often buy JPY in response to international crises or negatively perceived global events, thus driving the value of the yen higher. As the yen strengthens, foreign investors (who form the majority of the Japan equity market) sell Japan equities – which suggests that Japan's equity market performance is often driven by geopolitical events rather than underlying fundamentals.

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Over the longer term, company fundamentals and long-term secular growth drivers have been much more important to corporate profits than the direction of the Japanese yen. On the other hand, this periodical disconnect between market prices and company fundamentals can provide long-term investors with excellent opportunities to accumulate high-quality companies at more reasonable valuations.

What role does Japan play in an Asia Pacific portfolio?

In summary, we believe that adopting a research-driven, bottom-up investment approach to Japan equities can provide attractive and sustainable returns over the long term. Investors with Asia Pacific portfolios could benefit from having an allocation to high-quality Japanese companies that complement existing holdings and add value through diversification.

Japan has strong, globally-competitive franchises in the machine vision, industrial robots, semiconductor production equipment, electronic components and medical equipment industries that cannot be found elsewhere in Asia Pacific. These companies typically have a dominant market share and are supported by secular growth drivers.

For example, Hoya, a leading manufacturer of lenses and related optical products, has developed a near monopoly in materials such as Extreme Ultraviolet (EUV) mask blanks used in the production of semiconductors, and glass substrates used in Hard Disk Drives (HDD). Similarly, Lasertec has a global monopoly (80-100% market share) in mask blanks and photomasks inspection equipment.

Other examples include Keyence (the world's largest provider of vision sensors and machine vision systems), Sony Corp (a leading conglomerate with 40% market share in gaming consoles and 50% market share of image sensors), Olympus (the largest medical equipment company in Japan with 70% global market share in gastrointestinal endoscopes) and Murata Manufacturing (the largest manufacturer globally of multi-layered ceramic capacitors).

Additionally, many Japanese companies have expanded into overseas markets to look for growth, particularly across the Asia Pacific region in general and China more specifically. The leading Japanese consumer companies enjoy strong brand awareness and have been gaining market share through product innovation and high quality standards.

We believe that Asia Pacific, which accounts for 60% of the global population, will continue to be an important source of consumer demand for Japanese companies – particularly as income levels rise. Pigeon (mother-and-baby products), Unicharm (feminine hygiene products and adult diapers) and Shiseido (skincare and cosmetics) have all been successful in developing strong consumer franchises and have grown shareholder value significantly over the years.

There are also many high-quality companies in Japan powered by secular growth drivers in the domestic market. Examples include domestically-focused companies like Nitori and Workman, which should continue to enjoy stable demand – and should be relatively defensive in terms of portfolio performance in the event of a global slowdown. Others have unique business models – found only in Japan – and are well positioned to deliver high growth and shareholder returns due to the lack of meaningful alternatives.

Indeed, Japanese companies can deliver earnings growth that is just as high as those in Asia ex-Japan and can add alpha to Asia Pacific portfolios that have the option of going "off-piste". While there are many myths and misconceptions surrounding Japan equities, we believe a research-driven and long-term investment approach can uncover the "hidden gems" in the Japan market. We believe these companies could become much larger in three-to-five years' time, to the benefit of client portfolios.

Source: Company data, FSSA Investment Managers, as of 30 June 2020