FSSA INVESTMENT MANAGERS

Japan Equities



Business as usual

Over the past six months, global equity markets have remained weighed down by uncertainty. Meanwhile, in Japan, Prime Minister Abe's announcement that consumption tax is set to rise from 8% to 10% this October has escalated fears of a pending recession.

At times like these, we like to reiterate that our investment process has not changed. It centres on identifying companies which we believe can deliver attractive and sustainable returns over the long term. We adhere to our philosophy and ignore short-term noise, spending our time assessing the fundamentals of the companies we own or might like to own.

We look for quality management teams, strong balance sheets and long-term track records which remain steady in down cycles. In Japan, this usually translates to companies driven by secular growth trends that are able to perform well, despite the direction of the broader economy. We aim to find companies that are able to deliver sustainably high returns on invested capital and which adopt focussed strategies within niche markets. We like to see business models based on recurring revenue streams, where high margins offer resilience in down markets. We have little in common with the benchmark and maintain a high active share.

Since our last note, we have identified a number of new ideas that fit the above criteria and have made three more research trips to Japan. In this note, we will discuss a few of the companies we met that are bucking downward growth trends.

Finding opportunities amid Japan's labour shortage

Japan's job market continues to tighten, with 153 companies forced to close in 2018 due to staff shortages. A number of shops and services have considered curtailed operating hours; and Prime Minister Abe has launched a new immigration scheme, with two new visa categories for blue-collar workers in the most labour-critical sectors to stimulate the flow of foreign workers into the country (though it is likely that Japan's more conservative businesses may offer some resistance to this).

With unemployment at a 26-year low and jobs per applicant at a 44-year high, companies competing for young talent have been promoting a more attractive corporate culture. Indeed, attitudes to work/life balance were already starting to shift well before Abe's 2018 "work style" legislative reforms.

However, Japan's lack of workers is not its only problem. The country ranks only 20th out of 36 for labour productivity amongst its OECD[1] peer group (based on GDP per hour worked). Long working hours have not helped, nor has the ageing population. With Japan's growing labour shortages, improving productivity is paramount; a sentiment evidenced by increased spending on innovative IT solutions by Japanese companies across the board.

But, Japan has a surprisingly poor IT literacy rate; another hurdle on the path to improved productivity. The country's own Minister for Cyber Security made headlines last year when he admitted to never having used a computer. In a perfect storm of poor productivity, insufficient manpower and the growing trend of automation, IT solutions pose a credible lifeline in some sectors. Of late, we have endeavoured to look at companies which should benefit from these spending hikes, as more businesses upgrade their existing paper-based systems to increase efficiency in Japan's tightest labour market since the 1970s.

One such business is **Rakus**, a cloud-based software company that we have been looking at for some time. Rakus targets SMEs (small and medium enterprises), a sweet spot for cloud-based companies, due to particularly-low IT competence among employees. Amid labour shortages and increased government incentives, demand for cloud-based services is rising.

[1] Organisation for Economic Co-operation and Development

While Rakus benefits from a benign competitive environment, we believe what sets the business apart is its understanding of clients' needs. The company promotes effective and user-friendly products, and understands the need to persuade clients of the merits of these products versus old pen and paper solutions. Clients tend to stay with Rakus for the long term as its customer base has a low churn rate; and revenues, which have been growing consistently, are recurring in nature.

Rakus's flagship product is its expense management software, Rakuraku Seisan, which has grown significant market share over the last 10 years. Despite its success, the management continue to invest heavily in advertising and have a sales team who actively engage with SMEs on the benefits of cloud-based software. They understand the importance of being the first to attract new clients in a sticky market. While the majority of new business activity for overseas cloud-based companies takes place via online advertising and enquiries, this often does not work in Japan. Thus, Rakus's sales team conducts face-to-face pitches, another advantage over its peers.

Rakus has channelled its advertising spend towards taxis and television this year to maximise exposure to SME owners, and targets a compound annual growth rate for revenue and profit of 30% in three years. While the current advertising drive has impacted operating profits in the near term, we expect this strategy to pay off in the years to come.

Digital billing system, Rakuraku Meisai, is a newer product, but has the potential to be a significant growth driver. While other comparable products target larger companies, Rakuraku Meisai is tailored specifically to SMEs. We estimate that the potential market which could benefit from bill digitalisation is worth JPY20-30bn.

We owned Rakus previously and took profits in 2018, before adding the company back to our portfolios earlier this year. We had perhaps sold too early as, despite expensive valuations, our conviction in the company remained strong. We realised that quality of management, strength of franchise and clear visibility on earnings growth are far more important than near-term relative valuations.

The management, led by founder and president Takanori Nakamura, has a clear strategy and a long-term mind set. Nakamura believes that Rakus is well-positioned for the growing emphasis on technological efficiency at SMEs; and we would agree. We believe Rakus should be a considerable beneficiary of Japan's structural labour shortage and the move towards digitalisation.

We also met **OBIC**, Japan's third largest enterprise resource planning (ERP) vendor, during a recent trip. Its core piece of software is OBIC7, designed for business support functions such as human resources and accounting. The business has evolved to target medium to large companies with a typical workforce of 500 to 1,000, and has 10% market share in this segment. More recently, the company has started to promote its cloud-based solutions, which constitute 10% of overall revenue, having grown 65% year-on-year. OBIC has a solid track record, with operating profit growing every year since its 1998 IPO.

We believe OBIC has a unique approach to people and business: hiring only new graduates into the 'family' to preserve its culture; and keeping the majority of its functions in-house. Chairman Masahiro Noda founded the company in 1968 and the Noda family retains a 25% stake. While we have historically struggled with poor information disclosure from OBIC, over time our understanding of the business has improved, along with our conviction. The company's EBIT[2] margin has been increasing over the last two decades, and is now close to 55% (among the highest in its sector). We see this as indicative of the Noda family's strong stewardship and dedication to profitability.

The size of OBIC's client base has remained fairly static in recent years, as it veered away from SMEs towards larger clients, thereby shrinking its target universe. We expect growth to be driven by the consistent increase in revenue from existing clients, thus maintaining OBIC's track record of high cash flow generation and improving margins. OBIC has a high quality in-house sales team, who have an integral understanding of their clients' needs and who actively promote new services and functionalities to existing customers. Competitors tend to use third-party distributors, who lack the same understanding of the client base and their motivation for growth.

The company has weathered economic downturns well, with its understanding of the local market a key advantage. In Japan, customisation is key and OBIC understands this better than its foreign competitors. We believe that OBIC is another business in prime position to benefit from Japan's increased spending on automated solutions.

An evolving business; encouraging prospects

In a different sector, we built a position in retailer, **Workman**, after witnessing a meaningful shift in its business model as it expanded its product offering. Workman was founded in 1980 and today operates close to 840 franchised stores nationwide, with 15% market share. It is a trusted brand for value and durability.

The company specialises in professional apparel, namely uniforms for the construction and manufacturing industry. This business model has proven to be resilient through down markets, with a consistent revenue stream as most customers replace low-priced uniforms and protective wear each season (twice per year). The cost of specialist uniforms is frequently subsidised by employers who put an increasing emphasis on site safety.

[2] Earnings before interest and taxation

Workman's performance through the global financial crisis in 2008 was relatively stable, with just single digit profit declines in 2009 and 2010. After that, demand was bolstered by the scale of reconstruction operations along the eastern coastline of Japan following the 2011 Tōhoku earthquake and tsunami.

Workman is aware that Japan's ageing population could impact demand over the longer term and has responded by launching a new store format: Workman Plus. The new Workman Plus stores are more accessible – found in shopping malls and urban areas, rather than just at roadsides – and sell low-cost active and outdoor wear, targeting consumers who would normally buy brands such as North Face, Nike and Under Armour.

Workman has successfully leveraged its expertise in the design of robust and durable professional apparel to expand its brand to a new mass audience – and at a much lower price point than equivalent foreign brands. Demand has been boosted by Japan's secular "athleisure"[3] trend and the new stores have proven to be especially popular with women (the old Workman stores were never able to attract female shoppers).

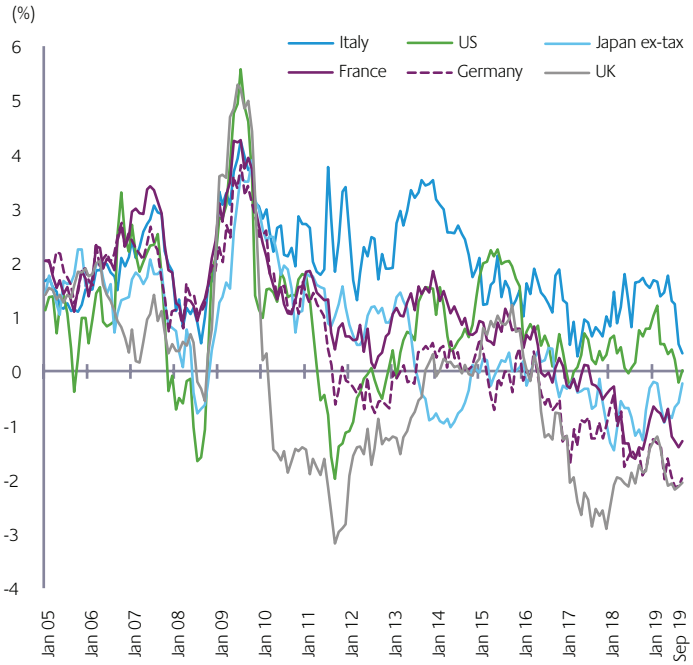
This kind of expansion looks encouraging. New Workman Plus stores are already generating two to three times more sales than original Workman shops and store openings attract the attention of both media and online bloggers. Workman has stated it will now only open Workman Plus stores; and over time, plans to convert its old stores to the new format, which we believe to be the key growth driver of the business over the longer term. The Workman Plus brand should strengthen, as affordable, functional apparel continues to grow in popularity among deflationary-minded Japanese consumers. Its high return on invested capital of 34% is, among our Japanese holdings, second only to Fast Retailing (38%), and indicative of a strong foundation for sustainable growth of the overall business.

To conclude

Since 2013, in a bid to achieve its stated 2% inflation target, the Bank of Japan (BOJ) has been aggressively buying Japanese government bonds (JGBs) and exchange traded funds (ETFs). At the end of 2018, the BOJ owned 78% of Japan's ETFs, having bought upwards of JPY23trn-worth during those intervening years. This has raised concern among investors, who believe that such levels of ETF trading have distorted the market by inflating prices. But, TOPIX valuations are at a historical low and, in reality, market movements are much more dependent on the behaviour of foreign investors than on the BOJ's purchasing programme.

Secondly, with record-low bond yields globally, fear of economic stagnation has become far more than a Japanese problem, with "Japanification" now a globalised term within cautionary tales across Europe and the United States. USD16trn worth of global bonds currently trade with sub-zero yields (representing 30% of the total), and nearly half of these are Japanese.

Selected developed markets' real bond yields



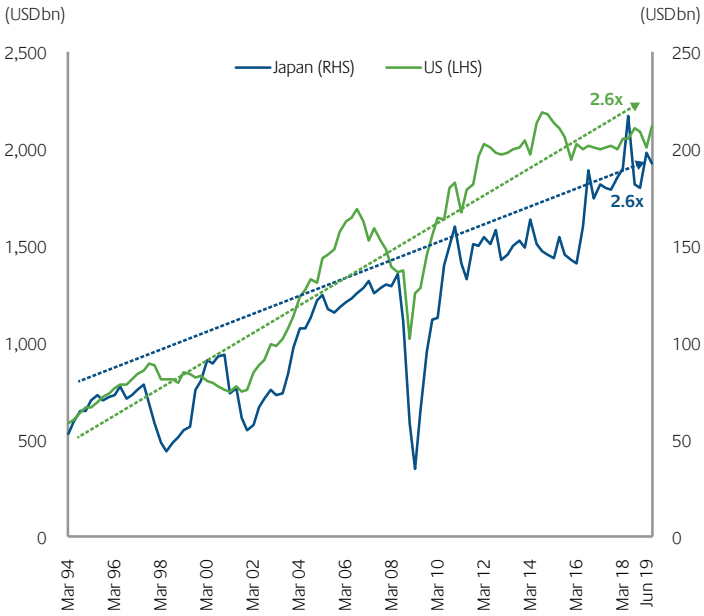
Source: Deutsche Bank, as at September 2019.

As a result, investing in Japan has come to be seen as inherently low growth. Despite this, we believe that the prospects for our holdings remain attractive, as we continue – as we have always done – to invest on a bottom-up basis and focus on the fundamentals of the businesses we own. With the global backdrop of a low interest rate environment, we focus on identifying businesses which can generate sustainable and fast-growing free cash flow, a key indicator of a company's value.

Indeed, despite 20 years of low growth in Japan, corporate profit growth has risen on par with the United States, and with more attractive company valuations. Japanese companies have learned how to survive and prosper by continually looking at new ways to innovate and improve operational efficiency, rather than rely on favourable macro conditions. In this sense, they are, perhaps, ahead of the global curve.

[3] The trend of wearing active wear in day-to-day settings.

Japan's corporate profit growth has been growing on par with the US



Source: Ministry of Finance and Bureau of Economic Analysis. Data here refers to Japan corporate current profit (net of taxes and before dividends) and US corporate profits with inventory valuation and capital consumption adjustments. As at the end of June 2019.

As long-term investors, our ability to look past the short-term noise, the anxiety over impossible-to-predict recessions, and the geopolitical crises enveloping one country or another is what helps to boost our overall absolute returns. We continue to focus on what we do best, which is to look for companies with quality management, strong franchises, sustainable earnings and conservative financials. These are the companies that we believe are best-placed to grow our clients' investments over the next five to ten years.

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