First State Stewart
首域盈信

First State Stewart Asia – Japan Equities

Client Update

July 2017

– The Fund invests primarily in a portfolio of equity securities which are established or have significant operations in Japan and which are listed, traded or dealt in on regulated markets worldwide.

– The value of the Fund may be more volatile as the Fund could be exposed to the legal, political and economic conditions of a single country. The value of shares in the Fund may be impacted due to changes in the exchange rates of currencies. The Fund may use financial derivatives instruments for hedging and efficient portfolio management. Derivatives involve a level of risk. It is possible that the entire value of your investment could be lost.

– You should not base your investment decision solely on this document. You should not invest unless the intermediary who sells it to you has advised you that the Fund is suitable for you and explained how it is consistent with your investment objectives.

In search of an investment solution in 21st century Japan

The slow pace of change in Japan and the meagre improvements made so far have been a difficult pill to swallow for Abenomics supporters. On top of the lack of reform, there is the ageing population, a deflationary environment and negative interest rates to contend with. Unfortunately, it is far too easy to get stuck on the top-down negativities when investing in Japan and lose sight of the real investment opportunities on the ground. We have been mindful of this and, while we share the market's concerns at the macro level, we believe that there are numerous gems – some hidden, others clearly exposed – which possess a distinguished franchise and management philosophy, or otherwise have shown signs of progressiveness in their efforts to change the way they do things.

In fact, a recent trip to Japan reinforced our long-held view: that Japan *is* changing; but in its own way and at its own pace. For example, 80% of the companies listed on the Topix now have at least two independent directors, up from 30% in 2012. This is a positive step in the right direction, though there is still some way to go. Among the companies we visited, Nifco, a global plastic auto-parts manufacturer, said that it would focus on lifting its ROE – and subsequently announced its plan to divest the *Japan Times*, a peripheral business which had long been criticised as a value-destroying asset. Meiji Holdings, a leading confectionary company in Japan, holds Nestle up as its benchmark; it has set a 10% operating profit margin as the minimum standard of competence required to compete on the global stage.

Alongside these positive manoeuvres and amid acute labour shortages, we believe the deflationary environment in Japan could be coming to an end. While recent unemployment figures stood at 2.3% – the lowest since 1994, the ratio of jobs to applicants rose to 1.8x – the highest in 25 years. One of the biggest conundrums in Japan's economy has been its anaemic wage growth, despite the tightening labour market. This must change – and we are starting to see some evidence of upwards pricing pressure. Yamato Holdings, the largest door-to-door delivery services company in Japan, recently announced a price hike for the first time in 27 years and is considering withdrawing its same-day delivery service for Amazon Japan. Seven & I Holdings, a master franchisor of Seven Eleven convenience stores, remarked on the possibility of raising prices in light of concerns on their recent decision to subsidise franchisees.

Initially, one might sense that *Japan Inc* has a lower priority on returns, or has a lack of motivation and alignment. True, Japanese companies are run not primarily for shareholders, but for all stakeholders; and the Japanese management style is based on a deep-rooted belief in corporate social responsibilities over profit maximisation. On the other hand, taking a step back, one might consider that Japan has taken major, progressive strides forward after its unprecedented economic collapse in the 1990s, which had been exacerbated by decades of deflation and an ageing population.

This is easily recognised by travellers coming to Japan – not only by the attractions of Japan's modern cities, such as zero traffic jams, highly-developed infrastructure and a cleanliness far above any other country's norms – but also by the increasing number of Japanese firms that have shifted the focus to quality-driven growth and innovation, away from the quantity-oriented philosophy that once defined the post-war period. Though the changes seem incremental, we believe one should not underestimate the rationality behind incremental change, nor neglect the fact that such increments usually add up to more radical changes in the long run.

In the current era of disruption, one might ponder whether Japanese corporations, with their deeply ingrained conservatism, would be able to cope. Our belief is that a certain pedigree of Japanese companies can – and these are the ones that form our investment opportunities. Japanese companies are particularly good at cumulative rather than radical innovation – a notion which reflects the current positioning of Japanese firms in the value chain: Japanese firms may have lost the smartphone battle

(where new models overtake old ones at lightning speed), but they dominate the key component markets (where technology advances on a more incremental basis). Similarly, Japanese firms may have lost share in fast-changing consumer goods markets such as home appliances and fashion apparel, but they boast a strong presence in B2B markets such as factory automation, motors, and commercial air conditioners – where quality and safety are prioritised over fast marketing and prudent customers grant sufficient lead-time for Japanese companies to adjust to new trends and technologies.

In Japan, a society of deference and adherence to rules, either management quality or an idiosyncratic corporate culture is key to the success or otherwise of a company's performance and, by extension, its potential investment return. Those managers who are leading more purposeful businesses seem to be motivating their people largely through sheer force of character – and by displaying true leadership. Of course this is also true in the West (and most other places too), but there the equity-cult means that more often than not it is just about the dollars. That is not necessarily the case in Japan. As Thomas Edison once said: "I never did a day's work in my life, it was all fun." In Japanese culture, employees have other reasons to perform well, such as perfectionism, or a sense of mission, or the pursuit of harmony.

Overall, the Japanese proclivity towards excellence and product obsession, combined with more than two trillion US dollars of cash sitting on companies' balance sheets, present an appealing investment opportunity – particularly as we believe it is better to travel well than to arrive. In this, we believe the direction of travel appears to be rather encouraging.

Automation and robotics: the next industrial revolution

> "The factory of the future will have only two employees: a man and a dog. The man will be there to feed the dog. The dog will be there to keep the man from touching the equipment."
> – Warren Bennis.

In order to tackle global issues of an ageing population and the increasing challenges in precision technology, we believe automation has become a secular movement, spilling over from traditional manufacturing industries such as automotive and electronics into general industries such as pharmaceutical, food and beverages and logistics. This has been boosted by initiatives such as *"Industrie 4.0"* in Europe and the *"Made in China 2025"* strategy more recently announced by the Chinese government.

Although automation in the manufacturing industries is nothing new in itself, the use of robots is now reaching a tipping point. It took almost 30 years for the global operational stock of industrial robots to grow to 1 million units in 2010; this number is expected to reach 2.6 million in 2019. Large-sized industrial robots and compact-sized robots are expected to grow at 10% and 15-20% CAGR respectively over the next three-to-five years, of which the leading Japanese automation companies are poised to benefit.

There are a number of driving forces behind this predicted growth. Firstly, is the emergence of collaborative robots, or 'co-bots'. These are compact-sized and mobile robots designed for collaborative work with human operators. Co-bots are an attractive option for smaller and medium-sized enterprises unwilling or unable to commit to the large outlay for traditional automation systems.

Secondly, robots are becoming progressively smarter and more capable. By harnessing the growth in computer processing power, new-generation robots have been fitted with vision sensors and controllers that can 'see' their surroundings and make judgement calls that would otherwise require manual recalibration. Today, vision-guided robots account for less than 15% of the total; this ratio is expected to grow significantly, particularly in non-automotive industries where the product lifecycle is shorter and procedures are less standardised.

Thirdly, smart technology and greater interconnectivity, coined as the 'Industrial Internet of Things', have led to new applications, one of which is the trace, track and control (TTC) system used in production processes. TTC pinpoints where in the process problems occur, thus contributing to greater efficiencies in supply chain management by allowing manufacturers to quickly identify and correct any issues. TTC systems in manufacturing facilities are currently only around 15% of the total global stock and also expected to rise significantly in the coming few years.

Keyence Corp

Keyence Corp is a leading factory automation company, making sensors, laser markers and machine vision systems. We believe it is one of the best companies to own in this segment. It has a strong culture and focuses on direct sales to provide customised solutions. Together with its fabless business model, these factors contribute to its high profitability, healthy balance sheet, large cash pile and superior returns on invested capital.

We first met with the company in 2010, after a top management change led to Mr. Yamamoto, the youngest of the directors, being appointed president. Despite being one of the most profitable companies in Japan, Keyence was notorious for its inefficient capital allocation, unattractive shareholder return policy and low overseas exposure.

Through a series of meetings with the company, we found that its corporate culture was notable in that it displayed zero tolerance towards complacency and focused primarily on value added services for its clients. Rare to see in Japan, Keyence has a relatively flat organisational structure and values meritocracy over seniority. Employees are evaluated on both quantitative measures employing strict KPIs as well as qualitative ones such as the ability to cross-sell products of other departments to realise the benefits of teamwork. The appraisal process is built on the management's belief that both output and process are equally important, a notion that we believe is sensible.

Despite the high standards set by the firm, Keyence has been able to recruit ambitious and motivated people who share the company's performance-driven philosophy, mostly hiring graduates more likely to be inculcated with these values. By hiring the 'right' people, Keyence had no need to enforce disciplined behaviour and instead focused on creating a good working environment. Its employees strived to maximise performance and achieve challenging targets out of their own volition and were rewarded with industry-high remuneration in return. As a result, employee turnover at the company remains low.

Over time, we began to better understand its business franchise. Keyence operates a direct sales and fabless business model (as opposed to a distributor sales model) and employs technical salespeople as 'engineering consultants'. These consultants are particularly adept at creating an end market for Keyence's products by demonstrating technology applications and proactively advising on product solutions of which its customers may be unaware. They do not target particular industries or products, but design and sell solutions wherever they see demand from their customers. Due to this consultative sales approach, both sales and net profit per employee are among the highest in the industry. We believe this is a key intangible moat that has led to Keyence's superior profitability metrics and long-term sustainability.

Absent sizeable competitors, Keyence has been at the forefront of the industry, introducing 'hit' products and applying its user-friendly operating system to integrate hardware and software solutions. This latter part enables its products to deliver more powerful performance despite using commoditised hardware. For this reason, Keyence is regarded as the *Apple* of the automation industry.

Keyence's business model has allowed it to make superior returns, which in turn has accumulated as cash on the balance sheet and should serve as a buffer during a downturn as well as a war-chest for potential acquisitions. Meanwhile, its performance-driven culture has been the key reason for its superior track record and its ability to launch innovative new products. In all, we believe Keyence is well-positioned to meet the growing demand for automation amid an expanding market.

Harmonic Drive Systems

In December 2016, we initiated a position in Harmonic Drive Systems, another company that has benefitted from the automation and robotics trend; it has a global monopoly in strain-wave speed reduction gears and enjoys high technical barriers to entry. The company is the most upstream in the value chain in the robotics industry. Harmonic Drive's speed reduction gear is a key component in a robotic system and accounts for the largest portion of a robot's cost structure. The lucrative nature of this part led to many new players – both from overseas and in Japan – attempting to enter this niche market. Nabtesco, a leading automation company that focuses on a different type of gear, was one of which the most renowned that tried and failed to develop a competing strain-wave mechanism.

Harmonic Drive System's success and market leadership in speed reduction gears can be attributed to its product-focused mind-set. Although strain-wave speed reduction gearing was invented as early as 1957, Harmonic Drive Systems is the only company that has been able to develop and evolve this technology.

Through years of cumulative innovation it has 'perfected' the strain-wave gear and its application. These efforts have culminated in a product and business model that has become extremely hard to compete with. We believe that its continued focus on R&D means that its technology leadership should remain sustainable in the wake of challenges from new market entrants as well as substitutes.

As an investment proposition, we consider Harmonic Drive Systems as a quality cyclical, with its strong franchise reflected in its sound financials. Over a full cycle, Harmonic Drive Systems generated around 25% normalised after-tax return on capital employed and strong cash flow generation. As the company is currently in expansion mode to meet burgeoning demand from end-consumers, its cash flow metrics could come under pressure in the short-term due to rising working capital requirements; however, we remain confident that the company will recover its initial capital outlay over time.

Historically, Harmonic Drive Systems was perhaps overly conservative and slow to expand capacity, which resulted in long delivery lead-times. However, this seems to be changing. The management increased its stake in Harmonic Drive AG, an equity-method affiliate in Germany, in response to the growing demand for collaborative robots in Europe; has ramped up production capacity to drive future growth; and has stepped up R&D in an effort to develop more innovative new products which utilise different mechanisms and materials.

Overall, with its unerring focus on its core business, respectable long-term return on capital employed, and the management's positive attitude to future growth visibility, we believe that Harmonic Drive Systems is a company to own for the long-term.

Attractive on a long-term view

We are aware that the valuations of both Keyence and Harmonic Drive Systems are not cheap. Both in absolute terms and relative to its history, the earnings multiples of these two companies are close to historical highs. That said, in our opinion both companies should be better positioned than more conventional businesses when the inevitable downturn occurs, due to their strong competitive moats, highly profitable business models, strong cash flow generation and healthy balance sheets. As fundamental, long-term investors, now, arguably, could be the best time to consider these companies, when the global investment landscape is experiencing a number of radical secular shifts. Automation (and robotics) is just one of many examples. With this in mind, we wait patiently for market dips in order to add to our positions with a greater margin of safety.

Top 10 holdings (%)

	Sector	Fund	Index*
Keyence Corp	Information Technology	5.8	1.3
Ryohin Keikaku	Consumer Discretionary	5.0	0.2
Recruit Holdings Co Ltd	Industrials	4.9	0.6
Start Today Co Ltd	Consumer Discretionary	4.7	0.1
Tsuruha Holdings	Consumer Staples	4.4	0.1
Misumi Group	Industrials	4.1	0.2
Asahi Intecc#	Health Care	3.2	0.0
Kusuri No Aoki Holdings#	Consumer Staples	3.1	0.0
Nitori Holdings	Consumer Discretionary	3.1	0.3
Daito Trust Construction	Real Estate	3.0	0.3
TOTAL		**41.3**	**3.3**

Source: First State Investments, as at 30 June 2017. *Index: MSCI Japan Index. # Non Index Stock at end of period.

Cumulative performance (%)

	Since inception	6 months	3 months
First State Japan Equity Fund	13.1	16.2	9.1
MSCI Japan Index	8.4	9.9	5.2

Calendar year performance in USD (%)

	2016^
First State Japan Equity Fund	-2.7
MSCI Japan Index	-1.3

Source: First State Investments, Lipper, Nav-Nav (USD total return), as at 30 June 2017. The fund above refers to First State Japan Equity Fund Class I (USD-Acc) which is the non-dividend distributing class of the fund, the performance quoted are based on USD total return (non-dividend distributing). ^Performance from inception date to 31 December 2016. Inception date: 6 September 2016.

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