First State Stewart

First State Stewart Asia – Japan Equities

Client Update

March 2018

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- The Fund's investments may be concentrated in Japan or a single sector which may have higher volatility or greater loss of capital than more diversified portfolios.
- Investing in small/mid-capitalisation securities may have lower liquidity and their prices are more volatile to adverse economic developments.
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Sustained global demand a boon for Japanese equities

The Japanese stock market rallied in 2017, surging past levels last seen in the early 1990s. A sustained recovery in global trade, as well as strong domestic sectors and continuous cost rationalisation provided a boost to Japanese corporate earnings, which grew at a much stronger pace than expected. In aggregate, net profits in the first half grew by around 20% year-on-year, beating estimates and consensus by a wide margin.

From a bottom-up perspective, our meetings with management indicated that demand recovery was well underway across a wide range of industries. **Harmonic Drive Systems**, which makes speed reducers for precision instruments, saw orders soar 117% year-on-year due to increasing demand for robots. **Komatsu**, which manufactures construction and mining equipment, has experienced "unprecedented" demand for its machines. And **Disco Corp**, a precision tools maker for the semiconductor industry, said that the number of orders it had received for machinery to make 3D NAND[1] chips seemed to suggest the start of a new super-cycle. Orders from other industries such as electronic components, sensors and high-performance computing chips have also been robust, driven by technological innovation and miniaturisation.

In 2017, Japan's stock market performance and currency performance decoupled for the first time since the start of Abenomics[2]. Our view, as we have often reiterated, is that Japanese companies do not need a weak currency to perform well. Contrary to popular belief, strong corporate profits tended to go hand-in-hand with a strong yen (and has done so for at least for the past six earnings cycles), as the exchange rate is more often driven by trade balances than by financial flows. Domestic non-manufacturing businesses have steadily outpaced the manufacturing sector in terms of profits since the early 1980s and is now around 70% larger on this basis. With a longer time horizon, the impact from currency performance is negated – Japanese corporate profits have grown by 170% since 1994, while the Japanese yen strengthened by 16% against US dollar over the same period.

In addition, the source of Japanese earnings has changed significantly over the past few decades. Increasingly, corporate profits are derived from domestic-focused companies, rather than from exporters. We have found numerous examples of fast-growing domestic (non-exporter) companies in Japan and have invested in the likes of **Start Today, Tsuruha, Nitori** and **MonotaRO**.

On valuations and disruptive forces

Japan's stock market growth has raised some concerns around valuations. However, despite the market's recent turmoil, fundamentals have surprised on the upside. The labour market and production capacities have turned increasingly tighter; and the capital expenditure cycle looks favourable across multiple industries and regions. Japanese companies have amassed high cash levels and continue to deleverage despite record high profit levels. Meanwhile, banks are over-capitalised. When there is no excess in the economy, where is the bubble?

[1] Flash memory using Negative-AND technology

[2] Economic policies based upon 'three arrows' of monetary easing, fiscal stimulus and structural reforms advocated by Shinzō Abe, Prime Minister of Japan.

On a price-to-equity basis, Japanese equities are better-valued than their US counterparts and on a similar footing to European stocks. On an earnings yield basis, valuations for Japanese equities look more attractive, compared to the zero interest rate and the negative yield on almost two-thirds of the Japanese bond market.

Nevertheless, quality companies are not cheap. The 12-month forward price-to-earnings ratio for our Japan portfolio stood at 24x vs. 14x for the TOPIX[3]. Return-on-equity (ROE) for the TOPIX is around 8% and projected earnings growth over the next two years is 7% CAGR[4]. Meanwhile, the ROE for our portfolio is around 20% with more than 15% projected earnings growth CAGR. This differential may not seem high on a one-year basis but should prove to be substantial over the long term.

Our main portfolio strategy is to identify a select number of companies that we believe can be much bigger in five to ten years' time, ignoring the short-term noise and sector/style rotations. In today's world, we believe it pays to take a step back and assess the longer-term trends and broader industry drivers. The market's tendency to mean revert is no longer a certainty as technology has altered the traditional economic models of demand and supply – and with it the old ways of thinking about labour utilisation and consumption.

Regardless of how strong a company's track record is, or how formidable the pricing power, disruptive upstarts may well erode an incumbent's advantages. There is no guarantee that today's winners will stay on top. To remain at the forefront, companies need to reinvent themselves and be nimble enough to respond to new opportunities and challenges as they arise. What we regard as 'quality' today may be no longer relevant in the future; possibly, it may even be dangerous.

With continual disruption and companies speeding towards innovation, what is far more important, in our view, is to find companies that look forwards, not backwards, and are investing into new areas and new products beyond the control of macro factors (not least because we believe much of economic forecasting is a fool's errand).

The type of companies we want to own are still those that have high quality management, a strong franchise and conservative financials; but, importantly, they are leaders that perhaps have some prescience on tomorrow's world – and have taken steps to stay relevant and compete.

New additions – Komatsu and Isuzu

In general, our investment approach favours high quality stocks which are often more expensive than the market average. We prefer to pay more for quality and sustainable growth, rather than pay less and move down the quality curve. In our view, quality companies may lag in the short term during euphoric markets, but tend to perform much better in the long run, when fundamentals regain their footing. Moreover, investing in quality companies does not require an ability to time the market – just the patience and courage to hold on to your convictions.

Notwithstanding our stance on quality, on occasion we invest in cyclical companies, which we believe are attractively-valued and have shown strong signs of bottoming-out. Last year, with signals pointing to a demand pick-up, we initiated positions in **Komatsu**, a leading manufacturer of construction and mining equipment, and **Isuzu Motors**, the largest light commercial vehicle manufacturer in the world.

Earnings at trough levels presented an attractive opportunity to purchase Komatsu, a high quality cyclical. The company's track record has been relatively consistent over multiple cycles – it is cost-competitive against peers and has maintained resilient margins due to its strong sales discipline and cost control. Moreover, the majority of Komatsu's mining-related profits are derived from selling parts and services, which means that earnings have been relatively smooth.

With the benefit of hindsight, its acquisition of Joy Global in 2016 seems well-timed and at the bottom of the cycle. There is little overlap in terms of products and geography; and with Komatsu's track record on cost control – fixed costs have been flattish for the past 15 years – we would expect the acquired entity to reach a similar 15% EBITDA[5] margin over time although of course this cannot be guaranteed.

Meanwhile, with the industry consolidating into an oligopoly, we believe Komatsu is well-poised to capture greater share. Replacement demand for the 40,000 or so mining machines put into use over the past decade should drive sales volume up, with anticipated sales reaching four or five thousand per year in a year or two, up from three thousand last year.

Adding to the investment case is Komatsu's culture, which is focused on prudence, quality and cost-consciousness. As an example, during the commodity super-cycle, while its competitors over-expanded, Komatsu resisted from making aggressive investments; and when the market turned, Komatsu chose to focus on its core customers, rather than cut prices and chase market share.

Assuming top-line growth in the high single digits for the next few years and operating margin at the historic 15% level would translate to around 13% return-on-equity. Current price-to-book at 2.2x is in the middle of its historic range – not particularly cheap, but not too expensive for a high quality cyclical on the start of an earnings recovery.

Similar to Komatsu, we bought **Isuzu Motors** last year, when it was trading around historic low valuation levels (excluding the 2008 global financial crisis). With overseas demand starting to recover and the company trading at around 1x book, we believed the stock looked undervalued compared to peers such as Hino and Volvo.

[3] Tokyo Stock Price Index
[4] Compound annual growth rate
[5] Earnings before interest, tax, depreciation and amortisation

As a highly cyclical stock, Isuzu had been affected by the oil price as well as sluggish growth in Association of Southeast Asian Nations (ASEAN), where it derives the majority of sales (volumes in some countries had dropped to more than half the peak of the previous cycle). However, despite the cyclicality, Isuzu has managed to absorb external factors such as raw material costs and improve margins.

There are signs of recovery, including a strong pick-up in Indonesia – where it plans to add more lines, expand its dealer network with local partner Astra International and grow its after-sales services. In 2017, unit growth in Indonesia reached more than 10%, with demand driven mainly by public construction; in 2018 this is expected to accelerate to 27%.

The current management seems sensible and prudent; and the new President, Masanori Katayama, who assumed the position in 2015, has embarked on improving ROE and shareholder return. The dividend has only been cut once since 2000 and there have been a few rounds of share buybacks in recent years, as the benefits of a solid balance sheet and strong cash flow generation were passed on to investors.

Performance and portfolio review

We believe that the perception of Japanese equities as a macro trade or a “value play” should be re-evaluated. Within our Japan portfolios we have invested in a number of companies that have delivered consistent growth, driven by sustainable factors.

The three-year performance of the strategy has borne out our longer-term approach. During this period, our Japan portfolio outperformed the benchmark, the MSCI Japan Index, 91% of the time in down markets and 44% of the time in up markets, with an overall outperformance ratio of 58%. In absolute terms, the strategy’s performance during down markets was 2% vs. -32.5% for the benchmark, and 68.1% vs. 70.9% during up markets.[6]

As the strategy recently passed its three-year milestone, we reflect on some of the companies that added to performance over the period.

Domestic consumer stocks **Start Today** and **Nitori Holdings** were among the top contributors to performance (thus disproving the myth of no growth in Japan). In our view, Start Today is probably the best Japanese e-commerce platform to own for on-trend fashion. The ZOZOTOWN website is one of the few in Japan that generates a high level of direct traffic (rather than via search engines) and, despite a stellar rise in 2017, still looks attractive based on expected revenue growth over the next 5-10 years.

Meanwhile, Nitori, which has a vertically-integrated business model designing, manufacturing and retailing furniture and soft furnishings, has an outstanding track record even when compared to global peers. The company has increased sales and profit every year for 30 years; and continues to expand with new store openings in urban areas.

Automation companies **Keyence Corp** and **Misumi Group** performed well due to the uptick in capital expenditures across multiple regions and industries. We continue to believe that the growth in automation is a long-term secular trend and that these companies are on the right side of disruption. Keyence has shown impressive sales momentum and enjoys high operating margins at around 55% due to its direct-sales and fabless business model. Similarly, Misumi has delivered robust sales growth both in factory automation and its VONA business. Both should continue to benefit from the capital expenditure cycle in 2018.

Asahi Intecc continued to grow earnings and market share, with shortages at US suppliers (due to hurricane disruptions) boosting extraordinary demand for guidewires and adding to its strong underlying fundamental growth. In the US, Asahi’s contract with distributor Abbot is due to expire at the end of June 2018, which should lead to further market share gains and improved margins as it switches to a direct sales model.

One of the biggest detractors over the period was **Casio Computer** – which has since been divested from the portfolio. The majority of Casio’s profit came from watches, where its G-Shock and Baby-G timepieces generated high margins of around 23%. We had purchased the company when it was trading at around 15x price-to-earnings, which we believed to be relatively cheap for a consumer company. However, we underestimated the headwinds facing the global watch industry as smart devices took off. As Casio tried to create new profit centres (systems equipment, 2.5D printers and some other niche areas) to diversify away from watches, the company incurred significant losses which impaired the overall profitability of the business. Our lesson learnt – an attractive valuation may be less important when considering the rapid decline of a company’s franchise.

Conclusion

To conclude, the fundamental outlook for the global economy in general and Japanese earnings in particular appears to be solid going into 2018 – and valuations do not seem too stretched after the recent turmoil. As long as inflation levels and interest rates stay low, we are optimistic that the environment for Japanese equities should remain constructive.

Business activity has benefitted from the unusually-low interest rate regime and harmonised monetary policies from central banks around the world, leading to a widespread and synchronised recovery across both emerging and developed economies.

In Japan, recent data showed that output grew by 2.5% in the third quarter – up from previous forecasts and marking the seventh straight quarter of growth. Core consumer inflation printed 0.9% year-on-year in November, which, although still some way away from the stated 2% target, displays a positive trend momentum.

[6] Based on month-by-month performance for the First State Japan Equity Fund, Class III USD Shares, as at 31 January 2018

This has raised concerns that the Bank of Japan (BoJ) might reduce its massive stimulus sooner than expected. However, our view is that the BoJ will anchor to its current 10-year JGB[7] yield around zero and the future BoJ governor (whether that be Haruhiko Kuroda, securing a second term, or a new governor, if appointed) will adopt similar policies.

On the other hand, as bottom-up investors, we believe there are still plenty of opportunities to acquire good quality businesses, especially as our time horizon is more long-term. Looking forward, we believe that investing in Japanese companies can continue to deliver attractive returns for our clients.

Top 10 holdings (%)

	Sector	Fund Weight	Index Weight*
Keyence Corporation	Information Technology	6.3	1.6
Start Today Co Ltd	Consumer Discretionary	5.4	0.2
Recruit Holdings Co Ltd	Industrials	4.8	0.7
Misumi Group Inc	Industrials	4.4	0.2
Tsuruha Holdings Inc.	Consumer Staples	4.1	0.1
Ryohin Keikaku Co., Ltd.	Consumer Discretionary	3.8	0.2
Nitori Holdings Co., Ltd.	Consumer Discretionary	3.6	0.3
Komatsu Ltd.	Industrials	3.1	1.0
MonotaRO Co., Ltd.	Industrials	2.8	0.0
Asahi Intecc Co Ltd	Health Care	2.8	0.0
TOTAL		**41.0**	**4.3**

Source: First State Investments as at 31 Jan 2018. Source: *Index: MSCI Japan Index.

Cumulative performance in USD (%)

	Since inception	1 Year	6 months	3 months
First State Japan Equity Fund	46.3	48.7	24.5	12.2
MSCI Japan Index	27.9	25.0	15.6	8.5

Calendar year performance in USD (%)

	2017	2016^
First State Japan Equity Fund	42.9	-2.7
MSCI Japan Index	24.0	-1.3

Source: First State Investments, Nav-Nav (USD total return), as at 31 January 2018. 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. Past performance is not indicative of future returns.

[7] Japanese Government Bonds

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