First State Stewart

First State Stewart Asia - Japan Equities

Japan Update

April 2016

The First State Japan Equity Fund recently marked its one-year anniversary in February 2016. Over the course of the year, we continued to expand our research coverage, visiting over 300 companies and carrying out in-depth analysis to identify attractive investment opportunities.

In the second of our Japan equities updates, we provide further insight on some of the key themes in the portfolio: ongoing industry consolidation; the rise of the Chinese consumer; and corporate restructuring to improve shareholder returns. This includes an update on some of the companies we own and a few new holdings that we added. We also review the performance of the fund and identify the main contributors to performance over the period.

Bottom-up continues to diverge from top-down

The Japanese economy seems to have stalled yet again. Economic indicators show sluggish growth on the back of weak consumption and global trade. Throughout 2015, core CPI inflation hovered around zero, while core-core CPI inflation (which excludes food and energy) rose modestly – though nowhere close to the 2% inflation target aimed for by the Bank of Japan.

Despite such a gloomy macro backdrop, corporate profits in Japan surged in 2015, buoyed by a weak yen, the decline in energy prices and most importantly, ongoing corporate restructuring as Japanese companies reduced costs, increased efficiencies and improved shareholder returns. Aggregate profits and average profit margins reached record highs in 2015 – exceeding even the previous peak seen in 2007.

However, our research suggests that there is a big divergence between individual company performance and the larger macro picture. Through our bottom-up stock picking approach, we try to identify companies that are able to deliver sustainable growth over the long run, despite facing a prolonged weak domestic economy and the risk of a global recession. Quality companies with progressive management teams are keenly aware of what is needed to survive over many cycles in Japan: being able to find continual ways to innovate and improve profitability.

Ongoing industry consolidation a key theme in the portfolio

Corporate Japan is well-known for being conservative and consensus-driven and incumbents are often resistant to change. However, from a contrarian point of view, companies with the opposite values can often be winners over the long term. **Nitori Holdings** (Consumer Discretionary) and **ABC-Mart** (Consumer Discretionary) fit into this category. Both companies are expanding from their traditional stronghold in rural areas to open new stores in urban areas and taking market share from weaker players. E-commerce activities and overseas expansion add to the potential long-term growth. We hold significant positions in both companies in the First State Japan Equity Fund.

Nitori Holdings has enjoyed 29 years of consecutive growth, making it one of the most successful retailers in Japan. The company has continually looked for ways to improve its product offering and expand into new areas in order to grow market share. Historically, its furniture outlets were typically large-format stores in rural areas. More recently, Nitori has opened a number of new, small-format 'Deco Home' stores in the centre of major cities, mainly selling home fashions such as cushions, decorative plants and small home appliances that typically enjoy a higher purchase frequency. These Deco Home stores are smaller, but are located in more convenient locations to attract urban consumers. The company has been experimenting with different aspects of the Deco Home format to try and identify the optimal format for increased profitability, focusing on the choice of locations, product mix and visual merchandising.

On the product side, Nitori has continued to innovate with its own-brand 'N' series of hi-tech products. There are, among others, self-warming mattresses for winter use ('N Warm') as well as moisture-proof blankets ('N Moist'). In addition, the company has seen strong sales in its Nitori Quality Line and its semi-customisable Nitori Studio products, with plans to expand these product offerings to meet customer demand.

On the overseas front, Nitori has long-term expansion goals, however it has been relatively cautious in this area. The company first tested the waters in Taiwan in 2007 and now has 25 stores there so far; it formally announced its entry into China and the

United States in 2014. Current valuations have not factored in much upside on its overseas business – there is potential there, but it is to be monitored carefully, in our view.

Similarly, ABC-Mart, Japan's No. 1 footwear retailer, has enjoyed 12 years of consecutive operating profit growth. The company has gained market share consistently over the years, expanding its footprint from rural areas into major cities as well as from low-end footwear to high-end versions. ABC-Mart now has 849 stores (as at end February 2016) with several sub-brands such as 'Lady Charlotte' for ladies footwear, 'Grand Stage' and 'Premium' for higher-end footwear and 'Sneaker Select' for sports shoes. Outside of Japan, ABC-Mart has a small but growing presence, with subsidiaries in Korea, Taiwan and the United States. Meanwhile, domestic online sales are growing at around 30% year-on-year, albeit from a low base of around 2%.

ABC-Mart owns a number of well-known brands such as Hawkins and Vans, and develops nearly half of its shoes in-house while outsourcing production to suppliers in lower cost countries. This gives ABC-Mart greater pricing power and improved profitability levels compared to its peers. The other half of its product range includes global brands such as Nike and Adidas. ABC-Mart has built strong relationships with these brands, often securing exclusive selling rights to a wide range of higher-priced and limited-edition shoes.

ABC-Mart's strong operational efficiency, higher sales productivity and tight cost control combined with the exclusivity of its global brand premium products has boosted the company's market share. We added to the position over the year as it was trading at a modest discount to peers and at reasonable valuations for the company's expected growth.

Demand for Japanese premium products boosted by China's middle class

Another key theme in the portfolio is the demand for Japanese products from China's middle class. Despite the weak Chinese economy, China's middle class households are still growing in number. Per capita income in China has been growing by around 11% per annum since 2010, leading to hundreds of millions of people being lifted from poverty and into an emerging middle class. These newly affluent households are driving consumption trends in China.

We have witnessed a noticeable trend of Chinese consumers shifting their discretionary spending habits as they move up the income ladder. With increased sophistication comes a heightened focus on quality and innovation and a pattern of trading-up, which has aided Japanese brands such as Muji and Zojirushi.

As a result, we hold **Ryohin Keikaku** (Consumer Discretionary), a retail company that owns the Muji brand, whose philosophy: 'No Brand Quality Goods' is an emphasis on the idea that form should follow function. The company believes that the aesthetics of simple, functional and practical products can be desirable in itself – a unique philosophy that taps into the 'anti-consumerism' and 'minimalist' movements.

Muji products are environmentally-friendly and organic and the company strives to minimise waste and streamline processes throughout its design and operations. As a result, the company is able to offer high-quality products – around 8,000 SKUs covering household, lifestyle and food products. Its new, large-format stores in prime locations provide a one-stop shopping experience, while its 'Café & Meal' restaurants and 'Muji to Go' airport shopping outlets are also doing well.

Muji products have sold particularly well in China, where Japanese products are perceived as high quality and can command a premium price. With around 140 stores generating around 70% of Muji's East Asian operating profit, China is by far the largest growth driver for the company in the region.

We also own **Zojirushi** (Consumer Discretionary), a leading manufacturer of rice cookers from a rice-worshipping nation, which has 20-30% market share in Japan, Taiwan and the United States, but less than 1% market share in China, where it was a late entrant. In China, sales of high-end rice cookers are growing at around 30-40% year-on-year, albeit from a low base. Rice cookers are already ubiquitous in Chinese homes, but a growing awareness of premium brands and increased knowledge about added functionalities have helped to grow demand for Zojirushi products.

Zojirushi has a strong reputation for quality and design technology, with champions for its brand praising the superior, fluffy-tasting rice made in its rice cookers. Its high-end model NP-WU, with a price as high as US$1,500, is hand-moulded for perfectly even heat distribution. It has a platinum-coated lid which is used to generate the optimal level of amino acids and is even equipped with a sensor to monitor the steam, with over 100 possible micro-adjustments for 'steam perfection'.

Meanwhile, the number of mainland Chinese tourists visiting Japan has risen significantly – signs of a long-term structural trend taking shape as tourist visa requirements are relaxed. Government policies to increase the number of products eligible for tax-free shopping as well as plans to double the number of tax-free shops by 2020 has made Japan an attractive destination for visiting tourists.

Around 4.3 million mainland Chinese tourists visited Japan in the first nine months of 2015 according to data from the Japan National Tourism Organisation – making China at 25% of the total the largest single source of foreign tourists to Japan. **Matsumotokiyoshi** (Consumer Staples), the largest drugstore operator in Japan, has been a large beneficiary of tourist dollars from this segment. Their retail outlets employ a number of Chinese-speaking staff in order to look after one of their most profitable groups of customers.

In Japan, Chinese customers have been buying everything in large volumes, from baby diapers to toothpaste, as well as over-the-counter drugs and heath supplements and many other premium and everyday items. From virtually nil in 2014, inbound tourism accounted for around 10% of total sales for Matsumotokiyoshi in 1H2015. We initiated a position in Matsumotokiyoshi last year and have added on weakness.

Corporate transformations a boon for profitability

Successful corporate restructurings can be highly profitable for long-term, patient investors. Often, the catalyst for corporate restructurings is driven by a new management team, with new ideas to revitalise the company. In some ways, this clear delineation – new management, new structure – is an easy way to draw a line in a company's historical underperformance. Judging the quality of new management can be a good reason to back a company at the start of its restructuring path.

Existing management can also have a transformative effect on enhancing corporate value, profitability and shareholder returns. The challenge as fund managers is judging the right entry point to such investments. As conservative investors, we tend to err on the side of safety and so we prefer to see some evidence of a turnaround before committing clients' capital. We will often buy a toehold in such companies and wait for further results before building a more meaningful position. There are two new holdings in the portfolio that fall into this category: **Marui Group** and **Cocokara Fine**.

Mr Aoi has been president at the **Marui Group** (Consumer Discretionary) since 2005. In 2015, Mr Aoi put together strategic plans to transform the group from an ailing department store brand to an on-trend shopping mall offering a 'diversified lifestyle experience'. At its flagship store in Shibuya, which reopened after renovation in December 2015, sales have risen by around 30% as three out of four of its tenants renewed their leases under the new 'fixed plus variable rent' model.

The company estimates that it will take about five years to fully complete the transition across its chain of stores, which, if successful, should increase the company's profitability and shareholder returns. The company aims to return all profit to shareholders – the recent JPY50 billion share buyback is one example of this commitment – which shows alignment of interests with minority shareholders. As a result, we initiated a toehold in Marui Group on reasonable valuations and will continue to monitor the company's transition.

Cocokara Fine (Consumer Staples) is one of the largest drugstore chains in Japan and another new holding in the First State Japan Equity Fund. The company was formed in 2008 after the merger of Seijo and Segami Medics, two drugstore operators based in the Kanto region. Through industry consolidation, Cocokara continued to expand, looking for similar-sized operators in other regions to acquire – merging with equals meant that Cocokara could gain best practice from other operators.

The management centralised the company's procurement and IT systems, cut costs, improved efficiencies and embarked on a large-scale renovation project to ensure that acquired stores could offer a uniform sales experience and be rebranded with the Cocokara signage. Profits at Cocokara initially took a hit as the company tried to impose a unified product offering without taking into account the diversity of its nationwide customer base. As those issues were addressed, profitability recovered. Profit margins at the company are still low relative to peers, which suggests it has room to improve further.

Performance Review

The First State Japan Equity Fund outperformed its benchmark index over both the six months and the 12 months to the end of February 2016, providing a positive return despite declines in the wider Japan equity market over the same period.

Hoshizaki Electric (Industrials), a manufacturer of ice machines and commercial refrigerators, was a key contributor to performance. Ongoing corporate restructuring has helped the company grow organically in the domestic market as a result of new channels and products, as well as in overseas markets through various synergistic acquisitions. The company has delivered decent growth and consistently improved margins, with 5-year revenues and operating profits growing at 8% and 25% CAGR respectively.

Hoshizaki proved to be relatively defensive during the market crash in early 2016 and has since made up for lost ground. Valuations are not cheap, but the company has a strong balance sheet and a decent free cash flow yield that should insulate it from further market shocks. Hoshizaki is a significant holding in the portfolio, though we have been controlling the position size and trimmed a bit on valuation concerns.

Asahi Intecc (Health Care), a global leader in medical equipment manufacturing, also rose over the period. We discussed this company briefly in our previous update. Asahi Intecc has a strong franchise and a significant moat effect due to the superiority of its technology – no competitor has yet been able to match its product strength in percutaneous transluminal coronary angioplasty (PTCA) guide wires.

Over the past year, from its leading position in PTCA guide wires, Asahi has been growing market share in other products such as peripheral guide wires, guiding catheters and balloon catheters. In particular, Asahi's favoured position in the market for peripheral guide wires led the company to switch from intermediated sales to direct sales in the United States, effectively doubling its selling price (as it no longer has to give away partnership incentives). In the United States, the market for peripheral guide wires is around seven times that of the Japan market; Asahi's market share there is only around 8%, compared to 50-60% in Japan.

Meanwhile, Asahi has an exclusive distribution agreement for its PTCA guide wires with industry giant Abbott Laboratories which is due to expire in 2018 – another potential opportunity to move into direct sales and grow market share in the long run.

We are comfortable holding on to the position, as we believe the long-term investment case for Asahi Intecc remains intact. However, a sustained rise in its share price over the past year suggests that its valuation is getting reasonably full – as a result, we trimmed the position and are keeping a close eye on valuations.

On the negative side, exporters such as **Kubota Corp** (Industrials) and **NGK Spark Plug** (Consumer Discretionary) lagged as a result of the strong yen. Kubota Corp declined despite delivering decent earnings as, in addition to the strong currency, declining commodity prices raised concerns around

demand for the company's agricultural machinery products. NGK Spark Plug also declined over the period – the company makes all its key components in Japan while over 80% of its revenue is generated overseas. Meanwhile, demand for its products had slowed due to the weak economic outlook in Asia.

Market Outlook

The primary driver of Japan equity market returns has been earnings growth which, despite investor scepticism, continues to outpace the US and Europe. Going into 2016, we expect earnings growth for quality companies to continue, as decent top-line growth, high operational gearing and lower tax rates provide tailwinds for Japanese corporates.

The major concern and potential downside risk is currency volatility, policy misstep and external demand weakness. Although the weakness of the yen had helped to boost profitability in the past, the sensitivity of Japan's corporate profits to the yen has since fallen, due to cost cutting and restructuring measures.

In addition, corporate governance reforms have meant that shareholder returns have become an increased point of focus for Japanese company management. We expect this trend to continue as Japanese companies with excess cash and limited investment opportunities continue to look for ways to boost return-on-equity (ROE) and streamline capital efficiency.

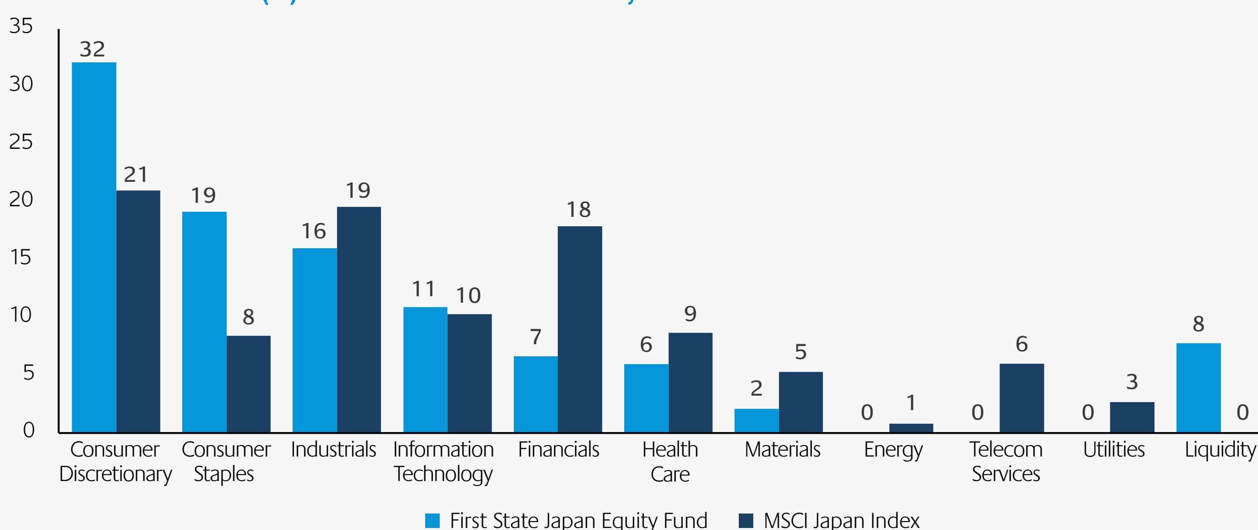
Although the macro environment remains soft, we believe that the Japanese equity market provides the bottom-up investor with plenty of attractive investment opportunities. We look for quality companies with a progressive management team, a strong innovation mindset, and long-term structural growth drivers. In effect, quality companies that should prove resilient in the event of a downturn and provide attractive returns over the long run.

Top 10 holdings as at the end of February 2016

Company	Fund weight (%)	Index weight* (%)	Sector
Ryohin Keikaku	4.4	0.2	Consumer Discretionary
Keyence Corp	4.1	0.9	Information Technology
Sundrug Co#	4.0	0.0	Consumer Staples
Misumi Group#	4.0	0.0	Industrials
Start Today Co Ltd#	4.0	0.0	Consumer Discretionary
Nitori Hldgs	3.9	0.2	Consumer Discretionary
Daito Trust Constuction	3.9	0.4	Financials
Casio Computer Co Y50	3.7	0.1	Consumer Discretionary
Tsuruha Holdings#	3.7	0.0	Consumer Staples
Technopro Holdings#	3.6	0.0	Industrials

Source: First State Investments. *Index: MSCI Japan Index.
Non Index Stock at end of period.

Sector breakdown (%) as at the end of February 2016



Source: First State Investments.

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