First State Stewart

First State Stewart Asia - Japan Equities

Japan Update

November 2016

In our previous reports, we discussed some of our key long-term investment themes, which are still intact. In this report, the third of our regular updates on Japan equities, we highlight some of the key holdings in the Japan portfolio and our investment rationale for purchasing these stocks.

Over the course of 2016, the First State Stewart Asia team have expanded their market coverage even further. So far this year, we have met with around 180 companies in Japan through our intensive corporate visits program.

There are some positive signs on the ground. Through our meetings, we see clear evidence of changing behaviours in an attempt to offset the structural headwinds that Japanese companies face and have noticed an increased focus on return-on-equity (ROE) and shareholder returns.

As always, we believe that a bottom-up stock selection process is the best way to identify long-term leaders. Quality companies should continue to diverge from the rest, despite the challenging economic backdrop.

Portfolio positioning

On portfolio positioning, we reduced our positions in companies with high overseas exposure, as we expect weak global trade, China concerns and the continued strength of the yen to punish exporters.

We trimmed both **SMC Corp** (Industrials) and **Daikin Industries** (Industrials) earlier this year when the yen was undervalued, on the view that its record high margins and valuation multiples would face increasing downside risks due to continued weakness in global trade.

Meanwhile, we added to well-run, domestic companies that we think should deliver consistent cash flow growth and market share gains, such as **Tsuruha** (Consumer Staples), one of the leading drug store operators in Japan, **Daito Trust Construction** (Real Estate), a wealth planning consultant that provides a 'one-stop-shop' for property services from apartment construction to property management, **TechnoPro Holdings** (Industrials), which we will go into detail below, and **Tosho** (Consumer Discretionary), a fitness club and business hotel operator with a focused strategy, strong cost control and high business acumen.

We also added to companies with specific growth factors such as **Misumi Group** (Industrials), covered below, and **Ryohin Keikaku** (Consumer Discretionary), a minimalist lifestyle brand 'MUJI', which we covered in a previous update.

We still do not like and do not own any low-quality franchises that either lack pricing power or struggle with poor returns; examples of this are the mega banks, commodity and energy firms, or trading companies. On the other hand, we do own good quality consumer stocks such as specialty retailers, e-commerce businesses, confectionary brands and leading personal care companies.

Among our long-term investment themes, we own some factory automation companies, as we believe the double whammy of long-term demographic changes across the globe and the need to improve efficiency gains should benefit these companies.

We also own companies that tap into the growth trend of business process outsourcing, which helps businesses reduce fixed costs and provides flexibility to deal with changing demand in a tightening market.

High quality, low cost components drive sales

One of the key holdings in our portfolio is Misumi Group (Industrials), a global leader in the factory automation components business. The company produces a range of products that help to improve factory efficiencies and cut the costs of production.

We like Misumi's 'asset light' and 'made-to-order' production model, which yields relatively high margins. The company has a catalogue of more than 16 million components, but partners with small-scale component makers to outsource around 70% of its production. It also mass-produces semi-finished products in lower-cost countries such as China and Vietnam, which are subsequently customised in its domestic factories.

Misumi has gone overseas to diversify its customer base. From around 24% of sales five years ago, Misumi's overseas sales ratio is now around 46%. We think this expansion strategy could limit its potential for margin improvement in the near-term due to capital requirements. However, we think that Misumi's business model and its emphasis on high quality, low cost components and fast delivery time is attractive. We believe it should continue to benefit from the increasing demand for automation and have been adding on market weakness.

Improved fuel efficiency standards lifts demand

Nifco (Consumer Discretionary), is a new idea in the portfolio. Nifco manufactures plastic components for use in automotives. It has steadily grown its content per vehicle, as car manufacturers increase their usage of plastic to reduce weight and meet tighter fuel efficiency standards.

The barrier to entry for plastic manufacturers like Nifco is not the technology itself but is the close working relationship it has with its customers. Nifco's engineers sit in its customers' offices to identify solutions and propose new plastic products to replace metal parts.

Since Nifco is the ultimate owner of any new product designs (which are protected by patent), the company becomes the sole supplier of these jointly-designed products. We like that it is able to sell these products on to other customers, thus achieving cost savings and economies of scale.

The valuation is attractive, but is by no means cheap. Similar to most other global industrial companies, Nifco is sitting on record high margins and profit levels. However, we think that its proposal-based business model, customised designs and the ability to continue growing its content share per vehicle, coupled with industry tailwinds should mean that the company would be relatively resilient in the event of a downturn.

TechnoPro boosted by R&D and IT spending

TechnoPro Holdings (Industrials) is an industry leader in the technology staffing and service market and a clear beneficiary of the outsourcing trend. Overall, the number of 'non-regular' employees in Japan, which includes part-time workers, temporary and contract employees, and dispatched workers (indirectly employed, via an agency), has been rising for several decades.

TechnoPro employs around 12,000 engineers in diverse technical fields such as machinery, electrics/electronics, software development and IT infrastructure. Demand has been strong due to increased spending in areas such as research and development (R&D) and IT. We like that TechnoPro invests in continual training to increase their engineers' technical expertise and provide more added value.

The dispatched worker market in Japan is highly fragmented, which is a potential growth driver for TechnoPro. Despite being one of the leading players in the sector, TechnoPro's market share is only in the low-teens. New legislation should lead to further consolidation in the market – acquisitions would allow TechnoPro to add to its staffing numbers as well as acquire technical expertise in areas where it has yet to grow.

The management are capable and shareholder-friendly and we like the openness of the company culture. Newly listed in 2014, TechnoPro currently trades at a discount to peers; we think the company is attractively valued considering the company's growth potential.

Another outsourcing model

Relo Holdings (Financials) provides comprehensive outsourcing services in the field of employee fringe benefits. Its main business areas include corporate housing management, residential property management, corporate fringe benefits and overseas business (such as relocation services).

Although the barriers to entry in this industry are relatively low, the difficulty lies in the execution, where Relo has strived for improvements. Relo aims to become a 'world-class relocation company' – its vision is to make the Relo name synonymous with relocation services and fringe benefit solutions and has set ambitious targets to achieve this.

The management are decent quality and we like the company's energetic culture, which we think will help Relo gain market share. We also like Relo's long-term relationships with its client companies, which has led to stable and recurring earnings. In the event of a downturn, we believe Relo should prove to be a resilient holding.

Performance review

The First State Japan Equity Fund has delivered decent returns since launch.

Both Misumi Group and TechnoPro are top ten holdings in the fund and were among the top contributors to performance over the six month period. **Nitori Holdings** (Consumer Discretionary) is another top ten holding in the portfolio. The company has produced strong sales growth and has kept up the pace of expansion by introducing new store formats while their competitors have struggled. Nitori has successfully managed to offset the negative impact of a weaker currency from the BoJ's expansionary policies; and has also delivered record high margins by launching innovative products.

Domestic companies executing well

Like Nitori, many of the top performing stocks in the portfolio are domestic-focused companies that have executed well, despite the weak external environment. **Tsuruha Holdings** (Consumer Staples) and **Sundrug** (Consumer Staples) are two of the largest drug store operators in Japan. Both companies have good quality management at the helm and continue to report strong growth as they consistently gain market share from alternative retail formats. We like their prudent management style, healthy balance sheets and decent financial track record.

Within the drug store sector, our strategy is to own national champions and industry consolidators such as Tsuruha Holdings, which has a good track record in M&A and post-merger integration; as well as regional dominators such as **Kusuri No Aoki** (Consumer Staples) in the north west of Japan, which adopts a differentiated business model and generates high returns. We added to Tsuruha and, in the summer of this year, we increased our position in Kusuri No Aoki when it was sold down to attractive levels amid the general market malaise.

Start Today (Consumer Discretionary), a fashion apparel e-commerce platform, also added to performance as it delivered robust transaction value growth and announced a record high number of new retailers on its platform. The company has forged ahead with customer engagement through an improved CRM system and promotional campaigns that have helped to boost the conversion rate (shopping cart items converted to actual purchases). It also raised its dividend payout to 40% and has been active in buying back shares to lift return-on-equity to 60%.

E-commerce penetration in Japan is low compared to other developed countries, but has been rising steadily. We think Start Today has ample room to grow given its dominance in the fashion wear market and the changing mind-set of Japanese consumers.

Individual stocks finding it tough

There were a few disappointments in the portfolio. Gulliver International, which changed its name in July to **IDOM Inc.** (Consumer Discretionary), is a used car distribution business. The stock fell significantly as it revised its earnings outlook downwards and slashed its dividend pay-out.

Casio Computer (Consumer Discretionary) fell on concerns around inbound tourist demand. However we believe the correction is overdone – tourism only accounts for around 2-3% of revenue – and think that the valuation now looks quite cheap at around 13x price-to-earnings. **NGK Spark Plug** (Consumer Discretionary), which makes plugs and sensors used in combustion engines, fell back due to yen strength.

Outlook

The Japan equity market has been highly volatile over the past year, partly due to ineffective central bank policies, a weak global economy and the strong currency. Arguably, Abenomics has not worked (so far), when we consider the anaemic wage and loan growth, the sliding inflation rate, and, particularly, the lack of progress on structural reforms.

The velocity of money in the economy has continued to decline, despite Japan's near-zero interest rate policy since 1999. The reason for this is weak demand rather than an issue with supply. Given the sluggish levels of global trade – a key driver of corporate profit – and the record high cash levels on Japanese balance sheets, we think it unlikely that Japan's corporations will want to borrow even if interest rates are at all-time lows.

On the other hand, ROE improvement is a positive, long-term structural trend. We continue to see clear evidence of companies changing their behaviour, as the focus shifts to margin improvement, capital management and shareholder returns.

Moreover, Japan is less sensitive to the yen than most people think – exports are just 18% of GDP. However, the Japan equity market has moved in lockstep with USD-JPY rate – and is likely to continue doing so in the near future, as foreign investors' trading activities account for more than 70% of the total market turnover.

In our view, not only do these windows of high volatility provide us with renewed opportunities to buy good companies at discounted valuations, but also, watching how companies perform during these periods can serve as a touchstone of franchise quality and management execution.

With a lacklustre outlook for the global economy and the view that the BoJ is reaching its limits in monetary easing, we see little possibility of yen depreciation or outperformance of the Japan market in the near term. That said, the fundamentals of select, quality companies have shown resilience and seem to have decoupled from the top-down macro. In our view, returns in the Japan equity market have been and will continue to be driven by individual stock selection.

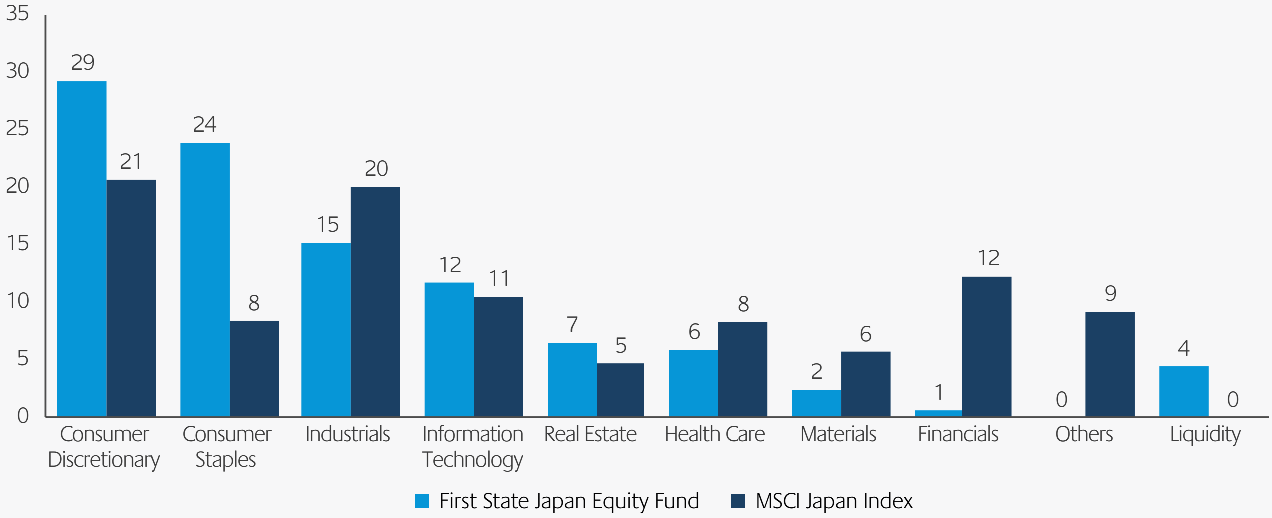
We have taken advantage of the current environment to top up on our high-conviction holdings. A return to fundamentals should mean that companies with good, long-term growth prospects and healthy balance sheets should once again prevail.

Top 10 holdings as at the end of September 2016

Company	Fund weight (%)	Index weight* (%)	Sector
Tsuruha Holdings	5.4	0.1	Consumer Staples
Ryohin Keikaku	5.2	0.2	Consumer Discretionary
Start Today	4.4	0.1	Consumer Discretionary
Daito Trust Construction	4.4	0.4	Real Estate
Misumi Group#	4.4	0.0	Industrials
Nitori Holdings	4.4	0.3	Consumer Discretionary
TechnoPro Holdings#	3.8	0.0	Industrials
Hoshizaki Electric	3.7	0.2	Industrials
Tosho Company#	3.4	0.0	Consumer Discretionary
Keyence Corporation	3.2	1.1	Information Technology

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

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



Source: First State Investments.