

Japan Equities

The Japan equity market underwent significant volatility in the first quarter due to the coronavirus pandemic and concerns about its impact on the global economy. The sell-off was indiscriminate and across all sectors, with little differentiation between the higher quality, well-managed companies that we own and their less attractive peers.

Although it was frustrating to see the widespread market carnage and the impact on our short-term performance, the panic-selling created an opportunity for us to add to our conviction stocks at attractive valuations. Since then, some of our holdings have subsequently rebounded (although it is too early to call an end to the coronavirus market panic).

After every crisis in Japan's history – including the Global Financial Crisis (GFC) in 2008 and the Tōhoku earthquake and tsunami in 2011 – the behaviours of consumers and corporations fundamentally changed. In light of the current global health crisis, we tried to envision any positive developments that might arise from the situation and sought to identify companies that could benefit.

For example, the percentage of workers equipped with remote-working capabilities in Japan is currently below 20%¹. We believe this will inevitably rise, leading to higher expenditure on technology-related goods and services. As we adapt to the new norms of social distancing measures and travel restrictions, the use of e-commerce, digital payments, telemedicine, cloud services, virtual and online entertainment, and online education platforms have accelerated – and are likely here to stay.

In the midst of such uncertainty, we believe our Japan portfolio is well-positioned. Our investment approach is inherently conservative and more than 80% of our portfolio companies have a secure net cash position. In a world awash in high levels of debt, we believe these companies should offer a reasonable amount of downside protection.

A large portion of the portfolio is invested in purely domestic companies with higher visibility with regards to demand. This includes drugstores and discount food retailers offering daily necessities, software and technology solutions providers operating a recurring revenue model, and online platforms in e-commerce and digital payments. We believe they should remain resilient in the event of a global recession.

Among our portfolio holdings with high overseas exposure, we have invested in leading Asian consumer franchises, global medical

equipment manufacturers, factory automation companies, and other technology leaders. They are all high-quality companies with dominant market share in their respective niche industries and reinforced by solid balance sheets.

Despite shorter-term disruptions, we remain confident that our portfolio companies can bounce back from adversity and become even stronger after the crisis.

Adding to high conviction companies

Earlier this year and in anticipation of a sharp slowdown, we evaluated our portfolio holdings, looking for companies that we believe should remain relatively defensive. We took advantage of the market volatility to consolidate the portfolio into higher conviction ideas and purchase companies on our watch list that had become more reasonably valued.

Among the companies we added to were Japan's largest drugstore operator and largest maintenance, repair and operations (MRO) e-commerce platform. Both companies proved to be highly defensive and benefited from increased demand for hygiene and healthcare products amid coronavirus concerns. Notwithstanding the temporary sales boost, we believe the long-term investment case for both companies – as the leading players in their respective industries – remains intact.

The drugstore operator's business model is bearing fruit and its performance is starting to diverge from competitors. It offers one-stop solutions for consumers, with a particular focus on dispensary/pharmacy services (a sizeable market worth JPY7.5 trillion²). While its drugstore peers dismissed the idea of dispensing prescriptions due to high initial costs, this drugstore made upfront investments and has become one of the largest dispensaries in the country.

Although this drugstore's market share of the prescription drug market by revenue is still 2%, it has only recently started to benefit from the change in consumer behaviour and the increased use of dispensaries near their homes. This trend is in accordance with government policies to promote the use of community-based healthcare (as opposed to hospitals and clinics); therefore, we believe there is still room to grow. Around 7% of the JPY6.5 trillion³ drugstore market is prescription sales,

¹ Source: Ministry of Internal Affairs and Communications (MIC): *2018 Communications Usage Trend Survey (Company Edition)*

² Source: Ministry of Health, Labour and Welfare: *2018 Trends in Dispensing Medical Expenses*

³ Source: Ministry of Economy, Trade and Industry: *Preliminary Report on the Current Survey of Commerce, March 2020*



of which this drugstore already takes a 31% share. We believe this drugstore should continue to gain share in a consolidating market, due to its strong brand and established infrastructure.

We believe there is still a long runway of growth ahead for the MRO platform, as it continues to gain market share in the fragmented MRO industry. Compared to 30% e-commerce penetration in the overall business-to-business (B2B) market, e-commerce penetration in the MRO segment is only 10%⁴. We believe the pandemic will likely accelerate the shift towards online purchases, particularly when factoring in economies of scale and the benefit of lower procurement costs. Amazon has proven to be less of a competitive threat than previously anticipated, as the MRO platform holds a stronger presence in the B2B sector.

We also topped up our position in Japan's largest enterprise resource planning (ERP) systems provider, which we wrote about in detail in a previous note. This provider has been resilient in the current market environment and has performed steadily in previous downturns. Operating profit has grown consistently for the last 22 years, including the GFC and the Tōhoku earthquake periods.

Recurring revenue businesses have continued to grow, with cloud services and on-premises support accounting for 39% of sales and 48% of operating profit. With more people working from home, we expect cloud-based services to become an increasingly larger business.

Similarly, we took advantage of market weakness to add to a company that provides membership benefits (such as travel management and healthcare) to corporate clients. The majority of revenue is recurring and has grown by around 11% a year for the last five years.

Despite the short-term sell-off, we believe the longer-term investment case remains solid and the company could become much bigger in five years' time. While Japanese companies and government entities have traditionally provided welfare services for their employees in-house, this benefits company has become a major outsourced supplier of value-add services to the employee, while also saving costs for the employer. In addition to fringe benefits, the CEO has communicated his vision for newer platform businesses, such as payment settlements and healthcare.

We also added to the largest online payment processing company in Japan. As a growth-oriented company focused on sustainable growth over the medium to long term, the management are committed to delivering 25% compounded annual profit growth over the next five years.

One of the key risks for this company is if its biggest clients start to process payments in-house after reaching a certain scale. This was the main reason behind the revenue slowdown in 2019, as some of its customers shifted the services previously provided by this payments company to an internal division.

However, we believe there is still plenty of room to grow, as e-commerce penetration in Japan is only 7% of retail sales. With more offline retailers and consumer brand companies launching e-commerce portals, we believe this company is well-positioned to capture the market, due to its extensive experience and track record in the payments industry.

The emergence of cashless payment transactions could be another growth driver. Japan's cashless payment penetration is relatively low at 18%⁵ compared to countries such as South Korea (95%), the UK (67%) and the US (44%). Recent policies, such as merchant subsidies and consumer rewards programs (which have been primary catalysts in other nations), are expected to accelerate the pace of transition. This could open doors to larger addressable markets, such as the offline cashless payment (JPY300 trillion) and the public tax/utilities market (JPY100 trillion).

New positions

As bottom-up investors, we do not rely on benchmark indices or sectors to construct portfolios. Investment ideas are generated by meetings with company management, followed by detailed fundamental research and analysis on companies we might want to invest in. The recent market volatility allowed us to buy high quality stocks on our watch list that we had followed for some time, but were too expensively valued in the past.

Among the new positions was a leading manufacturer of lenses and related optical products. Having observed its performance over time, we increasingly appreciated its corporate philosophy of being a *"big fish in a small pond"* and its strong focus on corporate governance and shareholder returns. Unusual in a Japan context, this company has a strong profit-centric culture and its track record has been consistently good.

Over the past 10 years, total shareholder return was 78% of free cash flow after acquisitions (it is company policy to return all excess free cash flow to shareholders after budgeting for capital expenditures and acquisitions), or 73% as a proportion of net income. On top of that, there is JPY290 billion net cash on its balance sheet (or 9% of market cap). The board believes this is too high, which means we should probably expect to see share buybacks in future.

⁴ Source: Ministry of Economy, Trade and Industry: *2018 Infrastructure Development for a Data-Driven Society in Japan (Market Research on Electronic Commerce)*

⁵ Source: Company presentations, February 2020



The business can be categorised into two major divisions: Life Care and Information Technology (IT). In the IT segment, which focuses on glass-related products used in the technology manufacturing process, this company has developed a near monopoly in certain materials, such as Extreme Ultraviolet (EUV) mask blanks used in the production of semiconductors, and glass substrates used in Hard Disk Drives (HDD).

Around 40-50% operating profit margin (OPM) is generated on these products, as there is virtually no competition. As semiconductor leaders such as Taiwan Semiconductor (TSMC) and Samsung start to migrate their chip production to more advanced and smaller nodes, we believe that average selling prices (ASPs) for this company's EUV products should rise. The capacity of both products is expected to double over the next few years.

We also purchased the largest medical equipment company in Japan with 70% global market share in gastrointestinal endoscopes⁶. Despite its strong franchise, we have been concerned in the past with its complacent culture and low profitability. However, we believe there are positive changes underway: the majority of its senior leadership team has been replaced with externally-hired managers, which should bring fresh new perspectives, as well as the ability to make drastic changes where it is needed.

The executive management team now consists of five key people in CxO⁷ leadership positions, thus streamlining the decision-making process. In addition, the core Medical business has been restructured and simplified from five divisions into two, with Endoscopic Solutions managed from Japan and Therapeutic Solutions to be managed from the US.

After the reorganisation, the corporate strategy has refocused on strengthening the company's leadership in gastrointestinal endoscopes. It is investing in China, where the overall penetration of gastrointestinal endoscopy is low, by increasing its training programs to resolve the bottleneck of insufficiently qualified doctors (China has only 22 endoscopists per million people, compared to 250 per million in Japan⁸). Chinese government policies to promote endoscopic diagnosis support its penetration into mid-tier hospitals, which should increase demand for this company's products exponentially.

In addition, the company has committed to controlling costs in order to improve margins and profitability. The majority of consolidated profit comes from its Endoscopic Solutions segment, which generates around 29% OPM. However, consolidated OPM is only 9% - much lower than global peers (Medtronic, Stryker and Johnson & Johnson all generate OPM above 20%).

The company aims to improve its OPM to 20% by fiscal year (FY) 2023. We continue to monitor the progress, as we believe that there could be considerable upside if its transformation plan is executed well. While it is early days and there is still much to be done, we believe the direction of travel is encouraging. The position is a relatively modest one, though we have been adding on weakness.

What we sold and lessons learned

We sold a number of companies pursuing lower quality growth to make room in the portfolio for the companies mentioned above. These companies had made overseas acquisitions which, in our view, diluted earnings and distracted management from the main local business.

The first is a leading corporate services company, providing leased housing, global relocation services and fringe benefits. We initially bought this company for its recurring revenue model, which offers stable earnings growth and downside protection during economic downturns, as demonstrated during the GFC.

However, we started to question the investment case amid signs that the company had bigger ambitions for its global relocation services. In particular, a large overseas acquisition in 2019 of a global relocation business caught our eye. The purchase price was expensive at 139x price-to-earnings ratio (PER) and it led to a spike in financial leverage. Like many Japanese companies who remain passive investors of their overseas purchases, this company's culture did not seem globally-savvy enough to transform the acquired business.

As such, we had been reducing our position since last year. As the coronavirus started to spread, our portfolio review led us to completely sell out of the position as we considered the impact of a recession on its global relocation business – and, given that better-quality companies could be purchased at bargain prices amid the market sell-off.

Similarly, the second company's overseas acquisitions have been a major concern on profitability. We initially believed that this company, which primarily dispatches engineers in Japan (88% of operating profit), should benefit from increasing labour shortages in this particular sector.

In hindsight, we should have exited this position when we noticed this company's longer-term ambitions on making overseas acquisitions. Instead, we held on to it because of its cheap relative valuation, even though we increasingly had concerns about the quality of its business. Similar to the first company, Covid-19 aggravated the risks of this company's overseas exposure (an auto

⁶ Source: Company presentations, November 2019

⁷ C-level corporate executives

⁸ Source: Company presentations, November 2019



manufacturing business in the UK) and its manufacturing staff dispatching business, both of which are macro-sensitive.

Among engineering dispatch companies, we have greater conviction in an alternative company, which has a longer-term mindset (the company trains its engineers in more advanced skills) and higher exposure to IT engineers (50% in headcount terms, compared to this company's 20% mix), where demand has been resilient and growing rapidly.

Both of these disposals seemed to be cheaper than peers, which initially gave us comfort as lower valuations provide a greater 'margin of safety'. However, as we subsequently realised, optically-cheap companies do not necessarily protect capital.

Most investors look at companies in a much too simplistic way: growth vs value. However, in reality, all investors should be looking for value; that is, to buy companies where the market value is below intrinsic value. But, a lower price-to-earnings ratio (PER) or price-to-book (P/B) valuation, based on 12-month earnings or book value, does not mean that a company is cheap, nor that there is more value to realise compared to companies at a higher PER or P/B. The issue with these ratios is that they cannot capture a company's long-term profit/cash flow growth, nor its resilience during economic recessions.

We look at valuations from a more holistic perspective and believe that quality companies can justifiably command a premium – particularly those that have these three qualities concurrently: 1) high return on invested capital; 2) strong and sustainable growth; and 3) high earnings visibility, supported by a strong franchise and management team.

Our portfolio holdings generate 37% weighted average ROIC, indicating that these companies have higher profits that can either be reinvested for long-term growth or be returned to shareholders. We also believe companies with a high-calibre franchise or management team warrant a lower discount rate (cost of capital) because earnings visibility is higher. As such, the best-performing companies in the current down-market have typically had higher valuations relative to the market – which is what we have experienced in our Japan portfolio.

Interestingly, for some of our high-conviction holdings, it is difficult to pinpoint a single numerical value based on today's business. These companies evolve over time, as the management invent new business lines to grow earnings. For example, we own a company that started by offering pharmaceutical marketing services (information on drugs that is emailed to doctors). However, 20 years later, its services include contract research, job placement and medical records software. The pharmaceutical marketing segment now accounts for only 16% of consolidated sales.

As part of our investment approach, we are disciplined in conducting regular fair market valuation reviews; however,

our conviction in a company's franchise, management and sustainability of growth plays an equally important role in our holistic investment decision-making process.

Performance review

The top contributors to performance year-to-date are the same companies that we had added to during the sell-off – though they were sold off along with the market, they subsequently rebounded, as investors realised there should be little negative fallout from the coronavirus. Out of the companies that performed poorly, we sold the engineering dispatch company, as mentioned earlier, but we remain long-term owners of the rest and have been adding on weakness.

Two of the companies that detracted from performance specialise in selling quality, affordable clothing. They were highly defensive during previous economic recessions as their stores attracted price-conscious customers. However, Covid-19 has particularly affected discretionary retailers due to a weaker consumer appetite and widespread store closures. Even so, while these short-term disruptions undoubtedly affect earnings, they are temporary in nature and, in our view, do not affect the long-term investment case.

We believe the first brand should continue to strengthen, as affordable, functional apparel continues to grow in popularity among deflationary-minded Japanese consumers. The second company, led by a passionate and visionary founder, has a strong franchise supported by solid brand equity and a decent growth outlook both domestically and overseas. Both companies generate the highest ROIC among industry peers – 34% and 38% respectively, indicating a strong foundation for sustainable growth.

Despite being recruitment-related businesses, the next two detractors from performance proved to be resilient in previous economic downturns relative to competitors. The first business only hires nurses and careworkers – roles that enjoy strong demand irrespective of the economic cycle, due to Japan's ageing population and labour shortages in the care sector.

The second company is not only a recruitment company, it also runs various online media portals – the equivalent of Yelp (online local business reviews) and Expedia (online travel agency) in Japan. The marketing media business accounts for 38% of earnings before interest, tax, depreciation and amortisation (EBITDA), online job advertising and recruitment accounts for another 38%, and the general staffing business is around 24%.

Due to Covid-19, most job interviews have been delayed or cancelled – companies do not want to host face-to-face meetings and they have been reluctant to shift the process completely online. In addition, restaurants and the travel industry were hard hit, which affected this company's business as well.



However, both companies are leading franchises operated by capable management. We believe the first company will likely remain a key beneficiary of structural labour shortages in the niche care sector; and the second company's asset-light model, entrepreneurial culture and track record of achieving a leading market share in its domain bodes well for future growth. As consolidation in each industry accelerates due to Covid-19, we believe stronger companies such as these should increase their leadership over peers.

Last words

In the throes of a downturn, pessimism is abound, which is understandable and expected. But the Chinese word for "crisis" (危机), which consists of two letters with opposite meanings – danger and opportunity – suggests that we should look at the status quo from another perspective. Likewise, great investors in history exploited market volatility in a downturn, which ultimately generated superior returns.

We have two observations on the companies that have been resilient (so far) during Covid-19. The first type are those that have already built a dominant franchise and are best positioned in a Darwinian world, where survival of the fittest is the name of the game. The other type are those leading the disruption in their respective industries, either by innovating or helping others adopt better business processes. Regardless of the type, capable management, whether charismatic or visionary, is indispensable to creating successful companies.

It is the darkest nights that produce the brightest stars; and our findings remind us that our investment philosophy of focusing on high-quality companies with strong franchises, financials and management is for the benefit of long-term returns and in the best interest of our clients, especially during times of turmoil. As we stay true to our colours, we will continue to invest in companies that we believe can spot and grasp opportunities in the midst of a crisis.

Important Information

This material is solely for the attention of institutional, professional, qualified or sophisticated investors and distributors who qualify as qualified purchasers under the Investment Company Act of 1940 and as accredited investors under Rule 501 of SEC Regulation D under the US Securities Act of 1933. It is not to be distributed to the general public, private customers or retail investors in any jurisdiction whatsoever.

This presentation is issued by First State Investments (US) LLC ("FSI" or "First State Investments") a member of MUFG, a global financial group. The information included within this presentation is furnished on a confidential basis and should not be copied, reproduced or redistributed without the prior written consent of FSI or any of its affiliates.

First State Investments funds are not registered for sale in the US and this document is not an offer for sale of funds to US persons (as such term is used in Regulation S promulgated under the 1933 Act). Fund-specific information has been provided to illustrate First State Investments' expertise in the strategy. Differences between fund-specific constraints or fees and those of a similarly managed mandate would affect performance results. This material is provided for information purposes only and does not constitute a recommendation, a solicitation, an offer, an advice or an invitation to purchase or sell any fund and should in no case be interpreted as such.

Any investment with First State Investments should form part of a diversified portfolio and be considered a long term investment. Prospective investors should be aware that returns over the short term may not match potential long term returns. Investors should always seek independent financial advice before making any investment decision. The value of an investment and any income from it may go down as well as up. An investor may not get back the amount invested and past performance information is not a guide to future performance, which is not guaranteed.

Certain statements, estimates, and projections in this document may be forward-looking statements. These forward-looking statements are based upon First State Investments' current assumptions and beliefs, in light of currently available information, but involve known and unknown risks and uncertainties. Actual actions or results may differ materially from those discussed. Actual returns can be affected by many factors, including, but not limited to, inaccurate assumptions, known or unknown risks and uncertainties and other factors that may cause actual results, performance, or achievements to be materially different. Readers are cautioned not to place undue reliance on these forward-looking statements. There is no certainty that current conditions will last, and First State Investments undertakes no obligation to publicly update any forward-looking statement.

PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE PERFORMANCE.

Reference to the names of each company mentioned in this communication is merely for explaining the investment strategy, and should not be construed as investment advice or investment recommendation of those companies. Companies mentioned herein may or may not form part of the holdings of FSI.

The comparative benchmarks or indices referred to herein are for illustrative and comparison purposes only, may not be available for direct investment, are unmanaged, assume reinvestment of income, and have limitations when used for comparison or other purposes because they may have volatility, credit, or other material characteristics (such as number and types of securities) that are different from the funds managed by First State Investments.

Apart from First State Investments, neither the MUFG ("the Group") nor any of its subsidiaries are responsible for any statement or information contained in this document. Neither the Group nor any of its subsidiaries guarantee the performance of any fund or the repayment of capital by any fund. Investments in a fund are not deposits or other liabilities of the Group or its subsidiaries, and the fund is subject to investment risk, including loss of income and capital invested.

For more information please visit www.firststateinvestments.com. Telephone calls with FSI may be recorded.