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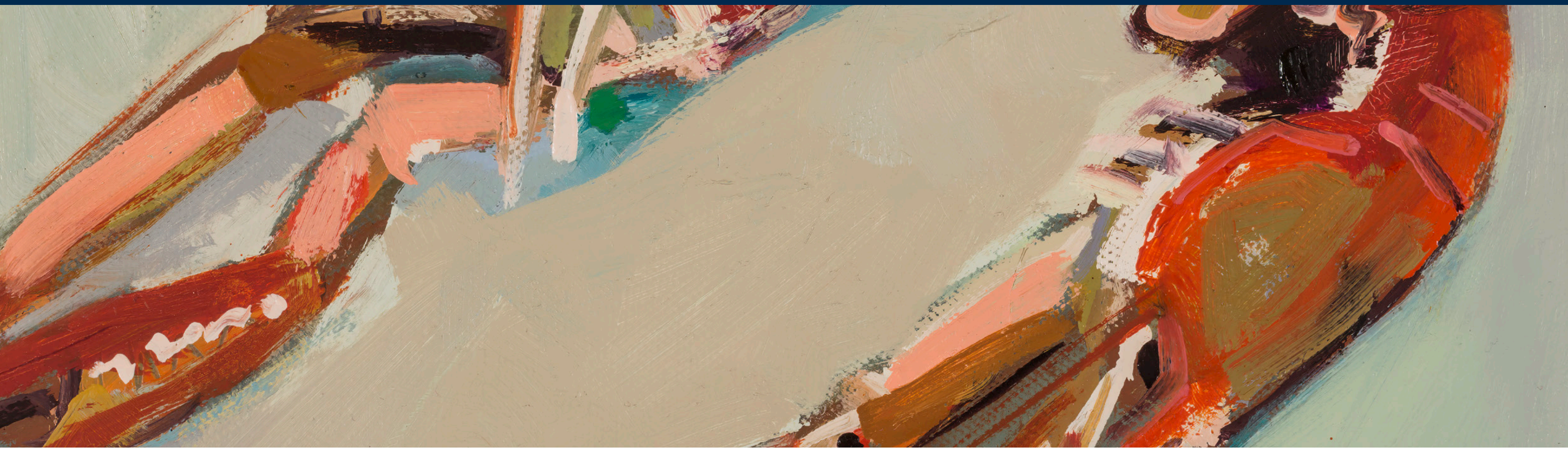

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"GANBATTE KUDASAI!"

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"*Ganbatte kudasai!*" is a commonly used exhortation in Japan to do one's best, hoping that success will be achieved in the face of adversity. This is perhaps an apt expression as the country grapples with Covid-19 flare ups just a few weeks before the Olympics, never mind the long-term challenges presented by the well-catalogued structural issues facing the economy. In this article, Investment Manager Alistair Ceurvorst and Investment Analyst Gareth Evans look beyond the headlines and discuss how enterprise and innovation can be found whatever the seeming economic and demographic hurdles.

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Since his appointment as Japan's prime minister some nine months ago, Yoshihide Suga has continued to pursue the broad range of reform and stimulus policies enacted by his predecessor's administration in 2012, popularly and collectively known as 'Abenomics'. The efficacy of Abe-san's 'Three Arrows' reform programme has long been debated, but the Bank of Japan's quantitative easing policy, representing the first arrow in the quiver, has remained a policy constant throughout. As elsewhere in the world, aggressive monetary stimulus has been helping to paper the cracks in some fundamentally stressed businesses in Japan and has helped to underpin equity prices.

The second arrow related to efforts to promote growth through massive fiscal stimulus, although consumption tax hikes in 2014 and 2019 partially undid some of the benefits of the government's munificence. Although Japan has been much scorned for the burgeoning accumulation of debt and the persistence of budget deficits that such fiscal profligacy entailed, it is ironic that the pandemic has forced many other developed countries to readily adopt the same playbook.

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In many ways, these particular arrows have not hit their mark. Since its invocation, and despite periodic bouts of economic vigour, Abenomics has not provided the sustained shot-in-the-arm that was the intention of its creator. 'Japanification' has become a cruel byword for a moribund environment typified by zero-percentage interest rates, low/negative inflation, insipid growth and towering public debt. The nation's challenging demographics, for one, have played their part in stifling broad economic potential. Amidst this, new-boy Suga-san has made some bold moves, although the devil-in-the-detail has been left out of the country's plan to reduce carbon emissions by 46%; 2013 being the nominal starting point.

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Yet it is a tribute to Japanese incrementalism that, in the corporate sphere, the third arrow – that of reform – is gradually taking hold. The historical and cultural function of Japanese enterprises has led to a balance between stakeholder and shareholder rights that has often over-favoured the former. The government has been pushing corporate reform however, encouraging companies to focus on shareholder rights, governance and improving returns, while exhorting domestic investors to be more engaged in the relationship with investee companies. The latter is something about which we at Walter Scott have never required much prompting.

In March, we saw such 'engagement' as shareholders voted for an independent inquiry into voting irregularities at the Toshiba AGM. This was the first time that this had happened at such a major company. In early April, private equity company CVC launched a privatisation bid for Toshiba, and while this seems to have been parked in the sidings for now, press comment suggests other bids may be circling.

Last year we wrote about the relative success of Japan in handling the pandemic, but a resurgence in infection rates has somewhat tainted the country's Covid-19 credentials. At the time of writing, the already delayed Olympics could see a further postponement. Recent data has reflected the insipid near-term outlook for the domestic economy, although recovery is expected to take a firmer hold later in the year. Business confidence has been resilient nonetheless, as evidenced by the improving 'Tankan' (a quarterly economic survey) numbers, particularly amongst larger corporations. A rosier global outlook and strong growth in China continue to enliven the prospects for the country's exporters.

So it was against this backdrop that two of our Research team members recently visited Japan, or at least 'virtually', in the same way that we conducted our research trip to Taiwan last year – a week largely dedicated to 'e-meeting' companies across a spectrum of industries.

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One of our areas of investigation was the not-unrelated topic of digitalisation trends in Japan. It is ironic that a country which makes many products that are enabling our lives to go ever-more digital is lagging in this regard. It is a society where face-to-face interaction and the use of hard-copy paper (and cash!) have been deeply enmeshed in its culture. Japan Inc has

however been increasingly embracing the strategic and commercial merits of digital capability across a variety of spheres. Arguably, the spirit of kaizen, continuous improvement, is being brought from the factory floor to the office. If difficult demographic circumstances were not enough to prompt greater investment in this area, the pandemic has accelerated the digitalisation process, and the 'trip' provided us an opportunity to meet with a number of companies in associated fields ranging from internet infrastructure to healthcare databases, which we will continue to assess.

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A key message that is perennially reinforced by such visits is that enterprise and innovation can be found in any country, irrespective of economic travails. Honed by tough domestic markets and intense international competition, Japan remains home to a variety of world-class businesses.

We 'e-visited' one of the world's leading supplier of sensors and measuring instruments which are mainly used in factory automation. The company is effectively 'fabless', focusing on design and sales, with manufacturing almost entirely sub-contracted, selling directly to users with solutions often customised to specific requirements. In bypassing several layers of distribution, it has captured the most profitable element of the industry, thereby retaining a healthy profit margin. In addition, with about 25% of sales classified as new or unique products, the company has a very high degree of control over its pricing.

Since 1988 up until the fiscal year ending March 2020, the company's sales and net earnings had compounded annually at close to 15% per annum, although the business has been inevitably impacted by the pandemic. However, just-released fourth-quarter results, for the year ending March 2021, saw revenues and earnings before interest and tax rise 15% and 24% respectively year on year, representing a strong acceleration from what was an already improving previous quarter. In our meeting, management noted that the backdrop for capex investment had improved markedly. This is in line with the encouraging outlook given by several other factory automation (FA)-related companies. This exceedingly cash-rich business retains a very significant opportunity to grow its business, both in Japan and in overseas markets, and with that will come exceptional levels of internal wealth creation, in our view.

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Although not 'visited' on this trip, having spoken with the company a couple of months ago, a major factory automation and robotics business recently announced fourth-quarter results that reflected these improving FA trends. Revenues comfortably exceeded management's conservative prior revenue growth guidance. The company's core FA and robot divisions are performing well, with the latter propelled by increasing adoption in electric vehicle manufacture. The outlook for this fiscal year calls for 20% and 28% year-on-year growth in revenues and earnings respectively, although the current exceptional buoyancy in the robodrill market, with these products mainly employed in the manufacture of smartphone casings, could fade at some stage.

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One of the world's leading electronics components manufacturers struck a confident tone, with management expressing optimism over current portfolio positioning. The company has global market shares ranging from 30% to over 95% in ceramic capacitors, various electronic filters and connectivity modules. The results for the nine-month period ending in December 2020 saw operating profit post a robust 19% gain despite the Covid-stricken environment. The company remains bullish on the prospects for multi-layer ceramic capacitor (MLCC) demand particularly from increased automobile-related content and 5G smartphones. The double-digit growth in MLCCs, as forecast in the mid-term plan (2022-2024) last November, derives from expectations that even if unit volumes for vehicles are not growing strongly, the per unit component content will continue to be strong, with growth deriving from developments in car entertainment, drive trains and advanced driver-assistance systems.

As 5G is increasingly rolled out, the sophistication of componentry entailed in its proliferation will be a growth opportunity for the business. It is expected that higher manufacturing utilisation rates should benefit margins, while capital expenditure should return to more ‘normal’ levels following a two-year period of hefty investment. This is a cyclical business, but it has had a track record of delivering strong returns over the long term.

Earlier this year, a well-known Japanese air conditioning company announced third-quarter results that, true to recent form, came in ahead of expectations, with guidance for fiscal year ending March 2021 being raised. Earnings before interest and tax was up a consensus-beating 24% year on year as a result of strong cost control. As has been the story of late, the strength in residential air-conditioning units, driven by consumer concern over air quality and the trend toward working from home, offset weakness in the commercial sector. Our ‘e-meeting’ was encouraging in that management expect a recovery in industrial and commercial demand as the pandemic-blighted service sector in particular starts to recover. The key long-term drivers remain. Growing populations, urbanisation, industrialisation, rising living standards, and the shift towards air conditioners being regarded as an aspirational yet near-necessary product in many locations, remain powerful drivers of the air conditioning industry. With its focus on developing highly energy efficient and environmentally friendly systems, the company remains superbly placed to benefit from these trends.

In the decades we’ve been investing in Japan, our perspective on investment opportunities has not been limited by the economic and structural challenges the country continues to face. Macroeconomic torpor does not translate into lack of corporate vigour. We invest in companies, not stock markets. For us, Japan remains an excellent hunting ground for many market-leading companies that are leveraging on, or indeed driving, long-term trends that will generate strong returns for their businesses for many years to come.

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