JAPAN – FOCUSING ON FUNDAMENTALS

FIRST PUBLISHED SEPTEMBER 2024

In this article, Executive Director Charlie Macquaker discusses recent events in Japan, and highlights the importance of looking beyond the 'macro' and focusing on company fundamentals.

For many investors, the bullish narrative for Japanese equities over the last few years has hinged on hopes of a liberation from deflation, an improvement in the country's competitiveness thanks to a weak yen, and the promotion of better corporate governance. This optimistic perspective has, in reality, proved more complex than billed. Inflation has risen, but it has raised import costs for businesses and squeezed personal spending. The latter has contributed to bouts of economic anaemia, which have been compounded by a stodgy demand environment in some of the country's trading partners such as China. In the pursuit of monetary policy normalisation, the Bank of Japan has raised interest rates,

CHARLIE MACQUAKER
Executive Director – Investment

resulting in the recent yen strength that sent the market into a short-lived tailspin. This may temper the extent and pace of further interest rate hikes, especially as inflation is expected to slow and the central bank is forecasting insipid growth.

CHASING REFLATION

Despite the tepid economic backdrop, the market has chased domestic reflation themes including banks, and trading houses over the last couple of years. Banks have been sought after on the prospect of higher rates, but in view of earnings inconsistency and balance sheet opacity and their inherent use of leverage, few banks anywhere have met our investment criteria. Although trading houses have enjoyed a period of solid earnings growth, this has largely been driven by volatile commodity prices. This is unsustainable in our view and therefore future returns may not reflect those seen over the past few years. Reflective of these trends, and due to valuation compression experienced by growth stocks in 2022, over the last three years, the MSCI Japan Value Index has risen 31%, while the MSCI Japan Growth Index has fallen 6%[1].

Throughout the history of Walter Scott, our optimism on Japanese equity opportunities has never been founded on macro rejuvenation. Rather, it has been based on the fundamental merits of individual, leading companies in areas such as technology, med-tech and factory automation where we see excellent long-term growth trends. However, some of these companies have endured headwinds at the operating and equity market level in recent times. This is due to downturns in capital investment cycles, and broad concerns about China exposure.

HEADWINDS AND GREEN SHOOTS

However, based on what we are hearing from such businesses, we are seeing some signs of recovery. SMC is a leader in motion automation technology, focused on pneumatic equipment such as valves, actuators, and flow control equipment. Pneumatics contributes to automation in every industry as the technology is relatively inexpensive, compact, and environmentally friendly. SMC's products move objects around in a wide range of industrial processes, from automobile and semiconductor manufacturing to food processing. This remains a growth market, but the company has been affected by muted capital investment by its customers, given the weak industrial environment.

However, overall orders rose 7% in the latest quarter, due to strength in semiconductor, electronic and medical industry-related areas with China leading the charge. Looking beyond current headwinds, SMC remains a beneficiary of the adoption of automation across multiple industries due to increasing labour costs, an ageing labour force and growing demand for production consistency.

Air-conditioning company Daikin has had to navigate choppier waters of late, following a year which had seen the company produce record profits. The company has noted weakness in the European heat pump and US residential markets, although a new factory in Mexico is enabling the company to raise production capacity and increase sales into manufacturing and data centres. China is 12% of Daikin's sales, and a focus of investors has been the company's fortunes in the country in the face of the travails of its property market. However, operating profit has remained high in China thanks to sales growth in higher value-added products and cost reduction efforts.

THE WORLD NEEDS COOLING

The key long-term positive for Daikin is its positioning in a market laden with growth opportunities. The demand for cooling in a warming world, and to provide it in a greener way, plays to the company's strengths given Daikin's focus on developing highly energy-efficient and more environmentally friendly systems. While the global air-conditioning market is expected to grow at a compound annual rate of 7% from 2023 to 2030, there are also opportunities in the developing world, as shown by Daikin's 44% increase in sales in India in the first quarter.

Robo-giant Fanuc's first-quarter results saw a recovery in order trends after six quarters of negative growth, with the turnaround primarily led by a strong rebound in Chinese demand. Management increased guidance for the current year, and in our view, the results may represent a turning point in Fanuc's orders and earnings cycle. Fanuc continues to be exceptionally well positioned to capture value from the expanding global automation market.

Shin-Etsu Chemical, a leading chemicals and materials company, has been seeing something of a growth hiatus following a period of very strong profit expansion. However, the company has noted improvements in a few key areas. The important PVC market, where US housing is the largest source of demand, appears to be bottoming out, benefiting from previous price hikes as well as an upturn in the domestic market. Meanwhile, semiconductor wafers and production materials provided the biggest positive, with both recovering strongly. While the company is exposed to industry cycles, it benefits from a diverse portfolio of world-class businesses which collectively generate good long-term returns. Shin-Etsu also enjoys a robust balance sheet which allows the company to invest through the cycle in capacity expansion, strategic acquisitions, and new technologies in the pursuit of long-term growth.

Despite the challenges of a low-growth domestic environment, sensor maker Keyence has grown operating profits at an annualised 14% over the last ten years. The company has successfully expanded overseas, which accounts for more than 60% of total sales. In the process, Keyence has managed to keep gross and operating margins above 80% and 50% respectively. This has been achieved through its innovative, customer-focused approach to sales and 'fabless' (outsourced) production. Though innovative in its business, with the proliferation of automation, deep learning, 3-D vision, automotive and the Internet of Things driving long-term growth, it remains deeply conservative in its financial management. Its rock solid balance sheet protects the business during economic downturns and allows it to maintain investments through periods of weakness.

SELECTIVELY BULLISH

We don't look at Japan through the prism of themes and economic wish lists. With a focus resolutely on company fundamentals, we view it as a home to an array of quality growth companies – leaders in their fields that can compete and prosper on a global stage. Some of these businesses have had to navigate lengthy periods of earnings volatility. However, thanks to their financial strength, an ability to innovate, excellent management and market-leading positions, they remain well positioned to take advantage of long-term growth trends. In our view, their fundamental and competitive strengths should be recognised in returns to investors over time.

---

[1]Walter Scott, Factset, MSCI data 31 August 2021 to 27 August 2024

WALTER SCOTT & PARTNERS LIMITED, ONE CHARLOTTE SQUARE, EDINBURGH EH2 4DR
TEL: +44 (0)131 225 1357 · FAX: +44 (0)131 225 7997
WWW.WALTERSCOTT.COM

1.0_COM001985_24/09/2024