FSSA Investment Managers

Client Update

Maintaining conviction on Japan equities

April 2022

The performance of the FSSA Japan Equity strategy has been under pressure year-to-date, driven by a violent style and sector rotation from quality growth to financials and cyclical companies. We have experienced similar rotations in the past and each time it was triggered by the same thing – sharply rising expectations of US interest rate hikes leading to a sell-off by foreign investors. However, the macro environment in Japan remains fundamentally different from the US and we believe the market concern is unwarranted. Economic growth has been anaemic and inflation is being driven largely by the cost-push from rising commodities prices, rather than improved wage growth and increased demand. The Bank of Japan (BOJ) has reiterated its accommodative monetary policy as it is more concerned with economic growth and the uncertainties related to geopolitical risks rather than inflation.

When factor analysis is the cause of market volatility, as we have seen recently, business fundamentals are disregarded and optically-high valuation, high-growth companies are often sold off arbitrarily. Over the first quarter, our Japan portfolios declined across the board, led by large holdings such as Recruit Holdings, GMO Payment Gateway and Benefit One – companies in which we have been invested for many years. Nonetheless, we continue to believe that the fundamentals of these businesses remain sound and the recent market correction has provided us with an attractive entry point to add to our existing holdings.

Looking through to the fundamentals

Thanks to the strong support from our existing client base, we have been able to take advantage of lower valuations in the Japan market to add to our high-conviction holdings. In particular, we have added to small- to mid-cap companies with purely domestic exposure and a defensive earnings outlook.

For example, Benefit One's share price corrected significantly in the past three months, and it is now trading at a level from before its announcement that it was acquiring a large competitor. As a leading corporate fringe benefits service provider, Benefit One generates high returns on capital employed (ROCE) based on its highly scalable business model. The acquisition of JTB Benefit Service, the third largest fringe benefits player in Japan, is expected to solidify Benefit One's dominant market position and provide synergies with its new business pillars in healthcare and a digital human resources (HR) platform. As a result, Benefit One plans to upgrade its midterm plan after the announcement of its full-year financial results. It aspires to transform its business model in the next five years.

GMO Payment Gateway also declined as a result of the market rotation. We think its current share price weakness presents an opportune moment to top up our position. The company is the largest online payments service provider in Japan with 25-30% market share. It has an impeccable track record of delivering 25% compounded annual profit growth since listing and the CEO is highly confident that the company can sustain this trajectory in the next five years.

We also own Recruit Holdings, a leader in the global human resources (HR) industry. Recruit's main growth driver is its HR technology business, primarily through Indeed, the largest online career search engine in the world. The business demonstrated its resilience through the Covid recessionary period, as revenue was virtually flat in fiscal year (FY) 2021, while EBITDA margin[1] declined only slightly from 16.8% to 15.8%. Driven by labour shortages and strong pent-up demand, revenue subsequently more than doubled in the first half of FY2022 with 118% year-on-year growth. Though the number of job postings continues to trend strongly across regions, the market is concerned about the growth slow-down — but we believe that the correction is overdone.

Well positioned for the uncertainties ahead

Given the global outlook and inflationary pressure, we believe that the FSSA Japan Equity portfolio is well positioned for the uncertainties ahead. Around half of the portfolio is invested in software and commercial services-related companies that generate high gross margins and should face limited pressure on cost inflation. Additionally, most of them have high recurring revenues, which provides greater visibility on future earnings. The remainder of the portfolio is invested in global leaders that have dominant market share and few competitors. They possess strong pricing power and operational efficiency, which should defend against cost inflation as well as supply chain shortages. Based on our meetings with management teams over the past six months, we believe the business fundamentals of our portfolio holdings are intact. Additionally, some companies have expressed an intention to protect shareholder returns via potential share buybacks, supported by their strong balance sheets and cash flow generation.

Despite the market volatility, our investment process remains unchanged. We continue to look for companies that are run by highly capable and risk-aware management teams, possess superior pricing power, and are positioned in secular growth industries. We own high-quality businesses that can deliver sustainably-high ROCE and profit growth and are relatively uncorrelated to the macro environment. Considering these factors makes it easier to add to portfolio companies when they are sold off amid sector and style rotations — especially when there has been no change in their long-term fundamentals.

Meanwhile, our long-term investment philosophy provides us with the luxury of being able to ignore the short-term noise of the market. We invest on at least a three-to-five-year time horizon and consider ourselves owners of a part of a business rather than just a piece of paper. To us, short-term market volatility is not a “risk”, but an opportunity to add to high-quality companies at more attractive valuations. While we cannot forecast macro movements or outsmart the market on a short-term basis, we are resolute in our belief that quality always pays off in the end.

[1] EBITDA margin is a measure of a company’s profitability and is calculated as (earnings before interest, tax, depreciation and amortisation)/revenue

Source: Company data retrieved from company annual reports or other such investor reports. Financial metrics and valuations are from FactSet and Bloomberg. As at 11 April 2022 or otherwise noted.