FSSA Investment Managers

Client Update

FSSA Japan Equities

February 2022

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> "The best way out is always through."
>
> Robert Frost

The FSSA Japan Equity strategy declined by 3.0% in December and 18.8% over the month of January, driven first by a sharp "growth to value" rotation and then a sell-off by foreign investors from mid-January onwards. This has been a global phenomenon, with high-valuation growth stocks in most developed markets facing similar sell-offs on concerns about inflation and interest rate hikes.

With an awareness of the changing market environment we had revisited some "value" companies over the past year, but we struggled to build conviction as these "cheap" companies had little to recommend them other than low valuations. Many of these companies, particularly financials, trade primarily on market narratives. Though they may be highly correlated to expectations of US interest rate hikes, we prefer to base our investments on company fundamentals rather than macro predictions.

The factor rotation meant that the FSSA Japan Equity strategy underperformed during the up-market in December, as we had virtually zero exposure to the sectors that performed well such as banking and insurance, construction, food, transport equipment and wholesalers.

From mid-January, as views about the global economy turned pessimistic, foreign investors sold off Japan equities almost indiscriminately. Despite fundamental differences between Japan and the US, the Japan market often withstands heavy selling in these circumstances, given its deep and highly liquid market structure. As we have noted in the past, foreign investors own less than 20% of the Japan market but they account for more than 70% of turnover, which amplifies the market's volatility during these periods.

We have experienced this situation a number of times before, as these macro catalysts – rather than a shift in the fundamentals of our holdings – have been the main cause of portfolio drawdowns in the past. The magnitude has increased over the years, but on a longer-term basis the strategy has always bounced back strongly after the market reverts and investors appreciate strong company fundamentals.

Broad and arbitrary sell-off in portfolio holdings

When factor analysis is the cause of market volatility, as we have seen recently, the fundamentals are disregarded and high-valuation, high-growth companies are often sold off arbitrarily. Our investment philosophy suggests that the best thing to do in these instances is to look past the short-term volatility and continue to focus on identifying high-quality companies that we can invest in for the long term. We cannot forecast macro movements or outsmart the market on a short-term basis, but we are resolute in our belief that quality always pays off in the end. If we invest on at least a 3-5 year time horizon and seek out capable companies that are in it for the long run, we believe we can continue to deliver decent absolute returns for our clients.

As such, we continue to look for companies with effective management teams, dominant franchises and conservative financials that are able to deliver sustainable earnings growth regardless of the macro environment. The majority of the strategy is held in large-cap stocks (above USD 5bn), accounting for approximately 71% of the portfolio. These are large and established companies with

superior franchises, dominant market share, strong pricing power and a continual ability to innovate. We believe their longer-term prospects remain solid, despite the recent share price weakness.

Examples include Keyence, which is one of the most attractive companies to own in the automation industry, in our view. The company has been sold off on concerns about high valuations and supply chain issues; but it continues to be highly profitable, generates superior returns on invested capital and has a healthy balance sheet with net cash. Sales and net profit per employee are among the highest in the industry, due to its direct sales and fabless business model, and its highly technical salespeople. We believe this is a key intangible moat that should continue to lend support to its superior profitability metrics.

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, while EBITDA margin surged to 39%. As market sentiment turned in January, Recruit was sold off on concerns that its high growth would be unsustainable, though the number of job postings continues to trend strongly across regions including the US, Europe and Australia.

In the small-cap space, our exposure to stocks listed on the TSE Mothers Index[2], has risen in the past two years after we identified attractive new opportunities to invest in. The Mothers Index has fallen by more than 30% since November 2021, driven by foreign investors and very thin trading volume. Our current exposure to these companies is relatively low – just 3.2% for the FSSA Japan Equity strategy and 0.8% for the FSSA Japan Focus strategy. We trimmed some expensive small-caps in the first half of 2021, but then added on weakness after they pulled back sharply later in the year.

Information technology and industrials

In terms of sector performance, the strategy's large exposure to the information technology (IT) and industrials sectors (around 30% in each) have been among the hardest hit by the factor rotation. Benefit One, GMO Payment Gateway, Keyence, Raksul, Recruit Holdings and Shift have all declined 25-35% year-to-date. All except Raksul are among the portfolio's top holdings. We believe there has been no change to these companies' underlying fundamentals – but they have become collateral damage amid the market rout. Our conviction in these companies remains high and we have taken the opportunity to accumulate at lower valuations.

A point to note is that the majority of stocks we own in the industrials sector are commercial service providers, rather than industrial goods manufacturers. They often trade at optically-high valuations, a key reason for the recent sell-off, but we like them because they exhibit faster, more stable growth and generate high margins. In other words, they are the type of quality companies that we find attractive as long-term investments.

We mentioned Recruit Holdings earlier, while another example in this sector is Benefit One, a leading fringe benefits service provider in Japan that generates high returns on capital employed (ROCE) based on its highly scalable business model. Despite its robust growth outlook and fundamentals, its share price corrected in January and it is now trading at a level from before its announcement that it was acquiring a large competitor.

The acquisition of JTB Benefit Service, the 3rd 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 an employee human resources (HR) platform. As a result, Benefit One plans to upgrade its midterm plan at the next shareholders' meeting (profits are currently growing at a compound annual growth rate (CAGR) of 30%). It aspires to transform its business model in the next five years.

Among our technology holdings, around half are hardware manufacturers including semiconductor production equipment (SPE) makers, factory automation companies and electronic components suppliers, while the rest are software and IT services companies. SPE manufacturers like Lasertec and Tokyo Electron have performed well over the past year, including the recent month, on solid earnings results and reports of accelerated sales orders. We expect them to continue to enjoy robust demand due to the rising semiconductor content value across all of our day-to-day devices.

Our holdings in software and IT services companies have not fared so well, despite many of them having business models built on recurring income, high ROCE, a robust franchise, and are either positioned in underpenetrated industries or with a strong track record of adding new avenues of growth to their business portfolio.

One example is GMO Payment Gateway, the largest online payments service provider in Japan with 25-30% market share. We think its current share price weakness presents an opportune moment to top up our position. It remains

[1] EBITDA margin is a measure of a company's profitability and is calculated as (earnings before interest, tax, depreciation and amortization)/revenue
[2] The Tokyo Stock Exchange Mothers Index is often compared to the NASDAQ Index, as it houses high-growth smaller-cap stocks that are not yet ready to list on the main market. These stocks are often popular with retail investors.

one of our largest portfolio holdings. The company has an impeccable track record of delivering profit growth of 30% CAGR since listing and the CEO is highly confident that the company can sustain this trajectory in the next five years.

Shift, which started as a software testing company and expanded into IT services, was also sold off in the recent market rotation despite reporting solid earnings results with wider margins and better-than-expected operating profits. Shift aims to disrupt the inefficient multi-subcontracting structure that is prevalent in Japan's IT industry, and plans to accelerate the pace of hiring to 8,000 engineers a year by FY2030 to keep up with demand for its services. We think its growth potential is significant as Japanese firms start spending more on digital transformation projects.

Our exposure to unprofitable software companies makes up only a small portion of the portfolio (about 1.25-1.75%). They enjoy low customer churn rates (0.5-1% on a monthly basis), have a strong market position, and are led by high-quality management teams. We believe they should be good investments in the long run as they benefit from the low but growing digital service penetration in Japan.

Taking advantage of the market volatility to add to quality companies

Despite the magnitude of the recent sell-off, we remain convinced of the quality of the management and franchises at our portfolio companies, and we are excited about capturing new opportunities within our investable universe. Over the past three months, we arranged 54 one-on-one meetings with management teams – some with companies owned in the portfolio, and others to investigate new ideas. The meetings reassured us that these companies' fundamentals and structural growth drivers remained largely intact and in some cases have even improved.

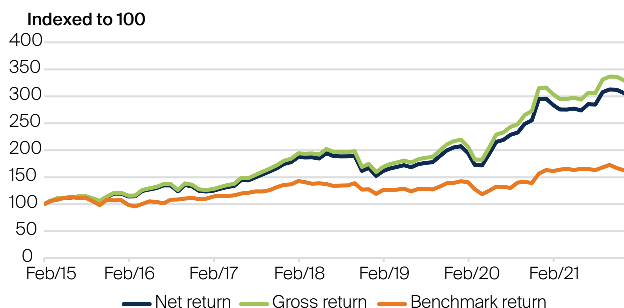
The recent market correction has provided us with an attractive entry point to these companies. Before the market rotation, the FSSA Japan Equity strategy traded at single-digit premium to the 5-year weighted average Price-to-Earnings Ratio (PER). By the end of January, it traded at a 12-month PER of 32x, a 12% discount to the 5-year weighted average. Meanwhile, the portfolio generates 21% return on equity (ROE), 46% returns on capital employed (ROCE), and 3-year earnings growth of 17% CAGR based on relatively conservative estimates. This indicates that the quality of our underlying holdings remains high, especially when compared to the market.

The valuations of a number of holdings previously considered "expensive" are now one standard deviation (1std) below the historical average. These include Recruit Holdings, GMO Payment Gateway and Nihon M&A Center. The stock price of Covid beneficiaries such as Freee and Hennge have also come down to pre-Covid levels (albeit our exposure is very small). Thanks to the strong support from our existing client base, we have been able to take advantage of these lower valuations to add to existing holdings across the board.

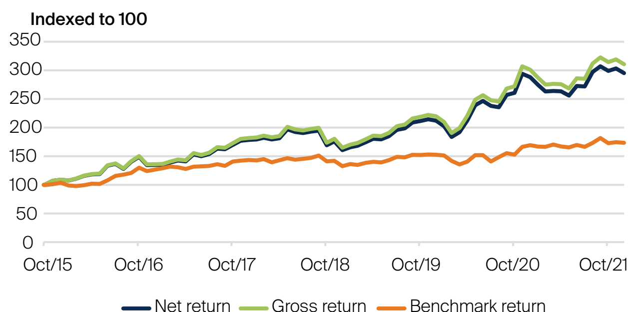
In the meantime, a number of new opportunities have emerged from our long watch-list, and we have been waiting on the sidelines to initiate new positions when the valuation becomes sufficiently enticing. We acknowledge this investment strategy is only possible because of our long-term investment horizon – and is what is expected from our clients.

The FSSA team's focus on long-term investing, bottom-up stock selection and quality companies has been borne out by the longer-term performance of the FSSA Japan Equity strategy and the FSSA Japan Focus strategy. Since inception in February and October 2015 respectively, the FSSA Japan Equity strategy has delivered 18% annualised returns and 11% annualised active returns, while the FSSA Japan Focus strategy has delivered 19% annualised returns and 10% annualised active returns (both as at 31 December 2021).

JAPE III USD Acc - Total returns vs benchmark (since inception)



JAPF B GBP Acc - Total returns vs benchmark (since inception)



Source: First Sentier Investors, as at 31 December 2021

Data is up to 31 Dec 2021 with the axis showing annual periods since inception.

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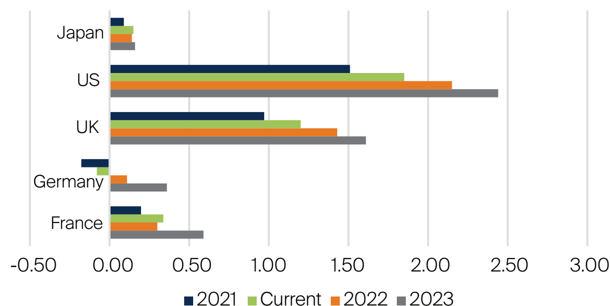
Inflation and outlook

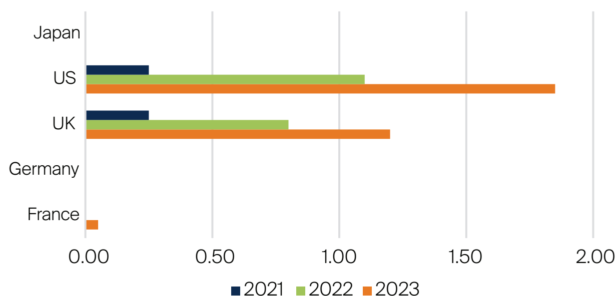
Historically, inflation and the timing of rate hikes in the US and Japan have been markedly different, though this does not seem to make a difference to the now-negative sentiment surrounding Japan's domestic growth or small- to mid-cap companies. Although supply-side disruption and rising commodity prices are indeed likely to contribute to inflationary pressure worldwide, in Japan low inflation expectations have been prevalent for decades. Annual consumer price index (CPI) growth remains suppressed and has been below 1% for many years.

From our recent company meetings, we note that Japanese consumer brands plan to absorb inflationary cost pressure as much as possible, as price hikes have been historically challenging due to consumers' deflationary mindset. The Bank of Japan (BOJ) also confirmed its plans to maintain the current monetary easing policy, which theoretically prolongs the investment duration for Japanese equities with a stable low cost of capital, unlike in most other countries looking to normalise their monetary policies.

Consensus forecast of 10-year bond yield



Consensus forecast of central bank rate



Source: Bloomberg, CLSA, as at 24 January 2022

Meanwhile, the ongoing state of emergency (due to Covid) is seen as an indicator that smaller companies will suffer from the weak domestic economy. However, recent data suggest that household finances are robust, with stable wage income and increased deposits to buffer against the temporary decline in consumption. The record-high JPY 56trn fiscal package announced in 2021 should support overall GDP growth too.

While there are many uncertainties around the global outlook and the Japan market, our portfolio holdings have been resilient in the past and, over the longer term, we believe they should be able to grow regardless of the macro situation. Companies with an asset-light business model, a high proportion of recurring revenue, the ability to create new avenues of growth and a cash-rich balance sheet tend to be less prone to an economic shock, in our experience. Most importantly, our investee companies have strong corporate cultures and are led by highly capable managers — which, in our view is the ultimate source of a company's lasting competitive advantages.

Considering these factors makes it easier to add to portfolio companies when they are sold off amid sector and style rotations. To us, short-term market volatility is not a "risk", but an opportunity to add to high-quality companies at more attractive valuations.

Source: Company data retrieved from company annual reports or other such investor reports. Financial metrics and valuations are from FactSet and Bloomberg. As at 31 January 2022 or otherwise noted.

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