Japanese growth: an evolving opportunity

Donald Farquharson
Head of Japan

After a challenging period for growth investing in Japan, Donald Farquharson, Head of Japanese Equities at Baillie Gifford reflects on how the landscape is changing and why it's time to take the 'this time it's different' story seriously.

Returning to the UK in 1995 after four years working as an investment analyst in Japan, I was invited to write a market piece to be entitled "Japan: Why this time is different." This was in the context of a stock market, which had already fallen in yen terms by 60 per cent – mitigated partly by a strengthening currency – a short-term prime rate (against which banks set their lending rates), which had fallen from 6 per cent to 0.5 per cent, and inflation hitting zero for the first time in decades. Would the next five years be different? As some may recall, despite a surge at the end of the 1990s in the global TMT boom, the Japanese market didn't bottom until 2003 (returning to this level again in 2009 and 2012).

I was reminded of the "why now is different" piece, when I was invited earlier this year to join a panel discussion entitled: "Revival of the Japanese Stock Market: Is This Time Different?" I can't remember how many times during my 30-plus years of investing in Japan I have been asked to submit similar pieces, though, with the TOPIX index at long last breaking through its 1989 high, this time is at least optically different. Yet what is taking the market to new highs implies traditional, cyclical phenomena: banks, carmakers and heavy industrials are among the best performers. The higher growth innovators have been largely ignored in this latest market rally.

Japan top-down has looked very different from Japan bottom-up for some time: demographic headwinds have, for example, contributed to Japan's world leadership in automation and robotics, not stifled it. Over the past 30 years, TOPIX earnings growth has far exceeded that of the S&P 500 before adjusting for inflation. In real terms, it is more than double. At first glance, this appears to challenge our core philosophical tenet, that investment returns will follow earnings over the long run, but rather it supports it, as intra-market earnings growth diverged markedly and backing the right companies paid off. During the past 30 years, the Japan All Cap Strategy has risen fivefold.

Yet, during this period, 'value' (as defined by MSCI) has far outperformed 'growth' – unusually when compared to other major markets and perhaps counterintuitively. The outperformance reversed momentarily between 2009 and 2020, but nearly all of this gain has now disappeared in the past three years. I have argued that corporate Japan has been changing fundamentally for a number of years – the product of a domestic and then global financial crisis and loss of competitiveness in several key, research-intensive industries – and so too has the investment opportunity, yet growth investing has been out of favour now for almost three years. We should have moved beyond the belief that investing in Japan was simply about value rotation, but we have not.

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Taking a fresh look

Japan is not the single, generic investment opportunity it is often presented to be. There are more entrepreneurial, founder-led businesses in Japan than ever before: over half the names in our portfolios fit that description, our exposure to first generation founder-owners being over four times that of the market. Management is more aligned to their shareholders and long-term incentive at larger companies is now equivalent to their salary for getting the job done. The average revenue growth rate of the top 20 per cent of the market is no different from where it was historically, but the constituents of growth have changed markedly. To see this as evolving consistently across corporate Japan is to ignore the persistence of competitive advantage.

If our interest is to remain narrowly focused on more cyclical areas of the market, we need also to be aware of the fragilities. Banks margins may be low partly because of central bank policy, but they are also low due to excess savings and liquidity. Japanese bank deposits are up to 60 per cent larger than their loans, making pricing difficult. The last time rates went up in the early 2000s, spreads actually narrowed. And Japanese carmakers in the shift to full electric drivetrains look uncomfortably squeezed longer term between Tesla at one end and the Chinese and South Korean makers at the other.

We have come a long way from a time when the best that investors in Japan could hope for was a cyclical recovery, an opportunity to invest in a short-term rebound, where lack of adaptability and labour market rigidity meant earnings would collapse at the first sight of an economic slowdown. Postwar pre-tax profit margins for all companies never exceeded 4 per cent until 2015: they subsequently rose to 7.7 per cent and, despite the Covid setback, bottomed at 4.5 per cent. This is helped by the resilience of some of Japan's leading companies and should continue to help as rates rise and economic reality bites: the average gross margin of our portfolio, at 35 per cent, is over 10 percentage points higher than that of the market.

There have been significant shifts in the Japanese market over the past 30 years: in the early 1990s, the banks dominated both the market and its governance, Japan accounted for 40 per cent of global consumer electronics production and Hitachi, NEC and Toshiba each had about 10 per cent of the memory market. Some companies, like Sony, adapted to become a leading provider of digital content, while others, like Sanyo or Sharp, did not. Dominance of an industry can be both a blessing and a curse, an unassailable lead or a competitive moat waiting to be filled. *Kaizen*, or continuous improvement, has helped some companies navigate competitive threats, while for others it has resulted in inflexibility and an inability to adapt. Murata, for example, has managed to maintain its lead in analogue semiconductor components for decades, partly because – as Chris Miller describes in his book *Chip War* – its business is not fixated on Moore's Law: "Clever design matters more than shrinking transistors." Analogue products have longer life cycles, lend themselves to technical perfection and require a fraction of the capital investment of an advanced logic or memory chip fabricator.

Finding Japan's new edge

As investors, we are required not just to identify a competitive advantage today but the sustainability of that edge into the future. Whether Japan's automotive industry, which still employs almost one tenth of the country's workforce, is able to continue to apply *kaizen* techniques in the transition towards full electric vehicles is open to debate. Toyota Motor's electric ambitions are still anchored to a transitional hybrid market it dominates – roughly half of the electric cars it plans to make in 2030 will still use a fuel engine. But EVs have different supply chains, major design and construction differences. Giga-casting, which replaces the traditional method of building separate components on a production line to one integrated assembly line, which Toyota reckons could halve production cost, wasn't an innovation developed by the *monozukuri* master, but by Tesla. We are investing in the electric enablers, like Murata and ROHM, rather than car makers, but we need also to be open to the possibility of ultimate success, which will also be decided by consumer appeal and ownership experience.

Japan's information technology (IT) business is an example of how a structured, low-growth industry can be transformed. Innovation hasn't come from the monolithic structure of the prime vendors, but from newer vendors addressing quality assurance or Cloud computing providers. Japan underspends on IT when compared to other developed countries and dedicates three-quarters of its limited engineer resource to system maintenance. This feels like a major opportunity for companies like SHIFT, which is able to direct IT projects in a more agile manner, or freee and Recruit Holdings, which have developed Cloud-based software solutions for small- and medium- sized businesses. An acute skills shortage is helping vendors price their services according to the value delivered to the client: ironically, the current tender system achieves the opposite.

Japan remains an attractive market for unrecognised, idiosyncratic growth. Our investments cover a wide range of opportunities, which may be found elsewhere in the world, but where often industry structures, cultural habit or complexity can make the opportunity and barriers to entry greater. Take for example the wholesale service industry: in the United States there are 47,000 wholesalers; in Japan, there are 360,000. These are both an inefficiency and a tax on operation. A company like MonotaRO, the leading online platform for maintenance, repair and operation (MRO) equipment, brings simplicity, speed of delivery and lower cost to its clients' operations, where less than 5 per cent of equipment today is ordered online. MonotaRO's sales have grown at over 20 per cent compound annual growth rate (CAGR) over the past 10 years, virtually all of this coming within Japan. Over the same period, the wholesale industry has grown less than 2 per cent per annum.

Often too, the growth can be unrecognised, as the market perceives the absence of a catalyst to unlock the underlying value. GMO internet, which has grown its revenues at 12.5 per cent CAGR over the past 10 years, remains dominant in nine areas of internet infrastructure and trades at a significant discount to the value of its listed subsidiaries. This appears to ignore the implicit value of operating a platform business. It became a dominant player in e-signature because it is the most likely first port of call for a business establishing its online presence.

Better bosses

And management matters. The point may appear an obvious one, but I'm not sure that it was so important 30 years ago. Salaryman management were rotated through every three years and it was hard for an incoming CEO to diverge from the path of his (always his) predecessor or to establish a record deserving alignment to wider stakeholders. It is hard to say at what point this changed, but I feel it happened gradually through the challenge of more dynamic, founder-run companies. Their modus operandi was different and they were attracting the best graduates. The corporate governance code played its part in changing the mindset of senior executives certainly, but it is no panacea. I am sceptical that pressuring the lowest-rated companies on book value can improve general profitability. That implies that all businesses are ultimately of similar quality.

A good example of effective operators is Sony, which we first bought 10 years ago. We were first interested in another company, So-net Entertainment, a Sony-affiliated internet service provider owning shares in another company of interest to us, M3, the medtech platform. When Sony bought out the minorities of So-net, co-CEO Kenichiro Yoshida became Sony's deputy CFO and ultimately its CEO. Hiroki Totoki, now President and COO, worked with Yoshida at So-net and helped establish Sony Bank. The pair are arguably the most capable management team in Japan today, having transformed a business which ten years ago got half its revenue from consumer electronics, while today it makes most of its money through digital content.

We see the same potential for transformative growth in other, gifted managers, such as Deko Idekoba at Recruit, Susumu Fujita at CyberAgent and Masaru Tange at SHIFT. Japan being Japan, we also face a greater challenge of intergenerational management transfer, something on which we actively engage – and invest. Nihon M&A addresses the opportunity of over a million companies facing succession issues.

Masaru Tange, chief executive of Shift Inc. @ Bloomberg/Getty Images.

Learning and looking ahead

Some of the investment mistakes of the past five years have been painful. We were wrong, for example, not to follow our instinct to buy when Rakuten committed $6bn to building a mobile network or to set clearer parameters for its success. Having now done so, we have stronger conviction, albeit at a much lower share price. Today's valuation could be easily justified by either of its ecommerce or fintech businesses in isolation and even partial success in mobile, which seems more likely, could similarly justify the market cap of the entire business, if they achieve just 10 per cent market share and half the EBIT margin of its competitors. Rakuten enjoys ecosystem advantages, which the incumbents can only envy.

We were wrong too – with hindsight – to keep buying Japanese cosmetics makers during Covid. These were meant to be resilient brands, but a slower return to normality in Asia and sluggish recovery in travel laid bare some fragilities. More disciplined buying with clearer waypoints for adding would have been helpful. If hotel prices in Tokyo are any indicator, the travel revival seems at long last well underway, Japanese cosmetics' popularity appears undiminished and we can rely once again on the trends which made both Asia and skincare among the fastest growing areas of luxury consumption.

The past three years have been as challenging a period for the philosophy we have consistently adhered to that I can remember. We have to acknowledge our mistakes, correct and learn from them. But we should not deviate from the simple, core belief, which has carried us through similarly harsh periods – that share price performance ultimately follows earnings growth. The portfolio characteristics haven't changed, we have continued to place emphasis on financial resilience as a factor likely to increase the likelihood of success and, though the market has especially punished jam-tomorrow, over 90 per cent of the portfolio is invested in profitable companies proving jam-today.

The best investments are made in the depths of despond. I simply don't know which of the 50-plus shares we are invested in will become the eight to tenfold winners of the next 10 years, as Keyence or Sony were in the last 10 years. Disciplined, long-term investing is about enduring the periods, when everyone thinks you're wrong, but the underpinnings of growth are established and unrecognised. That is why I believe this time could be very different.

Important information and risk factors

Performance

Annual past performance to 30 September each year (net%)

	2019	2020	2021	2022	2023
Japanese Equities All Cap Composite	-4.7	12.5	18.2	-34.0	11.4
Japanese Equities Growth Composite	-6.5	18.6	15.4	-40.1	12.8
Japanese Equities Income Growth Composite	-4.1	7.6	16.6	-28.8	10.7
TOPIX	-5.8	7.4	20.6	-28.4	25.9

Annualised returns to 30 September 2023 (net%)

	1 year	5 years	10 years	Since inception
Japanese Equities All Cap Composite	11.4	-1.4	4.5	4.5
Japanese Equities Growth Composite	12.8	-2.9	3.4	5.6
Japanese Equities Income Growth Composite*	10.7	-1.0	N/A	4.2
TOPIX	25.9	1.9	4.8	5.2

Inception date of the Japanese Equities Income Growth Composite: 31 July 2016.

Source: Baillie Gifford & Co and TOPIX. USD. Returns have been calculated by reducing the gross return by the highest annual management fee for the composite.

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Author biography

Donald Farquharson

Donald joined Baillie Gifford in 2008 and became a partner in 2017. He heads the Japanese Equities Team and is co-manager of the Japan Growth Strategy, which he has run since 2009. He is also a member of the International Alpha Portfolio Construction Group. He spent 20 years at Schroders as a Japanese specialist and headed its research team in Tokyo between 1991 and 1995. He graduated MA (Hons) in Arabic Studies from the University of St Andrews in 1987 and is a CFA Charterholder.

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