



Baillie Gifford Shin Nippon

BGS is trading on a rarely available wide discount...

Overview

Update
21 April 2023

Baillie Gifford Shin Nippon (BGS) is managed by Praveen Kumar, who aims to identify Japanese small caps which have exceptional growth potential, ideally buying them early and holding for years if not decades. BGS has an excellent track record over the longer run, as we discuss in **Performance**. This has been driven by exceptional returns in individual stocks which have typically been held for a long period – almost a third of the portfolio by weighting has been held for over a decade and in total 60% for over five years.

Praveen focuses exclusively on identifying exceptional companies rather than making calls on market or sector direction. Aided by a deep team of Japanese specialists (see **Management**), the portfolio he has constructed at present is heavy in niche manufacturers, often with specialised technology, and in digital disruptors. The portfolio displays a sensitivity to the growth factor and tends to be volatile.

Last year saw a significant sell-off in growth stocks as markets reacted to rising interest rate expectations. BGS was not immune, and had a tough year of performance. However, Praveen says the long-term growth outlook for his companies has not deteriorated, but in some cases has actually improved. He views the cheaper portfolio and market as a major opportunity, and the board arranged an extra **Gearing** facility in March 2023 in order to allow him to take advantage.

BGS has traded on a premium during periods when growth has been in favour and in periods when recent performance has been good, but the shares have fallen to a 10.4% discount to NAV at the time of writing.

Kepler View

BGS has an unabashedly high-risk, high-return strategy. Managed without reference to a benchmark or market cycles, it is focused on maximising long-term growth by finding companies with exceptional growth opportunities. This has led to excellent returns over the long run but has worked against it over the past 18 months as macro factors have dominated market returns and growth stocks have de-rated. We think there is an argument that markets have already overshot, with the portfolio now trading on a reduced premium versus the market. This, plus the wide discount, means there is potentially an exciting opportunity to invest for the long term.

The **Portfolio** contains many interesting companies with the potential to dominate international markets, particularly in the technology industries. It also contains multiple companies benefitting from secular changes in Japan, dominating in niches and/or developing new markets. The Japanese economic situation looks interesting at this point in time, with modest inflation, wage growth, and the belated lifting of COVID restrictions all encouraging domestic economic activity. This could be a further boost for BGS' portfolio in the near future. On the other hand, if global interest rates remain higher for longer, then this will likely weigh on the portfolio's valuations.

BGS runs with significant gearing, and the highly active approach means there are sector and style biases which bring volatility. But for investors who can stomach that volatility, we think it offers the potential for excellent long-term returns.

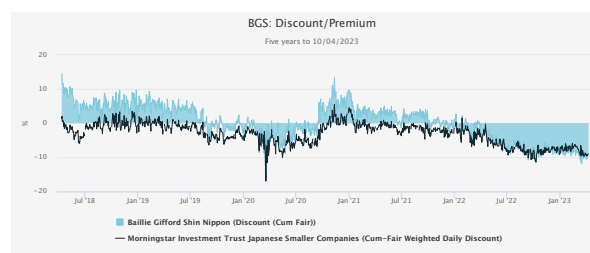
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Key Information:

Price (p)	148.6
Discount/ Premium(%)	-10.4
OCF (%)	0.74
Gearing (%)	16
Yield (%)	0.0
Ticker	BGS
Market cap (£)	466,607,693



BULL

Excellent track record of adding alpha

Highly active and long term in approach which increases alpha-generating potential

Has the lowest charges in the sector

BEAR

Tends to be very volatile, with gearing contributing

Growth factor is out of favour and this could weigh on the trust in the near future

The Japanese market can be very sensitive to a global recession



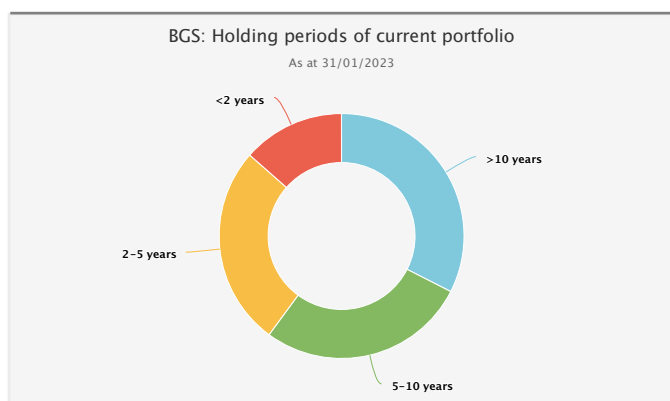
Portfolio

Baillie Gifford Shin Nippon (BGS) owns a portfolio of Japanese small caps which is managed by Praveen Kumar of the Baillie Gifford Japanese Equities Team. Praveen aims to identify exceptional companies which have huge potential upside over many years, and ideally decades, of growth. This is likely to come through having a disruptive business model or technology, and/or operating in a niche which the company can control and dominate. Praveen sets out to identify the winners and acts with high conviction when he has found them, building a portfolio which has next to no overlap with the Japanese small cap market and holding on to companies in which he believes through cyclical ups and downs. He can also invest in private companies, with up to 10% of the portfolio (measured at the time of investment), which enlarges the opportunity set for investment and allows the trust to benefit from early rapid growth in companies which have not yet listed. As of the end of January 2023, four holdings in the portfolio were unlisted, making up 3% of total assets.

The team attest to three core beliefs: that investing should be for the long term, thinking in decades rather than years; that they should embrace asymmetry, looking for companies with the greatest potential upside (the downside in long-only investing is always limited to 100% in absolute terms); and that they should invest in exceptional growth companies not the market.

As for the first point, the chart below shows how it has been implemented. Almost exactly a third of the portfolio by weighting has been held for over ten years (or roughly 29% by number of holdings). This reflects the fact that many investee companies have proven themselves capable of remarkable growth, with some generating truly exceptional returns. It also reflects the strategy of continually focusing on the long-term. Praveen looks for companies he believes can at least double their share prices over the next five years, and if that remains true of any holding he will hang onto it, resisting the temptation to take profits.

Fig.1: Holding Periods



Source: Baillie Gifford

As for the second belief, it is the longest-held stocks that have driven the trust's exceptional long-term **Performance**. Online payments facilitator GMO Payment Gateway is one of the companies that has been held for over a decade. The stock has delivered returns of c. 3,500% while in the portfolio. While the shares have derated over the past two years, it remains one of the largest contributors to the trust's five-year returns. The company still makes up 1.2% of the portfolio (as of the end of January), with Praveen noting it is still growing earnings at 20-25% a year thanks to its dominant market position, and expanding outside of its original payments business. As one of the more liquid names in the portfolio, it has been used as a source of funds for other positions at times, with the money being recycled into smaller companies. GMO Payment Gateway is an extreme example, but there are eight other companies which have delivered in excess of 500% in the ten years to the end of January 2023, all but one of which are still held in the trust and have been for over a decade. By contrast, losses are necessarily limited to 100% in absolute terms, although Shin Nippon has never lost all its money on a position. The ten positions which have lost the most over the years have lost between c. 60% and 75%, with far fewer having lost money than gained money. Most of those that have lost money have already been sold, with Praveen tending to run his winners as the thesis is proven, trimming positions as they reach 5% of the portfolio as a risk management rule. Similarly, the portfolio remains well-diversified, with c. 80 holdings. Praveen accepts that occasionally his 'swing for the fences' approach will lead to misses, and both these features are, in our view, sensible measures to limit the volatility that comes with his high conviction, long-term strategy. Notably, Praveen also tends not to invest in pre-profitable companies, and they make up only a small portion of the portfolio.

Turnover remained low during 2022, at 12.6% versus a five-year average of 15.1% according to Morningstar, despite it being a volatile year for markets and a tough one for growth strategies like BGS. In Praveen's view, the market move is largely explained by a de-rating of growth stocks rather than a changing growth outlook for his companies. For example, one of the areas of the portfolio that has been under pressure is the holdings in e-commerce and internet-related stocks. In Praveen's view, only one or two of BGS' online companies have seen their outlook negatively change. One is online cosmetics vendor istyle, which has displayed poor corporate governance and Praveen has reduced the position size to reflect this risk. Online shoe store Locondo is another position being monitored, Praveen and the team have a weakening conviction that shoe sales will migrate online.

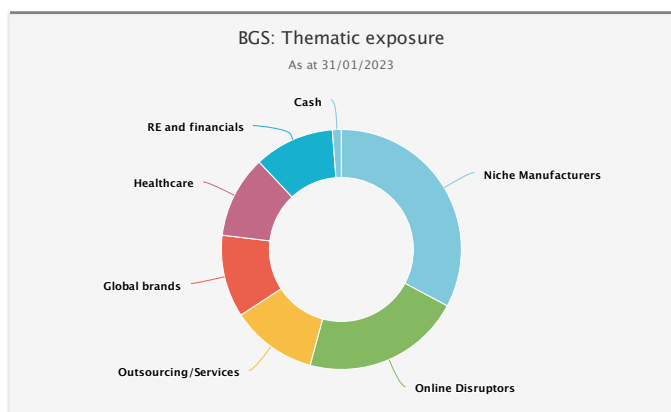
The third belief is that investors should invest in exceptional growth companies, not in the market. This means paying no attention to the index or benchmark,



which is presented only as a comparator rather than a target. BGS is highly active as a result, with an active share consistently above 90%. A high active share increases the chance of adding alpha, but it can also lead to underperformance if some key stock picks go wrong. While the diversification in the portfolio tempers this, BGS did suffer from this dynamic in the 2023 financial year, with five companies detracting at least 1% from relative returns. Given the overall market moved against BGS' growth style, this was not sufficiently offset by the winners to outperform.

Given what Praveen is looking for, companies with exceptional growth prospects, some biases come out in the portfolio. These stem from stock-specific decisions rather than deliberate positioning. The largest themes that the team identify are niche manufacturers, online disruptors and outsourcing, and service providers. There are also companies with strong brands that have global reach, and niche healthcare plays, whether that be care providers or device manufacturers, as well as opportunities in financials and real estate.

Fig.2: Thematic Exposure



Source: Baillie Gifford

Praveen sees a huge opportunity in the sell-off in growth stocks of the past 18 months, and the trust has taken out an additional **Gearing** facility to be able to take advantage. He sees opportunities both in the existing portfolio and in new ideas and notes that from current valuations, relatively modest assumptions about earnings growth can meet and exceed his minimum targeted five-year return of 100%. At the margin, there has been some slight reorientation into niche manufacturers. This includes sophisticated companies across various industries, which often have global markets into which to grow. For example, Jeol is the only company in the world to make direct write electron beam mask writers. Their new machine does not require the use of patterned masks, allowing advanced chips to be produced faster and cheaper. This method could therefore be hugely valuable to many large chip manufacturers. Another example is Horiba, which

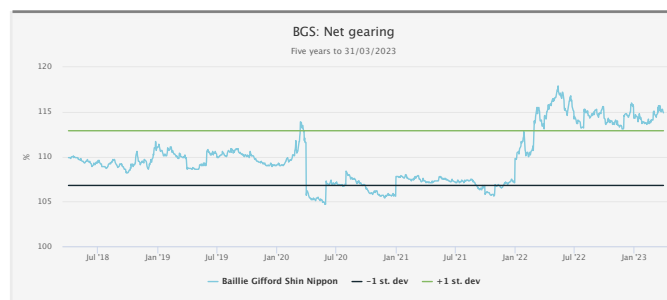
manufactures specialist equipment used to collect and control toxic gases used in semiconductor production. The company has an 80% market share, and Praveen expects it to generate 20% in earnings growth per annum in the coming years. The semiconductor market has gone through a cyclical downturn over the past year, but Praveen remains focused on the long-term outlook for this industry which is clearly one of exceptional growth given the ubiquity of semiconductors, for example in electric vehicles.

Many of BGS' companies have this sort of international opportunity, but more common is a domestic focus. These are generally companies which are growing a niche business at the expense of rivals, and therefore not so sensitive to the health of the domestic economy, but a healthy domestic economy is definitely of benefit. In this respect, Japan looks to be in a good position. It has healthy levels of inflation and wage growth which the authorities have been trying to achieve for years. There is also a burst of activity from its belated release of pandemic restrictions last autumn which means both domestic consumers and tourists are spending more. Praveen argues this creates a favourable backdrop for strong businesses to be able to raise prices ahead of costs and therefore grow profitability.

Gearing

The board has approved a new gearing facility in recent months to allow Praveen to take further advantage of the exceptional number of opportunities he sees after a sell-off in growth companies. BGS has historically run with a modest level of fixed, long-term gearing, which has averaged 9.8% over the past five years. Most of the debt is fixed, with loans worth ¥14.1bn (c. £85m) at an average interest rate of 1.4%. This would amount to 16% of NAV as of the end of February, after a fall in the value of the portfolio over the past 18 months. This was offset by a small amount of cash in the portfolio to give a net gearing figure of 15%. However, in March 2023, a new ¥2bn revolving credit facility was drawn, so we would expect gearing to pick up in the coming months. Praveen describes the current opportunity as a rare one and tells us he sees both new ideas worth investing in and existing

Fig.3: Net Gearing



Source: Morningstar



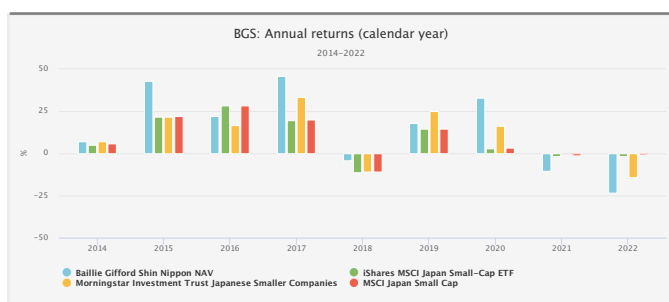
holdings at highly attractive valuations. Notably though, this is being driven by stock-specific opportunities rather than a view on the short-term prospects for the market as a whole. Gearing increases the beta of a portfolio in down markets as well as in rising markets.

Performance

Praveen and the team focus on the long-run outlook for companies, believing this is a route to generating alpha. The long-term returns generated have been truly exceptional. BGS has returned 208.4% in NAV total return terms over the past decade (to 06/04/2023). This compares to returns of just 115.1% to the MSCI Japan Small Cap Index. The two other trusts in the AIC Japanese Smaller Companies sector have returned 105% and 89% over the same period.

The best returns came in the first eight years of this period, with 2021 and 2022 being difficult years (see chart below). In 2015 and 2016, high returns to disruptive individual companies in the portfolio drove relative returns. In 2017, the market focused increasingly on those with e-commerce or internet-related business models, and this boosted BGS' portfolio. In 2020 these themes drove the market again in the aftermath of lockdowns, and the trust did exceptionally well. However, in Q3 2021, growth areas of the market began to underperform as the market came to expect higher interest rates for longer as the inflation threat loomed. Meanwhile, typical value sectors, particularly energy and mining, outperformed. BGS has little exposure to these industries.

Fig.4: Annual Returns



Source: Morningstar

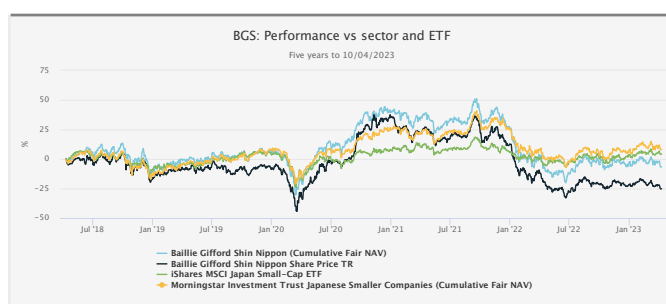
Past performance is not a reliable indicator of future results.

This tough environment continued into 2022. We think it is fair to say that the exceptional social and economic environment of 2020 led to a remarkable expansion of valuation multiples in companies seen as beneficiaries of lockdowns and those with the greatest expected earnings growth. However, the two years since have seen an equally dramatic reaction which may have overshoot (as markets are wont to do). A growth portfolio such as BGS' typically trades on a premium versus the market, justified by the

extra earnings growth expected which should grow the size of the businesses you are purchasing shares in. This premium has shrunk over the past two years. While in 2019, pre-lockdowns, the portfolio was trading on a forward P/E of 24x versus 15x for the index, as of the end of January 2023 it was trading on 18x versus 12x for the benchmark. Given that Praveen expects much higher earnings growth from his portfolio in the coming years, this looks like an attractive rating on which to be buying the portfolio, leaving aside the share price discount. Praveen's enthusiasm about the opportunity is shown by the board's arrangement of a new **Gearing** facility in order to be able to take advantage.

The tough 2021 and 2022 have brought down the trust's five-year numbers. As the below chart shows, the NAV total return has been -6.6% compared to an average return of 8% for the sector and 4.4% for the iShares MSCI Japan Small Cap ETF, representing a passive investment in the index.

Fig.5: Five-Year Performance



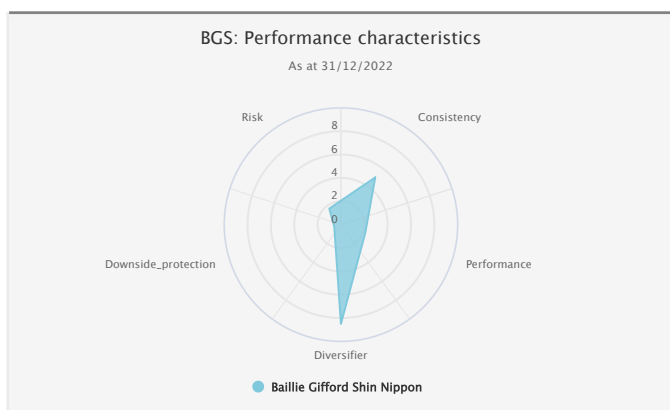
Source: Morningstar

Past performance is not a reliable indicator of future results.

Praveen takes a high-conviction approach to generating returns by investing in high-growth companies which he is willing to hold on to through difficult periods. This, the sector and industry biases that stem from his focus on growth, and good governance means BGS tends to be quite volatile. This comes through in our proprietary KTI Spider Chart shown below. This shows how BGS has performed versus an expanded peer group of all Japan and Japan small-cap trusts over the past five years in some key categories. Each category is scored out of ten, and scores are normalised to the peer group. After the experience of the past two years, BGS has a low score for performance, reflecting risk-adjusted outperformance. Similarly, it has a low score for risk and downside protection, reflecting the volatility in the strategy. However, the trust has a very high score for diversification, having been less correlated than its peers to Japanese equities, world equities, and bonds. We think this is an interesting benefit of investing in BGS: it offers good diversification as well as alpha potential, which should improve risk-adjusted returns on a portfolio if it repeats in future.



Fig.6: KTI Spider Chart



Source: Morningstar, Kepler calculations

Past performance is not a reliable indicator of future results.

Dividend

The company is focused on capital growth and does not pay a dividend. All fees are charged to the revenue account, which is in deficit.

Management

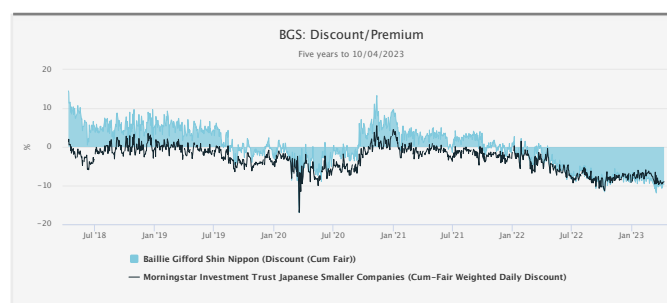
BGS has enjoyed strong continuity of management approach and personnel over the years, in keeping with the long-term investment philosophy. Praveen Kumar has managed the trust since December 2015, when he replaced John MacDougall, who had been in charge for eight years. Praveen joined the Japanese desk as an investment manager in 2011, having been with Baillie Gifford since 2008. He is part of a Japanese equities team of 13 based in Edinburgh led by the head of Japanese equities, Donald Farquharson, who has 34 years of experience. Donald is one of eight team members with over a decade of experience with a further four, more junior, investment managers and analysts and one ESG representative. There are also an additional two researchers based in Japan who provide thematic input, attending trade shows and conventions to generate ideas about broader trends in the country. Praveen also manages the open-ended Baillie Gifford Japanese Smaller Companies Fund and is the deputy manager of the all-cap Baillie Gifford Japan trust.

Discount

BGS has traded on a premium when risk appetite has been higher and growth strategies in favour. However, at the time of writing it has fallen to a 10.4% discount. To us, this looks like good value compared to an average par rating over the past five years. We think this could prove an excellent long-term entry point, although it may take a reversion in style leadership for BGS to recover a premium

rating, and if rates globally stay higher for longer this may weigh on the discount.

Fig.7: Discount



Source: Morningstar

When possible, the board have taken advantage of the trust trading on a premium to issue new shares and grow the trust. In the financial year ending January 2021, BGS issued as much as 7.8% of the share capital as of the start of the year. In the year ending January 2022, shares worth a further 4.3% were issued. Over the course of the 2023 financial year, a tiny number of shares (<0.1% of the share capital) were bought back, and buybacks have continued since year-end. The board states it will buy back further shares, “if the discount to NAV was substantial in absolute terms or in relation to its peers, should that be deemed desirable.”

Charges

The trust has an OCF of 0.74%, the lowest of the four Japanese smaller companies trusts. This is largely thanks to the management fee being the lowest of the four trusts in the sector, although the growth in the size of the trust in recent years has also contributed, and BGS is now by some way the largest trust in the peer group. The management fee is charged on net assets on a tiered basis. On the first £50m, the manager is paid 75bps, on the next £200m 65bps and on the remainder 55bps. At the trust’s size of £520m in net assets (according to JPM Cazenove), we calculate that amounts to an ongoing rate of c. 62bps. The KID RIY is 1.17%, lower than the sector average of 1.47%, according to JPM Cazenove, although we note methodologies may vary.

ESG

Sustainability issues are integrated into the stock selection process, with ESG analysis considered as a part of the investment decision and ongoing monitoring. In keeping with their long-term approach to investment, Praveen and the rest of the Japan team aim to be constructive shareholders, engaging with company management in the interest of long-term value creation.



Praveen tells us governance is typically good at the companies he is looking at, given they tend to be entrepreneurial and focused on growth. However, the team's engagement efforts can help improve matters further. For example, he highlights Outsourcing, a staffing company focusing on the manufacturing and IT sectors. The team have been engaging with management to encourage improvements in accounting controls and procedures following the emergence of irregularities in 2021. The company has now adopted a superior, internationally-recognised structure which less than 2.5% of quoted companies in Japan have. Another example is istyle, the cosmetics company. istyle has decided to appoint a non-Japanese, female director, bringing a focus on diversity and gender equality. They are also exploring how to improve their emissions reporting and reduce their impact.

Despite this focus on engagement, BGS does not have explicit ESG objectives and so may not satisfy the most stringent ESG investors. Morningstar rates the portfolio as low for sustainability based on an analysis of its underlying holdings, although we believe this may reflect the absence of information for some of its holdings, particularly the smaller ones, so would not over-emphasise this.



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