Baillie Gifford™

Short Briefings on Long Term Thinking – Episode 35

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Japan: a new dawn for growth investing

Your capital is at risk.

Malcolm Borthwick (MB): With its elegant clubhouse and beautifully manicured greens, Koganei Country Club is one of Tokyo's most prestigious golf courses. In the late 1980s, one businessman offered over three-and-a-half million dollars to any member who would sell them their spot. Not one of them accepted.

This marked the peak of Japan's heady trade in golf membership driven by its booming economy. Property prices were surging and, in 1989, the Nikkei stock index hit an all-time high. Many believe that Japan would soon overtake the United States as the world's largest economy. Then the bubble burst. Japan's lost decades followed, marked by slow growth, falling prices and rising unemployment. By 2004, you could pick up a membership of the Koganei Country Club for less than half-a-million dollars, a fraction of its previous value.

But things are finally stirring Japanese equities are among this year's best performers. Inflation has returned, and exporters are rediscovering their mojo. So, is this recovery sustainable?

Welcome to *Short Briefings on Long Term Thinking*. I'm Malcolm Borthwick managing editor at Baillie Gifford. And I'm joined by Donald Farquharson, head of Baillie Gifford's Japanese Equities Team. Over the next 20 minutes or so, we'll consider whether this time it's different.

But first, a quick reminder, as with all investments, your capital is at risk and your income is not guaranteed.

Donald, it's great to have you with us on *Short Briefings on Long Term Thinking*. Thanks for joining us.

Donald Farquharson (DF): Thank you

MB: So, let's start at the beginning of your career in Japanese equities. You started in 1990. Moved to Tokyo in 1991. Paint a picture of what Japan was like then for an equity investor.

DF: The things that I would say were striking then was, even though Japan was the biggest market in the world at the start of the 1990s, [there were] not a lot of foreign visitors to Japan, at the time there were 3 million.

It still felt, living out there, that you were living in an environment which for the foreigner was slightly alien and slightly undiscovered. The other thing that I noticed, and I go back twice a year, I've just been to Japan, is how the physical environment changes.

When I was there, the whole area around Tokyo Station and next to the Imperial Palace, there was a height limit of six stories. So all the buildings were quite low and of course today it is an extraordinary skyline that Tokyo has. And I'm constantly going back and I'm getting into areas of town, and I think: “I don't recognise this.” And realise that it was just around the corner from where my office was.

MB: I mean that's extraordinary that it was quite undiscovered, because if you look back to the 80s, you had global asset allocation of about 30 or 40 per cent in Japan. Why was it so undiscovered for foreign investors?

DF: Well, of course a lot of foreign investors were nowhere near the benchmark weight in Japan. That has predominantly been true throughout my investing career, that looking at sort of the measures of index weights, it looks like foreigners have neglected the market. And periodically as when Prime Minister Koizumi came into power and there was the expectation of reforms, then Shinzo Abe, a similar sort of reform-driven market, you start to see foreigners getting interested in this market again. We may be going through that period again right now. But I would say that there’s a lot of transitory money that comes from overseas into Japan.

MB: And you mentioned Shinzo Abe, Kazumi. There have been 17 different Japanese prime ministers since you started looking at Japanese equities back in 1990, which is extraordinary. How have things changed to present-day Japan, because as you say, you're just back?

DF: The engagement with companies has changed a huge amount. So when I was out there in the early 1990s, you could meet a lot of companies, but they didn't have an IR function as such. So they often didn't really understand where you were coming from, and I remember very long, very turgid, very unrevealing meetings that I would have with a lot of these companies.

As an example of that, you’re probably aware that the biggest companies in the world at the time were Japanese banks. And yet there was no disclosure at all of their non-performing loans, and everyone knew they had them but they didn't really crystallise in most cases until the end of the decade. It was 10 years on before we actually got to see how bad the lending of the banks had been. So that's one thing that I would say has changed. Governance has changed a lot. In some areas, Japan has really embraced governance. They are the single biggest signatories to the Task

Force on Climate-related Disclosures (TCFD). So in some respects, governance is very good. In some other respects, I still think it's got a long way to go.

MB: We're seeing a recovery this year in Japanese equities. And I'm sure you've been asked this question quite a lot during the course of your career. But is this recovery more sustainable? Is it real?

DF: So firstly, I'm very enthusiastic. I think this is a really exciting time to be invested in the Japanese market. But if you look at what has driven the market, which has been a factor of rising interest rates, a weaker currency. [It] has been classic cyclical rotation. So car companies and banks and some deep cyclical businesses have done extremely well on the back of that. And these are generally not the areas that we've been invested in. The car companies we're concerned that they face double pressures at the high end from electric vehicle makers like Tesla, and the low-end Chinese makers. The banks, nearly every bank in Japan has twice the level of deposits that it does loans. And I think that creates a really difficult environment for any lender to price the loans at an appropriate level.

MB: And why do you think the growth companies haven't been part of this rally and how this might change?

DF: I think a lot of them have faced some headwinds because they did very well in the period running up to and during the early period of Covid. And as things have returned to normal, growth has optically looked as though it's been slowing. Interestingly we're now starting to see the next up-leg, and that's just simple comparatives. I was in Japan in September '22, and I was in Japan in September this year. And a marked difference in confidence and the enthusiasm that a lot of the entrepreneurs were exuding. So that's probably why I think ultimately the growth that these companies are demonstrating will ultimately come through in terms of earnings and in terms of cash flow and ultimately will drive share prices.

MB: And what's interesting is that a lot of these growth companies have strong balance sheets, haven't they?

DF: That's an unusual factor. I think in Japan that a lot of these companies also have a lot of cash. That's a support to the valuation, but it's also a support to their ability to grow because they have the financial resources to do it and they aren't dependent on external shareholders giving them more money or the banks.

MB: And Donald, let's have a look at some of the growth companies you visited when you were in Japan. One company that I'm particularly fascinated by, because I love photography, is Olympus. And I always think of cameras when I think of Olympus. But I should be thinking of endoscopes – which are medical inspection tools which examine you internally.

DF: You should, yes. So Olympus, I met with the CEO when I was out there. He's a German, Stefan Kaufmann. And they don't do cameras anymore, so they exited the camera business. They've also exited the scientific solutions microscope business as well. So they are now solely focused on endoscopy, on making endoscopes, which are used in gastrointestinal respiratory and surgical procedures. And they are overwhelmingly the market leader. They have about 70 per cent of the global market in reusable endoscopes, which is the main way in which endoscopy is practised. And it's an interesting one because their competitors Japanese. This is an area where *monozukuri* – making things, there's an art, it's cross-disciplinary. So the only two companies that make endoscopes in any size, are Hoya and Fujifilm, two other Japanese companies.

MB: And you mentioned their CEO there, Stephen Kaufmann. That sounds quite unusual, a European CEO or Western CEO in Japan.

DF: It is still, and, you know, one of the things we've challenged a lot of our companies on is the lack of diversity, which is not just a gender diversity, but the fact that very few boards have international experience even though their business may be internationally facing. Kaufmann has been with the company for almost 20 years, so he knows the company extremely well.

He's been brought in at a time where the company is having to respond to some warning letters from the FDA, which actually has nothing to do with their product. It has everything to do with their reporting. And it was a classic case of where a Japanese company believes because its product is near perfect, it doesn't need to provide all the paperwork that the regulator requires. And they’ve got themselves into a bit of a problem. Kaufmann seems to have got them back on track. It was a good time to be revisiting the company. And I'm very optimistic on a company that is lowly valued and still dominates its industry.

MB: So one interesting trend we’re seeing in Japan at the moment is we’re seeing more mergers and acquisitions there than most areas of the world, actually where the M&A market is pretty quiet. And an interesting company in the portfolio is Nihon M&A, which helps companies through the takeover process. Tell me more about them.

DF: Yes, and I really like this one and it’s had a couple of bumps along the way. So the share price has come down a long way. And that sort of is what attracted us back to a company that we have followed for a long period of time. It’s a great example to highlight because people talk about the demographics of Japan, and invariably when they talk about the demographics of Japan, it's about this stifling growth, you know, because you haven't got a growing population. There can't be any long-term growth, a contracting workforce and like.

In the case of Nihon M&A, it is advising small companies on mergers and acquisitions. You've got in Japan about three and a half million small, medium-sized companies. And it's reckoned that roughly half of those companies have a CEO founder who is over the age of 70 and is facing a real succession issue. This is where Nihon M&A can step in. It's by far and a long way the biggest advisor in this area, and companies aren't concerned solely about getting the best price. They're concerned about their workforce. They're concerned about the continuity of their business. And that's where Nihon M&A has a skill that others can't replicate.

MB: And you mentioned small- and medium-sized businesses there. And that's a great opportunity for a plug for a past podcast I did with your colleague Praveen Kumar on SMEs which you can find in the library of *Short Briefings on Long Term Thinking*. Let's move on to another company, DENSO. They've got a very interesting history and they've got links with Toyota - and that still accounts for around about half their business. I think what's interesting about DENSO is [that] they're involved in the motor trade, and you don't actually invest in any car companies in Japan. But why do you invest in DENSO?

DF: Yeah, DENSO is in my view a sort of Toyota-plus-plus. So it is increasingly the added value that goes under the bonnet. That's probably a traditional way of expressing it because increasing their business is about the electrification of the powertrain. Very little is traditional combustion engine now. DENSO is an R&D intensive business. It spends far more on research and development as a proportion of sales than Toyota itself does. Eighty per cent of all its forward investment is into semiconductors and into software. Themselves and probably Bosch are the only two suppliers on that scale that are able to spend $4bn-plus a year on R&D. They are the ones that are adding most of the value within power semiconductors and in the ability of a car to electrify.

MB: And we talk a lot about clusters. Paint a picture to the listeners of what that ecosystem is like.

DF: You've got Toyota Motor at the centre. Interestingly Toyota City is one place where you see no other cars than Toyota Motor Cars. And around that is the cluster we're talking close to Nagoya. That is the traditional heartland of motor manufacture in Japan.

When I was out there, I actually had the opportunity to go to the research centre that Toyota has for the development of all solid-state batteries. An area where they reckon that technologically they've invested far more. They have more patents. They are ahead of all other battery producers, and this could be the future technology that will be driving our cars. It's more efficient. It's much quicker, it's less than 10 minutes to fully charge an all-solid-state battery. It has a lot of advantages that lithium-ion batteries don't have.

MB: It's really interesting because there's a lot of focus obviously on the cars, but there's a whole other competition that's going on in Europe, the States, Japan and China with batteries.

DF: Yes, and it's something that we've been considering in terms of how we benefit from the way in which cars are changing. So a company like ROHM, which makes the next generation wafer and devices to go into cars, silicon carbide. 60 per cent of its business is to the car market. So, it is a car supplier. You know, Panasonic makes batteries for the Tesla, but also other OEMs. So, yes, the nature of that business is changing a lot.

MB: What I find interesting about Baillie Gifford is that often there's rotation around the investment teams and investors will move to different strategies. You've been focused on Japan throughout your career. What fascinates you about this country?

DF: I'm fascinated by the culture. I'm fascinated by the preconceptions that people have and hold. And I think that gives us an advantage as long-term investors. Sometimes I have to tell people that if you look over the last 10 years, Japanese earnings growth for the market has been much higher than it has been in the United States. People don't believe that, but they can go back and check that. It's actually been true earnings growth over the duration of my career, but we're coloured by all these comments around you know, deflation and the sorry state of the Nikkei. So it's a much more vibrant, much more exciting market than I think many give it credit for, you know. Some of the changes that we're investing in. IT services. Factory Automation is an obvious place. There are some fabulous Japanese brands. Skincare being one area and cosmetics that we've been investing. So there are lots of opportunities. It's a great hunting ground.

MB: And why is it so misunderstood?

DF: I think there's still this hangover of... We still talk about Japanese exporters, but most of the exporters don't export. I mean exports as part of GDP are I think lower than they are in the UK. So Japan does export some goods. The automotive sector is one area where it does still produce cars and sells cars. So people often look at the headlines, but they don't look beyond it, I think, bluntly, is why it's misunderstood.

MB: And we always end the podcast just asking our guests about what book they're reading at the moment. What are you reading at the moment Donald?

DF: Well, I've literally just put down a book about Masayoshi Son called *Aiming High*, which is an interesting account of basically his life, and it's taken up to 2020, I think. It's fascinating at a number of levels. We know that he was very successful, very early and very prescient in his investment in Alibaba. But I think it's forgotten how frequently he made very bold calls. He was in university when he sold his first translator business, which he developed at the University of California, Berkeley to Sharp. He made over a million dollars while still a student back in the in the very early 1990s. He invested in Yahoo. And he invested in a lot of companies that Baillie Gifford more broadly has an interest in. In ByteDance. In Coupang. In ARM Holdings, which is of course the company that he's just brought back to the market. So he has a very clear and long-term vision and he's prepared to act boldly and invest boldly on it.

MB: And quite typical of the alignment, I guess of a lot of – not just in the Japanese strategy – but in terms of the founder leader of Softbank: we do like founders and that's something that's become more and more concrete as your career has developed at Baillie Gifford, isn't it?

DF: That's right. I mean, I looked back at our main Japanese portfolio in 1990. And we only had 4 per cent of the portfolio invested in what would have been regarded as a founder-run company. Today, almost half of the names that we hold in the portfolio are founder-run companies. So, the opportunity set has changed spectacularly. You're sitting in the room with the person who set up the company and who holds the vision for where that company is going to go.

MB: That's a positive way to end the podcast, Donald. Thanks for joining us.

DF: Thank you.

MB: And thanks for investing your time in *Short Briefings on Long Term Thinking*. You can find all our episodes at bailliegifford.com/podcasts. Or subscribe at Apple Podcasts, Spotify and other platforms. And if you enjoyed listening, why not check out our article 'Discovering the unsung superstars of Japanese technology', which we've linked to in the show notes. Goodbye.

Show notes

Is the time ripe for Japanese growth stocks? Donald Farquharson is Baillie Gifford's head of Japanese equities and knows the market better than most. In the latest episode of *Short Briefings on Long Term Thinking,* he draws on a recent visit to the country to explain why conditions seem favourable for a cohort of domestic companies with long-term mindsets.

Background

There's a sense of renewed confidence and enthusiasm in the air in Japan. The country is home to the world's second-largest market for equities after the US, but it doesn't get a corresponding degree of attention from international investors.

The reason is partly because of the nation's past weak economic performance. But a recovery is underway, and critically, many of its growth stocks have strong balance sheets, big ambitions and a positive story to tell.

In this episode, Baillie Gifford partner Donald Farquharson draws on his experience of investing in Japan since 1990 to explain why he's particularly optimistic about the opportunities ahead for a select group of companies. They include the medical equipment maker Olympus, the car components manufacturer DENSO and the takeover advisory service Nihon M&A Center.
He also shares why he thinks some misunderstand Japan and why it's no coincidence that many of the companies he backs are founder-run.

Resources:

From Yahoo! to Z Holdings: the evolution of an online pioneer
Donald Farquharson's LinkedIn page
Aiming High: Masayoshi Son, Softbank Group and Disrupting Silicon Valley
Past podcasts

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DENSO
Koganei Country Club
Nihon M&S Center
Olympus
Panasonic
ROHM Semiconductor
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Toyota

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