QUAERO CAPITAL

COMMENTARY ON JAPAN TRIP – SUGOI DESU NE

December 2022

Portfolio review

We visited 28 companies which included 12 companies in our portfolio and in some cases, this presented the first opportunity to meet the managements in person after numerous remote meetings. Here are our observations from the meetings and discussions we held.

Tokyo is a delight as the once crowded streets have partially emptied with work from home and the city projects a feeling of calm in a very uncertain world. The Japanese are responding to global events and announcing a major uplift in national security spending in the coming years. There are no obvious signs of distress. At prevailing currency rates, a visit is a must.

Corporate management near-term focus on wage growth - First time in 3 decades

Numerous managements agree with the likely secular wage growth argument; unions are pressing for 5-6% increases in the Spring 2023 Shunto. Our company visits revealed cases of 10% graduate salary increases for Spring 2023. Toyota have announced a major increase in graduate salaries which appeared as front-page news in the Nikkei newspaper. Base salaries at many large corporates rose 3-4% in 2022 with similar or larger increases planned for 2023. Performance based pay and bonus levels are seeing substantial change; in one case, the company whom we visited almost doubled sales bonuses.

Both fulltime and part time labour shortages are evident. Mid-career mobility is at record levels and leading to substantial wage inflation. Consequently, hiring and retention are the most pressing issues. This trend is only likely to deteriorate further as – anecdotally - a combination of Covid and the weaker yen have materially reduced the flow of foreign workers. Certain sectors are more obviously affected, principally IT and engineers. Retailers face significant cost pressures from wage growth. One of the largest retail groups with annualised JPY 300bn profits revealed that every 1% increase in wages would cost JPY 13bn.

A factor worth monitoring is whether companies have budgeted for higher wages in their current medium-term plan - our findings suggest only partly.

Implications

The likely emergence of sustainable patterns by younger consumers which reduces the historic reliance on older consumers.

Corporate restructuring and IT led cost saving initiatives, DX, will only accelerate and start to feed through into the mid and smaller sized companies. This capex should last for 3-5 years according to a meeting with one of the largest providers of hardware and software to SMEs.

Industry consolidation accelerates as small companies will struggle to afford the wage growth and lack the financial resources to invest in automation.

Deep analysis of these higher costs is required as there is evidence already of margin compression for certain companies. Our assessment is that sell-side analysts have so far underappreciated the magnitude of the higher costs in their earnings forecasts.

Investment plans/Reshoring/Shift away from China

There is no doubt that Covid/higher cost pressures/US -China trade disputes are all contributory factors behind the decisions to reduce manufacturing footprint in China unless required for domestic sales. Managements are increasingly frustrated by lengthening approval processes especially at the local government levels for new manufacturing plants and are tiring of the endless disruptions to production caused by lockdowns. The most recent easing of Covid restrictions has come too late.

Managements are directing investment into 3 specific locations – reshoring in Japan, minor expansion in SE Asia/India and in the US.

Within the semiconductor industry, semiconductor production equipment companies face an uncertain period. At present METI in Japan is allowing ongoing equipment shipments to Chinese customers though the US Department of Commerce has instructed US suppliers - such as Applied Materials - to withdraw their engineers and halt further shipment. Potentially another chip shortage looms on the horizon and the recent surge in new plants outside of China will not be operational much before 2025 at the earliest. Certain companies in this sector we visited are growing increasingly alarmed. A government sponsored consortium with the private sector have announced plans to build advanced semiconductor manufacturing in Japan.

Reshoring in Japan is driven by the perception that SC reliability is high and the desire to reduce forex volatility. The US remains the favoured destination. We learnt that Japanese consultants hired to find manufacturing locations have record enquiries. The issue is the availability of skilled labour. Several companies we met have raised wages by over 20% at their US plants which has not materially improved retention levels. (A cautionary tale for Powell and the Fed)

Implications

Reshoring provides another stimulus to domestic capex and the labour market.

We see pressure on Japanese brands in China escalating given the publicity surrounding their reduced footprint.

Also, there is risk of further shortages in Semiconductors and hence finished products. The recent Apple production issues at Foxconn is arguably likely to be repeated.

Near-term the parts and IC shortages are normalising but not yet completed.

Overseas, the Japanese manufacturers are not interested in expanding their European footprint - organically or via acquisitions - despite lower asset prices.

The Domestic Economy

A gradual recovery induced by the economy reopening is happening and it is still reliant on government funded assistance in industries such as travel with tax breaks for the self-employed. Tourism has risen sharply from the October immigration relaxation although the significant contribution from Chinese tourists pre Covid is still largely absent today.

Domestic capex is strong amid expectations of a 2023 normalisation of domestic auto production levels given stable supply chain levels. Tokyo and Osaka are experiencing one of the strongest periods of private sector construction seen for decades. The building industry is a special situation in that 2024 regulations regarding overtime working hour restrictions imply a shift from a 6-day week to a 5-day week. Order books remain totally full through 2025 and certain related companies in the industry that we saw are requesting further project delays with their customers. This is even more striking given the rampant construction cost inflationary pressures. Retail producers have raised prices sharply in October and for now industry pricing discipline has been maintained, even though consumption levels have declined. The key issue in 2023 is whether further companies can push through another series of price hikes as clearly their input costs will see further upward pressure. The Japanese government has confirmed a major U-turn on Nuclear energy with legislation to extend the lifecycles of existing plants and providing approvals for new plant construction.

Implications

Domestic cost pressures are accelerating further cost cutting initiatives. Certain sectors face clear margin pressure without substantial volume sales improvements. These may be difficult as domestic consumers are clearly feeling the cost inflation pressure except for the top 2 income quartiles, as is the case in the US. Service sector inflation is high with leading hotel prices at record highs.

The industrials are faring better and in many cases passing through the cost pressures into selling prices. High market shares and more limited numbers of suppliers are contributory factors. Industries such as IT are experiencing strong demand and are clear price setters. Our meetings here confirmed a multi-year cycle ahead with an ever-larger shortage of engineers.

Certain manufacturers have benefitted from the global parts shortages and the weaker yen but these two contributors to earnings have peaked out.

Energy security and supply will be enhanced through expanded nuclear expansion. This is very much a long-term positive and another factor behind management decisions to reshore manufacturing. A faster path to normalisation of energy prices will contribute to lowering manufacturing and distribution costs which raises international competitiveness.

Overall portfolio conclusion

The strategy of investing in cash generative companies with further restructuring and industry consolidation opportunities remains right. Over a midterm time horizon, this represents the best potential real money returns from our fund as these beneficial developments are not priced into current valuations that still seem low. As an example, the stock market places no value with Seven &I Holdings on their potential stream of non -retail earnings as they look to monetise their daily 22m customers through financial services and other banking services. The leaders in their industries could offset many of the rising cost pressures. Furthermore, we are not invested in higher cyclical capital-intensive companies, more on that below. We will be rechecking this hypothesis on costs in the coming months as we certainly expect a number of companies - outside of our portfolio - to forecast lower 2023 earnings.

The contribution from Nakamura-san – both our current Tokyo-based analyst and a former employee of mine - is proving extremely helpful and having a positive factor on our returns.

Portfolio implications

We have decided to exit one small position in Payroll, the dominant payroll outsourcing company in the market as future large scale customer acquisitions will

be slow whilst certain existing customers with global operations are shifting to a one shop supplier such as ADP. The focus on smaller sized customers seems sensible but will be very competitive and highly price sensitive.

One of our most encouraging meetings was with Chiba Bank. Our original investment thesis probably understates the true potential for long term earnings. Unlike the major Japanese banks, management have invested heavily in technology to acquire new customers and provide a wide range of products/services. In their local market they are experiencing significant market share gains and have formed an alliance with 9 other banks across Japan. From a cost perspective the overhead ratio is already below 50% and trending lower compared to around 65% at many leading banks who have not embraced the modern fintech model. Earnings and shareholder returns should see substantial improvement in the coming years without the likely contribution from higher spreads as interest rates rise. A return to close to book value would result in a 50% gain in the share price.

Shareholder returns

Corporates are still raising their total pay-out returns, dividends and share buybacks combined but there is a growing sense amongst larger corporates that share buybacks are more problematic especially at prices above book value. We are very excited about our 2-Tier dividend proposals having received significant interest from managements. To that end we have enlisted the collaboration of a leading Japanese investment bank to engage with the companies as we need a local partner to not only continue the dialogue but also educate the domestic institutional client base whilst also protecting us from compliance and insider trading issues. At some meetings, the managements expressed a longer-term objective to use their paper as an acquisition currency and they were therefore fully engaged with our proposals that would materially move the share price. Clearly, this suits our preferred type of investment - leaders with predictable cashflows. The last major buybacks for some companies could emerge if the BOJ sell their positions back to the companies, which is one of the possible disinvestment options currently under discussion.

Conclusion

The business community have a laser like focus on profit margins. The pressure from activists and the lurking presence of major global PE investors affords no time for complacency. The PE firms are current heavily engaged with corporates over total control and part disposal proposals. As previously commented upon in the monthly report, one must pinch oneself to think that the mighty Toshiba could fall into PE ownership!

Corporate profits will adjust to the peaking out of the yen, which in itself will lower certain cost pressures. Interest rates will rise post Kuroda’s term at the BOJ, given more entrenched inflationary pressures - such as wage growth - and thereby result in some yen appreciation. The consensus view is that the Yield Curve Control bands will be widened in 25 bps increments - from the current 25 bps level - to allow an orderly response from markets. This new direction of wages will prove a pivotal point for an economy with an historic low level of labour/GDP whilst invigorating the younger consumer demographic. Amongst developed stock markets, Japan proves the most resilient - in terms of running yield - whilst share prices are supported by low valuations. This is further supported by a diminishing free float - courtesy of the buybacks - amidst a largely disinterested foreign investor base, except for Taiko Fund shareholders.

We will endeavour to extract the benefits of these changes in the returns of the fund.

Thank you for your continued support.

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