WOLFGANG FICKUS, CFA

JAPAN EQUITIES THE BEST IS YET TO COME

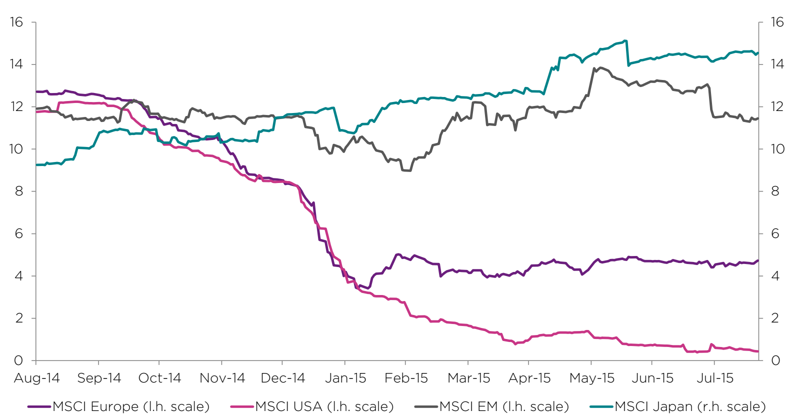
Wolfgang Fickus, CFA
Member of the Investment Committee

Our analysis of corporate Japan shows that Abe's 3rd arrow is the crucial one to close the big return gap to European and US equities. This goes well beyond a reduction of the corporate tax rate. It is about a change in culture, i.e. with the adoption of the Japanese Corporate Governance and Stewardship codes of which Comgest is a signatory. Our company contacts signal to us that 'this time is different' in the drive to become more shareholder-oriented. In this context the Comgest Japan portfolios are already invested in high ROE growth franchises. Our portfolio ROE is 14.8%, which compares favorably with an 8.7% RoE for the MSCI Japan index, while its 2015E EPS growth of 18.2% is superior to the benchmark as well. For us Japan already offers a rich pool of quality growth franchises – often overlooked and under researched. Nonetheless we would be happy to have an even bigger opportunity set in the future. As a Japan specialist, we are confident that changes are going in the right direction.

Japan equities - growth and momentum fine, but returns still lagging

Japan has been an outstanding region in terms of earnings growth and earnings revisions over the past 2 years. The evolution of the current year earnings growth expectations over the past 12 months illustrates the strong earnings growth and revision momentum.

Figure 1: 2015 EPS growth expectation since August 2014



Source: Factset
Data as at 24/08/2015

Looking at 2014 and 2015 EPS growth trends these have clearly been superior to the rest of the world, both for the MSCI Japan as well as the Comgest Growth Japan fund. Earnings growth has hence been and continues to be a good reason to invest in Japan. Earnings momentum also continues to be an argument in favor of Japanese equity as well as the Comgest Japan equity strategy. The 2015 EPS estimate for our current Comgest Growth Japan portfolio has been revised up by 7.5% over the past 12 months compared to a 4% upgrade for the MSCI Japan.

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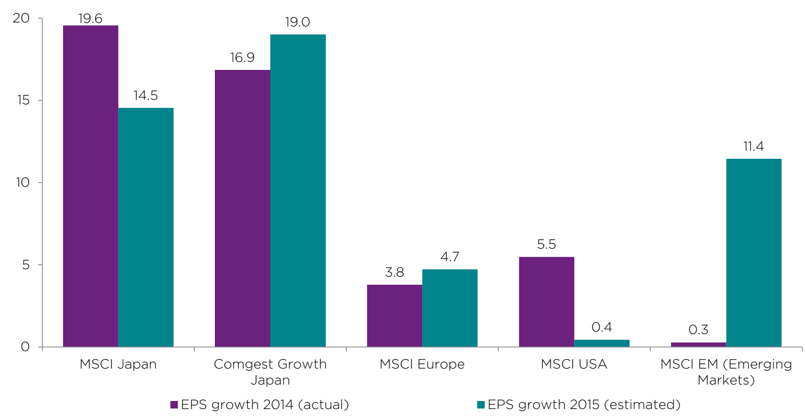
Figure 2: EPS growth 2014 and 2015



Source: Factset
Data as at 24/08/2015

Figure 3: 10-year EPS growth CAGR (2004 - 2014)

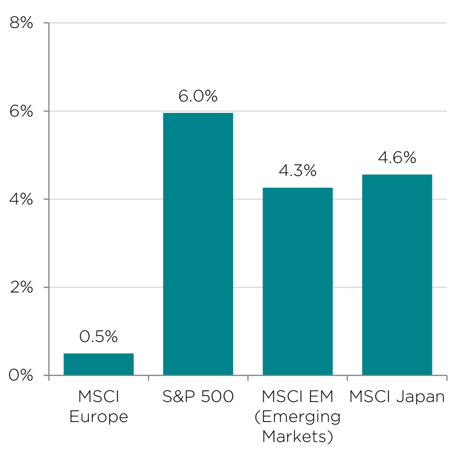
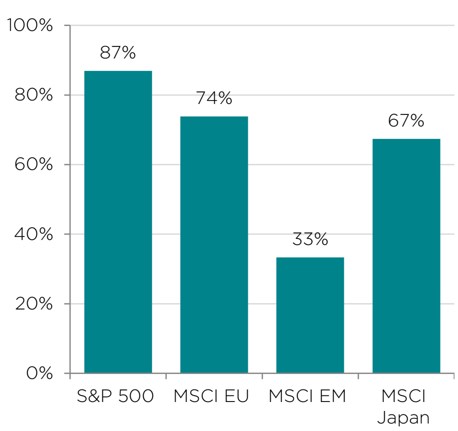


Figure 4: Free cash conversion (ex-financials, avg, 2004 - 2013)



Source: Factset
Data as at 30/06/2015

While we welcome these sound growth fundamentals one of its pillars has been the devaluation of the yen versus all major currencies. As highlighted in a previous note on European equities, currency fluctuations drive volatility of reported earnings figures, but don't add to organic growth, which is what matters most to us. Therefore we focus on what could positively drive organic growth of corporate Japan, namely premier Abe's 3rd arrow with a notable focus on tax reductions and corporate governance improvements. This arrow will take longer to strike, but in our view could substantially improve the chronically weak capital returns in Japan.

When compared to Europe and Emerging Markets, free cash conversion and earnings growth in Japan have been rather robust over a longer time frame. However, free cash conversion ratios in Japan are comparatively high on a significantly lower net profit base. Hence the quality of net earnings is high, but profitability isn't necessarily.

The tables (Figures 3 & 4) illustrate the growth and free cash fundamentals of the MSCI Europe, S&P 500, MSCI Emerging Markets and MSCI Japan over the past 10 years, when excluding financials. To measure growth and cash fundamentals we calculated the free cash conversion rate for every index as well as the realized EPS growth over this period.

While earnings growth and free cash conversion have been robust in a short and long-term as well as global context, capital returns have continued to be very weak in Japan. They have been lagging global standards by a rather wide margin. While Europe, for example, has been lagging growth, Japan crucially lags better capital returns.

Earnings growth is not universally good. It depends on how much that growth costs in terms of how much capital must be invested to support it. In other words, the question is how capital consumptive growth is? The textbook way to answer that question is by looking at a company's returns on incremental invested capital (RoIIC) and comparing them with

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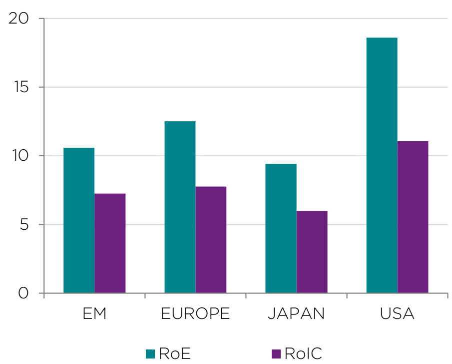
its weighted-average cost of capital (WACC). In an unlevered company the return on equity should exceed the return expectation of the equity holders.

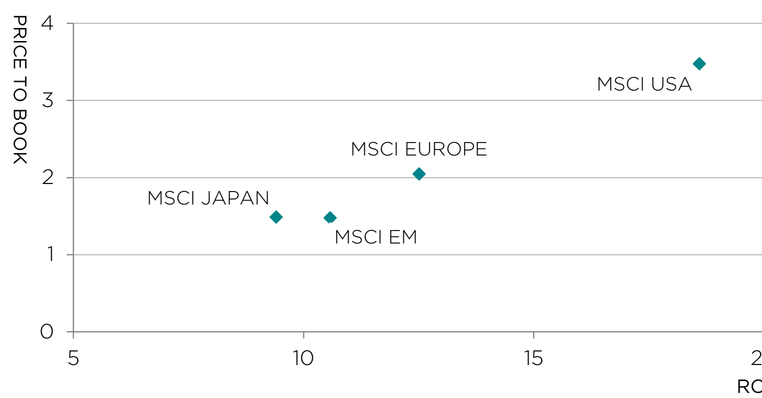
The table below (Figure 6) shows why Japan has still so much potential and why Abe's third arrow, which targets better corporate governance (i.e. to disentangle keiretsu groups and improve capital structures and returns in more general terms) and lowering of corporate tax rates, has so far to go. Low capital returns simply have valuation implications.

Figure 5: 2014 ROE and ROIC comparison (MSCI indices ex financials)



Source: Factset / Comgest
Data as at 30/06/2015

Figure 6: ROE vs. Price-to-Book multiples (2014, actual)



Source: Factset
Data as at 30/06/2015

– **Capital returns lag global standards**

The DuPont model is a tool to decompose the constituents for ROE generation. As such it is a useful tool to analyze, why Japan's ROE is comparatively weak.

The table below summarizes in form of a heat chart (green is best in class, red is worst in class) the ROE drivers for Japan in comparison to EMs, Europe and the USA. Japan is substantially lagging in terms of profitability and boasts by far the highest tax burden. The MSCI Japan ex financials generated a 6.4% EBIT-margin in 2014, less than half the level of the US market boasting an EBIT-margin of 13.9% with its prominent and highly profitable healthcare and IT industry. Japan's tax burden is 15% percentage points higher than Europe's record low 20% average tax rate on PBT.

Figure 7: ROE drivers in the DuPont model (MSCI indices ex-financials, market cap weighted)

	PROFITABILITY = EBIT/SALES	INTEREST BURDEN = EBT/EBIT	TAX BURDEN = NP/EBT	PRODUCTIVITY = SALES/ASSET	FINANCIAL LEVERAGE = ASSETS/EQUITY
EM	9.5%	0.87	0.77	0.73	2.30
EUROPE	10.6%	0.83	0.80	0.69	2.94
JAPAN	6.4%	1.02	0.65	0.77	2.71
USA	13.9%	0.90	0.76	0.77	2.73

Source: Factset
Data as at 30/06/2015

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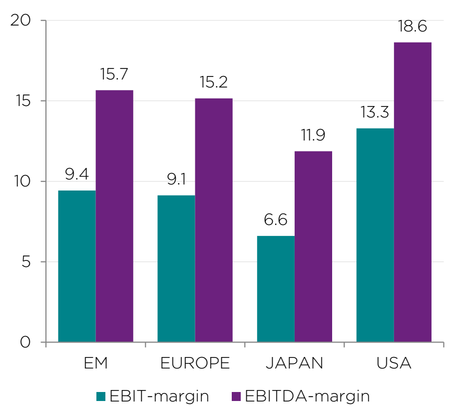
– **Different industry structure does not explain profitability gap**

While we extracted financials from this analysis, a remarkably different industry structure might explain to some extent the widely divergent profitability and productivity levels. Most notably, Japan has an index rich in industrials and automotives, but it also has amongst the lowest shares of energy and materials stocks compared to other indices. Hence different index industry composition does not appear to be the sole explanation for the large profitability gap of corporate Japan to the rest of the world.

Japanese companies tend to use to a large extent the tax shield of high depreciation. However, comparing EBITDA-margins in an international comparison does not change the picture of the substantially lower profitability of 'corporate Japan' relative to the rest of the world. The problem lies in Japan's high operating expense base, while utilization of production capacities as measured by asset turns is strong.

Figure 8: 2014 EBIT and EBITDA-margins in a global comparison



Source: Factset
Data as at 30/06/2015

It is often said that, although as analysts we have to look at specific cases, Japan is known for its philosophy of "Wa", the search of harmony in society. Hence, companies are run for all their stakeholders, which comprise employees and suppliers. That might explain, why profitability targets or payout ratios have not always been the prime objectives of running a business in Japan. Job security, for example, can be a very valuable target in such a set-up, which is not always aligned with shorter-term profitability or productivity targets. In that context, there is again a similarity between Germany and Japan, which we have already pointed out in our previous investment letter on Japan. In Germany 50% of its supervisory board members are employee representatives. That has not been an obstacle to successful corporate governance in Germany and it also is in the interest of shareholders. Cultural differences exist and will continue to exist. This is reflected in different governance and board structures in various countries. But running a company successfully ultimately requires adequate capital returns and this should not be a question of cultural differences as currently seems to be the case in Japan. In addition, Japan needs to close the return gap as a sound base for closing its valuation gap to other developed geographies. It does not need to follow the Anglo Saxon way, but it has to find its way to improve governance. This will be an important prerequisite to success.

– **Financial leverage is not low in Japan, but the cost is**

Another striking feature is that Japan's ROE is positively driven by an exceptionally low interest burden. This is not the result of exceptionally high non-operating income, which is reported below the EBIT-line, but very low interest rates. The multi-year deflation has pushed lending cost to an exceptionally low level when compared to other regions. While financial leverage has come down drastically over the past 15 years, a net debt to EBITDA ratio of 2x for CY2014 remains a rather high gearing ratio in a global context. In a nutshell: financial leverage is not low in Japan, its cost is exceptionally low.

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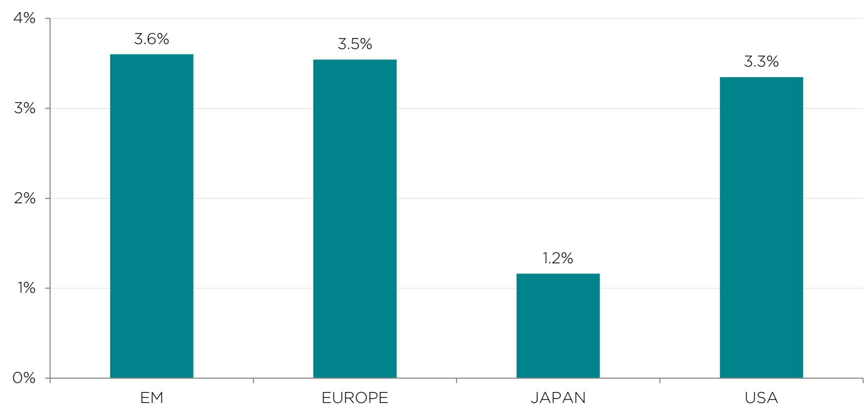
Figure 9: Interest expense as % of short- and long-term interest bearing liabilities



Source: Factset
Data as at 30/06/2015

– **Tax burden is significantly higher than elsewhere**

The average corporate tax rate stands at 35% of pre-tax profits in 2014 versus 24% for the US, 20% for Europe and 23% for emerging markets, all excluding financials. A corporate tax reform as planned by Abe's 3rd arrow could hence become a tangible long-term driver for the Japanese equity market with the corporate tax rate planned to be at 25% by 2017. Last year's VAT hike has been an important step to finance a future reduction of corporate income taxes. Reducing the tax burden would lift the ROE of the MSCI Japan ex financials into the teens, but would not be sufficient to close the gap to Europe or the US, for example.

A new fiscal law makes retained earnings taxable at 10%. This could have a sizeable effect on improving payout ratios, which are lower than in Europe, EMs or the USA.

– **Reform of capital gains tax would be helpful**

A comprehensive corporate tax reform would ideally imply the reduction or even abolition of capital gains tax levied on cross shareholdings, similar to the German model at the beginning of the century. In the old German 'Hausbank' model German banks frequently lent to corporates they held stakes in. The abolition of capital gains tax under the Schröder government led banks to sell down these stakes.

A similar process could lead to a reduction in Japan's keiretsu groups such as Mitsui, Mitsubishi, Sumitomo, Fuyo, Sanwa or Toyota. Equity accounting of such groups of companies additionally dilutes ROE as subsidiaries are recognised without any recognition of the subsidiary's debt. They might also be a reason for alienating foreign investors as they represent a ring fence of compliant shareholders that might be a licence to be complacent. The new Corporate Governance Code, which became effective at the beginning of June 2015, obliges companies to disclose a policy regarding cross-shareholding structures. This is at least a start.

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The Corporate Governance and Stewardship Code – a wind of change starts to blow

The so-called third arrow of Shinzo Abe's economic policy is focused on improving micro-economic performance, notably through a corporate governance reform. However, one has to admit that assessing the quality of corporate governance remains a judgement call, which is hard to prove with facts and figures. Nonetheless, three major drivers have led this governance's improvement to be measured through the lens of the ROE.

– **Corporate governance code targets ROE improvements**

A new Corporate Governance Code is notably aiming to improve ROE and shareholder value over time. This includes the requirement for companies to "explain their basic strategy with respect to their capital policy". Many companies are aware of ROE being the preferred measure of return by investors and many have switched to ROE as a performance indicator rather than revenue size or growth, which does not say anything about corporate value generation. With regards to "Cross-Shareholdings" the Code states that the board should disclose their policy on cross-shareholdings and examine the economic rationale and future outlook for any existing shareholdings annually. From our point of view, it might be hard to explain such shareholdings in a satisfactory manner in many cases. The Corporate Governance Code requires at least two independent directors to "significantly enhance the possibility that their presence will be fully leveraged". The "Role and Responsibilities of the Board – 1" includes the duty to explain any failure to deliver on mid-term business plans or commitments to shareholders. Principles which oblige top managers to state business strategies and capital allocation, and explain failures to deliver on those targets, should become a very powerful tool.

The combination of what was already a gradual move to raise returns, focus on shareholder value and institutional changes, is likely to push Japan to a higher ROE world. Given Japan's history (i.e. the 2011 Olympus corporate governance scandal) the scepticism of foreign investors towards this is understandable.

On a recent trip to Japan we met with 14 companies at top management level as well as industry experts (i.e. Daiwa Institute, ISS) and politicians (Minister of State for the national strategic specials zone) on governance and general ESG issues. While many companies are just starting to embrace the idea of corporate governance, we do genuinely believe that "this time is different". Out of the 14 companies, 10 had two independent directors on their boards already. On a broader level, for example, 1,300 companies in TOPIX have at least one independent or outside director, which is up from 844 last year.

– **Olympus scandal raises awareness for governance reforms**

On the other hand, a lot still needs to be done as a fair number of companies are still pretty unprepared for governance questions, i.e. the remuneration of their top executives. A constructive dialogue with shareholders about sustainable growth and corporate values has not been on the agenda previously. An exception to the rule is Olympus. Having suffered a lot from its corporate scandal in 2011, the company has 8 independent directors out of a total of 13.
The board has been completely restructured, with the aim of having

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more counter power following this scandal.

From a board structure viewpoint Hoya is an interesting company. This company has adopted a corporate governance structure based on Western style that is to say a board with 3 board committees (audit, compensation, nomination). Additionally, the board is majority independent with 5 independent outsiders and only 1 executive director who is the CEO.

– **ESG scores of Comgest holdings are high. Comgest signed up to the Japanese Stewardship Code**

While many Japanese companies are just beginning to embrace the idea of corporate governance, ironically the ESG scores of our Japanese holdings are rather robust. This has to do with corporate Japan's strict focus on efficiency, notably energy efficiency (the 'E' in ESG) as well as involvement with employee interests (high level of professional education, job safety etc.), the 'S' in ESG.

As a long-term oriented quality growth investor, Comgest endorses and has signed up to the Japanese Stewardship Code (JSC) and engages and votes on any issue affecting the long-term sustainable value of the companies, in which we are invested. As of today, Comgest is invested in 41 Japanese companies.

The JSC is a government backed initiative that requires institutional investors to engage with its investee company to enhance long term returns and to act as responsible investors. This is perfectly in line with what we do as a quality growth investor. Its principal objective is to enhance the dialogue between companies and shareholders by honing in on the investors role within corporate governance. A major aspect of this dialogue takes place with investors' votes at the AGM. After a wide consultation with its clients, ISS (the global leader in proxy voting) has decided to recommend to vote against the renewal of Directors of companies that have had lackluster performances with a ROE below 5% for five years or more. This new practice is the direct result of all this governance reform that is taking shape in Japan.

– **Nikkei 400 can become a status**

Investors and companies have increasingly paid attention to the constituents of a very sought after index: the JPX Nikkei 400. This index was created to offer exposure to companies with higher shareholder focus. Among the various criteria used for inclusion, 3-year average ROE is definitively a key metric. In a country known for its specific sociology, this inclusion can be a "status", nudging companies to strive for index inclusion. This informal pressure to be part of the JPX index (which by construction cannot accommodate all listed components) is due to the GPIF's decision to employ this index for passive investments. The GPIF is the second largest pension fund in the world with more than $1400Bn of Assets under Management. The purchase of ETF's linked to this index by the Bank of Japan also gives it considerable weight.

One short-term issue is that around 3,000 independent outsiders need to be elected to company boards in Japan, but the number of candidates is limited to within Japan. In the interest of minority shareholders Japanese companies must find the right independent directors with relevant skills

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with regard to their particular businesses and should not hire independent directors only for the sake of complying with the Japan Stewardship Code or the Corporate Governance Code. As a signatory of the Stewardship Code and in view of our active ESG approach, we will be very carefully watching the profile of these independent directors in the companies we invest in, similar to the work we do on EM, US and European shareholdings today.

Comgest Growth Japan fund – a portfolio positioned in high ROE franchises

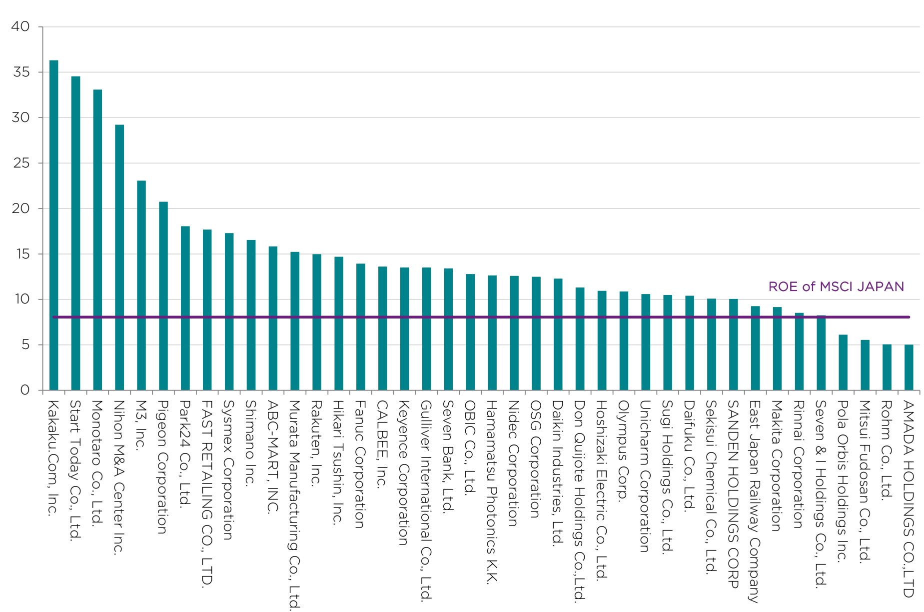
By virtue of our quality growth investment approach, Comgest does not tend to be invested in keiretsu groups. We target companies with entry barriers, sound pricing power and value generative growth potential. Respect for ESG criteria is implicit in our quality growth approach and explicit in internal ESG scores with direct valuation implications. The respect of minority shareholders and the generation of adequate capital returns go with it.

– **Quality Growth approach implies solid ESG**

Accordingly the Comgest Growth Japan portfolio ROE is substantially above the Japanese average. The Comgest Growth Japan fund currently boasts a ROE of 14.8% compared to an average of 8.6% for the MSCI Japan ex financials based on FY2014 accounts. That said we have seen some of our companies change in the wake of the discussions around the new Corporate Governance Code. Keyence tripled its dividend per share for the FY March 2015. Unicharm has announced its three fifteens goals: 15% ROE, 15% EBIT-margin and 15% sales growth. Fanuc has opened up for the first time to its minority investors by creating an investor relations department and a dividend payout target of 30%.

– **Comgest Growth Japan ROE is substantially above market**

Figure 10: Comgest Growth Japan - ROE 2014 (actual) by portfolio holding



Source: Factset
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Performance and positioning

Comgest offers two single-country Japan funds. The Comgest Growth Japan fund is Irish-domiciled (yen denominated), while Comgest Japan is a French-domiciled fund (Euro denominated). Both funds are UCITS IV compliant.

– **Identical portfolio management for both Japan funds**

Both funds are managed identically in line with the Comgest quality growth approach. Hence we currently hold 41 positions (as of May 29, 2015) with an active share of 90% in both funds. The funds can be characterized as all cap funds with – very roughly speaking – 1/3rd exposure to small-caps (below 5bn USD market cap), mid-caps (between 5 and 10bn USD) as well as large-caps (above 10bn USD).

Both funds have outperformed their Topix benchmark year-to-date as well as over 1/3/5 years and the track record for the fund management team lies with Chantana Ward and Richard Kaye. In their Morningstar peer group both funds are positioned in the 1st quartile year-to-date as well as over 2/3/5 years. In line with our quality growth approach both funds are not invested in banks, materials and energy stocks. While we do not exclude these sectors from our research effort à priori, we do not tend to find companies in these sectors that post double-digit EPS and with high visibility (i.e. with low sensitivity to the economic cycle) for the upcoming 5 years.

Currently the funds trade on a CY2016 PE of 24x for expected EPS growth of 15%, hence a PEG ratio of 1.6x. The MSCI Japan trades on a more attractive PEG ratio of 1.2x, yet its ROE of 8.7% is largely inferior to the Comgest funds, which generate ROE of 14.8%. It is worth noting that the higher PE is very common to companies that match our 'quality growth' criteria as they tend to show more sustainable earnings growth combined with sound value generation (expressed in high ROE).

– **Comgest funds show high ROE and solid earnings growth**

In terms of earnings momentum, FY 2015 EPS for the Comgest funds mentioned above has been revised up by 7.5% over the past 12 months, which compares favorably with an upgrade of 3.5% for the MSCI Japan. Performance of our funds as well as the index has been driven to a similar extent by re rating and earnings growth over the past 12 months.

The Japan portfolio has been driven by a variety of very different quality growth franchises as domestic institutional buyers such as GPIF emerge for the first time in two decades, under pressure to deliver returns in the newly inflationary environment and with the objective to invest in high ROE companies. In the first half of the year, the portfolio was driven by large caps such as Murata Manufacturing, a global leader in passive components, and Fanuc, the global robotics leader. Its performance was not least due to its opening to the investor base and more reasonable future capital allocation. In the mid cap space Sysmex Corp. performed strongly. It is the global market leader in blood analysis and testing equipment and services. Similarly, Hamamatsu Photonics, which as the global leader in photo multiplier tubes for medical equipment, is able to detect a single proton with its ultra-sensitive optical sensors. All these companies are leading high tech global engineering franchises.

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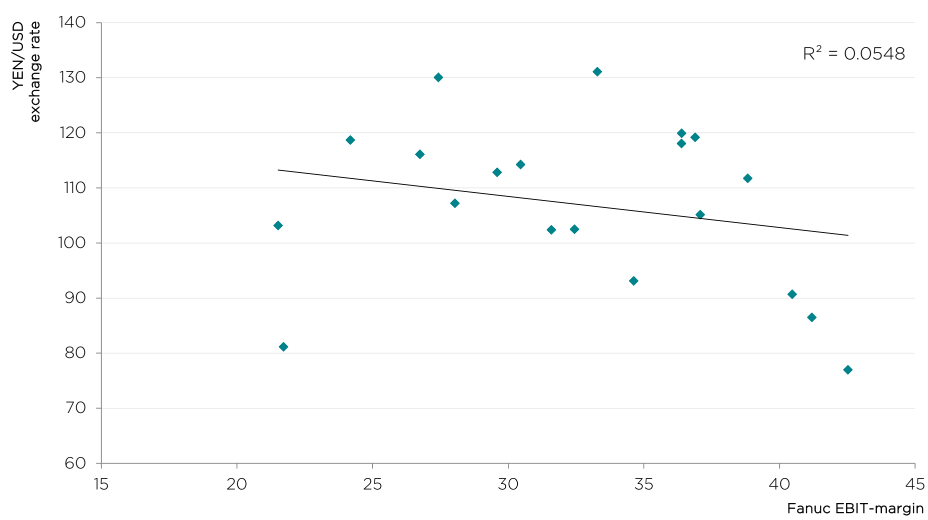
– **Currency is not a relevant variable in our stock picking decisions**

A lot of investors might view Japan as a simple currency play. As we have argued in a recent note (see our investment letter 'Does a weak € matter?') currency is not a relevant variable in our stock picking decisions, as it does not tend to drive competitiveness over the long-term and as such it is a random variable. We make sure that our companies do not have significant currency mismatches between free cash generation and liabilities. Our analysis suggests that our largest holdings have roughly 40% of their revenue on average derived from Japan.

The scatter diagram below (Figure 11) plots Fanuc's FY1995-2014 EBIT-margin against the relevant YEN/USD exchange rate for these years. The graph underpins that there is no correlation between both. While the weak yen has undoubtedly been a driver for earnings growth over the past two years in Japan, it is the large pool of quality franchises which we are focused on. Those companies do not depend on favorable currencies to be very profitable. It is a misconception if you bought our Japan funds on account of the weak yen.

Figure 11: Fanuc – no correlation between YEN/USD exchange rate and profitability (CY1995-2014)



Source: Factset
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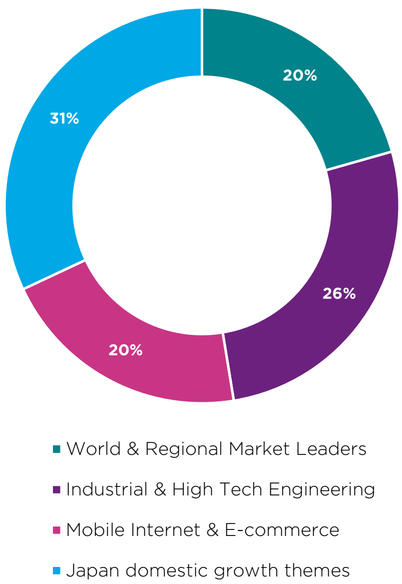
Figure 12: Positioning of the Comgest Growth Japan portfolio by investment theme



Source: Comgest
Data as at 30/06/2015

It is important to underline that your portfolio continues to be a concentrated one. Given that benchmark considerations play no role in our investment process, the positioning of your fund is much different from an index, which is rich in automotive, industrial and high tech engineering franchises. Your portfolio is roughly 50% exposed to those more traditional Japanese themes. On the other hand we have a strong pool of mobile internet, eCommerce and social media stock picks in the portfolio, which represent circa 20% of the portfolio. Innovative and successful companies such as price comparison site Kakaku.com or M3, a kind of Japanese Facebook for doctors, are part of this strongly growing pool of companies. Domestic growth themes in Japan are no macro consumer bets as you might suspect knowing our long-term and macro agnostic investment style. Consumer spending is cyclical and no base for our stock picking. This part of the portfolio comprises companies, which embrace, for example, the negative demographics in Japan, i.e. Sugi's consolidation of the pharmacy market and its offering targeted towards the elderly. Orientation towards the successful SME market in Japan is another characteristic of this pool of companies. Nihon M&A Center, the exclusive consultant to successor-less SMEs is an example. Japan is a particular country in many respects, so growth trajectories might also somehow appear atypical. The fact is that there is a lot of growth beyond the immensely successful export industry of Japan.

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Wolfgang Fickus graduated from the University of Cologne (Germany) where he majored in business administration and studied at London Business School. He holds a business graduate (Diplom-Kaufmann), a CEMS-Master and is a CFA® charterholder. Wolfgang started his career in 1995 at Paribas Asset Management Paris as a European-equity fund manager. In 2000 he moved to WestLB where he worked until August 2012 as an analyst for European Technology stocks before becoming Head of Mid-and Small Cap Research. Wolfgang joined Comgest in September 2012 and is a Member of the Investment Committee.