'Japan, Inc' Does Not Exist

by Richard Kaye

A little like the terms 'Wild West' or 'Hollywood', so the term 'Japan Inc.' offers a broad-brush impression with loose geographical association, rather than a readily definable entity.

Nonetheless, investors often tar all Japanese companies with the same brush, and many discussions of Japanese equities begin with an analysis of the demographic and fiscal situation of the country called Japan. Few investors in Apple or Intel would pay much attention to the budgetary situation of the US government or of the State of California; it is mostly in smaller markets that individual stocks suffer from guilt by association with an entire country.

We have little interest in defending the economic health of the country called Japan. If Japan revives, that should help us; if it stays the same, that will barely affect us. Whether Japan's problems are on a different scale to other developed countries' anyway needs to be discussed - but not here. Rather, we are interested in the arbitrage opportunity offered by the mistaken association of Japan as a country with the fortunes of companies domiciled there.

Given a widespread refusal by the investment community to look at it in detail, and brokers' sharp reduction in analyst coverage, it is not surprising that the Japanese market hides many treasures and has become one of Comgest's richest investment opportunities.

We have held a roughly 30% weight in Japanese equities in our global fund for several years and this has generated generally positive attribution, despite the 2011 Fukushima Earthquake and Thailand Floods (wiping out considerable Japanese manufacturing capacity).

Figure 1: Comgest Japanese equities performance vs. global benchmark
Source: FactSet, Comgest. Data at end

Our separation from ''the market'' can be shown by the difference between the EPS trend of the Japan-domiciled companies in which we invest and the average for TOPIX constituents.

The consistency of EPS growth for our invested companies, despite the volatility of the Yen, attests the relatively separated nature of our companies' environments.

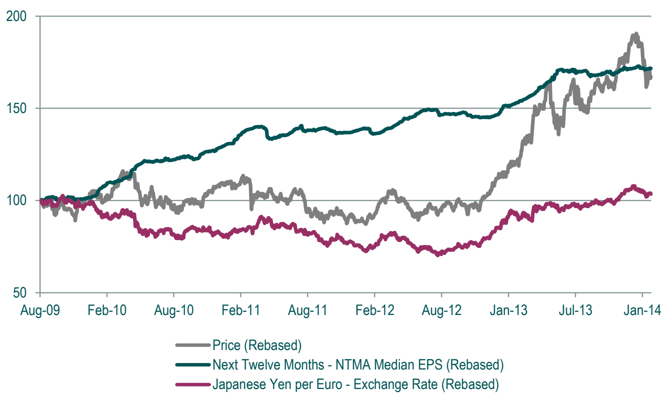

Figure 2: Comgest Growth Japan - EPS growth (in Yen) less correlated with Yen exchange rate movements.
Source: FactSet. Data as at 17/02/2014. Data rebased at 100 as at 28/09/2009.

Spot the Japanese company

Being 'Japanese' affects companies only in their tax bill and their reporting currency. Some may

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say that Japanese labor law or even Japanese work ethos must be taken into consideration, but we would counter that most Japanese companies have mostly added headcount outside Japan for two decades, so dilute both these factors.

We have demonstrated by the performance record that money can be made in the Japanese market by bottom-up investing, and that a discussion of the vague entity 'Japan', whether it be on the theme of 'Abenomics', 'demographics', or 'geopolitics', is at best tangential to individual stock investment decisions, and at worst entirely irrelevant.

Many of Japan's leading companies, and our portfolio holdings, have little to do with Japan. Canon, for example, derives less than 10% of its profit from Japan, Daikin a diminishing ratio of total profit, 28% at last count, Fanuc more – 40%, we estimate, but only because its customers buy its robots to supply their factories in China.

This point can be illustrated by the example of a very 'French' company, L'Occitane, and very 'Japanese' company, Canon. L'Occitane has in fact considerably higher Japan exposure than Canon, if we look at Japan as a proportion of total business, or as a proportion of recent growth.

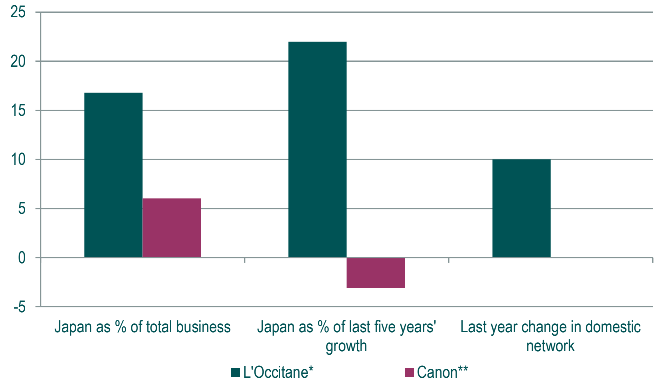


Figure 3: L'Occitane and Japan
Source: Company data.
*Fiscal Year 2013 data
**Operating profit exposure of Canon Marketing (Japan) divided by Canon Inc., 2013 data.

Comgest invests in several companies domiciled in France, but the economic circumstances of France are only tangential to these investments. Our Europe fund has outperformed the Europe market benchmark long-term through investing in global franchises with visible recurring growth, with scant regard to the political or demographic circumstances of the geographies where those companies are domiciled.

We focus therefore here on some examples of companies, happening to be headquartered in Japan, which have cultivated excellent global franchises, and examine how they did it – with no regard to the country in which they were domiciled.

Piranhas and moats

We showcase here two examples of excellent business models of Japanese companies, in which Comgest has invested. The excellence has little to do with these companies' geographic location, but much to do with an accumulated installed base of customers which any rival struggles to imitate. It is classic Warren-Buffet-piranha-filled moats investing, and it works in any market. These practitioners just happen to be in Japan.

Case Study One: Robotics

Fanuc and Keyence have been enigmas not only for investors in Japanese equities but for observers of the Factory Automation industry globally. They do not just make great products; they make great profits. In good times and bad, even with the currency against them, both companies have consistently earned over 30% Operating Profit margin.

Fanuc makes good money because it has a large installed base of customers for its Numerical Controller, who have been loyal to Fanuc through generations of engineers. Fanuc's profit grows because this installed base of customers grows – for the obvious reasons that China is automating, the US is re-industrializing, and precision manufacturing requirements increase the role of machines. Nearly every addition to the

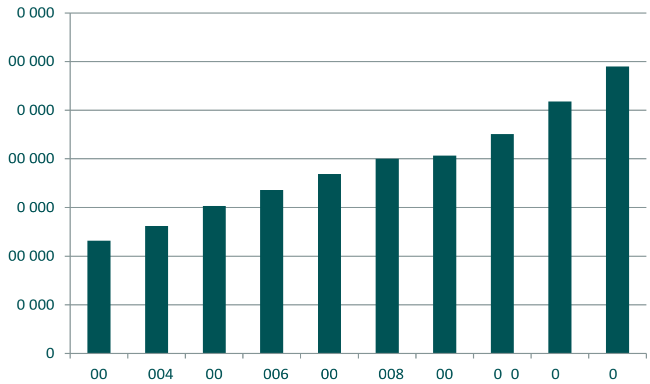


Figure 4: Fanuc's moat: most of these robots use Fanuc.
Source: IFR, in units of robots.

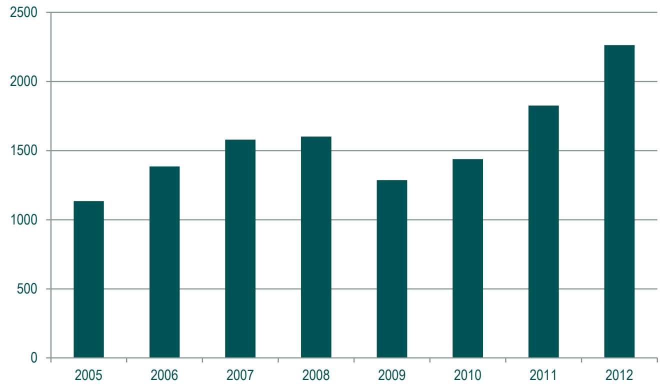


Figure 5: Fanuc profits* in million USD
Source: Company data.
*Pre-tax profit represented as a 3-year moving average in million USD, to offset volatility in customer inventory and currency.

global population of robots and machine tools is an addition to Fanuc's recurring revenue stream, and its incremental cost on Numerical Controllers is minimal.

Fanuc's moat has been dug over decades. Typical robot longevity is seven years, and the loyalty to Fanuc Numerical Controllers has been fostered over generations of robots, and machine tools.

The below comparison of Fanuc and Germany's Kuka, its nearest global comparable, is self-explanatory: Fanuc's superior franchise in its core

Figure 6: Cash flow return on investment (CFROI) of Fanuc and its nearest overseas comparable, Kuka
Source: Company data.

Numerical Controller business has allowed it more consistent returns than Kuka.

Case Study Two: Medtech

Hamamatsu Photonics and Olympus and are not household names, at least for their core business, which is diagnostic componentry and flexible endoscopes, respectively.

However, both make similar margins in their medtech divisions to Fanuc and Keyence, although they have been less recognised for this by the global investment community.

Neither company invented its core product – photomultiplier tube for Hamamatsu or endosope for

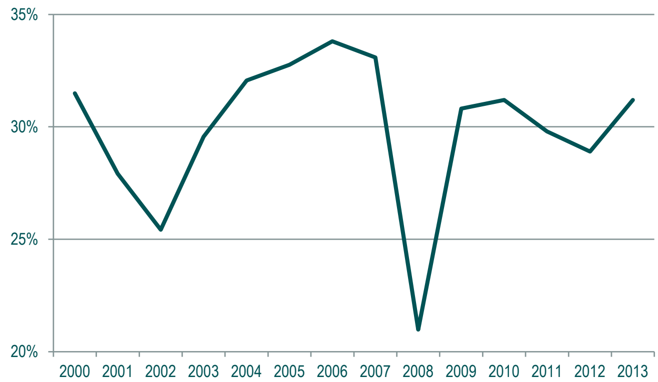
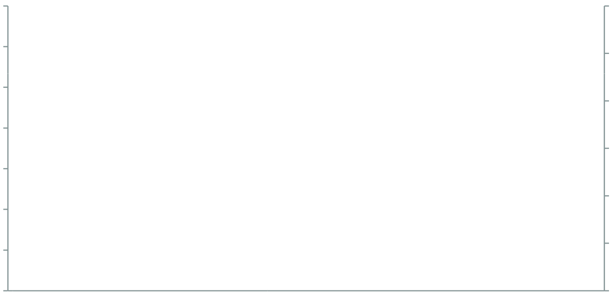


Figure 7: Hamamatsu divisional pre-tax margin, optical components.
Source: Company data.

Olympus – but each has become globally the most trusted manufacturer of it, and as with Fanuc owes its preeminence, pricing power and therefore profitability to a large and growing installed base of customers.

Olympus' overall profitability is compromised by its camera business, but Hamamatsu has been a Comgest investment for some years. Hamamatsu's photomultiplier tubes are used mainly in Positron Emission Tomography (PET) scan equipment, which itself is manufactured by General Electric, Philips, Siemens, etc. The tube is indispensable to an amplified and highly precise image of a tumor, and Hamamatsu's technology has been de facto standard since the 1980s thanks to adoption by General Electric which gave that company a clear competitive advantage.

Increased emphasis on diagnostic medicine, including in emerging economies, and a steady upgrade cycle for PET scan equipment as manufacturers look to reduce diagnosis times, have allowed this market to grow fairly consistently. As with Fanuc's Numerical Controller the incremental cost to the company of manufacturing each new unit is negligible, so incremental profitability elevated.



Conclusion: Global Franchises can be Found in Japan

Japan is, despite 2013's rally, still perhaps the most misperceived market, and therefore one of the richest opportunities, especially for an investor in quality growth.

Comgest's process allows us to find such franchises, represented by an installed base, defended by customer loyalty, and numerically attested by high capital returns.

The volatility of investor sentiment towards companies which are domiciled in Japan offers us important arbitrage opportunities, which we intend to use to our clients' advantage going forward.

Richard Kaye graduated from Oxford University where he majored in Oriental Studies. He started his career in 1994 with Industrial Bank of Japan as an analyst of technology stocks before joining Merrill Lynch in 1996 in the same role. He went on to work for Wellington Management Company as portfolio manager of Japanese TMT stocks before joining Comgest in 2009.