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FOR PROFESSIONAL INVESTORS ONLY

On the ground in Japan

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"Those of you in window seats on the right side of the plane might catch a view of Mount Fuji in a few minutes". The Captain's words prompted everyone to scan the horizon for signs of the famous mountain. It always surprises me that Fuji is so big that, when weather conditions are right, it sticks up above the clouds. Anyway, cloud cover was too thick and there was no sign of it.

I was on my way to Japan to spend a few days visiting companies. Usually I do this twice a year, but this was my first visit of 2018. This is because, after a slow start in January, when corporates were initially confused by the implications of MiFID II, we have had huge numbers of them visiting us in London this year. And, particularly for the larger companies, the opportunity to meet the top management is too good to miss. Indeed, just before I left, I had a one-on-one meeting with the president of Hitachi. However, particularly in the Japan Fund, we own several companies based in the regions, which are more reluctant travellers. The plan was to do a reasonable amount of travelling over the course of the week.

Life beyond analyst notes and annual accounts

Yet our trips to Japan are not just about meeting companies. They are also about observing sentiment and monitoring changes that don't make the pages of an analyst report. Before starting my meetings, I headed for Shibuya. This area in Tokyo is known for the famous pedestrian crossings, at which thousands of pedestrians stream across a big junction from lots of different directions every few minutes. Unfortunately, it is now so famous that every tourist in Tokyo wants to film themselves walking across it.

My reason for going to Shibuya was to check out the progress of building works at the station. We own shares in several Tokyu Group companies. The Tokyu Group is midway through a massive redevelopment of the area, which, despite its worldwide reputation, was somewhat down at heel. The latest new building there, Shibuya Stream, opened a couple of months ago and it was good to see that the restaurants were very busy on a Monday lunchtime. The stream in question is not quite the babbling brook implied by the name, but there was no shortage of diners happy to sit looking out at it (and into the backs of the apartments on the other side of it – there is clearly still some work to be done). Next door, progress on Shibuya Scramble Square, a mixed office and commercial building which will have a roof garden from which to view the Shibuya crossing, was well underway, as were a series of overhead walkways to connect all these new buildings. It is difficult to convey the extent of the Tokyu Group's plan for the area around Shibuya station; it is completely transforming it. And it is being rewarded by seeing the big tech companies move in. Shibuya has always had a strong tech presence, but a shortage of office space meant that the bigger players located elsewhere. Now Google has signed up for one of the new buildings.

When I checked in at the Imperial Hotel, there was a slightly odd notice about additional security measures in place. It turned out that Mike Pence, US Vice President, was staying

there on the Tokyo leg of his Asian trip and that half of the lifts had been reserved for him and the huge security detail which accompanied him. The hotel was so full that they were warning of a 30-minute wait for breakfast next morning. And inflation is definitely starting to hit the hotel sector, as room rates and even breakfast prices had risen by over 10%.

Japan Inc back on track after natural disasters

As usual, I saw a mixture of companies, from sectors such as construction, services, technology, manufacturing and (unusually for me) pharmaceuticals. A couple of themes stood out.

Firstly, Japan's series of natural disasters over the summer affected production and logistics for a number of companies, but things are finally back on track. For one or two, however, the implications were more severe. Tokyo Rope saw the roof of its Osaka plant damaged by the earthquake, together with a quantity of its stock. This will be covered by insurance, but for now the company has just incorporated the losses from the damage into its numbers. Toyobo, an Osaka-based specialty chemicals company which we hold in the JOHCM Japan Fund, suffered a fire at the plant which makes fibre for airbags. This happened when the electricity, which had been cut off during the typhoon, came back on again. The president explained that he had spent the past two months securing supply of fibre (there are very few global manufacturers) to make sure that the supply chains of the automakers were not affected. Toyobo, too, has incorporated the cost of the damage into its forecasts, but not the insurance claim.

Secondly, manufacturers dependent on the smartphone replacement cycle are having a tough time. The situation for those reliant upon the semiconductor cycle is more nuanced. The share prices of such companies have collapsed. However, I visited two companies, one of which polishes silicon wafers and the other which supplies chemicals for etching the fine lines onto semiconductors. Both said that the market remains tight, that their customers have asked for long-term contracts because they are concerned about securing supply of wafers and that they are continuing to put through price increases. For the manufacturing sector as a whole, higher raw material and energy costs were a factor in the first half of the fiscal year, but in most cases companies will be passing at least some of those costs onto customers, albeit with some delay. Meanwhile, companies in the construction industry and related suppliers remain very upbeat. Order books are full, pricing remains firm and they expect good conditions to last beyond 2020.

A tight labour market, a tight property market

Evidence of the labour shortage is everywhere. Convenience stores in Tokyo have foreign students behind the counter. Reception desks at Tokyo-based companies are now a thing of the past. The visitor turns up and is faced with a telephone and an internal directory for the various departments. Offices are looking smarter in Tokyo (several companies said that it was important to offer a nice working environment to attract staff).

After a couple of days in Tokyo, I set out for a day in Osaka. I started with a meeting with Daibiru, the Osaka-based real estate



company we own in the Japan Fund. The spokesman explained that the Osaka property market is currently very tight. It is a couple of years behind Tokyo in its recovery, so rents are just starting to rise. But there is no new supply coming in stream for at least the next three years. And with some older offices being turned into hotels to accommodate Osaka's tourism boom, the longer-term outlook seems very favourable. There was also a lot of excitement around Osaka's bid to host the 2025 World Expo. Tokyo is so focused on the Olympics in 2020 that nobody had even mentioned this to me, but companies in Osaka (as well as Daibiru, I visited two of our construction-related companies and Toyobo) were very excited about the forthcoming announcement of the successful candidate city. A win for Osaka would extend the current construction boom for at least another 2-3 years.

I didn't stay overnight in Osaka, but instead caught an evening train to Toyama, on the Sea of Japan coast. This was my first visit to Toyama and the main reason was to visit Albis, a local supermarket company we bought for the Japan Fund this year. I chose to stay in a hotel operated by the Dormy Inn chain, which is aimed at business travellers but is now becoming very popular with foreign tourists. No wonder. My room was not much bigger than my bathroom in the Imperial Hotel, but it had absolutely everything I needed and the bath, though tiny, was actually made of cedarwood and fed from the hotel's own hot spring downstairs. The second floor onsen had a series of hot spring baths, which were open 24 hours. And from 9:30pm until 11pm each evening they served delicious free noodles in the restaurant. All this for around £100 a night.

The visit to Albis was very interesting. It's a small regional supermarket, but Mitsubishi Corp, the giant trading house, has been building a stake in it and has helped Albis make decisions such as to invest in a new processing centre to take some of the food preparation work out of the stores. This will start operation next spring. The company specialises in fresh, local produce, particularly fish, for which Toyama is famous. Having abandoned its original wholesaling business to focus on supermarkets a few years ago, it has grown sales, profits and margins consistently and is making use of M&A to acquire other local players cheaply. I managed to check out two of their stores. One was an Orange Mart, a group of four stores which Albis has recently acquired. The other was an Albis store. We actually had lunch at Orange Mart, which was a really nice store, with great displays of fresh fish and delicatessen items. It was bright, clean and the displays were beautiful. The Albis store was equally impressive. The consumption tax is due to increase from 8% to 10% next year, but food will be exempt, which we believe makes supermarkets relatively defensive. In regions such as Toyama, there is as yet little threat from online retail. Indeed, given the Japanese obsession with freshness, I'm not sure there ever will be. Albis trades on less than 12x earnings.

Time for book and bed

We finished in Toyama on Friday evening. I stayed on for another night of onsen and free noodles and returned to Tokyo the next day via the new Hokuriku Shinkansen, which was completely full. For my last night in Japan, given that business was finished and I was now paying for myself, I decided it was time to finally try a capsule hotel. To be fair, I didn't go quite as far down the capsule route as I might have done. Capsule hotels are generally at stations and are designed for salarymen who have had too much to drink on a night out with colleagues and miss the last train home. However, some operators are bringing a modern twist to the concept. I had arranged to stay at Book



and Bed. This is a bizarre combination of library and hostel. The beds are tiny wooden cabins located in amongst the bookshelves. My "room" was now the size of my bathroom at the Dormy Inn in Toyama. Customers are invited to browse the book shelves, settle down with a book on one of the large sofas and, when they eventually feel tired, retreat into their capsule. A small curtain separates you from the rest of the room. It was an all-round

pleasant experience. The staff were lovely, the other guests were extremely well-behaved (it really does have something of the library about it, despite the bar and background music) and my capsule was remarkably comfortable. I sat up reading until late, then wriggled into my bunk and had an excellent night's sleep. For this, I paid ¥5100, which is about £35.

At Haneda Airport the next day, I watched as the plane beside me pushed back from the stand to taxi to the runway. The airport workers who had been in charge of it stood, in strict order of seniority and bowed deeply as it moved away. They then waved, first with one hand, then with two. It was as if this was the first plane they had ever despatched. But it's an exercise they repeat many times every day. Japan is still a land of incredible customer service.

Hidden domestic treasures

It was a fascinating trip. Writing up my company visit notes, I found myself concluding in almost every case that the company in question was trading too cheaply, given the quality of its business model. It is frustrating that our companies are being ignored by a market which has been dominated by investors who appear to want to play big, global themes and seem to have little interest in the underlying strength of the Japanese economy. Perhaps, as some of those big global themes start to become less attractive, the merits of these niche businesses will start to be appreciated. In the meantime, valuations are low, earnings are strong and dividend support is good.

As we pulled up through the clouds on our way back to London, there it was, Mount Fuji, almost floating above the clouds, with its signature snowy top. Like the famous peak, the value in our domestic stocks can be shrouded from view, but it is most definitely there.

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