

## JAPAN EQUITIES

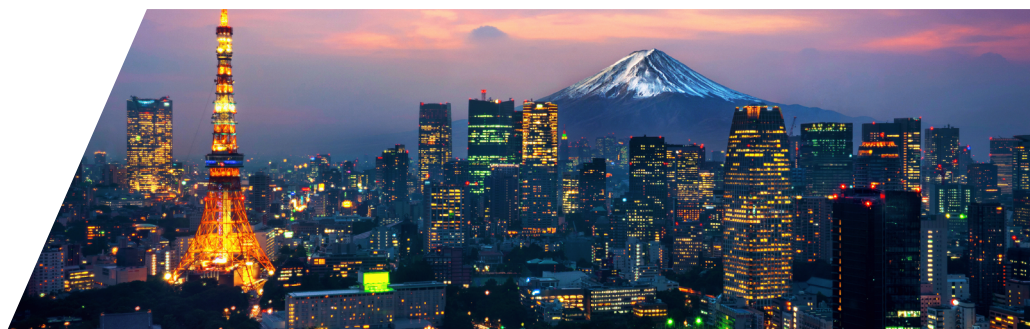
# LOOKING BEYOND JAPAN'S VALUE RALLY



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*In recent years, investor focus in Japan has shifted towards cyclical stocks, including automotives, commodities and financial services. These stocks have demonstrated strong performance on the back of a historically weak Japanese yen and previously rising global interest rates. Comgest believes that Japanese companies exposed to structural growth trends – such as digitalisation, ageing populations and Asia's growing middle class – are less dependent on short-term economic cycles and more likely to deliver consistent long-term returns.*

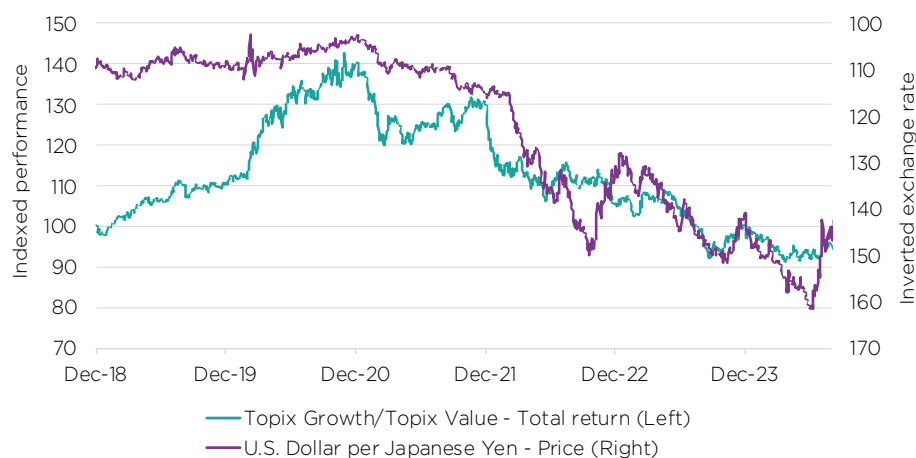
### DON'T LET VALUE DISTRACT YOU FROM QUALITY

Japan is globally renowned for its rich cultural exports. From sushi and ramen to anime and video games, Japanese products continue to innovate and captivate consumers. The country's companies are synonymous with efficiency, reliability and technological advancement. Despite the daily use of Japanese products by companies and consumers, Comgest believes that Japan remains largely misunderstood by investors. Japanese companies often receive less analytical coverage than their counterparts in the United States and Europe.

As a result, we believe that there is an investor tendency to follow the crowd when it comes to investing in Japan. For instance, since mid-2021, investor sentiment in Japan has gravitated to the so-called value sectors, which encompass cyclical products like automobiles, commodities and banks. In our view, this trend underscores a lack of investor research and attention paid to Japan. From our perspective the recent value rally has been driven not by quality or company fundamentals, but by a weak yen and the high liquidity associated with cyclical stocks, as shown in *figure 1*.

At Comgest, we seek global companies that dominate highly concentrated markets. We aim to build our portfolios with companies that possess competitive advantages, high barriers to entry and pricing power that we believe makes them capable of sustainably growing their earnings. As long-term quality growth investors, we tend to avoid cyclical sectors. In our experience, the company fundamentals behind cyclical rallies tend to be weak and overly reliant upon macroeconomic conditions. Our Japanese equities strategy is supported by several long-term growth drivers, including digitalisation, ageing global population, productivity enhancers and the rise of Asia's middle class.

Figure 1. Topix Growth/Topix Value compared to USD/JPY



Past performance is not indicative of future returns.

Returns may increase or decrease as a result of currency fluctuations. Source: Factset data as of 30-Nov-2024 expressed in local currency. Indices: Topix Growth, Topix Value, Topix. Indices are used for comparative purposes only and the Strategy does not seek to replicate the indices.

## FROM PAPER TO DIGITAL

Despite its reputation for technological leadership, Japan has been a late adopter to cashless payment methods.<sup>1</sup> The country has remained a cash-based society for much longer than other developed economies. In 2018, Japan's Ministry of Economy, Trade and Industry (METI) published "Cashless Vision," a plan of proposed measures aimed to achieve 40% cashless payments by 2025.<sup>2</sup> According to METI, cashless payments have increased in Japan from 13.2% in 2010 to 39.3% in 2023.<sup>3</sup>

We believe that Japan's gradual shift towards cashless payments presents long-term growth opportunities for investors. **GMO Payment Gateway**, the country's largest cashless payment company, offers companies with a wide range of cashless services, including in-store payment terminals and digital payroll technology. Founded in 1995, the company has achieved consistent revenue and profit growth over the past 19 years.<sup>4</sup> GMO Payment Gateway has consistently achieved its earnings growth targets since 2005, despite facing challenges, such as the 2008-2009 Global Financial Crisis, 2011 Fukushima Earthquake and the COVID-19 pandemic.<sup>4</sup>

GMO Payment Gateway's revenue model employs a tiered approach, targeting businesses of all sizes. The company generates revenue through initial sales for payment terminals recurring fixed charges, transaction volume charges and transaction value charges.<sup>4</sup> In our view, Japan's accelerating shift toward cashless payments could benefit established digital solutions providers, including GMO Payment Gateway, in the years to come.

## ACCELERATING AUTOMATION

The Japanese economic miracle, which took place between the 1960s and early 1990s, earned the country a reputation for innovation and high-

<sup>1</sup> Lewis, Leo. "Cash Is No Longer King in Japan as Use of Coins Drops Sharply" *Financial Times*, 11-Jul-2023.

<sup>2</sup> Kutty, Naoko, and Naoko Tochibayashi. "How Japan Is Moving towards a Cashless Society with Digital Salary Payments." *World Economic Forum*, 20-Sept-2024.

<sup>3</sup> "2023 Ratio of Cashless Payment Among the Total Amount Paid by Consumers Calculated." Japanese Ministry of Economy, Trade and Industry, 29-Mar-2024.

<sup>4</sup> GMO Payment Gateway. "Financial Results Briefing for FY2024." GMO Payment Gateway, 13-Nov-2024.

## KEYENCE

quality exports – especially automobiles and technology.<sup>5</sup> Many of Japan's leading businesses during this era became disciples of *kaizen*, a business philosophy based on continuous improvement, efficiency and quality.<sup>6</sup> This approach, championed by industrial giants like Toyota<sup>7</sup>, underscores the importance of maintaining a long-term perspective, identifying the root causes of inefficiencies, accelerating innovation and reducing waste.

Japan's push for better productivity and manufacturing quality led to its early adoption of robotics and automation.<sup>8</sup> Today, the country's ageing population, declining labour force participation and low immigration rates, have further incentivised automation solutions. **Keyence**, a leading manufacturer of industrial automation equipment, exemplifies Japan's rich expertise in this field. Founded in 1974, the company provides manufacturers with sensors, lasers and measurement systems essential for automating factory processes.

Keyence styles itself as a knowledge-based company with a team of consultants that work directly with suppliers to produce cutting-edge sensors that can spot microscopic assembly-line mistakes that could cost manufacturers time and money. As global workforces age and more processes become automated, we believe that Keyence will be well-placed to provide customers with solutions to keep their factories running in an efficient manner.

### FILLING LABOUR SHORTAGES AS SOCIETIES AGE

As the world becomes older and birth rates decline, countries are likely to face labour shortages. Japan, which has experienced a steady population decline since 2009, offers a glimpse into the future for other countries around the world.<sup>9</sup> The country's ageing population and declining birth rate have led to a significant labour shortage with 51% of companies reporting insufficient employees in May 2024.<sup>10</sup>

The Japanese government, meanwhile, forecasted that the country's labour force would decline by 12% between 2022 and 2024. The country is projected to face a shortage of nearly one million foreign workers by 2040, the number needed to meet its economic growth targets.<sup>12</sup> **Recruit Holdings**, the Japanese recruitment agency that operates job listing platforms Glassdoor and Indeed, is leveraging technology to match qualified job candidates with employers in Japan and abroad. Launched in 1960, the company is one of Japan's oldest and largest human resources company. To address its shrinking labour force, Japan is turning to both women and foreigners – groups that have been historically marginalised in Japanese workplaces.

From our perspective, Recruit Holdings can play a critical role in filling job openings by matching non-traditional job candidates with companies, such as women and foreign workers. While Japan has improved its female employment rate from 60.7% in 2012 to 72.4% in 2022<sup>13</sup>, we believe that Recruit Holdings can continue to identify untapped home-grown talent and match qualified women candidates with employers.

## RECRUIT

<sup>5</sup> Crawford, Robert. "Reinterpreting the Japanese Economic Miracle." *Harvard Business Review*, February 1998.

<sup>6</sup> Kerbache, Laoucine. "Kaizen: We Can See Clearly Now!" HEC Paris, 15-May-2012.

<sup>7</sup> "What Is Kaizen and How Does Toyota Use It?" Toyota, 31-May-2013.

<sup>8</sup> Deng, Liuchun, Minako Fujio, Xin Lin, and Rui Ota. "Labor Shortage and Early Robotization in Japan." *Economics Letters*, December 2023.

<sup>9</sup> Yokoyama, Erica. "Japan's Population Falls at Record Rate." *Time*, 25-July-2024.

<sup>10</sup> Inoue, Yukana. "Japan's Labor Crunch Persists despite Slight Improvement." *The Japan Times*, 6-May-2024.

<sup>11</sup> Oi, Mariko. "Can AI Help Solve Japan's Labour Shortages?" *BBC News*, 19-Apr-2024.

<sup>12</sup> Komiya, Kantaro. "Japan Faces Shortage of Almost a Million Foreign Workers in 2040." *Reuters*, 4-Jul-2024.

<sup>13</sup> Jones, Randall S. "Addressing Demographic Headwinds in Japan: A Long-Term Perspective." *OECD*, 2024.

## SECURING CUTTING-EDGE SEMICONDUCTORS

Computer chips are the backbone of the global economy, powering an array of products from computers and smartphones to cars and medical devices. These chips, composed of billions of transistors – tiny switches smaller than a virus and invisible to the human eye – are fundamental to modern technology.<sup>14</sup> In 1965, Intel co-founder Gordon Moore predicted that the number of transistors on a chip would double every two years, an observation known as “Moore’s Law.”<sup>15</sup> This principle has shaped the industry’s relentless pursuit for smaller chips over the past six decades. The recent rise of artificial intelligence, 5G connectivity and Internet of Things (IoT) devices have further amplified the demand for enhanced computing power and smaller chips. Consequently, semiconductor manufacturers require specialised equipment capable of ensuring design precision down to the nanometre.

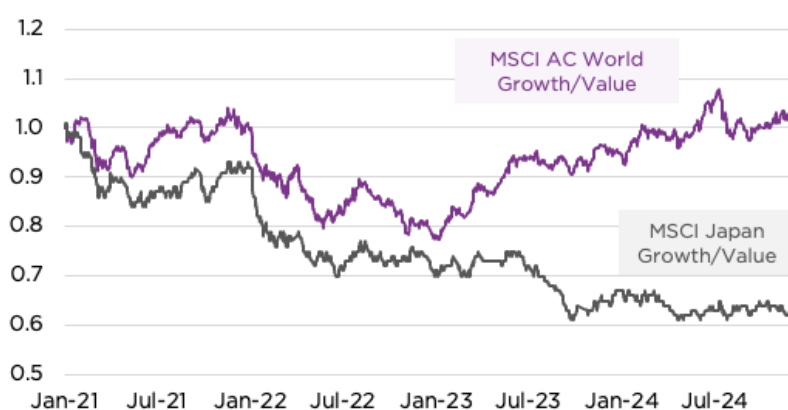


Few companies in the semiconductor value chain have been able to keep pace with Moore’s Law and the industry’s appetite for shrinking chips. **DISCO**, a Japanese maker of specialised equipment for the “back-end” stages of the semiconductor manufacturing process, has emerged as a key player. During the latter stages of this costly manufacturing process, the presence of a microscopic particle or production error, could result in a defective chip.<sup>14</sup> DISCO produces a wide variety of products aimed at ensuring precision and cleanliness, including grinders, dicing saws, dicing blades and polishing pads.<sup>16</sup>

Founded in 1937 as a grindstone manufacturer, Disco’s technologies now command 80% of the global back-end semiconductor manufacturing market.<sup>17</sup> By the close of 2024, the global semiconductor industry grew by 19.0% year-over-year, reaching \$627 billion in total sales.<sup>18</sup> In our view, DISCO’s dominant position in the “back-end” stages of the semiconductor manufacturing industry makes it well-placed to benefit from future technological advancements and the growing demand for computing

power. Despite rising geopolitical tensions between China and the United States, we believe that DISCO’s entrenched role in the semiconductor value chain is unlikely to be challenged due to its diversified client base. Unlike other semiconductor production equipment manufacturers, DISCO’s top customer contributes only 5% to total sales, reducing the potential impact of sanctions or trade measures.<sup>17</sup>

Figure 2. Relative performance “growth” vs. “value”



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## THE FINAL CURTAIN CALL

Globally, value stocks are underperforming with Japan standing out as the notable exception (see figure 2). We believe that growth stocks are better positioned to deliver consistent long-term earnings than cyclical companies tied to short-term economic cycles.

<sup>14</sup> Rodgers, Lucy, Dan Clark, Sam Joiner, Bob Haslett, Irene de la Torre Arenas, and Sam Learner. “[Inside the Miracle of Modern Chip Manufacturing](#),” *Financial Times*, 28-Feb-2024.

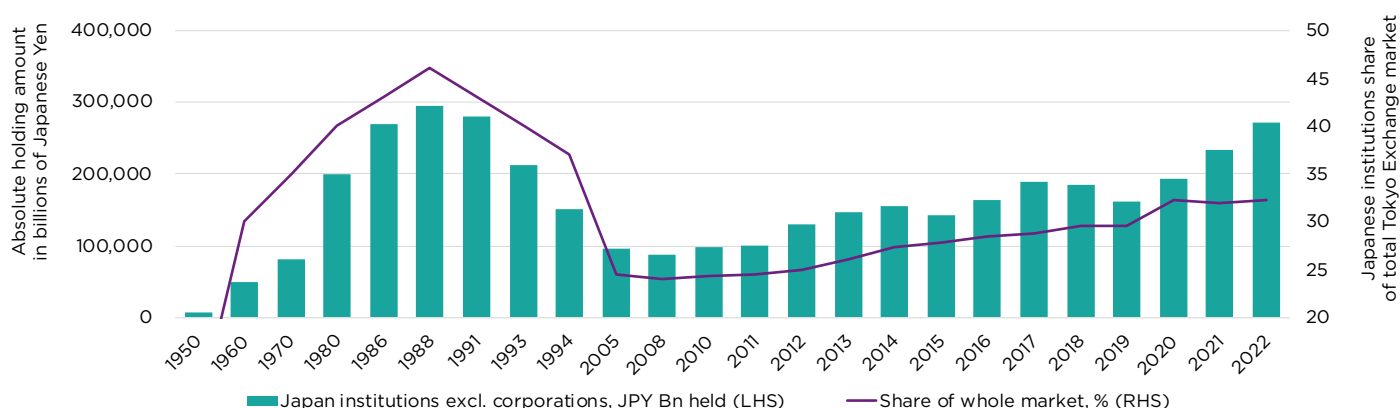
<sup>15</sup> Tardi, Carla. “[What Is Moore’s Law and Is It Still True?](#)” *Investopedia*, 2-Apr-2024.

<sup>16</sup> “[Product Information](#),” DISCO Corporation. Accessed 3-Jan-2025.

<sup>17</sup> Comgest interview with company representative, April 2019

There are already signs that investors are starting to wake up to the news that value stocks are starting to fade. The resurgence of the Japanese investor, for instance, is a positive development for quality growth investors like Comgest. Japanese financial institutions have been buying more Japanese stock – now holding nearly 40% of the total share of the Tokyo Stock Exchange (see figure 3). From our perspective, Japanese investors are arguably among the best placed to determine where to find great Japanese companies. We believe that they are less likely to be interested in cyclical stocks that are likely to fade away in the future, but companies with strong fundamentals that should deliver consistent returns over the long term.

Figure 3. Change in Japanese investor base since 1950



Source: Tokyo Stock Exchange

Despite Japan's recent value rally, we maintain our conviction that companies with quality growth attributes that are exposed to structural trends, such as digitalisation, ageing populations and Asia's growing middle class, should be better positioned for substantial long-term earnings growth. While the market has leaned toward short-term value plays, we believe that these structural growth drivers should continue to accelerate in the future. Our Japan Equities strategy will continue to filter out the market noise, focus on our long-term investment horizon and follow our quality growth approach.

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**Richard Kaye - Analyst / Portfolio Manager**

Richard Kaye joined Comgest in 2009 and is an Analyst and Portfolio Manager specialising in Japanese equities. He is also a member of the Comgest Group's Investment Committee. With a wealth of experience in Japanese equities, Richard became co-lead of Comgest's Japan equity strategy upon joining the Group. He started his career in 1994 as an Analyst with the Industrial Bank of Japan and then joined Merrill Lynch in the same role in 1996. In 2005 he moved to the Wellington Management Company in Boston as a Portfolio Manager of Japanese TMT stocks. Richard graduated from Oxford University (UK) where he majored in Oriental Studies.

**Chantana Ward - Analyst / Portfolio Manager**

Chantana Ward joined Comgest in 1999 and is an Analyst and Portfolio Manager specialising in Japanese equities. She is also a non-executive member of the Board of Partners. Chantana co-leads portfolios within Comgest's Asia ex Japan, Asia including Japan and Japanese equity strategies, and has been an important contributor to the development of these strategies. Based in Paris, she travels regularly to Japan to research companies and spend time with the Tokyo-based team members. Chantana holds an MSc in Finance from Baruch College's Zicklin School of Business in New York, a dual diploma with The American University of Paris.

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