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Greetings from Comgest's Japan Equity Investment Team!

Japan, the world's third-largest economy, posted its third straight quarterly expansion in Q2 2023 – a 4.8% annualised growth rate.¹ Although lower than initial 6% estimates, this still ranks it the top performer among major global economies.² Over the same period, the country's Topix index rose to a 33-year high as investors sought bargains and undervalued stocks.³ With this in mind, Comgest's Japan investment team hit the road to engage with some of our long-held brands to find out how they're faring amid a weakened yen that's been boosting exports and post-Covid demand driven by domestic consumers.

POST-COVID CONSUMER REBOUND?

Q2 was the quarter to finally head outside and wander around brick and mortar shops. The masks came off in April, Covid was declared officially over by the World Health Organisation in May and Chinese visas were eased in July. Although life may be returning to a pre-Covid "normal", some lock-down habits and comfort seem hard to shake.

During and post-Covid, fashion trends have leaned more towards casual living and athleisure, a look that the Japanese fashion brand Uniqlo sells in (affordable) spades. Founded in the '80s to emulate US and European brands Gap and Benetton, Uniqlo's owner, the **Fast Retailing Group**, and its President Tadasi Yanai have set an ambitious goal to become the world's largest retailer – aiming for five trillion yen (around US\$33 billion) in sales by 2028, and 10 trillion yen (US\$66 billion) in 2033.

One way to accomplish this is by further expanding into the US, where they currently only hold a 1% market share. Given the enormity of the US market and Uniqlo's attractively priced clothing, they could potentially seize a sizable market share from the similarly styled Gap, which has seen dwindling in-store (-7%) and online (-11%) sales.⁴ New COO Daisuke Tsukogashi, who was appointed in August



¹ OECD: [GDP Growth - 2Q 2023](#); Kihara, Leika and Yoshifumi Takemoto. [Japan cuts Q2 GDP on weak spending, wages slide](#). Reuters, 8-Sep-2023.

² Sposato, William. [Japan's GDP Bump Is Real but Fragile, Foreign Policy](#), 30-Aug-2023.

³ [Japan's Topix ends at 33-year peak as bargain hunting supports](#), Reuters, 1-Sep-2023.

⁴ Birch, Kate. [Mind the Gap – fashion retailer Uniqlo targets US market](#), Business Chief, 1-Sep-2023.

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2023, joined Fast Retailing in 2002 and brings his success in growing Uniqlo's North America business to the overall firm.

Comgest has long engaged with Fast Retailing – holding the stock since 2009, after having previously sold it in 2005. During our recent discussions at their offices, they referenced their 300 billion yen target for US sales (US\$2 billion) by the fiscal year 2027 and a 20% operating profit margin (OPM). This may be reaching, but their OPM does keep rising: North America was just 5% in FY/2019, while in FY/2022, it rose to 10%. In our view, a 15% OPM for North America and Europe should be achievable since comfortable fashion seems here to stay, regardless of inflationary costs.

In contrast, their OPM in Southeast Asia is 19% on average, but in some of those countries that margin hits >20% and the company's priority for now is to expand market share. Meanwhile, the OPM for China was 18%-19% pre-Covid, which – since then – has only dropped to 15%. Their aim is to return to pre-Covid figures. Based on China's economic recovery since January, we are not too worried.

Another question that our analysts debated, and which we posed, was whether labour costs have affected the company's profitability. In a vertical industry, they're at a high level and companies have been raising wages to increase productivity. Fast Retailing noted in January 2023 that they would raise wages by as much as 40%, a sign that Japan's low salaries may be starting to budge after decades of deflation and cost-cutting.⁵ However, the Group didn't raise everyone's wages, just those who performed well. CEO Tadashi Yanai's goal is to motivate those who try to do more and to seek more of those people. Over the long term, their personnel cost ratio should decrease.

Among other priorities for management is to make further progress on their digital consumer retailing format, shift their management towards a global perspective, focus on sustainability, expansion of their other labels and avoid brand damage from increased prices resulting from inflation or exchange rates.

Another company meeting led us to Kakogawa in the Hyogo prefecture and the headquarters of [Kobe Bussan](#), a company engaged in food production, franchising, restaurants and renewable energy. We have held the stock since January 2020. Kobe Bussan's business approach is to keep their prices lower than competitors. Direct importing was a cost push on imported goods, and although their relative profit margin has narrowed a bit, they've been slowly reclaiming it.

During our conversations with Kobe Bussan, they noted that the company is on track to open and operate 40 grocery stores this year (Q1 2023: 7 opened, 2 closed; Q2 2023: 17 opened, 6 closed). According to Kobe Bussan, the closures are mostly being done to move from ageing buildings to newer and larger premises. Despite rising utility costs and challenging conditions, the company is still attracting new franchisees. Based on our information, we are not seeing many franchisees completely exiting the market, but a few are being acquired by other grocery store entities.

While some companies may provide financial support for rising utilities and labour costs to franchisees, Kobe Bussan's approach has been to continuously encourage their franchisees to be energy efficient, from their use of appliances such as freezers or that of autonomous ordering systems for each store, etc.

Although Kobe Bussan has implemented cost reductions across certain products as inflation and yen depreciation compounded prices, the company did hike some prices in March and April, and apply a bit of shrinkflation to various products. Kobe Bussan's budget of around JPY140-145 million leaves some buffer room, but further currency depreciation could lead to more price increases.

⁵ Swift, Rocky. [Uniqlo owner gives Japan Inc a jolt with 40% wage hike](#), Reuters, 11-Jan-2023.



Kobe Bussan, ready-to-eat 'Chisona' space
Image: Comgest

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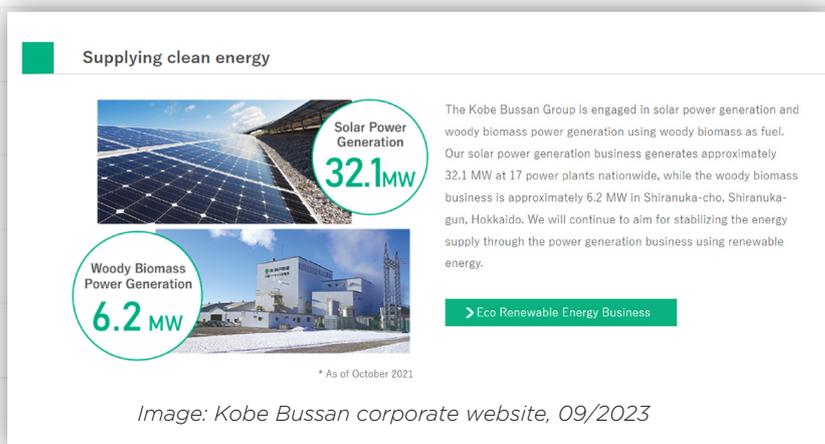
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As of end Q2, almost every one of their products has seen a price hike of about 7% year-on-year.⁶ Domestic material and labour costs, coupled with the yen's depreciation, are driving price hikes by companies across the board. The few that haven't raised prices (yet) tend to be very small players. Even with price hikes, Kobe Bussan is aiming to make sure they're still cheaper than competitors.

The company estimates that post-Covid there has been a gradual decrease in store traffic over the past year as businesses reopened and customers returned to going out. In terms of general supermarkets, Kobe Bussan believes they're 30% cheaper on general merchandise and the difference is almost flat to marginally lower versus discount stores. They further noted that their new product launch frequency and publicity hasn't changed. We believe that the store opening and internal product ratio targets of their medium-term plan are on track, and the company's role as a force of efficiency in the fragmented and arguably backward Japanese supermarket industry remains very exciting.

With regard to renewables, the company focuses on solar panels and biomass, but does not provide them to franchisees, instead selling them to power companies. Kobe Bussan will continue with existing plants but does not plan on building any new ones after the launch of a new solar power generation system this winter. They are not halting their renewables business, but will continue to sell the power they generate as Japan's fixed period **Feed-in-Tarif (FIT) Scheme** concludes. For the next 20 years, 1MW of energy is expected to be sold for JP¥32 (US\$0.21).



Supplying clean energy

Solar Power Generation 32.1 MW

Woody Biomass Power Generation 6.2 MW

The Kobe Bussan Group is engaged in solar power generation and woody biomass power generation using woody biomass as fuel. Our solar power generation business generates approximately 32.1 MW at 17 power plants nationwide, while the woody biomass business is approximately 6.2 MW in Shiranuka-cho, Shiranuka-gun, Hokkaido. We will continue to aim for stabilizing the energy supply through the power generation business using renewable energy.

[Eco Renewable Energy Business](#)

* As of October 2021

Image: Kobe Bussan corporate website, 09/2023

In terms of ESG, the company has hired an external consultant to review their plants and directly managed plants and governance structure to de-carbonise as part of Japan's push for carbon neutrality. They also indicated that they are planning to adopt the **Task Force on Climate-Related Financial Disclosures (TCFD) recommendations**, and are aiming to publish a Sustainability Report, which we will follow up on as this has been an area of discussion among our analysts.

THE 'NEXT' TAIWAN?

As a semiconductor powerhouse, more chip capacity is being added in Japan than anywhere else this year, reflecting the country's geopolitical advantages and technology leadership in the semiconductor supply chain, as can be seen by **Keyence**, whose head office we visited in Osaka.

A standout among other Japanese automation companies, Comgest first invested in the company over 14 years ago and knows its management well. Keyence is a global leading supplier of sensors, measuring systems, laser markers, microscopes, and machine vision systems worldwide. Their products include sensors, meters, projectors, image processing devices, programmable logic controllers and touch panels, among others. Like chip firms such as Nvidia, Keyence does not manufacture products but rather designs them and assists customers in deploying them in their factories.⁷

Their Q2 2023 revenue growth of 15.8% year-on-year was largely in line with expectations, excluding the effects of a weak Japanese yen.⁸

⁶ Source: Kobe Bussan Investor Relations

⁷ [Why Japan's Automation Inc is indispensable to global industry](#), The Economist, 12-Feb-2022.

⁸ Kondo, Jason. [Keyence Earnings: Outperforming Other Factory Automation Players Amid Headwinds](#), Morningstar, 7-Aug-2023.

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The company also reinforced their global headcount, which grew 18% year-on-year in 2022 to above 10,000 employees for the first time, after a limited increase between 2019 and 2021.⁹ During our discussions, they indicated that profit per person – already higher in Japan than overseas – has gradually increased in the last two years.

Although many people know Keyence in Japan, it's a different story outside of the country. For this reason, we believe the market has room to grow and could capture market share elsewhere. In addition, their productivity numbers are increasing.

Regarding peers, Keyence sells specific equipment where its use and performance can be very differentiated, hence the company's profits. 20% of sales come from new products, and the company is highly efficient in R&D with low expenses. Keyence aims to be creative and problem-solving, such as a recent product that incorporates artificial intelligence (AI). Rather than using dealers, their staff engage in direct sales so they can understand challenges faced by local sites, enabling them to sell new products in Japan and around the world. Staff salaries are linked to their performance.

In the pre-Covid and post-Covid world, sales in Asia were weak – with China accounting for 60% before decelerating. In the FY/2021 versus FY/2022, Keyence had zero growth, as opposed to FY/2021 versus FY/2020 where there was 45% growth. In the Americas and EU, growth has steadily continued for 10 consecutive quarters as their products are well known in the market.

In terms of new products, there's been no sharp or drastic changes. Every year fluctuates, but if they launch 10 new products, then typically 70% are unique and 20% are new. Can their OPM further improve? We think there's room for their gross margins to grow, especially on high value-added products.

While Keyence hasn't yet declared carbon neutrality goals, in 2016 they did set a target to reduce GHG emissions in scopes 1 and 2¹⁰ by 42% in 2030.

SHIFTS IN GOVERNANCE

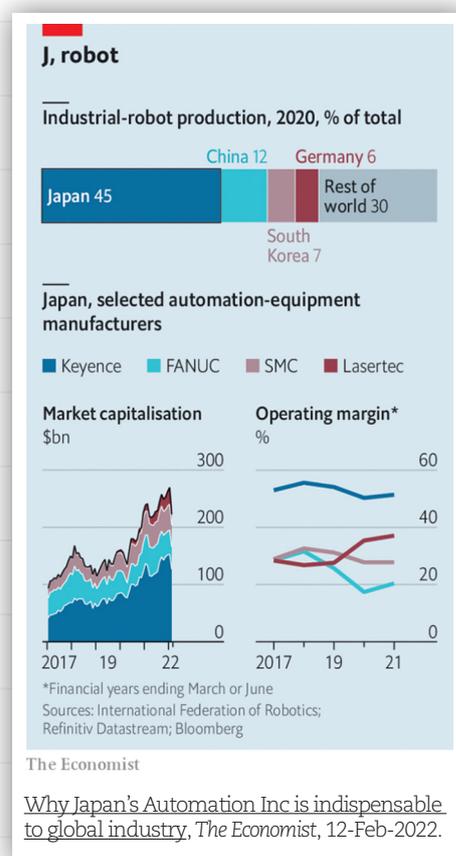
Toray Industries (Toray) and **Ajinomoto**, two Comgest holdings since June 2007 and March 2023 respectively, focus on globally unique growth businesses in carbon fiber or semiconductor packaging, and are 'poster children' for governance changes.

Tokyo-headquartered Toray fuses nanotechnology into its operations, using organic synthetic chemistry, polymer chemistry and biotechnology as its core technologies.

As part of its 2023-2025 management strategy, Toray projects 42% growth for pressure vessels, 30% growth in carbon fiber composite materials revenue and a doubling of capital investment.¹¹

Out of the company's 2.51 billion yen (US\$16 million) in revenue for 2022, its Carbon Fiber Composite Materials business ranks third behind Fibers & Textiles and Performance Chemicals, contributing 282 billion yen (US\$1.8 billion).¹²

Toray is reportedly the world's leading manufacturer of carbon fiber, with a capacity to produce almost



⁹ Kondo, Jason. [Keyence Earnings: Outperforming Other Factory Automation Players Amid Headwinds](#), Morningstar, 7-Aug-2023.

¹⁰ For more information on Scopes 1 and 2, [Deloitte: Zero in on Scope 1, 2 and 3 emissions](#).

¹¹ Gardiner, Ginger. [Toray announces growth, investment in carbon fiber composite materials](#), Composites World, 29-Mar-2023.

¹² Gardiner, Ginger. [Toray announces growth, investment in carbon fiber composite materials](#), Composites World, 29-Mar-2023.

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58,000 tons of regular tow and large tow carbon fiber via plants in Japan, France, Korea, Hungary, Mexico and the US. Toray has a leading 50% market share in China, which has a high appetite and increasing volume of production. When you look at the state system, it's a closed market. In addition, Toray reportedly controls more than 50% of the global polyacrylonitrile (PAN) fiber market — historically more than two pounds of PAN is required to produce 1 pound of carbon fiber.¹³

As a leader in carbon fiber, customers know and trust in Toray's high quality products. Stability is their biggest strength as newcomers find it difficult to displace their products, which can be used in diverse industries:

- Nuclear: Propellers
- Aerospace (while profit in the space has dropped significantly, Toray is aiming to recapture demand)
- General industries and sports

That said, soaring utility prices in Japan are impacting carbon manufacturing, which uses a lot of energy. Pricing is also cyclical as their main ingredient is acrylic, which means their selling price changes.

Over the quarter, Toray announced that Chairman Akihiro Nikkaku will become their new President and representative member of the Board. The current president Mitsuo Ohya will be appointed as the new Executive Vice President and representative member of the Board. Nikkaru has a long history in textiles and brings vast expertise in strategic pricing, planning and marketing activity as well as making assets more efficient. This presents the company with a new mindset as well as the task to enhance profitability of each segment.

Ajinomoto – also Tokyo-based – is a Japanese food company and provider of biopharmaceutical contract development and manufacturing services (CDMO) – provided our analysts with an update on amino acids, their CDMO business and substrate films at their Nihonbashi, Tokyo headquarters. Meeting with management face-to-face enhanced our faith in the company's expansion plans.

Ajinomoto has had an 8-fold increase in CDMO capacity and is aiming to monetise this aspect of their business and technology.

Medical and food-related amino acids is a sub-category with a 60 billion yen (US\$400 million) sales target. Most of those sales come from a 20-fold increase in the amount of amino acids sent to pharmaceutical and biotech companies. Ajinomoto's market share of high-end amino acids is around 40%.

The company's CDMO specialises in small molecular nucleic acid medicine made from DNA with rapid growth in clinical applications. There's strong business for this in Belgium, India and Japan. Ajinomoto is the only company in the world to be able to use technology to create nucleic acid-based medicine and produce regenerative nucleic medicine, which has growing interest from medical, pharma and biotechnology companies.

The rapid growth in demand for nucleic medicine offers new opportunities for hundreds of R&D companies, such as no need for additional capex and potential for exceptional business growth.

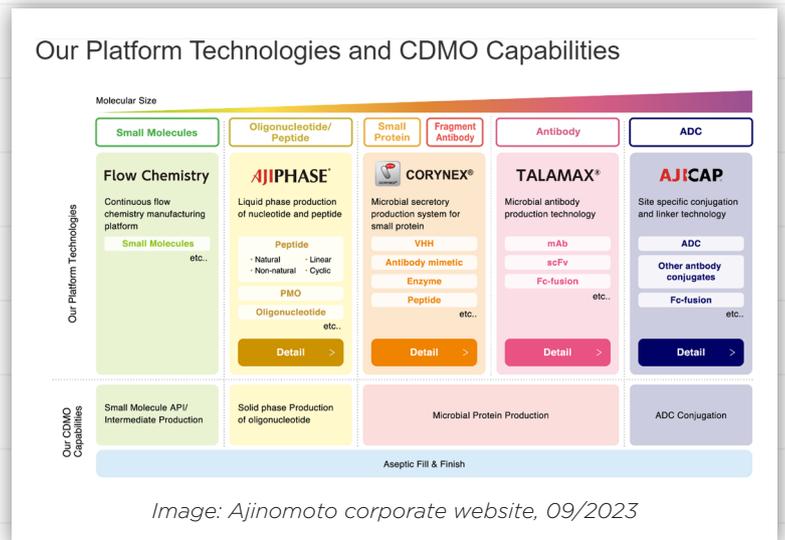


Image: Ajinomoto corporate website, 09/2023

¹³ Gardiner, Ginger. [Toray announces growth, investment in carbon fiber composite materials](#). *Composites World*, 29-Mar-2023.

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INFLECTION THEMES

With Japan's headline-grabbing 4.8% annualised growth rate in Q2, driven largely by exports, investment and domestic consumption, the country seems to be rebounding post-Covid.

However, China, the largest trading partner for export-reliant Japan, has only managed a sputtering economic recovery since re-opening its borders and in more recent months has been grappling with a worsening crisis in its property sector.¹⁴

While this could have an effect, we believe that the removal of group travel restrictions from China will be a boon for our investee companies which benefit from physical traffic, like Fast Retailing or Kobe Bussan, and that this effect has not yet manifested in share prices.

Being on the ground in Japan on a daily basis has enabled us to see the themes on investors' minds that are driving the Japanese market to 33-year highs: governance changes, semiconductor chip capacity and technology leadership in its supply chain and the post-Covid rebound. These themes, all of which are reflected in Comgest's Japan Strategy, could represent an opportunity for long-term investors as they become more widely appreciated.

(As of 3 October 2023, US\$1 = JPY 149.94)



Members of Comgest's Japan Team at an on-site visit
(left to right) Makoto Egami, Richard Kaye, Chantana Ward, Junzaburo Hyuga

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- The value of all investments and the income derived therefrom can decrease as well as increase
- Changes in exchange rates can negatively impact both the value of your investment and the level of income received
- Emerging markets may be more volatile and less liquid than more developed markets and therefore may involve greater risks

¹⁴Kajimoto, Tetsushi. [Japan capex growth weakens with companies wary about China slowdown](#), Reuters, 1-Sep-2023.

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