WOLFGANG FICKUS, CFA

JAPAN EQUITIES
TURNING THE CORNER FOR GOOD?
THE JAPAN INVESTMENT CASE FOR GROWTH INVESTORS

Wolfgang Fickus, CFA
Member of the Investment Committee

With a contrarian view of Japanese Prime Minister Abe's *Third Arrow* of "Abenomics", we are confident that Japanese equities have finally turned a corner for good, and that Japan has become fertile ground for long-term growth investors. Our opinion is that it is a mistake to persist in viewing Japan as a value and momentum market mainly for passive investors and market timers. A tangible sign of the success of Abenomics is Japan's ongoing structural economic reform. Following two years of foreign equity outflows, we believe now is the time to revisit the Japan equity investment case for growth investors. As a Japan specialist, Comgest has been invested in Japanese growth franchises since 2001, and this paper describes how Comgest applies our quality growth investment style to the current market context. Over the past five years, our Japan strategy has returned 23% p.a.[1] driven by a portfolio delivering 16% EPS growth and outperforming the TOPIX index by 3.1% p.a.[2] Today we notably see our industrial sector holdings improving, while the relative valuation of our portfolio at 23x versus 15x P/E for the market is attractive. Portfolio earnings growth is expected to remain in the double digits for 2017 and 2018.

THE THIRD ARROW

— The Japanese equity market rose for the fifth consecutive year in 2016 despite a sell off by foreign investors

The Japanese equity market rose for the fifth consecutive year in 2016 despite a sell off by foreign investors. After initial Abenomics excitement, which culminated in 2013 with record inflows by foreigners into the Japanese equity market, foreign flows have remained negative for the past two years. This has been offset by domestic institutional buyers such as

[1] Currency: yen
[2] Net of fees, Comgest Japan strategy as of 2-Jun-2017. The index is used for comparative purposes only and the portfolio does not seek to replicate the index.

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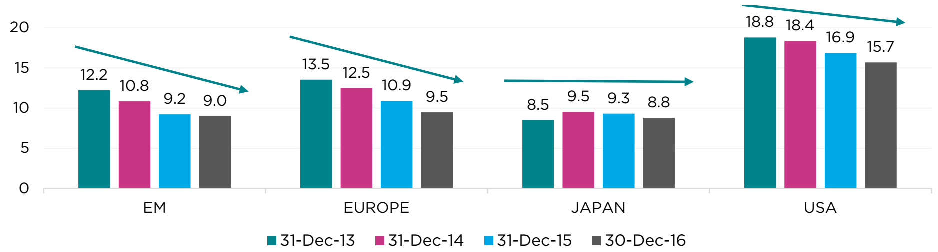
the Government Pension Investment Fund (GPIF), which raised its equity ratio from 12% in 2012 to a current 23%. The Bank of Japan is also continuing to buy domestic shares and now holds more than 2% of the TOPIX market capitalisation.

In our view, Abe's *Third Arrow* of structural reform is the most crucial part of the Prime Minister's economic program since the benefits are intended to be permanent.[3] While some investors may have interpreted the yen's short-lived 2016 appreciation and modest headline inflation figures as a failure of Abenomics, we are maintaining our contrarian view.

Figure 1. ROE LTM – Japan catches up to EMs and Europe

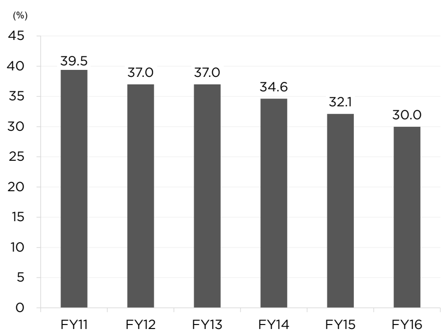


Source: FactSet, MSCI indices ex financials

— **Japan has been the only region in the world where companies have an improved ROE over the past four years.**

The benefits of the *Third Arrow* can be seen in the numbers: Japan has been the only region in the world where companies have an improved ROE over the past four years. *Figure 1* demonstrates how Japan has caught up with Emerging Markets and Europe in terms of equity returns, whereas in 2012, the country was a distant bottom performer. This performance is particularly worth noting since Japan was among the countries hardest hit by weak global trade, which still remains 20% below pre-global financial crisis levels. On the flipside, the very open Japanese economy could be one of the primary beneficiaries if and when global growth and the trade environment improves. Consequently, contrary to what might have been a more plausible statement a few years ago, we think it is a mistake to continue to identify Japan as a value or momentum market.

Figure 2. Japan - Corporate Tax Rate



Source: Abenomics, Government of Japan, March 2017.

Better capital allocation and lower corporate tax rates are driving the improved ROE. As per *Figure 2*, the effective tax rate in Japan decreased from nearly 40% in 2011 to below 30% in 2016, while an increase in share buybacks (*Figure 3*) indicates improved capital allocation. In addition, better corporate governance means that

[3] Fickus, Wolfgang. "Strong Yen: A false positive for investors in Comgest's Japan strategy", Comgest, May 2016; "Japan Equities: The best is yet to come", Comgest, August 2015.

WOLFGANG FICKUS, CFA

TURNING THE CORNER FOR GOOD?

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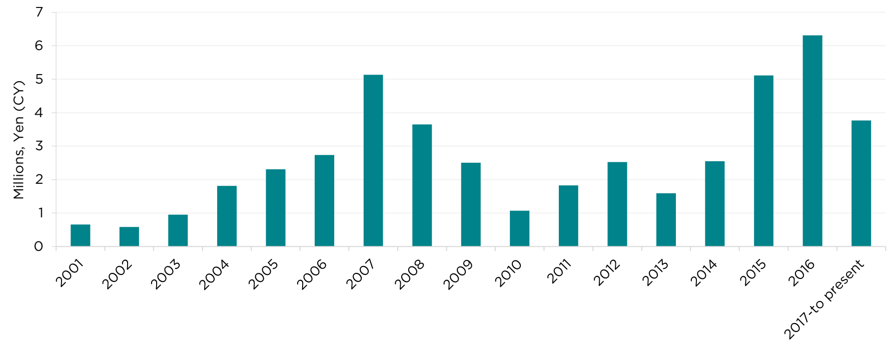
nearly 100% of listed Japanese companies[4] now have outside directors. Conversely, cross-shareholdings – often a sign of cosy yet inefficient cross-corporate relationships – have been reduced by 60%.

Figure 3. Topix Share Buybacks



Source: Factset, January 2017

While headline inflation rates continue to stay below a targeted 2% rate, core CPI[5] progressed from a deflation territory of -1% to -1.5% in 2010-2012 to a modest inflation of approximately 1% in 2013-2016. Beyond these figures is the pivotal fact that the deflationary spiral, which led the Japanese to tighten their consumption habits, has ended. In addition, the labour participation of women has increased by one million during the past three years and the unemployment rate is still historically low, exerting pressure on wage increases.

JAPANESE EQUITY: FROM A VALUE MARKET TO AN ATTRACTION FOR GROWTH INVESTORS

— Earnings growth in Japan has consistently placed in the top spot in returns for growth investors over the past five years

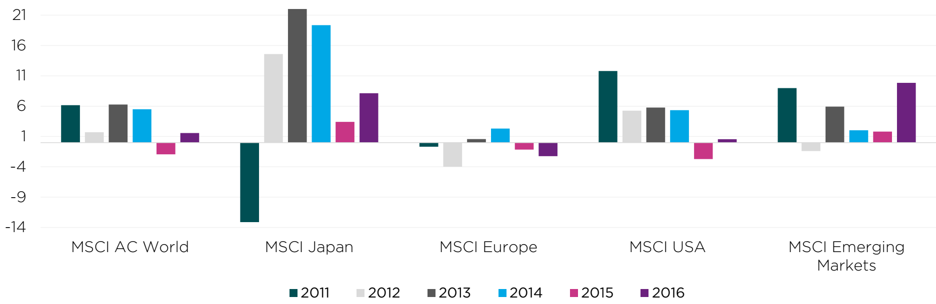
Earnings growth has consistently placed Japan in the top spot for growth investors over the past five years due to a consistent improvement in shareholder returns and despite the lacklustre global growth and trade environment. This is in stark contrast to the perception that Japan is a value or momentum market, which may have been a valid view prior to Abenomics. As *Figure 4* demonstrates, while the EPS growth outlook for the MSCI Japan ex financials of 16% for 2017 is higher than the

Japan's deflationary spiral, which led the Japanese to tighten their consumption habits, is over

[4] Companies listed on the First Section of Tokyo Stock Exchange; Source: Abenomics, Government of Japan, January 2017.
[5] Japan Statistics Bureau; Core CPI = all items less food (less alcoholic beverages) and energy.

global average, its 2017 valuation of 15x P/E is on par. In our view, the Japanese equity market has an attractive valuation-to-growth equation with a PEG ratio of 1.15x.[6]

Figure 4. EPS - Japan consistently among strongest growing geographies



Source: Factset, as of March 2017.

For Comgest, there is no doubt that Japan has made a comeback with growth investors in recent years. However, the Japanese equity market merits much closer attention than most international growth investors are willing to pay. Despite Prime Minister Abe's reforms, our frequent exchanges with institutional investors signal that there is still a lot of unease regarding Japanese equities after two decades of bear markets until 2012.

— **Between 2011 and 2016, Comgest's Japan strategy returned 21% *p.a.* based on an EPS CAGR of 16% for the portfolio holdings**

As a long-term quality growth investor, our experience has been very positive over the past five years. During this same time frame, Comgest's Japan strategy returned 21% *p.a.*[7] based on an EPS CAGR of 16% for the portfolio holdings. With the value rally that began in the second half of 2016 in mind, investors may ask whether Comgest's Japan strategy is well positioned for this market context or if our industrial core can still drive performance in an environment where global growth may accelerate?

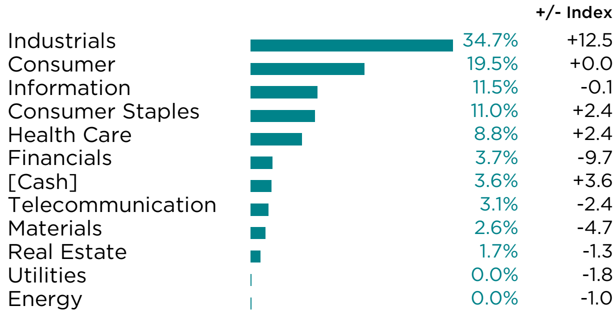
COMGEST JAPAN PORTFOLIO: ATTRACTIVELY VALUED, DOUBLE-DIGIT EARNINGS GROWTH, IMPROVING INDUSTRIAL SECTOR

In April 2016, the Comgest Japan strategy reached a high valuation relative to the TOPIX index – 25x versus 13x P/E, which has since normalised after the flat relative and absolute performance of 2016. Today, the P/E premium to the market is around 50% – 23x versus 15x P/E, which is in line with the average of the past seven years. This is the price paid for the high earnings visibility and the

[6] PEG is defined as P/E 2017 divided by EPS CAGR 2017-2018.
[7] Period: 31-Dec-2011 – 31-Dec-2016

long duration of earnings growth of our quality growth stock picks. The 16% of earnings growth for the portfolio's holdings[8] slightly lags behind the 10% growth rate of the MSCI Japan index, but remains above Comgest's double-digit EPS growth hurdle.

Figure 5. Sector Breakdown (%)



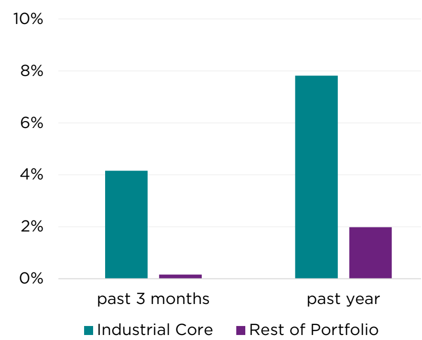
Source: Comgest/Factset, March 2017

RISING EARNINGS ESTIMATES FOR CYCLICAL QUALITY GROWTH FRANCHISES

Japan boasts many strong industrial franchises and Comgest's Japan strategy has invested in a number of global market share leaders such as Fanuc, Daikin, Daifuku, Komatsu and Shin-Etsu. The portfolio's 35% exposure to the industrials sector is the highest in comparison to all other strategies managed by Comgest. This increases the strategy's appeal to investors who are seeking quality growth that benefits from larger industrial exposure than other Comgest strategies are able to deliver.

As a long-term equity investor, knowing what the contribution of this industrial core is to the earnings growth delivered by the Comgest Japan strategy is important. The question to ask is simply whether the earnings momentum is moving in the right direction. The industrial core of Comgest's Japan strategy turned out to be a positive swing factor this year with regard to expected 2017 EPS growth (*Figure 6*), while the portfolio's domestic franchises are delivering stable growth.

Figure 6. 2017 EPS Revisions



Source: Factset, March 2017

[8] EPS CAGR 2017 and 2018 for portfolio companies and MSCI Japan

WOLFGANG FICKUS, CFA

TURNING THE CORNER FOR GOOD?

THE JAPAN INVESTMENT CASE FOR GROWTH INVESTORS

STRATEGY PERFORMANCE DRIVEN BY INDUSTRIAL CORE AND DOMESTIC GROWTH FRANCHISES

— Strong fundamentals continue to be rewarded irrespective of volatile short-term sector rotation trends — to which our concentrated quality growth investment style is agnostic

Comgest does not apply a sector allocation approach and due to bottom-up stock picking does not tend to be exposed to banks or cyclical energy and materials businesses. Despite the unfavourable sector exposure of Comgest's Japan strategy, alpha generation has continued to be strong. The portfolio performed 12.2% (as of June 2, 2017) versus 7.2% for the TOPIX benchmark YTD, while the relative performance was flat versus the TOPIX benchmark in 2016.[9]

— Comgest Japan Portfolio's top two performers at the beginning of 2017 are domestic Japanese franchises

Despite the strategy's strong exposure to industrials, which benefited from a sector rotation into more cyclical businesses, the top two portfolio performers at the beginning of 2017 are classic domestic growth franchises: MonotaRO and Start Today. This is important since strong fundamentals continue to be rewarded irrespective of any volatile short-term sector rotation trends to which our concentrated quality growth investment style is agnostic.

- **MonotaRO:** This online maintenance, repair and operations services and products (MRO) supplier for Japanese industrials delivered strong top-line growth of 21% in Q4CY2016 and 24% in Q1CY2017. Despite heavy investments in expansion (new logistics centre) and productivity (160 automated vehicles), MonotaRO's margin continues to expand, particularly online, as they take a greater share of the Japanese MRO market, where they are already the undisputed market leader. The continued investment that we observe reinforces the company's long-term competitive advantage.
- **Start Today:** The best performing stock in our Japan portfolio for 2016 jumped 17% based on the results announced February 1, 2017, with their net profit almost doubling. The stock is up 52% YTD.[10] The company is known for its "Zozotown" homepage where Japanese can buy apparel online. E-commerce penetration continues to positively surprise us in Japan and the growing transaction volume per purchase at Start Today exemplifies this trend.

— The industrial core of our Japan portfolio has positively contributed to 2017 earnings revisions over the past three months

In the last 12 months, our cyclical growth franchises such as Fanuc, Komatsu and Shin-Etsu have strongly contributed to performance. While this performance has largely been driven by a re-rating, it is the industrial core that has positively contributed

[9] The index is used for comparative purposes only and the fund does not seek to replicate the index.
[10] As of 8-Jun-2017.

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TURNING THE CORNER FOR GOOD?
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to 2017 earnings revisions over the past 3 months. Meanwhile, the earnings of Suzuki Motors, Shin Etsu and Fanuc have been revised up by 45%, 25% and 12%, respectively, during this same period. Although we are not momentum investors, we closely monitor these short-term earnings trends, particularly with regard to our more industrial growth franchises which can be more cyclical. We are encouraged by these companies' recent comments on their long-term growth trajectories as they indicate a potential stabilisation of previously weak business trends.

CONCLUSION

— **Investors stand to benefit from ongoing structural improvements within corporate Japan, and in the Japanese economy**

Foreign investors may have viewed Japanese equities as the value and momentum market, but our opinion is that the Japanese equity market has finally turned an important corner and is now fertile ground for long-term growth investors. For us, the market is as interesting today as it has been for the past five years. Investors stand to benefit from the ongoing structural improvements within corporate Japan, and in the Japanese economy as a whole, as well as from the potential for stronger global growth and trade. In this environment, we view the quality growth approach of Comgest's Japan strategy to be attractively valued, with the potential for robust growth.

Wolfgang Fickus, CFA
Member of the Investment Committee

Wolfgang Fickus is a graduate of the University of Cologne (Germany) with a degree in business administration (Diplom-Kaufmann) and studied at the London Business School. He also holds a CEMS Master's in international management and is a CFA® charterholder. Wolfgang began his career in 1995 at Paribas Asset Management Paris as a European-equity fund manager. In 2000, he moved to WestLB where he worked as an analyst for European technology stocks before becoming the Head of Mid- and Small Cap Research in 2005. Wolfgang joined Comgest in September 2012 and is a Member of the Investment Committee.

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www.comgest.com

COMGEST S.A.
17 square Edouard VII, 75009 Paris,
France
Tél : (+33) 1 44 94 19 00
info@comgest.com

COMGEST FAR EAST LIMITED
Level 10, 28 Hennessy Road,
Hong Kong
Tél : (+852) 3972 0200
info.asia@comgest.com

COMGEST ASSET MANAGEMENT INTERNATIONAL LIMITED
46 St. Stephen's Green,
Dublin 2, Ireland
Tél : (+353) 1 631 0100
info.camil@comgest.com

COMGEST ASSET MANAGEMENT JAPAN LTD.
Prime Building 5/F, 2-13 Hayabusacho,
Chiyoda-ku,
Tokyo 102-0092, Japan
Tel: (+81) 3 5212 4371
info-jp@comgest.com

COMGEST SINGAPORE PTE. LTD.
Comgest Singapore Pte. Ltd,
8 Temasek Boulevard,
#20-01A Suntec Tower Three,
Singapore 038988
Tel: (+65) 6672 7100
info.asia@comgest.com

COMGEST DEUTSCHLAND GMBH
Sky Office
Kennedydamm 24
40476 Düsseldorf
Tel: (+49) 211 44 03 87 0
kontakt@comgest.com

COMGEST US LLC
101 Arch Street, 8th floor
Boston, MA, 02110, USA
Tel: (+1) 857 304 0135
info.us@comgest.com

COMGEST BENELUX B.V.
Gustav Mahlerplein 3-115
1082 MS, Amsterdam
The Netherlands
Tel: (+31) 6 229 20 612
contactnl@comgest.com