Investment insights from Japan

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Much has changed in Japan

I have been visiting Japan for well over a decade, however due to COVID this was my first trip since 2019, and much has changed over this time.

1. COVID has exposed multiple areas of structural underinvestment.
2. Electric vehicles (EVs) are on the rise globally (although not yet in Japan).
3. Similar to other economies, inflation is ever present in Japan, with accompanying wage pressures.

The digital transformation revolution

What struck me after landing was that the first taxi I was in took credit cards — and so did every other cab. This is something we take for granted, but last time I was in Japan, most taxis only took cash. I thought, “Wow, investment into digital product and digital transformation (DX) has really picked up.” This conclusion was correct, as of the 16 meetings over four days I attended, virtually all companies spoke of related investment. COVID resulted in a move to working from home and like many, Western businesses adapted and learned efficiencies rather quickly. This was the case only for select businesses in Japan, as many had historically invested very little in infrastructure so they lacked the necessary digital capabilities to cope with the sudden office exodus.

As in the west, COVID was a catalyst for change. Throughout the pandemic, Japanese businesses started to invest in DX, but I believe this is only the beginning of what is sure to be an enduring trend. Companies we spoke with estimated growth of around 10% for the next few years. In a largely non-growth economy, this growth is staggering. There is a potential for our portfolios to benefit from this trend through our current investments in Nomura Research Institute (a consultancy similar to Accenture that focuses on companies' digital infrastructure) which helps businesses form plans to transform their operations, as well as our existing investments in Keyence, a global leader in automation solutions. Other businesses that benefit from this trend are now a focus area for us.

Automotive electrification

Switching to another area where Japan is also lagging the rest of the world — EVs. Think about the various Battery Electric Vehicles (BEVs) you have seen on the road. Tesla, of course, but brands such as Volkswagen, Hyundai and Ford also come to mind. Toyota, one of the largest automotive companies globally, is noticeably absent from this list. Our meeting with Toyota revealed that the sleeping giant has awoken. Under new management, Toyota aims to deliver its first scaled BEV in 2027. It was also clear that Toyota will be embarking on a multi-billion dollar investment program in order to build a BEV platform. This will send reverberations throughout the manufacturing sector in Japan. Given the higher robot density (a measure of robots used in manufacturing per 10,000 workers) of BEVs compared to internal combustion vehicles, we believe that robotics may become a key beneficiary of Toyota's higher spending, setting up the potential for our investment in robot maker Fanuc to see outsized gains.

Inflation, labour and wage pressures

No country-centric trip would be complete without gaining a view on the overall economic environment. In Japan, much like other developed economies, inflation is rampant, and there are labour shortages as well as wage pressures. What is different is that labour shortages, driven by aging demographics, existed prior to COVID — but there were still minimal wage pressures. Driven by higher inflation, wage pressures are now evident, which when combined with labour shortages create a very dynamic environment. The Bank of Japan has started removing certain elements of quantitative easing (QE), but we expect further changes as the year progresses. Japanese banks have not done well for several years, but higher rates materially benefit them. Anticipating the beginning of the end of full-fledged Japanese QE, late last year we initiated a position in one of the country's megabanks, SMFG, which is a beneficiary of higher rates.

I conclude by saying virtual meetings are great but are no match to concentrated in person meetings which allows one to tie together themes, opportunities and challenges in a highly efficient manner. One such example of this is staffing firm, Technopro, which we have a position in, and believe has the potential to benefit from all three themes – DX, the rise of EVs, as well as structural labour shortages. The additional benefit of world-class sushi, fruit and beef is partially offset by the jet lag, for which there is still no perfect solution.

Thank you for your continued support.

David Mann

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