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ValueInvestor INSIGHT

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Safe and Sound

Masa Takeda of SPARX Asset Management explains why his investment opportunity set is so small, how the ongoing implementation of "Abenomics" impacts his investment approach, the industry sectors where he believes Japanese companies have an advantage, and what he thinks the market is missing in SoftBank, Asics and Unicharm.

INVESTOR INSIGHT

Masakazu Takeda
Hennessy Japan Fund

Japan may not have a prominent value investing culture, but Masa Takeda had free rein to develop his passion for it upon joining Tokyo-based SPARX Asset Management in 1999. He studied great active value investors – including Warren Buffett, Charlie Munger, Bill Ruane, Marty Whitman and Jean-Marie Eveillard – while also learning the trade from Sparx founder Shuhei Abe, an investing innovator in his own right in Japan.

The Hennessy Japan Fund that Takeda has long co-managed – SPARX is the subadvisor to the fund – has earned a net annualized 8.4% since 2003, vs. 4.4% for the Russell/Nomura Total Market Index. Among areas in which he's finding value today: mobile telecom, consumer products and running shoes.

Describe how you've customized your value approach to investing in Japan.

Masa Takeda: I'm firmly in the growth-at-a-reasonable-price camp, looking for companies with sustainable competitive advantages, run by smart management, when their stocks are trading at attractive prices.

There are several qualities we look for in companies. First is a simple and intelligible business model that I as an individual can easily understand. We also want inherently safe and sound businesses, meaning we have to believe the companies in which we invest can prosper over very long time horizons, through adverse conditions. That's why we gravitate toward firms with well-capitalized balance sheets and durable competitive advantages stemming from things like strong consumer-brand franchises, scale and low costs. They typically earn above-average returns on equity and have above-average sustainable earnings-growth potential. Finally, they have exceptional management, which to us primarily means allocating capital with a good understanding of cost of capital. In Japan this isn't as widely appreciated as it is in the U.S. and Europe.

A good example of a company we find interesting would be Shimano [7309:JP], which has been in our portfolio since 2007. It controls 70-80% global market share in high-end gear and braking systems for bicycles. It has strong relationships with the top racers in the sport, who provide regular feedback that consistently leads to new product technology, which helps strengthen the company's consumer brand image. It has a time-tested business model, consistently earning high margins and returns on equity and capital for decades. Looking ahead, there are no signs of dramatic structural change in the industry, and the number of bicycle riders should continue to rise on the back of increasing health consciousness. Management also has proven to be good at capital allocation, even aggressively buying back stock at the right times in a way that few companies do in Japan.

Given your standards, is your opportunity set at any given time pretty small?

MT: Yes. We may only have 50 stocks at any given time that meet our criteria for quality, and that group doesn't change very often. As a result we run concentrated portfolios, with only 10 to 15 names in our most-concentrated portfolios, and 20 to 25 names in the Hennessy Japan Fund we manage for U.S. investors. Once we invest in a name we also tend to stay invested – our annual turnover rate runs around 10%, plus or minus. Most of the time we just stay on the sidelines, trying to be patient and waiting for the right opportunity. We may have one new idea every year or two.

What tends to make the rare name attractively priced?

MT: It usually has to do with short-termism, which is prevalent in Japan (just as it is in other countries) and can cause the market either to significantly undervalue a company's long-term prospects or overreact to a short-term difficulty. We'll also likely be more active when the market sells off across the board in a more or less indiscriminate way.

It's not a typical investment for us in every way, but last August we took a position in SoftBank [9984:JP]. We had followed the company for years and the share price was badly lagging in large part due to the struggles at Sprint, in which Softbank took a majority stake in 2013.

In August the company made several announcements that caught our attention. Mr. Son [Masayoshi Son, SoftBank's founder] spoke publicly about his commitment to turn around Sprint within the next two to three years, and SoftBank increased its ownership stake in the company from 79% to 83%. SoftBank announced that it was buying back ¥120 billion, or $1 billion, of its own stock, and it also said its new President, Nikesh Arora, who came from Google, was buying SoftBank shares with his own money amounting to ¥60 billion. I'll describe our analysis in greater detail later, but we concluded the market was overemphasizing the problems at Sprint relative to the rest of the company and bought an initial stake. Short-term, our timing hasn't been good.

Part of the structural-reform effort under Prime Minster Shinzo Abe in Japan is for corporate management to be more shareholder focused. Are there signs that's working?

MT: I definitely think things are changing for the better, but still very slowly. More management teams talk in terms of return on equity, for example, which was unheard of five or ten years ago. Companies are taking a more shareholder-focused approach to mergers and acquisitions, are more proactive on things like share buybacks, and have become more receptive to activist investors. I don't want to overstate the case, but there is progress.

I'd add that the best intentions don't always have the expected results. A focus on return on equity is important, of course, but can be dangerous if it's used to focus too much on cost efficiency at the expense of investing in growth. Share buybacks can be great investments, but only when done at the right times and when financed intelligently. As reforms take hold, assessing these types of issues will become increasingly important.

ON INDUSTRY THEMES:

The world increasingly needs factory automation and we expect Japanese companies to continue as global leaders.

Do you consider Japan's broader regulatory and political reform efforts, known as Abenomics, a success so far?

MT: I'd first answer that question with a disclaimer, which is that our strategy doesn't bank one way or the other on initiatives like Abenomics. Japan has been in a difficult macroeconomic environment for decades, so we've trained ourselves to look for investment opportunities that promise growth regardless of prevailing economic conditions. That's fundamental to our approach and it doesn't change based on government policy initiatives.

Having said that, Japan in my opinion is moving in the right direction. Compared to pre-Abenomics times, the difference is night and day. Reflationary measures based on monetary easing and fiscal stimulus have had an impact. The yen's weakness has pushed exporters to all-time-high earnings, which are being reinvested in R&D, domestic production facilities and expanding overseas capacity. That should improve the competitive strength of Japan, Inc. and produce benefits for some time even if the currency stabilizes at today's levels. I don't mean to imply the economy is robust – as evidenced by the recent central-bank move to negative interest rates – but it at least appears to be at the surface after for so long being underwater.

The structural-reform efforts also underway are broad-based and designed to improve the potential long-term growth rate of the economy, through things like cutting corporate taxes, reducing regulatory burdens, increasing employment participation by women and retirees, encouraging better corporate governance, and encouraging more individual stock ownership. It won't be good enough for just one or two initiatives to work, success will require progress on multiple fronts. These types of reforms will take longer to enact and have an impact, and it's too early to gauge their success.

More practically, how do you manage currency risk?

MT: Short-term, our view is that currency exchange rates almost never reflect their theoretical fair value, based on relative interest rates or purchasing-power parity. For that reason we take no real position on the direction of exchange rates.

Part of our definition of a safe and sound business, however, is one that is relatively insulated from currency volatility. That may come from having high margins, as in the case of Keyence [6861:JP], for example, which makes sensors used in factory automation and does a majority of its business outside Japan. It has 50% operating margins, so even if a dollar buys 10 fewer yen tomorrow, the negative impact on Keyence's short-term profitability is quite negligible. For an automaker like Toyota, with at best 10% operating margins, the impact is much more prominent.

The other way to mitigate currency risk is by investing in companies with extensive local-market production. We want to own companies with broad geographic cost bases that naturally insulate them from the impacts of currency swings.

Are there industry sectors you've tended to favor?

MT: We're focused on finding strong individual franchises, but one broader area we're bullish on is factory automation, where Keyence is an important player. Japan has been dealing with high labor costs, labor shortages and an aging workforce for decades, so companies have been forced to emphasize factory automation in order to increase productivity. In a world that increasingly needs factory automation – in developed countries facing demographic challenges and in emerging markets facing higher labor costs – we believe Japanese companies can continue to be global leaders.

Another area we are big on is personal-care goods, including skin care, cosmetics, hair care, oral care and baby care. We observe that Japanese brands have strong appeal to Asian consumers and are generally perceived as being of higher quality and better value for the money. As emerging Asian markets grow and middle-class populations expand, we believe branded consumer-products companies like Unicharm [8113:JP], which makes diapers and sanitary napkins, and Kao [4452:JP], which is like the Procter & Gamble of Japan, are very well positioned for success.

Given all the attention being paid today to China, do you have any investment-related insights on it you'd like to share?

MT: I'm not a macroeconomist and don't profess to know what is going to happen in China. If I apply common sense, I expect the economy to go through short-term – and even sharp – self-correcting mechanisms, but over time to be OK. It gets back to what I said earlier about investing in Japan. Our goal as investors is to find opportunities that don't rely heavily on the macroeconomic situation going your way to succeed. One of our holdings, Ryohin Keikaku [7453:JP], is a specialty retailer selling household products and apparel under the brand name Muji. Despite all the negative news out of China, it is revising its earnings guidance upward, in large part due to success in China. The Muji brand has strong appeal to Chinese consumers and there's a very long runway for growth as those consumers continue to increase their spending on the types of things Muji stores sell.

Why is your investment in SoftBank not a typical one for you?

MT: Normally I don't invest in situations this complicated, with so many moving pieces. It's also in this case less a bet on the business *per se*, and more a bet on Mr. Son, who I think is one of the best CEOs of all time in Japan. He started this business in 1981 and opportunistically built it from scratch into a company with a ¥6.3 trillion market cap. He's 58 and shows every sign that he wants to continue growing Softbank globally for many years to come.

The company has three main business lines, mobile telecom in Japan, Sprint in the U.S., and what is essentially a venture-capital business investing primarily in Internet-related companies around the world. When we value each separately we arrive at an intrinsic value significantly higher than the current market value.

Walk through how you arrive at an estimate of intrinsic value.

MT: Mobile telecom in Japan is a mature business that we're valuing more like a perpetual bond with a fixed coupon. It generates about ¥600 billion in annual operating profit. After interest costs of ¥160 billion – including costs for debt carried on the domestic balance sheet that was taken on to buy Sprint – and assuming corporate income taxes of 30%, it earns a net profit of ¥300 billion. Depreciation and capital spending in the business are now more or less the same, so free cash flow is roughly equal to net profit. Using a discount rate of 6% on the low end and 10% on the high end in our discounted-cash-flow model, we arrive at an intrinsic

INVESTMENT SNAPSHOT

SoftBank Group
(Tokyo: 9984:JP)

Business: Technology holding company with operating mobile-telecom businesses in Japan and the U.S., as well as a large portfolio of Internet-based venture-capital investments.

Share Information
(@1/29/16, Exchange Rate: $1 = ¥121.12):

Price	**¥5,265**
52-Week Range	¥4,540 – ¥7,827
Dividend Yield	0.8%
Market Cap	¥6.32 trillion

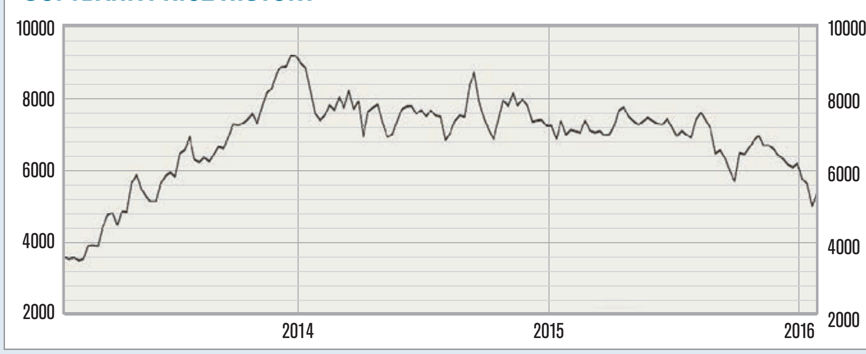
Financials (6 mo. FY2015, annualized):

Revenue	¥8.85 trillion
Operating Margin	15.5%
Net Profit Margin	11.5%

Valuation Metrics
(@1/29/16):

	9984:JP	S&P 500
P/E (TTM)	11.5	20.9
Forward P/E (Est.)	10.6	15.9

SOFTBANK PRICE HISTORY



THE BOTTOM LINE

Masa Takeda believes the company's high-profile struggle to turn around Sprint is, one, not as doomed as the market seems to expect, and two, is obscuring considerable asset value it possesses elsewhere.

Sources: Company reports, other publicly available information

value for this business of ¥3 trillion to ¥5 trillion.

Sprint, which is going through a particularly tough time, is very difficult to value because the turnaround is far from certain. Prior to the most recent commitment to the business on Mr. Son's part I probably would have put the value at zero or even negative. But there's clearly value there if he's able to do in the U.S. with Sprint what he did in Japan after acquiring Vodafone Japan in 2006. Vodafone Japan at the time was dead third in the sector, with a leader, NTT Docomo, that was more than 10x bigger. Mr. Son focused first on network quality and speed, investing in a cost-efficient manner in the infrastructure necessary to provide top-notch voice and data service. Next he turned to marketing, securing the exclusive rights to the iPhone when it first came to Japan, introducing a number of attractive rate plans, and building recognition for the SoftBank brand. He's trying to replicate all this with Sprint.

There's plenty of reason to be skeptical. Sprint's balance sheet is quite weak and the company continues to burn through cash. At this point though, I'm still willing to ascribe a ballpark estimate to Sprint's value. Its subscriber base is larger than SoftBank's in Japan, 57 million versus around 38 million, and its average revenue per user [ARPU] is also higher. So if they can straighten Sprint out, couldn't it one day be worth the ¥3 to ¥5 trillion value of the Japanese business? We're not assuming that, but are valuing Sprint now at ¥2 trillion. We think that's conservative, especially when you consider that Sprint has $20 billion worth of tax loss carryforwards that we estimate have a present value of roughly one third of that ¥2 trillion value estimate.

The next source of value is the venture-capital business. The primary publicly traded holdings are a 32% stake in Alibaba Group and a 36% stake in Yahoo Japan. There are also a large number of prominent unlisted holdings, including Snapdeal, a leading online marketplace in India, Ola, a taxi-app company like Uber in India, Didi Kuaidi, an Uber competitor in China, Grab Taxi in Singapore, and Coupang, an e-commerce company in South Korea. Some of these private holdings may not prove to be successful, but some may be very successful. To be conservative, we value this part of the business using only the publicly traded holdings on an after-tax basis, which comes to around ¥5 trillion.

That brings our full-company intrinsic value estimate for SoftBank to ¥10 to ¥12 trillion, again, assuming no value for most of the venture-capital holdings. That compares to a current market value of around ¥6.3 trillion. So even if Sprint blows up, we believe we're investing with a large margin of safety in an entrepreneurial company with an exceptional track record. We think the risk-return profile here is very much in our favor.

Describe the upside you see in running-shoe company Asics [7936:JP].

MT: We like sport-related businesses in general, as I touched on earlier with Shimano, and the running-shoe business in particular. The customer tends to be brand loyal and a serious runner goes through four pairs of shoes a year, creating strong replacement demand. Running is one of the cheapest forms of exercise, so it's fairly recession-resistant and we also expect a tailwind from more and more people all around the world taking it up as exercise. The business also generates a lot of cash because it doesn't require heavy capital spending.

The shoe business is also attractive because of the lack of exit barriers. If you are

INVESTMENT SNAPSHOT

Asics
(Tokyo: 7936:JP)

Business: Manufacture and sale worldwide of athletic shoes, athletic apparel, sporting equipment and outdoor equipment, sold primarily under the Asics brand name.

Share Information
(@1/29/16, Exchange Rate: $1 = ¥121.12):

Price	**¥2,211**
52-Week Range	¥1,955 – ¥4,000
Dividend Yield	1.1%
Market Cap	¥442.12 billion

Financials (2015 guidance):

Revenue	¥425.00 billion
Operating Margin	6.3%
Net Profit Margin	2.1%

Valuation Metrics
(@1/29/16):

	7936:JP	S&P 500
P/E (TTM)	25.7	20.9
Forward P/E (Est.)	19.9	15.9

THE BOTTOM LINE

Focused somewhat more on functionality than fashion compared to its higher-profile global competitors, the company has a strong track record of growth that Masa Takeda expects to continue. Assuming it can compound earnings at 10% over the next ten years, his discounted-cash-flow analysis yields a per-share intrinsic value estimate of ¥3,100.

Sources: Company reports, other publicly available information

a laggard in a capital-intensive business, you may stay in the game much longer and make things miserable for your competitors in order to avoid the heavy losses of shutting down. That's not the case in athletic shoes, which is a positive for industry winners like Nike, Adidas and Asics that rarely have to engage in price wars.

Where does Asics fit in the market from a competitive standpoint?

MT: Asics is #1 in the high-performance running-shoe segment. I don't have the number for last year, but in recent years almost one of every two runners in the New York City Marathon who finished the race in less than five hours wore Asics shoes. The company principally serves hard-core runners and I'd say is more focused on functionality than fashion, which is more important for Nike and Adidas.

The bulk of Asics' business today is in Europe and the U.S., although Asia is growing rapidly, primarily due to burgeoning demand in China. The base started small, but revenue in China in local currency terms has been increasing at better than 50% per year. Asics has also done well in recent years in developing what it calls its sports-style business, primarily in sports-related apparel and non-running shoes. This business should continue to benefit from the trend, led by the U.S. but happening everywhere, toward increasingly casual dress in almost all occasions.

The stock, at a recent ¥2,200 is off 45% from its 52-week high. Why?

MT: In December the company revised its earnings guidance downward, citing two primary reasons, a currency-related hit from Brazil and a 3% slowdown in running-shoe sales in the U.S. The shares had been trending down before that, but after the announcement we concluded the correction had been overdone and added to our position. This is something we've owned for a long time and we've historically had success trimming when it gets more expensive and adding when it gets less expensive. The business has been more stable and solid than the share price sometimes reflects.

The company has increased earnings over the past ten years at around 10% a year, and we expect that to continue for a number of years going forward as it maintains its position in a growing running-shoe business, expands geographically, and selectively builds out its product lines. Based on our DCF analysis, assuming a discount rate of 10%, we estimate intrinsic value at around ¥3,100 per share, roughly 45% above the current price.

Expand on your investment case for diaper-maker Unicharm.

MT: We consider Unicharm more of an emerging-markets play, based on the positive appeal its brands have in high-growth and relatively unpenetrated Asian markets. The current profit mix is roughly 30% from baby diapers, under the brand names MomyPoko and Moony, 40% from sanitary napkins, 20% from adult diapers, and the rest from smaller product lines such as pet care.

The company's market shares in all areas are very strong. It's the biggest seller of disposable baby diapers in Japan, with a 35% share. In India, which it entered in 2009, it now has 30% of the overall-country diaper market, but more than 50% of the business in big cities like New Delhi. In Indonesia and Thailand they have more than 60% market share. The Chinese market is still fragmented, but Unicharm is #2 there, with just over 10% of the market.

INVESTMENT SNAPSHOT

Unicharm
(Tokyo: 8113:JP)

Business: Global manufacturing and sale of branded consumer products primarily for the baby care, feminine care, personal care, pet care and household cleaning markets.

Share Information
(@1/29/16, Exchange Rate: $1 = ¥121.12):

Price	**¥2,268**
52-Week Range	¥2,035 – ¥3,398
Dividend Yield	0.7%
Market Cap	¥1.37 trillion

Financials (2015 guidance):

Revenue	¥760.00 billion
Operating Margin	11.3%
Net Profit Margin	5.8%

Valuation Metrics
(@1/29/16):

	8113:JP	S&P 500
P/E (TTM)	50.4	108.4
Forward P/E (Est.)	28.9	15.0

THE BOTTOM LINE
Benefitting from the favorable halo that Japanese consumer-products brands tend to enjoy throughout Asia, the company is well positioned to grow as disposable incomes rise in places like India and China, says Masa Takeda. Assuming it can achieve the 10% annual cash-flow growth he expects, he estimates fair value for the shares today at ¥3,000.

Sources: Company reports, other publicly available information

The numbers are comparable across Asia in sanitary napkins and adult diapers.

It's interesting to note that management has been content to be latecomers to new markets. They study the first movers and refine the company's marketing and distribution strategy to take market share once it's ready to enter a market. That's always been their approach and it's proven both prudent and successful.

As with Asics, Unicharm's share price has been weak over the past year as well, in this case due to some growing pains in certain emerging markets and the stock market overall pulling back on its enthusiasm for emerging-markets exposure. But we see a very long growth runway for this business. If you're a young mother raising a newborn, your family's rising disposable income will make high-quality disposable diapers increasingly within reach, and you'll be less likely to sacrifice quality for a lower price. Usage levels will continue to grow – in Japan market penetration for disposable diapers is close to 100%, while in China it's 20% and in India it's only 3%. Birth rates will also be an important tailwind. Only one million babies are born per year in Japan. In China that number is more like 17 million, and in India it's over 20 million. The details are obviously different, but the feminine-care and adult-diaper businesses have their own similar tailwinds that should benefit high-quality branded products.

How do you see that translating into upside for the company's shares, now at around ¥2,270?

MT: The trailing P/E multiple today looks quite stretched. Earnings have been negatively impacted by accounting adjustments related to merger transactions in years past, as well as by things like currency headwinds in Indonesia and increased price competition in China. Looking beyond those, however, we assume Unicharm can increase or maintain its current market-share levels and can compound cash flow at 10% per year over the next ten years, and at 5% annually from there. Based on our DCF, again with a 10% discount rate, we estimate intrinsic value at around ¥3,000 per share.

Risks?

MT: There's always executional risk when a company is expanding in new markets. But one thing we like about consumer brands is that once they establish consumer mindshare, the business tends to be very sticky. It's also a positive that technology is unlikely to significantly disrupt these types of businesses. Baby diapers are not going to go away.

Given your propensity to hold stocks for a long time, what will prompt you to sell?

MT: If the business continues to do well and generates high returns on equity, we are not quick to sell even when a stock we own reaches intrinsic value. But that has its limits. A few years ago we invested in Pigeon Corp. [7956:JP], which makes bottles and other baby-care items. It had a very strong market share in Japan and was growing strongly outside of Japan, particularly in China. Over the next 18 months earnings grew something like 40%, but the stock went up nearly 6x. That was just too much and we ended up selling most, but not all, of our position.

A different example would be Mizuno [8022:JP], which is in the sporting-equipment business, primarily in Japan. We first invested in the company in 2006, under the assumption that the family running it would realize it was in too many businesses and would refocus it on its strongest brand franchises, resulting in significantly improved returns on equity and capital. Years passed and that effort never really materialized, so I ended up throwing in the towel. The good news is that we didn't lose much on the stock – a clear advantage of trying to own safe and sound businesses.

Have you reexamined the bullish view you shared with us last year [*VII*, May 31, 2015] on conglomerate Mitsubishi Corp.?

MT: This unfortunately is a stock I've owned for many years and my bullishness has yet to really be vindicated. I still believe the company owns interesting assets and will benefit from recasting its portfolio to rely less on resource-based businesses and more on emerging-Asia investments in such areas as fertilizer and retail. The problem over the past year has been a still-high exposure to energy, but with the shares now trading at less than 60% of a book value that continues to grow, I see no reason to exit the position. Successful investing is all about batting average. I haven't given up hope that this will one day be a hit. VII

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Top ten holdings for the Hennessy Japan Fund can be found here. Fund holdings and sector allocations are subject to change at any time and should not be considered a recommendation to buy or sell any security.

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