Japan Small Cap Investing: Unearthing Hidden Gems

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Japan’s Resurgence: Uncovering Opportunities amid Economic Revival

Japan’s economy has been commanding renewed attention from global investors as a compelling investment destination amid promising signs of revival. Market dynamics and a series of pivotal reforms have propelled the Nikkei 225 to reach heights not seen in over three decades, surpassing the 30,000 yen mark, and are drawing interest in what opportunities can be uncovered in this transformed market.

A key driver behind Japan’s economic revival has been its swift rebound following the gradual reopening from restrictions imposed by the global pandemic. Despite experiencing a technical recession in the latter part of 2022, the country has witnessed a firm recovery in economy activity at the start of 2023. Inbound demand from increasing numbers of overseas visitors has contributed to domestic demand recovery, and is expected to continue moving forward. There are also signs of change in Japan’s price and wage norms to further support a favorable domestic demand environment. We believe that this trend will favor small-cap stocks, whose share of domestic demand stocks is high.

In terms of central bank policy, the Bank of Japan has maintained its loose monetary stance under the new leadership of Governor Ueda, even in the face of four-decade-high inflation rates. Governor Ueda will wait to see how the outbreak of financial system instability affects the real economy in the future, and we maintain our view that the central bank is highly likely to make some policy adjustments going forward. It is assumed that the yen will not depreciate as unilaterally as it did last year.

Valuations in Japan have also caught the attention of investors, with the TOPIX 12-month forward price-to-earnings ratio rising as high as 13x in the first half of 2023. Notably, value stocks have broadly outperformed growth stocks. Warren Buffett also helped draw attention to Japanese equities with a visit in April, his first in 12 years. While it is hard to imagine Mr. Buffett expanding his portfolio directly into Japanese small-cap stocks, there are many small caps that could be investment targets influenced by ideas like Buffett’s if their management’s awareness of capital efficiency continues to shift at the current pace.

A New Era of Governance: Embracing Reform

It is the evolving governance landscape that has truly captured investor interest. The newfound responsiveness of Japanese companies to investors’ interests can be attributed to the surge in shareholder activism and notable efforts by the Tokyo Stock Exchange (TSE) to push for improved corporate value. The TSE has sent an unprecedentedly strong message to its market constituents by requiring all listed companies on both the Prime and Standard markets to formulate and disclose plans for realizing management that is conscious of the cost of capital and share price. Among Japan’s small-cap stocks, there are many value stocks that maintain high ROIC but lack awareness of the cost of capital and have accumulated an unnecessary level of cash and equity, resulting in low ROE and PBR below 1.0x. While we have been in periodic dialogue with such companies for a long time about these topics, some companies that have been slow to listen to investor demands are beginning to change their attitude at the urging of authorities.

The number of parent-child company pairs listed on the TSE has been declining since 2007. The introduction of the Corporate Governance Code in 2015 has accelerated this trend, and various external factors (including the increase of activist investors, increase in engagement activities by traditional asset managers, and the ongoing
reforms by Japan Exchange) could add further pressure to unwind parent-child listings. Our existing Japan Small Cap strategy has benefitted from 16 takeover bids over the past eight years.

Five Good Reasons to Invest in Japan Small Caps

1. Breadth, Resilience and Inherent Strengths

The perception of smaller Japanese companies as inward looking and exposed to a country with an aging population is, like most generalizations, not an ideal basis on which to make an investment decision.

Many investors are unaware that Japan has over 3,000 listed companies, and is home to a huge number of high-quality and resilient innovators that are often hidden from view amid a layer of mundane and mediocre businesses.

Unearthing these “hidden gems” can give investors access to a trove of stable, quality companies spanning a variety of industries, from medical equipment to kitchen appliances, that are innovative and resilient yet undervalued compared to their assets. Some of these small cap stocks will be beneficiaries of the ongoing M&A trend, as investors seek to acquire smaller, cash-rich companies.

2. An Asset Class Offering Superior Returns

![Chart of TOPIX vs Russell/Nomura Small Cap Index Returns]

**Gross cumulative returns from 2003 to 2023.**

Source: TOPIX, Russell/Nomura Small Cap Indices. Please refer to the disclaimer at the end of this document.

History has proven that investors cannot ignore smaller companies. Small-cap equities have outperformed their larger peers across most timeframes and have the potential to generate higher returns than large caps.

Returns on the Russell Nomura Japan Small Cap index have been higher than those of the TOPIX index over the past twenty years, clearly demonstrating that this asset class offers a strong investment case that can complement and moreover enhance returns for investors in the broader Japan equity market.
3. Beauty in Simplicity

Compared to their large cap counterparts, small cap companies tend to have simpler business models. It is no coincidence that strong companies have simple, basic business models that allow them to make decisions swiftly and adapt to changes in the business environment.

Whether it is kitchen equipment producers, medical device manufacturers, or machine tool specialists, these smaller, specialized companies can respond quickly by keeping things simple.

4. Under-researched and Under-valued

Smaller companies tend to have less analyst coverage than their larger peers. This leads to greater discrepancies between fundamentals and market valuations, providing a rich environment for active investment.

5. Unique Diversification Benefits

Small caps are relatively insulated from geopolitical risk. They are also less vulnerable to currency fluctuations as smaller firms tend to generate a higher proportion of revenue from within Japan. Investing in Japan small caps also provides access to the potential future drivers of innovation across a wide variety of industry sectors.
The Nomura Japan Small Cap Equity Strategy

This Strategy has been managed since February 2020 with the investment objective of achieving long-term capital growth. With over 3,000 stocks in Japan, our focus is on unearthing hidden gems among small- and medium-sized listed companies. In other words, we offer investors a broad, unique and under researched opportunity set.

“We like to dig for companies that are profitable, have strong balance sheets, yet are undervalued. We actively monitor management quality and corporate fundamentals – factors representing the heartbeat of companies that are poorly covered by sell side analysts, and have the most potential to be mispriced.”

Access to Companies

The Portfolio Manager conducts over 500 meetings per year with listed companies. In total, our analysts conduct more than 5,000 meetings annually.

Investment Style

While the Japan Small Cap Equity Strategy has a slight value bias, we also look for elements of growth. There are mainly three types of investments that we look for:

1. High Quality Value Stocks: Profitable companies with strong balance sheets that are undervalued due to the lack of research coverage.

2. Growth Stocks: Companies with firm expectations of superior growth opportunities offered both by cutting edge technologies and innovative business models that are highly competitive and disruptive to traditional Japanese business practices.

3. Opportunistic Investments: Our approach is designed to identify not only quality businesses, but also businesses that are deeply undervalued, despite being well-run and able to ride the recovery wave.
We actively monitor management quality and corporate fundamentals – factors representing the heartbeat of companies that are poorly covered by sell side analysts, and have the most potential to be mispriced. Selecting these winners requires patience and a commitment of resources to cover the vast number of companies and diverse range of businesses.

The Strategy typically holds around 100 to 200 stocks. In the small cap markets in particular, diversification helps to mitigate liquidity risk, and we want to achieve exposure to a breadth of investment opportunities in order to raise risk-adjusted returns.

**Unwinding of Parent-Child Listings is Accelerating**

The number of parent-child pairs listed has been declining since 2007. Often, small-cap subsidiary stocks are TOBed and the share price rises. Our existing strategy has benefitted from 16 takeover bids over the past eight years. We have been in regular dialogue not only with subsidiaries themselves, but also with their parent companies to discuss synergies with the subsidiaries and issues with parent-child listings.

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Source: Nomura Asset Management
Note 1: Shinkawa changed its name to Yamaha Motor Robotics and remained listed as a consolidated subsidiary of Yamaha.
Note 2: ZOZO is still listed as a consolidated subsidiary of Z Holdings Corp. (formerly Yahoo!)

**Example of Governance Improvement: Maruzen**

This company is one of the largest commercial kitchen equipment makers in Japan, supplying to restaurants and convenience stores. With a sound balance sheet and high profitability, the company is benefitting from shifts in food consumption patterns.

There has been significant progress in corporate governance for larger companies since the introduction of the Corporate Governance Code in Japan. Smaller companies still lag behind their larger counterparts, but Maruzen is also gradually becoming more shareholder-friendly. Until a few years ago, the company refused individual interviews, but now they accept investor meetings on a regular basis.
The company does not require a huge amount of capital investment, but it continues to hoard cash on its balance sheet. However, thanks to our years of dialogue and encouragement by authorities, the company’s attitude is gradually changing. The payout ratio, which was in the 10% range just a few years ago, has steadily increased to just under 30% last year and 40% this year. In addition, an activist fund this year made a shareholder proposal to return 100% of its profits to shareholders, putting the market under increasing pressure. We will also continue to engage with the company for further improvements.
About the Portfolio Manager

Makoto Ito, CMA, has more than 19 years of investment and research experience.

Previously, he had experience in investment research in emerging market equities, particularly Chinese equities, and after joining Nomura Asset Management in 2006, he worked as a financial sector analyst before managing Japanese equities in 2008. He was appointed as a Senior Portfolio Manager in 2015.

Note: CMA is a Chartered Member of the Securities Analysts Association of Japan.