

# JAPAN – LAND OF THE RISING ‘SON’

Second Quarter 2016



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## PRAVEEN KUMAR

### *Investment Manager*

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Praveen graduated BEng in Computer Science from Bangalore University in 2001, and an MBA in Finance from the University of Cambridge in 2008. He previously worked for FKI Logistex before joining Baillie Gifford in 2008. After completing the investment graduate trainee programme Praveen joined the Japanese Equities Team as an Investment Manager in 2011.



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*Conversations on Japan are often hijacked by references to the so-called three deadly Ds: debt, demographics and deflation. These are often cited as reasons why Japan faces a bleak future. However, there are equally compelling arguments as to why these concerns might be overstated and, indeed, misleading. While Japan faces many challenges on account of these three factors, there is another ‘D’ which is likely to be far more important in shaping Japan’s future: Dynamism.*

History leaves little doubt about Japan’s capacity to adapt to a new environment. The late 19th century saw the dramatic evolution of Japan from an isolated, feudal society to a modern one, a period referred to as the ‘Meiji Restoration’. This was necessitated by a desire to develop an advanced and industrialised economy capable of projecting strength along the lines of the Western colonial powers at the time. Japan demonstrated its propensity for transformational change again in the 20th century, this time as part of the rebuilding process following the devastation of the Second World War. To put the impact of these two events in context, the pre-Meiji era saw output doubling in 150 years, after the Meiji restoration the same increase took 45 years and the 20th-century doubling was accomplished between only 1963 and 1970!

Ironically, the lingering effects of Japan’s rapid development after World War Two – the so-called ‘miracle years’ – now bind Japanese psychology and policy to inappropriate routines and practices that once had economic logic behind them but are now unproductive. Nowhere is this current mind-set typified more than in the ‘salaryman’ and ‘jobs for life’ ethos embedded among the vast majority of traditional Japanese corporates. It is primarily for this reason that, despite being a rich and developed nation, Japan has a number of industries that remain grossly inefficient. Such industries are often dominated by large, slow moving incumbents which have little incentive to change the status quo as they control large profit pools. This ultimately raises costs and limits choices for customers. More importantly, it also prevents the process of creative destruction which is an essential ingredient for a vibrant and healthy economy.

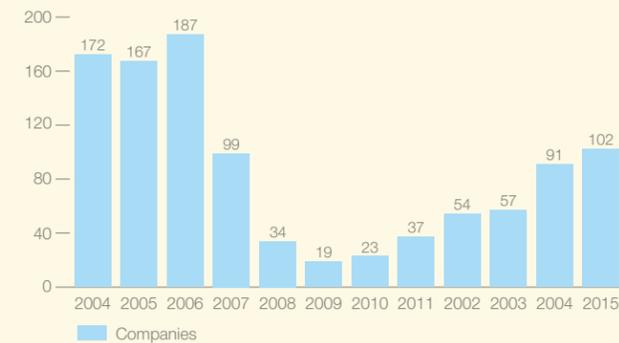


I recently spent six weeks in Japan with my family, during which I met some industry experts and senior management teams of 55 small to mid-sized companies, both public and private. As an overriding impression from these meetings and my trip in general, I believe that Japan is on the cusp of a third wave of transformation. This is being led by an increasing crop of dynamic entrepreneurs who are willing to take risks in order to disrupt the established order characterised by group think, extreme risk aversion and respect for authority. These entrepreneurs are building exciting, high growth and scalable businesses, often using the internet as a powerful medium of transmission, and disrupting existing industries or creating completely new business models in the process. For instance, Bengo4.com runs a website that matches individuals with lawyers. At the moment, consumers don't always have access to the best legal advice and this problem is compounded

by the sheer number of lawyers in Japan. By listing their services on Bengo4.com, lawyers can advertise themselves to customers who can then make an informed choice. Broadleaf is an IT company that has developed an online, cloud-based system for ordering auto parts. Garages in Japan deal with a large number of suppliers to source spare parts and the entire system is paper and fax based. Consequently, a simple car repair job can take days. Broadleaf's system removes this inefficiency and makes the entire process easier and quicker. MonotaRO, which operates an online system for ordering repair and maintenance equipment, is growing rapidly as it continues to take share from bricks and mortar suppliers. iStyle, which has developed a user-based rating system for cosmetics, is seeing rapid uptake of its services both in Japan and overseas.

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IPOs in Japan



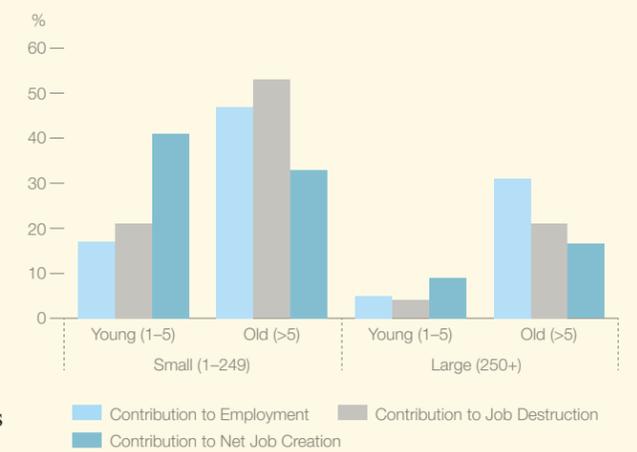
Source: Japanese stock exchanges statistics.

As these examples illustrate, different sectors of Japan's economy are seeing the emergence of high growth smaller businesses, many of which are going public, resulting in a healthy IPO market. For me though, the most encouraging development has been the diffusion of this dynamism and entrepreneurial spirit to traditional sectors such as manufacturing. This is partly being driven by Japan's demographics and is resulting in corporate control being passed on from the first generation of conservative and inward-looking founder managers, to young, Western educated and globally-minded successors. Nippon Ceramic is a classic example of this trend. This is a manufacturer of high-end ultrasonic sensors used in cars with advanced driver assist technologies such as automatic parking and collision avoidance. From its establishment in 1975, Nippon Ceramic was led by its founder who ran the business very conservatively, lacked ambition and didn't believe in shareholder returns. Following a change in management recently, the company is now run by the young and ambitious son of the founder. He has now set the company on a high growth path by prioritising overseas expansion, and is directing the company's resources towards the fast growing autos end-market. This trend of increasing creativity, innovation and dynamism

was also evident among the private companies I met during my trip. GLM, an unlisted company established by a Kyoto University graduate, has developed an all-electric vehicle sports car, modelled on Tesla but with one very interesting difference. The company has developed a chassis that is customisable, meaning that the same chassis can be used to manufacture different car models. This is an example of a company bringing manufacturing-related innovation straight out of a university lab into the real world, and I strongly believe we are likely to see many similarly innovative businesses emerge from Japan in future.

The importance of dynamic, younger and smaller companies for an economy in general, and Japan in particular, cannot be underestimated. An OECD study of 18 developed economies has shown that younger and smaller companies have contributed disproportionately to net job creation over the past decade. In Japan, it is estimated that firms aged three years or less account for just 8.5% of total businesses but represent almost 40% of gross job creation.

Percentage share in total employment, total job destruction and total job creation



Source: Criscuolo, Gal, and Menon (2014).



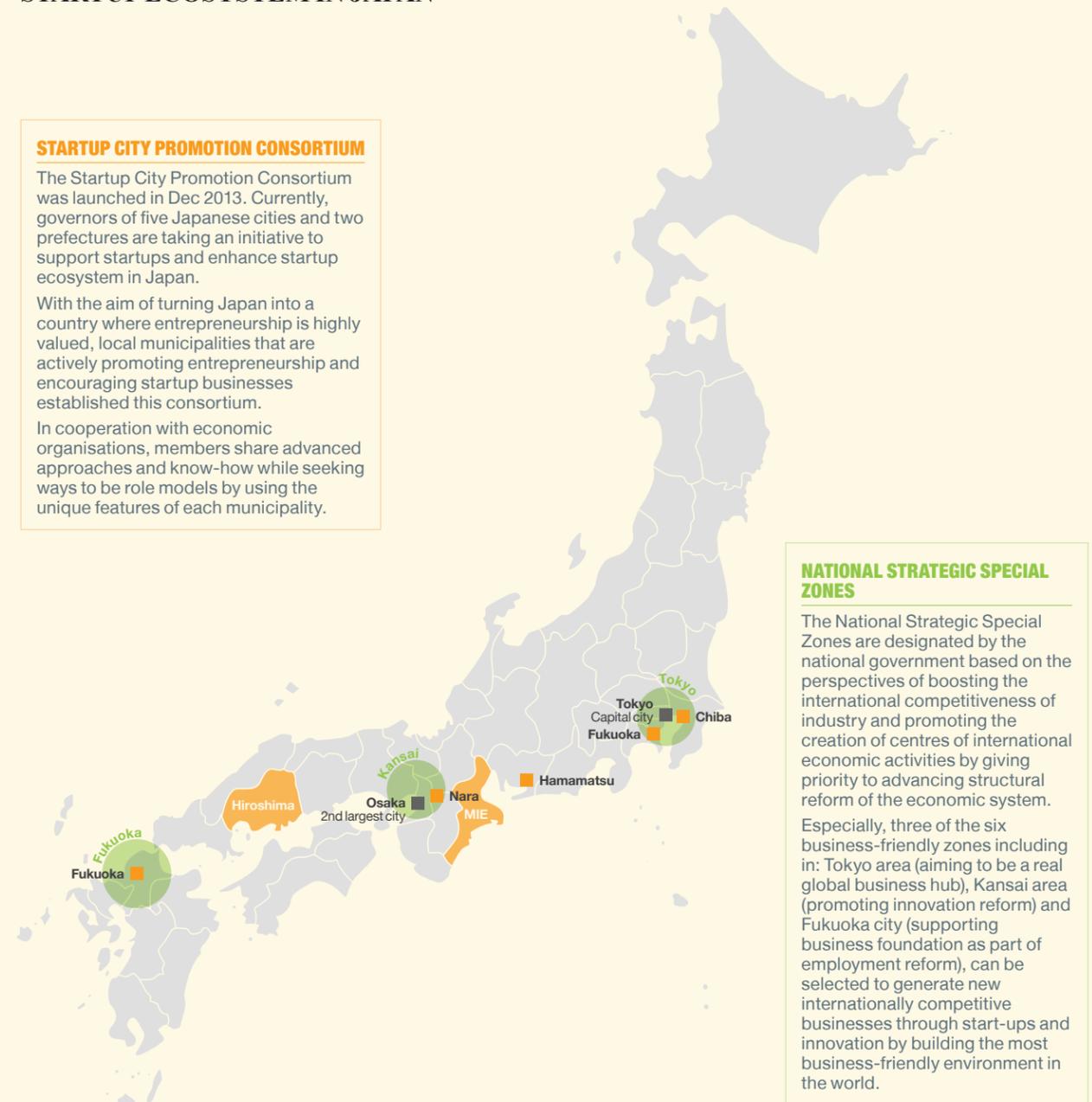
## STARTUP ECOSYSTEM IN JAPAN

### STARTUP CITY PROMOTION CONSORTIUM

The Startup City Promotion Consortium was launched in Dec 2013. Currently, governors of five Japanese cities and two prefectures are taking an initiative to support startups and enhance startup ecosystem in Japan.

With the aim of turning Japan into a country where entrepreneurship is highly valued, local municipalities that are actively promoting entrepreneurship and encouraging startup businesses established this consortium.

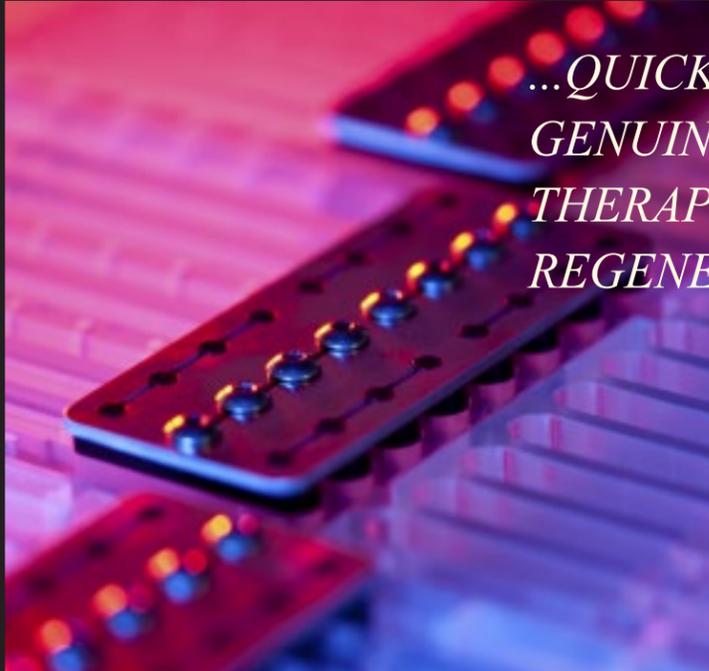
In cooperation with economic organisations, members share advanced approaches and know-how while seeking ways to be role models by using the unique features of each municipality.



### NATIONAL STRATEGIC SPECIAL ZONES

The National Strategic Special Zones are designated by the national government based on the perspectives of boosting the international competitiveness of industry and promoting the creation of centres of international economic activities by giving priority to advancing structural reform of the economic system.

Especially, three of the six business-friendly zones including in: Tokyo area (aiming to be a real global business hub), Kansai area (promoting innovation reform) and Fukuoka city (supporting business foundation as part of employment reform), can be selected to generate new internationally competitive businesses through start-ups and innovation by building the most business-friendly environment in the world.



*...QUICKER APPROVAL OF  
GENUINELY INNOVATIVE  
THERAPIES INVOLVING  
REGENERATIVE MEDICINE*

For its part, having adopted a piecemeal approach historically, the Abe government is now playing an increasingly active role in supporting dynamic and innovative young business. For instance, on the regulatory front, there have been some radical changes implemented in a short space of time. The retail electricity market has now been deregulated. Regional utilities, which until now had a monopoly over power generation and transmission, are now having to compete with smaller and nimbler players with a structural cost advantage.

The nearly 60 year old Pharmaceutical Affairs Law was amended in 2013 to allow quicker approval of genuinely innovative therapies involving regenerative medicine, a move designed to position Japan as the world leader in this area. This should benefit young biotech companies such as Sanbio and Healios that are developing genuinely novel, stem cell based therapies to cure previously untreatable medical conditions (brain injury related stroke in Sanbio’s case, while Healios is targeting age related blindness). Clusters have

been set up in a number of Japanese cities to encourage start-ups, and ample funding has also been made available. I met a few industry experts involved in research and in setting the government’s healthcare policy, and a common refrain in these meetings was the pleasant surprise expressed at the high level of state support and involvement in this area. Having had limited participation in venture capital historically, there is increasing engagement of the private sector in this area. I met the head of Rakuten’s newly instituted, Japan focused venture capital fund. He echoed my view regarding the increasing pool of young, dynamic and high growth Japanese smaller companies. Japan now has a long list of established firms across sectors who are actively engaged in venture capital, and this has resulted in the availability of ample risk capital for young businesses. As an investor in high growth smaller companies, I think all these are hugely exciting developments.

*– It was hugely encouraging to meet numerous entrepreneurs willing to take risks and build durable businesses, and increasingly benchmarking themselves globally.*

I strongly believe this is an exciting time to be investing in Japanese smaller companies. I have always held the view that there is no dearth of exciting, dynamic and high growth smaller businesses in Japan and my six-week stay in Japan only served to reinforce this. It could be argued that such companies are now witnessing a strong tailwind in the form of an unexpectedly high level of state support, numerous growth opportunities across sectors as a result of prevailing imbalances and structural deficiencies, and a generally more favourable business environment. It was hugely encouraging to meet numerous entrepreneurs willing to take risks and build durable businesses, and increasingly benchmarking themselves globally. These rising ‘sons’ of Japan should not only make investing in Japanese smaller companies an exciting proposition, but also give the economy a much needed dose of dynamism.



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