THE UNLISTED OPPORTUNITY IN JAPAN

Andrew Brown, Client Service Director. Fourth Quarter 2018.

BAILLIE GIFFORD

RISK FACTORS

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Baillie Gifford has previously held the following stocks: CyberAgent, Digital Garage, GMO Internet, Line Corp, Mercari, Morpho, Nintendo, Peptidream, Raksul Inc, Recruit Holdings, SBI Holdings, SoftBank, Toyota, Yaskawa Electric Corp.

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BAILLIE GIFFORD

Calton Square, 1 Greenside Row, Edinburgh EH1 3AN
Telephone +44 (0)131 275 2000 www.bailliegifford.com

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THE UNLISTED OPPORTUNITY IN JAPAN

BY ANDREW BROWN

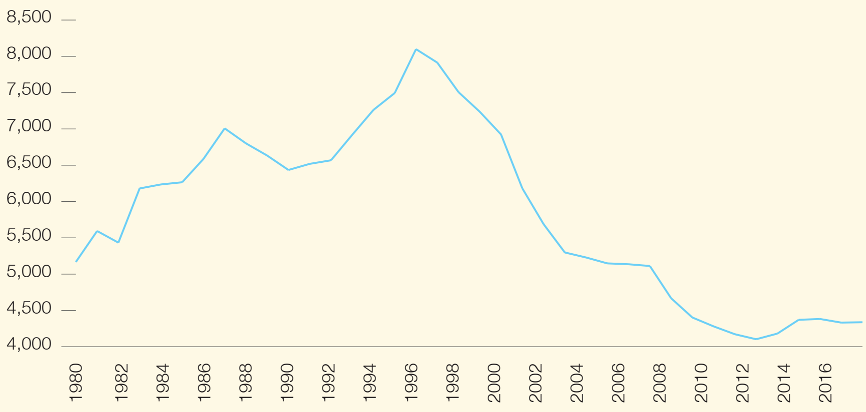
In June this year, Japan's first tech startup unicorn – defined as a business which is valued above $1 billion in private funding rounds – listed on the Tokyo Stock Exchange. With only a few others in the pipeline this pales in significance compared to other major markets, notably the US and China. It is also consistent with our observation that the unlisted equity market in Japan remains nascent in its development. However, although Japan appears to be late to the unlisted party, there are promising signs of change. We are considering how we, as investors, should approach the unlisted opportunity set in Japan to ensure that our clients can gain access to the most exciting growth businesses.

JAPAN LAGS BEHIND US AND CHINA

Before focusing on Japan, some global perspective seems appropriate. In recent years, there has been a build-up of high-growth American and Chinese companies in the later stages of private markets, exhibiting the same characteristics of public companies that we have been analysing for decades. According to a recent survey by Deloitte and China Venture, there are currently 106 and 98 unicorns in the US and China respectively, many of which have reached valuations in excess of $5 billion. This development seems to have been driven by changing cultural attitudes among management teams, the availability of capital – there are now over 800 venture capital (VC) funds operating in the US alone – and the increasing prevalence of technology-led business models, which have more limited capital requirements and are therefore able to scale faster without raising public finance.

In Japan, there appears to be a number of structural impediments which have held back the development of the VC industry. These include: the reluctance of banks to lend to private companies; an unwillingness of founders to cede control of their business; a long-standing social pressure for young people to join established companies; lack of clarity on the regulatory backdrop; and low levels of English spoken, which deters overseas investors. Furthermore, a poor investment record within the domestic VC industry and a withdrawal of capital since the financial crisis have provided further headwinds and perhaps explain why, in the main, Japanese companies rarely stay private beyond the first round of VC funding.

Number of listed domestic companies in the US



Source: World Bank, World Federation of Exchanges.

MERCARI – JAPAN'S NEWEST UNICORN

Founded in February 2013, Mercari is a smartphone-based app which boasts more than 10 million active users. Its core business in Japan is growing strongly, supported by rising online penetration and market share gains from smaller competitors. After spending just over five years as a private company, it listed on the Mothers section of the Tokyo Stock Exchange with a valuation of $6.5 billion dollars.

© Bloomberg/Getty Images

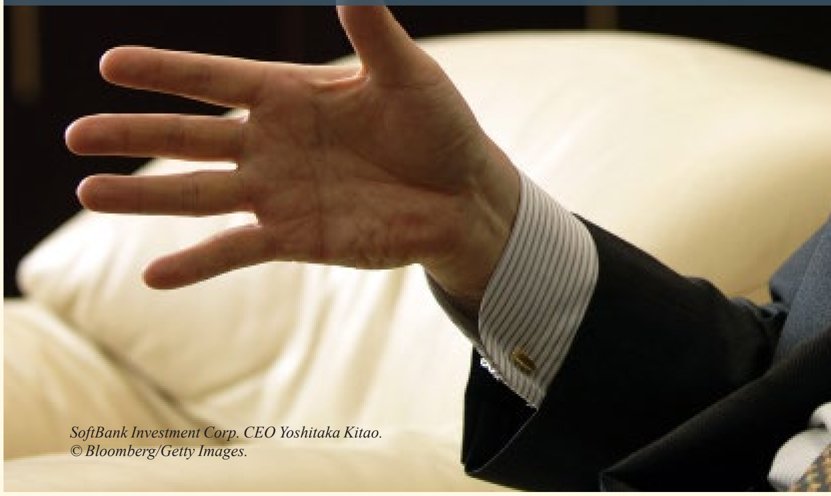
SIGNS OF CHANGE IN JAPAN?

Although only around $2.7 billion was invested in Japanese start-ups in 2017 (which compares to $71.9 billion in the US and $40 billion in China) this marked the highest level on record and there are grounds for expecting continued growth. For a long time, graduates from Japan's top universities chose to work at major banks and trading companies, lured by the appeal of a job for life. However, mindsets are perhaps changing in the wake of the financial crisis and the legacy of the Great East Japan Earthquake; both of which appear to have altered the way young people approach their careers and engendered more flexible attitudes.

Government policy has also been helpful, although many people believe a lot more needs to be done before Japan becomes a destination of choice for start-ups to rival the US, China or Singapore. In 2015, the government began offering business visas to overseas entrepreneurs from select countries to encourage more diversity of thinking. However, onerous qualification requirements have meant that only a limited number of entrepreneurs have been accepted on the programme. Regulations for new business formations were also loosened within special economic zones and start-up cafes were established in major cities to provide necessary support. Perhaps the most significant policy change has been the decision to shorten and simplify the approval process for regenerative medicine, which was a major factor in the decision for some biotech businesses to shift their operations elsewhere to Japan.

SBI HOLDINGS – FINANCIAL DISRUPTOR AND LEADING VC INVESTOR

SBI holdings is best known for its online brokerage business, which is rapidly taking share from traditional incumbents, and its broader online financial ecosystem. However, the company's venture capital arm is also emerging as a major earnings driver for the company, as well as acting as a form of research and development for the core business. As at March 2018, group assets under management in private equity business equated to 218.8 billion yen. Although it is rarely a lead investor, it seems that a number of Japan's most promising start-ups are keen to include SBI among their early stage investors, both for its close links with major financial institutions and to benefit from its operational expertise.

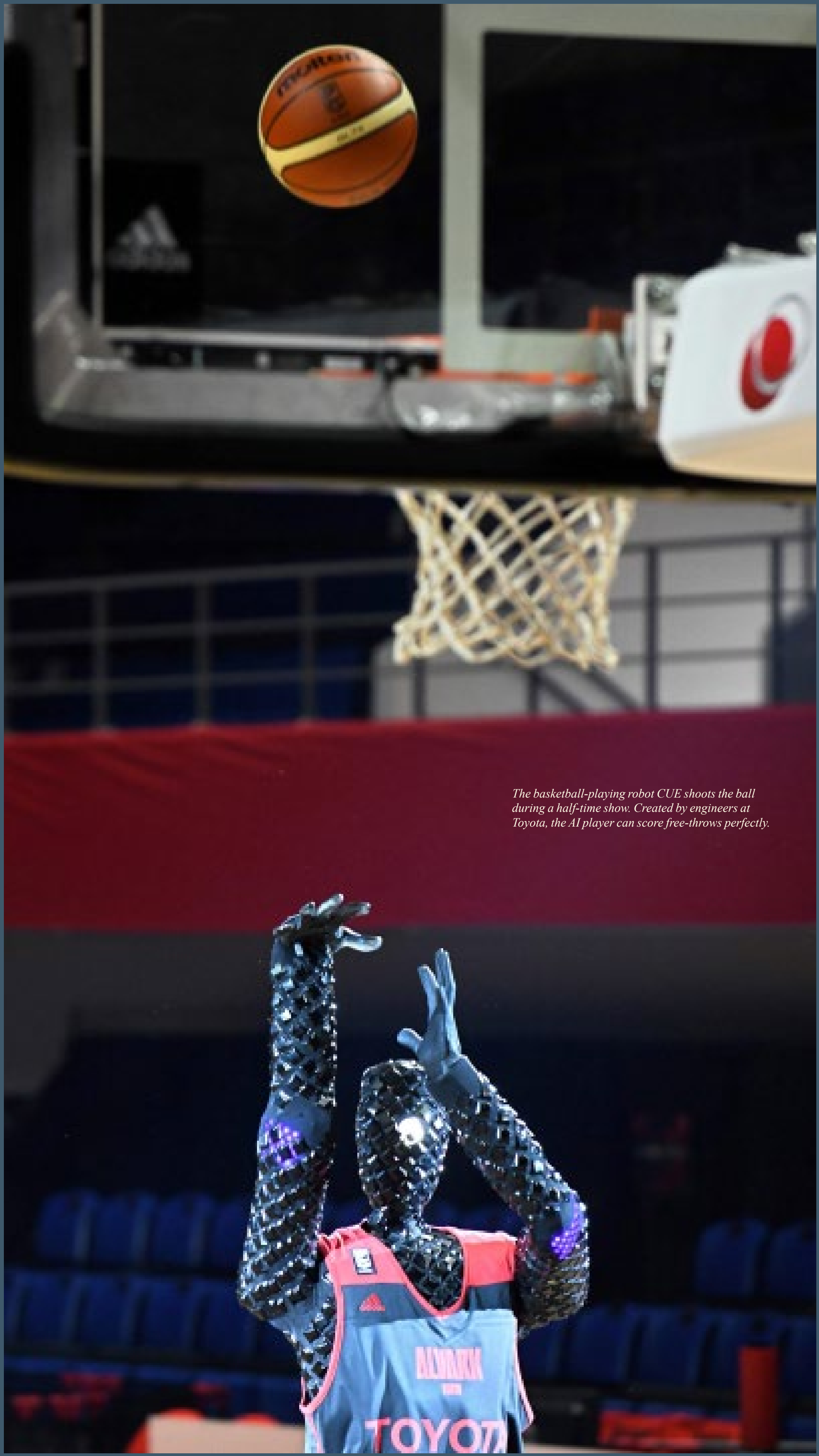


SoftBank Investment Corp. CEO Yoshitaka Kitao.
© Bloomberg/Getty Images.

JAPAN'S VENTURE CAPITAL INDUSTRY STEPS UP

The availability of funding for Japanese start-ups has also improved greatly from a very low base. The University of Tokyo's VC arm Edge Capital has committed approximately $500 million to 90 start-ups through its four funds. Although the level of capital invested is modest, nine of its investments have now listed on Japanese exchanges including Peptidream, a peptide-based drug discovery platform, and Morpho, a specialist in image processing technologies being applied to autonomous driving. Both have progressed to become leaders in their field. The government-sponsored Japan Investment Corp, which has a stated aim of nurturing growth industries through public and private partnerships, has also committed a small amount of funding to private companies. It partners with public organisations such as Japan's Science and Technology Agency and Japan Venture Research, and tends to co-invest with Japanese listed companies.

By far the largest contribution to funding for start-ups has come from the corporate sector. Japan's leading VC investor JAFCO has recently increased its investment run rate significantly, as well as the amount committed to each deal, noting that there has been a vast improvement in the number of attractive early stage investment opportunities. In recent years there has also been a notable increase in VC subsidiaries being established by Japanese companies operating across a range of sectors. Chief among these is leading online brokerage and asset manager SBI Holdings, which has its origins as a spin off from SoftBank.



The basketball-playing robot CUE shoots the ball during a half-time show. Created by engineers at Toyota, the AI player can score free-throws perfectly.

Among the 218 billion yen SBI Holdings has invested in unlisted companies as at end March 2018, almost two-thirds relate to domestic businesses. Other internet businesses which have established credible VC arms include: online media platform CyberAgent; internet holding company Digital Garage; specialist in web infrastructure, payment and foreign currency broker GMO Internet; and mobile messaging service Line.

For long-term growth investors such as ourselves, the move from these leading domestic internet platforms to develop VC capability is interesting on a number of fronts. Firstly, it is helping them to improve their core business offering through integrating the latest technologies into their operations, and indeed to defend themselves against potential disruption. We can see this through SBI Holdings which is looking to incorporate technologies it has learnt about through its blockchain and AI fund into its everyday transaction and data management processes. Secondly, these businesses are well-placed to add value to their investee companies by leveraging their broader relationships within the industry and potentially making valuable connections. Finally, and perhaps most importantly, because these companies are investing overseas as well as in Japan, they are able to share global best practice and provide a mechanism for keeping Japanese technology relevant and cutting edge.

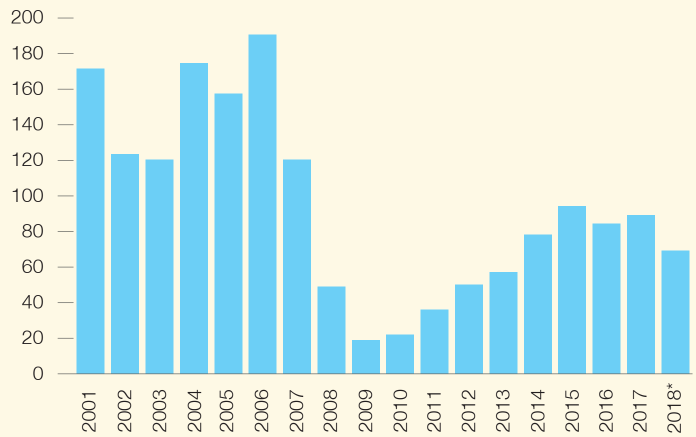
It is encouraging to see that some of Japan's more traditional companies are also committing money to start-ups, largely in order to keep abreast of the latest technological developments. Behemoth auto manufacturer Toyota has invested $100 million in 11 companies which focus on artificial intelligence, autonomous driving and machine learning. Management consider this investment as part of their overall research and development budget. At the same time, Yaskawa, a leading manufacturer of servo motors and industrial robots, developed a VC arm in 2017 motivated by a willingness to stay in touch with new developments in the industry. Meanwhile, entertainment business Nintendo has recently partnered with US VC firm Scrum Ventures to seek out unique technologies which could disrupt the console gaming industry.

Of course, by far the most significant investor in overseas unlisted businesses is SoftBank, both through its $93 billion Vision Fund and, to a lesser extent, on its own balance sheet. Although conspicuously focusing outside its domestic market, SoftBank does operate a subsidiary called Deepcore which invests in early stage domestic deep learning ventures. Given SoftBank's reach and influence, it also seems highly likely that it will play a pivotal role importing disruptive technologies into Japan.

INVESTMENT IMPLICATIONS

So, with some auspicious signs that the environment for unlisted investments in Japan is improving, what impact does this have on our investment process? Although the Japan specialist strategies that are currently available to our institutional clients remain restricted to listed companies, for some time we have included private firms within our research efforts. This has largely been motivated by a willingness to follow disruptive businesses before they list, so that we can make informed decisions when they become investible for our clients. That was the case with Mercari and also the cloud-based printing and logistics platform Raksul, now held in our small cap funds. With an increasingly lively IPO market in Japan, we would expect to see many more examples in the coming years. Our work in this area has also been motivated by a commitment to fully understand the competitive landscape in which our holdings operate. For example, for many years, several of our holdings cited subsidiaries of then listed media and staffing giant Recruit as a competitive threat, so we paid close attention well before its IPO. Finally, with many holdings now running incubation funds themselves (as noted above) we, as long-term, committed and engaged investors, have a duty to follow them closely and consider their potential value to the overall business.

Number of IPOs in Japan

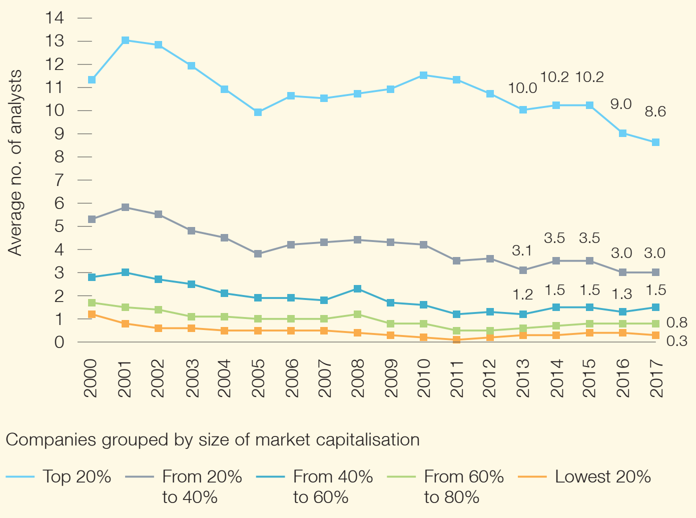


Source: Bloomberg. * As at 31/10/18.

In many ways our approach to investment is particularly suited to private companies. We adopt a broad-brush approach to valuations, considering the potential size of the opportunity and the range of potential outcomes. At the same time, we rarely change our investment views on the back of quarterly results, and indeed encourage our investee companies to make decisions which may weigh on short-term profits if they help contribute to long-term value creation. Furthermore, as a firm, we have been making great strides building up networks of leaders in their field and for some time have prioritised proprietary and independent research. So we are increasingly well set up to analyse companies that do not disclose much information to the financial services community.

The prospect of launching a specialist fund of unlisted investments in Japan seems quite distant. Our research suggests that the VC industry is developing slowly, a general risk aversion culture remains a headwind and, as such, the breadth of attractive private opportunities available to our clients today is limited. This may well change as Japan's lost decades fade further into the past and success stories like Mercari come to bear. With more companies listing earlier, Japan's small cap exchanges offer an abundance of fascinating businesses which are not well understood by the market.

Analyst coverage of Japanese companies



Source: Mitsubishi UFJ Morgan Stanley Securities, from Astra Manager, as at 1 December 2017.

Note: Covers stocks listed on the Tokyo Stock Exchange. Stocks are divided into five equal-sized groups by market capitalisation as at each financial year end.

We continue to research private companies on a case-by-case basis and follow developments closely. In the event that we identify exceptional private businesses, we will leverage the expertise developed from within the firm and reach out to clients accordingly. What makes us particularly excited is that we are witnessing a steady flow of companies, whether listed or private, with innovative new business models which are disrupting established practices. This is great news for growth investors in Japan.

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ABOUT THE AUTHOR

ANDREW BROWN
Client Service Director

Andrew is a Client Service Director with responsibility for Japanese and Developed Asian equity clients. Andrew maintains a close relationship with the Japanese Investment Team and conducts regular stock research and investment trips to Japan, as part of his specialist client service role. He is Chair of the Japan Product Group. Prior to joining Baillie Gifford in 2007 Andrew held roles at Scottish Widows Investment Partnership and Ernst & Young. He graduated from Durham University with BA (Hons) in History and Politics in 1998 and is a holder of the UK Securities Institute Diploma.

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Calton Square, 1 Greenside Row, Edinburgh EH1 3AN
Telephone +44 (0)131 275 2000 / www.bailliegifford.com