
JAPANESE SMALLER COMPANIES FUND AND SHIN NIPPON PLC – MANAGER INSIGHTS

Praveen Kumar, investment manager of Japanese Smaller Companies Fund and Baillie Gifford Shin Nippon PLC, explains how Covid-19 will accelerate changes in the behaviour and working practices of corporate Japan and why this should result in numerous growth opportunities for fast-growing, nimble and disruptive smaller business.

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Praveen Kumar: Hello. My name is Praveen Kumar and in this video today, I'd like to share four things with you.

First, the impact of Covid-19 on Japanese smaller businesses; second, the growth opportunities emerging out of Covid-19; third, the changes that we've been making to the portfolio; and fourth, the outlook for Japanese smaller companies.

The impact of Covid-19 on Japan's smaller businesses

In terms of the impact of Covid-19, 2020 has so far proven to be challenging for businesses everywhere, and Japan is no exception. However, like the broader Asian region, Japan was among the first countries to be hit by Covid-19, but with the recent lifting of its state of emergency, Japan is also among the first to emerge out of this crisis. Thanks to its rigorous approach of contact tracing, testing, longstanding cultural habits like wearing masks, and a compliant population, Japan has so far recorded one of the lowest numbers of Covid-19 related deaths compared to other major economies.

However, the impact of Covid-19 on corporate Japan has been harsh, with the brunt of this being borne by Japanese exporters as overseas demand remains very weak. Measures taken by companies to contain the spread of Covid-19 have resulted in widespread disruption of supply chains. The pain has been acute at some of the smaller Japanese manufacturers that don't have the luxury of a strong balance sheet.



Growth opportunities emerging due to Covid-19

But it is not all bad news.

This crisis is also creating exciting new growth opportunities for dynamic, entrepreneurial and nimbler smaller businesses. I would like to highlight three areas where we see significant growth opportunities emerging as a result of this crisis.

Firstly, ecommerce and digitalisation; second, software services; and third, healthcare.

Taking these in turn, Japan has been a laggard relative to other developed markets in adopting new technologies as Japanese companies, in general, have under-invested in IT over the years. The current crisis is laying bare the inadequacies of corporate Japan's current IT infrastructure. This is serving to accelerate digitalisation in the current climate and is creating numerous growth opportunities for smaller businesses that are trying to solve these kinds of structural issues.

One such company that we own in the portfolio is Bengo4.com. It offers an online, digital contracts service which allows companies to eliminate paper-based contracts for employment, real estate and legal matters, to name a few. The current crisis is resulting in a large number of companies subscribing to Bengo4's digital contracts service. Sales for this service more than doubled over the past year and the company expects to maintain a similar pace of growth over the next 12 months.

Another holding, GMO Payment Gateway, is also emerging as a major beneficiary of the current crisis. This is Japan's leading online payments processing company and is seeing rapid growth as an increasing number of people opt to shop and transact online.

We are also seeing significant changes in the attitudes of traditional Japanese companies in terms of how they treat employees. There is a growing emphasis on workplace reform and maintaining employee satisfaction; something that, traditionally, Japanese companies haven't bothered to spend much time on. This is resulting in a strong tailwind for software companies like Cybozu and oRo, both portfolio holdings that provide easy to use software that allows companies to automate and streamline a number of tasks related to HR, payroll, marketing and project management, to name a few.

Finally, on healthcare, given Japan's ageing society, the current crisis has hit home the need for the government to be able to reach out to the elderly and vulnerable in order to provide them with much-needed medical services. Japan's health ministry is taking measures to address this issue and is now encouraging companies to provide patients with services like online consultations, telemedicine and remote diagnostics. Portfolio holdings M3 and Noritsu Koki are prime beneficiaries of these changes as they are among the leading players in these areas.

It is worth mentioning that we have over half of the portfolio invested in disruptive and rapid growth businesses that are offering products and services designed to solve structural issues in Japan. It is our observation that the current crisis is only serving to accelerate the previously discussed trends in favour of these companies.



Changes to the portfolio

In terms of portfolio changes, there has been very little activity. At the margin, since the back-end of last year, we have been trimming our exposure to cyclical business and adding to our internet stocks. As patient, long-term investors with a five to 10-year investment horizon, we are averse to making changes in times of crises, especially when we remain confident of the underlying strengths of the businesses we own. Over three quarters of the portfolio is in stocks that have a net cash position on their balance sheet so there is significant resilience in the portfolio.

Outlook

As for the outlook for Japanese smaller companies, it is easy to be gloomy and pessimistic at the current time given the large-scale disruption caused by Covid-19. However, we remain optimistic about the future growth prospects for Japanese smaller companies. It is our belief that Covid-19 will accelerate changes in the behaviour and working practices of corporate Japan and this should result in numerous growth opportunities for fast-growing, nimble and disruptive smaller business.

There has never been a better time to invest in Japanese smaller companies, which remains a hugely exciting asset class.

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Investment in smaller companies is generally considered higher risk as changes in their share prices may be greater and the shares may be harder to sell. Smaller companies may do less well in periods of unfavourable economic conditions.

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