MOI GLOBAL

Hikari Tsushin: Mid-Cap Compounding Vehicle in Japan

Jiro Yasu and Patrick Rial of Varecs Partners presented their in-depth thesis on Hikari Tsushin (Japan: 9435) at Asian Investing Summit 2019.

Thesis summary:

Hikari Tsushin is a USD 10 billion market cap company that is unique in Japan for its highly rational capital allocation strategy. The company is one of the largest shareholders of Berkshire Hathaway in Japan. Jiro and Patrick view it as one of the most avoided stocks by Japanese portfolio managers due to its checkered past. The company sells a variety of products that generate recurring revenue streams. It invests the cash flows in customer acquisitions, stock buybacks, shares of U.S. compounders, and shares of undervalued Japanese stocks, creating steadily growing intrinsic value over time.

Hikari directly and indirectly distributes B2C and B2B products such as cellular phones, water-servers, insurance products, internet services, and fax machines. Hikari is a rare compounder in Japan, building businesses that produce recurring revenue and profit. There is a 30-40% IRR hurdle for new customer acquisition cost. The company maintains high operating margins due to one of the best cold-calling armies in Japan. Intrinsic value per share will compound through rational capital allocation; the cash flow will be invested in new customers, own shares, shares of U.S. compounders, and undervalued Japanese companies (both minority and majority stake). Here are some valuation metrics: EV/LTM EBIT: 13.3x, EV/LTM EBITDA OF 11.6x, PBR of 4.0x, 19.7x P/E and recent share price of JPY 20,600. Hikari's share price has compounded at an annual rate of 21.8% for the last five years.

Jiro and Patrick believe Hikari is avoided by most portfolio managers in Japan due to its collapse in 2000. Hikari was one of the most popular stocks in the tech bubble days, and reached over a 5 trillion yen (approximately USD 50 billion) market capitalization in 1999. As the tech bubble busted in 2000, Hikari share price also dramatically collapsed. The shares were not traded for 20 trading days due to the TSE limit-low rules. It lost 95% of its value in two months. Currently, only 5% of its shares are owned by Japanese mutual funds.

The following transcript has been edited for space and clarity.

Jiro Yasu: This is our sixth presentation at an MOI Global event. We are excited to talk about our new idea and also share updates on our past ideas.

Let me start with a brief overview of our company. We've been doing this since 2006. Our strategy is to focus on investing in undervalued Japanese equities. Typically, we invest in family-run companies, which tend to have higher operating margins. We try not to invest in low-growth businesses, and we prefer stable revenue stream companies. Our focus is on smaller companies – typically, we invest anywhere between $150 million to $1 billion market cap. We are a true long-term business owner. Our average holding period is over five years, and our turnover has been 15% to 20% per year. Our portfolio has many names we've owned for over ten years.

We try to build a good constructive relationship with the management team, which tends to allow us to have a larger investment in such companies. This has helped our performance over the years. Our AUM has grown to around $310 million, but we try to keep the amount

small to enjoy our investment capability in smaller companies. Our client base comprises mainly US- and European-based endowment, foundations, and family offices. Interestingly, we have almost no money from Japanese institutional investors. My family invests about $20 million in the fund. Our team is also small – there are three people running this strategy.

Update on Ideas Presented in the Past

In 2013, we pitched the idea of Japanese animation companies Toei Animation and Sotsu. Toei doubled in two years, and we exited then. It's rather embarrassing to say, but it has doubled again since then, so Toei has been doing great. We kept our investment in Sotsu, which is struggling a bit and testing our patience. We have not given up yet, but our position got smaller as our AUM grew. The problem with this company is the lack of profit growth so far. The management has changed a few times, the most recent change taking place in 2018. The president was replaced. There's a lot of growth in content-related business, but this company has not been able to capture it yet. The share price got cheaper in the last few years. Today, 75% of market cap is in cash and securities, there is no debt, and it's traded at 2.6x EBIT.

The other idea we pitched in 2015 was EM Systems. This is a software company serving mainly Japanese pharmacies. The share price has been performing well, gaining 200% since 2015. EM Systems announced its new five-year business plan in 2018, deciding to transform itself into a full SaaS company. Due to the change, profit is expected to decline in 2019 and 2020, but the company aims to increase its operating profit by 50% in five years. It has been buying back shares, twice in the current fiscal year. EM Systems still owns the beautiful office building in front of Shin-Osaka station, and it is still fully occupied. We estimate the building is worth about half of the market cap. Excluding the cash and the property, it's trading at 6.6x LTM EBIT. This remains one of our largest portfolio holdings. As it transforms into a SaaS company, we expect it to create a lot of value for us going forward.

Agrochemical company Agro Kanesho is an idea we presented in 2016. The share price has been performing well, up 140% so far. The company recently decided to build a new factory to increase the production capacity for future growth. Also, it has been trying to buy product rights from larger international firms because they are consolidating. In 2018, it acquired one from Dow DuPont. In addition, it has been developing new products, with one approved by the Japanese government and lasted to launch in 2020. Agro Kanesho announced its new five-year business plan in 2018. Operating profit will decline initially because of the new factory depreciation and the amortization of the goodwill due to the acquisition from DuPont. However, at the end of this business plan, the company aims to have a 50% increase in operating profits. It deployed some cash into the acquisition and the factory, but still, a third of market cap is in cash. It trades at 10x EBIT.

Our 2017 idea was Amuse, a management company for Japanese artists, rock musicians, celebrities, and actors. It has 400 client relationships. Unfortunately, the share price is down about 1% since our presentation. At the same time, TOPIX appreciated 10%. It's a big underperformer. The share price went as high as JPY 4,000 in early 2018 but then corrected by 40%. We still like the business, so we increased our investment in those times. In terms of business revenue, 2018 was a better year, but the company struggled a bit to translate it into better operating profit due to the increased cost of live events. Amuse recently had its 45th anniversary, which also added to costs. The company has a joint venture with Line, the dominant messaging service in Japan – about 70% of the Japanese population use this app. The JV is for a ticket-selling platform, which started in 2018 for smaller events, but it will gradually open to larger events in 2019. Also, the company decided to open up its music

portfolio to streaming services, like Apple Music or Spotify. As a result, operating profits from the rights business grew by 34% year-on-year. Currently, about 55% of the market cap is in cash and securities. The company trades at 5.4x LTM EBIT. We still like this business, and we think the stock is extremely cheap now.

CRE, our idea in 2018, is up 9% since our presentation. The company was the best performer in our portfolio in 2018 but the worst one so far in 2019, down about 10%. CRE, which does business related to logistics, announced its five-year business plan in 2018, the target being about 5 billion yen in operating profit. The company is busy acquiring businesses. In 2018, it bought 51% of logistics-focused IT provider Brain Wave and 100% of Logicom, another major master-lease operator in Japan. CRE has also been buying back shares, about 2% last year. Excluding debt for development, it's traded at 3x EBIT. We still think it's very cheap, and it remains one of our core holdings.

Investment Thesis on Hikari Tsushin

The new idea, Hikari Tsushin, is quite different from our past ones. First of all, it's not very small – it's market cap is JPY 950 billion, or about $8.6 billion. Hikari distributes, directly and indirectly, many B2C and B2B products such as cellphones, water servers, insurance products, internet, faxes, and copy machines. It doesn't sell exciting products, but we like it because we believe it to be a very rare compounder in Japan. The things it sells produce recurring revenue and profit. It has a very high hurdle rate for new customer acquisition cost, 30% to 40%, which is quite unusual in Japan. Also, we believe it has one of the best cold-calling armies in Japan. The current share price is about JPY 20,000, but our estimate of intrinsic value is JPY 23,000. It has a modest 16% upside potential from here, but we think the intrinsic value per share can compound through rational capital allocation.

The company has been investing cash flow in new customer acquisition and also own shares in US compounders. I think Hikari is one of Japan's largest shareholders in Berkshire Hathaway. It is also investing in many undervalued smaller Japanese companies, both minority and majority stakes.

Over the last five years, the share price has compounded at an annual rate of 21%. It would have been better to come into this idea five years ago, but we think it's not too late from this level.

Hikari has huge distribution capabilities and network – 197 subsidiaries, 136 partners, and a sales staff of 30,000. It maintains a proprietary database of clients, so its people know whom they should call when new products are introduced. This is likely the reason its cold-calling army is so efficient.

As Hikari explains in its pitch book, it tends to spend money to acquire clients, at which point the business doesn't produce much profit. As long as the company believes the products can grow and it can gain more clients, it pays the acquisition cost. At some point, the recurring profit will exceed the acquisition cost, so the business will start producing profits. Interestingly, as it sees a business has limited potential to acquire new clients, it will start reducing acquisition costs, and at some point, it will stop using any acquisition cost. After that, all of the recurring profit will become operating income.

The company has an IRR of 30% to 40%. The customer acquisition cost will compound over the years. Hikari expects to make about JPY 100 billion of recurring profit this year, but it is investing half of it in customer acquisitions. Hopefully, this JPY 50 billion investment will

produce maybe JPY 15 billion of new profit next year. It will keep doing this over the years, so the return on customer acquisition will pile up. As long as it can find new products and keep investing in new customer acquisitions, its recurring and operating profit should grow over the years.

When it comes to financial performance, revenue decreased in 2016, which was due to Hikari changing the accounting standards from Japanese GAAP to IFRS and some change in revenue recognition for the cell phone segment. Excluding that one-time accounting effect, the business has been growing. The company is somewhat levered – net assets are about JPY 200 billion, and total assets are about JPY 680 billion, so it's about 3x levered. It has been issuing public bonds over the years and borrowing money for ten years at a fixed rate of less than 1%, so it's taking advantage of the low rate environment in Japan.

In terms of cumulative capital allocation, Hikari has produced JPY 337 billion of stock profit in the last five years and invested JPY 145 billion into customer acquisition. Net income was JPY 150 billion, of which the company paid about 30% as a dividend. It has also been doing buybacks, spending 22% of net income. Additionally, it is an active investor in both US compounders and undervalued Japanese companies – in the last five years, it has net equity investments of JPY 26 billion, or about 17% of net income. Over the same period, the cumulative acquisition of equity was JPY 170 billion, while the total sale was JPY 145 billion. Hikari does some acquisitions and sometimes sells businesses, but this was not a big part of capital allocation in the last five years. The company makes a lot of money in stock profits, investing a large portion of them in customer acquisition. Also, it pays a decent dividend, repurchases shares, and buys equities in the market.

Patrick Rial: As regards its investment strategy, Hikari has equity investments worth about $1.9 billion, split between US and Japanese stocks. When the company came close to bankruptcy after the internet bubble, the founder, Mr. Shigeta, started looking for a better, more stable way to run his business. At that time, he came to admire Warren Buffett and Berkshire Hathaway. In fact, about half of Hikari's US portfolio is Berkshire Hathaway A shares while the rest is split between stocks Berkshire owns (like Visa or Wells Fargo) and high-performing compounder type companies like Danaher, AB InBev, or Jack Henry. The efficiency and high return nature of the US companies it invests in is illustrated by the fact that the median return on capital employed is about 35%, which is quite similar to what Hikari earns on its own capital employment. We don't think the company makes these investments to generate big returns. What it's doing is using its ownership to get access to IR, and through that, learn the best practices of each of these companies and implement them.

When you compare Hikari on a valuation basis to some international compounder type companies, its five-year annualized return is about 22%-23% on a total return basis. In 2019, it will generate something like 13% operating margins despite being in a commodity type of business. Similarly to Danaher and Constellation, it has almost no fixed assets, and its working capital needs are also close to zero. It has incorporated a lot of the best capital allocation and business practices. Yet, on a valuation basis, Hikari is trading at 13x EBIT, whereas the median for many overseas compounders is around 26x.

The strategy with the Japanese portfolio is quite different from the US. Hikari is mainly investing in deep value type stocks and benefiting from either improved valuations or the ability to increase its holdings and influence with the company if the valuation stays low. We estimate that the Japanese portfolio is worth about $1.5 billion. There are over 100 publicly disclosed investments across Hikari and about ten other subsidiaries, but there are also lots

of companies where it doesn't meet the disclosure threshold. We think there are maybe another 100 companies it is invested in. We calculate an ROI for the stock portfolio of 215% since 2002 versus a total TOPIX return of 114%. In short, Hikari has done quite well with this value strategy.

If you examine the public filings and disclosures for holdings at the 5% threshold, you can see Hikari tends to pay less than 4x EBIT and 0.3x EV-to-sales when it initiates these purchases. In 2018, the number of filings spiked. Purchases have strongly accelerated in the last six months to a year. The company did two bond issuances in late 2018 – JPY 10 billion and JPY 25 billion for 10-year and 20-year bonds, 2% or less than 1% coupons, respectively. Hikari doesn't have high capex needs and is investing these proceeds into the stock market, hoping to capture that risk premium with the value stocks it's buying. Many of the companies it buys into look a lot like value traps to us, but because Hikari is generating robust cash flows from its main business, it can increase its stake in underperforming or poor capital allocation-type companies and become the catalyst that unlocks the value.

Let me give you two examples of Hikari investments. One is a company called ActCall, which provides emergency home services, such as a locksmith or plumbing, on a subscription basis. ActCall had a real estate division which was found to falsify profits and sales figures. Once that came to light and the company did an investigation, the president resigned. They had an extraordinary loss posting and canceled the dividend, and the shares collapsed in 2018. At that point, Hikari stepped in, buying a 25% stake through a new share allotment. It also took five out of nine board seats at ActCall. Having gained control, it is now shutting down various underperforming business lines, including the real estate business, and it is focusing wholly on growing the core subscription-based business. This represents an example of Hikari doing a bit of opportunistic or distressed investment that a lot of other investors, perhaps even ourselves included, wouldn't do due to reputational risk. I think it shows the strength of having a permanent capital base and ongoing inflows.

Japan Best Rescue (JBR) has the exact same business model as ActCall, but this is not a distressed or special situation. It is a pure value investment. JBR had been growing steadily for a number of years, but in 2016, it made a forecast for declining earnings. In the middle of that year, when the shares were trading at just 1.5x EV/EBIT, Hikari unveiled its 5% stake and quickly raised that to 9% and over. Soon afterward, JBR announced a buyback, and that declining profit turned into growing profits. The growth engine for this company restarted, and the shares rapidly appreciated over the next couple of years. We estimate that Hikari made about a 6x return on this investment in less than two years. Besides buying at very low prices, Hikari really understands the dynamics of lifetime value of a customer for a subscription type of business, and it has great understanding of how to value a company which is growing quite well and its value is increasing, but the reported earnings are weak or negative.

Yasu: We believe Hikari is still avoided by most portfolio managers in Japan because of what happened in 2000. It was a very hot stock during the tech bubble days, reaching JPY 5 trillion and making its owner one of the richest men on Earth. When the tech bubble burst, Hikari also had its own problems, so its market capitalization collapsed. The company's shares were not traded for 20 days due to the limit-low rules of the Tokyo Stock Exchange, and this is still the record in Japanese history. Hikari lost about 95% of its value in just two months, and a lot of people still remember this.

To calculate the intrinsic value of the company, we looked into many of the US compounders and came up with 10x multiple to recurring profit to calculate their business value. Then we

came up with about JPY 1 trillion for business value, and then cash, debt, and investment for a total intrinsic value of JPY 1.091 trillion. Divided by 46 million shares, we get an intrinsic value per share of JPY 23,635. It's only a 16% upside from here, but we like it because we believe the intrinsic value will compound in the future due to the company steadily investing its recurring profit into new customer acquisition. Also, it will invest its excess cash flow in greatly undervalued Japanese companies and US compounders. Moreover, it buys back shares, so the modest discount at the current share price is a good entry point to ride on the future compounding.

The following are excerpts of the Q&A session with Jiro Yasu and Patrick Rial:

Q: A question on the core business itself: when I hear cold-calling, it sounds like something with a lot of regulatory risk in the US and Europe. It's also something potentially going away due to technology. What do you think about the long-term viability of that business?

A: Japan is slow to implement such regulations, and companies are not making calls to people who don't want to take a call. We, as a company, get cold calls from time to time, but since we are not much interested in hearing about the products, the calls tend to stop right away. This company has a good list of people who love to listen to new products pitches. I think there are some issues, but compliance is a bit stricter for public companies, and as long as Hikari observes the rules, it should be okay to keep making calls.

Q: In terms of customer acquisition cost, could you elaborate a bit because it would seem that by now, it would pretty much have everyone's phone number. If it's pitching a new product, it's just calling the same people with a different product. Where does the customer acquisition cost really come in?

A: For example, a main focus for us today is water servers. Hikari sells water servers to home and small offices, and then those clients will buy potable water over the years. On the day it sells a water server, the company doesn't make money due to the delayed cost of the machine itself. But as time goes by, the client keeps buying potable water from Hikari, and at some point, the profits from the water will exceed the cost of the server.

Q: Is the long-term plan to make the investment portfolio even bigger and become more like a Berkshire Hathaway type of vehicle?

A: Mr. Shigeta, the owner of the company, really loves investing. He has his own investing firm, which also files 13F in the US, but it has a much bigger portfolio. As long as Hikari finds good value in Japanese and US companies, I think the equity portfolio will grow over the years. However, it has sold down some names when they get to very high valuation. For example, I think it had an investment in Constellation Software in Canada but has exited it because the valuation maybe got too high. Interestingly enough, it built some relationship with Constellation Software and started a joint venture in Japan. Hopefully, they can do something together. I think it will keep doing this over the years.

Q: Can you elaborate a bit more on the recurring profit? It sounds like it would exclude the customer acquisition cost. Is it also after tax?

A: This is all before tax. The stock profit, the recurring profit, is before customer acquisition cost. If you deduct the customer acquisition cost from the stock profit, you'll get the operating profit. We have a 30% tax rate in Japan, so if you deduct that from operating profit, you'll get the net income.

Q: Is this business at all cyclical? The stock profit over the last ten years has gone up very steadily and strongly. If there is a recession, what would happen in the near term?

A: If a recession causes a lot of cancellation, the stock profit may go down. On the other hand, products like cellphones, water, and fax machines are needed even in times of recession, so there might be some resilience in the revenue and stock profit during an economic downturn. We are not too worried about that.

About the instructors:

Jiro Yasu has more than 15 years of investment experience in the Japanese equity markets including at Varecs Partners, First Eagle Investment Management and Daiwa Securities America. As the Representative Director of Varecs Partners, Jiro spearheads the investment firm's efforts to identify mid-sized listed Japanese companies where corporate value can be realized for all stakeholders by working together with management. Jiro holds a BA in economics with a specialty in econometrics from Keio University.

Patrick Rial joined VARECS Partners in 2015 as Senior Analyst. He joined from J.P. Morgan Securities Japan where he worked in equity strategy and small cap research. Prior to J.P. Morgan, he was a product manager at Morgan Stanley MUFG Securities. Mr. Rial began his career as a financial journalist covering Japanese equity markets. He has been a CFA charterholder since 2011. He holds a BA in economics and history from Georgetown University.