Kobayashi Pharmaceutical: 125 Year High Quality Business with Wide Moat, High Returns on Capital, Shareholder Aligned Management and Multiple Catalysts

Sid Choraria presented his in-depth investment thesis on Kobayashi Pharmaceutical (TSE: 4967) at Japan Investing Summit 2013.

The following transcript has been edited for space and clarity.

MOI Global: It's a real pleasure to welcome Sid Choraria, Managing Partner of Marwar Capital based in Hong Kong. I met Sid in Hong Kong about a year ago and he's really a true value investor. He's focused on Asia, just launched a fund to take advantage of the mispricings available to bottom-up investors in Asian markets, which often tend to be macro-driven.

Sid is able to take advantage of these macro-driven markets by being a true value investor focusing on bottom-up companies. He brings a tremendous amount of experience to the job including from Goldman Sachs in Hong Kong and Bandera Partners in New York where he worked as an analyst at this New York-based deep value and special situations hedge fund.

As you can see here on the slide, Sid will present his best Japanese investment idea today. He's done a ton of work on this idea and it's a bit different from the idea we just heard in the previous sessions. So for those of you looking for wide moats and great businesses, I hope you will enjoy this session. And with that Sid, please go ahead.

Sid Choraria: Thank you for the opportunity, and good morning, good evening to everyone. My name is Sid Choraria and I'm Managing Partner at Marwar Capital, a value investor based in the Asia Pacific region.

Today, I'm very excited to present an under-researched, underfollowed, high-quality business in Japan which has a very rich 125-year old history – a wide moat, a business with very high returns on capital and sustained market share, and management that has a value-creating track record.

The business that I would like to present today is **Kobayashi Pharmaceutical** [Tokyo: 4967]. It's traded on the Tokyo stock exchange under the ticker 4967. Kobayashi has a market capitalization of $2.2 billion and an enterprise value of $1.8 billion.

Moving on to the next slide, before we dive into the Kobayashi opportunity, I just want to spend a few minutes on the value investing opportunity in Asia Pacific. As Oliver mentioned, I'm generally very excited to be based in Asia.

Asia provides a very fertile hunting ground for disciplined long- term value investors given the often-misperceived "too far, too hard" bias with very few sophisticated boots on the ground creating this tremendous opportunity for the next fifteen, twenty years.

So we have over 11,500 companies that have over $50 million in market cap with over 55% of all companies in Asia with practically no analyst coverage. To add to that, Asia is about 25% of the world's market cap but you only have 5% of hedge fund assets under management, which further accentuate this, few "sophisticated boots on the ground."

The too-far, too-hard mentality for sophisticated value investors largely based in developed markets like the U.S. and U.K. creates this tremendous opportunity for disciplined investors on the ground in Asia.

Just a few points on the investment philosophy that I follow, we're focused on a "best ideas portfolio" of high quality, good businesses at very attractive prices and niche growth or which is a smaller companies, which have the potential to become much bigger companies that must meet the 5Cs criteria to give the complete package and offer a high margin of safety.

The 5Cs are as following – the first being circle of competence. Do we understand the business? Can we reliably predict the business model? The second is if it's not a no-brainer in terms of its valuation and it's not demonstrably cheap relative to estimate of intrinsic value, we're simply not interested and prepared to wait. The third C is a wide durable and enduring competitive moat with a history of proven predictability.

Corporate governance is front and center of our investment philosophy. We're looking for honest, capable management in Asia that are focused on a "core" business, that know their strength, that have "skin in the game," and are 100% aligned with shareholder interest.

We're simply not interested in businesses that are just cheap. Corporate governance is significantly critical, not just in Asia, but around the world, and finally the last C, which is a presence of one or more catalysts that would enhance the margin of safety.

So with that, I'd like to dive into Kobayashi on slide three. So why is Kobayashi worth your attention? I'd like to highlight a few key points on the opportunity. The first, it's a very high-quality business with 125-year-old history with over 150 brands.

The company sells very simple predictable products and sometimes products that sound ridiculous including toilet bowl cleaners, body warmers, cooling sheets, heat pads, and oral hygiene, and many more. It has a very rich history over the last 125 years.

Second, the company has genuine competitive advantages. We can see this through the stability of the high market share over 30% in several of the product categories in Kobayashi's "cash cow" consumer products business.

The evidence is shown through the higher returns on tangible capital employed, which are in excess of 50% and unlevered returns on equity greater than 10%.

So the business really features excellent economics with a practically debt-free balance sheet, consistently strong free cash flow, margin and earnings growth, net income has grown consecutively for fifteen years, dividend increases every year for fourteen years, timely share repurchases in 2008 during the financial crisis and predictable low levels of capital intensity make Kobayashi a very interesting opportunity.

It's demonstrably cheap for a high-quality company with a moat that's been around for 125 years, with management that has "skin in the game" that focuses on the core business.

At a market cap of $2.2 billion, enterprise value of $1.8 billion, the current share price of 5,400, this company came in our radar in around the 4,700 range. This company trades, when it came in our radar around 7.5x, it currently trades at just a little over 8x EBITDA, debt-free balance sheet with minimum levels of capex and working capital intensity.

Now, the business is misunderstood for various reasons. The management has undergone divestments of two of its key businesses, which are being loss-making – the wholesale business in 2008 and the medical devices business very recently in 2012. So their business shows ugly sale declines on databases, which is misleading.

The management is focused on the crown jewel, consumer products business whose margins have been stable. And the overall greater focus on the "cash cow" business after the divestments, make this a very compelling opportunity to watch out for.

So on page four, I'd like to just introduce the history of Kobayashi Pharmaceutical. Kobayashi traces its roots back to 1886 when founder Chubei Kobayashi founded the first store in Nagoya, Japan and moved to Osaka in the early 1900s.

I was fascinated with this company as I've pored through the financial reports and spoke to management, really I would say that the success of the 125-year-old foundation of this business is really built around the core ethos of the company which is people, hit products, and sales.

Such was Mr. Kobayashi's impact in Japan that a statue is erected in Tokyo in 1928 upon Chubei Kobayashi's passing away to recognize his impact on Japan. Now, you just need to look just at some of the hit products that the company's continuously and it's been time-tested.

If you look at Hakkiri headache medicine that the company launched in 1939, Ammeltz an external anti-inflammatory in 1967, Bluelet, a toilet flush deodorizer in 1969, Sawaday, an air freshener in 1975, and a car freshener in 1977, the Netsusama sheet, a cooling gel sheet for high temperature in 1994, the company demonstrated a track record of hit products and creating new markets where it takes 100% market share often and is a market leader.

Importantly, the company is run by successive generations of the Kobayashi family. You've had over 125 years. You've had six presidents with an average tenure of twenty-plus years in the business.

Moving on to slide five, so why does the Kobayashi opportunity exist? Why is Mr. Market offering a very high-quality business with management that has "skin in the game," that knows a lot about the core business, that has created value through loss- making divestments at a very attractive valuation?

Simply for the following reasons – firstly, Kobayashi is a perfectly simple business, which sounds dull, is not in a hot industry or perhaps even ridiculous. Some of the products include toilet cleaners, pain relief, cooling gel sheets, products that people have to keep buying. The company operates in a stable, mature industry with limited change. Indeed, several products have never had to change for over 45 years.

Secondly, the company is practically not covered by analysts. There's one local Japanese analyst that covered the company up until a few months ago, Mitsubishi UFJ, and oftentimes those reports have been all of one page long and the analyst has chosen retail comparables with entirely different business economics.

We are encouraged that since our coverage and publish of Kobayashi, we've had the first non-Japanese broker Barclays initiating coverage on Kobayashi. Foreign ownership has also started increasing with MFS having a 10.5% stake.

But for all practical purposes, the company remains misunderstood, under-followed, and under-researched with the market yet to catch on to the transformation over the last several years.

Given the divestments that I talked about of two business segments, the medical-devices business and the wholesale business in 2008 and 2012, investors primarily looking for sales growth or perceiving

Japanese companies as in decline will drop Kobayashi in that bucket. We'll see declines over a five-year period on databases, which is misleading.

So Mr. Market has ignored this transformation that would lead to a greater focus on the crown jewel "cash cow" consumer products business, which is simple, perfectly predicable and in a business area that Kobayashi has sustained high returns on capital and market share.

Finally, the "Japanese value trap" – you mention a Kobayashi or a Japanese company, the initial gut reaction by even the most sophisticated investors that perhaps have not done the work would be club it in the Japanese value trap bias.

Kobayashi, as we'll go through, is not your typical Japanese company. The company has high returns on capital with management that is excellent, with a track record of excellent capital allocation, and has done the right things by shareholders.

Moving on to slide six, when we think at Marwar Capital about high-quality businesses, we define the key characteristics of a high-quality company as simply the following – must meet the three characteristics of economies of scale. When combined with some degree or a great degree in Kobayashi's case of customer captivity that rivals cannot match for wide sustainable competitive advantages, Kobayashi fits all of these high-quality characteristics we can look for.

The company has significant local economies of scale allowing the company to purchase products in bulk from suppliers of raw materials leading to margin expansion and fixed cost spread over more units with average cost per unit declining.

The second being sustained high returns on invested capital. The company has returns on capital in excess of 50%.

Thirdly, customer captivity – economies of scale combined with customer captivity lead to what we think provide sustainable competitive advantages. The customer captivity is evident through the stability in its high market share and the gap relative to number two and number three in excess of 30% in several categories.

Moving on to slide seven, to introduce Kobayashi's business lines, the business is simply made up of three lines of businesses. The first being consumer products, which account for last year 1.1 billion in revenue, which is 89% of the group sales; 164 million in operating income, which account for over 95% of total group operating income. The second line of business is the mail-order business and the third is the medical-devices business.

Now, Kobayashi's crown jewel consumer products business that has consistently had margins of around 15% consists of 150 simple household brands delivering high margin and contributing nearly 95% of Kobayashi's operating earnings.

The overseas operations are clubbed within Kobayashi's consumer products business and account for about 8% of FY2013 revenue. We'll talk more about the overseas business in later slides.

The medical devices business, as I mentioned with the divestments, changed from a subsidiary to an equity method affiliate in FY2013 as 80% of the shares were transferred in May 2012. And the remaining will be transferred this year May 2013 with the full effect coming into play next year.

Moving on to slide eight, Kobayashi demonstrates competitive advantages and the lack of change that Mr. Buffett seeks. The business model has persistently high market share and the business has demonstrated the ability to create new markets and expand these niche markets.

We're inspired by a quote by Mr. Buffett that says, "Our approach is profiting from the lack of change rather than from change. With Wrigley's Chewing Gum, it's the lack of change that appeals to me. I don't think it's going to be change hurt by the Internet. That's the kind of business I like."

We think Kobayashi's 125-year-old track record with the ability to create and take 100% market share in many of the new categories the company has constantly invented itself, present some of these characteristics.

The high market share of the business has been time-tested. The company has niche consumer product categories on the right of the slide with sustained market share in several of its product categories of over 50%. Products like Ammeltz since 1967 have existed with very minimal changes.

Kobayashi generates new markets with 100% share in these new markets. The company launches twenty to 25 new products annually with a fast in time to market in just about thirteen months, which we think provides significant competitive advantages.

What attracted us to Kobayashi is management's open culture of encouraging employee proposals that generate over 20,000 ideas per year. So it's invented the "kick" starter or crowdsourcing model.

Moving on to slide nine, when we look at Kobayashi the one key point that comes up for Asian companies or Japanese companies in particular is corporate governance, front and center. We think Kobayashi is a company that's run by disciplined management with a track record of excellent value creation.

A Japan idea typically invokes your "value trap" perception. Kobayashi is not your typical Japanese company. The management instituted a propriety management index indicator, the EVA concept adopted from U.S.-based Stern Stuart since over ten years ago to measure efficiency of capital employed and has aligned senior management compensation along these lines. This is incredibly rare in Japan.

Secondly, the company has, as I mentioned, six generations of the Kobayashi family in 125 years leading to an average tenure of twenty-plus years. The current president Akihiro Kobayashi, who was recently anointed, has served for fifteen-plus years in various business lines as Senior Executive Director and has approximately about 11% of shares outstanding.

Management has shown the ability to create value creation through divestment of low-margin businesses and bolt-on M&A. The company has a history of dividend increases and timely share repurchases in May 2008 at very attractive prices.

What amazes us about Kobayashi is the commitment to the highest standard of corporate governance, transparency and disclosure. The annual reports were amongst the highest quality that we read over fifteen years of company filings, and I would encourage investors to go over them.

Kobayashi has shareholder-friendly management with a track record of value creation, high returns on equity over the last ten years, which is contrary to the typical corporate governance model or the bias that most investors have about Japan.

Moving on to slide ten, this page simply shows the key drivers for return on invested capital and return on equity. Kobayashi has consistently high returns on tangible capital invested employed and returns on equity. This demonstrates management's value-creating ability and the competitive moat.

Moving on to slide eleven, this is a one-year snapshot of ROIC drivers tree. When we think about value creation, we simply think about companies create value by investing capital to generate future cash flows at rates of return that far exceed their cost of capital.

Now, Kobayashi has been able to sustain high levels of ROIC due to the long lifecycles of its businesses and products, genuine competitive advantages due to economies of scale, customer captivity and sustained market share. Kobayashi will continue to create shareholder value by sustaining its returns on invested capital and pursuing disciplined growth.

Moving on to slide twelve, I would now like to spend some time talking about the last C, which is catalysts. The first being the divestment of low-margin businesses allows for management to spend all of their time now on the crown jewel consumer products business.

Management's active divestment of non-core operations continues to fully yield margin improvements in in FY2014. If you'll look at the chart on the bottom left, you will note that the wholesale business and medical devices business had low margins and management's going to entirely be focused now on the "cash cow" business, the consumer business.

To summarize, management sold the wholesale operations through a share swap in 2008. Now, this resulted in a 45.1% sales decline but margins increased that same year by over 400 basis points.

In 2012, management has sold 80% of its medical devices subsidiary to **Mitsubishi Corporation** [Tokyo: 8058] with the following 20% stake sale in May 2013. So similarly, over the last five years you see a sales decline but management now is focused on the pie that they need to be focused on.

Moving on to slide thirteen, we think that Kobayashi's niche products, simple, predictable, easy-to-understand products that have had very long lifecycles, the growth opportunity in overseas Southeast Asian markets represent a free call option. The company's simple, predictable products have significant growth potential that is already beginning to materialize in overseas markets.

Now, they recently established local subsidiaries to further rollout their overseas strategy in Singapore in 2009, Malaysia and Taiwan in 2011, Indonesia in 2012. Simply, management has the target of increasing its Asia, China exposure to 48% of the FY2015 target.

We think that's very realistic given management has consistently over the last ten years under-promised and over- delivered, and the products are simple, predictable, easy-to-use products, being replicated in overseas markets that have a very compelling demographic.

Moving on to slide fourteen, as I mentioned, Kobayashi when we came across it had just one local Japanese broker publishing one-page reports on Kobayashi. We note that the first non-Japanese broker Barclays has initiated coverage with a price target of ¥7,200 that should serve to shine greater attention on this high-quality company. Prior to Barclays, the company was actively covered just by one local analyst.

Foreign ownership is also increasing. MFS investment management has taken about a 10% stake in Kobayashi. Other value-oriented investors include First Eagle, Fidelity, Norges.

Moving on to slide fifteen, Kobayashi management has had a history of disciplined M&A and capital-allocation track record. We believe that bolt-on M&A opportunities that are disciplined will continue to act as a catalyst for Kobayashi.

As you can see, management has had a track record of conducting free cash-flow generative bolt-on acquisitions. Most recently over the last several years, two in the U.S. with Heatmax a U.S. body warmer manufacturer in 2006 and Grabber a U.S. body warmer manufacturer with strong distribution ties in the U.S.

Kobayashi is committed to expansion of operations with proactive investments in its overseas business. Moving on to slide sixteen, Kobayashi is demonstrably undervalued for a high-quality company with 125-year old track record, with management that has “skin in the game” and has a track record of focus on profitable growth and returns on capital.

At current levels, Kobayashi trades at just over 8x EBITDA with practically no debt and minimum levels of capital intensity and working capital. This translates to about 29% discount to its median, 11.5x EBITDAof some of the Asian comparables.

Kobayashi at these prices is demonstrably undervalued given the profile of the business with returns on capital in excess of 50%, competitive moat, sustained high market share, and value-creating catalysts such as the ones we went through – the divestments of its non-core divisions. The business transformation is yet to be fully recognized by the market.

Moving on to slide seventeen, in conclusion I would like to mention that Kobayashi is the complete package, which meets the 5Cs criteria. Kobayashi is a high-quality company that is simple, easy to understand, and predictable. Secondly, Kobayashi is demonstrably cheap relative to its intrinsic value. The greater focus on its core consumer products business will only enhance the intrinsic value of this company.

Third, the company has significant competitive advantages that are evident through its history of sustained high returns on capital, profitability and market share.

Fourth, Kobayashi has discipline management with intelligent capital allocation, with “skin in the game.” The company’s focus on returns on capital and aligning senior management compensation to metrics is very rare in Japan. Kobayashi is a hidden gem in Japan.

Catalysts finally provide multiple ways to win, which increase the margin of safety in Kobayashi as a long-term compounding machine in Japan. With that, I would like to turn it back and see if there are any questions.

MOI: Thank you so much, Sid. I was wondering perhaps you could place this idea in a bit more context for us? With your philosophy of the 5Cs, how often is it that you’d come across a company like this let’s say in Japan? And then specifically with Kobayashi, where do you feel that you had to make some compromises when it comes to these 5Cs in the case of Kobayashi?

Choraria: So as value investors, being disciplined with your investment philosophy and staying true to that is extremely important. Let’s talk about the 5Cs. Our philosophy is to define the best fifteen to twenty ideas across Asia Pacific, which includes Japan, of high-quality value and niche growth small companies with the potential to become big companies.

Now, because we run a fairly concentrated portfolio, the ability to be disciplined and make sure the companies meet this 5Cs criteria is oftentimes that Mr. Market being very fickle and some of the macro trends that you described Oliver, the true test of a value investor is patience and waiting for some of these great businesses that meet this 5Cs to become available at the right price.

So talking about the first C, it has to be a business we understand and reliably predict. It has to be demonstrably cheap and in the case of Kobayashi it was a no-brainer. It’s not the cheapest stock in our universe; we have significantly cheaper stocks, but this is amongst the higher quality companies we’ve come across especially in Japan with management’s “skin in the game,” focusing on returns on capital.

Competitive advantage—we’re inspired by Bruce Greenwald’s work in this field—we think that a company needs to have economies of scale, customer captivity and/or a low cost structure. We’re simply not interested in businesses that are cheap, that we understand, that don't have a competitive moat because it's survival of the fittest.

Fourthly, corporate governance cannot be stressed, in fact we place greater emphasis on corporate governance than simply price alone. We look for management that is 100% aligned with shareholder interest and there will be no compromise on that.

Again, we're looking for the best fifteen to twenty ideas in a very fertile hunting ground with over 6,300 companies that are practically not covered, with very few sophisticated boots on the ground, and Mr. Market often gives you the opportunity to buy these businesses.

Finally, catalysts, we're inspired by Seth Klarman's work on catalysts enhancing the margin of safety. We look to the last C to enhance our margin of safety although it could be one catalyst or it could be multiple catalysts – in the case of Kobayashi, multiple catalysts.

So when we looked at Kobayashi, it wasn't the cheapest company in our universe but it was certainly very cheap relative to the high quality. It certainly met all the 5C criteria. And when you're trying to construct a concentrated portfolio, you can afford to be disciplined and make sure the companies meet all these 5C criteria.

MOI: Given the domestic nature of this business, do you hedge the yen exposure for the investment at all?

Choraria: No, I do not. I'm a stock investor. I'm not an expert in reading country balance sheets. Further, given that we're in multiple countries in Asia, I'm not just looking in Japan. We're in twelve to fifteen countries across Asia. Diversity provides for an ample FX hedging in the first place. So I'm not an FX expert, I stick to simply what I know, which is buying great businesses at attractive prices that meet the 5C criteria.

MOI: Also, what is the long-term organic growth rate for the core consumer businesses? And are you worried about demographic trends in Japan? In other words, is growth dependent on bolt-on acquisitions?

Choraria: The consumer products business, I don't have the number with me at the moment, but it has grown approximately 8% to 10% CAGR over a very, very long period. But more importantly, it's had predictable margins. If you look at the consumer products business, it's about 16% operating margins for a long time.

Now, this being management splitting their time between three entirely different businesses, two of which are going to be divested, two of which have been divested, and therefore we like to see management that is completely aligned with shareholders but more importantly watching that one basket that they really know and really know very well.

In terms of the demographics of Japan, that's actually a positive in Kobayashi's case given many of the products that they come up with. So we certainly don't get into predicting macro or FX, we simply are not experts in that, but in this case we try to understand that but we leave that to other macro experts.

We simply think that in Kobayashi's case the macro case even for Japan actually is a significant plus so we like that. But in Kobayashi's case even if the macro wasn't, we would still be very interested at the prices that the company is being offered by Mr. Market.

MOI: Can you elaborate on the export markets for the company and do you have the breakdown of domestic versus export sales? And what's just your view on the potential growth for exports?

Choraria: Very simply, we visited several stores in Hong Kong and several stores across Southeast Asia and we spoke to sales representatives that consistently told us that the heat rubs and cooling gel sheets of Kobayashi were amongst the bestselling. Now, they've barely penetrated markets like Hong Kong although the products are there. Given the company's simple, predictable products, the company has to do very little to get this product right.

So as of FY2012, Asia and China accounted for approximately 37%, U.S. accounted for 38%, the U.K. accounted for 6% and other regions accounted for 19%. The company in FY2012 as I mentioned had sales of 82.7 million from overseas businesses so approximately about 8% of the overall sales.

Management targets of growing this 82.7 million business primarily through its growth in Asia and China increasing from 37% to 48% are realistic. Again, we have seen evidence of management establishing these local subsidiaries to further rollout the overseas strategy in Singapore in 2009, Malaysia and Taiwan in 2011, Indonesia in 2012.

And our diligence on the ground suggests that the Kobayashi products are amongst the bestselling where they have penetrated it, and the company has significant growth opportunity to grow from 37% in Asia and China to 48% while the U.S. would decline at the same time in terms of total contribution from 38% to 28%.

MOI: Here's kind of a related question to what you just talked about, it says since their products seem not particularly glamorous and the brand probably not very well known outside Japan, how do they actually expect to increase the market share abroad? Is it through advertising, competitive prices, localization? You say that it can happen without significant capital investment, so if you could just shed a little more light on that?

Choraria: Absolutely. They have various tie-ups to various distributors that are leading distributors in the regions and they've established these local subsidiaries, which are being a work in progress over the last five years in the overseas strategy in Singapore, Malaysia and Taiwan.

Now, there's going to be some level of customer advantage and advertising but our diligence suggests at least in Hong Kong that Kobayashi products are being well received in stores across Hong Kong. We visited Mannings, we visited [another store]… the company's products have already begun getting customer advantage.

Now, there is tremendous opportunity. Management has under- promised and over-delivered in the fifteen years that we've bored through the company's financials and I do think that given the setup, given the distribution, given the tie-ups with various distributors, the company will be able to achieve its overseas growth plans.

Again, they just have to get a little bit of this right. I t doesn't need to go completely right, this represents just a free call option really.

MOI: And what are some of the key single products that they have? Is there any one product that accounts from more than 10% of revenue?

Choraria: They don't breakdown single products as a percentage of revenue. But certainly as I mentioned if you look at slide eight, I would like to highlight the market share in the number of years several of the key products have existed. Now, they've existed without minimal changes for many of the products. So I would highlight Ammeltz, which is a muscular pain product.

A product that I know folks in Hong Kong that use it and vouch for it, Bluelet the toilet flush deodorizer has been in existence for 45 years. You have the cooling gel sheet Netsusama that's been around for nineteen years and Eyebon the eye-cleansing product that is a key product.

So some of the products on page eight are some of the key products for the company and they don't break it down. I don't think there's a concentration on any one product given the number of brands they have, which is 150.

The only one thing I would add is that the company has, and I don't have this on my slides, but the company has had a very effective marketing strategy as they move to various local markets with customizing the product in each of the countries. Again, I could send you some updated slides, which could be uploaded but the company tailors its product to local cultures in China, in the U.S., and they've had a track record of doing so.

MOI: There's a related question – is private-label penetration a risk? It seems that some products could be prone to commoditization and retailer private label inroads. Perhaps you could also mention who the key competitors are in Japan?

Choraria: Again, the company operates in various of these product categories, so depending on what product you're looking at, whether it's cooling gel sheets or toilet-bowl cleaners, air fresheners, they have various products, but if you look at any of these categories, Kobayashi has sustained the market share over a long period in all of these categories.

Private labels, again, they maybe a risk but what we're encouraged by is our framework to identify businesses with a competitive advantage, namely economies of scale. Kobayashi has been around for 125 years. The company has entrenched relationships with supplies for bulk purchases of products that lead to fixed costing spread over more units with average cost per unit declining.

Now, combined with economies of scale, the company has customer captivity and very high product recognition in Japan, which have led to the stable market share. So the combination of this provides the company a real moat to defend against some of those risks that are going to be apparent in any given industry. But this framework allows for the company to be very competitive over a long period of time.

MOI: Just a question related to management – you said that you spoke with management, could you elaborate on what was your goal to get out of that conversation and was there anything that made you concerned?

Choraria: This is one of the points that I cannot stress more in Kobayashi's case. Management of Kobayashi, again, you just have to look at the 125-year-old history. You have twenty-year tenure at an average for the six CEOs that have run Kobayashi. The current president, Akihiro Kobayashi, has spent fifteen years plus in the business – still a young guy and has "skin in the game."

What amazed me about Kobayashi is that and this is why I ended up publishing this report was management's focus on return on capital. I fundamentally believe as a value investor, businesses create value through sustaining high returns on capital and generating cash flows that they are able to reinvest, far exceeding the cost of capital. That's the only way you're going to create value.

And then you need to have managements that understand that and do that. Now, in Kobayashi's case specifically, they don't just talk the talk, they actually do it. They've instituted a proprietary management index indicator, the EVA concept from Stern Stuart, and I tried to understand from management the rationale of that. And they understand that value is created if they pursue not just growth for the sake of growth but profitable growth that they can invest in projects that have returns on capital exceeding the cost of capital.

So that was a very fundamental concept that most companies don't get, certainly not in Japan, and certainly this is one of the reason why Kobayashi is under-researched, underfollowed despite its 125-year track record.

I would be farfetched to try and find 125-year-old business in a developed market or even in several emerging markets that come across with the quality that is under-researched and with quality of management.

What also impressed me was some of the other points, which are timely share buybacks in May 2008 at very attractive prices, management—again the dividend payout ratio is fairly low, which is only about 30% but consistent with Japan, management has raised dividend for fourteen consecutive years.

Again, they've pursued bolt-on M&A and my conversations with management about this aspect, the recent acquisitions with Heatmax and Grabber, but they're focused on only pursuing acquisitions that are additive to business that are free cash flow generative bolt-on acquisitions was very, very apparent from management.

So in sum, I would say this is exactly the kind of management that I would say fits the third C with its corporate governance, which is extremely important as a value investor. Kobayashi's management demonstrates that they get it.

MOI: And I'll just take this last question – what do you feel is the biggest risk with this investment?

Choraria: The biggest risk for me is any time when I look at a company, the biggest risk—I'm inspired by a quote that Mr. Buffett says, "This loss of focus when we evaluate a high-quality business is the thing that worries me and Charlie the most." And for me, when I speak to management, I want to know that they're focused 100% on the core business, 100% on the business they know very well, 100% on higher margin businesses.

And this is a risk. Do I see as they pursue acquisitions overseas that they stray away from their core? Now that's certainly not the case, because management has shown their intentions through divestments of loss-making business. So certainly, the main risk, which is just focusing on the core and disciplined acquisitions and not straying away from what they know, that's really the biggest risk.

About the instructor:

Sid Choraria is an Asian Equities Portfolio Manager focused on identifying exceptional businesses, cultures and CEOs/management teams to invest like a business owner, preferably for 10 years or longer.

The typical company Sid prefers is a business that can endure the risk of impermanence over decades. His research indicates that over 98% of investable companies fail the test. The culture must be unquestionably superior. Such companies are customer obsessed and have strong non-transactional relationships with constituents. Sid prefers early-stage pricing power that is not discovered. The universe is limited to exceptional Asian businesses and great global companies with significant revenue and cash flow from Asia very material to shareholder value.

In Aug 2013, Sid elicited a rare response from legendary Warren Buffett with a letter and thesis on an under-followed, 135-year-old Japanese company. The company, Kobayashi Pharmaceutical (4967 JP) founded in 1886 is as old as Coca Cola and Wrigley's chewing gum but with poor coverage when Sid discovered it. He presented the idea on MOI in 2013. Since the letter, business value has quadrupled compounding roughly 26% outperforming the S&P, NASDAQ and respective Asian indices. The inversion lessons influenced Sid's journey to focus on less followed companies, great cultures and businesses that can endure the test of time.

Sid enjoys mentoring young talent and giving back knowledge by speaking at the world's top universities like Harvard, Princeton, Columbia Business School, NYU Stern, LBS, USC and Brown. From 2014-2016, he consistently won a few research awards for probing research on Asian companies judged by over 70 judges. His contributions have featured in Goldman Sachs Alumni Network, CNBC, Sydney Morning Herald, Alpha Ideas India, Value Spain, Intel and GIC.

Sid has worked in Asia for 15 years and grew up in the region. Previously, he has served in senior investment roles in Asia, at multi-billion long-only and long-short funds. He worked at Goldman Sachs technology investment banking in Asia. These experiences taught him the significant importance of teams, culture and incentives.

Sid received his MBA from New York University Stern School in 2011 and was recipient of the Harvey Beker Scholarship. During his MBA, Sid worked at Bandera Partners, a fund focused on small mid cap activism, run by Jeff Gramm, Author of "Dear Chairman", Greg Bylinsky and Andy Shpiz.