MOI GLOBAL

Value Investing in Japan: Our View on Engagement

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Engagement is the new buzz word in Japanese fund management. Firms such as Neuberger Berman[1] and UBP[2] have launched new engagement funds, and many institutional investors have created dedicated departments to focus on engaging with companies. We are often asked if we are an engagement fund because we have a concentrated portfolio. But for us, engaging with a company is just one of our tools, and not the end goal of the fund. Imagine two investment candidates. One is a well-run, highly profitable, growing company trading at a modest multiple, but where engagement would be difficult. The other company is a low-margin, no-growth company at a super-low multiple that looks ripe for engagement. Which would you invest in? An "engagement" fund may be attracted to the latter opportunity because that is the purpose of the fund. But we see our purpose as compounding capital at an attractive rate for clients over time. We always say we are fine making money by doing nothing (in fact it is the most relaxing way to invest!), so we may prefer investing in the first opportunity if we believe it will make more money with lower risk.

Having said that, engagement is an important part of our investment process. By discussing important topics such as long-term growth strategies, buybacks, acquisitions, dividends, selection of independent board members, succession planning, etc. and sharing our opinion on these matters with CEOs, we learn a lot about the quality of the business and the people who run it. Such deep understanding of companies helps us build conviction for making large investments and staying invested with companies for the long-term, even when shares appreciate a lot.

Throwing a stone in the pond

There is a saying that the sound a stone makes when thrown into a pond tells how deep it is. When we observe the reaction of companies to our attempts to engage with them, we gain a better understanding of how much trust we should put in management.

At the end of 2018, we sent letters to 11 of our portfolio companies suggesting they do buybacks. The market plunge in the final months of the year made shares of these companies extremely cheap and we were busy buying. We wanted to share our view on share prices and let them know that we were buyers. Likewise, we felt it was also a good time for them to buy back shares, significantly increasing true value per share.

One of our long-term holdings held an emergency board meeting on the first business day of 2019 and approved a buyback program. We got a call from the chairman and we expressed our sincere appreciation of his leadership and prompt action.

One thing we don't do is take credit for such results. We could say "They did it because of us!! Our engagement worked!!" But, I think that is not the real story. The chairman was surely paying attention to the declining share price over the holiday season and was thinking about what course to take. A buyback must have been one of the options on his mind. Our letter may have helped him decide, but all the heavy lifting was done by him and his colleagues. Also, there may have been other investors that similarly pushed the company to act and we were just one of those voices. So, I think claiming credit is not the right thing to do. It is better to just say thank you for the action and allow our confidence to increase, we think.

In fact, this was not the first time this company did a buyback. It bought back shares aggressively right around the financial crisis in 2008. We like the company because they are a smart capital allocator, have a good sense of the value of the company, buy back shares when they are cheap, and are disciplined acquirers of competitors. That is why we have continued to be a shareholder for over 10 years even though shares appreciated more than 10x from their low.

On the other hand, some companies we wrote to decided not to take any action. But, even so, we felt the letter was a good exercise because it helped spark valuable discussions. Consequently, we decided to exit from two small investments as we learned that they have no intention to allocate capital logically. One company had never even allowed us to meet with the CEO, despite numerous requests.

When we look back at historical profit attribution data, we are happy to see that positive performance has mostly come from our large, long-term investments, while losses have predominantly resulted from smaller holdings. We believe throwing these stones to companies help us to not only build conviction and allocate significant capital to certain companies, but also help us to give up on some companies while they are still small positions in the portfolio. As Mr. Soros always says, “It’s not whether you’re right or wrong, but how much money you make when you’re right and how much you lose when you’re wrong.” We believe our engagement with companies has improved our odds of investment success.

Who is the engagement champion?

What is the point of engaging with a company? For us, as already discussed, we think it is a trust-building exercise. We think we have a logical approach to long-term value creation, so when company management is open to our opinions, we feel more confident they will make smart decisions and grow the value of the business.

For some funds, it seems maximizing engagement statistics is more important than maximizing returns! According to the FSA[3], 269 institutional investors have signed on to the Stewardship Code as of September 2019. Some large asset management firms publish Stewardship activity reports every year. Although the definition of engagement meetings differs, it seems these institutional investors averaged about 500-750 such meetings last fiscal year. The champion of the engagement meetings was Nikko Asset Management, which proudly says they had 3,939 engagement meetings with 1,459 companies, according to their activity report[4].

If each of the 269 investors have 500 engagement meetings every year, that would be about 130,000 meetings. If they have 3,939 engagement meetings like the champion, that would be over 1 million (remember we have about 2,100 companies on the TSE 1st Section). Some institutions claim they prepare thick proprietary pitchbooks for their meetings. Since the E of ESG is an important consideration for these investors, we really hope they don’t print them out!

A sad fact of investing is that effort and results often don’t positively correlate. For all the thousands of engagement meetings some funds hold, it is hard to point to any clear results.

Shareholders matter

We don’t spend much time thinking about shortcomings in how our portfolio companies are run and what we should do to “fix them.” Rather than deal with such frustration, we try to avoid those situations altogether. Instead, we spend a lot of time thinking about how we can help portfolio companies and be good partners in building value.

Our investors are mostly U.S. college endowments, family offices in the US and Europe, as well as some allocators that manage money for smaller endowments and family offices. We got our first significant outside capital 4 years ago, when we were just three guys with $40 million in AUM. I guess we were not an easy approval candidate for the investment committee.

That courageous investment team took career risk to pursue investing with us, and we feel a need to perform well to repay their trust. To improve our odds of success, our investors frequently offer us assistance. If we are investigating an industry, they might introduce us to other managers or private equity firms which know the industry well. If some other investors are looking at us, they readily provide reference calls. If there is another fund that could be a role model for us, they are happy to make an introduction. We feel they always think about us and are looking for ways to help. We feel quite fortunate to be supported by such investors and therefore feel a strong fiduciary duty for their capital. I am sure our investor base will have a positive impact on our long-term results.

We have similar feelings towards our portfolio companies. When we invest with undervalued companies, there may be a good reason why people don't like them. We underwrite the risk and try to prove we are right and others are wrong over time. So, we also need them to perform well. Like our fund investors, we always think about how we can provide assistance to our portfolio companies.

About 5 years ago, I encountered a firm selling US apartment buildings to Japanese investors. If I buy an old enough apartment building in the US, I can depreciate the value of the building over a just few years and minimize my taxable income by booking the depreciation as a loss. After the depreciation is finished, I can sell it and book capital gains on the depreciated value. In Japan, the capital gains tax rate is much lower than the income tax rate, so I can lower my taxes by doing this.

Although I was not interested in this scheme, I noticed the tax advisor of the firm was a CPA who also worked in healthcare patents and royalties. That sounded interesting. I asked for a meeting and discovered one of companies he advises is a consulting firm helping US-based medical technology companies get regulatory approval and develop marketing strategies in Japan.

A lightbulb went on in my head and I thought of one of our portfolio companies: a medical device manufacturer with a nationwide sales network and interest in selling third-party products. I introduced the consulting firm to our investee. Soon after, they signed a partnership with a US medtech maker. Sales of those products imported into Japan are now an important growth driver for our portfolio company. So even when I am working on something unrelated like taxes, my mind is also always on our portfolio companies!

Our "always thinking about you" approach has been helping us in developing good constructive relationships with our portfolio companies. If you are persistent in showing your feelings to the company by continuously sending relevant articles, introducing interesting people, sharing findings and thoughts on developments related to the company, etc., we believe most of companies will be open to us some day. (However, we still get "No" responses to CEO meeting requests from some companies. Another sad fact.)

Our investors help us become better investors by offering help, teaching us best practice, and giving us a global perspective. But, they respect our time and don't want to be destructive or waste it. We also respect the precious time of the management teams of our portfolio companies. Although we love to spend as much time as possible with CEOs of our portfolio companies, we are not going to request hundreds of meetings with them which could be, we think, pretty destructive. With We Co. (aka WeWork), we saw the results of a combination of a charismatic founder CEO and Softbank as a shareholder. We believe having the right investor base is a crucial success factor both for us and our portfolio companies.

What does VARECS means?

Some investors ask us what VARECS means. A fair question indeed. It means VAlue Realization by Creating Solutions. Two former partners and I named the company when we launched in May 2006. Our planned strategy was: invest in cheap companies, tell them how to realize value, companies act on our advice, and then we make money. Since we were quite young (32-33 years old) and overconfident, we had no doubt of our ability to pursue "VARECS" and make money.

Immediately, we found things are a lot more difficult than we thought. Finding cheap companies and telling them how to realize value is the easy part. For example, we invested with a company with cash exceeding its market capitalization. We advised them to realize value through a special dividend or buyback. Then, the company would have much better return on equity and valuation would improve. We would make money both from receiving a dividend in excess of our investment and valuation improvement for the business, which we got for free. We thought it was no-brainer.

For some reason, the management team did not share our vision. They insisted the balance sheet cash was needed to fund future expansion and protect the company in tough times. We advocated changing how they allocate capital and managing the balance sheet more efficiently. But, we failed. In the end, we learned such companies tend to have no-growth or shrinking businesses, and the management team worries about the future a lot. In particular, they feel an obligation to provide lifetime employment to all full-time employees. So, while there is no financial liability on the balance sheet, their employees are like a debt they need to service for the long term, even as the business shrinks.

If you define success of engagement as changing the way management runs the company, I think it will be quite hard. People can change, but our experiences taught us they don't change very often, especially when they have a nice life. If you look at CEOs of cash-rich companies, they are rich people and enjoying the life of a CEO. They are not going to dramatically change how they allocate capital, even though that is the logical and right thing to do.

Trying to create a virtuous cycle

We didn't change the name of our company, but we changed our definition of successful engagement. Instead of trying to change people, we simply want to increase our odds of investment success by engaging with our portfolio companies. Does it bring any benefit to our portfolio companies? We believe it does. We often invest with family run companies (why? It could be next blog topic. Stay tuned.) Such families usually have a large stake but do not have majority control. So, with us as a long-term strategic shareholder, management can truly focus on long-term value creation.

We are not saying success always come with long-term strategies, but CEOs of public companies often complain about the difficulty of executing strategies that require near-term pain due to a lack of understanding by short-term shareholders. At least, we can encourage and support our CEOs to pursue such goals.

Ideally, our engagement allows us to deploy larger capital with a company and stay invested for the long-term, then the CEO executes their long-term strategy based on our understanding and support, then the business grows and intrinsic value increases. If we repeat this cycle over and over, we think we can help creating a virtuous cycle for the company. Then, we can finally say our engagement worked!!

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[1] https://bit.ly/2SpOqkr

[2] https://bit.ly/2ZlHXIN
[3] https://bit.ly/2Zjbp26
[4] Only Japanese. https://bit.ly/2Qg1MNF