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# SHORT BRIEFINGS ON LONG TERM THINKING – EPISODE 30

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Why small companies are big in Japan

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MB Hello and welcome to *Short Briefings on Long Term Thinking*. Thanks for joining us. I'm Malcolm Borthwick, managing editor at Baillie Gifford. When you think of Japan conglomerates such as Sony, Hitachi and Mitsubishi which have powered Japan's export growth for a generation come to mind. You probably don't think of Shima Seiki – a manufacturer of automated knitting machines, Descente, which owns licences to use brands such as Le Coq Sportif and Umbro, and Shoei, a maker of handmade motorcycle helmets.

The equivalent of Germany's Mittelstand, these small and medium-sized businesses (SMEs) are the beating heart of the Japanese economy. Japan has over three and a half million small and medium sized businesses. They employ about seven in 10 workers in the private sector. These are the firms that are sometimes overlooked, but not by Praveen Kumar, manager of Baillie Gifford Shin Nippon, who joins me in our Edinburgh studio.

But before we start our conversation, some important information. Please remember that, as with all investments, your capital is at risk, and your income is not guaranteed. Praveen, it's great to have you back on *Short Briefings on Long Term Thinking*. Thanks for joining us. The last time we spoke was back in episode eight, when we chatted about Japanese cosmetics.

PK Thanks for having me again, Malcolm. And you're right. Last time we had a chat about Japanese cosmetics. This time around, I felt it would be quite interesting to discuss this massive swathe of SMEs that, as you say, are the beating heart of Japan's economy and which, for a number of reasons, have been overlooked for a very long period of time. Not just by overseas investors but, funnily enough, by a lot of domestic investors as well. So therein lies our opportunity.

MB So, let's start with some context. How do we define SMEs, and why are they significant?

PK So, there are a number of definitions. The one that we tend to use for simplicity is



a company that has less than, say, 300-odd employees. If you want to speak in terms of the size, by way of market capitalisation, we typically go for companies that are less than, say \$1.5bn dollars in market cap. So, those would be the ones that we would consider as being small or medium-sized businesses in Japan.

MB And when did we see the shift in Japan towards more of these small and medium-sized businesses?

PK It's quite interesting because Japan has had sort of two waves of innovation. The first was obviously when Japan started industrialising, well before the First World War, in the 1800s. And then after the Second World War, we had the second wave of industrialisation when Japan was rebuilding, as a result of the after-effects. Around that time, so all through the 60s 70s, and 80s, a lot of that innovation, a lot of that rebuilding was led by some of the big corporates that we see today.

To give you some examples, Sony, Toshiba, Hitachi, Toyota, and Honda in automotives. These were all the bellwethers of the Japanese economy at the time, and they, in many cases, monopolised the R&D [research and development] and the innovation that was happening in Japan at the time.

But since then, we've seen a significant shift. You could almost consider this to be the third wave of innovation that we're seeing in Japan, where a lot of Japanese companies have moved away from building these big physical products, these consumer electronics-type products. And they've identified specific niches within these larger industries, where they've suddenly realised that they have some in-house expertise built over the decades. And they've established leading global positions in these critical components across many supply chains.

So that is the shift that we've seen in recent decades, and which, I think, is a trend that is likely to continue over the coming decades. So that's the shift from the large companies to these SMEs.

MB I mentioned that Mittelstand, and how a lot of people think of Germany when it comes to small and medium-sized enterprises. There are comparisons, aren't there, between how the economies of Germany and Japan have evolved over the years?

PK That's absolutely right. And this is something that always has fascinated me, not just from a business perspective, but from the makeup of the economy and some of the cultural aspects. Say, for example, your savings rates. Both Germany and Japan have tended to have quite high savings rates, for instance. And both have national champions in massive sectors like the auto sector. Also, both had to do a significant rebuilding job of the country and the economy post-World War Two.

So, there are quite a lot of parallels. Even if you look at demographics, they are sort of similar to Japan, perhaps maybe a bit more at the extreme end. But what really fascinates me when I look at Germany and Japan is just this entire suite of SMEs. Obviously, we know the Mittlestand in Germany. We don't have a nice catchy name for the Japanese SMEs. But these are the engine blocks or the



building blocks of corporate Japan and Germany. One slight difference is that in Germany, a lot of these businesses tend to be private. In Japan, you do tend to see a lot of these SMEs, which are often run by founders and entrepreneurs that are listed, which is good news for us because that gives us an opportunity to identify and invest in these businesses.

MB Give me some examples of these companies, Praveen.

PK One of my favourite examples a company called Shoei, which makes really high-end premium helmets. I've got a catalogue here. Some of the helmets look absolutely sci-fi futuristic. So, a very, very simple product part because the helmets are virtually handcrafted. And, you know, there is a bit of labour intensity to the way the company makes its helmets. These are very, very high-end products, they have a cult-like following, especially among the hardcore biking community globally. And they have a rapidly growing business in China, which is at a much earlier stage in terms of people embracing biking as a form of leisure, for instance.

But the history of the company is very interesting. And this is quite typical of how entrepreneurs end up starting up these businesses. The founder of Shoei used to work at a traditional Japanese inn that was owned by his parents. Two of the most regular customers at the inn – one of them just so happened to be the founder of Honda.

Obviously, he hadn't yet founded Honda at the time, but he was a keen biker. So, you know, after a round of biking with his friend who used to come to this inn, and this guy apparently had a very, very nice, handcrafted helmet with, some nice paintings, and that caught the fancy of the founder of Shoei, who was quite young at the time.

And they struck a very close relationship. And then this guy, the biker, went on to establish Honda, which as we know, is a big global company. And then, the founder of Shoei established the company making helmets, so he decided to leave his parents' inn and start manufacturing helmets for bikes. And the friendship that they struck early on continued through the years. So much so that Honda actually ended up adopting Shoei as the de facto helmet manufacturer for its own bikes. So a really interesting backstory to Shoei, which is now a big, well-known global brand.

MB Looking through this magazine you brought in, these are very high-end helmets in terms of design and specificity. Is that typical of Japanese SMEs?

PK That, in many ways, is what we see a lot of these SMEs do. If you look at these SMEs and the businesses, they're in the products they make, at a very high level. You will look at those products and say, 'Oh, is there much innovation here? What else can they do with these products?', It seems like a pretty standard product that will be anyone's initial impression. But the clever bit that the Japanese have perfected over the years is that within that simple-sounding product, they're able to innovate in ways that are quite difficult to understand.



I'll give you an example. You think a helmet is a pretty standard product. Everyone's probably worn one during their lifetime. But within that, they've innovated the material that they use for the helmets – really robust, sort of lightweight material, the biggest innovation they've done is in terms of the amount of electronics that they've actually crammed into that helmet, without compromising on the weight or the comfort. And on the shape, which is again, quite important. And obviously, you know, safety is the key thing here.

One of the recent models that they've launched, and there's a very nice video on YouTube of this model, is called Opticson. They've developed almost a supplementary mirror, which actually shows the rider a map, and gives them very useful information in terms of the best route to take, and you can even receive and make calls just by voice control. So, there's a lot of innovation they've managed to build into this helmet, which is quite typical of how most Japanese companies tend to approach innovation. It's not necessarily a big bang, or evolutionary new product, but within existing products that can constantly try to make it better, refining the manufacturing techniques and trying to end up with a premium product.

MB And another company which I thought was fascinating is that we mentioned earlier is Shima Seiki, a manufacturer of automated knitting machines.

PK Yes, that's absolutely right. And again, another example of a company that's pretty small, not that well known even to a lot of investors in Japan, and develops this knitting machine. And to be honest, the company developed this quite a long time ago, it's not necessarily a recent innovation. But what this machine does is to take the software design of whatever garment you want to make, which you upload to this machine, and it produces that entire garment in just one production run. So, it's like you're pressing a switch, and the whole garment, whether it's a jumper or a pair of trousers just comes out the other end. The traditional way of making those would be you manufacture the different bits first, and then you stitch them [together].

And that stitching process involves a degree of manual labour, but it also generates the most waste, because you got to make sure all the different bits fit correctly. Then there's excess cloth you need to get rid of it. So, all those issues are just completely taken away by this 'whole garment' machine. And when you think about reducing waste, climate impact and ESG, etc, something like this with Shima Seiki, with its whole goal and machine, fits right in the middle of that. And as we know, the apparel industry, globally, is among the largest waste producers. So, in its own small way, Shima Seiki, I think, is addressing this issue.

MB And the other company that we talked about in the introduction is Descente, a couple of European brands link to that in terms of their distribution, Le Coq Sportif and Umbro, and they have licences not just in Japan, but some other countries in the region. How do Western sports brands perform in countries like Japan? Are they popular?

PK So, the Western brands in Japan are popular, but the overall market is still



dominated by Japanese brands. So, if you talk about running, for instance, brands like Asics – a Japanese company – dominates the domestic market.

Nike and Adidas also have a decent share, but within that, if you break the overall market down into specific niches, you do have a lot of domestic Japanese brands dominating those niches.

And Descente is a classic example. Across Baillie Gifford I suppose we have a bias towards family-run businesses. Descente was for a long period of time run by the founding family. But they were so conservative in their business approach, they didn't seem to understand the changing nature of the industry, changing customer preferences, and over that resulted in a significantly underperforming business, which resulted in a big trading company in Japan called Itochu coming in taking a big stake in the business.

And they basically got rid of all the founding family members and bought in their own professional management team. And that resulted in a significant turnaround of the business. But what Itochu have done – apart from the management team – has also focused the company's efforts on China, which is a massive market. They've engineered a joint venture between Descente and one of China's largest sporting goods companies, Anta Sports. Anta Sports is helping Descente expand its brand through its considerable reach across China and helping it with advertising and marketing as well.

MB And within Shin Nippon, you're very much focused on small and medium-sized businesses. When do small and medium-sized businesses become too big for your portfolio?

PK For us, what is important is the starting point. When we invest, we specifically look for small-sized businesses. Typically my sweet spot tends to be between the \$300-\$500mn – or ¥30-¥50bn range. That's the range in which we would typically like to take an initial holding. But for us, we are looking for companies that can generate really outsized returns for shareholders. And when I say outsized returns, I don't mean two times or five times, I'm really talking of 10x 20x, over an extended period between 5-10 years.

Now you don't find them everywhere. They are very rare businesses. To give us the best chance of picking those types of businesses, and more importantly, sticking with them, and running our winners, we need to be very patient. We need to minimise the amount of trading activity that we do, just because the shares have gone up a bit. A lot of people will probably end up thinking in terms of taking some profits but we think slightly differently.

With that sort of investment philosophy, we don't think it is an issue in the company getting big – that is probably the result of success. So, we are happy to run our winners for as long as we think the growth opportunity is still there. Once that part of the investment case starts to weaken, once we start feeling that there is not much growth to be had in the future, from that point that would be the trigger for us to think about selling the shares. It's very rarely got to do with market cap



or any numbers around it. It's just the growth opportunity.

**MB** And you were in Japan recently, the first time that you've been back to Japan since the start of Covid-19. What was it like?

**PK** I was really pleased to finally get back to Japan. I think it's been almost three years. And the first thing that I struggled a bit with was jetlag, obviously, as I had lost a bit of practice. It took me a couple of days, but it was absolutely fantastic being back in Japan. I was there for two weeks, during which I met around 35 to 40 companies. What was striking to me was, unlike what we see in the popular press here in the UK, where we get our daily dose of grim news about one thing or the other, the businesses that I met, the vast majority of them were reasonably optimistic. I would say sort of cautiously optimistic. And this wasn't just a feeling that, 'OK, things are better in Japan, Japan has reopened to tourism, they've dropped a lot of requirements.' It was more rooted in just simple data – looking at all the books, looking at the trends in the orders that a lot of these companies were receiving.

And, not just looking at short-term order trends, but a bit further out, say two, three years out. Going back to the example of Shoei, their sales and profits have been growing exceptionally rapidly. Shoei sales and profits have absolutely exploded mainly on the back of Europe and the US. You can imagine why the company will be quite encouraged and optimistic. Especially when it is seeing the Chinese market open up, that would massively boost their already significant growth profile. So that was the first thing that struck me, that most of the businesses are not really too concerned about a lot of these external events.

The business conditions remained very favourable. A lot of the companies, especially the manufacturers remained brutally cost-competitive. The second thing that struck me was (this is a softer cultural aspect) that every single person I met was wearing a mask. So, a lot of these company meetings I was going into the first question was asking was, please, can I take my mask off? And in some cases, the executives were actually quite happy that I asked that question because they took the masks off as well.

And one final point, if I may, is there's a lot of regulatory change across a number of sectors that we're seeing, and in a lot of these will be strong tailwinds for a number of companies.

Within the real estate sector, the government has now liberalised the way real estate transactions take place. So previously, there was a big element of having paper-based contracts and having some face-to-face interactions with the broker or with your agent. All those have been taken away. Now you can basically buy and sell or lease or rent a property completely online without meeting anyone. And without even seeing the property, if you want. Which is fantastic news for some of our holdings, [such as] a company called GA technologies, which is Japan's leading online real estate platform.

**MB** And do you have a go-to for when you're back in Japan, in between these





company meetings that you like to do from a cultural perspective?

PK I think, for investors, or anyone who's going to Japan, my advice would be to spend as little time as possible in Tokyo. Because, you know, Tokyo is not at all completely representative of what's actually happening in the real economy. It's a bit like London because you know, London, it's almost a market unto itself. It says nothing about what's happening in the broader UK.

My advice would be to actually go and travel. I spent a day in Osaka, for instance. Although it was a short trip, this time around, I usually go to a few other places, not just to meet companies, but to get a feel for what's happening in the local economy. I maybe visit a few stores, chat with a few non-investment people, journalists and a few academics.

So that would give a slightly more rounded view of what's happening in the real economy rather than simply visiting Tokyo and going to conferences, which can be quite an artificial environment.

MB [That is] absolutely essential as well for an investor in SMEs, given that they're based all around Japan. That's a great way to end the podcast. Praveen, thanks very much for joining us on *Short Briefings on Long Term Thinking*.

PK No worries. Thank you very much, Malcolm.

MB Thanks for investing your time in *Short Briefings on Long Term Thinking*. You can find our podcast at [bailliegifford.com/podcasts](http://bailliegifford.com/podcasts), or subscribe at Apple Podcasts, Spotify, or on TuneIn.

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