Baillie Gifford Shin Nippon

BGS's portfolio is seeing strong sales growth but looks cheaper and cheaper...

Update
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Overview

Baillie Gifford Shin Nippon (BGS) aims to deliver high long-term returns by investing in Japanese smaller companies with exceptional growth potential. Historically, the trust has delivered outstanding returns when the market has been moving in its favour, such as in the 2015 to 2020 period. Since 2021, however, a number of factors have been working against it, with both small caps and growth stocks falling out of favour, and **Performance** has suffered.

However, manager Praveen Kumar reports that company fundamentals still overwhelmingly look strong. The portfolio's sales growth, both achieved and expected, remains over twice that of the market, while the premium being paid for this extra growth has got smaller and smaller. While he has made some efforts to ensure sources of growth in the portfolio are diversified, he remains committed to the low turnover and highly active approach and has recently been finding opportunities in companies exposed to the AI revolution. The trust retains its geared position in the market, with net gearing of c. 18% as of the end of March. Praveen notes that the strategy saw tough periods following the dot-com bust and the Great Financial Crisis, and in both cases, this was followed by strong periods of returns.

As BGS's style has fallen out of favour, the **Discount** has widened. In response to this and the challenging performance of recent years, the board has committed to a performance-conditional tender offer for 15% of the shares to be made if the NAV per share underperforms the MSCI Japan Small Cap Index on a total return basis over the next three years (to 31/01/2027).

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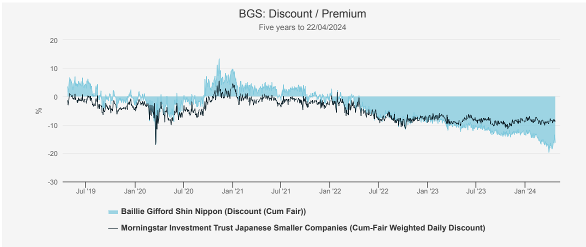
Key Information:

Price (p)	113
Discount/Premium(%)	-16.2
OCF (%)	0.72
Gearing (%)	1
Yield (%)	0.7
Ticker	BGS
Market cap (£)	341,462,358



Kepler View

Japan is in favour with investors in 2024, as corporate governance reforms aimed at unlocking value in companies with low price-to-book metrics take effect. This has pushed investors into cheaper companies, rather than the higher-growth companies that BGS invests in, and similarly to companies with poorer, complicated governance rather than the more entrepreneurial firms Praveen favours. Additionally, larger companies have taken most investor attention, perhaps due to their greater liquidity and familiarity as underweight investors look to get involved.

However, another reason for Japan being in favour is the relatively strong economic situation it is in, with modest inflation and wage growth meaning that the Bank of Japan has been able to move away from negative interest rates. In our view, this creates an encouraging picture for corporate earnings growth in Japan which could see smaller companies do well on a fundamental level. That said, we will likely need to see a broadening of investor interest into the small cap space and into higher-growth companies to see BGS outperform.

Calling a turning point is difficult, but BGS looks attractive on a fundamental level at the moment. The growth metrics look strong, while Praveen notes that the focus on profitability in the Japanese market is being felt in his portfolio companies too, and means management teams are incentivised to boost returns. If sentiment shifts, we think this could be a powerful combination.

BULL
Highly active and long term in approach which increases alpha-generating potential
Low OCF relative to peers, with low turnover style also reducing cost drag
Valuation premium to the market lower than it has been historically

BEAR
Tends to be very volatile, with gearing contributing
Growth factor is out of favour and this could weigh on the trust in the near future
The Japanese market can be very sensitive to a global recession

Portfolio

Baillie Gifford Shin Nippon (BGS) is an undiluted, unapologetic growth strategy, with a strong style bias and an aggressive focus on growing capital over the long term. Manager Praveen Kumar invests in Japanese smaller companies, aiming to identify those which can at least double in value over five years, and hoping to find those that can grow further and faster and that he can hold onto for longer. Praveen's portfolio bears very little resemblance to the market, with an active share percentage consistently in the 90s. It is not concentrated in style, with a high number of stocks versus its peers, but Praveen looks for asymmetric return potential and companies which can potentially grow to a multiple of their size over time. As such, there is the potential for relatively small positions to deliver meaningful returns to the portfolio. Turnover tends to vary between 10% and 20%, implying an average holding period of between five and ten years, and was 12% for the 12 months to 31/03/2024.

As discussed under **Performance**, BGS delivered exceptional returns in the five years to early 2021, but since then a number of factors have worked against it, and the portfolio has significantly sold off. As a result, the valuation premium paid for the extra growth potential is now modest, while the expected growth rate remains much higher than the market, implying the long-term outlook on a fundamental basis is attractive. In particular, we would highlight the EV/EBIT multiples in the table below on valuation. These strip out the exceptional events that can reduce net earnings, arguably looking at underlying profitability. Sales and earnings on BGS's portfolio have grown faster than the market, while sales growth is anticipated to be well over double that of the market in the coming three years. The expected EBIT is only modestly higher, but this reflects the strategy of investing in companies that can deliver the highest long-term growth, which often means investing heavily at the start. Indeed, it is worth noting that Praveen will hold temporarily unprofitable companies if he thinks sales growth will be strong and profitability can be achieved in future. When we spoke to Praveen he suggested the forecasts may be conservative, and he would be disappointed if we didn't see higher growth in the coming years.

Portfolio Characteristics

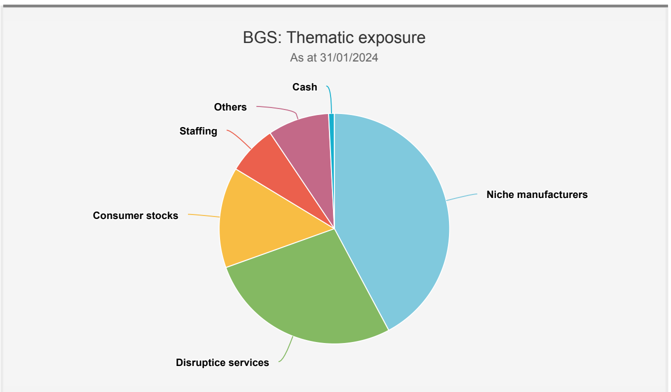
	BGS	MSCI JAPAN SMALL CAP
VALUATION		
Forward P/E (x)	17.5	13.8
	14.1	13.3
HISTORICAL GROWTH		
5yr sales growth (%)	7.2	3.5
5yr earnings growth (%)	7.3	4.5
FORWARD GROWTH		
3yr expected sales growth (%)	9.6	3.7
3yr forward EBIT	12.2	12.0

Source: Baillie Gifford, as at 31/01/2024, data excludes negative earnings for company and index, except 3yr forward EBIT

In this regard, the portfolio is benefitting from the corporate governance reforms that are sweeping through Japan. A recent focus has been on directing companies to improve profitability and raise their valuations. Praveen reports there has been a decisive shift in management mentality towards achieving profitability, and he expects this to lead to portfolio companies racing to prove their business model works. Currently, only c. 6% of the portfolio is unprofitable, meaning having delivered operating losses for a number of years rather than simply delivering one bad quarter. This includes four unlisted companies, which make up a small proportion of the portfolio (just 3.7%) but offer further differentiation from the index and the typical sector peer.

Sales growth potential is one of the key things Praveen looks for in companies. He aims to uncover those small caps with the greatest growth potential, which could mean those operating in a niche with limited competition, or those opening up a new market. Companies the team consider niche manufacturers make up c. 42% of the portfolio, as the chart below shows. Suppliers of disruptive services are the next largest bucket, and these include software providers as well as companies delivering services online. Consumer stocks include companies benefitting from strong brands, sometimes benefitting from sales growth in China and other Asian companies as well as Japan. That said, the vast majority of sales exposure is domestic Japan, with c. 65% of the portfolio invested in companies that generate the vast majority of their sales in their home country. Staffing as a theme is broken out as this reflects the importance of recruitment services in a country with a declining working-age population, as Japan has been for many years.

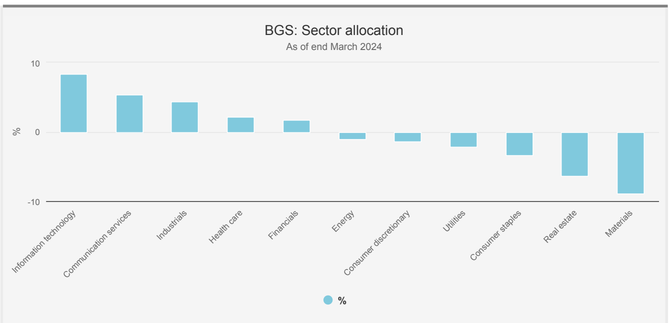
Fig.1: Thematic Exposure



Source: Baillie Gifford

Japan's economy and society have some distinguishing features which influence the investment cases for a number of the companies in the portfolio, such as the recruitment specialists. Holdings here include TechnoPro, Japan's largest IT-focussed staffing company. Other holdings are benefitting from the later shift online of Japan's economy, such as GMO Financial Gateway, a leading point-of-sale payments operator. At a sector level, the portfolio tends to be overweight information technology and industrials, and underweight typically lower-growth, less entrepreneurial sectors such as materials, consumer staples, and utilities.

Fig.2: Relative Sector Exposure



Source: Baillie Gifford

Many of the themes that have proven successful for the portfolio over the long run have not been working in its favour for the past three years. We discuss these factors in the **Performance section**, but one issue that we would highlight is the outperformance of large-caps over small-caps. This is a global phenomenon, even if in Japan the country's specific economic circumstances are very different. One dimension of the trend is the outperformance of those large-caps that are seen as being major beneficiaries of the growth of artificial intelligence (AI). In the US, Nvidia, Google, Meta, and Microsoft have been amongst the winners, and in Japan, it is large-cap semiconductor manufacturer Tokyo Electron that has particularly benefitted. That isn't to say that there won't be small-cap winners from the AI revolution, and in our view, it may be that the large-caps are simply the most obvious stories and so are getting early investor attention before it broadens out. BGS owns a number of companies in the semiconductor supply chain which stand to benefit. For example, Jeol, which sits in the niche manufacturers basket, has a monopoly on a technology used to print on silicon wafers using electron beams. There are also examples of software companies using AI to improve their services. Bengo4 is a long-time holding which offers a number of services to the legal profession online. It is using AI tools to revamp its offering, building systems which can search through legal rulings and documents to help prepare for and manage cases, and Praveen thinks there is scope for the company to boost what it can earn from a client, and recharge its growth rate. One new addition to the portfolio in 2023 was Appier Group. This is an AI software company founded by a Taiwanese couple resident in Japan. It uses large language models that support retail businesses in their tracking of consumer behaviour. The business is growing both inside and outside Japan.

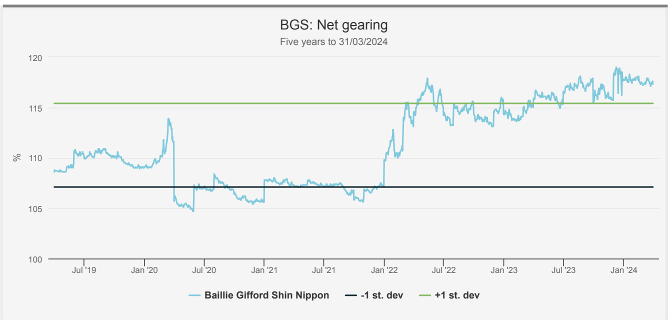
These sorts of stories have not been in favour in Japan over the past three years. However, Praveen notes that style has worked against the trust at times in the past before the market swings around its way again. As such, he is sticking to the strategy and continues to look for the most exciting growth prospects. One new entry into the portfolio is Oisix , Japan's leading online meal kit provider, which is continuing to grow its sales and profits despite the overall market being sluggish following a Covid-19-induced boom. Praveen has also been looking for growth ideas from sectors he has typically been light on. For example, SWCC was first bought in May 2023. This is a traditional manufacturer of high voltage electrical wires and cables but is undergoing a transformation under its current president. She is the first female president in the company's history and the first from an R&D background. She has changed the structure of the business, moving it from being a capital-intensive wire and cable manufacturer to an asset-light manufacturer and consulting business. As a result, profits are growing at a 32% run rate this year and this has been rewarded by the market, with the share price more than doubling since the initial purchase.

In the sales column, Praveen has also sold some stocks in which he has lost conviction. For example, Pigeon, which manufactures baby bottles and accessories, has been sold. Praveen argues it has lost some focus and fallen behind its competitors in some important respects. However, seven sales over the year are not high in relation to history, and overall turnover has remained low. In Praveen's view, the vast majority of companies in the portfolio have been performing well, with valuations de-rating as small-cap growth stocks fall out of favour.

Gearing

The gearing strategy is to maintain geared exposure to the portfolio in order to enhance the growth potential. The benefit of taking this approach is that it increases returns when the portfolio rises in value, and means the board and/or manager does not have to attempt to time cyclical moves in the market, which is notoriously difficult. On the other hand, the downside is that when portfolio performance is poor, losses are also magnified. The sharp rise in the gearing position visible in the chart below reflects a sharp sell-off in the NAV between October 2021 and May 2022. However, the more recent, gradual rise reflects a decision to increase the gearing facilities to take advantage of investment opportunities and the low cost of debt. During the financial year ending 31/01/2024, a new three-year Y2,000m facility was arranged and drawn down to add to the existing three-year Y7,000m borrowing capacity, renewed in November. These facilities are supplemented by two others that mature in 2024 and total Y7,100m in borrowing capacity. The cost of debt is very low in Japan, reflecting low interest rates, and as of the end of January, BGS had total borrowings of Y16,100m, or c. £86.5m, at an average cost of 1.7%. Net gearing amounted to c. 18% of NAV at the end of March. In our view, the gearing adds to the attractions of the trust as a recovery play and a long-term growth investment, as it increases the potential for a short-term recovery to be swift and for returns in the long term to be magnified as markets rise. However, it also contributes to this being a volatile and risky investment, along with the strong style bias and small-cap focus, all of which should be considered.

Fig.3: Net Gearing

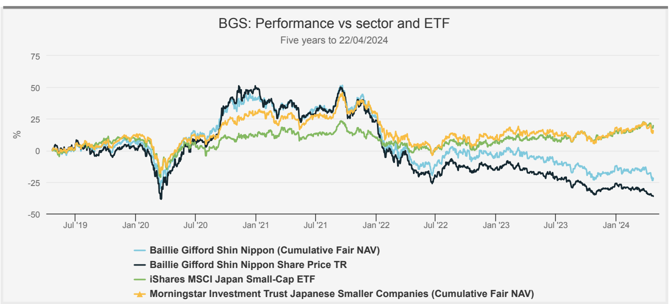


Source: Morningstar, Kepler calculations

Performance

BGS has experienced a boom and bust over the past five years, as a helpful environment gave way to one in which a number of factors worked against it. The below chart shows how the NAV has sold off significantly since late 2021, and over five years NAV total returns are -21.9%. The iShares MSCI Japan Small Cap ETF has returned 19.7% over the same period, and the AIC Japanese Smaller Companies sector 21.3%.

Fig.4: Five-Year Performance

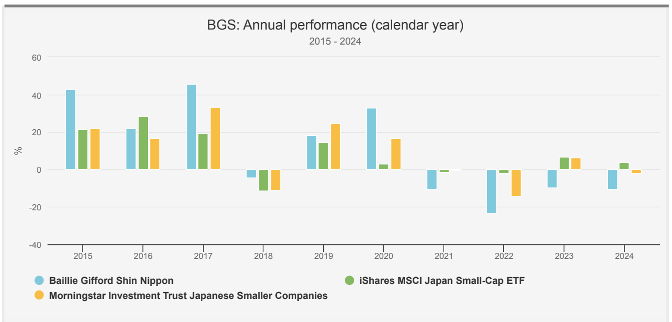


Source: Morningstar

Past performance is not a reliable indicator of future results.

If we look back a little further, we can see that 2021 brought to an end a very good run of performance, in absolute and relative terms. The chart below shows annual returns since 2015 when Praveen took over management. It is striking how strong returns were from 2015 through to 2020, with BGS delivering exceptional returns in rising markets and even outperforming in the only down year for the market, 2018. We note this isn't the first time BGS has had a tough period of performance. Looking back beyond Praveen's tenure, the strategy struggled in the aftermath of the dot-com bust and the 2008 financial crisis, and in both cases delivered a strong performance in the following years.

Fig.5: Returns



Source: Morningstar

Past performance is not a reliable indicator of future results.

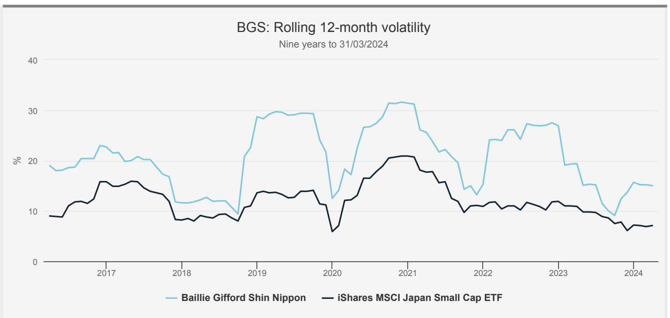
In our view, nothing has changed in the style or approach of the manager, but it is simply the case that a number of factors have shifted against the strategy at the same time. In 2021, the reflationary rally following the end of western lockdown restrictions saw a global shift to value over growth. As expectations for rates rose, growth equities re-rated significantly. This was most impactful in 2022 when fears of global recession also hurt equities, and there was a dash to cash. While equities recovered as 2023 went on, large caps have outperformed globally, not just in Japan. In Japan, corporate governance reforms have seen the market gain favour internationally, but investors have focussed on large-caps and unlocking value in poorly governed, lowly valued companies, exactly where BGS doesn't invest.

The strong style bias, focus on small-caps, and consistent employment of **Gearing** have all contributed to BGS being very volatile, both when it has been outperforming and when it has been underperforming, as the below chart shows.

For us, what is most important to see is that the management approach hasn't changed. This strategy has proven to have great growth potential in the right environment, and any watering down would limit its ability to do so when the environment changes. Turnover was low over 2023, and although some moves have been made to broaden the types of growth ideas in the portfolio (see

Portfolio section), the focus remains on identifying those companies with the highest long-term growth prospects.

Fig.6: Volatility



Source: Morningstar

In Praveen's view, we probably need some of the froth to come out of the Japanese market to see a re-rating start. Currently, there is strong investor interest in cheap companies, which typically means those that BGS is not invested in, and growth companies are being disregarded. This means that on a fundamental basis, growth companies are arguably looking ever more attractive. As discussed in detail in the **Portfolio section**, the valuation premium of the portfolio to the market is relatively low, but the expected growth rate is much higher. In our view, this bodes well for future returns when the environment changes, although it is hard to predict when that will be.

Dividend

BGS is focussed on capital growth and typically has not paid a dividend. All fees are charged to the revenue account and the board notes that shareholders should not rely on the trust to provide a regular and stable source of income. That said, a dividend of 0.8p per share was paid for the 2024 FY, broadly the minimum required to be paid to meet investment trust status. Dividends have risen on the underlying portfolio in recent years, and this has seen a revenue account deficit wiped out.

Management

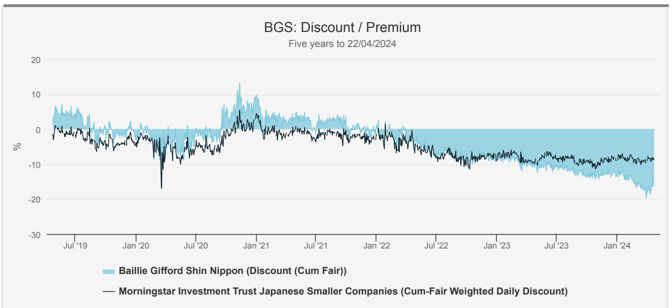
Praveen Kumar has managed the trust since December 2015. Praveen joined the Japanese desk as an investment manager in 2011, meaning he has over a decade of experience investing in the country. He joined Baillie Gifford in 2008 and works from Edinburgh, where he is part of a Japanese equities team which includes ten investment managers. Baillie Gifford has a collegiate approach to idea discussion which means that Praveen is not the only investor looking for opportunities in his space, and the team also includes two investment specialists and an ESG analyst who can provide input. He also has access to the services of two investment consultants based in Japan who provide thematic input, attending trade shows and conventions to generate ideas about broader trends in the country, although Praveen will also make periodic trips to Japan himself. Praveen also manages the open-ended Baillie Gifford Japanese Smaller Companies Fund and is the deputy manager of the all-cap Baillie Gifford Japan trust.

Discount

With BGS's strategy falling out of favour, the discount has moved out considerably. At the time of writing it is 16.2%, having averaged 12.9% over the past year. The board has responded decisively with a performance-triggered tender offer for 15% of the shares to be made if the NAV per share underperforms the MSCI Japan Small Cap Index on a total return basis over the next three years (to 31/01/2027). We think this is attractive for prospective shareholders as it raises the possibility of seeing a proportion of an investment realised near NAV while increasing the incentives on the manager to improve performance. In the meantime, the board has also committed to spending £100,000 on marketing the trust to retail investors and continues to implement share buybacks. Over the financial year ending 31/01/2024, the trust bought back 4.4m shares, or 1.4% of the issued share capital at the start of the period, and since then the buybacks have accelerated, with c. 38m shares being repurchased in the two months since (2.7% of those in issue).

We think all this shows commitment to see the discount narrow, and this should be viewed as encouraging by investors. In our view, though, the most likely way for the discount to decisively narrow is for performance to improve and the NAV to outperform the benchmark. We note that the last time the growth style was in favour in Japan, BGS traded on a premium and issued shares to meet demand.

Fig.7: Discount



Source: Morningstar

Charges

BGS's latest ongoing charges figure (OCF) is 0.72%. This is the lowest in the four-strong AIC Japanese Smaller Companies peer group, the average of which is 1.13%. It is worth noting that BGS is the largest in the sector, which helps reduce the impact of fixed costs. However, the low OCF also reflects the fact the management fee is the lowest in the group. This is 0.75% on the first £50m of net assets, 0.65% on the next £200m and 0.55% on the remainder. The latest KID RIY is 1.13% which compares to a sector-weighted average of 1.43%, although we note that methodologies may vary.

ESG

Baillie Gifford describe themselves as “actual” investors, which is intended to capture the idea that they are long-term in their approach. This brings with it a concern for sustainability, which encompasses good governance and sustainable business practices. BGS is not a sustainable strategy per se, but the team integrate ESG considerations within their investment approach by virtue of this long-term focus. They seek to engage with companies to inform investment activities and effect change, all with the ultimate goal of improving returns for all shareholders.

BGS has a below-average score from Morningstar for sustainability, but this reflects low coverage by Morningstar of the portfolio. Japanese small-caps are often not covered by many analysts, and the information available to shareholders can be poor. Ongoing reforms are having some effect on this, and can also lead to opportunities for engagement to have a positive effect on a company’s share price.

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