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Japan company focus: Hitachi or Rakuten?

Japanese equity market – background:

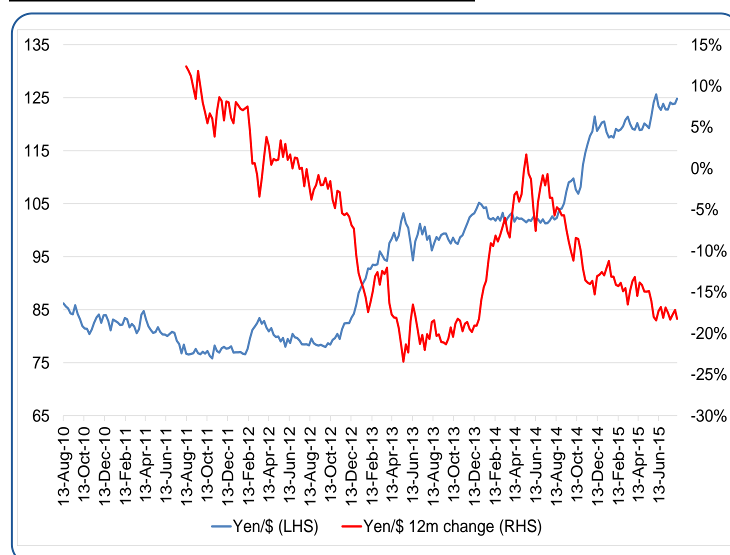
The Japanese stock market has been receiving a lot of attention over the past year as investors have expected Prime Minister Shinzo Abe's structural reforms, the weaker yen and the enormous quantitative easing (QE) programme of the Bank of Japan (BoJ) to breathe life into the economy and bolster corporate profits. With the second quarter earnings season in both the US and Japan now drawing to a close, that expectation has again proved justified. To date, the S&P 500 Index has seen top-line revenue contraction, for 2Q, of about 5%, and a roughly 3% earnings contraction during the quarter; the Nikkei on the other hand achieved 6% top-line growth, which produced a whopping 40% earnings increase over the same period.

And this is not a once-off phenomenon, Japan has been on a winning streak for a number of quarters. Now, investors are often suspicious of yen-denominated earnings growth that has been achieved in an environment of a depreciating currency (see Figure 1), viewing such growth as predominantly a fiction generated by financial engineering at a national level. While there has been a risk that equity market investors make gains in yen, only to lose those gains when translating back into US dollar, due to currency weakness, we note that it is possible to hedge one's yen exposure and make a small carry on this position, due to Japan's extremely low interest rates. Thus, effectively, there is little (if any) cost to hedging the currency risk.

However, we highlight that the yen now appears to be extremely cheap and may well not have much more downside risk from current levels. This raises the question: if earnings have grown largely due to yen weakness, and that trend is coming to an end, why continue to expect earnings growth from Japan? While the case for buying (or avoiding) Japanese equities is complicated, the argument to be made in favour of Japanese equities is much broader than simply the first-round effects of currency devaluation. There are also, as noted above, structural reforms and corporate governance reforms (whether QE is outright positive is very debatable), as well as potential second-round effects if the boost to earnings and GDP initially caused by currency weakness gains momentum and an economic life of its own.

Japanese assets also present the opportunity for improving an investor's portfolio diversification and should be considered for that reason as well.

Figure 1: Japanese yen vs US dollar:



Source: Company data, Anchor Capital estimates

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We scan the globe looking for good opportunities. We provide our model portfolios, as well as news and views on our watch-list, which is continually reviewed and updated.

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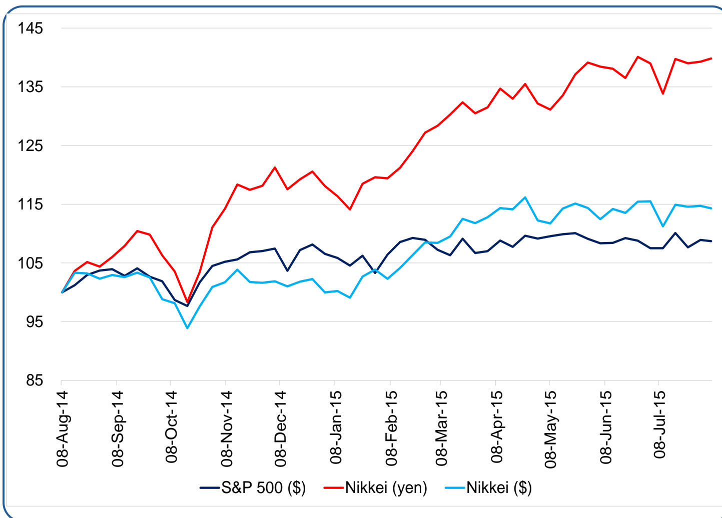
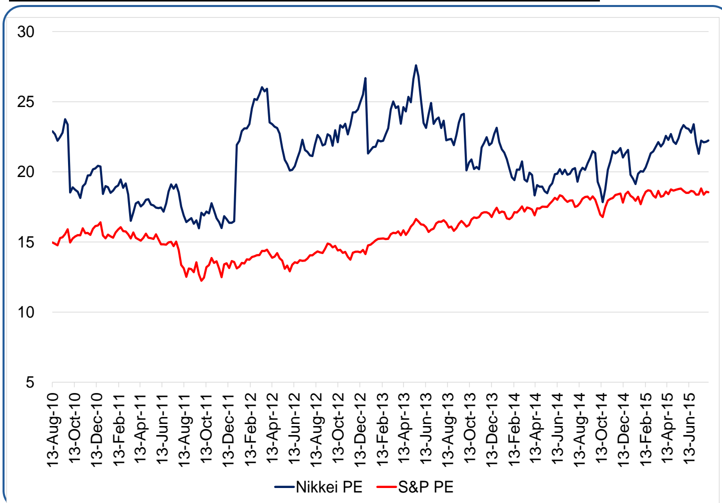
Figure 2: Equity market performance over the past 12 months, S&P 500 vs Nikkei (August 2014 rebased to 100):



Source: Company data, Anchor Capital estimates

Figure 3: P/E multiples for the S&P and Nikkei:



Source: Company data, Anchor Capital estimates

There are a number of possible approaches to investing in the Japanese equity market and we suggest two alternatives here, along with a company that might be suited to that strategy. The first approach is to invest in the Japanese corporate reform theme; this would involve buying large, perhaps 'old economy,' Japanese companies that have grown bloated and inefficient but which have commenced a turnaround programme that, if successful, could result in a significant recovery in ROE and earnings. Hitachi, we suggest, is a candidate for this approach. A second approach is to buy a high-growth, 'new economy' stock that gives an investor the Japanese exposure but that already has a vibrancy and global competitiveness that some of the older companies are trying to regain. Rakuten, in our view, is a candidate for such an approach.

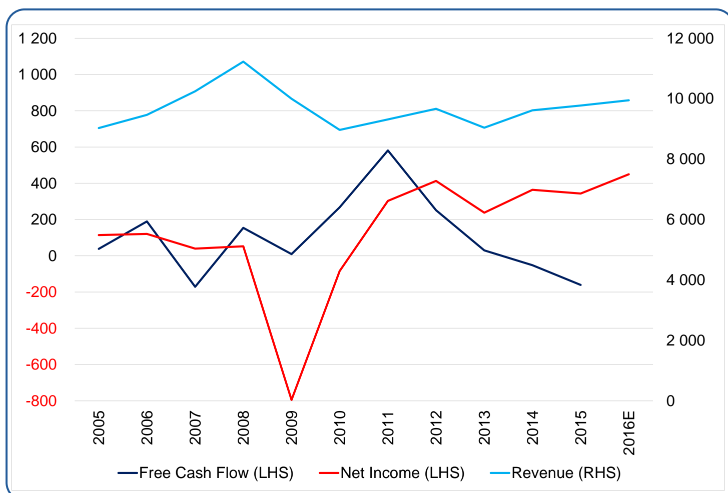
Hitachi Ltd (6501:JP; Market Cap JPY3.8trn/ $30bn) is a diversified conglomerate with interests in numerous different businesses, principally industrial electronics, though ranging from software and ATMs to banking and elevators. Hitachi is currently in the process of a business restructuring that targets global competitiveness, cost cutting and improved working capital management. The company recently reported diluted EPS of JPY11.36 *(exchange rate of $1:JPY124.89)* for 1Q16 (quarter to June 2015), 31% up on the prior year's comparable quarter and ahead of analysts' consensus. Annualised, this number is almost exactly equal to the prior fiscal year's diluted EPS print of JPY45 which would put the stock on a P/E of 17x. Management, however, retained their full-year guidance for attributable net income of JPY310bn, up 43% on the year ended March 2015, which translates into EPS of c. JPY64 and a P/E of 12x (vs Nikkei 12m forward P/E of 18.6x). It is important to note that this forecast only represents a partial recovery to where earnings were in 2014, given that profits went backwards by 47% in FY15. The geographic composition of the company's revenue is c. 48% Japan, 24% Asia (ex-Japan), 14% North America and the remainder from Europe and other areas.

We think Hitachi is a potential candidate for investors who want exposure to the corporate reform theme in Japan – though, given that intention, we would prefer to own a basket of shares exposed to this theme as opposed to focusing on a single name. The bull case for Hitachi is that moderate success in its reform programme, including cost control and cash-flow management, could buoy earnings and allow for a rerating of the stock. So, if the company is able to grow revenue by only 5% from its 2016 guidance level, and improve the profit margin from 4.5% (2016 guidance) to 6%, EPS could get close to double the levels achieved in 2015 and result in a forward P/E of 8.7x.

Hitachi could be described as bloated with excess costs, employees and general inefficiencies and so the potential for cost cutting to increase earnings is potentially quite large. It should be borne in mind that a cost-cutting exercise would be much more difficult in Japan where there are legal and cultural barriers that would not be present in other contexts. The company has reported a cost reduction target of about JPY90bn-JPY100bn p.a. which is the bulk of its forecast increase in FY16 profits, i.e. Hitachi forecasts net income of JPY450bn in 2016 vs JPY343bn in 2015. We note that Hitachi is exposed to weakness in Chinese construction as well as weakness in mining capex, both of which could prove to be headwinds for some time.

Hitachi, up to now, has not been a high-growth company, indeed revenue has oscillated around the JPY9trn-JPY10trn level for the past 10 years though profitability has been much better in the past few years vs the earlier part of the last decade. The company has produced some rather ambitious sounding statements in regard to reforms, such as the following, from the 2014 annual report: "Hitachi aims to be a leader in global markets, we are still just at the starting line." But, thus far, its quantitative guidance has been much more modest. However, because it is such a low-margin business (profit margins were 4% in the most recently reported quarter), modest successes in cost control can yield pretty large increases in profits. Unfortunately, that equation cuts both ways and small misses can decimate profits. This sensitivity can be seen in Hitachi's earnings history where the company's earnings were decimated in the Asian Financial crisis (1998), IT bubble collapse (2001) and Global Financial Crisis (2008 and 2009). A further risk is that Hitachi continues to have difficulties converting earnings into cash. ***/continued….***

Figure 4: Revenue, income and cash flow history (JPYmn):

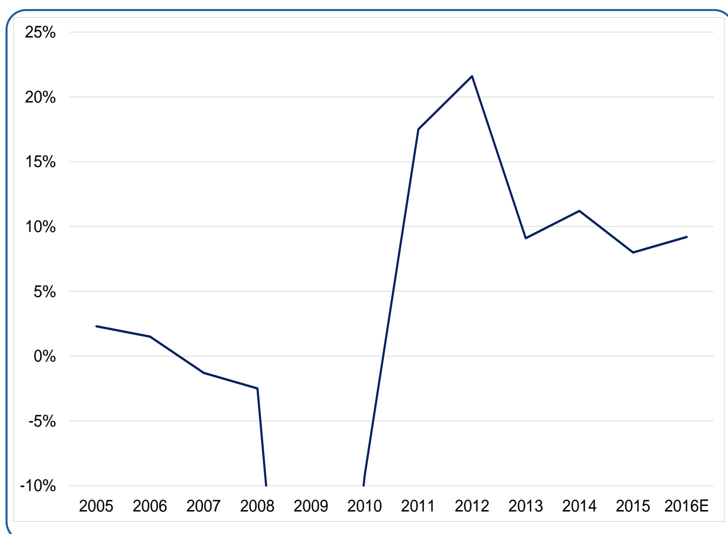


Source: Company data, Anchor Capital estimates

Note that the company began reporting under IFRS from the June 2015 quarter and that the history is still under the old standards

The free cash flow figure that management disclose is operating cash flow less investment cash flow, both gross, which obscures the composition of capex between the "stay in business" kind and that directed towards growth. Either way, the high capex has yet to translate into revenue growth. We note that c. 3.5% of revenue is spent on research and development each year, while the EBIT margin was only 5.5% in 2015.

Figure 5: Hitachi ROE history:



Source: Company data, Anchor Capital estimates

Figure 6: Hitachi summary financial statements:

Year to March		2014A	2015A	2016E	2015 g%	2016 g%
Revenue	JPYbn	9 666	9 775	9 950	1%	2%
EBIT	JPYbn	691	534	620	-23%	16%
EBIT margin	%	7%	5.5%	6.2%	-24%	14%
Net income	JPYbn	525	343	450	-35%	31%
Profit margin	%	5.4%	3.5%	4.5%	-35%	29%
Attributable net income	JPYbn	414	217	310	-47%	43%
Diluted EPS	JPY	86	45	64	-47%	43%
Spot share price	JPY	779				
P/E	x	9.1	17.3	12.1		

Source: Company data, Anchor Capital estimates

Rakuten (4755:JP) is a JPY2.9trn ($24bn) Internet services company and potentially an extremely high-growth business. The name 'Rakuten' is the Japanese word for optimism, which suits the positive attitude that the company exudes. Rakuten is exposed to the macro-theme of rising Internet and smartphone penetration and is building something of an Internet-based ecosystem in which there appears to be powerful synergies between the various businesses the company has built and acquired. The core of the existing business involves a business to business to consumer (B2B2C) e-commerce platform that is the largest such platform in Japan and also one of the largest in the world. The Rakuten Ichiba website was ranked 1st in the Nikkei BP Consulting fall-winter 2014 web brand survey which "measures the brand potential of corporate websites". Rakuten Travel handled the second-highest number of domestic travel transactions in Japan. The high-growth zones of the business involve its Internet Finance segment and a number of recent acquisitions. At present, these latter businesses are loss making and the whole question of whether Rakuten's P/E multiple of 39x is too demanding hinges on how one interprets these business segments. In summary, we do like the business very much and, in spite of the quite demanding valuation, we think it may have a place within a diversified portfolio.

Rakuten reported 2Q15 results on Thursday (6 August) with diluted EPS up 94% QoQ, revenue growth of 25% QoQ and non-GAAP operating income up 28% QoQ. While we do regard Rakuten as a high-growth business this quarter's EPS growth is an anomaly for a number of reasons. First, we note that the comparative 2Q14 number followed on the heels of the last consumption tax hike (April 2014), which resulted in Japanese consumers front-loading intended future consumption into 1Q14 and thus 2Q14 was quite weak and an artificially low base for comparison. Second, there was a large swing in the accounting tax rate, so much so that an 18% rise in profit before tax, QoQ, became an 88% rise in profit after tax, QoQ. We therefore think it perhaps makes more sense to compare 1H15 with 1H14 earnings to reduce the distorting effects of the consumption tax hike on the base; thus, 1H15 delivered diluted EPS of JPY20.8, growth of 20% on 1H14; revenue growth was 20% YoY.

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Looking forward, management have guided the market to expect growth in FY15 on the FY14 base but haven't given more specific quantitative guidance. We note that while 1H15 was strong, Rakuten also had an extremely strong quarter in 4Q14, which is unlikely to be repeated, and so we expect FY15 to show somewhat less than 20% EPS growth on the FY14 base.

Figure 7: Rakuten 2Q15 (June) quarterly results:

Rakuten Quarterly Results		2Q14	2Q15	Q/Q %
Revenue	**¥Bn**	**138.3**	**173.2**	**25%**
- internet services	*¥Bn*	81.0	102.8	27%
- internet finance	*¥Bn*	*56.8*	*69.6*	23%
- other	*¥Bn*	*11.7*	*13.8*	18%
- intercompany elimination	*¥Bn*	*-11.2*	*-13.0*	16%
Operating Income (IFRS)	**¥Bn**	**22.2**	**26.2**	**18%**
add: one-off item excluded	¥Bn	*0.0*	*1.2*	-
add: amortization of intangibles exp	¥Bn	*1.5*	*2.1*	38%
add: stock compensation exp	¥Bn	*0.4*	*1.4*	291%
add: other IFRS exclusions	¥Bn	-	-	-
= Operating Income (non-GAAP)	**¥Bn**	**24.1**	**30.9**	**28%**
- internet services	*¥Bn*	*14.0*	*16.9*	21%
- internet finance	*¥Bn*	*9.7*	*16.9*	73%
- other	*¥Bn*	*0.7*	*-1.1*	-259%
- intercompany elimination	*¥Bn*	*-0.3*	*-1.8*	515%
Finance income	¥Bn	0.1	0.1	-22%
Finance expense	¥Bn	0.8	1.1	37%
JVs and Associates	¥Bn	0.0	0.1	50%
PBT	**¥Bn**	**21.5**	**25.3**	**17%**
Tax	¥Bn	14.4	11.9	-18%
Tax %	%	67%	47%	-30%
PAT	**¥Bn**	**7.2**	**13.4**	**88%**
Minorities	¥Bn	*0.2*	*-0.2*	-185%
Attributable Net Income	**¥Bn**	**7.0**	**13.6**	**95%**
Diluted EPS	¥	5.3	10.2	**94%**

Source: Company data, Anchor Capital

So, as noted, Rakuten is not cheap on a headline P/E basis. It trades at 39x FY14 EPS and, given the extremely strong 4Q14 EPS print (that quarter alone delivered more EPS than the entire first half of FY15), the company would be doing well to deliver mid-single digit growth on the FY14 base. Thus, the one-year forward P/E is probably not much lower than 38x. This compares poorly to the likes of Alibaba which is on a one-year forward of about 30x. What makes Rakuten interesting is that it has some very high-growth businesses that are currently loss making but which, if these businesses start to show even a modest profit margin, could produce a step change in earnings (we expand on this below).

Rakuten could be split into an **Internet Services** and an **Internet Finance** business. The Finance segment is growing rapidly and is highly profitable: revenue for 2Q15/2Q14 was up 23% but operating income was up 74%. This business comprises about 42% of profits. Now, what is very significant is that Rakuten's Internet Services business could be split into the more stable but highly profitable Rakuten Ichiba and Rakuten Travel (these, taken together, contribute 58% to profits); and the high growth but still loss making **Other Internet Services**. How one understands this latter component will make or break the investment case for Rakuten. This component grew revenue by 51% for 2Q15/2Q14 and it generates more revenue than the core Rakuten Ichiba and Rakuten Travel combined (note that the Ebates acquisition, which took place in October 2014, has inflated the revenue growth number as it was not part of the 2014 base). Yet the segment is loss making, which, we understand, is due to its aggressive pursuit of market share and growth. **Other Internet Services** includes **Overseas E-commerce** (principally Ebates) and **E-book Services**. **Kobo** is an e-book company that was acquired by Rakuten in 2012. It appears to be growing rapidly with its user base swelling from 6.5mn at the time of the acquisition to 23mn in 2014, and 24.6mn in June 2015 (18% YoY). Rakuten's global e-book business is presently loss-making and the Group expects it to be close to break-even on the EBITDA level in FY15.

The **'Other'** segment includes Viber, telecommunication services, professional sports, marriage introduction and other services. The fact that **Viber,** the acquisition for which management has such high hopes, is plonked so unostentatiously into the 'Other' category is a testament to the degree to which a cursory perusal of the financial statements can be terribly misleading in Rakuten's case. Viber is a voice over Internet protocol (VoIP) and instant messaging app that had 516mn unique user IDs and 236mn monthly active users, as of January 2015 (up to 606mn unique IDs at June 2015, in which monthly active users were up 41% YoY). It was acquired by Rakuten in March 2014 for $900mn, c. 3.8% of its current market capitalisation. WhatsApp, as a comparison, had about 600mn active users in January 2015 which grew to around 800mn active users by April 2015; the company was acquired by Facebook for $16bn in February 2014. Viber is expected to play a crucial part in the 'ecosystem' that Rakuten hopes to build. It is quite crucial that the businesses over which management is most excited – Ebates, Viber, Kobo, are presently loss leaders.

For the purpose of getting a sense of what could happen to earnings if these growth engines start to turn a profit, we could consider two possible scenarios: (1) Other Internet Services and the Other segment are breakeven; (2) Other Internet Services and the Other segment achieve a 10% profit margin on 2Q15 revenue levels. Under these scenarios, operating profit would be up 24% and 46%, respectively (if this flowed through into an equal percentage EPS growth, the stock would be on a P/E multiple of about 32x and 27x, respectively). And while that is quite impressive, the 'vision' and purpose of these divisions is not to stabilise them at current levels but to grow them significantly. Thus, one can see that the upside, if the strategy works, is very large.

Figure 8: Rakuten scenario analysis:

Rakuten - scenario analysis		Q2'15	%
Reported Non-GAAP operating income	¥Bn	30.9	
1. Operating Income if loss making segments becoming break-even	¥Bn	38.3	24%
2. Operating Income if a 10% profit margin in loss making segments is achieved	¥Bn	45.2	46%

Source: Company data, Anchor Capital estimates

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Returning briefly to the **Internet Finance** segment, we note that it includes Rakuten Card, Rakuten Bank, Rakuten Securities, Rakuten Life Insurance and Other Financial Services. Rakuten Card has been top ranked for customer satisfaction and has the fastest growth rate of transaction volume in Japan, about 35% YoY in FY14 (it is currently ranked about 5th in size, thus there is still scope to grow its market share). Rakuten Bank was named ‘Best Consumer Internet Bank’ by Global Finance Magazine, for the third consecutive year in 2014. Note that this segment is the most difficult to forecast and that the securities component is leveraged to financial market volatility.

In a world where top-line revenue growth is becoming rarer, Rakuten is unusual in that it has delivered 17 consecutive years of revenue growth; this growth number came in at 15.4% in FY14 and 20% for the 1H15 period on 1H14. Rakuten has been growing both organically and through acquisitions; the effect of the latter can be seen on its shares outstanding which grew by 8% in the first six months of CY15, the higher shares in issue potentially placing a drag on EPS growth going forward.

The company’s pretty extensive “Englishnization” project means it could be much more open to creative breaths of fresh air than some of its other, more cloistered, corporate peers.

Lastly, note that during 2014 the company saw what they described as a “cooling in consumer sentiment following the consumption tax hike” and there is a risk of a recurrence of this with the projected further increase in Japan’s consumption tax from 8% to 10% in April 2017.

Blake Allen

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