The SilverBullet

Investment Philosophy

SilverCross Global Small-Cap Fund invests in a portfolio of 25-35 high-quality smaller companies. It invests in companies with defensible business models across global developed markets.

The Manager applies four core principles in its stock selection. Its aim is to drive attractive long-term investment returns in excess of the benchmark while keeping portfolio turnover low.

Core Selection Principles

Create Value with a sustainable business model.

Compound Growth thanks to a scalable business model.

Undervaluation implies an asymmetric risk / reward profile.

Insider Ownership ensures alignment with management.

About The SilverBullet

A silver bullet refers to a straight-forward solution perceived to have high effectiveness. With this newsletter we aim to offer a mix of thought-provoking research and small-cap insight.

SilverCross Global Small-Cap Fund

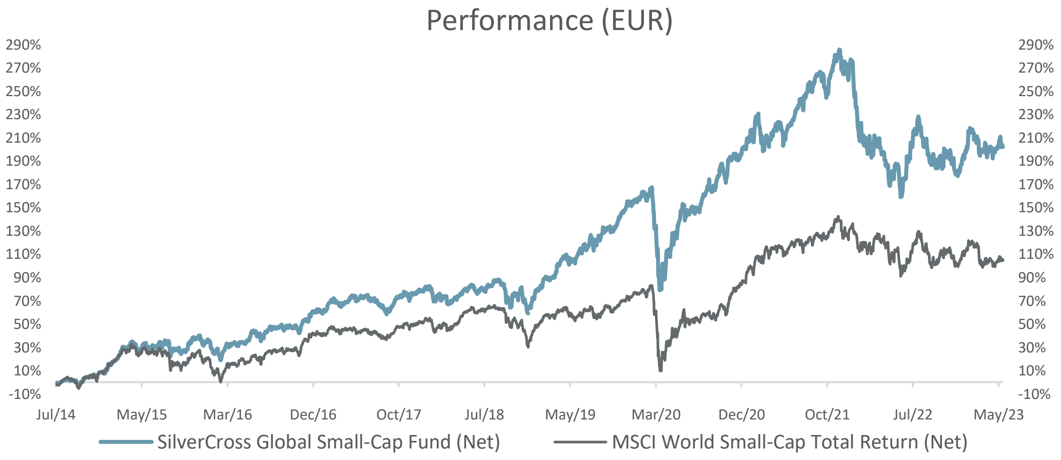
Our Recent trip to Japan

The SilverCross team had a busy start to the year visiting companies. Our trip to Japan was the first in 4 years, as Covid travel regulations were only lifted in October last year. Whilst we could technically still visit earlier, many if not most companies were reluctant to meet us in person. It is easy to forget what kind of life we were living just a couple years ago under Covid, but Japan was a stark reminder. Perhaps it was the time difference, at some points it felt like we travelled back two years as we were separated with Perspex during meetings and face masks remained compulsory indoors!

It was useful to be on the ground again, to see the developments for ourselves and to meet management of companies in person. We came back feeling encouraged by the opportunities in the country. It was a productive two weeks. We had 28 meetings mostly with top management and we returned home with several potential investment candidates. We ventured out beyond the capital of Tokyo also visiting Osaka, Nagoya, Hamamatsu and even the remote city of Kagamihara. There we visited one of the main factories of our long time holding, Menicon, the leading contact lens manufacturer in Japan. Kagamihara is in the Gifu Prefecture roughly 260km west of Tokyo. The site produces its 1-day Premio contact lens which is one of its main products that drives growth and market share gains. The Menicon team included the factory manager, who extensively explained the details of the production process.

We saw the difficulty of mass producing safe to use, high quality contact lenses with a high level of automation. This factory produces close to 1 million lenses per day and operates 24 hours. It still has ample room to expand. Currently there are 8 production lines in operation and over time it can accommodate up to 15. The company learns from preceding lines to improve output for new lines. For example, the eighth line produces 40% more than the first line that was installed. Menicon expects the tenth to be 20% more productive than the latest. Moreover, the number of operating days can expand from 300 days a year to 320. Not by increasing work hours but by reducing maintenance downtime. It gives you an idea of the efficiency gains the company could enjoy.

Menicon certainly has clear structural competitive advantages that enabled a leading position and led us to invest in the first place. During our visit, however, we were able to appreciate the accumulation of small improvements that make it a formidable player. We believe this will be difficult to replicate. As a side note, we were also happy to see equipment by, Nordson, another one of our world leading portfolio companies being used in Menicon's high precision factory.



As of 31 May 2023	YTD	1-Year	3-Year[1]	5-Year[1]	Inception[1]
SilverCross Global Small-Cap TR Net	7.9%	5.9%	6.9%	11.2%	13.3%
MSCI World Small Cap TR Net	2.0%	-3.5%	10.7%	5.0%	8.4%

[1]Annualised

SilverCross Global Small-Cap Fund

Fund Details

Managers since July 2014:	David Simons & Chris Andrews
Inception date:	30 July 2014
Currency:	EURO
Share Class:	A
Management Fee:	1.15%
Total Expense Ratio:	1.40%
Minimum Investment:	100,000
ISIN code:	NL0010832242
Bloom-berg:	SCGSCFA NA

Menicon also has a factory in the Netherlands located in Emmen, where it produces Orthokeratology lenses which is another key growth driver. **On June 26th, we will organize a factory tour at the Emmen facility** and we hope to have some of our clients to visit alongside us so that we can show you first-hand where your money is invested. Please kindly contact your relationship manager if interested.

Hayato Nakayama & Chris Andrews at SilverCross Team Tour of Menicon's Kagamihara Factory

We met all our Japanese portfolio companies during this trip. We gained further insight and continued to feel encouraged by the progress and their long-term prospects. As a result of this trip, we concluded to invest in a new company which we have previously researched and followed for several years. We hope to share more details about this soon.

Cultural differences

It was just as important to remind ourselves of the cultural difference reflected both in consumer behaviour and business practices. We previously quoted Morgan Housel who said "Your personal experiences make up maybe 0.00000001% of what's happened in the world but maybe 80% of how you think the world works". What may be so 'normal' here in Western Europe often is not elsewhere. This is precisely why we find it so important to be there and experience it for ourselves. Among businesses we noted a few practices that are unique to Japan. For example, through several enterprise software companies, we learnt their relatively new-found most effective marketing channel is through TV Commercials. A founder of a leading listed enterprise software company was also initially befuddled only to reach the same conclusion. This initially seemed to us an ineffective spend of resources, but in Japan it works.

Another unique dynamic of note is the industry structure for IT engineers in Japan. Typically, many technology companies abroad hire core developers and engineers to keep them in-house. In Japan, more than 70% of graduates turn to joining IT Engineering companies commonly known as System Integrators (SIs). Often these SIs develop critical systems for clients, and this means that the expertise does not accumulate within the companies themselves but within SIs. Understanding the differences is important as it helps us understand structural differences and opportunities that may not be obvious if you base it on your home country practices.

A benefit to be away from Japan the last 4 years was that we could also clearly compare the changes in Japanese society and the things that haven't. For instance, in many places, technological adoption was generally higher. We saw digital payments were more widely adopted even among small businesses. However, we also felt there is some ways to go. There were things we felt were still inefficient but persisted due to tradition. It was common to see four people doing work that could be done by two. In our own meetings, we were often greeted by four members of the company and through the entire meeting only one would speak. We often weren't entirely sure what the others were doing. We also saw basic and tedious tasks that are often automated abroad, still done by a person and with paper. There were many more examples like this. As you can imagine, tallying up these inefficiencies, the costs can quickly compound. Put this all in the context of a country that is supposedly facing a labor shortage. One digital solution company told us that in government and municipalities, there are about 10,000 different types of workflows to be handled, most of which is manual paperwork. Of this just the top 300 cost close to 5 trillion JPY in labour costs. Even for payments, we were excited to see the progress on cashless solutions, but believe it will get even better. At train stations, where most go for their daily commute, we still couldn't use a payment card at the ticketing machine and needed cash! Yet these clear examples of inefficiencies are precisely where the opportunities lie for long-term focused investors.

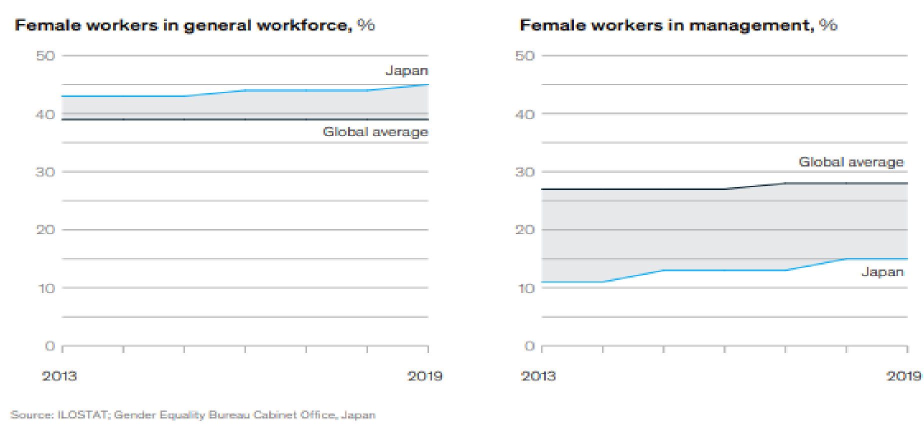
Gradually and then suddenly

We think there are 2 key opportunities. As we alluded to earlier, the first is Digitalization, more commonly known as DX. There is significant room for efficiency gains. It is also long due, and businesses are now finally revisiting their pre-existing work styles. This has become a clear focus in part thanks to analog work customs being severely disrupted by Covid. Japan is in dire need of DX as cost pressures loom thanks to the weaker yen and inflation. The urgency will continue to rise. A traditionally slow decision to change has led to a large portion of Japan still running on legacy IT systems. Japan has identified a 'digital cliff' that is impending and will come as soon as 2025. By then the labor shortage in the IT industry it is expected to double. At the same time 60% of core IT systems used by corporates would reach an average life of 21 years. In other words, Japan will need significant upgrades from these legacy systems which in turn pose a massive tailwind for scalable digital solutions.

The signs of change are there, terms like 'DX' and 'Hatarakikata Kaikaku' which means workstyle reform has entered common Japanese lexicon. Though not to the level of what we see in Europe and the U.S., we certainly experienced a marked change in the level of digital solutions being used. The Ministry of Economy, Trade and Infrastructure (METI) sees digitalization lagging the rest of the world and is now a top priority. The Government has set up a new agency called the digital agency in 2021. Their slogan? "Government as a startup''.

Payments and Healthcare is where we see a particularly large runway for this trend, and we look to benefit from it through our investment in GMO Payment Gateway and EM systems. For payments the government estimates the yearly cost to maintain infrastructure for cash payments to be 2.8 trillion Yen (20bn EUR). For healthcare, there is an additional tailwind due to the ageing population driving healthcare costs to rise meaningfully. This increases the need for efficiency. The government is subsidizing stakeholders to adopt more digital solutions for this field where EM systems is a direct beneficiary.

The second opportunity lies in improving governance and consequently shareholder friendliness. This should ultimately attract more interest from investors to the Japanese stock market, not just to listed blue-chip companies. We have seen a marked change in attitude towards ESG topics among corporates. In terms of governance, we are starting to see management increase their focus on a broader set of stakeholders and greater emphasis on shareholder value creation. Albeit still behind other markets, there has been a clear acceleration of governance activities recently. The country published its inaugural Corporate Governance Code in 2015, more than a decade after the Netherlands. The latest revision, published in 2021, encourages companies to enhance board independence, board diversity and integrate material sustainability issues into their long-term growth strategies. This transition towards growth-oriented governance centres on long-term value creation, management accountability, and constructive dialogue with shareholders.



Source: McKinsey

As a result, management teams are becoming increasingly shareholder friendly. These changes have meant that our engagement with management has become more productive and further opened the possibility for meaningful change. With the benefit of our experience engaging with European and US companies, our portfolio companies appreciate the insight we can provide. Since 2020, the average board independence ratio of our Japanese holdings has increased 5 percentage points to 47%, while the average female board representation has almost doubled from 8% to 15%. Although these figures still lag their European and US counterparts, they are noticeably higher than the average ratios in the Topix Index of 34% and 8%, respectively.

We consider this to be notable progress in a market where homogenous management teams, in terms of race, age and gender, have been the norm. Initiatives to encourage better governance and wider sustainability issues are beginning to be implemented by multiple stakeholders. Last year, the Tokyo Stock Exchange (TSE) reorganized listings into three new segments - Prime, Standard and Growth. To be included in the new Prime market, the most coveted of the three segments, companies will have to meet a number of criteria. Most notably, companies will need to adhere (on a comply-or-explain basis) to the revised Governance Code. Companies that fail to meet the TSE's updated standards will have until 2026 to comply or be de-listed.

So far, we have observed gradual positive changes, but this could accelerate at a much faster rate going forward. A key feature of Japanese society is its collectivist culture. People tend to operate more cohesively compared to 'individualistic' societies. Whilst the decision to change can be frustratingly slow, we have observed that the change itself happens extremely quickly. For instance, the Japanese government's decision to roll out Covid-19 vaccine mandates were slow compared to other countries yet the speed at which it was administered to the population was much faster. We have seen a similar phenomenon in the equity markets as well. Just 4 years ago, the management of companies we met did not even know what ESG or SDGs meant. Yet today, almost all companies now have investor presentations with slides dedicated to these topics and would proactively engage in them.

Conclusion

The top-down view often discourages foreign investors to invest in Japan. Whether this is due to the lack of familiarity, language barrier, ageing population, lack of economic growth or shortage of labor. Whilst these points are not unfounded many see the danger of investing there as a result and at times misunderstand what is happening.

Many see Japan as the country with an ageing demographic and shrinking population. The popular term 'Japanification' is not without reason, yet this is not something unique to Japan but increasingly global. It is reported the fertility rate of Japan is now higher than neighboring nations like China, South Korea and Taiwan. Another challenge that others often cite is the labor shortage. What most don't realize is that between 1995 to 2015 part time employment expanded from 20% to 40% of total employment. Since, we have seen an inflection in full-time employment which has been on the rise, a sign of re-allocation of human resources to more critical and higher value-add jobs. Moreover, changes in immigration policy led to an increase in foreign workers, doubling since 2015. We saw this ourselves, in our recent visit we encountered noticeably more foreign workers.

It is also argued the economy is stagnant and has limited growth prospects. Yet as we discussed, we see areas where we expect a massive long-term growth opportunity, mainly to solve some of the major inefficiencies that continue to plague Japan. This opportunity set is expanding as governance further nudges excellent businesses to also be excellent stocks, that is, by being more shareholder friendly.

Taking a step back, it is worth remembering that Japan remains the 3rd most populated developed country in the world and 3rd largest country by GDP. It has the 3rd largest stock market in the world with close to 3800 listed companies and growing. This represents a market capitalization totaling 740 trillion JPY (5.3 trillion EUR). Simply due to the large number of stocks, it follows that statistically, it is highly probable for there to be attractive investment opportunities. Yet currently 46% of stocks in the TOPIX are not covered by an analyst, in other words a large portion of investment opportunities are waiting to be discovered.

In Japanese the word for danger is "KiKi" written with 2 letters as 危機. The first letter signifies danger but the second signifies opportunity. It's an apt way to describe the reality. We very much feel the 'opportunity' part is overlooked and especially for long term quality focused investors, we are excited about the investment opportunity the region can bring and the prospects for our five existing SilverCross Japanese holdings. Our knowledge of the Japanese market continues to deepen and with it we expand our list of high-quality companies we follow. We look forward to sharing more ideas from Japan in the future.

SilverCross Global Small-Cap Fund

About the author

Hayato Nakayama is an investment analyst at SilverCross Global Small-Cap Fund. SilverCross is an asset manager based in Amsterdam, The Netherlands. It is focused on managing a high-conviction global small-cap equity portfolio.

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