February 2021

# Views from the Japan Equities Small Cap Desk

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*"Japan set out a course for vehicle electrification"*

## Why Toyota Group's earnings could surpass the pre-pandemic level

When I look at earnings results for the October-to-December quarter which have been released by all the domestic companies by now, I noticed that a string of companies, especially manufacturers, have achieved strong performances. I can think of two reasons below. While coronavirus-induced economic shocks started to ease off first in China, then in other countries, each company maintains its cost-saving measures including emergency policies.

In particular, the recovery in the auto industry has been outstanding. The coronavirus pandemic seems to have rather spurred on auto demand given a sharp recovery in auto sales in many countries once social-mobility restrictions were loosened.

Earnings improvements by **Toyota Motor** and its affiliated parts makers were eye-openers. Operating profit margins for the latest quarter hit 10%, an unprecedented level in the auto/ auto parts industry, at a number of makers.

Toyota group companies could enjoy strong earnings because they achieved a relatively early sales recovery relative to the industry. Toyota could do so because it is rapidly expanding its market share in China where the auto market picked up first by using its hybrid technology while enjoying strong sales in its flagship vehicle, the RAV4, regardless of the pandemic. In addition, Toyota could continue its production with less trouble in sourcing parts than US or European peers.

Furthermore, parts makers reviewed their cost structures during the latest coronavirus crisis after making upfront investments in overseas expansion by setting up overseas bases or vehicle electrification by increasing their research and development, which boosted their profitability. While costs might have declined only due to temporary factors such as the emergency cost-cutting plans and a decrease in business trips following the spread of the coronavirus with a possibility to turn up again as the infection abates, parts makers shouldn't allocate a budget for unnecessary spending that was exposed through the crisis response any more.

The strength of these auto/ auto parts makers is likely to continue in the FY2021. The biggest risk factor in the short term is the chip shortage. Slightly increased demand and supply bottlenecks in the chip market led to a supply crunch because chip makers, excluding those from China, have been reluctant to invest in cheaper general-purpose chips for a few years. I heard that it takes more than six months to receive some types of chips after placing orders if they newly negotiate an additional business deal. However, Toyota is likely to limit damage from this problem better than its peers by taking advantage of its ability to respond quickly and using its advanced bargaining power.

The tricky task for the traditional auto industry in the mid-/long-term is vehicle electrification and de-carbonisation. Europe pulls ahead of other regions in restrictions on internal combustion engine vehicles, but Japan set out a course for vehicle electrification following the regime change last year and the US is also expected to introduce bold environmental policies thanks to a change of government. This trend will continue for sure despite some possible revisions.

Toyota hasn't showed its presence yet in the narrowly defined electric vehicle (EV) market. While **Tesla** has an overwhelmingly strong presence as a maker of EVs that use only stored electricity, the US maker is so unique in various aspects that it is unlikely to hold supremacy in the low-end car market.

Although Toyota doesn't have a presence as a completed EV maker, it is actively engaged in research and development of basic technology for EVs. In particular, Toyota is at the forefront of development of fully solid-state batteries that are safer than others in that they contain no organic solvents.

On the other hand, Toyota has a predominant track record in hybrid cars (HVs) that are powered mainly by gasoline with battery-powered motors as a complement. It seems unrealistic to remove all the CO2 emission at a stroke by promoting EVs, so I think HVs should be the most realistic tool to achieve CO2 emission reduction targets at the current pace.

Toyota is also a worldwide leader in the technology for fuel cell vehicles (FCVs) that use hydrogen as a fuel. I think as an amateur that the FCV is the most appropriate answer to cover the needs of long-distance buses/ trucks with natural energy because it is easier to set up a refueling infrastructure for them than for passenger cars.

**Source: Based on an article by Tatsuro NIGAURI, published in The Nikkei Online Edition on 27 February 2021.**

## About Tatsuro NIGAURI, CMA

Mr Tatsuro Nigauri is a Japanese small-cap equities manager with three decades of experience managing money based in Tokyo. He joined the firm in October 2002 and has managed the Japan Equity Small Cap Absolute Value strategy since its inception in 2004 and the UCITS funds since their launch in 2017.

He started his career as a research analyst at the Daiwa Institute of Research in 1991. Mr Nigauri is an award-winning manager and has received many accolades, including the Lipper Fund Awards Japan (2012, 2013 and 2016), the R&I (Rating and Investment Information) Fund Awards (consecutive years from 2012-2019) and the J Money Fund Awards (2016 and 2017). He obtained a BA degree in economics from the University of Tokyo in Japan, and is a Certified Member Analyst of the Security Analysts Association of Japan.

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