

Views from the Japan Equities Small Cap Desk

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The Potential of Home Improvement Stores

My investment strategy is all about Value, so I often take a backseat to the trends of the stock market. Since 2018, we have increased the proportion of automobile and steel-related companies in our portfolio as a response to the sell-off of manufacturing related stocks due to concerns about US-China frictions. In reality, the negative impacts from the US-China frictions seem to have been limited, but the strategy wasn't successful last year, in part because of the subsequent coronavirus outbreak.

However, the market finally changed at the beginning of this year. With the advance of COVID-19 vaccinations in Europe and the United States, undervalued stocks related to the manufacturing industry have been reviewed and stock prices have bottomed out. The review of these undervalued stocks started with large-cap stocks, and the effect has not yet fully spread to the medium and small-cap stocks of which I invest in. However, I believe that there is a high possibility that the review of these stocks will continue with the next announcement of financial results and other materials.

Accordingly, my investment policy will remain unchanged, with a focus on low-cost manufacturing stocks. However, there is a group of stocks which have benefited from the increase in 'stay-at-home consumption' during the coronavirus pandemic and have seen prices rise.

Specifically, companies that sell daily necessities and housing-related products, such as internet retailers, supermarkets and home improvement stores.

Code	Company name	Sales (billion yen)	y/y (%)	Net income	y/y (%)	Business
3050	DCM Holdings Co Ltd	471.1	8	18.5	35	A large retail chain with underlying brands such as Carma, Daiki, Homack, etc.
7516	Kohnan Shoji Co Ltd	442.0	18	18.6	58	Although it is based in Kansai, it actively opens stores in the Kanto and Tokai regions.
8218	Komeri Co Ltd	378.0	8	16.9	42	Unique approach targeting farmers.
2790	Nafco Co Ltd	238.0	9	12.1	140	Originally furniture stores and strong in interior design.
9842	Arcland Sakamoto Co Ltd	178.4	63	8.7	80	Acquired 'Viva Home' from LIXIL in 2020.
3546	Alleanza Holdings Co Ltd	157.4	14	5.1	170	A retail chain with sub brands such as Daiyu eight, Time in the Chugoku/Shikoku region, etc.

Source: SMDAM, Financial results up to February 2021.

I decided to pay special attention to home improvement stores. In the case of internet retail companies, even though stock prices have adjusted, they still largely reflect growth potential. As for supermarkets, I believe that the majority of companies are valued at a reasonable PER (price-earnings ratio) that excludes the effects of the current special levels of demand. On the other hand, most home improvement stores have been undervalued since before the coronavirus outbreak, and although they were revalued, their stock prices are now down again.

In March and April of 2020, demand for daily necessities at home improvement stores began to rise. After the first state-of-emergency was lifted, there was less reluctance to visit stores, but interest in the comfort of homes grew due to the prolonged stay-at-home period, and demand expanded in a wide range of fields, including furniture, DIY products, home appliances, gardening and pet-related products.

On the other hand, stock prices rebounded sharply in April last year after falling from February to March. After that, however, prices started to adjust in anticipation of a reaction to this special demand, and some stocks have been pushed back to levels close to those in 2019.

The growth rate announced by each company in March this year compared to the same month of the previous year has generally slowed significantly. From April to June, most companies will probably be down from the previous year. Most of the earnings forecasts for fiscal year 2021, which are currently being announced, are expected to show either a decline or small increase in profit. But you would imagine that has already been factored into the stock price. Rather, I think the key point to pay attention to is the extent of improvement compared to the results of the previous fiscal year.

Stock prices of the 3 major listed home improvement stores



Source: Bloomberg. Data from 31 Dec 2019 up to 29 April 2021.

Many people who have now become aware of the practice of improving their homes using their own two hands are likely to continue with their changed lifestyles even if restrictions on going out are eased. Luckily, this spring was sunny all over Japan, and it was a good time to start gardening and planting flowers. Also, some people who haven't used DIY products in a long time may want to upgrade to better tools.

Home improvement stores are a "suburban" type of business that has relatively low importance in urban areas with low ratios of detached houses and limited living spaces. Many young people in urban areas have shopped at home improvement stores for the first time since the outbreak. If even some of them become established as customers, the lifespan of the business will greatly increase.

In equity investment, it is important to predict the direction of business performance, but I think it is wrong to focus too much on changes in growth rates and avoid undervalued companies. The timing of when the decline in profits reacts to the special level of demand becomes apparent to everyone is a good opportunity for investment.

Increasingly attractive to purchase due to the rise of stay-at-home consumption:

In the home improvement stores industry, where the number of stores is directly linked to profitability, mergers and acquisitions are also very active. In June 2020, **Arcland Sakamoto**, a mid-sized listed company that operates **Home Centre Musashi** that is mostly located on the east coast around Niigata Prefecture, announced that it will acquire a subsidiary home improvement store, **LIXIL Viva** (currently **Viva Home**) from **LIXIL** (5938).

The takeover bid (TOB) price was 2600 yen, which was about 30% higher than the average stock price for the 3 months prior to the announcement of the TOB. The TOB was completed and LIXIL Viva became a wholly owned subsidiary in November of the same year. With the acquisition, LIXIL Viva expanded its store network to include the Tokyo metropolitan area, Hokkaido and Kyushu.

Kohnan Shoji acquired as a subsidiary **Pan Pacific International Holdings**, which operates **Don Quijote** and others, and **DOIT** (Saitama city) **Home Centre Reform** in February 2020. DOIT has a strong selection of building materials and operated 16 stores mainly in the Tokyo metropolitan area. The Kansai-based Kohnan Shoji aims to expand its business in the Tokyo metropolitan area through the acquisition.

According to the **Japan DIY Home Dealers Association** (Chiyoda, Tokyo), the total sales for home improvement stores in 2020 (January to December) was 2830.9 billion yen for the 33 companies included in the calculation, and the sales compared to the previous year increased for all stores and 33 existing stores. It seems that the demand for goods due to hoarding and stay-at-home consumption under the pandemic pushed up sales.

Over the past year, the environment surrounding the home improvement store industry has changed in response to major changes in consumers' lifestyles, such as spending more time at home and in the surrounding areas before travelling long distances. An industry with high sales growth potential is an attractive target for mergers and acquisition.

Source: Based on an article by Tatsuro NIGAURI, published in The Nikkei Online Edition on 24 April 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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NOTES:

† Source: SMDAM, as at 31 December 2020.

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