

Views from the Japan Equities Small Cap Desk

Author



Tatsuro NIGARI, CMA
Senior Portfolio Manager

Undervalued Public Works Related Stocks

Since 2018, in the growth-stock dominated market, my basic strategy has been to invest in cheap stocks and I have been having a relatively hard time. But this year I have been finally able to outperform the small-cap stock market as a whole. This is due to the fact that the global spread of coronavirus has been halted by vaccinations, the overall economy is expected to recover and the recently unpopular, undervalued manufacturing industry stocks are gaining attention.

In particular, the end of March financial results for fiscal year 2021 announced last month exceeded expectations due to a rapid recovery in automobile demand. The stock market has also generally reacted favourably to stocks which reported good financial results and is rising.

In particular, it appears that small cap stocks are still undervalued in the manufacturing sector, even though their stock price have risen due to good financial results. Due to the market being dominated by growth stocks for the past three years, there has been just a slight rise from the very low level the stocks prices were at before. However, in terms of balance, I think we should also pay attention to companies that are not benefitting from the economic recovery.

The current global economy is being supported by national fiscal spending to combat the coronavirus. If this pandemic ends, the economy recovers and the US dollar interest rate rises, the global flow of money will change drastically.

On the other hand, even if the vaccination roll-out progresses, the risk of the infection spreading again due to an outbreak of a variant is not zero. In any case, I think it is dangerous to bet only on the economic recovery.

Regarding this, my last column [\[here for link\]](#) was about the home improvement store industry. In this article, I will focus on another industry that has been undervalued but left unnoticed, the construction industry with its high proportion of public works (government infrastructure) projects.

In recent years, the profitability of companies who are engaged in public sector projects has improved significantly due to the easing of excessive competition. In the previous fiscal year, even though there were different trends between companies, overall a high level of profit was recorded.

Although most companies forecast a decline in earnings for the current fiscal year, we believe that overall we will be able to maintain a high level of performance in this industry, which tends to make conservative announcements.

Historically, the 1990s was a time when public works were bloated. As an economic measure against the bursting of the bubble economy, construction bonds (government bonds issued for the purpose of construction/public works) were issued and various facilities and infrastructure were built in local areas. I started to follow and support volleyball in the mid-90s, and I remember that at that time, shiny roads were built all over the country and grand gymnasiums were opened and tournaments held many times each season.

However, in the 2000s, the budget for public works started to shrink in response to the expansion of social security expenses. Under the slogan "from concrete to people," the Democratic Party of Japan (DPJ) administration, which was inaugurated in 2009, continued to reduce the budget for public works projects despite the recession, and related industries were severely damaged.

The trend changed again in 2012 when the Abe administration was inaugurated. In order to maintain infrastructure over the long term, policies were changed to ensure that related industries also had the profits necessary for upkeep and renewal construction work, and each company's performance gradually improved.

However, the current public works budget is still small compared to the 1990s. What's more, it's focused on maintaining and renewing what was once built, and it doesn't mean that more and more facilities and infrastructure are being built with questionable needs. In the future, even if fiscal discipline becomes very popular once again, the budget for public works will not be significantly reduced.

An emerging area where maintenance and renewal is most needed is national highways. Expressways that have been maintained since the 1960s have begun to deteriorate, and there is a need to carry out large-scale, long-term maintenance and renewal work in the future.

In bridge sections of the expressways, there are not many cases where replacement is needed, but it is necessary to replace the floor slabs that support the pavement once every 10 years. In the past few years, professional operators have established techniques to quickly replace slabs while minimizing road closures, and scheduled upgrades have begun.

As for roads, pavements are also an area where stable renewal work can be expected. Profitability has recovered significantly as the number of unprofitable bids have decreased. In the previous fiscal year, the decline in the price of asphalt, contributed to record profits for each company. As might be expected, the profit for this quarter will decrease due to the rise in crude oil price, but the stock price is generally cheap even when calculated based on this quarter's forecast.

Speaking of a highly specialized field, I cannot forget the field of marine engineering. In order to maintain ports and harbours, dedicated equipment such as dredgers and skilled operators are required. This is an area where excessive competition is not likely to occur.

In particular, construction of offshore wind power stations will attract attention in the future. Construction of a tower on the seafloor after foundation work is done, and the installation of windmills and generators on top of the tower is a difficult task. In Japan, where typhoons and earthquakes frequently occur, this is an area where the power of specialized contractors becomes evident.

In addition, prior to the construction of the power station, it is necessary to first assemble the equipment and develop a base port for loading it onto a dedicated ship, and construction will only proceed with total mobilization of contractors who don't work on the power station construction itself.

It doesn't require as much expertise as bridges, paving or marine engineering, but we need to pay attention to companies that were once referred to as mid-size contractors.

Most of these companies were exposed to the reduction in public works budgets before the damage from the bubble burst had healed and went through bankruptcy and private consolidation to rebalance at a reduced level. However, since these companies were once second only to the five major general contractors, they have high added value in the construction fields.

Activist funds, or so-called activist investors, are said to be increasing their investment in these companies. These companies have improved their profitability by narrowing down the field of construction work, and their financial positions have become healthier than ever before.

If their activities result in dividend increases or share buybacks, it would be welcome to our shareholders.

Source: Based on an article by Tatsuro NIGAURI, published in The Nikkei Online Edition on 21 June 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.

For more information contact:

Business Development and Client Relations

Junya OKADA +44 (0)7534 060 236

Jennifer SANDS +44 (0)7534 060 362

Marius ERIKSEN +44 (0)7534 058 983

Email: uksales@smd-am.co.jp

Sumitomo Mitsui DS Asset Management (UK) Limited
 5 King William Street, London, EC4N 7DA
 United Kingdom
www.smd-am.co.uk

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NOTES:

† Source: SMDAM, as at 31 March 2021.

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