

Views from the Japan Equities Small Cap Desk

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“...there are some industries clearly far more profitable than they were at any time before the pandemic”

Unprecedented positive results for metal recycling

Amid the spread of coronavirus, business performance has been polarised. Businesses related to experiences, such as restaurants and tourist sites, have suffered on the one hand, while industries related to goods, centred around the manufacturing industry, are thriving thanks to global economic measures and stay-at-home spending.

If we look back over the most recent quarter, the profit growth compared to the same period in the previous year is particularly large. A key reason for this is that we are comparing with the start of the first wave of the pandemic when COVID-19 anxieties were at their peak, as such we shouldn't take this at face value. However, there are some industries clearly far more profitable than they were at any time before the pandemic.

Metal recycling industry stock prices far exceed the Nikkei average



Note: 2020 year end base value of 100

The container shipping industry is one example of this growth. In addition to greater demand for goods, the global supply and demand for tonnage suddenly tightened as distribution routes became longer due to changes in production sites and port closures brought on by the coronavirus pandemic. As a result, freight rates have risen to unprecedented levels, and there is no telling when they will readjust.

Japan's three major shipping companies have integrated their container shipping divisions and are using equity to capture profits, but the contribution of these companies far exceeds that of the main companies, which are also doing well.

Scrap dealers go public and profits soar

On the other hand, in the world of small-cap stocks that I am involved in, there is no industry in which the impact of rising market prices can be booked as profit. However, metal recycling companies are the one group that stands out as comparable and whose listings are gradually increasing in number.

The most typical representative of this industry would be the scrap dealer, which accepts construction waste materials and scrap automobiles. They separate out valuable materials, mainly steel scrap, reduce the volume of the remaining parts and dispose of it appropriately. It's an old industry that could not utilise the stock market in the past, despite being a capital-intensive business, as it had no listed companies.

However, in recent years, as a result of corporate restructuring and management transparency, three companies are now listed on the stock market: Envipro Holdings, Ibokin, and Rever Holdings (joint holding company, TRE Holdings (9247), was listed on 1 October following a merger with Takeei).

Looking at the operating profits of each of these companies for the April-June period, they all posted profits for the quarter alone equivalent to about 80% to 90% of their record annual profits. Although the amount of money paid to those who bring in all kinds of metal waste has also gone up, the rise in the price of steel scrap and other valuable materials is thought to far exceed this increase.

As for non-ferrous metals, there are recycling companies that specialise in specific metals. Daiki Aluminium is a secondary alloy business that procures aluminium scrap from all over the world, melts it and adjusts its composition in Japan and other Asian countries, and supplies it to foundries. They also achieved a quarterly operating profit equivalent to about two-thirds its record profits.

Metal recycling industry approach past record high profits					
	Sales (billion yen)	y/y (%)	Operating profit (billion yen)	y/y	Growth ratio (%)
Envipro	140	114	8.8	return to profit	88
Ibokin	22	76	2.66	48	81
Rever	112	74	12.94	1649	93
Daiki Aluminium	495	74	55.21	334	68
Kurotani	160	60	13.06	return to profit	54
Matsuda Sangyo	701	31	41.89	156	46
Furuya Metal	111	76	44.06	333	95

Note: Results for Apr-Jun '21, ratio based on highest profit for full year to date.

In Toyama Prefecture, a region famous for its copperware since the Edo period, Kurotani Corporation, who recycle copper and other metals, just achieved a quarterly profit of just over half of its all-time high. While Matsuda Sangyo, which extracts gold and platinum from used industrial materials and jewellery purchased by second-hand dealers, also posted a profit of just under half of its all-time high.

Although not a scrap dealer, Furuya Metal provides materials and equipment made from platinum group noble metals to electronics manufacturers, and collects used products for recycling. The company also reported a quarterly profit that was equal to its highest ever annual profit.

Investment in efficiency progresses with growth in scale of business

The main factor contributing to these companies' strong performance is the rising metals market, backed by a booming global manufacturing industry, which is not necessarily stable. Even if market conditions remain high going forward, margins will eventually narrow due to higher recovery prices, and if they fall back, profits will be greatly reduced, even if only temporarily.

However, we cannot ignore the fact that the strong business performance is partly due to the corporate efforts of each company, such as improving the efficiency of their processing and expanding procurement routes. In particular, scrap dealers are now able to make aggressive capital investments as a result of their increased financial strength due to corporate restructuring and stock listings. As well as being highly efficient, the new processing machines have also improved worker safety, which is considered significant not only in terms of profit, but also from a social perspective.

In addition, the expansion of procurement routes is the most important management issues for recyclers. Metal ingots are versatile and can be sold to anyone as long as the quality and price are commensurate with a new product.

However, when it comes to procuring scrap metal, it depends on a complex and long value chain that includes dismantlers, waste collectors, processors, and trading companies, so establishing a purchase route requires persistent efforts in many different directions.

Procurement network for scrap metals influencing growth

I think the company that is ahead of the game in this area is Daiki Aluminium Industry. For decades, the company has been expanding its procurement channels in emerging countries such as Russia and Africa. In these countries, the use of automobiles and other industrial goods has been expanding in line with economic growth, but the machinery industry has not developed domestically to meet this demand. Therefore, they rely on imports for products, while exporting scrap to industrial countries such as Japan and other Asian countries. The company has taken advantage of this trend and has built a global procurement network by being involved in the upstream as much as possible.



Daiki Aluminium Industry has established a procurement network for waste Metals, including Russia and countries in Africa (from the company's website).

By developing a global procurement network, it will be possible to supply each lot of scrap to the most appropriate plant at each point in time. Diversifying the procurement network will also help reduce the time and cost associated with adjusting the components.

Metal recycling is also a highly significant business from an environmental perspective. Mining ore is generally an environmentally hazardous activity, and refining metal requires large amounts of energy, so it is important to recycle as much as possible. I don't think there is any need to glorify this business as it has pure economic value, but if we can increase the recovery rate through capital investment and technological advancement, it would make a fantastic contribution to society.

Source: Based on an article by Tatsuro NIGAURI, published in The Nikkei Online Edition on 12 October 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 March 2021.

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