DOMESTIC DISRUPTORS: FOR SOME JAPANESE COMPANIES, BREAKING WITH CUSTOM OFFERS A RARE PATH TO GROWTH

By emphasing efficiency over tradition, ABC-Mart and MonotaRO have achieved high growth despite Japan's stagnant economy.

January 2018

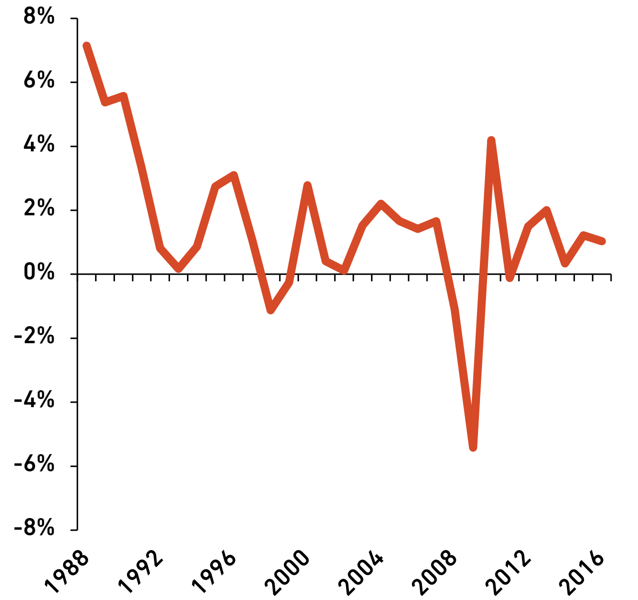
KEY TAKEAWAYS

- Despite nearly three decades of low growth in Japan, some domestic businesses have flourished by disrupting their industries and taking market share from competitors. The key to their success: introducing efficiencies into Japan's tradition-bound industries.
- ABC-Mart has shaken up Japan's highly stratified footwear industry by integrating vertically, creating efficiencies that allow it to sell popular shoe brands profitably at a discount. ABC-Mart is now the largest shoe retailer in Japan.
- MonotaRO, a wholesaler of industrial supplies such as protective glasses, disposable gloves, and dust masks, is challenging the traveling salesman model of wholesaling by introducing online ordering and its inherent pricing transparency. The firm's lower prices have allowed it to take sales from less-efficient competitors.
- Are these companies at the vanguard of a new Japanese dynamism, or just outliers? Though the answer is not yet clear, examples like these present investment opportunities—if identified early.

Japan has endured nearly three decades of low economic growth and a stock market that remains roughly 40% below its 1989 high-water mark. Though President Shinzō Abe's fiscal reforms and the Bank of Japan's aggressive monetary policies have had modest success in reviving the economy, GDP growth averaged just 1.2% in the five years since Abe came to power in 2012. One reason is Japan's aging and shrinking population. The elderly tend to consume less than younger people, while the shrinking population diminishes economic output. Add nagging deflation fears and the highest level of government debt to GDP of any developed country and it can be hard to draw a convincing turnaround narrative for the world's third-largest economy despite recent green shoots.

Yet in corporate Japan not all is bleak. Many Japanese companies have prospered during its "lost decades" by exporting products or production to faster-growing markets. A few have taken a more difficult path to prosperity by disrupting their domestic markets, which typically requires eschewing time-honored business customs.

JAPAN GDP GROWTH RATE, 1988-2016



SOURCE: WORLD BANK

Though domestic disruptors are easy to find around the world, they are far less common in Japan, in part due to the island-nation's customs and culture. For one, the Japanese have long cherished conformity over individualism, creating an environment not generally conducive to entrepreneurship. There's even a local proverb that the Japanese like to hammer the nails that stick out in their midst—not-so-subtle advice for would-be disruptors. Additionally, Japanese business practices are still heavily characterized by long-standing personal relationships, family ties, and customs, creating strong cultural resistance to change. A third impediment is the risk aversion that permeates Japan's business culture, a disposition reinforced in recent decades by the inauspicious, low-growth business environment.

While genuine disruptors may be few and far between in Japan, when they do arise they represent opportunities for adroit investors. The two examples that follow were chosen by Harding Loevner Japan Analyst Yoko Sakai, CFA to illustrate how, by paving a path of efficiency through Japan's traditional business arrangements, domestic disruptors can achieve high growth amidst the nation's continued economic malaise.

HOW ABC-MART DISRUPTED THE FOOTWEAR INDUSTRY

Footwear distribution in Japan, as in many countries, has historically been multi-tiered. Shoe brands sold their products to wholesalers, which were then sold down the chain to regional distributors, eventually reaching retail stores and the consumer. In fact, even today there are sometimes three or more intermediaries between shoemakers and retailers, each surviving on thin profit margins.

Into this competitive landscape stepped Masahiro Miki and his wholesale footwear and apparel business, Kokusai Boeki Shoji, which he established in 1985. As the business expanded, Miki saw an opportunity to disrupt the growing Japanese casual footwear industry—which he viewed as a particularly uncompetitive component of the broader apparel sector—through vertical integration.

SHOPPERS BROWSE INSIDE AN ABC-MART LOCATION IN TOKYO, JAPAN.

SOURCE: DICK THOMAS JOHNSON; LICENSE: CC BY 2.0

In 1990, the company rebranded itself as ABC-Mart and opened four retail stores focused on athletic shoes, yet continued serving other retailers—its new competitors—as a wholesaler. In 2002, however, it ended those relationships and began supplying its own stores exclusively, further escalating competition with its now-former retail clients. Miki oversaw this expansion into retail personally as well as professionally—the CEO worked alongside his store employees on weekends.

By operating at multiple levels of the supply chain and side-stepping middlemen, the integrated company was able to cut costs and provide lower prices to shoppers, capturing more layers of profit margin. The shoe seller also adopted point-of-sale IT systems many years before other retailers, which enabled it to keep close track of product sales across its expanding store network and thereby manage inventory with greater precision. This investment allowed ABC-Mart to capitalize on nascent trends faster than rivals and maintain "fresh" storefronts, while also helping reduce capital tied up on slow-moving stock.

The acquisition of exclusive distribution rights to popular foreign brands such as Vans and Hawkins helped generate store traffic, as did trademark deals that allowed the company to design and sell shoes under popular Western brand names tailored for the Japanese market. Shoe stores competing within ABC-Mart's growing geographic footprint could not match the chain's low prices, product range, and greater operating efficiency. ABC-Mart became the Number One shoe retailer in Japan in 2012 and now operates over 1,100 footwear stores in Japan, South Korea, and Taiwan.

MONOTARO UPENDS INDUSTRIAL SUPPLIES SALES

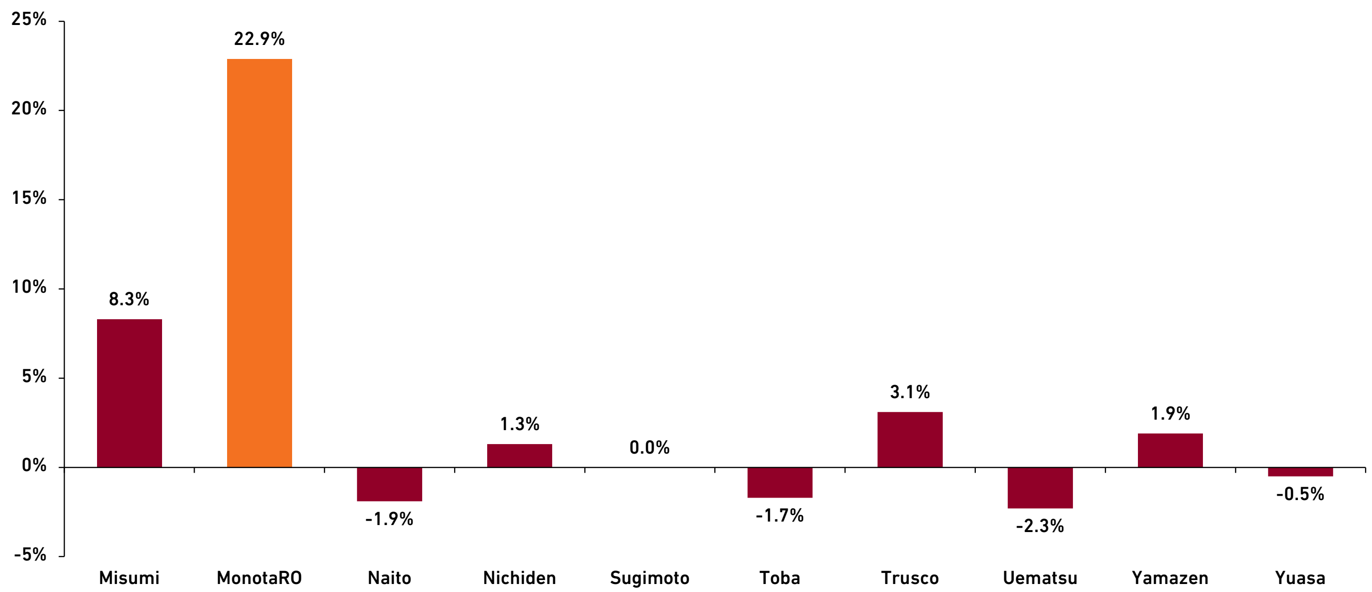
For decades, car repair shops, construction companies, and manufacturers relied on traveling salesmen to provide them industrial supplies such as protective glasses, disposable gloves, and hand tools, collectively known as maintenance, repair, and operations (MRO) goods. Competition among MRO wholesalers who operated these traveling sales teams was traditionally low, with each usually tending to its own region. As a result, the typical small- or medium-sized business customer had little opportunity to comparison shop and scant bargaining power over its MRO supplier. Given the information asymmetries, product pricing was ad-hoc—the salesman who relied on his relationships and "personal touch" to make sales would charge whatever he could get away with.

Sensing an opportunity to improve on this relationship-based sales model, Sumitomo, one of Japan's largest conglomerates, founded MonotaRO in 2000 in a joint venture with Grainger, the US MRO market leader. MonotaRO's innovation was to introduce transparent pricing through an online sales platform. As the online model obviated expenditure on sales teams, MonotaRO's lower operating costs allowed it to undercut traditional rivals.

MonotaRO's online approach was not without pushback. When the company started selling online, the firm, wanting to present itself as a "one-stop shop" of sorts, sought a broad product range to differentiate itself from their offline competitors. As MonotaRO was not large enough to negotiate low prices from manufacturers, it needed to purchase stock from rival MRO wholesalers. Recognizing the threat MonotaRO's new approach presented to their industry, many wholesalers refused to sell to their new rival. Moreover, Zenkikouren, a national association of tool wholesalers, pressured manufacturers to refrain from selling to the new e-commerce company. The young firm had to threaten legal action before the wholesaler association backed down.

MonotaRO's business eventually grew large enough that it could bargain with suppliers from a position of strength and pass savings to customers. Over time, small-business customers started to gravitate toward MonotaRO's low and consistent prices as well as the convenience of ordering supplies

MONOTARO'S REVENUES OUTSTRIP MRO PEERS: COMPOUND ANNUAL GROWTH RATE, 2007-2016



SOURCE: COMPANY FINANCIAL FILINGS AND INVESTOR RELATIONS MATERIALS online when needed, breaking relationships with their former MRO sales representatives in the process. MonotaRO now has more than two million online business customers.

Even as other MRO wholesalers such as Misumi and Trusco introduced their own e-commerce platforms, MonotaRO's sales rose at a 23% compound annual growth rate from 2007-2016, far outstripping its larger competitors. As e-commerce still only represents roughly 10% of total MRO sales in Japan, the firm has ample runway for future growth.

IS DYNAMISM RISING IN JAPAN?

ABC-Mart and MonotaRO broke with long-standing traditions and succeeded, but it remains to be seen whether they, and other successful domestic disruptors, represent the vanguard of a more dynamic economy or are simply outliers. To be sure, tradition still holds sway in many of Japan's largest industries, where long-fostered personal relationships and ingrained customs continue to underlie many business arrangements. Still, ever-growing global trade and a never-ending stream of new ideas from the internet could undermine Japan's traditional business practices over time.

The Japanese may eventually grow more comfortable with the odd nail sticking out in their midst—and perhaps one day embrace disruptors rather than hammer them down. Until they do, outliers that dare to innovate in traditional-yet-inefficient industries will continue to present rare opportunities for investors who take the time to understand the organization of Japanese business and have the skill to recognize incipient change.

CONTRIBUTORS

Harding Loevner Analyst Yoko Sakai contributed research and viewpoints to this article.

DISCLOSURES

The "Fundamental Thinking" series presents the perspectives of Harding Loevner's analysts on a range of investment topics, highlighting our fundamental research and providing insight into how we approach quality growth investing. For more detailed information regarding particular investment strategies, please visit our website, www.hardingloevner.com. Any statements made by employees of Harding Loevner are solely their own and do not necessarily express or relate to the views or opinions of Harding Loevner.

Any discussion of specific securities is not a recommendation to purchase or sell a particular security. Non-performance based criteria have been used to select the securities identified. It should not be assumed that investment in the securities identified has been or will be profitable. To request a complete list of holdings for the past year, please contact Harding Loevner.

There is no guarantee that any investment strategy will meet its objective. Past performance does not guarantee future results.

400 CROSSING BLVD, FOURTH FLOOR • BRIDGEWATER, NJ 08807
T (908)218-7900 • F (908)218-1915 • HARDINGLOEVNER.COM