

March 1, 2019

Dear clients and colleagues,

This week we attended the SMBC Nikko Japan Conference in Tokyo. Over 230 companies and 250 investors participated. Sentiments seemed more positive than last December when we attended the Nomura Conference. Not all sectors are exposed to the same level of risk from a global economic slowdown. Exporters, which were obviously negatively affected last year, are now talking about possible order recovery in late 2019. However, some other industries remain resilient, Technology, Health Care and Infrastructure for example.

Technology terms such as IoT, big data, artificial intelligence (AI) and robot are often heard during our meetings with companies around the world. In 2016, Japan had already launched a vision for a “super-smart society” called Society 5.0, aimed at creating a society where various social challenges could be resolved by incorporating technology innovations. The following industries are expected to see major changes.

- **Health Care** - We all know that Japan is facing the serious problem of an aging population ahead of other developed countries. Technology solutions are being developed to connect and share medical records to enable remote medical care services and to use AI and robots at nursing care facilities.
- **Mobility** – Under-populated rural areas lack access to public transportation. One solution could be to use autonomous driving taxis and buses. Similarly, to counter the driver shortage caused by the fast growing e-commerce segment, a single-driver cargo truck convoy could use an unmanned-following-vehicle system and drones to improve distribution and logistics.
- **Infrastructure** – A significant portion of Japan’s public infrastructure was built decades ago and has deteriorated. Labour shortages add to the cost of inspection and maintenance. Sensors, AI and robots will be used to inspect and maintain roads, bridges, tunnels and dams.
- **FinTech** – A large percentage of Japanese financial transactions are still conducted in cash and the use of IT by companies is limited. Possible solutions are to use blockchain technology for money transfers, to introduce open application programming interfaces (API) to FinTech firms and banks and to promote cashless payments.

This week we’d like to profile a core holding of our portfolio – Internet Initiative Japan (IIJ). As the name suggests, it is Japan’s first internet service provider (ISP). We have met with the company many times in the past and again this week. Management expects high single-digit sales growth in the next few years with potential margin expansion.

Internet Initiative Japan (3774 JP)

www.ij.ad.jp

Business Overview

Founded in 1992, IJ is Japan's leading internet infrastructure provider, offering Internet connections, hosting, outsourcing, wide-area-network (WAN) services along with system integration services. More than 80% of its revenues are recurring. IJ has the largest market share in public cloud services and is also the number one player in the mobile virtual network operator (MVNO) market in Japan.

Today, the company serves more than 10,000 corporate clients, mostly blue chips, and operates in Japan, the US, Europe, China, Hong Kong and Southeast Asia. It employs more than 3,000 staff worldwide, over 70% of which are technical engineers.

Investment Theme

- Innovation

Target Market

There are several growth drivers of IT infrastructure in Japan:

- Increased IT investment and a Japanese economic recovery
- Increasing need to outsource complicated IT systems
- Explosion of data traffic due to the pervasive use of portable devices

Management

The Chairman and CEO, Mr. Koichi Suzuki, is the founder of IJ. He is well regarded and known as the internet pioneer in Japan. We have met him several times at investment conferences. Mr. Suzuki owns 5.6% of the company.

ESG

IJ issues a comprehensive Corporate Governance Report regularly. Five of the 13 board directors are independent and three out of four auditors are independent.

IJ obtained ISO/IEC 27001 certification for information security management systems back in 2007. As a pure IT company its negative impact on the environment is minimal. IJ does not provide much public disclosure on its environmental and social practices. However, it has expressed an interest in improving, so a year ago we shared our ESG questionnaire with them and discussed the 40 or so questions we ask companies about their ESG practices.

Competition

In the corporate ISP market, there are only a small number of high-end providers. For example, NTT Communication is strong in the small- and medium-sized enterprises (SMEs) market.

In the MVNO market, big players such as IIJ, OCN, JCI and Biglobe have a total market share of around 70%.

Competitive Advantages

- First full-scale ISP in Japan with an excellent track record of reliability and quality
- Long-term relationship with blue chips: More than 50% market share in blue chip companies. IIJ covers most of the top ten revenue companies in major industries
- Total network solution provider
- Largest internet backbone network in Japan which is comprised of over 20 network operation centers

Growth Strategy

Cloud business is the growth driver. IIJ aims to provide comprehensive solutions of network cloud services and system cloud services as its core product to enterprise customers. IIJ's cloud-related revenue has been increasing at double-digit rates in recent years.

Risks

- Labour shortages and wage increases
- The cost of interconnectivity services provided by NTT Docomo cannot be negotiated in advance, which could cause some surprises.

Have a great weekend.

The Global Alpha team