Lincoln Private
Investment Office

London

June 2019

Japan - time to blossom?

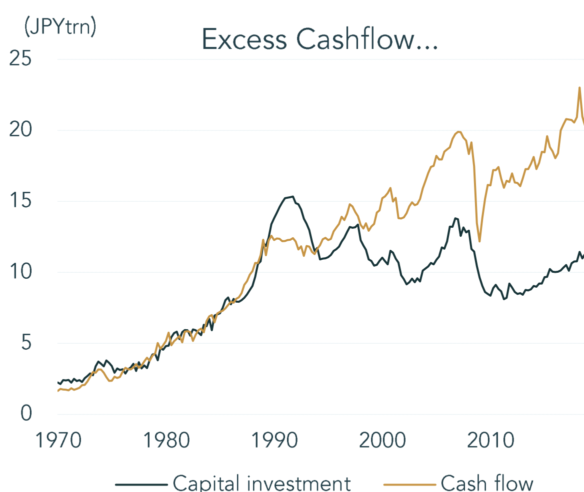
After 30 years on the Chrysanthemum Throne, Japan's Emperor Akihito abdicated in April of this year, the first Japanese emperor to do so since 1817. As the Reiwa era commences under the reign of Emperor Naruhito, we revisit the investment case for the world's 3rd largest equity market.

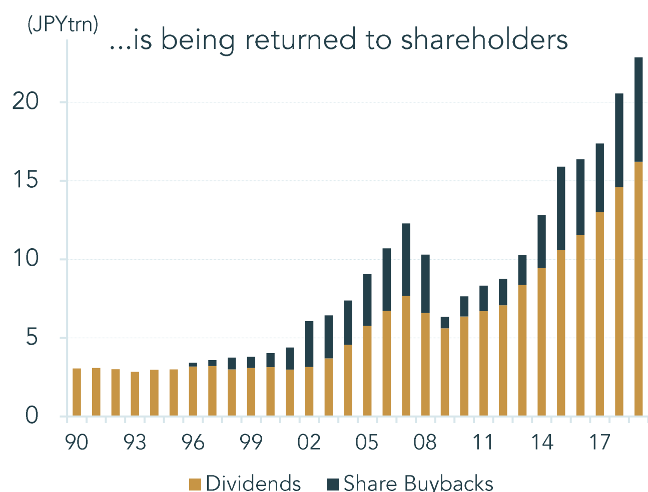
Integral to an understanding of Japanese markets is a grasp of the historical context of the prevailing corporate culture, the roots of which can be traced back to the Second World War. Japan's military regime worked with the wealthy families that controlled its businesses to direct maximum resources to the war effort, eliminating a shareholder-friendly dividend culture in favour of excessive capital expenditures.

Linked to this pursuit of strategic production, bank lending replaced equity as the main source of corporate funding and banks became entangled in corporate affairs. As corporate invoices went unpaid during wartime, many firms were driven to bank loans for survival. In the years that followed, bank ownership of listed shares went from 10% in 1949 to 43% in 1988, as loans were forcibly swapped to equity.

The post-war era also saw the Allied Occupation Forces dismantle the influence of wealthy Japanese families. With their large insider stakes offloaded at a discount to the public, companies responded by creating alliances, known as 'keiretsu', to defend against hostile takeovers and external pressure. These corporate cross-shareholdings persisted well into the 21st century. At the same time, Japanese citizens worked hard to re-build the economy, prioritising job security over higher wages. The legacy of this period is evident in today's culture. Senior management positions are synonymous with company loyalty and, until recently, management teams were more concerned with the interests of internal allies and bank officials on the board, than those of shareholders.

The unwinding of cross-shareholdings started more than two decades ago. However, it took the introduction of the Stewardship Code (2014) and the Corporate Governance Code (2015) to make a tangible difference to shareholder returns. In 2015, half of listed companies had no independent directors; by 2017, 90% had at least two. Whilst dividends and share buybacks have been trending upward for some time, the following charts illustrate the step change since 2015.





Sources: Nomura, from MoF data, company disclosures and Toyo Keizai data

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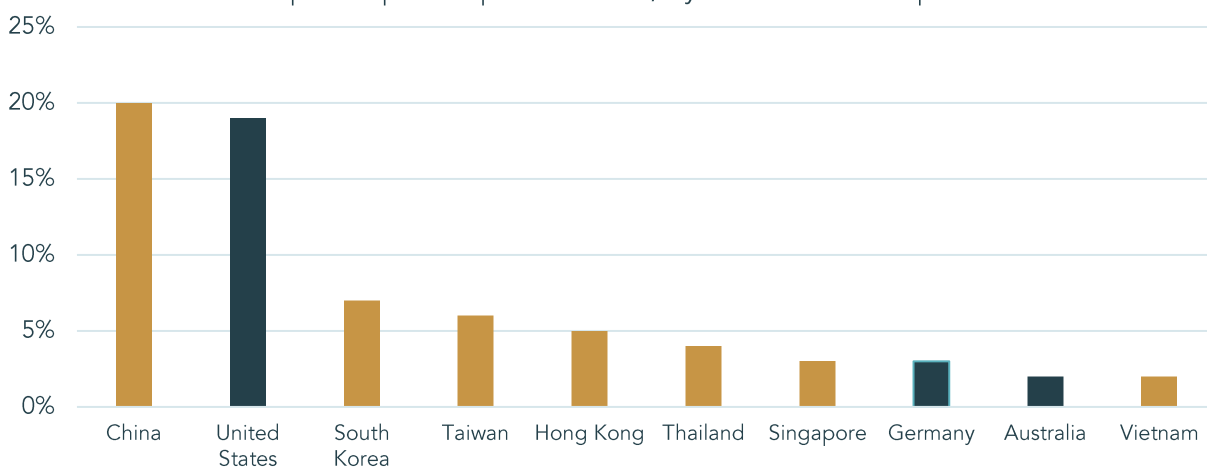
The two codes have also induced a re-alignment of shareholder and management interests. In 2013, there were only four companies in the Topix 500 that had any form of stock-based compensation in place. This rose to nearly 350 by 2017. Taking a more pertinent example from a shareholder's perspective, only 8% of the top 1,200 listed companies had an explicit dividend target in 2004. This figure stood at 43% in 2016.

Moving on from these idiosyncratic sources of return, it seems prudent to take stock of the Japanese economy. Perhaps its most characteristic feature is a shrinking population. An ageing populace and a diminishing natural workforce are indeed a cause for concern in isolation. However, we observe promising responses, starting in the political sphere. Immigration reforms passed by Prime Minister Shinzo Abe last year aim to bolster the country's supply of guest workers. Promisingly, Japan's net migration hit a record +165,000 in 2018. Abe's reforms make it easier for workers to become permanent residents, attracting more skilled manpower alongside Japan's strong inflows of students.

Skilled labour is an important part of the broader productivity solution required to meet the country's demographic challenge. Fortunately, awareness of this reality exists at a corporate level. Leaders are recognising, partly out of necessity, that productivity, rather than upholding the job for life culture, is essential to sustainable growth. With unemployment near 26-year lows at 2.5%, competition for workers is stiff. We hear increasing anecdotal evidence of a shift towards the meritocratic, productive ethos of many educated, young workers. Take Mitsubishi for instance, whose Midterm Corporate Strategy 2021 includes explicit commitments to train workers for management positions regardless of age and to remunerate employees on merit.

Given the ubiquity of Japanese brands in our lives, take Toyota or Sony, it is little surprise that exports account for 18% of GDP. Again unsurprisingly, the lion's share of exports is made up of high-margin, finished goods such as vehicles (21%) and machinery & computers (20%). Arguably more interesting is the destination of the exports, shown in the chart below. Japan has a myriad of trading partners across emerging markets, particularly in Asia. Consequently, it is leveraged to the Asian growth story of which we have been proponents for some time.



Sources: Trade Map, International Trade Centre, 2018 data

A word on tourism, which remains an attractive feature of the investment case for Japan. As the country prepares to host the Rugby World Cup this year and the Olympic and Paralympic Games in 2020, it is easy to envisage a bumper year for companies servicing these events. Far from being a mere flash in the pan, tourism is an established industry; last year alone, Japan welcomed over 30 million tourists. The government has set an official goal to attract 40 million visitors by 2020 and 60 million by 2030. If achieved, these annual waves of consumers will be sustainable drivers of parts of the economy.

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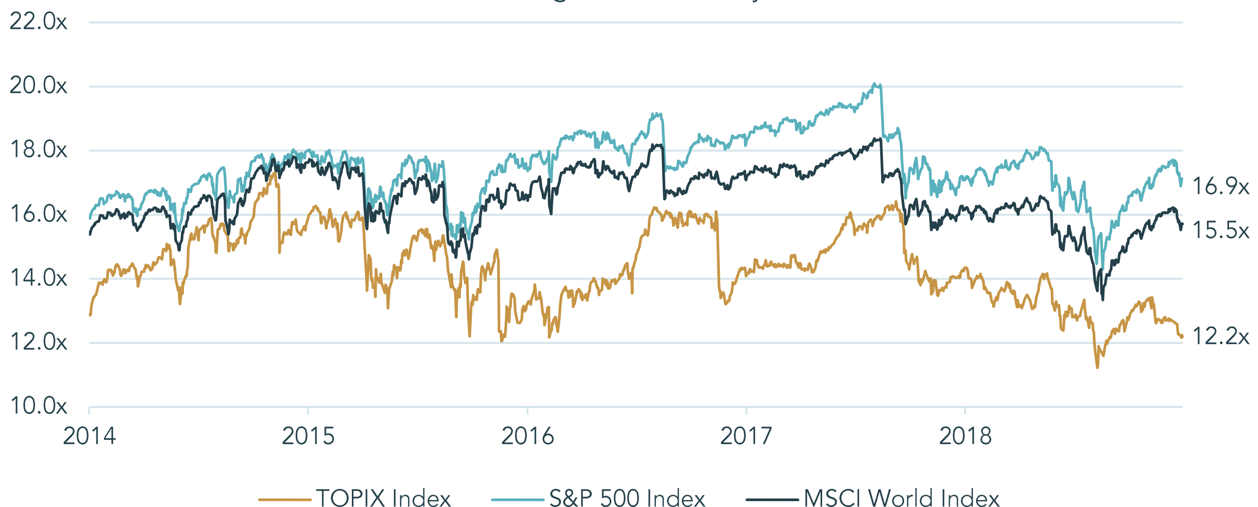
So, where does this leave Japanese equities? Investors have been slow to recognise the shift in corporate attitudes. They have also been rightly cautious of Japan's exposure to cooling global growth, albeit that many of Japan's trading partners are forecast to grow at very attractive rates. It has been a particularly trying last twelve months for investors in the region, as equities have been periodically punished for their exposure to the US-China trade war. The result is that Japanese equities are cheap, with the Topix trading on a forward price-to-earnings ratio of 12.2x, a 22% discount to both its 10-year average and to global equities (MSCI World Index).



Sources: Bloomberg, 2019 data

With 57% of companies in the Topix Index in a net cash position, and a very well covered dividend yield of 2.6% on the index, we feel that the market is attractively priced. To put the first figure in context, just 19% of S&P 500 constituents have more cash than debt. As corporate Japan evolves, we see scope for enhanced returns from cash distributions and multiple expansion. We continue to run an overweight allocation to the region and believe that our high-calibre value and income-focused managers are the optimal way to take advantage of its opportunities.

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