Japan at the Dawn of the Reiwa Era

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One of the many things that set Japan apart from the rest of the world is its measurement of time. Japan is the only country in the world that still uses Chinese-style imperial calendars. The prior Heisei Era corresponded to the reign of Emperor Akihito on the Chrysanthemum Throne from 1989 until his abdication on 30 April 2019. On the First of May, Crown Prince Naruhito, who is Akihito’s son, ascended to the throne, marking the start of the Reiwa Era. 2019 is now known as the year Reiwa 1. In Japanese, Reiwa is written like this: 令和. The first character Rei 令 means “good fortune,” while the second character Wa 和 can be translated as “peace” or “harmony.”

The dawn of the Reiwa era provides a good opportunity for us to recognize the progress that Japan has made during the prior Heisei period, which began in January 1989, near the climax of Japan’s massive stock market bubble. The period is rightly associated with the post-bubble financial system breakdown, and a painful process of de-leveraging, entrenched deflation, and low growth that followed in its wake. But we must also recognize that the Heisei period was also one of great progress, including strong per capita economic growth, liberalization of the economy and society, integration of women and the elderly in the workforce, and political stability backed by social cohesion. Today, Japan’s cutting-edge culture, restaurants, and excellent powder skiing are attracting attention from around the world.

What will characterize the Reiwa era? In part, it will be defined by Japan’s response to the challenge of a shrinking and aging population. The country will also need to come up with better ideas for achieving a sustainable energy mix and navigating geopolitical tensions. We think that Japan’s position with regard to these challenges may be evaluated more positively in the coming years: Is a gradually declining population really such a bad thing when automation and artificial intelligence is changing the nature of work? Japan will rise to meet these challenges in its unique way, and its companies will sometimes be part of the answer.

No one knows how these longer-term issues will play out. This paper will take a look at the current state of some key areas that we see as relevant when analyzing Japan’s stock market at the dawn of the new era.

Politics

Japan has remained largely immune from the populist movements that have gained strength across much of the world in recent years. This may be helped by the fact that Japan’s migrant population is relatively small due to the country’s immigration policy. So, it is harder for the Japanese population to blame immigrants for their problems. Regardless, Japan continues to enjoy a stable and largely competent political leadership under Prime Minister Shinzo Abe, who was re-elected to lead the ruling Liberal Democratic Party (LDP) last September.

There is rising speculation that Abe may call a double election for both houses of the Japanese Diet in July. The LDP enjoys a massive lead in opinion polls currently, though the party leadership is concerned that the planned consumption tax hike from 8% to 10% planned for October could shrink that lead. We believe that the most plausible reason for holding a double election would be to propose a delay (or even a cancellation) of the tax hike. Many analysts place a probability of such a delay at 40% to 50%.

A delay in the tax hike would be a positive outcome, in our view, as it would allow monetary easing to combine with fiscal easing—a situation Japan has not experienced since the start of Abenomics, except at the very beginning. We believe that Japan needs to focus its efforts on making a definitive escape from deflation, rather than pursuing fiscal sustainability at this point.

What is clear is that Abe’s ruling LDP party is likely to continue to control both the upper house and the lower house of the Diet, which will allow for the continuation of market-friendly economic policies.
Market Cycle

Japan’s market has been highly cyclical, so investing in it demands a keen understanding of various market cycles. The flow-of-funds cycle is particularly relevant given the continuous decline of dedicated Japanese funds globally, as well as the trend of Japanese institutional investors continuously reducing their domestic equity weightings over the past two decades.

In this context, foreign investors did not appear particularly excited about buying Japanese equities during the final years of the Heisei period. Foreign investors sold ¥5.7 trillion worth of equities in 2018, the largest net amount since 1987. The net selling has continued during the first three months of 2019 (Exhibit 1).

The net selling was more than offset in 2018 by net buying from the Government Pension Investment Fund (GPIF) and the Bank of Japan (BoJ). The BoJ buys only passive exchange-traded funds (ETFs). GPIF is also largely passive in its equity book, although it is demonstrating some leadership in promoting environmental, social, and governance (ESG) initiatives in its investment activities. Foreign investors tend to be active investors. Therefore, in short, the recent market has been characterized by a reduction in active and an increase in passive equity owners.

This appears to have hindered the market’s price discovery mechanism and pushed prices further away from intrinsic values in many cases. We believe that the more the stock market is driven by such flows into passive and smart beta funds, the greater the opportunity it will become for active stock pickers like us as mispricing becomes ever more pronounced. These opportunities bring the potential for future outperformance.

Fundamentals and Valuations

The Japanese stock market has lagged its US, European, and Chinese peers in 2019 so far. This is partly driven by a perception that earnings growth has peaked for this cycle. Many investors view the Japanese stock market as a play on the global manufacturing cycle, which is represented by global Purchasing Managers Index (PMI) statistics.

Global PMI data weakened over much of the past year, as trade tensions, Brexit, and other concerns impacted investor sentiment. This accounts for much of the weakness in the Japanese market. It is encouraging that global PMIs appear to have bottomed and are beginning to demonstrate a meaningful pickup. This could add to interest from macro investors and help Japan achieve a sustained recovery.

In our view, the popular perception vastly overstates Japan’s position as a play on the global cycle and currency exchange rates. Many companies reported sharply slowing orders and sales in China during the end of 2018. In addition, sales and earnings guidance for the current fiscal year is also likely to be highly conservative in most cases, which may disappoint the market. However, we have already seen signs of recovery in key areas of the global supply chains, such as smartphones and factory automation. The potential for an easing of US–China trade tensions would likely accelerate this process.

Longer term, the fundamental story in Japanese equities continues to improve, as profit margins continue their structural uptrend, combined with a rising share of Japanese corporate profits coming from the more domestically focused non-manufacturing sector. On top of this, meaningful corporate governance progress had accelerated (see below).

Paradoxically, lower valuations have accompanied these improving fundamentals. Japan’s Topix Index is trading at its lowest level relative to the United States’ S&P 500 Index since Prime Minister Abe returned to power in late 2012 (Exhibit 2). Japan’s 12-month forward price earnings ratio (PER) was 12.56x as of 17 April. This is near the bottom of its long-term historical range, and is 26% below that of the US equity market (Exhibit 3). This means that Japan is trading 14% below its 10-year average, while the United States and Europe are trading at 12% and 6% above theirs, respectively. We believe this should be of keen interest to all contrarian investors.
Japan market’s Price to Book Ratio (PBR) remains well below that of the United States and Europe (Exhibit 4). Why is this? One reason is Japan’s lower return on equity (ROE). While the ROE of the Japanese market remains well below that of the United States, it has somewhat narrowed the gap with the US and European markets (Exhibit 5). A second reason is that Japanese balance sheets are often bloated with excess capital. When a US stock trades below book value, it often reflects the belief that losses and write-downs are likely to reduce the book value. By contrast, a Japanese stock trading below book value often means that investors think that the company has excess capital that is not likely to ever be deployed effectively.

For leading global companies, the importance of intangible assets like brands, software, and patents continues to increase. In an effort to improve capital efficiency, US balance sheets have been optimized—resulting in an asset-light structure dominated by intangible assets. By contrast, Japanese companies continue to have excessive levels of equity that is backed by low yielding assets like cash, real estate, and the stock of other companies. In fact, over 50% of Topix non-financial listed companies have net cash on their balance sheets, and book value backed by tangible assets continues to increase (Exhibit 6). Japanese companies often possess valuable intangible assets, though their balance sheet value is often considerably understated.

We see potential for the “unlocking” of value by boosting returns through reducing excessive tangible assets. Is this likely to happen? Private equity funds have certainly discovered the opportunity in Japan, and are ramping up efforts to take asset-rich companies private, often with the support of management. KKR, a leading US-based private equity firm, recently told the Financial Times that “[Japan] is our highest priority right now other than the US … this is the best value today. If you look at value to price of stock and cost of capital, it’s here.”2 Will this “unlocking” benefit public
equity investors? We believe so, and in the next section discuss two potential catalysts.

First Catalyst: Rising Shareholder Engagement and Activism

Share buybacks reached record levels in 2018, and were up over 150% year over year during the first quarter of 2019. We believe that one catalyst was increasing activism in Japan by both local and foreign players.

Investors are becoming more ambitious in their efforts to improve corporate value through replacing directors and management. A particularly interesting example happened earlier this year when the Japanese trading firm, Itochu, launched what appears to have been a successful hostile takeover bid for the mid-cap sportswear company Descente. We see this as a sign that Japan’s market for corporate control is starting to open. Hostile takeovers have historically been rare in Japan. In a sign of the changing times, the tender offer document spelled out Itochu’s view that the Descente board was “dysfunctional.”

Other recent examples include:

- **Olympus**: ValueAct, a US asset manager, appeared to succeed in its campaign to promote change at Olympus. In January, the firm announced significant changes to its management team and governance structure, and also nominated an independent director from ValueAct.
- **LIXIL**: Several well-respected overseas investment firms have initiated a campaign to remove LIXIL’s Chairman & CEO, who is the son of the founder, and to reinstate the previous CEO who appeared to have been fired somewhat arbitrarily.
- **Toshiba**: King Street, a US-based asset manager, has engaged in a campaign to change the board of directors of Toshiba, including putting King Street’s founder on the board as an independent director.

Second Catalyst: Corporate Governance Improvement Efforts

Prime Minister Abe was recently quoted as saying that corporate governance remains at the “very top” of his list of important reforms. While policy initiatives are not as swift and powerful as we would like, the developments are continuing and we consider this rising pressure to be another significant catalyst.

First, the government as encouraged by the Tokyo Stock Exchange is considering ideas of how to reduce the number of companies that trade on the TSE First Section (TSE1). Unlike almost all other equity markets, in Japan most passive money goes into a stock market index that contains all of the stocks in the market—over 2,000 companies in the case of TOPIX. In most other markets, the main index contains far fewer companies. The concern is that many companies on the TSE1 may not be taking their responsibilities seriously as listed companies—many have failed to engage with investors or provide regular updates on financial results. While these failures push away active investors, such poorly governed companies enjoy increasing investment from passive funds due to their TSE1 status, in addition to their traditional “stable shareholders.” The TSE has not yet come up with a clear plan on how to achieve this reduction. A previous effort to create a governance-focused index, called the JPX 400, has disappointed in terms of gathering assets or motivating company management. More details on specific policy actions in this area are expected in the coming months.

Second, there are increasing signs that the governance improvement effort is slowly ramping up from “policy” (which some companies feel free to ignore) to legal requirement, coming from both the Ministry of Justice and the Financial Services Agency (FSA). One focus is the Financial Instrument Exchange Law which impacts the crucial market for corporate control. We hope this will include an effort to tighten the rules for Take Over Bids (TOBs) and Management Buy-Outs (MBOs), to bring them closer to international standards. Currently, “squeeze out” rules allow a takeover to be approved with only 67% shareholder support, not the usual 90%. As a result, TOBs can be
carried out without making a tender for 100% of the stock; rather the bid is often for just enough to get a controlling stake. Such rules help undermine adequate protection of minority shareholder interests.

These potential changes in the legal code could also have the highly positive effect of making publicly listed subsidiaries more difficult to maintain. A sneak preview of how significant such a change could be was provided recently when the media speculated that Hitachi would sell its stake in the publicly traded Hitachi Chemical. Although Hitachi has not yet announced the sale, investors re-rated both stocks in response to this potential unwinding.

**Conclusion**

The Japanese market looks highly attractive to us. Flows have led to depressed valuations that represent an opportunity for talented active managers. We believe there are also increasingly clear catalysts in the form of rising shareholder engagement/activism and corporate governance improvement efforts. Such catalysts may help to finally unlock value in many Japanese companies, and might represent a truly exciting start to the Reiwa era.
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Notes
1  As of 29 March 2019. Source: CLSA
2  Source: Financial Times, Asian edition of 15 April 2019

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