Is Japan Finally Getting Serious about Shareholder Value?

The Japanese equity market is currently one of the most exciting stories for investors. Structural reforms in the economy and corporate governance are changing management behavior and empowering investors. As a result, Japanese corporations are changing how they approach balance sheet management and returns on investment.

This more energized approach to capital management is not unlike what happened in the United States during the 1970s. If Japan follows the same trajectory, Japanese companies are poised for a multi-year improvement in operating margins, return on equity, and attention to shareholder value. We see evidence that the transition is already under way, making Japan’s equity market one of the most promising long-term opportunities for investors today.
Since Lazard began investing in Japan in the 1980s, we have witnessed several market inflection points. The first infamously resulted in big negative changes not only for investors but for the entire Japanese economy. A combination of reckless fiscal policy and loose monetary policy unleashed a real estate and stock market boom in the 1980s, which led to massive overinvestment in low-yielding assets. Many thought that Japan had pioneered a superior form of capitalism. In fact, the massive asset bubble burst in the early 1990s, and the Japanese economy and equity market descended into a trap of debt, deflation, and poor corporate governance.

Today, in our view, Japan has reached another inflection point—but this time, we think the outcome is likely to be very positive for investors. Corporate governance reforms put in place several years ago are changing management behavior and empowering investors, essentially altering the dynamics of corporate control. Japanese boards are increasingly considering the interests of minority shareholders, which, in turn, is changing how Japanese corporations approach balance sheet management and returns on investment.

This emerging shift to a more energized approach in capital management is not dissimilar to what happened in the United States during the 1970s. If Japan follows the same trajectory, Japanese companies are poised for a multi-year improvement in operating margins, return on equity, and increasing attention to shareholder value. With balance sheets rich in financial assets, they also have ample ability to increase dividends and stock buybacks.

The early evidence suggests this is already happening. Trailblazers like Sony, Tokyo Electron, and Hitachi have led the way, and management teams at many other companies are following. Today’s inflection point suggests to us that the Japanese equity market may currently be one of the most promising long-term opportunities for investors.

Lazard’s Japanese equity strategies are well positioned to find the opportunities that arise from this shift. In addition to focusing on mispriced securities, we bring two crucial strengths to the investment process: deep industry knowledge, with both local and global perspectives, and a long history of constructive, active engagement with companies in Japan.

The Opportunity: Japanese Equity Market Valuations and Fundamentals

Equity market returns depend on earnings growth and shareholder returns, both of which have trended strongly higher since 2012 (Exhibit 1). We think that that the policy reforms under former Prime Minister Shinzo Abe, particularly the Corporate Governance Code’s encouragement of cross-shareholding reduction and attention to the cost of capital, contributed to the change in management behavior that brought about these increases.
Equity market returns also depend on valuation multiples. While Japanese corporate earnings steadily improved during the late 1990s and 2000s, the progress was hidden by valuation multiple compression. Currently, valuations are attractive in Japan, both historically and compared with other markets, which should be of interest to long-term investors (Exhibit 2).

Many corporate balance sheets in Japan are still bloated with excess cash and financial assets (Exhibit 3). This gives companies ample ability to increase dividends and stock buybacks in an effort to improve shareholder value.

Yet, Japan is still on the low side for dividend payouts compared with other countries, implying considerable room for improvement (Exhibit 5).

In fact, shareholder returns including dividend payments and stock buybacks have risen to historically high levels over the past few years. Japan currently has some of the highest dividend yields in the world (Exhibit 4).

In our view, Japanese companies are generally too cash rich. However, corporate governance pressure is at last forcing them to make bigger payouts and respond to shareholder interests in general. We expect that newly empowered investors will continue to engage with companies to unlock this previously trapped value for years to come.

**Why Now: The Strengthening of Reforms and the Macro Environment**

While we find that the corporate governance reforms put in place several years ago are powerfully changing management behavior and empowering investors, that is not the end of the story. Japan plans to continue strengthening corporate governance with changes in 2021 and beyond.

Regardless of whether Prime Minister Yoshihide Suga remains in power, we think reforms in three important areas will progress this year.

- **Revision of Japan’s Corporate Governance Code:** The initial introduction of the code in 2014 delivered a wake-up call to all publicly traded companies to raise their standards by adopting “fundamental principles for effective corporate governance.” It has been very helpful in improving discussions and engagement between companies and investors. The code is being strengthened this spring to include guidelines on climate financial disclosure and workforce diversity, and to raise the minimum number of required independent directors to one-third of the board. While we would have liked even more ambitious revisions, we recognize that these represent continued progress in improving Japan’s corporate governance.
We also foresee three notable macro developments:

**Reorganization of the Tokyo Stock Exchange (TSE):** In April 2022, the TSE will reorganize with the goal of raising the standards required for companies to trade on its prestigious First Section, which will be renamed the “Prime Market.” As a result, some of the 2,000-plus companies that now trade on the First Section will be demoted to a lower prestige section that will be called the “Standard Market.” We expect that the pressure to avoid demotion will lead many management teams to improve their corporate governance and their attentiveness to asset owners.

**Business portfolio reorganization:** Last year, Japan’s Ministry of Economy, Trade and Industry (METI) issued what we believe to be a highly significant directive, “New Practical Guidelines for Business Transformations.” This guidance takes aim at the root causes of poor profitability at Japanese companies: too many companies in most industry sectors, which undermines pricing power; and too much business diversification, which dilutes management attention and perpetuates the holding of non-core divisions earning returns below the cost of capital. We expect the METI directive and other policy initiatives from the Suga cabinet to accelerate important structural changes.

These developments come at a particularly opportune time for Japan. The hit to the global economy last year because of the COVID-19 pandemic has prompted many governments to accelerate their borrowing and global central banks to increase their balance sheets to unprecedented levels in efforts to support their economies. We think monetary and fiscal expansion will continue in 2021, led by infrastructure and social spending in the United States under the Biden administration.

**Macro Issues**

Japan’s economy suffered less economic damage from the pandemic than did many of its peers, and the abundance of global liquidity should support Japanese corporate profits this year. Purchasing managers’ indices (PMIs) already point to a potential recovery in foreign demand for Japanese products despite a subdued outlook for domestic consumption.

We also foresee three notable macro developments:

1. **Fund flow potential:** Many developed equity markets are close to historically high valuation multiples, but Japan’s is not high by historical standards. In addition, we believe that foreign investors remain underweighted to Japanese equities, having been net sellers during the Abe administration. These factors suggest the potential for increased foreign demand for Japanese equities in the coming years.

2. **Inflation:** Unprecedented global fiscal and monetary stimulus seems likely to put upward pressure on inflation in the global economy. We think valuations of many Japanese companies underestimate the extent to which a rise in inflation would boost profitability and corporate value.

3. **Recovery for value stocks:** Valuation premiums for growth stocks over value stocks rose to historically high levels in 2020, but in the past, value has outperformed in Japan during periods of economic recovery and rising inflationary pressure. Value companies may also outpace growth in earnings in an environment of monetary and fiscal expansion.

**Lazard Japanese Equity Team’s Approach to Unlocking Value**

With positive structural change and a supportive macro environment, how can investors best take advantage of the opportunities in Japan’s equity market?

Lazard’s Japanese Equity team takes a long-term, contrarian approach that seeks to identify mispriced securities. Our team’s blend of local presence in Japan and a global perspective helps us to uncover inefficiencies and long-term structural changes that are relevant to the value of Japanese companies. We believe that this approach delivers an opportunity set that is not available through global or international mandates.

Our team has two primary strengths that will allow us to take advantage of the market opportunity resulting from corporate governance reforms. The first is our deep industry understanding. Lazard’s global perspective and local market presence give us a differentiated view on companies and industry trends. Two of our current investment views offer examples of how we unite our global and local perspectives.

- **Semiconductor production equipment (SPE):** Structural changes in the global semiconductor production industry have tempered its historical cyclicality, based on our analysis. Demand-side dynamics look particularly favorable to us in 2021 as companies require more logic and memory chips to facilitate digital transformation, automation, and advanced telecommunications.

- **China exposure:** We expect that trade and diplomatic frictions between the United States and China will continue in 2021 and prolong a bifurcation in global supply chains. Among the beneficiaries will be Japanese companies that sell capital goods to Chinese manufacturers, particularly in the areas of automation and environmental sustainability.

*Active engagement is a second important strength we bring.* Our team aims to increase the corporate value of the companies we invest in through supportive engagement on environmental, social, and governance (ESG) risks and opportunities and their impact on long-term corporate value.

Japan has a higher percentage of companies trading on the market at low price-to-book ratios than the United States and Europe have, and we believe that this is directly related to the ESG standards of Japanese companies. When we engage with company
managements, we aim to encourage and support their efforts to improve their ESG practices. Ultimately, we believe that corporate value will increase as the market recognizes the growth potential of a firm that meets high ESG standards, reducing the firm’s cost of capital.

In Japan, our engagement approach depends on relationships of mutual trust and two-way sharing of global industry-specific expertise with company management, senior management, or board members. We often follow up on these discussions with a formal written letter to the board. While we may discuss our ESG engagements with investors, we do not share such views publicly.

Conclusion: A Transformation in Profitability

The Japanese equity market is now one of the most exciting investment stories for investors seeking attractive returns—both alpha and beta. Structural reforms of the economy and corporate governance are changing management behavior and empowering investors. The result, in our view, is a long-term transformation in the profitability of Japanese businesses and an unlocking of previously trapped value.

Positive change like this does not happen at the same pace across companies and industries, and it often requires engagement by investors—which plays to the strengths of active management. With our long focus on bottom-up company analysis and active engagement, Lazard’s Japan Equity team is well positioned for this potential opportunity to deliver strong long-term investment results.

About the Team

The Lazard Japanese Equity team takes a long-term, fundamental value-oriented, contrarian approach that seeks to identify mispriced securities. The team’s blend of local presence in Japan and a global perspective helps uncover inefficiencies and long-term structural changes that are relevant to the value of Japanese companies. Consisting of 6 investment professionals who have, on average, more than 24 years of industry experience, the Japanese Equity team also leverages the analysis of a dedicated US-based macro and strategy consultant, as well as Lazard’s global research platform, which includes more than 250 investment professionals.
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