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Time to think yes Japan, not ex Japan

John Hock | Altrinsic Global Advisors | 10 February 2015

Individual stocks in Japan offer some of the most compelling asymmetric risk/return profiles within the equity landscape and across asset classes.

Japan has become a nation to which many investors are largely indifferent. They shouldn't be. Once 45% of the world's market capitalization, Japanese equities now constitutes less than 8% of the MSCI World Index. Over the past 25 years, Japanese equities have gone from being the most highly valued in the world to trading amongst the lowest. Many Japanese companies are global leaders and innovators in important areas including nanotechnology, green technologies, industrial automation and pneumatic control, robotics, transportation technology, and manufacturing.

Although the economy is the world's third largest, lingering deflation and the rise of China, South Korea, and other regional economies is unsettling for Japan and a catalyst for change. This desperation is leading to aggressive reform initiatives that are more ambitious than any time since the Meiji restoration in the late 19th century. These initiatives will take time and will be characterised by fits and starts. Most importantly, meaningful change is taking place at the company-specific level, as a growing number of deeply undervalued companies are increasingly embracing efforts to boost shareholder value. This presents opportunity.

JAPAN IN CONTEXT. WHAT HAPPENED?

As shown in Chart 1, Japanese equities have lost much of their significance in the eyes of many global investors. Having represented 45% of the investable universe at its peak in 1989, Japan's current representation in the MSCI World Index is now less than 8%. Although policies were effective in maintaining high levels of employment during this period, the ongoing deflation, structural rigidities in the economy, lack of corporate restructuring, and poor corporate governance weighed on share prices. The financial sector, in particular, was ravaged by the decline in share prices, the collapse in property values, and growth in non-performing loans. Gravity had an impact as well, given the elevated valuations in the 1980s that have now fallen to the lowest levels among major markets, as shown in Chart 2.

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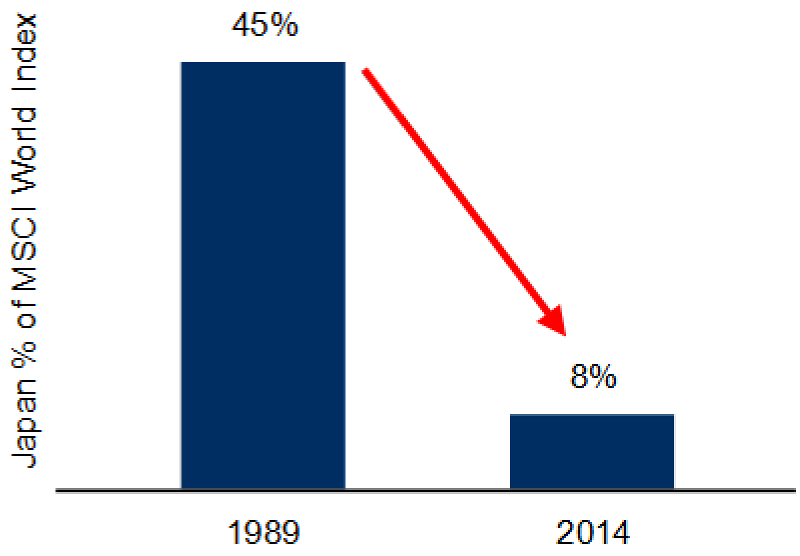
Chart 1: Japanese representation in Global Markes has collapsed

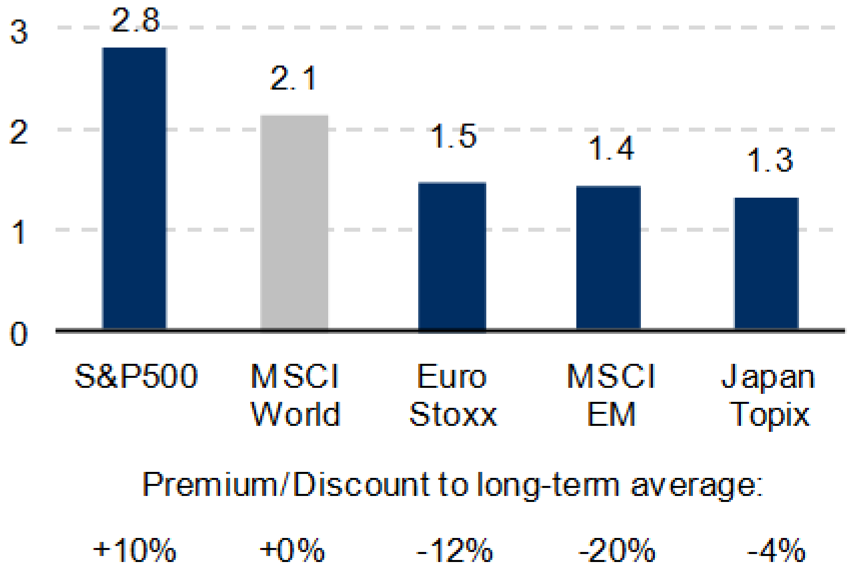
As of 31/12/14



Source: MSCI

Chart 2: Regional price to book ratio

As of 31/12/14



Source: Bloomberg

THE CATALYST FOR CHANGE: DESPERATION AND ABENOMICS

Desperation is currently playing an important role in jumpstarting the pace of change and restructuring that is long overdue. Japan is the world's third largest economy with a rich culture of innovation, but threats and competition from its Asian neighbors have intensified. China has supplanted Japan as the world's second-largest economy and has been overt in pursuing stronger military capabilities. China's economic might create opportunity for many Japanese companies, but it also creates anxiety. Likewise, progress in South Korea and throughout Asia, both economically and politically, has had a similar effect on the mood in Japan. Unfortunately, Japan and many of its companies were slow to restructure and placed little emphasis on shareholder value. At the macro level, the Abe administration is capitalising on the growing national recognition that Japan is under threat and must change. The recent Japanese election culminated in an overwhelming vote of confidence for Abe's stimulus measures and reform initiatives. A similar recognition is taking place in many corporate boardrooms, as the need to be more effective global competitors is becoming a top priority. This objective is creating an unprecedented ground-swell to focus on the need for capital discipline and shareholder value.

ABENOMICS: TWO ARROWS AND A THOUSAND NEEDLES

At the policy and macro level, developments are positive, but they are also the greatest sources of uncertainty. The first two arrows of the Abe administration's three-arrow policy incorporated a brilliant and very clear narrative that was followed by specific and easily validated action plans that involved fiscal and monetary stimulus. The third arrow was similarly presented and perceived, when in actuality it represents a multitude of challenging structural reforms that some characterise as the "thousand needles."

Unlike the first and second arrows, there can be no simple validation. Rather, the reforms will progress in periods of fits and starts given the challenge they pose to deeply embedded societal and cultural norms. Thus far, Prime Minister Abe is effecting deep change within important ministries and leveraging his high approval ratings and political capital to advance reforms in many areas, including agriculture, energy markets, labor markets (including female workforce participation), healthcare, and immigration.

We believe that additional tax reforms aimed at reducing corporate tax rates and/or offering incentives for capital expenditures will be favorably received by investors. Likewise, measures to enhance corporate governance and to restructure the government’s pension fund with a higher domestic-equity weighting (from an original 12% to 25%) should be supportive. We expect that the sentiment surrounding the third-arrow reforms to remain a source of volatility but with an improving trend that coincides with tangible measures of progress.

VALIDATION AND OPPORTUNITIES

Our conviction in Japan is based on the underlying value and scope for a select number of individual companies to unleash this value via shareholder friendly initiatives. This is not a macro call, as Abenomics' success in boosting growth and interest rates in a constructive way adds a significant amount of optionality to the thesis. Evidence so far suggests significant progress. In the last year, the number of Japanese companies with independent board members has increase from 62% to 74%, dividends grew 20%, and share buybacks increased 60%. Earnings per share have increased 75% from 2013 levels and consensus estimates are for 9% growth in the coming fiscal year. We are encouraged by this progress but reiterate that this is being led by a small but growing number of Japanese companies.

THE JAPANESE OPPORTUNITY EMBODIED IN YOKOHAMA

Bank of Yokohama is one such opportunity embodying many of the virtues noted - undervaluation, focus on shareholder return, validation of this focus in the form of its actions (dividends, buybacks), and further upside optionality if macro policies (Abenomics) are successful. Bank of Yokohama is the largest bank in Japan's Kanagawa prefecture, adjacent to Tokyo. Yokohama is a port city and export hub to Asia and continues to attract export-related industry. It also gets a demographic boost from young people who, not being able to afford Tokyo rents, commute from Yokohama. This commercial/residential dynamic provides a solid base for lending growth. The market is currently valuing this franchise at a 20% discount to its book value and a 37% discount to global peers. Its capital base is strong with a 6.7% tangible equity to asset ratio and tier one capital ratio exceeding 10%. Unlike banks in much of the world, its liquidity profile is robust and is completely funded by deposits. The bank's ROE has climbed to 7.6%, and we think it will climb further as modest lending growth, strong fee income, and prudent capital management boost returns on equity. Management embraces the concepts of shareholder value, and it currently pays a dividend that yields 4x the prevailing local long-term bond yield and is engaged in a meaningful share buyback. Any success by Abenomics in boosting growth and increasing interest rates in a constructive manner could unleash even further ROE expansion and shareholder return than we forecast. We believe this holding offers investors substantial long-term prospects via growth in book value, cash returns, and valuation rerating.

CONCLUSION

With equity markets near historical highs globally, interest rates near historical lows, and volatility in commodity prices, it is increasingly difficult to identify undervalued opportunities where the upside payoff is outsized considering downside risk. Japan is one such source of investment opportunities. Despite low valuations and evidence of progress in boosting shareholder value in a growing number of companies, there remains a tremendous amount of indifference toward Japan. These are common characteristics of rewarding opportunities.

John Hock is founder and Chief Investment Officer of global equities manager, Altrinsic Global Advisors, available in Australia through NAB Asset Management.