JAPAN'S MARKET AWAKENING: NEW DAWN FOR INVESTORS

Executive Summary:

Ativo Capital, a global equity manager focused on investing in undervalued, high-quality companies, identifies Japan as a potentially generational investment opportunity. This perspective stems from Japan's departure from a prolonged deflationary period, wage growth, and positive shifts in monetary policy. Despite historical underperformance, factors such as increased shareholder value initiatives, technological advancements, and favorable government policies signal a turning point. This note delves into the historical context, bullish factors, and potential risks, concluding with actionable insights for long-term investors.

Ativo Capital, an expert in global equity management, focuses on identifying and investing in undervalued companies that stand out for their ability to create significant shareholder value by generating superior cash flows over their cost of capital. Historically, Japanese companies have lagged in this regard, often delivering less shareholder value over the past four decades when compared to their international peers in the US, Europe, and emerging markets like China, Taiwan, or India. Nonetheless, we're witnessing a significant transformation in Japan, which we believe heralds a unique, long-term investment horizon. This shift, underpinned by a variety of compelling factors, positions Japan, much like India but for distinct reasons, as a potentially extraordinary opportunity for investors looking to the long term. This document aims to delve into the historical financial landscape of Japan, examining the reasons behind its prolonged underperformance and highlighting why we're now approaching an inflection point that could redefine Japan's market proposition for the foreseeable future.

In the aftermath of World War II, Japan embarked on a remarkable journey of rapid industrialization, underpinned by a succession of government policies focused on economic growth. This remarkable transformation was fueled by a highly educated workforce and the establishment of the Keiretsu system - networks of large, interdependent business groups that included conglomerates, trading companies, and banks holding shares in one another. This system enabled Japanese firms to achieve rapid scaling and financial robustness, allowing them to compete globally by offering competitively priced goods. Consequently, Japan ascended to become the world's second-largest economy, fostering industry leaders in finance, automotive, electronics, and chemicals.

During the 1980s, Japanese companies accounted for nearly half of the global equity market capitalization, with the Nikkei 225 index surging over 400% between September-1982 to the peak in December -1989. In 1989, the largest company in the world was Industrial Bank of Japan with a market capitalization close to 105 billion dollars. Out of the top ten largest companies in the world six were Japanese while the remaining four were American. The trailing 12-month P/E ratio of the Nikkei was 60. (Fast forward to today there is no Japanese firms in the top ten. 8/10 are US and Toyota Motors which is the largest Japanese firm is the 30th largest company in the world and 9th largest non-US company). The Nikkei 225 subsequently lost 82% of its value by February-2009. Even though Japanese equities have recovered post GFC, and in particular post 2012 when the Bank of Japan ("BOJ") under Governor Kuroda started purchasing ETFs, between 1990 and 2023, investors in Japan would have earned an abysmal compounded annual rate of return of -0.3%.*

* Credit Suisse Global Investment Returns Yearbook - 2023

The reason Japanese equities took so long to recover was an extended period of deflation lasting almost 30 years, a strong yen making exports uncompetitive, and the Keiretsu system which focused on maximizing profits by increasing market share with low prices as opposed to expanding margins. This historical context sets the stage for understanding Japan's current economic and market conditions, highlighting the significant shifts underway that present new investment opportunities.

Our growing optimism toward Japan, despite a history of underweighting in our investment portfolio, reveals a multifaceted rationale for our bullish outlook, particularly post-COVID. Our analysis suggests that Japan is entering a new market regime characterized by several pivotal shifts:

1. Transition from Deflation:

Japan is emerging from its long-standing deflationary environment. This is a significant positive shift, as, in contrast to other economies, higher inflation is beneficial for Japan, signaling a healthier economic dynamic.

2. Wage Growth and Consumption:

There's a notable increase in wage growth, leading to enhanced consumer spending and a greater tolerance for price increases passed on by businesses. This cycle of wage growth and consumption underpins a strengthening domestic economy.

3. Monetary Policy Shifts:

As Japan positions itself to potentially raise interest rates while other nations are cutting theirs, this divergence could bolster the Yen. A stronger Yen benefits global investors with exposure to Japan, especially aiding the performance of Japanese small-cap companies.

4. Corporate Financial Health:

Japanese firms, on average, boast higher net cash levels than their Western counterparts, coupled with an increase in shareholder-friendly activities such as higher dividends, share buybacks, and a reduction in cross-holdings. These measures are indicative of robust corporate health and financial prudence.

5. Regulatory and Investor Activism:

There is a concerted push from regulators for companies to enhance shareholder value, alongside a rise in investor activism and restructuring efforts. These developments are poised to unlock significant value within the Japanese market.

6. Encouraging Domestic Investment:

With the introduction of a new tax-free program under the Nippon Individual Savings Account (NISA) scheme, Japanese policymakers are incentivizing domestic investors, traditionally less exposed to equities than their Western counterparts, to increase their stake in the equity markets. This move aims to deepen market participation and investment in stocks.

7. Shift in Investor Sentiment:

The last few years have seen a marked improvement in investor sentiment towards Japan, with many viewing it as a viable alternative to China within the Asian investment landscape. This shift is reflective of a broader reevaluation of Japan's market potential.

8. Technological Leadership:

Japan's leading edge in critical technologies such as semiconductors, automation, robotics, battery technology to name a few positions it at the forefront of driving long-term secular growth and productivity enhancements across various sectors.

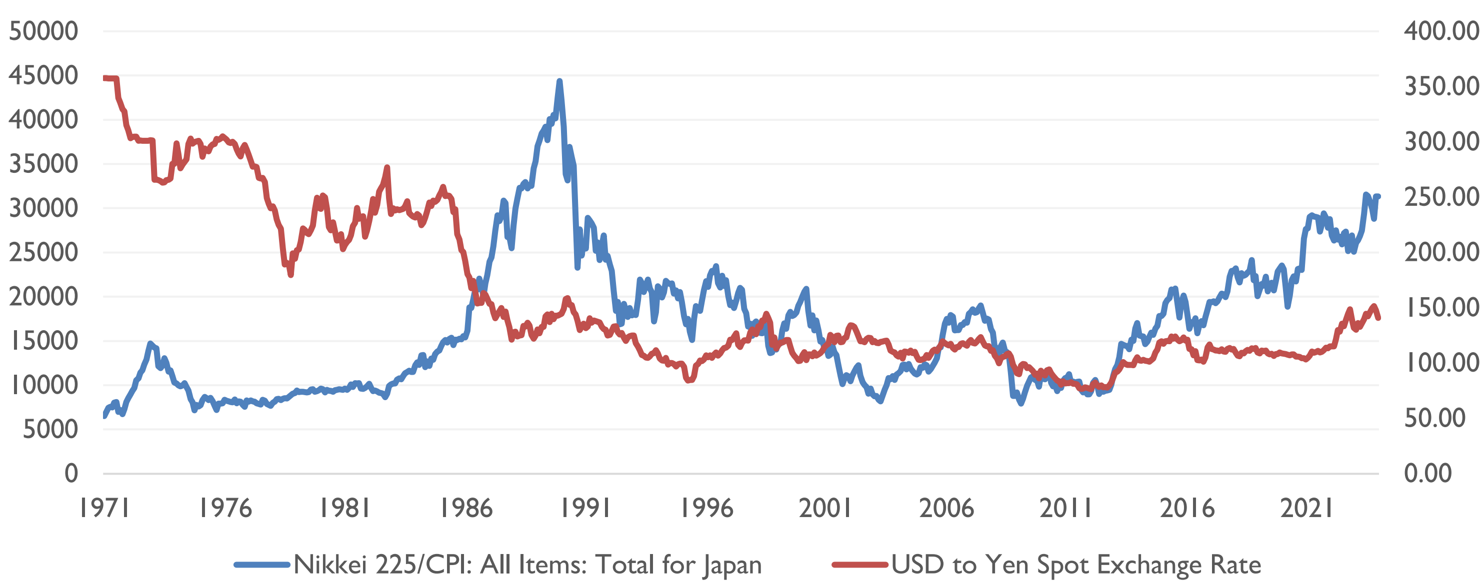
9. Government-led Digitalization:

Efforts by the Japanese government to digitize multiple sectors of the economy are expected to foster innovation and efficiency gains, further bolstering the country's economic prospects.

Since the introduction of ultra-easy monetary policies by former BOJ Governor Kuroda in 2013, followed by the adoption of negative interest rates in 2016—policies continued under his successor, Ueda—Japan has been gradually emerging from a prolonged deflationary period. By 2021, inflation rates began to rise, reaching levels not seen in four decades, albeit still modest compared to other developed economies. The current headline inflation above 3% is effectively the highest in forty years. This shift, alongside the depreciation of the yen to levels last set in 1990 due to Japan's unique monetary stance amidst global rate hikes, has spurred a notable rally in Japanese equities.

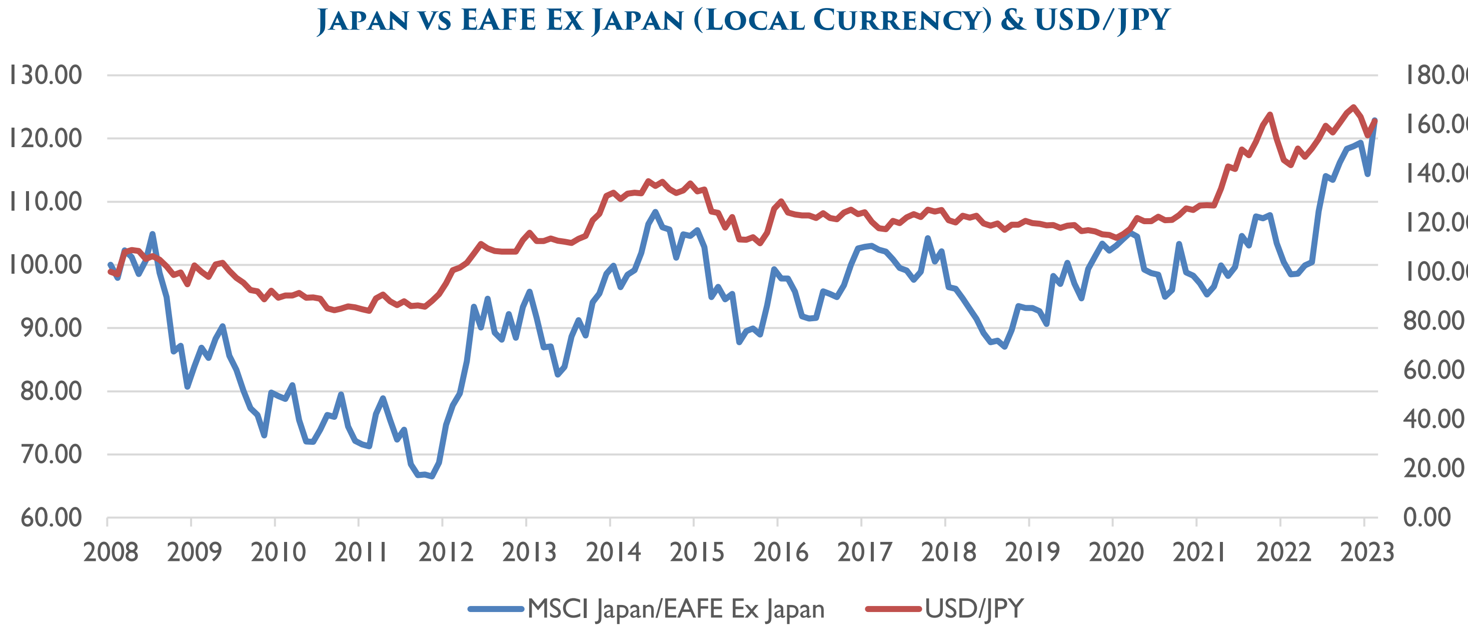
The Nikkei 225 just surpassed its historical 1989 peak (though it's still got some ways to go on an inflation adjusted basis as you can see from the previous chart), signaling a significant market adjustment, even though its economy slipped to being the fourth largest in the world behind the US, China and Germany.

Nikke Stock Average - Inflation Adjusted & USD/JPY Spot (1971-2023)



Source: Board of Governors of the Federal Reserve System (US), Nikkei Industry Research Institute, Statistics Bureau of Japan

The current price-to-earnings ratio of MSCI Japan is 16.95 which is close to the average of the last 15 years and far cry from the inflation valuations of the 1980s, indicating a more balanced investment landscape. Japan has outperformed most of its developed market counterparts since 2012 and a lot of this outperformance can be attributed to the depreciating yen.

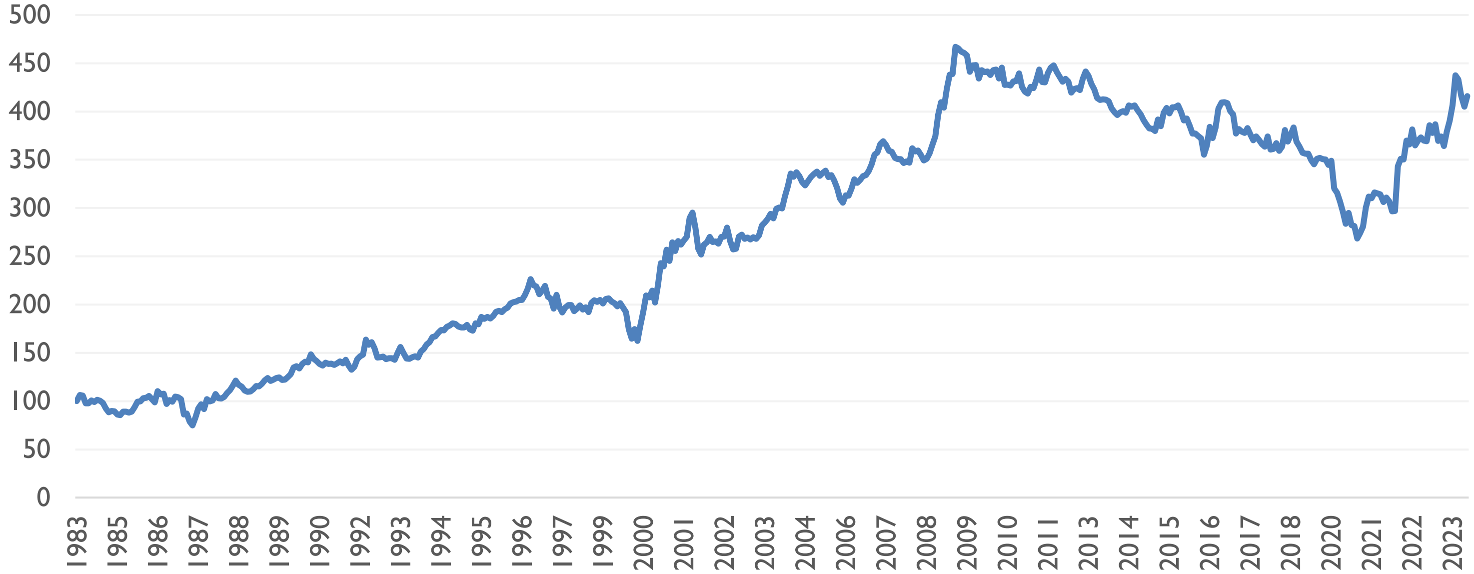


Source: MSCI, Ativo Capital, Board of Governors of the Federal Reserve System (US)

With inflation exceeding 3% and wages on the rise, Japan faces an improved economic landscape, prompting speculation that the Bank of Japan might increase interest rates for the first time in seventeen years. This economic shift comes amidst a severe labor shortage, worsened by demographic challenges, leading to significant wage increases. A nationwide wage hike of 3.6% in 2023, the largest hike in thirty years, was negotiated by Rengo the largest labor union organization. However, this situation has also led to an uptick in bankruptcies due to labor constraints. Despite these challenges, corporate profits and cash reserves are at an all-time high, with firms beginning to raise prices in response increased import costs due to a depreciating yen and, signaling a potential for higher profitability and improved margins. The Japanese Ministry of Economy, Trade and Industry (METI) is actively working to enhance the international competitiveness of Japanese businesses, fostering an environment conducive to mergers, acquisitions, and industry consolidation.

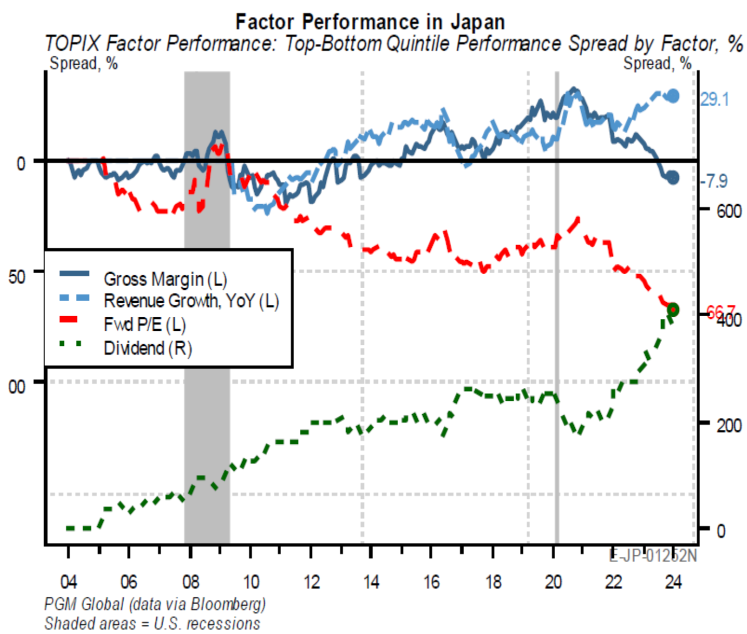
In a significant move in 2023, the Tokyo Stock Exchange (TSE) restructured its listing segments from five to three, implementing stricter criteria to encourage companies, especially those trading below book value, to adopt strategies aimed at improving their operations and increasing shareholder value beyond their cost of capital. This shift could potentially lead to lower market segment listings for non-compliant firms. Additionally, the TSE's new policy excludes cross-shareholdings from being considered as tradable shares, addressing a historical impediment to shareholder returns in Japan. Despite the necessity for a sustainable return on equity/investment (ROE/ROI) of 7-8% for value generation, currently only 20% of firms in the MSCI Japan index achieve an ROI above 8%, compared to 64% for the MSCI USA index. These measures should unlock value in Japanese equities and further increase payouts to investors. This should bode particularly well for value stocks in Japan which have historically outperformed their growth counterparts in Japan compared to the US.

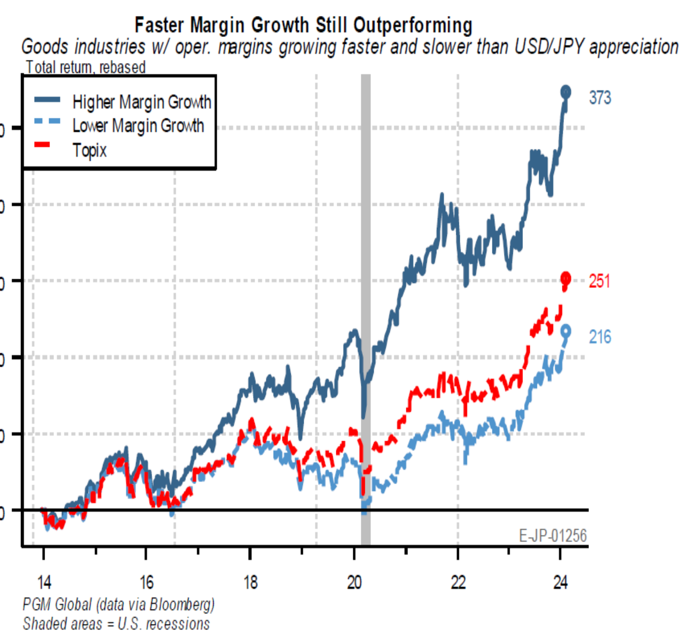
MSCI Japan Value/Growth



Source: MSCI, Ativo Capital

Our investment methodology, which zeroes in on companies exhibiting a Net Cash Flow Return on Investment (CFROI) exceeding their capital costs, is optimally designed to pinpoint and leverage value within the Japanese market. We also tend to favor companies with increasing dividends and buy-backs. Corporate margins have been increasing in Japan the last few years but most of the margin improvement has come from the benefits of a depreciating yen. So, focusing on just the level of margins is not enough. Investing in companies with high Gross Margins has historically worked very well in Japan but the performance of this factor has completely reversed since the value rally in Japan since 2020 which also coincided with the yen depreciating. What is more important right now is identifying companies that are growing their margins faster than the weak Yen. Additionally, firms that are increasing dividend yields and buy-backs are outperforming.





Our analysis indicates significant potential in Japanese small-cap stocks, which stand to benefit from the various economic measures discussed in this note. The attractiveness and performance of Japanese small caps should further improve with an appreciation of the yen, expected to occur if the Bank of Japan (BOJ) opts to increase interest rates at a time when other major central banks may begin to lower theirs.

The confluence of recent economic reforms in Japan and our investment approach bolsters our confidence in the unique opportunity presented by the Japanese market at this juncture. We are optimistic that these changes herald a promising era for long-term investors. Finally in closing if Katsushika Hokusai's famous painting – "The Great Wave off Kanagawa" is an apt depection of how the tumultous investment landscape has played out in Japan over the last forty or so years another famous Japanese painting comes to mind to possibly envisioning a hopeful and prosperous future for investments in Japan – Fujishima Takeji's – "Sunrise over the Eastern Sea"!

Conclusion:

Ativo Capital's comprehensive analysis underlines a pivotal moment for Japan's market, driven by structural reforms, monetary policy shifts, and a rejuvenated corporate sector. These factors collectively signal a significant departure from Japan's historical market dynamics, underscoring a robust investment thesis for long-term growth.

Actionable Insights:

1. Prioritize Small Caps:

Given the potential yen appreciation and BOJ's monetary policy direction, Japanese small caps are particularly attractive for their growth potential and sensitivity to domestic economic improvements.

2. Focus on Dividend Growth and Share Buybacks:

Identify companies demonstrating a commitment to increasing dividends and share buybacks, signaling financial health and shareholder value prioritization.

3. Leverage Structural Reforms:

Engage in sectors and companies poised to benefit from METI's competitiveness initiatives and TSE's listing reforms, focusing on those with strategic plans to improve operations and shareholder returns.

4. Monitor Technological and Digitalization Leaders:

Invest in companies leading in technology, automation, robotics, and benefiting from government digitalization efforts, as these sectors represent long-term growth drivers.

5. Adapt to Market Dynamics:

Stay responsive to Japan's evolving economic landscape, particularly regarding inflation trends, currency movements, and interest rate adjustments, to optimize investment strategies.

Japan's market is on the cusp of a transformative era, offering significant opportunities for informed and strategic investors.

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Disclosures and Disclaimers