Hosking Partners®

The opportunity in Japan

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THE OPPORTUNITY IN JAPAN

THE CONTEXT

The representation of Japanese equities in global portfolios has been declining for 30 years, and the country now represents only ~6% of the MSCI ACWI global benchmark. This is despite Japan being the world's third largest economy and its stock market consisting of 3,800 listed companies. For many years, the perception among global investors was that the interests of minority shareholders in Japanese companies were subordinate to those of other stakeholders. Decades of poor aggregate shareholder returns, combined with a depreciating currency, justified the label of 'value trap'. More recently, aging demographics has seen Japan's balance shift from a surplus of labour to a shortage. Coupled with nearly three decades of unconventional central bank policy resulting in vast equity ownership by the BOJ, this has been a catalyst for a renewed focus by policymakers and market participants to drive an improvement in the return on capital of Japanese corporates. This gives reason for optimism that the 'lost years' are over and, dare we say it, this time is different. Hosking Partners' employment of the capital cycle approach to investing that links returns on capital with long-term shareholder returns, positions us effectively to identify and capitalise on this opportunity through a long-term, diversified strategy.

WHAT HAS HAPPENED RECENTLY?

The Tokyo Stock Exchange (TSE) has played a key role in the recent revitalisation of the Japanese stock market. The origins of these changes trace back to Prime Minister Shinzo Abe's "three arrows" reforms – relating to monetary policy, fiscal policy, and an economic growth strategy – initiated after the December 2012 general election. The TSE's reform efforts gained momentum with the introduction of the Corporate Governance Code in 2015 and reached a pivotal moment with the publication of the TSE's Guidelines for Investor and Company Engagement in 2021. The TSE is actively pursuing a series of reforms to prompt Japanese companies to enhance capital efficiency and improve returns on capital, addressing the substantial undervaluation of domestic shares compared to global counterparts. The initial focus is on improving firms' price-to-book ratios (PBR) to above 1x, as more than 50% of Japanese equities are currently trading at a discount to net assets. Longer-term, significant opportunity exists in improving the aggregate returns on capital earned by Japanese corporates through a clearer link between corporate strategy and value creation.

OTHER POSITIVE FORCES AT WORK

The TSE is not acting alone in this quasi-activist approach. Indeed, support by complementary actions from aligned players is serving to increase the efficacy of reform, while also extending its duration:

1. **Reforms on mergers and acquisitions published by Japan's Ministry of Economy, Trade, and Industry (METI)** seek to reduce the obstacles to value creation through M&A dealmaking and industry consolidation.

2. **A more proactive stance on the part of global proxy voting agencies**, such as ISS and Glass Lewis, has resulted in their recommendation that institutional investors – both domestic and foreign – vote against Japanese executive teams and their boards if non-operating assets are excessive (the average Japanese company has ~25% of its net assets in domestic and foreign equities), as well as where boards lack sufficient independent directors (independent directors represent on average 35% of board members in Japan as of 2022, versus >85% in the US).

3. **AGM voting trends by both domestic and foreign investors** demonstrate declining approval ratings for the companies that are not taking, or even considering, action.

4. **Near-historic numbers of campaigns by overseas activist investors** have been targeting companies with meaningful capacity to reduce non-operating assets (including owned land, which according to JGAAP accounting standards must be carried at historic cost), bloated net cash positions, or where proactive portfolio management (spin offs/divestments) would result in unlocking value.

WHAT IMPACT HAS THIS HAD?

Short-term results are encouraging. 40% of Prime Market constituents (~1,600 of Japan's largest or most liquid listed companies) have published 'capital improvement plans' and total shareholder returns (the combination of dividends plus share repurchases) are hitting all-time highs for the third consecutive year. But there is still a long way to go. By way of vivid example, 46% of Japanese companies have a net cash balance sheet (built up in response to the bursting of Japan's bubble economy thirty years ago) compared with less than 20% in the US. The trend of improving shareholder returns supports an increase in sell-side research on Japanese companies, which is important for attracting additional overseas investor attention and inflows. Today 70% of Japanese listed companies have fewer than two sell-side brokers publishing research on them.

LONG-TERM PROSPECTS

There is a significant opportunity for consolidation within industries, as industry fragmentation in Japan remains high relative to global standards. For example, there are more than ten listed drugstore chains in Japan, more than nine large pharma companies, as well as hundreds of regional banks. At the same time, countless private SMEs in Japan are navigating the challenges of succession. Corporate finance firm Nihon M&A estimates there are 930,000 private companies in Japan whose owner-manager is aged 70 or above. As students of the capital cycle, we would expect to see industry consolidation result in the release of capital and improving returns. Companies in consolidated industries can find it easier to push through price increases – a further lever to improve returns on capital - something that has been absent in Japan for many years prior to the return of inflation in the last 18 months.

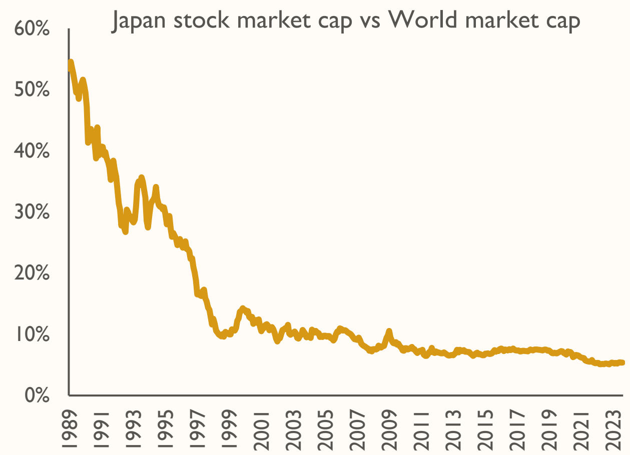
HOW IS HOSKING PARTNERS CAPTURING THE OPPORTUNITY?

We believe our diversified approach is well-positioned to capture the significant value on offer in Japan. Avoiding concentrated bets is important because progress will be non-linear and the greatest dislocation between price and value exists in some of the less liquid and smaller cap parts of the market (more than 50% of the Japan portfolio consists of companies with a market cap below US$5bn). Our investments alongside a collection of activist investors who have been agitating for change behind the scenes for some time already provides further leverage to our active management approach. Hosking Partners exposure to Japan comprises an eclectic mix of >50 names across a diverse range of sectors. From bloated paper and packaging businesses concealing world-class technology divisions, to oligopolistic oil refineries, from niche medical technology equipment players with activists chomping at their heels, to media companies with globally-renowned IP trading at negative enterprise values…All offer the powerful combination of steeply discounted valuation and an improving trajectory for returns on capital.

THESIS IN SIX CHARTS

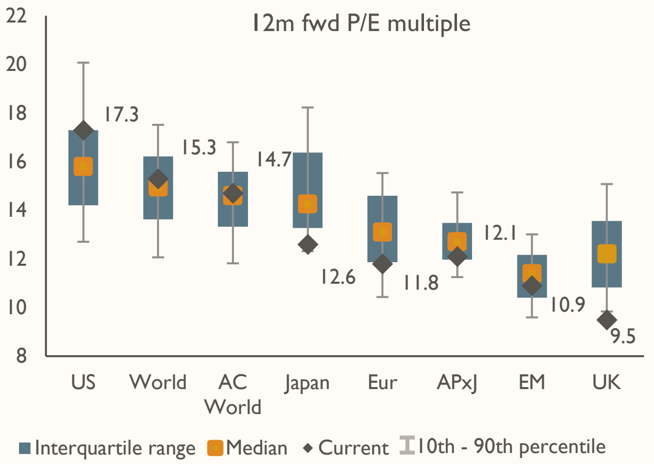
1

Global investors are significantly underweight Japan[i]…



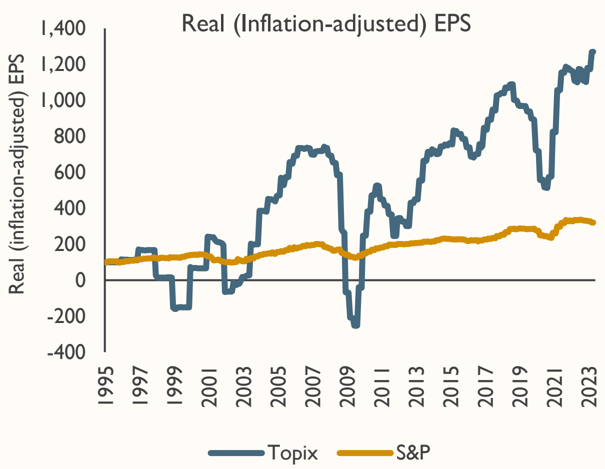
2

Japan valuations at all-time historic lows, 55% <1x P/B[ii]…



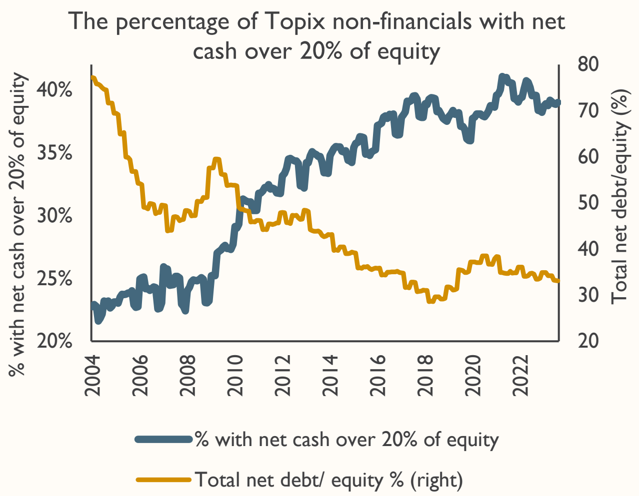
3

Valuation is not explained by a lack of profitable growth[iii]…



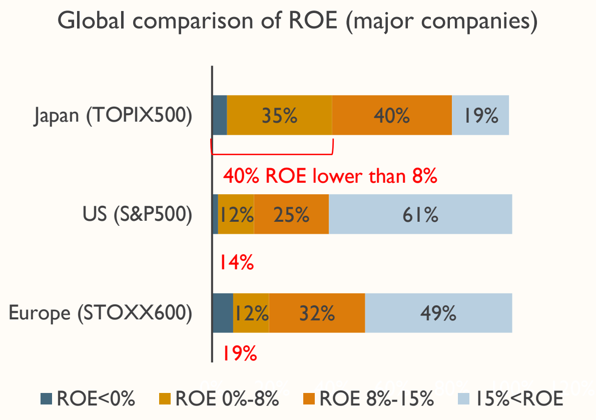
4

Instead, B/S are bloated with cash & non-op assets[iv]…



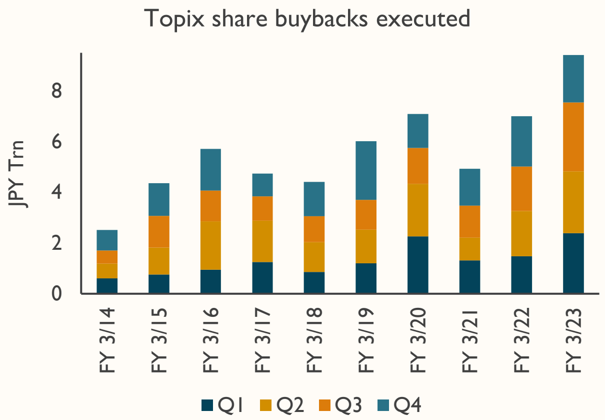
5

Capital efficiency opportunity for ROE improvement[v]…



Shareholder returns (div + BB) at historic highs[vi] .

6



HOSKING PARTNERS ON THE GROUND

All smiles after Jeremy and Chris asked the TSE to make their first delisting.

[i] CLSA. 31 Aug 2023
[ii] Goldman Sachs Global Investment Research. 06 Dec 2023
[iii] CLSA. 01 Oct 2023
[iv] CLSA. 01 Oct 2023
[v] https://www.fsa.go.jp/en/refer/councils/japan_corporate_governance_forum/06.pdf. 01 Jul 2022
[vi] CLSA. 31 Mar 2023

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