

# Unlocking value in Japan

## NOMURA

**Peter Jenkins** of Nomura Asset Management looks at the long-term potential for gains in Japanese equities

Global equity markets have risen sharply over recent months as investors have become more optimistic on the prospects for recovery. During this period, Japanese equities have lagged other markets, bringing back unpleasant memories of previous false dawns. Paradoxically, the prospects for Japanese equities have continued to brighten and the danger now is missing the boat.

### Economic recovery

The Japanese economy has been hit hard by the global economic downturn. With domestic demand sluggish, growth in recent years has come disproportionately from the export sector. Consequently, the collapse of world trade in 2008 had a big impact on Japan, and the early months of 2009 saw annual export declines of up to 50%. However, Japanese exports are staging a strong recovery led by shipments to emerging markets and Asia. Japan is certainly benefitting from being in the right neighbourhood and supplying the right products, namely capital goods. This despite the fact that the yen has appreciated by around 6% against the dollar over the last 12 months. Whilst yen strength has been a drag on growth overall, Japanese exporters have proved themselves adept at dealing with currency pressures over the years; the yen having risen against the dollar by over 175% since the 1985 Plaza Accord.

### Cheap market

Even without a strong recovery, Japan appears to be discounting plenty of bad news. The market is cheap; cheap relative to other world markets and cheap against its own history.

In terms of corporate earnings the market looks attractive. On a price-to-earnings (PER) basis, the market is trading on a prospective multiple in the low 20s, certainly no more expensive than other major world markets and a far cry from the heady multiples of the late 1980s.

When viewed against the value of company assets, stock prices in Japan are also cheap. The market as a whole trades at a 20% premium to its book value, a 40 year low. This compares favourably to the US and UK markets which trade at around twice book value.

On a dividend yield basis, the Japanese equity market looks attractive with a yield of around 1.9%, which is significantly above the 1.3% yield on 10-year Japanese government bonds. So from an income perspective, equities appear much more attractive than bonds, particularly given that dividends should grow over time. By comparison, the FTSE100 is yielding around the same as 10-year gilt yields and US 10-year bonds offer around 1% more income than the S&P500.

### Why is Japan cheap?

Essentially the Japanese market is cheap because equity returns have been poor. The technology of Sony or Toyota may be admired, but technology and market share often come at the expense of profitability. This is manifest in the Returns on Invested Capital (ROIC) which lag those in the US and Europe throughout the economic cycle. See chart 1.

### Corporate restructuring

However, there is hope on the horizon. There is growing

evidence that Japanese companies, spurred on by more demanding shareholders and increasingly competitive business conditions, are changing fast. For example loss-making business divisions that companies have carried for many years are being wound down or restructured. A recent example was the merger of the struggling handset businesses of NEC, Casio Computers and Hitachi. Indeed M&A activity is an important indicator of such business restructuring and is a key mechanism for unlocking value. M&A activity has been rising in the years since 1985 both by number of cases and also by value.

Another important change is balance sheet management. In the past, Japanese companies have tended to hoard cash. This provides extra financial flexibility but at a cost of depressing overall returns. Moreover surplus cash can tempt companies to invest in uneconomic projects. A positive development is the growing number of companies which are returning surplus cash to shareholders. Corporate payouts, the proportion of earnings returned to shareholders in the form of dividends and share buybacks, have been rising inexorably, pleasing shareholders immediately through raised dividends and over the longer-term through improved returns on equity. Japanese payout ratios have risen to around 30%, but this lags the UK and Europe where payouts are typically around 50%. This illustrates the potential for Japanese companies to lift dividends and increase share buy-backs in the future.

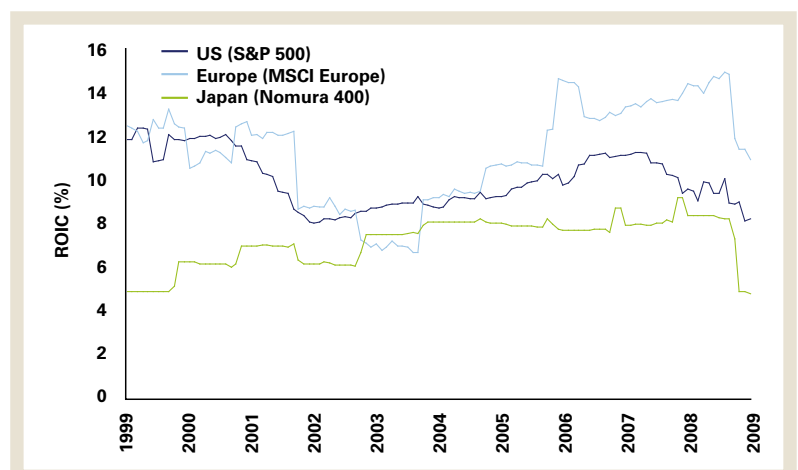
### Summary

There are reasons to believe that Japanese equities represent an attractive investment opportunity at present. Japan is a prime beneficiary of global recovery and strength in Asia, and on key measures, the market is cheap on historical and global comparisons.

Over the longer-term, a powerful catalyst for an upward re-rating of the market is corporate restructuring which promises sharply improving returns to shareholders. The potential is there. ■

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Chart 1: ROIC Around the World



Source: Nomura Securities.

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