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Matthews Asia

Matthews Asia Perspective:
Growth Opportunities in Japan

Small- and medium-sized listed Japanese companies are finding opportunities at home and across Asia

The sustained growth of Asia and Japan's increasing integration with the rest of Asia is what makes Japan's equity markets attractive. In what can appear a crowded equity fund market, lead manager Kenichi Amaki says the Matthews Japan strategy offers real opportunities to tap Japan's potential.

'Our firm has invested exclusively in Asia for more than two decades and we know Asia well. We have deepened our conviction that Japan's ties with the rest of Asia are becoming stronger,' he says.

That relationship has changed substantially. Once, Asia was considered as a low-cost manufacturing hub for Japan's global brand titans. Labour was cheap but low wages meant few Asian economies were big or rich enough to be considered as important end markets for goods. The rise of the middle classes has changed all that. As incomes rise, consumers are eager to seek out the quality, yet now affordable, branded goods that Japan excels at. With Asian growth expected to outpace that of developed Western markets, the opportunity for corporate Japan to benefit from its integration with the rest of Asia has a multi-year horizon.

Based on more than 40 years of combined experience investing in Japanese equities, Amaki and co-manager Taizo Ishida also believe in looking beyond Japan's global titans. For the last 15 years or so, most Japanese equity investors have considered the market as a "large-cap value" play, investing in big names at low prices. The two managers believe the market still represents an element of value on a price-to-earnings and price-to-book basis when compared with American and European peers, although the gap has been significantly closed in the recent Japanese market rally. Importantly, active Japan investors can find many long-term growth opportunities across the market-cap spectrum.

'We take an all-cap approach. We look for growth irrespective of company size. Japan certainly has some global champions, but there are also a lot of companies to invest in, besides the titans, that investors have never heard of and that don't get covered by most research analysts because Japan's lost decade depleted the talent pool of analysts covering Japanese small-cap and mid-cap companies' says Amaki.

There are three types of stocks with particular growth appeal. The first are the global leaders, companies with world-leading technologies, products and services. Japan is home to more global brands than any other nation in Asia. With strong brand recognition, they already dominate sectors such as autos and home appliances across the world. Second are the "Asia growers," generally companies that derive a significant or growing portion of revenues from Asia, capitalizing on the growth of Asia's middle class. Third come domestic niche players that can deliver innovative products and services in sectors such health care, e-commerce and B2B services within Japan. They too can grow even as demographics stunt the prospects of traditional players.

'An innovative idea and strong business model can still exploit inefficiencies, even with an aging population. Domestic niche players are the most under-rated category. It takes a lot of effort to find opportunities under the radar,' says Amaki.

He and Ishida believe the Matthews Japan portfolio has a small- and mid-cap bias because of Japan's market structure, not because they deliberately target such stocks. Sell-side analyst coverage is patchy, with a larger number of companies worth US$3 billion or less covered by just one analyst or no analysts at all. Less coverage leads to more undiscovered gems lower down the cap scale.

Amaki is also mindful of sentiment and flows. International investors have powered the Japanese equity market rally since Prime Minister Shinzo Abe unveiled "Abenomics," or his monetary, economic and reform policies to drag the economy out of deflation.

'Japan is not immune to sentiment,' he admits.

In other markets, small caps tend to fall fairly hard and fast in such circumstances. That may be the case for some smaller Japanese companies, but not necessarily for all.

'It depends on the names. The frothy, speculative stocks will correct, but quality, steadier growth names that do not attract much attention on the way up, tend to fall less hard on the way down, particularly if foreign ownership levels are low,' says Amaki.

Given the increasing importance of Asia as a market for Japanese goods, the slowing economy in China is a direct issue for many firms. The strategy is cushioned to a certain degree as only around 35% of the portfolio's corporate revenue comes from overseas. Even so, that level is higher than the market.

'China is a concern but not enough to make us reconsider our stocks. We hold a lot of companies that operate in China in the consumer-orientated space, which continues to do fairly well,' says Amaki, highlighting that Chinese wages are rising at 10% per year, as are retail sales.

Other areas of the Chinese economy are genuinely slowing. Having been a good source of investment ideas, the Japanese automation sector faces a tougher sales environment as capital goods investment is scaled back. The Chinese auto industry was a good customer of niche Japanese robot manufacturers until recently. Overcapacity has led them to scale back their expansion plans; Japanese machinery exports are already in retreat.

Governance is a perennial question mark for investors in Japan too. Amaki says the situation is improving year-on-year, recently nudged along by the country's new corporate governance code. Small-cap and mid-cap governance levels are often surprisingly high, thinks Amaki, as many firms are relative newcomers to the market and far more attuned to shareholder values.

Recent volatility, partly prompted by events in China, has presented more investment opportunities. Amaki says that he has been following several quality names for a long time, but only now do they represent potential growth-at-a-reasonable-price candidates.

Kenichi Amaki and Taizo Ishida are both fans of Abenomic reforms, but warn investors against investing in Japan purely on the back of Shinzo Abe's policies.

'Mr. Abe should be re-elected in September as the leader of the Liberal Democratic Party, but he will not be in power forever. It is important to separate Abenomics from Mr. Abe himself,' says Amaki.

While the media and short-term investors expect quick and wide-ranging change, Amaki says he looks at the opportunities from a realistic position: every reform is a step in the right direction, even though the to-do list remains long. Yet despite the political will, real GDP remains fairly stagnant. Amaki urges investors to look beyond the headline figures.

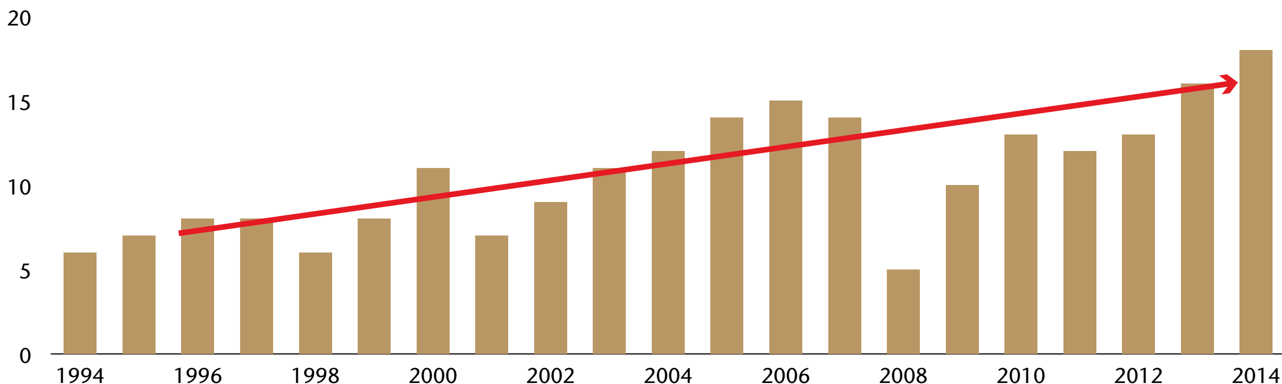
The country may not be growing, but listed companies are doing well. Net income of listed stocks rose more than 20% in April-June from the previous year.

'GDP is the wrong measure. Corporate earnings will outpace GDP in the years ahead. We expect double-digit earnings growth for the fiscal year that ends in March.

'Investors need to focus on the long-term potential of companies that will continue to grow over the next five years,' he says.

Collectively, enthusiasm about Japan has led to significant re-ratings. A number of sectors are already at full value, with some consumer staple stocks already looking expensive. Japan's top internet companies are trading at levels similar to their Silicon Valley peers, calculates Amaki.

Even though the earnings outlook is positive, Japan still trades on a discount to U.S. and European peers, particularly if one considers the potential for improving returns to shareholders going forward. Post-correction, the TOPIX is on a P/E of 15x and a price-to-book of 1.3x. Increasing shareholder value is a priority, average ROE is set to rise to 8.5%—a level similar to that in Europe. (TOPIX data as of Aug 21, 2015)



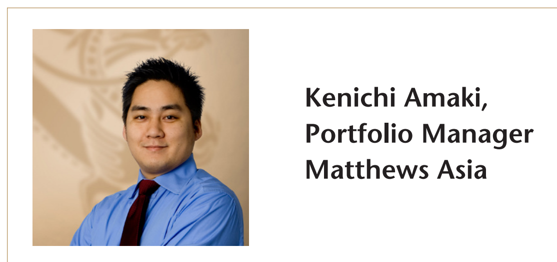
CAGR = Compound Annual Growth Rate
Sources: Ministry of Finance Japan, Bloomberg

The Tokyo Stock Price Index (TOPIX) is a market capitalization–weighted index of all companies listed on the First Section of the Tokyo Stock Exchange. Indices are unmanaged and it is not possible to invest directly in an index. Index characteristics do not represent or predict the performance of any investments.

Price-to-Earnings Ratio (P/E Ratio) is a valuation ratio of a company's current share price compared to its per-share earnings and is calculated as the market value per share divided by the Earnings per Share (EPS).

Price-to-Book Ratio (P/B Ratio) is used to compare a stock's market value to its book value. It is calculated by dividing the current closing price of the stock by the latest quarter's book value per share. A lower P/B ratio could mean that the stock is undervalued.

Return on Equity (ROE) is the amount of net income returned as a percentage of shareholders equity. Return on equity measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested, and is calculated as net income divided by shareholder's equity.



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