Japan 2.0: A New Generation of Growth

It has become all too easy to dismiss the case for investing in Japan, with its aging population, years of moribund economic growth, deflation and doubts over the effectiveness of government reform. So many times it has promised to deliver, and so many times investors have been left disappointed.

There are two prevalent misconceptions when it comes to looking at Japan. Firstly many investors have lost patience with Abenomics and disregarded the amount of time it takes for change to take hold and leave a lasting impact on markets. Secondly, many investors remain focused on what we call Japan 1.0: the old Japan, the value story with its focus on large exporters.

However, investing in Japan has changed dramatically in the last 15 years. Today, we see companies that are taking advantage of growth opportunities in domestic and global markets where businesses and consumers have new product and service needs—Japan 2.0 versus Japan 1.0.

DON'T LET THE MACRO DRAG YOU DOWN—Asia's Rising Household Incomes are a Runway for Japanese Growth

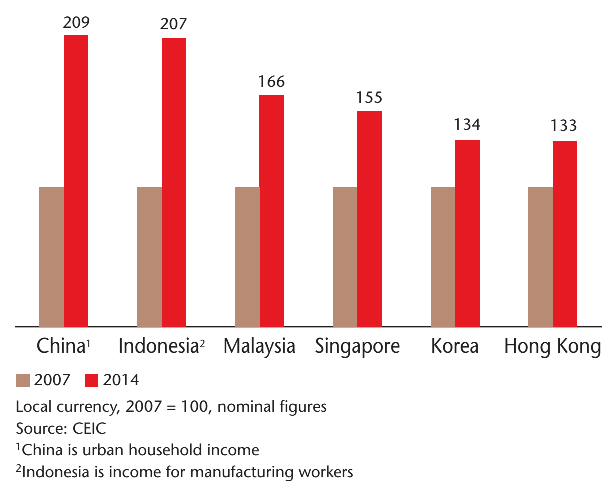
As a macroeconomic growth story, Japan has appeared fairly unattractive. However, just because the economy may be weak, it does not mean an absence of investment opportunities. What has changed is where these opportunities are. For Japan 2.0, the growth stories involve domestic Japan (rather than the global leaders of the past), and even more so in those companies that are benefiting from growth within Asian economies and further afield.

The integration of the Japanese economy with the rest of Asia is somewhat underreported, yet is of great importance. It is a story that has evolved over the past 20 years, so much so that many Japanese companies are successfully growing their market share both in the Business-to-Consumer (B2C) and Business-to-Business (B2B) landscapes across Asia.

In the consumer space, Japan offers well-established and well-managed consumer brands, which are lacking in the rest of Asia. Japanese brands are typically associated with quality while its product positioning is often in the affordable segment (in contrast to European/U.S. brands that dominate the luxury segment).

A decade ago, Japanese products were simply too expensive for Asia's middle class, but as incomes have grown, consumers have sought to trade up for better quality, thereby creating a market for Japanese brands that did not previously exist. Furthermore, discretionary spending in China is expected to grow considerably by 2020 and Japanese consumer brands are well-positioned to tap this growth.

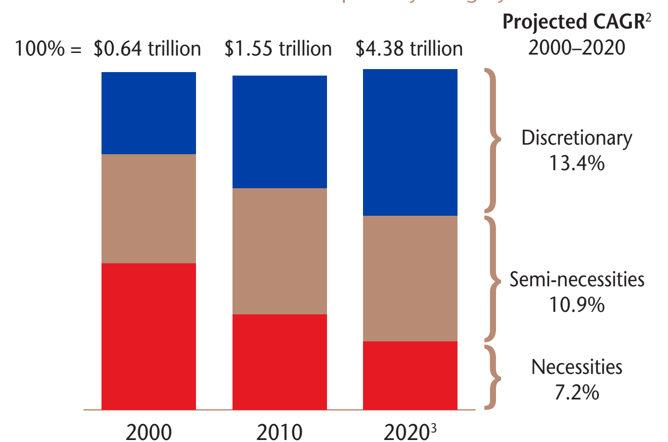
FIGURE 1. ASIA HOUSEHOLD INCOME



Local currency, 2007 = 100, nominal figures
Source: CEIC
[1]China is urban household income
[2]Indonesia is income for manufacturing workers

FIGURE 2. DISCRETIONARY SPENDING IN CHINA IS EXPECTED TO GROW CONSIDERABLY BY 2020

Urban households' annual consumption by category[1]



1 In real 2010 dollars; in 2010 $1 = 6.73 renminbi. Figures may not sum to 100% due to rounding.
2 Compound Annual Growth Rate
3 Forecast
Source: McKinsey & Company; Meet the 2020 Chinese Consumer

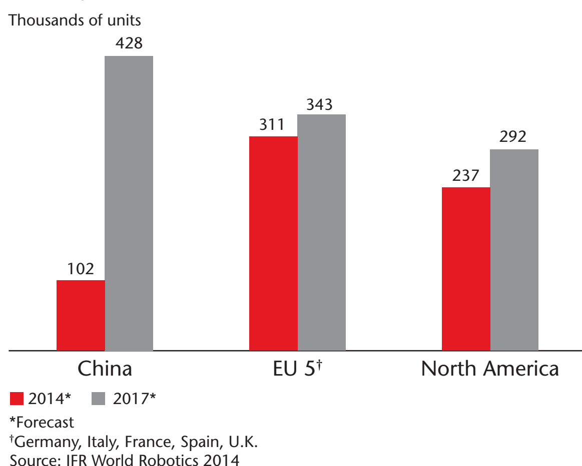
DISCRETIONARY SPENDING IN CHINA IS EXPECTED TO GROW CONSIDERABLY BY 2020

As Asian economies develop, so do their populations' demands for health care. For Japanese health care companies, there are opportunities to tap growth in nascent markets where there is a need to develop health care infrastructure and temper the cost of overall health care provision.

Meanwhile, Japanese health care firms are building up expertise and capabilities that will increasingly be in demand elsewhere globally as China and the West all face aging populations and the rise of lifestyle diseases.

Another way in which Japanese companies are increasing profitability within Asia involves the other side of the rising income story. While real rising incomes are great for consumers, they place greater pressure on companies having to pay these higher wages. As a result, businesses have been forced to adopt more technology into their processes to drive productivity and protect profit margins. Robotics and other modes of automation are increasingly being utilized to counter the impact of more expensive and scarce labor. Indeed, the adoption of automation and robotics is set to soar in China and other Asian countries to both boost efficiency and improve quality. This is very favorable for related businesses over the next decade because automation and robotic penetration in China and the rest of Asia is still extremely low compared with countries like Japan, Germany and South Korea.

FIGURE 3. ROBOT STOCK IN CHINA WILL SURPASS NORTH AMERICA AND MAIN EU COUNTRIES IN 2017
Estimated operational stock of industrial robots, 2014 and 2017



*Forecast
†Germany, Italy, France, Spain, U.K.
Source: IFR World Robotics 2014

Meanwhile, more important than the fact that wages are rising, China and other Asian countries need to improve the quality of their output and climb the value chain. While China has been well-known as the world's manufacturer of low-end products like children's toys, it has also risen up to produce smartphones, LED screens and other technology. This shift from a relatively simple to a much more complex product requires higher quality along the entire supply chain. We believe automation is imperative for these companies as it can help increase in the quality of products and to deliver that quality consistently. In terms of robotics, Japan has some of the leading companies in the world, in addition to several key component suppliers, which can be beneficiaries of increasing demand in the next decade.

WHERE ARE JAPAN'S DOMESTIC GROWTH OPPORTUNITIES?

In Japan, robots have long been used to supplement the country's aging workforce. This demographic shift is ultimately about the shortage of younger people, and a key question is: how can businesses adapt? Beyond robots, there are other companies that can offer solutions and even capture opportunities from weak demographics.

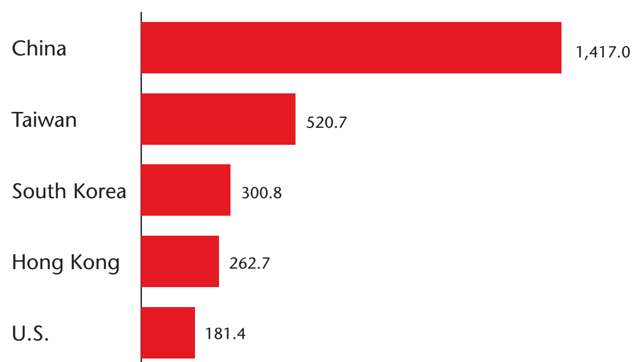
Take companies operating in the health care sector. As Japan gets older there will be a natural increase in demand for health care. Japan has one of the largest health care markets in the world, and companies that can revolutionize health care and related technologies stand to benefit.

The cost of hiring employees is also going to rise in the medium term. Companies that can provide services to make businesses more efficient, such as B2B services companies, are well-positioned to capitalize on this trend. As companies grow and people become harder to hire, companies are seeking to outsource non-core operations, such as human resources, to specialist providers. We think this penetration still has room to increase as labor becomes both more scarce and expensive going forward.

Rising wages tend to go hand in hand with rising consumption. One area that we believe could benefit is e-commerce. Japan has the fifth-largest number of internet users in the world but e-commerce penetration is still at relatively low levels. In 2015, retail e-commerce sales accounted for approximately US$89 billion, or up to almost 7% of total sales. By 2019, this is forecast to reach US$134 billion and 9.7% respectively. In addition to increasing sales, we believe there is scope for productivity gains through warehouse automation.

But it's not only via e-commerce that we see more demand for Japan's products and services. Over the past few years, Japan has experienced significant growth in inbound tourism as a result of rising household incomes in Asia and supportive government policies such as visa relaxation. A large portion of these tourists are coming from China, but it is also growing in broader Asia—and Japanese companies are benefiting from the tourism spend. As Figure 4 shows, Asian countries made up four out of the top five spending nations in Japan last year, with China taking the lion's share by a large margin.

FIGURE 4. CHINA IS TOP SPENDING NATION
Total expenditure by tourists in Japan, billions of yen



Source: Japan Tourist Agency Figures for 2015

Finally, while service businesses currently occupy a growing share of the Japanese economy, they are a minority among listed companies. This, in part, is because of the fragmented nature of many Japanese markets, where leading companies tend to only control a 5% or 10% market share. We believe this may change over the next decade, in part due to demographics. As business owners retire, they will sell up to their competitors or exit the market, lacking any successors to the business.

Meanwhile, what is often overlooked is that listed companies in Japan are still just a subset of the overall economy. Not all companies are listed on the stock market, but those that are tend to be the larger businesses with better pricing power. They are more productive and over time, if listed Japanese companies can consolidate market share, their profits can grow, even though the entire profit pool for the country may not be growing. Companies that can use their capital efficiently should profit.

IMPROVING CORPORATE GOVERNANCE PAVES THE WAY FOR GROWTH

When it comes to corporate governance, investors are slowly starting to reap the benefits from Shinzo Abe's reforms. Although it is on the back of strong profit growth, dividend payouts in Japan are at a historical high and buybacks have increased substantially as well.

But improving corporate governance in Japan is not simply about dividends or share buybacks. In the long run, it's about improving capital returns and capital allocation. Over time, businesses are going to be challenged, environments will become difficult; the companies that can survive with less volatility will be those managing a quality business and deploying capital efficiently.

Today, when I visit Japanese companies, management teams are talking about shareholder returns, balance sheet management and capital efficiency—a marked change to previous years. However, while it is a significant step it won't produce results instantly. Improving capital returns and capital allocation is an area we believe will play out over a five to 10-year time horizon.

JAPAN 2.0

Japan will always be dominated by discussions about macroeconomic, political and regulatory headwinds. These are things outside of our control. What we can control is our analysis of a company and avoiding areas of the market that tend to be sensitive to cyclical ebbs and flows.

Yet there remain some very strong Japanese companies that represent the real growth story in Japan today: Companies that can capture domestic demand, tap into Asia's ongoing evolution and take global market share. We believe Japan is home to many. It's a story that has taken some 15 years to come to the fore, but which should last a lot longer going forward. As such, Japan 2.0 looks to be the dawn of something new.

Disclosure and Notes

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