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INSIGHTS

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Its Time To Revisit Japan

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Up until very recently the Japan equity market has stood out as a serial underperformer. This has justified many investors' beliefs about the Japan equity market. Commonly, the "right view" was to ignore Japan and to continue to allocate limited resources to identifying opportunities in other markets.

In recent years these kinds of beliefs have become further entrenched amid high levels of uncertainty arising from external factors, including the numerous global market shocks. There have been entrenched market perceptions surrounding the effects of government debt levels, deflation, and demographics in Japan. The dire situation borne out by the major disaster in Japan, and then the political situation between China and Japan has also contributed to greater market uncertainty about Japan's immediate future.

First and foremost, we believe starting valuations are critically important when investing in equities, and in our opinion, Japan offers compelling value. Since last year's Lower House elections culminated in a landslide victory for the Liberal Democratic Party (LDP), market expectations have begun to shift and typically entrenched market views on Japan are beginning to be challenged.

As a result, we believe there are pre-conditions now in place which offer a very compelling investment opportunity for investors today.

"Pro-growth" LDP policies have begun to trigger shifts in entrenched market views

Japan's Lower-House election on 16 December 2012 resulted in a comfortable majority for the Liberal Democratic Party (LDP). The "pro-growth" monetary and fiscal policies advocated by the LDP, outlined below, have begun to influence market expectations especially in terms of the potential of a weaker Yen in the future.

- Monetary Policy
  The Bank of Japan and the government have entered into a policy accord committing to a +2% medium-term inflation target

- Fiscal Policy
  Plan to rebuild roads, ports, and housing damaged by the March 2011 Earthquake; improve ability of public infrastructure to survive natural disasters; increase spending on community policing and national security

- Economic Target
  Establish a nominal GDP growth target of 3%; policies have yet to be outlined in detail with a growth strategy due to be delivered in June 2013

While these policies sound promising, skepticism lingers; Japan has had a long history of delivering little in the way of top down policy reform. While it is still early in the day to form any conclusions, there are reasons to believe the new administration may make a difference. Notwithstanding this, the possibility of a change has introduced a wider range of perceived market outcomes. This combined with the very attractive valuations on offer has increased market risk to the upside in Japan.

Political will – A platform for change

The **first observation** is that for the first time in a long while, with a large majority in the Lower House, the LDP have received from the Japanese public a clear mandate and ability to legislate change.

The **second observation** is that this time, unlike previous occasions, both the fiscal and monetary stimulus are coordinated. The Bank of Japan would acknowledge the sweeping election result represents the public's support for a more concerted approach to economic revitalisation. Accordingly, the agreement reached between the LDP and the Bank of Japan stated that the central bank will do its utmost to achieve the 2% inflation rate "at the earliest possible time".

There was a rapid currency response post the election, and may reflect changing inflation expectations. The market's longer term inflation expectations may continue to be revised on the back of a coordinated policy approach.

The **third observation** is that industrial revitalisation is a key government policy. Its stated aim is "…generating innovation and strengthening the competitiveness of industries through promoting business investment and improving infrastructure".

The most important aspect of this is that the starting point to implementing this policy is now very different as there is arguably strong corporate health in Japan. Previously the corporate environment was characterised by significant debt deleveraging, and this proved to be a strong headwind for effective government policy during this period.

Starting point – Good corporate health

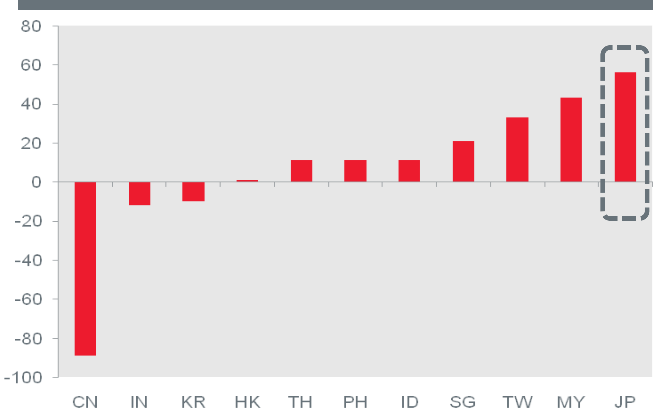
Corporate Japan has been operating in a tough environment for a long time, and companies have been forced to adapt in order to remain competitive. Companies have been restructuring and rebuilding balance sheets for more than ten years. During that time we have seen a significant improvement in profitability.

Corporate restructuring has included a reduction in excessive capital spending, which has improved capital allocation. These activities have enabled corporate Japan to consistently generate free cash flow well in excess of net income after taxes.

At an aggregate level Japan's ability to generate free cash flow is impressive:

- Highest free cash flow in Asia
- Only market in Asia generating free cash flow in excess of dividends, pointing to sustainability
- Free cash flow goes to paying debt and funding future operations

Median free cash flow to profit ratio - Japan versus Asia universe



Source : Forensic Asia, as at Latest Financial Year, October 2012

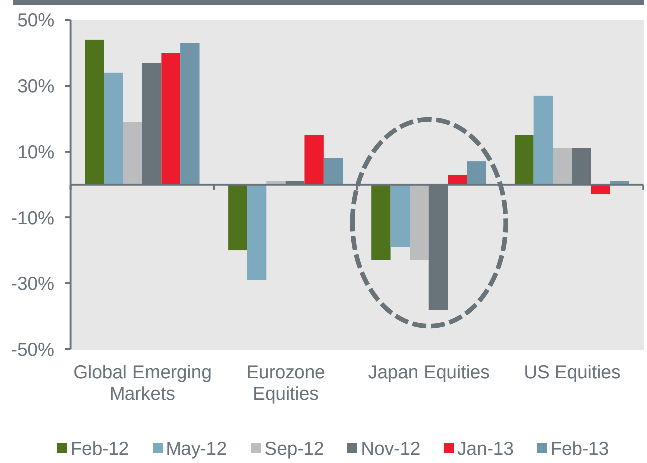
There is more good news; the process of corporate debt deleveraging is coming to an end. Arguably, the Japanese credit cycle is now different to the European and US credit cycle. For example, total bank loans in Japan have bottomed and are beginning to rise, which is also supportive of the domestic outlook.

Investors appear to be reappraising Japan

Focus is upon Japan in what seems the first time in many years. According to the Merrill Lynch Global Fund Manager Survey, fund manager investment intentions for Japan have risen. Japan allocations have moved from a sustained and large underweight to a small overweight allocation.

The survey went on to state that allocations to Japan averaged net 31% overweight from 2003-07. While investors intended allocations have risen more recently, they remain at levels far below the last historical peaks.

Fund manager survey – Equity net % asset allocation

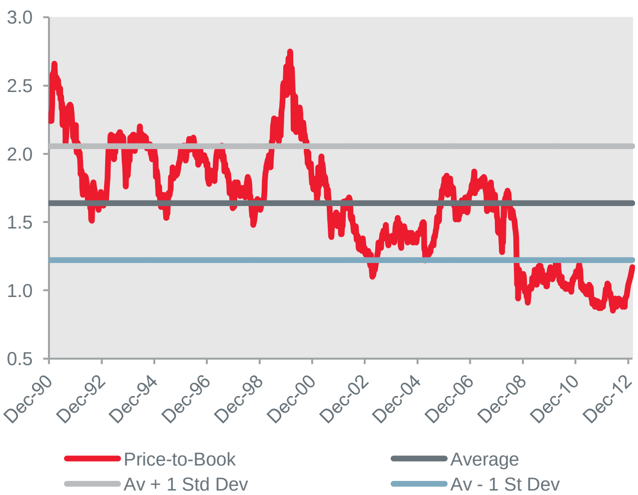


Source : BofA Merrill Lynch, Fund Manager Survey, 12 Feb 2013

Starting valuations matter most

Whilst the relatively strong performance for Japan's equity market at the end of 2012 and into 2013 was more than welcome, valuations remain very attractive.

Japan - Price to book (x)



Source : Datastream, 28 February 2013

Currently, the TOPIX Index, a broad market index, is trading at 1.2X book value, with a fiscal year ending March 2014 prospective price to earnings (P/E) of 13.5X and a current dividend yield of 2.0% (JP Morgan, 28 Feb 2013).

Company valuations have been gradually de-rating from the high levels witnessed in the 1990s to a point where the market is trading at very attractive levels versus its own history.

Additionally, Japan's equity market is trading at attractive levels versus major markets – this is something that could not be said for more than a generation.

Whilst the broader Japan market is attractively valued, our analysis also suggests there remains a wide valuation dispersion within the market. This is particularly attractive for a bottom up stock picking approach aimed at identifying opportunities based on valuation.

Not in the price?

Whilst valuations remain attractive, our analysis suggests there are crucial elements that have not yet been incorporated into the share price for a good many companies.

The first is the strong balance sheet health displayed by many companies. Strong balance sheet health points to sustainability with significant levels of free cash flow being generated and used to invest in new businesses, repay debt, and return value to shareholders via dividends and buy-backs.

The second is the meaningful change we have observed in corporate attitudes which points to delivering their competitive edge. Many companies have refocused on core businesses; are moving to higher margin business models; and are using their strong balance sheets to pursue sensible merger and acquisition opportunities to gain overseas market access and to diversify into complimentary products.

Forecasting the impact of the proposed LDP policy initiatives is difficult. However we observe that for some investors there is now a reason to reassess their long held negative views on Japan. Perhaps, as part of an overall reassessment, the market will begin to view Japan as a place for stock pickers.

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