JAPAN EQUITY OUTLOOK

June 2017

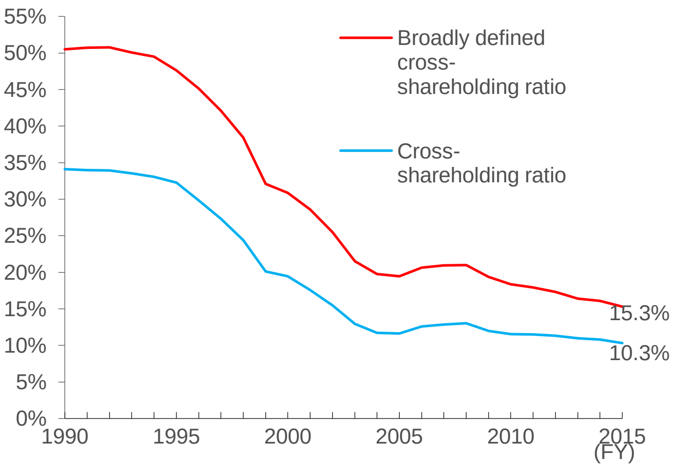
Importance of shareholder distribution in a globally low growth environment

Over the past five years, there is one factor that has been most effective in beating the Japanese stock market; shareholder distribution.

In the Japanese equities market, high dividend strategies have significantly outperformed other strategies. We believe that – in a low growth, low interest rate environment where investors yearn for yield – these strategies will continue to outperform.

Historically, Japanese firms have tended to put less priority on shareholders, and have not been proactive in distributing to shareholders. During the post-war era, Japan's economy was led by the corporate banks under the "convoy capitalism"[1] concept. Protective measures such as cross-shareholdings, and repayment of debt were prioritised over returns on equity (ROE) and dividends.

Exhibit 1: Cross shareholdings in Japan



Source: Nomura Securities

Banks have lost some of their power since the bubble burst in the early 1990s. But concepts such as cost of capital are still not fully understood by corporate executives. Just as Warren Buffet stays away from companies with low capital efficiency, or low shareholder distribution, global investors have stayed away from Japanese companies. As a result, Japanese equities have been underweighted in global markets.

To tackle this issue, Prime Minister Abe introduced the Stewardship Code and Corporate Governance Code. These Codes aim to change companies and turn around the Japanese equity market and economy. The goal is to create a sense of shareholder primacy, enhancing capital efficiency and increasing shareholder distributions by companies.

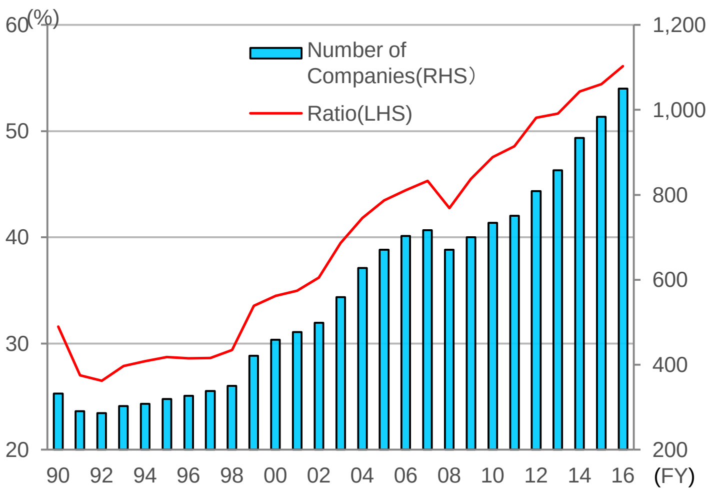
Cash is King

"We would like to have a rock solid balance sheet, by keeping enough cash so that we won't go bust even if the Global Financial Crisis were to happen three times."

This is what the CFO of a major manufacturing company recently said to us regarding the use of their excess cash. This is quite frustrating for equity investors; however, this attitude is not unusual among Japanese companies.

On a global comparison, Japanese companies have significantly more cash on their balance sheets. If we look at the major companies in the TOPIX 500 (excl. financials), companies with liquidity at hand higher than their interest bearing debt account for more than 55%. More than half of the companies are net cash. Even after Abenomics policies were put in place, companies have not necessarily changed much in the way they hoard their cash.

Exhibit 2: Companies with positive Net Cash



Source: Nomura Securities

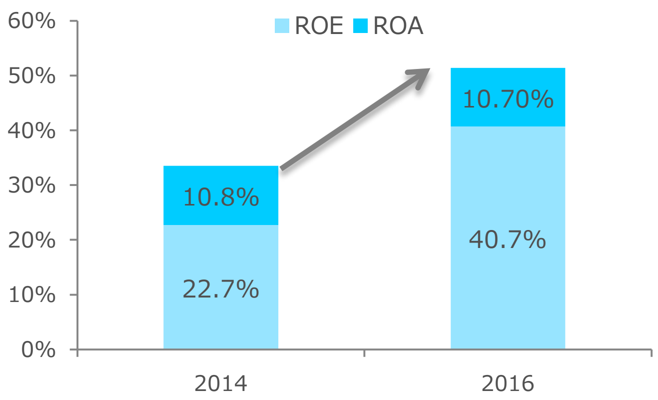
[1] "Convoy Capitalism", a Japanese system where the government acts as a convoy to guide and protect companies to achieve overall economic growth.

Changes taking place over the past 3 years

Corporate executives now face more demands from Japanese shareholders than ever before. They appear to be confused by this trend; however, positive changes are starting to take place.

- As illustrated in Exhibit 3, companies citing ROE/ROA targets in their medium-term plans has risen from 2014 through 2016.
- Number of companies with multiple outside directors has quadrupled.
- Dividends have hit a record high of JPY11.2tn.

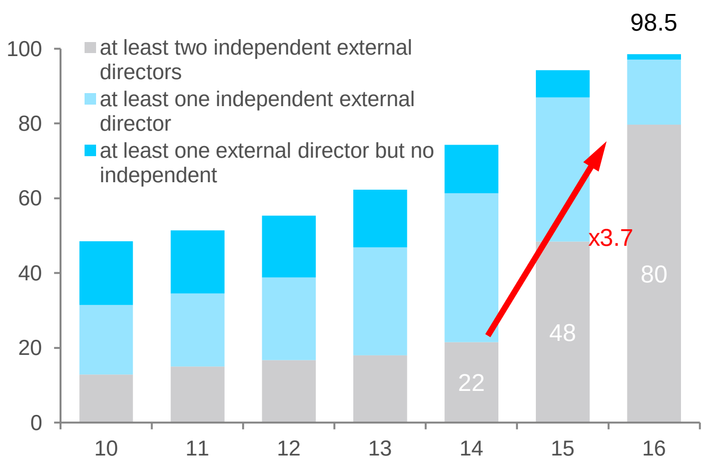
Exhibit 3: Percentage of companies citing ROE/ROA targets in medium-term plans



Source: Japan IR Association

Many companies uniformly set a dividend payout ratio of 30% and a total payout ratio (including buybacks) at 50% - regardless of earnings growth outlook in their medium term management plans. Cash balances of these companies continue to rise as a result. Global investors like Nikko Asset Management are demanding 40-50% payout ratio, with total payout ratio of 80-100% for cash-rich companies. But, there still remains a wide gap between investors' expectations and companies' actions.

Exhibit 4: Percentage of companies with outside directors



Source: Japan IR Association

The revised Stewardship Code

In May 2017, the revised Stewardship Code was made public by the FSA, three years after the Stewardship Code was first introduced in 2014. Institutional investors have a fiduciary duty to meet these new responsibilities. We are now at a new stage where substantial improvements in governance are expected, and the FSA is calling for a shift "from form to substance." The core of the revised code can be summarised in five key points;

1. Effective oversight by asset owners
2. Asset managers' governance and management of their conflicts of interest
3. Engagement in passive management
4. Enhanced disclosure of voting records
5. Self-evaluation of asset managers

The aim of these revisions is to enhance Japanese companies' capital efficiency and shareholder distribution. Of all the points discussed, we think that point #3, Engagement in passive management, deserves the most attention.

It makes sense to attempt to enhance shareholder value of companies we hold in our passive funds. Because, unlike active funds, we cannot sell passive positions due to issues with the quality of the management.

In March 2017, Nikko Asset Management formed a team of analysts (Active Ownership Group) responsible for engagement with mid/small cap companies. Our goal is to leverage this team to not only engage with all the companies we hold in our funds (including passive funds) to enhance the shareholder value of these companies, but also to identify attractive alpha opportunities for our active funds.

We are also expecting to see a large impact from point #4, Enhanced disclosure of proxy voting records. Many insurance companies and asset managers in banking groups, which hold shares of companies for business relationship reasons, will face increasing pressure to vote against company proposals which conflict with shareholder interests. There is an increasing chance that top executives will be forced out of their companies, because they are currently destroying shareholder value through their low ROE or low shareholder distributions. We believe the domino effect from actions, such as a dismissal, would have a major impact in Japan.

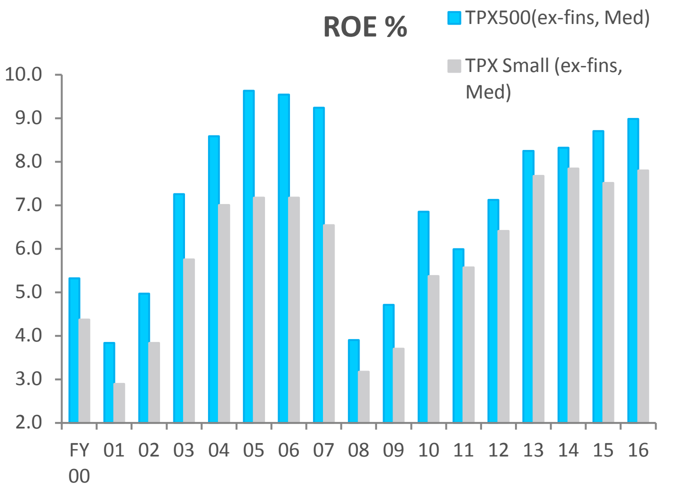
A myriad of opportunities in mid/small cap space

In the governance context, we believe there is a myriad of opportunities in the mid/small cap space for three main reasons;

1. Roughly half of the TOPIX index companies do not have sell-side analyst coverage (*under-researched*)
2. Declining number of small cap analysts (*less competition*)
3. Concentration of companies with low capital efficiency and/or low shareholder distribution in mid/small cap segment (*room for change*)

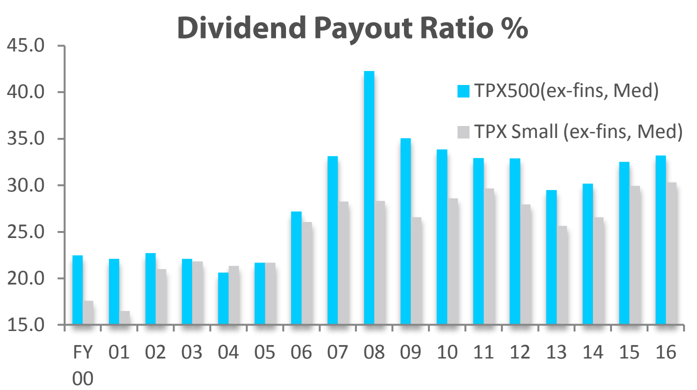
When we split the TOPIX companies into TOPIX 500 and TOPIX Small (which consists of approximately 1,500 companies), we can clearly see how TOPIX Small companies lag the TOPIX 500 companies in both ROE and dividend payout ratio (Exhibit 5). Decomposing ROE with a DuPont analysis also gives a clear picture that the difference in ROE between these groups mainly comes from profit margin and financial leverage.

Exhibit 5: ROE% TOPIX 500 vs. TOPIX Small (ex. fin, median)



Source: Bloomberg

Exhibit 6: Dividend Payout% TOPIX 500 vs. TOPIX Small (ex. fin, median)



Source: Bloomberg

With the latest revision to the Stewardship Code, we believe many of these mid/small cap stocks will be pressured to take measures to enhance capital efficiency.

Shareholder Primacy – an imperative for Japan

There is no doubt that the core of Abenomics policies has been to boost the equity market.

The first stage of Abenomics has been to rally the equity market by the yen weakness and the support of the BOJ's unprecedented monetary easing.

The second stage is to improve ROE and shareholder distribution. There is an increasing likelihood that the Corporate Governance Code will also be revised, to continue to push forward with this agenda.

Until a meaningful impact is felt, Japanese companies may appear to be slow to react; however, once such change starts to take place, we believe they will start to move together rapidly.

Active investors into Japanese equity are well positioned to benefit from both the alpha and beta that this unique market has to offer.

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