

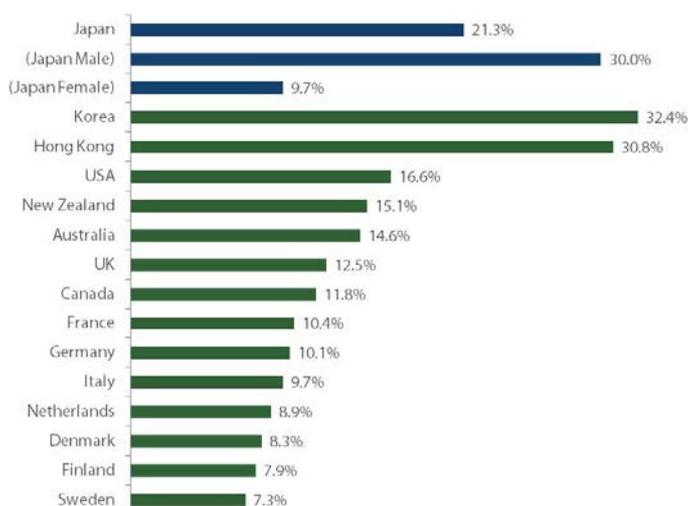
JAPAN EQUITY OUTLOOK

July 2017

“Work style reform” and a historically tight labour market

Japan has long been known for its distinctive work culture in which strong devotion to one’s company, characterised by long working hours and a diminished personal life, is rewarded with a guarantee of lifetime employment (Exhibit 1). However, as the government moves to promote “work style reforms”, or measures aimed at changing Japan’s employment practices, excessive overtime work is likely to soon become a thing of the past.

Exhibit 1: Proportion of employees working long hours



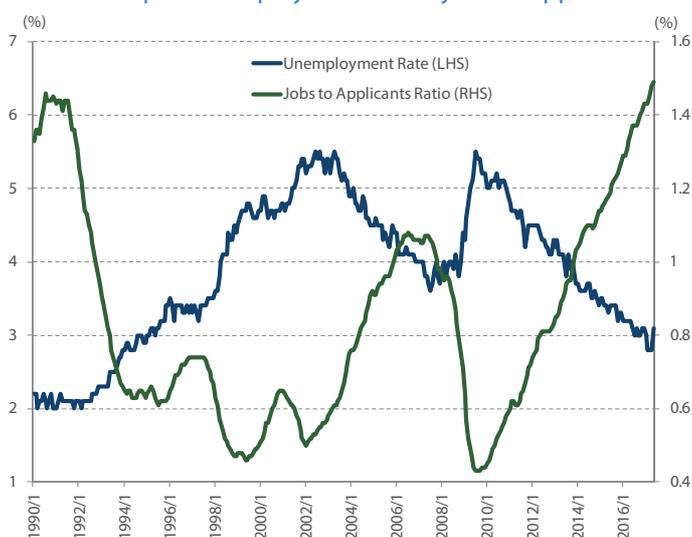
Source: The Japan Institute for Labour Policy and Training (2014)

These measures started to take shape in March 2017, when the government released its action plan on “work style reform”. The plan aims to enhance labour productivity as well as allow workers more time to pursue personal interests or change their career path. It is centred on restricting overtime work and improving compensation for non-permanent employees.

The government steps are amid a backdrop of Japan’s tightest labour market in decades, a result of policy support in recent years from the “Abenomics” economic measures. The current unemployment rate in Japan is 3.1% (as at May 2017) and the economy has seen 53 consecutive months of on-year increases in the number of people employed. Meanwhile, the jobs-to-applicants ratio, which indicates the number of open positions available for each job seeker, currently stands at 1.49 (as at May 2017), its highest level in 43 years (Exhibit 2).

This all means that companies are finding it increasingly difficult to procure sufficient labour. To compensate, some firms are increasingly making adjustments to another factor of production, capital.

Exhibit 2: Japan unemployment rate & jobs-to-applicants ratio



Source: Bloomberg (January 1990-May 2017)

Companies looking to employ productivity enhancing capital

In a survey conducted by the Nikkei in March 2017, 80% of respondent companies indicated that they were either planning or considering the implementation of productivity enhancing investments. Furthermore, more than 70% of respondent companies indicated that they would invest in productivity enhancing technology to address excessively long employee working hours.

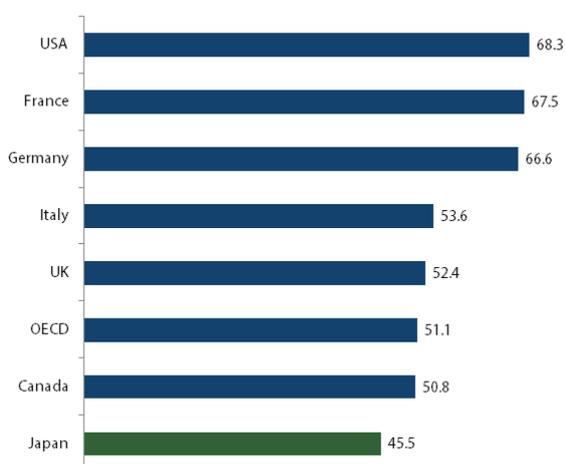
Such investments would take the form of adopting time management systems and promoting flextime and remote work. Other manifestations would include the use of big data and artificial intelligence to enhance productivity in functions such as sales/marketing and back/middle office operations. While merely one quarter of all IT engineers in the US work for IT vendors, this number rises to three quarters in Japan. We therefore think that many companies in the IT service sector will benefit from increases in IT investments in Japan.

Significant room for improvement in non-manufacturing sector

In terms of productivity enhancing capital, Japan's manufacturing sector is a global leader in adopting factory automation for industrial production, while the country is also home to many of the leading providers of these systems. Many users of factory automation, such as Japan's top automakers, have achieved high productivity that has attracted attention from around the globe.

However, labour productivity in Japan's non-manufacturing sectors remains quite low. This is underlined by the OECD in its latest "Going for Growth 2016: Japan" report, in which it states: *"The productivity level in services relative to manufacturing is particularly low in Japan, dragging down economy-wide labour productivity, which is significantly below the average of the upper-half of OECD countries."*

Exhibit 3: Labour productivity in 2015 - G7 countries, GDP per hour worked, US dollars, current PPPs



Source: OECD Compendium of Productivity Indicators (2015)

Part of the rationale for the employment reforms the government is promoting is that Japanese companies and their employees need to enhance their current productivity to bring it in line with other advanced countries. Japan's non-manufacturing sector, which makes up about 70% of the overall economy, has significant room to improve its labour productivity. We therefore believe there are many investment opportunities among firms whose products or services can enhance the productivity of this sector.

Benefits of using technology

A good example of a service sector which is attempting to enhance productivity can be found in Japan's convenience store industry. There are currently about 55,000 convenience stores in Japan, and the industry is struggling to find employees. Against this backdrop, one of the leaders in the industry is expected to increase capital expenditure by over 40% in FY2017.

One such expenditure is for the purchase and installation of dishwashers at all of its stores. The firm says that this measure

will save one hour per store per day—or the equivalent of about JPY 300,000 in personnel costs per year—by not having workers wash dishes by hand. Furthermore, by adopting the RFID system (Radio Frequency Identifier) for production management, the firm says that per-store per-day work time can be reduced from 170 minutes to eight minutes, or the equivalent of about JPY 800,000 in costs per year. Efficient store operation can result not only in cost savings, but also in a better working environment that can help attract new employees.

The construction industry is also facing a manpower shortage and is therefore also expected to take advantage of labour saving capital. Currently, more than 40% of the 3.3 million skilled construction workers in Japan are over the age of 50. It is therefore estimated that at least one million workers will leave their jobs over the next 10 years¹. At the same time, given the redevelopment of large-scale buildings, projects related to the 2020 Tokyo Olympics and reinforcement projects for aging infrastructure, a decline in the number of new construction projects is unlikely. This is expected to make the labour shortage in the construction industry even more acute.

In order to deal with this situation, Japan's Ministry of Land, Infrastructure and Transport has started to promote the use of "ICT" (Information Communication and Telecommunication) as part of its new "i-Construction" standard which aims to raise productivity in construction projects. The government is expected to restrict participation in the public bidding process to firms that use ICT either for measurement or actual construction. This will likely boost construction-related demand for materials and machines, as well as for technology infrastructure.

Plenty of investment opportunities in Japan

As we have seen, Japanese companies are poised for a pickup in capital expenditure, led by productivity enhancing investments.

In anticipation of this, Nikko Asset Management has been managing a robotics-themed Japanese equity fund since January 2016. Helped by rising awareness of the need for labour saving investments, it has been one of the best performing funds so far this year.

As with the above-mentioned fund, Nikko AM's Japanese equity strategies invest in many of the stocks that benefit from factory automation investments in the manufacturing sector and labour saving investments in the non-manufacturing sector. The common denominator is that Japan has a substantial need for automation which can be met by competitive and innovative companies. Addressing the challenges of low productivity in Japan will result in a wealth of product and process innovation that will eventually be exported overseas.

¹ Japan Federation of Construction Contractors

We therefore believe that the sectors in Japan—such as factory automation or IT services—that benefit from productivity enhancing investments will provide attractive investment opportunities for many years to come.

It is also worth keeping in mind that the firms that newly use such technology stand to benefit from productivity increases and therefore present investment opportunities of their own.

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