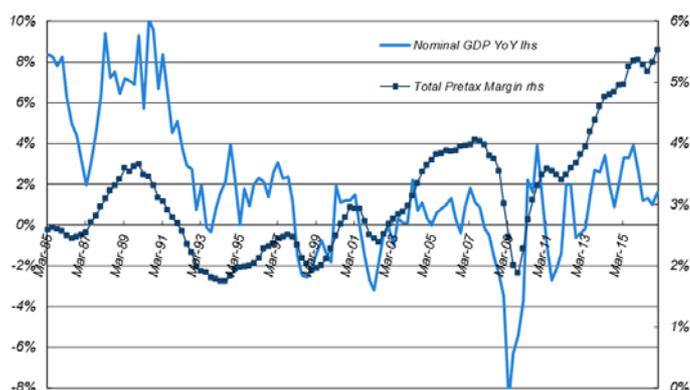


JAPAN'S "SHOW ME THE MONEY" CORPORATE GOVERNANCE: 4Q UPDATE

Overall corporate pre-tax profit margins in Japan accelerated in the recent quarter, partially due to a weaker Yen, but also to the continuation of long-term structural corporate-governance improvements. Moderate growth in the global economy also helped the manufacturing sector, while the non-manufacturing sector, which is nearly entirely domestically focused, hit another record high.

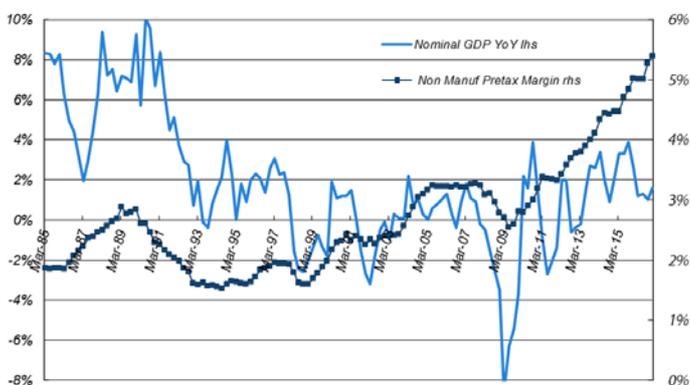
Four-quarter Average of Pre-tax Profit Margin vs. Japanese Nominal GDP YoY Growth

(for all non-financial companies, not just listed ones)



Sources: Japan Ministry of Finance, Bloomberg, data through CY4Q16.

...and for Non-manufacturers (excluding financials):



Sources: Japan Ministry of Finance, Bloomberg, data through CY4Q16.

The fact remains that, partially due to the encouragement of the Abe administration, Japanese corporations are continuing their structural shift towards higher profitability. Abenomics is "icing on the cake" of the **"Show Me the Money"** corporate governance improvement that we have long-highlighted in our thought leadership effort on Japan. Indeed, while increasing the number of independent directors and other

recent governance issues are very important in the intermediate term for Japan, it is crucial for investors to understand that the profitability message has actually been understood by most Japanese corporates for over a decade. This is shown by the divergence in the profit margins from the trend in GDP growth in the charts above, showing that even though GDP growth has remained subdued, profit margins have surged.

Since the Koizumi era, Japan has embarked on major rationalizations in most industries, with the number of players usually reduced from seven down to three. The fruits of this restructuring were slower to ripen than in Western world examples, and they were hidden by a series of crises (the Lehman shock, the turbulence in China, the strong Yen and of course, the Tohoku crisis), but since Abenomics began, the global backdrop for Japan has been stable and there have been no domestic crises, thus allowing the fruits to ripen.

Conclusion

We expect that the overall four-quarter average pre-tax profit margin will rise mildly in the 1Q and improve further in the following quarters due to a stable Yen. Furthermore, many sectors are continuing their rationalizations and cost-cutting that will help support their profit margins. Of course, if the Yen were to weaken to 120:USD, then profit margins should be even stronger than expected. One should also note that these Ministry of Finance statistics do not cover post-tax income, and due to recent corporate tax cuts, the overall net profit margin (excluding extraordinary write-offs) has expanded even more sharply than the pre-tax data shown above, thus "showing the money" to shareholders to a very large degree through earnings-driven dividends and share buybacks. In our view, Japan is the only major country that is going through a structural improvement in corporate governance, and thus deserves special attention by global investors.

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