A Closer Look

Japan's Investment Landscape – Can the Good Times Last?

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- **Rarely is an investment thesis black or white; Japanese equities are no exception. On one hand, we see an administration committed to measures to spur the economy. On the other hand, Japanese companies have historically lagged global peers with regard to profitable revenue growth, returns on capital, and shareholder alignment.**
- **The Japanese government is commencing its reform program's most difficult phase — to engender substantive, corporate-level change by opening the economy and changing management behavior. Our longer-term skepticism centers on whether Prime Minister Abe's monetary and fiscal policy changes will result in lasting improvements.**
- **Over the next 12 months, we see potential for attractive returns as aggressive monetary policy causes the yen to weaken further and government institutions are encouraged to buy equities. We maintain a modest overweight position in Japanese equities, with a hedge on the yen.**

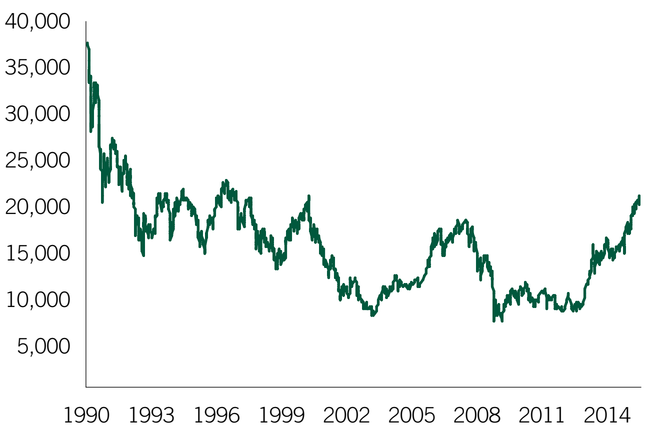
Investing in Japanese equity markets has not been easy over the past two decades. Japan's deflationary spiral and multiple recessions contributed to market volatility. So too has local politics — just over the last decade, Japan has elected eight prime ministers.

Bessemer's investment process combines top-down, macroeconomic research with our portfolio teams' bottom-up company analysis. In this *A Closer Look*, we discuss the process with Japanese equities in mind. Our bottom line: we remain cautious in the long term toward Japan's economy and its stock market. However, over the next 12 months, we see potential for attractive returns.

The Current State of Abenomics

Until recently, Japan's equity markets have exhibited a long pattern of decline. In the past 25 years, the Nikkei 225 index (the Nikkei) has lost 47% of its value (Exhibit 1).

Exhibit 1: Nikkei 225 Index — Past 25 Years

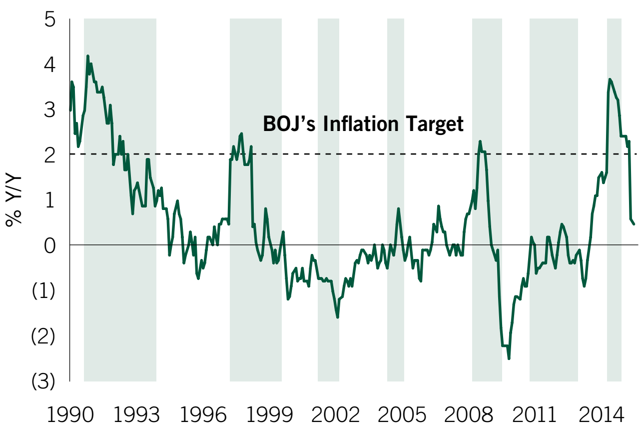


As of June 30, 2015.
Source: Bloomberg

The equity market's lack of support, in turn, reflects the country's deflationary spiral and pattern of falling into recession. Over the last 25 years, inflation, as measured by the Consumer

Price Index (CPI), has exceeded the Bank of Japan's (BOJ's) 2% target approximately 16% of the time on a monthly basis (Exhibit 2).

Exhibit 2: Japan's CPI — Past 25 Years

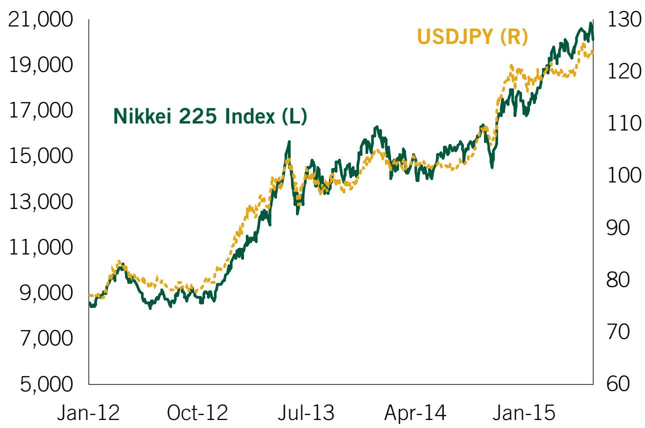


Consumer Price Index as of June 30, 2015. Grey-shaded bars indicate Japan's recessions.
Source: Bloomberg, Federal Reserve

Mindful of the decades-long economic slump, Japanese Prime Minister Shinzo Abe took aggressive steps to jump-start Japan's economy after his election in late 2012. Dubbed as "Abenomics," this stimulus program is based on "three arrows": monetary easing, flexible fiscal policy, and structural reform.

Abe's first arrow, monetary easing, has pressured the Japanese yen, fueled equity market sentiment, and driven corporate growth estimates higher. Indeed, Japanese stock market gains since Abe's inauguration are in part due to yen weakness. The weaker currency enhances expectations for Japanese exports and corporate performance, which, in turn has driven broader markets (Exhibit 3). While the yen may weaken further from these levels, an economic strategy that relies on continued currency weakness seems unsustainable over the long term. In order to experience further, meaningful growth in Japanese stock valuations, fundamentals also need to improve.

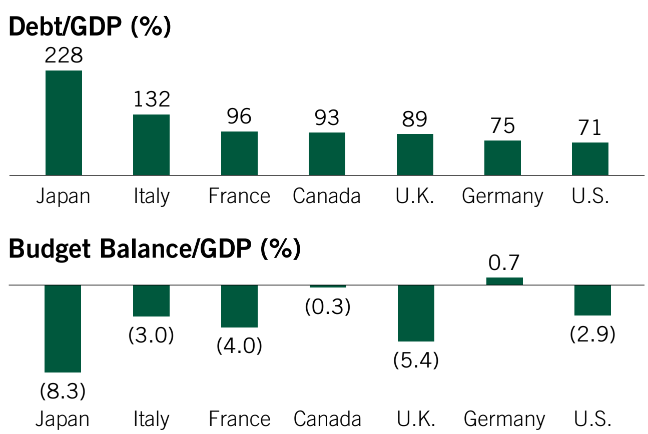
Exhibit 3: Japan's Stock Market vs. Yen



As of June 30, 2015.
Source: Bloomberg

Abe's second arrow, flexible fiscal policy, has increased our longer-term concerns regarding Japan's government debt load. One of Japan's many challenges is the struggle to stimulate the economy and balance a fiscal budget that currently stands at a deficit of 8.3% of gross domestic product (GDP). And, at approximately 228% of GDP, Japan's total government debt makes further tax cuts or spending increases less palatable (Exhibit 4). Indeed, Japan is still dealing with the hangover effect from April 2014's Value Added Tax (VAT) increase from five to eight percent as most recent inflation readings, once adjusted for the VAT increase, remain flat.

Exhibit 4: Debt and Budget Balance as % GDP



As of December 31, 2014.
Source: Bloomberg

While some have criticized the pace of Abe's structural reforms, the third arrow, there still appears to be at least modest improvement on this front. Abe has pushed local firms to focus more on shareholder value versus lifetime employment, for instance. He also has taken steps to encourage more women in the workforce. While it is difficult to prove causation, these changes have come alongside improved Japanese business confidence. Indeed, over the past two years, Japan's Purchasing Managers Index (PMI), a measure of economic health in the manufacturing sector, has averaged 52.3, above the expansionary threshold of 50. This compares to an average of 49.7 in the two years preceding Abe's inauguration.[1]

The Investment Outlook

Rarely is an investment thesis black or white; Japanese equities are no exception. On one hand, we see an administration committed to measures to spur the economy. On the other hand, Japanese companies have historically lagged global peers with regard to profitable revenue growth, returns on capital (ROC), and shareholder alignment. The country's huge debt burden also concerns us, especially over the long term, as Japan's desire to shrink its budget deficit is likely at odds with generating sufficient economic growth.

Bessemer Investment Management portfolio managers Michael Crawford and Alex Christie recently spent time in Japan. Michael manages the Large Cap Strategies - Global mandate, while Alex runs the Large Cap Core mandate. They returned with somewhat differing insights about the country's economic prospects, government reform initiatives, and the corporate environment. Investment Strategist Joseph Tanious interviewed Michael and Alex to better understand their outlooks on Japan and how they will position Japanese equities within their respective portfolios.

What are the takeaways from your trip to Japan?

Alex Christie: First, change at the corporate level is progressing more than I expected. Should structural and cultural reforms succeed in taking hold, I anticipate substantial upside for local shares. Second, even if policy doesn't stimulate growth, I see opportunities to invest in specific industries and companies that could still do well.

Michael Crawford: I agree with Alex that there are some positives, but I am a bit more skeptical about the upside potential, especially looking at the next five to 10 years. It will be difficult for Japan to implement many structural changes quickly. As a result, I continue to believe that Japanese equity investing requires selectivity and deep research.

Do you think Abenomics can succeed in the long run? Are the companies you're meeting with optimistic?

Michael Crawford: While several companies I met with believe it can be done, I'm not entirely convinced.

Abe vowed to shake up Japan's corporate environment to create better returns and attract investors. He has a powerful "tool box" of initiatives which includes a focus on revising regulatory and tax systems and continued emphasis on corporate management innovation. These are positive tailwinds for the country and its companies.

However, Abe faces significant challenges, including demographics and the fiscal deficit. The country's low birth rate and aging population contribute to what many call a "death spiral." Simply put: Japan is losing workers to retirement and death more quickly than it is producing them.

What are some of the big changes affecting the Japanese corporate landscape?

Alex Christie: Government mandates and economic forces are driving material changes at publically listed companies. Managers referenced rising corporate wages, increased female labor participation, infrastructure spending, increased consumer lending, deregulation of the power and natural gas sector, corporate governance reform, and management focus on capital efficiency.

These changes are affecting the way companies do business and the way people spend money. My conversations with managers left me with

[1] Markit data

an overall positive view. But I'm concerned that some managers are implementing reforms to please government officials rather than to improve corporate operating performance.

How might some of these changes affect companies you are analyzing? Can you provide an example?

Michael Crawford: The government is committed to removing historical regulatory impediments in important sectors such as pharmaceuticals. For example, the nation's drug trial and approval process has been so cumbersome that global competitors have effectively bypassed the country.

Lack of competition is a stagnating force. While local drug companies have reaped short-term benefits from a dearth of competition, they've had no motivation to innovate. Legislation will likely streamline the drug approval process and will reward new drugs approved in Japan with higher legally permissible prices.

We positioned ourselves to benefit from this regulatory change with our investment in Astrellas Pharma Inc., one of the larger listed Japanese pharmaceutical companies. Though the company had enjoyed some success, Astellas generally relied on licensing drugs from larger overseas companies to generate Japanese market sales. The current streamlined drug approval process prompted Astellas to collaborate domestically and internationally to enhance, successfully, its new drug pipeline.

The company's agreement with U.S.-listed Medivation, Inc. helped it obtain approval for the potential blockbuster drug, Xtandi. Even more recently, Astellas has entered into a joint venture with Amgen to collaborate and move forward five pipeline drugs in Japan.

Where do you see opportunity in Japan?

Alex Christie: Should the government be successful with reforms, we believe that Japanese corporations should be able to improve profitability and ROC. The jury is still out on how successful management teams will be — but we believe there is a lot of potential runway.

Given improving wage growth and consumer credit, there is interesting potential in the consumer and consumer finance sectors. Of course, given the competitive nature of retail and changing consumer preferences, it is very important to buy shares of companies with sustainable business models.

Michael Crawford: The government has pushed for management teams to target return on equity (ROE) of 8%. In fact, Prime Minister Abe has pushed for the creation of the JPX-Nikkei Index 400, an index designed to attract global investors. This index will be composed of companies that, among other requirements, produce high ROE. Improved ROE would, implicitly, increase ROC. This is clearly music to our ears.

The Japanese government understands that ROE is a crucial metric for capital allocation, but the question is: What is management on the ground doing about it? The answer is that they take seriously the need to improve ROE. However, I am not convinced they all grasp the metric's importance in terms of value creation.

We are committed to find and own companies with extant high returns on capital and ROE in excess of 8%. I questioned company management teams about whether they intended to reduce net cash balances, sell equity investments, and divest inter-company shareholdings. Initially, most managers seemed resistant to these Abe-promoted ideas.

However, portfolio company Fanuc, a global leader in automated machine tools and robotics, recently announced measures to improve balance sheet efficiencies. The company currently holds a significant cash balance that equates to over 60% of its total assets. Fanuc announced plans to return this cash to shareholders through an increased dividend payout ratio, cancellation of treasury shares, and a pledge to buy back shares on the open market opportunistically. After the announcement, the company's share price climbed 28%.

Company actions to restructure are likely to be highly accretive to intrinsic values — and therefore share prices. These restructurings may present opportunities.

What sectors might you avoid? And what are the biggest risks to Japanese investing in the current environment?

Alex Christie: We see increasing investment risk in the natural gas distribution industry. Deregulation of the gas distribution industry will lead to increased competition which will pressure profits. At the same time, the restart of nuclear power will reduce the demand for natural gas generated power, which means there is less business for gas distributors. There is also a risk that liquid national gas (LNG) prices, which are often linked to oil prices, will rise as the oil market tightens over the next few years. Gas prices in Japan have a delayed pass-through mechanism, which helped distributors when oil and thus LNG prices were falling. This will reverse and become a headwind to earnings when oil and LNG prices increase.

Michael Crawford: Japanese companies have poor records integrating international operations. I remain wary of any Japanese companies that allocate capital to large, international acquisitions.

Positioning Around Japan

Over the coming 12 to 18 months, we believe the Abe administration and the BOJ's efforts will keep a weakening bias for the yen, support many local companies' earnings estimates and the broader equity market in turn. Our portfolio managers broadly remain constructive and hedge yen risk where possible (Exhibit 5).

Exhibit 5: Near- and Long-Term Considerations

Near-Term (12- to 18-Month) Considerations
PMI, a measure of manufacturing data, has improved and is currently above 50. The index number continues to suggest economic expansion. PMI averaged 52.3 in the last two years vs. 49.7 in the two years preceding Abe's election.
Tankan, a business sentiment forecast index, has risen sharply since Abe's election and continues to highlight optimism. The Tankan forecast index is currently at +7 vs. -15 when Abe took office.
The BOJ has adopted a formal 2% inflation target. More aggressive monetary policy is likely coming; this will exert more downward pressure on the yen.
The new ROE-focused index, the JPX-Nikkei Index 400, is likely to incentivize company management to generate higher profitability.
Valuations are reasonable; the current forward P/E ratio stands at 15.3x earnings relative to a 10-year average of 15.8x.
Government entities, such as the Japanese Government Pension Investment Fund, have been selling local bonds and buying stocks over the past several quarters. This trend is likely to continue and provides support for Japanese equities.

Long-Term Considerations
Japan's government debt load stands at 228% of annual GDP, the highest in the developed world.
Servicing Japan's government debt already consumes 10.5% of the country's fiscal budget. Higher interest rates/inflation will add more pressure.
Japan's population growth has declined steadily over the years and currently averages an annual -0.2%. This decline makes positive economic growth harder to achieve.
Corporate profitability, as measured by ROE, has historically been weak relative to global competitors. The MSCI Japan Index is currently at 8.5% vs. global equities at 11.5%. Time will tell if Japanese managers are able, truly, to improve this and other metrics for the better.

Source: Bessemer Trust

Over the longer term, however, we will need to see more follow-through on reforms to maintain this positive view. Frankly, we remain skeptical that Abe's monetary and fiscal policy will work as planned. Just as one example, consider the BOJ's goal of sustained 2% inflation. If successful, such higher inflation is highly likely to push interest rates higher on Japanese government bonds (JGBs); the 10-year JGB currently yields around 50 basis points. That, in turn, makes interest payments on Japan's overwhelming debt increasingly challenging.

Michael and Alex, along with their respective teams, continue to maintain a modest overweight position to Japanese equities overall, making careful, selective investments in Japanese companies.

Special thanks to Rebecca Patterson and Meghan Shue for their contributions to this A Closer Look.