Unlocking Hidden Value in Japan

The Nikko Asset Management Investment Guide

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Foreword

For the past few decades, there has been a general sense that global equity investors should be underweight Japan. After all, investors have been hearing the same criticisms repeated for decades. Conventional wisdom says Japan is a country encumbered by a shrinking and ageing population, stagnant growth, and a stale corporate culture, and should therefore be avoided. Such criticisms are inaccurate and outdated. While many global investors still only see the Japan of the past, they are missing out on the way Japan is shaping all our futures.

The Japan of today is one where a decade of corporate and stock market reforms has started to bear fruit, and where successive governments have prioritised revitalising the Japanese economy. This has created a more shareholder-friendly environment and is helping companies to deliver vastly improved profit margins thanks to superior technology, stronger corporate governance and – particularly from within the Asia-Pacific region – better economic growth.

But the investment case for Japan goes far beyond corporate improvements. At a time of great global uncertainty and disruption, Japan has much to share with the rest of the world. Japan is seen as a trusted global ally, and the world's most persuasive trading partner. It is also a significant – and vibrant – cultural force.

Arguably, Japan's greatest challenge in recent times has been to take the lead in addressing critical issues soon to be felt by many other nations. It is therefore no surprise Japan has responded with humane and intelligent approaches to healthcare, and is also ready to accelerate the transition from fossil fuels to low carbon alternatives. Japan is also embracing some traditional ways of thinking – about sustainability and the circular economy – that will prove invaluable as the world looks to make the difficult transition towards a green economy.

And while global investors have been looking elsewhere, Japan has spent invaluable time learning from past mistakes, while demonstrating great resilience and strength. The changes currently taking place in Japanese society have opened the door for companies with the knowledge and technology to tackle and solve social issues. For example, Japan's demographic challenges have resulted in exceptional innovation – particularly in the field of healthcare. But above all, Japan displays a quiet determination to do things better, often for the benefit of society as a whole. This is what makes Japan a long-term investment opportunity that global investors cannot afford to ignore.

This investment guide is our way of telling the world about the Japan we know, the one we see from the inside. We want to help bring more investors into Japan's trusted inner circle, by sharing our knowledge, offering a fresh perspective, and exploring the investment opportunities we think will resonate for the next decade and beyond.

We hope you enjoy reading this guide.

Stefanie Drews
President, Nikko Asset Management

The Japan of today

Chapter 1

John Vail
Nikko Asset Management Chief Global Strategist

The Japan of today

Japan's economic, geopolitical and 'soft power' is rising, placing Japan on an upward trajectory for the rest of the decade and beyond.

A democratic beacon

Home to one of Asia's oldest democracies, Japan has grown to symbolise a fair and free society, built on the rule of law, freedom of the press and strong institutions. Japan's internal strengths, and as a model country, are undisputable. According to Human Rights Watch, the world's third-largest economy is a prosperous liberal democracy with a vibrant civil society.[1] Moreover, over several decades, Japan's main strategy for exerting influence on the world's stage has been through cultural influence and measured diplomacy. Even China, one of its closest neighbours and fiercest competitors, recognises the value of being on good terms with Japan.

Political stability has been a feature in Japan for more than a decade. Since regaining power in 2012, the Liberal Democratic Party, alongside its smaller coalition partner Komeito, has been successful in multiple national elections, a considerable achievement within a democratic country. With the ruling coalition enjoying firm public support, Japan has become a 'safe haven' compared to its developed market peers, including the US. Furthermore, Japan's political stability is critical to ensuring the culture of corporate governance reform, which began to accelerate during the 'Abenomics' era, is allowed to continue.

Economic improvements since the Abenomics era

When Shinzo Abe was voted into power for the second time in 2012, on the back of an overwhelming majority, his first task was to address the economic slump Japan had fallen into since the 1990s. His 'three arrows' policy programme of 1) higher government spending, 2) more accommodative monetary policy from the Bank of Japan and 3) a package of structural reforms intended to raise the economic growth was designed to shake the Japanese economy from its slumber.

Although Abe departed office due to ill health in 2020, his two successors have continued in the same vein, embedding Japan's structural economic reform efforts. Since Prime Minister Fumio Kishida took office in November 2021, his government has wasted no time in reconfirming its accord with the Bank of Japan signed in 2013 whereby they will work together to achieve 2% inflation and sustainable growth. For example, the Bank of Japan's purchases of Japanese government bonds and exchange-traded funds has helped lower the yen's value, which has supported export-driven companies and boosted Japanese stock prices significantly for almost a decade. Japan's monetary policy is expected to remain accommodative, which will continue to create a constructive environment for Japanese companies in the decade to come.

The role of the yen in the Japanese economy

The Japanese yen (JPY) is the third most frequently traded currency in the world after the US dollar (USD), and euro (EUR).[2] The yen gained a reputation for sharp swings during the 1980s, and traditionally a weak yen is believed to bring positive effects to the Japanese economy, as it helps exporters. However, since global companies such as Toyota began to ramp up their production capacity overseas, this has helped to lessen the impact of yen fluctuations. While currency does impact Japan's exports, and a weaker yen is generally positive, Japan should be considered as more substantial than a pure currency play. In many respects, the role of the yen has become much less of an influence on whether to invest in Japanese companies.

A nation growing accustomed to investing

In addition, Japan's home-grown equity culture is beginning to blossom. With the introduction of the Nippon Individual Savings Account (NISA), based on the UK ISA template, individuals are being actively incentivised to build personal wealth through equity investing, while benefiting from tax exemptions. Although different alternatives are being worked through, the NISA programme should help encourage more of Japan's population to move away from the tendency towards sitting on cash savings and instead into owning their own investments, while also providing further capital injection into successful businesses. As of September 2021, the investments in regular NISA accounts amounted to around JPY 23.55 trillion.

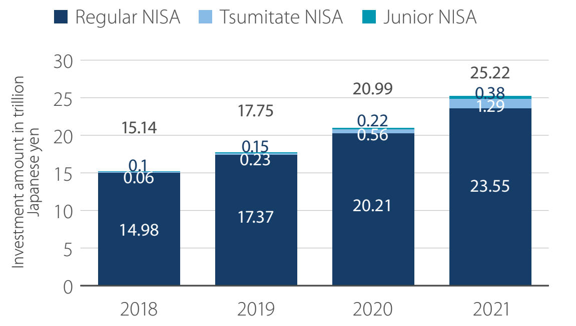
1 https://www.hrw.org/world-report/2021/country-chapters/japan

2 https://www.oanda.com/currency-converter/en/currencies/majors/jpy/

Chart 1

Investment amount of Nippon Individual Savings (NISA) in Japan from 2018 to 2021, by type

(in trillion JPY)

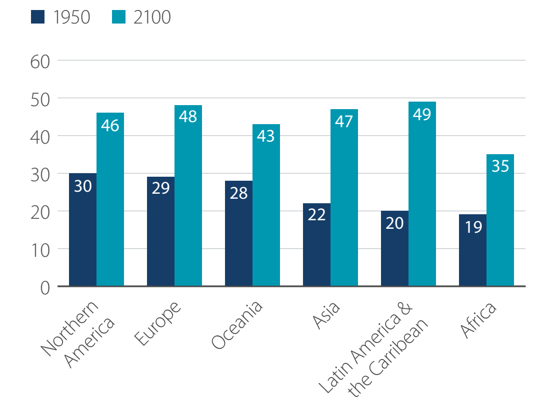


Source: Japan's Financial Services Agency (30 September 2021)

Chart 2

What will the world look like in 2100?

Median age by region, 1950 vs. 2100



Source: Statista, United Nations Department of Economic and Social Affairs

Demographics as a first-mover advantage

Japan boasts a highly-skilled labour force, has lower wages compared to other developed market competitors, and, thanks to the Bank of Japan's accommodative policy stance, has cheaper financing than almost anywhere else in the world. And yet, Japan's ageing population has often been used by global investors as a key reason not to invest. Japan's demographic challenge is well-known. As a country with one of the world's highest life expectancies, the cost of treating the elderly is increasing steadily each year – straining a healthcare system that is financially dependent to a large degree on Japan's shrinking population of workers. But as Chart 2 demonstrates, an ageing population is not solely a concern for Japan; it's an issue already impacting countries all over the world. In this area, Japan can be considered as having first-mover advantage: it values its citizens and is committed to coming up with innovative ways to care for them.

For example, robotic-assisted surgery systems help surgeons to perform complex operations requiring high precision. Although robotic technology originated in the US Navy, and led to American companies dominating the market, Japanese companies have started to overtake their US counterparts. Today, the leading robotic surgery system is Hinotori, jointly developed by Kawasaki Heavy Industries and Sysmex Corporation. Hinotori is operated remotely by a surgeon who views 3D images from an endoscope. In August 2020, Hinotori became the first robot-assisted surgery system developed in Japan to receive regulatory approval from the Ministry of Health, Labour and Welfare.

Japanese companies have adapted, and grown profitability

Just as 'necessity is the mother of invention' in critical areas such as healthcare, Japanese companies across almost all sectors have become adept at dealing with labour shortages by adapting working practices and increasing automation. Chart 3 shows Japan's nearly two-decade inverse correlation between its declining workforce and incline in corporate profits.

In fact, aside from interruptions from global crises, Japanese companies have experienced a 20-year bull market in profit margins, which can be attributed to a combination of improved corporate governance, enhanced technology, and global, especially Asian, economic growth. Dividend payouts issued to investors (discussed in Chapter 2) have increased significantly during this period also, and earnings per share growth has been heightened ever further due to significant share buybacks.

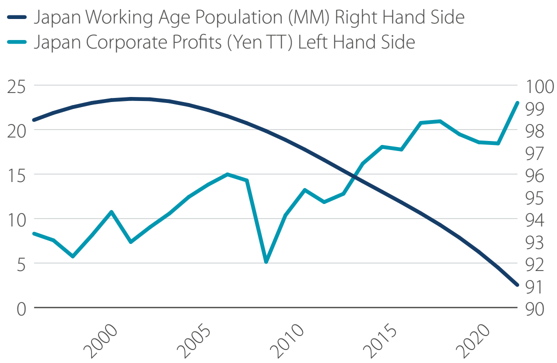
References to individual stocks are for illustration purposes only and do not constitute a recommendation to buy or sell.

There should therefore be little doubt that Japan can counteract demographic challenges in innovative ways, with corporate profits continuing their strong upward trend, and thus rewarding shareholders, and that other countries facing similar demographic concerns will be looking to Japan for guidance and inspiration.

> "Asian countries depend on Japanese technology as well as shared supply chains for economic progress."

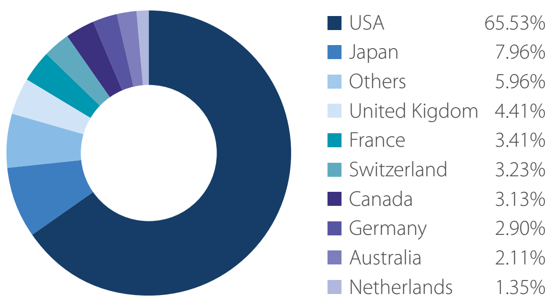
John Vail,
Nikko Asset Management Chief Global Strategist

Chart 3
Secular growth in corporate profits, despite demographics



Source: OECD, Japan MOF (31 December 2021)

Chart 4
MSCI World Index – Country Allocation



Source: MSCI (30 June 2021)

Japan is a vital investment conduit to Asian growth
Japan occupies a unique place in the world, serving as a bridge between east and west, and between developed and emerging markets. Japan is the second largest country in the MSCI World Index, and is the third-largest economy in the world, after the US and China. Japan is also the fourth largest global exporter.[3] Close to 60% of Japan's exports are within the Asia Pacific region, the most common destinations being China, South Korea, Chinese Taipei and Hong Kong, while only 25% of its exports are to the Americas and 16% to others, including Europe and Africa.[4]

Because of its close proximity, Japan has deep cultural and economic ties with other countries in the Asia Pacific region. Japan is uniquely positioned as a familiar developed market that is reaping the benefit of emerging market growth trends, while not necessarily being exposed to the same accompanying risks. For example, other Asian countries depend on Japanese technology as well as shared supply chains for economic progress. As Japanese companies grow their businesses overseas, and other Asian-Pacific countries, including China, rely on Japanese technology to achieve their economic development goals, Japan's economic ties with Asia's growth journey should continue to strengthen.

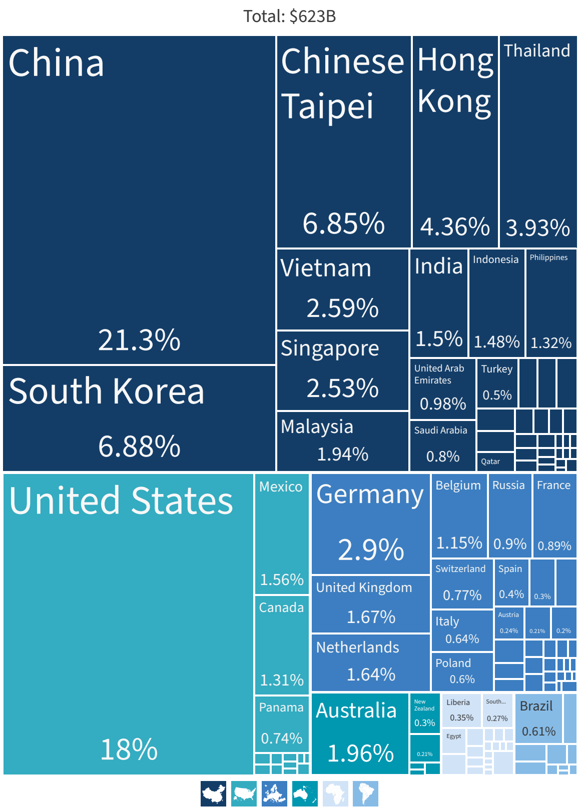
3 https://oec.world/en/profile/country/jpn

4 https://oec.world/en/profile/country/jpn#yearly-exports

Any comparison to a reference index or benchmark may have material inherent limitations and therefore should not be relied upon

Chart 5

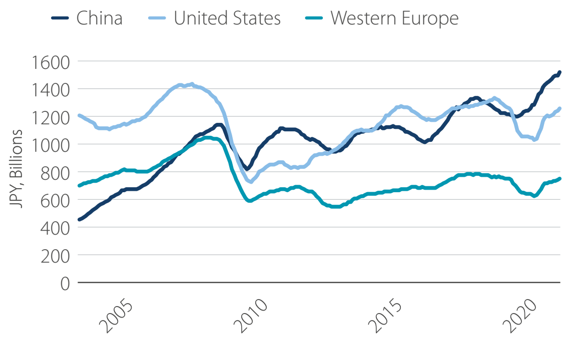
Japanese export destinations by country (2020)



Source: Observatory of Economic Complexity (OEC)

Chart 6

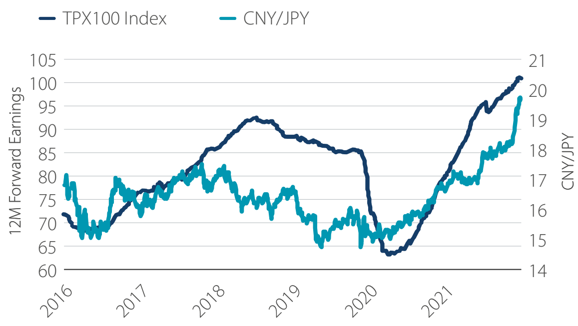
Japan's exports to China, US and Europe



Source: Nikko AM, Bloomberg

Chart 7

TOPIX Forward Earnings vs CNY/JPY



Source: Nikko AM, Bloomberg (13 April 2022)

Moreover, since joining the World Trade Organization (WTO) in 2001, China has become an increasingly important importer of Japan goods. As Chart 6 shows, Japan's exports into China have grown nearly four-fold over the last two decades, whereas over the same period exports to the US are flat and exports to Europe are down.

While the success of Japan exports is increasingly tied to demand from China, its relative competitiveness and earnings prospects has also been driven by the currency pairing of the Chinese yuan/renminbi (CNY) and the JPY. Over the last two years, CNY/JPY has appreciated roughly 30%, helping to lift forward earnings by nearly 70%. China's determination to maintain a strong capital account and strong currency policy is expected to continue to benefit the earnings of Japanese companies, while also demonstrating the level of integration of Japan's economy within the Asian ecosystem.

Japan as a game-changer for the green economy

In the race to become carbon neutral, almost every country in the world is likely to have a degree of reliance on Japan to help them achieve their net-zero ambitions, most likely through Japan's dominance and leadership in the fields of semiconductors and hydrogen.

1. Power semiconductors

Both China and the West are courting Japan because of the raw materials required specifically for green technology and the need for semiconductors. Besides producing advanced semiconductors, it also dominates several of

Any comparison to a reference index or benchmark may have material inherent limitations and therefore should not be relied upon

the highest value-added portions of the semiconductor production equipment process. As a recent press release from Toshiba states, power semiconductors "are essential components for managing and reducing power consumption in every kind of electronic equipment, and for achieving a carbon-neutral society".[5]

Japan's New Energy and Industrial Technology Development Organization (NEDO) is coordinating a project aimed at reducing the energy loss of power management devices by 50% while reducing the cost of mass-producing silicon carbide power semiconductors to the same level as standard silicon-based chips by 2030. Reports suggest the Japanese government has committed to spending JPY 30.5 billion (US$260 million) on the project, and private investment is believed to be considerably higher.

If successful, the widespread adoption of more advanced power semiconductions would prove a 'game-changer' for energy-efficient green technology, resulting in cheaper and more efficient electric vehicles, renewable energy generation, computers, telecoms and datacentres, as well as changing the way consumer electronics, including air conditioning and lighting, consume energy.

2. Hydrogen

Reducing carbon emissions is critical to limiting the effects of climate change, and hydrogen has drawn a significant amount of attention as a clean alternative to carbon-emitting fossil fuels. With nuclear energy a politically difficult option for Japan, hydrogen is expected to play a key role in ensuring the country achieves its ambitious goal of carbon neutrality by 2050. However, the drive towards adopting hydrogen, and replacing fossil fuels is still in its early stages, meaning there are many companies with technologies and ideas that are yet to be discovered by the market. But one particular company, **Kawasaki Heavy Industries**, is already fast becoming a global leader in the clean energy market.

Kawasaki Heavy is the only company in the world to possess core technologies related to every stage of the hydrogen supply chain. It has technology that few other companies can replicate, and it is capable of producing, storing and transporting the notoriously volatile fuel and then using it to generate power. In 2021, it unveiled the world's first tanker capable of shipping liquid hydrogen. The firm is aiming for net sales of JPY 500 billion (US$4.5 billion) in its hydrogen segment by 2040. We explore Japan's potential in delivering hydrogen-based clean energy further in Chapter 4.

The Japan of today: of increasing geopolitical importance

In an era of fractious global politics, where international economics and geopolitical issues have become interlocked, Japan's increasingly integral role in global affairs is impossible to ignore. While Japan remains the largest trading partner and most influential neighbour of China, Japan is also an essential partner for US policy towards China. This is a delicate geopolitical balancing act to maintain, but Japan is arguably one of very few nations capable of maintaining the equilibrium between these two superpowers.

In April 2021, Prime Minister Suga became the first foreign leader to meet with US President Joe Biden, issuing a joint statement promising a "global partnership for a new era".[6] As a feature of this partnership, the US and Japan have pledged to further increase their inter-reliance in critical supply chain areas, while also cooperating on expanding export control mechanisms. Moreover, for decades, Japan has consistently sought to keep its currency from rising against the dollar, fearing the effects of a strong yen on its export sector. This alliance should ensure Japan faces little pressure from the US regarding currency appreciation.

5 https://toshiba.semicon-storage.com/ap-en/company/news/news-topics/2022/02/corporate-20220204-1.html

6 US/Japan joint leaders statement, April 2021

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> President Biden and Prime Minister Suga recommit themselves to an indelible Alliance, to a rules-based approach to regional and global order founded on universal values and common principles, and to cooperation with all those who share in these objectives. The United States and Japan will remake these commitments for a new era.

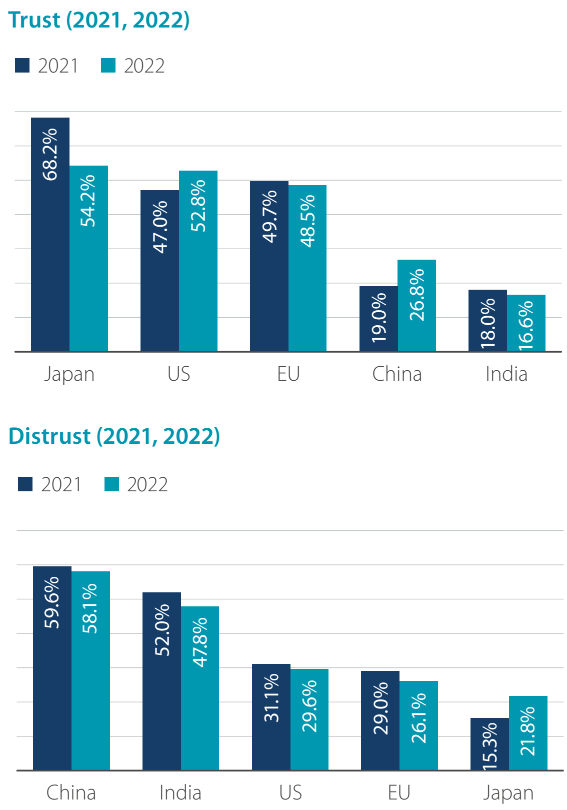
Joint leaders statement,
April 2021

Japan's 'soft power' is expanding

Because of its pacifist constitution, Japan's military power is essentially limited to self-defence. However, since China overtook Japan to become the world's second-largest economy in 2010, Japan has become a master of the subtle art of building soft power. Soft power is the term used to describe how a nation's cultural and economic influence – rather than military coercion – can be used to build trust, respect and in persuading other countries to take action. Over time, soft power can build greater bargaining power in international negotiations and exert greater economic and geopolitical influence. Japan's soft power is undeniable across Asia and beyond, and is the key to Japan's more expansive and authoritative presence on the global stage.

Japan's large capital reserves and its financial capabilities are significant tools for geopolitical influence. Since well before the Abe era, Japan has been engaged in skilful diplomacy, not only with the US and China, but also the Middle East and India, in offering a credible investment alternative to China. Unlike China, which has recently sparked more division than unity in its relationships with outside investors, Japan has earned a reputation for a more liberal approach, and willingness to seek productive relationships based on mutual economic development. In its *State of Southeast Asia Report 2022*, the ASEAN Studies Centre reported that, despite the challenging geopolitical environment, Japan was still the most trusted major power among Southeast Asians, with 54.2% of the respondents expressing confidence in Japan, followed by the US (52.8%), and the EU (48.5%).[7]

Chart 8
Trust and distrust rankings of major powers in ASEAN



10% weighting was applied to 2021 data resulting in a change of results and rankings.

Source: The Southeast Asia 2022 Survey Report

Where does Japan's soft power come from?

Japan's cultural influence on the rest of the world is nothing short of phenomenal. Internationally recognised as the home of consumer innovation and choice, Japan's art, cuisine and retail brands have a global appeal and rarely attract negative criticism from international consumers. Japan's reputation for technological

7 https://www.iseas.edu.sg/wp-content/uploads/2022/02/The-State-of-SEA-2022_FA_Digital_FINAL.pdf

innovation has earned the trust of international consumers, and ensured famous Japanese brands, such as Toyota, Honda, Bridgestone and Sony are viewed as innovative, reliable, high-quality and efficient.

Despite the long shadow created by the COVID-19 pandemic, in sporting terms, the Tokyo Olympics in 2021 were a success for Japan. Finishing third behind the US and China, Japan secured a record 27 gold medals. Moreover, Japanese cultural influences – everything from manga to Pokémon and Hello Kitty have enhanced Japan's global standing. As a result, other countries are keen for international trade agreements that bring more Japanese exports to their shores.

For example, **Sony** is one of Japan's most iconic consumer electronics brands, and has transformed itself into a soft power titan, with a footprint spanning films, music, gaming, and even financial services. A brand loved by its users, its PlayStation 5 (PS5) sold more than 10 million units worldwide in less than six months, making it Sony's best-selling gaming console ever.[8] In 2022, *Spiderman: No Way Home*, produced by Sony Pictures, became the sixth-highest grossing movie of all time, with global box office receipts of US$1.8 billion.[9]

A conservation heritage

With 25 world heritage sites, Japan is a country of outstanding natural beauty. It remains the top travel destination for Southeast Asians for choice of travel destination (22.8%) and has consistently maintained its lead since 2020. Japan is also widely considered to be a front-runner in global environmental conservation. The Kyoto Protocol, which was adopted in Kyoto, Japan, on 11 December 1997 began the global imperative that would make countries make a clear and binding commitment to reducing the emission of greenhouse gases known to contribute to global warming.

8 https://www.sie.com/en/blog/a-new-milestone-sie-sells-10-million-playstation-5-consoles-globally/

9 https://variety.com/2022/film/news/spider-man-no-way-home-avatar-box-office-record-1235180474/

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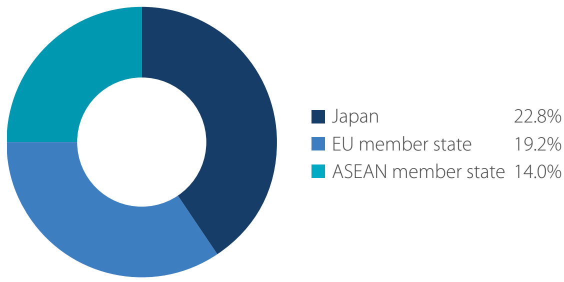
Chart 9

Most preferred country to visit for Southeast Asians



Source: The Southeast Asia 2022 Survey Report

Japan's influence as a free trade promoter

While the Japan of the past was successful, its growth was aided by protectionist policies that placed tough restrictions on imports from other countries, while promoting exports. However, the Japan of today is markedly different in its approach. Japan's growing reputation as a reliable and trusted neighbour, and commitment to expanding its area of soft power influence, has helped it to emerge as Asia's leading voice on free trade and investment.

Joining the Trans-Pacific Partnership (TPP) in 2013 was a core element of Abe's expansionary economic programme, not only through promoting Japan's economic and trade interests, but also ensuring political order and stability for the Asia Pacific region as a whole. After Donald Trump withdrew the US from the trade agreement in his first day in office in 2017, Japan successfully, and bravely, pressed for a rapid renegotiation, which led to the Comprehensive and Progressive Agreement for Trans-Pacific Partnership(known as TPP-11), which came into force in 2018.

Even without the involvement of the US, the new agreement between 11 signatories is an impressive and substantial undertaking. It creates an economic block encompassing more than 500 million people, in countries generating a combined US$11 trillion in GDP. More importantly, TPP-11 is a forward-thinking initiative, dealing with essential contemporary issues such as e-commerce, telecommunications, state-owned enterprises, anti-corruption, labour rights and the environment.

EU-Japan Economic Partnership Agreement
Japan's commitment to relationship building has not been confined to its more local neighbours. In 2019, following talks that begin in 2013, the EU-Japan Economic Partnership Agreement (EPA) entered into force. This agreement establishes an economic zone of 635 million people representing 30% of total world GDP and 40% of world trade.[10] Overall, the EPA will ultimately remove 97% of the tariffs Japan currently applies to European goods and 99% of those applied by the EU. Also, the agreement is unique in that it is the first trade deal to include a specific commitment to the Paris Agreement on climate change.

> "Our country does not produce natural resources. Our strength is that we have people – a quite well-educated population that is fairly diligent in doing things… In order to utilise that asset, we have to have interaction with the outside world, and that definitely means free trade, and creating a more liberalised investment climate.[11]"

Jun Yamazaki,
Japanese Ambassador to Singapore

The Regional Comprehensive Economic Partnership Agreement
Japan was also a leading participant in the Regional Comprehensive Economic Partnership Agreement (RCEPA) signed in 2020. The agreement (signed by 10 Association of Southeast Asian Nations (ASEAN) nations as well as Japan, Australia, China, India, Korea and New Zealand), will eventually eliminate up to 90% of the tariffs on imports between the signatories – who represents half of the world's population, 30% of global GDP and about a quarter of world exports and foreign investment. This is the first multi-lateral trade treaty between China, Japan and South Korea, and will significantly expand trade between Japan and China, as well as the ASEAN nations and the other RCEPA members.

10 https://trade.ec.europa.eu/doclib/docs/2017/july/tradoc_155725.pdf

11 https://www.bbc.co.uk/news/business-47086737

Summary
Japan's cultural influence, and willingness to take the lead with diplomacy and international relationships has given it significant geopolitical authority, and presented an important counter-narrative to the protectionism prevalent in other key markets. This in turn, has contributed positively to Japan's economic growth, helping to create a 'positive feedback loop'. In an era of instability and insecurity, Japan's moderate and harmonious perseverance is a quality many nations wish to emulate and benefit from. The world wants to do business with Japan, and equity investors are recognising the investment potential this also brings.

Where Japan leads, others will follow.

Key chapter points

- The economic and corporate reforms initiated under Shinzo Abe remain locked-in, and Japan's soft geopolitical power is increasing on multiple levels.
- Japanese companies are overcoming demographic challenges through innovations such as robotics, while its green technology (especially the development of hydrogen as an energy source) demonstrates the scale of its ambition.
- Although Japan's success is increasingly interlinked with the rest of Asia, it is also forging deeper trade and diplomatic connections across the world, including with Europe and the Middle East. As other countries have stepped back, Japan has bravely emerged as the new leader in global free trade.

Chapter 2 explores Japan's improved corporate environment, outlining the reforms laying the foundations for future commercial success, as well as the evolving dividend culture.

Japan's new corporate climate

Chapter 2

Junichi Takayama
Nikko Asset Management Japan Equity Investment Director

Japan's new corporate climate

Japan's resurgence is supported by governance reform and a progressive corporate climate, making it increasingly attractive for overseas investors – and building the foundations for Japan's future.

An improved corporate culture
Japan used to be routinely criticised by global investors for its inflexible, weak and outdated corporate culture. But the Abe administration placed corporate governance as one of the key components of its reform agenda. It recognised that opening Japanese companies up to greater scrutiny would improve their performance and make corporate Japan more competitive on a global scale.

Strengthening boardroom independence
One of the first initiatives aimed at strengthening corporate governance was for firms listed on the Tokyo Stock Exchange to increase the number of independent board directors. In 2014, the Tokyo Stock Exchange changed its guidelines, recommending companies have at least one independent director on their respective boards. In the same year, the Companies Act was amended to require companies without independent directors to explain their reasons for this at shareholder meetings.

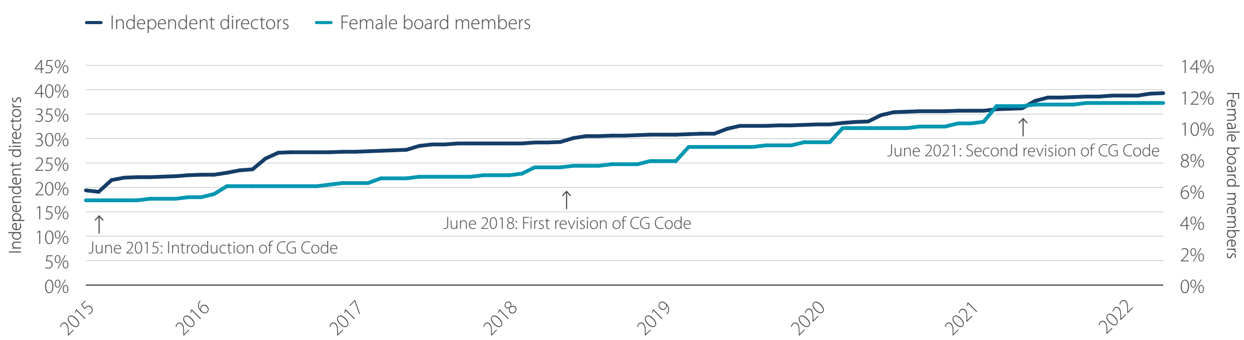
In 2015, a new Corporate Governance Code was introduced, which stated companies should have at least two independent directors. The Code also helped foster a climate of disclosing and communicating important governance and risk management information, while also maintaining the need for independent oversight. Since then, Japan's Corporate Governance Code has been revised further in 2018 and again in 2021, to strengthen corporate governance practices within companies.

The main points of the most recent revisions were:

- **Enhancing board independence:** Prime-listed companies are required to increase the number of independent directors to 'a minimum of one-third' of their board, from the previous requirement of 'at least two' independent directors. The Code also calls for companies to have independent directors with managerial experience at other companies.
- **Promoting diversity:** Companies should disclose their policy and voluntary measurable targets aimed at promoting diversity by appointing females, mid-career and non-Japanese professionals. Businesses should also disclose human resource development policies to ensure diversity and include the status of implementation.
- **Sustainability and ESG:** Prime-listed companies will be required to improve climate-related disclosure based on Task Force on Climate-related Financial Disclosures (TCFD) recommendations or equivalent international frameworks.

Chart 10 shows the number of independent directors since the Corporate Governance Code was introduced in 2015, and following the subsequent revisions. It appears

Chart 10
The changing board composition TOPIX companies



Source: QUICK

the tipping point for independent directors has been reached. There has also been a steady increase in the number of women appointed to company boards since the Abe era. Moreover, the promotion of diversity is expected to open up old school, male-dominated boardrooms to new talent with different perspectives. Finally, other important changes include calling for English disclosure and higher transparency on strategies with respect to business portfolios, which will not only help investors to gain a better understanding of companies but will enable them to engage with management teams more effectively.

Tokyo Stock Exchange restructuring

On 4 April 2022, the five segments of the Tokyo Stock Exchange (First Section, Second Section, Mothers, JASDAQ Standard and JASDAQ Growth) were restructured into three sections (Prime Market, Standard and Growth). The First Section used to be viewed as a market whereby, once listing requirements were achieved, companies faced little incentive to make corporate improvements, and their position within the market was seldom threatened.

The biggest rationale behind the reform was therefore to remove corporate complacency, by ensuring companies were motivated to keep improving their business operations or risk being delisted. As a result, the move should result in higher shareholder value, thereby attracting more capital into the Japanese market and enhancing the global competitiveness of the Tokyo Stock Exchange. Companies will be subject to a more stringent listing criteria, as well as being required to adhere to certain corporate governance standards or face the prospect of being demoted or delisted. As well as being required to disclose investor information in English, companies listed on the Prime Market will be expected to provide enhanced investor disclosure on climate change (based on Task Force on Climate-Related Financial Disclosures (TCFD) or equivalent).

New section requirements

The new Prime section is now solely for companies that have demonstrated they can have "constructive dialogue" with investors. Companies must have tradeable shares accounting for over 35% of shares outstanding and have a tradable market cap of over JPY 10 billion. As mentioned previously, Prime Market companies must also have a minimum of one-third of independent directors on the board.

The Standard section will accommodate companies that can demonstrate sufficient liquidity and possess governance levels considered of a high enough standard for open market investors. Companies must have tradeable shares accounting for over 25% of shares outstanding and have a tradable market cap of over JPY 1 billion. The Growth section will focus on newer companies with high growth potential, but still have work to do before being considered suitable for inclusion

Chart 11

The Tokyo Stock Exchange's new structure

Number of Listed Companies

Old Market Segment \ New Market Segment	Prime Market	Standard Market	Growth Market	Total
First Section	1,839	338		2,177
Second Section *JASDAQ Standard		1,127		1,127
Mothers *JASDAQ Growth		1	465	466
New listing on 4 April 2022	-	-	1	1
Listed Companies in the New Market Segment	**1,839**	**1,466**	**466**	**3,771**
Disclosure of plans to meet the Continued Listing Criteria	**295**	**209**	**45**	**549**

**The number of listed companies in the old market segment is as of 3 April, 2022, and the number of listed companies in the new market segment is as of 4 April, 2022.*

Source: 2022 Tokyo Stock Exchange, Inc.

Any comparison to a reference index or benchmark may have material inherent limitations and therefore should not be relied upon

in either of the other two markets. Companies must have tradeable shares accounting for over 25% of shares outstanding (and at least 150 shareholders), and have a tradable market cap of at least JPY 0.5 billion.

According to the Tokyo Stock Exchange, 664 companies (roughly one-third) formerly listed in the First section did not meet listing requirements for the Prime Market when they applied to join in 2021. Those companies were given the option of either carrying out corporate actions that would satisfy the Prime Market, or face a "demotion" to Standard if they were unable to meet the requirements. As a transitional measure, the Tokyo Stock Exchange allowed companies to be listed on Prime on condition they submitted a plan to meet the requirement in the future, although no clear deadline for submission of these plans was stated.

'Comply or explain' is better for investors

After the new structure was announced, many large shareholders began disposing of their shares at the request of companies, to ensure the company met the more stringent listing requirements. Management buyouts, share buybacks and full consolidation of listed subsidiaries also increased—thereby unlocking value. The restructuring took place on 4 April 2022. While the Tokyo Stock Exchange gave companies a generous window in which to comply with the new listing rules, its 'comply-or-explain' policy is clearly intended to create a more level playing field for various investors in Japan over time. Moreover, the 295 companies that did not meet the requirement but ended up getting listed on the Prime Market as a transitional measure were all required to submit plans to take corrective actions. These companies will continue to be under scrutiny by the bourse, and more widely by investors.

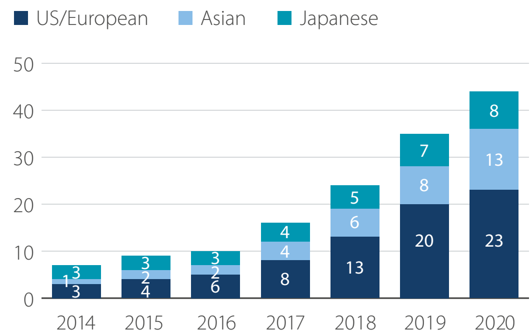
Shareholder activism is increasing

Shareholder activism was once considered taboo in Japan. However, this has also changed over time. In 2014, there were only seven activist investors targeting Japanese companies, but as Chart 12 demonstrates, as more have recognised the attractiveness of the Japanese market, that number has increased to 44. There is even a Japanese retail fund employing an activist strategy. Shareholder activism also now comes in many forms, including the old-school 'greenmailer' asset-strippers, participation groups focused on constructive boardroom engagement, and other investors choosing to take a hands-on approach to initiate change.

Chart 12

Shareholder activists in Japan

Activists are increasingly exerting more pressure on companies to unlock value



Source: IR Japan

Investors are making themselves heard

Market culture has been changing dramatically, allowing shareholders to be more vocal, and sometimes even hostile, to the companies they invest in. Crucially, the lines between shareholder activism and stewardship are increasingly blurred, particularly due to the increased prevalence of ESG considerations at boardroom level. In recent years there has been an increase in shareholder activism related to human capital management, especially following the COVID-19 pandemic, where poor human capital practices were blamed for high levels of employee attrition, as well as poor output and product quality. This trend of engagement on human capital issues is now a worldwide phenomenon, and Japan is no exception.

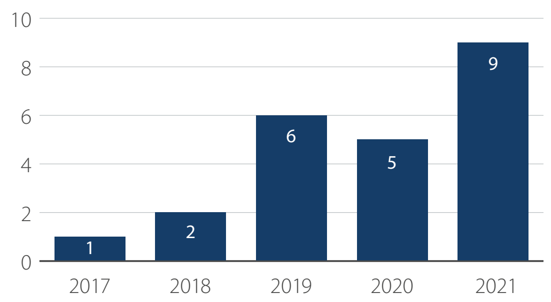
The key point is that when activist investors choose to champion issues that would be in the collective interest of all shareholders, they can now expect to gain support from institutional investors who share the same concerns and are required by the Stewardship Code to act in the best interests of their clients. In other words, activists now have the leverage to make things happen.

Corporate takeovers more likely

While activist investors are making their presence felt, strategic investors are stepping up their efforts to acquire companies outright – often without the prior consent of the target company's management teams, as Chart 13 shows.

Chart 13

Number of hostile tender offers on the increase



Source: IR Japan (31 December 2021)

SBI Holdings versus Shinsei Bank

One such example was the showdown between online financial firm SBI Holdings and Shinsei Bank, which resulted in the first-ever hostile acquisition attempt in Japan's banking sector. In September 2021, SBI Holdings launched a tender offer for Shinsei Bank's shares, in an attempt to turn Shinsei Bank into its subsidiary. To fend off the takeover attempt, Shinsei Bank used a 'poison pill' defence and put the proposal to a vote at an extra-ordinary shareholders' meeting in November 2021. The Japanese government held a stake in Shinsei Bank (as the result of a bail-out in the 1990s) and it was widely reported that the government agency that held the shares would not support the poison pill measure.

This sent a clear message to capital markets that the Japanese government favours competition for corporate control and viewed it as beneficial for investors and society. Shinsei Bank eventually withdrew its poison pill and cancelled the extraordinary shareholders' meeting. SBI Holdings's tender offer for Shinsei Bank was accepted in December 2021, and the two parties agreed to integrate and collaborate under a new management team.

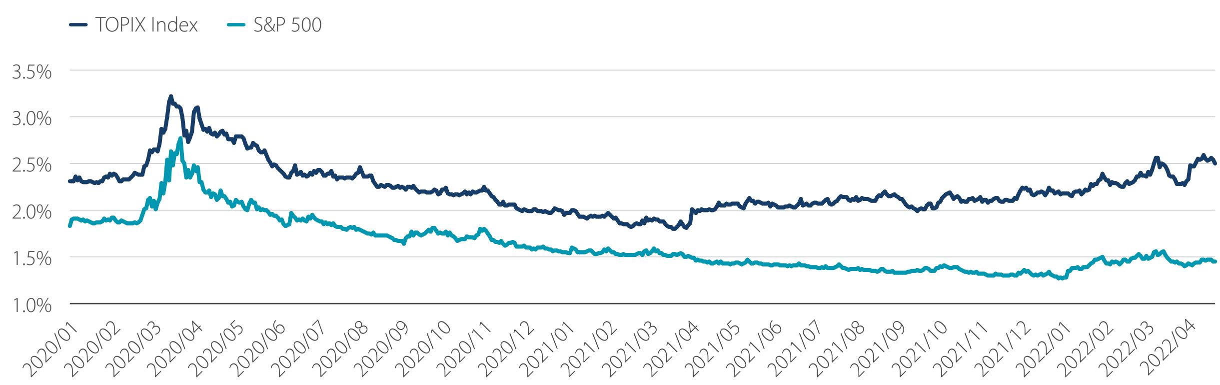
Improved dividend prospects for investors

The more competitive environment for Japanese companies has resulted in corporates placing greater emphasis on shareholders, and efforts to return more capital to them. At the time of writing, companies in Japan have demonstrated considerable resilience from the negative consequences of the pandemic, and corporate Japan's more conservative approach to cash preservation has granted many businesses with stronger dividend cover compared to other developed market competitors, especially those in the US. As a result, Japanese stocks are sitting on significant excess cash levels, leaving plenty of room for further shareholder returns, making Japan an attractive income investment destination. Chart 14 shows the dividend yields of Japan (TOPIX) and US (S&P 500). Japan's current dividend yield level, and the potential upside in dividends compared to the US, warrants closer attention from overseas investors.

References to individual stocks are for illustration purposes only and do not constitute a recommendation to buy or sell.

Chart 14

Dividend yields of TOPIX and S&P 500

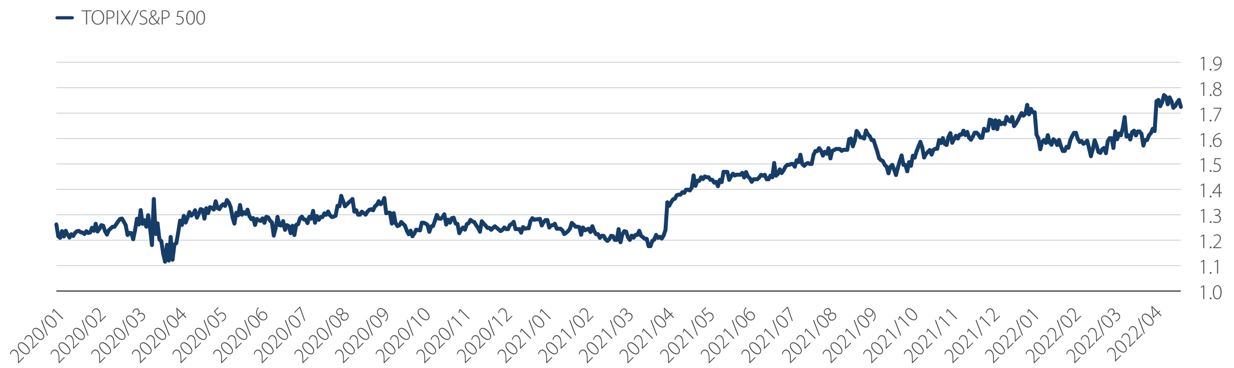


Source: Bloomberg (20 April 2022)

Any comparison to a reference index or benchmark may have material inherent limitations and therefore should not be relied upon

Chart 15

Japan, US dividend yield relative ratio



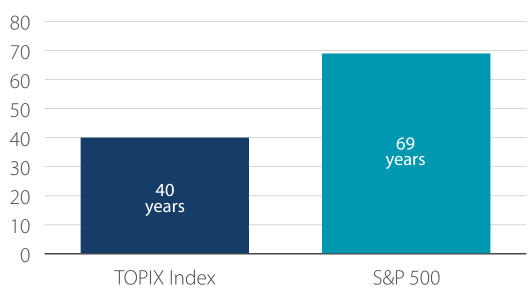
Source: Bloomberg (20 April 2022)

Chart 15 shows the relative ratio between the two markets (Japan dividend yield divided by US dividend yield); we can see that from this perspective Japan is currently more attractive. Furthermore, from a broader perspective, the Japanese equity market has shown a tendency to perform better than its US counterpart when US yields are rising (Chart 17). This characteristic offers investors the option to diversify away from the US market, with its heavy exposure to the tech sector, at a time when interest rates are expected to rise.

Chart 16

Equity duration TOPIX and S&P 500

Number of years for invested capital to be recouped



Source: Bloomberg, 20 April 2022

Japan's dividend prospects in an era of higher interest rates

Chart 16 shows the 'equity duration' – the number of years it theoretically takes for invested capital to be recouped (the inverse of dividend yield) – of the TOPIX and the S&P 500. Japan's equity duration is 40 years, while the equity duration of the US index is 69 years. A shorter duration can be construed as less sensitivity to interest rates as the proportion of cash flows that make up a stock's value will likely be received sooner. Therefore, the Japanese equity market could fare better when interest rates rise.

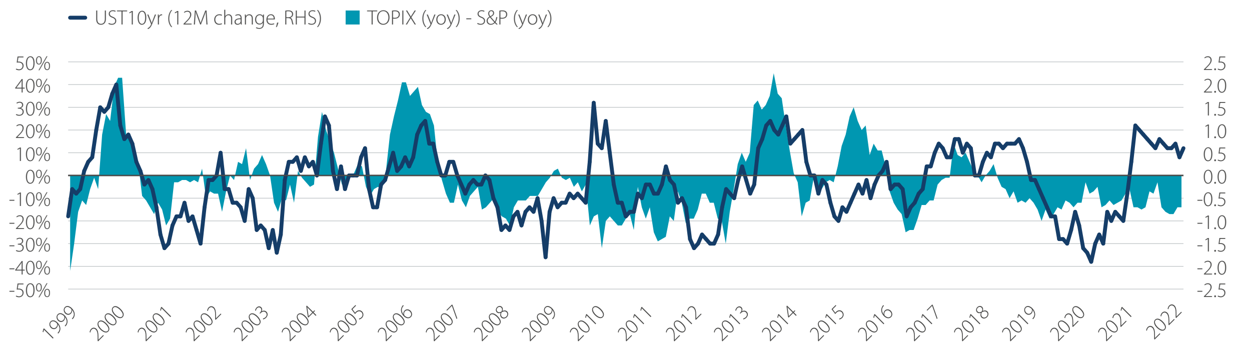
Summary

Corporate culture in Japan is clearly changing. The current structural reform programme is doing what it set out to achieve, improving the attractiveness of Japanese companies, and giving investors more reasons to invest. A more transparent, competitive and dynamic environment is helping to build better businesses that are dedicated to maximising shareholder value. This value will only increase for those investors entering the Japanese market in the post-pandemic era. As the after-effects of the COVID-19 pandemic continue to fade, investors will become more focused on structural change that unlocks and builds value.

Any comparison to a reference index or benchmark may have material inherent limitations and therefore should not be relied upon

Chart 17

TOPIX tends to fare better than S&P 500 when US yields rise



Source: Bloomberg, 31 March 2022

Also, as Japan aims to become carbon-neutral by 2050, the pivot towards hydrogen noted in Chapter 1 should serve as another long-term catalyst for structural change. Japanese companies have an abundance of advanced technology related to hydrogen energy, including those linked to automobiles and energy infrastructure, and these companies and sectors stand to benefit as global economic conditions improve. This is shaping up to be an exciting period for Japanese companies, and a potentially significant opportunity for investors to give due consideration.

Key chapter points

- Since Abe's premiership, improved corporate governance has become integral to corporate Japan, and companies must 'comply or explain' to avoid damaging consequences.
- Now on a firmer footing, corporate activity in Japan has accelerated, with more takeovers, more shareholder engagement and activism leading to a more dynamic stakeholder-friendly corporate culture.
- One aspect of this involves greater dividend activity, as Japan becomes a more mature – and more competitive – environment for shareholders.

Chapter 3 explores how stocks can continue to maintain and grow shareholder returns, and how investors can unlock the hidden value within Japan's equity markets.

Any comparison to a reference index or benchmark may have material inherent limitations and therefore should not be relied upon

Unlocking Japan's hidden value

Chapter 3

Junichi Takayama
Nikko Asset Management Japan Equity Investment Director

Unlocking Japan's hidden value

Although growth investing has led following the global financial crisis, Japan's value stocks are now in the ascendency. Crucially though, value investing is about knowing where to look and when to invest.

Since the global financial crisis, the low economic growth, low interest rate era has kept growth investing in the spotlight, both in Japan and across the rest of the world. However, a turnaround for value stocks is currently underway, and looks set to last for several years. Why is this shift being ignored by global investors? To answer this question, you must start by examining the past.

Comparing the bubble era and the present

Compared to the 1980s, Japan's market environment has changed dramatically. In 1988, the Nikkei 225 was trading at a price-to-earnings ratio of 63x, due primarily to excess liquidity and amid a proliferation of widely-criticised cross shareholdings. The price-to-book ratio of the Nikkei index was 5x, suggesting many of its constituents were heavily overvalued and artificially supported. As Japanese equities fell from their exaggerated valuations, and entered into two consecutive 'Lost Decades', this pushed value to the periphery, and investors have spent the subsequent years avoiding Japan and its so-called 'value traps'.

The Japan of today

As Charts 18, 19 and 20 illustrate, the market environment for Japanese equities is in a much healthier state compared to the bubble era. At the end of March 2022, the Nikkei's Forward P/E ratio is a healthy 14x. Moreover, its P/B ratio is now at just 1.3x compared to the 5.0 reached in 1988.

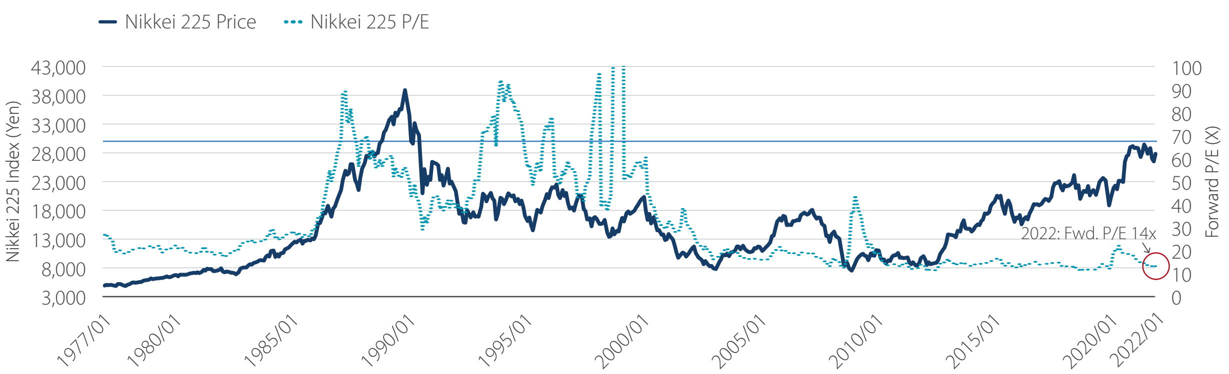
Similarly, the dividend yield of the Nikkei demonstrates how shareholder expectations have evolved. Back in 1988, when overseas investment into Japan was at its peak, the Nikkei's dividend yield was a modest 0.46%, as Japanese companies placed little importance on dividends at the time, and valuations were stretched. In 2022, the Nikkei dividend yield has risen to a much more favourable 2.45%.

> "The secular, structural changes unfolding in Japan are also significant tailwinds for value-driven investing."
>
> **Junichi Takayama,**
> Nikko Asset Management Japan Equity Investment Director

Chart 18

Nikkei price/earnings ratio: 1988 vs 2022

Period: Jan 1977 - March 2022



Source: Mizuho Securities, based on data by Nihon Keizai Shimbun and Toyo Keizai

Any comparison to a reference index or benchmark may have material inherent limitations and therefore should not be relied upon

Chart 19

Nikkei price/book ratio: 1988 vs 2022

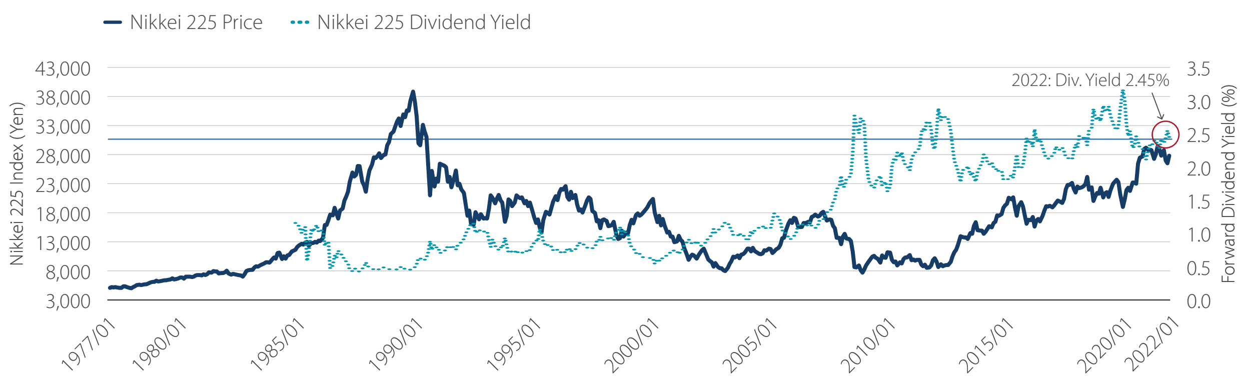
Period: Jan 1977 - March 2022

Source: Mizuho Securities, based on data by Nihon Keizai Shimbun and Toyo Keizai

Chart 20

Nikkei dividend yield: 1988 vs 2022

Period: Jan 1977 - March 2022



Source: Mizuho Securities, based on data by Nihon Keizai Shimbun and Toyo Keizai

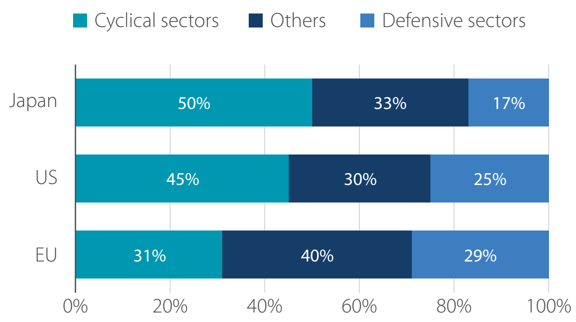
Structural reforms are benefiting value-heavy sectors

Importantly, the secular, structural changes unfolding in Japan outlined in Chapters 1 and 2 are also significant tailwinds for value-driven investing. Japan's high level of cross shareholdings – long associated with corporate underperformance, complacency and lax governance – has declined sharply since its peak in the early 1990s.

The unwinding of these shareholdings reflects the changing relationship between Japanese companies, senior management and shareholders. Also, Japan's steady programme of market reform initiatives, including the realignment of the Tokyo Stock Exchange, has the potential to accelerate improvements in corporate governance and unlock previously overlooked value opportunities.

Any comparison to a reference index or benchmark may have material inherent limitations and therefore should not be relied upon

Chart 21
Sector breakdown by country and region



Source: SMBC Nikko Securities

Japan's long-term cyclical and diversification opportunities

Japan is the most sensitive to economic cycles among the major economies, with the highest proportion of cyclical stocks compared to the US and the EU (Chart 21). As global economies recover from pandemic-caused downturns, we expect foreign investors to reconsider their stance on Japan and start increasing their allocations. This, of course, is alongside the greater prevalence of domestic investment from Japanese investors already outlined.

From a portfolio construction perspective, Japan equities offer attractive diversification benefit due to its relatively low correlation to other equity markets. While Europe is highly correlated to the US (0.85), Japan's correlation to the US and Europe are relatively low, 0.64 and 0.68, respectively.

Despite Japan's tighter trade relations with China and the Asia ex-Japan region, its equity market correlation with the region is just 0.57, reflecting a significantly different risk profile. From this perspective, Japan benefits from Asia growth but is not exposed to the same market risks, such as with the impact of the US-China trade war, or more recent China regulatory crackdowns.

In addition, the long-term global shift toward a decarbonised society will continue to present opportunities for companies with environmentally-friendly technologies, especially in hydrogen and battery technology. Japanese companies within the value sphere have an abundance of advanced technology related to hydrogen energy, including those linked to automobiles and energy infrastructure, and these value plays stand to benefit significantly from improved economic conditions.

Chart 22
Japanese equity correlation to other equity markets

	Correlation Matrix (20Y)						Average Pairwise Correlation		
	Japan	US	Europe	Asia ex	LatAm	EMEA	DM	EM	Global
Japan		0.64	0.68	0.57	0.46	0.58	0.66	0.53	0.58
US	0.64		0.85	0.74	0.67	0.71	0.74	0.70	0.72
Europe	0.68	0.85		0.69	0.63	0.67	0.76	0.66	0.70
Asia ex	0.57	0.74	0.69		0.75	0.81	0.66	0.78	0.71
LatAm	0.46	0.67	0.63	0.75		0.83	0.58	0.79	0.67
EMEA	0.58	0.71	0.67	0.81	0.83		0.65	0.82	0.72

Source: Bloomberg (April 2022)

Any comparison to a reference index or benchmark may have material inherent limitations and therefore should not be relied upon

Chart 23 below suggests the turning point has been reached, that the divergence in returns between growth stocks and their value counterparts has become extreme, and that a period of reversion to the mean is the most likely consequence. With a shift from growth to value already underway, running alongside the upward path of interest rates, this presents a long-term opportunity for value-driven investments.

The question for investors now is this: if Japan now presents a significant investment opportunity, how can investment managers best capture it?

Capturing value opportunities
It seems almost inexplicable to suggest the equity market of the third-largest economy in the world is overlooked and under-researched, but that is unquestionably still the case. Most global equity managers have a structural underweight to Japan, and they are quick to dismiss it as characterised by slow growth and lowly returns. Also, with growth having been in the spotlight for two decades, value opportunities are still frequently over-looked by the broader market, and especially those with long memories of 'value traps'.

To combat this perception, investment in today's Japan must begin with ensuring value traps are avoided, and by creating the environment wherein true long-term value can be discovered. To be successful, a combination of 'horizontal' and 'vertical' research must be employed.

Blending horizontal and vertical research
Horizontal research – the accumulated knowledge of Japanese companies and industries – is essential to identifying value companies and unlocking value. Context is key. Having a historic understanding of Japanese companies provides insights that can help to determine:

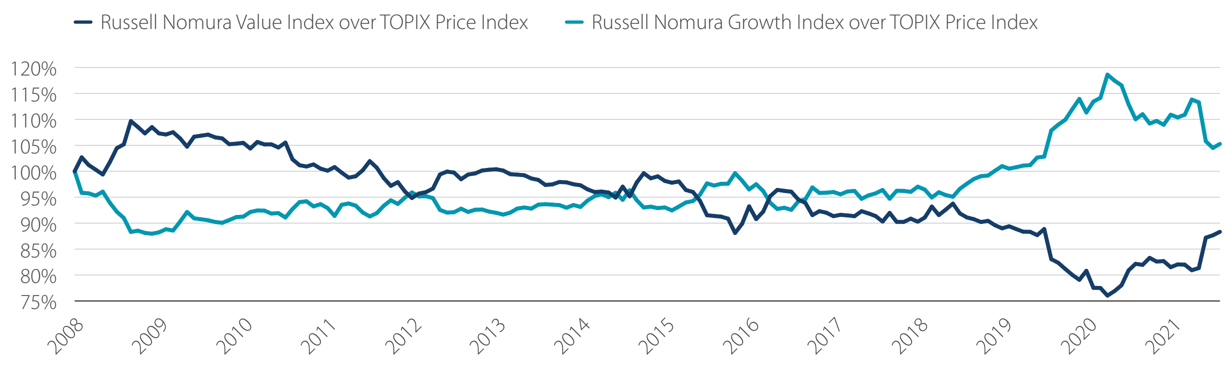
- Why the company is trading at a low valuation, within a broader context
- The quality of management
- Balance sheet strength
- Non-financial information not yet priced-in by the market, but indicative of future earnings and cash flow generation

All of these, and more, can offer signals for a potential catalyst leading to positive change.

However, to access information beyond financial statements, sell-side research, and local news flow, an on-the-ground presence is needed. A vertical research approach can deliver invaluable insights that help put into context the idiosyncratic risks of individual companies and sectors.

In vertical research, questions can be asked that only individuals with a real-world and real-time knowledge of the organisation can answer. Therefore, when meeting companies it's important to not just meet with senior

Chart 23
Value vs growth (cumulative returns)



Source: Tokyo Stock Exchange and Russell/Nomura Japan Equity Index (31 March 2022)

Any comparison to a reference index or benchmark may have material inherent limitations and therefore should not be relied upon

management, but with its employees throughout the organisation, from product developers to factory floor workers. Not only can vertical research help to deepen an understanding of a company, including opportunities and risks, it can also strengthen the relationship with senior management, introducing insights and observations that can be used to inform, educate and change the company from within.

Catalyst-driven investment

The aim of blending horizontal and vertical research within value investing is to identify catalysts. Catalysts can be either supply-side, such as corporate restructuring or management reshuffles, or demand-side, through the launch of new products and services (as in the case with **Nintendo**, following the launch of its Nintendo Switch gaming system which can be used anywhere).

The process of identifying catalysts can include looking for companies whose management and employees share a sense of crisis that propels them to implement the changes needed to unlock value. This requires a patient approach, since such structural changes often take time to manifest. A value-driven investment team may research a company for three to five years before making an investment, but when the investment is made, it will be held for a similar (if not longer) period.

Relationship building

One of the fundamental advantages of a value-driven approach to Japanese equities, is that it complements the new corporate environment being built in Japan. Trust remains a highly valued currency in Japan, and at its core, value investing aims to develop and maintain deep and lasting relationships with companies – across all levels of its corporate structure – to build high conviction positions. Although the relationship between Japanese companies and shareholders has become more demanding, and more contentious, at times, the relationships that these companies foster with investment managers can be more constructive, with the investment managers occupying the middle ground between the company and other shareholders.

Summary

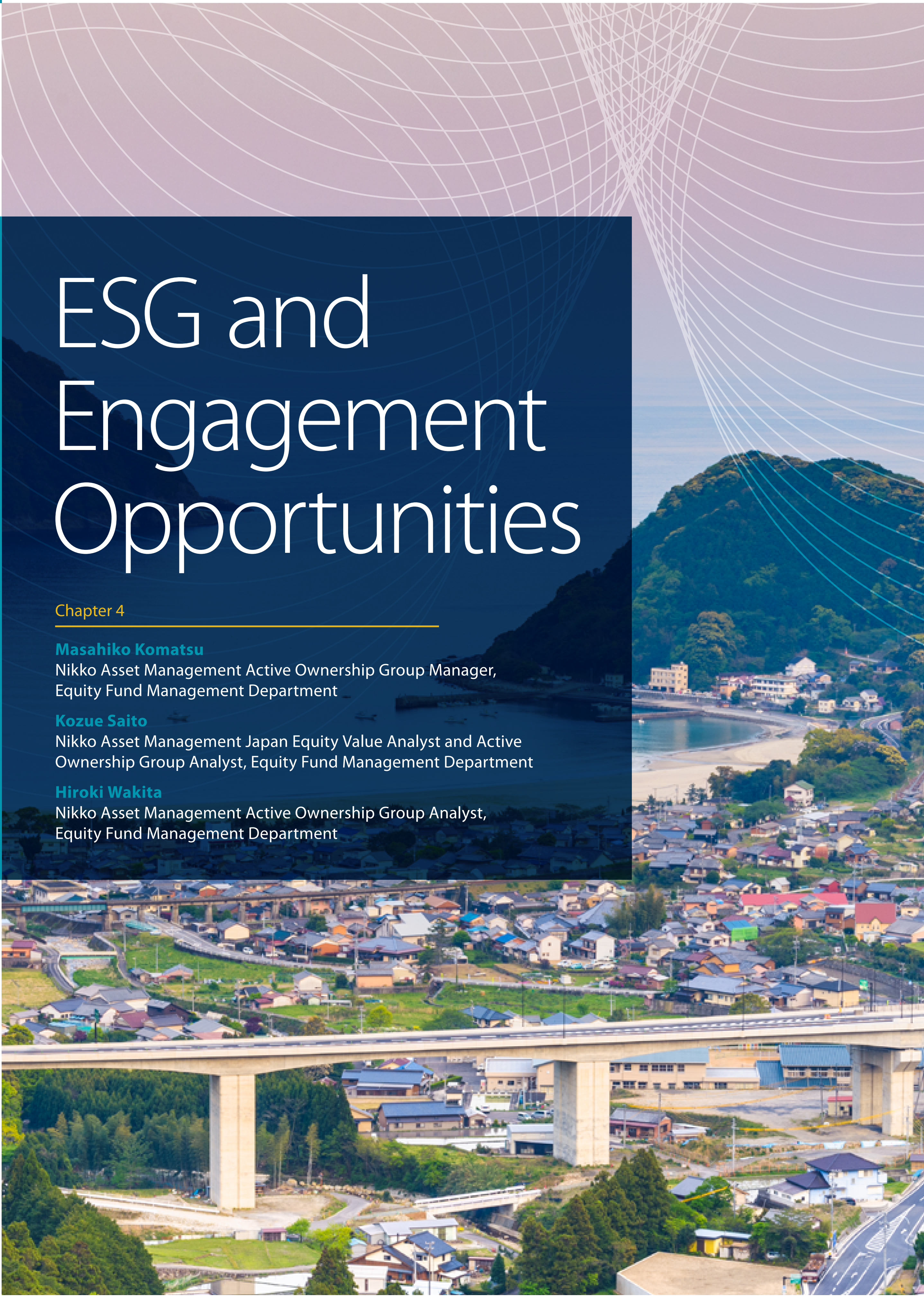
Whereas Japan's equity markets were historically undercut by weak institutions and brittle governance, the opposite is true today. Japan has learned that corporate reform and strong governance is an evolutionary process, and equity markets are now firmly underpinned by the country's more mature economic foundations.

The long-awaited turnaround in Japanese equities is still in its early stages, but the momentum is building. As structural changes encouraging better corporate governance and increased shareholder engagement continue, Japanese companies will continue to experience catalysts that unlock hidden value. In this type of market, applying a value-oriented investment approach can be extremely effective in delivering stable, long-term returns, especially when compared to a momentum-led approach.

Key chapter points

- The Japanese equity market is in a much healthier state compared to 30 years ago, and enjoys a more competitive environment that increases the potential of value catalysts.
- Moreover, the rebound in long-overlooked value stocks has also just begun, with the cycle at the early stages of its value-supportive phase.
- A combination of active engagement alongside deep horizontal and vertical research can help to mitigate risks, avoid value traps and unlock hidden value that others miss.

Chapter 4 focuses on Japan's role as a leader in clean energy technologies, and how companies are satisfying the needs of all stakeholders through ESG engagement.



ESG and Engagement Opportunities

Chapter 4

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ESG and Engagement Opportunities

While in today's world many companies display their ESG credentials like a badge, Japanese companies have long held a sustainable mentality, even though they seldom articulate this more widely. That's because in Japan, a deeply ingrained connection to the environment and society has always been common sense, not something that needed to be articulated.

Japan's circular economy has deep roots

It's impossible to look at the Japan of today without remembering its history. Japan's deep connection to the environment and society has been a feature for centuries, dating back to the Edo period from the 17th to 19th century. During this period, when Japan's economy was effectively closed off from the rest of the world, its urban economy was nurtured with a respect for nature and determination to maximise all available natural resources.

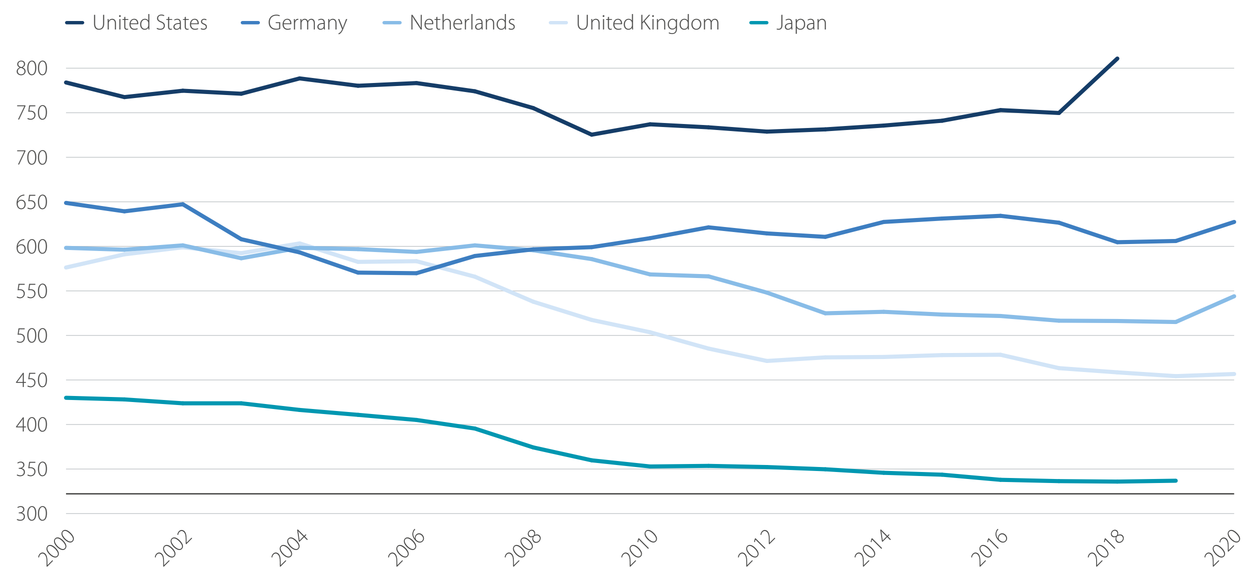
According to historian Tanaka Yuko: "Edo was a circular economy in which energy and resources were supplied domestically and all major life resources – clothing, food, and housing – were recycled and reused".[12] As the rest of the world slowly adapts by introducing their versions of a sustainable circular economy, these instincts are already ingrained in Japanese culture as seen in chart 24, and are therefore being reintroduced at a faster rate of progress.

And yet today, across many important ESG metrics, Japan lags its developed market peers, meaning there is still the opportunity for significant improvement. Active engagement of Japanese companies is therefore essential in order to 1) encourage them to better articulate positive ESG activities already underway, or 2) drive new ESG initiatives forward, thereby unlocking further value. As the world's third largest economy, with an investment universe of 3,700 companies, there is clearly a lot of work to be done, but meaningful engagement on ESG principles certainly has the potential to deliver extremely positive results.

12 Tokyo Updates: How Tokyo Can Become a "Circular City" as Taught by the Edo Period (2022)

Chart 24

Municipal waste in kilograms per capita

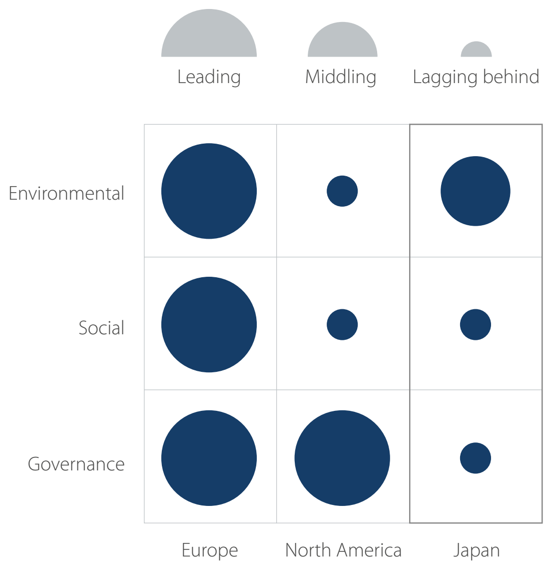


Source: Waste - Municipal waste - OECD Data

Chart 25

Japan has the opportunity to unlock greater value across all aspects of environmental, social, and governance performance

ESG performance (large and smaller companies combined)



Source: McKinsey analysis

Stakeholder capitalism and engagement

Similarly, Japan has had a culture of stakeholder capitalism – putting people and the planet first in corporate and economic policies – for centuries, which has now been more firmly reinforced through government policies.

> "Japan's industry has historically developed on a philosophy of seeking to benefit not just oneself but all three stakeholders, which are the seller, the buyer and the community, thereby contributing to society."

Tokutaro Nakai,
Vice Minister of the Ministry of the Environment

As outlined in Chapter 2, the establishment of the Stewardship Code, one of the key pillars of an economic revival plan initiated by then prime minister Shinzo Abe in 2014, was a watershed in terms of changing how institutional investors interact with the corporations they invest in. One of the Code's key elements is "constructive engagement with investee companies" that institutional investors are asked to undertake to foster sustainable growth.

More specifically, the Stewardship Code encourages engagement between institutional investors (such as asset managers) and investee companies in the following ways:

- Asset owners, such as pension funds, are asked to monitor whether the asset managers investing on their behalf carry out stewardship activities that are in line with the asset owners' policies, and the quality of dialogue between asset managers and investee companies is a key evaluation point.
- The code emphasises constructive engagement between institutional investors and investee companies to solve governance issues the latter may be facing.
- Institutional investors tasked with passive management are encouraged to actively take charge of engagement and voting (based on the premise that passive management offers institutional investors fewer options to sell investee companies' shares and therefore they are able to promote longer-term corporate value growth).

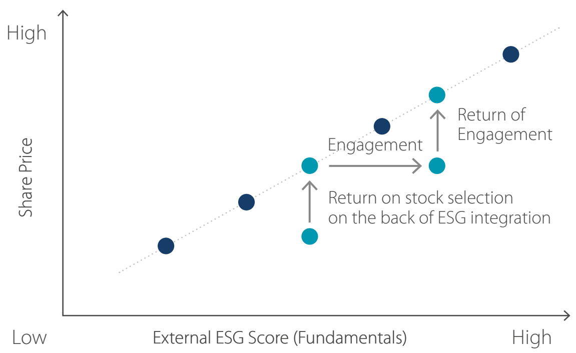
How engagement leads to alpha

Engagement has come into focus thanks to its positive impact on all parties involved: asset owners, institutional investors and investee companies. Academic research shows engagement activity by large institutional investors aimed at companies with potential areas of improvement, such as governance, low return on assets (ROA) and excessive cash holdings, has had a positive impact on target companies. This has resulted in higher return on equity (ROE), more independent directors and proportion of shares owned by management.

Within Japan's changing landscape, we believe that engagement is a significant source of differentiation. In identifying undervalued names which have the potential to enhance their value due to ESG-related factors (Chart 26) engagement with these firms – on

Chart 26

Returns from ESG integration and engagement



Source: Nikko AM

issues such as decarbonization, managing human capital, and enhancing their governance frameworks – will improve their fundamentals, enhance their corporate value and ultimately lead to higher returns.

More importantly though, engagement with Japanese companies can offer another dimension, by shining a spotlight on hidden value. There is a strong case to suggest that the ESG credentials of many Japanese companies are going unnoticed at the global level, either because Japanese companies have reputational or legacy issues to overcome, or that companies neglect to make their ESG case as forcefully as they could.

Kawasaki Heavy Industries: engineering a hydrogen-based society

Kawasaki Heavy Industries (Kawasaki) has a worldwide reputation as a multinational industrial manufacturer of motorcycles, engines and heavy equipment. It doesn't have a reputation as being a provider of clean energy. But after playing a role in helping Japan become an industrial powerhouse in the 20th century, Kawasaki Heavy has its sights set firmly on the 21st century with its emphasis on hydrogen.

Hydrogen is expected to play a key role in plans for Japan to become carbon neutral by 2050, as Japan reduces its reliance on fossil fuels. Green hydrogen has been labelled 'the ultimate clean energy', because it can be used like petrol to power vehicles, but also to generate electricity. Whilst hydrogen can be produced from fossil fuels, it can also be extracted from water through electrolysis, using electricity to split H_2O into hydrogen and oxygen, which is a technology we expect to accelerate in the coming years.

But since Japan does not possess the required natural resources, nor have the space to build large-scale solar farms for electrolysis, it will have to acquire hydrogen from Australia and the Middle East, which have abundant natural resources, land and sunlight for solar farming. Shipping hydrogen to Japan currently presents a big technological challenge. It must be turned from gas into liquid by cooling it to -253°C before it can be transported. At a reduced volume, hydrogen storage, transportation and distribution efficiency increases dramatically.

From a value perspective, Kawasaki appears significantly undervalued. It already has several years' experience of transporting and storing liquefied natural gas at temperatures of -162°C. Kawasaki already possesses the state-of-the-art technologies needed for the mass transportation of hydrogen that could transform Japan into a hydrogen-led society. In April 2022, Japan's hydrogen association HySTRA announced the completion of the world's first maritime transport of liquefied hydrogen, including its loading and unloading, in Kobe, Japan.[13]

Kawasaki is an example of a cutting-edge company being judged on its legacy operations rather than its future possibilities. From an engagement perspective, it has not been able to fully articulate the scope of its clean energy ambitions to the broader investment community, or to reposition itself away from its 'heavy industry' reputation. In recognition of this, Kawasaki has created a 'Sustainability Promotion Department' that will look to explain its clean energy initiatives more thoroughly.

13 HySTRA celebrates completion of world's first liquefied hydrogen vessel voyage in Japan (2022)

References to individual stocks are for illustration purposes only and do not constitute a recommendation to buy or sell.

Selected shades of hydrogen

Colour	GREY HYDROGEN	BLUE HYDROGEN	TURQUOISE HYDROGEN*	GREEN HYDROGEN
Process	SMR or gasification	SMR or gasification with carbon capture (85-95%)	Pyrolysis	Electrolysis
Source	Methane or coal	Methane or coal	Methane	Renewable electricity

Note: SMR = steam methane reforming.
* Turquoise hydrogen is an emerging decarbonisation option.

Source: Green hydrogen: A guide to policy making (irena.org)

Snow Peak: a new model of the Japanese circular economy

As societies adapt to life after the coronavirus pandemic, some companies are rising to the challenge by offering new lifestyles for a post-pandemic world. One such company is camping gear manufacturer **Snow Peak**. Already an established outdoor brand with a global following, it is trying to evolve from a camping-focused enterprise into a business providing "nature-oriented life values" to a wide variety of individuals through many aspects of life.

Snow Peak sees social values being challenged by rapid digitalisation and advances in technology and its stated social mission is "reviving humanity that has diminished in modern society", with clear echoes of the circular economy instilled throughout the Edo era. For example, Snow Peak's values promote the following aspects of life:

- **Playing:** Promoting camping as part of everyday life, promoting local communities and strengthening connections within the family and the workplace.
- **Clothing:** Developing clothing suited, in function and design, for both outdoor and everyday use, promoting traditional craftsmanship and textile recycling, and connecting consumers with local sustainable clothing producers.
- **Eating:** Promoting the outdoor "off the grid" cooking experience and encouraging locally available, organic produce and traditional farming methods.
- **Living:** Offering nature-oriented lifestyle tips in urban settings.
- **Working:** Improving the contemporary working experience by introducing elements of nature – such as remote working in the garden and using camping gear.

In an era of disposable goods and 'fast fashion' that has raised ethical and sustainability concerns, Snow Peak's outdoor goods are 'guaranteed for life', and the company promises to repair or replace any item that doesn't live up to the company's standards. Specifically, the company has built a business model that it claims has transcended mass production and mass consumption by producing products that are very high-spec and designed to be repaired repeatedly instead of being discarded.

Despite these credentials, Snow Peak is a company with a relatively low ESG ratings, and therefore remains off the radar for ESG-focused investors. Deeper engagement with the company suggests this is not a concern for the company itself, and that by focusing on its core activities, and continuing to live its sustainability-driven values, it will be appreciated by its customers and, over time, by investors.

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Ajinomoto: solving the world's nutritional and health crises

In addition to the global emphasis on reducing carbon dioxide, cutting methane emissions is also essential to slowing the current pace of global warming. Methane's lifetime in the atmosphere is shorter than that of CO_2, but methane is said to be more than 25 times more potent than CO_2 in trapping heat within the atmosphere.[14] As such, reducing methane emissions is critical to slow global warming and presents an immediate opportunity to tackle climate change.

The climate impact from the agricultural sector – particularly around meat and dairy farming – has been known for decades, but the role of livestock in the production of methane emissions has come under increasing scrutiny in recent years. As Chart 27 shows, agriculture is responsible for a significant portion of global greenhouse gas (GHG) emissions, of which cattle are the major contributor. The Food and Agriculture Organization (FAO) also notes that cattle raised for both beef and milk production, as well as for inedible outputs like manure and draft power, are major GHG emitters, representing about 65% of the livestock sector's emissions.[15]

According to the US Department of Agriculture, the global population of cattle was estimated at one billion in 2021. However, simply reducing cattle populations would also cause a shortage in the supply of protein, one of the three essential food groups, along with carbohydrates and dietary fats. Plant-based proteins offer both an alternative to meat and a way to reduce methane emissions.

The **Ajinomoto Group** (Ajinomoto) is playing a significant role in providing plant-based protein to consumers around the world. The food producer was founded in 1909 and has traditionally focused on developing its business in agriculture-producing countries. Today, Ajinomoto competes globally with rivals such as Nestlé and Unilever, and is a leading player in developing regions such as Africa, where it has established an extensive local presence. The company's global stance also reflects its key philosophy, established at the time of its founding, of contributing to society by providing the underprivileged with not only nourishment but an enjoyable eating experience.

Ajinomoto was the first company to commercialise the use of 'umami', also known as monosodium glutamate, a savoury taste which earned a place alongside sour, sweet, bitter and salty. Seasonings with umami add a meaty richness to plant-based protein dishes, and have helped improve the eating experience and nutritional balance of consumers for whom meat is a luxury.

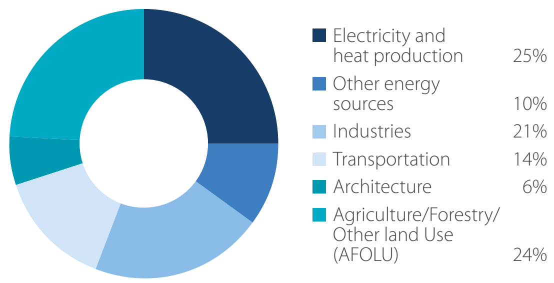
However, Ajinomoto's work, and contribution to society, is not just limited to seasoning. It is also a leader in identifying and solving health issues associated with dietary practices.

Excessive salt consumption is known to cause significant health problems, such as stroke, heart disease, osteoporosis and cancer, and is estimated to have become a serious health issue in more than 95% of countries around the world. Studies have shown that replacing salt with umami seasoning delivers significant health benefits, while the amino acids found in umami could help the elderly by preventing some of the negative effects of Ageing.

Chart 27

Global GHG emissions by economic sector

49 GT CO_2 conversion (2010)



Note: Gt = billion metric ton

Source: Mizuho Securities Equity Research, based on IPCC AR5 Working Group 3 Report

14 https://www.epa.gov/gmi/importance-methane

15 https://www.fao.org/news/story/en/item/197623/icode/

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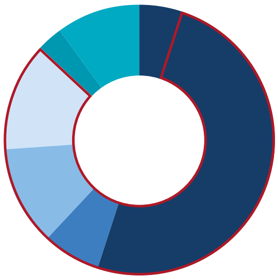
Chart 28

How ammonia is used around the world (as at 2012)



Source: The Institute of Energy Economics, Japan and NEXANT data compiled by Nikko AM

Also, Ajinomoto's expertise in the field of amino acids can also be used in areas such as ammonia production. Ajinomoto is working to develop a method to produce ammonia in its amino acid production facilities, this would enable it to make small-scale 'green' ammonia for local consumption, leaving a much smaller carbon footprint compared to current large-scale and capital-intensive ammonia production methods.

Ammonia is considered an important potential source of 'next generation' energy. As with fossil fuels, ammonia is both a chemical energy store and a fuel, where energy is released by the breaking and making of chemical bonds. However, compared to hydrogen, ammonia liquefies at a more manageable minus -33°C and is therefore much easier to store and transport. Ammonia is also a very widely used chemical (Chart 28) with the storage and transportation infrastructure already in place. Ammonia is expected to be used extensively as an early-stage alternative to hydrogen, until the technology and infrastructure for the effective transportation of hydrogen matures.

Are investors fully pricing in climate change risks and opportunities?

While investors are increasingly aware of climate change, the evidence suggests the market is not yet capable of fully pricing in risks and opportunities resulting from climate change. According to estimates released by Japan's Government Pension Investment Fund (GPIF), under a scenario in which global warming is held at 1.5°C above pre-industrial levels, the CVaR (Climate Value-at-Risk, which measures the potential impact of climate change on corporate and security values) for Japanese equity is positive at 0.6%, compared to -11.4%

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Chart 29

Japanese companies dominating decarbonising technologies

Rank	Company	Key technologies
1	Toyota Motor (Japan)	Fuel cell EVs, hydrogen infrastructure, EVs
2	General Electric (US)	Geologic carbon sequestration, high efficiency thermal power generation
3	Mitsubishi Heavy Industries (Japan)	CO_2-absorbing materials, high efficiency thermal power generation
4	Siemens (Germany)	Hydrogen/ammonia power generation, wind power generation
5	Hyundai Motor (South Korea)	Fuel cell EVs, hydrogen infrastructure
6	Hitachi (Japan)	Industrial machinery electrification, power semiconductors
7	Toshiba (Japan)	CO_2-absorbing materials, hydro power generation
8	ExxonMobil (US)	CO_2-absorbing materials
9	Honda Motor (Japan)	Fuel cell EVs, hydrogen infrastructure, EVs
10	Honeywell International (US)	CFC (chlorofluorocarbon) reclamation

Source: Nikkei

for foreign equity. This predicted outcome is a result of patent competitiveness in the automobile, energy supply and chemicals sectors. It means that collectively, there may be more opportunities than risks for Japanese companies as the world moves towards net zero. Reaching the 1.5°C target is far from a forgone conclusion; the risk that we overshoot exists and makes the focus on cleaner sources of energy as important as ever.

In a separate study conducted by data analytics firm astamuse, Japanese companies dominate the rankings for key decarbonising technologies, including hydrogen, carbon capturing and electric vehicles (EV) (Chart 29). As countries across the world increase their efforts towards achieving net zero targets, it is likely that new markets will be created that leverage these advanced technologies, meaning investors will start pricing in these opportunities into stock prices. Therefore, skilled active investors will have opportunities to profit from the market inefficiency as additional climate related disclosure will not only shed light on the additional risks but also on opportunities that can contribute towards creating long-term value.

Summary

The growing importance of ESG and social responsibility is an opportunity to identify hidden value in firms that are willing to tackle and resolve social issues. Moreover, the shift toward a decarbonised, more sustainable society is creating growth opportunities for companies with environmentally friendly technologies, especially in clean energy solutions. However, while companies everywhere are keen to demonstrate their ESG credentials, very few companies are capable of making a meaningful difference to the future direction of the world.

While companies such as Kawasaki and Ajinomoto possess the technology, the know-how and the resolve to drive this change, the technologies themselves are either still intangible – and yet to be represented in data – or are still experimental and not recognised as these company's main source of profits. It is therefore understandable that global investors, even those with an ESG lens – are still overlooking such businesses. But these hidden value companies, driven by a combination of problem-solving innovative and deep-rooted sustainability principles, deserve a closer look.

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Key chapter points

- Japan has a long-standing circular economy heritage and ingrained culture of using limited resources effectively. This is evidenced in the way that traditional companies have pivoted from traditional practices to find innovative solutions to modern challenges.
- Companies like Kawasaki Heavy and Ajinomoto are at the forefront of the clean energy transition, by prioritising the secure production, storage and transfer of hydrogen and ammonia. While Snow Peak is continuing to affirm the principles introduced by Japan's Eco-era circular economy.
- While there's still room for improvement, active engagement is already helping some Japanese companies to better articulate their current ESG activities, while encouraging others to drive new initiatives forward, thereby unlocking further investment value.

Chapter 5 focuses on where Japan is headed over the next 5-10 years, its role in helping the world to reach net zero targets, and some of the key issues concerning Japanese equities that investors should consider.

Where is Japan headed?

Chapter 5

Shigeru Aoyagi
Team Leader and Portfolio Manager for the Japan Value Strategy at Nikko Asset Management

Where is Japan headed?

Following the bursting of Japan's 1980's equity bubble, I have personally witnessed the many changes and challenges faced by the Japanese economy.

Japan's economic downturn was so long that excessive pessimism prevailed, and its stock market has cheapened to levels rarely seen in other parts of the world. The share prices of many Japanese companies are at a discount although they possess attractive products, technological capabilities, and content.

Japan as a solutions provider

It has already been 30 years since Japan's growth peaked, with the economy shifting to its maturity phase. During this phase, many innovations – all of which are top notch globally – have been created to solve the social issues that have arisen. These innovations include: robot technology and environmental technology to supplement labour shortages; the world's leading hydrogen value chain; power devices that contribute to power saving and CO_2 reduction of components in the electrification era by freely controlling current, voltage and frequency; and media and entertainment content tremendously popular with global youth. We are confident that these innovations will be in demand amid the challenges that the world will face in the future and therefore will be monetised in many situations.

In the early 2000s, "Japanification" was a widely used expression, serving as a warning of what not to become. Time has passed and the global economy is losing momentum and gradually running out of new frontiers. Many countries and regions are facing some of the difficulties Japan experienced in the past as side effects of growth, including falling birth rates, declining working-age populations, harmful effects of urbanisation, and environmental threats. Having dealt with these issues earlier, Japan is positioned to provide clues to others who are now looking to solve these problems, and to also capture their demand. We are strongly convinced that due to the cash flow created by these drivers, the Japanese stock market will surpass the Nikkei's record high of 38,915 points set 30 years ago, in the near future.

Positioned for new geopolitical and economic realities

Recent developments such as the COVID-19 pandemic and the Russia-Ukraine conflict, have threatened to overturn existing global structures. The pandemic divided the world, challenging the concept of social convenience and efficiency based on borderless globalisation, and drastically changed the way we live. The Russia-Ukraine conflict also highlighted the existence of camps whose values differ from those of what can be considered the established structure. Some countries and regions that rely on natural resources for their national revenues and have no other industrial base, or who believe that top-down controls and regulations are needed to maintain their social systems, likely favour such values. The struggle between differing sets of values will be prolonged, in our view. Instead of a borderless and globalised economy, we may consider the possibility of a completely contrasting development. Security risks may promote armament and energy-related infrastructure investment at the national and regional levels. At the civilian level, these risks may create incentives to deliberately invest and build production activities and information infrastructure within a limited area; they may also promote research and development in clean energy, such as hydrogen, to replace fossil fuels.

Rising inflation can prompt companies to reduce intermediate costs such as those related to energy and distribution networks and relocate their production bases; it can also encourage consumers to move to areas where the cost of living is cheaper. Within such a shift to a "local production for local consumption" type economy and increasing global divisions, free trade and expansive economic partnerships that utilise regional alliances are expected to play an important role. We expect such developments to accelerate in the future.

A conduit to Asian growth

There are various intra-regional alliances in the world, including those currently under negotiation. The Pacific Rim, in particular, boasts a significant number of intra-regional alliances based on high levels of cultural standards and trust. The ASEAN encompasses a population of over 600 million and has abundant mineral resources and a sophisticated production infrastructure; the 12 countries that are expected to participate in the Trans-Pacific Partnership (TPP) make up 40% of the global economy; the Quadrilateral Security Dialogue, known as Quad, is a framework for security and economic cooperation between Japan, the US, Australia, and India – home to a huge population, wealth of natural resources, and extensive industrial power. Japan has the geographical advantage of being able to access, as well as serve as a hub, to any of these alliances.

In addition, China's economy has entered a more mature phase, with focus shifting to the services sector as the country faces the structural challenges of a rapidly ageing population. The Cross-Border Interbank Payment system (CIPS) for renminbi transactions has received attention, as China's goal is to make the currency settlement system the new de facto in the wake of the Russia-Ukraine conflict. But if CIPS it is to replace existing networks such as SWIFT, a certain amount of confidence in the renminbi will be required; as such, actions that favour the country's terms of trade will be subject to major restrictions. Going forward, the Chinese economy is expected to affect the world economy as an inflation factor rather than a deflationary one. This could be an important turning point for neighbouring Japan as its terms of trade – in addition to the relative competitiveness of its labour force and goods and services – will improve for the first time in a long time.

Many of the current events impacting society also represent business opportunities borne from the transformation of economic structures – and we believe Japan has a critical role to play. Japan's own growth potential is limited, and the country still faces challenges. However, after overcoming many difficulties, I believe Japan has finally reached the light at the end of the tunnel. As an asset manager, nothing would be more satisfying than to see investors view Japan as a valuable presence within their portfolios that enables them to greatly capture growth opportunities across the wider Asia Pacific region.

“As an asset manager, nothing would be more satisfying than to see investors view Japan as a valuable presence within their portfolios that enables them to greatly capture growth opportunities across the wider Asia Pacific region.”

Shigeru Aoyagi,
Team Leader and Portfolio Manager for the Japan Value Strategy at Nikko Asset Management

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Headquartered in Tokyo since 1959, Nikko Asset Management and its subsidiaries employ personnel representing 25 nationalities, including 205 investment professionals. The firm has a presence through subsidiaries or affiliates in a total of 11 countries and regions. More than 400 banks, brokers, financial advisors and life insurance companies around the world distribute the firm's products.

The investment teams benefit from a unique global perspective complemented by the firm's historic Asian DNA, striving to deliver consistent excellence in performance. The firm also prides itself on its progressive, solution-driven approach, which has led to many innovative funds launched for its clients.

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