

# JAPAN: FINALLY TURNING AROUND

*Promising signs from the Land of the Rising Sun.*



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The Japanese economy has taken a hard fall since 1989, when the Japanese market represented over 60% of the MSCI EAFE index. In our view, only recently has it begun to look attractive again; however, in order to uncover this attractiveness, one needs to look three to five years into the future and focus on some of the structural and secular changes taking place in the economy.

Despite some modest recovery since March of 2003, Japanese equities are still trading close to 20-year lows, and a look at some common valuation ratios—price-to-earnings (at 18 times) and price-to-book (at 1.6 times)—reveals both are trading at historical lows as well. In addition, compare the relative attractiveness of equities to bonds in the early 1980s, when 10-year government bonds yielded 7%, equities returned 4% profit, and dividends were 1%; today, equities yield over 5% and dividend yields are 1% compared to the bond yield of 1.4%. It seems quite compelling, then, that equity valuations today are far more attractive than at anytime in the past 20 years.

If you now broaden the comparison and look at Japanese valuations in a global context, the price-to-earnings and price-to-cash flow ratios are comparable with other major markets; however, price-to-book is low by global comparison. The low price-to-book in Japan can be explained by the lowest return on equity (ROE) of the major global markets. The key point here is that if the ROE has room to improve, the price-to-book valuations should be re-rated upwards—and this is already beginning to happen: most recently it surged to 8.8%, a level comparable to the “good times” in the late 1980s. This recent recovery is a direct result of record growth in profit margins as management has squeezed more incremental after-tax profit per unit of sales and more sales per unit of total assets, while reducing their dependence on debt.

## EQUITY EMERGING

In contrast to past years, Japanese corporations such as Toyota, DoCoMo, and Takeda Pharmaceutical are

paying more attention to their shareholders and have begun to increase dividend payout ratios in order to give some of this increased profitability back. Secondly, since share buybacks were deregulated in 2000, the total payout by companies has increased to record highs, reaching 30% to 50% of after-tax profits at some corporations.

An indication this trend will continue is based on the notion of the changing structure of share ownership within Japanese public companies. Traditionally, cross-holdings of major companies had long placed priority on growing business scale, so that the collateral business interests of the cross-shareowners could be maximized. However, the collapse of the bubble in the 1990s and the dissolution of cross-holdings increased the presence of a new class of shareholder: pension funds and foreign investors who are most interested in pure investment returns, and are consequently pressuring management to place more emphasis on governance, profits, returns, and increasing the shareholder payout ratio.

Despite the positive changes and developing trends, Japan still has a long way to go. According to the United Nations, foreign ownership as a percent of GDP has grown from 4.7% in 1989 to 22% in 2003, a move which still ranks Japan (the world's second-largest economy) 132nd on the list, sandwiched between Burkina Faso and Bangladesh! The recovery is also exposed to some cyclical risks, as Japanese companies are largely export-driven and dependent on the U.S. and China as trading partners. This means risk, but having the largest developed economy closest to the fastest-growing economy can also be a positive. Other cyclical factors to be wary of include consumer spending (which has been stalled by tax increases), and demographics (aging population). Nevertheless, the story of a turnaround in Japan is a story to watch: the country's corporations have improved profitability, and management is more aligned than ever with shareholders values, but there is still room to improve. ■