RBC BlueBay Asset Management

Asian takeaways

Okonomiyaki Observer

For Professional Investors Only | Marketing Communication

Maya Funaki
Portfolio Manager

Chris Lai
Portfolio Manager

Siguo Chen
Portfolio Manager

Published July 2024

Three months on from our last trip to Japan, which coincided with the excitement of the Nikkei 225 reaching all-time highs, our most recent research trip offered an opportunity to take stock and reflect on the substantial changes that we are seeing in both the Japanese economy and the market.

In April, we saw the Nikkei correct somewhat from its historic highs, although it has been steadily regaining strength since. Interestingly, whilst the mood on the ground during our March visit was somewhat muted in spite of the stellar market performance, the feeling this time around was considerably more buoyant. In Tokyo, there was a general sense of optimism; in March, the country saw the largest wage hike in 33 years at the spring wage negotiations, and this should start to translate into real wage growth over the coming months, with the nation beginning to incorporate price hike culture[1].

We're already seeing this feed through in consumption trends, particularly amongst the younger generations and employees of large corporates who are early beneficiaries of the wage hikes. As examined in our previous Japan trip note, luxury spending has been robust, with high-end department stores such as Isetan Mitsukoshi reporting strong sales and seeing its share price rally by close to 60% since the end of February[2].

Interestingly, broader consumer concerns surrounding a weaker yen appear to be dissipating (despite the currency's recent direction of travel) as Japanese residents accept this "new normal" price hike environment, and whilst the correlation between the equity market and the yen seems to be diminishing, a weak yen brings with it underlying benefits such as rising corporate earnings, inbound tourism and increased foreign direct investment.

[1] Reuters, Japan union group announces biggest wage hike in 33 years, presaging shift at central bank. 15.03.2024.
[2] Bloomberg, as at 11.06.2024.

Despite the region's traditional values, Kansai businesses are moving with the times.

On the corporate side, our general takeaways were also broadly positive. March end interim results were encouraging, although initial guidance and mid-term plans were broadly regarded as overly conservative by excitable overseas investors, contributing to the short-term drag on market performance. There is room for upwards revisions on both the earnings and the currency side, with many companies using FX assumptions in the range of 140 yen to the dollar. Governance reform also continues to be a central focus for Japanese corporates with management mindsets refocusing on value creation, something that we expect to drive further profitability over the long-term.

Go west

To put this to the test, we visited the western region of Kansai, home to cities such as Kyoto, Osaka and Kobe, and also a well-established hub for businesses. Kansai, and Osaka in particular, have long been associated with merchant culture, and local businesses in the area continue to promote traditional values from this background. However, even in this area of deep-rooted values, we are seeing companies looking to adapt to Japan's new corporate landscape, leveraging three embedded philosophies (*shimatsu* 始末 – maximising on resources, *saikaku* 才覚 – creating new ideas, and *sanyo* 算用 – focusing on profitability) to help them do so.

Companies such as Nintendo are one example of this, seeking to improve ROI and leverage intellectual property (IP) through innovation. The company recently completed its seventh year of selling Nintendo Switch consoles, with units sold in FY24 totaling around 15.7 million making it the highest selling console globally[3]. However, the company is not resting on its laurels, with the highly anticipated Switch successor expected to be announced this year, and much speculation surrounding new features and product innovation.

Nintendo World in Japan's Universal Studios reflected the brand's, and its IP's, overall popularity, bustling with visitors (not deterred by the inflated entry prices and ride pass costs). Plans are already well underway to expand the attraction, opening Donkey Kong Country later this year.

Nintendo stores in both Shibuya and Kyoto are similarly drawing in tourists, offering official merchandise that is harder to access abroad. The company is working hard to create *Seikaikan*, the global recognition of its characters, which should in turn lead to top line growth in merchandise, as well as helping to expand the life cycle of first-party software sell-through for titles such as Zelda, Mario and Pikmin.

Asics, a sportswear company best known for its running shoes, is another interesting Kansai case study, originating in Kobe. Until recently, the business' central focus was on the development of strong products, limiting its marketing efforts under the assumption that high quality products would sell themselves – a mindset that was shared by numerous Japanese companies, and a weakness when it came to competing on a global scale.

"Governance reform also continues to be a central focus for Japanese corporates with management mindsets refocusing on value creation."

Businesses are adapting product offerings to appeal to an evolving consumer base.

[3] Nintendo Co., Ltd., Financial Results Explanatory Material, Fiscal Year ended March 2024, 07.05.2024.

More recently, the company has been looking for ways to boost marketing ROI and push up average selling price (ASP). Asics has been overhauling its brand perception, rethinking its product offering and establishing influential partnerships, helping to solidify its place in the fashion mainstream on the back of the 'Dad Shoes' trend[4]. Company management have shown their adaptability as they move from a company focused on product quality targeting a narrower consumer base, to one focused on product appeal to a much broader audience.

We're seeing this mindset change across the market more broadly with the introduction of digitalisation. The use of apps, for example, is facilitating the collection of more personalised and targeted data, allowing for systemised analysis, through which Japanese corporates are able to better leverage their strengths and use marketing costs more efficiently.

The times they are a-changin'

As we saw with Japan's Universal Studios, tourist areas and attractions are witnessing high visitor numbers, and inbound travel has seen a strong recovery since the country's reopening on the back of yen weakness (Figure 1).

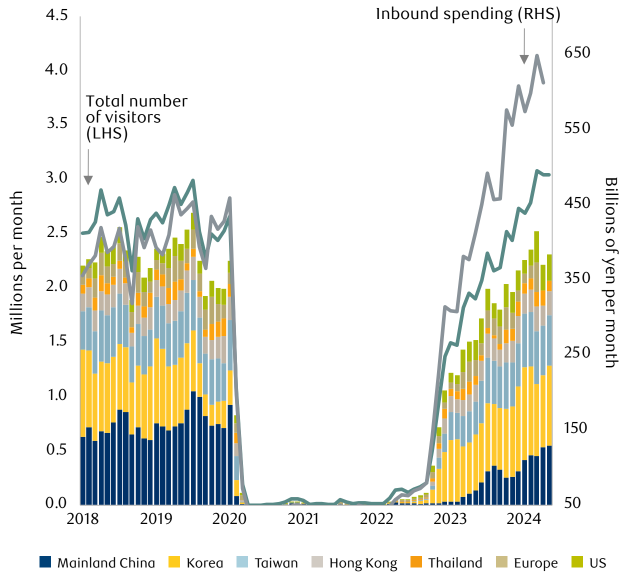
Whilst increased foreign tourist numbers are not welcomed by everyone – with some residents noticing overcrowding, heightened congestion, and bottlenecks in taxi services – we're seeing an interesting opportunity for Japan's service industry as inefficiencies become more apparent[5]. The country has a strong reputation for its *Omotenashi* (high quality customer service), but foreign tourists, and business travelers in particular, often do not require over-politeness, which can add an additional burden to the service sector's labour shortage and lead to delays at restaurants, hotels and beyond.

"Most importantly, we're witnessing a significant shift in management KPIs, refocusing attentions from sales and margins, to ROE and ROIC."

Travelling back from Kansai to Tokyo on the Shinkansen (Japan's high-speed rail network) we discovered that, despite purchasing our tickets online and being issued with a QR code, we still needed to queue to receive a paper ticket. Even well-reputed services such as this could benefit from streamlining, with digitalisation having an important role to play here.

On the equity market side, a new term – "tourist investor" – has been coined to describe foreign investors who are just starting to take interest in the Japanese market, likely exacerbated by the uncertain outlook for the Chinese economy.

Figure 1: Inbound tourist arrivals have returned to pre-pandemic levels



Source: Japan National Tourism Organisation,Goldman Sachs. Data as at May 2024.
Note: Europe visitor numbers as at March 2024.

Corporates seem to be responding appropriately, and whilst we had already seen some enhancement in Japan Inc's attitude towards overseas investors with market-wide corporate governance reform efforts, this is being even more finely tuned. Companies are making efforts to improve communications with foreign investors, and we saw evidence of this at the conference, with some presentations and group discussions taking place in English without the need for translators.

Most importantly, we're witnessing a significant shift in management KPIs, refocusing attentions from sales and margins, to ROE and ROIC. Things are changing at the balance sheet level, and companies are moving away from cash-heavy models, increasing CapEx to target improvements in areas such as production efficiency – particularly key given the country's labour shortage – and Research & Development.

Visiting tech companies and gauging plans for process improvements.

[4] Forbes, Comfort-first footwear market surges: how ugly shoes became a fashion statement, 06.04.2024.
[5] The Japan Times, Japan likes tourists, just not this many, 08.06.2024.

Meeting with tech companies during our trip, we noted that businesses are looking to increase automation with the aim of boosting productivity. One company, for example, outlined plans for the use of robots in the production line, considering using such automated processes at night as a bolster for more manual labour during the day.

We were similarly encouraged by conversations with health care companies, looking to prioritise R&D efforts. Well-established industry players such as Daiichi Sankyo and Peptidream are making exciting progress in this area with strong pipelines announced, and when compared to other biotech companies that we closely monitor in the APAC region, it's clear to see that Japanese players such as these have an edge when it comes to innovation and IP ownership.

It is similarly encouraging to note the changes that these firms are making when it comes to prioritising shareholders, both in terms of disclosure and investor access. It certainly seems that the Tokyo Stock Exchange's reform efforts are reaching all areas of the market and driving positive change for the investment community.

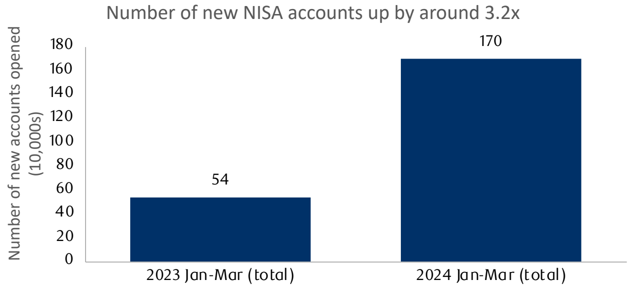
Wouldn't it be NISA

Along with a changing corporate mindset, we're also seeing developments amongst Japanese retail investors who are steadily adopting Japan's NISA (tax-free savings) scheme (Figure 2). Households in Japan have historically held savings in cash, whilst the new scheme offers strong incentives to redeploy capital into equity investments.

Risk appetites appear to be changing as retail investors, who previously considered equity investment akin to gambling, are reframing their views. The government are helping to drive change here, positioning Japan as an asset/wealth management-friendly country, with Kishida, Japan's Prime Minister, demonstrating this move by making a public appearance at the conference we attended.

Familiar faces – Kishida (left) and Honda (right) are helping to bring equity investment to the mainstream.

Figure 2: NISA account openings were up by over 3x year-over-year in Q1 2024



Source: Japan Securities Dealers Association, Morgan Stanley Research.

Other familiar faces are also getting involved. A former-star-football-player-turned-angel-investor, Keisuke Honda, whom we also met at a conference in Singapore, made an appearance as well. His goal is to educate younger generations in Japan on the concept of taking risk in order to achieve growth, as well as seeking to promote global innovation from Japan via his new fund, which will invest in domestic startups. Discussing his vision with us he stated "we have Toyota and Sony, but we lack FANG. We need to invest in new technologies".

As the NISA scheme continues to gain traction, there is strong inflow potential for Japan's equity market. At present, around 50% of total purchasing volume is in domestic stocks, an impact that should mimic the Bank of Japan's ETF purchases to the tune of 7-8 trillion yen per year[6].

Movin' on up

The Bank of Japan's termination of its negative interest rate policy (NIRP) is paving the way for dollar-based investors to start buying Japanese equities without the concerns surrounding depreciating returns on a dollar base. Whilst a rate hike is expected in July, the yen recently reached a 38-year low at close to 162 yen to the dollar, and whilst it may see some strengthening moving forwards, we think it's unlikely to go back to below 120 in the near term[7]. As well as providing a conducive environment for investors, this backdrop will help to strengthen Japan's reputation amongst tourists as offering high quality at low prices.

We're seeing positive change as the definition of "high quality" in areas such as customer service adjusts to global standards, leading to increased efficiencies, and as corporates continue to emphasise governance reform, measuring their performance against an evolving set of KPIs.

On the market side, the environment for active investors such as ourselves should become more interesting as it evolves from one driven by passive money and "tourist investors", into one driven by stock picking as more investors wake up to Japan's enormous potential.

6 Morgan Stanley Research, BOJ, JSDA. Purchase amount of domestic stocks through NISA (annualised based on the cumulative purchase from Jan-April 2024).
7 Bloomberg, as at 4 July 2024.

Authors

Maya Funaki

Portfolio Manager

Maya is a portfolio manager on the Asian Equity team at RBC GAM. She is the lead manager for the team's Japan strategy and is also the team's industrials specialist. Prior to joining the organization in 2015, Maya had worked as an analyst at a multinational investment bank in the investment banking division. She started her career in the investment industry in 2011.

Chris Lai

Portfolio Manager

Chris is a portfolio manager on the Asian Equity team at RBC GAM. He is the team's financials and real estate specialist. Prior to joining the organization in 2015, Chris was a sell-side equity analyst at a multinational investment bank where he specialized in the financials sector across Asia. He had earlier worked at a major financial services holding company in a number of sales and risk management roles in different parts of the world. Chris started his career in the investment industry in 2012.

Siguo Chen

Portfolio Manager

Siguo is a portfolio manager on the Asian Equity team at RBC GAM. She is the lead manager for the team's China strategy and is also the team's healthcare specialist. Prior to joining RBC GAM in 2017, Siguo was a sell-side equity analyst with a multinational investment bank where she specialized in China and Hong Kong consumer sectors and Hong Kong Equity strategy. She started her career in the investment industry in 2012.

Published July 2024

RE/0116/07/24

RBC BlueBay
Asset Management