Japan Macro and Investment Perspectives from our Trip with Asia Alternatives

We just returned from an outstanding trip to Hong Kong and Japan, organized by our colleagues at Asia Alternatives, one of the first Asia-dedicated fund-of-funds with $15.5 billion in AUM. During the trip, we discussed and spoke to a wide array of investment managers representing different strategies and geographies in Asia. In this note, we will focus on Japan, as it is our opinion that the country is in a transformational phase, and presents a very interesting long-term investing opportunity.

From a macro stand-point, Japan's GDP is on the path to recover from above pre-Covid levels. The expectation is 2.2% and 1.1% GDP growth for 2023 and 2024, respectively. Though this might not seem like much, it is important to remember that the Japanese economy has essentially moved sideways for the better part of three decades. This reacceleration in growth, however modest, represents an important new phase in the Japanese economy. Importantly, the main underpinning of Japan's growth is expected to be domestic economic activity. The three main economic drivers supporting this growth are: corporate investment, private consumption, and trade.

On the political front, Japan continues to be a very stable country with strong institutions, rule of law, and technocratic decision-making. Two years after officially becoming Japan's 64th prime minister (PM), Fumio Kishida can look to the future with cautious optimism, as he is expected to become one of the longest-serving prime ministers in recent history. In the last 25 years, only two PMs have remained in power longer than him: Junichiro Koizumi and Shinzo Abe (Koizumi's heir apparent, who went on to become the country's longest-serving leader). Kishida is the protégé of Abe and the leader of the Liberal Democratic Party, who has ruled Japan for 64 of its 68-year history. Prime Minister Kishida has continued Shinzo Abe's legacy of structural reforms, namely: labor market reform, corporate governance reform, and digitalization innovation reforms that should serve to boost productivity.

During the administration of the late Prime Minister Shinzo Abe, who was assassinated on July 8, 2022, Japanese women entered the labor market as never before. This has had an enormous impact, to the point that today a larger percentage of Japanese women are in paid employment than in the United States - a remarkable turnaround from historical precedence. Much of the inspiration for "Abenomics" came from Kathy Matsui, now a founding general partner of Tokyo-based MPower Partners, whom we met in person on our trip. Mrs. Mitsui was the sole woman among hundreds of Japanese investment

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- Japan is in a transformational phase, and presents a very interesting long-term investing opportunity.
- The main underpinning of Japan's growth is expected to be domestic economic activity, driven by corporate investment, private consumption, and trade.
- PM Kishida has continued Shinzo Abe's legacy of structural reforms, namely: labor market reform, corporate governance reform, and digitalization innovation reforms that should serve to boost productivity.
- Japanese public equities are much cheaper than US stocks; and even though we are near a 33-year high, we are trading at a level in the Nikkei 225 similar to that of 1990.
- We also have strong conviction that returns in the Private Equity space in Japan will be strong over the next decade.

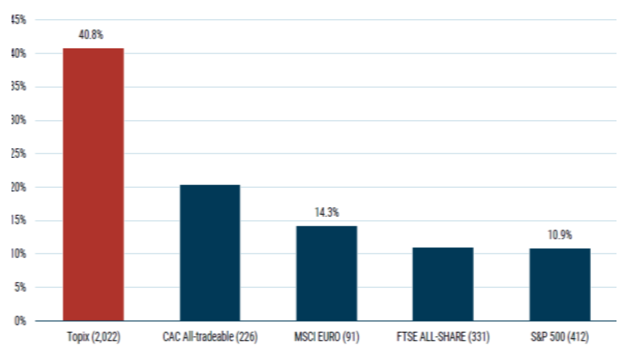
For more on how we are positioning our portfolios, please contact your investment advisor or ideas@bigsurpartners.com strategists during the 1990s. Matsui became the first female partner at Goldman Sachs Japan and argued in her 1999 thesis "Womenomics" that increasing female participation in the workforce would substantially boost Japan's gross domestic product. This is a very positive trend occurring today as Japan entrepreneurial and cultural frameworks transform.[1]

From a geopolitical standpoint, the U.S. and Europe are anxiously looking to decrease dependence on China, making Japan's manufacturing capabilities, location, and labor pool highly attractive. Japan is forming stronger ties with the US and Europe, as it aligns itself on both economic and national security priorities. Additionally, Japan enjoys incipient inflation supported by interest rates that are much lower than most of the developed economies in the world. After battling deflation for three decades, inflation is being widely welcomed in Japan, since deflation in general only serves to discourage spending and investment. Inflation is a welcomed change for companies that have struggled to increase prices and profitability for decades. In the FX market, the Japanese Yen (JPY) has been very weak and almost touched 150 from 130 to the US dollar at the beginning of 2023. What has caused the JPY to weaken is the divergent monetary policies between Japan and the USA. While the Fed has been tightening monetary policy via an aggressive cycle of interest rates hikes, the Bank of Japan (BOJ) continues its massive monetary easing policy, with BOJ Governor Kazuo Ueda stating at a press conference in September, "We are not at a stage where we can make concrete plans" on the timing of ending the yield curve control.[2]

In addition to the restaurant industry, tourism and construction are suffering labor shortages. Many industries rely on foreign workers, but the weak yen reduces the amount of wages after conversion into the home countries' currency. Some say the appeal of working in Japan has diminished, making it more difficult to lure foreign workers to Japan. The yen's depreciation may accelerate the labor shortage, and this in turn may impact inflation through higher wage pressures.

A weak JPY increases the profits of exporting companies and of multinational corporations (MNCs), both in JPY terms while also improving their business performance. On the other hand, it pushes up import prices. Japan relies on imports for much of its fuel and food, and a weaker JPY is a major contributor to higher prices. Gasoline prices have been held down by government subsidies, but temporarily hit an all-time high in September. Food prices are also rising sharply due to the higher distribution costs and increased prices of packaging materials. With the public becoming increasingly concerned about high prices, a continued weak JPY is not desirable. Finance Minister Shunichi Suzuki has applied the brakes to the current JPY depreciation, by indicating that he does not rule out any measures to respond appropriately to the

Percent of non-financials with net



Source: CLSA, BLoomberg

[1] Abenomics refers to the economic policies implemented by the Government of Japan led by the Liberal Democratic Party since the December 2012 general election. They are named after Shinzō Abe, who served a second stint as Prime Minister of Japan from 2012 to 2020.

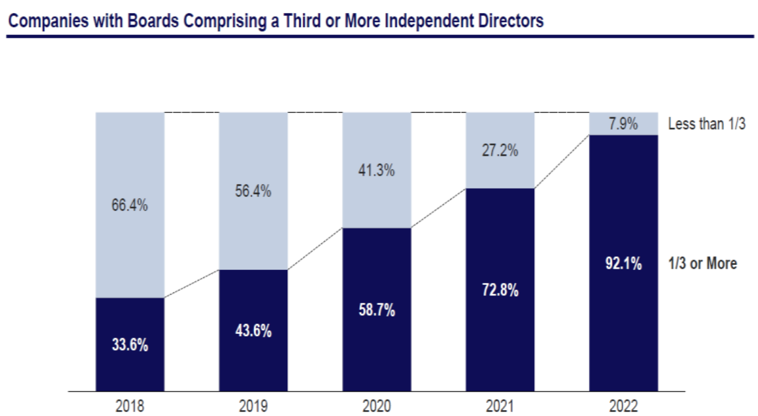
[2] Yield curve control is a monetary policy action whereby a central bank purchases variable amounts of government bonds or other financial assets in order to target interest rates at a certain level. It generally means buying bonds at a slower rate than would occur under a Quantitative Easing policy.

sharp fluctuations, including currency intervention.

Japan is extraordinarily overcapitalized. More than 40% of the non-financial corporations in Japan have net cash as a percent of total equity that is greater than 20%. This excess cash represents "no-brainers" for companies to improve asset efficiency bolstering Return on Equity (ROE) and profits. In addition, the huge cash positions free corporations from the obligations to banks (that made them focus on their lenders rather than their shareholders), and instead use those cash piles to simplify corporate structures. This also explains the huge pick-up in Mergers & Acquisitions (M&A) activity via buybacks, corporate activism and even hostile takeovers. The number of listed companies with a parent owning a control stake has dropped sharply, thus improving corporate valuations.

Japanese public equities are much cheaper than US stocks; and even though we are near a 33-year high in the Japanese stock market, we are trading at a level in the Nikkei 225 similar to that of 1990. Almost half the benchmark Topix index trades at less than book value, while the index has a forward price/earnings ratio of 14 times, versus 18 for the S&P 500.

On the corporate side, Japan is finally dealing with the issues in corporate governance, moving to an investor centric model, with business reforms bolstering companies' profits, focusing on shareholder value and increasing ROE by rationalizing business portfolios and enhancing independence in advisory boards. As a result, companies with boards comprising a third or more independent directors jumped from 34% in 2018 to 92% in 2022 (see graph).



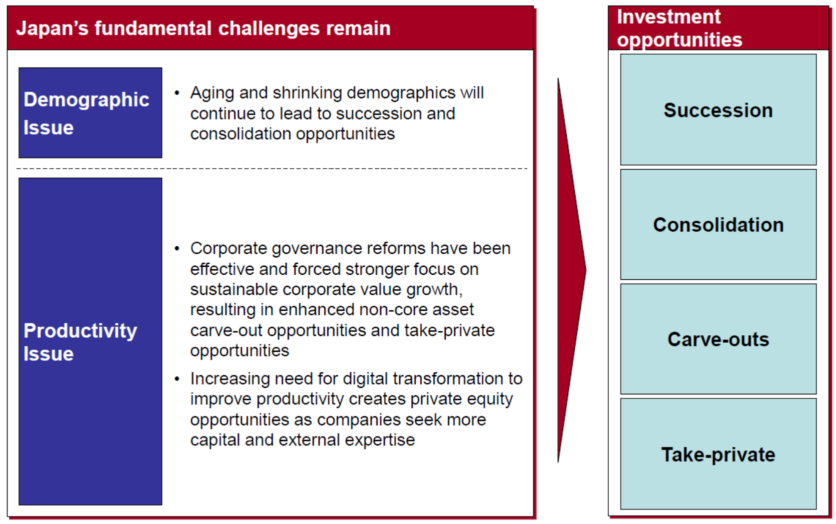
Source: Tokyo Stock Exchange.

The Tokyo Stock Exchange (TSE) has pressed companies to present plans to improve capital returns if their stock trades below book value. Listed companies are now required to have at least 35% of their total shares issued owned by public shareholders, which has also boosted shareholder activism leading to increased investment activities such as spinning off some non-core assets entirely and, for assets that they do want to keep, increasingly taking them private. These measures should all be highly value accretive.

Even though the narrative in the western media and investors is that Japan is a hot market, given the weakness of the JPY, both markets have had almost identical performance measured in USD. This tight correlation seems awkward given the broadly diversified Japanese market versus the tech-dominated S&P500. Multinational Corporations (MNCs) will likely continue to outperform, since large cap companies like Sony, Toyota or Mitsubishi earn a large percentage of their revenues overseas.

We also have strong conviction that returns in the Private Equity space in Japan will be strong over the next decade. Japan's private equity market has been growing in terms of both number of deals and deal size: the number of private equity investments tripled over the past 10 years and although the macro-economic prospects going forward may be low, there are ~57% of Small and Medium Enterprises (SMEs), (which represent more than 99% of the companies in the country) facing generation succession issues which creates opportunities to lead ownership transitions, where Private Equity penetration remains low at 0.4% of GDP (vs. 2.6% in the U.S.).

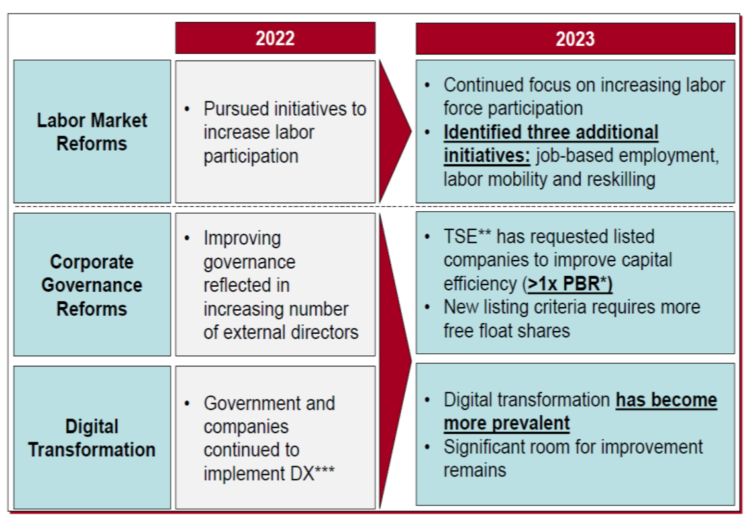
Japan's fundamental domestic challenges and sustained structural reforms will continue to create attractive opportunities and deal flow, given two structural mega-trends. One is related to corporate governance reforms, where large conglomerates ("keiretsu") are "carving-out" and spinning-off non-core businesses. The second is related to the aging and shrinking population, that is bringing a flurry of family succession and consolidation opportunities for PE managers. Managers with strong relationships with conglomerates and ultra-high net worth family owners are key (especially in a closed-knit Japanese society). This does not mean that all private investment will yield high risk adjusted returns. Mid-large buyouts represent the biggest opportunity and low-hanging fruit for private equity, whereas late-stage and Venture Capital (VC)growth in the country is still premature with limited players and scarce capital. Our colleagues from Asia Alternatives supported the main Private Investment opportunities in Japan as depicted by the chart above.



Source: Asia Alternatives

Conclusion

While external factors are positively aligned for Japan (mainly imported inflation and the geo-political environment with the US-China de-coupling) and internal structural reforms are for real (to tackle both the demographic as well as the productivity challenges), we believe that change will be gradual. As such, we believe investors should be overweighting Japan risk assets (public and private), even though the short-term remains highly uncertain. For the medium term to long run, the shift toward market capitalism ought to lead to better-run companies that are worth more. Many institutional global investors are still under-weighted Japan and there's no doubt a long-lasting change is underway, which should attract more



Source: Asia Alternatives

buyers to join in. We strongly believe Japan will out-perform in the next 5-10 years and eventually catch-up or close the under-performance it had with the US markets since the deflationary spiral of the 1980s. In addition, Japanese companies have a new strong focus on dividends and buy-backs, following a more US style approach to capital allocation.

However, addressing demographic and productivity challenges is key to Japan's sustainable economic growth. The main demographic issue is population aging and shrinkage (population is expected to decline by -0.6% CAGR in the next 30 years) and a declining labor force. While the government is trying to attract immigration, the difficulty of the Japanese language as well as a weak JPY present challenges. These issues will continue to remain a challenge for Japan for years to come. Nevertheless, we believe an investment in Japan is a risk worth taking, as we are seeing consistency through the Abenomics legacy manifested in multiple reforms and transformative efforts which will translate into continued progress.

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