



Japanese equities

+7,5%

Improvement in Japanese companies' returns (ROE) in the last two decades¹

42%

Enterprise valuation multiple (EV/EBITDA) at a 20-year low (down 42% in the period)²

30%

Depreciation of the Japanese yen since January 2022

¹ Source: Bloomberg as of 19/02/2024 (MSCI Japan index).

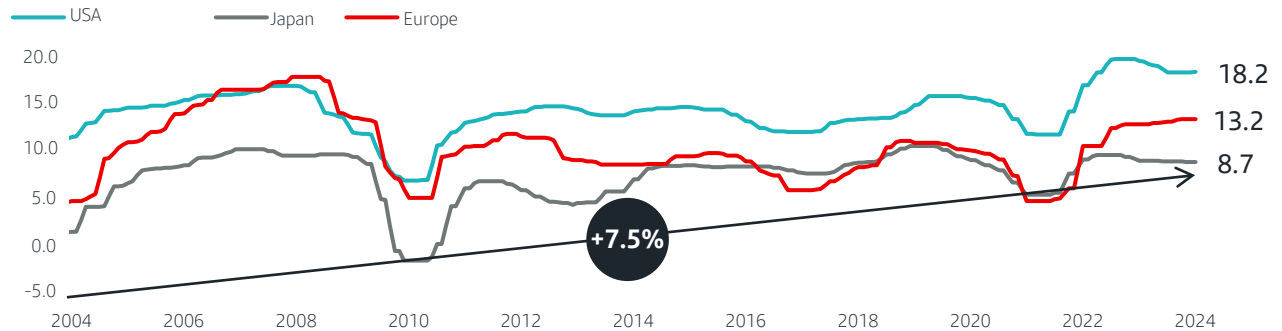
² Fuente: Bloomberg as of 19/02/2024 (MSCI Japan index).

³ Fuente: Bloomberg from 01/01/2022 to 19/02/2024.

Improved returns at Japanese companies

ROE: MSCI Japan vs MSCI USA and Europe

Source: Bloomberg. Data as of 19/02/2024



Japanese companies have improved how they manage funding over the last 20 years. The top chart shows that, in terms of ROE, Japanese companies have outstripped US and European companies in that period. This growth has been driven mainly by the modernisation of business management approaches in Japan.

One example of this modernisation of management is the greater efficiency in managing funding. Previously, Japanese companies tended to have almost no debt and considerable liquidity (sometimes more than 50% of the balance¹ sheet), which had a negative impact on ROE. However, their performance has been positive since 2003, with the return on equity (ROE) growing by 7.5%.

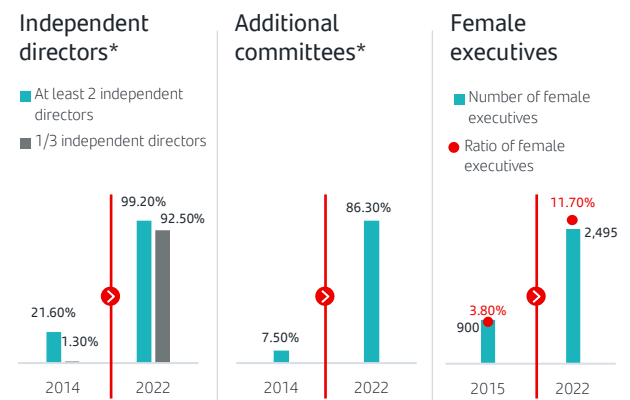
Japan's Corporate Governance Code was drafted by a committee of experts in August 2014 based on the G20/OECD Principles of Corporate Governance²; it is reviewed every three years. This code was introduced in order to enhance companies' transparency, efficiency and risk management.

The main goals of the code are

- Generate growth at companies by fostering transparency.
- Support sustainable growth by companies.
- Modernise governance and the capabilities of management bodies.
- Promote investment by Japanese retail investors.

Examples of changes introduced by the Code

Source: Nomura



*Large cap companies on the Tokyo stock exchange (1st Section).

Another factor that might help boost the valuation of Japanese enterprises is the change in domestic demand for equities. Historically, Japanese retail investors had almost half of their wealth in cash or bank deposits. To reduce this gap, the government introduced tax exemptions as an incentive to purchase equities. In 2014, it introduced a 20% exemption in the tax on capital gains and dividends for investments of JPY 1.2mn per year for a maximum period of 5 years; however, from 2024 onwards this exemption will be doubled and apply indefinitely. This reduces the incentive to invest in overseas equities.

1. MFS Equity Investment Topics – Supplemental (31/12/2023).
 2. OECD: Organisation for Economic Cooperation and Development.

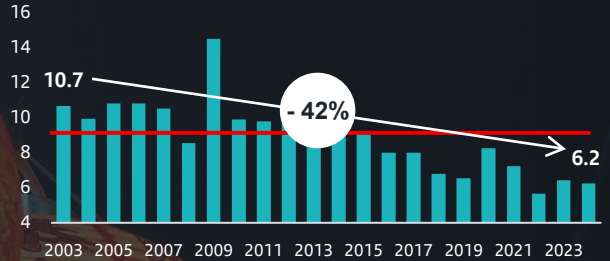
Entry level (valuation and exchange rates)

The Japanese equities market gained 28% in 2023, while the S&P 500 had appreciated by 24%. However, **the outlook remains positive. Japanese companies' multiples are at a 20-year low.**

In the graph on the right plots EV/EBITDA, which is a ratio of the company's valuation to its earnings before interest, taxes, depreciation and amortisation. Similar conclusions are obtained with other valuation metrics (for example, EV/revenue or EV/EBIT).

EV/EBITDA ratios

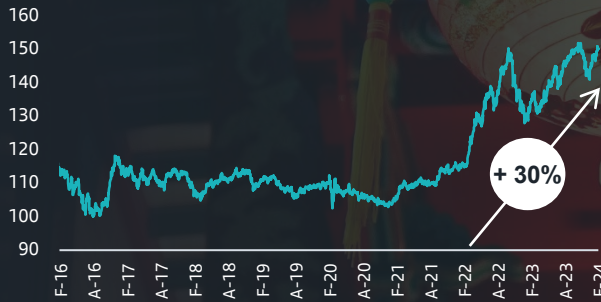
Source: Bloomberg. Data as of 19/02/2024



Depreciation of the yen might benefit investments in local currency

JPY/USD

Source: Bloomberg. Data as of 19/02/2024



If the BOJ eventually decides to raise rates, Japanese investors could repatriate some assets to Japan, which would cause the yen to appreciate. At present, the exchange rate is around JPY 150 to the USD¹ (-30% since the end of 2021). To put that into context, **it is a 30-year high.**

In October 2022, Japan's central bank intervened when the exchange rate reached 150 JPY/USD (which does not mean it will not be allowed to exceed 150 JPY/USD again), so investing in yen might benefit from the exchange rate, especially considering the BOJ's hawkish² stance.

Macro outlook: Moderate inflation

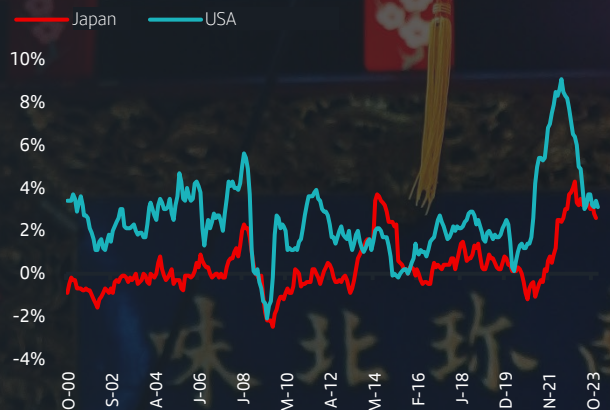
In the last few years, inflation in Japan has typically been **very low, and occasionally negative** (deflation). This contrasts with the 2% target adopted by most developed countries' central banks.

However, the **cultural shift** taking place at companies is also reflected in workers **demanding higher wages, which could push inflation higher.**

Companies that have pricing power should be able to maintain their margins. Consequently, net profits might increase in an inflationary environment.

Inflation

Source: Bloomberg. Data as of January 2024



1. Exchange rate as of 16/02/24.

2. Central banks are said to take a hawkish approach when they seek to shield the economy from excessive inflation. There are several measures available to them, but the most common and widely used is to adopt a restrictive monetary policy.

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