Japan's Value Mandate for Reform

Why catalyst investors can't find a catalytic converter for Japan's stock market reform

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We've written for years about the cheapness, in our opinion, of Japanese stocks. Today, the median stock on the Tokyo Stock Exchange trades at just over 1x price/book while the S&P 500 trades at 3.97x.

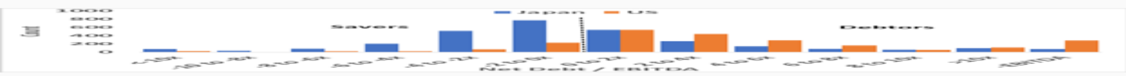
But now the top brass at the Tokyo Stock Exchange are mad as hell, and they're not going to take this anymore. The Tokyo Stock Exchange has formally "ordered" all listed companies trading at below book value to raise their price/book multiples above 1x, publish a plan to do so, or risk being delisted eventually.

Now, at first glance, the exchange ordering the 50% of Japanese companies that trade at below book value to increase their valuations seems about as effective as Persian king Xerxes ordering the sea to be whipped to prevent future storms from destroying his fleets. After all, markets set prices, and a Japanese company cannot directly control the numerator of that P/B ratio.

But upon further reflection, we realized the plan was so crazy it just might work. You see, companies do have some control over the denominator in the P/B ratio. Companies can choose to either retain surplus profits on their balance sheets, increasing book value, or pay out those profits through dividends or buyback, reducing book value. Despite becoming significantly more profitable since Abenomics, Japanese companies have historically been highly averse to high payout ratios and highly inclined to hoarding cash on the balance sheet. And how that book value (the net assets) of Japanese companies has been managed over the last few decades is perhaps one of the biggest reasons global investors have remained well underweight Japan.

We recently highlighted the long-term effect of this in the below chart showing the difference in cash hoarding and debt borrowing levels among all Japanese versus US companies. Japanese companies are very frugal by comparison.

Figure 1: Current Net Debt/EBITDA for US vs Japanese Public Companies



Source: Compustat. All listed stocks in each market >$25M in market cap. Excludes REITS *and Financials. Only shows companies with positive EBITDA (89% of Japanese stocks and 64% of US stocks) or negative EBITDA and net debt (far right bar).*

Japan's dividend payout ratios have slowly improved over the last decade to approach levels closer to the US in the historical data. However, the total payout ratio (including stock repurchases less stock issuances) has been about 4x higher in the US compared to Japan over the same period, according to the same source. This has been the case until recently and even more so, just recently.

And if the Tokyo Stock Exchange succeeds either by hook (further increased payout ratios) or by crook (improved investor sentiment) in driving up the valuations of the many Japanese stocks trading at below book value, we believe there could be significant profits in store for long-suffering Japan bulls.

We've given significant thought to just how to maximize returns in the event these reforms work out, and our friends at Man Group may be on to something when they write that "This Time is Different" for Japanese equities.

Of course, to maximize returns in Japan today, it would seem to make sense to buy a portfolio of different Japanese public companies that currently trade below book value, as those are the ones subject to the new reform pressure. And perhaps you'd want to buy Japanese public companies that are well below 1x price/book under the logic that a lot of reform is better than a little.

Practically, how would you do this? With over 3,000 stocks in Japan, half of which are below 1x P/B, it sounds quite easy. Buying a value portfolio might sound like a natural candidate, given they should definitionally capture stocks below 1x P/B. To execute this, any old Japan mutual fund or ETF with "value" in the name would seem like a good fit.

But are you buying what you think? To test this, we calculated the holdings of the academic value portfolios (small and large caps among almost all Japanese stocks) compared to our approximation of commercial index construction rules like those of the MSCI (small and large caps among Japanese stocks >$400M in market cap). We also compare to an investible retail product, the iShares Japan Value ETF (EWJV), whose smallest stock is at $3.7B. iShares doesn't offer a Japanese small value ETF.

Below are the % of stocks in each portfolio today that would meet the catalyst criterion of 1x price/book or below, and those that would handily meet it at 0.7x P/B or below.

Figure 2: Inclusion of Catalyst Stocks by Index Construction Rules

Source: Compustat. All listed stocks in each market >$25M in market cap. Excludes REITS and Financials. "Commercial Index" excludes all stocks below $400M in market cap. iShares MSCI Japan Value (EWJV) holdings from company website as of 5 June 2023. For each factor portfolio, breakpoints of market median for size and P/B used to split portfolios.

Of the different “value” portfolio construction variants, only the academic small value portfolio on the left had the majority (64.4%) of its stocks in companies under 0.7x price/book, which would (in theory) feel significant pressure under the new regulation to meaningfully reform their balance sheets. But even here, the other third of your exposure is in stocks that feel little or no regulatory pressure for reform. And that’s the best of the portfolio variants!

On the far right, the large-scale retail value ETF has most of its exposure in stocks where the regulation doesn’t even apply at all. And it’s even worse than shown above because most ETFs are capitalization weighted. In this case, half your money is weighted in the top 20 holdings, 75% of which are above 1x price/book. This is because larger stocks with more liquidity are systematically more expensive than smaller stocks.

So you would probably want to buy small value if you were hopeful about this catalyst. But the Japan market rally that began when news of the reform initiatives broke seems to have gone first to the more liquid stocks, which are easily accessible via retail products like ETFs. Year to date, the MSCI Japan Large Value Index is well ahead of the (publicly uninvestable) MSCI Japan Small Value Index.

And purchase prices have followed the initial fund flows. By our calculation, on the same indexes shown above, YTD multiples have expanded significantly more for the large liquid stock index variants compared to the smaller academic index variants, despite the smaller indexes having the same or better growth expectations, according to independent estimates.

Figure 3: YTD Multiple Expansion and Revenue Growth Estimates

Source: Compustat. 1-year forward revenue growth estimates are the median stock in each portfolio from Compustat’s estimates.

If the reform catalyst plays out, a rising tide may lift all boats, and one might do quite well investing in Japanese large value. But it is curious to us that the stocks you would expect to be most in demand based on the catalyst criterion (and fundamentals) have seen prices rise the least so far this year as investors got excited about Japan.

But perhaps funds just flow where they easily can at first. Japan is a 70% passive market, and Japanese academic small value is not easily investable by the public.