

As Japanese companies change, investment opportunities bloom

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We remain bullish about many of the corporate changes taking place in Japan. Toyota Group recently announced it was taking Toyota Industries private (its auto parts and forklift business) to simplify the group's structure. The news has only increased market speculation that more companies may follow suit. With firms buying back stock, unwinding cross-shareholdings and pursuing mergers, we have seen a real revolution in how Japanese companies are thinking about shareholder returns.

Coupled with increasing wages and rising prices, we expect investor interest in the Japanese equity markets to continue over the medium term, even after the recent bout of tariff-related volatility and rising bond yields. The ongoing improvement in corporate returns is also positive in our view, but there is still work to be done. Of the 4,028 active stocks on the Tokyo Stock Exchange at the end of March 2025, about 44% have price-to-book values below one, while 30% of companies have a return on equity of less than 5%, according to data from FactSet.

However, we think uneven progress and the uncertainties surrounding global trade and long-term interest rates, along with the corporate changes taking place, make individual stock selection even more important in unlocking value in Japanese stocks.

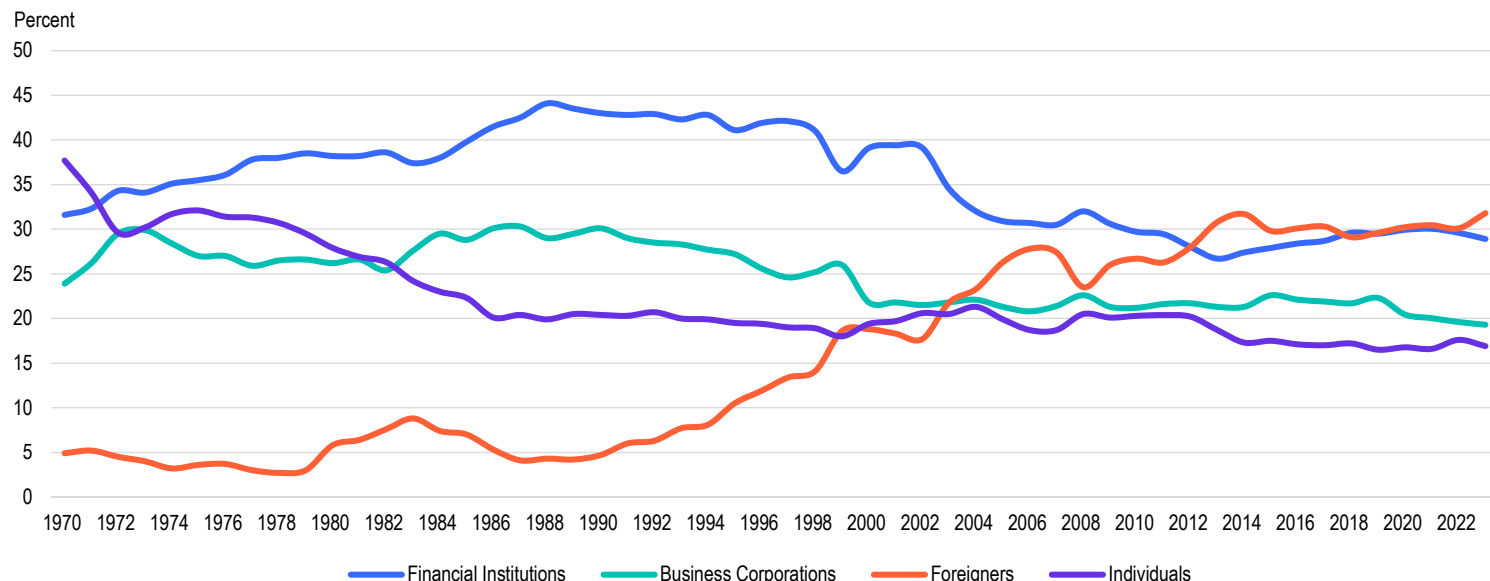
Good time for a change

The push to improve corporate governance has made Japan a more appealing equity market, in our view. The Tokyo Stock Exchange (TSE) is urging Japanese companies to shed years of complacency to improve returns, reduce their cost of capital and unload their cross-shareholdings. The latter, notably, is seen as a barrier to market efficiency and transparency and to mergers and acquisitions and can dilute shareholder rights.

With big companies like Toyota Motor finally starting to rationalize their ownership stakes in a range of companies, we are seeing more companies unwind cross-shareholdings and pursue mergers or sales of listed subsidiaries. According to data from the Japan Exchange Group, corporations have been steadily selling their holdings of Japanese stocks, with total ownership ticking down to 19.3% of the value of shares in 2023 from a high of 30.3% in 1987. Foreign ownership has increased. (See Exhibit 1 on the next page).

Exhibit 1: Japanese Corporations and Financials Trim Stockholdings

Percentage of Japanese Shares Held on a Market Value Basis

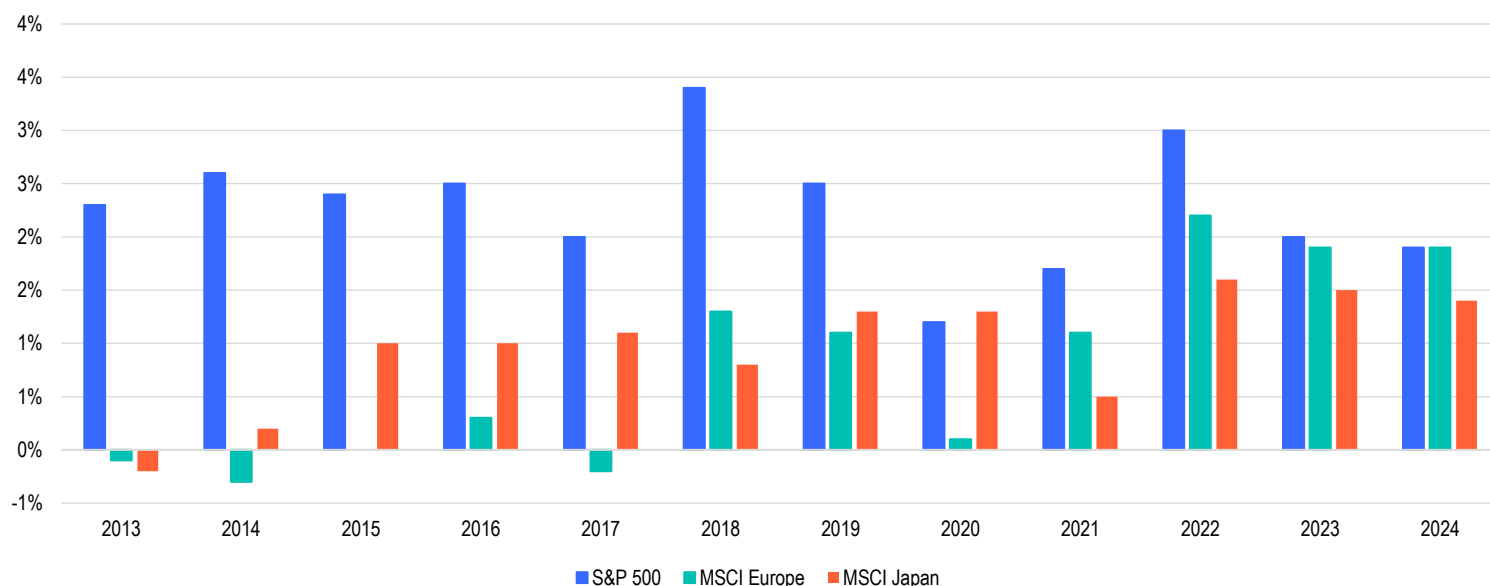


Source: Japan Exchange Group Shareownership survey, as of July 2024.

Those companies with clear plans to catalyze returns and reduce their cost of capital, and that are willing to buy back stock trading below intrinsic value after the unwinding of cross-shareholdings, are particularly appealing to us for greater analysis. We are already starting to see an increase in buybacks in Japan, which are nearing levels seen in Europe and the United States. (See Exhibit 2). Improving economic growth makes business investment more attractive, and companies have been boosting capital spending.

Exhibit 2: Net Buybacks as a Percentage of Market Capitalization in Japan are Rising

2013-2024



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Dealmaking on the rise

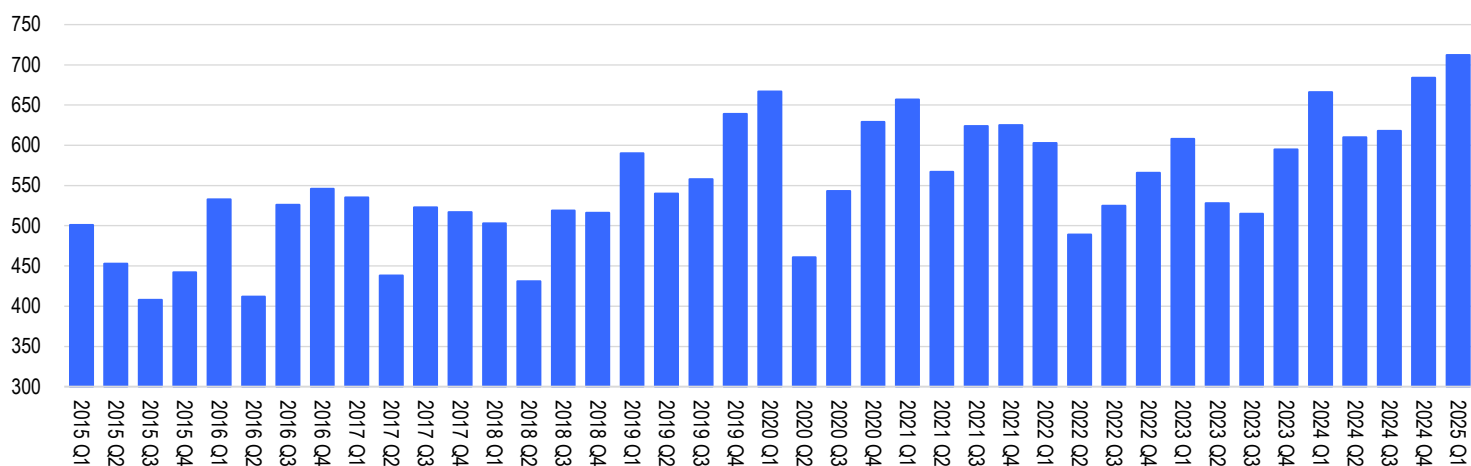
At the same time, with valuations low and major companies flush with cash, dealmaking in Japan is on the rise. As with the TSE's efforts to get companies to improve returns, the Ministry of Economy, Trade and Industry (METI) has issued guidelines to better ensure companies are transparent in merger dealings and has asked corporate boards to seriously consider takeover proposals to enhance both value and shareholders' interests.

As a result of these efforts, we have seen merger activity climb, as Japanese companies become keener to either unload assets or to snap up cheaply valued businesses to help them expand. Additionally, wage inflation is making it more difficult for sub-scale and low-return companies to absorb the higher costs, making mergers more appealing. Hostile takeovers from foreign firms are slowly gaining traction in the once resistant Japanese market. Activist investors, too, are more aggressively pushing through needed corporate changes, and companies are going private to better focus on retooling or improving their businesses.

In all, total merger activity in Japan reached US\$140 billion in 2024, according to Bloomberg data. While below the US\$155 billion in 2023, the number of deals is increasing, and we have seen much more deal activity in the first quarter of 2025 than first quarter of 2024 (See Exhibit 3).

Exhibit 3: Quarterly Number of Japan Mergers Rising

First Quarter 2015-First Quarter 2025



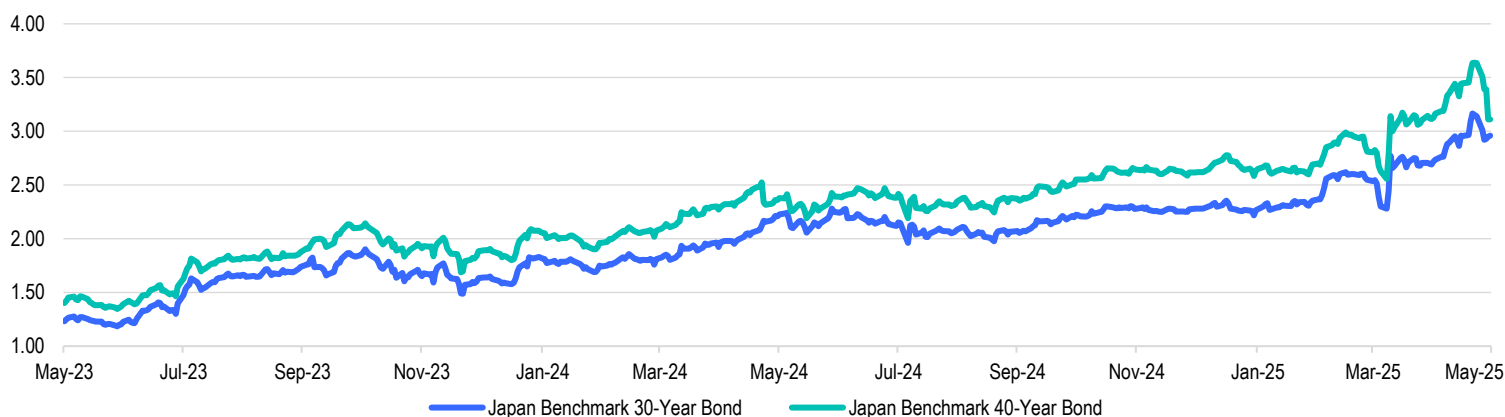
Source: Bloomberg.

Better economic times ahead?

While the structural factors in the Japanese market are positive in our view, the rebound in the domestic economy remains slow. And, a recent rise in long-term interest rates underscores concerns about rising domestic prices, renewed fiscal concerns and lackluster demand for new bonds from big financial firms. (See Exhibit 4) Nonetheless, as wage growth climbs, inflation returns and economic activity slowly increases, we expect to see more interest in Japanese stocks over time.

Exhibit 4: Japanese Bond Yields Rise on Fiscal Concerns

May 31, 2023–May 31, 2025



Source: FactSet.

The ongoing wage improvements should give consumers more spending power, which can eventually help Japan finally exit the decades of deflation, stagnant wages and anemic economic activity, in our view.

Overall, the pace of wage gains has been increasing, rising at a 2.8% year-on-year pace in 2024 after a 1.2% pace in 2023, according to the Japanese Ministry of Health, Labor and Welfare. Wage growth remained strong in early 2025. And with labor shortages, we expect some companies to consider further wage increases to attract more workers.

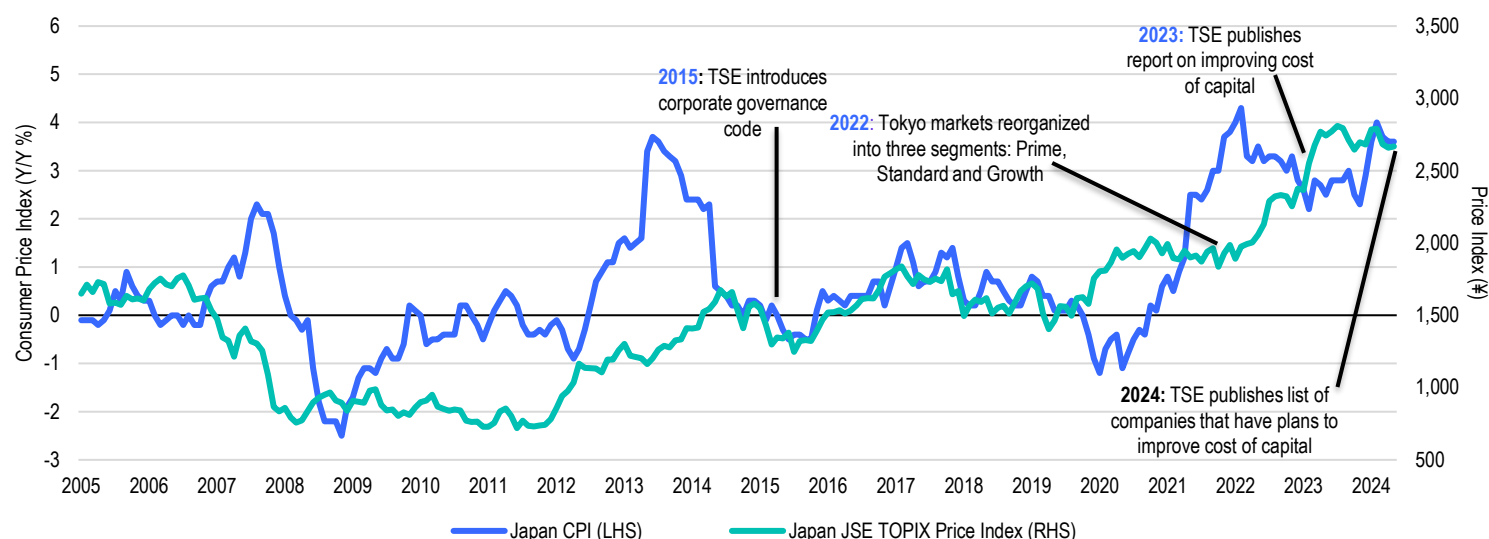
We also have begun to see signs that higher wages may be leading to more consumption, with our recent analyst trips finding packed malls and shopping centers. However, Japanese consumer spending has only recovered to levels seen nearly a decade earlier.

As rising wages help end falling prices and stagnant incomes and boost economic activity, we would expect the Bank of Japan (BoJ) to normalize monetary policy over the next few years. Altogether, we believe the TSE's efforts and inflation's return should support Japanese equity prices. (See Exhibit 5)

Exhibit 5: Inflation Has Increased Year-over-Year Alongside Stocks Recently

Consumer Price Index in Percent vs. Japan's TOPIX Index

December 31, 2005-March 31, 2025



Sources: FactSet. The TOPIX is a free-float adjusted, market capitalization-weighted index and is used as a benchmark for investment in Japanese stocks. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.**

Catalysts can unlock value over time

Sifting through the Japanese market, our research has uncovered stocks that are trading at attractive valuations and willing to embrace structural changes. We believe that an improving economy and good wage growth may create long-term value opportunities and that the Japanese market continues to have long-term appeal for stock picking. With uncertainties continuing in the United States, we believe it's a good time to focus more on finding value in Japan.

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