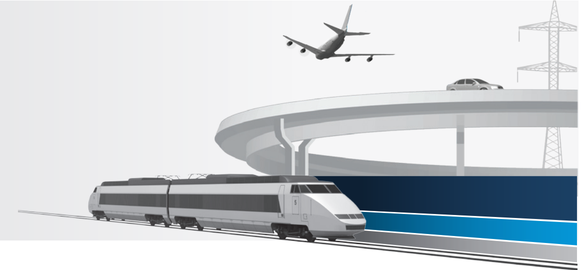
First State Investments

Made in Japan



Jessica Johnson, Analyst, Global Listed Infrastructure | March 2017

Japan is open to improving corporate governance. Since my last trip to Japan, there was noticeable change in engagement with investors, including discussions on diversity – particularly women in the boardroom – and incentives linked to financial performance.

Japan is starting to deliver some volume expansion. Port volumes turned positive for the first time in two years. Rail and airport volumes are robust and will receive a boost from the 2019 Rugby World Cup and 2020 Olympics. Sentiment is lifting and domestic companies are expanding their operations.

Identifying mispricing across the globe is one of the advantages of sector coverage within our team. Japanese gas utilities remain unloved with low expectations reflecting impending market de-regulation – risks are to the upside. In contrast, the Chinese gas utilities are still a consensus buy and the risk of regulatory intervention is being downplayed.

Key insights are explored below.

Alignment and diversity improving

In April 2013 I wrote a travel diary entitled "Japan: can user-friendly become shareholder-friendly?" Last week I got to revisit this idea and see what had changed.

Although the pace of improvement in governance for Japanese companies since 2013 has been slower than originally hoped, I came away from my discussions with company management in a positive frame of mind. We talked about the linkage of management incentives to financial performance, rather than just social and qualitative measures. There is still plenty of room to improve; I would like to see a greater focus on total shareholder return (TSR), and incentives linked to longer time periods. However it is encouraging that this is being discussed, and that we are starting to see changes to pay structures.

Japanese utility companies have a history of destroying shareholder value by making overseas acquisitions at high prices. I would prefer to see them increase their dividend payout ratios or buyback more stock. My conversations from this trip do not leave me hopeful that this will change anytime soon, but perhaps if management incentives are linked to TSR they will be more closely aligned with their shareholders and it will help the decision-making process in this area.

Also on the subject of governance, a desire to improve board diversification (starting with better representation for women) was discussed at three of my meetings with company management. Currently, only half of the Japanese companies we cover have any women serving on their boards, and of the companies that do, it's only one female in a boardroom of over 10 members. In addition, the majority of the board members tend to be officers of the company, who cannot be considered independent. It feels like the conversation is evolving and heading in the right direction.

Trent and Jessica at Kamigumi's headquarters in Kobe

Source: First State Investments

In 2013 Abe-san had just come into leadership and everyone was very optimistic and upbeat about the future. Fast forward four years and the optimism remains, although at a more subdued pitch. "Things are better than before Abenomics" although the hoped-for economic development has not yet followed. In the last couple of quarters, volume growth for port operator Kamigumi (owned by the Fund) has turned positive after over two years of negative volume growth. Rising auto exports have been a big contributor to this improvement.

Domestic companies are expanding their operations – for example moving to larger offices in new developments in Tokyo. This is being reflected in low vacancy rates and robust rental growth for Tokyo commercial property. This is positive for companies such as East Japan Railway and Tokyo Gas (both owned by the Fund) that have property development exposure. Rail volumes in Japan, especially for business travellers, have remained robust, further supporting the view that the domestic economy is improving. This is positive for domestic passenger rail operators such as East Japan Railway and Central Japan Railway.

And of course there is a buzz in the air in anticipation for the 2019 Rugby World Cup and 2020 Olympics. Japan Airport Terminal hopes to increase its international slots by 45% in preparation for the increase in tourism that these two events will bring.

Japanese gas utilities unloved

Japanese gas utilities such as Tokyo Gas have underperformed every Asia Pacific, UK and US utility company within our investment universe over the 12 months (to Feb 2017). In the lead-up to the planned de-regulation of Japan's residential gas retail market in April 2017, the market has taken a very bearish view of how company earnings may be affected. It is important to remember that residential volumes only make up 20% of Tokyo Gas's customers; over 50% are industrial customers. When Japan's industrial gas market was de-regulated in 2004, the effect on earnings was negligible.

In April 2016, over 750 companies applied to the Ministry of Economy, Trade and Industry (METI) for a licence to sell power after the electric retail market was de-regulated. In contrast, only five companies have so far applied for a license to operate in the gas retail market. The reason for this discrepancy is Japan's lack of centralised gas pipeline infrastructure. While the ability exists to buy electricity on the wholesale market and sell it on to retail customers, the gas market lacks the domestic gas hub that would be needed to do the same. Instead, long-term contracts for importing Liquefied Natural Gas (LNG) are needed. Once imported, there is no national pipeline network to transport the gas. Even if new entrants to the market did get the gas to Tokyo, they would still then have to pay to use Tokyo Gas's gas pipeline network; an earnings portion that brokers seem to be discounting. These reasons give me confidence that the recent underperformance is an over-reaction and that Tokyo Gas will re-rate once we see the limited effect that de-regulation has on its earnings.

Expectations high for China gas utilities

Chinese gas distribution companies currently boast some of the best Returns on Equity (ROEs) in our utility universe, at around 20%. The Chinese government's aggressive plans to reduce air pollution by encouraging people to use gas rather than alternative fuel types is driving this strong structural growth story. As the Chinese economy has slowed and the oil price has decreased we have seen industrial gas volumes come off from very high levels. However that means that instead of 20% volume growth pa, these companies now see volume growth rates of "only" 10% pa.

The story is solid – but I think 2017 could bring significant headwinds for this sector, potentially giving us an opportunity to buy. We have already seen regulators in some Chinese provinces cut allowed margins for their gas distributors. If this were to happen across the board, we could see 30% earnings downgrades across the sector. This is considered likely as over the last two years we have seen the government first target upstream (Exploration & Production) companies, followed by transmission companies. To date, distribution companies have been left relatively unscathed but could be the next domino to fall. Furthermore, as gas penetration rates rise, the risk increases that connection fee revenues may be cut. Gas distributor ENN Energy Holdings derives half its earnings from connection fee revenue. Its peer Beijing Enterprises gets none, as connection fees were reduced in Beijing once penetration rates exceeded 70%.

However even if the government does enforce margin cuts, these companies are still in a position to earn very healthy returns. ROEs just may be in the 12% to 15% range instead of the 20% that they have been used to. The market is still looking backwards at what these companies have done in the past. Until expectations are rebased, we will wait for our opportunity.

Can't ignore the geopolitics

In the five years that I've been with the team, I have never been on a trip where geopolitics has been such a dominant discussion point. The aftermath of Brexit, the US election and recent events in Asia Pacific were all front of mind. Although we are bottom-up stock pickers, we can't ignore how politics effect the companies and sectors we invest in. Every company I met with was concerned about geopolitics, particularly between Korea/China/USA and my observation is that this concern has been exacerbated by events in recent months.

The sector that has been most negatively affected by uncertainty in the region is the port sector. Yantian International Container Terminal (owned by Hutchison Port Holdings Trust) in East Shenzhen has over 40% of direct volume exposure to the US and would be the most negatively affected if tariffs were imposed on Chinese exports. Hutchison Ports (not held by the Fund) also faces the added headwind of high borrowing levels and floating rate debt. As a result, any change to US interest rates will have a direct impact on their interest costs.

China Merchants Ports and COSCO Shipping Ports (both held by the Fund) have also been held back by concerns on possible trade tariffs. Both companies however offer some diversification with significant international port operations in Europe, South Asia and Africa making up between 15-30% of their earnings. They continue to trade at undemanding valuations and significant discounts to book value.

Conclusion

Japan remains one my favourite places in the world to visit. I hope that the pace of progress in governance and increased shareholder focus improves before my next trip. I left feeling confident on our positions in the gas and rail companies, but cautious (and frustrated) on the way these very cash-positive companies can overspend on overseas investments.

In Hong Kong, our holdings in the port companies offer deep value, with depressed valuation multiples and low market expectations for volumes and earnings. For now I believe the Chinese gas companies have more downside risks to play out. And I would love to see more companies pay out cash, as Power Assets Holdings (held by the Fund) did while I was away – returning capital to shareholders in the form of special dividends. Share buybacks, which Japanese corporates prefer, would also be warmly welcomed.

Lastly, as we see on news outlets around the world (and in the Twittersphere), geopolitics remains at the forefront of everyone's minds. However we remain confident that our long-term, bottom-up investment process will enable us to continue to identify fundamental value within the infrastructure investment universe.

Philippine bananas being unloaded at Kobe port

Source: First State Investments

Highlights

- Flying into Haneda Airport, only 20 minutes by taxi to Tokyo CBD vs Narita Airport which takes over an hour on the train.
- Catching the shinkansen (bullet train) from Tokyo to Kobe and back again for a day trip to meet companies – such a fast, efficient and punctual service.
- Becoming an expert on bananas after spending an hour at Japan's largest banana and citrus fruit import facility. Did you know that 60% of the fruit imported into Japan are bananas? Bananas are the number one favourite fruit by far (pineapples and kiwifruit a distant 2nd and 3rd).
- Japanese food (fresh and tasty!) and the people – some of the most polite, kind people I've been fortunate enough to meet on my travels.

Lowlights

- I think the Japanese government trying to promote work-life balance by limiting the working week to 60 hours is a positive development. I was disappointed that management weren't as supportive of this initiative and seemed more concerned with the pressure this may put on their labour costs.
- Comparing Japanese utilities, which are enthusiastically investing in new domestic coal plants, with the US utilities that I cover, where coal plants are getting shut down in favour of cleaner energy sources.
- Companies that have idle cash on their balance sheets and refuse to give it back to shareholders, but instead will likely destroy value by investing overseas, or keep it in a bank account earning almost zero interest.

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