Japan Field Research Trip - June/July 2024

RMB Japan Fund portfolio managers Masa Hosomizu and Ilhwa Lee visited Japan in June and July 2024. Below are key observations they had from the trip.

Observations by Masa Hosomizu

Macro Observations: Exchange Rate, Inbound Tourism, Inflation

The yen was cheap. This was clear throughout the entire visit to Japan. The yen exchange rate was as low as 160 yen while I was there, hitting the lowest levels in the past three decades. Given that the average exchange rate of the yen had been around 110 yen per dollar for a while, each purchase at coffee shops, grocery stores, and restaurants felt like they were at a steep discount. Indeed, Tokyo has the most Michelin star restaurants in the world, be it Sushi, French or Italian. I dined at a Michelin star French restaurant providing one of the best meals I have ever had and included a very entertaining French maître d', yet the check was less than $200 per person (compare to $300 if the yen was not so cheap). No doubt other inbound tourists felt the same benefit from the exchange rate. I observed many non-Japanese tourists shopping and dining all over Tokyo.

Though it was hard to see in the U.S. dollar, inflation in Japan was more evident in local currency. However, local consumers had an appetite for increased spending. At a coffee shop, we noticed many young people enjoying (and Instagram-ing) the high-end coffee drinks hand-brewed by barista. Even at local convenience stores, traditional rice balls (Onigiri), which regularly cost around $1 a piece, were 5-10% more than last year. They were selling well, too, as the absolute price is still more affordable than other options.

Meeting with Government Officials: Update on Corporate Governance Reform

As is my regular routine in Japan trip, I met with teams of the officials at the Financial Service Agency (FSA), Ministry of Economy, Trade and Industry (METI), and the Tokyo Stock Exchange (TSE) to discuss the progress of the reform initiatives in Japan and our view and opinions as an investor.

I discussed the corporate governance reform progress in Japan with the senior officials at the FSA and the METI. They seemed particularly interested in hearing what the regulators can do further to facilitate fair equity markets, which is the foundation of the sound development of the capital markets. I reiterated the standard of corporate governance that has been improving in Japan over the past ten years, yet there continues to be several areas where regulators can update the rules for better practices, such as the unfair tender offer privatization deals by family-owned companies, or conflict of interest cases related to the ineffective independent directors within the companies that are in parent-subsidiary relationships.

TSE officials were particularly interested in learning how they can improve their initiatives to encourage better capital efficiencies at the listed companies on the board. At the beginning of 2024, TSE demanded that all companies listed on its Prime Board publish respective capital allocation policies to improve their capital efficiency and valuation (the so called "more-than-1x-PBR requirement"). Six months after the TSE demand, approximately 70% of the Prime listed companies filed their respective plans to improve capital efficiency and reward shareholders. However, as much as 30% of the companies are not publishing any plan at all, including some of the largest companies in Japan. We suggested to the TSE officials that they should press those not taking actions further with follow-up discussions in the upcoming study group at the TSE.

Meeting with Other Activist Funds, Media Reporters - More Activism Investing in Japan

As shareholder activism flourishes and more shareholder proposals at annual shareholders meetings (AGMs) are filed in Japan this year, I met with some of the other activism fund managers who were also visiting Tokyo. Activists are getting more vocal and increasing pressure on companies. Having more activism managers helps to make the voice louder and be heard by the companies, general investors, and regulators. It also benefits our investment strategy. It is better to have other vocal investors among the shareholder list in our investing companies, as such a bandwagon effect does have an impact on executives to encourage corporate actions.

The media is getting more supportive of such trends, believing it is good for Japan. Key media such as Nikkei, Bloomberg, and Reuters, are unanimously ran special media reports during the Annual General Meeting (AGM) season in June and discussed why these reforms are important for the Japanese corporate culture and economy.

Our Activism Case - AGMs of NEC and JAE

During my stay in Japan, I attended two AGMs at companies in which we invest: ; NEC Corp. (6701 JP) and Japan Aviation Electronics Industry Ltd. (6807 JP, JAE). JAE was a publicly listed subsidiary of NEC for many years. Earlier this year, NEC decided to divest its stake in JAE, and sold part of its stake to JAE itself through a discount buyback program. However, the media later reported that there were several potential buyers of JAE who were willing to pay more than a 50% higher price than the buyback price. Executives at NEC and JAE deliberately rejected to protect the job of executives at JAE, some of whom were ex-directors of parent NEC, and did not disclose these facts to the public. Believing there was some misconduct at NEC and JAE based on the conflict of the interests, we ran a media campaign to oppose the deal, and decided to voice our opinion at their AGMs in Tokyo. While I confronted the CEOs of NEC and JAE at their AGMs with heated exchanges of discussions, the CEO of NEC admitted they had such higher bidders for JAE (but justified their unreasonable decision to sell at much lower price). While forcing these executives to confess their suspicious actions at the AGMs were a good outcome, I am determined to put more pressure on them to take actions to benefit the general shareholders going forward.

Observations by Ilhwa Lee

The benefit of the unusually weak Japanese currency is not limited to the traditional export sector. Japan's inbound tourism statistics are already trending above pre-pandemic peak levels, with tourists from South Korea, Taiwan, Hong Kong, and Singapore more than making up for the slow recovery of visitors from mainland China. It is no surprise that the level of patience required to go through immigration at Haneda airport as a foreigner has become comparable to the experience at O'Hare without Global Entry, despite the former's reputation for an efficient process. As early as the next morning, all these visitors would flood the streets, from major shopping areas like Shibuya to small hot spring towns like Yufuin on the southernmost main island of Kyushu, despite Japan's unwelcomingly muggy weather at the end of June.

In downtown Tokyo, retail shops, restaurants, department stores, and shopping malls were packed with customers. While the signs of recovery are everywhere, the pace of recovery is certainly not being felt equally by everyone. The prices of many goods and services most accessible to dollar spenders have notably increased, to the extent that they have almost fully neutralized the impact of the weak currency in many cases. The daily rates of global hotel chains are already far above their pre-pandemic levels, even in dollar terms, for instance, making it almost feel like their prices are linked to U.S. inflation. Real estate prices continued to rise, supported by foreign demand, while price arbitrage opportunities that existed last year for Asian tourists looking to shop for global luxury goods in Tokyo closed quickly.

However, this polarization is also creating new opportunities for local businesses. With a certain portion of these goods and services becoming increasingly inaccessible to locals, domestic competitors have much more wiggle room to raise prices without compromising their price competitiveness. A handful of overseas asset owners or local elites, whose bonuses are paid at least partially in U.S. dollars, seem also be more willing to pay up for domestic goods and services they enjoy, potentially creating a trickle-down effect throughout the rest of the economy. Sophisticated inbound tourists looking for bargains are already venturing beyond their typical tourist spots and moving far deeper into local areas usually untouched by foreign demand.

Locals have not been completely crowded out by elevated foreign purchasing power either. In fact, they are preparing for a comeback. Average Japanese consumers, who found themselves squeezed between higher energy prices and slow wage growth last year, are now seeing their disposable income grow again this year. Either way, companies have more room to raise prices, and customers with higher wages can afford to accept the change. Today’s Japan looks like anything but an economy suffering from structural deflation.

In the meantime, there were some early signs that the Japanese government's efforts to address the country's structural labor shortage issues were actually making an impact. In a traditional hot spring hotel in the population-losing province of Kyushu, for instance, a hotel manager from Nepal was giving orders to his multinational hotel crew from other South Asian countries, China, and even Japan. Few of his multinational guests would even notice his subtle accent when speaking in Japanese. In fact, many from Europe, Hong Kong, and Singapore would appreciate his ability to quickly switch to English as needed. After all, more than 50% of their guests on any given day are non-Japanese. When the hotel crew communicated with each other, Japanese was used as the lingua franca, something almost inconceivable just ten years ago.

One important question remains: is Japan willing to share the benefits of this economic recovery with foreign investors? The answer seems increasingly to be yes this time. Our meeting with the Tokyo Stock Exchange (TSE) reaffirms that the organization remains committed to continuing its efforts to fully establish shareholder capitalism in Japan. The TSE's push for improving equity valuation has been well received by global investors, and it has triggered Japanese management to become more aware of stock prices and capital efficiency. Almost every company we met, large or small, was prepared to articulate its plan to better allocate capital and improve capital efficiency. Feedback to investor relations (IR) from investors is also taken seriously and internally shared with relevant parties. One night over dinner with friends, a friend working in the M&A department at a large Japanese corporation complained about how the company's IR executive was giving him a hard time for 'wasting precious shareholder capital in mediocre deals,' referring to Curi RMB Capital’s most recent feedback to the company during an IR meeting. This changed culture and mindset of Japanese corporations should help investors take their fair share of the benefits from all the changes occurring as described above.

Searching for transportation options to our last meeting location, Japanese Google Maps identified the exact train car number to transfer to the next train with the minimum number of steps. The Tokai Shinkansen, Japan's high-speed railway system operated by JR Central, can accommodate up to 17 train departures every hour. This marks the highest operational density in the world for a train system operating at 200 miles per hour, with an impressive record of zero accidents since its establishment in 1964. Japan's relentless pursuit of operational excellence has always been part of its culture. After all, it is the birthplace of several well-known operational best practices still widely adopted in manufacturing today, including Just-in-Time, Kaizen, Lean Manufacturing, and Poka-Yoke.

What has hampered corporate Japan from leveraging its operational efficiency to build efficient businesses and create great investment opportunities for investors has always been its notoriously inefficient capital allocation decisions. Today, Japanese management finally seems motivated to address this overdue and bizarre imbalance issue. Marrying the country's culture of unparalleled operational excellence with improving capital efficiency may potentially lead to far more value creation opportunities for Japanese corporations than what we have become accustomed to over the years. Perhaps this transformation resembles Shohei Ohtani's venture into "two-sword style." Investors should be looking forward to it.