THE JAPAN–CHINA NEXUS—HOW IMPORTANT IS IT FOR INVESTORS?

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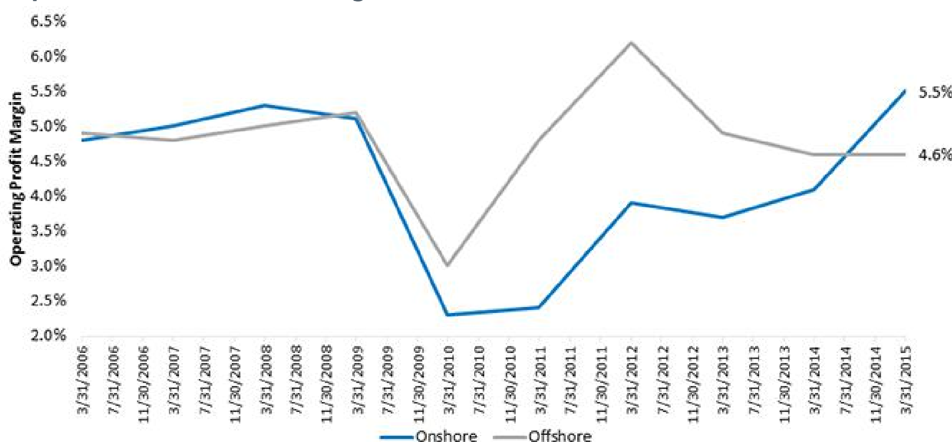
09/15/2015

For economists, Japan and China appear like a match made in heaven. Where Japan is rich in capital and poor in labor, China's situation is exactly the reverse. Putting the two together should yield a powerful growth machine. For economists, it does not get much better than this. For investors, unfortunately, the Japan-China nexus poses significant complexities. Yes, the economists were right and China's opening up and modernization did indeed deliver high economic growth; but if China was the key force pulling up demand for Japan's capital stock and technology, then surely the current slowdown could spell disaster for "Japan Inc." More importantly, we must remember that the spoils of high growth get distributed more or less in line with the relative resource endowment: Japan's rate of return on capital got pulled up, while China's employment and labor income gains were unprecedented in economic history (while China-based profitability was not). Now, if the growth dynamic reverses, exactly the opposite should happen: China may suffer rising unemployment, and Japan should get hit by falling rates of return on capital. For investors, it does not get much worse than this and, in our view, fear of this top-down worry is currently a factor behind the "risk-off Japan-down" dynamics. **Linkages, Perceived and Real** The good news is that the realities of the Japan-China nexus run almost counter to the big worry outlined above: An analysis of the most comprehensive and consistent data set—the annual Survey on Overseas Business Activities by Japan's Ministry of Economy, Trade and Industry (METI)—reveals that China's importance for Japanese industrial profits has actually dropped over the past five years: total Manufacturing sector profits surged by a factor of 2.63, from 9.7 trillion yen to 25.5 trillion yen, between the fiscal year ending March of 2010[1] and the fiscal year ending March of 2015; but China's contribution to this growth was a mere 9.1%, i.e., 1.7 trillion yen. At 12%, the U.S. contribution over the same five-year growth period was larger. The real driver was the profit surge from domestic onshore sales, which accounted for 59.5% of the upturn in aggregate profitability. Make no mistake: Japan's domestic demand has mattered more than generally perceived. **Profits related to China were 12.3% of total industrial profits in fiscal year ending March of 2015** More specifically, the share in total profits generated by China dropped from 17.6% in fiscal year ending March of 2010 to 12.3% in fiscal year ending March of 2015. Importantly, we draw attention to the total contribution from both exports and offshore China-based factories owned by Japan. Here, the Chinese offshore contribution plunged by almost one-third, from 15.2% of total profits in fiscal year ending March of 2010 to 8% by fiscal year ending March of 2015; but the contribution from direct exports actually rose, from 2.4% to 4.3% of the total. **The key takeaway is twofold:** • First, the drop-off in China's importance for Japan appears to be primarily caused by the falling profitability of Chinese operations. • Second, while straight exports have grown in importance, the overall dependency on China is relatively small (exports accounting for less than 5% of the total). **If profits related to China drop 40%, this would cut Japanese profits by just 5%** In practical terms, the following base scenario analysis emerges: if profits related to China were to drop by 40%, the resulting hit should cut total profits by only about 5%, because the most recent data shows that the share in total profits generated by China was about 12.3% as of the most recent measurement date,

stated above (12.3% times 40% drop equals approx. 5%). On today's consensus expectations of 9% profit growth (Bloomberg consensus for (TOPIX)[2], this still leaves a reasonable cushion, in our view. **Data safety cushion** It should be noted here that our analysis very consciously leaves room for upside estimation bias. This is because the profit data is based on current operating profits and not on retained earnings. Moreover, the industry breakdown of both exports and offshore production reveals a heavy bias toward automobile and truck as well as telecommunication equipment makers. The former hold about 44% of global capacity in offshore operations, and the latter about 30%. Against this, the all industry-wide average offshore production dependency is only 22.9%. We consciously left this cushion that actually overestimates the dependency on China. This is because a slowdown in China's growth is clearly poised to generate a general downward dynamic to global profitability, in our view. **The U.S. matters more** What about Japan's dependence on the U.S.? The same analysis suggests that 18% of Japanese profits stem from the U.S.—4.6% from Japanese exports to America, and 13.4% from Japanese factories in the U.S. Make no mistake: For Japanese profits, the U.S. is significantly (about 1.5 times) more important than China. Interestingly, as with China, the overall importance of the U.S. contribution has dropped over the past five years, from 27.9% to 18% of total profits. Again, the pure export contribution rose from 2.1% to 4.3%, but the onshore contribution declined from 25.8% to 13.4%. This dynamic can be attributed to the yen's depreciation: for exports, a weaker currency immediately feeds into higher margins: the dollar revenues translate into higher yen revenues, while local yen-based input costs stay the same. However, for offshore factories, both costs and revenues rise, leaving margins unchanged. This dynamic applies to both the U.S. and China because of China's de-facto currency link to the U.S. dollar. **The real story – domestic margins** Clearly, it is right to worry about the negative pull on Japanese profits from a Chinese slowdown. However, these concerns should not distract from the seriously positive profit dynamics generated in Japan's domestic market: over the past five years, total profits rose from 9.7 trillion yen in fiscal year ending March of 2010 to 25.5 trillion yen in fiscal year ending March of 2015. Exports accounted for 30.2% of this growth, the offshore contribution was 10.3%, but the contribution from rising domestic sales was 59.5%. The fact that this was generated by a 5% rise in domestic sales (while exports rose 7%) is testimony to the power of fixed-cost gearing —the "slingshot" effect from domestic sales growth inflecting from negative to positive is more impactful than the relatively steady growth from exports. **Analysis of Operating Profit Margin for Japanese Manufacturing: Onshore vs. Offshore** Firms (3/31/2006 to 3/31/2015)



Source: Ministry of Economy, Trade and Industry annual Survey on Overseas Business Activities, with data through fiscal year ending 3/31/2015.

Focus on domestic demand, i.e., small and mid-cap All in all, the real story of Japan's rise in profitability over the past five years is due to a sharp rebound in domestic sales. In contrast, offshore linkages have suffered significant margin contraction. One should thus expect a refocus on onshore investment, in our view. In the immediate future, fears of a more protracted global slowdown may impede more aggressive capital expenditure

(capex) plans—few managers are bold enough to add capacity during a downturn. However, the conditions for a strong rebound in Japan-based capital spending are falling into place, in our view. For investors, the relative attractiveness of Japan's domestic small- and mid-capitalization companies should follow. That's where the rise in earnings visibility should continue to improve, in our view. **"Team Abe" poised to counter the global slowdown** At the same time, policy makers should take note that still about 40% of Japanese profits is dependent on global forces, split almost evenly between exports and offshore operations. Given the negative global dynamics in general, a more proactive and stimulative policy mix may be warranted, in our view. We expect a newfound pro-growth policy drive from "Team Abe" over the coming couple of months, including the Bank of Japan. ***Unless otherwise noted, the source for all data is the Ministry of Economy, Trade and Industry's annual Survey on Overseas Business Activities, with data through fiscal year ending 3/31/2015.*** [1]Japan's fiscal year ends March 31 of each year. "Fiscal year ending March of 20XX" means the 12-month period prior to that date. [2]Source: Bloomberg, as of 9/8/15.

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DEFINITIONS

Capital : Wealth available for a particular purpose, such as starting a company.

Capital stock : Measure of investment available in a particular economy that represents the ownership interest in its businesses.

Rate of return on capital : Measure of how well a company generates cash flows on the money that has been invested.

Tokyo Stock Price Index (TOPIX) : A free float-adjusted market capitalization-weighted index that is calculated based on all the domestic common stocks listed on the Tokyo Stock Exchange First Section.

Upside estimation bias : Process of estimation where a conservative standard is applied in such a way that there is potential for an original estimate to be too conservative for the observed reality.

Retained earnings : Portion of earnings that is not paid as dividends but held by the company for future investment opportunities.

Margins : Focused on issues impacting the overall economic landscape as opposed to those only impacting individual companies.

Input costs : Costs of resources used to produce a good or service.

Currency link : Measure that prevents a currency from fully market-determined behavior due to rules that may impact its exchange rate against another currency or currencies.

Fixed-cost gearing : Impact that can allow operating profit to increase at a faster rate than sales due to a firm's cost structure.

Onshore : Refers to Japanese firms producing goods and/or services within Japan that can be sent outside Japan.

Offshore : Refers to firms producing goods and/or services outside Japan, frequently in the country to which they are being sold.

Capital expenditures : Spending by a company typically made to enhance longer-term productive capacity.

Market Capitalization : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.