



Japanese Banks Are Cheap—But for Good Reason

Value investors are being tempted back into the sector, but problems remain.

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KEY INSIGHTS

- Following the sell-off in global equities in late 2018, Japanese banks are currently trading around their lowest valuations in more than a decade.
- However, Japan's banking sector continues to face many challenges—and this is duly reflected in the current valuation levels.
- Japan has one of the most crowded banking industries in the world. Given the highly competitive landscape, profit margins are being continually squeezed.



Archibald Ciganer
Portfolio Manager,
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Japanese banks are currently trading around their lowest valuations in more than a decade, encouraging value investors back into the sector. Certainly, banking stocks appear cheap—but they have looked cheap for many years and, we believe, for good reason.

For value investors, the investment thesis here seems clear. Given the current

low valuations, any improvement in Japan's interest rate environment could be exponentially reflected in the share prices of banking stocks. While this argument has merit, improving rates alone are not enough to overcome the long-term challenges that remain within the sector, including oversaturation and unfavorable demographics.

(Fig. 1) Japanese Bank Earnings Face Ongoing Pressure

As of December 2017



Source: Federal Reserve Economic Data, Economic Research Division, annual data, not seasonally adjusted.

¹ Value of banks' net interest revenue as a share of its total interest earning assets.

-27.9%

Japan banking sector (TOPIX) annual return in 2018

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Weak Earnings/Profitability Outlook

The Bank of Japan's (BoJ) ultra-loose monetary policy has created a very difficult environment for banks to make a profit. A combination of quantitative easing and negative interest rates have effectively scythed through Japanese banks' earnings.

Traditionally, commercial banks make their money from the interest received from customer loans as well as the interest paid on cash reserves held on short-term deposit. Since 2013, the BoJ's quantitative easing program—buying large volumes of government bonds in the open market—has suppressed long-term bond yields. For banks, this has resulted in a steady decline in their earnings from lending. As bonds have matured, they have been replaced with those offering progressively lower yields, meaning the interest that banks can charge on customer loans has also steadily fallen. At the same time, weaker demand for new loans from cash-rich corporates and an aging population have compounded the negative impact on earnings.

Banks were dealt another blow in January 2016 with the BoJ's introduction of a negative interest rate policy, effectively charging them for holding cash on short-term deposit. Designed to encourage greater spending and boost inflation, the policy has eroded banks' earnings further as returns on their cash reserves have all but evaporated. Given this backdrop, the earnings outlook for the sector appears weak, and it is hard to see this changing any time soon.

A Highly Competitive Environment

Japan has one of the most crowded banking industries in the world. The number of bank branches per 100,000 people (including post office branches

that also offer banking services) is 34.0, compared with a global average figure of 12.2.² In highly populated areas, the density of banking options is especially apparent, providing customers with ample choice. Given this competitive landscape, profit margins are continually being squeezed tighter.

So, even if we do see an improvement in interest rates, for example, the positive flow through to banks' bottom lines is diluted as a lot of this will ultimately be competed away. The saturation of bank branches is a structural problem that will continue to drag on earnings/profits until we see some meaningful consolidation within the sector.

Shifting Population Trends

The outlook for Japan's many regional banks looks particularly challenging. These small and mid-sized banks mainly serve populations in less built-up areas of the country outside the major cities. With domestic lending as their core business, the negative interest rate environment has been damaging. Regional banks have seen a steady decline in earnings over recent years with many posting losses or, at best, seeing margins squeezed toward zero.

In addition, populations in rural and suburban areas of Japan are declining as well as getting older. Regional banks are acutely exposed to these structural trends and, as such, face declining prospects for growing their loan portfolios. This pressure has already prompted some regional banks to merge in order to better compete in an increasingly difficult environment. This is a positive; however, we need to see a lot more of this kind of industry consolidation before any meaningful impact is felt.

²Sources: The World Bank and International Monetary Fund. Commercial bank branches per 100,000 adults. As of December 2017 (latest available data). TOPIX—Tokyo Stock Exchange, Inc.

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Meanwhile, other regional banks struggling to grow their loan book are turning to riskier assets as well as other businesses, like securities trading or mergers and acquisitions, to boost their bottom lines. Given the potential lack of expertise in these areas, this opens Japan's financials sector up to a range of possible new risks.

Cross-Shareholdings

Japan's history of corporate cross-shareholding is also relevant here. Certainly, improved governance standards over the past decade have seen an undeniable reduction in the practice of cross-company ownership. The slow unwinding of these complex arrangements has played a part in encouraging foreign investment and helped to drive Japanese equities higher over recent years.

Nevertheless, the culture of interrelated companies owning large stakes in each other's businesses remains a feature of the market. Nowhere is this more evident than in the banking sector, with companies relying on lenders as friendly shareholders to ensure financing, fend off takeover threats, and provide united support against more demanding investors.

Cross-ownership is particularly evident among Japan's major banks, but many mid-size and smaller banks also maintain similar corporate relationships. These often opaque alliances between companies are the antithesis of progressive governance, encouraging management complacency and diluting accountability to minority shareholders.

In short, Japan's domestic banking environment remains challenging. Loose monetary policy, negative interest rates, fierce competition and structurally weak loan growth are all negative influences on earnings. In order to boost earnings, some banks are also diversifying into new businesses and regions, and these moves imply increased credit risk.

As detailed in recent communications, we remain positive about the Japanese equity market outlook. The very real structural improvements taking place in the economy and the equity market are already being reflected in company returns, and this is a long-term positive trend. That said, avoiding pockets of structural weakness is also paramount, and calls for an active investment approach. In this vein, we are confident that we can continue to find quality Japanese businesses with strong earnings growth potential and, thus, capable of delivering long-term outperformance.

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