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Resilience Under Pressure:

Japanese Corporate Earnings in a Post-pandemic World

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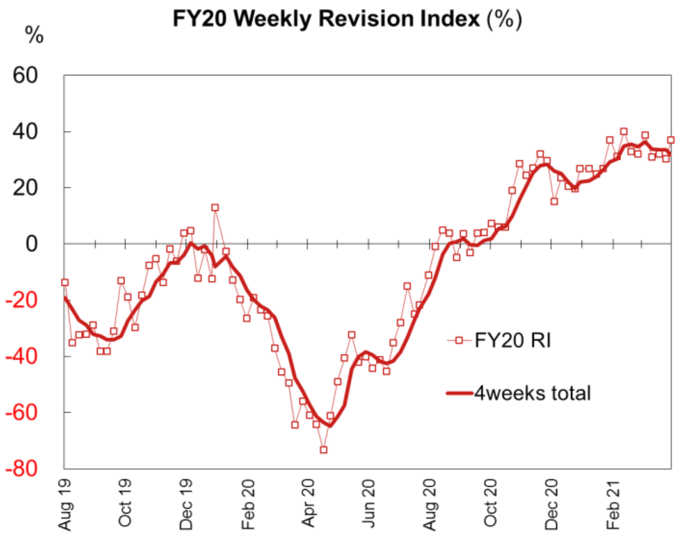
After dissecting the corporate financial results of an extraordinary fiscal year for Japan's equity market, our teams of 22 sector analysts and 38 Japan equity portfolio managers in Tokyo are preparing for the AGM season that kicks off in early June. With an approved list of more than 2000 Japanese equities, this is a period of intense scrutiny from our investment professionals into earnings guidance and corporate strategy.

Earnings announcements for FY2020, ending in March, are now complete, and we can confirm that corporate earnings in Japan have staged a much faster recovery than the market had anticipated in the wake of the pandemic and the March 2020 market sell off. We should not underestimate the scale of that disruption – with economic activity plummeting even more rapidly than during the Global Financial Crisis of 2008. A shock to the system of this scale left corporations unable to make reasonable forecasts for their earnings. Instead, it left us to make our own assumptions and to evaluate the potential damage to profits amid a rapidly changing and unpredictable global economic and public health crisis. Our analysis suggested that recurring profits of the Tokyo Stock Exchange first section could suffer a slump of almost 30% under a stressed scenario incorporating the widespread disruption to domestic and global economic activity.

In the end, the actual earnings results exemplified the resilience of the Japanese corporate sector as well as the determination of policymakers worldwide to avoid a rerun of the financial crisis 12 years earlier. It is true that the Japanese economy itself has lagged behind the breakneck recovery pace seen in the United States and China. Nevertheless, Japanese corporations, especially manufacturing firms in the electronics and automobiles sectors, have been able to capitalise on the strong demand recovery overseas. This allowed them to repeatedly beat earnings expectations over the course of the fiscal year. In aggregate, we can now see that FY2020 earnings closed the fiscal year almost flat (0% growth) from the year before.



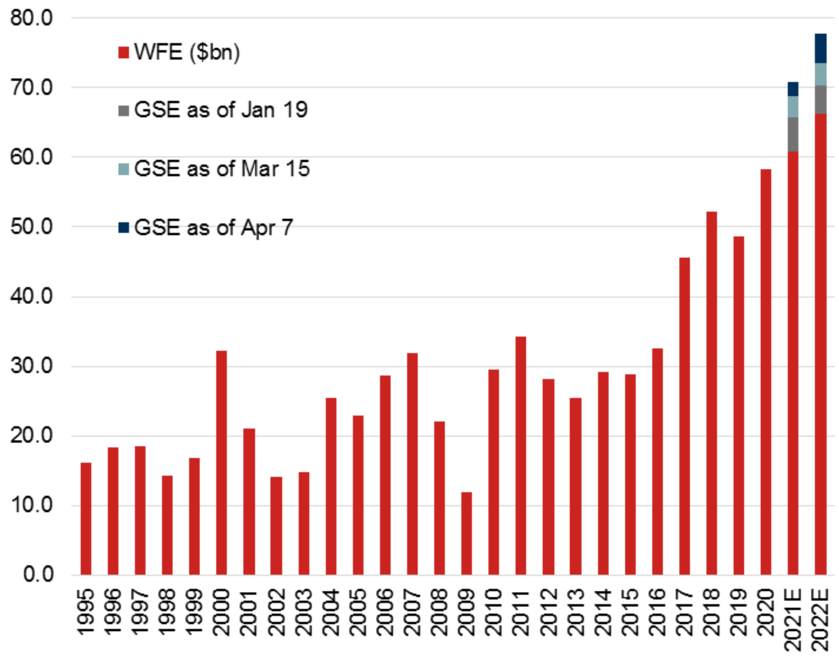
Source: QUICK; compiled by Daiwa.
Note: TSE1 basis. Companies with QUICK Consensus recurring profit forecasts. RI = (upward revisions − downward revisions) / total no. of issues with revisions.

Behind the surprising resilience of corporate earnings in Japan lie several structural changes that reflect the reality of a post-pandemic economy. For the Japanese market, two of the principal shifts are the insatiable demand for information technology and the structural transformation of many Japanese firms.

Powering the Data Economy

If unimaginable volumes of data are the fuel behind what has been dubbed the "fourth industrial revolution", then processing capacity is its engine. This ever-expanding demand for information technology has gained further impetus from the sudden and unexpected need to accommodate a societal shift towards working from home, especially in the knowledge-based developed economies. Both private consumption and corporate spending have increased thanks to enhanced telecommunication capacity, while the introduction of 5th generation mobile communication technology has effectively turbocharged this spike in hardware demand. The 5G network requires many more electronic components of greater sophistication that can be created only through advanced manufacturing processes. Naturally, many of the global chip producers have focused on these latest technical advances, while industries such as automobiles still rely on microcontroller chips that are typical of earlier technology generations. They are now facing serious supply shortages of these legacy semiconductor components. The latest earnings announcements from many Japanese electronics companies highlighted the prospect of buoyant business conditions over the coming quarters.

Semiconductor Manufacturing Equipment Market Outlook



Source: SEMI, (Goldman Sachs Estimates);

Note: WFE (Wafer Fabrication Equipment)

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Corporate Transformation and Adaptation

Structural transformation of Japanese businesses has often accelerated in response to urgent external pressure. For example, despite component procurement difficulties across the automobile industry, Toyota Motor has managed to register steady profits on the back of stable automobile sales. At the same time, some other carmakers have had to downgrade their earnings due to slower sales caused by shortages of components such as microcontrollers. Toyota, known as the innovator of “Just in Time” production systems that minimise inventory to reduce costs, revealed it had successfully adapted to holding higher inventory levels of such key components, while maintaining a competitive cost structure.

Long before the Covid-19 pandemic, there had been many other cases where Japanese manufacturers restructured their supply chain management or found new opportunities based on their experience of exogenous shocks such as natural disasters. US-China tensions have been another outside influence on supply reconstruction decisions of Japanese companies, especially in the area of information technology. While seeking to reduce its industrial supply chain dependence on China, the US government is now promoting the “on-shoring” of high-tech manufacturing. At the same time, China’s authorities also intend to accelerate technology sector capital expenditure in order to catch up with its global competitors. Caught in the midst of this strategic economic competition are the many Japanese suppliers of semiconductor manufacturing equipment and functional materials needed for the production of the most advanced chip products. These suppliers stand to benefit from this massive investment drive. Given the latency of several years to bring new chip manufacturing plants to full operation, we can expect Japan’s semiconductor production equipment, factory automation, functional materials, and other crucial links in the technology value chain to benefit from this tight supply-demand outlook for a few years to come.

From Resilience to Recovery

We should not forget that the Covid-19 pandemic is still an unfolding crisis for many countries, especially in the developing world. Japan meanwhile is grappling with the implications of hosting the postponed 2020 Olympic Games under such conditions. Complications include the identification of new Covid-19 variants and the slow progress of vaccine distribution. However, since these underlying conditions are largely priced in to Japanese share prices already, we believe the Japanese market presents many appealing investment opportunities despite the constraints imposed by the pandemic.