The **VIEW** *from* **BURGUNDY**

The SUN *also* RISES

In 1998, the consensus on Japan was a pessimistic one. As a result of its poorly regulated financial system, poor capital allocation, and poor corporate governance, the stock market performance of the island country was appalling. Over a span of two weeks, Tony Arrell and Richard Rooney, Burgundy's Chair and Vice Chair respectively, visited companies and met with analysts, economists, and strategists to understand the country's neglected position. Inside a time that would later be known as the Lost Decade for its period of economic stagnation, the two set out to find out whether Japan represented an investment opportunity. The Sun Also Rises is a reminder of Burgundy's commitment to value and that value only appears when things are weak.

- Burgundy Asset Management, 2020

At the end of 1989, Japan was flying high. Its economic model was considered by many to be the best in the world. Under the benign and extraordinarily competent direction of the Ministry of International Trade and Industry, the famous MITI, Japanese companies went after markets like attack dogs and mauled foreign competitors. Stock prices had shrugged off problems in other markets and were trading at dizzying levels.

With the petty cash from the massive structural trade surplus they ran with the U.S., Japanese buyers were buying trophy assets at enormous prices: Rockefeller Centre, Pebble Beach Golf Course, van Gogh's "Sunflowers."

Eight long years later, the trophy assets have all been sold either to avert bankruptcy or as part of insolvency liquidation. The Japanese economy has averaged about 1% compound growth in the 1990s, and aside from the markets it dominates, like automobiles, consumer electronics, and some other technological and industrial niches, it seems to be almost peripheral to most market participants. The stock market that proudly called itself the largest in the world in the late 1980s has receded to only about 40% of its 1989 price level, while the American stock market has risen almost 200%. Even Canada's stock market has managed to increase by about 90% in that period. Japan has been suffering through the most prolonged and severe bear market that any major stock market has seen since the 1930s.

What went wrong? In search of some answers to that question, Tony Arrell and Richard Rooney, Burgundy's Chairman and President, respectively, travelled to Japan in the last two weeks of January 1998. They visited 25 companies in their offices and saw another 30 at a conference put on by Nomura Securities. They also met with analysts, economists and strategists from Nomura, Morgan Stanley, SBC Warburg and Cazenove, as well as Canadian Embassy personnel. The basic question was whether Japan represented an investment opportunity.

There are three main reasons for Japan's appalling stock market performance: a ramshackle and poorly regulated financial system, poor capital allocation and poor corporate governance. There have been other serious problems, of course, both political and economic, but our concern at Burgundy is stock market performance, so we will restrict ourselves to strictly market-related phenomena.

BAD BANKS

The banks are a millstone around the neck of the Japanese economy. They are the heart of the old, highly regulated, relationship-driven Japanese system. Each of the major banks, like Dai-Ichi Kangyo, Fuji, or Sumitomo, is the head of an industrial group, or keiretsu. The group normally consists of dozens or even hundreds of companies in many different industries. The core bank provides loans at highly favourable rates to these keiretsu companies, and owns shares in all of them. The group companies in turn own shares in the banks, and in each other. If a keiretsu company gets into financial trouble, it is "rehabilitated" with the help of the lead companies in the group. Outsiders can get loans, but at higher rates of interest. Real outsiders, like entrepreneurs, often cannot get loans at all.

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Japanese regulations allow for four kinds of banks: city banks, like the three referred to above; long-term credit banks, like Industrial Bank of Japan; trust banks, like Mitsui Trust and Banking; and regional banks, like Shizuoka Bank and Bank of Fukuoka. The city banks are the main providers of capital to Japanese industry through normal credit lines. The long-term credit banks give term loans for longer periods. The trust banks handle the depository business and run the pension funds. Regional banks are supposed to provide credit to small- and medium-sized businesses. A corporate bond market does not really exist; the bond market mainly deals in Japanese government bonds. So interest rates are not set by a free market, but by a combination of regulations and relationships.

This system worked quite well until the bubble economy of the late 1980s. At that point, with apparently limitless amounts of money to be made in real estate, the Japanese banks began to funnel more and more money to real estate and construction firms in the hot markets of Japan. At the peak in 1990, with Japanese real estate at surreal price levels (everyone seems to recall that, in theory, the grounds of the Imperial Palace in Tokyo were "worth" as much as all of California), the Japanese banks had loans outstanding to these companies for 500-1,000% of shareholders' equity. The security for these loans was real estate at grossly inflated prices.

As reality set in during the early 1990s, the Japanese government colluded with the major banks in window dressing their loan portfolios. "Stimulus packages" totalling US$570 billion were undertaken to keep the economy growing, but also to give the real estate and construction sector the wherewithal to continue paying interest, since most of the "stimulus" occurred in this sector. Lax regulation allowed the banks to be very coy about their non-performing loans, and there was no pressure for write-offs from the Japanese Ministry of Finance or the Bank of Japan. Even the Bank of International Settlements got into the act, allowing the Japanese banks to count as equity their unrealized gains on the enormous stock portfolios they held in *keiretsu* companies.

Looking at this cozy, expedient and unreal arrangement, one is reminded of Pierre Laval, the Prime Minister of Vichy France, and his address to the collaborationist Chamber of Deputies after D-day, in which he said, "Gentlemen, we are all up to our necks in manure, so nobody splash."[i] That was very much the attitude of the Japanese bankers and financial officials.

The market splashed for them, as it has a tendency to do. The relentless downward spiral in property prices eroded the collateral base of the loans, while the slide in stock prices weakened the capital base of the banks as their unrealized capital gains disappeared. Non-performing loan balances began to rise even under the poor disclosure rules of Japanese banks, and the capital erosion forced the contraction of lending. The result has been a ferocious credit crunch, aggravated by the tendency of Japanese banks to continue to lend on the basis of relationships rather than risks. This has led to a peculiar situation where interest rates are extraordinarily low, but loans are unavailable to most borrowers. Until this rationing system is replaced by a system that distributes money based on interest rate spreads between different credit risks, as in most other areas of the world, Japan will continue to wallow in a low growth, quasi-recessionary environment.

Ironically, if the $570 billion in stimulus packages had been put aside to restructure the financial system rather than to help some overleveraged construction companies, Japan today would be in much better shape. It would be able to play its appropriate role as senior regional economy in the Asian crisis and the world would be a safer place. But the half measures of government policy seem to have no end.

BAD CAPITAL ALLOCATION

Readers of *The View* know that we have a major problem with companies that allocate capital in inefficient ways. Unfortunately, that includes most of corporate Japan. The problem is twofold – a culture of employee entitlement and a surprising lack of financial sophistication.

Modern Japan's economic policies are based on an implicit deal between industry and government. The government provides a rudimentary welfare state and pro-business regulation, and business provides lifetime employment and social benefits including housing, health care and education. This implicit lifetime employment guarantee is why Japanese companies are always looking for new markets and products in which to deploy surplus labour. Where a North American company in a mature industry would be looking to downsize that business or perhaps exit it altogether, in Japan, the management would only do such a thing if it were faced with immediate bankruptcy. Normally, they would look to start a new line of business in order to second workers from the original one. Another factor is that managements are paid based on the size of the workforces they manage rather than profitability, which makes downsizing even more difficult for them.

Within these constraints, Japan has done a good job of maintaining employment. But the cost has been to keep alive large industries that in other economies would have been forced to restructure or disappear. In North America, such companies would be starved for capital until they were able to earn a decent rate of return on reduced capital bases. In Japan, they get loans from group banks and continue to operate. So again, the banks are the main culprit.

All companies, in all industries, use this employment system. The basis of the whole system is seniority. At Kyocera, one of Japan's leading high-technology companies, we asked what would happen if two engineers were hired at the same time, with one proving to be an average performer and the other one a star. After 10 years, how much would the two make? The rather puzzled answer was that they would make about the same amount, but the more talented engineer would have a higher position in the firm than the average performer. In Japan, being entrusted with higher responsibilities is the reward, not increased salary. But at this company, as

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at many others, we were told that the company was hiring "mid-career managers" from other firms, which was unheard of until recently.

This employee entitlement system is a major barrier to capital efficiency, not so much because it makes labour markets so rigid, but because it dilutes the concept of return to shareholders almost out of recognition. New projects are reviewed mainly on their ability to generate near-term employment rather than long-term returns. As a result, concepts such as return on investment, discounted cash flow and cost of capital are almost unknown and rarely used in Japan. Not surprisingly, most Japanese companies have balance sheets that bear no relationship to the risks inherent in their businesses, and have returns on equity that average about 3%.

And obviously, when you are constantly looking for new businesses to get into, and you may or may not be able to get money from the bank, it is only wise to keep a plentiful supply of cash on hand. A great many Japanese companies have very large cash hoards on which they can sit for decades. From a return on capital viewpoint, this is a disastrous decision.

Archaic government policies also prevent Japanese managements from allocating capital efficiently. For example, the Japanese tax code discriminates against dividends from corporations to individuals, so special dividends are an expensive and inefficient way to return money to shareholders.

And stock buybacks were illegal until late 1994, and are still comparatively rare.

BAD CORPORATE GOVERNANCE

Managements in Japan do not generally feel that they work for, or are in any way responsible to, the shareholders as a group. Where there are major keiretsu shareholders, there is a strong sense of obligation, but minority shareholders are usually ignored. Indeed, so intense is the aversion of Japanese managements to embarrassing questions raised by minority shareholders that almost all Japanese companies hold all of their annual meetings on the same day of the year, at about the same time of day. More preposterous still, a blackmail industry has sprung up in Japan of people who threaten to disrupt annual meetings and will instead "protect" it for a large fee. These exploiters of the Japanese fear of embarrassment are called "sokaiya." Japanese managers would be amazed at the pointed questions and outraged filibusters that are such a common feature of North American annual general meetings.

Boards of directors in Japan are huge, cumbersome and inbred. Outsiders are shunned and Board appointments are rewards for long service rather than strategic appointments designed to improve the business. We asked several Japanese managers how the Board was elected, and all said that it was appointed by management. While Canadians cannot cast the first stone here, with so many ineffective, management-appointed Boards of our own, the Japanese situation is much worse.

Managements could be forgiven much if they just owned some stock themselves. But they usually own none at all. Options plans, which have grown so common and so large as to become an abuse in North America, were not legal in Japan until recently. So management, with no stake in the company, no sense of responsibility to shareholders outside the keiretsu, no real guidance or correction from the Board, and usually no need for equity financing, does exactly what it wants to do with the business.

DARKEST BEFORE DAWN

Does this sound like a buy story so far? Probably not. But there is another side to the story. Japan did not achieve its miraculous economic development by accident. Remember, this is a small island group, remote from all other large capitalist economies, with little in the line of natural resources. Its society and economy, as recently as 1868, was feudal in structure and resembled that of a European country in 1600, except for a vastly higher general level of personal hygiene and aesthetic taste. One hundred and thirty years later, it is a true colossus, a world economic power.

Japan's only great natural resource has been its people. They are industrious, cooperative and disciplined. They are true believers in education and self-improvement. And they have shown an amazing ability to learn and adapt.

This is perhaps the most instinctively collectivist society in the world. Everything must be done by consensus, and there is not yet a consensus on what changes Japan must make to restore its position. So on a macro level, Japan may continue to stumble toward a solution for a long time, with a sick banking sector dragging down growth levels. There appears to be little hope for a Resolution Trust type of package to put the current system out of its misery. When a solution does appear, it will be peculiarly Japanese and probably quite effective, but there is no sign of a public policy consensus anytime soon.

But on a micro level, there are signs of life. In 1995, two Japanese companies bought back their stock. In 1996, 12 companies did. Last year, 117 announced stock buybacks. Several Japanese companies are reducing the size of their Boards of Directors, and some are even appointing outsiders. An increasing emphasis on return on equity is apparent from a reading of recent Japanese annual reports and our meetings with Japanese managers.

Modest stock option plans have been introduced by a number of Japanese companies. Deregulation is taking place everywhere in Japan. This is one of the most highly regulated societies in the world, and the red tape is coming off, though slowly. Indeed, the scope of deregulation in Japan is so comprehensive that we see it as a sort of slow motion revolution. In banking, insurance, retailing, health care and telecommunications, to name only a few sectors, the old system is dying, and a new one has yet to take shape. But the new system will be more market driven than the old one; that is for certain.

The Japanese are among the world's great savers. They have the world's largest pool of liquid savings in bank accounts earning microscopic yields because they are only interested in return of capital, not in getting competitive returns on capital. Japanese liquid savings, including pension funds, amount to over US$9 trillion, and only about 7% of those savings are invested in equities. In North America, almost everyone has exposure to the equity markets, either directly or indirectly. In Japan, almost nobody does. The army of potential equity buyers is huge, and it has a lot of ammunition. The mutual fund industry is tiny, though that will change with Fidelity and Merrill Lynch about to enter the market.

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Japan is a neglected stock market. When we attended a Nomura conference, we were startled at the youth of many of the participants. On enquiring, we were told that Japan had been such a bad market for so long that new hires in money management firms were immediately given the Japan file by the previous rookie, who gratefully graduated to analyzing a market that sometimes went up. Most money managers have been underweighted in Japanese stocks for their entire careers, and for the last eight years that has been a good decision.

Japanese stocks are undervalued. One in eight Japanese stocks is a "net-net" – the classic Ben Graham investment, where if current assets were used to pay all liabilities, there would still be more cash per share left over than the current stock price. One in three listed stocks trades at a discount to book value. Dividend yields higher than the 10-year bond yield (admittedly a tiny 1.5%) are common.

CONCLUSION: BUY

Value only appears when things look bleak, and things look very bleak in Japan in early 1998. We think that the overwhelming pessimism with which Japan is viewed presents an opportunity. The contrast to North American markets could not be greater. Mr. Market is manic on America and depressive on Japan. Given a clear choice between the North American markets (where conditions are ideal for equity investors) and Japan (where problems are so very evident), most people would not hesitate to invest in America. Yet it is the prospect of improvement that ultimately drives equity prices, and how much better can it get in the U.S.?

The risks in Japan are short term, and they may be substantial. A real old-fashioned financial crisis could lead to very poor short-term stock market performance. A weakening yen could exacerbate the situation. But to some degree, these risks are known and discounted in stock prices. And a crisis may actually give rise to the consensus that is necessary for action in Japan and that has so far eluded the country.

Japan's great strengths are being overlooked, and its weaknesses exaggerated. Value plus neglect equals opportunity. Japan is a buy. ■

This issue of The **VIEW** *from* **BURGUNDY** *was written by Richard Rooney, FCPA, FCA, CFA*

Date of publication: March 1998

ENDNOTES

i. Laval, Pierre. Address to the Chamber of Deputies. 1944.

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