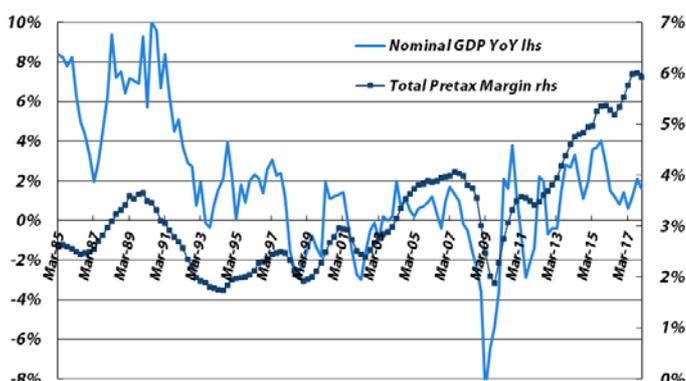


JAPAN'S "SHOW ME THE MONEY" CORPORATE GOVERNANCE

Last night's release of the fourth quarter data on aggregate Japanese corporate profits showed a continued pause in our long-term theme about improving corporate governance. The overall corporate pre-tax profit margin fell slightly from its record highs (nearly double the level of the 1989 bubble period), but that for non-financials mysteriously sank a bit further.

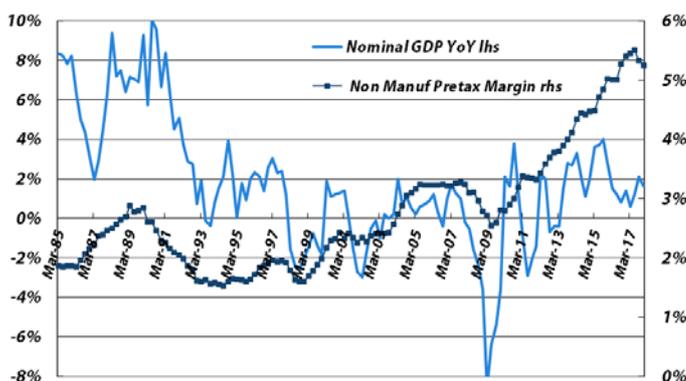
Four-quarter Average Pretax Profit Margin vs. Japanese Nominal GDP YoY Growth

(for all non-financial companies, not just listed ones)



Sources: Japan Ministry of Finance, Bloomberg, data through CY4Q17

Non-manufacturers (excluding financials):



Sources: Japan Ministry of Finance, Bloomberg, data through CY4Q17

The latter fact is noteworthy, as it has not occurred since the Lehman shock. It is all the more surprising because the recent earnings season was very good, even for non-manufacturers. That said, this data covers unlisted firms, which may be suffering from higher labor costs and shortages of labor inputs, and non-manufacturers are more labor-intensive than manufacturers. Notably, on a four quarter average, non-manufacturers' profits continued to rise 5% YoY, the same as

for the past few years. Also, another positive note is that the high overall profit margin indicates that manufacturers expanded profit margins dramatically in the quarter.

We are skeptical that this is the beginning of a downturn in overall profit margins, although it seems likely that non-manufacturers' will plateau for a while. Given that their profits are 50% larger than manufacturers, it will be also difficult for overall profit margins to rise. Another important point is that if the Yen remains near 110 and the global economy continues to be strong, profit margins do not need to rise from their high level in order for profits to increase. The overall theme of the "Show Me the Money" corporate governance improvement that I have long-highlighted on Japan remains intact and that the profitability message has actually been understood by most Japanese corporates for over a decade. This is shown by the divergence in the profit margins from the GDP growth trend in the charts above, showing that even though GDP growth has remained subdued, profit margins have surged.

Since the early 2000s, Japan has embarked on major rationalizations in most industries, with the number of players usually reduced from seven down to three or four. The fruits of this restructuring were slower to ripen than in Western world examples, and they were hidden by a series of crises (the Global Financial Crisis of 2008-2009, the strong Yen period of 2009-2012, the 2011 severe Thai floods that halted a large amount of auto and electronics production, several periods of political turbulence with China that included boycotting many Japanese goods and, of course, the tsunami/nuclear crisis of 2011), but since Abenomics began, the global backdrop for Japan has been stable and there have been no domestic crises, thus allowing these fruits to ripen.

One should also note that the Ministry of Finance statistics cited in this report do not cover post-tax income, and due to recent corporate tax cuts, the overall net profit margin (excluding extraordinary write-offs) has expanded even more sharply than the pre-tax data shown above, thus "showing the money" to shareholders to a very large degree through dividends and share buybacks. In my view, Japan is the only major country that is going through a structural improvement in corporate governance, and, thus, deserves special attention by global investors.

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