Daiwa Securities

Special Report

Japan
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Japan Back in Form: Abe's Three Arrows Catalysts for Change

- PM Abe's three arrows: bold monetary easing, flexible fiscal policy, growth strategy to spur private-sector investment
- Japan's energy problems
- Sino-Japanese relations a notable risk factor

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7th Daiwa Investment Conference Tokyo on 4-8 March

Over 300 firms, mostly from Japan/other parts of Asia, to participate; record number of overseas institutional investors expected. We hope this report helps to deepen the understanding of investors coming to the conference.

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Introduction

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Weaker yen provides massive boost to profit, market cap

Changes since mid-Nov 2012

The yen depreciated by Y13/$ between 14 November 2012, when former Prime Minister Yoshihiko Noda announced the dissolution of the lower house, and 22 February 2013. The aggregate market cap of the 210 firms in the Daiwa Universe rose by Y58 trillion over the same period. We estimate that such a correction of the strong yen would boost aggregate recurring profit of 200 (excl. financials) firms in our universe by Y3.2 trillion in FY13 (based on each firm's sensitivity to currency rates [dollar and euro] multiplied by changes in those rates vs. the yen).

Firms with fiscal years ending March had all announced 3Q FY12 results by mid-February. While currency rates and share prices had marked meaningful changes, equity analysts noted that other fundamentals had not altered significantly.

Meanwhile, the second Abe Cabinet has gotten off to a good start. The Bank of Japan has introduced a 2% inflation target and the government has made clear its intention to elect a proponent of reflation to lead the central bank. The Cabinet also achieved its aim of drawing up a supplementary budget for FY12 and a general budget for FY13 by January. Moreover, at a Japan-US summit meeting held on 22 February, Mr. Abe reconfirmed the importance of the Japan-US alliance and laid the groundwork for Japan to join negotiations for the Trans-Pacific Partnership free trade arrangement.

What's in this report

This report draws together the views of Daiwa Securities Group researchers in a wide range of areas. We explore the Abe administration's so-called three arrows, its three-pronged approach to economic policies, namely aggressive monetary easing, flexible fiscal policy, and economic growth strategies to encourage private-sector investment. We also look at the energy problems facing Japan, as well as Japan's relationship with China, which is a focal risk factor.

For end-2013, our strategist Kazuhiro Miyake forecasts a Nikkei Stock Average of 13,200 based on Y90/$, or 15,300 based on Y100/$ (page 5). Strategist Yuji Kameoka thinks the yen-dollar rate could reach Y100/$ within FY13 (page 8). Strategist Makoto Morita and our analyst team forecast aggregate FY13 recurring profit growth of 33% y/y based on Y90/$, or 45% based on Y100/$ (page 9). An update of Daiwa's top picks is provided in the appendix (page 33-34).

Government back in action, private sector to join in

The government has sprung back to life, hammering out a rapid succession of measures to revive the economy, end deflation, and correct the strong yen. These policies are designed to breathe life back into the corporate sector. As a result, we expect corporate sector performance to improve and Japanese firms to return to a sustainable growth trajectory.

Abe gov't aims to end deflation, strong yen; Japan shares could reverse prolonged bear trend

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Deflation, strong yen hurt Japan's economy

We believe the Japanese stock market has been in a bull trend since June 2012 despite lingering doubts among market participants. TOPIX fell 75.9% from the all-time high in December 1989 to the recent serious low in June 2012, a bear market of 22 years and six months. Has anything changed in the environment surrounding the Japanese stock market? Japan has endured a sluggish economy and stock market for two decades, often referred to as the "lost 20 years," which is often attributed to deflation, or a vicious circle of deflation and yen appreciation. The biggest difference now is that the BOJ has shifted from policies that allowed deflation and yen appreciation to those aimed at ending them. These include the introduction of an inflation target of 2%, partly due to strong pressure from the new administration, led by Shinzo Abe.

Deflation in Japan has persisted for 15 years since 1998. The deep-seated expectation that the yen will continue to appreciate has caused Japanese firms to keep a lid on wages and employment in order to stay competitive against overseas rivals. A strong yen has also caused import prices to decline, which has led to a drop in prices in general. Japan has been trapped in a vicious cycle in which the decline in prices squeezes corporate earnings, forcing firms to cut wages and employment. This has led to reduced household income, driving down domestic prices further. Moreover, the loss of export competitiveness due to a strong yen has caused exports and capex to shrink, hurting corporate earnings and depressing GDP. For Japan to end deflation, the yen needs to weaken and oversupply needs to be corrected. In this context, we believe the BOJ's monetary policy holds the key.

Abe's anti-deflationary, reflationary policy

The previous DPJ government emphasized consumer interests and wealth distribution policies such as expanding social security, rather than creating wealth (economic growth). In contrast, the new Abe administration launched in December 2012 focuses on businesses/economic growth. With economic recovery and end to deflation at the fore (so-called Abenomics), the government intends to pursue (1) aggressive monetary easing (subsequently achieving weaker yen), (2) increased public spending centering on social infrastructure, and (3) other measures to promote economic growth such as deregulation and opening up the country. Of these, we believe monetary easing is particularly important. The administration has persuaded the BOJ to adopt a 2% inflation target and introduced a system to check results of BOJ policy through the Council on Fiscal and Economic Policy. Looking at the upcoming appointment of a new BOJ governor and deputy governors (between late Feb, mid-Mar), we believe the government will move to appoint dovish candidates who will strive to achieve the inflation target. The new BOJ leaders will probably take aggressive easing measures (significant expansion of balance sheet) to achieve the target, as they would be blamed if the target were not met. We think such aggressive measures by the BOJ will prompt a rise in the expected inflation rate and a decline in the expected real interest rate, leading to yen depreciation and stock rallies. This would improve corporate and household balance sheets, leading to a turnaround in sentiment in both sectors (wealth effect). In addition, a weaker yen would help increase exports, resulting in greater domestic production/capex and improved corporate earnings. As a consequence, wages and household income would probably rise and consumer spending increase. Meanwhile, for increased public spending centered on social infrastructure, the government has compiled a 15-month budget aimed at boosting the economy. This is comprised of a large supplementary budget for FY12 amounting to Y13.1 trillion (Y10.3 tril excl. portion that does not lead to increased production) and an FY13 budget. Additionally, a basic economic policy to be announced around June will likely outline a medium/long-term plan for reviving Japan's finances. The government will also likely move toward opening up the country, working to join the Trans-Pacific Strategic Economic Partnership (TPP), and expanding Japan's free trade agreements. The Abe administration aims to achieve the three policies in rapid succession by gaining market support for its speed and the ability to deliver.

Skeptical investors, future key events

Many investors are doubtful about the sustainability of the latest upswing in the Japanese stock market, which has remained weak for 22 years. In particular, overseas investors, who have a large sway on the Japanese market and are traditionally long-term investors, still seem unconvinced that Japanese stocks have reached a major turning point as the Japanese government and the BOJ have disappointed them in the past. However, the following three events could help improve their confidence.

First is the appointment of the next BOJ governor and deputy governors, expected between late February and mid-March. The government is likely to nominate Asian Development Bank President Haruhiko Kuroda as the governor, and Gakushuin University Professor Kikuo Iwata, and BOJ Assistant Governor Hiroshi Nakaso as the deputy governors. Since the new governors need to be approved by both Diet chambers, focus will be on whether and how the ruling parties (LDP, New Komeito), which do not have a majority in the upper house, will gain support from opposition parties. Mr. Kuroda and Mr. Iwata are representative figures advocating inflation targets and aggressive monetary easing. Approval of these appointments should boost the viability of the Abe administration's reflationary policy.

Second is the release of FY12 corporate results and FY13 earnings outlooks, from late April through early May. The extremely strong yen is correcting, while China's economy increasingly appears to be seeing a cyclical recovery, the worst of Europe's sovereign debt crisis seems to have passed, and the US economy could recover faster than expected if it can deal with the fiscal cliff. FactSet consensus estimates call for a rapid improvement in Japanese firms' earnings. For FY13, TOPIX constituents' EBIT and EPS are estimated to rise around 20% and 40% y/y, respectively—this currently ranks Japanese firms' EBIT among the highest of major nations' companies, and EPS is by far the highest (Chart 1). Notably, profit growth far exceeds that for European and US firms. Moreover, Japanese firms' current estimates probably assume roughly Y85/$. If this were revised to the current Y90-94/$, estimates could be raised sharply. This looks set to be a major trigger to increase domestic and foreign investor confidence in the turnaround of Japanese firms.

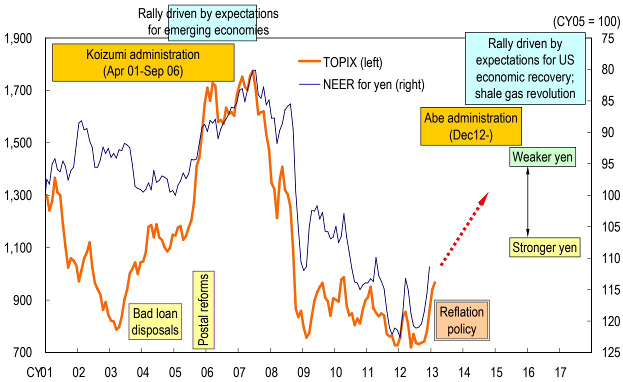
■ **Chart 1: Corporate Earnings Outlook by Country— Japan Likely to See Highest EPS Growth in FY13**

	Sales		EBIT		EPS	
(y/y%)	FY12	13	12	13	12	13
TOPIX	1.8	3.5	0.5	22.3	18.4	40.3
MSCI Japan	1.6	3.5	0.4	23.2	17.7	43.3
MSCI USA	2.1	3.4	3.0	7.0	7.0	7.9
MSCI Germany	5.1	1.8	9.3	3.9	8.1	2.9
MSCI France	3.3	0.6	-2.3	8.7	-13.9	20.2
MSCI Italy	10.7	-0.3	8.6	-1.9	10.2	8.0
MSCI United Kingdom	-1.1	1.3	-9.1	2.5	-4.8	5.8
MSCI Hong Kong	6.1	8.5	10.7	12.9	-10.1	7.7
MSCI Singapore	9.9	8.0	-2.3	4.6	5.4	-2.9
MSCI China	9.0	10.5	-2.0	11.6	-0.4	11.4
MSCI India	14.0	9.2	11.4	15.2	10.8	13.7
MSCI Indonesia	10.9	10.4	3.2	9.1	6.4	13.3
MSCI Korea	9.5	6.0	10.1	22.7	11.5	20.5
MSCI Malaysia	5.5	5.0	4.6	9.3	6.7	7.1
MSCI Philippines	18.5	9.9	9.4	11.5	11.7	11.6
MSCI Taiwan	7.3	6.6	8.6	27.6	1.0	28.3
MSCI Thailand	15.2	5.1	6.0	14.7	13.8	14.6

Source: FactSet; compiled by Daiwa.
Note: FactSet consensus forecasts as of 25 Feb 2013.

Third is the upper house election in July. We are focused on whether Mr. Abe and the LDP can claim victory and end the Diet deadlock. If they do, the government will be able to implement "Abenomics" more smoothly. One barometer of the Abe administration's popularity is the Cabinet approval/disapproval rating in public opinion polls. Recent newspaper polls show the Abe Cabinet's approval rating at a lofty level of around 70%. The strong thumbs-up seems to stem from Mr. Abe urging the BOJ for further monetary easing and other changes in its policies, yen depreciation, improved economic sentiment, and higher stock prices. If the Abe administration's reflationary policies succeed in ending deflation and weakening the yen, shares could rally more sharply than during the Koizumi administration, a period deemed by the stock market as the most successful in the last two decades in terms of policies (Chart 2).

■ **Chart 2: Yen's Nominal Effective Exchange Rate and TOPIX**



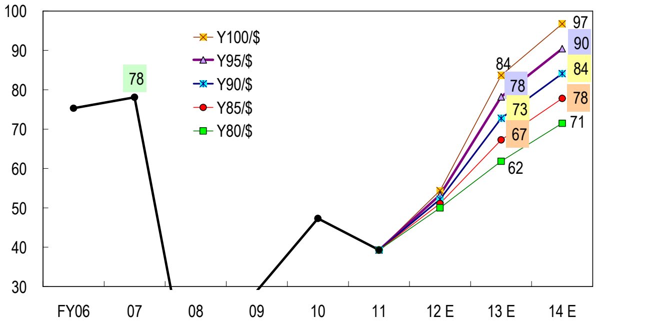
Source: BOJ, Bloomberg; compiled by Daiwa.

Bullish market starts under skepticism

- Assuming Y90/$, we forecast EPS of 81 for 2014 (73 for FY13, 84 for FY14), end-2013 TOPIX of 1,100, and Nikkei Stock Average of 13,200.
- Assuming Y95/$, we forecast EPS of 87 for 2014 (78 for FY13, 90 for FY14), end-2013 TOPIX of 1,190, and Nikkei of 14,300.
- Assuming Y100/$, we forecast EPS of 93 for 2014 (84 for FY13, 97 for FY14), end-2013 TOPIX of 1,275, and Nikkei of 15,300.

Buying interest tends to center on just a handful of winners amid yen appreciation and deflation. In contrast, yen depreciation and an end to deflation would make market drivers out of not only exporters and foreign demand-driven firms (automakers, tire and other automotive names, robot and other capital goods makers, and key component and advanced material manufacturers). Drivers from domestic demand-oriented sectors would include financials and real estate. Yen depreciation could also revive sectors and firms that were thought to be close to failing due to erosion of competitiveness.

■ **Chart 3: TOPIX-based EPS Forecasts by Currency Rate Scenario**



Source: Compiled by Daiwa.
E: Daiwa estimates.

Retail investors may shift from selling on strength to net purchases

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Trading by retail investors soaring

Retail investors appear to have returned to the stock market. As the market has rallied, their gross turnover has soared, maintaining an uptrend since the final week of November 2012 (Chart 1). Many entries or returns were likely made by retail investors who had been steering clear of the stock market. The winter 2013 edition of the Japan Company Handbook (released Dec 2012) has already sold out, with sales roughly 50% higher than for the previous edition. The handbook, which is issued quarterly, outlines all listed companies' business activities, shareholder compositions, and earnings trends, and is considered an essential tool for stock investment. Meanwhile, margin trading regulations were relaxed in January 2013. Trading by retail investors will probably become even more vigorous as the regulatory reforms gain wider recognition.

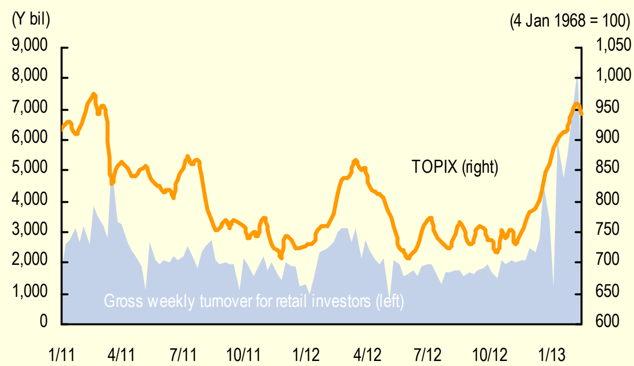
Buying on par with selling after having lagged earlier

As shown in Chart 2, more subtle trends emerge when equity market turnover is analyzed on a net basis. Although TOPIX entered a sharp rally from mid-November 2012, retail investors remained net sellers through the end of the year. The market's sharp recent gains probably led to severe selling pressure initially, with investors tempted to take profits after having observed a prolonged period of weakness. However, purchases and sales have been roughly even since January 2013. We have recently sensed greater enthusiasm among investors, as evidenced by a string of fully booked conferences for retail investors at Daiwa since the start of 2013. Furthermore, there have been many seminars at which the attendance rate among applicants has risen from 60-70% to more than 90%. Participants' attitudes also appear to have changed, with a significant number taking notes while listening intently, even at mid-day seminars held at our regional branches on weekdays.

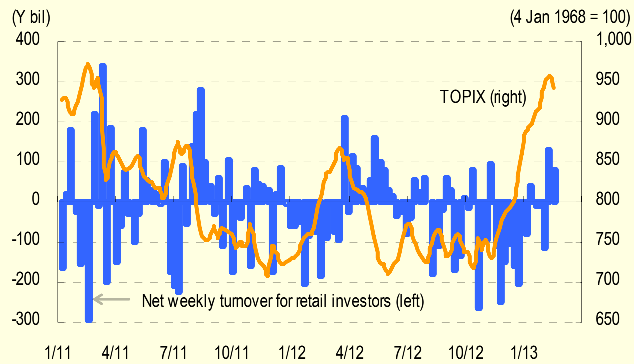
Might finally shift to net purchases

In the week of 4-8 February 2013, retail investors net bought Y129.5 billion in shares, representing their highest weekly net purchase since the week ended 11 May 2012. The following week also saw a high level of net purchases (Chart 2). The ratio of net aggregate unrealized gains to total open long margin positions remained in negative territory from early 2006, but has picked up rapidly following the market's recent rally. By mid-January, the ratio had moved into positive territory, suggesting improvement in investor sentiment. There have also been visible changes in stock selection by retail investors. Sectors such as electrical/electronics and electric utilities were popular through end-2012, as investors apparently targeted potential rebounds in sectors that seemed oversold. Since January 2013, transactions have been centered on fields such as securities, automobiles, and megabanks, indicating heightened confidence in recent trends such as the market rally, yen depreciation, and an economic recovery. Meanwhile, many investors have sought new market stocks in fields such as online games, iPS cells, and Euglena products. Retail investors, who jointly hold about Y1,500 trillion in financial assets and whose stock selection has become increasingly diverse, could remain net buyers for some time.

■ Chart 1: Gross Equity Market Turnover for Retail Investors



■ Chart 2: Shift to Net Purchases for Retail Investors



Source: Tokyo Stock Exchange (TSE); compiled by Daiwa.
Note: Turnover for retail investors based on combined total for 1st and 2nd sections of Tokyo, Osaka, and Nagoya stock exchanges.

Monetary easing and currency rates

Yen to weaken to Y100/$ on BOJ easing, risk seeking, higher interest rates overseas

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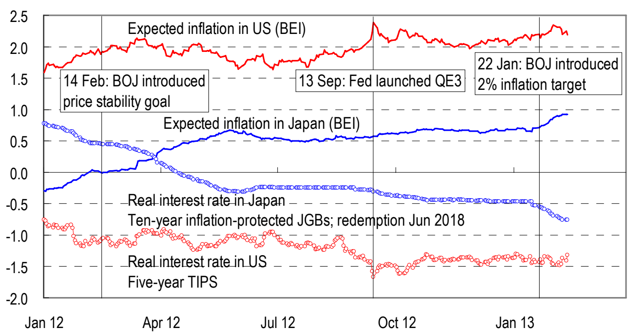
BOJ monetary easing to weaken yen over medium/long term

Monetary easing measures implemented by the BOJ should serve to weaken the yen over the medium to long term. Going forward, while the BOJ intends to increase asset purchases from the second half of this year through next year, the Fed could reduce or cease its asset purchases. The yen's monetary base would rise more than the dollar's as a result, which would be a factor to weaken the yen. In addition, expected inflation is rising in the US. Over the medium/long term we see expectations for a Fed rate hike and higher real interest rates increasing if inflation exceeds 2.5%, one of the conditions for the Fed to end its low interest rate policy.

Meanwhile, although Japan's expected inflation rose after the BOJ adopted a 2% inflation target, the country's inflation is still a long way from hitting the target. Japan's inflation and the outlook for it are unlikely to rise quickly. As a result, expectations for the BOJ to hike its key rate are also unlikely to increase for a long time. Real interest rates are likely to stay low amid expectations for monetary easing to continue. Japan has implemented monetary easing for longer than other countries. Its relatively low real interest rates should fuel yen depreciation over the medium/long term.

■ Chart 4: Expected Inflation in Japan, US and Real Interest Rates (%)



Source: Thomson Reuters; compiled by Daiwa.

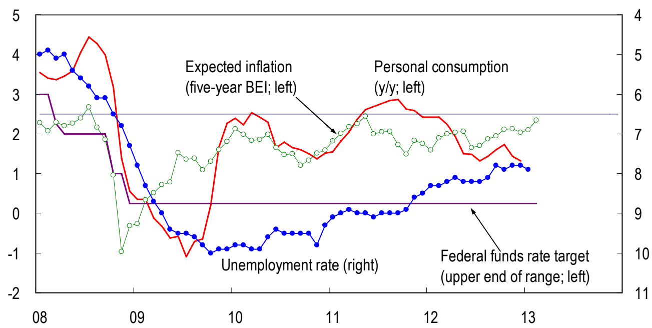
We think expectations for BOJ monetary easing policies are unlikely to increase over the short term. The BOJ has adopted a 2% inflation target. However, recent asset purchases are only on track to reach the amount slated for the first half of 2013, and we think it may be difficult to significantly expand purchases given that the central bank is in some cases failing to draw sufficient offers from financial institutions for its purchases. In addition, in light of overseas calls to restrain yen depreciation, we do not envision announcements of new measures to step up monetary easing for the time being. The yen could strengthen briefly as expectations for monetary easing policies peak out.

Risk seeking and higher overseas interest rates to work to weaken the yen

Yen depreciation has fueled a rally in the equity market on expectations for earnings of Japanese firms to improve. However, stock prices have also risen globally, not only in Japan. The causes of yen depreciation were mostly expectations for government and BOJ policies, but the risk-seeking moves seen in global stock markets likely also played a part. The low-yielding yen tends to be sold off heavily amid risk seeking, resulting in the yen weakening vs. major currencies. Key for the yen is whether or not risk seeking and expectations for a global economic recovery continue.

On that note, we highlight that policy effects are starting to emerge in the global economy. Expectations for an economic recovery in 2013 have spurred risk seeking and a rise in overseas interest rates, and these factors have worked to weaken the yen. An unemployment rate of 6.5% is one of the conditions for the Fed to end its low interest rate policy, and the rate seems likely to reach this level in 2014, which is earlier than previously expected. An improvement in economic indicators would push market interest rates higher in the US, and a reduction in asset purchases by the Fed in the second half of 2013 would further accelerate the rise in interest rates. Overall, the rise in risk tolerance has so far been limited as interest rates have fallen (bond prices risen) alongside rising stock prices. Going forward, however, we expect risk tolerance to rise further as a strengthening economic recovery pushes interest rates as well as stock prices higher.

■ Chart 5: Expected Inflation in US and Unemployment Rate (%)

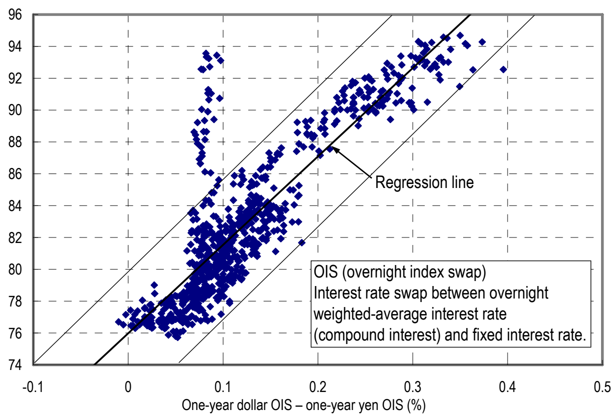


Source: Thomson Reuters; compiled by Daiwa.

Rate could reach Y100/$ in FY13

Expectations for the yen to weaken vs. the dollar tend to trigger greater yen selling and less dollar selling at times when risk appetite is healthy. Healthy risk appetite tends to result in the yen being sold off heavily, rather than currency selling being spread across the dollar and yen. Yen crosses and the yen-dollar rate alike are thus easily swayed by risk tolerance. Going forward, we expect overseas interest rates to rise amid risk seeking. However, we see the yen weakening more vs. the dollar than in the past few years when US interest rates rise. We think the rate could reach Y100/$ in FY13. We also expect the yen to weaken across the board, including vs. the euro and won.

■ **Chart 6: Japan-US Interest Rate Differential and Y/$ Rate**



Source: Thomson Reuters; compiled by Daiwa.
Note: Based on data from 4 Jan 2010 through 12 Feb 2013.

■ **Chart 7: Outlook for Exchange Rates** (Y)

	Actual 2012 End-Sep	End-Dec	Our estimates 2013 Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	2014 Jan-Mar
$	77.9	86.1	90.0	92.0	95.0	98.0	99.0
			86-95	87-95	89-97	92-100	94-102
€	100.2	113.9	120.0	123.0	129.0	135.0	137.5
			113-128	114-129	119-134	123-138	125-140
A$	80.9	89.4	92.5	95.5	99.5	104.0	106.0
			89-98	89-99	92-102	96-106	98-108
C$	79.2	86.5	89.5	92.0	96.5	101.0	103.0
			86-95	86-95	89-99	93-103	95-105
NZ$	64.6	70.7	74.5	77.5	80.5	84.0	86.0
			71-80	71-81	73-83	76-86	78-88
Won (per 100 won)	7.00	8.10	8.25	8.60	9.05	9.50	9.80
			8.0-8.8	8.0-9.0	8.3-9.3	8.7-9.7	9.0-10.0
Turkish lira	43.4	48.2	50.5	52.5	54.5	57.0	58.0
			48-54	49-55	51-57	53-59	54-60
South African rand	9.4	10.2	10.0	10.6	11.3	12.1	12.5
			9.6-10.8	9.7-10.9	10.3-11.5	11.1-12.3	11.6-12.8
Brazilian real	38.4	42.1	45.0	47.0	50.0	53.0	55.0
			42-48	43-49	46-52	49-55	51-57
Yuan	12.4	13.8	14.4	14.8	15.5	16.1	16.4
			13.8-15.1	13.9-15.2	14.4-15.7	15.0-16.3	15.4-16.7

Source: Compiled by Daiwa.
Notes: 1) Actual figures based on midday rates in New York.
2) Estimates for end of quarter on top line, range during quarter on bottom line.

Impact of monetary easing and weak yen on corporate earnings

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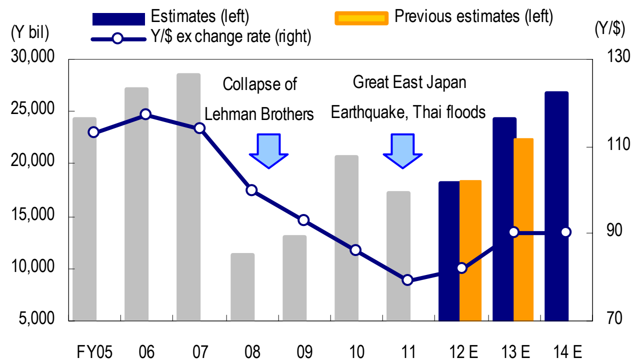
Monetary easing—part of the Abe administration's three-pronged economic reform program—is causing the yen to weaken and Japan's expected inflation rate to rise. Japanese companies have for some time struggled in the face of deflation and yen appreciation. The government's presentation of policies for addressing these two major issues represents a significant step forward, and has brightened the outlook on corporate earnings. Japanese companies have faced many challenges since the Lehman crisis, including yen appreciation, the Great East Japan Earthquake, flooding in Thailand, and a global economic downturn. We think corporate earnings will finally enter a period of meaningful growth in FY13, backed by the yen's retreat from historically strong levels.

■ **Chart 8: Aggregate Recurring Profit for Daiwa 200 Firms**



Source: Compiled by Daiwa.
Notes: 1) Current estimates as of Mar 2013; previous estimates as of Dec 2012.
2) Y/$ rates for FY12 and beyond based on our current assumptions.
E: Daiwa estimates.

See sharp profit growth in FY13

For major firms under our coverage (Daiwa 200), we forecast y/y growth in aggregate recurring profit of 5% for FY12, 33% for FY13, and 11% for FY14. We expect profit to surge in FY13 on an additional boost from yen depreciation, along with benefits from earlier restructuring and cost-cutting efforts. Our estimates assume Y90/$ and Y120/€, implying upside if the yen weakens further going forward. We estimate that each Y1 depreciation against the dollar or euro would lift aggregate FY13 recurring profit by 0.9%. Sensitivity to currency movements would be high for companies with business models centered on producing in Japan and exporting from Japan, including players in the automobiles, machinery, precision instruments, and electronic components sectors.

■ **Chart 9: Currency Sensitivity of Daiwa 200 Firms** (Y bil)

	Rec profit	Boost to rec profit from Y1 yen depreciation		
		% of rec profit	$	€
	(A)	(B + C) / A	(B)	(C)
FY13 E				
Daiwa 200	24,191	0.9	177	45
Excl. electric & gas utilities	24,141	1.0	190	45
Manufacturers	15,065	1.4	169	41
Basic materials	2,263	0.5	11	1
Assemblers	9,046	1.8	129	38
Other	3,757	0.9	30	2
Non-manufacturers	9,125	0.1	8	5
FY14 E				
Daiwa 200	26,766	0.8	179	47
Excl. electric & gas utilities	26,231	0.9	183	47
Manufacturers	16,677	1.2	163	42
Basic materials	2,498	0.5	11	1
Assemblers	10,095	1.6	126	39
Other	4,084	0.7	26	3
Non-manufacturers	10,089	0.2	17	5

Source: Compiled by Daiwa.
E: Daiwa estimates.

Weak-yen benefits to vary among firms

Currency sensitivity reflects direct weak-yen benefits, including boosts to overseas earnings and improved margins on exports. Going forward, one notable point will be the extent to which this factor is visible in Japan Inc's earnings performance. We think this will depend largely on companies' competitive environments and business strategies. Yen depreciation will likely lead to cost increases for companies that curbed promotional and personnel expenses or demanded price cuts from suppliers during earlier periods of yen appreciation. Meanwhile, price wars could partially offset weak-yen benefits in industries where competition is fierce. For companies whose competitive strength vs. overseas rivals is rising as a result of yen depreciation, we anticipate market share expansion and other benefits beside direct earnings boosts implied by currency sensitivity.

The weak yen scenario on Chart 10 shows recurring profit estimates assuming Y100/$ and Y130/€. Case 2 reflects direct earnings boosts implied by currency sensitivity, as well as other effects of yen depreciation, including cost increases and the expected impact of a greater competitive advantage. This Case 2 scenario calls for the Daiwa 200 to show y/y aggregate recurring profit gains of 45% and 10% for FY13 and FY14, respectively, more or less in line with what could be expected purely from currency sensitivity (Case 1). However, the Case 2 weak yen scenario shows an added boost beyond what is implied by currency sensitivity for the paper & pulp and steel sectors, which should see an improved competitive edge over overseas rivals. Meanwhile, machinery and precision instruments firms would likely see heated competition between Japanese businesses partially offset benefits from yen depreciation under Case 2.

■ **Chart 10: Earnings Outlook Assuming Yen Depreciation** (Y bil)

	FY13 E recurring profit								FY14 E recurring profit							
	Base case scenario (Y90/$; Y120/€)		Weak yen scenario (Y100/$; Y130/€)						Base case scenario (Y90/$; Y120/€)		Weak yen scenario (Y100/$; Y130/€)					
			Case 1			Case 2					Case 1			Case 2		
	A	Y/y	B	Y/y	B / A	C	Y/y	C / A	D	Y/y	E	Y/y	E / D	F	Y/y	F / D
Daiwa 200	24,191	33%	26,413	45%	9%	26,438	45%	9%	26,766	11%	29,026	10%	8%	28,969	10%	8%
Automobiles	4,872	32%	5,753	56%	18%	5,643	53%	16%	5,435	12%	6,276	9%	15%	6,220	10%	14%
Electrical/electronics	2,124	235%	2,532	299%	19%	2,480	291%	17%	2,401	13%	2,820	11%	17%	2,743	11%	14%
Machinery	1,020	21%	1,177	40%	15%	1,140	36%	12%	1,151	13%	1,317	12%	14%	1,272	12%	10%
Precision instruments	1,030	39%	1,249	68%	21%	1,185	59%	15%	1,109	8%	1,328	6%	20%	1,268	7%	14%
Steel	740	470%	725	458%	-2%	950	632%	28%	775	5%	760	5%	-2%	977	3%	26%
Pulp & paper	75	23%	62	2%	-17%	125	105%	67%	109	45%	96	55%	-12%	139	11%	28%
Foods	1,176	12%	1,207	15%	3%	1,233	17%	5%	1,246	6%	1,284	6%	3%	1,335	8%	7%
Toiletries	218	10%	224	13%	3%	222	12%	2%	239	10%	246	10%	3%	244	10%	2%
Electric/gas utilities	50	Profit	-80	Loss	-	-80	Loss	-	535	970%	501	Profit	-6%	501	Profit	-6%

Source: Compiled by Daiwa.
Notes: 1) Case 1 reflects only currency sensitivity.
2) Case 2 reflects currency sensitivity plus impact of cost increases, greater competitive edge over overseas rivals.
E: Daiwa estimates.

Automakers well positioned to benefit from weak yen

Given their competitive advantage vs. overseas rivals, Japanese automakers are well positioned to benefit from yen depreciation. However, we think their recurring profit levels will only about reflect 70% of the direct boosts implied by currency sensitivity, as we expect competition to intensify in the domestic market, and promotional costs to increase after having been curbed when the yen was strong. Furthermore, Toyota Motor (7203) will probably see an end to one-off price cuts that it requested from its affiliated parts suppliers amid earlier yen appreciation.

Meanwhile, besides direct earnings boosts implied by currency sensitivity, automakers should enjoy volume growth on benefits from increased promotional spending. Furthermore, they will probably have greater flexibility in how they utilize their overall production setups, as yen depreciation translates to lower costs for domestic production bases relative to overseas locations, a positive given that domestic plants have been difficult to utilize due to their high costs. As such, earnings boosts from the weak yen could exceed expectations.

Significant benefits for electronic component makers

Yen depreciation should provide relatively direct profit boosts for electronic component makers such as Murata Manufacturing (6981) and Nitto Denko (6988). Both companies have successfully differentiated their products based on technological leadership, and should therefore see limited pricing pressure, even amid yen depreciation.

Machine tools, precision instruments sectors poorly positioned to benefit

Weak-yen benefits will probably be partially plowed back into making price cuts in the machine tools and precision instruments sectors. Yen depreciation could easily spark greater price competition in these sectors, as Japanese firms hold a large share of the market, meaning most major players will benefit from a weak yen. We also envisage significant pricing pressure in these areas, as some companies lifted wholesale prices amid earlier yen appreciation.

Meaningful benefits for steel, pulp & paper

By lifting competitive advantage vs. overseas rivals, yen depreciation should lead to improved business conditions for steel makers such as JFE Holdings (5411) and Nippon Steel & Sumitomo Metal (5401), and paper industry names such as Nippon Paper Group (3893). These firms have all suffered as their Korean and Chinese counterparts went on the offensive amid yen appreciation. However, imports have begun to slow as the yen has weakened.

With a domestic supply glut likely to ease significantly as imports fall, Japanese companies should enjoy merits from volume growth as well as price hikes. Higher raw material prices may trigger pronounced margin erosion over the short term, but we think meaningful earnings boosts will emerge thereafter.

Negative impact for domestic demand-oriented firms

Yen depreciation will likely weigh on earnings for power companies through higher fuel costs, and also suppress earnings for food and toiletries names, given their wide use of imported raw materials. Passing on higher costs to customers will be a key issue, but government policies largely determine the capacity for electricity rate hikes. With the planned consumption tax rate hike looming in FY14, we also think food and toiletries firms will struggle to pass on higher prices to customers over the short term.

Shift to inflation would benefit domestic demand-oriented firms

We are encouraged by budding positive signs (e.g., rise in expected inflation rate) regarding Japan’s efforts to reverse its deflationary trend. Prime Minister Shinzo Abe has requested that companies enjoying earnings improvement consider lifting employee remuneration levels. A wide range of industries (mainly domestic demand-oriented) will likely benefit if personal income levels rise on a meaningful pickup in corporate earnings from FY13.

Our main focus is on real estate prices. There have recently been signs pointing to an uptrend in prices, with increased appetite among REITs for real estate purchases, and rent hikes for prime Tokyo properties owned by Mitsui Fudosan (8801) and Mitsubishi Estate (8802). In our view, a marked rise in real estate prices would provide meaningful benefits in areas such as real estate, REITs, and the financial sector. The opinions of our financial and real estate sector analysts are outlined in the following section.

Impact on real estate, financials

Real estate

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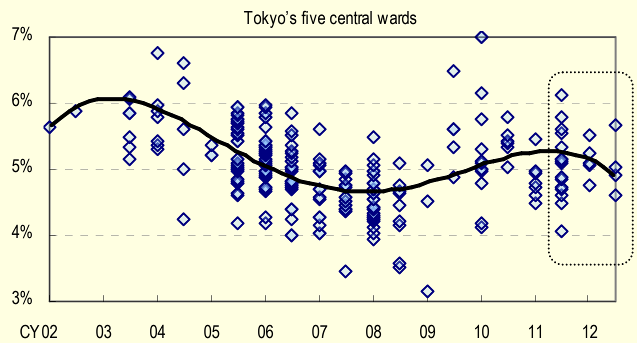
Expectations increasing for a rise in real estate prices in the Tokyo metropolitan area

We recommend a Positive stance on the real estate sector mainly in view of increasing expectations for a rise in real estate prices, especially in the Tokyo metropolitan area. With the large supply of new office buildings that hit the Tokyo market in 2012 having run its course, we expect the supply-demand balance for offices to improve from 2013. Going forward, we see asking rents ceasing their decline as the office building vacancy rate drops. Although we expect it to take a while before asking rents rise meaningfully, there has apparently been a sharp rise in demand for sophisticated buildings complete with earthquake resistance and other disaster prevention features since the Great East Japan Earthquake. Indeed, real estate investments appear increasingly attractive now that major developers have started to hike asking rents for some buildings seeing strong demand. Amid this backdrop, further monetary easing should support capital inflows to the real estate market. We see an increasing likelihood of real estate prices rising as a result.

We expect monetary easing to have a positive impact on the J-REIT sector as higher real estate prices boost the value of REIT properties. In real estate dealings, we are seeing signs of office building cap rates declining in the Tokyo metropolitan area. Indeed, we expect cap rates to decline meaningfully going forward, as REITs' appetite for real estate purchases has been increasing since the outset of 2013.

■ REIT Acquisition Cap Rate on Office Buildings



Source: Company materials; compiled by Daiwa.

Financials

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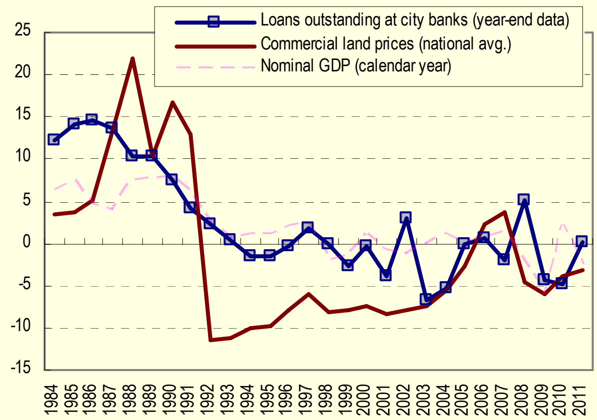
End to deflation via monetary easing would bring meaningful benefits

We recommend a Positive investment stance on the banking sector. We envisage upward earnings revisions for FY12 amid narrower equity impairment charges. We also expect many major banks to implement more aggressive programs to increase total shareholder payouts via dividend hikes and share repurchases in FY13. Banks are still trading at low price-to-book multiples vs. overseas financials and the broader market, and should play catch-up sooner or later. Furthermore, domestic lending operations should enter a profit growth trajectory if the new government succeeds in its pledge to end asset deflation (boost land prices), the economy expands, and long-term interest rates rise (see chart below). If profit growth expectations increase in view of this scenario combined with brisk overseas operations, major banks could garner attention as growth stocks, and P/E multiples could expand, as they did in FY04-06.

Increased liquidity through monetary easing should have a positive impact on earnings at securities companies, too, as equity market turnover increases and money shifts to risk assets.

■ City Bank Loans, Nominal GDP, Land Prices (y/y %)



Source: JOB, Ministry of Land, Infrastructure, Transport and Tourism, DIR; compiled by Daiwa.

Fiscal policies

Flexible fiscal policies

Masahiro Kushida

Flexible fiscal policies are a key part of the Abe administration's three-pronged approach to reinvigorating the economy. Along with an emergency economic stimulus package, the Cabinet has also approved a supplementary budget proposal for FY12 (on 15 Jan), a general budget for FY13 (29 Jan), and an outline of tax reform proposals for FY13 (29 Jan). As such, announcements of fiscal stimulus measures have likely run their course for the time being. The supplementary budget proposal became law after gaining approval of the upper house, where the ruling parties lack a majority, on 26 February.

The supplementary budget for FY12 and main budget for FY13 aim to provide fast-acting economic stimulus to spur meaningful expansion in public investment, which had been declining under the DPJ's shift in focus "from concrete to people." Meanwhile, the government is also aiming for fiscal discipline, with the total amount of new government bonds issued to be capped at a level below estimated tax revenue in FY13.

The outline of tax reform proposals for FY13 includes a net Y236.0 billion in tax reductions in the initial fiscal year (Y152.0 bil tax reduction in a normal fiscal year, as maximum individual income tax rate raised, basic exemption for inheritance tax reduced). Excluding items subject to emergency economic stimulus measures, the tax reductions should amount to Y237.0 billion in the initial fiscal year and Y333.0 billion in a normal fiscal year. The tax breaks are to be applied in areas such as housing and automobiles, where an increase in the consumption tax in April 2014 could trigger rush purchases prior to the tax hike and a pullback in demand thereafter. The proposals also include some steps that are clearly aimed at boosting the economy, such as measures to (1) encourage domestic capex, (2) boost corporate employment and increase labor's share of corporate income, (3) expand R&D tax credits, and (4) raise the deductible limit for entertainment expenses.

The Abe Cabinet has unveiled a number of plans for annual expenditure and revenue since its inauguration just over a month ago. Such plans are generally seen as prioritizing a near-term economic recovery with minimal painful cuts in expenditure prior to the upper house election (slated for July) and consumption tax hikes, the final decision on which will likely be made by the government six months prior to implementation. With little time to spare before the upper house election, it seems Mr. Abe is aiming to strike a delicate balance between boosting the economy, keeping his approval rating, and maintaining fiscal discipline. In other words, he has aimed for the best compromise in his policy mix.

Amid various constraints, the government appears to be focusing on (1) businesses ahead of family finances/ the public sector and (2) workers/the young ahead of the rich/the elderly. Mr. Abe seems to be hoping that a revitalized economy will trigger increased corporate sector investment and higher wages, leading to a more motivated working population with higher income. At the same time, the intent appears to be to encourage the wealthy and corporations to spend more to further stimulate the economy. The upper house election in the summer will be followed by a final decision on the consumption tax hike. In the second half of this year, therefore, we expect debates to heat up over revising the tax system and adopting a more proactive policy mix, including budget, as Japan moves from its currently delicately balanced compromise toward FY14 and beyond.

■ **Chart 11: Main Expenditures in FY12 Supplementary Budget, FY13 Budget** (Y bil)

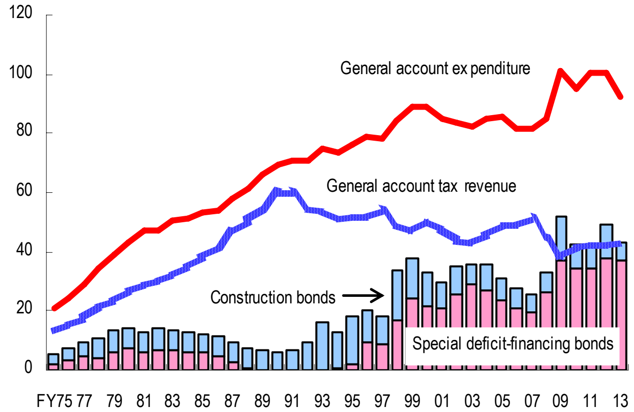
FY12 supplementary budget	13,105.4
Post-quake reconstruction and disaster prevention	3,788.9
Creation of wealth through growth	3,137.3
Ensuring a sense of security in daily life and revitalizing the regions	3,102.4

FY13 budget	92,611.5	2.5%
Social security	29,122.4	10.4%
National tax revenue grants to local governments	16,392.7	-1.2%
Defense	4,753.8	0.8%
Public works	5,285.3	15.6%
Debt servicing	22,241.5	1.4%

Source: Ministry of Finance; compiled by Daiwa.
Note: Percentages indicate chg. vs. initial FY12 budget.

Based on the current FY12 supplementary budget and FY13 budget, outstanding long-term debt issued by the central and local governments should amount to Y977 trillion at end-FY13, which is around 200% of GDP. Like the previous DPJ administration, the LDP-New Komeito coalition aims to trim the primary deficit in half (expressed as a percentage of GDP) vs. the FY10 level by FY15 and turn it to a surplus by 2020. In our view, along with calling upon the BOJ to explain the route to ending deflation, the government should explain by itself how it intends to achieve these aims before the market grows tired of waiting. Recent conditions suggest realizing these targets will not be easy.

■ Chart 12: Tax Revenue, Expenditures, JGB Issuance (Y tril)



Source: Ministry of Finance; compiled by Daiwa.
Note: Actual figures through FY11, budget proposal incl. supplementary budget for FY12, government's plan for FY13.

Public investment/post-quake reconstruction and social security occupy heavy weightings in annual government expenditure. Below we introduce the opinions of our analysts covering affected industries, namely Hideaki Teraoka (construction and real estate) and Katsuro Hirozumi (healthcare).

The opinions of our analysts regarding the FY13 tax system reforms are shown on page 17.

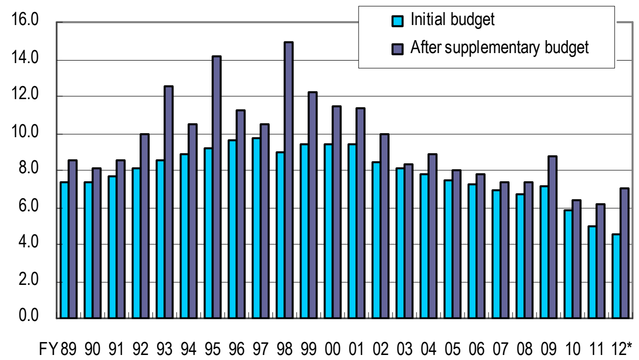
Revival of public works and the construction sector

Hideaki Teraoka (81) 3 5555-7127 (hideaki.teraoka@daiwa.co.jp)

Public works spending to rebound

We recommend a bullish stance on the construction sector, given the heightened possibility of public works projects, which have been on a slide, reversing course under the Abe administration. Including the supplementary budget, central government spending on public works totaled Y6,200 billion in FY11. In FY12, the government has set aside another Y2,400 billion toward public works in the supplementary budget. Combined with the initial budget, the total for that year should reach Y7,000 billion (Chart 13). Public works spending looks set to bottom out and rebound after having remained on a downtrend since peaking in FY98.

■ Chart 13: Central Government Spending on Public Works (Y tril)



Source: Cabinet Office, Ministry of Finance; compiled by Daiwa.
** FY12 levels based on draft budget.*

Aiming to strengthen infrastructure, boost economy by focusing on public works

We suspect that there are two main aims behind the new administration's focus on public works. The first is to make Japan more disaster-proof, mainly through infrastructure redevelopment aimed at preventing disasters. The country's aging social infrastructure (roads, tunnels, bridges, ports, dams, etc.) was a widely acknowledged problem, even before the Great East Japan Earthquake. This is because it is generally considered necessary to upgrade or replace concrete structures within 50 years of their construction, and much of Japan's social infrastructure is now approaching its replacement period after having been built in rapid succession during a period of sharp economic growth (Chart 14). However, public works have until recently been a target for cutbacks in the national budget, following criticism of reckless spending on construction of infrastructure that was barely needed, and deterioration in fiscal health at both the local and central government level.

■ Chart 14: Aging Social Infrastructure

Structure	Number	Age data
Tunnels	8,534	18% were 50+ years old in Apr 2009. 46% in 20 years.
Quays	560 km (length)	5% with depth of 4.5+ m were 50+ years old in FY09. 48% in 20 years.
Dams	494	5% were 50+ years old in 2007. 35% in 20 years.
Elementary & junior high schools	31,723	70.7% were non-timber structures 25+ years old in May 2010 (area basis)

Source: Ministry of Internal Affairs and Communications; compiled by Daiwa.
Note: Figures for infrastructure managed by central/local government bodies.

That said, public demand for disaster prevention measures soared after the earthquake. With the noted possibility that the Nankai Trough could produce a massive quake in the not-too-distant future, policies regarding redevelopment of social infrastructure are being revised. Examples of this include the LDP's election pledge to completely revamp social infrastructure, and the New Komeito's insistence on a "new deal" for disaster prevention and reduction measures. In June 2012, the LDP presented a basic bill on measures for strengthening social infrastructure to the Diet, but the bill was scrapped due to the dissolution of the lower house. The party is now revising the bill, and plans to resubmit it to the Diet. If passed, it could result in a high level of public works over the next ten years. In particular, we think there is a good chance that maintenance and rebuilding of aging tunnels, highways and bridges will shift into high gear.

In fact, Y1,165.8 billion of the proposed Y1,880.1 billion supplementary budget in FY12 for the Ministry of Land, Infrastructure, Transport and Tourism, which is linked closely to the construction sector, is set aside for quake reconstruction and disaster prevention efforts. Notably, a hefty Y423.9 billion is earmarked for road construction and improvement. Major focal points will likely be repairs of aging highway structures (incl. tunnels, bridges) and the completion of unbuilt portions of high-grade expressways connecting major cities (Y62.3 bil allocated for latter). We think considerable emphasis will be placed on completing connections across the country, as the March 2011 quake served as a reminder of the importance of road networks.

The other aim of the new administration's emphasis on public works is to boost Japan's economy. Public works expansion served as Japan's main measure for stimulating the economy during periods of weakness through the 1990s. However, such expansion came to be viewed negatively, largely due to criticism over the construction of infrastructure that was barely needed. Since 2000, the government has had reduced scope for using public works expansion as an economic stimulus measure. At the same time, however, it has also failed to draw up other effective measures for an economic recovery. While current conditions may justify public works expansion, the government once again seems to be using it largely as a stimulus measure. Opinion on the impact of public works expansion is probably divided heavily. Nonetheless, Miyagi Prefecture—one of the most severely damaged areas—has shown clear economic benefits from post-quake reconstruction work, even in the relatively short time since such work began. If carried out only where deemed necessary through sufficient analysis, public works expansion should contribute to an economic recovery.

Abundant large-scale projects

In addition to the boost provided by these policies of the new government, we expect various large-scale projects to take off in FY13-14. With an especially rich lineup of civil engineering projects, we see increased opportunities for major general contractors. Post-quake reconstruction projects seen gaining momentum include the construction of coastal roadways in Sanriku, rebuilding of disaster-hit locations (urban development, incl. collective relocations), and waste decontamination. Beyond reconstruction, projects include the outer Tokyo beltway (Nerima-Setagaya connection), new *Shinkansen* (bullet train) routes in Hokkaido, Hokuriku, and Kyushu, redevelopment of the area around Shibuya Station, the maglev Chuo *Shinkansen* project, large-scale revamps to highways in Greater Tokyo, and the rebuilding of the National Stadium. The construction market may well be entering an upward phase of its mid/long-term cycle.

Construction industry's stance on policies of new administration

The construction industry has suffered from a prolonged decline in public works projects and sluggish private-sector capex. Naturally, many companies have welcomed the new administration's policies emphasizing public works projects. However, capacity constraints may prove a drag, due to the construction industry's earlier headcount reductions amid a slump in the domestic construction market. A surge in orders for public works and large projects could lead to an even graver labor shortage. With this in mind, many industry participants are seeking systematic order placement from customers.

The most widely voiced expectation of Japan's new administration is for an increase in private-sector investment stemming from an economic recovery. With a weighting of just under 20% in many cases, public works projects within Japan actually provide only a small portion of parent sales for general contractors. Instead, their earnings depend heavily on domestic private-sector projects, which typically carry a weighting of 70% or more. Since the Lehman crisis, a slump in domestic private-sector investment has led to meager demand. Amid such conditions, margin erosion stemming from fiercer competition for capturing orders has become a serious issue.

Notably, yen strength and concern over power supply due to problems at nuclear plants have apparently served to curb domestic capital spending by manufacturers. Yen strength is gradually easing, backed by expectations for bold monetary easing by Japan's new administration. Resolution of the nuclear plant problem will probably require some time, but expectations for a pickup in private-sector construction work are rising, as the new administration has announced tax system reforms designed to boost capex. A balanced recovery in both public works and private-sector investment would probably be ideal for the construction industry.

Skilled labor shortage poses risk

A shortage of skilled workers is a cause for concern. In particular, there is an increasingly serious lack of workers for concrete formwork and reinforcement in the Tohoku and Kanto regions. A skilled labor shortage typically pushes up labor costs and leads to additional costs due to construction delays, exerting downward pressure on margins. While systematic order placements become crucial, contractors need to seek reasonable orders with a focus on profitability.

Recent trends show that second-tier general contractors have suffered greater erosion in margins on construction work than major industry players. This likely reflects their disadvantages in areas such as securing materials/skilled labor and negotiating with subcontractors. We think major general contractors will maintain a competitive edge over the near term, and we are focusing on Taisei (1801), which appears to have the highest profitability among major players.

Ballooning social security and the pharmaceutical and healthcare sectors

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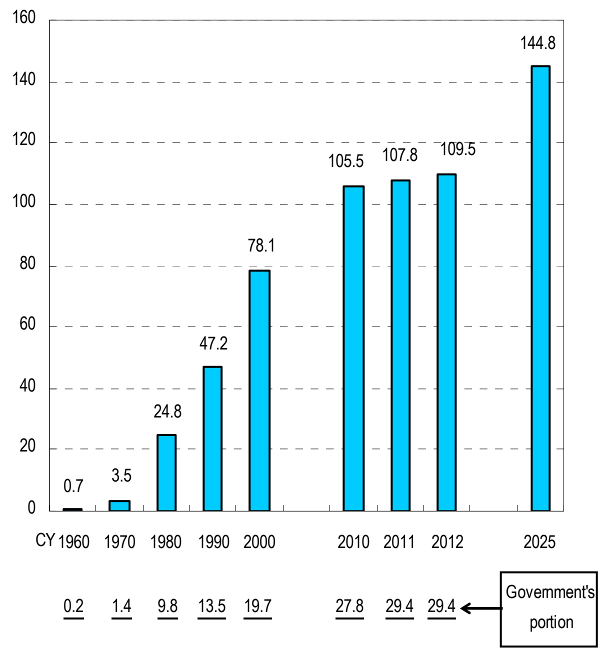
Japan's ballooning social security spending

The government's regular budget for FY12 earmarks Y26.4 trillion for social security spending (healthcare, elderly care, social welfare, pensions), 52% of the total budget of Y51.2 trillion (excl. national debt service, tax revenue sharing with local governments). Total spending on these programs is around Y110 trillion per year (with the government responsible for more than Y29 tril), a figure that is expected to rise to around Y145 trillion in 2025 (Chart 15). Outlays are all but certain to increase substantially from here on out as Japanese society ages further. Thus, it will be impossible for the country to get its fiscal affairs in order without reforming these programs.

■ **Chart 15: Social Security Spending** (Y tril)



Source: Cabinet Office, Ministry of Finance; compiled by Daiwa.
Note: 2010-12 figures based on initial budget. 2025 figure Ministry of Health, Labour, and Welfare estimate as of Mar 2012. Government spending figure for 2012 assumes government pays 50% of national pension expenses.

The Liberal Democratic Party and the Abe administration have made winning the July upper house election priority number one. As such, they seem reticent to press forward with reforming social programs, given that meaningful reform would require streamlining and limiting benefits. One telling example of this attitude in practice is the government's recent decision to leave out-of-pocket health care expenses at 10% of total cost for seniors aged 70-74. The Koizumi administration passed a law raising this rate to 20%, but in 2007, during the first Abe administration, the LDP suffered a major defeat in an upper house election. Fearing opposition from seniors, officials suspended implementation of the law just before it was set to go into effect at the start of FY08. Thus, the rate has stayed at the low 10% level, at an annual cost of around Y200 billion, for quite a long time, stretching from the time of the previous LDP-led government through the changeover to DPJ control and now back again to another LDP-led administration.

Three approaches: raise taxes, increase out-of-pocket expenses, cut benefits

In the run-up to the lower house election late last year, the LDP pledged in its manifesto to constrain the premium burden of employee insurance and elderly care insurance. This inclusion seems to be another sign of the party's tendency to favor policy that benefits corporations more than households or the public sector.

To tackle this problem there are only three options available: (1) increasing tax expenditures (and finding steady source of funding), (2) raising the out-of-pocket expenses charged to program users, or (3) cutting benefits. The Abe government considers economic revitalization to be a top priority, assuming that continued economic growth will limit the burdens of rising premiums on corporations and out-of-pocket expenses on program participants, thus making the overall system more sustainable. After reaching a three-party agreement, the LDP, New Komeito, and Democratic Party of Japan passed legislation establishing a framework for integrated reforms of social security programs and taxation. The law calls for an increase in the consumption tax as a means to secure a stable source of funding for social security programs, while at the same time hiking out-of-pocket expenses and "streamlining" and "optimizing" benefits, (i.e., limiting or reducing them).

Government to differentiate hospital functions to limit costs

We are unlikely to get a clearer idea of the specifics of benefit limitations until after the upper house election. The three-party agreement on unified tax/social security reform contained two concepts of service provision that will likely define the government's approach: differentiating hospital functions and enhanced coordination of at-home care. Using these approaches, the government hopes to limit medical and elderly nursing care expenses heading into 2025, when the elderly population is projected to peak as Japan's baby-boom generation will have reached age 75 or older. Specifically, this refers to the process of classifying hospital space as "acute care beds" for patients undergoing surgery, "long-term care beds" for patients needing extended treatment, or some other category based on the type of care needed. In addition, the plans call for transitioning hospitalized patients to home-based medical care or elderly nursing care, conditioned on close coordination with medical institutions. The idea is that reclassifying hospital beds should shorten hospital stays, while greater usage of home-based care is intended to limit the need for hospital beds in the first place. Putting patients under elderly care rather than costlier medical treatment should also help curb cost increases.

Already, the government has taken steps to promote differentiating hospital beds. In FY10 and FY12, NHI reimbursement revisions gave considerable favor to acute care institutions. This, along with government subsidy programs such as the Fund for Revitalizing Regional Medical Care, has spurred a boom in hospital capital spending. Beneficiaries of this trend include medical equipment makers like Nihon Kohden (6849), as well as medical supply/consulting firms such as Ship Healthcare Holdings (3360). Now that Japan's three major parties have reached broad agreement on policy goals for 2025, this trend seems likely to continue over the next few years.

Generics promotion to remain key theme going forward

However, given that the government's overarching goal is to limit total medical/elderly nursing care expenses, bullish sentiment for domestic healthcare sector firms is unlikely to last indefinitely. Investment appetite should lose steam once the push to differentiate hospital bed functions makes a certain amount of progress. At this point, government support for the industry on this front will likely be pulled back. We expect the trend to shift around 2016-18.

As a means to control healthcare expenses, promotion of generics is likely to remain an important theme going forward. The government had targeted generic sales equaling 30% of total volume in FY12, but at this point generics only have a market share of somewhere around 26-29%. A fresh government target is likely to be finalized as early as March 2013. Currently, discussions are moving in the direction of changing the market share calculation to include only drugs for which generic alternatives exist in the measure of total market size. The government seems likely to set a goal of raising the market share of generics from the current 40% or so under the new methodology to 60%. If this comes to pass, the generics market would likely expand by roughly 50% on a sales volume basis. In this scenario, generics firms with ample production capacity are likely to increase market share, so we remain focused on firms like Sawai Pharmaceutical (4555) and other potential beneficiaries.

A look at the FY12 supplementary budget proposal shows that an additional Y50 billion has been allotted to the above-mentioned Fund for Revitalizing Regional Medical Care (on top of Y517 bil budgeted so far). This is likely to add momentum to capital spending by medical institutions. The draft FY13 budget includes plans to reform the public assistance system by streamlining medical assistance and the eligibility criteria for livelihood assistance. This is in line with the LDP's campaign pledge to cut benefit levels by 10% and marks a clear step toward prioritizing social protections. On a slightly different front, the government has set aside funds to support research into pharmaceutical applications of regenerative medicine as part of its plans to promote medical innovation. Companies involved in this field are likely to benefit.

Outline of tax reform proposals for FY13

Masahiro Kushida

Chart 16 shows the main details of the tax reform proposals announced by the LDP and New Komeito on 24 January.

As mentioned earlier, the tax reform proposals include measures to reduce the burden on purchasers of homes and automobiles when the consumption tax is hiked. These include the extension and expansion of home loan tax credits, as well as the abolition of automobile acquisition tax. The reforms should represent a positive for both the automobile and housing sectors, as the measures are expected to moderate the impact of swings in demand triggered by the consumption tax hikes (rush purchases prior to the hikes, consequent drop-off after the tax hikes take hold). According to our analyst (Hideaki Teraoka), the measures for housing were unsurprising as such steps have been debated since last year. He also believes that if the tax credits are only to be in place through end-2017, the measures could simply be delaying any drop-off in demand until a later date. He would see little to celebrate unless the government implements permanent measures to refund the full amount of the extra burden imposed by the tax increase in line with industry requests. As for automobiles, our analyst (Eiji Hakomori) stated that tax reductions are already in place for eco-cars, with some models exempt from automobile acquisition tax. Having a framework in place to offset the impact of the consumption tax hike would be a positive. However, it is unlikely to be a factor to boost demand. Going forward, his focus will be on the possibility for tax system reforms to accelerate the shift to eco-cars.

Some of the content of tax reform proposals had already been reported in the news prior to the official release. However, the stock market did react positively to a measure to make gifts of education funds from grandparents to grandchildren tax-exempt. Stocks in the education space garnered attention as a result. Our analyst (Satoshi Tanaka) noted that households with the capacity for giving such gifts are already sending their children to cram schools and the like in many cases, so expectations for the measures to have an impact may have been bloated. Nevertheless, he believes the measure could accelerate a shift from low-priced to high-priced services and from group to private lessons.

Our analyst Kazunori Tsuda commented on consumer spending overall, including the consumption tax hike.

He takes a positive view on the introduction of tax reforms that will encourage firms to pay higher salaries. Higher pay and diminished anxiety over the future as the economy picks up are indispensible for invigorating consumer spending, in his view. He also views the measures that urge a shift of income and assets from the elderly to the young positively.

In addition, the tax reform proposals announced by the ruling parties included the introduction of reduced tax rates for certain products when the consumption tax is hiked. Mr. Tsuda believes the measure would represent a positive for firms such as supermarkets and convenience stores, which handle food and other daily necessities. Our food sector analyst (Tokushi Yamasaki) agrees that the introduction of reduced tax rates would be a positive for the food sector, but he warns that an eye will need to be kept on which products will be subject to the reduced rates. He believes that fresh foods are generally likely to be subject to the tax reductions, while non-essentials such as alcohol and confectionery are not. The picture is less clear for processed foods (seasonings, chilled and frozen foods), which fall between the other two categories. Once the classifications are clear, it will be vital for firms to be able to pass along the consumption tax rise to customers for products that are not subject to the reduced tax rates.

As for the tax system for corporations, the reforms include revisions to existing stimulative measures such as tax credits for capex and R&D. For R&D, the maximum tax credit will be reinstated in line with the FY11 framework. This should provide a boost to the bottom lines of firms that are able to take advantage of this facility, such as those in the pharmaceutical sector. Meanwhile, the capital goods sector should benefit from tax credits for capex. More than this, though, we will be looking to see whether or not the measure, together with the correction of the strong yen since the LDP returned to power, triggers a favorable turn in investment sentiment in the manufacturing industry.

The above-mentioned tax credits for salary growth are a unique feature of the tax reform proposals. Firms will be eligible for a 10% tax credit not only for job creation but also for salary increases. Following talks with business groups such as the Japan Federation of Economic Organizations, the prime minister has called upon firms to increase employees' incomes by hiking wages and paying bonuses. Lawson (2651) has announced an annual salary hike of around 3% for regular employees in their late 20s to 40s.

■ **Chart 16: Main Content of Tax Reform Proposals for FY13 (↓ shown for tax reduction, ↑ for tax increase)**

Corporations		
R&D expenses	Maximum limit for R&D tax credit to be lifted to 30% of corporation tax amount	↓
Promotion of capital investment	Accelerated depreciation (30% of acquisition value depreciated in first year) or tax credit equivalent to 3% of acquisition value for companies increasing capex by more than 10% y/y	↓
Promotion of salary growth	Tax credit equal to 10% of salary increase for companies where average salary raised, etc.	↓
Entertainment expenses for SMEs	Fully deductible up to Y8 mil per year	↓
Green investment	Immediate depreciation of co-generation systems (power/heat supply)	↓
Households		
Income tax	Top marginal rate lifted to 45%. Applies to incomes of over Y40 mil.	↑
Inheritance tax	Top marginal rate lifted to 55%. Applies to taxable estates of over Y600 mil. Basic allowance reduced by 40%.	↑
Housing	Extend housing loan tax credit program to end-2017. Reduces up to Y400,000 in taxes (up to Y600,000 in disaster areas) each year	↓
	Annual tax break of up to Y250,000 for self-financed energy efficiency improvements	↓
Auto	Automobile purchase tax to be abolished in Oct 2015. Tax breaks on eco-friendly cars expanded	↓
	Extend weight tax. Reduce tax on fuel-efficient cars	↓
Gift	Lump-sum gift of up to Y15 mil for educational purposes from grandparents to grandchildren tax-exempt (through end-2015)	↓
Japanese ISA	Dividends/capital gains of up to Y1 mil a year on stocks/equity funds tax-exempt for five years	↓
Reduced consumption tax rates for some items	Introduction aimed for Oct 2015, not for Apr 2014 (when first hike is planned)	↓

Source: Compiled by Daiwa.

Growth strategies, deregulation

Fleshing out a growth strategy

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The new government has kicked off discussion of growth strategy, with the goal of encouraging private investment. Growth strategy is a component of the Abe administration's three-pronged approach to economic policy, the others being aggressive monetary easing and flexible fiscal policy.

The strategy will aim to pave the way to economic growth by improving the overall competitiveness of Japanese firms through proactive government support in growth areas such as medical services, nursing care, energy, and agriculture. The Industrial Competitiveness Council and Regulatory Reform Council will hash out what measures to take, with final decisions slated for June.

Though previous administrations have come up with other growth strategies in recent years, their effectiveness has not been clearly felt. There are also concerns of possible negative impacts on growth from expanding government debt caused by aggressive public spending.

What sort of growth strategy does Japan need? We will attempt to find answers by discussing factors that underpin economic growth.

Better productivity needed for economic growth

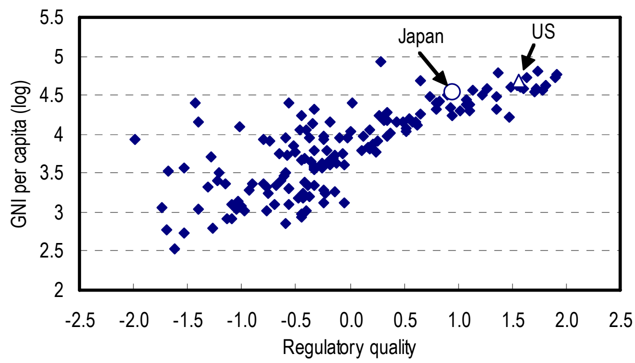
A nation's economic growth reflects capital accumulation, labor force, and productivity. When an economy matures, return on capital gradually declines, slowing capital accumulation. In addition, since Japan has an aging society with a low birth rate, the labor force is unlikely to increase barring massive immigration. As such, measures to improve productivity are essential for Japan to achieve economic growth.

Technology, efficiency key to productivity growth

Technological advancement is often said to increase productivity, but it is also important to improve efficiency through the optimum allocation of capital and labor to sectors where they are needed.

In order to promote technological advancement and improve efficiency, we believe a sophisticated market system that encourages corporate investment is needed. Characteristics of such a system would include adequate protection of intellectual property rights (significant benefit to developers of new technologies), efficient information sharing in investment markets, conditions promoting fair competition, a solid systemic foundation/commitment to providing the security needed for the smooth functioning of trade, and a structure to control the effects of externalities (such as pollution). Creating a system necessary to realize a market's full potential is primarily the job of the government, which is tasked with directing firms to develop new technologies and improve efficiency while responding to changes in the economic environment. The chart below shows that per capita income tends to be higher in countries with better regulatory quality.

■ **Chart 17: Regulatory Quality and Per Capita Income**



Source: World Bank's Worldwide Governance Indicators; compiled by DIR.
Notes: 1) Log of gross national income per capita at purchasing power parity for 2011.
2) Regulatory quality of zero represents mean for 153 countries. Higher values are better outcomes.

Tapping overseas demand, deregulation induce growth

Tapping overseas demand would increase profits enjoyed by developers of new technologies, thus providing greater incentives for technological development. Easing or eliminating regulations that distort resource allocation would also help productivity.

To ensure that the market fosters productivity, some regulatory support is naturally needed. However, once established, regulations are often tricky to revise or eliminate even after conditions change, often due to resistance from beneficiaries of existing regulations.

Complementing the government's own efforts to deregulate, external pressure can also be effective in updating rules to reflect the changing environment.

Trade pacts such as the Trans-Pacific Strategic Economic Partnership Agreement (TPP) not only involve the elimination of tariffs but also the lowering of various non-tariff barriers, which could prompt domestic deregulation.

In this process, it is important for the government to allow a transition period for parties that would suffer from reforms. Reforms aimed at encouraging corporate investment would likely boost the economy significantly. As harmonizing intellectual property rights and other cross-border trade rules would enhance trade security, it is vital for Japan to participate in moves to achieve this in light of the global development of Japanese businesses going forward.

The Abe administration seems to be focusing on specific growth areas, but we think it should prioritize deregulation and making trade agreements. In our view, creating an environment with minimum restrictions to corporate activity would lead to desirable economic growth.

Prime Minister Abe's new policymaking apparatus

Makoto Morita

The Abe administration has assigned two organizations the roles of policy decision-making centers: the Council on Economic and Fiscal Policy (CEFP) and the Industrial Competitiveness Council (ICC), a sub-body under the Headquarters for Japan's Economic Revitalization. The CEFP's primary mission is to take the lead in macroeconomic policy, covering monetary and fiscal matters. The ICC, on the other hand, is expected to tackle microeconomic policy with a focus on economic growth strategy. Under former Prime Minister Junichiro Koizumi, the CEFP was the main body in charge of overall economic policy, led by economics professor Heizo Takenaka. This time around, under Prime Minister Abe, discussion of growth policies will likely be the ICC's purview.

Another critical policy body is the Regulatory Reform Council (RRC), set up to promote elimination of regulations deemed an impediment to growth. Regulatory reform is indeed an important theme in Japan's growth strategy, so discussions at the RRC are likely to have a significant influence over economic policy.

Mr. Abe has appointed eight experts as special cabinet advisors to serve as his brain trust. We advise keeping an eye on these key players given their influence on the direction of policymaking.

■ Chart 18: The Abe Administration's New Policymaking Bodies

Brain trust (Special Advisors to the Cabinet) → **Abe Cabinet**

Cooperation

Council on Economic and Fiscal Policy (main focus on macroeconomic policy)	
Shinzo Abe	Prime Minister
Taro Aso	Deputy Prime Minister, Minister of Finance
Yoshihide Suga	Chief Cabinet Secretary
Akira Amari	Minister of State for Economic and Fiscal Policy, Economic Revitalization
Yoshitaka Shindo	Minister of Internal Affairs and Communications
Toshimitsu Motegi	Minister of Economy, Trade and Industry
Masaaki Shirakawa	Governor, Bank of Japan
Motoshige Ito	Professor, University of Tokyo
Yoshimitsu Kobayashi	CEO & President, Mitsubishi Chemical Holdings (Vice Chairman/Executive Director, Japan Association of Corporate Executives)
Norio Sasaki	President, Toshiba (Vice Governor-elect of Nippon Keidanren, to take office in Jun)
Susumu Takahashi	Chairman, Japan Research Institute

Industrial Competitiveness Council (main focus on microeconomic issues)	
Shinzo Abe	Prime Minister
Taro Aso	Deputy Prime Minister, Minister of Finance
Akira Amari	Minister of State for Economic and Fiscal Policy, Economic Revitalization
Yoshihide Suga	Chief Cabinet Secretary
Toshimitsu Motegi	Minister of Economy, Trade and Industry
Ichita Yamamoto	Minister of State for Science and Technology Policy
Tomomi Inada	Minister of State for Regulatory Reform
Saki Akiyama	President, Saki Corporation
Motoyuki Oka	Senior Advisor, Sumitomo
Sadayuki Sakakibara	Chairman, Toray Industries
Masahiro Sakane	Chairman, Komatsu (Vice Chairman, Nippon Keidanren)
Yasuhiro Sato	President, Mizuho Financial Group
Heizo Takenaka	Professor, Keio University
Takeshi Niinami	President, Lawson
Kazuhito Hashimoto	Professor, University of Tokyo
Yasuchika Hasegawa	President, Takeda Pharmaceutical (Chairman/ Representative Director, Japan Association of Corporate Executives)
Hiroshi Mikitani	CEO, Rakuten

Regulatory Reform Council	
Motoyuki Oka	Senior Advisor, Sumitomo (Chairman of the Council)
Junji Annen	Professor, Chuo University
Mitsudo Urano	Chairman, Nichirei
Sadakazu Osaki	Head of Research, Nomura Research Institute
Hiroko Ota	Professor, National Graduate Institute for Policy Studies
Yuri Okina	Research Director, Chief Senior Economist, The Japan Research Institute
Yasufumi Kanemaru	CEO, Future Architect
Soichiro Sakuma	Director, Nippon Steel & Sumitomo Metal
Kaori Sasaki	CEO, ewoman
Hisao Taki	Chairman, Gurunavi
Kotaro Tsuru	Professor, Keio University
Yukihiro Hasegawa	Assistant Editor, Tokyo Shimbun, Chunichi Shimbun
Izumi Hayashi	Attorney at Law, Eitai Sogo Law Office
Toshihiro Matsumura	Professor, University of Tokyo
Ryuichi Morishita	Director, AnGes MG

Source: Various materials; compiled by Daiwa.

Council on Economic and Fiscal Policy

A draft economic policy is expected from the CEFP as soon as June. Major items on the agenda include examining the effectiveness of past monetary and fiscal policy and formulating guidelines for the future, boosting employment and incomes, promoting corporate investment, mapping out energy strategy, and improving government finances through a revision to social security programs and other measures. The CEFP has also been assigned the job of making the necessary deliberations in autumn of this year ahead of the consumption tax increase scheduled for April 2014.

One notable aspect of the CEFP is that the BOJ governor is a member. A meeting is scheduled to take place every three months to discuss monetary policy and price levels. Apparently, the BOJ is expected to provide progress reports on its inflation targets at these meetings. As the public forum where the administration will regularly communicate demands to the BOJ, the CEFP is expected to help deepen collaboration between the government and central bank.

Industrial Competitiveness Council

The Headquarters for Japan's Economic Revitalization comprises the prime minister and all Cabinet members and was established to enable interdepartmental collaboration in economic policymaking. Within this organization, the ICC has the role of leading debate on specific economic growth strategies.

The ICC has 17 members, ten of whom are not Diet legislators, including Keio University Professor Heizo Takenaka, who led the CEFP during the Koizumi years, and corporate leaders such as Rakuten President Hiroshi Mikitani, Lawson President Takeshi Niinami, and others chosen from outside the usual roster of old-guard heavy hitters in the financial and manufacturing sectors.

Based on discussions at the inaugural meeting on 23 January 2013, Prime Minister Abe (ICC Chairman) instructed his Cabinet to adopt the following ten policy responses: (1) promote regulatory reform, (2) revise the nation's innovation/IT policies, (3) push for economic partnerships, (4) establish a responsible energy policy, (5) remake global warming policy, (6) reform regulations to enable industrial "creative destruction," (7) encourage young people and women in the workforce, (8) promote growth-minded agricultural policy, (9) pursue a strategy of securing resources and exporting infrastructure; and (10) promote cultural exports (via the "Cool Japan" campaign).

At the second meeting on 18 February, the non-MP members separated into groups to discuss priority themes with economic revitalization minister Akira Amari, Minister of Economy, Trade & Industry Toshimitsu Motegi, and relevant Cabinet ministers. The themes were: (1) industrial "creative destruction," (2) enhancing human resources and reforming employment regulations, (3) bolstering Japan's appeal as a place to do business, (4) creating both supply and demand for clean and economic energy, (5) fostering a healthy, high-longevity society, (6) expanding exports and bolstering competitiveness of agriculture, and (7) strengthening scientific and technological innovation and enhancing IT.

A third meeting was held on 26 February, where members discussed the TPP.

Regulatory Reform Council

The Abe administration considers regulatory reform one of the pillars of its economic growth strategy, and for that reason the RRC has a major part to play. The RRC membership mainly consists of corporate leaders, academics, and other non-MPs. The chairman, Sumitomo Senior Advisor Shoichiro Oka, is also a member of the ICC. Alternate Chairwoman Hiroko Ota (Professor, National Graduate Institute for Policy Studies) served as minister of economic and fiscal policy in the first Abe administration. The results of discussions in this council will be reflected in the economic growth strategy to be announced in June. In that sense, the RRC will need to coordinate with the ICC.

The RRC has had three meetings so far, on 24 January 15 February, and 25 February.

At the second meeting, the council identified four broad areas of focus: (1) healthcare and medicine, (2) energy and the environment, (3) employment, and (4) entrepreneurship and industrial "creative destruction." Within these categories, the council's secretariat listed 59 items as examples of matters that have been brought up in the past (see Chart 19). Professor Ota characterized these regulations as being one of two types: (1) "sheer cliffs," those that both entrenched bureaucrats and affected industries and interest groups oppose eliminating, and (2) "iron fences" that are mainly protected by the bureaucracy alone and could be changed with a strong enough push.

At the third meeting, the council established four working groups, one for each of the above areas of focus. The groups were tasked with identifying priority areas with a focus on economic growth and producing concrete proposals by June. Urgent and difficult matters will be discussed in full committee to resolve them in a timely manner. Specific issues slated to receive this top-priority treatment include (1) online sales of over-the-counter drugs, (2) deregulation of childcare services, (3) easing the environmental assessment process for coal-fired thermal power plants, and (4) reforming the electric power industry.

Resolving the six challenges faced by Japan

Masahiro Kushida

Japan's business class, most notably represented by the Nippon Keidanren, has cited six challenges for the Japanese economy and its corporations: (1) yen appreciation, (2) burdensome corporate income taxes and social security premiums, (3) slow progress in forming economic partnership agreements (EPAs), (4) an inflexible labor market, (5) unjustifiable environmental regulations (incl. 25% CO_2 emissions reduction target), and (6) supply shortages and rising costs of electricity.

Items 1-4 and 6 are longstanding complaints, whereas item 5 became an issue during the years of DPJ leadership. Energy supply and costs became a serious problem after the March 2011 earthquake and subsequent nuclear disaster. All six of the issues affect Japan's attractiveness as a place to do business. Lagging behind other developed nations on these attributes is a serious problem for Japan's economic competitiveness.

Developments leading to the reversal of yen appreciation are well under way and include the Abe administration's "reflationist" policies, Japan moving from a trade surplus to a trade deficit, and a shift to risk-on sentiment in global markets.

In FY11, the government passed a law cutting the statutory income tax rate from 40.7% to 35.6%. It was subsequently raised to 38.0% for three years through FY14 after the passage of a special corporate income tax to fund post-quake reconstruction. This level remains high compared with other major countries.

Following the US-Japan summit on 22 February, Prime Minister Abe now appears likely to announce Japan's participation in talks over the proposed Trans-Pacific Partnership (TPP) trade agreement. Developments in debate over this issue, as well as agricultural policy, bear watching given the opposition to the TPP among agricultural interest groups, not to mention elements within the LDP. The ultimate decision of whether to join the treaty will likely be significant for the performance of food sector shares. In addition to the TPP, the business community favors early initiation of talks to form a Japan-China-Korea FTA and an EPA with the EU. Promoting trade agreements like these, proponents contend, will enable Japan to globalize in a way that improves the quality of the economy and corporate sector.
The DPJ-led administration made labor regulations tighter, for instance by banning day labor-based temp work in most cases. Now, however, the aforementioned RRC is likely to rekindle debate on these issues.

See the next section "Energy policy" for more on the business lobby's proposals on environmental regulations and energy policy. For the purposes of this section, however, note that the ICC plans to revisit the energy and environmental policies of the previous administration, including the CO_2 reduction target.

Industrial policy

The government is planning to release a major policy document comprehensively covering fiscal and economic affairs, aiming for June. For more specific policies, the government plans on releasing a detailed economic growth policy.

DIR Economist Mikio Mizobata has argued that the government should prioritize creating an environment that removes the barriers to corporate activity, rather than adopting a policy of targeting specific sectors as growth areas. However, what areas the government decides to focus on will likely have a significant impact on stock market performance.

Areas that have come up so far in government discussions and media reports include regenerative medicine, energy resource development and procurement, domestic infrastructure enhancement and infrastructure exports including ICT, improving education and R&D, Japanese cultural exports ("Cool Japan"), and fostering a growth-minded agricultural sector. The Cool Japan initiative has been around for a while now, and at this point we have our doubts as to whether any listed firms will benefit anew from policy action in this area going forward. The same could be said for moves to promote a more aggressive agricultural sector, but specific actions may be worthy of focus as the government's promotion of joining the TPP could spur meaningful action.

Whatever the ultimate policies are, they will require funding. Some initiatives may receive funding in the draft FY12 supplementary budget or FY13 main budget. However, some may only get funded in FY14 or later, and in some cases the private sector may be called upon to help. In our view, for Mr. Abe's three-pronged approach to work, politicians will need to work closely with bureaucrats (and perhaps also the private sector). We will continue monitoring how the government's new policies will impact individual firms.

■ **Chart 19: List of Past Proposals for Regulatory Reform**

Key issues by category
I. Healthcare & medicine ■ **Promote healthcare, improve medical infrastructure:** Promote regenerative medicine; reduce lag in medical device/drug approval with other major countries; combination of treatments covered and not covered by insurance ■ **Promote use of ICT:** Allow online purchases of over-the-counter drugs; integrate health insurance claim data; move to electronic prescriptions and medical histories; promote distance medicine ■ **Improve elderly nursing care service**
II. Energy & environment ■ **Stable energy supply:** Designate regions available for wind/geothermal power development; improve transparency in environmental assessment process for construction of coal-fired thermal power plants; reform electric power regulations (full liberalization of retail electric power; spin off power distribution ops) ■ **Localize energy production and consumption:** Simplify procedures for installing solar panels on farmland ■ **Provide fee/discount schedules for green energy** ■ **Promote eco-cars** ■ **Promote diversified power sources**
III. Employment ■ **Improve work environments:** Reform of overtime exemption for white-collar workers and flex-time regulations ■ **Rationalize regulations for employment conditions** ■ **Rationalize temporary employment regulations:** Revise regulations on 26 professions permitted to work as temps, incidental tasks, temp work for other professions ■ **Revise job placement regulations** ■ **Improve/increase childcare facilities** ■ **Employee dismissal regulations acceptable to both labor and management**
IV. Entrepreneurship, industrial "creative destruction" ■ **Entrepreneurship support:** Investment vehicles; big data/cloud computing; comprehensive exchange ■ **Promote supply of funds for growth:** Personal defined-contribution pensions ■ **Improve infrastructure for resilience against disasters:** Reconstruct condominium buildings; relax restrictions on condominium floor area ■ **Speed up export/transport processes** ■ **Promote industry realignment:** Relax industry concentration restrictions; simplify process of intra-group reorganization ■ **Strengthen competitiveness of agriculture** ■ **Expand efforts in special reconstruction zones to rest of country**

Source: Cabinet Office; compiled by Daiwa.

Energy policy

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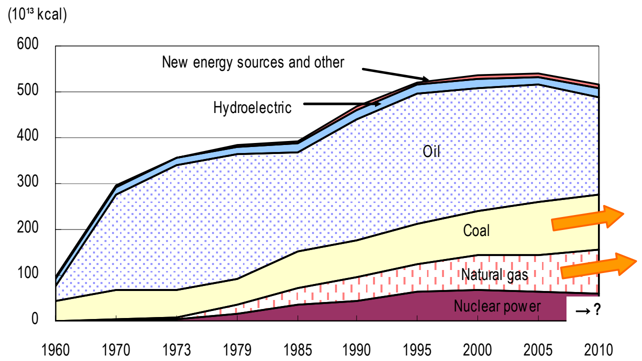
Overview of energy policy

■ Chart 20: Breakdown of Japan's Primary Energy Supply



Source: Ministry of Economy, Trade and Industry (METI); compiled by Daiwa.

Oil accounts for around half of Japan's primary energy supply, followed by coal and natural gas. The weighting of oil exceeded 70% during the 1970s, but has declined since as it has been replaced by natural gas and nuclear energy. It seems that technological advancement has prompted a shift to cheaper energy sources.

Japan's energy policy challenges

Japan imports most of its energy resources, including crude oil, natural gas, and coal. Price control and the stable procurement of imported energy resources are important to Japan. However, there is a dilemma—if Japan prioritizes stable procurement, its price negotiating power tends to weaken, but if it prioritizes prices, procurement stability could be affected.

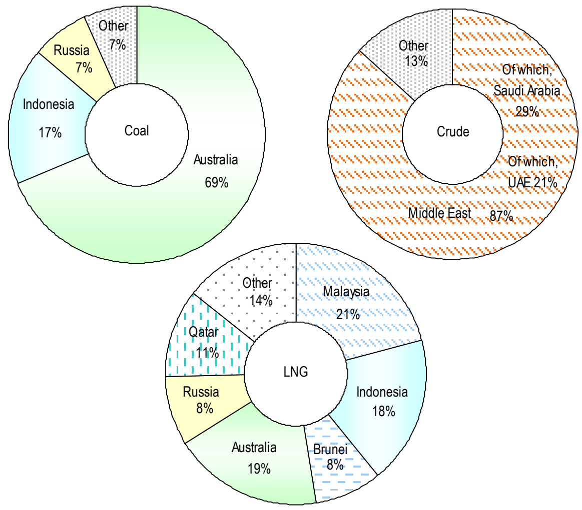
Since the weighting of thermal power generation has increased as a result of a decline in capacity utilization at nuclear power plants following the Great East Japan Earthquake, price control and the stable procurement of energy resources have become even more important.

■ Chart 21: Import Ratios for Major Energy Resources (2010)

2010	Domestic production (A)	Imports (B)	Import ratio (B / [A + B]; %)
Crude oil (000 kl)	853	214,357	99.6
Natural gas (mil m³)	3,343	86,086	96.3
Coal (000 MT)	1,145	105,049	98.9

Source: Institute of Energy Economics, Japan.
Note: Natural gas volume based on conversion of 1 MT = 1,220 m³.

■ Chart 22: Import Sources for Coal, Crude Oil, Natural Gas (2010)



Source: Ministry of Finance, METI; compiled by Daiwa.

In addition to price control and stable procurement, Japan needs to lower its dependence on imported resources. Nuclear power would provide a solution, as its fuel cost per unit of power generated is low. At present, however, 95% of nuclear power generation in Japan is suspended. Whether operations at these reactors will be resumed will be discussed later. Over the short term, we think utilization of most domestic reserves of energy resources will be difficult in terms of profitability.

Price control and stable procurement of imported energy resources

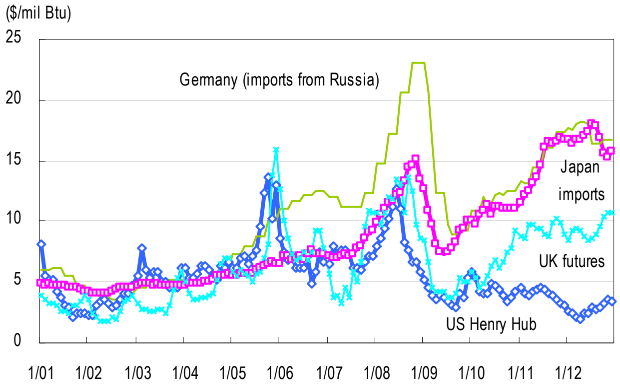
Reducing cost by purchasing US shale gas-based LNG

Shale gas produced in the US is cheaper than what Japan is currently paying to import LNG, so if the US starts supplying Japan with LNG produced from shale gas, this would reduce Japan's import costs. We think it would also contribute to stable procurement, as it would mean more diversified sourcing.

Due to the shale gas revolution, natural gas prices in the US and Europe are lower than crude oil prices. Meanwhile, Japan's LNG import prices are often linked to crude prices and therefore remain high.

If Japan starts to import shale gas-based LNG, prices of which would be linked to US natural gas prices, Japanese LNG users would see lower purchase costs. In addition, users would probably be able to negotiate better conditions for contracts even under the pricing formula linked to crude prices. It is difficult to negotiate crude prices lower for individual contracts since crude oil is commoditized worldwide and is relatively easy to transport. However, we see room for negotiating prices lower for LNG. In fact, LNG prices are determined on an individual contract basis in many cases. Also, such deals involve a mix of factors (e.g., dedicated vessel for each contract).

■ Chart 23: Natural Gas Prices in Major Economies



Source: Commodity exchanges; compiled by Daiwa.

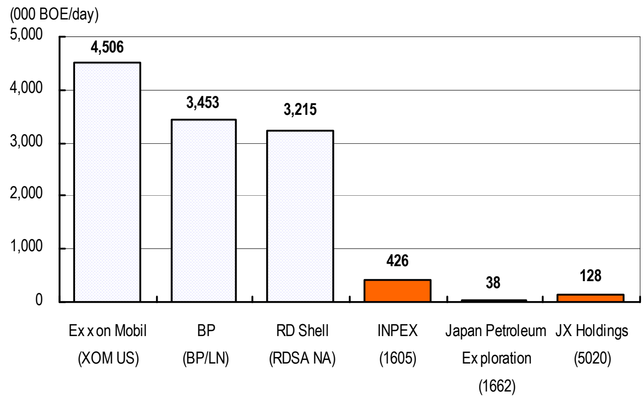
The export of shale gas-based LNG from the US to Japan is not expected before 2017, given the time required for building liquefaction plants and pipelines. In addition, although the US Department of Energy released a commissioned report in December 2012 saying that exporting shale gas would be in the national interest, exporting any energy resources requires government permission.

Participation in upstream projects

Acquiring interests in energy resource development projects would help stabilize procurement. Companies participating in such projects would see benefits such as key information for price negotiations, as well as skills and knowledge regarding upstream operations. Japanese companies are proactively investing in overseas upstream projects, backed by an array of government measures set up to support such moves.

It helps to have an established track record and expertise in energy resource development in order to obtain a stake in upstream projects. Japanese firms have been steadily building up experience in this area, as evidenced by INPEX's (1605) leading role in some of the world's biggest projects, including the Ichthys LNG project (production to start around end-2016, annual production of 8.4 mil MT expected). However, the business scale of Japanese players is still small compared to global oil majors.

■ Chart 24: Japanese Firms' Interests in Upstream Projects



Source: Company data; compiled by Daiwa.

Lower reliance on imported energy

Restarting nuclear power plants

While there are 50 commercial nuclear power reactors in Japan, as of end-February 2013 only two were in operation (No. 3 and 4 reactors at Kansai Electric Power's Oi Nuclear Power Plant), a situation which reflects increasing concern about the safety of nuclear power plants following the disaster at Tokyo Electric Power's Fukushima Daiichi Nuclear Power Plant on 11 March 2011.

The new administration of Shinzo Abe (which took office Dec 2012) and the LDP have made many positive comments about restarting the plants. While the situation differs by plant, we could indeed see moves to resume operations accelerate from July 2013.

Why nuclear power plants need to be restarted

There are various discussions regarding the total cost of nuclear power generation, but all in all, fuel cost per unit of power generated at nuclear plants is much lower than at thermal power plants. The level of carbon dioxide (CO_2) emission at nuclear plants is also much lower that at thermal plants.

Japan's nine electric power companies are set to post total consolidated recurring losses of around Y1.6 trillion in FY12. This is mainly due to the cost of making up for suspended nuclear power generation with thermal power. With the power companies applying for government approval to raise prices to reflect the increased costs, the suspension of nuclear power plants has hurt not only profits of the power companies but also the broader domestic industry through higher costs.

■ Chart 25: Cost and CO_2 Emission per Unit Power Generated

	Nuclear power	Coal thermal power	LNG thermal power	Oil thermal power	Wind power	Mega solar	
Cost per unit of power generated	Over 8.9	9.8	11.1	23.0	9.9 ~17.3	30.1 ~45.8	Y/kWh
Of which, fuel costs	1.4	4.5	8.6	17.3	0	0	Y/kWh
CO_2 emission per unit of power generated	20	943	474 (steam) 599 (compound)	738	25	38	g-CO_2/kWh

Source: National Policy Unit, Central Research Institute of Electric Power Industry; compiled by Daiwa.
Notes: 1) Blue shading indicates comparative advantage, pink shading comparative disadvantage.
2) Costs are for 2010, based on Y90/$.
3) CO_2 emission volume for 2008.

Developments to date

Following the March 2011 earthquake/tsunami, Tokyo Electric Power suspended its Fukushima Daiichi/Daini nuclear power plants, while Tohoku Electric Power suspended its Onagawa and Higashidori plants. As the Fukushima Daiichi disaster fueled concerns about the safety of nuclear plants, Chubu Electric Power suspended its Hamaoka Nuclear Power Station at the request of the government. Other plants have also been stopped after undergoing regular inspections. With regular inspection commencing at Hokkaido Electric Power's Tomari Nuclear Power Plant in May 2012, all nuclear plants in Japan came to a halt.

Upon the approval of then-prime minister Yoshihiko Noda and the other three Cabinet members, the No.3 and 4 reactors at the Oi Nuclear Power Plant were restarted in July 2012 after passing stress tests conducted by the former Nuclear and Industrial Safety Agency (NISA). However, NISA was abolished in September 2012 due to conflict of interest (tasked with both promoting and regulating nuclear power generation). The Nuclear Regulation Authority (NRA), which superseded it, effectively invalidated results of NISA's stress tests, saying that its decision to restart other nuclear power plants will be based on new standards to be introduced in July 2013.

Government/coalition moves to restart nuclear plants

The newly established LDP-led Abe administration is taking a positive stance on restarting Japan's nuclear plants. The administration has also said it will reconsider the previous Democratic Party of Japan (DPJ)-led government's policy to eliminate all nuclear plants by the end of the 2030s.

That said, Prime Minister Abe has clearly stated that he will entrust the decision on the safety of the plants to the NRA. With the organization set to compile a new safety standard in July 2013, moves to restart the nuclear plants should come into full swing thereafter. Japan's upper house elections are also scheduled in that month. Given the delicate and controversial nature of the issue, with public opinions showing distinct pros and cons, we believe that the Abe administration and the LDP are unlikely to hammer out a clear policy on restarting nuclear power plants before the elections.

■ Chart 26: Nuclear Power Generation Since Fukushima Daiichi Accident, Future Outlook

2011	
11 Mar	Great East Japan Earthquake Accident occurs at Fukushima Daiichi nuclear power plant. Nuclear emergency declared.
30 Mar	NISA orders utilities to implement emergency safety measures.
9 May	Chubu Electric shuts down Hamaoka nuclear plant at request of government.
20 May	Tepco decides to decommission No. 1-4 reactors at Fukushima Daiichi plant.
11 Jul	Government reveals it will evaluate safety of nuclear plants based on stress tests. Says first round of tests could be used to approve restarting nuclear power plants.
15 Aug	Government decides to split NISA regulatory operations from METI.
2 Sep	Yoshihiko Noda (Democratic Party of Japan) becomes prime minister.
12 Sep	Nuclear Damage Compensation Facilitation Corp launched.
2012	
13 Feb	NISA approves stress test results submitted by Kansai Electric, endorses safety of No. 3, 4 reactors at Oi nuclear power plant.
5 May	No nuclear reactors operating in Japan after Hokkaido Electric shuts down Tomari No. 3 unit for scheduled maintenance.
16 Jun	Based on February investigation report, government approves resumption of No. 3, 4 nuclear reactors at Oi plant. No. 3 unit reactivated 9 Jul, No. 4 restarted 25 Jul.
31 Jul	Nuclear Damage Compensation Facilitation Corp buys Tepco preferred shares.
19 Sep	NRA established.
26 Dec	Shinzo Abe (LDP) becomes prime minister.
2013	
6 Feb	NRA releases outline of new safety standards.
18 Jul	Deadline for introduction of new NRA safety standards.
Jul	Upper house election to be held.
Autumn	Restart of some idled nuclear power plants?

Source: Various materials; compiled by Daiwa.
Note: Shaded area represents future plans, assumptions.

■ Chart 27: Government/ruling Parties' Comments on Nuclear Power

		Comments	Impact
14 Sep 12	Noda Cabinet Innovative Strategy for Energy and Environment	Three principles for breaking away from dependence on nuclear power: • Strictly apply rules limiting nuclear power plants to 40 years of operation • Restart only nuclear power plants endorsed as safe by NRA • Refrain from building, expanding nuclear power plants	Negative
		Enhance policy to make Japan nuclear-free during 2030s, with focus on green energy.	Negative
21 Nov 12	LDP Manifesto	Aim to draw conclusion on all reactors within three years as to whether or not to restart.	Positive
		Pursue every possible way to better utilize all energy sources and come up with best mix for economy and society, without dependence on nuclear power.	Negative
26 Dec 12	METI Minister Toshimitsu Motegi Press conference	Previous administration's policies, such as being nuclear free in 2030s, must be reconsidered.	Positive
28 Dec 12	Prime Minister Shinzo Abe	Media said Abe told Cabinet members that suspended nuclear reactors would need to be restarted after safety approval in a bid to ensure electricity supply.	Positive
9 Jan 13	NRA Chairman Shunichi Tanaka Press conference	Safety assessments may not be completed on all nuclear reactors within three years as aimed by new government, considering administrative procedure.	Negative
28 Jan 13	PM Shinzo Abe First speech to Diet	Made no mention about nuclear power.	-
4 Feb 13	LDP's resource and energy strategy panel	Media reported most panel participants called for restarting nuclear power plants. Hiroyuki Hosoda (LDP acting secretary-general) maintained Japanese economy cannot survive without nuclear energy.	Positive
18 Feb 13	METI Minister Motegi's action plan	One way to ensure diverse energy sources is to use nuclear power that has been approved as safe.	Positive

Source: Various materials; compiled by Daiwa.

Steps for restarting plants

Going forward, we expect to see the NRA compile new safety standards, which they will use to inspect plants, with the government making decisions on restarting them. Apparently, the emerging consensus is that the first restarts will be in autumn 2013 at the earliest.

Depending on the details of the new safety standards, however, additional measures may need to be taken at the plants, which could cause delays. It is widely believed that if a power company needs some time to complete the measures, they may be allowed a period in which they can restart the plants while the related work is still ongoing. In any case, uncertainties remain until the new safety standards are put in place.

Note that legally speaking, the government cannot actually order the suspension of nuclear power plants. Chubu Electric Power suspended its Hamaoka Nuclear Power Station in acquiescence to a government request, while the reason given for suspended operations at other plants is that they are undergoing scheduled inspections.

Timing of restarts to differ by plant

The timing of restarts will likely differ by plant depending on how far they are in meeting the new safety standards. It is also unclear at this point how long inspections under the new standards will take.

Media reports have said that Shikoku Electric Power's Ikata Nuclear Power Plant and Kyushu Electric Power's Sendai Nuclear Power Plant will be restarted at a relatively early stage. The two plants do not need to have any additional seawalls constructed, are pressurized water reactors (PWRs), and are not located within active fault zones.

Meanwhile, for certain plants, the issue is not how soon but whether or not to restart. This includes boiling water reactor (BWRs) plants, plants that may be within active fault zones, and older plants.

Different measures may be taken for PWRs and BWRs in terms of installation of filter vents. Filter vents eliminate radioactive substances from steam let out when pressure within containment vessels rises during an accident. This will likely become one of the most expensive and time-consuming measures that the new safety standards require. It is widely believed that PWRs will be allowed to restart during the period the vents are being installed, as the containment buildings are large and the reactors present little risk of hydrogen explosions. BWRs, on the other hand, will most likely need to have filter vents installed before they are restarted.

The change to the Nuclear Reactor Regulation Law in 2012 has limited the operating period of nuclear plants to 40 years in principle, and 60 years at most. Electric power companies could decide to give up on some of the older reactors, if additional cost burdens do not make economic sense. That said, Minister of Economy, Trade and Industry Toshimitsu Motegi has implied that the above-mentioned cap on operating periods, adopted during the DPJ-led administration, could be revised.

■ Chart 28: Domestic Nuclear Power Plants, Compliance with New Standards

Operator	Nuclear plant	Reactor type	Approved output (MW)	Sea walls (planned completion)	Active fault risk	Years operating
Tokyo Electric Power (9501)	Daiichi (Fukushima)	BWR	1,884	-	None	33~34
	Daini (Fukushima)	BWR	4,400	-	None	25~30
	Kashiwazaki-Kariwa (Niigata)	BWR	8,212	Under construction (Jun 2013)	Study not needed but fact finding ongoing	15~27
Chubu Electric Power (9502)	Hamaoka (Shizuoka)	BWR	3,617	Under construction (Dec 2013)	Study not needed but fact finding ongoing	8~25
Kansai Electric Power (9503)	Oi (Fukui)	PWR	4,710	Under construction (FY13)	Under investigation	27~38
	Takahama (Fukui)	PWR	3,392	Under construction (FY14)	Study not needed but fact finding ongoing	20~33
	Mihama (Fukui)	PWR	1,666	Under construction (FY15)	Under investigation	36~42
Chugoku Electric Power (9504)	Shimane (Shimane)	BWR	2,653	Under construction (partially completed, FY13)	None	24~38
Hokuriku Electric Power (9505)	Shika (Ishikawa)	BWR	1,746	Completed	Under investigation	6~19
Tohoku Electric Power (9506)	Onagawa (Miyagi)	BWR	2,174	Completed	None	11~28
	Higashidori (Aomori)	BWR	1,100	Under construction (May 2013)	Indicated	7
Shikoku Electric Power (9507)	Ikata (Ehime)	PWR	2,022	Unnecessary since built on high ground	None	18~35
Kyushu Electric Power (9508)	Genkai (Saga)	PWR	3,478	Unnecessary since built on high ground	None	15~37
	Sendai (Kagoshima)	PWR	1,780	Unnecessary since built on high ground	None	27~28
Hokkaido Electric Power (9509)	Tomari (Hokkaido)	PWR	2,070	Under construction (FY14)	None	3~23
The Japan Atomic Company	Toukai Daini (Ibaraki)	BWR	1,100	Under review	None	34
	Tsuruga (Fukui)	BWR PWR	357 1,160	Under review Under review	Indicated	42 26

Source: Company materials, media reports, industry statistics; compiled by Daiwa.
Notes: 1) Fukushima Daiichi plant excludes reactors 1-4 (decommissioning decided).
2) Chugoku Electric's Shimane plant includes unit No. 3, which is yet to start operating.

Renewable energy

The Abe administration and LDP have exhibited a positive stance toward introducing renewable energy. Indeed, the party's manifesto and the action plans of the Minister of Economy, Trade and Industry include introducing renewable energy to the fullest extent possible.

In July 2012, the previous Yoshihiko Noda administration introduced a feed-in tariff scheme that obliges electric power companies to purchase power from renewable energy (solar, small hydro, wind, biomass, geothermal) suppliers at prices and for periods pre-determined by the government upon such suppliers' application. If the purchase prices exceed the power generating cost of an electric utility, it can impose a commensurate surcharge on customers. In a bid to promote the use of renewable energy, the purchase prices are in fact set at levels which enable energy suppliers to secure appropriate profits. Purchase prices of power generated at facilities approved by the government are fixed for a pre-determined supply period (10-20 years depending on type of energy).

That said, purchase prices for new applications are reviewed every fiscal year based on discussions of the procurement price calculation committee under the Ministry of Economy, Trade and Industry. FY13 purchase prices are currently being discussed—we think prices for solar power will be reduced reflecting lower prices for power generating systems, while those for wind and geothermal power will probably be left unchanged.

We believe the government will continue to promote the introduction of renewable energy. Expansion of power generation using renewable energy would help Japan reduce its reliance on imported fuels. However, it will likely be some time before renewable energy comes on a par with current mainstay sources of electricity such as hydropower, thermal power, and nuclear power—renewable energy is still inferior to conventional energy in terms of cost as well as stability of power output.

Methane hydrate

Over the long term, one notable domestic energy resource is methane hydrate (burning ice)—methane molecules combined with water molecules in a low-temperature, high-pressure environment. Reserves in the sea around Japan are said to total as much as 100 years' worth of the country's LNG-equivalent energy consumption. Although commercially viable production has yet to be on the horizon, we think it warrants attention.

Addendum: Electricity system reform

Electricity supply system reform pursued by the previous Democratic Party of Japan administration, including the separation between electricity generation and transmission/distribution, is likely to be continued by the LDP and Abe administration. A METI panel on power system reform has been meeting since February 2012 and submitted a report in February 2013. The panel called for the establishment of an organization to ensure more efficient and stable power supply throughout Japan, the complete liberalization of electricity retailing, and the separation between power generation and transmission/distribution, all of which are to be achieved in three phases through 2020. The energy action plan unveiled by METI Minister Motegi on 18 February also incorporated such initiatives. The implications are enormous for the power utility sector, but implementation details have yet to be hammered out.

Outlook for related sectors

Electric utility

Covered by Syusaku Nishikawa

Progress toward restarting nuclear power reactors would be an extremely positive development for the sector. Almost all power companies are likely to book considerable recurring losses in FY12 on increased fuel costs. The resumption of nuclear power generation is essential for returning to the black in FY13 and beyond. As such, focal points will be the scheduled July 2013 release of new safety standards as well as the time needed for relevant NRA investigations.

Gas utility

Covered by Syusaku Nishikawa

LDP and Abe administration policies seem unlikely to provide considerable benefits to the gas sector in the short term. Tokyo Gas' (9531) and Osaka Gas' (9532) electricity operations are currently brisk, but earnings could weaken temporarily if domestic electricity supply/demand eases due to resumed nuclear power generation.

However, the gas firms' electricity businesses are expected to remain on a growth trend over the medium term. The expanded use of combined cycle power generation technology will probably drive increased demand for city gas. Further electricity deregulation could give gas firms increased room to break into the market.

Exploration/production

Covered by Takahiro Yano

The government seems committed to providing continued support to players in gas/oil exploration and production, as it appears to be exploring the possibility of having JOGMEC (Japan Oil, Gas, and Metals National Corporation) provide liability guarantees for firms making forays into shale gas. Furthermore, if it can make headway with Russia in energy cooperation, it could create increased business opportunities in the easternmost part of Russia for Japan's exploration/production firms, particularly for Japan Petroleum Exploration (1662), which has a stake in the Sakhalin-1 oil and natural gas project.

Oil

Covered by Takahiro Yano

Lower import prices on crude oil and other forms of energy would help reduce refinery fuel costs for the oil sector, a positive for earnings excluding the impact of inventory valuation. We also see no major change in the trend of reductions in domestic crude oil processing capacity in the wake of August 2009 legislation that requires energy suppliers to use fossil fuel resources more efficiently (deadline for related measures: Mar 2014). One potential concern is the spread of fuel-efficient hybrid vehicles, which reduces the volume of gasoline consumption. However, JX Holdings (5020) appears to be readying itself for a shift to clean energy, given its plans to increase the number of rapid recharge stations to 4,000 locations by 2020 to prepare for increased market penetration by electric vehicles.

Capital goods

Covered by Hirosuke Tai

While visibility remains clouded about the restart of nuclear reactors, we foresee higher demand for coal/LNG-fired power plants (new construction, capacity expansion). Business opportunities exist not only for leading firms in this field, such as Mitsubishi Heavy Industries (7011), Hitachi (6501), and Toshiba (6502), but also for Mitsubishi Electric (6503), IHI (7013), and other makers of associated equipment.

Ahead of nuclear power plants coming back online, we anticipate demand materializing from this summer in areas such as those related to pre-start inspections and safety countermeasures. Even though relevant implementation policies in these areas are still unknown, this will probably prove positive for earnings, as the volume of work undertaken in the wake of the Great East Japan Earthquake should start shrinking going forward, entailing a heavier fixed-cost burden barring contributions from new projects.

Over the long term, promising projects include offshore wind power generation and ocean mineral resource development. In fact, trial operations of an offshore wind farm have started in Choshi, Chiba Prefecture. We expect more of these projects once depth and cost issues have been solved. On the ocean mineral resources front, the LDP outlined the use of methane hydrate and other seabed minerals in its manifesto. As such, we look forward to stepped-up development through joint efforts of the government and leading private-sector players.

General trading firms

Covered by Jiro Iokibe

Rising LNG import prices in the East Asia region in recent years have translated into higher equity-method gains and increased dividend income from interests in overseas LNG projects held by major general trading houses such as Mitsubishi (8058) and Mitsui & Co. (8031). For the five major general trading houses combined, we estimate net income from LNG operations will mark a record of Y266.4 billion in FY12, underpinning profit in their energy operations. LNG trading prices in the East Asia region are mostly linked to crude oil prices in long-term contracts, and we do not expect this situation to change for the time being. Accordingly, the greatest earnings risk for trading firms' LNG (and in turn energy) operations is a drop in crude oil prices. Even if high LNG trading prices in the Asia region cause Japan's buyers to step up demands for the link with crude oil prices to be severed, we think it will take at least a few years to complete negotiations over contract revisions with suppliers.

In response to the changing energy map triggered by the shale revolution in the US, general trading firms have aggressively pursued large-scale investments in North American shale gas/oil rights since 2010. They have also actively participated in LNG export plant projects. Trading firms have adopted such strategies to hedge against a drop in LNG prices in East Asia, as well as in consideration of a responsibility to supply energy to Japan's electric and gas utilities. However, while the shale boom caused investment expenditures in shale interests to spike, natural gas prices have slumped in North America. This has landed contributions from shale gas rights in the red and put trading firms at risk of writing down the value of their assets in the short term. Mitsui & Co. has teamed up with independent US petroleum company Anadarko (APC US), investing in shale gas rights in Pennsylvania and shale oil rights in Texas. Mitsubishi is participating in an LNG project on Canada's west coast led by Royal Dutch Shell of the Netherlands. The firm has also acquired upstream rights for gas development in British Columbia. Sumitomo (8053), Itochu (8001), and Marubeni (8002) have all already purchased shale oil/gas rights in the US. As for contracts for importing LNG from the US, Mitsubishi and Mitsui & Co. have signed a basic agreement to import a total of 8 million MT a year from US firm Sempra Energy's Cameron LNG project in Louisiana. Sumitomo together with Tokyo Gas has struck a precedent agreement with US firm Dominion to import 2.3 million MT of LNG a year from the Cove Point export project in Maryland. However, the US government has yet to approve exports from either of these LNG plant projects.

Meanwhile, Marubeni and other general trading firms have made aggressive inroads into overseas IPP projects. Trading firms also appear to be considering forays into large-scale IPP projects in Japan, where electric utilities such as Tokyo Electric Power are inviting bids.

Relations with China

Importance of Japan-China relations

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There are concerns about the negative impact on trade and investments between Japan and China, as well as drags on Japanese firms in China, from deterioration in the relationship between the two countries. While some have pointed out that the impact is more severe for Japan since China is the largest importer of its goods, the negative effects of the diplomatic tensions certainly go both ways. The percentage of local procurements by Japanese companies in China is rising, and Japanese technology is crucial to China's conservation of energy and natural resources. China and Japan therefore both face damage to their economies that will only worsen as the problem persists. We hope to see improvement in the situation through talks between the countries' high-level government officials soon.

China is Japan's biggest importer

The cooler relationship between Japan and China caused by territorial disputes over the Senkaku Islands in September 2012 has hurt trade and investments between the two countries. The issue is also a source of concern for the operations of Japanese subsidiaries incorporated in China.

China is the largest importer of Japanese goods. It accounted for 19.7% of Japan's exports in 2011 and 18.1% in 2012. The fall in Japan's exports to China widened from August to September 2012, with y/y declines of 9.9% in August and 14.1% y/y in September. The decline narrowed in October, but expanded thereafter, tumbling 15.8% in December.

While the drop in Japanese exports to China in 2012 is significant, we note that it largely reflects the dampening effect of the super-strong yen on Japan's overall exports through that point as well as economic deceleration in China. Deterioration in the relations between the two countries seems to add only slightly to the decline in Japan's exports to China. Additionally, Japanese firms operating in China are increasing their percentages of local (Chinese) procurements, which may also be curbing exports of materials and parts from Japan.

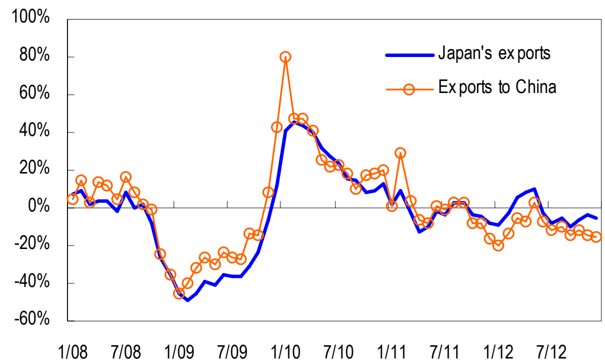
Economic impact of fall in exports to China limited for Japan

Looking at the impact on Japan's GDP from the decrease in exports to China (assuming exports decline from Nov 2012 at same rate seen in Aug-Oct for all items), Daiwa Institute of Research estimates drags of only 0.07 percentage points on GDP growth if exports fall for six months and 0.08 points if they decline for one year. As such, the impact on Japan's economy seems likely to be small.

Chinese market crucial for Japanese firms

According to the Survey of Overseas Business Activity by the Ministry of Economy, Trade and Industry (METI), FY10 recurring profit for Japanese subsidiaries incorporated in China amounted to Y1,731 billion, or 15.9% of overseas subsidiaries' global total. The survey also found that around 70% of sales by Japanese subsidiaries (manufacturers) in China were made in the country and the rest were exports, underscoring the importance of China as a source of demand. Already nearly two-thirds of these companies' procurements are local and the percentage has been growing every year. With this in mind, we think concerns about the impact of worsened relations between Japan and China extend to local Chinese firms as well as Japanese companies operating in China.

■ **Chart 29: Japan's Exports to China**



Source: Ministry of Finance Japan statistics; compiled by DIR.

Japanese car sales narrowing declines

Japanese cars became a target for boycotts of Japanese products and acts of vandalism during anti-Japan protests in China in September 2012. Among products exported from Japan to China, the slump in cars was the most notable. In October 2012, sales of Japanese cars produced in China plummeted 59.4% y/y. Seen in a more positive light, consumers did continue to purchase such cars, albeit at only around 40% of the year-earlier level. Moreover, declines narrowed rapidly, with purchases falling only 25.9% in December.

A high regard for Japanese cars probably accounts for the swift narrowing of sales declines. Chinese customers are very loyal to Japanese products (not only cars), including those produced locally, with a high proportion of them wishing to replace products with new ones produced by the same manufacturer. Chart 30 shows changes in various countries' share of car sales in China from August 2012 (prior to anti-Japan protests) to December 2012. The figures show that German cars lost more share than Japanese cars over the period, while the share occupied by Chinese cars expanded 10.6 percentage points. Granted, the Chinese have likely grown more hostile toward the Japanese overall. However, with customer loyalty to Chinese products relatively low, we fully expect Chinese customers to return to purchasing Japanese cars sooner or later.

■ **Chart 30: Share of Car Sales in China by Country (Aug-Dec 2012)**

	Chinese cars	Japanese cars	German cars	American cars	Korean cars	French cars
Aug 2012	36.4%	18.6%	20.8%	12.3%	9.1%	2.7%
Sep 2012	42.7%	12.2%	19.3%	12.8%	9.7%	3.3%
Oct 2012	45.1%	7.6%	21.6%	12.5%	9.7%	3.3%
Nov 2012	43.7%	11.7%	18.5%	13.1%	9.8%	3.0%
Dec 2012	47.1%	14.9%	14.4%	10.9%	9.7%	2.8%
Chg. in share from Aug-Dec	10.6% pt	-3.8% pt	-6.5% pt	-1.4% pt	0.6% pt	0.1% pt

Source: China Association of Automobile Manufacturers; compiled by DIR.

Furthermore, firms that make inroads into China play an extremely important role for local governments. For example, Nissan, Toyota, and Honda all operate in Guangzhou City, Guangdong Province. These three firms employ around 26,000 people in the area, or 1.1% of the 2.39 million people employed in Guangzhou's urban areas. However, they rank as the fourth, sixth, and ninth highest tax paying firms in Guangdong Province. The three firms combined paid 22 billion yuan (Y275 bil) in taxes to Guangzhou City in 2011, accounting for 6.5% of the city's tax revenue.

Moreover, the local people are passionate about locally produced cars. For example, many of the taxis in the city of Beijing are locally produced by South Korean automaker Hyundai Motor. If a passenger compliments the driver on the comfortable ride and nice interior, the response will likely be, "That's because it's a Beijing car." The Beijing people apparently believe these are Beijing, not Korean, cars. Cars produced locally by Japanese automakers likely generate similar feelings of attachment. The affection of the local people toward locally produced cars probably accounts for the above-mentioned high proportion of such cars in local purchases.

Finally, we highlight China's policy support for energy-saving cars. In January 2012, China's State Council announced a five-year plan for increasing the sophistication of industry, which included promoting the spread of energy-saving cars with fuel consumption of 5.9 liters of gasoline or less per 100 km.

To sum up, we expect production in China by Japanese automakers to pick up going forward on the back of (1) strong customer loyalty, (2) the importance of Japanese firms to local governments in China, (3) the affection for locally produced Japanese cars among the people, (4) a boost from Chinese government policies, and (5) the efforts of Japanese firms operating in China to overcome adversity.

Japan's energy saving and environmental technologies vital for China's construction of an eco-civilization

As part of its revisions to the party constitution on 14 November 2012, the Chinese Communist Party integrated the "construction of eco-civilization" as a pillar of its Chinese-style socialism. Behind the revision was a sense of impending crisis amid increasing resource constraints, worsening environmental pollution, and the destruction of the ecosystem. The effects of such issues are becoming visible in serious health problems among the Chinese people, as well as the PM-2.5 problem (air polluting particulate matter with diameter of 2.5 micrometers or less), the impact of which on surrounding countries/regions, including Japan, is of concern.

Strengthening development in the areas of energy/resource conservation and clean energy in China and stepping up investments in environmental protection will be vital to China's construction of an eco-civilization. Japan's energy-saving and environmental technologies will be needed if China is to take steps to conserve energy and protect the environment.

Outlook and concerns

Xi Jinping was appointed secretary-general for the Chinese Communist Party 18th national congress in November 2012. Given that his power base includes the People's Liberation Army, we believe he had to take a hard line on foreign policy. Notably, the Jul-Sep period includes extremely sensitive dates in history, as it marks the anniversaries of the Marco Polo Bridge Incident (7 Jul), the end of the Pacific War (15 Aug), and the Liutiaohu Incident (18 Sep). The circumstances call for rational and refined responses from both Japan and China.

Deterioration in relations between Japan and China results in economic losses for both countries. Prolonging the sour relations will only result in greater losses. We await an early improvement in affairs through high-level political dialogue.

Business in China following anti-Japan protests

Makoto Morita

The dispute over the Senkaku Islands heated up in September 2012, triggering anti-Japan protests and boycotts of Japanese goods in China. This dealt heavy blows to some Japanese players with Chinese operations. The dust has settled now some six months after the demonstrations, providing a clearer picture of the fallout. The damage varies by company, but the bulk of firms have recovered from the protests, excluding players in fields where the Chinese government is heavily involved, such as electric power and healthcare.

China remains a very attractive growth market for many Japanese firms. Still, the risks to Chinese operations warrant attention for some time going forward, since the outlook on Japan-China relations remains unclear.

■ **Chart 31: Japanese Exports to China by Category** (Y bil)

2012	Aug	Sep	Oct	Nov	Dec	Chg. from Aug to Dec
Chemicals	132	132	148	137	142	7.9%
Raw materials	132	132	130	121	126	-4.5%
Machinery	197	171	190	163	175	-11.2%
Electrical machinery	236	248	230	208	217	-8.1%
Transport equipment	91	88	56	52	61	-32.3%
Other	178	184	194	178	183	3.2%

Source: Trade statistics; compiled by Daiwa.

Consumer-facing businesses

Many consumer-facing firms have staged a recovery from slumps following the demonstrations. Automakers took a heavy hit, with shipments dropping roughly 60% y/y in October 2012 after the demonstrations. However, January 2013 shipments appear to be between roughly flat and down 10% y/y, excluding the impact of the Chinese New Year Holidays. Inventory work-downs amid production cuts have roughly played out, more or less eliminating the negatives on the production front. Dealerships are also demonstrating clear signs of a rebound, as evidenced by an upturn in footfall y/y. Nissan's (7201) *Sylphy* won China's car of the year in 2012, further evidence that the backlash against Japanese cars has died down.

With Chinese operations clearly on the mend, negatives from the protests have also more or less faded for retailers such as Fast Retailing (9983) and players in the foods and toiletry spaces, including Yakult Honsha (2267) and Unicharm (8113).

One firm where concerns remain is Shiseido (4911). Its Chinese operations still struggle, showing only a weak rebound after the protests. This could stem from Chinese consumers avoiding Japanese goods for gifts or face-to-face purchases where they might be seen by others.

B2B businesses

Many Japanese machinery makers and electronic component firms supplying products to Chinese manufacturers saw sales slump, but the blame likely goes to a slowdown in the Chinese economy rather than fallout from the Senkaku dispute.

The protests have had an impact on players in the auto parts industry, who suffered when Japanese automakers cut back on production. However, with more Japanese cars moving off dealership lots, these firms should enjoy a pickup in sales as production returns to normal levels.

Business involving Chinese government agencies

Japanese firms appear to be losing ground in fields with heavy government involvement. For example, NGK Insulators (5333) had been a regular supplier for insulators used in power generation, but Chinese and European firms appear to be gaining favor. Machine tool makers have also seen a slump in orders from players in the railway space and other areas where the Chinese government is likely to be a major stakeholder. In healthcare, there has been a steep decline in sales of drugs and medical equipment that can be replaced by rivals' products. However, Chinese operations account for a small weighting of total sales at Japanese pharmaceutical firms, meaning only a minor impact on consolidated earnings.

Negatives for M&A moves by Japanese firms

Although it is not clear whether political fallout is at play, some Japanese firms have seen the completion of acquisitions held up by reviews by Chinese regulatory authorities. Approval has yet to be granted for Marubeni's (8002) acquisition of Gavilon. Such delays can hinder business strategies and thus warrant careful attention.

Appendix: Our top picks update

Masahiro Kushida
Japan equity analysts

We will briefly introduce on our stock picks in this section.

Update on our earlier stock picks for 2013

Near the start of this year, we compiled a report entitled *Daiwa's Top Picks for 2013*, which presented our outlook based on a bottom-up approach. Specifically, we highlighted the stocks listed in Chart 32, most of which we still recommend now.

Among the names shown, real estate, construction and construction materials players have performed poorly so far in 2013. However, in the case of the **real estate sector**, we view this as merely a temporary lull following the sharp gains marked through end-2012. With REIT cap rates falling, the sector could re-enter an uptrend if rises in rents and property prices become pronounced. There is a growing sense of caution over the possible emergence of factors that would push up costs in the **construction sector**, as some second-tier players have announced downward revisions. However, this sector could also recapture market attention if the Diet approves the LDP's bill on measures for strengthening social infrastructure, and there is widespread recognition of improving public-sector demand and solid private-sector demand.

The top performer among our earlier picks, **Mazda Motor (7261)**, appears fairly priced, with weak-yen benefits seemingly priced into current trading levels. Among auto industry subsectors, auto parts and tire makers now seem increasingly attractive. On this front, we are focusing on **Sumitomo Rubber Industries (5110)**.

■ **Chart 32: Overview of Top Picks for 2013**

Code	Company	Points	Share price [Y; as of 22 Feb]	Chg
Weakening yen plays				
7201	Nissan Motor	Benefits from favorable turn in model cycle to emerge, spurring share price gains	939	16%
7261	Mazda Motor	*SkyActiv* powertrains to drive sharp earnings growth in FY13	271	56%
6988	Nitto Denko	Provider of new value-added products; short-term drivers include ITO film, weaker yen	5,230	24%
6981	Murata Manufacturing	No. 1 in passive components; products sparking advances in wireless technology; weaker yen also positive	5,970	18%
Beneficiaries of loose monetary policy				
8306	Mitsubishi UFJ Financial Group	Expectations for upside earnings surprise; active programs to increase total shareholder returns laudable	513	11%
8766	Tokio Marine Holdings	Share price boost from weaker yen, aggressive capital strategy positive	2,728	14%
8591	Orix	Upside potential if market attention turns to end of deflation, rising real estate prices	10,240	6%
8804	Tokyo Tatemono	See significant upside for shares on new contributions from large buildings, consolidation of SPCs	441	0%
Reconstruction/infrastructure plays				
1801	Taisei	Expect acquisition of large projects in FY13	259	-9%
5233	Taiheiyo Cement	Should benefit from reconstruction/infrastructure demand; earnings expansion accelerating in cement, mineral resources ops	221	-6%
4204	Sekisui Chemical	Two M&A deals likely to fuel earnings growth; PVC pipe ops to gain from infrastructure spending, electronics materials from touch panel materials ops	864	15%
Quality yet unloved defensives				
7453	Ryohin Keikaku	Solid earnings at home, room for growth overseas; enhanced shareholder returns possible; stock undervalued on P/E	5,980	24%
3774	Internet Initiative Japan	Shares may jump two- to threefold over long term on growing demand for cloud data centers	2,557	29%
Dogs of 2012				
2503	Kirin Holdings	Growth in overseas operations, generous shareholder returns	1,313	30%
8267	Aeon	Major share price catalysts in place, incl. easing of weight on share supply/demand, progress in group restructuring	1,074	9%
4151	Kyowa Hakko Kirin	Antibody technology to sustain longer-term earnings growth; next medium-term business plan a catalyst	936	10%
9201	Japan Airlines	Building solid earnings base aimed at sustainable growth; low valuations	4,395	19%
M&A movers and shakers				
7011	Mitsubishi Heavy Industries	MHI to play key role in raising Japan's profile on international stage; track record under strong yen suggests record profits when yen weakens	516	24%
8015	Toyota Tsusho	Notable as one of few Africa stocks; to see synergies from CFAO acquisition	2,330	10%

Source: Excerpt from 8 Jan 2013 report Daiwa's Top Picks for 2013*; compiled by Daiwa.*

Our new picks

Although stock trading levels have already risen on expected benefits from yen depreciation, valuation metrics still suggest significant upside for steel sector names, given expectations for volume growth and improvement in the metal spread (spread between product and raw material prices). We recommend **JFE Holdings (5411)**.

We are also focusing on **NEC (6701)** as a turnaround stock. It now seems a safer play following progress with restructuring efforts focused on shifting away from hardware sales.

We see two standouts among domestic demand-oriented firms. The first is **Capcom (9697)**, which announced downward revisions to its FY12 projections, but nonetheless seems poised to set a new profit record in FY13 on a pickup in packaged software sales and growth in social game and pachislot operations. The other is **Kakaku.com (2371)**, which should enjoy faster profit growth on contributions from its *Kakaku.com* and *Tabelog* websites.

The likelihood of improved industry conditions is the main factor behind our bullish outlook on Sumitomo Rubber Industries and JFE Holdings. On the other hand, our recommendations of NEC, Capcom, and Kakaku.com owe more to company-specific growth drivers, though these firms should also benefit from favorable industry conditions. Individual stock selection is now likely to have an even greater impact on investment returns.

■ Chart 33: Overview of New Picks

Code	Company	Points	Share price [Y; as of 22 Feb]	Chg
5110	Sumitomo Rubber Industries	Large scope for upward revisions, given firm's conservative targets, weak-yen benefits, anticipated trends in price of natural rubber	1,379	33%
5411	JFE Holdings	Earnings to pick up sharply in FY13 on weak-yen benefits, metal spread expansion, effects of inventory valuation	1,939	21%
6701	NEC	Making progress with restructuring aimed at shifting away from hardware sales; poised to carry out aggressive strategies backed by longstanding technological edge	233	29%
9697	Capcom	To set new profit record in FY13 on pickup in packaged software sales, growth in social game/pachislot ops	1,465	11%
2371	Kakaku.com	Consumable goods/service price comparisons, *Tabelog* driving growth	3,625	27%

Source: Compiled by Daiwa.

Please also see:

Daiwa's Top Picks for 2013
Our bottom-up picks
[reg. 8 Jan]

Company/sector reports

- **JFE Holdings (5411)** [reg. 1 Feb]
  Lifted rating; yen depreciation to spur sharp earnings turnaround in FY13
- **NEC (6701)** [reg. 1 Feb]
  Risks receding; our forecasts lifted
- **Console Game Makers** [reg. 29 Jan]
  Looking for improved profitability on growth/diversification in games market
- **Kakaku.com (2371)** [reg. 7 Feb]
  Consumable goods/service price comparisons, *Tabelog* driving growth

Readers with L-Zone accounts are encouraged to click on the linked image or report titles to access the full reports.

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4: Underperform TOPIX/benchmark index by 5-15% over the next six months.
5: Underperform TOPIX/benchmark index by more than 15% over the next six months.

Benchmark index: TOPIX for Japan, S&P 500 for US, DJ STOXX 600 for Europe, HSI for Hong Kong, STI for Singapore, KOSPI for Korea, TWII for Taiwan, and S&P/ASX 200 for Australia.

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