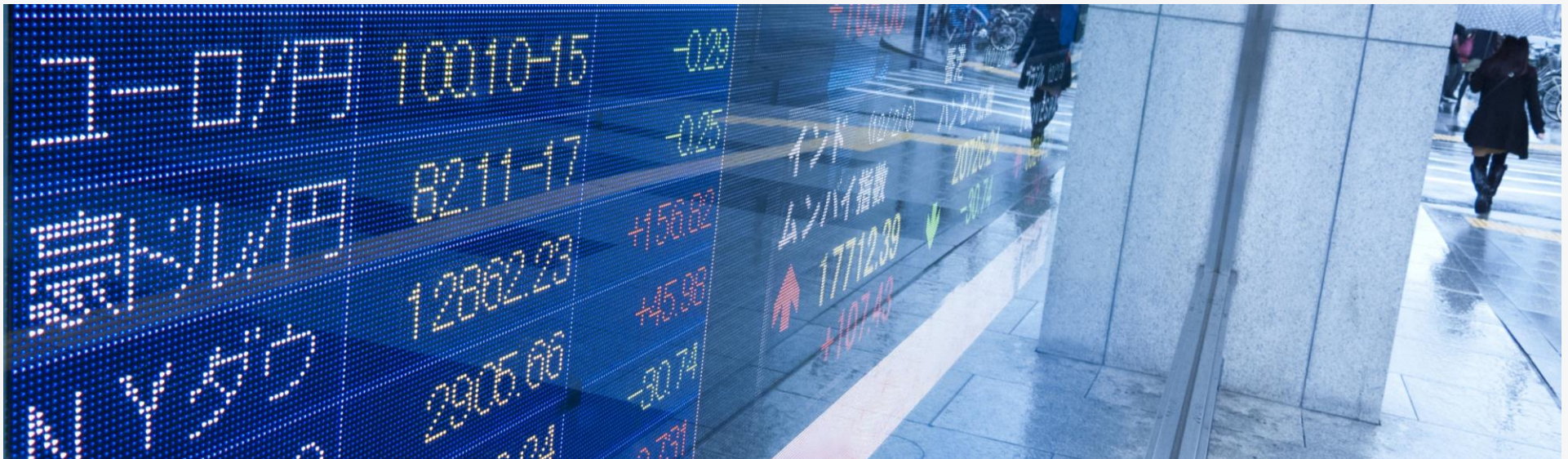


Special Report

Japan's Equity Renaissance: A Strategic Approach to Growth and Value



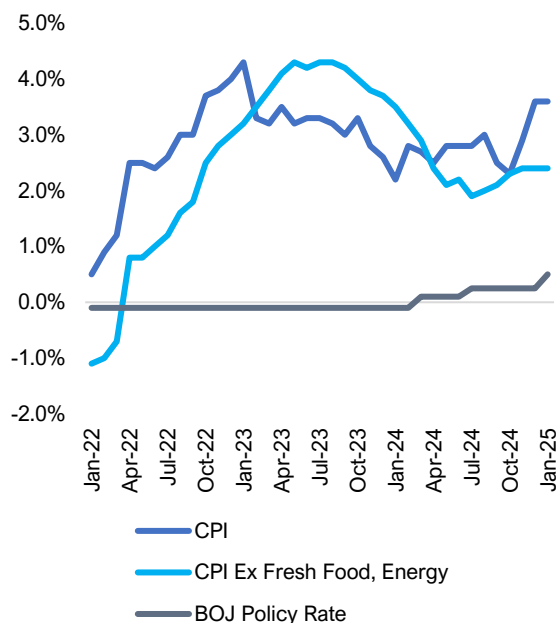
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Japanese Economy

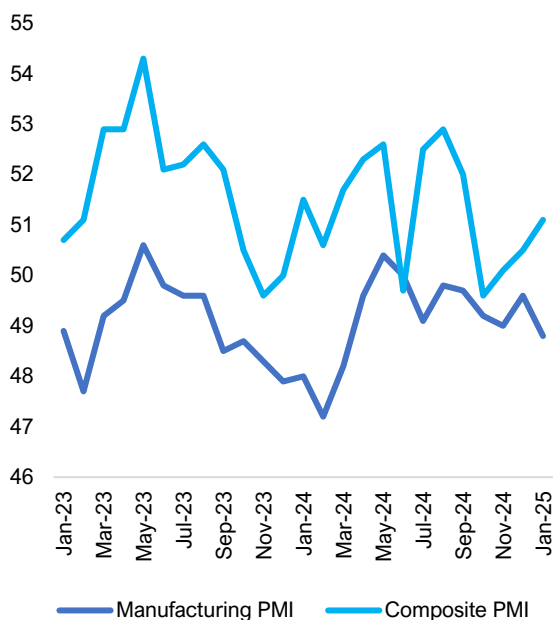
Economic recovery driven by loose monetary policy, services and, potential strong wage growth

Inflation and Policy Rates



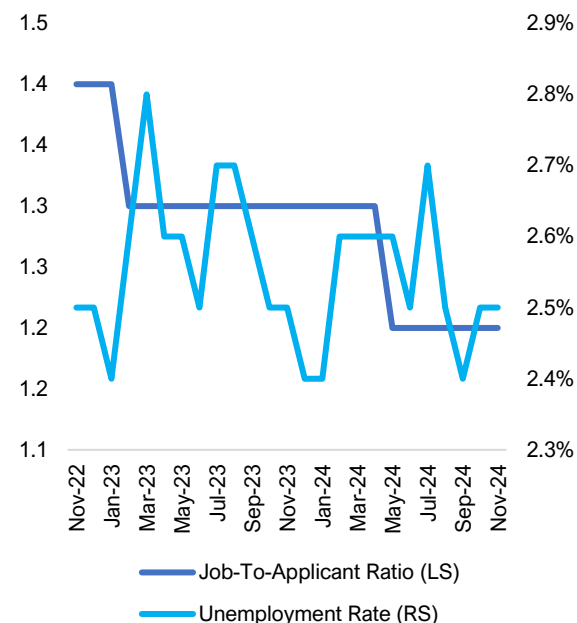
- Japan witnessed increasing headline and core inflation with negative real wage growth.
- The BOJ continued to maintain a loose monetary policy with negative real rates despite policy rates increasing to 0.5%.
- The policy reflects BOJ's focus on boosting growth and consumption.

PMI



- Manufacturing PMI faced headwinds reflecting challenges like global demand slowdowns and supply chain disruptions.
- However, composite PMI highlights the recovery in the Japanese economy, where consumption remains weak, but services see resilient growth.

Labour Market

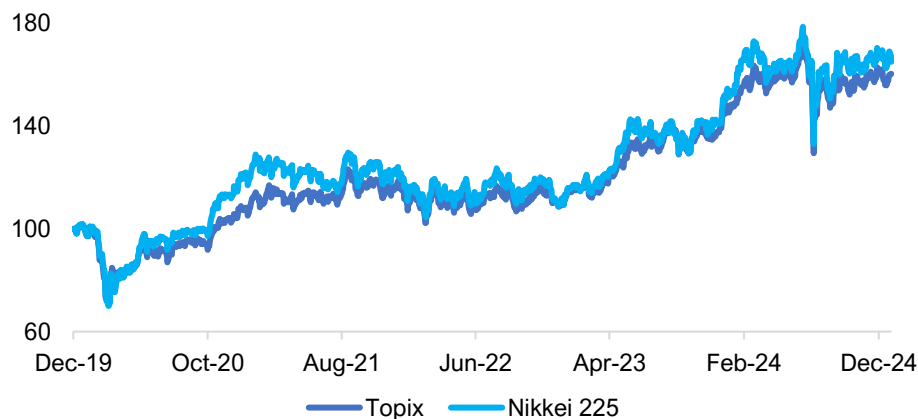


- Japan's labor market remains tight with low unemployment.
- During the 2024 Shunto wage negotiations, Japan's average wages grew 5.1%. Wage growth could remain high in 2025 Shunto, too.
- This could lead to positive real wage growth and a boost in consumption.

Japanese Equity Markets

Navigating Japan's Equity Markets Through Reform, Volatility, and Recovery

Nikkei 225 and TOPIX 5-year Stock Price Performance



- Both indices increased in 2024, and the Nikkei 225 surpassed its 1989 peak supported by a boost from global economic recovery, structural reforms, renewed investor confidence, and strong corporate earnings, as Japan's export-oriented sectors, such as technology and automotive, saw sustained demand.
- However, in August, both indices crashed, with the Nikkei 225 underperforming TOPIX. This downturn was driven by hawkish comments from BOJ's Governor, which spooked the markets and led to an unwinding of Yen-short carry trades.
- After September, the indices showed signs of stabilization as the BOJ reaffirmed its commitment to maintaining low interest rates and provided clarity on its yield curve control policy, helping market sentiment.

TOPIX Forward PE with 5-year Median



- Forward P/E ratio for TOPIX peaked mid-2024 at ~16x because of strong corporate earnings, sectoral outperformance in technology and clean energy, and improved corporate governance with record share buybacks.
- A significant valuation dip occurred in Q3 2024, as markets crashed. TOPIX fell under a 14x forward PE, reflecting investor caution amid expectations of hawkish monetary policy and market downturn.
- The drop below the five-year median suggests a period of market repricing, in which investors reassessed earnings sustainability, external economic risks and currency impact on Japan's export-driven sectors.
- However, volatility remains elevated, indicating lingering uncertainty around Japan's economic trajectory, global risk sentiment, and potential earnings revisions.

Diluted EPS Y/Y Growth	2020	2021	2022	2023	2024
TOPIX	(47.9)%	136.7%	8.6%	7.5%	19.2%

Source: Bloomberg, Aranca Research

Key Drivers of Outperformance

Significant Internal and External Structural Changes



Corporate Governance Reforms

- Japan's adoption of the Corporate Governance Code (2014) and its revisions has improved transparency, board independence, and capital efficiency, focusing on aligning management with shareholder interests. Emphasis on sustainability and ESG practices, alongside global best governance standards, has attracted foreign investors and boosted market confidence in Japan's corporate environment.
- This has led to an increased focus on return on equity, profitability, and growth, which fits with the GARP strategic focus on quality growth stocks at reasonable valuations.



Activism and Shareholder Pressure Amid Low Valuations

- Many Japanese companies hold significant cash reserves or underused assets, making them prime targets for activists who push for better capital allocation and returns. These cash reserves and underused assets have contributed to low valuations and price-to-book (P/B) ratios below 1, presenting compelling value opportunities for investors.
- Shareholder activism, specially from foreign investors has pushed Japanese companies to adopt more growth-oriented strategies. Japanese cross-holdings have also steadily declined, freeing cash, which is used up for a record shares buyback in FY2025.



Technological Innovation

- Japan's aging population is driving demand for technology-driven solutions like automation and healthcare innovations.
- Japan has seen growth in technology-driven sectors like AI, robotics, semiconductors, and biotechnology due to high demand for automation and AI. These high-growth industries provide opportunities for GARP investing, in which companies exhibit solid growth potential.



Outlook

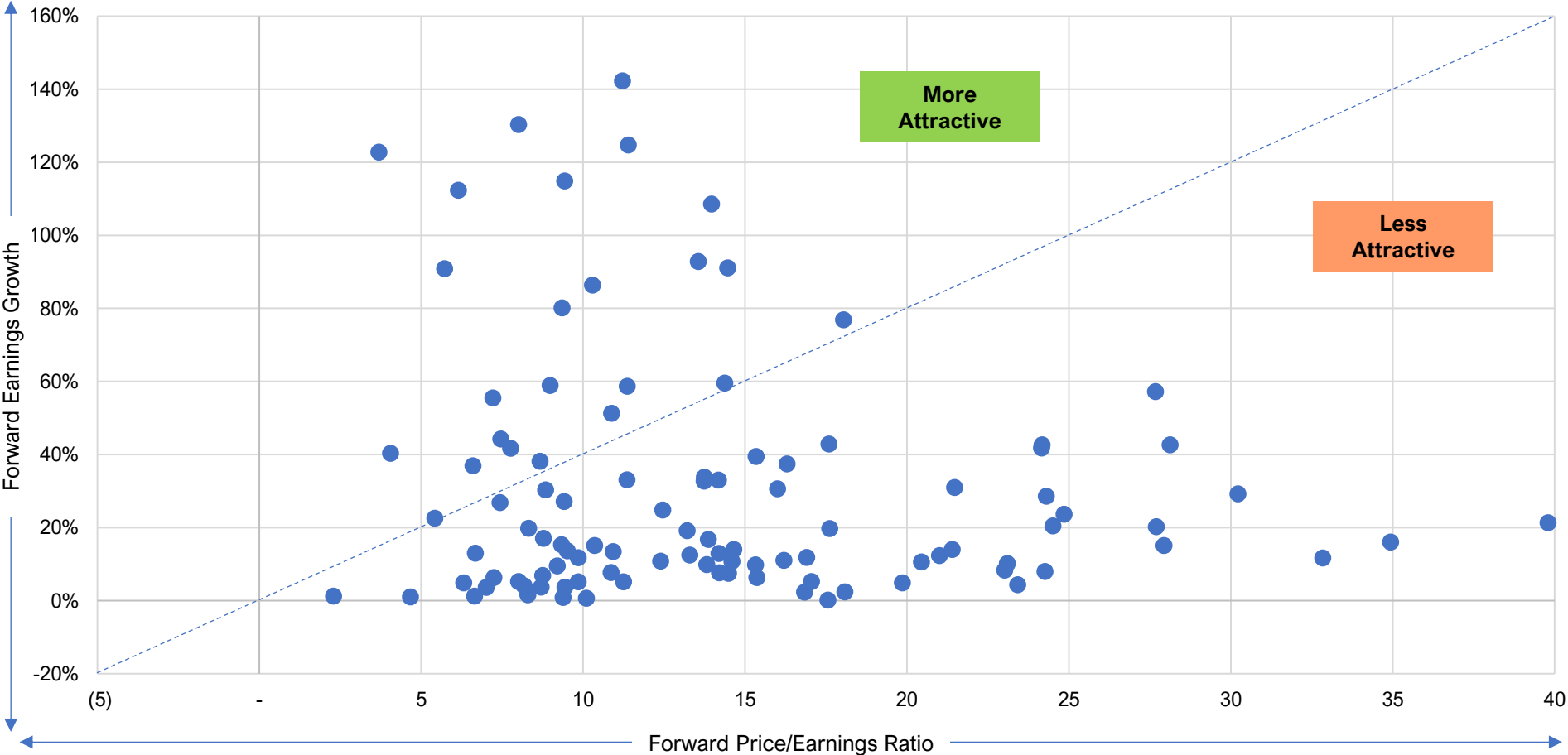
- Japan is likely to be on the path of sustainable inflation, which could result in higher growth. Positive real wage growth could increase consumer spending, boosting earnings of domestic companies and GDP growth.
- Japanese equities are also well-positioned to benefit from the AI theme with the prevalence of AI-related semiconductor stocks. Additionally, the country's corporate governance reforms and foreign investor appetite could boost value stocks, making GARP a good strategy.

GARP Strategy in Japanese Market

We evaluated GARP Metrics to form a portfolio which could outperform in Japanese markets

The Quadrant shows all Nikkei 250 companies mapped as per their 1-year Forward Earnings Growth and Forward PE multiple

Prima facie, companies above the line are GARP companies, given their higher growth and lower valuations relative to companies below the line.



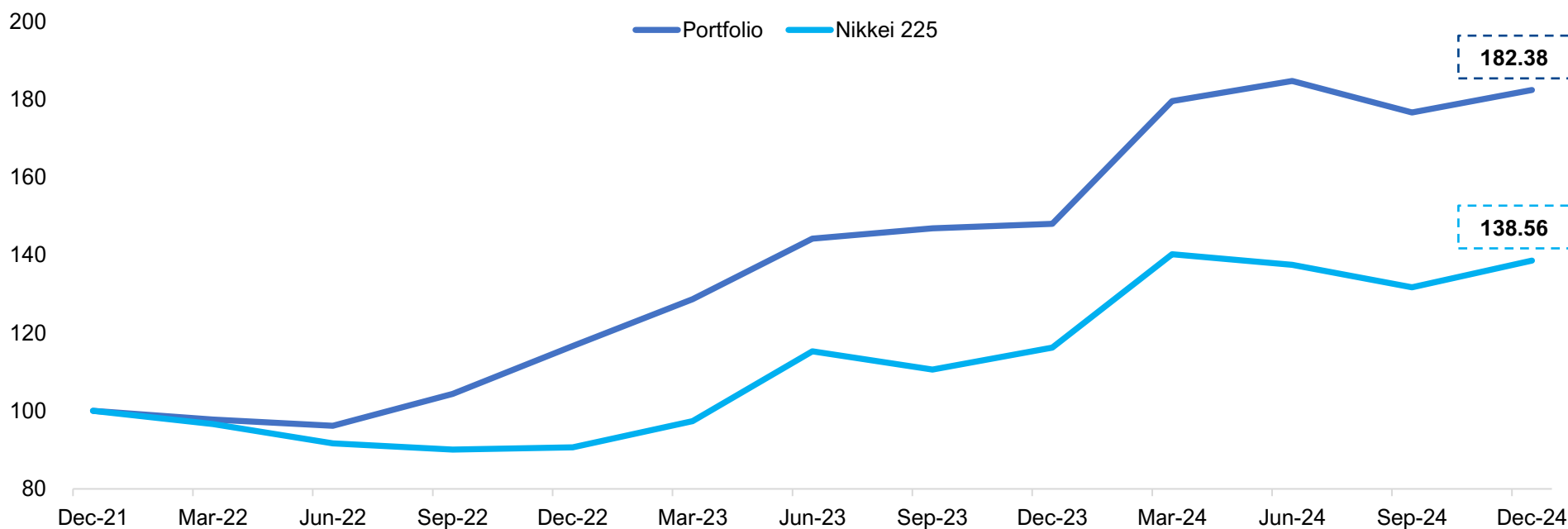
Source: Refinitiv Eikon, Aranca Research

Back-testing the GARP Strategy

A portfolio of 10 stocks selected using GARP outperformed the Nikkei 225

A portfolio of equally weighted 10 Japanese stocks (constituents of Nikkei 225) selected using a combination of GARP Metrics outperformed the broader Nikkei 225 Index

Comparison of GARP Portfolio Against Market Index (Quarterly Rebalancing)



3-Year Annualized Returns	Portfolio	Benchmark	Alpha	Alpha Summary	Success rate	Average Positive	Average Negative
Quarterly Rebalancing	22.2%	11.5%	10.7%	1 Year	61.8%	12.8%	-8.1%
Half-Yearly Rebalancing	20.2%	10.1%	10.1%	6 Month	64.7%	7.8%	-6.0%
Yearly Rebalancing	13.4%	10.1%	3.2%	3 Month	67.6%	5.0%	-5.3%

Source: Refinitiv Eikon, Aranca Research

Appendix

Methodology for selecting the GARP Portfolio

Methodology

1 Growth and Value

- To assess Growth and Value, we used PEG and EVSG ratios by calculating them using 12-month forward revenues and profits. We excluded companies with negative earnings or negative revenue or profit growth.
- These ratios focus on sales and earnings growth and the valuation of the company relative to sales and revenues, providing us with an idea about the growth and valuation of a company.

2 Ranking

- Next, we ranked each of these two metrics for all Nikkei 225 companies at various points in time from 2019 to 2024.
- We excluded companies that were expected to experience negative growth in revenues or earnings and even those with losses. We only included companies expected to grow.
- We took a weighted average of these ranks by assigning **60%** weight to PEG and **40%** to EVSG.

3 Portfolio Construction

- We back-tested this thesis by building a portfolio containing of the 10 best companies as per the weighted average of PEG and EVSG ranks.
- The portfolio would only invest in 10 such companies with equal weights. Rebalancing will occur quarterly, and companies which provide the best combination are bought.
- We found such a portfolio outperformed the Index.



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