



Japanese Banks Are Cheap—But for Good Reason

Value investors are being tempted back into the sector, but problems remain.

March 2019

KEY INSIGHTS

- Following the sell-off in global equities in late 2018, Japanese banks are currently trading around their lowest valuations in more than a decade.
- However, Japan's banking sector continues to face many challenges—and this is duly reflected in the current valuation levels.
- Japan has one of the most crowded banking industries in the world. Given the highly competitive landscape, profit margins are being continually squeezed.



Archibald Ciganer
*Portfolio Manager, T. Rowe Price
Japan Equity Strategy*

Japanese banks are currently trading around their lowest valuations in more than a decade, encouraging value investors back into the sector. Certainly, banking stocks appear cheap—but they have looked cheap for many years and, we believe, for good reason.

For value investors, the investment thesis here seems clear. Given the current

low valuations, any improvement in Japan's interest rate environment could be exponentially reflected in the share prices of banking stocks. While this argument has merit, improving rates alone are not enough to overcome the long-term challenges that remain within the sector, including oversaturation and unfavorable demographics.

(Fig. 1) Japanese Bank Earnings Face Ongoing Pressure

As of December 2017



Source: Federal Reserve Economic Data, Economic Research Division, annual data, not seasonally adjusted.

¹ Value of banks' net interest revenue as a share of its total interest earning assets.

-27.9%

Japan banking sector (TOPIX) annual return in 2018

“...weaker demand for new loans from cash-rich corporates and an aging population have compounded the negative impact on earnings.

— Archibald Ciganer
Portfolio Manager, T. Rowe Price
Japan Equity Strategy

Weak Earnings/Profitability Outlook

The Bank of Japan's (BoJ) ultra-loose monetary policy has created a very difficult environment for banks to make a profit. A combination of quantitative easing and negative interest rates have effectively scythed through Japanese banks' earnings.

Traditionally, commercial banks make their money from the interest received from customer loans as well as the interest paid on cash reserves held on short-term deposit. Since 2013, the BoJ's quantitative easing program—buying large volumes of government bonds in the open market—has suppressed long-term bond yields. For banks, this has resulted in a steady decline in their earnings from lending. As bonds have matured, they have been replaced with those offering progressively lower yields, meaning the interest that banks can charge on customer loans has also steadily fallen. At the same time, weaker demand for new loans from cash-rich corporates and an aging population have compounded the negative impact on earnings.

Banks were dealt another blow in January 2016 with the BoJ's introduction of a negative interest rate policy, effectively charging them for holding cash on short-term deposit. Designed to encourage greater spending and boost inflation, the policy has eroded banks' earnings further as returns on their cash reserves have all but evaporated. Given this backdrop, the earnings outlook for the sector appears weak, and it is hard to see this changing any time soon.

A Highly Competitive Environment

Japan has one of the most crowded banking industries in the world. The number of bank branches per 100,000 people (including post office branches

that also offer banking services) is 34.0, compared with a global average figure of 12.2.² In highly populated areas, the density of banking options is especially apparent, providing customers with ample choice. Given this competitive landscape, profit margins are continually being squeezed tighter.

So, even if we do see an improvement in interest rates, for example, the positive flow through to banks' bottom lines is diluted as a lot of this will ultimately be competed away. The saturation of bank branches is a structural problem that will continue to drag on earnings/profits until we see some meaningful consolidation within the sector.

Shifting Population Trends

The outlook for Japan's many regional banks looks particularly challenging. These small and mid-sized banks mainly serve populations in less built-up areas of the country outside the major cities. With domestic lending as their core business, the negative interest rate environment has been damaging. Regional banks have seen a steady decline in earnings over recent years with many posting losses or, at best, seeing margins squeezed toward zero.

In addition, populations in rural and suburban areas of Japan are declining as well as getting older. Regional banks are acutely exposed to these structural trends and, as such, face declining prospects for growing their loan portfolios. This pressure has already prompted some regional banks to merge in order to better compete in an increasingly difficult environment. This is a positive; however, we need to see a lot more of this kind of industry consolidation before any meaningful impact is felt.

² Sources: The World Bank and International Monetary Fund. Commercial bank branches per 100,000 adults. As of December 2017 (latest available data). TOPIX—Tokyo Stock Exchange, Inc.

“...populations in rural and suburban areas of Japan are declining as well as getting older. Regional banks are acutely exposed to these structural trends and, as such, face declining prospects for growing their loan portfolios.

— Archibald Ciganer
Portfolio Manager, T. Rowe Price
Japan Equity Strategy

Meanwhile, other regional banks struggling to grow their loan book are turning to riskier assets as well as other businesses, like securities trading or mergers and acquisitions, to boost their bottom lines. Given the potential lack of expertise in these areas, this opens Japan's financials sector up to a range of possible new risks.

Cross-Shareholdings

Japan's history of corporate cross-shareholding is also relevant here. Certainly, improved governance standards over the past decade have seen an undeniable reduction in the practice of cross-company ownership. The slow unwinding of these complex arrangements has played a part in encouraging foreign investment and helped to drive Japanese equities higher over recent years.

Nevertheless, the culture of interrelated companies owning large stakes in each other's businesses remains a feature of the market. Nowhere is this more evident than in the banking sector, with companies relying on lenders as friendly shareholders to ensure financing, fend off takeover threats, and provide united support against more demanding investors.

Cross-ownership is particularly evident among Japan's major banks, but many mid-size and smaller banks also maintain similar corporate relationships. These often opaque alliances between companies are the antithesis of progressive governance, encouraging management complacency and diluting accountability to minority shareholders.

In short, Japan's domestic banking environment remains challenging. Loose monetary policy, negative interest rates, fierce competition and structurally weak loan growth are all negative influences on earnings. In order to boost earnings, some banks are also diversifying into new businesses and regions, and these moves imply increased credit risk.

As detailed in recent communications, we remain positive about the Japanese equity market outlook. The very real structural improvements taking place in the economy and the equity market are already being reflected in company returns, and this is a long-term positive trend. That said, avoiding pockets of structural weakness is also paramount, and calls for an active investment approach. In this vein, we are confident that we can continue to find quality Japanese businesses with strong earnings growth potential and, thus, capable of delivering long-term outperformance.

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

T.RowePrice[®]

Important Information

This material is being furnished for general informational purposes only. The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, and prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. **Past performance is not a reliable indicator of future performance.** The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources' accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The views contained herein are as of the date written and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price.

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request. It is not intended for distribution to retail investors in any jurisdiction.

Australia—Issued in Australia by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. For Wholesale Clients only.

Brunei—This material can only be delivered to certain specific institutional investors for informational purpose upon request only. The strategy and/or any products associated with the strategy has not been authorised for distribution in Brunei. No distribution of this material to any member of the public in Brunei is permitted.

Canada—Issued in Canada by T. Rowe Price (Canada), Inc. T. Rowe Price (Canada), Inc.'s investment management services are only available to Accredited Investors as defined under National Instrument 45-106. T. Rowe Price (Canada), Inc. enters into written delegation agreements with affiliates to provide investment management services.

China—This material is provided to specific qualified domestic institutional investor or sovereign wealth fund on a one-on-one basis. No invitation to offer, or offer for, or sale of, the shares will be made in the People's Republic of China ("PRC") (which, for such purpose, does not include the Hong Kong or Macau Special Administrative Regions or Taiwan) or by any means that would be deemed public under the laws of the PRC. The information relating to the strategy contained in this material has not been submitted to or approved by the China Securities Regulatory Commission or any other relevant governmental authority in the PRC. The strategy and/or any product associated with the strategy may only be offered or sold to investors in the PRC that are expressly authorized under the laws and regulations of the PRC to buy and sell securities denominated in a currency other than the Renminbi (or RMB), which is the official currency of the PRC. Potential investors who are resident in the PRC are responsible for obtaining the required approvals from all relevant government authorities in the PRC, including, but not limited to, the State Administration of Foreign Exchange, before purchasing the shares. This document further does not constitute any securities or investment advice to citizens of the PRC, or nationals with permanent residence in the PRC, or to any corporation, partnership, or other entity incorporated or established in the PRC.

DIFC—Issued in the Dubai International Financial Centre by T. Rowe Price International Ltd. This material is communicated on behalf of T. Rowe Price International Ltd. by its representative office which is regulated by the Dubai Financial Services Authority. For Professional Clients only.

EEA ex-UK—Unless indicated otherwise this material is issued and approved by T. Rowe Price (Luxembourg) Management S.à r.l. 35 Boulevard du Prince Henri L-1724 Luxembourg which is authorised and regulated by the Luxembourg Commission de Surveillance du Secteur Financier. For Professional Clients only.

Hong Kong—Issued in Hong Kong by T. Rowe Price Hong Kong Limited, 21/F, Jardine House, 1 Connaught Place, Central, Hong Kong. T. Rowe Price Hong Kong Limited is licensed and regulated by the Securities & Futures Commission. For Professional Investors only.

Korea—This material is intended only to Qualified Professional Investors upon specific and unsolicited request and may not be reproduced in whole or in part nor can they be transmitted to any other person in the Republic of Korea.

Malaysia—This material can only be delivered to specific institutional investor upon specific and unsolicited request. The strategy and/or any products associated with the strategy has not been authorised for distribution in Malaysia. This material is solely for institutional use and for informational purposes only. This material does not provide investment advice or an offering to make, or an inducement or attempted inducement of any person to enter into or to offer to enter into, an agreement for or with a view to acquiring, disposing of, subscribing for or underwriting securities. Nothing in this material shall be considered a making available of, solicitation to buy, an offering for subscription or purchase or an invitation to subscribe for or purchase any securities, or any other product or service, to any person in any jurisdiction where such offer, solicitation, purchase or sale would be unlawful under the laws of Malaysia.

New Zealand—Issued in New Zealand by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. No Interests are offered to the public. Accordingly, the Interests may not, directly or indirectly, be offered, sold or delivered in New Zealand, nor may any offering document or advertisement in relation to any offer of the Interests be distributed in New Zealand, other than in circumstances where there is no contravention of the Financial Markets Conduct Act 2013.

Philippines—THE STRATEGY AND/ OR ANY SECURITIES ASSOCIATED WITH THE STRATEGY BEING OFFERED OR SOLD HEREIN HAVE NOT BEEN REGISTERED WITH THE SECURITIES AND EXCHANGE COMMISSION UNDER THE SECURITIES REGULATION CODE. ANY FUTURE OFFER OR SALE OF THE STRATEGY AND/ OR ANY SECURITIES IS SUBJECT TO REGISTRATION REQUIREMENTS UNDER THE CODE, UNLESS SUCH OFFER OR SALE QUALIFIES AS AN EXEMPT TRANSACTION.

Singapore—Issued in Singapore by T. Rowe Price Singapore Private Ltd., No. 501 Orchard Rd, #10-02 Wheelock Place, Singapore 238880. T. Rowe Price Singapore Private Ltd. is licensed and regulated by the Monetary Authority of Singapore. For Institutional and Accredited Investors only.

Switzerland—Issued in Switzerland by T. Rowe Price (Switzerland) GmbH, Talstrasse 65, 6th Floor, 8001 Zurich, Switzerland. For Qualified Investors only.

Taiwan—This does not provide investment advice or recommendations. Nothing in this material shall be considered a solicitation to buy, or an offer to sell, a security, or any other product or service, to any person in the Republic of China.

Thailand—This material has not been and will not be filed with or approved by the Securities Exchange Commission of Thailand or any other regulatory authority in Thailand. The material is provided solely to "institutional investors" as defined under relevant Thai laws and regulations. No distribution of this material to any member of the public in Thailand is permitted. Nothing in this material shall be considered a provision of service, or a solicitation to buy, or an offer to sell, a security, or any other product or service, to any person where such provision, offer, solicitation, purchase or sale would be unlawful under relevant Thai laws and regulations.

UK—This material is issued and approved by T. Rowe Price International Ltd, 60 Queen Victoria Street, London, EC4N 4TZ which is authorised and regulated by the UK Financial Conduct Authority. For Professional Clients only.

USA—Issued in the USA by T. Rowe Price Associates, Inc., 100 East Pratt Street, Baltimore, MD, 21202, which is regulated by the U.S. Securities and Exchange Commission. For Institutional Investors only.

© 2019 T. Rowe Price. All rights reserved. T. ROWE PRICE, INVEST WITH CONFIDENCE, and the Bighorn Sheep design are, collectively and/or apart, trademarks of T. Rowe Price Group, Inc.