JAPANESE RETAILERS GASPING FOR BREATH

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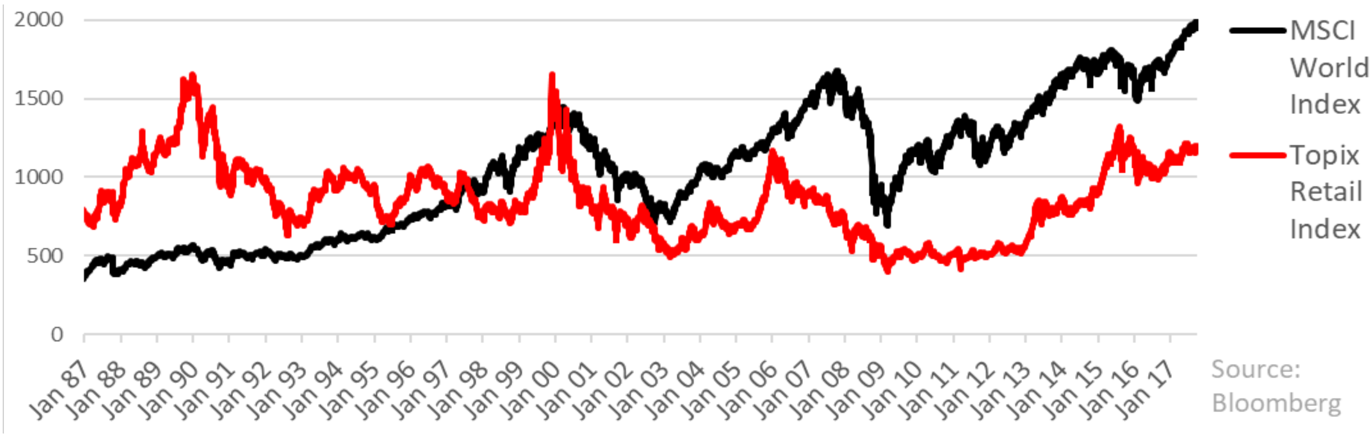
Market Views

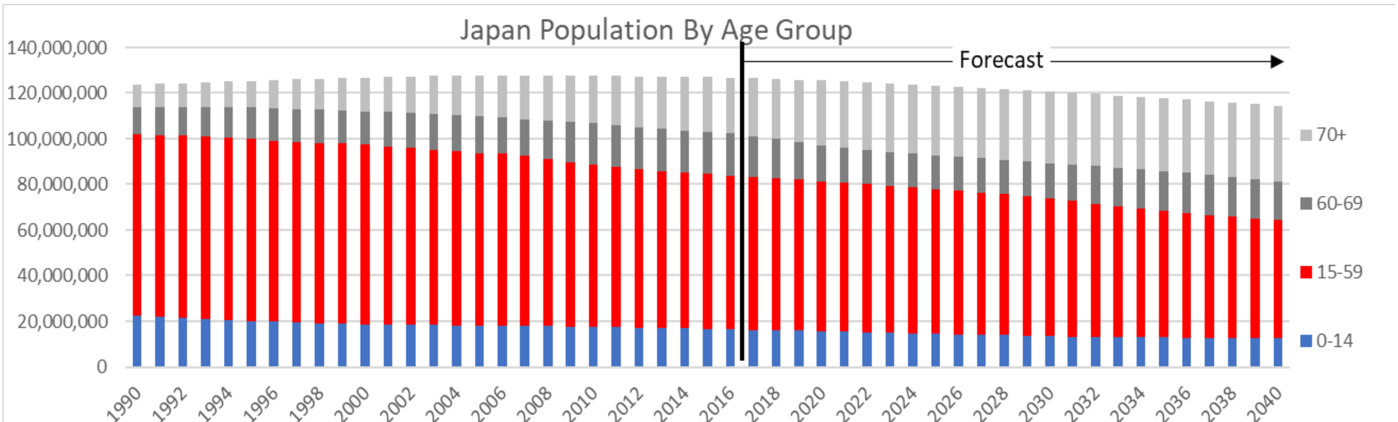
"Mid-sized retailers in Japan are experiencing a shrinking pool of consumers, losing market share to online operators and facing aggressive large-scale competitors that cut prices even as they face a disproportionate rise in their own labour costs. Some players in the retail sector are likely to be squeezed out of the shrinking pool and left gasping for breath as margins evaporate."

Japan has a number of industries that face a long term structural decline associated with its accelerating demographic decline. These are good areas to look for rewarding shorts late in the global credit cycle, even as other markets continue to rise. Japan's retail sector has been a prime example; if we look back at the last global credit cycle, which finished in 2007, the Topix Retail Index fell by 21% in 2006 even as the MSCI World Index rose 18%. It also went on to decline significantly into 2007 and 2008 as the global credit cycle rolled over. I believe we are again at a late stage of the global credit cycle where shorts that can provide returns now, as well as returns during the next downturn, are highly appealing. It is interesting to see that the Topix Retail Index has fallen by over 10% since its peak in this cycle two years ago, while the MSCI World Index has risen by over 12% over the same period.



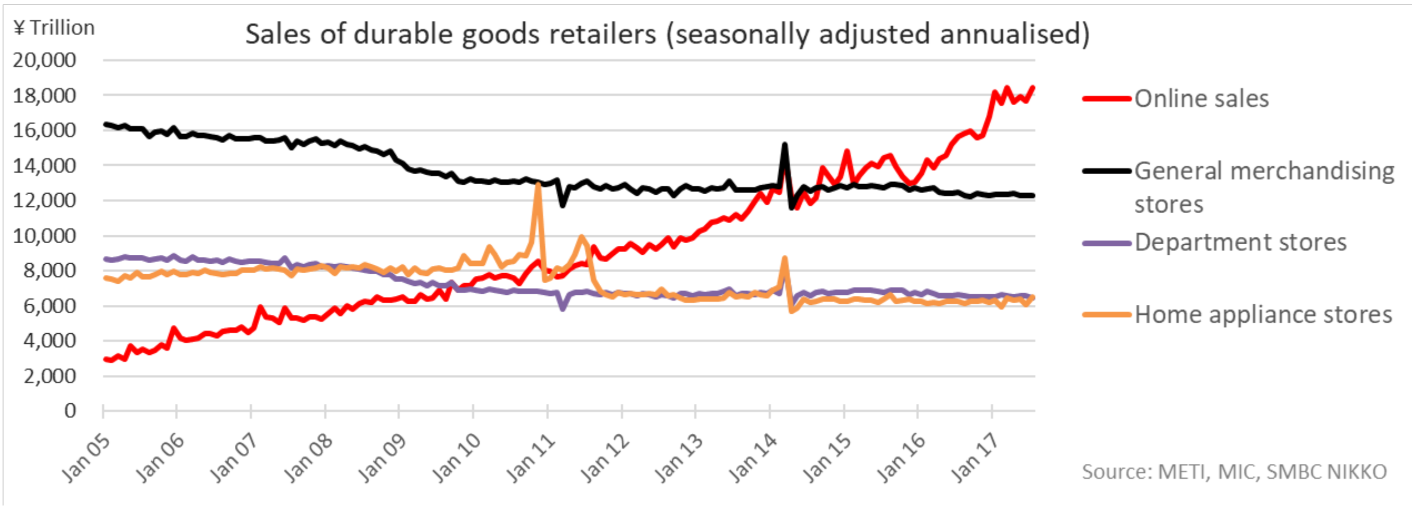
Source: Bloomberg

In its simplest terms, Japan's retail sector faces weak structural demand due to deteriorating demographic conditions. Total retail sales have fallen by 4.5% over the last twenty years (Source METI). Much of the decline is due to aging effects, with the elderly, the fastest growing segment, spending less as they age. Meanwhile the working age population, which drives consumption, shrinks. Japan has also now began a process of accelerating total population decline which brings an even greater challenge for retailers.

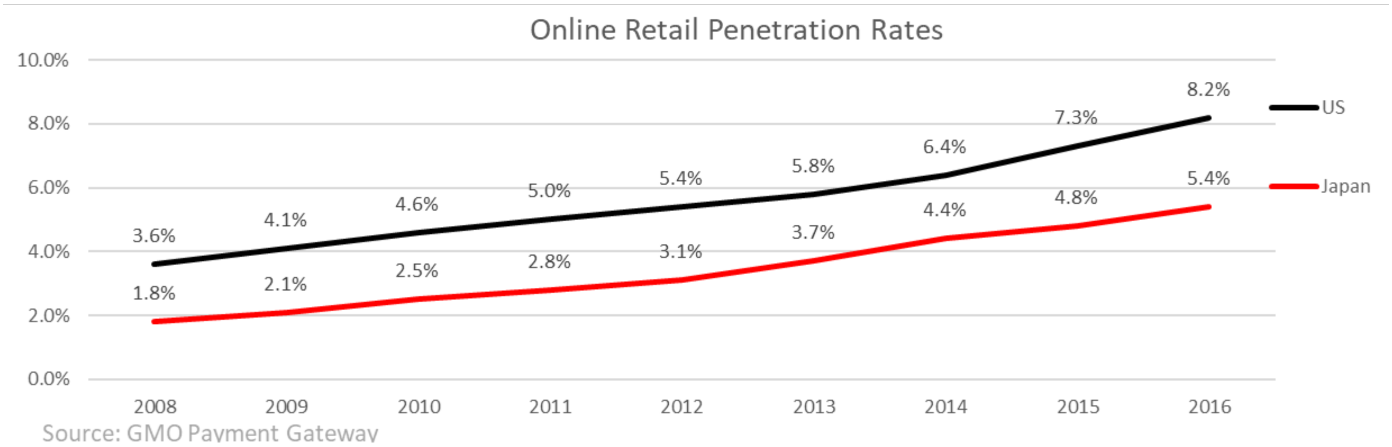


Source and forecasts: U.S. Census Bureau International database

Of course, within a structurally weak consumption environment there are winners and losers. The following charts shows that online sales in Japan, which tend to be durable goods, have taken market share from bricks and mortar durable goods retailers such as department stores, home appliance stores and general merchandising stores.



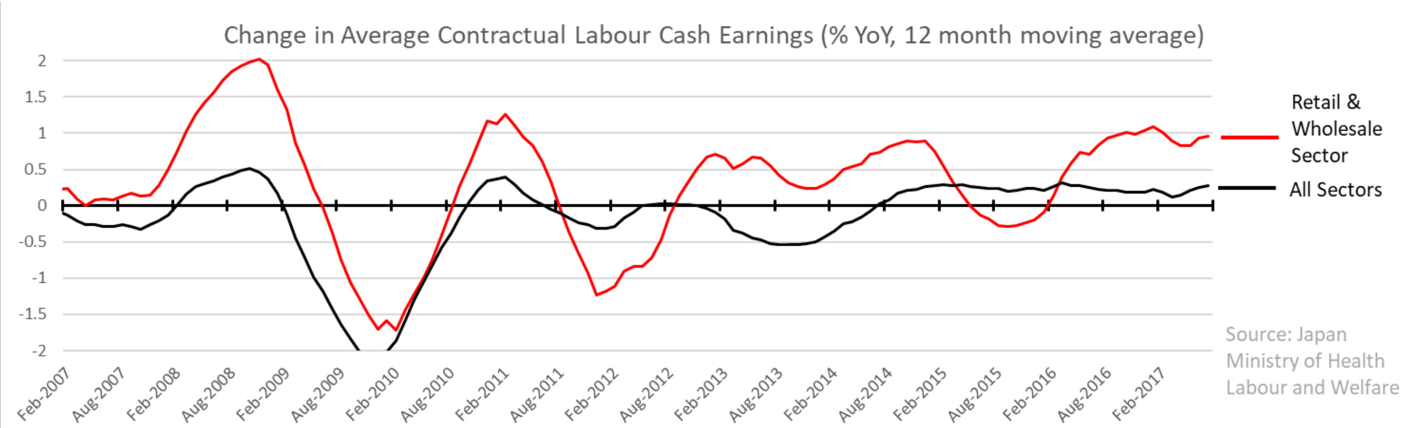
This trend looks set to continue, it is clear to me that, while online sales uptake in Japan began later than other developed economies such as the US, the online penetration rate is following them rapidly higher. It is likely that the recent demise of many US bricks and mortar retailers, from intensifying online competition, is coming to many retailers in Japan.



There are also winners and losers within non-durable goods retailing. For example, regional supermarket chains, many of which are listed, are facing a massive influx of competition following the removal of protections under Japan's Large Scale Retail Sales Law. National chain supermarkets are entering regional prefectures on mass. There has also been a phenomenal expansion by Japan's major convenience store chains into regional areas. To add to this there is a concerning trend of large format national drug store chains competing with supermarkets, some drug chains now generate over 70% of their sales from food, sundries and cigarettes. Major national chain supermarkets, convenience stores and drug stores have significant store expansion plans to come.

To take market share, in a weak environment, large national players are being increasingly aggressive in pricing. Seiyu (owned by Wal-Mart) has just announced it will cut prices on 103 items by 7%, this is following similar cuts to 466 items last month. Aeon, Japan's largest national chain supermarket operator, has also cut prices multiple times this year and its CEO suggests "Escaping deflation is a grand illusion. From now on we will support consumers by focusing on discount shops". Price cuts have also come from all three of the largest convenience store operators as well as many non-food retailers. It is no surprise that the Hitotsubashi University's retail (excluding cigarettes) Point of Sales Consumer Price Index (CPI), recently turned negative YoY again. What is most concerning is that yet again the price cuts have failed to invigorate consumer spending, according to the most recent credit card spending data (Source: NOWCAST, Inc./ JCB, Co., Inc). Even if Japan's aggregate CPI data sees some YoY growth this year, due to rising energy and health care costs, it is clear that swathes of retailers are experiencing pricing compression.

While pricing remains weak there has been one area of inflation for Japan's retail operators, their own labour costs are rising disporportionatley faster than the national average. This squeezes operating margins for retailers. Over the last year employees in the sector have seen their monthly contractual cash earnings increase by an average of 0.98% YoY, four times more than the weighted average across all industries in Japan at 0.23%. The retail sector is considered a less desirable industry to work in and has traditionally offered some of the lowest pay. Retailers are now being forced to offer pay rises and convert roles from temporary to full time, which also brings about a dangerous rise in fixed costs. Unfortunately, at the same time the shift from higher paid sectors in Japan, which have less labour supply shortage, like office workers and manufacturers, to lower paid sectors like medical care is constraining the growth in national wages, or in other words the purchasing power of retail customers.



It is clear that mid-sized retailers in Japan are; experiencing a shrinking pool of consumers, losing market share to online operators and facing aggressive large-scale competitors that cut prices even as they face a disproportionate rise in their own labour costs. Some players in the retail sector are likely to be squeezed out of the shrinking pool and left gasping for breath as margins evaporate. Japan's retail sector has proven in the past an ability to collapse late in the global credit cycle, before the rest of the world, under its own structural pressures, even as other markets continue to rise, then fall further when the global cycle turns. As structural pressures beging to overtake again and the competitive environment deteriorates, certain names offer particularly appealing short returns even if the global credit cycle continues to build, and even more appealing returns if the global cycle turns.

INFORMATION

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