

Japan Macro Strategy

TPP's possibilities and stock market impact from Japan's perspective

Economics

Japan

Summary

Importance of TPP agreement for investment strategies

The TPP is a multi-national treaty involving 12 Asia-Pacific countries, and negotiations are progressing in 21 areas, looking to liberalize not only trade but also services and investment. Eliminating tariffs and reforming the domestic regulatory framework under the TPP is likely to have a major impact on direct external investment and on domestic industries, not just on participating nations' trade. As TPP agreement is gaining growing recognition we summarize its impact on Japanese industry and the stock market.

Benefits of TPP participation for Japan

TPP membership will benefit Japan in the three areas of exports, imports, and growth in direct external investment. For exports, trade counterparty nations will scrap tariffs and simplify trade procedures, facilitating exports of Japanese manufactured products. Japanese tariffs will also be scrapped and trade procedures simplified, enabling procurement of a broad spectrum of products cheaply, including clothing, food and housing products. For direct external investment, trading partner nations' trade procedures and visiting workers' arrival and residence will be speedier and simpler, while investment rules will be drawn up, likely making it easier not only for large companies but also for SMEs to move into Asia-Pacific markets. However, rising imports and regulatory reforms could also have an adverse impact on Japanese domestic industries.

TPP impact: benefits of scale could widen differentials

For the overall market the details of the TPP will be positive for large caps but negative for mid-sized/small caps, in our view. At present large caps remain at an advantage in the market among external demand plays as the yen has weakened rapidly. However, there is no clear differential among domestic demand plays, and mid-caps are at moderate advantage to large caps in the market. Among these domestic demand plays in particular, the market could shift to large-caps over the medium to long term, depending on what agreement is reached under the TPP.

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TPP's macro implications

1. TPP's aims and progress

The Trans-Pacific Partnership (TPP) is an international pact between countries around the Pacific to allow the free movement not only of goods but also of services and investment as far as is possible. The WTO, which has more than 150 member nations, is not strict about eliminating tariffs or deregulation, while liberalization is taking a significant amount of time. Furthermore, bilateral agreements such as FTAs apply country by country, and can actually impede liberalization. The TPP is a multi-lateral accord (currently 12 countries, shown in Figure 1, but others such as South Korea, Thailand and The Philippines are showing an interest), and includes 21 different areas such as Government Procurement, Intellectual Property, Cross-Border Services and Labour, seeking not only to eliminate over 90% of tariffs but also liberalize services and investment.

TPP's aim is to liberalize and draw up rules not only for physical goods but also for services and investment

Figure 1: Countries in TPP talks, percentage of global GDP

Participating Nation	% of World GDP	Participating Nation	% of World GDP
US	21.5%	New Zealand	1.4%
Japan	8.4%	Brunei	
Canada	2.5%	Vietnam	
Australia	2.1%	Singapore	
Mexico	1.6%	Peru	
Malaysia	0.4%	Chili	

Source : IMF World Economic Outlook Database

The first point is to look at the status of the various negotiations as TPP agreement draws near. TPP negotiations are underway in 20 areas even outside the topic of scrapping or cutting tariffs. According to Japanese government sources, about two-thirds of the 29 agreement 'texts' have yet to be signed, but many are close to conclusion. Broad outline agreements are also taking shape in areas where negotiations have run into difficulty (Figure 3).

Negotiations either complete or nearly there in many areas

Figure 2: TPP negotiation status by area

Negotiation area	Key issues	Status
Market Access for Goods	Scrap/cut tariffs on agricultural products, industrial & mineral	○
Rules of Origin	Proportion of local raw materials used in goods on which tariffs	○
Trade Facilitation	Simplify customs clearance procedures, make trade regulations	⊙
Sanitary and Phytosanitary	Ensure food safety, quarantine measures	○
Technical Barriers to Trade	Unify standards on industrial products etc.	○
Trade Remedies	Rules on emergency import limits (safeguards)	○
Government Procurement	Prevent discrimination against foreign-made products in	○
Intellectual Property	Gear up data protection for new drugs, extend copyright	×
Competition	Limit preferential treatment of state enterprises	×
Cross-border Services	Deregulation in the service sector	⊙
Temporary Entry	Relax restrictions on business people's entry into countries,	⊙
Financial Services	Deregulation in the financial services sector	○
Telecommunications	Deregulation in the telecoms sector	⊙
E-Commerce	Draw up rules to expand e-commerce	○
Investment	Procedures for settling disputes between governments and	×
Environment	Abolish relaxed environmental standards designed to boost	○
Labour	Abolish relaxed labour standards designed to boost exports	○
Legal Issues	Ensure transparent management of the agreement, prevent	○
Dispute Settlement	Procedures for settling disputes between member states	○
Cooperation	Support developing economies in establishing systems, training	⊙
Cross-Cutting Issues	Measures and rules to support SMEs, ban arbitrary changes	⊙

Source: Various press reports

Note: ⊙ denotes 'agreed', ○ denotes 'close to agreement', x denotes 'stalled'

2. Schedule

The Trade Promotion Authority (TPA) and related legislation empower the US president to negotiate trade agreements, and it is seen as vital that the US House of Representatives passes these for TPP agreement to be reached. If the president is given TPA, debating and voting will have to be concluded within a certain timeframe once he submits the TPP trade agreement draft to the House of Representatives, while the House will be unable to revise the president's proposal, and will have to vote to either agree to or reject it. If the TPA legislation is passed by the lower House in June–July, a cabinet-level meeting of the 12 TPP participants will take place at an early date, likely increasing the probability of an outline agreement on the TPP. However, there is considerable opposition in the US House of Representatives, mainly among Democrats, and the risk that related legislation will not be passed has been identified.

Once agreement has been reached it is expected to take 3–6 months for the treaty to be prepared and finalized. If agreement is reached in June–July there are hopes that the TPP could go into effect within 2015, or in early 2016 at the latest. However, agreement between Japan and the US does not signify agreement among the other 10 countries. Accord has still not been reached in some individual

Important for TPA bill to be enacted in the US Congress to allow TPP agreement

areas, and there is still considerable uncertainty over the schedule from agreement to implementation.

3. Why would Japan join the TPP?

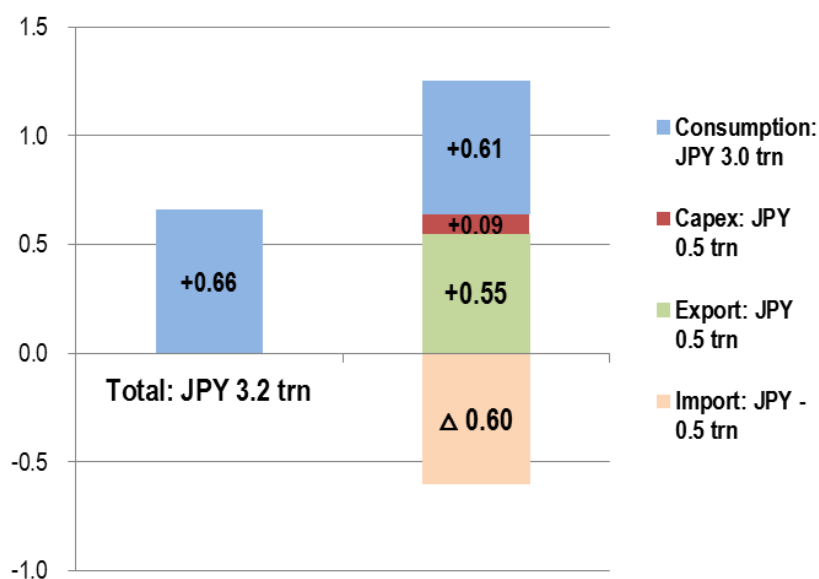
The following three points summarize the benefits of TPP participation for Japan.

1. Trade counterparty nations' tariffs will be scrapped and trade procedures simplified, making it easier to export Japanese manufactured products.
2. Japanese tariffs will also be scrapped while trade procedures will be simplified, allowing a broad spectrum of products to be procured cheaply.
3. Trading partner nations' trade procedures and foreign workers' arrival and residence will be speedier and easier, while investment rules will be drawn up, facilitating the entry not only of large companies but also of SMEs into Asia-Pacific markets.

Hitherto Japan has targeted trade liberalization through EPAs (Economic Partnership Agreements) rather than FTAs (EPAs are currently in force with 14 nations/regions, signed with one country, and under negotiation with eight countries/regions). An EPA is a bilateral pact, and less than 90% of tariffs are eliminated, lower than the 90%-plus under FTAs. However, EPAs include external cooperation, such as economic support. If TPP agreement eliminates tariffs a step further, manufacturing sector tariffs in Asian and South American emerging markets such as Vietnam, Malaysia, and Chile will come down even more, in addition to the US and Australia, likely providing direct benefits to Japan's transportation equipment, electric machinery and general machinery industries. However, the Japanese manufacturing sector has made progress in transplanting production abroad, while many tariffs have already been lowered under past FTAs and EPAs, so the additional impact may be limited. According to the government's official calculation on the impact of the TPP (using a general equilibrium model), scrapping all tariffs would push up exports by the equivalent of 0.55% of GDP (¥2.6trn) but also increase imports by 0.6% of GDP (¥2.9trn). Adding in the knock-on effect to investment and consumption, overall GDP would be 0.66% (¥3.2trn) higher than if tariffs were not eliminated (Figure 3).

Direct benefits for export industries in terms of tariffs

Figure 3: Economic impact of TPP (government estimates)



Source: Excerpt from Cabinet Secretariat materials

Eliminating or lowering non-tariff barriers among member states could also lead to growth in direct external investment by Japanese companies. For example, infrastructure investment could increase in the Government Procurement sector, if there is agreement with countries such as Malaysia, which is not signed up to Government Procurement under an EPA, or Vietnam and Brunei, which have insufficient commitment in EPA agreements. In Intellectual Property, the TPP could bring stronger and better measures in Brunei, which has no Intellectual Property text under an EPA, or Malaysia and Vietnam, which have poor regulation on counterfeit goods and pirating. If liberalization expands to new areas under the Competition text, it would become easier to grasp current regulations in relations with Singapore, Malaysia, Brunei and Vietnam, likely providing greater legislative stability over investments. In the Financial Services and Investment segments, there are various barriers to investment, such as foreign currency regulations, requirements to employ home-nation labour, and requirements for technology transfers, so including high-level deregulation could help improve the environment for overseas investment (see Asian Economic Perspective 'ASEAN Linkage-Trans Pacific Potential' (November 2013) for details).

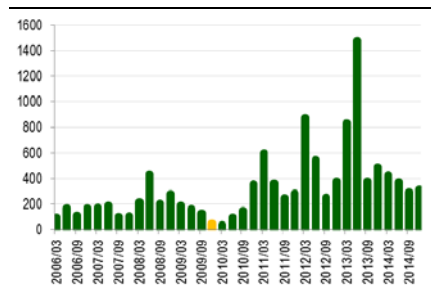
Looking back at trends in direct investment into countries with which Japan has signed FTAs and EPAs in the past, there has been a clear increase in direct investment in countries such as Vietnam, Indonesia, Peru and Chile after the EPAs came into effect. It goes without saying that direct external investment is affected by factors such as forex and growth in partner nations, but we feel cutting non-tariff barriers may have accelerated investment (Figures 5–13). According to a Japan Bank for International Cooperation survey on promising countries and regions for business expansion on a medium-term timeframe (roughly three years), China's share of the votes (each country's or region's votes over the total number of votes) has fallen whereas other regions' appeal has risen, such as Vietnam (India is currently top, followed by Indonesia in second place, China in third, Thailand in fourth and Vietnam in fifth). Progress in deregulation under the TPP is expected to make member nations even more attractive as business locations.

Eliminating/lowering non-tariff barriers among member states could fuel growth in direct external investment by Japanese companies

On the other hand, top of the list in looking at the impact on Japan's domestic industry is the likely increase in agricultural imports. As noted above, the government estimates that imports will increase by 0.6% of GDP (¥2.9trn), assuming competing domestically produced goods are replaced by cheap imports, and as prices fall even on domestic products with no direct rivalry, affected by growth in low-priced imports. In non-tariff areas, too, the government points to a decline in the scope of public medical insurance, a fall in food safety standards, and the influx of foreign unskilled labour. Ministry of Foreign Affairs materials also point out concerns that across-the-board rules will be applied under the Sanitary and Phytosanitary chapter rather than on a case-by-case basis, that terms for invoking safeguards under Trade Remedies will be tougher, that there could be pressure to change measures under existing FTAs and EPAs under the Competition, Cross-Borders Service and Investment texts, and that additional commitments could be required in the Financial Services segment, such as for postal and mutual aid services. Be that as it may, the content of negotiations has not been revealed in detail, so there is much uncertainty about the merits and demerits of these at this stage.

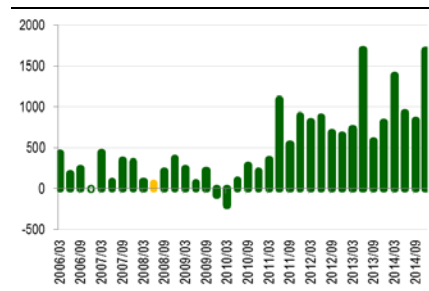
Japan may also be affected by agricultural import growth, pressure to ease restrictions

Figure 4: Direct external investment (Vietnam)



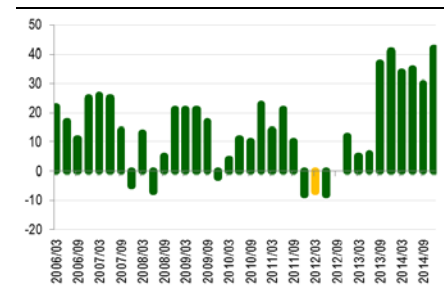
Ministry of Finance, UBS. Note: unit = ¥100m; yellow column denotes when EPA came into effect (Oct 2009)

Figure 5: Direct external investment (Indonesia)



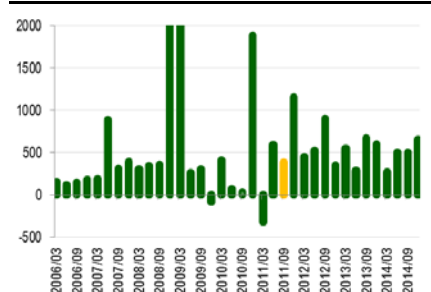
Source: Ministry of Finance, UBS. Note: unit = ¥100m; yellow column denotes when EPA came into effect (Jul 2008)

Figure 6: Direct external investment (Peru)



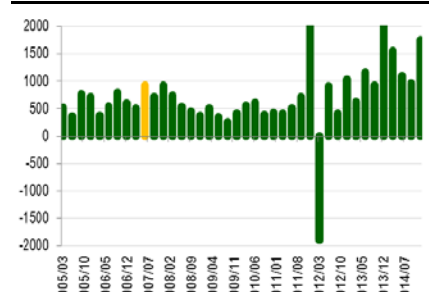
Source: Ministry of Finance, UBS. Note: unit = ¥100m; yellow column denotes when EPA came into effect (Mar 2012)

Figure 7: Direct external investment (India)



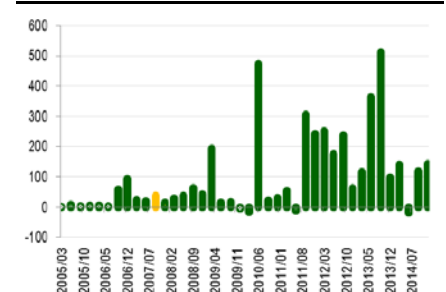
Source: Ministry of Finance, UBS. Note: unit = ¥100m; yellow column denotes when EPA came into effect (Aug 2011)

Figure 8: Direct external investment (Thailand)



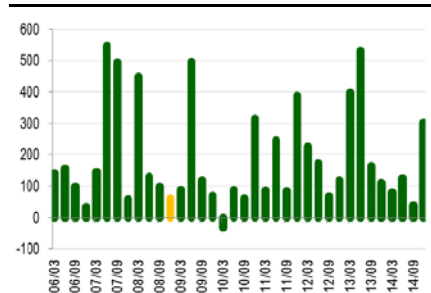
Source: Ministry of Finance, UBS. Note: unit = ¥100m; yellow column denotes when EPA came into effect (Nov 2007)

Figure 9: Direct external investment (Chile)



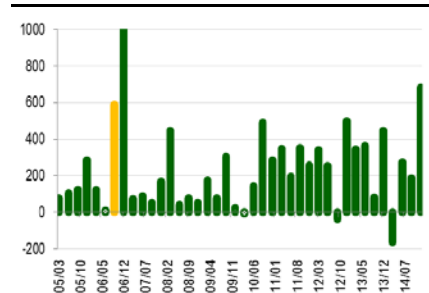
Source: Ministry of Finance, UBS. Note: unit = ¥100m; yellow column denotes when EPA came into effect (Sep 2007)

Figure 10: Direct external investment (The Philippines)



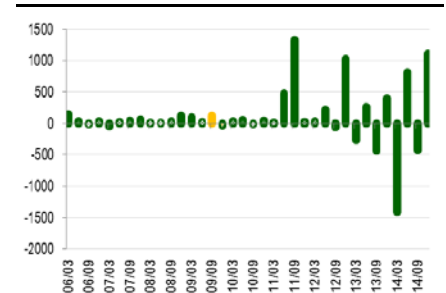
Source: Ministry of Finance, UBS. Note: unit = ¥100m; yellow column denotes when EPA came into effect (Dec 2008)

Figure 11: Direct external investment (Malaysia)



Source: Ministry of Finance, UBS. Note: unit = ¥100m; yellow column denotes when EPA came into effect (Jul 2006)

Figure 12: Direct external investment (Switzerland)



Source: Ministry of Finance, UBS. Note: unit = ¥100m; yellow column denotes when EPA came into effect (Sep 2009)

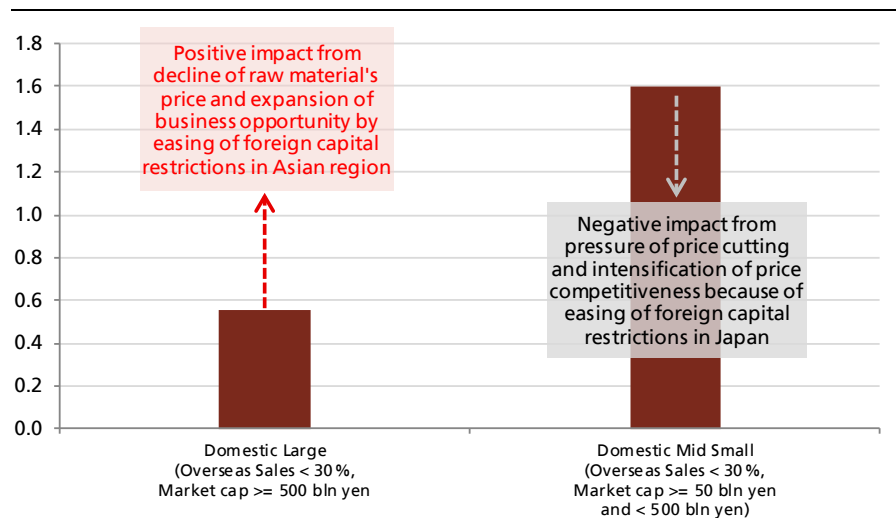
TPP impact: benefits of scale could lead to wider gaps

Before we move on to detailed explanations about individual industries by our analysts, we summarize our overall impression of the TPP and its impact at the sector level.

Tomohiro Okawa

In terms of the market as a whole, we believe the TPP will be positive for large-caps but negative for mid-sized and small caps. First, large caps remain at an advantage in the market among external demand plays as the yen weakens rapidly, whereas there is no clear differential among domestic demand plays, and mid-caps are at moderate advantage to large caps in the market. Among domestic demand plays, the market could shift to large-caps over the medium to long term, depending on what agreement is reached under the TPP.

Figure 13: Domestic demand plays; YTD performance by size



Source: Bloomberg, UBS

Clearly, it is hard to make any quantitative estimates of the ramifications for earnings and share prices before specific details have been decided, but it is possible to assess the broad trajectory by briefly setting out the impact on each industry.

As far as we can tell from what is already visible, our analysts' forecasts suggests that corporate earnings could be directly affected in four sectors, namely food products, automobiles, financial services, and telecoms, depending on the content of the TPP agreement. The details of TPP negotiations and progress with these will merit close attention for food products, financial services, telecoms and other so-called domestic demand plays in particular. We identify two key phrases by industry segment, namely 'elimination of tariffs' for the manufacturing sector and 'deregulation on foreign capital in Asia' for non-manufacturing. The content of the TPP itself is wide-reaching, both in areas covered and in the negotiations, but we think it is possible to comprehend the general picture and progress by grasping the significance of these two in terms of their stock market impact.

Two key phrases: Elimination of tariffs, Deregulation of foreign capital in Asia

(1) Food products (elimination of tariffs)

- Positive: Generally positive for major food product manufacturers, restaurants and fresh meat as eliminating tariffs lowers primary materials costs.
- Negative: Negative for materials companies forced to cut selling prices or production, in particular small/mid-sized materials manufacturers with no competitive strength in pricing.

(2) Automobiles (elimination of tariffs, preferential tax system for mini-vehicles)

- Moderately positive: Scrapping tariffs in stages over the long term could be positive as the burden on prices diminishes. However, the impact is likely to be limited, in any case, since major passenger car manufacturers in particular have made progress in establishing local production.
- Negative: Debate about revising the preferential tax scheme for mini-vehicles could emerge, possibly having a negative impact in terms supply and demand over the near term.

(3) Financial services (deregulation on foreign capital in Asia)

- Positive: Overseas business accounts for 30–40% of customer services net operating profit at the mega-banks in particular, and financial deregulation in Asia under the TPP could have a substantial positive impact (including restrictions on foreign investment ratios, branches and employment).

(4) Telecommunications (deregulation on foreign capital in Asia)

- Positive: Scrapping foreign capital restrictions could provide opportunities for M&A in mobile business in emerging economies (such as Vietnam and Malaysia) and for disseminating optical telecoms technology in wireline business.
- Negative: Conversely, the ban on bandwidth auctions could be lifted in Japan, too, raising concerns over a high cost burden associated with rising bandwidth prices, which would be negative.

Summarizing the above, it is fair to say the TPP will basically be positive for major domestic demand plays, in particular mega-enterprises with market cap in excess of ¥500bn which reap great benefits of scale. For example, in the manufacturing we think the benefits of eliminating tariffs will accrue more to major companies which manufacture or sell final consumer goods than to mid-sized and small firms primarily processing intermediate goods, while in the non-manufacturing sector it makes sense to think that looser restrictions on foreign capital could encourage major domestic service companies with the strength to expand overseas to target external demand as well, delivering benefits. In this sense, steady agreement in TPP negotiations would likely be one factor driving the performance gap between large caps and mid-sized/small caps still wider over the longer term. There is great upside in the particularly heavily regulated financial services and telecoms industries, and companies could become conspicuously reliant on external demand for good or ill, and sales weightings mainly to Asian emerging nations in particular could increase.

TPP particularly beneficial for large-cap domestic demand companies

TPP impact on the food sector

We think the TPP will affect the food industry in the following ways.

Naomi Takagi

- Eliminating tariffs is likely to lead to large volumes of low-priced agricultural, fresh meat, and associated processed product imports from TPP member states into Japan.
- The top priority for the state in terms of special exemptions are rice, wheat, sugar, and others in which differentiation is impossible. Goods such as dairy products, beef and pork may be excluded from the list of exceptions. Reports have emerged that an outline agreement has been made in Japan–US TPP negotiations on beef and pork.
- Food product manufacturers, the restaurant industry and supermarkets could benefit from reduced primary costs by importing these products. However, cuts in selling prices are also expected. Food companies with strong enough brands to lift margins without transferring all of the benefits of lower raw material costs into prices will likely be at an advantage.
- Some companies' sales are likely to rise on the back of higher imports. A typical example is the fresh meat industry, which is expected to increase meat imports as tariffs are eliminated.
- On the other hand, we would expect some raw materials companies (edible oil, flour milling, animal feed, dairy products) to suffer eroding markets, falling selling prices, and pressure to lower production volumes because of import growth triggered by scrapping tariffs. Edible oil and flour companies produce mixed fodder as a by-product, and will be under pressure to overhaul production systems as the fall in the number of livestock farmers cuts demand for mixed fodder.
- However, although this will be a headwind for such basic materials companies, independent, mid-sized companies will find it even harder to survive as large firms also struggle to stay afloat. Impetus for industry realignment is likely to gather pace in the future, creating a structure in which companies increase their grip on prices and major players are at an advantage.
- Hefty tariffs of over 20% remain in place not only on relatively unprocessed food raw materials but also on processed foods in some categories. Companies will be able to benefit from lower primary costs if tariffs on raw materials are scrapped, but their markets are also likely to be invaded if tariffs on processed food products themselves are eliminated, as well. That said, overseas brands are unlikely to eat into the household market. The more likely targets will be the commercial, processing, and intermediary product markets.
- The US and the EU compete in international markets by making direct payments to farmers. Instead of a scattergun policy such as household income support to all farmers, a programme of income support (direct payments) limited to farmers working towards large-scale, efficient operations should open the door to the TPP.

TPP impact by subsector and individual company

We look at whether the TPP will be positive or negative by product category and by subsector and individual company.

Wheat flour-related: bread, instant noodles, flour milling

The state currently imports all wheat, adds a mark-up, and sells it on in the domestic market. This mark-up represents a cost to subsidize domestic wheat farmers. The mark-up added by the government to the import price is about 30% of the selling price. The tariff on wheat is exceptionally high at 200%, so all flour millers procure wheat via the government. If wheat tariffs are scrapped the government is likely to liberalize its selling price at the same time — in other words, cut the mark-up. It is unlikely to be scrapped altogether, but bread and instant noodle manufacturers, which use wheat flour as their main raw material, stand to benefit from lower primary costs. We estimate that wheat flour costs amount to ¥50bn at Yamazaki Baking, ¥20bn at Nissin Foods and ¥12bn at Toyo Suisan. If the roughly 30% mark-up is cut to 10%, it will save ¥10bn at Yamazaki Baking, ¥4bn at Nissin Foods, and about ¥2.4bn at Toyo Suisan. Even if the companies lower their selling prices, they will likely be able to lift margins, without passing along all the savings into prices.

We think the impact on the flour milling business is likely to be initially negative. Scrapping the mark-up would lead to a sharp drop in the wheat flour price, diminishing the companies' capacity to generate cash. However, it would also be a last chance to correct pricing. They will be able to curb cuts in selling prices and aim to improve margins. Realistically, however, the mark-up is unlikely to disappear completely — some is likely to remain. In this case, we would expect an increase in imports of products such as cheap wheat flour and secondary processed products (such as pasta and premix) as tariffs are eliminated, depressing demand for relatively expensive domestic wheat flour-based products, and probably leading to lower sales. Liberalizing meat imports would lead to a reduction in the number of domestic livestock farmers and demand for formula feed would also fall. Disposing of bran (one part of formula feed) made in the process of milling wheat into flour will become a problem. Companies are likely to start to shift their flour mills offshore to reduce the quantity of bran they produce. Further, purchasing may also shift from a market-pegged system via the government to SBS (simultaneous buy and sell: free trading) via trading companies. In the future about 20–30 medium-sized and small flour companies (market share of about 20%) are likely to become the target of an industry shakeout, realigning the industry to the advantage of majors companies (purchasing, selling, production power). Consequently we think the two majors' benefits of scale will grow over the medium to long term as they increasingly dominate the industry.

Positive for bread, instant noodles, initially negative for flour milling, but good for majors over longer-term as they become increasingly dominant

Meat-related: processed meat

An 18 April 2015 Nikkei article reported that the Japanese government had reached an outline agreement with the US, which is pushing Japan to open up the beef and pork markets. Specifically talks are underway to cut the import tariff on US-produced beef from 38.5% to 27.5%, then to about 20% in stages over 10 years after the TPP start date and to about 10% over 15–20 years (Nikkei, 6 February 2015). Under Japanese pork tariffs, discussions will look at scrapping the 4.3% levy on high-priced products over ¥524/kg, and making a staged reduction

Lower pork raw material prices, increased imported meat trading volume likely to benefit fresh meat industry

in the ¥482/kg tariff on low-priced pork less than ¥65/kg to about ¥50 (Nikkei, 18 April 2015). However, the proposals on pork tariffs look unrealistic, since cheap pork priced at less than ¥65/kg does not exist. Japan introduced the so-called 'gate price system' (the cheaper the pork, the higher the tariff) to prevent the market being flooded with low-priced pork produced overseas. Under the gate price system, the standard import price is set at ¥546.53/kg, and tariffs are imposed on any pork cheaper than this to bring it back up to the standard price. Pork which is more expensive than the standard price is subject to a flat 4.3% ad valorem tariff. We think the gate system is likely to survive, but revisions to terms are likely to form the heart of negotiations, and we think the standard import price is likely to be lowered. Consequently it will be possible to procure cheap pork (such as picnic grade, the primary raw material for sausages) correspondingly cheaply, while high-priced pork will become even more expensive.

We think the TPP will benefit the domestic fresh meat industry, for the following reasons.

(1) Pork is the primary ingredient for ham and sausages. The gate system will survive, but a cut in the standard import price will lower raw material procurement costs in the low-price segment. If companies can resist downward pressure on prices and respond by changes in volumes — such as by increasing production — factory capacity utilization and gross margins will improve.

Gate system for pork tariffs likely to survive, but standard import price lowered

(2) Tariffs are also likely to be reduced on seasoned pork (20% tariff), which is an alternative to pork as a raw material for ham and sausages. Seasoned pork is flavoured minced meat made by mincing pork and adding pepper in certain proportions. The major ham and sausage manufacturers spend about ¥20bn on seasoned pork, and scrapping tariffs would knock around ¥4bn off costs. Downward pressure on prices would merit vigilance, but if companies could respond in volume terms, such as through increased production volumes, they would have the chance to improve gross margins, while the risk of imports eating into the household market would be low, even if imported products were to come into Japan.

Cut in tariffs on seasoned pork, too

(3) A growing influx of US beef and pork as tariffs are eliminated would soften the market near-term, having some negative ramifications. However, we could look for an increase in trading volume of high-margin US beef.

Increased trading volume of high-margin imported beef

If large volumes of US beef were exported to Japan, the impact on indigenous wagyu might be limited, but the market for domestically produced Holstein beef could decline. A fall in livestock farm numbers would likely squeeze the supply of domestic cattle, which are mainly Holstein, leading to rising prices and a perceived price premium to imported products, possibly even eroding the purpose of rearing domestic beef cattle altogether in the future. However, the major processed meat manufacturers have relatively low exposure to domestically produced beef cattle. We think gross profits per kilogramme are higher on US-produced cattle, and increasing weightings to livestock generating rich gross profits would likely bring greater benefits.

Large volumes of pork could also be exported to the Japanese domestic market. Pork is the livestock category most heavily affected by the TPP, which is likely to deal a heavy blow to domestic pork farmers. However, pig farming is increasingly being run by companies, and firms such as NH Foods are also gearing up their pork farming operations. The number of pig farmers will likely decline further under the

TPP, replaced by corporate pig rearing operations, and we think this will put large companies in a relatively strong position.

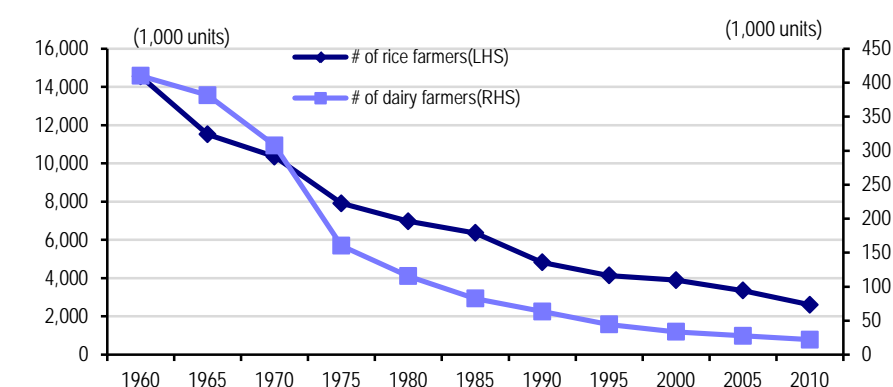
Dairy products: positive and negative effects mixed

In the dairy business, domestic production volume has more than quadrupled over 50 years (from 2m tonnes to 8.5m tonnes), while the number of dairy farmers has plunged from 400,000 households to only 20,000, with farms expanding in scale and improving efficiency. Dairy farming has evolved, but we think its policy influence has significantly diminished. On the other hand, a large number of very small-scale rice farms have survived thanks to price hikes under the policy of reducing acreage under cultivation, so although production volume has fallen, farmers in this sector have maintained their political clout.

Business farm households' share amounts to 38% for rice but 95% for dairy, so the latter has developed into large-scale, efficient operations whose priority in terms of being protected has fallen.

Dairy farmers' political power in decline

Figure 14: Number of dairy farmers and rice farmers



Source: MAFF

The impact of eliminating tariffs on high-tariff goods in the dairy industry will likely be mixed, including (1) lower sales of industrial-use butter and skimmed milk powder, (2) falling processed milk prices, and (3) a cut in primary costs for domestically produced cheese.

Various effects

However, important points which could heavily affect the industry are the possibility that soaring markets caused by a global dairy product supply/demand squeeze could offset the reduction in primary costs, and the probability that the closure of domestic dairy farms would lead to an inexorable slide in raw milk production, keeping the domestic raw milk supply/demand balance tight. On top of this, even if tariffs come down under the TPP, it may be impossible to import cheap milk products, while the domestic squeeze on raw materials is likely to continue.

Global supply/demand squeeze for dairy product raw materials

If the TPP brings an increase in cheap imports, it will also be important to see whether or not the domestic milk price declines. If it does not, foreign products will become more competitive, leading to a decline in demand for domestically made products. Taking the hypothetical future closure of Hokkaido dairy factories

manufacturing products such as butter, skimmed milk powder and cheese, the corresponding surplus of Hokkaido raw milk, which is highly competitive on the domestic market, will increasingly find its way into the rest of Japan. This would make it hard for dairy farmers in the rest of Japan to survive, leading to a step-down in the number of domestic dairy farms, but possibly leading to simultaneous efficiency improvements and income support for a limited number of large agricultural concerns. If domestic milk prices were to fall to the extent it could compete on equal terms with imports, there could be an optimistic scenario under which dairy manufacturers have opportunities to export domestically made butter and cheese to Asian markets. However, falling milk prices are a political problem entwined with the issue of income support for farmers.

Tariffs on representative dairy products are high, including 190% for skimmed milk powder, 376% for butter, 35% for fresh cheese, 40% for processed cheese and 35% for ice cream. We would expect imports to be used in place of particularly high-tariff butter and skimmed milk powder. Commercial use accounts for more than 70% of the total for butter and just about the entire amount for skimmed milk powder. In the family use segment, consumers have deep-seated confidence in domestic products in terms of quality and brands. New Zealand butter has been available in the market in the past, such as during periods of emergency imports, but did not sell well. The dairy majors' butter sales (FY14) amount to ¥22bn at Megmilk Snow Brand (including just under ¥10bn for commercial use), ¥15.6bn at Meiji (just over ¥10bn), and ¥13.4bn at Morinaga Milk (¥9–10bn). Skimmed powdered milk sales are highest at Megmilk Snow Brand at ¥10bn.

Imports will not encroach on the drinking milk market, given that this is delivered daily. However, the price of processed milk, an alternative, is likely to fall, and this could affect consumer sentiment on ordinary milk. Processed milk is the primary raw material for skimmed milk powder and butter, which can be sourced cheaply. However, the colour and taste of imported skimmed milk powder are different from the domestically produced counterpart, raising difficulties.

Eliminating the 35–40% tariff on cheese would bring benefits, as well. Domestic cheesemakers can source cheap imported natural cheese as a raw material for domestic processed cheese. In particular, companies with high exposure to imported cheese as a raw material would be at an advantage. Natural cheese will be imported from abroad as a product in itself, so competition with domestic products will escalate. However, domestic products are also improving their intrinsic appeal, and they should be able to maintain their positioning within the home-use market.

However, it is worth bearing in mind that dairy products account for a mere 6% of global trade volume. Dairy product demand growth in China and India would squeeze supplies of raw materials in this sector. Domestic users would be at risk in terms of supply if they were to rely entirely on imports just because imported dairy products are cheap. Domestic dairy product manufacturers may be weeded out, but at the same time they could have an increasingly important role.

Impact on individual stocks

Figure 15 divides the impact of the TPP by company and sector. The keywords for likely beneficiaries are lower primary costs, price resilience, and sales growth. We can look for primary cost margins to improve at companies which can benefit from lower primary costs and resist pressure to cut prices. This equates to companies with high market share and a robust grip on prices. A typical example is Yakult

Scrapping tariffs on high-tariff milk products likely to lead to substitution by imports

Processed milk selling prices could fall

Cut in cheese tariffs has positive aspect, too

Dairy products account for less than 6% of global trade volume, and a rise in actual product market prices caused by a global supply/demand squeeze could offset tariff cuts

Positive for NH Foods, Yakult, etc.

Honsha. Many of its main raw materials are high-tariff items such as skimmed milk powder and sugar. We estimate that scrapping tariffs would reduce its primary materials costs by about ¥5bn. Price cuts are highly unlikely, and this would likely be a good chance to improve its primary cost margin. Fresh meat company NH Foods is likely to be able to increase sales on the back of rising imports, while at the industry level the same is true for the frozen/chilled storage industry. NH Foods will reap substantial benefits from lower raw material costs if pork tariffs are cut.

Keywords for moderate beneficiaries are lower primary materials and passing benefits on into prices. Such companies will have to transfer cheaper primary costs into prices, but can improve margins. These include instant noodles, seasonings, bread and confectionary. Confectionary manufacturers are likely to see reductions in various primary costs, including wheat, processed edible oil and raw materials for dairy products. Seasoning manufacturers may be able to improve margins by maintaining prices, since it is hard to identify underlying raw materials.

Keywords for a moderately negative impact are the commercial and processing markets. Some processed foods are subject to comparatively high tariffs, and imports may encroach on the commercial- and processing-use markets. Companies involved in products with relatively high tariffs and exposed to these markets are likely to be adversely affected, such as Fuji Oil (margarine, shortening and other processed fats) and some dairy manufacturers (butter, skimmed milk powder).

The straightforward keyword for companies adversely affected is 'upstream.' This is the raw materials industry faced with an inflow of cheap imports, market encroachment and falling domestic production, namely areas such as edible oils, flour and animal feed. However, on a medium- to long-term view we envisage sector realignment on which industry survival will be at stake, and ultimately we can also look for positive change, with majors ultimately at an advantage and improved control over pricing.

Moderately positive for processed food products with strong brands

Moderately negative for Fuji Oil, some dairy firms

Raw materials companies adversely affected

Figure 15: TPP impact

Impact	Positive	Slightly positive	Neutral	Slightly Negative	Negative
Key word	Cost reduction, Price resistance, Sales grow th	Cost reduction, Price cut pressure, Overseas, production	Minor impact	Commercial and corporate-use market	Up stream
Sub-sector	Meat-product Lactobacillus beverage, Refrigerated warehouse	Instant noodles, Baking industry, Frozen food, Seasoning, Confectionery, Dairy products	Beer, Tabaco, Refined sugar	Processing oils and fats, Dairy industry	Oils and fats, Milling, Feed,
Company	Nippon Meat Packers, Yakult , Cold storage warehouse	Kew pie, Toyo Suisan, Yamazaki Baking, Nissin Foods, Ajinomoto, Kikkoman, Confectionery, Curry roux	JT, Asahi, Kirin	Processing oils and fats, Dairy products, Tomato seasoning	Cooking oil, Flour,

Source: UBS

Figure 16: Tariffs on food products

Item	Tax rate
Beef	Meat: 38.5% Organ meat, tongue: 12.8%
Pork	Balance custom duty
Poultry	Boneless: 11.9% Chicken thigh with bone: 8.5%
Sausage	20%
Seasoned pork	20%
Ham, bacon	10%
Wheat	¥17/kg (Markup, 30-35%)
Flour	¥90/kg(50-60%)
Processed flour	20-25%
Skin milk	190%
Yoghurt	320%
Butter	376%
Daily spread	239%
Fresh cheese	35%
Processed cheese	40%
Whip cream	25.5%

Item	Tax rate
Rice crackers	35% -40%
Candy	35%
Caramel	35%
Chewing gum	30%
Ice cream	28-35%
Chocolate	10%
Processed chicken	6.0%
Fish fry (frozen)	9.6%
Shrimp fry (frozen)	6%
Hamburg (frozen)	25%
Pilaf (frozen)	¥40.2/100g
Pizza (frozen)	30.0%
Dumpling (frozen)	6%
Instant curry	9.6%

Item	Tax rate
Raw sugar	¥41.5/kg(22%)
Raw oil	¥10.9/kg
Soy beans oil	¥13.2/kg
Palm oil	3.5%
Canola oil	¥13.2/kg
Margarine	29.8%
Soy sauce	9.6%
Tomato ketchup	25%
Mayonnaise	13%
Dressing	12%
Mustard	12.2%
MSG	Brazilian: 5.2% - 6.5% Indonesia: 1.7% - 2.6%
Pasta sauce	9.6%
Jam	28%

Item	Tax rate
Wheat noodle	1pack (100g) ¥3.4
Pasta	1pack (100g) ¥4.0
Instant noodles	1pack (100g) ¥3.2
Coffee	12.3%
Roasted coffee	20%
raw coffee	No duty
Tea	20%
Orange juice	25.5 - 29.8%
Beer	No duty
Wine	15.0%
Fish (fresh, chilled)	Salmon, tuna, bonito, eel: 5% Sardines: 10%
Processed fish	Salmon, herring, tuna, bonito: 9.6% Salmon caviar: 6.4% , crab: 6.5%
Frozen vegetables	Potato: 10%, asparagus, bean: 20% Sweet corn: 12.5%, mushroom: 16%

Source: MoF, UBS

Automobile sector investment viewpoint

Kohei Takahashi

Conclusion: moderately negative near-term, positive long-term

Based on discussions surrounding TPP participation so far, we estimate TPP membership could be negative for overall automobile demand over the near term as the preferential tax system for mini-vehicles is overhauled, but positive for the sector over the long term as the US eliminates tariffs and as mini-vehicle manufacturers become competitively stronger on the global stage.

However, in terms of the headlines, the Japanese auto industry appears to be a one-way net exporter to the US, and it is important to note there could be pressure to accept some demerits in return for Japanese demands for special treatment in areas such as agriculture.

Important markets for the Japanese auto-makers such as China, Thailand and Indonesia are not participating in TPP negotiations, and our discussions at this juncture look at Japan-US relations in isolation. Amongst emerging economies, the industry structure could be substantially changed by the Regional Comprehensive Economic Partnership (RCEP), composed of ASEAN plus six nations, and including Indonesia and Thailand, which the Japanese firms are considering for expansion as export bases, as well as China and India, which are expected to be growth markets over the medium to long term, so this will likely be watched closely.

US tariffs: set to be scrapped over the long term

The US currently applies import tariffs of 2.5% on passenger cars and 25% on trucks, as well as tariffs on goods such as parts. In light of debate so far, we estimate that these will be lowered incrementally over 10–20 years. A 2.5% levy on an automobile priced at \$20,000 amounts to \$500, and the reduction in this tariff portion at least would be positive.

The three major passenger car companies (Toyota, Honda, Nissan) in particular have built up local production to reduce exchange rate volatility. Merely scrapping the 2.5% tariff is unlikely to provide a powerful incentive to lift exports, and we think factors such as forex rates will be more important in determining export volumes.

The truck brands manufactured by the Japanese OEMs fall into the light-duty truck category, which is a niche segment. Nevertheless, eliminating the 25% tariff would have a major impact. Forex rates constitute a more important factor, just as with passenger cars, but Japanese truck exports from Japan to the US could expand sharply from 25,000 units in 2014 (about 4% of total truck exports).

Tax breaks on mini-vehicles: scrapped as a non-tariff barrier?

There are no limits on mini-vehicle manufacture, and overseas manufacturers are free to enter the market, even now. The preferential tax system on mini-vehicles is also partly to favour the regions. We do not think there is any need to abolish the preferential tax system from the perspective solely of the TPP or non-tariff barriers. However, the ruling LDP (LDP Tax Commission) is looking to raise mini-vehicle tax

TPP moderately negative near-term, positive long-term

RCEP important in business with emerging economies

Tariff cuts to create scope for lower prices over the long term

Limited impact on Japanese passenger car production

Prospects for truck export growth

Could TPP be the pretext for scrapping mini-vehicle tax breaks?

rates to increase tax revenue. We think the TPP may be used as a pretext to scrap the preferential treatment of mini-vehicles in stages.

However, we believe any decision to scrap the preferential tax scheme for mini-vehicles will also require an overhaul to the complicated automobile taxes, as well as tax system integration with categories other than mini-vehicles over the long term. Further, if companies no longer need to develop engines and body sizes to comply with mini-vehicle specifications unique to Japan, this category is likely to be merged with small cars over time, likely helping the mini-vehicle manufacturers to become more competitive over the long term.

Likely to help lift mini-vehicle manufacturers' relative competitive strength long-term

Capital relations with dealers: increasingly independent?

The large number of dealers directly run by the automobile OEMs is cited as a Japanese non-tariff barrier. In the US and many other countries, manufacturers are prohibited from directly running dealerships, in view of anti-trust legislation. We think that a ban on directly managed dealerships could lead to active acquisitions by highly competitive independent dealers with rich cash backing as consolidated subsidiary dealerships are spun off.

Growth in independent dealers?

However, competition is currently escalating, particularly for mini-vehicles, and many dealers have apparently sunk to operating losses. The problem of management succession at dealers is also becoming acute. Worsening dealership earnings in the past are behind the increase in the number of consolidated dealers in Japan, whose population is declining and ageing. Realistically speaking, we believe joining the TPP is unlikely to accelerate dealership realignment.

Adoption of volume targets for imports from the US?

There is also some debate about setting targets for Japanese imports of vehicles from the US in order to correct the automobile import/export imbalance (automobile imports from the US to Japan are miniscule compared with exports from Japan to the US).

Mandatory increase in vehicle imports from the US?

The Japanese market is dominated by small cars and hybrids, whereas medium/large-sized cars, pick-up trucks and SUV form the bulk of the US market, and differences in the classes of vehicles produced/sold play a major role. Seen from the demand side, only limited vehicle types could realistically be imported from the US to Japan. Setting numerical targets and seeking to substantially lift imports would likely require measures such as large vehicle subsidies that run counter to the underlying spirit of the TPP, and we think the chances of this are remote.

Financial sector investment viewpoint

Shinichi Ina

Substantial benefits for private sector financial institutions overall

Major financial institutions' profit growth is increasingly dependent on international business. Loan balances are on the increase in Japan, too, but spreads are being squeezed by low interest rates and escalating competition, and the domestic picture for net interest income remains bleak. In overseas business however, financial institutions are maintaining net interest margins at a certain level while lending is rising sharply, and overseas business has reached 30–40% of customer services net OP at the three mega-banks in particular through active M&A and asset buying.

Just about all the major Japanese financial institutions' business strategies mention further expansion in overseas services, and if the TPP relaxes financial restrictions in Asian nations, we think they stand to reap considerable benefits. In other words, many Asian countries set upper limits on foreign investment in their own financial institutions, and Japanese financial institutions have been able to become only minority investors in such countries. Regulations affecting areas such as branches and employment also hamper Japanese financial institutions' business expansion. We think that easing such restrictions would lead to growth in M&A and investment in local Asian financial institutions mainly by major Japanese banks and insurers, increasing contributions to group earnings.

On the other hand, there may be pressure for further commitments in the Japanese financial system with regard to financial institutions with state capital or those not directly under FSA authority (such as mutual aid). That said, the broad direction of debate is to strip such financial institutions of competitive advantages, and this would not be negative for competing private sector financial institutions.

Telecoms sector investment viewpoint

Stephen Leung

Negotiation highlights

(1) Common rules for bandwidth allocation (in other words, all TPP member states conduct bandwidth auctions)

(2) Ease/scrap foreign ownership restrictions on telecoms operators

Merits

Opportunities for Japanese telecoms companies to move into overseas markets

Easing or scrapping foreign capital restrictions on telecoms operators could open the door for Japanese telecoms companies to move into overseas telecoms markets such as in Vietnam, Malaysia, and other Asian emerging economies. In other words, there would be opportunities to participate in mobile communication markets via M&A, and to drive the uptake of Japanese fibre telecoms in the wireline market.

Demerits

Japanese telecoms operators would face the risk of bandwidth auctions in Japan.

Bandwidth auctions would impose a major financing burden on the telecoms operators. Auctions would inevitably inflate bandwidth usage costs, while bandwidth prices could be driven irrationally higher. An auction system would make it easier for a scramble for bandwidth to take place, imposing costs on Japan's telecoms operators.

Construction sector investment viewpoint

Toshihiko Okino

The TPP is likely to affect the construction industry in the Government Procurement segment — in other words, opening up public works to foreign companies. This certainly has some potential to exacerbate competition. However, even now some public works projects above a certain value are open to international companies under WTO agreements on Government Procurement, but this has not prompted swathes of foreign construction companies to move into Japan and stoke competition. The construction industry has grown via various local business practices from setting contract values with project originators through to sourcing subcontractors. Japanese construction companies working according to such business practices operate in a low-margin industry in which even the major general contractors achieve OP margins of just a few percent at best. We believe the market offers little to prompt foreign construction companies to take on board risk and move into Japan, with all the initial costs. It will be a different story if moves emerge to eliminate all business practices as non-tariff barriers, but this does not look realistic to us, either. The TPP will probably have no great direct impact on Japan's construction industry, in our view.

JREIT sector investment viewpoint

Junichi Tazawa

We think TPP participation would have only limited overall impact on the JREIT sector, but there could be some effects arising from the globalization of property trading.

If uniform global rules were decided for real estate trading and restrictions on foreigners investing in real estate were eased/scrapped, JREITs' overseas asset purchasing could increase, and the JREIT sector's global expansion could progress. On the other hand, lowering barriers preventing overseas companies from participating in Japan—such as by globalizing uniquely Japanese real estate trading practices and the complicated tax system — could exacerbate competition between JREITs and overseas investors in property purchasing and reduce JREITs' opportunities to acquire property in Japan.

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