Japan – Outlook 2016

2016 Outlook and top picks/Key Calls

Equity Strategy

Japan

Japan Equities Research Team

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Resilience of the Japanese market to be confirmed in 2016; TOPIX target 1,890

In 2016, Japan's stock market could see fairly solid growth. We envisage further firm profit growth of around 8% alongside (1) yen depreciation against the US dollar following a Fed rate hike (especially from a second increase); (2) measures favourable to Japanese companies, such as corporate tax cuts; and (3) progress in 'kakusei' (governance reform) as well as expectations for higher ROE. We think TOPIX could reach 1,890 points by end-2016 and the Nikkei Average could advance to 23,500.

Japanese stocks could see a 'great rotation'

We believe Japanese stocks could see a 'great rotation' (from domestic-demand to manufacturing/external demand and from momentum to value) from the first half of 2016. Numerous factors could support this, including expectations for yen depreciation and for an external-demand driven manufacturing sector alongside a US rate hike, as well as slower public fund inflows, including from the GPIF and BoJ, which have provided momentum effects up to now, and a focus on the next consumption tax increase. We expect to see a turnaround in manufacturing industry, including autos and machinery, but relatively challenging conditions for such domestic-demand sectors as retail and real estate.

Growth to be driven by domestic demand amid ongoing yen weakness

Supported by a recovery in domestic consumption and capex, Japan's real growth could continue to average around 1%, with rises of 1.3% in 2016 and 0.7% in 2017. A recovery in consumption may depend on higher wages (we forecast growth of 1.3% in base compensation in the spring labour negotiations) and more stable food prices. We assume ¥130/US$ at end-2016 and ¥135 in 2017. Even without any easing by the BoJ, the yen looks set to weaken. Any decision on lifting Japan's consumption tax rate will be a major political focus.

Key Calls and top picks

Key Calls highlight our high-conviction stock ideas. Our Key Call stocks are Alps Electric (6770), which we believe has ample growth drivers in the smartphone parts field, and ORIX (8591) on M&A-driven profit growth and potential for greater shareholder returns. In this report we also provide top picks for each sector.

Top stock picks and Key Calls

Company Name	Rating	Price Target (Y)	Upside(%)	Mk Cap (Ybn)	Company Name	Rating	Price Target (Y)	Upside(%)	Mk Cap (Ybn)
Kajima (1812)	Buy	780	+8.3%	747.6	Yahoo Japan (4689)	Buy	620	+19.9%	2,973.7
Meiji Holdings (2269)	Buy	12,000	+20.2%	1,523.8	Nissan Motor (7201)	Buy	1,600	+23.6%	5,429.7
Nitto Denko (6988)	Buy	11,000	+28.1%	1,418.3	SMFG (8316)	Buy	5,685	+18.0%	6,587.3
NSSM (5401)	Buy	3,000	+17.6%	2,425.2	Key Call: ORIX (8591)	Buy	2,440	+34.8%	2,373.3
Daikin Industries (6367)	Buy	10,600	+18.7%	2,606.3	Mitsubishi Estate (8802)	Buy	3,800	+43.7%	3,667.8
Yokogawa Electric (6841)	Buy	1,800	+17.0%	410.5	ORIX JREIT (8954)	Buy	195,000	+21.8%	339.4
Disco (6146)	Buy	15,000	+26.1%	425.4	ANA Holdings (9202)	Buy	420	+20.8%	1,220.9
Sony (6758)	Buy	4,200	+32.6%	3,997.4	NTT (9432)	Buy	5,400	+14.2%	10,014.3
Key Call: Alps Electric (6770)	Buy	5,300	+42.5%	714.8	Hikari Tsushin (9435)	Buy	11,000	+24.2%	405.4

Source: UBS estimates as of 3 December 2015

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Equity Strategy

Tomohiro Okawa (Strategist)

UBS Research THESIS MAP We see mainly undervalued stocks rising based on three expectations; we forecast TOPIX at 1,890

PIVOTAL QUESTIONS

Q: Could Japanese stock valuations increase? Japanese equity valuations look relatively appealing based on global comparisons and 10-year historical comparisons and as such we think they have room to rise. First, they could target the 10-year historical PE of 16x and then the 17x reached during the 2013 and mid-2015 rallies. We see upside potential of 11% from the current level of just above15x.

Q: What will drive growth in Japanese stocks in 2016? Three expectations could drive Japanese stocks in 2016: 1) further yen depreciation against the dollar based on strength in the US; 2) profit improvements on corporate tax cuts; and 3) accelerated use of cash connected with Japan's corporate governance reforms ('awakening'). We think (1) could boost company earnings, mainly for manufacturers; (2) could improve profit, although conditions ahead of implementation are unclear; and (3) could support ROE and shareholder returns. Assuming 8% EPS growth we expect forward PE to rise to 16-17x.

Q: Will Japanese stocks see a 'great rotation'? Domestic demand-oriented sectors have been strong since 2013, helped by stable profit growth and physical supply-demand, driven by public pension money and smart-beta investors. We expect these trends to weaken and we look for high-valuation domestic-demand stocks that have benefited up to now to peak. The manufacturing and resource sectors seem undervalued and set to benefit from yen depreciation to follow a Fed rate hike. Autos, rubber products, iron & steel and machinery should outperform.

WHAT'S PRICED IN?

Expectations for first US rate hike are priced in; future pace is the next trigger: With the weakening of the yen to ¥125/$ and the equity market rise since mid-November, share prices seem to have priced in expectations for the first US interest rate hike to some extent. Conversely, share prices have yet to price in our expected rate of ¥130/$ at end-2016, and if the Fed hikes rates as expected in December 2015, the stock market should gradually price in a further weakening of the yen, depending on the pace of subsequent hikes (a rate hike in March 2016 could be particularly important).

UBS VIEW

End-2016 TOPIX of 1,890 and Nikkei Average of 23,500 (+18%): We see upside of about 18% in 2016 based on cyclicals making up lost ground on yen weakening following a Fed rate hike, EPS growth (8%) from top-line growth and margin improvement, valuations rising to reflect increasing relative appeal, positive tax system changes, governance reform and expectations for ROE increases.

Upside scenario (+31%): If positive policy measures such as a corporate tax cut and changes to inheritance taxes are taken and easing measures in various countries accelerate, we would expect PEs to rise further on higher risk money inflows. Forward PEs could reach the 19x levels seen in 2005, which would mean a jump in TOPIX to 2,100 (+31%). If China steps up its monetary easing it should reduce the risk of an emerging market slowdown, which would be a positive for the manufacturing/resource sectors plagued by China concerns.

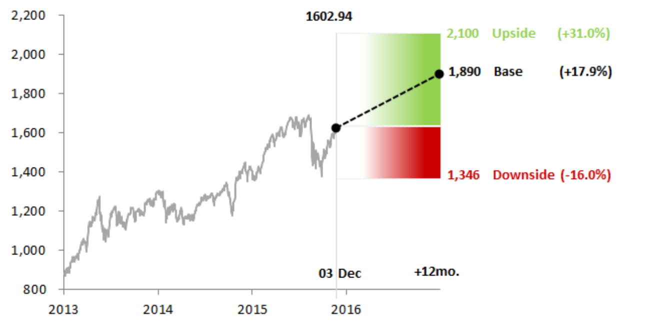
Downside scenario (-16%): If the US delays its rate hike, or if the US economy slows following the rate hike and/or the rate hike impacts emerging markets, it would necessitate a pricing in of risk-off generated yen appreciation. In that case, surplus liquidity would be unlikely to push valuations higher. If the yen settles in at ¥110/$, TOPIX would drop to 1,350 (-16%).

EVIDENCE

Three expectations not yet priced in: 1) We estimate that expectations for a US rate hike and a weaker yen are priced in at the mid-¥120/$ level; 2) expectations for profit improvement from a corporate tax cut and changes to inheritance taxes will be discounted hereafter; and 3) expectations for faster cash digestion from corporate governance reforms are in a lull but future moves could have a positive impact. We think Japanese stocks are likely to continue to rise strongly in 2016 if there is support from a strong US and a weaker yen, active tax revisions and profit growth, corporate governance reforms and ongoing ROE improvements.

OUR THESIS IN PICTURES

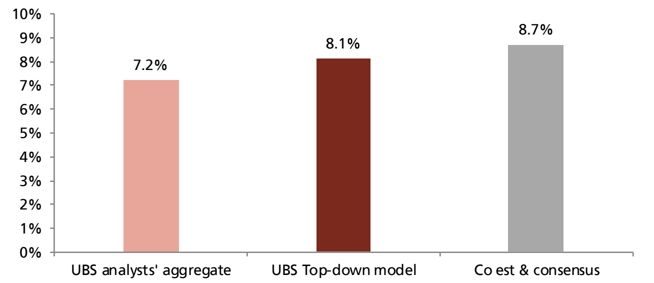
UBS TOPIX forecast



Source: UBS estimate

Our base scenario for TOPIX at end-2016 is 1,890 points

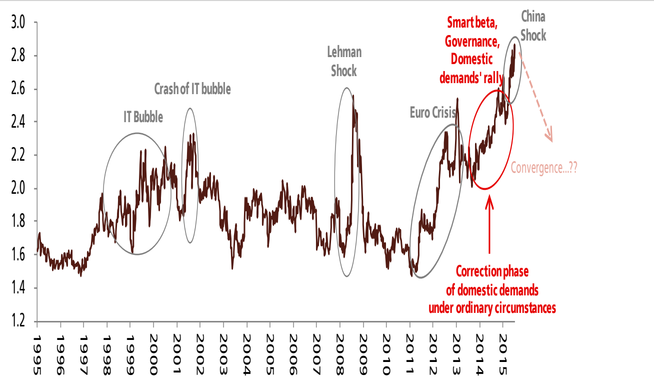
TOPIX EPS forecast



Source: Bloomberg, UBS

We expect growth of about 8% in TOPIX EPS in 2016 as earnings continue to rise steadily

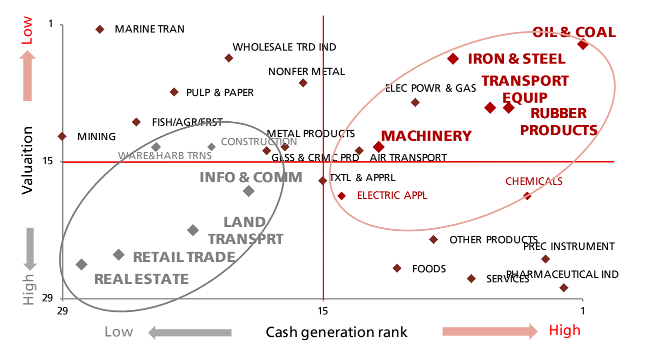
Domestic/overseas demand stock PBRs to converge



Source: Bloomberg, UBS

There could be a major market rotation (a sector-factor preference reversal) from the first half of 2016

Sector recommendations



Source: Bloomberg, UBS

Overweight: low PBR, high cash-generative overseas demand sectors
Underweight: high PBR, low cash-generative domestic demand sectors

Strategy outlook 2016

End-2016 TOPIX of 1,890; Nikkei average of 23,500

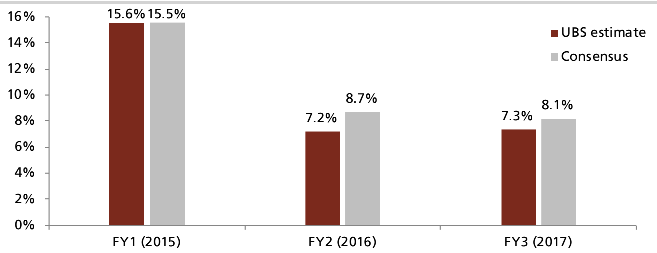
Japanese stocks have risen by a healthy 15% in 2015, but the question now is what upside remains? Compared to 2014 and 2015, when Abenomics was in full swing, there are fewer expectations for support from policy, public pension money or the BoJ. However, we still see good upside for the Japanese market in 2016.

In terms of overall sentiment, our APAC strategist, Niall Macleod, expects Japan to remain overweight among Asian stocks in 2016 and is taking a positive stance. Key points include continued GDP growth, positive policy moves such as a corporate tax cuts, continued expectations for 'kakusei' (improved corporate governance), a weaker yen and relatively firm EPS revisions (see APAC Equity Strategy Outlook 2016 for details). Including this vantage point, we foresee upside potential for Japanese stocks as well as potential for profit growth in 2016.

UBS forecasts and assumptions for Japan's equities market

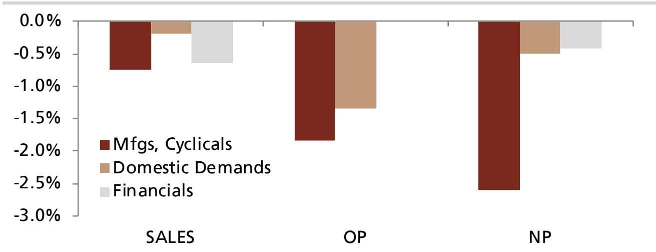
Profit growth is likely to slow relative to 2015 but we still expect stable profit growth of around 7% from 2016. Our estimate looks slightly weaker than the market consensus of about 9% growth, mainly due to our slightly more downbeat view on the manufacturing sector. In particular, we assume heavy impact from analysts' pessimistic views of China's supply-demand climate.

Figure 1: TOPIX EPS growth, UBS estimates



Source: Bloomberg, UBS

Figure 2: Surplus liquidity and PE growth rates



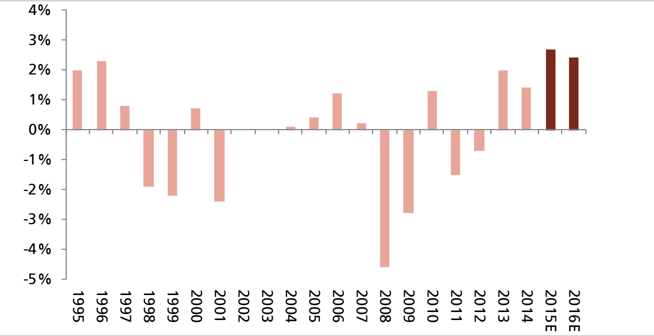
Source: Bloomberg, UBS

However, these assumptions do not necessarily mean share prices will slow relative to 2015. Next, we consider the situation in the light of sales and margins.

Sales outlook: The 2016 consensus forecast is for growth of about 2.4% in TOPIX sales. This may look somewhat weak relative to 2013, but sales look set to rise for the fifth straight year since 2012, which would be unusual case among the industrialised markets. In the previous rally in 2005, sales growth ended after about three years. Accordingly, such long-term stable growth should be considered positive, in our view. In our TOPIX sales estimates (based on a multi-variate regression model using as variables yoy changes in import prices, US real GDP, Japan nominal GDP, and Japan's CPI), we assume growth of 4%. We believe the gap of a little over 1% to the consensus projection may stem from differences in assumptions for the pace of US interest rate hikes and outlook for the dollar/yen (end-2016, ¥130). As noted above, we assume sales growth of 4%.

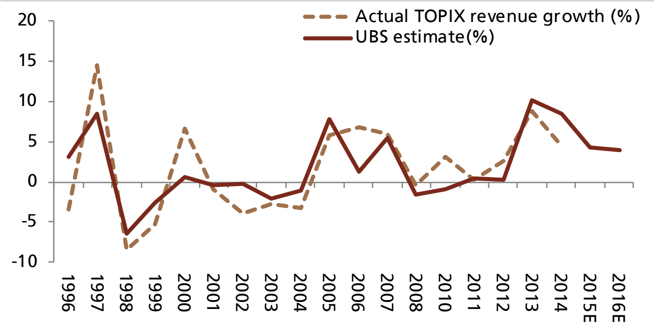
Erratum: TOPIX forecast at beginning of Contents section corrected to 1,890; lead analyst corrected to Tomohiro Okawa

Figure 3: TOPIX sales growth (actual and consensus ests.)



Source: IBES, UBS

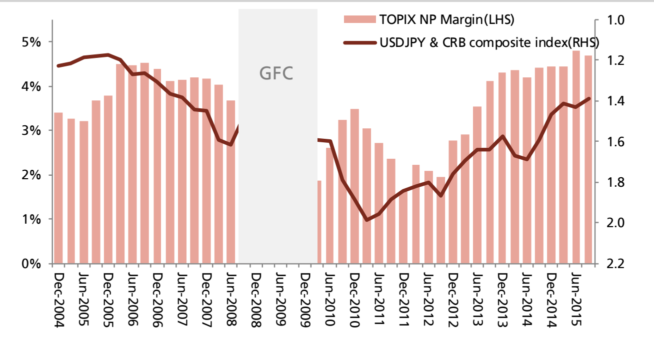
Figure 4: TOPIX sales growth (actual and UBS estimates)



Source: IBES, Bloomberg, UBS

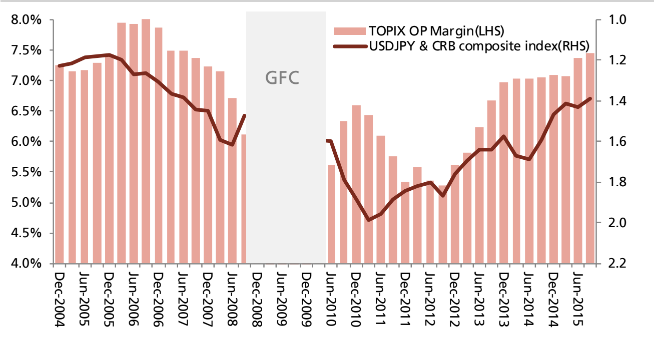
Margin outlook: Changes in TOPIX margins basically lag the dollar/yen and commodity prices (a lag of about two or three quarters; reverse scale used in the composite index shown in Figures 5-6). The recent actual OP margin is 7.5% or so, while the NP margin is around 5%, although historically, the yen has been declining and commodity prices have continued to fall. From this perspective, for 2016 at least, we assume an OP margin above 7.5% and an NP margin of at least 5%.

Figure 5: TOPIX NP margin and USD/JPY & CRB composite index



Source: Bloomberg, UBS

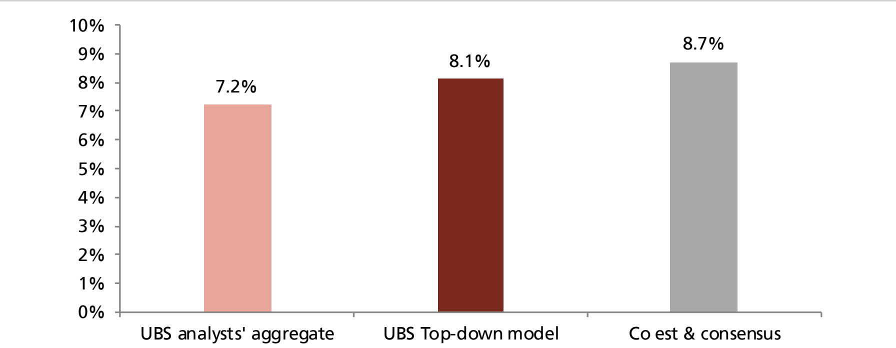
Figure 6: TOPIX OP margin and USD/JPY & CRB composite index



Source: Bloomberg, UBS

EPS growth outlook: Based on two of the above variables (sales growth of 4% and an NP margin of 5%), we estimate end-2016 EPS at ¥111.5, up 8% from our end-2015 projection of ¥103. The estimate using a top-down model is right in the middle of that based on our bottom-up model and the market consensus view. Thus we would not expect much of a surprise either on the upside or downside.

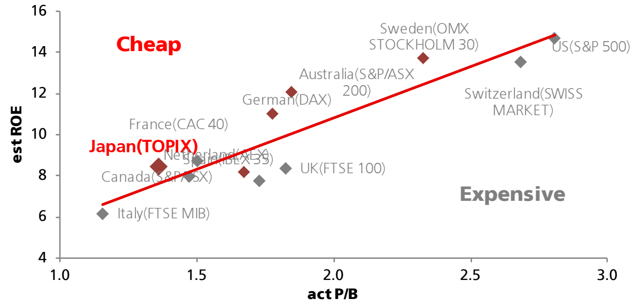
Figure 7: TOPIX EPS forecasts



Source: Bloomberg, UBS

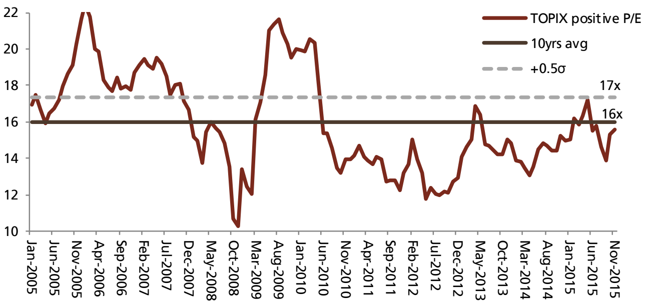
Q: Could Japanese stock valuations increase?

Figure 8: PBR-ROE in major markets



Source: Bloomberg, UBS

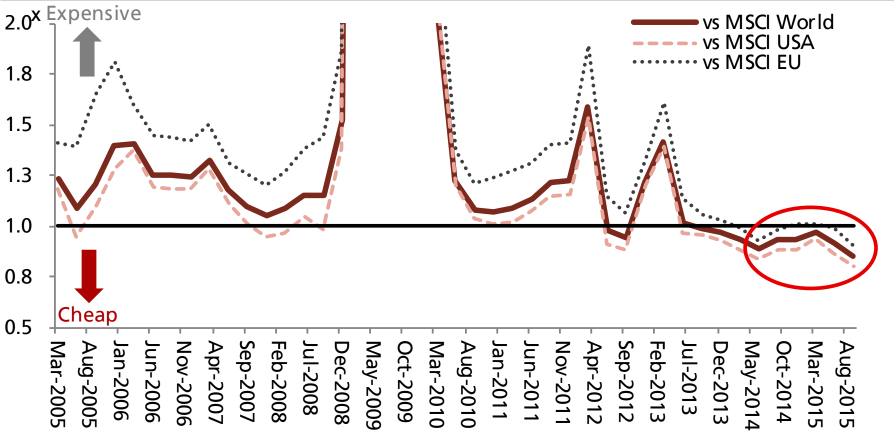
Figure 9: Positive TOPIX PE over the past decade



Source: Bloomberg, UBS

Basically, we believe Japanese stocks have appeal relative to those in other advanced markets and therefore we think valuations could increase. However, the question is, to what extent? Figure 8 shows a PBR-ROE matrix for the leading markets and Figure 9 plots PER (when profits are in surplus) over the past decade. In both cases, Japan looks rather undervalued. The undemanding PBR levels that have been seen recently are likely to be confirmed as we expect ROE to rise alongside a further commitment to corporate 'awakening.' PE may seem to have shifted to contraction in the past ten years, particularly since 2010, after the financial crisis. However, it has basically continued to expand and contract within a fixed range. If PE was to catch up with the historical trend while preserving this relationship, we think it could notch up 2.6%, to around 16x. Assuming PE rises to the +0.5 sigma line (the peaks for the recent market rallies of 2013 and 2015), we estimate the multiple could advance 11% to 17x. Also, Japanese stock valuations look appealing in terms of PER even on an international comparison (Figure 10).

Figure 10: International PER comparison



Source: Bloomberg, UBS

Based on the above projected EPS of ¥111.5 and our estimate for TOPIX (using our forecast for EPS and assumption for PER), we estimate that the past average multiple of 16x would equate to 1,780 points (upside of 11%) and the 2013 and 2015 peak of 17x would imply 1,890 (upside of 18%). We hence believe there could be a substantial advance in 2017. In our view, the peak touched in the recent market rally seems realistic and we do not think our assumption is too high.

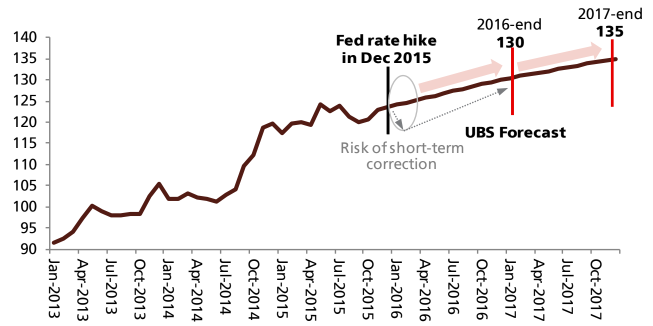
Q: What will drive growth in Japanese stocks in 2016? Three expectations

Based on our assumptions, we do not expect share prices to slow compared with 2015. In our current outlook for Japanese stocks, three factors that we do not believe have been fully discounted by the market include: 1) further yen depreciation against the dollar based on strength in the US; 2) profit improvement due to corporate tax cuts; and 3) accelerated use of cash in connection with Japan's corporate governance 'awakening' (Kakusei).

1) Strong US and yen depreciation: an interest rate rise is key, but in March 2016, not December

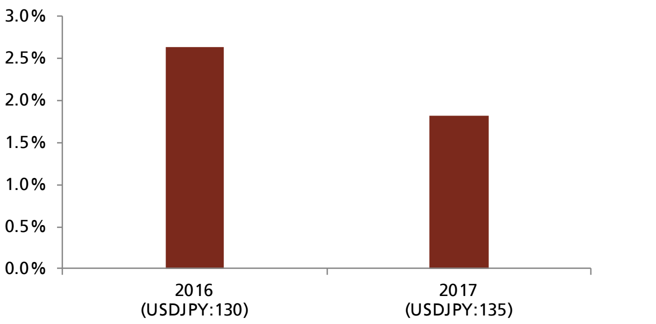
UBS's economics team assumes three or four interest rate rises a year from 2016 and believes that, as a result, the interest rate disparity between Japan and the US will widen and the yen will depreciate to ¥130/$ at end-2016. This would naturally be positive for corporate earnings as many Japanese firms are very sensitive to overseas macro trends. We estimate that if the yen reached ¥130/$, EPS would rise around 2.5% on a TOPIX conversion basis. The consensus view is that the US FOMC will raise interest rates for the first time in December, while opinions vary as to the pace of any subsequent hikes, but if the second interest rate increase is in March 2016, the probability of interest rate hikes about four times a year would increase, which would likely facilitate rapid yen depreciation.

Figure 11: UBS ¥/$ forecast



Source: UBS

Figure 12: TOPIX EPS impact based on UBS ¥/$ assumption



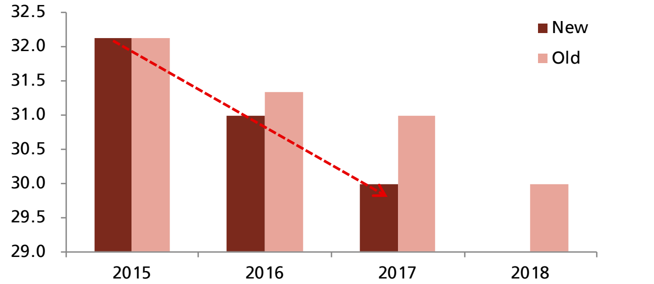
Source: UBS

2) Tax structure: Expectations for profit improvement alongside corporate tax cuts and changes to inheritance taxes

Corporate tax cut: The government announced in November that it aims to front-load its corporate tax cut plan from 'less than 31% in FY17 and the 20% level in FY18' to 'the 20% level in FY16'. If this plan, for FY16, is fixed, it should be discounted by the market. It would be difficult to quantify the impact, as pro forma standard taxation would be reinforced to make up for the tax cut, but a corporate tax cut should certainly bring large benefits to Japan's listed companies.

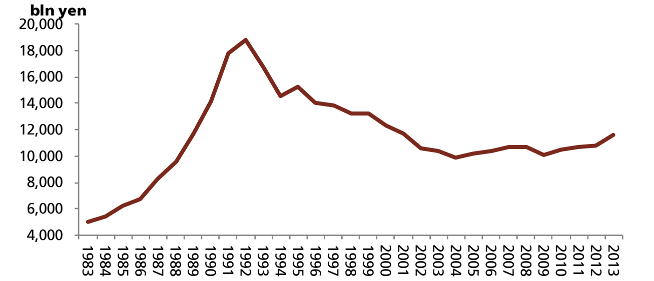
Changes to valuations of listed stocks for inheritance tax: The FSA has proposed that under the government's tax reforms, the valuations of listed stocks for inheritance tax purposes should be reduced from 100% to 70%. It is uncertain whether this proposal will be adopted, but if it is, it is expected to shift inherited assets, amounting to about ¥100trn every year, from real estate, for which valuation is currently 80%, to stocks, or to lead to a slowdown in stock sales.

Figure 13: Effective corporate tax cut: a 'before and after' comparison



Source: UBS

Figure 14: Japan taxable inheritance value

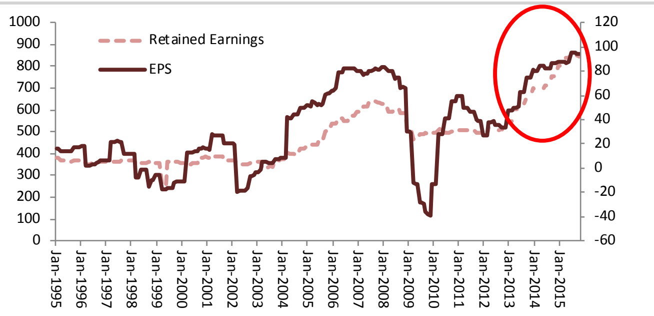


Source: MoF, UBS

3) Expectations for faster use of cash through corporate governance 'awakening' (Kakusei)

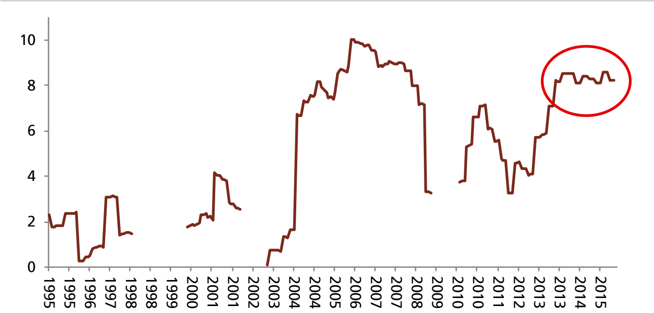
The pace of improvement in ROE, a measure of the success of corporate governance reform ('awakening'), has been improving slightly, but the pace of improvement remains slow and TOPIX ROE peaked in 2014.

Figure 15: TOPIX EPS and retained earnings



Source: Bloomberg, UBS

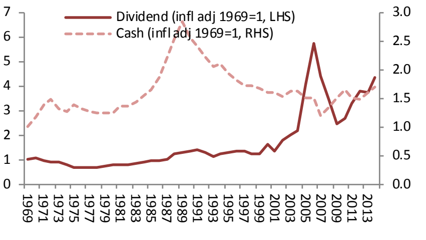
Figure 16: TOPIX ROE



Source: Bloomberg, UBS

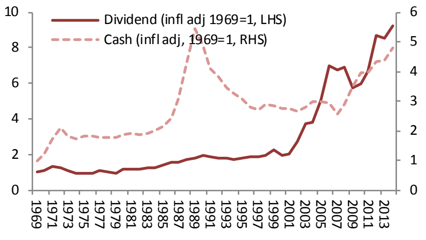
The main reason for this is growth in savings, not profit growth. The failure of companies to end their saving behaviour looks negative, but the manufacturing sector appears to have started using its cash more actively. Pressure from the government that began with the introduction of Japan's corporate governance and stewardship codes in 2015 is unlikely to weaken and may even become stronger. This could also be seen as a positive, because companies that generate strong cash flow and are in the manufacturing sector, which may have already begun to move, are likely to meet expectations for returning more value to shareholders. At the very least, the environment has probably become favourable for further shrinkage of the 'E' component of ROE.

Figure 17: Dividend and cash trend (adjusted for inflation) for manufacturing companies over ¥1bn



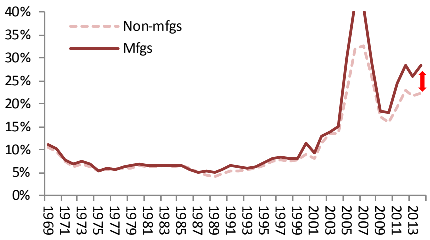
Source: MoF, UBS

Figure 18: Dividend and cash trend (adjusted for inflation) for non-manufacturing companies over ¥1bn



Source: MoF, UBS

Figure 19: Manufacturing and non-manufacturing dividend/cash trends

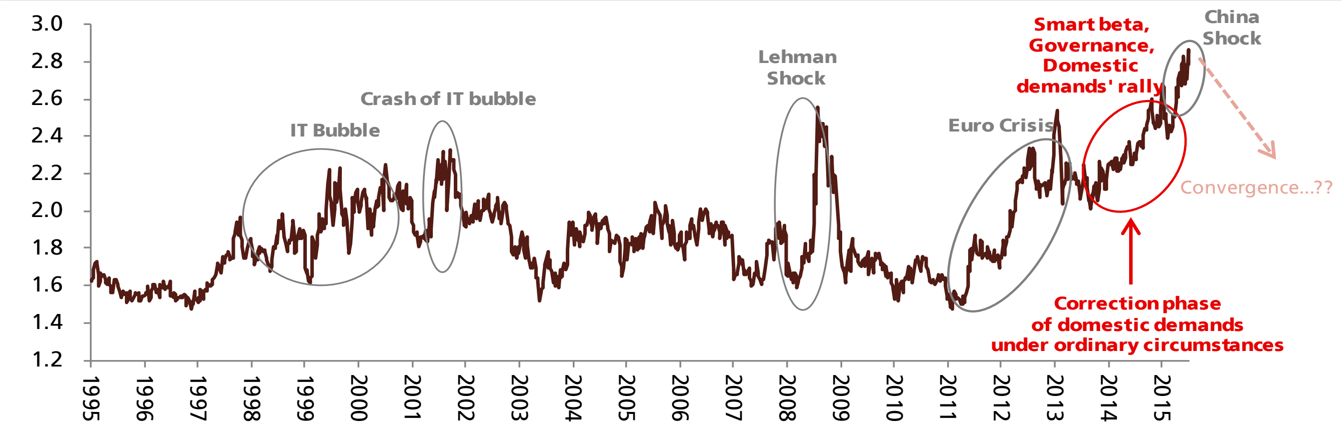


Source: MoF, UBS

Q: Will there be a 'great rotation'?

The question of where surplus liquidity flows into the market is as important as what happens in the stock market as a whole. In 2016 there could be a major change from the sector preferences and investment style that have prevailed until now. Specifically, a change in the investor types that drive investment could result in a factor rotation and a change in macro environment conditions could lead to a sector rotation: changes that, in turn, could prompt a correction in the gap between strong domestic-demand stocks and weak external-demand stocks.

Figure 20: Ratio between highest PBR quadrant for domestic-demand defensives and lowest PBR quadrant for external-demand cyclicals

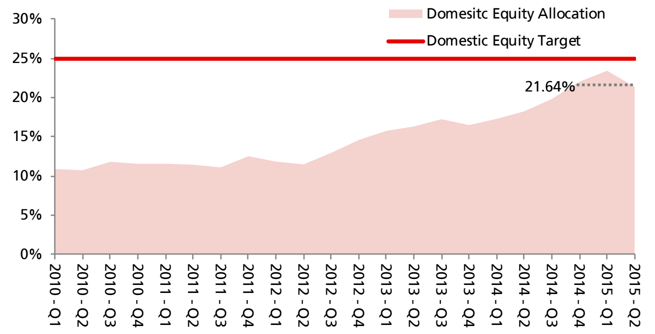


Source: Bloomberg、UBS

1) Factor rotation: Change in major players and slower passive money inflows

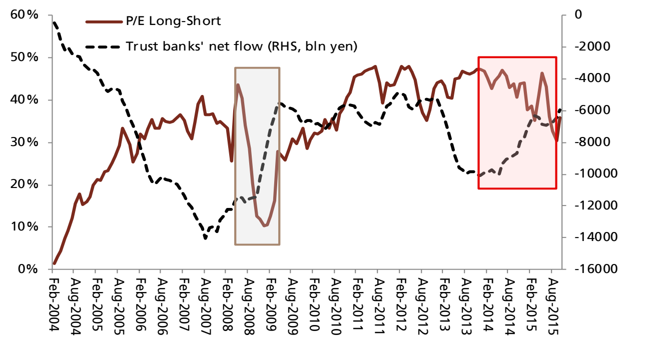
Since 2013, large inflows of passive funds into the Japanese stock market, including from the GPIF and BoJ, have polarized the performances of individual stocks. In fact, PE became less effective when their buying increased rapidly. The trend toward corporate governance reform has put the spotlight on the JPX Nikkei 400, which the GPIF and BoJ have used as an investment vehicle, and a variety of funds have been pumped into high-momentum stocks. However, we expect this trend to slow from 2016. The GPIF's allocation to domestic stocks declined to 21.64% in Q2 but is currently near its target of 25% as it became a net seller of stocks in November, along with the subsequent rise in the share prices of trust banks. As long as the equity market does not fall sharply, we think scope for buying remains limited. Aggressive easing by the BoJ is also unlikely, given current levels. This is creating an environment that favours undervalued stocks.

Figure 21: GPIF domestic stock allocation



Source: GPIF, UBS

Figure 22: Trust bank flows and PE investment impact

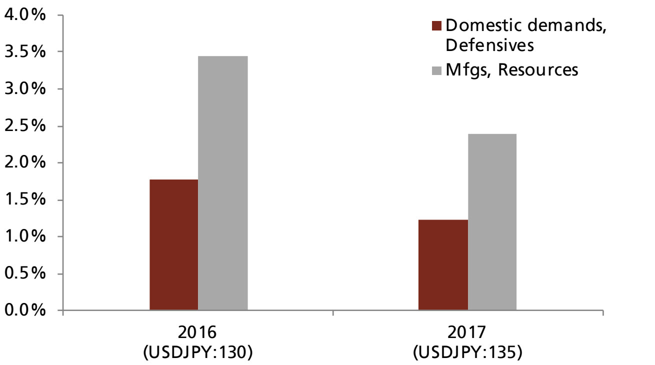


Source: TSE, UBS

2) Sector rotation: Fed rate hike, yen depreciation & consumption tax hike

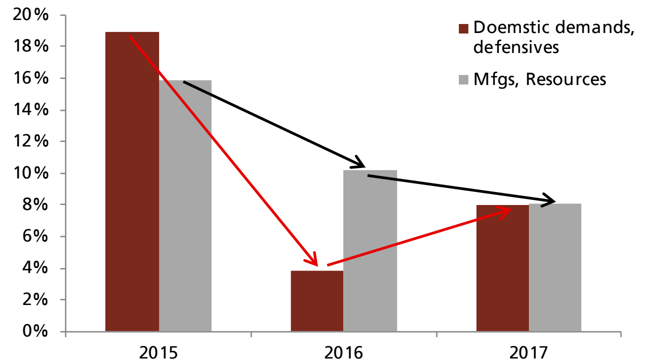
The US rate hike is the key to sector views. If the Fed hikes in December, as we expect, a wider interest rate spread is likely to cause the yen to rise to ¥130 by end-2016 and ¥135 by end-2017. Based on our forecast model, this would boost earnings by 3.5% for manufacturing/resource sectors and by 1.5% for domestic-demand sectors.

Figure 23: Earnings impact on manufacturing/resource sectors based on our exchange-rate assumptions and sensitivity models



Source: UBS

Figure 24: Consensus EPS growth for domestic demand and manufacturing/resource sectors



Source: Bloomberg, UBS

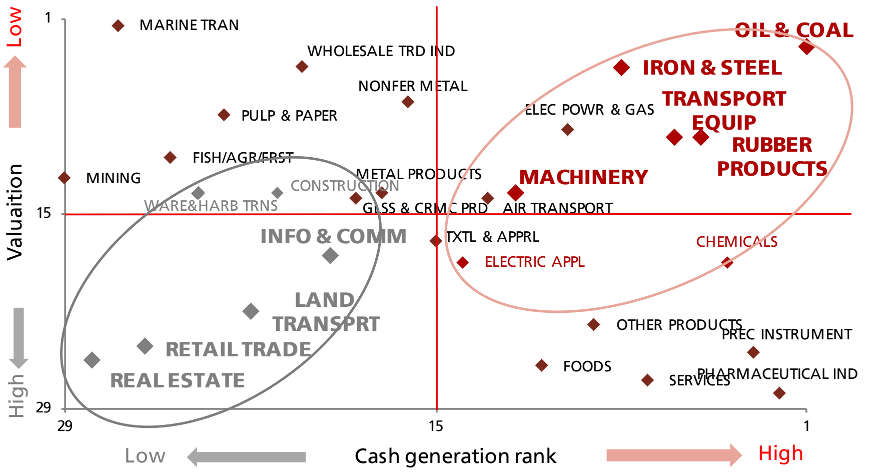
We also expect profit growth in domestic-demand sectors to slow in 2016, primarily in a pullback from strong growth in 2015. Also, taking into account the impact from the consumption tax hike planned for April 2017, growth in share prices is likely to be limited in domestic-demand sectors.

Sector selection

Based on the above arguments, we choose which sectors to overweight (OW) and which to underweight (UW). Our basic selection criteria:

- OW manufacturing and resource sectors, UW domestic-demand sectors.
- OW undervalued sectors and UW overvalued sectors.
- OW strong cash-generating sectors and UW weak cash-generating sectors.
- Figure 25 shows a matrix of the sectors meeting these conditions.

Figure 25: Sector matrix based on valuations and cash-generating ability



Source: Bloomberg, UBS

We assign valuation rankings within each sector based on actual PBR and forward PE (the lower the number, the lower the valuation) and assign cash-generation rankings based on FCF-to-total asset ratios in each sector (the lower the number, the higher the cash-generating capability). Of course, sectors in the upper right quadrant, where valuations are low and cash-generating capabilities high, are attractive; those marked in red are manufacturing or resource sectors. Although the chemicals and electric machinery sectors do not look very undervalued, we believe they are worth considering as alternatives to attractive (OW) sectors. In contrast, the sectors in the lower left quadrant have high valuations and low cash-generating capability; the domestic demand-sectors are marked in grey. To summarize:

- OW: Autos, rubber products, iron & steel, machinery, and petroleum and coal products.
- UW: Retail, real estate, land transportation, and information & communication.

Because of our focus on free cash flow and total assets, we exclude financials, but their overall growth rate is weak and we do not see them as OW sectors.

Upside/Downside Scenarios

Upside risks (+31%)

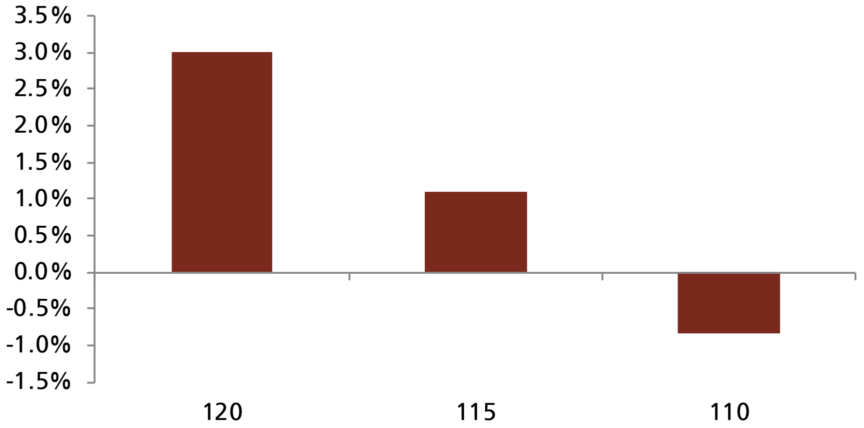
Possible upside risks to our scenario include a further increase in PEs brought about by an influx of risk funds into the equity market if there is a decision to make positive tax code changes and BoJ easing measures accelerate. In that case, although possibly too optimistic, there would be more than a zero probability of the forward PE reaching around the 19x achieved in the previous rally market of 2005. Using EPS forecasts, this would mean a jump in TOPIX up to 2,100, up 31% from current levels. Additionally, if China in particular was to take a more accommodative stance, the risk of an emerging market slowdown would decrease and be a positive for Japan's manufacturing and resource sectors.

Downside risks (-16%)

If the US delays its rate hike, the US economy slows following the rate hike or the rate hike has a very strong negative impact on emerging markets, it could reverse the tide

of expectations, increase the risk of a global recession and necessitate a pricing in of strong yen appreciation from the market switching to risk-off mode. Figure 26 shows forecast EPS growth for three scenarios in 2016: 120, 115, and 110.

Figure 26: Y/$ assumption and forecast EPS growth



Source: UBS

We think a decline in the yen to around ¥110/$ could result in negative EPS growth. Because there would not be much of an inflow of funds into stocks and other risk assets under these conditions, excess liquidity is unlikely to have the effect of pushing valuations higher. Although a fairly pessimistic scenario, if the yen strengthens to 110, TOPIX could fall to about 1,350, a 16% decline. This probably needs to be kept in mind as a possible risk scenario.

UBS Research THESIS MAP Domestic demand to lead growth as the yen continues to weaken steadily

PIVOTAL QUESTIONS

Q: Will consumption recover? Yes. Companies are gradually starting to increase allocations to employment and wages. We believe wage growth will feed through to stronger consumption in 2016 as wages continue to rise, positive real wage growth becomes established, and government policy also provides support. However, we believe the negative impact on the economy from the next consumption tax hike will be visible in FY17.

Q: Will a gap start to open between export volume and production? Yes. With export volume growth only gentle, we think capex will shift focus from increasing export volume to expansion in new areas, such as new product development, R&D, and payroll cost-savings.

Q: What will the Three New Arrows bring? 2016 will bring the Upper House election in July and the decision on whether to raise the consumption tax rate again around October, while Abenomics is likely to focus on policies to expand domestic demand by encouraging corporate and household savings to feed through to demand. We are also focusing on the direction of tax system reforms. At this point, we assume another rise in the consumption tax rate.

Q: Will the yen continue to weaken? Yes. BoJ and US Fed monetary policies are moving in different directions, with the former maintaining a loose policy and the latter raising rates, and the resulting differential in US-Japanese interest rates is likely to weaken the yen further. We forecast ¥130/$ for end 2016 and ¥135 for end-2017.

Q: Will inflation reach 2%? No. It should be fairly easy for core CPI to accelerate to about 0.5% as the impact of energy prices drops away. On the other hand, the rise in food prices should gradually slow and we estimate that core CPI will be stable, at around +1%.

WHAT'S PRICED IN?

Consumption recovery, continued yen depreciation: 2016 growth of 1.3% yoy broadly matches the consensus but our forecast for rising consumption (+1.3% in 2016) is slightly above the consensus (+1% yoy). Our yen-dollar rate estimate of ¥130/$ at end 2016 envisages a weaker yen than consensus (¥125/$) because Japanese and US monetary policies are moving in different directions.

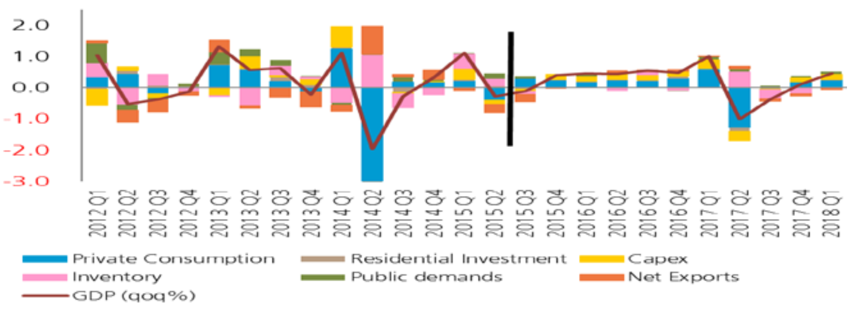
UBS VIEW

Real GDP growth to remain positive, at +1.3% yoy in 2016 and +0.7% yoy in 2017: We estimate that core CPI will be stable, at about 1%, running at 1% at the end of 2016 and 1.3% at the end of 2017 (excluding the consumption tax hike).

EVIDENCE

Sustainability of rising wages, positive real wage growth to become established: Companies are gradually starting to increase allocations to employment and wages. The main reasons that rising wages should start to lead visibly to growth in consumption are that: 1) a sustained increase in nominal wages is likely to lead to more active consumption; 2) positive real wage growth should become firmly established; and 3) we can look for policy support for household incomes and corporate wage hikes.

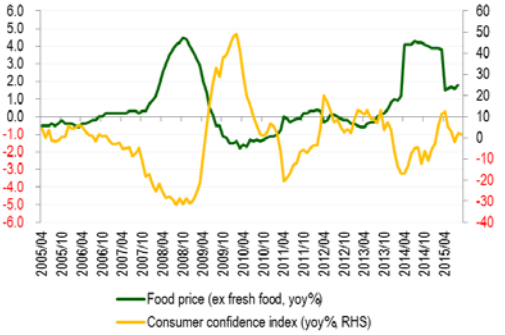
Japanese economic growth to accelerate gently, mainly on domestic demand



Source: Cabinet Office, UBS estimates

OUR THESIS IN PICTURES

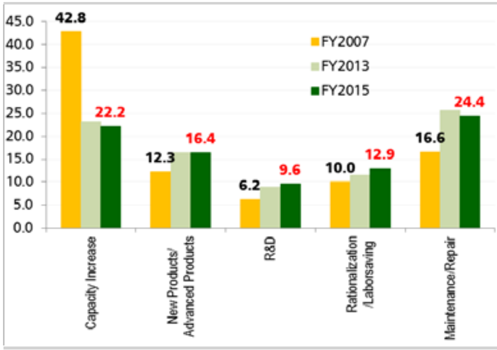
Food prices and consumer sentiment



Source: Ministry of Finance, Cabinet Office, UBS

Somewhat of an inverse correlation can be seen; if food prices stabilise, this could be key for improving consumer sentiment

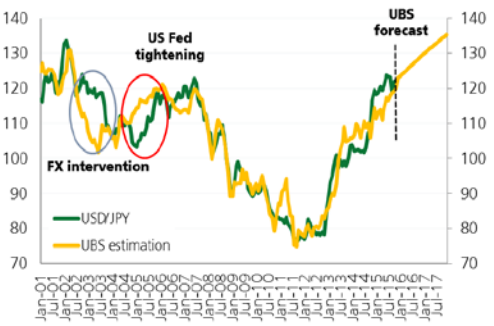
Changes in drivers of manufacturing industry capex (weighting by value)



Source: Development Bank of Japan, UBS

Factors driving manufacturing industry capex are changing substantially compared to 2007, when sectors expanding capacity were the mainstay

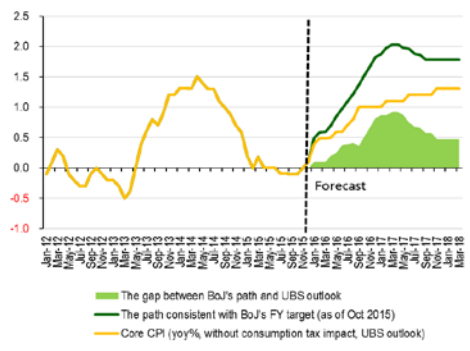
UBS forecasts for USD/JPY



Source: Bank of Japan, Bloomberg、UBS

Even without additional easing by the BoJ, yen depreciation could continue on a widening gap between Japanese/US interest rates

Core CPI (BoJ and UBS forecasts)



Source: Ministry of Internal Affairs and Communications, Bank of Japan, UBS

Prices could continue to rise gently alongside a recovery in domestic demand, but achieving 2% could be tough

Macro Economy

Japanese economic outlook for 2016-17

We estimate that real GDP will continue to grow, accelerating from +0.5% yoy in 2015 to +1.3% yoy in 2016 and +0.7% yoy in 2017. Under a weaker yen, we expect domestic demand to be the main driver, primarily consumption and capex. However, we factor in a demand rush ahead of the 2ppt consumption tax hike due in April 2017, and the subsequent pullback, and we think this will push up 2016 growth by 0.4ppt. On average, we see growth at 1%, in line with the potential growth rate.

Japanese economic and political highlights

Q: Will consumption recover?

Companies in both the manufacturing and non-manufacturing sectors have gradually started to increase allocations to wages as they book record-high earnings, but the pace has been slow. The link between rising wages and consumption growth is weak, and we estimate that real consumption will decline by 0.7% yoy in 2015. However, in 2016 ongoing wages growth should encourage higher consumption. We expect growth of +1.3% in 2016 and +0.1% in 2017. But this partly reflects the rush in demand to beat the next consumption tax hike and the subsequent pullback, and we envisage average growth of about 0.7%.

The first reason for consumption to rise is the recognition of sustainable wage growth. The government will likely press companies to lift wages further in the run-up to the 2016 Shunto (spring wage round). There should also be further rises in the minimum wage, which impacts part-time workers. The 2015 Shunto (spring wage negotiation round) brought a 2.5% increase and we expect this to accelerate to about 2.8% in 2016. The second reason is that growth in real wages should take root as food prices stabilise. Core-core CPI, which shows the underlying trends in prices, currently stands at -0.1%, but the negative contribution from energy-related prices should disappear from here on. Meanwhile, the yen is only likely to weaken at a moderate pace going forward and global commodity prices look set to decline further, so the contribution made by food prices will probably weaken. Due to technical factors a rebound to about 0.5% can be expected, but we do not believe inflation will run above 1% in 2016. Growth in nominal wages should finally remain consistently above the rate of inflation. Weaker growth in food prices is likely to have a big impact on consumer sentiment. The third reason is policy support. Abenomics will focus on reviving domestic demand in the run-up to the July 2016 Upper House election and the year-end decision on whether to raise the consumption tax rate the following year. We think developments such as a supplementary budget, policies under Three New Arrows and tax reforms will include various measures to support household incomes, mainly focussing on households with two working parents and families with children. Incentives such as corporate tax breaks are also being introduced for companies that raise wages.

Q: Will a gap start to open between export volume and production?

Japan's real export and production indexes have correlated closely with each other following the financial crisis. Global economic expansion is slowing, while Japan's manufacturing sector has seen its competitive edge erode, blunting export volume growth, and production is also no longer rising. However, with contract currency-

based export prices falling sharply, a moderate recovery can be expected from here. Companies have kept contract currency export prices relatively steady despite the sharp fall in the yen since Abenomics, leading to high nominal earnings even in the absence of increased export volumes. However, the weaker yen has prompted some firms to start to repatriate operations from around mid-2014, such as by re-allocating overseas investment to Japan, and they have begun to find room for price cuts. We believe conditions will be increasingly conducive to growth in real exports if prices decline and the global economy proves stronger than expected. We estimate that real exports will turn up from +1.4% yoy in 2015 to modest growth of +2.7% in 2016 and +2.9% in 2017.

A gap may start to become evident in the relationship between export volume and production. The manufacturing sector is sitting on high savings, and its capex is likely to be driven by fresh motives, such as new product development, R&D, payroll cost-savings, and repair/maintenance, not by traditional investment to expand production capacity in a bid to increase volumes. The non-manufacturing industry also faces structural change, including responding to an aging society, IT, inbound consumption and the Olympic Games, and there is a great appetite to invest, alongside an increasingly acute labour shortage. Major companies' capex plans showed growth of 10.9% yoy in BoJ's October Tankan, as strong as plans in FY07. Firms have not yet moved to the implementation phase but we think they are likely to become more active from here if uncertainty over the global economy lifts and strength in domestic demand is confirmed. We estimate that capex growth will pick up from 0.9% in 2015 to 3.5% in 2016 and 2.5% in 2017; therefore, while there will be some impact from the next consumption tax hike, on average, we envisage consistent growth around 3%.

Q: What will the Three New Arrows bring?

Two key events will take place in 2016, namely the July Upper House election and a decision around October on whether or not to raise the consumption tax rate once more. In particular, the decision on whether to go ahead with the next consumption tax hike or defer it again is likely to have a major impact on the economy and markets in H2 2016. Abenomics is likely to switch from policies undertaken aimed at yen depreciation and the wealth effect to initiatives to encourage corporate and household savings to feed through to demand, in a drive to revive domestic demand and raise cabinet approval ratings. More precisely, preferential measures for households with children and those with low incomes will take concrete shape in developments such as budgets and tax reforms. A radical overhaul to income taxation is due to take place under tax system reforms, and alongside a gift tax, an inheritance tax and taxes levied on financial assets, we could see a comprehensive policy to redistribute income. Those over-60 own more than 65% of the ¥1,717trn in household savings in Japan (end-June 2015), and asset transfers would likely stimulate consumption among younger generations. The FSA is seeking revisions to the system of inheritance tax asset appraisal (lowering equity appraisal value from 100% to 70%) and if they are implemented capital could start to flow into equities from individuals. On the corporate side, areas likely to be in the spotlight include a cut in the corporate tax rate to under 30% as soon as possible. However, some firms are also likely to be affected by reinforced pro-forma standard taxation rules and revisions to Japan's special taxation measures. As for market deregulation, the focus will be on the four fields highlighted by the Prime Minister's office report on 5 November: 1) self-driving automobiles, 2) use of robots for freight transportation, 3) remote operations and

IoT, and 4) artificial intelligence in medical diagnosis. Further details are likely to be announced by the summer.

Q: Will the yen fall further?

BoJ and US Fed monetary policies are moving in different directions, with the former maintaining a loose policy and the latter raising rates, and the resulting differential in US-Japanese interest rates is likely to weaken the yen further against the dollar. The impact of higher interest rates may already be partially factored in, but the two-year forward federal funds rate has not been discounted, so the gap in interest rates is likely to lead the yen to depreciate further, to ¥130/$ at the end of 2016 and ¥135/$ in 2017, although this would mean a more gentle pace of decline than in the past. However, yen depreciation of more than 10% has a major adverse impact on SMEs and households over the near term. The government/BoJ could intervene if the yen drops steeply. The yen could also appreciate under temporary risk-off conditions, as happened in 2004 immediately following US rate hikes. That is because US two-year rates tend to rise as they factor in the pace of hikes in policy interest rates.

Q: Will inflation reach 2%?

Energy has hitherto made a major negative contribution to core CPI (all items excluding fresh food), but the impact of this should fall away, setting the stage for acceleration to about 0.5% in H1 2016. On the other hand, although food prices have risen consistently because of the delayed impact of yen depreciation and as firms transfer costs into prices, growth in these should gradually slow (turning negative QoQ), making inflation far above 1% unlikely. We estimate that the core CPI will reach +1.0 at the end of 2016 and +1.3% at the end of 2017, remaining steady at around the 1.0% mark. Core CPI has been heavily influenced by moves to pass along the impact of the weaker yen and food prices, but we think growth from the demand side supported by recovery in consumption will also be evident in 2016-17.

The BoJ is keeping its monetary policy loose as it targets a 2% inflation rate but has not committed itself irrevocably to reaching this in two years, and even if prices rise only gently, it is unlikely to ease, provided the economy continues to grow firmly at a rate of at least 1% (annualized) amid a gradually falling yen. We put the likelihood of additional easing by the BoJ in 2016 at 10% for the first half of the year and 30% for the second half of the year, so we see a 60% chance of it not happening at all over the year. That said, expectations of further easing may grow around autumn 2016, when the decision on the next consumption tax hike will be made. The BoJ is also likely to ease without hesitation if the yen strengthens to ¥117/$ or beyond, or if the economy threatens to turn down.

There is little upward pressure on 10-year JGB yields from domestic factors, since the BoJ continues to buy about 90% of JGB issuance and domestic prices are rising only gently. Indeed, we think the dynamics of overseas investors' risk-on behaviour associated with rising US interest rates will have a greater impact on Japanese interest rates. We estimate that a 1% rise in the US two-year interest rate would push up Japan's 10-year yield by 0.18ppt. We estimate that Japan's 10-year interest rate will trend upwards, albeit very gently, alongside a recovery in domestic demand and higher US interest rates, reaching 0.5% at the end of 2016 and 0.7% at the end of 2017.

Upside and downside risk scenarios for Japanese economy

On the upside (15% probability), key points include robust overseas economic growth (particularly the US and China), as well as substantial tax reforms and deregulation on the policy front. A reduction in the corporate tax rate to below 30%, the abolition of some fixed asset taxes and radical deregulation in areas such as healthcare, medical/nursing, robots/IoT and AI would likely also encourage corporate capex. In our upside scenario, we forecast 2016 GDP growth of 1.8% and core CPI at 1.3%.

On the other hand our downside scenario (10% probability) posits the threat of yen appreciation triggered by rapid risk-off behaviour in overseas economies. Companies would emphasize savings again and both wage growth and capex would likely slow. On the policy front, we would expect a supplementary budget of about ¥10trn from the government, as well as further BoJ easing on a similar scale. We think a supplementary budget would push up GDP about 1%, factoring in the multiplier effect. However, this would come through after a significant time lag and only a very small amount of the impact would be felt in 2016. Although the BoJ would ease monetary policy further, it has less scope to do so than the US or Europe, and we could not look for the same impact on yen depreciation as before. We would expect real 2016 growth of -0.7% and core CPI of -0.4%, dropping sharply.

UBS Economic Forecasts

New UBS Economic Forecast as at 16 November 2015

	2015				2016				CY			FY		
Q/Q	Q1 A	Q2 A	Q3 A	Q4 E	Q1 E	Q2 E	Q3 E	Q4 E	2015E	2016E	2017E	2015E	2016E	2017E
Real GDP	1.1	-0.2	-0.2	0.4	0.4	0.4	0.6	0.5	0.6	1.3	0.7	0.9	1.8	-0.2
Real GDP (annualized)	4.6	-0.7	-0.8	1.5	1.7	1.8	2.2	1.9						
Domestic Demand*	1.2	0.0	-0.3	0.5	0.4	0.4	0.5	0.4	0.2	1.3	0.6	0.9	1.7	-0.2
Private Consumption	0.4	-0.6	0.5	0.4	0.3	0.4	0.4	0.5	-0.6	1.3	0.0	0.7	1.7	-1.1
Housing	2.0	2.4	1.9	0.5	1.0	1.0	1.2	2.0	-2.2	4.9	-1.0	3.7	4.8	-3.9
Capex	2.4	-1.2	-1.3	0.5	1.0	1.2	1.2	1.2	0.0	2.2	2.4	0.2	3.9	0.8
Public Investment	-1.3	2.1	-0.3	-1.0	0.5	0.5	-1.0	-1.0	0.9	-0.3	1.4	0.9	-0.7	2.4
Net Exports*	0.0	-0.2	0.1	-0.1	0.0	0.1	0.1	0.1	0.4	0.0	0.1	0.0	0.1	0.0
Exports	1.9	-4.3	2.6	0.5	1.5	1.2	1.0	1.0	3.1	3.8	2.9	1.4	4.8	2.3
Imports	1.9	-2.8	1.7	1.5	1.5	1.0	0.8	0.8	1.1	4.1	2.6	1.7	4.6	2.3
Y/Y														
Real GDP	-0.8	1.0	1.0	1.1	0.4	1.0	1.8	1.9						
Nominal GDP	2.6	2.5	3.1	2.6	1.7	2.3	2.9	2.8	2.7	2.4	1.5	2.5	2.8	0.6
Industrial Production	-2.1	-0.4	0.6	0.7	0.5	2.7	3.6	3.3	-0.3	2.5	2.4	0.2	3.2	2.1
Labour Market Y/Y														
Unemployment Rate (%)	3.5	3.4	3.4	3.3	3.3	3.2	3.2	3.2	3.3	3.2	3.1	3.3	3.2	3.1
Total Employee Earnings	1.4	0.8	1.0	1.0	1.0	1.1	1.1	1.1	1.1	1.1	1.2	1.0	1.1	1.2
Others														
GDP Deflator	3.5	1.5	2.1	1.4	1.3	1.2	1.1	0.9	2.1	1.1	0.8	1.6	1.0	0.8
CPI	2.4	0.5	0.2	0.8	0.9	0.9	1.1	1.0	0.9	1.0	1.2	0.6	1.0	1.2
Core CPI**	2.1	0.1	0.0	0.2	0.7	0.8	1.0	1.0	0.6	0.9	1.2	0.2	1.0	1.2
Current Account (% GDP)	3.1	3.4	3.0	3.5	2.9	2.8	2.5	3.5	3.2	2.9	3.2	3.2	3.0	3.1
Interest & Exchange Rates (end period)														
BoJ Policy Rate	0-0.1	0-0.1	0-0.1	0-0.1	0-0.1	0-0.1	0-0.1	0-0.1	0-0.1	0-0.1	0-0.1	0-0.1	0-0.1	0-0.1
10 yr Yield	0.45	0.36	0.35	0.40	0.40	0.45	0.45	0.50	0.40	0.50	0.70	0.40	0.55	0.70
JPY/USD	120	120	120	126	126	127	127	130	126	130	135	126	130	135

* Contribution to growth (pts), ** ex. fresh food.
Source: Cabinet Office, MIC, METI, BoJ, Bloomberg, UBS estimates

Construction

Toshihiko Okino (Analyst)

UBS Research THESIS MAP	MOST FAVORED	LEAST FAVORED
	Kajima, Maeda	**None**

PIVOTAL QUESTIONS

Q: Will orders continue to rise at Japan's general contractors?

Orders are likely to be placed for the Chuo maglev shinkansen line, the new National Stadium and for large-scale redevelopment projects in downtown Tokyo through the end of FY15. As a result, orders for Japan's 50 major general contractors are very likely to more or less peak in FY15. Construction demand should remain robust from FY16, but given the limits to these firms' construction capacity, orders are likely to move sideways or advance only slightly from their current level, in our view.

Q: How much will profit margins improve?

Gross margins on building works in the general contractors' parent construction units are improving rapidly on stronger order profitability, as labour and other costs have stopped rising. Taisei's gross margin exceeded 9% in H1 FY15. Still, if labour costs start to increase again, further gross margin upside could be limited and gross margin is unlikely to remain higher than 10%.

WHAT'S PRICED IN?

An OP margin of 5% is priced in: Taisei's FY15 guidance, which was revised up in mid-November, assumes 5.4%. Thus its margin is already higher than 5%, so this level is probably already discounted.

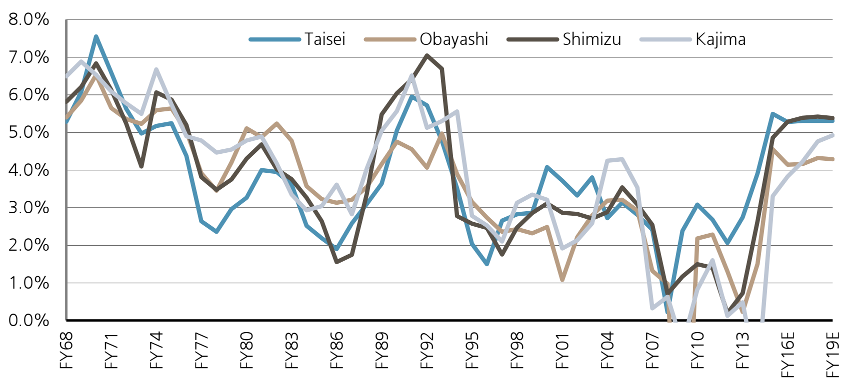
UBS VIEW

The OP margin is unlikely to exceed 6% or approach 7%: As supply-demand has tightened in the construction market, general contractors' price negotiation capabilities have clearly improved. However, they receive about half of their orders through competitive bidding, so price competition has not totally disappeared.

EVIDENCE

The OP margin was well above 5% only during the bubble period: General contractors' OP margins remained stable, at 6-7%, during the growth period in Japan's construction industry through the early 1970s, but in the saturation phase that started with the Oil Shock in 1973, their OP margins exceeded 5% sharply only in the early 1990s, when orders taken during the bubble period in the 1980s fed through to sales.

Operating profit margins at Japan's Big Four contractors (parent basis)



Source: Company data, UBS estimates

Kajima (1812)

Profit margin finally improved

Good room for profit margin improvement among big general contractors

Kajima is lagging Japan's other three leading general contractors in terms of its earnings recovery due to losses from several unprofitable projects, which it took on just prior to and after the March 2011 earthquake. However, for these projects, provisions for heavy losses have already been appropriated, and almost all of them should be completed in FY15 or FY16. Furthermore, the company has booked provisions of about ¥80bn in total for losses on a highway construction project in Algeria, and the risk of additional losses seems low in the near term. We believe Kajima could be revalued as a laggard in terms of its earnings and share price.

Profit margins on building works should improve rapidly

The gross margin on building works in the parent construction business reached 6.7% in H1 FY15, up sharply from -0.4% in H1 FY14. Almost all the unprofitable projects for which the company has already booked losses are expected to be completed in FY15 and FY16, allowing gross margin to improve further to 7.0% in FY16 and 7.4% in FY17. However, Kajima's gross margin is still likely to be lower than at the other three leading general contractors, which already achieved figures in excess of 8% in H1 FY15, so it has considerable room for further improvement.

Focus on orders and the earnings trend over next six months

Full-term OP guidance was revised up by 42.5%, from ¥40bn to ¥57bn, on 2 Nov, but the firm's profit plan for H2 still looks rather conservative. A further upward revision to full-term guidance is likely at the Q3 results announcement in mid-February. Also, if the company succeeds in receiving orders for the Chuo Maglev line and major redevelopment projects in central Tokyo, it should have a positive impact on the share price.

Valuation: We reiterate our Buy rating

We maintain our price target of ¥780, which is close to our fair value estimate (adjusted for unrealised real estate gains), derived by applying to BPS of ¥488 a PBR of 1.47X, assuming FY16E adjusted ROE of 9.2% and COE of 6.3%.

RIC: 1812.T / BBG: 1812 JP

12-month rating	Buy
12m price target	¥780
Price (3-Dec)	¥720
Up/Downside	+8.3%
Market cap	¥747.6bn
	US$6.05bn
03/16E	
P/BV (UBS)	1.6x
Net Cash (Debt)	(¥105.8)bn

Operating Profit	
03/16E	
UBSE	¥60.0bn
IFISE	¥57.4bn
CoE	¥57.0bn
03/17E	
UBSE	¥70.0bn
IFISE	¥71.2bn

1812 - Highlights (¥bn)	03/13	03/14	03/15	03/16E	03/17E	03/18E	03/19E	03/20E
Revenues	1,485.0	1,521.2	1,693.7	1,710.0	1,770.0	1,810.0	1,850.0	1,860.0
Operating profit	18.5	23.0	12.7	60.0	70.0	78.0	88.0	90.0
Recurring profit	24.6	27.0	21.4	65.0	75.0	83.0	93.0	96.0
Net profit (reported)	23.4	20.8	15.1	41.8	44.6	49.6	55.8	57.7
EPS (reported, ¥)	22.6	20.0	14.6	40.3	43.0	47.8	53.7	55.6

Profitability & Valuation	03/13	03/14	03/15	03/16E	03/17E	03/18E	03/19E	03/20E
EBIT margin %	1.2	1.5	0.7	3.5	4.0	4.3	4.8	4.8
ROIC (EBIT) %	5.0	7.4	4.8	23.9	27.4	30.1	33.4	33.7
EV/EBITDA x	8.5	8.3	10.9	7.1	5.9	5.0	4.1	3.7
PE (reported) x	10.5	18.0	32.4	17.9	16.8	15.1	13.4	13.0
Net dividend yield %	2.1	1.4	1.1	0.8	1.1	1.4	1.7	1.9

Source: Company data, UBS estimates (for all charts on this page)

Upside scenario

In our upside scenario, public spending remains at a high level to support the economy while private sector capex recovers in earnest and real estate prices rebound, allowing the valuation to exceed ¥900, with PBR surpassing 2.0X.

Downside scenario

In our downside scenario, public sector operations are curtailed as part of fiscal restructuring but private sector capex contracts due to economic weakness and real estate prices decline, leading valuation to fall below ¥500, with PBR under 1X.

Company profile

Kajima is one of Japan's largest construction companies, which are generally known as the "super general contractors". The firm has built up a strong reputation in a wide range of building work, from skyscraper development to nuclear power plant construction. The company also has a good track record in real estate development.

Food, Beverages and Tobacco

Naomi Takagi (Analyst)

UBS Research THESIS MAP

	MOST FAVORED	LEAST FAVORED
	Meiji HD	**Nissin Food Products**

PIVOTAL QUESTIONS

Q: Can price increases be maintained or are selling prices likely to turn down?

The trend in food unit prices. In 2016, the wave of price increases and food inflation that has been seen this year could subside. Unless the yen weakens too sharply, raw material prices could decline and cost pressure ease, or at least costs could rise at a far slower pace than in 2015. In this phase, the main focus is likely to be on whether recently raised unit prices can be maintained or turn down.

Q: What is the trend in overseas business earnings?

Another key factor is overseas earnings. Growth momentum could vary by company but most firms should be able to maintain growth in overseas operations in FY16. We focus on Suntory and Kewpie. Conditions may remain challenging for Kirin, which is developing its operations in S. America.

Q: Is restructuring likely to progress?

Structural reform could be key, possibly including withdrawal from less profitable businesses, reducing exposure to less profitable products, and facility realignment. We believe firms that commit to such action will stand out. Our focus stocks are Meiji and Yamazaki Baking.

WHAT'S PRICED IN?

Slower profit growth in FY16 as price increases run their course: In FY15, most companies in the sector should achieve strong profit growth by raising their prices. Strong earnings performances have already been priced in. The consensus view for FY16 is that price increases will have run their course, unit price declines can be expected, and earnings growth will slow sharply.

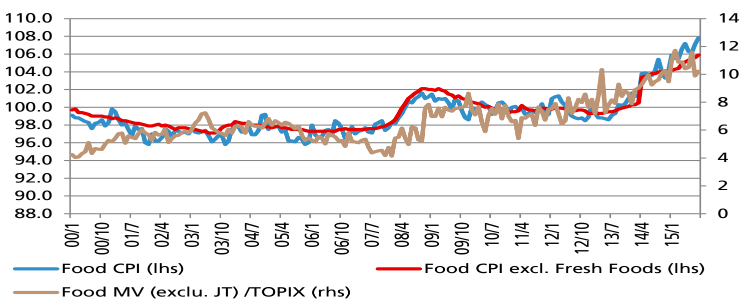
UBS VIEW

Companies that achieve high-quality profit growth should emerge in 2016: Profit growth is likely to slow in 2016. Still, companies with strong brands have improved their price negotiating powers and those able to maintain higher prices and achieve high-quality profit growth on the back of stronger volumes, lower raw materials costs, and structural reforms could emerge in FY16.

EVIDENCE

Profit margin improvement to continue at an increasing number of companies: As profit awareness has improved, food manufacturers and retailers, where demand has not declined even after price increases, are reporting strong earnings. Therefore, we believe pressure from retailers will ease and manufacturers' price negotiating abilities will improve to counter downward pressure on prices.

Food CPI and food sector performance



Source: MIC, UBS

Meiji Holdings (2269) – Still undergoing change

Reason for Buy rating: Strong momentum

Meiji has the best profit growth momentum in Japan's food sector, based on its ability to expand sales and implement reform. The OP margin is 5.8% in FY15, above the initial target of 5%, but further rises are expected. Meiji aims to reinforce its managerial structure to allow it to take margin to a high single-digit rate or even 10%. Its strengths lie in a product line-up that targets Japan's senior population, a key source of growth in domestic demand (probiotics, chocolate, sports/nutrition). Meiji is allocating operational resources around its core products and enhancing its brand strength. We see good room for cost savings and the production structure is being re-aligned.

Earnings forecast: Double-digit profit growth to continue in FY16

We forecast FY15 OP of ¥72bn (+40% yoy), whereas guidance is ¥66.5bn. We expect sales growth, price revisions, and companywide efforts to improve costs to drive strong profit growth. In FY16, profit from pharmaceuticals is likely to fall due to the latest drug price revisions, while price rise effects will probably disappear on the food side, but higher sales can still be expected and raw material cost pressure could ease greatly. Also, structural reforms are still being implemented, including revisions to its less profitable products and improvements to the subsidiaries' cost structures. FY16 should bring further double-digit profit growth: we expect an 11% rise in OP, to ¥80bn.

Catalysts

Meiji has made upward revisions at each of its recent results releases, as it has turned in strong profit growth. Towards FY16, it may exceed assumptions again through-better-than expected rates of sales growth and cost improvements. Longer-term catalysts include expansion overseas. Meiji entered the milk business in full in China in 2014 and sales could reach ¥6bn in FY15, up from ¥2bn in FY14. In this market, it mainly handles yogurt, milk and lactic acid bacteria beverages. It has differentiated itself from local products and its products are being accepted and penetrating the market at a fast rate despite high unit prices. Meiji's products are mainly sold by Japanese retailers, but if its sales channels widen and sales growth accelerates as a result, it could be promising.

Valuation: PT of ¥12,000 (based on a FY17E PE of 30X)

Our PT adds a 20% premium to the FY17E processed food sector average PE of 25X. We expect the dividend to rise from ¥70 in FY15 to ¥100 in FY16. Meiji's ability to benefit from higher domestic demand based on the added value in its products and its efforts to continuously improve its corporate structure should drive medium-term profit.

RIC: 2269.T / BBG: 2269 JP

12-month rating	Buy
12m price target	¥12,000
Price (3-Dec)	¥9,980
Up/Downside	+20.2%
Market cap	¥1,523.8bn
	US$12.34bn
03/16E	
P/BV (UBS)	3.5x
Net Cash (Debt)	(¥173.4)bn

Operating Profit	
03/16E	
UBSE	¥72.0bn
IFISE	¥71.8bn
CoE	¥66.5bn
03/17E	
UBSE	¥80.0bn
IFISE	¥79.8bn

2269 - Highlights (¥bn)	03/13	03/14	03/15	03/16E	03/17E	03/18E	03/19E	03/20E
Revenues	1,126.5	1,148.1	1,161.2	1,236.9	1,247.2	1,265.7	1,282.6	1,304.4
Operating profit	25.9	36.5	51.5	72.0	80.0	88.0	93.5	103.0
Recurring profit	29.1	39.1	53.6	75.5	82.0	90.0	95.5	103.4
Net profit (reported)	16.6	19.1	30.9	58.6	53.0	58.9	62.8	67.4
EPS (reported, ¥)	113.0	129.4	209.8	398.1	359.7	399.8	426.6	458.0

Profitability & Valuation	03/13	03/14	03/15	03/16E	03/17E	03/18E	03/19E	03/20E
EBIT margin %	2.3	3.2	4.4	5.8	6.4	7.0	7.3	7.9
ROIC (EBIT) %	6.7	8.7	11.3	14.7	15.9	17.2	18.0	19.7
EV/EBITDA x	5.2	6.5	8.5	14.4	13.1	12.2	11.7	10.7
PE (reported) x	16.3	20.9	22.2	25.1	27.7	25.0	23.4	21.8
Net dividend yield %	2.2	1.5	1.1	0.7	1.0	1.2	1.3	1.4

Source: Company data, UBS estimates (for all charts on this page)

Upside scenario

Upside support could come from faster-than-expected sales of probiotic yoghurt and a neutral impact from raw materials costs, as well as stronger-than-assumed sales growth in China and the Chinese operation moving into the black earlier than expected. If probiotic yoghurt sales grow 10% in FY16 and FY17 (our current forecast is 7.5%), the negative impact of high raw-materials prices eases, and the Chinese operation turns into the black, FY17 OP could reach ¥100bn (our current forecast is ¥88bn) and EPS could be ¥440. Under this scenario, we estimate that upside valuation could reach ¥13,200 based on a PE of 30X.

Downside scenario

If growth in probiotic yoghurt sales slows to a low-single-digit rate (2-3%) from FY16, OP might only come to ¥80bn in FY17. With EPS at ¥360, we estimate downside valuation could be ¥9,000 under this scenario, based on a PE of 25x.

Company profile

Meiji Seika merged with Meiji Dairies in 2009. In April 2011 dairy and confectionary operations were re-organised around Meiji Co. and pharmaceuticals into Meiji Seika Pharma. Meiji has the top share (42%) of yogurt sales and pioneered the growing probiotic yogurt market with its LG21/R-1 brands; sales are an unrivalled ¥75bn. It has the top share for powdered milk (40%+). Meiji is number one in confectionary sales but its core chocolate share is just 17%. It has new drug operations, mainly in the communicable disease and central nervous areas, and generic drug operations. Generics have gained a 10%+ share in each.

Chemical and synthetic fibre

Takaaki Muramatsu (Analyst)

UBS Research THESIS MAP | MOST FAVORED | LEAST FAVORED

Nitto Denko, Toray | **JSR, SUMCO**

PIVOTAL QUESTIONS

Q: How long is the favourable cycle for the petrochemicals sector likely to continue?

It should continue through the end of 2016. Naphtha crackers in Japan have maintained high capacity utilization of 90% or more in 2015 due to improved competitiveness stemming from the lower crude oil price, slower imports due to the yen's weakness, and capacity reductions within the sector. In 2016 we expect a further reduction in domestic capacity, while output of ethylene from shale is unlikely to expand much. Therefore, we expect capacity utilization to remain high.

Q: How strong is profit growth expected to be in FY16?

We forecast that OP growth at the companies that we cover will slow sharply from 27% in FY15 to 9% in FY16, as profit growth drivers such as lower raw materials and fuel prices and the weaker yen run their course, and because streamlining effects are expected only at some firms.

Q: What are the risks for the sector?

Risk factors include stiffer competition with Asian peers due to Asian currency devaluation. There could be some big price discounts, particularly for LCD materials and other electronic materials. Also, if coal prices continue to fall, chemical products that originate from coal, such as CTO (coal to olefin) in China, could become more competitive.

WHAT'S PRICED IN?

Benefits from the weaker yen, low crude oil prices and streamlining effects are priced in: We believe the weaker yen, at over ¥120/$, crude oil at around $40, and streamlining scenarios are all priced in. Still, volume growth hardly seems to have been discounted except for carbon fibre and some other products, so we see some upside at companies that have new drivers for higher volumes or that can support expectations for growth. Also, among the companies that announce new medium-term plans, there should be some upside at those that can demonstrate an increasing commitment to ROE by unwinding their cross-shareholdings or taking other steps to improve asset efficiency.

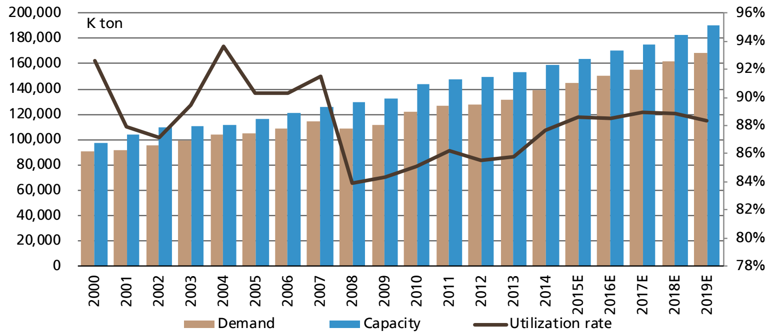
UBS VIEW

Expectations for volume growth should drive valuations upwards: Toray and Nitto Denko are promising in terms of volume growth. Toray's valuation should rise on increasing expectations for growth in auto-use carbon fibre and high-functional sewn products on the back of demand for weight reductions. For Nitto Denko, we believe short-term concerns over LCD materials will be more than offset by expectations for medium-term expansion in nucleic acid drugs and auto-use tape.

EVIDENCE

Greater clarity on reinforced regulations governing passenger vehicle fuel efficiency in 2017 or beyond should be a catalyst: The reinforcement of regulations governing passenger vehicle emissions in the US and China from 2017 could generate demand for new auto parts.

Ethylene global supply-demand balance



Source : IHS Global, UBS estimates

Nitto Denko (6988)

Expect bigger contribution from non-display operations

Rising earnings contributions from auto materials and medical products

Nitto Denko is one of our top picks for three key reasons: 1) Medium- to long-term growth can be expected on the back of rising demand for auto-use tape and medical products. 2) Although the outlook for core products, polarising and ITO film is not that bright due to the saturation of the LCD industry and stiffer competition, new product releases should allow profit margins to improve. 3) We believe the valuation deserves a premium due to growing expectations for earnings contributions from a new blockbuster drug.

We forecast FY16 OP at ¥130bn, +8% yoy

Our FY15 OP forecast matches the company's guidance, at ¥120bn. For FY16, we forecast OP of ¥130bn, +8% yoy. That is almost in line with the consensus but the markets may not be too confident about profit growth in FY16, given concerns over weaker LCD panel supply-demand.

High expectations for progress in liver cirrhosis treatment drug

Nitto Denko should be able to accelerate the launch of its fibrosis treatment drug, which has been granted Fast Track designation by the US FDA. The company aims to move to the next step as soon as phase 1-b testing in the US is completed next spring. The firm should announce details of its next action plan in January-March 2016.

Valuation: Maintain Buy rating

Our PT of ¥11,000 is based on UBS-VCAM, assuming a medium-term OP margin of 14.5% and WACC of 5.8%. This corresponds to a FY16E PE of 19x. Short-term concerns over weakness in display-related demand should gradually disappear, while over the medium term, we expect bigger contributions to earnings from automotive materials and the medical products business to drive the valuation.

RIC: 6988.T / BBG: 6988 JP	
12-month rating	Buy
12m price target	¥11,000
Price (3-Dec)	¥8,586
Up/Downside	+28.1%
Market cap	¥1,418.3bn
	US$11.48bn
03/16E	
P/BV (UBS)	2.1x
Net Cash (Debt)	¥231.6bn

Operating Profit	
03/16E	
UBSE	¥120.0bn
IFISE	¥122.6bn
CoE	¥120.0bn
03/17E	
UBSE	¥130.0bn
IFISE	¥130.7bn

6988 - Highlights (¥bn)	03/13	03/14	03/15	03/16E	03/17E	03/18E	03/19E	03/20E
Revenues	675.6	749.8	825.2	849.1	893.9	929.4	966.6	1,007.0
Operating profit	68.7	72.3	106.7	120.0	130.0	138.0	146.0	154.0
Pre-tax profit	67.4	71.7	105.9	119.0	129.0	138.0	146.0	154.0
Net profit (reported)	43.8	51.0	77.9	88.6	96.1	102.8	108.7	114.7
EPS (reported, ¥)	266.3	309.3	471.7	536.8	582.1	622.9	658.7	694.8

Profitability & Valuation	03/13	03/14	03/15	03/16E	03/17E	03/18E	03/19E	03/20E
EBIT margin %	10.2	9.6	12.9	14.1	14.5	14.9	15.1	15.3
ROIC (EBIT) %	21.0	20.3	26.6	26.6	27.4	27.2	27.3	27.5
EV/EBITDA x	4.9	6.6	5.2	7.2	6.6	6.4	6.2	5.9
PE (reported) x	14.9	17.8	12.4	16.0	14.8	13.8	13.0	12.4
Net dividend yield %	2.5	1.8	2.1	1.6	1.9	2.1	2.2	2.2

Source: Company data, UBS estimates (for all charts on this page)

Upside scenario

Our upside scenario assumes volume TV demand is around 3% higher than existing assumptions, price erosion in polarizing and ITO film will be around 2pt lower (at -6%) and profit margins on industrial tape will improve 1pt. Under these circumstances, we estimate FY16 OP could come to ¥140bn and EPS ¥630. Applying a PE of 20x to this would imply upside valuation of ¥12,500 per share. Also, if trials for the company's new fibrosis drug proceed steadily, and if expectations for future earnings contributions accelerate due to tie-ups with pharmaceuticals manufacturers or licence income, PE could rise further. There are an estimated 6m hepatic cirrhosis patients worldwide, with expenditure per patient over ¥2m. The terminal illness market is worth over ¥10trn. Assuming retail sales at ¥300bn, with the company's sales at 20% of this and half of sales as OP, we would estimate a theoretical contribution of ¥30bn to OP and ¥90 to EPS.

Downside scenario

Our downside scenario assumes polarising and ITO film volumes are 5% lower due to a slowdown in TV and smartphone shipments, price erosion worsens by 2pt (for a 10% fall), and industrial tape profit margins deteriorate 1pt. Under these circumstances we estimate FY16 OP could come to ¥110bn and EPS ¥490. Applying a PER of 15X to this to reflect slower earnings momentum would imply downside valuation of ¥7,300 per share.

Company profile

Founded in 1918 to promote home-grown production of electrical insulating materials, Nitto Denko has drawn upon its expertise in enabling technologies and its customer base to expand product coverage and steadily advance sales. Key products include industrial tapes, LCD optical film, IC package materials, flexible circuit boards, processing materials for electronic devices, medical tape-related products and high-molecular film products. Sales growth has accelerated since the mid-1990s as electronics markets have expanded, and in recent years, LCD optical film has been the main driver.

Steel and Non-Ferrous Metals

Atsushi Yamaguchi (Analyst)

UBS Research THESIS MAP MOST FAVORED LEAST FAVORED

Nippon Steel & Sumitomo Metal, UACJ **Kobe Steel, Sumitomo Metal Mining**

PIVOTAL QUESTIONS

Q: How long will the downtrend in metals prices continue?

Steel product and non-ferrous metal prices should bottom soon. In China, steel product prices are already well below marginal cost levels. Prices for non-ferrous metals, including nickel but excluding copper, are also below or close to marginal costs. However, final product demand is weak and prices should return to close to production costs, assuming they recover. On the macro economy side, further monetary easing in the US and China's economic measures should be catalysts for an upturn in prices.

Q: How long will Chinese mills stay in the red? How will protectionism affect the sector?

The Chinese mills' hot-rolled steel product prices are estimated to be $50-90/tonne lower than marginal costs, but these mills are continuing to operate, encouraged by the government, which is emphasizing employment. However, a turning point could be reached sometime in 2016. If import duties are raised in various markets, Japanese mills are very likely to be affected, so we see some downside risk to steelmakers' FY16 earnings.

Q: Will China's high exports further depress S/D for aluminium rolled products in Asia?

As China is accelerating its exports of aluminium metal and rolled products, global supply-demand conditions are easing. This situation is likely to continue in 2016. However, supply-demand is easing only for commodity-grade products, while the high-grade product market, including can lid materials and auto-use products, should hardly be affected.

WHAT'S PRICED IN?

FY16 earnings are forecast at slightly higher than double H2 FY15 earnings: for the major steel and non-ferrous metals companies, the stock market appears to be factoring in a slight improvement from double H2 FY15 earnings. UACJ appears to assume weak capacity utilization at its Thai plant.

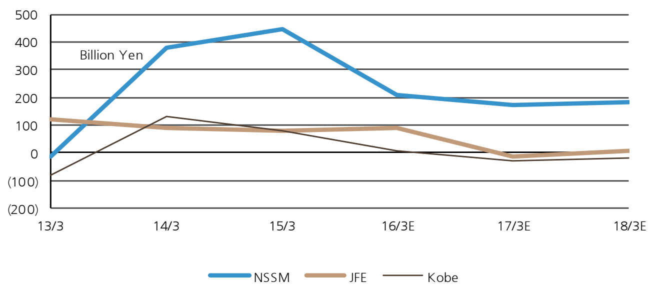
UBS VIEW

A continued slump at the steel and non-ferrous metals firms is a risk; UACJ to recover: A possible risk for the steelmakers is that crude steel output reductions could drag on due to increasing protectionism. We do not think the market is fully aware of this situation. If prices stagnate, conditions could be tough for the non-ferrous metals smelters as well. However, NSSM should generate FCF through restructuring and continue its dividend payments. Over the next two years, we expect UACJ to achieve the strongest profit growth, in contrast to the market forecast.

EVIDENCE

Restructuring benefits and technological capabilities are overlooked: NSSM should expand its FCF through BF integration and asset sales in March 2016, allowing it to continue its capex and dividend. We visited UACJ's Thai operation recently and confirmed steady orders from the major US can makers and Japanese automakers. As the company has high technological capabilities, its capacity utilization should rise.

FCF at the big three blast furnace steelmakers



Source: Company data, UBS estimates

Nippon Steel & Sumitomo Metal (5401)

BF integration makes NSSM most competitive in Asia

The industry is facing its toughest ever operating conditions due to oversupply from China and increasing protectionism. NSSM's earnings may appear to be weaker than those of its Asian peers, but this is because the firm is continuing to invest in infrastructure for growth in what is a challenging market. Next spring, the company plans to start integrating its BFs, which should make it the most cost competitive high-grade steel mill in Asia. In non-core operations, NSSM should continue with its property sales to enhance ROE and generate ample FCF. We expect the firm to maintain the top position in the global steel sector in terms of market cap.

Earnings forecast: lower than the market's assumptions

In FY15, declining export prices, earnings deterioration at overseas subsidiaries, and currency weakness in emerging markets are depressing earnings. Both volumes and prices are weaker than the company's assumptions, so we believe guidance will be revised down slightly. NSSM's guidance/market consensus/our forecast for FY15 RP is ¥250bn/¥308.7bn/¥244bn, respectively. In FY16, the end of output cuts and output growth, cost savings through the BF integration, the restart of coke furnaces in Nagoya, and reaction to a negative inventory impact should all support improved earnings. Export spreads, which are deteriorating in H2, are likely to make a full-term contribution. We forecast 12% yoy growth in profit on an adjusted basis excluding the inventory impact, but we assume a $20/tonne recovery from the bottom in export prices in H2. The consensus/our forecast for FY16 RP is ¥370.3bn/¥325bn, respectively. We expect consensus to drop to our forecast level. Increased protectionism could bring downside risk.

Catalysts: Output reductions in China and, on macro side, monetary policy

Further monetary easing in the US and economic measures in China on the macro economy side, as well output reductions in China and consequent price rebounds in the steel sector, could be catalysts. A weak yen is a positive, while yen appreciation would be the main earnings risk, as it would be likely to trigger lower domestic prices.

Valuation: Buy with a price target of ¥3,000

Our PT is based on 11x our FY16E adjusted EPS of ¥273. The PBR is at the bottom of its past range, so we see the stock as undemanding on a long-term view.

RIC: 5401.T / BBG: 5401 JP

12-month rating	Buy
12m price target	¥3,000
Price (3-Dec)	¥2,552
Up/Downside	+17.6%
Market cap	¥2,425.2bn
	US$19.64bn
03/16E	
P/BV (UBS)	0.8x
Net Cash (Debt)	(¥1,896.2)bn

Recurring profit

03/16E	
UBSE	¥244.0bn
IFISE	¥283.7bn
CoE	¥250.0bn
03/17E	
UBSE	¥325.0bn
IFISE	¥333.5bn

5401 - Highlights (¥bn)	03/13	03/14	03/15	03/16E	03/17E	03/18E	03/19E	03/20E
Revenues	4,389.9	5,516.2	5,610.0	4,999.0	4,980.5	5,067.0	5,185.5	5,293.0
Operating profit	20.1	298.4	349.5	207.0	283.7	358.7	406.7	443.7
Recurring profit	76.9	361.1	451.7	244.0	325.0	402.0	452.0	491.0
Net profit (reported)	(124.6)	242.8	214.3	180.0	231.0	275.0	301.0	326.0
EPS (reported, ¥)	(131.1)	255.4	225.5	189.4	243.1	289.4	316.7	343.0

Profitability & Valuation	03/13	03/14	03/15	03/16E	03/17E	03/18E	03/19E	03/20E
EBIT margin %	0.5	5.4	6.2	4.1	5.7	7.1	7.8	8.4
ROIC (EBIT) %	0.7	8.8	10.3	6.1	8.4	10.4	11.7	12.5
EV/EBITDA x	5.2	5.8	5.1	5.6	4.6	3.9	3.3	2.9
PE (reported) x	NM	11.7	13.1	13.5	10.5	8.8	8.1	7.4
Net dividend yield %	0.5	1.7	1.9	2.4	2.7	2.7	2.7	2.7

Source: Company data, UBS estimates (for all charts on this page)

Upside scenario

We see limited upside to FY16E earnings, but if the global economy expands more sharply than we forecast and if crude steel output rises 1m tonnes more than we anticipate, EPS could climb to ¥355. Under these circumstances, based on the same valuation, we estimate that the stock could reach ¥3,900.

Downside scenario

We assume that export prices will rise $20 in FY16 and we believe output will recover, so we forecast EPS at ¥222, which would imply fair value of ¥2,400, in line with the current level, based on the same valuation. However, if the yen appreciates and unit selling prices decline ¥5,000/tonne, we estimate that EPS could drop to ¥97, implying downside valuation of ¥1,700, equating to a PBR of 0.5x.

Company profile

Nippon Steel and Sumitomo Metal merged in 2012 to form Japan's leading steelmaker. Former Nippon Steel is a pioneer of the domestic steel market, with particular strength in automobile-use thin sheets and electromagnetic sheets. Former Sumitomo Metal is among the global majors in terms of market share for seamless pipe, and it is known for its railway products. The merged entity is a leading company in various product areas. The firm also operates globally (automobile-use thin sheet: North America, Latin America, Asia, and China; seamless pipe: Brazil; railway-related products: US). The company's aim is to become the number one full-line steelmaker.

Machinery

Hidehiko Hoshino (Analyst)

UBS Research THESIS MAP MOST FAVORED | LEAST FAVORED

Daikin Industries | **Fanuc, Komatsu**

PIVOTAL QUESTIONS

Q: Will there be another wave of machine tool- and smartphone-related capex?

We are cautious about the prospects of a resurgence in smartphone-related capex. Growth in the Chinese smartphone market, which was strong, has slowed as the proportion of phones featuring metal casings reached 90% in 2015 (UBS estimate), while capex is likely to be affected more by the economic cycle, including the smartphone replacement cycle, than structural factors. We rate Fanuc, which has benefitted from capex, Sell.

Q: Will demand for hydraulic excavators in China start to recover?

We believe hydraulic excavator demand in China will show only a moderate recovery in FY16; therefore, we do not expect the supply-demand gap to disappear. As we believe price competition will get even tougher, the two major domestic players will probably stay in the red in FY16. Except for Hitachi Construction Machinery, none of the companies are likely to record structural reform costs in their construction machinery operations in China, but we believe capacity and payroll reductions are probably unavoidable. We rate Komatsu and Hitachi Construction Machinery Sell.

WHAT'S PRICED IN?

A HoH decline in H2 FY15 is almost priced in: About 30% of the 65 machinery companies from which we gathered data revised down their FY15 guidance at Q2 results. Moreover, FY15 RP guidance, which initially assumed growth, now calls for a decline. Therefore, signs of an earnings slowdown are emerging and the market may have factored in some deterioration.

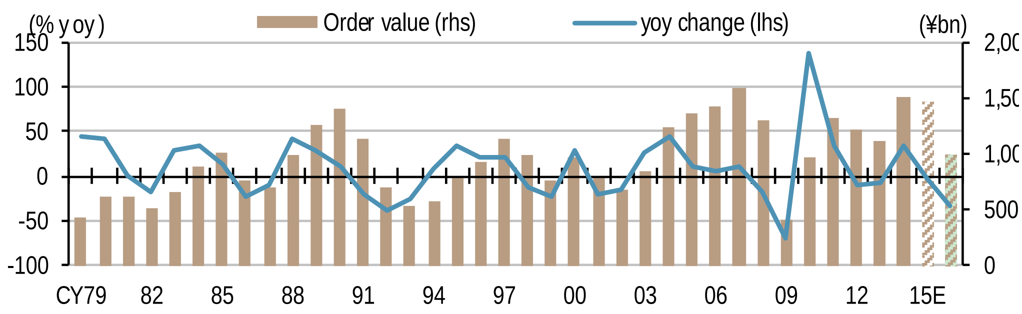
UBS VIEW

Analysis of the industrial structure and the medium- to long-term cycle is increasingly important: Consensus earnings forecasts for FY16 assume profit growth for most companies, but we forecast profit declines for about a half of the firms that we cover. In particular, we believe it is increasingly important to analyse structural aspects, including the business climate, rather than the short-term recovery in smartphone-related capex and hydraulic excavator demand in China.

EVIDENCE

Machine tools reflect the absence of order drivers: The order climate surrounding machine tools, the main stream for the machinery sector, shows that capacity utilization rates for smartphone-related machine tools installed by early spring this year are low. The Japanese government is likely to continue to provide subsidies for energy-efficient equipment in 2016, but the conditions for applying for them could be tougher than this year. In the US, we see no drivers for the order recovery, with weak employment in the manufacturing sector and sluggish business sentiment.

Machine tool orders and yoy change (calendar year base)



Source: JMTBA, UBS estimates

Daikin Industries (6367)

Market cap could exceed ¥3trn in 2016

RIC: 6367.T / BBG: 6367 JP	
12-month rating	Buy
12m price target	¥10,600
Price (3-Dec)	¥8,927
Up/Downside	+18.7%
Market cap	¥2,606.3bn
	US$21.10bn
03/16E	
P/BV (UBS)	2.3x
Net Cash (Debt)	(¥325.1)bn

Operating Profit	
03/16E	
UBSE	¥215.0bn
IFISE	¥216.4bn
CoE	¥212.0bn
03/17E	
UBSE	¥230.0bn
IFISE	¥235.1bn

Market cap could top ¥3trn for first time if Daikin's multiples rise in 2016

Japan's machinery sector is likely to see declines in sales and profit in 2016 in the absence of further weak yen benefits, as the outlook for the global economy remains uncertain. However, we expect Daikin to achieve yoy OP growth of 7% in FY16 as its core air conditioner operations continue to grow in Europe, Asia and the US, and its product mix improves on the back of highly competitive inverter and multi-split air conditioner technologies. In China, where profitability is high, local currency-based sales growth should recover moderately, having hit bottom, at -9%, in H1 FY15. If the stock's valuation multiples expand, the market cap could top the ¥3trn mark for the first time in 2016.

We forecast consolidated OP of ¥215bn for FY15 and of ¥230bn for FY16

We forecast consolidated OP of ¥215bn (+¥3bn relative to guidance) for FY15 and ¥230bn for FY16. Our FY15 forecast is almost in line with the consensus forecast. Daikin was again on top in terms of OP among the five infrastructure-related companies for the second straight quarter in Q2. It applies Japanese accounting standards, unlike the other four, so it records goodwill, and adjusting for this, its lead over the other four should be even greater. In addition, weak yen benefits have been smaller than for Komatsu and Kubota.

Chinese air conditioner sales growth very likely to bottom in Q3

Daikin's air conditioner sales growth on a local currency basis improved QoQ in Q2 in Europe and the US, but was unchanged, at -9%, in China. However, OP in China declined only 7-8%. The firm's operations are expanding steadily in Asia and the US. In H2 through H1 FY16, Daikin aims to continue to focus on higher air conditioner production in Europe, where its inventories were all cleared by the end of H1, and product differentiation in the residential multi-split air conditioner market in China. In Asia, the company is seeing further growth and sales mix improvement in Vietnam.

Valuation: We maintain our ¥10,600 price target

We maintain our Buy rating and our price target is ¥10,600 based on a FY16E PER of 18X excluding goodwill. The PER valuation that underpins our new price target is in line with the average for stocks in our coverage. We will be watching closely to see if the multiple advances in 2016.

6367 - Highlights (¥bn)	03/13	03/14	03/15	03/16E	03/17E	03/18E	03/19E	03/20E
Revenues	1,290.9	1,787.7	1,915.0	2,080.0	2,170.0	2,250.0	2,400.0	2,500.0
Operating profit	88.6	156.5	190.6	215.0	230.0	245.0	270.0	280.0
Recurring profit	94.1	155.6	194.2	213.0	230.0	245.0	270.0	280.0
Net profit (reported)	43.6	92.8	119.7	134.0	145.0	156.0	171.0	188.0
EPS (reported, ¥)	149.7	318.3	410.2	459.2	496.9	534.6	586.0	644.2

Profitability & Valuation	03/13	03/14	03/15	03/16E	03/17E	03/18E	03/19E	03/20E
EBIT margin %	6.9	8.8	10.0	10.3	10.6	10.9	11.3	11.2
ROIC (EBIT) %	10.6	14.5	16.2	17.4	18.2	19.3	21.1	21.5
EV/EBITDA x	7.7	8.8	9.4	9.9	8.9	7.9	6.9	6.4
PE (reported) x	16.7	16.2	17.1	19.4	18.0	16.7	15.2	13.9
Net dividend yield %	1.4	1.0	0.7	0.6	0.6	0.6	0.6	0.6

Source: Company data, UBS estimates (for all charts on this page)

Upside scenario

If the global economy, including China, recovers in FY16, and if Daikin's OP margin stays as high as it was in Q2 FY15 (11.6%) through the firm's own internal efforts, sales could be higher than our forecast by ¥80bn, OP by ¥22.9bn, and EPS by ¥49. Under these circumstances we estimate that the valuation could reach ¥11,480.

Downside scenario

If the global economy, including China, slows suddenly in FY16, and the company sees a yoy OP decline, sales could be lower than our forecast by ¥60bn, OP by ¥18bn, and EPS by ¥38. Under these circumstances we estimate that the valuation could be ¥9,900.

Company profile

Daikin is Japan's biggest manufacturer of air conditioners and globally ranks first for sales. The company's main competitors are Panasonic, Mitsubishi Electric, Carrier and Trane. The company has other operations, such as the chemical business, including fluorocarbon polymers, and the hydraulic equipment business.

Shipbuilding and plant

Hidehiko Hoshino (Analyst)

UBS Research THESIS MAP

	MOST FAVORED	LEAST FAVORED
	Yokogawa Electric	**JGC**

PIVOTAL QUESTIONS

Q: Will risk management structures be reinforced in 2016?

Project management structures are likely to remain a risk factor for Japan's shipbuilding and plant companies in 2016. Q2 results showed cost overruns in certain plant and ship-related projects at some companies. These firms reported heavier provisions, as delays in their initial delivery schedules will affect subsequent deliveries. We rate MHI Buy but we are monitoring the test flights being carried out by MRJ and progress in the firm's passenger vessel construction.

Q: Plant materials companies: Will they maintain their relative strength in FY16?

We believe plant materials companies will again be worth looking at in 2016, as they were this year, amid the tough operating conditions that surround the shipbuilding and plant industry. This is because their service businesses are likely to provide support, but also because we look positively on their commitment—particularly Yokogawa Electric's internal efforts—to reinforcing their earnings through restructuring and flexible cost allocation. Yokogawa's H1 OP margin exceeded 10% and the company's position relative to its peers is improving steadily.

Q: Which areas are attracting attention amid tough capex conditions in the oil and gas industry?

Ongoing declines in natural gas prices should be positive for GTCC demand over the medium term, in our view. For prime mover plant, power generation is likely to shift more towards gas and away from coal in the US and China as environmental regulations are tightened around the world. We are focusing on MHI as a major GTCC company.

WHAT'S PRICED IN?

The major shipbuilding & heavy machinery firms revised down guidance at Q2 results: The share prices of Japan's shipbuilding & heavy machinery and major plant companies have been underperforming TOPIX year to date, but their relative share prices have not deteriorated since Q2 results, so additional costs for ongoing projects appear to have been priced in.

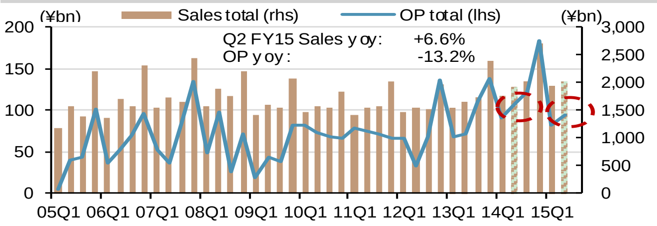
UBS VIEW

Risk management structures could determine company momentum: We believe the real strengths of the leading companies in this sector will come under the spotlight as: 1) projects for which shipbuilding and plant companies posted additional costs in FY15 are again recorded in FY16; 2) the way in which provisions are booked, and the stance towards them, differs by company; and 3) risk management structures are unlikely to change easily. We expect the momentum disparities between companies to become clearer in 2016.

EVIDENCE

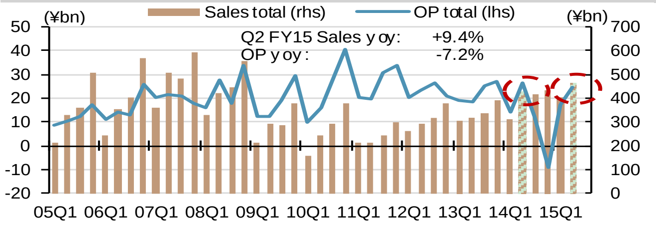
Additional costs have been recorded more than once on some projects in FY15: Some major shipbuilding and plant companies recorded additional costs for the same projects in both Q1 and Q2, which makes it hard to understand how much risk these companies are assuming for each project.

Five shipbuilding/HM firms; total sales (Q-base)



Note: HM – heavy machinery. Source: Company, UBS

Three dedicated plant firms; total sales, OP (Q-base)



Source: Company, UBS

Yokogawa Electric (6841)

Strengthening profitability to advance to next stage in 2016

Will continue to reinforce profitability in 2016 even amid tough conditions

There has been pronounced improvement in Yokogawa's profitability in 2015 as a result of successful restructuring effects and an increase in the OP margin for controls to 10.0% by our estimate (company plan 8.7%). Contrary to our forecast, overseas control orders are also continuing to increase. In 2016, on the other hand, efforts laid out in the current medium-term plan to optimize the cost structure (total expected impact of ¥20bn over three years) are expect to get into full swing and we expect the OP margin for controls to remain at 10% even amid decreased volume. We think this will lead to revaluation of the company amid a difficult operating environment.

UBS focus: relative strength in 2016 on downstream process competitiveness

In the oil and gas industry, the company has relatively strong competitiveness in downstream areas where capex is relatively firm, and we think its competitiveness relative to other companies could improve further in 2016. Distributed control systems (DCS) accounted for 50% of the company's sales in this area in FY15 and market share for petrochemical use is also high at around 40%. Options for resource procurement are increasing with expanding shale oil and gas production, and there is also the positive structural factor of an increase in the number of cases where plant process parameters are being changed or adjusted.

UBS consolidated OP forecast ¥40bn in FY15 and ¥40bn in FY16

We forecast consolidated OP of ¥40bn in FY15 (¥4bn above the company plan) and ¥40bn in FY16. In FY15, the company has flexibly used its internal resources and we think there is still room for cost cutting effects to exceed the company plans. In FY16, we forecast a 5% decrease in control orders and despite lower volume, we expect some effects to emerge from fundamental efforts to optimize the cost structure, including purchasing, logistics and development costs (company plan ¥10bn).

Valuation: Maintain Buy rating and ¥1,800 PT

We maintain a PT of ¥1,800 based on a FY16E PER of 18X. In the short term, we expect the company plan to be revised upward at Q3 results. Furthermore, if OP in FY16 can be kept flat in line with our forecast amid tough operating conditions, we think there could be increasing scope for the equity market to revalue the company.

RIC: 6841.T / BBG: 6841 JP

12-month rating	Buy
12m price target	¥1,800
Price (3-Dec)	¥1,539
Up/Downside	+17.0%
Market cap	¥410.5bn
	US$3.32bn
03/16E	
P/BV (UBS)	1.7x
Net Cash (Debt)	¥22.7bn

Operating Profit

03/16E	
UBSE	¥40.0bn
IFISE	¥38.9bn
CoE	¥36.0bn
03/17E	
UBSE	¥40.0bn
IFISE	¥39.3bn

6841 - Highlights (¥bn)	03/13	03/14	03/15	03/16E	03/17E	03/18E	03/19E	03/20E
Revenues	347.9	388.5	405.8	417.0	413.0	423.0	443.0	463.0
Operating profit	18.4	25.9	29.8	40.0	40.0	42.0	46.0	49.0
Recurring profit	18.0	25.7	33.4	41.5	41.5	43.5	47.5	50.5
Net profit (reported)	14.7	12.3	17.2	28.2	27.5	28.5	31.5	33.5
EPS (reported, ¥)	57.0	47.9	66.9	105.7	103.1	106.8	118.1	125.6

Profitability & Valuation	03/13	03/14	03/15	03/16E	03/17E	03/18E	03/19E	03/20E
EBIT margin %	5.3	6.7	7.3	9.6	9.7	9.9	10.4	10.6
ROIC (EBIT) %	11.4	15.6	18.7	25.8	23.7	21.8	21.7	22.2
EV/EBITDA x	7.3	8.4	6.8	6.1	5.7	5.4	4.9	4.3
PE (reported) x	15.1	27.9	20.0	14.6	14.9	14.4	13.0	12.3
Net dividend yield %	1.2	0.9	0.9	1.3	1.3	1.6	1.9	2.3

Source: Company data, UBS estimates (for all charts on this page)

Upside scenario

In the upside scenario to our FY16 forecast, the crude oil price strengthens quickly, similar to the recovery phase seen in 2009. Under these circumstances, we estimate ¥16bn could be added to FY16 sales, ¥4bn to OP and ¥9.3 to EPS. Based on FY16E PE of 18X, this would imply a theoretical share price of ¥1,970.

Downside scenario

In the downside scenario to our FY16 forecast, the crude oil price is slow to recover and the current price level is maintained through 2016. The last time crude oil declined, local currency-based orders fell just 10%, but if orders fall 20% this time, we estimate it could knock ¥41.2bn off sales, ¥10.3bn off OP and ¥23.9 off EPS, implying a theoretical share price of ¥1,360 based on 18X FY16E PE

Company profile

Established as an electric meter research institute in Tokyo in 1915, Yokogawa made a full entry into the industrial analyser market in 1964. In 1975, it released Centum, the world's first distributed process control system, which supported Japan's petrochemical industry. Since the 1990s, the focus of growth has shifted overseas due to weak domestic capex. The control business now accounts for most of earnings and overseas is the growth driver. Backed by experience from the domestic petrochemical industry, the weighting of downstream to upstream products is also heavy overseas.

UBS Research THESIS MAP

MOST FAVORED: **Disco**

LEAST FAVORED: **Advantest**

PIVOTAL QUESTIONS

Q: What is the outlook for WFE?

The UBS tech team estimates growth rates of +1.4% in CY15, -0.1% in CY16 and +3.7% in CY17. Market growth rates are not expected to be high. By application in CY16, DRAM-2 is estimated at 0%, NAND +20%, logic +6.5%, and foundry +4.3%. In other words, we expect positive growth for logic and negative growth for memory.

Q: What will the likely timing be for next-generation 10nm foundry investment?

We estimate this will come in April-June 2016. TSMC has said it will start volume production of 10nm products in Q4 2016. To do this, we believe TSMC will need to place equipment orders no later than in April-June. Samsung and Intel are very likely to invest at the same time.

Q: Will sector re-alignment continue?

We are monitoring to see if Lam Research and KLA Tencor can successfully merge. There is no overlap in the market segments in which these two companies are engaged. If achieved, the merger could raise expectations for large mergers elsewhere. For Japanese companies, interest is likely to focus on Hitachi subsidiaries.

WHAT'S PRICED IN?

High growth not expected: Large customers include only around six companies and demand fluctuations are small. In addition, the pace of transistor miniaturization is slowing due to technological barriers and smaller investment effects. As a result, we cannot expect growth to be as high.

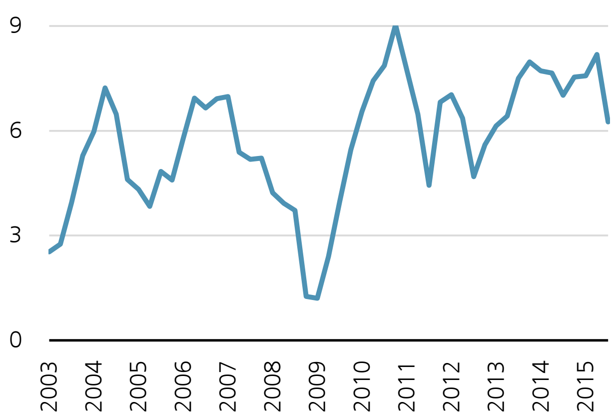
UBS VIEW

Stock selection focus on company-specific factors: Low growth in market scale is not limited only to SPE. Among the applications that drive semiconductor demand, including smartphones, PCs, tablets, TVs and autos, the only area where growth can be expected is smartphones. We prefer stocks with growth anticipated based on company-specific factors.

EVIDENCE

Focus on back-end investment: Investment preference was previously placed on front-end equipment as a result of strong effects from investment, and the priority placed on back-end equipment was conversely lower. However, as can be seen in Intel's belated 10nm investment, if the pace of front-end technological advancement slows, the priority placed on back-end investment could increase.

Quarterly order value trend for top 9 companies ($bn)



Source: Companies and UBS

Disco (6146)

Results likely to emerge soon

Back-end investment expected to grow

Reasons we are positive include 1) near-term earnings are likely to bottom in Q3 (Oct-Dec); 2) semiconductor investment could shift from front-end to back-end processes for a little while; and 3) profit growth is easy to foresee over the next several years. Semiconductor investment is very likely to grow more for back-end than for front-end equipment. This is because back-end technologies are lagging behind front-end and a slowdown in front-end technological advancement leads to a smaller investment burden, and this amount of reduction for front-end can then be used to expand investment in back-end equipment.

Profit likely to increase over next several years

We estimate that OP will grow gradually from ¥34bn in FY15 to ¥37.5bn in FY16 and ¥39.5bn in FY17. While these estimates discount factor (1) above, they do not reflect factors (2) and (3). In the H1 results briefing, Disco's president commented that integrated fan-out (INFO) orders would reach around ¥5-6bn in the first half of 2016. If this investment is actually made, orders can be expected to be around ¥6bn. We intend to conduct more detailed analysis to see if customers other than TSMC could emerge.

Catalysts

The share prices of SPE companies are correlated with quarterly orders. Share prices rise when orders increase and fall when orders decrease. Consequently, a possible catalyst is news flow concerning higher or lower quarterly orders. Disco provides detailed earnings updates and we intend to use these to confirm the monthly order trend. The number of companies in the tech sector able to grow is also shrinking. As a result, gaps in valuations could widen depending on whether or not there is growth.

Valuation: Maintain PT of ¥15,000

For the valuation, we use PER of 20.0X as profit growth drivers are likely to emerge, and our PT is Y15,000. 20X PER is in line with the tech growth company average.

RIC: 6146.T / BBG: 6146 JP	
12-month rating	Buy
12m price target	¥15,000
Price (3-Dec)	¥11,900
Up/Downside	+26.1%
Market cap	¥425.4bn
	US$3.44bn
03/16E	
P/BV (UBS)	2.6x
Net Cash (Debt)	¥47.9bn

Operating Profit	
03/16E	
UBSE	¥34.0bn
IFISE	¥30.5bn
CoE	¥26.1bn
03/17E	
UBSE	¥37.5bn
IFISE	¥33.5bn

6146 - Highlights (¥bn)	03/13	03/14	03/15	03/16E	03/17E	03/18E	03/19E	03/20E
Revenues	93.7	104.9	125.9	132.0	137.0	142.0	148.0	154.0
Operating profit	11.6	17.4	26.8	34.0	37.5	39.5	41.5	43.5
Recurring profit	11.6	17.4	26.5	33.5	37.0	39.0	41.0	43.0
Net profit (reported)	7.5	12.1	20.1	23.4	25.9	27.3	28.7	30.1
EPS (reported, ¥)	221.8	356.5	562.1	654.9	725.5	764.7	803.9	843.1

Profitability & Valuation	03/13	03/14	03/15	03/16E	03/17E	03/18E	03/19E	03/20E
EBIT margin %	12.4	16.5	21.3	25.8	27.4	27.8	28.0	28.2
ROIC (EBIT) %	12.6	17.8	25.4	32.1	35.7	37.4	38.8	39.9
EV/EBITDA x	7.7	8.4	7.7	9.1	8.2	7.6	7.3	6.9
PE (reported) x	20.0	17.8	14.6	18.2	16.4	15.6	14.8	14.1
Net dividend yield %	1.3	1.4	2.0	2.7	3.3	4.4	5.6	5.7

Source: Company data, UBS estimates (for all charts on this page)

Upside scenario

In order of likelihood, we believe upside could come from 1) semiconductor investment shifting from front-end to back-end equipment; 2) confirmation by the market of Disco as a growth stock among tech companies that are generally weak; and 3) explosive growth in semiconductor shipment volume from the emergence of IoT. If all of these materialize, valuation could be ¥16,000 based on a PE of 20X, in line with tech companies with clear growth factors.

Downside scenario

In order of likelihood, we think downside could come from: 1) slower final demand for PCs, smartphones and TVs due to negative effects from the strong dollar; 2) lower growth potential for the semiconductor market on a slower pace of semiconductor technological innovation; and 3) a loss of price negotiating power as a result of fewer companies due to sector re-alignment among customers. If all of these materialize, valuation could be ¥5,000 based on the historical low PBR of 1.0X.

Company profile

Core products are focused on cutting, grinding and polishing technologies and include dicers, grinders and polishers. The company also manufactures various consumables for this equipment. Profit margins are estimated to be highest on consumables. Customers are not limited to semiconductor manufacturers and extend to industrial areas.

Consumer electronics

Kenji Yasui (Analyst)

UBS Research THESIS MAP

MOST FAVORED: **Sony**

LEAST FAVORED: **Toshiba, Sharp**

PIVOTAL QUESTIONS

Q: Which industries are likely to see growth hereafter?

Infrastructure technology that contributes to energy efficiency is one likely area. The business areas engaged by global heavy equipment companies mainly focus on electric power generation and consumption equipment, as well as transport machinery. We think the management of these large companies ultimately focus on energy efficiency.

Q: Which companies are likely to see profit growth?

These companies are few, in our opinion. Among areas that drive tech demand, such as smartphones, PCs, tablets, TVs, digital cameras and autos, the only one likely to see continued positive growth is smartphones. For devices overall, strong growth cannot be anticipated. As a result, we expect companies that post profit growth to be limited.

Q: Is a strategy for growth visible?

The gap between companies here is large. A company for which profit growth is easy to foresee is Sony, with profit growth from CMOS sensors and PS4. In the infrastructure area, companies with growth strategies include Mitsubishi Electric and Hitachi. The focus for Fujitsu is on restructuring. Unfortunately, it is difficult for Sharp and Toshiba to establish strategies for growth at this point.

WHAT'S PRICED IN?

Concerns over whether growth is possible: In addition to a lack of growth for devices other than smartphones, there are also concerns about a macro slowdown in China and profit growth is difficult to foresee. It will likely be difficult for valuations to rise until profits actually rise, as the range of business areas is very broad.

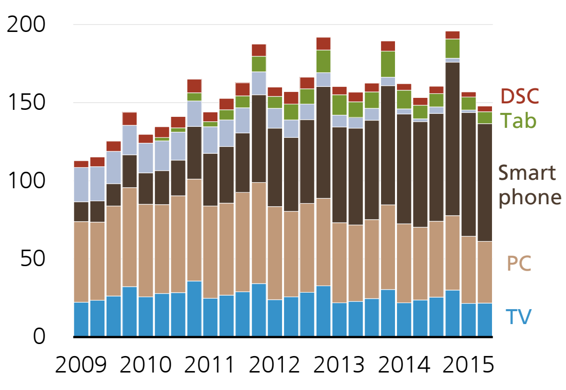
UBS VIEW

Share prices likely to rise when profit starts to increase: Earnings forecasts are certainly complex and difficult to make, but on the other hand, share prices are simply correlated with earnings. In other words, share prices tend to rise near term if the impression from results is good, and they tend to fall if impressions are bad. If profit growth continues due to structural factors, we think share prices can be expected to rise over the long term.

EVIDENCE

Separation through fierce global competition: Slower market growth can readily give rise to M&A and other re-alignment. In fact, large-scale re-alignment is ongoing, such as GE's acquisition of Alstom's thermal power business ($13bn), Dell's acquisition of EMC ($67bn) and Nokia's acquisition of Alcatel (€15.6bn).

Total set revenue



Source: Data Quest, DisplaySearch, UBS estimates

Sony (6758)

Profit growth easily visible

Profit likely to grow over next several years

The factors behind profit growth are clear, in our opinion, and we believe profit growth over several years, not just one, is a significant difference from other major consumer electronics companies. We expect profit growth on multiple fronts, including growth in the number of cameras installed in smartphones in the device business; profit from the PS4, now in the third year since its launch, in the game business; and steady profit growth for music, pictures and financial services. Profit growth heretofore has been cancelled out by losses for TVs and smartphones, but share has stopped falling for TVs and earnings have stabilized. The remaining risk appears to be in smartphones.

Annual profit growth of roughly ¥80bn expected

We estimate OP will continue to rise by roughly ¥80bn, from ¥400bn in FY15 to ¥480bn in FY16 and ¥550bn in FY17. Expected drivers of profit growth include CMOS sensors +¥30bn-40bn, games +¥20bn-30bn, and music, pictures and financial services +¥15bn. On the other hand, earnings for finished sets like TVs, smartphones and digital cameras are correlated with changes in market share. In other words, as market share increases, earnings readily turn positive and stabilize. Earnings are currently stable, with market share flat in areas other than smartphones.

Catalysts

Quarterly results are a catalyst. Earnings for Sony are difficult to forecast because business scale is large and covers many areas. As a result, the impact of overall earnings on the share price is overwhelmingly large compared with other sectors. When results are good, the share price tends to outperform for a short time after the announcement, in line with sentiment. Conversely, if sentiment is weak, it can easily underperform. The current share price may already look demanding based on PE, but we think it could rise further if profit growth continues.

Valuation: PT ¥4,200

We have a PT of ¥4,200 based on FY16E EV/EBTIDA of 6.4X, which is equivalent to PE of 20X. Given the scarcity of earnings growth drivers in the tech sector overall, Sony's clear earnings growth drivers should give it a high valuation.

RIC: 6758.T / BBG: 6758 JP	
12-month rating	Buy
12m price target	¥4,200
Price (3-Dec)	¥3,167
Up/Downside	+32.6%
Market cap	¥3,997.4bn
	US$32.37bn
03/16E	
P/BV (UBS)	1.5x
Net Cash (Debt)	¥994.7bn

Operating Profit	
03/16E	
UBSE	¥400.0bn
IFISE	¥391.9bn
CoE	¥320.0bn
03/17E	
UBSE	¥480.0bn
IFISE	¥504.2bn

6758 - Highlights (¥bn)	03/13	03/14	03/15	03/16E	03/17E	03/18E	03/19E	03/20E
Revenues	6,795.5	7,767.3	8,215.9	8,070.0	8,000.0	8,110.0	8,125.0	8,120.0
Operating profit	226.5	26.5	68.5	400.0	480.0	550.0	604.0	643.0
Pre-tax profit	242.1	25.7	39.7	423.0	503.0	573.0	627.0	666.0
Net profit (reported)	41.5	(128.4)	(126.0)	197.3	247.3	288.8	319.9	341.3
EPS (reported, ¥)	41.1	(123.0)	(107.8)	168.8	211.5	247.0	273.7	291.9

Profitability & Valuation	03/13	03/14	03/15	03/16E	03/17E	03/18E	03/19E	03/20E
EBIT margin %	3.3	0.3	0.8	5.0	6.0	6.8	7.4	7.9
ROIC (EBIT) %	(5.3)	(0.5)	(1.2)	(6.4)	(7.8)	(9.1)	(9.9)	(10.6)
EV/EBITDA x	(10.4)	(14.0)	(14.1)	(5.9)	(5.3)	(5.0)	(4.7)	(4.6)
PE (reported) x	26.8	NM	NM	18.8	15.0	12.8	11.6	10.8
Net dividend yield %	2.3	1.3	0.0	0.6	0.6	0.6	0.6	0.6

Source: Company data, UBS estimates (for all charts on this page)

Upside scenario

In order of likelihood, upside could come from: 1) unexpectedly strong earnings growth in overall set business; 2) an increase in the number of cameras installed on smartphones; 3) new game software with explosive popularity; and 4) a new business model that leverages content. If all of these are realized, we would expect FY16 OP of ¥600bn, PE of 20X and fair share price of ¥5,600.

Downside scenario

In order of likelihood, downsides could come from: 1) loss of market share and a turn to a declining earnings trend in set business; 2) a decline in the number of cameras installed on smartphones; 3) the loss of market share to a game competitor with a new platform; and 4) a decline in the number of customers in the content business that weakens its ability to negotiate prices. If all of these are realized, we would expect FY16 OP of ¥300bn, PBR of 1.0X, and fair share price of ¥2,200.

Company profile

Sony is one of Japan's leading consumer electronics manufacturers. The company's diverse business portfolio spans electronics, games, movies, music, and finance. Sony is a big brand outside Japan, and with its high overseas sales weighting, it is well known as a global firm. The electronics business has endured weak conditions for a long time, but signs of a bottoming are emerging. Far-reaching investments in image sensors could bring growth. Steady growth is likely for games, movies, and music.

Electronic components

Shingo Hirata (Analyst)

UBS Research THESIS MAP

	MOST FAVORED	LEAST FAVORED
	Alps Electric, Murata Mfg.	**Kyocera, Rohm**

PIVOTAL QUESTIONS

Q: Are smartphones likely to drive growth?

We believe they are. Volume growth in smartphones is likely to slow from +9% yoy in 2015 to +5% in 2016. However, higher functionality, including more advanced communications functions with the shift to multi-modes/multi-bands and carrier aggregation; more sophisticated camera functions; and increasing use of new interfaces, such as Force Touch and haptic technology, should drive demand for high-function components.

Q: Is a growth scenario that assumes greater use of electronic components in autos too optimistic?

We believe this growth scenario remains intact. Shipments of auto-use electronic components were generally weak in 2015 due to the slowdown in China's macro economy and other emerging markets. However, demand for motors, sensors, auto-use semiconductors and capacitors should continue to rise alongside reinforced fuel efficiency and emission regulations, as well as the introduction of stricter emission gas measuring methods following Audi/VW's emission manipulation issue and advances in ADAS technology.

WHAT'S PRICED IN?

The market is skeptical on sustainability: Given the slowdown in growth in smartphones in China and concerns over sales at some major companies in the US, it is becoming the consensus view that the smartphone era is coming to an end. For Alps Electric (6770), the consensus outlook seems to be that growth is not sustainable, as camera actuators have made a very big contribution to its profit growth.

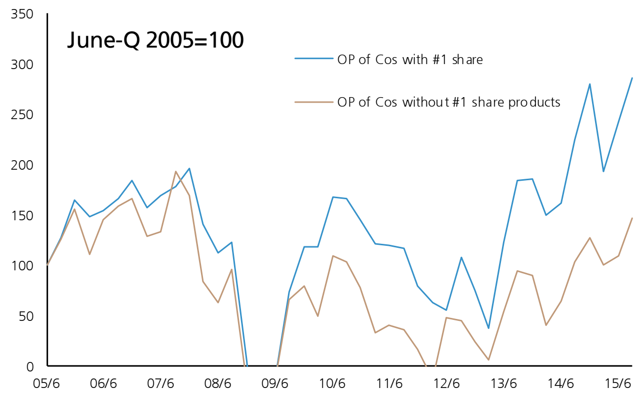
UBS VIEW

Strong players should continue to win: Alongside the shift in smartphones to higher functionality, we believe companies that are able to supply differentiated products in large volumes will continue to win. We believe Alps Electric is improving its ability to release new products in addition to camera actuators, and that it is well placed to grow its profit alongside improved smartphone functionality.

EVIDENCE

The disparities are widening: Comparing OP index levels at the companies in our coverage that have products that command top market shares and those that do not, the disparity between them is gradually widening and the winners and losers are becoming clearer. We cannot say for sure that this trend will continue, but we believe this bigger gap points to a sharper contrast between component manufacturers alongside more advanced functionality.

OP trend



Source: Company data, UBS

Key Call: Alps Electric Co. (6770)

Undemanding stock with clear growth drivers

Advanced technology drives growth; focus on changes at company as well

Camera actuators (VCM/OIS) are driving growth at Alps as smartphone camera functionality improves. The company is well ahead of competitors based on its strong mass manufacturing capabilities utilising automated production machinery. A full entry into the haptic motor market and bigger market share also offer opportunities for upside. President Toshihiro Kuriyama, who was appointed in 2012, is taking the initiative in changing the business portfolio, and the firm now seems more able to generate cash and release new products. Despite these changes, the stock's multiples still look undemanding.

Consensus forecast to go up

We forecast FY15 OP of ¥67bn, +25% yoy, in line with the consensus forecast (¥67.6bn). For FY16, we forecast OP of ¥85bn, +27%, 4% higher than consensus (¥81.5bn). We expect increased use of OIS by the major smartphone makers in the US, contributions from new products, and improved auto-use product profit margins to drive profit growth. Alps' share of the US haptic motor market is limited to about 5%, but in view of its advanced technology and mass production capabilities, we see upside potential here. We assume the firm's US share will expand to 20% in FY17, and we forecast OP at ¥100.1bn for the year, 8% higher than the consensus.

Focus on growth in shareholder returns and FY16 capex

We estimate that the electronic components business could generate free cash flow of roughly ¥19bn in FY15. Also, if the conversion of the ¥30bn CB issue is completed by the end of the term, we estimate that the parent company would effectively be free of borrowing (net debt in FY12 was ¥84bn). As a result, we think the company can be expected to raise the dividend along with its October-December results and that shareholder returns could also be improved in the medium-term business plan starting FY16. If capex guidance remains at a high level in FY16, we think expectations for growth from new products such as haptic motors are likely to increase further.

Valuation: Key Call Buy rating, PT ¥5,300

Our PT is based on a FY16E PE of 18X. We have factored dilution from the ¥30bn CB issue into our EPS forecast. Despite the existence of clear growth drivers and changes that are taking place at the company, the stock remains undemanding, at 14X FY15E PE, compared with the sector average of 19X.

RIC: 6770.T / BBG: 6770 JP

12-month rating	Buy
12m price target	¥5,300
Price (3-Dec)	¥3,720
Up/Downside	+42.5%
Market cap	¥714.8bn
	US$5.79bn
03/16E	
P/BV (UBS)	3.1x
Net Cash (Debt)	¥35.1bn

Operating Profit	
03/16E	
UBSE	¥67.0bn
IFISE	¥67.6bn
CoE	¥60.5bn
03/17E	
UBSE	¥85.0bn
IFISE	¥81.3bn

6770 - Highlights (¥bn)	03/13	03/14	03/15	03/16E	03/17E	03/18E	03/19E	03/20E
Revenues	546.4	684.4	748.6	788.2	847.6	914.8	957.6	969.7
Operating profit	6.9	28.5	53.5	67.0	85.0	100.1	104.0	105.0
Recurring profit	7.7	28.1	57.6	67.0	85.0	100.1	104.0	105.0
Net profit (reported)	(7.1)	14.3	34.7	55.1	58.3	66.3	69.3	70.0
EPS (reported, ¥)	(39.5)	79.9	193.8	281.3	297.8	338.6	353.5	357.3

Profitability & Valuation	03/13	03/14	03/15	03/16E	03/17E	03/18E	03/19E	03/20E
EBIT margin %	1.3	4.2	7.2	8.5	10.0	10.9	10.9	10.8
ROIC (EBIT) %	3.4	13.4	23.8	26.5	31.0	35.2	36.0	36.2
EV/EBITDA x	6.9	4.7	4.9	7.7	5.8	4.9	4.5	4.1
PE (reported) x	NM	11.5	9.6	13.2	12.5	11.0	10.5	10.4
Net dividend yield %	0.9	0.5	0.8	0.8	1.3	1.6	1.9	1.9

Source: Company data, UBS estimates (for all charts on this page)

Upside scenario

Upside could come from higher OIS penetration rates and a bigger market share, and a higher share of the market for haptic motors. We assume 23% for smartphone OIS penetration in FY16 and a 55% market share for Alps, and we have discounted virtually no contribution from haptic motors. If OIS penetration reaches 30% and Alps' share reaches 60%, and half of the new smartphones launched by key clients feature haptic motors, we estimate that OP could come in at ¥100.0bn, with EPS at ¥414, implying a upside valuation of ¥7,400.

Downside scenario

Downside could come from shrinkage in the OIS penetration rate and a market share decline, as well as weaker sales for major smartphone clients in North America. If the OIS penetration rate only reaches 10% in FY16 and market share is 30%, and smartphone shipment volume for the major customers in North America falls 10% yoy, FY16 OP might only reach ¥50bn, with EPS at ¥150, implying downside valuation of ¥2,200.

Company profile

Alps Electric manufactures and markets auto electronic parts and consumer electronic-use electronic parts, particularly smartphone components such as touch panels, switches, connectors, sensors and camera structural parts. In addition to electronic parts, the group includes listed consolidated subsidiaries Alpine Electronics (40.67% stake), which focuses on car navigation systems, and Alps Logistics (48.94%).

UBS Research THESIS MAP

MOST FAVORED: **Yahoo Japan (4689); CyberAgent (4751)**

LEAST FAVORED: **Nintendo (7974)**

PIVOTAL QUESTIONS

Q: How will Internet competitive strategies change with end of smartphone penetration? Through a shift from securing new customers to securing loyal customers. A phase of volume growth accompanying an increase in new smartphone users is ending. Changes in the sector's competitive strategies have been flagged by the strengthening of promotional measures for Yahoo! Premium members by Yahoo Japan and the Prime Video/Music services offered by Amazon.

Q: Will the Japan smartphone game market grow in 2016? We do not expect it to grow. In CY16, we expect the market to come in at ¥872bn, flat yoy. Puzzle and Dragons and Monster Hunter enjoy large market share, but they are reaching the end of their life-cycle. Meanwhile, the various companies' new productions seem to be lacking in an innovative experience, while from a risk avoidance standpoint, the supply of IP titles stands out. We note the risk that the market could start to contract substantially unless major new hits emerge.

Q: Can video services succeed as a business? We think they could succeed, but through ads in the medium term. Momentum has risen with the advent of Netflix, but a number of companies are vying to win fee-paying members. The prevailing view in the stock market is that profit cannot be generated from video services. Still, we believe the shift from TV ads to smartphone video ads will accelerate in the domestic market and video services could gradually ramp up as businesses mainly through ads rather than membership charges.

WHAT'S PRICED IN?

An absence of investment themes for after smartphone games: Valuations have fallen off due to changes in trends in the e-commerce market (slowing growth at the upper-ranked companies) and entrenched disappointment in new services (video, etc.) due to premature expectations.

UBS VIEW

A balanced Internet the next key phrase: No new stars appearing is not necessarily a bad thing. We envisage a phase in which the market expands as major companies that have won the confidence of existing users provide more appealing and convenient services. We think the right direction and flexible, substantial investment capacity are needed.

EVIDENCE

Forward-looking investments to watch: Yahoo Japan: additional ¥20bn in promotional outlays for H2. CyberAgent: H2 investments of ¥7bn in the video area. mixi: investment in TicketCamp, which generates earnings in games. GMO: investment in mine, which generates foreign exchange earnings. Rakuten: pushing through with the shift to a user-first model (restraining ads).

Domestic internet/game-related market forecasts(UBS estimate)

(¥bn)	CY13	CY14	CY15 E	CY16 E	CY17 E	CY18 E	CY19 E	CY20 E
EC total	**11,166**	**12,797**	**14,260**	**15,930**	**17,720**	**19,570**	**21,400**	**23,480**
(y/y)		14.6%	11.4%	11.7%	11.2%	10.4%	9.4%	9.7%
Product sales EC	5,993	6,804	7,630	8,530	9,480	10,460	11,410	12,360
(y/y)		13.5%	12.1%	11.8%	11.1%	10.3%	9.1%	8.3%
(EC %)	3.9%	4.4%	4.9%	5.5%	6.1%	6.7%	7.2%	7.8%
Service EC	4,071	4,482	5,000	5,680	6,450	7,280	8,120	9,220
(y/y)		10.1%	11.6%	13.6%	13.6%	12.9%	11.5%	13.5%
Digital EC	1,102	1,511	1,630	1,720	1,790	1,830	1,870	1,900
(y/y)		37.1%	7.9%	5.5%	4.1%	2.2%	2.2%	1.6%
Smartphone game	550	793	872	872	829	804	780	756
(y/y)		44.2%	10.0%	0.0%	-5.0%	-3.0%	-3.0%	-3.0%
Ad market total	**5,976**	**6,152**	**6,270**	**6,460**	**6,600**	**6,760**	**6,900**	**7,140**
(y/y)		2.9%	1.9%	3.0%	2.2%	2.4%	2.1%	3.5%
TV advertising	1,902	1,956	1,982	2,061	2,102	2,176	2,208	2,319
(y/y)		2.8%	1.3%	4.0%	2.0%	3.5%	1.5%	5.0%
(% of total)	31.8%	31.8%	31.6%	31.9%	31.8%	32.2%	32.0%	32.5%
Internet advertising	938	1,052	1,185	1,318	1,452	1,595	1,739	1,892
(y/y)		12.1%	12.7%	11.2%	10.2%	9.9%	9.0%	8.8%
(% of total)	15.7%	17.1%	18.9%	20.4%	22.0%	23.6%	25.2%	26.5%

Source: METI, UBS estimates, UBS Japan internet research team

Yahoo Japan (4689)

Preparing in 2015; smartphone strength to emerge in 2016

Rating reflects potential strength in Japan's maturing smartphone market

Japan's smartphone market is in a cut-over phase moving from quantitative growth to qualitative growth (please see our 12 June 2015 report). We think Yahoo Japan is placed best as a potential winner amid such change. Future success hinges not simply on stimulating use, but in integrating use over various, diverse areas (media, premium services, commerce, and financial settlements), and we believe the company is steadily preparing for this. Already well positioned (we believe Yahoo Japan retains its edge in the smartphone era), the company looks to have the right timing in terms of the move to the time-line format with smartphones and the tie-up with Askul.

2015 a year of preparation; fruits of success to be focus next year

We forecast FY16 OP of ¥235.5bn, above the IFIS consensus of ¥220.2bn. There are market concerns that the ¥20bn increase in sales promotional outlays in for H2 FY15 could continue through FY16 and push down the company's profit. We believe some cost items, such as shopping and cards, could continue in FY16, but we expect that to be absorbed by ongoing growth in the ad business and believe double-digit yoy profit growth on an organic basis is possible (excluding one-off profit related to Askul and additional promotional costs for H2). For Yahoo Japan, 2016 could be an important year in which it needs to make the market award it, which could double profit in the future.

Clear success from large increases in promotional costs could be catalyst

A focus will be distribution value in the shopping business. If the recent growth trend of 30% rises further, market expectations could rise for expansion in market share, further synergies with finance operations and growth in ad revenue from rising momentum in sales venues. Basically, we believe this is a contest in which Yahoo Japan has already secured likely success simply by tracing a path similar to what it pursued as a pioneer in the e-commerce market.

Valuation: Maintain PT of ¥620 and Buy rating

Our PT is based on FY14-18E CAGR and an adjusted PEG ratio of 3X. Average adjusted PE is around 26X.

RIC: 4689.T / BBG: 4689 JP

12-month rating	Buy
12m price target	¥620
Price (3-Dec)	¥517
Up/Downside	+19.9%
Market cap	¥2,973.7bn
	US$24.08bn
03/16E	
P/BV (UBS)	3.6x
Net Cash (Debt)	¥553.3bn

Operating Profit	
03/16E	
UBSE	¥204.7bn
IFISE	¥237.0bn
CoE	- bn
03/17E	
UBSE	¥235.5bn
IFISE	¥220.2bn

4689 - Highlights (¥bn)	03/13	03/14	03/15	03/16E	03/17E	03/18E	03/19E	03/20E
Revenues	343.0	386.3	428.5	467.1	523.0	580.6	645.7	682.3
Operating profit	186.4	197.4	197.2	204.7	235.5	265.8	299.0	319.5
Pre-tax profit	188.6	197.6	208.3	206.1	236.9	267.2	300.4	320.9
Net profit (reported)	115.0	125.1	133.9	122.7	141.1	159.3	179.6	192.0
EPS (reported, ¥)	19.8	21.8	23.5	21.6	24.8	28.0	31.6	33.7

Profitability & Valuation	03/13	03/14	03/15	03/16E	03/17E	03/18E	03/19E	03/20E
EBIT margin %	54.3	51.1	46.0	43.8	45.0	45.8	46.3	46.8
ROIC (EBIT) %	124.2	167.7	166.1	174.3	194.9	211.1	224.8	231.0
EV/EBITDA x	6.7	12.2	9.1	10.3	8.7	7.3	6.1	5.3
PE (reported) x	14.7	24.1	18.9	24.0	20.8	18.5	16.4	15.3
Net dividend yield %	1.4	0.8	2.0	0.8	1.0	1.2	1.2	1.4

Source: Company data, UBS estimates (for all charts on this page)

Upside scenario

Further growth in advertising revenue and profit driven by an early recovery in search ads, faster growth in smartphone ads and margin improvements could create upside. A 15% overshoot in the marketing solutions segment's sales versus our assumptions could raise our FY16 consolidated sales estimates from ¥523bn to ¥575.8bn and take our consolidated OP estimates up from ¥235.5bn to ¥261.3bn. At 3X PEG, this could take per-share valuation up to about ¥800.

Downside scenario

Prolonged low growth in advertising revenue and profit in the wake of a further drop in search ads and slower growth in smartphone ads could create downside. An approximate 10% shortfall in the marketing solutions segment's sales versus our assumptions would reduce our consolidated sales forecast from ¥523bn to ¥487.8bn for FY16 and lower our consolidated OP forecast from ¥235.5bn to ¥216.9bn for FY16. At 3.0X PEG, this could lead per-share valuation to fall to about ¥450.

Company profile

Yahoo Japan is a comprehensive internet service operator that runs the Yahoo Japan portal. Its main revenue sources are display and search-linked advertising, e-commerce operations such as Yahoo Auctions and Yahoo Shopping, and personal fee-based services through Yahoo Premium. The management structure was overhauled in June 2012 with the appointment of Manabu Miyasaka as CEO. Under its highly-driven, new leadership team, the company is committing to various new initiatives, including a number of short-term targets, one of which is to double OP to Y330bn based on a "user first", "smartphone first" approach.

Auto and auto parts

Kohei Takahashi (Analyst)

UBS Research THESIS MAP

	MOST FAVORED	LEAST FAVORED
	Nissan, Denso	**Toyota Industries, Suzuki**

PIVOTAL QUESTIONS

Q: Will volume growth exceed our expectations?

We note substantial downside risk. We expect global volume growth to slow to 2.2%/year in 2015-17 and we think combined volume growth for North America and Japan, which are particularly important for Japanese firms, could slow from 8.8%/year in 2012-14 to 0.7%/year in 2015-17. In the near term, we are focusing on China, and from the latter half of 2016, on a potential recovery in the ASEAN market.

Q: Will margins continue to improve?

The OP margin is close to the peak and room for further improvement looks to be limited. Most companies recently achieved record OP margins. As top-line growth slows, we are concerned about a potential rise in sales incentives and declines in auto parts prices. We are focusing on companies that do not depend on the top line, as they are able to reduce costs and improve their sales mixes.

WHAT'S PRICED IN?

Optimistic about North America: North America is a source of earnings for Japanese companies but the risk of a slowdown in volume growth and stiffer competition is growing, particularly for passenger vehicles. However, the market is rather optimistic, expecting improvement in margins. For China and other emerging markets, we believe a slowdown in growth and stiffening competition are priced in, to some extent.

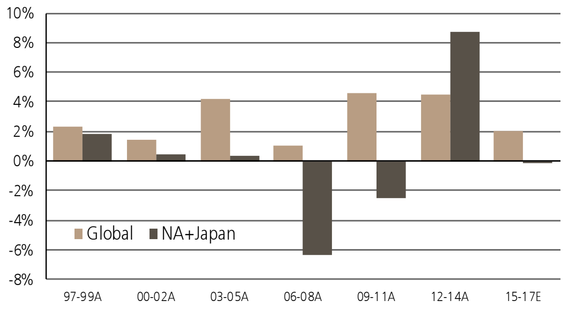
UBS VIEW

Neutral on the sector overall: Our long-term view is neutral to negative as margins are at peak levels and growth is likely to slow. However, there are no signs of serious deterioration in North America or Japan, and with PER discounts in the auto and auto parts sectors expanding relative to the market, valuations are not stretched. As there are some short-term upside catalysts, including a demand recovery in China and output growth at the Japanese automakers, our sector view is neutral. A focus for us is environmental and advanced safety technologies as long-term growth drivers and factors for PE premiums.

EVIDENCE

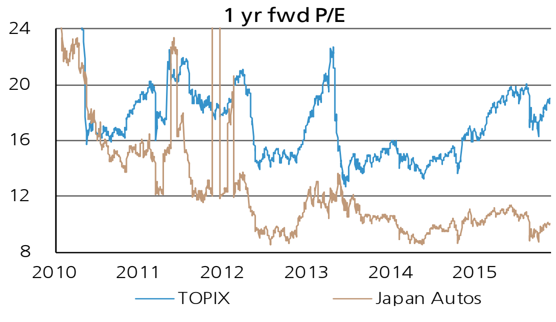
Production in China and Japan: 1) in China there are signs of improvement, including support from tax cuts, higher 2.0L and large SUV demand and slower price erosion, while according to our Evidence Lab survey the appetite to purchase in the next year is strong. 2) FY16 guidance at Toyota group suppliers suggests high HoH growth for H2. 3) PEs of China-related and auto parts firms in the Toyota group do not look particularly overheated.

Three-year annualized growth rate for auto sales



Source: IHS, UBS

Japan autos: one-year forward PE



Source: Datastream, UBS

Nissan Motor (7201)

Main drivers are cost reductions and China

Reason for Buy: Rising profit to reach goal in FY16 medium-term plan

Measures to improve margins without depending on top-line growth should be the growth driver. In advanced nations, cost reductions in the overall supply chain are proceeding, while in emerging markets, ongoing cost cuts include those for fixed costs. In China, we expect volume growth in the near term due to tax reductions, while the sales mix could improve on the release of an SUV model. We expect the company to accelerate its efforts to improve margins in a bid to achieve the FY16 OPM target of 8% (partially consolidating the Chinese operation) in its medium-term business plan.

Earnings forecasts: Growing cost reductions; volume growth in China

We forecast FY16 OP at ¥870bn (+48% relative to FY14 earnings), equity-accounted profit, mainly from China, at ¥144.5bn (+36%), and EPS at ¥170 (+56%), assuming ¥122/$. We forecast an OP margin of over 8%, reaching the target of the medium-term plan (partially consolidating the Chinese operation).

Catalysts

Catalysts include: 1) sales growth in China; 2) accelerated cost reductions in Japan and Asia, where earnings are low; and 3) acceleration of the pace of OP margin improvement in H2 FY15. If we assume FY16 FX at ¥135/$, we estimate OP at about ¥1trn and EPS at ¥200, and by applying 9.5X PE to this, we estimate fair value at ¥1,900. The company's FX sensitivity is the second highest in the sector, next to FHI, at ¥12bn for OP (1.4% of FY16 forecast) per every ¥1/$ change.

Valuation: PT of ¥1,600

Our ¥1,600 PT is based on the sector average PE of around 9.5X applied to our FY16 EPS forecast of ¥170. Since BPS was ¥1,176 at the end of September 2015, downside appears limited.

RIC: 7201.T / BBG: 7201 JP

12-month rating	Buy
12m price target	¥1,600
Price (3-Dec)	¥1,295
Up/Downside	+23.6%
Market cap	¥5,429.7bn
	US$43.97bn
03/16E	
P/BV (UBS)	1.1x
Net Cash (Debt)	¥917.6bn

Operating Profit

03/16E	
UBSE	¥755.0bn
IFISE	¥758.5bn
CoE	¥730.0bn
03/17E	
UBSE	¥870.0bn
IFISE	¥832.5bn

7201 - Highlights (¥bn)	03/13	03/14	03/15	03/16E	03/17E	03/18E	03/19E	03/20E
Revenues	9,629.6	10,482.5	11,375.2	12,370.0	12,570.0	12,570.0	12,620.0	12,750.0
Operating profit	523.5	498.4	589.6	755.0	870.0	845.0	823.0	847.0
Recurring profit	504.4	527.2	694.2	810.0	1,020.0	991.0	973.0	999.0
Net profit (reported)	335.1	389.0	457.6	550.0	713.0	695.0	686.0	704.0
EPS (reported, ¥)	80.0	92.8	109.2	131.2	170.1	165.8	163.6	167.9

Profitability & Valuation	03/13	03/14	03/15	03/16E	03/17E	03/18E	03/19E	03/20E
EBIT margin %	5.4	4.8	5.2	6.1	6.9	6.7	5.5	6.6
ROIC (EBIT) %	7.6	6.1	6.1	7.1	8.1	7.9	7.7	7.8
EV/EBITDA x	4.9	5.2	4.4	5.2	4.9	4.7	4.5	4.2
PE (reported) x	9.9	10.6	9.4	9.9	7.6	7.8	7.9	7.7
Net dividend yield %	3.2	3.1	3.2	3.2	3.9	3.9	3.9	3.9

Source: Company data, UBS estimates (for all charts on this page)

Upside scenario

In our upside scenario, Nissan's new SUVs and larger vehicles sell well in the US and sales in North America and China exceed our forecast by 10%, leading to improvement in the regional sales mix. Meanwhile, additional cost savings in Asia help improve earnings in emerging markets, leading to a recovery in the OP margin in those nations to 8%, surpassing the company's overall average. Under these circumstances, FY16 consolidated OP margin would reach the target of 7% (based on current accounting standards) set out in the medium-term plan and EPS would exceed ¥200. Applying PE of 10.4X (10% premium to current forecast) to this because of stronger profit momentum, we arrive at upside valuation of ¥2,100.

Downside scenario

The downside scenario is that the US market peaks out at 16m units in FY16 and incentives at Nissan rise by 20%. At the same time, profit in China track sideways due to an intensification in price competition. We estimate this could restrict FY16 OP to ¥570bn, with EPS of ¥136. This would imply downside valuation of ¥950 on a PBR of 0.8X.

Company profile

Placing sixth in terms of global autos sales volumes, this auto manufacturer has close relations with Renault in all areas, from management to production and procurement (Renault has a 43% stake in Nissan, while Nissan's holding in Renault comes to 15%). Renault/Nissan and Daimler have cross-shareholdings of 3.1% each. Nissan is deepening its relationship via the Infiniti brand. The medium-term business plan running through end-March 2017 targets an OP margin of 8% and a global market share of 8%.

UBS Research THESIS MAP

	MOST FAVORED	LEAST FAVORED
	Sumitomo Mitsui FG, Suruga Bank	**Sumitomo Mitsui Trust HD, Aozora Bank**

PIVOTAL QUESTIONS

Q: Will the uncertainty surrounding the regulatory environment be cleared up?

The uncertainty should be reduced substantially by the end of FY16 but the impact of tougher regulations is likely to be priced in the first half of the year. The debate over revisions to sovereign risk weightings is likely to drag on.

Q: Will there be progress in unwinding cross-shareholdings?

The three megabanks should start to sell off their policy shareholdings in earnest in 2016 and record big stock sales gains.

Q: Will the Japanese banks' overseas operations continue to grow?

We believe they will but the pace of growth could slow due to risk relating to emerging market economies and resource prices. Also, profitability could deteriorate as dollar-based procurement interest rates rise.

WHAT'S PRICED IN?

The unwinding of cross-shareholdings leading to greater shareholder returns: Expectations for policy shareholding sell-offs; the booking of sales gains; and earnings expansion and, in turn, higher shareholder returns are priced in, to some extent, in our view.

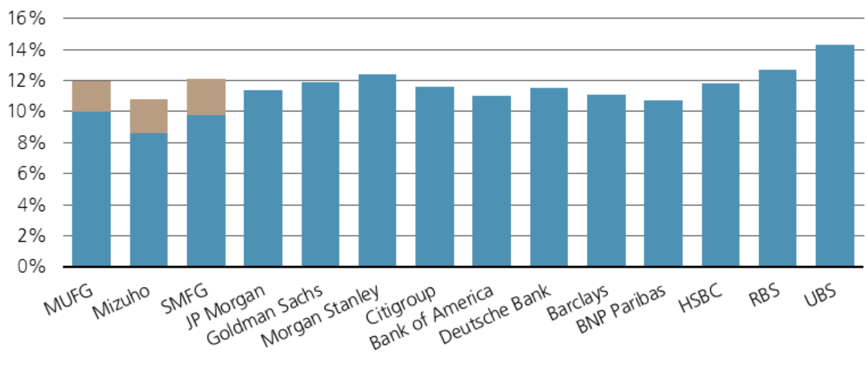
UBS VIEW

Capital reinforcement rather than shareholder returns: Profit is likely to rise due to gains from the sale of policy shareholdings, but these gains should be used to reinforce capital rather than for shareholder returns, as the Japanese banks' capital bases are more fragile than those of their global peers. This could disappoint the market.

EVIDENCE

RWA to rise at least 20%: We believe RWA will rise at least 20% due to risk-weight revisions and the introduction of a capital floor. Global banks are already starting to reinforce their capital in preparation for this.

Global comparison of fully-loaded CET1 ratios (as at Sept. 2015)



Source: Company data.

Note: Brown colouring for the Japanese mega banks represents unrealized gains on other securities included in CET1

Sumitomo Mitsui Financial Group (8316)

Relatively undervalued among three megabanks

Increasing capital policy options

SMFG has been relatively inactive in its shareholder returns and reducing its policy share holdings, in contrast to peers, including MUFG, which has bought back stock, and Mizuho, which has announced that it will actively sell off cross-held stock. Therefore, the bank has underperformed the sector. As a result, the shares look increasingly undervalued and the bank's equity capital has been reinforced, which should provide it with more capital policy options.

Gains from policy shareholding sales drive earnings

In view of the policy shareholding sales target that it announced at its H1 FY15 results, we believe SMFG aims to reduce its policy shareholdings by around ¥500bn over the next five years, so we assume stock sales gains of ¥100bn for FY16-FY20. Compared with the consensus forecast, our forecast is higher for FY16 and beyond, which is probably because of different assumptions for stock sales gains.

Catalysts

Possible catalysts include overseas M&A that can support higher ROE, as well as share buybacks and dividend increases. Higher lending to SMEs in a recovering economy and rising interest rates are also potential catalysts, as is faster-than-assumed reductions in policy shareholdings.

Valuation

Our PT of ¥5,685 is based on a PBR-ROE matrix (0.81X/7.9%).

RIC: 8316.T / BBG: 8316 JP

12-month rating	Buy
12m price target	¥5,685
Price (3-Dec)	¥4,818
Up/Downside	+18.0%
Market cap	¥6,587.3bn
	US$53.34bn
03/16E	
P/BV (UBS)	0.7x
Tier1 Ratio	13%

Net Profit

03/16E	
UBSE	¥767.8bn
IFISE	¥783.5bn
CoE	¥760.0bn
03/17E	
UBSE	¥836.1bn
IFISE	¥807.5bn

8316 - Highlights (¥bn)	03/13	03/14	03/15	03/16E	03/17E	03/18E	03/19E	03/20E
Total income	2,792.9	2,898.2	2,980.4	2,914.9	2,980.0	3,035.6	3,079.1	3,102.3
Net operating profit	1,166.2	1,242.4	1,310.5	1,204.9	1,265.0	1,315.6	1,354.1	1,377.3
Recurring profit	1,073.7	1,432.3	1,321.2	1,241.9	1,332.9	1,367.3	1,381.0	1,402.4
Net profit (reported)	794.1	835.4	753.6	767.8	836.1	864.5	888.8	920.3
EPS (reported, ¥)	586.5	611.5	551.2	561.6	611.5	632.3	650.1	673.1

Profitability & Valuation	03/13	03/14	03/15	03/16E	03/17E	03/18E	03/19E	03/20E
ROE (UBS) %	13.8	12.3	9.3	8.2	8.4	8.2	7.9	7.8
P/PPOP (diluted)	3.2	5.2	4.5	5.5	5.2	5.0	4.9	4.8
P/BV x	0.6	0.9	0.6	0.7	0.6	0.6	0.6	0.5
P/E (local GAAP, basic)	4.8	7.7	7.8	8.6	7.9	7.6	7.4	7.2
Net dividend yield %	4.3	2.6	3.3	3.1	3.3	3.5	3.7	3.7

Source: Company data, UBS estimates (for all charts on this page)

Upside scenario

If share sale gains increase to around ¥200bn annually on the sale of cross-held stock and improved market conditions, we calculate that ROE could improve by around 8.5pp and valuation could rise to about ¥6,040. If shareholder returns are higher than estimated and lending to SMEs increases in real terms, we think SMFG could also easily outperform.

Downside scenario

A possible downside risk for valuation involves higher credit costs from economic deterioration and the announcement of large-scale M&A that would make it difficult to expect growth in enterprise value. Assuming the credit cost ratio worsens by 10bps more than expected and no dividend increase or share buyback, ROE could fall about 7.0%. Under these circumstances, we estimate valuation could decline to about ¥5,200.

Company profile

SMFG is one of the three leading Japanese financial groups. It was established in December 2002. Group companies include Sumitomo Mitsui Banking Corp., Sumitomo Mitsui Card, and The Japan Research Institute. SMBC Nikko Securities (the former Nikko Cordial Securities) and Cedyna Financial became wholly-owned subsidiaries in 2009 and 2010, respectively.

Diversified financial

Shinichi Ina (Analyst)

UBS Research THESIS MAP

MOST FAVORED

ORIX (8591), Nomura HD (8604)

LEAST FAVORED

Sony Financial HD (8729)

PIVOTAL QUESTIONS

Q: Will the shift from savings to investment start in earnest?

If large-scale IPOs widen individual investors' horizons and if such investors feel their experience has been successful, their activity should increase.

Q: Will there be more insurance company M&As?

In 2015, various domestic and overseas insurance companies conducted M&As. In view of the saturation of the domestic market and the need to secure opportunities for growth, we believe there will be more M&A in domestic and overseas markets.

Q: Where is ORIX headed?

ORIX is no longer just a leasing firm but a general financial company, and this direction is unlikely to change. However, earnings contributions from businesses that are more resilient to market fluctuations should increase, making ORIX's business model more stable.

WHAT'S PRICED IN?

The assumption that there will be no change: Share prices factor in the assumption that there will be hardly any shift from savings to investment, that ORIX will remain heavily dependent on one-off profit, making its recent profit levels unsustainable, and that the company will remain inactive in shareholder returns.

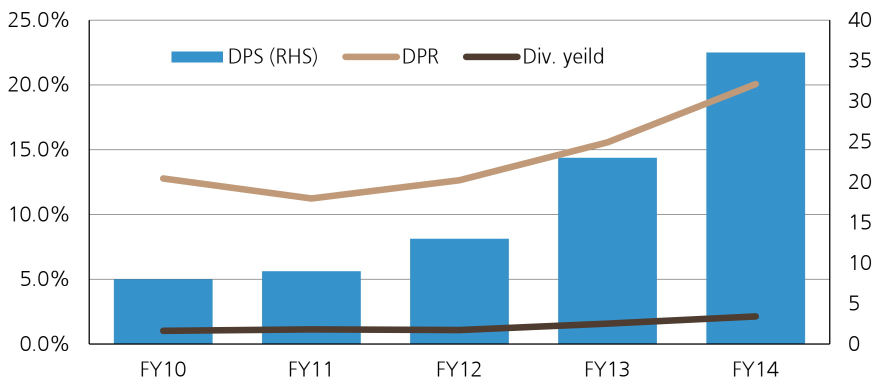
UBS VIEW

Potential upside at the securities companies and ORIX: Individuals, particularly those who have done well from big IPOs, are likely to move more of their money from savings to investment. This should allow brokerage company earnings to expand. We also expect ORIX's valuation to trend up as the company establishes a stable business model, its dividend increases and its beta falls.

EVIDENCE

Will ORIX become a dividend stock? ORIX is expanding shareholder returns and becoming more appealing in terms of its dividend yield.

ORIX shareholder returns and dividend yield



Note: the dividend yield is the year-end figure, based on the stock price.
Source: Company documents

Key Call: ORIX (8591)

Dividend rising as earnings expand

Business model should be more stable over medium term

Earnings are firm but ORIX's heavy dependence on gains from property and business sales and its complex and highly diversified business portfolio lie behind its undemanding valuation, in our view. In the short term, earnings could be volatile due to gains and losses from changes in the business portfolio, but over the medium term, we expect the business model to shift to one that is more resilient to swings in market conditions, centring on commission income, so that ROE can stabilise at over 10%. Under these circumstances, the payout ratio should rise and beta decline, allowing valuation to advance from its current level.

Earnings to expand

We assume that profit will continue to rise, driven by organic growth, and that the target of ¥300bn set out in the medium-term business plan will be achieved as past investment in renewable energy and others contribute to profit growth. On the other hand, the consensus view is that ORIX's medium-term plan targets will not be reached, mainly because the company is heavily dependent on asset and business sales.

Catalysts

Catalysts could include M&A and share buybacks, which could contribute to higher ROE. Another potential catalyst is growth in real estate-related profit from improvements in property market conditions. A further possible catalyst involves higher earnings contributions from renewable energy related operations.

Valuation

Our PT of ¥2,440 is based on average PE of 10.8X weighted by business type on our FY16-17 forecasts.

RIC: 8591.T / BBG: 8591 JP	
12-month rating	Buy
12m price target	¥2,440
Price (3-Dec)	¥1,810
Up/Downside	+34.8%
Market cap	¥2,373.3bn
	US$19.22bn
03/16E	
P/BV (UBS)	1.0x
Net Cash (Debt)	(¥5,631.8)bn

Net Profit	
03/16E	
UBSE	¥282.9bn
IFISE	¥263.3bn
CoE	- bn
03/17E	
UBSE	¥289.7bn
IFISE	¥263.5bn

8591 - Highlights (¥bn)	03/13	03/14	03/15	03/16E	03/17E	03/18E	03/19E	03/20E
Revenues	1,066.7	1,341.7	2,174.3	2,202.9	2,178.4	2,233.4	2,278.8	2,329.5
Operating profit	150.2	201.0	256.8	362.5	403.7	430.8	455.0	478.6
Recurring profit	172.9	291.2	344.3	437.9	443.7	460.8	485.0	508.6
Net profit (reported)	112.2	186.8	234.9	282.9	289.7	301.3	317.8	333.9
EPS (reported, ¥)	103.1	147.3	179.5	216.1	221.3	230.2	242.8	255.0

Profitability & Valuation	03/13	03/14	03/15	03/16E	03/17E	03/18E	03/19E	03/20E
EBIT margin %	14.1	15.0	11.8	16.5	18.5	19.3	20.0	20.5
ROIC (EBIT) %	2.8	4.0	13.6	(43.7)	(56.2)	(69.5)	(99.4)	(160.8)
EV/EBITDA x	14.1	14.3	11.9	11.4	10.5	10.1	9.8	9.4
PE (reported) x	8.1	10.4	8.6	8.4	8.2	7.9	7.5	7.1
Net dividend yield %	1.6	1.5	2.3	2.7	3.2	3.6	3.9	4.1

Source: Company data, UBS estimates (for all charts on this page)

Upside scenario

We are using weighted average PE based on profit contributions from each segment as our valuation basis, but if contributions from those businesses with high multiples rise as a result of changes in the business portfolio, valuation could advance. For example, based on the 13.4X multiple for the asset management segment, valuation would climb to an estimated ¥3,020.

Downside scenario

Earnings could stagnate if worsening markets hamper exits from investments or changes in the business portfolio, or lead to higher valuation losses in areas such as the real estate portfolio. Under these conditions, weighted average PE may not rise. Valuation could be marked down as far as ¥1,940 if profit stalls at the FY14 level.

Company profile

ORIX is a top domestic nonbank in terms of the amount of operating assets. Founded as a leasing company in 1964, ORIX subsequently expanded its business portfolio through product diversification, overseas growth and M&A, and leasing assets have fallen to about 30% of total operating assets. It is gearing up its approach to new growth areas, including "Finance + Service", Asia, and environmental and energy services.

Housing and Real Estate

Toshihiko Okino (Analyst)

UBS Research THESIS MAP	Most FAVORED	LEAST FAVORED
	Mitsubishi Estate	**None**

PIVOTAL QUESTIONS

Q: Will office rents rise at a faster pace?

Yes, if vacancy rates continue to decline. The vacancy rate for the five innermost wards of Tokyo stood at 4.46% in October, so it is approaching 4%. As new supply is likely to be restrained through 2017, the rate could fall below 4% if there is no serious economic downturn. If supply-demand tightens further, rent rises are increasingly likely to accelerate, from 4.13% yoy in October.

Q: Is the commercial real estate market overheated?

In addition to JREITs, private funds, sovereign wealth funds and private placement REITs are also actively buying properties, so there are a lot of buyers within the market, while there is only a limited amount of property for sale. This is leading some parts of the market to overheat. However, yield on high-grade offices and retail facilities in central Tokyo has been relatively stable, at around 3.5% for the past year or two, and not many transactions at exceptional prices are being seen.

Q: Will there be any impact on the market from the condominium issue in Yokohama?

We cannot rule out the risk that condominium sales could slow due to the condominium issue in Yokohama, as well as the impact of declining affordability as a result of price increases. However, condominium sales account for only just over 10% of OP at Mitsui Fudosan and Mitsubishi Estate, so if there is any impact, it should be minimal.

WHAT'S PRICED IN?

Concerns over a return to deflation are priced in: Despite improvement in fundamentals in the real estate market and rising cash flow, Japan's three major real estate companies are trading at a discount of 20-30% to NAV, and their share prices have been stagnant for the past two and a half years. We believe this is because future macro factors, including a slowdown in the CPI, have been priced in.

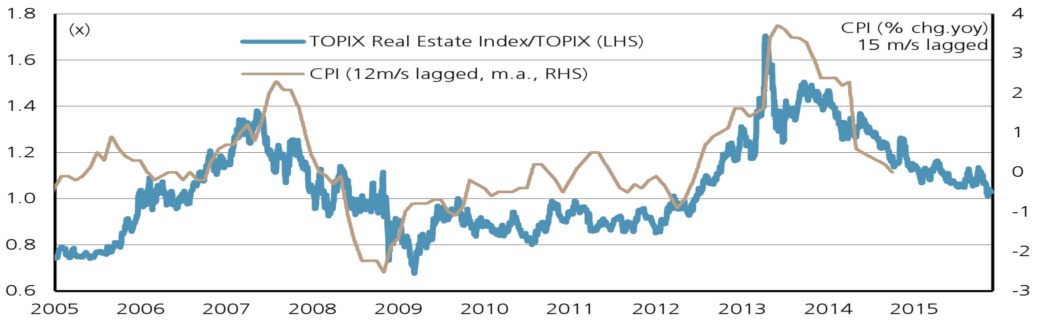
UBS VIEW

Share prices lead the CPI for about a year: The share prices of the major real estate companies tend to lead the CPI for about a year. If the CPI hits bottom in 2015 and continues to advance, this should be positive for the real estate sector, which is sensitive to the economy.

EVIDENCE

The CPI is likely to trend up at a moderate pace in 2016: We believe the CPI hit bottom, at 0.2%, in July-September 2015 and will advance to 1.1% in July-September 2016.

TSE Real Estate Sector Index relative to TOPIX vs. CPI



Source: Datastream

Mitsubishi Estate (8802)

Rents rising in Marunouchi

Rents reach ¥50,000/tsubo in Marunouchi

At end-Sept, the vacancy rate stood at 2.26% for the 39 office buildings that Mitsubishi Estate owns in Marunouchi, Tokyo's best office location. Rents are rising, reflecting tight supply-demand, and some tenants leasing relatively large, single-floor space are paying as much as ¥50,000/tsubo. Therefore, rental income from existing buildings is trending higher than the company's initial assumption. In addition, the Otemon Tower JX Building was completed in October fully tenanted and should contribute to earnings from FY16. The company has lagged Mitsui Fudosan and Sumitomo Realty & Development in terms of its profit recovery, but profit should hit bottom in FY15 and return to a steady growth trend from FY16.

Sales and profit to rise from FY16 as more new buildings are completed

In addition to income growth from existing buildings alongside higher rents, earnings from the Otemon Tower JX Building and the Dai Nagoya Building, which were both completed in October, will make full-term contributions in FY16. Furthermore, the Otemachi Financial City Grand Cube is due to be completed in April 2016, followed by the Otemachi Park Building in January 2017. These buildings should contribute to profit growth from FY17.

Further market rent growth should be positive for share price

According to Miki Shoji's latest survey, average rents for the five innermost wards of Tokyo rose 4.13% yoy in October. Therefore, the uptrend continued but the pace has slowed over the past several months. However, the vacancy rate stood at 4.46% in October, approaching 4%, indicating that supply-demand has tightened further. If rents rise at an even faster pace, it would be positive for the share price. BoJ policy announcements, such as on additional monetary easing, or statistics that indicate an economic recovery or a rise in the CPI should also have a positive impact on the share price.

Valuation: Maintain Buy rating

Our PT remains ¥3,800 (implied cap rate of 3.6%), based on a 5% premium to our FY15 NAV estimate of ¥3,553.

RIC: 8802.T / BBG: 8802 JP

12-month rating	Buy
12m price target	¥3,800
Price (3-Dec)	¥2,644
Up/Downside	+43.7%
Market cap	¥3,667.8bn
	US$29.70bn
03/16E	
P/BV (UBS)	0.7x
Net Cash (Debt)	(¥1,785.3)bn

Operating Profit	
03/16E	
UBSE	¥153.0bn
IFISE	¥148.4bn
CoE	¥150.0bn
03/17E	
UBSE	¥170.0bn
IFISE	¥165.5bn

8802 - Highlights (¥bn)	03/13	03/14	03/15	03/16E	03/17E	03/18E	03/19E	03/20E
Revenues	927.2	1,075.3	1,110.3	1,007.0	1,110.0	1,158.0	1,184.0	1,187.0
Operating profit	118.3	161.3	156.3	153.0	170.0	189.0	198.0	208.0
Recurring profit	92.4	139.6	133.1	131.0	145.0	161.0	166.0	171.0
Net profit (reported)	45.5	64.3	73.3	78.6	84.5	95.2	98.5	101.9
EPS (reported, ¥)	32.8	46.3	52.9	56.7	60.9	68.6	71.0	73.4

Profitability & Valuation	03/13	03/14	03/15	03/16E	03/17E	03/18E	03/19E	03/20E
EBIT margin %	12.8	15.0	14.1	15.2	15.3	16.3	16.7	17.5
ROIC (EBIT) %	3.0	3.9	3.7	3.5	3.8	4.2	4.3	4.4
EV/EBITDA x	22.3	25.3	24.4	25.7	24.2	22.4	21.7	21.0
PE (reported) x	50.4	59.0	47.5	46.7	43.4	38.5	37.2	36.0
Net dividend yield %	0.7	0.4	0.6	0.5	0.6	0.6	0.7	0.7

Source: Company data, UBS estimates (for all charts on this page)

Upside scenario

If the Tokyo office vacancy rate falls well below 5% and supply-demand for office space tightens, leading to rising expectations for higher rents even for less competitive buildings, the implied cap rate could drop below 3%, and we estimate that upside valuation in this scenario could exceed ¥4,000.

Downside scenario

If office demand decreases due to an economic slowdown and the Tokyo office vacancy rate changes from a downtrend to an upturn and exceeds 9% again, the implied cap rate could climb above 6%, and we estimate that downside valuation in this scenario could decline to around ¥2,000.

Company profile

Mitsubishi Estate owns and manages around 30 office buildings in the Marunouchi area of Tokyo. Situated in front of Tokyo Station, this is a high-status commercial district in Japan. The redevelopment of office properties owned by Mitsubishi Estate in this area is the most important business issue for the company. In addition, the firm is focusing on condo development and real estate solutions operations. Mitsubishi Estate also has a portfolio of overseas assets, including properties in New York and London.

JREITs

Junichi Tazawa (Analyst)

UBS Research THESIS MAP | MOST FAVORED | LEAST FAVORED

ORIX JREIT, Mori Hills REIT | **Mori Trust Sogo REIT**

PIVOTAL QUESTIONS

Q: At what pace is the dividend likely to rise and what are the drivers for dividend growth?

We forecast average dividend growth of 4.4% for the sector in 2015 and 3.5% in 2016. Although external growth is likely to contribute less as property purchasing conditions get tougher, we expect strong internal growth as rents recover, particularly in the office sub-sector.

Q: What are your sub-sector preferences?

Our order of preference is the office market at the top, followed by hotels, logistics facilities, residential property and finally commercial/retail facilities. We are positive on the office sector, where rents look set to rise, and the hotel sector, which should benefit from inbound demand. However, we are somewhat cautious on the outlook for the commercial/retail facility subsector, which is struggling with a slow economic recovery, particularly in suburban areas, and will face further pressure from the next consumption tax increase, due in April 2017.

Q: Will the Bank of Japan continue with its JREIT purchasing?

The Bank of Japan's JREIT buying has slowed but we expect it to continue. The central bank's purchasing is currently running at about ¥90bn a year, and if this pace continues, it will own about 5% of most AA-rated stocks by mid-2016. Therefore, some purchase restraint will probably be needed in the first half of next year.

WHAT'S PRICED IN?

A moderate improvement is being priced in: We believe moderate growth in rents, ongoing low interest rates, and a further stiffening of competition in the market for property acquisitions are being priced into investment unit prices. Valuations show a dividend yield/JGB yield spread of just over 3.0%.

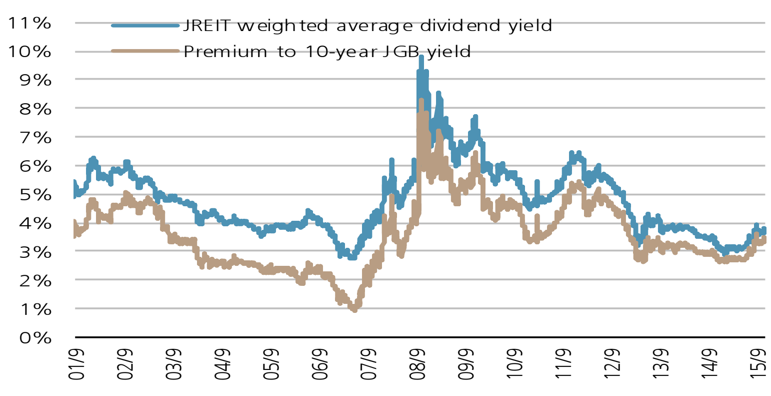
UBS VIEW

Valuations are still undemanding: The recovery in real estate market prices should continue as office rents recover, so there should be room for dividend growth on the back of higher rents. In turn, we see some upside potential in investment unit prices.

EVIDENCE

The yield spread should fall to around 2.5%: When Japan's real estate market was recovering in 2005-06, the yield spread was allowed to fall to about 2.5%, so from 2016, the spread should decline from its current level of over 3% to the mid-2% range.

Historical spread for the JREIT dividend yield and 10-year JGB yield



Source: Datastream, Company data, UBS

ORIX JREIT (8954)

Overall strengths stand out in challenging market

Expecting dividend growth on back of numerous drivers

ORIX JREIT is a general REIT with the longest track record in the sector. Its property portfolio, worth over ¥550bn, is highly diversified, and downside earnings risk is low. The company's good growth potential is underpinned by: 1) external growth, utilizing the ample pipeline provided by the ORIX group; 2) the flexibility to acquire the most appropriate types of property, depending on market conditions, by using its position as a general REIT to its advantage; and 3) expectations for stronger rent growth than the sector average, as its properties are relatively new (11 years, on average) and, therefore, highly competitive. In view of the company's strong growth potential, we see the current unit price, at a FY16E dividend yield of 3.6% and a 9.6% NAV premium, as very undemanding.

Earnings forecast: We expect dividend growth to continue

DPU came in at ¥2,929 (¥2,727 excluding one-off gains from property sales) in the August 2015 period and we forecast ¥2,840 for February 2016 and ¥2,900 for August 2016. External growth using support from the sponsor (we expect property acquisitions of ¥40bn per year) and a further recovery in rents should drive the dividend higher. We expect the dividend to rise further from 2017 and believe DPU of ¥3,000 can be achieved. With LTV at 46.1%, the company has borrowing leeway of ¥43bn and a solid balance sheet. Even if some big tenants leave its properties, the company should be able to maintain dividend growth through further borrowing and property purchases.

Continued property acquisitions are catalysts

Conditions for property acquisition are tough and an increasing number of REITs are likely to find it harder to purchase property from 2016. However, a strong pipeline, worth about ¥700bn at the sponsor level, should enable ORIX JREIT to maintain its buying activity and achieve much stronger external growth than the sector.

Valuation: Price target of ¥195,000; maintain Buy rating

Our price target is derived by discounting our seven-year AFFO (adjusted funds from operations) forecast and the NAV forecast at the end of the seven-year period by a cost of capital of 3.50%. This equates to a FY16E dividend yield of 3.0% and a premium to NAV of 33.8%.

RIC: 8954.T / BBG: 8954 JP

12-month rating	Buy
12m price target	¥195,000
Price (3-Dec)	¥160,100
Up/Downside	+21.8%
Market cap	¥339.4bn
	US$2.75bn
08/16E	
P/BV (UBS)	1.1x

EPS	
08/16E	
UBSE	¥5,566.0
IFISE	-
CoE	-
08/17E	
UBSE	¥5,697.0
IFISE	-

8954 - Highlights (¥bn)	08/13	08/14	08/15	08/16E	08/17E	08/18E	08/19E	08/20E
Net rental income	25.6	29.5	36.4	39.5	42.5	46.1	47.9	48.0
EBITDA	16.3	18.8	23.7	25.2	27.1	29.5	30.5	30.6
EPS (UBS, ¥)	4,285.0	4,722.0	5,526.0	5,566.0	5,697.0	5,965.0	6,173.0	6,202.0
DPS (¥)	4,763.0	5,083.0	5,646.0	5,740.0	5,860.0	6,110.0	6,160.0	6,190.0
NAV per share (UBS, ¥)	112,900.0	125,258.0	140,464.0	145,791.0	152,605.0	159,827.0	165,635.0	170,478.0

Profitability & Valuation	08/13	08/14	08/15	08/16E	08/17E	08/18E	08/19E	08/20E
PE (UBS)	23.6	27.4	29.8	28.8	28.1	26.8	25.9	25.8
EPS (UBS) yield %	4.2	3.6	3.4	3.5	3.6	3.7	3.9	3.9
Net dividend yield %	4.7	3.9	3.4	3.6	3.7	3.8	3.8	3.9
Prem/(disc) to NAV ps %	(10.3)	3.4	17.4	9.8	4.9	0.2	(3.3)	(6.1)
EV/EBITDA (UBS) x	20.0	22.5	23.6	22.7	21.6	20.2	19.2	18.9

Source: Company data, UBS estimates (for all charts on this page)

Upside scenario

If rents, particularly in the Tokyo area, rise more quickly than expected, and if the company continues to use its premium to NAV to allow it to go on acquiring large, high-grade properties, the unit price could appreciate to around ¥206,000, equating to a dividend yield of 2.7% based on company guidance for the current term, driven by expectations for faster dividend growth.

Downside scenario

The unit price could fall to ¥140,000, representing a dividend yield of 4.0% against company guidance for this term, if rents rise at a slower pace, major tenants move out of the company's properties, or new properties are acquired at a slower pace a result of much stiffer competition in the real estate market.

Company profile

ORIX JREIT's originator is leading financial services firm ORIX. Focusing on the Tokyo metropolitan area, this is a diversified fund that invests in a variety of properties, including office buildings, hotels, residential property, etc. The asset manager, ORIX Asset Management, is a wholly-owned subsidiary of ORIX and led by a board that is made up mainly of ORIX directors. The leadership team, including company president Yoshitaka Kamemoto, has a strong track record in real estate investment and management.

Transport

Jun Harada (Analyst)

UBS Research THESIS MAP

MOST FAVORED

ANA Holdings, JAL, Kintetsu World Express

LEAST FAVORED

Nippon Express, Yamato Holdings, Central JR

PIVOTAL QUESTIONS

Q: Will demand for travel to Japan remain strong even if the Chinese economy slows?

Yes. In 2015, there still were not as many Chinese visitors to Japan as visitors to South Korea in 2014. Growth is very likely to slow but we believe there is still considerable room for expansion. Also, long-distance routes to Europe and the US are more important for airline earnings, and they are still seeing double-digit rates of growth.

Q: What impact is a slower global economy likely to have on the freight transport sector?

It is likely to have a major impact on marine transporters, whose fixed-cost ratios are high, and on airlines with dedicated air freight fleets. However, marine transporters that have stable sources of earnings (such as Nippon Yusen) and forwarders with relatively low fixed costs (Kintetsu World Express) should be able to maintain fairly solid earnings.

Q: Could the construction of the new Maglev lines contribute to higher shareholder value?

There are some headwinds here, such as: 1) rising construction costs (¥9trn in total scheduled); 2) the decline in the working population (down about 16m before the line reaches Osaka); 3) the emergence of the LCCs; and 4) development of new telecom technologies (lower demand for business travel).

WHAT'S PRICED IN?

FY16 profit is likely to decline alongside the slowdown in the global economy: Kintetsu World Express' share price has declined nearly 30% from its May-June high, although no particularly negative news has been announced. This reflects stock market concern over China risk, in our view.

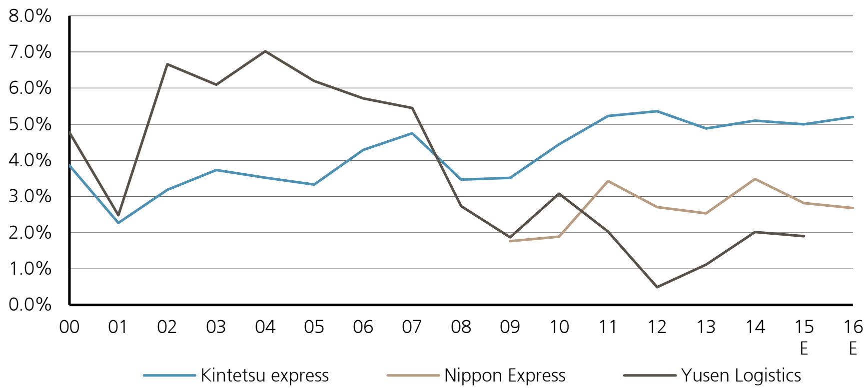
UBS VIEW

Impact could vary depending on the earnings structure: When demand is declining, the cargo space costs that freight forwarders pay to airlines fall sharply and forwarders' profit margins often improve.

EVIDENCE

Margins are stable: Kintetsu World Express's OP rose in Q2 despite lower sales in the China region. The same trend was confirmed at the company's peer, Yusen Logistics. KWE traditionally excels in cost management and has maintained high OP margins.

Operating profit margins at the major freight forwarders



Source: Company Data

ANA Holdings (9202)

Earnings disparity with JAL to narrow

Strong growth to continue

ANA Holdings is our top pick in Japan's transport sector, primarily because the airline is sufficiently capable of supplying seats, training staff and marketing its operations so that it can benefit fully from rising inbound demand. Additionally, with Skymark Airlines due to come under its wing, the company's domestic operation, which commands a 50% market share, is likely to strengthen its position further as a stable source of earnings. Finally, low fuel prices are likely to provide considerable support over the next few years.

RP to top ¥100bn mark for first time

The Nikkei Shimbun newspaper reported on 19 Nov that seat occupancy had fallen to around 50% on the Paris route, but we estimate that sales from these routes account for only just over 1% of total passenger income, including the domestic operation. Therefore, we expect FY15 RP to reach ¥116bn, which is 29% higher than the company's guidance and would mean a 73% yoy rise. We expect another record-high profit, at ¥143.3bn (5% higher than IFIS consensus), +24% yoy, for FY16, driven by double-digit growth in international passenger numbers and lower fuel costs due to reduced hedging effects.

Upward revision to guidance seems very likely

At the Q2 (July-September) results announcement, management maintained its FY15 guidance (¥90bn for RP), citing the uncertain macroeconomic outlook. However, in October, the airline's international passenger kilometers saw their strongest rate of growth in FY15, at +19.2% yoy. In view of this, we believe the company is highly likely to raise its guidance at Q3 results. In the latter half of FY16, ANA plans to start code-sharing on its domestic routes with Skymark Airlines, which is undergoing corporate rehabilitation. Sales growth should then accelerate further.

Valuation: Increasingly appealing, as share price has declined

Our price target of ¥420 is based on a DCF analysis assuming an OP margin of 8.5% in 10 years, equating to a FY15E PE of 16X and EV/EBITDA of about 6X. Both multiples are high relative to those of major global airlines but we believe a premium can be fully justified by differences in competitive conditions and ANA's strong long-term growth potential.

RIC: 9202.T / BBG: 9202 JP

12-month rating	Buy
12m price target	¥420
Price (3-Dec)	¥348
Up/Downside	+20.8%
Market cap	¥1,220.9bn
	US$9.89bn

03/16E	
P/BV (UBS)	1.4x
Net Cash (Debt)	(¥484.4)bn

Operating Profit

03/16E	
UBSE	¥135.0bn
IFISE	¥135.8bn
CoE	¥115.0bn
03/17E	
UBSE	¥156.0bn
IFISE	¥153.3bn

9202 - Highlights (¥bn)	03/13	03/14	03/15	03/16E	03/17E	03/18E	03/19E	03/20E
Revenues	1,483.6	1,570.1	1,713.5	1,788.0	1,864.0	1,938.0	2,012.0	2,090.0
Operating profit	103.8	66.0	91.5	135.0	156.0	175.0	185.0	190.0
Recurring profit	77.0	42.9	67.1	116.0	143.3	162.6	172.9	177.5
Net profit (reported)	43.1	18.9	39.2	70.0	93.1	105.7	112.4	115.3
EPS (reported, ¥)	14.3	5.4	11.2	20.0	26.7	30.2	32.2	33.1

Profitability & Valuation	03/13	03/14	03/15	03/16E	03/17E	03/18E	03/19E	03/20E
EBIT margin %	7.0	4.2	5.3	7.5	8.4	9.0	9.2	9.1
ROIC (EBIT) %	8.5	5.4	7.5	10.8	12.2	13.4	13.7	13.3
EV/EBITDA x	5.4	6.4	6.4	6.3	5.6	5.0	4.6	4.4
PE (reported) x	13.3	39.5	23.7	17.4	13.0	11.5	10.8	10.5
Net dividend yield %	2.1	1.4	1.5	1.4	1.7	2.0	2.0	2.0

Source: Company data, UBS estimates (for all charts on this page)

Upside scenario

The long-term strategies announced by management in February call for ¥2.5trn in sales and ¥200bn in OP (8% OP margin) in 2025, mainly from smooth growth in international travel operations. Since: 1) ANA already has 50% of the domestic market; and 2) JAL has kept its OP margin above 10% since it restructured, it is not particularly unrealistic to expect these targets to be beaten, in our view. Based on a long-term OP margin of 10% in the UBS VCAM model (our base case assumes 5.0% for 2015 and on), we estimate valuation could come to ¥530 per share.

Downside scenario

Conversely, if management focuses too much on competition with JAL for market share and resorts to the sort of heavy discounting seen in FY02, there could be a return to the low earnings of the past. Based on an OP margin of 3%, which was the average in the 2000s, for six years hence in our UBS VCAM model, we estimate valuation per share could be below ¥100.

Company profile

The sharp contraction in JAL's operations following corporate rehabilitation in 2010 makes ANA Japan's largest airline in terms of sales. Airline sales comprise 46% domestic passengers, 32% international passengers, 2% domestic cargo, 8% international cargo and 12% others. With a 50% market share, the domestic passenger unit is a stable earnings source, but more international flights in/out of Haneda and growth in freight through the Okinawa hub means ANA's reliance on domestic routes is falling. There are two LCCs in the group: Vanilla Air (consolidated subsidiary) and Peach Aviation (equity affiliate).

Stephen Leung (Analyst)

UBS Research THESIS MAP | MOST FAVORED | LEAST FAVORED

NTT, SoftBank | **NTT DOCOMO**

PIVOTAL QUESTIONS

Q: What is the MIC's mobile tariff action plan outcome likely to be?

We do not believe Japan's mobile tariffs are particularly high. Therefore, we think the action plan will be: 1) no strong enforcement of operators on price plans and the MIC could encourage operators to give end users the option of choosing service-only plans or 2-year instalment plans with handset subsidies; and 2) smaller data plans for lighter subscribers.

Q: Why buy SoftBank, given Sprint and Alibaba are already listed?

1) We think SoftBank's three-year EBITDA CAGR will be 4.9% between FY14 and FY17. The CAGR is being driven by a solid domestic segment and contributions from Sprint. The turnaround key for Sprint is network improvement: namely, small cell and beamforming. Together with its edge as an unlimited data plan provider, a rich 2.5GHz inventory spectrum and leverage from SoftBank's infrastructure vendor relationships, this could be a two-year story, in our view. 2) Alibaba should be viewed as a SoftBank asset. Fluctuations in Alibaba's share price do not affect SoftBank's fundamentals. 3) We favour SoftBank's exposure to Indian Internet investments prior to their IPOs.

WHAT'S PRICED IN?

To what extent is growth potential reflected in NTT's share price? We have analysed the extent to which growth potential is reflected in NTT's share price. Part 1: We calculated value based on the FY15 EPS consensus forecast (business value if growth is zero). Part 2: We estimated additional business value based on consensus from FY16 to the third year. Part 3: We subtract Parts 1 and 2 from the current share price to derive the growth in business value expected by the market from year three onward. According to our analysis (we also estimate that SoftBank is undervalued), the market currently values the company 45% below its value when long-term value growth from Part 3 is included.

UBS VIEW

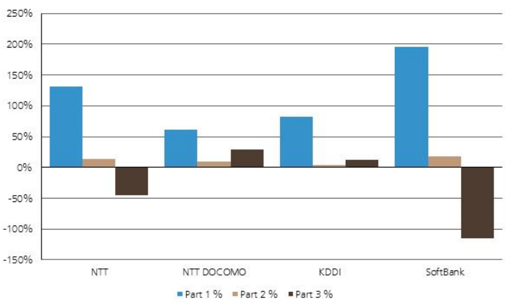
Margins improving for NTT's fixed-line business: The margin story for NTT's FTTH wholesale business is not limited to FY15 and will span multiple years due to the reduction of marketing costs. For SoftBank, we think Sprint business improvement is a two-year story.

EVIDENCE

Participation in MIC taskforce meeting: The focus was more on providing tariffs that are more fair and easier for users to understand than on the level of mobile tariffs.

Cost-cutting effects from Hikari Collabo: Cost reductions from Hikari Collabo in H1 were larger than we estimated. This stemmed mainly from cost reductions from Hikari Collabo (sales expenses and outsourcing costs to OS companies) for NTT East and NTT West.

How much growth in priced in?



Source: Bloomberg cost of equity of NTT (5.1%), NTT DOCOMO (8.5%), KDDI (8.3%), SoftBank (3.9%)

NTT (9432)

Top pick in telecom

Reasons for rating: Stable with clear outlook, active shareholder returns

1) Stable with a clear outlook: In the telecom sector, we give NTT and SoftBank Buy ratings. We believe NTT is more stable than SoftBank. 2) Among the four telecom companies, NTT has the most active stance on shareholder returns; 2016 is right in the middle of the company's three-year (FY14-FY17) business plan and it is continuing to provide returns to shareholders to achieve its EPS target of ¥350 in FY17. The total return of 3.6%, including a FY16E dividend yield of 2.3% plus 1.3% from share buybacks, looks attractive.

Earnings estimates

We estimate OP of ¥1.35trn and EPS of ¥335 in FY16 and ¥1.45trn and ¥370 in FY17. Our OP forecast is in line with IFIS consensus in FY16 and 1% higher in FY17. For the fixed-line business, we expect OP margin to increase (from 2% in FY14 to 9% in FY17E for NTT East/West combined). In the mobile business, NTT DOCOMO announced a ¥1,700 plan with unlimited calls up to five minutes long (only for 5G and higher users) in September. An MMD survey shows that roughly 26% of users are on 5G/month or higher plans. We estimate that 5.2m existing customers will move from the ¥2,700 to the ¥1,700 plan and we forecast FY15E OP for NTT DOCOMO of ¥717bn.

Catalysts: Cost cutting, Hikari Collabo data points, share buybacks

1) Cost reductions: The company has reconfirmed its target (FY17 capex to be lowered -¥200bn and opex -¥600bn from FY14). 2) Hikari Collabo progress: Announced quarterly. The number of Hikari Collabo FTTH wholesale partners increased to 200 from 40 in February. We estimate 22.5m FTTH subscribers for East/West combined in FY16 (+20% to 22.5m for East/West in FY14-FY17, ARPU -6% at ¥5,200 level). 3) The company achieved its full-year share buyback target (¥93.6bn, 21m shares) in October. There has been no announcement of additional purchases in H2 but we estimate share buybacks of ¥120bn in both FY16 and FY17, given the company's positive stance on shareholder returns and on achieving its EPS target of ¥350.

Valuation: PT ¥5,400 based on SOTP, maintain Buy rating

Our PT is based on SOTP. The three parts are NTT East/West/Comm/Dimension Data by DCF (WACC=5.25%, g=0%); NTT DOCOMO by DCF (WACC=6%, g=0%) and PT ¥2,300; and NTT Data at market price.

RIC: 9432.T / BBG: 9432 JP

12-month rating	Buy
12m price target	¥5,400
Price (3-Dec)	¥4,730
Up/Downside	+14.2%
Market cap	¥10,014.3bn
	US$81.09bn

03/16E	
P/BV (UBS)	1.1x
Net Cash (Debt)	(¥3,253.8)bn

Operating Profit

03/16E	
UBSE	¥1,282.1bn
IFISE	¥1,268.7bn
CoE	¥1,250.0bn
03/17E	
UBSE	¥1,351.4bn
IFISE	¥1,377.6bn

9432 - Highlights (¥bn)	03/13	03/14	03/15	03/16E	03/17E	03/18E	03/19E	03/20E
Revenues	10,700.7	10,925.2	11,095.3	11,445.4	11,568.0	11,782.0	11,939.4	12,071.4
Operating profit	1,202.0	1,213.7	1,084.6	1,282.1	1,351.4	1,466.5	1,556.2	1,629.5
Pre-tax profit	632.3	715.5	932.4	1,246.3	1,086.9	1,236.4	1,425.6	1,607.6
Net profit (reported)	520.6	585.5	518.1	654.9	694.8	752.4	801.2	840.5
EPS (reported, ¥)	214.8	254.6	238.9	310.9	334.7	369.5	397.4	416.9

Profitability & Valuation	03/13	03/14	03/15	03/16E	03/17E	03/18E	03/19E	03/20E
EBIT margin %	11.2	11.1	9.8	11.2	11.7	12.4	13.0	13.5
ROIC (EBIT) %	8.0	7.9	6.9	8.0	8.5	9.2	9.8	10.2
EV/EBITDA x	3.8	4.2	4.7	5.3	5.3	5.1	4.9	4.7
PE (reported) x	8.7	10.3	13.7	15.2	14.1	12.8	11.9	11.3
Net dividend yield %	4.3	3.3	2.8	2.1	2.3	2.5	2.7	3.0

Source: Company data, UBS estimates (for all charts on this page)

Upside scenario

Our upside scenario sees FTTH recognition in Japan increasing significantly and FTTH wholesale operations beating our expectations. NTT East/West could stop FTTH direct sales in one year and benefit from sales/marketing costs savings, taking margins up to 12% for NTT East and 6% for NTT West, on our estimates. Also, FTTH household penetration could reach 80%, with NTT East/West taking 70% of the market. In addition, we think NTT DOCOMO could learn from its past experience, helping OP improve to the ¥900bn level in FY17. Under this scenario, upside valuation could come to ¥6,200.

Downside scenario

In our downside scenario, FTTH recognition in Japan remains low and FTTH wholesale performs worse than our base-case expectation. NTT East/West only stop FTTH direct sales in five years, so sales and marketing costs remain, holding margins down at 6% at NTT East and 2% at NTT West, on our estimates. Also, FTTH household penetration could stay at 50%, with NTT East/West taking a 70% market share. In addition, under this scenario, NTT DOCOMO experiences repeated executional problems, holding OP at the ¥700bn level in FY17. Under this scenario, downside valuation could come to ¥4,000.

Company profile

NTT is Japan's largest telecommunications company, a holding company with 100% stakes in three core fixed-line businesses: NTT East, NTT West and NTT Communications (NTT Com). NTT East and NTT West handle regional telecommunications operations and NTT Com handles long-distance telecommunications operations. NTT is expanding its global and cloud offerings. NTT DoCoMo, in which NTT has about a 60% stake, accounts for about 40% of revenue and 60% of EBITDA.

Small and Mid-Caps

Mariko Watanabe (Analyst)

UBS Research THESIS MAP | MOST FAVORED | LEAST FAVORED

Seria, Daiichikosho, Technopro, Anicom HD, Hikari Tsushin, H.I.S. | **Japan Exchange Group**

PIVOTAL QUESTIONS

Q: Are interest rates likely to remain low?

We believe they will. Historically, there has been a high negative correlation between small-cap stocks and interest rates. We believe global liquidity excess and the BoJ's monetary easing policy are likely to continue. If interest rates turn upwards for one reason or other, small-cap stocks are likely to turn down.

Q: Is earnings expansion likely to continue?

We believe it will, but at a slower rate. We forecast OP growth of 14% for TOPIX small caps, 16% for Jasdaq and 66% for Mothers stocks in FY15, and 9%, 14%, and 20%, respectively, for FY16. Earnings are starting to deteriorate due to the economic slowdown in China and currency weakness in emerging markets, and we forecast lower growth in FY16.

Q: Are Japanese small cap stock valuations demanding?

No, they are not. Consensus-based PEs for Japanese small caps are 16X for FY15E and 14X for FY16E, compared with global averages of 27X and 19X respectively, and averages for the industrialized markets of 31X and 20X.

WHAT'S PRICED IN?

Japan is underweighted: The weighting of Japan within the MSCI World Small-Cap Index is 11.5% (as at the end of October 2015). Many global funds are underweighting Japanese stocks.

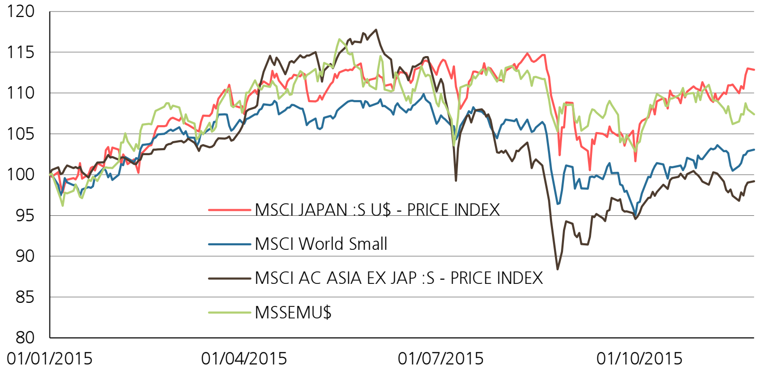
UBS VIEW

Japan outperforms the global market unexpectedly: Normally, small-cap stocks tend not to advance when the economy is peaking, but Japanese small-cap stocks could outperform the global average in 2016, as they did in 2008.

EVIDENCE

Japan saw the strongest advance in 2015: Year-to-date in 2015, the MSCI World Small-Cap Index has advanced 1.5%. With a rise of 13% on a US dollar basis, Japan was the top performer. As Japan is underweighted, it could continue to outperform in 2016.

MSCI World Small Cap Index (USD 2015/1/1=100)



Source: Thomson Reuters

Hikari Tsushin (9435)

Solid earnings structure; rising expectations for shareholder returns

Investment case

Hikari Tsushin is no longer just a mobile phone sales agency. We believe the market underestimates the company's expanding product line-up for corporate clients, earnings growth on the back of rising contract volumes, and strong cash flow generation capabilities. Amid the uncertain outlook for the economy and corporate earnings, this firm's very defensive earnings structure should attract renewed attention.

More new profit highs as product line-up expands, productivity improves

Continued contract commissions have doubled in the past five years alongside growth in the product line-up and a rising contract balance, and stability and absolute cash flow levels have improved notably. The accumulation of high-priced contracts for IT solutions for corporate clients, telecom services and water servers have driven earnings, while in the insurance field, competitive conditions have improved as sales regulations have been reinforced. We expect OP to reach new highs, at ¥40.9bn in FY16 and ¥45.9bn in FY17. Our forecast for FY17 is above the consensus estimate of ¥44.9bn.

High cash flow generation capabilities

Potential catalysts include higher sales and contract volumes, which are drivers for earnings and cash flow, as well as lower cancellation rates, rising new product sales, and shareholder returns. Management aims for continued improvements in ROE. The company has been paying dividends quarterly and buying back shares since FY12, and has bought back shares worth a total of ¥37.4bn and retired 19% of outstanding shares in the past five years. As at end-September 2015, its investment securities stood at ¥98.1bn, with unrealized gains of ¥45.2bn. The company has suggested that it will sell securities that it holds purely for investment and may return the funds from these sales to its shareholders.

Valuation

Factoring in stable cash flow, our PT is based on an ROIC model assuming WACC of 4.9%. This equates to FY16E PE of 20X and FY17E PE of 18X.

RIC: 9435.T / BBG: 9435 JP	
12-month rating	Buy
12m price target	¥11,000
Price (3-Dec)	¥8,860
Up/Downside	+24.2%
Market cap	¥405.4bn
	US$3.28bn
03/16E	
P/BV (UBS)	2.3x
Net Cash (Debt)	¥77.7bn

Operating Profit	
03/16E	
UBSE	¥36.8bn
IFISE	¥37.1bn
CoE	¥36.0bn
03/17E	
UBSE	¥40.9bn
IFISE	¥41.1bn

9435 - Highlights (¥bn)	03/13	03/14	03/15	03/16E	03/17E	03/18E	03/19E	03/20E
Revenues	500.3	565.2	562.5	572.1	543.6	542.2	545.5	547.8
Operating profit	24.6	31.8	32.1	36.8	40.9	45.9	50.3	54.1
Recurring profit	27.2	39.7	36.6	38.5	43.0	48.0	52.4	56.2
Net profit (reported)	16.9	29.4	20.8	25.4	25.3	28.3	29.8	32.1
EPS (reported, ¥)	346.7	641.6	451.6	550.1	547.4	612.8	644.4	694.0

Profitability & Valuation	03/13	03/14	03/15	03/16E	03/17E	03/18E	03/19E	03/20E
EBIT margin %	4.9	5.6	5.7	6.4	7.5	8.5	9.2	9.9
ROIC (EBIT) %	75.1	88.7	69.8	52.4	49.6	55.3	60.2	64.3
EV/EBITDA x	2.0	2.7	3.3	6.1	5.2	4.2	5.4	4.7
PE (reported) x	10.8	10.5	16.6	16.1	16.2	14.5	13.7	12.8
Net dividend yield %	2.5	2.1	2.1	2.0	2.3	2.5	2.7	2.9

Source: Company data, UBS estimates (for all charts on this page)

Upside scenario

Our upside scenario assumes FY16 OP of ¥40bn, based on stepped-up business investment in response to economic growth, more new contracts for office machinery and telecoms services, stiffer competition over market share among the telecoms carriers, and higher volume incentives. Additionally, if the equity risk premium declines to 5% to reflect substantial improvements in the economy and corporate earnings and consequently greater interest in the stock market, we estimate upside valuation based on ROIC would come to ¥14,500.

Downside scenario

Because ongoing commissions are a key source of earnings for the company, a decline in contracts would be unlikely to impact earnings in the near term (but would have an impact long term). If long-term interest rates rise to 3% because of Japan's deteriorating government finances, the value of shareholdings is cut in half as a result of a weaker economy and stock market, and the risk premium rises to 8%, downside valuation based on ROIC would come to ¥5,500.

Company profile

In 1994, with the introduction of cell phone sales in Japan, Hikari Tsushin started marketing mobile phone and PHS handsets and began to expand its sales to personal users. The product line-up was then broadened to include rental servers and Sky PerfecTV tuners. More recently, in addition to mobile phones, the company has started selling fixed lines, data cards, insurance, office equipment and various eco products. Hikari Tsushin has a strong sales network that serves around 1m companies across Japan.

Risk factors

Kajima (1812)

If public works demand falls at a faster pace than we expect, earnings could come under pressure. Japanese general contractors are all potentially exposed to the risk of business suspension or delisting as authorised public works contractors, as well as substantial fines and penalties, in the event of being found guilty of bid-rigging or other acts of wrongdoing.

Meiji Holdings (2269)

Risks include a slowdown in probiotic yogurt sales, sharp increases in the cost of inputs for dairy products, price competition with generic drugs and excessive capex.

Nitto Denko (6988)

General risk factors for Nitto Denko include weaker-than-expected demand for electronics products, such as TVs; smartphones, tablets and PCs; and automobiles, due to an economic slowdown or other factors, and sudden fluctuations in the financial and capital markets (stocks, FX, interest rates). We estimate that every Y1 the yen weakens against the US dollar adds about Y2bn to operating profit. Additionally, in mainstay LCD operations, we see a risk of changes in how optical film is used due to evolution in LCD technologies, the maturing of optical film technologies, market deterioration, price declines due to stiffer competition, and loss of market share.

Nippon Steel & Sumitomo Metal (5401)

The company produces a wide swathe of products from steel sheet to steel pipe and operates around the globe. Earnings are very exposed to global economic trends. The company has a high export weighting and demand from domestic customers in the export industry is strong, so yen strength has a negative impact on earnings. If energy prices languish, there is a risk that earnings in the steel pipe business could be adversely affected.

Daikin Industries (6367)

We see risks in the air conditioning business as being weak global construction investment and unseasonable weather (ie, cool summer temperatures). The company's FX sensitivity is +/–Y700m for every Y1 swing against the US dollar and +/–Y400m against the euro. High materials prices are also a risk.

Yokogawa Electric (6841)

When forecasting the company's earnings, we believe it is necessary to take into account potential delays in energy development projects due to sluggish global economic conditions or geo-political risk, as well as risk of diminished business opportunities in the domestic control business as plant amalgamation proceeds in the Japan petrochemical sector and elsewhere. When considering the longer-term growth scenario we project, we bear in mind the risk of losing competitiveness with local peers in planned LNG projects due to a rise in North American natural gas prices.

Disco (6146)

Risk factors include: 1) price pressure from clients; 2) M&A at competitors to share value; and 3) lower semiconductor unit shipments.

Sony (6758)

Potential risks include a lower market share for the finished set business, a decline in smartphone CMOS sensor input coefficients, competitors' platforms turning out to be more popular in the games business, a reduction in the number of software content vendors, reduced price negotiating power and disappointing quarterly results.

Alps Electric Co. (6770)

Risk factors include volume declines for consumer electronics such as smartphones and game machines, weak sales of particular models of the company's products, market share losses due to competition, a decline in profitability due to deterioration in yields, lower auto output, higher-than-expected increases in R&D and other fixed costs, declines in the market values of publicly traded subsidiaries Alpine and Alps Logistics for whatever reason, and lower export sales due to yen appreciation.

Yahoo Japan (4689)

1) The internet services business is prone to severe changes in technology and the market environment. These changes in the external environment can have an enormous impact on the profit of individual companies. 2) Most internet services businesses hold large quantities of individual data and customer information. If this data were to be leaked, not only would it have a major impact on the profit of the company concerned, it could also lead to a decline in confidence in the sector as a whole and a fall in demand for internet services.

Nissan Motor (7201)

Risks include expansion in the European market; very popular new Nissan models; increased market share in China and any advance in profitability; and sharp declines in sales incentives in the US.

Sumitomo Mitsui Financial Group (8316)

Deterioration in the macroeconomic environment at home and abroad and stricter regulations are risk factors.

ORIX (8591)

As the company operates various businesses, it seeks to disperse risk, but a relatively large risk would be a decrease in corporate activity due to a sluggish domestic economy. Reduction in risk volume is progressing but the company still has real estate holdings, so weak real estate prices would present a risk.

Mitsubishi Estate (8802)

There could be downside risk for Mitsubishi Estate's share price if deterioration in the office market, particularly in Tokyo, drags due to weakness in the economy or other factors.

ORIX JREIT (8954)

Since office buildings account for more than 50% of the portfolio and retail facilities 20%, the risk of an earnings decline could increase if an economic downturn results in a sharp reduction in rent levels, or if there is a succession of contract cancellations by major tenants. Also, if there is a major deterioration in the financial environment, there could be an increasing risk of a reduction in dividends and higher refinancing risk as the interest payment burden rises. Also, since the REIT depends heavily on its sponsor for property purchases, if the sponsor's stance on property sales changes, it could lead to a slowdown in external growth.

ANA Holdings (9202)

Crude oil: The company indicated that a $1 decline in the fuel oil price would boost profit by ¥1bn- 1.5bn on an unhedged basis. Yen: the company indicates that every ¥1 of appreciation would dent profit by around ¥2bn. Non-operating earnings: At Japan's airlines, losses associated with selling off or disposing of aircraft and aircraft parts are recorded under non-operating earnings. RP can be substantially distorted, depending on how big/small the item is.

NTT (9432)

A potential risk is execution in FTTH broadband wholesale. Also, competition from KDDI and SoftBank could damage NTT DOCOMO's profitability, ultimately hurting NTT.

Hikari Tsushin (9435)

Hikari Tsushin acts as a distributor for telecom providers and manufacturers, with sales conducted in accordance with the terms and conditions of its distribution agreements. A change in policy at these telecom providers and manufacturers can have an impact on its earnings. Hikari Tsushin owns shares in listed and unlisted companies in IT-related businesses, and when stock prices weaken or the companies it invests in inexperience a worsening of business conditions or go bankrupt, the valuations of its investment securities can decline. The company's insurance business is subject to a broad range of regulations, including related laws and rules, oversight by the Financial Services Agency and other relevant regulators, and directives from the insurance companies it does business with. If an insurance company fails to pay a claim, the company's business is affected, and any unforeseeable changes in, or the establishment of, new laws and regulations can affect operating results in the insurance business. Acquiring a competitor is an option the company has to expand its business. Although the acquisition process would include sufficient due diligence, unlike in the past, the acquisition may not lead to an expansion of sales channels or an increase in profit, thereby affecting the company's financial position. The Ministry of Internal Affairs and Communications' Mobile Business Study Group is considering mandating the unbundling of mobile handsets and usage fees. If handset prices rise, it would improve yields at the distributors, but if the handset upgrade cycle quickly becomes longer, it could impact Hikari Tsushin's earnings.

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Statement of Risk

Forecasting earnings and corporate financial behaviour is difficult because they are affected by a wide range of economic, financial, accounting, and regulatory trends, as well as changes in tax policy.

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Buy	FSR is > 6% above the MRA.	49%	33%
Neutral	FSR is between -6% and 6% of the MRA.	40%	26%
Sell	FSR is > 6% below the MRA.	12%	18%
Short-Term Rating	**Definition**	**Coverage**[3]	**IB Services**[4]
Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%

Source: UBS. Rating allocations are as of 30 September 2015.
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UBS Securities Japan Co., Ltd.: Tomohiro Okawa; Daiju Aoki; Daisuke Uchiyama; Takaaki Muramatsu.

Company Disclosures

Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
Advantest[16]	6857.T	Neutral	N/A	¥1,107	04 Dec 2015
Alcatel-Lucent[7, 13, 16]	ALUA.PA	Buy	N/A	€3.70	04 Dec 2015
Alibaba Group Holding Limited[10, 16, 18b]	BABA.N	Buy	N/A	US$84.85	04 Dec 2015
Alps Electric Co.[7]	6770.T	Buy	N/A	¥3,705	04 Dec 2015
Alstom[7, 13]	ALSO.PA	Neutral	N/A	€27.93	04 Dec 2015
ANA Holdings[14]	9202.T	Buy	N/A	¥342.7	04 Dec 2015
Anicom Holdings	8715.T	Buy	N/A	¥2,930	04 Dec 2015
Aozora Bank[7]	8304.T	Neutral	N/A	¥432	04 Dec 2015
Central Japan Railway	9022.T	Sell	N/A	¥21,510	04 Dec 2015
CyberAgent	4751.T	Buy	N/A	¥5,220	04 Dec 2015
Daiichikosho	7458.T	Buy	N/A	¥4,185	04 Dec 2015
Daikin Industries	6367.T	Buy	N/A	¥8,740	04 Dec 2015
Denso[7]	6902.T	Buy	N/A	¥5,837	04 Dec 2015
Disco	6146.T	Buy	N/A	¥11,870	04 Dec 2015
EMC Corporation[4, 6a, 6b, 6c, 7, 16]	EMC.N	Buy	N/A	US$25.92	04 Dec 2015
Fanuc	6954.T	Sell	N/A	¥22,095	04 Dec 2015
Fuji Heavy Industries	7270.T	Neutral	N/A	¥5,064	04 Dec 2015
Fujitsu[3b, 4]	6702.T	Buy	N/A	¥646.6	04 Dec 2015
General Electric Co[4, 5, 6b, 6c, 7, 16, 18a]	GE.N	Buy	N/A	US$30.49	04 Dec 2015
GMO Internet[7]	9449.T	Buy	N/A	¥1,823	04 Dec 2015
H.I.S.	9603.T	Buy	N/A	¥3,920	04 Dec 2015
Hikari Tsushin[2, 4]	9435.T	Buy	N/A	¥8,610	04 Dec 2015
Hitachi[4, 7]	6501.T	Buy	N/A	¥728.8	04 Dec 2015
Hitachi Construction Machinery	6305.T	Sell	N/A	¥1,922	04 Dec 2015
Japan Airlines[5, 7]	9201.T	Buy	N/A	¥4,249	04 Dec 2015
Japan Exchange Group[7]	8697.T	Sell	N/A	¥1,900	04 Dec 2015
JGC	1963.T	Neutral	N/A	¥2,111	04 Dec 2015
JSR	4185.T	Neutral	N/A	¥1,899	04 Dec 2015
Kajima	1812.T	Buy	N/A	¥712	04 Dec 2015
Kewpie Corporation	2809.T	Neutral	N/A	¥3,005	04 Dec 2015
Kintetsu World Express	9375.T	Buy	N/A	¥2,271	04 Dec 2015
Kirin Holdings[7]	2503.T	Neutral	N/A	¥1,733.0	04 Dec 2015
Kobe Steel	5406.T	Neutral	N/A	¥146	04 Dec 2015
Komatsu	6301.T	Sell	N/A	¥2,014.0	04 Dec 2015
Kubota	6326.T	Neutral	N/A	¥2,048.5	04 Dec 2015
Kyocera[16]	6971.T	Neutral	N/A	¥5,745	04 Dec 2015
Maeda Corp.	1824.T	Buy	N/A	¥765	04 Dec 2015
Meiji Holdings	2269.T	Buy	N/A	¥9,840	04 Dec 2015
Mitsubishi Electric[7, 14]	6503.T	Buy	N/A	¥1,367.5	04 Dec 2015
Mitsubishi Estate	8802.T	Buy	N/A	¥2,558.0	04 Dec 2015
Mitsubishi Heavy Industries[5]	7011.T	Buy	N/A	¥633.3	04 Dec 2015

Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
Mitsubishi UFJ Financial Group[7, 16, 18c]	8306.T	Neutral	N/A	¥803.6	04 Dec 2015
mixi	2121.T	Buy	N/A	¥5,060	04 Dec 2015
Mizuho Financial Group[2, 3a, 4, 5, 6a, 7, 16]	8411.T	Neutral	N/A	¥247.9	04 Dec 2015
Mori Hills REIT Investment[4]	3234.T	Buy	N/A	¥153,600	04 Dec 2015
Mori Trust Sogo REIT	8961.T	Sell	N/A	¥206,900	04 Dec 2015
Murata Manufacturing	6981.T	Buy	N/A	¥18,860	04 Dec 2015
Nintendo	7974.T	Sell	N/A	¥18,980	04 Dec 2015
Nippon Express	9062.T	Sell	N/A	¥560	04 Dec 2015
Nippon Steel&Sumitomo Metal	5401.T	Buy	N/A	¥2,485.5	04 Dec 2015
Nippon Yusen	9101.T	Buy	N/A	¥308	04 Dec 2015
Nissan Motor	7201.T	Buy	N/A	¥1,262.0	04 Dec 2015
Nissin Foods Holdings	2897.T	Sell	N/A	¥6,390	04 Dec 2015
Nitto Denko	6988.T	Buy	N/A	¥8,606	04 Dec 2015
Nokia[5, 7, 16]	NOKIA.HE	Buy	N/A	€6.80	04 Dec 2015
Nomura Holdings[5, 7, 16]	8604.T	Buy	N/A	¥735.4	04 Dec 2015
NTT[16]	9432.T	Buy	N/A	¥4,691	04 Dec 2015
NTT DOCOMO[16]	9437.T	Neutral	N/A	¥2,395.0	04 Dec 2015
ORIX[2, 4, 5, 7, 16]	8591.T	Buy	N/A	¥1,769.0	04 Dec 2015
ORIX JREIT[2, 4, 5]	8954.T	Buy	N/A	¥159,200	04 Dec 2015
Rakuten[7]	4755.T	Buy	N/A	¥1,496.0	04 Dec 2015
Rohm	6963.T	Neutral	N/A	¥6,740	04 Dec 2015
Samsung Electronics	005930.KS	Buy	N/A	Won1,269,000	04 Dec 2015
Seria	2782.T	Buy	N/A	¥5,290	04 Dec 2015
Sharp	6753.T	Sell	N/A	¥128	04 Dec 2015
SoftBank Group Corp[2, 4, 7, 8]	9984.T	Buy	N/A	¥6,375	04 Dec 2015
Sony[2, 4, 5, 7, 16]	6758.T	Buy	N/A	¥3,091	04 Dec 2015
Sony Financial Holdings	8729.T	Neutral	N/A	¥2,316	04 Dec 2015
Spirent Plc[5, 14]	SPT.L	Neutral	N/A	69p	04 Dec 2015
SUMCO	3436.T	Neutral	N/A	¥1,248	04 Dec 2015
Sumitomo Metal Mining	5713.T	Neutral	N/A	¥1,411.0	04 Dec 2015
Sumitomo Mitsui Financial Group[1, 2, 4, 5, 7, 16]	8316.T	Buy	N/A	¥4,744	04 Dec 2015
Sumitomo Mitsui Trust Holdings[4, 7]	8309.T	Sell	N/A	¥466.9	04 Dec 2015
Suntory Beverage & Food Limited[5]	2587.T	Buy	N/A	¥4,905	04 Dec 2015
SURUGA Bank	8358.T	Buy	N/A	¥2,462	04 Dec 2015
Suzuki Motor[5]	7269.T	Sell	N/A	¥3,770	04 Dec 2015
Taisei	1801.T	Neutral	N/A	¥794	04 Dec 2015
Taiwan Semiconductor Manufacturing[16]	2330.TW	Buy	N/A	NT$140.50	04 Dec 2015
Technopro Holdings[2]	6028.T	Buy	N/A	¥3,520	04 Dec 2015
Toray	3402.T	Buy	N/A	¥1,107.0	04 Dec 2015
Toshiba[4, 5, 7]	6502.T	Neutral	N/A	¥302.3	04 Dec 2015
Toyota Industries Corporation	6201.T	Sell	N/A	¥6,500	04 Dec 2015
UACJ	5741.T	Buy	N/A	¥292	04 Dec 2015

Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
Yahoo Japan[7]	4689.T	Buy	N/A	¥515	04 Dec 2015
Yamato Holdings	9064.T	Sell	N/A	¥2,370.0	04 Dec 2015
Yamazaki Baking	2212.T	Buy	N/A	¥2,396	04 Dec 2015
Yokogawa Electric[5]	6841.T	Buy	N/A	¥1,502	04 Dec 2015

Source: UBS. All prices as of local market close.
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