Interview with Oleg Kapinos, Head of Global Distribution Strategy of Asset Management One

Would Japanese Firms' Competitiveness in Some Niche Markets Lead to Japan's Strategic Indispensability to Strengthen Her Economic Security?

By *Japan SPOTLIGHT*

There has been recent skepticism about Japan's industrial competitiveness in the light of declining productivity. But there are some niche industries where Japanese companies' share of the global market exceeds 10-20%. This is good news for the Japanese economy's supply side. Moreover, it could make it indispensable for Japan to prevent the superpowers from economic coercion regarding critical products for which it is heavily dependent on them. To counter such coercion, the victim nations would need some other critical goods that would force the superpowers to increase their own dependency on them.

***Japan SPOTLIGHT* interviewed Oleg Kapinos, head of Global Distribution Strategy of Asset Management One, who has been working in financial development and investment research for many years, and has expertise in Japanese business and industries.**

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Japanese Competitiveness in Niche Markets

JS: How do you assess Japanese firms' competitiveness in various niche markets? Are there niche markets where Japanese firms are dominant or have cutting-edge technologies or products, or where Japanese products are seen as indispensable?

Oleg Kapinos

Kapinos: They are strong in areas where they have accumulated a lot of know-how and where there are high barriers to entry. Some examples would be semiconductor equipment manufacturing. Not the semiconductors themselves, but rather the cutting and grinding equipment produced by some niche Japanese players. Some pharmaceutical companies also have a very strong presence in areas like cancer immunology treatment and Alzheimer's disease treatment. They specialize in the fields where a lot of R&D and significant accumulation of know-how is required, and they can be quite strong in those. But are there many of them? Probably not.

JS: Are you saying that those indispensable products are not necessarily cutting-edge technologies?

Kapinos: Some of them are, but they tend not to be on the consumer side. We are talking about some very specialized technologies that are very difficult to replicate.

JS: The steel industry is not considered high tech, but do you think some Japanese steel companies spend a lot on R&D and produce indispensable products?

Kapinos: I think it comes down to the quality of the products. I am not a specialist on the steel sector, but I do know that some of the Japanese companies are some of the largest steel producers in the world.

JS: How about chemicals? I've heard that Japanese chemicals companies are competitive in certain niche markets.

Kapinos: Yes, absolutely. This is a good example. Some of these chemical companies are actually not pure chemical businesses that you would think of – they are not related to oil and refineries or anything like that. Some of them, for example, produce materials that go into electric batteries. And this is a great play for us as investors on the electric vehicles theme, because batteries are the key component in electric vehicles. It all comes down to how good your batteries are, and there are a couple of Japanese companies that are world leaders in producing the materials that go into them. Even though you could say they are a niche player in this regard, they stand to grow significantly because this is a growing trend, you could say a mega trend.

Niche Market Strengths & Large Market Losses

JS: My second question is about high specialization in

niche markets among Japanese companies. Does this lead to a loss in large markets for products with universal use?

Kapinos: I think to some degree it already has. If you look at consumer electronics, they have definitely lost a lot of market share to other Asian players. This has to do with many factors. First of all, I think it has to do with costs. If you think about the Chinese and Korean manufacturers that overtook Japan in this regard, they enjoyed a cost advantage, primarily thanks to the lower labor costs. And you can argue about why that was the case. In China, for example, I think a lot of the labor cost cheapness came from very low safety standards. I think Japanese companies are also under threat in the automotive sector. There are some interesting exceptions, however. I mentioned, for example, that chemicals are still showing strong growth because they are latched onto electric vehicles.

The trading houses are also a very unique business model that as far as I know only exists in Japan. These are very unusual companies that continue to record quite strong growth. People tend to view them as commodity plays, and in the past they probably were, but if you look at what they actually do, they are basically huge corporate venture capital firms. They make a lot of investment in other companies, and they are quite disciplined about how much return they aim to generate on those investments, so it is basically a huge portfolio similar to those at venture capital firms.

JS: I see, thank you. But overall, this Japanese strategy may not necessarily be successful in terms of profit-earning capacity?

Kapinos: I think we need to distinguish between revenues and profits. Revenues are how much you sell, and in terms of how much you can sell, we are talking about scale. In many markets, your capacity to grow sales will be limited by the size of the market. And I agree that it will be very difficult for many smaller niche players to grow revenues, because they tend to operate in smaller markets. If you look at profits, however, it is the other way around because they are the dominant players. They can actually pass a lot of costs on to their customers and in this way enjoy higher profit margins. In terms of profitability, it happens to be a very good business model. One exception which I just mentioned is chemicals, because they are linked to electric vehicles. This is a very fast-growing market, and they should see their sales grow as the market expands. Even if they maintain the same market share, their revenues will grow because the market overall is growing.

Niche Market Competitiveness as Strategic Indispensability

JS: In terms of economic security, might this niche market strategy be effective in getting some kind of indispensability that could perhaps counter coercive policies by trading partners?

Kapinos: I think there are two questions in one here. One question is how Japanese companies that specialize in these niches are impacted by the changing geopolitical climate. And the other one is what it means for economic policy. I believe we need to differentiate between these questions because they are very different. One is about how companies do business, and the other is about what governments do.

On the first point, I think overall, increasing geopolitical risks are clearly a threat and are already having a negative impact. Examples would be that you have to be much more careful with your supply chains. Tariffs are obviously a problem with what President Donald Trump's administration is doing. So there are some threats, but, at the moment at least, it does not seem like they are making a huge impact. There is some negative impact, but it is manageable.

In terms of macroeconomic policy, it is obviously a completely different dimension. Does it mean that, for example, these companies could be useful as a tool in trade negotiations or tariff negotiations? They potentially could be. As you mentioned, there are some indispensable products that many companies in the world rely on, including in the United States and China. It could be a bargaining chip, but given how these negotiations are usually done, I do not think it is going to be a major one. It is probably going to be something on the sidelines rather than the main topic.

JS: National security today is also closely linked to the economy. Do you think that having more indispensable goods would be good for national security as well?

Kapinos: That is a difficult question. Economic policy is not my area of expertise, but from my point of view, it is going to be of limited use. And this is just my personal view, not necessarily the view of the firm. I think when superpowers struggle, they are guided more by ideology than by economic interests. I would venture a guess that having indispensable goods is unlikely to have a big impact because the superpowers have much more important ideological stakes to consider than these relatively minor economic ones.

JS: How about products that are dual use? Those products might be crucial for national security as well. Do you think Japanese industries are good at producing dual-use products?

Kapinos: This is a little bit out of my area of expertise. I do know that there is a very small number of companies in Japan that produce products like that. How competitive are they? I do not know much about this, but if you think about modern warfare, it is changing rapidly and is much more reliant on things like drones. I think in this light Japanese companies do have a lot of products that could be of dual use.

Role of Industrial Policy for Economic Security

JS: Do you think industrial policy is playing an important role in raising industries that are dual use? Japanese industrial policy today does not seem to be very powerful, but in some countries like the US or some European countries, industrial policy seems to be becoming more popular.

Kapinos: First of all, the situation in Europe is slightly different from Aisa, because Europe feels under immediate threat. And as you know, there have been some very specific initiatives at the European Union level to increase manufacturing of weapons. This is a very specific and a very clear strategy that we are not really seeing in Japan. Having said that, one good example would be a very powerful push to increase domestic semiconductor manufacturing. We are now finally seeing some onshoring of semiconductor manufacturing returning, and that is in close cooperation with Taiwan. I am sure there are a lot of dual-use goods produced that way. And again, going back to how modern warfare is fought, cutting-edge technology is becoming increasingly important. When speaking about this, we are entering the world of very subjective assessments and it is purely my personal view, but I believe this policy in Japan is insufficient relative to the level of threat that Japan is facing.

JS: Industrial policy used to be considered a protectionist policy, and considered very bad in light of market mechanisms. But now the view of economists seems to be changing. I still believe that intervention in the market is occasionally causing inefficiency in the market. What do you think?

Kapinos: This is a very fundamental question about how markets should operate, and I think one way of looking at it is to take a step back and look at history. Pretty much since the end of World War II, we had Pax Americana, where we had relative stability with few large military conflicts. More or less, we could say that international law was respected and enforced, and obviously the US was the global policeman who enforced these laws – along with other countries, but the US role was very important. On the back of that, we had unprecedented liberalization and globalization, which really gained speed in the 1990s and continued for some time. That created this idea that cross border M&A, for example, is a good thing because it increases your efficiency. You do not have to produce everything locally. You can use global supply chains and that was very positive for companies' profitability, and in terms of what goods the consumers were getting. And I think it increased global wealth very substantially.

The important principle here is that it was all based on the promise that if somebody broke the rules, they were going to be punished, and the US was the global policeman. If you look at what has been happening more recently, this system is starting to crumble. We are seeing that the US is stepping back from this role. This makes it quite hectic and is obviously changing the calculus for companies because they have to account for the possibility that, for example, global supply chains might be less reliable than they used to be. This is reviving the idea that maybe you should be more concerned about reliability and doing things locally. So where does this leave M&A and niche companies? I think we are still going to see international M&A, but companies will be much more careful about which regions they will target and which regions they would be willing to accept money from. And governments are going to become increasingly vocal on what can be sold and what cannot be.

I do know that in Japan there is a list of areas restricted by the government that tells you where you cannot make an acquisition. I would expect this to expand going forward as the situation is changing. Whether or not this is appropriate is a bit of a political question, so I do not think I should be voicing too much opinion on that. This is something for the Japanese government and the people of Japan to decide, but I believe it is important to understand that the global system that supported globalization is breaking down somewhat, so you do have to account for that.

JS: I see. I'm still curious about your view on the market mechanism. Policy authorities are concerned about security and are trying to stop some acquisitions. Do you think this is causing inefficiency in the market and is a legitimate concern?

Kapinos: The answer is yes to both of your questions. Yes, it is going to cause some inefficiencies and increase costs. But is this a legitimate concern? It is a very difficult question, because how do you assess what is a legitimate concern and what is not? You have to have some clear mechanisms in place that tell you this is a safe transaction, and this is a transaction of concern. And governments are not always very good at doing this, but I think it is an appropriate reaction to the changing global environment. How efficiently can the governments do this? This is the second question, which is entirely different.

Economic policy is not my area of expertise but I think Japan generally is doing a decent job in this area, despite implementation challenges. Globally, we see accelerating deglobalization that will cause inefficiencies, which will probably lead to higher costs as well. So, business-wise, this is not a great trend.

Japanese Companies' Earning Capacity & Macro Policy

JS: My last question is related again to macro policy. Japan is in a very difficult budget situation. In order to mitigate inflation, we need to raise interest rates and interest payments will rise. That would add pressure to government debt and eventually that could be disastrous. Therefore, do we perhaps need to raise corporate earnings capacity in order to raise tax revenue? How do you assess Japanese corporate behavior in light of that tax revenue question?

Kapinos: This question is receiving a lot of attention in the financial industry because it has implications for the markets. First of all, the structure of Japanese tax revenue is such that it is predominantly coming from individuals and not from the corporate side. If you look at the OECD statistics, about 40% of Japanese tax revenue is coming from social security contributions, and only about 15% comes from corporate taxes. So overall, the role that individuals play in terms of tax revenue is much more significant. Then we need to take a step back and look at how interest rates, which almost certainly are going to go up in Japan, are going to impact the budget situation. There have been some interesting projections done by market participants, and the ones that I have seen are actually saying that at least for another five years this is going to be positive for Japan. Why? Because higher inflation means higher tax revenues. And for the time being, the rate of inflation is expected to be much higher than the rate of increase in interest rates, causing a positive effect on the amount of outstanding government debt. We have already seen that the share of government debt to GDP came down a little. The analysis that I have seen projects that we are probably going to see this trend continue up to around 2030, at which point the situation will likely reverse and start deteriorating again.

So, where does this leave the tax revenues from the corporate sector? Obviously, if you are in the position of defining economic policy, betting on niche companies will not get you very far. They will increase their profitability and that means that tax receipts will go higher. But if you look at the overall equation, because they are niche players and have less scale to grow their revenues, the resulting expansion of tax receipts is not going to be very high. If the government is trying to do something about that, they probably should encourage other areas.

One area that comes to mind is venture capital. Startups produce outsized levels of growth, and even though the majority of these companies will fail, the successful ones will produce much higher growth rates. If you can create an ecosystem where these companies thrive, you will eventually see higher levels of growth and higher tax receipts on the back of that.

As you know, in Japan this sector is still in its infancy. We do not have many of these companies, but in terms of how much they have grown over the past 10 years, it is quite remarkable. I do know that investors in Europe, for example, are keeping this on their radars. And whereas in the past these startups in Japan were very small and very niche, we are now finally getting to an ecosystem where venture capital is stepping in. They do have the funding that they need, and they are getting increasingly interesting business ideas.

JS: What is your prediction for the growth of Japanese startups?

Kapinos: In my subjective view, they are going to grow quite aggressively, and this has to do with the change in culture, especially among the younger generation. These people are much more opportunistic than previous generations. They do not want to stick to one company for life. Many of them are inspired by Silicon Valley success stories, and willing to start their own businesses, because they see this as a way to earn much more money and do what they like. So I think we are going to see more startups in Japan.

One problem that they must overcome, however, is acquiring a global mindset. In my opinion, this is the most significant hurdle. Many of the startups coming out of Japan tend to address a very niche segment of the market that is usually created by the unique circumstances of Japan, and is very difficult to apply to other markets. I believe this is the biggest problem that they have to overcome, and having a global mindset is crucial to that end. Some of them already do, but many do not. The funding is more or less there already, but it is the mindset that needs to change.

JS: Are there any promising areas for startups in Japan like, for example, artificial intelligence?

Kapinos: At the moment, AI seems to be dominated by some of the larger players. The technology itself is already well established. It is about how you use it. And that comes back to business models. I think it is plausible that there will be startups that can use it in new ways and be successful, but I cannot be certain. It is rather random. At this point, it is just one of many tools at their disposal.

JS: I see. Thank you for your time. JS

Written with the cooperation of David S. Spengler, who is a translator and consultant specializing in corporate communications.