Global Listed Infrastructure

Ame futte ji katamaru / 雨降って地固まる / The land strengthens after the rain (Japanese proverb)

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Leisure travellers are leading the Japanese passenger rail traffic recovery

Pent up demand has resulted in increased spend per passenger in rail companies' retail segments

Decreasing energy demand represents a headwind to Japanese utilities' growth outlook

Capital return opportunities remain plentiful in Japan, in contrast to most other developed markets

Last quarter I visited infrastructure companies in Tokyo, Osaka and Nagoya. The trip included visits to ten corporate head offices and three site tours. This paper seeks to share some of the key findings from my meetings with Japanese passenger rail and utility companies.

Recovery in travel and retail spend

Traffic recovery remains the key upside risk for Japanese passenger rail (JR) companies. While Japan was one of the last countries to re-open its borders after COVID-19, travellers have quickly returned to both Shinkansen (bullet train) and Conventional (local) railways. Leisure demand has led the way, and has now surpassed pre-pandemic levels. Business travel volumes are still approximately 10% lower. The following chart illustrates JR West's traffic recovery (note, Shinkansen has a higher mix of business passengers than Conventional).

JR West – Passenger volumes vs 2019 levels

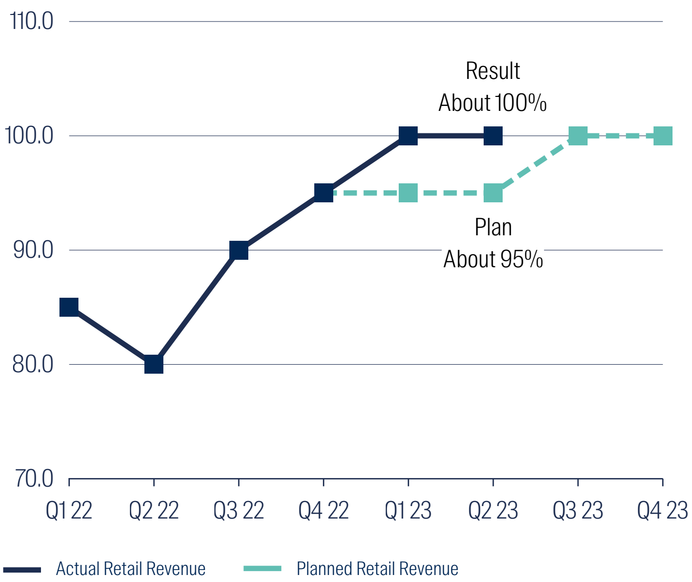
Shinkansen Conventional

Source: FSI, Company data.
Data as at 30 September 2023.

COVID-19 was downgraded by Japan from infectious disease status (requiring quarantine) in May 2023. Since then, business travel has increased as workers have begun to return to the office full time. We assume this recovery trend will continue throughout 2024.

Retail spend per passenger has also recovered to above pre-pandemic levels, highlighting the pent up travel and spending demand present in Japan. Although passenger volumes for JR Central and JR East have not yet recovered to 2019 levels, retail revenue for both companies has already reached 2019 levels owing to increased spend per passenger. The following chart illustrates the recovery in JR East's retail revenue over recent quarters.

JR East Retail Revenue (%, compared with December qtr, 2019)



Source: First Sentier Investors, company data and estimates. Data as at 31 October 2023.

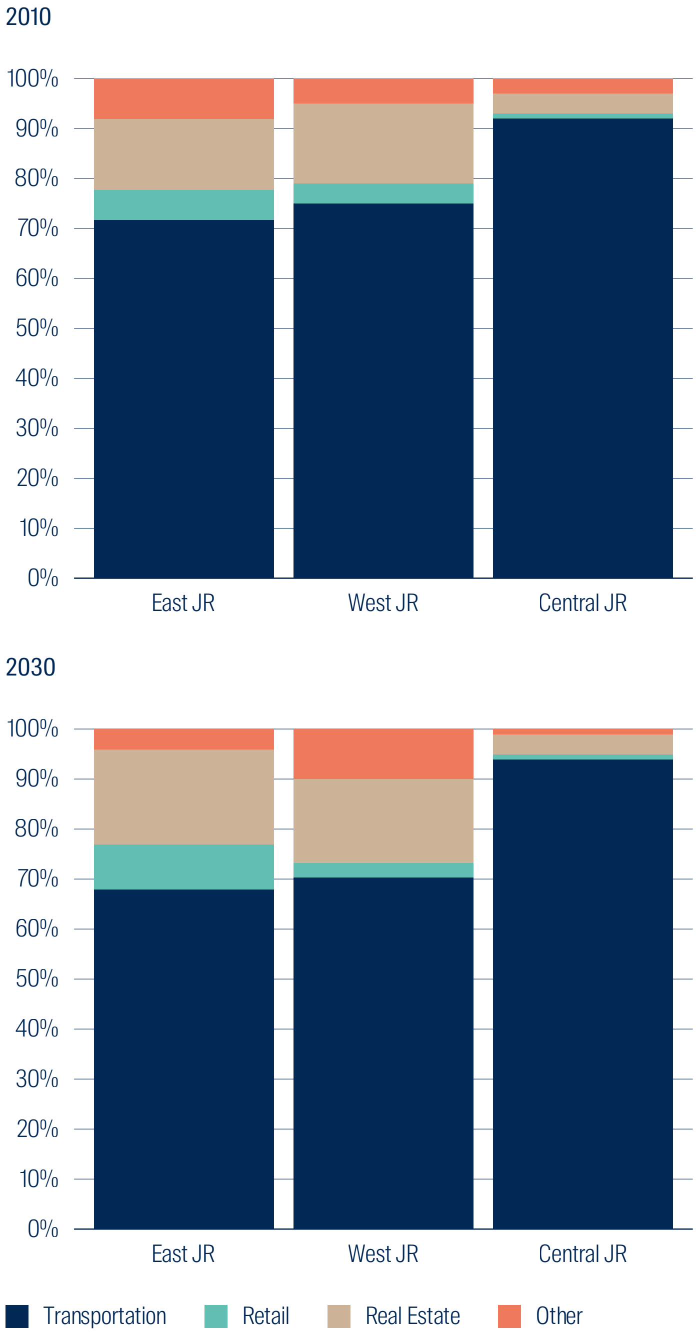
We expect that retail revenues will continue to grow; although pent-up demand may wane, the return of additional passengers over time is expected to make up for this.

Stations or cities?

The Japanese rail companies are investing more into their retail and real estate businesses than ever before. For example, JR East estimate that by 2027 their revenue split will be 60% transportation and 40% other (ie real estate and retail). The company plans to target a 50/50 split after 2027. Over the next three years, JR West plans to allocate 60% of their growth capex[1] towards real estate and city development, and only 20% to their transportation business[2]. We believe that this is likely to help offset the demographic challenges facing Japan; namely an ageing and declining population.

As the following charts illustrate, we expect that transportation will decrease as a proportion of the overall business for JR East and JR West, while real estate becomes more significant for both companies. JR Central remains the outlier, owing to its investment related to the "Maglev" or Chuo Shinkansen (a new Shinkansen route from Tokyo to Osaka that will travel 500km/hr and take 67 minutes).

EBITDA[3] split 2010 vs 2030



Source: Company Data, FSI estimates.
Data as at 31 October 2023.

1 A form of capital expenditure undertaken by a company in order to expand existing operations or to further its growth prospects.
2 Source: Company data, First Sentier Investors, as at 31 October 2023.
3 Earnings Before Interest Taxes Depreciation and Amortisation.

Even with the current 10% decline in business travel, the JRs have had the benefit of their revenues being diversified beyond the transportation business. For example, transportation revenue for JR West recovered to 86% of pre-COVID-19 levels in the June quarter of this year, while real estate revenue was 114%[4]. We assume transportation will reach 100% of pre-pandemic levels in Japan (as they have in other parts of the world) by March 2025. We think that continued investment in their real estate and retail segments are important to their growth outlook, and that doing so provides risk to the upside.

Visiting Osaka Station

This is the point where the station meets the sky bridge to office and hotel buildings and escalators to the department stores.

Source: First Sentier Investors

For those visiting Japan, it is amazing to witness the scale of the railway stations and the synergies between the rail, real estate and retail businesses. When JR Central constructed the JR Gate Tower and JP Tower in 2017 (above their station in Nagoya), it transformed the city. When touring this, you can see first-hand the flow-through effect and synergies of connecting the four tower blocks through a pathway called the "sky street" on Level 15 of each of them. JR Central have created a hub. The bottom floor is the bus, train, taxi and Shinkansen terminal. Passengers must then travel up through department stores, retailers and restaurants in order to reach the "sky street" which connects the hotel and office lobbies of all 4 towers. Having this monopoly, has enabled JR Central to shift Nagoya's downtown to above their station, where they will also eventually connect the "Maglev".

I also toured JR East's new Miraina tower (a large scale, modern office building). The company has shifted the ticket gates of Shinjuku railway station to connect through to the lobby. This competitive advantage is something that cannot be replicated. We think by investing and developing office buildings, hotels and department stores, the JR companies will turn their stations into "hubs" that people travel to, not through.

Shinjuku Station surrounded by offices, hotels and department stores

Source: First Sentier Investors

Utility demand and growth challenged

Similar to the Japanese rail companies, the country's utilities are also experiencing challenges with growth. Unlike the rails however, they have the added headwind of decreasing demand. Every utility I visited attributed this to warmer weather, declining service territory populations, more efficient appliances, better insulated buildings and energy saving targets from the government. While warmer weather is usually negative for gas demand but positive for electricity demand, the positive impact is not enough to offset the other factors driving the decline in demand.

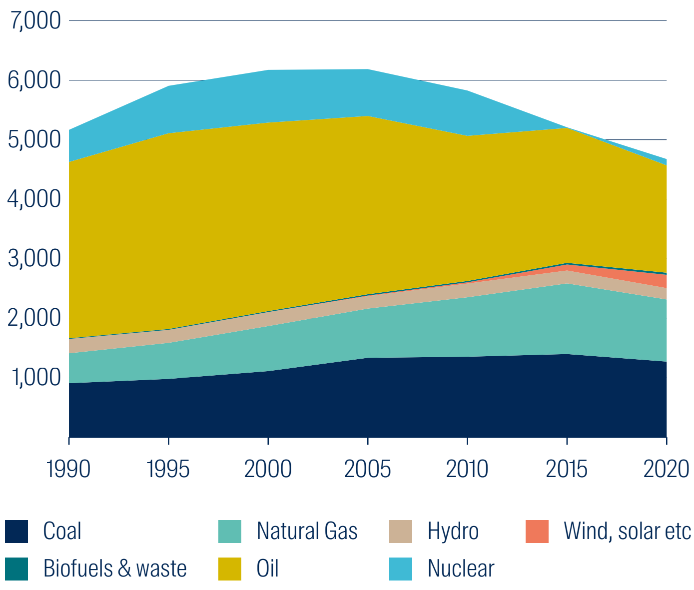
4 Source: Company data, First Sentier Investors, as at 31 October 2023.

To compensate for this, Japan's utility companies are seeking other avenues of growth. While you may expect their investment to be focused on domestic renewables such as solar and onshore wind, this market remains restricted by Japan's challenging topography and limited space. The alternative low carbon energy sources – offshore wind and nuclear – both have their hurdles. The biggest obstacle to nuclear remains negative public sentiment and earthquake / tsunami risk, as seen with the 2011 Fukushima disaster. Prior to the earthquake in 2011, 30% of Japan's energy needs were met by its 54 nuclear power plants. Today only 12 nuclear power plants have been restarted that make up around 8% of the energy mix today[5].

Japan's challenge with offshore wind is its deep coastal waters. This means that offshore wind farms would need to be floating rather than fixed to the sea bed, which comes with additional cost.

For these reasons, Japan's utilities have selected different markets to invest in. For Tokyo Gas this includes US shale gas; Osaka Gas is exploring gas distribution in India; while Kansai Electric Power is investing in data centres. The list goes on. Though these investments may help their growth targets, they are diversifying away from their core strategies and geographies, which comes with its own risks.

Japan energy supply (historic) mtoe (million tonnes of oil equivalent)



Source: IEA

Net Zero by 2050?

When speaking about the Net Zero targets set by the government, Japanese utilities almost all said that the targets will be challenging to meet. The government's current targets imply an energy mix of 30-40% nuclear and carbon capture and storage (CCS), and 50-60% renewables by 2050[6].

These targets seem optimistic; this amount of nuclear would need all existing plants to be restarted and new nuclear plants to be built. The necessary amount of CCS would require a substantial amount of space to be made available. Also, while nuclear plants are now being restarted and public sentiment is gradually warming to this, I expect there would be backlash if any new nuclear plants were proposed.

Capital management

Selected Japanese listed infrastructure firms have under-levered Balance Sheets, in a country with very low interest rates compared to the rest of the world. This backdrop enabled JR West to increase its dividend in late 2023, with further upside potential in 2024 and 2025. Osaka Gas recently announced its first share buyback since 2010, in a move that was broadly welcomed by shareholders. We have been advocating for Japanese companies to increase their dividend payout ratios, so this has been positive to see.

These increased capital return opportunities in Japanese infrastructure are in contrast to companies in the rest of the developed world which face higher interest expenses and increased equity needs.

5 Source: International Energy Agency as at 31 October 2023.
6 Source: JERA as at 31 October 2023.

Important Information