

The value of digital payment

Equity preferences **30 August 2019 – 08:28 am BST**

Chief Investment Office GWM

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- Japan is one of the last holdouts for cash in the developed world, but with government encouragement, it should now transition more rapidly to digital payment systems.
- The country is well-positioned to transform from an analog cash-based economy to a digital-money economy, given that it needs to improve productivity due to a shrinking workforce.

Over the past decade, smartphones have brought many of the things we use and consume daily onto a single hand-held device. Messages, pictures, movies, music, books and newspapers are now stored on or fed through to our smartphones, which have replaced other forms of media and communication.

Smartphones now look ready to take on one of the last great analog holdouts. Soon, we believe cash will no longer move so readily from hand to hand in Japan, and along with the rising use of plastic, we expect transactions via the smartphone to make headway.

Eighty percent of all payments in the country are currently in cash; only 20% are via plastic. The slow adoption of IC-chip-based cards is partly due to their cost given the still relatively low level of competition among Japanese banks, and partly because the ATM network is so ubiquitous. China, South Korea and many other countries are more advanced in terms of cashless payments.

The government's "Cashless Vision" initiative expects a boost in the cashless ratio from 20% currently to 40% by 2027. Even before this initiative, Japan had changed its banking laws in 2017, allowing third-party players access to accounts with the holder's approval. This regulation allows account holders to move money more easily from a bank to a digital wallet using their mobile phone.

By 2026, we expect 40% of total payments in Japan to be noncash, and 7–10% to be made via digital cash – online, contactless payment systems linked to digital wallets and bank accounts. Despite its low popularity currently, we are optimistic digital money will gain momentum in the next two to three years and its use will also exceed that of prepaid travel cards such as Suica and Pasma by 2026.

Recent developments

Over the past six months, several internet-related companies have launched digital payment systems, including Pay Pay by one of the largest internet operators, LINE Pay and Rakuten Pay.

The value-added tax in Japan will rise to 10% from 8% in October, but consumers can get back 5% if they use cashless payments. Though this move will end in June 2020, it will likely motivate many people to start using digital payments in their daily transactions. While momentum is gaining pace, most existing users of digital pay-



Toru Ibayashi



Chisa Kobayashi

Most Preferred	
KDDI	JPY
LINE	JPY
NTT	JPY
Rakuten	JPY
Sumitomo Mitsui Financial Group	JPY
Yahoo Japan	JPY

Source: UBS

Thematic Benchmark: MSCI Japan

ments are early adapters or heavy internet users who already shop almost exclusively online. So we believe the Japanese government's support for cashless payments will be a game-changer for consumer behavior.

Recent CIO selection changes

Company / Trade Date	Old	New	Comment
Rakuten 30/8/2019		Most Preferred	Rakuten is one of the major digital payment platformers in Japan, but unlike its rivals, the company does not spend much on marketing promotion. Also, its operations are supported by Rakuten EC and credit card users. We like Rakuten's strength in credit card business in Japan.
Japan Post Holdings 27/8/2019	Most Preferred	Removed	The recovery of Japan Post's insurance earnings will likely take longer than we expected, thus we remove the stock from our EPL.
LINE 26/7/2019		Most Preferred	We think LINE Pay is well positioned to become a leading mobile cashless payment system in Japan that will reduce labor costs and improve efficiency. The upcoming government digital cash-back initiative (5% of sales if payment is made by cashless) should cashless payment adoption in Japan to the next level, in our view.
Screen Holdings 9/7/2019	Most Preferred	Removed	After recent outperformance of the share price, we believe near-term positive catalysts have mostly priced into the share price. Thus, we remove SCREEN from our EPL.
Rakuten 28/6/2019	Most Preferred	Removed	After recent outperformance of the share price, we believe near-term positive catalysts have mostly priced into the share price. Thus, we remove Rakuten from our EPL.
Mizuho Financial Group 27/6/2019	Most Preferred	Removed	The company revealed the new mid-term plan, in which they touched upon a possible use of capital for growth investments and dividends/share buybacks. However, we believe it will take a bit more time until we see catalysts. Thus, we remove Mizuho Financial Group from our EPL.
Rakuten 27/5/2019		Most Preferred	Rakuten is one of the major digital payment platformers in Japan, but unlike its rivals, the company does not spend much on marketing promotions. Also, its operations are supported by Rakuten EC and credit card users.
Fujitsu 22/5/2019	Most Preferred	Removed	After recent outperformance of the share price, we believe near-term positive catalysts have mostly priced into the share price. Thus, we remove Fujitsu from our EPL.
LINE 22/5/2019	Most Preferred	Removed	While we still believe LINE Pay will be a leading mobile payment application over the long term, its strategic business is in the investment phase and operating losses are expected to widen for some time. Thus, we are removing LINE from our EPL.
Rakuten 1/4/2019	Most Preferred	Removed	After recent outperformance of the share price, we believe near-term positive catalysts have mostly priced into the share price. Thus, we remove Rakuten from our EPL.
Tokyo Electron 22/2/2019	Most Preferred	Removed	After recent outperformance of the share price, we believe near-term positive catalysts have mostly priced into the share price. Thus, we remove Tokyo Electron from our EPL.
GMO Internet 14/2/2019	Most Preferred	Removed	After recent outperformance of the share price, we believe near-term positive catalysts have mostly priced into the share price. Thus, we remove GMO Internet from our EPL.
KDDI 14/2/2019		Most Preferred	We believe KDDI's smartphone-based payment platform and financial services business should boost customer retention and average revenue per user (ARPU) over the long term. A relatively high dividend yield should support its share price.
Mitsubishi UFJ Financial Group 6/11/2018	Most Preferred	Removed	UBS CIO has become restricted on the name and, thus, removed it from the Equity Preference List where it has been previously.
Screen Holdings 5/11/2018		Most Preferred	We believe higher digital payment needs will lead to larger data saver capacity and stronger DRAM demand, which should benefit Screen Holdings' earnings over the long term. Given Screen's world-leading position in the semiconductor manufacturing equipment sector, we believe its shares are undervalued.

The value of digital payment Equity preferences

Name	Selection	ISIN	CCY	Share Price	52 Week		P/E		Div Yield		P/BV	Div. Cover
					High	Low	19E	20E	19E	20E		
KDDI	Most Preferred	JP3496400007	JPY	2,830.00	3,173.00	2,331.50	10.8 x	11.2 x	3.92%	4.15%	1.5 x	2.4 x
LINE	Most Preferred	JP3966750006	JPY	3,650.00	5,140.00	2,911.00					5.3 x	
NTT	Most Preferred	JP3735400008	JPY	5,061.00	5,294.00	4,050.00	10.9 x	10.4 x	3.73%	4.01%	1.0 x	2.4 x
Rakuten	Most Preferred	JP3967200001	JPY	954.00	1,313.00	707.00	16.2 x	57.3 x	0.46%	0.46%	1.5 x	13.4 x
Sumitomo Mitsui Financial Group	Most Preferred	JP3890350006	JPY	3,429.00	4,775.00	3,380.00	6.6 x	6.4 x	5.47%	5.80%	0.4 x	2.8 x
Yahoo Japan	Most Preferred	JP3933800009	JPY	263.00	415.00	250.00	15.3 x	13.8 x	3.38%	3.38%	1.5 x	1.9 x

Based on consensus estimates provided by Factset as of August 29, 2019

Name	Sector Country	ISIN Valor	Currency Share Price	52w High 52w Low	Selection Analyst
KDDI	Communication Services Japan	JP3496400007 249625	JPY 2,830.00	3,173.00 2,331.50	Most Preferred toru.ibayashi@ubs.com UBS Securities Japan Co., Ltd.

Company profile

KDDI was founded in October 2000 through the merger of DDI, KDD and IDO, becoming KDDI in April 2001. The company's core segments include Personal (au mobile, FTTH, CATV), Value (financial/commerce, apps, movie/music distribution), Business (ICT solutions, corporate data centre services), Global (overseas communications for corporates/individuals) and Others (telecom facility construction/maintenance). The current three-year plan calls for a transformation from a telecoms provider to a life design company by offering settlement, merchandise sales, energy/financial services and further growth in domestic telecoms.

What drives our opinion

KDDI's Smart Money Concept aims to establish strong and long-term engagement with its subscribers by strengthening smartphone-based payment settlements and by reinforcing its smartphone-based financial services offering. It currently offers credit card, prepayment, bank and loan services, and will soon start online securities services through a partnership. We believe KDDI can bolster its smartphone-based payment services and increase ARPU over the long term. The telecom company targets EPS to grow by 1.5x in FY25 driven by earnings growth and continuous share buyback. A relatively stable dividend policy and high dividend yield should support the share price's downside risk.

Why it is Most Preferred

We believe KDDI's smartphone-based payment platform and financial services business should boost customer retention and average revenue per user (ARPU) over the long term. A relatively high dividend yield should support its share price.

LINE	Information Technology Japan	JP3966750006 32886296	JPY 3,650.00	5,140.00 2,911.00	Most Preferred toru.ibayashi@ubs.com UBS Securities Japan Co., Ltd.
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Company profile

LINE Corp operates the mobile messaging application LINE, which is a global platform started in Japan in 2011. It has 165m global monthly active users in its four major markets: Japan, Taiwan, Thailand and Indonesia (as of Q118). The company was dual listed on the Tokyo Stock Exchange and the New York Stock Exchange in July 2016. Naver Corp, based in Korea, is its parent company (73.3% stake as of Q118).

What drives our opinion

We believe Japan will transform into a cashless society in the next few years, and LINE is well positioned for future growth through its LINE Pay platform. Although there is no clear winner yet among the mobile payment platforms in Japan, LINE has disclosed the most aggressive loyalty scheme and vendor acquisition initiative in Japan so far. LINE's strength is that it has a very large number of monthly active users (164m) through its messenger service applications. A UBS survey highlighted that millennials regard LINE Pay as the leading service in the cashless space. We believe LINE Pay will be a game changer for the company, as it should improve LINE's sales mix and drive the company's profit for the next few years.

Why it is Most Preferred

We think LINE Pay is well positioned to become a leading mobile cashless payment system in Japan that will reduce labor costs and improve efficiency. The upcoming government digital cash-back initiative (5% of sales if payment is made by cashless) should cashless payment adoption in Japan to the next level, in our view.

NTT	Communication Services Japan	JP3735400008 764057	JPY 5,061.00	5,294.00 4,050.00	Most Preferred toru.ibayashi@ubs.com UBS Securities Japan Co., Ltd.
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Company profile

First established in August 1952, NTT was privatized in April 1985. It realigned its corporate structure in July 1999 with NTT as a holding company and fully-owned subsidiaries NTT East/West and NTT Communications. Its core segments include regional, long-distance and international and mobile communications; data, including network system services and system integration; and others (real estate, finance, construction, electric power). Its current medium-term plan pursues a B2B2X model for sustainable growth and aims to provide individual and corporate clients with value through a variety of service providers.

What drives our opinion

Japan is moving towards becoming a cashless society. We believe NTT is in a very good position to take advantage of this movement through its subsidiaries NTT Data and NTT Docomo. NTT Data is one of the major data management companies in Japan and will likely play a crucial part in the big data business, while NTT Docomo is a core telecom player working closely with the Japanese government on its cashless society vision. NTT's mid-term plan is to increase EPS by 40% from FY2019 to FY2023 by earnings expansion and share buybacks. NTT offers a relatively high dividend yield which reduces downside risks for the share price, in our view.

Why it is Most Preferred

NTT plays a crucial part in digital payments, mainly through its subsidiaries. The telecommunication company's stable cash-flow every year and relatively high dividend yield buoy the share price.

Name	Sector Country	ISIN Valor	Currency Share Price	52w High 52w Low	Selection Analyst
Rakuten	Consumer Discretionary Japan	JP3967200001 1065454	JPY 954.00	1,313.00 707.00	Most Preferred chisa.kobayashi@ubs.com UBS Securities Japan Co., Ltd.

Company profile

Japan's biggest e-commerce operator, Rakuten has created a unique 'eco-system' by combining merchandise e-commerce (Rakuten Ichiba), services e-commerce (Rakuten Travel, etc.), and financial operations (credit cards, banking, securities, etc.). The company has established a good balance between the analogue (e-commerce consultants, strong confidence with outlets) and digital areas (including data science). Rakuten also stands out on the global stage as an Internet firm. The Vision 2020 plan that it announced in February 2016 targets OP of ¥300bn in December 2020.

What drives our opinion

Rakuten is one of the largest e-commerce operators in Japan and issues credit cards by leveraging its large number of e-commerce users. While Rakuten's plan to launch a mobile phone operation is not welcomed by investors due to the large amount of capital expenditures required, this cost should be less than initially expected. In recent months, its peers have also launched mobile payment services that should drive digital payment usage in Japan. We believe Rakuten is one of the leading companies in the fintech area and that it can leverage its e-commerce user base to expose customers to other services, boosting future earnings. Thus, we still believe the shares are undervalued.

Why it is Most Preferred

Rakuten is one of the major digital payment platformers in Japan, but unlike its rivals, the company does not spend much on marketing promotion. Also, its operations are supported by Rakuten EC and credit card users. We like Rakuten's strength in credit card business in Japan.

Sumitomo Mitsui Financial Group	Financials Japan	JP3890350006 1479596	JPY 3,429.00	4,775.00 3,380.00	Most Preferred toru.ibayashi@ubs.com UBS Securities Japan Co., Ltd.
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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 Cedyne Financial became wholly owned subsidiaries in 2009 and 2010, respectively.

What drives our opinion

While the company's share price has significantly underperformed against the market benchmark index for the last two years, we believe a modest hike of long-term interest rates should drive its share price up from 2H18 onwards. Also, Sumitomo Mitsui Financial Group's medium-term business plan focuses on cost reduction and business concentration, unlike the previous one that called for top-line growth. Digitalization should also enhance a business environment and should optimize its cost structure. The company's price-to-book value is trading well below 1x, and its relatively high dividend yield should limit the share price's downside risk.

Why it is Most Preferred

Sumitomo Mitsui FG is one of the core major banks that would lead digital payments in Japan. The bank revealed its cashless strategy in early 2018. Cashless payments would benefit the bank not only from cost reductions in note/coin management and ATM operations, but they will also enable the bank to leverage customers' payment data to improve services, in our view.

Yahoo Japan	Communication Services Japan	JP3933800009 721046	JPY 263.00	415.00 250.00	Most Preferred toru.ibayashi@ubs.com UBS Securities Japan Co., Ltd.
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Company profile

Yahoo Japan is Japan's number one Internet company. Media and commerce are the core business segments. The media business runs the Yahoo! JAPAN portal and various internet services/mobile apps. The company earns revenue mainly from display ads (Yahoo! Display Ad Network and brand panels) and search-linked advertisements. The commerce business runs e-commerce related services (Yahoo! Auction, Yahoo! Shopping, Yahoo! Travel, etc.), subscriber services (Yahoo! Premium, Yahoo! BB, etc.), settlement and finance-related services (Yahoo! Wallet, Yahoo! Card, etc.) and obtains fee income and member revenues.

What drives our opinion

Yahoo Japan operates a popular search engine in Japan. Its new management team is changing the company's business model to focus on new revenue streams. With Japan becoming a cashless society, we believe its new cashless payment service, PayPay, operated along with Softbank, will drive earnings. Yahoo Japan's e-commerce businesses allow users to make purchases by using their Yahoo points, Softbank mobile payments and other financial services via PayPay. The Japanese government also supports the cashless market and is planning a rebate program for cashless payments to offset the impact of the VAT hike due in October. This should encourage consumers to embrace cashless payments.

Why it is Most Preferred

We believe Yahoo is well-positioned to take advantage of the potential long-term growth of Japan's cashless market. The government also plans to assist new technologies, which should also support the company's earnings growth.

Toru Ibayashi, Analyst, UBS Securities Japan Co., Ltd.



Based in Tokyo, I'm responsible for interpreting Japan's economy, corporate earnings, political changes, and providing investment insights. I was senior investment manager at another asset management firm before joining UBS in 2006. I have an MBA from the Goizueta Business School at Emory University in Atlanta, Georgia, and am a chartered member of the Securities Analysts' Association of Japan.

Toru Ibayashi

Chisa Kobayashi, Analyst, UBS Securities Japan Co., Ltd.



Chisa Kobayashi is an Analyst at UBS CIO WM in Tokyo, joining the team at the end of 2013. Prior to joining UBS, Chisa worked in sell-side research starting 2007, covering the Japanese auto sector as well as global auto sector research. Chisa also had covered Japanese mid- and small-cap stocks.

Chisa Kobayashi

Appendix

Contact

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UBS CIO GWM equity selection system

We provide two equity selections: Most Preferred (MP) and Least Preferred (LP).

Most preferred

We expect the stock to outperform the benchmark in the next 12 months.

Least preferred

We expect the stock to underperform the benchmark in the next 12 months.

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Most Preferred	86%

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LINE 4, Rakuten 3, 5, Sumitomo Mitsui Financial Group 1, 2, 3, 4, 5, 6, 7, 8; Yahoo Japan 3,

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History of Selection Changes (past 12 months)

Company	Selection Date	Selection Status
Fujitsu	22.5.2019	Not Listed
GMO Internet	14.2.2019	Not Listed
Japan Post Holdings	27.8.2019	Not Listed
KDDI	14.2.2019	Most Preferred
LINE	26.7.2019	Most Preferred
	22.5.2019	Not Listed
Mitsubishi UFJ Financial Group	6.11.2018	Not Listed
Mizuho Financial Group	27.6.2019	Not Listed
Rakuten	30.8.2019	Most Preferred
	28.6.2019	Not Listed
	27.5.2019	Most Preferred
	1.4.2019	Not Listed
Screen Holdings	9.7.2019	Not Listed
	5.11.2018	Most Preferred
Tokyo Electron	22.2.2019	Not Listed
	18.9.2018	Most Preferred

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