Meiji Institute for Global Affairs

MIGA COLUMN GLOBAL DIAGNOSIS

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Short Curriculum Vitae - Sumitaka Fujita

Joined C. Itoh & Co. (the current ITOCHU Corporation) in 1965.

Appointed Director of the Board in charge of Business Development in 1995, Managing Executive Director in 1997, Senior Managing Executive Director and CFO in 1999, Executive Vice President and CFO in 2001, Executive Vice President, CAO, CFO, and CCO in 2003, Vice Chairman in 2006, Senior Corporate Advisor in 2008, and Advisory Member in 2011 (current position).

Other Positions:

Appointed Outside Director of Orient Corporation in 2007, Outside Director of Furukawa Electric Co., Ltd. in 2008 (current position), Outside Director of Nippon Sheet Glass Co., Ltd. in 2009, Outside Director of NKSJ Holdings in 2010, Chairman of Japan Association for Chief Financial Officers (JACFO) in 2011 (current position), and Outside Director of Olympus Corporation in 2012 (current position).

ROE, Financial Strength, Shareholder Return, and Stock Price Performance among Japanese Companies

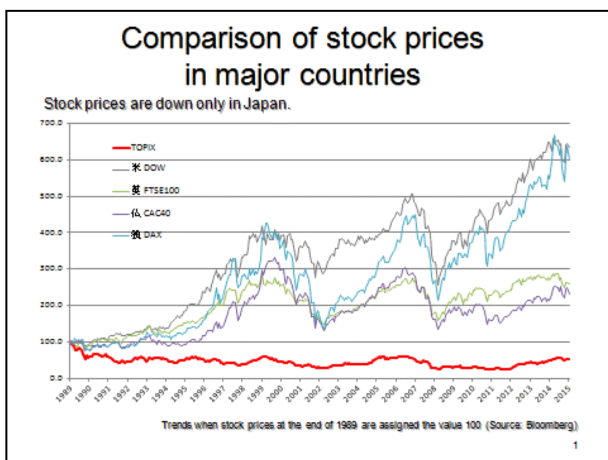
- Characteristics and issues by comparisons of Japanese, U.S., and European companies –

The figure in Data-1 compares Japanese companies with U.S. and European ones in respect of stock price performance over the last 25 years. As shown in this figure, the performance of Japanese stock has clearly been inferior. When the level in 1989 is assigned the value 1, stock prices have undergone four- to five-fold increases at U.S. and German companies and two- to three-fold increases at U.K. and French companies. In

contrast, they have basically been flat (1 or less) at Japanese companies. (The Japanese figure rose slightly in 2015, but went back down in 2016. The general trend is as noted above.)

One of the factors behind this trend is capital efficiency. There are data indicating that the return on equity (ROE) over the last 30 years among Japanese companies (on the basis of stocks on the Tokyo Stock Price Index (TOPIX)) averaged 5 percent. Meanwhile, cost of shareholder's equity among Japanese companies may be placed in the range of 6 – 7 percent. Viewed from the perspective of capital efficiency, this means that not even cost of shareholder's equity can be covered, and may evidence the correlation with the aforementioned poor stock price performance. The figure in Data-2 presents a comparison of companies in the various countries over the last few years in respect of ROE. It can be seen that, even in recent years, there has been no change in the relative inferiority of Japanese companies in this respect.

(Data-1)



(Data-2)

ROE at companies in various countries

	December 2011	December 2012	December 2013	December 2014	December 2015
Japan (stocks included in TOPIX)	3.3	5.7	8.5	8.5	7.7
U.S. (stocks included in the S&P 500)	15.0	13.6	15.3	15.1	12.1
UK (stocks included in the FTSE 100)	16.0	9.4	12.6	15.7	5.7
China (stocks included in the SSE Composite Index)	15.3	13.9	14.0	13.7	11.0
World average (stocks included in the MSCI World Index)	11.7	10.6	12.1	12.4	9.5

Data source: Bloomberg

Viewing this area from a slightly different perspective, the figure in Data-3 below compares major Japanese, U.S., and European companies in respect of ROE, debt/equity (D/E) ratio, and short-term liquidity/monthly turnover ratio.

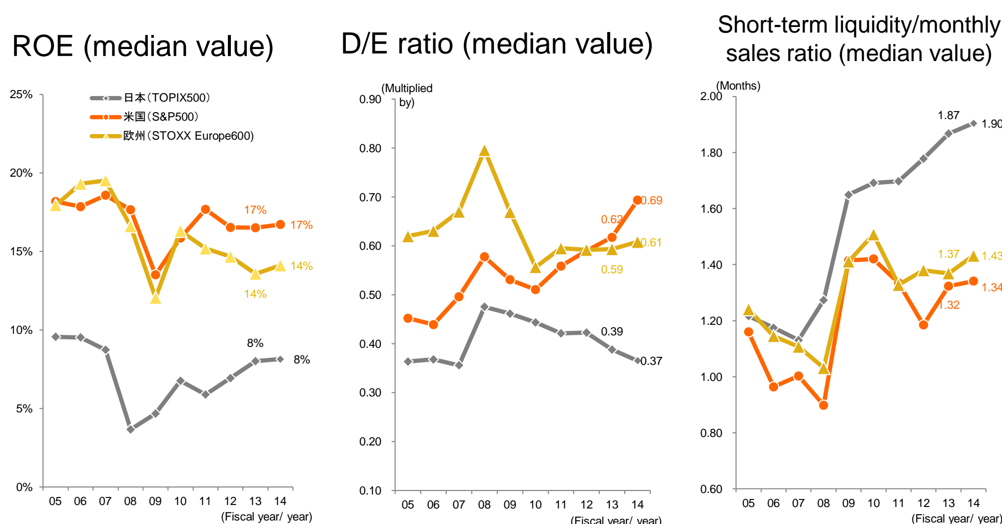
The trend in the recent past shows that the median ROE figure is about 8 percent among Japanese companies, lower than the corresponding figures of about 14 percent among European companies and about 17 percent among U.S. companies. However, Japanese companies have a better D/E ratio at 0.37 as compared to 0.61 among European companies and 0.69 among U.S. companies. As such, they could be said to have superior

financial strength. This trend is reflected in that appearing in the comparison on the basis of the short-term liquidity/monthly turnover ratio. The ratio is 1.34 among U.S. companies and 1.43 among European companies as compared to 1.90 among Japanese companies. It can be seen that the Japanese companies generally have a higher short-term liquidity.

While some are of the opinion that the difference in leverage is the main cause of the low ROE among Japanese companies, a comparison with respect to the three factors making up ROE (i.e., financial leverage, total assets turnover ratio, and profit margin) reveals that the leverage and turnover ratio are about the same; the difference lies in the sales profit margin . In short, there are data indicating that margins among Japanese companies are less than half as high as those among U.S. and European companies, and that this is responsible for the low ROE. Therefore, it is clear that a difference of leverage is not the cause.

(Data-3)

Trend of ROE, D/E ratios, and short-term liquidity/monthly sales ratios among major companies in Japan, the United States, and Europe



Note: Based on companies that were included in the major stock indices (TOPIX 500 for Japanese companies, S&P 500 for U.S. companies, and Dow Jones STOXX Europe 600 for European companies) for the last ten consecutive years and enabled acquisition of the pertinent data (excluding companies in the financial industry; 377 Japanese companies, 354 U.S. companies, and 384 European companies over the ten consecutive fiscal years 2005 – 2014).

Data are as of March 8, 2016 for Japanese companies and March 30, 2016 for U.S. and European companies.

ROE = Net profit divided by average equity capital at the beginning and end of the term D/E ratio = Interest-bearing debt divided by equity capital. Short-term liquidity/monthly sales ratio = Short-term liquidity divided by sales x 12. A 12-month conversion was made for irregular settlements.

Figures for net profit are those before payment of dividends for preferred stock. Equity capital is equal to shareholder's equity for Japanese companies and ordinary stock plus preferred stock for U.S. and European companies. ROE and D/E ratios exclude excess of debt.

Source: Prepared by Nomura Securities Co., Ltd. based on the Nomura Research Institute data base for Japanese companies and the Thomson Reuters data base for U.S. and European companies.

2

Here, let us take a look at the situation as regards shareholder return among major Japanese, U.S., and European companies from the perspective of total amount, dividend

ratio, and total return ratio.

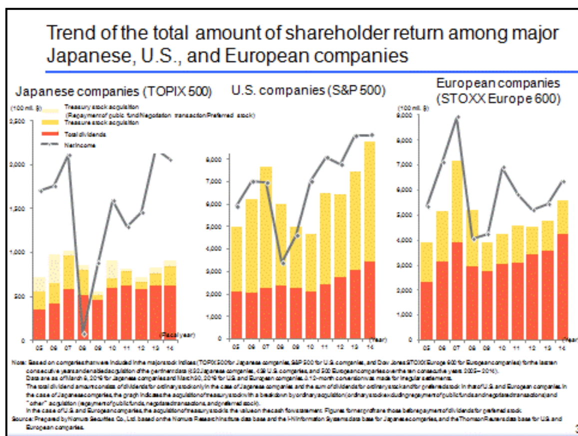
In the first place, as shown in Data-4, the total shareholder return as percentage of the amount of net profit in the term in question among Japanese companies is much lower than that among U.S. and European companies. In addition, whereas dividends account for the main part (almost all) of the shareholder return among Japanese companies, it can be seen that almost all of the net profit is directed to shareholder return among both U.S. and European companies. Another characteristic of U.S. companies is that most of their shareholder return derives from share buy back. At European companies, on the other hand, dividends account for the main part of shareholder return, as at Japanese companies.

Next, let us view the trend of dividend ratio (dividend amount divided by net profit) and total return ratio ((dividend amount plus share buy back) divided by net profit). This trend is shown in the figure in Data-5 below.

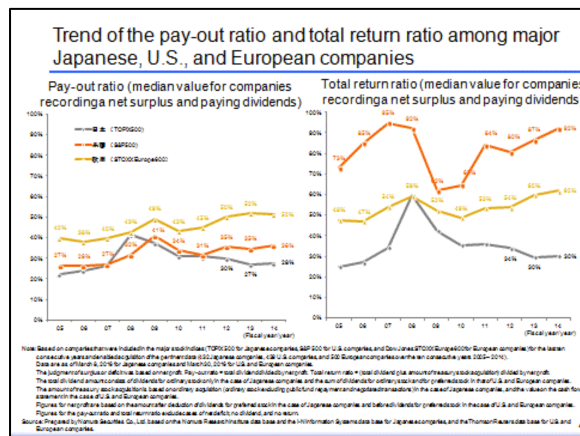
Dividend ratio at Japanese companies (28 percent) is on about the same level as at U.S. companies (36 percent), but the corresponding figure for European companies is higher than Japan's at 52 percent and has been in the range of 40 – 50 percent since 2004. In contrast, the total return ratio among Japanese companies is clearly lower than among U.S. and European companies (It is 92 percent for U.S. companies, 62 percent for European companies, and 30 percent for Japanese companies).

Among U.S. companies, the total return ratio was about 90 percent in 2007 and 2008, dropped to about 60 percent in 2009 and 2010, and again rose to the 90-percent order in 2014.

(Data-4)

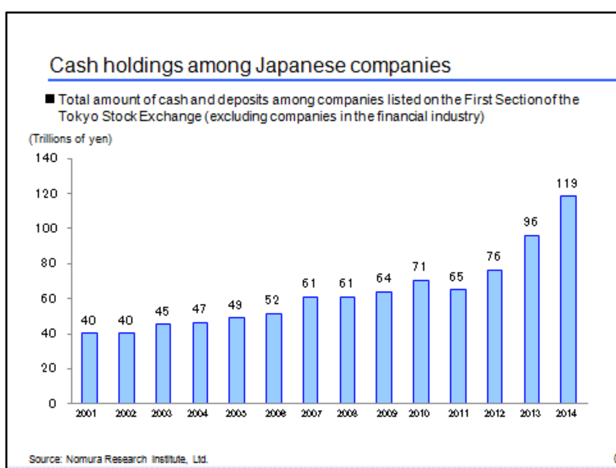


(Data-5)

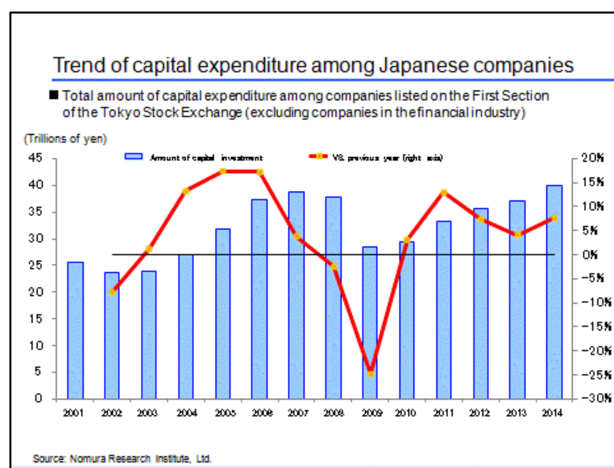


To shift our perspective a bit, let us consider the figures in Data-6 and 7 below, which show the trend of capital expenditure and the cash holdings among Japanese companies. It may first be noted that cash held by Japanese companies reached a record-high 119 trillion yen in fiscal 2014. In contrast, capital expenditure was up only slightly from the previous year even in fiscal 2014. In addition, there are data showing that the rate of cash equivalent relative to the market capitalization among Japanese companies is about twice as high as among U.S. and European companies in terms of the general trend over the last ten years.

(Data-6)



(Data-7)



As indicated by the above, capital efficiency among Japanese companies is lower than that among U.S. and European companies as far as ROE is concerned, but the net profit posted is generally not cashed out, and there is also relatively less reinvestment of it for growth. One can see that Japanese companies tend to attach less priority to shareholder return (dividends and share buy back), and to keep cash on hand.

As a result, they also have relatively plentiful internal reserves and sounder financial strength. As viewed from the standpoint of the optimal capital structure, they also characteristically have considerable resiliency, in the sense of preparedness for financial crises and demand for funds in emergencies.

In the eyes of investors, nevertheless, this may mean that there are not very good prospects for growth. A low ROE and a paucity of opportunities for growth suggest that investors cannot expect much in the way of a proper return to shareholders, and consequently are not going to vigorously invest in such companies. In other words, there

is little appeal for the stock market of Japan, and this could induce a vicious circle in which the market fails to attract even risk money needed to spur the growth of industry. The inflow of funds into the capital market assists corporate activities and provides the drive needed for the development of new industries and economic advancement. In light of this factor, the situation could be considered an issue of major importance for the Japanese economy. It will presumably be one of the items on the coming agenda for reform of corporate governance at Japanese companies, which has just begun over the last year or two, toward the goals of heightening Japan's competitive and spurring its recovery using the earning power of its companies as the driving force.