Market Insight: Japanese Equities

Tokio Marine Asset Management (London) Limited
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End of corporate 'cash hoarding' in Japan leads to new era of dividend boom

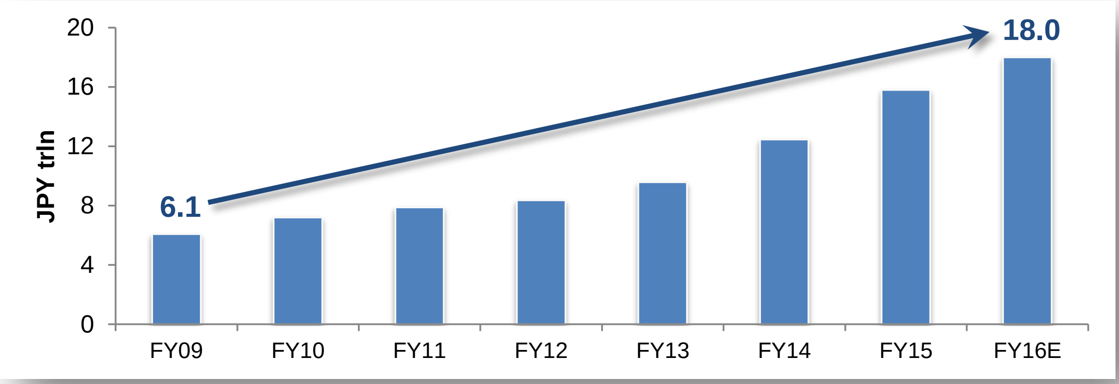
As shareholder payouts rise to record levels, Tokio Marine Asset Management explores the drivers behind this significant corporate change and why investing in smaller cap names may be the way to maximise access to the trend.

Japan is lagging behind. Or is it?

Japan has a long-ingrained reputation for not being the friendliest of countries to shareholders. Japanese corporates historically avoided focusing on dividends or share buy-backs, with long standing practice of cross-shareholding alongside a passive domestic investor attitude doing little to incentivise companies in this area.

Yet since 2009, the total amount of dividends paid and share buy-backs conducted among Japanese corporates has increased from ¥6trn to ¥18trn in 2016. This is an unprecedented threefold increase (see chart 1).

Chart 1 Share Buy-backs and Dividends in Japan, JPY trn



Source: Brokerage data, TMAM estimate

From negative to positive

Driving shareholder improvements in Japan are a number of factors including the easing of deflationary pressure and a growing focus on corporate governance by the

Japanese government.

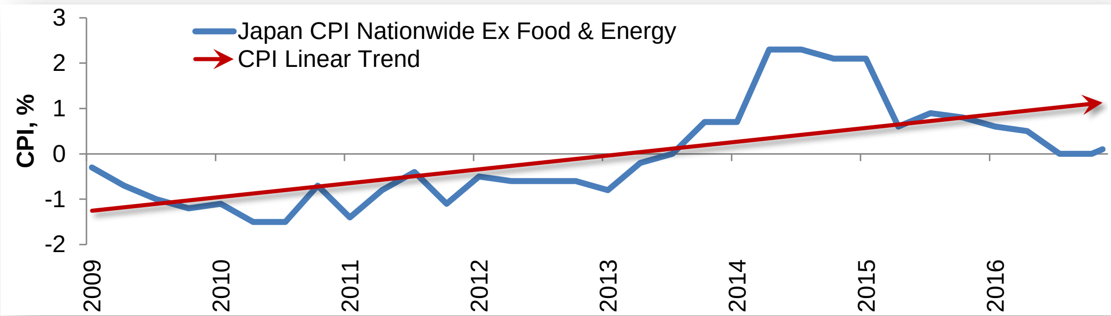
Thanks to Prime Minister Abe's 'Three Arrows' Abenomics reforms, Japan's core consumer price index has this year reversed its downward trajectory and cautiously begun entering into positive growth territory, rising for the first time in over a year in January (see chart 2). Though it is a slow increase, it is one that is likely to stay the course as the Bank of Japan continues to push ahead with plans to accelerate inflation towards its long-held 2% target.

The Japanese government in particular has continued to demand change from businesses, and corporate governance reform is an integral part of Prime Minister Abe's Japan Revitalisation Strategy which was approved by the Cabinet in June 2013.

The Strategy prompted the introduction of the Stewardship Code in February 2014 and the Corporate Governance Code in June 2015, thus placing pressure both on investors (asset managers and owners) and listed companies to engage in constructive dialogue (see timeline on chart 3).

This environment has made companies much more inclined to return cash to shareholders in the form of dividends and/or share buy-backs. In the year after the introduction of the Corporate Governance Code, Japanese companies paid out record dividends and share buy-backs.

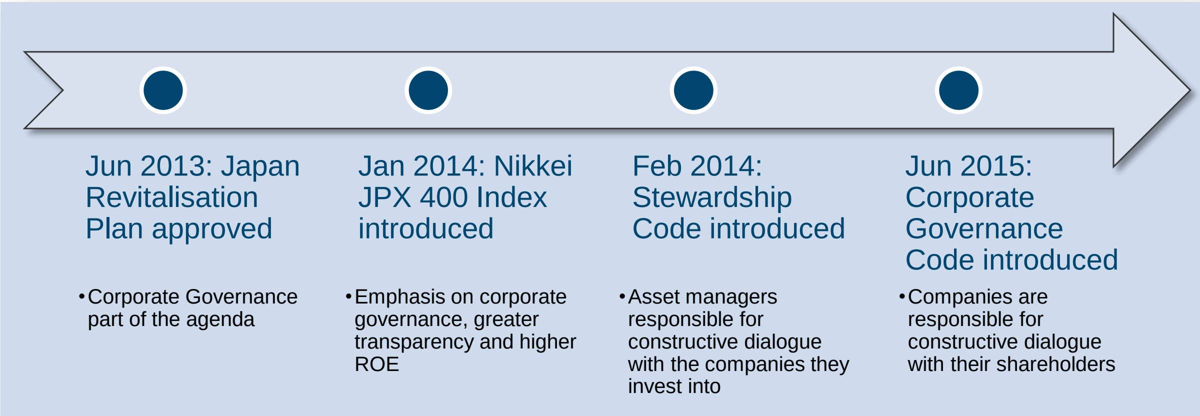
Chart 2 Japan CPI (ex Food & Energy), %



Source: Bloomberg

This increase signals why the era of corporate cash hoarding is perhaps now at the 'beginning of the end' as more companies realise it can no longer be justified to simply hold cash on balance sheets. For investors, understanding which companies are most likely to benefit from these changes in shareholder and corporate attitude is also becoming paramount.

Chart 3 Timeline of Corporate Governance Reforms in Japan

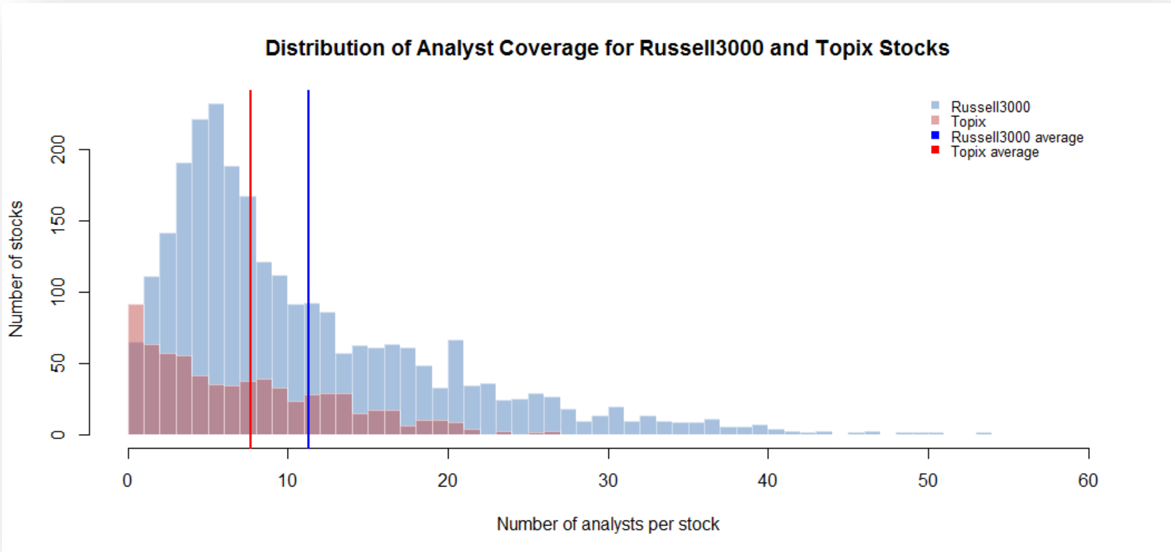


Source: Japanese FSA website

Company focus

With Japanese stocks comparatively under-researched versus other developed markets (see chart 4), the region is arguably never the easiest of markets to invest in. However, hidden opportunities are abundant, especially in the small-to-mid-cap range. Over the year to 31 December 2016 the MSCI Japan Small Cap index has returned close to 4.30% versus the wider MSCI Japan's negative performance of -0.74%[1].

Chart 4 Analyst coverage comparison: Japan and the US

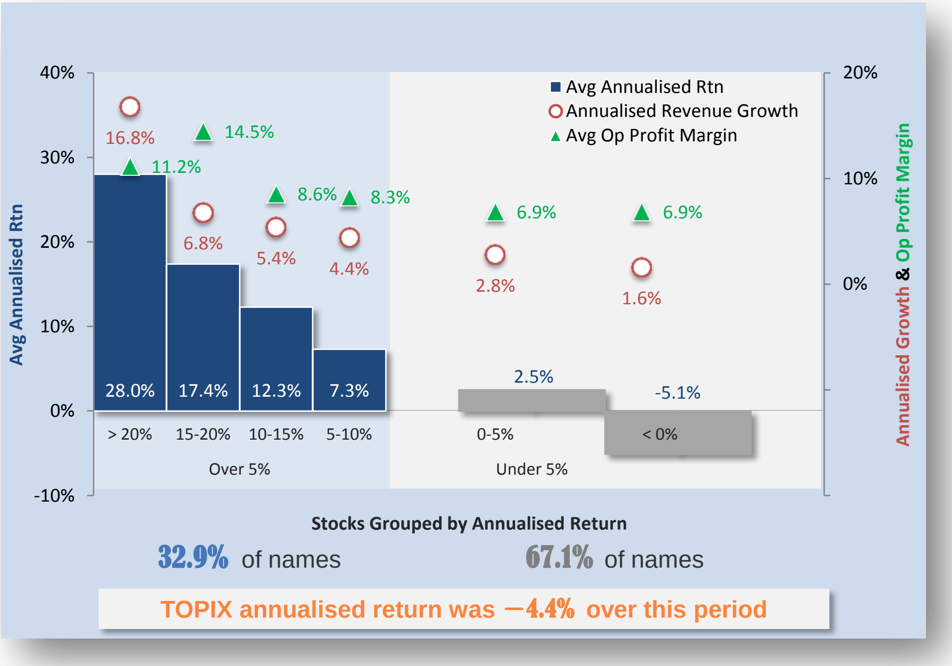


Source: TMAML analysis based on data by Bloomberg

1 Henderson Global Dividend Index, February 2017

In terms of company fundamentals, about a third of Japanese small-to-mid cap stocks show resilience and strong operating results even in difficult markets (see chart 5). We believe this speaks volumes about their potential, but it also shows that careful selection is essential in order to realise it.

Chart 5 Small & Mid Cap Stocks Grouped by 10 Year Annualised Performance



Source: TMAM, Bloomberg

Benefitting from corporate governance reform

In terms of the ongoing changes mentioned above at a corporate and shareholder return level, it is among the smaller companies that opportunities abound. One of the reasons is that smaller companies, with their less complex business structures, tend to be more flexible for change and open to embracing higher corporate governance standards. They are importantly also better positioned to improve their return-on-equity, even when they only implement limited changes to their operational and financial strategy.

Meanwhile, as with all investments, strong cash generation in the core business is an important factor when researching stocks. At Tokio Marine Asset Management we believe it is also what this cash is used for that matters when analysing a company's long-term growth.

For us, cash needs to be maintained at a level optimal for sustainable business expansion, where just enough is reinvested in the form of CapEx and/or M&A, and the rest is returned to shareholders as dividends or share buy-backs.

The macro environment in Japan is set to remain supportive of further dividend growth as continued quantitative easing should keep CPI on its upward trajectory, while heightened awareness of corporate governance issues shows no sign of abating and should continue to pressure corporates to stop holding cash. With this in mind, there is good reason to believe that investors in Japanese stocks will benefit.

● Tokio Marine Asset Management is a Japan/Asia equity specialist with 30 years' market experience and approx. $56bn AUM (as at 31 March 2017).

● For more information about the issues raised in this article, please contact Business Development at Tokio Marine Asset Management (London) Ltd.

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