Awakening Japan Inc.

September 25, 2014

by Yu Zhang

of Matthews Asia

More than a year and a half has passed since Japan unveiled “Abenomics,” its aggressive reflationary policy to reinvigorate its stalled domestic economy. While the first two “arrows” of Abenomics—ultra–easy monetary and expansionary fiscal policies—have made progress in ending deflation and “importing” inflation into the economy, investors have shifted their attention to the so-called third arrow—Japan’s growth strategy.

Can credible structural reform be implemented to remove impediments to the country’s economic growth and awaken Japan Inc.? From a dividend investor's point of view, Japan today represents a particularly interesting investment study—over the last decade, corporate Japan has been in a balance sheet deleverage mode. As a result, many companies today have not only restored their financial soundness but are sitting on excess idle cash. On the other hand, the median dividend payout of Japanese companies has not expanded much at all over the same period, remaining at below 30%. This lags the average for Asia Pacific. However, as inflation is re-introduced in Japan today and the government pushes for better corporate governance, will we find meaningful changes to shareholder return policies? I recently spent a week in Japan, seeking answers to this question.

After meeting with several companies from diverse sectors and industries—a small sample group, I realize—I got an answer that was less straightforward than I had initially expected. While many Japanese companies these days do have a shareholder return policy in place, the substance behind these policies varies. And the new inflationary conditions in Japan and the government's policy initiatives don't seem to play a meaningful role yet in encouraging corporate managers to increase shareholder returns. Rather, it is a case-by-case situation, determined largely by individual company fundamentals. For example, some companies with businesses that are more exposed to global markets and that compete internationally, are indeed becoming more progressive in terms of their shareholder return stance, as those companies increasingly benchmark their performance against domestic Japanese, rather than international, peers.

One company I met on the trip, a top player in its industry, said it understands that its shareholder return policy still lags its global peers. It believes that is partly why valuations on its stock have traded at a discount, even if its business is still quite competitive. Recognizing this problem, the company is actively reviewing its dividend policy. On the other hand, I still see plenty of Japanese companies in which the deflationary mindset has been deeply ingrained. Another company I met with has been stockpiling cash for years, even though its underlying business is generating healthy free cash flow and has no borrowings on its balance sheet. So why does it still cling to a large amount of idle cash without paying higher dividends to shareholders? The firm has indicated that it met with financial difficulties in the 1960s. Ever since then it has maintained a policy of hoarding excess cash for extra security to prevent a recurrence of past financial woes.

If past deflationary conditions can justify cash hoarding, today's inflationary environment should remove that rationale. At least in theory, Japanese companies should have fewer incentives to cling to idle cash—and instead reinvest it into their business, or return excess cash to shareholders. However, in reality, companies are just like human beings who have their own unique preferences and exhibit different tendencies. Top-down, macro conditions may provide backdrops conducive to certain changes. But the decision to adapt to the new conditions and make progress is still up to individual companies. Note to investors: whether or not you are a dividend investor or a pure growth investor, one should never get too caught up on the macro theme, and remember that on-the-ground due diligence is imperative.

There is no guarantee that companies will maintain or grow their dividend pay-out ratio, or pay dividends. Past Performance is no guarantee of future results.

Yu Zhang, CFA
Portfolio Manager
Matthews Asia

consequential caused by the use of this information. Investing in small- and mid-size companies is more risky than investing in large companies as they may be more volatile and less liquid than large companies.