Positive Signs for Japan's Post-Coronavirus Outlook

The pandemic is fast-tracking change in corporate Japan.

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KEY INSIGHTS

- Japanese companies are sitting on large stockpiles of cash, which should see them well placed to negotiate a possible near-term global economic recession.
- Japan also stands out as a potential longer-term beneficiary of the coronavirus pandemic, as it forces companies to embrace new work solutions and technologies.
- The impact of this fast-tracking of change in corporate Japan, in terms of productivity alone, could be significant for long-term Japanese growth.

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These are extraordinary times. Beyond the immediate risk posed to public health, the coronavirus pandemic is set to have far-reaching implications, globally. Already we have seen the severe economic dislocation caused by the crisis, the result of which will almost certainly be a global economic recession. However, as impossible as it may seem, not all the potential impacts of the pandemic will be negative. From an investment perspective, Japan stands out as a potential beneficiary, as the coronavirus compels traditional businesses to find innovative working solutions and embrace new technology. Of course, some will adapt and progress better than others, so active selection will be key.

In Times of Crisis, "Cash Is King"

Far from being immune to the impact of the coronavirus outbreak, the high-beta Japanese equity market suffered steep losses during the first quarter, amid the universal flight from risk assets. What was encouraging, however, was that despite the extreme uncertainty, Japanese companies, in aggregate, continued to increase shareholder returns in the form of share buybacks and dividends.

As the saying goes, "in times of crisis, cash is king," and corporate Japan is flush with it. Japanese companies went into the coronavirus crisis with the highest level of cash reserves ever recorded, with more than USD 6.5 trillion collectively sitting on Japanese company balance sheets at the end of December 2019, according to the Japan Ministry of Finance. What's more, Japan's cash reserves are broad-based, spread across almost every sector of the economy.

Figure 1 highlights that, as of December 31, 2019, Japanese companies collectively have a substantial cash cushion, which is particularly supportive during times of heightened market stress. Meanwhile, abundant cash

USD 6.5+ trillion

Cash held on Japanese company balance sheets.[1]

Japanese Companies Are Flush With Cash

(Fig. 1) Cash and liquid assets as percentage of total corporate assets

As of December 31, 2019.
Source: Japan Ministry of Finance, data analysis by T. Rowe Price. Includes nonfinancial stocks only.

reserves also give Japanese companies optionality. That is, they can use excess cash to pay down debt, to reinvest in the business, or to pay increased returns to shareholders and improve return on equity (ROE) ratios. In recent years, Japanese companies have clearly focused on this third option, allocating vast sums to fund higher returns to shareholders via record-level share buybacks and dividend increases.

Higher Returns To Shareholders, and Room for Further Potential Increases

Since the start of the Abenomics economic strategy in 2012, the total payout ratio of Japanese companies (i.e., dividends and share buybacks) as a percentage of net company profits has almost doubled to around 60% at the end of 2019.[2] Given the historical tendency of Japanese companies to inefficiently hoard cash on balance sheets, we believe this sizable increase in shareholder returns is impressive.

Nevertheless, there remains more capacity for higher returns to be paid to investors. Over the same 2012 to 2019 period, Japanese company cash and short-term deposits have also nearly doubled. Rather than slipping back into bad habits, we would like to see companies use more of this money to fund higher payouts to shareholders and improve their ROE ratios.

The trend toward increased shareholder returns has been encouraged, in part, by Japan's improved corporate governance regime, a topic that we have discussed at length previously. Prime Minister Shinzo Abe has prioritized bringing Japanese governance standards into line with global peers. This has seen the implementation of a new governance framework, based on global best practices, and also incentivizing companies to increase returns for shareholders.

Given their large financial resources, we anticipate fewer Japanese companies will be forced to cut dividends in the near term, compared with other, less cash-rich, global market counterparts. And we believe Japanese equities will only become more attractive if, in the aftermath of the pandemic, companies can show that they are willing to use their cash stockpiles and be first out of the blocks to reward shareholders.

How the Pandemic Is Fast-Tracking Change

The coronavirus pandemic is changing the way Japan works, with significant longer-term ramifications. The constraints imposed by the coronavirus, for example, have brought many of the inefficiencies of corporate Japan to light—and forced companies to explore flexible working solutions and new technologies.

Some firms have implemented artificial intelligence (AI) call center solutions, while others have adopted media/conferencing platforms in order to stay connected with isolated workers.

[1] Source: Japan Ministry of Finance. As of December 31, 2019.
[2] Source: Corporate reports, Japan Exchange Group, Empirical Research Partners Analysis. Data exclude financials and utilities, net of share issuance.

The Pandemic Is Fast-Tracking Change

(Fig. 2) Japan's rigid corporate environment has been highlighted

of Japanese companies had remote work systems in place[1]

of Japanese companies didn't allow employees to work from home[2]

[1] Source: Japan Internal Affairs Ministry, as of 2018. Survey of companies with 100+ employees.
[2] Source: Reuters, as of February 2020. Survey of Japanese companies across sectors conducted January 2020 to February 2020.

> "Japanese companies went into the coronavirus crisis with the highest level of cash reserves ever recorded...

Indeed, for a nation known for its technological prowess and innovation, many Japanese companies continue to use outdated technology. This is at least partly rooted in older employees' reluctance to embrace modern technology. There are also legally embedded hurdles, such as the requirement for many company documents to be physically stamped with an official seal. Maintaining such traditional practices is a hindrance to progress in today's digitally efficient world.

A symbol of Japan's conservatism is the fax machine. While the fax machine has long been consigned to the "yesterday's technology" bin in other major economies, a recent study by the Japanese government showed that virtually every Japanese company, and one-third of all households, still use them for a good proportion of their communications.

Crisis Accelerates Move to Innovative, Flexible Working Solutions

Working from home has been an inevitable innovation for corporate Japan, after the government called on companies to reduce the number of people in offices by 80% to help stem the spread of the coronavirus. For many Japanese workers who detest their congested daily commutes, long hours in the office, and the inefficiencies of their organizations, working from home has been a revelatory experience, one that they will be keen to continue once the lockdown is fully eased.

In Japan, long hours in the office, entertaining clients until late, and working overtime have long been regarded as necessary for career success. This work culture has steadily been changing as older workers progressively retire and are replaced by a new generation of more progressive-minded employees.

The emergence of the coronavirus has amplified this trend. The necessity of having to find flexible working solutions has helped some Japanese businesses to realize that remote working is not only possible but is a viable alternative to long hours spent in the office. Happier workers can be more productive. Meanwhile, the Japanese government acknowledges that, for Japan's economy to keep pace with the world's major economies, many traditional working practices need to change in favor of more modern solutions, such as remote working, digital transacting, and moving businesses online.

> ...it is forcing Japanese companies to adapt and embrace new work solutions and technologies.

Resilience and persistence have been hallmarks of the Japanese equity market over recent decades. These qualities, and the large stockpile of cash held on company balance sheets, should enable Japan to successfully negotiate a potential near-term global slowdown—and perhaps even lead an eventual recovery. Looking longer term, the coronavirus pandemic has laid bare some of corporate Japan's shortcomings. If there is some small silver lining to the coronavirus pandemic, it is that it is forcing Japanese companies to adapt and embrace new work solutions and technologies. The impact of fast-tracking change in Japan, in terms of productivity alone, could prove significant for long-term Japanese growth.

WHAT WE'RE WATCHING NEXT

In recent weeks, a strong growth tailwind has further supported our bias toward companies that can potentially deliver durable growth in the medium to long term. The coronavirus has brought forward some of these growth outlooks as consumers are forced to work and consume remotely and embrace new technology in their everyday lives. As such, we are watching our holdings in areas like payment processing and other technology-oriented solutions, closely. Although they have performed relatively well through the crisis period, we have very high conviction in these names as our clarity in the growth outlook has actually improved.

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