

J.P.Morgan

Enhancing shareholder value for Japanese corporates





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1 Introduction

Japan is home to many of the world's largest publicly listed companies. Yet, shareholder returns of these firms have lagged their international peers in the past several years, evident in the valuations of Japanese equities that have continued to trade at a discount when compared with global stocks of similar size and scale. For example, the average enterprise value (EV) over earnings before interest, taxes, depreciation, and amortization (EBITDA) for a S&P 1500 company was 16.6 times as of June 30, 2021, when compared to the 14.0 times average for a typical Nikkei company¹.

A key reason for this is because Japanese companies continue to fall behind in capital efficiency, demonstrating lower return on capital employed (ROCE) vis-a-vis their global counterparts. While there has been increased focus among Japanese companies to address this, they still have some way to go before closing the gap with global peers.

In this report, we examine how Japanese listed firms have fared in their working capital management over the past 10 years and how enhancing treasury management can improve both the profitability and balance sheet efficiency of Japanese companies, and help them generate more value for their shareholders. We will look to:

- Examine the ROCE performance of Nikkei 225 companies compared to their S&P 1500 counterparts over the past five years
- Assess the historical working capital and cash trends of Nikkei 225 companies
- Provide industry insights on key industry segments within the Nikkei 225
- Analyze the role of treasury in generating shareholder value

¹ Source: Capital IQ; For comparison purposes, S&P 1500 metrics have been calculated based on industry weights of Nikkei 225

2 Calculation methodology

I) ROCE measures the ability of the company to generate profits on the capital deployed in the business and it has two major components: operating income and capital employed. Improvement in ROCE can be achieved by generating more operating income while reducing the capital employed to do so. ROCE is calculated as follows:

$$\text{ROCE} = \text{EBIT}(1 - \text{tax}) / (\text{Average total debt of last two calendar years} + \text{Average book value of equity of last two calendar years})$$

II) The Cash Conversion Cycle (CCC) is the number of days it takes to convert inventory purchases into cash flows from sales. The CCC is a metric that helps quantify the working capital efficiency of a company and is derived from three different components:

- Days Payable Outstanding (DPO) or the number of days from the time a company procures raw materials to payment to suppliers
- Days Inventory Outstanding (DIO) or the number of days the company holds its inventory before selling it
- Days Sales Outstanding (DSO) or the number of days taken to collect cash from customers



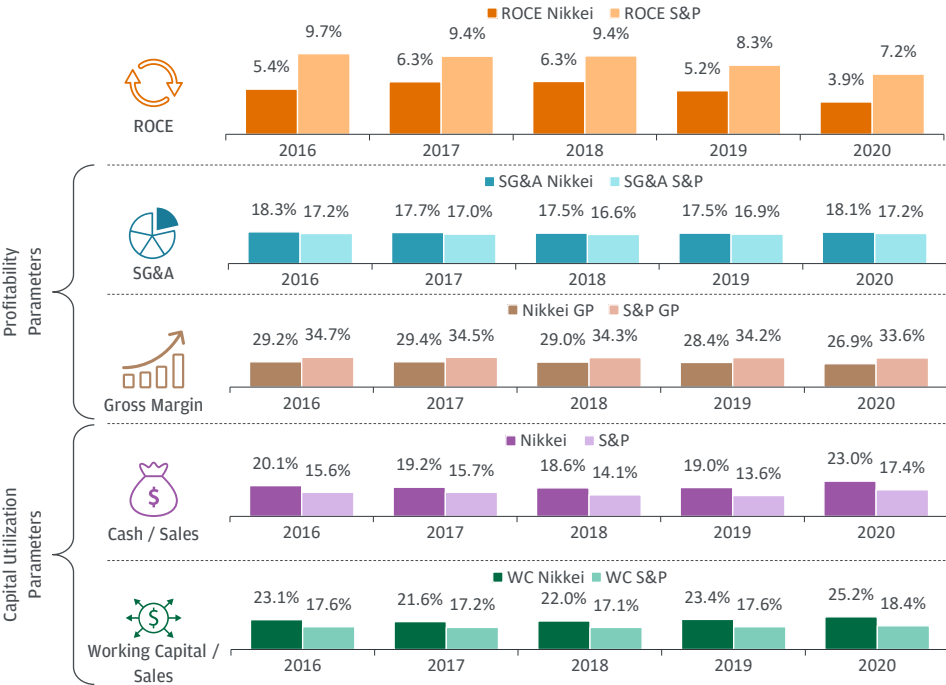
Companies can improve their working capital by effectively managing the individual components of their CCC via reducing inventory levels (decreasing DIO), extending payment terms with suppliers (increasing DPO) and speeding up collections from customers (shortening DSO). As a general rule, the lower the CCC, the better the working capital efficiency.

Note:

To avoid the distortion of data, financial services and real estate firms in the S&P 1500 and Nikkei 225 were excluded from the calculations due to their distinct business models and unique working capital metrics in comparison to other industries. Companies with high volatility in working capital and those with incomplete data were also removed; For comparison purposes, S&P 1500 metrics have been calculated based on industry weights of the Nikkei 225.

All numbered data have been collated from Capital IQ for the purpose of calculations.

3 Comparing ROCE between Nikkei 225 and S&P 1500 companies



Source: Capital IQ

Notes: For comparison purposes, S&P 1500 metrics have been calculated based on industry weights of Nikkei 225

SG&A stands for Selling, General & Administrative expenses as percentage of sales

Working Capital / Sales is calculated as average Working Capital of current calendar year and previous calendar year divided by sales of current calendar year; Working Capital is calculated as Trade Receivables + Inventory - Trade Payables

Cash / Sales is calculated as average cash and cash equivalent of current calendar year and previous calendar year divided by sales of current calendar year

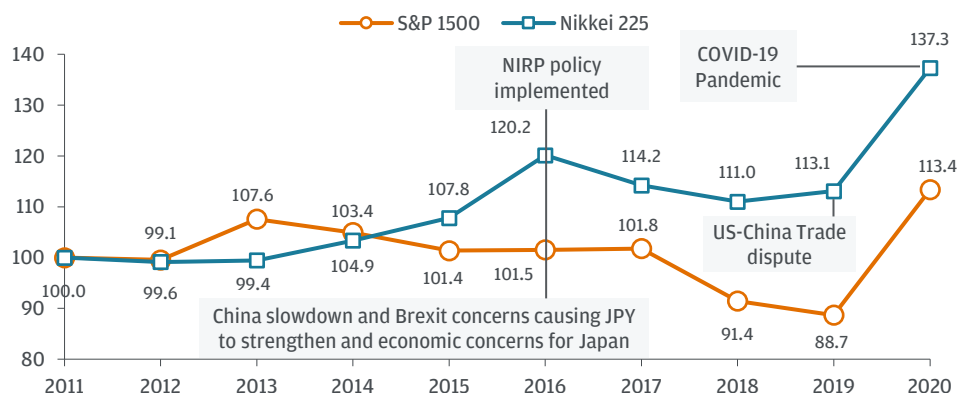
In calendar year 2020, a typical company listed on Japan's benchmark Nikkei Index generated a 3.3 percent lower return on capital employed (ROCE) as compared with an average S&P 1500 company.

Upon examining the ROCE, we observed that the lower ROCE is because of high direct expenses (low gross margins) and indirect expenses (high SG&A, or selling, general and administrative expenses), reducing the overall profitability as well as due to high cash and working capital levels, increasing the overall capital base. Nikkei companies on an average have 0.9 percent higher SG&A and 6.7 percent lower gross margins while their cash/sales levels and working capital/sales levels are higher by 5.6 percent and 6.8 percent respectively when compared with S&P 1500 companies.

We also observe a deterioration of ROCE of Japanese corporates from 6.3 percent in 2017 to 3.9 percent in 2020. A significant increase in both cash and working capital levels during this period have been the major causes for this trend.

Takeaway: Japanese companies have consistently lagged their global counterparts in their capital efficiency and there are multiple areas contributing to this trend which would require a concerted effort not only from the business but also from broader finance teams.

4 Cash levels at 10-year highs



Source: Capital IQ

Note: Blue line represents numbers on the chart calculated as average cash / sales for all Nikkei 225 companies rebased to 100 as of 2011; Orange line represents numbers on the chart calculated as average cash / sales for all S&P 1500 companies rebased to 100 as of 2011; For comparison purposes, S&P 1500 metrics have been calculated based on industry weights of Nikkei 225; calculations exclude real estate, financial institutions, NBFIs and any outliers

An interesting trend emerged when we assessed the cash levels of Nikkei-listed firms over the past 10 years and how they compare against S&P 1500 companies.

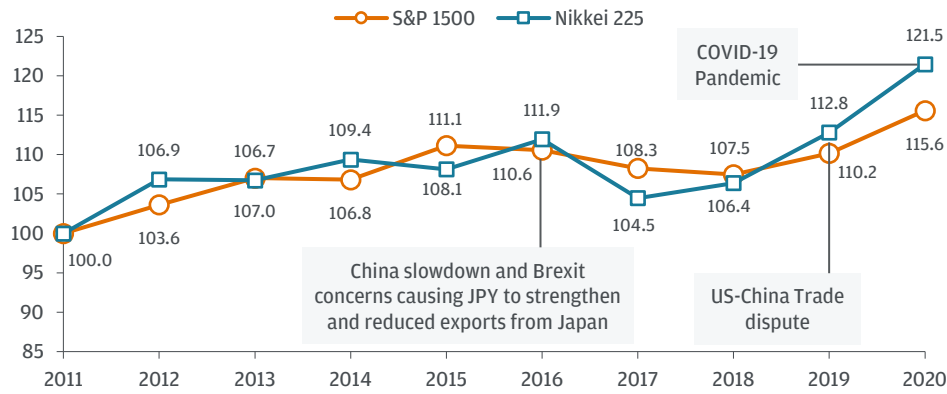
The cash levels of Japanese companies on average began to overtake their S&P 1500 counterparts in 2014 with two notable events causing dramatic gains during this period. The first was in 2016, when the uncertainties surrounding Brexit and China's economic growth caused the Japanese yen as a safe-haven currency to strengthen, resulting in headwinds for many of the large Japanese firms that are net exporters. This created uncertainty around Japanese economy prompting the companies to shore up their liquidity buffers until the economic concerns faded. Japan's expansionary monetary and fiscal reforms to boost demand and inflation also contributed to the increase in corporate cash levels. A reduction of cash levels followed in 2017 and 2018, as the government's negative interest rate policy reduced the appeal of holding cash.

The second event that triggered elevated cash levels was observed in 2020 during the onset of the pandemic. The low Interest rate environment, coupled with regular stimulus packages, also made it easier for companies to increase their cash holdings.

As companies look to recover from the pandemic and shift focus from cash preservation to cash deployment into growth activities, we can expect a reduction of cash levels over the next few years.

Takeaway: Japanese companies have historically maintained higher cash levels than their global counterparts; these levels have further increased and at a quicker pace in the last 10 years. As the economic activity returns to pre-pandemic levels, there is significant potential for Japanese companies to deploy this excess cash towards business growth and bring cash levels inline with their global peers.

5 Working capital levels also at a peak



Source: Capital IQ

Note: Blue line represents numbers on the chart calculated as average working capital / sales for all Nikkei 225 companies rebased to 100 as of 2011; Orange line represents numbers on the chart calculated as average working capital / sales for all S&P 1500 companies rebased to 100 as of 2011; For comparison purposes, S&P 1500 metrics have been calculated based on industry weights of Nikkei 225; calculations exclude real estate, financial institutions, NBFIs and any outliers; working capital is calculated as receivables + inventory - payables

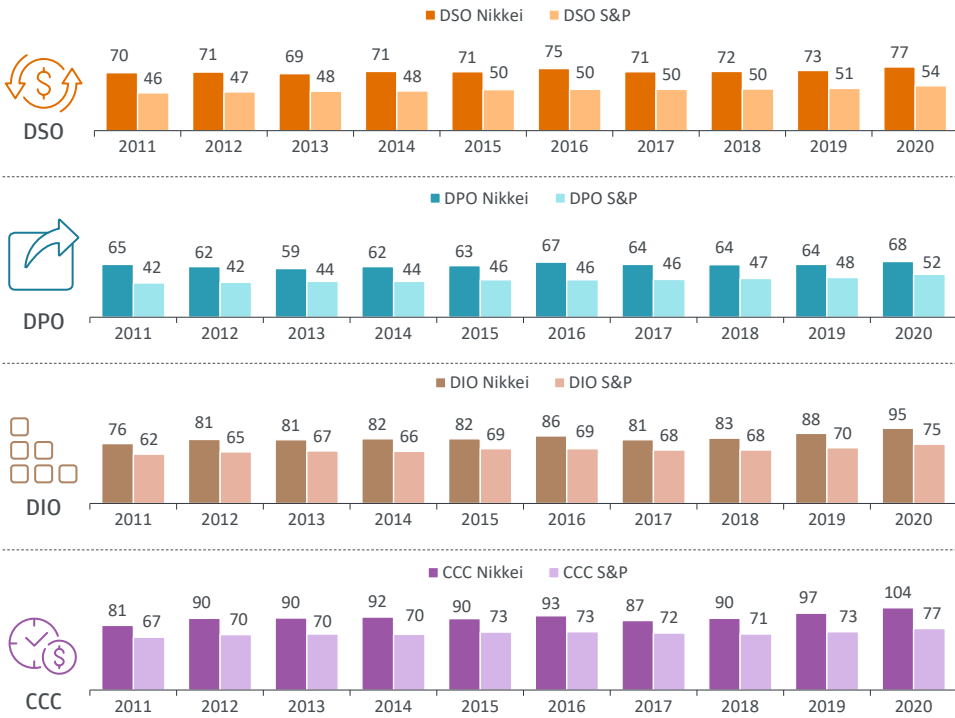
Working capital levels at Nikkei-listed companies stayed range-bound in the first half of the last decade, in line with global counterparts. In 2016, the levels were elevated when exports fell as the Japanese yen strengthened, resulting in higher inventory levels. A rise in receivables also contributed to the increase in working capital, as companies offered better terms to reduce their inventories.

Working capital levels began to increase dramatically in 2019 due to the U.S.-China trade tensions, which prompted companies to increase inventory levels to manage supply chain risks. Working capital peaked in 2020 as the pandemic exacerbated supply chain disruptions and slowed consumer demand, causing a further build-up in inventory levels. Receivables also increased, as customers defaulted or delayed their payments.

With a global economic recovery under way, working capital levels in 2021 will likely trend lower as consumer confidence rebounds, and demand for goods and services returns.

Takeaway: Working capital levels are at 10-year highs suggesting that significant amounts of liquidity are currently trapped in working capital, which if released can be a critical source of capital to fund future growth during recovery phase.

6 Performance gap in working capital compared with peers



Source: Capital IQ

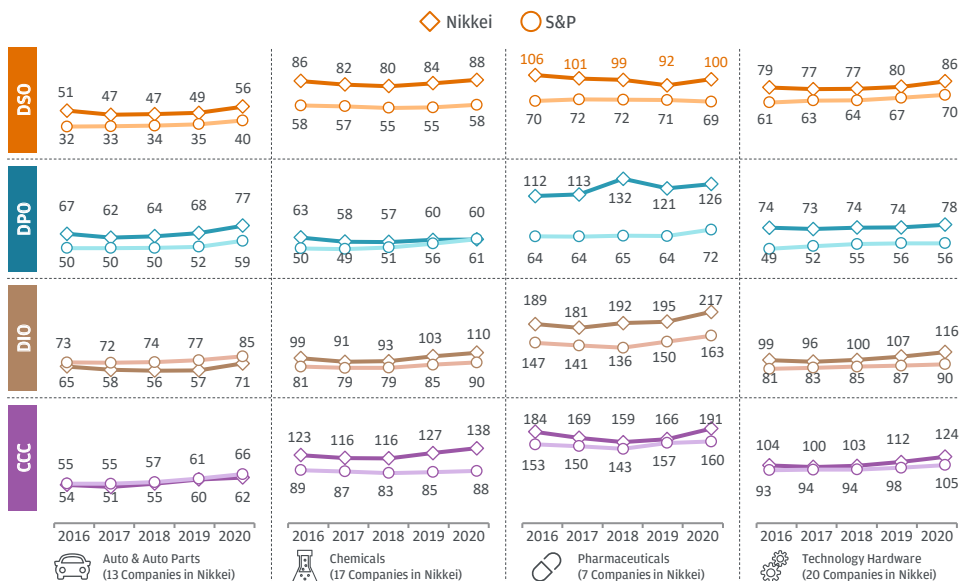
Note: Modified J.P. Morgan Working Capital Index S&P 1500 companies data used S&P 1500 Industries have been assigned weights of Nikkei 225 Industries for comparison

On average, Nikkei-listed companies have shown to be less efficient in their cash conversion cycle (CCC) as compared to their S&P 1500 counterparts in the last 10 years. As at the end of 2020, the average CCC of a Nikkei firm is 104 days compared with 77 days on average for its U.S. counterparts.

The slower collection cycle or days sales outstanding (DSO), and higher inventory levels or days inventory outstanding (DIO), of Nikkei companies are the key reasons for their sub-optimal CCC. The average DSO has deteriorated by about seven days over the past decade, a trend that was partially offset by a three-day improvement in days payable outstanding (DPO) over the same period. The average DIO also deteriorated, by nineteen days in the same period.

Takeaway: Increasing the DPO at the cost of suppliers is not sustainable and sufficient for companies looking to improve their working capital. It will require a single-minded effort from Japanese companies to revise and formulate a holistic plan for working capital efficiencies via centralization, standardization, and automation of working capital processes.

7 Deep dive into sectors



Source: Capital IQ

Note: Modified J.P. Morgan Working Capital Index Index S&P 1500 companies data used S&P 1500 Industries have been assigned weights of Nikkei 225 Industries for comparison

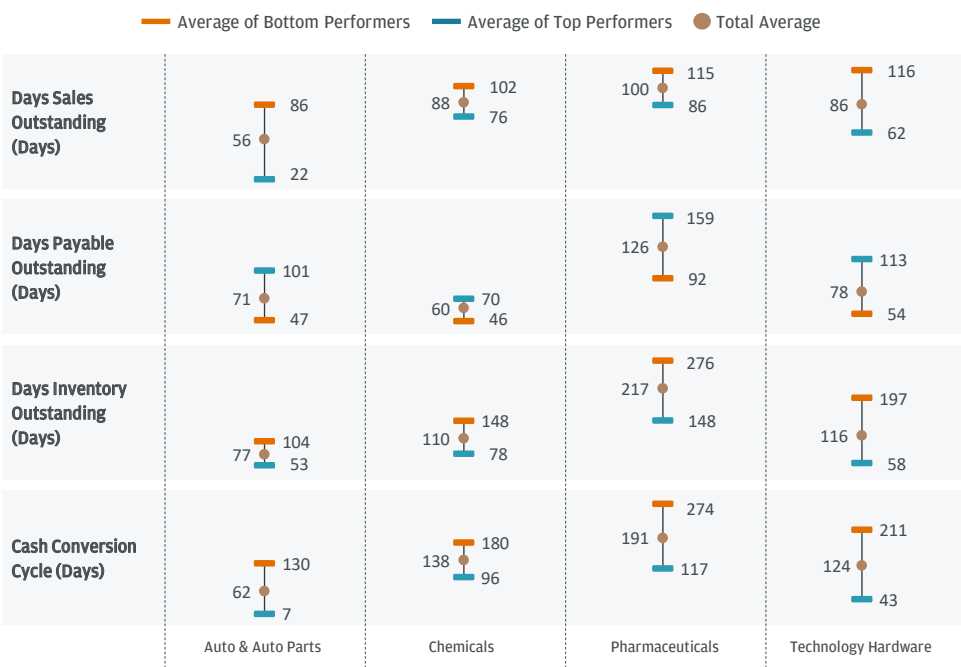
We examined four industries that make up the key sectors in the Nikkei Index – Auto & Auto Parts, Chemicals, Pharmaceuticals and Technology Hardware – and compared their industry working capital efficiency ratios with those of the S&P 1500 industry averages over the past 10 years. Below are the key findings from the analysis:

- **Auto & Auto Parts:** Japanese automakers have done consistently better in both DIO and DPO as compared to their global counterparts. However, owing to significantly slower collection cycles, the combined benefits of better DIO and DPO were completely offset by a higher DSO, putting their overall CCC performance in line with the S&P 1500 auto industry average.
- **Chemicals:** There is a significant gap between the CCC performances of chemical companies that make up the Nikkei and the S&P 1500, mostly due to the difference in the speed of collection cycles. The Nikkei companies have historically witnessed a longer payment cycle (DPO) than their S&P 1500 peers on average, helping to narrow the CCC gap. However, over the last five years, S&P 1500 companies have improved their DPOs and have caught up with Nikkei companies, resulting in widening of the gap between their CCC.
- **Pharmaceuticals / Technology:** For both the pharmaceutical and technology sectors, S&P 1500 companies have fared better in their CCC performances compared with their Nikkei counterparts, due to faster collections and better inventory management. However, Nikkei companies have been able to manage their payable cycles better than S&P 1500 companies, allowing them to partly offset the negative impact of higher DSO and DIO.

Takeaway: Comparing Japanese corporates vis-a-vis S&P 1500 companies on working capital metrics suggests multiple opportunities across Japanese industries to release liquidity. Treasurers should assess the levers driving their CCC and devise a sustainable strategy to improve working capital.

8 Industry benchmarking

Snapshot of the average working capital performances between the top and bottom performers



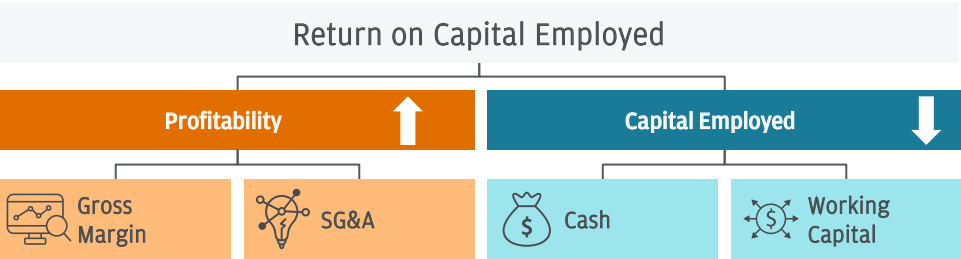
Source: Capital IQ

We observed a wide gap between the top and bottom performers in terms of CCC across the key industries within the Nikkei Index, suggesting that a significant amount of working capital remains trapped. Based on our calculations, assuming every organization improved its working capital and moved into the next performance quartile¹ of their respective industries across the DSO, the DPO and the DIO metrics, an estimated \$139 billion in liquidity trapped in working capital could be released as free cash flow.

Takeaway: Companies with less efficient working capital management should look at industry best practices and benchmark their performance on a continuous basis to identify and release trapped capital as they plan for business recovery.

¹ For the analysis we split the companies within each industry into four performance quartiles (with the first quartile representing the performance of the top 25 percent companies within the industry and the fourth quartile corresponding to the bottom 25 percent)

9 Treasury’s role in driving ROCE



Executive Summary

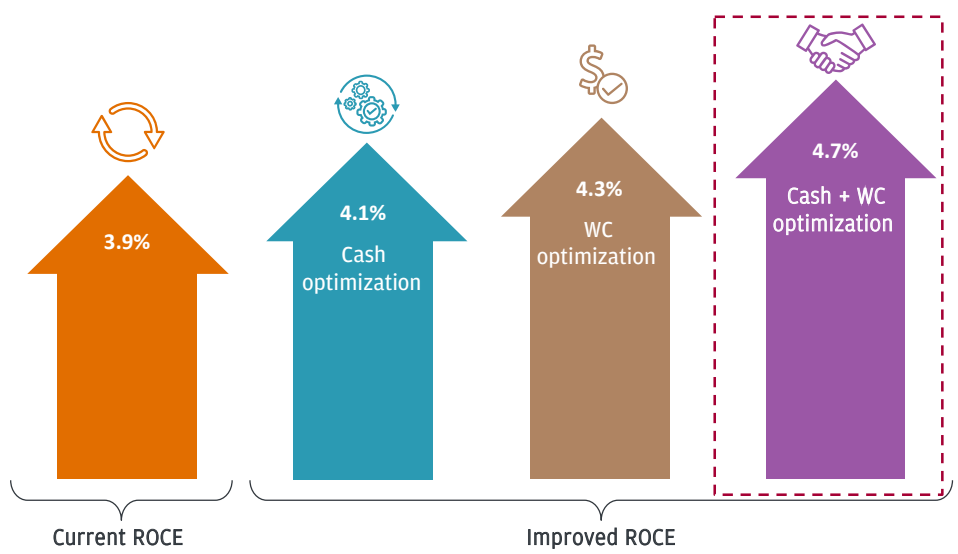
Improve operating cash flows via optimized P2P process and financing solutions	Reducing indirect expenses by leveraging standardisation, centralization and automation of Treasury process	Reduce Operating Liquidity Requirement and Cash management through centralized cash visibility and control	Free up trapped cash in Working Capital (WC) through optimized structures and digital solutions
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Given the historic underperformance of ROCE of Japanese companies vis-à-vis their global competitors, improving the efficiency of treasury can be the solution, as the treasury directly or indirectly controls many of the individual constituents of ROCE. To help with that, treasurers need to examine all the components impacting the ROCE of their organization, set measurable objectives based on benchmarking and evaluate solutions that can help them achieve the goals. Treasurers can utilize the following framework to help them improve the various components impacting ROCE.

- **Gross margins:** Treasurers can contribute to improved gross margins by helping to boost revenues such as supporting their company shift to new business models including direct-to-consumer, e-commerce or subscription models; or by reducing the cost of sales via an optimized procure-to-pay process, providing them with clear visibility on their payables to avail discounts from their suppliers. A dynamic discounting solution for cost of sales reduction and offering holistic payments options for customers to support new-age models, can also help companies achieve their gross margins targets.
- **Selling, general and administrative expenses (SG&A):** We observed a wide gap between the top and bottom performers in terms of running the finance function. Based on APQC benchmarks, top performers on average spend 0.62 percent of sales while the bottom performers can spend as much as more than three times this amount for performing the same functions. Significant improvement in indirect expenses (SG&A) can be achieved by leveraging standardization, centralization, and automation in treasury processes. Digital solutions like virtual accounts, earnings credit rate and reconciliation tools can help reduce costs to a great extent.
- **Cash:** Given the consistently high level of cash maintained by Japanese companies, there is considerable scope for reducing cash levels through liquidity centralization, and improvements to cash visibility and the accuracy of cash forecasting. Cash released in the optimization process also presents opportunities for companies to retire expensive debt, fund internal projects and acquisitions, as well as pay back shareholders which can further help in improving shareholder returns.

→ **Working Capital:** There is a large amount of free cash flow that is currently trapped in the supply chains of Japanese companies. If released, this cash can help corporates fund much-desired growth during the recovery phase of COVID-19. This freed cash can further help boost revenue growth as well as ROCE, helping Japanese companies to achieve parity with or even overtake global counterparts in generating higher returns on capital. A mix of automation tools, financing solutions like supply chain finance and dynamic discounting, and centralization can help companies achieve working capital optimization.

Based on calculations, assuming Nikkei companies improve their cash levels and working capital levels to S&P 1500 companies', that can significantly boost the ROCE of Nikkei companies from 3.9 percent currently to 4.7 percent.



Source: Capital IQ; J.P. Morgan analysis

10 Conclusion

The global economy came under tremendous pressure in 2020 as the pandemic severely impacted businesses and supply chains worldwide. This had a significant negative impact on the ROCE of companies, as their profitability took a hit while their working capital and cash levels rose.

As the macroeconomic environment improves, we are witnessing an increase in consumer and business optimism leading the overall recovery in the bottom lines of companies. Coupled with a normalization in working capital levels and a reduction in cash as companies start to invest in growth, we should see ROCEs rising again to pre-pandemic levels. For Japanese companies, however, the task can be more challenging. Japanese companies need to take a more strategic approach in improving their returns on capital, and treasury can play a key role.

We believe achieving a world class treasury for Japanese companies rests on three pillars:

- **Think global:** As companies expand their footprint globally, there is a need to establish a globally integrated and centralized treasury, enabling better visibility and control over treasury processes and liquidity sources. Setting up treasury operating models such as regional treasury centers, shared service centers and in-house banks, may sometimes be key to achieving the optimal treasury state. However, the path to reaching the optimal state is not fixed and depends on many variables including the type of business, the current state of its treasury and its future goals. It is important, therefore, for companies to learn from industry leaders and peers, and choose global partners with the right solutions and experience to help in the journey.
- **Digitization:** Automation and digitization are extremely important when it comes to achieving an optimal treasury state. Digitization of manual processes can significantly improve the speed and quality of treasury processes while cutting the operational cost. Tools based on technologies like robotic process automation, machine learning and artificial intelligence have proven to be effective across many treasury functions, including payments reconciliation, reporting, cash visibility and cash forecasting. The use of such automated tools can help in streamlining operations, driving data-driven decision-making and freeing up resources that can provide more strategic value to the organization.
- **Liquidity and working capital optimization:** The importance of liquidity and working capital management cannot be overstated, given the impact the pandemic has had on corporates worldwide. Efficient working capital and liquidity management through streamlined processes, trade finance solutions and efficient liquidity structures can bring about significant balance sheet efficiencies, and provide cheap and reliable sources of funding.

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