
Mizuho Economic Outlook & Analysis

October 20, 2017

Corporate behaviors shown in cash flows *Signs of change in broadly-defined investment (M&A, etc.) and* *funding in Japan*

< Summary >

- ◆ Until FY2015, much of the growth of cash generated by expanding profits was not diverted to investment but was used for shareholder returns and debt repayments. In FY2016, however, interest-bearing debt turned higher as investment and loans for financing M&As expanded.
- ◆ In addition to domestic capital spending remaining robust, overseas investment, after taking a breather following some Japanese companies' withdrawals from China, began to expand again. M&As are on the rise, mainly in overseas markets. The number of M&As by unlisted companies reached a record high, broadening the base for further M&As by Japanese firms.
- ◆ Borrowings and funding through corporate bond issuance are expanding in the negative interest rate environment, but equity financing remains sluggish. Going forward, while Japanese companies are expected to continue enhancing shareholder returns and expanding broadly-defined investment, it is necessary to keep close tabs on the possibility of the investment stance of Japanese firms shifting due to concerns over the future of the global economy.

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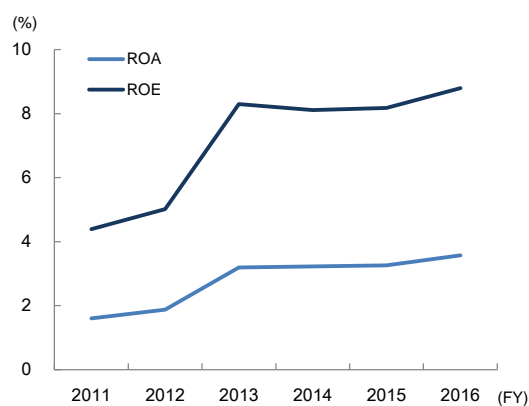
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1. Amid improving corporate earnings, signs of change seen in corporate investment and funding behaviors

In tandem with the expanding earnings of Japanese companies, return on assets (ROA) and return on equity (ROE) of listed companies, etc.,¹ have also been improving (Chart 1). In particular, ROE now exceeds 8%, the minimum target level indicated in the ITO Review of Competitiveness and Incentives for Sustainable Growth – Building Favorable Relationships between Companies and Investors of 2014, suggesting an enhancement of capital efficiency. Together with improved earnings, listed companies’ ongoing efforts to increase shareholder returns through dividend payments and repurchases of own shares apparently helped improve their ROE (Chart 2). In FY2016, however, an expansion of share repurchases by listed companies took a breather, which may have given rise to the possibility that funds generated by growing earnings are now being directed to investment. Under these circumstances, this paper will look into possible changes in broadly-defined investment, including M&A activities, and funding by examining corporate expenditures and procurement based on an analysis of overall cash flows of listed companies, etc.²

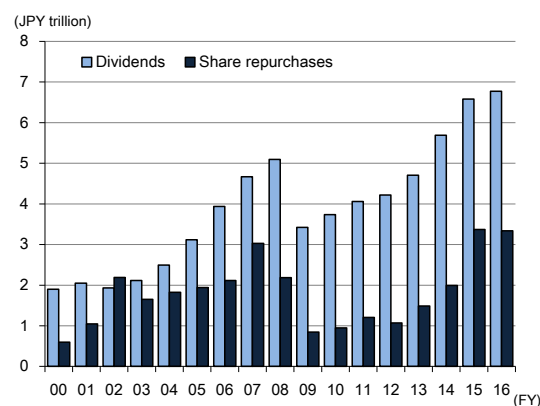
Chart 1: ROA and ROE of listed firms, etc.



Note: Listed companies, etc., mean the total value of listed companies and companies required to submit financial statements, on a consolidated accounting basis, excluding financial businesses.

Source: Made by MHRI based on Nikkei NEEDS-FQ

Chart 2: Dividend payments and share repurchases by listed firms, etc.



Note: Listed companies, etc., mean the total value of listed companies and companies required to submit financial statements, on a consolidated accounting basis, excluding financial businesses.

Source: Made by MHRI based on Nikkei NEEDS-FQ

¹ Listed companies, etc., mean listed companies and companies required to submit financial statements. An analysis in this paper was conducted on a consolidated accounting basis, excluding financial businesses.

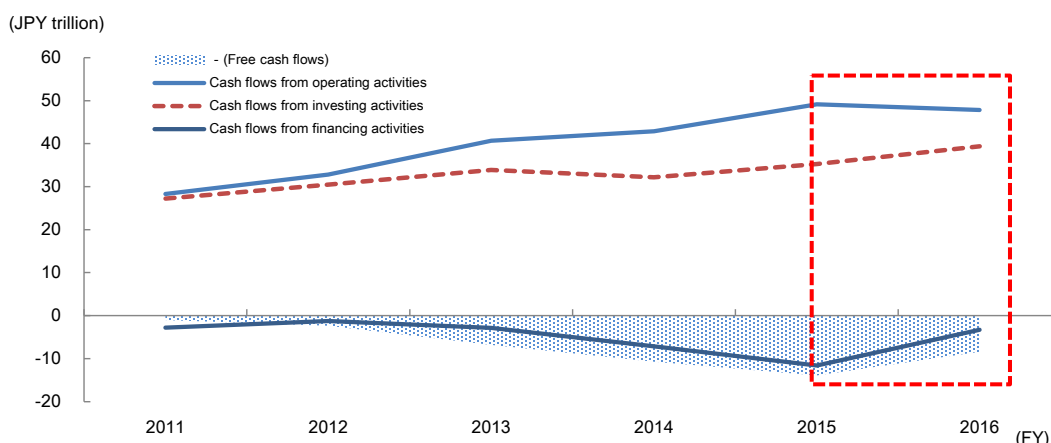
² For an analysis of cash flows of listed companies, there are several preceding studies, including one by the Research and Statistics Department of the Bank of Japan (BOJ) (2007). The analysis in this paper was conducted along the lines of the BOJ study.

2. Positive margins of free cash flows and negative margins of financial cash flows both narrow in FY2016

First, let us look at overall developments with cash flows of listed companies, etc., to gain an overall picture (**Chart 3**). Cash flows from operating activities, an indicator of the corporate power to generate cash, have been following the trend of expansion, growing some 1.5 times in FY2015 over FY2011. During the same period, cash flows from investing activities, an indicator of corporate investment trend, expanded, but their increasing trend was weaker than that of cash flows from operating activities until FY2015, allowing free cash flows, or the difference between cash flows from operating activities and cash flows from investing activities, to expand. This suggests that much of cash, which has been generated at an accelerating pace in recent years, has been put aside as surplus cash, or for payments of borrowings and shareholder returns, instead of being directed toward capital spending, M&A, and other investment activities. In fact, in tandem with the expansion of free cash flows, cash flows from financing activities, an indicator of corporate fund-raising operations, have seen their negative margins grow larger, showing that Japanese companies have used larger cash on hand for debt repayments and shareholder returns.

Moving into FY2016, however, while the growth of cash flows from operating activities slowed, cash flows from investing activities expanded, resulting in the year-on-year positive margins of free cash flows to narrow. Cash flows from financing activities also significantly reduced their negative margins, an indication that Japanese companies are now beginning to shift from debt repayments to raising funds, as well as strengthening their move towards investment.

Chart 3: Overview of Cash Flows of Listed Companies, etc.



Note: 1: Listed companies, etc., mean the total value of listed companies and companies required to submit financial statements, on a consolidated accounting basis, excluding financial businesses.

2: For comparison with cash flows from financing activities, free cash flows are shown in negative value on the chart.

Source: Made by MHRI based on Nikkei NEEDS-FQ

3. Major changes seen in FY2016 were growth of investment and loans, including M&A, and interest-bearing debt

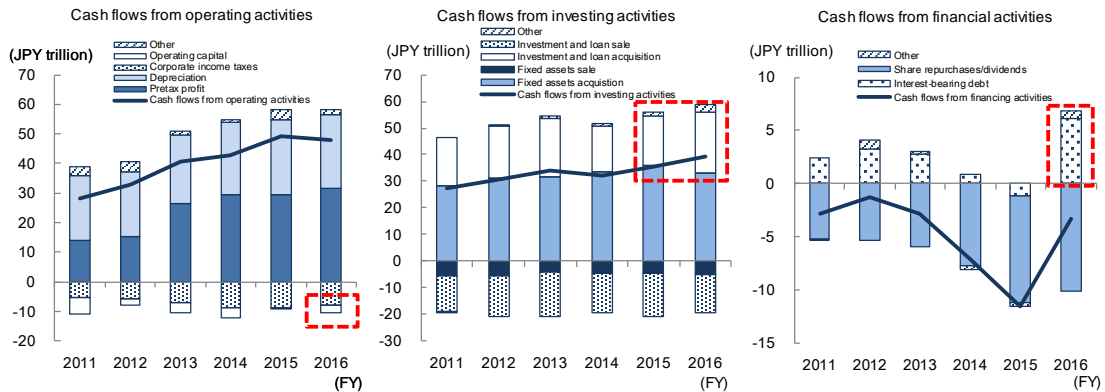
Next, let us observe the respective changes detected in cash flows from operating activities, investing activities, and financing activities (**Chart 4**). Cash flows from operating activities continued to expand until FY2015, aided by improving pretax profits. While pretax profits increased in FY2016 as well, depreciation expenses declined from the previous fiscal year, keeping cash flows from operating activities roughly in the year-before range. Meanwhile, cash flows from investing activities have been growing moderately, but the pace of their increases quickened in FY2016 as investment and loans, including those for M&A deals, expanded significantly. Cash flows from financing activities saw their negative margins expanding until FY2015, as purchases of own shares and dividend payments increased, and interest-bearing liabilities shifted from an excess of procurement to an excess of repayments. In FY2016, however, negative margins of cash flows from financing activities narrowed significantly, as shareholder returns took a breather and interest-bearing debt turned higher.

These changes become more conspicuous by looking at the ratios of major items of expenditure to cash flows from operating activities (**Chart 5**). Until FY2015, the ratios of capital spending and investment and loan acquisitions to cash flows from operating activities had been on the decline, while shareholder returns had been expanding up to around FY2015. During this period, interest-bearing liabilities transitioned from procurement to repayments. In FY2016, however, interest-bearing debt moved back to an excess of procurement as investment and loan acquisitions turned higher.

Let us also look at what happened with cash and cash equivalents in FY2012-FY2016 (**Chart 6**). The line graph for cash and cash equivalents on the chart shows a decrease into FY2015, but appears to indicate an expansion again in FY2016. Actually, however, interest-bearing debt increased more than cash and cash equivalents in FY2016, apparently giving an upper hand to the cash-out. In fact, the cash-out amounts, shown by bar graphs in the negative territory on the chart, increased from FY2014 to FY2016. It appears that the cash-out was driven by an increase in the fixed assets acquisition in FY2015 and by the investment and loan acquisition in FY2016.

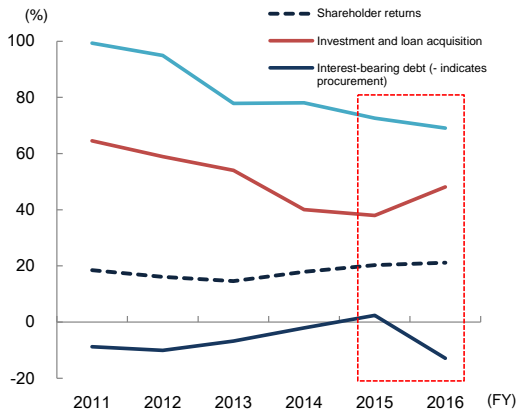
As seen above, the expansion of broadly-defined investment, including M&A, and the increase in interest-bearing liabilities greatly characterized the behavioral changes of Japanese companies in FY2016. As such, the next section will more closely examine the trends in capital spending, M&A and financing by Japanese companies to identify factors behind their behavioral changes and to provide insight on future trends.

Chart 4: Contribution by factor to cash flows from operating, investing and financing activities



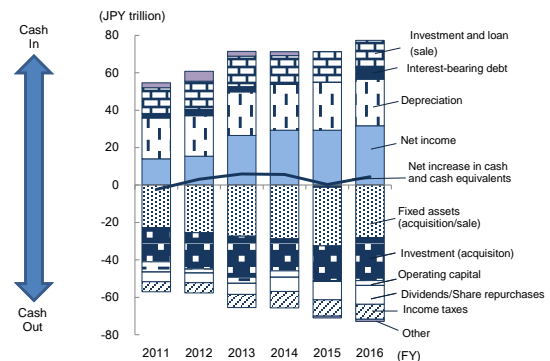
Note: Listed companies, etc., mean the total value of listed companies and companies required to submit financial statements, on a consolidated accounting basis, excluding financial businesses.
 Source: Made by MHRI based on Nikkei NEEDS-FQ

Chart 5: Ratios of major items of expenditure to cash flows from operating activities



Note: Listed companies, etc., mean the total value of listed companies and companies required to submit financial statements, on a consolidated accounting basis, excluding financial businesses.
 Source: Made by MHRI based on Nikkei NEEDS-FQ

Chart 6: Cash-in and Cash-out



Note: Listed companies, etc., mean the total value of listed companies and companies required to submit financial statements, on a consolidated accounting basis, excluding financial businesses.
 Source: Made by MHRI based on Nikkei NEEDS-FQ

4. Capital spending rising moderately both domestic and overseas, moves to increase overseas production likely to continue going forward

Let us look at capital spending first. In Japan, capital spending has kept rising moderately since FY2012. By type, construction investment and investment in intellectual property (R&D and investment in software) has remained robust (**Chart 7**). Machinery investment grew somewhat weaker in the first half of FY2016, but started expanding again from the second half of FY2016. In the background is the rising demand for machinery investment in response to increasing global demand for information

technology as well as higher demand for investment in labor-saving machinery amid the mounting sense of labor shortage in Japan. Mizuho Research Institute. expects domestic capital spending to continue to moderately increase in FY2017 as well.

Overseas, Japanese companies' investment has also stayed largely on the course of moderate expansion (**Chart 8**). The growth of foreign direct investment slowed in FY2014-FY2015, but began expanding again in FY2016. An expansion of reinvestment of profits stands out as a characteristic trend in recent years. Japanese companies appear to be intensifying their stance of enhancing local investment, rather than sending profits back to Japan.

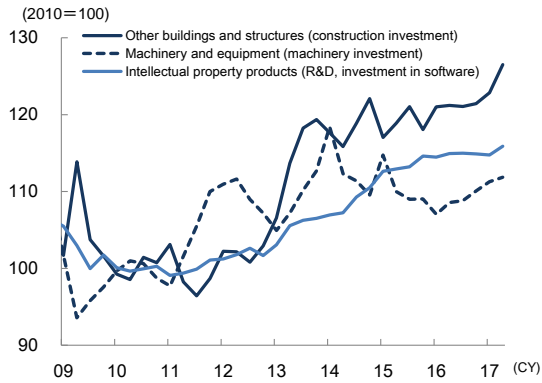
The ratio of overseas capital spending by large Japanese corporations to their total capital spending rose sharply toward FY2013, but subsequently leveled off or declined modestly (**Chart 9**). However, their plans for FY2017 call for greater investment overseas again. According to large corporations' medium to long-term overseas supply plans, about 60% of them intend to enhance their overseas supply capacity. Thus, large Japanese corporations are expected to continue to boost their overseas investment.

Looking at large corporations' overseas capital spending by region, investment in Asia declined from FY2013 through FY2016, while investment in North America increased (**Chart 10**). The lower weight of investment in Asia may have been affected by the withdrawal of Japanese firms from the Chinese market (**Chart 11**)³. In FY2017, however, Japanese companies' investment in Asia is expected to increase again. As an increasing number of Japanese companies are moving the nexus of investment out of China to member states of the Association of Southeast Asian Nations (ASEAN) (**Chart 12**), the demand for investment in Asia, particularly in the ASEAN region, appears to stay robust.

In light of the developments reviewed above, Japanese companies are expected to continue expanding their capital spending domestic and overseas in FY2017. However, according to the Bank of Japan (BOJ)'s September "Tankan" Short-Term Economic Survey of Enterprises in Japan released on October 2 FY2017 capital spending plans by larger manufacturers have been revised downward, albeit marginally, from the June Tankan survey. Japanese companies may be taking a cautious view of the prospects of the global economy, in part due to lingering concern over a possible slowdown of economic activities in China. It is necessary to keep close tabs on a possible shift in the investment stance of Japanese companies.

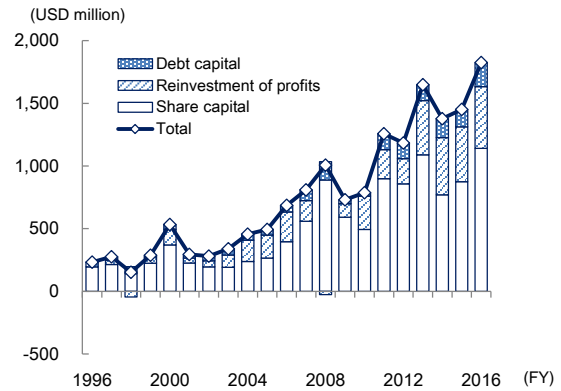
³ The number of Japanese companies advancing into North America is not necessarily increasing as shown in Chart 11. However, increased investment by U.S. subsidiaries of Japanese companies already there may have helped push up the U.S. ratio of overseas capital spending by region in Chart 10.

Chart 7: Domestic capital spending by type (Gross fixed capital formation by type)



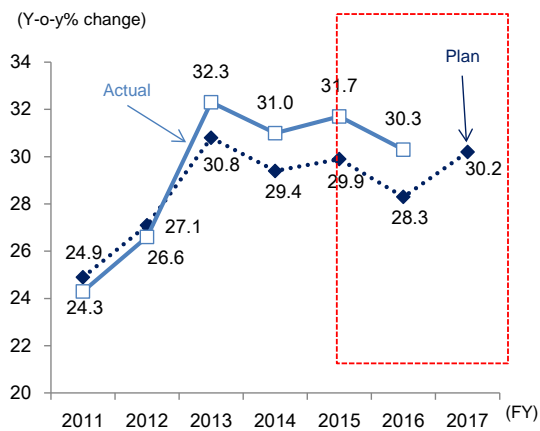
Note: On a quarterly basis, nominal, seasonally adjusted.
Source: Made by MHRI based on Cabinet Office, *National Accounts*

Chart 8: Foreign direct investment



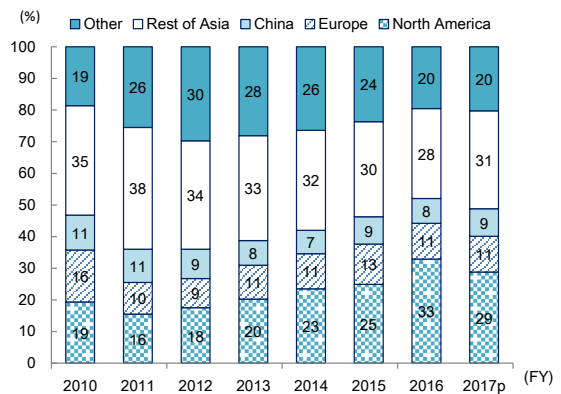
Source: Made by MHRI based on Bank of Japan, *Balance of Payments*.

Chart 9: Overseas capital spending ratios for large corporations (Actual and Plan)



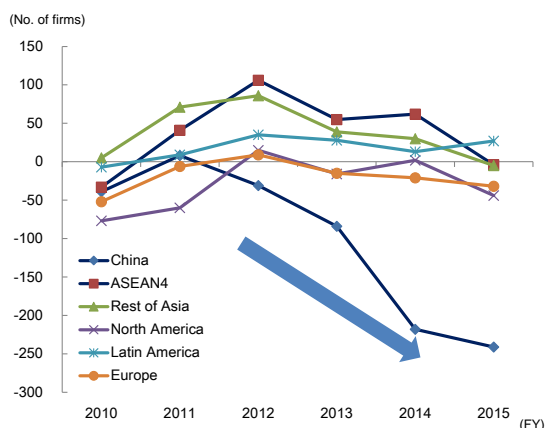
Source: Made by MHRI based on Development Bank of Japan, *Survey on Planned Capital Spending*

Chart 10: Share of large corporations' overseas capital spending by region



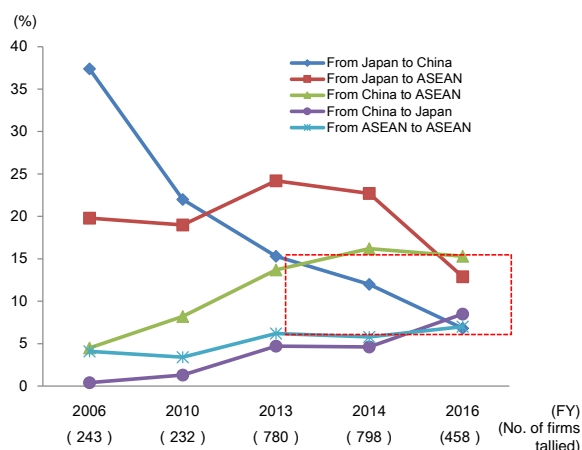
Note: Plans for FY2017.
Source: Made by MHRI based on Development Bank of Japan, *Survey on Planned Capital Spending*

Chart 11: Overseas advances and withdrawals by region (Advances - Withdrawals/Dissolution)



Note: Graphs in the chart show the number of firms obtained by subtracting the number of dissolution and withdrawals from the number of advances.
 Source: Made by MHRI based on Ministry of Economy, Trade and Industry, *Survey of Overseas Business Activities*

Chart 12: Main patterns of transfer in Japanese firms' base reorganization



Source: Made by MHRI based on Japan External Trade Organization (JETRO), *Survey on the International Operations of Japanese Firms*

5. M&As rising mainly overseas; value growth modest, but active investment expected to continue

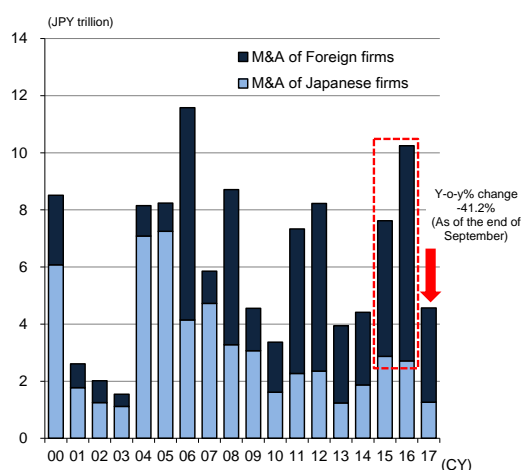
The next point is about M&As. The combined value of mergers and acquisitions by listed companies has been rising since 2014 (**Chart 13**). While the combined value of M&As has now recovered to the levels before the Lehman Brothers debacle, but the breakdown has undergone significant change. The rising M&A value has been driven by the acquisitions of overseas companies. If anything, the Japanese yen has remained rather weak against other major currencies since 2014, a phenomenon that is normally considered as a headwind for Japanese companies' acquisitions of foreign firms. Despite this adverse factor, the value of M&As of foreign firms increased considerably apparently reflecting the proactive stance of Japanese companies on M&As of overseas businesses. According to a questionnaire survey on M&A players by RECOF, the themes that have been driving M&A deals in recent years include "the dwindling domestic market and the slowing growth" and "intensification of global competition," which apparently have motivated Japanese companies.

Looking at the overseas M&A targets by region, during a period between 2014 and 2016 when the funds spent on acquisitions showed particularly strong growth, the shares of firms in North America and Europe increased, while the shares of Chinese and other Asian companies declined. These patterns are similar to those of capital spending overseas by Japanese companies, which suggest that during the slowdown of the Chinese

economy from the second half of 2014 to 2015, Japanese companies shelved their M&A investment in China as well as in the rest of Asia that is highly dependent on China economically (**Chart 14**).

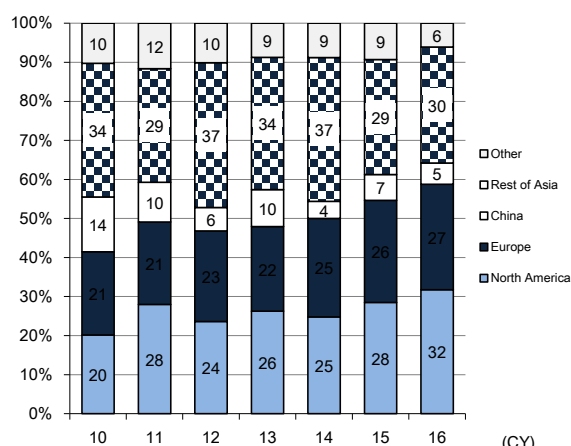
As for 2017, the overall M&A data as of the end of September show that the value of M&As dropped nearly 40% year on year both for domestic firms and overseas companies. After a string of failed big-ticket M&A bids for foreign companies, some Japanese companies may have turned cautious about acquiring large foreign companies. On the other hand, the number of M&A deals rose 19% year on year for Japanese firms and 11% for foreign companies, indicative of the still hearty appetite for medium-sized or small-scale acquisitions. This suggests the broadening bases of both potential buyers and potential bought-out companies eager to make use of M&A to expand business operations or acquire new business opportunities, going beyond the boundaries of big versus big deals. For example, the number of M&A transactions by unlisted companies reached a record in 2016, and M&A deals are particularly active in such industries as services and wholesale trade. One conceivable reason for this is the serious succession issue among small and medium-sized companies. Furthermore, M&A bids for venture businesses are also on the rise, with non-financial industrial companies actively coming into play along with venture capital firms. Under these circumstances, it would not be far off the market to expect Japanese companies, shored up by favorable earnings and large surplus funds on hand, to remain positive about M&A activities, despite the recent lull in increases in the total value of M&A deals.

Chart 13: Changes in the value of M&As by listed firms



Source: Made by MHRI based on RECOF

Chart 14: Regional composition of foreign firm M&As (No. of cases)



Source: Made by MHRI based on RECOF

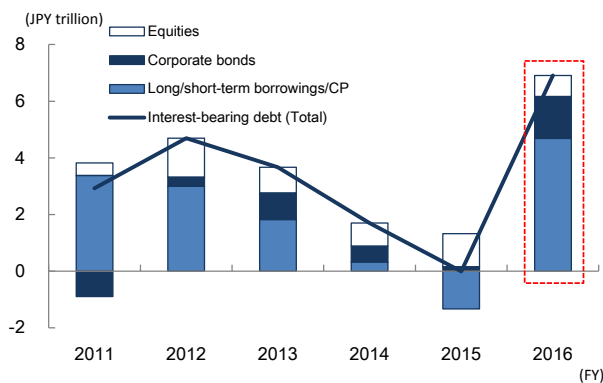
6. Borrowings and bond financings growing in the negative interest rate environment, but funding with new shares lackluster

Lastly, let us touch upon the funding trend. The changes in interest-bearing liabilities of listed companies, etc., show that funds raised kept shrinking between FY2013 and FY2015, and repayments of debt exceeded newly raised funds in FY2015 (**Chart 15**). However, the picture turned around in FY2016, as financings again exceeded repayments by a significant margin⁴.

The breakdown of the increase in interest-bearing debt in FY2016 shows that borrowings and corporate bonds grew substantially, but proceeds from issuance of new shares remained lackluster. With negative interest rates prevailing, Japanese companies are actively raising funds via borrowings at low interest rates or bond placements.

As consumer prices in Japan hardly show signs of creeping up, the Bank of Japan (BOJ) is expected to hold on the current easing monetary policy for the time being and the world of low interest rates appears to continue for a while. Against this background, Japanese companies are likely to maintain moves to raise funds through borrowings and issuance of corporate bonds instead of equity financing.

Chart 15: Interest-bearing debt of listed companies (changes)



Note: Listed companies, etc., mean the total value of listed companies and companies required to submit financial statements, on a consolidated accounting basis, excluding financial businesses.

Source: Made by MHRI based on Nikkei NEEDS-FQ

7. Conclusion

In sum, against the backdrop of improving corporate earnings, Japanese companies have been more than forthcoming about shareholder returns. On top of this, they appear to be flexing their muscle to enhance broadly-defined investment, including capital spending and M&As. In FY2016, reflecting this rising demand for funds for broadly-defined investment, Japanese companies are again expanding efforts to raise funds by making use of interest-bearing debt. Particularly conspicuous are higher issuance of corporate bonds and increased borrowings.

Going forward, Japanese companies are expected to continue to make broadly-defined investments both domestic and overseas, in addition to shareholder

⁴ Interest-bearing debt increased mostly in the information-communication and real estate industries. Excluding the two industries, however, interest-bearing debt did still increase, spawning signs of change in fund-raising by Japanese companies.

returns. However, it is necessary to closely monitor the risk of corporate investment stances changing at any moment if concerns over the future course of the world economy dampen investment sentiment among Japanese companies. As pointed out in Arita *et al.* (2017), Japanese companies, in comparison with European and U.S. peers, are still structured to have low returns on low risks⁵. Expectations are high for Japanese companies to take proactive risk-taking and investment actions from the medium to long-term point of view.

⁵ Comparison of the dispersion and medium value of ROE of listed companies among the four major industrial countries in FY2012-2016 showed that Japan had the lowest dispersion (thus, low risk) and lowest profitability (thus, low return). For details, see Arita, *et al.*(2017), "Has Japan Enhanced Its Earning Power."
(<https://www.mizuho-ri.co.jp/publication/research/pdf/insight/jp171002.pdf>)

Refer to the original Japanese report at the following with respect to reference material.

<https://www.mizuho-ri.co.jp/publication/research/pdf/insight/jp171020.pdf>