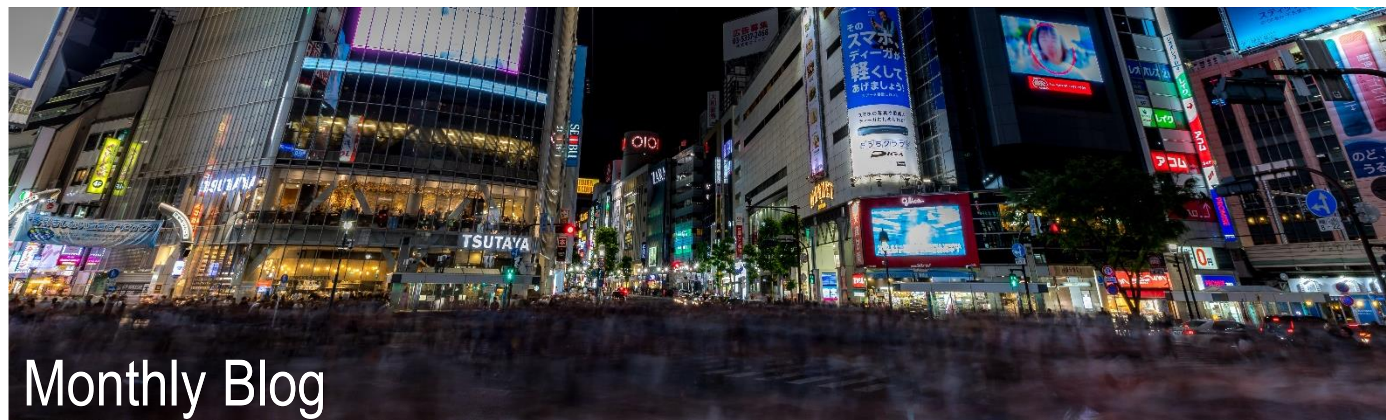

Monthly Blog

PM’s Perspectives

10 March 2020

Companies are becoming more dependent on capital gains

There are several ways for companies to earn revenue and we see more and more companies booking capital/revaluation gains in recent years following the rise of asset prices. For example, **SoftBank Group** cares more about the price volatility of its investment destination in China, **Alibaba,** than the profits in its core business. The company even began to redefine itself as an investment company instead of a telecom carrier. Major trading houses are also making more money from their business investments than by trading businesses. Capital/revaluation gains stand out at **Itochu Corporation**, while **Mitsubishi Corporation** is going to raise the target of capital gains for the new mid-term management plan. The ratio of capital gains against the total revenue is also rising at technology companies such as **Rakuten, CyberAgent** and **GMO Internet,** that already operate investment businesses.

The increase of capital gains is a result of accommodative monetary policies and asset price increases. For example, leasing companies used to make money by using short-term funds for mid-/long-term finance lease transactions. This mechanism worked well until 2007 with the gap between contract terms as the revenue stream. However the sector experienced a downturn in profitability when lease accounting standards were revised in 2008 and demands decreased. The shrinking spread between long- and short-term interest rates also hit the sector. On the other hand, prices of aircrafts/real estate were rising on the back of monetary easing policies at that time. So leasing companies changed their business model and started to use capital gains as a source of earnings. They have successfully earned capital gains by taking price volatility risks and selling aircrafts after their lease periods.

Something quite interesting about the trading houses described above and SoftBank is that they have not only put money into companies but also made efforts to raise their corporate values. SoftBank Group has improved its investment returns by expanding its business in Japan through its subsidiaries including **SoftBank Corp** and **Yahoo** after having engaged in overseas investments, while Mitsubishi Corporation released a business operating plan instead of a business investment plan and has started to pursue value improvement of investment destinations by managing them by itself. The more capital gains companies earn, the more they may focus on value improvement rather than just waiting for asset price increases.

Now that the share of capital gains against overall corporate revenue is higher than before, corporate earnings are hit harder by asset price declines. If the aircraft price declines in the future, Mitsubishi Corporation would not just lose capital gains that had been booked until then but would also be forced to book losses on asset sales and impairment losses. This is not only a problem for Mitsubishi. Many other Japanese companies that have accumulated capital gains from stocks and real estate are facing the same issue.

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The impact of asset price volatility on the economy seems to be growing just like that of corporate earnings. Traditionally there were two channels from stock price rallies to economic recoveries. Higher share prices boost consumption while lower capital costs spur capital investments. However, I noticed through my everyday interviews that domestic companies don't seem to be as interested in capital investments even when the capital costs come down. They don't increase their investments unless cash inflows increase as most companies are excluding a part of some industries, such as real estate and financials. These companies have financial policies in place in order to keep free cash flow positive. However, if asset prices rise on the back of monetary easing policies, they may decide to sell their assets and pour the proceeds into new investments. What I want to mention here is that the economy now fluctuates through these new channels, namely asset price increases → cash inflows through asset sales → cash outflows through capital investments, capital injections and so on.

I assume a so-called asset price cycle (asset price increases → decline in profitability for new investments → asset price declines → improvement in profitability for new investments → asset price increases) which affects the earnings results of companies that depend on capital gains, just like manufacturers repeat an inventory cycle (production increase → inventory growth → production cutback → drop in inventory → production increase), and the cycle then determines their earnings results.

The asset price increase boosts capital gains, which means an increase of funds for reinvestments. Increased investments will bring about a further increase of asset prices, leading to bigger capital gains for investment companies. However, when companies continue to reinvest in assets at a high price, their profitability should decline down the road, leading to a correction of overvalued asset prices. At this stage, companies lose not only their capital gains but also funds for reinvestment, which leads to a further decline of asset prices. Companies will be forced to book losses on sale or impairment losses, but the profitability for new investments improves at this stage thanks to a decline in asset prices. Asset prices will then turn up once again when investors begin to appreciate the cheaper assets.

We often come across manufacturers carrying over sales at the end of the fiscal year (FY) to the next FY in good times while enhancing sales promotions at the end of the FY in bad times in order to avoid fluctuations in earnings. Companies with huge capital gains do the same thing. They often book impairment/revaluation losses at the end of the FY in good times while booking capital gains and revaluation gains in bad times.

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Mr KAMIISHI joined Daiwa SB Investments in 2009 and covered US & European equities as a strategist from 2010 to 2013. He moved to Hong Kong in 2013 as an analyst for the auto & industrials sector in Asia Pacific ex-Japan equity. In 2015, he returned to Japan and covered the IT & services sector as a Japan equity analyst. In 2016, he became a portfolio manager in the Value + Alpha group.

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Note: Daiwa SB Investments Ltd. (DSBI) merged with Sumitomo Mitsui Asset Management Company, Limited (SMAM) on 1 April 2019.

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