Japan: A Source of Dividend Growth

July 2020

Executive Summary

- The COVID-19 pandemic has stressed companies' cash flows, so companies with limited reserves find their ability to pay dividends compromised.
- Investors face the prospect of reduced dividend yields from constituents of major western market indices such as S&P500, especially when sovereign bond yields are at historic lows.
- Companies that successfully sustain superior dividends benefit from share prices that reflect higher future earnings.
- In this article we explain the characteristics of the Japanese equities market causing investors to examine Japanese companies as a source of higher dividend returns.
- We explain how the investment team managing the Japan Equity Sustainable Dividend Strategy target companies expected to deliver sustainably higher dividends and capture this valuation premium.

An Evolving Dividend Environment

Against the perceived wisdom that Japan is not shareholder friendly like the US, since 2013 the trend has been for Japanese companies' dividends to increase while those in the US have been largely flat. The average dividend yield on Japan's broad based TOPIX index now exceeds the S&P500 yield.

One of the effects of the COVID-19 pandemic has been to put many companies' profitability under threat, questioning numerous 'blue chip' companies' ability to maintain dividend payouts.
In particular aggressively managed companies with limited cash resources and high borrowings have found their plans to pay dividends or buy back shareholder capital compromised by the financial impact of the economic shut-down.

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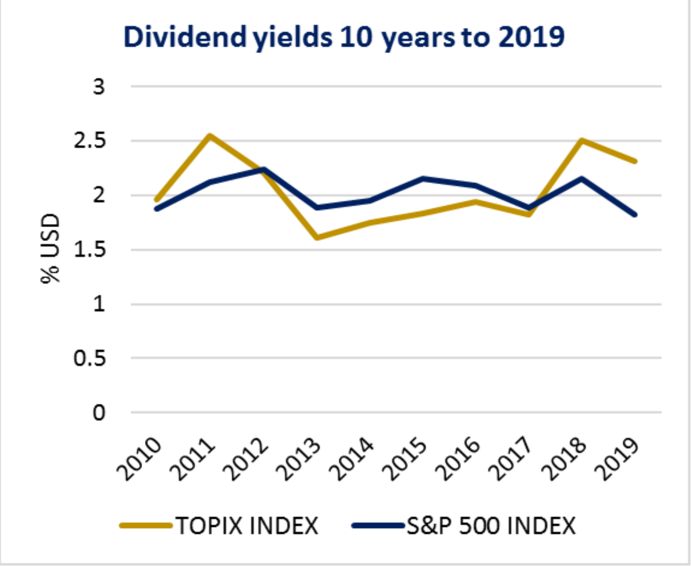
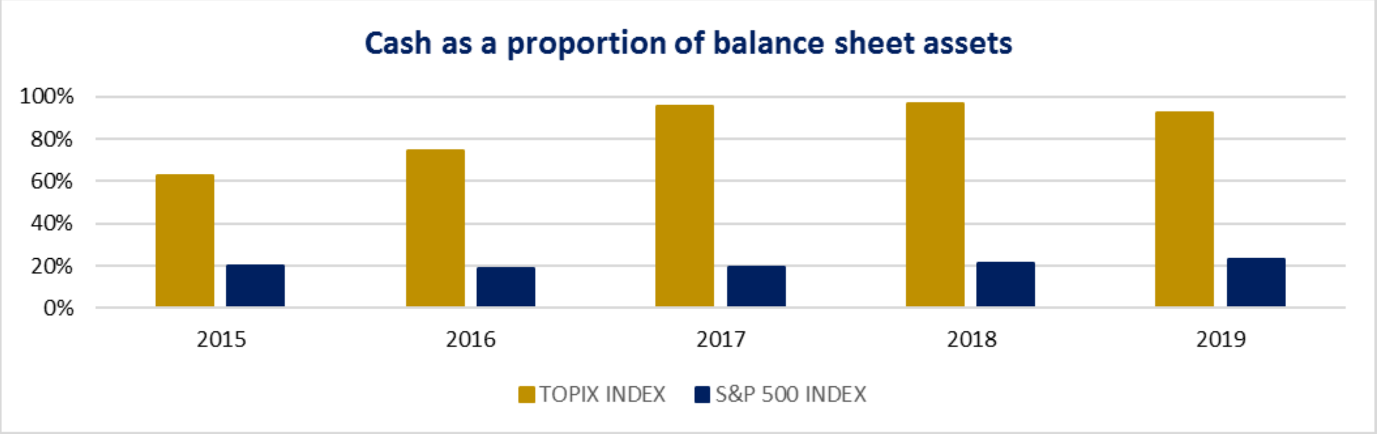


Source Bloomberg
Percentage annual average gross dividend yields calendar years 2010 -2019.

Changing Behaviours

Japanese companies generally tend to be cautiously managed with high cash holdings and low borrowings, characteristics not generally regarded as consistent with maximising shareholder returns.

However Japan's corporate sector has seen major changes in the past decade due to numerous reforms from Prime Minister Shinzo Abe's government who has backed corporate governance reforms, combined with societal changes such as founder-owners passing on management control to the next generation.

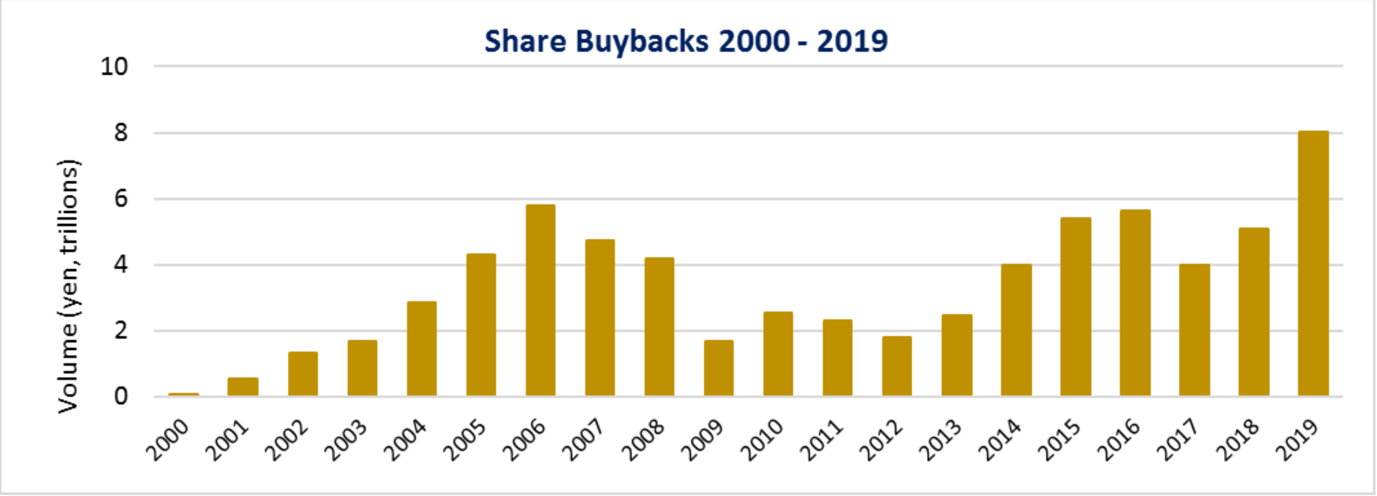


Source Bloomberg
% cash/net assets, calendar years 2015-2019.

The impact of these initiatives have been so profound that even keiretsu cross-shareholdings , financial and industrial groupings originally intended to protect companies from short term pressures that tend to block shareholder friendly changes, are being challenged and dismantled.

Another indicator of the degree of momentum behind change is that Japan is now the world's next largest private equity market after US, with powerful activist shareholders freely challenging the status quo.

These changes in the corporate environment have been critical factors in creating an environment conducive to increasing not only dividend yields but also share buybacks to historically high levels, approximately equivalent to an additional 1% yield.



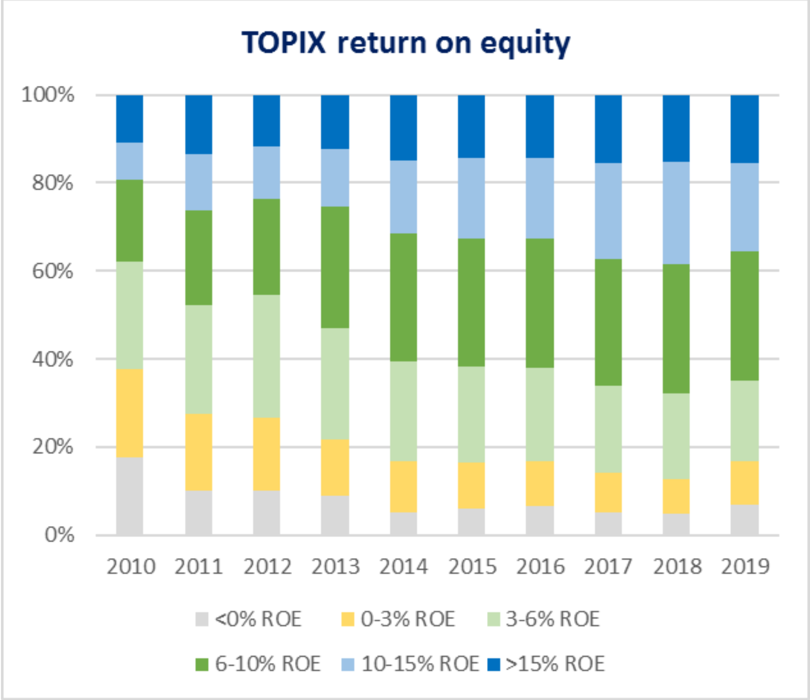
Source Bloomberg
TOPIX share buyback volume 2000-2019

Sumitomo Mitsui DS Asset Management

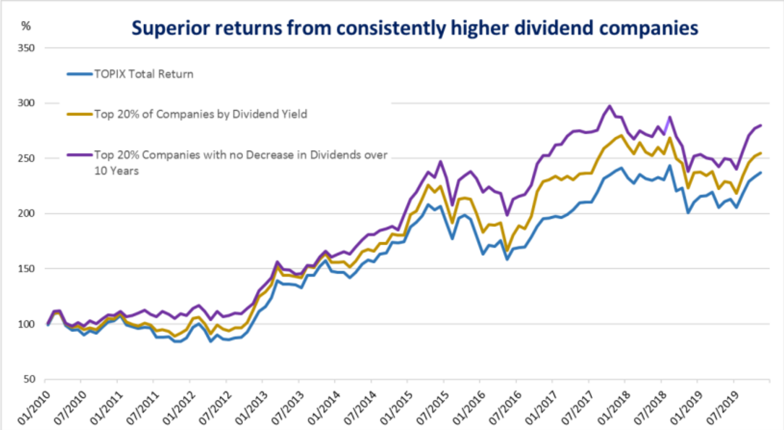
Shareholder Returns Vary

The majority of companies continue the traditional approach of prioritising the interests of broad stakeholder groups, such as local community and employees. However the last decade has seen a growing cadre of highly successful companies prioritising the interests of shareholders. As a consequence the TOPIX index is made up of companies with a very broad range of profitability – almost a fifth of companies achieve a return on equity of less than 3%, while a similar proportion return more than 15% per annum.

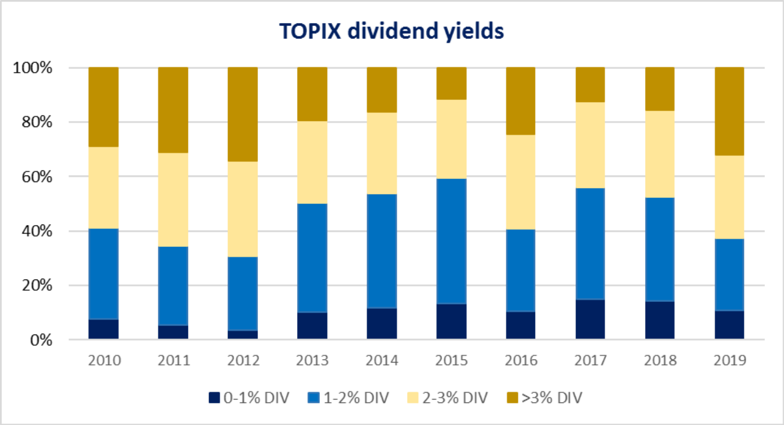
With shareholder returns varying so widely it is clear how important it is to be selective when investing, seeking out well manged companies and avoiding those that don't prioritise shareholders' interests.



Source Bloomberg
All TOPIX constituents' return on equity percentage, calendar years 2010-2019.



Source Bloomberg & SMDAM
Market-cap weighted portfolios are rebalanced at end of May each year.
Value as at Jan 2010 = 100



Source: Factset; All TOPIX constituents percentage dividend yield, calendar years 2010-2019.

Dividend Growth Drives Returns

In the 1950s Myron Gordon and Eli Shapiro articulated their Dividend Growth Model theory that's now part of recognised financial academia, stating that share values directly reflect the discounted value of future dividends. (Dividends, Earnings and Stock Prices, MJ Gordon, Review of Economics and Statistics 1959).
The Sustainable Dividend Strategy is designed to exploit the investment team's view that superior total returns can be achieved by investing in companies that pay consistently higher dividends. The investment team invests in companies that can sustain paying higher than average dividends over the long term, while avoiding companies that run the risk of having to reduce dividends.

Share buybacks are regarded by the investment team as another important way of returning capital to shareholders, however the team believe buybacks are to a greater extent influenced by the economic cycle and therefore have a less powerful relationship with share values.

Portfolio Holding - Kyowa Exeo Corporation

Kyowa Exeo Corporation develops and implements sophisticated and innovative systems connecting cities and their populations through telecommunications, electrical equipment and renewable energy. The company is expected to benefit from the upcoming introduction of 5G networks, continued upgrading of urban infrastructure and environmental systems for recycling and the efficient use of resources.

The Sustainable Dividend Strategy started investing in Kyowa Exeo Corporation in February 2016, since when the investment team has regularly meet with senior management. The company has a strong reputation for paying dividends as its managers have a history of not reducing payout levels in more than 20 years.

The current dividend yield is in excess of 3%, the investment team believe this level is sustainable as its supported by high levels of net cash and the underlying business' strong ability to generate cash. The Dividend Coverage Ratio was 5.50 in 2019 falling to 1.74 in 2020, when the dividend represented 3.34% of distributable reserves.

Management have periodically carried out share buybacks when there is scope for prudent distribution of further retained profits.

Source: Sumitomo Mitsui DS Asset Management, Bloomberg

Portfolio Holding - Tokyo Ohka Kogyo

Tokyo Ohka Kogyo manufactures chemicals and equipment used in the production of semi-conductors and liquid crystal devices, and in the assembly of electronic devices. The company specialises in photoresist products, light sensitive materials widely used in silicon wafers and circuit boards.

The strategy first invested in Tokyo Ohka Kogyo in February 2019. The investment team believe that demand for photoresist products will continue to grow due to increased demand for silicon chips and future developments in miniaturisation.

Tokyo Ohka Kogyo has both a strong net asset position as well as generating significant cash flow, which the investment team believe makes future dividend increases sustainable. The dividend payout level has not been reduced since the Global Financial Crisis; since 2011 the dividend has increased by more than 350% taking the current dividend yield to 2.3%.

The 2019 Dividend Coverage Ratio was 1.08, with the year's dividend representing 3.43% of distributable reserves.
Tokyo Ohka Kogyo has a flexible policy for share buyback, for which it uses to distribute excess operating profits.

Source: Sumitomo Mitsui DS Asset Management, Bloomberg

Disclosures

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