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Views from the Japan Equities Small Cap Desk

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Measures to prevent P/B ratios below 1 and enhancements in shareholder returns.

Recently, there has been a lot of discussion in the stock market about how to deal with companies that are undervalued by investors. This was triggered by the Tokyo Stock Exchange's (TSE) announcement that it would require companies with P/B ratios below 1 to improve their capital efficiency. The share prices of many low P/B ratio firms are on an upward trend due to speculation that various measures will be introduced to improve investment attractiveness.

My basic strategy is to invest in undervalued stocks. Although I do not necessarily focus on the asset side, I have benefited in some ways from the recent developments triggered by the TSE's requirements, as the P/B ratios for our investment portfolio are generally below 1. Apart from these individual interests, I believe that the series of developments are also broadly socially desirable.

Steady progress in enhancing shareholder returns

Many companies that have been forced to respond seem to view the TSE's policy as an abrupt change. However, it is not only a recent development that the TSE has become concerned about the large number of companies with P/B ratios below 1 and has identified low capital efficiency as a contributing factor. The reality is that while the problem has been highlighted time and again, improvements have been slow. The TSE has simply taken a step forward as a method of encouraging companies to change.

In my view, the "agitation" by the mass media and securities firms has contributed greatly to the momentum of the discussions and debate. Their focus on capital efficiency measures seems to be on shareholder return measures such as dividend increases and share buybacks. The TSE, on the other hand, is not necessarily seeking only shareholder return measures. Instead, the TSE has announced that it is seeking measures to improve overall capital efficiency.

Unfortunately, it is often the case that the media and stakeholders oversimplify the issue, and measures that may not be essential are vigorously promoted. This time, however, the situation is different. I also believe that the measures to improve shareholder returns, which are emphasised by the media and securities firms, are the most important measures to improve capital efficiency. Instead, we believe that the TSE's stance may be too general, and this may be obscuring the essence of the issue.

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Many companies are moving forward in their own modest ways to improve shareholder returns. Setting dividends and total returns, including share buybacks, has become commonplace. However, although financial assessment based on assets and liabilities is used as a prerequisite for setting a desirable shareholder return policy, few in Japan refer to external standards and implement them properly. The prevailing assessment is based on cash flow from operating activities, and in most cases aims to be "slightly above average" or "average" compared with the industry, which leaves significant room for improvement.

The "need for cash" is an excuse.

On a balance sheet basis, most Japanese listed companies currently appear to be overcapitalised for the business they are in. While the business itself has achieved a high level of asset efficiency, internal retained earnings have historically accumulated in the form of cash and deposits. In many cases, this has resulted in low return on assets (ROA) and return on equity (ROE).

In addition, it is logical for companies with highly stable earnings to use debt to improve the efficiency of their use of equity, but few companies actually do this. Some management groups even argue that "why should the cash and deposits we earn and accumulate be transferred outside the company", which is out of the question.

Firstly, the reason shareholders have accepted internal retention in the past should have been with the expectation that the funds would have been used within the business. If funds were not being used effectively, then a request for change should have been inevitable.

There are also many companies that claim that cash reserves are necessary for the stable operation of the business. However, most of them may be overly defensive.

Consider this example, I myself used to be an analyst in charge of a company that was debt-free and held cash and deposits exceeding its market capitalisation. They said they were doing this 'to keep their employees employed even if their sales went to zero for six months'. However, when the work at one of their sites was closed, they promptly laid off all of the employees at that site. The company was subsequently delisted through a takeover bid (TOB) by the owners. I remember that at that time, the directors were caught out for insider trading.

As this case shows, overcapitalised companies not only harm shareholders, but may, in some cases, lead to lax management. I believe that these companies should enhance shareholder returns, or at least not have excessive internal retention.

Unused retained earnings also has a negative macroeconomic impact. In recent decades, the Japanese economy has seen a decline in household savings rates due to factors including an ageing population. At the same time, companies, which are supposed to absorb funds, have increased their savings, and as a result, the economy is now in a situation where the government has to run a budget deficit to help keep the economy running.

Instead of hoarding excessive cash and deposits on hand, effective capital investment and mergers and acquisitions (M&A) should be carried out and appropriate expenses paid. The remainder is then returned to shareholders. I believe this is the responsibility of the top management.

Investors also need to evaluate the company carefully. Of course, there are many cases where enhanced shareholder returns are undesirable. In particular, companies whose low profitability of the business itself is the essential cause of their low valuation need to embark on more serious structural change rather than strengthening returns. As the realisation of structural change is difficult to achieve in a short time, it should be watched with some degree of long term perspective from the market's viewpoint.

Also, there are undervalued companies that are not favoured by capital and are easily and wrongly marginalised by investors. For example, when a company is sufficiently profitable and has a good attitude towards shareholder returns, but the share price is low, this would suggest an incorrect price and my stance on such companies is to "buy them quietly and wait patiently for valuations to return".

Source: Based on an article by Tatsuro NIGAURI, published in The Nikkei Online Edition on 14 February 2023.

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Mr Nigauri is an award-winning manager and has received many accolades, including the Lipper Fund Awards Japan (2012, 2013 and 2016), the R&I (Rating and Investment Information) Fund Awards (consecutive years from 2012-2019) and the J Money Fund Awards (2016 and 2017). He obtained a BA degree in economics from the University of Tokyo in Japan, and is a Certified Member Analyst of the Security Analysts Association of Japan.

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