

Global Insights

THE LIGHT FROM THE EAST



EXECUTIVE SUMMARY

- The Japanese economy's growth has come thanks to Japan's unique combination of strong corporate operating earnings yields, ultra-low finance costs, and ample opportunities to improve operations.
- The yen weakened in 2022 as the Bank of Japan (BOJ) prevented domestic yields from rising with those of comparable foreign securities. As the BOJ relaxes and eventually eliminates its cap on government bond yields, the yen should find a more natural level, which would imply a 12% appreciation, per consensus forecasts.
- The persistence of ultra-low interest rates partly reflects the inefficiency of the corporate sector, whose savings (retained earnings) consistently exceeds investment demand. Over the past decade, policymakers have pressured companies to boost return on equity targets and divest non-core assets.
- As these efforts intensify, a more robust market for corporate control is likely to emerge.

BACKGROUND

For many investors, Japan represents something of a paradox: how has the economy grown at one-third the rate of North America’s over the past decade? The answer lies in Japan’s unique combination of high operating earnings yields and ultra-low finance costs.

The recent spike in interest rates has introduced an arithmetic impediment to M&A activity: U.S. corporate assets yield less, on average, than the liabilities issued against them.

That’s not the situation in Japan, where borrowing costs remain well below operating earnings yields (Table I), leading to a *pro forma* residual cash return to equity that’s 6x higher than available in the U.S. (Figure I). The irony is that, despite this favorable backdrop, listed Japanese businesses tend to suffer from abnormally low returns on equity (ROE). This disconnect has drawn the attention of policymakers, activist investors, and stock exchanges, all of whom are increasing pressure on companies to raise ROE targets.

Table I.
Operating Earnings Yields & Financing Rates by Economy (Listed Companies)

| | EBITDA YIELD | FINANCING RATE | DIFFERENCE |
|--------|--------------|----------------|------------|
| Japan | 16.4% | 5.9% | 10.5% |
| Europe | 11.9% | 9.3% | 2.6% |
| China | 7.9% | 9.7% | -1.8% |
| U.S. | 7.3% | 11.1% | -3.8% |

Figure I.
Japan Boasts 6x Higher Residual Cash Yield to Equity (Pro Forma)

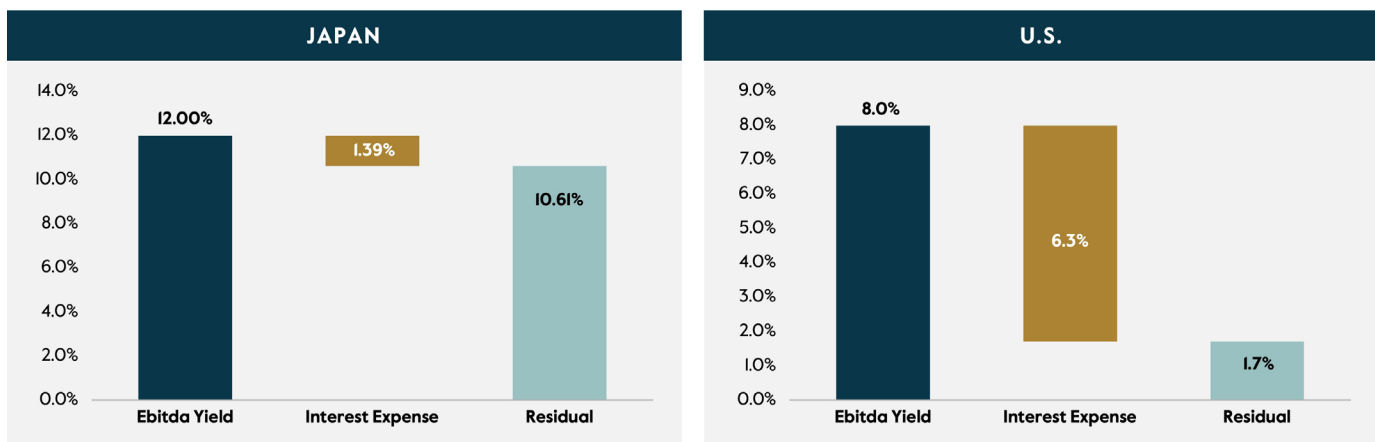


Table I. Source: Carlyle Analysis of Bloomberg data using S&P Broad Market Indices, May 5, 2023. There is no guarantee any trends will continue.

Figure I. Source: Carlyle; S&P Capital IQ; S&P LCD; Bloomberg, April 2023. Presented for illustrative purposes only. Example assumes a 60/40 debt/equity split, 2.5% LBO interest rate for Japan, and 10.5% LBO interest rate for the U.S.

A greater focus on capital efficiency metrics almost inevitably results in a more robust market for corporate control. The simplest way for a company to meet a higher ROE target is by selling those business units that currently fail to meet it. This yields economy-wide benefits when those assets prove more productive under new ownership. And, as observed in the U.S. and other markets, a broad restructuring of this sort also tends to spur delistings that allow public companies to plot a new course with trusted and economically aligned capital partners. Take-privates can look especially appealing to management if the alternative is drawn-out negotiations with new, activist shareholders with their own plans to boost ROE.

The factors that have caused the Japanese market to outperform over the past decade not only persist today, but have become more salient. And the current configuration of global valuations, interest rates, and exchange rates suggests that even greater outperformance may lie ahead.

THE PERSISTENCE OF JAPAN'S ULTRA-LOW FINANCING COSTS

Macroeconomic perspectives about Japan have gone on a peculiar roundtrip over the past two decades. At the turn of the century, Japan was viewed as an anomaly due to persistently low (or negative) inflation and interest rates. As the same disinflationary vise gripped Europe and North America in the years after the Global Financial Crisis (GFC), Japan came to be seen as the vanguard of advanced economies. It was but the first to encounter what was to come. Following the great inflationary shock of 2021-22, Japan is again regarded as an outlier, with interest rates and acquisition financing costs well below those in the rest of the world (Figure 2).

Central banks exert enormous short-term influence on interest rates, but real rates are anchored, over time, by economy-wide savings and investment propensities. The corporate

Figure 2.
Differences in Financing Costs, Japan – U.S.

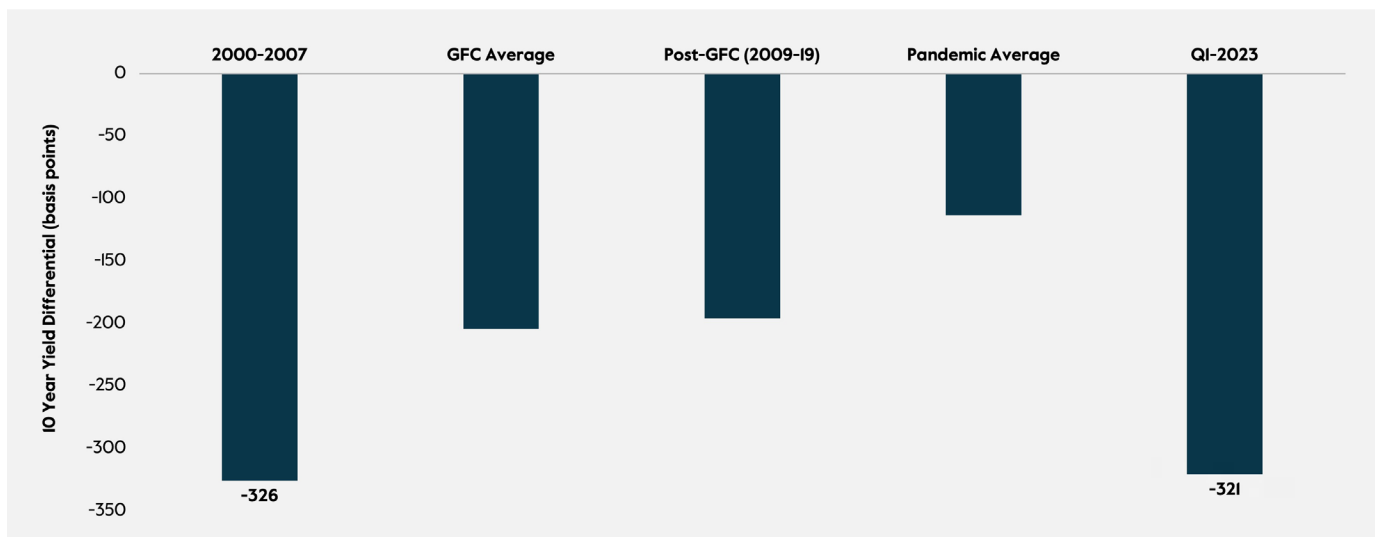


Figure 2. Source: Carlyle Analysis; Federal Reserve Board of Governors, May 2023.

sector plays an integral role equilibrating this market. Corporate capex is the main driver of aggregate investment, which delivers opportunities for households, pensions, and insurers to channel their savings into productive capital, and retained earnings account for a large share of economy-wide savings and provide the primary means for businesses to fund their own projects. As a result, real interest rates tend to be high when corporate capex requires external sources of funding and low when the corporate sector can fund most (or all) of its investment in-house.

While people often think of the relationship between investment and interest rates in cyclical terms, Japan proved it can have a structural character as well. Over the past 20 years, the Japanese corporate sector has run cash flow surpluses averaging 6% of GDP (Figure 3). The riskless return on household savings has been so anemic because businesses have no need for it. Each year, Japanese businesses generate enough cash to fund their entire capital budget, in the aggregate, with the equivalent of \$300 billion left over to lend to the government or acquire assets. With more lenders than would-be borrowers in the corporate sector, it should be no surprise that banks' loan-to-deposit ratios have collapsed and economy-wide savings exceeds total investment (Figure 4).

Figure 3.
Japanese Corporate Sector Savings Exceeds Investment

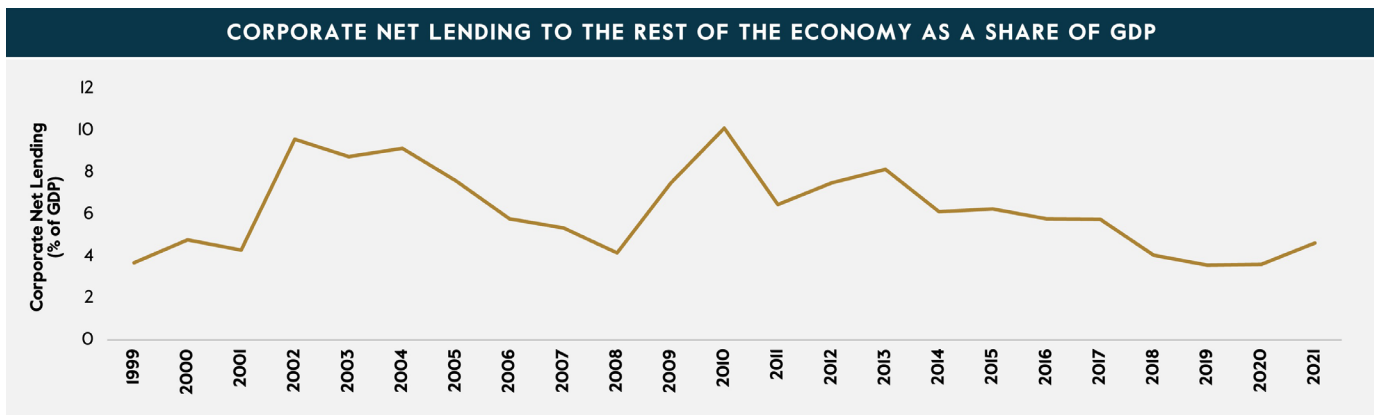


Figure 4.
More Lenders than Borrowers

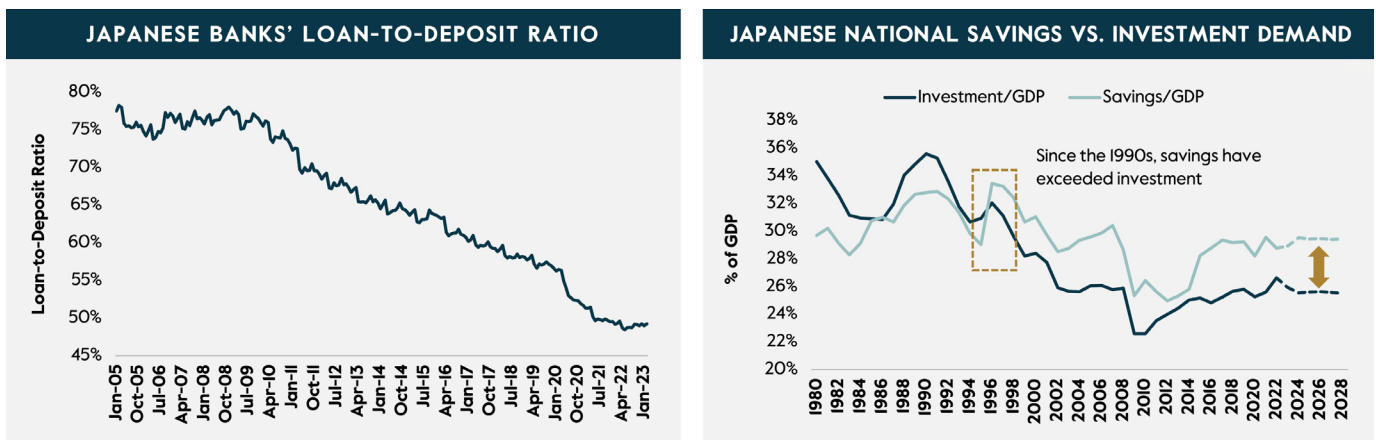


Figure 3. Source: OECD, National Accounts, May 2023.
Figure 4. Source: Carlyle; Bank of Japan; IMF WEO Database, April 2023. There is no guarantee any trends will continue or forecasts will materialize.

THE GLOBAL INFLATION SHOCK & FX ADJUSTMENT

The record monetary tightening of 2022-23 arrived at an inopportune time. Japan needed low rates to attract additional borrowers at the same time that the Fed and other central banks took interest rates to levels explicitly designed to deter additional borrowing. In response, the Bank of Japan (BOJ) prevented yields on Japanese Government Bonds (JGBs) from rising commensurately (Figure 5). With yields effectively capped by the BOJ, the exchange rate was forced to bear all of the adjustment, as investors sold JGBs to buy higher-yielding alternatives in foreign currencies (Figure 6, p. 7).

Japan has not been immune to the inflation shock. Prices rose 4.3% in the year ending January 2023 and core inflation remains well above the BOJ's 2% target. But by driving up the cost of (largely dollar-denominated) imported raw materials, the nearly 30% drop in the yen imported much of this inflation. This suggests that new BOJ Governor Ueda does not need to touch the money market interest rates on which most leveraged loans are based, but can continue the process, begun by his predecessor last December, of gradually raising (or altogether eliminating) the cap on JGB yields so the yen can find a more natural level.

Such a course would imply that USD/JPY gradually drifts to I20 over the next few years, according to IMF projections, equal to a 12% cumulative strengthening of the yen.¹ Near-term movements will depend on policy actions on both sides of the Pacific, but no one should worry about the yen as a long-run store of value. Yen foreign exchange markets are dominated by the flows of Japanese institutions – not foreign speculators – which have converted their yen into nearly \$10 trillion of foreign-currency assets. Any meaningful depreciation in the yen would likely generate huge, offsetting repatriation flows, as banks, insurers, and exporters sell down their stock of foreign assets to take advantage of the discounts available in the domestic market. Moreover, since the bulk of Japanese borrowing is denominated in yen, its depreciation actually boosts Japan's net worth, as the market value of yen-denominated liabilities declines relative to dollar-and-other-foreign-currency-denominated assets (Figure 7, p. 7).

Figure 5.
BOJ Prevents Yields from Rising

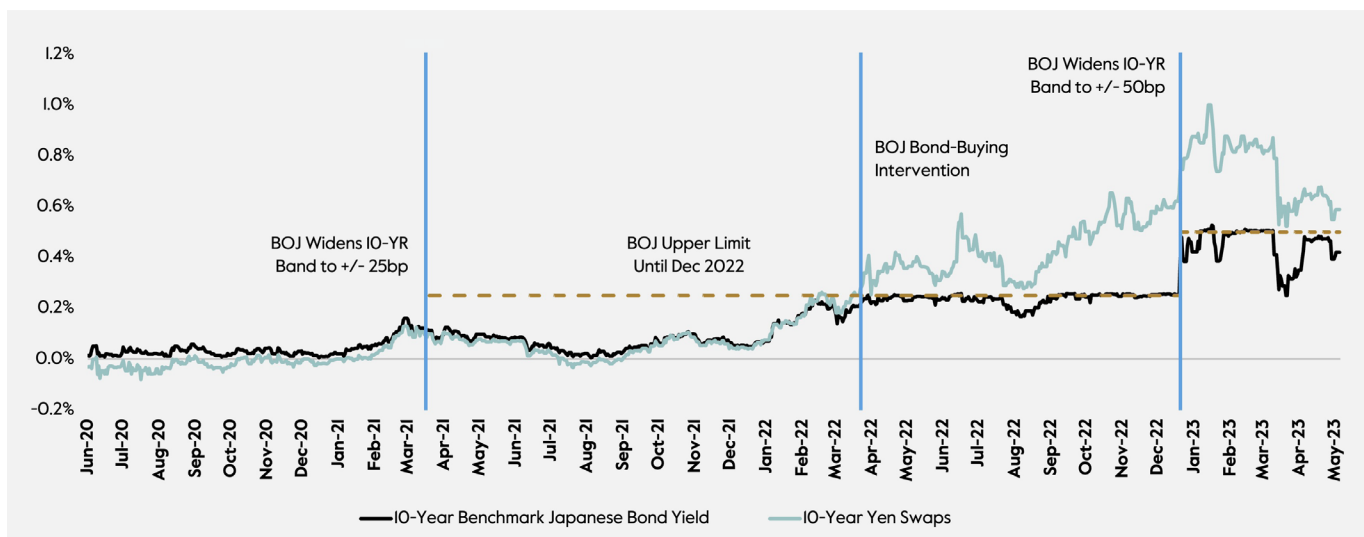


Figure 5. Source: Carlyle Analysis, Bloomberg, May 5, 2023. There is no guarantee any trends will continue.

1. Measured as USD/JPY as of May 8, 2023 relative to the terminal USD/JDP forecast in the IMF's 2023 WEO Database, April 2023.

Figure 6.
With Yields Capped, FX Bears the Adjustment

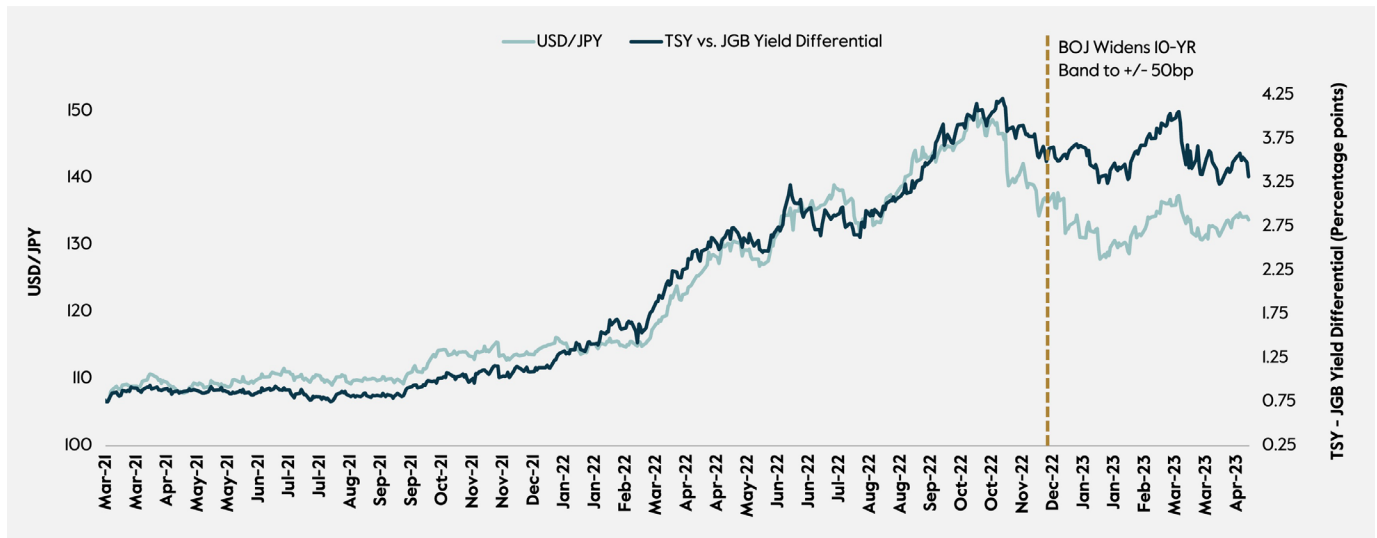


Figure 7.
Japan World's Largest Net Creditor

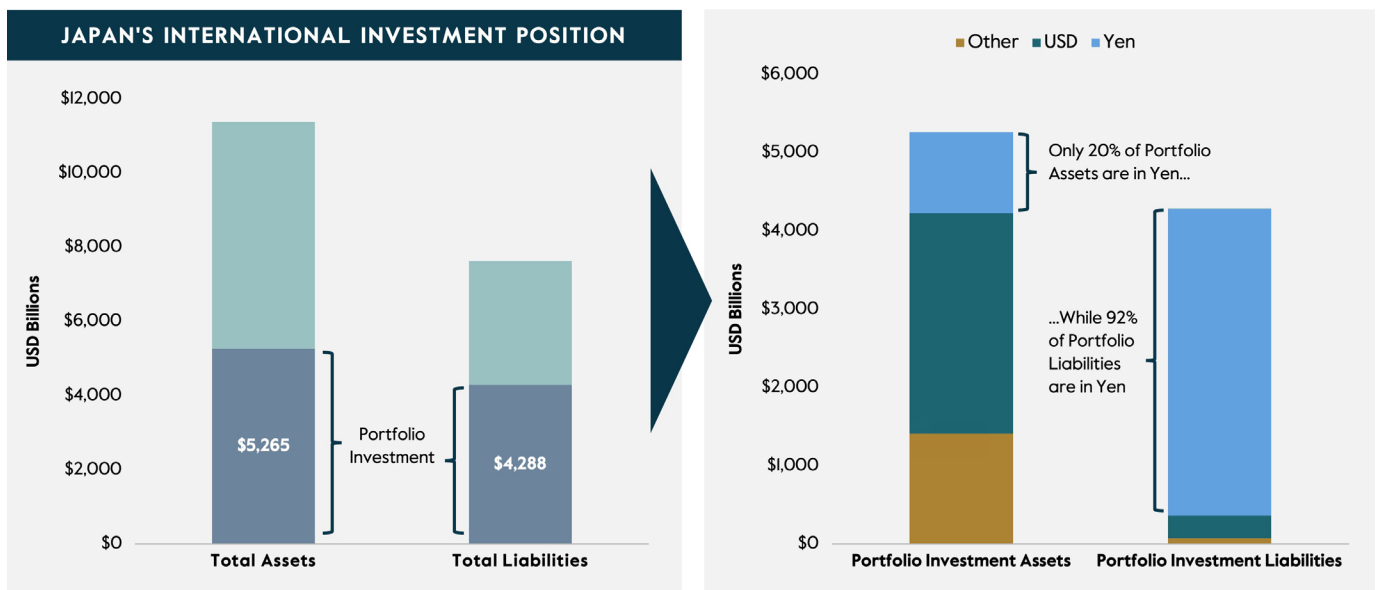


Figure 6. Source: Carlyle, ICE BAML, April 26, 2023. There is no guarantee any trends will continue.
 Figure 7. Source: Carlyle; Bank of Japan; Bloomberg, April 2023.

CASH SURPLUSES & CORPORATE INEFFICIENCY

The Japanese corporate sector is as characterized by capital inefficiency as it is cash abundance. In many ways, these are two sides of the same coin: because the corporate sector makes such inefficient use of cash, it needs to hold more of it. Roughly 40% of listed businesses on the Tokyo Stock exchange finished 2022 with net cash holdings equal to more than 20% of their equity.² When netting out cash holdings from outstanding debt, corporate leverage ratios have declined to just 30% of assets in an environment where indebtedness should be far more attractive.³

Corporate cash holdings are used to fund working capital, capex, and serve as a buffer against cash flow volatility at the holding company and its subsidiaries.⁴ Conglomerates often build cash reserves to fund cross-subsidy schemes that use earnings generated by healthy subsidiaries to cover losses that may arise elsewhere in their portfolio of businesses. Sustaining the operations of low or even negative margin businesses pushes average Japanese operating margins well below those observed in the U.S. or Europe.

SPINOFFS & DELISTINGS

Corporate inefficiency introduces massive deadweight costs for the economy as a whole. Since 2010, the real return on invested capital in Japan has been 470bp per year lower than in the U.S., on average (Figure 8). When compounded over 10 years, this implies that each dollar invested by U.S. businesses in 2013 generated 58% more GDP by 2023, on average, than the same dollar invested by the Japanese corporate sector.

Productivity shortfalls of this magnitude are especially costly today given Japan's demographic realities. GDP growth comes from either more inputs (hours worked, capital invested) or more output per unit of inputs (productivity). With the labor force in long-term decline and Japanese investment rates already above those of peer economies,⁵ future growth will depend almost entirely on enhancing the productivity of labor and capital.

The Japanese government understands this and takes the challenge seriously. Over the past decade, policymakers have pressured companies to boost profitability, distribute

Figure 8.
Productivity of Capital, U.S. vs. Japan

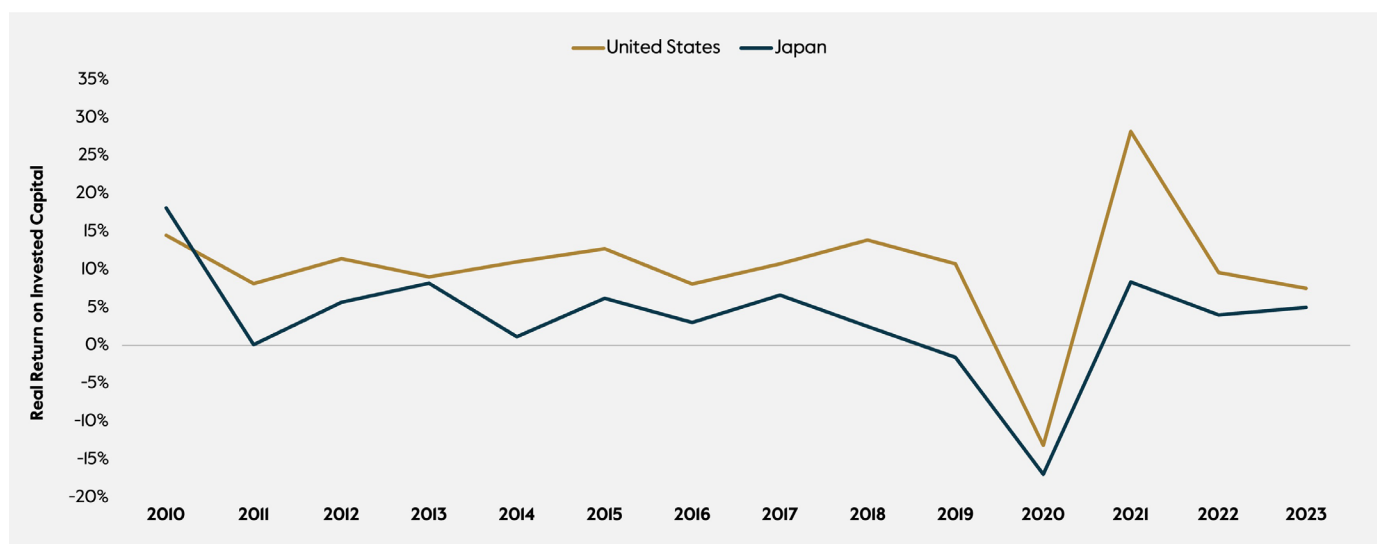


Figure 8. Source: Carlyle Analysis; IMF, 2023 WEO Database, April 2023.

2. CLSA, cited in "Japan Inc's Cash Hoarding Habit Has Painted a Giant Target on its Back," Financial Times, December 16, 2022.
3. IMF, Japan: Selected Issues, March 7, 2023.
4. IMF, Japan: Selected Issues, March 7, 2023.
5. IMF, 2023 WEO Database, April 2023.

more cash to investors, and divest non-core assets. In 2014-15, the Japanese government passed the Companies Act and introduced a Stewardship and Corporate Governance Code to establish independent committees and increase the appointment of outside directors on corporate boards.⁶ This code was subsequently amended in 2018 and 2021 to further strengthen shareholder rights, board independence, and management transparency. The 2021 revisions – timed to take effect at the same time as the Tokyo Stock Exchange’s (TSE) new three-tier listing regime in April 2022 – provides more clarity to the role boards should play boosting capital efficiency and requires companies to meet higher governance standards to become members of the “prime” section of the TSE.⁷

These reforms have generally worked as intended,⁸ but the most beneficial effect of strengthening of shareholder rights has been the introduction of a new entrant to the market: activist investors. The Code generally relies on a “comply or complain” standard that shames companies for unacceptable performance but leaves corrective action to

them. This opens the door to activists, eager to buy stakes in relatively cheap Japanese companies (Figure 9) and then furnish its management with their plan to boost returns. Since the introduction of the Code, the number of activist funds operating in Japan has risen 5x, typically demanding that management streamline operations and boost shareholder distributions.⁹

While activists may have success on their own terms, their arrival often introduces acrimony. Companies fearing activist pressure after being “named and shamed” under the Code may prefer to restructure as a private company. If a company is going to have a new capital partner, better for management to select that partner themselves in a take-private transaction rather than have that partner picked for them through an unsolicited stock purchase. The “rising wave” of shareholder activism has already spurred a 3x increase in delistings since 2015 and that number could increase substantially from here (Figure 10, p. 10).

Figure 9.
Valuations by Market

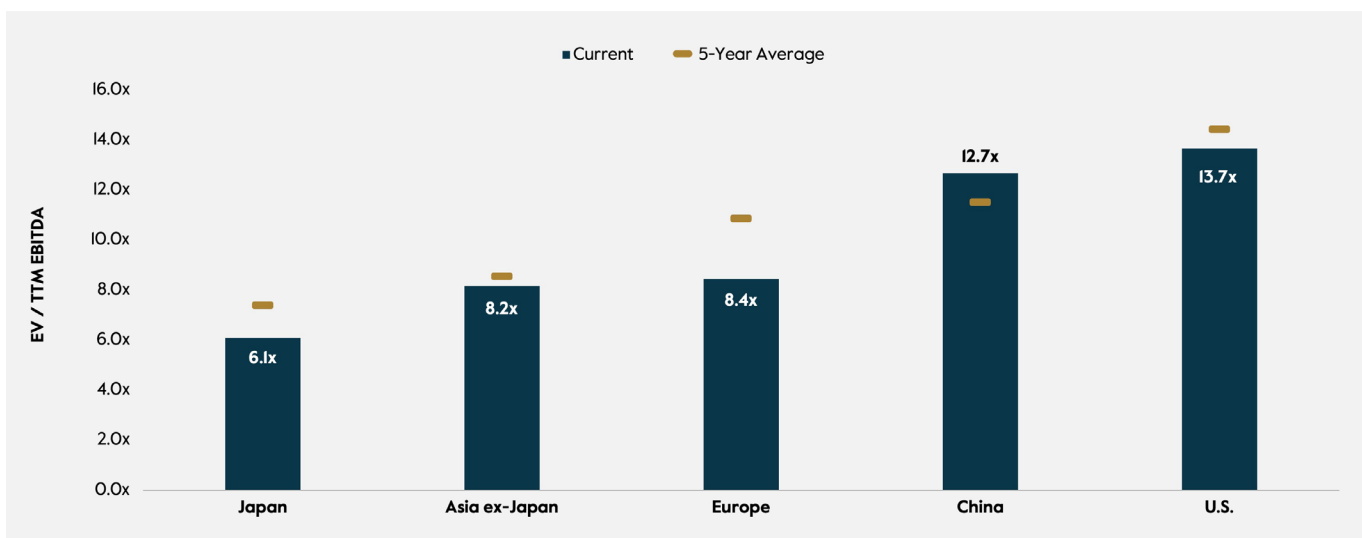


Figure 9. Source: Carlyle analysis of Bloomberg data of S&P Broad Market Indices, May 5, 2023. There is no guarantee any trends will continue.

6. Key Points Concerning the Revision to Japan’s Corporate Governance Code, Oxford University, 2021.
 7. Oxford.
 8. For instance, independent directors account for over one-third of the Board of Directors for nearly 80% of listed companies, up from 10% in 2014. Tokyo Stock Exchange, 2023.
 9. “Tokyo booms for shareholder-relations advisers as activists raise pressure,” Reuters, January 31, 2023.

There are signs that we could be at the early stages of an inflection point in Japanese M&A activity. Governments generally do not devise policy with the interests of prospective acquirers in the forefront of their mind. But in this case, a more robust market for corporate control is precisely what Japan needs to boost productivity and living standards.

Even after the recent increase in take-privates, the number of listed nonfinancial businesses in Japan remains 41% higher than in the U.S., on a per capita basis (Figure II). If Japan is going to close the capital productivity gap with the U.S., it will be by getting more of these assets into the hands of new owners.

Figure 10.
Japanese Public Company Delistings

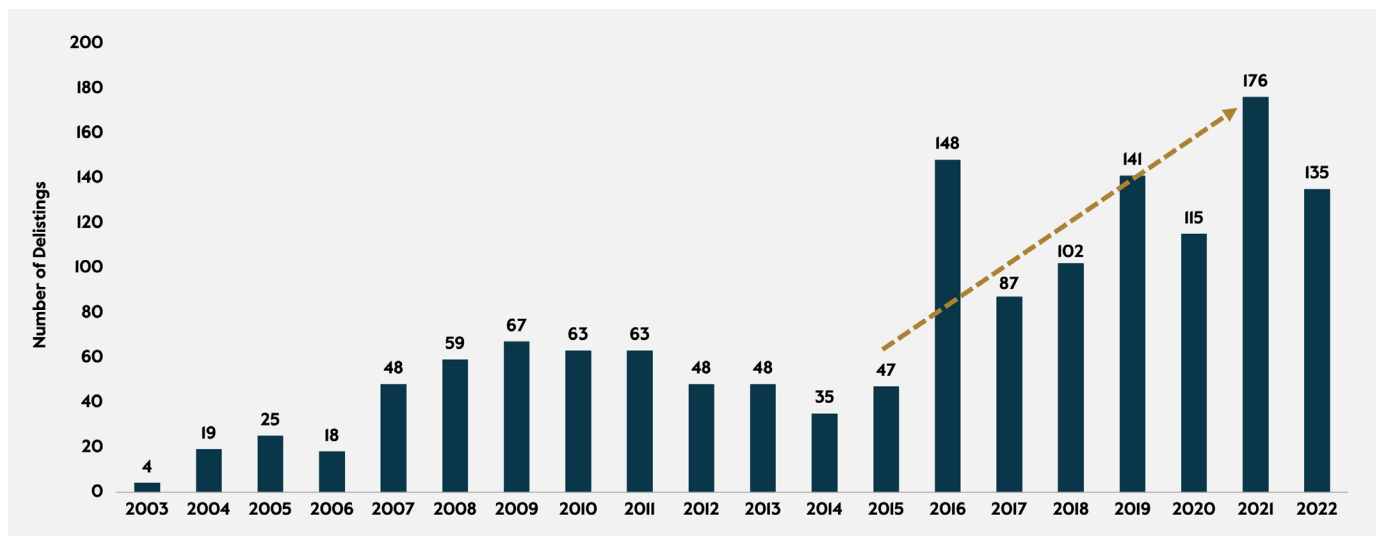


Figure 11.
Listed Companies in the U.S. and Japan

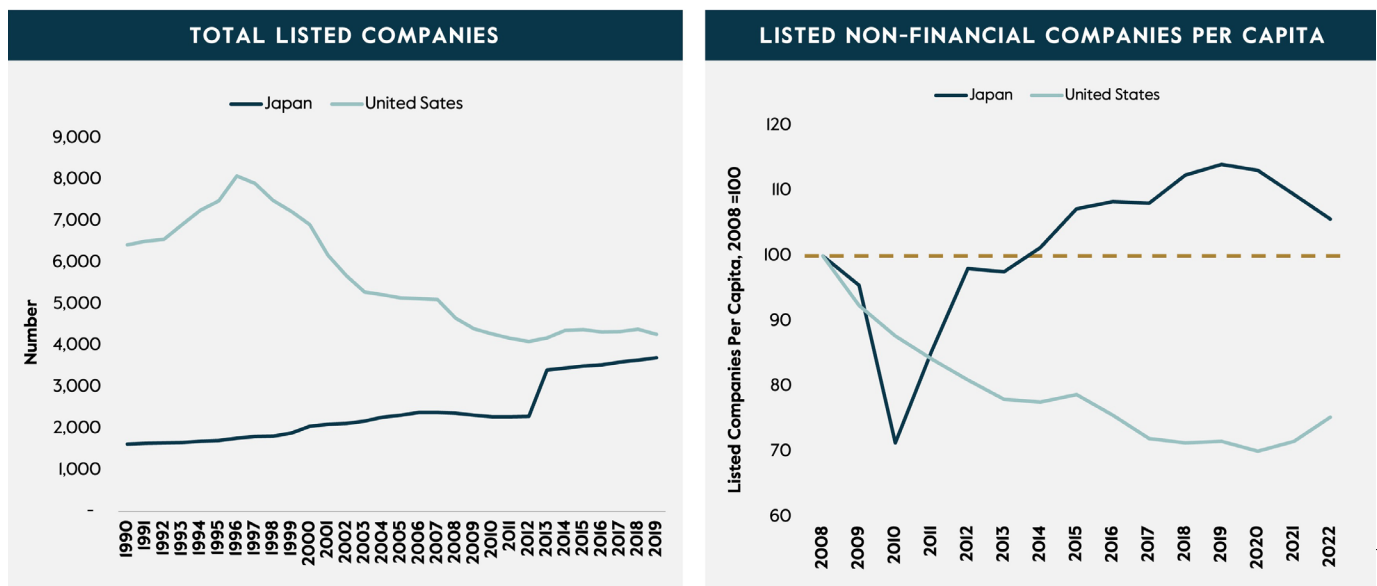


Figure 10. Source: Carlyle analysis of S&P Capital IQ data, May 2023. There is no guarantee any trends will continue.
Figure 11. Source: Carlyle Analysis; World Bank, WDI Database, CRSP Database, May 2023.

CONCLUSION

Increased focus on corporate governance and capital efficiency metrics almost always results in a more robust market for corporate control, as listed companies look for ways to add value by selling non-core assets or plotting new futures as private companies. We could

be at the beginning of a step function increase in the volume of transactions that take advantage of Japan's unique combination of high operating earnings yields, ultra-low interest rates, and significant margin expansion opportunities.

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