J.P.Morgan

Enhancing capital efficiency and long term growth with working capital optimization: Working capital index Japan report 2023

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01 Summary

- The macroeconomic environment in FY2022 for Japanese companies can be best described as a tale of two cities.
- On the one hand, Japan witnessed healthy GDP growth in the first half of the financial year, fuelled by optimism. Japanese companies benefited from a number of tailwinds including materialization of pent-up demand, strong government stimulus packages and ultra-easy monetary policy, both aiming at boosting the country's economy and supporting the minimum wage hike to spur domestic consumption. Additionally, the fall in the value of the Japanese Yen helped exporters, as Japanese-made goods became more competitive.
- The recovery, however, slowed towards the second half of the financial year thanks to multiple unexpected headwinds including the conflict between Russia and Ukraine, pushing the cost of fuel and basic commodities for manufacturers in Japan. This consequentially weighed on manufacturers' profit and discouraged them from raising wages and capital investment. Critically, the weakness in Japanese Yen also compounded the core inflation rate which hit household spending and consumer confidence in the domestic market. Additionally COVID restrictions in China, the largest trading partner for Japan, for the majority of the period FY 2022-2023, also impacted the demand for Japanese products and disrupted supply chain. Economic slowdown in the US and Europe and weak signs in China economy exacerbated these challenges further.
- The Japanese economic situation is likely to remain unstable. Navigating challenges and seizing potential opportunities to achieve business goals will require a strategic and disciplined approach in optimizing working capital management. Through insights derived from benchmarking and analysis of the drivers of working capital metrics, this report aims to help treasury and finance professionals for Japanese companies track working capital trends and guide their initiatives for recovery and growth.
- Working capital optimization has also become more critical for Japanese companies following the Corporate Governance reform initiatives by the Tokyo Stock Exchange. Management of the companies listed on the Prime and Standard sections were urged to place greater emphasis on stock prices and capital efficiency by careful consideration of the cost of capital and return of equity, instead of just sales and profit levels on the income statement, to achieve sustainable growth and increase corporate value in the mid to longer term.

02
Key findings at a glance

¥24.9 TRILLION Estimated working capital that can be released across the Nikkei 225 companies

ROCE gap between Nikkei 225 and S&P 1500 increased by **0.6%** ROCE

CCC
Gap in CCC has increased by

27.8 2022 ▲ **27.9** 2023

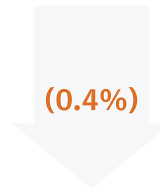
Difference between Nikkei 225 and S&P 1500

Cash
Gap in cash has increased by

7.2% 2022 ▲ **7.7%** 2023

Difference between Nikkei 225 and S&P 1500

EBIT
Gap in EBIT has decreased by



(4.4%) 2022 ▼ **(4.0%)** 2023

Difference between Nikkei 225 and S&P 1500

0.5 points
Increase in WC index

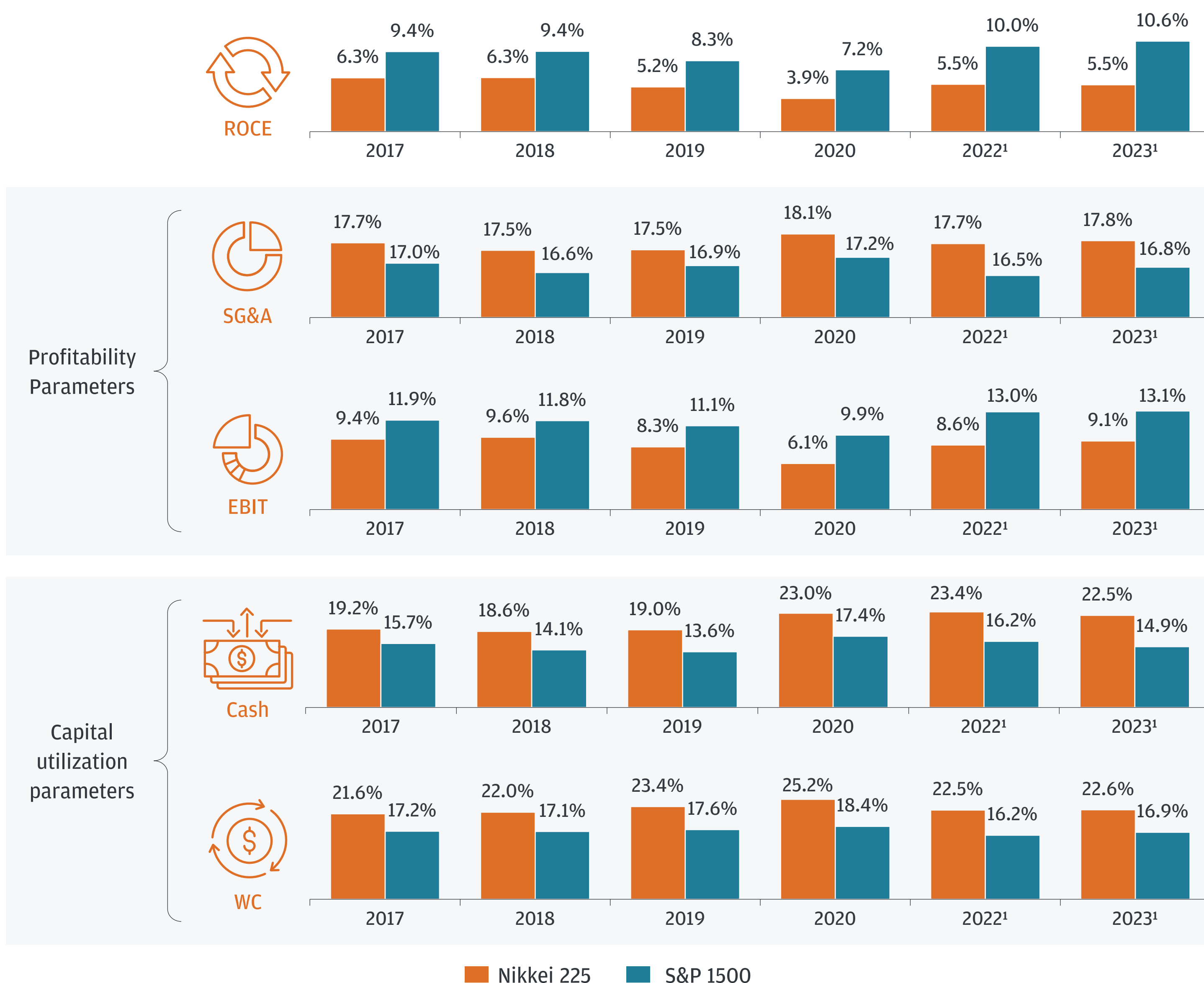
177.4 days
Difference between leaders and laggards

5.2 points
Decrease in Cash index

Overall, 3.5 days rise in CCC primarily due to rise in DIO and offset by fall in DSO

- 6.1 days deterioration in DIO
- 3.2 days improvement in DSO

ROCE Gap widened between S&P 1500 and Nikkei 225 companies



Source: Capital IQ; S&P 1500 figures are modified using industry weights of Nikkei 225 for comparative purposes

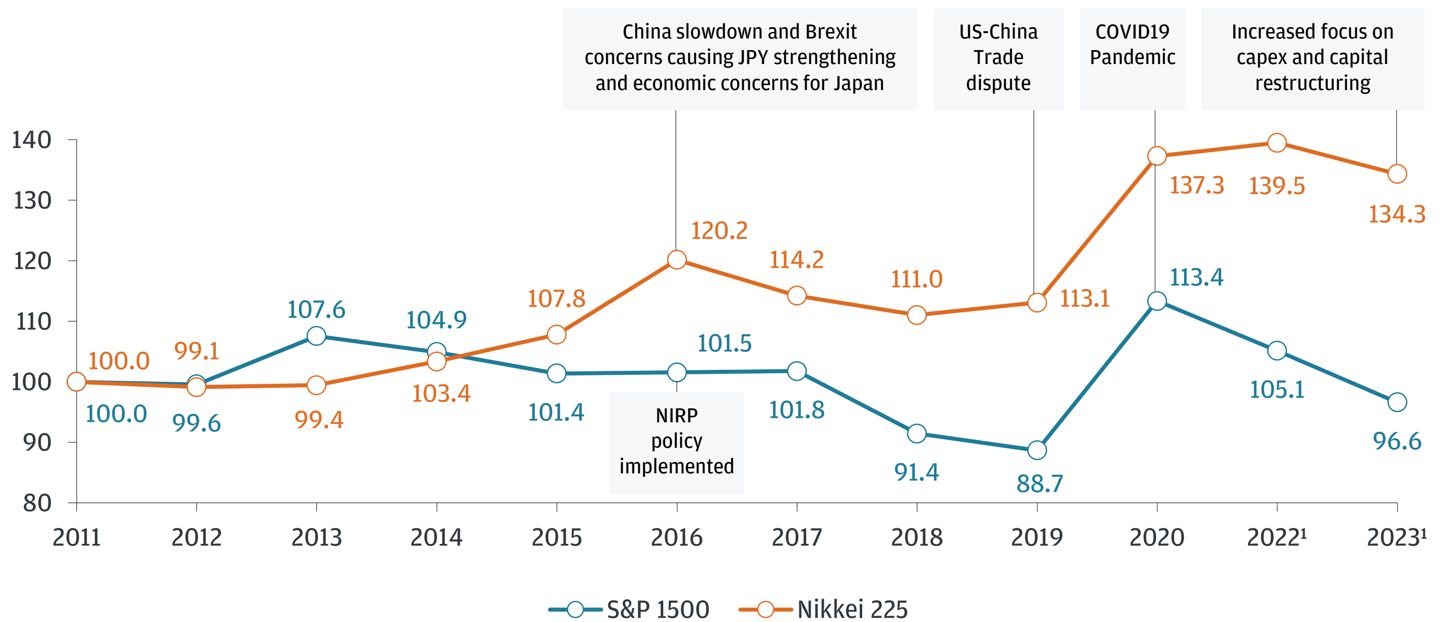
[1] Values are as of Dec year end for both Nikkei 225 and S&P 1500 till 2020, post which Nikkei 225 financials are changed to March year end while for S&P 1500 it continues to be December year end, a quarter before the Nikkei 225 March year end. The year label shown on the chart corresponds to Nikkei 225 March end financial year; ROCE is calculated as EBIT * (1- tax) / Average total capital; total capital is sum of Equity and Debt

Nikkei 225 companies saw their return on capital employed (ROCE) at 5.5% on average, versus 10.6% for the S&P 1500 companies over the financial period

Although the ROCE of Nikkei 225 companies had marginally improved to pre-pandemic levels, the gap to S&P 1500 companies compared had worsened by 0.6%, mainly driven by a few factors:

- On the balance sheet, Nikkei 225 companies' Cash Conversion Cycle (CCC) was slower by 27.9 days (0.1 day longer year on year); Nikkei 225 companies had 7.7% higher cash level (0.5% higher year on year) as a percentage of sales at 22.5%
- On the income statement, Nikkei 225 had higher Selling, General & Administration (SG&A) Cost although the gap in Earnings before Interest and Tax (EBIT) has improved by 0.4% from 4.4% to 4.0%

Cash levels decrease globally



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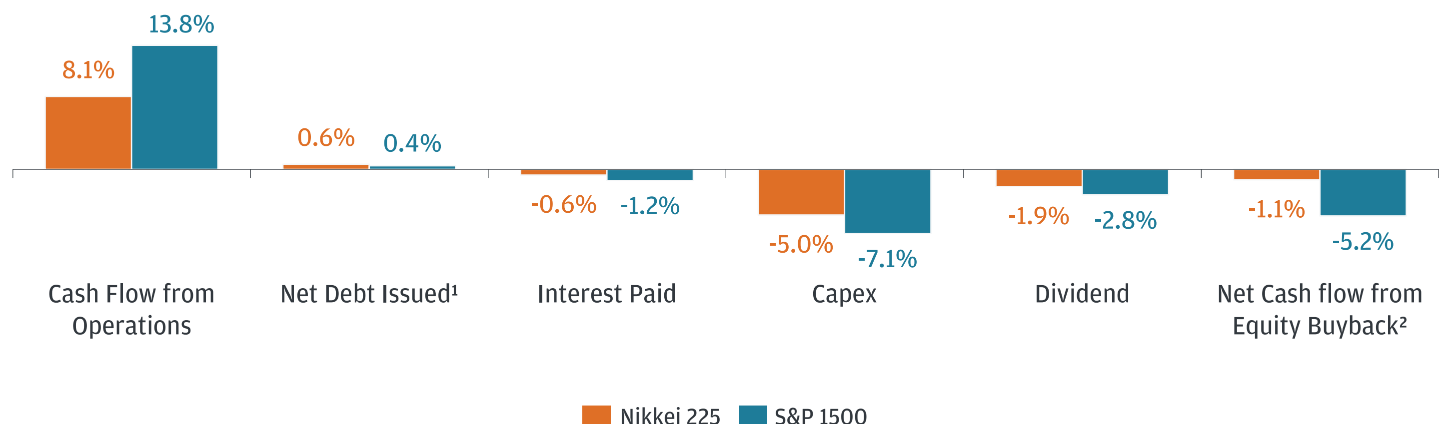
As companies look to recover from the pandemic, cash levels decreased due to a shift in focus from cash preservation to cash deployment into growth activities. However, for Nikkei 225 companies, the cash index fell by only 5.2 points, relatively modest as compared to an 8.5 point drop for their S&P 1500 counterparts.

This drop in cash levels comes as Japanese corporates saw record high capital expenditure, which stemmed from preparation for expected growth in demand post-pandemic. Nikkei 225 firms saw record levels of buybacks and dividend payouts for the year ending March 2023, resulting in lower cash levels. Additionally, high inflation and depreciation of the yen meant that companies needed to spend more on purchases of supplies.

That said, there were differences observed in cash flow allocation when comparing Nikkei 225 and S&P 1500 companies. In Japan, the weaker yen supported exports, but sluggish domestic demand in Japan combined with China restrictions led to lesser cash generated from operations for Japanese corporates as compared to US counterparts.

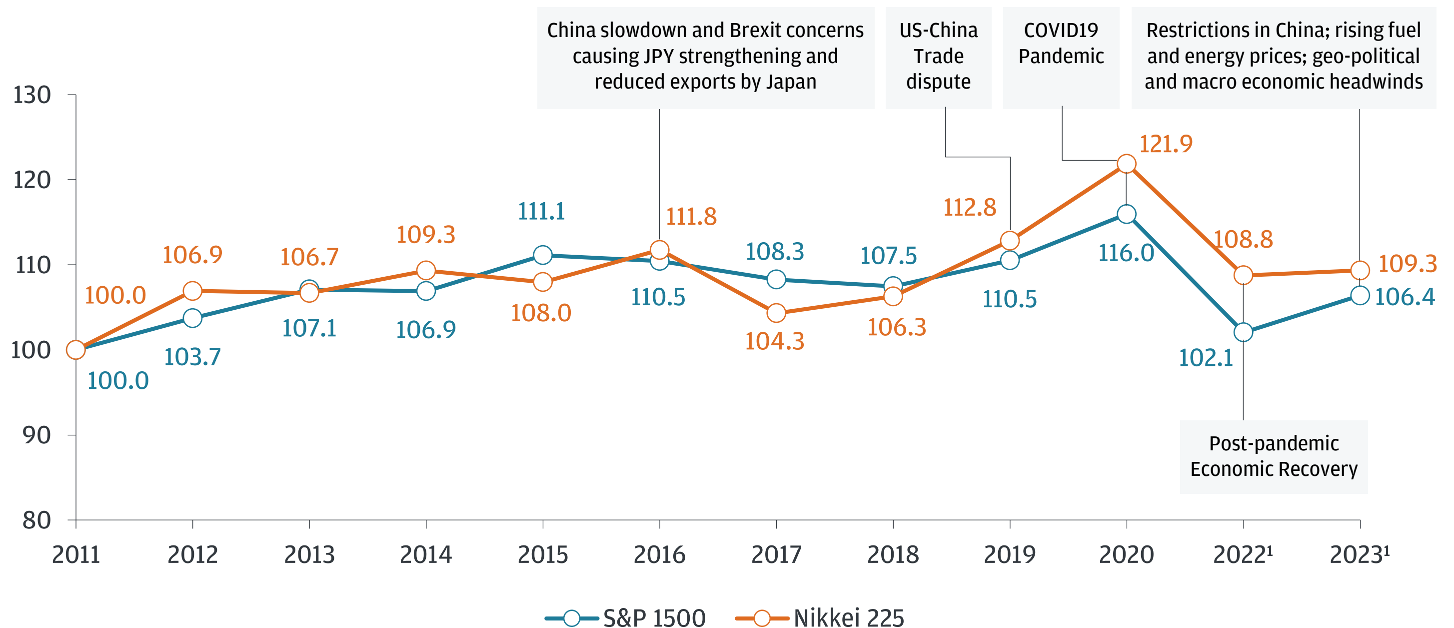
Cash allocation (% of total revenue 2023)



While both Nikkei 225 and S&P 1500 companies saw a slight increase in new net debt issuances, the former has raised more debt considering cheaper domestic interest rates in comparison to the latter. Lower interest rates resulted in Nikkei 225 companies paying lesser interest as a percentage of total revenue in comparison to their S&P 1500 counterparts.

Corporates in both US and Japan saw high levels of equity buybacks, partly triggered by regulatory changes in respective markets. For companies in the Nikkei 225, this came as a response to guidance issued by the Tokyo Stock Exchange, urging companies to focus on stock prices and capital efficiencies. In comparison, share buybacks accelerated for the S&P 1500 in the fourth quarter as companies advanced repurchase plans from early 2023; this was in response to a 1% tax on net corporate share repurchases which took effect on January 1, 2023.

Working capital reverses direction



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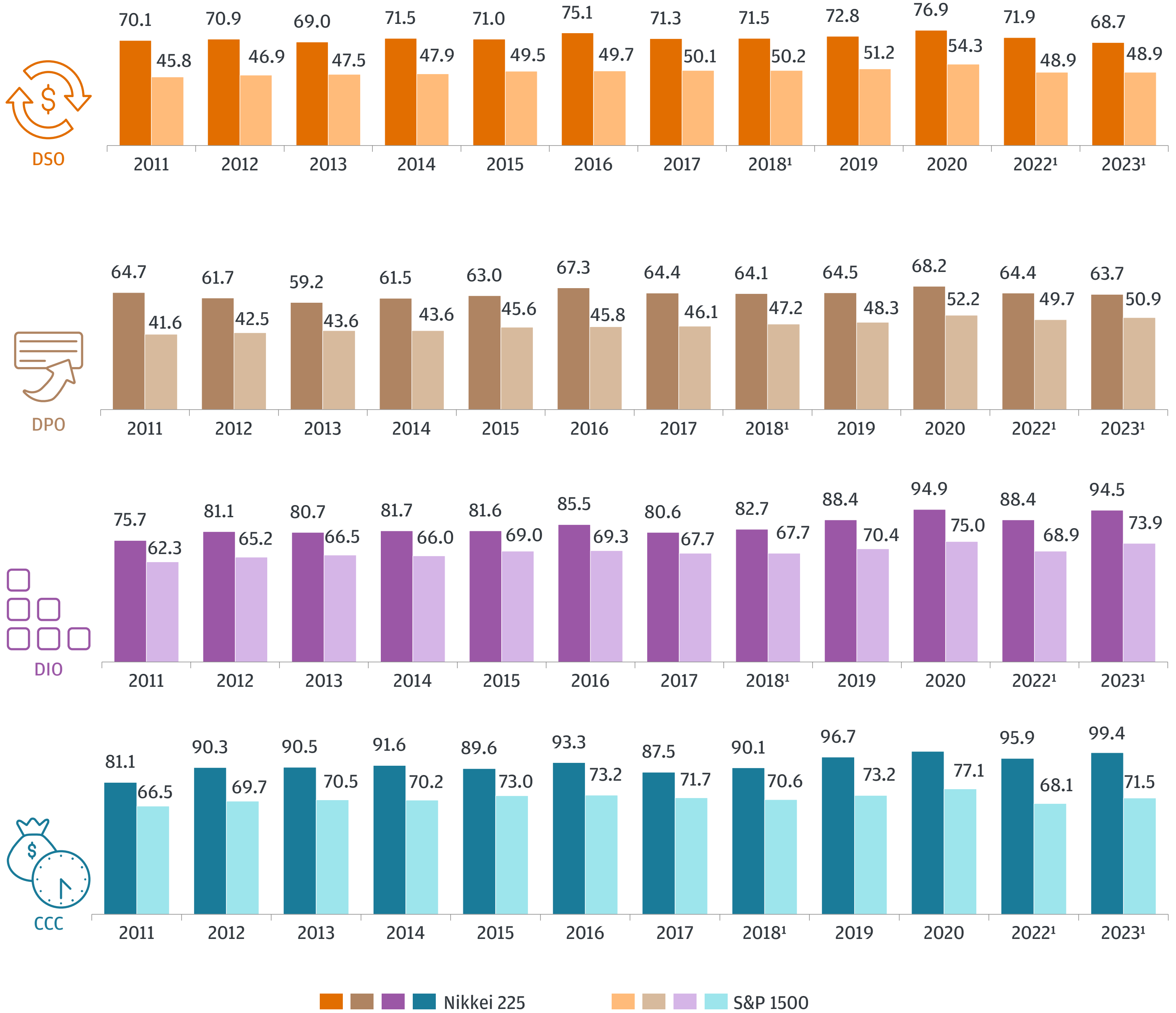
Overall, working capital levels increased by 0.5 points for Nikkei 225 companies and 4.3 points for S&P 1500 companies largely due to demand normalization following the FY2021 demand spike.

Corporates also built up inventory buffers to mitigate the impact of supply chain disruptions in response to the Ukraine-Russia war as well as China restrictions.

For corporates, the pressure on working capital is likely to continue in the face of an uncertain macroeconomic environment. Potential headwinds include mounting signs of an economic slowdown in the US and Europe, continuing supply chain disruptions, sluggish domestic demand in Japan and choppy recovery of the Chinese economy.



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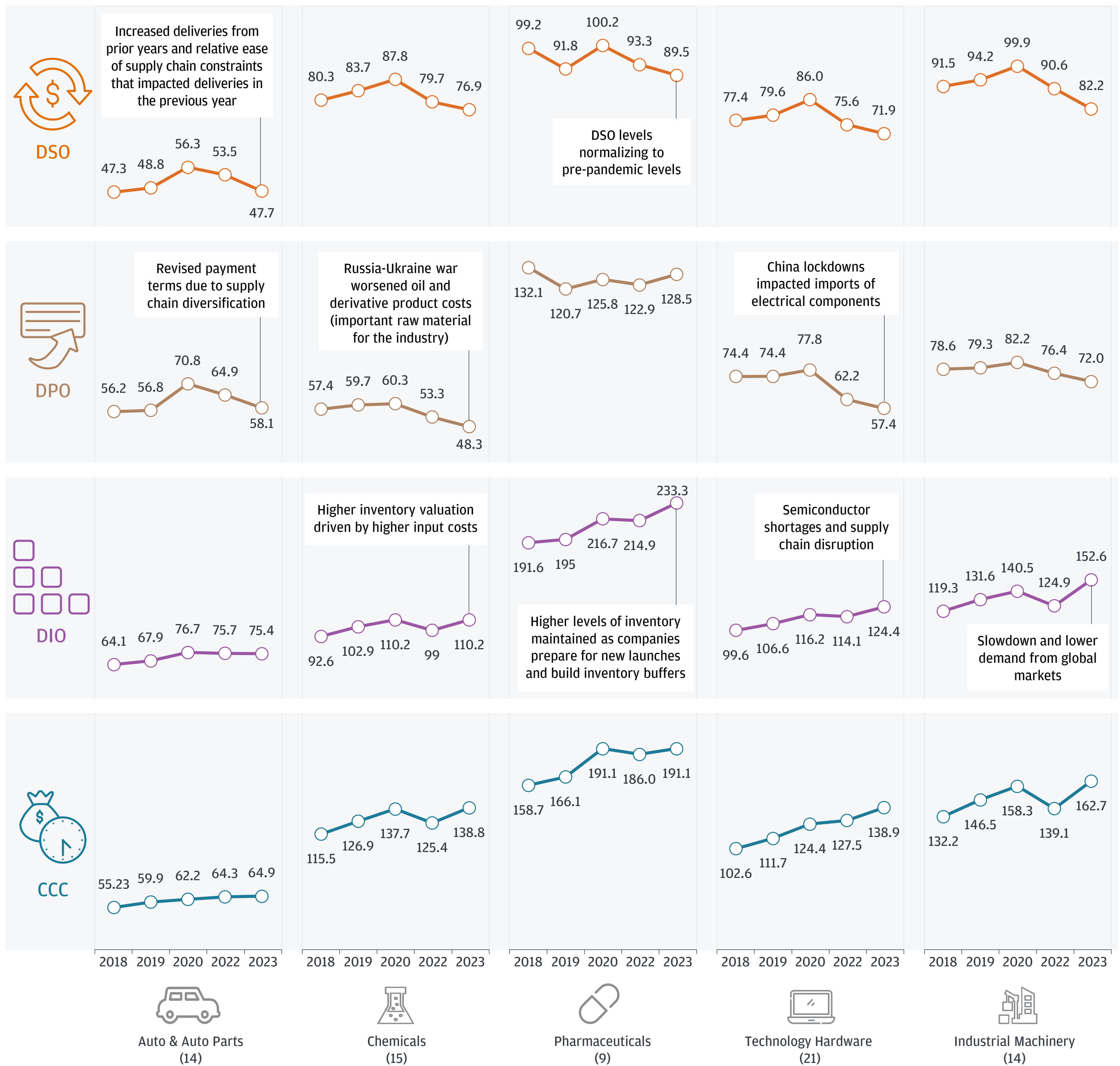
03
Industry snapshots

There is an estimated JPY 24.9 trillion of liquidity trapped in working capital across industries, which could be released as free cash flow if every organization improved by one quartile across DSO, DIO and days payable outstanding (DPO) metrics.



Auto & auto parts

The CCC for the auto and auto parts industry remained largely unchanged with a marginal increase of 0.6 days. However, a deeper dive into the individual components highlight a stark fall in DSO (5.8 days) and DPO (6.8 days).

Affected by supply side shortages including semiconductors over the past 2 years, Japanese corporates looked for alternative suppliers or paid faster to suppliers to source critical supplies, potentially impacting DPO.

Demand for Japanese auto products increased due to backlog from the past two years as supply side constraints affected production. With supply chain challenges easing slightly, auto companies were able to fulfill backlog orders, aiding them to sell faster and push for early collections.

Chemicals

Companies in the Chemicals industry saw their CCC increase by almost 13.4 days due to a combined effect of increase in DIO (11.2 days) and fall in DPO (5 days).

Japan is heavily dependent on the import of petroleum and mineral oil products which form the key raw materials for organic chemicals. Supply chain disruptions caused by the Russia-Ukraine war and extended lockdowns in China resulted in companies maintaining higher inventory buffer for these products. In addition, higher input costs led to higher inventory valuation, thereby further increasing DIO.

Shortages caused by supply chain disruptions and the continuously depreciating Yen prompted companies to pay faster to secure supply and safeguard against further increasing costs thereby lowering the DPO.

Pharmaceuticals

CCC for the industry increased by 5.1 days primarily driven by higher DIO, which increased by 18.4 days. This was partially offset by an improvement in DSO (3.8 days).

To reduce medical costs, the “Basic Policy on Economic and Fiscal Management and Reform 2021” promoted generic drug usage. This led companies to increase production of such drugs to meet the regulatory requirement as well as the increasing demand. While demand and production increased for generic drugs, inventory for branded drugs piled up.

COVID-related pharmaceutical inventory also increased since demand decreased drastically once lockdown measures were lifted.

Some companies also launched newer drugs which resulted in inventory buildup before launch, further contributing to the rise in DIO.

Technology hardware

CCC for the industry deteriorated by 11.4 days, mainly due to rise in DIO (10.3 days) and fall in DPO (4.8 days).

Many technology corporates shifted to a just-in-case inventory model to manage the impact of supply chain disruptions, leading to higher inventory levels.

The overall demand globally in 2022 decreased as pent-up demand from 2021 was absorbed and higher inflation reduced the disposable income for consumers. This led to an increase in inventory.

Yen depreciation could have led some Japanese corporates to pay faster for the exports as delayed payments could mean higher Yen payouts, reducing the DPO levels on an average.

Industrial machinery

CCC for companies in the industrial machinery segment saw a steep increase of 23.6 days, primarily due to an increase in DIO days of 27.7 days.

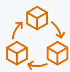
COVID disruptions in China, which is one of the largest importers of Japanese machinery products, impacted the demand negatively, resulting in higher DIO levels as corporates struggled to sell their inventory quickly.

Slowdown in the global economy and volatile China recovery can lead to corporates holding back on capital expenditure, further putting working capital in pressure going forward for Industrial machinery sector.

04 Strategies for the future

Strategic investments

- Rising cost of working capital (WC) amidst uncertain macroeconomic environment
- Selective investments and partnerships to help set company for future success and mitigate against uncertainty
- Keen focus on post-merger integration of the acquisitions done during low interest period to realize synergies

 Supply chain diversification

- Companies are looking to diversify supply chains amidst adverse economic and geopolitical conditions
- Corporates are moving towards a China+1 strategy or looking to nearshore operations
- Disruptions are fading but uncertainty persists

Treasury and technology

- Increased focus on modernization, data intelligence, and innovation
- Adoption of openness and real time capabilities
- Use of data to prepare for future scenarios
- Leverage bank for trusted relationships

What it means for Treasurers ?

Working capital optimization

Liquidity management

Cost optimization

Post-merger treasury integration

Treasury centralization

Strategic investments

- With macroeconomic uncertainty on the horizon and higher global interest rates, the cost of holding working capital is going to be high. Businesses in Japan can look for selective investment and partnership opportunities to help set their companies up for future success and mitigate risks. There can also be significant synergy opportunities that can be realized through post-merger integration from the acquisitions done in 2020-2021 period when global interest rates were low.

Supply chain diversification

- Supply chain disruptions in the past 2 years have forced corporates to re-evaluate their supply chains and invest towards mitigating any major risks. With economic and geopolitical conditions likely to remain uncertain in the near future, corporates in Japan will also need to explore various supply chain diversification strategies including "China plus one" strategy, nearshoring or friend shoring to diversify and mitigate supply chain risk.

Treasury and technology

- Japanese corporates are seeing an increased emphasis on modernization, innovation and data intelligence across verticals. Those who adapt quickly will benefit from data insights that may help them make informed business decisions to prepare for the future.

For treasurers, Working Capital and liquidity optimization needs to be the key focus areas to free-up significant trapped capital that not only will help companies to invest into different strategic priorities mentioned above, but will also narrow the ROCE gap with the U.S. companies.

Authors

Tahreem Kampton

Global Head of Trends & Advisory,

Payments, J.P. Morgan

tahreem.kampton@jpmchase.com

Jasmine Tan

Head of Payments Advisory, Asia Pacific

Payments, J.P. Morgan

jasmine.tan@jpmchase.com

Vikrant Verma

Senior Treasury Advisor,

Payments, J.P. Morgan

vikrant.verma@jpmorgan.com

J.P.Morgan

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