Cash Hoarders and Debt Dependants

Although most of our readers will know by now that we do not construct portfolios with reference to a market index, we do think it is useful to compare the salient characteristics of our portfolios to that of the market indices to have a sense of where our biases lie and to illustrate to our investors where we differ from the average portfolio. One overwhelming difference compared to the Nikkei index (and therefore other managers, we surmise) is the portfolio's 50% higher dividend yield, at 2.5% versus 1.6%. We think that dividends in Japan will continue to make up a significant part of overall long-term returns, in just the same way as they have done in the past and reflecting the experience of other developed world markets like the USA and the UK. Accessing companies at high starting yields, or at levels from where dividends can grow in real terms, is thus a cornerstone of our strategy in Japan.

Another feature is that companies in our portfolio are more conservatively financed - with only one company carrying net debt and the median company having net cash of as much as 23% of its current market capitalisation. Of course, these companies holding onto net cash can be characterised as being either prudent or inefficient with the management and allocation of capital, especially with interest rates so low. The balance between the two is a fine judgement. Prudence is justified if the company fears a sudden requirement for cash to spend on fixed investment or acquisitions. Yet if the business is predictable and cash generative, as many of them are, it may be more beneficial to modestly leverage the balance sheet to bolster return on equity, and downright wasteful to hoard cash.

We judge that most companies in our portfolio are still inefficient with their allocation of capital. However, they are moving in the right direction and many have begun to distribute larger proportions of free cash flow as dividends and to fund share repurchases. But they have a long way to go. Currently payout ratios, including share buybacks, are just over 53% which implies that unless new acquisitions are made, cash balances will still increase year by year.

Across the market there is only a modest proportion of companies that we define as 'cash hoarders' (i.e. having positive net cash in the balance sheet). Today they represent 24% of the Nikkei Index (ex financials) by number, which probably reflects the cash generative nature of these businesses more than anything else. When ownership of the market was dominated by cross-shareholders, these owners cared little for financial returns and thus were unconcerned about capital allocation so cash generative companies accumulated idle cash on their balance sheets. Interestingly, this led to even greater distortions at the opposite end of the scale. Capital intensive, cyclical businesses amassed far too much debt, partly because there was a ready supply of it from the major cross-shareholders at all times. Poor business conditions or weak balance sheets were never a major cause for concern as the main shareholders were always there to support the business in bad times, thus they became dependent on debt. However, cross-shareholders now own less of the market and thus have less obligation to support these businesses than before. Yet, despite the huge improvements in profits over the last few years, many of these businesses remain dangerously geared. Today 34% of the Nikkei Index (ex financials) carry net debt greater then 50% of current market capitalisation (companies we classify as 'debt dependant'), averaging 8 times current operating profits. In the future, if profits fall, these companies will quickly look to preserve cash. This means dividend cuts, and in extremis new equity issues, to bolster balance sheets.

This polarisation in the balance sheet strength of Japanese companies is yet to be fully priced into shares, as we illustrate in the chart overleaf.

	"Cash Hoarders"		"Debt Dependants"	
	Nikkei 225*	S&P 500*	Nikkei 225*	S&P 500*
Proportion of Index**	24%	29%	34%	15%
Net Cash/ Market Cap	14%	8%	-94%	-119%
Return on Capital	14%	50%	5%	8%
Dividend Yield	1.5%	0.9%	1.7%	2.9%

Japan yield premium 0.2%
US yield premium 2.0%

Source: Bloomberg as at 9 January 2008.
*excluding financials
**by number of companies

Definitions
Cash Hoarders *– Companies with positive net balance sheet cash*
Debt Dependants *– Companies with net debt at 50% or more of market capitalisation*
Return on Capital *(tax adjusted operating profit/ fixed assets + working capital)*

The return on capital for the cash hoarders was 14% against 5% for the debt dependants, while the average dividend yields for both groups of companies was 1.7% and 1.5% respectively. To us, a 0.2% dividend yield premium for such low return businesses, together with the risk implicit in their leveraged balance sheets, seems poor compensation. When investors recognise this - and this will most likely be when business conditions worsen - we think yields on poor quality stocks will have to rise much more. There is little chance of this happening through rising dividends, only falling prices.

It is interesting to look at comparable characteristics in the S&P 500 index and note that although a greater percentage of the index (ex financials) is made up of cash hoarders, a far smaller percentage is made up of debt dependant companies. At the same time the US cash hoarders hoard less net cash. Of even more interest to us is that they have dividend yields of 0.9% and returns on capital of 50%, yet the debt dependants have a dividend yield of 2.9% and returns on capital of 8%. This seems more logical: a 2% dividend yield premium is demanded by investors to account for the low return and high leverage characteristics of debt dependant US companies. We do not expect Japanese companies to emulate US ones exactly, however it certainly gives a good indication of the direction in which they might move as shareholder pressure intensifies.

Overall, we think the figures support our contention that Japanese market pricing has yet to reflect the true reality of these Japanese balance sheet anomalies.

Issued by Lindsell Train Limited. LTL 000-059-5 04 February 2008

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