Corporate Cash Flows Enter a New Phase -*From Defensive Debt Repayments to Aggressive Investments*

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If we define "corporate excess cash" as the difference between the cash flows that corporations generate from their businesses and the amount of cash they use for making real investments in capital equipment in Japan—which we might also call a surplus of corporate savings over corporate investments—Japanese companies have shown an excess cash position since the end of the 1990s (Chart 1). In general, surplus funds are used by corporations either to increase their financial assets or reduce their financial liabilities. The main flow of corporate funds through the middle of the first decade of the 21st century went to paying down the excessive borrowings incurred during Japan's bubble era. Thereafter, the flow shifted to making investments overseas.

We will divide Japanese corporations into three groups, based on the weight of the liabilities on their balance sheets, and examine their fund-raising and fund-usage activities. First, corporations that have had relatively low debt burdens, mainly large companies in the manufacturing sector, have had cash surpluses for a prolonged period. Since they did not have excessive borrowings to begin with, they directed their excess cash mainly into overseas investments (to purchase shares of their overseas subsidiaries). Next, corporations that have had medium debt burdens, mainly large companies in the nonmanufacturing sector, began to show cash surpluses at the end of the 1990s, and they used this cash to repay their excessive borrowings. The adjustments in their debt levels have recently been largely completed, and they are beginning to redirect their cash from debt paybacks to overseas investments. Finally, corporations that have had heavy debt burdens, mainly small companies in the nonmanufacturing sector, began to experience cash surpluses at the end of the 1990s, and, subsequently, have directed their cash toward the repayment of debts. However, they have still not completed the adjustments in their debt levels. These companies are believed likely to have reduced their capital investment levels to secure funds to repay their debts and have allowed their capital equipment to age and become obsolescent (Chart 2).

How will corporations use their cash in the coming years? Options for cash usage among corporations include making real investments in Japan, mainly in capital equipment and facilities; expanding financial assets, including making direct investments overseas; and reducing liabilities, including the further repayment of borrowings. Let us look first at the option of making capital investments in Japan. Corporations, in general, will not experience the high rates of growth that prevailed in the past, and, basically, growth rates will most likely continue on a gradual downward trend. On the other hand, overseas direct investments are expected to continue to rise, mainly among companies with light to medium-sized debt burdens. Factors behind this will include the outlook for economic growth rates in many industrialized countries, including Japan, to come to a virtual standstill, while, in contrast, the emerging countries of Asia and other regions will sustain high rates of growth. However, there is a possibility that companies with medium-sized debt burdens that now have enough leeway to allocate cash to investments with an eye to future growth and development may expand their capital investments in Japan. The reason is that, although the declining birthrate in Japan and the trend toward the demographic aging of the population will be factors restraining domestic demand, there will be instances where these trends give rise to new demand, mainly in the service industries. Looking next at the option of further reduction in liabilities, including borrowings, companies that have always had light debt burdens and did not take on excess debts during the bubble period and companies with medium-sized debt burdens that have recently completed adjustments in their debt levels will probably not be very prominent. On the other hand, companies with heavy debts that have not completed their debt adjustments will probably continue to reduce their borrowings.

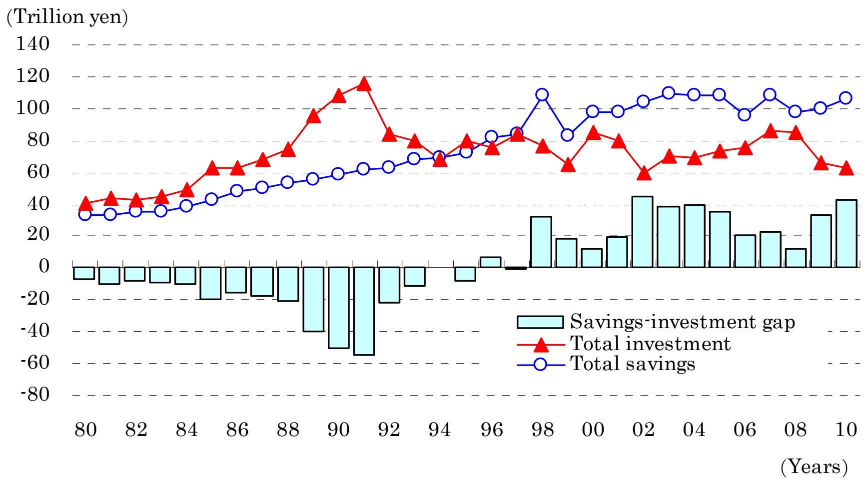
As corporations continue to show cash surpluses, how should banks, which can offer cash to companies, be involved? Let us examine this issue by looking again at the previously mentioned three groups of companies. For companies with light debt burdens, banks will find it necessary to become involved mainly in investment banking activities, including the arranging of overseas M&A deals. For companies with medium-sized debt levels, banks will have to become involved not only in investment banking overseas but also respond to the funding needs of these companies for investing in Japan in response to changes in demand in the service sector. For companies with high debt levels, it will be important for banks to provide consulting services to encourage these companies to restructure their financial positions to make it possible for them to make future-oriented investments. Banks will be called on to take risks aggressively with their strong financial base by lending and providing other financial services to support the growth of those companies.

As the expanding cash surpluses of corporations are directed into overseas investments, even if corporate profits increase as a result, if these funds go into overseas investments, it will be difficult for cash used in this way to contribute to economic growth in Japan. It is only natural that funds will flow toward overseas investments where expected returns are higher, but this will mean that domestic investment and employment opportunities will not expand. The value added generated by corporations is distributed among workers, the government, investors, and others. If domestic capital investment becomes stagnant, it will be useful to consider a review of how value added is distributed, including expansion in the share allocated to personnel expenses from the perspective of investing in human resources.

Under apparently similar cash surplus conditions, during times when companies are reducing their borrowings, this means they are shrinking their balance sheets, but when they are expanding their financial assets, this means they are expanding their balance sheets. It also means that corporations are taking a more "aggressive" management stance. We would like to emphasize especially that companies with medium-sized debt levels, which have considerable leeway for expanding their businesses in Japan and overseas, have entered a phase of expansion in their financial assets. These companies with medium-sized debt levels have relatively high levels of employment and capital investment. Also, many of these companies, because they are domestically oriented, have strong influence on the domestic economy. If these companies increase their expenditures with an eye to capturing future growth as domestic demand undergoes changes along with such trends as the declining birthrate and the demographic aging of the population, this will present an excellent opportunity for the Japanese economy as a whole to escape from its tendency toward shrinkage. Moreover, as corporations with medium-sized debt levels benefit from these positive trends, as they are encouraged and urged onward by their banks, and as the heavily indebted companies, many of which are dependent on domestic demand and employ significant numbers of personnel, proceed with their balance sheet adjustments, these developments should open the way for building a solid foundation for new growth in the Japanese economy as a whole.

(2012.3.9)

Chart1: Savings-Investment Gap in Japan's Corporate Sector

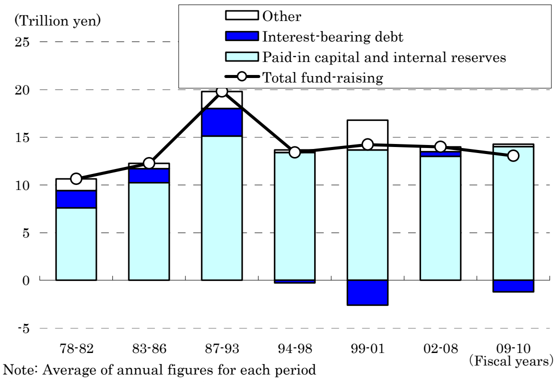


Source: Cabinet Office, *National Accounts Statistics*

Chart 2: Fund-Raising and Fund-Usage of the Three Groups of Corporations

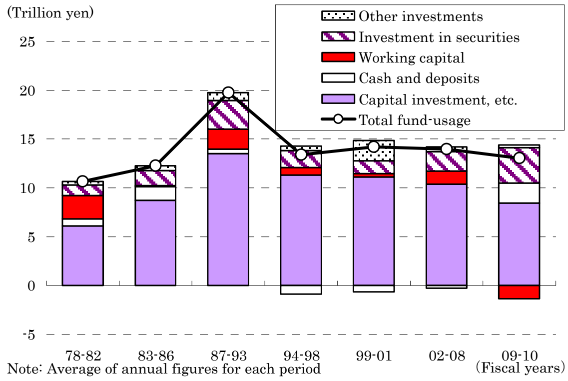
Low-Debt-burden Corporations

Fund-Raising



Note: Average of annual figures for each period
Source: Ministry of Finance, *Annual Report on Financial Statement Statistics of Corporations by Industry*

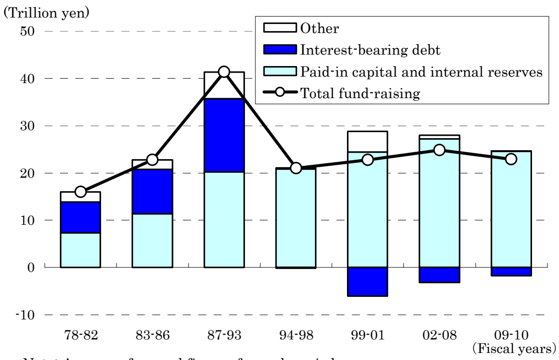
Fund-Usage



Note: Average of annual figures for each period
Source: Ministry of Finance, *Annual Report on Financial Statement Statistics of Corporations by Industry*

Medium-Debt-Burden Corporations

Fund-Raising



Note: Average of annual figures for each period
Source: Ministry of Finance, *Annual Report on Financial Statement Statistics of Corporations by Industry*

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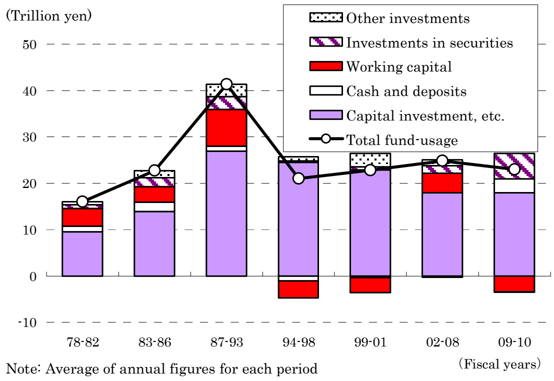
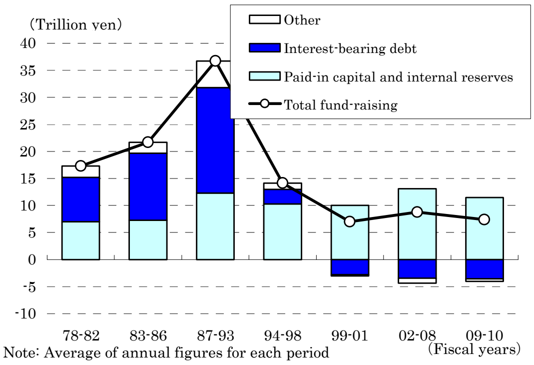


Note: Average of annual figures for each period
Source: Ministry of Finance, *Annual Report on Financial Statement Statistics of Corporations by Industry*

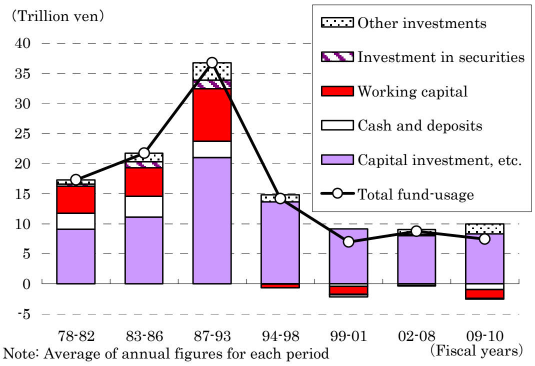
Heavily-Indebted Corporations

Fund-Raising



Note: Average of annual figures for each period
Source: Ministry of Finance, *Annual Report on Financial Statement Statistics of Corporations by Industry*

Fund-Usage



Note: Average of annual figures for each period
Source: Ministry of Finance, *Annual Report on Financial Statement Statistics of Corporations by Industry*

*This is an English summary of a report originally published on March 9, 2012. The full report is available only in Japanese, but the author will answer questions regarding the topic by e-mail.

*The information and the views contained herein are subject to change without notice.