

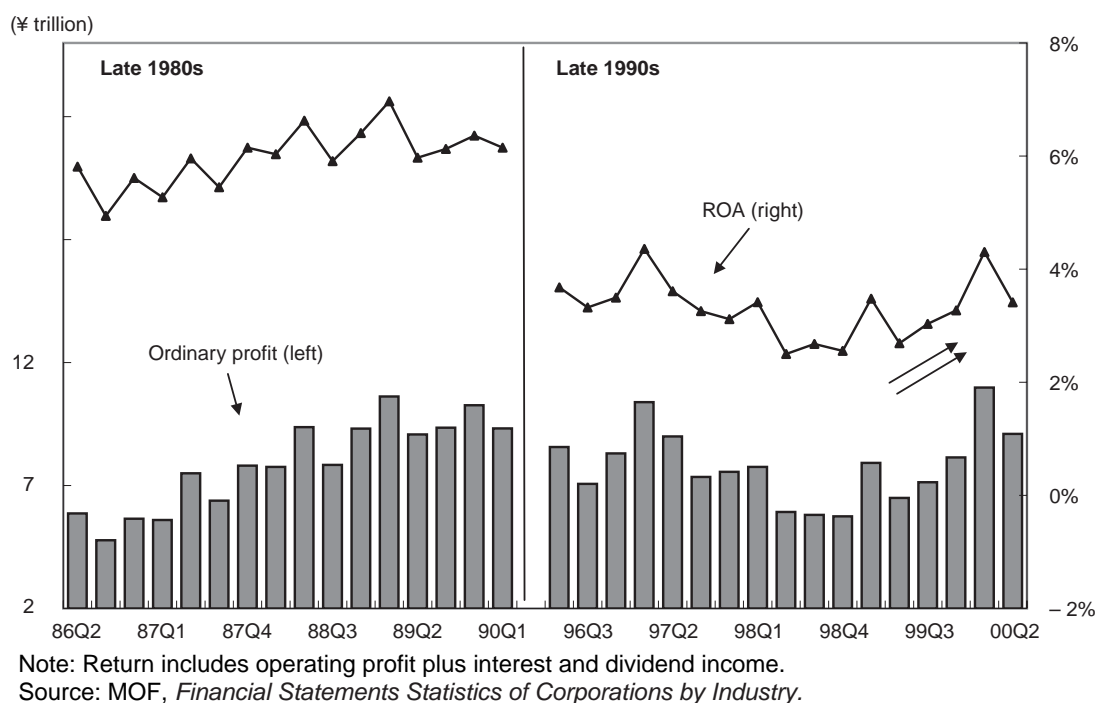
# Is the Corporate Sector's Return on Assets Recovering?

By Takeshi Hyuga  
Economic & Industrial Research Group

In fiscal 2000, companies are likely to post their second straight year of double-digit earnings growth. Despite lingering weakness in some industries, the overall picture is good — ordinary profits have recovered to levels that match past economic recoveries.

But while the rapid earnings recovery has already helped the return on assets (ROA) to match the previous recovery peak (fiscal 1996), it remains low compared to the 1980s (Figure 1).

**Figure 1 Earnings Recover, but ROA Trails Behind**



According to a recent survey, companies are shifting their emphasis from absolute profit levels to rates of return and management efficiency. Thus despite the fact that earnings already match the peak of the previous recovery, companies remain concerned about the low rate of return. In this paper, we compare the factors behind the present improvement in corporate earnings with conditions in the previous recovery phase (from October 1993), and try to ascertain the future trend in returns.

Due to the large impact on ordinary income from non-operating sources — particularly capital gains or losses from securities — our analysis uses earnings as measured by operating income plus interest and dividends earned (or EBIT excluding capital gains) to gain a more accurate view of corporate business results on a single year basis.

## 1. Factors Behind the Earnings Improvement

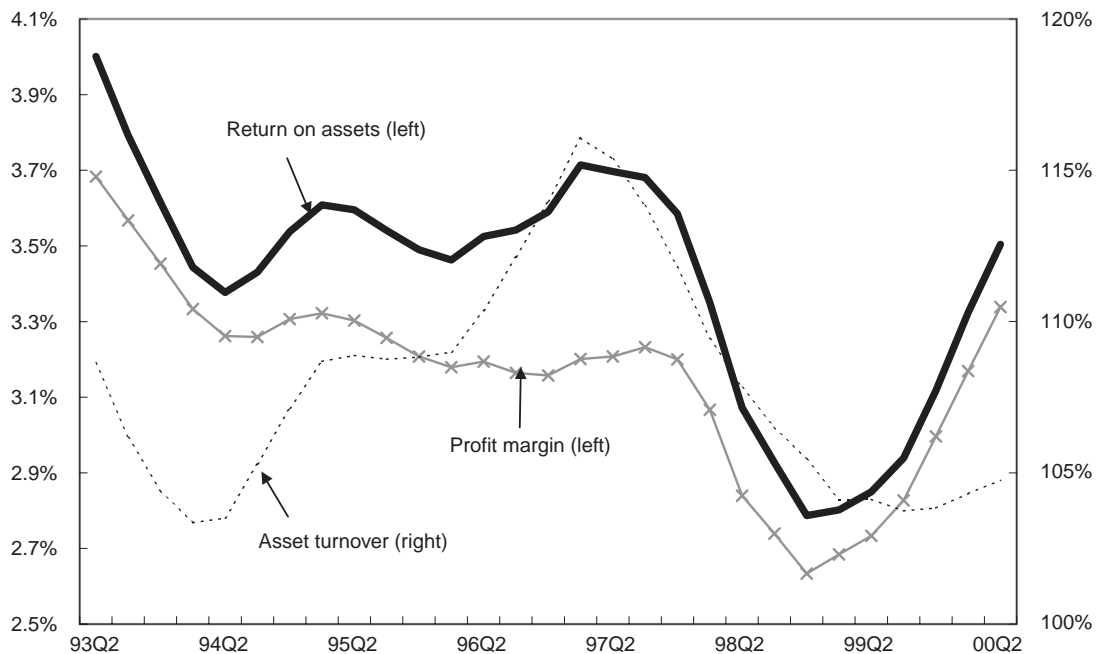
### 1. Components of ROA

In using ROA as an indicator of the return on all capital used in corporate business activities (shareholder's equity and debt capital), we can use the balance sheet convention that total assets equal liabilities plus shareholder's equity, and break down ROA into two components — the ratio of earnings to sales (profit margin), and the ratio of sales to assets (asset turnover). From this perspective, it becomes clear that while higher asset turnover caused ROA to increase in the previous recovery, in today's case ROA is increasing due to a rising profit margin (Figure 2).

$$\frac{\text{Earnings}}{\text{Liabilities + Shareholder's equity}} = \frac{\text{Earnings}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Assets}}$$

(Profit margin)      (Asset turnover)

**Figure 2 ROA, Asset Turnover, and Profit Margin**



Note: Shows moving averages of past four quarters.

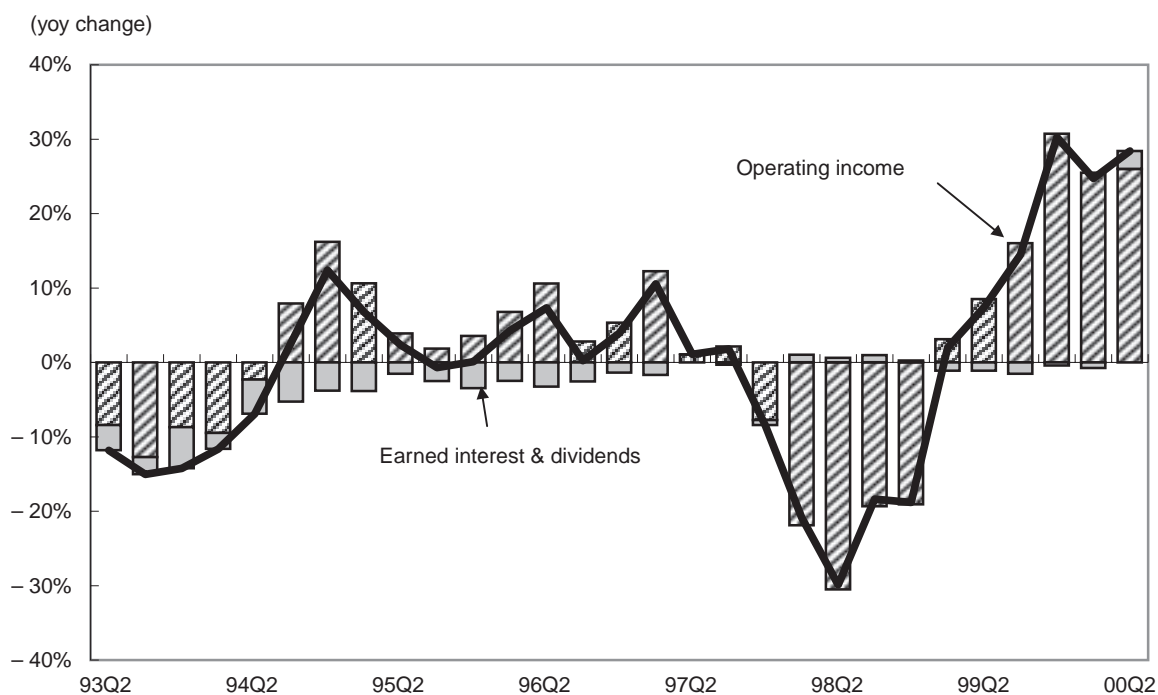
Source: MOF, *Financial Statements Statistics of Corporations by Industry*.

## 2. Cost Reduction — Differences from the Previous Recovery

### 1. Decline in the break-even point in sales

The difference mentioned above is attributed to stronger operating profit growth in the present recovery (Figure 3).

**Figure 3 Operating Profit Plus Interest & Dividend Income (% yoy change)**



Source: MOF, *Financial Statements Statistics of Corporations by Industry*.

Given the relatively moderate growth in sales, the strength of this operating profit growth lies on the cost side. To better grasp cost trends, below we look at the movement of the break-even point in sales.

By tracking the break-even point, we can see how the cost-centered corporate profit structure changes.

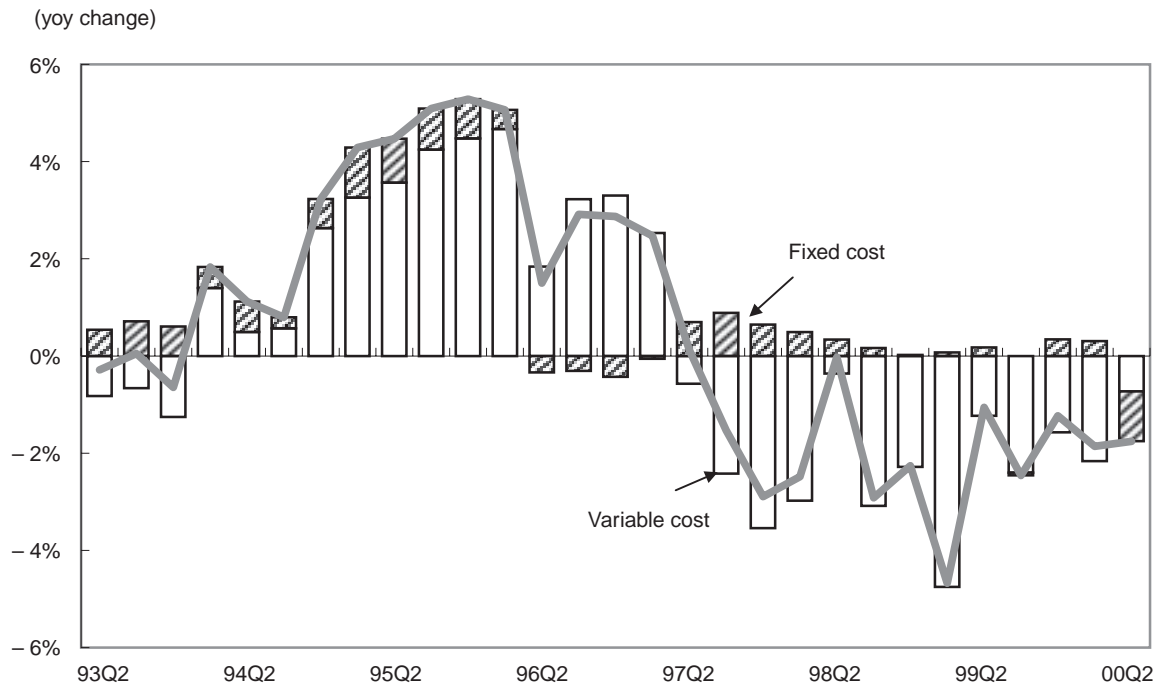
$$\text{Sales break-even point} = \frac{\text{Fixed cost}}{1 - (\text{Variable cost} / \text{Sales})}$$

Indeed, the break-even point indicates that costs have been reduced on a much larger scale this time than in the previous recovery.

Since the July-September 1997 quarter, the break-even point has consistently declined year-on-year for

three straight years, indicating the magnitude of the cost reductions. This trend is continuing into the present recovery as companies relentlessly cut costs regardless of improvement in their business results.

**Figure 4 The Break-Even Point in Sales (% yoy change)**



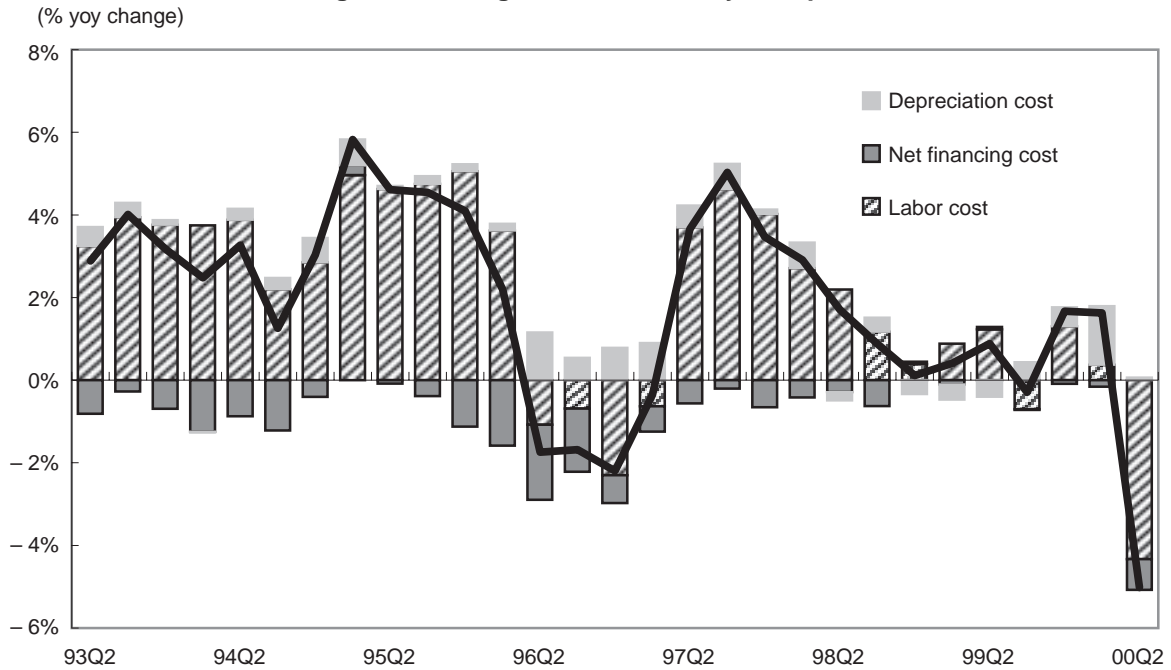
Source: MOF, *Financial Statements Statistics of Corporations by Industry*.

Another significant point is that since fiscal 1997, the reduction of variable costs has played a larger role than that of fixed costs in overall cost reduction (Figure 4). Below we examine the content of fixed and variable costs in greater detail.

## 2. Fixed costs — Reduction of labor cost

Compared to the previous recovery, the present recovery is characterized by restrained growth in labor cost, which comprises 80% of fixed costs (the remainder being financing and depreciation costs). Despite an increase in the number of corporations, total fixed costs are almost unchanged from the previous year, indicating that payroll and wage cuts have caused labor costs per company to decline (Figure 5).

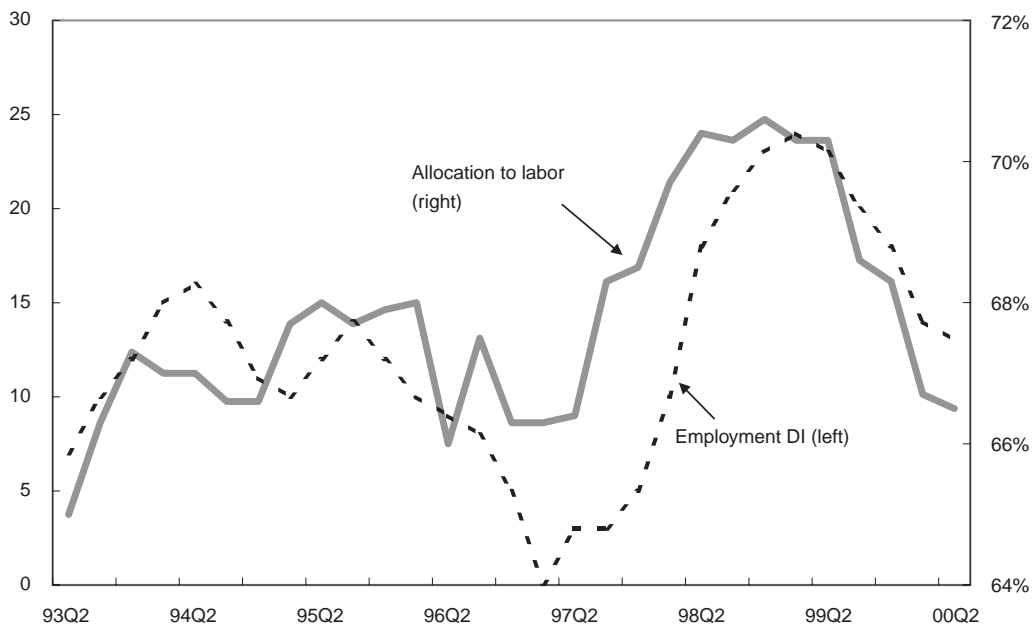
**Figure 5 Change in Fixed Cost by Component**



Source: MOF, *Financial Statements Statistics of Corporations by Industry*.

The restrained growth in labor cost aims to correct the excessive labor cost burden of the late 1990s, the extent of which is evident from the significant increase in the allocation to labor (= Labor cost / [Ordinary profit + Depreciation expense + Interest expense + Labor cost]; Figure 6).

**Figure 6 Allocation to Labor and Employment Sentiment DI**



Notes: Allocation to labor is seasonally adjusted. DI value is the aggregate for all companies.  
Sources: MOF, *Financial Statements Statistics of Corporations by Industry*; BOJ, *Tankan Survey*.

The allocation to labor, which had fluctuated at around 60% before 1990, spiked to over 70% in the 1990s. For companies, this increase implied higher costs and lower profits, and given the lower economic growth expectations, they could no longer postpone addressing the high labor cost.

On the other hand, the reduction of net financing expense (= Interest expense - Interest & dividend income), which had previously played a prominent role in reducing fixed costs, has played a minor role this time due to the fact that interest rates had already dropped significantly (Figure 5).<sup>2</sup>

### *3. Variable costs — Decline in primary product prices*

In the previous recovery, rising oil prices and the yen's depreciation from 1995 (causing higher import prices of raw materials) caused variable costs to rise, squeezing corporate earnings.

In the present recovery, however, a worldwide price decline in primary goods triggered by the Asian crisis of 1997, along with a slowdown in the domestic economy, caused prices to decline significantly, which greatly helped to reduce variable costs. Even after the economy began recovering, variable costs continued to decline year-on-year, contributing significantly to the recent recovery in corporate performance (Figure 4).

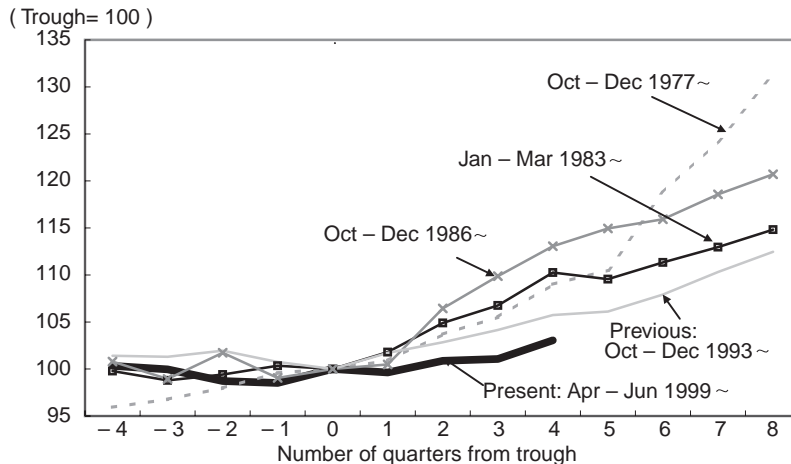
Moreover, unlike fixed costs, variable costs consist mostly of materials costs, and thus are largely beyond the scope of a company's control. Thus while variable costs have benefited corporate performance, they have not strengthened the underlying profit structure.

### **3. Difference in Sales Recovery Pace — Volume and Price Factors**

Whereas sales turnover improved in step with the previous recovery, it has hardly budged even one year into the present recovery (Figure 2).

This is attributed to the extremely moderate recovery in sales (Figure 7).

**Figure 7 Sales Recovery Pace in Past Economic Expansions**



Note: Seasonally adjusted

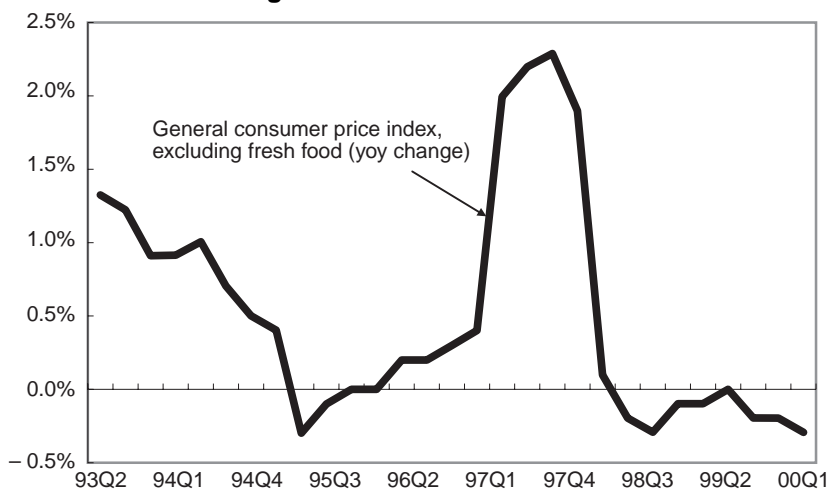
Source: MOF, *Financial Statements Statistics of Corporations by Industry*.

The sluggishness in sales can be traced back to the unprecedented cost cutting efforts and labor costs in particular, along with a shift in emphasis to management efficiency and returns. As a result, the business recovery has not translated directly into higher household incomes and consumption.

In addition, while consumer confidence has been recovering from the financial shocks of 1997, looming concerns regarding the burgeoning fiscal budget deficit and viability of the social security system have limited the recovery in the propensity to consume.

Aside from these factors affecting the balance of supply and demand (volume), the weakness in sales growth is also attributed to falling product prices and declining inflation. Whereas the consumer price index generally rose year-on-year in the previous recovery, consumer prices in the present recovery have declined (Figure 8).

**Figure 8 Domestic Inflation Rate**



Note: Unadjusted for effect of 1997 consumption tax rate increase.

Source: MACA, *Monthly Report of Retail Prices*.

In this situation, even if sales volume increases, a proportionately larger decline in unit prices will cause total sales to decline. Thus sales growth in the present recovery has been tempered by both volume and price factors.

## 2. Will ROA Continue to Improve?

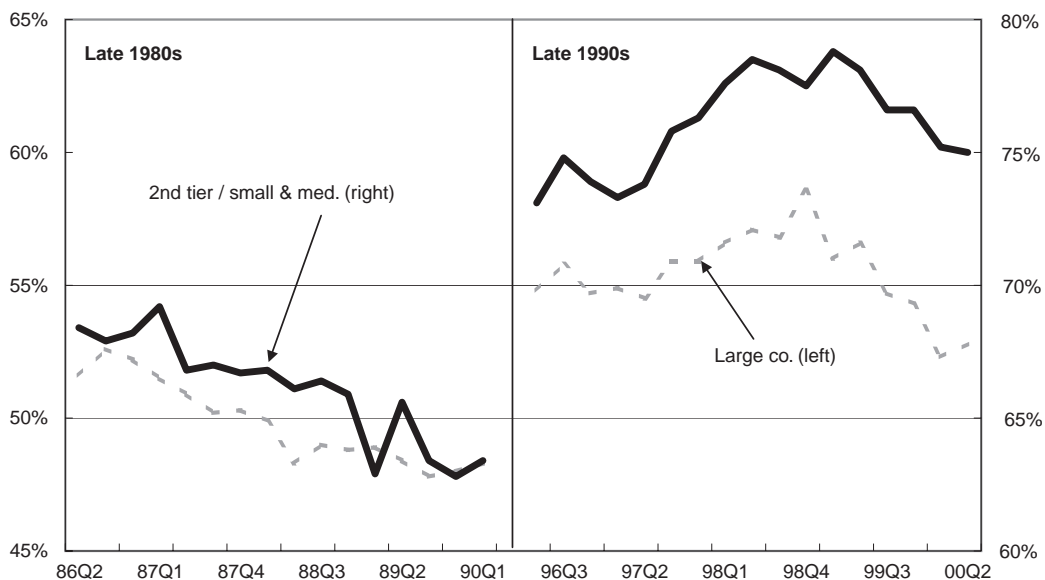
### 1. Profit Margins

#### 1. Reduction of labor cost will continue

The allocation to labor of large companies has finally declined to the upper limit reached in the late 1980s. On the other hand, it remains high among small and mid-sized companies (Figure 9).

Based on the tendency of the allocation to labor to rise in recessions and fall in expansions, we expect it to continue falling as the recovery progresses. Thus pressure to contain labor costs at large companies will gradually abate, and in the future, salaries are likely to grow in correlation with earnings. On the other hand, since the allocation to labor at small and mid-sized companies still needs considerable time to return to pre-1990 levels, their labor cost cutting pressures will remain strong. On balance, due to the prevalence of small and mid-sized companies, labor cost cutting pressures will remain in place for the corporate sector as a whole.<sup>3</sup>

**Figure 9 Allocation to Labor by Company Size**

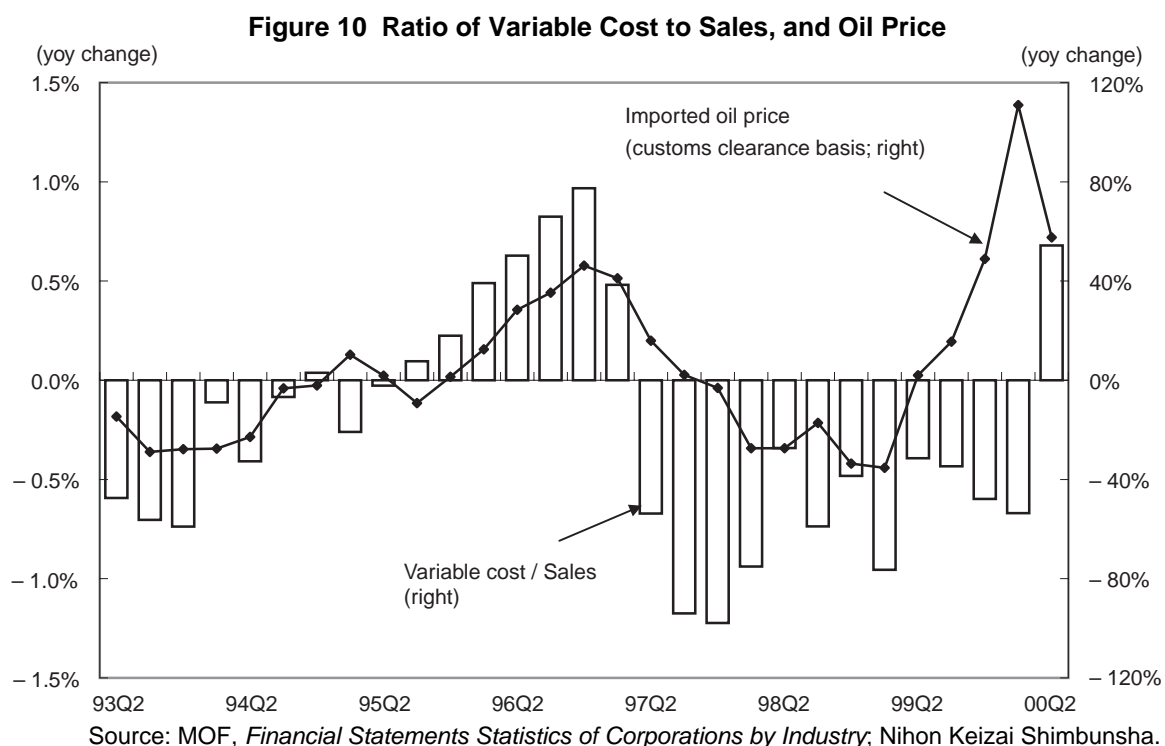


Note: Seasonally adjusted. Large companies have a capitalization of at least ¥1 billion, and small and mid-sized companies have less than ¥1 billion.

Source: MOF, *Financial Statements Statistics of Corporations by Industry*.



In the previous recovery, low profit margins were partly attributable to rising variable costs as raw material prices increased. With oil prices having risen in the present recovery, the possibility exists ahead for variable cost increases to squeeze corporate earnings. In fact, the variable cost to sales ratio, which had declined year-on-year until the January-March 200 quarter, increased 0.7% in the April-June quarter (Figure 10).



Given the rising variable cost to sales ratio (due mainly to higher raw materials prices), and the present difficulty of passing on higher costs to product prices, companies are likely to manage costs by trimming fixed costs, and labor costs in particular. If oil prices remain high, wage growth will be restrained in the next fiscal year as well.

## 2. Return on Assets

### 1. Sales recovery to remain moderate

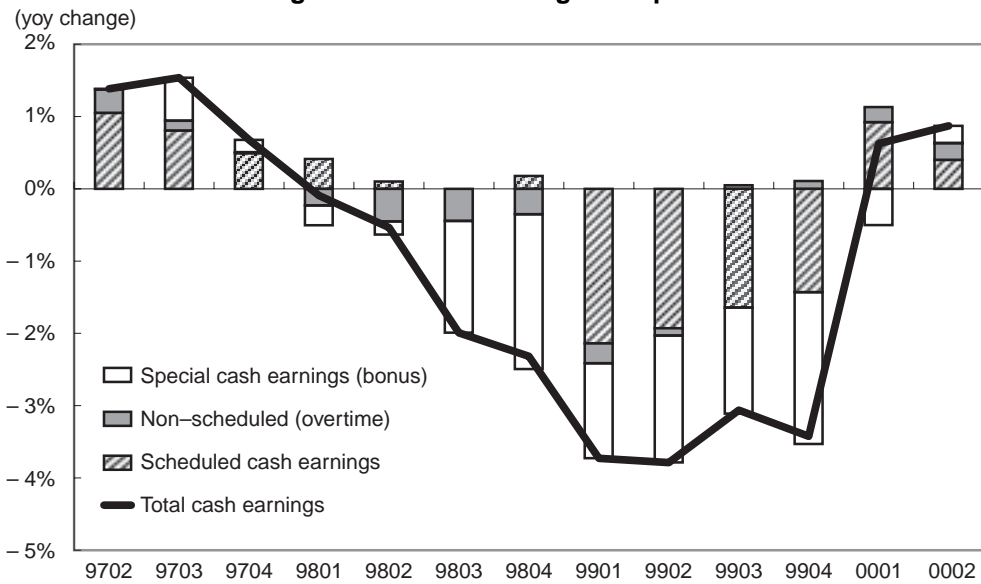
As business results recover, employee incomes and consumer confidence are improving, final consumption is gradually showing signs of improvement (Figures 11 and 12).

However, since companies are also expected to persevere in cutting labor costs, income growth will remain moderate. Moreover, improvement in consumer confidence will also be restrained due in part to the growing fiscal deficit and the prospect of future tax increases.

There is concern that if labor costs continue to be reined in to offset high primary product prices, consumption will suffer from blows to both income and consumer confidence, thereby further dragging down corporate sales.

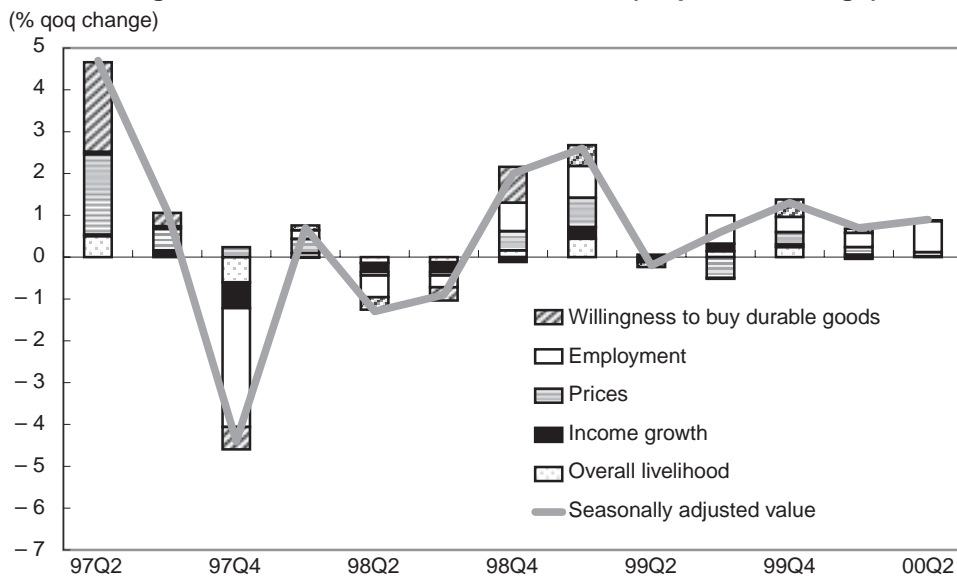
In light of this, although factors to improve consumption already exist, we expect sales to continue its present modest pace of improvement.

**Figure 11 Cash Earnings Composition**



Note: Includes businesses with at least 5 employees.  
Source: MOL, *Monthly Labor Survey*.

**Figure 12 Consumer Confidence Index (sequential change)**



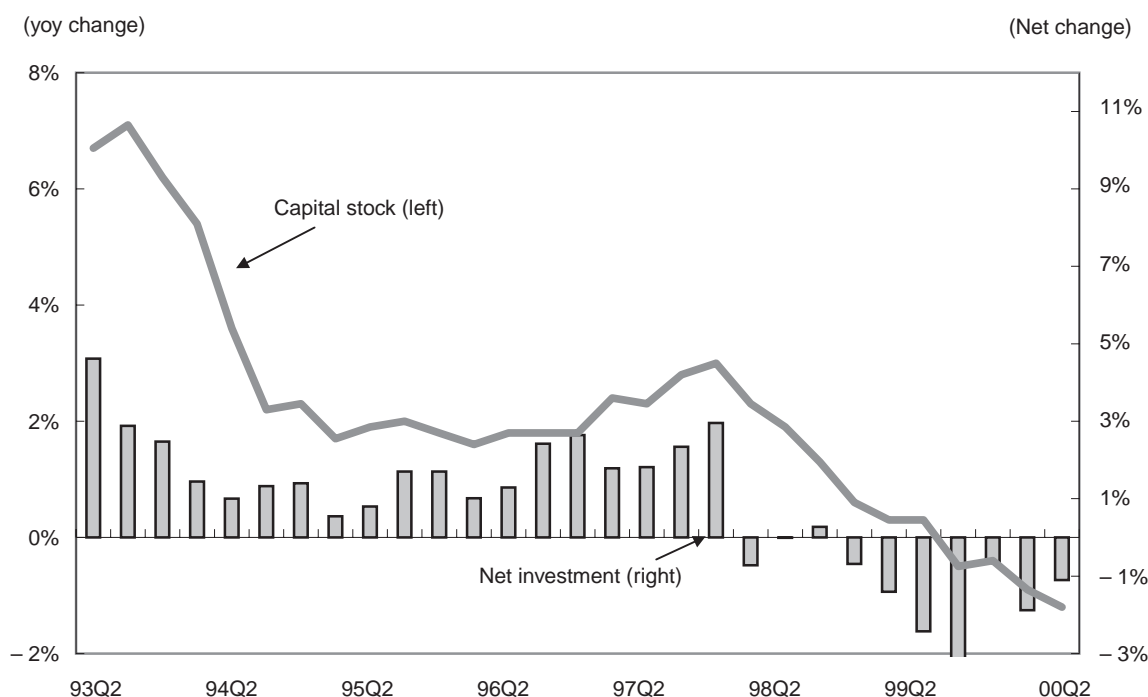
Note: Seasonally adjusted.  
Source: EPA, *Consumer Trend Survey*.

## 2. Capital investment is sound, but not sustainable

Despite concerns that growth in capital investment was negative in the April-June 2000 quarter from the previous quarter, judging from machinery orders and corporate investment plans, capital investment is likely to sustain the economic recovery during the present fiscal year.

But despite this growth in new capital investment, net investment including depreciation is not growing. With the emphasis on returns, capital investment is weak compared to past recovery phases (Figure 13).

**Figure 13 Net Investment and the Decline in Capital Stock**

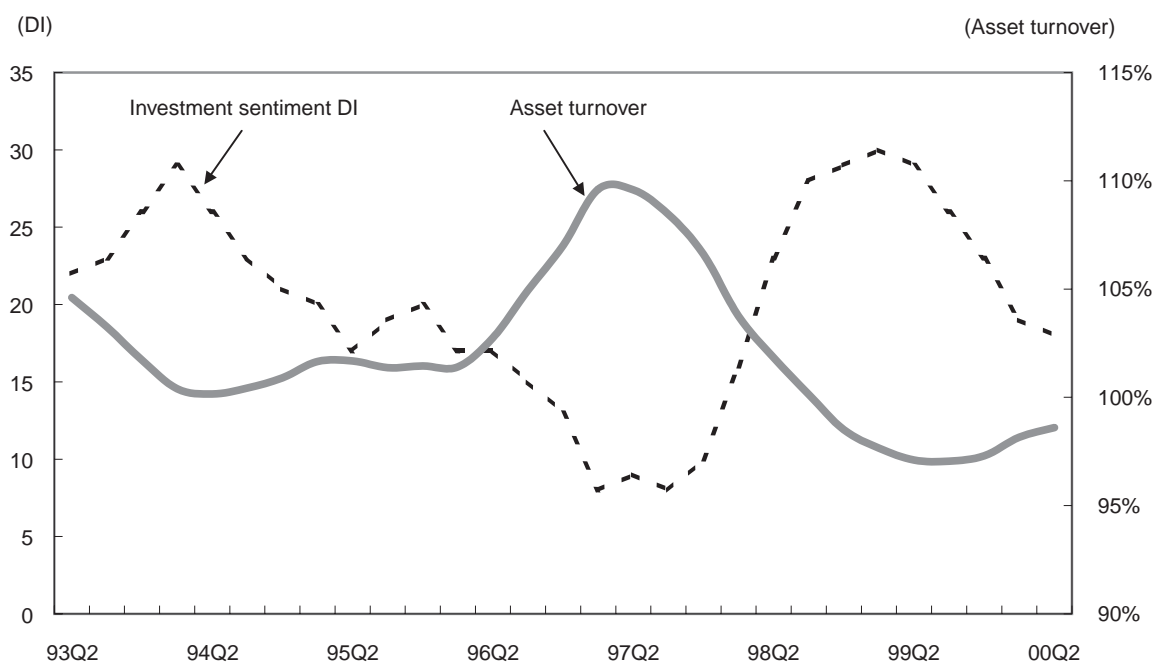


Note: Capital stock for 99Q3 excludes an abnormal value for large companies (capitalized at ¥1 billion or more) in "other service industries." Net investment is defined as: (New fixed investment — Decrease in other tangible fixed assets) / Stock of other tangible fixed assets

Source: MOF, *Financial Statements Statistics of Corporations by Industry*.

Among small and mid-sized companies, whose sales have not recovered significantly, capital investment is restricted to essential areas such as IT related investment, replacement investment, and investment to promote energy savings and rationalization. They appear to be waiting for utilization rates to increase and investment efficiency to improve (Figure 14).

**Figure 14 Investment Sentiment DI and ROA**



Notes: ROA is a trailing four-quarter moving average for manufacturing.

Source: MOF, *Financial Statements Statistics of Corporations by Industry*; BOJ, *Tankan Survey*.

While IT related investment is likely to improve corporate returns, network problems and other obstacles raise doubts as to the actual size of its effect. Thus while companies recognize the importance of IT investment, rather than boosting IT investment and increasing the risk of excess capacity, companies are more likely to depreciate their excess investment, and within this scope make investments in line with expected returns.

Thus while it is driving the economic recovery at present, IT related investment is not likely to be substantial enough for investment driven economic growth to accelerate over the long term.

### *3. Corporate returns to trend moderately upward*

For continued improvement in return on assets, companies need to: (1) continue to contain costs (particularly fixed costs) and improve profit margins, despite major progress already in improving business results, and (2) continue to reduce excess capacity while making IT investments as necessary to improve returns, as well as to improve asset turnover. These measures will lead to sustained ROA improvement, albeit at a moderate pace.

The present outlook for this fiscal year is that earnings will continue to recover, and ROA will also improve as a result of a sales recovery, the small increase achieved in this year's wage settlements, and

expected recovery in consumption as incomes rise. However, from the following year, improvements in business results and ROA may gradually slow because the variable cost to sales ratio has already begun rising, and the modest pace of recovery in sales.

From a longer perspective, present cost reduction efforts and investment trends indicate that companies have unmistakably made a major shift in emphasis to management efficiency targets such as ROA. While fluctuations in returns are tied to business cycles, corporate returns have finally stopped their decade long decline and begun what appears to be a modest yet decidedly upward trend.

## **Notes**

1. EPA, 1999 *Survey of Corporate Activity*.
2. The official discount rate was lowered to its present level of 0.5% in September 1995. Later, the unsecured overnight call rate was reduced to 0.25% in September 1998, and the zero-interest rate policy taken in February 1999.
3. According to MACA's *Labor Force Survey*, approximately 65% of all non-farm workers belong to companies with less than 500 employees.