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Nomura Shareholder Yield 70

EQUITY QUANTITATIVE RESEARCH

70 stocks with proactive shareholder returns

Global Markets Research

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Research analysts

Japan quantitative research

Sayuri Otsuka - NSC
sayuri.otsuka@nomura.com
+81 3 6703 1397

Yasuhiro Shimizu - NSC
yasuhiro.shimizu@nomura.com
+81 3 6703 1748

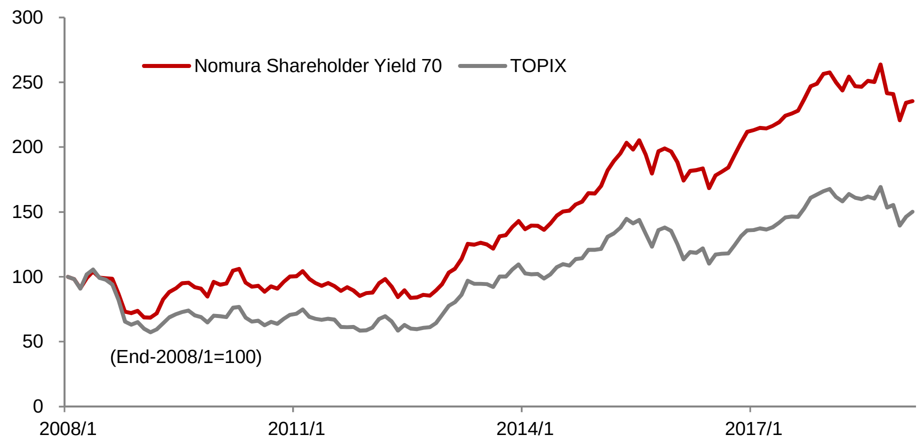
Targeting returns resulting from improved capital efficiency owing to shareholder returns

Improvement in capital efficiency at Japanese corporations has become a major investment theme. Pressure on Japanese companies to improve capital efficiency and increase shareholder returns appears to have heightened to an unprecedented degree, particularly since the release of Japan's stewardship code in 2014 and the implementation of its corporate governance code in 2015.

The Nomura Shareholder Yield 70 is based on the concept of targeting returns that arise as a result of improvements in capital efficiency. It does this by investing in Japanese corporations that are proactively providing shareholder returns via dividends and share buybacks. We use "net shareholder yield" as a quantitative measure of the aggressiveness of shareholder returns. We base this on the net shareholder payout, which is the total value of dividends and share buybacks minus the total value of capital increases, over the past three years. The Nomura Shareholder Yield 70 is a market cap-weighted index comprising the top 70 stocks in terms of net shareholder yield selected from all listed Japanese companies (excluding financial stocks), with individual stock weightings capped at 2%.

It is not necessarily the case that higher shareholder returns are always desirable. If, however, a company is unable to make effective use of the capital it has collected from shareholders, returning excess capital to shareholders can increase capital efficiency and lead to higher corporate value and improved share price returns. The Nomura Shareholder Yield 70, which comprises stocks that proactively return profits to shareholders, has outperformed the TOPIX by 3.8% on an average annual basis over the past 11 years or so.

Fig. 1: Index performance: Nomura Shareholder Yield 70



Note: Period of analysis is February 2008 through February 2019. Based on monthly returns including dividends. We did not take trading costs into account. Analysis is based on past performance and does not guarantee future performance.

Source: Nomura

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See Appendix A-1 for analyst certification, important disclosures and the status of non-US analysts.

Shareholder returns increasingly attracting attention in recent years

Improvement in capital efficiency at Japanese corporations has become a major investment theme. As part of the government's growth strategies, Japan's stewardship code was released in 2014, laying out principles "for institutional investors in order to fulfill their stewardship responsibilities, such as promoting the mid- to long-term growth of companies through dialogue." The following year (2015) brought the implementation of Japan's corporate governance code, which established principles for achieving effective corporate governance. We think this has heightened the pressure on Japanese companies to improve capital efficiency and increase shareholder returns to an unprecedented degree (Figure 2).

At the same time, while ROE has been improving at Japanese companies, it remains lower than at companies in the US and elsewhere. On the other hand, according to the Financial Statements Statistics of Corporations by Industry, cash and deposits at Japanese companies (all sizes, all industries, excluding financials and insurance) had reached ¥222trn in FY17. This situation has been drawing criticism from investors. For example, at the 11th meeting of the Council of Experts Concerning the Follow-up of Japan’s Stewardship Code and Japan’s Corporate Governance Code in October 2017, participants noted that retained earnings had been building up at Japanese corporations in the form of cash and deposits, and that many investors think corporate cash on hand is above optimal levels. The FY17 survey entitled Approaches toward Enhancing Equity Values conducted by the Life Insurance Association of Japan also suggested that investors are hoping for a further increase in shareholder returns, with more than 80% of respondents selecting "around half" or "very few" when asked what proportion of companies were offering satisfactory dividends and other shareholder returns.

The various measures promoting improvement in capital efficiency and shareholder returns aim to raise corporate value through constructive dialogue between investors and management, in turn facilitating sustained growth in the Japanese economy. We do not see these efforts as temporary, and we expect attention to continue to focus on shareholder returns and their impact on capital efficiency over the long term.

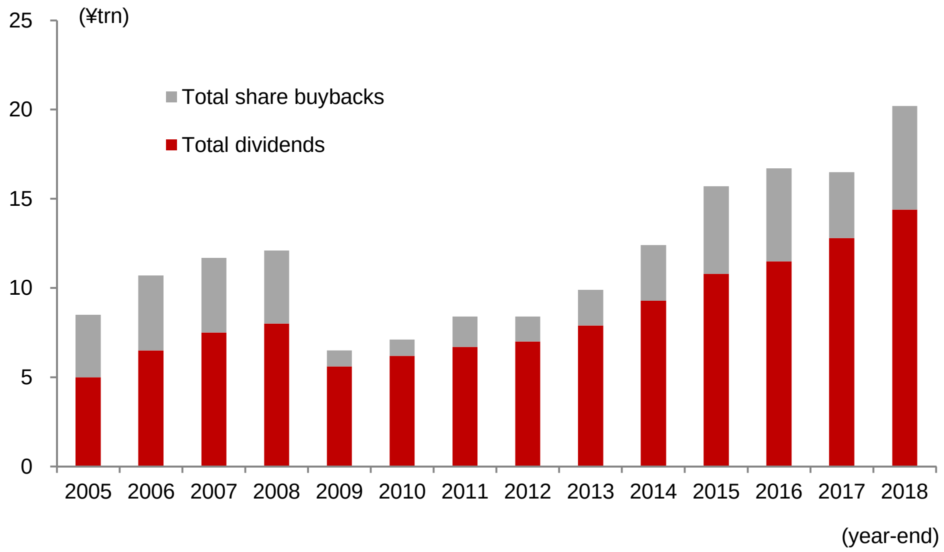
Fig. 2: Major events strengthening corporate governance

(yyyy/m)	Event
2013/6	Japan Revitalization Strategy published
2014/1	Launch of JPX-Nikkei Index 400
2014/2	FSA publishes Japan's stewardship code
2014/4	Government Pension Investment Fund (GPIF) announces investment in JPX-Nikkei Index 400
2014/5	GPIF announces acceptance of stewardship code
2014/8	METI publishes Ito Report
2015/5	Revisions to Companies Act implemented
2015/6	TSE starts applying corporate governance code
2015/9	GPIF signs United Nations Principles for Responsible Investment (PRI)
2017/5	FSA revises stewardship code
2017/7	GPIF announces investment in ESG
2017/10	11th meeting of Council of Experts Concerning the Follow-up of Japan’s Stewardship Code and Japan’s Corporate Governance Code
2017/10	METI publishes Ito Report 2.0
2018/6	TSE revises corporate governance code

Source: Nomura

In recent years, Japanese companies have been increasing their total shareholder payouts, which comprise both stock dividends and share buybacks (Figure 3). As Figure 3 shows, while the change in dividends has been relatively gradual, share buybacks have changed more sharply. This may be because of management attempts to keep dividend payments roughly stable while taking a more flexible approach to share buybacks. Turning to the correlation between shareholder returns and net profits, as shown in Figure 4, we see that the total shareholder payout (dividends plus share buybacks) tracks net profits more closely than do dividends alone. We conclude that it is important to look at a company's share buybacks, in addition to its dividends, to get a more accurate picture of management's stance toward returning profits to shareholders.

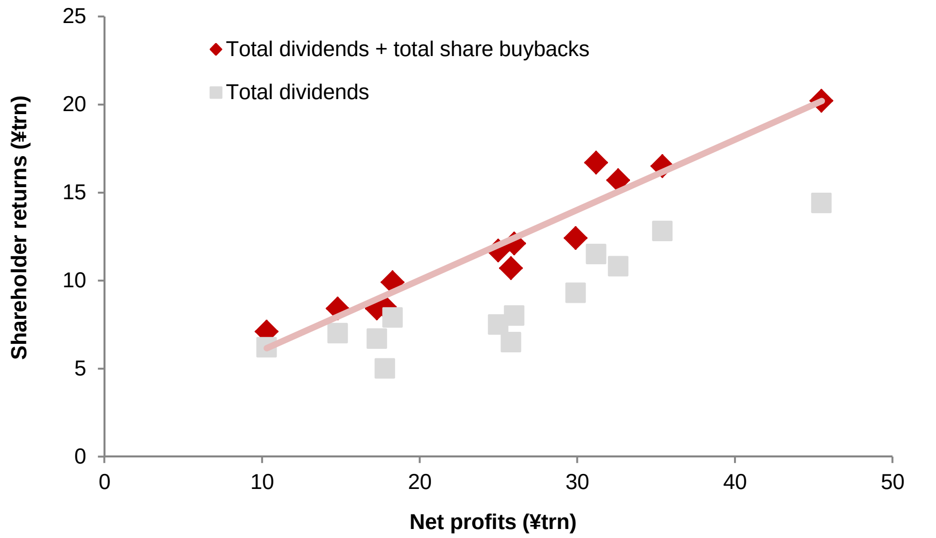
Fig. 3: Shareholder payout for Japanese stocks



Note: Period of analysis is end-2005 through end-2018. Shows total dividends and total share buybacks for all listed companies over the calendar year. Total dividends for 2018 include estimates.

Source: Nomura

Fig. 4: Correlation between shareholder returns and net profits

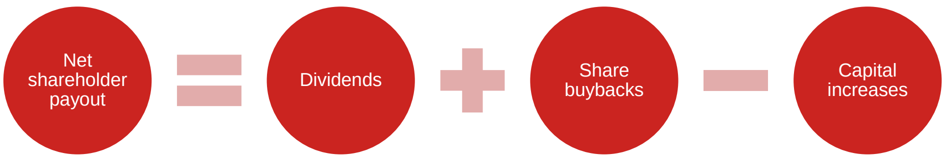


Note: Period of analysis is end-2005 through end-2018. Plots correlation between total net profits at all listed companies for the most recent period as of the year-end and total dividends and share buybacks for the calendar year. As total net profits were negative in 2009, data for this year has been excluded. Total dividends for 2018 include estimates.

Source: Nomura

The Nomura Shareholder Yield 70 is based on the concept of targeting returns that arise as a result of improvements in capital efficiency. It does this by investing in Japanese corporations that are proactively providing shareholder returns via dividends and share buybacks in response to the growing pressure to improve capital efficiency and increase shareholder returns. As a quantitative measure of the aggressiveness of shareholder returns, we use “net shareholder payout”, which is the total value of dividends and share buybacks minus the total value of capital increases, over the past three years. We subtract the value of capital increases, as from the standpoint of corporate finance these are the reverse of share buybacks, and could thus be regarded as negative shareholder returns. We therefore think the net shareholder payout is a more accurate gauge of a corporation's stance toward shareholder returns. In order to facilitate comparisons between corporations of differing sizes when selecting stocks, we calculate the "net shareholder yield" by dividing net shareholder payout by market cap.

Fig. 5: Calculation of net shareholder yield



$$\text{Net shareholder yield} = \frac{\text{Total dividends} + \text{total buybacks} - \text{total capital increases}}{\text{Market cap}}$$

Note: For total dividends, share buybacks, and capital increases we use the average for the past three years, while for market cap we use the most recent figure.

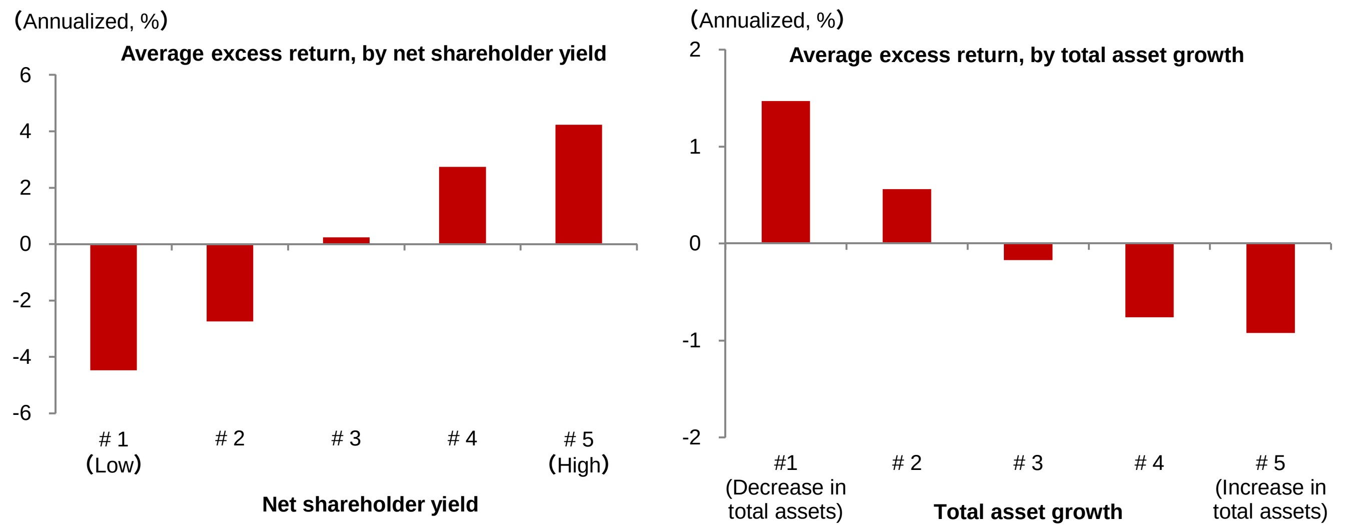
Source: Nomura

The impact of shareholder returns on share price performance

It is not necessarily the case that higher shareholder returns are always desirable. If a company has high profit margins and considerable potential for growth, investing its limited capital is likely to do more to boost corporate value than returning this limited capital to shareholders. However, if the company is not able to use the capital raised from its shareholders effectively, returning this capital to its shareholders via dividends or share buybacks is likely to do more to boost its capital efficiency and increase both its corporate value and its share price. Indeed, our analysis shows that companies that have taken a more aggressive stance on shareholder returns and downsizing assets have tended to see a stronger subsequent share price performance (Figure 6). We think this indicates that, on average, companies are unable to use their capital efficiently and have surplus assets.

There are many different views on why holding surplus cash and deposits or assets has a negative impact on corporate value. One of the main arguments put forward is that when a company has more cash and deposits than it needs, this gives its management team too much discretion, and it is therefore more likely to carry out unsuitable investments or increase expenditure. Another argument is that, because companies tend to prefer to raise funds internally, from their retained earnings, rather than externally, for example via borrowings or capital increases, they tend to build up more retained earnings than they need, which reduces their capital efficiency and corporate value. Both of these arguments show that when a company has, for whatever reason, a strong desire to hold cash, this can lead to irrational behavior, and in our view this explains why holding surplus cash and deposits or assets has a negative impact on corporate value and share prices. On average, this negative impact is likely to be reduced for companies with a proactive stance on shareholder returns, and we would therefore expect this kind of proactive stance to boost capital efficiency and corporate value.

Fig. 6: Share price performance, by shareholder returns

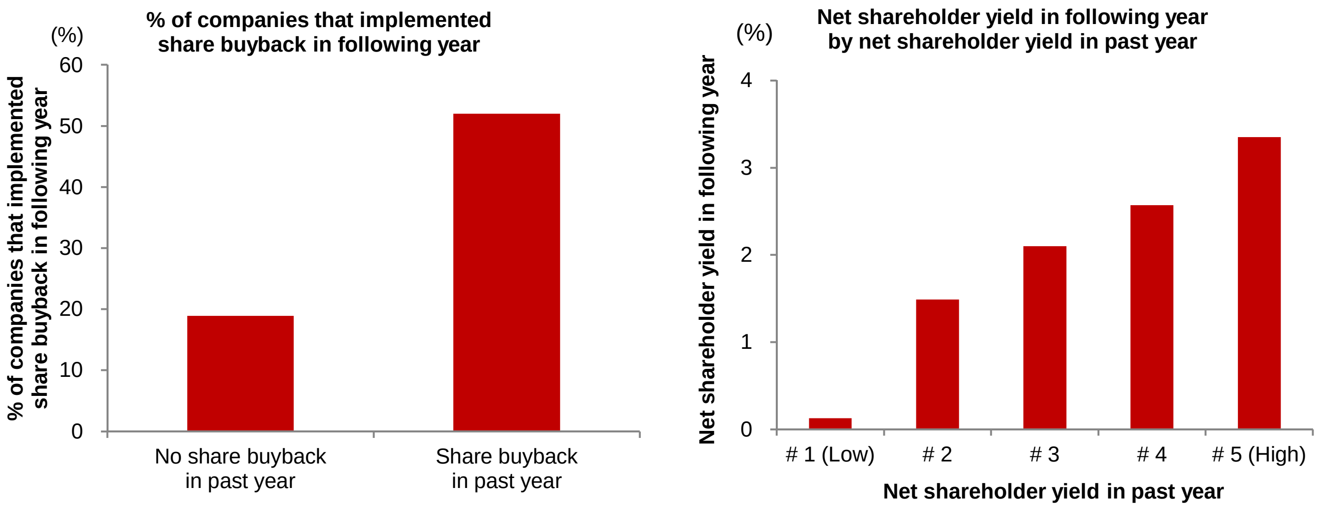


Note: Period of analysis is February 2008 through February 2019. (Left-hand chart) We divided the universe of Russell/Nomura Total Market Index (the benchmark index) constituent stocks into five groups at the beginning of each month, based on net shareholder yield, with an equal number of stocks in each group. We then calculated the annualized average excess return on each group of stocks (equally weighted, including dividends) versus the benchmark index. (Right-hand chart) We replaced net shareholder yield, in the left-hand chart, with total asset growth (change in total assets in previous fiscal year and fiscal year before that).

Source: Nomura

In addition, companies that were proactive on shareholder returns in the past tend to have larger shareholder returns in the future too (Figure 7). More specifically, companies that carried out share buybacks in the past tend to continue to carry out share buybacks in the future, and companies that had a higher net shareholder yield in the past tend to have a higher net shareholder yield in the future. Notably, companies often see their share price rise after they have announced a share buyback. By selecting stocks that have been proactive on shareholder returns in the past, we think investors could expect strong share price performance in the future too as a result of the share price impact of future share buybacks.

Fig. 7: Continuity of shareholder returns



Note: Shows data from the beginning of February 2008 through the beginning of February 2018. (Left-hand chart) We divided the universe of Russell/Nomura Large Cap Index constituent stocks into two groups at the beginning of each month—companies that had carried out a share buyback over the year to the end of the preceding month and those that had not. We then calculated the average percentage (over the period of analysis) of companies in each group that carried out a share buyback over the following year (based on number of companies). (Right-hand chart) We divided the universe of Russell/Nomura Large Cap Index constituent stocks into five groups at the beginning of each month based on net shareholder yield over the year up to the end of the preceding month, with an equal number of stocks in each group. We then calculated the simple average (over the period of analysis) of the net shareholder yield over the following year (net shareholder payout over the following year divided by market cap at the end of the previous month) for each group.

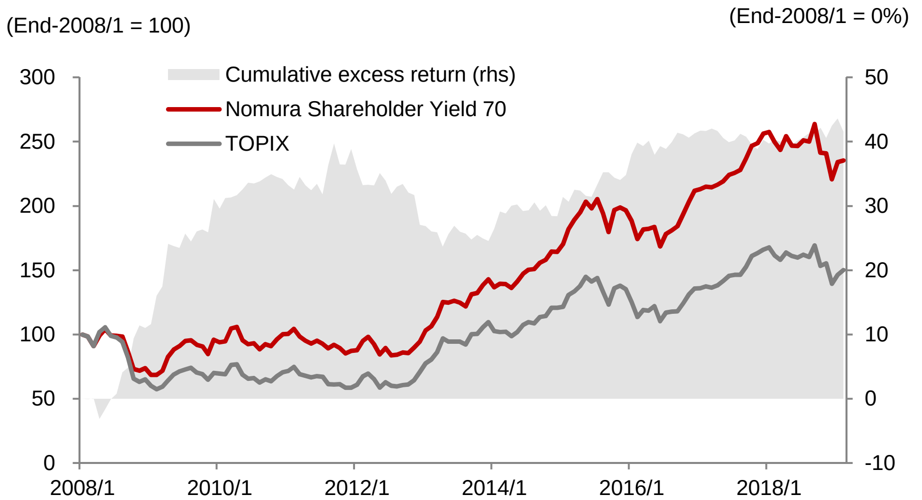
Source: Nomura

Index performance and characteristics

In this chapter, we look at the performance and main characteristics of the index. It comprises 70 Japanese large-cap, highly liquid non-financial stocks with a high net shareholder yield, weighted by market cap (to a maximum of 2%)[1]. The index is reconstituted once a year, and companies are rated every year in terms of the extent to which they are proactive on shareholder returns, based on new data. The index is also market cap-weighted at the time of its periodic reconstitutions, with individual stock weightings capped at 2%. This helps to reduce excessive weighting towards specific large-cap stocks while reducing the weighting of small-cap stocks, thus bringing down impact costs and facilitating diversified investment.

On average, the index has outperformed the TOPIX by 3.8% a year over the past 11 years or so (Figure 8). The actual shareholder yield (dividend yield and share buyback yield) on the index at the time of the periodic reconstitution has been higher than the equivalent yield for TOPIX over the past three years, and the actual yield over the year following the periodic reconstitution has tended to be higher than for the TOPIX too (Figure 9).

Fig. 8: Index performance: Nomura Shareholder Yield 70

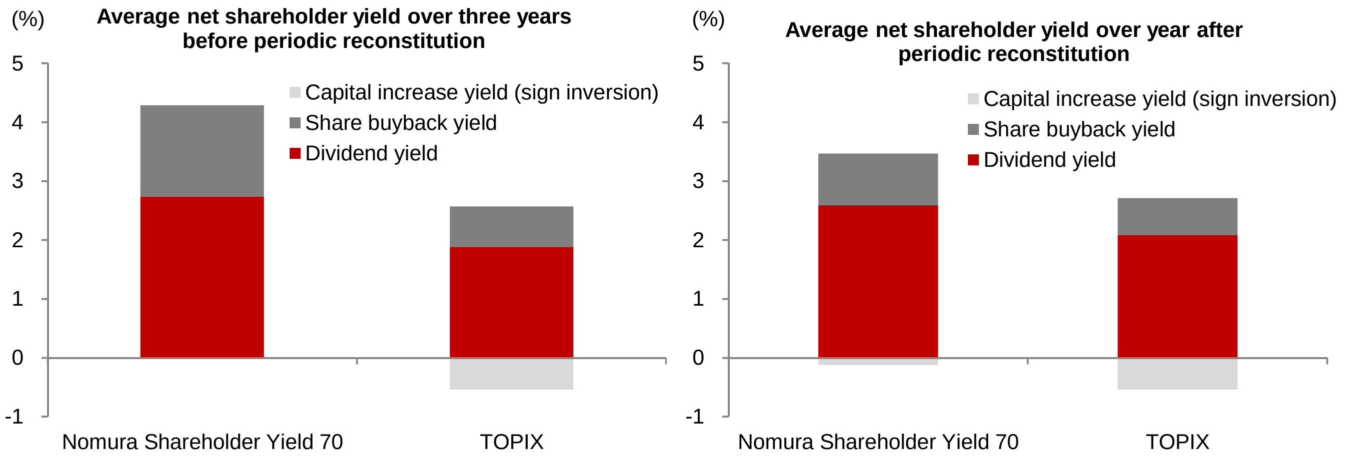


	Absolute return		Excess return versus TOPIX
	Nomura Shareholder Yield 70	TOPIX	Nomura Shareholder Yield 70
Average return (annualized, %)	9.21	5.46	3.75
Risk (annualized, %)	17.10	18.79	5.76
Return / risk	0.54	0.29	0.65

Note: Period of analysis is February 2008 through February 2019. Based on monthly returns including dividends. We did not take trading costs into account. Analysis is based on past performance and does not guarantee future performance.
Source: Nomura

[1] Please see our index rulebook for details of the index.

Fig. 9: Average net shareholder yield at time of periodic reconstitution

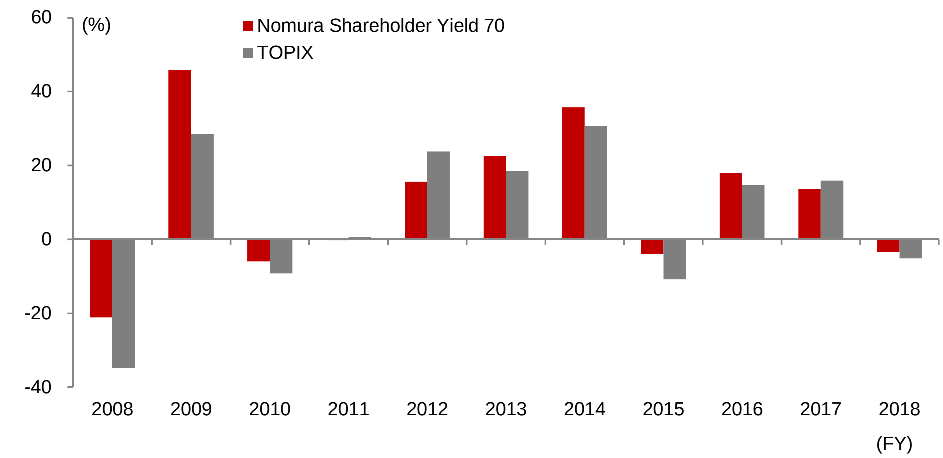


Note: Period of analysis is periodic reconstitutions from early February 2008 through early February 2018. Left-hand exhibit shows the average over the period of analysis, weighted by index weightings, for each type of yield (total dividends, total share buybacks, or total capital increases, over the three years before the periodic reconstitution, divided by market cap at end of previous month, and annualized) for index constituents as of the time of the periodic reconstitution. Right-hand exhibit shows the average over the period of analysis, weighted by index weightings, for each type of yield (total dividends, total share buybacks, or total capital increases, for the year after the periodic reconstitution, divided by market cap at end of previous month) for index constituents as of the time of the periodic reconstitution.

Source: Nomura

Finally, we look at how the index has performed in individual fiscal years and at its recent sector weightings. Since 2008, the index has always delivered positive excess returns in years in which the TOPIX has fallen, and has often delivered positive excess returns in years in which the TOPIX has risen too (Figure 10). Companies that provide proactive shareholder returns tend to be high dividend yield stocks and stocks likely to generate higher capital efficiency too, and the defensive characteristics of high dividend yield stocks have provided support whenever economic conditions have been bad, while expectations of higher ROE have also helped to ensure stable excess returns whenever economic conditions have been good.

Fig. 10: Annual return on Nomura Shareholder Yield 70



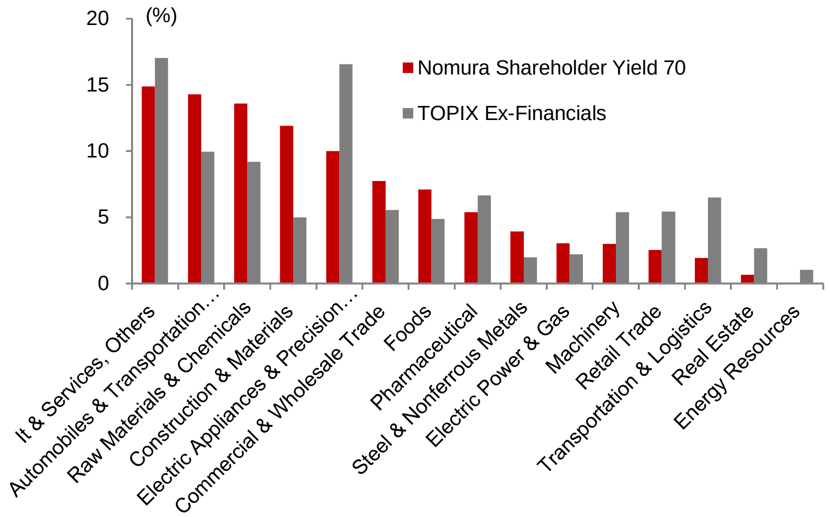
Note: Period of analysis is end-March 2008 through end-February 2019. Index returns include dividends. We did not take trading costs into account. Analysis is based on past performance and does not guarantee future performance.

Source: Nomura

As of end-February 2019, sector weightings for the Nomura Shareholder Yield 70 varied more smoothly than those for the TOPIX Ex-Financials (Figure 11). In our opinion, this partly reflects the wide range of sectors containing companies that are proactive about shareholder returns, and the fact that the 2% weighting cap for individual stocks in the

Nomura Shareholder Yield 70 means that the substantial weightings of large-cap stocks in the TOPIX are distributed between a wide range of individual stocks in the Nomura Shareholder Yield 70 .The particularly high weightings of the IT & services, others and automobiles & transportation equipment sectors in the Nomura Shareholder Yield 70 reflect proactive shareholder returns at major telecom carriers and automakers that have been focusing on shareholder returns as part of their capital policies amid solid earnings.

Fig. 11: Sector weightings of Nomura Shareholder Yield 70



Note: As of end-February 2019. Weightings of index constituents based on TOPIX-17 Series sectors.
Source: Nomura

Appendix A-1

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When bonds are purchased via public offerings, secondary distributions, or other OTC transactions with Nomura Securities, only the purchase price shall be paid, with no sales commission charged. Bonds carry the risk of losses, as prices fluctuate in line with changes in market interest rates. Bond prices may also fall below the invested principal as a result of such factors as changes in the management and financial circumstances of the issuer, or changes in third-party valuations of the bond in question. In addition, foreign currency-denominated bonds also carry the risk of losses owing to factors such as foreign exchange rate fluctuations.
When Japanese government bonds (JGBs) for individual investors are purchased via public offerings, only the purchase price shall be paid, with no sales commission charged. As a rule, JGBs for individual investors may not be sold in the first 12 months after issuance. When JGBs for individual investors are sold before maturity, an amount calculated via the following formula will be subtracted from the par value of the bond plus accrued interest: (1) for 10-year variable rate bonds, an amount equal to the two preceding coupon payments (before tax) x 0.79685 will be used, (2) for 5-year and 3-year fixed rate bonds, an amount equal to the two preceding coupon payments (before tax) x 0.79685 will be used.
When inflation-indexed JGBs are purchased via public offerings, secondary distributions (uridashi deals), or other OTC transactions with Nomura Securities, only the purchase price shall be paid, with no sales commission charged. Inflation-indexed JGBs carry the risk of losses, as prices fluctuate in line with changes in market interest rates and fluctuations in the nationwide consumer price index.The notional principal of inflation-indexed JGBs changes in line with the rate of change in nationwide CPI inflation from the time of its issuance. The amount of the coupon payment is calculated by multiplying the coupon rate by the notional principal at the time of payment. The maturity value is the amount of the notional principal when the issue becomes due. For JI17 and subsequent issues, the maturity value shall not undercut the face amount.
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In interest rate swap transactions and USD/JPY basis swap transactions ("interest rate swap transactions, etc."), only the agreed transaction payments shall be made on the settlement dates. Some interest rate swap transactions, etc. may require pledging of margin collateral. In some of these cases, transaction payments may exceed the amount of collateral. There shall be no advance notification of required collateral value or collateral ratios as they vary depending on the transaction. Interest rate swap transactions, etc. carry the risk of losses owing to fluctuations in market prices in the interest rate, currency and other markets, as well as reference indices. Losses incurred as such may exceed the value of margin collateral, in which case margin calls may be triggered. In the event that both parties agree to enter a replacement (or termination) transaction, the interest rates received (paid) under the new arrangement may differ from those in the original arrangement, even if terms other

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In OTC transactions of credit default swaps (CDS), no sales commission will be charged. When entering into CDS transactions, the protection buyer will be required to pledge or entrust an agreed amount of margin collateral. In some of these cases, the transaction payments may exceed the amount of margin collateral. There shall be no advance notification of required collateral value or collateral ratios as they vary depending on the financial position of the protection buyer. CDS transactions carry the risk of losses owing to changes in the credit position of some or all of the referenced entities, and/or fluctuations of the interest rate market. The amount the protection buyer receives in the event that the CDS is triggered by a credit event may undercut the total amount of premiums that he/she has paid in the course of the transaction. Similarly, the amount the protection seller pays in the event of a credit event may exceed the total amount of premiums that he/she has received in the transaction. All other conditions being equal, the amount of premiums that the protection buyer pays and that received by the protection seller shall differ. In principle, CDS transactions will be limited to financial instruments business operators and qualified institutional investors.
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