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# Stock repurchases in Japan: A solution to excessive corporate saving?[☆]

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ABSTRACT

Since the 1990 s profitable Japanese companies have faced lower domestic growth opportunities; they have invested less, yet most have not increased their payout. This has resulted in a substantial deleveraging of their balance sheets. The popular term for this phenomenon is "corporate saving." Corporate saving by Japanese companies is now at the highest level in history. Dividends and stock repurchases are two potential ways to resolve excessive corporate saving. Stock repurchases in particular offer a fast, flexible and very public method to solve the problem of excessive corporate savings. This research is an investigation of stock repurchases by Japanese companies from 2000 to 2009. Companies repurchase their stock to return excess cash to investors, resolve governance issues, adjust capital structure and send signals. This paper uses accounting and stock market information to explain this behavior. Contrary to recent research on American firms, we find that replacement of dividends does not appear to explain stock repurchase behavior in Japan. We find evidence that repurchase behavior in Japan is linked to excessive corporate savings. However, repurchases are also closely linked to the ownership structure of the firm. Firms whose dominant owners are other members of the firm's industrial group are less likely to repurchase. Bank ownership has mixed implications for repurchases. Firms having foreign and individual ownership are more likely to repurchase stock. Foreign and individual ownership appears to improve governance and thus may be a partial solution to excessive corporate savings.



## 1. Introduction

Japan experienced an enormous economic crisis in the late 1980s, comparable in some respects to the recent European financial crisis and the Lehman Shock (as it is referred to in Japan). Real estate and stock market prices collapsed; there were major debt defaults; and domestic spending on consumption slowed. Japan has subsequently experienced a long period of low/zero growth and deflation that continues to this day. This contributed to a substantial fall in investment, a desire to reduce debt and an obsession to hoard liquidity by Japanese firms. In theory, boards that are sensitive to the interests of shareholders, an active market for corporate control and stockowner pressure all would push firms to disgorge excessive cash balances through changes in payout policy. Yet it seems that these forces have not been effective. Japanese firms currently hold huge amounts of cash; the total was 224 trillion yen in the third quarter of 2013 [Nakamichi and Ito (2014)]. Such "corporate savings" are unprecedented, and arguably excessive from a corporate governance perspective.[1] Furthermore, Japan's excessive corporate savings are not unique. Gruber and Kamin (2015) have documented that there is now a world-wide corporate savings glut.[2] And, while finance researchers have not yet developed a fully practical theory of optimal capital structure, very low debt levels are surely excessive. Dividends and stock repurchases are two ways to reduce excessive corporate savings. Stock repurchases in particular are fast and very flexible. Repurchases certainly have the potential to reduce excess corporate savings. Yet, Japanese companies have continued to accumulate savings even since the practical legalization of repurchases in 2000. This research asks why repurchases have failed to achieve their potential.

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[1] Mr. Takuji Aido, an analyst at UBS in Tokyo, suggests that if the current trend in corporate savings continues unchanged, Japanese firms as a whole will have zero net debt by 2025 [Tricks (2010)].

[2] Japan is arguably the first example of excessive corporate savings. Yet, companies in other countries have been quick to follow Japan's example—even before the financial crisis of 2008. This was noted as far back as 2005 by analysts at JPMorgan Research [Loeys, Mackie, Meggyesi and Panigirtzoglou (2005)] and the *Economist* (2005).

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Until 1995, the repurchase of stock by Japanese companies was not a practical possibility for legal, historical and accounting reasons. Yet, since 1995 repurchases of stock have increased dramatically. A further revision to financial regulations in 2000 made stock repurchases a practical tool for boards and bosses to manage the right-hand side of their balance sheets. This research examines the reasons why stock repurchases have become so important in Japan. In general, repurchases are associated with theories of excess cash flow, undervaluation, signaling, leverage management, defense against unwelcome takeovers and greenmail, and the prevention of dilution that can be caused by the exercise of options granted to employees. Repurchases may also help firms manage their "corporate savings," which in fact is just a popular term for a combination of already well-developed ideas: free cash flow, maturity, optimal leverage and governance issues. Indeed, the legalization of repurchases in the 1990s was, in part, a consequence of the recognition that firms needed flexibility to adjust their capital structures to a low-growth, low-investment economy.

Japanese stock repurchases have increased enormously since the year 2000, yet the motives and full impact of these repurchases are evolving and not yet fully understood. Stock repurchases have now become a standard tool that management can use to adjust capital structure, send signals and deal with governance issues. An excellent example of this is the recent announcement by video game maker Nintendo; it reported a large loss, a dramatic change in strategy, reduced salaries for senior officers and a large stock repurchase plan in the same public statement [Yasu and Amano (2014)]. Nintendo's stock price climbed significantly after the announcement.[3]

This research contributes to a better understanding of corporate savings and Japanese corporate governance by examining stock repurchases over the period from 2000 to 2009. This period has not been the focus of prior research. This research is also unique because it examines *actual* stock repurchases. Most other research focuses on the *announcement* of stock repurchases using standard event-study methodologies. The distinction between actual repurchases and the market's reaction to the announcement of intended repurchases is important.[4] The event study approach is essentially testing whether the market considers repurchase announcements to signal value-enhancing changes (or new value-influencing information). These are interesting questions to be sure—and questions already largely addressed in a very substantial literature. Yet the research question we address is different. We are not using the market's responses to validate ideas about announcement information. Rather, we are attempting to explain the actual stock repurchases themselves. We argue that actual repurchases are more than information that signals something about the company. Actual repurchases are an important result driven by the qualities and situation of the company. We seek to understand the motivations for stock repurchases in the context of capital structure, cash flows, governance, ownership and corporate savings. Our research is also interesting because we document how stock repurchases are uniquely related to Japanese corporate ownership structures. In spirit, this research is most similar to work by Dittmar (2000) on United States companies; it uses a similar methodology. Research by Wada (2005) and Kang, Kim, Kitsabunnarat-Chatjuthamard and Nishikawa (2013) also examine Japanese stock repurchases. However, our work is importantly different from theirs. We examine a much later and more relevant period as well as a much larger sample of firms. And as explained above, we also focus on *actual* repurchases; they look at *announcements* of intent to repurchase stock. Kang *et al.* are mainly interested in how a company's relations with its main bank impact the market's evaluation of stock repurchase announcements. We take a broader approach to the determination of repurchase behavior in Japan.

The following section discusses the main motivations for stock repurchases. It draws on the extensive stock repurchase literature and on the research that describes the unique aspects of Japanese capital markets. Section 3 describes the evolution of stock repurchase regulations in Japan. Section 4 outlines our hypotheses; section 5 discusses our data. Section 6 explains how well our tests conform to theory. The final section is a conclusion.

## 2. Motives for stock repurchases in Japan

Although we discuss several reasons for stock repurchases in this section, our main focus is on the use of stock repurchases intended to reduce excessive corporate savings. Japanese firms are especially likely to be underleveraged in the 21st century as a consequence of the slow economic growth that followed the collapse of the bubble economy. Mature, healthy firms earned modest profits and tended to pay down their debt, especially bank debt. Consequently, leverage fell for most firms. Firms also had relatively few growth opportunities, invested less and tended to accumulate cash. Insufficient debt, excessive cash balances, as well as excess cash flows have important, negative implications for the corporate governance of these firms. In this situation, it makes sense for Japanese firms to return capital to their investors. Stock repurchases are one way to do this.

When companies are faced with excess cash and few promising investment opportunities, managers can choose to pay this to the firm's owners from among two main alternatives: dividends and stock repurchases. For many years dividends were the primary choice. Yet, according to aggregate data from Compustat for the United States, stock repurchase programs increased from 4.8% in 1980 to 41.8% in 2000. Share repurchases grew at an average annual rate of 26.1% over the period 1980 to 2000, while dividends only grew at an annual rate of 6.8%. The total amount of repurchases in the United States increased from $5 billion in 1980 to $349 billion in 2005. Russolillo (2013) reported in the *Wall Street Journal* that S&P 500 stock repurchases were 128.2 billion in the third quarter of 2013. Stock repurchases are important in Canada as well.[5] The case is similar for Japan. Lewis and Inagaki (2016) report that repurchases will set another record for the fiscal year that ends in March 2017.

Implicit in all stock repurchase explanations is the idea that the firm has excess cash, or can raise cash without too much difficulty to buy back stock. Jensen (1986) suggests that repurchases can be used to distribute such excess cash; this potentially solves a corporate governance problem by limiting the free cash flow that might be diverted to non-optimal purposes by managers who choose to seek their own interests rather than the interests of shareholders. Research by Stephens and Weisbach (1998) and

[3] The president of Nintendo, Mr. Satoru Iwata, said that the salary cuts and strategy change were significant, but "That won't [benefit] shareholders, that's why we decided on the buyback. But that's not [the only] reason. We've been rewarding our shareholders mainly through high dividends, but we cannot generate as much profit as we used to make." See also *Japan Times* (2014). Yet another example is that of Toyota Motor. Toyota reported that profits were expected to fall by about one third mainly due to a stronger yen for the fiscal year ending March 2017. At the time, Toyota announced a 500 million yen stock repurchase plan; this will be about 3.2 percent of its outstanding stock (Inagaki 2016).

[4] Regarding the use of the event study methodology in Japan, it is important to understand that not all stock repurchase announcements are actually followed by repurchases. Furthermore, the actual timing of stock repurchases is often not known by market participants. Japanese firms typically give a range of possible dates for their "intended" repurchase plans. Partial repurchases of the stated plan can occur on any of the dates in this range. Completed repurchases are announced after the repurchase.

[5] Fernando and May (2010) and Ikenberry, Lakonishok and Vermaelen (2000) analyze the timing and performance of stock repurchases in Canada.