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MARKET INSIGHTS

INVESTING IN JAPAN: IMPROVING CORPORATE GOVERNANCE SPURS JAPAN

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GOVERNANCE REFORM DRIVEN BY THE ECONOMIC IMPERATIVE TO DELIVER STRONGER RETURNS

Japan's new shareholder stewardship code is the latest indication of a stronger focus on corporate governance by companies and investors in the country. But changes in attitudes toward governance were long underway. Both Japanese companies and institutional investors have strong reasons to achieve higher returns and improve corporate behaviour.

Aging population and unwinding cross-shareholdings provide added impetus for corporate reform.

Institutional investors in fast-aging Japan face growing pension liabilities, which challenge them to realise higher investment returns. At the same time, the breakdown of corporate cross-shareholdings is among the factors forcing companies to become more shareholder-friendly. The stewardship code comes amidst a backdrop of powerful economic imperatives to improve corporate governance and performance.

Fig.1. Japanese government's new voluntary stewardship code for institutional investors

	Summary of the Code's Principles Institutional investors should:
1	Disclose a clear stewardship policy
2	Properly manage conflicts of interest
3	Monitor status of investee companies
4	Seek common understanding with investee companies and solve problems through engagement
5	Have a clear voting policy and disclose voting activity
6	Report to clients/beneficiaries
7	Have skills and resources necessary for engagement

Source: Japan Prime Minister's Office, June 2014.

BREAKDOWN OF CROSS-SHAREHOLDING SYSTEM PROMOTES GREATER ALIGNMENT WITH SHAREHOLDER INTEREST

Japanese companies have been deleveraging and rationalising business structures for some time. This process is driven not by top-down government action but by economic necessity. Corporate restructuring began many years before the promise of policy reform and accelerated during the financial crisis.

More and more Japanese companies realise that they have to earn a higher return on assets to remain globally competitive.

Breaking down Japan's corporate cross-shareholdings system is one example of the ongoing corporate restructuring process.

In the past, Japanese companies commonly accumulated shareholdings in other firms, with the banks being at the centre of this system of directing capital on the basis of group relationships. This system of capital allocation may have been effective in Japan's post-war rebuilding phase but is long past its use-by date, driven by regulation, market performance, and policy encouragement.

Companies are realising they have to rely on the market, rather than on group relationships, if they wish to retain access to capital. Greater dependence on capital markets may encourage shareholder-oriented behaviour and positive uses of cash.

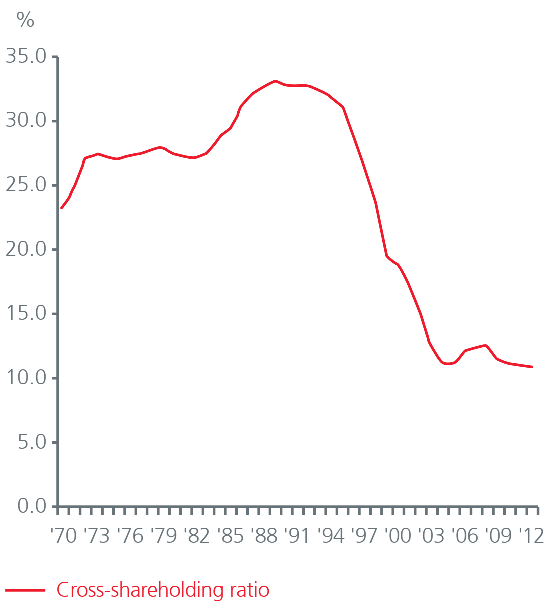
What is driving the breakdown in cross-shareholdings?

Capital adequacy and solvency regulations motivate banks and insurers, historically the biggest holders of cross-shareholdings in Japan, to reduce on-balance sheet equity positions. The unwinding of cross-shareholdings by non-financial companies has also gathered steam, encouraged by mark-to-market accounting rules.

As companies become less dependent on each other and increasingly reliant on capital markets to raise capital, they will be exposed to big institutional investors who are motivated by an imperative to improve returns.

The change already underway at the company level could receive positive feedback as big shareholders buy into reform.

Fig.2. Unwinding of high levels of cross-shareholding is an indicator of improving corporate governance



Source: Nomura, as at 31 May 2014.

PENSION OBLIGATIONS TO A FAST-AGING POPULATION FORCE INSTITUTIONAL INVESTORS TO FOCUS ON RETURNS

Growing need to meet large pension commitments to current and future retirees

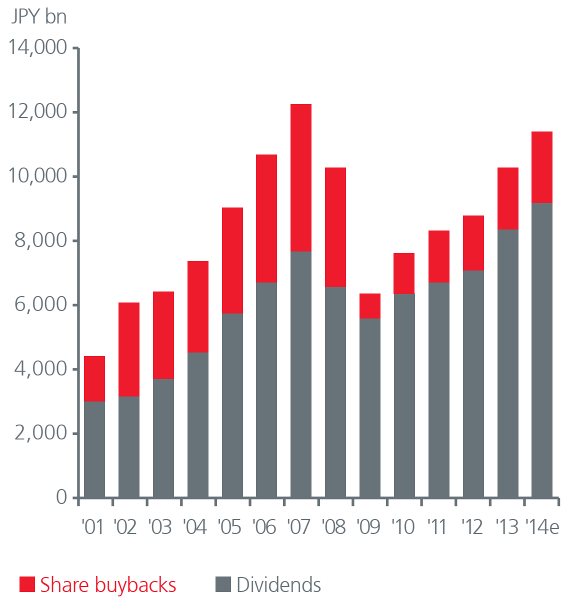
Institutional investors' economic imperative to improve returns stems from the growing need to meet large pension commitments to current and future retirees in fast-aging Japan. The switch from an environment of deflation to modest inflation also encourages this shift in investor behaviour. After years of low growth and deflation, Japan's economic environment appears to be changing. In an inflationary environment, institutional shareholders, including Japan's large state pension fund, can no longer rely on heavy bond holdings to deliver positive total real returns. As big investors increase their equity allocations, they turn their attention to getting the most out of their stock holdings.

This is where the stewardship code comes in. The code encourages institutional investors to engage and challenge company management on issues that would increase shareholder returns, such as dividend payouts. When on their best behaviour, companies should invest cash in value-enhancing projects or return cash to shareholders through cash dividends or stock buybacks. This has not always been the case in Japan, as evidenced by the high level of cash stockpiles and cross-shareholdings in the past.

GROWING EVIDENCE OF SHAREHOLDER-FRIENDLY CORPORATE BEHAVIOUR

In addition to the unwinding of cross-shareholdings, Japanese companies are substantially increasing the levels of cash they return to shareholders. There have been many recent examples of such investor-friendly corporate behaviour. As corporate restructuring led to stronger earnings in 2013, more of this was passed on to shareholders in the form of share buybacks and dividends. A total of JPY 10.3 trillion in profits was returned to shareholders in this way in the last fiscal year, an increase of approximately 20% from the previous year.

Fig.3. Increasing share buybacks and dividends support total shareholder returns



Source: Nomura, based on company and Toyokeizai data, as at 31 May 2014.

Bad habits appear to be on the way out – cash-hoarding is on the decline.

For example, Nippon Telegraph & Telephone announced a repurchase of almost 4% of outstanding shares for up to JPY 250 billion, while insurer NKSJ Holdings, Inc. announced buybacks and dividends of up to 1.2% of outstanding shares for up to JPY 10 billion. Mitsubishi Corp, a trading company, last month announced a plan to buy back up to JPY 60 billion of its own shares, which represents its first stock buyback in seven years.

GOVERNMENT BACKING FOR CORPORATE REFORM IS ENCOURAGING

The Japanese authorities increasingly recognise that poor corporate governance has a significant impact on Japan's future prosperity. A regime that encourages domestic investors to assert their ownership rights is only part of the solution.

One of the items in Prime Minister Abe's proposed growth strategy is to follow the stewardship code with a similar corporate governance code for listed companies. This is expected to be published by mid-2015.

While the shareholder stewardship code encourages investors to better fulfil their fiduciary duty, its best contribution will be to accelerate a positive reform process already underway.

Economic imperatives are the ultimate driver of behaviour, and these are present for companies and institutional investors in Japan today.

The imperative to focus on returns remains strong for large Japanese shareholders facing growing pension liabilities and for companies restructuring to retain competitiveness. The shareholder code, and the intention to follow it with a code for companies, signals growing recognition of this reality by policymakers. A positive feedback dynamic between companies, institutional investors, and policymakers could accelerate the process of corporate reform for the ultimate benefit of shareholders.

THE OPPORTUNITY

The rewards of corporate restructuring, such as the powerful earnings growth by Japanese companies over the last year, remain unrecognised in stock valuations. As the result of corporate reforms, many companies have an earnings power which is not yet reflected in their share price. This unrecognised fundamental improvement provides an opportunity for investors today.

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