Oldfield Partners

Corporate governance, shareholder return and the unlocking of Japanese value

The attitude to investor returns and capital efficiency in Japan appears to have changed significantly in the last six months.

Over the years there have been periods in which company managements have talked about raising dividend yields or targeting higher Return on Equity (ROE), but they have either not materialised or have been short lived. However, there are a number of reasons why we think that the current positive corporate trends in these areas should be more sustainable. Not the least of these reasons has been the impact of the Ito Review by the Ministry of Economy, Trade and Industry, which highlighted, *inter alia*, the low ROE of Japanese companies compared to those in other markets; and the creation of the new JPX Nikkei 400 index last year, which was launched in response to that report, and which evaluates, among other factors, ROE and shareholder return as important measures of selecting companies for inclusion in that index.

By way of background, it is important to remember that following the bursting of the 1980s' property and stock-market bubble, management efforts focused on repairing balance sheets burdened by high levels of debt. After the 2008 global financial crisis and in an environment of a punishingly strong yen, cash flow was aimed at moving production facilities overseas and cutting costs aggressively as a means of coping with international competition. However, with the election of Prime Minister Abe in late 2012 and the announcement of his 'Three Arrows Policy' for revitalising the Japanese economy things changed.

The yen strength was rapidly reversed by the aggressive monetary easing by the Bank of Japan and has forced companies to reassess their priorities in terms of overseas production and capital expenditure. Whereas previously the focus was on building new facilities overseas to be nearer to end markets and in order to reduce costs, management is now looking at renewing domestic production lines, many of which are decades old: one of our holdings, Komatsu, has just rebuilt a Japanese factory that was over 40 years old and in so doing has raised productivity dramatically and cut energy consumption by over 80%. In the past, change at Japanese companies often only came about as the result of difficult operating conditions, but it seems that this time the pressure is of a different type.

This is all very relevant to the subject of shareholder return and corporate governance. Mr Abe and his government are aiming to reform the corporate landscape of Japan in order to raise economic growth not just by lowering interest rates and weakening the currency: through fiscal reforms (the 'Second Arrow') and regulatory change (the 'Third Arrow') they are intent on raising the efficiency of domestic companies in order to spur corporate returns, thereby raising tax revenues and helping to reduce the fiscal deficit. Moreover, it is clear that Mr Abe is serious about corporate governance reform as a means of achieving improved shareholder returns for pension providers, thus placing less of a strain on welfare budgets. In this regard, the interests of everyone are much more closely aligned than in the past.

Key to the change in corporate governance have been three initiatives that are changing the attitudes of Japanese management, either directly or indirectly through pressure applied by shareholders, most notably domestic institutions that have generally in the past taken a passive attitude to exercising their fiduciary duty to vote at company meetings and challenging management.

The first of those initiatives was Japan's Stewardship Code which was drawn up in February 2014. According to a recent report by Daiwa Securities as of the end of February 2015, 184 institutional investors and pension funds had signed up to that code, including the largest, the Government Pension and Investment Fund (GPIF). Both the Code and the involvement of the GPIF have had a major influence in changing investor attitudes in a number of areas, including raising significantly the percentage of assets that are committed to equities, as well as the use of voting power to effect corporate change.

Secondly, ISS (a leading global provider of corporate governance and proxy advice) in its Proxy Guidelines for 2015, which were issued in November 2014, introduced a benchmark for ROE. ISS recommended voting against the top executives of companies posting an ROE of less than 5% in each of the previous five fiscal years.

The third influence is the publication by the Tokyo Stock Exchange on 5th March, 2015 of a Corporate Governance Code. The main aim of the governance code is to stimulate 'growth-oriented governance' with particular emphasis on improving profitability and capital efficiency. It is expected to have a significant impact on Japanese companies in the following three areas: disclosure of ROE targets; increasing the number of outside directors and enhancing their authority; and the unwinding of cross-shareholdings, as well as the eventual removal of holdings by listed parent companies in listed subsidiaries.

Inevitably the impact of these guidelines and regulations should mean a significantly improved landscape for the investor in Japanese equity as capital efficiency is improved, excessive cash balances reduced, cross-shareholdings unwound and latent land and other assets utilised or disposed of.

As a value investor, the risk is of falling into value traps. In the past, this has been particularly so in Japan where large cash balances and unutilised assets have been an attraction for many years. We have dodged some of these traps by recognising an intransigent attitude on the part of a company's management, but those attitudes seem to be changing. We recently added ceramics company Kyocera to the portfolio, even though the President of the company said to us in a meeting in our offices in December that improving ROE and shareholder returns was not a priority for him. We made that investment because the gap between the stock price and the underlying value at this operationally well-run company was very large and that the President's attitude might be forced to change.

Whereas we understand that pressure from foreign investors may not be fruitful with a traditional Japanese management, the fact that much of the pressure for change is now coming from the government, domestic institutional investors and individual Japanese shareholders is likely to mean that it actually happens; and Takeyuki Ishida, an executive director of ISS in Japan, recently commented that change was afoot because the '*kuki*' (atmosphere or environment) in Japan had changed. That being the case, we have revisited some stocks that previously we might have avoided as value traps: not only Kyocera, which has the equivalent of 70% of its market capitalisation in net cash and equity holdings, but also, for example, optical equipment company Ushio Inc. and healthcare equipment manufacturer Fukuda Denshi each with nearly 50% of market capitalisation in net cash and equity holdings.

Moreover, our investments in Hitachi, NTT, Mitsubishi UFJ Financial Group and Toyota, for example, are based not only on management that has been and is restructuring a poorly performing business, but also recognises the importance of improving shareholder returns. Our holding in Hitachi also recognises the fact that they have shrunk the size of the board of directors and brought in independent outside directors, including some foreigners, something that we are also seeing at another of our holdings automotive components company Denso.

We recognise that the improvement is likely to happen slowly. Change tends to take time in Japan, but when a strong consensus has built, as seems to be happening now with regard to shareholder returns and capital allocation, it tends to endure. There is enormous scope for change and we continue to research carefully those companies with promising businesses, which also have strong balance sheets that can lead to better shareholder returns and we are looking particularly at the scope for the unwinding of operationally unimportant equity holdings and unutilised land and other assets.

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The value of all investments and the income from them can go down as well as up; this may be due, in part, to exchange rate fluctuations. Past performance is not necessarily a guide to future performance.