Robeco Active Ownership

Progress made on improving corporate governance in Japan

- Update on engagement program after three and a half years
- Significant room for improvement in capital management
- Many companies accept need for changes but others reluctant

In 2019, Japan’s Prime Minister Shinzo Abe received a “Lifetime Achievement” award from the International Corporate Governance Network (ICGN) for his contributions to the G in ESG. Indeed, it is not often that a prime minister of a country places such emphasis on corporate governance practices by making it a central theme in a plan for a nation’s economy.

But this formed part of his so-called ‘Abenomics’ comprising the ‘three arrows’ of monetary easing, fiscal stimulus and structural reform. As part of the latter, the Japanese Financial Services Agency introduced the Principles for Responsible Institutional Investors in 2014. Another tool in the armory of reform was the introduction of Japan’s Stewardship Code, which was intended as a soft law to revitalize corporate competitiveness and performance.

Backed by various ministries, large domestic pension funds and institutional investors, the code has encouraged investors to exercise their shareholder rights, and to engage their investee companies to improve governance practices to achieve better returns.

In 2015, Robeco’s active ownership team conducted a research project to assess the status of corporate governance in Japan, aiming to enhance our stewardship activities for our Japanese equity investments. Three and a half years later, we review in this article what progress has been achieved.
Stakeholder versus shareholder orientation

There are public policy debates in the US and UK about whether business should have a wider social purpose, and whether a stakeholder approach could make listed companies more resilient. In Japan, however, the concept of fiduciary duty is less well developed, and Japanese companies have historically given more weight to multiple stakeholder (employees, customers and suppliers) than to shareholders. Companies relied on easy financing by the keiretsu (or corporate networks) rather than investors. This resulted in a lack of transparency, a lack of accountability to minority investors, and a lack of focus on shareholder returns.

We therefore focused our engagement on these objectives:

- Improving communication with the public markets via higher quality disclosures, providing clear strategic guidance, and procuring more effective communication with institutional investors
- Protecting shareholder rights, and aligning a company management’s incentives with those of investors
- Increasing the number of independent board members, and
- Prioritizing sustainable value creation by seeking more robust financial strategies on capital allocation

The role of the board; it’s more than counting outside directors

A high degree of independence of directors on boards is often seen a best practice in corporate governance. In Japan, the number of independent directors often is low. The Tokyo Stock Exchange has set a recommendation for companies to have at least two. Most companies meet that minimum, and many others have added additional independent directors. In conversations with Japanese corporates though, we often feel that appointing independent directors is seen as a compliance requirement, and they seem reluctant to add more. Companies often complain that it is hard to find enough capable professionals to serve on the company’s board.
In our view, this reluctance relates to a fundamentally different notion for the role of the board. In the US and most of Europe, the board oversees the executive management and the company’s strategy and has a more supervisory role. But in Japan, the board is often concerned with operational matters, and sitting on it is seen as the pinnacle of someone’s career at the company. Our objective to increase the number and quality independent members has only been met at a few of the companies in our project, and has proven to be difficult to implement in practice.

**Significant room for improvement in capital management**

Over recent years, Robeco, together with the Asian Corporate Governance Association and other investors, has engaged with policymakers and influential stakeholders to include these critical issues in policy revisions. In 2017, we provided feedback to Japan’s Financial Services Authority for the proposed revision of the Corporate Governance Code to establish the Guidelines for Investor and Company Engagement. The guidelines are intended to act as a practical means to shape the agenda for investor dialogue with companies. We recommended that companies provide a credible financial strategy to help investors assess its management of debt and equity capital, and the framework on how a company intends to use its capital to create economic value.

‘The growth in returns has barely kept pace with the growth in earnings per share and cashflow’

An ICGN statement in 2018 further supported the “improvement of corporate disclosure reflecting discussions on capital cost, shareholder return, growth strategy and cash usage… and how this relates to the company’s long-term value creation”.

Our engagement with our portfolio holdings has evolved from asking for high-level milestones to be met, to encouraging the adoption of specific measures, including reducing excess assets by disposing of cross-holdings, increasing dividend payout ratios, and conducting share buybacks.
In order to achieve sustainable economic value creation, a company’s return on invested capital (ROIC) should exceed its weighted average cost of capital (WACC). Our analysis concluded that the majority of companies had poor capital management, with 70% of 2,000 TOPIX companies having a 5-year negative return on their ROIC when compared with their WACC.

Although companies’ dividend payout ratios have risen by 29% over the last five years, their debt to equity ratios have declined by 14.4%. Therefore, the growth in returns has barely kept pace with the growth in earnings per share (EPS) and cashflow. The current dividend payout ratio of 35% is only just above the post-Abenomics average. The lack of progress on this measure helps explain why there has been little reduction in cash on balance sheets, despite large increases in EPS and dividends per share. More encouragingly, the total payout ratio (including net buybacks) as a proportion of net profits has increased for the TOPIX to 46% in 2Q 2019 from 34% in 4Q 2017. However, this still remains well below Europe (75% for MSCI Europe) and 105% for the largest 500 US companies in 1Q19.

Significant efforts have been made to close the information asymmetry between management and investors. In the early stages of our engagement, conversations with a portfolio company were often formalistic and at a high level. Throughout the project, we have noticed an increased willingness from the Japanese to discuss ESG topics, the implementation of governance standards, and to take feedback on reporting. Selectively, we also noticed that persistent engagement has improved our access to more senior management at companies. Corporate Japan seems to have embraced the Sustainable Development Goals and companies are quite willing to provide additional narrative on their sustainability performance. Yet, we are under the impression that some companies might use their sustainability efforts as a distraction from poor financial performance.

Effective company engagement requires a few essentials, which include meetings in person as well as using communication in writing; demonstrating the financial as well as societal benefits of following a recommended course of action; and asking for specific milestones. We also found that meetings which included our portfolio managers benefits both the credibility of our agenda and the inputs of our fundamental investment cases.

Conclusion

Japanese corporate governance has improved since the introduction of the Corporate Governance Code in 2015. Investors have welcomed improvements, such as the continued unwinding of cross-shareholdings, increased shareholder return, and more independent directors on boards. Momentum is also gathering amongst investors exercising their fiduciary duty, as we’ve seen an increase in the number of shareholder proposals. These developments are positive, and we are hopeful that the undervaluation of Japanese companies will narrow compared to other developed markets.

Abenomics’ ‘three arrows’ represent a bold move to invigorate corporate Japan, and to enhance returns for investors in Japanese companies. A key requirement for the success of structural reforms includes minority investors engaging in persuasive dialogue with companies to create financial strategies that support sustainable value creation. These strategies are aligned with recommendations by Japanese institutions and include:

- Measuring the true cost of debt/equity,
- Setting appropriate hurdle rates for specific categories of businesses and assets
- Making realistic assumptions about risks/returns

While many companies have accepted the need for change, others have been demonstrably reluctant to accept our desired outcomes. Our escalation process included writing to company boards and incorporating financial metrics systematically into our voting process. We now vote against company proposals for director (re)elections and the allocation of capital. Recent shareholder meetings have continued the activist momentum, with the number of shareholder proposals being filed up 29% from last year. Together with the tailwind of supportive policymakers, we believe that significant opportunities still lie ahead for active managers to hold corporate managers accountable to shareholders.

We believe that strong representation on the board that looks after the interest of minority shareholders is often still lacking. Recent scandals have confirmed our assessment that board oversight on management for many Japanese corporates should be much further improved. Incentives between management and shareholders are hardly ever aligned.
A holistic approach for returns is seldom, if ever, part of the management’s KPIs, and this often leads to the wrong focus on metrics.

Our progress on our engagement with ten companies in this theme can be summarized as follows:

- Improving communication: this was our objective for seven companies, and of these we concluded that it was effective for five and negative or non-effective for two.
- Shareholder rights: an objective for eight companies, effective for five, and negative/flat for three
- Board composition: an objective for eight companies, effective for four, negative for four
- Shareholder value: an objective for eight companies, effective for four, negative/flat for four.

Based on our initial objectives at the start of the engagement with portfolio companies, we can broadly conclude that we were very effective in improving corporate disclosure and communication and fairly effective in winning more rights for shareholders. But we had mixed results when we escalated the engagement challenge into areas like board composition and shareholder value. We are continuing our engagement with two of our original ten companies under a new theme of ‘Corporate Governance in Asia’, including capital management as a further goal of improving shareholder value.