Cidel
Asset Management

Environmental, Social and Governance Case Study

cidel.com

Will Japan's Corporate Governance Reforms Benefit Investors?

Philip Young, CFA
Equity Team Analyst

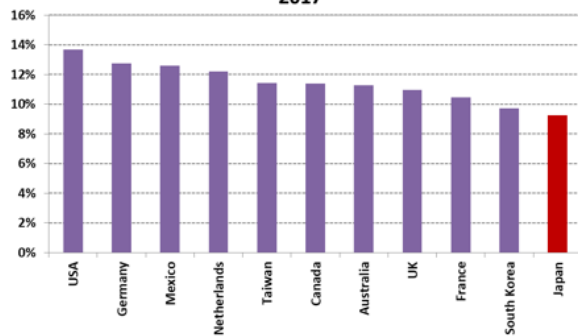
Japan has a reputation for not being the most investor-friendly country in the world. This stems partly from a perception that Japanese companies are run for the benefit of management and employees rather than shareholders. In fact, shareholders in Japan have tended to have relatively limited input on how companies are managed, largely owing to weak corporate governance standards.

Over the last few years however, the Japanese government has taken strides to address the country's corporate governance shortcomings. As part of our research efforts at Cidel, I recently travelled to Japan to investigate ongoing reform initiatives there, and the potential investment implications.

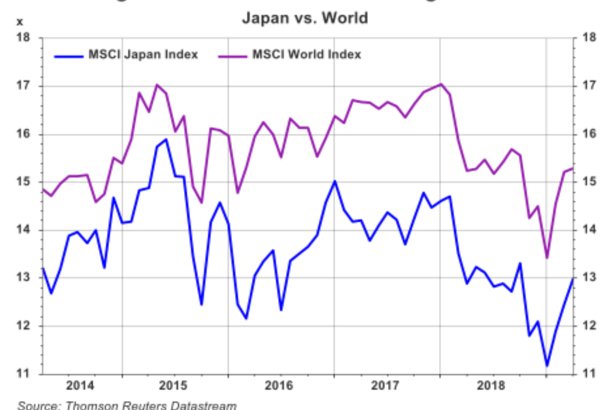
The Situation

The primary objective of corporate governance is to ensure that management acts in the best interests of its shareholders. One of the most effective ways to encourage management accountability is to have a board of directors with a majority of independent members, that is, members who are not company employees and/or are not closely tied to the company. Such boards are more likely to advocate for shareholder interests as members can challenge management without fearing they will lose their jobs.

For this reason, in most developed countries, independent corporate boards are the standard. The median level of board independence is 85% in the U.S. and 80% in Canada – but a mere 27% in Japan. Typically, Japanese boards are full of company insiders, such as long-term employees. Such boards can be susceptible to "group-think" and status quo bias and ultimately, make corporate decisions that are less than optimal for shareholders.



Source: Bloomberg, USA based on S&P 500 Index, Germany based on DAX Index, Mexico based on S&P/BMV IPC Index , Netherlands based on AEX-Index, Taiwan based on TAIEX Index, Canada based on S&P/TSX Index, Australia on S&P/ASX 200 Index, UK based on FTSE 250 Index, France based on CAC 40 Index, South Korea based on KOSPI Index, Japan based on TOPIX Index



Source: Thomson Reuters Datastream

[1]Thomson Reuters, 2018; U.S. based on S&P 500 Index; Canada based on S&P 500 Index; Japan based on Nikkei 225 Index.
[2]Bloomberg, 2017.

The negative impact of boards that are not shareholder-friendly can be seen in the poor capital efficiency of Japanese companies. As Figure 1 shows, in 2017, Japan's median corporate return on equity (ROE) – how much profit is generated for every dollar of equity invested in the business – was amongst the lowest in the world. One contributing factor has been Japanese firms' practice of holding large equity stakes in the companies of their major customers and/or suppliers to strengthen business relationships. Because the stakes are justified by personal rather than economic rationale, these so-called "cross-shareholdings" almost always depress ROEs.

Another factor is Japanese companies' practice of holding large amounts of cash – far more than necessary – to buffer against difficult business conditions. Since cash generates minimal returns, the excessive cash levels hurt shareholders, particularly in Japan where interest rates are often negative. A more shareholder-friendly strategy would be to return surplus cash to investors in the form of dividends and share repurchases.

All in all, Japan's track record of capital inefficiency has dampened investor enthusiasm for the country's equity markets. As Figure 2 shows, Japanese stocks trade at a significant discount on a forward price-to-earnings (P/E) basis compared to stocks from other developed countries.

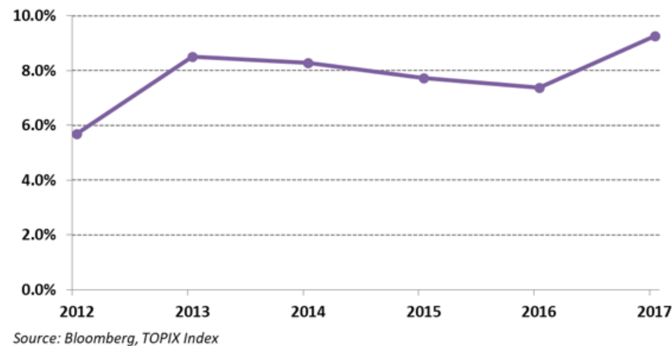
The Reform

In 2013, as part of an economic revitalization program, Japanese Prime Minister Shinzo Abe launched a major push to improve corporate governance in the country. The government has undertaken several initiatives to increase board independence, reduce cross-shareholdings and boost ROEs. In June 2014, Japan began to require public corporations to have at least one independent director on their boards – or if they could not do so, to justify why not. A year later, the government increased the minimum number of independent directors to two, with a recommended independence level of at least 33%. In June 2018, Japan's Corporate Governance Code was revised to strongly encourage companies to reduce their cross-shareholdings. Today, business relationships alone are no longer an acceptable justification for owning shares in other companies.

The Outcome

There are encouraging signs that Japan's reform initiatives are having a positive impact. In the last few years, company boards have experienced a substantial increase in outside influence and companies who do not have many outside board members face much more scrutiny. The percentage of listed corporations with at least two independent directors rose from 22% in 2014 to 87% in 2017. Japan has also seen an upswing in the number of professionals, such as lawyers and accountants, serving on boards. (This is a positive development since it adds valuable skill sets to the group.) Finally, Japanese companies are returning more cash to shareholders than they used to. The dividend payout ratio of listed companies in Japan rose from 26% in 2013 to 31% in 2017. Altogether, the reforms have delivered significant improvement in corporate ROEs in Japan, as Figure 3 shows.

[3] Morgan Stanley, Disrupting Corporate DNA - Japan and APxJ Collaboration, August 15, 2018.
[4] Bloomberg, Tokyo Stock Price Index.



Nevertheless, there is still more work to be done. Japan has made limited progress addressing the cross-shareholdings issue, for example. In 2017, public companies still owned 21.8% of the Japanese equity market – almost the same as in 2013. However, based on our discussions with management teams in Japan, we see more companies today actively considering ways to reduce their cross-shareholdings.

While Japan still has a long way to go to reach global best practices, corporate governance is definitely on the right track. Improved governance has the potential to increase both the competitiveness of Japanese corporations and the overall Japanese economy. We expect the ongoing initiatives to gradually improve ROE in the country and boost investor sentiment towards the Japanese stock market. At Cidel, as we strive to provide our clients with the most attractive investment opportunities from around the world, we will continue to monitor Japan's progress.

[5]Morgan Stanley, Disrupting Corporate DNA - Japan and APxJ Collaboration, August 15, 2018

*Cidel is an operating name of Cidel Asset Management Inc.
This material is not intended to be relied upon as a forecast, research or investment advice, and is not a recommendation, offer or solicitation to buy or sell any securities or to adopt any investment strategy. The information contained in this document has been compiled by Cidel Asset Management Inc. from sources believed to be reliable, but no representations or warranty, express or implied, are made by Cidel Asset Management Inc. as to its accuracy, completeness or correctness. The opinions expressed are as of the date of this publication and may change without notice and are provided in good faith, but without legal responsibility. Cidel Asset Management Inc., carrying on business as Cidel ("Cidel" is a registered trademark) is registered as a portfolio manager, investment fund manager and exempt market dealer in Ontario. Cidel is also registered as a portfolio manager and exempt market dealer in the provinces of Alberta, British Columbia, Manitoba, New Brunswick, Newfoundland and Labrador, Nova Scotia, Prince Edward Island and Saskatchewan. In Quebec, Cidel is registered as a portfolio manager, investment fund manager and exempt market dealer. This document may not be reproduced, distributed or published by any recipient hereof for any purpose.