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OPINION

Responsible Investing

Japanese boards slowly learn the language of 'engagemento'

Steady reform of corporate governance hints at gradual unravelling of 'value traps'

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When RWC's Japan Active Engagement team started work more than 15 years ago, "activism" was associated with high-profile attempts by mainly foreign investors to force change at Japanese companies through ownership.

"Engagement" was an unfamiliar concept — so much so that there was no Japanese word, and one had to be imported from English: "engage-ment-o". Interactions between investors and managers were then essentially interrogative. Investors asked the questions and managers, more or less, gave the answers. The notion that investors might make suggestions for changes in the ways in which companies were managed was, at best, novel and, at worst, anathema to Japanese company managers.

Many hitherto successful activist investors in other regions who had high hopes of Japan were met with resistance, resentment or policies designed to block their efforts. This led to Japan's reputation for "value traps", where poor corporate governance held back investor returns.

The Children's Investment Fund's attempt to take a large stake in utility provider Electric Power Development was decisively blocked by the Japanese government in 2008. The UK fund reacted by publicly urging investors to steer clear of Japan until its corporate governance improved.

Other vexed examples include Steel Partners' attempt at a hostile takeover of Bulldog Sauce, which resulted in a landmark court-approved poison pill in 2007. Two years later, the US hedge fund faced similar disappointment by abandoning, at a loss, a two-year battle to take a majority stake in brewer Sapporo Holdings.

Since then, the environment has changed dramatically. Japan's prime minister Shinzo Abe put weight behind his "third arrow" of reform by introducing the stewardship code in 2014, followed by the corporate governance code in 2015. These reforms in turn formalised the concept of engagement and introduced the mechanisms needed to monitor management behaviour and better promote stakeholder interests.

The change in corporate attitudes — and therefore behaviour — has taken time and is still by no means the norm.

Certain sectors, such as financial services, remain entrenched in the old ways of Japan Inc. Scrape below the surface, however, and the number of explicit and behind-thescenes challenges have been meaningful. Corporate governance is changing.

Historically, many Japanese companies have been criticised for their inefficient hoarding of cash. Yet shareholder return through buybacks and dividends hit a historical high of Y16tn ($150bn) in 2019.

Although still high, the number of companies with anti-takeover measures has halved in 10 years, according to a report published last year by the Tokyo Stock Exchange. In 2015, 50 per cent of listed companies lacked independent directors, but now over 80 per cent have at least two. Following the lead given by Japan's Government Pension Investment Fund, all public funds (which between them own a quarter of domestic equities) have now signed the stewardship code.

Pre-Abenomics, 96 per cent of companies held their shareholder meetings on the same day — that number is now 30 per cent. Recent reports suggest that overt shareholder activism is now almost as common in Japan as it is in the US and confrontational events which would have been inconceivable 20 years ago now occur quite often, some with positive results.

The lure for these activists is not limited to corporate Japan's infamous cash pile, or the potential returns from disaggregating keiretsu (group of companies with interlocking business relationships and shareholdings) behemoths from their conglomerate discounts. The appeal also lies in the change in corporate attitudes that, in a country that values consensus, has now reached critical mass.

Investors focusing on environmental, social, and governance considerations should feel encouraged by these changes, not least of which were the recent revisions to the country's stewardship code to explicitly incorporate these factors.

Despite Japan's high level of consumption, the country's surprisingly low domestic carbon footprint and a general appreciation of risk from natural disasters makes the "E" part of the ESG agenda perhaps less contentious than some other developed economies.

On the "S" side, much of Japanese society is centred around the idea of wa, or harmony, and companies often see themselves as pillars of their local communities. However there is concern over worker welfare and the phenomenon of severe overworking leading to stress-related illness or karoshi, death by overwork.

Another concern is the extreme homogeneity of Japanese management when evidence suggests that diversity helps to temper risk.

On "G" for governance, Japan still has a long way to go. But efforts by the activist community have helped encourage companies to build more robust governance practices, increase shareholder return, streamline corporate structures, increase transparency and secure succession.

Last year alone in the RWC Nissay Japan Focus Fund we had, within our 20 stock portfolio, two meaningful share buybacks, two poison pill mechanisms against hostile takeovers abolished and a number of companies which more generally improved their governance structures.

This collective outcome would have been unthinkable even five years ago — progress might be modest but there is no doubt that the momentum of change is building.

Yet despite these signs of change, Japan still trades like a value trap, with multiples below other developed markets and foreign shareholdings at near-historical lows.

In a global economy that faces severe challenges, Japan's fundamental picture remains resilient. Drawn by the combination of corporate Japan's governance reform, lack of debt and abundance of cash, the influx of activists could be the catalyst Japan needs to unlock the value that has been trapped for decades.

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