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Investment **Research**

Tough Love:

How a More Effective Market for Corporate Control Will Unlock Trapped Value in Japanese Companies

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The Japanese equity market has long offered investors a paradox: A large number of stocks boast quality businesses and abundant levels of net cash and liquid assets, yet the market values them well below their liquidation value. Enterprising investors could take over these companies and realize this value, but Japan's weak market for corporate control has historically prevented them from doing so. As a result, investors have, often correctly, considered these stocks to be value traps. However, the corporate governance reforms put into place several years ago are powerfully changing management behavior and empowering both active and activist investors. Engagement is an increasingly powerful tool in helping to unlock trapped value, and we believe growing pressure from investors should reduce or eliminate the country's "corporate governance discount" in the coming years. This paper explains how increased engagement from asset managers and activist investors, combined with increased private equity activity targeting listed firms, are catalysts to unlocking value in Japan.

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"Thus, it appears that the question of whether or not a business should be continued is one that at times may deserve independent thought by its proprietors, the stockholders ... And a logical reason for devoting thought to this question would arise precisely from the fact that the stock has long been selling considerably below its liquidating value. After all, this situation must mean that either the market is wrong in its valuation or the management is wrong in keeping the enterprise alive. It is altogether proper that the stockholders should seek to determine which of these is wrong."

—Security Analysis, Benjamin Graham, David L. Dodd ¹

Japan: Value Trap or Value Opportunity?

When Graham and Dodd published the seminal value investing text, "Security Analysis," in 1934, they raised the question of whether stocks trading below their liquidation values are value traps or value opportunities. The question remains particularly relevant to Japanese stocks.

We recently ran a screen of more than 27,000 stocks trading on developed markets stock exchanges. The screen selects all stocks that meet Graham's liquidation criteria, suggesting that current assets (which usually excludes stock holdings) are greater than total liabilities. Out of that group, the screen selects only stocks that are investable (market capitalization over \$400 million), cheap (trading for less than 1.5 times book value), and good businesses (return on operating assets above 4%).

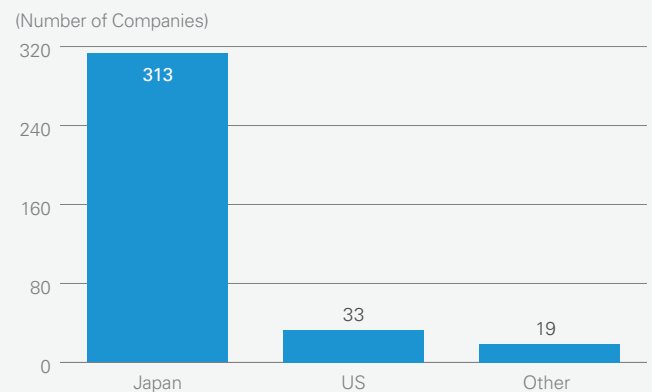
No fewer than 313 of the 365 stocks that meet these criteria are Japanese, including well-known names such as electronics component maker Kyocera, broadcaster Nippon Television, mobile crane manufacturer Tadano, and office furniture and logistics leader Okamura, (Exhibit 1).

We believe that the root of Japan's value problem is its weak market for corporate control. The market for corporate control refers to the role equity markets play in facilitating hostile corporate takeovers. In other words, if a company fails to create value for its shareholders, an investor or group of investors will realize there is value to be had in taking over the company, either to install new management that will take those opportunities, or to liquidate its assets. There may even be value in merely threatening to take over or replace management. Corporate managers may work harder to increase value for shareholders when the threat of losing their jobs serves to focus their mind.

A well-functioning market for corporate control should normally prevent stocks with viable businesses from trading below liquidation value. As corporate finance theorist Henry Mann put it, "The lower the stock price, relative to what it could be with more efficient management, the more attractive the takeover becomes to those who believe that they can manage the company more efficiently. And the potential return from the successful takeover and revitalization of a poorly run company can be enormous."²

But historically, that hasn't happened in Japan. Why?

Exhibit 1
313 Quality Japanese Stocks Trading below Liquidation Value



As of 31 August 2020
Source: Lazard, Bloomberg

Policy Reform: Opening the Door to Corporate Takeovers in Japan

The history of corporate governance in Japan features stable shareholders and insider-dominated board structures that have shielded underperforming management teams from the external discipline imposed by a well-functioning market for corporate control. The result was that corporate management teams often prioritized stakeholders over the owners of the company, including employees, suppliers, customers, and themselves.

An awareness of the need to bolster Japanese equity returns through improved corporate governance began to take root in key government ministries, led by the Financial Services Agency (FSA), in the mid-2000s. In late 2012, Japanese President Shinzo Abe's administration made corporate revitalization a key part of its growth strategy by introducing a series of highly significant corporate governance policy reforms. The explicit goal was to raise the value of Japanese companies through improvements in capital efficiency. The tacit goal was to open further Japan's market for corporate control.

More than eight years on, however, there are still over 313 stocks meeting our screening criteria. As cash has continued to accumulate on corporate balance sheets, the aggregate return on equity for Japanese stocks still lags that of American and European stocks. Many global investors seem to have concluded that the reforms have failed, as foreign investors have been net sellers of Japanese stocks since 2013. However, we would contend that the opposite is true: Reform is working, and a trend toward increased activism and engagement is likely to accelerate, rather than falter.

Decline of Strategic Shareholders

The distribution of market ownership has improved significantly in Japan since Abe took office, a development that we believe is crucial to strengthening the market for corporate control. To understand how the former affects the latter, one must understand the malign influence of the shareholder category known as "strategic" or "allegiant" shareholders, who are estimated to represent around 35% of market ownership in Japan.³ This group is composed mainly of businesses and financial institutions that invest to secure a business advantage instead of an investment return. They almost never sell and always vote in favor of management and the continuing business relationship.

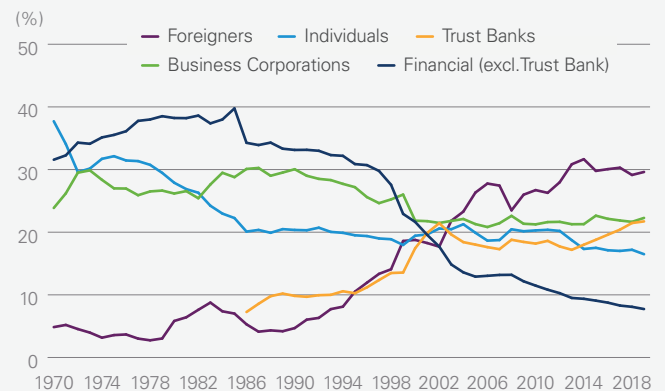
It is important to distinguish strategic shareholdings from "cross-shareholdings." The latter, in which two listed companies hold shares in one another, is a subset of the former. Cross-shareholdings are estimated to represent around 15% of the market. Major stakeholders that prioritize relationships over what is best for a business and for shareholders contribute to Japan's enervated market for corporate control.

Academic research demonstrates that companies that hold large equity positions in other companies do not benefit from their investments. They tend to have lower profit margins and boast no advantages over other firms in terms of asset growth or stability of margins. In addition, the management teams sheltered by allegiant shareholders typically avoid tough decisions—implementing layoffs, for example, or closing down a non-productive division to invest in more promising businesses.⁴

The good news is that the Abe administration's corporate governance policy reforms have been effective in decreasing the influence of strategic shareholders. Japan's Corporate Governance Code was revised in June 2018 and is expected to be revised again later this year, while its Stewardship Code was revised in March 2020. Both revisions cast new light on conflicts of interest in the company-investor relationship and imposed helpful disclosure requirements. As a result, strategic investors have increasingly sold their strategic holdings or else modified their focus to earning a return from their investments.

Foreign investors, who are less likely to engage in strategic shareholdings, now comprise the biggest group of investors in the Japanese equity market, representing about 30% of market value (Exhibit 2). The problematic strategic shareholder category, represented as business corporations and financial institutions excluding trust banks, appears to be declining as a proportion of market ownership.

Exhibit 2
The Evolution of Japanese Stock Ownership



As of 29 October 2020

Note: The market value of Trust Banks are included in that of Financial Institutions in and before the 1985 survey.

Source: Haver Analytics, Tokyo Stock Exchange

Signs of Change

Japan's market for corporate control is increasingly active. The actors applying external pressure include other Japanese companies, activist investors, and private equity (PE) firms.

A. Other Japanese Companies

The cases below illustrate examples of hostile takeover bids and healthy attempts at business portfolio rationalization.

Date	Company	Target	Event
July 2019	HIS	Unizo	First hostile takeover bid in Japan by one listed company for another listed company since 2012. HIS bid failed in a bidding war, which the private equity firm Lone Star won.
October 2020	Nitori	Shimachu	Media reports said that Nitori, a retailer with high return on invested capital, plans a hostile takeover bid for Shimachu, a low ROIC retailer. The news upset the planned friendly acquisition of the target by retailer DCM. Nitori appeared to have a credible plan to increase corporate value by bringing the target's business model in line with its own.
January 2020	Maeda Corp	Maeda Road	After Maeda Road attempted to buy back 24% of its stock from Maeda Corp, the latter launched a hostile bid for a further stake in the former. The bid succeeded and Maeda Corp took control of Maeda Road, replacing its senior management.
September 2020	Colowide	Ootoya Holdings	Both firms compete in Japan's restaurant chain industry, where operating conditions have deteriorated due to cost pressures, last year's VAT hike, and COVID-19. Colowide launched a takeover bid that appears to have succeeded in taking control of Ootoya and introducing a new corporate strategy.

B. Shareholder Activism

Shareholder activism isn't new to Japan: Both foreign and domestic funds engaged in a round of hostile activism in the 2000s. These efforts were widely judged to have failed, however, because the activists were often not seeking to achieve an improvement in corporate value. Their actions may have set back the cause of improving corporate governance in Japan.

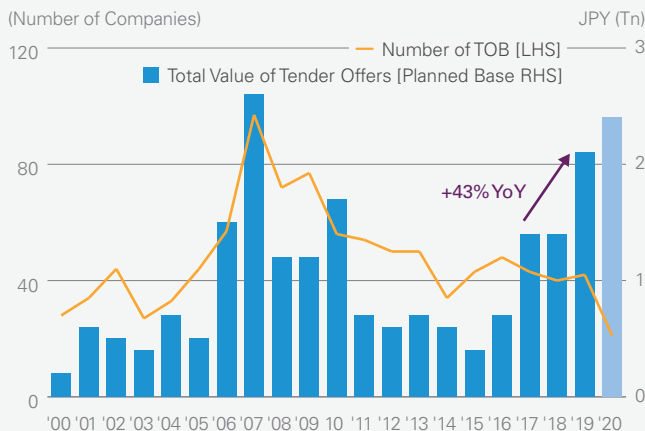
The last 10 years have been more active, as Exhibits 3 and 4 show,

and we believe they've also been more successful. While not lacking in hostility in all cases, the tone over the past decade has been more collaborative. For example, in 2013 Sony CEO Kenichiro Yoshida said publicly that insights from the US activist Third Point had helped him to restructure Sony Pictures, though Yoshida did not make the specific changes Third Point demanded.

Activist investors attempt to achieve management change by:

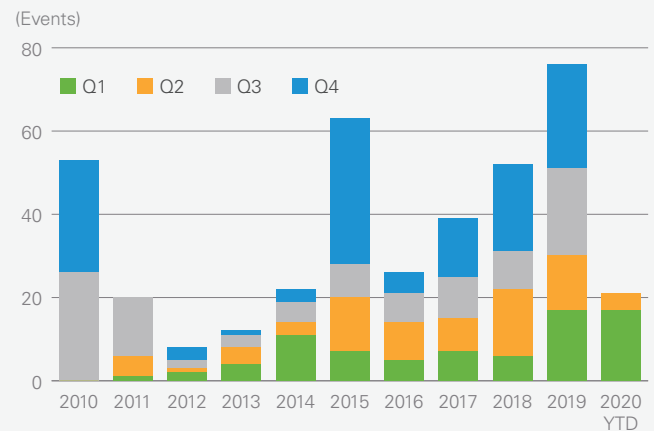
- Making shareholder proposals
- Publicly distributing well-researched reports detailing their value-increasing proposals
- Making takeover bids, which often are not intended to win control, but rather to keep pressure on management to avoid backsliding

Exhibit 3
Tender Offers for Japanese Companies Reach Historic Heights



As of 10 June 2020
Source: Goldman Sachs

Exhibit 4
Activist Campaigns Continue to Gain Steam in Japan



As of 15 June 2020
Source: Bloomberg, CLSA

The most significant recent examples include:

Date	Activist	Target	Event
February 2020	Elliott	Softbank	Elliott proposed that SoftBank aim to reduce its conglomerate discount by divesting its holdings of Chinese IT firm Alibaba.
April 2020	Oasis	Sun Electric	Oasis called an Extraordinary General Meeting (EGM) of Suncorp and succeeded in passing its shareholder proposal, for which there were few precedents.
May 2020	Oasis, Asset Value Investors (AVI)	Fujitec	Oasis filed a shareholder proposal demanding that elevator manufacturer Fujitec cancel its treasury shares. The request was scaled back from the investor's plans to demand reduction in excess cash due to COVID-19. Following the annual general meeting (AGM) in June, Fujitec announced it may seek an extraordinary general meeting (EGM) "in order to bring about a change of leadership at the Company to ensure that progress is made to improve Fujitec's corporate value for the medium and long term, to the benefit of all stakeholders." AVI released a public research report detailing specific proposals to improve Fujitec's corporate value.
June 2020	Ichigo	Fujitsu	Fujitsu proposed Ichigo head Scott Callon as its own choice for independent director.
July 2020	Effissimo, 3D Investment	Toshiba	The two funds made proposals for five new independent directors, which received more than 30% support in all five cases. Subsequently, the board committed to hand back most of the proceeds from the upcoming IPO of its memory chip business to shareholders.

C. Private Equity

Leading global private equity (PE) funds have recognized the opportunity in Japan: abundant and cheaply valued tangible book (Exhibit 5), the desire for conglomerates to sell off non-core businesses, and an opening of the market for corporate control. KKR, a leading US-based private equity firm, told the Financial Times in spring of 2019 that "[Japan] is our highest priority right now other than the US ... this is the best value today. If you look

Exhibit 5
Price to Tangible Book Ratio

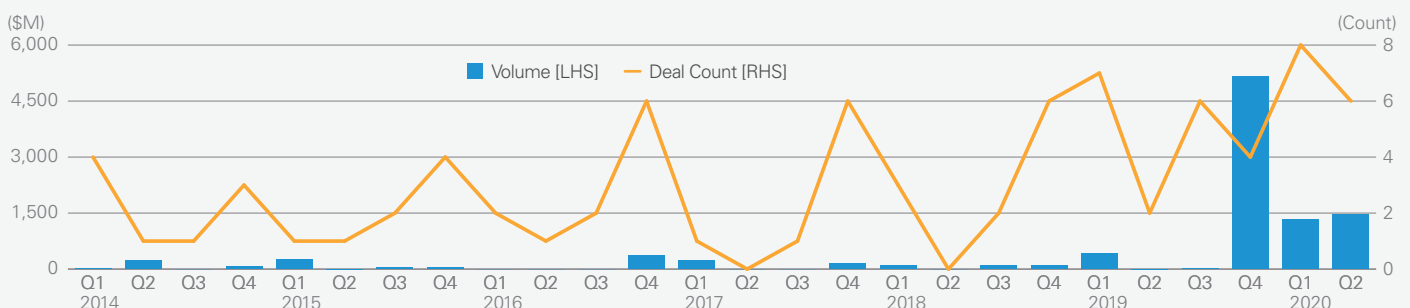


at value to price of stock and the cost of capital, it's here." KKR, along with other leading global PE firms such as Bain Capital, Lone Star, Carlyle, and CVC, have been busy this year doing deals or raising money for Japanese investment activity.⁵ While private equity action does not directly affect investors in public markets, the shadow of their activity contributes to an environment in which shareholder concerns are taken more seriously.

PE funds do not generally make uninvited bids for or proposals to target companies, but they do sometimes piggyback on takeover efforts when publicly listed companies put a company "into play." However, their purchases of businesses and entire listed companies highlight the opportunity in undervalued tangible assets like cash and land, which the PE firms sell off (adding the proceeds to their investment return) before re-listing the firm (usually with negative tangible book value) on the public market after a few years.

The recent hostile bid for the real estate company Unizo by travel agency HIS is a good example of this trend. The ensuing bidding war saw 15 firms participating in the bidding, including well-known global players Blackstone and Fortress. The private equity firm Lone Star Funds eventually prevailed and agreed to buy Unizo for ¥6,000 per share, three times Unizo's price prior to the HIS bid.

Exhibit 6
MBO Deals in Japan: 2004 to 2020, Quarterly



The Unizo deal was structured as a management buyout (MBO), with Lone Star providing the financing to Unizo executives. MBOs in Japan have increased recently from a low base, with Bain Capital's MBO attempt for the Osaka-based drugstore chain Kirindo in September 2020 just the latest example. Many Japanese public companies remain substantially undervalued relative to their value in the private market. We believe there is potential for PE activity to increase going forward.

Japanese companies continue to have excessive levels of low yielding assets such as cash, real estate, and the stock of other companies. We see considerable potential for Japanese companies to unlock value for shareholders by reducing excessive tangible assets and boosting returns through higher dividends, share buybacks, or reinvesting back into their businesses.

Recently, the distinction between PE funds and shareholder activists has begun to blur. PE funds have become more content to hold less than a simple majority while retaining control of targeted firms, while shareholder activists have become more willing to work with incumbent management over the long term by sending staff under its influence to the board. One example of this is the US fund ValueAct's success in forcing Olympus to appoint three foreigners to its board of directors.

The Behind-the-Scenes Engagement Approach

Investor engagement lies at the other end of a spectrum of actions investors can take to attempt to make companies more efficient or more valuable to shareholders. Effective engagement seeks to realize trapped value through quiet collaboration with management, and we believe it is much more effective in Japan than the public confrontations pursued by the more aggressive activists. This approach depends on:

- Access to top management
- Having or developing a long-term relationship with the company
- Holding and maintaining a meaningful stake in the company

Such a collaborative approach still requires investors to be aggressive, direct, and often confrontational, and is best achieved through one-on-one meetings with board members (especially the outside directors) and written follow-up to the entire board. A high degree of sensitivity to Japanese cultural issues is required to be effective, and usually involves more art than science.

Until recently, corporate managers have had little incentive to take requests made in letters or engagement meetings seriously, much less act on them. However, this is changing as the market for corporate control opens. For one thing, Japanese companies increasingly recognize that investors can team up and collaborate to multiply the force of their requests. If that happens, savvy

managers will recognize that if the shareholder they are engaging with has legitimate concerns and the management team ignores them, the next group of people sitting across the table may try to take over their company.

Japanese shareholders are also legally more powerful than in many other countries. In most cases, CEOs and board members can lose their jobs if they gain less than 50% of the annual proxy vote. There has been a recent tendency for board members with low approval ratings to either retire from the board or take shareholder-friendly actions, such as buybacks, prior to the next year's proxy vote.

The power of engagement is particularly important for smaller cap companies. We often meet companies trading at a discount to the value of their tangible assets. Management generally appears to have little interest in the share price. In such cases, the engagement agenda will focus on the question of why the company is listed given the expense and burden of being a public company. Companies often tell investors that they wish to be listed in order to help with hiring and retaining staff. Without a compelling *raison d'être* for staying public, the potential for PE companies or others to take more companies private could result in a windfall for existing shareholders.

Investors need to remain keenly focused on the risk of falling into "engagement traps" where the management is never likely to change despite their engagement efforts, and meanwhile, intrinsic value is slowly deteriorating. Assessing whether or not this situation applies is part of the art of engagement.

COVID-19 and Japan's Market for Corporate Control

The COVID-19 pandemic will result in long-lasting changes in individual, corporate, and government behavior, and we believe these changes can and should unlock further value for shareholders. Two changes in Japanese management behavior are particularly relevant to this paper: capital allocation and corporate culture.

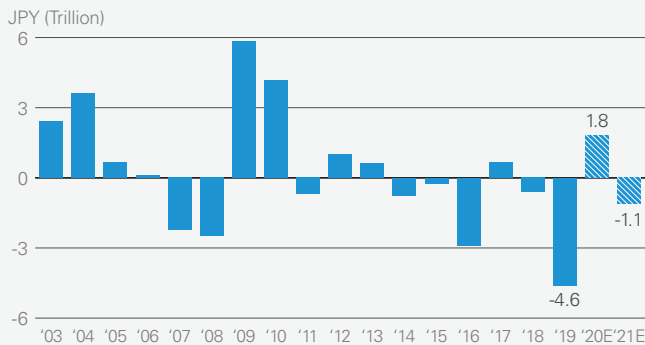
Regarding capital allocation, the pandemic has cast "un-optimized" cash-rich balance sheets in a new and more positive light. Nassim Taleb, in *Antifragile: Things That Gain from Disorder*, explains his concept of "anti-fragility." He notes that there is no good opposite word for the English word "fragile," since the opposite he refers to is not "robust." Rather, he explains: "Some things benefit from shocks; they thrive and grow when exposed to volatility, randomness, disorder, and stressors and love adventure, risk, and uncertainty."⁶

One could make the case that historically Japan has indeed demonstrated anti-fragile qualities. The country has used its crises, particularly the 1868 Meiji Restoration and the post-WWII period, to benefit and become stronger.

Similarly, times of crisis can present opportunities for Japanese companies with strong balance sheets. One example is Mitsubishi UFJ's \$9 billion equity investment in US investment bank Morgan Stanley's equity in fall of 2008, when many of its overseas rivals were overextended. Strong balance sheets offer companies the option to avoid bankruptcy, retain talented staff, and improve their competitive position.

Following the 2008 global financial crisis, equity issuance by Japanese companies rose to record levels in 2009 and 2010. This often resulted in equity dilution that hurt shareholder returns. Based on the preliminary results of the 2020 AGM season, we do not expect similar dilution this time. Goldman Sachs forecasts that while equity supply will increase in the current fiscal year, the favorable trend toward reduction will continue in the next fiscal year (Exhibit 7). This seems plausible to us.

Exhibit 7
Goldman Sachs Net Equity Supply Forecasts: 2020 +¥1.8 Tn, 2021 -¥1.1 Tn

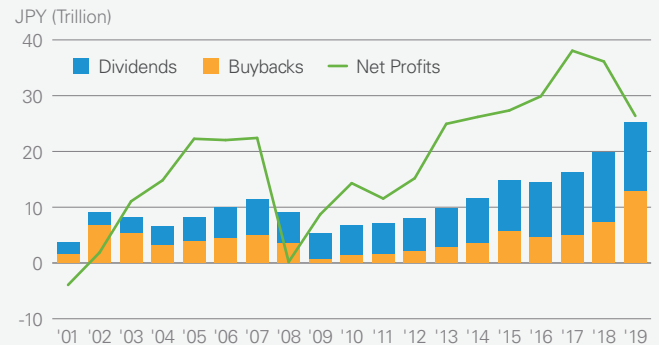


As of 29 May 2020

Note: The dates in the chart represent Japan's fiscal year.

Source: Goldman Sachs

Exhibit 8
TOPIX 500 Dividends, Buybacks, and Net Profit

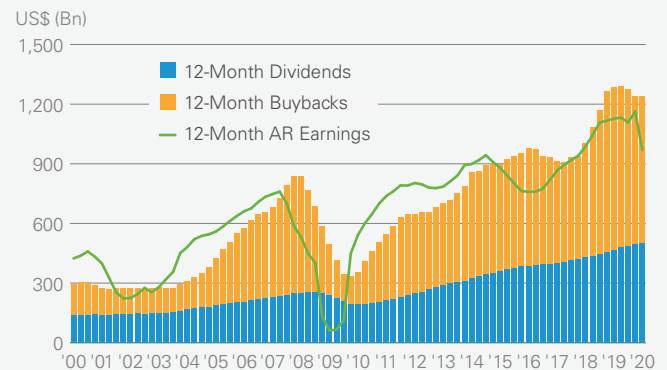


As of 15 June 2020

Note: The dates in the chart represent Japan's fiscal year.

Source: Bloomberg, CLSA

Exhibit 9
S&P 500 Annualised Share Buybacks, Dividends, and Earnings



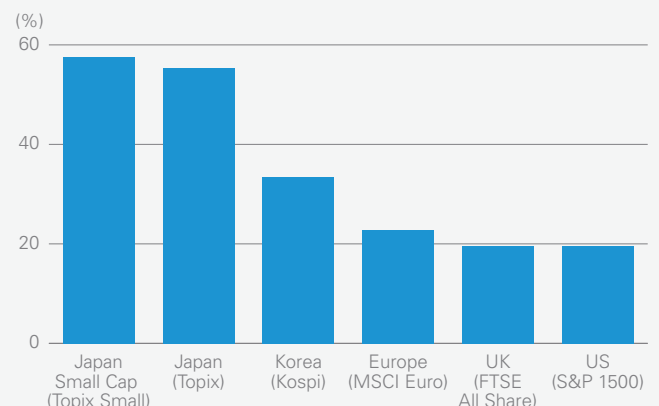
As of 30 June 2020

Source: CLSA, S&P Dow Jones,

COVID-19 appears to have led several activists to scale back their demands for dividend increases and share buybacks at over-capitalized Japanese companies. We agree that in the current environment, management attention should be focused on business structure, rather than activist demands for more dividends and buybacks. Yet, it is entirely appropriate to demand that corporate managers either increase shareholder returns or invest excess cash in value-adding investments going forward. Despite rising to a historic high level in FY 2019, Japanese companies have returned to shareholders much less than their net profit over the past 18 years (Exhibits 8 and 9).

By contrast, US companies have paid out more than their net profit for the past five years. The trend toward increasing shareholder returns may have been triggered by the surprise decision of Microsoft in July 2004 to return around \$75 billion to shareholders, most of which came in the form of a special dividend and buyback program.⁷ Prior to 2004, Microsoft had been accumulating excess cash on its balance sheet, just

Exhibit 10
Percentage of Non-financial Companies that are Net Cash



As of 15 June 2020

Source: Bloomberg, BCLSA,

as many Japanese companies are today. Other US companies followed Microsoft's lead, and these shareholder-friendly activities have boosted the US market relative to other regions ever since.

Japanese companies can and should use this crisis to *increase* shareholder returns. The Japanese market includes more net-cash companies than other major markets do (Exhibit 10), particularly among smaller market capitalization companies. If a cash-hoarding member of the Japanese business establishment were to announce a dramatic change in policy comparable to what Microsoft did in 2004, we think that much of the market would follow its lead.

Far from slowing down some of the positive changes that were happening to Japanese companies, COVID-19 has actually catalyzed important changes in Japanese corporate culture, which we believe could be highly significant for shareholders.

- A greater focus on productivity and output for notoriously underproductive white collar workers: Working from home undercuts the traditional "salaryman" mentality that time spent in the office equals contributing to the company.
- Open and honest communication: Communication may paradoxically improve from more meetings being conducted remotely. It is unfortunate that Japanese workers have had to develop the skill of "reading the air" to advance, which means guessing what one's superiors want to hear and providing it. However, we see evidence that past cultural norms seem less binding on a video call.
- Flattening the organization: Remote working shows signs of increasing the connections between top management and individual business units. Kinya Seto, the CEO of building supplies maker LIXIL, recently told the Financial Times that his understanding of the business and level of direct communication has improved substantially since many of his managers began working from home, in part because he had more opportunities to speak directly to employees working below his direct reports.

The Future of Policy Reforms

Japanese Prime Minister Shinzo Abe has championed reforms that have led to substantially better corporate governance in Japan, which in turn contributed to rejuvenated growth in corporate profits and stock market returns. Does his resignation put that legacy at risk? While it certainly creates a degree of uncertainty, we do not expect the gains of the Abe era to evaporate. Corporate governance reforms had already begun prior to Abe's return to power in 2012, following a year-long stint as prime minister from 2006–2007. Even if further policy reforms stall, the progress of the Abe era has been institutionalized, leading to increased engagement between investors and companies and activism on the part of investors.

Despite Abe's departure, we expect that corporate governance policy progress will continue, particularly in the following areas:

Collaborative Engagement

A recommendation that investors may find it beneficial to work together was added in the 2017 revision of the Japan Stewardship Code. The wording was changed in the 2020 revision to recommend "collaborative engagement" among investors in their efforts to realize value-increasing changes in management behavior.

An excellent, though admittedly unusual, example of such collaborative engagement happened at the AGM for LIXIL in 2019. In advance of the AGM, several well-respected overseas investment firms initiated a campaign to remove LIXIL's Chairman & CEO Yoichiro Ushioda, a member of one of the group's founding families, and reinstate the previous CEO, Kinya Seto, who had been fired arbitrarily. The campaign succeeded in restoring the talented former CEO to his former position with a mandate to continue his business restructuring efforts.

We expect the Japan Stewardship Code to be revised in the fall of 2021 and to include the promotion of "collective activities" among shareholders and investors. We expect a full or partial repeal of the current rule that restricts investors holding 5% or more of a company from communicating with other investors in the same company. This will clearly make collaborative engagement easier.

FSA and TSE Guidance

The Japanese Financial Services Agency (FSA) plans to begin revising the Corporate Governance Code starting in fall 2020. Potential agendas might include:

- Requiring a minimum of three outside directors on the Board of Directors
- Introduction of a 20% dissenting vote threshold at the AGM to press corporate managers toward announcement of a remedial action plan
- Application of a cost-of-capital assumption to all facets of corporate activities
- Reinforcement of governance standards among auditing companies, including nomination of outside directors for their boards
- Improvement of the quality and relevance of personnel who are nominated as outside directors

The prestigious First Section of the Tokyo Stock Exchange will significantly tighten its listing criteria in April 2022. We expect that the option of becoming a private company will become increasingly attractive to many companies as they calculate they may be ejected from the First Section. Much uncertainty remains, but it is clear that many small cap company management teams are reconsidering the merits of remaining publicly listed companies. This represents an opportunity for investors.

Japanese Ministry of Economy, Trade, and Industry (METI) Policy

The Japanese Ministry of Economy, Trade and Industry (METI) has recently issued two helpful sets of policy guidelines that we expect will help accelerate the opening of the market for corporate control.

First, the Fair M&A Guidelines, released in 2019, provide a framework to protect the interests of minority shareholders in M&A transactions. However, more progress is needed. In particular, we note two recent transactions that failed to provide sufficient protection to minority shareholders: the MBO of nursing home operator Nichii Gakkan, instigated by Bain Capital, and the buyout of convenience store Family Mart by its majority owner Itochu.

We think change is needed specifically in these areas:

- In Japan, an entity is allowed to make a tender offer for less than 100% of the shares of the target company. The unfortunate consequence of this is that squeeze-out rules allow for minorities to be bought out at unfavorable terms. The threshold for being able to “squeeze out” minorities is usually set at the low level of 67% of the vote count compared to the international norm of 90% of the vote count. This creates the potential for abuse of minority investors, particularly since many investors automatically vote to support the bidding company.
- M&A prices are justified through three valuation methods: (1) discounted cash-flow analysis, (2) comparable company analysis, and (3) average market price over past half year. The fact that the investment banks calculating the M&A price carry out these three methods without any disclosed assumptions before arriving at a premium—usually in the range of 30% over the prior 6-month average stock price—suggests that the analysis may simply be a way for investment bankers serving the interests of their corporate clients to justify a predetermined takeover price. It is the role of the company’s independent directors to make sure that a proper sale process takes place so that minority shareholder interests are protected. Activists’ roles are to make this case.

Second, in late July 2020, METI released its excellent “Business Restructuring Study Group” paper. The report explains the need for better business portfolio management. Its main point is that Japanese management teams need to consider the disposal of non-core businesses, and it provides examples of best practice in this area. The paper also helpfully ties this to key corporate governance issues, including the responsibilities of the board, the skills required of board members, the proper role of investor engagement, setting of KPIs, and the creation of well-designed remuneration schemes. We expect that this will further empower investor engagement and activism. It should also support progress in enlightened changes in management behavior.

Proxy Voting

As previously noted, shareholders in Japanese companies have the power to vote out CEOs and board members who muster the support of less than half their shareholders. Recently, board members with low approval ratings have been opting to proactively retire or take actions that increase shareholder returns in advance of a proxy meeting.

While there have been few historic instances of CEOs being voted out by proxy, there appears to have been at least one example in the 2020 AGM proxy voting process. Further, we expect that the Japanese Corporate Governance Code will continue to emulate provisions in the United Kingdom’s equivalent code that demands companies to communicate “corrective action” in cases where dissent rates exceed 20% on specific proposals. Recently, it has become clear that the logistics of Japan’s voting also need to be reformed.⁸ The Tokyo Stock Exchange should make online voting mandatory as an important first step.

ISS and Glass Lewis are the two leading proxy advisors giving advice to investors in Japanese companies. While their advice often appears to be based on mechanical criteria, they have become increasingly empowered and influential. Often, their advice conflicts, which helps domestic investors pick the more comfortable vote of supporting management. Overall, however, the role of these services is becoming more important and positive. In particular, we expect to see new guidelines from Glass Lewis that would recommend shareholders vote against CEOs (or other representative directors) of companies whose mark-to-market value of strategic equity holdings relative to net asset value exceeds 10%. ISS is said to be planning similar voting policy advice.

Investors who signed Japan’s Stewardship Code are required to disclose how they voted on proxy votes, or else to explain why they do not disclose. This requirement has resulted in high voting rates of dissent, particularly among leading Japanese institutional investors. Increased dissent votes have been accompanied by an encouraging trend to eliminate “poison pill” provisions—defensive measures a company takes to make itself unattractive in order to avoid an unwelcomed takeover—in recent years. In short, the CEOs of underperforming companies have come under increasing pressure.

A peculiar cultural feature of the Japanese corporate world is the power of shame to motivate behavior. No CEO or board member wants to face the public embarrassment and loss of face that comes with a low and falling proxy vote approval and will place high priority on taking action to avoid the outcome of support levels falling, even if they remain well above the 50% level needed to remove them. Thus, the politely delivered, and often tacit, threat to vote “AGAINST” at the next proxy vote opportunity represents another powerful tool of engagement.

Conclusion

Until recently, hostile takeovers and MBOs have been very rare. As a result, the Japanese equity market currently offers many high-quality businesses with abundant levels of net cash and other financial assets that are trading well below their liquidation value. Such companies have historically been considered “value traps” because investors believe that Japan’s weak market for corporate control protects entrenched and underperforming management teams from sufficiently considering the interests of their shareholders. This paper has argued that both top-down and bottom-up changes have shifted the balance of power.

We expect that opening Japan’s market for corporate control will produce positive changes in management behavior and reduce the corporate governance discount the market currently places on Japanese stocks. This is because the management of companies with good businesses and strong balance sheets will face increasing pressure from both activists and investors working on behind-the-scenes engagement. Private equity firms will likely continue to act when they can to arbitrage gaps between market prices and much higher private market values. This should illustrate the extent to which many poorly governed companies have been excessively discounted by the market.

The COVID-19 pandemic is combining with the opening of the corporate control market to encourage or force long-lasting changes in Japanese management behavior and corporate culture. Japanese managers can, and we believe they should, use this crisis to *increase* shareholder returns, unlike some of their overextended peers in other regions.

Investors, companies, and the Japanese people may all benefit as Japan’s market for corporate control opens further and makes companies more valuable. The immediate benefit is likely to increase the effectiveness of both activism and investor engagement aiming to unlock trapped value. We believe those companies that do not improve their operating performance and efficiently deploy their capital will be forced to go private.

While an uptick in activist campaigns and private equity activity helps open the market for corporate control, we still believe that behind-the-scenes engagement is now the most effective tool to unlock shareholder value, particularly when investing in mid and small cap companies. The opening market for corporate control could potentially empower active investors with the tools to unlock value. More aggressive methods can make it difficult to build productive long-term relationships. We believe in the Japanese market, long-term investors can realize the most value over time by deeply understanding companies, and developing strong relationships of trust.

We believe that the opening of Japan’s market for corporate control is still in its early stages. Its significance is not yet fully reflected in market valuations. According to the principle that “it is better to travel than to arrive,” global investors may wish to reconsider whether Japan’s “value traps” actually represent new opportunities to realize value through “win-win” engagements with Japan’s excellent companies.

This content represents the views of the author(s), and its conclusions may vary from those held elsewhere within Lazard Asset Management. Lazard is committed to giving our investment professionals the autonomy to develop their own investment views, which are informed by a robust exchange of ideas throughout the firm.

Notes

- 1 Security Analysis by Benjamin Graham, David L. Dodd, 1934
- 2 Manne, Henry G. (1965). "Mergers and the Market for Corporate Control". 73 Journal of Political Economy 110
- 3 Codrington Japan, report by Campbell Gunn from 11th December 2019
- 4 Dr. Tsumuraya of Hitotsubashi University – An Empirical Analysis of Strategic Equity Holdings, Nikkei BP, May 2020
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- 6 Antifragile – 'Things that gain from disorder' by Nassim Taleb, 2014
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Important Information

Published on 6 November 2020.

The performance quoted represents past performance. Past performance does not guarantee future results.

TOPIX is a free-float adjusted market capitalization-weighted index that is calculated based on all the domestic common stocks listed on the TSE First Section. TOPIX shows the measure of current market capitalization assuming that market capitalization as of the base date (January 4, 1968) is 100 points. This is a measure of the overall trend in the stock market, and is used as a benchmark for investment in Japan stocks. The index is unmanaged and has no fees. One cannot invest directly in an index.

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