Corporate Governance in Japan 2017

:;

Kintaro-ame culture must be killed off

Mike Newman
President & CEO
Analogica K.K.

March 2nd, 2017

Executive Summary

No corporate governance code is perfect

In our report of August 2015 it was made clear that *"**NO** corporate governance code is perfect."* However, the emphasis was that corporates needed to focus on the quality of independent directors rather than submit to a quantitative box ticking exercise when it came to complying with the new corporate governance code (The Code). While the Tokyo Stock Exchange (JPX) can be rightfully pleased with the progress of compliance by listed entities, when looking through the data, there appears a concerted effort by corporates to employ independent directors with a bent on not upsetting the status quo. That would appear at odds with the spirit of The Code.

SOX failed

We made clear that the introduction of the Sarbanes Oxley Act (SOX) and other corporate governance codes - which pushed for more independence on boards to ensure fiduciary duty to shareholders - did not prevent investor losses hitting all-time records. Good corporate governance is about building a culture of trust (both inside and outside the boardroom).

Time with FSA & TSE

We have been fortunate to spend ample time with the Financial Services Agency (FSA) and JPX discussing the potential revisions to The Code. We have put forward three suggestions to increase transparency and achieve the slated goals of the document:

Quality of independent directors imperative

One, we have always suggested that the quality of independent directors is imperative. Forget SOX as a prerequisite. A well-managed company should never feel threatened by the number of independent directors challenging consensus in the boardroom. Good governance is being open to constructive criticism. If a company has lacked strategic direction for years, a fresh perspective from independent minds is invaluable. Our greatest criticism gleaned from the published data is the high concentration of the **three A's** (attorneys, accountants and academics) as independent directors which is more acute the smaller the company. Diversity (of opinion) on boards is imperative but the figures suggest a group think mentality (Kintaro-ame) approach skewed to such a narrow field of professions limits innovation as no two companies are alike. How do authorities change it?

Avoiding kintaro-ame

Simply, secondly, and more importantly we think that companies need to introduce proper incentive structures for executives. Our studies show that companies tend to perform better when board members (insiders) have a higher proportion of their remuneration linked to stock performance. Stock incentives, especially in larger corporations, are often a minuscule part of total compensation for leaders. So much so that there is little incentive to focus on chasing real returns through more aggressive strategy. Fix this and independent director selection will be more serious.

Higher executive performance linked pay works

Third and finally, we think that the authorities should encourage corporates to adopt English language financial materials. A growing number are but the pace is slow. By doing so would invite more eyes from investors in markets where shareholder returns are prioritised. This would create an environment that would encourage Japanese corporates to unlock shareholder value. The JPX would accrue large upside. Not only would it gain more status as a proper global exchange, it would invite higher activity which would improve liquidity which is a virtuous circle for a financial exchange.

Encourage wider English language financial materials

In short, Japan remains by and large a masterclass in risk avoidance. Until company executives have performance linked remuneration structures we believe independent directors will do little to help drive shareholder returns. Kintaro-ame independent director selection is not the way forward. By prioritising the linkage of remuneration, driven by higher disclosure via English language we think the ultimate aims of The Code can be achieved and the soft corporate governance approaches we have seen to date with the failures of Toshiba, Sharp and Olympus can be consigned to history.

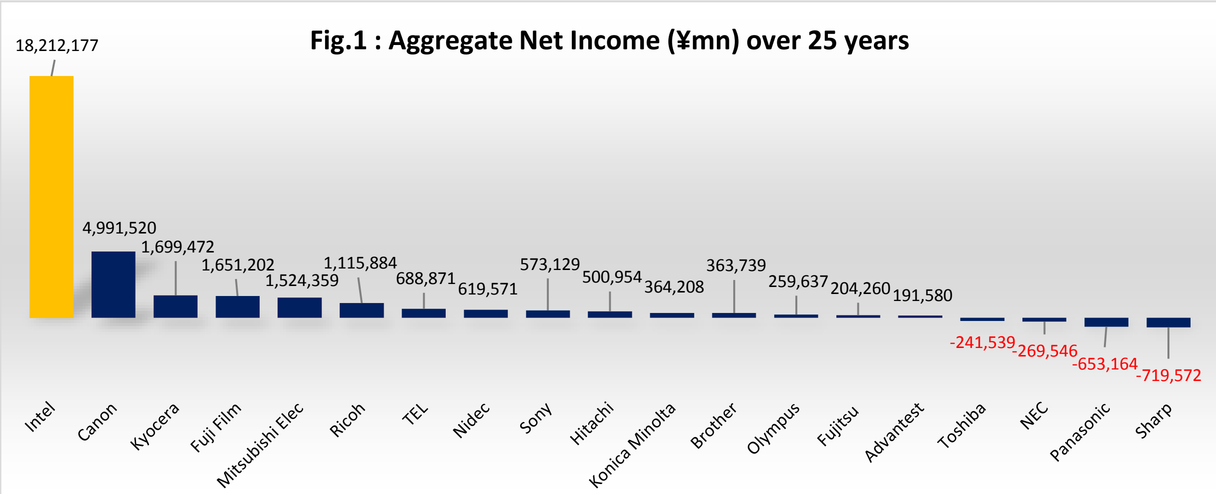
A preamble – getting Japanese corporations to put shareholders first

Need to move away from risk avoidance

Perhaps one of the greatest frustrations in Japan is that there are so many wonderful companies in terms of product which are needlessly destroy value due to poor strategic decisions. Take this example.

Intel vs Japan's monster 20 tech companies

We wrote in our note, *'Japan's Misguided Matryoshka M&A'* on December 9th 2015, that *"In the last 25 years, Intel Corp on its own has managed to make 31% (now 41% as of Dec 2016) more net income than all 20 of Japan's largest tech companies combined on a currency adjusted basis. That is right. Intel on its own has thumped the likes of Sony, Panasonic, Toshiba, Sharp, Mitsubishi Electric, NEC, Hitachi, Fujitsu, Fuji Film, Konica Minolta, Brother, Nidec, Kyocera, Canon, Olympus, TDK, TEL, Ricoh, Advantest and Nikon combined."*



Source: Company data, Custom Products Research

What happened to the Sony of old?

Sony used to be the champion of innovation in the 1980s. The Morita era was the envy of the technology world. The Walkman and HandyCam. When was the last time you bought a Sony product? Now Sony, like many of the aforementioned names, is nothing more than a collection of commoditised business lines which has made it vulnerable to regular write downs and restructuring. I am not sure if the 'extra' in extraordinaries is required such is the frequency.

Are we getting adherence to the essence of what The Code states?

The *Japanese Corporate Governance Code* makes it very clear that company boards should:

A reminder

"…Endeavour to select independent director candidates who are expected to contribute to frank, active and constructive discussions at board meetings…independent directors should…aim to contribute to the sustainable growth of companies and increase corporate value over the mid to long term. Companies should appoint at least two independent directors that sufficiently have such qualities…"

As of the end of 2016, JPX claim 78% of TSE 1st section listed corporates has two or more independent directors, Fig.2. Fig.3 shows the progress of the small/mid cap stocks which have had more 'grace period' to comply or explain with The Code.

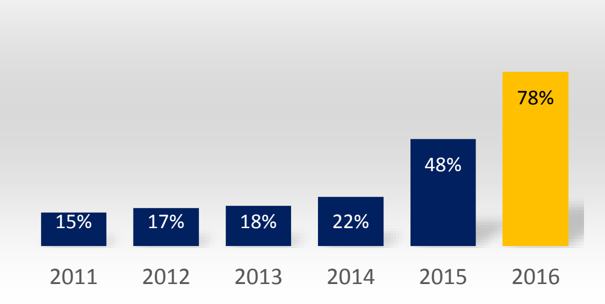


Fig. 2: TSE 1st Section companies with 2 or more Independent Directors

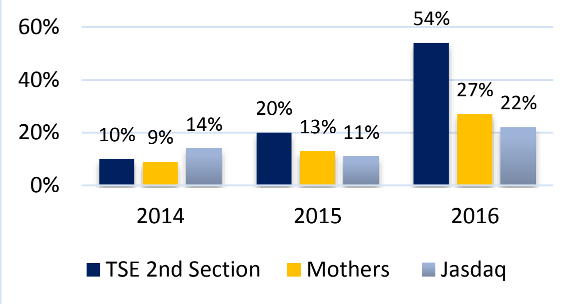


Fig.3: Listed Small/Mid Companies with 2 or more Independent Directors

Source: Custom Products Research, Japan Exchange Group (JPX)

The pertinent question was what type of independent directors were Japanese companies hiring?

In our previous corporate governance report we echoed the FSA by writing,

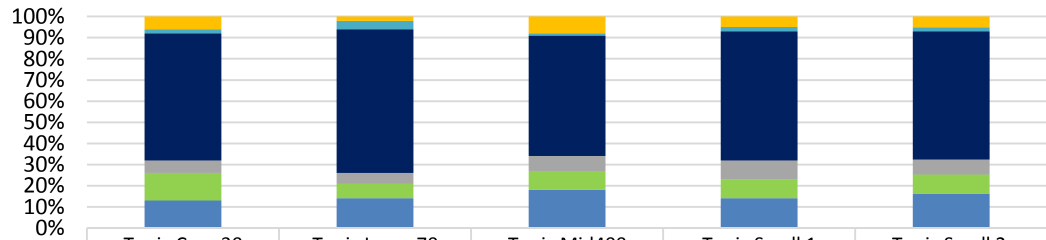
It is a mindset issue

"Improving board behaviour is a ***mindset issue, not a regulatory one****. A successful company should be willing to encourage open debate. More so for a company that has been struggling for years with its strategic direction. Both would benefit from fresh perspectives offered by independent minds…Companies must focus on qualitative aspects when hiring independent directors over quantitative parameters. Soft options to meet minimum regulatory requirements to protect the status quo is a recipe for failure. Independent directors should not be viewed as an 'unavoidable cost' but as a 'wise investment' for firms. Which company would rationally choose inferior staff for its operations?* ***Would an airline actively seek unqualified pilots to fly its passengers?*** *That is not the way of sustaining good reputation in the long run."*

Too Conservative

As discussed in the February 4th, 2016 report, *'Bambi in the Boardroom'*, our visits to several recruitment firms in Japan suggested that most listed corporates wanted to hire as '*conservative as possible'* to meet the requirements of the regulator rather than hire people that may actually added real value.

Fig.4: 2016 - Independent Directors by Profession in Japan (%)



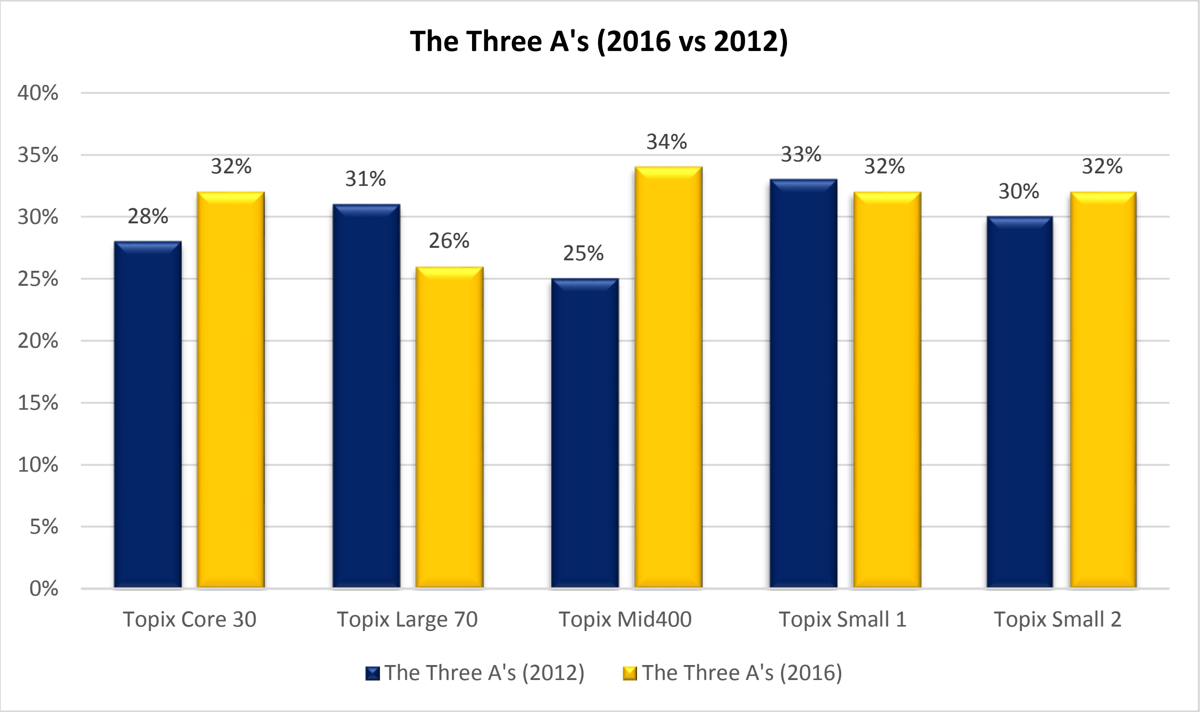
	Topix Core 30	Topix Large 70	Topix Mid400	Topix Small 1	Topix Small 2
Other	6%	2%	8%	5%	5%
Tax Professional	2%	4%	1%	2%	2%
Other Company	60%	68%	57%	61%	60%
Academic	6%	5%	7%	9%	7%
Accountant (CPA)	13%	7%	9%	9%	9%
Attorney	13%	14%	18%	14%	16%

Attorney Accountant (CPA) Academic Other Company Tax Professional Other

Source: Custom Products Research, Japan Exchange Group (JPX)

The three A's

In Fig.4, the types of independent directors by profession reveals some interesting trends. There has been a strong trend to hire the three A's (attorneys, accountants and academics) which tends to rise the smaller the market capitalisation, Fig.5. We tend to view the skew towards these professions as a risk-averse. In an aggressively changing financial industry, how much value will a university professor add to discourse? With the dismantling of the sell-side and the large shift toward ETFs will a lawyer create insight for the board to tackle the changing nature of shareholders? Will an accountant provide sufficient value added to get management to unlock deep value?



Source: Custom Products Research, Japan Exchange Group (JPX)

Companies are unique

Of course each company has its own unique set of requirements, issues, positives and changing landscapes. While it is clear corporates have selected a safety first approach, we would hope that the FSA and JPX encourage companies to expand their horizons when it comes to independent directors. In order to do that we believe that executive compensation is a must to drive such behaviours.

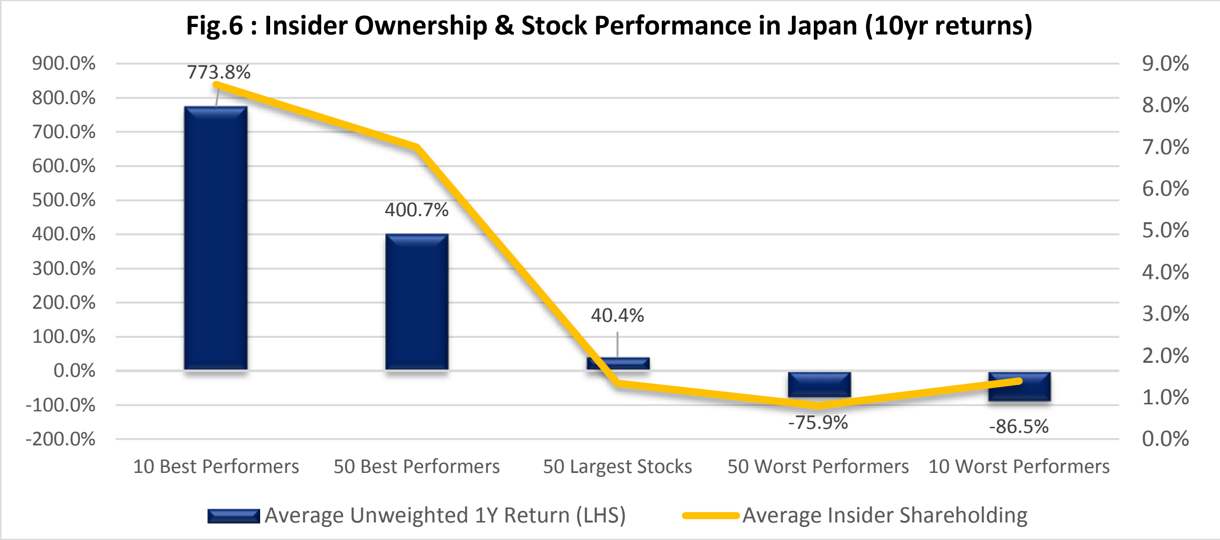
Executive Compensation linked to shareholder return works

Size matters

We compiled a report, titled *'Size Matters'*, on the impacts of insider (executive) ownership in Japan on total returns. While the report is from April 2016, the large skew we have witnessed over 1, 5 and 10 year total return periods were evidence enough that the argument would still hold.

10-fold higher

Invariably small cap companies had higher levels of insider owners and the performance was as follows. The Top 10 & Top 50 performers performed at least 10x better than the 50 largest stocks and their average insider ownerships were more than triple.



Source: Custom Products Research

Breaking it down into the one, five and ten year segments we found:

One Year View

One year View

On a one year view, this is how the tale of the tape falls for average insider ownership, unweighted returns and average market capitalisation.

Fig. 7	Average Insider Shareholding	Average Unweighted 1 Year Return	Average Market Cap (¥bn)
10 Best Performers	17.20%	242.6%	185
50 Best Performers	11.33%	97.1%	287
50 Worst Performers	1.39%	-44.9%	409
50 Largest Stocks	0.91%	-11.3%	4,400
10 Worst Performers	0.12%	-55.4%	326

Source: Custom Products Research

Five Year View

Five year View

When expanding the survey to 5-year performance we see that very similar outcomes occur to those in the one year with the exception that the Top 50 stocks had relatively higher insiders to the Top 10 but we are quibbling. Stocks such as MonotaRO (3064) which ranked 2nd in performance in our screen has small insiders on total outstanding shares, but it is approximately half owned by Grainger (GWW US). GWW's David L. Rawlinson II sits on the MonotaRO board and presumably encourages US-style returns policy.

Fig. 8	Average Insider Shareholding	Average Unweighted 5 Year Return	Average Market Cap (¥bn)
10 Best Performers	8.10%	2927.8%	236
50 Best Performers	11.20%	1008.9%	382
50 Largest Stocks	1.37%	115.5%	4,191
50 Worst Performers	1.70%	28.0%	491
10 Worst Performers	0.05%	-51.5%	279

Source: Custom Products Research

10 Year View

10 year View

When we expand the survey to 10 year performance we see that very similar outcomes occur and conclude that in the Japanese market, owner-operators tend to outperform corporates run by salarymen who seem keen to just to preserve the status quo.

Fig. 9	Average Insider Shareholding	Average Unweighted 10 Year Return	Average Market Cap (¥bn)
10 Best Performers	8.50%	773.8%	284
50 Best Performers	7.00%	400.7%	519
50 Largest Stocks	1.34%	40.4%	4,182
50 Worst Performers	0.80%	-75.9%	702
10 Worst Performers	1.39%	-86.5%	737

Source: Custom Products Research

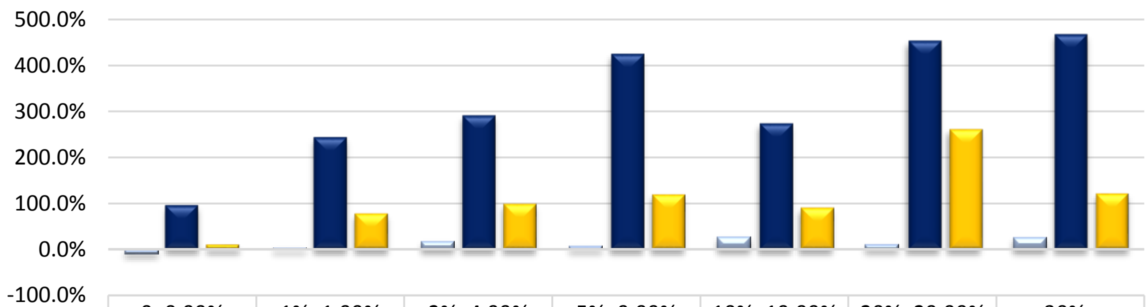
Incentives More effective than independent directors

Insiders (classified as shareholdings by the management board) seem to have a large bearing on share price performance, clearly providing a platform of engagement with the company's fortunes and seemingly much more effective than just hiring two independent directors.

Goldilocks shareholder ratios?

So what is the ultimate level of insider ownership? We decided to breakdown the insider ownership into segments of 0.00%~0.99%, 1.00%~1.99%, 2.00%~4.99%, 5.00%~9.99%, 10.00%~19.99%, 20.00%~29.99% and 30.00%+. This is what we discovered.

Fig.11: How much Insider Holding seems Ideal? - Performance by Insider Ratio (%)



	0~0.99%	1%~1.99%	2%~4.99%	5%~9.99%	10%~19.99%	20%~29.99%	30%+
1 Year	-8.60%	4.5%	18.8%	8.4%	28.5%	11.3%	26.6%
5 Year	95.9%	243.5%	291.4%	424.8%	274.0%	453.2%	467.1%
10 Year	10.3%	77.8%	98.7%	119.5%	90.6%	260.2%	121.5%

1 Year 5 Year 10 Year

Source: Custom Products Research

Getting scientific

Fig.11 reveals that insider ownership below 1% consistently provides the worst returns in 1, 5 and 10 year time frames. 10%~19.99% tended to be the worst performing insider cohort amongst the 5%+ categories. We can provide the full list of stocks to investors in Excel. Please email me at michael.newman@custprd.com. Our Appendix holds a list of stocks up to 50 names for each category.

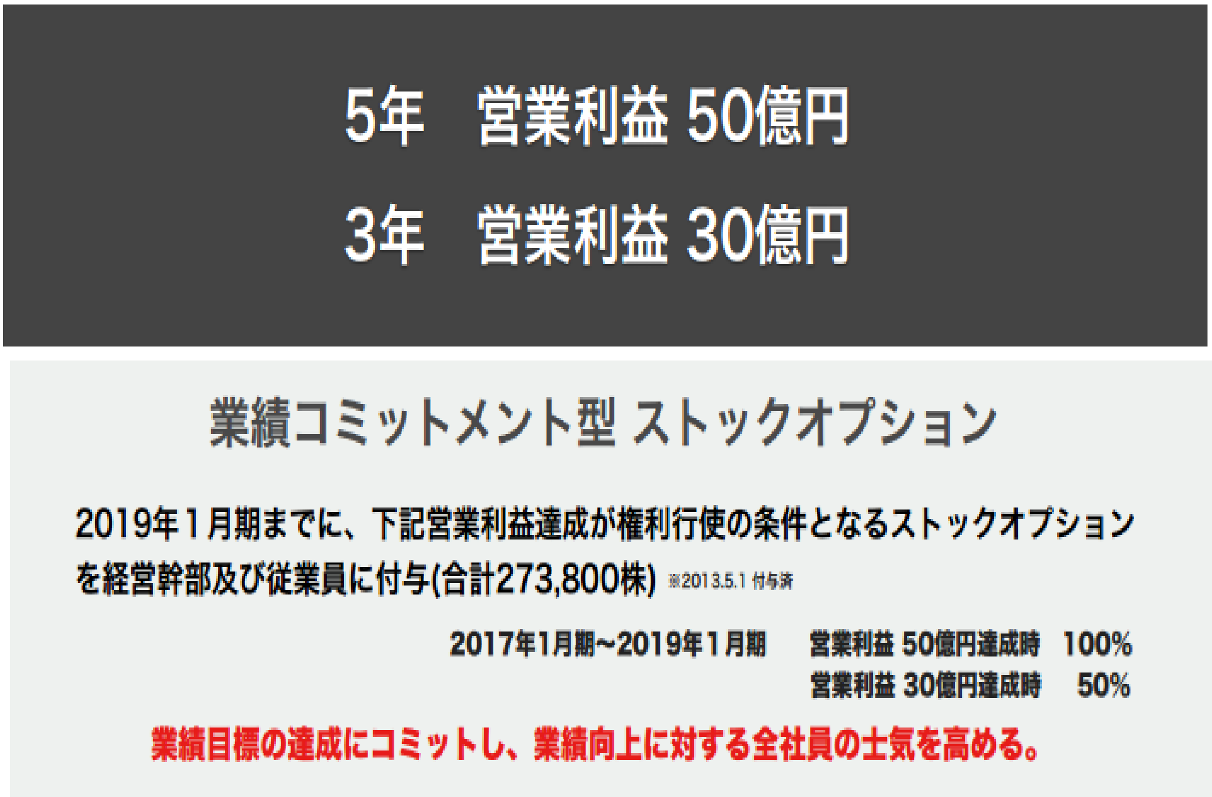
In order to get skin in the game, companies need transparent executive incentives

Some good example of transparent executive incentive structures

Ironically leaders like Carlos Ghosn of Nissan Motor (7201) who has ¥3bn of company stock and was paid around ¥1bn in annual compensation at the helm of Nissan is very much the exception to the norm. Most investors will have felt very comfortable rewarding Ghosn for turning a nearly bankrupt business into a $40bn rejuvenated, competitive and hungry behemoth. Japanese corporates must understand that lifting the incentive proportion for executives will please shareholders far more than hiring two independent directors who are unlikely to rock the boat.

Buyma parent Enigmo (3665) has very clear shareholder targets for management which shows shareholders very clearly that 50% of options for management will be awarded if the company hits ¥3bn operating profit by FY1/2017 and 100% if ¥5bn hit by FY1/2019. 43-year-old CEO Shokei Suda owns around $23mn shares. Enigmo's 5-year performance is 813.4% (as at Feb 28, 2017) and insiders amount to c. 20% of outstanding shares. Transparency seems to work in giving investors confidence management is putting its money where its mouth is.

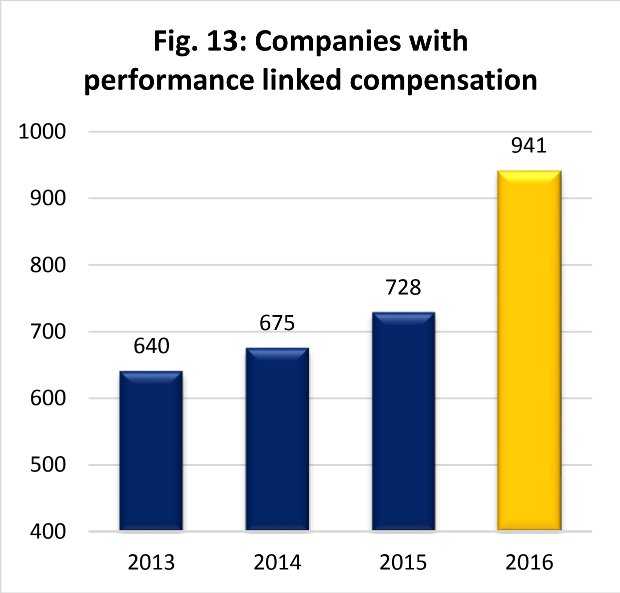
Fig. 12: Enigmo's management outlines executive options based on hitting targets

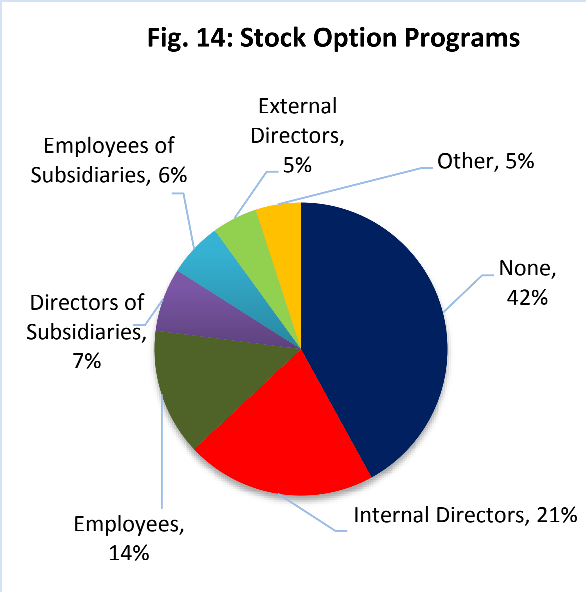


Source: Enigmo

26% have performance linked remuneration

More Japanese companies are adopting performance based incentives according to JPX. We view this as a positive sign. As of the end of 2016, around 941 companies, or 26% of the total listed on JPX have performance linked compensation, Fig. 13.

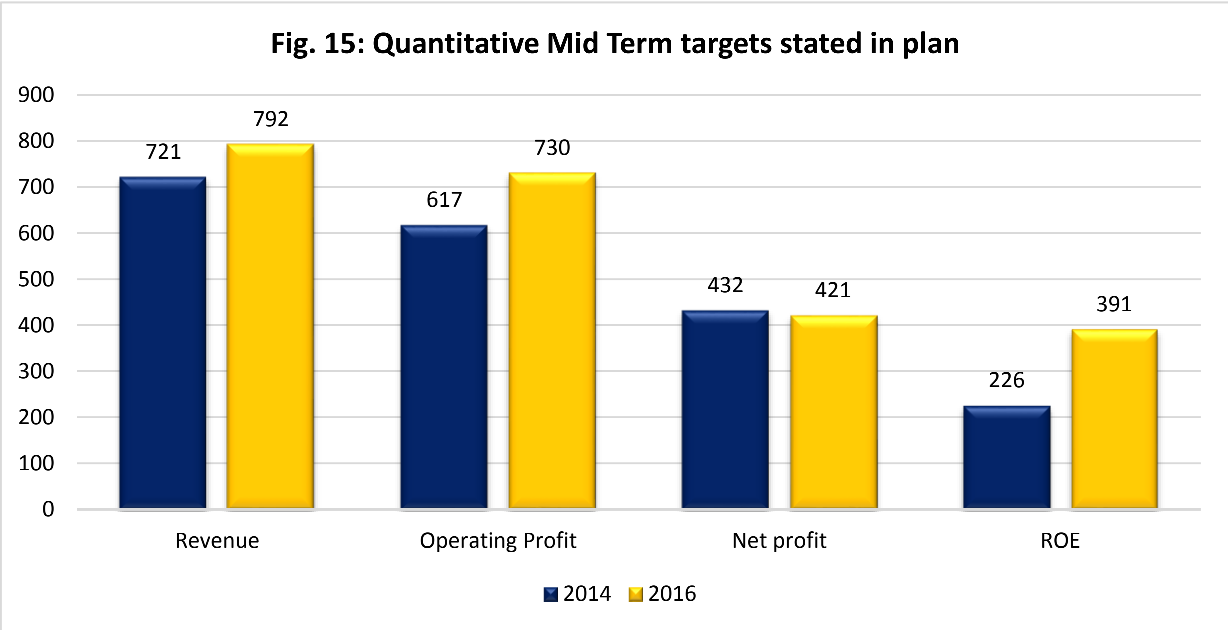




Source: JPX

Mid-term targets

It is important that companies attach transparent mid-term performance targets that comfortably satisfy shareholders. We see that only 11% of corporates are stating quantitative ROE targets in their mid-term plans. While it is sharply higher than the 6% in 2014 companies should be getting comfortable with providing such guidance.



Source: JPX

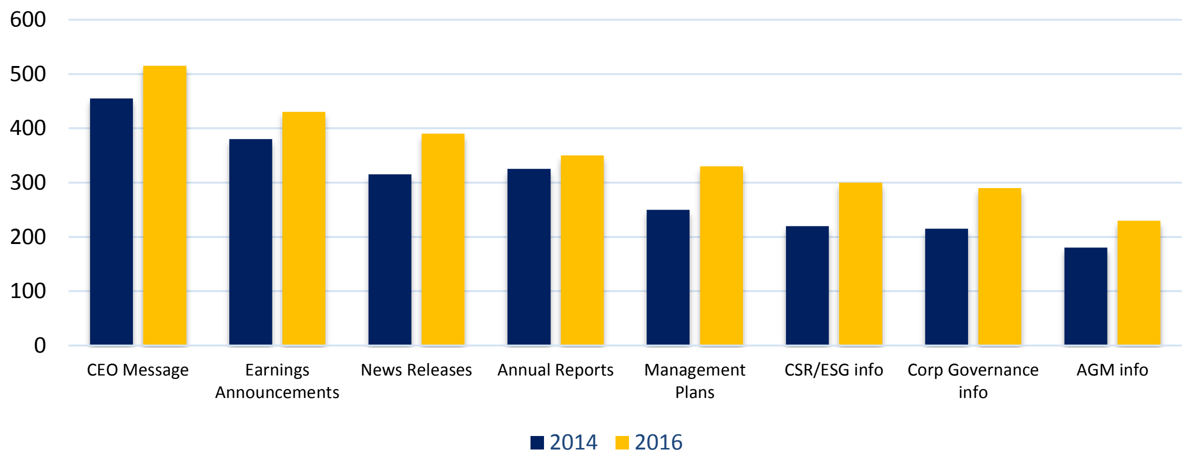
English language disclosure important to encouraging global standards

English materials

According to JPX, a growing number of corporates are publishing more English language materials for earnings announcements, product releases and so on. Increasing English disclosure would invite more eyes from foreign investors which are more used to markets where shareholder returns are prioritised. This would create an environment that would encourage Japanese corporates to unlock shareholder value.

Around 15% of companies now have a CEO message in English but only 11.8% have earnings announcements and less than 10% have mid-term plans or corporate governance statements for foreign investors.

Fig. 16: English Disclosure on Corp Websites

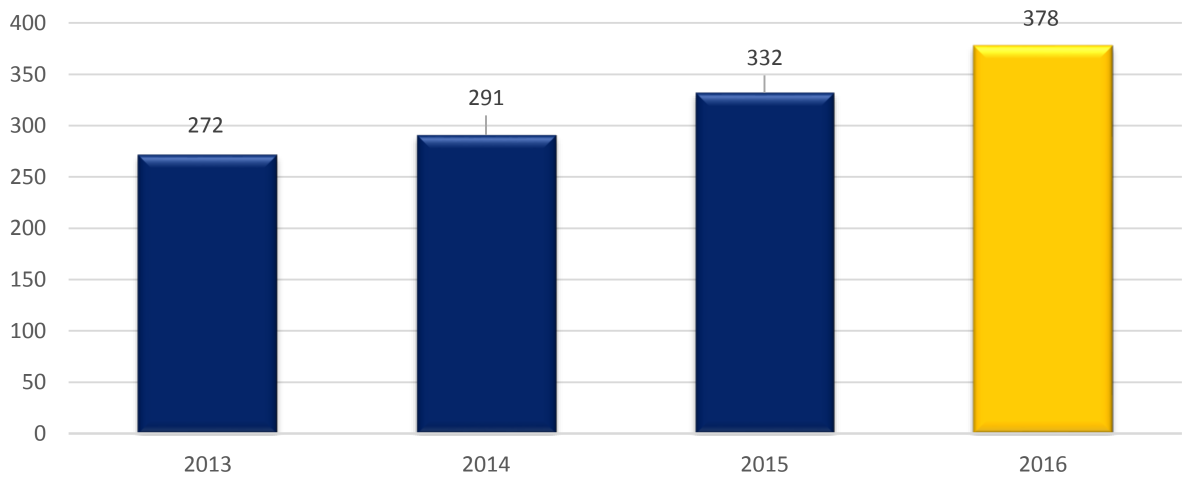


Source: JPX

CEOs getting more active

We note that C-level management is taking a more proactive approach to meeting with foreign investors. While moving from less than 7.7% in 2013 to 10.7% looks encouraging we believe that incumbent shareholders of many companies are missing out on a large pool of capital.

Fig. 17: # Japanese corporate CEO/Chairman engaged with foreign investors



Source: JPX

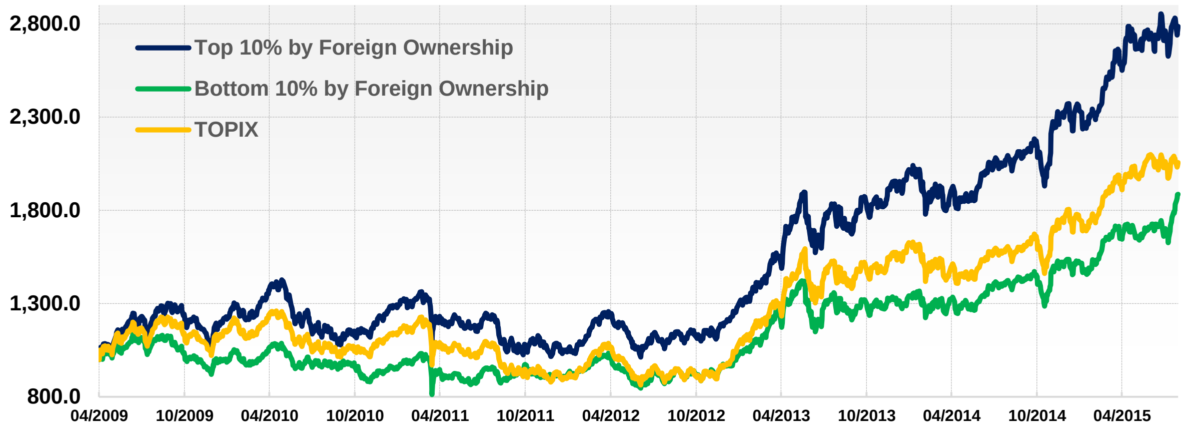
Benefits of foreign owners

To put that in perspective, given the high levels of foreign participation in the market, corporates should not look at providing English transparency as a chore but an opportunity. Not only does higher foreign investor activity help market liquidity if companies are prioritising shareholder returns higher share prices assist with future capital raisings should it be required and lower the cost of issuance.

Higher foreign ratios

Companies with higher foreign shareholder ratios have tended to perform better than those that do not, Fig.18. Even before The Code was introduced, high foreign ownership became a good proxy for companies that practiced better shareholder focused business practice.

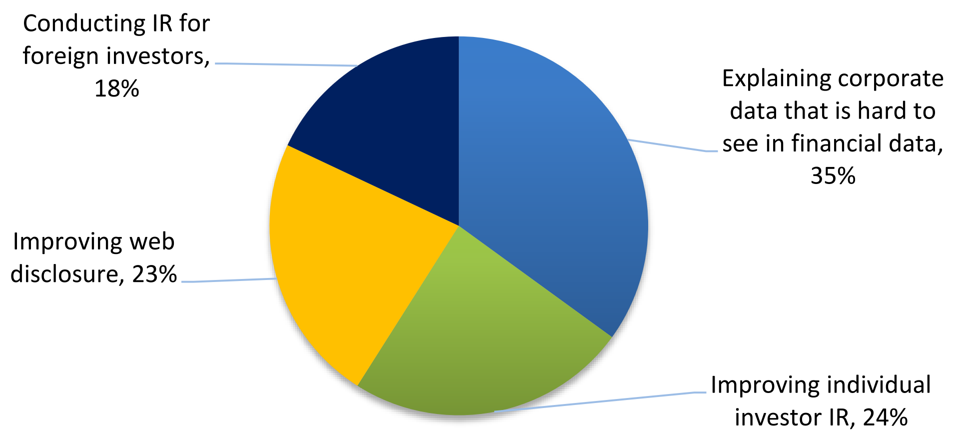
Fig.18: A proxy for best practice corporate governance held in higher foreign ownership ratios



Source: Custom Products Research

However one concern we have is when corporate investor relations departments were surveyed by JPX on future plans, the answers put a low relative priority on foreign investors, Fig.19.

Fig. 19: Future IR focus areas



Source: JPX, Custom Products Research

Summary

Congrat-ulations are still in order

We congratulate the authorities for achieving a good start on getting corporate Japan engaged on corporate governance. While it is easy to hurl criticism at Japanese companies for avoiding taking more decisive action in hiring independent directors that will make an appreciable difference, we must accept certain cultural norms.

Let us not forget Japanese corporate reluctance

Government leadership is still important in fostering corporate change. It is worth reminding ourselves that it was Prime Minister Junichiro Koizumi that had to introduce the concept of 'Cool Biz' in the early 2000s to combat energy shortages and hot weather because corporates were too risk averse to come up with such basic common sense approaches themselves.

Therefore we encourage the FSA and JPX to push forward with the three steps we outlined in this report. Perhaps we could even argue that we should reverse the order. Drive English language disclosure which would bring higher levels of scrutiny over shareholder return policy thanks to investors far more geared to performance based metrics. This would entail a push toward higher levels of performance based remuneration which in and of itself would encourage corporates to hire independent directors that added real value to their process as opposed to just pleasing the regulator by merely complying. No more Kintaro-ame please.

No more Kintaro-ame

Win-win-win

The prospect of higher market turnover and liquidity for JPX, positive re-ratings for more Japanese stocks enabling cheaper access to capital and a growing legion of happy shareholders will mean the corporate governance code will contain exactly what it says on the tin: win-win-win.

Important Disclosures:

This material was prepared for you and is for your information and use only. This material should only be distributed to other members of that organization on a need to know basis and should not be distributed or disseminated to any other person or entity.

This material is for information purposes only and it should not be regarded as an offer to sell or as a solicitation of an offer to buy the securities or other instruments mentioned in it. This material is based on current public information that Analogica KK ("Analogica") considers reliable, but we make no representation that it is accurate or complete, and it should not be relied on as such. No investment opinion or advice is provided, intended, or solicited. Analogica offers no warranty, either expressed or implied, regarding the veracity of data or interpretations of data included in this report. This material is provided with the understanding that Analogica is not acting in a fiduciary capacity. Opinions expressed herein reflect the opinion of Analogica and are subject to change without notice.

The products mentioned in this document may not be eligible for sale in some states or countries, and they may not be suitable for all types of investors. The value of and the income produced by products may fluctuate, so that an investor may get back less than they invested. Value and income may be adversely affected by exchange rates, interest rates, or other factors. Past performance is not necessarily indicative of future results. If a product is income producing, part of the capital invested may be used to pay that income.

Contact

Tokyo
Michael Newman
President & CEO
Analogica KK
+81-80-4446-8200
mcn@analogica.jp

Office Locations

Headquarters
942 Win Aoyama
2-2-15 Minamiaoyama,
Minato-ku, Tokyo
Japan 107-0062

Tokyo
17/F Roppongi Hills North Tower
6-2-31 Roppongi,
Minato-ku, Tokyo
Japan 106-0032