ClearBridge Investments

Governance Reform Key to Boosting Japanese Equity Performance

Key Takeaways

- Japan's economic revitalization is an ongoing process with improving corporate governance at the heart, providing the potential for years of beneficial structural reforms.
- Implementation and revisions to the Corporate Governance and Stewardship Codes have caused Japanese companies to adopt more practices geared toward enhancing shareholder value and bringing corporate operations more in line with global standards.
- We view increasing board independence, more transparent shareholder communications and adoption of incentive-based remuneration as key areas of improvement for Japanese companies in the near term.

The bold economic policies and strategies enacted in Japan starting in 2012 were in direct response to the years of turmoil following the global financial crisis. Economically, Japan was experiencing a contracting GDP, falling exports, deflation and rising debts. Politically, the country was rudderless and burning through a revolving door of five prime ministers in five years, who often promoted inept or poorly timed polices. Shinzo Abe rose to power after the general election in 2012, advocating for bold policy transformations around economic reflation, government stimulus and structural market reforms. Ultimately, this became known as Abenomics, centered in his "three arrows" approach of monetary easing, fiscal stimulus and structural reforms designed to address decades of weakness and underperformance of the Japanese economy and capital markets. Abenomics was meant to transform Japan from a laggard to a leader. Each of the three arrows is significant and important on its own, and collectively they would become the backbone of revitalization.

While Japan remains challenged in generating significant inflation and economic growth, the measures have resulted in improved personal consumption and employment, especially among women who have become a critical part of the workforce as Japan's population ages. More important to us as active equity managers has been the structural reforms component – the third arrow – which is targeted toward improving

corporate governance and structurally enhancing the competitiveness of Japanese companies with their global peers. While progress has been slow, we believe the competitiveness of Japanese companies, as measured by return on equity (ROE) and shareholder returns, is improving (Exhibit 1).

In 2013, Abe's first cabinet outlined principles for reform in key areas of governance to foster improvement over time. Reform followed a two-pronged approach of constructive engagement between investors and corporations, building a virtuous circle of asset owners and asset managers with Japanese corporations, management teams and boards of directors. The principles for the asset owners became Japan's Stewardship Code in 2014, and the principles for corporations became Japan's Corporate Governance Code in 2015. Each of these codes have continued to be modified and improved.

Asset owners, which include Japanese institutional investors, are expected to drive implementation of the Stewardship Code, with the broad goal of promoting sustainable growth among the companies in which they invest through constructive engagement. As with governance, the goal is to drive Japanese asset owners and asset managers to adopt practices more in line with active shareholder standards. A core tenet of the code is transparency in investment policies and regular reporting of proxy voting and progress in other areas related to the performance of portfolio companies.

The Governance Code is intended to provide growth-oriented governance with structure, by promoting timely, transparent and decisive decision-making that fulfills companies' accountability to shareholders and stakeholders. Its success relies on ongoing dialogue with shareholders, information disclosure and transparency, active participation of a company's board of directors in serving shareholders as well as appropriate cooperation with a company's other stakeholders.

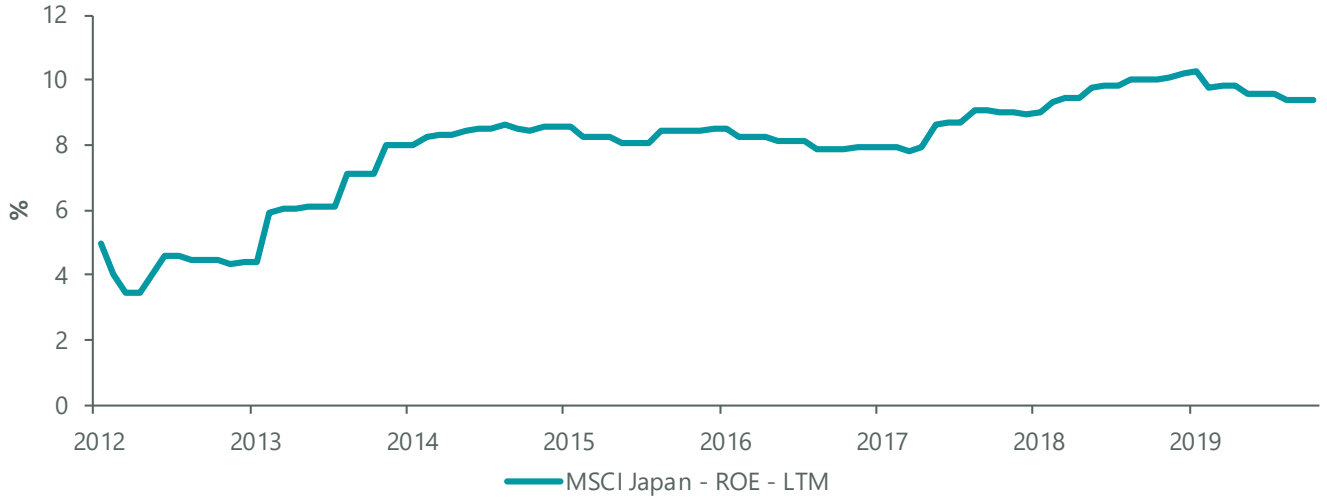
Shareholder Engagement Leading to Governance Improvements

Shareholder engagement has been growing sharply since the launch of the Stewardship Code, especially the use of shareholder proposals. Although the majority of proposals do not pass, a clear trend exists for the number of proposals being put forward as well as in the number of votes in their favor. Specific areas showing growing support of shareholders include disclosures of capital cost, management incentive compensation, anti-takeover defenses, dismissal of directors or auditors and the unwinding of cross shareholdings. This trend is one we have every reason to believe will continue, driven in part by the more actively and engaged shareholder base, as well as the positive returns companies can achieve from positive policy changes.

Fanuc, a Japanese precision equipment and robot manufacturer held across our international growth portfolios, is a supplier of automation equipment used to make a vast range of products including smart phones and automobiles. While Fanuc has been a global leader in this highly competitive industry, it has trailed its global peers in being shareholder-oriented, efficiently operated and structured. Fanuc has materially improved its governance practices in direct response to the Corporate Governance code.

Historically, the company held high levels of cash and large blocks of its own stock yet maintained a low dividend payout ratio. Since 2015, Fanuc has

Exhibit 1: Structural Reforms Have Led Return on Equity to Double



Data as of October 31, 2019. Source: FactSet.

reduced its cash from around $8.3 billion to $5.6 billion and cut its holding of company stock from 18.3% of outstanding shares to 5%. It also established a 5% ceiling for treasury stock and a policy to cancel all shares which exceed that level. Fanuc also established a policy for a shareholder payout ratio of 60% -- double its previous level. Fanuc has put much of this excess capital to work by returning some to shareholders and by investing significantly in expanding its facilities both in Japan and globally. This expansion included opening a large facility in Michigan in October that has significantly improved its global production and business structure. To maintain its leadership and invest for future returns, the company increased its workforce from 5,840 in 2015 to 7,866 in 2019. On the board level, Fanuc has improved oversight by tripling the number of independent directors.

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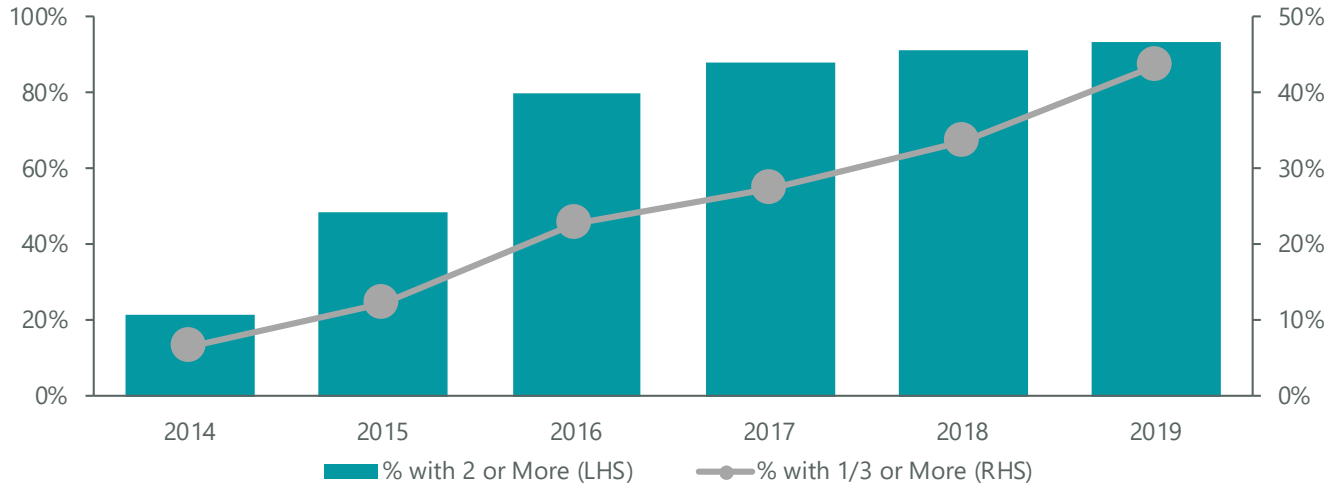
The Stewardship Code clearly encourages greater input from shareholders to management teams, and activist investors existed long before these codes were put into place. However, in the current environment, we believe management teams are under increased pressure to respond to shareholders including activists.

Sony has attracted several activist investors in 2019 who, in a very public way, have recommended several steps for the company to take to improve corporate governance and unlock shareholder value. The investors specifically requested the unwinding of Sony's cross shareholdings and the return of those proceeds to shareholders, an increase in ROE by increasing debt in-line with global peers and the exiting of non-core divisions to focus the company on creative entertainment. Sony's executives, board, and external advisors evaluated the recommendations and provided a written response. After a thorough review by management, the board and the firm's external advisors, Sony committed to selling its entire 5% stake in imaging and medical device company Olympus, one of the four holdings requested, and returning proceeds to shareholders. Although the company agreed only to this step, their written response will be the basis of further communication with shareholders. The Sony board and its engagement were a key factor in this outcome: the company has a diverse board comprised of Japanese and non-Japanese citizens, 11 of the 13 members are independent and two of the independent members are women.

Sony's efforts have occurred in an environment of greater scrutiny of governance practices. A 2018 revision to the Corporate Governance Code enhanced board committees, lowered cross shareholding percentages, strengthened the role of pension funds, which represent a significant asset base, and increased ESG awareness. Japanese companies that do not have a majority of independent directors on their boards must establish independent advisory, nomination and remuneration committees. Companies are now prohibited from threatening to cut off business relations if cross shareholdings are sold and are required to ensure pension funds have adequate personnel to fulfill their role as asset owners.

As we enter 2020, we believe there are several key areas where Japanese public companies can show near-term corporate governance improvement.

Exhibit 2: Nearly All Japanese Companies Have Appointed Independent Directors
Two or More Independent Directors - Tokyo Stock Exchange-Listed Companies



Data as of July 12, 2019. Source: Japan Exchange Group.

One is to increase penetration of independent board members on committees (Exhibit 2), as well as functioning of these independent board members with independence criteria. Another is more accessible shareholder meetings, with further improvement in access to early digital disclosures in English weeks prior to general shareholder meetings to support more informed shareholder voting.

One of the areas with greatest potential for change and impact on shareholder returns is greater adoption of comprehensive incentive-based remuneration. Japanese management compensation is overwhelming fixed and not directly aligned with shareholder interests. When Japanese management teams do have some variable compensation, it is most commonly only tied to key performance indicators (KPIs) around profitability targets and not shareholder returns. We expect greater use of variable compensation tied to shareholder interest will bring Japanese management teams closer to their global peers and deliver higher returns to shareholders. When executive compensation is tied to KPIs around both profitability and total shareholder returns (TSR), this increases the likelihood of more management teams delivering on TSR.

As Japanese companies commit to further governance improvements, they should continue to close the performance gap with their global peers and make Japanese equities more attractive. Cosmetics maker Shiseido is one of the best examples of what improved governance can do for share performance. Shiseido has made significant strides in increasing board independence as well as strengthening its audit function and independent oversight and is well ahead of its Japanese peers in having women on its board. The management team in place since 2014 has focused on modernizing the corporate structure to global standards, which has led to robust sales and earnings growth and caused the shares to rise more than four-fold over the last five years. We will continue to engage with the Japanese companies we own across our portfolios, sharing best practices on corporate governance and related shareholder friendly approaches, encouraging greater disclosures and helping set progress benchmarks.

About the Author

Thor Olsson
Director, Portfolio Manager

- 22 years of investment industry experience
- Joined predecessor in 2000
- BA from La Salle University

ClearBridge Investments
620 Eighth Avenue, New York, NY 10018 | 800 691 6960
ClearBridge.com