ClearBridge
A Franklin Templeton Company

Governance Reforms Power Japan Forward

Key Takeaways

- A new emphasis on corporate governance has helped to revitalize the Japanese equity market by improving corporate profitability and enhancing shareholder engagement and sustainability disclosures.
- These initiatives have begun to change the ways Japanese companies do business as share buybacks, activist engagement and M&A activity — once frowned upon — become more common.
- We believe these catalysts are only the beginning of a movement toward greater profitability and higher valuations for Japanese companies, creating compelling opportunities for long-term value investors.

Governance Revitalizes Japanese Market

International investors are finding new reasons to be excited about Japan, with strong inflows powering both the Japanese Nikkei 225 Index and the Tokyo Stock Price Index to new all-time highs. While there are several catalysts for this rise in Japanese markets, including a weaker yen (beneficial to Japan's export-focused economy) and investors looking for new regional exposures to avoid China's slow economic recovery, one of the most compelling is how Japanese companies are improving their corporate governance. While corporate governance reform has been a decade-long project by regulators and policymakers, the market finally appears to be rewarding Japanese companies for improving their governance models and focusing on greater profitability, better investor relations and more openness to investor activism.

Tokyo Stock Exchange Restructuring Sets the Tone

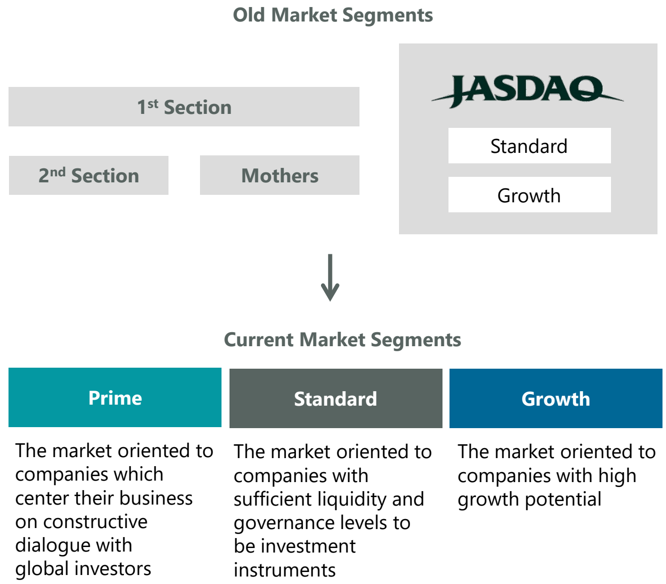
Historically, Japanese companies have faced widespread criticism for their lack of transparency and reluctance to focus on shareholder returns. Much of this is rooted in the collective capitalism that permeates Japanese society, where an unspoken social contract leads corporations to prioritize employee well-being and societal cohesion over pure economic profit. While some may criticize this as inflexible and inefficient, it has allowed the country to endure 30 years of stagnation without significant political unrest or decline in the standard of living.

However, after these decades of economic malaise, with Japanese companies losing share to regional rivals in China and South Korea, the introduction of Prime Minister Shinzo Abe's "Abenomics" in 2013 kicked off a series of programs to implement reforms aimed at improving performance through better governance. While these early initiatives helped to improve investor engagement, increase the number of independent board members and reduce the number of cross-shareholdings held by companies, on a wide, systematic scale these principle-based approaches to improving corporate governance saw only measured success.

More significant, however, was the Tokyo Stock Exchange's 2022 restructuring, which realigned its market into a three-tier exposure (Prime, Standard and Growth). This reclassification, stemming from a need to resolve and simplify Japanese market segments after the TSE's integration with the Osaka Securities Exchange in 2013, was widely touted as a means to help improve the TSE's global competitiveness by ensuring listed companies have sufficient incentives to continue improving their business operations and creating shareholder value, ultimately enticing more capital into the Japanese market. As a result, the TSE was able to implement new and more intensive inclusion criteria for companies wanting to be listed in the highly coveted Prime segment, seen as both a status symbol and a means to attract and recruit top talent and maintain business relationships with clients and financial institutions. This reorganization also marked a drastic shift in the pursuit of improved governance from a principles-based approach to a rules-based approach of more stringent requirements across a range of areas, including financial reporting, disclosure, shareholder rights and board composition.

Beyond market capitalization and liquidity requirements, the biggest change was the call for companies to "take action to implement management that is conscious of cost of capital and stock price."[1] Specifically targeting companies with a price-to-book ratio (PBR) of below 1x, the TSE has required management and the boards of these companies to begin disclosing how they intend to make improvements to metrics such as return of equity, return on invested capital and PBR.

Exhibit 1: The Changing Nature of Tokyo Stock Exchange



As of Jan. 15, 2024. Source: Japan Exchange Group.

The TSE has already begun publishing a list of companies which have submitted improvement plans — in effect rewarding the companies seen as proactive and transparent while calling on laggards to explicitly explain why they are not. As of the latest report in July 2024, 86% of companies in the Prime market segment have provided a business plan to address and improve their capital efficiency, up from 49% in December 2023.

Exhibit 2: Fiscal Transparency is Increasing

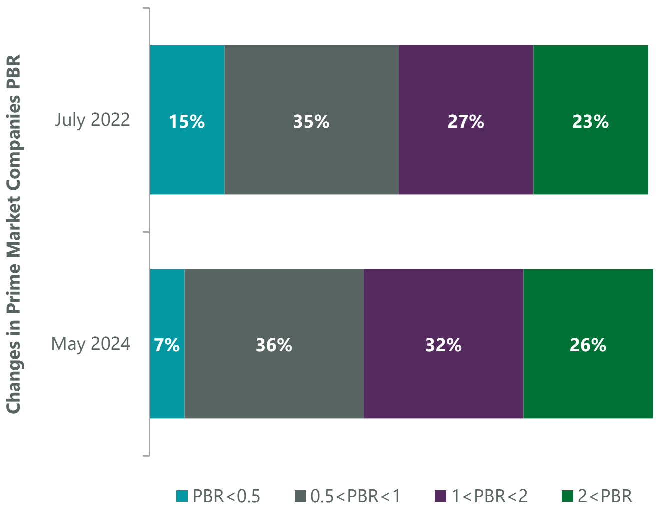
As of July 31, 2024. Source: Japan Exchange Group.

1 "Tokyo Stock Exchange, Inc. (TSE) has published a list of companies that have disclosed information regarding 'action to implement management that is conscious of cost of capital and stock price.'" *Japan Exchange Group*, January 15, 2024.

Improved Governance Shows Early Success

The impact of these changes is already being felt. Between July 2022 and May 2024, the percentage of Prime companies with a PBR below 1x declined by 7%, a measured but encouraging shift during a period of such intensive transition.

Exhibit 3: Japanese Companies Making Fiscal Improvement a Priority



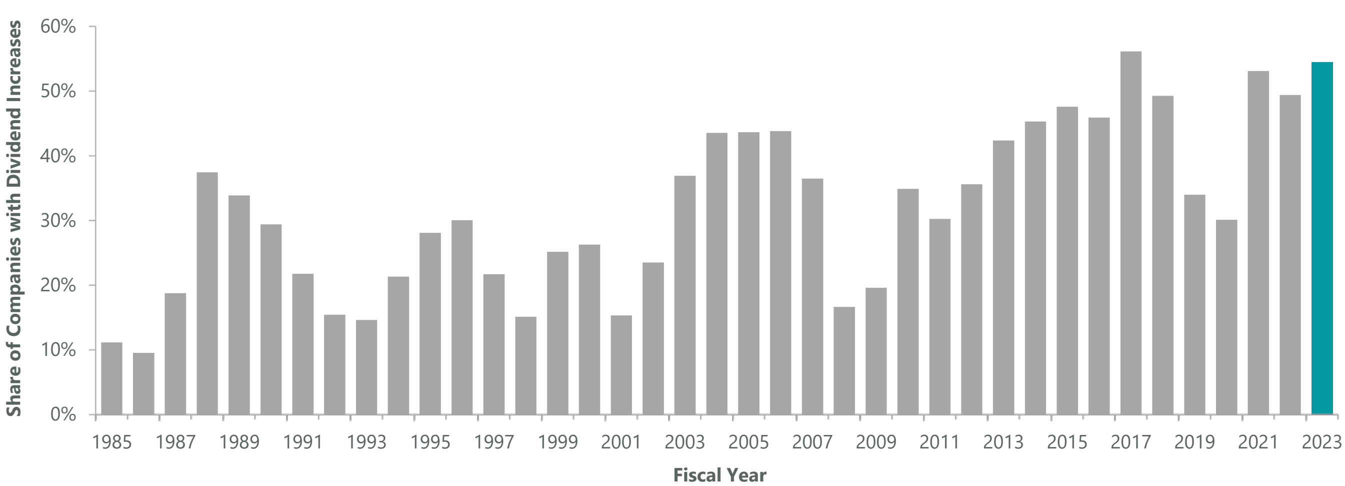
As of May 31, 2024. Source: Japan Exchange Group.

This has also prompted companies to initiate share buybacks and dividend payments to improve their financial metrics and ratios, actions that have historically been perceived as aggressive. For instance, in 2023, Japanese companies collectively bought back approximately ¥960 billion (US$65 billion) worth of stock, setting a new all-time high for the fourth consecutive year in a row. Meanwhile, the number of companies enacting dividend increases in 2023 reached its second-highest level since 1985 (Exhibit 4). This drastic departure from companies' historical practice of holding high cash reserves is closely tied with the new TSE requirements and disclosure practices as companies look for ways to quickly improve shareholder value while they navigate a more systematic transition to improve longer-term profitability.

Moreover, the focus on greater shareholder engagement has led to a boom in investor activism in Japanese companies. Prior generations of Japanese management teams regarded activists as asset-strippers and corporate raiders that needed to be guarded against. Hence corporate Japan developed multiple lines of defense, including cross-shareholdings and poison pills. For years, while investors could see significant value opportunities in the country, most were discouraged due to a lack of means to unlock the value as the society seemingly united against unfriendly foreigners. However, with the recent focus on improving returns, Japanese management seem more open to shareholder engagement. The result has been a dramatic increase in activist interest, with Japan now being the second-largest market for activists globally, with approximately US$318 billion invested year to date, nearly doubling the entire amount invested in 2023.

This increase in investment has also led to a record number of shareholder proposals for the third consecutive year, with a total of 81 shareholder proposals voted on at Japan's top 225 companies during the March 2023 proxy season, up from 63 in 2022. Despite their mixed success, 41 of these resolutions received 10% or more support from shareholders in a sign that these proposals are increasingly being

Exhibit 4: Dividend Increases in Vogue in Japan



As of March 31, 2024. Source: Bank of America, QUICK. Based on listed companies with fiscal years ending in February and March, aggregated number of companies with dividend per share increases on an annual basis.

supported as a means to increase corporate value. And this trend shows little sign of slowing; as of May 2024, 64 companies had already received shareholder proposals, more than half of the entire total of 2023.

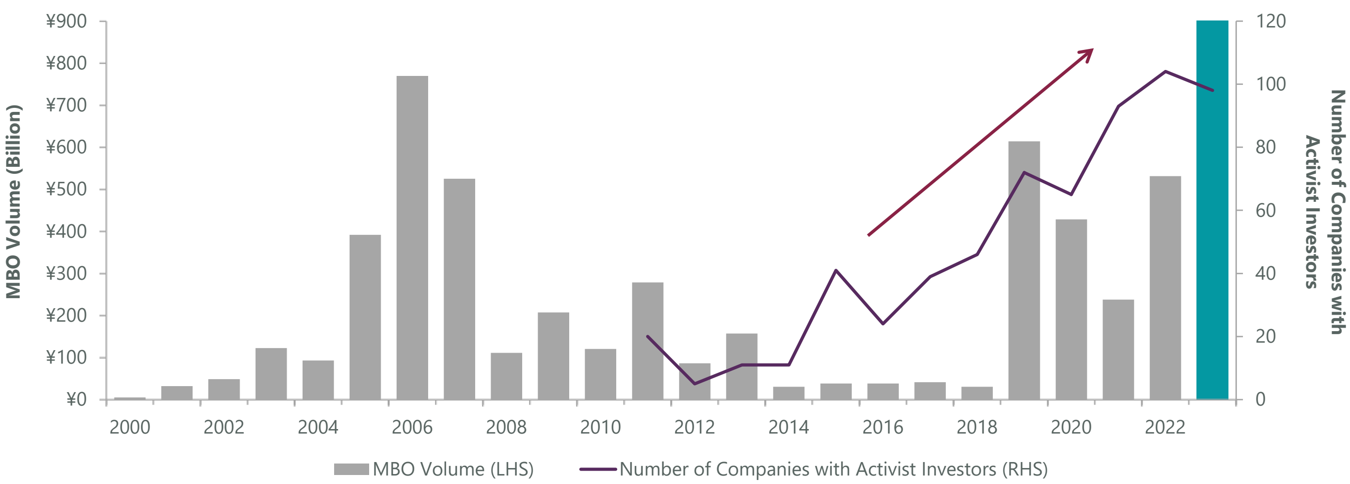
Greater activist investing has also helped spur a wave of companies liquidating cross-shareholdings, or shares held by a publicly traded company owned by another publicly traded company — historically maintained by Japanese companies to support and promote business relationships. However, with the TSE announcing that these shareholdings will no longer be counted as tradable shares for their new market criteria and pressured by activists to divest, companies are taking swift action to reduce them. According to the Nikkei, for fiscal 2023, Japanese companies unwound ¥369 trillion (US$25.6 billion) worth of cross-shareholdings, up 86% from the prior year and a record high since disclosures began in 2019. Notable standouts included some of Japan's largest companies such as Toyota, Hitachi, Mitsubishi Electric and Fujitsu.

This new wave of reforms has also opened the door to a more conducive environment for M&A activity. With pressure from the TSE and activist investors, companies are increasingly focusing on their core business competencies, spinning off weak-performing subsidiaries or divisions while looking for opportunities to consolidate fragmented markets through acquisitions. This, combined with low interest rates and cash-rich balance sheets, has been a boom to dealmaking. According to Bain & Company, Japanese-related M&A reached a total of US$123 billion in 2023, its highest level in four years and accounted for over 20% of Asia's entire transaction volumes — a sharp contrast to the decline in other Asian countries. Additionally, the combination of low-cost capital and rising regulatory requirements and costs has helped to spur a new wave of management buyouts (MBOs), which last year reached their highest level since 2000 (Exhibit 5).

Even the prospect of Japanese companies being acquired by foreign entities, once considered anathema, is seeing new light under these governance reforms. For instance, until recently many Japanese companies retained a "poison pill" defense to deter activist shareholders and potential takeover bids. However, this tradition was abruptly overturned in July 2022 when Japan's Supreme Court ruled that that implementation of such a plan serves to entrench management and challenges shareholders' rights. With the effectiveness of these protections in doubt and a greater emphasis on financial performance, more Japanese companies are entertaining takeover bids, such as the recent offer by Canadian-based retail convenience store operator Alimentation Couche-Tard to acquire Japan's Seven & i Holdings, most known for its flagship 7-Eleven chain of convenience stores, the largest operator in the U.S. convenience retail market with approximately 15% market share. While it remains to be seen whether a deal can be reached, this bid is symbolically important because it shines a spotlight on the undervaluation and underperformance of a good asset. Even if Seven & i's board were to refuse the deal, there would be pressure on management to implement change and create value on its own. Either way, shareholders should benefit.

Ultimately, we believe that these reforms have not only helped to improve investor confidence in both Japanese companies and the Japanese market overall but have also helped invite a new wave of international capital contributing to recent market highs.

Exhibit 5: Market Reforms Fuel MBO Activity



As of Nov. 29, 2023. Source: Bank of America, Bloomberg.

Increasing Emphasis on ESG Integration

Besides the focus on financial improvement, the initiatives to improve corporate governance have also helped to spur greater integration of sustainability and ESG considerations into Japanese companies' long-term plans. In 2021, Japanese policymakers revised the Corporate Governance Code to increase attention to sustainability and environmental, social and governance (ESG) matters.

- Environmental: The revision spells out specific considerations on environmental issues, such as requiring companies to develop and disclose initiatives to promote sustainability based on the Task Force on Climate-Related Financial Disclosures recommendations.
- Social: The revision requires companies to set measurable goals for ensuring diversity in managerial positions by appointing women, non-Japanese people and mid-career hires, as well as disclosing its human resources development policies.
- Governance: The revision set in place specific aims to encourage companies to strengthen their board of directors by appointing more qualified and independent directors; this includes constituting the board with at least one-third of independent, outside directors, establishing a nominating and compensation committee, disclosing a list of each board members' knowledge, experience and skills and having independent directors with managerial experience at other companies.

Governance Improvements Create Value Opportunities

While the early successes of these corporate governance initiatives appear to be paying off broadly, value investors are especially poised to capitalize on these catalysts. Despite the recent rise in the Japanese market, many companies are still trading below their book value, or have a PBR of less than 1x. However, we believe that this provides an ample hunting ground for long-term opportunities, as many of these companies have unlevered and cash-rich balance sheets. This focus on improving companies with low valuations, and especially given that the TSE has stressed that their PBR below 1x is by no means the end goal of its long-term market improvement plans, should naturally prove beneficial to value stocks. Given a new and growing focus on shareholder engagement and fiscal responsibility, we believe that there are significant opportunities for companies to use this period of transition to clarify and improve their core competencies, which should lead to long-term benefits.

Case Study: Hitachi's Governance Turnaround

Electronics conglomerate Hitachi is frequently cited as an example of successful restructuring and governance turnaround in Japan. What is less well appreciated though is the significant amount of time and steps involved in truly restructuring the company. Founded in 1910, Hitachi previously operated a sprawling ecosystem of businesses across industrial, technology and energy sectors, with 22 listed subsidiaries and one of the largest workforces in Japan. However, the company lacked focus in an era when low cost and quick time to market were critical competitive advantages and attempts to reduce costs and complexity were largely ineffective while returns remained low. As a result, when the Global Financial Crisis hit in 2008 Hitachi posted a ¥787 billion loss, the largest ever for a Japanese manufacturer, and was forced to raise capital to shore up its balance sheet. Hitachi's situation was not unlike that of other large Japanese conglomerates at the time, but Hitachi's strategic direction since then illustrates potential for value creation by addressing these shortcomings.

In the wake of the record loss, Hitachi named a new CEO, Takashi Kawamura, who kicked off a significant wave of structural reforms. On the governance side, Hitachi added more independent and non-Japanese directors, which was unique at the time. Today, nine of 12 directors are independent and five are non-Japanese, which is important for a global business that needs such a perspective. On the operational side, Hitachi commenced a transformative portfolio restructuring, selling many of its non-core businesses, which were cyclical and capital intensive. Divestitures over the past decade have included semiconductors, hard disk drive, television and automotive businesses, as well as stakes in listed subsidiaries in construction machinery, semiconductor equipment, chemicals and metals. At the same time, Hitachi has redeployed the capital businesses where it had existing strengths, with notable acquisitions including Ansaldo (rail), ABB Power Grids (energy) and GlobalLogic (IT services).

Today, the company no longer owns shares in any listed subsidiaries and has consolidated its business into three main units where it has competitive advantages. In Digital Services, the company is a leading IT services provider in Japan with a strong customer relationships and high revenue visibility.

Case Study: Hitachi's Governance Turnaround (Continued)

In Green Energy and Mobility, Hitachi's power grid business is benefiting from surging demand from grid modernization activities globally. In Connected Industries, Hitachi aims to be a leader in building systems and industrial products with emphasis on environmentally conscious technologies. And, while sales levels in the most recent fiscal year are just getting back to 2008 levels (due to significant divestitures — US$20 billion in the past five years alone), net profits today total over ¥600 billion.

Hitachi's transformation has been ongoing for 15 years, spanning four different CEOs and requiring navigating through several large macroeconomic shocks — a good illustration of the immense value that can be unlocked through structural reform in Japan, but also a reminder that the process will take time. Even for Hitachi, there is still room to go: gender diversity remains very low throughout all ranks of the company; there are still cross-shareholdings that can be sold; and return on invested capital remains below management targets.

Conclusion

Japan has made significant strides in enhancing its corporate governance practices. Through both government initiatives and new regulations from the TSE, Japanese corporates have been strongly encouraged to improve corporate financial performance, which has invited greater shareholder engagement and entailed improving integration of sustainability issues. As a result, a flood of share buybacks and dividends, greater activist involvement and a surge in M&A activity are revitalizing interest in the Japanese market and propelling it to new all-time highs.

We believe we are still in the early innings of true structural reform in Japan. Sustainably improving financial returns and capital allocation is a long and difficult transformation. Japan is a conservative society that prioritizes social harmony, and thus change will occur at its own pace in a way that is acceptable to its culture. The interesting thing about a consensus-focused culture, however, is that once the tide shifts, the whole country is likely to follow en masse.

Three decades of deflation have created a defensive mindset in Japanese corporations where they prioritized cash, protected jobs and fended off foreign threats. As the country emerges from this defensive posturing, there are many opportunities for value creation through governance improvement that we believe will offer strong sources of portfolio alpha generation.

About the Authors

Grace Su
Managing Director, Portfolio Manager

- 23 years of investment industry experience
- Joined a predecessor firm in 2008
- MBA in Finance from the Wharton School at the University of Pennsylvania
- BS in Business Administration from the Haas School of Business, University of California, Berkeley

Jean Yu, CFA, PhD
Managing Director, Portfolio Manager

- 22 years of investment industry experience
- Joined a predecessor organization in 2002
- MBA in Health Sector Management and Finance from Duke University
- MD from Beijing Medical University

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