

Knocking Down Walls: Making Japanese Companies Responsive to Their Shareholders

Wednesday, February 5, 2020



Hugh Patrick, Howard Smith, Tsuyoshi Maruki, Ken Hokugo, Alicia Ogawa, Tim Laurie

Featured Speakers:

Howard Smith - Portfolio Manager, Japanese Equities, Indus Capital Partners

Tsuyoshi Maruki - President & CEO, Strategic Capital, Inc.

Ken Hokugo '93 - Director, Head of Corporate Governance; Director, Hedge Fund Investments, Pension Fund Association of Japan

Tim Laurie - Investment Analyst, Fir Tree Partners

On Wednesday, February 5, 2020, the Center on Japanese Economy and Business (CJEB) hosted a panel discussion on the impact of activist investors on corporate governance in Japan.

Alicia Ogawa, Director of the Project on Japanese Corporate Governance and Stewardship at CIEB, moderated the event.

Professor Ogawa opened the discussion by highlighting developments in investor activism in Japan. Japan has recently become a top market for investor activism and is deploying more investment in activist strategies than any other country, even the United States. From 2014-18, the number of activist funds increased each year in Japan, due in part to the government's commitment to improving corporate governance and stewardship. Professor



Alicia Ogawa

Ogawa cited lenders' declining influence in protecting their borrowers' management teams and the undervaluation of Japanese companies relative to developed markets as other causes for increased investor activism in Japan. Professor Ogawa further noted that foreign investors now own one-third of the market and account for 70 percent of the turnover on the Japanese stock exchange.

Professor Ogawa then discussed the objectives of activist investors and their strategies to influence corporate governance. Unlike passive investors who monitor share price and adjust their holdings based on the company's stock price performance, activist investors make investments with the purpose of achieving a material change in the company. Professor Ogawa noted that activist investors generally begin by meeting with senior management of the target company and expressing their ideas for improvement. In addition, activist investors engage

with regulators and other key stakeholders to discuss ways to better maximize the value, efficiency, productivity, and innovative capability of the company. Activist investors also interact with shareholders to forge consensus on the target company, subject to a jurisdiction's legal restrictions on these communications. If those strategies prove unsuccessful, Professor Ogawa noted that activist investors would then make their arguments directly with the public through both traditional and online media. Investors may also take a more aggressive approach by voting against management at the annual shareholder meeting or putting their own proposals to the shareholders for a vote.



Howard Smith

Professor Ogawa then introduced the panel and asked Howard Smith, Portfolio Manager for Japanese Equities at Indus Capital, to share his experiences in the Japanese market. Mr. Smith began his remarks by providing the audience with background information on Lixil, a building materials and housing equipment manufacturer in Japan.

Indus Capital, a Lixil shareholder, supported the company's management and shared its long-term strategic vision. Mr. Smith noted, however, that there was a sudden breakdown in corporate governance at Lixil that precipitated a conflict between shareholders and the company's management. Lixil's CEO, Kinya Seto, announced his resignation from the company to the surprise of shareholders. Mr. Smith indicated that it was not a resignation but rather a coup attempt spearheaded by Lixil's Chairman. The board's nomination committee, a

mechanism for hiring and firing top executives, was unable to prevent the Chairman from taking this unilateral action.

Indus Capital wrote a letter to the company's management, asking them to explain the personnel change. Mr. Smith noted that Indus Capital was one of several minority shareholders to express concerns over Mr. Seto's firing. Collectively, the shareholders determined the architects of the coup and later called for an Extraordinary General Meeting (EGM) to remove the Chairman and Chief Operating Officer of Lixil. Lixil's management successfully stymied their attempts, prompting the shareholders to seek a court injunction to host the EGM. Before the shareholders hosted the meeting, Mr. Smith noted that both the Chairman and CEO, acknowledging shareholder dissent to their coup attempt, resigned of their own volition.

At the Annual General Meeting (AGM), shareholders voted on two separate slates of directors. The first slate was proposed by the company's management, and the second slate was proposed by the company's former CEO, Mr. Seto. All 8 candidates on Mr. Seto's slate were voted in by shareholders, along with 6 candidates on the company's slate. Mr. Smith observed that although Lixil's board grew to fourteen directors as a result of the AGM, the vote was a victory for the rights of minority shareholders. Mr. Smith further noted that the significant support for Mr. Seto's slate of directors among large domestic asset managers illustrates Japan's progress on corporate governance and the ability of Japanese institutions to exercise their fiduciary responsibility.

Professor Ogawa then introduced Tsuyoshi Maruki, President and CEO of Strategic Capital Inc. Mr. Maruki began his remarks by discussing Strategic Capital Inc.'s investment in Tosho Printing, a company that offers bookbinding, publishing, and printing services. Despite

Tosho's declining sales and net income, Strategic Capital Inc. deviated from its usual investment strategy to invest in Tosho Printing. Mr. Maruki discussed the impetus for this decision by noting the company's significant cash and cash equivalents on its balance sheet. The parent company, Toppan Printing, held 52 percent of shares outstanding in Tosho Printing. To achieve material changes in Tosho Printing's performance, Strategic Capital Inc. accumulated a position in the company and requested a one-on-

one meeting with both Tosho and its parent Toppan Printing. Although Toppan Printing refused to meet Strategic Capital, during the meeting with Tosho Printing, Strategic Capital proposed that Tosho Printing restructure its business model and use some of its cash reserves to pay



Tsuyoshi Maruki

its shareholders a special dividend. If Toppan and Tosho did not intend to comply with the rules of capitalism, Strategic Capital proposed that Toppan Printing make Tosho Printing its wholly owned subsidiary.

Their campaign to achieve changes in Tosho Printing included four formal proposals at AGMs, newspaper advertisements in Nikkei, and the creation of a website to explain its proposals to the public. Strategic Capital Inc.'s proposals, and efforts to sway public opinion among shareholders, culminated in the parent company's decision to make Tosho Printing a wholly owned subsidiary of Toppan Printing. Mr. Maruki concluded his remarks by noting the

difficulties in achieving this result while recognizing the importance of achieving their objectives given the poor management and corporate governance practiced by the parent company.

Professor Ogawa then introduced Tim Laurie, an Investment Analyst at Fir Tree Partners. Mr. Laurie began by discussing JR Kyushu, a company that operates intercity rail services in Kyushu and conducts business in the retail, hotel, restaurant, and construction industries. JR Kyushu operated as a government-owned railway until 2016 when the government decided to sell a 100 percent stake of the company through an Initial Public Offering. Mr. Laurie then described the company's value proposition, which included robust earnings from its high-quality real estate assets, zero net debt on its balance sheet along with an AA credit rating, and an ability to create value across all sectors of its business.



Tim Laurie

Fir Tree Partners invested in JR Kyushu based on this value proposition and regularly engaged with its management team. Mr. Laurie noted that Fir Tree Partners made several recommendations to management in advance of its AGM to allow the company ample time for implementation. The recommendations included lowering its cost of capital through debt issuance and buying back 10 percent of shares, proposing

three new board members who possessed real estate and investment expertise, and establishing a stock compensation plan to better align management with shareholders. Mr. Laurie noted that the proposals, though unsuccessful, received significant support among

shareholders. The buyback proposal received 35 percent of shareholder approval, and the board member proposals received as much as 42 percent approval. He stated that the company decided after the AGM to buy back 2 percent of shares, issue debt, and increase their dividend payout ratio. Also, despite owning only a 6 percent stake in JR Kyushu, Fir Tree Partners was able to demonstrate an appetite among shareholders for changes to the company and has made JR Kyushu's management more responsive to shareholders' concerns as a result.

Professor Ogawa then introduced Ken Hokugo '93, Director of Corporate Governance and Hedge Fund Investments at the Pension Fund Association of Japan. Mr. Hokugo began his remarks by discussing competing economic indicators in Japan and their relationship to corporate governance. The Nikkei 225 Index has risen in value by more than 100 percent since 2012, but the Price to



Ken Hokugo

Book Ratio for one-third of listed Japanese companies remains below 1. Mr. Hokugo observed that the reason for such low valuation (Nikkei 225 at today's level, despite the fact that it is more than two-fold of what it was in 2012) stems from a lack of effective corporate governance in Japan. Japanese companies have made efforts to comply with Japan's corporate governance code by appointing external directors and establishing nomination committees. Mr. Hokugo commented, however, that most companies do make superficial rather than substantive changes that actually improve corporate governance. He pointed out that companies often

appoint external directors with close ties to the management team, undermining the true independence of these directors while they may appear to be independent based on TSE rules.

One factor that precludes a corporate governance culture thriving in Japan, Mr. Hokugo noted, is the continuing influence of “allegiant” shareholders that support management and are unlikely to support reforms to a company’s governance. While the existence of allegiant shareholders among public companies is well known, Mr. Hokugo stressed that unlisted companies are also a significant source of allegiant shareholdings in publicly traded companies. Mr. Hokugo indicated that allegiant shareholders might comprise up to 40 percent of the total for listed companies on average in terms of the number of shares, not value. He concluded his remarks by acknowledging Japan’s progress, but noted the challenges that persist given unwillingness on the part of many Japanese companies to make fundamental changes to their corporate governance.

Professor Ogawa then asked the panel to define success in investor activism in Japan. Mr. Smith defined success as witnessing a governance structure in a company that is unequivocally attempting to the best of its ability to maximize the value of the company on behalf of its shareholders. For Mr. Maruki, success is both increasing the valuation of a company and enhancing a company’s corporate governance framework. Mr. Laurie stated that success is creating change that increases the long-term value of a company. Professor Ogawa then asked Mr. Hokugo to identify one element of corporate governance in Japan that he would change. Mr. Hokugo noted that he would like to see Japanese equity markets accept “decent” and “quality” activist investors more widely and support regulatory changes that are more conducive to activist investing.

Hugh Patrick, CJEB Chairman, asked Mr. Laurie how an activist investor, who has a strong relationship with a company's management, would respond to an unexpected increase in the stock price. Mr. Laurie noted that Fir Tree Partners would engage the company to determine the reasons for the unexpected increase, and generally makes investment decisions based on the overall upside in the company. Professor Ogawa added that there is a misperception that activist investors are short-term shareholders despite evidence that activist strategies take place over a long-term time horizon.

Professor Ogawa then thanked the panelists for their time and invited the audience to join CJEB for a post-event reception.

