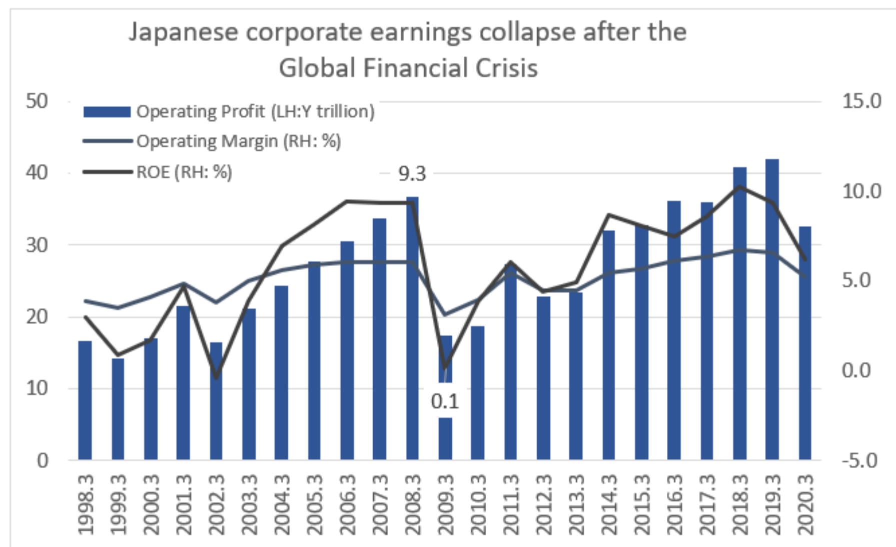
HORIZON KINETICS

JAPAN SPECIAL OPPORTUNITY STRATEGY

Part 3: The Making of a Generational Opportunity

During the 30 years following the collapse of its credit bubble in 1989, Japan spent the first 15 years working on non-performing loans disposals. When the corporate sector finally started recovering, it then suffered the successive effects of the 2008 global financial crisis and the 2011 Great East Japan Earthquake.



Source: Japan Exchange Group

Companies that had historically depended on bank loans for corporate financing had hardly learned to communicate with and utilize the capital markets.

They underinvested and failed to create a more vibrant industrial presence that would be competitive and dominant in the global market. Meanwhile, Japan lost its competitive superiority in many global industries it had once dominated, such as consumer electronics, automobile manufacture, and semiconductors, to global competitors from South Korea, China, and Taiwan. There was a demographic shift, as well. The population peaked at 128 million in 2010, and the population's aging was accelerating. The historical corporate priorities of maintaining employment and nurturing long-term relationships with their banks and business partners, instead of seeking profitability and return on investment, had to change.

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In 2013, to tackle the challenges of declining national power and competitiveness, Prime Minister Abe launched his "Growth Strategy", popularly known as Abenomics. Abenomics called for regulatory reforms aiming to raise corporate productivity and profitability, toward revitalizing the Japanese economy. He stated that this was the critical moment for Japanese businesses to focus on their core competencies through restructuring, so as to bolster earnings power and international competitiveness.

This was also the first time that the government recognized the equity market as an important part of the economy. Abenomics introduced a series of new regulations, legislation, and rules to change the mindset and behavior of Japanese publicly listed companies toward achieving sustainable growth and maximizing corporate value. An essential element was to install a functional capital market to replace the 'main bank' system.

A part of that system were Japanese institutional investors, such as banks, trust banks and insurance companies, which historically had acted as passive investors and which had rarely voted against company managements' proposals, because they had long term business relationships with investee companies, such as managing their insurance policies or corporate retirement accounts.

In 2014, the FSA introduced the Stewardship Code to combat this clear conflict of interest, and made the financial institutions and managements accountable for their investments and voting choices.

Specifically, the Stewardship Code required Japanese institutional investors to start a dialogue with their investee companies on the topics of improving their returns on equity and shareholders' returns. Japanese financial institutions now had to disclose their voting decisions, along with explanations of those decisions, and had become accountable to vote for the benefit of shareholders. They were also required to disclose their own evaluations on how they had fulfilled their responsibilities under the Stewardship Code. As of December 2020, over 290 financial institutions implemented this code[1].

Nippon Life, for example, Japan's largest insurance company, posted detailed reports on its dialogue with investee companies and their voting results on their website. According to their report of the June 2020 round of shareholder meetings, Nippon Life voted against the re-election of directors on 51 out of 271 proposals, or about 19% of those companies about which Nippon Life had significant concerns with respect to earnings performance, shareholder returns, or the quality of independent directors. Japanese financial institutions are no longer passive investors.

[1] *FSA*

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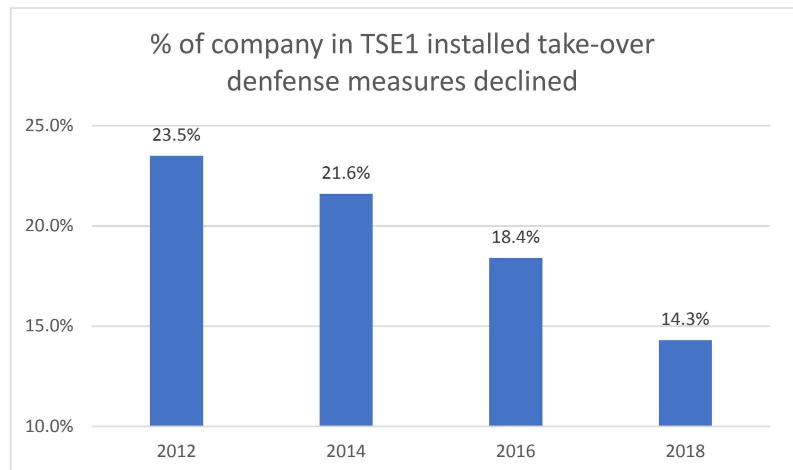
For the June 2018 round of shareholder meetings, Japanese institutional investors voted against 80% of the companies' proposals to reinstall take-over defense measures. The number of companies adopting take-over defense measures declined significantly[2]. This was inconceivable before the Stewardship Code was introduced.



In 2020, Institutional Shareholder Services (ISS) proposed to vote against the election of executives if a company allocates 20% or more of its net assets to cross-shareholdings or if less than one-third of the board is composed of outside directors. Such third-party proposals, which were irrelevant for Japanese institutional investors in the past, are becoming increasingly important. The concept of fiduciary duty has been installed. Consequently, Japanese corporations, previously accustomed to being monitored by their main banks – which were, essentially, insiders – now had to disclose and explain their business strategies, capital allocation decisions and, most importantly, their governance structure to investors.

In 2015, the FSA, in concert with the Tokyo Stock exchange, introduced the Corporate Governance Code. This required Japanese corporations to engage in constructive dialogues with investors and shareholders regarding corporate value and their strategy to improve profitability and capital efficiency. It also required companies to have at least two outside directors, and to explain the status and their future intentions on cross-shareholdings.

The Corporate Governance Code specifically highlighted two aspects of the governance issue on the Parent-Subsidiary listing structure, a custom long embraced in Japan and nearly impossible to dismantle. One is effectiveness of capital allocation and group business strategy, and the second is its potential conflict of interest to the disadvantage of minority shareholders.

As insiders, parent companies have far more information than outside investors, and ways to utilize subsidiaries' assets for their own benefit. Until the 2014 corporate law legislation, a Group's strategic decisions and transactions were rarely disclosed. Under the legislation, group companies were required to disclose their related party transactions, and parent companies' managements could no longer be counted as 'outside' directors of subsidiaries.

This Parent-Subsidiary listing structure was often born out of parent companies giving opportunities for the subsidiaries to be independent and to make efficient decisions. The status of 'public' companies themselves enjoyed exceptional trust in Japanese society; parents were keen to have their sons and daughters work for such 'publicly listed' companies, so as to secure their near-guaranteed income and promotion path for the rest of their working lives. The parent companies

[2] *Tokyo Stock Exchange*

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often used their subsidiaries to transfer their senior employees to high-ranking positions as a fulfilment of the promised titles and salaries.

The Corporate Governance code raised cross-shareholdings as another business custom that had become an obstacle to improved capital efficiency. These regulations required companies to disclose a list of their cross-share ownerships, along with a reason for each holding, an explanation of the legitimacy of those holdings based on their cost of capital, and a statement of their strategy to lower their ownership levels in these investees. Cross-shareholdings and Parent-Child listings were no longer embraced, but were becoming a shortcoming that companies would have to defend in their mandated dialogues with investors.

Every 3 years, the FSA and Tokyo Stock Exchange, along with a working group comprised of asset managers, corporate management, professors and lawyers, review and revise the Stewardship and Corporate Governance codes. They use a 'comply or explain' approach, the practice widely used in European countries, instead of legally binding corporate and institutional investors to follow the rules. This has contributed to the efficient and smooth adoption of new rules and increased transparency by requiring companies to explain when they do not comply.

Five years ago, an attempt to revise corporate laws to mandate that companies have at least one outside director failed due to strong opposition. However, today over 95% of the TSE 1st Section of listed companies (which form the constituents of TOPIX, the Tokyo Stock Price Index), have more than two independent outside directors. The number was just over 21% in 2014. Moreover, close to 60% of them have boards with more than one third independent outside directors, which increased from just 6.4% in 2014. This year, the corporate laws mandating at least one outside corporate director became effective in March. Surprisingly, some Japanese institutional investors now demand a higher standard, stating their voting policy to vote against director elections when outside directors constitute less than one third of director seats.

In 2017, "Group Governance System Guidelines" created by the Ministry of Economy, Trade and Industry (METI) added further pressure to review and reorganize parent-child group listing structures. To incentivize corporate reorganization, METI introduced Tax-Free Spin-Off legislation. This allows companies to separate group subsidiaries that were held for the previously discussed historical reasons rather than for business merit, enabling them to focus on their core competencies without significant tax consequences. METI stated that without their artificial group constraints, independently managed companies would be able to make more efficient business and capital allocation decisions, increasing the corporate values of both the parent and spin-off companies.

In February 2020, perhaps the most substantive and market-impacting change was announced. The Tokyo Stock Exchange revised its listing structure into three major listing categories: Primary, Standard and Growth, where Primary is the most prestigious section and replaces the TSE 1st Section. There are about 2,200 companies on the TSE 1st Section, which is what comprises the TOPIX Index constituents. In order to remain listed in the Primary section, companies will be required to have a minimum publicly traded share float of 35%. The message is clear; no one group of shareholders should own two thirds of the voting power of public companies.

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Here, too, they are required to comply rather than explain the reason for not complying with the corporate governance code, and to maintain an active dialogue with shareholders on shareholder returns and on profitability based on their cost of capital.

Additionally, the TSE set a minimum share-float ratio of 25% in order to be publicly listed at all. A further important change was made to the definition of the publicly traded float: any cross-shareholdings that are under 10% of the total share count are no longer counted as float share, and any strategic investment by financial institutions will also be categorized as non-floating shares. This should further incentivize corporates to unwind cross-shareholdings.

In the Spring of 2021, the FSA is scheduled to announce a revision of the Corporate Governance Code. According to their discussion paper, the key revisions will likely come on the issue of cross-shareholding and the Parent-Child listing structure, requiring further transparency and measures to install the independence of subsidiaries. The Corporate governance code effectively works as a guideline for investors and publicly listed companies. Publicly listed companies are required to disclose and explain their compliance with the Corporate Governance Code. Investors are accountable to assess investee companies' compliance with the governance code and to vote accordingly. The costs and operational burdens for keeping those old structures are rising.

June 2021 has been set as a reference date for the TSE listing reorganization.
January 2022 will be when, following a period during which the TSE will communicate with listed companies on the selection of listing categories, the final decision on the listing category for each company will be announced. Moreover, the TSE will also change the TOPIX Index calculations and membership. New members will be selected only from the Primary listed companies, and those exiting constituents that do not meet certain liquidity requirements will gradually be cut from a weighting in the Index.
April 2022 will be the effective date for this reorganization of listing categories. Companies that are willing to implement measures to meet the new requirements will be granted a one-year adjustment period.

In Japan, the concepts of corporate governance, corporate control, fiduciary duty, maximizing corporate values, and shareholder return that have been the premise of a healthy capital market in the Western world did not exist. The Japanese government, in a graduated but forceful manner, brought them into play and existence in order to end the inefficient systems that ultimately became dysfunctional and a burden that impeded economic recovery and corporate growth.

The TOPIX is only now re-attaining the level at which it peaked in 1989, over 30 years ago, yet the composite book value of those companies has more than doubled.

Corporate leverage has been reduced so dramatically – to a debt-to-EBITDA ratio of just 0.14x, as of February 2020 – that the term leverage doesn't really apply. Really, the Japanese market, at least on a global comparative basis, is underleveraged. Likewise, corporate profit margins and return on equity have improved over the last decade.

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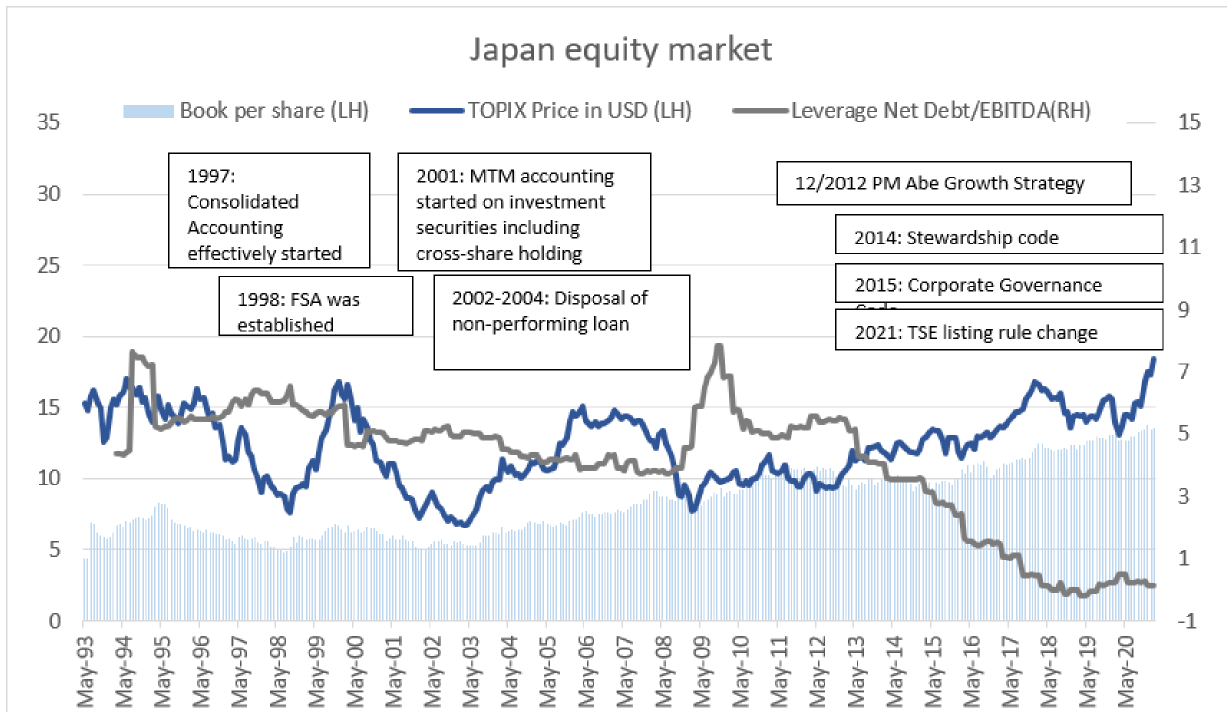

Source: Bloomberg, FSA, METI, Horiozn Kinetics

The presence of foreign investors is becoming more important. Foreign ownership of the Tokyo Exchange market expanded from a mere 4% at the end of 1989, to about 30% today, and foreign investors represent 70% of the exchange trading flow. Corporate restructuring and successful take-over bids by activists are rising and, most importantly, hostile take-overs among Japanese corporations are emerging. Fundamentally and structurally, the Japanese equity market overall is opening up. In the process, it is offering a value investment opportunity that was rarely sought in Japan in the past, since the market overall was considered a "value trap".

That's a description of the overall market. But that is not the topic or interest of this paper or strategy, except insofar as it has enabled this strategy – and the special sub-set of companies that comprise it – to exist.

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