JAPAN'S SHAREHOLDER REVOLUTION

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The recent introduction of shareholder friendly corporate governance reform in the world's third largest equity market could prove to be one of those watershed moments investors always remember.

Since Prime Minister Shinzo Abe shot the first of the "arrows" in his grand Revitalization Strategy (aka "Abenomics") in April 2013, the Japanese stock market has gained more than 25 percent (in US dollar terms).[1] Of course, during the same period the Euro Stoxx 50 Index advanced by a similar percentage and the S&P 500 Index rose more than 40 percent. However, at current valuations, the Nikkei 225 Index is still only about three-quarters of where it was in 2000 and less than half its peak of 1990.[2] Considering its history of market recoveries followed by disappointment, the same question remains: What, if anything, has changed to cause Japan to break out of a range-bound stalemate that has lasted some 20 years?

We think investors may have finally received their answer earlier this year in the form of a series of corporate governance measures that could reshape the entire dynamic of how Japanese companies relate to their shareholders.

Relative to the world's other major developed equity markets, corporate governance has long been a source of tension for those investing in Japan. In contrast to the US and UK, where shareholders' interests come first, Japan's industrial revolution was built on the "multiple stakeholder" model where value is shared with all interested parties, including workers, creditors, public authorities and other corporations. The initiatives now underway suggest an emerging appetite to increase focus on the creation of value for the providers of share capital.

For the first time, each Japanese corporation is encouraged to meet a minimum return on equity target (8 percent) and to have at least two independent directors on its board.

In recent years, we have seen the shareholder dynamic in Japan begin to change, as more Japanese companies initiated dividend hikes and share buybacks to widen their international shareholder base. The drawing up of the Japanese Stewardship Code in early 2014 was an important milestone, ratcheting up pressure on the institutional investor community to "refine their dialogue" with Japanese corporations. Another key development has been the creation of the JPX Nikkei 400, an index composed of companies with capital efficiency and investment-friendly management cultures. Last October, in a sign of how seriously the government planned to throw its weight behind the shareholder-friendly movement, the Government Pension Fund transferred a large block of fixed-income holdings into passively managed equity mandates indexed against the JPX Nikkei 400 Index. Even more controversially, it has also placed money with activist investors.[3]

$0.86 **Lost Decades**
Today's value of 1 USD invested in Japan's stock market in 1990[4]

With the recent finalization of the corporate governance code,[5] however, the government builds on these earlier gains and moves the ball considerably downfield. For the first time, Japanese corporations are encouraged to meet a minimum return on equity (ROE) target (8 percent).[6] New standards of board independence must also be met — the sine qua non of corporate governance — with all publicly traded companies now required to have at least two independent directors.[7] The measures follow a "comply or explain" approach that subjects corporate managers to very public regulatory and shareholder pressure if they fail to meet the standards in a timely manner. Parallel to these actions, International Shareholder Services has announced it will recommend voting for management change in any Japanese company with an ROE of less than 5 percent.[8] It is hard to overstate the impact these recent developments could have on corporate behavior and ultimately shareholder value creation.

QE Meets ROE

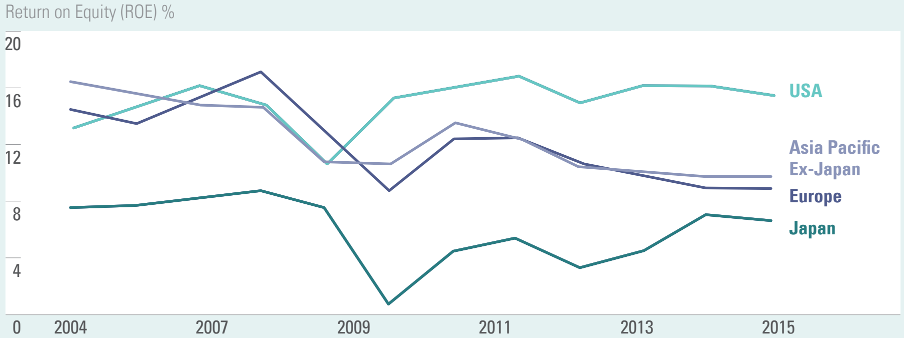
According to the Ito Review, the government-commissioned whitepaper by university professor Kunio Ito, much of what has ailed the Japanese stock markets these past several years can be traced to a failure of managers to embed measures of corporate performance such as ROE into day-to-day financial calculus.[9] As seen in Figure 1, ROE in Japan is far lower than in other developed nations. By our own calculations, only about 50 percent of Japanese companies would meet the 8 percent threshold recommended by the Ito Review.[10]

Conventional wisdom would have it that this is primarily a balance sheet management issue — i.e., more a problem with the denominator, or the "equity," in the net earnings/equity ratio that determines ROE. To examine this, we carry out a classic Dupont composition of ROE, splitting it into its five constituent parts (Figure 2). Profitability, or numerator, metrics are shaded in blue. Balance sheet, or denominator, metrics are shaded in gray.

Interestingly, in our analysis, the denominator metrics for Japan are not glaringly out of sync with international peers. Leverage, represented by assets/equity (row E), reflects the ability of a company to employ debt to fund profit expansion. Just looking at row E, it might seem that leverage in Japan is roughly on a par with levels in the rest of Asia and only modestly below those in the US.

However, if we delve a bit more deeply into the *nature* of the balance sheet, as shown in Figure 3, a somewhat different picture emerges. As we can see, cash and investments — including cross-holdings (where companies own shares in other companies) and separate parent-subsidiary listings — as a percentage of total equity are far higher in Japan than in other markets. This is consistent with our own observations of Japanese management policies. Many Japanese companies are debt-free, with cash earning very little return. Dividend payouts are also much lower in Japan than in other developed markets. In the process, capital tends to get accrued through retained earnings, the balance sheet becomes bloated, and the transmission mechanism of shareholder value creation eventually breaks down.

Figure 1: ROE in Japan, Asia Pacific Ex-Japan, USA and Europe
2004–2015



Source: FactSet, SSGA Fundamental Equities, as of August 24, 2015; ROE is defined as the aggregate of net profit/common equity for all companies in MSCI indices (MSCI USA, MSCI Asia Pacific ex-Japan, MSCI Europe, MSCI Japan) ex-financials.

Past performance is not a guarantee of future results.

Balance Sheet and the Value Creation Dial

So what would be the impact on corporate performance if we eliminated excess cash and cross-holdings through share buybacks, as the new reforms encourage? In Figure 4, we work through this hypothetical exercise. We looked at the data from the 300 companies in the MSCI Japan Index as of March 2015, and considered a scenario whereby each company returns 50 percent of cash and investments on the balance sheet to shareholders through share buybacks (movement from orange dot to blue dot).[11] As excess capital is returned to shareholders and equity shrinks, there

Figure 2: Dupont Decomposition Analysis — Why is Japan's ROE Lower Than Other Nations?

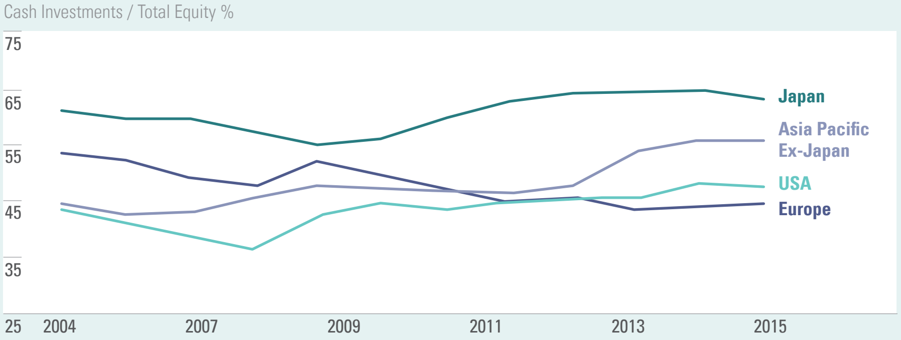
Dupont Decomposition	MSCI Japan		MSCI USA		MSCI Europe		MSCI Asia Pac Ex-Japan	
Metric	**2014/2015**	**10-Year Avg**	**2014/2015**	**10-Year Avg**	**2014/2015**	**10-Year Avg**	**2014/2015**	**10-Year Avg**
(A) Net Profit / Pre-tax Income (Tax) (%)	62	57	70	68	73	68	79	77
(B) Pre-tax Income / EBIT (Interest) (%)	96	91	89	87	77	87	93	97
(C) EBIT / Sales (Margins) (%)	7	6.4	12.7	12.5	9	10.4	8.6	9.7
(D) Sales / Assets (Asset Turns) (%)	73	79	74	78	67	72	71	79
(E) Assets / Equity (Leverage)	2.4	2.6	2.7	2.7	2.9	2.9	2.3	2.2
(F) Return on Equity (ROE) (%)	**7.5**	**6.7**	**15.8**	**15.5**	**9.8**	**12.6**	**10.6**	**12.6**

Source: FactSet, MSCI World, as of August 24, 2015. ROE (F) = A*B*C*D*E. Analysis is based on MSCI Data ex-financials. Data is based on last reported financial year-end of underlying companies in the relevant indices.

ROE = net profit (numerator)/equity (denominator). Profit Metrics Balance Sheet Metrics

Past performance is not a guarantee of future results.

Figure 3: Cash & Investments as Percentage of Equity in Japan, Asia Pacific Ex-Japan, USA and Europe
2004–2015



Source: FactSet, SSGA Fundamental Equities, as of August 24, 2015. ROE is defined as the aggregate (cash + investments/common equity) for all companies in their respective MSCI Indices (MSCI Japan, MSCI Asia Pacific ex-Japan, MSCI USA, MSCI Europe).

are two effects: The market-rating multiple of capital (price/book) and ROE (net income/equity) both increase. This much is to be expected. What’s particularly telling, though, is that the change actually shifts ROE from the left of the critical hurdle rate line recommended by Ito (8 percent) to the right. Insofar as this reflects the minimum return expected by shareholders contributing capital to a company’s operations, this represents a potentially significant shift in the ability of Japanese companies to move the value-per-share creation dial.

Margin Improvement and the Multiple Stakeholder Society

Still, balance sheet shrinkage on its own cannot create sustained, long-term growth. Issuing dividends and share buybacks can certainly move share prices (and, in fact, to some extent may already be “in the price” of the recent Nikkei Index gains), but such announcements can easily be a one-time adjustment. They create the *potential* for longer-term, more sustainable stock price appreciation. For that potential to be realized — for the ROE dots in Figure 4 to shift from blue all the way over to purple — we need to go back to our Dupont decomposition in Figure 2 and focus on the numerator metrics. Higher corporate tax rates (row A) are one issue that stands out. (We should note, however, there has recently been meaningful progress on this front, which we’re likely to see continue as reduced tax rates hit income statements.) Clearly, operating margins are a much bigger issue as they are roughly half of those in the US.

Figure 5 offers another view of operating margins, plotting them against other regions over the last decade. If anything, the pattern is even more apparent. So why are margins so low? Some reasons have to do with structural issues — energy and material costs and labor market inflexibility — beyond companies’ control. But there are also opportunities to enhance cost competitiveness. The Ito Review suggests that one good place to start is management incentive practices. Executive compensation is modest relative to international peers, and even more to the point, notes the report, it is only tentatively aligned with corporate performance.

The Japanese corporate sector is also heavily reliant on bank financing; indeed, in many cases companies list banks among their biggest shareholders. This has created a network of interlocking cross-holdings and board directorships that has largely internalized corporate risk and sealed off corporate Japan from the more demanding providers of capital in the bond and equity markets.

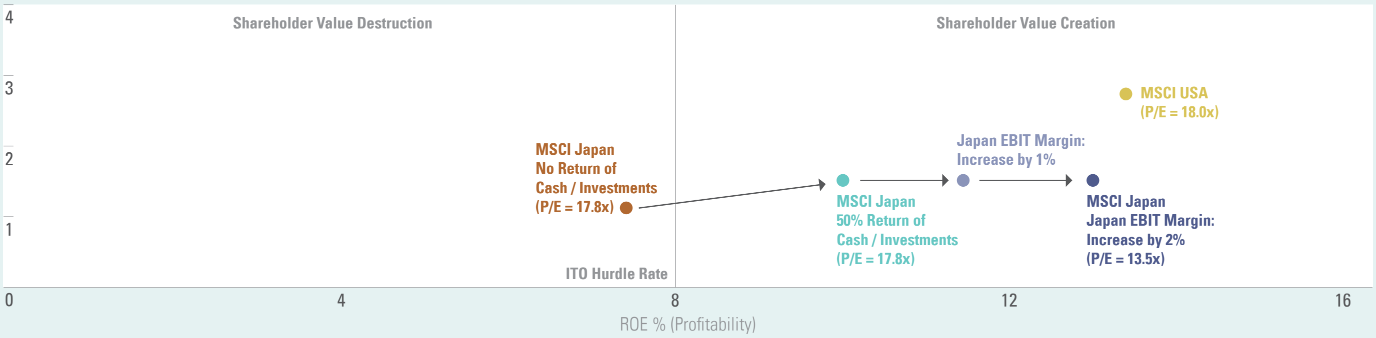
For much of the postwar era, corporate Germany was very much the product of the multi-stakeholder society. Then, in the mid-1990s, Bayer, Hoechst and Daimler Benz broke ranks, and the rest is history.

All of these factors hinder the effectiveness of capital allocation. Changing such practices is nearly always challenging. However, there is precedent to suggest that once critical mass is achieved in the governance arena, the transformation can occur more quickly than one might think.

For much of the postwar era, corporate Germany was very much the product of the multiple stakeholder society. Not unlike Japan, ties between banks, insurance companies and corporations sheltered the corporate sector from the pressure to become more efficient.

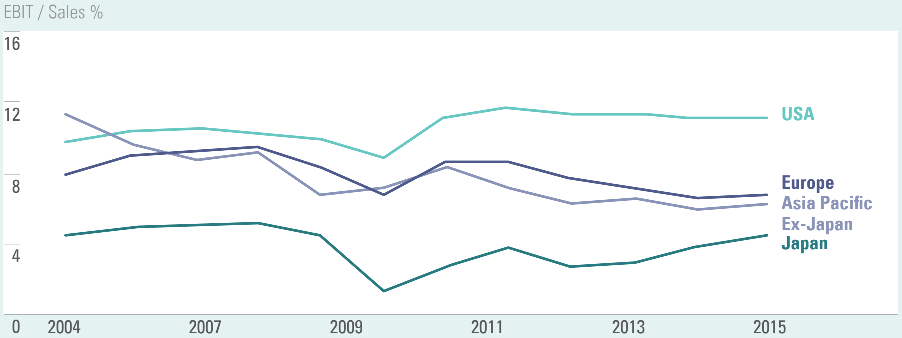
In the mid-1990s, companies such as Bayer, Hoechst, and Daimler Benz broke ranks to embrace the concept of shareholder value creation, and others followed.[12] In response to the improvement in economic returns, the German stock market underwent a dramatic re-rating that lasted until the late 1990s. Even after the bursting of the tech bubble in 2000, earnings

Figure 4: Scenario Analysis — Moving the Value Creation Dial



Source: SSGA, MSCI, FactSet, as of August 24, 2015. P/E is the price to earnings ratio based on actual reported earnings. This hypothetical scenario is for illustrative purposes only.

Figure 5: EBIT Margins in Japan, Asia Pacific Ex-Japan, USA and Europe
2004–2015



Source: FactSet, SSGA Fundamental Equities, as of August 24, 2015. EBIT Margins = EBIT/Sales. MSCI Indices include (MSCI USA, MSCI Europe, MSCI Asia Pacific ex-Japan, MSCI Japan, excluding financials.

power remained double that of the mid-1990s. With some bellwether Japanese corporations already having embraced governance in a public fashion in 2015, the portents for the future are good.

If operating margins were to increase by 2 percent, the price-to-earnings ratio would fall from 15.6x to 11.8.x, almost half the level in the US. Markets wouldn't be able to ignore that.

For illustrative purposes, in Figure 4 we simulate how an increase in Japanese operating margins from today's levels to European levels might further increase Japanese corporate performance. The light purple and dark purple dots simulate a 1 percent and 2 percent rise in Japanese operating margins, respectively. The accompanying boost to economic returns is dramatic, with ROE rising from 9.5 percent to 12.6 percent in the latter case — putting it close to ROE in the US. However, the real story is the change in price to earnings (P/E). If operating margins were to increase by 2 percent (all else being equal), the price to trailing actual earnings ratio would fall from 17.8x to 13.5x, far below the level (18.0x) in the US. It's unlikely the markets would be able to ignore an increase in earnings power as enticing as that. Even if the current Japan stock market valuation is pricing in balance sheet restructuring, clearly it is not pricing in a significant improvement in operating margin. At a time when some major developed markets are still looking rich, the game-changing governance reforms mean there is still a lot to play for in Japan.

The Barbell Approach

In the short time since these reforms have been introduced in Japan, the number of announcements of share buybacks and dividend hikes has increased significantly. The prospect of inclusion in the JPX 400 could be a significant motivation for companies to focus on making those returns to shareholders. Still, we believe a sustained improvement in ROE will demand a new innovation to drive value creation over the long haul. After addressing the low-hanging fruit of capital management, there is further room for improvement in margins through the culling of low-margin businesses. For that to happen, though, all players in the investment chain must buy into value-creation principles. This is Professor Ito's aspiration of an "asset management nation" defined by the "careful management of long-term assets." The early signs are good.

So which Japanese companies will be the greatest beneficiaries of governance reform? On the State Street Global Advisors Fundamental Equity team, we are tackling the opportunity by taking a "barbell" approach. We think companies with a dominant market share, strong franchise, a significant international shareholder base, but low ROE, have the potential to fare well. Also, firms with productive core businesses where ROE is diluted by clearly identifiable, underperforming, non-core businesses may be of interest. On the other end of the barbell are companies starting from a very low ROE base that might take the opportunity to adapt to the new principles. Firms with an ROE close to zero might very well produce the most dramatic changes.

As value investors, we seek to invest where we see good upside potential, and corporate governance reform in Japan could crystallize such opportunities. We also recognize the risk that execution could fall short of the most optimistic expectations. As Germany showed in the mid-1990s, if enough corporations embrace the new governance culture others will undoubtedly follow. Even if US-style shareholder-centricity is a bridge too far, German-style shareholder-sensitivity is potentially within reach. Ultimately, we believe Japan's use of governance as an instrument of economic policy could prove even more impactful for its stock market than Abenomics' broader strokes. At the very least, the latest reform creates a much more fertile environment for active investors.

[1] Bloomberg, as of August 17, 2015.

[2] Bloomberg, as of August 17, 2015.

[3] Bloomberg, May 20, 2014.

[4] Bloomberg, July 31, 1990–July 31, 2015.

[5] Ito Review of Competitiveness and Incentives for Sustainable Growth — Building Favorable Relationships between Companies and Investors. Final Report, August 2014.

[6] Japan's Corporate Governance Code [Final Proposal]: Seeking Sustainable Corporate Growth and Increased Corporate Value over the Mid- to Long-Term (March 2015). Council of Experts, FSA, Tokyo Stock Exchange.

[7] Companies Act, originally published in June 2014.

[8] If no improvement is evident over the preceding five years.

[9] The Industry Competitiveness Enhancement Act of December 2013 was passed to promote restructuring of long-term low-profitability companies.

[10] SSGA FE, Factset as at August 2015.

[11] FactSet, as of August 24, 2015.

[12] Beyer, Jurgen, and Hoppner, Martin, "The Disintegration of Organised Capitalism: German Corporate Governance in the 1990s," 2003.

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