



UNION BANCAIRE PRIVÉE

WHITE PAPER

Does improving governance in Japan matter? | June 2020

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Executive Summary

- The launch of the Corporate Governance Code in 2015 could be a real, long-term game changer for Japan, as historically poor corporate governance has been considered a key reason for local companies' low ROE and global investors' underweights.
- Improvements in governance have not happened uniformly across all companies, which has resulted in large differences in governance structures between companies, with some leaders and many laggards.
- The return differences are large and persistent. The market has not recognised these return differences and the valuations of companies generally does not yet differ between companies with good and bad governance.
- It is important to identify the long-lasting criteria and metrics that are essential to consider during this transformative period for Japan.

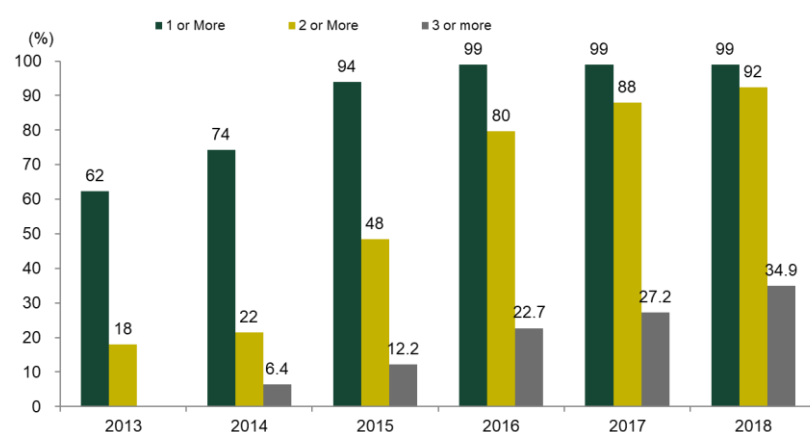
2015: a game-changing year

Before the introduction of the Corporate Governance Code in 2015, most companies in Japan looked the same in terms of their **board structures**:

- The majority had either one or two outside directors, who were often not independent;
- Only a small minority of companies had any meaningful presence of independent directors before 2014;
- Very few companies had board committees and almost none had stock incentive plans.

What came first was a sharp increase in the number of independent directors, although the increase was not across the board. As can be seen in the chart below: while a majority of companies quickly followed the requirement to have at least two independent directors, there were still many companies that were slow to comply. On the flip side, there was a significant number of companies that quickly exceeded the minimum requirements.

Percentage of TOPIX 500 companies with independent directors



Source: Tokyo Stock Exchange (2019)

During the last five years, we have seen a remarkable increase in the use of committees for:

- Nominations
- Compensation
- Auditing

With continued small increases in their adoption over the years, the use of committees has increased and now nearly three-quarters of companies in the TOPIX 500 use them. Moreover, these are generally properly constituted committees, i.e. being both chaired by outside directors and with majority of members being external directors. Thus, **outside influence** on boards has increased sharply, which is to the benefit of minority shareholders.

Today, more than two-thirds of the largest 500 companies in Japan have some form of stock-based compensation plan. Thus, **shareholder alignment** should also improve significantly as these stock compensation plans are put in place. More importantly, looking at board governance structures was not an important factor for stock selection because there were few meaningful differences. However, this situation has changed dramatically over the past five years.

We have seen structural transformations at many companies, so that in 2020 it has become possible to differentiate companies based on their board governance structures.

Now that the 2015 Corporate Governance Code requires companies to have at least two independent directors, with a recommended level of 33% of directors, the concept of oversight by outside directors has gradually started to emerge.

We believe that the need to explain business strategies and management decisions to outsiders and to take outside opinions into consideration should improve governance and performance.

Though the weightings of cross-shareholdings have been declining since the 1990s, around 30% of all shares of listed Japanese companies are still held by **allegiant shareholders**. This provides significant protection to the management of many companies.

The revision of the Corporate Governance Code in 2018 specifically addresses the issue of cross-shareholdings and should accelerate the unwind. Companies not protected by allegiant shareholders tend to outperform.

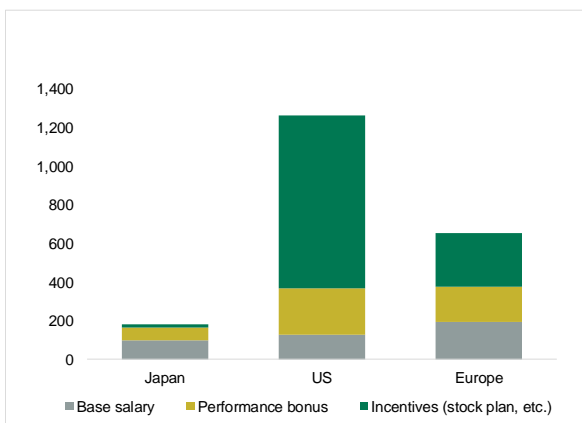
Team up with the best

The dispersion in the board structures of Japanese companies is wide and often badly explained. Naturally, some companies have good board structures that meet international best practices while others are entrenched, insider-dominated, old-fashioned businesses. Looking closely at these structures gives investors a window into the management mindset and whether a company will engage with and listen to shareholders, or simply ignore them.

Proactive companies with a positive attitude towards governance reform can be identified as those companies that empower their independent directors and give them clear responsibilities, for example by putting them in charge of the audit, nomination and compensation committees. Laggards, i.e. obstructive companies, can be identified by their entrenched boards and the minimal influence and power of independent directors.

The introduction and greater use of stock- and incentive-based remuneration systems is one of the most important areas for governance reforms. However, the compensation structure in Japan is starting to change with the introduction of stock-based incentive plans. We believe management behaviour should change as their interests start to align with shareholders' interests.

Median CEO remuneration in 2018 (JPY million)



Source(s): Pay Governance, HKP Group. US data is for S&P 500 companies, FY 2018; Europe data is for 71 STOXX Europe and EURO STOXX 50 companies, FY 2018; Japan data is for TOPIX Core 100 companies based on results up to the fiscal year ended March 2019. Exchange rates are averages for the year as at end-2018.

Conclusion

When contemplating the adoption of new corporate governance policies, we can classify companies into three groups:

- Early adopters of new governance structures who try to achieve best practice;
- Reactive companies who will follow the rules set by the government and usually also the precedents set by proactive companies;
- Obstructive, slow reformers that avoid adopting new governance structures unless forced to do so.

We have found that, over time, the differences between boards' governance structures among proactive, reactive and obstructive companies are becoming larger. The widening gap comes from proactive companies becoming much better, reactive companies showing moderate improvement and obstructive companies refusing to change and improve their governance structures. Intuitively we would expect to find that companies with better governance structures would demonstrate better performance metrics than companies with poor governance structures. Our understanding of Japanese corporate governance reforms confirms this is indeed the case and that this trend will last for a long time. Furthermore, our analysis shows that widening governance differences are resulting in greater performance-metric dispersion. This implies that it is increasingly important that investors pay attention to board governance structures in their stock selection process, not only in the foreseeable future, but also over the coming decades.

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