Investor activism

Leading critic of Japan Inc puts funds on alert

Hokugo to stress dangers of cross-holdings and 'allegiants' hidden in registers

Deeply ingrained support systems, often in the form of cross-shareholdings, are holding back reform of Japan's corporate culture, says a prominent pension fund director © AP

Leo Lewis in Tokyo YESTERDAY

One of Japan's most outspoken advocates of better corporate governance will arrive in London this week to alert some of the world's biggest funds to the dangers hidden on Japan's shareholder registers.

He is hardly the first to sound the alarm but Ken Hokugo's mission carries unusual weight, coming from a senior director of Japan's Pension Fund Association — a pillar of the establishment that manages more than $120bn in assets on behalf of company employees.

Mr Hokugo, who delivered a similar talk to US investors last month, is in London to foment foreign pressure on Japanese companies to abandon their networks of cross-held shares and their "allegiant" shareholders — companies, banks and insurers they do business with, are linked to by history or have assembled precisely to protect management from any awkward minority shareholder resolutions. At least 35-40 per cent of all the shares of all listed Japanese companies are held by allegiant shareholders — "close to the level of some emerging markets", he warned.

If the cross-holdings and allegiant support systems remain in place, progress on governance reform and better returns on equity will hit a wall of culture, habit and protectionism, Mr Hokugo said.

After several months of negotiations with business interests and other lobbies, the country's Financial Services Agency published its revisions to the 2015 corporate governance code this month. Sections that were watered down or scrapped since the FSA's original proposal included one that would have pushed boards to increase the minimum number of independent directors beyond two.

But what survived were principles demanding that signatories to the code disclose the policy behind maintaining their holdings in other companies. Critically, it added that when companies do signal their intention to sell, the management of the stock they are selling cannot "imply possible reduction of business transactions". But even now analysts and investors suspect it lacks the teeth to succeed on its own.

Japanese companies are cash rich

% of non-financial stocks that have net-cash balances

Source: CLSA
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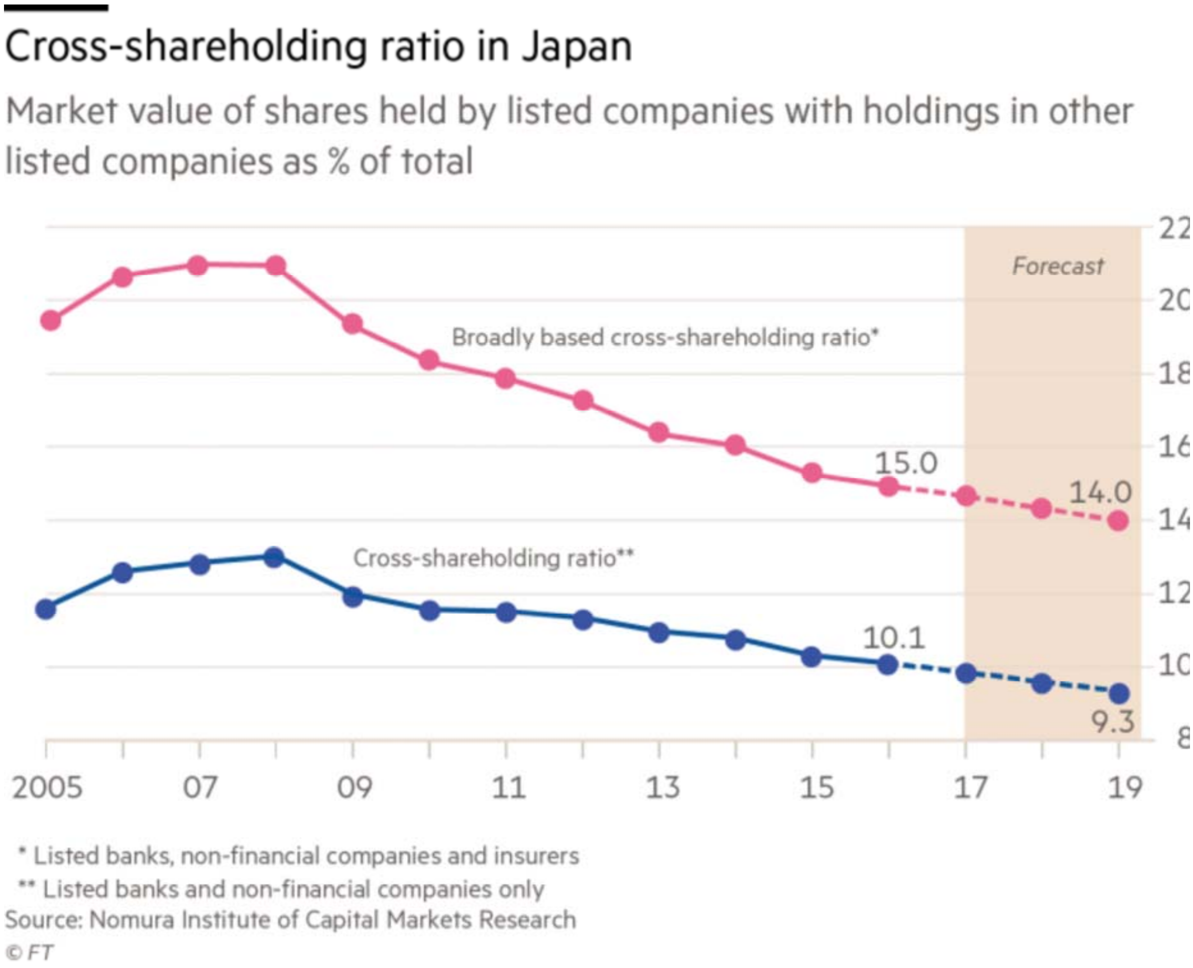
That problem — and its likely persistence in the face of the new code — was illustrated recently when Japanese media reported on the way in which acquisition financing had been parcelled out between major banks as Takeda Pharmaceutical assembled its £46bn bid for Shire. An unnamed executive from Mizuho, which was not included in the line-up of banks, told reporters it had been left out as a direct consequence of its earlier decision to sell down its stake in Takeda.

[Allegiants] nullify the fundamental function of a sound stock market and nullify the market's function of efficiently allocating capital or labour force

Ken Hokugo, Japan's Pension Fund Association

Activists who have battled with corporate Japan and its maintenance of cross-held shares have also encountered these realities and can see that the incentives to maintain allegiant shareholding lists remain strong. Zuhair Khan, a strategist with Jefferies, warned that the situation remains severe. According to his calculations, a third of companies in the Topix500 index have more than 50 per cent of their shares held by allegiant shareholders, and a further third have between 33 per cent and 50 per cent of their shares held by friendly banks, insurers and other corporates.

"The distribution of allegiant shareholding means that hard activism when shareholders are trying to get resolutions passed that require two-thirds support are only likely to have some hope of success at one-third of [Japanese] companies," said Mr Khan. He applied this logic to a high-profile skirmish that pits the UK-based fund Asset Value Investors against one of Japan's biggest media groups, Tokyo Broadcasting System.



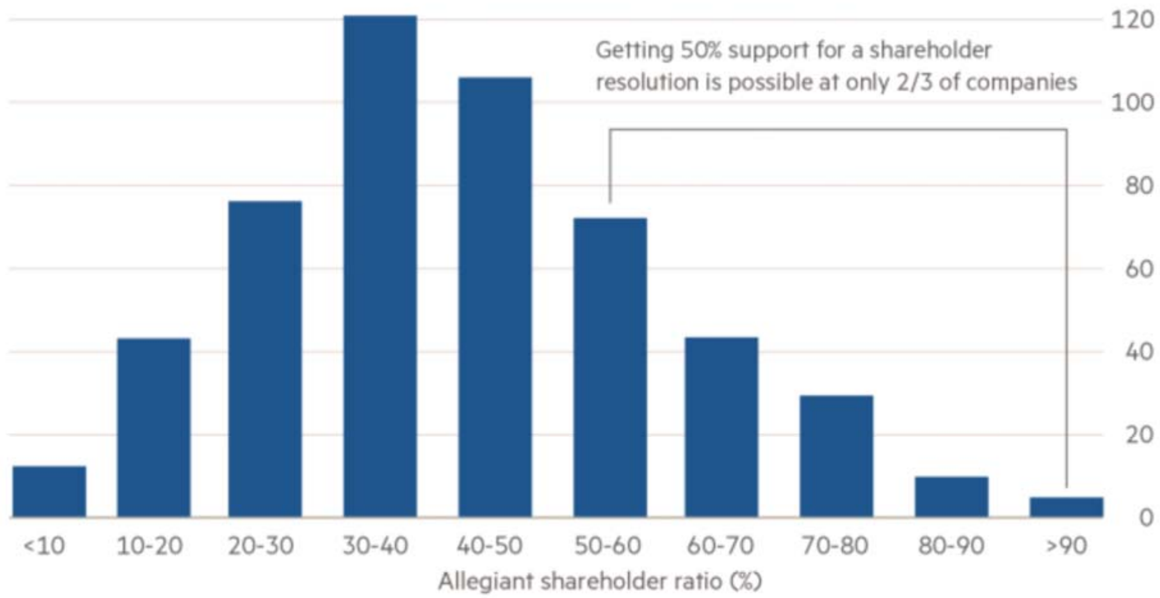
AVI is the latest in a line of foreign funds to mount an explicit challenge to Japanese companies sitting on unjustifiable value that should be returned to shareholders. TBS has a particularly eye-catching catalogue of cross-shareholdings and inefficient deployment of capital — about 75 per cent of its assets are not related to its media business. AVI's proposal, on which TBS investors will vote this month, calls on the broadcaster to sell 40 per cent of its particularly hard-to-explain holding in the chipmaker Tokyo Electron.

Other campaigns led by the activist likes of Elliott, Silchester and Oasis have, at their core, the assertion that Japanese managements are cavalier with the interests of minority shareholders and have been allowed to get away with that stance by stuffing their shareholder registers with sources of guaranteed support. In the case of TBS, allegiant shareholders are estimated by Jefferies and others to account for 80 per cent of the shareholder register.

Mr Hokugo's cautionary tour of investors also mounts the counter-argument to recent signals of progress. He was expressly sceptical of a long-running research series produced by analysts at Nomura which, in June 2017, declared that the cross-shareholding ratios (shares held by companies in other companies excluding insurers) had fallen below 10 per cent for the first time. That presents a picture of progress that ignores the continuing influence of the allegiant shareholders, he said.

Allegiant shareholder ratio in Japan

Holdings by companies, banks and insurers



Source: Jefferies
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The effects of the allegiants "nullify the fundamental function of a sound stock market, and nullify the market's function of efficiently allocating capital or labour force", according to Mr Hokugo.

Other Japan analysts have reached the same conclusions, with CLSA strategist Nicholas Smith noting that despite the post-2015 governance drive, the ratio of companies hoarding cash is rising: some 56 per cent of non-financial companies in the Topix are net cash, against 20 per cent in the US and Europe. ROE, he adds, may be rising but at a slower pace than net profit margins.

The first page of Mr Hokugo's presentation — attempting to set the tone for Japan's season of annual shareholder meetings that begins this week — bluntly demands that "the leash must be kept tight" on Japan Inc.

Allegiants underlie Takeda confidence

As Christophe Weber, the chief executive of Takeda Pharmaceutical, met with US investors last week, he was brimming with confidence that he would win the requisite two-thirds shareholder approval to close the Japanese

So confident was Mr Weber that he declared that “Shire will be approved by shareholders” in a recent interview with Bloomberg, triggering a statement later to clarify that the shareholders would be given the opportunity to vote on the offer.

Analysts said Mr Weber’s bold assertion was partly a reflection of the presence of allegiant shareholders. Large institutional investors based in Japan rarely challenge the company management and this deal is likely to be no different.

The votes of these large domestic investors are also expected to silence the noise from a group of shareholders including several founding family members of Takeda, who have hired a former UBS analyst to try to derail the planned takeover of the Irish rare diseases specialist.

The dissidents, who previously opposed Mr Weber’s appointment as Takeda’s first non-Japanese president in 2014, hold just over 1 per cent of Takeda’s stock, giving them little direct power to overturn the Shire deal.

While Mr Weber admitted that founding family voices can hold “moral weight”, he downplayed the group’s influence: “They have a different view from the company direction for a long time even before I joined the company. In my understanding, they do not represent the family although they are part of the family.”

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