Japan's Return-on-Equity Revolution

By Seth Fischer

Could corporate Japan soon shake its reputation for inefficient balance sheets that hurt productivity and trip up investors? It may be hard to believe, but there's reason for optimism.

The government of Prime Minister Shinzo Abe—re-elected with a new mandate last month—is increasingly driving corporate efficiency by focusing on the metric that counts most: return on equity (ROE), or how much profit companies generate on shareholders' capital. In Japan the nail that sticks up gets hammered down, and with ROE Mr. Abe has picked the right nail.

Shinzo Abe's reforms are empowering shareholders and spurring profits.

Consider the new JPX-Nikkei 400 stock index, which started trading in late November. To be included in the index, companies need to rank in the top 400 on the Tokyo Stock Exchange according to ROE (accounting for 40% of the ranking), operating profit (also 40%) and market cap (20%). Japan's massive Government Pension Investment Fund, which manages more than $1 trillion, recently doubled its investment in Japanese stocks to 25% and benchmarked itself to the new index, moving away from the Nikkei 225. To stay competitive, other pension funds and insurers will follow.

Press reports last year detailed how the president of Amada, a manufacturer with a market cap of $3.3 billion, didn't like being left off the new JPX-Nikkei 400. So the company announced that it would pay out all of its net income in dividends and share buybacks to improve its ROE to 7% and earn a spot in the index. The next day, Amada stock rose 30%.

Last year also saw the groundbreaking announcement by Institutional Shareholder Services—advisor to 90% of institutional investors—that it would recommend voting against corporate management at any Japanese firm with average ROE under 5% over the past five years. That might be a low hurdle in the U.S., where the average ROE on the S&P 500 is 20%, but more than half of companies on Japan's Topix index have returned even less than a nickel per dollar of investment during the past five years.

Then there's the company law, passed in June, requiring firms to have at least one outside director by April 1. Some 24% of large-cap firms on the Tokyo Stock Exchange don't have any outside directors today, and 40% have only one. The financial regulatory authority and the Tokyo Stock Exchange, meanwhile, have jointly called on companies to have at least two outside directors, plus a majority of outsiders on their audit committees. For failing to meet any of these standards, companies must explain their noncompliance, a red flag few would risk waving.

Japan's historically passive and friendly shareholder environment is hardening. Since the establishment of the Japanese Financial Services Agency's "Stewardship Code" in February 2014, more than 160 Japanese and foreign institutional investors (including my firm) have pledged to dictate their proxy votes with the goal of enhancing medium- and long-term investment return by improving corporate value. Which is a far cry from Toyota Chairman Hiroshi Okuda's famous 2001 statement that to run Japanese companies primarily in the interests of shareholders would be irresponsible. Come proxy season this June, watch out.


Reuters

ABE'S RETURN The third arrow of Abenomics looks to drive corporate efficiency by emphasizing profits on shareholder capital.

For two years the Abe government's economic-reform record has been mixed at best, with many observers frustrated by minimal progress on free trade, labor liberalization and more. But on corporate reform, and especially the imperative to increase ROE, there has been a visible sense of crisis among Japanese leaders.

"A longer-term issue confronting Japan is how it will maintain and grow its national wealth given its shrinking population," said the August final report of an influential commission, led by Tokyo University Professor Takatoshi Ito, advising the Government Pension Fund. "This issue can only be solved by companies enhancing their earning power and delivering sustained value creation, which will drive returns on long-term investments and result in the overall optimization of the economy's 'investment chain.' "

The Ito commission recommended that Japanese firms target a minimum of 8% ROE—still a long way from the 20% average of the S&P 500 and the 16% average of Bloomberg's European 500, but 50% higher than the 4.6% average of Japan's Topix index as of last summer. (The Topix average today has climbed to near 8.5%, but that is due to yen depreciation more than enhanced corporate value.)

Low ROE results from low profit margins, excess cash and assets, or both. The easier problem to solve is excess cash and assets, as illustrated by Amada's dividend payments and share buybacks. Other companies will likely follow suit in the months to come.

Investors rarely had success pushing for such payouts from Japanese companies in the past, but the Abe government's reform push is yielding more constructive shareholder engagement. As Amada's finance chief, Tsutomu Isobe, said last year of initially being excluded from the new JPX-Nikkei 400 index: "I wasn't too surprised when I heard we hadn't made it because I knew how low our ROE was, but our president was a little shocked." He added: "We've had lots of requests from foreign investors for one-to-one meetings in Japan since our announcement. It's pretty much doubled from last year."

So the much-maligned "third arrow" of Prime Minister Abe's economic agenda is actually shaping up to be an ROE revolution. That's good news for Japan and for investors world-wide.

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