

# The Japan Update

## July 2014

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### Momentum Builds for Companies to Enhance Their Earning Power

– Introduction of Stewardship Code and Launch of JPX-Nikkei Index 400 –

The plan to lower Japan's corporate tax rate as part of the government's growth strategies is attracting a great deal of attention from the markets, but equally important is the government's initiative to strengthen corporate governance and to change how company managers think about governance. Especially since companies will be able to keep more of their earnings after the corporate tax rate is decreased, rather than just using that money to top up already abundant cash reserves, the government aims to promote more efficient use of these funds, particularly in ways that would enhance companies' earning power.

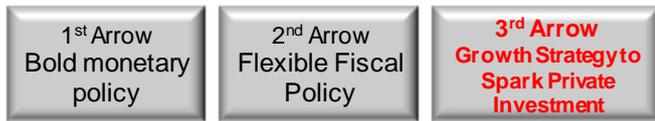
Given the common practice of cross-shareholding in Japan and the lack of independent external directors, the improvement of corporate governance has been an ongoing theme for Japanese firms that have so far fallen far behind their overseas peers in this area. Japan has therefore recently introduced a Stewardship Code with the goal of encouraging domestic institutional investors, who have long remained "silent shareholders", to more actively participate in improving the management of the companies they invest in through constructive dialogues with them and/or exercising voting rights. Japan's Government Pension Investment Fund, which is the world's largest pension fund and whose every move draws the close scrutiny of the market, has announced its acceptance of the Code, as have many other institutional investors. Considering the potential to further boost the intrinsic value of listed companies and therefore shareholder returns, this development has attracted a lot of attention, particularly among overseas investors.

The JPX-Nikkei Index 400, a new stock price index, was also launched at the start of this year. As part of its stock selection criteria, the JPX-Nikkei 400 incorporates return on equity, an indicator of how efficiently shareholder investment capital is being used. It is hoped that as companies aim for inclusion in the index, they will become more aware of capital efficiency which will in turn provide a boost to initiatives aimed at improving corporate governance. As momentum builds for companies to improve their earning power and companies begin to more actively use their cash reserves (e.g. on capital expenditures, operational restructuring, M&As or shareholder returns), we may see the emergence of a virtuous cycle where growing earnings will give companies even more capital to re-invest. From a macro perspective, it is hoped that this will result in sustained economic growth and ultimately push up stock prices.



## Strengthening Corporate Governance

The “Three Arrows” of Abenomics



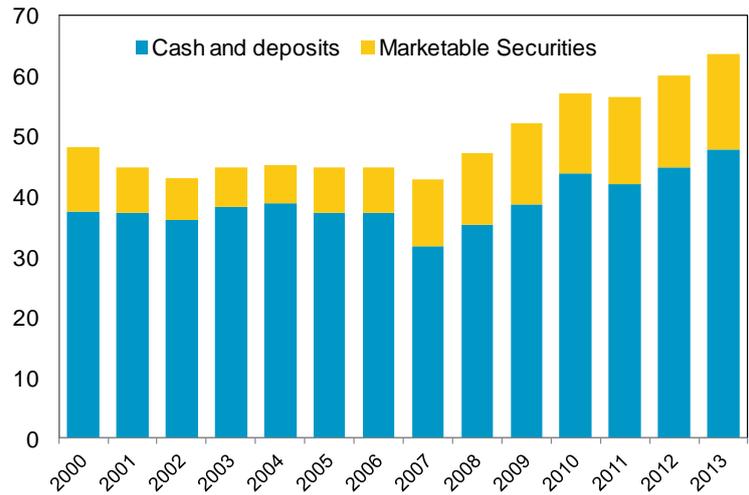
**Stresses importance of strengthening corporate governance with the aim of enhancing companies' earning power**

- Initiatives aimed at strengthening corporate governance
- Establishment of Stewardship Code:** Guidelines to encourage institutional investors to actively contribute to the sustained growth of the companies they invest in.
  - Launch of JPX-Nikkei Index 400:** Establishment of an index comprised of stocks selected for profitability and quality of management.

Source: Nikko AM; “Japan Revitalization Strategy”, Office of the Prime Minister.

## Expectations for More Active Use of Corporate Cash Reserves

Companies' Cash and Deposits (FY2000 – FY2013)



\*Firms in all industries, excluding finance and insurance, with more than ¥1 billion (approx. US\$ 9.8 million) in capital.

Source: Nikko AM; “Financial Statements Statistics of Corporations by Industry”, Ministry of Finance.

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