The Japan Update

23 June 2015

Taking Advantage of Japan’s Corporate Governance Reforms

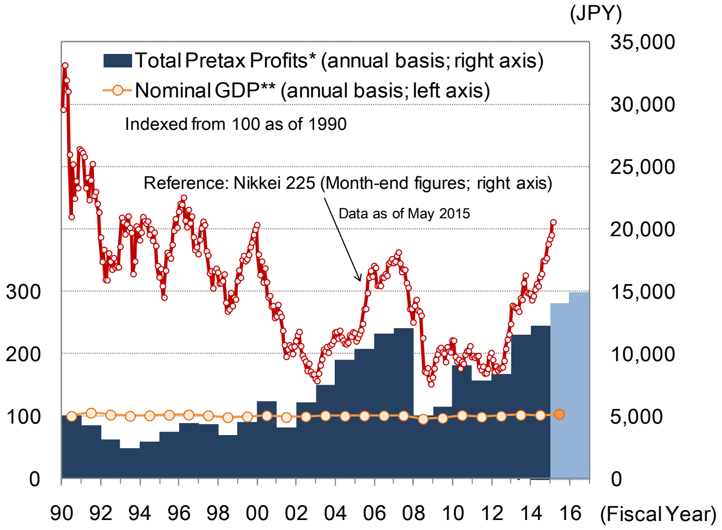
Japan’s nominal GDP, commonly used to gauge a country’s real standard of living, has remained mostly unchanged since the 1990s following the collapse of Japan’s asset price bubble and the onset of deflation. But even given the difficult low-growth environment, companies have on the whole been able to exhibit a capacity to generate earnings, with firms listed on the TSE First Section (excluding financial institutions) recording their highest pretax profits in seven years in fiscal year 2014, while further profit growth is expected over the next two years (see graph on below left).

The administration of Prime Minister Shinzo Abe, which has placed a great deal of importance on companies’ ability to generate earnings, determined that it needed to establish a virtuous economic cycle through encouraging firms to make more effective use of their accumulated capital. With this in mind, it made corporate governance reform a centerpiece of its economic policy and has since launched initiatives, such as Japan’s Stewardship Code in 2014, to promote oversight by institutional investors of the companies they invest in. It subsequently introduced Japan’s Corporate Governance Code, which came into effect in June 2015, in order to encourage the corporate management of companies to consider the perspective of third parties, including that of their shareholders. Such initiatives have created a positive tension between investors and the firms they invest in, leading to expectations of improved ROE and better returns as companies increase capital expenditures aimed at achieving growth and as they expand shareholder returns through share buybacks and dividends hikes.

As a reflection of these trends, a Japanese daily newspaper published an article on 2 June heralding the advent of a “governance-driven market”, while on the same day a major U.S. financial daily released an editorial titled “Abe Topples Japan Inc.” The latter expressed the view that that while corporate Japan has traditionally resisted change, thanks to the government’s introduction of Japan’s Corporate Governance Code, companies in Japan are now enthusiastically embracing change. Expectations for governance reforms also appear to be very high among foreign investors, and capital flows into Japan from overseas have helped boost the Nikkei 225 over the JPY20,000 mark and propel it on 12-day winning streak through the beginning of June. However, whether or not such expectations are met will depend on domestic investors. Many Japanese investors, including retail investors, are rediscovering Japanese equities as an appealing asset class and are not afraid to make demands of companies in their role as shareholders. If investors and company management can work together to raise enterprise values, corporate reforms will result in even larger benefits for both companies and shareholders.

Ordinary Profits of TSE First Section Firms (excluding financial institutions)

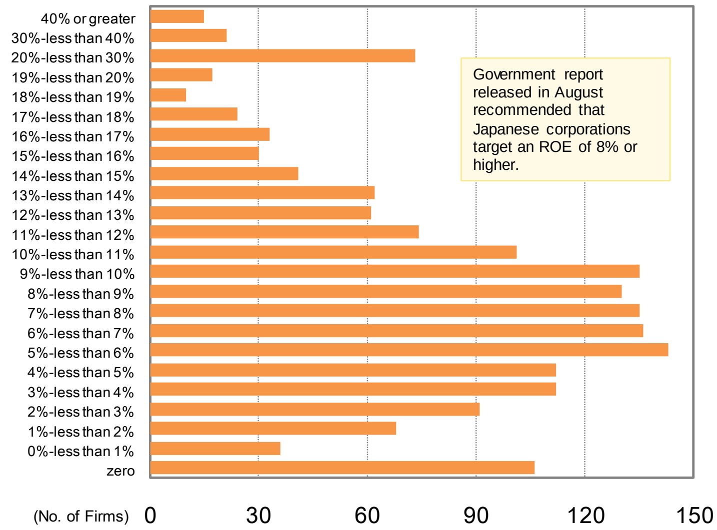
(FY1990 – FY2016 (forecast))



Sources: Tokyo Stock Exchange, Inc., Nikko AM
Ordinary profit forecast: Nikko AM;
Nominal GDP Forecast: Japan Government

TSE First Section Firms Broken Down by ROE Level (excluding financial institutions)

(Recent annual earnings up until FY2014)



Sources: Tokyo Stock Exchange, Inc., Nikko AM

The graphs above are based on past data and do not guarantee future outcomes.

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