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Mixing it up?

Shareholder activism, corporate governance and the outlook for M&A in Japan

An Economist Intelligence Unit white paper

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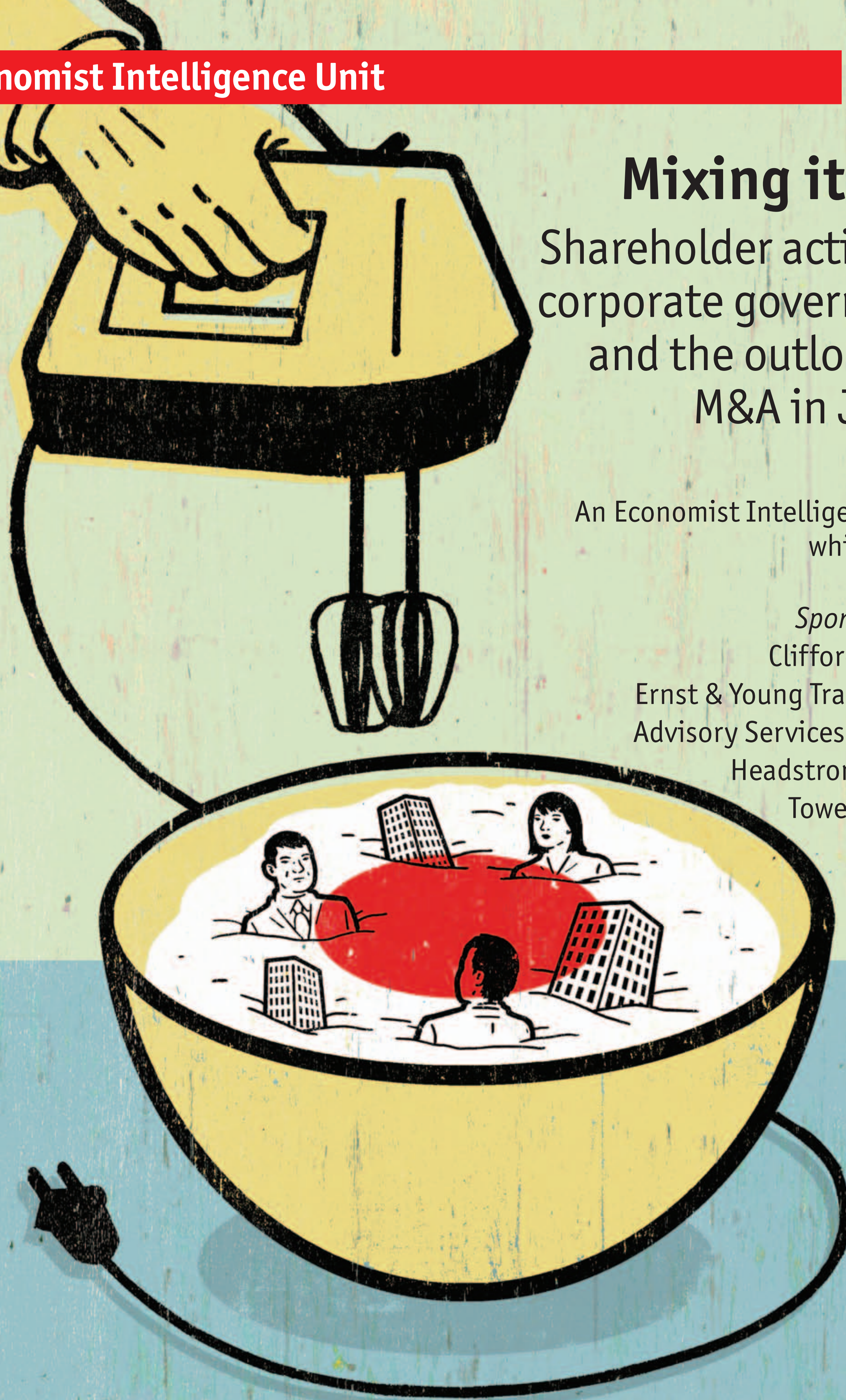

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Preface

This report is based on in-depth interviews with numerous senior executives, experts and officials involved in corporate transactions in Japan. In order to encourage candour among interviewees, in certain cases we agreed not to disclose their identity. The views expressed herein are solely those of the interviewees, where attributed, or the Economist Intelligence Unit, and in no way reflect the opinions of the sponsors.

Interviews were conducted face-to-face in May and early June 2008, in English and Japanese, by the author, Miki Tanikawa. The report was written in English and translated into Japanese. The report was edited by David Line of the Economist Intelligence Unit; the Japanese translation was edited by Takato Mori. Gaddi Tam was responsible for design and layout. The cover was designed by Dan Page.

About the author

Miki Tanikawa is a Tokyo-based financial journalist. Over the past decade he has produced nearly 600 feature articles on business, finance, real estate and asset management in Japan. His journalism career includes a stint as business news reporter for the *New York Times*, contributions to *BusinessWeek* and *Time* magazine, and a regular column for the *International Herald Tribune*. Drawing on his journalistic experience and a graduate degree from the Fletcher School of Law and Diplomacy at Tufts University, he also teaches business, international relations and journalism at various Japanese universities, including Sophia University in Tokyo.

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Executive summary

Recent battles by activist investment funds for tighter control of Japanese companies have led to serious questions about Japan's investment environment, both for activist shareholders and strategic investors. First, Steel Partners, a US fund, was labelled an "abusive acquirer" by the Japanese Supreme Court when it took Bull-Dog Sauce, a Japanese condiment maker, to court over the "poison pill" defence the company had used in mid-2007 to ward off Steel's hostile takeover bid. Then, in April 2008, the government blocked a proposal by TCI, a UK fund, to increase its stake in J-Power, an energy provider, on the grounds of national security. These cases, plus a new wave of defensiveness on the part of poorly performing Japanese companies, have led foreign governments and business bodies to lambast Japan's attitude to foreign investment. In turn, the corporate establishment in Japan has closed ranks, accusing activist investors of greedy short-termism.

This report, the latest in the Economist Intelligence Unit's series of annual surveys of the M&A and investment environment in Japan, examines the furore surrounding these recent battles and assesses the background to these views and the development of Japan's corporate governance and investment environment in a broader context. It is sponsored by Clifford Chance, Ernst & Young Transaction Advisory Services, Headstrong Japan and Towers Perrin. Some of the report's key findings are as follows:

- **Japan has not taken a step back, but nor is it opening rapidly.** The rising numbers of "poison pill" takeover defences (now in place at over 500 listed firms in Japan) and growing levels of cross-shareholdings give the impression that Japan has taken a major step back in its attitude towards foreign investment. However, given reforms in the past 10 years to commercial law, regulations and guidelines concerning M&A (such as the approval in 2007 of triangular mergers for foreign acquirers) the broader picture is more of steady, if slow, progress. Moreover, although investor pressure has historically had a limited effect on management, some shareholders are learning to work within the constraints of Japan's corporate environment to maximise the value of their investments.

- **A perception gap prevents fruitful dialogue between shareholders and managers.** Many outside investors view Japanese management as a self-protecting, self-governing group with no external accountability, and with concomitant disregard for the interests of shareholders. Japanese management, for its part, sees activist-type investors as greedy and short-sighted and intent on taking quick profits by making opportunistic demands of management. Recent acrimonious battles have underlined this perception, but the reality is less stark: managers in Japan do often feel social responsibilities to the company's other stakeholders, and operate according to these responsibilities, which means shareholder value is often further down the list of managers' priorities than in other developed economies. However, some investors are beginning to find ways to persuade managers that their interests and those of the

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shareholders are ultimately aligned. "I believe people expect much more than financial performance from corporations," says Atsushi Saito, president of the Tokyo Stock Exchange, "...although I would not deny that the bottom line is to make profits."

- **An aggressive approach is probably ill-advised.** The approach of some activist investors has been inimical to candid discussions with management about raising corporate value. "Once you get into an 'us-vs-them' type of struggle, there is no way out," says one interviewee. "I don't see room for a no-holds-barred type of investor violence," says Mr Saito. Funds that have taken a more constructive approach—such as Ichigo Asset Management, Carlyle and Atlantic Investment—have made good inroads into improving management performance. Moreover, managers recognise the benefits that external expertise can provide. "[The investors] don't say things like 'We are going to educate the management' publicly," says Hiroaki Niihara, director of METI's corporate affairs division, "But in reality they do educate the management in a more subtle manner."

- **Shareholders' concerns are being taken more seriously.** In some cases, foreign activist investors have won battles against management— in May 2008, for example, Steel Partners rallied other shareholders to defeat the proposed reappointment of seven directors of Aderans, a maker of hairpieces. But there is also domestic pressure for reform. Pension-fund managers recognise the need to get higher returns from their investments, and the government is promoting the slogan "From savings to investments" as a means to help solve Japan's dire fiscal problems. "Taking good care of minority shareholders and Japan's aging pensioners is very much in keeping with Japan's values," says Scott Callon of Ichigo.

- **There are signs that corporate governance is improving.** Recognising that the likelihood of a hostile takeover is actually quite small, some firms have opted to drop their takeover defences, including Shiseido, a leading producer of cosmetics, and Nissen, a mail-order company. This has been part of a larger debate about the importance of good corporate governance in creating a strong and successful enterprise. In Nissen's case this includes appointing independent outside directors. Some companies are realising the best protection against being acquired (whether by an activist financial buyer or a strategic rival) is good management and efficient use of shareholders' money.

- **Investors remain at the mercy of major legal gaps.** Most market players agree that some problems need instant resolution to reinforce shareholder protection. Companies' ability to issue shares to third parties is a major problem—allowing poorly performing managers to dilute the holdings of activist shareholders at will. Many believe that short of legislation on the matter, the TSE must issue stricter regulations to counter this, although it seems reluctant to do so. "The exchange has a responsibility to ensure fair and healthy formation of share prices according to the *Kinsho-ho* [Financial Products Trading Law] and not regulating it violates that responsibility," says Tatsuo Uemura, a law professor at Waseda University.

In conclusion, despite the acrimony of recent battles, most participants see that there is increasing scope for shareholders and managers to work more closely in Japan to raise corporate value. In addition, it is important not to see this as a matter of Japan vs foreign investors; given the country's fiscal and demographic problems it is crucial for domestic investors to realise greater returns from their assets. Nevertheless, activist investors will be constrained for the time being by the fact that Japanese managers often feel a variety of social obligations on top of their financial ones. There are also significant cultural differences (which strategic acquirers have long had to acknowledge in their M&A transactions). In turn, Japan is slowly recognising the benefit of placing shareholders nearer their rightful place at the summit of corporate priorities.

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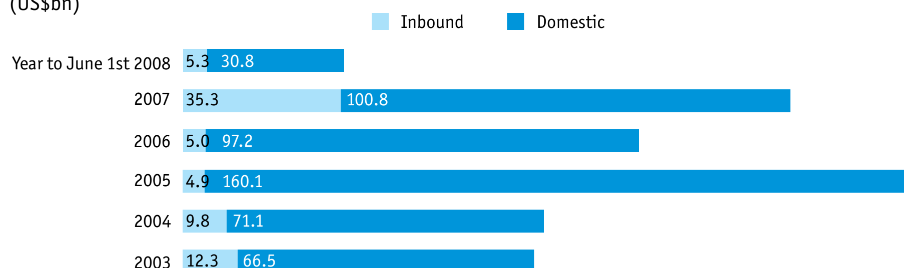
Introduction

June is a tense period for managers at Japanese listed firms, as most hold their annual shareholders' meetings in this month. A large proportion are held on a single day, traditionally as a way of minimising the impact of *sokaiya*, corporate blackmailers who used to disrupt the meetings to extort money from company bosses. This year many companies fear disruption of a different sort, given the recent furore surrounding foreign activist shareholders. The reaction of corporate Japan to recent bids by investment funds from the US and the UK to increase their control over Japanese companies has been shrill, and the rejection of these bids (in one instance by the target company's "poison pill" defence, later upheld by the Supreme Court, and in the other by the government) has led many foreign investors to question whether Japan is becoming ever more closed to outside investment.

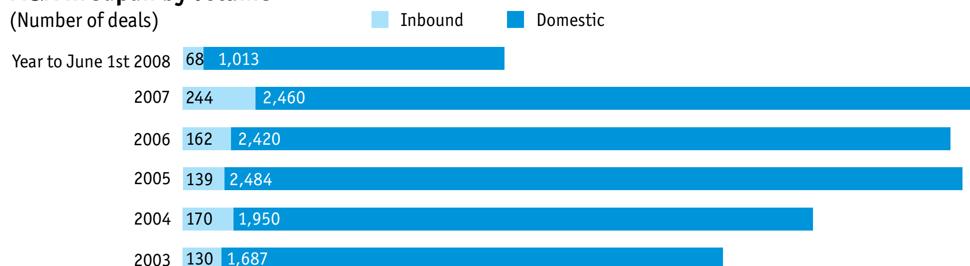
This report, the latest in the Economist Intelligence Unit's annual series of white papers on the state of Japan's M&A environment, examines whether this contention is valid. No-one would deny that for portfolio and strategic investors alike—foreign and domestic—Japan is a challenging market, and many obstacles may prevent the realisation of expected returns on investment. Certainly, standards of corporate governance are a long way from matching those routinely expected of companies operating in the US or Europe. The system of stakeholder capitalism that prioritises employees and customers ahead of shareholders (and rewards management for longevity rather than corporate performance) is alive and well, despite recent reforms.

Nevertheless, reforms have been made. As one interviewee for this report notes, 20 years ago the concept of M&A was "impossible" in Japan. Since then, as Japanese companies have been forced to streamline and restructure, the volume of domestic and cross-border M&A has risen steadily, totalling 2,460 domestic deals and 244 inbound deals in 2007, according to data from Thomson Reuters. (This compares to 2,354 domestic and 1,087 inbound deals in the UK in 2007.) Legal and regulatory reforms have been passed making it easier for companies to spin off subsidiaries, and for foreign investors to acquire them. Yet, to the frustration of many investors, the wishes of shareholders remain a long way down the list of

M&A in Japan by value
(US$bn)



Source: Thomson Reuters



priorities for many managers. Listed companies appear to be getting more defensive, putting takeover defences in place and raising the levels of cross-shareholdings among allied (and sometimes non-allied) firms.

These frustrations are summed up in a recent paper by the Asian Corporate Governance Association[1], which lambasts Japan's corporate governance and calls into question the basis of shareholder capitalism in the country. With over a quarter of Japanese shares being owned by non-resident investors (including the seven funds that support the ACGA's paper) Japan can hardly ignore their complaints. Yet the common reaction in Japan's business community has been one of shock at the recent attack on its priorities, and defensiveness about the unique responsibilities of Japanese management.

Looking past the rhetoric on both sides, this report assesses the situation from a neutral perspective, examining the points of view of Japanese and foreign shareholders, M&A practitioners and managers at Japanese companies. The first section assesses whether Japan's investment environment has indeed taken a step back in recent months. The second section looks at the tensions between Japanese management and activist shareholders, and how shareholder pressure may work constructively (or not) to influence managers' corporate strategy. The third section assesses what progress is being made towards prioritising shareholders' interests, and what problems investors and M&A practitioners believe must be addressed in order for them to realise the maximum potential returns on their investments in Japan.

[1] *White Paper on Corporate Governance in Japan*, Asian Corporate Governance Association, May 15th 2008. Available at http://www.acga-asia.org/public/files/ACGA_Japan_White_Paper_FINAL_May15_2008_English.pdf

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1. A step back?

A new "Dejima mindset"?

Japan appears to be under siege. The nation's listed companies have been called outdated and their managers inward-looking and xenophobic. This view is exemplified best by the comments of the EU trade commissioner, Peter Mandelson, who in a recent speech referred to the return of the "Dejima mindset", referring to an island off Nagasaki to which Dutch traders were confined—barring closely controlled excursions—until the mid-19th century.[2]

This view has not come out of thin air. Japanese managers' exclusive and clubby attitude has been highlighted by a recent public parade of failed investment bids, in particular the attempt by Steel Partners, a US investment fund, to acquire Bull-Dog Sauce, a condiment manufacturer, and the attempt by The Children's Investment Fund (TCI) of the UK to acquire a larger stake in a publicly owned utility company, J-Power. In mid-2007 Bull-Dog rejected Steel's hostile advance and diluted its stake in the company by issuing extra stock to other shareholders, and only cash to Steel. This defence was upheld by the Japanese courts, which—to the incredulity of many investors—declared the US fund an "abusive acquirer". In April 2008 the government blocked TCI's bid to raise its stake in J-Power from 9.9% to 20% on grounds of national security, reinforcing the impression that activist foreign investors are not welcome in Japan.

Bolstering the opinion of foreign investors that Japan is reverting to being a closed economy, listed Japanese companies, alarmed at the prospect of possible hostile acquisition attempts, have moved to hold greater numbers of shares in each other, reversing a decade-long trend in which cross-shareholdings were unwound (cross-shareholdings hit an estimated 50% of all outstanding shares in the 1980s but were at around 11% in 2007, according to a *Nikkei* estimate.) They have also instituted extensive defence mechanisms to ward off potential buyers, in many cases offering financial incentives to hostile suitors to dissuade their advances. Indeed, by mid-May 2008 some 500 listed companies in Japan, around 15% of the total, had installed such defences. And 200 plan to submit resolutions to adopt takeover defences at their shareholders meetings in June (underway as this report went to press). Critics have said that this defensiveness has led many existing and potential foreign investors to give up on Japan, leaving shares in publicly traded Japanese companies floundering. By early June the Nikkei 225 index had lost around 25% of its value in 12 months, while the valuations of around 30% percent of companies listed on the first section of the Tokyo Stock Exchange were below book value. Foreign investors were net sellers of Japanese stocks in six of the 12 months to March 2008 (although they returned in April-May, reflecting market weakness elsewhere).

Those who agree with Mr Mandelson's contention that Japan has indeed returned to the "Dejima mindset" insist that Japanese companies

[2] "Unfinished Globalisation: Investment and the EU-Japan relationship"; speech by Peter Mandelson, Tokyo, April 21st 2008, available at http://ec.europa.eu/commission_barroso/mandelson/speeches_articles/sppm201_en.htm

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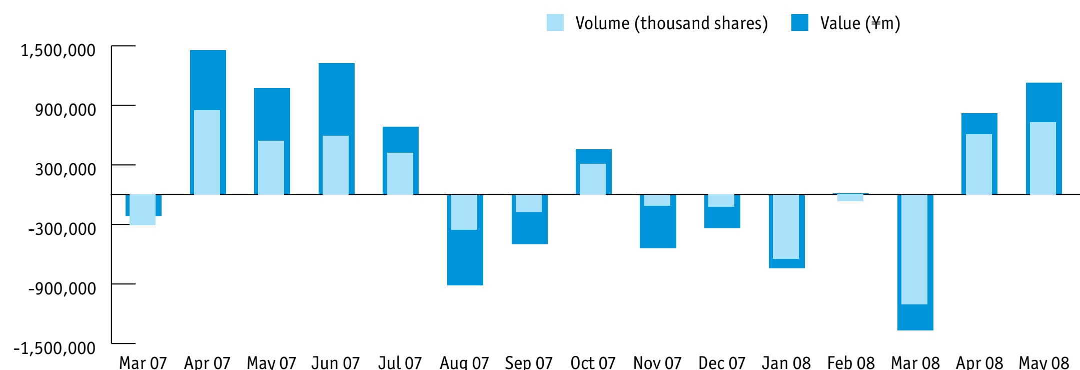
Net monthly balance of investments in listed Japanese stocks by non-residential investors



Source: Tokyo Stock Exchange

have backwards and outdated management and inadequate corporate governance standards. The time has come, it is asserted, for Japan to adopt a system that is more consistent with the globally accepted management principles that recognise shareholders as the primary stakeholders to whom management is accountable. With markets becoming increasingly globalised and corporate standards converging around the world, this is no time to revert back to Japanese-style stakeholder capitalism.

Slow progress

Does this picture, so often depicted in the media in recent months, fairly represent the state of affairs in corporate Japan? Established domestic investors and financiers suggest that the criticism is perhaps too harsh, given progress on reforming Japan's investment environment over the past 10 years. "The way in which [Western investors] view Japan is often emotion-driven, and their perspectives are therefore superficial and boom-oriented," contends Taku Yamamoto, chief fund manager at Japan's Pension Fund Association (PFA), the country's largest private-sector retirement fund manager, which controls ¥13trn (US$125bn) in Japanese pension assets. The PFA is hardly a silent investor: it has recently begun voting against the re-election of directors at firms in which the PFA invests should their return on equity fall below 8% for three consecutive years (the average for listed firms in Japan is around 10%).

Mr Yamamoto feels there is an element of herd mentality about external perceptions of Japanese corporate health. He notes that global investors were extremely cautious about Japan in the late 1990s, during the crisis in its financial sector. "Then along came Yoshiaki Murakami and suddenly foreign investors decided that Japan was a place with golden opportunities," he says, referring to one of Japan's most notorious activist investors, who rose to prominence in the early years of the current decade. When the performance of Japanese corporations failed to meet their expectations, investors "swung to argue that Japanese managers were to blame and that there was something wrong with the system here," he says.

Mr Yamamoto and others suggest that the fuss generated over cases like Bull-Dog and J-Power obscures a more nuanced transition in Japan's

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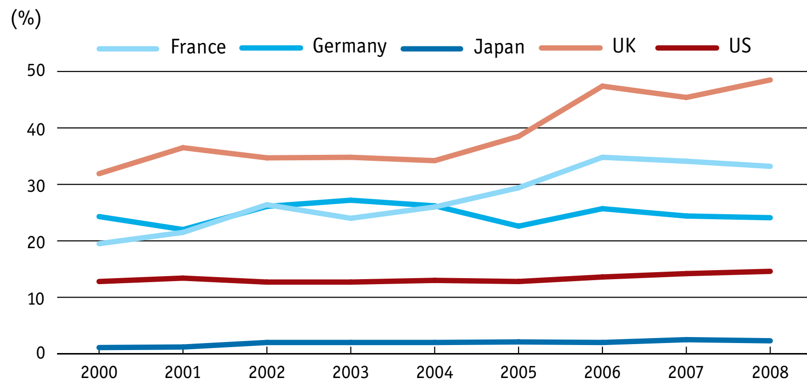
management style, corporate governance and investment environment. That is not to ignore the fact that many Japanese companies are underperforming, and investors—both inside and outside Japan—are conscious of the need for more capable and flexible management. “There ARE problems with Japanese corporate management and their governance mechanism, and we are putting pressure on them to rectify things,” Mr Yamamoto says.

But the perception that Japan has taken a step back may not be accurate. “If anything, [Japanese companies] have always been inward looking and closed; I don’t believe they are becoming more so,” says Noboru Terada, former executive investment officer at the Government Pension Investment Fund, and now a member on the advisory council of the CFA Institute Centre for Financial Market Integrity (an international organisation that monitors investment standards in global capital markets). Indeed, it is difficult to argue against figures that show that Japan has the lowest level of inward investment of any major economy: the stock of foreign direct investment in Japan was equivalent to just 2.3% of GDP in 2007, compared to 48.5% in the UK, 33% in France and 14.6% in the US.

Stock of FDI as % of GDP



Source: The Economist Intelligence Unit

Nevertheless, taking a longer view, progress has been made. “When the concept of M&A first arrived around 1990, when activists like T Boone Pickens Jr made a splash, many managers considered M&A to be impossible in Japan,” Mr Terada notes. “Things are moving in a right direction. It’s just that there is still a resistance to the idea of doing M&A along the lines familiar in the West.”

Nor are the changes merely synthetic. In the past 10-15 years, Japan’s commercial code has been overhauled to make corporate restructuring easier. In 1997, the holding company framework was legalised, opening the way for a drastic restructuring of corporate groups and widespread consolidation in many industries. In 1999, mergers using stocks became legal. In 2000, further revisions to the commercial code made it easier to spin off corporations. In 2005, tender-offer guidelines were established by the Ministry of Economy, Trade and Industry (METI), and in 2007 “triangular mergers”, allowing the use of the acquirer’s shares as consideration in M&A via local subsidiaries, were authorised for foreign takeovers.

But have these changes in fact made Japanese management even more nervous about the threat from overseas? Some suggest that managers got cold feet when the laws allowing foreign triangular mergers were enacted. “Japanese managers feel their defences have been stripped away bit by bit over the years,” says Kunio Kojima, vice-chairman and president of the Japan Association of Corporate Executives (Keizai Doyukai). “First cross shareholdings were unwound, then they saw the departure of familiar investors and then their replacement by blocks of foreign and individual investors.” The triangular merger law was bound to trigger a defensive reaction.

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Moreover, fears of being the victim of a hostile acquisition were exaggerated by the actions of Japan's most notorious domestic shareholder capitalists. Both Yoshiaki Murakami and Takafumi Horie, an entrepreneur and former president of an internet portal company named Livedoor that made a hostile bid for a respected television network, took delight in shaking up Japan's corporate culture. Both were arrested in 2006, for fraud and insider trading respectively, doing serious damage to the public perception of their aggressive style of business, and to activist investors' perception of the authorities' attitude towards their activities.

With this background, and change that has been—for Japan—rapid and wide-ranging, defensiveness is perhaps not surprising. But this is a different matter from saying that the environment for M&A in Japan has taken a major step back.

Q&A: Hiroaki Niihara, METI

Those who believe Japan's bureaucracy to be resolutely on the side of old-style Japanese management (exemplified perhaps by the comments of Takao Kitabata, METI vice-minister, who has called shareholders "fickle and irresponsible"[3]) may be surprised by the opinions of Hiroaki Niihara, director of METI's corporate affairs division. The EIU spoke to Mr Niihara shortly before METI released updated guidelines on anti-takeover defences, issued as this report went to press.

***EIU:** In 2005 METI issued guidelines on corporate defence mechanisms, in response to calls from Japanese management over the legal uncertainty of many of these. With fresh uncertainty in recent months, managers are now hoping that the government will come up with some form of legislation that clarifies what kind of corporate defence system is legally watertight. What's your opinion of this?*

Hiroaki Niihara: Our provisional conclusion on this is we don't want such a law. Issues concerning corporate control should be determined by the shareholders. When an actual buyer appears, the price will be revealed to the shareholders, who will decide what to do... If you have a law that lets management devise a rock-solid defence that they can use under any circumstances to fend off a buyer, it will betray the workings of the capital markets. Even if the law says the measures are good if you get 50% shareholder approval, or two thirds, or even 80%, you might have 20% opposed. Even the last remaining stock holder might be opposed to it, and he or she has the right to sell to the proposed buyer. Allowing a certain defence system to be effective robs them of that right to sell.

***EIU:** Some people believe that listed corporations should be required to appoint external board members to check management and fairly represent the interest of the shareholders. What do you think about this idea? Should there be a legal requirement to name external board members?*

HN: The question really is why haven't the external boards really been functioning right now. That's because there is a question of independence. In the US, you cannot serve as an external director if you are related to the managers, or have business transactions with the company or are employed by affiliated firms, or have been any of these things in the past three years. In Japan, those types of people CAN sit on the board as external board members. This has been a source of governance-related problems in various areas, at least from the perspective of the investors. One possibility is to revise the company law and adopt the American definition for external board members. The same goes with the so-called external auditors.

You also have the question of how many independent directors there should on the board, but the question of independence should precede the numerical issue. Once you impose numbers under the current definition, you won't be able to fix the problem of independence later, leaving a scar in the system.

***EIU:** Your comments give the impression that you hold very different views from METI's vice-minister, Mr Kitabata...*

HN: Mr Kitabata and I share the same thoughts and aims, but the conclusions that flow from them are different. We all want corporations to grow, but some fail to see the financial side of it. Companies cannot grow if investors don't believe those businesses are worth investing in.

Fundamentally, what builds enterprise value is close collaboration among the stakeholders. Unless management and investors communicate, respect each other and work together, you won't be able to build corporate value. In that sense, the biggest missing piece in Japanese corporate management is investor relations. This isn't just releasing facts and data. Top managers should address investors more closely and explain how and why they want to manage the company.

There are lots of foreign investors that own Japanese companies without people noticing it. They meet with Japanese managers on a regular basis, building trust. They don't say things like "We are going to educate the management" publicly. But in reality they do educate the management in a more subtle manner.

[3] As quoted by the *Nikkei*, "Being Too Selective About Shareholders Carries High Cost", February 5th 2008

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2. The perception gap

Interviews with Japanese managers and local financial intermediaries on the one hand, and activist investors and consultants on the other, reveal a wide gap in perceptions between the two groups, which quite often leads to a misreading of each other's intentions. Many outside investors view Japanese management as a self-protecting, self-governing group with no external accountability, and with concomitant disregard for the interests of shareholders. Japanese management, for its part, sees activist-type investors as greedy and short-sighted and intent on taking quick profits by making opportunistic demands of management.

To be sure, there are nuances of opinion on both sides, but this common gap in perceptions reflects a fundamental difference in views on the respective roles in corporate governance of management and shareholders. This often leads to both parties becoming entangled in fruitless public debates about the demerits of each other's point of view. Yet there are signs that with the right approach, activist investors and management can work together.

The role of the enterprise in Japan

Managers at many big Japanese companies believe that enterprise value derives fundamentally from their stakeholder-driven model of the business, which involves the long-term commitment of employees, customers and affiliated companies. This corporate model has proved especially resilient and successful in certain types of manufacturing businesses, particularly cars, electronics goods and machinery, the end products of which require a long-term commitment to *kaizen* (incremental improvement). Examples of success are not hard to find; indeed companies like Toyota and Canon have regularly garnered the admiration of competitors and investors worldwide.

Of course, there is no answer to the charge that in certain cases, especially at underperforming listed companies, managers are more concerned with protecting their jobs than any high-minded commitment to the responsibilities of stakeholder capitalism. A common view is that this is perhaps true of 20% of Japanese companies that are underperforming. However, at companies that are not obviously in trouble but that are being run in a way many investors would see as too conservative, such as those that accrue large piles of cash on hand, management often denies that its primary responsibility is to satisfy the shareholders—for example, by raising dividends at the expense (as they would see it) of long-term security or capital expenditure plans. Managers interviewed for this report continue to see the importance of the symbiotic co-existence of a company's primary stakeholders—management, employees and customers—in society as a whole, much though more modern-minded investors would like to think this was a remnant of the "Japan Inc" mindset.

While the style and form of traditional Japanese management has gone through some major adjustments—and even radical make-over in some cases—management tenets such as long-term employment and seniority-based pay remain largely intact. Many more Japanese employees are leaving their employers mid-career and switching to other jobs, but employment models at big traditional companies are resistant to change.

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These companies hire hundreds or thousands of new employees straight from college each year and dedicate company resources to train them into core management-track workers. Top management personnel are drawn from the ranks of long-time workers, who slowly rise through the organisation.

When faced with a takeover bid, top management might take a strongly defensive position, partly to protect their own jobs but also in the larger context of preserving the corporate community. To this community they often owe a great deal, which generates fealty to the long line of past company presidents and a sense of obligation to the successive generations of future managers who are under their wings. In their view, it would be unacceptable to the retired presidents, and to future would-be managers, for the company to lose its identity simply because the current president was remiss in protecting its name and reputation. In many cases, the bosses do not believe their defensive actions stem purely from their own personal interests.

When this view is placed alongside the tenets of shareholder primacy, it is easy to see why differences of opinion are frequent. The conflicts are cogently expressed by the ACGA, in its recent white paper, which received the backing of seven foreign investment funds, which between them own billions of dollars' worth of Japanese equities. The paper calls the Japanese system of stakeholder capitalism "outdated and fundamentally inaccurate" and calls on managers to exercise an "enlightened adherence to the rules and conventions of international capital markets" and to "restore shareholders to their rightful, legal place as the owners of companies". It reiterates the fundamental investor rationale that "shareholders invest their savings in companies because they trust that management will look after these funds and provide a fair return. When managers fail to do so, they effectively break their most fundamental contract with shareholders."[4]

Reshaping Japanese corporate governance to give shareholders primacy is no easy task, and blaming managers for their commitment to other stakeholders does not necessarily recognise the tensions inherent in such a change. To be sure, many investors are cognisant of these tensions. "If we believe Japanese management is not doing enough for shareholders, I believe this is not necessarily a problem with the managers," says Scott Callon, president of Ichigo Asset Management, an independent investment firm.

Rather, Mr Callon maintains, "it is a problem with what Japanese society is asking from those managers. Working on behalf of your employees, your customers and your shareholders is incredibly demanding. I totally reject the view that Japanese managers are not professional or qualified. The management teams I meet are incredibly capable. They are working to deliver success first and foremost to employees and customers, and secondarily to shareholders. Raising the priority of shareholders is not a problem of motivation or commitment but of the social goals managers are being asked to achieve."

Despite this, it is hard to ignore the validity of the ACGA's charge that Japanese companies must respect the "fundamental contract with shareholders" they enter into when taking their money. Yet given the intricate social structure upon which many Japanese corporations are built, it may not be realistic to expect them to change

[4] *White Paper on Corporate Governance in Japan*, op cit.

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A question of approach

The conflicting priorities of investors and managers inevitably lead to tension. Interviews with Japanese management, as well as management consultants and financial intermediaries, suggest that the approach commonly taken by aggressive foreign investors exacerbates this tension and often makes later negotiations fruitless.

A buyer who acquires a large block of shares without the knowledge of the management already faces an uphill battle in trying to get managers to respond to their concerns. "Managers are offended if you buy without their knowledge," says the principal at a major US hedge fund. "They think, 'why didn't they talk to us beforehand?'" Consequently, managers will dig in their heels over suggested changes. "Things fall into place more naturally if you talk to the management first," agrees Mr Kojima of Keizai Doyukai, although he disagrees that it is absolutely necessary. "The question is what you do when things turn sour. But I would think that in a soured relationship, the buyer would be the one that gives up in the end."

The perception gap is deepened if the investors make public comments that further antagonise management and the business community at large. "Steel Partners' PR was a disaster", comments the president of the private equity wing of a Japanese financial conglomerate. The US fund was quickly demonised as a bully in Japanese management circles. A white paper on M&A issued by Keizai Doyukai in April 2008[5] identifies two types of buyouts: those that are "healthy" (*kenzen*) and those that are "pernicious" (*akushitu*). The report does not reveal specific names, but Japanese interviewees note that the authors had Steel Partners (as well as Yoshiaki Murakami) in mind when writing the latter definition.

Managers certainly feel antagonised by Steel's approach. "We don't see any evidence of respectability in this company," says the senior manager of a firm partly owned by Steel, citing his disappointment over the kind of public debate the fund initiated to pressure the management to shape up. "When they publish 'letters' addressed to our company, they go to the press first before they send it to us. How can they go public first if it is addressed to us?"

At some firms at which activist shareholders are in the midst of public battles with managers, even rank-and-file employees may join in condemning the "strong-arm" tactics of the investors, suggesting how extensively demonised the group becomes within the company. This antagonism is unlikely to lead to management change that will enhance shareholder value, interviewees assert. "Once you get into an 'us-vs-them' type of struggle, there is no way out," says a management consultant with an American firm in Japan. "You will not end up in a situation where you can have a candid discussion."

Stick and carrot

Pressure tactics by investors evidently do have their place. Steel Partners, in collaboration with other shareholders, recently defeated the board members of Aderans, a maker of wigs and hairpieces, in their

[5] "Changing laws to promote healthy M&A", Keizai Doyukai, April 14th 2008. Available in Japanese at http://www.doyukai.or.jp/policyproposals/articles/2007/080414a.html.

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J-Power: a very public battle

The attempt by The Children's Investment Fund (TCI) of the UK to raise its stake in J-Power, a listed energy company, to 20% from 9.9%, illustrates the sharp divide in perceptions between managers in Japan and activist foreign investors. TCI, which has conducted successful campaigns against recalcitrant management worldwide (including at Deutsche Börse, ABN Amro and others) found its bid for a bigger stake in J-Power blocked by METI in April 2008. METI contended that in gaining such a stake and interfering with J-Power's management to satisfy short-term shareholder interests, TCI risked Japan's national security—for instance, by jeopardising its plans to invest in a recycled plutonium nuclear-power plant.

The rejection of TCI's bid is the first time the government has turned down an investment proposal from a foreign buyer on national security grounds, and it has ignited serious debate about Japan's willingness to accept foreign investment. Domestically, however, the incident is seen in a different light. Deserved or undeservedly, evidence from interviews as well as other media sources suggests that TCI is increasingly being labelled as a bully by J-Power and, by extension, the business establishment in Japan. Yoshihiko Nakagaki, president of J-Power, revealed his feelings to the *Sankei Shimbun*[6], a Japanese newspaper, on June 5th, saying: "Even within the foreign investor group, you can see the difference between those investors who make extreme demands and those who don't." A large section of corporate Japan seems to agree that the government acted appropriately in blocking TCI: according to a *Nikkei* survey[7] of Japanese respondents, 49% approved of the government's action while only 15% disapproved (some 36% said they had no opinion).

This is quite counter to the prevailing views held by the foreign business community, which has commended both TCI's tactics and the substance of its demands of J-Power's management. "Compared to Steel Partners, I thought TCI had taken a very sensible approach," remarks a senior executive at a US management consultancy in Tokyo. A fund manager at a foreign investment group concurs, blaming J-Power's managers for running to METI for protection. "It is very clear that the government's true intention is to protect the management of J-Power," he says.

The case is perhaps not a typical one given the strategic significance of energy production in Japan (which relies on imported hydrocarbons and nuclear fuel for nearly 100% of its energy needs). When asked about the issue, Atsushi Saito, president of the Tokyo Stock Exchange, mentioned that most countries have industries in which, for reasons of national security, foreign investors aren't allowed to hold more than certain percentage of shares.

[6] "Q&A with J-Power's president", June 5th 2008.
[7] "Quick Survey", *Nikkei*, May 26th 2008

own re-nomination, forcing out the boss and six directors—the first time shareholders had managed to oust directors in a Japanese company in such a fashion. Aderans' share price immediately rose around 9% on the news.

Goldman Sachs, in a recent research note, mentions three positive recent reactions to shareholder pressure. These are the Steel Partners-led coup at Aderans on May 29th, the raising of dividends by Ono Pharmaceutical in

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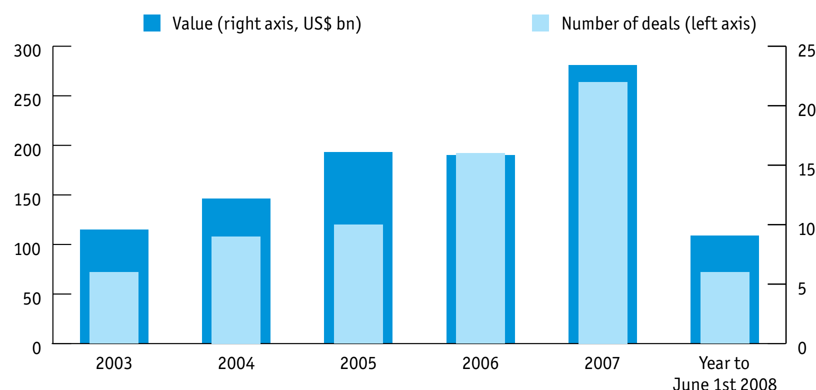
2007 at the behest of Brandes, an investment firm, and a detailed response by Gakken, an educational services company, to calls by Effissimo Capital Management for widespread strategic reform. Goldman's analyst concludes: "While some may regard these developments as irrelevant in the grand scheme of things, we believe that at the margin, these represent governance improvements that should not be ignored."[8]

Arguably such changes are likely to remain on the margin. For investors looking to take more substantial holdings, or complete control, and engage in strategic discussions with the management team to realise higher enterprise value, a patient approach that seeks to develop a deeper relationship with the target firm from the start is perhaps most advisable.

From the Japanese point of view, when investors buy a company they are not seen as buying just financial assets, but investing in a strategic relationship. The target's managers will move quickly to evaluate the characteristics of the investor (whether Japanese or foreign) including their level of tolerance, dependability and diligence. The level of suspicion inevitably rises concerning institutional or financial buyers rather than strategic or industry-related ones, and the number of such deals has been rising steadily in recent years.

Interviewees note that Japanese companies often become defensive when they don't understand why the investors are trying to buy the company, referring to the sometimes opaque operations of private equity and hedge funds. If it is a strategic deal it is seen differently. Nonetheless, even when it comes to financial-sponsored acquisitions or minority shareholdings, there are signs that a productive relationship can be built between investors and management, assuming the right approach is taken and shareholders make some allowances for the idiosyncrasies of the Japanese system. Carlyle Group, for example, takes a softer line, sometimes spending years convincing managers of Japanese companies to work together to reap mutual benefit by raising shareholder value. Its involvement in Kito, an industrial machinery maker that Carlyle helped relist on the first section of the TSE, and Willcom (formerly DDI Pocket, a mobile-phone service provider) are two good examples. Other examples are Mr Callon's Ichigo, and Atlantic Investment, which describes itself (in a recent *Nikkei* article) as a "constructive activist" fund, as seen in its efforts to placate the management of IHI, a heavy electrical machinery maker, before acquiring its shares.[9] As Hiroaki Niihara, director of METI's corporate affairs division, explains, through close collaboration these investors do end up educating management, although they don't shout about it publicly. (See Q&A on page 14.)

Financial-sponsored M&A, Japan



Source: Thomson Reuters

[8] Kathy Matsui, "More Fear Than Greed=More Outperformance", Goldman Sachs, June 2nd 2008

[9] "'Constructive Activist' Fund Fosters Good Relations With Mgmt", *Nikkei*, June 3rd 2008.

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Q&A: Shuhei Abe, President, Sparx Group

Sparx is one of Japan's leading asset management companies and has been involved in several high-profile M&A deals in recent years, including the takeover of camera manufacturer Pentax (by Hoya, an optical equipment maker) and the merger of electronics firms JVC and Kenwood, both in 2007. The EIU talked to the founder of the group, Shuhei Abe, about its approach to acquisitions in Japan and how best to maximise corporate value.

***EIU:** There seems to be a lot of tension recently between investors on the one hand and Japanese management on the other. What is behind this?*

Shuhei Abe: Capitalism seems to be insufficiently understood here. Japanese management does not understand that the ultimate goal of management is to produce value added beyond the cost of capital... Activist investors seek to make profits in the short term using that argument as leverage. [But] if you look at it in short periods like year to year, it is sometimes difficult to meet the cost-of-capital requirement. So investors and management have to understand each other and come to terms on how to achieve a good average return over a given period.

***EIU:** Compared to some investors, you seem to take a softer approach with management. Do you try to make sure managers will co-operate with Sparx before you invest?*

SA: More than the willingness to cooperate, it's important that they can understand you at an intellectual level. Most managers do have the capacity; they are very serious, dedicated people, and rarely do they have any ill intent towards investors. But as investors, you still have to be reasonable. I wouldn't go to a company after gathering up a lot of shares and tell them to distribute all the cash they own. Then they would have a reason to question your integrity.

***EIU:** So when dealing with the management, you would rather not be confrontational?*

SA: Basically yes. We don't have to put ourselves in the spotlight by causing ripples. That won't lead to any solutions that set the company on course to achieve good mid- to long-term value. It actually takes time to guide the company into doing things we want them to do because you need to get everyone on board. For example, at Pentax, we had told the management the same thing consistently and that was that in 10 years they would have no future alone. They began to think the same way we did and started looking for a partner that complemented their strength.

To make a decision to merge with another company is a historic action that needs a lot of courage for salarymen. To get them to do this, you have to lay the groundwork. They may not do things purely for the benefit of investors but they will do them in the best interests of their friends [ie, colleagues]. We helped them [Pentax employees] redefine their thinking on this: their friends would be those who joined the company in the past five to 10 years and who would be working for the company for another 10 or 20 years. They therefore had to make a decision for those people, and when they appreciated that line of thinking they understood they were left with few options.

***EIU:** What sort of systematic changes would you recommend to close the gap between management and investors?*

SA: Society has to create a system that rewards managers more. Given the huge responsibility they are made to bear, their compensation is too small. In some extreme cases, there may be top managers at Japanese megabanks who only get salaries equivalent to those of people with just two or three years' experience at a foreign investment bank. I do think you have the other extreme in the US, where you end up having managers who work under short-term incentive schemes, and that creates a very fragile organisation. The question is how do we find the middle ground somewhere between these two extremes.

3. Priorities for change

Despite the strong resistance shown by many Japanese managers to shareholders' demands, the need for change is undoubtedly recognised. Under increasing pressure to improve the performance of their operations (both globally and domestically), few Japanese managers deny the need for increased supervision, in the form of corporate governance mechanisms that ensure a good return on investment. Moreover, none interviewed for this report deny the need to protect shareholders' interests and increase returns to them. The question is how and how fast changes can be made in corporate Japan, and how much this change will be the result of direct shareholder pressure on recalcitrant management.

Our research suggests that the need for change is recognised (and in some cases under way) in several areas, including on the philosophy of corporate governance, the status of investors and shareholders in Japan's corporate society, and some aspects of corporate strategy. These trends may slowly make the investment environment in Japan more conducive for would-be acquirers, both strategic and financial, although all interviewees concede that much more remains to be done.

Defence measures and corporate governance

Despite undoubtedly negative short-term trends in Japanese corporate governance—particularly the rise in the number of anti-takeover defences and cross-shareholdings—there are signs that things are now moving in the right direction, albeit at a slow pace. For one thing, there has been a realisation on the part of some managers that the knee-jerk reaction since the approval of triangular mergers in 2007 (and the fuss over the Bull-Dog and J-Power battles) is unwarranted. "People get very excited and talk about foreign investors coming in and aggressively buying companies," says a management consultant at a US consulting firm in Tokyo. "But there is no way any Western investor is going to try to take over a company on a hostile basis if nobody in the company wants to be bought. It is hard enough to do it when people support you, what with all the cultural challenges."

Recognising that the danger may be overblown, a small but growing number of companies have given up their takeover defences recently. According to Goldman Sachs[10], nine such companies have done so in the past two years. Shiseido, a leading Japanese cosmetics company, is one. "We have discussed pros and cons since last summer and determined that the risk of facing a hostile bid is small," the president of the company, Shinzo Maeda, told the *Nikkei* recently.[11] More significantly, companies are recognising that improved corporate value—what all investors wish to see—is the best defence against hostile acquisition. "Our market capitalization, which was ¥500bn about three years ago, now stands at around ¥1trn. I believe boosting corporate value is the best takeover

[10] "More Fear Than Greed", *op cit.*
[11] "Higher Corp Value Best Takeover Defense: Shiseido CEO", *Nikkei*, June 1st 2008

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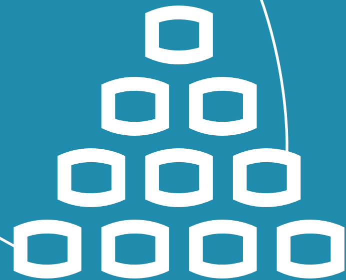

Well, 9 out of them can be found here.

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Companies that have removed their poison pills

Company name	Announcement date
Uniden	June 23rd 2006
Tsugami	June 23rd 2006
Commseed	June 26th 2006
Sho-Bond Corporation	August 2nd 2007
Nissen Holdings	February 25th 2008
Nihon Optical	March 10th 2008
Toyama Chemical	April 14th 2008
eAccess	April 17th 2008
Shiseido	April 30th 2008

Source: Goldman Sachs

defence," Mr Maeda said. (Unsurprisingly, a recent survey by the *Nikkei Veritas* shows that firms with takeover defences tend to be those with the worst performance indicators, with many reporting below-average ROE and a price-book ratio of less than 1.[12])

Nissen Holdings, a leading mail-order company based in Kyoto, is another example of a company that has rethought its takeover defence. Tamaki Wakita, executive officer of the company with responsibility for strategic planning, stresses that the decision to remove the defence was part of a wider discussion on the importance of having solid corporate governance principles—echoing Shiseido's stated belief that fundamentally, being a successful company is the best way of controlling your own destiny.

At Nissen, Mr Wakita says, after heated and repeated discussion on the issue, directors came to the conclusion that a defence system that could weaken management discipline was unnecessary. Going one step further, the company decided it would need outside directors to safeguard its corporate value. "We figured that to achieve the company founder's vision to create an on-going, everlasting corporate group, we need a good [external] corporate governance mechanism," Mr Wakita says. "Then, if the managers make a serious error of judgment or become protective of their own interests, the outside directors will check it." Moreover, outside directors can bring "expertise, value judgments and other viewpoints that might contribute to lifting shareholder value."

These examples suggest that in some rare cases, corporate governance in Japan is changing slowly in line with investors' demands. But where improved corporate governance has been instated, the emphasis has been to link it to the overarching goals of the company, rather than purely to benefit shareholders.

A new status for shareholders?

This reflects a larger debate about the status of shareholders in Japanese corporate society. Few disagree with the need for shareholders to be higher up the corporate value chain. Given the pension-funding problems facing Japan's legion of imminent retirees, the consensus is that the country would benefit from a vibrant stock market and greater returns to shareholders. Indeed, "From savings to investment" is a national slogan used in numerous government policy papers and advisory reports. Far from being a gimmick to let greedy investors take a profit, making the market work better has become part of Japan's national economic agenda.

In theory, the obligation of the management to provide fair returns to shareholders has never been in question, says Mr Terada of the CFA

[12] "Firms With Takeover Defences Tend To Have Lower ROE: Survey", *Nikkei Veritas*, April 20th 2008

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Institute Centre for Financial Market Integrity. "So long as you are a stock-holding company [*kabushiki kaisha*, or KK], shareholders are the owners and managers are obliged to work for the owners." But the reality is that the interests of other stakeholders such as workers and customers are given priority. Mr Callon of Ichigo sees the need for a rethink of corporate priorities: "What has to happen is that we need to embrace a stakeholder vision of Japanese companies that fully includes the shareholders." He thinks this is eminently achievable. "We can do it; there is no tension with or challenge to Japanese society or values in this. Taking good care of minority shareholders and Japan's aging pensioners is very much in keeping with Japan's values. So it is a matter of will."

Integrating shareholder interests into management decision making will not be straightforward. One issue will be breaking down the aforementioned traditional company employment model and compensation structure, based on seniority, and rewarding managers (as elsewhere in the world) with shares and stock options that will align their personal interests more with those of shareholders. Currently managers are often paid less than their peers in comparable non-Japanese companies. The reward for top managers is often the prestige in managing the handover to the next in a long line of company presidents, and sticking around as an honoured figurehead, rather than in taking home a fat paycheque. If they were paid more, and more in line with corporate performance, one interviewee from a Japanese private-equity group asserts, their attitude to M&A would change.

Mr Wakita of Nissen also suggests establishing a corporate practice and culture whereby management and staff communicate with investors closely and listen to them carefully. "Japanese companies have an excellent practice of listening to customers diligently,'" he says. "Just like they try to feed back customer's needs into products, they can listen to the voices of the investors and feed them back to management on a regular basis. It's like a *kaizen* activity. "

Here, the concept of *kaizen* and how it works for Japanese corporations is key. *Kaizen* is a commitment to make incremental improvements to products—whereby workers voluntarily commit to making those changes. "If you try to force things on Japanese management, you get an adverse reaction," Mr Wakita says. Instead, Japanese management should launch a programme of *kaizen* to listen to the voices of the investors and create a culture to reflect their wishes in corporate strategy.

Cash back

On a more practical basis, the views of investors have started to filter through to corporate strategy—although much remains to be done, and the need remains to convince managers that shareholder demands are aligned with the company's best interests. For example, one of the biggest issues for investors in Japan is the level of cash reserves Japanese firms tend to maintain on their balance sheets, and their disproportionately low payout ratios. Managers generally cite concerns for the future, capex plans, and unspecified emergency needs as reasons to retain so much cash. Investors, domestic and foreign, are adamant that large cash reserves be used productively or returned to shareholders.

Part of the difference of opinion between management and investors over the right level of cash on hand results from different conceptions of risk. "Frequently, the management team is far less confident about the future than shareholders, who have invested in the company precisely

because they believe in the company's future," says Mr Callon. "There could be more risk-taking. Companies don't need to be run with cash equivalent to 50% of their market capitalisation. It could be 30%. You could have leaner companies with leaner capital structures and smaller cash cushions and they will still be very successful." A US hedge fund manager, who describes himself as otherwise generally sympathetic to Japanese management, concurs, saying "[Japanese companies] hold much too much cash for any emergency need."

Mindful of some Japanese managers' aversion to giving up cash to short-term investors at the expense of long-term goals, Mr Callon suggests increasing stock repurchases. "It is a far more flexible tool... Dividends are a forward commitment that can be tough for companies to change." In addition, he says, "when you repurchase stocks you strengthen the shareholder group... You actually create a longer-term shareholder base, which is a nice fit for Japanese companies with long-term orientations."

Some signs of progress are creeping out. According to data compiled by the *Nikkei*,[13] listed Japanese corporations paid out a total of ¥12trn in the year ended March 2008, nearly half of total net profits of ¥25.2trn (which were up only 1% year on year). Of this total, stock repurchases rose 15% year on year to total ¥4.6trn. Big Japanese companies are leading the way. "Toyota has done massive stock repurchases and cancelation of stocks, sending signals to the shareholders that those stocks will not be reissued and dilute returns," Mr Callon notes. "So Japan is moving forward. Those of us who believe in Japan and the opportunities here need to support that forward progress."

This progress is too slow for many investors, though. Cash dividends paid out in the financial year to March 2008 totalled ¥7.6trn, up 14% from the previous year. Although this is encouraging, the ratio of net profits to dividends is still only around 30%, compared with payout ratios in the 30%-50% range for many US and European companies, which means investors are likely to continue to agitate for higher returns.

[13] "Shareholder distributions neared half of net profits", *Nikkei*, June 2nd 2008.

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Legal loopholes

Although Japanese commercial codes have been revised in the past decade to make corporate restructuring and M&A easier, there are outstanding issues that interviewees agree must be changed to give investors a level playing field. One of the sorest issues is that of third-party share placements executed by the management of listed companies, which dilute the holdings of existing shareholders. Foreign and domestic investors alike have been troubled by cases that involved financially struggling companies that placed large amounts of shares or warrants, sometimes in excess of 100% of the existing shares, to a third party under a closed arrangement with the management. Other cases involved giving shares to an ally, or a "white knight", to protect the company from an unwelcome merger proposal—in effect invoking a "poison pill" defence. Shares are sometimes offered at considerable discount to the prevailing market price.

Mr Callon, who is on the whole sympathetic with the actions of Japanese corporate managers, calls third-party issuances "the single biggest vulnerability in investor protection in the Japanese equity markets today", adding: "I don't understand how we can allow management to issue new stock just to their friends. I think that is profoundly wrong and subject to abuse." The head of the corporate group at a foreign law firm in Tokyo points out that a related problem is that business transactions between a company and its listed subsidiaries can be problematic. "There is no regulation on contracts that can be entered into by a listed subsidiary with its parent or other related parents," he says, so you get contracts that favour that particular shareholder at the expense of other shareholders."

The solutions to these kinds of issue are not difficult to find. The UK has the strictest rules on the matter, requiring by law that new stock issuance be made on a pro-rata basis to all existing shareholders. In the US, the New York Stock Exchange statutorily demands pro-rata share issuance, but only if the issuance exceeds 20% of the company's existing capital. But as the lawyer points out, "in the US they have independent directors on the board, and that's their way of dealing with this problem to make sure shareholders are properly looked after."

Regarding the issue of subsidiary-parent contracts, one solution suggested is that related-party transactions be regulated by an independent body and then be subject to a vote by shareholders (with shareholders from the contracting party excluded). Mr Niihara from METI thinks that some form of oversight is definitely necessary. "It's not so much a question of whether they are actually doing any shady things or not," he says, "it's a question of finding a way to ensure that minority shareholders' interests are not compromised for the sake of the parent firm. In the case of listed subsidiaries, having truly independent directors should be a must."

The issue of whether stricter regulation is the answer to such problems is unresolved. The government, via its Council on Economic and Fiscal Policy (which is chaired by the prime minister, Yasuo Fukuda), has called for structural reform to discourage poison pill defences and make the investment environment more conducive to FDI. However, despite pleas from investors, the Tokyo Stock Exchange seems reluctant to institute new regulations. Atsushi Saito, the president of the TSE, says "stern warnings" and codes of conduct may be preferable. (See Q&A on p29.)

Tatsuo Uemura, a professor of law at Waseda University, argues that ideally, there should be legislation that specifies that shares issued by a listed company should be publicly subscribable, and only and in rare cases (such as where the company is facing bankruptcy) should firms be able to place shares with a third party. In the absence of such legislation, Professor Uemura reckons the TSE is obliged to regulate third-party share allotment. "The exchange has a responsibility to ensure fair and healthy formation of share prices according to the *Kinsho-ho* [Financial Products Trading Law] and not regulating it violates that responsibility," he says.

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Q&A: Atsushi Saito, President, Tokyo Stock Exchange

EIU: *There is growing concern and criticism about the M&A environment in Japan. Foreign investors in particular have expressed worries that Japanese corporations are moving in the wrong direction, away from more globally accepted corporate governance standards. Is this actually the case?*

Atsushi Saito: I think that if there is criticism, we can use that to our advantage and improve matters. But one has to be aware that no nation will sacrifice itself for the sake of other nations. People from other countries make targeted criticisms with a view to benefiting themselves. I find it a strange argument that only one particular style of M&A is good. If a Japanese company wants to do an M&A because it believes it would raise its corporate value, it should do so. Nippon Sheet Glass merged with Pilkington, for example. Shareholders probably thought that was a good idea because share prices went up.

I don't know to what extent those critics are really concerned about Japan. Is their criticism because they care about Japan or is it because their own markets have been performing badly? I don't know, but it's up to the Japanese to figure out what to do and how. Based on my own 40-year experience in finance, I do believe that M&A is a good thing and should be planned and implemented strategically.

EIU: *What is your view on the strengthening of cross-shareholdings by Japanese companies?*

AS: The move to strengthen cross-shareholdings is an attempt by managers to protect themselves, and it's questionable from the point of view of improving shareholder value. Many of these managers are fine, respectable people, but as in all markets they must operate with supervision. Historically, some kind of watchdog has worked to make the management efficient—whether it was the government or the banks. Corporate governance by financial institutions has outlived its usefulness, giving way to corporate governance by equity holders.

The investors' profit motive makes the system function. Japanese people, however, have qualms about allowing this simple profit-making motive to be the fundamental guiding principle in all this. They are afraid of narrowing it all down to that simple principle of profit making and returns, although I would not deny that the bottom line is to make profits. In fact, I believe people expect much more than financial performance from corporations. People do approve of investment funds driven by financial motives, but that's just one aspect of it.

EIU: *Defence mechanisms appear to be an effort to preserve corporate identity and to protect companies against investors' short-term profit motives, often with the justification that it undermines long-term investment goals. Is this view accurate?*

AS: In the 1980s, Wall Street analysts used to criticise companies like Toyota and Fuji Film for hoarding lots of cash. They argued the cash should be redistributed to shareholders or reinvested. But since then, those companies have significantly closed the gap with their respective rivals, GM and Kodak, which used to be far ahead of them.

Trillions of yen in cash worked wonders. When the business cycle goes down, banks do not lend you money. Bankers take away your umbrella just when it starts raining and then wants to lend you one when it clears up. That's what financial lending is all about. When I was young, Nissan was superior to Toyota in size and strength. They traded places because Toyota had large amounts of internal reserves. Nissan was not able to borrow when it wanted to, to make a significant amount of capital investment. Toyota has always moved to expand capex at the bottom of the business cycle so they could buy equipment very cheaply and invest very efficiently. Mindful of investor demands not to retain cash and facing tough demands from the labour unions, GM ended up facing the challenges it does today. How did Toyota successfully develop the Prius over the past 10 years? That's because it had solid cash reserves. It's a product of channelling and dedicating a lot of financial and human resources to it for a long time without posting any sales or profits. Once Prius emerged in the market, it instantly beat GM.

I would like to ask those fund managers who are looking for companies to earn profits on a quarterly basis what kind of explanation they have for Toyota's strategies like these?

Make no mistake. I do think that there needs to be pressure from shareholders.

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Human beings have a tendency to be lazy, so there needs to be pressure from the market, but I don't see room for a no-holds-barred type of investor violence. There needs to be a proper balance there.

EIU: *Investors point out certain regulatory holes in the Tokyo market such as the ability of the management to place significant amount of shares with a third party, to the detriment of the existing shareholders. What is your position on this?*

AS: We have been giving warnings to the issuers that such actions are not desirable. A large-scale third party share placement is permitted under Japanese law, unless there is an unusually steep discount to the price. Since I joined the TSE I have issued multiple warnings to the managements that have done this.

EIU: *Is the TSE thinking of introducing regulations on this issue?*

AS: The action is legal. To place a complete ban on something that is lawful might not be the best thing. There is the possibility of hampering the freedom of corporate management. So, what we have done is to give stern warnings to corporations to the maximum extent possible, on the basis that it compromises the rights of the shareholders. The warnings do have an impact in that they expose companies' names to the public, telling investors that these companies disregard the interests of their shareholders.

EIU: *Many people have also questioned the practice of listing subsidiaries majority owned by the parent company…*

AS: In principle, I don't think it is a good thing. I wouldn't rule it out totally—in some cases, the autonomy of management is ensured and there are cases of listed subsidiaries in places like Hong Kong. But we shouldn't allow the subsidiaries to be sacrificed for the sake of the parent. I do believe that given the growing transition to consolidated accounting, the parent-subsidiary listing is not desirable. In fact, last year about 50 companies delisted from the TSE, most of which were subsidiaries of a larger group.

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Conclusions

None of the investors, managers and M&A advisers interviewed for this report pretend that the investment environment in Japan is devoid of serious problems. But recent debate has done little to bring the two sides—activist investors and Japanese management—closer together. The research for this report suggests that one of the most effective ways to enhance corporate value is for closer co-operation between the two, and making efforts to understand the background behind opposing views may help facilitate such co-operation. Undoubtedly, all stakeholders have something to gain from helping Japanese companies achieve their maximum potential. The outlook is positive in that, to this extent, investors' and managers' goals appear to be getting more closely aligned.

Although it has been played out as such in the media in recent months, the debate is very far from an issue of "Japan vs the rest of the world". Indeed, the need for Japanese retirement funds to secure greater returns from their equity holdings is of crucial importance to the future of the country, given its demographic and fiscal problems. The nation's largest pension investors are already taking note and applying pressure to managers, albeit in a more understated way than some foreign funds have done.

Although external pressure has been effective in some cases, further progress is likely to require that domestic and foreign investors work with Japanese managers, and explain how shareholders' priorities can fit with the broader corporate and social obligations that Japanese managers feel they must bear (in much the same way that foreign strategic acquirers have had to acknowledge cultural differences in their M&A transactions in Japan). There are ways this can be done without violent change; for instance, establishing a corporate culture whereby management and staff communicate with investors as closely as they do customers, and consider their suggestions an extension of *kaizen*.

Corporate Japan's bid to improve its own governance standards should nevertheless be a grass-roots affair. Investors would claim with some justification that it is too easy for poorly performing managers to hide behind their responsibilities to their employees and society at large, as well as behind "poison pills". But for the time being, investors will find themselves constrained by the fact that Japanese managers often feel social obligations on top of their financial ones, and shouting loudly about dividends may not be the best way of convincing them that their interests and those of the shareholders are one and the same.

Still, the consensus is that reform needs to begin at home. Mr Callon recalls that he declined an invitation recently to appear on a TV show that planned to debate "Why have foreign investors abandoned Japan?" He says they had got the wrong topic. "The key issue is not why foreign investors have abandoned Japan; it is why have Japanese investors abandoned Japan? If we cannot make this market attractive in any sort of permanent or stable way to local investors, we will not be able to make it attractive in any sort of permanent or stable way to global inventors, who don't have any sort of priority commitment to Japan as a place to invest."