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Capturing long-term investors the Toyota way

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(Opinions expressed herein are strictly those of the authors)

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CAPTURING LONG-TERM INVESTORS THE TOYOTA WAY

In the on-going quest for innovative capital structures, Toyota has recently provided an interesting twist and tied in knots a number of institutional investors. Toyota believes that developing the next generation technologies will require massive investments over many years. It also believes that the current state of investment practices, the prevalence of roaming funds and the general emphasis on short-term stock prices, all work against the required investor stability for such long-term undertaking.

"As a result, we have determined that, in raising capital for research and development of next generation technologies, it is desirable to match to the extent possible the period in which investments in research and development contribute to our business performance with the period in which investments are made in us by investors. To that end, we have decided to issue the First Series Model AA Class Shares with voting rights and transfer restrictions that assume a medium to long term holding period".

Reference document of the 111th ordinary general meeting, p.32

In a historical vote on June 16th 2015, Toyota shareholders adopted with a 75% majority the proposal to issue Model AA Class Shares. These shares will be sold only in Japan; they will not be listed, but will have voting rights. They will be priced at 120% of the ordinary shares and will be paid a dividend at a rate lower than ordinary shares but at an increasing rate every year. The company will commit to buy back the shares at the original price after five years. But at that time, holders of these shares will have the option of converting their shares into ordinary common shares at a conversion ratio yet to be determined.

Toyota will thus enlist the support for at least five years of patient shareholders, mostly Japanese retail investors, in order to pursue fundamental research into future technologies. It will raise an initial US$4 billion and is authorized to issue up to US$12billion of these shares for that purpose. If that endeavour is successful, all shareholders will benefit; of course, the impatient and the fickle may miss out but won't be missed.

There seems to be no legal impediment for a Canadian company adopting this type of capital structure provided, alas, it gets the support of its actual shareholders.

Many “foreign” pension funds voiced their opposition to Toyota’s proposition. The influential CalSTRS (the pension fund of California teachers), Ontario Teachers’ Pension Plan, the Florida State Board of Administration, and somewhat surprisingly, Canada Pension Plan Investment Board (CPPIB) have all declared their intention to vote against the new Toyota shares.

As the CEO of the CPPIB has been doing an active and persuasive advocate of long-term investment agenda, one would have expected the CPPIB to support an innovative capital structure designed to draw in long-term investors and partly shield the company from the short-term pressures of financial markets. It appears however that the CPPIB still clings to the obsolete notion whereby two classes of shares are a capital sin that “*can entrench management against shareholder pressure for change*” (CPPIB proxy voting guidelines). Which shareholders and what change are questions best left unanswered.

In a rare instance, the two largest proxy advisory firms issued opposing recommendations to their clients. ISS recommended voting against the Toyota proposal while Glass Lewis came out in favour of it! ISS, it seems, worries that “*a rise in the number of stable investors could lead to overly cozy relations between the company and its shareholders. This would make it difficult for the market to exercise adequate oversight of the company's management*”. So, stable investors are *bad;* the “*market*” is always right!

In a press release, CalSTRS Director of Corporate Governance argued that “[…] *the new share class proposed by Toyota would be structured as debt instruments, with guaranteed and defined dividend payments. Yet, these shares would also have voting rights equal to those of common stock that don’t enjoy this equity risk exposure shield.*” Fundamentally, CalSTRS is also sticking to the dogma about “one-share-one-vote”. One has to wonder if these funds, out of principle, have refused to buy shares of Berkshire Hathaway; Alibaba; Google; Facebook; Groupon; Expedia, UPS; Tyson; Ford, Nike, The NY Times;

News Corp; CBS, Comcast, Blackstone; KKR; Apollo; Pershing Square Holdings, Third Point, etc.

All in all, the Toyota innovation should be closely examined by all who believe that currently dominant capital structures open the door wide to all types of stock market agitators and tourist investors. It is an empirical fact that these sorts of "shareholders" pressure management and boards of directors to deliver quick boosts in stock price, even if it means cutting down on R&D and capital expenditures.

Toyota is thinking "out of the box". It is high time for institutional investors to clear their own thinking of shackles and cobwebs.