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Japan discovers "good" corporate governance, American style

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JAPANTODAY

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(Opinions expressed herein are strictly those of the author)

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JAPAN DISCOVERS “GOOD” CORPORATE GOVERNANCE, AMERICAN STYLE

Not so long ago in an age when they were eating the lunch of American corporations, the Toyotas, Hitachis, Sonys, Canon, Hondas were governed in the worst possible way, at least according to the canons of American governance.

Their boards were made up almost exclusively of corporate insiders, with no independent directors, no diversity, no obeisance whatsoever to the diktats of governance gurus and enforcers, no responsiveness to investment funds and financial markets. Of course these were also the days when corporate control resided in keiretsus (or network of interconnected firms and banks). Only 5% of the Japanese companies’ shares were owned by foreign investors in 1990. But “the times they are a changing”.

Now foreign investors, holding over 30% of their shares, are unrelenting in their pressure for Japanese companies to adopt American-style governance. New governance codes have been written and Japanese stock exchanges are pushing for their implementation.

Foreign money managers and institutional investors stand to benefit from changes in the ethos of Japanese companies which would make them more like American companies in their devotion to shareholder value creation.

That may be the inevitable outcome of a globalized financial market but Japanese promoters of this new governance orthodoxy did not quite understand that “good” governance provides the lever, the entry point for activist hedge funds and their cohort of supporters. These funds thrive, and can implement their standard recipes, only where publicly listed companies have no controlling shareholders and when they can robe themselves with the mantle of defenders of “good” governance.

And they are now coming to Japan in droves.

On April 7th 2016, having lost a board fight to Daniel Loeb (head of Third Point LLC., an activist hedge fund known for its aggressive tactics) Toshifumi Suzuki, founder, chairman and chief executive of Seven & i Holdings Co. (owner of the Seven-Eleven chain) resigned his position. The result represents a victory for shareholder activists who have targeted Japanese companies on the back of Prime Minister Shinzo Abe’s corporate governance campaign for businesses to increase shareholder returns. (FT.com, April 7th 2016)

More and more U.S. activist hedge funds are likely to follow Loeb's lead as the American activism plow field becomes less fertile in potential targets.

Is that good of bad for Japan?

What this sort of activism has really achieved until now is the subject of an-going, statistics- loaded debate in Academia and vitriolic dispute between legal experts and fund managers.

The key issue, the bone of contention, is whether activist hedge funds are short-term agitators making money for their fund by pushing companies to implement measures, usually of the financial kind, that boost stock prices in the short term.

Our study

We analyzed all U.S. activist events of the years 2010 and 2011, some 290 campaigns by 165 activist hedge funds targeting 259 firms. In order to benchmark what happened with these 259 targeted companies, we set up a random sample of 259 companies selected to match the targeted companies in terms of industry classification and market value. (See our article "The Game of 'Activist' Hedge Funds: Cui Bono", International Journal of Disclosure and Governance, advanced online publication, 31 December 2015)

What do the activist hedge funds want? As they keep their stakes in a company for a relatively short time (less than 2 years on average), they push for moves that will generate a quick boost in stock prices. Their standard moves are always a variation or combination of the following:

- Get their nominees on the board, usually as a first step to their next moves;
- Push for a sale of the company;
- Advocate selling assets, division, including spin-offs;
- Demand cuts in all costs to generate cash;
- Call for any "excess" cash to be used to buy back shares or to increase dividend pay-out.

We found pretty clear evidence that the much vaunted "improvements" in operating performance (ROA, ROE, Tobin's Q) result mainly from some basic short-term financial manoeuvres (selling assets or divisions, cutting capital expenditures, buying back shares, etc.).

In general, the stock's performance of targeted companies over a three-year span barely matches the performance of a random sample of companies. But the activist hedge funds, by timing their entry and exit of a stock, by benefiting from the "control" premium on getting companies sold off, may well achieve highly positive results.

For targeted companies, the most immediate consequence is the likelihood of being sold off. Indeed, a striking result of our study was the number of targeted firms that were sold or that disappeared over a four-year span: 95 targeted firms or 37% of the total, while the random sample shows a "normal" attrition rate of some 15% over the same period.

Our research does not provide any evidence of the superior strategic sagacity of hedge fund managers but does point to their keen understanding of what moves stock prices in the short term. Indeed, in none of the 259 cases studied did hedge funds make proposals of a strategic nature to enhance the long-term performance of the firm.

Japan's corporate governance reforms of recent years drew the attention of shareholder activists. Their activities might be touted in some quarters as beneficial, but actually the impact of their tactics, when applied on a massive scale, should concern society, governments, pension funds and other institutional investors with pretense of a long-term investment horizon.