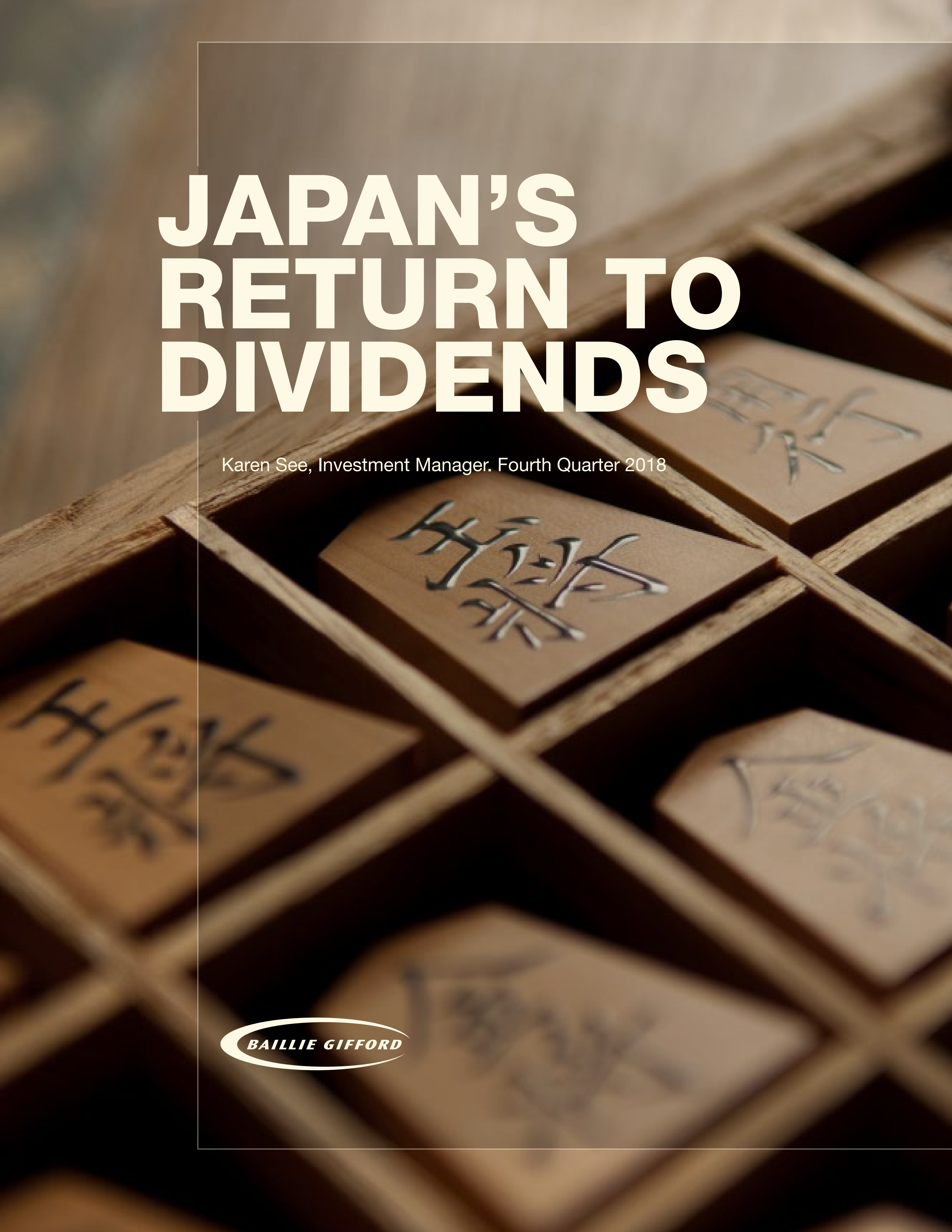

JAPAN'S RETURN TO DIVIDENDS

Karen See, Investment Manager. Fourth Quarter 2018

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Cover Image: Traditional Japanese board game.

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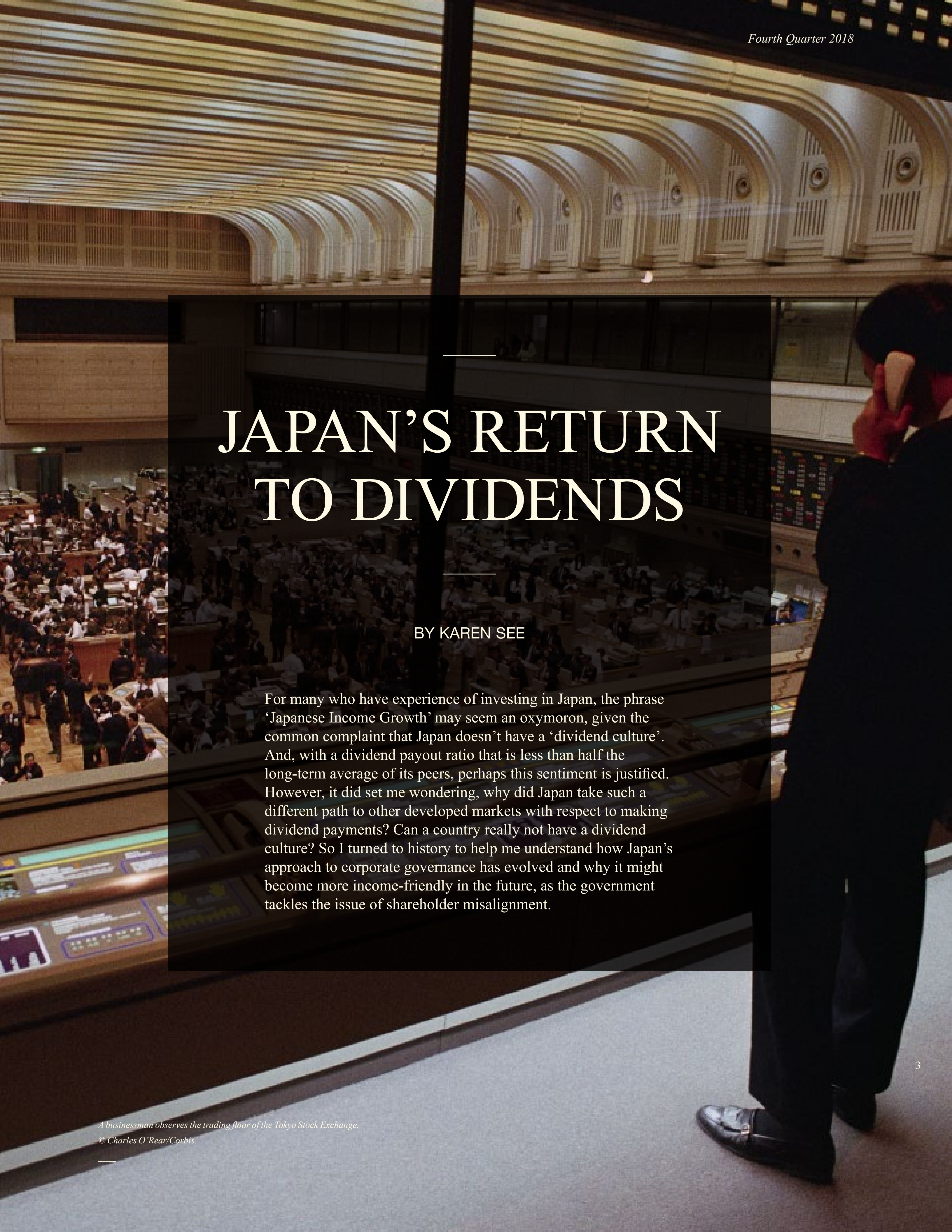


JAPAN'S RETURN TO DIVIDENDS

BY KAREN SEE

For many who have experience of investing in Japan, the phrase 'Japanese Income Growth' may seem an oxymoron, given the common complaint that Japan doesn't have a 'dividend culture'. And, with a dividend payout ratio that is less than half the long-term average of its peers, perhaps this sentiment is justified. However, it did set me wondering, why did Japan take such a different path to other developed markets with respect to making dividend payments? Can a country really not have a dividend culture? So I turned to history to help me understand how Japan's approach to corporate governance has evolved and why it might become more income-friendly in the future, as the government tackles the issue of shareholder misalignment.

A businessman observes the trading floor of the Tokyo Stock Exchange.
© Charles O'Rear/Corbis.

THE SHAREHOLDER-FRIENDLY JAPAN

Winding the clock back 100 years, Japan was a more shareholder-friendly place than the West. Share ownership was more widely dispersed, and dividend payments were common and in abundance. This stemmed not from legal protection nor shareholder activism, but because, at that time, inside and outside shareholders were better aligned.

During the Meiji Restoration (1868–1912), Japan went through a period of rapid industrialisation and modernisation. In 1878, the securities market, the Tokyo Kabushiki Torihikijo – later to become the Tokyo Stock Exchange – was established to help raise funds to support these rapidly expanding industrial enterprises. Even at this early stage, the idea of the 'independent director' already existed in the form of the 'zaikaisewanin', or business co-ordinator. These were successful businessmen who would join the board of newly-listed companies to monitor, give guidance and business advice. During this era, zaikaisewanin were a feature of around two-thirds of listed companies.

By the 1930s, wealthy family groups, the so-called 'zaibatsu', controlled many of Japan's key businesses across a range of industries. Individual investors, however, continued to participate actively in the stock market. Importantly, despite the imbalance of inside/outside share ownership, minority shareholders' interests were largely looked after as a whole. The large shareholdings of zaibatsu families were seen as a mark of trustworthiness and meant that they were able to provide companies with a financial safety net, when required. During periods of economic distress, these companies were able to leverage resources from the rest of the holding group to navigate the storm and survive.

These features make Japan stand out as a case study for corporate governance. Because, although individual investors lacked the protection of a formalised legal framework, the institution of trust was so well-established that the result was a thriving and well-functioning equity market.

Pedestrians strolling down a shopping street in Tokyo's Ginza district, circa 1930s.

IT ALL CHANGED WITH THE WAR

The turning point came following a series of social and political shocks. We can trace the beginning of the corporate Japan we know today to the start of World War Two. The military government wanted to channel as many resources as it could into supporting the Japanese war effort, so it started working more closely with the zaibatsu groups and their banks in a bid to maximise production and put in place an industrial infrastructure. In this environment, dividend payments were suspended in favour of re-investing capital in industrial production facilities. During this time, bank lending overtook the securities market as the main source of corporate funding. The relationship between banks and corporates became a lot more intertwined.

After the war, the zaibatsu system was dissolved by the Allied Occupation Forces (AOF) as it tried to curb the influence of this powerful group. The zaibutsu companies' shares were bought for pennies and sold cheaply to the public. During this period, the AOF also established a legal framework to protect investors' interests. Ironically, it was also around this time that the shareholder-friendly nature of Japanese corporates, where dividend payouts were a regular feature and a company's key stakeholders were aligned, started to reverse.

The suspension of wartime compensation to companies in the 1940s meant that many businesses had to take out bank loans to survive. The average debt-to-asset ratio for companies by the start of the 1950s was over 60 per cent, compared to less than 30 per cent in other countries. Companies struggling to pay off the debt ended up taking out debt-to-equity swaps to survive. This marked the beginning of banks playing a major role in the share ownership of listed companies: the percentage of listed companies owned by financial institutions went from 10 per cent in 1949 to 43 per cent in 1988. Banks were not the only institutions that started owning more stocks. With the dissolution of the zaibatsu system, corporates started to come together to form alliances, known as the keiretsu system, to defend themselves against take-overs and outside influence – often centred around their own trading companies or large banks, and with cross-shareholdings.

Workers busy in the shipbuilding yards of Yokohama, during Japan's post war recovery, circa 1950s.

A new social contract was drawn up where workers agreed to work hard without demanding high wages in return for job security.

After the war, the whole nation worked together to rebuild their country and economy. A new social contract was drawn up where workers agreed to work hard without demanding high wages in return for job security. This is when lifetime employment and seniority pay, the two hallmarks of the Japanese employment system, were established. These have far-reaching implications on how corporations are run in Japan to this day. Most people in senior management rise through the ranks of the company. Their loyalty to the company is rewarded with a seat on the board and because of this, their top priority is safe-guarding their fellow workers' jobs. This legacy remains.

Management's interests have moved some distance from that of the company's shareholders: representatives from the main banks often sit on the board, steering strategy towards business conservation rather than growth. Managements are composed of those whose loyalties lie with their fellow workers and therefore are unwilling to close down divisions or cut jobs when required, and a large bloc of cross-shareholdings from other friendly corporates conspire to make sure that management cannot be booted out under their watch. All of these are reasons why Japan has garnered the reputation of not being the most shareholder-friendly place to invest in. But many forget that it once was. Corporate ownership policy has responded to social and political changes in the past, and can do so again.

When safe-guarding jobs is no longer the management's top priority, it gives them more scope to implement effective business strategies.

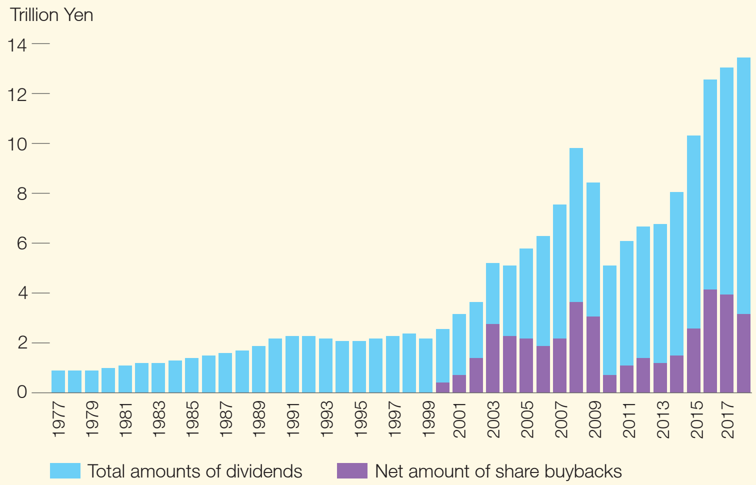
WHAT NOW?

In many ways, the current system is vastly outdated. It was made for the post-war recovery era with very specific economic goals in mind. Japan has failed to adapt the system to reflect its new economic and social reality. However, it seems that we're finally reaching the point where change is both desired and necessary.

One factor that is driving change in Japan is the need to counteract an increasingly ageing population and with it a shrinking workforce. Management are beginning to realise that focusing on increasing productivity – rather than upholding the job for life culture – is crucial if Japan's economy, and society at large, is to continue functioning in a sustainable manner. This change in attitude alone should be liberating: when safe-guarding jobs is no longer the management's top priority, it gives them more scope to implement effective business strategies.

The key change in post-war Japan that set everything else in motion was the dramatic revamp of corporate ownership. A powerful, long-term focused inside shareholder (the zaibatsu families) was replaced by financial institutions that favoured interest repayment to dividend payment, cash hoarding over growth investment and risk aversion over risk taking. With the mandated unwinding of cross-shareholdings, the influence of bankers is significantly diminishing. The unwinding of cross-shareholdings started more than two decades ago. However, it took the introduction of the Stewardship Code and Corporate Governance Code, in 2014 and 2015 respectively, for the increasingly dispersed corporate ownership to make a tangible difference to overall shareholder returns.

Total Shareholder Returns of Japanese Listed Companies



Source: Mizuho Securities Equity Research, based on TSE.
Note: Note: TSE 1st listed companies as of each fiscal year end excluding financials and Japan Post. Net amount of share buybacks (reported on cash flow statement). Data as of 19 October 2018.

This increase in shareholder returns is the fallout from the government finally tackling the root cause of the problems at the heart of the share ownership system in Japan: the misalignment of interests between inside and outside shareholders. Listed companies are now required to have at least two independent directors on their boards. Institutional investors are also required to play a more active role as the stewards of the business. Both these measures have introduced greater challenge to the way in which managers run the business. They can no longer rely on their friendly cross-shareholders to keep them in their posts, nor can they continue to ignore the interests of shareholders. It is still early days, but changes so far are encouraging.

PROGRESS SO FAR

The headline matrices are looking promising so far. Total shareholder returns have doubled in recent years, through dividend payouts and share buybacks. The number of independent directors has also risen dramatically. In 2015, half of listed companies had no independent directors; by 2017, 90 per cent had at least two. However, there are a few more subtle changes happening in the background that are worth highlighting.

The dramatic rise in the number of independent directors on Japanese boards in the last couple of years is a promising start. However, this is only the first of many steps companies need to take if they are serious about changing board dynamics. It is all well and good having these newly-appointed independent directors in place but unless their roles come with explicit powers to challenge management and well-defined governance duties to perform, it could be that ultimately they fail to have a meaningful impact on the way in which business decisions are made. Undoubtedly there is more to be done, but it is pleasing to see the proportion of Topix 500 companies that have a committee board structure having increased from 20 per cent in 2015, to 70 per cent two years later in 2017.

One of the key problems with corporate Japan from a shareholder's perspective is the complete detachment of management's strategic agenda from that of shareholders' interests. One way of solving this is by increasing insider share ownership. Back in 2013, before the introduction of the two governance codes, there were only four companies in the Topix 500 that had any

The dramatic rise in the number of independent directors on Japanese boards in the last couple of years is a promising start.

form of stock-based compensation in place. This has risen to almost 350 by 2017. Greater inside ownership, particularly at management and board level, should encourage those with executive power to think more like owners.

Returning to the dividend payout levels of companies, here too we can also see a difference. This is evidenced by a greater portion of Japanese companies including explicit dividend related targets in their medium-term plan. Only 8 per cent of the top 1,200 companies had an explicit dividend target in 2004; in 2016, this figure had risen to 43 per cent. This is a good sign because it suggests that managements are finally incorporating shareholder returns into their capital allocation decision making process.

INVESTMENT IMPLICATIONS

For a long time, many global income hunters have excluded Japan from their income-generating strategies due to the low income yielding nature of many Japanese businesses. However, we think that a reforming Japan now presents a unique proposition to investors.

With over half of the listed companies having a net cash position, compared to around 21 per cent in the US, there is plenty of room for companies to return cash to shareholders without impeding their growth efforts. This point is important as it makes it possible to invest in businesses that can both grow as well as return more to investors. As a result, there is now a wider pool of companies and industries to invest in that might traditionally have been out-of-bounds for income seekers. And with dividend payments starting to increase, we should begin to see a more sustainable stream of income from an unconventional source – Japan.

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ABOUT THE AUTHOR

KAREN SEE
Investment Manager

Karen graduated BSc (Hons) in Economics with Japanese from University of Birmingham in 2011. Karen joined Baillie Gifford in 2012 and is an Investment Manager in the Japanese Equities Team.

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bailliegifford.com/thinking

Principal Office: Calton Square, 1 Greenside Row, Edinburgh EH1 3AN
Telephone +44 (0)131 275 2000 / www.bailliegifford.com

780 Third Avenue, 47th Floor, New York, NY 10017
Telephone +1 (212) 319 4633 / www.bailliegifford.com