

Power struggles

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As Japanese businesses and bureaucrats block outsiders, domestic forces vie to open the country further

Illustration by David Simonds



“ZIMBABWE” is the comparison that Michael Connors of Hermes, a British pension-fund manager, mockingly draws when describing Japan's shareholder democracy. Hermes is the principal adviser of the pension schemes for many large companies, including BT and Royal Mail, and oversees billions in Japan. But corporate governance as opaque as the politics of an African dictatorship, Mr Connors grumbles, costs shareholders dear.

In recent months, corporate Japan has done an excellent job of fending off foreign investors. Peter Mandelson, the European Union's trade commissioner, calls it the most closed market in the industrialised world. Rare victories do take place: on May 29th a shareholder vote led by Steel Partners, an American activist investor, prompted the removal of six directors and the boss of Aderans, a wigmaker. But last year Steel's attempt to acquire Bull-Dog Sauce, a venerated condiment brand, was rebuffed. Bull-Dog's poison-pill defence was successfully defended all the way to the Supreme Court. Steel has since quietly sold its stake in Bull-Dog.

Then there is the case of the Children's Investment Fund (TCI), a British hedge fund. In mid-May, the trade and finance ministries blocked TCI from doubling its 9.9% stake in J-Power, a big electrical utility. Although the ministries put their decision down to unspecified national-security concerns, it looks as if they feared that TCI would siphon off J-Power's cash as dividends and dash away, leaving the company ill-prepared to pay for building a nuclear power-plant and investing in its network. TCI responded by buying shares in companies that hold cross-shareholdings in J-Power, to press for change indirectly. And it vowed to kick up a stink when J-Power holds its annual shareholder meeting in June.

The Bull-Dog and J-Power squabbles are merely the latest and most visible conflicts between the Japanese business and political establishment and foreign investors. More than a quarter of Japanese shares are owned by foreigners, who account for more than 60% of the trading. Meanwhile, the stockmarket value of more than half the firms on the market's first tier is below their book value. In other words, they are worth more broken up and sold than they are as going concerns.

Things are so dire that eight big international investment funds, including Hermes—which together hold billions of dollars in Japanese equities—have called for sweeping reforms and greater shareholder democracy. They want Japanese firms to take on independent directors, refrain from introducing poison-pill defences, unwind defensive cross-shareholdings and unload their cash by increasing dividends, among other things. More than 600 firms had adopted poison-pill defences by 2007, twice as many as in 2006. And cross-shareholdings increased in 2006 and 2007, having fallen for almost a decade.

Yet the metaphor of shareholder democracy is misplaced, quips one government official, since Japan is barely a functioning political democracy: the ruling Liberal Democratic Party has been in power nearly continuously since 1955. Besides, he continues, Japanese managers treat all stakeholders equally: they do not only ignore shareholders, but everyone else too. As Alex Emery of Permira Advisers, a large British private-equity fund, puts it: "Japan is not just closed to foreigners—it's closed to everyone."

Foreigners have been calling for change for years, to little effect. But lately there have also been calls for change within Japan. In May the Council on Economic and Fiscal Policy, an influential group appointed by the prime minister, put forward a series of proposals, the boldness of which is a strong rebuke to the insular ministries and their managers.

The first reform, devised by a group on foreign direct-investment (FDI) associated with the council, proposed making takeovers of Japanese firms easier, to attract more foreign capital. (Japan's cumulative FDI in 2006 was around 3% of GDP, compared with 14% in America and 45% in Britain.) The group also recommended reducing the tax burden. Japan's corporate-tax rate, at almost 40%, is one of the highest among rich countries.

Second, the council called upon the Tokyo Stock Exchange to establish new rules to discourage anti-takeover defences. Third, it proposed dividing Japan's \$1.44 trillion public-pension scheme, the world's largest, into smaller funds and placing them in the hands of external fund-managers rather than retired bureaucrats. The idea is to

revitalise the stockmarket, increase accountability and diversify risk, says Takatoshi Ito, an economist at Tokyo University who is on the council.

Investors are also taking action. Japan's Pension Fund Association (PFA), which invests \$120 billion on behalf of 27m members, has startled Japanese bosses by voting against the renomination of directors at firms that earn a return on equity (ROE) of less than 8% for three consecutive years. (The average in Japan is around 9.5%, compared with 19% in America and Europe.)

Tomomi Yano, the director of the PFA, notes that the fund, around 65% of which is invested in Japan, produces a return of just 4%; in four years in the past decade it posted negative returns. That is a big problem in Japan, which has a shrinking workforce and a growing cohort of retired people. Of the 1,000 firms the PFA invests in, almost half did not make the grade and the PFA either voted down the directors or told them to improve their performance. "It needs to be a dialogue," says Mr Yano.

Most promisingly, Japanese institutional investors are starting to hold bosses to account. In May Nikko Asset Management said it would oppose reappointing directors in cases where ROE falls below the industry average and the company does not present a plan to fix things. Daiwa has issued guidelines advising big firms not to list subsidiaries without placing outside directors on their boards, and Nomura and Nissay have developed guidelines covering ROE and takeover defences respectively. These moves are modest by Western standards, but in Japan they represent a big and welcome shift.