BORDER TO COAST PENSIONS PARTNERSHIP

NEW BEGINNINGS? CORPORATE GOVERNANCE AND THE OUTLOOK FOR JAPAN AND KOREA

JAPAN'S STUNNING TURNAROUND IN CORPORATE GOVERNANCE HAS CAPTIVATED MARKET ATTENTION OVER THE LAST YEAR, PROPELLING THE NIKKEI TO RECORD HIGHS. NOW KOREA COULD BE FOLLOWING SUIT. DOES THIS MARK A NEW BEGINNING FOR TWO OF THE GLOBAL MARKET'S PERENNIAL CORPORATE GOVERNANCE LAGGARDS? BORDER TO COAST PORTFOLIO MANAGERS HERNAN ENRIQUEZ AND JOHN LOTHIAN ANALYSE THE CASE FOR WHY THIS TIME MIGHT BE DIFFERENT.

First very gradually, then all at once

They say drastic change happens two ways: first, very gradually, and then all at once. Improvements in corporate governance in Japan have followed the same long and grinding pattern of two steps forward, one step back, before taking a great leap forward over the last year. Why has reform accelerated so rapidly after decades of subpar progress? And how might Japan's experience shed light on Korea's push to improve corporate governance and eliminate the infamous "Korea discount" wherein Korean stocks trade much lower multiples than global peers?

Back to bad old days

Let's dial back 25 years: it's the mid-1990s, and Japan Inc. has still not accepted that the old high-growth economy is never coming back. Management ignores shareholders because financing is provided by banks and *keiretsu* [1]partners. Disclosure is poor. Companies report only once or twice a year and only at the parent level. Japanese accounting regulations allows management to limit transparency and distort earnings. Active investors are framed as "vulture funds" or fronts for organised crime extortion. Very few in the C-suite believe the old ways need to change.

As bank lending dries up, global capital markets demand transparency

So, what happens? First, bank lending dries up. Buried under mountains of bad bubble-era real estate loans, the banks are unable to fulfil their traditional role as providers and stewards of capital, leaving corporates to fend for themselves in global capital markets.

Reformers push for an overhaul to accounting and disclosure standards to align with international norms: for the first time, companies are required to produce consolidated financial statements; schemes like reserve accounting are eliminated; mark-to-market is introduced for on-balance sheet securities; management is pushed to discuss operations and strategy with outside investors.

Institutional investors and international competition force painful change

Behind the scenes, the Chief Investment Officers of Japan's pension system—now consolidated into a handful of mega asset owners—quietly signal that less profitable companies will be excluded from their investment portfolios: low-returning investments can no longer be tolerated given the urgency of funding the country's rapidly aging population.

Activist investors, often working behind the scenes to engage with management, gradually succeed in redefining their image as beneficial supporters of the companies with which they engage.

At the same time, unrelenting competition from global markets forces Japan's traditional corporate groups into painful restructuring. One by one the former giants of corporate Japan undergo radical transformation—Hitachi, Toshiba, Matsushita (now Panasonic), Sony, Mitsubishi, as well as the trading houses and old city banks.

Meanwhile, the old guard begins retiring and is replaced by a new generation of managers eager to modernise their companies.

Geopolitics spur political support for reform

In the early 2010s, China replaces Japan as the world's second largest economy, stoking fears in the Japanese establishment that Japan will fall permanently behind its much larger neighbour. Noted nationalist Shinzo Abe is elected to run the country for a second time and vows to revitalise the Japanese economy as a matter of national urgency.

The Abe administration introduces Japan's first-ever stewardship code in 2014 and an updated corporate governance code in 2015, outlining the framework by which companies are to fulfil their obligations to shareholders.

PM Kishida puts all the pieces together

Enter PM Kishida promoting a "new kind of capitalism" focused on two areas: (1) sustainable increases in real wages, and (2) the creation of a new pillar of "investment income," as Japanese convert cash savings into wealth-generating assets. Achieving these goals will require a thriving, well-managed corporate sector, which means subpar corporate governance is no longer politically acceptable. All the pieces are now in place for rapid change.

Change comes "all at once"

In April 2022, the Tokyo Stock Exchange (TSE) introduces a new structure to incentivise better governance: a Prime market for companies committing to strict governance standards and engagement with shareholders; a Standard market for those lacking management resources or will power to qualify for Prime, and a Growth market for high-growth start-up companies.

The TSE tightens the screws in January 2023 with specific measures to force compliance, singling out companies whose shares are trading at below 1.0x book and requiring them to submit detailed plans for raising returns above their cost of capital.

The impact of these moves has been tremendous. We are finally seeing movement across the listed universe to eliminate inefficient operations and tighten up lazy balance sheets. The market has responded by making Japan one of the best performing markets over the last 12 months.

Best is yet to come?

In our view, the process still has considerable room to run. We recently had the opportunity to sit down with Hiromi Yamaji, CEO of Japan Exchange Group (JPX), the operator of TSE and Osaka Stock Exchange, to discuss the progress of reforms and what else is left for Japan's reformers. He was very clear that this is just the beginning, and they didn't plan to rest. He said that the minute you take your foot off the pedal standards start to slip, and so they will always be looking to take governance to the next level.

We are very enthusiastic about this trend and the potential for attractive risk-adjusted returns over the long term for our Partner Funds.

Is Japan's corporate governance reform contagious?

We are also watching Japan's neighbour, South Korea, very closely. Traditional corporate structures are similar between the two: South Korea's famous *chaebol* corporate groups were modelled after

Japan's sprawling pre-war *zaibatsu* conglomerates, the forerunner of the post-war *keiretsu* system of interlocking cross shareholdings, the unwinding of which has been such a large part of Japan's corporate governance reforms.

Many Korean companies are valued well below the book value of their assets precisely because of these interlocking and controlling shareholdings.

As in Japan, reform has been slow and gradual. Critically, directors have a fiduciary duty under country's Commercial Act to the company itself and not its shareholders, a legal distinction point that has often worked to minority shareholders' disadvantage in the past. Whilst we are seeing some clear improvements, as companies cancel treasury shares and begin raising dividends, the 'Korea Discount' persists.

President Yoon pushes for upgrading Korea's tax code and improving incentive structure

South Korean President Yoon Suk Yeol has pledged to carry out tax reforms aimed at eliminating this discount. Korea's punitive tax system translates into inheritance tax as high as 60%, and tax on dividends up to 50% for controlling shareholders. Hence, the families that run Korea's chaebols have little incentive to create corporate value or share it with other investors by increasing pay-out ratios and returning capital to shareholders.

Launch of "Corporate Value-up" programme

In February, the Financial Services Commission (FSC) and the Korea Exchange held an initial seminar on the "Corporate Value-up" programme. It's three pillars include: (1) supporting listed companies to prepare, implement and communicate their corporate value-up plans; (2) supporting investors in making informed evaluations and investments in companies that demonstrate outstanding improvements or high value; and (3) establishing a dedicated system to support the implementation of the Corporate Value-up Program.

Investors have responded somewhat lukewarmly to these proposals, given participation is voluntary and immediate and visible impact still lacking. But we note that investors reacted similarly to Japan's initial attempts to improve governance before the TSE adopted a "name-and-shame" strategy. We understand from the Japanese experience of reform that positive change takes time but can gather momentum quickly and produce outstanding results when the right measures are adopted.

With discussions ongoing, further tax reform also remains a possibility. Considerations around changes in the Stewardship Code to encourage investors to engage more on governance measures are encouraging, as are other initiatives such as mandatory treasure shares cancellations and changes in the ISA limits to promote further domestic retail investment.

Further progress: other pieces of the puzzle fitting into place

As the Japanese case shows, changes in attitudes by corporates and capital markets participants never progress in a straight line. We see reason to believe, however, that this time might indeed be different. The government, the FSC, and the Korea Stock Exchange seem to be approaching the current round of reform with a long-term view and appear willing to offer both "carrots and sticks" to affect change.

The growing presence of domestic individual investors, currently estimated at 14 million (or 30% of the voting electorate), makes the political case for reform more urgent. As in Japan, an ageing population and the lowest birth rate in the world mean investment returns are of critical importance for the National Pension Service, which currently owns roughly 6% of the domestic equity market. Finally, Japan's recent successes make the benefits of the corporate governance improvement much more palpable. We are reminded of the old saying that "nothing spurs the Koreans into action more than seeing the Japanese succeed!"

Investing in Asia

What do all these changes mean for our investing activities at Border to Coast? They certainly create more opportunities for us to invest our Partners' capital for long-term gain.

We are attracted to quality businesses with a runway of long-term growth opportunities but with share prices trading at reasonable levels—what some call "quality at a reasonable price." In our experience, these kinds of durable corporate franchises, bought at attractive entry prices, are best able to generate long-term value to match Partner Funds' long-term pension obligations.

The positive change happening now in Japan and beginning to take root in Korea will not only improve the quality of the companies we own today but broaden our investable universe as more companies improve their balance sheets, make more rational decisions on their portfolio of businesses, and position themselves for the growth opportunities best suited to their inherent capabilities.

Roughly two thirds of our Japanese holdings are included on the TSE's new Prime 150 index, which was recently created from a ranking of Japan's most efficient allocators of capital. The remaining one third of our holdings are listed on the TSE's Prime section, which means they have committed to continuous improvement in governance. Progress has been slower in Korea than in Japan, but that suggests greater potential for the relatively strong businesses we own to fare even better. More than half of our Korean positions trade below book value, which means we could see significant appreciation should the Value-up programme make progress.

Engagement with portfolio companies is an extremely important part of our process—as active stewards of our Partner Funds' capital we will leverage our position as long-term investors to persuade and even pressure management to improve corporate governance. In some cases, this means direct dialogue with company management. We also draw on the expertise of our Responsible Investment team who are excellently placed to engage with management to promote strong corporate governance and we use our collective voice, collaborating with fellow investors and participating actively in voting shareholders resolutions.

The long and winding road that Japan and Korea have travelled will undoubtedly feature more twists and turns. We believe our patient long-term approach, backed by our deep understanding of the two country's economic systems and the historical process of change and improvement, will position us well to engage with our portfolio companies, make prudent investments in new opportunities, and continue delivering investment performance and value for Partner Funds.