Daiwa SB Investments

PM'S PERSPECTIVES

VALUE + ALPHA GROUP

3 July 2019

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Attention Points for Investors - Practical Guidelines on the Group Governance System

The Japanese government finally began to tackle the governance issues of listed subsidiaries[1], which I pointed out in this report two years ago. The administration warned that this issue "may damage the credibility of the Japanese stock market"[2] at the meeting of the Council on Investments for the Future on 21 June, before the Ministry of Economy, Trade and Industry (METI) published a 'Practical Guideline on the Group Governance System' (Group Guideline[3]) on 28 June. While the Group Guideline was set to complement the Corporate Governance Code, it is key to corporate governance reform in 2019. So we may find large progress in investors' and companies' attitudes toward listed subsidiaries in the future.

Overview of practical guidelines on the group governance system (Group Guideline)

No.	Summary	Attention point for investors
3.2	The company should liquidate non-core businesses early before they fall into the red and concentrate on core businesses.	Whether the company reviews its business portfolio based on capital costs to find non-core businesses or not. Whether the company can sell non-core businesses before they fall into the red or not.
3.3	The company should build a system to manage business portfolios.	Whether the company has written rules about the rebalancing of business portfolios or not. Whether criteria for business closing and new investment are adequate or not.
3.4	The company should create a mechanism to evaluate each segment in a single uniform way by consolidating BS and CF and setting capital costs.	Whether employees are aware of performance indicators for each segment or not.
6.1.1	Even if shares in a subsidiary is held below 40% by its parent company, the company group is subject to this governance system.	-
6.1.3	In conflict of interest transactions of listed subsidiaries, due consideration should be given to the interests of minority shareholders.	Whether minority shareholders can accept these transactions or not. Whether listed subsidiaries provide loans to their parent companies or not.

6.2.1	The parent should conduct a periodic overhaul on holding of listed subsidiaries from the viewpoints of corporate value improvement and capital efficiency. The board of directors should discuss whether they have rational reasons to maintain listed subsidiaries as well as whether they can secure the viability of their governance systems. The parent should fulfil its accountability by information disclosure to investors.	How serious the group is toward the resolution of parent-subsidiary listings (how willing it is about acquiring 100% ownership of blue chip subsidiaries and divesting non-core businesses.) Whether earnings per share (EPS) and return on equity (ROE) will go up after the liquidation of listed subsidiaries or not.
6.3.3	Those that have belonged to the parent for the past 10 years are not entitled to assume independent external directors of listed subsidiaries.	-
6.3.4	Listed subsidiaries should raise the ratio of independent external directors. If they cannot put it into practice right away, they should at least deliberate important conflicting interest transactions at a committee consisting primarily of independent external directors.	Whether independent external directors account for a majority of board members of the listed subsidiary or not.
6.4.2-6.5.3	Managers and compensations at listed subsidiaries should be decided independently from the parent.	Whether the parent is not parachuting a retired director as a top manager of listed subsidiary.

Source: Created by Sumitomo Mitsui DS Asset Management based on METI data

In conclusion, the Group Guideline is critical of low-profit businesses and listed subsidiaries, and companies are supposed to take action to fix these problems.

The Group Guideline consists of seven chapters, spanning 142 pages, and the table above shows only its highlights. I believe that investors are interested in two topics; the management of business portfolios in Chapter 3 (3.2, 3.3, and 3.4) and the governance of listed subsidiaries in Chapter 6 (6.1.1, 6.2.1, 6.3.3, 6.3.4, and 6.4.2-6.5.3).

Chapter 3 is about the management of business portfolios. The chapter promotes the optimisation of business portfolios based on capital costs, with a recognition that profitability of Japanese companies is lower than that of counterparts in the West. The strongest point for investors is “whether the company can identify a business whose profitability falls below capital costs as a non-core and liquidate it quickly before it falls into the red”. Managers are required to have not only guts but also abilities to build this structure.

Chapter 6 is about the governance of listed subsidiaries. The chapter does not simply mandate to increase the number of independent external directors at listed subsidiaries, but rather criticises subsidiaries that remain listed, as described in 6.2.1 below. As the hurdles to keep subsidiaries listed were raised by the Group Guideline, an increasing number of companies are likely to delist their subsidiaries in the future. Investors should applaud this trend, because a parent company is likely to succeed in acquiring 100% ownership of its listed subsidiary due to its deep knowledge of the subsidiary’s business. In case of the sale of the subsidiary, we can expect a decrease of conglomerate discount as the subsidiary is a non-core asset for the parent.

Cited from “6.2.1 Viewpoint of strategy for the group business portfolio (underlined by the writer)”

- The form of listed subsidiaries also exists in Western countries as an intermediate form in the wake of organisational restructurings such as M&A, carve-outs and spin-offs, so it has a certain significance at least as a transitional option for dynamic strategies of business portfolios in group management.
- Given these problems, it is important for the parent company to periodically review whether it is optimal to have a subsidiary as a listed company from the viewpoint of corporate value improvement and the capital efficiency of the group as a whole while keeping in mind that the significance of the listed subsidiaries may change over time.
- From this viewpoint, when the parent company decides to maintain the subsidiary listed for a while, its board of directors is required to deliberate on the following two points in particular and fulfil its accountability to investors through information disclosure. (…)

The Section 6.1.3 gave an example of conflict of interest; a case in which the listed subsidiary does not pay interests commensurate with the capital costs. As this guideline spreads across the business world, the corporate practice by the listed subsidiary to deposit cash at the parent company on the grounds that "the interest rate at the parent is higher than that of the bank deposit" may die out.

Although it is somewhat regrettable that there were no references to shareholder return policies for listed subsidiaries in the Group Guidelines, the enactment of policies focusing on the governance issues of listed subsidiaries itself is absolutely epoch-making. The resolution of these issues will definitely enhance the reputation of the Japanese stock market among foreign investors.

Reference

1 “Governance issue of listed subsidiaries which is reflected on stock prices” by Takuya Kamiishi (2017) https://www.daiwasbi.co.jp/pdf/market/2089/fm_20170626.pdf (in Japanese)

2 “Action Plan for Growth Strategy” by the Council on Investments for the Future (2019) http://www.kantei.go.jp/jp/singi/keizaisaisei/miraitoshikaigi/dai29/siryou1.pdf (in Japanese)

3 “Practical Guideline on Group Governance System (Group Guideline) by METI (2019) https://www.meti.go.jp/press/2019/06/20190628003/20190628003_01.pdf (in Japanese)

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Note: Daiwa SB Investments Ltd. (DSBI) merged with Sumitomo Mitsui Asset Management Company, Limited (SMAM) on 1 April 2019.

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Disclosures

On 1 April 2019, Sumitomo Mitsui Asset Management and Daiwa SB Investments merged to form **Sumitomo Mitsui DS Asset Management.**