# Increasing Overseas Investors & Corporate Governance in Japan

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## Structural Diversification of Corporate Governance

Corporate governance among Japanese firms has undergone a significant change since the banking crisis of 1997. *Chart 1* shows the characteristics of the corporate governance and inside structure of Japanese firms listed on the stock exchange in 2002 as examined by cluster analysis, focusing on various indicators showing, among other things, their financing /ownership structure (market-oriented – high dependence on the capital market/ownership by institutional investors; or relation-oriented – high dependence on banks/stable ownership); the extent of inside governance reform ("outsider board" – appointment of outside directors, and high degrees of organizational separation of supervisory/executive functions and information disclosure; or "insider board" – superiority of promoted insiders, and low degrees of organizational separation of supervisory/executive functions and information disclosure), and the characteristics of the employment system (market-oriented – high levels of short-term employment/stock option/merit-based compensation; or relation-oriented – maintenance of long-term employment and seniority wage systems, etc.).

According to the chart, Japanese firms, formerly characterized by the main bank system, cross-shareholdings, the board comprising insiders and long-term employment, have become extremely diversified. They are presently marked by the dominance of a hybrid type combining market-oriented outsider governance and relation-oriented governance. Another notable trend is the participation of entrepreneur-type emerging firms centering on the information technology (IT) sector, which make active use of a stock option system and other techniques. On the other hand, there still exist no few Japanese firms that retain traditional characteristics. Meanwhile, an increase in overseas investors has had a significant impact on the diversification of Japanese firms.

This article highlights how the evolution of Japanese corporate governance has been affected by the growth of overseas investors.

## From Insider Ownership to Outsider Ownership

The ownership structure of Japanese firms has long been characterized by the superiority of ownership by banks and businesses, which is based on long-term transactions and supported by the tacit understanding between managers that ownership will not be sold to an unfriendly third party. Let us call this "insider ownership."

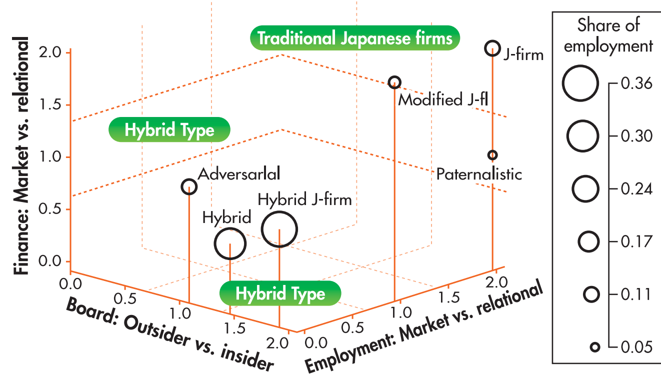
By contrast, ownership by institutional, individual and foreign investors represents the aggregate share of stockholders who aim to maximize their investment returns. As such, their ownership may be called "outsider ownership." As shown by *Chart 2,* the aggregate share of insider ownership among the firms listed on the First and Second sections of the Tokyo Stock Exchange surged from the second half of the 1960s and, after surpassing 60% in the first half of the 1970s, stabilized at that level until the first half of the 1990s.

The ownership structure, marked by such superiority of insiders, displayed a distinct change from the mid-1990s as outsider ownership shot up from the banking crisis. This brought about a reversal in the relative shares of outsider and insider ownership again in 2003. As is clear from *Chart 2,* it was a steep rise in the ownership share of foreigners that played a central role in the surge of outsider ownership. Foreigners' ownership share was limited to about 5% until the bubble-economy period (the second half of the 1980s), but it kept on climbing in and after 1990 and reached 28% at the end of fiscal 2006.

## Direct Investment & Reform of Governance

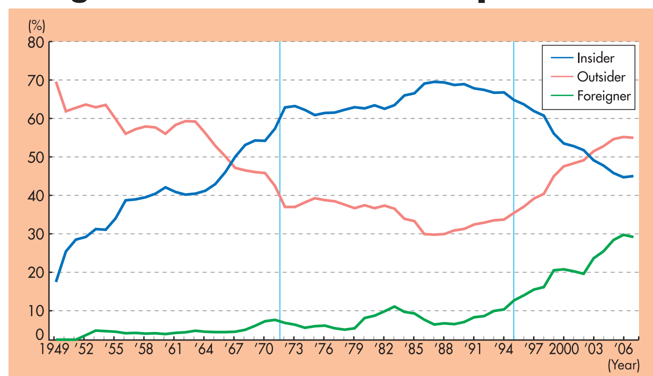
The rapid increase in foreign ownership was attributable to a number of factors. One was a rise in direct investments by foreign firms.

CHART 1
**Change in corporate governance in Japan**




*Source: : G. Jackson and H. Miyajima (2007)*

CHART 2
**Long-term trend of ownership structure**




*Note: Insider: Aggregate shareholdings by banks, insurance firms & other businesses*
*Outsider: Aggregate shareholdings by individuals, mutual/pension funds & foreigners*
*Source: Tokyo Stock Exchange*

This "out-in" type of merger & acquisition (M&A) played an important role in industries marked by the superiority of foreign firms in regard to management, technology and operation such as financial institutions (banks, securities houses and insurance companies), automakers and pharmaceutical firms.

A notable example is Renault's capital participation in Nissan Motor Co. In 1999, the French automaker acquired a 36.85% equity stake in Nissan and sent Carlos Ghosn into Nissan as chief operating officer (COO). This partnership is well known as a successful instance of complementing each other's management deficiencies (Nissan's management capability and Renault's manufacturing capability). Similar cases are also well known in the reorganization of financial institutions – the takeover of Long-Term Credit Bank of Japan by the corporate rehabilitation fund Ripplewood and capital participation in Nikko Securities Co. by Citigroup Inc.

Such M&A deals by foreign firms had a direct impact on the reform of Japanese firms' corporate governance. When Ghosn arrived as COO, Nissan introduced an executive officer system and an executive pay scheme linked with company earnings performance that included the allocation of stock options. Meanwhile, Shinsei Bank, Aozora Bank and Nikko Citigroup changed their board structure to the high degrees of separation of supervisory/executive functions by introducing an executive officer system, or a committee-style system that is prevalent in the United States.

## Activist Funds & Management Discipline

The second factor behind the sharp rise in foreign shareholdings was an increase in activist funds as typified by Steel Partners, which gathered momentum especially from 2004. At the end of fiscal 2007, more than 1% ownership by activist funds was confirmed in regard to about 300 listed companies, while as many as 123 companies reported more than 5% activist fund ownership, according to an estimate by the NLI Research Institute .

Activist funds targeted Japanese firms that possessed huge amounts of cash, deposits and securities or which were likely to provide great opportunities for arbitrage transactions because of their possession of superior real estate and other advantages. They consisted mainly of companies with free cash flow among traditional Japanese firms (as shown in *Chart 1*). However, activist funds' takeover bids (TOBs) and stockholders' proposals on management policies to those firms all ended in failure or compromise. Even so, companies targeted by funds or potentially very likely to become their targets went ahead with the transformation of their financial policies, such as the retirement of treasury stocks and dividend hikes. Activist funds thus began to function as an important disciplinary mechanism for having Japanese firms that lost growth opportunities.

## Increase in Institutional Investors & Board Reform

The third factor behind the rise in foreign shareholdings was expanded ownership by foreign institutional investors. As shown in *Table 1,* the ownership share of foreign institutional investors initially increased among blue-chip companies of international renown like Sony Corp. and Canon Inc. From 1999, foreign ownership in IT-related firms continued to soar. For instance, at the end of fiscal 1999, the share of foreign ownership in NEC Corp. stood at just under 30%. Moreover, as stock prices lingered low and the sale of stockholdings by banks made headway from the spring of 2003, foreign investors' ownership share also surged rapidly among capital-intensive industries with a high ratio of overseas sales as well as automakers and conglomerate firms, until then marked by high insider ownership.

The growth of foreign ownership progressed in parallel with the unwinding of cross-shareholdings between firms and banks. Following the banking crisis, major commercial banks started to sell stock holdings in order to secure funds for writing off nonperforming loans. The move was accelerated by a law regulating stockholdings by banks (enforced from April 2001). Banks, requested to scale down their stockholdings, went ahead with the sale of ¥1 trillion to ¥1.5 trillion worth of stocks per year from 1998 to 2005. In this context, it claims attention that banks tended to sell stocks in companies of high credit ratings ahead of other stocks. This selective sale was also underlaid by the fact that companies, which had already extricated themselves from dependence on banks in regard to corporate financing, sold bank stocks in their possession. In this process, the ownership share of foreign institutional investors displayed an uptrend.

The investment activities of overseas institutional investors displayed strong preferences. This can be confirmed by a simple model explaining the change in foreign ownership share by way of such indicators as the market-book ratio, asset scale, dependence on corporate bonds (corporate bonds divided by the combined total of borrowings and corporate bonds) and the ratio of total liabilities to net worth. Foreign institutional investors preferred stocks of large-scale, highly viable and low-risk companies highly rated by the capital market.

## Accelerated Board Reform

The increase in the ownership share of foreign institutional investors contributed to accelerating the reform of corporate governance centering on the board of directors. Until then, the boards of Japan's big businesses had been marked by their large size and consisted primarily of promoted insiders except for directors dispatched by banks. As such, the organizational and human separation of executive and supervisory functions left much to be desired. Foreign investors, it is said, brought heavy pressure for reform to bear on transparency-lacking boards by such means as "exit and voice," including persuasion and the exercise of voting rights, while on the other hand attaching premiums to companies with highly transparent boards (hiring outside directors or introducing an executive officer system).

In fact, in parallel with the rise in foreign investors' ownership, board reform continued to make rapid headway from 1999. Up to the end of fiscal 2007 in March 2008, 1,136 of the 2,178 companies listed on the First and Second sections of the Tokyo Stock Exchange finished reforming their boards, according to NEEDS-Cges data. Only 53 of them adopted a committee-style corporate governance system, but as many as 1,083 firms introduced an executive officer system. At the same time, the size of the board was scaled down –

from 16.6 directors in 1993 to 9.0 in 2007 on the average. Speedy decision making was thus sought. Meanwhile, the introduction of outside directors also made progress. As of fiscal 2007, firms appointing outside directors accounted for 21.7% while 696 companies introduced a stock option system.

The progress in corporate governance reform owed a great deal to pressure from foreign institutional investors. This understanding is also supported by my simple regression analysis that tests whether companies with a high ownership share of foreign institutional investors take a positive attitude to reform or not. The result suggests that the individual firms' willingness to reform corporate governance as measured by the adoption of an executive officer system, reduction in board size and introduction of outsider directors is positively related to the high share of foreign institutional investors as well as other variables such as the extent of business diversification and the ratio of overseas sales.

## Effects on Corporate Behavior & Performance

The impact of overseas institutional investors is not limited to promoting board reform. Prof. Christina Ahmadjian of Hitotsubashi University reported in 2007 that the larger the ownership share of foreign institutional investors, the more positive was a stance on the reorganization of business (the scaling down of unprofitable divisions and the reduction of employment). Moreover, the presence of foreign investors has had the effect of expediting the corporate choice of M&A. Even in Japan where M&A had been slow to take place, an M&A boom developed from 1999, and companies chose M&A as part of their growth strategy. Associate Prof. Yasuhiro Arikawa of Waseda University and this author in 2008 sketched out a model for explaining the corporate choice of M&A by such factors as growth potential and the ownership of cash and deposits, and thereby indicated that companies with a high ownership ratio of foreigners take a positive attitude to M&A.

Moreover, there is little doubt that overseas institutional investors served to upgrade corporate performance through their function of having corporate management exercise discipline. In their regression analysis in 2007, Fumiaki Kuroki of Nissei Asset Management and this author regressed annual changes in corporate performance (proxied by Tobin's q and ROA, and both are standardized by industrial averages) upon the ownership structure, controlling other variables such as corporate size and the ratio of total liabilities to assets. The results clearly indicate that the larger the ownership share of foreigners at the outset of the fiscal year, the greater the improvement of performance.

In short, foreign institutional investors invested in companies boasting great growth potential and profitability, which had built up a solid reputation in the market in parallel with the unwinding of cross-shareholdings. It is safe to say that companies with large blocks of outstanding shares taken over by foreign institutional investors made vigorous efforts for board reform and information disclosure against the background of mounting pressure from institutional investors in such forms as the exercise of voting rights and persuasion while improving their performance through appropriate investment, positive M&A and business reorganization.

TABLE 1

### Foreign & institutional investors in selected firms

| | Canon | | NEC | | Nippon Steel | |
|---|---|---|---|---|---|---|
| | FRGN | Outsider | FRGN | Outsider | FRGN | Outsider |
| 1990 | 15.5 | 43.9 | 10.7 | 36.8 | 2.1 | 30.9 |
| 1995 | 36.3 | 53.6 | 14.8 | 41.8 | 12.4 | 39.0 |
| 1997 | 38.5 | 53.9 | 17.6 | 43.1 | 10.4 | 39.9 |
| 1999 | 40.7 | 56.7 | 29.8 | 54.1 | 15.7 | 47.8 |
| 2001 | 45.8 | 63.5 | 28.4 | 55.4 | 14.0 | 49.6 |
| 2003 | 50.2 | **68.2** | **36.4** | **76.9** | 21.9 | 64.2 |
| 2004 | **51.7** | 65.7 | 31.6 | 73.4 | **24.0** | **64.7** |
| 2005 | 51.1 | 65.2 | 29.5 | 75.0 | 21.3 | 59.9 |
| 2006 | 47.0 | 63.3 | 27.7 | 73.5 | 20.7 | 53.6 |
| 2007 | 43.5 | 58.7 | 25.6 | 72.6 | 18.3 | 50.3 |

*Note: FRGN is the share held by foreigners.*
*Outsider: Aggregate shareholdings by individuals, mutual/pension funds & foreigners*
*Source: Financial statements of individual firms*

## Impact of Financial Crisis

Nevertheless, the above-mentioned flow from insider ownership to outsider ownership, accelerated since the banking crisis, appears to be showing signs of change as a result of the outbreak of the global financial crisis stemming from the US subprime mortgage issue from the summer of 2007. After that, the worldwide M&A boom came to an end, bringing about a sharp decline in TOBs of Japanese firms by foreign businesses. Moreover, the activities of activist funds have diminished owing to restrictions on fund availability. At the end of January 2009, the number of cases in which the ownership share of foreign activist funds exceeded 5% showed a fall to 97. Furthermore, after the outbreak of the subprime mortgage crisis, foreign institutional investors' investment pattern in the Japanese stock market turned to net selling. From September 2008 when Lehman Brothers collapsed, their sale of Japanese stocks gained momentum. Their cumulative total of net selling added up to ¥4.3 trillion from September 2008 to January 2009.

Such a change since the outbreak of the financial crisis will inevitably have no small impact on corporate governance among Japanese firms. First, the withdrawal of foreign investors, including activist funds, will signify the receding of their pressure on Japanese companies that need to reform their corporate governance (traditional Japanese firms shown in *Chart 1*). Secondly, it will also spell reorganization of the ownership structure of hybrid-type firms. As already noted, foreign institutional investors had purchased the stocks of large-scale Japanese firms with high profitability and credit ratings. Therefore, Japan's leading firms, classified here as a hybrid type, are presently confronted with massive selling pressure in the stock market. In the face of a steep fall in stock prices, emergency relief measures (the Bank of Japan's outright purchase of corporate bonds from financial institutions and the resumption of activities by Banks' Shareholdings Purchase Corp.) have already been set in motion. In addition to such public intervention, there is the possibility that the ownership of banks and business firms will become a subject of study again. Under these circumstances, how best to prevent a reversal to insider control will come up as an extremely important challenge in designing future corporate governance in Japan. JS

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