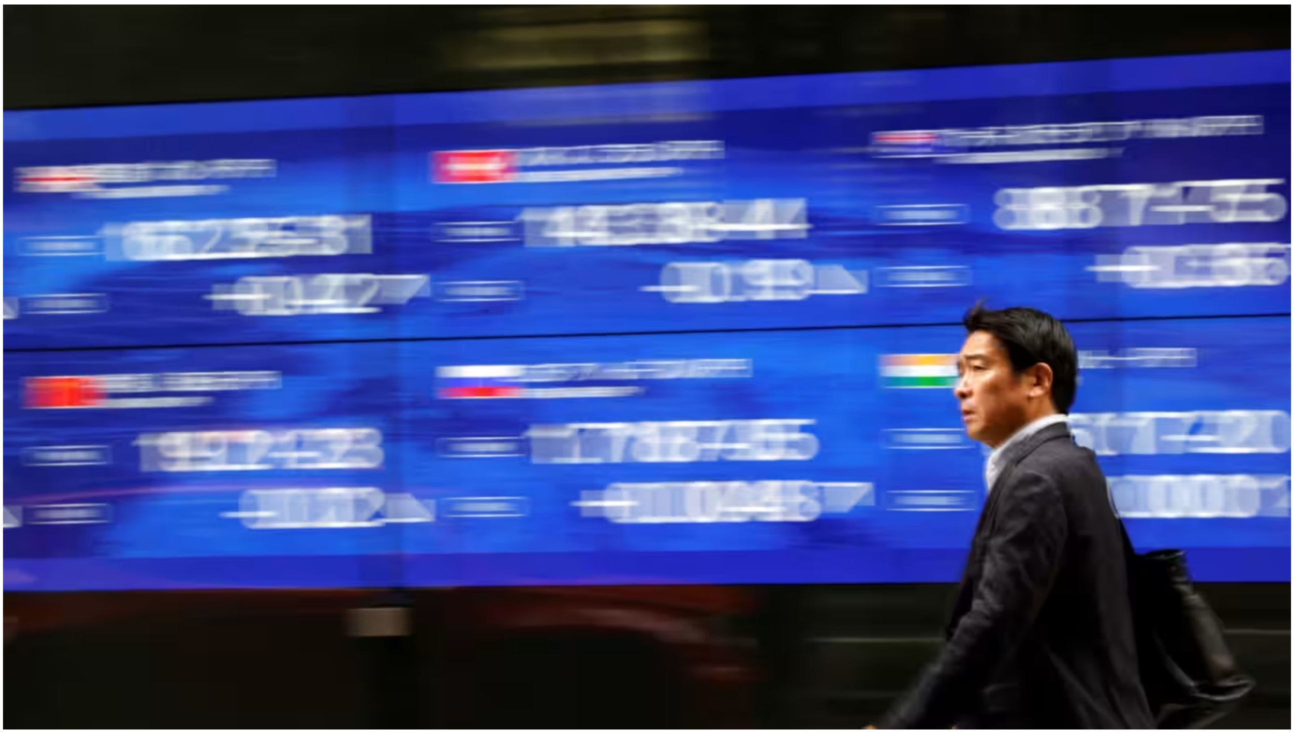
MARKETS

'Japan is waking up' on corporate governance, Dalton co-founder says

Companies like Toyota would benefit from more outside directors: James Rosenwald



Better corporate governance would make Japanese share prices soar, activist investor James Rosenwald argues. © Reuters

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NEW YORK -- 2023 was a year of progress for Japanese corporate governance reform, says James Rosenwald, the co-founder of Dalton Investments who pioneered activist shareholding in the country.

"Japan is waking up. Most CEOs are waking up," Rosenwald told Nikkei Asia in a recent interview, saying that if companies follow his advice, the Nikkei Stock Average could reach 40,000 by 2025.

Edited excerpts from the interview follow.

Q: How do you conduct dialogue with Japanese companies in your portfolio?

A: We sent what I call "holiday letters" to 50-60 portfolio companies on December 23rd, along with the Tokyo Stock Exchange's new request to explain the company's cost of capital and a plan for improving capital efficiency. Each letter is tailored specifically to that company. Most of them focus on three major areas:

No. 1: Aligning the interests of senior management by issuing more restricted stock, including the board of directors and senior and junior management.

No. 2: Improving capital allocation by using cash and leverage to enhance shareholder value, either through share purchases or increased dividends.

No. 3: Increasing the number of independent directors to over 50% with possibly additional female directors.

Q: What are your views on restricted stock?

A: Why shouldn't family companies also give restricted stock to senior and junior management throughout the company, just like Amazon, Facebook Meta or Google? The Ministry of Economy, Trade and Industry (METI) targeted a certain number of times of annual salary as the recommended amount to change the behavior of management. We completely agree with that. Now you're starting to feel like an owner. They think about making money, they think about profit margin, they think about return on their investment.

James Rosenwald, a co-founder of Dalton Investments, urges Japanese companies to issue restricted stock to senior and junior managers to make them think like an owner. (Dalton Investments)

Q: How should companies improve capital allocation?

A: Japanese management should manage the balance sheet a little bit better because they can borrow at less than a 1% interest rate for seven years. With the capital, you can either pay dividends to shareholders, buy back more stock, use it to buy high-return businesses or do something rather than just sleep. Take advantage of the government's current central bank, just like Warren Buffett.

Q: Can you give me a good example?

A: One of our portfolio companies is MinebeaMitsumi. The president of the company is acting like a private equity manager: He's borrowing money, and he's buying companies in Japan. He buys all sorts of different companies, and he buys them at 10 times earnings before interest and tax as EBIT and he's borrowing money at less than 1%. This is a fantastic use of capital and balance sheet, and I think he's going to make a lot of money. And his shareholders are going to make a lot of money.

Q: What are your thoughts on independent directors at Japanese companies?

A: Most Japanese companies need to improve this part. Last year, we put forward shareholder proposals -- including more independent directors -- to Toyota Motor, which still has only 40% of its board members independent. The proposal was to raise that to a minimum of 50%. They were trying to convince me that Toyota Motor doesn't need more independent directors.

But no other major automobile companies in the world -- BMW, Mercedes and Tesla -- have less than 50% independent directors. Even Hyundai Motor in South Korea has more than 50% independent directors.

I was an owner-driver of Toyota for more than 30 years, but now I have a Tesla. And I don't like my Tesla: It has fantastic software, but terrible hardware. Toyota has fantastic hardware, and the software is trying to catch up. I said, "If you had more independent directors from Google, Facebook, Microsoft earlier, you might have been able to understand what was going on in the combination of software and hardware."

Q: What was Toyota's reaction?

A: We withdrew our shareholder proposal because they indicated that by June 2024, they would seriously consider increasing it to 50%. I don't want to be viewed as such a big pain with Toyota Motor, but I want to stimulate them and show them that any shareholder can put forward such a proposal, and hopefully, they will increase to 50% in 2024. My impression was we came to a sort of gentlemen's agreement that they would do that in 2024.

Q: How do you see Japanese companies dealing with unsolicited takeovers?

A: In Japan, unsolicited takeovers have been viewed as so hostile for so long that I think it's going to be difficult for CEOs to make that kind of decision. I think they would rather only do friendly M&A. But the new METI M&A guidelines do provide lots of support for unsolicited bids. I'm positive that METI would like to see consolidation in many industries. There are just too many publicly traded companies in every single industry, and consolidation might make some global leaders.

Q: What improvements have you seen in Japanese corporate governance over your years as an activist investor?

A: I have been investing in Japanese companies for 50 years. The first investments were in 1972 -- Kirin Beer and the Bank of Tokyo. I've only seen improvement in Japanese corporate governance since 2014, 2015. Before that, nobody even talked about it. Before then, we didn't own any salaryman companies, because the government and the Tokyo Stock Exchange were not my friends. Now the Tokyo Stock Exchange is the No. 1 activist in Japan. The [government and the Bank of Japan] and Japan's Government Pension Investment Fund are now also quiet activists. Those are the three biggest activists in Japan.

Japan is waking up. Most CEOs are waking up. Most companies are very interested when we send letters. The power of Institutional Shareholder Services and Glass Lewis as proxy advisory firms is rising, and Japanese pension funds are waking up and starting to vote.

This is still early days, but if Japanese pensions and investors wake up and start voting in favor of stock performance, the Japanese stock market is going to fly. I think if Japanese companies follow Warren Buffett and use the three items in our letter, the Nikkei Stock Average will reach 40,000 by 2025.