How the Tokyo Stock Exchange Is Pushing for Better Shareholder Returns

It's a new chapter for balance-sheet reform.

Jessica Bebel • May 3, 2024

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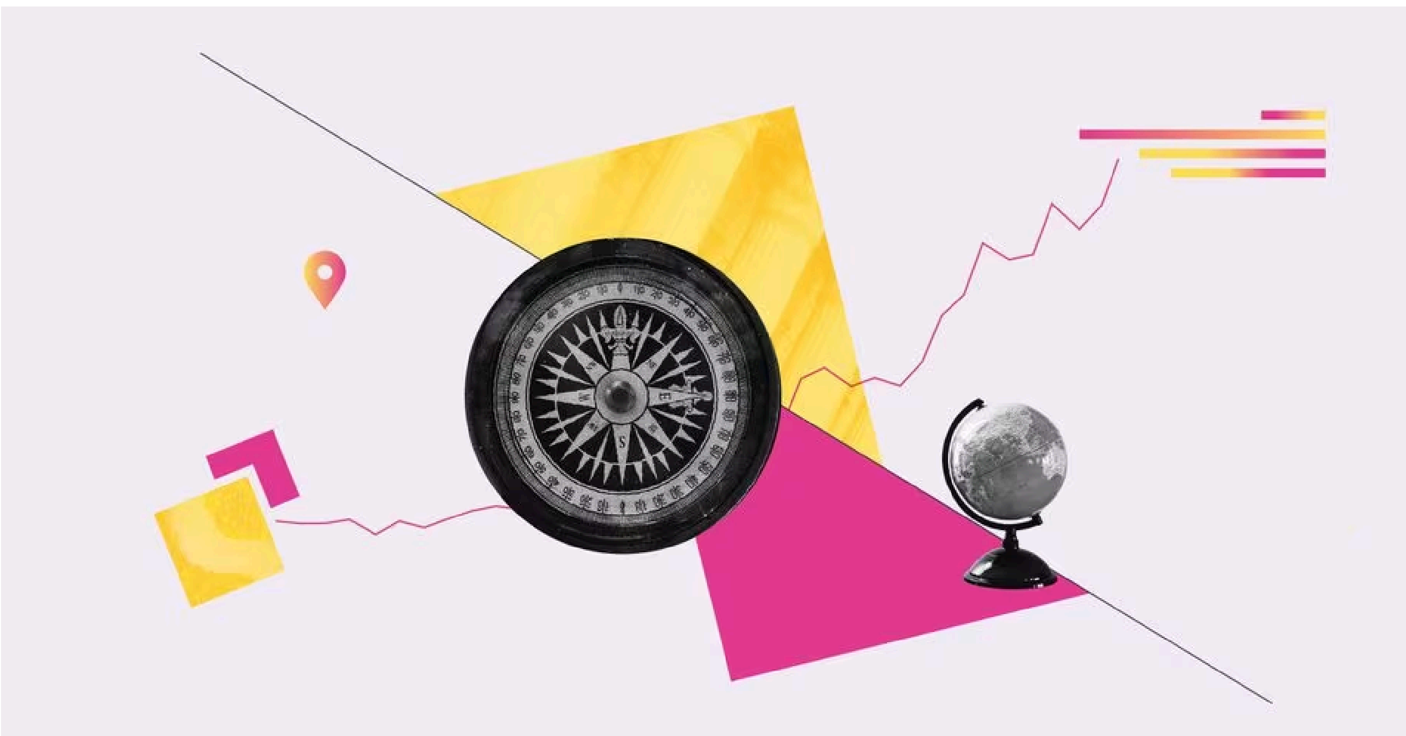

On this episode of *The Long View*, Carl Vine, co-head of Asian Investment for M&G, talks the Japanese equity market, structural issues, and investing policy.

Here are a few excerpts from Vine's conversation with Morningstar's Christine Benz and Dan Lefkovitz:

How the Tokyo Stock Exchange Is Pushing for Better Capital Allocation

Christine Benz: We wanted to ask about policies related to investing in Japan. Tokyo Stock Exchange has really pushed for better capital allocation with an eye toward improving shareholder returns. They're focused on price/book. Can you talk about that whole effort and how big a factor it is?

Carl Vine: You've really hit on what I think is a very important aspect of the rally in Japan that we've seen in the last year and a half. I think the anatomy of that rally, I feel, was started in late December '22 when the Bank of Japan finally came out and said, look, we might be thinking about changing interest rates. Obviously, it then took them another 15 months. But the cat was out of the bag then that they may be winning this long-term fight against inflation. And then obviously Warren Buffett became a bit more vocal in early '23.

But then around the same time as Buffett, we had Yamaji (Sama) of the Tokyo Stock Exchange come out and do something, which I think honestly is quite extraordinary in some sort of global context. So, the head of the stock exchange came out and very publicly said, any company that's got a price/book ratio—not my favorite metric as it happens, but anyway—any company that's got a price/book ratio of less than one—so about half the stock market at that point—you need to write me a letter of apology. I'm paraphrasing a little bit here and being a bit flippant. But that is what he said, I want you to write Tokyo Stock Exchange and tell us what you're going to do about it. And his message, the message that was then given with more nuance across TV interviews and radio interviews and podcasts and so on, was you need to make a decision whether you want to be listed on my stock exchange or not. If you want to be on my stock exchange, you need to understand your cost of capital, both what it should be and what you need to do to earn at least that cost of capital. And I want you to write that to me and my team at the Tokyo Stock Exchange and then we're going to make that information public. And then in a year's time, which is now about seven weeks ago, I'm going to name the companies that have not yet written that letter and I'm going to do this all publicly. So, we're going to get into the shame motivation. They gave them one year to get it done, then he said, I'm going to name and shame.

So pretty radical for the head of a stock exchange to take that level of stance and to be supported. It's not like the Cabinet Office didn't leak out messages that he was overstepping the mark. He was well supported. Nobody held him back whatsoever. So, I think for me as an investor, particularly with our engagement orientation, where we've been trying for a long time to build an investment program that tries to help companies on their journey of self-improvement. This has made my job so much easier actually, because it's not just a foreign investor that's turning up and telling you to do various things with your balance sheet. You've now got the head of the stock exchange saying, if you don't understand your cost of capital, go and find out. And if you don't want to do that, fine, you can delist. And being listed in Japan is quite prestigious. So, we've seen a response. We've definitely seen a response. We've seen a response from investors. Investors took that pressure very positively. The only game in town in 2023 in terms of intramarket behavior, frankly, was—well, there were two. There were semiconductors, but then really the big game was low price/book stocks. They all outperformed indiscriminately, I should say. But a pretty amazing aspect of what we're seeing in Japan now is this state-coordinated sponsorship of really trying to cajole the corporate sector to improve returns on invested capital. There's not that many times in history where I've seen such a top-down focus on that.

Has There Been a Reduction of Companies That Trade Below Price/Book?

Dan Lefkovitz: That’s fascinating. Have you seen a meaningful reduction in the number of companies that trade below price/book? I’m curious what you’re seeing in terms of capital allocation and how companies are using profits for dividends versus share buybacks versus reinvestment.

Vine: I’d say the changes that we’ve seen in the last year, it didn’t just start a year ago. This really did start, as I said, in the 2011-12 period when Abe came out and said, we’re going to do things differently, the social contract is going to change. We’ve seen over a decade of growth in dividends, growth in earnings. Compound earnings growth has been about 8%, 9% in Japan over the last decade. It’s pretty impressive for an economy that’s been bereft of any growth. And it’s not overly blessed in the technology sector like the US. So that’s been some pretty impressive, very broadly spread earnings growth. We’ve had dividends growing more. So, I think dividends have probably compounded, I think almost about 12%, something in that region for over a decade now. Payout ratios are still pretty low, about 40% in Japan. Lots of scope for further increases in dividends. Every year, for as many years I can remember we’ve had successive increases in buybacks. So yeah, Japan is getting religion about more efficient deployment of capital.

That’s an old story. And I think the Japanese equity story, some people are just fatigued with it. They say, I’ve been hearing about Japanese restructuring calls for 20 years. And I have some sympathy for that. It has been going on for a long time. But you haven’t seen for 20 years the types of changes that you’re seeing now. So, the fact that it’s an old story doesn’t mean to say that it’s a story you should ignore. The facts are bearing out that something very big is happening. I think we’re entering a new chapter now of the balance-sheet reform, which is before it was more at the edges, we’ll do a few buybacks, we’ll nudge up the payout ratio. I think we’re now seeing examples of companies saying, “Actually, I’ll go from a 30% payout ratio to an 80% because it’s the appropriate thing to do.” We’re seeing less incremental change and we’re seeing changes more driven by first-principle thinking rather than let’s just do a bit more than we did last year. So, we’re seeing some more radical changes.

We’re also seeing the concept of the best owner, the best owner concept in corporate finance. Let’s say, I’ve got five divisions and I think I’m the best owner of these two divisions, but those three would probably be more competitive if they were part of another company. Simple concept, but it’s never really been pervasive in the thinking of boards of directors in Japan. That’s totally changed. Every company we speak to now that’s got more than one business line, which is most of Japan—a lot of diversification in the corporate sector—they’re all figuring out, actually, we’re going to focus on these two or three things where we’ve got global competitiveness and these two or three things we’re going to go and find out who else this business needs to live with. That corporate re-optimization is releasing massive corporate value across Japan. And I think it will be a multiyear trend. That won't happen overnight.

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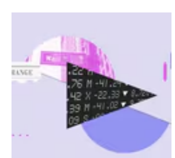

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