September 2014

Linking Japan

Bimonthly Investment Insights

Appetite for Acquisition Returning?

Following a Lengthy Lull, Japanese Firms Begin Testing Outbound M&A Waters

Publisher's Note

Finally summer is ending. Those of you who have been to Japan in the summer know it is far from bearable. And global warming has even made the northern island of Hokkaido far less likeable than previous years—though the sushi is hands down still the best in the world.

Japan finds itself still waiting for the third arrow to hit its targets. Prime Minister Abe announced his cabinet early this week and it is heavy on women—a potentially positive improvement—but weak on "implementors and influencers." So overall an appeasement of his Womanomics team but potentially ho-hum results. The one shining—positive or negative—is the appointment of Yasuhisa Shiozaki as the Minister of Health, Labour and Welfare. Minister Shiozaki now sits on top of the national pension and he has regularly preached about responsibly investing in the market to get preferable returns over the abysmal ones of today. Global securities firms are salivating for a chance to manage the capital—hopefully progress will emerge here.

Otherwise we will have to see if improved governance and Prime Minister Abe's new cabinet point us in the right way because 900,000 plus entities are behind in their consumption tax payments, making me for one question if a 10% consumption tax even makes sense.

The one positive I have seen is Suntory's acquisition of Beam, as it has led to a Beam bourbon festival at the Roppongi Hills complex in Tokyo this month. Unfortunately, I am a single malt lover.

J. Michael Owen
Chairman
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Meanwhile, We're Still Waiting

Having Taken Its Swings, the Bank of Japan Calls on Government, Corporations to Step Up to the Plate

Richard Smart - Writer, Japan

The "quantitative and qualitative monetary easing" policies of the Bank of Japan (BOJ) appear to be working. There is still a need to reform Japan's economic and fiscal policy mix under Prime Minister Shinzo Abe, known as Abenomics. But the BOJ is doing its part. There are signs that the bank will attain its target of 2% inflation within two years.

Stimulating an economy, however, comes with risk. And unleashing what is, in relative terms, the most intense stimulus package the world has ever seen—worth 1.4 trillion yen (about $14 billion)—could have unprecedented and unpredictable destabilizing effects.

BOJ Governor Haruhiko Kuroda remains unfazed. "Annual consumer inflation will hover around 1.25%, before picking up again in the latter half of the current fiscal year," he said at a July news conference. "We're seeing rises in wages and prices. I therefore think fewer companies will continue to resort to the type of price competition they deployed in times of deflation."

As part of the bank's mix to end deflation, it plans to nearly double the nation's monetary base from 2013 levels by the end of 2014, increase Japan government bond purchases and invest an additional 1 trillion yen in exchange traded funds and 30 billion yen in Japan real estate investment trusts.

The investment in J-REITs and ETFs is designed "with a view to lowering risk premia of asset prices," according to the bank. In other words, the bank is pumping money into these two asset classes to reduce the amount of risk taken by people choosing to invest in Japan. The BOJ invests in domestic asset management companies, which then put that money into the market, thus reducing volatility in the Nikkei stock exchange at a time when risks such as a downturn due to the 3 percentage point sales tax hike in April occur.

There are, however, risks to this strategy and reasons to be skeptical. "The purpose behind the BOJ's buying of ETFs linked to the Nikkei-400 index is to help drum-up interest in the product," says Mintcho Petkov, an independent adviser and former dealer at Citigroup based in Tokyo. "I don't believe the BOJ expects the change will significantly improve the effectiveness of their market operations. As such it is a fairly innocuous policy shift."

Petkov believes the BOJ has already done its part, and that the onus is on the government and corporations to bring about real economic change. "The main risk is that [the ETF purchases] may be used as a way to avoid tackling the real issues that keep Japanese companies' returns on equity at one of the lowest in the world, namely poor corporate governance and low labor productivity."

Alternatives

The BOJ's action is half the story. Economic statistics after the tax hike are the other. Exports are declining, sentiment is weak and growth estimates for the year have been cut. Japan also faces a decision by the end of the year on a further hike in the sales tax—by 2 percentage points to 10% in October 2015. A failure to raise the tax further could send a signal to markets that the nation is not serious about long-term fiscal consolidation, with consequences. Japan's debt of more than 1 quadrillion yen has long been considered unsustainable if action is not taken. Sales tax hikes are seen as a step in the right direction. Abenomics, as an attempt to resuscitate the economy, was also seen in a positive light. Keeping momentum going is essential.

The problems are in part structural and in part out of the government's hands. The third arrow of Abenomics—growth strategy—has yet to be fired. The prime minister has repeatedly told foreign audiences he will "act like a drill" against the bedrock of vested interests. He has so far failed to do so. His term in office has been mainly focused on security policy. But there is still time, even if it seems unlikely there will be a third arrow in the coming months.

Tobias Harris of Teneo Intelligence points out that the next session of parliament, according to a speech made by Abe in late July, will be devoted to revitalizing rural areas. That, he says, increases the likelihood that the third arrow will turn out a dud. "By delaying 'third arrow' legislation until 2015 at the earliest, the shift to rural revitalization makes it increasingly unlikely that the government will realize major structural reforms during its tenure."

Does that mean, third arrow absent, the BOJ will have to increase the money it is pumping into the economy? Petkov thinks not. "Increasing the amount of monthly asset purchases is unlikely to bring any additional benefits," he says. "In fact, many BOJ speakers have expressed their confidence in reaching the 2% inflation target and Kuroda has actually started pushing back on the government to do its part and enact the promised structural reforms."

So the economy, seemingly stuck between a rock and a hard place, must look to the private sector. Incomes are dropping and investment is not as strong as required to create a "virtuous cycle" that can bring about a truly vibrant Japan. But that can change.

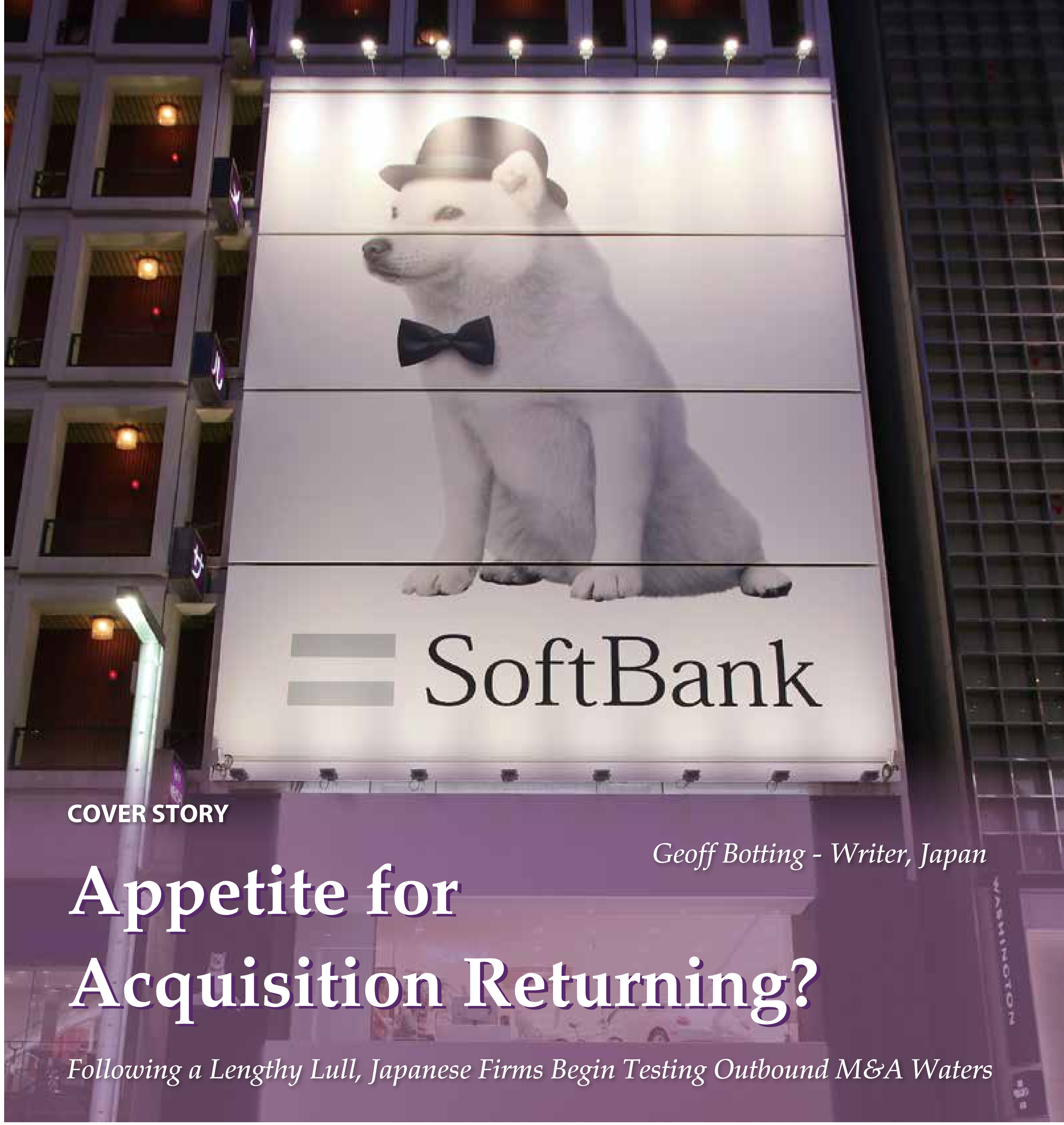
"…tackling the real issues that keep Japanese companies' returns on equity at one of the lowest in the world, namely poor corporate governance and low labor productivity."

The BOJ and government are in a stalemate. Kuroda believes, maybe correctly, that the bank is doing its part. And the Abe administration, heading for the two year mark, is not particularly suffering at the opinion polls. Approval ratings are now below 50%, but Abe is 20 months into his tenure. By this point, all previous prime ministers had reached the chopping block since Junichiro Koizumi left office in 2006. Most ended their tenures with single-digit approval ratings in opinion polls. Sitting back, embracing stability and allowing the economy to move along without intervention may be the best idea for Abe.

Michael Cucek, consultant and author of the popular blog Shisaku, points out that the current predicament—real wages shrinking as prices rise—may in fact be evidence that Abenomics is working. The BOJ and the government have done their part; it's time for executives to contribute. He believes the government should take the following line: "The executives of Japan's multinationals can bank their currency devaluation boosted profits, leading consumption to fall off a cliff, too—or they can buckle down and start raising national incomes by either paying more to existing workers, hiring more workers, engaging in some capital expenditure or distributing profits among shareholders."

Abenomics is at another crossroads. With stimulus looking to have gone as far as it will go, the effects of the weak yen having run their course and the government having done all it is likely to do for now, it is now up the private sector. Abe appears to be playing a game of brinksmanship with the corporations. Sometimes, brinksmanship is required.

Richard Smart is a writer, editor and translator based in Tokyo.
His interests include Abenomics, politics and social change in Japan.



COVER STORY

Geoff Botting - Writer, Japan

Appetite for Acquisition Returning?

Following a Lengthy Lull, Japanese Firms Begin Testing Outbound M&A Waters

When Japanese companies look at their domestic market, they don't see a lot of growth on the horizon. But when they look into their bank accounts, they find plenty of cash, and they might also note their extremely easy access to credit.

So where is Japan's M&A mania? The conditions, after all, appear ideal. Even the government is prodding Japanese corporates to seek greener pastures abroad.

"If Japanese companies want to grow on the world stage, they're going to have to grow internationally. And it's much easier to grow through M&As than organically," notes Eric W. Sedlak, a lawyer at Jones Day in Tokyo.

Yet large sections of Japan Inc. remain on the sidelines. The volume of outbound M&A deals from Japan was down sharply last year to US$52.5 billion, a 53% drop from the previous year, according to Dealogic.

"It was almost like corporate Japan last year took a deep breath, and said, ‘Right, we’ve done the first wave of overseas acquisitions, what do we do next?’” says Graeme Preston, a corporate partner at Herbert Smith Freehills in Tokyo, referring to a surge of deals directly following the 2011 earthquake and tsunami.

Even so, 2014 started off with a bang. In a mega-deal worth US$13.6 billion, beverage maker Suntory Holdings announced in January it would purchase Beam of the United States, which makes Jim Beam bourbon and other alcoholic beverages.

A month earlier, Softbank, having completed another massive deal—a US$21.6 billion investment in Sprint Corporation—announced it had its sights on T-Mobile, another U.S. mobile carrier. Softbank President Masayoshi Son and his lieutenants had been been engaged in an ambitious lobbying campaign to win over U.S. regulators, until they announced in early August they would pull out of talks over fears U.S. regulators would block the deal.

The question now is whether these high-profile deals are isolated events or finally are a signal of a breakout for inward-looking Japan Inc.

Sedlak reckons that a slight upturn in M&As could be in the offing, depending on how some of the deals progress.

“Things in Japan usually don’t move that quickly. I think [the trend] will probably increase, but I’m not certain it’s going to increase 50% or anything like that,” he says. Yet he adds: “Things can blow hot and cold. Somebody might get burned in a country, and then Japanese investment in that country dries up.”

Preston, who specializes in deals involving technology, media and communications, is considerably more optimistic. “This is my personal view, but I think we’re seeing a return of ‘big ticket’ deals as the focus shifts away from Asia (where deal values have been generally low) back to the U.S. and Europe. I think it's possible we could see some really significant deals and strategic alliances this year.”

He adds that he expects Europe to be a hot spot for Japanese companies looking to merge or acquire assets across all sectors.

Clearly, outbound M&As here have plenty of scope for growth. In Japan, the deals usually account for around 3% of the market value of all publically traded companies, whereas the figure for the U.S. is 6%, according to figures in a Bloomberg report in July.

So what continues to hold back Japanese companies?

The rising costs of merging and acquiring is one consideration, according to Sedlak.

“I think Japanese companies missed their chance after 2008 and 2009, when the Japanese economy was very strong among the G-7 economies and the yen was very strong,” he explains. “Effectively, valuations were down in the rest of the world, which was on what you might call a ‘half-price sale.’”

Since then, valuations have climbed and the yen has weakened, making overseas assets more expensive.

Preston, however, sees the weakening yen factor as a ‘red herring.’ “A lot of Japanese companies have huge cash reserves in U.S. dollars and a significant percentage of their revenue is earned in U.S. dollars. So as the yen weakens, a lot of companies’ balance sheets start to look better than otherwise,” he says. “If you have a good balance sheet, it enables you to go and do M&A overseas.”

Another constraint to M&A growth is related to Japan’s demographics, according to Sedlak. “There are limited human resources in Japan. A lot companies find themselves stretched when they try to do overseas investment because they don’t have enough solid English speakers who also have finance or engineering skills. These are the people required to integrate the acquired company into the Japanese one.”

He predicts the situation will only grow worse. Japan’s birthrate remains low and research shows that today’s young Japanese are considerably less interested in learning English or studying abroad compared to baby boomers or their parents’ generation, who will soon be retiring.

“Japanese companies should be looking at people in their late 60s and early 70s, who are still ‘genki’ (energetic) and have the [necessary experience],” Sedlak says.

Japan Inc. should also take a hard look at its domestic situation, where consolidation among industrial small and medium-sized enterprises could boost efficiency and profits. In the years following the end of World War II, Japan produced a slew of these SMEs. Their founders have long since retired, and many of the successors have spent recent years floundering in a saturated and stagnant market at home—while also trying to figure out how best to respond to globalization.

“Companies supplying, say, auto parts [that are] one level up on the chain could get a wider human capital base if they were to consolidate,” Sedlak says.

Referring to companies he has worked with, and which already have subsidiaries in Asia, he says: “Maybe you don’t need two finance managers. You could free up one, who could be sent to the overseas operations.”

“In order for [companies like this] to survive, they may need to operate in four ASEAN countries, instead of two.”

In the 1980s and into the early 1990s, Japanese investors made the headlines for their overseas dealings that were ambitious but offered no discernible synergies, or for grabbing exotic status symbols like golf courses or landmark buildings.

That attitude has since changed, according to Sedlak. “I think the Japanese now are pretty strategic about what they’re buying. They’re much more careful than how they used to be about biting off more than they can chew.”

Nowadays, when the companies beg off deals, they normally do so on thoroughly technical or financial grounds, such as concerns over the compatibility of product lines, etc.

At the end of July, ANA Holdings, the holding company of All Nippon Airways, pulled out of talks to take a 49% stake in Asian Wings, a domestic airline in Myanmar, where foreign investment has been piling in since a civilian government took over in 2011. The Japanese airline cited “intensified competition” in the Southeast Asian country for its decision.

“On one hand, it’s disappointing that Japanese companies are not being more adventuresome; on the other hand, it’s probably due to responsible decisions,” Sedlak says.

Despite the lackluster number and volume of outbound deals, Japan Inc. does seem to have evolved in its attitudes toward M&As. On July 16, 2009, The Economist noted that Japanese business people commonly associated mergers with failure. That way of thinking has largely faded, especially in light of moves by Suntory and Softbank, among others.

“One thing that should, in the long run, improve Japanese companies’ performance is investing overseas, because the return on equity and assets outside Japan is higher than in Japan,” Sedlak says. “So if the companies expand outside Japan, their performance and share performance will improve.”

Geoff Botting is a freelance journalist and translator based in Tokyo. He has been in Japan long enough to have witnessed the pre-bubble exuberance first-hand, and then watched developments unfold following the burst, some 2 + decades ago.

A Softer Approach

Corporate culture can be impacted by a variety of factors including the industry the companies are in, the “age” and depth of history of each company, and demographics such as average age and experience level of employees, the proportion of female employees and the personnel system in place—these elements and more contribute to the construction of values held and the vision shared by members of a particular company.

The impact of culture is implicit, and corporate culture is undocumented, and for these reasons it can be considered the most challenging aspect of a merger. Due diligence conducted prior to the merger generally focuses on the tangible aspects of the integration, and though depending on the source it is said that anywhere from 30 to 50% of failed mergers are attributed to clashing corporate cultures, time is not dedicated to the “soft” aspects of the integration as it is too difficult to accurately assess the impact such studies and measures might have.

Why do M&A deals fail?

Rank	Top 10 Pitfalls in Achieving Synergies	Negative Impact
1	Incompatible cultures	5.60
2	Inability to manage target	5.39
3	Unable to implement change	5.34
4	Synergy non-existent or overestimated	5.22
5	Did not anticipate foreseeable events	5.14
6	Clash of management styles/egos	5.11
7	Acquirer paid too much	5.00
8	Acquired firm too unhealthy	4.58
9	Need to spin off or liquidate too much	4.05
10	Incompatible marketing systems	4.01

Source: Forbes (survey of 500 CFOs)
*“Negative Impact” index – scale of 1 through 7 (7 being the highest)

Perhaps there is change in the wind concerning how integrating corporate culture is approached. At the spring 2014 Infinity Ventures Summit held this May in Kyoto, Monex Group (8698) CEO Oki Matsumoto was interviewed concerning M&As. His company, an online brokerage firm, acquired electronic trading platform TradeStation of the U.S. in 2011. “When it’s a domestic transaction, I avoid using the term ‘M&A’. In the case of a U.S. firm, I think you really have to use the term ‘acquisition’ as it’s more direct and clear. The head of the U.S. firm and its management need to know I’m in charge.” He said that the relationship with the U.S. firm was very strong, but added that “it’s a very vertical relationship and very regimented, like a military structure. If you don’t do it that way, it actually makes it difficult for them. That’s the real difference between domestic and cross-border M&As.”

He observed that when a major Japanese firm acquires a U.S. company, a Japanese person is generally appointed to the top spot. “That way Japanese executives are in charge both in Japan and overseas, with foreign executives in the ranks below.” Matsumoto doesn’t agree with that, choosing instead to have the foreign subsidiary headed by a foreigner. “I keep a firm grip on the top spot and leave the local management to (him or her)… when you want to recognize the best existing qualities of both sides, especially when it involves a foreign firm, this is the best way to accomplish that.”

Nicholas Benes, Representative Director of The Board Director Training Institute of Japan

Code of Conduct

Abe Administration Takes Firm Action Towards Meaningful Corporate Governance Reform

Linking Japan *speaks with Nicholas Benes concerning Japan's understanding and acceptance of corporate governance, its evolution, and the significance of the Abe administration's historic decision to make corporate governance improvement the lead "pillar" in its growth strategy.*

LJ: There are things about Japan that are impossible to learn, such as the culture and, of course, corporate governance, without spending some time here.

NB: The trouble with this topic is that it's arcane and deep. You'd be amazed at how many institutional investors have huge amounts of money invested here, but are not very knowledgeable about what's really going on in Japan, in practice and in the law.

You would like to see an ongoing debate on a broad front concerning how to improve corporate governance and "best practices" and why it's important to do so, but so far, the discussions have lacked the necessary depth.

At The Board Director Training Institute of Japan (BDTI), we are constantly on the lookout for developments in laws and practices abroad that we can mention on our web Discussion Forum, because there is very little comparable Japanese-language content available, and most people here do not follow such developments in other countries.

Many of the major Western media outlets, professional groups, and topical experts regularly provide a wide range of articles on corporate governance, but coverage of similar content is relatively sparse in Japan, with the exception of the single issue of external directors. The overemphasis on the introduction of external directors on the part of the Japanese media—as if it is a panacea or the only aspect of governance that matters—is a rather misleading, superficial look at a subject that is rather deep.

Having said all this, I think we are at a tipping point.

LJ: Could one of the many reasons the discussion on corporate governance has not advanced be that there have not been as many incidents of impropriety?

NB: It is hard to tell whether there are fewer instances of impropriety. It is true that there are fewer instances of governance mishaps that are caused by personal greed. They exist, but they happen comparatively rarely. In contrast, the typical corporate scandal in Japan occurs because managers cover up something embarrassing out of a misdirected sense of loyalty to the company, things snowball, and later on the cover-up is uncovered.

If you consider instances such as the many product defects—some deadly—that went unreported at Mitsubishi Motors for many years, or Paloma's abysmal handling of a recall of defective water heaters, personal greed was not a factor. This is a key difference between Japan and other nations. Here, we tend to have incidents such as unreported safety violations or data leaks, companies not paying out on insurance policies, falsified accounting where no one benefits personally, or the simple non-maximization of shareholder value. These things happen, and then are not made public or there is not enough accountability about the "fix," because the boards of these companies are overwhelmingly populated by insiders.

However, there are many exceptions. In a well-managed company here, such as Toyota or Nidec, there is rigorous internal management that is actually a component of the corporate culture, and an environment that breeds executives that will carry forward these principles. The problem with this is, as an investor, do you want to invest your money on faith? Can you properly assess the corporate culture to begin with? And, is it accompanied by any checks against groupthink?

LJ: How do you introduce external directors into a culture like that and have them serve a meaningful function? Do they have to be Japanese?

NB: I think it may be better if some of them are not Japanese, as many firms here have begun globalizing. This is one reason Toyota introduced three external directors to its board last year.

Naturally it's better if a company appoints external directors because it believes it is best, rather than just because it is a requirement.

I've been a member of four different boards for a total of about seven years, including companies that were listed, unlisted, and one that had just been delisted—Livedoor post-scandal. I noticed that these boards all had commonalities in terms of what was working well and what wasn't.

This experience is really what motivated me to establish BDTI. I discovered that on the one hand, even a single external director—a lawyer or investment banker, for example, who's fluent in Japanese, diplomatic and persistent—can have a significant positive impact on a company in many ways.

On the other hand, there are limits to the impact you can have on some of the most crucial issues that affect corporate value. After a while, I realized that in these cases, my own analyses and arguments were usually not the problem. Rather, the biggest problem often was that many other people on the board did not have the fundamental skill sets required for the position—knowledge of finance, governance practice, and basic corporate law about their own duties, for instance. Moreover, they were not participating in board meetings as directors, but rather as division heads. They did not have director "mindsets" such that the board would be a real board providing oversight.

This all poses an even bigger problem if there's only one of you and eight of "them." The fundamental dynamic of a board meeting is that if, for instance, I raise questions about a certain topic and I'm met with silence, it's very difficult to carry on a truly constructive dialogue. It can be done—I have done it myself—and what happens is that after a few hours I let them know that I intend to vote against the measure or issue. This without fail initiates a discussion on compromise, as boards here prefer to conclude such discussions with complete agreement, a unanimous vote. Though this represents the external director gaining some degree of traction, your view may not win out on the really crucial issues.

These are major issues here—the lack of basic "directorship" skills, including an understanding of best practices, the purpose of corporate governance, and the duties and role of directors. As a result, when people serve as an external director, they often operate under the subliminal misconception that the main responsibility is to be on the lookout for major scandals or accounting fraud, but not do much more. They tend to view the role in a very limited way.

The way to introduce external directors with greater impact is through a corporate governance code. The corporate codes of Hong Kong and Singapore, for example, require that one-third of the board be composed of independent directors, and companies that do not comply are required to justify their decision.

The corporate governance code should contain specific guidelines with regard to the function and role of independent directors, outline the necessity to form committees of independent directors in certain situations, and put companies in a position to then be required to explain why they cannot or will not implement these best practices. This is the essence of disclosure that facilitates good "stewardship."

Another key policy should be to broaden understanding about governance via training. This really needs to start long before a person is in a position to be named to the board. To make it explicit corporate policy for managers to receive such training, and director training later on, would ease the minds of foreign investors when they see the names of newly nominated directors on the proxy statement. Since it's not realistic to expect Japanese companies to have boards that are composed of a majority of independent outside directors anytime soon, it becomes all the more important to ensure that the inside directors have the necessary training.

LJ: Shareholders in Japan have broader rights than shareholders in the U.S. But the fact that the bulk of annual general shareholders meetings in Japan seem to take place in a two-week period at the end of June isn't really indicative of this.

NB: It is true that there is still a concentration of AGMs in late June, but almost perversely, the fact that shareholders have strong rights provides a sort of "excuse" contributing to this.

Generally shareholders here have the right to vote on the proposed dividend and related proposals. It's not an advisory vote—if a shareholder resolution is passed, it must be implemented. Because of this, most companies' Articles of Incorporation require that the shareholder meeting be held within three months of the cutoff date for shareholder voting purposes, which is set as the fiscal year end date. Legally, the shareholder meeting must be held within three months of the cutoff date.

In most cases, the fiscal year ends in March here, so this inevitably leads to the concentration of AGMs at the end of June. But this is sort of an "excuse," because in reality, a well-managed company can close its books within a month to six weeks, and then you add a notice period. And if companies wanted to, they could amend their Articles to specify a cutoff date that is after the fiscal year end.

Most votes are done by proxy, so the current concentration of AGMs in June puts huge timing pressure on the proxy advisory firms as well as on institutional investors abroad who want to research the company more deeply—and perhaps even speak directly with someone there—prior to voting their proxy.

But as I said in general shareholders here have strong rights. Shareholders in Japan also have "access to the proxy." Despite repeated attempts this is still not available to shareholders in the United States. What this means is that shareholders in Japan have the right to nominate directors and require their names to be put on the proxy statement.

Shareholders also have the right to approve aggregate director compensation—and again, this is not an advisory vote. This is an issue that outside directors are well-suited to preside over.

LJ: Cross-shareholding has been practiced in Japan for several decades. Isn't it considered a protective mechanism against hostile takeovers, among other things?

NB: Yes. The practice really came about back when Japan joined the OECD in the early 1960s. To guard against hostile potential takeover attempts of Japanese companies by foreign firms, Japanese firms sold large blocks of shares to other domestic firms, and vice versa. Life and casualty insurance firms used cross-shareholding as a means of securing contracts in the 1970s and 1980s. Cross-shareholding was never actually based on a formal agreement—it was mainly done in order to maintain or protect a relationship, but with a quasi-defensive motivation in mind. The level has come down considerably, but there are still firms where cross-shareholding accounts for 30 to 40% of their shares.

LJ: Are such companies going to be encouraged, by the corporate governance code or in some other way, to explain the nature of those arrangements?

NB: It's not clear just how that will be handled. The current administration has received advice from Germany—Japan's Policy Research Council chairman Yasuhisa Shiozaki met with former Chancellor Gerhard Schroeder, who was successful in implementing pretty widespread reform, including a reduction in cross-shareholdings through a tax incentive.

There has been talk in Japan of possibly requiring additional disclosure by companies about their rationale for each "policy shareholding." What I hope happens is that companies are not only required to justify each shareholding, even if only briefly, but that they are also required to show that the amount of the holding, and the aggregate value of all policy holdings, is not of such a level as to adversely affect the company's risk profile.

LJ: Beyond the risk issue, don't such holdings also serve to suppress the potential value of the stock and hamper liquidity?

NB: Absolutely. The good news is, once you do commit to making that type of disclosure, you open yourself up to criticism unless you have a good reason for the shareholding. Even then, over time companies will need to be able to show that the stock provided a good return, or that return and analysis of the stock was a factor in the continued holding of the shares. I think many companies with policy shareholdings are not even following the stocks very closely.

Domestically, the biggest problems with the policy discourse on corporate governance in Japan are that it's very narrowly focused, and that the majority of people who participate in this conversation have never sat on a board of directors.

LJ: Tell us a bit about the courses you offer at BDTI. Are most of those who enroll already directors, or in line to be appointed, or do you also get enrollees earlier in their careers?

NB: Most of the people who attend our courses are at a point in their careers where they've got another five to six years before being considered for appointment. We do also have some people who are already directors or statutory auditors. And while there are a certain number of people who enroll independently, it's encouraging to see that the majority of our participants are people who've been selected by someone senior at their companies who simply believes in the importance of good governance. It is also encouraging that we are now receiving more requests to provide customized courses for firms, sometimes for the entire board.

We offer our directorship course in English as well as Japanese. We also offer a wide range of drill-down seminars, compliance training, and e-Learning about the Company Law and governance fundamentals.

LJ: Japan's Stewardship Code, introduced earlier this year, was signed by nearly 160 companies. Would there have been this level of apparent acceptance if this Code had been introduced five or ten years ago? Was the creation of the code a function of the global financial crisis?

NB: It was certainly partly attributable to the crisis, as was the growth strategy in general. Concern about Japan's national debt burden was also a factor. I formerly chaired the Growth Strategy Task Force of the American Chamber of Commerce in Japan, and in 2010 we produced a white paper based on extensive economic analysis and covering education, entrepreneurship, labor mobility, tax, corporate governance and other areas—essentially all of the themes addressed by the third arrow of Abenomics. In past attempts, government growth strategies in my view amounted to little more than wish lists the bureaucrats obtained from industry. Our white paper was very thorough and based on economic research, and we proposed that there were only three ways to grow an economy—you could add capital, but there was already capital; it just wasn't sufficiently productive. You could add people, but Japan is aging and its workforce is decreasing. That left productivity enhancement as the one remaining avenue to pursue. Productivity growth has been rather low over the last two decades, so solutions to enhance productivity were needed.

The Abe administration has done a good job in assembling this growth strategy, a pillar of which is raising corporate productivity and "earning power." Toward this, the strategy also calls for corporate governance reform and a lower corporate tax rate. The need for productivity growth is mentioned very early and prominently in the strategy. The government has actually come out and stated that companies should redeploy their cash reserves in capital investments, realignment and M&As, and not simply continue to let the reserves grow. This is an indication to me that at long last, true corporate governance reform in Japan is underway.

一般社団法人戦略的グローバルIR協会
Strategic Global IR Management Association

SGIM Seminar

Wednesday, September 17, 2014

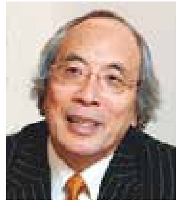
"The Increasing Importance of Direct Dialogue with the Markets"

Date/Time: September 17 (Wed.) 14:00 – 16:30 (Doors open at 13:45)
Venue: Conference Square M Plus, Grand Room, 10th Floor, Mitsubishi Building
Fee: Members FREE, Non-members 5,000 yen

TIME	PROGRAM
13:30 – 14:00	Doors open/registration
14:00 – 14:15	Welcome address **Masaki Kai**, Representative Partner, SGIM
14:15 – 14:45	"Japan's Stock Markets from the Perspective of Foreign Investors" **Masayuki Yokota**, Executive Account Manager, Head of Asset Finance, New Listings, Tokyo Stock Exchange, Inc.
14:45 – 15:15	"The Impact on IR of the Stewardship Code and Corporate Governance Code" **Nicholas Benes**, Representative Director, The Board Director Training Institute of Japan
15:15 – 16:15	Dialogue **Masayuki Yokota**, Tokyo Stock Exchange, Inc. **Nicholas Benes**, The Board Director Training Institute of Japan
16:15 – 16:30	Upcoming SGIM activities/seminars

Masaki Kai
Representative Partner
President
FinanTec Co., Ltd.

J. Michael Owen
Representative Partner
Chairman and CEO
Transpacific Enterprises



Kiyohiro Sugashita
Partner
Director and CEO
Sugashita Partners, Ltd.

SGIM's Raison D'etre

The Japanese Business Environment

Advancement of Abenomics

- √ Mounting expectations for the future
- √ Accelerating national IR by the government with the goal of marketing Japan to the world
- √ Increasing attention of foreign investors on Japan's economic recovery

Effect of Abenomics on the Financial Markets

- √ Increased capital inflow to stock markets from inside and outside of Japan
- √ Time to reconsider how to determine a company's fair value
- √ Launch of NISA, the Japanese version of ISA, which promotes the shift of capital from savings to stock investments

Increasing demand for strategic corporate IR activities by companies

Increasing the competitiveness of Japanese companies by promoting globally effective strategic IR

Stronger Relations between Japanese Companies and Foreign Investors

- √ Active communication is indispensable
- √ Transparent and timely information disclosure is vital
- √ Solid corporate governance is essential
- √ Need to pursue the strength of Japanese management and its essence

Globally effective strategic IR is imperative

Contact SGIM for details
Strategic Global IR Management Association
Assistant Directors: Yumi Yamazaki / Hiroki Kai
E-mail: info@sgim.or.jp
TEL: +81-3-4500-6887

Up in the Air

The Future of Skymark is in Doubt

Major air industry deregulation took place in Japan in the mid-1990s. At that time, Japan Air Lines (JAL), All Nippon Airways (ANA) and Japan Air System (JAS) combined to hold a 95% share of Japan's domestic air market. ANA's strength was domestic routes, where its share was just under 50%, while JAL controlled more than 3/4 of international passenger air service operated by Japanese carriers. Until deregulation, airlines were unable to compete through airfares, as regulations held that pricing for a particular route was to be based on distance. Discounted fares were extremely hard to introduce until the Civil Aeronautics Law was revised in 1994, the same year Kansai International Airport (KIX) opened. Two years later, in response to demand for further liberalization, the government transitioned from distance-based fares to a zone fare system which allowed carriers to establish fares as they saw fit within a specified range. This made possible a variety of discount and seasonal fare products.

The capacity situation, which in the Kansai region was abated with the opening of KIX, improved in the Tokyo Metropolitan Area as well in 1997, with the completion of the 3rd runway at Tokyo International Airport (now Haneda).

When Skymark Airlines launched operations with service between Haneda and Fukuoka Airport on September 19, 1998, it became the first new entrant into the domestic Japanese aviation market since JAS in 1945. Skymark—and Hokkaido International Airlines (now Air Do), which operated between Tokyo and Sapporo—were the first-ever budget carriers to operate in Japan. Skymark's fares were set at about half that of the established carriers—under 17,000 yen per one-way flight.

During its first few years, Skymark—founded by Hideo Sawata, president of travel giant H.I.S.—incurred significant losses. Having recorded an unconsolidated net loss of more than 1.9 billion yen during a nine-month period ended July 31, 2003, the carrier moved to raise capital in September of that year through a third-party allotment. Of the 100,000 new shares, 66,666 were issued to Shinichi Nishikubo, then-Chairman of internet service provider Zero. This made Nishikubo the largest shareholder at about 35%, and he was named President of the airline, with Sawada becoming Chairman, in January 2004. In November 2004, Skymark merged with Nishikubo's Zero, and this gave Skymark access to Zero's cash reserves and its IT expertise. Nishikubo has headed the carrier since then, and is at the center of its presently very precipitous situation. After a significant investment into establishing international routes with business class offerings went sour, Skymark—Japan's no. 3 carrier—finds itself in dire financial straits. How did the airline arrive here, so soon after its financial success in 2011? Is there any hope for this independent carrier's survival?

Shooting from the Hip?

In an interview with Nikkei Business Online published on July 31, Nishikubo talked about what led him to decide that changes were needed at Skymark.

"Skymark, in contrast to the relatively high airfares of the majors, sells tickets at reasonable rates, and can still turn a profit. Meanwhile, the LCCs are embroiled in what is no more than a price battle; it's a war of attrition. That's why Skymark has to find a platform on which to compete with the majors in order to continue to secure profits.

"[An overview of the air industry] shows us that the most profitable area is business class on long-haul international flights. One business class seat provides two-and-a-half-to-three times the space of an economy class seat, but costs seven to eight times as much. The majors are charging way too much for business class seating. You can't charge 300,000 yen for that seat regardless of how good the food may be.

"I first began thinking about purchasing A380s about four years ago. Once performance growth in domestic routes leveled off, I knew the next step had to be international routes. Today everyone talks about how great the LCC business model is. To me, though, it's transient. That's why we set our sights on business class and premium economy.

"There's virtually no variation in the product lineup in the LCC business model. If we are limited to domestic routes and performance struggles, there's nowhere for us to go. In contrast to that, despite everything that's happened the majors have survived because they can rely on the breadth of products. Even as competitive as the domestic price battle has gotten, ANA and JAL are posting profits. That's because they operate international routes. We need to acquire that tool as well. We won't be able to move forward only with domestic routes."

Nishikubo noted that the decision to move forward with the recently cancelled A380 purchase agreement was motivated by the carrier's strong performance at the time—Skymark posted all-time highs in revenue and operating income for the period ending March 2011.

"The reason our performance was so strong is also attributable to good fortune. JAL entered rehabilitation, and the yen had appreciated and settled there. I figured JAL would return at some point, and I also figured the yen could not continue at that level forever. I did not see us posting losses, and thought that we'd be OK if we could achieve profits of seven to eight billion yen."

Fit to be Tied?

Last year Delta Air Lines was named as a possible tie-up suitor to Skymark. When JAL entered rehabilitation a few years ago, Delta worked to forge a partnership with them, but was unsuccessful as JAL decided to remain a member of the Oneworld alliance, which also includes American Airlines and British Airways. ANA is a member of the Star Alliance and partners with carriers such as United Airlines and Singapore Airlines, leaving Delta as the only top U.S. carrier that had not joined forces with

	15th Period April 1, 2010 – March 31, 2011	16th Period April 1, 2011 – March 31, 2012	17th Period April 1, 2012 – March 31, 2013	18th Period April 1, 2013 – March 31, 2014
Operating revenue	58,023	80,255	85,943	85,975
Ordinary income	10,968	15,747	8,091	-403
Net income this term	6,325	7,705	3,778	-1,845
Earnings per share (yen)	90.53	88.17	41.55	-20.29
Total assets	37,357	67,736	74,230	78,771
Net assets	17,359	42,882	46,824	44,689
Net asset value per share (yen)	244.15	469.12	510.6	486.26

a major Japanese carrier. Skymark's position as the only other major independent Japanese airline, its plans to tool up for international service, and Delta's strong desire for additional slots at Haneda International Airport, contributed to such tie-up talk.

However, apparently talk was all it will ever amount to. When interviewed by Nikkei Business Online, Delta Air Lines Senior Vice President - Asia Pacific Vijay Dube unequivocally denied any interest on the part of Delta in a partnership with Skymark. "There's absolutely no chance. You can quote me on that. We have done no analysis on this, and are not considering it at all. We have no interest in supporting Skymark, and will never invest in the carrier. There is absolutely no chance of that happening."

Skymark chief Nishikubo also has no intention of entering into a tieup—with Delta or anyone else. He said in the aforementioned interview that the significance of Skymark's existence is that it operates independently and does battle with the majors, and as such does not intend to form a partnership with another carrier. On July 29, Nishikubo apparently told reporters at an emergency press briefing at the Ministry of Land, Infrastructure, Transport and Tourism (MLIT) he was proud of what the airline had accomplished, and asked for support in continuing to operate Skymark independently.

The Future is Now

In the summer of 2012 when JAL emerged from rehabilitation and relisted, ANA publicly opposed the move. Skymark chief Nishikubo, however, was very much in favor of JAL's return to the market. Below is an excerpt from Nishikubo's position statement to MLIT in July 2012 on the occasion of JAL's relisting (originally in Japanese):

"When [JAL] failed two years ago, financial institutions cut off lines of credit, several billion yen in public monies were provided, and many employees were laid off. We took on about 650 of those employees, which is a small figure considering the total number of those who lost their jobs. Operation on numerous regional routes was suspended, and a number of companies outside the JAL group found themselves on the brink of bankruptcy. JAL's failure had a serious negative impact on national interest. [JAL's] relisting restores stability to the industry, which results in stability for my company, so to me it's gratifying… a few years ago when Hokkaido International Airlines and Skynet Asia Airways failed, ANA absorbed them, stating it was for the sake of 'industry stability,' which distorts the concept of free competition of newly established air carriers. Improving one's own position under the guise of 'industry stability' is evidence of a lack of character."

Skymark insists it will not enter into a cooperative agreement. Delta flatly denies any interest in the carrier. ANA's history seems to indicate they will not line up to extend a helping hand. JAL has not to this point made a definitive statement. And even if they had proposed some kind of partnership Nishikubo would likely just brush it aside. Does that mean he has no qualms about coming under the control of MLIT in a worst-case scenario? Given the carrier's mounting losses, the penalty of a reported 70 billion yen (US$681 million) it may be required to pay Airbus for the cancelled order on top of the 26 billion yen (US$260 million) it has already paid them, announcements concerning route closures and now a report of food past its expiration date having been served aboard a recent flight, it's going to take more than Nishikubo's strong will and independent spirit to keep this airline flying. For the sake of 'industry stability,' the hope is that Japan's air market does not return to the days of the two-party system.

Dashboard on Japanese Economy

September 2014

Linking Japan provides regular updates of major Japanese economic indices. Our hope is that this information will adequately convey an overview of Japanese economic trends to our readers. In order to refine and better meet this objective, please provide us with feedback and requests regarding the information posted here.

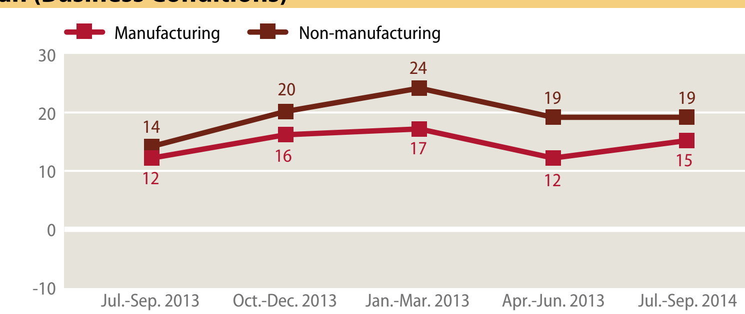
* indicates provisional figures.
** Data not available at time of publication.

GDP (Gross Domestic Product)

	Nominal Gross Domestic Product (trillion yen)	Nominal Growth Rate period-on-period (%)	Real Gross Domestic Product (trillion yen)	Real Growth Rate period-on-period (%)
Fiscal 2010	480.2	1.3	512.4	3.4
Fiscal 2011	473.7	-1.4	514.2	0.3
Fiscal 2012	472.6	-0.2	517.6	0.7
Fiscal 2013	*481.4	*1.9	*529.3	*2.3
Jan. - Mar. 2014	*486.7	*6.4	*535.1	*6.1
Apr. - June 2014	*487.2	*-0.4	*525.8	*-6.8

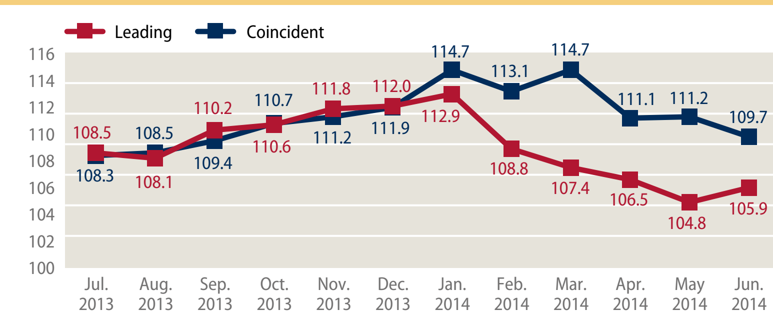
Tankan (Business Conditions)

	Business Conditions (Large Enterprises/ Manufacturing) Favorable (%) - Unfavorable (%)	Business Conditions (Large Enterprises/ Nonmanufacturing) Favorable (%) - Unfavorable (%)
Jul. - Sep. 2013	12	14
Oct. - Dec. 2013	16	20
Jan. - Mar. 2014	17	24
Apr. - June 2014	12	19
"Jul. - Sep. 2014 (forecast)"	15	19



Indices of Business Conditions

	Indices of Business Conditions	
	Leading (2010 = 100)	Coincident (2010 = 100)
Jan. 2014	112.9	114.7
Feb. 2014	108.8	113.1
Mar. 2014	107.4	114.7
Apr. 2014	106.5	111.1
May 2014	104.8	111.2
Jun. 2014	105.9	109.7



Consumption

	Consumption Expenditure year-on-year (%)	Retail Sales Value year-on-year (%)	Number of New Cars Sold (thousand)	Department Store Sales year-on-year (%)
Jan. 2014	1.1	4.4	49.6	2.9
Feb. 2014	-2.5	3.6	56.5	3.0
Mar. 2014	7.2	11.0	78.3	25.4
Apr. 2014	-4.6	-4.3	34.5	-12.0
May 2014	-8.0	-0.4	36.3	-4.2
Jun. 2014	-3.0	-0.6	45.3	-4.6
Jul. 2014	-5.9	*0.5	46.0	-2.5

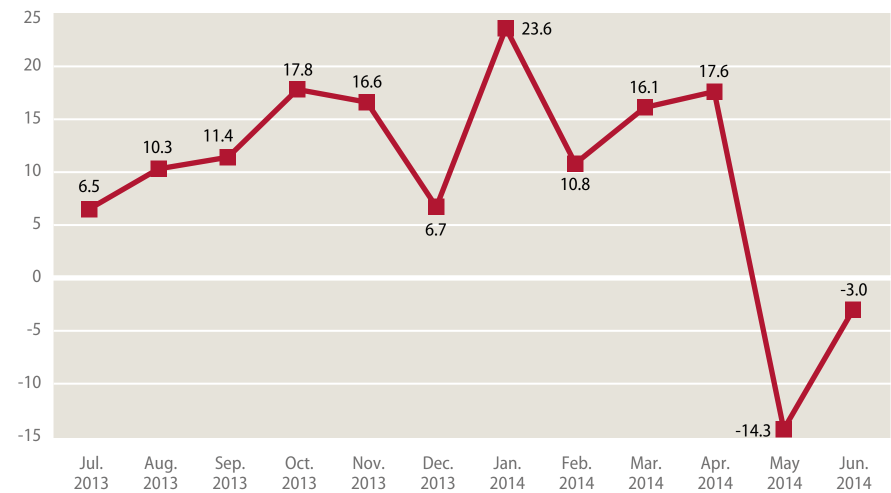
Consumption Expenditure: Household with two or more people, change from actual results of previous year.
Number of New Cars Sold: Total of passenger cars, trucks and buses. Includes light motor vehicles. Survey conducted by Japan Automobile Dealers Association and Japan Mini Vehicle Association.
Department Store Sales: Based on existing department stores. Survey conducted by Japan Department Stores Association.

Housing

	Number of New Housing Construction Starts (thousand units)	Number of Condominiums Sold		Orders Received for Construction year-on-year (%)	Contracted Amount of Public Works year-on-year (%)
		Tokyo Metropolitan Area (units)	Kinki Region (units)		
Fiscal 2010	819	45,012	21,609	-5.2	-8.8
Fiscal 2011	841	45,173	20,415	7.1	-0.5
Fiscal 2012	893	46,754	24,114	2.4	10.3
Fiscal 2013	987	55,245	23,353	20.1	17.7
Jan. 2014	987	1,826	711	15.2	28.8
Feb. 2014	919	2,651	1,668	12.3	3.7
Mar. 2014	895	4,641	1,848	-8.8	18.1
Apr. 2014	906	2,473	1,222	104.9	10.0
May 2014	872	4,300	1,588	13.7	21.1
Jun. 2014	883	3,503	1,690	9.3	14.3
Jul. 2014	839	4,222	2,016	24.4	3.5

Machinery Orders / Operating Rate

	Machinery Orders (Private) (Excluding Vessels and Electric Power Generating Equipment) year-on-year (%)
Fiscal 2010	9.1
Fiscal 2011	6.2
Fiscal 2012	-3.0
Fiscal 2013	11.5
Jan. 2014	23.6
Feb. 2014	10.8
Mar. 2014	16.1
Apr. 2014	17.6
May 2014	-14.3
Jun. 2014	-3.0



Indices of Industrial Production

	Shipments		Inventories	
	Change month-on-month (%)	Change year-on-year (%)	Change month-on-month (%)	Change year-on-year (%)
Fiscal 2010	—	8.4	—	-1.8
Fiscal 2011	—	-1.5	—	5.2
Fiscal 2012	—	-1.8	—	4.5
Fiscal 2013	—	2.9	—	-3.4
Jan. 2014	5.1	9.3	-0.4	-3.9
Feb. 2014	-1.0	6.5	-0.9	-3.4
Mar. 2014	-0.2	6.5	1.4	-1.4
Apr. 2014	-5.0	2.4	-0.5	-1.9
May 2014	-1.0	-0.8	3.0	0.8
Jun. 2014	-1.9	*2.2	2.0	2.8
Jul. 2014	*0.7	*-0.7	*0.8	*2.8

Industry

	Indices of Production Integrated Circuits year-on-year (%)	Crude Steel Production (thousand tons)	Indices of Tertiary Industry Activity (2005=100)
Fiscal 2010	8.3	110,793	97.8
Fiscal 2011	-14	106,462	98.5
Fiscal 2012	-4.0	107,305	99.2
Fiscal 2013	7.1	111,523	100.5
Jan. 2014	-0.9	9,397	101.5
Feb. 2014	9.0	8,449	100.6
Mar. 2014	11.0	9,721	103.2
Apr. 2014	-5.0	8,946	97.3
May 2014	-11.3	9,590	*98.2
Jun. 2014	-2.7	9,135	*98.1
Jul. 2014	*-5.1	*9,297	**

Monthly data for Indices of Tertiary Industry Activity is seasonally adjusted value.

Unemployment Rate and Active Job Openings-to-Applicants Ratio

	Unemployment Rate (%)	Active job openings-to-applicants ratio (times)
Fiscal 2010	4.9	0.56
Fiscal 2011	4.5	0.68
Fiscal 2012	4.3	0.82
Fiscal 2013	3.9	0.97
Jan. 2014	3.7	1.04
Feb. 2014	3.6	1.05
Mar. 2014	3.6	1.07
Apr. 2014	3.6	1.08
May 2014	3.5	1.09
Jun. 2014	3.7	1.10
Jul. 2014	3.8	1.10

Unemployment Rates from March to August 2011 are supplementary-estimated figures including those for three prefectures of Iwate, Miyagi and Fukushima.

Trade

	Trade and Customs Clearance		Import Price Indices year-on-year (%)
	Export (billion yen)	Import (billion yen)	
Fiscal 2010	67,788.80	62,456.70	5.7
Fiscal 2011	65,288.50	69,710.60	7.0
Fiscal 2012	63,940.00	72,097.80	1.7
Fiscal 2013	70,857.40	84,612.90	13.5
Jan. 2014	5,252.40	8,047.40	12.7
Feb. 2014	5,799.30	6,604.10	6.2
Mar. 2014	6,383.60	7,834.30	4.4
Apr. 2014	6,067.50	6,882.40	2.6
May 2014	5,607.40	6,518.20	0.6
Jun. 2014	5,940.50	6,769.00	4.3
Jul. 2014	6,192.00	*7,154.20	*2.8

Finance

	Monetary Basis year-on-year (%)	Total Outstanding Loans of Banks year-on-year (%)	Domestically Licensed Bank Weighted Average Lending Rate Annual Rate (%)	Newly Issued Government Bonds Yields (10 years) Annual Rate (%)
Fiscal 2008	—	—	-	-
Fiscal 2009	—	—	-	-
Fiscal 2010	6.4	-2.0	1.573	1.255
Fiscal 2011	14.9	-0.1	1.477	0.985
Fiscal 2012	8.7	1.1	1.383	0.560
Fiscal 2013	44.0	2.3	1.280	0.640
Jan. 2014	51.9	2.5	1.254	0.620
Feb. 2014	55.7	2.4	1.250	0.580
Mar. 2014	54.8	2.3	1.234	0.640
Apr. 2014	48.5	2.2	1.233	0.620
May 2014	45.6	2.4	1.229	0.570
Jun. 2014	42.6	2.5	1.222	0.565
Jul. 2014	42.7	*2.3	1.219	0.530
Aug. 2014	**	**	**	0.490

Call Rate: Unsecured, overnight. Average figure.
Total Outstanding Loans of Banks: Average of outstanding loans.

Newly Issued Government Bonds Yields (10 years): Figures as of end of the period. Announced by Japan Bond Trading.

Consumer Price Index

	Consumer Price Index (general, excluding fresh food)		
	All Japan (2010 = 100)	month-on-month (%)	year-on-year (%)
Fiscal 2010	99.8	—	-0.8
Fiscal 2011	99.8	—	0.0
Fiscal 2012	99.6	—	-0.2
Fiscal 2013	100.4	—	0.8
Jan. 2014	100.4	-0.3	1.3
Feb. 2014	100.5	0.1	1.3
Mar. 2014	100.8	0.3	1.3
Apr. 2014	103.0	2.2	3.2
May 2014	103.4	0.4	3.4
Jun. 2014	103.4	0.0	3.3
Jul. 2014	103.5	0.1	3.3

Stock and Yen Exchange Rates

	Nikkei Stock Average (yen)	Yen Exchange Rates against the U.S. Dollar (yen)	Yen Exchange Rates against the Euro (yen)
Fiscal 2010	9,951.17	85.71	113.14
Fiscal 2011	9,183.44	79.05	108.96
Fiscal 2012	9,612.07	82.89	106.73
Fiscal 2013	14,406.76	100.16	134.20
Jan. 2014	15,578.28	103.94	141.50
Feb. 2014	14,617.57	102.13	139.32
Mar. 2014	14,694.83	102.27	141.47
Apr. 2014	14,475.33	102.56	141.63
May 2014	14,343.14	101.79	139.77
Jun. 2014	15,131.80	102.05	138.75
Jul. 2014	15,379.29	101.72	137.84
Aug. 2014	15,358.70	102.96	137.13

Nikkei Stock Average: Average for the period.
Yen Exchange Rates: Tokyo, interbank, spot trading, average for the period.