Asian Corporate Governance Association (ACGA)

"The Catalysts and Constraints for Shareholder Activism in Asia"

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Agenda

1. The concept of "shareholder activism"
2. Traditional catalysts and constraints
3. History of shareholder activism in Asia
4. Country case studies—India, Japan, Korea
5. Concluding remarks

1. Concept of "shareholder activism"

An evolving idea:

- Classic notion drawn from the experiences of US and UK investors, who were initially responding to corporate weaknesses and poor returns in their markets (from 1980s, 1990s on)

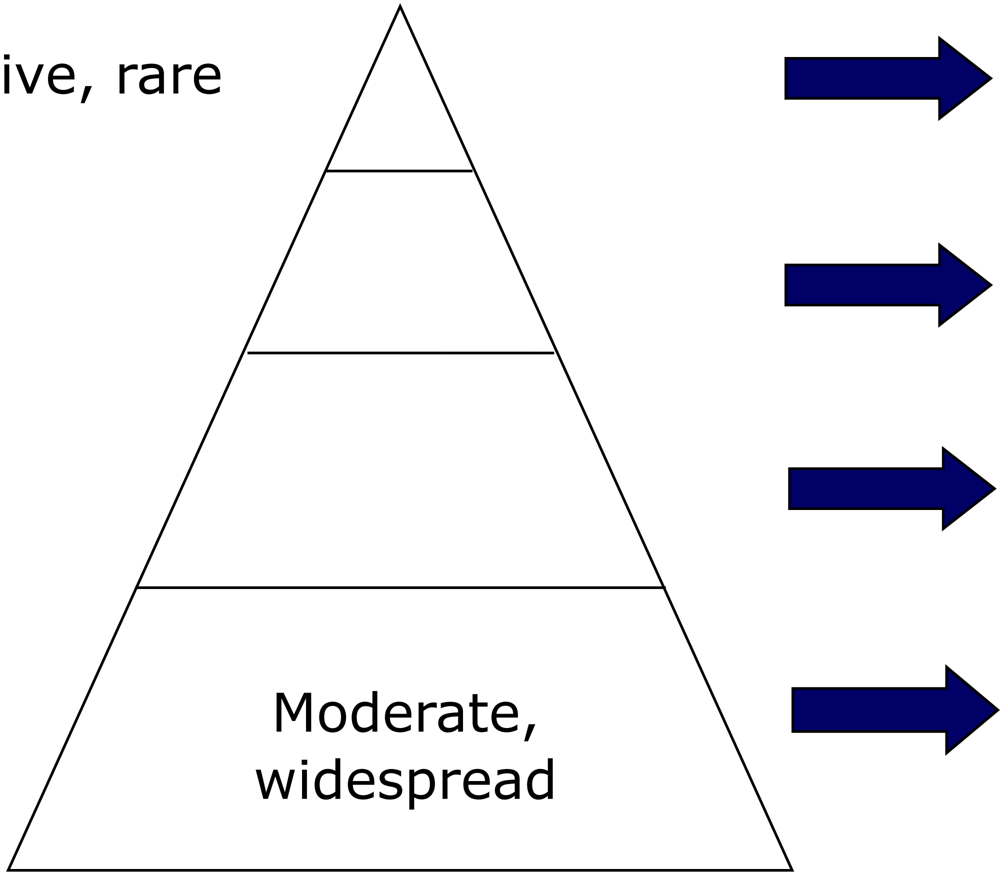
    - "Shareholder return" driven, focussed on unlocking value

- Newer definitions are broader and draw upon: growing concerns about climate change; the breaking down of conceptual walls between "corporate governance" (CG) and "corporate social responsibility" (CSR); the rising influence of European investors and changing perspectives among North American/British investors

    - Emphasis on "responsible investment" (RI), focussed on value as well as environmental, social, and governance (ESG) factors
    - Use of the term "engagement" rather than "activism"

Degrees of activism

Aggressive, rare



Proxy battles;
law suits

Public campaigns;
attending AGMs

Informed voting;
"focus funds"

Private meetings
with management;
"engagement"

A British description

Hermes Pensions Mgt launched JV fund with Lens of the US (1998)—press release stated the following:

- The fund to be based on “relational shareholder activism”
- First ‘focus’ fund with major UK institutional backing
- Concentrate on mid- to large-cap stocks on LSE
- The “specific aim of assisting in the improvement of shareholder returns on companies with hidden underlying value”.
- It will “take a pro-active approach to its selected investments and will, wherever possible, work with the identified companies’ management and other shareholders to develop and implement plans that achieve optimal long-term shareholder value. These plans may involve strategic, management or capital changes.”

An American description

“The Global Principles of Accountable Corporate Governance create the framework by which CalPERS executes its proxy voting responsibilities. In addition, the Principles provide a foundation for supporting the System’s corporate engagement and governance initiatives to achieve long-term sustainable risk adjusted investment returns. Throughout this document, CalPERS has chosen to adopt the term "shareowner" rather than "shareholder." This is to reflect a view that equity ownership carries with it active responsibilities and is not merely passively "holding" shares.”

CalPERS Global Principles of Accountable Corporate Governance (April 2008), p6

A Dutch description

The need for responsible investment

"PGGM and its clients have a clear view of the importance of responsible investment. Pension funds have an obligation to generate good returns to ensure that sufficient resources are available to pay the pensions of the funds' participants both now and in the future.....

"Responsible investment requires a proper risk analysis that also takes account of environmental, social and corporate governance factors. It also requires active engagement not only with companies but also with supervisory and regulatory bodies. We take these factors into account in a large proportion of our investment decisions. We pursue good corporate governance and make use of our voting rights whenever possible.

PGGM, *Annual Responsible Investment Report 2008, p4*

What value can investors add?

The late Alastair Ross Goobey, Former CEO, Hermes Pensions:

“Institutional investors are often ridiculed as potential agents of change. How can we know better than the professional managers how a pharmaceutical company or an engineering firm should be run? ….

“I would point out one very important input we can make that is unavailable to most company managements. In the UK equity market alone, we invest in about 900 companies, and we meet with perhaps one-third of those every year. ….

“While we probably cannot bring any specific insight into how to make money, we certainly can and do warn of patterns that seem doomed to destroy shareholder value over the long-term.”

“The Responsible Owner in Action”,
Corporate Governance International (CGI 2, 1999), p115-118

2. Catalysts and constraints

Traditional catalysts—globally

- Growing concentration of institutional ownership of listed companies (ie, by pension and investment funds) from 1980s onwards. This led to….

- Emergence of notions of 'active' and 'responsible' share-ownership—in part a philosophical reaction to the traditional ethos of fund management (ie, vote with your feet if you don't like a company). Also pragmatic….

- Passive (ie, index investing) pension funds—cannot easily sell, since they must track an index; hence, activism is a way to improve value in underperforming stocks or counter crises.

- Development of the idea of "stewardship"—institutional investors are stewards for the capital of their clients and beneficiaries.

- Growing body of evidence that better corporate governance pays over time.

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Governance pays
(or at least helps)

Examples of broker and academic studies:

1. **CLSA Asia-Pacific Markets**, "CG Watch" surveys (especially 2002, 2003, 2004). Showed that better governance correlates with stronger share price performance in several Asian markets.
2. **Goldman Sachs JB Were**, "Corporate Governance Investing Update", Sept 2, 2009. Based on 8 years of data, found that "the corporate governance signal has provided good returns".
3. **Nomura Securities**, "Identifying shareholder-friendly companies", June 20, 2008.
4. **De Nicolo, Laeven & Ueda,** "Corporate Governance Quality: Trends and Real Effects". Good governance has a positive effect on the real economy.
5. **Hamao, Kutsuna & Matos**, "Foreign Investor Activism in Japan: The first ten years", June 2010. Long-term returns on activism are low overall, but positive for events involving hostile funds.
6. **Becht, Franks & Grant,** "Hedge Fund Activism in Europe", May 2010. Disclosure of acquired stakes associated with large positive abnormal returns across a number of jurisdictions.

Constraints

Traditional limiting factors:

•Investment philosophy—'it is not our job to intervene' (a typical refrain from the mutual fund industry).

•Investment time horizons—governance improvements take time to produce results, yet many investors are short-term focussed (because they are judged by their clients on a quarterly basis).

•Compensation—most fund managers are paid annual bonuses, hence think short-term; they are not paid to think longer term.

•Conflicts of interest—many investment management firms are part of large corporate/investment banks, which have powerful corporate relationships at the parent level; this impedes their ability to act independently and 'criticise' listed companies.

•Many fund managers are sceptical about corporate governance—they do not see it adding any real value.

This debate can go around in circles forever…..

3. History of shareholder activism in Asia

1. **Early adopters – late-1990s:**
   - Emergence of outspoken activists in Hong Kong (David Webb), India (IGF), Korea (Hasung Jang) and Singapore (David Gerald)
   - Mostly retail shareholders

2. **Second phase – ca 2000 – 2005:**
   - Entry of Pension Fund Association (PFA), Japan.
   - Early proxy battles: Murakami vs Shoei (2000), Tokyo Style (2001-2) in Japan; Sovereign Asset Management vs SK Corp in Korea (2003-5)
   - Government-sponsored retail shareholder groups appeared in Malaysia (MSWG) and Thailand (TIA).

3. **Third phase – ca 2006 – present:**
   - Arrival of mainstream institutions, mostly foreign, with a focus on proxy voting and engagement
   - Slow emergence of state pension and investment funds (EPF in Malaysia; GPF in Thailand; NPS in Korea)
   - Retreat of PFA in Japan; Murakami sent to jail; failure of aggressive activism by TCI and Steel Partners
   - Arrival of friendly activists in Japan (JEC, Symphony, Ichigo)

4. Country case studies

1. India
2. Japan
3. Korea

India

Catalysts

- More reactive than proactive – scams such as Satyam (2009) led investors (retail) and regulators to act.

- Investor associations exist, but all are for retail shareholders and usually city or state-based, not national. The Securities and Exchange Board of India (SEBI) has registered 25 of these associations to date.

- SEBI also has an investor education and protection fund. In 2009, it amended regulations to allow it to fund investor associations to fight collective suits in Indian courts.

- In May 2009, Midas Touch Investor Association, filed an US$1 billion class-action lawsuit against Satyam Computers, the company's founders, Price Waterhouse and the company's former independent directors. SEBI agreed to fund the suit, but the Supreme Court dismissed it.

India

Catalysts continued

- First independent proxy advisory firm, InGovern, set up in 2010 and is giving voting recommendations on companies to both domestic and international institutional investors. Another proxy advisory service, Institutional Investors Advisory Services India, was set up this year.

- In addition, a new initiative, Responsible Investment Research Association (RIRA), was set up this year to facilitate dialogue and awareness of responsible investment in India.

India

Constraints

- Domestic institutional investors tend to “vote with their feet”.

- India is a large country with no national institutional or domestic investor association.

- India is not one country, but an amalgamation of states that have different languages, cultures and political aspirations. This makes it difficult to find common ground to work together.

- Shareholdings by promoters (majority shareholders) are substantial, usually over 50%.

- Civil suits are allowed, but court cases usually drag on for years and are prohibitively expensive.

- Courts can award costs in favour of the successful party, meaning plaintiffs may not only end up paying compensation but also the costs of the defendant company.

India

Constraints continued

- Corruption is a huge deterrent to activism—the close ties between businesses, politicians, the police and even the lower courts make investors wary of taking on 'big business'.

- Foreign institutional investors are less likely be active in India than in more developed markets like Japan, Hong Kong, Singapore and Korea. This is due to a lack of understanding of what can be done both from a legal and regulatory standpoint, and the fact that the country is lower on their radar screen.

Japan

Catalysts

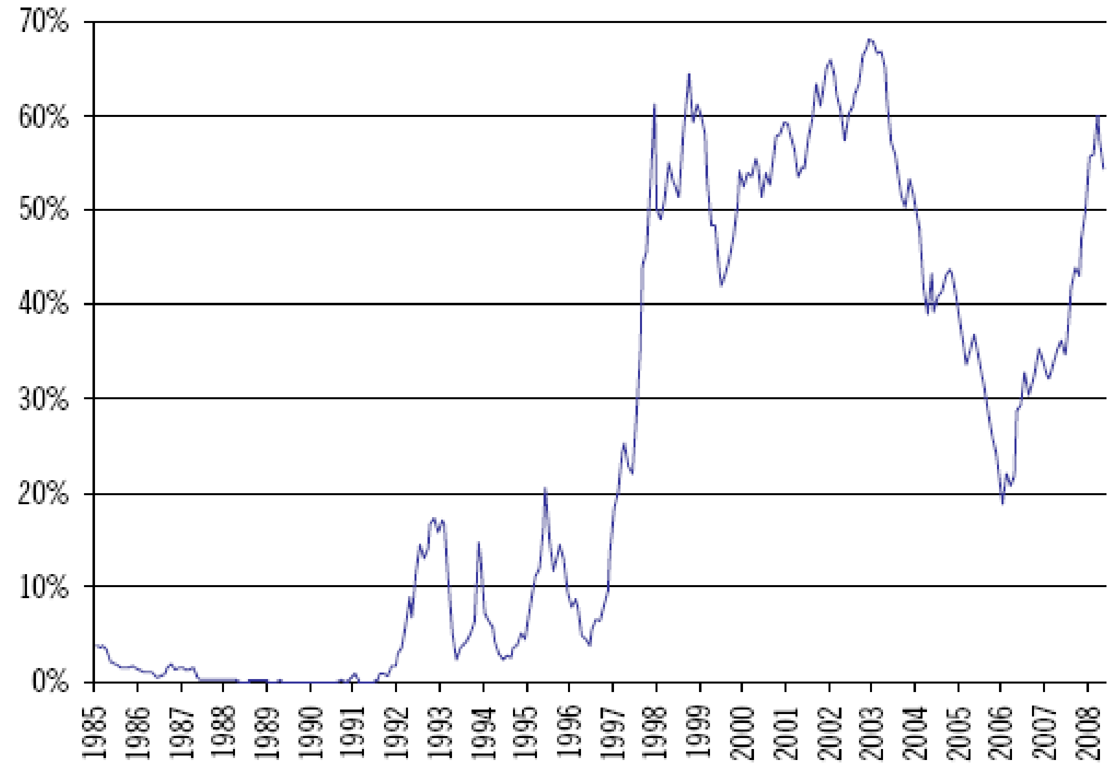
•A perennial underperforming stock market, with many companies trading below their book value, with low dividend yields and payout ratios, and with low return-on-equity (ROE) ratios—much of this caused by the fact that many companies hoard cash.

•Most early activism (Murakami, Steel Partners, The Children's Investment Fund) targetted companies with excess cash and/or that were underperforming. The sought, mostly unsuccessfully, higher dividend payouts.

•While Japan has some world-class companies with well-known brands (Canon, Toyota, Shiseido, Sony), many listed firms are SMEs that would benefit from guidance on strategy, communication and governance. Hence the rise of "friendly activists" (Ichigo, Symphony, Asuka, Taiyo, Japan Engagement Consortium), who work closely with companies and help them to improve performance and value.

Trading below book value (Japan)

Figure 4. Percentage of listed Japanese companies trading below book value



Source: Toyo Keizai, Nikko Citigroup Limited.

Japan's long suffering shareholders

Figure 3. Cross-border valuation and profitability comparison

	ROE	Dividend Payout Ratio	Div Yield (%)	PER 1 Year Forward	PBR	PCFR
Japan	**8.71**	**28.58%**	**1.68%**	**15.55**	**1.48**	**7.02**
Germany	15.69	36.78%	3.17%	11.89	1.82	6.09
Canada	14.53	41.90%	2.36%	14.76	2.59	11.55
Italy	13.55	54.76%	5.05%	10.39	1.47	4.51
United States	15.01	31.97%	1.87%	14.81	2.54	10.36
France	15.17	53.63%	4.53%	11.37	1.79	6.19
Australia	15.95	63.52%	4.16%	14.64	2.43	15.73
Netherlands	17.69	41.72%	3.76%	11.41	1.96	3.43
Spain	16.88	45.38%	3.44%	11.82	2.24	6.63
United Kingdom	20.18	39.58%	3.79%	12.78	2.11	10.32
World	**14.74**	**37.53%**	**2.57%**	**13.69**	**2.14**	**8.67**

Lowest ROE

Lowest Payout Ratio

Lowest Dividend Yield

Highest PER

Lowest PBR

Source: S&P Citigroup, Nikko Citigroup Limited.

Japan

Constraints

Japan ticks many of the classic boxes, although culture exacerbates these challenges:

•Conflicts of interest—domestic institutional investors are often subsidiaries of large banks and insurance companies, hence are restricted by the relationships that their parents have with listed companies.

•Culture—'public shareholder activism is not the Japan way'. Investors prefer to give their message behind the scenes. But even public statements of principle are typically out of the question.

•Foreign vs local—"corporate governance" is often seen as a foreign idea, hence very difficult for domestic investors to work with foreign investors.

•Lack of political leadership in Japan behind corporate governance; also lack of agreement within government on the right way forward. A fragmented polity.

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Korea

Catalysts

- The Asian financial crisis and a string of corporate failures in the late-1990s fuelled a minority shareholder rights movement led by Hasung Jang, a business professor at Korea University.

- Shareholder activists were, in turn, empowered by the CG reforms of liberal President Kim Dae-jung (1998-2003).

  - People's Solidarity for Participatory Democracy (PSPD) Participatory Economic Committee (PEC).
  - Solidarity for Economic Reform (SER)—a successor to PSPD-PEC.
  - Center for Good Corporate Governance (CGCG), a specialist information provider and activist group.

- Roh Moo-hyun, another liberal who succeeded Kim, continued CG reforms, though corporate resistance mounted as the economy recovered.

Korea

Catalysts

- In April 2006, investors allied with Professor Jang started the first CG 'focus fund'.
    - Korea Corporate Governance Fund, managed by Lazard Asset Management.
- Meanwhile, foreign activist investors such as Sovereign Asset Management of Monaco (owned by two New Zealand brothers) and Carl Icahn of the US launched major proxy battles against two large Korean companies.
    - 2003-05: Sovereign Asset Management vs SK Corporation, the country's largest oil refiner and part of the SK Group chaebol.
    - 2006: Carl Icahn vs KT&G (Korea Tobacco & Ginseng).

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Korea

Constraints

- Once the Asian economic crisis was over, both the government and companies lost the sense of urgency for CG reform.

- President Lee Myung-bak, the conservative incumbent, has put aside CG reform in favour of pro-business, pro-growth policies.

- Big businesses, which were never keen on CG reform, have turned it into a box-ticking exercise; good CG culture has failed to take root internally.

- Minority shareholder activists also have lost momentum and so far have been unable to win over mainstream investors.

- Nationalist backlash has stymied foreign activist investors as well (eg, Lone Star).

Concluding remarks

- Globally and speaking generally, shareholder activism has evolved from being largely "shareholder return" driven to taking on a broader mantle of "responsible investment", with a focus on E, S and G.
- Underlying belief that activism can unlock hidden value in a company remains—and much activism by individual funds in Asia remains principally focussed on governance and performance.
- Despite the scepticism of large sectors of the investment industry, investors who devote resources to activism and engagement generally find that there is a medium to long-term payoff. But much depends on their investment philosophy, expertise, and time horizons. Some payoffs can be quick (eg, takeovers).
- The catalysts for activism in Asia are strong—yet the constraints are equally strong, if not stronger. This explains why much activism has failed or has to operate behind the scenes. The notion remains alien and hostile to many Asian listed companies.

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