IR Insight

Prepared by Tokyo consultancy Investor Impact, Inc., **IR Insight** *provides analysis about the latest IR trends and recommendations on communications strategies that positively impact corporate value.*

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INVESTOR IMPACT

Impact of JPX-Nikkei Index 400 on the Market and Corporate Management

The Japan Exchange Group, Inc. (JPX) launched a new stock price index, JPX-Nikkei Index 400, on the Tokyo Stock Exchange (TSE) on January 6, 2014, the first day of trading in 2014. Among the various stock price indexes of the TSE, the Nikkei Index and the Tokyo Stock Price Index (TOPIX) are best known. However, these indexes focus primarily on indicators of corporate scale, such as market capitalization, trading volume, and liquidity. In contrast, the new index evaluates companies from a management perspective and includes the efficiency of capital (Return on Capital, or ROC) and other indicators that are of interest to shareholders and potential investors.

Accordingly, the stocks contained in the new index were chosen from the perspective of global investment criteria. The core criteria for the new index span (1) liquidity and scale (transactions value, market capitalization), (2) profitability (ROE, Operating Profit Ratio), and (3) management perspective indicators (corporate governance, adoption of International Financial Reporting Standards (IFRS), and disclosure in English).

Companies in the JPX-Nikkei Index 400 were given scores based on the above criteria, and, of the 400, 388 were listed on the First Section of the TSE, 1 on the TSE Second Section, 1 on the Mothers Exchange, and 10 on the Japanese Association of Securities Dealers Automated Quotations (JASDAQ) exchange. The composition of the new index will be reevaluated in August each year. The TSE has described the 400 companies included in the index as “highly attractive to investors.” JPX’s intent is quite ambitious and transparent, but what real impact will the JPX-Nikkei Index 400 have on the market and on corporate management?

The new index reflects a strong awareness of the thinking of global investors. It incorporates indicators of profitability and other elements that are fundamental to stock indexes, but it also emphasizes other elements, including whether or not companies have appointed independent directors (two or more), adopted (or are scheduled to adopt) IFRS, and whether the company's disclosure materials are available in English. As a result, the new index addresses various conditions required by global investment criteria, and it is hoped that it will play the role of encouraging sustained increases in corporate value.

The balance of funds placed in investment trusts (mutual funds) and exchange traded funds (ETFs) that are linked to the JPX-Nikkei Index 400 has risen well above ¥100 billion. In addition, in November 2013, the Osaka Exchange (formerly Osaka Securities Exchange) began trading in futures linked to the new index. Moreover, the Government Pension Investment Fund (GPIF), which is responsible for the management of Japan's public pension funds, amounting to ¥120 trillion, in April 2014 chose the new index as a benchmark (indicator for comparative performance) for Japanese equities and began to use it in asset management operations. What everyone will be waiting to see is whether the new JPX-Nikkei Index 400 will be what is needed to revitalize Japan's stock markets and highlight the attractiveness of Japanese corporations domestically and abroad.

How might the JPX-Nikkei Index 400 have an impact on markets and companies?

■ Impact on Listed Companies and Their Response

From the corporate side, activities are already under way to increase Return on Capital, both in companies with low and with high ROEs, in order to raise corporate value. In the future, this movement is likely to grow stronger. Specific actions in this area include raising companies' target dividend payout ratios and purchasing treasury shares. It is fair to say that competition among the 400 companies that are included in the new JPX-Nikkei Index 400 to retain that status and among companies that want to be newly included in the index will likely be a force that will impart new energy to the market.

Based on this premise, what about the ROEs of Japanese companies? Although we should be aware that that efficient use of capital, as measured by ROE, is required and is an important indicator of management performance, in actuality, ROEs of Japanese companies are extremely low compared with European and U.S. companies. Japanese managements tend to put emphasis on measures of scale, including sales and profits.

According to a survey prepared by Japan's Life Insurance Association[1] in fiscal 2013, the average ROE of U.S. companies is 15.8%, versus 5.3% in Japan. Also, a comparison of targets of medium- to long-term plans and actual performance shows that Japanese companies attained 60% or more of their targets for sales and income (rates of growth), but attained only 35.8% of their ROE targets. On the other hand, surveys of what targets investors want company managements to attain show that 90.8% want attainment of ROE targets, the highest among all targets. Therefore, there is clearly a gap between what Japanese companies are achieving and what investors want them to achieve.

Looking more closely at foreign investors, most of these investors are global investment funds, and they have investments in Japanese equities. Therefore, in analyzing companies from a global perspective, from the investors' perspective, Japanese companies must compete with companies around the world in terms of ROE. Although the ROEs of Japanese companies are on a rising trend, there is still considerable room for improvement. With the exception of certain companies, the understanding of the Cost of Capital among Japanese companies is still low compared with other countries. In fact, some data show that, while the average Cost of Capital is said to be between 6% and 7%, a majority of Japanese companies report an ROE of less than the Cost of Capital. Looking ahead, ROE will become an increasingly important measure for assessing corporate value.

The two pillars supporting corporate value are corporate governance and information disclosure. The TSE has pointed out that there is a correlation between the appointment of independent directors and ROE. According to the TSE, the higher the ratio of independent directors, the higher the ROE becomes. In fact, looking at data for fiscal 2012, in cases where corporate boards have a majority of independent directors, the ROE of those companies was 12.75%. When the ratio was between one-third and one-half, the ROE was 4.67%, and, when independent directors accounted for less than one-third of board seats, ROE was 1.17%. Similarly, according to a Goldman Sachs report[2], companies with superior corporate governance tend to have a high ROE. As these comments suggest, managements of listed companies must proactively commit themselves to ROE as a core indicator.

On August 7, 2014, the JPX Group announced the results of its periodic review of the stocks included in JPX-Nikkei Index 400[3]; the revised index will become effective on

1 http://www.seiho.or.jp/info/news/2014/pdf/20140418_2.pdf

2 Goldman Sachs Global Investment Research; FY3/14E and FY3/15E using consensus net income forecasts (IBES or Toyo Keizai)

3 http://www.tse.or.jp/english/news/17/140807_a.html

August 29. Following this review, the status of 31 stocks was affected. Within the index, highest priority is given to profitability. Because of the substantial improvement in operating income of Japanese companies in fiscal 2013, the three-year moving average ROE of listed companies, which is one of the index criteria, increased. Therefore, an important development in the revised index was that a number of stocks were newly included in the index. As the JPX-Nikkei Index 400 receives more attention, this will place significantly greater pressure on companies to improve their ROE.

In parallel with the adoption of the JPX-Nikkei Index 400, Japan's Financial Services Agency has issued its Stewardship Code, which is a code of behavior that aims to encourage improvements in corporate management through dialog among companies and institutional investors, as assessed in the previous edition of IR Insight[4]. Therefore, for investor relations officers (IROs) "improving dialog with shareholders and investors" and "providing disclosure that is sufficiently in-depth, timely, and fair" will become increasingly important.

Investor Impact will continue to provide a broad range of IR consultancy services from the corporate client perspective to contribute to increasing corporate value by improving disclosure and dialog with investors.

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4 "Japan's Stewardship Code: Implications for Investor Relations", IR Insight, July 2014