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## Shareholder Engagement

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It has been suggested to me that it was Hermes which invented the expression 'shareholder engagement'. Whether or not this is true, that expression, and also the word "activist", can mean quite different things to different people. So I'd like to start by explaining what engagement or activism means from Hermes standpoint and why we have become involved in this kind of activity.

Hermes is, effectively, the executive arm of the British Telecommunication Pension Scheme, which, with assets of £71 billion (¥17.5 trillion), this is a very big pension fund. That means that it can't really move in a very nimble fashion, and, for that reason, it has adopted a fairly typical, approach for a large pension fund - "core and satellite" - which has a large index core portfolio with another portion which is managed actively around the periphery. The important point is that we are so big in so many markets that really, our ability to sell out of all of the companies whose activities we may disapprove of, or not entirely approve of, is very limited. To put it in another way - the 'Wall Street Walk' is not really an option which is open to us in most circumstances, and that is true across all of the major markets in which we invest.

For that reason, we have always been very concerned about the stability, viability and efficiency of the companies in which we invest. If you take the view that you're effectively going to be investing in these companies forever and you don't have the option of exiting, then you naturally become pretty interested in how well they're going to do. A lot of work has been done by Hermes over the years in this connection. We are members of numerous corporate governance organizations around the world, and our views on corporate governance and on what we refer to as "stewardship" are set out comprehensively in *The Hermes Principles*, which were written several years ago and which are available in both English and Japanese on our website.

A word on stewardship - I'm often asked by Japanese colleagues what "stewardship" means. The simple explanation is that the level of stewardship in a company is the honesty, the skill and the efficiency with which the assets which are given to the company by the shareholders are managed in the interests of the shareholders. And it is stewardship, in a sense, which is the more important focus of our attention, rather than governance as and of itself.



Our focus on corporate governance and stewardship comes at some cost. Clearly, being an involved shareholder requires quite a lot of work and, within the Hermes head office, we have over 50 people dedicated full-time to this stewardship activity. We are a little different from a conventional investment management company, in the sense that the skill-sets of the people here are much broader. We have people with experience in operating companies of various kinds - not only investment management but in strategic consulting, law, accountancy, corporate governance, politics etc. So it's a very broad skill-set and we undertake our governance and stewardship activities across all the major markets, and so this is quite a substantial undertaking.

Our fundamental approach is to invest in companies that are healthy but underperforming - or rather, these are the companies with which we engage. We always try to work as quietly and as cooperatively as possible with the management of the companies involved, in order to increase shareholder value.

There are a number of areas in which we think shareholders can play a legitimate role. Broadly speaking, those are where we think that a company is in danger of going off the rails because the governance is unsound or where there are problems in broad operational strategy, and/or capital structure. However, it's not our belief that we should get involved with the micromanagement of companies. Clearly, if you believe that the management of the company is competent, you should as far as possible let them get on with it. However, there are certain strategic changes which we often think are necessary, and those are the areas that we focus on.

One of the mechanisms through which we do this is through the so-called Focus Funds. From the point of view of our shareholder, the British Telecom Pension Scheme, this is, in effect, a kind of self-funding way of creating a catalyst for the broader value of the pension fund portfolio, but it is also a separate business in itself, which has become quite successful. The Focus Funds, all of which take a broadly similar approach, now cover the European, UK large- and small-cap markets and, more recently, as a joint operation with Nissay Asset Management Corporation in Japan, we have the Nissay Hermes Stewardship Fund. We have been involved in this kind of activity for a number of years.



To illustrate how the Focus Funds work, let us first introduce a case study from our home country: the UK.

The case study involves a major brewer called Bass, which had three strong divisions. It was a leading global operator in hotels. It was the UK's biggest pub operator, and it was also a substantial brewery, which was its original business. We had a number of problems with this company: We wanted them to unwind the conglomerate structure which we thought was inefficient. We wanted them to stop making further value-destructive hotel acquisitions. We felt there was scope for them to return cash to shareholders. We had some concern about the discipline of their capital investment program. And the significant governance issue at that point was that we wanted them to separate the role of the chairman and the CEO.

The initial investment was made after a substantial period of underperformance in the shares. This was the beginning of what, for us, was quite a long and occasionally painful process of discussion with the company. A relatively early success came with the disposal of a brewery, and then the company fairly quickly conceded the general governance point by splitting the CEO and chairman roles. We then went through a long period of discussion about the broader agenda, and that was interrupted as these things often are, by external events - in this case 9/11 - which caused a sharp downturn in the share price.

Over an extended period, we did manage to make some progress with the management. The SID, or Senior Independent Director is a recognized role within the UK Combined Code, and refers to a person whom a concerned investor can approach if they have worries about the company and, for one reason or another, do not want to take the issue up with the chairman. We approached the senior independent director with our engagement agenda, and unfortunately, either he or somebody else leaked this to the media, so the affair actually became quite public – something which we usually try hard to avoid. However, the rest of our engagement agenda was pretty much implemented in the following few months, and then the share price then spiked up here as a result of a hostile bid.



That, however, was not the end of the story. It was not just a quick win. The companies into which the conglomerate was subsequently broken down each achieved significant improvements across the board and produced substantial share price out-performance. This is quite a good example, if you remember that we, or at least our parent, is always going to be there, of the Focus Funds' laying the foundations for long term value through short time activity.

We are very conscious that a 'one size fits all' approach to engagement is really not feasible. Clearly, one has to be sensitive to local roles and local circumstances. And the European case study which follows – and which we will keep anonymous - is a case in point.

This is a French company. It's interesting because it bore a number of similarities to some traditional Japanese companies that we might see. It's a retailing and consumer finance group which is majority-owned by the founding family. It had very low returns and what was a pretty substantial and up-market real estate portfolio, some of which was in central Paris. There was a perceived lack of rigor in the store portfolio management, and the company was generally pretty closed to investors - it was really not very good at investor relations at all.

We did a lot of work on this before we first approached the company, and our engagement issues were as follows: We wanted them to separate the returns into real estate and retailing, to see how the company was really operating. They had a number of loss-making stores in France and we wanted them to exit those businesses. We wanted them to concentrate on their French business, and de-emphasize their less profitable international business. And we wanted them generally to improve their investor relations work.

Now, this is interesting, because when we first met the company, which again, was after a substantial period of underperformance, they were very surprised at the insights that we had. We said that their store in Lyons and their stores in some of the other provincial centers in France were really underperforming your Paris stores – and that they really should be getting rid of them. They said: "How do you know?" "We've never told anybody that". So they were really surprised that we knew the company as well as we did, and that, of course, was the on basis of some very substantial research work upfront.



We then presented our agenda to the senior management and, after some time, they began to implement changes. The company announced the first store closure in its history, and then the separating off of the real estate business, and this was followed by a subsequent announcement of another store closure. Then, aided by an improved investor relations strategy, the market realized what was going on, and we saw a very handsome appreciation in the share price, as the fund exited. So that was a very successful “textbook” engagement.

Now, coming onto Japan. I’d like to briefly say - why are we involved in Japan; why we think investors need to engage with Japanese companies; some of the obstacles to that engagement and how we’re trying to get around them.

One reason for engaging with Japanese companies at the moment is that the main cyclical factors which have been working in favor of profitability in Japanese companies are probably running towards a cyclical peak. So we feel that the macro variables that have been pushing things along until recently are probably going to slow up, and so we need really to be looking much more at the content of the companies themselves, in order to bring about improved performance.

Why engage in Japan now? The “lost decade” left a vacuum of poor governance and stewardship in the corporate sector. The banks have dropped out of the scene, and the management really have been very much in control of the situation and not necessarily doing things to the benefit of the shareholders. So we feel that somebody needs to get involved in trying to impose some kind of discipline and it really ought to be the shareholders.

What are the obstacles? I will here make some statements of our view but will also refer throughout to quotations from the Tokyo Stock Exchange White Paper on Corporate Governance, which came out recently.

The statements are:

Shareholders are not recognized as owners, they’re just thought of as another stakeholder.



The corporate auditor system, we believe, entrenches management power. We believe that a company with a committee system at least provides the possibility of greater access for shareholders to the company.

Outside directors are seldom used and are often, in our view, not really independent at all.

We think that the corporate governance seen in Japan is very much a situation where Gresham's law has come to bear - that is to say that bad corporate governance is driving out good governance.

The bottom line of all this, really, is that insiders are really always in charge.

The Tokyo Stock Exchange White Paper states that shareholders are very seldom mentioned as being owners of the company at all, in the reports on corporate governance that the companies returned to the TSE.

Only 2.5% of TSE-listed companies adopt a committee system; 97.5% have a corporate auditor system. Now, our belief here is that, although under the law, more than 50% of corporate auditors on a board have to be external, we believe that that definition of external leaves a lot to be desired. And also, of course, there is a break between the board of corporate auditors and the executive board, so it is really just an advisory relationship, whereas in a company-with-committees structure, any external director effectively becomes an internal director, and therefore has direct access and much greater influence.

Another point about the mechanics of Japanese corporate governance highlighted in the White Paper is that, in most cases, the chairman of the company does not actually chair the board meeting, which certainly from a UK perspective, seems a slightly ridiculous situation. In most cases, the board meetings are, of course, shared by the president.

Most companies, of course, don't have any external directors and quite a lot of those that do, have external directors which are in fact employees of their parent company. Should we regard parent



company places as external directors? The clear answer to that, from our point of view, is “absolutely not”.

What do I mean about Gresham's law being applied to corporate governance? The situation in Japan at the moment is that companies can select either to institute a company-with-committees system or they can have a board of auditors or a *kansayaku* system. Given that, in our view, the *kansayaku* system or the board of auditors system enables the management to pretty much get on and do what they want, and doesn't subject them to too much scrutiny from the shareholders, it's hardly surprising that most company managements will select that easier option. And so, the fact that there are two options – there's the easy option - the board of auditors option – which, in our view, is the “bad currency”, which will exclude the good option – the “good currency” from our point of view. Another analogy one might use is that the directors are unlikely to choose the company-with-committees system, because it would be equivalent to turkeys voting for Thanksgiving.

But the bottom line of all this is that we think that insiders are always in charge. So what can we do about it? If you can't get access to the board – and it is very difficult to get to boards - you can't really do much about anything.

If you could, would you consider voting them out? It would be very difficult to get domestic shareholder approval for doing anything as radical as that. We might be able to do that in another market, but we certainly couldn't do it in Japan.

Can we push for major changes in management personnel? It is very difficult to find replacement management at this level, and, in most cases, we actually wouldn't want to. We do not usually doubt the competence of management; it is just their strategic direction which we sometimes think is inadequate.

Can we incentivize managers to maximize short term returns? This is a very contentious issue, and by and large, we at Hermes are not too concerned about remuneration issues in management in Japan at this stage. We think there are much more important items on the agenda.



So how do we do it? How do we actually engage in Japan, given that we don't have a number of the tools and levers available to us that we would have in other markets? We have tied up with Nissay Asset Management, who we feel have a very similar world view to our own. They are, by definition, long term investors. They are concerned with the quality of the companies they invest in. They don't want to be disruptive, and they are very concerned with long term stability. And there's a small team at Hermes, and a small team at Nissay, we work together to identify companies that we think should be approached, with which we should engage, and then, the frontline troops are always the guys from Nissay, because we think they're much more user-friendly to the Japanese companies. They're not threatening. They're also there all the time, so that they can have many meetings, whereas with us flying in and out, it would be difficult. And we believe that our colleagues in Nissay are likely to have a far better understanding of the internal "politics" of the Japanese companies than we have. And we have to accept that any kind of substantial engagement is an inherently "political" activity, and so understanding the internal politics of the companies is pretty crucial in deciding whether you really want to get involved.

Anyway, here's a case study. Here's something that happened in the last two years. We try not to mention the names of the companies we're involved with and will call this one 'Company X'. This is a very successful manufacturer with a leading world market share in its mainstream product range and it has been in existence for a long time. It was established in the Meiji Period. It is substantial in size – with a market capitalization of over ¥ 500 billion. It is quite typical in a number of other ways; it is a regional company with very conservative management and a typical Japanese corporate governance structure - in other words, in our view, a shareholder unfriendly corporate governance structure.

What were they doing wrong? They were destroying shareholder value through excessive diversification into irrelevant and unprofitable business areas - a fairly familiar scenario in a lot of cases - and we believe that they continued with these rather fruitless activities because of that commitment to stakeholders other than the shareholders. They also had over-extended their offshore manufacturing capacity and this was giving rise to inefficiencies. We also believed that



there was the possibility to return cash to shareholders in the medium term. The shares had underperformed the market substantially in the two years before we took our position.

So our engagement agenda was that we wanted them to dispose of or close down the uneconomic business lines; to rationalize their offshore manufacturing; and to consider returning cash to shareholders. What were our expectations? We believed, from our initial CFROI analysis and also from our evaluation of the potential value of the engagement, that there was a 30% plus upside in the share price, if we were successful. We also realized that this kind of engagement, which would involve things like closing down business lines, selling off companies and so on, is quite “heavy” and we expected it to take at least two years to make any significant progress. So that’s where we were starting from.

On the face of it, it didn’t look a terribly suitable case but - from the Hermes point of view - we were rather surprised at how successful this was. The Hermes meetings with the senior management, which were on a separate track, suggested to us that they really were very conservative and they seemed to take an entrenched view about their diversified businesses. We thought it was going to take a very long time to achieve the desired change.

But, to our surprise - to Hermes’ surprise, anyway - within 18 months, the management had announced closure of some of their foreign manufacturing subsidiaries; they had disposed of a materials subsidiary to a Japanese company; they had disposed of some other non-mainstream business to other Japanese operators. So there was a dramatic shake-up in this company. Things that had been described in the annual report two years earlier as being absolutely central to the company’s future, suddenly were gone. So this was a company that really had moved pretty fast. The result was that the share price outperformed the index by over 30% in one year, and we, as the fund, exited from the position with a substantial profit. What was very important to us all along was that we would maintain a good relationship with the management. We could always come back and talk to them again. So we left with a substantial profit, a good relationship with the management, and given our rather quiet style, both in Hermes and in Nissay, one thing that was very important to us in all of this was that in this entire exercise, which for us was quite substantial and quite successful, was that nobody else even knew we were there.



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So engagement can take various forms and we always try to play it gently. We try to talk rather than to fight. Winston Churchill, who certainly was involved in his share of fights, is famously quoted as saying, “to jaw-jaw is always better than to war-war” – meaning that it’s always better to talk than to fight. And that is a view with which we would have a lot of sympathy.