Are Japanese companies getting executive incentives right, and how would investors know?

Visibility on the KPIs for Japanese senior remuneration strategies is low.

by **Kazutaka Kuroda** | October 19th, 2016

In Japan, executive remuneration has been less discussed than other more common corporate governance issues such as the compliance rate to the principles prepared by the Tokyo Stock Exchange or independent director effectiveness since the enactment of Japan's Corporate Governance Code. However the Code's Principle '4-2' stresses the significance of executive remuneration in establishing an environment that supports appropriate risk-taking by executive directors and senior management. It also says that "the remuneration of management should include incentives that reflect mid- to long-term business results and potential risks, and promote healthy entrepreneurship". Additionally, its Principle '3-1-iii' requires listed companies to disclose "broad policies and procedures in determining the remuneration of the senior management and directors".

In response to these principles, companies have diverse pay packages for their executive directors and senior management. This, and a subsequent article, will summarise the main trends of cash and stock incentives for large Japanese companies. The research covers the practices of the latest JPX-Nikkei 400 Index substitutes based on:

・Three-year ROE (Return On Equity).
・Three-year cumulative operating income.
・Market capitalisation on the base date for selection.

In other words, they are the role models for Japanese companies from the viewpoint of the recommendations in the Ito Review and the Japan Revitalisation Strategy in terms of advanced executive remuneration strategy. In this part 1, we mainly focus on the cash incentives of those 400 companies.

Although overseas investors have recognised that one of the reasons for Japanese companies' lower ROE than in other developed countries results from limited incentives for executive directors and senior management, 95% of the 400 companies do have variable pay in their remuneration packages. 83% of the 400 have cash incentives in their annual bonus (i.e. annual payment based on annual targets). However, only 22% of the 400 companies publicly define the KPIs (Key Performance Indicators) used for this variable pay. Approximately three-fifths of the 400 do not disclose sufficient details on these annual bonuses. This flouts fiduciary duty and accountability to shareholders, even if the pay packages involved are relatively modest.

Most KPIs used for annual performance are calculated as a growth in items on the income statement (e.g. revenue, operating income, EBITDA, and net income), and/or cash flow (e.g. operating cash flow and free cash flow). However, two groups of KPIs are more appropriate when focusing on corporate long-term financial sustainability: EVA/ROIC EVA (Economic Value Added/Return on Invested Capital) and ESG. EVA/ROIC focuses on whether companies create value after periodical payment to capital (i.e. debt and equity) providers. Use of these indicators is more effective to measure corporate long-term financial sustainability than simply reviewing the growth of items in the income and cash flow statements. Only five out of the 400 companies use these indicators:

・Kao Corporation, a personal care products provider.
・Astellas Pharma.
・Asahi Glass.
・OMRON Corporation, a Japan-based provider of industrial automation, electronic components, automotive electronic components, and social infrastructure systems.
・Kawasaki Heavy Industries, a provider of environmental and recycling plants, industrial plants, precision machinery, industrial robots, and infrastructure equipment.

Furthermore, additional material ESG KPIs are the best proxies to estimate the trends of financial indicators. There are only three companies that have introduced ESG KPIs.

・Ube Industries, a provider of chemical products and construction materials.
・Sumitomo Metal Mining have variable pay linked to occupational health & safety performance.
・NSK, a bearing manufacturer, links a part of executive remuneration to product quality control performance.

The proportion of companies with cash incentives linked to the long-term is far less than that of companies with annual bonus (i.e. 83%), even though the 400 companies are certainly committed to sustainable value creation and selected with high profitability and ROE in the long term. Only six companies or 1.5% of the 400 companies have this type of cash incentive.

・Taiyo Nippon Sanso Corporation, an industrial gas manufacturer.

・JSR Corporation, an elastomer and resin products provider.
・OMRON Corporation.
・Ryohin Keikaku, a self-brand “MUJI” goods retailer, implement annual payments linked to the performance according as their mid-term financial targets.
・Mitsubishi Gas Chemical has a lump sum performance pay when the directors retire, different from retirement benefits, fixed pay at their retirement.
・Nishi-Nippon Railroad has two-tier cash incentives linked to long-term targets: annual payments according as their mid-term financial targets, and three-year EBITDA growth rate.

Part 2 will discuss stock incentives and levels of executive remuneration.

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