Role of Company Performance in Director Evaluation (Japan)

Background

Capital efficiency is low among Japanese companies compared to companies in other markets. According to Merrill Lynch Strategist Naoki Kamiyama, the average return-on-equity ratio (ROE) over the 18 years through 2012 was only 3.6 percent for Japanese companies compared to 10-11 percent for U.S. and European companies. Although some Japanese companies keep surplus cash for identifiable or plausible future investments, others do not appear to have internalized even the concept of capital efficiency. According to ISS' 2013-14 policy survey results, a significant majority of investor respondents indicated that ISS should either always consider company performance when evaluating directors or consider it when a company has exhibited problematic governance practices that the board does not appear to be addressing. With respect to performance metrics used to evaluate directors, most investor respondents indicated relative total shareholder return and a substantial majority indicated financial metrics (e.g. ROE, ROA, ROIC, EPS, margins, economic value change).

Return-on-equity ratio (ROE) is more familiar than total shareholder return among Japanese issuers, and therefore, ROE is more likely to be accepted by issuers. However, a drawback to using ROE is that it can be manipulated arbitrarily.

Current ISS Benchmark Policy

ISS currently does not have a policy that considers financial performance as a systematic factor in determining vote recommendations on director elections.

Policy Directions

ISS is considering several options in formulating a benchmark policy incorporating a company's performance when evaluating directors for 2015 or beyond. These options are as follows:

A. Always consider some measure of capital efficiency, such as the return-on-equity ratio (ROE), as a factor in the vote recommendation on director elections.
B. Always consider a measure of stock performance, such as relative total shareholder return (share price appreciation plus dividend payouts against benchmark index, "Relative TSR") as a factor in the vote recommendation on director elections.
C. Always consider both Relative TSR and ROE as factors in the vote recommendation on director elections.
D. Consider performance metrics (ROE and/or TSR) on a case-by-case basis, such as when poor performance is coupled with a governance concern.

Request for comment/feedback

Please feel free to add any additional information or comments on this policy. In addition, ISS is specifically seeking feedback on the following:

1. Please specify which approach above (A, B, C, or D) that best reflects the views of your organization.

2. If your organization would consider a performance metric when evaluating directors, how should ISS use the performance metric to measure a company's performance, i.e., in terms of time frame for measurement, absolute threshold or relative, time-series, or cross-sectional?

To submit a comment, please send via email to policy@issgovernance.com. Please indicate your name and organization.