News

A $3 Billion Hedge Fund Praises Japan's 'Phenomenal' Spinoff Plan

by Tom Redmond and Yuki Hagiwara
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- Trade ministry made corporate spinoffs tax-free from April 1
- Move comes after removing taxes on stock-based compensation

Hedge fund manager Jamie Rosenwald is excited about tax reforms, but it has nothing to do with Trump trades.

While U.S. politicians grapple with partisan rancor, Japanese bureaucrats at a ministry once renowned for overseeing the nation's industrial policy have been rolling out tax changes that might have gone under the radar of global investors.

In the land of the original zaibatsu industrial groups, companies -- starting this month -- are able to spin off businesses tax-free, under new rules. The change follows the Ministry of Economy Trade and Industry's removal of taxes last year on restricted stock -- a form of management compensation tied to a company's long-term performance.

The tax measures are part a broader initiative by Prime Minister Shinzo Abe's administration to increase focus on returns to shareholders. They're music to the ears of Rosenwald, who heads the $3.1 billion hedge fund Dalton Investments in California. Both spinoffs and stock-based pay have been less common in Japan than other major markets.

"Here you have probably one of the world's largest fields of conglomerates that all trade at massive discounts," Rosenwald said in an interview during a visit to Tokyo. The government has now given management the tools to make a lot of money for themselves -- as future restricted shareholders -- along with the existing stock owners, he said.

The rationale is that spinning off unrelated businesses will allow managers to unlock their value -- while aligning executives' interests with those of shareholders through stock holdings will encourage management to take

that approach. U.S. experience indicates that spun-off companies outperform, one sign of the potential for Japan

"For the past two decades, Japanese firms have had extremely low profitability, and their market value hasn't been growing at all compared to overseas counterparts," said Genta Ando, a trade ministry official who works on corporate governance. "We're laying the groundwork for management that takes profitability into account."

It's yet to be seen how effective the new measures will be in a country where tradition and decades-old or even centuries-old corporate-network relationships are valued for nonfinancial reasons. And Rosenwald says banks have tended to oppose spinoffs because they reduce the collateral available for loans.

Even so, other corporate-governance changes instituted since Prime Minister Shinzo Abe took office are having an impact. Dividend increases and stock buybacks are surging, and firms are putting more outsiders on boards.

More broadly, investors are citing increased engagement between corporate managers and shareholders -- creating a channel for advocating spinoffs that wasn't previously as available. Ando says that before the tax changes, corporate management had no incentive to look at spinoffs. That's even as some Japanese conglomerates trade at levels close to, or even below, their book values.

Company	Price-to-Book Ratio
Mitsui & Co.	0.8
Mitsubishi Corp.	0.8
Hitachi Ltd.	1

Outside Japan, spinoffs have long been viewed as a way to increase the total value of a group of disparate businesses. Back in 1997, hedge fund manager Joel Greenblatt published "You Can Be a Stock Market Genius," considered a bible for investing in such separations. The analysis found spinoffs often increase in market value after listing, and that the parent's shares sometimes rise, too.

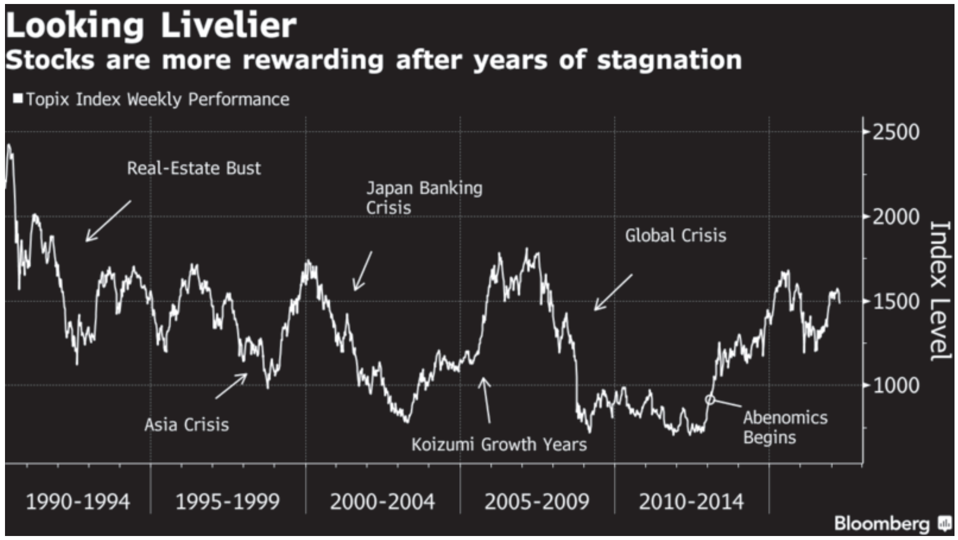
Stock-based pay is also less widespread in Japan, partly due to taxes on the receipt of stock options, and because the equity market basically fell for more than 20 years. Some 65 percent of executive compensation in Japan was fixed salary in 2015, while medium- to long-term incentives accounted for 13 percent, according to Deloitte. In the U.S., just 10 percent was fixed and 67 percent was based on longer-term performance.

Restricted stock can be used to tie a person to a company for a number of years, by making it only transferable once such a condition is met. But unlike stock options, the recipient gets dividends and voting rights from the start.

"It's a step in the right direction," Takeyuki Ishida, director of Japan research at proxy adviser Institutional Shareholder Services Inc. in Tokyo, said of the tax-treatment change. "Japanese management usually don't feel as if they are shareholders."

Twenty-four of the 3,000 companies ISS covers, or about 1 percent, have sought shareholder approval for restricted-stock compensation since last June. They include the brewer Kirin Holdings Co. and tractor-maker Kubota Corp., Ishida says.

Some firms were already increasing stock-based pay anyway. Shiro Hayashi, who heads Dalton's Japanese advisory arm, says the hedge fund invested in Mitsubishi Heavy Industries Ltd., another conglomerate, after screening showed that it had become one of the biggest issuers of stock options.



"Fifteen years ago, the CEO of Mitsubishi Heavy clearly stated in front of analysts and journalists that the company had nothing to do with ROE," Hayashi said. But "in the last five to seven years, there have been dramatic changes."

Ishida at ISS sounds a note of caution. On spinoffs, he questions whether the tax exemption can really bring major change, and says companies should design compensation systems that fit their situations, rather than just following bureaucrats' lead. It would be pointless for a firm that's restructuring to increase performance-linked pay, he says.

But Rosenwald, whose firm has about $1.4 billion in Japanese equities, says the changes will allow Dalton to broaden its range of holdings, because it only invests in companies where management owns a significant amount of shares.

He expects more shareholder proposals for spinoffs, though he declined to comment on whether he's preparing to do that for Mitsubishi Heavy. The company itself praises the new tax measure. Spokesman Genki Ono said by email the firm now has more choices, since the previous tax burden made spinoffs difficult in Japan.

"It's just, like, phenomenal," Rosenwald said of the ministry's plan. "Abenomics seems like it's changing from the top down."