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Special Edition

Corporate value creation requires reform from the inside

– Interview with George Buckley by Sadayuki Horie –

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Executive Summary

Japanese listed companies have started to adopt Japan's new corporate governance code. The code is expected to promote a healthy entrepreneurial spirit among corporate management. To gain insight on the keys to improving Japanese corporate governance, Sadayuki Horie spoke with Sir George Buckley, formerly a long-serving CEO of 3M, among other companies, and still active as a director of several leading global companies, including Hitachi.

Sir George Buckley

Chairman, Ownership Capital

Started Ownership Capital in January 2013. He retired as Chairman and CEO of 3M in 2012 after a long and successful business career spent mainly in the United States. He was previously Chairman and CEO of Brunswick Corporation and Chief Technology Officer at Emerson Electric Company. Currently he is Chairman of Smiths Group plc, Chairman of Expro International and a member of the Board of Directors at a number of major international companies, including PepsiCo and Hitachi.

Sadayuki Horie

Senior Researcher
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Nomura Research Institute

Joined Nomura Research Institute in 1981. Seconded to Nomura Asset Management from 1996 to 2001. Currently a visiting professor at Osaka University of Economics' Graduate School of Business Information Systems. Member of FSA's Council of Experts Concerning the Japanese Version of the Stewardship Code since August 2013. Vice Chairman of Government Pension Investment Fund's Investment Committee since April 2014. Member of FSA's Council of Experts Concerning the Corporate Governance Code since August 2014.

How does Japanese corporate governance stack up?

Sadayuki Horie: Sir George, you've had a long career as CEO of major US and European corporations, including 3M, and now are vigorously serving as a director of several companies, most notably Hitachi. Based on your wealth of experience in Europe, the US and Japan, what is your impression of Japanese corporate governance?

Sir George Buckley: Corporate governance differs widely from country to country in terms of its emphasis. Japan has a softer approach.

Horie: How so?

Buckley: In Japan there are more codes and less overt regulation than overseas. Japanese codes are based on the principle of comply or explain, but they are regarded mostly by Japanese companies as if they were regulations. This is very positive. Japanese companies do not behave as if they have a choice about complying.

I think this is cultural. The Japanese culture is one where companies' senior executives are expected by society to always behave responsibly and take the proper actions on behalf of shareholders. Japan has a well-established compliance culture. Shareholder rights are seen as stronger on paper possibly than they are in reality, but I think that's a positive reflection of Japanese culture. I suspect if there were activist shareholders in Japan, you would find that the law would back them up, but aggressive shareholder activism does not play much of a role here. There's more trust in the corporation here, more trust in society, more trust in the government in Japan than in most other countries.

Horie: Most Japanese strictly follow the rules, but I don't think such rigid compliance is desirable in terms of corporate value creation. I believe we have to change our mindset.

Buckley: I agree. Without a value-creative mindset, companies will go into decline.

I was recently looking at a very fine Japanese company that has very good products but made no profit and has had low growth for many years. No profit means no real ability other than depreciation to generate cash flow to reinvest in the company's future. A company that doesn't grow and doesn't make profits is likely doomed to fail eventually. Such companies are not uncommon in Japan. So reforms are needed for the sake of better shareholder value creation, not just driven by government level, but from within the companies themselves.

The government is probably thinking that if reforms come from the outside first, companies will be encouraged to reform from the inside. For example, the new corporate governance code recommends utilizing outside directors. I think this recommendation will be very effective in promoting reforms from within companies.

Having worked in America most of my adult life, I personally think the Japanese government and companies should try to reform faster, but not too fast. We don't want to fracture Japanese society's value system, which is very, very good. I deeply admire Japanese's respect for the law, respect for institutions and respect for history. Change can only take place at a certain rate without it possibly causing instability.

Horie: From the standpoint of balancing various stakeholders' interests, many Japanese companies seem to place too much importance on stakeholders other than shareholders. Shareholders consequently tend to play a small role. To improve governance, I think that Japanese companies should rethink the balance among their stakeholders.

Buckley: I agree that finding proper balance among stakeholders is very important. I think Japanese companies do quite well in this respect, but they need to do the shareholder piece a little better and also do organic growth and value creation better. We especially need faster growth as a means of greater shareholder value creation. One should always remember that the best way for a company and its employees to be secure is if the company is prosperous and prosperity for a company comes fastest from higher growth rates. In those conditions, all stakeholders win.

In America, the idea of stakeholder balance has emerged only in recent years. Many investors believe that driving returns for shareholders is the main role of the CEO and Board of Directors. In America you see extreme cases where activist investors push for ultra-short-term results, sometimes driving companies to favor the ideas of only one shareholder and forgetting the need to invest in the future.

This is not balanced, not among shareholders and not between shareholders and other stakeholders such as employees, customers and suppliers. There is no question that, over time, companies sometimes become complacent and some need a jolt to wake them up. But I completely disagree with this extreme activist form of pressing for only near-term results I think it just isn't good for the long term health or security of companies.

CEO mindset for value creation

Horie: Getting back to your earlier point that Japanese companies should focus more on value creation, how do Japanese CEOs' mindsets need to change in this regard?

Buckley: I think CEOs have to come back to the core question of how to best ensure their company's long term success and prosperity. They must make sure that their company has a sustainable competitive advantage or it will fail in the end. They must ask themselves, am I doing what's right to make this a sustainable competitive company?

There are a number of "great company" metrics that CEO should focus on to make sure that their companies are prospering. Great companies outperform the market in terms of EPS. They have above-average sales growth rates. They gain market share every year. They have high customer satisfaction rates and high employee satisfaction. They have a stable or improving return on invested capital. They have good reputations as employers. They also have good ESG indices. This is the anatomy of a great company.

How can CEOs make their companies into great companies? I think about companies from two vantage points: looking down from 10,000 meters and a closer-up view from 1,000 meters.

At the 10,000-meter level, there are four key points. First, a company must have a dream, not a fantasy, a dream. Without it, a company doesn't know where they are headed. Second, it must have a robust strategy for achieving that dream. Third, it must hire and promote absolutely superb people. They are what separate the best companies from mediocre ones. The fourth and last point is that they must engage in relentless execution of the strategy.

At the 1,000-meter level, value creation comes from working on five things, (1) driving sales growth higher, (2) boosting operating margins, (3) legally and morally lowering their tax rates, (4) increasing working capital turns and (5) increasing the company's exit multiple or PE multiple.

Horie: So great companies focus on these key points. Which are particularly important for Japanese companies?

Buckley: For most companies in the west today, particularly the US and UK, growing sales is more important than boosting margins because most companies already excel operationally and therefore do not have much scope to improve their operating margins. They are already quite high in many cases. Many Japanese companies, however, still have quite a lot of work to do on improving their operating margins in addition to driving sales growth. They have to do both.

And, as you know, I love innovation. For most mature companies who have established competition, you need to ask, can you be confident that you can do better your rivals in terms of procuring raw materials? Probably not. Can you outdo them in manufacturing products? Probably not either. Can you outsell or out market them? Probably not either. So the only way to beat them is to outthink them. This is where innovation comes in. Innovation is a key for all companies seeking to accelerate their growth and building sustainable competitive advantage.

Improving effectiveness of the Board of Directors

Horie: What is independent directors' most important role on a Board of Directors?

Buckley: To be independent, means having an independent mind and being able to speak independently, unthreatened by the company's management.

Independent directors can't be fired or demoted or posted somewhere else like employees can. But even in American society, it's not easy for inside directors to disagree with the CEO or chairman, so it has to be made constructive. I think external directors can play a very important role in reforms in Japan.

Horie: What do you think about separation of the CEO and chairman roles? A chairman who is also CEO would not be independent of the Board of Directors. What is your opinion on this issue from the standpoint of independence?

Buckley: It's quite an interesting question because I'm chairman but not CEO of Smiths plc and was previously both chairman and CEO of 3M.

When I was at 3M, I was very much an advocate of the chairman and CEO roles being filled by the same person. This is because history shows that one person can do both successfully. In America there is no correlation between performance and whether a company has a single chairman/CEO or a separate chairman and CEO.

I think whether both jobs can be done by the same person very much depends on the qualities of the individual. If someone has the right qualities, is respectful of the other directors and the duties of the two positions, he or she should be able to lead the Board of Directors as chairman while working for the Board of Directors as CEO.

Having said that, I think there is a lot of merit in having a separate chairman, based on my experience in the UK. A CEO normally has vast responsibilities but, for the most part, doesn't have anyone to consult with. Done correctly, the chairman can be an independent advisor, trusted counselor; guider and friend of the CEO, and a quiet and trusted voice that can help the management make wise decisions. He can do this while still protecting the shareholders against bad management. In fact he can probably do it better by keeping all parties in mind.

How to promote engagement between investors and companies

Horie: The Japanese corporate governance code emphasizes the importance of dialogue between companies and their shareholders. I likewise believe that institutional investors and corporate management should discuss long-term value creation with each other. However, I hear from Japanese companies that hardly any investors seek to engage in constructive discussion of long-term corporate value. In fact, Japanese investors seem to be mostly interested in companies' short-term prospects. What can be done to can change this situation?

Buckley: First, this is a problem all over the world, not just Japan. Like other nations, Japanese investors must be persuaded to take more interest in the long term health of a corporation. I personally believe that long-term investment is the most important factor in the health and security of a company. In markets, various factors such as economic cycles and seasonality come into play that affect near term investor returns. To neutralize such factors, long term investing throughout the cycle is crucial and a way of avoiding short term issues.

You still have to pick good companies even if you invest through the cycle. A bad company is still a bad company no matter what your investment thesis is. Investors who hold concentrated portfolios of relatively few stocks must be particularly knowledgeable about their companies to be able to pick good ones. To help investors gain such knowledge, companies must be prepared to provide long-term oriented investors with access to management because there are many subtle things about a company you can learn from the inside than just the outside oriented financial reporting. Investors should look more closely at companies' ESG performance also.

Another important factor, one not evident from financial reporting, is what I call "buried treasure." Buried treasure includes how efficient a company is run, both operationally and energy-wise, how productive its manufacturing processes are, what yield it gets from raw materials, how valuable its patent portfolio is and, most important of all, how high is its new product vitality index. Investors also need to understand how the core business is eroding and declining. These are all indicators of potential sales and earnings growth.

Last, but not least, is what I call the Solomon Index, which is the wisdom of management, their energy, their hunger, their engagement, their brilliance. Although hard to quantify, the Solomon factor is an important factor that separates great companies from the rest of the pack. It can be scored on a 0 -10 scale. These are the approaches we use in my involvement at Ownership Capital.

Horie: So dialogue with management enables investors to deepen their understanding of such factors not visible from the outside. Lastly, I want to ask about engagement activities that investors conduct to engage in deeper dialogue with management. I think that the skill set required to productively engage with management is somewhat different from the skill set required to evaluate companies. What does it take to successfully conduct engagement activities?

Buckley: First of all, engagement is hard to achieve, but it's essential for success. If you try to engage with a very large company, management may listen to you, but often their mind is fixed and they don't always listen to outside views as well as they might.

That said, anyone would listen to a Warren Buffett. Now, Warren is an extremely positive example of a wise investor and advisor. So if a company were to be

approached by a very knowledgeable and experienced investor, one who really understands what happens inside companies, I think the company would be more receptive to input and engagement. For example, if an executive has a proven track record on growth or innovation, there is a lot they could do to help companies become more innovative and grow faster. So why not listen? An experienced manufacturing person is going to understand the quality of a company's manufacturing and other processes. So I think investors need domain experts, both in technology, manufacturing and logistics specialists. I think successful former CEOs and EVPs representing investors can help companies, should they wish to engage. Such expert engagement would be a very valuable opportunity for the companies also.

Horie: So investors might be better able to engage with companies if manufacturing and finance experts team up. Thank you very much for sharing your valuable insights.

about NRI

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