Investment Stewardship, Asia ex Japan – 2024 Q2

July 2024

J.P.Morgan
ASSET MANAGEMENT

J.P. Morgan Asset Management is committed to delivering long term risk-adjusted returns to its clients. We believe that one of the key contributors to strong investment returns is a deep understanding of the corporate governance principles and practices of the companies in which we invest. We expect all our investee companies to demonstrate and aspire to high standards of governance in the management of their businesses, as far as is reasonably practicable.

A key component of our investment approach is regular engagement with our investee companies to better understand their operating, strategic and governance issues. As a fiduciary, we recognise the importance of active ownership on behalf of our clients and maintaining a dialogue with the companies in which we invest, to ensure that our clients' interests are represented and protected. We therefore meet regularly with the senior executives of our investee companies, to exercise our ownership responsibilities. Where a governance issue is material, we will engage with the company to better understand the issue and seek to promote best practices. Our analysts and portfolio managers may take these issues into account as part of their investment process.

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Market developments and trends

International collaboration is crucial for advancing sustainable finance and mobilising private capital for green projects.

Collaborations among countries help define the common ground for sustainable finance and drive capital towards energy transition

In early May 2024, the UK and Singapore convened for their 9th Financial Dialogue. Sustainable finance was one of the key topics discussed and a few key areas in the discussion included the development of globally comparable transition plans, the implementation of standardised disclosures and the establishment of ESG rating and data products. The dialogue also highlighted the need for substantial private capital to mobilise green finance projects in Asia. The two countries agreed to collaborate on sustainable infrastructure investments, and Singapore's Financing Asia's Transitions Partnership (FAST-P) was presented as a key initiative to support such endeavours.

Later in the same month, the Monetary Authority of Singapore (MAS) and the People's Bank of China (PBOC) held the 2nd China-Singapore Green Finance Taskforce meeting in Beijing. The meeting focused on aligning taxonomies, facilitating green finance flows, and developing a decarbonisation rating platform. MAS and PBOC committed to completing the mapping of the Singapore Asia Taxonomy with the International Platform on Sustainable Finance Common Group Taxonomy by the end of this year. The alignment is crucial for facilitating the issuance of cross-border green bonds, and demonstrating the impact of cooperative framework on global green finance.

International collaboration among countries is important in advancing the support for sustainable financing and investing.

Emerging markets are improving corporate governance standards to align more closely with those of developed economies.

Regulators' initiatives critical in driving governance practices

Corporate governance in emerging markets has faced criticism for lagging behind the robust standards prevalent in developed economies. While progress has been gradual, investors would always advocate for more. Recently we saw some key initiatives announced in Asia, which signal positive changes on the horizon.

The Stock Exchange of Hong Kong has taken a significant step by proposing enhancements to its corporate governance code and related listing rules[1]. The proposed changes include designating a lead independent non-executive director when the board chair is not independent, mandatory director training, regular board performance reviews, and stricter limits on multiple directorships. Additional measures to promote gender diversity and strengthen risk management and internal controls further underscore the commitment of the Stock Exchange of Hong Kong to elevate market quality and foster investor confidence.

The Singapore Exchange Regulation (SGX RegCo) aims to enhance shareholder engagement by proposing a rule[2] that requires listed issuers to assist shareholders in convening general meetings promptly. This includes facilitating announcements, ensuring board attendance, and providing necessary support to requisitions, ultimately empowering shareholders to drive corporate change and enforce market discipline.

[1] The Stock Exchange of Hong Kong Publishes Consultation Paper on Corporate Governance Code Enhancements

[2] SGX RegCo: Consultation Paper on Facilitating Shareholder-Requisitioned meetings

The Shenzhen Stock Exchange published the Handbook for Performance of Duties of Independent Director and Audit Committee (in Chinese only)[3]. The handbook outlines the overall responsibilities of independent directors and audit committee, and the standards for the performance of duties by independent directors and by audit committee's members. This initiative aims to clarify expectations and improve the efficacy of the crucial governance roles within the board.

We welcome these regulatory advancements which help move listed companies in these markets towards embracing enhanced corporate governance, bringing them closer to the standards observed in developed economies. In the last section of this report "Spotlight on" we share our insights about corporate reform.

AI governance an evolving topic in corporate engagement

The development of AI necessitates responsible and ethical governance to address concerns about privacy, security, and societal values.

The development of Artificial Intelligence (AI) is exciting considering its potential benefits . But there are undeniable concerns about its potential impact on privacy, security and societal values. As AI systems become more sophisticated, particularly with the use of generative AI, the need for responsible and ethical development becomes paramount. Government agents in different parts of the world are working on this issue.

After the announcement of the draft framework earlier this year, Singapore released the "Model AI Governance Framework for Generative AI"[4] at the end of May. The framework covers nine principles surrounding accountability, data quality, transparency, safety, and security. The framework encourages collaboration between policy makers, industry, and researchers to build a trusted ecosystem for generative AI. In June, Hong Kong's Office of the Privacy Commissioner of Personal Data (PCPD) has issued the "Artificial Intelligence: Model Personal Data Protection Framework"[5] , which focuses on the governance of AI primarily from the personal data privacy perspective.

For investors, understanding the AI governance initiatives is important. These frameworks can influence the legal and regulatory landscape, impacting the development, deployment, and commercialisation of AI technologies. Violation and data privacy and liabilities claims associated with the AI are some of the legal risks for companies. Misinterpretation of the use of AI, or "AI washing" is also a major issue that has drawnthe attention of the U.S. Securities and Exchange Commission.

We have been engaging with Asian tech companies over the past two years to understand their AI governance. Lenovo is a recent case that you can find in the next section "Corporate Engagement".

[3] Shenzhen Stock Exchange: Handbook for Performance of Duties of Independent Director and Audit Committee

[4] AI Verify Foundation and Infocomm Media Development Authority: Model AI Governance Framework for Generative-AI

[5] PCPD: Artificial Intelligence: Model Personal Data Protection Framework

Corporate engagement

Hindustan Unilever

Asset Class: Equity

Market: India

Stewardship priority: Governance and Natural Capital

Focus: Board structure and composition and Waste Management

Issue

Last year, the company raised the royalty payment to its majority shareholders substantially, from 2.65% to 3.45% of revenue, with insufficient justification in our view. Since the new royalty is within the 5% limit, shareholders' approval was not compulsory and the company did not table the resolution for a shareholder vote. We are concerned with the protection of the interests of minority shareholders.

We also want to understand more from the company on its initiatives regarding plastic reduction.

Action

The lack of board independence may lead to insufficient protection for minority shareholders.

We engaged with the company and shared our concerns about insufficient protection for minority shareholders. We questioned the independence of the board, particularly since the Executive Chair was appointed by the majority shareholder. The company had not elaborated in details the internal governance of royalty payments. We do understand the company has conducted annual board evaluation internally, led by its Executive Chair, but we believe an external evaluation by an independent third party is needed.

The company committed to growing sustainably, driving meaningful brand growth whilst reducing the company's environmental footprint and improving social impact. Many of the company's original 32 compass goals set in 2021 have a 2025 delivery date. The focus now is to consider goals for 2030 which are being endorsed by the Board, guided by three principles: targeted goals, appropriate resource allocation, and mobilising the supply chain/advocacy where HUL recognises changes must be led in the value chain.

The company recognises that a variety of initiatives are needed to bring down footprint without decoupling from growth. Also, to comply with the regulatory EPR framework in India which has cascading requirements in 2024/2025, HUL has adopted the plastic strategy, same as Unilever, which is "less plastic, better plastic, no plastic".

Corporate engagement continued

Outcome

We expressed our concern of insufficient protection of minority shareholders by voting against the re-election of the board Chair. To uplift board governance, we see the need for the appointment of an independent director.

We welcome the company's constructive actions on managing its plastic footprint and will dig deeper into its actions and target-setting going forward.

Ganfeng Lithium

Asset Class: Equity

Market: China

Stewardship priority: Governance, Social Stakeholder Engagement

Focus: Board Structure and Composition, Capital Allocation, Supply Chain Management

Issue

Ganfeng's board has four independent directors, implying 40% independence. This is higher than the one-third requirement by the regulator but lower than our expectation of majority independence. The company has been proposing a general mandate that allows them to issue new shares up to 20% of their issued capital while 10% is the limit we are more comfortable with.

Social issues from the supply chain is another focus of our discussion. As a major purchaser of mineral resources from suppliers, we are keen to understand the corporate's supply chain management, in particular the handling of labour issues.

Action

There is pressure to ensure supply chain transparency and accountability while reducing reliance on external raw materials.

Ganfeng acknowledged the pressure coming from customers and investors to conduct due diligence and audit of its suppliers based on global practices and standards. Ensuring transparency and accountability across complex supply chains require significant effort, particularly when dealing with diverse and geographically dispersed suppliers.

At present, more than half of its mineral resources is procured overseas, primarily in Australia and Argentina. Reducing the reliance on external sourcing of raw materials is one of its approaches to mitigate the risks associated with its supply chain. By working on expanding the production of lithium materials from new projects and other sources it owns, the company has targeted to reach a 75% self-sufficient ratio over the next two to three years.

Corporate engagement continued

Regarding governance issues, we shared with the company our expectations of majority board independence and the 10% limits for general mandate in terms of the number of shares as well as the share price discount. Failure to meet these expectations could result in us voting against the resolutions related to general mandate and elections of directors.

The company appreciated the clarity of our governance expectations and voting policies. With respect to directors' appointments, the company sees challenges in finding candidates amid a smaller candidate pool, following the regulatory reform of China's independent director system.

Outcome

We found our dialogue honest and constructive. Ganfeng has been receptive to our suggestions and we will follow up on these topics later this year.

Lenovo Group

Asset Class: Equity, Fixed Income

Market: Hong Kong

Stewardship priority: Social Stakeholder Engagement

Focus: AI Governance

Issue

AI governance is a key topic we engaged with Lenovo due to its continued investment and the growing portfolio of AI technologies. The handling of sensitive personal data, content algorithms and content moderation have drawn scrutiny from regulators globally. Financial impacts from non-compliance with the evolving regulations can include significant fines and losses in market capitalisation.

Action

We first raised this issue with the company in March 2022, to understand its public commitment to accountable and gender-fair AI practices as it joined the 'Women and AI' Charter from Cercle InterElles, a French-based network across scientific and technological industries. In February 2023, we met with its senior AI data scientist and senior manager of global AI business. We asked about its AI governance principles, the oversight structure and the current practices to mitigate risks arising from these emerging technologies. We asked for specific examples of whether Lenovo rejected any AI solutions, because it deviated from its responsible AI principles, and asked the company to disclose its AI governance practices.

Corporate engagement continued

Ensuring accountable and gender-fair AI practices involves establishing responsible AI committees and adopting comprehensive AI governance principles.

In November, Lenovo discussed its approach to responsible AI on its website, indicating that it has established a responsible AI committee, to develop and oversee AI principles that comprises a group of 20 people with diverse backgrounds. Lenovo further indicated that it has created six pillars for its responsible AI practice, which include diversity and inclusion, privacy and security, accountability and reliability, explainability, transparency and environmental and social impact. In its FY23/24 ESG report, it officially included this topic as a social material topic in its ESG materiality assessment. In February 2024, it committed to UNESCO's recommendation on the ethics of artificial intelligence to build an ethical and responsible AI. It also followed our recommendations and detailed its two-page responsible AI principles and guidelines. In late June, it appointed a chief security and AI officer, reporting directly to the CEO, to lead AI governance. We are pleased with the engagement progress on this topic.

Outcome

We see important progress bring made to our ask regarding the governance of AI. As the use of AI is evolving rapidly, we could engage further on this topic going forward.

Critical minerals are commonly used in electronic products. Human rights management along the supply chain was another area we want to have better clarity from the company. Based on Responsible Business Alliance (RBA) supplier audits, they are related to excessive working hours and insufficient time off for employees. It does not comment on human rights risks associated with the sourcing of critical minerals including cobalt, which we believe is a material issue faced by a number of consumer electronics companies including Lenovo. In March this year, we published the "Child Labour in Cobalt Mining" paper summarising our thoughts and engagement findings on cobalt and child labor. We will continue to engage with the company on this topic.

Corporate engagement continued

Yum China (YUMC)

Asset Class: Equity

Market: China

Stewardship priority: Governance, Strategy Alignment with Long Term

Focus: Capital Allocation, Executive Compensation, Shareholder Rights

Issue

Effective capital allocation decisions, reasonable executive pay structure aligned with the performance and protection of shareholder rights and interests are at the centre of creating more attractive risk-adjusted returns. We sought to understand the company's executive compensation practices to assess the overall quality of its corporate governance and long-term prospects.

Action

Executive remuneration strategies often include Short-Term and Long-Term Incentives with ESG metrics, annual board evaluations for effectiveness, and balancing shareholder returns between dividends and buybacks.

The company explained to us the design of its executive remuneration strategy, including the formulation of Short-Term and Long Term Incentives. Its Short-Term Incentives(STI) included operational metrics such as store sales growth and membership growth, while the Long-Term Incentives(LTI) consisted of TSR (total shareholder returns) benchmarking to different indices, system sales and ROIC (Return on Invested Capital). The company also mentioned ESG contributed to 10% of LTI with metrics being the reduction of sugar and salt usage on a three-year cumulative basis.

On board evaluation, we learnt from the company that there is an annual review of the overall board and committees to ensure board effectiveness. Third parties could also be involved to facilitate the evaluation, and the results would be discussed internally. We recommended the company disclose high-level findings of the evaluation.

Lastly, we communicated our expectations on shareholder return by the company. While YUMC has been focused on buybacks, we preferred that the company distribute dividends instead. The company reiterated that they are cautious about over-promising on dividend payouts, and has budgeted more than US$3 billion of capital return for three years, of which 25% would be spent on dividends and the rest on buybacks.

Outcome

We will emphasise our asks about more dividends and share examples regarding board evaluation disclosure via email.

Proxy voting

We review all resolutions to ensure that votes cast are in the best economic interests of our clients. As such, we vote in a manner that is intended to be beneficial to delivering the long-term value of the companies in which we invest. Most resolutions raised are uncontentious, and we typically vote in support of incumbent management. However, in a number of instances, we either abstain from voting or vote against specific resolutions. In Asia Pacific, we have appointed Institutional Shareholder Services Inc. (ISS) to assist us in the processing of proxies and to provide us with recommendations based on our Proxy Voting Guidelines. At the same time, we are under no obligation to accept these recommendations if we believe that client interests are best served by voting differently.

Between April and June 2024, we voted on 13,860 proposals at 1,322 Asia ex Japan company meetings, of which China and Hong Kong accounted for close to 69.5% of the total number of meetings, followed by Taiwan (10.0%), Association of Southeast Asian Nations (ASEAN) (9.5%), and India (8.1%). Our voting statistics for the quarter are summarised below:

J.P. Morgan Asset Management voting for Asia ex Japan companies in 2024 Q2

*All Asia ex Japan companie	2024 Q2		2023 Q2	
Number of meetings	**1,322**		1,039	
Number of votable proposals	**13,860**		10,903	
Votes with management	**11,806**	**85.2%**	9,388	86.1%
Votes against management	**1,961**	**14.1%**	1,441	13.2%
Abstain and withhold	**92**	**0.7%**	74	0.7%
Total number of proposals voted	**13,860**	**100.0%**	10,903	100.0%
Number of shareholder proposals voted for	**294**		278	

Key Markets	China, HK		Taiwan		India		ASEAN		Australia		South Korea	
Period*	**2024 Q2**	2023 Q2	**2024 Q2**	2023 Q2	**2024 Q2**	2023 Q2	**2024 Q2**	2023 Q2	**2024 Q2**	2023 Q2	**2024 Q2**	2024 Q2
Number of meetings voted	**919**	685	**132**	77	**107**	47	**126**	207	**33**	18	**5**	5
Number of proposals voted	**10974**	7982	**1081**	503	**454**	227	**1119**	2036	**218**	130	**14**	25
For	**9234**	6884	**1008**	472	**365**	191	**991**	1709	**196**	107	**12**	25
Against	**1665**	1069	**73**	31	**89**	36	**114**	282	**18**	23	**2**	0
Abstain/Withhold/DNV	**75**	29	**0**	0	**0**	0	**14**	45	**3**	0	**0**	0
As % of total												
For	**84.1%**	86.2%	**93.2%**	93.8%	**80.4%**	84.1%	**88.6%**	83.9%	**89.9%**	82.3%	**85.7%**	**100.0%**
Against	**15.2%**	13.4%	**6.8%**	6.2%	**19.6%**	15.9%	**10.2%**	13.9%	**8.3%**	17.7%	**14.3%**	**0.0%**
Abstain/ withhold	**0.7%**	0.4%	**0.0%**	0.0%	**0.0%**	0.0%	**1.3%**	2.2%	**1.4%**	0.0%	**0.0%**	**0.0%**

Propsoal category	2024 Q2			2023 Q2		
	Number of Proposals	**As a % of total**	**% voted Against / Abstain / Withold**	**Number of Proposals**	**As a % of total**	**% voted Against / Abstain / Withold**
Capitalization	1,375	10%	24%	1487	14%	27%
Compensation	1,087	8%	14%	898	8%	21%
Director related	3,742	27%	22%	2703	25%	14%
Strategic Transactions	743	5%	31%	602	6%	28%
Routine business	4,476	32%	4%	3416	31%	4%
Others	2,437	18%	14%	1797	16%	13%

Similar to our observations in the past years, the April– June quarter coincided with the peak of the AGM period in China, Hong Kong, Taiwan and ASEAN. In China and Hong Kong, we voted against 1665 proposals, of which 34.5% were director items related proposals. In ASEAN, we voted against 114 proposals, of which 50.9% were also director items related proposals.

Proxy voting continued

Directors’ election

During the quarter, we voted against 2,930 proposals related to director election due to concerns about overall board independence and long-tenure of independent directors and the lack of female director on the board. About 78.7% of these proposals came from China and Hong Kong companies. Please refer to the following voting highlights:

COSCO Shipping Energy Transportation (HK/China)

As company’s material for annual shareholder meeting lacked sufficient disclosure. We were inclined to vote against the proposed amendments to its constitution regarding independent directors. We engaged with the company to get a clarification, and the company explained that the change is to align with the regulatory changes by showing a detailed comparison between the new and the old constitutions. We decided to support the resolution.

Compensation

During the quarter, we voted against 152 proposals related to compensation due to concerns about failure to provide clarity on the increase of total remuneration and the grant of incentive schemes. About 76.3% of these proposals came from China and Hong Kong companies. Please refer to the below voting highlight:

Tenaga Nasional Berhad (Malaysia)

Tenaga Nasional Berhad is Malaysian multinational electricity company. The company held an AGM to seek an approval of grant and allocation of shares to Jalaluddin bin Megat Hassan. We voted against this item due to a lack of sufficient disclosure on performance conditions for the grant. Also, we believe that supporting the item would be not be the best interests for minority shareholders.

Capitalisation and capital allocation

During this quarter, we voted against 438 proposals related to capitalisation, capital allocation and strategic transactions. About 95.5%of these proposals came from China and Hong Kong companies. Please refer to the following voting highlights:

Vanguard International Semiconductor (Taiwan)

The company held an AGM to seek an approval for resolutions regarding M&A and capital raising. We had concerns over the company's resolutions because of the risk and return of the investment and the potential shareholder dilution. After our engagement with the company, we clarified more details about the intended investment with the company that the investment would be beneficial to the company's long-term growth and value-accretive for its shareholders. Consequently, we changed our voting decisions by supporting the resolutions.

Shareholder proposals

During the quarter, we observed 325 shareholder proposals in the region but the most of them were proposed by controlling shareholders about director re-election. We supported 294 proposals and voted against 31 proposals related to election of directors. Please refer to the following voting highlights:

Woodside Energy Group (Australia)

The company set aspirational net zero targets for Scope 1 emission and has been lagging peers in disclosure. Some of the company's assumption of the net-zero pathways are also outdated. We had a pre-AGM call with the Chair to understand their thoughts on climate and emissions. Woodside considers gas a major beneficiary in energy transition and aims to grow its gas assets. The Chair stated the company's stance about the uncertainty of energy transition and mentioned about the discomfort in Scope 3 emission reductions. We supported the re-election of the Chairman but voted against the Say on Climate resolution as the company has been using some outdated assumptions for its climate analysis.

Spotlight on: Corporate Reform

Michiko Sakai
Portfolio Manager,
Japan
Exp: 14,10

Seol Kim
Portfolio Manager,
Korea
Exp: 17,7

James Sutton
Portfolio Manager,
IEG
Exp: 14,14

Felix Lam
AxJ Investment
Stewardship, Sustainable
Investing Team
Exp: 19,2

In this quarter's report, we asked five individuals from our Global Equities and Sustainable Investing teams about recent corporate reform efforts around the world. We wanted to illustrate whether the drivers of corporate reform are structural and how we are capturing these recent efforts in our investment process. We spoke to Michiko Sakai, Seol Kim and James Sutton who are Portfolio Managers in Japan, Korea and the International Equity Group (IEG), respectively. We also spoke to Felix Lam who is an Investment Stewardship Specialist in the Sustainable Investing team.

1. Over the last year, corporate reform as a theme has risen to the forefront for companies across the world. What is driving corporate reform and a greater focus on shareholder return in Japan and Korea? Is there a common trend or is it specific to the region?

Felix: The desire to attract foreign investment is a major driver for Asian regulators to drive corporate reforms. Companies adopting best global governance practices and focusing on generating returns are generally having more attractive risk-adjusted rewards.

Notably, one major characteristic of Asian markets is the high prevalence of controlling shareholders of families or states. Due to the concentrated ownership, the operation and decision making of these companies could be streamlined and become more efficient. Having controlling shareholders may also help nurturing sustainable growth and business successes more efficiently. On the other hand, conflict of interest and the lack of transparency and accountability are some key risks for investing in these companies. Regulators play a critical role in continuing to uplift governance in order to mitigate the investment risks and ensure shareholders rights are protected.

In March 2023, the Tokyo Stock Exchange sent out the request, asking all listed companies on the Prime and Standard Markets to take "action to implement management that is conscious of cost of capital and share price". This initiative and other actions taken by the regulators on corporate reform since the announcement of Japan Revitalization Strategy by the Prime Ministry's Office in 2013-2014 are generally well received by investors. Earlier this year, South Korea introduced the Corporate Value-up Program and voluntary guidelines for companies about this. Most recently, the Hong Kong Exchange proposed the amendments that could enhance the corporate governance of listed companies. We welcome more initiatives to be rolled out by regulators in the region to enhance board effectiveness, minority shareholders' protection and overall transparency and accountability, which are major pain points for investors.

Source: J.P. Morgan Asset Management. Data as of June 2024. The securities above are shown for illustrative purposes only. Their inclusion should not be interpreted as a recommendation to buy or sell. Experience figures: years in industry/firm.

Michiko: Corporate governance reform is the biggest reason to be excited about Japan. One very important difference in these couple years is that we have more evidence that the change is real: there is improving capital efficiency, improving shareholder returns and management teams are becoming more aligned with minority shareholders.

Poor governance structures had been a weak point historically in Japan, and it is a result of multiple factors. First, low confidence in economic outlook. GDP growth had been low and there was a prolonged deflationary environment over the last three decades. As a result, corporates kept cash on their balance sheets to prepare for rainy days. The second reason is shareholder structure. There was little pressure from shareholders. Before, indirect finance represented a large part of the equity market, or in other words, large banks were large shareholders for many companies. They cared less about better governance and shareholder return. Cross-shareholdings had been a large chunk of overall market value. Now, direct finance is becoming a larger part of the equity market. Activists, large institutional investors and asset owners are collectively engaging with corporates on improving governance. Lastly, there was low board independence. Representation of external directors sitting on the board was not sufficient, hence little pressure to challenge management to drive changes.

Coming from a low base, we are seeing corporate governance improving. Board structures are in much better shape. For example, the ratio of companies with more than one-third of the board being independent are up significantly from 6.4% ten years ago to over 60% recently. The change in investor profiles and collective pressure is leading corporates to pay more attention to minority shareholders. We have seen the number of activist campaigns up more than ten times in the past 10 years. In our engagements with corporates, they are more willing to have more constructive discussions compared to before.

Seol: Corporate reform and better shareholders return are not completely new occurrences but helped by Japan's push for corporate reform and the Korean government's push via the "Value up" initiative. Korea's push for governance improvement started in the form of a Stewardship Code adoption in 2018 and through limiting majority shareholder voting rights for audit committee members in 2020. This has resulted in the number of activist campaigns rising from 10 in 2018 to 42 in 2023. The latest push in the form of the "Value Up" program is an extension of preceding changes in response to strengthening consensus that poor corporate governance is a hinderance to the economy.

There has been a few key drivers of recent corporate reform in Korea. Firstly, there has been a rise in retail investors which has meant a greater proportion of household assets in equity and pensions. Politically, retail investors account for 32% of eligible voters, setting the backdrop for bilateral support for the reform. Economically, there has been a greater distribution of corporate wealth to retail investors through capital gains and dividend income.

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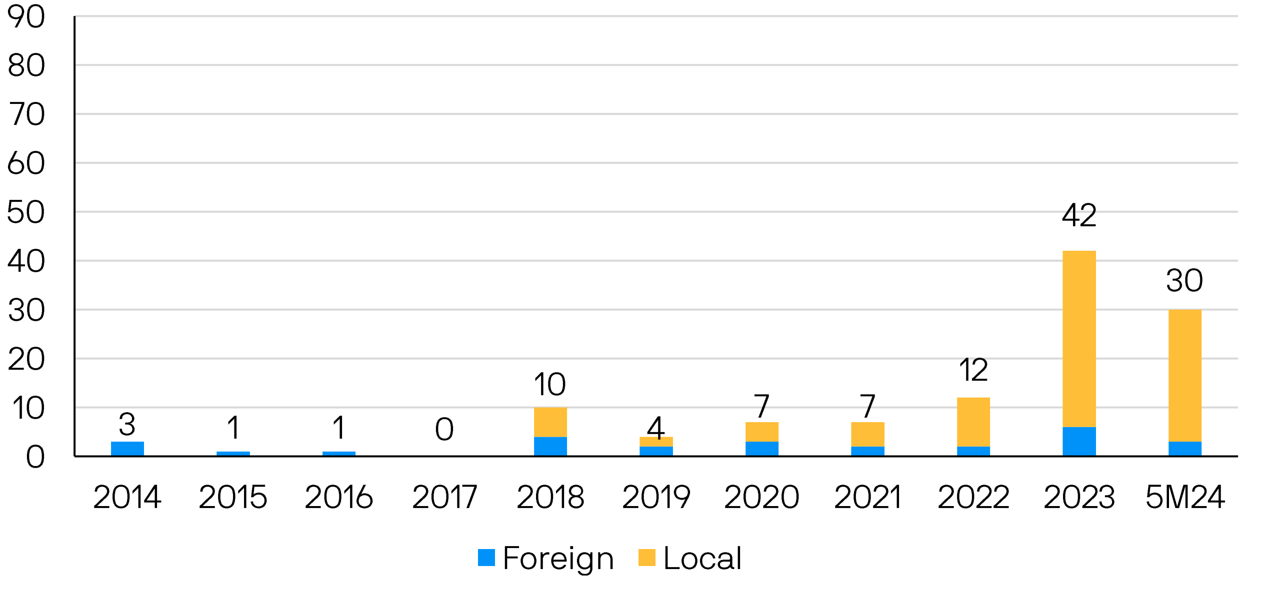
Secondly, there has been a better understanding about efficient capital allocation from corporates. It is true that Korean corporates still have a long way to go and we still see disappointing capital allocation decisions here and there. Having said that, the new third generation leadership of Chaebols understand the capital markets better than their forefathers given their exposure overseas (9 of 10 chaebol leaders are educated in US or UK) and greater sensitivity to the capital market given stricter government regulations.

Thirdly, as a lowered growth outlook and low returns are a drag to the national pension, increasing shareholder return is one of the few policies that can help improve the national pension. We find that the growth potential in Korea has decreased substantially as the population is fast aging however, there is ample capital. This is different compared to the past when Korea enjoyed mid-to-high single digit GDP growth per annum.

Lastly, minority shareholders are becoming more vocal, bigger and better educated. The number of shareholder activism campaigns has increased since 2021, initiated by both local and foreign companies.

Number of activism campaigns by entities in 2014 – current



James: The following comment was made by Shane Duffy, a fellow Portfolio Manager in IEG, after his trip to Japan in May last year: "The change in Japan is real and is happening pervasively. Japan has undoubtedly improved over the last decade. Since former Prime Minister, Shinzo Abe, launched 'Three Arrows,' payouts and ROEs have generally risen. But this has taken the market from a major negative outlier to something more in line with global norms. There is still a large number of companies with some combination of excess cash on balance sheets, low RoEs and low PB multiples. Thanks to the bold interventions of the Tokyo Stock Exchange and the increased profile of activists, there does seem to be tangible momentum around improving corporate returns across a broad enough swathe of companies to make a difference."

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Not wanting to be outdone by Japan and faced with a similarly sclerotic corporate sector, the Korean government launched a "Value-Up" program which will "encourage and support companies' efforts to return more capital to shareholders and improve governance." It is of course dangerous to extrapolate from the Japanese experience thus far and assume that exactly the same playbook will unfold in Korea. One difference is the Chaebol families, who control the large Korean conglomerates, are disincentivized to unlock value if it diminishes their control or increases their inheritance tax liability (60% in Korea) as the reins are passed on to the next generation. In spite of this, there is massive opportunity from a low base. For example, Kia still only has a payout ratio of 25% despite net cash being 40% of market cap.

2. Could you talk about why companies are suddenly embracing corporate reform now and how this is positive for shareholders? Has shareholder value already been unlocked?

Michiko: Since the introduction of the corporate governance code and stewardship code in 2014 and 2015, we have seen continuous improvements. A stream of positive changes were already seen for over 10 years. But the pace has picked up in the past couple years after the Tokyo Stock Exchange reform and collective engagement by asset owners and investors like ourselves. A record number of companies announced buybacks in 2024. We also have had the largest total value of buybacks in 2024 as well. Cumulative total shareholder return in the past 10 years shows a clear uptrend and with a 10% total shareholder return CAGR, Japan is one of the highest within major equity markets globally. Companies are rationalizing their balance sheet, exiting unprofitable business, reducing cross shareholdings (as seen in property and casualty insurance and automotives). Corporates are more willing to engage and improving disclosures, and engagement is no longer a one-way conversation generated by investors. We are already seeing shareholder value being unlocked however, there are many more legs.

Seol: The pace of corporate reform happening is slow but we do not think it is sudden. Payout and stock cancellations have gradually risen, and more and more companies have increased board independence and diversity in the past several years. As aforementioned, the number of activism campaign has increased and the proportion of "against" votes at annual general meetings has increased over time. We do not believe shareholder value has already been unlocked given issues such as holding company discounts, lazy balance sheets and investments in non-core assets. We believe the Korean government's Value Up program can encourage both shareholders and corporates to focus on improving governance. The government revised the Stewardship code this March to promote regular monitoring of "capital allocation" by institutional shareholders and the politicians are discussing various measures to entice and pressurize corporates to communicate capital allocation more and improve shareholder return policies (for example, Commercial Act revision or tax changes). The bottom line is we think the general direction is heading towards the improvement of overall corporate value albeit slow.

Source: J.P. Morgan Asset Management. Data as of June 2024. The securities above are shown for illustrative purposes only. Their inclusion should not be interpreted as a recommendation to buy or sell. Experience figures: years in industry/firm.

Felix: In addition to meeting the changes in listing rules and regulations, companies are also facing more pressure from long-term investors who demand better corporate governance practices. In Asia, we have been asking companies for board independence levels which are above listing requirements. Using the voting power given as shareholders, we would express our opinions with respect to companies' performance and governance practices.

3. How strong is the momentum for these initiatives and will corporate reform be a theme that is here to stay for the long term?

Michiko: Very strong. Corporate governance improvement is the single most important long term investment theme for Japanese equity. Even though the corporate governance has seen improvements in the last decade, there is plenty more room to improve from here and the pace of improvement has been picking up.

Gross shareholdings are believed to take up approximately 10% of the market cap of the TOPIX. Cross-shareholding is when a listed company has equity ownership in other companies for reasons such as business partnerships. It requires a lot of capital and not all equity holdings create capital gains. If all TOPIX companies were to liquidate their entire equity holdings to fund buybacks, it is estimated that RoE would increase from 9.9% to 12.2%. Moreover, 50% of all companies listed excluding banks are net cash as Japanese corporates are cash rich. For comparison, in the US and Europe, this ratio is in the mid-teen percentages. Yet the TOPIX total payout ratio is 40-50%, much lower than S&P's 80-100%. Therefore there is more room to grow shareholder return or put capital to better use.

Seol: "Peer pressure" (or "naming and shaming")" and "legislative changes" are strong momentum drivers for corporate reform initiatives. Although the Value Up program is not mandatory, we believe the proposed guidelines by the government can encourage corporates to communicate more and focus on reforming to improve their overall value in the future. Legislative changes such as to inheritance tax or the Commercial Act would be powerful tools to make changes in a short period of time but we do not assign very high probability to these as the opposition party has a majority in the 22nd National Assembly. As explained in response to the first question, we think some of the drivers for corporate reform are structural so we think it is a theme to stay for the long term. Almost a third of voters are stock investors therefore pressure to improve governance will continue. Even tax changes, while unlikely in the short term, will likely evolve over the longer term to align with the interests of all shareholders.

Felix: Corporate reform is obviously gaining momentum. As the gap between local corporate behaviour and global governance practices remain relatively wide, we expect the momentum of corporate reform to be maintained. For regulators in Asia, the desire to attract international capital continues to stay strong with the hope to bring valuations of the regional listed companies closer to their counterparts in developed markets.

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4. How do we capture corporate reform within our investment process? To what extent do we give credit to companies on a forward-looking basis versus waiting to see tangible actions before giving credit?

Michiko: The delta of possible changes from many Japanese corporates is big. There is a large pool of corporates with the potential to improve their corporate value through governance improvements. Different companies have different agendas and priorities. Investment opportunities are quite widespread and not limited to those poorly managed companies with a low P/B ratio. We are seeing corporate governance progress in various sectors such as property and casualty insurance, construction and property and as a result we made a few changes to our research assumptions.

For example, for the property and casualty insurance subsector, in February the local regulator, the Financial Services Agency, urged insurers to sell their entire cross-shareholdings. These 4 insurance companies came up with plans to sell down all of their cross shareholdings worth around 43 billion dollars (6.5 trillion yen). This is following a price-fixing scandal that heightened scrutiny of their business practices. We have reflected the full elimination of cross shareholdings in our forecasts. 50% of released capital will be allocated to buybacks and the remaining 50% to reinvestment. Reinvestments rates are different depending on past track records.

Seol: We try to capture corporate reform through our ESG checklists and through a premium or discount to our exit multiples. We can give credit to companies on a forward-looking basis if there is no track record of abusing minority shareholders and if they have a clear capital allocation strategy. However, we are cautious about building in too much expectation for companies which have not had any tangible actions.

James: A note from our Automotives Analyst on Kia gives a good explanation of how he has tried to get ahead of the “Value Up” initiative in Korea (learning lessons from Japan) and this insight had investment implications. I would caveat that it is very difficult to know ahead of time which companies are going to instigate reform and often on the day that a large change in capital allocation is announced (for example, a buyback or an increase in payout ratio) the stock moves up sharply. That is why it is still important to focus on the operating business and view additional improvements to corporate governance as a bonus if it materializes.

Felix: We have developed a suite of tools for evaluating the listed companies we invest in. Among these tools are a set of ESG questions, which our investment teams provide answers, and our proprietary quantitative ESG scores. A change in the corporate behaviour and governance practices (for example, changes in diversity of the board and the design of executive compensation) could change our answers to the ESG questions and quantitative ESG scores, impacting our evaluation of companies and our investment decisions.

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5. Could you share successful engagement examples where we have steered companies towards making progress on governance? How do we measure progress?

Seol: We incorporate an ESG agenda whenever we communicate with companies. Additionally, we co-work with the Sustainable Investing Stewardship team to communicate with companies on annual general meeting agendas and to try to inform companies of our expectations and standards. It is difficult to measure progress but we continuously challenge companies on a relative basis and in a historical context and monitor development. One example is our engagement with KB Financial Group. During our engagement, we shared our concern for loss-making, margin-dilutive overseas investments and urged the company to focus on shareholder return. We believe this has led the bank to display industry-leading total shareholder return.

Felix: We have engaged with Hong Kong listed Techtronic Industries, a world-leading manufacturer of power tools, hand tools and outdoor power equipment. Among our key requests for changes were achieving a majority independent board and a fully independent audit committee with a member who has a strong auditing and accounting background. In the first half of 2024, the company made significant changes to the board. Following these changes, the board has reached majority independence and its audit committee has met our expectations.

In order to track the progress of our engagements over time, we have established four stages in our engagement journey, starting from Milestone 1, issues raised to the company. The ending stage will be either Milestone 4, the company implements changes, or Milestone 0, engagement failed. For our engagement with Techtronic, we achieved Milestone 4 for both of our engagement requests regarding the board. More details about our approach to engagement progress can be found in our 2023 Global Investment Stewardship Report published in April 2024.

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