Asia's corporate reform: A path to sustainable growth and higher equity returns

February 2025

Vasilios Tsimiklis, CFA, M.Sc.
Associate Portfolio Manager & Investment Strategist, Multi-Asset and Currency Management

Key highlights

- Corporate reform is gaining momentum in Asia, returning focus to profitability and shareholder value. Japan, traditionally known for hoarding cash and misallocating capital instead of maximizing shareholder returns, is leading the way, but reform efforts are also gaining traction in Korea and China.
- This matters for investors as corporate reform can act as a powerful force that strengthens market fundamentals and increases expected equity returns. A constructive view of corporate reform underpins our relatively positive outlook for the Japanese equity market.
- By increasing expected returns, corporate reform also reinforces the strategic purpose of public equities in general, ensuring they remain the cornerstone of a well-diversified investment portfolio.

Introduction

Investor assessment of expected equity market performance often rests on the interaction of current valuations, expected monetary policy, and the extent of geopolitical risk. In Asia, another factor is becoming increasingly important: corporate reform. Led by Japan, governments and regulators in major Asian countries have intensified efforts to address longstanding corporate governance challenges that have weighed on company profitability and suppressed local equity market performance.

In January 2023, the Tokyo Stock Exchange (TSE) launched an ambitious initiative to dismantle entrenched inefficiencies often associated with Japanese corporations. Traditionally known for hoarding cash and misallocating capital, Japanese public companies have historically prioritized interests of a narrow group of stakeholders—entrenched management, employees prioritizing lifetime job security, and suppliers—instead of maximizing shareholder returns.

TSE corporate reforms aim to break this behavior and realign interests between shareholder and management interests. By shifting corporations back to a focus on profitability and shareholder value, capital efficiency is enhanced, leading to higher long-term expected equity returns, including as a result of stronger foreign capital inflows. And higher expected returns reinforce the purpose of public equities in investor portfolios, ensuring they remain the cornerstone of well-diversified portfolios for many investors.

Corporate reform is only part of the solution

Japan's corporate reform is part of a wider strategy by public authorities to revitalize an economy trapped in a cycle of low growth and recurring deflation since the bursting of the 1990s real estate bubble. Previous reform efforts, such as Abenomics in 2014, fell short. This time appears different. Results are already visible: the economy is reflating. After eight years, the Bank of Japan (BoJ) finally exited its Negative Interest Rate Policy in 2024; and the equity market has returned over 56% since early 2023 (Chart 1), helped in part by yen weakness that has been another core element of broad policy. Notably, equity returns in Japan since 2023 have broadly matched those in the US. Considering the outsized contribution of the "Magnificent Seven" to US returns over this period, Japan's performance is impressive, reflecting market-wide enthusiasm supported by an improving fundamental outlook for the country.

Chart 1: TOPIX return climbs 56% since January 2023

Cumulative total return for the TOPIX

Source: The information was prepared by CIBC Asset Management Inc. using data from the following third-party service provider: Bloomberg. Data as at Dec 30, 2024

Corporate reform can spread quickly. As companies witness the positive impact of corporate reform, they are incentivized to emulate these efforts. Success tends to breed success. It happened in Germany in the mid-1990's where corporate reform began with a single company and quickly spread across the market (see Box 1).

We are seeing the same pattern in Japan today. In addition, Japan's reform efforts have also inspired other countries in Asia, with both South Korea and China announcing initiatives in 2024. Although each country's approach varies—China, in particular, is also focused on enhancing investor protection and reducing operational risks—they share the goal of increasing valuations and lifting shareholder returns. Looking forward, we expect corporate reform in Asia to underpin long-term investment opportunities for global equity investors by driving relatively strong earnings growth and justifying higher valuations.

1990's German corporate reform – a template for Asia

In the early 1990s, German corporations faced mounting challenges stemming from globalization, European integration, and economic stagnation in the aftermath of reunification. These pressures prompted significant corporate reforms to address inefficiencies in traditional business structures and nurture adaptation to an increasingly competitive global environment.

A major turning point came in 1994 when Höchst, at the time a leading pharmaceutical conglomerate, embarked on a major restructuring effort. This initiative focused on improving profitability and shareholder value by reorganizing its operations into smaller, more autonomous profit centers. This decentralized approach enhanced accountability, streamlined decision-making, and boosted efficiency, marking a clear departure from the rigid, hierarchical models that had long characterized German firms. As a result, Höchst's return on equity (RoE) rose from 4% to 14% in the following three years.

One inspired many

Höchst's success, along with peer pressure, inspired similar restructuring efforts across major conglomerates like Siemens and Daimler, paving the way for widespread reforms. Companies began implementing share buybacks, increasing dividend payouts, spinning off non-core businesses, and embracing hostile takeovers. Privatization of state-owned enterprises also gained momentum, particularly in sectors such as telecommunications and transportation.

Powerful impact on RoE

Germany's shift toward a market-oriented model proved to be a significant driver of equity returns. Between January 1993 and December 1997, Germany outperformed the MSCI World Index by almost 80%, with market RoE increasing from under 4% to over 12% and price-to-book (P/B) ratios rising from about 2.1 to 3.5. These achievements were particularly notable given the weakness of domestic demand following the German reunification boom-bust cycle. They also highlight that while reforms may seem small individually, their collective impact over time can significantly impact expected returns. Today, Japanese corporations share several similarities with Germany's corporate landscape of the 1990s. The success of Germany's shareholder-focused reforms highlights the opportunity for similar improvements in Japan.

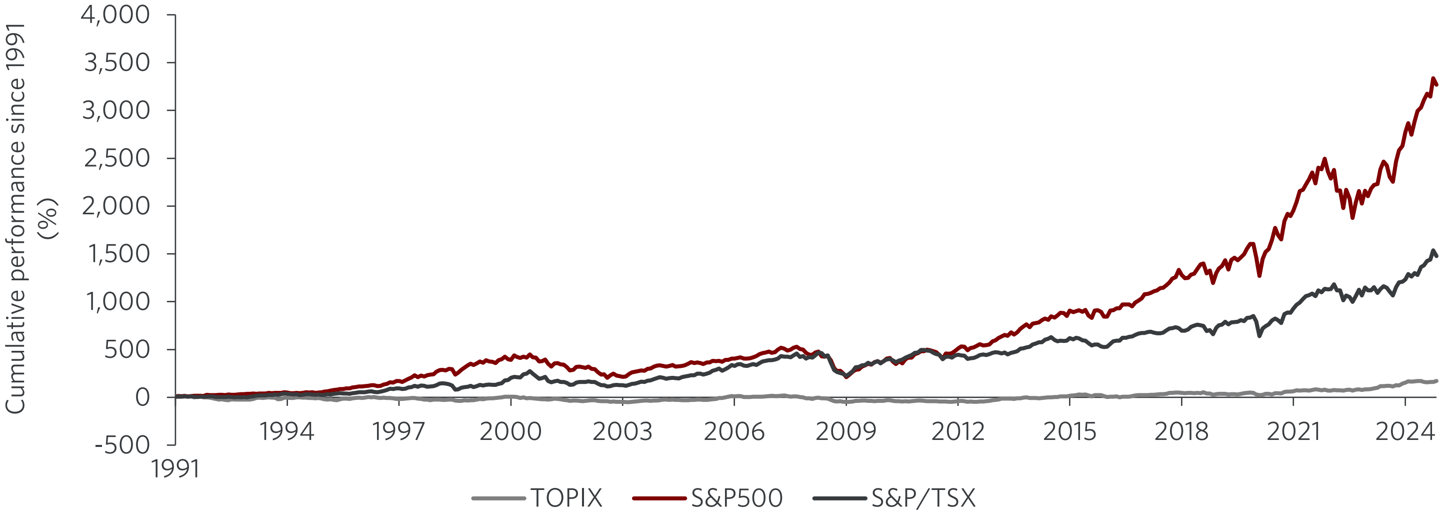
The need for reform in Asia today

Mounting market, economic, and social pressures underscore the urgency of corporate reform in many Asian countries. In Japan, companies have historically been characterized by low growth and inefficiency, with management teams prioritizing stability and narrow stakeholder interests over shareholder value. Hierarchical structures and high levels of cross-shareholdings—where companies hold shares in partner companies to shield one another from shareholder demands—have insulated Japanese management from market pressures, supporting entrenched management teams and often causing firms to trade below book value due to inefficient capital use.

This stakeholder-over-shareholder approach gained traction in Japan following the real estate bubble burst in the early 1990s. The decades of low growth and low or negative interest rates that followed rendered cash hoarding essentially costless, reinforcing the corporate sector's inefficient capital allocation. Over time, these practices led to low productivity, weak profitability, and significant underperformance of Japanese equities compared to global peers such as the S&P 500 and Canada's S&P / TSX Composite Index (Chart 2).

Chart 2: Japanese equities have significantly underperformed the S&P 500 & S&P/TSX since 1991

Cumulative total returns by market



Source: The information was prepared by CIBC Asset Management Inc. using data from the following third-party service provider: Bloomberg. Data as at Dec 30, 2024

Addressing the 'Korea discount'

In a similar manner, South Korean equities currently suffer from a "Korea discount" and tend to trade at lower valuations relative to global peers. This discount is mainly due to corporate governance concerns tied to chaebols—large conglomerates controlled by founding families who often hold top management positions and maintain close government ties. Chaebols fueled rapid growth from the 1960s onward, but they also fostered governance practices that limited transparency and capital efficiency. As a result, the "Korea discount" has persisted, further worsened by recent high-profile corruption scandals that reinforced the need for reform.

Even in China

In China, the need for corporate reform is pressing as the nation aims to address critical challenges in its economy and financial markets, including the importance of enhancing investor confidence, improving protection for shareholders, reducing operational risks, and creating transparent disciplinary mechanisms.

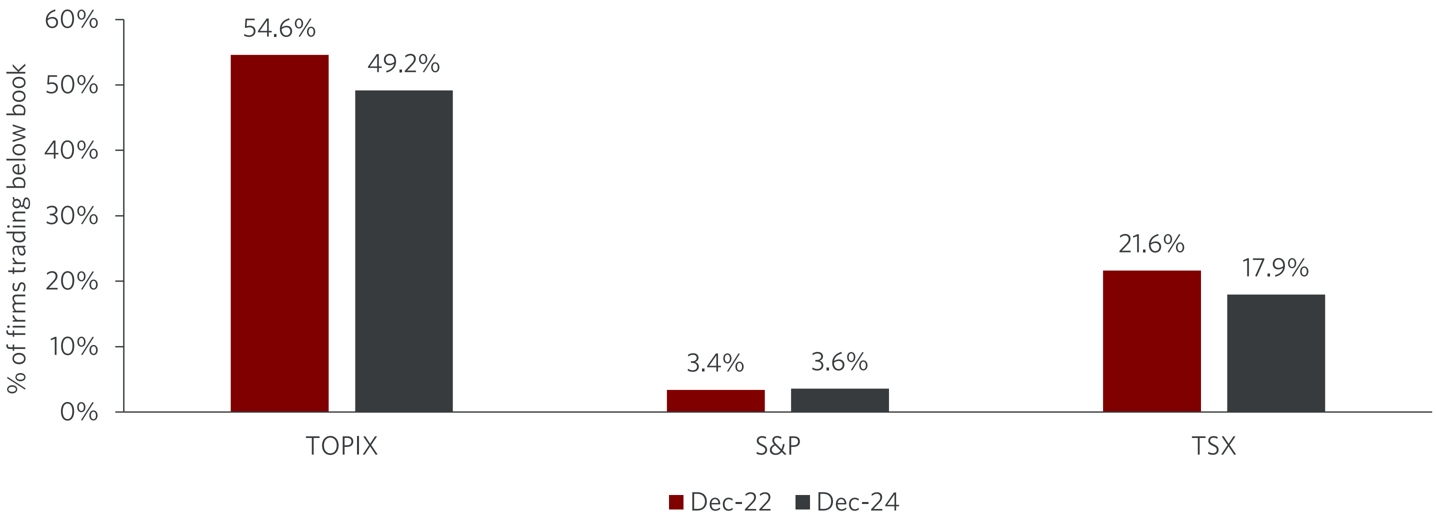
In all three economies, corporate reform is increasingly seen as essential to improving capital allocation, boosting valuations, and aligning management practices with global standards, all of which are key to fostering investor confidence and sustainable growth, and to enhancing expected equity returns.

Japan sets the stage

In early 2023, the TSE introduced new corporate governance guidelines, urging companies to "be conscious of the cost of capital and stock price, and develop and promote efforts to improve these." Initially directed at companies trading below book value, this message has since expanded to all firms, reflecting a broader commitment to capital efficiency and shareholder value. Decades of capital accumulation during Japan's deflationary periods left Japanese companies trading at significant discounts to global peers with nearly half of index constituents still trading below book value today (Chart 3).

Chart 3: Considerable scope for further improvement in Japanese corporate valuations

Percentage of firms trading with price / book ratio below parity



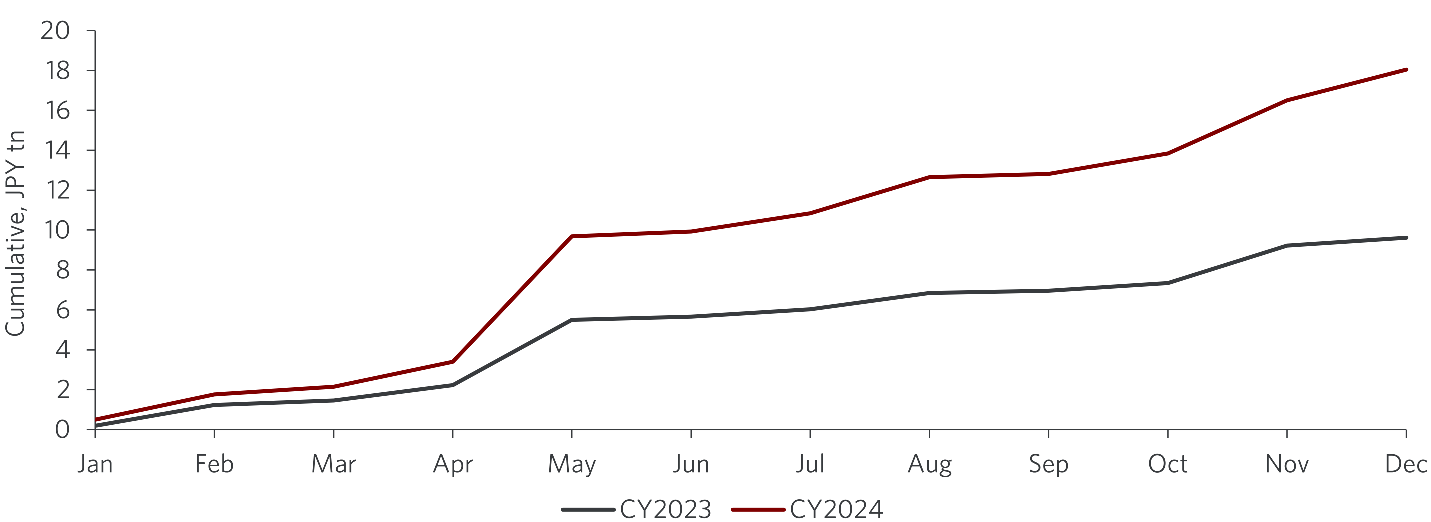
Source: The information was prepared by CIBC Asset Management Inc. using data from the following third-party service provider: Bloomberg. Data as at Dec 30, 2024

Buybacks have soared

Since the TSE's directive, Japanese companies have become the largest cumulative buyers of Japanese equities, rapidly increasing stock buybacks to record levels (Chart 4). Dividend increases also rose sharply in 2023 and 2024, with expectations of further increases. And unwinding of cross-shareholdings, a form of capital misallocation where one company holds shares of another in order to align interests (currently comprising about 10% of the TOPIX), which progressed steadily since 2018, accelerated in recent years with reductions of over six trillion yen in 2022 & 2023. In 2024, major companies, including Toyota and leading lenders such as Mitsubishi Financial, Sumitomo Mitsui Financial, and Mizuho Financial, have committed to unwinding over two trillion yen in combined cross-shareholdings within three years (equivalent to about 20% of their cross-shareholdings). Reducing cross-shareholdings frees up capital, enhancing both capital efficiency and profitability, and raising return on equity (ROE) in companies with fewer such holdings. As such, announcements have been met with investor enthusiasm, typically resulting in substantial stock price increases. Reflecting expectations of additional unwinding announcements, companies with greater amounts of cross shareholdings have outperformed the broader index since the start of 2023 (Chart 5).

Chart 4: A significant acceleration in announcements of share buybacks

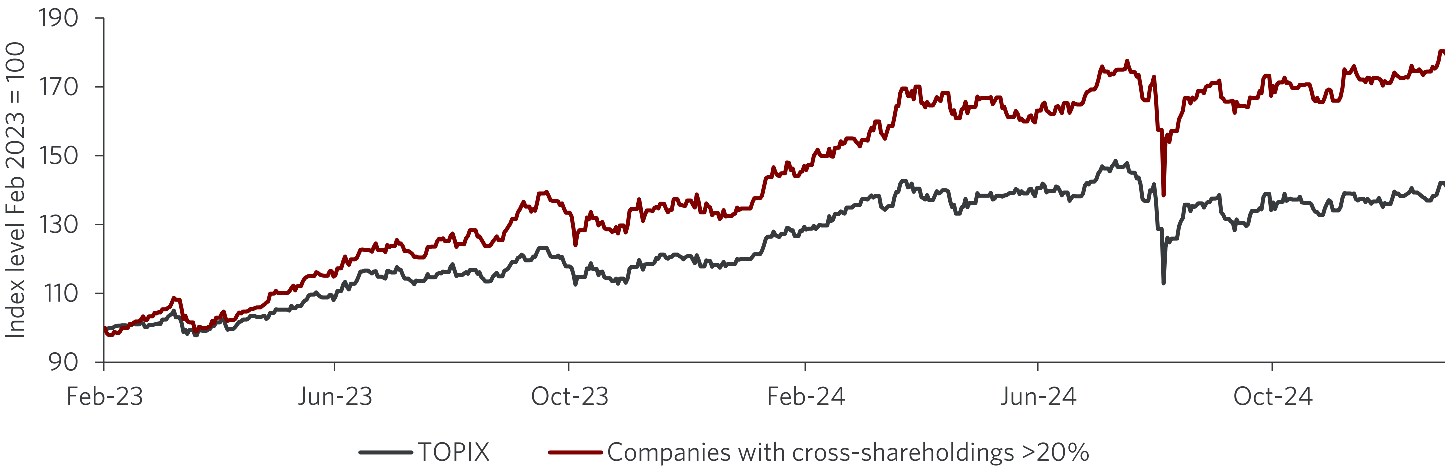
Announcements of share buybacks (tn JPY)



Source: The information was prepared by CIBC Asset Management Inc. using data from the following third-party service provider: Goldman Sachs. Data as at Dec 30, 2024

Chart 5: Strong outperformance by companies with greater percentage of cross-shareholdings

Performance of TOPIX vs. companies with cross-shareholdings >20%



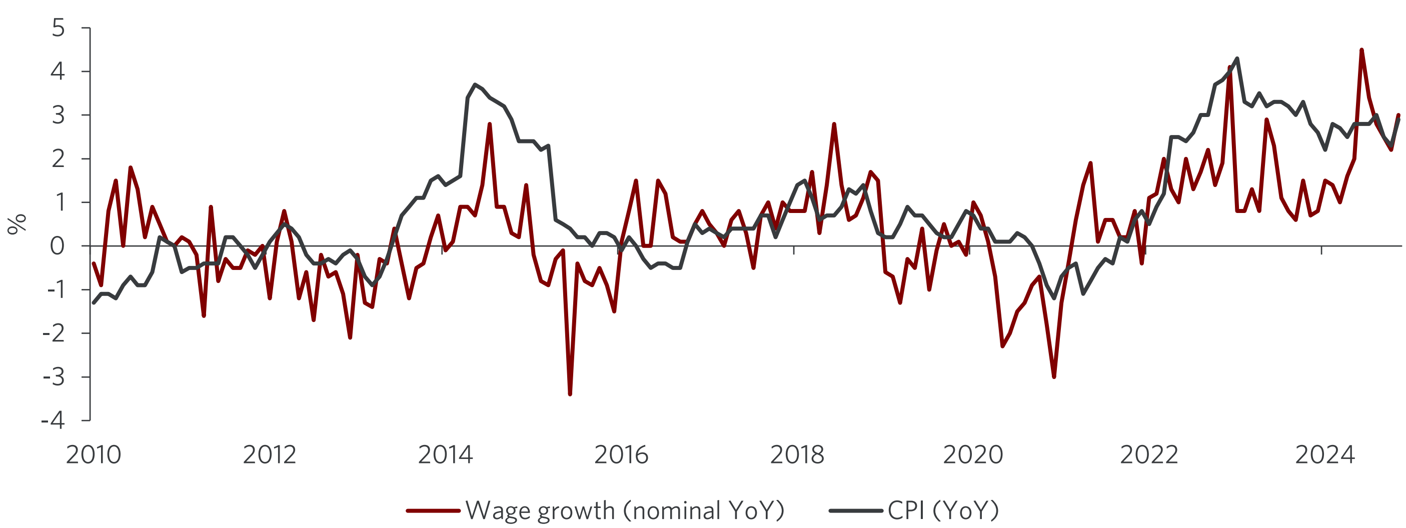
Source: The information was prepared by CIBC Asset Management Inc. using data from the following third-party service provider: Bloomberg. Data as at Dec 30, 2024

Currency weakness has been an important part of the plan

A weaker yen has been a central pillar of efforts to reflate the Japanese economy, thereby playing a key role in driving corporate reform. Since January 2023, the yen has depreciated by about 20% against the US dollar. Currency weakness has contributed to higher inflation. This increases the cost of hoarding cash, which encourages corporate management teams to allocate resources more efficiently and invest in productivity-enhancing measures. Additionally, yen depreciation bolsters export-oriented industries, resulting in higher corporate revenue and earnings. In turn, this facilitates robust and sustainable wage growth—an essential component of the BoJ's envisioned virtuous cycle between wages and prices (Chart 6). As reforms continue to take hold and Japan gradually escapes its decades-old deflationary trap, the reliance on a weaker currency to sustain growth will diminish, paving the way for a more balanced and resilient economy.

Chart 6: Sustained wage growth is critical to maintaining consumer price inflation in line with the BoJ's 2% target

Nominal wage growth vs headline CPI



Source: The information was prepared by CIBC Asset Management Inc. using data from the following third-party service provider: Bloomberg. Data as at Dec 30, 2024

More investor activism

Investor activism has also risen sharply, including by threefold during the first half of 2024 compared to the same period of 2023. Japan is now the second-largest market for shareholder activism after the US. Japanese companies are also taking steps to strengthen board independence and diversity, with nearly 90% of companies now including at least one-third independent directors in 2024, up from 65% in 2020. Furthermore, Japan aims to have women comprise at least 30% of directors at major companies by 2030, which would represent significant progress in inclusivity.

Strategic carrot, not stick

While the TSE's strategy has been akin more to a carrot than a stick, it remains highly strategic in its approach to ensure ongoing progress. Earlier this year, it began publishing a list of companies that have disclosed corporate reform initiatives, effectively leveraging peer pressure—a powerful motivator in Japan—through a "name and shame" approach to boost compliance. Starting in early 2025, the TSE plans to enhance this list by setting specific deadlines for companies considering disclosures and highlighting firms updating their initiatives, further amplifying the pressure to comply.

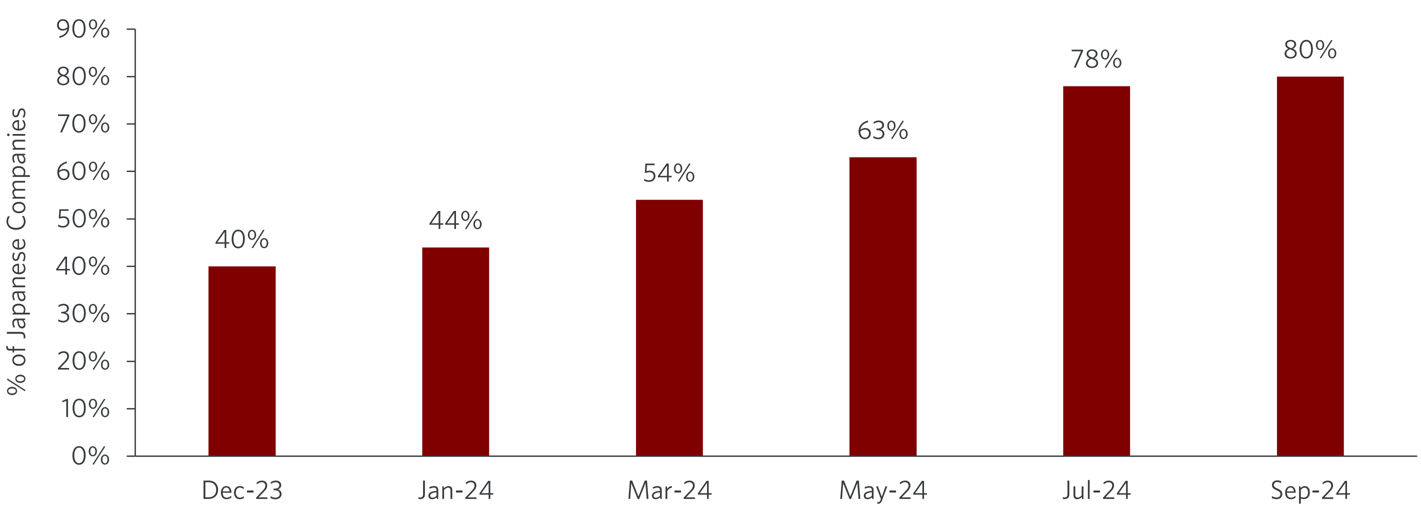
Hiromi Yamaji, President and CEO of the TSE, has emphasized the organization's commitment to improving corporate governance. He envisions going beyond stock buybacks and dividends to embrace more substantive, lasting changes, such as improving communication with shareholders and instilling a management mindset which is constantly conscious of the cost of capital and its impact on profitability and corporate value.

Good early progress, with more expected

While there is room for further progress, results so far appear promising. The number of companies disclosing initiatives continues to climb (Chart 7), firms trading below book value has declined by 5% since early 2023, and the equity market has returned 56%, outperforming most country indexes other than the US, and reaching a new all-time high in 2024. That said, Japanese equity indexes are still no better than flat over 35 years, suggesting that the rally is only getting started. This contrasts with other markets—including the S&P 500 and SPX/TSX— that have regularly achieved new highs during this period, with P/E expansion a primary driver of performance in the US. If Japanese corporate reform and economic revitalization efforts continue to succeed, a 35-year market peak becomes irrelevant and valuations could rise substantially.

Chart 7: The number of Japanese companies disclosing reform initiatives expected to approach 100% in 2025

Percentage of companies having disclosed corporate reform initiatives



Source: The information was prepared by CIBC Asset Management Inc. using data from the following third-party service providers: Goldman Sachs and JPX. Data as at Dec 30, 2024

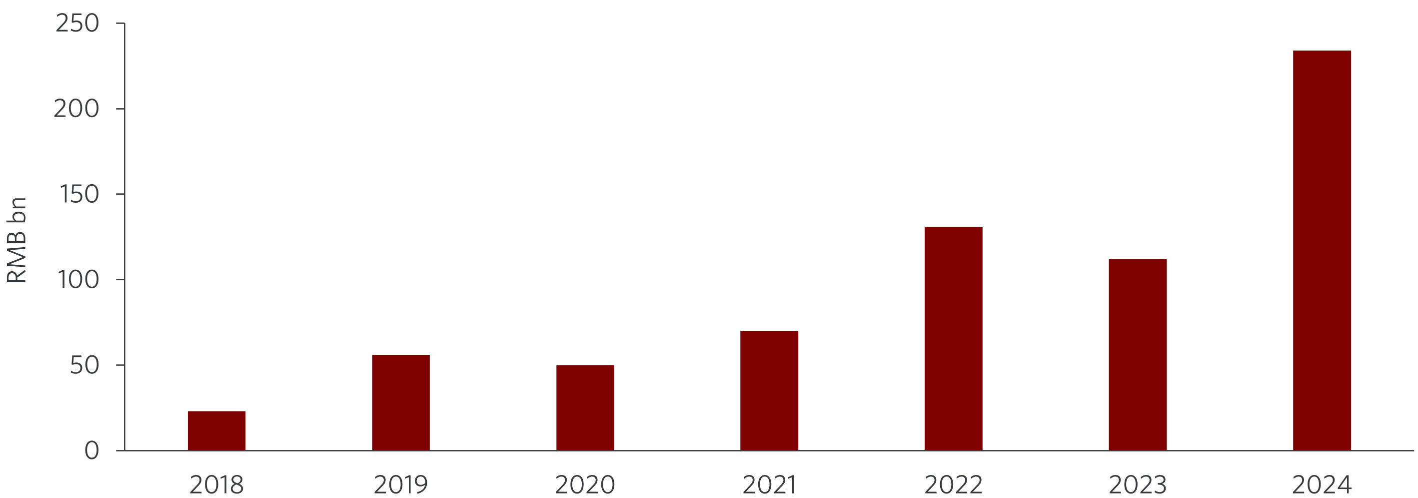
Korea & China take note

Japan's success has not gone unnoticed. In 2024, South Korea and China have announced their own versions of corporate reform. Both equity markets, and particularly Korea, hold significant long-term potential for growth, given their low starting points. South Korea's approach, known as the Value-Up program, is most similar to Japan's effort, and is focused on transforming corporate culture, improving disclosures, and enhancing investor relations. This program specifically targets chaebols, aiming to increase transparency and accountability and to reduce the influence of controlling-family shareholders. Encouragingly, South Korea's reforms have garnered bipartisan support, with opposition leaders recently advocating for the abolition of the financial investment income tax—a key measure to reduce tax burdens for chaebol shareholders, who are often resistant to reforms due to the tax implications of rising stock valuations.

China's approach centers more on investor protection and shareholder value than on governance features like board independence or shareholder activism. Though China is in the early stages of reform, these initiatives, like those of Japan and South Korea, are backed by senior government officials, reflecting alignment with broader economic restructuring goals. Key policy measures include strengthening market oversight, raising IPO standards, implementing clear delisting procedures, boosting shareholder returns through dividends and buybacks, and increasing investor protections by curbing fraudulent practices. Additionally, authorities aim to expand institutional equity ownership. With institutional investors' preference for stable, predictable cash flows and returns, there is a concerted push to further increase dividends and buybacks by Chinese companies (Chart 8)[1].

Chart 8: Chinese A-share market buybacks hit record high in 2024

Buybacks for Chinese A-share market (bn of RMB)



Source: The information was prepared by CIBC Asset Management Inc. using data from the following third-party service provider: Financial Times and Wind. Data as at Dec 30, 2024

Conclusion

Japan's economy and equity markets are undergoing profound changes. Policymakers are working concertedly to end Japan's prolonged economic stagnation. This has contributed to equity markets reaching multi-decade highs in 2024. Central to this effort is corporate reform, which is refocusing companies on sustained profitability, improving return on equity, and increasing shareholder value. As businesses move away from a domestic outlook dominated by stagnant wages and deflation, this shift has the potential to create a positive cycle of wage growth, price increases, and consumer spending, providing renewed momentum for the broader economy and revived animal spirits, and for higher equity returns. A constructive view of Japanese corporate reform underpins our relatively positive outlook for the Japanese equity market. Corporate reform's influence will also spread further in Asia, notably South Korea and China, and likely beyond.

About the author

Vasilios serves as an Associate Portfolio Manager and Investment Strategist within the Multi-Asset & Currency group at CIBC Asset Management. His primary responsibilities include Tactical Asset Allocation across asset classes, and providing strategic investment direction for global financial markets. Additionally, he conducts in-depth research on key market themes, identifying emerging trends and assessing portfolio implications.

Vasilios Tsimiklis, CFA, M.Sc.
Associate Portfolio Manager & Investment Strategist,
Multi-Asset and Currency Management

About CIBC Asset Management

At CIBC Asset Management, we believe every customized investment solution begins with research and rigour. We specialize in a variety of investment solutions such as equities, fixed income, currency management, liability-driven investments, asset allocation and responsible investments.

Across a spectrum of investment solutions, we commit to robust research. Dedicated sector and regional analysts focus on industry research and security-specific idea generation. Our investment professionals leverage deep and diverse expertise by sharing proprietary research across asset class teams. By sharing insights across asset class teams, we maximize opportunities to add value to our client portfolios.

Contact us anytime

To learn more about CIBC Asset Management and our investment solutions, please contact your advisor or your CIBC representative. For more insights, connect with us on LinkedIn.

[1] A key challenge to successful corporate reform in China is a risk of persistent 'Japanifaction', whereby the end of a property sector bubble, in the context of multiple macro headwinds, and in the absence of sustained proactive policy actions, ushers in a period of prolonged deflation and weak GDP growth.

01/25