TRANSFORMING TEIKOKU

Asset Value Investors

AVI

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London SW1Y 6AL

Introduction to AVI

Specialised international equity boutique

- founded in London in 1985
- Long-term shareholder

Experience in Japan

- investing in Japan for over two decades
- ¥55bn invested in Japanese companies
- Public campaign www.improvingtbs.com conducted in 2018, drawing considerable attention to TBS's "strategic shareholdings"

Strategies	Approach	Current AUM
AVI Japan Opportunities Trust ('AJOT')	invests in cash-rich small-cap Japan listed companies	¥21bn
AVI Global Opportunities Trust ('AGT')	invests in family-backed holding companies, closed-end funds and Japanese cash-rich companies. 26% of the fund is allocated to Japan	¥150bn

Source: AVI as at 31/12/2019. Global and Japan AUM figures incl. gearing.

THE PROBLEM

(TEIKOKU SEN-I TSE:3302)

Summary – The Problem

- **Teikoku is a high-quality business, providing essential disaster prevention equipment through an impressive distribution network**
- **Its share price and corporate value are being suppressed by an inefficient balance sheet, with 70% of assets held in low-returning cash and investment securities**
- **Hulic, a real estate business completely unrelated to Teikoku's core business, alone accounts for over 30% of Teikoku's total assets**
- **This situation has been allowed to persist by the implicit support of Teikoku's "group shareholders"**
- **A balance sheet heavily loaded with low yielding cash and "strategic securities" hurts Teikoku's shareholders by dragging down ROE and creating a "sum of the parts" discount in which non-core assets are valued by the market at a discount to their real value**
- **Teikoku's overly large balance sheet, along with other Japanese companies with a similar problem, is damaging Japan and its economy. Coupled with weak shareholder oversight, this is a contributing factor to why Japanese companies trade at severely lower valuations compared to other global developed markets like North America and Europe**

Source: AVI and Capital IQ as at 30/09/2019

Engagement History with Teikoku

- AVI, on behalf of its clients, owns 5.2%[1] of Teikoku's outstanding shares
- We have been shareholders since March 2018
- From the beginning we have sought to work constructively with Teikoku
- Open discussions with Teikoku's directors and management

Meeting 1	June 2018
Letter 1	July 2018
Meeting 2	November 2018
Letter 2	January 2019
Meeting 3	February 2019

Meeting 4	May 2019
Letter 3	November 2019
Meeting 5	November 2019
Letter 4 (Available Publicly)	January 2020

[1]AVI as at 31/12/2019.

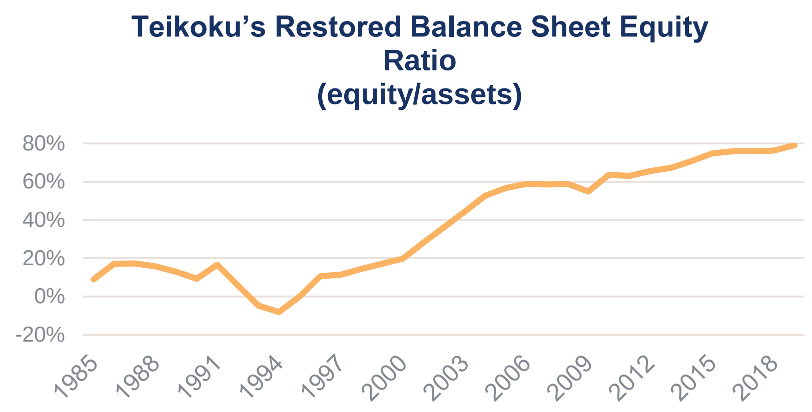
Teikoku's Business Overview

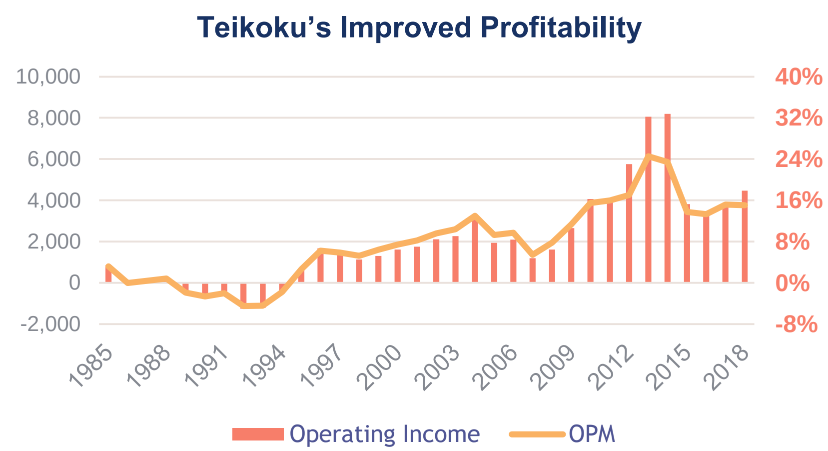
- The market leader and experienced manufacturer of fire hoses in Japan – 45%[1] market share
- Building on this strong base, Teikoku has developed a diverse and high-quality product mix

[1]Estimated value from IR meeting

Impressive Track Record

- In the early 1990s as the Japanese textile industry declined, Teikoku found itself in a precarious financial position
- Chairman Iida and President Shiraiwa, who both joined the board at this time, oversaw the large restructuring of the company's management and a change in strategy towards disaster prevention equipment
- The company improved its profitability while also restoring its balance sheet back to health
- The company has ever since been financially stable and highly profitable





Source: AVI, Capital IQ

Teikoku is a High-Quality Business

- **Market demand is robust: Japan is especially vulnerable to natural disaster. Safeguarding against and recovery from them will continue be a high priority for the Japanese government**

- **In the last few years alone the government allocated trillions of yen to disaster**

> ***"The Government will continue to take all possible measures related to disaster management to protect the lives, property, and lifestyles of the Japanese people in preparation for a range of disasters"***
>
> Shinzo Abe, 01/09/2019 (Disaster Prevention Day)

- **Quality products, strong distribution network and high margins**

- **Low CAPEX requirements and high margins underpin a business that, with a more efficient balance sheet, could generate an ROE in excess of 20%**

Value Destructive Balance Sheet

- Quality business is hidden under a mountain of non-core assets
- 70% of balance sheet assets are allocated to low returning net cash and investment securities
- These have a return on equity to Teikoku of less than 1%

Teikoku's Asset Breakdown (¥m)

Non-core assets, account for <u>**70%**</u> of assets

Asset light business model

Source: AVI and Capital IQ as at 30/09/2019

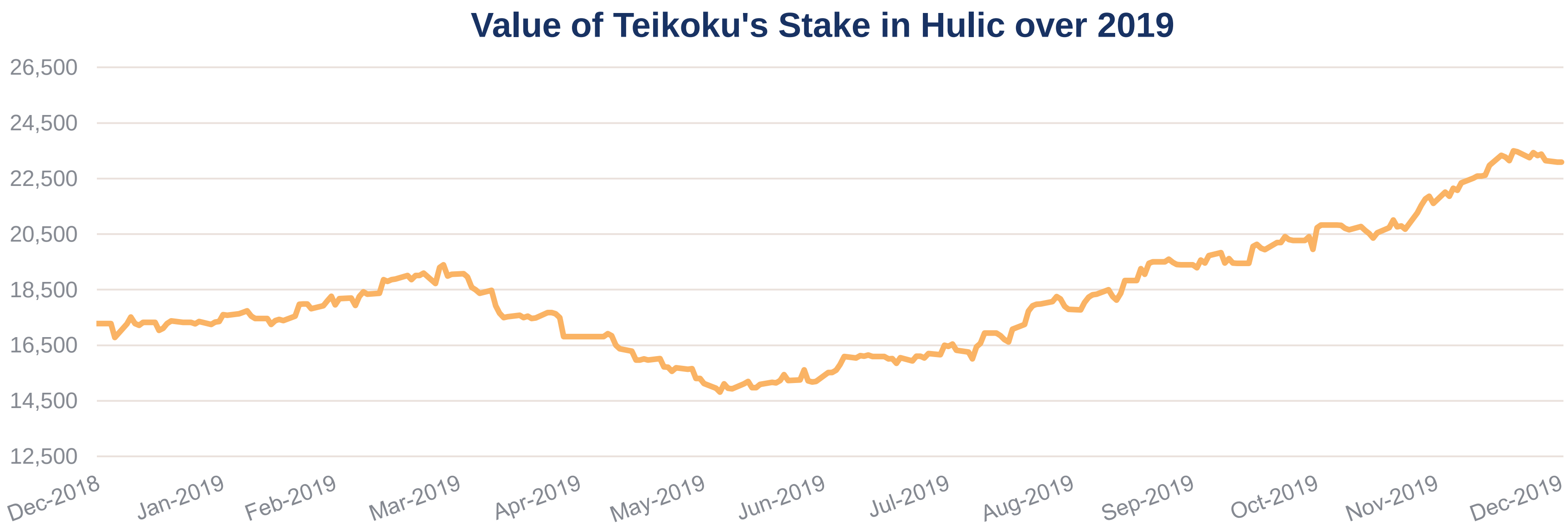
Caused by the Senseless Accumulation of Cash…

- Teikoku has a strong and profitable business which coupled with low capital expenditure means it generates an abundance of free cash flow[1]
- Companies can allocate free cash flow in four ways, doing nothing is the least productive and destroys potential corporate value
- Over the past five years Teikoku has generated ¥15bn in free cash flow, of which only 40% has been allocated to grow corporate value, the rest sits idly on the balance sheet

Source: AVI, Capital IQ, [1]Free cash flow = net income + non-cash expenses – changes in working capital – capital expenditure

…and an Unjustifiably Large Stake in Hulic

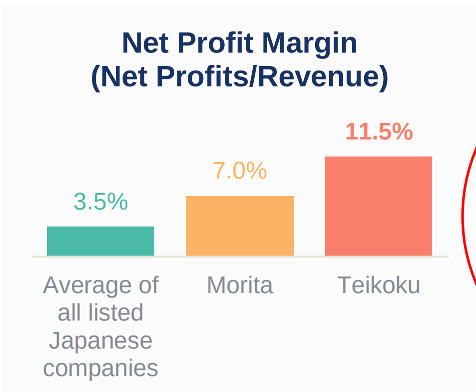
- Teikoku has given no quantitative justification for its ¥23bn investment in Hulic
- It has blindly allowed its stake in Hulic to grow in value such that it now accounts for over 30% of total assets
- Principle 1.4 of the Corporate Governance Code states that "when companies hold shares of other listed companies as cross-shareholdings, they should disclose their policy with respect to doing so, including their policies regarding the reduction of cross-shareholdings" (emphasis added)

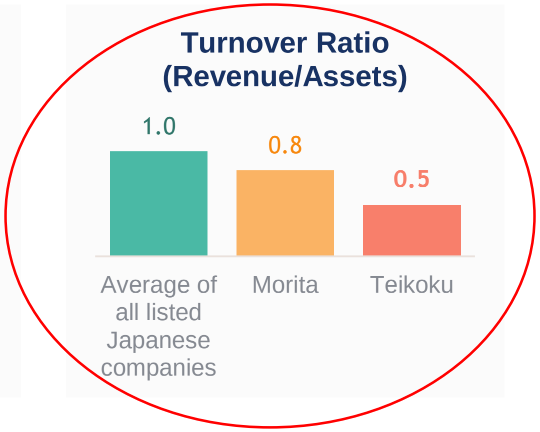


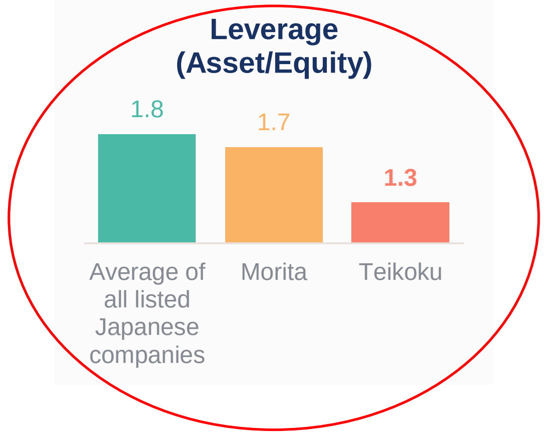
Source: Capital IQ as at 31/12/2019

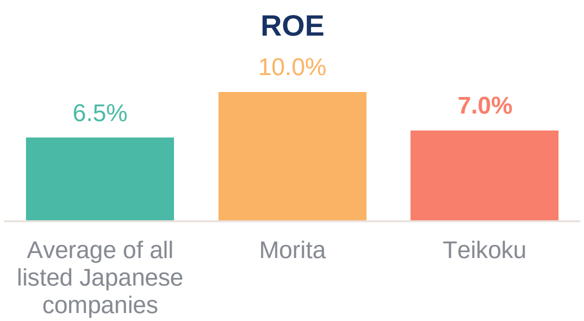
Teikoku's Low ROE Due to Weak Capital Efficiency

- Teikoku's net profit margin is far higher than both the average Japanese company and closest peer, Morita, which has a similar product mix to Teikoku
- But Teikoku's ROE is barely above the average and below Morita's





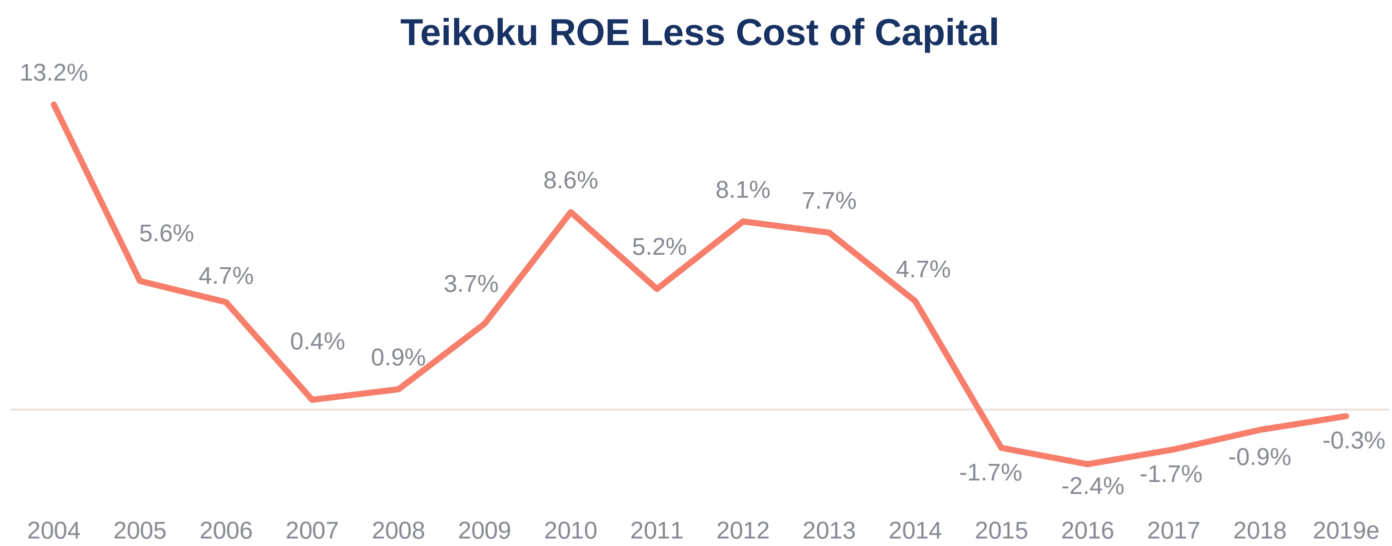




Source: AVI and Capital IQ as at 31/12/2019, Teikoku data for FY2018

Teikoku's ROE Below Cost of Capital

- Teikoku seems to underappreciate the importance of cost of capital
- Teikoku's estimated 2019 ROE of 7.6% is below our estimated 7.8% cost of capital[1] and below the minimum 8.0% recommended in the Ito review

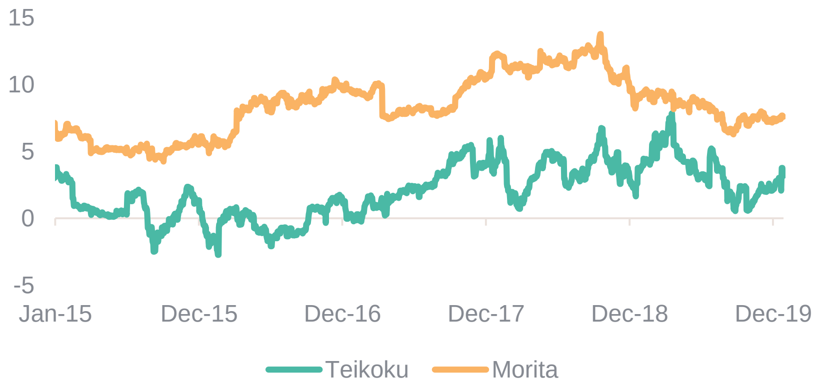


Source: [1]AVI cost of capital calculation in Appendix I.

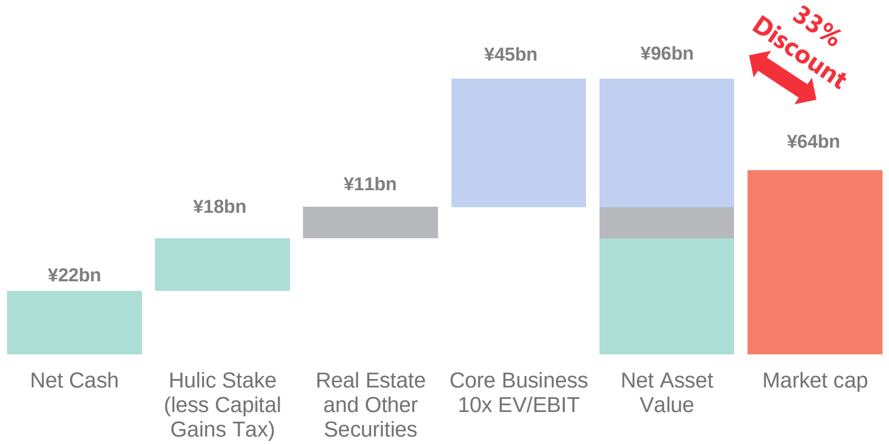
An Inefficient Structure for Shareholders Destroys Corporate Value

- Non-core assets trapped in Teikoku are valued by the market at a discount to their real value
- Teikoku's 2.6% in Hulic accounts for 25% of Teikoku's market cap (after capital gains tax), and cash accounts for 34% of Teikoku's market cap, resulting in a very low implied valuation for Teikoku's high-quality business
- Inefficient structure depresses Teikoku's valuation and creates a "sum of the parts discounts"

Underwhelming Valuations Teikoku's EV/EBIT



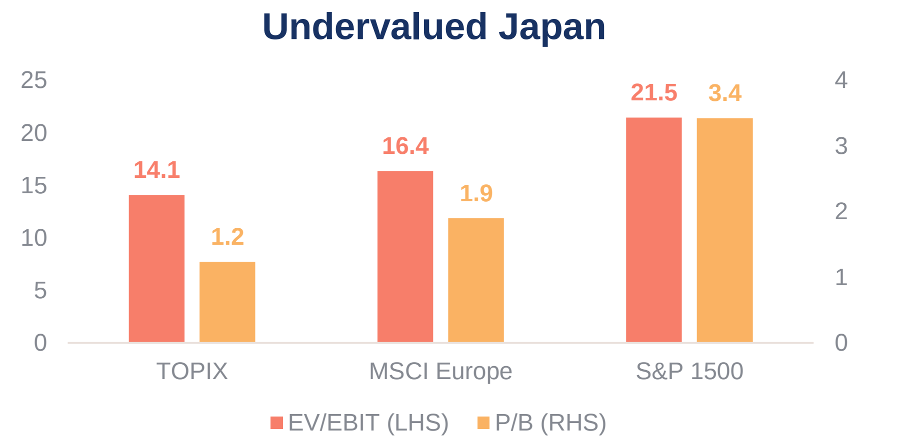
Sum of the Parts Discount at Current ROE

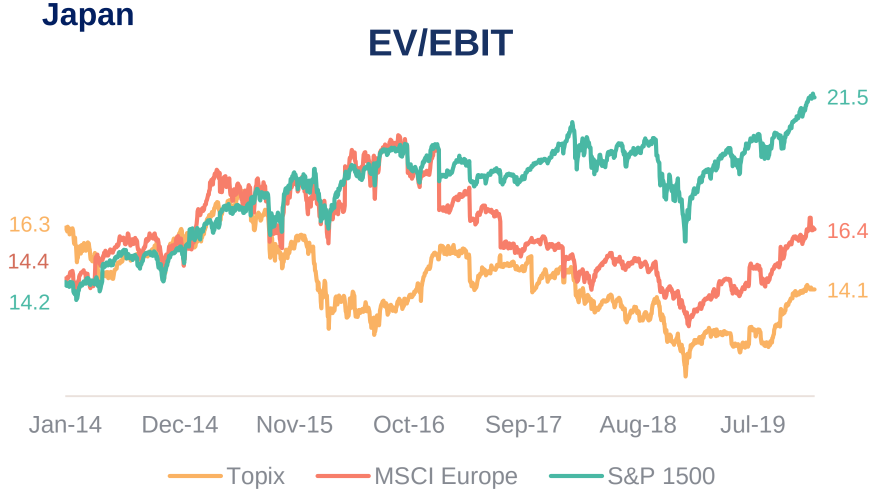


Source: AVI and Capital IQ as at 31/12/2019

Japan Trades at Discount to Global Markets

- Japanese companies are undervalued relative to other global indices
- Teikoku's unhealthy balance sheet and blind support from "group shareholders" is a symptom across corporate Japan
- It is the reason that Japan's stock market is undervalued relative other developed global indices
- Over the past five years, while valuations have been increasing in the US and Europe, they have fallen in Japan





Source: Bloomberg as at 31/12/2019

THE SOLUTION

The Solution

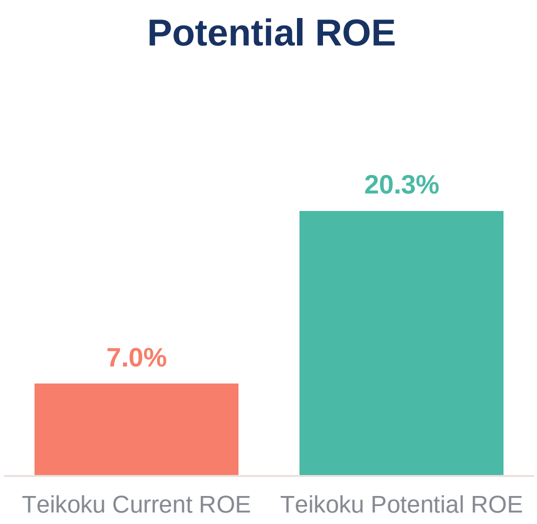
- **Status quo of low pay-out ratios and excessive accumulation of cash is not an adequate strategy**
- **Obvious way to reverse value destruction is to sell down/distribute stake in Hulic and return cash to shareholders**

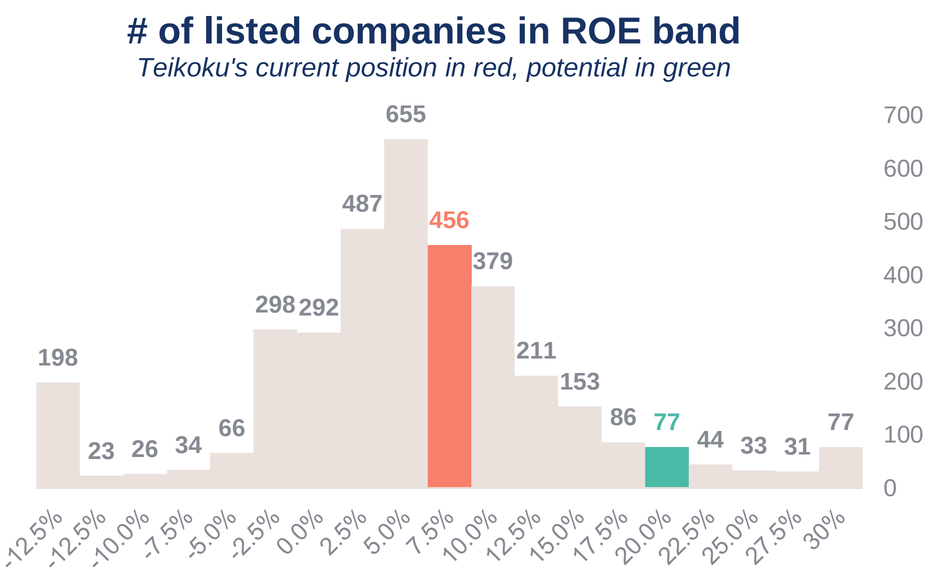
Current Stance
✗ Unjustifiably large allocation to Hulic
✗ 70% of balance sheet assets in net cash and investment securities
✗ Static return to shareholders
✗ No capital policy

Solution
✓ Sell or distribute stake in Hulic
✓ Increase the payout ratio to prevent the continued build up of cash and conduct a buyback to reduce existing cash
✓ Flexible shareholder return policy dependent on business performance
✓ Teikoku should disclose a detailed capital allocation strategy, considering its cost of capital and improving ROE

Teikoku Could Achieve a Much Higher ROE

- **Underneath Teikoku's inefficient balance sheet hides a phenomenally high-quality business**
- **Due to its capital light model, Teikoku could achieve a substantially higher ROE**
- **Matching the capital efficiency* of the average Japanese company, Teikoku could generate a ROE of 20+%**
- **20% ROE would put Teikoku in the 90th percentile of companies in Japan, compared to the current unremarkable 55th percentile**
- **If conducted through a buyback, Teikoku's share price could increase by +120%[1]**





*1x Revenue/Assets [1]Calculation in Appendix III,

THE OBSTACLE:

“GROUP SHAREHOLDERS”

Previous Shareholder Proposals

- Over the past two years, Sparx submitted proposals to Teikoku similar to those AVI is submitting this year
- These drew attention to Teikoku's inefficient balance sheet, its growing cash pile, and its stake in Hulic
- Despite being in shareholders' best interests, the proposals failed to receive sufficient support

2018 Shareholder Proposals

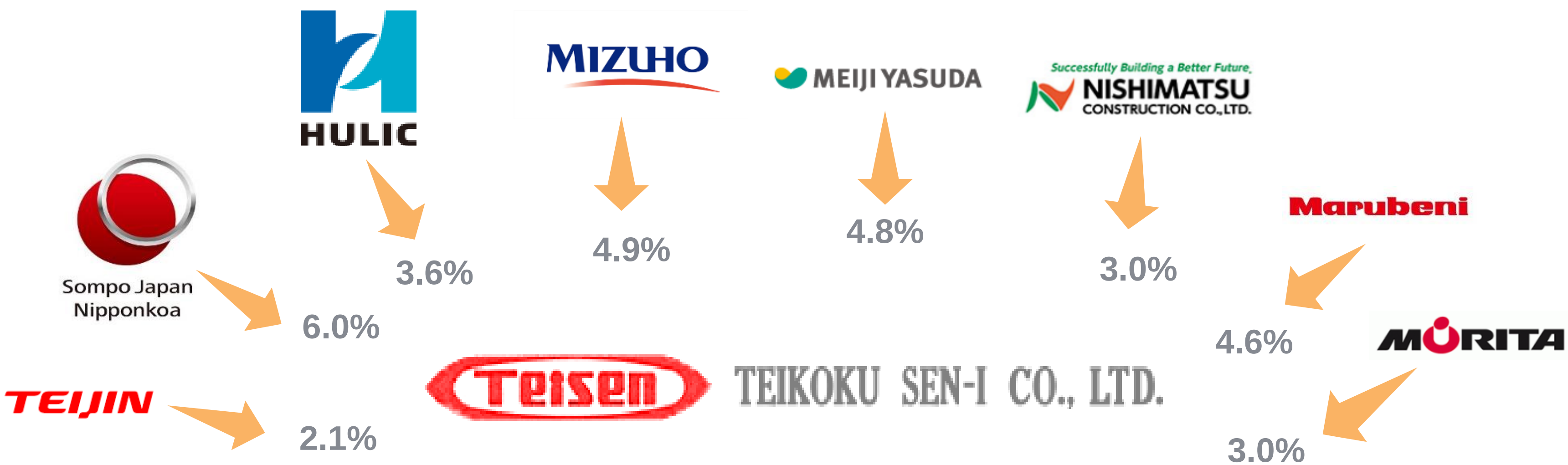
	Support
Approve alternative allocation of income, with a final dividend of JPY 90	20.3%
Amend Articles to Reduce Directors' Term	28.4%

2019 Shareholder Proposals

	Support
Approve alternative allocation of income, with a final dividend of JPY 95	22.9%
Amend Articles to Reduce Directors' Term	n/a Teikoku reduced the Directors' Term
Appoint Shareholder Director Nominee Natori, Katsuya	20.0%

Blocked by Teikoku's Group Shareholders

- "Group Shareholders" vote with management based on historic business ties, even though doing so supports corporate value destruction
- They blocked Sparx's proposals and implicitly supported continued corporate value destruction
- Core members of Teikoku's "Group Shareholders" are well-known companies that pay lip service to corporate governance but whose voting is inconsistent with accepted principles of good governance.



Total Group Shareholders = 32%

As at 30/06/2019, Teikoku's 2019 Securities Report

Supported by Institutional Shareholders

- Both domestic and foreign shareholders supported proposals for a higher dividend last year
- These institutions voted rationally in the best interests of all shareholders

Teikoku Group Shareholders

IT IS TIME FOR TEIKOKU'S "GROUP SHAREHOLDERS" TO STOP VOTING PASSIVELY WITH MANAGEMENT, AND TO VOTE IN THE INTERESTS OF ALL SHAREHOLDERS AND BEST GOVERNANCE PRACTICES

Source: AVI

OUR SHAREHOLDER PROPOSALS

Shareholder Proposals

- **Our proposals are intentionally modest**
- **Proposals are intended to be a first step toward much-needed balance sheet reform that Teikoku's shareholders can accept in the short-term**
- **If Teikoku's "Group Shareholders" will acknowledge the need to reform Teikoku's balance sheet in the interests of all shareholders, AVI is confident that the proposals will receive majority support**

(1) Increase dividend amount to limit future cash build up

- Propose a ¥76 dividend for a 50% payout ratio, instead of management's forecasted ¥40 and 26% payout

(2) Introduce a modest buyback to reduce the current cash burden

- Propose a buyback of ¥2bn, amounting to 3% of outstanding shares, which can be funded by a sale of just 10% of Teikoku's stake in Hulic

We Welcome Further Input

- We invite all stakeholders or interested parties to get in touch at info@transformingteikoku.com
- Visit our dedicated website www.TransformingTeikoku.com for further information

APPENDIX

Appendix I – Teikoku's Cost of Capital

- **Misunderstanding by some companies surrounding the cost of equity (CoE):**

  Dr Ryohei Yanagai, Ito Review member, commented that old-guard CEOs *"understand the cost of debt. But the cost of equity is invisible,"* as they don't have to pay cash to service it.

- **Teikoku has little debt, so its cost of capital is entirely from equity**
- **Teikoku's cost of equity can be calculated a number of ways. We use a blended average of three methodologies resulting in a cost of capital of 7.6%**

Capital Asset Pricing Model (CAPM)

8.6%

$$CoE = RFR^{1} + Beta * (EMR - RFR)$$

Risk Free Rate (RFR)	-0.0%
Beta	1.2
Expected Market Return (EMR)	7.4%[1]

Market Implied Expected Return

7.8%

$$CoE = \frac{\text{TOPIX Earnings}}{\text{TOPIX Price}} + \text{Growth Rate}$$

TOPIX Earnings	118
TOPIX Price	1,744
Market Profit Growth Rate	1.0%

Market Implied From PBR

6.4%

$$CoE = \frac{ROE - \text{Growth Rate}}{PBR} + \text{Growth Rate}$$

PBR	1.2x
ROE	7.0%
Teikoku Profit Growth Rate	3.0%

Source: Capital IQ, Bloomberg, AVI estimates as of 20/01/2020

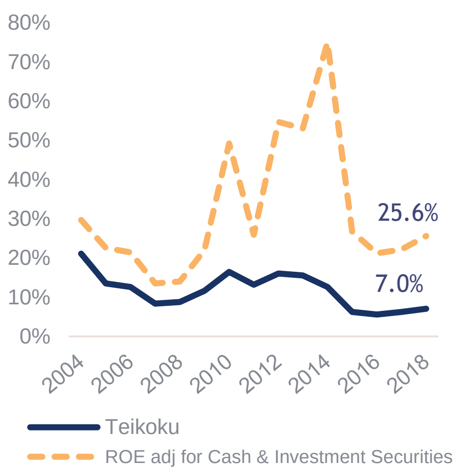
[1]Average of 10, 5 and 3 year TOPIX total return

Appendix II – Teikoku's ROE

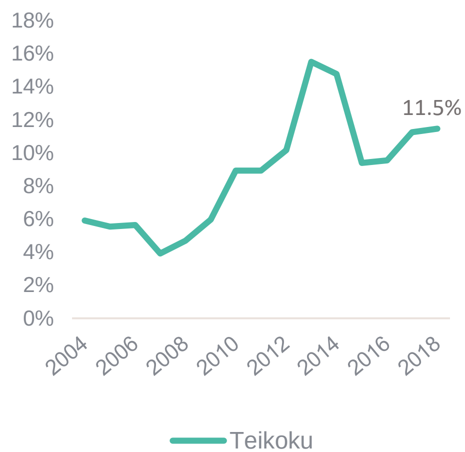
- **ROE is as much related to balance sheet efficiency ('E') as it is profits ('R')**
- **While Teikoku has been successful on the profit side it has failed to consider how equity can impact corporate value**
- **For illustrative purposes we have shown how Teikoku's ROE would have trended if it operated with zero net cash and with no investment securities**

ROE = Net Income/Sales x Sales/Asset x Assets/Equity

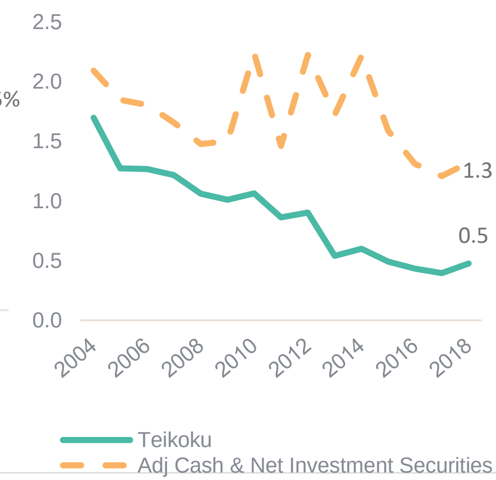
ROE



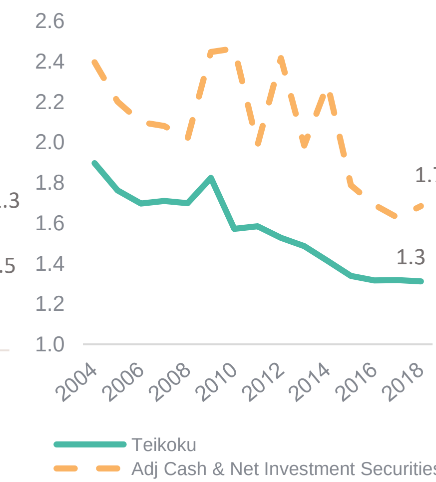
Net Profit Margin



Asset Turnover



Leverage



Source: Capital IQ and AVI

Appendix III – Share Price Upside on Higher ROE

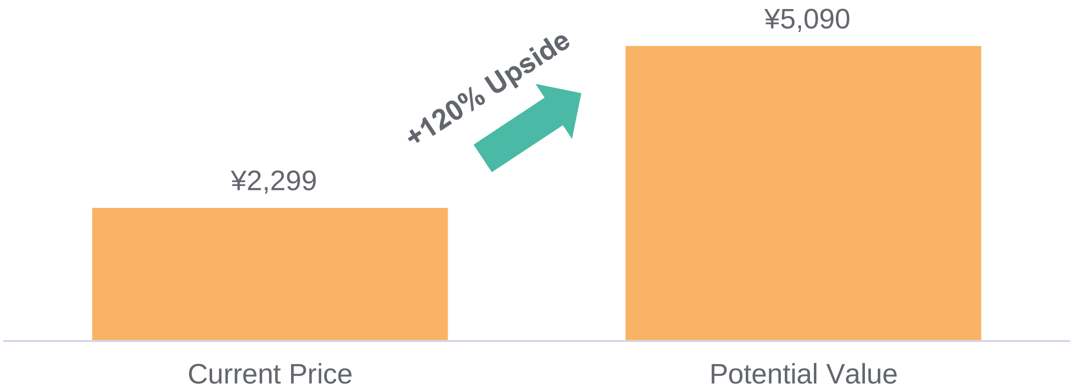
- If Teikoku reduced the excess capital on its balance sheet through a buyback it could dramatically increase its corporate value
- Buying back ¥34bn worth of shares (54% of outstanding), at prevailing share prices, would result in an ROE of 20.3% and +120% upside
- Buyback would result in an revenue/assets of 1.0x – in line with the average listed Japanese company

$$\textit{Corporate Value Per Share} = \textit{Book Value Per Share} * \frac{\textit{ROE} - \textit{Growth Rate}}{\textit{Cost of Equity} - \textit{Growth Rate}}$$

Potential

$$\text{Corporate Value Per Share} = ¥5{,}090 = ¥1{,}343 * \frac{20.3\% - 3.0\%}{7.6\% - 3.0\%}$$

Potential Value Upside From Improved ROE



Source: Capital IQ and AVI, as of 17/01/2020