Asset Value Investors

A NEW DAWN FOR CORPORATE JAPAN

Embracing Reform & Growth

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A New Dawn for Corporate Japan: Embracing Reform & Growth

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Contents

Introduction

Japan's small to mid-cap stock market offers a fertile hunting ground for untapped opportunities, as regulatory reform and changing corporate attitudes combine to provide a rare environment for constructive engagement. The increasing prevalence of shareholder activism in Japan, coupled with regulatory tailwinds, presents abundant potential in the under-researched and inefficient small-cap market. Our conviction in Japan remains steadfast, with a supportive macroeconomic backdrop providing impetus for companies to prioritise shareholders and change business practices. This article provides a brief overview of recent regulatory reform, highlights the relative undervaluation of Japan despite strong earnings, details several key tailwinds for constructive engagement, and outlines why small-cap, cash- rich companies provide the best exposure to the Japan opportunity.

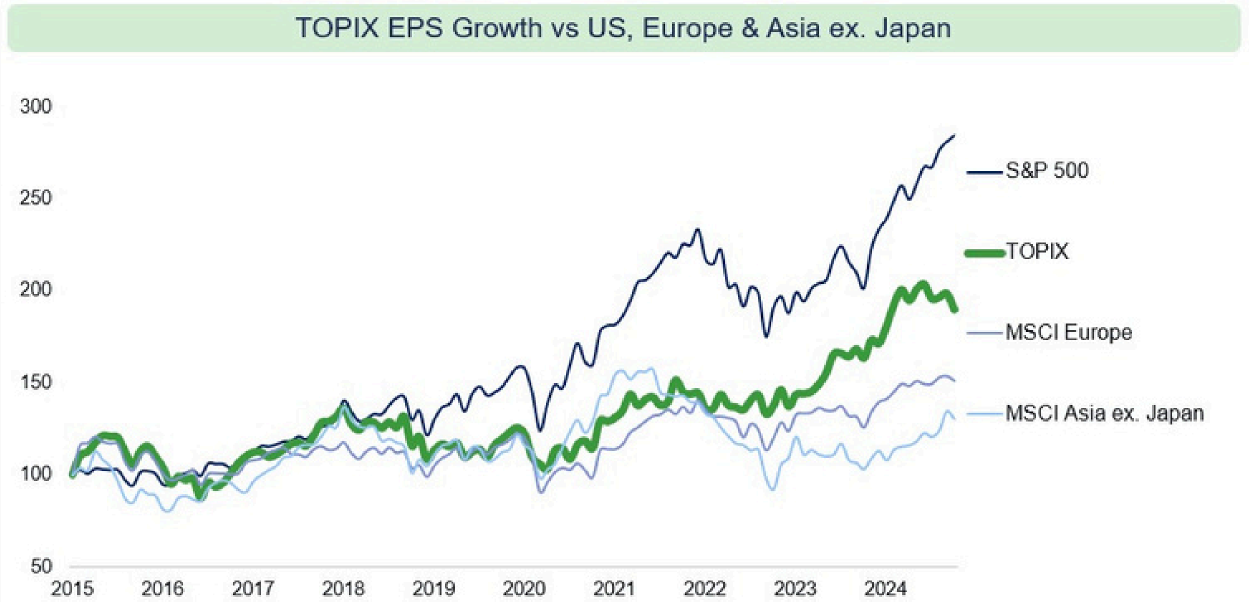
Recent Governance Reform

In the years following the 1990's bust, management of Japanese companies prioritised high employee retention and the perceived safety of cash accumulation, in the absence of growth and shareholder returns. This changed with the introduction of Abenomics in 2012, which ushered in an era of structural reforms, shareholder engagement and a focus on improving corporate value. Importantly, an implicit message was given to corporate management that the Government would no longer save ailing zombie companies, and that instead, they were being given the tools to save themselves. Reinforced by the subsequent Stewardship and Corporate Governance Codes and various interventions since, the environment towards shareholders has transformed. The chart below summarises the various market reform events that have occurred, alongside the TOPIX index, which has risen +270% since the end of 2011.

Source: AVI as at 31/10/2024. **Note: 1**Topix indexed total return since 31/12/2011.

Earnings in Japan Outpacing Valuation

Governance reforms are leading to higher earnings. Helped by deleveraging, lower corporation tax and business restructuring, Japanese company earnings have grown at a compound rate of 7% since 2015, a rate only exceeded by companies in the US.



Source: Bloomberg (as at 31/10/2024).

Yet, while Japan has generated strong earnings growth, it has suffered from declining valuations. Now trading at a discount to the S&P 500, MSCI Europe and MSCI Asia ex Japan, the MSCI Japan Index's EV/EBIT has declined from 17x at the start of 2015 to 11x at the end of October 2024. Despite being one of the best performing global equity markets, Japan is also one of the cheapest.

Source: Bloomberg (as at 31/10/2024).

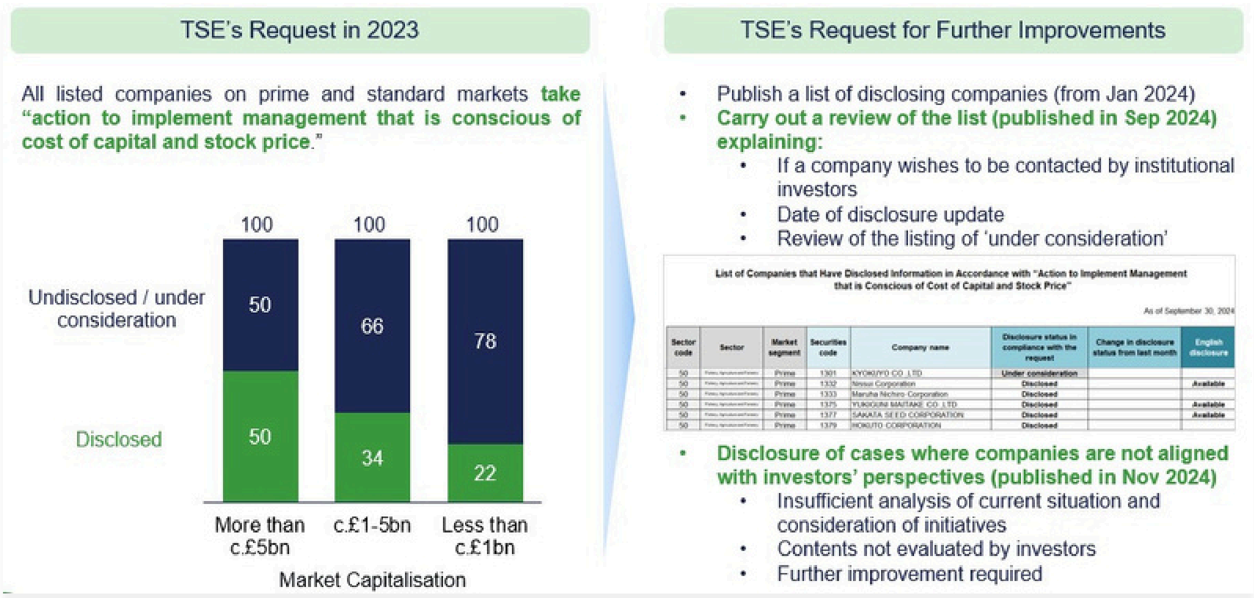
Tailwinds for Shareholder Constructive Engagement

The market environment in Japan is more attractive and supportive of a constructive engagement strategy than ever before, with several key tailwinds:

1) further pressure from the TSE requesting improved disclosure around capital efficiency;
2) unwinding of cross-shareholdings;
3) increasing shareholder activism impact;
4) private equity firms targeting the Japanese market with dry powder;
5) and the Japanese government encouraging unsolicited acquisition offers.

1) Pressure from TSE – Capital Efficiency Disclosure

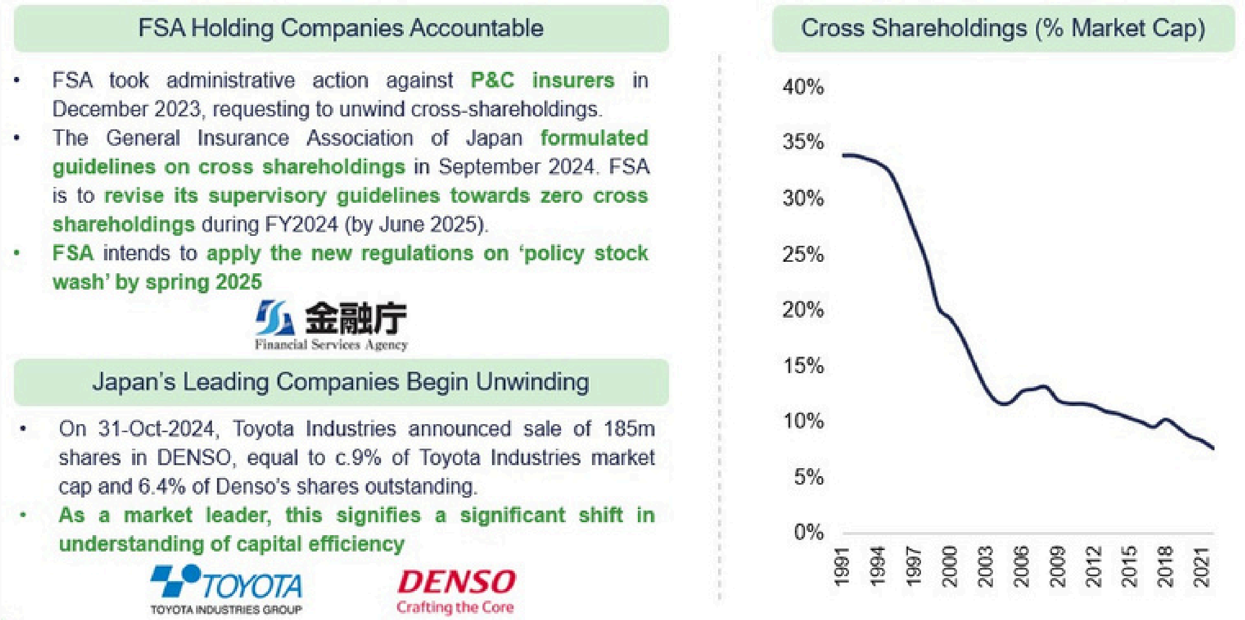
In 2023, the TSE requested all listed companies on the Prime and Standard markets take "action to implement management that is conscious of cost of capital and stock price." Following on from this, in 2024 the TSE began publishing a monthly list highlighting companies without or with inadequate disclosures of plans for improvement, as well as companies that are willing to speak to investors and have English disclosures available. As of 30 September 2024, the list provided an evaluation of 2,170 companies.



Source: AVI, TSE, Bloomberg, Dai-ichi Life Research Institute (as at 31/12/2024).

2) Unwinding of Cross-Shareholdings

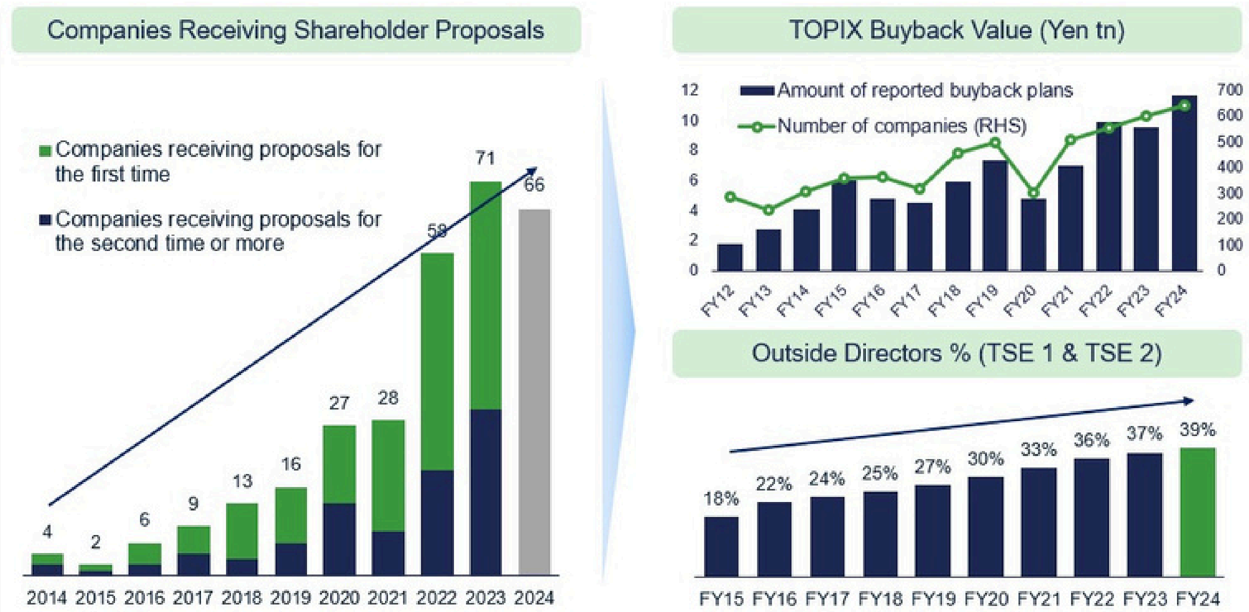
Since 2015, cross-shareholdings have fallen by -47%. Cross-shareholdings serve to reduce management accountability and shelter management from shareholders – the unwinding of these serves as a strong tailwind for supporting engagement from minority shareholders. The Financial Services Agency of Japan (FSA) is adding pressure for companies to unwind cross-shareholdings, and even traditional companies like the Megabanks, KDDI, Kyocera and Toyota Industries (details below) are responding.



Source: AVI, Capital IQ (as at 31/12/2024) **Note:** 1Includes Tokio Marine & Nichido Fire Insurance, Sompo Japan Insurance, Mitsui Sumitomo Insurance, and Aioi Nissay Dowa Insurance.

3) Increasing Shareholder Activism

Shareholder activism is delivering results in Japan, with share buybacks and Director independence both at an all-time high. The number of companies receiving proposals is continuing to rise.

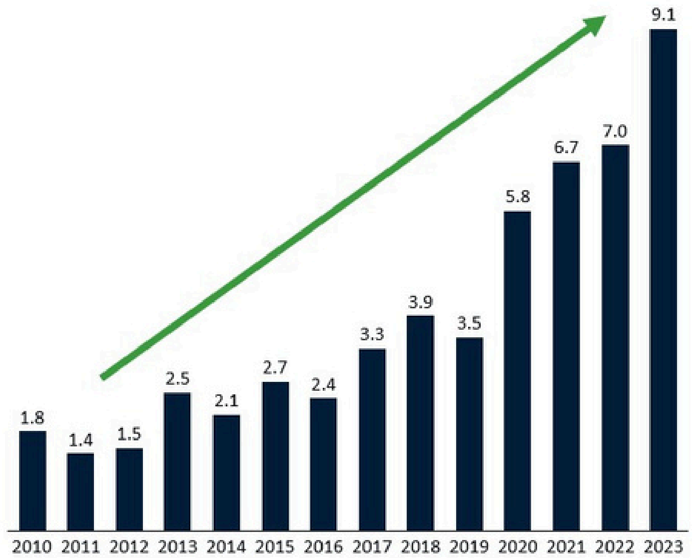


Source: AVI, SMBC, GoToData (as at 31/12/2024). **Note:** 12024 categorised data not yet available. The grey bar represents the total number of companies receiving proposals.

4) Private Equity Dry Powder

Private equity firms are increasingly viewing Japan as a market ripe for deal opportunities, particularly among the small to mid-cap space. Supported by METI guidelines encouraging M&A activity, the value of PE backed deals in Japan reached new heights in 2023, as Japan's share of deal activity in the Asia-Pacific region grew substantially.

Amount of dry powder held by PE funds with interest in Japan
Unit: JPY in trillion



Global funds' entrance to Japan market

- Carlyle raised USD2.8bn for its fifth Japan buyout fund in May 2024
- KKR looks to spend more than USD6.3bn over the next decade
- An influx of global/domestic funds opening Japan offices over the last decade
  - EQT (2019)
  - Apollo (2018)
  - Blackstone Group (2017)

Source: PWC white paper based on Preqin database (as at 31/12/2024).

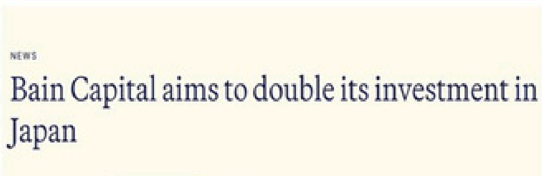
5) Unsolicited Acquisitions

In line with the rising level of PE activity, the government in Japan is also encouraging unsolicited acquisitions. The Ministry of Economy, Trade and Industry (METI) now require management to consider all unsolicited offers, which previously were often dismissed without proper explanation.

BainCapital

Launched Unsolicited Offer for Fuji Soft

- A rare unsolicited acquisition offer marks a significant shift in the PE landscape in Japan
- Binding offer 7% higher than KKR for Y9,450 per share, valuing the software developer at $4bn
- Fuji Soft's Board recommended shareholders to tender shares to KKR's initial offer


NEWS

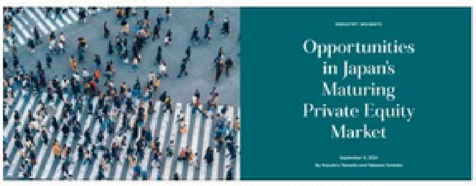
Bain Capital aims to double its investment in Japan

May 2024 Press Release

THE CARLYLE GROUP

Largest Japan-Focused Buyout Fund

- Raised $2.8bn for its fifth Japan buyout fund, its largest investment vehicle for Japan
- 70% larger than previous fund due to backing from domestic and global investors
- Target deal size: Y20bn to Y50bn (£1bn to £2.5bn) is within AVI's investment universe



September 2024 Press Release

Source: AVI, Reuters, Bain Capital, The Carlyle Group (as at 31/12/2024).

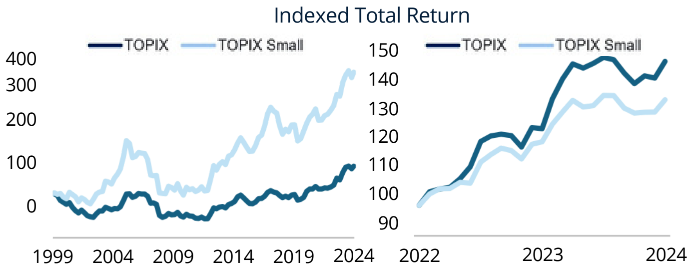
Why active allocation to small-cap, cash-rich companies?

The purest way to gain exposure to the Japan opportunity and the upside of corporate reform is through small-cap companies. While large-cap companies are dominated by global giants, with heavy dependency on exports and overseas demand, small-cap companies predominantly have domestically biased sales, more nimble decision-making, and engagement efforts can have significant impact. There are a plethora of wonderful small companies operating in niche markets with lofty barriers to entry. Being smaller, their marginal growth opportunities are greater, both overseas and domestically as industries consolidate. The returns speak for themselves, since 2002 small-cap companies in Japan have generated an annualised +1.6%1 outperformance relative to their large-cap counterparts. That trend, however, experienced a profound shift over the past two years as dramatic and extended JPY weakness has helped to drive large-cap outperformance, centred around a narrow group of exporters. Within this group, some large-cap industry leaders have also been quick to respond to pressure from the Tokyo Stock Exchange and Global Investors, raising their valuations even further.

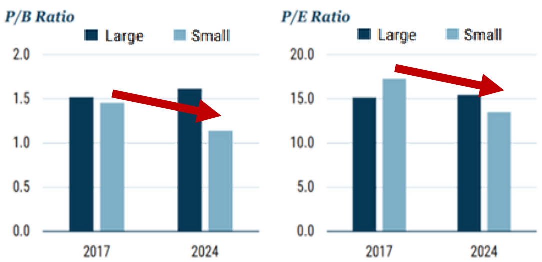
Topix Core 30 vs Topix Small → 24% performance differential from 2023-2025

Yet recently, regulators have turned their attention to **small-mid cap companies**, (FSA, TSE), urging them towards higher valuation multiples and share prices. Japan fund flows driving the stock market "boom" have been dominated by ETF and Futures buying from foreign investors and the BoJ. Now, the central bank has stopped buying ETFs, fundamental stock pickers are returning, and the re-vamped NISA tax incentive program should spur investment from domestic individual investors.

SC Long Term Outperformance, LC Resurgence Last 2y



SC Discount Widened Over Last 7y

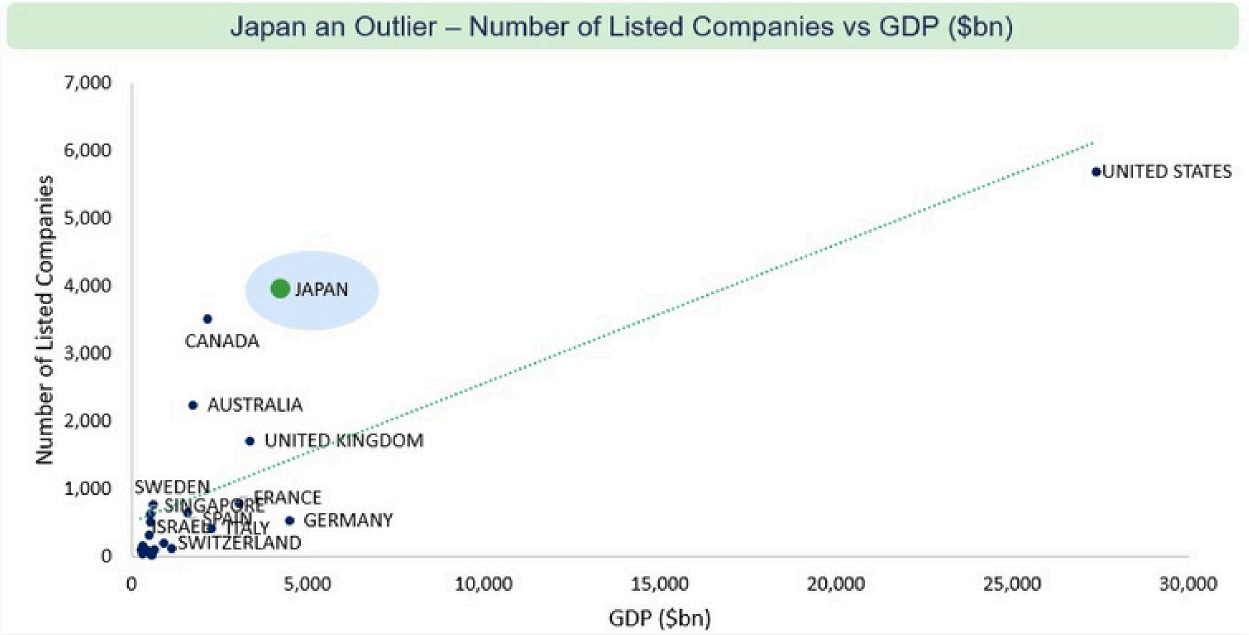


Source: GMO white paper in 2024, Bloomberg, AVI (as at 31/12/2024).

Small-Cap, Cash-Rich Companies Outperform

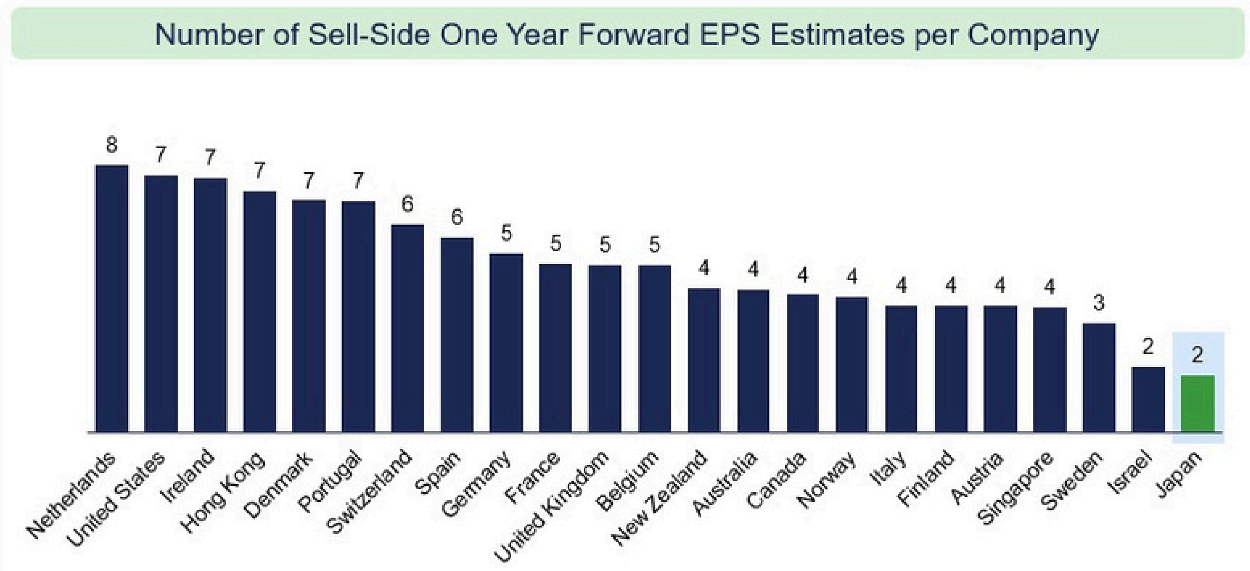
Source: FactSet, Capital IQ (as at 30/09/2024). **Note:** AVI Universe includes companies based in Japan (excl. financials), with low EV/EBIT, substantial net financial value and low earnings volatility. 1Annualised outperformance of TOPIX Small vs TOPIX +1.6% since October 2002, with annualised returns of +8.8% for TOPIX Small and +7.2% for TOPIX (as at 30/09/2024).

Active managers in Japan are spoilt for choice with the number of small cap companies. Excluding Hong Kong, whose stock exchange is home to mainland Chinese companies, only Sweden and Singapore have more companies proportionally to their respective GDP than Japan. If Japan were to have the same ratio of listed companies to GDP as other developed nations, then almost 3,000 of the ~4,000 listed companies would need to be taken over/privatised. The Japanese small-cap market provides almost unparalleled opportunity for consolidation and privatisation, and examples of both events are clearly accelerating.



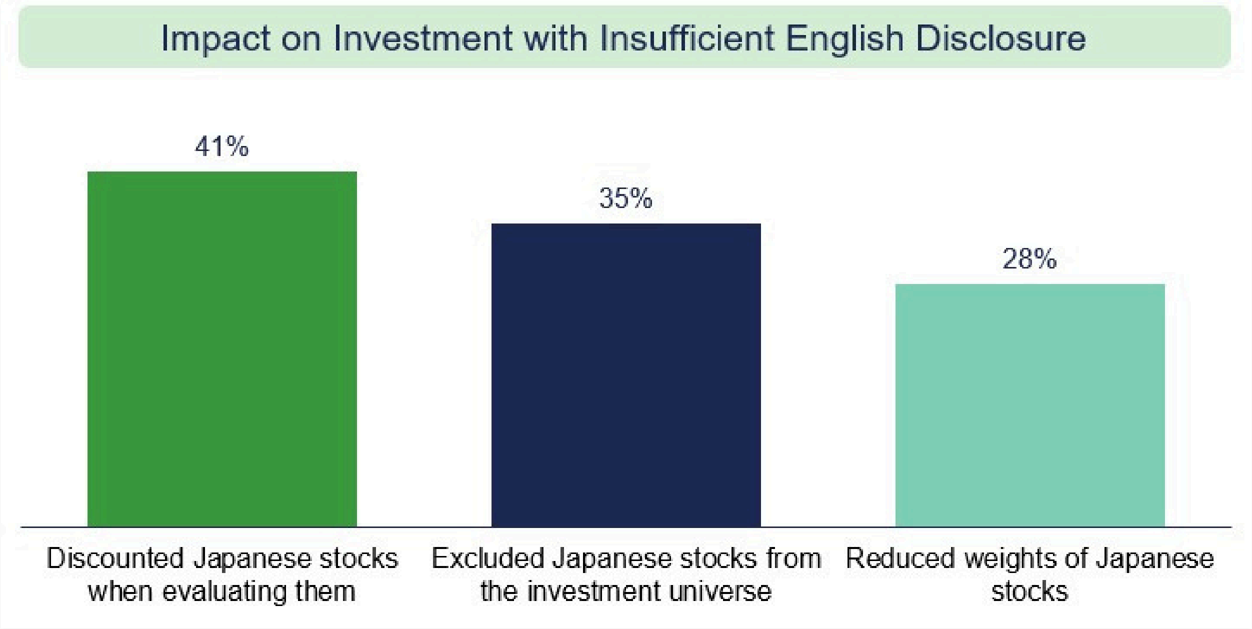
Source: FactSet Universal Screening, The World Bank (as at 31/10/2024).

The high number of listed companies in Japan leads to poor analyst coverage and in turn more opportunities for active managers to exploit. On average, listed companies in Japan have two sell-side earnings forecasts, compared to 7 in the US and 4 in China. Of 23 developed countries defined by MSCI, Japanese companies have the least coverage.



Source: AVI, FactSet Universal Screening (as at 17/11/2023). **Note:** Based on MSCI developed countries and primary country of listing.

The poor sell-side coverage is compounded by poor IR disclosure, with information not always translated into English and access to senior management difficult. A study by the Tokyo Stock Exchange (TSE) found that 41% of investors discounted Japanese companies that had insufficient English disclosure and 35% excluded them entirely. Non- fundamental factors like poor disclosure create mispricing opportunities for firms that have the resources to undertake detailed research and Japanese speakers to overcome the language barrier.



Source: TSE latest survey (as at 31/08/2023).

While the Government and Regulators are doing all they can to drive reform, responsibility lies with shareholders to help management drive change. The prevalence of activism in Japan continues to rise and is delivering results. Activism not only helps to rectify low valuations through improved shareholder communication and balance sheet restructuring, but also through strategic initiatives designed to boost margins and growth. Sitting on the sidelines passively waiting for reform leaves money on the table, and with Japan being the second largest market for activist events globally, it's a prime target for engagement. The purest exposure to Japan regulatory and corporate reform is through smaller companies. They have historically outperformed larger companies and those with excess cash have generated further outperformance. With private equity firms circling, the market is positioned for consolidation with an outsized number of small companies to target. However, with 4,000 companies to choose from with poor analyst coverage and limited English disclosures, in-depth research, detailed market knowledge, Japanese language capability, and intensive engagement experience are needed to determine which companies are ripe for change. For active managers, with the small to mid-cap universe offering stark pricing inefficiencies and plenty of room for constructive engagement, Japan offers compelling potential to generate significant alpha.

Asset Value Investors

AVI

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