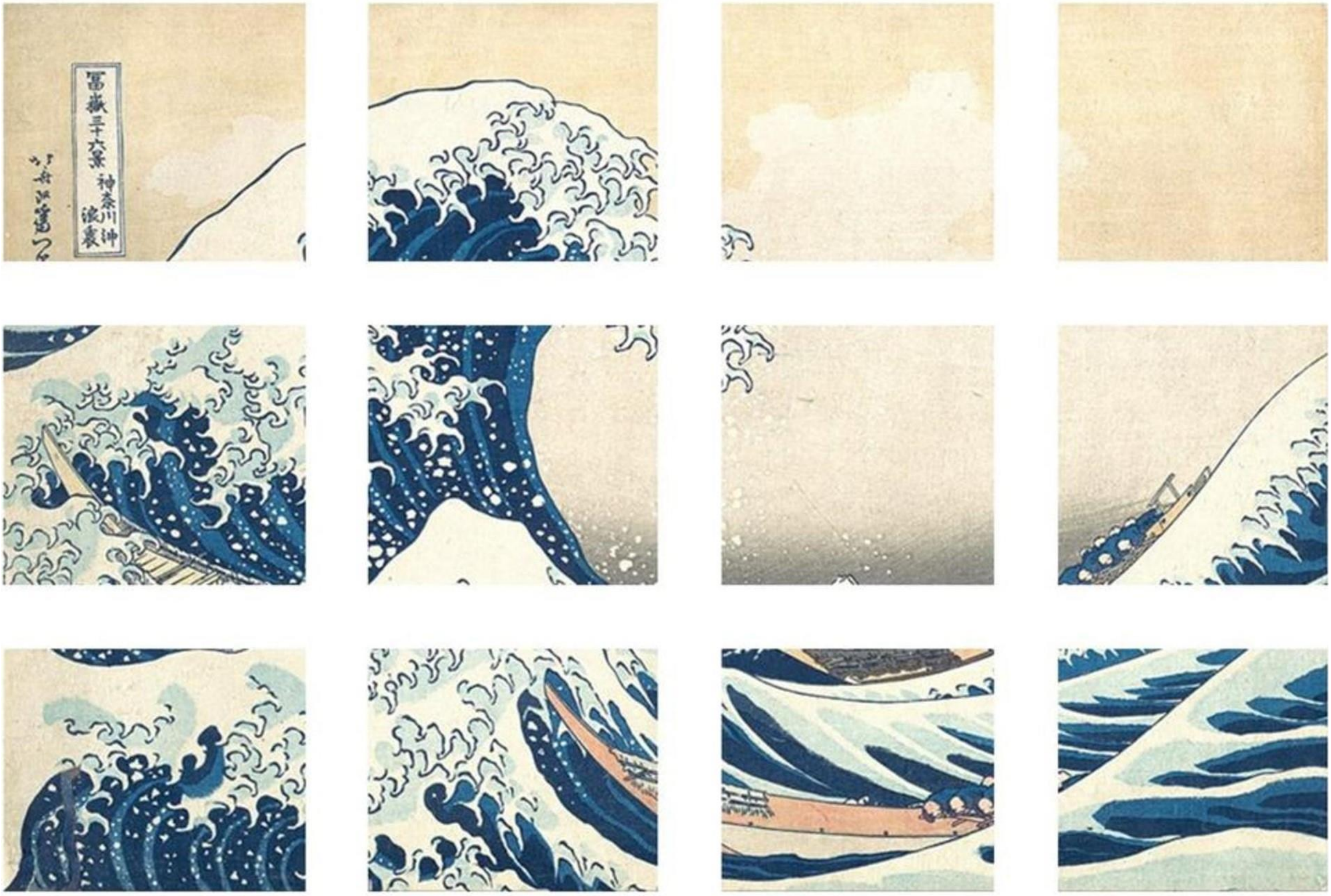
Asset Value Investors

The Corporate Governance Wave in Japan

Capitalising on Change



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The Corporate Governance Wave in Japan: Capitalising on change[1]

Hokusai's T*he Great Wave Off Kanagawa* (神奈川沖浪裏) has famously been described as "the most reproduced image in the history of all art”[1] and is attributed with inspiring Western artists and musicians from Van Gogh and Monet to Debussy through, amongst other things, the unanswered questions embedded in the imagery. Is there a terrifying storm occurring or simply a wave breaking against a clear sky? Are the fast barges being buffeted by the waves and are the sailors in peril, or are they master oarsmen timing the swells to their advantage?

Recent conversations with asset owners have brought this debate to mind, as many are not sure what to make of Japan's stellar performance over the last two years. Those who have been invested had some of their gains eroded by the feeble Yen, others have sought cheap companies but have ended up stuck in value traps, while some have enjoyed returns that have out-paced MSCI World, MSCI World Small and a certain Mr. Buffett (*AJOT +157% vs Berkshire Hathaway +132% (gross) since AJOT inception 23.10.18-31.01.25*). Is it really different this time? Does the corporate governance wave have further to rise? Can this once-in-a-generation shift in corporate Japan be navigated? Do attractive opportunities still exist and if so, can they actually be found?

Emphatically, yes.

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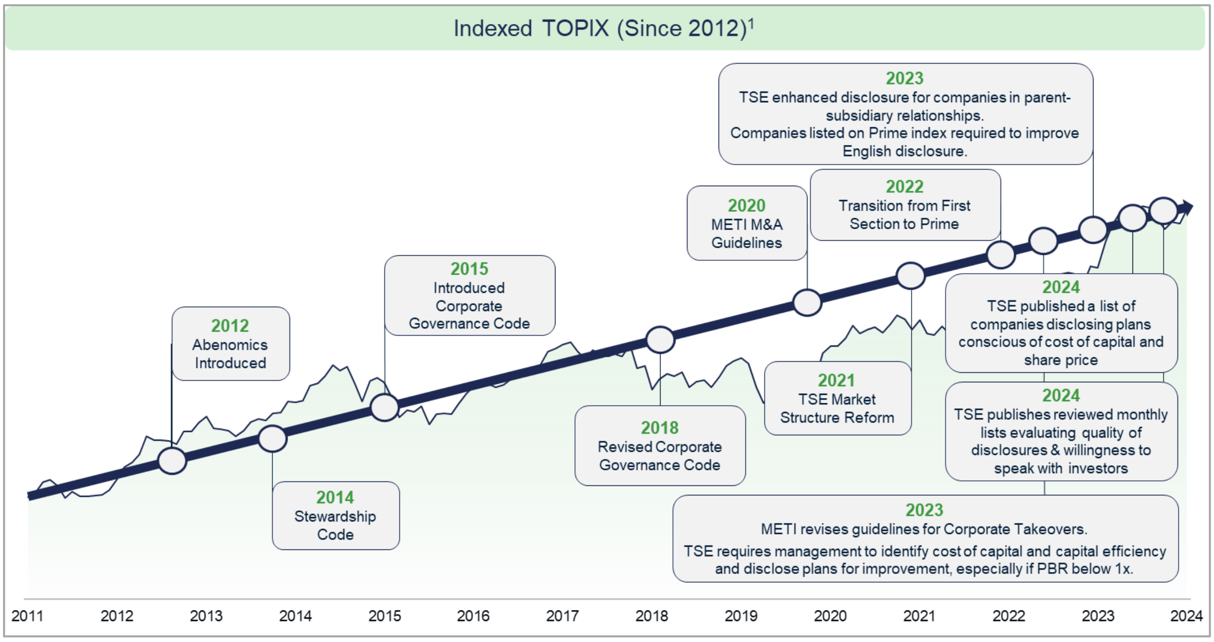
[1] Patrick Wood, 20 July 2017

The most straightforward question to answer is whether Japan is really changing. We would argue not only that it is already, irrevocably transformed, but that we are only at the beginning of a sea-change in corporate culture which will have long-term and far-reaching impact on the Japanese market.

Abe's legacy

Although Corporate Governance reform notably formed late Prime Minister Abe's third arrow, the initial rumblings of change have taken over a decade to not only gain momentum, but to begin to be recognised by foreign investors. Isolated headlines over time have made way for almost weekly highlights in the form of buybacks, cross-shareholding unwinds, better shareholder disclosure, and corporate events. Some Japan-watchers will have dismissed claims of permanent and meaningful developments as a ripple rather than a wave of change, and protest that we have seen investors be excited, and then disappointed, before. We would argue instead, that perhaps the main reason why "it's different this time", is that the pressure on corporate Japan to change isn't a result of foreign *Barbarians at the Gate*[2]. Instead, the forces being applied are stemming from Japan itself.



Abe's lasting legacy has been supported and cemented by a truly extraordinary coordinated and orchestrated effort from the Tokyo Stock Exchange (TSE), the Government, the Bank of Japan, and large domestic asset owners to drive change. The TSE's "name and shame[3]" list of companies who are and, more importantly, who are not

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[2] *Barbarians at the Gate, the fall of RJR Nabisco* by Bryan Burrough and John Helyar, published 1989
[3] On March 2023, Tokyo Stock Exchange, Inc. (TSE) requested that all listed companies on the Prime and Standard Markets take "action to implement management that is conscious of cost of capital and stock price"

taking measures to improve their valuations, is all the more astonishing because it was implemented by a Japanese regulator. This measure alone brought 50% of Japan's c.4,000 listed companies who are trading below 1x PBR[4] firmly into the TSE's crosshairs. On a recent visit to our offices, TSE representatives assured us that they will continue to adjust and amend measures to bring about positive change in 2025.

Not all heroes wear capes

Tokyo Stock Exchange President and CEO Hiromi Yamaji speaks to Nikkei Asia in Tokyo. (Photo by Ken Kobayashi)

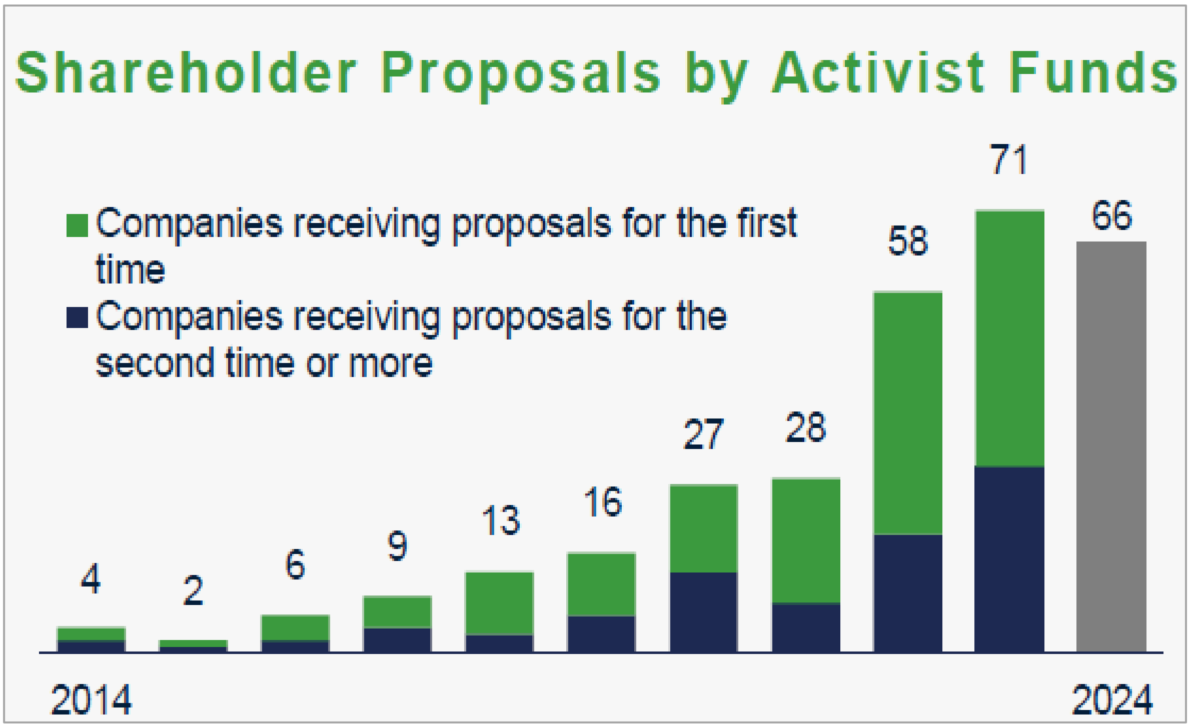
MARKET SPOTLIGHT

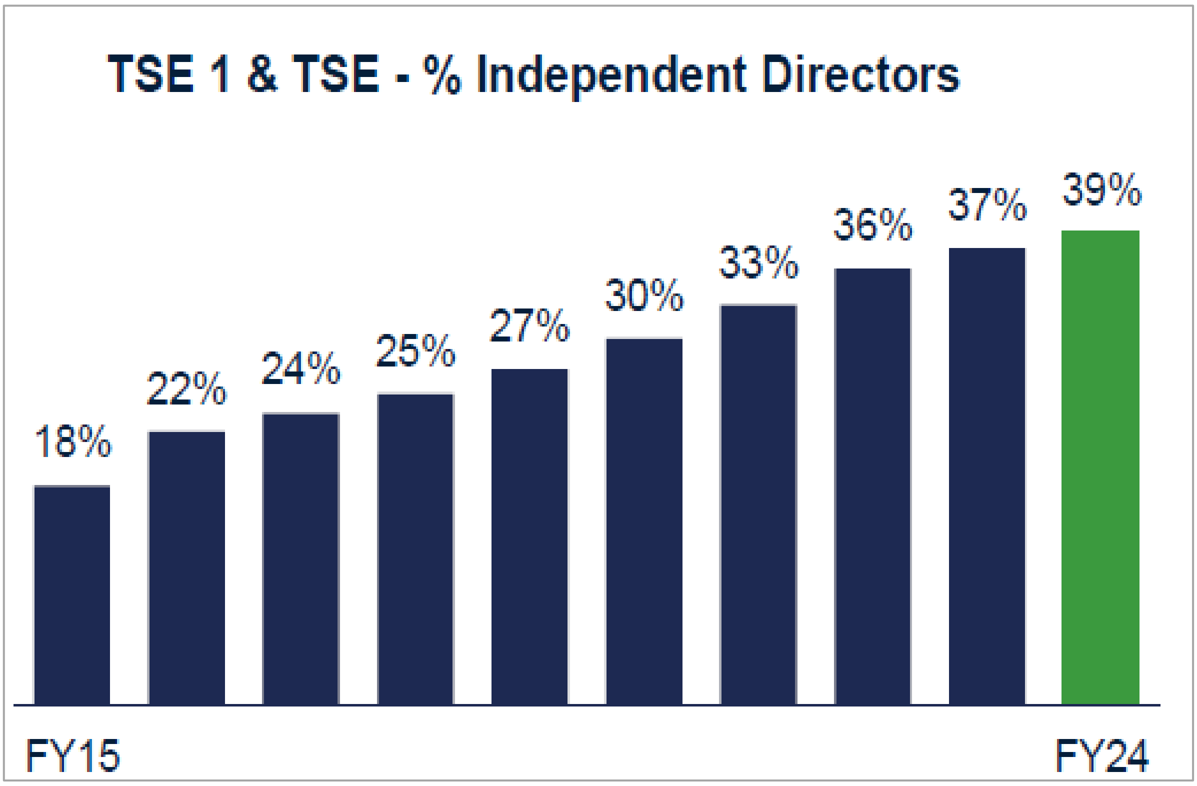
Tokyo Stock Exchange boss tells Japan to embrace activist investors

'Frank, open discussions' could help decision-making, says CEO Yamaji

In another power move, the Ministry of Economy, Trade and Industry (METI) released guidelines to promote corporate takeovers in 2023, stressing that credible takeover offers must be considered and can't simply be dismissed. Since then, a number of high-profile unsolicited takeover bids have been launched (e.g. Nidec and Makino Milling, Bain and KKR for Fuji Soft).

[4] Tokyo Stock Exchange website, as of 19.02.25





Changing corporate attitudes

The results of corporate governance reform are irrefutable and have been making international headlines, with household names like Hitachi, Mitsubishi Electric and Fujitsu announcing cross-shareholding unwinds, activism activity coming to the fore and buy-back levels hitting historical highs. In a recent remarkable move, the stalwart of Japan Inc, Toyota Motor, unexpectedly committed to unwinding their cross-shareholdings and doubling their ROE to 20%[5] (vs 9% market average).

Toyota's uncharacteristic and much-welcomed commitments are reflective of changes happening across the market, with evidence clearly indicating that Japan has crossed a veritable Rubicon in terms of corporate attitudes. What is also clear, however, is that there is still a long way to go. That is especially true in the world of small-mid caps, which make up 65% of the Japan universe[6].

The average large cap company in Japan has 12 analysts covering them, whereas the average small-cap company has 0-1[7]. Small-cap companies in Japan are also notorious for their weak or utterly lacking shareholder communication in Japanese, let alone English. Alongside their infamously overcapitalised balance sheets, this lack of coverage, knowledge and access to the small-cap universe is part of the reason why companies trade at a significant discount to their Japanese and global peers and why they are such an attractively inefficient hunting ground for those who do the work.

The case for small-caps has been compelling for some time, but as with the broader market, there lacked a catalyst to spur these companies into action. Many a wary investor has been lured by the promise of cheap, high-quality companies with bounties of cash and assets on their balance sheets, and left Japan disillusioned and disappointed. Now though, it is not just one catalyst creating waves in Japan, it is many.

Together, the reforms being encouraged across Japan's regulatory establishments are pushing and moulding corporate Japan into a shape that is more familiar and accessible to foreign investors, enabling a reassessment of what Japan's market can offer. Where else in the world can you find a market so broad and so deep, so well-capitalised and so under-owned? According to global private equity companies, nowhere else. As the co-founder of KKR stated in a recent interview, "If I were 30 years old today and I could speak Japanese, I'd go to Japan[8]".

Private equity's interest hasn't appeared overnight. Over the last few years, large global players have opened offices in Tokyo and have been researching and assessing the market, waiting for the corporate governance seeds sown over a decade ago to bear fruit. At the same time, smaller domestic firms have been established and are contributing to an increasingly healthy and sophisticated private equity industry. In 2024, takeover bids in Japan hit an 18-year high and we have felt this pick-up in activity at a strategy level, with four of our portfolio companies bought out over the year.

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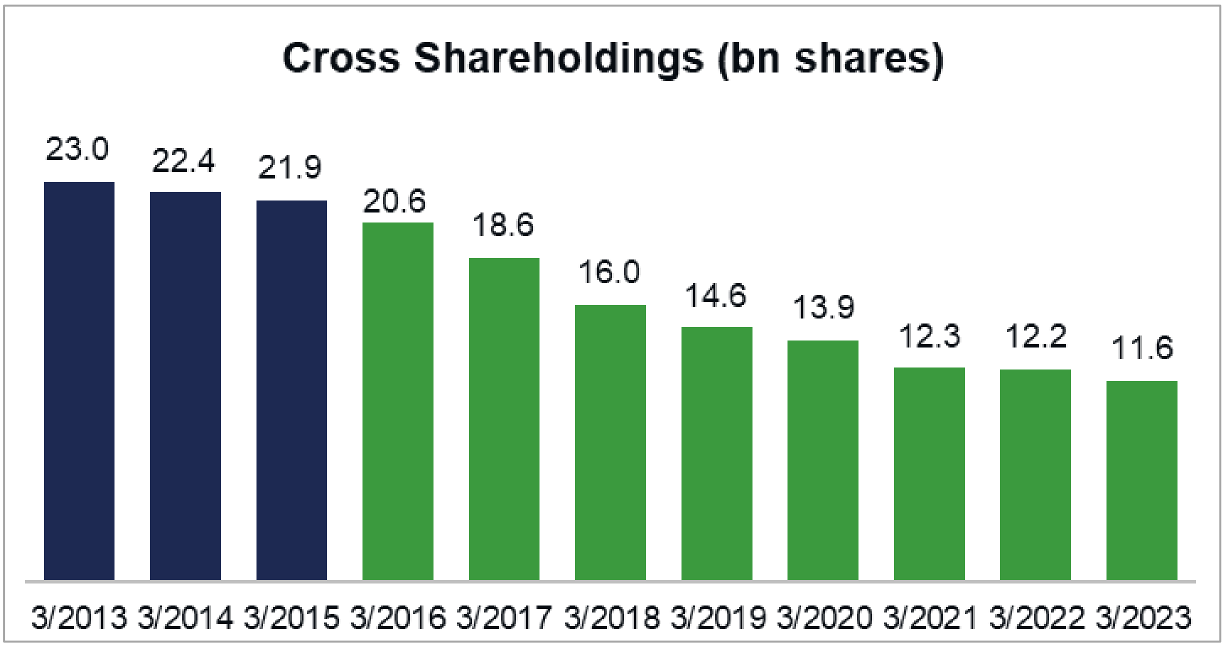
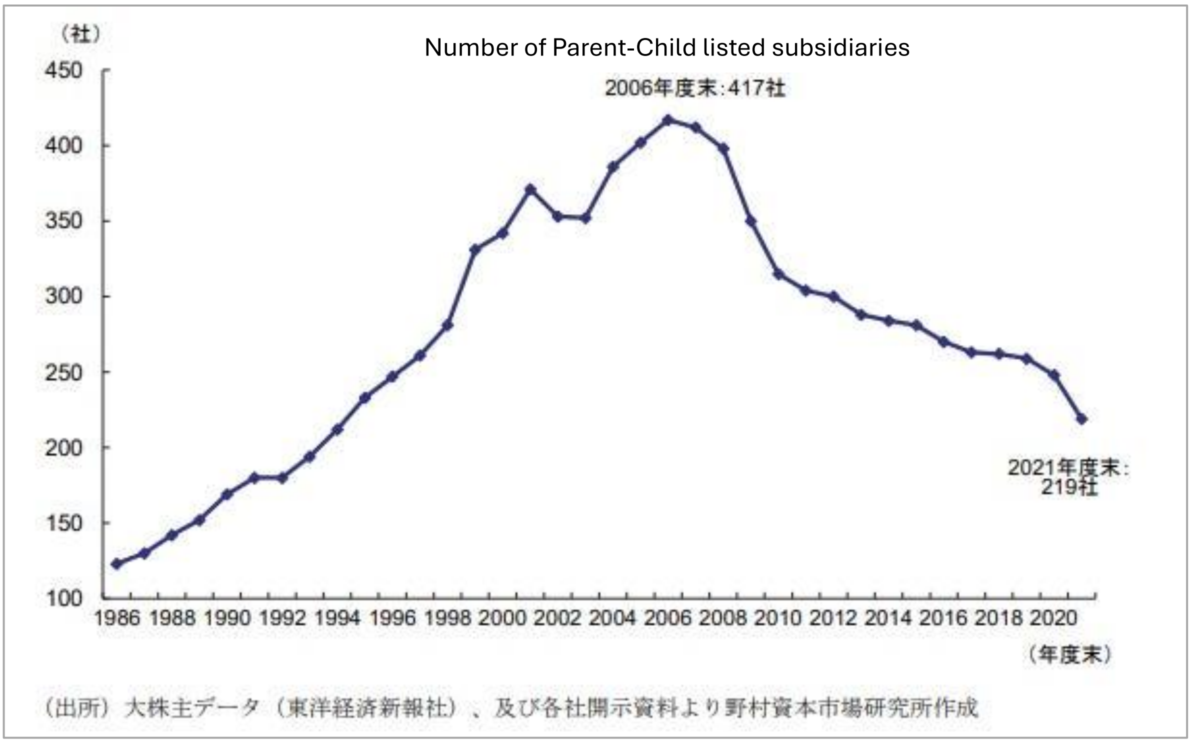
[5] Nikkei newspaper December 25, 2024
[6] Bloomberg data, 19.02.2025
[7] AVI research, Bloomberg data, 19.02.2025
[8] Attributed to George Roberts by co-founder Henry Kravis, Nikkei newspaper interview 17.10.2024

The acceleration felt within private equity is a direct result of engagement and activism momentum building, which in turn has driven change at corporate management level across the market. The post-war *keiretsu* spider's web of cross-shareholdings have acted as pseudo-poison pills for decades, protecting listed subsidiaries and preferred business partners from acquisition. Large unwinds from some of the household conglomerate names have been effective at almost halving the amount of cross-shareholding tie-ups since the corporate governance code was introduced in 2015[9].



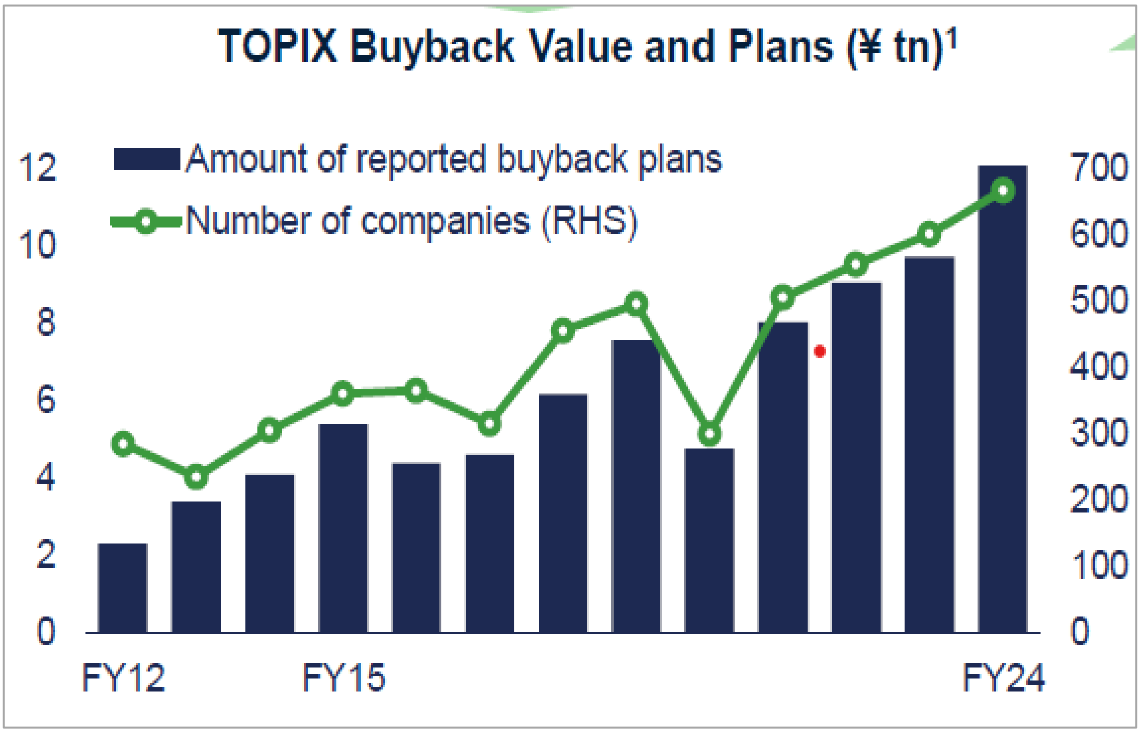
Parent-child subsidiaries are another area of focus for the TSE where they are making solid progress. Listed subsidiaries often exist purely for the convenience of the parent company, and will have limited, if any, pricing power or real agency over business strategy. The number of parent-child subsidiaries peaked at 417 in 2006 and has since steadily dropped to 219 in 2024[10]. The Alps Logistics buyout in 2024 at a 194% TOB premium is an example of the opportunities presented by the existence of parent-child subsidiaries.

[9] [1]Bloomberg, based on materials by BofA Global Research and Fidelity International (as at 30/09/2024)
[10] Toyo Keizai newspaper, April 2024



Buyback plans have reached historically high levels and continue apace. Although highly encouraging, there remains enormous scope for this pattern to continue with over 1000 listed companies holding more than 30% of their market cap in cash[11]. Undervalued (or zero-valued) real estate assets provide another rich source of hidden corporate value, for those who do enough digging. In December, TSI Holdings announced they were selling their old office building, for a staggering 30% of their market cap, and even above our independently assessed valuation.

[11] Tokyo Stock Exchange, 19.02.2025



Opportunity in small-cap Japan

Historically, small-caps in Japan have consistently outperformed their larger counterparts, but that pattern was disrupted two years ago when the Yen dramatically weakened by over 30%. Large-cap exporter beneficiaries were driven to heady heights by the currency tailwinds and an astonishing 27% performance gap between large and small companies resulted over two years[12]. The Bank of Japan is under increasing pressure from domestic consumers and companies to ease imported inflation resulting from the weak yen and have committed to a slow and steady normalisation of monetary policy. The question is how long a weak yen will weigh on small-caps, and what will happen when we see that pressure start to be released.

AVI has been investing in Japan for over 40 years as part of our global approach, but it was the realisation back in 2016 that we were witnessing the beginnings of a rare and remarkable shift in corporate culture that inspired us to launch a Japan-dedicated strategy. Since AVI was founded in 1985, our investment philosophy has focused on identifying undervalued, under-researched, and overcapitalized companies, and engaging intensively with management to address and correct these inefficiencies. The opportunity set available in Japan to find precisely those sorts of companies, simply does not exist anywhere else. We believe that our engagement and constructive activist approach is particularly suited to Japanese companies. The idea of self-help has percolated slowly through the market over the past ten years, and there is a growing sub-

[12] Topix Core 30 vs Topix Small 31.12.22-31.12.24 Bloomberg, AVI

set of companies who want to improve their valuations but are not sure how. This is again, especially pertinent in the small-mid cap space.

Our approach differentiates AVI from many of our peers, and from traditional US activist doctrine. We have found that offering solutions to the issues that keep corporate management awake at night is a far more effective opening salvo than taking a more aggressive and antagonistic stance from the offset. We come bearing management consultant-led gifts. Our investment team started their careers at the world's top management consulting firms and investment banks. They draw on this extensive experience to thoroughly analyse companies, often producing an initial 70-80 page research report for company management that covers both the company and its peers. These bespoke reports include a comprehensive roadmap for improving operational efficiency, margins, profits, capital allocation, ESG metrics and, ultimately, valuations.

We believe it is crucial to ensure that our in-depth work is not in vain and to maximize the likelihood that management will value our guidance and implement at least some of our recommendations. The alternative is to fall foul of the dreaded Japanese value trap, which is still very much a threat. As mentioned, there are nearly 4,000 listed companies in Japan, half of which trade at <1x price to book, most of which are over-capitalised, and countless which have dormant and under-valued real estate or other assets. Even now, most of these companies remain reluctant, if not outright resistant, to accepting shareholder advice or demands. Thoroughly assessing management prior to investment is a key part of our process, and our team meet with directors, non-executive directors, employees and industry experts to garner as comprehensive a picture as possible of a company's "engageability". Building strong relationships with the company and maintaining an intense pace of engagement are key pillars of our approach, with the team meeting each company on average 2-3 times a quarter and doing c.250 meetings in total a year. The Japan strategy's idiosyncratic returns and outperformance over both the small-cap index and the net cash universe are testament to the thoroughness of our process and our efforts to avoid low-quality companies who, even with a push, will likely continue to stagnate. Instead, we seek companies with whom we can build constructive relationships and long-term value. Inevitably we will sometimes have to apply firmer pressure through shareholder resolutions or public campaigns, but always in a manner that is constructive and respectful. We do not presume to think these companies should undergo a complete cultural shift, many of which have long histories and have built market-leading expertise or products in their specific industries. Instead, we encourage and support the integration of perspectives that, though initially unfamiliar to our investee companies, will resonate with foreign investors and help them reassess Japanese companies, ultimately recognising their true value.

It was this same unique blend of cultural elements that drew foreign attention to Kokusai. Often hailed as the pinnacle of Japanese art, it was, ironically, the subtle kinship foreign artists felt to their own Western traditions that fuelled *The Great Wave's* popularity. Kokusai deftly incorporated aspects of Western art into his work, bridging the cultural divide and both familiarising and elevating Japanese art in the eyes of the West. This marked the beginning of a symbiotic exchange of ideas and traditions that continues to this day.

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