Update on the Tokyo Stock Exchange's Reforms

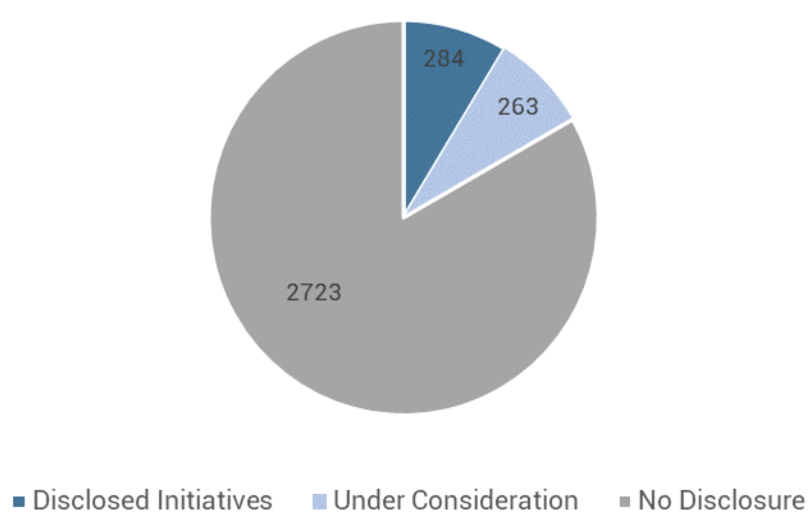
The Tokyo Stock Exchange (TSE) recently released the minutes for the August 29, 2023 meeting, the 11th meeting of the TSE's "Council of Experts Concerning the Follow-up of Market Restructuring" and the 1st meeting since the adoption of its Price Book Ratio (PBR) 1.0 initiative. That initiative set a minimum target price/book of 1.0 for listed companies in Japan and asked all companies to disclose a "Action to Implement Management that is Conscious of Cost of Capital and Stock Price". As part of this, management teams were required to consider and disclose their cost of capital and specifically address how they planned to achieve a Return On Equity (ROE) above 8% which is deemed consistent with achieving a PBR above 1.0. To us, this request was revolutionary in that for the first time, Japanese company management was being mandated to explicitly focus on something which until then had often been viewed as none of their concern: namely the price of their stock!

The minutes of the August 29, 2023 meeting provided an insight into just how serious the TSE was about its initiative. To us, the message from the minutes of the meeting and associated presentation materials was clear:

- The TSE has no intention of slowing down its initiative and Japanese company management will continue to face pressure from the TSE to comply
- Companies should disclose their ROE targets
- Japanese companies need to improve their PBR to 1.0 ***at a minimum***
- Importantly…. Companies that have a PBR of above 1.0 are not excused – they too need to actively consider their cost of capital and disclose their plans.

Update on progress

Figure 1 – Status of Disclosure by Number of Companies (Prime and Standard Segments of the TSE)



Source: TSE

As Figure 1 shows, there has been a steady uptake of the TSE's request, with 284 companies making their public disclosures and another 263 stating that these are under consideration. However, this leaves a sizeable part of the listed universe (2723 companies to be precise) which have yet to comply.

Figure 2 – Breakdown of Prime segment companies disclosing by market capitalization and PBR

Market Capitalization (USD)	PBR <1	PBR >1
>$700m	30.4%	20.6%
$170-700m	21.6%	9.1%
<$170m	12.5%	8.1%

Source: TSE

Figure 2 makes it clear which companies have been quickest on the uptake. The larger companies in Japan are clearly feeling the greatest pressure to comply, particularly if they have a persistently low PBR. It is also fair to note that these larger companies often have greater resources to spend in undertaking and disclosing these important reviews. Nevertheless, the TSE has made it clear that there are no exceptions for smaller market capitalizations or even for higher PBR companies – all companies need to comply with the request. While there will likely be a continued stream of disclosures coming particularly from large low valuation companies, we also believe there will be significant opportunities in the small cap space as these companies play catch up.

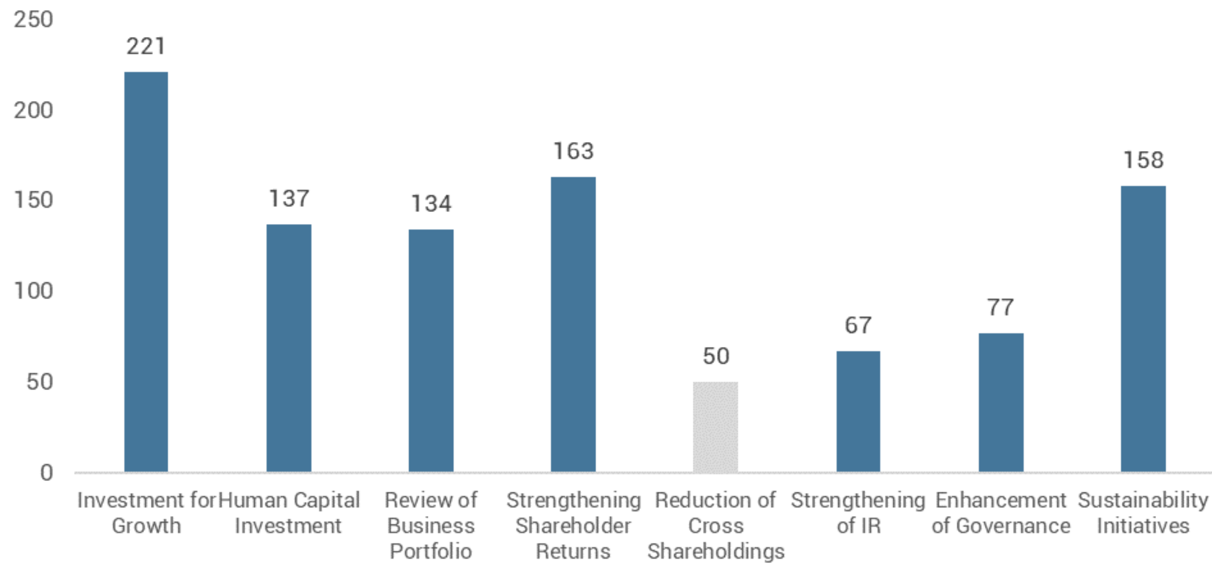
So what exactly is in the initiatives disclosed so far? Of the 284 disclosures so far made:

- 72 provided their cost of capital
- 235 set one or more explicit targets for their business:
    - 199 ROE targets
    - 57 Return of Investment Capital (ROIC) targets
    - 39 Price/Book targets

While the above is not exactly perfect, as seasoned Japanese investors, we believe the setting of target metrics such as the above represents a sea change in thinking for Japanese management.

Figure 3 attempts to summarize the content of the text of the initiatives, grouping them into broad categories where the management teams want to drive improvements. Clearly all of these are positive steps and we see the evidence of continued improvements in shareholder returns (record buybacks and dividends) as well as the start of a rationalization of company's business structures, including selling off or closing low profitability or non-core operations. It is also encouraging to see Japanese firms embracing sustainability initiatives, given these continue to lag global standards. However, we are particularly interested in the 50 companies that discussed the plan to unwind their cross-shareholding structure. We view cross-shareholdings (where inter-related companies such as suppliers and customers will hold stakes in each other's business) as one of the biggest remaining challenges in the Japanese equity market and intend to make this a major focus of our engagement over the coming year. In our view, the TSE reforms supply strong ammunition to engagement-focused managers such as Dalton in driving positive change.

Figure 3 – The content of the initiatives disclosed (Prime and Standard segments)



Source: TSE

The remarkable case of Aisin (7259)

Aisin is an $11bn market capitalization company which produces components and systems for the automotive industry, as part of the Toyota Group of Companies (Aisin is the fourth biggest division in the group). The company is 40% controlled by the Toyota Group and has historically acted in unison with the Toyota management and given limited focus to its minority shareholders. Despite this, and driven by the TSE's demands, on 14 September the company gave a "Mid/Long-term Business Strategy Briefing", which included some remarkable elements:

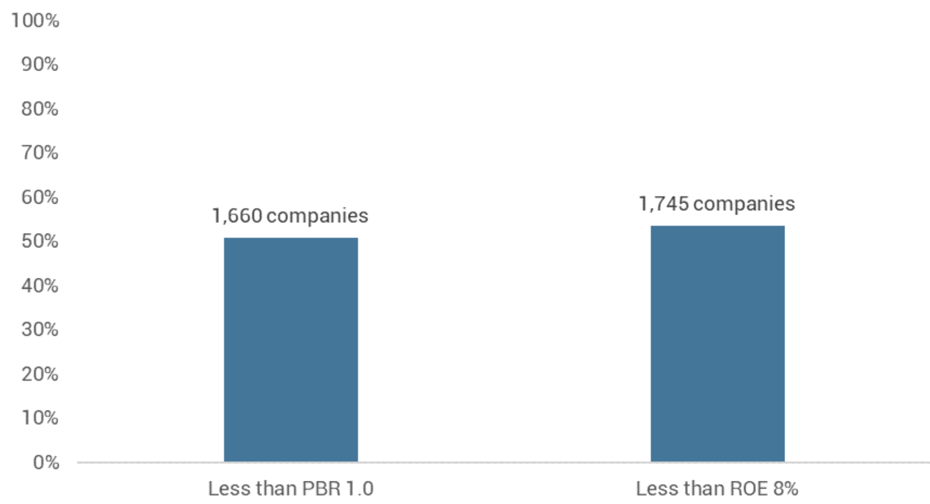
- Completely selling out of its (mostly Toyota Group) cross-shareholdings (JPY 250bn in total)
- Increasing shareholder returns through share buybacks and dividends
- Transferring out or closing non-core and low profitability business lines
- Setting explicit ROIC (13%) and PBR (>1x) targets
- Outlining a specific focus on key sustainability issues such as carbon neutrality

In our view, if a company like Aisin can move to completely unwind its cross-shareholdings, then this is an extremely positive sign for the wider Japanese market.

Conclusion

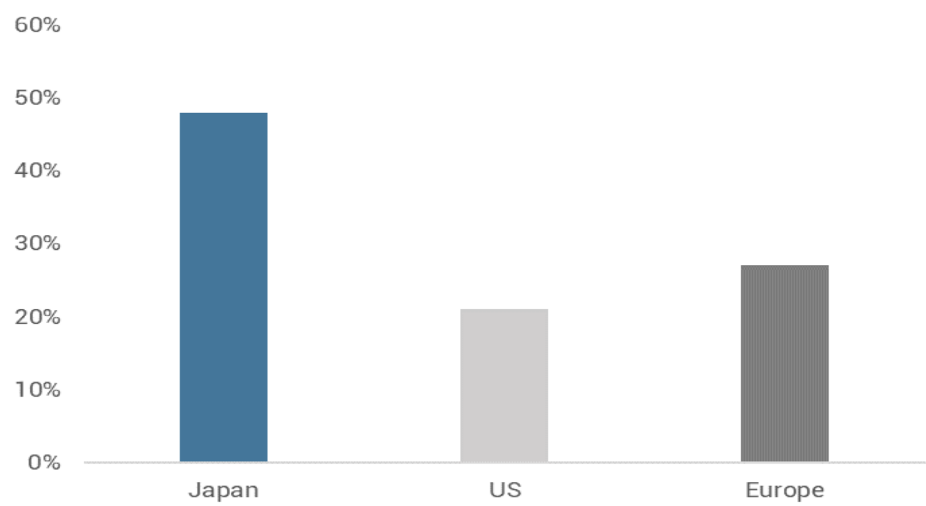
We are truly encouraged by the TSE's continued and persistent reform agenda and believe it is having a profound impact on the Japanese market. As engagement-focused investors, being able to speak to Japanese company management in the common language of cost of capital, valuation and ultimately share price is revolutionary. With the Japanese market's strong performance (at least in Japanese Yen!) in recent periods, we are often asked whether we believe the opportunity is over in Japan. On the contrary, we believe we are still in the early stages of a multi-year opportunity in the country, as the management of Japanese companies respond to the pressure to drive better returns for shareholders. As Figure 4 shows, there remain a huge number of companies listed in Japan with metrics below the TSE's minimum targets, most of which are yet to make public disclosures of their plans to address these failings. Even if we only consider the large-cap skewed TOPIX index, we see a pronounced gap between Japan and the rest of the world (figures 5 and 6) on these key metrics, meaning there remains the potential for sustained relative outperformance from Japan.

Figure 4 – Percentage of Prime and Standard segment companies trading below TSE targets



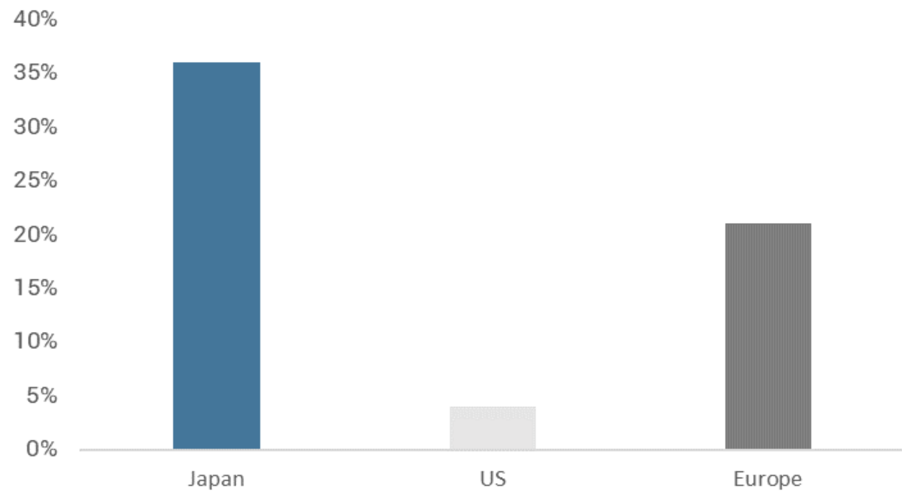
Source: Bloomberg

Figure 5 – Ratio of companies with ROE lower than 8% (TOPIX, S&P 500, STOXX 600)



Source: Bloomberg

Figure 6 – Ratio of companies with PBR lower than 1 (TOPIX, S&P 500, STOXX 600)



Source: Bloomberg

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