

# JAPAN SPECIAL OPPORTUNITY STRATEGY

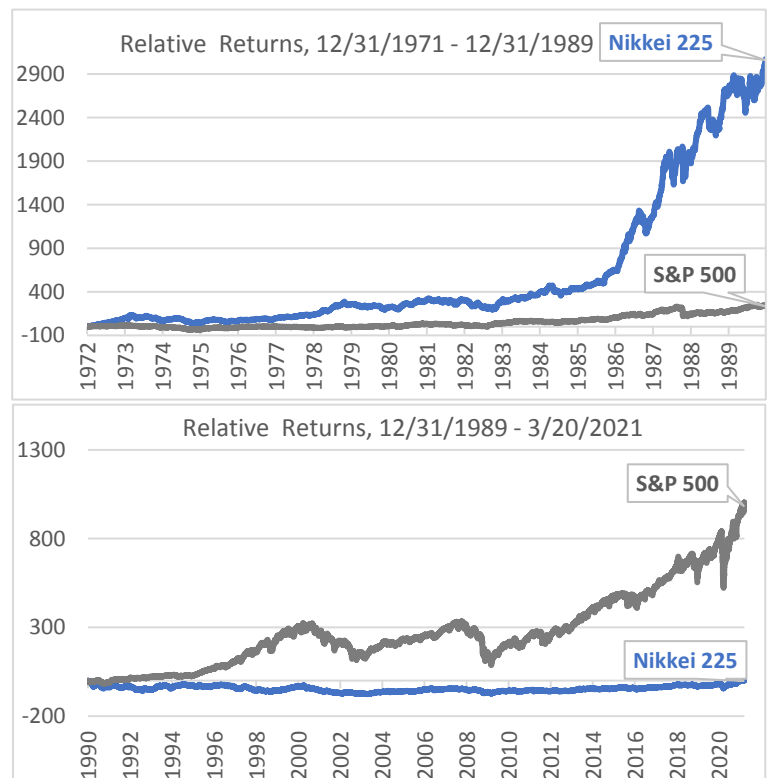
## An Index-Unavailable Nonrecurring Opportunity Set

*Historically unprecedented regulator-mandated policy and rule changes in Japan are now altering a 75-year insular cycle of protected corporate structure. Offered up: a uniquely diversified, non-correlated, and classic deep-value investment opportunity – with a known and near-term value realization catalyst.*

### Part 1: The Japanese Market You Know and the One You Don't

Japan is the second largest developed economy in the world, and is the third largest overall, after the U.S and China. It is the largest weight, at 25%, in the MSCI EAFE Index, followed by the U.K, at 14%. For two decades, Japan was the best performing developed market in the world when, as a bubble, it peaked in 1989. Shortly thereafter, its economic growth trajectory slowed, and has trended at an average of only 1% annual real GDP growth for the last 29 years. In the over 30 years since its peak, the Nikkei 225 Index has yet, in USD terms, to re-attain that 1989 level.

Japanese publicly traded companies are notoriously opaque as to their management and shareholder disclosures, and they have maintained a studied indifference toward maximizing shareholder returns. To boot,



Source: Bloomberg

they protected themselves from corrective action by hostile takeovers through their cross-ownership arrangements with one another.

With the well-known cultural policy of lifetime employment, corporate profit margins in Japan are nearly 10% lower than those of comparable companies in other nations. That, along with their cash-heavy balance sheets, resulted in lower returns on invested capital as well. This ‘value trap’ – there existing no external mechanism to force such companies to alter their policies – is reflected in the Nikkei 225 Index, which trades at both P/E-multiple and book-value-multiple discounts to other global indexes. There have been improvements in recent years, though, and regulatory changes to encourage greater transparency, efficiency and growth, and this has not gone entirely unnoticed. The Japanese stock market has begun to appreciate once again, but one can’t say that it has engendered any broad-scale interest.

That is the Japanese market you know. There’s also one that you don’t. Most investors are familiar with large Japanese corporations such as Toyota, Honda, and Sony. However, these might be more properly classified with other mega-capitalization, global-scale companies than with the local Japanese economy. This is no different than for other nations, to which investors gain exposure primarily through their mega-cap multi-nationals. For instance, the top 10 holdings of the iShares MSCI France ETF (EWQ) account for 50% of that index. More important than EWQ’s mega-cap concentration, over 70% of the revenues of those companies come from *outside* of France. By buying the iShares France ETF, one is, effectively, investing NOT in France.

The reason? It’s a function of how large the consumer sales base of France is in relation to global demand – the domestic market is simply not large enough to support mega-cap company size. In order to serve the massive liquidity needs of the pool of global investors, ETF organizers require global-scale trading liquidity, which requires a global-scope sales base.

The paradox: when investors seek the diversification benefits of *local* economies, they’re really getting essentially the same exposures they have already, such as within the S&P 500: of global multinationals. How different, in terms of systemic risk, is Toyota from General Motors or Daimler Chrysler, or Nestle from General Mills or Coca-Cola?

The same goes for Japan. Japan has a very large economy, rich in complexity. There are over 3,800 publicly listed companies, with a total market capitalization of \$7 trillion. Yet, the iShares MSCI Japan ETF (“IWJ”, \$13 billion of AUM, 301 constituents) includes fewer than 10% of those companies. And those large- and mega-cap companies do not represent or provide exposure to the Japanese economy.

The top 10 holdings (3% of the companies, 22% of the index value) of the iShares Japan ETF get 63% of their sales from *outside* Japan; the top 20 (one-third of the index by weight) get 61% of their sales from exports. Investors’ exposure, in this sense, is to the economies of Japan’s primary *export* markets – the U.S., Europe and other developed economies – and their cyclicity, not to those of Japan.

Moreover, the Japanese market itself has the same concentration and exposure misallocation risks as other markets. The 139 largest companies in Japan – in principle, fewer than 4% of the opportunities – account for almost two-thirds of the market value of the entire Japanese stock market. Only one-third of those largest companies source over 70% of their sales from Japan.

#### ishare MSCI Japan ETF vs. Japan: Top heaviness

	<u>The number of companies</u>	<u>Market cap</u>
<b>Japan Equity Market</b> (3862 companies, \$7 trillion market cap)	100%	100%
<b>Large-cap companies*</b> (139 companies, \$4.5 trillion market cap)	4%	64%
<b>ishare MSCI Japan ETF</b> (301 companies, \$5.5 trillion market cap)	8%	79%

\*market cap above \$10 billion

Source: ishare MSCI Japan ETF, Bloomberg

as of 3/15/2021

Beneath the surface of the large-cap layer of the Japanese stock market, though, exists an entirely different stock universe. These are the publicly traded subsidiaries of larger corporations. This so-called parent-child structure has been in place for generations. It is an unintended consequence, an outgrowth, of the corporate lifetime employment culture, which will be discussed more fully in the body of this report. And it has contributed to the seemingly institutionalized pattern of low profit margins, low innovation, and low sales growth that has come to characterize Japanese industry in recent decades.

#### ishare MSCI Japan ETF Top 10 Holdings:

<u>Company</u>	<u>% of Rev OUTSIDE Japan</u>	<u>MSCI Japan Index weight</u>
Toyota Motor	76	4.0
Softbank Group	21	3.5
Sony Corp	70	3.2
Keyence Corp	53	2.0
Recruit Holdings	45	1.6
Mitsubishi UFJ Financial	48	1.7
Nintendo Co	77	1.5
Shin-Etsu Chemical	73	1.4
Tokyo Electron	86	1.4
Takeda Pharmaceutical	82	1.5
<b>Average and total weight</b>	<b>63</b>	<b>21.8</b>

Source: ishare MSCI Japan ETF, Bloomberg

These parent-child subsidiaries are truly local, extremely cheap by any standard and historical measures, and are now about to undergo a revaluation. The process has already started. Following several years of increasingly insistent regulatory changes by the government to enforce shareholder accountability, which has determined that the existing corporate structure has interfered with a return to national economic vibrancy – the Tokyo Stock Exchange recently enacted dramatic rule changes that will take place in stages over the next 24 months. These will require parent companies to either divest or acquire a large swathe of those subsidiaries.

These subsidiary companies typically trade below book value, some even below net cash on the balance sheet. The valuation opportunity is not only extremely unusual historically amongst global equity markets, in today's markets it is unique. As importantly, this phenomenon is entirely idiosyncratic – it will be entirely de-linked from the rest of the world's markets, even from the Japanese market – a truly non-correlated return pattern, and one structured for a relatively predictable positive return. Moreover, as a discrete sector, these subsidiary companies are themselves highly diverse and uncorrelated with one another.

To properly understand the investment case for this universe – why these parent-child subsidiaries are undervalued and how they will stop being so – one must understand the manner in which they developed, their historical constituencies, and the cultural and corporate interests that protected them; and, likewise, the changing political forces that have arrayed to undo them.

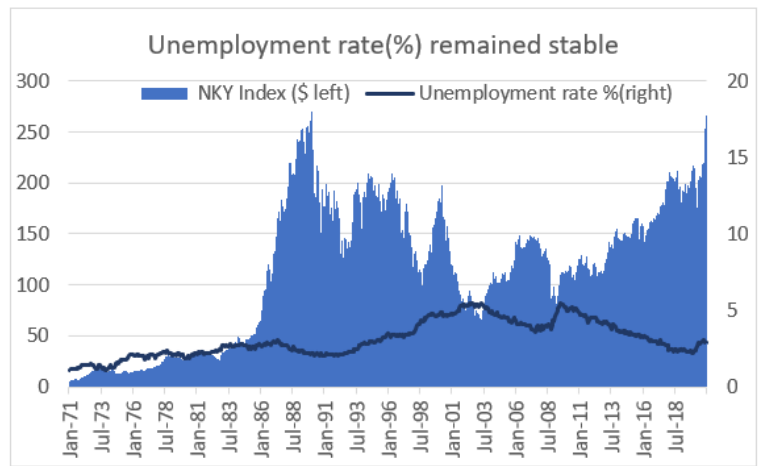


## Part 2: How the System Was Built, then Failed, and the Slow Beginnings of Its Rehabilitation

### *How the System Was Built*

Despite the presence of index-centric mega-cap companies like Toyota, Japanese corporations and the Japanese capital markets have been structurally decoupled from western developed markets for decades. That phenomenon has its roots in the unique social and economic system Japan built in the aftermath of World War II. To rebuild a stable society and economy, the government adopted a lifetime employment system, in which employees committed to work for one company for life. In return, the corporation guaranteed a unique salary, promotion, and benefits-by-seniority system. Upon being hired after school graduation, employees already knew what their title, salary and benefits would be at various ages, when they would retire, and how much they would be earning at that time.

During the nation's high economic growth phase from the 1950s onward, this stable workforce and controlled wage scheme supported Japanese corporations in investing in and expanding their businesses both domestically and globally. It did indeed provide social stability; even when the Japan credit bubble burst in December 1989, the unemployment rate remained as low as 2.1%.



Source: Ministry of Internal Affairs and Communications, Bloomberg

The successful history and the crisis-proven resilience of this system had a follow-on consequence. An outgrowth of this success was that maintaining the lifetime employment social contract and delivering the promise of promotion by seniority became the primary perceived responsibilities for corporations. This imperative became more strongly institutionalized over time. The managements, who are typically selected from among the most senior employees, are incentivized to pass on this system to the next generation.

However, it also created certain structural inefficiencies and even dysfunction. The system of labor market rigidity that worked in the four-plus decades of economic reconstruction and expansion following WW II was not structurally suited to a slower-growth environment.

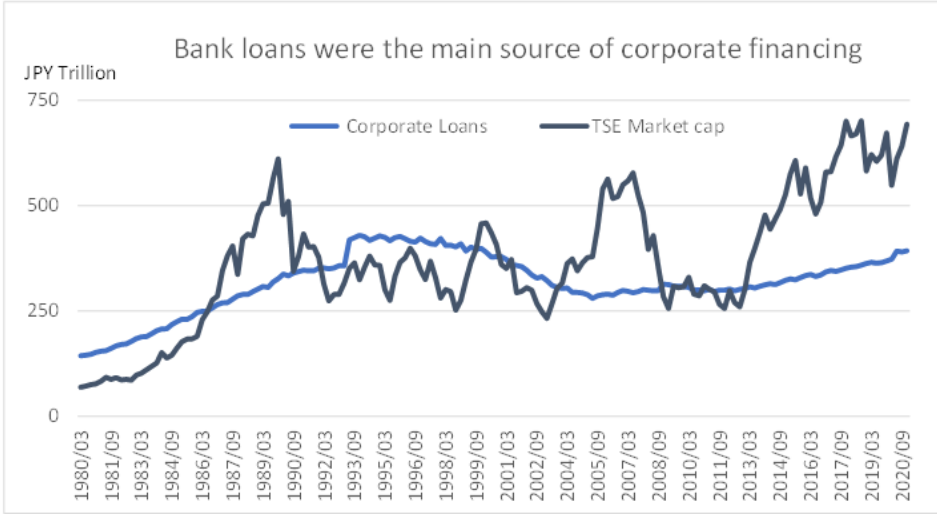
Beginning in 1992, real GDP growth slowed from a roughly 4.5% steady-state rate toward 1.0%. However, there was no employment market fluidity. Older workers could not be displaced by younger workers, because employees were not dismissed. There was not even a mechanism, even in principle – for no one

would have considered it – for a mid-career employee to seek, much less obtain, employment elsewhere. Moreover, a more talented entry-level employee could not be promoted above an earlier hire, because the system was based upon seniority, not merit.

Without an external solution, companies resorted to internal solutions. In response to overstaffing, they would create business divisions and subsidiaries for the express purpose of making new senior positions available for employees whose tenure had earned them this level of reward, while, thereby, making room for less-senior workers. The executives would bring with them the full complement of supporting personnel. A few aspects of this must be understood. First, the subsidiary created likely did not have a legitimate business purpose; it was often simply an existing department or function that was now given a separate corporate structure. Secondly, the executive chosen to head this new subsidiary was not necessarily qualified or best-qualified to do so, but was simply being accorded a degree of respect in accordance with his seniority. These subsidiaries were either wholly owned or, if eventually brought public, were captive to their majority-controlled parent company.

Drastically changing the business structure or cutting personnel costs to seek a higher financial return was simply considered neither necessary nor desirable, as long as the business remained profitable. However, when the economy slowed, the lifetime employment arrangement became increasingly difficult because it did not allow for layoffs. It made it impossible to swiftly restructure or eliminate a shrinking line of business in order to shift resources to new endeavors. Those drastic changes were allowed only when the business began to operate at a loss – in other words, when it was already too late to adjust and recover without significant resources and capital.

Another reason these inefficient corporate behaviors were allowed and accepted in Japan is because the country historically practiced a form of indirect finance, the so called “main bank system”, where banks played a major role in corporate finance. Banks’ aggregate outstanding corporate loan balances trended at about the same level as the Tokyo stock market capitalization until 2012 (that is, on a 1:1 basis).

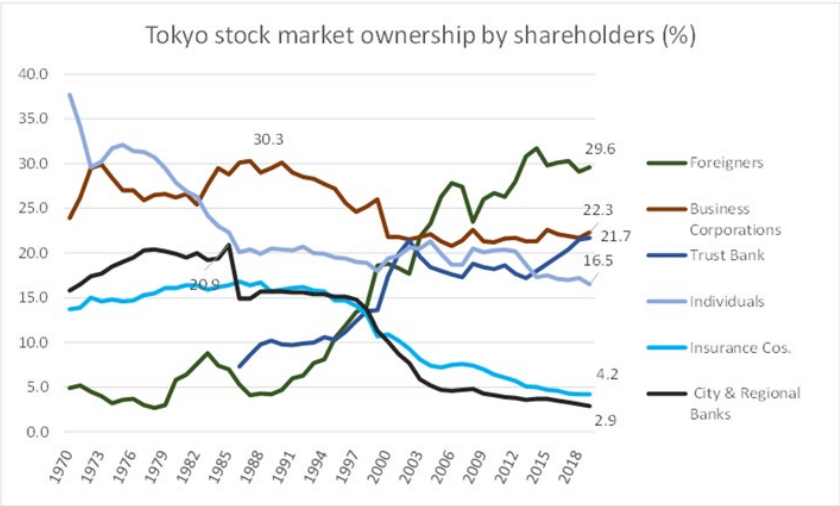


Source: BOJ, Bloomberg  
Note: corporate loans before 1993 were calculated as total loans-individual loans

Conversely, the U.S has a robust direct finance system, with the capital markets facilitating the majority of corporate financing. The U.S. securities exchanges aggregate market capitalization is about \$45 trillion, which is about 4.3x the amount of bank loans outstanding<sup>1</sup>. Unlike the U.S, where corporations face positive incentives, as from equity and debt capital providers, to increase the transparency of their businesses and to grow the enterprise value and shareholder returns, Japanese corporations are incentivized to cultivate their relationships with their “main banks”. A typical Japanese company will deposit and transact the majority of its cash management at its main bank and, in return, the bank provides loans and necessary financing. When the corporation might face financial difficulty, those “main banks” were expected to provide the necessary support.

Often the “main bank” employees were seconded to client corporations to monitor and intervene in their businesses. Banks were also protected by the government. The Ministry of Finance used the so called “Convoy System” for regulating the banking industries by setting interest rates, transaction fees and even service hours to eliminate competition, and did not allow a single banking bankruptcy. The relationship between a company and its bank was cemented by each owning some of the other’s equity. At one point, banks owned almost 21% of the Tokyo stock market.

This cross-shareholding mechanism was also extensively practiced among Japanese corporations, separate from their banking relationships, especially within keiretsu groups of businesses that shared interlocking business relationships. These often derived from the vertically integrated Zaibatsu groups that operated through the end of World War II, created and controlled by dominant founding families, and their supply chain companies. These business



Source: Japan Exchange Group

corporation cross-ownerships of the Tokyo stock market reached 30.3% by the late 1980s. This was a way to sustain long term business relationships and prevent disturbance from outsiders, namely, unknown shareholders. It also created an information asymmetry in the capital markets that supported the insular corporate culture. As a result, Japanese managements could dismiss “investors” who had no business relationship with the company, yet demanded higher shareholder returns, as “greedy” short-term traders. Japanese media supported this view. Consistent with this, the notion of a hostile takeover was long culturally taboo and criticized as a manifestation of greedy, uncivilized egos.

<sup>1</sup> The U.S commercial banks total loans and lease is Y10.4 trillion as of January 2020. Federal Reserve Bank of St. Louis, Bloomberg

Moreover, Japanese management rarely owned shares of their own company. Rather, they were paid in salary, according to their positions and seniority instead of in relation to their skills or capabilities and achievements. Therefore, share price became irrelevant for them.

The lifetime employment, dominance of indirect financing, and extensively practiced cross-shareholding among Japanese corporations all contributed to the creation and longevity of the insular systems in Japan. Those 'insiders' worked closely for their own mutual benefit, and dismissed 'outsiders', those who were not part of the system. The system lacked any self-correction mechanism; all were in the same ship, yet no one on the ship was incentivized to act against the consensus, a certainly painful path even if that was the right path. As a result, the system became inefficient and even dysfunctional when the Japan credit bubble collapsed in 1989. It took the country over 15 years to clean it up.



### ***How the System Failed, and the Slow Beginnings of Its Rehabilitation***

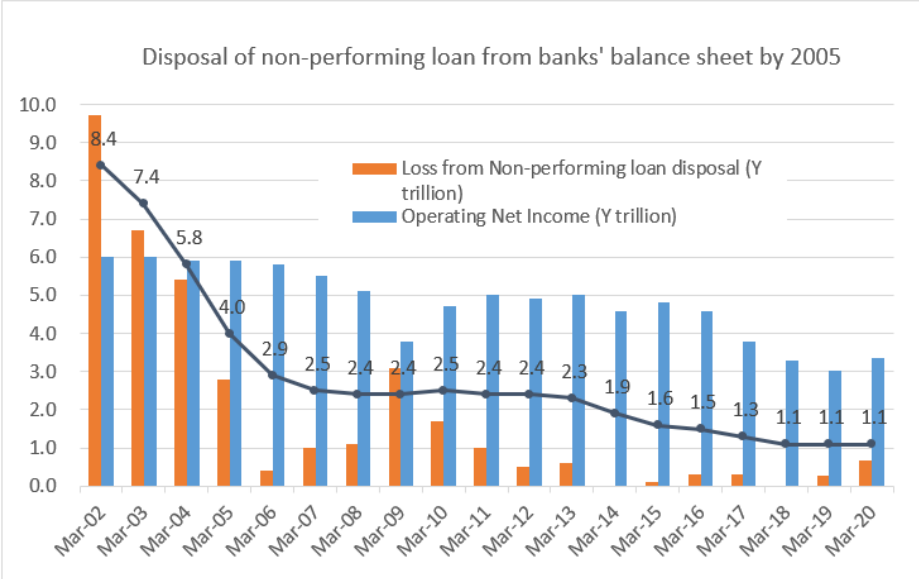
This system all worked well while the economy was expanding. Japan generated remarkable real GDP growth, at about 10% annually, during the high growth period from the mid-1950s to the early 1970s. The growth rate remained around 4.5% during the 1980s. The growth period came to an end after the Japanese credit bubble burst in 1989. This was a classic asset bubble created by loose monetary policy. The BOJ cut interest rates from 5% to 2.5% during the last four years of the bubble period, in an effort to combat the negative economic impact caused by the sharp appreciation of the JPY against the USD, which resulted from the Plaza Accord in September 1985. The bubble collapse significantly impaired the balance sheets of banks and corporations, which had expanded their investments in land and stocks, including cross-shareholdings. Economic growth thereafter declined to the 1% level in the early 1990s. However, this closed, stringent system lacked the flexibility to cope with that change.

It was after the first post-war bankruptcy of an insurance company and a securities firm in 1997, followed by the bankruptcies of large banks such as The Long-Term Credit Bank of Japan (now Shinsei Bank) and The Nippon Credit Bank (now Aozora Bank) in 1998, that the Japanese government finally recognized that the non-performing loans left from the 1980s credit bubble would not disappear without intervention and were causing serious social and economic damage. The government injected about Y7.5 trillion (\$63.6 billion) of public funds into 15 large banks in 1999.

Yet, even this was insufficient. Banks, afraid of being blamed for the mismanagement and of the possibility of government control, continued to avoid disclosing the actual level of non-performing loans. This, though, became increasingly difficult to hide, and in 1997, consolidated accounting reporting effectively became mandated, and Japanese corporations were forced to disclose their subsidiaries' assets and liabilities.

In 1998, the Ministry of Finance, which had long protected the banks from failure, spun off its monitoring division, which in 2000 was established as an independent financial regulatory agency, the Financial Service Agency (FSA), analogous to the U.S. SEC. In 2001, mark-to-market valuation accounting was mandated for the investments held on corporate balance sheets, and in 2002, this was also applied to cross-shareholding securities that were not categorized as subsidiaries or equity-method affiliates.

These changes obliged corporations and banks to disclose to the public the true value of their business investments and balance sheets, which had long been hidden among insiders, including their main banks. These regulatory and accounting changes set the stage for Prime Minister Koizumi’s “Financial Revitalization Program.” Launched in 2002, this was aimed to clean up banks’ non-



Source: FSA

performing loans, for the Japanese financial system to regain the trust of their investors. It targeted a lower non-performing loan ratio, to below 4%, prepared the public fund financing scheme<sup>2</sup>, and ensured support from the Bank of Japan to avoid systemic risk. During this period, dozens of large banks merged for survival, ultimately consolidating into today’s three mega banks, Mitsubishi UFJ Financial Group, Mitsui Sumitomo Financial Group, and Mizuho Financial Group<sup>3</sup>. In 2003, the largest regional bank, Resona Bank, accepted public funds and was practically nationalized<sup>4</sup>.

This was the turning point for Japan. This structural reform was painful yet necessary. Corporations, including financial institutions, were facing a significant economic downturn in the aftermath of the September 11 terror attacks and collapse of the dot.com bubble in the U.S. Japan’s export-oriented economy was highly correlated to global economic growth and liquidity. The deterioration in corporate earnings placed further pressure on Banks’s balance sheets, which were in the process of eliminating decades of old non-performing loans (NPLs). For the fiscal year ending March 2002, the Tokyo exchange-

<sup>2</sup> Under the “Financial Revitalization Program”, the government set up guidelines to utilize The Resolution and Collection Corporation and set up The Industrial Revitalization Corporation of Japan to inject necessary liquidity to support corporates and absorb NPLs from banks’ balance sheet. The Industrial Revitalization Corporation was dissolved in 2007 after completing its mission.

<sup>3</sup> Dai-ichi Kangyo Bank, Fuji Bank, and Industrial Bank of Japan merged to form Mizuho Financial Group, Sakura Bank and Sumitomo Bank merged to form Mitsui Sumitomo Financial Group, and Sanwa Bank, Tokai Bank and Toyo Trust Bank merged to form UFJ Holdings, which was subsequently merged with Mitsubishi Tokyo Financial Group that was formed from a merger of Tokyo Mitsubishi Bank, Mitsubishi Trust Bank and Nippon Trust Bank, to establish Mitsubishi UFJ Financial Group.

<sup>4</sup> Resona Bank accepted about Y2 trillion (USD 18.7 billion) from Deposit Insurance Corporation of Japan in exchange with preferred stock and common stock.



listed companies, in aggregate, posted a net earnings loss. In 2002 and 2003, the unemployment rate reached 5.5%, almost doubling the normal post-war level. Japan finally cleaned up most of the NPLs and zombie companies that had been hidden in banks' balance sheets, and resumed the economic recovery with a renewed system that had better transparency and sound relationships between banks and corporations.

As seen in an earlier chart of the market ownership structure of Tokyo Stock Exchange listed companies, banks' holdings of publicly traded stocks came down from around 15% of the market's share base to just 5% in 2005, and was further reduced to 2.9% as of 2019. At the same time, the ownership of Tokyo Stock Exchange companies by foreign investors had doubled from 13% to 26%, to surpass the domestic corporate cross-shareholding and group ownership level of 21%. Consequently, the Japanese equity market was finally beginning to open up, and the number of hostile take-over cases began ticking up in 2006 and 2007.

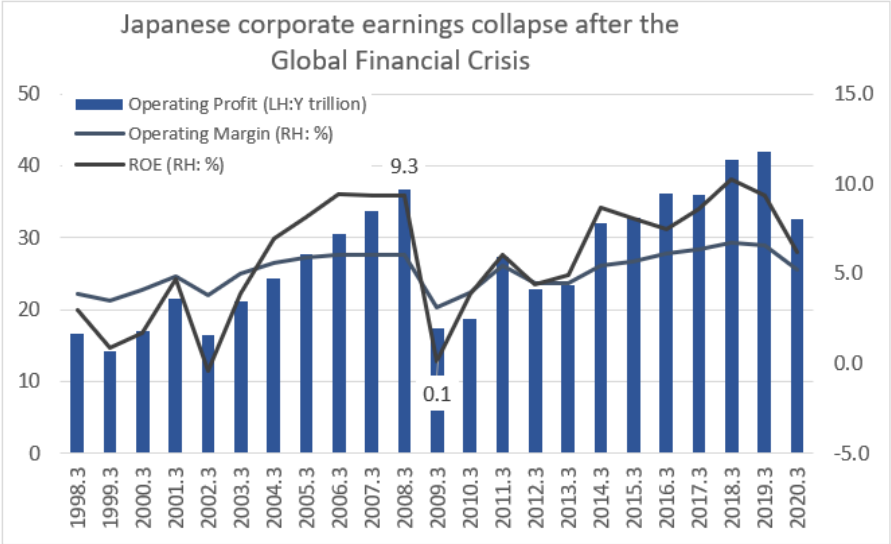
However, many of these take-over bids failed, because shareholders rarely voted for the bidder. After all, Japanese corporations owned more than half of the market in 2007: Japanese financial institutions, including banks, Trust banks and insurance companies, owned about 30% of the market, and non-financial Japanese corporates owned over 21%. Moreover, companies hastily adopted takeover defense measures to protect themselves. The number of companies that adopted takeover defense measures surged from about 100 as of June 2005 to 567 by 2008, reaching about 24% of listed companies<sup>5</sup>.



**Part 3: The Making of a Generational Opportunity**

During the 30 years following the collapse of its credit bubble in 1989, Japan spent the first 15 years working on non-performing loans disposals. When the corporate sector finally started recovering, it then suffered the successive effects of the 2008 global financial crisis and the 2011 Great East Japan Earthquake.

Companies that had historically depended on bank loans for corporate financing had hardly



Source: Japan Exchange Group

<sup>5</sup> Daiwa Institute of Research Holding Ltd, MARR Online (RECOF Corp)

learned to communicate with and utilize the capital markets. They underinvested and failed to create a more vibrant industrial presence that would be competitive and dominant in the global market. Meanwhile, Japan lost its competitive superiority in many global industries it had once dominated, such as consumer electronics, automobile manufacture, and semiconductors, to global competitors from South Korea, China, and Taiwan. There was a demographic shift, as well. The population peaked at 128 million in 2010, and the population's aging was accelerating. The historical corporate priorities of maintaining employment and nurturing long-term relationships with their banks and business partners, instead of seeking profitability and return on investment, had to change.

*In 2013*, to tackle the challenges of declining national power and competitiveness, Prime Minister Abe launched his "Growth Strategy", popularly known as Abenomics. Abenomics called for regulatory reforms aiming to raise corporate productivity and profitability, toward revitalizing the Japanese economy. He stated that this was the critical moment for Japanese businesses to focus on their core competencies through restructuring, so as to bolster earnings power and international competitiveness.

This was also the first time that the government recognized the equity market as an important part of the economy. Abenomics introduced a series of new regulations, legislation, and rules to change the mindset and behavior of Japanese publicly listed companies toward achieving sustainable growth and maximizing corporate value. An essential element was to install a functional capital market to replace the 'main bank' system.

A part of that system were Japanese institutional investors, such as banks, trust banks and insurance companies, which historically had acted as passive investors and which had rarely voted against company managements' proposals, because they had long term business relationships with investee companies, such as managing their insurance policies or corporate retirement accounts.

*In 2014*, the FSA introduced the Stewardship Code to combat this clear conflict of interest, and made the financial institutions and managements accountable for their investments and voting choices.

Specifically, the Stewardship Code required Japanese institutional investors to start a dialogue with their investee companies on the topics of improving their returns on equity and shareholders' returns. Japanese financial institutions now had to disclose their voting decisions, along with explanations of those decisions, and had become accountable to vote for the benefit of shareholders. They were also required to disclose their own evaluations on how they had fulfilled their responsibilities under the Stewardship Code. As of December 2020, over 290 financial institutions implemented this code<sup>6</sup>.

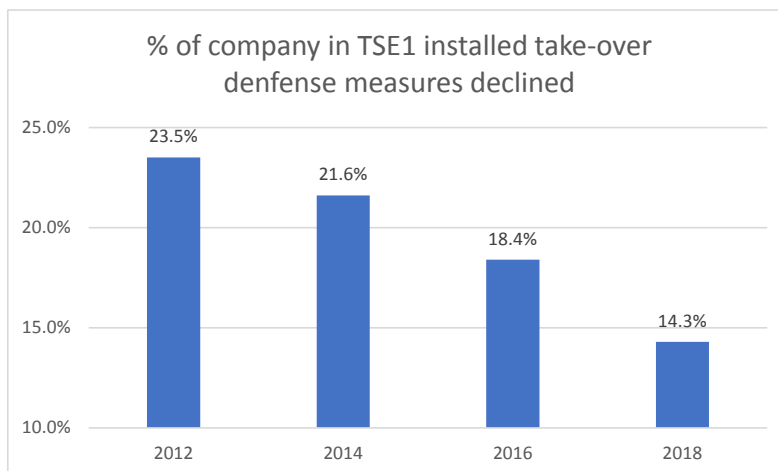
Nippon Life, for example, Japan's largest insurance company, posted detailed reports on its dialogue with investee companies and their voting results on their website. According to their report of the June 2020 round of shareholder meetings, Nippon Life voted against the re-election of directors on 51 out of 271 proposals, or about 19% of those companies about which Nippon Life had significant

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<sup>6</sup> FSA

concerns with respect to earnings performance, shareholder returns, or the quality of independent directors. Japanese financial institutions are no longer passive investors.

For the June 2018 round of shareholder meetings, Japanese institutional investors voted against 80% of the companies' proposals to reinstall take-over defense measures. The number of companies adopting take-over defense measures declined significantly<sup>7</sup>. This was inconceivable before the Stewardship Code was introduced.



In 2020, Institutional Shareholder Services (ISS) proposed to vote against the election of executives if a company allocates 20% or more of its net assets to cross-shareholdings or if less than one-third of the board is composed of outside directors. Such third-party proposals, which were irrelevant for Japanese institutional investors in the past, are becoming increasingly important. The concept of fiduciary duty has been installed. Consequently, Japanese corporations, previously accustomed to being monitored by their main banks – which were, essentially, insiders – now had to disclose and explain their business strategies, capital allocation decisions and, most importantly, their governance structure to investors.

*In 2015*, the FSA, in concert with the Tokyo Stock exchange, introduced the Corporate Governance Code. This required Japanese corporations to engage in constructive dialogues with investors and shareholders regarding corporate value and their strategy to improve profitability and capital efficiency. It also required companies to have at least two outside directors, and to explain the status and their future intentions on cross-shareholdings.

The Corporate Governance Code specifically highlighted two aspects of the governance issue on the Parent-Subsidiary listing structure, a custom long embraced in Japan and nearly impossible to dismantle. One is effectiveness of capital allocation and group business strategy, and the second is its potential conflict of interest to the disadvantage of minority shareholders.

As insiders, parent companies have far more information than outside investors, and ways to utilize subsidiaries' assets for their own benefit. Until the 2014 corporate law legislation, a Group's strategic decisions and transactions were rarely disclosed. Under the legislation, group companies were required to disclose their related party transactions, and parent companies' managements could no longer be counted as 'outside' directors of subsidiaries.

<sup>7</sup> Tokyo Stock Exchange

This Parent-Subsidiary listing structure was often born out of parent companies giving opportunities for the subsidiaries to be independent and to make efficient decisions. The status of ‘public’ companies themselves enjoyed exceptional trust in Japanese society; parents were keen to have their sons and daughters work for such ‘publicly listed’ companies, so as to secure their near-guaranteed income and promotion path for the rest of their working lives. The parent companies often used their subsidiaries to transfer their senior employees to high-ranking positions as a fulfilment of the promised titles and salaries.

The Corporate Governance code raised cross-shareholdings as another business custom that had become an obstacle to improved capital efficiency. These regulations required companies to disclose a list of their cross-share ownerships, along with a reason for each holding, an explanation of the legitimacy of those holdings based on their cost of capital, and a statement of their strategy to lower their ownership levels in these investees. Cross-shareholdings and Parent-Child listings were no longer embraced, but were becoming a shortcoming that companies would have to defend in their mandated dialogues with investors.

Every 3 years, the FSA and Tokyo Stock Exchange, along with a working group comprised of asset managers, corporate management, professors and lawyers, review and revise the Stewardship and Corporate Governance codes. They use a ‘comply or explain’ approach, the practice widely used in European countries, instead of legally binding corporate and institutional investors to follow the rules. This has contributed to the efficient and smooth adoption of new rules and increased transparency by requiring companies to explain when they do not comply.

Five years ago, an attempt to revise corporate laws to mandate that companies have at least one outside director failed due to strong opposition. However, today over 95% of the TSE 1<sup>st</sup> Section of listed companies (which form the constituents of TOPIX, the Tokyo Stock Price Index), have more than two independent outside directors. The number was just over 21% in 2014. Moreover, close to 60% of them have boards with more than one third independent outside directors, which increased from just 6.4% in 2014. This year, the corporate laws mandating at least one outside corporate director became effective in March. Surprisingly, some Japanese institutional investors now demand a higher standard, stating their voting policy to vote against director elections when outside directors constitute less than one third of director seats.

In 2017, “Group Governance System Guidelines” created by the Ministry of Economy, Trade and Industry (METI) added further pressure to review and reorganize parent-child group listing structures. To incentivize corporate reorganization, METI introduced Tax-Free Spin-Off legislation. This allows companies to separate group subsidiaries that were held for the previously discussed historical reasons rather than for business merit, enabling them to focus on their core competencies without significant tax consequences. METI stated that without their artificial group constraints, independently managed companies would be able to make more efficient business and capital allocation decisions, increasing the corporate values of both the parent and spin-off companies.

In February 2020, perhaps the most substantive and market-impacting change was announced. The Tokyo Stock Exchange revised its listing structure into three major listing categories: Primary, Standard and Growth, where Primary is the most prestigious section and replaces the TSE 1<sup>st</sup> Section. There are about 2,200 companies on the TSE 1<sup>st</sup> Section, which is what comprises the TOPIX Index constituents. In order to remain listed in the Primary section, companies will be required to have a minimum publicly traded share float of 35%. The message is clear; no one group of shareholders should own two thirds of the voting power of public companies.

Here, too, they are required to comply rather than explain the reason for not complying with the corporate governance code, and to maintain an active dialogue with shareholders on shareholder returns and on profitability based on their cost of capital.

Additionally, the TSE set a minimum share-float ratio of 25% in order to be publicly listed at all. A further important change was made to the definition of the publicly traded float: any cross-shareholdings that are under 10% of the total share count are no longer counted as float share, and any strategic investment by financial institutions will also be categorized as non-floating shares. This should further incentivize corporates to unwind cross-shareholdings.

In the Spring of 2021, the FSA is scheduled to announce a revision of the Corporate Governance Code. According to their discussion paper, the key revisions will likely come on the issue of cross-shareholding and the Parent-Child listing structure, requiring further transparency and measures to install the independence of subsidiaries. The Corporate governance code effectively works as a guideline for investors and publicly listed companies. Publicly listed companies are required to disclose and explain their compliance with the Corporate Governance Code. Investors are accountable to assess investee companies' compliance with the governance code and to vote accordingly. The costs and operational burdens for keeping those old structures are rising.

June 2021 has been set as a reference date for the TSE listing reorganization.

January 2022 will be when, following a period during which the TSE will communicate with listed companies on the selection of listing categories, the final decision on the listing category for each company will be announced. Moreover, the TSE will also change the TOPIX Index calculations and membership. New members will be selected only from the Primary listed companies, and those exiting constituents that do not meet certain liquidity requirements will gradually be cut from a weighting in the Index.

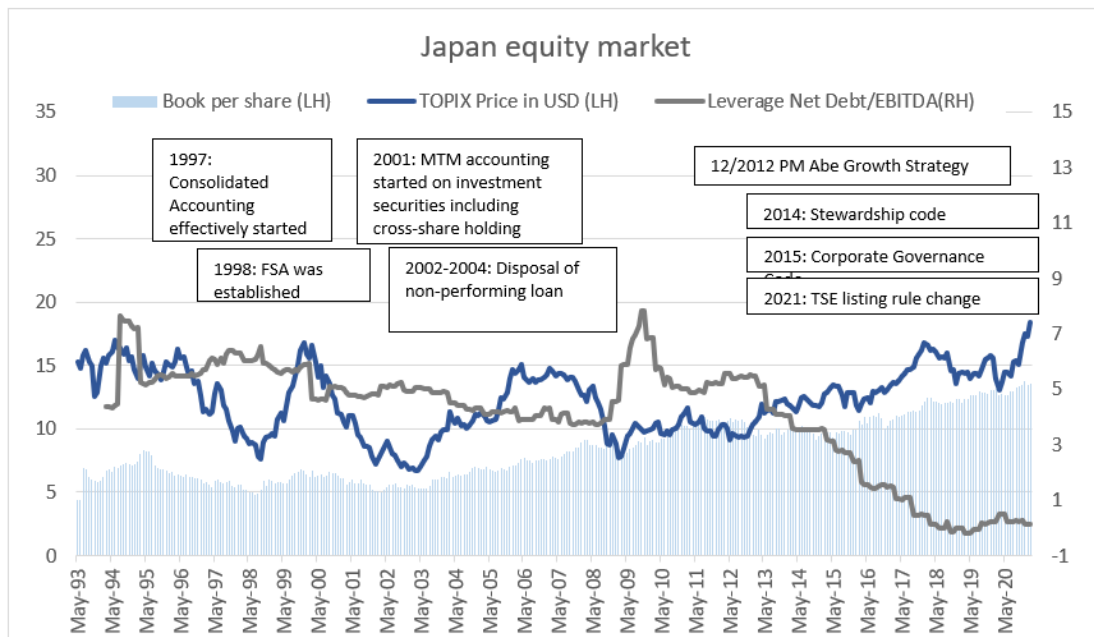
April 2022 will be the effective date for this reorganization of listing categories. Companies that are willing to implement measures to meet the new requirements will be granted a one-year adjustment period.

In Japan, the concepts of corporate governance, corporate control, fiduciary duty, maximizing corporate values, and shareholder return that have been the premise of a healthy capital market in the Western world did not exist. The Japanese government, in a graduated but forceful manner, brought them into

play and existence in order to end the inefficient systems that ultimately became dysfunctional and a burden that impeded economic recovery and corporate growth.

The TOPIX is only now re-attaining the level at which it peaked in 1989, over 30 years ago, yet the composite book value of those companies has more than doubled.

Corporate leverage has been reduced so dramatically – to a debt-to-EBITDA ratio of just 0.14x, as of February 2020 – that the term leverage doesn’t really apply. Really, the Japanese market, at least on a global comparative basis, is underleveraged. Likewise, corporate profit margins and return on equity have improved over the last decade.



Source: Bloomberg, FSA, METI, Horizon Kinetics

The presence of foreign investors is becoming more important. Foreign ownership of the Tokyo Exchange market expanded from a mere 4% at the end of 1989, to about 30% today, and foreign investors represent 70% of the exchange trading flow. Corporate restructuring and successful take-over bids by activists are rising and, most importantly, hostile take-overs among Japanese corporations are emerging. Fundamentally and structurally, the Japanese equity market overall is opening up. In the process, it is offering a value investment opportunity that was rarely sought in Japan in the past, since the market overall was considered a “value trap”.

That’s a description of the overall market. But that is not the topic or interest of this paper or strategy, except insofar as it has enabled this strategy – and the special sub-set of companies that comprise it – to exist.



## Part 4: Japan Special Opportunity Strategy

The Parent-Child listing structure and non-accountable corporate governance regime have been highlighted by the FSA and METI as major obstacles to Japan's achieving higher profitability and economic growth. However, there has been negligible progress to date on the former issue: there were 629 companies with majority owners in 2014, and 628 in 2018. This phenomenon is unique to Japan, among developed world markets. The U.S., France and Germany each have fewer than 30 listed companies that are majority owned by other publicly listed companies<sup>8</sup>.

However, the recently mandated regulations and deadlines are about to force the changes that the regulators have envisioned. Within this universe of over 600 publicly traded companies with majority owners are a range of truly unique investment opportunities. The subset within that universe that is attractive is sufficiently large to create an industry-diversified portfolio of deeply undervalued companies that are particularly likely to experience a value-realization event within a regulation-enforced two-year investment horizon.

Publicly traded subsidiaries that are over 75%-owned by their parent and its group companies are no longer qualified to maintain a Tokyo exchange listing status. For those subsidiaries listed in the TSE 1<sup>st</sup> Section – now to be known as the Primary section – the parent and group company ownership ratio has to be lower than 65% in order to remain in that section. That Primary listing is coveted; it means membership in the TOPIX and other indexes, which has implications for both corporate prestige and share valuation and cost of capital. Parent companies must now make a decision as to whether to spin off such a subsidiary or to acquire the minority interest that they don't own.

With the new focus on – and mechanisms to enforce – transparency, any acquisitions will have to reflect a public market clearing price. While that clearing price may justifiably be anticipated to occur at valuation premiums, it is not atypical for such subsidiaries to presently trade at deep discount-to-market valuations: below book value or at single-digit multiples of earnings.

There is a further market clearing-price factor at work: activist shareholders and hostile takeovers. While this is a phenomenon that barely existed historically, it is now increasingly present. Some activist investors, domestic and abroad, have already taken advantage of this structural opportunity, and have proven that parent companies were in fact at risk of losing control of key subsidiaries by keeping them listed. This time around, the re-emergence of shareholder activism has been received constructively by the target companies, as well as the general public. The cultural shift can also be observed in the domestic emergence of unsolicited takeover bids from Japanese companies.

- On October 2nd 2020, DCM Holdings (3050 JP) announced the acquisition of Shimachu Co (8184 JP) at Y4200 per share, which was a 42.6% premium to the prior 3 month average trading price. Four weeks later, Nitori Holdings Co (9843 JP) surprised the market by announcing a hostile counter-takeover bid, outbidding Shimachu with a price of Y5500 per share, a 31% premium to

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<sup>8</sup> METI "Group Governance Guideline": the U.S. has 28, 0 for the U.K, 18 for France, and 17 for Germany as of December 2018.

DCM Holdings offering price. As a result, DCM Holdings, which had a merger agreement in place with Shimachu, was forced to terminate the transaction, and Nitori Holdings succeeded in acquiring Shimachu. This was one of the first bidding wars by Japanese corporations where the price determined the winner, rather than management's agreement or preference.

- In the case of Idemitsu Kosan (5019 JP), the company failed in its December 2020 attempt to acquire 100% of its already 50.1%-owned subsidiary, Toa Oil (5008 JP), because one fund in the U.S accumulated an over 30% ownership interest during the parent's take-over period. Idemitsu Kosan's offering price was a 39% premium to Toa Oil's 3-month average trading price; yet, the shares traded higher than the offering price, as the U.S. fund continued accumulating shares in the market.

This class of subsidiaries often trades at a significant discount to like-industry peers. The majority ownership by their parent companies contributes to their lower trading liquidity and, of course, prevents the option of an unwanted acquisition, so there cannot be the type of takeover premium that might ordinarily exist. Their much smaller business size relative to the parent group companies, and of course the limited float, leave these subsidiaries hidden from index-based and global investors seeking a Japan allocation.

They are even hidden from sector analysts searching for competitive global companies: more often than not, these subsidiaries have significant net cash on the balance sheet; yet, the cash balance is not readily seen in typical data-base searches, because much of it is typically loaned to the parent company, which manages a cash pool within the group of subsidiaries. It might be startling to an American investor, but large Japanese corporations might have several hundred subsidiaries, though only a few would be publicly traded. Again, these subsidiaries were not listed to appeal to and take advantage of the capital market; rather, once public, they are managed in such a way as to avoid any dilution of the parents' ownership.

The Horizon Kinetics Japan Special Opportunity Strategy invests in those subsidiaries that own important assets and operating business for the group companies that the parent is likely acquire rather than divest. In these instances, the acquisition would streamline the parent company's operations and eliminate redundant costs (the subsidiary and parent each own separate, but largely duplicative, administrative divisions and operating units), and improve the value of their core business.

Many of these subsidiaries are the owners of some of their group's key raw or intermediate materials or operating assets, or provide important products and services to the parent companies. The two are both customers and suppliers to one another. They often conduct the exact same business and work together for their clients. One could easily invest in a parent company without knowing that important products and services are in fact owned and managed by their listed subsidiaries.

The Japan Special Opportunity Strategy portfolio is expected to own 20-30 companies that trade at low valuations and exhibit relatively stable earnings fundamentals. On a consolidated basis, the current portfolio companies have no debt leverage (the average balance sheet is in a net cash position). The industry sector diversification presently ranges from 15%-25% each, across Communication Service, Consumer Staple and Discretionary, Industrials, Information Technology, and Materials.



As an example of the differential valuations that are manifested in this separate equity class within the Japanese market, one could find an IT systems integrator trading below 1x price to sales, and at 4x cash flow, yet with a double digit ROE and an over 3% dividend yield. By comparison, the TOPIX Information and Communication sector group trades at 1.8x sales, 9.7x cash flow, and at a 1.8% dividend yield. One can find a chemical company that sells critical energy resources and materials to its parent company and has net cash on the balance sheet, yet which trades at 0.7x book value, 5x cash flow, and a 2.6% dividend yield.

Another dimension to the likelihood of a going-private transaction with a parent company is that the business size and market capitalization of these subsidiaries are generally less than half those of the parent companies, and they can be as small as 1/50<sup>th</sup> of the parent's market cap. Therefore, in many cases, the acquisition of the public minority interest does not require a large cash outlay by the parent company.

In 2020, the Japan Special Opportunity Strategy portfolio invested in three subsidiaries that were subsequently acquired by their parent companies. On average, the parent companies paid a 38% premium to the previous 3-month average trading price. One of these subsidiaries, which traded at 0.5x book value, was taken over at 0.8x book value. Despite the 60% value realization, one might judge the below-book-value price –which is to say lack of a true premium – as justified by the company's business deterioration amid the Covid-19 pandemic last year. In the past, parent companies did not have to pay a premium simply because competitive bidding did not exist and shareholders honored and accepted the group's decision. In this instance, there was a legitimate market-pricing element to the valuation. The operation of market forces is only likely to manifest itself more strongly, as the Japanese capital market has already started to see increasing numbers of hostile takeovers, counter takeover bidding, and activist funds demanding higher acquisition premiums. As well, very much unlike the past, the Japanese media is encouraging these healthy and normal competitive activities in the capital market.

The low valuations and unleveraged balance sheets of these companies provide a degree of risk protection not available in other developed markets. Moreover, in an environment in which parent companies are incentivized to take action within a diminishing regulatory window of time, there is likely to be an ever firmer floor as a counterforce against any further valuation discount. That makes them classic Graham value investments with high-return, low-risk possibilities and also, being so idiosyncratic, makes them uncorrelated with other asset classes. This very specific investment universe – in the unique regulatory historical basis for its creation and, therefrom, in the unique regulatory basis for its dissolution – is not correlated to the global macro economy or sector-specific trends, and not even to the Japanese economy and sector-specific trends – and is uniquely available only in Japan, with a limited investment period.





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