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[1].

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 1st 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

[1] *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.*

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 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 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 1/50th 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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