

Japan's Corporate Governance Updates: 2022-2023

Japan Catalyst Inc. (JCI) employs an engagement investment strategy towards Japanese companies through the Japan Catalyst Fund (Cayman domiciled, launched in 2021) and the Monex Activist Mother Fund (Japan domiciled, launched in 2020), for which JCI provides investment advice.

We strongly believe that improving corporate strategy and corporate governance of Japanese listed companies will be a crucial factor in revitalizing the Japanese economy. Through our engagement strategy, we have actively sought to improve the corporate strategy of Japanese companies, as demonstrated by our investments in JAFCO and SEPTENI. As we begin 2023, we are pleased to present our latest report detailing the key developments in Japan's corporate governance landscape for 2022 and providing an outlook for 2023. Our report also highlights a specific engagement theme that we believe holds great potential for the Japanese capital markets and our investment strategy in 2023.

Key Takeaways

- Rising shareholder activism and governance reforms in Japan are exerting unprecedented pressure on companies to improve capital efficiency and enhance corporate value, providing ample opportunities for engagement strategies.
- In 2023, the Tokyo Stock Exchange plans to further strengthen its reforms, with a specific emphasis on addressing capital inefficiencies and increasing market capitalization per company.
- Misallocation of resources, rather than an absence of resources, is a significant factor in the low productivity of Japanese firms. The “reallocation of production factors” with the aim of enhancing capital productivity and corporate value will be a central theme in the Japanese markets and for our engagement strategy in 2023 and beyond.

Overview

- **Growing Momentum for Activism:** Shareholder activism has continued to gather momentum in Japan as corporate governance reforms progress further. A series of developments in the governance and stewardship regime led by The Tokyo Stock Exchange (TSE) through 2021-2022 have shed light on inefficiently managed companies and have begun to shift the mindset and behavior of not only corporate leaders, but also domestic institutional investors, to be more proactive in advocating for improved governance practices.
- **Further Governance Reforms Ahead:** The TSE is posed to further strengthen its reforms in 2023. Following the rollout of its new market structure in April 2022, the TSE formed a “follow-up council” of experts, in which Oki Matsumoto is one of nine members, to discuss additional measures that can fundamentally enhance the mid/long-term corporate value of listed companies. With half of the companies trading at a price-to-book ratio below 1, the primary focus of Japanese regulators is to address capital inefficiencies and improve financial indicators such as PBR and ROE - companies that persistently generate low returns on capital and trade low PBR multiples will come under increasing scrutiny.

Overview

- **Greater Opportunities for Engagement:** As shareholder activism becomes more prevalent and governance reforms continue to make substantial progress, Japanese top management are facing unprecedented pressure from shareholders and regulators to improve capital efficiency and enhance shareholder value. This trend has created more opportunities for engagement strategies, as there are still relatively few companies that have a CEO or outside directors with strong expertise in finance and capital markets. Many corporate leaders are in great need of the assistance of a trusted partner in moving away from legacy models with lazy balance sheets and transforming their business and capital structure. Indeed, we have been approached by several CEOs and directors seeking our strategic advice on their capital policy through recommendations from CEOs of our core holdings.
- **Enhancing Productivity and Corporate Value through Resource Realignment:** With many Japanese industries experiencing a 30-year high corporate margin, we see an abundance of companies that have competitive operations, ample resources, and upward growth potential, yet whose stock is undervalued due to various factors, including inefficient capital structure and suboptimal business portfolio. While Japan's low economic growth is often attributed to the low labor productivity of Japanese companies, we often observe exceptional productivity in core businesses or on the front line. In our view, the productivity of Japanese companies lags behind that of other developed peers, owing to a misallocation of resources, rather than an absence of resources. Therefore, by effectively reallocating or consolidating misplaced production factors, including goods, capital, and human resources, among companies, their capital efficiency and productivity will be improved, thus enhancing Japanese firms' corporate value and competitiveness. With the Japanese authorities also recognizing this issue, we believe that this concept of the "reallocation of production factors" between Japanese companies, as well as between Japanese and overseas companies, will be a vital theme in the Japanese capital markets and for our engagement strategy for the current and upcoming years.
- **As a Domestic Constructivist:** Our strategy is to actively engage with companies that have a solid and competitive core business but suffer from adequate governance, and are willing or prepared to undergo change. We aim to lead the transformation of our target companies through constructive dialogue. Since our launch, leveraging Oki Matsumoto's unparalleled network and the team's distinguished financial expertise, we have unlocked engagement opportunities that no other player has ever been able to. On January 4th, 2023, Oki Matsumoto stepped down as Chairman of Monex, Inc, a core subsidiary of Monex Group, with the sole intention of focusing more on his engagement activities with listed companies as Chairman of Japan Catalyst. With his increased dedication to engagement and our distinct positioning as a constructive domestic activist, we are confident that we will continue to uncover more actionable opportunities and unlock value for our portfolio companies throughout 2023.

Key Developments in Japan’s Corporate Governance

Market Restructuring by the Tokyo Stock Exchange

➤ **Stricter listing criteria implemented:** With the aim of enhancing the attractiveness of its primary market, the TSE introduced a new market structure in April 2022, under which firms listed on its new top-tier “Prime Market” are required to meet higher liquidity standards and adhere to the 83 principles of corporate governance code. The new framework expects prime listed companies to have higher standards of governance and a commitment to medium/long-term corporate value creation with a focus on constructive dialogue with global investors. With the implementation of more stringent listing rules, 1,837 companies, comprising 84% of the former 1st section, have chosen to be listed on the Prime Market.

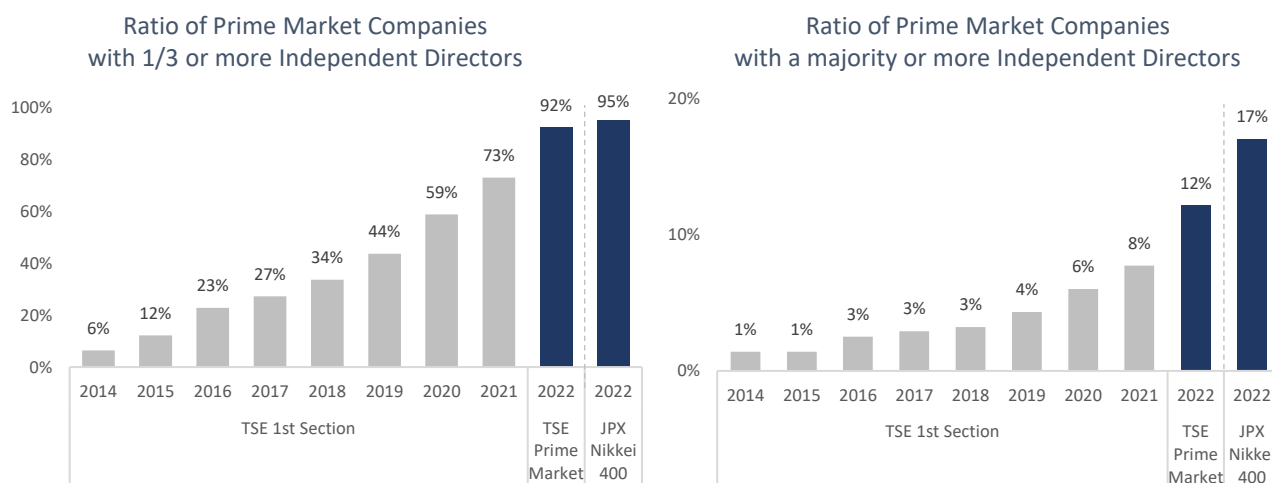
Highlights of TSE’s Market Restructuring

Agenda		Changes	Results
Simpler Market Segmentation		<ul style="list-style-type: none"> ✓ The stock market was restructured into three new market segments: Prime, Standard, and Growth 	<ul style="list-style-type: none"> ✓ 1,837 companies (84% of 1st section listed) selected Prime Market
Stricter Listing Criteria for Prime Market	Liquidity	<ul style="list-style-type: none"> ✓ No. of Shareholders: At least 800 ✓ Tradable Share Units: At least 20,000 units ✓ Tradable Share Market Cap: At least JPY 10 bn ✓ Trading Value: At least JPY 25 bn 	<ul style="list-style-type: none"> ✓ Median market cap of Prime Market: JPY 57.3 bn (as of July 2022)
	Governance	<ul style="list-style-type: none"> ✓ Fulfill the requirements of the Revised Corporate Governance Code ✓ A minimum of one-third independent board ✓ A minimum 35% of tradable shares ratio ✓ Disclose the rationale for cross-shareholdings 	<ul style="list-style-type: none"> ✓ 92% of Prime-listed companies appoint at least one-third of independent directors ✓ Cross-held shares worth JPY 2.3 trillion sold in FY 2021
	Business Performance	<ul style="list-style-type: none"> ✓ Total profit for 2 yrs at least JPY 2.5 bn ✓ Sales at least JPY 10 bn ✓ Market cap at least JPY 100 bn ✓ Financial Status at least JPY 5bn 	

Source: Tokyo Stock Exchange

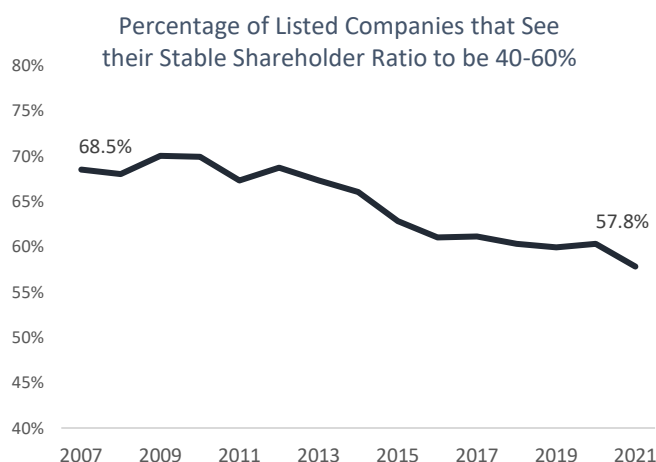
Governance Structures of Listed Companies

➤ **Board independence and diversity enhanced:** In response to TSE’s new listing standards, Japanese corporates have increased the independence and diversity of their boards. As of June 2022, 92% of prime companies have at least one-third of independent directors on the board, as compared to 73% in 2021, and 12% appoint a majority independent outside directors. In terms of gender diversity, 75% of Prime companies have at least one female director, compared to 52% in 2021, although the ratio of female directors among all directors remains at around 10%.



Source: Tokyo Stock Exchange, Japan Catalyst, Inc
 Note: As of June 2022

➤ **Dissolution of cross-shareholdings in progress:** Japanese firms have been gradually reducing their cross-shareholdings over the past decades, and as a result, the percentage of listed companies that perceive their “stable shareholder ratio” between 40-60% has been decreasing, although it still persists at around 60%. The implementation of the new TSE listing criteria mandating a minimum of 35% tradable shares ratio and the redefinition of “tradable shares” to exclude shares held by domestic banks, insurance companies, or business corporations, is believed to accelerate this trend of unwinding cross-shareholdings. The unloading of strategic holdings by Japanese companies has reached a new historical high of around JPY 2.3 trillion in the fiscal year ended March 2022 and is expected to continue in 2023.

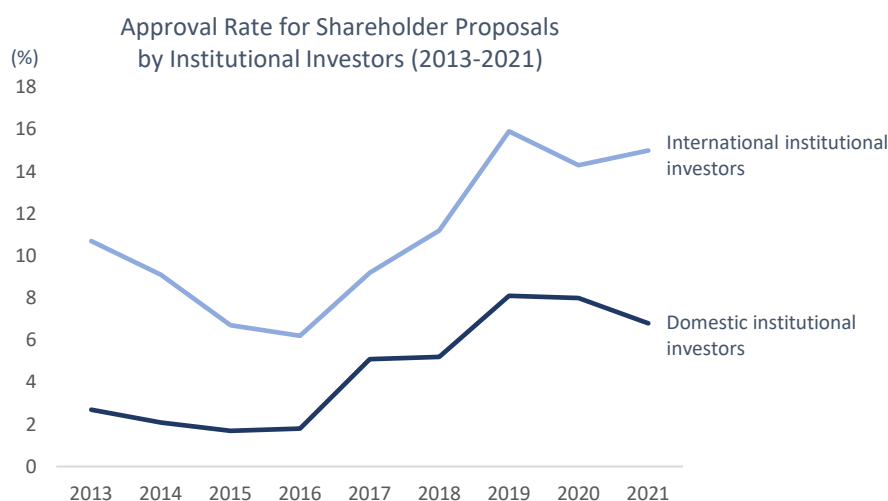


*Stable shareholder ratio = the percentage of shareholders the company subjectively views as stable

Source: Mizuho Securities Equity Research

Stewardship Practices of Investors

➤ **Stricter Voting Standards:** The 2017 revision of Stewardship Code, which mandates the disclosure of voting results and justifications, has led to a tightening of voting criteria by institutional investors and a shift in their voting behavior. In response to the TSE's market restructuring and the revised governance code, major asset managers and proxy advisory firms further updated their proxy voting guidelines to align with the new listing requirements in 2022. The criteria that were revised include the ratio of independent directors on the board, the level of cross-shareholdings, ESG integration, gender diversity and climate change. Notably, an increasing number of domestic asset managers are implementing more stringent voting rules for cross-shareholdings, which is anticipated to accelerate the trend of unwinding cross shareholdings prior to the 2023 AGM season.

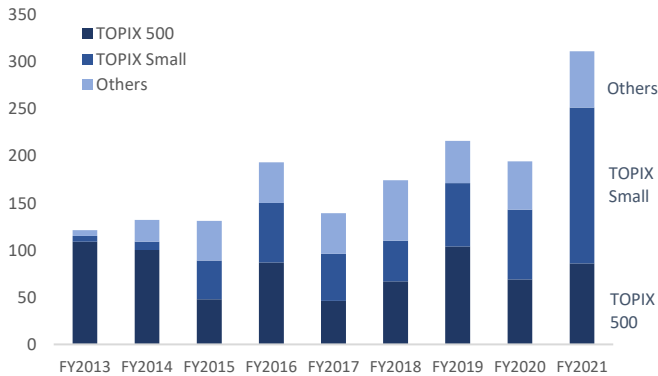


Source: Toyo Keizai

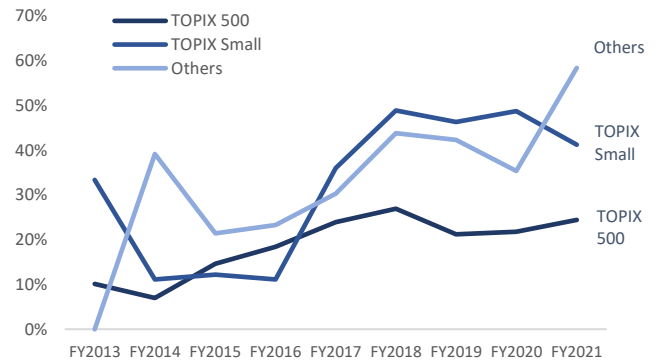
Note: Shareholder proposals submitted at the June AGMs in each year

➤ **Growing support for shareholder proposals:** With both domestic and global investors exhibiting ever-increasing level of activist activity, a record number of shareholder proposals were made in 2022: 292 proposals against 77 companies at the June AGMs, a year-on-year increase of 80% and 60%, respectively. As institutional investors' voting guidelines become increasingly stringent, these shareholder proposals garnered greater support than before. According to a survey by Nikko SMBC, proposals related to shareholder returns have seen particularly high approval rates, averaging 18.8% in 2022, a historical high. Despite this trend, the percentage of shareholder proposals for large-cap companies with over 20% support remains low at around 20%, with the average approval rate of only 10% in 2022, in contrast to management proposals which continue to receive over 95% approval. Growing support for shareholder proposals has placed more pressure on management than ever before, yet many companies continue to be protected by cross-shareholdings, making it difficult for activist investors to gain the necessary two-thirds or majority support for their proposals, particularly if the target board is unwilling to make changes.

Number of Shareholder Proposals (by Market Cap)



Percentage of Shareholder Proposals that received over 20% approval (by Market Cap)



Source: SMBC Nikko Securities

Note: Excludes shareholder proposals related to nuclear power plants. FY2021 covers the AGMs held between April 2021 to March 2022.

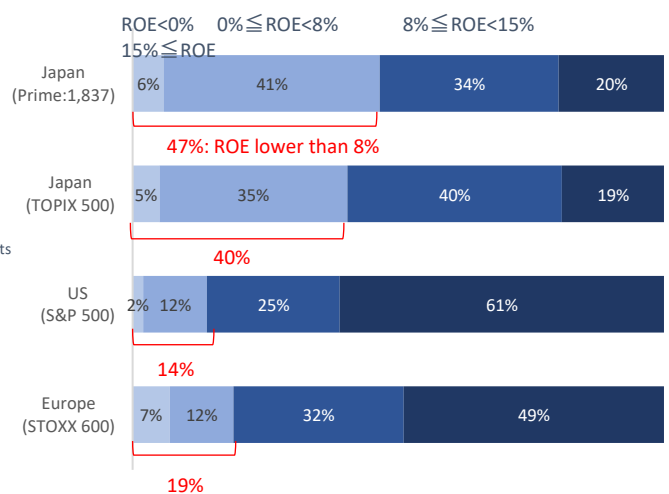
Reform Agenda for 2023

➤ **Improvements in formality but deeper changes needed:** While the TSEs' reforms have made progress in advancing governance structures and stewardship practices, the weak or absence of enforcement mechanism and incentives in their measures have left some fundamental issues unresolved. As of Dec 2022, out of the 1,837 companies listed on the Prime section, 269 do not meet the new listing criteria, but have been granted, under transitional measures, to remain prime-listed if they disclose their "action plans" to achieve the standards. This has drawn criticism from experts and investors as an end date for transitional measures or procedures for delisting have not been established. A further, broader issue is the low ROE and PBR multiples. Among 1,837 companies listed on Prime, roughly 50% trade at a PBR below 1x and an ROE less than 8%. Even among large-cap companies (TOPIX 500), approximately 40% exhibit the same level, falling behind their global counterparts.

PBR Distribution



ROE Distribution



Source: Tokyo Stock Exchange

Note: Compiled by TSE based on Bloomberg data as of July 1, 2022

- **Regulatory efforts to address capital inefficiency:** The TSE and the relevant authorities are poised to tackle long-standing issues related to capital efficiency and corporate value. Following the implementation of the new structure, the TSE formed a panel of experts, of which Oki Masumoto is a member, to discuss additional measures to enhance the effectiveness of their reforms. Over the past four weeks, the TSE held the fifth, sixth and seventh meetings, primarily focusing on how to incentivize Japanese companies to enhance capital efficiency and share value, as well as how to deal with underperforming firms. According to TSE records, the council has discussed that “*given the purpose of this market restructuring is to contribute to the improvement of corporate value of listed companies, it will be meaningless unless we address the fact that about half of all listed companies have a PBR below 1 and ROE below 8%*”. Based on a series of discussions, the TSE announced on January 30th, 2023 that the end date of transitional measures will be March 2025 and outlined specific initiatives to be implemented in 2023, such as requiring management and boards of directors to disclose plans for improving capital efficiency and profitability.

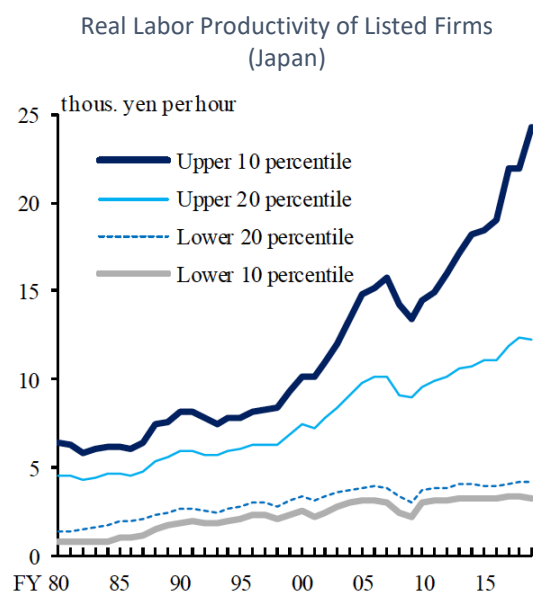
Outline of Future Actions Presented by TSE in Jan 2023

Agenda		Plans	Schedule
Transitional Measures		✓ Announce the end date of transitional measures (March 2025) and specific procedures for delisting	Implement promptly
To Enhance Long/mid-term Corporate Value	Capital Efficiency and Stock Price	✓ Require management and BoDs to properly identify the company’s cost of capital and capital efficiency and disclose policies and specific initiatives for improvement and their progress	Spring 2023
	“Quality” of Corporate Governance	✓ Re-emphasize the purpose of “Comply or Explain” principle and highlight inappropriate “Explain” cases ✓ Investigate the status of nomination committees and remuneration committees	Spring 2023 / Autumn 2023
	Disclosure in English	✓ Announce to mandate English disclosure for prime companies	Autumn 2023
	Dialogue with investors	✓ Require prime companies to disclose the status of dialogue with investors in their corporate governance reports	Spring 2023

Source: Tokyo Stock Exchange Explanatory Material on Jan 30, 2023

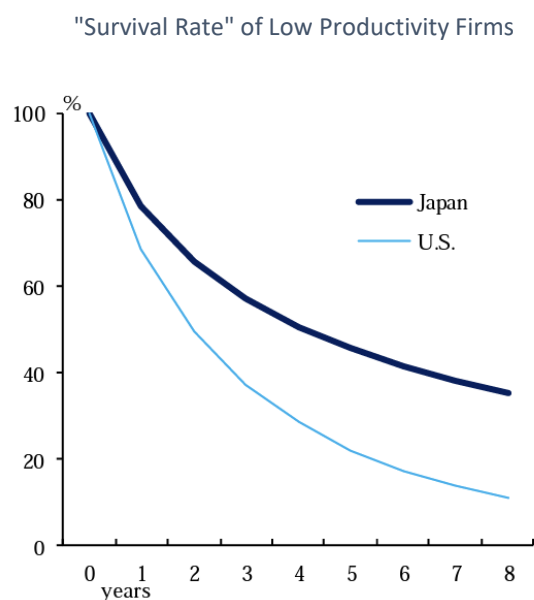
Key Engagement Theme

➤ **Boosting Productivity and Corporate Value through Strategic Resource Reallocation:** Japan's low labor productivity is a well-known factor contributing to its sluggish economic growth. In our view, the root cause of this productivity lag is not a scarcity of resources, but rather a misallocation of them. The highly developed nature of Japan's economy with a large number of long-established companies operating within a single industry or sector, such as manufacturing, has led to intense competition and a lack of consolidation. A survey by METI indicates that the market capitalization of the top five companies in each manufacturing sector as a percentage of the total market cap tends to be lower in Japan than in the US., where market size is significantly larger, indicating a need for restructuring. Furthermore, surveys by BOJ reveal that productivity disparities among Japanese firms have widened in recent years. The relatively low rate for low-productivity companies depresses Japan's average productivity. Therefore, by effectively reallocating resources including capital and human resources, from low-productivity firms to high-productivity firms, we believe that companies' capital efficiency and productivity can be significantly improved, thereby enhancing corporate value and competitiveness of Japanese firms. This will be a key focus of our engagement strategy in 2023 and beyond.



Source: Bank of Japan

Note: Real labor productivity is per hour worked



Source: Bank of Japan

Note: Low productivity firms = Lower 20 percentile

➤ **Advancing Effective Resource Reallocation through Constructive Engagement:** In alignment with this central theme, we will continue to engage with companies in a constructive manner to promote the efficient reallocation of resources, including capital and human resources, with the aim of enhancing capital efficiency. On January 4th, 2023, Oki Matsumoto resigned as Chairman of Monex Securities to devote even more time to engagement efforts as Chairman of Japan Catalyst. As a domestic constructive activist, we will continue to expand our efforts to engage in constructive dialogue with target companies and unlock value.

About Japan Catalyst

Japan Catalyst, Inc. was established as a part of Monex Group, Inc. with the goal of transforming the Japanese capital market and corporate sector. As the business environment rapidly evolves, there is a growing need for changes in corporate management, and companies are seeking to transform. By offering support through long-term investment and engagement, we aim to act as a catalyst for positive change in Japanese companies.

Company Website (English) <https://www.japancatalyst.com/index-en.html>

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