Interview with Taro Hirano

President, Chief Portfolio Manager
Japan Catalyst, Inc.

TARO HIRANO is the President and Chief Portfolio Manager of Japan Catalyst, Inc. Taro started his career at The Sumitomo Bank, Limited, and worked on regulatory matters and invested in hedge funds and equities. He moved to McKinsey & Company, Inc. in 1998 where his main projects were to conduct strategic business transformation, organizational reform and strategic execution over the years with top management of Japanese companies. In 2003, he joined AllianceBernstein as an equity analyst. He received high reputation on his analysis in a wide range of sectors including capital goods, technology, telecommunications, energy, transportation, commodities and consumer goods. He was a major shareholder in many investment cases, discussing corporate strategies with the management of leading Japanese companies and making capital policy recommendations. He was responsible for Asian equities as well as Japanese equities, was a leader in the global capital goods and transport sector, and played a central role in value investment. Taro received his B.A. in Mathematics from Tokyo University and MBA from INSEAD.

Q. What are the key characteristics of your investment strategy, and how does your approach differ from your peers?

Hirano: Our investment strategy is firmly rooted in the belief that optimizing corporate strategies and governance in Japanese listed companies can significantly enhance productivity and capital efficiency. This, we believe, is the key to unlocking the potential value that lies within Japan's corporate sector. We particularly focus on **strategically reallocating management resources,** such as capital and human resources, that may have been misaligned or underutilized. By doing so, we aim to improve return on equity, as a key metric of capital efficiency, thereby enhancing our target companies' competitiveness.

To achieve this, we take a **"constructive" activist approach**. We actively engage with the management teams of target companies that are seeking growth and transformation. Our primary goal is to help these companies implement internal reforms and drive long-term corporate value, ultimately benefiting all stakeholders involved.

What specifically distinguishes us is **our direct access to top-level management within Japanese companies**. Oki Matsumoto, Chairman of Japan Catalyst, Inc and CIO of the Japan Catalyst Fund, has both an incredibly wide and deep network across the corporate landscape, developed over his 20+ years of experience as the CEO of a listed company. Since launching our strategy in 2020, we've had the privilege to meet with almost every target company's CEO, regardless of the size of our equity stake, in a timely manner. As a respected member of Japan's corporate community, we are able to engage in deep, trust-based discussions with key decision-makers early in our engagement process. This level of access to CEOs and management is quite uncommon in Japan and gives us a distinct edge over those that tend to speak with IR and other executives who are not the key "decision makers" in a Japanese company.

Our deep local expertise is another key strength. Our team, all based in Japan, has extensive financial industry experience and a deep understanding of the Japanese corporate sector, business and cultural context, and regulatory environment. I bring to the team more than 20 years of investment experience, including 16 years as a value investor at AllianceBernstein, where I led the global industrial sector team and engaged in extensive dialogues with the senior management of Japanese and global companies. This expertise allows us to hold meaningful and constructive dialogues with top management at target companies, focusing on themes that enhance return on equity and foster long-term corporate value creation.

I believe that our unique combination of a constructive approach, access to top-level management, and local expertise positions us well to unlock value and deliver alpha to our investors.

Q. What are the key attributes you look for when seeking investment opportunities?

We seek out companies that have a **solid, competitive core business and growth trajectory** but for some reason, remain undervalued by the market, despite their promising potential. Our attention is especially drawn to companies facing challenges in capital efficiency, discipline, and governance – areas where our team's finance-oriented expertise can truly make a difference. What's key for us is **the potential upside that our active engagement could catalyze**. We diligently analyze each opportunity to determine how our involvement could address specific issues and unlock latent value, leading to substantial returns.

The factors contributing to a company's undervaluation can vary, but we often identify issues such as **loose balance sheets, insufficient corporate governance, sub-optimal business portfolios, or ineffective investor relations**.

When assessing loose balance sheets, we specifically focus on EV / EBITDA in relation to earnings power. Our interest isn't just in low multiples but also in **the quality of the business** – ideally, we are looking for quality businesses that are firmly on their growth track and demonstrating robust cash generation capabilities.

Another area of focus is the potential for **improving business portfolio management**. Historically, many Japanese companies have struggled to exit low-profit businesses due to the lifetime employment system, resulting in the persistence of these legacy businesses remaining under the conglomerate umbrella. Some companies may be overlooked by the market due to their size, or because management hasn't been fully committed to investor communications.

Furthermore, we measure **top management's open-mindedness and willingness** to change, as these qualities are crucial in driving successful transformations. This is possible given our access to the real "decision makers". This lets us evaluate the quality and likelihood of positive change before we establish substantial positions.

In essence, our goal is to act as a catalyst for transformation, ensuring that our investments are poised to deliver positive returns.

Q. Do you have any focus on specific sectors or market cap?

We maintain a **sector-agnostic approach** but tend to find ourselves favoring certain sectors, such as capital goods, over time. It is within these sectors that we often come across exceptional, long-standing companies with robust core businesses, reflecting Japan's rich manufacturing heritage. However, these companies also face governance challenges stemming from adherence to traditional practices. Recently, we are witnessing a faster pace of leadership transition in these companies, with younger management increasingly open to embracing global standards and best practices in their management style. This evolving environment presents us with abundant opportunities for our engagement strategy. That being said, we always **ensure sector diversification within our portfolio**.

In terms of market cap, **our range typically spans from USD 500 million to several billion**. We generally do not target micro or small cap companies with a market cap of USD 100 million or less, due to liquidity considerations. Currently, the typical target size is around USD 1-5 billion. Our access to management is based on our network and credibility, so we do not require a large position in target companies to initiate our productive engagement.

Q. Can you walk us through your investment processes, from idea generation to portfolio construction?

Our investment process begins with **a strong emphasis on fundamentals**. We conduct thorough bottom-up research and quantitative screening, gathering insights through companies' public disclosures and direct interactions with their investor relations or management teams. We also engage in conversations with other managers, such as U.S. long-only managers or our activist peers, which often spark interesting investment ideas. To ensure a comprehensive assessment, we evaluate opportunities from multiple angles, considering factors such as the discount from intrinsic value, the time value in industry cycle, and the potential upside from engagement, all aimed at avoiding value traps.

Once our team identifies a company with potential value enhancement through engagement, I bring the idea to Oki and Jesper for an in-depth discussion. We then formulate our investment decisions in the Investment Advisory Committee. After initiating a toehold position, primarily Oki or myself start engaging with top management, including the CEO or board members, to gain deeper insight into the company's inner workings and assess the feasibility and validity of further engagement. Oki takes the lead in this stage, leveraging his network to establish direct lines of communication with corporate executives and evaluate the readiness of management and the board's openness to change.

In Japan, executives tend to be hesitant to meet with investors, unlike their U.S. counterparts, and even when they do, they often prefer to talk only with larger stakeholders. However, thanks to our team's established presence in Japan and Oki's network, we are usually able to **start conversations with top management within a few weeks to a couple of months** after an idea takes shape. The respect executives have for Oki, viewing him as a peer CEO, substantially enhances the impact of our communication and engagement efforts.

As our dialogue deepens and we gain more confidence in the fundamentals and the potential for change in management or strategy, we increase our position. As our engagement evolves and our conviction in the probabilities of corporate actions grows, we move forward and further increase our stake to build core positions.

Q. Can you give us an overview of the strategy in 2022, along with some key factors that influenced it?

Our core strategy is to **drive internal reform within companies and unlock hidden value**. We strategically concentrate on companies that, despite their traditionally conservative nature, are now led by forward-looking management teams ready to embrace transformation.

In 2022, leaders across Japan faced numerous external challenges including the crisis in Ukraine, surging energy prices, accelerating inflation, and volatile currency fluctuations. These pressures pushed many companies back into a more conservative stance, leading to reactive rather than proactive decision-making. Through our continuous dialogues with top-tier executives, we discovered that leaders recognized the pressing need for change but struggled to find a starting point due to the overwhelming task of navigating these external challenges.

However, despite the complexities of achieving engagement outcomes in such a climate, we maintained our intensive dialogues with target companies. This commitment has allowed us to deepen our understanding of these companies and identify opportunities and catalysts for change. We believe **2023 presents a more favorable environment for management to work on internal reforms**, fueled by regulatory tailwinds, and we are ramping up our engagement activities to capitalize on this favorable landscape.

Q. How have recent developments in Japan's corporate landscape impacted your engagement strategy?

Japan's ongoing corporate governance reforms have been laying the groundwork for transformative changes in the corporate sector, and we are excited to see tangible, significant shifts among both management and investors. Take, for instance, the Tokyo Stock Exchange's new rule, implemented in March 2023. Now companies with a low PBR are required to publicly disclose their strategies and initiatives for improvement. Considering that half of the listed companies are trading below book value, this new rule is making waves, **putting pressure on the management of companies with structural problems to take decisive action**. A notable number of issuers have already begun to announce new corporate actions, including share buybacks.

Another pivotal shift occurred in 2022 when ISS and Glass Lewis tightened their voting criteria for companies that maintain a certain level of cross-shareholdings. Major domestic asset managers followed their lead, adopting similar rules. These changes have also placed considerable pressure on management to drive reform, as failing to do so could result in a sharp drop in approval rating for their own CEO appointments. This shift provides strong tailwinds for our engagement strategy. **CEOs are becoming more receptive to shareholders and are actively looking for trusted partners** to drive internal reforms and transform business and capital structures, and given that we actively target the CEO, this definitely plays to our strengths.

In light of these dynamic developments, we have **intensified our engagement activities and increased our high conviction positions** over the last few months. Our investment team is also evolving to better seize opportunities. In January 2023, Oki made a strategic shift by stepping down as Chairman of Monex, Inc, a core subsidiary of Monex Group, to dedicate more time to his role as Chairman of Japan Catalyst. This has enabled us to accelerate our research and engagement activities with target companies. In March 2023, we welcomed Takahiro Kusakari, the former CIO of a major Japanese mutual fund with over USD 2.5 billion in AUM, as a new Portfolio Manager. With our strengthened team and the evolving market environment, we are **further expanding our engagement efforts, using every tool at our disposal to unlock hidden value and generate alpha for investors**.

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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