DaltonInvestments

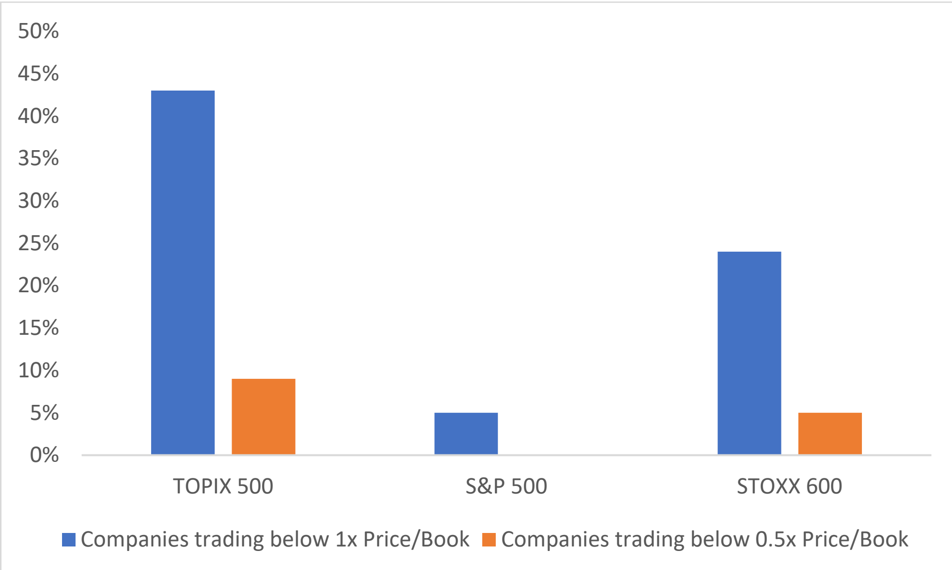
Price-to-Book is Back

The Tokyo Stock Exchange (TSE) is currently finalizing what Dalton Investments believes may be the single most significant development in the Japanese markets since the adoption of Abenomics. To recap, in April 2022, the TSE announced that companies would be reorganized into three sections – Prime, Standard and Growth – aimed at increasing the value of listed companies and attracting investors. Of the three, the top-tier Prime section would have the most rigorous listing standards related to liquidity (daily trading volumes and tradeable market capitalization), corporate governance and business performance (profitability and shareholder equity). Companies that did not meet them would be delisted or moved to a lower section of the stock exchange. However, the TSE was criticized for the limited immediate impact of the reforms, allowing over 1,800 companies to remain in the Prime section, including allowing almost 300 companies that did not fully comply with the new listing requirements to remain in the Prime section on a temporary basis. The TSE at the time set no clear end to this transitional period.

In January 2023, the TSE announced plans to firm up its previous reforms with hard deadlines for non-conforming companies, but perhaps more importantly, to require non-compliant companies to disclose action plans to increase their Price/Book ratio to 1x. This has the potential to be a huge boon to the Japanese market and particularly to value managers with a focus on engagement or activism.

In its presentation to the market, the TSE notes that across the Prime and Standard sections, over 1,800 companies trade for below 1x Price/Book – an anomaly globally. The group of companies included titans such as Toyota, Mitsubishi and Honda, with the group collectively representing some USD 2trn in market capitalization. If this group were to suddenly re-rate to the modest valuation of 1x Price/Book, Dalton estimates this would represent a market cap-weighted upside move in share prices of around 35% (or USD 700bn of value creation). Of course, for stock pickers the potential gains could be even higher – the TSE notes that 699 companies in the Prime and Standard sections trade below 0.5x Price/Book!

Price/Book Ratio Global Comparison



Source: JPX

<u>What is changing?</u>

Two major changes will be implemented by the TSE in Spring 2023, with others to follow later in the year:

1. Introducing a hard deadline for compliance with the listing requirements. This will be either March 2024 or March 2025 (to be finalized), with a one-year probation period proposed.
2. TSE will engage with companies as follows:
    a. Company management teams and boards of directors will be requested to discuss the stock price and/or market capitalization of the company, with an understanding of the company's cost of capital and return on invested capital, and look to make necessary policies and improvements, if required
    b. If the company continuously trades at a Price/Book ratio of less than 1.0x, the TSE will require more robust disclosures from the company, which include specific goals and processes to improve the Price/Book ratio
    c. In order to reflect measurable improvements for the benefit of investors, companies will be asked to provide periodic updates

Why the change?

Following market disappointment around the impact of the TSE's reforms of April 2022, a forum/working group was formed, including academics, Japan's Ministry of Economy, Trade and Industry (METI), Japan Exchange Group (JPX, the parent company of the TSE) and asset managers to discuss ongoing issues in the Japanese market and the changes required for higher overall stock prices to be achieved in Japan. JPX and the government now recognize that while many Japanese corporate management teams are world-class operators, they are frequently lacking in financial literacy, resulting in poor capital allocation, a low return on equity (ROE) and consequently a low Price/Book ratio. This limited financial literacy generally leads to a lack of understanding amongst management teams of the concept of "cost of capital" for their companies.

To achieve change, JPX believes it needs to shift the mindset for Japanese management teams from "profit and loss-driven" business management to "balance sheet and cash flow" business management. JPX has also expressed that drastic changes are required to reduce the number of companies with a Price/Book ratio of less than 1x.

What is the likely impact on the market?

In late January 2023, US activist Elliot appeared amongst the public ownership of Dai Nippon Printing (DNP, 7912), a conglomerate holding several leading businesses, including the metal masks used in OLED (Organic Light-Emitting Diode) manufacturing and lithium-ion battery pouches. Years of poor capital allocation had led to the massive over-capitalization of the business, structurally low ROE (averaging just 3%) and a low Price/Book ratio (between 0.6 and 0.7x). Within two weeks of Elliot's arrival, DNP announced a plan to undertake "the largest acquisition of treasury shares in DNP's history" to "create sustained business value and shareholder value with an ROE target of 10%, and expedite achieving a Price/Book ratio of more than 1x".

While the above could simply been seen as reflecting management's reaction to Elliot's aggressive reputation, perhaps more informative of the changes underway was the February 2023 announcement from watch-maker Citizen Watch that it would be buying back 22.1% of outstanding shares, instantaneously driving up its ROE and Price/Book ratio (along with its stock price!). This dramatic change in capital allocation policy was all the more remarkable for the apparent lack of an activist driving this change.

This for us is the key point. After many years of assiduous efforts to encourage better governance and capital allocation, Japanese activist managers such as Dalton now have new and immensely powerful peer activists – the TSE and ultimately the Japanese government. Based on our continued dialogue with both groups, we have been delighted to see an increasing desire to provide actively engaged investors like Dalton with the tools to encourage company managements to do their jobs in increasing corporate values. Indeed, based in part on our conversations with senior management at the TSE, and building on our past engagement efforts (Dalton was responsible for 13 of the total 55 companies that received shareholder proposals in 2022), we decided to support the goals of the TSE by sending a letter to all portfolio companies in December, notifying them of our intention to submit shareholder proposals in the upcoming AGM season, with specific requests for material improvements in the following key areas:

- Capital allocation - returning excess cash to shareholders through dividends and share buybacks – resulting in an increase in ROE (and likely raising the Price/Book ratio to the desired minimum of 1.0x)
- Board diversity – aiming for a majority of independent directors and increasing the representation of women on corporate boards
- Alignment of interest – putting in place significant restricted stock compensation (rather than cash compensation) for senior management

While the details of the updated TSE reforms remain to be ironed out, their direction is clear, as they resolutely pursue better governance, to make Japanese equities more attractive to investors. Dalton expects the following results from the new reforms:

- Strong absolute returns from low Price/Book Japanese stocks, in anticipation of better capital allocation activity
- Low Price/Book stocks outperforming high Price/Book stocks as investors rotate within Japan, in anticipation of better relative performance from the former
- An acceleration of the sale of cross-shareholdings and non-operating real estate assets, with proceeds used to implement share repurchase programs and ultimately boost ROE and Price/Book
- A lower resistance to activist demands (both privately and in the form of shareholder proposals) for increased share repurchases and dividend increases

With these changes, we are even more excited about the prospects for investing in Japanese equities and welcome your questions about these or other developments in Japan. Please contact Dalton's investor relations team (investorrelations@daltoninvestments.com) or your regular Dalton contact if you would like to schedule a call with our Japan team.

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