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Tokyo Stock Exchange (TSE) Reforms Continue – Shiro Hayashi / Masumi Nishida

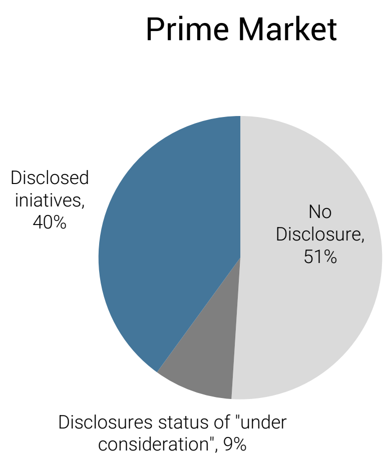
While acknowledging the valuable role we play in engaging portfolio companies and driving market efficiency, we recognize and applaud the Tokyo Stock Exchange (TSE) as Japan's most powerful activist, serving as the primary catalyst for reform.

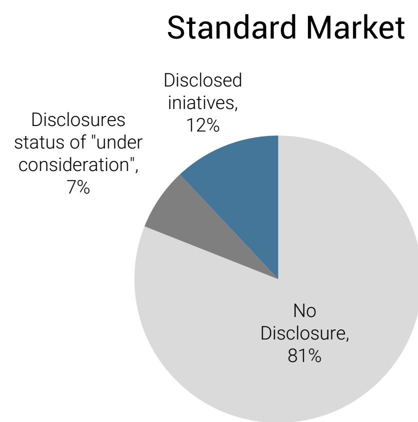
In recent years, the TSE introduced two revolutionary sets of reforms into the Japanese market. In April 2022, the TSE reorganized the company listing structure, categorizing companies into Prime, Standard and Growth Markets, setting stringent standards for the prestigious Prime Market, including market capitalization, liquidity and corporate governance standards. It then threatened relegation to the Standard Market, or even delisting, for non-compliant companies. In early 2023, the TSE went further, mandating that all companies disclose information regarding their "Action to Implement Management that is Conscious of Cost of Capital and Stock Price." While not a catchy title, this initiative was impactful, in that it not only compelled companies to formally assess and disclose key metrics such as cost of capital and return on equity (ROE), but also challenged companies trading with a price/book (P/B) ratio persistently below 1.0x to create concrete plans to achieve the magic 1.0x ratio.

The TSE continued its reform campaign during the week of 15 January 2023 with two new initiatives: the publication of a list of companies that have complied with its "capital improvement plans" and the introduction of a new demand that all companies listed on the Prime Market disclose key information in English, starting in March 2025.

"The list"

In a uniquely Japanese way, rather than naming and shaming the companies which have chosen not to comply, the TSE opted for positive reinforcement by publishing a list of companies that *had* chosen to comply. This approach, while seemingly indirect, effectively creates an implicit "naughty list" for non-compliant companies, leveraging social pressure and the desire to avoid reputational damage as powerful motivators for change. The effectiveness of shame and peer pressure in shaping corporate behavior in Japan should not be underestimated.





The TSE list shows that some 851 companies have already made public disclosures, while another 264 have stated their intention to do so. Within the Prime Market, the disclosure rate has doubled from 20% to 40% in just four months, demonstrating remarkable progress. Including those companies "under consideration", the non-compliant cohort appears destined to become a shrinking minority in the Prime Market.

Dalton has actively engaged with our non-compliant companies, urging public disclosure, and even submitting shareholder AGM proposals for companies which refuse. While the headline numbers are encouraging, the devil lies in the details.

Scrutinizing individual plans reveals varying levels of comprehensiveness. Discussions with TSE officials indicate widespread shortcomings that fall significantly short of what the TSE wants to achieve over the long term. For instance, a Dalton portfolio company is listed as compliant through having disclosed its capital improvement plan, but the plan itself lacks any analysis of cost of capital or ROE, and offers no clear path to achieving the coveted 1.0x P/B, likely quite disappointing for the TSE given the company's historical ROE of just 4% and P/B of 0.4x. Therefore, both the TSE and engaged market participants like Dalton, must actively encourage companies to embrace the true spirit of the TSE's initiative. Pushing for deeper analysis, concrete improvement plans, and a genuine commitment to shareholder value must remain a top priority.

English disclosures

While 97% of Prime Market companies currently publish some documents in English, these are often limited to financial statements. Important announcements like earnings updates and M&A news frequently remain solely in Japanese. Simultaneous English-Japanese disclosure for financial results currently sits at just 40%.

As of March 2025, this situation will change. The new TSE mandate will require all 1,656 Prime Market companies to disclose all information that could be seen to have a material impact on investment decisions, such as changes to earnings forecasts and M&A announcements, in English. There has yet to be any news regarding the Standard Market (where English disclosures are much more limited), but it is our hope that in time the entire market will be compelled to disclosure all key information in English.

Despite the recent excitement surrounding Japanese equities and ongoing corporate governance reforms, Japan remains a structurally underweight position in many active manager portfolios. GMO's recent study found that 84% of international managers are underweight Japan, with an average underweight of 7.5%.[1] A frequent concern cited by global investors is that Japanese equities are simply "too hard" due to language and cultural barriers. While the English disclosure mandate alone won't eliminate this challenge overnight, we believe it represents a significant step towards transparency and adherence to international best practices that can only be seen as a positive for the long-term attractiveness of the Japanese equity market.

Investment impact

As investors dedicated to active engagement, we've witnessed a remarkable shift in our dialogues with company management thanks to the TSE's transformative reforms. Gone are the days when discussions with management teams revolved solely around revenue growth and profit margins. Today, armed with the TSE's focus on key metrics like cost of capital and stock valuation, we find ourselves speaking the same language as company management, for the first time in our long history investing in Japan. This newfound alignment paved the way for our busiest and most successful year of engagement yet in 2023 and continues to shape our priorities for 2024. Below are our key areas for engagement in 2024:

[1] https://www.gmo.com/americas/research-library/japan-equities-are-compelling_insights/?utm_medium=email&utm_source=episerver-campaign&utm_campaign=article-subscription-push&utm_content=Insights&email=idouglas%40daltoninvestments.com&first_name=Iain&last_n

Themes	Proposals
Effective Capital Allocation	Formulate, disclose, and commit to a quantitative capital policy that includes "an appropriate level of financial assets (or capital structure)," "a specific capital allocation plan for the next three to five years," and "KPIs including ROIC and ROE and their targets (KGI). As a prerequisite for effective capital allocation, ensure that the board of directors possesses an understanding of the fair value of the company's shares. Reduce policy shareholdings, aiming for zero in the medium to long term
Strong Alignment of Interest	Establish, disclose, and commit to a path towards improving alignment of interest through stock ownership guidelines. Specifically, require directors to accumulate ownership worth 3-5 times their fixed compensation over a reasonable time frame
Board with High Independence and Diversity	Mandate that at least half of the board of directors comprise of independent outside directors while seeking to increase diversity by including women and experienced investors

We commend the significant improvements made by the TSE and remain committed to engaging with regulators, the stock market and other market participants to advance these reforms. These steps towards greater transparency and increased focus on minority shareholder rights undoubtedly represent positive catalysts for the long-term return potential of the Japanese market. For disciplined, long-term investors like us, the TSE's reforms provide valuable tools in our engagement toolkit, empowering us to advocate for positive change and unlock excess returns through engagement with management.

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