Japan Small Cap Investing:
Insight on Engagement Activities

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Trends in Improving Capital Efficiency of Japanese Companies

The Japanese equity market is experiencing two significant structural shifts that increase the appeal of buying Japanese stocks from a long-term perspective. One is a macroeconomic trend, namely, an end to the prolonged deflationary environment and the beginning of a virtuous cycle of wage increases and inflation. The other is steady progress in corporate governance, including accelerated efforts by listed companies to improve their capital efficiency. It is difficult to confidently assert that the macroeconomic shift will come to fruition, as it may be influenced by overseas political and economic factors, as well as the Bank of Japan's policy management. However, the latter is a theme that we investors can bet on with high confidence.

There has been a noticeable change in attitudes toward corporate governance, largely thanks to a series of government-led reforms, starting with the introduction of the Stewardship Code in 2014 and the Corporate Governance Code in 2015, and followed by the Tokyo Stock Exchange's ("TSE") market reforms and efforts to improve capital efficiency. This change is especially apparent among firms that previously had low awareness of capital costs and stock prices (especially among small-cap stocks).

As recently as ten years ago, it was not uncommon to find corporate managers who could not understand the terms "cost of capital" and "ROIC". There were also many companies that did not hold earnings briefings, or would simply refuse requests for engagement. In recent years, such cases have decreased markedly.

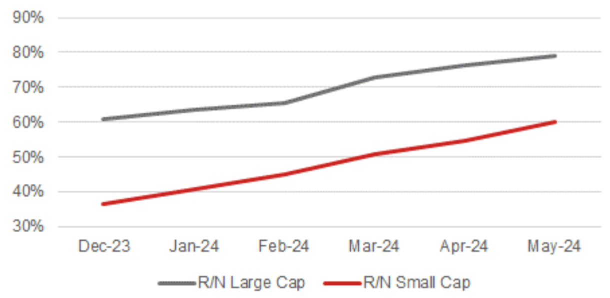
Building upon this trend, traditionally silent institutional investors in Japan are increasingly finding their voices and speaking out against listed companies, thanks in part to government-led encouragement of engagement activities. In truth, there is not much difference in the investment theory of active fund managers, even traditional institutional investors, and that of activists. Pressure from regular institutional investors is growing alongside the number of activists year by year, and it is highly likely that the overall capital efficiency of Japanese companies will improve further.

There is a high proportion of Japanese companies that have accumulated excessive amounts of cash and have bloated their shareholders' equity. In the past, the ROE of Japanese companies as a whole was rarely above 10%. However, with the practice of properly controlling shareholder equity taking root, it seems a likely future where the ROE levels of Japanese companies as a whole is in the mid-10% range, on par with European markets, if not with the U.S. market (close to 20%).

In recent years, small-cap stocks have lagged behind large-cap stocks. The main reason behind this is the advantage that large-cap stocks, many of which are export-related businesses, gained due to the yen's depreciation. Small-cap stocks have also lagged behind large-cap stocks in their efforts to improve corporate governance and capital efficiency, but this trend has been changing in a promising direction.

Since the beginning of 2024, the TSE has published a monthly list of companies that have disclosed plans related to "Action to Implement Management That is Conscious of Cost of Capital and Stock Price". The chart below shows changes in the disclosure status by company size. Initially, only 36% of Russell/Nomura (R/N) Small companies had disclosed plans, compared to 61% of R/N Large companies. However, over the last five months, R/N Small has been gradually catching up to R/N Large. Though the gap remains wide, 60% of R/N Small companies had disclosed plans by the end of May. As more companies join this trend, it has the potential to be a driving force for small cap outperformance over large caps, whose efforts have already begun to mature.

Percentage of Companies that have Disclosed Plans



Note: Russell/Nomura (R/N) Large Cap: top 300 stocks, R/N Small Cap: approximately 1,100 stocks excluding top 300 stocks. Source: Nomura Asset Management based on data from Russell Investments and Nomura Securities for Russell/Nomura Indexes, and Tokyo Stock Exchange. https://www.jpx.co.jp/english/equities/follow-up/02.html

Meanwhile, at Nomura Asset Management, our engagement activities with portfolio companies are a combined effort between our portfolio managers, corporate research analysts, ESG specialists, and engagement managers. In order to better support the work done by the Corporate Research Group, we have bolstered our capabilities for assessing and engaging with companies over the past few years by expanding our Responsible Investment Department and Engagement Department. As of the end of May 2024, the JSC portfolio comprised 132 stocks. Our team is conducting ongoing engagement with more than 70% of these companies with a particular focus on improving governance and capital efficiency. Below, we offer case studies of engagement activities with three companies among our Top 10 holdings.

Example of Engagement: Maruzen (5982)

Maruzen Co., Ltd. is a manufacturer and seller of commercial kitchen equipment. The company is expected to enjoy solid sales growth linked to Japan’s serious labor shortage and the resulting demand for labor-saving investment in restaurants and other businesses. The increase in inbound travelers will also indirectly benefit the company. Maruzen is gradually becoming more shareholder friendly.

10 years ago, the company turned down our requests for engagement interviews, but over the past six years, we've held regular investor relations meetings. The company has been accumulating cash on its balance sheet due to insufficient shareholder returns amid high profitability but limited growth. However, due to years of dialogue and pressure from the government and the TSE, the company's stance has gradually changed. The dividend payout ratio, which was in the 10% range just four years ago, has risen steadily from just under 30% two years ago to 40% since last year. Market pressure has also increased, with an activist fund proposing to return 100% of profits to shareholders last year. Just one or two years ago, the company's market capitalization was below its financial assets. Today, however, the company has rectified that situation and has achieved a PBR of 1.0x. Although the ROE target disclosed by the company is only 8%, the company is highly profitable and has the potential to generate an ROE that is easily double the company's low target if the company controls shareholder equity properly using its surplus cash. We will continue to engage with the company for further improvements.

Example of Engagement: Yurtec (1934)

Yurtec is a consolidated subsidiary of Tohoku Electric Power (9506) that is engaged in general facility engineering, including construction, maintenance, and repair work for its parent company. It has abundant financial assets and low ROE. It is expected to benefit from growing demand for renewable energy such as wind power generation and investment to expand its wide-area power transmission and distribution network. Only a few years ago, the company did not hold earnings conferences for investors. We have discussed improving capital efficiency and the issue of parent-subsidiary listings with both Yurtec and its parent company, Tohoku Electric Power. In the most recent medium-term management plans of the two companies, Tohoku Electric

Power set a ROE target of 8% or more in two years, while Yurtec disclosed a ROE target of 6% or more in FY2028, four years from now, and a ROE of 8% sometime in the first half of the 2030s. Yurtec has abundant financial assets, and we believe the company has the potential to raise its ROE level even earlier if it has the will to do so. We have pointed out to Yurtec that the speed of management is extremely slow. Furthermore, we are engaged in ongoing discussions with the parent company regarding managing this gap and whether it should encourage improvement on this issue. While we recognize that electrical construction companies like Yurtec are indispensable for maintaining the power grid, which is the lifeblood of electric power companies, we believe that the time has come for the parent company to reexamine the necessity of maintaining its subsidiary’s listing.

Example of Engagement: Osaka Steel (5449)

Osaka Steel, a consolidated subsidiary of Nippon Steel (5401), has abundant financial assets and low ROE. We have long been discussing measures to improve Osaka Steel’s efficiency and the issue of parent-subsidiary listings with both Osaka Steel and Nippon Steel. In January 2024, Osaka Steel responded to the TSE's request for "Action to Implement Management That is Conscious of Cost of Capital and Stock Price”. The content of the release, excluding the cover and past ROE/PBR charts, was essentially a single sheet of paper with no numerical targets for ROE or otherwise. We not only pressed Osaka Steel on whether this content truly complied with the TSE's request, but also pressed the parent company, Nippon Steel, to provide guidance to its consolidated subsidiaries. Up until last fiscal year, Osaka Steel did not issue any dividend forecasts at the beginning of the fiscal year, although it did issue earnings forecasts. This provides a glimpse of the company's disregard for minority shareholders. However, this spring, Osaka Steel presented a dividend forecast at the beginning of the fiscal year for the first time. The company's attitude is changing. Most recently, an activist fund made a shareholder proposal that has attracted market attention.

The Nomura Japan Small Cap Equity Strategy

This Strategy has been managed since February 2020 with the investment objective of achieving long-term capital growth. With nearly 4,000 listed companies in Japan, our focus is on unearthing hidden gems among small- and medium-sized listed companies. In other words, we offer investors a broad, unique and under researched opportunity set.

Access to Companies

The Portfolio Manager conducts over 500 meetings per year with listed companies. In total, our analysts conduct more than 5,000 meetings annually.

Investment Style

While the Japan Small Cap Equity Strategy has a slight value bias, we also look for elements of growth. There are mainly three types of investments that we look for:

1. High Quality Value Stocks: Profitable companies with strong balance sheets that are undervalued due to the lack of research coverage.

2. Growth Stocks: Companies with firm expectations of superior growth opportunities offered both by cutting edge technologies and innovative business models that are highly competitive and disruptive to traditional Japanese business practices.

3. Opportunistic Investments: Our approach is designed to identify not only quality businesses, but also businesses that are deeply undervalued, despite being well-run and able to ride the recovery wave.

We actively monitor management quality and corporate fundamentals – factors representing the heartbeat of companies that are poorly covered by sell side analysts, and have the most potential to be mispriced. Selecting these winners requires patience and a commitment of resources to cover the vast number of companies and diverse range of businesses.

The Strategy typically holds around 100 to 200 stocks. In the small cap markets in particular, diversification helps to mitigate liquidity risk, and we want to achieve exposure to a breadth of investment opportunities in order to raise risk-adjusted returns.

About the Portfolio Manager

Makoto Ito, CMA, has more than 20 years of investment and research experience. Previously, he had experience in investment research in emerging market equities, particularly Chinese equities, and after joining Nomura Asset Management in 2006, he worked as a financial sector analyst before managing Japanese equities in 2008. He was appointed as a Senior Portfolio Manager in 2015.

Note: CMA is a Chartered Member of the Securities Analysts Association of Japan.