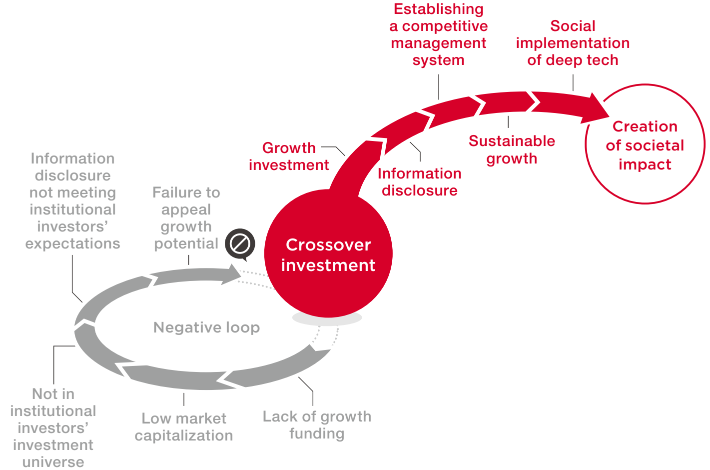
Responsible Investment: Our New Chapter in the Private Market

Structural Issues in Japan's Capital Markets

In March 2023, the Tokyo Stock Exchange communicated to all companies listed on the Prime and Standard markets regarding "Action to Implement Management that is Conscious of Cost of Capital and Stock Price," based on discussions from the Council of Experts Concerning the Follow-up of Market Restructuring. This was in response to concerns that listed companies are not appropriately implementing capital policies and human capital investments with consideration for capital costs and capital profitability. This has resulted in a lack of sustainable growth, and consequently, stagnation in industrial renewal and innovation, which is contributing to economic decline.
In addition, the Council also pointed out that Growth Market-listed companies need to enhance their information disclosure regarding growth strategies as well as their progress on such strategies in order to attract risk capital and realize high growth potential. These issues—namely, the lack of consideration for capital costs and capital profitability, the absence of sustainable growth strategies, and insufficient information disclosure—align with our long-standing recognition of the challenges in Japan's listed markets, as observed through our engagement with investee companies. It can be inferred that there are two factors arising from a structural challenge that crosses the private and public markets.

The first is the issue of "market depth." After being founded, companies raise funds for purposes such as research and development, capital investment, securing talent, and business expansion. They face difficulties such as lack of capital, market uncertainties, and intensified competition as they navigate the so-called "valley of death" from the seed and early stages to the mid-stages of growth, consequently, some companies consider going public as an option to pursue further growth. However, the Japanese market is confronted with the problem of having an extremely small number of capital providers connecting the private and public market during the later stages and post-IPO growth market compared to other countries. As a result, many companies fail to secure the necessary funding for growth investments, and end up going public without having reached a sufficiently large scale. In fact, 75% of companies that went public in the Growth Market from 2014 to 2020 had a market capitalization of less than 20 billion yen at the time of listing, with over 80% of them remaining below that threshold afterward. This has made it difficult for institutional investors, who target companies with market capitalizations of several hundred billion yen or more, to invest in them. There is a demand for funding that bridges the disconnect between the two markets and deepens the market.

The second issues is the problem of inadequate preparation brought about by the market disconnect. Venture capitalists (VCs) and investment banks, who have been "insiders" accompanying the company's growth before going public, usually disappear at the time of the IPO, leaving the company to face a multitude of "outsider" shareholders, such as institutional investors, who judge corporate value based on public information. Those newly listed companies may have an insufficient understanding of corporate governance and information disclosure expected by the public market, which could lead to a failure to effectively communicate their growth potential, as recognized by insiders, to outsider institutional investors. This situation may be attributed to the insufficient understanding of the post-IPO environment by private market investors, due to the disconnect between the private market and the public market. Consequently, institutional investors may not be able to accurately assess the company's growth potential and the likelihood of future cash flows, which prevents them from making investments. This can lead to a stagnation in the company's post-IPO market capitalization, and may result in a decrease in contact with institutional investors. Thus, the disconnect between the two markets may lead to stagnation in market capitalization both before and after a company goes public, along with creating information asymmetry between insiders and outsiders, resulting in a negative loop.



Building an Ecosystem to Transform Japan

In the "Policy Plan for Promoting Japan as a Leading Asset Management Center" announced by the Japanese government in 2023, promoting the supply of growth capital to startups is positioned as one of the priorities for achieving sustainable economic growth in Japan along with diversification of managed assets. In particular, there are growing expectations for startups with deep tech* that can

*Scientific technologies with the potential to impact society, such as solving economic and societal issues through the realization of commercialization and social implementation are achieved.

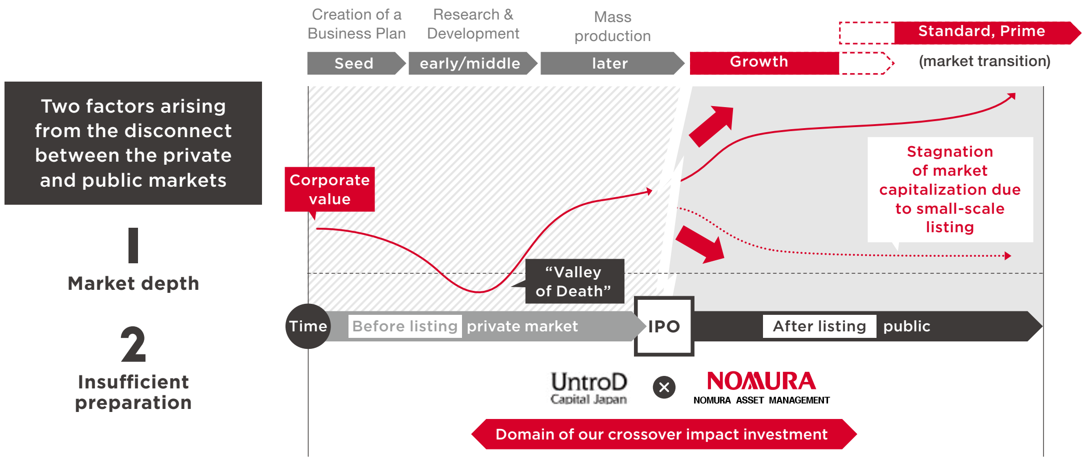
provide innovative solutions targeting various challenges facing Japan, such as declining birth rates and an aging population, climate change, natural disasters, and regional revitalization. In fact, according to the results of the "Survey on University-originated Ventures for FY2023" published by the Ministry of Economy, Trade and Industry, the number of university-originated venture companies expected to bring innovation to the economy and society increased to 4,288 companies in 2023, up 506 from the 3,782 identified in FY2022, marking a record high in both the absolute number and the annual increase.

The technologies and solutions needed to make society better become meaningful only when they are implemented in the real world. Therefore, it is necessary to go beyond the research stage and secure capital and excellent management teams to foster growth. For deep tech startups, including university-originated venture companies, continuous support from investors is essential to achieve sustainable growth and become a vital part of society. It is necessary for institutional investors to invest in startups before they go public, creating a deeper market and building an ecosystem that seamlessly connects the pre- and post-IPO markets to eliminate the disconnect.

Crossover Investment to Unlock Japan's Future

We believe that providing capital to technologies that transform and nurture a thriving society from the pre-IPO stage and supporting the establishment of both competitive management structures and information disclosure will lead to healthy market growth and a prosperous society. Therefore, we have started to collaborate with UntroD Capital Japan, Inc., a VC firm specializing in deep tech investment, to initiate impact-driven crossover investments. The strategy adopts a crossover investment approach involving investment in startups with deep tech from the pre-IPO stage and continuing to support their growth post-IPO, aiming to solve societal issues and bring positive impacts to society through impact investments. This combination of the three elements of deep tech, crossover and impact is a new endeavor in Japan.

It has conventionally been perceived that addressing social issues involves a trade-off with corporate growth and profitability. We believe that solving societal issues means developing new markets, and that appropriately reflecting the scalability of those markets in management strategies leads to sustainable corporate value enhancement and larger investment returns. The "Grand Design and Action Plan for a New Form of Capitalism" revised by the Japanese government in June 2024 stipulated that "The consideration of non-financial factors, including impact, when making investments does not constitute 'consideration of irrelevant matters,' similar to ESG considerations." Furthermore, it positioned the promotion of impact investments that pursue both the resolution of societal issues and economic returns as top policies, which was a strong message for us. We consider enhancing our clients' investment returns and creating a society where both our clients and future generations can enjoy prosperity as fulfilling our fiduciary duty, and we engage in impact investments with this in mind. We also believe that connecting the future envisioned by startups aiming to solve societal issues with the future desired by our clients is a role of an investment fund.



Building on a Decade of Progress: Embracing New Challenges in the Private Market

Together with UntroD Capital Japan, Inc., we will identify promising startups and execute investments. By combining our long-cultivated methods for enhancing the value of listed companies with UntroD's extensive knowledge in venture capital investment in the deep tech field, we will support the development of growth strategies focused on capital costs and profitability, strengthen corporate governance systems, and enhance information disclosure from the pre-IPO stage. Additionally, we will continue to hold shares post-IPO to provide growth capital and support the establishment of corporate structures that adequately meet the expectations of the public market, thereby achieving sustainable growth for deep tech companies.

As we celebrate the 10th anniversary of the establishment of the Responsible Investment Department in April 2016, we will embrace the new challenge of responsible investment in the private market. Our goal is to expand the investment chain into the private market and revitalize Japanese society. We are looking forward to keeping you posted on future developments.