Mizuho Custody Newsletter

December 2024 | Japan

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I. Market News

1. Foreign investors revisiting the Growth Market

Starting in January 2025, the Tokyo Stock Exchange (TSE) will publish a list on its website of Growth Market-listed companies that wish to engage more actively with institutional investors. Companies listed on the Growth Market tend to have limited connections with institutional investors. By publishing this list, TSE aims to support these companies' investor relations activities and facilitate connections. Additionally, the TSE will provide an English version of the list for companies that wish to connect with foreign investors.

The net buying amount by foreign investors in the TSE Growth Market in November reached its highest level since the market reorganization in the spring of 2022. Funds from foreign investors have begun to flow into the TSE Growth Market, as these investors actively seek out stocks with high growth potential in innovative technologies and services. If the market is revitalized through the buying of promising emerging stocks, it could also lead to an overall boost for Japanese stocks.

"Western institutional investors are showing interest in Japanese small and mid-cap stocks. They are seeking funds that can invest in promising individual stocks, and we have also received new inquiries. Investment is likely to become more substantial from next year onwards," predicts the head of investment research at a U.S.-based asset management company.

According to statistics released by the TSE, foreign investors' net buying amount in the Growth Market in November was JPY 45.3 billion (approximately USD 289 million), a significant increase from October, which saw net selling. Since the market reorganization in April 2022, this was the fourth time that buying exceeded selling, and November's amount was the highest. Even when looking at individual stocks, those with a high ownership ratio by foreign investors stand out.

For example, an entertainment company with a high market capitalization on the Growth Market (approximately JPY 200 billion) had an ownership ratio by foreign shareholders of about 18% as of July, an increase of about 6 percentage points compared to six months ago. This company, founded in 2018, began its business by renting machines to amusement facilities. It has grown its operations by acquiring game centers from companies without successors and utilizing information technology (IT) to improve management efficiency.

Another company provides next-generation cloud-based core systems for financial institutions, and due to its high technical capabilities, its system is now implemented by numerous major companies. The ownership ratio of foreign shareholders was about 18% as of March, an increase of more than 1 percentage point compared to six months ago.

The share price of a search engine company that connects professionals with individuals seeking help for their daily lives reached a five-year high in late November and has since maintained that range. According to a large shareholding report submitted by a UK-based investment fund on December 2, the fund increased its holdings of the company's shares by 1%, bringing its total ownership to 6%.

What these purchases of such companies have in common is the expectation that they will carve out new markets and expand profits through advanced technologies and innovative ideas. The outlook for the Japanese economy to recover with wage increases by companies and the normalization of the Bank of Japan's monetary policy also supports this buying trend.

Some investors appear to be buying with an eye on the TSE's review of the Tokyo Stock Price Index (TOPIX). The first phase of the review will be completed in January 2025, and long-term investors are now starting to position themselves for the second phase, which will include Growth Market stocks. A Japan-based fund manager remarked, "When deciding which stocks to include more in our portfolio, we hold larger positions in those that are likely to be adopted in the new TOPIX."

One of the major factors that make Japanese stocks less attractive compared to U.S. stocks is the lack of prominent emerging companies. The recent trend of foreign investors starting to buy shares of Japanese emerging companies can be seen as a sign of a turning point for the stagnant market. This may be a significant focus when predicting the outlook for the Japanese stock market in 2025.

Compiled from Nikkei Shimbun and Mizuho research
More details about the Growth Market can be found from below:
https://www.jpx.co.jp/english/equities/follow-up/b5b4pj000004yqcc-att/dh3otn000000mgt6.pdf

2. Unwinding cross-shareholding in 2024

Cross-shareholding, where companies hold shares of their business partners, is a symbol of Japanese-style capitalism. Activist funds and other foreign investors are urging listed companies to unwind these cross-shareholdings. While they serve as a "shield" to protect against hostile takeovers, they can also lead to low-profit transactions and weakened corporate governance. This results in deteriorating capital efficiency and is one reason why Japanese companies cannot utilize capital for growth investments as effectively as their U.S. and European counterparts.

In recent years, the mindset of Japanese companies has finally begun to change. Prompted by the Tokyo Stock Exchange's (TSE) request in March 2023 for management to be more conscious of capital costs and stock prices, listed companies have started to move away from hoarding capital. To enhance corporate value, it is necessary to improve earning power and increase capital efficiency through shareholder returns, while also boosting growth through investments and M&A.

Cross-shareholding is an old yet renewed topic. It is said to have originated in 1952 when a major real estate company in Tokyo's Marunouchi area (a major CBD in Japan), which was part of a zaibatsu conglomerate, had over 30% of its shares acquired by a stock market speculator. Consequently, many companies within the zaibatsu group were forced to buy back the shares at high prices. In the 1960s, as international capital flows became liberalized, cross-shareholding spread as a defense mechanism against acquisitions by foreign companies.

Such cross-shareholding practices have also evolved over the past 30 years. From the 1990s to the early 2000s, amid the deterioration of Japanese companies' performance due to the collapse of the bubble economy and the need to address non-performing loan issues, there was a growing trend among corporations and banks to sell off cross-held shares that had unrealized gains.

Since the mid-2010s, there has been renewed momentum to unwind cross-shareholdings in line with corporate governance reforms. According to a major domestic think tank, the policy holding ratio of listed company shares in fiscal 2023 was 30.8%, a significant decrease from 69.8% in fiscal 1990. The shares that were sold found buyers among foreign institutional investors, with the ownership ratio of foreign entities reaching a record high of 31.8% in fiscal 2023.

Cross-shareholding faces persistent criticism for rendering corporate governance superficial. Many cross-held shares yield low investment returns, which can easily result in deteriorating capital efficiency. Underpinning the low capital efficiency of Japanese companies is the conservative financial management that has been maintained for nearly 30 years.

Looking back, during the period of high economic growth up until the early 1970s, companies increasingly relied on interest-bearing debt, primarily through bank borrowings, and this dependency remained high in subsequent years. When the bubble burst in the early 1990s, leading to credit crunches, companies worked to reduce their debt while simultaneously increasing their equity capital.

As Japanese companies accumulated capital, their earning power and growth potential did not significantly improve, reducing their attractiveness as investment targets in the stock market. The return on equity (ROE), which indicates how much profit is generated from shareholders' equity, has stagnated at just under 10%. Over the past decade, Japanese companies have lagged behind their U.S. and European counterparts in terms of growth in capital expenditures, research and development spending, and mergers and acquisitions (M&A).

The movement to unwind cross-shareholdings has recently begun to accelerate. Major automotive group companies and megabanks are making significant progress. A leading non-life insurance company has announced a policy to reduce its cross-held shares to zero by around 2030. According to estimates by a representative of a U.S.-based securities firm, the balance of cross-held shares, which stood at around JPY 60 trillion (approximately USD 380 billion) as of the end of March, is expected to be reduced to 10-20% of the current level over the next four to five years, reaching a steady state.

The sale of cross-held shares is often initiated by the shareholders, with the companies being sold typically just agreeing to the sale. Shareholders generally leave the timing of the sale to the securities firms, which then sell the acquired shares to unspecified investors while carefully timing the sale to minimize price impact. However, recently, there have been cases where the companies being sold take a more proactive role, using the sale as an opportunity to review their shareholder composition. These companies engage in investor relations (IR) activities to attract potential buyers for the shares being sold. This approach helps them cultivate new shareholders, including domestic and foreign institutional investors as well as individual investors.

The head of the equity capital markets division at a U.S.-based securities firm notes, "There is significant interest among foreign investors in the trend of reducing policy holdings in Japan." If more companies actively engage in improving capital efficiency, corporate governance, and investor relations (IR) rather than passively accepting the sale of policy shares, it could deepen Japan's capital markets.

Compiled from Nikkei Shimbun and Mizuho research

3. Share buybacks mark historical high in 2024

Share buybacks by listed companies are expected to reach approximately JPY 17 trillion (about USD 108 billion) in 2024, a 70% increase from the previous year. This marks a record high for the third consecutive year. The number of companies conducting share buybacks also increased to 1,079, a 22% increase from 2023. Companies' movement toward shareholder returns has become more active in response to requests from the Tokyo Stock Exchange (TSE) to improve capital efficiency. Share buybacks are also being used as a way to absorb cross-held shares sold by major shareholders.

The large figure of JPY 17 trillion accounts for about 30% of the total net profit of all listed companies, which is close to the total amount of paid dividends. This means that the combined total of share buybacks and paid dividends reaches 60% of the net profit. Japanese companies have traditionally placed more emphasis on dividends, but share buybacks have also become an important way to reward shareholders.

Especially in 2024, there were companies conducting share buybacks multiple times within the year. For example, one of the megabanks conducted a JPY 100 billion (approximately USD 637 million) buyback in May and set an additional acquisition limit of JPY 300 billion in November. Other major financial institutions also increased their acquisition limits within the fiscal year.

There is also an aim to absorb the shares released through the unwinding of cross-shareholdings. A major chemical manufacturer plans to buy back its shares from five shareholders, including an insurance company and a megabank, for approximately JPY 94 billion by January 2025. A major auto parts manufacturer decided on a JPY 450 billion share buyback in October, in line with one of its major shareholders' intention to sell their holdings.

Companies are being requested by the TSE and investors to improve capital efficiency. Since March 2023, the TSE has been asking listed companies to manage with an awareness of capital costs and stock prices, and to disclose their plans on how they will achieve this. Among companies listed on the Prime Market, the number of companies that disclosed their plans was 660 (40% of the total) as of the end of

December last year, but this number has nearly doubled over the course of 2024, with 1,354 companies (83% of the total) having disclosed their plans. According to a tally by a U.S.-based securities company's equity strategist, 42% of the companies that have disclosed their plans announced share buybacks after December 2023.

Corporate performance is strong, and companies have the leeway to direct funds towards share buybacks. The net profit of all listed companies for the period from April to September 2024 increased by 15% compared to the same period the previous year, marking a record high for the fourth consecutive year. An investment officer at a major U.S.-based asset management company commented, "The increase in share buybacks and dividends is accompanied by the company's performance growth. We view this as a positive change in mindset."

There is also a movement to allocate acquired shares as stock compensation to employees, which will encourage employees' sense of participation in management. A major entertainment company announced a JPY 250 billion share buyback in May and stated that the acquired shares would be used for a restricted stock compensation plan. A major recruiting company, which announced a JPY 600 billion share buyback in July, is also considering using the shares for employee stock compensation.

Share buybacks are expected to remain active in 2025 as well. An equity strategist at a U.S.-based securities company says, "This upward trend in shareholder returns will not change as long as Japanese companies continue to reform their governance."

Share buybacks have a positive effect on improving ROE (Return on Equity). The ROE for all Prime Market companies in fiscal 2024 is expected to be around 9%, but this level is still far behind that of U.S. companies, which is approximately 20%. To catch up with overseas competitors, not only are capital measures such as dividends and share buybacks necessary, but also growth investments to enhance earning power are essential. It is also necessary to reward employees through wage increases. According to the Ministry of Health, Labour and Welfare, wage increases are sluggish compared to the inflation level. An economist at a Japanese securities company points out, "Wage increases have not gathered momentum as much as shareholder returns." The cash reserves of Japanese listed companies amount to approximately JPY 112 trillion (about USD 737 billion) as of the end of September. While increasing share buybacks, companies are also expected to allocate funds to wage increases and growth investments.

Compiled from Nikkei Shimbun, and Mizuho research.

II. New Equities Listing Approvals

Listing Date	Name of Company	ISIN Code	MKT
Dec-16	Housing staff Inc.	JP3765290006	P
Dec-16	Double Tree Inc.	JP3506030000	P
Dec-19	Postmate Holdings, Inc.	JP3856160001	P
Dec-19	BABY JOB CO., LTD.	JP3835710009	P
Dec-19	SIE Co., Ltd.	JP3161620004	P
Dec-25	In-dex, Inc.	JP3153310002	P
Dec-27	Thirty Four co.,ltd.	JP3310230002	P
Jan-08	COSMOS CHOUZAI Pharmacy Co.,Ltd.	JP3298300009	P

**Information compiled based on postings from the Prime (PR), Standard (ST), Growth (G), Tokyo Pro Market (P), NSE (N)、FSE (F) & SSE (S).*

***Board lot size is unified to 100*

III. Foreign Ownership Limit Ratio

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