Mizuho Custody Newsletter

September 2024 | Japan

Contents:

I. Market News

1. Cross-held shares' unwinding marks record high

Cross-shareholding had been a unique practice in Japan, in which a company holds certain amount of shares of its business partners, etc., to establish stable relationship under tacit gentlemen's agreement of being silent to each other at AGMs. This practice, has been subject to strong criticism from foreign investors for long, as it had given minority shareholders less opportunities to make their voice heard, and made management inclined to protect themselves.

Prompted by the Tokyo Stock Exchange's (TSE's) request to improve capital efficiency, the amount of cross-held shares sold by listed companies reached a record high of JPY 3.6 trillion (circa USD 25.1 billion) for the fiscal year ending March 2024, up by 90% compared to the previous fiscal year. The continued disappearance of this unique practice may also prompt companies to give serious consideration to M&A (mergers and acquisitions) involving Japanese companies.

Nikkei Shimbun, a leading Japanese financial daily, scrutinized the securities reports for the fiscal year ending March 2024 of over 2,000 companies, excluding financial sectors. The amount of cross-held shares unwound jumped up by 86% to JPY 3.6 trillion, significantly surpassing the previous record of JPY 2.2 trillion in FY 2019, when disclosures began. The total number of issues that have been cross-held decreased by 9% (2,727 shares) to 26,789 issues. Companies plan to use the proceeds from these sales for growth investments and shareholder returns, leading to further improvements of capital efficiency.

After World War II, Japanese companies strengthened their relationship via cross-shareholdings with business partners and group companies, who would continue to be stable shareholders to each other. The presence of "silent stable shareholders" who always implicitly sided with the management has protected the company from attempts to takeovers by external parties. Although these assets faced strong criticism from overseas investors since the assets have not brought significant returns to the companies, the TSE's request in March 2023 for 'management conscious of capital costs and stock prices' and the high stock prices turned the situation around.

A remarkable move was made by Japan's leading automobile group. The amount of cross-held shares sold by the main automobile company, which is the core of the group, was the largest ever, among listed companies, amounted to JPY 325.9 billion (circa USD 2.27 billion) in total. The automobile manufacturer reduced its holding position in 15 issues. Many companies within the group, including a transportation equipment manufacturer (JPY 240.1 billion), an in-vehicle engine manufacturer (JPY 125.8 billion), and a transmission manufacturer (JPY 111.7 billion), also sold large amounts.

The major electronics companies also followed suit. Among them, one company with a wide range of business areas has had stakes in hundreds of group companies historically due to political background. However, it has been investing the proceeds of those shares into growing areas such as IT (information technology). By promoting large-scale business restructuring, which enhanced capital efficiency, their

activities are well received in the market as a whole, reaching an all-time high in its stock price in this July.

Some companies are using the sales proceeds of its cross-held shares for their share buybacks. A major textile manufacturer plans to reduce cross-held shares by approximately JPY 100 billion (circa USD 699 million), which is half of the total, over the next three years, and to allocate all of the proceeds to share buybacks. Share buybacks reduces the company's equity capital on the balance sheet and improves some indicators such as Return on Equity (ROE) which is one of the indicators investors often look.

More companies are believed to unwind cross-held shares even from now. According to a major securities company, approximately JPY 2 trillion worth of cross-held share sales have already been announced by listed companies between this April and July. In industries such as automotive, electronics, and construction, some companies are going to unwind cross-held shares. A major sports equipment manufacturer announced plans to sell all of its cross-held shares by the end of 2024.

An analyst at a major foreign securities company points out, "Reduction of cross-held shares facilitates share buybacks and growth investments. For companies whose shares are sold, it provides an incentive with them to consider share buybacks, which may enhances their ROE." At AGMs, some investors voted against the appointment of top executives at companies with consistently low ROE, representing that they are watching those indicators closely.

The sale of cross-held shares could turn the environments about M&As involving Japanese companies upside down. This is due to sudden decline of stable shareholders, which may look "opportunities" for activist shareholders.

An analyst at a major securities company refers to one characteristic of companies that are more likely to be targeted for acquisition from overseas than others; a high foreign ownership ratio. "The unwinding of cross-shareholdings could indirectly make the companies look more susceptible to acquisition." he says. Recently, a major domestic retail company received an acquisition proposal from a leading convenience store chain in North America.

After stable shareholders have gone, the best defense for companies now facing acquisition proposals from overseas investors, appears to enhance their corporate value and increase market capitalization. Due to the impact of historically strong stock markets, the recorded amount of cross-held shares at the end of the previous fiscal year was approximately JPY 37 trillion (circa USD 258.7 billion) for corporations alone, still increasing from the previous fiscal year and remain at a high level. It is now essential for companies to develop further, to use the sales proceeds of cross-held shares in more effective ways to strengthen investments in growing business areas and human capital, as well as more returns to shareholders.

Compiled from Nikkei Shimbun and Mizuho research

2. TSE's reform: It has just begun

The Tokyo Stock Exchange (TSE) has been requesting listed companies to keep working to achieve "management that is conscious of capital costs and stock prices" since March 2023. Many of them have disclosed their plans by turns to improve indicators related to capital efficiency and market evaluation, such as PBR, ROE, and ROIC. As of the end of July 2024, about 78% of the companies listed on the Prime Market have complied with this request. This figure would rise to approximately 86%, also if it included the number of companies yet to disclose but are planning to disclose in the coming period.

TSE announced a review of their activities for this purpose in the past and its future strategies on August 30, 2024. While they commended that many companies had begun disclosing their plans and the continued efforts, they also pointed out that some companies have yet to make the disclosures. Furthermore, they touched upon issues such as differences in viewpoints on what need to be disclosed in the initiative between companies and investors. The TSE emphasized that their reforms had "just begun" and stated that they would further focus on creating an environment that helps enhancement of corporate value through constructive dialogue between listed companies and investors from the standpoint of market operators.

TSE anticipates that further advancement of their reforms may lead companies to pay more costs for maintenance of their listing status, which might result in

more companies choosing themselves delisted. However, TSE stated that it would respect such decisions of companies to be no longer listed. The TSE previously commented that it takes reduction of listed companies in number due to privatization “positive”. TSE reaffirmed its view that, in order to make Japanese market more attractive, it would prioritize "quality" rather than "quantity" of listed companies, which represents its goal as the realization of increased corporate value that fulfills investor expectations.

“If costs and burdens to maintain listed status outweigh the benefits, delisting may be a reasonable option. The number of listed companies on the TSE is approximately 3,900, which is large by global standards. We believe that TSE should be a market that attracts investment funds from both domestic and international sources to companies with good growth potential, and we put quality before quantity in terms of listed companies," says Mr. Yamaji, CEO of Japan Exchange Group (JPX).

To further develop its reforms, TSE consulted over 60 stakeholders, including domestic and international institutional investors, securities firms, trust banks, consulting firms, and think tanks that provide supporting services with listed companies, from June to July of this year. TSE also announced that it would make new approaches by categorizing companies listed on the Prime Market and Standard Market into three groups.

Group 1 consists of "companies that can carry out their initiatives on their own," which TSE will continue to support to refine their business activities. Group 2 comprises "companies appearing to be able to do better," and TSE intends to focus on supporting these companies in particular. Together, Groups 1 and 2 account for approximately 86% of the companies in the Prime Market. Group 2 includes companies that have been seen as the ones going somewhat wrong from investor viewpoints due to insufficient communication with investors. For these companies, TSE plans to release case studies around mid-November, highlighting the points investors expect, as well as points where visions of investors and those of companies do not sit well together. Additionally, TSE will touch upon how appropriate disclosures changes their reputation and evaluation in the market. TSE will also alter the monthly list of companies that have disclosed or are considering their initiatives, to establish a framework that encourages companies still under consideration to take action earlier.

Companies classified as Group 3 are those that have "not yet disclosed their initiatives," to which 14% of the companies in the Prime Market belong. Some of these companies are not willing to engage in dialogue with investors, attributing to their IR (Investor Relations) system being underdeveloped, lacking mindsets and basic structures to face investors, which is now essential for listed companies. This is partly due to presence of controlling shareholders (shareholders who holds a significant ownership of the company’s share), which makes these companies less sensitive to market pressures.

TSE established a department specialized in supporting listed companies in this January, providing opportunities for listed companies to learn key points and items to be noted to facilitate their IR (Investor Relations) activities. They also offer opportunities for dialogue in the form of a small meeting that enables two-way communication with institutional investors.

Both listed companies and institutional investors have a strong interest in what TSE would do next. In particular, institutional investors watch closely about the TSE's view on decline of listed companies in number, via MBOs (Management Buyouts) and other methods. The fluctuation of listed companies in number may impact revenues of the stock exchange as a listed company. As mentioned at the beginning of this article, the shift from "quantity" to "quality" could result in further increases of costs to maintain their statuses as a listed company. However, the increase of listing maintenance costs is essential for raising funds from a broad base of shareholders through listing. Listed companies are responsible for maintaining proper corporate governance structure, which enables shareholders to monitor management, sustainable growth, and the enhancement of corporate value over medium term to long term, as well as disclosures that are important for investment decisions. Based on the TSE's measures, listed companies would have to consider their future course of action.

The materials published by TSE is available from the below website:
https://www.jpx.co.jp/english/equities/follow-up/b5b4pj000004yqcc-att/dh3otn000000csa7.pdf

3. The government urges asset owners to become more “professional” in investments

In Japan, the "Stewardship Code (Principles for Institutional Investors)," which encourages improvement of corporate value through dialogue between asset management companies and their investee companies, has been in place since 2014. Asset management companies urge their investee companies to improve their governance structure, demand expansion of investments for their growing business area and of shareholder returns, and thus intend to drive stock price increases and boost investment returns.

While asset management companies have been as eager to have dialogues with corporations in Japan as one in Western markets have, some asset owners who entrust their funds to Japanese asset management companies found that some of them were not real professionals.

On August 28, the government publicized the "Asset Owner Principles," guidelines drawn up for developing investment capabilities of asset owners such as pension funds. These new principles demand asset owners to strictly check and monitor asset managers and investees, by setting goals on their long-term investment objectives and financial conditions from the perspective of pursuing the best interests of final beneficiaries. The principles aim to lead to the medium- to long-term growth and enhancement of corporate value of investee companies and to improve investment skills and capabilities of asset management companies through healthy competition.

The definition of “asset owner” is broad, covering public pensions, mutual aid associations, corporate pensions, insurance companies, university funds, and educational corporations that conduct asset management. They are very different in size and purposes of fund management. In Japan, for example, there are more than 10,000 corporate pension funds, and their structures differ by their size and the recognition of the companies sponsoring the funds. However, the government expects each asset owner to check their preparedness to pursue the best interests of end beneficiaries. By presenting this to their stakeholders (such as beneficiaries, donors, and contributors), they could deepen mutual understanding, leading to dialogue and collaboration, which could eventually enhance investment skills and capabilities. The government keeps propagation of the new principles so that the principles to spread further.

Major organizations such as the Government Pension Investment Fund (GPIF) and the Pension Fund Association (PFA, employee’s pension fund) have already announced their acceptance of the principles in this September. They also publicized their policies for initiatives aimed at developing investment knowledge and skills. Other pension funds are also following suit.

The Federation of National Public Service Personnel Mutual Aid Associations (KKR) will expand its exposure into alternative investments, in addition to conventional assets such as stocks and bonds. Private equity will also be a part of its portfolio.

The new principles require asset owners not only to set investment goals and policies but also to secure sufficient human resources and providing comprehensive information to beneficiaries. They also recommend recruiting investment managers, including external personnel, if necessary.

The KKR, which manages approximately JPY 11 trillion (circa USD 78.5 billion), plans to appoint the Chief Investment Officer (CIO), who will be responsible for investment management by fiscal year 2025, further enhancing expertise through training existing staff and hiring new staff. Following the example of the GPIF, KKR will file itself as a "Qualified Institutional Investor" and register as a professional investor. This will allow KKR to invest in financial products designed for professionals, such as private real estate investment trusts (REITs) and funds.

The upper limit ratio for alternative investments, such as real estate and infrastructure, which was previously 1% of the total assets, will be expanded to 5%. Private equity investments, including those in venture companies, will also be added to the investment assets. In selecting providers that will handle KKR’s assets, trust banks, asset managers and other institutions will be required to present clear fee structures, so that they can select appropriate providers.

The Pension Fund Association for Local Government Officials (PFA for LGOs), which manages approximately JPY 36 trillion (circa USD 257.1 billion),

also plans to newly appoint the Chief Investment Officer (CIO).

The PFA newly established a framework in August for corporate pensions to jointly monitor the exercise of voting rights by asset management companies. The PFA aims to enhance long-term investment returns by actively encouraging asset management companies to engage in dialogue with their investee companies.

The GPIF, KKR, PFA for LGOs, and the Promotion and Mutual Aid Corporation for Private Schools of Japan (PMAC) invest their funds according to the joint basic portfolio rule that stipulates to allocates funds to domestic and international stocks and bonds at a quarter for each. While the GPIF has appointed the CIO from private sector, some fund sponsors are critical that asset owners other than GPIF do not make clear about who is held accountable for their investment policy and decisions.

Corporate pensions with a certain scale of assets are now obligated to establish an “Asset Management Committee" in order to strengthen governance. However, according to a survey by a major auditing firm, while the Asset Management Committees are being organized at large companies, more than half of companies with employees between 500 and 999 in number have not established such committees.

According to the PFA, 19% of funds with assets ranging from JPY 5 billion to 10 billion (circa USD 25.7 to 71.4 million) are in contract with asset management consulting firms, whereas 71% for funds with assets exceeding JPY 100 billion (circa USD 714.2 million). For funds with small asset size, it is not an easy task to enhance their asset management capabilities.

The PFA manages the assets of its member pension funds in a collective investment scheme. The government also intends to promote this scheme lead by PFA. To enhance asset management capabilities, PFA incorporates possible adoption of an Outsourced Chief Investment Officer (OCIO), which is common among U.S. corporate pensions in the principles.

In a survey conducted by a foreign consulting firm commissioned by the Financial Services Agency two years ago, the firm stated about internal management structures of Japanese corporate pension funds that many of employees involved in the administration of the funds had backgrounds of corporate finance, and only few of them had ever engaged with long term fund investment. Pension funds in Europe and the United States are recognized as "professional investors," and their investment managers are held accountable for their investment decisions as professionals.

Compiled from Nikkei Shimbun, and Mizuho research.

4. METI to change the guideline on M&A in Japan

It has been a year since the Ministry of Economy, Trade and Industry (METI) formulated the "Guidelines for Corporate Acquisitions" in August 2023. The guidelines indicate how to ensure fair approaches on corporate acquisitions in Japan, aiming to enhance corporate value and encourage companies to deal with M&A (mergers and acquisitions) for benefits of shareholders. The guidelines require companies to give "sincere consideration" from the perspective of corporate value to "sincere proposals," and it is expected that the board of directors will deal with the issues appropriately from the perspective of corporate value, regardless of whether they are prepared with any takeover defense measures or not.

In the United States, where more M&A deals take place than other markets, prototype of M&A have been formed based on legal precedents. In Japan, where such legal precedents are still scarce, these guidelines could be seen as the fundamental principle for how the board of directors should act. METI expressed its expectation that the board of directors should not easily reject sincere proposals for acquisition that look helpful to enhance corporate value. METI also suggests that board of directors should make "reasonable efforts to secure shareholder’s interests even when accepting the proposals."

Since the announcement of the guidelines, the climate toward M&A in Japan has been showing significant changes. In Japanese corporate culture, hostile takeovers without the consent of the target company have been considered "bad behaviors." However, what happened in December 2023 made many market participants recognize a “fundamental change in this traditional mindset”. A major life insurance company expressed its intention to launch a tender offer (TOB) for a company providing employee welfare services. At that time, the welfare services company had already

accepted a takeover proposal from other company dealing with medical information, but the life insurance company jumped into the deal and eventually won and completed it. It is highly unusual that such a large company cut in to an ongoing M&A deal, and this case was a turning point for M&A deals in Japan. It was also an epoch-making event in Japan that an acquirer that joined the race late won the M&A deal by making better offer.

In drawing up the guidelines, METI took into account the opinions of both domestic and overseas investors as well as those of corporate stakeholders. They held briefing sessions for capital market participants in the United States and arranged opportunities to broadly listen to the opinions of overseas investors. A lawyer at a major law firm who involved in drafting the guidelines said, "Initially, some overseas investors were concerned that the METI might create defensive rules that would hinder acquisitions. However, within the ministry, the people were sharing awareness that M&As that enhance corporate value and shareholder interests to be more actively discussed in Japan. When we explained that we were aiming to promote M&A to be conducted in fair manners, overseas investors generally took it positively. We believe they clearly got our message to encourage them to invest in Japan '".

In August 2024, an overseas company operating a major convenience store chain made an acquisition proposal totaling JPY 6 trillion（circa USD 42 billion）for a domestic retail peer company. This proposal has captured executives at Japanese listed companies' interest in M&A.

The number of implementation of takeover defense measures by Japanese companies peaked at 574 in 2008 and has been on a declining trend since then, which came down to 251 as of the end of June 2024. One reason for this decline is that domestic institutional investors tightened their voting standards on takeover defense measures in 2017. On the other hand, in recent years, cases of abolition and discontinuance of takeover defense measures by companies with high institutional investor shareholding ratios have almost exhausted. Additionally, with the increase in unsolicited takeovers cases and the presence of activist investors getting stronger, some companies newly have immediate needs to implement takeover defense measures. Under the circumstances, the number of companies introducing these measures has declined only slightly in recent years. Consequently, although the number has halved since its peak in 2008, over 250 companies have still implemented takeover defense measures to date.

During the peak season for AGM in June 2024, six companies newly implemented takeover defense measures, thirteen companies either abolished or discontinued, and sixty four companies decided to continue. Among the companies that declared new implementations or continuations, the majority of them are small businesses with a market capitalization of less than JPY 50 billion (circa USD 350 million). The background of their needs can be summarized as follows: (1) the lower the market capitalization, the higher the risk of being acquired by other corporations or activist investors (large-scale purchase risk), and (2) while many institutional investors generally express opposition to the introduction or continuation of pre-warning type takeover defense measures, companies with lower market capitalization tend to have a small number of institutional investors as their shareholders, which makes it easier for them to secure approval votes. For instance, at AGMS held in June 2024, the average opposition rate to proposals for implementation or continuation of takeover defense measures was 66.8% among domestic institutional investors, and 93.8% among overseas institutional investors.

On the other hand, large companies with high market capitalizations tend to abolish their takeover defense measures. As of September 2024, only three companies with a market capitalization of JPY 1 trillion (circa USD 7 billion) or more (1.7% of companies in that market capitalization group) have implemented takeover defense measures, and only nine companies with a market capitalization between JPY 300 billion (circa USD 2 billion) and JPY 1 trillion (3.7% of companies in that market capitalization group) have been doing so. It is believed to be because "the larger the company's market capitalization, the higher the ratio of domestic and international institutional investors in its shareholder composition".

Since the publication of the METI's guidelines, practical processes of dealing with unsolicited takeovers have significantly changed. Firstly, according to the guidelines, the board of directors of a listed company that received a "sincere acquisition proposal" with the

aim of enhancing corporate value should give it "sincere consideration." For acquirers who proposed acquisition with an appropriate premium based on business synergies, the recipient of the proposal should analyze it sincerely, regardless of whether the recipient has any takeover defense measures. Even if the board of directors concluded to disagree with the proposal, as long as the proposal is logically structured, it would be extremely difficult to invoke takeover defense measures by judging the proposal as a "one that may harm the common interests of shareholders."

Before the guidelines were published, takeover defense measures were positioned as a countermeasure against abusive acquirers who harm corporate value and the common interests of shareholders. However, after the guidelines were formulated, the board of directors is now required to scrutinize the proposals from viewpoint of “more quantitative evaluations on corporate value”. Therefore, if the board of directors is dissatisfied with unsolicited acquisition proposal, it had to seek out a white knight who could present conditions that the board could agree to and had them make a counter proposal. In such cases, the stock price (i.e., corporate value) resulting from the acquisition proposal would be an important factor, and the price the white knight offered must exceed the one offered by the unsolicited acquisition proposal.

Under these circumstances, regardless of having takeover defense measures or not, the board of directors has to make appropriately assess and judge acquisition proposals from perspective of corporate value. This may imply that takeover defense measures is less necessary than before.

On the other hand, there are so-called “stealth acquirers” who abusively launch large-scale purchases with unclear intentions, negatively influencing management. In May 2024, the amended Financial Instruments and Exchange Act drastically altered public tender offer (TOB) rules. "Purchases that result in a shareholding ratio over 30%, including positions acquired in-market transactions" are now subject to TOB regulations (previously, only off-market transactions acquiring one-third or more were regulated, and in-market acquisitions were not subject to regulation). Consequently, the amended Act made it more difficult to conduct stealth acquisitions, by acquiring over 30% of shares in the market without conducting a TOB with a view of influencing company management.

Under the TOB rules, acquirers have to submit a TOB registration statement, disclosing purposes of the deal, the period and price of the purchase, the number of shares to be purchased, its business policy if they intend to gain control, and plans if they intend to involve in management. In addition, the acquiree of the TOB must express the board of directors' opinion (such as "approve," "oppose," "neutral," or "withhold") and is granted the right to question the acquirer. Thus, the TOB rules provides functions similar to those of takeover defense measures.

The guidelines published by METI have provided a certain level of clarity regarding how to deal with acquisition proposals, which hold the board of directors' more accountable for how they deal with them in terms of corporate value. On the other hand, while regulations against stealth acquirers have progressed to some extent by changing the TOB rules, acquisitions of shares that are 30% or less than the total shares issued in the market are still outside the scope of the rules.

From the perspective of keeping stealth acquirers away from companies, it is essential for them to make continuous efforts to enhance corporate value. If companies were involved in such acquisition proposal, they should deal with the situation, with leaving convincing evidence and taking appropriate processes from the standpoint of maintaining and enhancing corporate values as stated in the guidelines.

Compiled from Nikkei Shimbun and Mizuho research.

II. New Equities Listing Approvals

Listing Date	Name of Company	ISIN Code	MKT
Sep-06	Balleggs Co.,Ltd.	JP3778530000	P
Sep-24	Wedge Co.,Ltd.	JP3154880003	P
Sep-26	Top's Inc.	JP3629270004	P
Sep-27	HUMAN ADJUST Co.,Ltd.	JP3794450001	P
Sep-30	Neuromagic Co.,Ltd.	JP3756360008	P
Oct-01	TOBISHIMA HOLDINGS Inc.	JP3629810007	PR
Oct-01	GLTECHNO HOLDINGS,INC.	JP3386930006	S
Oct-01	AI FUSION CAPITAL GROUP CORP.	JP3160070003	S
Oct-01	ETS Group Co.,Ltd.	JP3130710001	S
Oct-01	Shimadaya Corporation	JP3356550008	S
Oct-11	alt Inc.	JP3201700006	G
Oct-18	INTERMESTIC INC.	JP3152840009	PR
Oct-16-Oct-22	Nihon Suido Consultants Co.,Ltd.	JP3678050000	S
Oct-23	Tokyo Metro Co.,Ltd.	JP3583900000	PR
Oct-25	Rigaku Holdings Corporation	JP3969750003	PR
Oct-28	Hmcomm Inc.	JP3161040005	G
Oct-22-Oct-28	Schoo,inc.	JP3397070008	G
Oct-29	Sapeet Inc.	JP3322790001	G

**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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