ZENNOR
ASSET MANAGEMENT

THE REVOLUTION CONTINUES: A TROJAN HORSE AND PERMANENT CHANGE

March 2023

Zennor Asset Management is a boutique asset management firm that manages the Zennor Japan Fund and the LF Zennor Japan Equity Income Fund (*coming soon*).

SMALL STEPS WITH A LARGE IMPACT

A Trojan horse, small steps, big shifts and a permanent change in behaviour

The Zennor Japan fund is focused on the ongoing revolution in corporate governance in Japan. We see this as a rolling series of small steps that nudge Japanese companies to improve their governance and their capital efficiency. In January we saw two more small steps from the Tokyo Stock Exchange that we believe are having a disproportionately large and positive impact. These two steps together act as a Trojan horse that moves capital allocation from the periphery to the centre of the investment dialogue in Japan.

> ***From now onwards companies will have to return more capital to shareholders in the short run, in the medium term stop accumulating assets which implies much higher dividends and buybacks permanently, and in the long run shift their business models to become less capital heavy which is likely to raise market wide valuations.***

The Tokyo Stock Exchange (TSE) is frustrated that so many Japanese companies do not match global corporate governance standards, and is gradually introducing updated guidance and suggestions for listed companies to improve their disclosure, reporting and governance structures. So far this has included reorganising the listing into Prime and Standard markets, encouraging Task Force on Climate-Related Financial Disclosures (TCFD) reporting and requiring companies to start sharing their Environmental, Social and Governance (ESG) Information. The TSE has also required increased independent directors and that companies should disclose the rationale for owning cross-shareholdings. In Japan this gradual, iterative improvement is called 'Kaizen' and the TSE has been slowly but relentlessly raising the bar for what constitutes a 'good' company. The pressure from social conventions in a group oriented society such as Japan should not be underestimated. The TSE's ambition is to make Japan a 'normal' global capital market and not the extreme outlier in balance sheet and valuation that it is today.

Require that management and the board of directors properly identify the company's cost of capital and capital efficiency, evaluate those statuses and its stock price and market capitalization, and disclose policies and specific initiatives for improvement and the progress thereof as necessary. ➢ Especially for companies that clearly need to improve, such as those with a PBR consistently below 1x.	Spring 2023	Prime and Standard

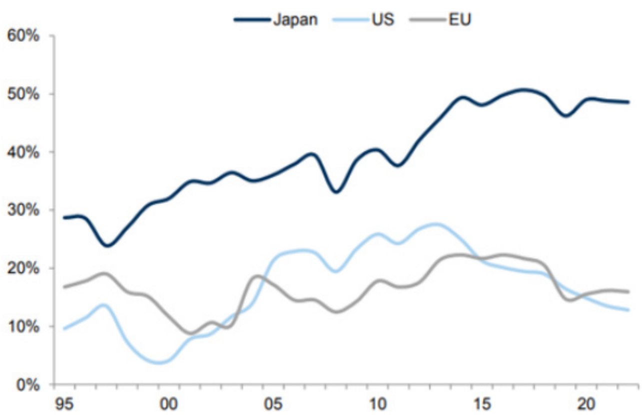
Now the TSE has turned their attention to the very large number of companies that trade below liquidation value and are 'persistently undervalued'. The changes to guidance in January are aimed directly at encouraging companies to address this. The TSE January presentation states a seemingly bland new policy, which we see as having two main areas of focus.

FOCUS AREA ONE: COST OF CAPITAL

The first aspect of this is designed to introduce a formal expression of a firm's cost of capital and increase awareness of capital efficiency at the senior management level. i.e. "how much capital do you have?" and "how much does this capital cost you?" Perhaps also questioning "how much capital do you actually use in your business?"

The chart below shows how Japanese firms diverge from those of other developed markets in that around 50% of Japanese firms have net cash versus <20% in Europe and the US. Many Japanese firms have focused on raising operating efficiency but have allowed their balance sheets to become very large suggesting a lack of awareness of the cost of capital.

Percentage of net cash listed companies



Source: Goldman Sachs Global Investment Research

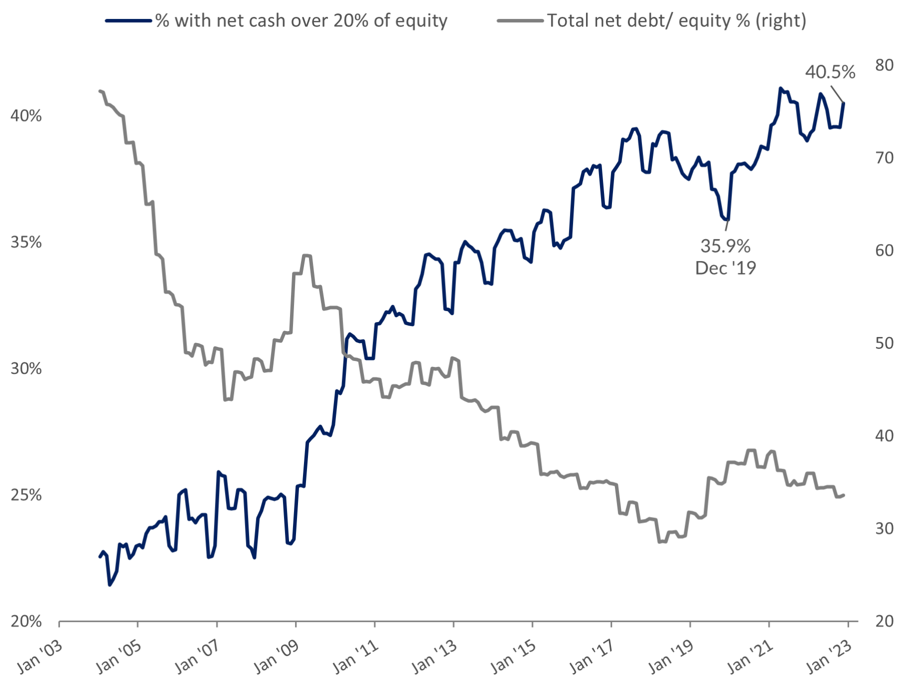
CONTINUED: COST OF CAPITAL

The impact on the cost of capital is also a function of the amount of net cash that has been accumulated over recent years. The proportion of companies with net cash may be stable recently but the quantity of net cash they hold has risen inexorably. More than 40% of companies have net cash >20% of their shareholders equity.

This calculation does not include investment securities or other non-core assets. Balance sheets in Japan are extremely strong but this is also very costly from a capital efficiency perspective and hurts market wide returns. The market has long been frustrated by companies with large balance sheets earning low returns on capital and destroying value (i.e. Cost of Capital is > Return on Investment). By asking companies to share their own thoughts on cost of capital, shareholders have an opportunity to engage with them over the amount of capital needed to run their business and how that capital is provided. All too often in Japan the amount of capital used is too high and it is almost entirely funded by equity. Often the operating business itself is delivering acceptable returns – it is the balance sheet that drags down capital efficiency.

Disclosing the cost of capital helps open up a new dimension to the conversation with companies about the correct size and shape of their asset base.

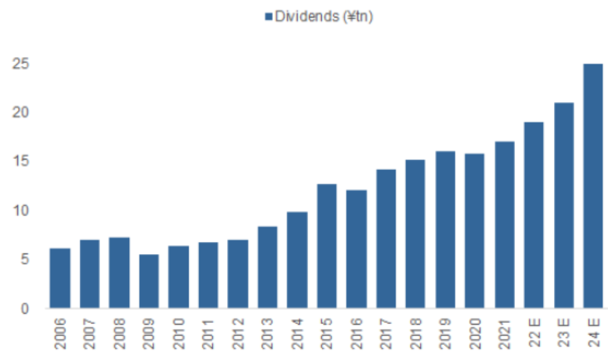
Percentage of Topix non-financials with net cash over 20% of equity



Source: CLSA, Bloomberg

The issue is not that Japanese companies have not been growing both their buybacks and their dividends over the last decade but that earnings are much higher than capital returns and so each year companies accumulate ever more cash. To improve their returns companies need to at the very least stop their balance sheets growing and most likely shrink their asset base. The current level of return is not yet high enough to stop the accumulation of excess non-operating assets. We believe that this is a very powerful tailwind for both dividends and also for buybacks – we also believe that this is likely to impact valuation levels as well.

Total dividend payments in Japan are expected to rise steadily from here



Source: FactSet consensus, Data compiled by Goldman Sachs Global Investment Research

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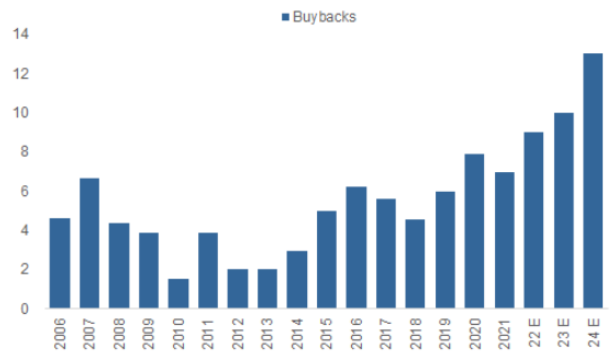
Buybacks are also expected to move higher



Source: FactSet consensus, Data compiled by Goldman Sachs Global Investment Research

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The natural conclusion from many of the cost of capital conversations will be that firms finally recognise that they have too much, very expensive capital.

FOCUS AREA TWO: PERSISTENTLY LOW MULTIPLE

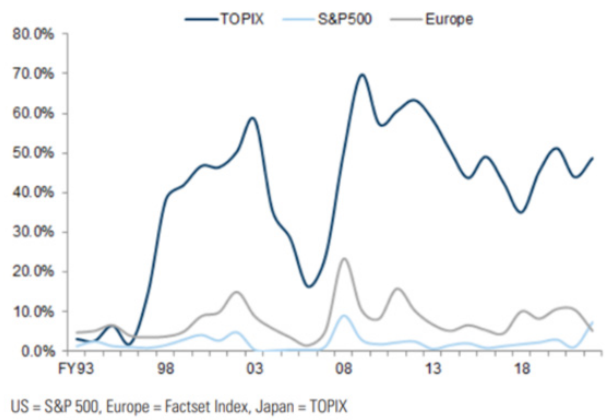
The second focus is on those companies with a persistently low multiple (especially below 1x Price to Book Ratio (PBR)) and asks that they take steps to reduce the undervaluation. Empirically there is a link between higher return on capital and higher valuations. Certainly companies who persistently earn less than their cost of capital rarely command high valuations. The connection that the TSE is making between companies failing to earn in excess of their cost of capital, large balance sheets and low valuation becomes clearer. In Japan >50% of listed companies trade below book value. This is quite different from other global developed markets at less than 10%. An active market for corporate control, stronger governance, less blending of high non-core asset levels with operating assets and greater alignment between managers and shareholders are all factors that limit downside to valuations outside Japan.

Our positive structural thesis for Japan is that Japan is becoming more like Europe and the US in this respect and that profound undervaluation in so many securities will be reduced. That the TSE explicitly highlights this area shows that this remains a key focus for them.

FOCUS AREA TWO: PERSISTENTLY LOW MULTIPLE

Trading below book means that you ought to be able to liquidate the company's assets as stated in the balance sheet for more than the current market valuation – there is no value applied for the company organisation itself (the combination of resources that should create economic surplus). As we have discussed before many Japanese firms have understated book values suggesting that they are even cheaper against assets than they appear on the computer screen. This is because Japanese accounting marks assets to whichever of the original book cost or the market price is lowest so assets acquired 50 or even 100 years ago are still marked at that historical level. Japanese firms have also often been required under JGAAP to amortise acquisitions. This reduces earnings but also the value at which M&A assets are carried on their books. This means that Book value in Japan is generally quite close to Tangible book with very little goodwill for brands, IP etc. that many global companies carry elsewhere. This suggests that relative to Western companies Japanese book is much more conservative and often understated to a significant degree against current market prices. These low PBR companies are the first target for the TSE in terms of addressing persistent undervaluation.

Percentage of Companies with P/B multiple below 1.0x
(Excluding financials)



Source: Goldman Sachs Global Investment Research

IMPLEMENTING CHANGE

So what can you do if you trade below book and do not want to anymore? The first thing is to look at whether your business is creating value in excess of its cost of capital. Perhaps due to a very large cash position you are falling short of this hurdle.... In this case the solution is to establish a plan that targets a higher level of Return on Equity/ Return on Invested Capital (RoE, RoIC respectively) in excess of your capital cost and outline the mix of earnings power and asset base will allow you to reach this target. It is likely that you will have to shrink your assets implying either large dividends, large buybacks or most likely both. One current example that has embraced this strategy (under shareholder pressure) is Dai Nippon Printing (DNP, 7912).

DNP's new mid term plan is illustrative of what we anticipate many companies will be thinking about to address the TSE request.

Due to their large balance sheet historic RoE was only 5% and the company traded around 0.6x PBR despite having many valuable assets and successful operating entities. It was known to be cheap but several investors had tried to generate change without success over the years. The changing environment and pressure from shareholders finally bore fruit this year - encouraged by these new TSE guidelines. The company's new plan targets a 10% RoE up from 5%. This will be achieved through selling 'idle assets' and reducing strategic cross-shareholding by 310bn and they plan at least 300bn stock buyback and an additional increase in the dividend payout ratio. Ahead of this plan DNP rallied from 0.6x PBR towards 1x PBR.

The TSE is clearly hopeful that this model of pressure, higher RoE targets through asset slimming and continued operating improvement will be more widely adopted. We do not believe that this is the end of the DNP transformation but only a first step. Even after this Mid Term Plan the company will still hold many low return, non-core assets whereas the actual operating business is generating a nearly 15% return and is growing quickly. The transformation journey has many years to run as DNP morphs from a low return, legacy print oriented and asset bloated company into a focused high technology, high return, high growth and much higher multiple business.

Clearly not every company will transform in the same way that DNP intends to. However, this example, the pressure from TSE and from shareholders all suggest that management teams at companies trading below book with large balance sheets without a clear plan to raise value will face a very tough time. The quickest and easiest way to change the dynamic and raise returns is to increase dividends, and slim the size of the asset base. We believe that this will be very beneficial for these kinds of stocks and is already visible in the conversations that we are having with companies.

THE OUTLOOK

How does this permanently change corporate behaviour? Once a company has committed to exceeding the cost of capital and to generating an appropriate valuation it is very hard for them to downgrade those aspirations. In practice this means the commitment becomes permanent – firms will constantly have to monitor their asset levels and ensure that those levels do not expand so much that they reduce returns. A market wide reduction in cross-shareholdings and push to raise returns also encourages managers to re-examine their business models and look for more capital efficient ways to manage their business.

Japanese companies have treated capital as though it were almost free and there are many areas of their business models that can be changed – working capital, financing, sales channels etc. once capital becomes seen as a cost to the company. As a case in point Komatsu (6301) competes globally against Caterpillar (CAT). Their operating margin is very similar but the RoE is 4x higher at CAT. This is a business model decision which means that CAT runs a much leaner capital structure. Unsurprisingly CAT trades at a far higher multiple of book – whilst Komatsu may not reach CAT's RoE in the near term it may well increase its RoE through leaner capital management and has the potential to substantially rerate as it does so. This story is true across Japan and is illustrative of the fact that – until now – equity capital has been treated as 'free'. Part 1 of the TSE plan will surely have a powerful long term impact.

This is great news for the Zennor investment thesis of a revolution in corporate governance and for our portfolio that has focused on meaningfully undervalued stocks with positive catalysts. We are recycling capital from some of our biggest winners last year into some businesses where we feel the pressure to change capital strategy will be most acute. The characteristics of these companies are of course low valuation, VERY robust balance sheets and where we can see positive capital change catalysts. The impact of these changes will be seen most strongly on the kinds of companies generally not owned by global investors – they are after all low returning, low valuation and frequently simply off the radar. As a consequence of these adjustments the the portfolio currently trades at a price to book ratio of 0.7x PBR compared to Topix which in on 1.1x PBR. We are confident that in reality our valuation is even cheaper when accounting for 'real' book. We also believe that the TSE changes will continue to encourage other companies to improve their returns – several of our holdings have very large investment portfolios and huge treasury stock positions. Whilst they may not trade below book they are certainly profoundly undervalued.

Zennor sees that these two seemingly innocuous changes at the TSE on disclosing cost of capital and acting to remove persistent undervaluation are in fact a Trojan horse that forces capital allocation decisions to the front and centre in Japan. The long term ramifications for higher returns on capital, shareholder return and market valuation are profound.

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