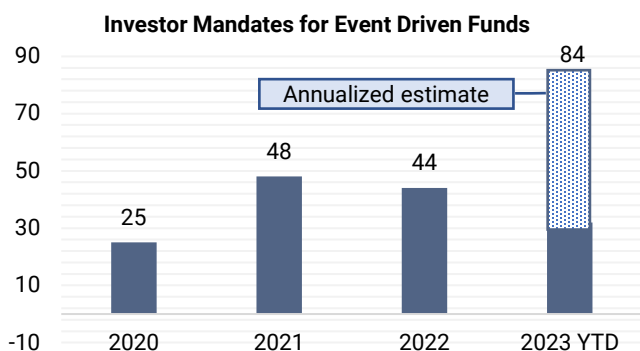


Investing in Change: Spotlight on Activism in Japan

Jefferies Capital Intelligence

Demand for Event Driven Strategies

The Jefferies Capital Intelligence team examines investor mandates for changes in hedge fund demand. We have observed a slight but notable uptick in allocators expressing interest in event driven funds. Typically, demand for event driven funds has been more muted and a smaller percentage of total mandates, but its recent growth is worth noting. Event driven investing is a broad strategy with many approaches, but we will focus on one corner of this strategy, activist engagement, specifically activism in Japan.



Source: Jefferies Capital Intelligence

Note: 2023 mandates for event driven managers is a year-to-date figure through 7/3/23 and on an annualized basis, the estimated number of investor mandates would nearly double that of last year.

In fact, the Jefferies Capital Intelligence team has seen a fivefold year-over-year increase in investor discussions for Japanese activists. This is off a very small baseline, but worth noting. Most of this demand is from family offices and fund of funds and allocators report multiple drivers behind this growing interest.

What Drives Interest in Japan, and Specifically Japanese Activism in 2023?

For many years, Japanese equities have been rangebound, with many companies trading below book value.¹ In some cases, Japanese companies were criticized for some of their governance practices, which were perceived to prioritize stability over shareholder interests.

In part to address this, the Japanese government has implemented policies known as Abenomics, with the aim of accelerating the country's economic growth. One key aspect of these reforms focuses on corporate governance, aiming to enhance transparency with shareholders, foster dialogue with institutional investors, and improve the profitability of Japanese firms. Japan's Stewardship Code of 2014 and Corporate Governance Code of 2015 were regulatory guidelines designed to address corporate governance concerns and promote sustainable, long-term growth for Japanese companies. These policy reforms are seen by some as paving the way for a more conducive activist environment in Japan.

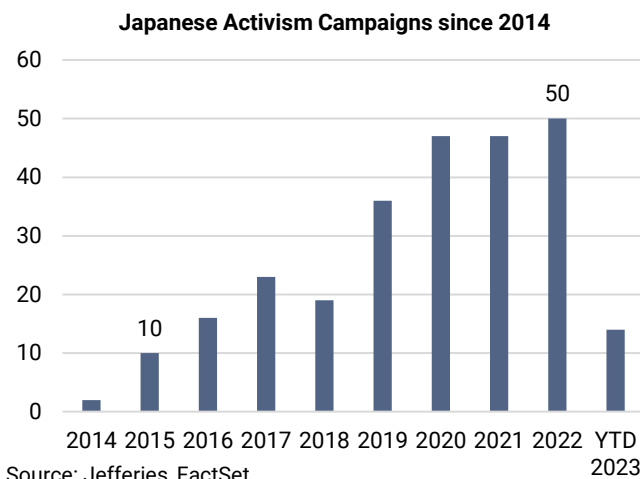
Three Main Objectives of Abenomics

- ❖ Renewed alignment between the government, stock exchanges, and shareholders
- ❖ Reassessment of corporate governance in Japan
- ❖ Pursue opportunities to generate higher corporate valuations

Undervalued Japanese companies are being identified and evaluated based on an investment framework of reassessed corporate governance practices. The Harvard Law School Forum on Corporate Governance notes that with undervalued companies, investors may focus on idiosyncratic opportunities of potential investments.² Managers are increasingly ramping up their pressure on companies to address their strategic operations and capital return to shareholders.

The yearslong effort to reform corporate governance has helped catalyze investor activism in the Japanese markets. Activism is a niche strategy and cross-border activism brings with it, its own set of challenges and opportunities. Activist hedge fund managers are exploring opportunities in Japan, and they hope to leverage the improving corporate governance environment to generate alpha.

The Jefferies Microstrategy team recently reported that in 2015, there were 10 activism campaigns for Japanese companies but by 2022, these campaigns increased to 50. Though not synonymous, we also witnessed growth in shareholder proposals. According to Investor Relations Consultant, IR Japan Holdings, the number of proposals submitted for this year's shareholder meetings is up ~60% from the same time last year.³



Source: Jefferies, FactSet

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Tokyo Stock Exchange Promotes Reform

More recently in January 2023, the Tokyo Stock Exchange announced its intention to enhance the value of companies trading below a price-to-book ratio of 1.0. In March, a letter was sent to Japanese companies trading below book value, urging a stronger focus on share price and capital efficiency.⁴ These engagements complement the Japanese government's initiatives and affirms the stock exchange's ongoing efforts to increase constituent value and attract foreign investors.

With greater alignment between the government, stock exchanges, and corporate executives, many argue that Japan is now an attractive market with many high-quality companies trading at undervalued levels, even as the Nikkei is trading at thirty-year highs.⁵ The corporate governance reforms in Japan may be providing activist fund managers with an environment to influence change and maximize shareholder value.

A Differentiated Approach to Investing

Activist hedge funds use a wide range of approaches to effect change, including screening for undervalued companies, conducting robust company due diligence, and in some cases, seeking governance changes in how the company is run.⁶ Improving corporate governance within Japanese companies is the primary means by which activist shareholders are looking to unlock value in 2023. Activist hedge funds may look to acquire a controlling stake in a target company, work collaboratively with company management and the board to effect change, and generate long-term shareholder value.

As a reminder, there are additional levers that activist hedge funds use that passive managers don't.

	Passive Investor	Active Investor
Conduct initial diligence of company and shareholders	✓	✓
Build stake in target company	✓	✓
Meet with company executives and share ideas to unlock value	✓	✓
Deepen engagement with company management		✓
Leverage controlling stake to influence changes at the executive or board level		✓

Portfolio Realignment Amid Shifting Sands

Allocators are reassessing and rebalancing their portfolios because of the many ongoing shifts in the global economy. Some factors are risk management, asset allocation, and regional exposure, among others. This may influence interest in Japan.

Additional drivers to investing in Japan:

- ❖ **Additional Diversification:** Investors may want to diversify their portfolio by adding new asset classes, strategies, or regions.
- ❖ **Potential Alpha Generation:** Investors may view the renewed approach to corporate governance in Japan as a unique opportunity to unlock value. By investing in activist managers with the expertise to create alpha in undervalued Japanese companies, they may be able to generate more favorable risk-adjusted returns.

Another pathway to gain exposure may be via a co-investment. While some investors may allocate to an activist manager in a commingled vehicle for Japan exposure, others can invest alongside a manager through a co-investment. Customization may be sought by allocators, as they have the option to target investments based upon deal size, industry, or geography.⁷

Some allocators believe that the inefficiencies in the Japanese markets can be alleviated by opportunistic managers. By conducting shareholder activism and constructively engaging with company management, allocators hope managers can capture the alpha in Japan.

Remaining Questions

But some questions remain about potential headwinds to this space.

- 1) **Equities:** One of the questions facing activists in Japan is whether there is still momentum to the upside, given that the Tokyo Stock Price Index (TOPIX) is trading at the highest level in over 30 years.
- 2) **Core Inflation:** Japan is experiencing inflation for the first time in thirty years. Market participants are contending whether this will be a headwind or tailwind to Japanese corporate profits.⁸
- 3) **Currency:** Debates remain about the benefits and drawbacks of a weak Yen, as it may benefit export-oriented manufacturers, yet also makes imports more expensive.⁹

Despite the recent rally and other economic questions, many argue that valuations of some Japanese companies are attractive, and these firms remain ripe for a reassessment of corporate governance. While it remains to be seen if some recent activism successes in Japan can be replicated, there is a growing interest among some allocators.

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How Jefferies Can Help

Jefferies is a full-service investment bank and capital markets firm, with 5,000+ employees providing insight, expertise and execution to investors, companies and governments. We offer deep sector and regional expertise across a range of products and services in investment banking, equities, fixed income, and wealth management in the Americas, Europe, the Middle East and Asia, across 40+ offices.

The Jefferies Capital Intelligence team leverages proprietary data from key industry stakeholders to extrapolate trends around capital allocation and portfolio construction. The team has a regional coverage model and has dedicated personnel covering hedge fund managers across the globe.

Jefferies Microstrategy is a bottom-up research product that uses company fundamentals to create insights into markets and sectors and combines it with top-down macro trends to develop systematic investment strategies and diagnostic screens for our global client base.

We welcome your inquiries and look forward to working with you.

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FOOTNOTES

¹ WSJ <https://www.wsj.com/articles/lessons-from-japans-lost-decades-11577874601>

² Harvard Law School Forum on Corporate Governance <https://corpgov.law.harvard.edu/2023/05/30/shareholder-activism-what-investors-look-for-which-companies-are-targeted-and-how-stocks-perform/>

³ Japan Times <https://www.japantimes.co.jp/news/2023/05/22/business/tse-shareholder-proposals-record/#:~:text=The%20number%20of%20proposals%20submitted,time%20high%20of%2058%20proposals.>

⁴ Nikkei Asia <https://asia.nikkei.com/Business/Markets/Tokyo-bourse-tells-Toyota-SoftBank-others-to-lift-capital-efficiency>

⁵ Bloomberg <https://www.bloomberg.com/news/articles/2023-05-31/global-money-is-fast-chasing-alternatives-as-china-anxiety-grows?leadSource=verify%20wall>

⁶ SSRN https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2291577

⁷ Mercer <https://www.mercer.com/content/dam/mercer-dotcom/global/en/shared-assets/global/attachments/pdf-2020-co-investments-a-primer.pdf>

⁸ Reuters <https://www.reuters.com/markets/asia/japans-consumer-inflation-hits-41-year-high-keeps-boj-under-pressure-2023-02-23/>

⁹ Wall Street Journal <https://www.wsj.com/articles/weak-yen-aids-toyota-other-big-japanese-companies-11660563699>

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