

SHAREHOLDER ACTIVISM IN JAPAN

MAY 2020

PRODUCED BY



Activist Insight

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DATA:

All data within are sourced from the Activist Insight Terminal and are as of April 30, 2020, unless otherwise stated.

Rounding may lead to summation errors.

Market cap ranges:

Large cap: > \$10 Billion

Mid cap: \$2 Billion - \$10 Billion

Small cap: \$250 Million - \$2 Billion

Micro cap: \$50 Million - \$250 Million

Nano cap: < \$50 Million

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FOREWORD

ACTIVISM IN JAPAN HAS BECOME MORE EXPLICIT IN RECENT YEARS, AS INVESTORS CAME TO BELIEVE THEY HAD THE GOVERNMENT'S TACIT SUPPORT FOR IMPROVEMENTS IN GOVERNANCE AND RETURNS. ITS FUTURE WILL DEPEND ON THE SAME MESSAGE CONTINUING TO BE HEARD, WRITES JOSH BLACK.

In his seven years as Japan's prime minister, Shinzo Abe has been synonymous with corporate governance reform. His Abenomics program of economic reform was the driver for 2014's stewardship code and 2015's corporate governance code. Both have since been tightened: the governance code in October 2018 and the stewardship code in March 2020.

Those actions have led to a flourishing of activism – the number of Japanese companies publicly subjected to activist demands rose from 14 in 2013 to 65 in 2019, following a largely smooth ascent. Japan is now the third-busiest country for activism, after the U.S. and Australia, and is one of the only major markets where activism has held up thus far in 2020.

It is not just hedge funds. According to Proxy Insight, support for dissident candidates in proxy fights had risen from 2.6% in 2017 to 22.8% for Japanese investors and from 4.8% to 39.1% for foreign investors by 2019. On shareholder proposals, Japanese support has risen from 7% in 2017 to 13% in 2019 and from 13% to 18% for foreign investors.

Although true breakthroughs are still rare and many companies are protected by cross-shareholdings, the genie is becoming harder to put back into the bottle. This special

report highlights some of the changes that have come over Japan's markets since Abe's accession – their politics, still in flux, the lure of unlocked value, and companies' receptiveness to foreign activists. We are grateful to Georgeson for its support on this project.

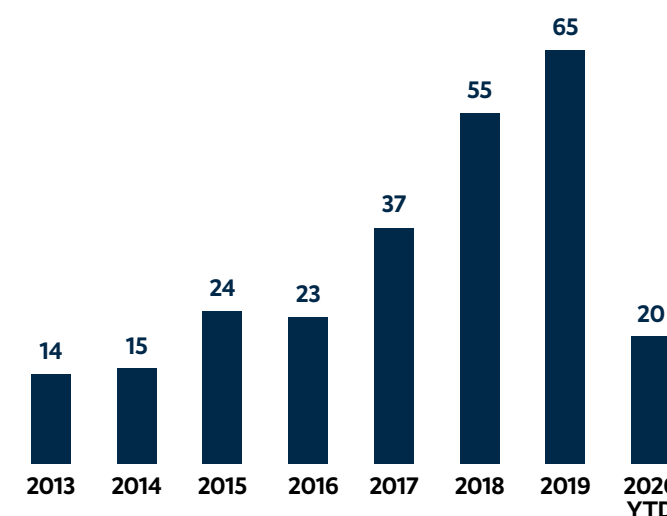
Although we have included data for the first quarter of 2020, this year may be an exceptional one, given the changes that have taken place since the COVID-19 pandemic cast a pall over global markets and forced the postponement of the Tokyo Olympic games to 2021.

Yet activist activity has held up and ValueAct Capital Partners, which had perhaps the signature win of 2019 at Olympus, has reportedly made another two investments in Japan. If 2020 poses some great uncertainties for the world economy, that is just as true outside of Japan, if not more so.

Predictions are beyond the scope of this report, but we will be continuing to track this story on *Activist Insight Online*. Please do consider a trial if you are not already familiar with our work, and we welcome feedback and suggestions for our future reporting.

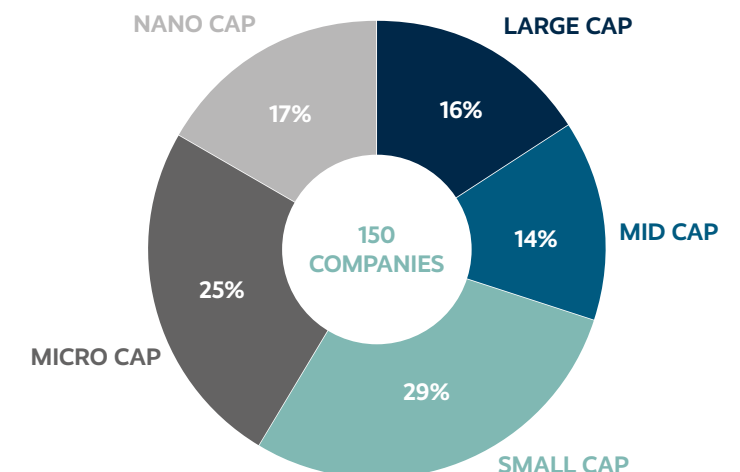
Thank you for reading, and stay safe. ■

JAPANESE ACTIVIST TARGETS BY YEAR



Number of Japan-based companies publicly subjected to activist demands by year.
Source: Activist Insight Online

JAPANESE ACTIVIST TARGETS BY MARKET CAP



Breakdown of Japan-based companies publicly subjected to activist demands between 2014 and 2019 by market cap. Rounding may lead to summation errors. Market cap ranges available on page 2.
Source: Activist Insight Online

MAKING JAPAN GREAT AGAIN

MORE THAN ANYONE ELSE, PRIME MINISTER SHINZO ABE IS RESPONSIBLE FOR THE RENAISSANCE OF SHAREHOLDER ACTIVISM IN JAPAN. INVESTORS APPEAR TO BELIEVE HIS GOVERNANCE REFORMS HAVE THEIR OWN MOMENTUM, WRITES JASON BOOTH.

Since Abe's election in 2012, government-mandated financial and governance reforms have made Japan one of the world's most shareholder-friendly and best performing markets. While Abe's term may end as soon as 2021 if he doesn't seek re-election, the changes his government has initiated look likely to remain in place.

It's not that Abe, seen by many as a right-wing nationalist, has an inherent interest in making life easier for activist investors. But improving Japan's economy begins with a stronger corporate sector. "This is Abe's version of 'make Japan great again,'" said Yoshito Sakakibara, an economist at investment consultancy Soleil Global Advisors Japan.

It's a stark difference from a decade earlier when what Sakakibara described as a "societal consensus against shareholder activism" was reflected in the government, media and courts systematically siding with incumbent management.

The year 2007 was a watershed. A legal bid by U.S. activist fund Steel Partners to stop Bulldog Sauce from implementing a poison pill was not only rejected, but the fund was branded an "abusive acquirer" and "vulture investor" by the courts. A month later, Yoshiaki Murakami, Japan's most high-profile activist, was handed a two-year jail term for insider trading, in what many saw as a warning to other investors. The Japanese stock market subsequently lost more than 50% of its value in the Great Recession, and remained depressed for the next five years despite strong recoveries elsewhere in the world.

Things began to change with Abe's election in December 2012. A new Corporate Governance Code was introduced in 2015 to encourage Japanese management to deliver better shareholder returns, improve balance sheets and board composition, reduce cross-shareholdings, and more effectively incentivize management. "The government finally started instituting guidelines requiring boards to fulfil their fiduciary duties, which is a radical change," said James Rosenwald, founder of Dalton Investments, which has been investing in Japan since the early 2000s.

That was followed by changes in the tax code to encourage stock-based executive and board compensation by deferring payment on restricted stock options while allowing holders to receive cash dividends and vote shares.

Finally, new M&A guidelines last year mandated that boards receiving a third-party takeover bid should create a committee of independent directors to evaluate the fairness of the proposal. The effectiveness of the guidelines was demonstrated when a committee of independent directors at hotel operator Unizo urged shareholders to oppose an "insufficient" tender offer by H.I.S., sparking a bidding war for the company. "Unizo showed us that the M&A guidelines have teeth," said Rosenwald.

Some observers worry that under new leadership, Abe's reforms might be slowed or even reversed. Such unease was apparent last year when new foreign exchange and foreign trade rules were brought in requiring prior-notification and screening for investments in certain business sectors. That sparked fears that M&A activity by foreign-based companies and investors could be stifled.

Nonetheless, long-time Japan-watcher J.C. de Swaan of New York hedge fund Cornwall Capital, who also lectures at Princeton University, is confident that Japan's corporate reform programs have "reached escape velocity." He noted that while buybacks and dividends are cyclical, hard-to-unwind structural changes like more independent board members and reduced cross-shareholdings seem to have become accepted parts of Japan's corporate fabric.

Demographic changes such as the rise of a millennial generation who have little memory or attachment to Japan's traditional "keiretsu" business culture of cross-shareholdings and lifetime employment also mean that politicians will have less incentive to reverse Abenomics. "The older generation is retiring, and the younger generation is much more open to change," noted Sakakibara. ■

ACTIVISM IN JAPAN

1989

T. Boone Pickens' bid for three board seats at Toyota supplier Koito Manufacturing rejected by shareholders in first notable proxy fight in Japan.

2000

Yoshiaki Murakami launches Japan's first home-grown hostile takeover bid at real estate and electronics parts firm Shoei. He's voted down by shareholders.

2008

U.S. fund Steel Partners wins seven board seats and ousts president at Aderans in first major proxy contest win for an activist investor.

2012

Shinzo Abe is elected Prime Minister, introduces Stewardship Code and other measures to improve governance, reduce cross-shareholdings, and incentivize Japanese management.

2013

Third Point Partners calls on Sony to sell its entertainment division, Oasis urges Nintendo to go mobile, and TCI seeks buybacks at Japan Tobacco as activists refocus on Japan.

2018

Over 50 Japanese companies publicly targeted by shareholder activists in one year, up from 15 in 2014. Companies targeted for board seats jump to 11, from just one in 2014, then doubled to 22 in 2019.

JAPAN IS NO PLACE TO HIDE FROM ACTIVISTS

JAPANESE COMPANIES SHOULD ALREADY BE THINKING ABOUT THE DANGER POSED BY TOMORROW'S ACTIVIST, WRITES CAS SYDOROWITZ, GLOBAL HEAD OF M&A AND ACTIVISM AT GEORGESON.

After record levels of activism in 2019 and with COVID-19 chilling activity worldwide, Japanese corporations could be forgiven for expecting respite in 2020.

Indeed, Japanese corporations may even be tempted to argue that their conservative balance sheets place them in a better position than international peers at a time when preserving cash is such a high priority. Such caution has often been a target of activists seeking increased dividends or buybacks.

Yet, while no activist wants to incur the ire of traditional investors at a time when many of their demands are either viewed as inappropriate or distracting to management teams in survival mode, redemptions and performance issues can make activists even more focused on high-conviction trades. They may not break cover until the other side of the COVID-19 pandemic, but they will continue with even more determination.

Foreign activists who have ventured into Japan do so from longstanding familiarity with the country's markets or from skepticism of Western markets, which were overvalued going into 2020, and are now badly affected by the pandemic. ValueAct Capital Partners, which has been successful in the past at Olympus, has this year taken a 7% stake in JSR and, reportedly, a \$1.1 billion position in Nintendo.

Others, especially at the smaller end of the market, have raised stable capital through listed vehicles with a mandate to focus on Japan. Dalton Investments' Nippon Active Value Fund listed in London in February 2020 after raising 103 million pounds. Asset Value Investors' (AVI) Joe Bauernfreund invests in companies that can increase shareholder returns through improved corporate governance.

This interest is inspiring domestic imitators. In Japan, Monex Activist Fund started operations in March this year, aiming to create value at Japanese listed companies through active engagement.

Moreover, victorious board campaigns at Lixil and Toshiba last year, and at Sun Corp in April, have demonstrated that

activists can be successful in initiating changes, especially to boards, without acquiescent management teams. Performance and governance challenges have created the opportunity to garner support from other investors to add new nominees.

Demands for share buybacks or special dividends, such as a campaign at Kirin Holdings by Independent Franchise Partners earlier this year, have not fared as well. AVI's campaign at Teikoku Sen-I, which sought an increased dividend and a share buyback, was not successful.

On the other hand, Elliott Management's campaign at SoftBank has kicked off a journey of self-discovery. Elliott asked for a \$20 billion share buyback, improved governance, and greater transparency, which led the company to sell assets. As well as paying down debt, which had weighed on the stock, SoftBank has promised big share repurchases. AVI also joined in on the SoftBank trade, creating collateral pressure, a tactic we will likely see more of in the future.

The COVID-19 pandemic will expose companies whose poor performance has been disguised by a bull market, and is likely to lead to a surge in M&A, as cheap money helps strong companies consolidate power by acquiring the less fortunate.

Activists may not have to wait long before opportunities arise. They will focus on operational performance and how boards and managers reacted during the crisis as they look for solid companies which need to fix their cost base and supply chains in order for their share prices to recover.

Georgeson's extensive experience providing companies with direct actionable intelligence can help defend against tomorrow's activist, especially when it comes to identifying the local and global entities making key voting decisions on behalf of investors. Our global presence and more than 80 years of experience supporting issuers means our counsel has influenced the largest companies against the most aggressive activists. ■



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ACTIVISTS GROW UP

HIGH CASH LEVELS STILL REPRESENT THE MAIN APPEAL OF JAPANESE COMPANIES, BUT ACTIVIST INVESTORS ARE INCREASINGLY SHIFTING THEIR DISCUSSIONS WITH EXECUTIVES TOWARDS STRATEGY, OPERATIONS, AND M&A, WRITES IURI STRUTA.

If there is one thing Japanese corporate executives hate most about activism, it is talking about how their capital allocation needs to be improved. But that is one of the key reasons why Japanese companies have been attractive for activists in recent years.

Cash back

Cash and non-core assets that have been hoarded on balance sheets can be easily divested and the proceeds either returned to shareholders or put to more productive uses to improve a persistently low return on equity (ROE).

“JUST FOCUSING ON WHAT TO DO WITH THE EXCESS CASH WILL NOT GENERATE A GREAT RESPONSE FROM MANAGEMENT.”

Balance sheet-related demands, such as dividends and share buybacks, have continuously represented the lion’s share of demands in Japan, particularly when compared

with other regions. Since 2013, balance sheet demands have represented an average of 32% of demands at Japan-based companies, versus 12% for Continental Europe and 10% for the U.S.

Activists such as Strategic Capital, Asset Value Investors and Sparx Group have for years been submitting proposals to optimize company balance sheets and were often joined by funds that do not typically engage in activism.

Digging deeper

Some see a move towards more sophisticated strategies in recent years, partly because it can be easier to engage executives by taking a high road. The best approach for an activist is to have a comprehensive discussion about the business and not focus chiefly on the balance sheet, multiple fund managers told Activist Insight for this report. However, if activists are talking about business and strategy changes, they rarely do so publicly, according to *Activist Insight Online’s* records.

“Cash balance is a key issue, but I think in the past two years, we and other activists are talking not only about the capital structure but the strategic direction of a company,”

Masakazu Hosomizu of RMB Capital said in an interview for this report. “Just focusing on what to do with the excess cash will not generate a great response from management.”

“Capital allocation is still an argument, and an important driver of value, but we are focusing more on margins and broader strategic angles than we were two years ago,” Daniel Lee from Asset Value Investors, said in an interview for this report.

Seth Fischer’s Oasis Management is one of the few activists that has always focused its campaigns on operational improvements, in addition to governance and strategy. He proposed Nintendo move into smartphone games, which resulted in the creation of the wildly successful Pokémon Go in 2016. This year, Fischer targeted Japanese baseball stadium owner Tokyo Dome and technology conglomerate Sun with proposals to enhance corporate governance and the underlying businesses. Oasis gained three board seats at Sun following a proxy contest, a “landmark” victory, according to Fischer.

“We’re finding opportunities to engage closely with management teams about how to improve their businesses and add value from every angle – including but not limited to improving board composition, improving management of ESG risks and disclosures, improving balance sheet efficiency, improving business operations, and long-term corporate strategy,” Fischer told Activist Insight.

Next step

The next frontier for shareholder activists could be a more active role in shaping the country’s M&A landscape,

“CAPITAL ALLOCATION IS STILL AN ARGUMENT, AND AN IMPORTANT DRIVER OF VALUE, BUT WE ARE FOCUSING MORE ON MARGINS AND BROADER STRATEGIC ANGLES THAN WE WERE TWO YEARS AGO.”

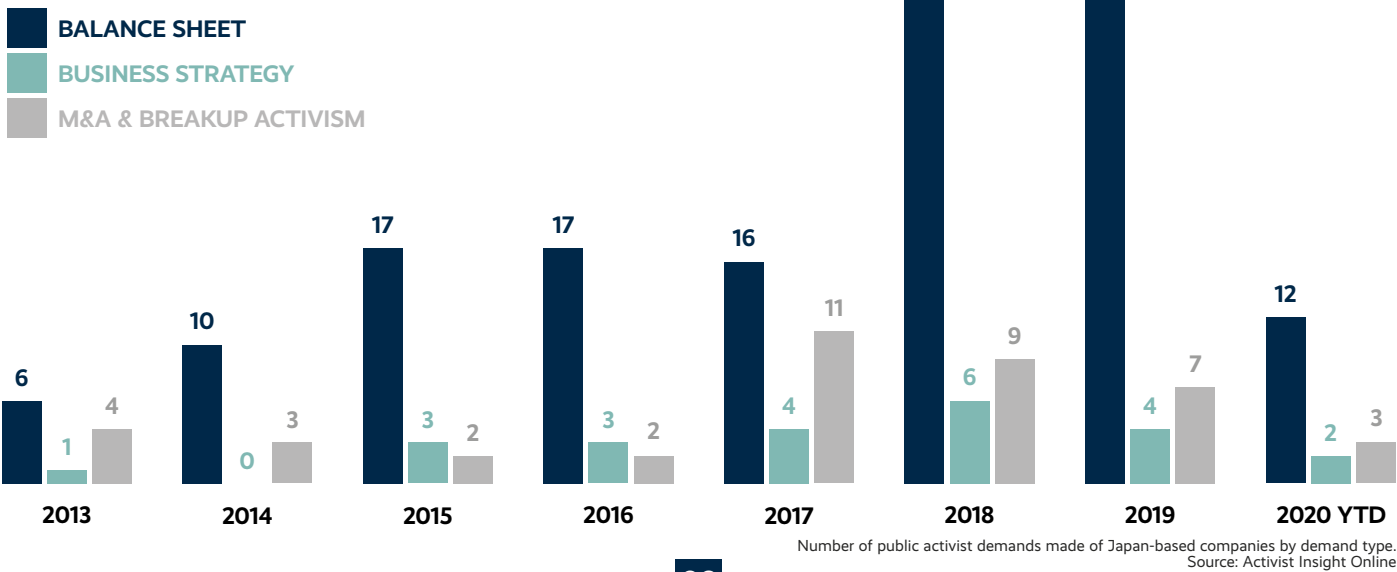
including making conglomerates leaner via asset sales. In 2019, Japan saw rare bidding wars at Unizo Holdings and NuFlare Technology, with the former’s stock appreciating twofold as a result.

M&A and breakup demands at Japanese companies, including spinoffs as well as support for and opposition to mergers, have increased in recent years but remain low relative to U.S. and European activist strategies – they are around half as popular as at American companies on average.

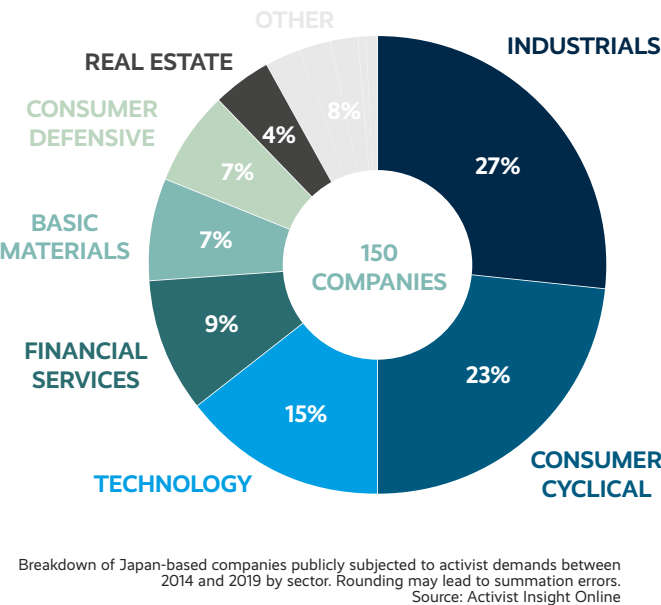
In 2017, Japan experienced a boom in opposition to M&A, as conglomerates consolidated listed subsidiaries, but the trend tailed off as many activist efforts ended in failure. In subsequent years, requests for asset sales have increased, last year reaching their highest level since at least 2013.

“Asset sales and spinoffs is M&A 2.0 for Japan. These demands will follow those of the first generation [of activists] whereby dividends and share buybacks were prioritized,” said James Rosenwald, the founder of Dalton Investments. ■

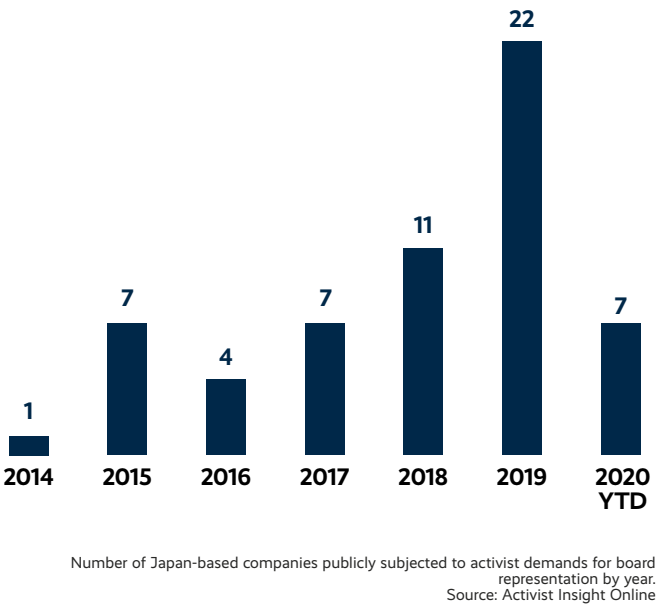
ACTIVIST DEMANDS IN JAPAN BY YEAR



JAPANESE ACTIVIST TARGETS BY SECTOR



JAPANESE BOARD CAMPAIGN TARGETS



FOREIGN DIRECT INVESTMENT

AMID 2019'S RECORD-BREAKING LEVEL OF ACTIVITY IN JAPAN, IT DID NOT GO UNNOTICED THAT THE NUMBER OF COMPANIES PUBLICLY SUBJECTED TO ACTIVIST DEMANDS BY U.S. INVESTORS ALSO HIT A PEAK, WRITES JOSH BLACK.

Starting in January with Olympus' settlement with ValueAct Capital Partners, 2019 saw U.S. activists publicly subject 12 Japanese companies to demands, up from seven in 2018. Mason Morfit's fund, a newcomer to Japan, led a charm offensive helped by executives at past targets and has since invested in two more Japanese companies. Other activists have used charm and offensiveness in different measures.

A fresh start

A hot market (the Nikkei 225 was up 20% in 2019), combined with unique fundamental opportunities and perceived governance improvements – including updates to the corporate governance and stewardship codes – led to last year's surge in activity. "Changes in 2019 were widely heralded

as meaningfully modernizing Japanese corporate governance," Third Point Partners' Dan Loeb wrote in his end-of-year letter.

"It's all about sum-of-the-parts at the end of the day," said Darren Novak, head of UBS' activism team in an interview for this report. "There is a plethora of companies that exist in Japan where people ask why these business divisions fit together. Plus, you take a look at the balance sheet and return on capital profile, these are the situations that activists dream of and haven't existed in the U.S. in years – the difficulty for activists is how to unlock those opportunities."

Indeed, demands such as breakups, repurchases and dividends have been a common theme from foreign activists. London-based portfolio managers at Whitebox Advisors and Asset Value Investors have asked Tokyo Broadcasting to shed noncore holdings in recent years. Toshiba faced calls from a group of activists led by King Street Management to boost its share repurchase program following the sale of its chip subsidiary. Eleven asset sale and 30 dividend or buyback demands were made in 2019, according to *Activist Insight Online*. Few were successful.

One activist to have unlocked that mystery is Elliott Management. A team of London-based portfolio managers built a nearly \$3 billion position in SoftBank early in 2020 and asked CEO Masayoshi Son to repurchase shares worth \$20 billion, among other things. As the impact of the COVID-19 outbreak threatened highly levered stocks, SoftBank announced the sale of \$41 billion worth of assets to pay down debt and increase buybacks announced since Elliott's demand to nearly \$23 billion.

Success comes in many forms. Third Point's second campaign for a breakup of Sony received a more respectful response than its 2013-2014 campaign at the electronics company, albeit still a firm "No." The stock was Third Point's biggest winner of last year.

Getting tetchy

Though rarely headline cases, U.S. activists also launched three proxy contests in Japan in 2019 – almost three times as many as in the previous four years put together. One, launched by King Street Capital at Toshiba, ended in a quick settlement.

Traditionally, those tactics have led to a backlash. "The gold standard here is how ValueAct approached the Olympus situation," Novak said. "In the back of many executives' minds is how activists behaved in the last wave of activism, around 2008-9 – certain tactics and demands do not translate well into the Japanese context."

However, Nicholas Benes, the head of the nonprofit Board Director Training Institute of Japan who won 35% of the vote on behalf of a London-based dissident in the proxy fight at

"MOST BOARDS ARE NOT USED TO OR READY FOR THE LEVEL OF FOREIGN DEBATE AND WILLINGNESS TO CONSIDER THEM IN THE BOARDROOM THAT COMES WITH AN ACTIVIST DIRECTOR."

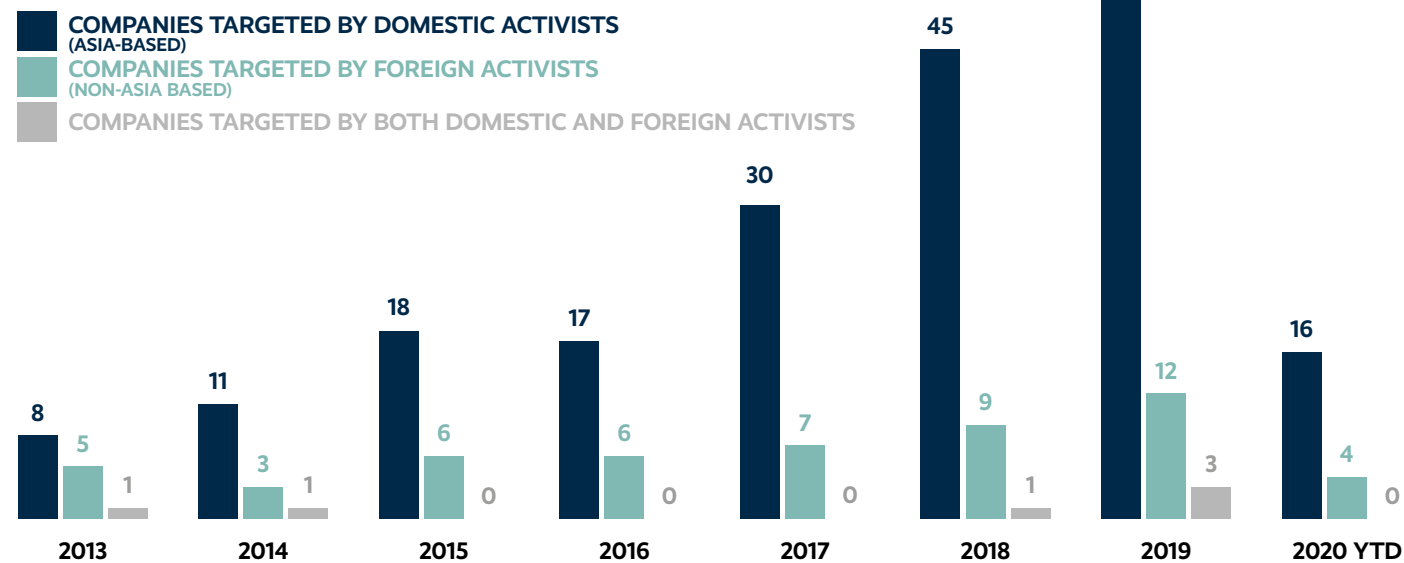
Kirin Holdings in March 2020, says activists are increasingly tolerated. "The very positive difference from 15 years ago is that you haven't seen any single event here be a huge step backwards in terms of governance," he told *Activist Insight* in an interview. "I don't want to say the more the merrier, but to some extent, it's almost as if each scandal, governance problem, or activist attempt is a step forward that the market and society now deal with in a more constructive, balanced way."

Instead, it was activists who finished the year frightened thanks to the new law on foreign investment. "Some foreigners ended the year confused about whether a market that had long been unfriendly to certain investors and had seemed finally committed to modernizing... was backsliding," wrote Loeb.

Concern that there are limits to that modernization are likely to persist. Some notable breakthroughs and increased activity do not necessarily mean activists will be storming boardrooms up and down the country. According to Benes, "Most boards are not used to or ready for the level of foreign debate and willingness to consider them in the boardroom that comes with an activist director." ■

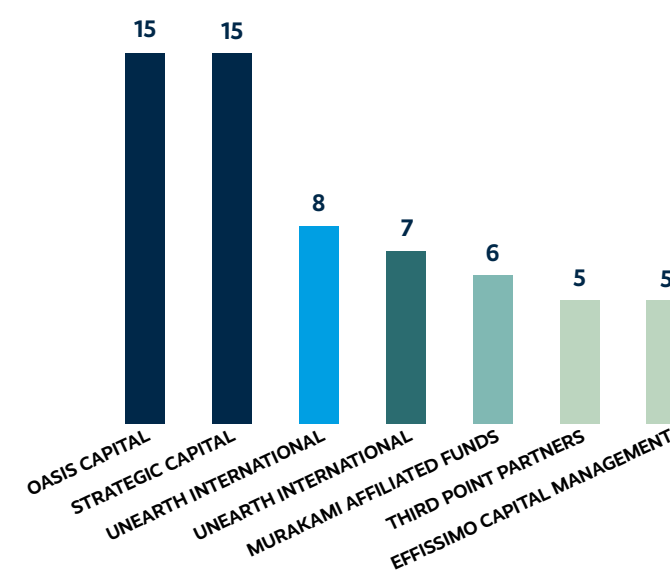
"IN THE BACK OF MANY EXECUTIVES' MINDS IS HOW ACTIVISTS BEHAVED IN THE LAST WAVE OF ACTIVISM."

JAPANESE ACTIVIST TARGETS BY YEAR AND ACTIVIST HQ



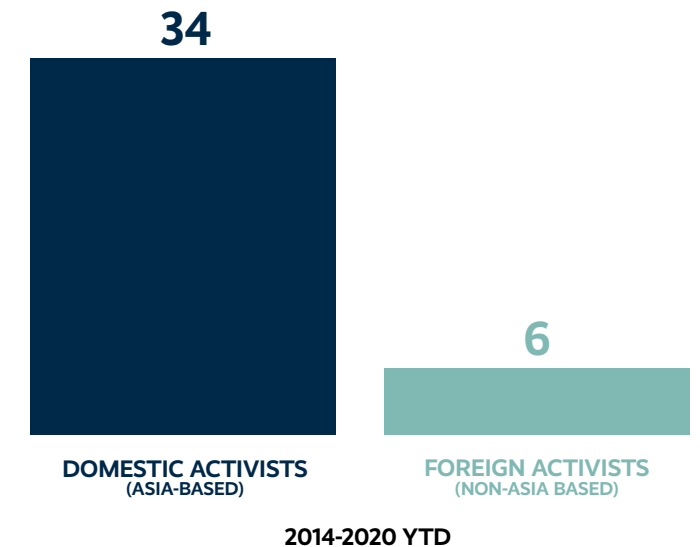
Number of Japan-based companies publicly subjected to activist demands, by year and activist HQ. Source: Activist Insight Online

TOP ACTIVISTS IN JAPAN



Top activists based on the number of Japan-based companies facing activist demands since 2013. Source: Activist Insight Online

PROXY CONTESTS IN JAPAN



Number of Japan-based companies facing proxy contests that reached a vote, by HQ of the activist that initiated the contest. Source: Activist Insight Online



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