

Mizuho Custody Newsletter

January 2023 | Japan

Contents:

I. Market News

1. More and more companies began using ROIC
2. The size of IPOs in Japan are becoming smaller
3. Investors find investment opportunity in companies with room for improvement in ESG ratings
4. TSE plans to reduce tick size of TOPIX Mid 400 companies

II. New Equities Listing Approvals

III. Foreign Ownership Limit Ratio

I. Market News

1. More and more companies began using ROIC

As a management indicator, more and more companies began using Return on Invested Capital (ROIC), showing how efficiently they are earning on the money they invested in business activities. In 2022, about 400 companies mentioned about ROIC in their earnings reports (Kessan Tanshin), up about 20% from the previous year, reports Nikkei Shimbun, Japan's leading financial daily. This is driven by growing calls for improved capital efficiency in response to revisions to the corporate governance code. It remains to be seen how companies could use the indicator to increase their actual corporate value.

Nikkei Shimbun has conducted a text analysis of securities reports (Yukashoken Hokokusho) and earnings reports (Kessan Tanshin) disclosed by listed companies. As of early December 2022, 402 companies, or 10% of the total, mentioned about ROIC. According to a research institute, 13% of the companies introduced ROIC targets in their medium-term business plans in 2021, which is 1/5 of the companies that introduced Return on Equity (ROE) targets (58%). ROIC is often used as a tool to

ultimately achieve ROE targets or to interact with investors.

Investors' increasing demand for companies' improved capital efficiency explains the recent introduction of ROIC at many companies. The low capital efficiency had been the same old story for many Japanese companies. As it has been encouraged to make engagement between investors and companies more open, investors became more active to interact with companies.

In the "Principles Regarding the Disclosure of Narrative Information" for securities reports introduced in 2019, ROIC was cited as one of the indicators for determining the level of achievement of business objectives. Every time the corporate governance code was revised, that prompted calls for companies to look more at capital efficiency. The reorganization of market segment at the Tokyo Securities Exchange in 2022 also heightened the momentum in the market.

However, companies' perception of ROIC falls short of investors' expectations. According to a 2021 survey by the Life Insurance Association of Japan, 46.3% of investors cited "ROIC" as a key management goal, while it was only 1/4 or 12.8% for the companies. "Cost of capital" is another that only a few companies focus on, where there is a gap with investors.

ROIC of Japanese companies lags behind that of foreign companies. In FY2021, ROIC of the listed companies (excluding financial institutions, etc.) on the Prime market was only 5.4%. This is lower than 11% for the U.S. (component of the S&P 500) and 7.1% for Europe (component of the STOXX 600).

This is because Japanese companies record lower profit margins in their core businesses than companies in Western countries. Breaking ROIC down into "after-tax operating profit margin," which indicates the profitability of core businesses, and "invested capital turnover," which indicates whether sales are efficiently generated using invested capital, invested capital turnover is 0.96, which is comparable to that of Western companies, but after-tax operating profit

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margin is as low as 5.6%. Many companies are slow in screening businesses and therefore still have low-profit businesses.

Companies with high ROIC tend to be less prone to downtrend of stock prices. Indexing the stock prices of about 1,700 companies whose ROIC exceeded the 7% threshold as a benchmark for capital costs in FY2021 (end of 2021 = 100), their share prices fell 4% as of 20 December 2022, outpacing the 8% fall in the Nikkei Stock Average during that period. Companies that mentioned ROIC in their 2022 earnings reports also fell 2%, less than the fall of the Nikkei Stock Average.

"Companies with improved ROIC are generating capital and therefore more shareholder returns could be anticipated. Many investors in Japan still look at ROE, but in the future, ROIC will become the standard," said a chief strategist of a securities firm.

The current provisional translation of Japan's corporate governance code stipulates about capital efficiency as follows:

"When establishing and disclosing business strategies and business plans, companies should articulate their earnings plans and capital policies, and present targets for profitability and capital efficiency after accurately identifying the company's cost of capital. Also, companies should provide explanations that are clear and logical to shareholders with respect to the allocation of management resources, such as reviewing their business portfolio and investments in fixed assets, R&D, and human capital, and specific measures that will be taken in order to achieve their plans and targets."

For more details of Japan's corporate governance code, provisional translation could be referred to from the following URL:

<https://www.jpx.co.jp/english/news/1020/b5b4pj0000046kxj-att/b5b4pj0000046l07.pdf>

Further, provisional translation of the Principles Regarding the Disclosure of Narrative Information prepared by the Financial Services Agency could be referred to from the following URL:

<https://www.fsa.go.jp/en/news/2019/20190606-3/01.pdf>

Information compiled from Financial Services Agency, Nikkei Shimbun, Tokyo Stock Exchange & Mizuho research

2. The size of IPOs in Japan are becoming smaller

The size of initial public offerings (IPOs) in Japan per case is getting smaller. The number of companies that were listed in the domestic markets including the Tokyo Stock Exchange ("TSE") is expected to remain high at over 90 in 2022, but the amount raised per company is expected to decrease by 40% from the previous year, reports Nikkei Shimbun, Japan's leading financial daily. This is because of the recent weak market due to the Ukraine crisis and uncertainty in the global economy. Issuers were shying away from doing large-scale listing deals, which made smaller deals stand out. Investors are looking more at profitability, and stock prices have not been favorable for companies in red ink.

Funds raised in the market (total amount of public offering, excluding over-allotment) per new listing case by 22 December 2022 was JPY 3.4 billion, down 40% from the previous year. Deputy chief of the underwriting department at a leading domestic securities firm said, "Issuers became conservative in estimating fund to be raised as the investors' confidence deteriorates, which eventually prompted deals to get smaller."

If the amount to be raised in the market exceeds JPY tens of billions, demand from overseas institutional investors will be essential in addition to that from domestic investors. The thing is, foreign investors have become increasingly cautious about investing in IPO stocks in Japan, which led some large scale IPOs to be postponed. In the first half of the year, eight companies withdrew their applications after being approved for listing on the TSE, which is four times in the number of the same period a year earlier.

After the companies went public, their fates divided into two in terms of stock prices. Of the 83 companies that were listed, 40% are currently traded below their IPO price.

Driving force of the move is foreign institutional investors' stricter selection of investees, putting more weight on profitability. They had been looking at the price-to-sales ratio (PSR), which calculates share prices based on revenue, but in the wake of the credit

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crunch, etc., they are shifting the indicator to the price-to-earnings ratio (PER), which calculates share prices based on profits.

Software-as-a-service (SaaS) companies that provides software in the cloud had been doing well by demands for streamlining operations with digital technology amid the pandemic. Up to now, they could enjoy high share prices as long as they had gained market share even if they lose money in the business. However the situation has turned upside down since 2021, when everybody had excess cash on hand due to monetary easing. A senior official of a leading domestic securities firm said, "It's a tough situation for SaaS, which used PSRs to calculate corporate value."

On the other hand, the number of IPO cases remained high. Some market officials predicted it would be less than 80 in 2022. In 2021, the number of IPO cases hit a 15 years high of 125, partly due to a concentration of corporate listings that had been postponed during the pandemic period, so some market participants expected a backlash in 2022. However, as reflected by TSE Mothers Index turning to upward trend since June indicating market recovery, 91 companies are expected to be listed in 2022, which is the fourth highest level in the past 10 years.

Many companies are still looking to go public, and the number of listings is expected to remain high also in 2023. A general manager of a public underwriting department at a major domestic securities firm predicts that the number in 2023 will be around 100.

However, there is a growing concern that interest rate hikes in the United States and Europe will cause a setback in the global economy. Unless demand returns from overseas institutional investors, who are the main takers of large listings, large-scale listing deals could be put on hold for a while.

To retrieve the details of the new listings on the TSE, please refer to the following URL:
<https://www.jpx.co.jp/english/listing/stocks/new/index.html>

Information compiled from Japan Exchange Group, Inc., Nikkei Shimbun & Mizuho research

3. Investors find investment opportunity in companies with room for improvement in ESG

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ratings

Investors find investment opportunities in companies with rooms for improvement in ESG ratings, as some companies to which ESG rating agencies gave lower ratings than they actually are due to lack of disclosures tend to be undervalued. More and more companies are tackling to improve their ESG ratings and their medium- to long-term returns, by enhancing their disclosure level and by supporting communication with rating agencies, reports Nikkei Shimbun, Japan's leading financial daily.

Share price of a company manufacturing dental equipment soared in late November last year, setting the record high since it has listed. One of the reasons was improvement of their ESG rating. One of the leading benchmark of ESG rating gave them "BBB", one notch higher, in October, the fourth ranking among the seven. In 2020, they got "B" rating, which is the second-lowest.

"Your ESG rating is so low that we can't invest even though we want to." Having been repeatedly complained by investors, the company took measures in April 2021 with advices from overseas institutional investors. When they checked information registered at rating agencies, they found some items not registered and ones that were scored differently from their own understandings. They started to provide explanations and additional information to the rating agencies.

Since 2021, the company has been publishing a sustainability report with more information, including social and governance issues. It also began to publish disclosure materials in English.

Sustainability measures such as climate change and human capital have become essential for sustainable corporate growth. A professor of a university in Japan said, "The trend of evaluating ESG initiatives will continue in the market for the time being."

Japanese companies tend to be rated lower in ESG than they actually are. According to an investment firm, 70% of the Japanese companies rated "medium" in its ESG evaluation turned out that they were rated "below average" by other ESG rating agencies.

The head of engagement at an asset management firm said, "Japanese companies tend to be less open in

disclosures or less accessible for the outsiders to reach their information than other countries, although their business strategies are appropriate."

It would be no use to just complaining the low ratings. It has become one of the roles of institutional investors to urge their investees to obtain higher ESG scores, which is difficult to achieve only by issuers.

Another conglomerate, which manufactures and sells machine parts, has been good at matching parts suppliers and buyers on its own network in a short period of time. The shorter it takes for ordering machine parts, the fewer their working hours would be, and the less they would have to pay utility costs of the office. If machine parts would be delivered earlier than before, they could improve operating rate of the production lines.

The asset manager advised this company that they should disclose these strength as items related to sustainability, such as improving energy efficiency or working environment. By taking this advice, the company obtained "BBB" from rating agencies last fall, which is one notch higher than before. Their share price went up afterwards.

A portfolio manager of a non-Japanese investment firm said, "Small and medium-sized companies look more promising in improving their approaches on ESG issues, as they are more accessible to their management." The current low ESG ratings of Japanese companies in general seem to imply that they have a lot of rooms to grow. Perhaps it should be taken as opportunities of "treasure hunt" to find stocks whose corporate value will grow as a result of improvements of their approach on ESG.

Japan Exchange Group, Inc. ("JPX") introduces ESG rating agencies and data providers that collect, analyze, and evaluate ESG-related information on companies, as well as ESG finance rating agencies that provide third-party evaluations (external evaluations) of green bonds, etc.

ESG rating agencies and data providers identify ESG related issues of high interest to investors and ones that are useful for investment decisions (in some cases, sector by sector), and collect, research, and evaluate corporate information using publicly disclosed corporate information and individual questionnaires.

They eventually provide those information to institutional investors.

ESG finance rating agencies provide second opinions on ESG-related finance, such as green bonds, and green ratings that assess how the funds raised in the project contributed to resolve environmental issues.

Details of these ESG rating agencies as well as ESG finance rating agencies are available in Japanese at the following website of the JPX:
<https://www.jpj.co.jp/corporate/sustainability/esgknowledgehub/esg-rating/index.html>

Information compiled from Japan Exchange Group, Inc., Nikkei Shimbun & Mizuho research

4. TSE plans to reduce tick size of TOPIX Mid 400 companies

Tokyo Stock Exchange ("TSE") will reduce the tick size of stock prices of 400 major companies by this spring, which will affect the companies making up the Tokyo Stock Price Index (TOPIX) Mid 400. For issues priced at JPY 1,000 or below, the tick size would be JPY 0.1 from JPY 1. It would give investors more opportunities to trade at favorable prices, and also aims at competing against the private trading system (PTS), which has finer tick size than the TSE does, reports Nikkei Shimbun, Japan's leading financial daily.

In 2014, TSE reduced the tick size of TOPIX 100, which comprises of 100 major companies. In 2021, TSE also reduced the tick size of listed ETFs. The tick size for the 400 companies that will be newly added this time will be the same as the previous 100 major companies.

Tick size varies depending on stock prices. Tick size for stock price over JPY 1,000 to JPY 3,000 or below will change from JPY 1 to JPY 0.5, and over JPY 3,000 to JPY 5,000 or below will change from JPY 5 to JPY 1. In case the stock price exceeds JPY 5,000, the tick size will be reduced according to the stock price.

When placing a buy order for a stock at a designating price, you will specify JPY 501 or JPY 502 with a tick size of JPY 1 unit, but you will specify JPY 500.1 or JPY 500.2 with a tick size of JPY 0.1 unit. Trading will be confirmed if there are sell orders in the same price range. If you can buy at JPY 500.1 or JPY 500.2, you

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will get a better deal than buying at JPY 501.

Costs incurred directly or indirectly by investors for trading stocks are called “execution costs”. If you could buy a stock cheaper or sell at a higher price, execution cost would go down. TSE estimates that reducing tick size of the 400 companies would save JPY 50 billion to JPY 70 billion a year in execution costs. At a council of the Financial Services Agency, there was discussion on adjustment of tick size to the level considered appropriate to reduce execution costs.

If tick sizes of issues with small trading volumes were reduced, buy and sell orders for those issues would be dispersed, making it difficult to have deals done. For this reason, the list was narrowed down to 400 major companies whose trading volume is above a certain level.

For TSE, this plan also aims to be competitive against PTS, which is run by private companies. PTS has been appealing to investors for its tick sizes finer than the TSE. Osaka Digital Exchange (ODX), which entered the PTS market as a newcomer in June 2022, has a tick size of JPY 0.1 to JPY 1 for over JPY 10,000 to JPY 30,000 or below. That of the TSE is JPY 5 to JPY 10.

PTS accounts for only about 10% of the market, but it is gradually growing. Some online brokerage firms offer “smart order routing (SOR)” systems that automatically place orders with more favorable terms comparing that of the TSE and that of the PTS. The systems has been attracting individual investors.

In Europe, tick size is determined according to the average number of trades in a day. U.S. has standardized the tick size of exchanges to a unit of 1 cent in principle, but it is being discussed to lower it to less than 1 cent to reduce execution costs.

Nippon Individual Savings Account (NISA) that starts in 2024 has the potential to be a catalyst of expanding investors’ base. It is essential to create an environment where investors can trade stocks with less costs and with more conveniences, including improving hard-to-see expenses such as execution costs.

TSE intends to optimize tick sizes for medium liquidity stocks with a view to developing an environment where various investors, centered around retail and long-term investors, can trade at better prices. TSE had been

calling for public comments from 22 December 2022 until 21 January 2023, and its details are available from the following URL:

<https://www.jpx.co.jp/english/rules-participants/public-comment/detail/d02/202121222-01.html>.

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New Equities Listing Approvals

Listing Date	Name of Company	ISIN Code	MKT
Feb-01	No.1 Urban Development	JP3653600001	P
Feb-22	PRIME STRATEGY	JP3832320000	ST

**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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