

## Letter from SuMi TRUST - Current Shape of Japan

SuMi TRUST engagement activities to support changing Japanese companies

*Written by Munehisa Matsumoto*

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### **Executive Summary**

1. The Japanese stock market has been deeply discounted compared to other markets. As the largest asset manager in Japan, SuMi TRUST acknowledges our responsibility to maximise the corporate value of invested companies and thereby to maximise mid- to long-term investment returns on the assets entrusted to us by our clients.
2. Discount factors for Japanese companies can be typically found in excess capital, undervaluation (due to a lack of disclosure or conglomerates discount), low profitability, and poor governance. Identifying the companies' issues and their drivers for change are the key elements for success in our engagement activities.
3. SuMi TRUST tackles the challenges in the Japanese stock market by engaging with companies along with dedicated engagement stories. We utilise MBIS, our proprietary framework to assess mid- to long-term growth potential of companies, as a tool for our engagement. We believe that objective opinion of own evaluation from the market participant would incentivise them to change.

On 29<sup>th</sup> December 1989, the Nikkei 225 hit an all-time high of 38,915. Since then, in 31 years the Nikkei 225 has never reached the same level. At the end of 1989, 32 of the top 50 global companies by market capitalisation were Japanese companies. However, at the end of year 2021, there was only one Japanese company, TOYOTA MOTOR, in the ranking.

The corporate environment has been transformed dramatically over the last 31 years. While the rules of competition have changed, many of Japanese companies have not made the necessary adjustments. For example, the global banking industry has constantly changed over the past decades, and business models have been globalised, sophisticated, and digitised with incredible speed. However, Japanese banks have been left behind in these areas partly because they were too complacent due to their past successes and partly because they were preoccupied dealing with their negative legacies. Although their size has grown through corporate mergers and reorganisations, their profitability has not improved, and far behind the top global banks in the United States and Europe. Even the most prominent Japanese bank, MITSUBISHI UFJ FINANCIAL GROUP (MUFG), has only one-fifth of the market capitalisation of JP Morgan. It is reasonable to assume that there should be a good reason for this valuation gap in the market.

On the other hand, it can also be said that the capabilities of Japanese companies are sometimes underestimated. In the manufacturing sector, for instance, there are several companies providing excellent products and technologies that are competitive in the global marketplace. However, for many of them are not fairly valued by the stock market considering their competitiveness. For example, SONY GROUP is a company with high brand recognition and a strong presence in gaming, motion picture, and semiconductor markets including CMOS sensors. Considering these strengths, the company may deserve a higher valuation in the market.

SuMi TRUST recognises that as the largest asset manager in Japan, we have a responsibility to support companies in their efforts to maximise their corporate value. For many years, we have established trust with Japanese companies through our communication and our research activities. Based on our relationship, we advise them to take proper actions and develop their potential capabilities to be reasonably valued by the market. We also provide companies with examples of best practices so that they can learn from others. We believe that these interactions will lead companies to maximise their corporate value, which will eventually raise the level of the entire stock market. Furthermore, there is a recent trend that many Japanese companies are strongly motivated to change and innovate their organisations because of market environment change, rising activist investors in Japan, and a heightened awareness of compliance with the Corporate Governance Code. By taking this trend as an opportunity, we aim to further strengthen our engagement activities to maximise their corporate values.

When we communicate with Japanese companies, we use our proprietary framework, MBIS, as a tool to assess a company's mid-to-long-term growth potential. The MBIS stands for "**M**anagement", "**B**usiness Basis", "**I**ndustry", and "**S**trategy", and we have utilised it since 2015. We collect and analyse non-financial information and score a company in each category to measure sustainable growth potential. The MBIS framework allows us to identify management issues and sources of competitiveness in companies. We gather information through direct management meetings, on-site tours, and referring to company disclosures. Additionally, we also consider alternative data sources like reviews and comments on the recruiting website posted by employees. MBIS also considers ESG-related factors so that we can identify potential growth accelerators and inhibitors from an ESG perspective. The information gathered from our research activities allows us to evaluate companies on several factors including corporate philosophy, long-term vision, and financial and business strategies.

MBIS also allows us to detect potential issues within a company to further investigate whether there are any discount factors affecting the stock price.

First, excess capital could be a discount factor. After the "bubble economy" burst in the early 1990s, Japanese companies cut investments and shareholder returns, and accumulated cash on their balance sheets. Lower investment led to lower growth rates, and the logic behind accumulating excess capital without returning it to

shareholders was difficult for global investors to understand.

Second, there are some companies that are undervalued relative to their capabilities. This could be due to a lack of appropriate disclosure by a company about its strengths and potentials, and because of conglomerates discounts in other cases.

Third, low profitability could also lower corporate value. There are still many businesses that are unprofitable or losing money but have not been sold or liquidated.

Finally, poor governance could lead to an excessive discount. In Japan, there has been a movement to improve corporate governance following the enactment of the Corporate Governance Code in 2015. However, we still see governance issues such as parent-subsidary listings and compensation systems.

In addition to the above analysis, we also assess companies' incentives for change and prioritise dialogue with companies that have higher motivation for change, in order to make our engagement more effective. For instance, events such as management changes or the formulation of a new mid-term plan can be an incentive for companies to change their organisation. Furthermore, external pressure, such as a high opposition to proposals at general shareholders' meetings and pressure from activists, can also motivate companies to implement reform. By analysing all discount factors, companies' incentives for change, along with the business and financial strategies that our analysts usually analyse, we prepare a dedicated engagement story for each company to conduct effective engagement activities.

To illustrate our engagement activities, we can examine the case of MEIKO (6787 JT), a manufacturer of printed circuit boards (PCBs) for automotive applications, as an example of our engagement activities. The company is the largest firm in Japan specialising in PCBs. The market for high unit price build-up boards for automotive applications is expected to grow rapidly and accounts for the majority of its revenue. Despite the company's potential, its stock price had been undervalued due to insufficient disclosures by the company about the growth potential of the PCBs market, its vigilant investment policy regarding profitability, as well as due to market concerns over the possible change in the company's CEO from the charismatic founder, who had been leading the company since its establishment.

In terms of the company's incentives for change, we are aware that the company has taken care of its stock price through communication over the years, and more recently, it has been strengthening its management structure. The company introduced stock options for its executives, increased the number of outside directors, and hired well-experienced management professional as senior management, which indicated a strong committed to change.

On this background, SuMi TRUST identified that the discount factors of MEIKO's corporate value would be 1) a lack of communication towards investors regarding its mid- to long-term growth potential, 2) concerns over its business stability and profitability, and 3) concerns over the possible CEO change, company culture, and low equity ratio. We advised them to send a message to its shareholders that MEIKO is a company involved in an essential business that supports the "CASE" (Connected, Autonomous, Shared, and Electric) market and

achieves sustainable profit growth. During our dialogue, we explained our analysis of its strengths and weaknesses by showing their MBIS scores. We then proposed disclosing certain indicators and how they should deliver messages to their investors.

In response to our engagement, senior management commented that our discussion materials were suggestive and informative, and promised they would include some indicators in their mid-term management plan. In fact, we could observe that our suggestions were reflected in some of their disclosure materials, proving that our dialogue was meaningful.

Another engagement activity that we would like to highlight is the case of a leading electronic manufacturer in Japan. A company with leading technologies and high brand recognition in Japan, as well as globally. However, the company is also recognised for its mediocre management and it has been in a vicious cycle of new investment and structural reform. In addition, the company's strengths, competitiveness, and strong positioning within the industry were less known since the company has diversified its business. As a result, the stock price of the company was discounted compared to its mid- to long-term potential.

Regarding the incentives for change, the company recently changed its CEO for the first time in nine years. The company took this opportunity to renew its basic management policy, which had never changed in the past. The company also announced an organisational reform to shift to a holding company structure. We expect that these actions show the company's motivation to change, and we believe that this could lead to maximising its potential, which had been discounted for a long time.

Based on this background, SuMi TRUST proposed the need for clear information on 1) management team and organisation, 2) competitiveness and customer base, 3) market environment and growth potential. Disclosing information on each operating subsidiary would enable investors to evaluate each subsidiary via sum-of-the-parts (SOTP) valuation methodology and eliminate conglomerate discounts. In addition, we also proposed the company to disclose KPIs, such as the concept of capital and cash allocation, return on invested capital, and timeline for investment recovery, to dispel an image associated with its past track record of the vicious cycle of new investment and structural reform. During our engagement with the company, we disclosed their rating of MBIS score, and gave them our honest opinion that we concern about their repeated vicious cycle of new investment and structural reform.

In response to our proposal, the company told us they would consider disclosing more information, including on each operating subsidiary. They also asked us to discuss this with the top management of their subsidiaries. Since the company is still in the process of dynamic change with the transition to a holding company structure, we will continue to work with them through our engagement activities.

In addition to engagement activities, we also hold briefing sessions to explain our MBIS framework to verify previous efforts, and to advance the effectiveness of our engagement activities. These sessions allow us to educate companies on our non-financial information evaluation framework and identify potential incentives for increasing corporate value. As a result of our deep, thoughtful, and timely dialogue with companies, we

believe that we can increase the chances to promote appropriate changes.

During our meeting, we explain the framework and evaluation method of MBIS, data and information sources for evaluation and the factors that we use for scoring MBIS, along with examples. We also explain the reason why the MBIS framework is important for improving corporate value, with the examples of the recent trend of declining stable shareholders, increasing activist activities, and increasing ratio of dissenting votes. We received feedback that it was useful to know how to evaluate non-financial information, and that they would like to know more about their own MBIS evaluation and that of their competitors. We believe that these activities will make companies more aware of their evaluation from an objective view, which will motivate them to improve their practices and encourage them to make changes.

As the largest asset manager in Japan, SuMi TRUST's goal is to maximise mid- to long-term investment returns on the assets entrusted to us by our clients. We aim to increase the corporate value of invested companies through engagement activities using MBIS. We will continue to engage with companies to promote better changes by identifying their issues and the drivers for change.

#### About Writer

#### **Munehisa Matsumoto, Head of Investment Research**

Munehisa Matsumoto has been the Head of the Research Analyst team since October 2018, when Sumitomo Mitsui Trust Asset Management was reorganised. He has been a research analyst since 2009.

Munehisa believes that a "Quantamental" approach is becoming more important in research activities and enhances his team to utilise "Alternative Data", which cannot be obtained from corporate financial statements, in addition to traditional data. He also believes that constructive engagement is important for maximising corporate value. Therefore, he emphasises engagement activities and collaboration with the Stewardship Promoting Department, which is responsible for Stewardship activities.



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