Elliott & the Land of the Rising Sun

Introduction

As Bill Ackman – Founder and CEO of Pershing Square Capital Management [AMS: PSH] mentioned on an interview with David Rubenstein in November of last year, some people are simply born to be activist investors. Clearly, that begs the question: What are activist investors? The strategy refers mainly to hedge funds or investment professionals that build minority stakes in companies to enact change and extract all the possible value out of a company's assets. This can happen in an amicable way or sometimes in a hostile fight for seats on the board of directors. Building a sizeable position in a company clearly comes at a cost and oftentimes activist investors utilise several financial instruments like leverage and derivatives to mitigate the cost of activist campaigns.

From a legal standpoint, in the United States activist investors must file what's called a "Schedule 13D" form within 10 days of having acquired a stake above 5% in a public company, it's important to note that this 5% must have voting rights. If one decides to build an important stake without any intention to sit in a position of power the investor may file a "Schedule 13G" which doesn't require you to list your intention behind the acquisition unlike the SEC Schedule 13D form. Recent years have seen a rise not only in the number of activist campaigns but also in the returns that funds focused on this strategy have been able to provide. 2023 was an incredible year as investors gained on average over 20% compared to 2022 which saw them lose 16% according to Hedge Fund Research data.

One could talk hours about the exciting takeover battles fought by shareholder activists by the likes of Bill Ackman & Carl Icahn as detailed in the book "When the Wolves Bite" detailing the fight over Herbalife [NYSE: HLF]. However, today we are going to focus on Paul Singer and his merry band of investors at Elliott Investment Management.

Elliott was founded in 1977 and is now a leading investment company with over $60bn in AUM. They employ several diverse strategies ranging from distressed securities to private equity. They are extremely well known for their role in the Argentinian sovereign debt crisis which culminated in their seizing of an Argentinian ship in Ghana to be made whole for billions in debt they had spent years trying to collect. However, they have been involved in several traditional activist battles including their stakes in BioMarin [NASDAQ: BMRN] and Catalent [NYSE: CTLT]. In the following pages we will focus on their activist campaign in the Japanese market.

Japanese Macroeconomic environment

The Bank of Japan has been the only major central bank not to raise interest rates over the past two years, keeping its policy rate at -0.1%, the world's only negative interest rate, despite 20 months of above-target inflation. However, the growing gap between borrowing costs in Japan and the US, as 10-year US Treasury yields reached their highest levels in 16 years, has put pressure on the BoJ to tighten its policy as the yen weakens. In October 2023, the BoJ undertook a significant step towards exiting its long-run ultra-loose monetary policy by allowing yields on the 10-year Japanese government bond to rise above 1%, revising its so-called yield curve control policy for the second time in three months. The central bank also updated upwards its core inflation forecast for the 2024 fiscal year: from 1.9% to 2.8%, as price growth this year has been higher than expected, with annual inflation (excluding energy and fresh food prices) at 4.2% in September 2023. Kazuo Ueda, Governor of the BoJ, has claimed that the main factor pushing up prices is a rise in import costs and that the central bank needs to wait for more sustainable signs of wage growth to ensure the economy does not fall back into decades of deflation. As a result of announcement, the 10-year JGBs yield hit 0.94% and the yen fell against the US dollar to 1$=150¥.

Although at the most recent meeting in January the BoJ kept overnight interest rates at -0.1%, Kazuo Ueda gave a few hints on when the bank might raise interest rates for the first time since 2007. For instance, The BoJ added a new phrase in its quarterly economic outlook report: "The likelihood of hitting the 2% inflation target has continued to gradually rise," — indicating that policy normalisation was approaching. Ueda also made clear that a cycle of increases was not guaranteed by a decision to end negative interest rates, saying: "An extremely accommodative financial environment will continue for the time being." Although many experts expect a policy change to be implemented in March or April, there remains a high level of uncertainty as the BoJ's decision heavily depends on prices and wages data in the upcoming months. An unwinding of the ultra-loose monetary policy could have major ramifications for international bond and currency markets, especially because of the recent volatility in the yen. The Japanese currency is still down 9.5% this year against the dollar but has pulled back from a historic low of ¥151 over the past months on expectations of policy tightening.

Among the major economies in the Asia-Pacific region, only Japan experienced an increase in M&A activity in 2023, with 14% growth in total value of transactions YoY. The M&A guidelines released in August 2023, aimed at cracking down on excessive defence tactics and removing a long-held stigma around unsolicited bids, became a major factor spurring corporate takeovers. Moreover, tightened Japanese labour market boosts M&A activity because companies start being targeted as labour reservoirs. In addition, as Japanese markets have matured and experienced slower growth, companies are turning to acquisitions to enable overseas expansion and development of new businesses to obtain higher shareholder returns. And finally, a relatively cheap yen and low interest rates make Japanese companies attractive to foreign investors. From 2013 to 2022, sponsor-led deals focused on Japanese entities increased threefold, with more than 300 companies acquired in 2022. Moreover, recent reforms by the Japanese government prioritising inspection of companies whose stock is trading at less than the book value of their equity, diversifying boards and enhancing disclosures, has fuelled interest of global private equity. Overall, high pressure from shareholders to produce higher returns, Japanese companies' lower valuations compared with their US and European peers, low interest rates, recent reforms and slower organic growth will continue to promote dealmaking.

Past Involvement in Japan

Elliott's love for the far east shouldn't come as a surprise to anyone with Tokyo's prominence as a world financial centre. In fact, in the year 2019 Japan lagged only the United States as the premier destination for Activist investors' capital. In recent years, Paul Singer and his subordinates have been hard at work investing in some of Japan's most influential and recognizable names.

In 2020, Elliott followed up on Softbank [TYO: SFTBY] Founder Masayoshi Son's claims that his company's stock was extremely undervalued by building an important position with a $2.5bn investment. This caused the stock price to increase by 7%. The rationale was that Softbank's portfolio companies alone were worth multiples of what the stock was trading at. Between Alibaba [NYSE: BABA] and their stakes in Sprint and Arm [NASDAQ: ARM] Elliott believed that the company's valuation was circa $150bn short of its true valuation. The situation started with Elliott demanding that Softbank buy back $20bn in shares to help boost the stock price, the advice was given along with the consensus that if the buyback did not occur Elliott would not hesitate to build a more hostile position. Elliott was not the only investment company that had built a large position in Softbank as Chase Coleman's Tiger Global also stated the important difference between the company's share price and its intrinsic value in what is known as the Softbank discount. Navigating difficult circumstances and governance issues abroad is what enables Elliott to make significant returns in complicated markets.

In 2021, Elliott continued their spending spree by building a position in Toshiba. Although their stake did not exceed the illustrious 5% level. Piling on right after an important activist campaign that saw several senior level executives leave Toshiba, Elliott saw long term value in the Japanese electronics company that got bought out last year by Japan Industrial Partners. The rationale behind their continued investment in Japan was a desire to expand their Tokyo team as the Macroeconomic environment caused valuations to be supressed thanks to the sale of non-core assets by several important Japanese companies.

Last year, in January of 2023 Elliott continue to cement itself as a big player in Tokyo with its investment in Dai Nippon [TYO: DNPLY] – the 147-year-old conglomerate with significant business in producing electric vehicle batteries & smartphone screens. It became its 3rd largest shareholder in the shadows as it stayed below the 5% threshold and was not required to declare their position. They built a $300m investment which allowed them to demand several moves from the management team: In a move analogous to their Softbank investment they pushed for a share buyback scheme, the sale of several real estate items in the portfolio and asked them to let go of their portfolio of minority stakes in other Japanese companies. This increased interest in Japan stems from public valuations that inaccurately sit below the book value of the companies and large amounts of dry powder being kept. In this move, Elliott hoped to take advantage of continuing valuation issues in Japan to benefit in one of the market leaders in the smartphone screen business with a 70% market share.

Current Developments

Elliott Management is calling for Japan's biggest property group, Mitsui Fudosan [TYO: MTSFY] (Market Cap as of 01.02.2024 $24.4bn) to launch a $6.8bn (¥1tn) share buyback as the US activist fund sees room for improvement of the firm's return on equity. Elliott also requests that the property group sell down its $3.6bn stake in Oriental Land, the company that runs Tokyo Disneyland. Mitsui Fudosan, founded in 1941, is a major Japanese real estate developer which owns and operates many properties worldwide, including office buildings, residential real estate as well as hotels and resorts. Its property empire includes iconic buildings as Tokyo Dome, Gran Tokyo North Tower, Mitsui Shopping Park LaLaport Bukit Bintang City Centre in Malaysia, Exxon Building in New York, three "Midtown" projects which dominate the Hibiya, Nogizaka, Yaesu districts of central Tokyo and many others. In the fiscal year 2022 (ended 31 March 2023), Mitsui Fudosan Co., Ltd. generated around $15.1bn (¥2.3tn) in operating revenue, up from $14bn (¥2.1tn) in 2021, while net income increased from $1.5bn (¥0.2tn) to $1.8bn (¥0.3tn) respectively.

Elliott's move is part of increasing pressure on Japanese companies to improve their market valuations, raise their standards of corporate governance and increase their returns on equity. That pressure has been intensified over the past months as in March the Japan Exchange Group introduced a radical new name and shame regime, pushing companies to lay out how they plan to boost their corporate value and shaming those that fail to do so. Higher governance standards mean that those firms with an inefficient balance sheet are being punished with lower share prices and becoming targets for activists who are widely attracted by Japan's equity market in past years. Mitsui Fudosan is not an exception: its market capitalisation represents a more than 33% discount to the market value of the property it owns, while ROE and ROTA were equal to 6.9% and 3.11% respectively at the end of 2022 fiscal year, which clearly indicates that the firm's management is not using its assets efficiently. Therefore, Elliott, holding at least 2.5% stake in Mitsui Fudosan, suggests a share buyback to increase the firm's ROE and share price.

Buybacks by Japanese companies in 2023 hit a record ¥9.6tn, with the number of companies announcing them exceeding 1,000 for the second year in a row. Here a logical question arises why have share buybacks become a common practice in Japan. The theory behind share buybacks is that they reduce the number of shares outstanding and increase earnings per share on the remaining shares, providing benefits to shareholders. A decrease in supply of shares restores equilibrium and increases the share price, which can lead to higher market capitalization and, thus, enterprise value. That is why share buyback are a good way for many undervalued Japanese companies to improve their ROE and valuation. Elliott's demand for the buyback follows a year-long stake building process by the US fund that has made it one of Mitsui Fudosan's top five shareholders. Nomura Asset Management, Vanguard and BlackRock are all major shareholders, and Elliott's stake is at least 2.5%. Moreover, the pressure for the huge buyback is part of a broader criticism of the company's governance and of the fact that its market capitalization represents a more than 33% discount to the market value of the property it owns. Although Mitsui Fudosan is the largest Japanese property group, its ROE of 6.9% is lower than that of main competitors as Nomura Real Estate Holdings and Sumitomo Realty & Development standing at 10% and 9% respectively. In general, Japanese companies return less of their profit to shareholders than their overseas counterparts. While in the U.S., over 80% of profits go to dividends and share buybacks, in Japan the proportion is only about 50%. That is why a share buyback might be an attractive option to Japanese companies with large cash balances to improve their returns on equity and bring value to shareholders.

Elliott also requests that the property group sell down its $3.6bn stake in Oriental Land [TYO: OLCLF], a Japanese leisure and tourism subsidiary of the Keisei Electric Railway Company, which manages Tokyo Disneyland, Tokyo Disney Sea and other theme parks. As of September 2023, Oriental Land was Mitsui's largest holding, making up 61.2% of its portfolio, while the company has sold off 16.6% of its stake in Oriental Land in the last six months. Currently Mitsui is the Oriental's second largest shareholder, owning a 5.4% stake. That is why announcement of a sell off led to a 2.2% fall in Oriental's share price. The pressure on Japanese companies to improve valuations has shown that lazy balance sheets will no longer be tolerated as now even previously untouchable elite companies like Mitsui Fudosan are targeted. Mitsui Fudosan's ownership of Oriental Land makes little sense as it drives down the group's ROTA, rather than increasing profits. Moreover, proceeds from a sell-down demanded by Elliott can be used more efficiently for a share buyback, which will increase ROE in the short run, or for R&D to boost future growth.

The stock of Mitsui Fudosan jumped by 11.8% after the announcement and hit a record $27.34 (¥4100), while shares of Oriental Land fell 2.2% following the news. The striking response contributed to the benchmark Nikkei 225 rising to a 34-year high. While some investors consider the share buyback a great move, others claim that Japan's focus on share buybacks is misdirected as the country falls further behind in R&D and innovation. Many Japanese companies have accumulated large cash balances because they underinvested in R&D and Human Resources for years. Maybe it would be more beneficial in the long run for Japanese companies to spend more money on R&D, boosting innovation and exploring new growth areas rather than repurchasing its stock.

Where do we see the Japanese market heading?

Beginning with a comprehensive overview, Goldman Sachs Research forecasts a 2.6% expansion, on an annual average basis, in global GDP over the next three years, exceeding the 2.1% consensus forecast among economists surveyed by Bloomberg. Notably, GS Research's forecasts for GDP growth in 2024 are more optimistic than the consensus for eight of the world's nine largest economies; for instance, Japan's forecast made at end of 2023 were anticipating Japan to outpace other countries with a forecasted real GDP growth of 1.5% in 2024, and 1.1% in 2025.

Delving into the Tokyo Stock Price Index (TOPIX index), a key pillar of this expected growth should be driven by the TSE pressure regarding the company governance related reforms, that will lead to robust global economic growth and pivotal stock market results, finally leading to a projected 8% growth in TOPIX earnings per share, driven by sectors that are recovering from cyclical downturns, such as electrical appliances, raw materials and chemicals, and machinery, as well as sectors including information and communication. Notably, the TOPIX has already outperformed, during 2023, major indices like the S&P 500 and Hong Kong's Hang Seng, marking its fourth-best annual performance since 2001 in local currency terms. However, in US dollar terms, the TOPIX still lags the S&P 500, which might explain the reluctance among dollar-based investors to increase their Japan weightings this year. Nevertheless, a slowdown in consumer and business spending has held Japan back at the end of last year, with the economy contracting for the second straight quarter, defying expectations for modest growth, and finally leading to Japan's economy slipping into a recession and losing its position as the world's third largest economy to Germany.

Interestingly, some economists say the recession is likely to rebound in the coming months; for instance, Min Joo Kang, a senior economist at ING Group said that, despite the disappointing fourth-quarter result, 2024 first quarter GDP is expected to bounce back because of two reasons: Firstly, private consumption should improve in the current quarter given a stabilization in inflation and expected growth in wages; Secondly, on the investment side, strong corporate earnings and solid demand for IT should also lead to increases in facility investment.

After decades of deflation, Japan is expected to finally break out of this cycle, as it enters a virtuous cycle of price increases and wage hikes; Indeed, most asset managers and investment banks expect the Japanese economy to be on a recovery path in 2024, where markets will be driven more by Japan-specific events than by global factors. Specifically, Nomura foresees a moderate recovery to continue until 2025, amid risks of slower growth by the second half of 2024. Indeed, according to Kyohei Morita, Nomura's Chief Japan Economist, "Inflation is also expected to decline toward 2024, driven mainly by food prices". Meanwhile, the Bank of Japan's (BOJ) view is that inflation should originate from within the country. That can be achieved through creating a virtuous cycle between wages and prices through an alignment of companies raising prices and increasing capital expenditure, resulting in wage negotiations, higher salaries and growth in real wages and private consumption."

Before 2023 began, few saw the rise of interest in investing in Japan, long considered the land that optimistic stock bets go to die. However, beginning in the spring of the last year, inspired by the confidence of Warren Buffett, and a realization that not only were things changing but had already changed, investors suddenly couldn't get enough.

Starting in 2020, Buffett's Berkshire Hathaway bought into five Japanese trading houses - Itochu, Marubeni, Mitsubishi, Mitsui and Sumitomo - and in 2023 increased its holdings in each of the companies to an average of 8.5%, finally aiming to hold them for the long term and planning to raise his stakes to as much as 9.9%. Supported also by the positive market sentiment, the Nikkei 225 index hit highs not seen since 1990, while headlines spoke of a "stock market miracle". In the months since, the optimism has been sustained: UBS Group appointed an equity strategist for Japan for the first time in seven years; Blackrock went overweight on Japanese stocks; and Investment flows from foreign funds into Japanese stocks rose sharply between April and June 2023 amid expectations for stock market reforms, totalling ¥7.9tn ($53bn) of net foreign buying in cash and futures. Two key pillars in explaining this trend, are the fact that the stock purchases were driven by TSE-related investor interest, as well as the positive impact of high-profile endorsements.

Lastly, foreigners and corporations are anticipated to remain net buyers of Japanese stocks, and domestic individual investors are expected to be further attracted to internal market participation due to the expanded new Nippon Individual Savings Account (NISA), a program created by the Japan's government to encourage people to save and invest, mostly in Japanese stocks and mutual funds, tax-free for 5-year periods.

Japan's geopolitical positioning in 2024 reflects a nuanced and dynamic engagement on the global stage, with a particular emphasis on its role within the Asia-Pacific region and its evolving defence and diplomatic strategies. A pivotal moment in Japan's geopolitical stance unfolded as it demonstrated leadership across various fields, from international trade and politics to regional cooperation. In the expansion negotiations of the Trans-Pacific Partnership (TPP) agreement, Japan took the lead after the United States withdrawal in January 2017, successfully navigating through the crisis and achieving the implementation of the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) with the remaining 11 countries in 2018. Additionally, Japan has advocated the concept of Data Free Flow with Trust (DFFT) to establish rules for cross-border flow of data and is leading international efforts towards its realization, as well as exhibiting a proactive stance in sourcing from geopolitical allies.

Japan's geopolitical positioning also emphasizes potential role as a bridge between various global factions, leveraging its unique historical and geopolitical stance. Notably, Japan's Minister for Digital Transformation, Kono Taro, emphasized Japan's potential to mediate in the Middle East due to its non-colonial history and religious neutrality in the region, setting it apart from European powers. Additionally, in Southeast Asia, Japan is positioned as a counterbalance to China, leveraging its economic, diplomatic, and technological strengths. Japan's engagement in the region is characterized by strong ties with economically significant nations, offering an alternative to China's influence. This includes promoting intra-regional business networks, advocating for regional issues diplomatically, and providing technological support to enhance maritime domain awareness.

Furthermore, a significant transformation is underway in Japan's defence posture, signalling a more assertive return to the geopolitical arena. This shift is highlighted by Japan's strategic realignment and increased defence spending, aiming for a more robust and forward-leaning stance. This strategic pivot was evident with the release of new national security documents and a defence build-up plan, signifying a departure from its post-1945 security posture. In this matter, Japan and the U.S. have both adopted record-breaking defence budgets for 2024, intensifying geopolitical dynamics, particularly in relation to China, with Japan's defence budget seeing a notable 16% increase, and the U.S. authorizing $886bn in annual military expenditure, signalling their commitment to regional security and stability.

Conclusion

In a bold move, activist investor Elliott Management is now focusing on Mitsui Fudosan, Japan's largest property group. Elliott's primary demand revolves around urging Mitsui Fudosan to launch a substantial $6.8bn share buyback program, boosting the firm's ROE, and increasing its EPS, potentially leading to a higher share price; While some investors view the share buyback positively, others argue that Japan's emphasis on share buybacks is misguided, especially as the country lags in R&D and innovation. Additionally, Elliott is also advocating for Mitsui Fudosan to divest its $3.6bn stake in Oriental Land, the company behind Tokyo Disneyland and Tokyo DisneySea.

Amidst the already uncertain result of similar moves, the current Japan's economic environment itself is uncertain; Despite recent economic setbacks, economists anticipate a rebound marking a potential turning point in Japan's battle against deflation; Concurrently, foreign interest in Japanese stocks has surged, fuelled by high-profile endorsements and positive market sentiment, while domestic investors are expected to be further enticed by the expanded NISA program.

TAGS: Elliott, Private Equity, Japan, Disney