ZENNOR
ASSET MANAGEMENT

ACTIVE OWNERSHIP REPORT

H2 2024

CONTENTS

VOTING BEHAVIOUR

Zennor considers voting a cornerstone of its stewardship responsibilities, offering a formal mechanism to support or challenge management policies. In Japan, even minimal levels of opposition can prompt internal reassessment and reforms.

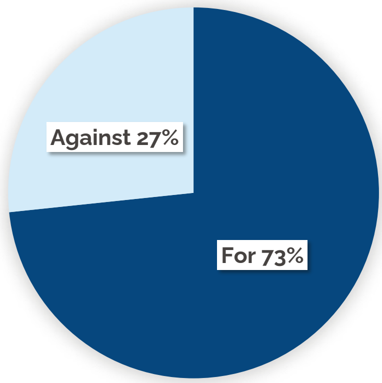
PROPOSAL STATISTICS

Most Japanese companies hold their Annual General Meetings (AGMs) in the first half of the year, resulting in relatively few proxy voting events during this reporting period—a total of five. These events comprised 30 management proposals, with 28 related to board matters and 2 to audit/financial issues.

Of the 28 board-related proposals, Zennor voted in favour of 20 and against 8. All board-related proposals pertained to the election of directors, board committee members, or auditors. The 8 votes against management were due to concerns over insufficient board independence, weak audit committee oversight, and suboptimal capital policies. Specifically, votes were cast against the election of directors and the audit committee chair, reflecting Zennor's commitment to robust governance standards.

Notably, there were no proposals explicitly addressing environmental or social issues during this period and the votes were insignificant due to the subject matter, or the size of the holding in the company.

Management Proposals — Votes Cast



VOTES VERSUS MANAGEMENT

Proposal Category Type	With Management	Against Management
Audit/Financials	2	0
Board Related	20	8
Totals	**22**	**8**

ALL VOTES

Proposal Category Type	For	Against	Abstain
Audit/Financials	2	0	0
Board Related	20	8	0
Totals	**22**	**8**	**0**

INVOLVEMENT OF THE FUND MANAGEMENT TEAM IN VOTING DECISIONS

All voting decisions are made by the fund management team on a case-by-case basis, adhering to Zennor's established voting principles. During this reporting period, the fund deviated from the recommendations of its proxy voting advisor, Glass Lewis, on five occasions. Each instance related to the election of directors and reflected Zennor's emphasis on governance standards that address specific company contexts.

While the fund generally aligns with Glass Lewis' recommendations, it occasionally diverges to account for nuanced situations where continued constructive engagement or tailored governance improvements are deemed more effective. These deviations highlight Zennor's agreement with the overall principles of the proxy advisor but differing views on their practical application in select scenarios. Typically, Zennor's voting is less generous to management than Glass Lewis' recommendation.

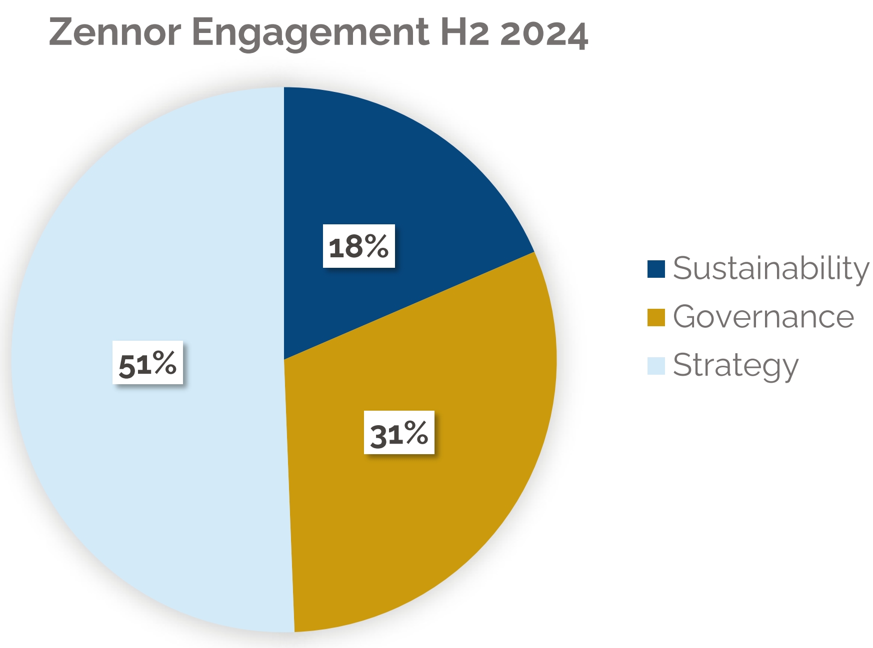
VOTES VERSUS GLASS LEWIS

Proposal Category Type	With Glass Lewis	Against Glass Lewis
Audit/Financials	2	0
Board Related	23	5
Totals	**25**	**5**

ENGAGEMENT

The nature of our focus is on very undervalued and under researched companies and this usually means that engagement of some kind is required to help unlock the value that we see. Consequently, a very high percentage of our portfolio is subject to engagement on governance, operational performance, and sustainability (ESG). The ongoing revolution in Corporate Governance in Japan is coincidental with the global focus on Sustainability. Frequently, these go hand in hand. Without good governance we do not believe that a company can ever be sustainable, so this remains a critical focus for us. One of our key objectives is to work with management teams and to help them think and act like owners of the business – oriented towards long run, per share value creation – for us this is consistent with good Sustainability. We keep track of these activities in our Engagement Tracker.

This chart shows the breakdown by primary engagement focus for each meeting during H2 2024. Strategy is an operating focus; whilst Governance captures board activity, corporate culture, and balance sheet reform; Sustainability is more than just carbon focused but this is a focus area of interaction with companies for us.



Zennor has had 81 engagement contacts regarding investments or potential investments over the period under review, covering the Zennor Japan fund and the more recently launched Japan Income fund and Zennor Special Situation fund. We have had calls and contacts with companies beyond this that are not rated as being specifically targeted 'engagements' but where we also look at Sustainability in those meetings. We do not usually record contact with analysts as engagements although this can sometimes be a 'back channel' to companies and a way of understanding other investor concerns.

There was a marked increase in our Sustainability interactions. We have become more proactive in sharing information with companies about how they might improve disclosure. This frequently involves several meetings and letters increasing engagement volume. A pickup in new stock offerings and several Zennor trips to Japan (four in H2 2024) also drove engagement volume higher. In general companies are being more responsive and welcome closer engagement. In one engagement on Strategy/Governance we agreed to sign an NDA with the company to facilitate deeper discussions.

The key engagement areas continue to be on encouraging compliance with TSE requests around thinking about cost of capital, long run optimal capital structure and addressing material undervaluation. This is a major focus within Japan and of our fund which the TSE has made constant upgrades to such as publishing case studies (most recently in November 2024) and a monthly list highlighting those firms in compliance with their requests. This pressure will continue. We have also focused on several cultural issues at firms that may express itself as Governance or Sustainability. For instance, at Toyota Group there have been several compliance issues which are broad enough that this reflects a systemic cultural issue rather than a specific challenge at one firm. Whilst at Nissan the poor culture has contributed to very bad outcomes and has now spilled over into a potential rescue merger with Honda Motor at distressed valuation multiples. With hindsight we have probably undervalued corporate culture as a source of value creation/destruction. Good cultures create good behaviours and can address short term challenges – bad cultures sometimes bury this negative news and leads to more serious longer-term failings and costs. We are increasing our efforts to understand culture better – but it is hard to quantify rigorously. Some firms having come under shareholder pressure have radically reduced their engagement with shareholders. Fundamentally, this is about alignment between managers and owners of the business – are they thinking about how to create long term value or about their own salary. One of our holdings was used (anonymously) as a bad example in the TSE's recent case study after we had flagged it to TSE.

FUJI SEAL (7864)

Q3 2024 - ZENNOR JAPAN FUND

Level: CFO, IR

Engagement Points: Sustainability

We initiated a position in Fuji Seal, which is a company in transition as its higher margin US business becomes a growth driver. The company had very poor data availability, so at their request we wrote to them with some suggestions as to how they could increase visibility and awareness of their activities.

SECOM (9735)

Q3 2024 - ZENNOR JAPAN FUND

Level: Senior Executives, IR

Engagement Points: Governance/ Sustainability

This meeting was a follow-up to our previous engagement letter with Secom. We have had extensive discussions with Secom about their capital policy and optimal balance sheet shape. We met with Mr. Fuse, Executive Director, over summer. We discussed the gap in return profile across the group and the long term value destruction in some segments, as opposed to their (fantastic) core business. Mr. Fuse was well aware of these challenges, and it became apparent that steps were under way to improve capital allocation through better application of the cost of capital, not just at a group level but also at a divisional one. We also discussed their Sustainability disclosure – subsequently, a much improved CSR report was produced by the company.

DAIEI KANKYO (9336)

Q3 2024 - ZENNOR JAPAN FUND

Level: President, Executive officer

Engagement Points: Strategy

Daiei Kankyo is Japan's leading waste management company, providing services from waste collection to final disposal. We highly rate the company management, but, as a result of strong cash generation, felt that they needed to look harder at their cash management and equity intensity in order to control their WACC. We met with the founder and Chairman and had a very fruitful conversation. The depth and intensity of this discussion may be seen in the fact that Zennor had to sign an NDA with the company ahead of the meeting.

SAKAI CHEMICAL (4078)

Q4 2024 - ZENNOR JAPAN FUND

Level: Board of Directors, IR

Engagement Points: Sustainability

Sakai is a producer of highly refined materials, mainly used in the technology industry. The firm has only recently exited the production of Ti02, which is highly energy-intensive and has a large environmental footprint. We spoke with them about how to ensure that the new profile of the company was recognised. Whilst the firm has conducted outreach to some organisations, such as CDP and specialist Chemical rating companies, it has not connected to those dealing with investors. We were able to share key contacts at firms such as MSCI, etc., to ensure that their data was properly picked up.

ENGAGEMENT LETTERS

When engaging with companies Zennor use letters to follow up on points raised and to keep a permanent record. The team believes that this engagement process is crucial for active managers as it supports their ability to achieve superior returns. By engaging constructively with company management, they aim to promote stronger, sustainable growth, better governance, and reduce business risks. These efforts are expected to result in better company outcomes for internal and external stakeholders.

At the end of this report we have included three examples of letters which Zennor has written to companies in H2 2024. We have included summaries and links below:

Click here to read the to full letters.

CARBON ANALYSIS

During the period we also conducted our yearly review of Carbon Intensity and risks around carbon pricing. Our portfolio exposure is far below that of the benchmark on a Weighted average basis. The analysis suggests that we stand at 49.6 tonnes of CO_2 / m USD against the Japan benchmark at 81.75 based on 2024 disclosure on a scope 1 and 2 basis (source: Bloomberg). Once again, the variance across different data vendors was wide depending on their level of granularity and freshness of data. In general, the quality and volume of disclosure is increasing. However, multiple sources including CDP disclosures, peer comps and alternative data are required to find even straightforward Scope 1/2 data. Our biggest contributors to our footprint are a copper miner Nittetsu Mining (1515) – part of the energy transition required metals, Toyota Industries (6201) a leading producer of components for EVs, and Dai Nippon Printing (7912) which makes components for EV battery production. Most of these firms' clients are exposed to these new 'greener' industries that should ultimately reduce carbon emissions downstream.

UN PRI SUBMISSION

We also completed our UN PRI submission and received feedback in November 2024. Which we are happy to share with you on request.

CORPORATE GOVERNANCE PROGRESS

On January 15th JPX updated their list of firms that had acted with management conscious of the cost of capital.

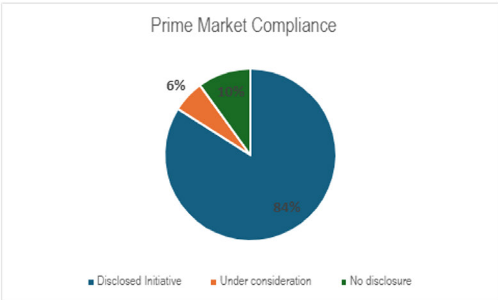
Click to view pdf.

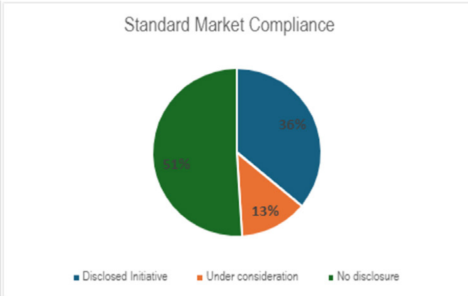
Substantive change with regards to Corporate Governance reform is now being seen in Japan. Share buybacks and rising dividends are now commonplace. Many foreigners remain sceptical, and this is backed up by Japan still being underweighted by mutual funds. The Tokyo Stock Exchange (TSE) have doubled down on their commitment to enhancing corporate restructuring and started publishing a list of companies who have responded positively to their request for engagement on cost of capital and shareholder returns. The TSE has also issued two useful guides: on the evaluation of capital efficiency plans and a long list of case studies most recently refreshed in November 2024.

Many Japanese companies are finally working to eliminate their cross-holding structures. One of our largest holdings, MS&AD Insurance Group (8725) will be selling down close to $25bn of strategic holdings over the next four years. The extra return to shareholders will equate to a further 3% total payout ratio making an 8% annualised ratio now in sight. Further news of cross shareholding unwinding came from Denso, an auto parts company in the Toyota group announcing that it will sell its entire 9% stake in Toyota Industries (6201) over 2½ years. Toyota Industries has 110% of its market capitalisation in long term securities. We expect that the company will look to buyback shares that become "loose" as a result of the Toyota group restructuring, and that the company will in turn look to unwind its large war chest of securities. Even conservative companies such as Kyocera (6971) have mentioned about reducing its KDDI stake and exiting underperforming divisions.

Earlier in the year the TSE asked companies trading below book value to explain their cost of capital workings and return on invested capital. The TSE is also eager to change management policy towards growth strategies. This includes exiting unprofitable businesses, restructuring the capital base, divesting idle assets, and using leverage instead of cash. They want companies to have a clear understanding of the cost of capital versus the return on invested capital. However, we still find that many of the companies we follow underestimate the cost of capital, and their large cash holdings inflate the cost dramatically. Recently, the TSE has been asking firms to consider their optimal capital and balance sheet structure which will again pressure low returning financial and operating assets.

The TSE updated list of companies that have disclosed measures in response to its requests for action. This list will be updated regularly. At the end of December 2024, 84% of prime companies have responded to the TSE's requests whilst 10% have not disclosed and 6% are "studying" (Chart 2). The standard market is a different story. 41% have no disclosure as yet and just 59% have disclosed plans or have plans under consideration.





The TSE has also brought examples and models of what 'good' companies should do via two useful guides. These have been produced partly to help companies who are not quite sure and partly to help fund managers – who are very sure – but who need a good way to communicate these concepts. This has been supplemented by examples of what not to do in November 2024.

It is true that the title could be catchier: 'Key Points and Examples Considering The Investor's Point of View in Regard to Management Conscious of Cost of Capital and Stock Price'

https://www.jpx.co.jp/english/news/1020/20240201-01.html

However, the contents are very useful. There are two elements: what best in practice capital efficiency plans look like in the real world (in Japan!) alongside real world examples across industries and market caps. Every company should be able to find a reasonable analogue within this list of 29 examples across different market segments come from companies as diverse as Inpex, Sumitomo Forestry, Kobe Steel, Concordia Financial Group, Sanyo Shokai, Mitsubishi Corp, Marui Group and Seino Holdings. In practical terms, we have a set of templates that can be applied to most scenarios – that have already been done and are 'approved' by the TSE. In a conservative group culture such as Japan being a follower is far easier than leading the way. We now have clear precedents. This is another step forward for Japanese governance and engagement.

EXAMPLE ENGAGEMENT LETTERS

1) Secom (9735)
2) Fuji Seal International (7864)
3) Kyoto Financial Group (5844)

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Secom (9735)

Dear Fuse san, Yokei san,

I am sure that you have received the latest JPX monthly case study 'Cases where companies are not aligned with investors' perspectives'

https://www.jpx.co.jp/news/1020/mklp77000000lw4e-att/mklp77000000lw76.pdf
This touches on many of the points that we have discussed...

- The appropriate cost of capital (10%) – CAPM is not sufficient!
- The appropriate incentive and performance alignment for management (Compensation)
- Urgency of action
- Being content with mediocre performance that exceeds 1x PBR or only just meets cost of capital as this ignores the potential for higher value creation. We strongly feel a lack of high performance aspiration and a lack of urgency at Secom
- Corporate value as the yardstick not size

Most importantly in your case.

- Application of cost of capital thinking to each business segment. As we have discussed only your security business has consistently exceeded the cost of capital. The recent PASCO buy-in, whilst cheap, will not improve the group RoIC. The JPX expects firms that cannot get divisions, and not just the entire company, to exceed their cost of capital need to take more drastic measures i.e. spin out, sell, withdrawal etc. As so many Secom divisions fall into this category, and have done so for many years, we expect decisive action from the management to address the underperforming against cost of capital areas such as healthcare, BPO, data centre, insurance, Nohmi, Pasco and excess financial assets and capital. This is also the JPX expectation.

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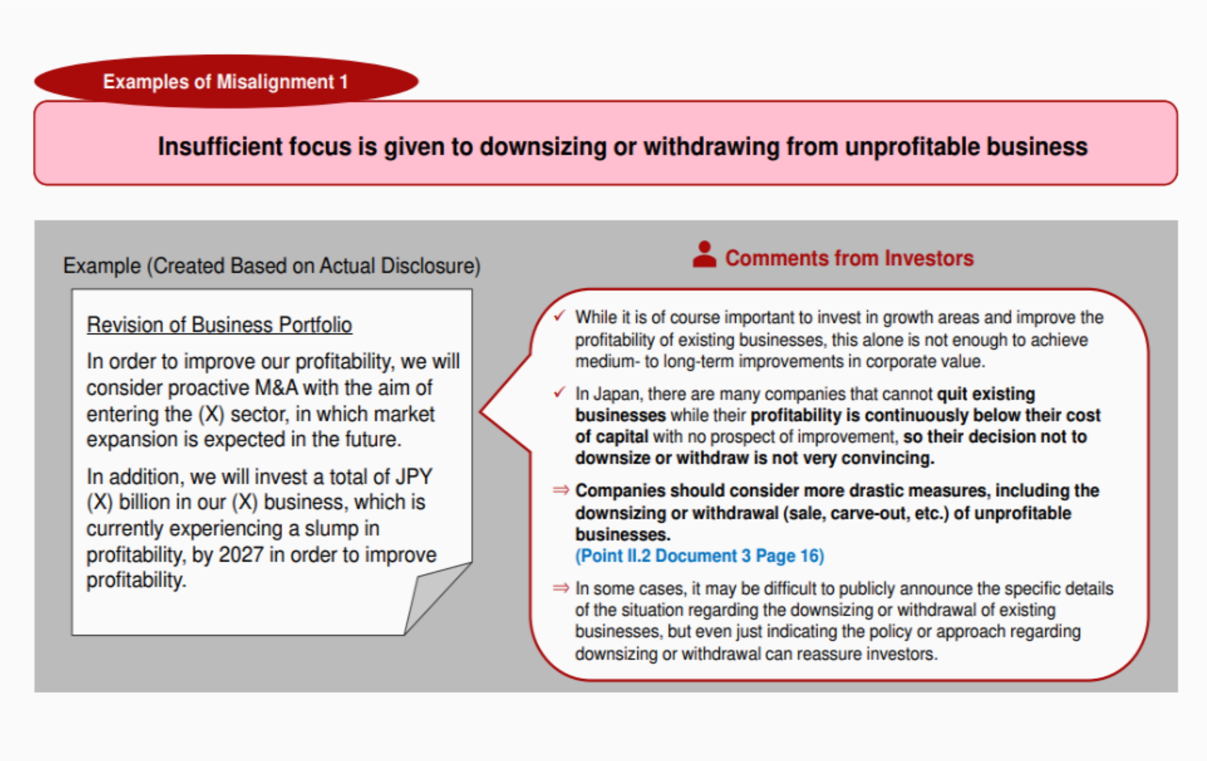

When I consider Secom and apply the analytical framework that the JPX has outlined the actions that need to be taken are obvious – and are exactly what Zennor has been urging you to do for some time!

We are concerned by CEO Yoshida's reported public comments about increasing the scale of the group rather than maximising corporate value. The acquisition of PASCO fits a 'scale' not a 'corporate value' maximising approach given its poor return level (although we acknowledge that it was a cheap asset). The growth strategy targets absolute sales, profits and an undemanding 10 % RoE target. This vague commitment falls short of JPX expectations. The overall tone of the plan is one that is unaware of the cost of capital and not pursuing a rigorously capital cost-based strategy. Secom can do much better.

The SECOM Group's targets for the fiscal year ending March 31, 2028, are for consolidated revenue of at least ¥1,250.0 billion, consolidated operating profit of between ¥160.0 billion and ¥180.0 billion, a dividend payout ratio of around 45% and an ROE of 10%.

	Targets for the fiscal year ending March 31, 2028	Notes
Consolidated revenue	At least ¥1,250.0 billion	
Consolidated operating profit	¥160.0 billion–¥180.0 billion	
Divided payout ratio	Around 45%	**Financial Strategies** • Enhance shareholder returns while maintaining a sound financial position • Invest in growth while remaining aware of cost of capital • Conduct share buybacks in a timely manner to achieve an ROE of 10%
ROE	10%	

The JPX highlights that this plan does not consider the capital structure, ideal balance sheet and capital allocation. The commitment to invest in 'growth' lacks rigour driven by returns around a cost of capital and the objectives for each division are not analysed through the cost of capital lens. Given their historic returns most of these divisions should not receive <u>any</u> capital and should be subject to 'drastic measures' and if an appropriate return on capital cannot be earned should be exited. There is a lack of urgency to address these capital destructive activities.

Secom, as many investors have highlighted, has a large and growing net cash and financial assets pile and this carries a very high cost once capital charges are considered. This is not investigated in the MTP. This highlights how far away from management conscious of the cost of capital Secom is now. With 600bn in cash, 11% of shares in Treasury, and a long list of equity holdings these all carry a 10% cost of capital and are clearly excess assets. Addressing the appropriate balance sheet shape is not given sufficient consideration.

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Insufficient consideration given to ideal balance sheets and capital allocation policies

Example A (Created Based on Actual Disclosure)

Strengthening Shareholder Returns

In order to secure a ROE that exceeds the cost of capital, we will raise the dividend payout ratio from the current 30% to 50% during the period of this medium-term plan (through FY2025). In addition, we will implement a share buyback of JPY 10 billion in total during the period of this medium-term plan.

*Provides no reference to ideal balance sheet or capital allocation policies.

Comments From Investors

✓ We feel that the company is **taking short-term measures to boost their share price and returning profits to shareholders as a one-off response, as they have not fully considered the ideal balance sheet or capital allocation policy.**

⇒ In order to gain the support of investors with a medium- to long-term perspective, it is important to **give thorough consideration and show shareholders what kind of balance sheet your company is aiming for in order to improve corporate value over the medium to long term, and how you will allocate the cash you have on hand (or will acquire in the future) to growth investment, shareholder returns, etc.** (Point I.3 Document 3 Page 12)

Example B (Created Based on Actual Disclosure)

Reduction of Cross-Shareholdings

By fiscal 2025, the final year of the medium-term management plan, the ratio of cross-shareholdings will be reduced to 10% or less of consolidated net assets, and the total amount of approximately JPY 20 billion in cross-shareholdings will be sold off in stages.

*Provides no reference to ideal balance sheet or capital allocation policies.

✓ It is good that the company is aiming to reduce its cross-shareholdings, but without indicating **what they will do with the funds obtained from selling these stocks, such as investing in growth or returning them to shareholders, it will be difficult to see this as a positive investment opportunity, as the company will simply be selling them off.**

⇒ We expect companies to **disclose their medium- to long-term capital allocation policy, including the funds obtained from the sale of cross-shareholdings.** (Point I.3 Document 3 Page 12)

remuneration

We recently discussed your compensation strategy. Despite the improved performance mix in your new plan this element is still very modest. Zennor urged you to increase the performance weighting and the quantum of total remuneration for the board members. We feel that the degree of alignment is not high enough at current. Management KPIs are also not set with a clear corporate value maximising orientation. We want to meaningfully reward success and outstanding execution.

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Examples of Misalignment 2

Performance-linked executive compensation is not necessarily an incentive for medium- to long-term improvements in corporate value

Example A (Created Based on Actual Disclosure)

In order to further motivate our directors to contribute to increasing corporate value and ensure that we achieve the targets set out in our management plan, we have introduced performance-linked compensation linked to management indicators (sales growth rate and operating profit growth rate) as shown in the table below.

Category	Ratio *In the case that 100% of targets are achieved	Method of Determination
Base compensation	60%	Fixed
Performance-based compensation	40%	Determined according to degree of target achievement for **sales growth rate** and **operating profit growth rate** (each weighted at 50%)

Comments from Investors

✓ While the introduction of performance-based compensation is a positive, the linked indicators are all based on the profit and loss statement, such as sales and operating profit, and there is a risk that this will prevent withdrawal from unprofitable businesses, etc. which does not lead to an awareness of efficient capital use.

⇒ In order to use executive compensation as a tool to align the perspective of executives with that of investors, we would like to see TSR, EPS, equity spread, and other indicators that investors place importance on more closely linked to executive compensation.
(Point II.4 Document 3 Page 18)

Example B (Created Based on Actual Disclosure)

In order to further motivate our directors to contribute to increasing corporate value and ensure that we achieve the targets set out in our management plan, we have introduced performance-linked compensation linked to management indicators (sales growth rate and operating profit growth rate) as shown in the table below.

Category	Ratio *In the case that 100% of targets are achieved	Method of Determination
Base compensation	60%	Fixed
Performance-based compensation	40%	**Determined according to degree of achievement of the initial forecasted** revenue and net income (each weighted at 50%)

✓ Performance-linked compensation is determined based on the "earnings forecast" announced at the beginning of the fiscal year, and there is a concern that this may provide an incentive to lower the earnings forecast.

⇒ While there is no uniform rejection of using earnings forecasts as the standard, it is expected that executive compensation should be carefully designed to provide a sound incentive for medium- to long-term improvement in corporate value.
(Point II.4 Document 3 Page 18)

Please share the JPX report with management and we look forward to discussing these matters with you shortly.

Kind regards
David Mitchinson, Zennor Asset Management

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Fuji Seal International (7864)

Dear Mr. Goto,

James was very grateful for the time he spent with you recently. He asked me to follow up regarding the Sustainability reporting and disclosure. Your webpage, Integrated Report and other measures all show how seriously you are taking Sustainability. This includes Third Party Verification by SGS. Leadership by the CEO is also impressive.

Rating and Information Availability

If we just look at the data that most investors receive from Bloomberg we can see that there are several major rating companies that have not recognised your efforts with any kind of rating.
The overall Bloomberg score does suggest that your overall scoring is generally better than your peer group. There is a big gap between what you do and what you are recognised for doing by the rating companies. I believe that your challenge is primarily a data accessibility one.

You do have some Sustainability details in your Management Policy document – however this is in Japanese and in a PDF. This kind of data is very hard for machines to read automatically and is often ignored. The data is also nested several layers deep in your website, making it harder to be found by machines. You could put this information (e.g. ESG Data Book) not only in a PDF but also on the main page of the relative section of your website, making it easier to detect and access. At least for key information.
Implementing TCFD reporting
(https://www.fsb-tcfd.org/wp-content/uploads/2017/06/TCFD_Final_Report_Japanese.pdf)
and adopting SASB industry standards
(https://www.sasb.org/standards-overview/download-current-standards/)
and GRI reporting
(https://www.globalreporting.org/standards/gri-standards-download-center/may)
may also help ensure that your data is reported in the correct way and is comparable. Including this data in regulatory releases also increases its visibility.
Looking at the TDnet from JPX, there are no disclosed ESG documents available for Fuji Seal. This is widely accessed and utilising TDnet would be a very effective way to spread your current information to many stakeholders. As you already have this documentation it is a shame not to use the TSE ESG portal for this.

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It would also be worthwhile speaking directly to the rating companies themselves.
(ESG評価機関等の紹介 | 日本取引所グループ (jpx.co.jp))
They will of course be able to share the best practice for ensuring your data is recognised. MSCI has the greatest global reach to investors and is seen as the 'gold standard' for data quality (esgissuercomm@msci.com). CDP, as you know, has very deep Climate information (japan@cdp.net). Sustainalytics also has a good reputation (issuer.relations@sustainalytics.com). I have found S&P to be rather poor in Japan but it is very well used in the USA (Clientsupportjapan@spglobal.com). There are many others!

Net Zero Target
If we look more specifically at your adoption of a Net Zero Target, whilst the target is clear, it is not yet supported by a credible plan, as the current plan appears insufficient to move to a sustainable temperature trajectory. This places a lot of pressure on the future carbon reductions to reach a net zero target.

You have replied to CDP for several years, but this has not been very effective yet. I think it is excellent that you have started doing this. I suggest contacting your CDP representative to ensure that they have the latest data and to look at what ways you can find to improve the data availability. For instance, the high-level Introduction does not capture your Carbon Emissions data at all, but this is disclosed later in the submission.

Reading your submission there seem to be some data issues - e.g. a lack of start/finish dates for Scope 1 and a lack of consistency between what kind of data was submitted. As you move towards the SBTi, this is likely to increase disclosure quality and robustness. It will also increase confidence in your transition plan.

How do leaders in the packaging sector comply? What can you learn?
We do not see Sustainability as simply a burdensome cost of reporting data (although it is tough) we see it as a potential tool to improve Fuji Seal. How can Fuji Seal utilise this information to strengthen the business and deepen your competitive edge? Which customers VALUE (and will pay for) your Sustainability? How can you find more of them? How does this improve your customer proposition?

Kind regards
David Mitchinson, Zennor Asset Management

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Kyoto Financial Group (5844)

Inokuma san,

Thank you very much for your precious time on Monday.

We are encouraged by the improving operating environment with a buoyant demand and stronger pricing and mix. This shows that there can be a bright future for Kyoto Financial as an operating company after the years of low banking profits.

As you are very well aware the company has not yet delivered operational and capital strategies that are aligned with shareholders, is conscious of the cost of capital or JPX requirements.

We do have some comments on the revised plan, capital allocation policy and governance which we would be grateful if you could share with Doi san and the board of directors. It is their role as the senior leadership of the company to consider the long run value creation strategy and especially devise the framework for capital allocation, which in a bank is especially important, that is conscious of the cost of capital and of the material undervaluation of your company as requested by JPX and by your shareholders. Your returns are low, even by the standards of regional banks, and your PBR ratio adjusting for your equity portfolio is profoundly undervalued. We heard this week that a bill will shortly be introduced into the Diet that will clarify the responsibility of external board directors towards shareholders. This will emphasise their fiduciary duty to maximise long run shareholder value and that they should act on behalf of shareholders and not the company management team. In Kyoto Financial's case this alignment with shareholders is still very weak. Your company urgently needs to bring additional independent board members into the company to improve operating execution by the management team and capital allocation. Today the company falls far short of the JPX requirements and does not show an ambition to meet them. We do not have confidence that the current board fully understands or is sufficiently empowered to fulfil its fiduciary duty.

We are not satisfied with the capital allocation plan. The 100bn JPY market value reduction amounts to a planned less than 5% per year reduction in the portfolio - we believe at the end that your overall balance sheet will be larger than it is today given only moderate growth assumptions. This is not a plan that is in any way conscious of the cost of capital. Your 1,000bn equity portfolio has an annual capital charge of at least 100bn. No policy conscious of the cost of capital can exist without a plan to radically address this issue. Your cost of equity is approximately 10%. The pace of balance sheet change is so slow that it amounts to no change at all. We contrast this to the policy at SMTH, who have committed to exit all of their positions and the mega banks who are all very actively shrinking their equity holdings. Kyoto Financial must develop a policy that resolves this issue - this is currently absent.

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Whilst the dividend payout ratio has increased and share buybacks have stepped up, both of which are welcome, the company will still be increasing its capital base as the payout ratio is not over 100%. Given that your capital base is already much too large compared to your operating business this will reduce returns even further. Kyoto Financial needs to bring the capital base in line with its operating requirements. This means that a long-term policy of greater than 100% payout ratio is required. As we discussed in our meeting using CET ratios but excluding your huge equity holdings from this calculation is deeply misleading. We think that this way of thinking is also impacting management thinking about capital allocation and efficiency. You have to generate a return on your entire capital base not just those parts that you would like to count.

The new targets do not suggest any long run optimal balance sheet shape. As the JPX has suggested this is something that management teams ought to consider and communicate with shareholders. Given your true CET is around 25-30% and your own targets are for 11% the company must obviously consider returning most of the capital to shareholders. At the current low valuation, the opportunity to do so through large buybacks is extremely value creating for the owners of the company. You have many relationship shareholders who have their own pressures to sell, and this could be a good opportunity for both Kyoto and those shareholders to improve capital allocation. Kyoto Financial must share a comprehensive long term capital strategy that is consistent with this gap between your operational requirement (10%+) and reality (25%+).
Whilst we are aware of the tax wedge there is no way to avoid this and must just be accepted. The question is how best to deploy the 700bn JPY to create the most value per share. This is a huge opportunity for management to create value. We would like them to take it.

Compensation and alignment by management with shareholders requires more thought. We are quite content for pay to be (much) higher in absolute terms - in exchange for much better operational and capital discipline. We would suggest radically increasing the weighting of performance pay and equity incentives alongside challenging targets. Many companies are moving to a 1:1:1 type compensation model - we would suggest an even higher weighting to operating performance and equity ownership by management 1:5:10! We suggest KPI targets that separates banking profitability and banking RoE from that of your investment portfolio and capital allocation decision. The bank must cover its cost of capital from operations and not rely on the support from the dividend stream. The KPI should include per share metrics rather than focus on absolute scale to encourage management that is conscious of the cost of capital and shareholder value creation. We would like the staff to benefit from the success of Kyoto and the improvement in share price through time. We would also like to see an ambition to increase valuation to greater than 1x PBR (including post tax equity gains).

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We are sure that similar views are held by very many investors who are dissatisfied with the operational and capital strategies at your bank. There is so much potential at Kyoto Financial - our request is that the board listen to shareholders and the JPX and put into place the correct strategies that address management conscious of the cost of capital and that is aware of the profound undervaluation of your shares.

We would welcome the opportunity to discuss these issues with Doi san and your independent board directors directly.

Kind regards
David Mitchinson, Zennor Asset Management

ZENNOR
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