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Views from the Japan Equities Small Cap Desk

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"…the "Prime market" and the TOPIX would be separated"

Views on the revision of the First Section of the Tokyo Stock Exchange

In February 2020, the TSE announced a policy to effectively encourage companies whose market capitalisation is below a certain level to withdraw from the Prime market, the successor to the First Section of the Tokyo Stock Exchange. However, the threshold of the market capitalisation was set at JPY10 billion for "tradable stock" alone, which is low compared to the level discussed in 2019. At the end of the year, the definition of "tradable stock" and the handling of the TOPIX, which is more important to investors, was announced, and the context of the market review finally came to light.

For portfolio managers such as myself, who generally invest in companies with a market capitalisation between JPY 3 billion and JPY 100 billion, the review itself was lacklustre. However I feel that there is little need to be confused because this proposal is relatively careful and I will explain why.

Regarding the definition of "tradable stock", it was announced that small cross-shareholdings as well as large shareholders such as owners and parent companies would be excluded. For some older companies, this effectively excludes them from the universe of the Prime market, but it is not a big problem for the overall market.

What is more important for investors is what will happen in their handling of the TOPIX, which is currently calculated for the entire TSE First Section. With regards to companies becoming excluded from the TOPIX index, the supply-demand balance will deteriorate significantly due to selling by passive funds that invest in all the companies included in the calculation with the aim of linking investment performance to the index. At present, it is said that the number of shares held by passive funds targeting TOPIX exceeds 10% of the total number of shares issued excluding those held by major shareholders, and it will be difficult to absorb them once they are released.

It was announced that the "Prime market" and the TOPIX would be separated, a transition period would be set, and adjustments would be made gradually between them. Specifically, while the transition to the Prime market will take place in April 2022, the replacement of the TOPIX from October 2022 to January 2025 will take place 10 times per quarter. In addition, it was also revealed that even if "tradable stock" is excluded, if by October 2023 the market capitalisation exceeds JPY 10 billion, it will be classified as "Prime market" and will pave the way for it to rejoin the calculation of TOPIX.

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This method makes it much easier to digest in the market, as the amount released per share is just over 1% of the number of outstanding shares, excluding those held by major shareholders. That said, there will be many releases until the middle of the transition period, which will weigh on the psychological supply and demand. However, in order to provide companies which do not meet the requirements immediately a chance of promotion, not all stocks will be sold unilaterally.

A company whose market capitalisation of "tradable stock" is less than JPY 10 billion should first aim to increase its stock price by expanding its business performance. There is a substantial grace period of nearly three years, during which the external environment is expected to undergo significant changes, so there should be considerable opportunity for a turnaround.

For companies that are undervalued and have a strong financial position, it is also a good idea to raise dividends drastically, to the surprise of investors. Many Japanese companies have fallen into a state of "high financial stability but with limited growth investment opportunities“, I believe it would be better for them to use all their profits for dividends.

Even for companies that are unlikely to achieve a market capitalisation of JPY 10 billion in tradable stock, if their financial position is strong, it would be better to repurchase their own shares during the transition period. From a corporate perspective, shares that have been bought up without looking at the company's fundamentals will be released as a result of the system change. It will not be pleasant to use funds to respond to this, but I think it is important to show an attitude of protecting shareholders from temporary supply and demand deterioration factors.

On the other hand, there may be brokerage firms that propose "capital increase to increase the market capitalisation" but do not be mistaken by such views. A capital increase that does not lead to an increase in business results could lead to a decline in stock prices both in terms of supply and demand and in terms of earnings dilution, which could in turn lead to a decline in market capitalisation.

Source: Based on article by Tatsuro NIGAURI, published in The Nikkei Online Edition on 15 January 2021.

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Tatsuro Nigauri is a Japanese small-cap equities manager with three decades of experience managing money based in Tokyo. He joined the firm in Oct 2002 and has managed the Japan Equity Small Cap Absolute Value strategy since its inception in 2004 and the UCITS funds since their launch in 2017. He started his career as a research analyst at the Daiwa Institute of Research in 1991. Nigauri is an award-winning manager and has received many accolades, including the Lipper Fund Awards Japan (2012, 2013 and 2016), the R&I (Rating and Investment Information) Fund Awards (consecutive years from 2012-2019) and the J Money Fund Awards (2016 and 2017).
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