



Strategic Capital



Proposal to unlock value of Kyokuto Kaihatsu Kogyo Co., Ltd (7226)





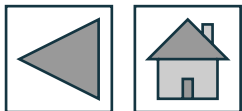
Executive Summary

Strategic Capital, Inc.'s (SC) goal is to unlock enterprise and shareholder value through dialogue with the Company's Executive Management ("Management") and the exercise of shareholder rights.

SC and the funds managed by our company are shareholders of Kyokuto Kaihatsu Kogyo ("Kyokuto", "Kyokuto Kaihatsu" or the Company"). In order to increase shareholder value, we have submitted the following proposals to Kyokuto by exercising our right to make a shareholder proposal

- i. Set dividend payout ratio to be 100%
- ii. ~~Eliminate Contingent reserve~~
- iii. Disclose the weighted average cost of capital
- iv. Authorize the AGM to dispose of rental real estate
- v. Dispose rental real estate
- vi. Authorize AGM to cancel treasury stock
- vii. Cancel treasury stock
- viii. Take action to reduce cross-shareholdings

Proposal withdrawn on May 17, 2022.
See [here](#) for details

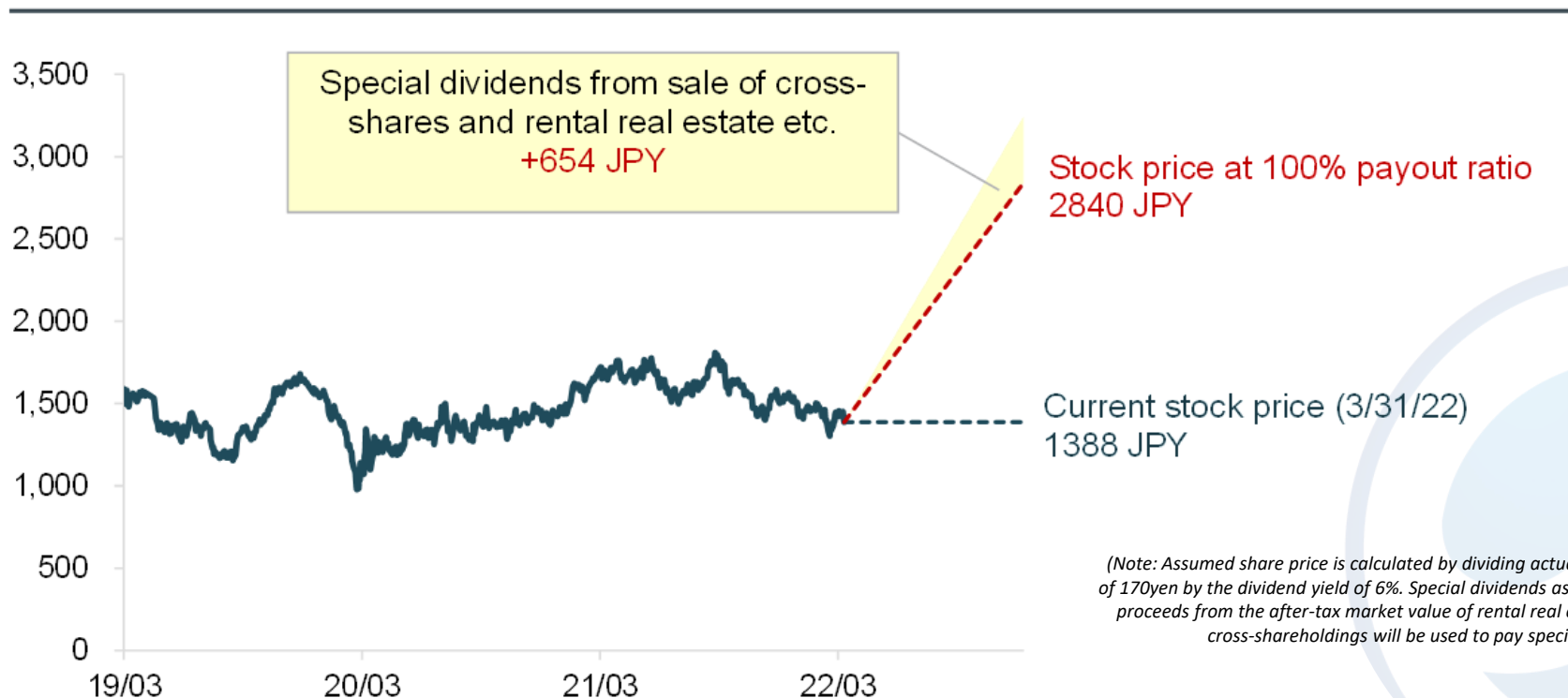




Assumed return to shareholders from the passage of the proposals

If our shareholder proposal is approved, the stock price is expected to climb to 2,480 yen. In addition, a special dividend of 654 yen/share would be distributed. When compared to the stock price on March 31, 2022, shareholders of record would earn a total return of +151%.

Assumed share price and special dividend





Background & key points on the proposals

Long-term share price weakness and excessive accumulation of equity capital → Set dividend payout ratio to be 100%

Since 2010, the Company's stock price has rarely exceeded dissolution value. We believe one of the reasons for the prolonged slump is the excessive level of equity capital and the corresponding low capital efficiency.

The Company's equity capital ratio is already high at around 70% and if the Company continues the current level of shareholder returns, equity capital will continue to build up and capital efficiency will further decline.

We propose a 100% dividend payout ratio to prevent further build-up of equity capital.

Contingent reserve held for unclear purposes → Eliminate Contingent reserve

Every year, the Company reduces Earned surplus carried forward which are the source of shareholders' returns and accumulate the amount to Contingent reserve. **On May 17, 2022, we withdrew the shareholder proposals regarding the contingent reserves.** Contingent reserve whose purpose is unclear.

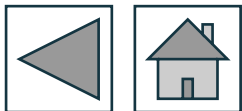
Please see [here](#) for details

We propose withdrawing all assets from Contingent reserve and using the proceeds as a source of funds for share buybacks or payout as dividends to increase shareholder value.

Ineffective leadership that ignores the cost of capital → Disclose the weighted average cost of capital (WACC)

Senior managements lack of awareness regarding the cost of capital may be one reason they make ineffective decisions that result in capital efficiency being at such a low level.

We propose the Company disclose WACC and the basis for calculation to encourage decisions to be made with the cost of capital in mind and unlock the stocks valuation.





Background cont'd

Rental real estate with low capital efficiency → Authorize the AGM to dispose of rental real estate. Sell rental real estate

As of March 31, 2021, the Company owns approx. 19.9B JPY at market price in rental real estate. However, we believe Management has neither the knowledge nor strategy in rental real estate, and hence it is extremely risky to leave the disposal of such assets as an exclusive decision of the Board.

Also, we estimate the ROIC of rental real estate to be only 2.7%, and clearly difficult to generate a return that will exceed the cost of capital.

We propose that the Company sell its rental real estate and use the proceeds to increase shareholder value.

Neglecting potential dilution risk from holding treasury stock → Authorize the AGM to cancel treasury stock. Cancel treasury stock

As of December 31, 2021, the Company held treasury stock equal to approx. 7% of the total shares outstanding. Despite the potential dilution risk to shareholders from holding such stock, senior management has neglected to dispose of its treasury stock holdings for over a decade.

If the Company is not going to cancel the treasury stock by its own volition, we propose to empower shareholders to decide at the General Meeting and speedily retire the stock.

Cross-shareholdings that loosen management discipline and reduce capital efficiency → Take action to reduce cross-shareholdings

The Company states that it holds cross-shareholdings to “increase profits by strengthening business relationships”. However, the business counterparties have denied this, and Management has not been able to make an appropriate judgement as to whether or not to hold cross-shareholdings.

We propose, that Management sell its cross-shareholdings based on clear criteria that takes into account the policies of the companies issuing the share of cross-shareholdings.





What's New

04.20.2022

Notified Kyokuto Kaihatsu of our execution of shareholders' right to make a proposal at the AGM. See press release [here](#).

04.20.2022

Campaign website for Kyokuto Kaihatsu opened

05.17.2022

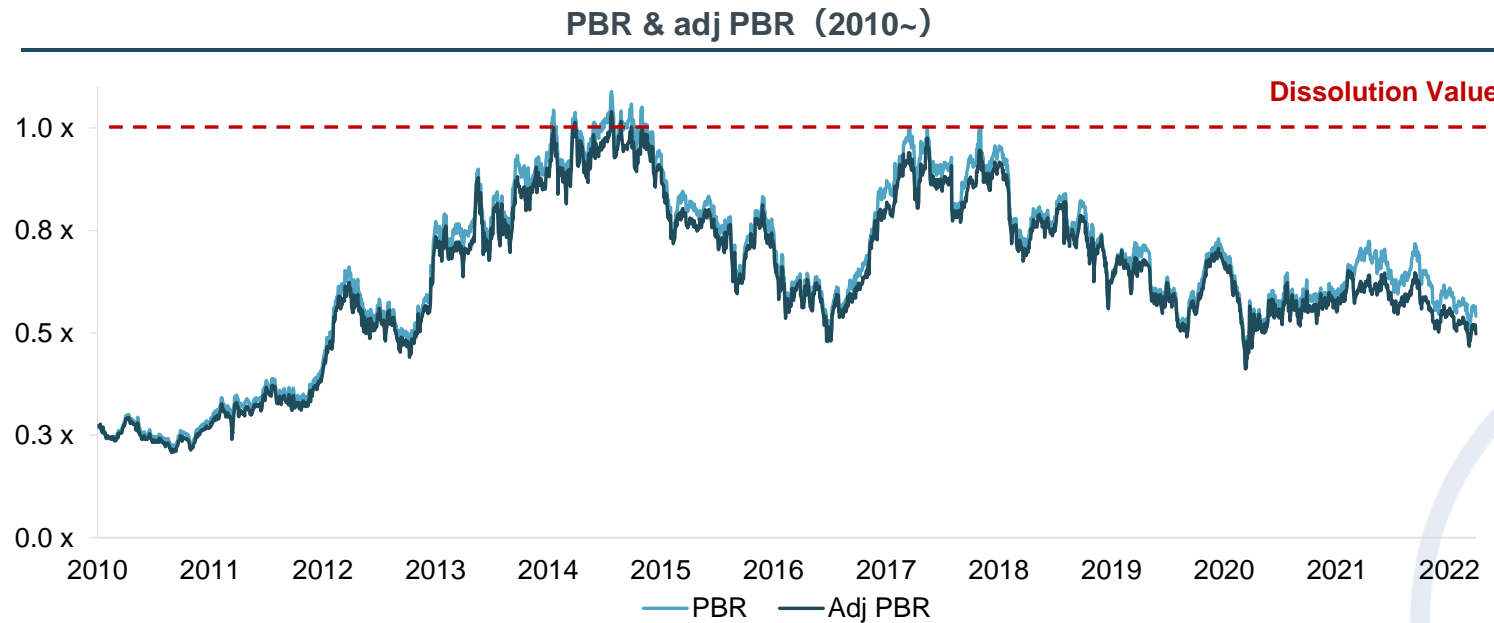
Withdrew shareholder proposal regarding contingent reserves. See [here](#) for details.



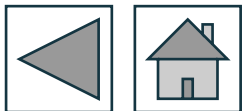


Stock price that constantly trades below dissolution value

Kyokuto's stock price has mostly remained below its dissolution value (PBR 1.0 x) since 2010. More recently , the PBR was 0.54x and when adjusted for unrealized gains on real estate holdings, 0.50x.



Data Source: Quick Astra Manager

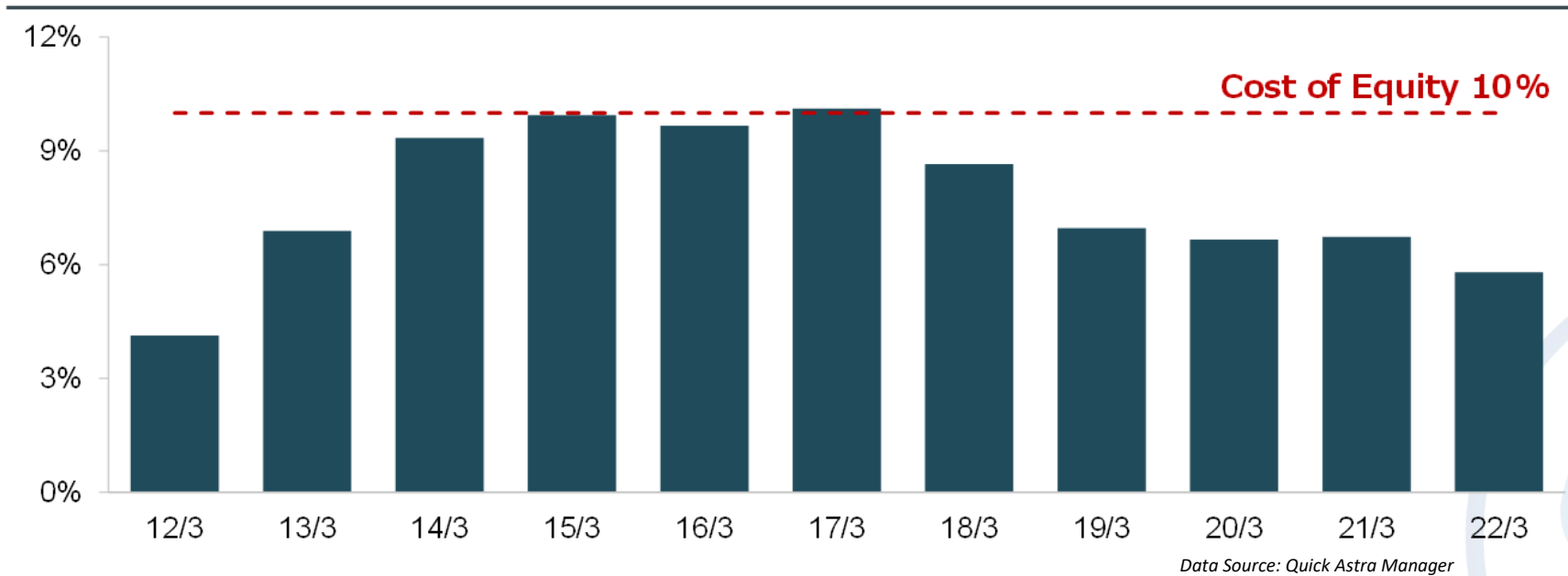




Capital efficiency below cost of capital

The cheap valuation indicates the Return of Equity (ROE) is below the cost of equity (COE). In our view, the Company's COE is about 10%. However, Kyokuto Kaihatsu's **ROE has been well below COE** and by extension well below investor's expectations.

ROE and Cost of Equity over time



[Click here for our basis for calculating the COE](#)





Capital efficiency below cost of capital

Theoretical PBR for each COE and g assuming an assumed ROE of 7.0%

Within ±5% of current stock price

	Expected cost of equity (COE)											
	7.0%	7.5%	8.0%	8.5%	9.0%	9.5%	10.0%	10.5%	11.0%	11.5%	12.0%	
Perpetual growth rate (g)												
0.0%	1.00	0.93	0.88	0.82	0.78	0.74	0.70	0.67	0.64	0.61	0.58	
1.0%	1.00	0.92	0.86	0.80	0.75	0.71	0.67	0.63	0.60	0.57	0.55	
2.0%	1.00	0.91	0.83	0.77	0.71	0.67	0.63	0.59	0.56	0.53	0.50	
3.0%	1.00	0.89	0.80	0.73	0.67	0.62	0.57	0.53	0.50	0.47	0.44	



RETURN

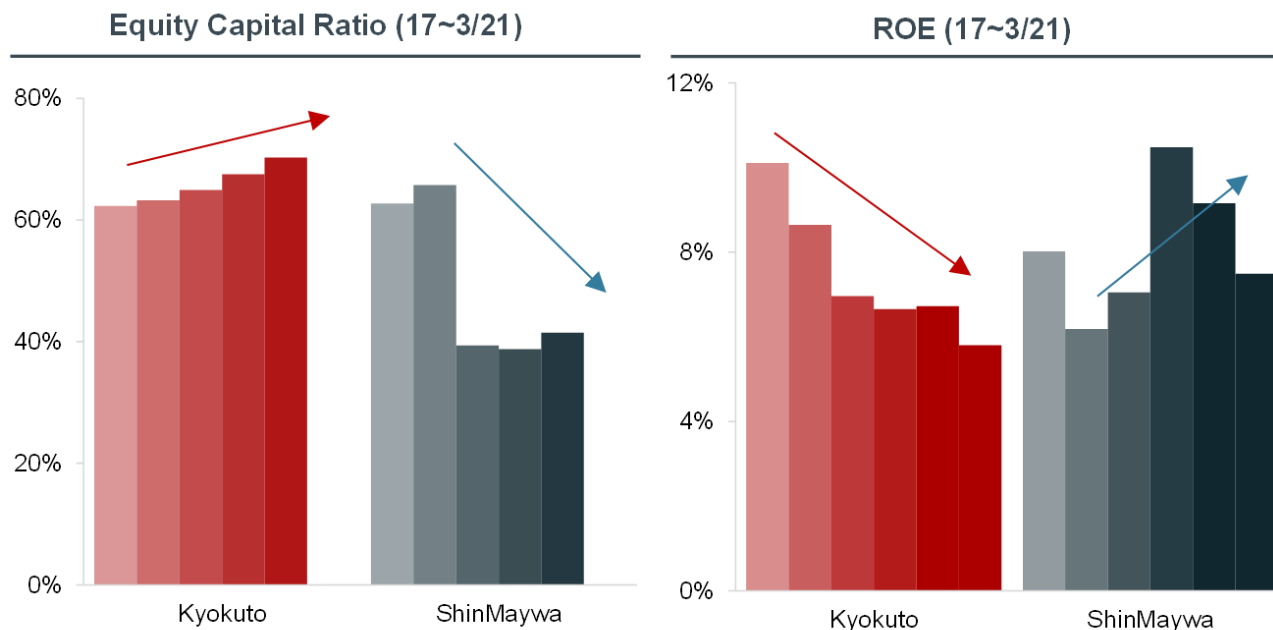
Data Source: Quick Astra Manager



What is causing the low capital efficiency

At 70%, Kyokuto's equity capital ratio is very high especially when compared to peer ShinMaywa Industries (7224) (the two companies broadly split the Japanese special purpose vehicle market). The excessive equity capital is also considered to be a major factor in why ROE has remained far below ShinMaywa.

Given the current situation, the Company should **set dividend payout ratio at 100% and change capital policy so equity capital does not increase further.**



Data Source: Quick Astra Manager, note - ROE is calculated using ordinary income after tax instead of net income to exclude impact of extraordinary gains and losses



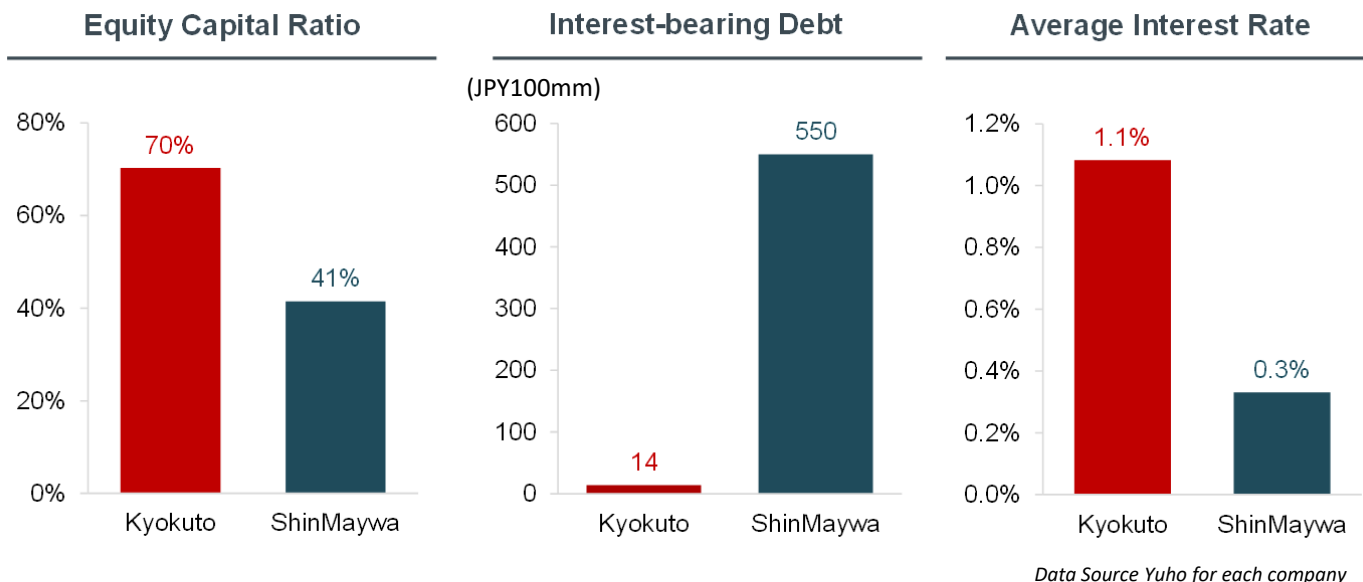


Excessive financial strength

In addition to capital efficiency being low, we believe the Company's financial strength is excessive. The average interest rate on the Company's debt is 1.1%, whereas the average interest rate for ShinMaywa Industries, which is not as financially strong, is estimated to be 0.3%. This indicates that financial institutions are assessing the financial strength of ShinMaywa to be sufficient and Kyokuto to be excessive.

President Tatsuya Nunohara has frequently stated in meetings with SC that it is difficult to implement a 100% dividend payout ratio because they need to make necessary investments, however it is clearly possible to achieve both investments and a 100% dividend payout ratio by utilizing interest-bearing debt.

We strongly urge Company Management to make capital policy decisions based on appropriate levels of capital efficiency and financial strength.

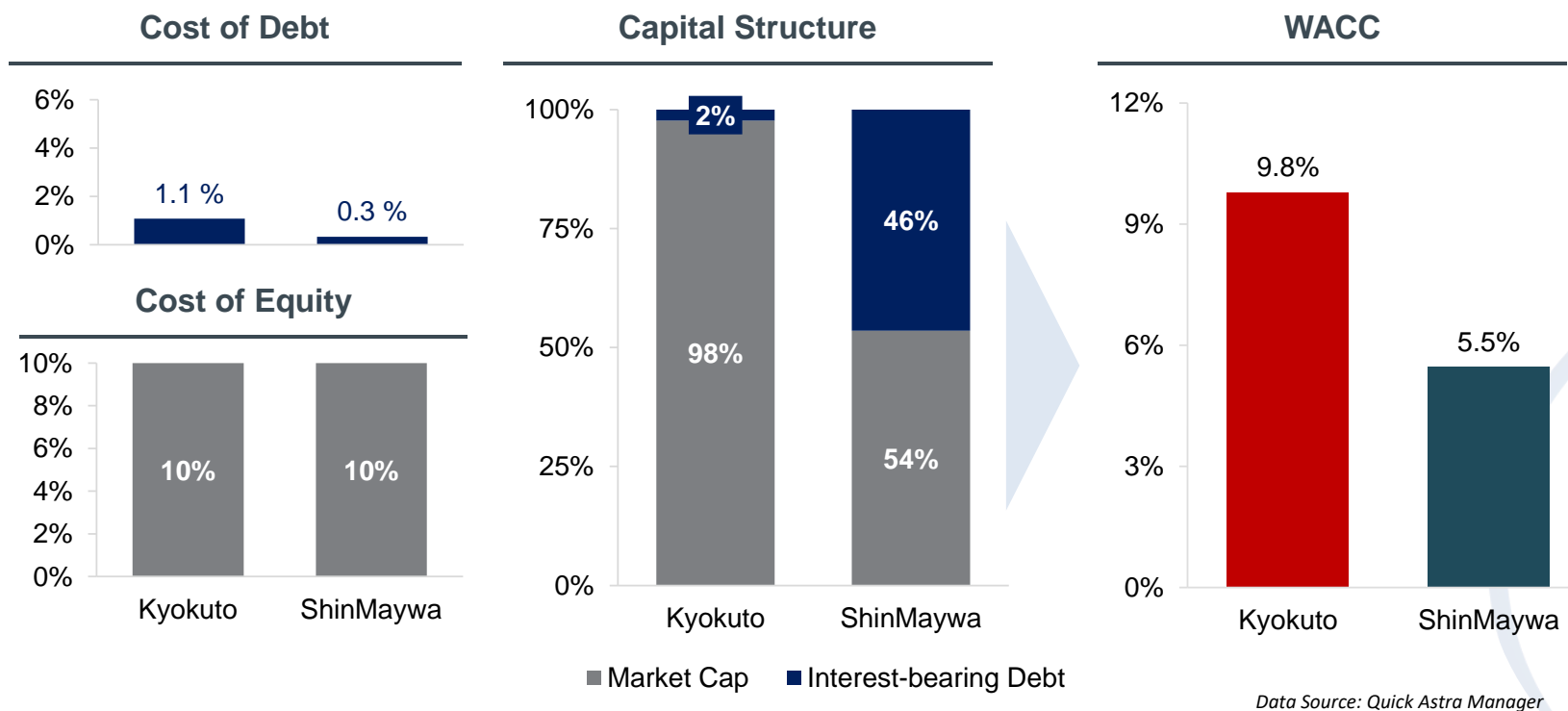




A capital policy that ignores the cost of capital

SC believes one reason behind Kyokuto's misguided capital policy is a lack of awareness of the cost of capital. Compared to ShinMaywa, which has reduced its WACC by issuing interest-bearing debt, the Company's WACC is significantly higher.

We believe the Company should practice management with an awareness of its cost of capital, and for that purpose, it should start by disclosing its weighted average cost of capital.





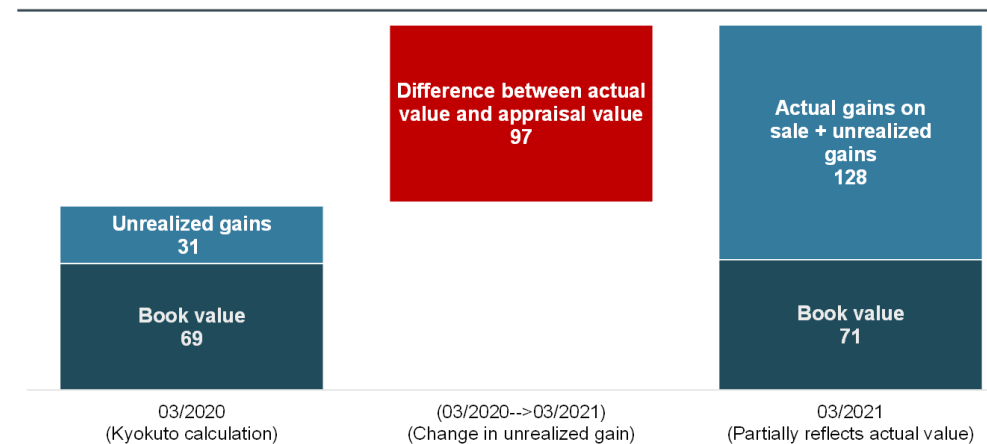
Management is unable to grasp the value of real estate

In March 2021, Kyokuto announced it sold a portion of its rental real estate, recording an extraordinary gain of approx. 13B JPY. As a result, the unrealized gains on rental real estate and similar assets increased fourfold from 3.1B JPY (as of March 2020) to 12.8B JPY (as of March 2021). The difference in unrealized gains suggests **the Company had underestimated the value of its real estate by up to 9.7 billion yen.** In fact, in an interview with SC, Director Harada stated, "Our company did not expect such a large gain on the sale."

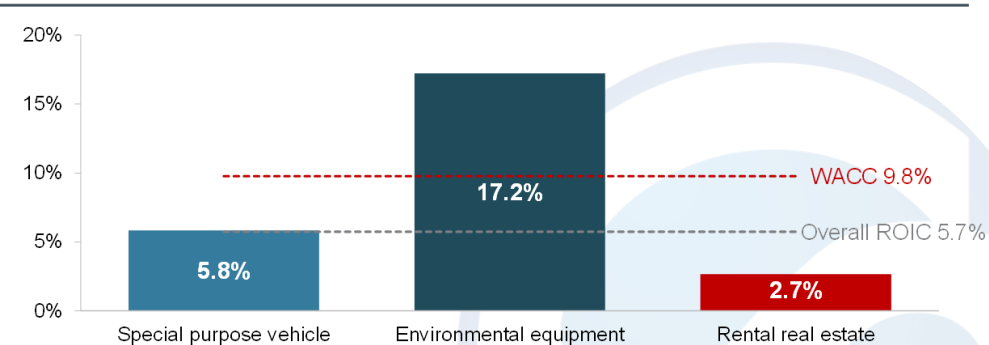
Currently the disposal of rental real estate is a matter decided exclusively by the Board of Directors, however we cannot expect the Board, which cannot even accurately estimate the sale price and does not have any strategy to improve the value of real estate, will make the right business decisions. Therefore, we believe that the disposal of such properties should be decided not only by the Board but also at the general meeting of shareholders.

Further the **ROIC of rental real estate is estimated to be 2.7%**, which is significantly lower than the core business of **special purpose vehicle** and **environmental equipment and systems**. As such, we believe that it is prudent to promptly sell the assets and use the proceeds to invest in the core business or to return the profits to shareholders.

Value of rental and other real estate held (100m JPY)



ROIC (03/2021)



Data Source Yuho. Calculated by dividing after tax operating profit for each segment by average segment assets for 03/2020 and 03/2021 (For rental real estate market value of asset for 03/2021 is used)



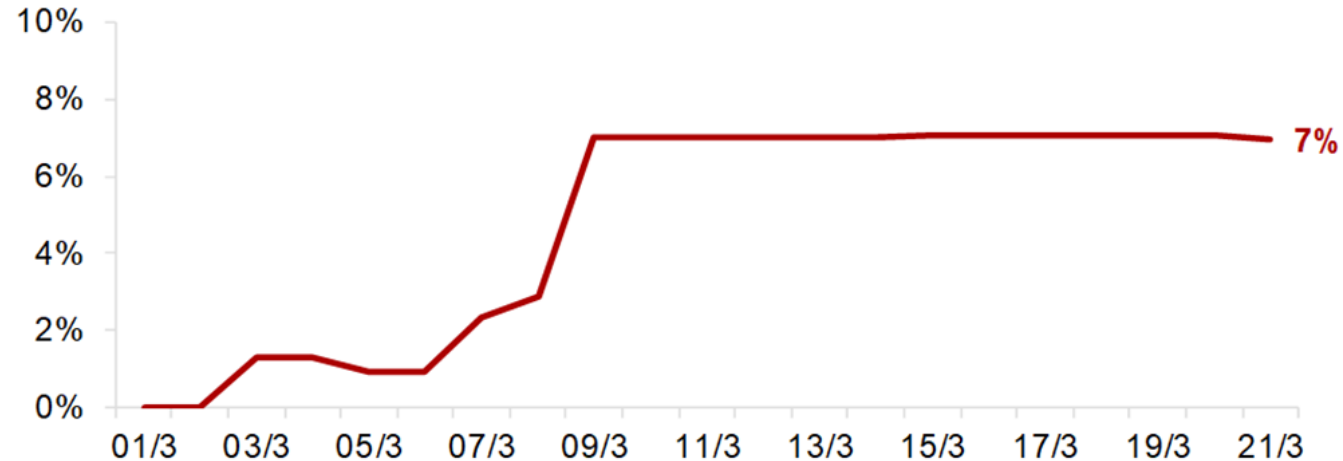


Management neglect of treasury stock

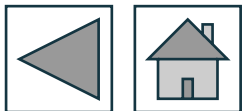
The Company has neglected to retire its treasury stock. The **number of shares held has remained virtually unchanged for more than 10-years, and treasury stock has represented about 7% of the total shares outstanding.** Treasury stock holdings are synonymous with potential dilution risk to shareholders and should be retired promptly if unused.

Given the fact that the Company’s Management has left treasury stock unretired for many years we also believe the General Meeting of Shareholders should be authorized to cancel the treasury stock

Treasury stock as a percentage of total shares outstanding



Data Source: Quick Astra Manager





Details on dialogues regarding cross-shareholdings

As of March 2021, the Company held approx. 12.1 B yen in cross-shareholdings including Sumitomo Realty & Development Co., Ltd. (“Sumitomo RD”) and Yuken Kogyo Co., Ltd. (“Yuken”)

In its Annual Securities Report, Kyokuto claims that it holds shares in both companies for the purpose of “increasing profits through strengthening business relationships.”

We would stress that Strategic Capital believes that companies should not hold *any* cross-shareholdings. However, in accordance with Kyokuto's disclosure, we ventured to examine the utility of the cross-shareholdings from the perspective of “increasing profits through strengthening business relationships” as noted above but the representatives of business partners, **President Nishima of Sumitomo RD and President Nagahisa of Yuken, explicitly denied this.**

In the first place, we believe that “increasing profits through strengthening business relationships” by holding stock is not feasible from the perspective of the principle of equal treatment of shareholders, and that the Management which makes such an erroneous statement in the Annual Securities Report, has not made an appropriate judgment regarding cross-shareholdings. **Therefore, we propose to sell the cross-shareholdings in accordance with certain criteria.**

Opinion on cross shareholding
(shared with International Corporate Governance Network)





Dialogue between SC and Sumitomo RD/ Yuken



If a company that holds shares of your company as cross-shareholdings and sells those shares, will it affect the business relationship?

While we value equity holdings as a basis for a long-term relationship of trust, we have never said selling the shares would cause us to cancel an order or do anything similarly threatening.


President Nishima
Sumitomo RD

As we are in compliance with the Corporate Governance Code Supplementary Principles 1.4.1 “When cross-shareholders indicate their intention to sell their shares, companies should not hinder the sale of the cross-held shares by, for instance, implying a possible reduction of business transactions”, we would respond accordingly.


President Nagahisa
Yuken





Our Dialogues

Dialogues with Kyokuto Kaihatsu

We have communicated our views in writing and through direct dialogues with Kyokuto's management both online and through face-to-face meetings. Due to the sheer magnitude of our dialogue with the company we cannot list them all but below are a sample.

Opinion expressed in letter
(December 2021)

- Kyokuto Kaihatsu's COE is at least 8.7%
- In order to raise the stock price above 1x PBR, it is necessary to raise ROE above COE

Click [here](#) for full text
(Japanese only)

Opinion expressed in letter
(October 2021)

- Sale of shares held by cross-shareholders can contribute to the enhancement of shareholder value.
- They should encourage cross-shareholders to sell their shares.

Click [here](#) for full text
(Japanese only)

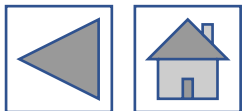




Revisions

04.20.2022 Campaign website for Kyokuto Kaihatsu opened

05.17.2022 Updated to reflect withdraw of shareholder proposal regarding contingent reserves





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