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NICOLE VETTISE, CAIA
Client Portfolio Manager, Equities—EMEA

KEITA KUBOTA
Head of Japanese Equities

KEI OKAMURA
Portfolio Manager, Japanese Equities

Japan’s New Horizon in Small Caps

We believe smaller companies are poised to shine brightly in the “land of the rising sun.”

Long labeled a country of “false dawns” and “lost decades”, Japan has failed in recent years to capture the attention of investors. However, we believe a seismic shift in Japan’s approach to corporate governance, coupled with compelling fundamentals, could warrant a reevaluation—particularly when it comes to small-capitalization stocks.

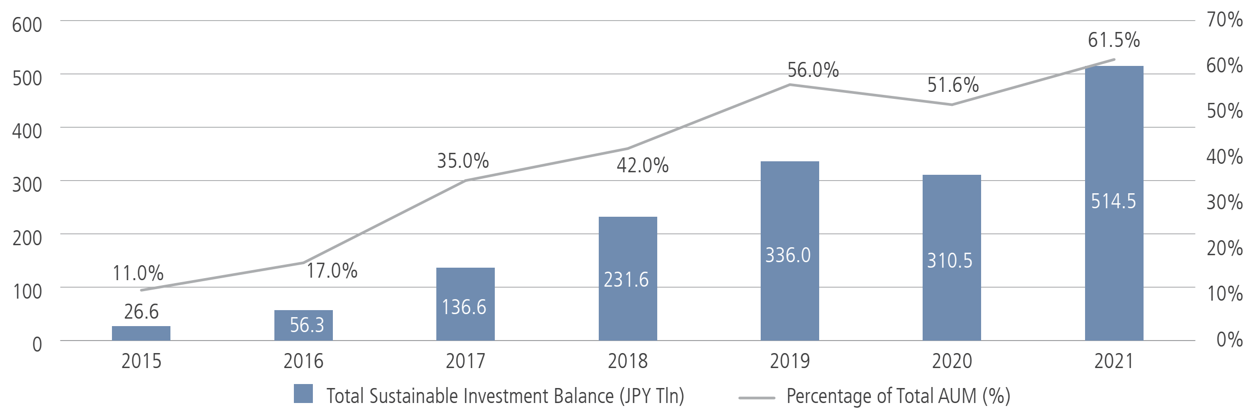
Japan’s ESG Reforms Grow Some Teeth

In our view, many investors have outdated perceptions when it comes to investing in Japan, notably an underappreciation of the transformation that has taken place regarding environmental, social and governance (ESG) factors in recent years. As such, we believe they risk missing out on a rerating that could occur as improving ESG profiles potentially unlock shareholder value.

While the impact of the previous Japanese government’s attempt to resuscitate the country’s weak economic heartbeat through “Abenomics” continues to be assessed, it’s generally acknowledged that reforms driven by the late Shinzo Abe sowed the seeds of governance reform. In our view, the introduction of the Stewardship Code in 2013, followed by the Corporate Governance Code in 2015, was game-changing, setting in motion a transformation in how Japanese institutions allocate capital and view stakeholders.

As time has progressed, so has the value that Japan places on ESG. The country's gargantuan pension scheme, the Government Pension Investment Fund, signed the UN Principals for Responsible Investing (PRI) in 2015, signaling to investors that, alongside governance issues, environmental and social issues would be at the forefront of its consideration. More Japanese institutions have followed its lead, and, today, Japan boasts the largest number of PRI signatories (in terms of assets under management) in the world, while almost 60% of assets today include a sustainability component (see display).

TOTAL SUSTAINABLE INVESTMENTS IN JAPAN



Source: "Sustainable Investment Survey 2021", Japan Sustainable Investment Forum, May 30, 2022.

Japan is also at the forefront of climate action, with almost 500 institutions supporting the recommendations made by the Task Force on Climate-Related Financial Disclosures (TCFD), while the government is pledging to reduce greenhouse gas emissions to zero by 2050 in order to reach carbon neutrality.

So, why has this progress not translated into a rerating of Japanese equities?

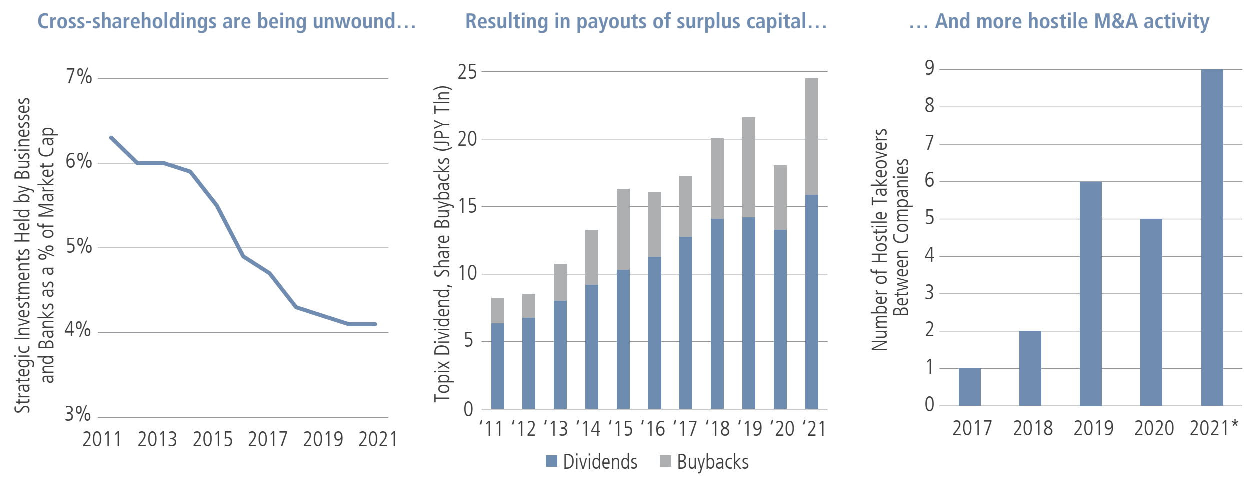
One of the reasons may be that investors see Japanese institutions' efforts to date as simply trying to appease stakeholders rather than truly addressing business fundamentals that could drive better outlooks for shareholder returns or long-term sustainable growth.

However, a seismic change is afoot that is likely to transform institutions' mindsets—in order to survive and potentially thrive: While the 2013 Corporate Governance Code lacked teeth and incentives to alter the mindset of managements, the revision of the Code in June 2021 addresses this weakness, and at the same time marks the biggest overhaul of the Tokyo Stock Exchange since its establishment in 1847.

The Code now includes an enforcement element that targets nearly 60% of the country's 3,800 listed companies, including small and midcaps, which will have to adhere to the code on a "comply or explain" basis to become members of the coveted Prime section of the Tokyo Stock Exchange. It also places greater emphasis on the role of corporate boards and their committees in potentially enhancing shareholder value, and broadens its scope to include sustainability issues such as gender diversity and climate change.

All this means that, over the next several years, Japanese equities are likely to see a shakeup. In our view, clear winners and losers could emerge as unprecedented changes in capital efficiency increase some companies' potential returns on equity and/or returns on invested capital. This has the potential to unleash further buyback activity and force a greater focus on dividend payouts, accelerating the upward trend we've already been seeing.

SEISMIC CHANGE IN OWNERSHIP AND USE OF CAPITAL



Source: Left - Nikkei Quick, SMBC Nikko, as of December 2021, based on all listed Japanese companies; center - SMBC Nikko, as of December 2021; right - IR Japan, as of October 2021. *2021 share buybacks is an annualized nine-month figure. Nothing herein constitutes a prediction or projection of future events or future market behavior. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed. Investing entails risks, including possible loss of principal. Indexes are unmanaged and are not available for direct investment. **Past performance is no guarantee of future results.**

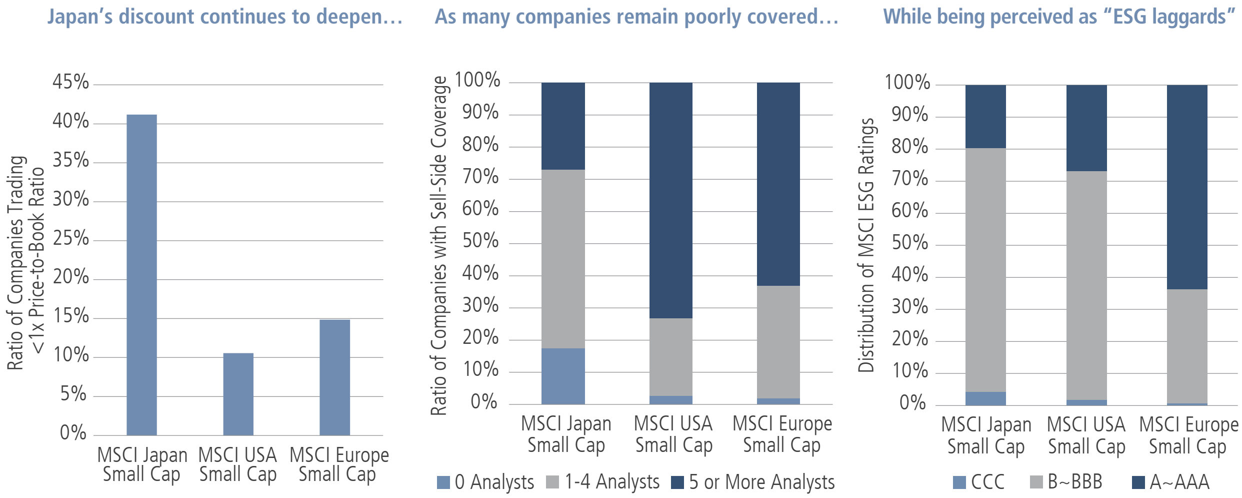
The positive impacts of reform are already evident: Japanese companies announced a record level of stock repurchases in May, amounting to almost twice that of the previous year. In our view, this suggests that Japanese companies are looking to address their inefficiencies and improve return outlooks on equity through buybacks and dividends.

Importantly, this development could be a catalyst to help address the long-term disparity in valuations between Japan and the rest of the world. In our view, such an improvement in capital efficiency and greater acknowledgement of stakeholders warrants a reassessment of Japanese equities by investors.

But while larger companies in general are already engaged with the market on ESG improvements, notably due to higher foreign ownership, smaller companies appear to struggle in navigating the new regulations.

To us, one of the attractions of smaller Japanese companies is that they are notably under-researched compared to those in other developed markets, offering a greater opportunity to uncover what we consider to be "hidden gems". Just under 18% of companies in the MSCI Japan Small Cap universe have no sell-side coverage, while less than 30% of companies in the index are covered by more than five analysts, compared to almost 75% for U.S. small-cap stocks (see display).

JAPANESE SMALL CAPS APPEAR TO LAG ON VALUATION, COVERAGE AND ESG REPUTATION



Source: MSCI, Bloomberg, as of January 2022. Nothing herein constitutes a prediction or projection of future events or future market behavior. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed. Investing entails risks, including possible loss of principal. Indexes are unmanaged and are not available for direct investment. **Past performance is no guarantee of future results.**

Opportunity in Fundamentals—and ESG Potential

This inefficiency opportunity is amplified when we consider ESG. Already, larger companies are typically scoring higher on ESG metrics than smaller companies thanks to factors including more disclosures and more resources (teams dedicated to ESG reporting), which includes the ability to publish in English. Smaller companies typically need handholding and education to help them navigate fragmented reporting standards—something that we believe creates meaningful opportunity, given the potential delta or "performance kicker" tied to engagement with them.

That said, we believe there should be a clear investment case for a company aside from the potential tied to engagement. In our approach, we favor investing in "hidden gems" that we categorize as follows:

- **Small Giants:** market leaders in growing niche industries protected by a competitive moat that provides pricing power
- **Emerging Disruptors:** next-generation innovators that are asset-light and, as a result, have low costs
- **Lost-Decade Survivors:** those that have built competitive "moats" by consolidating industries with high entry costs
- **Deep Discount:** undervalued companies open to engagement

Importantly, the proprietary scoring model we employ as part of our process is largely based on fundamentals and valuations, with ESG and engagement activities as essential elements. Along those lines, we look to drive improved outcomes through our engagement efforts, two examples of which are provided below.

Example: Engagement on Capital Management

For several years, we have been engaging with a road and highway maintenance service provider on capital management, the integration of financially material environmental and social responsibility issues, and corporate governance. In our view, the company has a unique business model that focuses almost entirely on repairing and reinforcing Japan's aging highways, leveraging its technological know-how backed by skilled engineers. The company's asset-light business has generated strong free cash flow, resulting in surplus capital, which has weighed on return on equity. Our engagement around capital management included advice on disclosing a medium-term plan on the use of cash and how to address strategic investments such as cross-shareholdings. The company has since dealt with many of the issues we raised, including introducing a new multiyear share repurchase program and a plan to reduce cross-shareholdings, helping to improve capital efficiency.

Example: Material Environmental and Social Issues

We have invested in one of Japan's largest paints makers, noting its cash generation, strong pricing power and overseas growth potential. As part of our process, in analyzing the environmental and social issues that could be affecting its business fundamentals and long-term growth outlook, we leveraged data from the Sustainability Accounting Standards Board's (SASB) materiality framework as well as Neuberger Berman's own materiality matrix, which suggested that GHG emissions, water management and toxic waste management were key environmental factors. The company was also flagged as a top 10 contributor to one of our strategy's exposure to climate change risk based on Climate Value at Risk (CVaR) analysis.[1] Our fundamental analysis suggested that the company's sustainability initiatives were focused primarily on managing its environmental footprint within Japanese operations. However, the efforts were not part of a mid- to long-term strategy to address the climate change risks affecting its global operations, and failed to capture the other material social factors.

In our engagement, we presented our views on the company's strengths and weaknesses as to sustainability, and what specific areas of disclosure could use improvement. As part of that process, we recommended that it adopt international best practices for ESG disclosure, such as SASB's chemicals sector disclosure guidelines, and presented global and domestic competitors that disclose based on the SASB standards. As a result of our discussions, the company's subsequent three-year business plan included a comprehensive materiality matrix and analysis covering most of the issues that we had highlighted, and published all related ESG disclosures based on the SASB standards, among other important steps forward. In addition, the company formally announced its support for the Taskforce on Climate-Related Financial Disclosures and committed to begin reporting on its climate change risk mitigation initiatives based on the four pillars of governance, strategy, risk management and metrics/targets by their next fiscal year.

In our view, this engagement was a model of our approach in striving to help companies pursue disclosure best practices that are aligned with globally recognized ESG standards. We believe such steps can make them more comparable to international peers, and potentially more investable to a broader array of global asset managers.

Inflation: A Key Differentiator?

As the world wrestles with the implications of an inflationary environment, the effects in Japan may be mixed. Japan is a net importer of many inputs, including energy and hard and soft commodities, so sharply high prices, along with a depreciating yen, may reduce profit margins for many companies if they cannot pass along prices to buyers. At the same time, the country's struggles with deflation and disinflation are widely known. To the extent the inflation rate can return to a moderate, sustained rate of 2%, as some expect, that could support revenues generally and earning potential for those with pricing power—something that we believe could ultimately determine who thrives and who does not. In our view, business fundamentals will be key, where scale, cost competitiveness and robust balance sheets will be needed to deal with rising costs.

[1] MSCI, Neuberger Berman data as of December 31, 2021.

Importantly, we see an abundance of pricing power and fundamental strength in the small- and mid-cap markets where we focus our efforts.

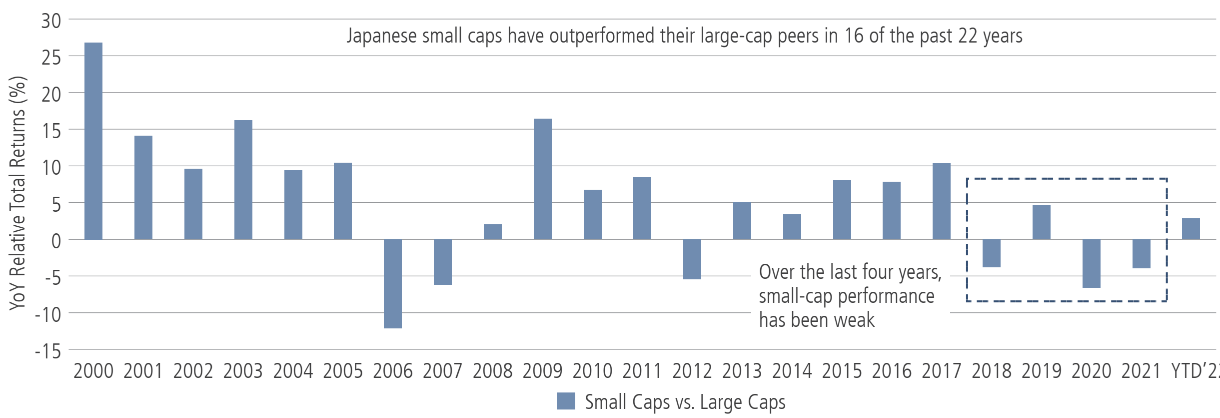
Example: Inflation Mitigation

Within our "Emerging Disruptor" basket, we invest in one of Japan's largest independent elevator maintenance and repair services providers. We believe its recurring fees are attractive in an inflationary backdrop as is its "asset-light" approach, which has been minimizing margin pressure. The company has grown its market share in an industry where the core safety aspect of the business requires that servicing cannot be deferred, whatever the economic situation. Many elevators installed at the height of the real estate bubble in the 1980s are due for repairs, offering strong potential for growth.

Fundamentals at a Turning Point?

Unlike in many other countries, Japanese smaller companies have historically shown themselves to be "all-weather" businesses. Fueled by their ability to consistently deliver on earnings, they have outperformed their large-cap counterparts 75% of the time over approximately the last 20 years (see display).

SMALL CAPS VS. LARGE CAPS: YEAR-OVER-YEAR RELATIVE RETURNS SINCE 2000



Source: Jefferies, FactSet. As of July 2022. Nothing herein constitutes a prediction or projection of future events or future market behavior. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed. Investing entails risks, including possible loss of principal. Indexes are unmanaged and are not available for direct investment. **Past performance is no guarantee of future results.**

The short periods of underperformance in 2006 and 2007, and since 2018, have generally not coincided with bull or bear markets, or a period of weak earnings. Rather, the common denominator is that these periods of underperformance followed peak relative valuations versus Japanese large caps; for example, approximately a 20% premium at the start of 2006.

Importantly, multiyear reratings have tended to follow troughs in relative valuation. As such, we believe the fact that the relative trailing price-to-book discount for Japanese smaller companies stands at a historical low (-22%) bodes well for potential long-term performance. Further, valuations of Japanese smaller companies are below their historical average on a 12-month forward price-to-book basis (14x versus 15.7x), while they are heavily discounted in comparison to their global peers on the same metric (-28%).[2]

[2] Source: Jefferies, as of July 2022.

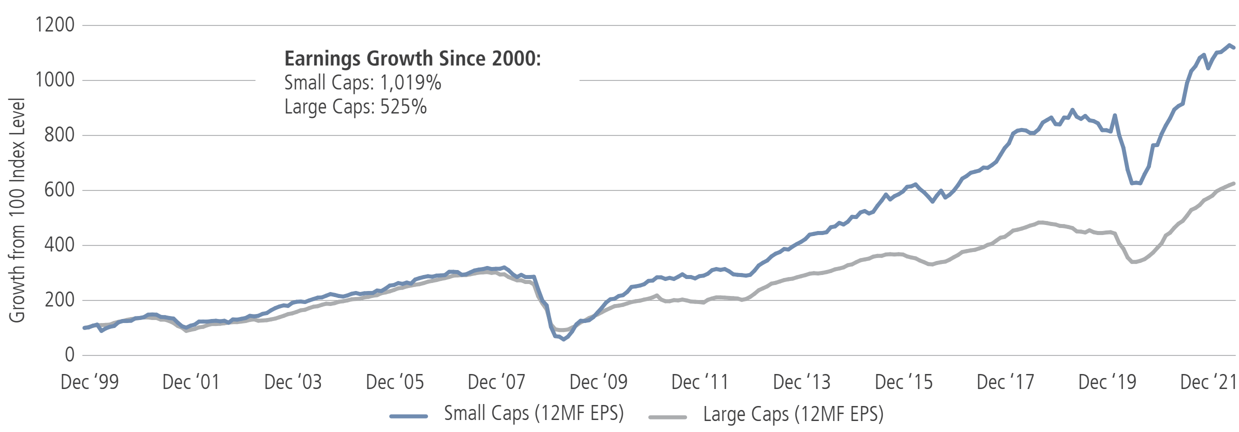
MSCI JAPAN SMALL CAP VS. STANDARD INDEX: RELATIVE TRAILING PRICE-TO-BOOK VALUE

Source: Jefferies, FactSet. As of July 2022. Nothing herein constitutes a prediction or projection of future events or future market behavior. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed. Investing entails risks, including possible loss of principal. Indexes are unmanaged and are not available for direct investment. **Past performance is no guarantee of future results.**

In addition, we believe the fundamentals of smaller Japanese companies are compelling. Many have an enviable track record when it comes to earnings, and overall, they have grown their earnings by a staggering 1,019% over the past 20 years—almost twice the rate of Japanese large caps (see display).

The pacing of these results has generally been consistent and delivered throughout various market cycles. It's worth noting that divergence between small and large company earnings accelerated after the Global Financial Crisis, as shown below. Given that revenues are predominantly domestic, Japanese smaller companies appear to have been relatively insulated from currency volatility and the decline in global trade over the past decade-plus.

JAPANESE SMALL VS. LARGE CAPS: 12-MONTH FORWARD EARNINGS ESTIMATES



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Conclusion: This Time Could Be Different

Some investors may feel wary of an allocation to Japanese equities given the false dawns of the past 30 years. However, we would suggest that such a view may be outdated, and having it could mean missing out on a compelling investment opportunity in Japan over the next several years.

In our view, the difference this time is the potential for ESG reform to force through changes that could potentially unlock shareholder value—particularly when it comes to certain smaller Japanese companies. In the context of more sustained inflation, we believe pricing power and solid business and capital strategy will be crucial in seeking to achieve success.

In this context, selectivity based on fundamentals, as well as the ability to engage with companies to maximize their potential, could be highly opportunistic in capitalizing on this new horizon for Japan's small-cap sector.

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Neuberger Berman
1290 Avenue of the Americas
New York, NY 10104-0001

www.nb.com