

100-0004

2-1-1 Otemachi, Chiyoda-ku, Tokyo

Otemachi Nomura Building

Zenkoku Hosho Co., Ltd.

Board of Directors

Hideharu Ishikawa, President & CEO

We are Hibiki Path Advisors, an institutional investor holding your shares in our client accounts. Today, as a minority shareholder who has been following your company for 10 years since listing in 2012, we have sent a letter to your Board of Directors with recommendations on your future IR expression, ROE thinking and capital policy. We are also more than happy to directly explain to your board of directors. Thank you for your consideration.

26th, August 2022

39 Temple Street #02-01, Singapore 058584

Hibiki Path Advisors Pte. Ltd.



Director/Chief Investment Officer

Yuya Shimizu



Recommendations for measures to improve Corporate Value and ROE of Zenkoku Hosho Co. Ltd.

Hibiki Path Advisors Pte. Ltd.

26th August 2022

Contents:

Introduction	3
1 . Explanation of the two issues behind the lower evaluation from the market	
(1). Superficial problems – the way you address your business	4
(2). Essential Issues - Declining trend in capital profitability (ROE)	7
2 . Proposing concrete measures to address superficial and essential issues	
(1). Superficial issues -emphasis on recurring nature of your business in your IR materials ...	9
(2). Essential issues – commitment to 15%+ ROE and two measures to achieve them.....	14
i. significant change in capital policy.....	15
ii. sophistication of asset management function	16
3 . a management philosophy that has a capital market on one's side	
(1). Valuation/Capital Cost Discussion Essential to Using Capital Markets Effectively	22
(2). Examples - Ship Healthcare Holdings Co., Ltd.	24
(3). Examples - General Dynamics	27
(4). Conclusion - Why should we stick to ROE?	28

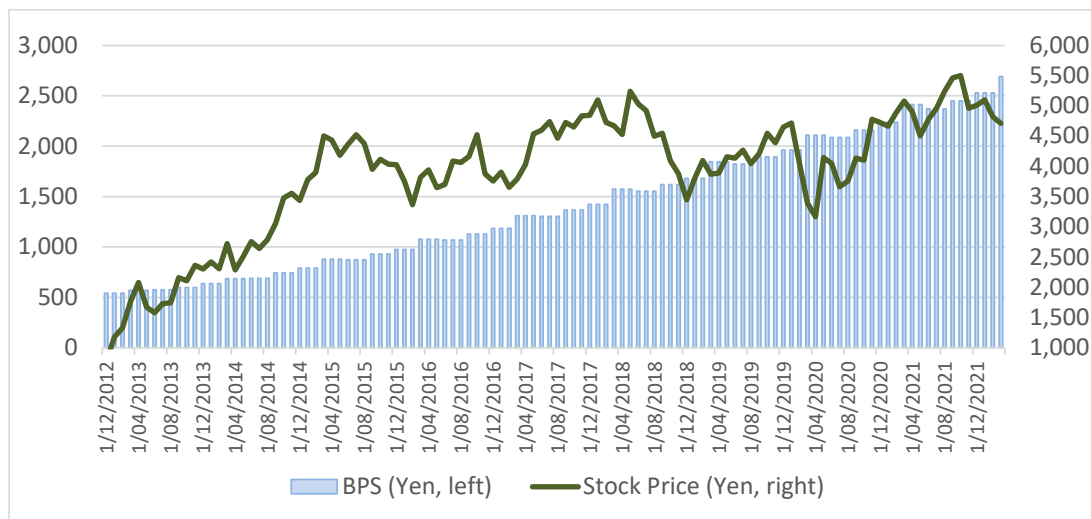
Introduction

Your company started out as a guarantor of public sector housing loans in 1981. In 1997, taking advantage of the business knowhow and credibility supporting the public sector, you entered into a private financial institution's housing loan guarantee business, and since then has achieved remarkable growth. In 2019, the Company became the top Japanese company with a guaranteed balance of over 13 trillion yen. In 2020, the Company acquired a A-range credit rating, which proved its financial base was solid. The current guaranteed balance reached 15.4 trillion yen (at the end of the 22/3 fiscal year), and the Bank built an overwhelming position with a share of 8.2% (estimated) of domestic private housing loans.

As a fundamental oriented long-term investor, we are attracted to three things in your business. First of all, your (1) housing loan credit scoring and pricing capabilities backed by years of experience and data, then (2) growth potential that makes use of your independent status and expanding market share by connecting with financial institutions throughout the country, and finally, (3) overwhelming cash flow generating capability standing on the foundation mentioned in previous two points. Shareholders' equity, which was 36.6 billion yen at the time of listing (December 2012), has increased to 184.8 billion yen in March 2022, with no capital increase since then. During this period, dividends exceeding 50 billion yen were also returned to shareholders, bringing the total amount to over 235 billion yen, creating a value of nearly six times initial equity base. Although the business is related to the Japanese housing market which is far from achieving high growth, your business growth so far has been phenomenal. We feel that President Ishikawa and the management teams' hard work resulted in the strong and fruitful relationship with financial institutions and achieved this growth, which you should be very proud of such results.

Looking at stock prices (Fig.1), however, the results have largely been disregarded, and stock prices have remained flat over the past five years, moving back and forth between about 3,000 yen and half to 5,000 yen. Your BPS has constantly and steadily been building up but stock price has not followed which sadly means that capital markets has been devaluing your stock relative to the quality of your business.

Figure 1: Trends in Net Assets¹ (BPS) and Stock Prices



(Source: Bloomberg, Hibiki)

In our view, there are two kinds of problems here, *Superficial* and *Essential*. These two are intertwined and intertwined, and it is becoming difficult for market participants to digest your future vision. In this letter, we would like to write three points: 1. The explanation of two of the problems we think about, 2. The proposal of specific measures to deal with each problem, and finally, 3. The best way of dealing with a company's capital market, which we would like your company to resonate with. We understand that internal discussions are currently underway on a variety of management issues as a preparatory stage for the next medium-term management plan to be announced next year. We sincerely ask that you consider the measures we have proposed in this letter and implement them.

1. Explanation of the two issues behind the lower evaluation from the market

(1) Superficial problems – the way you address your business

First of all, the Housing loan guarantee business is a B2B business, and it has been difficult for ordinary shareholders to understand the added value of its products and services since the time of listing. However, the strong surge in stock price at the time of listing was remarkable, and we feel that your company has been carrying out IR activities appropriately at that time. In addition, you have large shareholder base of more than 30,000 counts and the foreign shareholders accounts for more than 30%. The issue here is that you attracted many “growth oriented” shareholders at the time of listing, so the expression of your business in IR has emphasized the growth of new contracts for many years. As a result, the market's evaluation seemed to have declined around the time

¹ Used quarterly based BPS

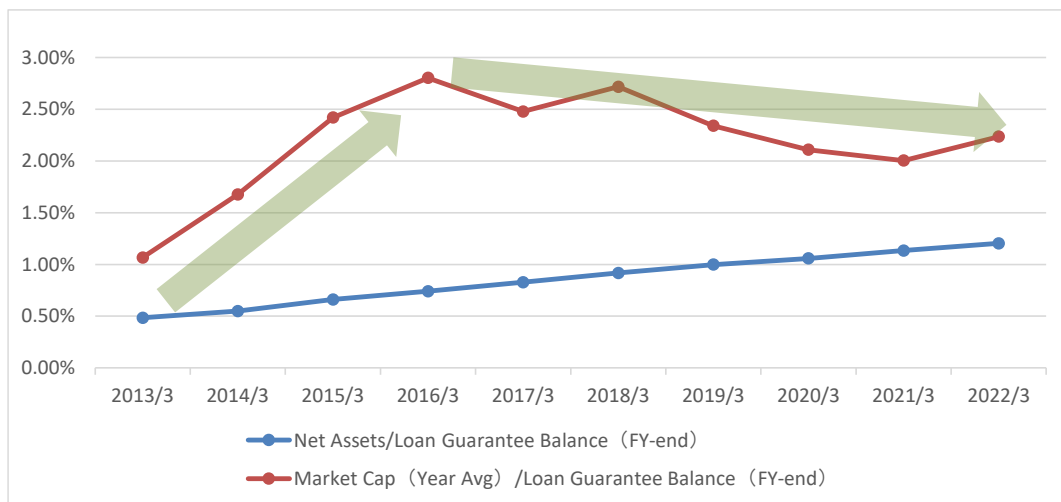
when number of new contracts reached the peak in 2017. As shown in Figure 2, stock prices (without axis) have been in a range from the fiscal year ended March 2018, when the number of new guarantees turned negative. However, the actual loan guarantee balance has steadily increased by 30.3% (annual rate of 6.8% CAGR) during 2018/3 to 2022/3! Even if the "growth rate" of the number of new contracts becomes negative, if number of new contracts are positive, the business *is expanding* and the business *is steadily "growing"*. I guess that the market is ignoring this fact. Figure 3 shows your shareholders' equity and market cap divided by the amount your loan guarantee balance (i.e shareholders' equity and market cap per unit of your loan guarantee balance). Despite the fact that the your equity capital in comparison to loan guarantee has increased resulting in better credit status of your company, market valuation (red-line) has been declining gradually since 2017.

Figure 2: Growth rate of new guarantee contracts, outstanding guarantee balance, and changes in stock prices



(Source: Annual Report, Bloomberg and Hibiki)

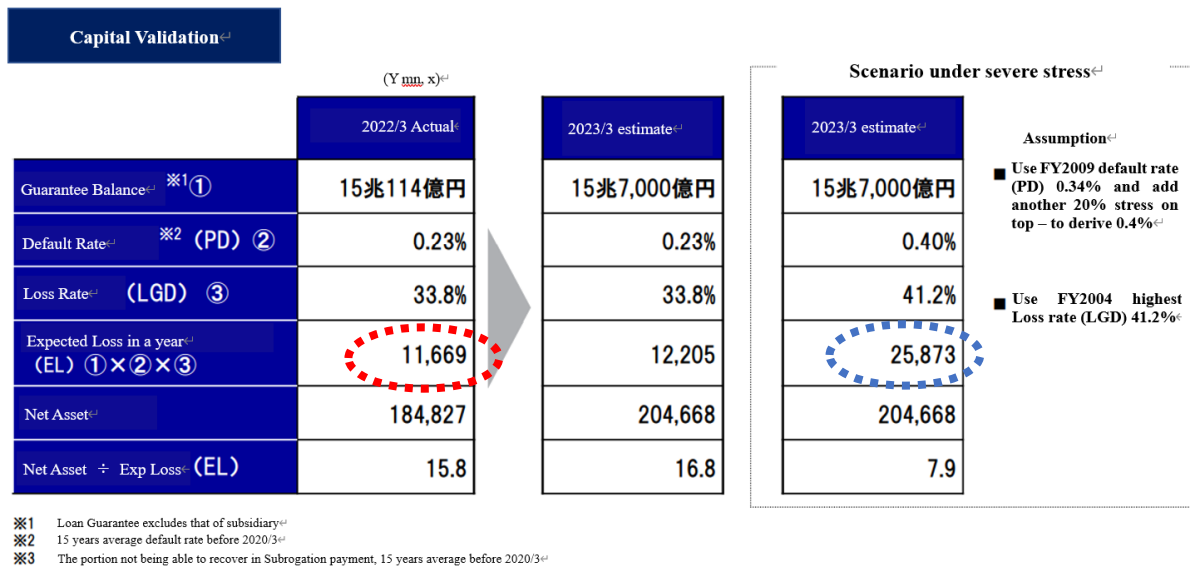
Figure 3: Market cap and shareholders' equity per one unit of guaranteed loan balance



(Source: Annual Report, Bloomberg and Hibiki)

Next point is the expression used in your analyst material, in the page "Capital Validation" (Figure 4). We understand that you would like to emphasize that financial position is rock solid even if a 2008 Global-financial - crisis (GFC) level shock or higher hits the housing market and continues for several years. We have also been following this figure for many years and have also looked into the actual history of the subrogation payment rate (i.e. the default ratio). We, like many others, were duly convinced that you have more than enough buffer to overcome any large shocks by carefully digesting the logic mentioned in this page and became a shareholder.

Figure 4: Capital validation (3/2022 Analyst Meeting Material)




(Source: Reproduced from 2022/3 analyst material)

While I agree that this representation is a highly effective way to convince both your clients (who are generally risk averse) and credit market that the bankruptcy risk is extremely small, I do believe that investors in the stock market may take your business risk with an overstated impression. Please allow us to elaborate further on what we mean by this.

In Fiscal 2020/3, the default rate and the loss rate used in this page have been extended from the previous "past 10 years" average value to the "past 15 years" average value, and potential loss risk has been recalculated based on more stringent numerical assumptions. We understand that you had preferred to have conservative assumption in place and if you continue to use 10 years rolling figure then the numerical assumption would have dramatically improved when GFC period will be excluded. Further to that, since the duration of mortgages is generally close to 15 years, you have suddenly implemented the target to maintain a **minimum capital of 15 times (15 years) of the estimated annual loss** amount calculated from the above default rate etc (by the way, in the 2022/3 period, it was achieved for 15.8 years, and it tends to improve further in the future).

However, with this representation, we feel that there is a risk that equity investors who have not analyzed your business in detail may look at it in a fast-thinking manner, saying, "*Even if the average loss rate for the past 15 years is hit, we will have shareholders' equity lasting for 15 years.*"

Of course, that is *not* the case. It is perfectly possible to absorb not only 11.7 billion yen (shown in Fig.4 ) , which is the annual loss risk estimated from the 15-year average loss rate and recovery rate, but also 25.9 billion yen (shown in Fig.4), which is estimated under stressed conditions, with your yearly operating profit (an average of 37.7 billion yen for the past 3 years). In other words, even if losses of 25.9 billion yen per year in a stress environment continue for far more than 10 years and the loss reserves are raised to a level commensurate with that, shareholders' equity will still continue to increase rather than decrease if current level of loan guarantee balance is maintained and stable cash flow continues. The issue we feel here is that the relationship between the potential capital risk and the periodic profit and loss is not represented in a coordinated manner and so it is potentially leading to the assumption of "unrealistic and excessive risk conditions" by the stock market investors.

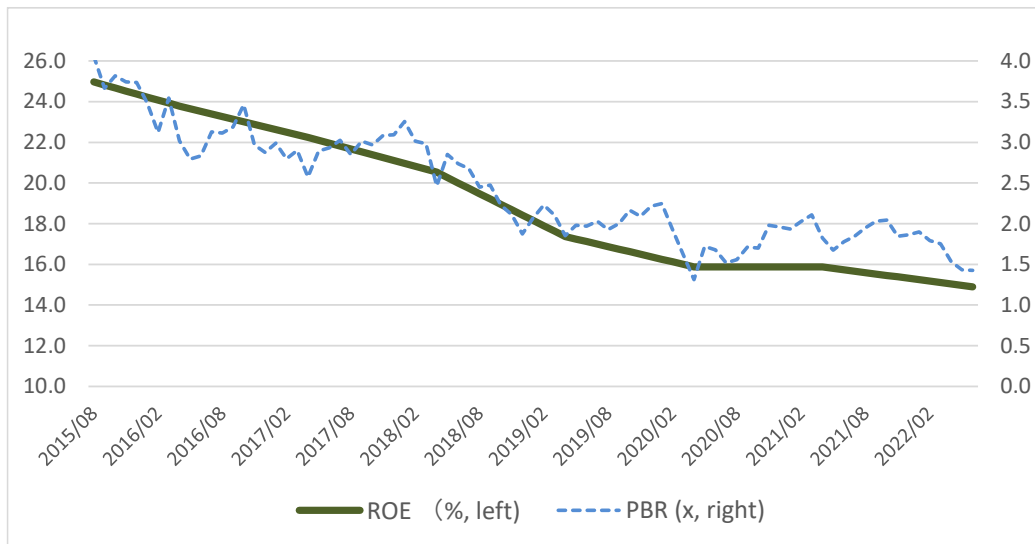
Regarding the ideas for countermeasures against the superficial problems presented here, (1) the problem of the growth rate of new contract numbers, and (2) the problem of representation of the capital part, we will describe in the Section **2. Proposing concrete measures to address superficial and essential issues.**

(2) Essential problem: declining trend in capital profitability (ROE)

We feel that the essential problem for decline in your evaluation is actually the decline in capital profitability, or ROE (return on equity). Figure 5 shows the 12⁻²-month lead trend for your ROE and PBR (Share Price Equity Ratio), and as you can see, the correlation is very high.

² ROE uses the average for the twelve months forward from the month in a rolling manner, and BPS, which is the premise of PBR, uses the ending value for the fiscal year

Figure 5: Trends in Your ROE Trend and P/B (2015-)

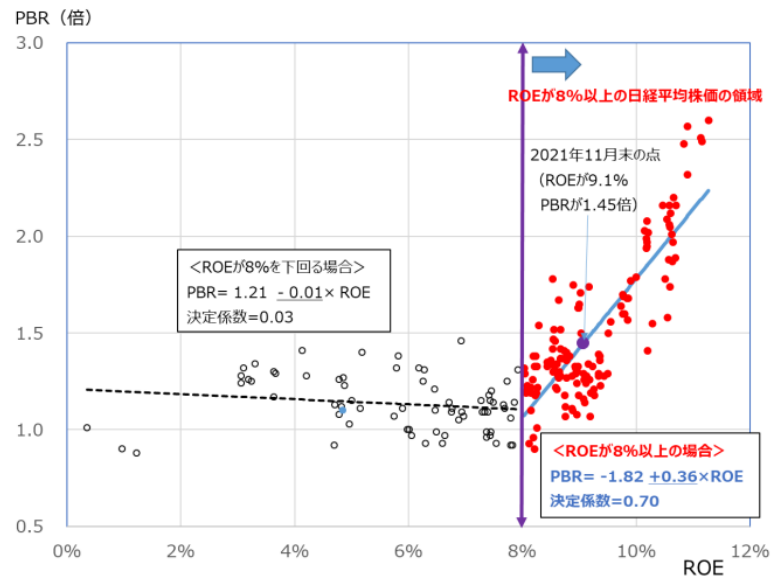


(Source: Bloomberg. Hibiki)

There are various patterns of a decline in ROE, but in the case of your company, it is a case where capital has accumulated due to business profits being extremely stable and profitable, and that business growth is also occurring. Until 2020, it is understandable that you prioritized the increase in capital level in order to obtain A-range credit ratings from the agency to solidify your reputation amongst your client base. However, even since then, your dividend payout ratio has continued to be significantly lower compared to your capital profitability, and so capital has continued to accumulate resulting in even lower capital profitability due to the denominator increase. While larger capital cushion helps your relationship with clients and the rating in credit market, it has worked oppositely in the evaluation from the equity market, in our view.

It is generally known that ROE is highly correlated with P/B not only in each companies but also in the entire market. As shown in the analysis using Nikkei Index by Nissay Asset Management in Figure 6, the correlation with P/B is broken when the ROE is less than 8%, but there is a beautiful positive correlation above that. Higher ROE results in higher P/B. If the ROE continues to decline, the market will anticipate and interpret this trend further, and the risk of a decline in P/B accelerating increases. We feel that this situation, in spite of the fact that your business condition is good, is a shame.

Figure 6: Relationship between Nikkei Stock Average ROE and PBR



(Source: Nissay Asset Management Market Report, December 22, 2021³)

We call this ROE issue "essential" because while the stock market is an aggregation of anomalies and noise in the short term, there is a theoretical and statistically proven fact that it converges to valuation that is commensurate with risk and profitability in the medium to long term. *No matter how you put it, no matter how profitable your profitability is now, if your ROE continues to decline, your P/B ratio will likely continue to decline.* Unless you present a clear direction to the issue of how to stop this decline in ROE, there is a concern that no matter how much effort is made to address the aforementioned superficial issues, market may just ignore. Then, from here on, in the next section, we would also like to discuss the ideas for countermeasures against this ROE lowering problem.

2. Proposing concrete measures to address superficial and essential issues

In this section, we would like to explain and recommend some concrete on each of the above mentioned superficial and essential issues.

(1) Superficial issues – emphasize on recurring nature of your business in your IR materials

Your business model is a typical recurring income business model. It is basically a business that, similar with life, property/casualty insurance, receives a steady amount of fees from customers as a reward to take-over the risk for a certain period. You also clearly mention this recurring nature of your business in the Appendix of your

³ <https://www.nam.co.jp/market/column/hosoku/2021/211222.html>

presentations. It is a business model that will typically obtain a high valuation from the market based on a relatively high future visibility.

The source of stable earnings is the outstanding amount of loan guarantee, and since the duration is approximately 15 years according to your presentation, it is of course an important KPI to accumulate new contracts, and it is undoubtedly an essential driver for maintaining and growing the current cash flow. However, it is not ideal for you when the market narrow-sightedly see it as the “one and only” ultimate KPI and we would suggest you to start shifting your focus to the *value of your contracts* rather than the *pace of the growth of new contracts*. We would like to cite two examples.

First, let's take a look at Berkshire Hathaway, one of the most successful companies in the world adopting a recurring type business model. They have already evolved into a conglomerate with an investment business and a variety of other businesses, but the core of the group is the cash flow generated by the non-life insurance business, which is said to be relatively high risk. In 2019, Buffett wrote in his annual letter (P/C Business = Property and Casualty Insurance Business)


One reason we were attracted to the P/C business was the industry's business model: P/C insurers receive premiums upfront and pay claims later. In extreme cases, such as claims arising from exposure to asbestos, or severe workplace accidents, payments can stretch over many decades.

This collect-now, pay-later model leaves P/C companies holding large sums – money we call “float” – that will eventually go to others. Meanwhile, insurers get to invest this float for their own benefit. Though individual policies and claims come and go, the amount of float an insurer holds usually remains fairly stable in relation to premium volume. Consequently, as our business grows, so does our float. And *how* it has grown, as the following table shows:

<u>Year</u>	<u>Float (in millions)</u>
1970	\$ 39
1980	237
1990	1,632
2000	27,871
2010	65,832
2018	122,732
2019	129,423

We may in time experience a decline in float. If so, the decline will be *very* gradual – at the outside no more than 3% in any year. The nature of our insurance contracts is such that we can *never* be subject to immediate or near-term demands for sums that are of significance to our cash resources. That structure is by design and is a key component in the unequalled financial strength of our insurance companies. That strength will *never* be compromised.

(Source: 2019 Berkshire Hathaway Annual Letter)

As you can see, Mr. Buffet's focus is on the “float” received from ongoing contracts rather than the new contracts, and it emphasizes that this float has increased significantly by the insertion of the table (part ). This not only means that business is expanding due to increase in premiums received, but also with stock value even considering the balance with the expense/liability (insurance claim).

In addition, a previous 1979 Annual Letter contains the following;

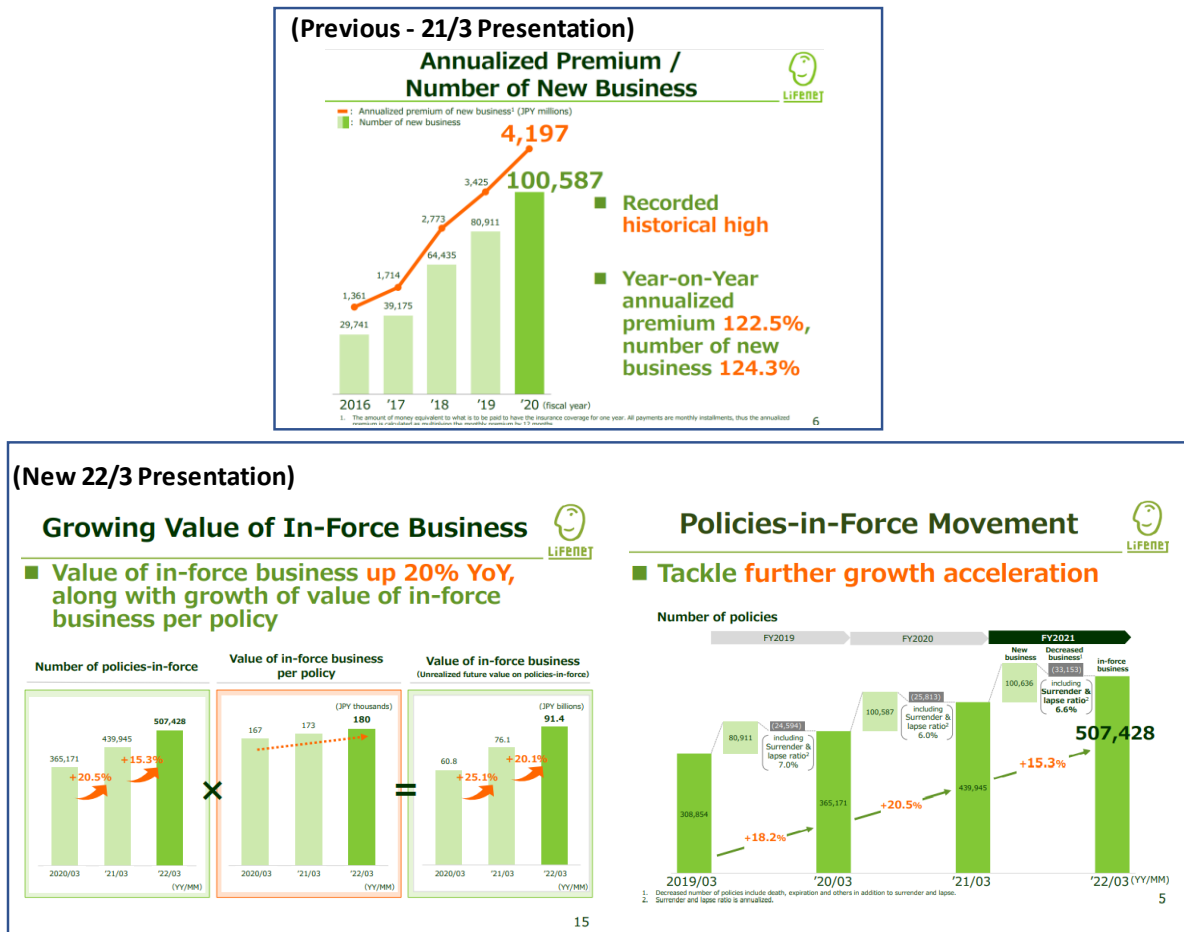
You will notice that earned premiums in this segment were down somewhat from those of 1978. We hear a great many insurance managers talk about being willing to reduce volume in order to underwrite profitably, but we find that very few actually do so. Phil Liesche is an exception: if business makes sense, he writes it; if it doesn't, he rejects it. It is our policy not to lay off people because of the large fluctuations in work load produced by such voluntary volume changes. We would rather have some slack in the organization from time to time than keep everyone terribly busy writing business on which we are going to lose money.

(Source: Berkshire Hathaway Annual Letter, 1979)

The beauty of Buffett's dialog with the market is that he always stresses the importance of increasing the *value* of business by carefully balancing the *Volume, Price and Risk* in a relatively high-risk and competitive non-life insurance market every year. He also boldly tells the market that negative growth in new contracts is totally acceptable when the risk pricing is not justified. It is a great way to control the expectation of investors, and in fact throw the question back to investors what "true growth" really mean.

Another IR expression example (Fig.7) that we would like to show is by Lifenet Insurance, which is an another investee company of Hibiki, and which has made a significant change in recent IR materials partly based on our suggestions. The Company also sells long-term insurance contracts to customers via the Internet. Similar to you, as it is still in high growth phase, market was watching "growth in new contracts" as the one-and-only KPI, then as growth of contracts stagnated after the covid-19, new contract YOY growth has gone negative and stock price collapsed. Although it is difficult to generalize, roughly speaking, short-term investors respond to "new contracts and orders", which are one of the leading indicators, rather than changes in values, while long-term investors place importance on "value and its direction". It was a wise judgment by the management team to shift focus on "value" in order to obtain support from long-term oriented shareholders (for our open letter to Lifenet Insurance, please see [Here](#)). Their IR materials has changed nicely, as shown here;

Figure 7: Lifenet Insurance (7157) 's IR Material Change



(Source: Lifenet Insurance Analyst Briefing Materials)

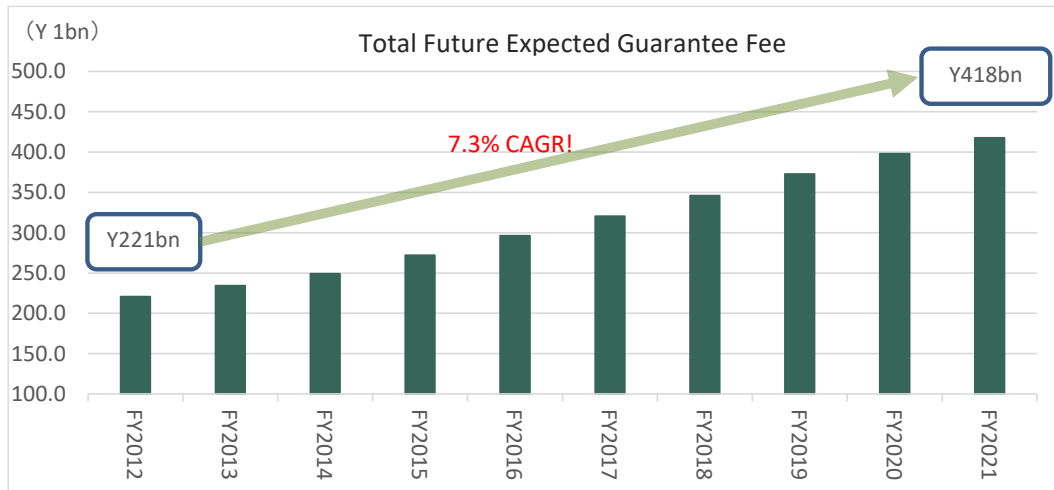
In the first few pages of the briefings, which tends to function as the eye-catcher, Lifenet had previously emphasized the growth of the new contracts, but most recently they changed the way they express as shown above – focusing on the value of the contract with long-term secure cashflow. We see this not as a contortion of fact, but as a right step forward to show the true nature of the value the company provides! Although the growth in new contracts is an important KPI, we expect that it is one of those important ones similar to the value of those contracts. This change in the way of expression has contributed to the significant recovery in stock price since the IR material was released in its Analyst meeting held on May 12, 2022, in our view.

For example, we think it is a good idea to present KPIs in the following way (Fig.8) in order to convert your expression method to a value based one. This is a simple estimate of the total future gross value of the guarantee fee income from the loan guarantee balance at the end of each fiscal year. The average rate of 0.34%/year is multiplied to the 15 year equally descending⁴ balance of loan guarantees until it reaches zero.

⁴ Equal monthly payment would result in longer duration but we adopt equal descending to be conservative

In practice, there are varieties in the terms and conditions of guarantee fees, and we believe it is more appropriate to subtract the decay based on the subrogation rate, but we as we are outsiders without access to those detailed data, we would like to show just the rough image of cashflow so are keeping it simple in our method.

Figure 8: Estimated Future Guarantee Income Value



(Source: Hibiki estimation)

We believe that it is possible to express the "total value of future estimated revenue", or "stock value" like we did here. Although there are some subtle differences, it can be said that the concept is very similar to "float" that Buffett says. In the fiscal year ending March 2022, the total value of this future cash stream exceeds 400 billion yen which is more than 8 times 2022/3 Revenue. There are not so many other businesses out there that already secures, with high probability, such sums of the future income stream. Also, the fact this stock-value has increased at an annual rate of 7.3% from the past is outstanding. This accumulation of stock value is the source of your value, your strength, and KPI that contributes most to maximizing your corporate value. We feel that with a small creative angle added to your expression, it will enable you to demonstrate to the capital market your "value" proposition.

Next, we would like to present our thinking on the expression of the "Validation of Capital". In order to alleviate the potential loss (EL) expressed in Figure 4 to be perceived as a potential direct hit to capital, we may as well add an analysis of "Validation of Loss Coverage" as a way of expressing it. This is to verify not only the capital portion but also the annual P&L portion (right side of Figure 9).

Figure 9: Capital Validation + Loss Validation

Validation of Capital Adequacy		Validation of Loss Coverage	
(Y mn otherwise stated)		(Y mn otherwise stated)	
	Mar-22		Mar-22
Guaranteed Loan Balance ^①	Y15.0114 trillion	Expected annual loss (EL)	11,669
Default rate ^②	0.23%	Credit cost already booked on PL ^④	2,171
Loss on recovery ^③	33.8%	Ex[ected add'l loss ^⑤ (EL- ^④)	9,498
Expected annual loss ^① x ^② x ^③ (EL)	11,669	Operating Profit ^⑥	39,470
Net Assets	184,827	Oper Profit after add'l loss (^⑥ - ^⑤)	29,972
<hr/>		Loss level where OP become zero ^⑦	41,641
Net Asset÷Loss (EL), x	15.8	Loss coverage ratio (^⑦ /EL), x	3.6

(Source: Hibiki from your materials)

As you can see, pro-forma Operating Profit after EL for 2022/3 would be 29.9 billion yen (^⑥ - ^⑤) by deducting the additional loss (11.7bn yen – 2.2bn yen = 9.5 billion yen) from operating income (39.5 billion yen). In other words, capital will continue to increase! Then, in order to balance the expression with "net assets ÷ losses", it maybe helpful to calculate the ratio of the hypothetical loss amount that would result into ZERO operating income - and compare it with current EL and mention it as "Loss coverage ratio". Based on 2022/3 fiscal year figure, the hypothetical loss that would result in zero operating income would be 41.64 billion yen, which is 3.6 times the current estimated loss of 11.67 billion yen (and 1.6 times the estimated loss under stress conditions described in Figure 4). In other words, based on current business size and structure, you can withstand 3.6 times the loss reasonably assumed from the data of the past 15 years without hurting your capital. By approaching from both the stock (capital) and the flow (profit and loss) sides, you can communicate your intrinsic strength in a balanced manner to not only the credit market but also to the stock market.

Until now, in this section 2, we have presented our views to overcome the superficial problems of (a) market's too much focus on new business growth, and (b) market's too much concern over capital risk. We sincerely ask you to consider our suggestions. However, there is an extremely high risk that solving these superficial problems alone will lead to a setback toward maximizing corporate value over the medium to long term. We hope you will consider this along with the counter-measures tackling the Essential problem explained below.

(2) Essential problem – commitment to 15% or higher ROE and two measures to achieve it

In this section, we would like to present two measures to solve the problem that a decline in ROE has led to a decline in your PBR. If we assume that your basic cash flow creation will remain unchanged, we believe that we need to take drastic measures including financial and strategic perspectives.

The two measures we would like to present are as follows. We would like to elaborate these in detail.

- i. Significant change in capital policy**
- ii. Sophistication of asset management function**

i. Significant change in capital policy

From the 2020/3 fiscal year, you have extended the default rate and the loss rate numeric assumption used in the "Verification of Capital" from the previous "Past 10 Years" average value to the "Past 15 Years" average value, and has presented the coverage ratio target of maintaining at the minimum the capital of 15 times (15 years) (net asset ÷ loss amount) of the estimated annual loss amount based on the potential loss risk calculation with more stringent numerical assumptions. This has already been achieved in the 2021/3 fiscal period, as well as 2022/3 fiscal period and also this fiscal year 2023/3 forecast.

It is also clear that, as mentioned earlier, the coverage ratio itself will not be significantly impaired even if the default rate surges to the historical average because capital itself is well protected by your ongoing recurring cashflow. However, with the current dividend payout policy of about 35%, the speed of capital accumulation is quite fast. Based on our own earnings forecast model, the decline in ROE cannot be stopped even if new contracts are successfully expanded with whatever the robust growth. In addition, the "net assets ÷ losses (Expected Loss)" ratio will expand from 16 to 17 years, and you will be marching into excess capital condition compared to what you have envisaged. We conducted a ROE simulation for the period 2023/3 to 2026/3 using reasonable assumptions⁵, as follows.

Case A (Steady growth): New Contracts 2% Growth p.a. — Payout ratio 35%, 50%, 75%, 100%

Case B (no growth): New Contracts flat 50,000⁶ per year — Payout ratio 35%, 50%, 75%, 100%

Case A: New Contracts steady 2% growth					Case B: New Contracts flat 50,000 a year (no growth)				
ROE Calculation					ROE Calculation				
Div Payout	2023/3	2024/3	2025/3	2026/3	Div Payout	2023/3	2024/3	2025/3	2026/3
35%	14.4%	13.7%	13.0%	12.4%	35%	13.9%	12.9%	12.1%	11.4%
50%	14.7%	14.2%	13.8%	13.4%	50%	14.2%	13.5%	12.8%	12.2%
75%	15.3%	15.3%	15.3%	15.3%	75%	14.7%	14.4%	14.1%	13.8%
100%	15.9%	16.5%	17.2%	17.9%	100%	15.3%	15.5%	15.8%	16.0%
Net Asset ÷ EL					Net Asset ÷ EL				
Div Payout	2023/3	2024/3	2025/3	2026/3	Div Payout	2023/3	2024/3	2025/3	2026/3
35%	16.1	16.8	17.4	18.1	35%	16.4	17.4	18.3	19.2
50%	15.8	16.1	16.5	16.8	50%	16.1	16.7	17.3	17.9
75%	15.2	15.0	14.8	14.7	75%	15.2	15.1	15.0	14.9
100%	14.6	13.9	13.2	12.6	100%	14.9	14.5	14.0	13.6

(Source: by Hibiki estimation)

We confirm that in our model, in both growth and no growth cases the earnings will continue to grow. The key issue is that the **payout ratio lever** has a far greater impact in ROE than the difference in growth rate of new

⁵ Assumptions: default rate will rise from 0.07% to 0.1% gradually, recovery rate to be 75% flat, provisions vs loan guarantee balance to rise to 0.038% from current 0.036%, etc.

⁶ Past 5 years average new contracts were 64,000 so we applied 20% discount to this to be conservative

contracts. If you also want to maintain 15 years worth of capital a dividend payout ratio of at least 70-75% is the most appropriate level to balance the ROE and capital adequacy. Then, there is a question whether it is best to return all of them the form of cash dividends or not. We have two ideas here.

One is to set the total shareholder payout ratio at 75% but combine with dividends and share buybacks. This would provide some buffer to prevent dividend to decline in any specific year where there maybe earnings decline, and also give room for you to conduct constant but flexible buybacks up to 75% payout ratio every year.

Another way of thinking is that since you use ROE, Capital adequacy, etc equity ratio measurement in your own KPI, it may be a good idea to change the way of thinking about dividend to *DOE "Dividend on Equity"*. For example, since the total payout ratio of 75% is around 7.5% by DOE, then maybe you can place DOE floor at 6% and conduct share buy-back to fill the gap between 75% payout.

There may well be concerns about the deterioration in stock liquidity if you repurchase more shares. However, there are many cases where investors appreciate such dividend policy and so more interest is gathered triggering improved liquidity. If you are further concerned that stock prices will rise and the minimum unit of purchase for individual shareholders will rise from the current level of around 440,000 yen, you can actually easily lower the hurdle for individual investors on minimum trade lot by conducting stock splits. In any case, we cannot emphasize enough that the most impactful and important thing to consider is to change the dividend or total return policy in order to prevent continuing decline of ROE.

In addition, we believe that the objective of maintaining a minimum capital of 15 times (15 years) of the estimated annual loss amount, needs to be reconsidered. As I mentioned earlier, your basic strength has improved to the extent that potential loss can be covered by the current expanding profit base. As you become larger, it is therefore expected that the "law of large numbers", which is the beauty of the insurance business model, is starting to work in your favor – and this 15 year coverage may well be excessive. We hope that you will thoroughly discuss within the Company and with the rating agencies the viability of this 15-fold (year) figure meeting the current situation of your company and whether you need to see it as the "absolute lower limit". We hope that you will disclose the basis of your thinking in the next medium-term management plan.

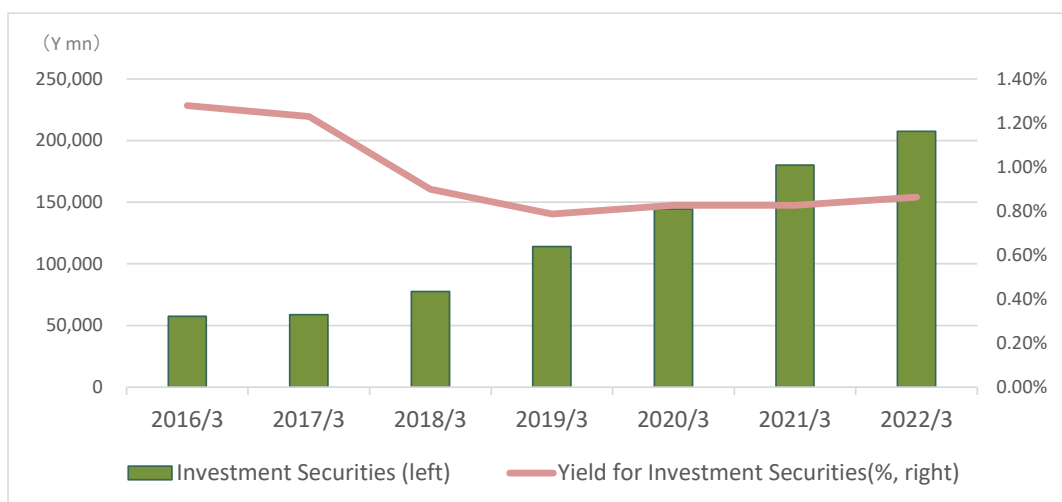
ii. **Sophistication of asset management function**

Your business model is to "receive the risk fee for a certain period of time by taking on the default risk", and the income stream consists of stable and long-term. Large part of this cashflow is received as down payment from your clients as "advance income" which is booked as liability, and the balance sheet for the 2022/3 fiscal year (current liabilities + fixed liabilities base) contains such advance income of 1.86 billion yen. This is actually similar concept, in nature, with Berkshire Hathaway and the Life Insurance Company that I mentioned earlier. It

maybe a stretch, but we can also say that it is also similar to public pension systems such as the GPIF (Government Pension Investment Fund), which have a long-term obligation to increase the wealth (pensions) of Citizens. In other words, it should be fair to say that you also run a business component of "asset management".

In your case, you have approximately 170 billion yen in cash deposits almost in line with your net assets, and on top of that 200 billion yen in investment securities. Figure 10 shows the trends in the year-end balance of securities (current assets + fixed assets) from the 2016/3 period and the interest ⁷rate on securities (dividend income). The return on investment is below 1.0% from the 2018/3 period.

Figure 10: Changes in your investment yield



(Source: Hibiki from Securities Report of Your Company)

The unearned income received from customers is booked on the liabilities side of your balance sheet, and with cash on the other side, which is a wonderful source of value-add, but we feel that you have been operating extremely conservatively until now. Interest on securities for the 2022/3 period and dividends received totaled 1.67 billion yen, or 0.86% in yield. This investment income is extremely small part of your business, at mere 3.4%, compared with your operating revenue, and is also extremely small compared to 200 billion yen worth of invested assets.

A summary of the securities is shown in Figure 11 based on your Securities Report for the 2022/3 fiscal year. The top 10 securities are also listed. There are various special provisions for the bonds you hold, and we understand that you purchase those with secure downside protection. However, we need to raise question that nearly 90% of investment securities are invested in products issued by financial institutions (who you do business with) with very small yield and downside protection which may indicate something like a “modified” cross-

⁷ Interest on Securities (Including Dividend of Shares) ÷ Total Outstanding Securities

shareholding type investment with financial institutions which may or may not be in line with the aim to maximize shareholder value.

Figure 11: Details of Investment Securities

			(Y mn)			(Y mn)
Current Asset	Hold to Maturity	Govt/municipal	1,611	Top 10 Holdings		
		Corp bond	8,099	Japan Post Insurance. Unsec Bonds w Defrred Provision on Int Payments and Pre-Maturity Redemption Clauses (Subordinated Bonds)		5,671
		Other	500	Meiji-Yasuda Life. #1 Sub-Loan Securitization 1st Unsec Corporate Bonds with Defrrf Interest Payment Clause and Pre-Maturity Redemption Clause (Sub		5,317
	Total	①	10,211	NIPPON LIFE INSURANCE. #3 Sub Loan Securitization Co., Ltd. #1 Unsec Bonds with Defrred Provision on Interest Payments and Pre-Maturity Redemption		5,000
Fixed Asset	Hold to Maturity	Govt/municipal	14,394	SMTB, LTD. #48 Trust and Corp Bond (Special Provisions on Restriction of Division and Special Provisions on Limitation of Liability Property)		5,000
		Corp bond	170,884	SMFG #7 Unsec Long-Term Corp Bond Subject to Voluntary Redemption (Debt Waiver Special Provisions and Subordinated Special Provisions)		5,000
		Other	3,822	Taiyo Life Insurance. #5 Unsec bonds with pre-term redemption clause (subord, limited-split-limited-number private placement with QII)		4,000
	Hold to Maturity total		189,100	Mizuho Financial Group,. #8 Unsec Long-Term Corporate Bonds with Optional Redemption Clause (Debt Waiver Special Agreement and Subord Special /		4,000
	Other Securities	Stocks	1,878	The Hokkoku Bank. #1 Unsec Bonds with Redeemable Be Maturity (Special Provisions for Exemptions Upon bankruptcy and Subord Special Provisions)		3,200
		Other securities	6,344	Credit Agricole S.A. #9 Non-Superior Yen Debentures with Pre-Maturity Redemption (2021)		3,000
	Other Securities total		8,222	Daiwa Securities Group. #1 Unsec Permanent Corporate Bond with Optional Redemption Clause (Debt Waiver Special Agreement and Subord Special A		3,000
	Total	②	197,322	Other		127,695
Total Investment			①+②			207,533

(Source: Hibiki from Your 2022/3 Annual Securities Report)

Comparing the yields, Dai-ichi Life's general account investment yield in fiscal 2021⁸ was 2.41%, while the investment (income) yield of the major Tokio Marine Holdings was 3.15%⁹ in fiscal 2021. Since are valued at book value, it is estimated that long-term held stocks has high yields, but both companies have investment portfolios that are widely diversified from domestic and overseas public and corporate bonds to equities.

In addition, GPIF has managed equities and bonds in a roughly half-to-half manner until present, as shown in Fig. 12. The investment results for fiscal 2021 were 5.42%, and the average long-term results for the past 20 years was 3.69%. This 20-year figure includes fiscal 2007 (-4.59%) and 2008 (-7.57%), when the global financial crisis occurred. We believe that GPIF's result demonstrates that diversified portfolio with certain risk exposure to equities can generate sufficient long-term returns even when there are some bad years.

⁸ Dai-ichi Life Annual Report 2022 p.62

⁹ Tokio Marine Holdings Co., Ltd. 2022/3 Term Securities Report p.22

Figure 12: GPIF Investment Results Summary (FY2021)



(Source: <https://www.gpif.go.jp/operation/the-latest-results.html>)

Finally, Figure 13-a, b, c shows the investment portfolio of Essent Group, a major U.S. mortgage guarantee company. In the U.S., mortgage market, higher than 80% LTVs (Loan-to-Value) are considered high risk, and it is known that debtors are generally required by financial institutions to guarantee the portion of their mortgage that exceeds the collateral security cover. In addition, even if it is a mortgage, it is basically a non-recourse obligation and the debtor tends to default relatively easily, so the risk that the guarantee company owes is extremely large compared to the general guarantee contract in Japan, and for example the default rate of the Essent Group guaranteed loan portfolio in fiscal 2021 is 2.16%¹⁰ (which is 31x more than your 2022/3 default rate of 0.07%!). However, Investment 4.96 billion USD (about 645.1 billion JPY) is carefully constructed to achieve long-term investment results while taking advantage of asset allocation between different risk rating and industries.

¹⁰ Essent Group 2021 Annual Report p.15

Figure 13-a: Asset Class Classification for Essent Group's Investments

Asset Class (S in thousands)	Investments Available for Sale by Asset Class			
	December 31, 2021		December 31, 2020	
	Fair Value	Percent	Fair Value	Percent
U.S. Treasury securities	\$ 448,793	9.1%	\$ 268,444	5.9%
U.S. agency securities	5,504	0.1	18,085	0.4
U.S. agency mortgage-backed securities	1,008,863	20.3	995,905	21.8
Municipal debt securities(1)	627,599	12.7	551,517	12.1
Non-U.S. government securities	79,743	1.6	61,607	1.3
Corporate debt securities(2)	1,455,247	29.3	1,126,512	24.7
Residential and commercial mortgage securities	545,423	11.0	409,282	9.0
Asset-backed securities	581,703	11.7	454,717	9.9
Money market funds	210,012	4.2	679,304	14.9
Total Investments Available for Sale	\$ 4,962,887	100.0%	\$ 4,565,373	100.0%

Figure 13-b: Credit Rating Classification for Essent Group's Investments

Rating(1) (S in thousands)	Investments Available for Sale by Rating			
	December 31, 2021		December 31, 2020	
	Fair Value	Percent	Fair Value	Percent
Aaa	\$ 2,412,273	48.6%	\$ 2,564,746	56.2%
Aa1	96,331	1.9	133,100	2.9
Aa2	354,951	7.2	260,462	5.7
Aa3	221,914	4.5	204,917	4.5
A1	263,820	5.3	249,710	5.5
A2	427,282	8.6	401,175	8.8
A3	274,525	5.5	229,882	5.0
Baa1	305,204	6.1	260,602	5.7
Baa2	274,011	5.5	178,926	3.9
Baa3	240,755	4.9	48,199	1.1
Below Baa3	91,821	1.9	33,654	0.7
Total Investments Available for Sale	\$ 4,962,887	100.0%	\$ 4,565,373	100.0%

(1) Based on ratings issued by Moody's, if available. S&P or Fitch Ratings ("Fitch") rating utilized if Moody's not available.

Fig. 13-c: Industrial composition of bonds held in the corporate bond portion accounting for 29% of the Essent Group Investments

(2) The following table summarizes corporate debt securities as of :	2021	2020
Financial	33.7%	34.9%
Consumer, non-cyclical	19.8	19.1
Communications	11.4	9.3
Industrial	7.0	5.3
Consumer, cyclical	7.0	8.0
Technology	6.8	6.1
Energy	6.0	8.2
Utilities	4.6	5.9
Basic materials	3.7	3.1
Government	—	0.1
Total	100.0%	100.0%

Essent Group does not seem to have invested in equities, and the interest rate environment in Japan and the U.S. is also very different, so it cannot be apple-to-apple but the income return (yield) on the Essent Group in 2021 is 1.81%, and the Investment income earns 0.89 billion dollars, which consists more than 1/10 of the Net premiums earned 87 billion dollars, creating a nice cashflow buffer helping its core business.

In the case of Japan, the interest rate has been at near zero for more than 10 years, and it is true that it has been difficult to generate meaningful investment return unless you invested in equities. In such circumstance, you may have been right to invest conservatively. However, given the global rise in interest rates, the time has come for you to strengthen your staff and take "appropriate" risks, to improve your own investment return and thus your ROE.

We understand that it is an extreme argument, but would like to still put forward as a brainstorming discussion on owning some equity investments. For example, the following is the trend of long-term issuer ratings of Toyota Motor Corporation and JGB.

Figure 14: Credit ratings for Toyota and JGBs

Toyota Motor Corp Credit Rating									
	2014	2015	2016	2017	2018	2019	2020	2021	2022
S&P	AA-	AA-	AA-	AA-	AA-	AA-	A+	A+	A+
Moody's	Aa3	Aa3	Aa3	Aa3	Aa3	Aa3	A1	A1	A1

(Source:S&P from Annual Report, Moody's from Moody's website)

JGB Credit Rating									
	2014	2015	2016	2017	2018	2019	2020	2021	2022
S&P	AA-	A+	A+	A+	A+	A+	A+	A+	A+
Moody's	A1	A1	A1	A1	A1	A1	A1	A1	A1

(Source:S&P from Ministry of Finance, Moody's from Moody's website)

Recently, Toyota Motor Corporation and JGB are rated in the same bracket both with S&P and Moody's. Then, the yield on Japan's 10-year Japanese government bonds has been around 0.2% even in the current phase of global interest rate hikes, but some Toyota's overseas corporate bonds, for example, have yields of 1-2% or more. The projected dividend yield for Toyota Motor Corporation's stock is 2.45% ¹¹and the daily liquidity (traded value) is more than 50 billion yen on average. Doesn't Toyota's dividend yield justify taking the risk while it can most likely grow further and be the ultimate survivor in global Automotive competition? We understand that equities is still a far stretch to your diversification, but there is a lot of room for consideration for such equity investment outside of cross-shareholding scope. This is because Berkshire Hathaway, led by Mr. Buffett, has a track record of significantly expanding its corporate value by investing most of its "float" in equities for decades.

¹¹ Estimated dividend yield based on 23rd August 2022 stock price

It may be necessary to assess carefully the risk in investing into equities. However, we think it is necessary for you to start analyzing the comparative risk/reward of expanded equity investments rather than just holding on to local bank stocks which you currently do, most likely due to business reasons. On the other hand, interestingly enough, it may even be possible for you to expand on your regional bank stock investment as we are starting to see major corporate governance improvement in the sector. The future flow of your warranty fees (unearned income) is actually considered a strategic asset rather than a liability. We would like you to consider a more sophisticated investment strategy that will contribute to improving ROE over the medium to long term.

~~~~~

We have proposed two measures to improve ROE, and the second **(ii. Sophistication of asset management function)**, we are aware that it is not easy to achieve this in the short term as the strategic shift requires time and resources to be invested. But, the first **(i. Significant change in capital policy)**, we believe, has a significant effect in attracting shareholders to support them during the near term where you consider shift and enhancement in business. On the other hand, as we have explained, even with your high profitability business, if there is no appropriate forward-looking capital strategies, you may even need to withdraw ROE 15% target which you have advocated for many years, in such situation we think that there will be a substantial risk that the decline in PBR will not stop even while you continue to grow your business nicely.

### 3. Management philosophy that gains support from capital markets

Finally, we would like to share with you examples of why we need to focus on ROEs. We would like you to understand that behind what we have been telling you so far, there is something about the principle of what capital markets exist for.

#### (1) Valuation/Capital Cost Discussion Essential to Using Capital Markets Effectively

What does the capital market exist for? In our view, it is to ensure that risk and reward are properly priced as capital costs and that firms can appropriately (and fairly) raise capital – so that Capitalism world would continue to function as the most effective means of creating wealth for human kind. Unlike private debt finance market (such as bank loans), capital market is the benchmark market where you can see at a glance how a company is valued by its stock price and credit level, and that has a significant impact on its capital procurement capacity and M&A potential going forward. In the following example, we would like to explain how high market evaluation such as P/B leads to comparative advantage in an abstract setting. Let's look at a case where you had Company B on the exact same scale, balance sheet and profit structure, and you acquire 100% of this company. The company has asset of 100, a capital structure of 50/50 D/E, and a net profit of 10 for the period. The ROE of both companies is 20%. The number of shares issued is simplified to one (1). Simple as that.

| Company B's B/S    |     |    |            | Your B/S           |     |    |            |
|--------------------|-----|----|------------|--------------------|-----|----|------------|
| Asset              | 100 | 50 | Liabty     | Asset              | 100 | 50 | Liabty     |
|                    |     |    | Equity     |                    |     |    | Equity     |
| Net Profit         |     |    | 10         | Net Profit         |     |    | 10         |
| ROE                |     |    | 20%        | ROE                |     |    | 20%        |
| D/E ratio          |     |    | 1.0        | D/E ratio          |     |    | 1.0        |
| <b>P/B (input)</b> |     |    | <b>1.0</b> | <b>P/B (input)</b> |     |    | <b>2.0</b> |
| # of Shares        |     |    | 1          | # of Shares        |     |    | 1          |
| BPS                |     |    | 50.0       | BPS                |     |    | 50         |
| Stock Price        |     |    | 50         | Stock Price        |     |    | 100        |
| P/E ratio          |     |    | 5.0        | P/E ratio          |     |    | 10         |

The only difference is the P/B ratio (independent variable here) – where your company is 2x and company B at 1x; your company is valued higher by the market. Assuming zero growth, since the cost of equity (COE) is a pure reciprocal of PER, your company COE is 10% and Company B is 20%. Let us assume that you will acquire this Company B in two different ways. The first is *i. Acquisition through stock swap* and the second is *ii. Cash acquisition*. We assume your valuation of 2x P/B continues with the merged entity since you will keep your managerial control and market reputation. Here are interesting differences between two methods;

| i. Stock Swap Case |     |     |              | ii. Cash Acquisition Case |     |     |            |
|--------------------|-----|-----|--------------|---------------------------|-----|-----|------------|
| Consol B/S         |     |     |              | Consol B/S                |     |     |            |
| Asset              | 200 | 100 | Liabty       | Asset                     | 150 | 100 | Liabty     |
|                    |     |     | Equity       |                           |     |     | Equity     |
| Net Profit         |     |     | 20           | Net Profit                |     |     | 20         |
| ROE                |     |     | 20%          | ROE                       |     |     | 40%        |
| <b>D/E ratio</b>   |     |     | <b>1.0</b>   | <b>D/E ratio</b>          |     |     | <b>2.0</b> |
| P/B (input)        |     |     | 2.0          | P/B (input)               |     |     | 2.0        |
| # of Shares        |     |     | 1.5          | # of Shares               |     |     | 1          |
| <b>BPS</b>         |     |     | <b>66.7</b>  | <b>BPS</b>                |     |     | <b>50</b>  |
| <b>Stock Price</b> |     |     | <b>133.3</b> | <b>Stock Price</b>        |     |     | <b>100</b> |
| P/E ratio          |     |     | 10.0         | <b>P/E ratio</b>          |     |     | <b>5.0</b> |

i. # of shares increase due to new issuance for stock swap  
 ii. No increase in equity as parent/sub will be offset

In cash acquisition D/E becomes 2x as equity won't increase. ROE also doubles to 40%!

As we assume in both case P/B will remain at 2x...

i. Stock Swap: due to valuation difference, # of shares issued will be smaller relative to equity increase. BPS ↑ to 66.7 and P/B ↑ to 133.3  
 ii. Cash: If P/B stays at 2x then stock price will remain the same 100. However, as P/E is now 5x, it is likely stock price may go up

In the case of a stock swap merger, the consent of the shareholders of both companies is required, so it is considered to be more difficult to execute. However, since new shares are issued to "shareholders" of Company B, adverse effects on financial conditions are avoided. Conversely, the cash acquisition case is a double-edged sword because the cash paid and equity accounts are offset between parent-sub which will raise the D/E ratio – and the ROE!

In either case, we can say that stock prices should have a positive impact. In the case of a stock swap (i), you buy Company B with your own stock paying lower valuation so that you can minimize the number of shares

issued (only 0.5 shares should be issued, since it is 1 times P/B and half of your own), the book-value-per share and stock price both will automatically increase by 33% which is a great accretive value increase for your own shareholders. Valuation may increase even further appreciating good management tactics. Also in the case of cash acquisitions (ii), as mentioned above, it is unlikely that PBR will remain at 2x after the acquisition because ROE will double to 40% due to increased profits without capital increase. It is just maths.

What we can see here is that in the case of i. stock swap, relative valuation of the two companies are the key component to consider and in the case of ii cash takeovers, apart from the your own valuation, how to "buy cheap" the counterparty will directly connected to the evaluation after the consolidation (If the acquisition price is high, goodwill will be booked on the consolidated BS, and in Japanese accounting standards it will hit your earnings with amortization cost).

*However, it goes without saying that in both cases it is important to have a high valuation on your own company.* This is because, theoretically, firms can raise capital at any time and can use it in the capital market. For example, if the you did cash acquisition in above case study and then felt that the D/E ratio should be brought down to the previous level, you should *just issues new shares*. However, if the stock valuation falls after the merger, the share dilution will occur more significantly and shareholder value can be damaged, but if the stock price rises further due to acquisition being highly regarded by the market and if the stock price rise to 20 times P/E then the you can raise additional capital at the cost of 5% ( $1 \div 20$ ). This is the real beauty of getting the capital markets on your side.

In Japan, it is still the greatest goal for majority of listed companies' managements to achieve growth focusing on revenues and profits – the P&L. However, it is actually just one of the many different ways to "maximize the corporate value per share". We cannot stress enough that it is also an extremely important management strategy to control capital costs through dialog with capital markets then be well prepared for times when opportunities such as attractive M&A rise retroactively and you can advance ahead of time without missing out on them.

In your company's KPIs, you have this 15 years worth of capital ratio to expected loss . If you view that the independent variables that consists your capital is only the yearly retained earnings, then you will likely become more risk averse. On the other hand, if you know that you try hard and can get the market on your side so that you can raise capital at any points, then, like the front wheel and rear wheel of a bicycle, the attack and defense are combined organically, and various management strategy options can be freely selected.

## (2) Examples - Ship Healthcare Holdings Co., Ltd.

I would like to share with you another case of our investee company. It is Ship Health Care Holdings Co., Ltd. (SHH), a company providing comprehensive procurement management and consulting services for medical



equipment, etc., with revenue of 514.3 billion yen for the 2022/3 fiscal year, operating profit of 20.5 billion yen, and market capitalization of 259.4 billion yen (as of 23<sup>rd</sup> August) listed on Prime section in TSE. It is a well-known top medical device dealer in Japan. This company is still a mid-cap stock in terms of market capitalization, but it is a company that is sophisticated at interacting with and using capital markets.

In 2016, SHH acquired non-publicly listed Konishi Kyowa Holding Co., Ltd. (KKH), with a combination of cash and stock swap. KKH's shareholders were mainly employees and owners. Figure 15 shows the financial information contained in the press release at the time (only in Japanese).

Figure 15: Press release from Ship Healthcare Co., Ltd – only in Japanese

| (14) 最近3年間の経営成績及び財政状態 |                               |              |              |                         |              |              |
|-----------------------|-------------------------------|--------------|--------------|-------------------------|--------------|--------------|
| 決算期                   | シップヘルスケアホールディングス<br>株式会社 (連結) |              |              | 小西共和ホールディング株式会社<br>(連結) |              |              |
|                       | 平成25年<br>3月期                  | 平成26年<br>3月期 | 平成27年<br>3月期 | 平成25年<br>8月期            | 平成26年<br>8月期 | 平成27年<br>8月期 |
| 連結純資産                 | 42,547                        | 47,621       | 75,864       | 13,804                  | 14,830       | 15,879       |
| 連結総資産                 | 144,389                       | 173,393      | 202,562      | 32,450                  | 34,357       | 35,404       |
| 1株当たり連結純資産(円)         | 1,022                         | 1,173        | 1,524        | 22,990                  | 24,699       | 26,443       |
| 連結売上高                 | 224,363                       | 259,189      | 273,327      | 75,821                  | 81,296       | 83,589       |
| 連結営業利益                | 12,544                        | 13,857       | 13,597       | 1,525                   | 1,539        | 1,358        |
| 連結経常利益                | 13,589                        | 14,754       | 13,910       | 1,658                   | 1,588        | 1,448        |
| 親会社株主に帰属する<br>当期純利益   | 8,589                         | 8,523        | 7,472        | 951                     | 989          | 837          |
| 1株当たり連結当期純利益(円)       | 208                           | 211          | 168          | 1,587                   | 1,650        | 1,397        |
| 1株当たり配当金(円)           | 45                            | 48           | 55           | 45                      | 50           | 50           |

(単位：百万円。特記しているものを除く。)

(Source: Extract from Press Release on March 1, 2016)

In terms of size, KKH's consolidated shareholders' equity amounted to 15.9 billion yen, which was approximately 20% of that of SHH which is strategically substantial for SHH. The transaction was a two-stage transaction that combined cash share transfer and share swap. First, by cash share transfer (KKH 28,000 yen/cash payment of 12.3 billion yen based on the valuation of the share), SHH acquired about 73% of KKH's share from the shareholders (SHH already owned 7% before), and SHH acquired the remaining 20% KKH share (about 3.1 billion yen) issuing its own shares at 2,814yen placing them to the remaining KKH owner (i.e., share swap).

The share exchange ratio was set at 9.95 shares of SHH (1: 9.95) for each share of KKH. The stock price used, SHH's 2,814 yen, is the market average price near to the effective date of the share exchange. KKH's price of 28,000 yen is the same price as the initial cash share transfer price of 80%, which was determined by DCF etc based on the value calculated by a third party. As you can see in Figure 16, in terms of P/B ratio, SHH is higher (1.6 x) compared to KKH (1.1x). In terms of P/E, KKH is rewarded a slight premium, but it can be said that it is almost equal to or less than the SHH considering the synergy impact after integration.

Figure 16: Stock Price Valuation by Consolidation Ratio

|     | Stock Price (Yen) | P/E (actual, x) | P/B (actual, x) |
|-----|-------------------|-----------------|-----------------|
| SHH | 2,814             | 16.7            | 1.6             |
| KKH | 28,000            | 20.1            | 1.1             |

(Source: Bloomberg, SHH materials, estimated by Hibiki)

In this hybrid cash/share exchange transaction, SHH's ROE rose automatically from 9.8% to 10.5% <sup>12</sup> due to the effect of the "ii.cash acquisition." In addition, SHH's shareholders equity per share (BPS) increased automatically by 1% thanks to the i. share exchange effect. Hypothetically, if we assume that the transaction in this case were 100% based on stock swap, BPS would have increased by about 7%. Whether it was a cash acquisition or a share exchange, it can be seen as a very beneficial integration for SHH shareholders. This was the result of SHH's acquisition of KKH at a <sup>13</sup>relatively low price, and the shareholders were very grateful that "the successful integration of such a great company automatically increased the value of one share." It is also a known fact that Post-merger Integration went well between the two and EPS continued to grow.

<sup>12</sup> Calculated using BS/PL actual figures prior to the transaction

<sup>13</sup> This is our own personal view

### (3) Examples - General Dynamics, Inc.

I would also like to briefly introduce General Dynamics, a major defense equipment company, which is often discussed as a case study for a business school in the United States. This is a completely different case from your situation, as the U.S. defense industry went through a severe down/up cycle. General Dynamics, a distinguished but half-hearted company in the 1980s, was successfully revived by the bold management strategy of the outsider CEO Bill Anders, who was appointed in 1991. He had the thought of "having the capital market to my side", and successor Jim Mellor (1993-1997), and Nick Chabraja (1997-2008), inherited the mindset, and the value created by Anders and his carefully selected two successors in the 17 and a half years from January 1991, when Anders took office, to July 2008, when Chabraja left the company, was 23.3% p.a. It was amazing where the stock price went 30x. (S&P500 return during the same period was 8.9%p.a.).

17 years between three CEOs are actually a very long period, and the business environment was changing rapidly from the period of disarmament to the period of re-expansion. Therefore, the initiatives that each CEO placed was different. To put it simply, CEO Anders concentrated on tightening his balance sheet by aggressively reducing the company's capital, and boldly bought shares, focusing on increasing the value per share. Mr. Warren Buffett, whose name has been mentioned several times here, became a shareholder after falling in love with Anders's strong sense of urgency. Buffett made the decision to buy General Dynamics shares after meeting Anders for only once, and he also delegated Anders the voting rights of his shares, which helped the confidence of Anders.

Mr. Mellor, Anders's right-hand man, was the "father of efficient operation" and the president of the company who polished up internal discipline. But while Mellor sold the non-core division similarly with Anders, he also initiated a major cash acquisition for Bass Iron Works in 1995, totaling \$300 million. Mr. Chabraja then took advantage of his stock market evaluation, which was at around 23 times forecast P/E helped by stubborn share buybacks by the past two CEOs. He then went out to acquire Gulfstream, a major private/business jet company, with a \$5.3 billion share swap (more than 1/3 of its own equity)! This was a prime example of how to make the most out of your company's strong stock price. General Dynamics stock price declined 30% in the next 6 months after the deal by investors getting concerned on dilution, but the consolidation effect was positive and the stock price tripled from there in the next three years.

I have also attached a Japanese translation of Mr. Thorndike's book "Outsiders" which shows the extraordinary story of General Dynamics.

#### (4) Conclusion - Why should we stick to ROE?

We have written so much including discussions on how to express IR and then measures to enhance corporate value focusing on ROE. There are many more parts that we would like to discuss but we shall go to conclusion, as per below.

*Aim to increase Revenue and Profits is extremely important for companies, but with that said, management further needs to commit to increase the shareholder value per share throughout many different measures, and need to let the capital markets recognize it. As the market recognize and appreciates the value, then you are granted more ammunition to feed to your winning strategy such as M&As*

The expansion of revenue and profits is mostly driven by management skills, passion and talents, and considering your past business performance and position in the industry, we are confident that you can keep growing the business – revenue and profits. However, the key factor many shareholders are concerned about your current situation the declining Return-on-Equity although your business is so profitable (Fig 5).

If the decline in ROE was caused by decline in profitability, which will require a lot of energy and time to recover, it will not be easy to make improvements. However, in your case, it is caused by capital base increasing faster than the profit as you run a profitable business with limited payout ratio. You cannot solve this by saying that you “will grow business even faster” as it implies a permanent "acceleration" of business which is totally unrealistic. Focusing on expanding revenue and profits is, in fact, a necessary condition for being appreciated in the capital market, but it is not a sufficient condition. It is a necessary-sufficient condition that per share value to increase based on well coordinated business and capital strategy.

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As a minority shareholder, we have made suggestions on measures to improve the IR expressions, corporate value and ROE of your company. While we are an investor who are not shy in making shareholder proposals when we view that issues should be addressed to all shareholders, we do not in principle make shareholder proposals that would likely only lead to a frustrating and non-constructive dispute and accusations at the shareholders' meeting. In light of our relationship of trust that has been developing with the management team of Zenkoku Hosho at IR meetings, we are not currently planning to bring such proposals to the Annual General Meetings. We ask, instead, that management team of Zenkoku Hosho to consider our proposals thoroughly and seriously, then take bold actions. If you implement our proposals, in our own humble view, it should be value

accretive to all shareholders including management, employees, and business partners. We look forward to seeing your mid-term plan with our suggestions being implemented.

26th August 2022

39 Temple Street #02-01, Singapore 058584
Hibiki Path Advisors Pte. Ltd.

※ This letter will be publicly disclosed on our website.

This letter in English is a translated material to the actual Japanese letter written by Hibiki Path Advisors and sent to Zenkoku Hosho Co. Ltd. board. While we pay close attention to the accuracy of the data and information collected in the preparation of this letter, we do not guarantee the accuracy. This letter does not solicit or recommend the purchase or sale of specific securities, nor does it provide any advice on investment, legal, tax or accounting matters.