Guidance for Collaborative Value Creation

May 29, 2017
METI
(Ministry of Economy, Trade and Industry)
As Japan faces a rapid aging of society and population shrinkage, it is essential to grow its national wealth over the long term by enhancing capital efficiency concerning various “capitals” (financial, human, intellectual capital, etc.) that are available only in limited amount.

Creation of a virtuous cycle and sustainable growth through the overall optimization of the economy’s investment chain(*) is crucial. In such an investment chain, companies deliver sustained value creation and generate returns on long-term investments by enhancing their earning power.

(*) The “investment chain” refers to the various paths and processes of capital flowing from its providers to the companies that allocate it to business activities.
2. Overview of measures related to the investment chain

In order for companies to enhance their earning power and deliver sustainable corporate value creation, it is important to **ensure that appropriate governance exercised** and to **encourage constructive dialogue between companies and their investors.**

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**Overview of related measures**

- **Revision of the Companies Act**
- **Corporate Governance Code**
- **Market participants**
  - Securities exchanges, sell-side analysts, etc.
  - Promoting dialogue between companies and investors
    - Dialogue-based general shareholders’ meetings
    - Promoting integrated disclosure
- **JPX Nikkei Index 400**
- **Stewardship Code**
- **Asset managers**
- **Institutional investors**
  - Pension funds, etc. (asset owners)
  - GPIF reform
  - NISA and defined-contribution pensions
- **Employees**
- **Beneficiaries**
- **Individual investors**
- **Companies**
- **Board of directors**
- **Managers, etc.**

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**Competitiveness and Incentives for Sustainable Growth: Building Favorable Relationships between Companies and Investors Project (Ito Review)**
3. Corporate investment in the investment chain

It is pointed out that strategic investment in intangible assets and efforts involving ESG factors are recognized as expenditures which drive profits downward in the short term. For creating corporate value, corporate governance, optimization of investments in allocation of various types of capital based on long-term strategies.
The Study Group on Long-term Investment (Investment Evaluating ESG Factors and Intangible Assets) was established at the Ministry of Economy, Trade and Industry (*) in August 2016.

(*) The Financial Services Agency and other entities are participating in the group as observers.

Japan Revitalization Strategy 2016

(i) Strengthening the initiatives that promote effective governance reform
A) “Promoting sustainable corporate value creation and mid/long-term investment”

Not only from the standpoint of promoting investments based on ESG (environment, society and governance) factors, the Government will also consider the way in which corporate management and investments creating sustainable corporate value should be and how such value should be evaluated, and the mechanism of governance facilitating the optimization of investments in human, intellectual, manufacturing and other capital resources based on long-term management strategies, and how managers should make investment decisions and how investors should evaluate those decisions, as well as how information should be provided, and reach conclusion on what policy measures the Government should take to encourage optimization of investments by the end of this fiscal year.
Based on the Japan Revitalization Strategy 2016, the Study Group examined management decisions, governance systems, investment decisions by investors, and information sharing that optimize investment in human and intellectual capital, etc. as measures to promote sustainable corporate value creation and mid/long-term investment and conducted a study on measures that will optimize investment. The Study Group **held the first meeting on August 24, 2016** and has held monthly meetings since then. **The ninth meeting was held on May 25, 2017.**

### Study Group on Long-term Investment

**Investment Evaluating ESG Factors and Intangible Assets**

<table>
<thead>
<tr>
<th>Name</th>
<th>Position and Affiliation</th>
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<tbody>
<tr>
<td>Kunio Ito</td>
<td>Professor, Graduate School of Commerce and Management, Hitotsubashi University ※Chairman</td>
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<tr>
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<td>United Nations Global Compact Board Member/Executive Advisor, Fuji Xerox Co., Ltd.</td>
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<td>Yuri Okina</td>
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</tr>
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<td>Kazushige Okuno</td>
<td>Managing Director (CIO), Norinchukin Value Investments Co., Ltd.</td>
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<td>Toshiaki Oguchi</td>
<td>Representative Director, Governance for Owners Japan KK</td>
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<tr>
<td>Tetsuya Kikuta</td>
<td>Executive Officer, Chief General Manager, Investment, The Dai-ichi Life Insurance Company, Ltd.</td>
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<tr>
<td>Tsutomu Miyagawa</td>
<td>Dean and Professor, Faculty of Economics, Gakushuin University</td>
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<Observers>The Financial Services Agency (FSA), the Ministry of the Environment (MOE), Japan Exchange Group, Inc., and Japan Business Federation (KEIDANREN)
6. Direction of policy study concerning information disclosure and dialogue between companies and investors

Importance of long-term investments by companies and investors and challenges concerning Japan’s information disclosure system

- As a source of competitiveness that enables companies to create sustained corporate value under the Fourth Industrial Revolution is a robust business model and a strategy for connecting the model to sustainable growth, it is important for corporate management to measure strategic investment not only in tangible assets but also in intangible assets, such as human resources, technology and knowledge. It is also important to appropriately explain the value of these management strategies in order to attract long-term investors.
- However, (i) Japanese corporate information disclosure methods, which also communicate value to investors, are inconsistent between companies, and (ii) there are complaints about a lack of disclosure concerning information on management strategies and non-financial information on ESG and other matters, which are often the bases for long-term investment decisions.
- In order to develop an environment that realizes the most effective and efficient methods of international disclosure of information items to which long-term investors attach importance, efforts will be made to simultaneously (i) improve the efficiency of the disclosure system and (ii) enhance disclosure of information relevant to assessment of long-term corporate value, improving the understanding of institutional investors and the quality of their dialogue with the companies, thereby increasing corporate earning power.

Revision of the information disclosure system

- Identifying similar items contained in securities reports and business reports and implementing standardization
- Increasing the freedom of information disclosure by streamlining disclosure items—by consolidating some items and abolishing others
- Permitting companies to combine securities, business and other reports into a single document
- Enhancing disclosure of non-financial information items to which long-term investors attach importance

"The most effective and efficient disclosure internationally"

Study by the Study Group on Long-term Investment

- Releasing the Guidance for Integrated Corporate Disclosure and Company-Investor Dialogues for Collaborative Value Creation (Collaborative Value Creation Guidance)
  - Releasing the Guidance which serves as a reference for how companies should both disclose information and engage in dialogue with investors in order to create value over the long term
  - A framework under which companies can present and explain information that should be taken into consideration, such as business models, sustainability and growth potential, strategy, performance and KPIs, and governance, under a value-creation scenario

Specific actions

Companies
- Information disclosure and dialogue based on the Guidance
- Deepening understanding through advanced examples of information disclosure (publishing best practices)
- Promoting effective and efficient disclosure of non-financial information
- Raising awareness of and distributing and disseminating the Guidance (holding symposiums, etc.)

Investors
- Institutional investors develop governance systems and asset owners assess asset management institutions, taking stewardship responsibilities into account
- Consideration, development and dissemination of investment formats that simultaneously achieve sustainable corporate value creation and an increase in investment returns over the mid/long term
- Enhancing surveys and statistics (identifying the value and contents of and future prospects for investment in intangible assets through statistics)

Promoting long-term investment and high-quality dialogue and engagement by companies and investors → Promoting sustainable corporate value creation and long-term investment
7. Overview of the Guidance

1.1. Corporate philosophy and vision
   - 2.1. Position in the competitive landscape
     - 2.1.1. Position in the value chain
   - 2.1.2. Differentiating factors

1.2. Relationship with society
   - 2.2. Essential elements for ensuring competitive advantage
     - 2.2.1. Management resources/Intangible assets
     - 2.2.2. Relationships with stakeholders to support competitive advantage
     - 2.2.3. Profit structure/drivers

   - 3.1. Recognition of ESG factors
     - 3.1.1. Speed and impact of technological change
     - 3.3.2. Country risk
     - 3.3.3. Cross-border risk

   - 3.2. Relationships with key stakeholders

   - 3.3. Risk in a changing environment
     - 3.3.1. Speed and impact of technological change

   - 3.4. Strategy for ESG integration

   - 4.1. Improving company positions within the value chain
     - 4.2. Securing and enhancing management resources and intangible assets
       - 4.2.1. Investment in human capital
       - 4.2.2. Investment in technology (intellectual capital)
     - 4.2.2.1. R&D investment
     - 4.2.2.2. IT/software investment
     - 4.2.3. Investment in brand and customer loyalty
     - 4.2.4. Organizations
     - 4.2.5. Investment to accelerate growth

   - 4.4. Capital allocation strategy
     - 4.4.1. Business portfolio management, including exit strategies
     - 4.4.2. Measuring intangible assets and monitoring investment returns

   - 5.1. Financial performance
     - 5.1.1. Management discussion and analysis (MD&A)
     - 5.1.2. Creation of economic and shareholder value

   - 5.2. Setting strategic KPIs

   - 5.3. Designing linkages between corporate value creation and specific KPIs

   - 5.4. Awareness of cost of capital

   - 5.5. Progress evaluation

   - 6.1. Ensuring the strength of the board

   - 6.2. Skill and diversity of CEOs and senior executives

   - 6.3. Skill and diversity of non-executive directors

   - 6.4. Monitoring strategic decisions

   - 6.5. Shareholder return policies

   - 6.6. Compensation policies

   - 6.7. Reviewing board effectiveness and identifying priority issues
**Fundamental concerns and current status**

A paradox of long-term low profitability

- Low profitability persisting despite Japan’s capacity to innovate
- The limitations of the practice of “double standard management,” which refers to the use of internal management metrics that differ from metrics used in the markets
- Concerns over the “short-termism in Japanese corporate management,” which results from insufficient policy for capital efficiency and long-term value creation

Japan: a country lagging in asset investment due to the absence of long-term investors

- The shallow foundation of long-term investors to support corporate value creation
- Incentive structures that encourage the short-termism that is characteristic of the Japanese market
- Low confidence in analysts’ ability to assess corporate value

Vicious cycle resulting from the absence of company-investor dialogue

- Fundamental difference in methods of defining corporate value
- Insufficient disclosure for assessing mid/long-term corporate value
- Insufficient dialogue for assessing mid/long-term corporate value

**Proposals and recommendations**

Toward simultaneous realization of innovation and high profitability

- Sustainable value creation through “collaborative creation” by companies and investors
- Shift to capital efficiency-focused management to raise corporate value
  - Awareness of capital costs
  - Strengthening CFO role
  - Japanese-style ROE-focused management, which adopts a mid/long-term increase of ROE as a management goal

Toward overall optimization of the investment chain

- Changing incentive structures for asset managers and analysts
- Shifting from passive investment to selection of stocks based on in-depth analysis
- Developing individual investors into long-term company supporters

Promoting high-quality dialogue

- Establishing the Management-Investor Forum to develop a favorable relationship between companies and investors
- Towards corporate disclosure that leads to sustainable corporate value
- Promoting true dialogue between companies and investors through “cooperation and struggle”

Reference (1) Summary of the Ito Review (*)

“Competitiveness and Incentives for Sustainable Growth: Building Favorable Relationships between Companies and Investors” Project Published in August 2014 by the Ministry of Economy, Trade and Industry.
Reference (2) Importance of intangible assets as a source of corporate value

Intangible assets (human resources, technology, knowhow, brands, etc.) are gradually replacing tangible assets (plants, facilities, etc.) as sources of corporate value.

- In the United States, the share of intangible asset investment in added value created by companies is higher than that of tangible asset investment.
- The share of intangible assets in the market value of S&P500 issues (500 major issues listed in the United States) has been growing annually.

**Investment in tangible and intangible assets by U.S. companies**

**Components of S&P500 market value**

**COMPOSITIONS of S&P 500 MARKET VALUE**

*Figure 8.1 The Intangibles Revolution*

Source: The End of Accounting and the Path Forward for Investors and Managers (Baruch Lev, Feng Gu), Willy Financial Series, Page 82
The value of intangible asset investment in Japan is smaller than the amounts in the U.S. and major European countries.

- The share of intangible asset investment in GDP is smaller in Japan than in countries such as the U.S., the U.K. and France.
- In the U.S. and the U.K., the share of intangible asset investment is larger than that of tangible asset investment.
- The share of intangible asset investment in Japan is around half of tangible asset investment.

Reference (3) Status of intangible asset investment

Source: RIETI, Policy Discussion Paper, Japan’s economic growth and its intangible assets (June, 2015)
Japanese companies are faced with a situation in which it is difficult to make long-term R&D investment intended to explore new markets.

**Breakdown of R&D expenditure by Japanese companies**

- **Improvement of existing technologies**: (Less than three years of research necessary until commercialization)
  - Example: model changeover of vehicles and seasonal model changes of mobile phones

- **Research related to disruptive technologies**

- **Research related to exploration of new markets**

**Changes in the substance of R&D programs conducted by Japanese companies**

- **Short-term R&D programs are increasing**: 43.8%
- **Mid/long-term R&D programs are increasing**: 12.7%
- **No change**: 43.5%

**Research programs that require remarkable technological advance but for which the market prospects are clear**

- (Five to 10 years of research necessary until commercialization)
- Example: autonomous driving

**Research programs which involve significant technological difficulties and for which the market prospects are uncertain at the moment**

- (More than 10 years of research necessary until commercialization)
- Example: quantum-dot solar cells and lithium-air batteries

Source: Reference materials distributed at a meeting of the R&D and Innovation Subcommittee of the Committee on Industrial Science and Technology Policy and Environment under the Industrial Structure Council
Reference (5) Non-financial information as a reference for investment decisions by investors

For investors the importance of non-financial information when making investment decisions is increasing.

The Unique Contribution to Investors’ Information: Financial Reports, Analysts’ Forecasts, and Nonaccounting SEC Filings

From 1993 to 2013

*Earnings forecasts by companies excluded from the above graph

Source: The End of Accounting and the Path Forward for Investors and Managers (Baruch Lev, Feng Gu)
The number of PRI (※) signatories has been consistently increasing from its establishment and reached almost 1,700 as of April 2017.※A voluntary and aspirational set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice.

PRI Signatories by Nation

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<tr>
<th>#</th>
<th>Nation</th>
<th>Signatories</th>
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<td>1</td>
<td>USA</td>
<td>315</td>
<td>18%</td>
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<tr>
<td>2</td>
<td>UK</td>
<td>246</td>
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<td>3</td>
<td>France</td>
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<td>4</td>
<td>Australia</td>
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As of April, 2017