The ITO Review of Competitiveness and Incentives for Sustainable Growth
-Building Favorable Relationships between Companies and Investors-
Final Report Executive Summary

Although Japan's macro economy is showing signs of improvement, in order to ensure that the economy enters a sustainable growth trajectory it is critical that at a micro level each company strengthens its competitiveness and profitability ("earning power").

A longer-term issue confronting Japan is how it will maintain and grow its national wealth given its shrinking population. This issue can only be solved by companies enhancing their earning power and delivering sustained value creation, which will drive returns on long-term investments and result in the overall optimization of the economy's "investment chain."[1] If there are any structural disincentives that impede this effort, they must be resolved so that the economy can head in a better and more balanced direction.

Based on such a recognition, this project facilitated dialogue and discussion among representatives from company management, investors, market participants, scholars, and those around the world. Starting with the inaugural meeting held in July 2013, there have been a total of 16 general meetings during the past year, with further focused debate occurring within the three subcommittees with respect to information and evidence collected from around the world. In April of this year an interim report was released and solicited further feedback, which served as the foundation for this final report, as summarized below.

I. Reforming Management to Achieve Sustainable Growth

１. Fundamental Concerns and Hypotheses

Continuously Low Profitability of Japanese Companies Has Led to Short-Termism in Company Management

Which country is the most innovative or has the greatest capacity to innovate? Although there are a variety of views with respect to this question, Japan is undoubtedly one of the

[1] The "investment chain" describes the various paths and processes of capital flowing from its providers down to where companies deploy it towards business activities.

strongest contenders.[2] Yet from the perspective of profitability Japan has suffered from a paradox in which it has experienced 20 years of continuously low profitability.

Management of Japanese companies have asserted that they have not been buffeted by the short-term fluctuations in the capital markets and have conducted capital investment and human capital development with a long-term perspective. However, given the reality of continuously low profitability, it is questionable whether truly innovative management decisions from the perspective of driving long-term sustainable growth have been made within companies whose management have relatively short tenures and which lack discipline towards capital efficiency and corporate value creation.
The more company management tend towards short-termism, the more difficult it becomes for them to invest in long-term innovation. In order for Japanese companies to drive innovation – which is the source of competitiveness – from a long-term perspective, Japan will require an inflow of long-term capital that can support such initiatives. If, on the other hand, Japan cannot attract such long-term capital, then a deterioration in the long-term competitiveness of Japanese companies is inevitable. What must be done to avoid such a vicious cycle? This indeed is the first concern addressed by this project

2. Discussion and Evidence

1) Main Reason for the Long-Term Depressed ROE of Japanese Companies Is Not Leverage but Rather Low Corporate Profitability (Section 3.1)

An international comparison of return on equity (ROE) – a metric that investors regard as an important profitability indicator – shows that Japanese companies have had a low ROE over the long-term despite a recent increasing trend. This comparison also shows that the ROE of Japanese companies exhibits little dispersion with most concentrated at low levels.

If one decomposes ROE into the factors of return on sales, asset turnover ratio, and financial leverage and then compare these with the US and Europe, there is not much difference with respect to asset turnover ratio and financial leverage, therefore indicating that the low ROE of Japanese companies is largely caused by their low profitability.

[2] One measure is provided by the World Economic Forum's *Global Competitiveness Report*, which ranked Japan number three globally in "Innovation and sophistication factors" (2013). In the "Capacity for innovation" sub-category, Japan ranked first or second globally from 2009 to 2012, but had dropped to sixth by 2013.

2) Four Common Characteristics of Companies that Maintain Profitability under Tough Conditions (Section 2.1)

Looking at the past 20 years during which Japanese companies exhibited lackluster profitability and share price performance, of the 1600 companies for which data was available during this entire period, roughly 200 companies exhibited positive total returns (inclusive of dividends).

Companies that displayed strong performance during this tough period had the following shared characteristics: 1) pricing power through differentiation and providing value to customers; 2) a relentless focus on generating an indispensable position and business portfolio optimization; 3) continuous innovation including collaboration with other companies (e.g. open innovation) ; and 4) a fearlessness towards change and the ability to rationally and proactively carry out reforms as part of that change.

3) Incentive Structures of Japanese Companies Have Influenced Managements' Managerial Timeframe and Capital Efficiency (Section 4.2)

When compared to international peers, executive compensation of Japanese companies is relatively low and has little alignment with earnings performance. One reason for this is that Japanese companies emphasize solidarity with employees and this may have become the basis for management's acceptance of low executive pay. It was also noted in discussions that non-financial management incentives such as a sense of mission, a sense of responsibility, and promotion of social trust play a major role for Japanese management. These factors are believed to mitigate the influence of capital market short-termism on Japanese companies, and are one element in allowing them to conduct stable business operations.

In comparison to Europe and the US, there does not appear to be a strong recognition that management of Japanese companies is being influenced by short-termism in the capital markets. One reason for this is that there is strong recognition that the greatest influence on Japanese management is the provision of high quality goods and services to customers and protection of employment, and that there is relatively little influence from shareholders. In addition, there is a view that the practice of "double standard management" – using internal management metrics different from metrics mentioned in dialogue with investors and the capital markets – also contributed to this tendency in the past. It was noted that another factor contributing to this tendency is the historic reliance on bank financing for capital, and the apparent lack of necessity to have close dialogue with the capital markets. While this may have supported long-term R&D and capital investments of Japanese companies, it has also resulted in a weak consciousness towards ROE and the cost of capital, and a lack of clarity in capital policy, including reinvestment of retained earnings and dividends.

The typical term of office of Japanese management is relatively short and fixed (e.g. 4~6 years) and tends to be independent of performance. While there is debate whether the term of office affects earnings performance, this incentive structure together with the aforementioned tendency towards stable operations may serve as an impediment for management making long-term decisions, taking necessary risk, and conducting dramatic business reforms. Companies with continuously low profitability or unclear approaches towards capital stewardship have a tendency to conduct earnings management with short-term performance (e.g. quarterly) in mind and refrain from making long-term investments. Concerns have been noted that such companies also become short-term oriented as a result of sell-side analysts overly focusing on quarterly earnings and short-term performance.

4) Gap Exists in the Understanding of the Cost of Capital and ROE (Section 3.2)

Many investors regard ROE as one of the most important measures when evaluating companies. ROE is a “result” of business activities and not a “goal” for management, implying that ROE will naturally rise as a result of improving competitiveness to support sustainable growth. Therefore, while investors generally seek that companies reinvest retained earnings, they also expect such reserves to be returned to shareholders in the event that they cannot be effectively put to work. Although there is some controversy as to whether companies should maximize ROE, there appears to be a common understanding that at the very least companies should target an ROE that is above their cost of capital. Investors seek to make long-term investments in companies that are expected to generate returns above their cost of capital through building a competitive advantage over the mid/long-term.

On the other hand, while Japanese companies recognize ROE as an important measure, they do not consider it to be the most important one. This is because there are some practical difficulties in utilizing ROE as a measure at the operational level, and the concept of financial leverage does not fit well with certain companies given that they often prioritize management without debt.

The cost of capital refers to the expected rate of return by the market. There exist diverse views with respect to what is to be considered an appropriate level for the cost of capital. There exists a quantitative measure called the Weighted Average Cost of Capital (i.e. weighted average of the cost of debt and the cost of equity). However, in practice the capital market often reflects "intangible value" that is difficult to quantify into the overall evaluation of the cost of capital. If companies recognize how the capital markets perceive the cost of capital and engage in dialogue with investors to promote a mutual understanding, there may be room to lower their cost of capital.

As a result of historically relying on bank financing for capital, not very many Japanese companies are conscious of their cost of capital, especially in comparison to global peers, and this poses a major problem. There is survey evidence showing that only 40% of Japanese listed companies are conscious of their cost of capital, and less than 10% of Japanese companies make any disclosures with respect to their cost of capital.

3. Proposals and Recommendations

1) Sustainable Value Creation through "Cooperative Value Creation" by Companies and Investors (Section 1.1)

Sustainable growth means to increase corporate value over the mid/long-term. This is achieved by generating returns above the cost of capital over the mid/long-term. Investors, in turn, can make long-term investments when they can expect companies to create such long-term value.

Investors who desire sustainable growth expect portfolio companies to retain all or part of their net income and to re-invest these funds as a source for continued growth. This implies that shareholders and investors both seek and support the sustainable growth of companies. In other words, sustainable corporate value creation should be viewed as the result of cooperation between companies and shareholders, and therefore management must recognize shareholders as a critical existence supporting such cooperation.

At the same time, investors should not evaluate shareholder value in isolation, but rather assess sustainable corporate value creation while recognizing that customer value, employee value, business partner value, and community value generated by companies all lead to the enhancement of long-term shareholder value.

2) Shifting to Capital Efficiency-Focused Management to Raise Corporate Value

Mid/long-term Increase of ROE as a Core Goal for Management（Section 3.1）

The sustainable growth of a company is the result of cooperative value creation with long-term investors, and should be evaluated using capital efficiency measures such as ROE. In order to promote global management of a business, companies must adopt internationally recognized management metrics such as ROE as target performance indicators and commit to managing to such measures. It is important that ROE is not viewed from a short-term perspective, and rather should be understood that an increase of ROE over the long-term contributes to the accumulation of resources necessary for increasing corporate value, and that this in turn increases value for various stakeholders including a rise in long-term shareholder value. It is important for companies to understand that their “sustainable growth rate” (a metric to indicate the potential growth rate in profitability that a company can achieve by recourse only to its retained earnings) is the minimum growth in profitability that they must deliver in order to sustain their current level of ROE. Companies should actively incorporate this reality into their business management.

Minimum Level of ROE to be Targeted and the Need for a Higher Awareness of the Cost of Capital（Section 3.3）

The most important concept in assessing an appropriate level of ROE is the cost of capital. Management of Japanese companies must deepen their understanding that a company capable of generating long-term returns above its cost of capital is regarded as a value-creating company. There is a survey showing that the average expected cost of capital for Japanese companies is a little more than 7%, and the same survey indicates that an ROE of 8% would exceed the expected cost of capital of 90% of global investors. Although the actual cost of capital differs between companies, the first step in receiving recognition from global investors is for a company to commit to achieving a minimum ROE of 8%.

Companies should further strive to achieve a higher ROE appropriate to their specific business and that will contribute to sustainable growth.

The cost of capital is an unspoken manifestation of shareholders and investors' level of trust and expectations towards companies and implied corporate roles and responsibilities, and captures both financial as well as non-financial aspects of operations. Shareholders and investors are demanding greater accountability as well as management discipline with respect to this cost of capital. The cost of capital, therefore, holistically encapsulates factors such as management's commitment, information disclosure, investor communication, and uncertainties and risks. A higher cost of capital serves as a negative factor towards corporate value assessment. Therefore, management must deepen their understanding of cost of capital, and communicate their basic thoughts on this to investors through constructive dialogue. It is important for management to realize that such a dialogue may reduce the cost of capital.

Considering Capital Efficiency from the Perspective of Corporate Value Creation（Section 3.4）

It would be mutually beneficial for companies and investors if company management were to examine their capital policies (dividends, share buybacks, re-investment, etc.) from the perspective of mid/long-term corporate value creation, and explain their views on this issue when engaging in dialogue with investors. When doing so, company management should be sure to integrate their explanation of capital policies, inputs, and outputs, including the cost of capital and ROE, to a coherent risk management framework.

Investors perceive retained earnings as a re-investment to drive future corporate value creation, and therefore hold expectations that such proceeds will be effectively used by a company. It is, therefore, important during the course of dialogue to discuss the role and use of retained earnings in light of mid/long-term business strategies as well as various risk factors. The same applies to discussions on cross-shareholdings and parent-subsidiary listings in that providing adequate explanation as to the purpose and business efficacy of these actions is important for company management to secure investor trust.

Strengthening and Developing CFOs（Section 4.2）

In order to incorporate capital discipline, such as the cost of capital and ROE, into mid/long-term management, reforming business models, management systems and incentive structures is needed. In addition, more precise risk management frameworks must be employed to ensure appropriate risks are taken in the pursuit of increased competitiveness. The presence of a capable CFO is a crucial prerequisite for a CEO to perform the above, and therefore efforts must be made to cultivate a pool of talented CFOs.

Using ROE throughout the Company（Section 3.2）

It is important for companies to decompose ROE into measures such as profitability and asset turnover ratios so that ROE can be translated into metrics usable at the operational level. To this end, the use of a metric such as ROIC (return on invested capital) can be useful in evaluating business operating units in terms of their specific returns on capital.
It is important that ROE be translated into internal goals, and that specific examples of this (e.g. decomposed management goals and logic trees) be provided when expressing management strategy to investors during the course of dialogue.
When investors have dialogue with companies, they should not only impose ROE expectations, but should work with companies to decompose ROE into subcomponents that can aid specific decisions such as production lead times, shortening inventory periods, and improving yields.

Enhanced Profitability and Capital Efficiency Will Lead to a Virtuous Cycle for the Japanese Economy.（Sections 3.1, 4.2）

If companies strengthen their profitability (as measured by metrics such as ROE) and increase their value-add, this will contribute to a virtuous cycle and the sustained growth of the Japanese economy. Indeed, it would lead to a wide variety of positive effects, including higher wages and investment in human capital, increased R&D and capital investments, diversification in companies' capital procurement, improved pension fund performance through stronger stock markets, increased tax revenues, and increased capital inflows from global investors. As such, higher capital efficiency via increasing ROE and focusing on the cost of capital is at the core of the third arrow of Abenomics.

Management of Japanese companies derive motivation from their sense of mission and from the recognition they receive from society. In addition to the positive effects outlined above, if the people of Japan monitor and evaluate Japanese companies from the perspective of investing the people's assets for the future, this should further add to the motivation of management.

II. Optimization of the Investment Chain

1. Fundamental Concerns and Hypotheses

Thin Foundation of Long-Term Investors to Support Corporate Value Creation

In recent years the shareholder structure of Japanese companies has dramatically changed, and is causing the relationship between company management and shareholders to change as well. On the other hand, the traditional practice of company's relying mostly on bank financing for additional capital along with the fact that household financial assets have historically concentrated in cash and deposits are cited as the reason behind Japan's capital markets having a thin foundation.

Do Japan's capital markets support mid/long-term corporate value creation and contribute towards the long-term growth of financial assets? Is the globally debated issue of capital market and investor short-termism and the resulting short-term orientation of company management causing similar problems in Japan? This is this project's second concern.

2. Discussion and Evidence

Japan's Distinctive Short-Termism Driven by Continuous Low Profitability (Sections 6.1, 7.1, 8.1, 9.1)

The average shareholding period (defined as the rate of turnover) in Japanese companies has been getting shorter every year. While on the one hand this measure may indicate the short-termism of investors, it also captures trends of increased market liquidity and diversity and therefore cannot be conclusive in determining that there has been an increase in investor short-termism.

The Japanese stock market functions as part of a global market and does also have characteristics of short-termism. However, there exist differences in the reasons for short-termism when compared to Europe and the US. In particular, the Japanese market lacks investors that make independent stock selection decisions based on mid/long-term perspectives.

One reason for the short-termism in Japan is the rational investor behavior of pursuing short-term investment opportunities given the history in Japan of little expectation towards long-term price appreciation. In order to promote long-term investments, there must be an expectation towards long-term stock price appreciation founded on long-term corporate profitability.

Another reason for short-termism in Japan is that the incentives of asset managers, asset owners, and sell-side analysts promote short-termism. There also exist many issues that need to be resolved in order to promote proper corporate value assessment and long-term investment, especially with respect to domestic institutional investors and sell-side analysts.

(1) With regard to pension funds as major asset owners, insufficient investment personnel as well as inadequate specialization has been noted as issues. Although pension funds should be looking at investment profitability from a long-term perspective, there is a tendency for them to assess their asset managers based on short-term (e.g. monthly or quarterly) performance.

(2) Most domestic asset managers are affiliated with financial conglomerates, and therefore have difficulty in securing long-term management commitment and specialization due to personnel rotations, and also have compensation structures that have little alignment with long-term performance. Furthermore, the fact that asset owners are making short-term performance assessments influences the manner in which investment organizations conduct their own assessments.

(3) Securities firms – which are the employers of sell-side analysts – have greater incentive to service short-term investors given that they contribute a larger portion of commission revenue in comparison to long-term investors. As such, it is noted that sell-side analysts are becoming overly short-term (excessively focusing on quarterly earnings), and are not adequately conducting mid/long-term fundamental analysis nor having proper dialogue with companies.

A third reason for Japanese short-termism is that companies are not effectively disclosing information necessary for investors to make long-term investment decisions. Institutional investors may have no choice but to focus on short term profitability for companies that don’t provide such explanations.

Fourthly, there are certain regulatory frameworks that may support short-termism. For example, the development of market infrastructure enabling high-frequency transactions at relatively cheap commissions and requirements for quarterly disclosure may be resulting in adverse effects such as the short-term orientation of sell-side analysts and institutional investors.

3. Proposals and Recommendations

1) Employing an Incentive Structure That Will Help to Optimize the Investment Chain (Sections 8.1, 9.1)

It is critical to create an environment that fosters the formation of mid/long-term household assets through investments into sustainably growing companies. As such, the incentives underpinning the various market participants supporting Japanese companies must be converted such that they lead to mid/long-term investments. Given the incentive structures and issues – pertaining to both institutional investors (pension funds, insurers, investment trusts, etc.) and individual investors – identified in this project, the various discussions and proposals of this project should be holistically addressed through the optimization of the investment chain. For example, enhancing the sourcing of personnel and the strengthening of corporate networks for institutional investors (especially asset owners such as pension funds), correcting the incentive structures of asset managers and analysts that cause them to excessively lean towards short-termism, and creating and implementing measures to promote a greater breadth of market participants making long-term investments based on corporate value assessment are important. The practice of commission sharing arrangement (CSA), which is broadly used in Europe and the US, is also worth considering.

2) Shift from Passive Investment to Stock Selection Based on Deep Analysis (Sections 8.1, 9.1)

It has been noted that the Japanese market has an abundance of institutional investors tending towards passive index investment, and that there is a lack of mid/long-term investors. Investors that track broad market indices do not make individual stock selections, and as a result the perception gap with companies is not bridged and cooperative value creation and dialogue is not promoted. The market must foster investors that make independent stock selections from a mid/long-term perspective. To this end, while active investment based on the evaluation of individual companies should be the mainstream, the use of indices that are based on certain corporate value criteria should also be considered as a complementary measure to promote greater liquidity in the equity markets.

It should also be noted that an excessive focus on passive investment approaches would imply that the capabilities and expertise of sell-side analysts are not being fully leveraged. Furthermore, investor short-termism leads to reduced demand for deep analytical work performed by analysts. Not just to avoid excessive passive investing but also to promote mid/long-term investments in companies, it is recommended that analysts provide basic analytical reports that are based on deep fundamental analysis and offer strong rationales to support any target prices.

3) Developing Individual Investors into Long-Term Supporters of Companies （Sections 5.1~5.3）

In order to promote long-term investments within the stock market, it is vital to foster individual investors who possess long-term perspectives. Especially important are those individuals who have so far been accumulating their financial assets solely in form of savings and deposits. The proportion of household financial assets invested in equities, bonds, and investment trusts is only 8~16% whereas the proportion of savings and deposits is in excess of 50% and amounts to over 800 trillion yen. This can be considered a “uniqueness” of Japan in contrast to Europe and the US. This unique feature of Japan has tremendous potential. If the vast savings of these potential investors can be invested in the stock market as supportive long-term shareholders, this would provide for a strong foundation to support the value creation of Japanese companies. It is therefore critical to promote the growth of individual investors. Gaining long-term support from the individual investor base should be a strong incentive for companies to provide clear explanations with respect to their corporate philosophy and “intangible value,” such that they can attract investments from individual investors.

Pension schemes –in particular the defined contribution plan and the Nippon Individual Savings Account (NISA) plan – play a crucial role as a source for long-term capital underlying sustainable corporate growth as well as promoting the awareness and understanding of individual investors. Therefore, it is important to improve the current pension system and also to enhance financial literacy.

III. Increasing Corporate Value through Company and Investor Dialogue

1. Fundamental Concerns and Hypotheses

Vicious Cycle Resulting from the Absence of Company and Investor Dialogue

The key to long-term corporate value creation and sustainable growth is to establish a virtuous cycle in which a company's innovation drives higher profitability and capital efficiency, which in turn attracts long-term capital from investors which can be deployed to drive further innovation.

Japanese companies, having dealt with arguably the toughest consumer market in the world, have improved the quality of their products and services to the highest standards. How much then have Japanese companies worked similarly with capital markets? Corporate value is created through dialogue with markets, and simultaneously strengthening competitiveness within both the consumer and capital markets. What are the current issues facing the dialogue between companies and investors? Although Japan introduced its own Stewardship Code, what exactly needs to be done to promote high-quality dialogue that will contribute to sustainable corporate growth, and how must information disclosure practices be changed to ensure such dialogue focuses on the mid/long-term perspective? This is the third fundamental concern that this project addresses.

The absence (or poor quality) of dialogue between company management and investors has resulted in a large perception gap. While on the one hand there is an anecdotal view that capital market short-termism has led to similar short-termism of company management, there is another hypothesis that company communication, rooted in the assumption of the short-term nature of capital markets, is itself the cause of investor short-termism. Here again exists a vicious cycle.

２．Discussion and Evidence

1) Fundamental Difference in Defining Corporate Value (Sections 1.2, 12.1)

Companies and investors would both agree with the view that corporate value must be increased over the mid/long-term. However, there appear to be divergent views on how "corporate value" is defined, and there is no uniformity of definition even amongst investors and analysts. This perception gap may hinder effective dialogue between companies and investors.

In general, corporate value is measured by economic value or shareholder value using a metric such as market capitalization or by discounting future cash flows to present value using methods such as DCF. A company is deemed to be value-creating if its returns exceed its cost of capital over the mid/long-term. On the other hand, there is a view that defines corporate value more broadly, and considers it to be the sum of value provided to each stakeholder such as shareholders, customers, employees, business partners, and the community.

While value creation can also be thought of as the maximization of value added, there exist two perspectives on this as well. One perceives value added as the aggregate of value distributed to respective stakeholders. The other perceives value added as any residual profit after 1) distributing value to respective stakeholders other than shareholders and 2) taking into account the cost of capital. In Japan it seems that the first perception has been implicitly and generally adopted.

It is important for companies and investors to engage in dialogue and share an understanding on how increasing value for all stakeholders (customers, employees, business partners and the community) will in turn lead to an increase in shareholder value and ultimately corporate value over the mid/long-term.

2) Lack of Disclosure Necessary to Evaluate Mid/Long-Term Corporate Value (Sections 11.1, 11.2)

While investors have generally praised the improvement in disclosure made by Japanese companies, there continues to be strong investor desire for integrated information on mid/long-term management strategies and business models that would aid in their assessment of long-term corporate value. Does the current disclosure framework meet these needs?

One issue raised with regards to the current disclosure framework is that there are redundancies with respect to the timing and content of existing company disclosures, and that these redundancies must be comprehensively reviewed. Also, with respect to quarterly disclosure and the earnings forecast framework, issues of debate include the varying degree of importance depending on the company and sector, the burdensome nature of disclosures, the impact on dialogue between companies and investors, and the influence on short-termism of investment communities. As a result, it was recognized that there are controversies over the current disclosure framework and it is necessary to discuss this fairly and objectively from several perspectives. It was noted that while on the one hand the role and significance of the disclosure framework has been appropriately recognized, it is also seen as contributing to the adverse effects of company and investor short-termism. In relation to this, Japan’s unique practice of sell-side analysts and newspapers providing earnings previews every quarter is of concern, as it results in “noise” with adverse effects for both companies and investors.

With respect to disclosure necessary for evaluating mid/long-term corporate value, investors suggest the need for information on management strategies, risks, and ESG (environment, social, and governance issues). However it was also pointed out that this information is not sufficiently disclosed.

3) Lack of Dialogue Necessary to Evaluate Mid/Long-Term Corporate Value (Section 12.1)

The establishment of Japan’s Stewardship Code has clarified investor responsibility to conduct “purposeful dialogue (engagement)” with companies and strive to aid in the increase of corporate value and sustainable growth such that mid/long-term investment returns are increased for institutional investors’ beneficiary customers. Engagement starts with companies and investors building a mutual understanding through communication, and then can evolve into the joint identification and resolution of various business issues. This project broadly examines the issue of dialogue and engagement from the perspective of what constitutes an ideal relationship between companies and investors and how the quality of dialogue and engagement can be enhanced.

Both companies and investors have issues to address before high-quality dialogue can be achieved. In addition to the aforementioned perception gaps on “corporate value” and “cost of capital” as well as issues surrounding disclosure, it was noted that investors need to strengthen their ability to analyze and assess mid/long-term corporate value. It was also noted that many institutional investors are tending towards passive index investment, which is resulting in reduced incentives to sustain dialogue and engagement with individual companies.

With respect to the principle of dialogue and engagement stipulated in Japan's Stewardship Code, given the strong view that true dialogue is lacking between companies and investors, there was heavy focus of discussion on this issue. Issues include the current state and content of dialogue and engagement, as well as the premises for such interaction. These discussions resulted in the fundamental recognition that some of the dialogue and engagement undertaken to this point has not necessarily been focused on the quality of interaction but rather on the number of interactions in and of itself. Furthermore, there is concern that in situations where investors do not possess adequate capability to assess the sustainable growth of companies, dialogue with such investors would inadvertently absorb management's time and thus potentially serve as an impediment to growing corporate value. The project's discussions focused on issues such as what constitutes appropriate purpose and content for dialogue with management and board members, what are best practices for dialogue and explanations to shareholders, and what do institutional investors seek in their interactions with companies. With respect to the use of the annual shareholder meeting as an opportunity for investors (shareholders) to have dialogue with companies, issues were raised vis-a-vis the concentration of shareholder meetings on same/similar dates and the short period of time between the end of the accounting term/shareholder meeting notice and the shareholder meeting.

3. Proposals and Recommendations

1) Establishing a Platform for Mutual Understanding and Advanced Dialogue (Section 12.4)

If sustainable corporate value creation is to be realized through "collaborative creation" by companies and investors, then both parties must forgo any preconceived notions, prejudices, and apprehensions, and work to build a relationship of mutual trust.

In order to achieve this, companies must abandon "double standard management" styles in which external communication with the capital markets differs from management metrics actually used within the company. Furthermore, the quality of dialogue between companies and investors must be raised. In particular, focusing on bilateral dialogue will help to resolve any perception gaps that may exist between companies and investors. It is therefore important for both parties to keep in mind the concepts of corporate value described above and establish a common goal for dialogue, and through this strive towards a deeper mutual understanding.

Any conflicts of interest between companies and investors must be resolved in order to seek a high-quality dialogue worthy of capitalism in the 21st century.

In order to promote sustainable corporate value creation, a forum (e.g. “Management Investor Forum: MIF”) should be established such that company management, investors, industry participants, market participants, and other related parties can gather and discuss the issues raised in this report such as appropriate disclosure from a long-term perspective and integrated reporting, and the promotion of constructive dialogue between companies and investors. Continued discussion at such a forum should help lead to concrete policies and practices aimed at realizing sustainable corporate value creation.

2) Towards Corporate Disclosure that Promotes Sustainable Corporate Value (Sections 11.1, 11.2)

Corporate disclosures should be reformed to provide investors with information that can be used to assess mid/long-term corporate value creation. Integrated reporting is necessary to avoid an over-emphasis on short-term performance and to allow for assessment (including non-financial information) of both the current state of companies as well as corporate processes aimed at future value creation.

As a first step, practical solutions and other measures aimed at offering investors a consistent and holistic framework for disclosure must be considered, under relevant disclosure requirements of the Financial Instruments and Exchange Law, the Company Law, and the various regulations of the stock exchange. While the current framework for quarterly disclosures and earnings forecasts has played an important role to date, it is necessary to correct the over-emphasis by investors and analysts on quarterly information. While this framework should not be reformed only because of “adverse effects”, it is important to consider reform of Japan’s corporate disclosure framework from multiple angles, including its cost effectiveness for both companies and investors, its role in the promotion of dialogue between companies and investors towards sustainable growth, its effect on the activities of market participants, and global trends.
In order for companies and investors to have deeper dialogue from a mid/long-term perspective with an aim to increase corporate value, it is also necessary to disclose information, including non-financial information, from a mid/long-term perspective. Investors should clearly communicate the type of mid/long-term, non-financial

information they need, and companies should communicate corporate strategy, risk information, governance, and ESG activities while connecting these key issues to financial metrics such as cost of capital and investment returns. This would help to promote the management literacy of Japanese companies. “Integrated reporting” would be one effective tool in achieving this.

3) Promoting True Dialogue between Companies and Investors through “Cooperation and Tension” (Section 12.1)

Two Sides of “Tension” and “Cooperation”

Dialogue and engagement between companies and investors should have aspects of both cooperation and tension.

Tension: Company management should communicate their visions and strategies aimed at corporate value creation and should seek to gain investor understanding and support. Such dialogue is also an opportunity for investors to evaluate and screen companies, and unfavorable screening results may result in termination of capital provision by investors. This is a moment of “tension”.

Cooperation: Sustainable growth is a result of a cooperative value creation between companies and shareholders. High-quality dialogue and engagement promotes mutual understanding and helps to increase corporate value, which is mutually beneficial to companies and long-term oriented institutional investors.

Dialogue and Engagement with an Appropriate Purpose and Content

The definition, purpose, approach, and suggested issues for dialogue and engagement have been comprehensively covered within the main body of this report and should serve as a practical reference.

It should be emphasized that purposeful dialogue and engagement has a much stronger element of bilateral communication compared to the IR activities that have taken place until now. Investors should inform companies of the type of information they require for making investment decisions and how they value companies. Investors should not only seek information from companies, but should also be ready to listen to the opinions and views of companies.

Dialogue and engagement is desirable only to the extent that it promotes the mid/long-term creation of corporate value and to help drive sustainable growth. To this end, institutional investors should prepare so that they have a deep understanding of the portfolio company and its surrounding business environment, and should not simply resort to narrow discussions of earnings numbers. Investors should instead be prepared for purposeful dialogue on a range of issues they can constructively discuss with companies, including issues such as governance, business strategy, earnings, capital policy, and risk management.

In conducting dialogue, discussion should not focus solely on earnings but should also extend to the balance sheet and cash flows, all from a long-term perspective. It is very important that dialogue also includes capital efficiency issues, including the cost of capital and the use of retained earnings. It is especially important that company management clearly communicate their perspectives on these matters to investors.

Another important issue for dialogue and engagement is non-financial matters such as ESG issues. There is great meaning in striving to attain mutual understanding with respect to these matters as it will help to resolve any perception gaps that may exist between companies and investors with respect to corporate value.

Understanding and Attitude that Companies Must Have towards Dialogue

Companies must ensure that any knowledge and information obtained through dialogue with investors is appropriately shared within management teams and taken advantage of in actual operations to enhance corporate value. Also, as one basis for investor dialogue, it would be beneficial for companies to prepare and use integrated reports as a means of expressing their business models and long-term visions to investors.

Companies should also recognize that the quality of dialogue they have with investors will impact their cost of capital, given that a company's cost of capital is a manifestation of elements such as trust, expectation, and accountability (financial and non-financial). Therefore, successful dialogue can result in investors obtaining a deeper understanding of the company, which in turn will contribute towards a lower cost of capital.

Although traditional IR activities emphasized communication with sell-side analysts from the perspective of fair and broad information dissemination, going forward it will be important to have direct dialogue with institutional investors, including buy-side analysts and portfolio managers. If companies move ahead with this type of direct dialogue, then unlike dealing indiscriminately with all investors, they can establish mid/long-term relationships with investors that possess a deep understanding and appreciation towards their management policies. If this type of relationship can be developed, then it becomes important for companies to deeply analyze their investor base in order to determine which investors with whom they should engage.

Understanding and Attitude that Institutional Investors Must Have towards Dialogue

Dialogue and engagement is desirable provided that it encourages mutual stimulation between companies and investors which results in promoting sustainable corporate value creation. Institutional investors should make adequate preparations to gain a deep understanding of portfolio companies and their business environment. Furthermore, investors should approach engagement with purposeful dialogue focused on business themes or topics in a constructive manner without excessively interfering in details of day-to-day corporate management/operations. While traditional IR meetings comprised of companies providing one-way explanations followed by Q&A sessions, going forward companies and investors should share thoughts and emphasize bi-directional dialogue. In order for this to happen, investors must realize their responsibility to represent the voice of the capital markets and the common interest of all shareholders.

In order for institutional investors to have dialogue with companies on the issue of corporate value, investors must have an appropriate investment valuation method that allows for long-term investment. It is important that investors clearly explain this valuation method to both companies and to asset owners. There is no possibility for genuine dialogue with investors who only invest based on short-term earnings estimates.

In order to conduct meaningful dialogue with companies and to strengthen the capabilities of institutional investors to this end, a platform should be established in which institutional investors can share knowledge and experiences with respect to dialogue. The mere establishment of such a platform should not be taken as the end goal, and rather importance should be placed on the continuous use of such forum to discuss and debate what constitutes meaningful dialogue and engagement. For example, issues of discussion should include who within a company investors should engage with, how deeply engagement should be conducted, and what kinds of issues should be the focus of the dialogue.

Providing an Opportunity to Enhance the Understanding and Involvement of Management and Directors

In addition to the content of dialogue and engagement, it is important to be conscious of "who" you are engaging with and "where" this takes place. With respect to topics such as company strategy and governance, it is useful to have dialogue and engagement with top management such as the CEO or board directors. It is also important to consider other forums for dialogue such as shareholder meetings and analyst meetings.

Given their aspect of representing shareholders, it is important for external directors to seek dialogue with shareholders, such as participating in IR activities and in investor engagement and stating their views within company annual reports.

Consideration of a "Corporate Governance Code" from the Perspective of Promoting Dialogue

As mentioned earlier, Japan's Stewardship Code asks institutional investors to improve and refine their dialogue with companies and methods for evaluating corporate value. At the same time, it presents an opportunity for companies to understand the importance of having dialogue with investors, and reviewing their organizations and management styles in light of aiming towards better dialogue. In order to further promote this process, Japan should consider the introduction of a "Corporate Governance Code" by first examining those that exist in other countries and carefully studying their purpose, content, establishment, and execution.

Reviewing the Process of Annual Shareholder Meetings as an Opportunity for Dialogue

It is important to enhance the processes for annual shareholder meetings as a place where companies can have dialogue with shareholders as well as satisfy their explanatory obligations. Companies should consider revising elements such as the date of the annual shareholder meeting, the record date, and the length of the associated notice period in light of global standards, as there exists strong investor demand for these to be reconsidered. In addition to rationalizing the disclosure framework for shareholders, companies should also evaluate effective means of having dialogue and engagement with shareholders prior to annual shareholder meetings.

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