

**Ito Review
of
Competitiveness and Incentives for
Sustainable Growth
– Building Favorable Relationships between Companies
and Investors–**

Final Report

August 2014

Fundamental Concerns and Messages	1
Executive Summary	13
Project members.....	33
1 Sustainable Growth and Corporate Value Creation.....	37
2 Characteristics of Sustainable Growth.....	42
3 ROE, Cost of Capital, and Stewardship of Capital	50
4 Management Systems and Incentives	66
5 Promotion of Mid/Long-Term Investment	73
6 Incentive Structures of Asset Managers.....	83
7 Challenges of Asset Owners.....	85
8 The Role and Incentives of Sell-Side Analysts.....	87
9 Short-Termism of Investors	92
10 Short-Termism of Management.....	98
11 Corporate Disclosure for Sustainable Growth	101
12 Dialogue and Engagement.....	109
 Reference Material	
1 Dates and Topics of Meetings	126
2 Providers of Evidence, Information, and/or Opinions	129

Fundamental Concerns and Messages

1. Fundamental Concerns and Hypotheses

Paradox – The World’s Most Innovative, Continuously Low-Profitable Country

Which country is the most innovative or has the greatest capacity to innovate? Although there are a variety of views on this issue offered by experts and statistical research, there is no doubt that Japan is one of the strongest contenders.



Kunio ITO
(Professor, Graduate School of Commerce and Management, Hitotsubashi University)

How is corporate profitability in this “most innovative” country? Based on typical measures of profitability, such as return on total assets (ROA) and return on sales (ROS), Japanese companies appear to be only half as profitable as their US and European counterparts, and this trend has continued for two decades. These “most innovative” Japanese companies have fallen into a paradox of continuously low profitability. Japan is the only country to shoulder a paradox so difficult to resolve, and it must confront this problem if it is to identify a path towards sustainable growth. This serves as the starting point of this project.

If mid/long-term investments in Japanese companies only produce low returns, then rational investors will focus more on profit opportunities from short-term investments. While there are various causes for the widely debated short-termism of markets, one hypothesis is that the short-termism of the Japanese stock market might largely be driven by investment opportunities tending towards the shorter term.

Limits of “Double Standard” Management and Concerns about “Japanese-Style Short-Term” Management

There is a view that until the 1980’s, during which Japanese companies were performing well, a “double standard” management style was practiced in which many management teams would manage the company under a long-term perspective, while on the other hand making profitability commitments to short-term oriented capital markets. This

management style is believed to have made long-term investments towards innovation possible.

However, this old “double standard” management started being perceived as problematic from the mid 1990’s. While management of many Japanese companies started to use ROE and EVA in their investor communication, metrics that the capital markets believe to be important, such metrics were not mentioned within the company and other metrics were used to actually manage the business. In other words, there was a strong tendency for management to use two different sets of language (i.e. management metrics) in their communications.

Unlike until the 1980’s, starting in the 1990’s the growth and profitability of Japanese companies dramatically declined and the markets started seeing through this “double standard.” Furthermore, while Japanese companies regularly disclose mid-term business plans, the actual rate of achievement of these plans is extremely low. One reason behind this may be a fundamental deterioration of Japanese managements’ ability to operate businesses, but it is also a result of management operating towards a different set of goals from those disclosed to the capital markets.

Ever since the late 1990’s this “double standard” management can be seen as a reason for the absence of or a lack of attention towards enhancing capital efficiency and growing corporate value. In addition, the tenure for CEOs of many Japanese companies tends to be relatively short (4 to 6 years) and is fixed irrespective of performance.

It has often been asserted that Japanese management, in comparison to their US and European counterparts, are not distracted by the short-term fluctuations of capital markets and operate their businesses with a long-term perspective. Large and continuous spending on R&D and capital investment, long-term employment practices, and investments in personnel training have all been cited as evidence of this. However, 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. There is also a hypothesis that the continuously low profitability of Japanese companies is a result of Japan’s short-term management style, which would be in contrast to that of US and European counterparts.

If management becomes short-term oriented it becomes difficult to make investments to support long-term innovation. In order to promote innovation, which is a fundamental driver of long-term competitiveness, the Japanese capital markets will require an inflow of long-term capital. If Japan cannot attract this long-term capital, the deterioration in the long-term competitiveness of Japanese companies becomes inevitable. What must be done

to avoid such a vicious cycle? This is the first fundamental concern of this project.

Japan as an “Under-Developed Asset Management Nation” Lacking Long-Term Investors

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.

Japanese companies have traditionally relied on bank financing as a source for capital, and this has influenced corporate governance. On the other hand, while the percentage of corporate ownership by non-Japanese investors has increased to 30% and that by domestic institutional investors has increased to 25%, corporate ownership by banks has fallen to under 5%. This change in share ownership structure is beginning to drive a change in the way Japanese companies are managed.

Relative to the US and Europe, Japanese households have a higher portion of their financial assets in cash and deposits and a lower portion in equities and investment trusts/ mutual funds. This has been the tendency over a long period of time, and shows Japan lagging behind other advanced industrialized countries with respect to well-balanced asset formation. The proportion of investments in Japanese equities by Japanese investment trusts and pension funds is also low, and in particular, the proportion of investments in Japanese equities by Japanese corporate pension funds is rapidly decreasing.

This reliance on bank financing and the historical tendency of household financial assets to be concentrated in cash and bank deposits are cited as reasons why Japan’s capital market lacks breadth. In addition to the problem of capital market short-termism, the lack of expertise of asset owners (e.g. pension funds), excessive focus on passive index benchmarking, the lack of independent asset managers, a decrease in the quality of sell-side analysts, and underdeveloped personnel evaluation structures are cited as problems for Japan. The ability of capital market participants (in particular, Japanese institutional investors) to assess long-term corporate value and make investments that generate returns for their clients, including ultimate beneficiaries, has come under question.

As an advanced country facing a continued trade deficit, recent current account deficits, and a declining population, Japan must transform itself into an “asset management nation” focused on deriving returns from long-term investments. In order to accomplish this, having untangled the various hypotheses, anecdotes and myths that surround these issues, Japan must explore positive solutions.

A Vicious Cycle Caused by Insufficient Dialogue between Companies and Investors

The key to increasing long-term corporate value and driving sustainable growth is to create a virtuous cycle in which innovation drives strong profitability and capital efficiency, which in turn attracts support and long-term capital from investors that can be used to drive further innovation.

Corporate management faces two major markets – the consumer market and the capital market – and must strive to raise competitiveness through working symbiotically with both markets. Japanese companies, having dealt with 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 with the capital markets? Have companies adopted the same attitude towards investors as they have towards consumers? Have companies been fostered and nurtured by investors, as they have been by consumers? Corporate value is created through an in-depth dialogue with the market and by strengthening competitiveness in each respective market. This is the third concern addressed in this project.

The absence (or poor quality) of dialogue between companies and investors is the source of large perception gaps. Management voices concerns that investors overly focus on short-term results and show little interest in mid/long-term operations, and seek change (i.e., surprises) rather than stability. On the other hand, investors criticize companies for not integrating profitability measures such as ROE and EV into business management, for continuously failing to deliver on mid-term plans, and for not adopting externally monitored governance structures. With respect to information disclosure, companies are concerned that investors simply chase short-term numbers such as quarterly earnings, show no interest towards non-financial data (vision, innovation, CSR, etc.), and do not help companies to understand the type of information that they as investors seek in order to make long-term investment decisions. On the other hand, investors complain that companies only disclose compliance information as per disclosure requirements and do not provide truly desired information that would be useful in assessing long-term corporate value.

A vicious cycle exists here as well. While one anecdotal view is that capital market short-termism induces short-term company management, another hypothesis is that company communication, assuming the short-term nature of the market, is causing the short-term behavior of investors.

Ever since the global financial crisis, there has been global exploration of ways to overcome company and investor short-termism and promote dialogue and disclosure that will support long-term corporate value creation. Based on the recommendations of the Kay Review, in the UK there have been debates about the stewardship responsibilities of institutional investors and the need for dialogue and engagement with companies. There have also been discussions of “integrated reporting” as a means of communicating the long-term value creation proposition of companies.

What are the challenges facing dialogue between companies and investors in Japan? The establishment of Japan’s Stewardship Code should be recognized as an advancement. This project will address issues such as what constitutes high-quality dialogue that contributes to sustainable growth of companies, and whether there are any problems with the current disclosure framework from the perspective of promoting mid/long-term communication between companies and investors.

Capital Efficiency and Corporate Value Creation Key to Building and Maintaining National Wealth

Although macro-economic indicators have shown improvement, a similar improvement in company fundamentals – such as profitability and capital efficiency – is necessary for Japan to be on a sustainable growth trajectory. If every company approaches business decisions from the perspective of corporate value and strives to continually add value, then this will ultimately serve as the source of value creation for the Japanese economy as a whole.

An even more critical perspective is building and maintaining Japan’s national wealth. Japan faces a rapidly aging and declining population and a decreasing stock of labor and household financial assets. Japan has no room to waste its limited resources and capital. Japan must effectively leverage the resources it has such as “financial capital” raised both domestically and overseas; “human capital” supporting management and operations; “intellectual capital” which is the source of innovation; “social/relationship capital” stemming from supply chains and social norms; and “natural capital” such as the environment. In other words, increasing capital efficiency in the broadest sense is crucial from the perspective of Japan’s survival.

Japanese companies – as a critical source of value creation – must strive to increase capital efficiency through their dialogue with investors, and contribute to the accumulation of a broad range of capital stock that will serve as the foundation for future economic prosperity.

2. Fundamental Messages

Departing from Practices and Legacies that Impede Sustainable Growth

From the perspective of the goals and fundamental concerns discussed above, company executives, long-term investors, securities analysts, market participants, and scholars gathered in this project to discuss and debate the variety of issues actually confronting Japanese businesses. All discussions have been made fully open and transparent to solicit input and evidence from around the globe.

The main goal of this project is to lay out a scenario to underpin the change necessary for Japan to achieve sustainable growth. This is done by objectively and rationally considering critical issues pertaining to the sustainable growth of Japanese companies and the inter-linked capital markets, and avoiding impressionistic and anecdotal debates. Furthermore, various issues and theories being debated across the globe are also considered in light of Japan's specific circumstances.

Japan has been recognized and praised for the prosperity it has achieved since its devastation in the Second World War. At the same time, however, it is a reality that Japan has faced various challenges in the past 10-20 years. Assessing Japan's capital markets and company management in light of global perspectives, rationally identifying weaknesses and limitations, and suggesting a path to overcome these will contribute to the Growth Strategy being put forth by the Abe Administration. It is time to overcome – with courage – those legacies and practices that serve as impediments to sustainable growth and re-energize Japan.

Becoming a “Model Nation-State” in the Simultaneous Realization of Innovation and High Profitability

Despite Japan having a strong capacity to innovate during the past quarter century, it has exhibited continuously low profitability. This paradox is unique to Japan. Innovation is the engine that drives economic and industrial growth not only for Japan but for the entire world. Innovation requires mid/long-term business management. If business management is indeed tending towards short-termism, then growth opportunities will be compromised as the seeds of innovation will not be sowed. If innovation does not produce strong financial results, then the capital inflow necessary to drive further innovation will be blocked. Japan must aspire to become a model nation-state in which both high levels of innovation and strong profitability (earning power) are simultaneously realized. This is a major challenge and hope that Japan carries into the 21st century. Japan's main task in achieving

sustainable growth within the global economy is to visibly demonstrate the results of innovation while not falling prey to short-term business management. Several key reforms are necessary in order to achieve this.

Sustainable Value Creation through “Collaborative Creation” by Companies and Investors

Sustainable value creation is achieved through “collaborative creation” by companies and investors. Corporate value is not created through the isolated efforts of a company itself. While value cannot be created without the persistent efforts of a company, any and all creation of value is difficult in the absence of continued support from investors.

A stock company is an economic entity in which the existence of shareholders – who receive “shares” in return for the capital they provide – is absolutely critical. Stated differently, a company provides shares as a “product” to capital market participants in order to source capital. However, shares as a product differ from the other products that a company produces and sells through its business activities. A typical product of a company carries some form of guarantee, in that if a defect or problem is identified within a predefined period of time, then the company will typically repair or replace the product for free. In contrast, shares as a product not only have no guarantee but also carry a clear risk. Despite this fact, investors choose to purchase such shares, and their incentive to do so is an expectation of return.

If this expectation is betrayed, then investors may express their “voice” of disappointment and frustration at shareholder meetings or may dispose (exit) their shares in the capital markets. A company therefore constantly faces both the “expectation” and “disappointment” of shareholders. A company’s cost of capital can thus be thought of as the minimum dividing point between such expectation and disappointment.

How genuinely have Japanese companies confronted this concept of cost of capital? Investors inevitably expect a return in excess of the cost of capital. While there exist a variety of measures to assess profitability, shareholders are predominantly interested in how the capital they have supplied is being efficiently deployed toward business activities and what results are being generated. Return on equity (ROE) is a globally accepted measure of these business results.

Towards a Capital Efficiency Revolution in which ROE Exceeds the Cost of Capital

Despite a slight recovery during the past year, for an extended period of time the average

ROE for Japanese companies has been below 5%, despite their cost of capital being far in excess of this level. This demonstrates the very low capital efficiency of Japanese companies, and can be taken as a structural problem. As a pillar of any capitalist economy, a stock company can generate corporate value and sustainable growth only if it is achieving a ROE in excess of its cost of capital over the mid/long-term. The capital markets will naturally eliminate companies that fail to do so. A key tenet of capitalism is to maximize capital efficiency while carefully considering labor's share of income. 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%. Needless to say, this 8% ROE is a minimum level and companies should seek to generate higher ROEs.

While achieving a higher ROE is the responsibility of company management, they should work to decompose ROE into accessible operational metrics that support a high level of motivation at the working level of the company. Raising ROE while maintaining a highly-motivated workforce is an appropriate and positive approach for Japanese companies, and can be called "Japanese-style ROE management."

New shareholders acquiring a company's shares and existing shareholders retaining their shares is evidence that the aforementioned "expectation" in absence of any guarantee is being met, and can be taken as shareholders supporting the company. Japanese companies must recognize the support they are receiving from shareholders, and strive to meet these shareholder expectations.

Let us consider the large retained earnings and the associated build-up of cash of Japanese companies in this context. As long as a company employs a dividend payout ratio below 100%, the growth of retained earnings is inevitable. Profits that are not paid out as dividends become retained earnings, and this should be perceived as an implicit agreement being made between companies and shareholders. In other words, shareholders hold the expectation that retained earnings will serve as a source of additional returns in excess of the cost of capital. Therefore, retained earnings are a manifestation of such expectations and also serve as a litmus test of management's ability to deliver on these expectations by generating returns higher than the cost of capital.

As discussed above, since shareholders carry no guarantee on their shares, they have the incentive to monitor on an on-going basis whether the company is meeting their return expectations. This monitoring constitutes corporate governance in action, underpinned by corporate disclosure. In this sense, corporate governance is at the core of any stock company and more broadly of capitalism itself. Improved corporate governance is such an urgent issue for Japan that it has been included in the Japanese government's growth strategy.

Corporate governance is founded on a balance between internal and external control, with the basic principle being that company management with their superior understanding of internal company dynamics will take the lead in establishing an appropriate control structure. However, it is problematic if authority is concentrated in an internally-selected CEO and for other internal directors to be unable to provide checks and balances. Japan faces a corporate governance challenge in that there is an insufficient supply of CFOs who can objectively assess a company's financial position and be a source of checks and balances. Japan must focus on developing a supply of professional CFOs.

Supplementing this internal management discipline is the external perspective offered by external directors. It can be said that Japanese companies have many implicit means of discipline, such as many companies having an implicit 4~6 year term for CEOs. While this practice may have prevented any CEO from serving excessively long terms, the continuously low profitability of Japanese companies is testimony to the limitations of this self-devised discipline. A new form of corporate governance taking into account the external controls offered by external directors is needed.

Becoming a “Dialogue-Rich Country” that Pursues High-Quality Dialogue between Companies and Investors

If sustainable corporate value creation is to be realized through the “collaborative creation” of companies and investors, then both sides must forgo any preconceived notions, prejudices, and apprehensions, and work to build a relationship of mutual trust. Purposeful and high-quality “dialogue and engagement” between company management and investors is essential to create this trust.

In recent years Japanese companies have increased their investor relation activities, and there are a growing number of Japanese companies whose management visit overseas investors to explain earnings. Despite this, there is still room to improve. As previously explained, while on the one hand company management may commit to earnings targets for investors, not all of these managements manage internal operations in alignment with these commitments and may use a different set of management targets within the company. As a start, companies must cleanly depart from this “double standard” management. Admittedly, this type of “double standard” management might have emerged as a means for company management to elude the short-termism of the capital markets and manage their businesses from a mid/long-term perspective. Nonetheless, this management style is not accepted nor acceptable within the global economy. Ensuring that commitments made externally towards investors are aligned with the internal management of business operations is at the heart of skilled management.

Dialogue is useful in resolving gaps and misunderstandings between company management and investors. Traditional IR activities involved the unilateral questioning by investors, with management simply providing responses to inquiries, and this has been the source of frustration on both sides. Dialogue is something entirely different from this traditional form of communication and must be bilateral in nature. It involves sharing a common goal, listening carefully, deeply understanding the thoughts and circumstances of the other party, making direct proposals if believed that they will contribute towards the enhancement of corporate value, and flexibly engaging in reciprocal communication. Key issues believed to be critical to engagement are further described in the main body of this report.

The Japan's Stewardship Code established in February of this year is expected to incentivize institutional investors to engage in such dialogue. Institutional investors bear explanatory responsibility towards asset owners (who supply capital), and will have to explain how they partake in dialogue. This is similar to how company management bear explanatory responsibility towards shareholders, and hence it is important to note that both parties share in this responsibility.

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 do so, existing disclosure practices must be carefully reconsidered. As part of this effort, "integrated reporting" is an important theme to be considered, as it can provide critical material for dialogue and engagement and help provide an explanatory roadmap for corporate value creation for investors. Given that integrated reporting is still a relatively new initiative even at the global level, Japan should aspire to become global best practice in this area and contribute creative solutions to this global effort. This would attract mid/long-term capital investment into Japan.

While seeking new and improved forms of disclosure from the mid/long-term perspective, attention must also be given to the adverse effects of existing information disclosure practices. Although quarterly earnings disclosures and earnings forecasts are conducted under the rubric of timely disclosure, these disclosures can trigger excessive reactions by certain kinds of investors, which in turn leads to excessive responses by company management. As this process can lead to short-termism, it is important for both companies and investors to not be overly fixated on short-term results and to focus on the mid/long-term.

Although it is important for dialogue and engagement to be carried out by Japanese companies, it is also vital to understand Japan's current state of dialogue and engagement in order to seek potential improvements. One proposal is to establish a "Management

Investor Forum (MIF)” that can serve as a forum to conduct this exploration. While specific member selection criteria need to be carefully thought out, the hope is that this institution will provide for periodic face-to-face interaction between company management and investors and serve as a forum to discuss and enhance dialogue and engagement.

Reforming and Optimizing the “Investment Chain”

The long period of low profitability of Japanese companies has exposed various problems in Japan’s investment chain – i.e. the various paths and processes of capital flowing from its providers down to where companies deploy it towards business activities. National wealth formation, deep and dynamic capital markets, and sustainable corporate value creation all have their foundation in the various players within the investment chain behaving in a sophisticated and efficient manner towards value creation. Any problem along this investment chain leads to a deceleration of activity and ultimately results in value destruction.

The long period of low profitability of Japanese companies has hindered corporate value creation, and as a result Japan’s capital markets have suffered from long-term stagnation. Given such an environment, it can be understood that one form of rational behavior was to maximize capital gains through short-term transactions. Passive investing, such as index benchmarking, was another form of rational behavior under this environment.

Such investment behavior has resulted in several side-effects, such as the short-termism of markets and the decline of fundamental research in the process of investment selection. In other words, asset managers’ demand towards deep analytical research deteriorated, which in turn led to the dis-incentivization of the analyst community to conduct deep analytical work.

It is expected that the proposed measures in this report will help to mitigate short-termism in the capital markets and promote mid/long-term investments. However, it is important that this be augmented with reforms in the incentive structures for asset managers and securities analysts. There is room to reconsider asset manager compensation schemes that excessively focus on short-term (e.g. quarterly) performance results. Similarly, given that strong analytical capabilities of the analyst community are essential for healthy capital markets, the incentive and compensation structures for analysts must also be reviewed.

Individual investors deserve focus as a source of mid/long-term capital in the 21st century. If Japan’s globally unparalleled JPY 800 trillion of Japanese household savings are deployed towards companies, then the investment chain would become much more robust. If individual investors – both those who invest through asset managers and those that

invest directly – can achieve stronger analytical capabilities and show keener eyes towards monitoring corporate activity and investment performance, then the quality of the investment chain would dramatically rise. As such, the individual investor community has the potential to become a massive “supporting community” of the mid/long-term corporate value creation process.

Reforming and optimizing Japan’s investment chain will lead to greater national wealth in the 21st century. The time has come for courage and unending effort to reform Japan.

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 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.

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.

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.

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) 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.

Project members

Committee Chair

Kunio ITO Professor, Graduate School of Commerce and Management,
Hitotsubashi University

Members

Tetsuo KITAGAWA Professor, Graduate School of International Management,
Aoyama Gakuin University

Ryoichi ARAI Lecturer Aoyama Business School

Junichi HAYASHI Researcher, Aoyama Gakuin International Management
Frontier Research Center, Aoyama Gakuin University

Shinichiro NEI Lead Executive Officer, Management Strategy (Overseas Offices),
ASAHI KASEI CORPORATION

Yasumasa MASUDA Senior Vice President, and Chief Financial Officer, Astellas
Pharma Inc.

Hajime YASUI Aarata Institute Leader, PricewaterhouseCoopers Aarata

Scott CALLON Chief Executive Officer, Partner, Ichigo Asset Management, Ltd.

Kenichiro YOSHIDA Senior Advisor, Ichigo Asset Management, Ltd.

Ryohei YANAGI Deputy CFO & Chief IR Officer Eisai Co., Ltd.
Visiting Lecture of Waseda Graduate School

Yoshiaki KANZAKI Senior Operating Officer, Otsuka Pharmaceutical Co., Ltd.

Satoshi ANDO Executive Officer, Investor Relations Headquarters, OMRON
Corporation

Toshiaki OGUCHI Representative Director, Governance for Owners Japan KK

Taku YAMAMOTO Director of Equity Investment, Pension Investment Department,
PENSION FUND ASSOCIATION

Ken SHIBUSAWA Chairman, Commons Asset Management, Inc.

Atsuto SAWAKAMI Chairman & Founder, Sawakami Asset Management Inc.

Ryusuke OHORI Managing Director, Chief Investment Officer, JPMorgan Asset
Management (Japan) Ltd.

Naomi YAMAZAKI	Representative Director, ESG Network of Shareholders and Companies
Iseo MAEDA	Senior Manager, Investor Relations Department SHISEIDO CO., LTD.
Kenji HASEGAWA	Head of Corporate Affairs Department, Legal Division. Nippon Steel & Sumitomo Metal Corporation
Kunio NOZAKI	Managing Executive Officer, SUMITOMO CHEMICAL CO., LTD.
Tsuyoshi KOBAYASHI	Director, Executive Officer, Corporate Planning Dept., SEVEN&i HLDGS. Co., Ltd.
Yoshinori HASHITANI	VP, Corporate Executive Office and Head of Corporate Workplace Solutions, Sony Corporation
Shigemichi KONDO	Senior Director, IR Group, Corporate Communications Department, DAIICHI SANKYO CO., LTD.
Katsuya KIKUCHI	Chief Analyst, Research Department, Daiwa Asset Management Co., Ltd.
Takatoshi YAMAMOTO	Corporate Auditor, FUJI HEAVY INDUSTRIES LTD. Audit & Supervisory Board Member, TOKYO ELECTRON LIMITED
Akiyoshi OBA	President & CEO, TOKIO MARINE ASSET MANAGEMENT CO., LTD.
Masashi OBA	Member of the Board, Senior Managing Director, Chief Financial Officer, Tokio Marine Holdings, Inc.
Satoshi MIYAZAKI	Senior Executive Officer, General Manager, Management Planning Div., TOTO LTD.
Takuo SASAKI,	Managing Officer, Toyota Motor Corporation Chief Officer, Accounting Group
Akira UCHIDA	Senior Vice President (Member of the Board), Chief Investor Relations Officer, Chief Social Responsibility Officer, Toray Industries, Inc. Head Office
Naoyuki KAINUMA	Department Manager, Investor Relations Department Corporate Communications Division, Don Quijote Holdings Co., Ltd.

Joji TAGAWA	Corporate Vice President, Investor Relations and M&A, NISSAN MOTOR CO.,LTD.
Toru TAKEUCHI	Board Member, Vice President & CFO, Director, Corporate Accounting Div., Corporate Sector, NITTO DENKO CORPORATION
Shinya TSUJIMOTO	Chief Executive Officer, Nippon Life Global Investors Singapore Limited
Isamu KAWASHIMA	Associate Senior Vice President, CFO, Member of the Board, NEC Corporation
Ryoko UEDA	Senior Research Fellow, Japan Investor Relations and Investor Support, Inc.
Yukio SUZUKI	CEO Chief Analyst, Belle Investment Research of Japan Inc.
Masahiko IGATA	Senior Managing Director, Nomura Institute of Capital Markets Research
Sadakazu OSAKI	Head of Research, Center for Strategic Management & Innovation, Nomura Research Institute,Ltd.
Atsushi SEKI	Vice President, Research, Barclays Securities Japan Limited
Tetsuyuki KAGAYA	Associate Professor, Graduate School of Commerce, Hitotsubashi University
Shoichi TSUMURAYA	Associate Professor, Graduate School of Commerce and Management, Hitotsubashi University
Mikiharu NOMA	Associate Professor, Graduate School of International Corporate Strategy, Hitotsubashi University
Hiroki SAMPEI	Director of Research, Fidelity Worldwide Investment
Akitsugu ERA	Head of Corporate Governance, Investment Division, Vice President, BlackRock Japan Co., Ltd.
Shuma UCHINO	Executive Vice President , Chief Financial Officer, Mitsubishi Corporation
Hiroaki TOYA	General Manager, LIM Global Advisors Ltd.
Motoyuki YUFU	Director,Corporate Accounting and Disclosure Division, Financial Services Agency (FSA)
Ryouta YASUI	Director, Listing Department, TOKYO STOCK EXCHANGE, INC.
Yoshiko SATO	Secretary General, Chief Research Fellow, Japan Investor Relations Association

Takuya FUKUMOTO Director, Corporate Accounting, Disclosure and CSR Policy
Office,
Economic and Industrial Policy Bureau, Ministry of Economy,
Trade and Industry

Takao HIROSAWA President, Business Policy Forum, Japan

1 Sustainable Growth and Corporate Value Creation

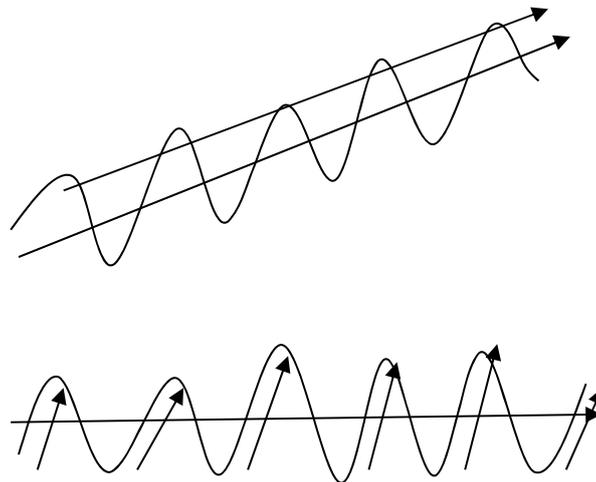
1.1 [Discussion Point]

What is “sustainable growth”? How should we interpret it in the context of the relationship between companies and investors?

[Discussion and Evidence]

- 01 Sustainable growth means a continued increase of corporate value over the mid/long-term.
- 02 Sustainable growth can be depicted as a continued increase of a company’s fundamental earnings or economic value over the mid/long-term, despite any short-term fluctuations. (See the upper chart below)

<Chart 1: Depiction of Sustainable Growth>



- 03 For investors, companies eligible for long-term investment are those expected to generate returns above their cost of capital over the long-term.

[Proposal/Recommendation]

- 04 As mentioned above, sustainable growth means a continued increase of corporate value over the mid/long-term. This can be realized by achieving performance above the cost of capital over the mid/long-term. Investors can make long-term investments in companies when they can expect such value creation.
- 05 Investors who desire sustainable growth expect portfolio companies to retain all or part of net income, and to re-invest it in order to support sustainable growth. In this regard, shareholders both seek and support the sustainable growth of companies. Sustainable growth, therefore, should be seen as the result of cooperation between companies and

shareholders. Management should recognize that shareholders are supportive of sustainable growth. If retained earnings cannot be effectively re-invested to drive growth, companies should consider returning this capital through means such as dividend payouts and share buybacks.

1.2[Discussion Point]

What is “corporate value”? There appears to be various definitions of “corporate value” and a considerable perception gap between companies and investors.

[Discussion and Evidence]

Defining “Corporate Value”

- 01 There are diverse views with respect to the definition of “corporate value”. Companies and investors often use the term in different contexts and/or time horizons.
- 02 Companies and investors (i.e. investment community at large) agree with the thesis that corporate value should be increased over the mid/long-term. However, there appear to be divergent views on how the term “corporate value” is defined and interpreted. Such difference in views can exist among companies, and also within the investor and analyst community. These perception gaps hinder effective dialogue between companies and investors.
- 03 How does one assess the value created by a company? It is often the case that shareholder value and economic value is associated with market capitalization and discounted cash flow (DCF) of future earnings. Companies that achieve returns greater than their cost of capital over the mid/long-term are typically regarded as value-creating companies.
- 04 On the other hand, some define corporate value more broadly, claiming that it is comprised of value for each stakeholder group including shareholders, customers, employees, business partners, and the community. In this view, corporate value can be defined as the sum of these respective values.
- 05 Regarding the point above, it was noted that sustainable growth has both a financial (share) angle and a management angle. The financial angle focuses on a company’s ability to generate cash flows over the mid/long-term, whereas the management angle recognizes broad management abilities including responding to societal demands. A global investor also noted that sustainable value creation is closely related to a company’s impact on the environment and society at large.

Two Divergent Views

- 06 There are two divergent views with regard to the relationship between corporate value, especially shareholder value and other stakeholder value. One view focuses on value distribution and contribution to society (“Working for the benefit of society”), while the

other view focuses on value creation and social responsibility (“Benefits of socially responsible behavior”). The first view examines the value distributed to each respective stakeholder in isolation. For example, this view would consider things such as inventory levels necessary to adequately supply goods to business partners (business partner value), the provision of high quality and reasonably priced goods and services for customers (customer value), the stability of employment necessary to support the livelihood of employees and their families (employee value), and shareholder returns (shareholder value); each in isolation. Therefore, this view regards corporate value as the sum of distributed stakeholder value, i.e., shareholder value (market capitalization or discounted cash flow) plus the aggregate of other stakeholder value.

- 07 The second view states that enhancing overall stakeholder value will ultimately increase shareholder value through improved profitability and financial competitiveness. For example, building trusted relationships with business partners helps to enhance pricing power; providing high-quality products and services to customers enhances profitability and competitiveness; and providing stable employment helps to secure a talented workforce; all of these therefore contributing to the overall profitability and competitiveness of the company.

The meaning of shares, shareholders, and public listings

- 08 On this point, the meaning of shares and shareholders from the view point of companies was raised. Fundamentally, shares are the source of capital that a company needs to grow its business, and in addition to the capital raised at the time of establishment a company raises additional capital through share issuance. Shareholders supplying new capital do not assign a specific tenure to their capital nor do they request for a specific interest payment. Rather, shareholders benefit from the appreciation of share value by the company growing its business and profits and having greater capacity to make dividend payments. Companies with a stronger capital base are able to borrow from banks and can receive credit for their payables thus making it easier to manage cash flow. Shares are thus the source of creditworthiness and of growth, and are long-term risk money. Therefore, shares are the basic economic foundation for any company.
- 09 From this perspective, shareholders can be said to be supporters of a company in that they provide companies with capital necessary for growth and creditworthiness – with no specific tenure nor interest payment conditions. While shareholders participating in the primary markets may have a strong sense of having capitalized the company, those participating in the secondary markets may not. However, as long as one is a shareholder, one effectively inherits the “supporter” role at a certain share price from the previous shareholder; and as long as a company services the expectations of shareholders as a going concern, this relationship persists.
- 10 The meaning and value of a company publicly listing its shares was also raised,

including the sourcing of risk money and the enhanced ability to carry out M&A to grow corporate value. Other elements of a public listing include clarification of a company's role as a public institution, disciplined and multi-faceted management through shareholder involvement, enhanced recognition of listed companies, and the use of employee stock programs and stock option plans. On the other hand, demerits of listing that were raised include management time being absorbed by shareholder dialogue (specifically those that do not contribute to corporate value enhancement), the need to comply with disclosure requirements, and the adverse effects of short-term share price fluctuations on management. As another example, if the debt markets are providing excess liquidity, then companies that can borrow money at low interest rates may make large-scale investments that are negative to short-term earnings. If there are large demerits to listing shares, then this can lead to a deterioration in competitive strength against unlisted companies, and therefore this must be considered from the perspective of sustainable growth.

- 11 On the other hand, from the perspective of shareholders, the shares that they acquire are part of their means for increasing their asset value, and investment performance is measured as the aggregate of share price appreciation and dividends. When explaining the theoretical value of a share using the dividend discount model, the basis for valuation is the company's cash flow generation capability underpinning sustainable dividend payments. From the perspective of asset allocation, equity investment falls within high-risk, high-return investing, which shows relatively strong performance in an inflationary environment in which cash and other low-risk products have a disadvantage.

[Proposal/Recommendation]

- 12 Although both companies and investors would agree with the thesis that corporate value should be improved over the mid/long-term, they hold divergent views with respect to the interpretation of "corporate value". There are different view as to the value-creating relationship between shareholders and other stakeholders. Efforts to bridge this gap should be made in order to achieve effective dialogue between companies, investors and analysts with the aim of collaborative value creation.
- 13 Companies face both the capital market as well as the customer (goods and services) market. While Japanese companies take great care of the customer market, they have been paying less attention to their relationship with investors, who are the main players within the capital market. Given that investors, especially global investors, focus on quantifiable corporate value (i.e. shareholder value), Japanese companies must pay more attention to the capital market and make further efforts to create shareholder value. In particular, companies must become conscious of their cost of capital and need to consistently generate returns in excess of their cost of capital. Japan's PBR, which is relatively low when compared globally, must also be raised.

- 14 Value creation can also be thought of as the maximization of value added. However, there exist two divergent views on the concept of “value added”. One is to think of value added as the aggregated sum of value distributed to various stakeholders. The other is to think of value added as any residual profit after 1) distributing value to stakeholders other than shareholders and 2) taking into account the cost of capital. In Japan it seems that the first view has been implicitly accepted in the market. While this first view should not be denied, greater emphasis should be placed on the second view, especially in light of Japanese companies needing greater support from investors globally.
- 15 When considering corporate value under the specific context of shareholder value (i.e. value added for shareholders), such value is reflected as “market capitalization” within the market mechanism. One should note that market capitalization can serve as currency by way of share exchange. Managing a company globally requires careful consideration of the effective use of market capitalization as a currency. In this regard, figures shown on financial statements are not the only source of a company’s financial strength and real money. Furthermore, the value of this currency can be amplified or shrunken by influencing the market’s perception (understanding and recognition) of companies through enhancing trust and expectation via proper communication.
16. However it is not appropriate to consider shareholder value in isolation. Creation of customer value, employee value, business partner value, or community value can also lead to the creation of shareholder value. It should be recognized that creating value for all stakeholders leads to the creation of shareholder value, which in turn, supports the long-term creation of corporate value.
- 17 ESG (environment, society and governance) is connected to the trustworthiness of companies. Corporate value can be regarded as the manifestation of the level of trust by stakeholders. Therefore activities to improve trust lead to corporate value creation. For instance, suppose a global clothing company is faced with a child labor issue at a factory in an emerging country. If it turns out that they are in breach of an international guideline, this would adversely affect their reputation and financial performance. The same would hold true if a company was partaking in unfair marketing activities. When evaluating the sustainable competitiveness of companies, investors should also focus on ESG activities of such companies.

2 Characteristics of Sustainable Growth

2.1 [Discussion Point]

What are the characteristics of companies that exhibit sustainable growth?

What are the underlying sources of their competitiveness?

[Discussion and Evidence]

Key Features of Value-Creating Companies

- 01 There are two benchmarks suggested by investors when assessing the competitiveness of companies with sustainable growth: 1) a dominant advantage (e.g. market share) within the market and 2) consistently high profitability.
- 02 As for profitability, of the 1,600 listed companies for which data was available, 200 of these companies displayed positive share returns (share price appreciation plus dividends) during a 20 year period of a lackluster equity market³. If one compares profitability across the globe, based on the level, stability, and improvement of cash flow return on investment (CFROI), even top tier Japanese companies lag behind peers in the US and EU, and there also exists disparity in performance among Japanese companies⁴.
- 03 Four common characteristics of companies exhibiting strong profitability and competitive advantage (sources for competitiveness) are: 1) the ability to provide value to customers; 2) selection and concentration to enable adequate positioning and the construction of a business portfolio; 3) continuous innovation, and 4) the ability to respond to changes in the environment and risks. These elements are recognized as important both by companies and investors.

Corporate Value Creation through Customer Creation

- 04 The underlying source for creation of corporate value is the creation of customers. The ability to offer differentiated goods and services and to keep providing value to customers is especially important.
- 05 When evaluating a company's ability to maintain its competitive advantage, investors focus on the creation of barriers of entry through differentiation, and sustained profitability achieved through pricing power.
- 06 Companies that continuously generate economic value conduct independent market

³ The research extracted companies which showed positive share return (including dividend) among companies that were both 1) listed on TSE (including OTC) at the end of 1989 and were 2) listed on the first section of TSE at the end of June 2013.

⁴ Since ROE is influenced by financial leverage, the research used cash flow return on investment (CFROI – ROI after adjustment of biases due to accounting standards) as the benchmark for capital efficiency focusing on business profitability. It compared companies with market capitalization of 500 million USD or more based on CFROI's 1) level (efficiency); 2) standard deviation (stability); and 3) improvement (rate of increase).

research and analysis beyond their immediate business partners and pursue differentiation with an awareness of potential market size and any limitations of their goods and services.

Optimization of Positioning and Business Portfolio

- 07 Companies that have improved their profitability over the long-term are those that have clarified their positioning in the value chain and have been recognized as indispensable. There are examples of companies that use the degree of their potential competitive advantage in a market as an important factor in making important corporate decisions.
- 08 In order to achieve sustainable growth it is imperative that companies optimize their business portfolio in response to changes of management environment and continually update the portfolio accordingly. The balance between withdrawal and upfront investment/new business expansion is especially important. There is an example of a major trading house that introduced an exit rule for businesses based on profitability and potential for growth.

Continuous Innovation

- 09 A company's viability as a going-concern heavily relies on the creation of new markets through innovation. Open innovation is an effective way to promote this. If a company has excellent technologies and strengths, it can partner/ally with other excellent companies. In this sense, companies must strive to cultivate their technologies and strengths.
- 10 Japanese companies have a certain tenacity that allows them to have a long-term perspective on business and not give up easily. As an example, a pharmaceutical company invested in R&D using revenues from other business lines, and was successful in developing a new medicine after 10 years. Another example of long-term R&D is carbon fiber. Some Japanese companies do not quickly withdraw from businesses that have been unprofitable in the short-term, and rather strive to keep such businesses and improve them.
- 11 On the other hand, investors pointed out that it is important for companies to explain, while recognizing any uncertainties, how such investments will contribute to the enhancement of corporate value over the mid/long-term.

Changes in Environment and Risks

- 12 In order to maintain continuous growth, adequate risk management is important when conducting business reform and business investments for the future.
- 13 Furthermore, an ability to promptly and appropriately respond to changes of business environment is required. Sustainable growth requires companies to make continuous changes by responding to changes in business environments, and not just keep doing

the same thing for a long time. One of the characteristics of vibrant, long-lived companies such as those listed in “100 Years-old companies”⁵ is that, just like biological evolution, they are highly adaptable to the environment and change their business areas innovatively and boldly. They fearlessly accept changes and proactively and efficiently respond to this by evolving their business, therefore achieving consistently good performance.

Management Capabilities That Strengthen Competitiveness

- 14 In order to effectively execute the aforementioned measures aimed at enhancing competitiveness and lead a company to success, there must be: 1) management leadership; 2) a management system (i.e. governance) supportive of goal achievement, and 3) management strategies and plans that consider capital efficiency.
- 15 Management leadership is a critical factor necessary to change a company’s business portfolio, including withdrawing from certain businesses.
- 16 Of the aforementioned 200 companies that achieved positive returns over the past 20 years, many of the top 10 companies were “founder-run companies”. There is research that suggests 35% of S&P 500 and 30% of Japanese listed companies are such founder-run companies. There is also research that suggests founder-run companies have managers with strong motivation and a long-term perspective, family values that adapt with changes in time, and a company culture in which monetary compensation is not the only critical element for employees⁶.
- 17 It was also noted that there are some progressive companies whose non-founder management conducts business innovation under the support and strong governance of the founding family.
- 18 On the other hand, the strengths of founder-run companies are often impressionistic. From the perspective of small/mid-cap investors, many of their target companies are founder-run, but given the dispersion in earnings and management capabilities between such companies, being founder-run alone is not enough to generate differences in valuation.
- 19 The two other important management capabilities – a management system (governance) and management strategies and plans focused on capital efficiency –are discussed later in this document.

[Proposal/Recommendation]

⁵ Teikoku Databank Historical Museum and Industry Research Department (eds.) “Conditions for Companies Which Survive 100 Years – Long-Lived Companies Are Not Afraid of Changes” (Asahi Shinsho) (in Japanese). Shoichi Kubota (Professor, Hosei University), “100 Year-old Companies – Tips for Survival” (Kadokawa SSC Shinsho) (in Japanese)

⁶ Research by Professor Yanagawa, University of Tokyo (March 18th, 2013 Nikkei Keizai Kyoshitsu) (in Japanese)

- 20 Open innovation is an important measure to create sustainable innovation given that it strategically integrates and unifies internal resources accumulated through long-term R&D with external knowledge and technologies. In order to achieve this, Japanese companies must depart with their “Do-It-Yourself” mentality and foster a corporate culture that actively promotes cooperation with other companies, governments, industry experts, and other academia.
- 21 Sustainable growth requires the ability to adapt to changes in environment. Management leadership is necessary in order not to fall into an innovation dilemma and to be able to innovatively change businesses. This is where founder-run companies have their advantage, but there are also non-founder-run companies successful at innovation. There might be lessons that can be learnt from such examples.

2.2 [Discussion Point]

In order to achieve sustainable growth it is important to flexibly adapt to changes in business environment and to take risks in order to drive innovation. Are Japanese companies making these efforts in practice?

[Discussion and Evidence]

- 01 Although many Japanese companies have continuously invested in R&D, does this mean that they take appropriate risk towards innovation and improving their competitiveness for the future? Does an increase in the cash and cash equivalents on the balance sheets of Japanese companies indicate a tendency to avoid risk? Here are some hypotheses presented on this matter.
 - 1) Influenced by a corporate governance system founded upon the “main bank system”, Japanese companies appear to have a tendency of selecting moderate risk and promote a safe course of direction as opposed to taking large risks. Part of this tendency is explained by such banks (as creditors) favoring activities that support a company’s ability to service debt as opposed to activities that might jeopardize a company’s ability to honor its debt obligations.⁷
 - 2) Japanese companies have adopted life-time employment for a long time. Under this employment system, management decisions tended toward the avoidance of large losses as opposed to pursuing high growth.
 - 3) For many Japanese companies the CEO’s term of office is 4~6 years⁸. The relatively short term of office may hinder a CEO’s ability to make long-term decisions with

⁷ Acharya et al. [2011] pointed out that stronger creditor rights in bankruptcy affect corporate investment choice by reducing corporate risk-taking, such as diversifying acquisitions and pursuing high recovery value in default.

⁸ The average CEO turnover rate from 1990 to 2012 for the TSE listed Japanese companies is 17%, from which the average term was estimated as 5.8 years. (Mikiharu Noma, Chairperson of the Planning Committee, Corporate Reporting Lab, Ministry of Trade, Industry and Economy [2013] (in Japanese))

respect to significant corporate reform given that the CEO may resign in the middle of this reform.

- 4) Employees who face uncertainties but challenge new possibilities are not adequately recognized and therefore there is little incentive for employees to take such risks. One background factor would be that uncertainties or expected losses are relatively easy to estimate, while expected returns are harder to quantify and are often perceived as being overly optimistic. Therefore, discussions in a conservative atmosphere tend to result in conclusions that risks should not be taken⁹.
- 02 In Europe and the US, there are examples where companies have gone bankrupt as a result of taking excessive financial risk or introducing excessive stock options. In such examples, while a company's ROE may be high for a short period, there is low chance of long-term sustainability and might require public fund injections in the future.
- 03 It was also pointed out that, despite the difficult backgrounds mentioned above, Japanese companies are capable of improving sustainability under adequate risk management and corporate governance.

[Proposal/Recommendation]

- 04 It should be recognized that the business environment is rapidly changing and therefore not taking concrete measures to enhance competitiveness is in itself a risk.
- 05 There is a view that low ROEs and share returns of Japanese companies is a result of companies prioritizing stability and longevity, which weakens the mindset of taking on challenges to enhance competitiveness, including the selection and concentration of business lines. If more companies take on challenges while adequately managing risks, then there is a greater possibility of an increase of companies with higher ROEs and share returns.
- 06 In particular, stronger competitiveness and enhanced cash flow generation is needed if companies are to deliver returns in excess of shareholders cost of capital. In pursuing this it is critical that precise risk management be employed as opposed to just blindly taking big risks.

2.3 [Discussion Point]

Are Japanese companies effectively using M&A? What are the issues for companies to achieve sustainable growth by using external resources such as M&A?

[Discussion and Evidence]

⁹ On this point, in behavioral economics, the existence of "loss aversion" (tendency to avoid losses and over-sensitivity) and "status quo bias" (incentive towards maintaining the status quo due to psychological burden associated with actions or choices that change the status quo) has been pointed out.

Increasing M&A by Japanese Companies

- 01 In addition to driving growth using internal resources (i.e. organic growth), many Japanese companies now complement their internal resources or functions by using M&A in their strategies.
- 02 While there have been many M&As between Japanese companies recently, there has been a large increase in Japanese companies acquiring foreign firms, with some of these being very large purchases. Aside from the post-Lehman crisis period of 2010~2011, Japanese companies have exhibited an increasing share of foreign company acquisitions (i.e. IN-OUT M&As) in the global market, and this share hit a record high from 2012 onwards¹⁰.
- 03 A closer examination of these M&As indicates a trend that differs from previous ones. Recent transactions indicate various patterns of growth opportunities such as increasing economies of scale, geographic expansion, concentration into competitive products, etc.
- 04 Looking at M&A transactions by region, the share within Asia and Oceania has consistently increased from 2002 to 2011, but has started decreasing from 2012; whereas share within North America and Europe has been rising. There is a trend to invest and acquire companies in big markets of mature economies in order to explore new distribution channels and markets¹¹.
- 05 Looking at M&A transactions by industry, while share in general consumer goods such as automobiles has decreased, share in consumer staples, such as food, medicine, or health care goods has risen. Share in industrial materials has also risen.
- 06 It was also suggested that Japanese companies tend to conduct domestic M&As as a means of deploying excess capital as opposed to truly assessing strategic opportunities. As for foreign company acquisitions (i.e. IN-OUT M&As), Japanese companies place more emphasis on transaction timing¹².

Challenges for Japanese Company M&A

- 07 A lack of human resources, specialized teams, and institutional know-how is often cited as challenges facing Japanese companies for M&A. According to a survey on M&A conducted on both Japanese and non-Japanese companies¹³, the most frequent challenge a Japanese company faces when considering and executing an M&A is the “lack of execution system and institutional know-how”. Only 20% of respondents had specialized teams for M&A. Only 7% had documented institutional knowledge pertaining to previous M&A experiences.

¹⁰ Kengo Nishiyama and Ken Takamiya [2013], “Trend of Japanese Companies’ Global M&A (First Volume)” (in Japanese).

¹¹ Ibid.

¹² Naoki Kamiyama [2013] “Japan’s Return Revolution (4): Proposal for Strategies to Revive Japan” (in Japanese)

¹³ Deloitte “Survey on the Realities of M&A 2013 based on M&A Cases” (in Japanese)

- 08 On the other hand, a senior manager of a company that strategically conducts M&As described the effective execution of recent global transactions by gathering talented staff from within the firm, therefore overcoming the apparent lack of in-house specialists. Another company cited an example in which they created a specialized team and require any potential transactions over a certain size to undergo rigorous assessment by this group management team.
- 09 Another challenge mentioned was that while it's possible to purchase a business there is a lot of reluctance in making decisions to sell them. There is a view that long-term employees are like a family, and therefore selling a business is a hard decision to make. Connections to the local community and negotiations with in-house unions also add to this difficulty in decision making. However, both companies and investors agree on the problematic nature of these factors hindering improvement of capital efficiency and forcing companies to face global competition with strategically weak business and product lines.
- 10 It was also noted that diversification into areas where a company neither has any experience nor can create synergies with existing businesses will prevent mid/long-term growth.

Successful Examples of M&A

- 11 There are examples which market participants view to be successful IN-OUT M&As done by Japanese companies. Such successes can be categorized as: clearly achieving contributions to earnings or orders from economies of scale in production and sales or expanding into new regions; successfully addressing the various needs of customers; strengthening a (niche) competitive advantage and securing strong market share; and exporting successful Japanese business models to enhance profitability.
- 12 It was noted that there appear to be factors underlying a successful M&A that are common to Japanese, European, American companies. Especially important is trust and a shared understanding (communication) between the purchaser and the seller. Due diligence is the most important part of the M&A process and key to executing a smooth post-merger integration¹⁴. In particular for cross-border M&As, one of the keys to success is to secure competent local managers and technicians and entrust them with management of the local company while ensuring that they share the vision and strategy of the corporate group.

[Proposal/Recommendation]

What Is Required of Japanese Companies' M&A Activity?

- 13 In order to integrate M&A activity into sustainable growth strategies, it is necessary for management to debate and arrive at a shared understanding of the following topics:

¹⁴ Deloitte [2013] "Best Practices of M&A in Japan, US, and Europe" (in Japanese)

the current state of mid/long-term business models; the relative strengths and competitiveness between business lines and products; and the advantages of M&A activity over organic growth. Also, there is an urgent need for companies to secure and develop internal human resources who specialize in M&A transactions such as the identification and selection of the potential targets, due diligence, and post-transaction matters.

- 14 Given the increase in cross border transactions, there is growing need for human resources with global expertise and experience. Securing human resources who can manage global and cultural diversity is especially important for in-out M&A transactions. Introduction of external directors could be effective if candidates are selected with the clear aim of supplementing such need for specialized knowledge and diversity.
- 15 Companies should make bold decisions with respect to the disposal or swapping of existing businesses that have high-market-share or are profitable provided that such decisions would significantly strengthen their core business. There are many cases where such decisions positively influence employees working for these businesses. Japanese companies face the challenge of overcoming a management culture and structure that has hindered offensive M&A activity.
- 16 Needless to say, it is important to capital markets that companies provide follow-up information based on the relevance of the matter, in addition to satisfying disclosure obligations at initial deal launch. In order to ensure that transactions are not value destructive, such as only pursuing expansion of scale, it is imperative that clear targets for corporate value creation be included in transaction criteria.

3 ROE, Cost of Capital, and Stewardship of Capital

3.1 [Discussion Point]

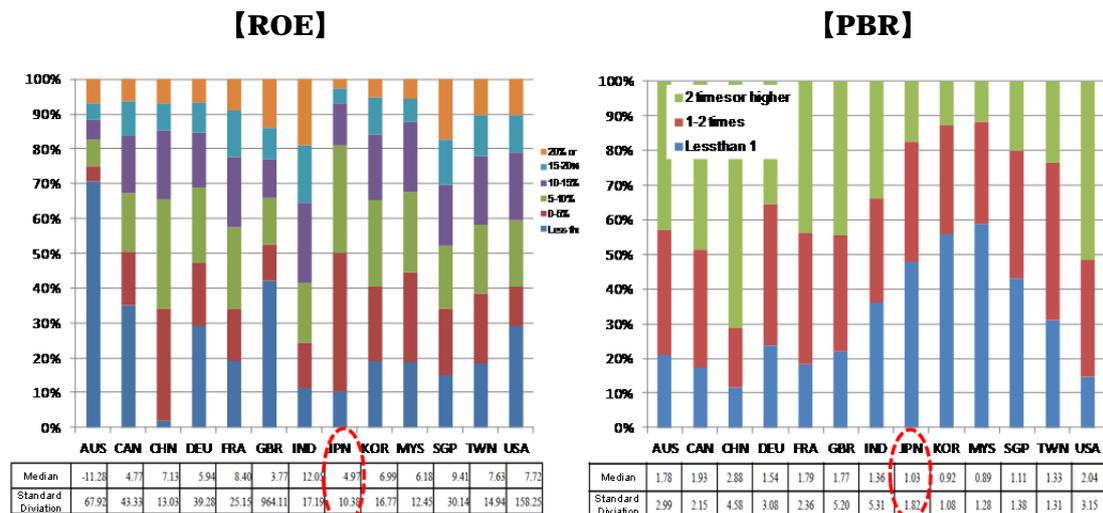
ROE of Japanese companies appears to be considerably lower than global standards. Are there any grounds or rationale to validate this perspective?

[Discussion and Evidence]

Current Level of ROE of Japanese Companies

- 01 Although the return on equity (ROE) of Japanese companies has recently shown an increasing trend, it has historically been low compared to that of other countries. Another characteristic of Japanese ROE is that there is relatively little dispersion among companies, and hence an apparent concentration at low levels.
- 02 As a result of low ROE, the price-to-book ratio (PBR) – which represents expectations for future corporate value creation – has been relatively low compared to that of other countries.

<Chart 2: International Comparison of ROE and PBR>



(Note) Individual companies' median value for the past 10 years was calculated based on 2000-2010 data in Compustat Global. The chart shows the distribution of individual companies' median value.

(Reference) Tetsuyuki Kagaya, Associate Professor at Hitotsubashi University "Toward the Sustainable Creation of Value by Japanese Companies – 1st Year Achievements by the Corporate Reporting Lab" (2013.7)

Examining Low ROE via its Components

- 03 When we break-down ROE into its sub components and compare return on sales (ROS), asset turnover ratio, and financial leverage between Japan, the US, and Europe,

Japanese companies appear not to be far behind in terms of asset turnover ratio and financial leverage, but their profit margins are significantly lower than their US/European counterparts.

<Chart 3: Breakdown of Capital Productivity of Japan, the US, and European Companies>

		ROE	ROS	Turnover ratio	Leverage
Japan	Manufacturing	4.6%	3.7%	0.92	2.32
	Non Manufacturing	6.3%	4.0%	1.01	2.80
	Total	5.3%	3.8%	0.96	2.51
U.S.	Manufacturing	28.9%	11.6%	0.86	2.47
	Non Manufacturing	17.6%	9.7%	1.03	2.88
	Total	22.6%	10.5%	0.96	2.69
Europe	Manufacturing	15.2%	9.2%	0.80	2.58
	Non Manufacturing	14.8%	8.6%	0.93	3.08
	Total	15.0%	8.9%	0.87	2.86

Note 1) Based on actual business results of 2012 calendar year. Financial and real estate industries are excluded.

Note 2) Companies included in this analysis were those included in TOPIX 500, S&P 500, and Bloomberg European 500 and whose data were available.

(Source) Analysis by Misaki Capital Inc. (Bloomberg data was analyzed based on the initial analysis by Naoki Kamiyama of Merrill Lynch)

- 04 While asset turnover ratio and financial leverage can vary by sector, Japanese companies consistently exhibit low ROE and profit margins across every sector when compared with their US and European counterparts. There may be the view that Japan's low ROE is caused by a relatively large concentration of manufacturers and capital intensive industries, but the data does not support this view¹⁵.
- 05 The data shows that Japanese companies with high ROEs also have high profit margins. Therefore, it would not be accurate to make the claim that a high ROE does not fit into the culture of Japanese companies¹⁶¹⁷. It should also be noted that capital-intensive

¹⁵ In capital goods industry, the average ROE for Japan, US and Europe is 6.8%, 15%, and 10.5%, respectively. In material industry, the average ROE for Japan, US and Europe is 2.2%, 12.1%, and 5.1% respectively. (Bloomberg data as of August 2013)

¹⁶ 76 companies that were selected for Tokyo Stock Exchange's Corporate Values Improvement Award showed higher profit margin (ROS) than the average in the last 10 years.

¹⁷ According to an analysis decomposing ROE into asset turnover ratio, financial leverage and profit margin, the average profit margin and asset turnover ratio of "sustainably growing companies" are 3.5% and 1.1 respectively – both higher than the average figures of

companies are most in need of improving their ROEs and ROICs so that they can effectively use the capital markets.

What Are the Reasons for Low ROEs?

- 06 As explained above, the low ROEs of Japanese companies are generally attributable to low profit margins. Profit margin is recognized as an important KPI by Japanese companies, which drives efforts to improve profitability through value added, differentiation, and cost cutting. Why is it then that Japanese companies tend to have low ROEs?
- 07 One reason is that a company's earning power and competitiveness is constrained by excessive price competition due to insufficient differentiation, product / service positioning, business portfolio optimization, innovation, and responses to changes in business environments as previously discussed. One company suggested a hypothesis of additional reasons including difficulty of reducing work forces when withdrawing from unprofitable businesses; a management culture that does not endorse one company making excessive returns compared to partners within the supply chain; and a tendency to normalize margins in the context of long-term business relationships. A relatively high cost structure in terms of system and infrastructure, such as high effective corporate tax rates, energy costs, and inflexible labor regulations have also been cited as challenges.
- 08 Excessive cash and deposits on the balance sheet have also contributed to low ROEs. This topic will be discussed later in this report. A high ratio of cash & deposits and marketable securities to total assets will result in lowering ROA given that the yield of government bonds is below 1%. Although some US companies have large cash and deposits, it was noted that the majority of such companies exhibit above average ROEs due to very high profit margins¹⁸.
- 09 Other reasons mentioned include the mindset of management towards ROE and a culture and governance model centered on bank financing.
- 10 With respect to the point on management's mindset towards ROE, it's not necessarily management's lack of recognition of ROE as a performance metric, but rather difficulty in practically adapting ROE as a metric, including how to ensure that all working levels

Japanese companies, whose profit margin and asset turnover ratio are 1.9% and 0.5 respectively. Here "sustainably growing companies" are those whose market capitalization is in the top 21 among constituents whose total returns (aggregate of the increase of market capitalization and total paid dividend) has more than doubled from the end of 1998 to October 2013.

Naoki Kamiyama [2013] "Japan's Return Revolution (4): Proposal for Strategies to Revive Japan" (in Japanese)

¹⁸ In the US, when a company holds excessive cash exceeding the amount of funds necessary for investment, shareholders often suggest dividend increases or share buybacks. In 2013, Microsoft and Apple accepted such suggestions by buying back a good amount of shares and increasing dividends.

within the company understand and can contribute to this metric.

- 11 With respect to the point on a historic reliance on bank financing, companies have traditionally focused on financial evaluations and credit assessment of their businesses by banks, which in turn has led to an incentive of preserving capital abundance. It was also noted that from a perspective of governance, a company having many external directors from their banks might have created an atmosphere that prioritized the creditor's view and therefore made it difficult to conduct investments that would maximize corporate value. Companies do not feel the need of equity financing in an environment where debt financing is significantly cheaper, thus further promoting a culture of reliance on bank financing.

[Proposal/Recommendation]

- 12 Soliciting long-term investment from investors would not meet success unless share prices of Japanese companies exhibit a long-term upward trend. If the share price is stagnant or continues to drop over the long-term, there will be little incentive for long-term investment. Under this context, one can appreciate the rationality of certain investors attempting to pursue returns through short-term trading.
- 13 As a start, efforts should be made to raise ROE, which is one of the most important KPI for investors, to globally competitive levels.
- 14 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.
- 15 Raising ROE to a level above the cost of capital should be established as a minimum goal. Companies should be cognizant of this minimum goal with the aim of reviving Japan as an investment-oriented nation that generates returns founded upon business models that create corporate value, and also reviving Japan as an attractive business-oriented and manufacturing-oriented nation.
- 16 In this regard, ROE and profitability must not be perceived from a short-term perspective, but rather must be recognized as a driver of corporate value over the mid/long-term. This leads to the overall growth of stakeholder value, and underpins the realization of "corporate value management" that ultimately leads to increased shareholder value over the long term. This can also be referred to as "cash flow-based management" in which emphasis is placed on cash flow generation while considering industry-specific factors and competitive environments for each company and taking into consideration specific investment time horizons. This also leads to the important determination of cash flow usage between re-investment for future growth and

returning cash to shareholders. In this regard, a company with a constant dividend payout ratio will see its capital base grow annually by the amount of retained earnings, and therefore must consider the growth of profit necessary to at least maintain its current level of ROE. Considering such a “sustainable growth rate¹⁹” should also be an important perspective for a company.

3.2 [Discussion Point]

Is there a perception gap between investors and management with respect to ROE?

[Discussion and Evidence]

Perception Gaps With Respect To ROE

01 There is a gap in perceptions towards ROE between Japanese companies and investors. Many investors regard ROE as one of the most important metrics when evaluating companies. While companies recognize ROE as an important metric, they do not consider it to be the most important metric of performance²⁰. This is because there are some practical difficulties in using ROE as a metric at the operational level, and the concept of financial leverage does not always fit with companies because they often prioritize management in absence of debt.

What Investors Want

02 Investors do not blindly argue that ROE should be the top priority. Although they do not believe in the supremacy of ROE, they do not consider companies with consistently low ROEs as value creating companies. Investors emphasize the reinvestment of retained earnings as a driver for growth. If companies cannot effectively use retained earnings to drive growth, investors expect to see a clear business plan of how excess capital will be managed, including returning funds to shareholders.

03 Investors expect management to pay appropriate attention to the cost of capital in the context of managing towards a higher ROE. The cost of capital is a critical junction

¹⁹ This is a typical method for estimating growth of dividends, which is used to determine the theoretical growth of profits and dividends with retained earnings as the only source of additional capital. Assuming a company has a constant ROE and dividend payout ratio (and that no additional equity capital is raised), the product of ROE and retained earnings becomes the expected increase in profit in the next accounting term. The sustainable growth rate is defined as the product of ROE and the portion of profits retained (i.e. $1 - \text{Dividend Payout Ratio}$) [Excerpt from Kunio Ito, *New Corporate Valuation*]

²⁰ Among the respondent companies to the following survey (around 600 listed companies), sales and operating profits are chosen as management KPIs by almost all of them, whereas 30% of respondents used ROE as a management KPI. Corporate Reporting Lab, Ministry of Trade, Industry and Economy [2013] “Survey on Actual Practices of IR/Communication for Sustainable Creation of Corporate Values ”

point between value creating and non-value creating companies, and therefore investors expect companies to clearly base plans and operations with this target in mind. There is some controversy as to whether companies should aim to maximize ROE, but there is a common understanding that companies should aim for a ROE above their cost of capital²¹²². There was a comment that ROE targets should be set at 8~10%²³, and that companies with global operations should aim for levels comparable to European and US counterparts (i.e. around 15%) in order to attract investors from around the world.

- 04 There is a shared recognition that ROE is an “outcome” of business activities and not a “goal” for management, implying that ROE will naturally rise as a result of improving competitiveness for sustainable growth and generating/growing cash flow through expansion into appropriate business lines and appropriate development and supply of goods and services. It was also mentioned that many companies have potential for higher ROE, but their ROE remains low because they have not fully differentiated their structures and processes for corporate value creation and taken advantage of their unique corporate identity.

ROE as a Management Metric

- 05 There is a view from companies that they share information on ROE and cost of capital for the purpose of communicating with external parties, but they do not necessarily use ROE internally as a management metric. ROE may be understood at top management – such as the CEO and CFO – but members further down the organization may feel that ROE has little to do with their operations. This raises a question if it is possible to breakdown ROE to sub components that can be associated at the operational level. There are also views that suggest corporate value creation should not be measured solely by ROE.
- 06 There are, however, some companies that do break down ROE and cost of capital into

²¹ Ryohei Yanagi. 2010. "Manual to Improve Management Accounting for Corporate Value Enhancement" Chuo-Keizai. : Equity Spread (calculated as ROE minus Cost of Equity (investment returns expected by shareholders) is one of KPIs for corporate value creation. From the eyes of investors, companies with positive equity spread are regarded as value-creating companies, and companies with minus equity spread are regarded as value-destructive companies.

²² From the perspective of investors, ROE is a measure of how companies are delivering on their responsibility with respect to the capital, additional paid-in capital, and retained earnings supplied by investors. If during the course of several accounting terms ROE consistently falls short of the cost of capital (cost of equity), then it can be said that there is a risk that companies lose their economic foundation.

²³ The Pension Fund Association (PFA) previously had a policy which required companies which had a three-year average ROE of less than 8% to explain their business plans and capital policies. Given this former PFA policy it was suggested that the appropriate level for ROE in Japan, inclusive of the notion of cost of capital, might be 8%.

KPIs and other metrics that can be used at the operational level.

- 07 Trading companies comprise a sector that exhibits strong management awareness towards the cost of capital. The first reason behind this is that trading companies effectively are managing a diverse portfolio of businesses (e.g. natural resources and industrial companies) from an investor-like perspective. The second reason behind this is that trading companies have transitioned their business models from traditional trading of goods and services to effectively one that pursues returns from risk assets. As an example, a major trading company categorized its business portfolio by profitability and growth potential as a means to promote selection and concentration of businesses. The same trading company also uses ROE in reference to the cost of capital as one of the decision-making criteria for assessing investments.
- 08 There is also an example of a manufacturing company that decomposes ROE or Return on Invested Capital (ROIC) into profit margins (ROS), asset turnover ratio, and financial leverage so that these metrics can be used at the operational level in a manner that best matches the company. There is also an example of an electronics manufacturer that has set a target ROE of 10% and evaluates business line performance using ROIC and free cash flow metrics.
- 09 One example of how ROE can be used in managing a business is via a division of labor between a holding company and its underlying operating company. In this case, the holding company uses ROE as a management metric and publicly declares this practice. ROE is further decomposed into financial leverage and ROA, and the latter is broken down into profit margin and asset turnover and is used as a goal for the operating company. The operating company's role and responsibility is to therefore strive towards growth of profit and efficient asset usage. On the other hand, the holding company is responsible for management and supervision including financial leverage, providing disclosure as a listed company, and maximizing corporate (shareholder) value across the group. While maintaining mutual communication, the operating company strives to maximize profit through providing the best possible services and products from the perspective of customers, and the holding company suggests optimal resource (business and organization structure, M&A, etc.) allocation to maximize overall profits.

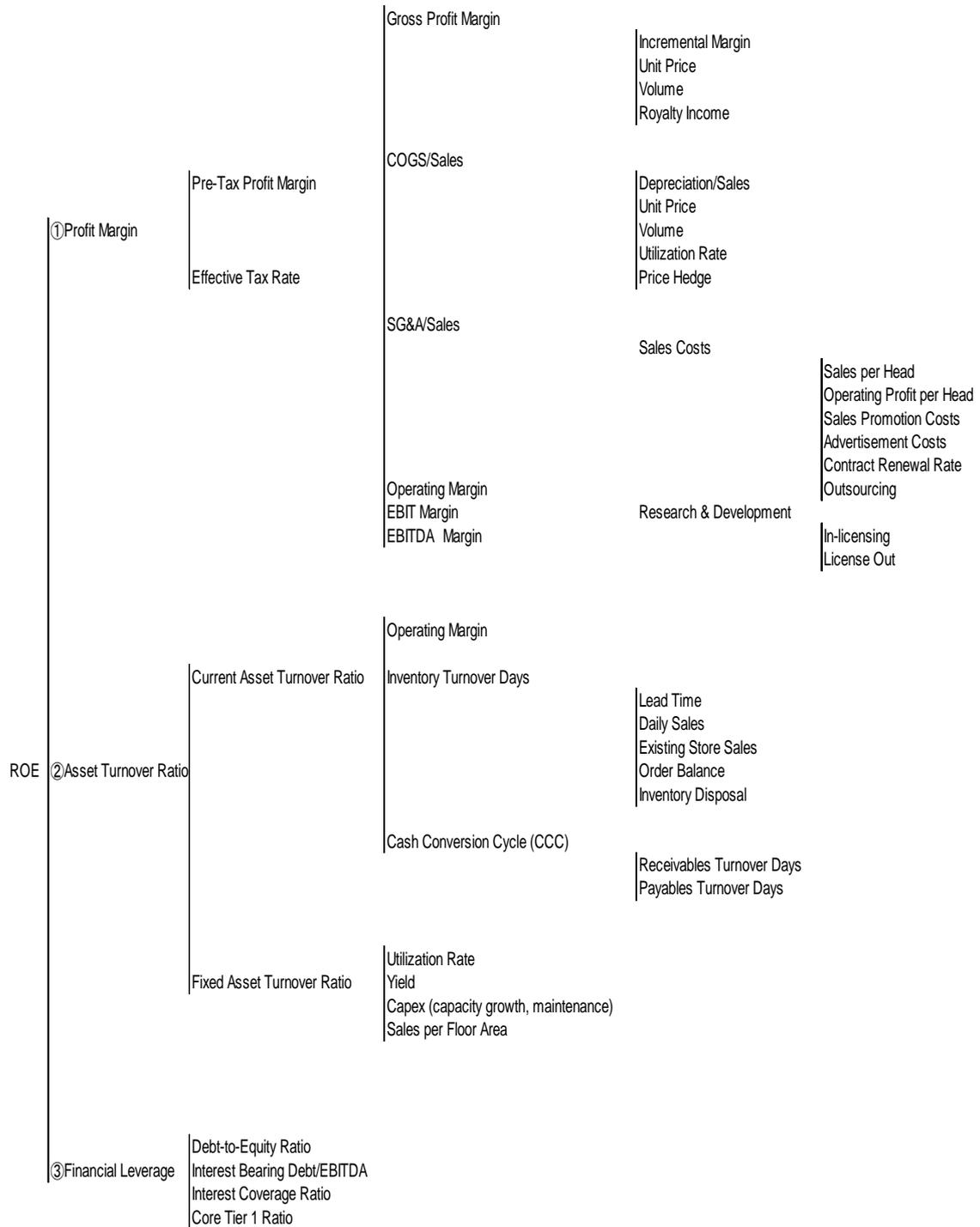
[Proposal/Recommendation]

- 10 ROE improvement can be regarded as the core of the third arrow of Abenomics. By improving ROE, companies can secure resources necessary for sustainable growth, which in turn drives the creation of corporate value. This can be thought of as “collaborative creation” of corporate value by both companies and investors.
- 11 Investors emphasize ROE and use it as a comparative metric both domestically and internationally. While the ROE of Japanese companies is on a rise due to effects of Abenomics and depreciation of the Yen, it should be noted that it still falls short when

compared globally.

- 12 Companies should be able to break down ROE into components that tie in with existing internal KPIs such that management reforms effectively take into consideration the ROE metric. Success lies in the ability to break down ROE such that it fits with the current state of business. Companies must leverage their strengths by fundamentally reforming and differentiating their business models as opposed to just making superficial changes. Companies should bear in mind that ROE is not just for investors but is also a KPI necessary to create a good cycle that strengthens their own management and business. With this notion in mind, companies must seriously consider how to best structure incentives, provide disclosures, and conduct dialogues with shareholders.
- 13 Investors should not unilaterally impose ROE when engaging with companies. Investors should also make efforts to promote a mutual understanding by helping to decompose ROE into several elements, such as reducing the manufacturing lead time, decreasing the number of inventory days, improving the yield ratio, improving operating rates, and disciplining price discounts on sales so that companies can better understand the dialogue at an operational level. The decomposition of ROE in Diagram 4 can be used as a reference while this was made with many industries in mind and with a recognition that not all elements will be relevant to every company.
- 14 Creation of corporate value is not exactly equal to an increase in ROE. One must note that there are elements beyond this. There are various forms of social value that cannot be measured by economic metrics, and the importance of this value is on the rise. Unless companies pursue various forms of value creation and gain the trust and satisfaction of stakeholders, sustainable growth cannot be achieved. Value creation is derived from improvement of social value as well as economic value. Therefore, it is important for management and investors to cooperate throughout the process of multi-faceted value creation in order to deepen a shared understanding.

<Diagram 4: ROE Decomposition Example>



Note: 1~3 are components of a three-factor decomposition known as the DuPont Model and consist of (Net Income / Sales) x (Sales / Total Assets) x (Total Assets / Shareholders' Equity). This decomposition has in mind a variety of industries and not all components will be relevant to every company.

3.3 [Discussion Point]

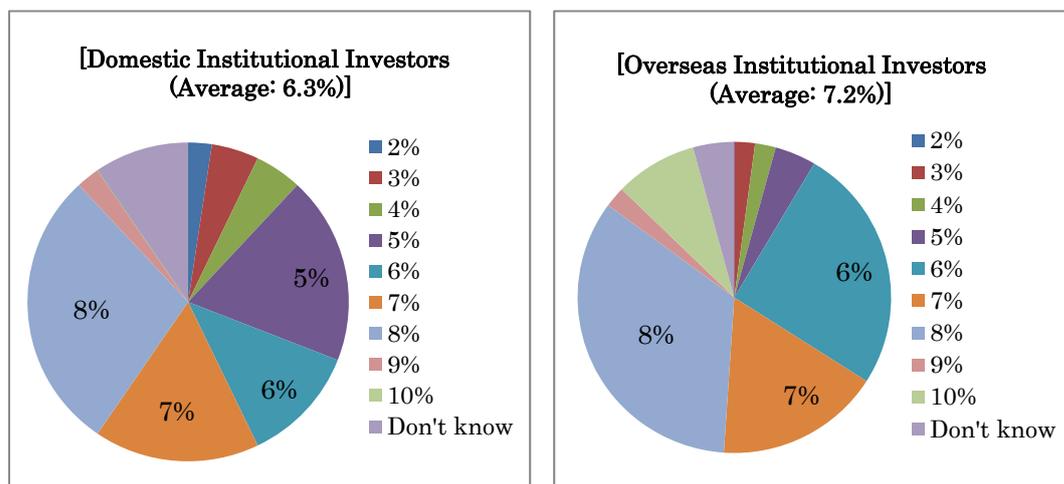
How should one think of the cost of capital? Is there enough understanding of the cost of capital by Japanese companies? If not, what are the reasons? What has resulted from such lack of understanding?

[Discussion and Evidence]

Clarification of Cost of Capital

01 Cost of capital refers to the rate of return expected by the market. As there is no absolute definition, there are diverse views over the appropriate level of cost of capital. One particular survey shows that the cost of equity expected for Japanese shares by both domestic and overseas investors vary considerably with the average for overseas investors being 7.2% and that for domestic investors being 6.3%.

<Chart 4: Cost of Capital Expected for Japanese Shares>



(Source) Ryohei Yanagi [2013] "Disclosure of equity spread and proposals for engagement" Accounting (Kigyo Kaikei) (in Japanese) 2013(1):86-93

(Note) The survey was conducted targeting 200 major institutional investors of UBS. Answers were obtained from 52 domestic investors and 47 overseas investors.

- 02 While there is a quantitative measure called the "Weighted Average Cost of Capital" (i.e. the weighted average between the cost of debt and the cost of equity), in practice it is not always the case that the capital markets interpret the cost of capital under this concept. The capital markets also reflect qualitative and "intangible value" in their overall assessment. There is room to reduce the cost of capital if companies engage investors with this understanding and try to promote a mutual understanding.
- 03 Companies must recognize the cost of capital from both a financial and non-financial perspective, including unspoken elements of trust, expectation, and roles & responsibilities between companies and shareholders/investors. It is understood that

there is general demand that companies establish management discipline and clarity of responsibility in this context.

To What Extent are Companies Conscious of their Cost of Capital?

04 There are not many Japanese companies that are conscious of their cost of capital²⁴. The historic reliance on bank financing is noted as one of the reasons behind this. When a company faced financial difficulty, its main bank would pressure the company to change its top management, and hence the main bank used to be an existence of great influence over a company. As a result Japanese companies would rarely face the capital markets for any financing. Although there has recently been an increase in syndicated loans, the main bank still plays a critical leading role in these.

[Proposal/Recommendation]

05 The cost of capital is a decisively important factor in the creation of corporate value and is the most important element in assessing an appropriate level of ROE. It is important for management of Japanese companies to further their understanding that a value-creating company is one that generates profit in excess of its cost of capital over the long term. Fortunately as a result of Abenomics' macroeconomic measures, ROEs of Japanese companies are on the rise. In order to accelerate this trend we must promptly increase the number of value-creating companies. According to one survey, the expected cost of capital for Japanese companies by global institutional investors is in excess of 7%. According to this survey, an ROE of 8% or more would satisfy the expected cost of capital of over 90% of global investors. When engaging in dialogue with global investors, companies should be conscious that the minimum expected level of ROE is 8%, and should strive to further increase their ROEs beyond this level in a manner befitting their respective businesses and connect this activity to generating sustainable growth.

06 Views on the level of cost of capital differ between companies and investors, and even among investors. An investor's recognition of future uncertainties is influenced by the competitiveness of a company's business, management's commitment towards value creation, adaptability to changes in business environment, and abilities to solve issues. This in turn is reflected in the investor's view of the cost of capital. Management must therefore be aware of the variety of factors affecting an investor's evaluation of a company, and use this awareness when engaging with investors and try to promote a

²⁴ Corporate Reporting Lab, Ministry of Economy, Trade and Industry [2013] "Survey on Actual Practices of IR/Communication for Sustainable Creation of Corporate Value" (in Japanese). Among the respondent companies to the survey (around 600 listed companies), roughly 40% of companies were conscious of the cost of capital. Those who disclose it to investors is a little less than 10% of the total.

mutual understanding. Such efforts will lead to a decrease in the cost of capital.

07 Management should not aim to provide numerical details with respect to their cost of capital, but rather should disclose their judgment criteria and internal standards on cost of capital, and solicit input from investors. This will be critical in enhancing management discipline and promoting corporate value creation.

3.4 [Discussion Point]

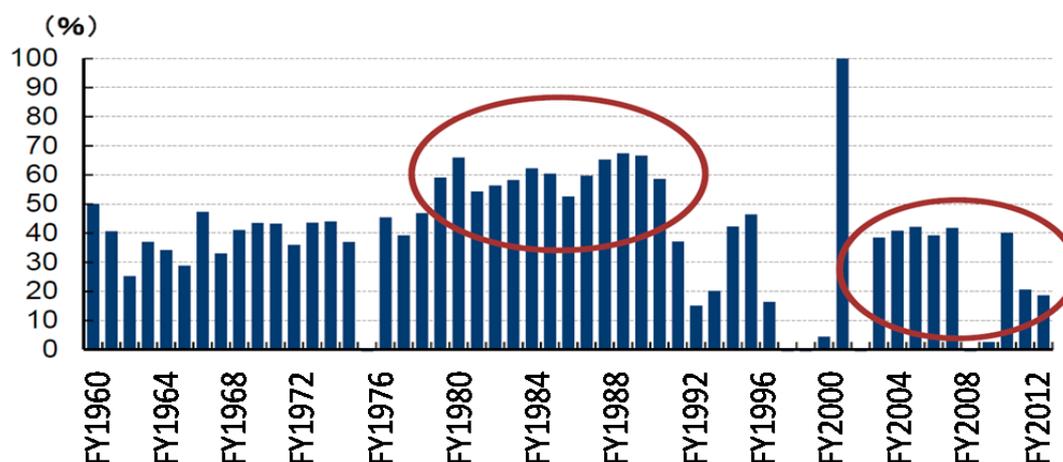
How should one understand the relationship between sustainable growth and the large amounts of liquidity accumulated on the balance sheet? Assuming that management of Japanese companies continues to employ a long-term business perspective, how does one explain this excessive amount of liquidity? Are capital policies of Japanese companies, including dividend policies, appropriate for increasing corporate value over the mid/long-term?

[Discussion and Evidence]

Levels of Retained Earnings and Capital Base

01 It has been noted that retained earnings of Japanese companies tends to be high compared with the counterparts in Europe and the US²⁵, although these levels have been decreasing recently²⁶.

<Chart 5: Trends of Retained Earnings of Japanese Companies²⁷>



(Note) Financial Statements Statistics of Corporations by Industry (Non-consolidated data. Financial

²⁵ When comparing the proportion of aggregated yearly gap of retained earnings in the total net earnings from FY1997 to FY2012, it was 63%, 13%, 32% for Japan, US, and Europe respectively. (Source: Bloomberg)

²⁶ The retained ratio (1 minus dividend ratio) of Japanese companies in 1980s was around 60%, but it is around 40% in the past 10 years except at the time of the post-Lehman financial crisis and the Great Tohoku Earthquake. Naoki Kamiyama [2013] “Japan’s Return Revolution (4): Proposal for Strategies to Revive Japan” (in Japanese)

²⁷ Naoki Kamiyama [2013] “Japan’s Return Revolution (4): Proposal for Strategies to Revive Japan” (in Japanese)

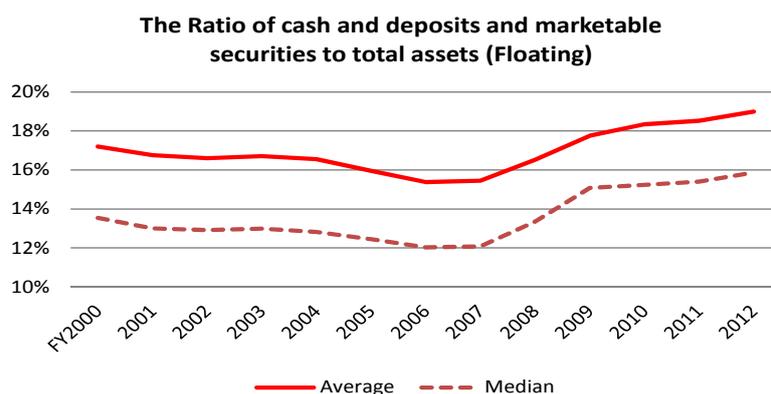
industry is excluded. Companies capitalized at 1 billion JPY or more)
 (Source) Ministry of Finance and BofA Merrill Lynch Global Research

- 02 From the shareholders' viewpoint, retained earnings are expected to be effectively reinvested to drive further growth. This implies that growth in profits sufficient to sustain the current level of ROE for future returns (e.g. dividends) is expected.
- 03 In general it is important to maintain an adequate level of capital that is neither excessive nor too modest. After the Lehman financial crisis, there has been criticism of some Japanese companies financing extensively in order to repay debt or to maintain a certain credit rating without any specific growth strategy. They are criticized by investors as having destroyed corporate value.

Cash Holdings of Japanese Companies and Expectation for Growth Investments

04 The cash holdings ratio of Japanese companies has been on the rise since 2006. While there is a view that these levels exceed those of European and US companies, there is also data that suggests this is not the case²⁸. There is an increasing number of Japanese companies whose balance sheet shows excessive cash reserves, making them practically debt-free. 22% of all listed companies (excluding the finance, insurance, securities, and leasing industries) have a ratio of cash and marketable securities to total assets in excess of 30%.

<Chart 6: The Ratio of Cash Holdings by Japanese Companies>



²⁸ Data covered non-financial sector constituents from TOPIX 500 (Japan), S&P 500 (US) and top 400 companies based on market capitalization (Europe). The median value and the average of the cash holdings ratio (cash equivalent / total asset) from 2002 to the end of March 2012 was 11.6% / 14.7% for Japan, 7.6% /13.2% for the US, and 8.1% /11.2% for Europe. Seiji Nakai and Naoki Kamiyama [2013] "Valuation of Cash Holdings: Comparison Between Japan, US and Europe Before and After the Post-Lehman financial crisis " *Securities Analyst Journal* (2013.6) (in Japanese)

(Note) The cash and deposit data is the average of 2,810 listed companies whose chronological data are available. (Consolidated accounting data were selected where available)

(Prepared by Shoichi Tsumuraya, Associate Professor at Hitotsubashi University)

- 05 However, this does not mean that Japanese companies do not invest for their growth as there is no evidence of these companies restricting their investment cash flow.
- 06 Should Japanese companies make investments by taking risks more aggressively? Is there a need to improve their cash-rich state? Some argue that Japanese companies should make investments in businesses more aggressively and lower the level of cash holdings, whereas others argue that they should refrain from excessive risk-taking and maintain the current levels of cash and deposits.
- 07 From an investor's perspective, the problem of Japanese companies holding excessive cash does not lie in the absolute magnitude of such holdings, but rather lies in such funds not being deployed in investments that earn a return above the cost of capital, and therefore destroy corporate value over the mid/long-term. For instance, a view was expressed that investors typically discount the excessive cash holdings of Japanese companies. It was noted that such concerns may be a reason for the relatively low PBR levels of Japanese companies.
- 08 Some of the reasons why companies hold cash include preparing for risks and securing funds for future investments. For example, capital market financing bears the risk of not being able to source liquidity during times of crisis, as evidenced by the extreme difficulty companies faced when issuing bonds and commercial paper after the Lehman financial crisis.
- 09 Investors understand that Japanese companies sometimes accumulate cash in order to cope with financial crises or large natural disasters. On the other hand, investors struggle to understand why companies without practical bankruptcy risk or those that can expect stable cash flow due to the nature of their industries hold excessive cash. This abundance of liquidity is also a concern when companies conduct in-out M&A transactions as it may lead to them paying excessive premiums.
- 10 While the appropriate level of cash holdings varies according to sectors or the specific state of companies, investors expect companies to clearly explain their thoughts with respect to their cash reserves.

Considerations of an Optimal Dividend Policy

- 11 From a statistical perspective, most Japanese companies have a dividend payout ratio centered at the average value of 30%, which is reflective of the tendency to "follow the crowd" and employ a "stable dividend" policy. Although the average dividend payout ratio is also 30% in the US, there is a large variance depending on the life-cycle theory of corporate growth, and in fact the data between 2007 and 2010 indicate the largest

statistical group was non-dividend-paying companies²⁹. It seems every company consciously plans an optimal dividend policy.

- 12 On this point, there is a survey showing that Japanese companies have a strong tendency to include the expressions “stable dividend” and “retained earnings for future investments” in their earnings briefings. On the other hand, the survey shows that global investors attach paramount importance towards “capital efficiency” among dividend policies of Japanese companies, and that they are dissatisfied with Japanese companies’ disclosure of dividend policies and IR briefings. There was also a comment from a domestic investor that Japanese companies fail to rationally explain policies on dividends and shareholder returns under the context of ROE and the cost of capital³⁰.

[Proposal/Recommendation]

- 13 From the investor’s perspective, retained earnings should be reinvested to help create further corporate value³¹, and they expect it to be efficiently deployed towards business investments. Investors should not only look at the sheer amount of cash shown on the year-end balance sheet, but rather should evaluate this figure taking into account the timings of risk measures as well as planned use of cash in its mid/long-term business strategies.
- 14 There are an increasing number of Japanese companies that are practically debt-free and their balance sheet shows excessive cash. Therefore, Japanese companies are expected to make positive investments for their growth, while considering overall capital efficiency and potential needs towards risk management. Listed companies fundamentally do not require excessive cash reserves, which also contribute to their risk of becoming acquisition targets.
- 15 Companies should offer explanations on their capital policies (e.g. dividends, share buy-backs, re-investments) and their thoughts on capital efficiency (e.g. the cost of capital and ROE), while also tying these into their recognition of risks. Such dialogue with investors will help to promote a mutual understanding that would be beneficial for both companies and investors.
- 16 When companies succeed in deploying capital to grow their businesses and instead of returning the proceeds to shareholders keep the proceeds as retained earnings, then these retained earnings should be viewed as additional capital provided by shareholders, with the trust that these retained earnings will be deployed on behalf of shareholders going forward. As such, if a company – as a going concern – is not

²⁹ Kazuhito Kondo and Ryohei Yanagi [2013] *Strategies for Finance and IR & SR in Order to Improve Corporate Value Evaluation* (Chuo-keizai-sha, Inc.) (in Japanese). Time-series data of TOPIX 500 and S&P 500 from 2007 to 2010.

³⁰ Ryohei Yanagi [2013] “Observation on Dividend Policies and IR – From the Viewpoint of Maximization of Shareholder Value” *Investor Relations* (Japan Academic Society of Investor Relations) 2013(7):58-76 (in Japanese)

meeting shareholder expectations and cannot secure their trust and confidence, then the company should be returning these retained earnings to investors. This loss of shareholder trust thus implies the loss of a fundamental economic pillar supporting the company.

- 17 From this perspective, how a company addresses risk and the use of retained earnings in the context of mid/long-term business strategy should be a critical focus of dialogue between companies and investors.
- 18 In order to secure investor trust, in their dialogue with investors companies must also be able to explain the purpose and reasons of cross shareholdings and parent-subsidiary listings and how they contribute to corporate value enhancement and management strategy.
- 19 It is important to consider dividend policies based on optimal capital structure. Minimization of the cost of capital without sacrificing financial soundness, and KPI-conscious capital structure adjustments through dividends and share buybacks are topics that can help the financial strategies of a company and dialogue with investors. Companies should determine a dividend policy upon holistically considering future investment opportunities, liquidity needs, and signaling effects.
- 20 The capital markets should facilitate liquidity by enabling companies to finance when necessary and to return capital when not needed. Deeper consideration must be given as to whether this function of the Japanese capital markets is in fact working properly.

³¹ According to Principles of Corporate Finance Global Edition – 10th Edition by Richard A. Brealey, Stewart C. Myers, and Franklin Allen, retained earnings is defined as a means of equity financing similar to the issuance of new shares. “Corporations raise equity financing in two ways. First, they can issue new shares of stock. The investors who buy the new shares put up cash in exchange for a fraction of the corporation’s future cash flow and profits. Second the corporations can take the cash flow generated by existing assets and reinvest the cash in new assets. In this case the corporation is reinvesting on behalf of existing stockholders. No new shares are issued.”

4 Management Systems and Incentives

4.1 [Discussion Point]

What kind of management systems is required for companies to build a constructive relationship with investors and to achieve the common goal of sustainable growth? How should the current functions of boards be evaluated and further developed?

[Discussion and Evidence]

Strengthening the Board

- 01 Regarding the structure of boards, both internal and external directors should be selected based on overall competence and experience and a healthy balance of values. Furthermore, an adequate number of directors must be maintained. Overseas investors expect each director to contribute a diverse range of expertise and experience so that the full board functions properly, rather than demanding each director to be equipped with all desirable abilities. It was noted that there seems to be a perception gap between Japanese companies and overseas investors with respect to the practical roles of directors and the right structures of boards.
- 02 As a means to strengthen the board, it was suggested that Japan may consider introducing periodical review of boards adopted in the revised UK Corporate Governance Code.
- 03 In order to strengthen the quality of directors, best practices from around the world were noted such as providing training and requiring certain qualifications for directors. It was noted that Japan is currently introducing similar measures³².

External Directors and Other Non-Executive Officers

- 04 As of FY2012, 203 of the 225 Nikkei Index constituent companies have already introduced external directors. Of the 211 companies that have audit & supervisory board members, 189 companies (i.e. roughly 90%) have done so as well. Two-thirds of those who have introduced external directors have appointed two or more of them. From 2008 until the present, not only has the ratio of external directors increased but their rate of attendance at board meetings has also increased, resulting in a stronger presence. Among all listed companies at the Tokyo Stock Exchange (1st Section), the ratio of companies with external directors increased 12% year-on-year and totals 74.3%

³² For example, the NYSE Listed Company Manual requires companies to disclose continuing education of directors (NYSE Listed Company Manual 303A.09). Also, there are various director training programs held by universities and the National Association of Corporate Directors. Asian exchanges also recommend director training. In Japan, there are various organizations providing training programs for directors (mainly targeted at independent directors), such as the Handbook for Independent Directors or seminars prepared by the Tokyo Stock Exchange.

(1,347 companies) as of July 2014.

- 05 Expectations for external directors are to be considered within the context of the functions of the board and the management system as a whole. Analysts and overseas investors noted the significance of external directors with respect to providing advice and criticism towards management's strategies beyond the bounds of industry, given their role of safeguarding the common interests of shareholders and supervising the management from perspectives of capital efficiency and fiduciary responsibilities.
- 06 With respect to independence of external directors, the need to strike the right balance to maintain their effectiveness as directors has been noted. While the independence of external directors is an important consideration, if external directors do not possess business experience then their contribution will be limited and a broad perspective going beyond the industry and company specific boundaries may not be achieved. Director candidates that would have no issues with respect to independence are typically scholars without business experience. On the other hand, knowledge and experience that can help their effectiveness as directors can be expected from senior management who used to be involved in related businesses or financial institutions which have business connections with the company. In particular, in the case of companies with very broad areas of activity, it was pointed out that if the director rules are too strict on the issue of independence, these companies with broad business scope would end up with only a handful of candidates with business backgrounds that could offer advice on management issues. On the other hand, there is also a view that if the responsibility of external directors is to keep an appropriate distance from management and supervise management from a shareholder's perspective, scholars without business experience are not necessarily ineffective as long as they can fulfill this responsibility.
- 07 Some overseas investors (e.g. ACGA³³) noted differences of functions and roles between Kansayaku (audit & supervisory board members) and external directors, and cited the benefits for Japanese companies expanding overseas to elect foreign persons as directors.
- 08 An example was cited of an independent organization in the UK that offers a framework for qualifications and assessments of independent directors, and also offers director recruiting services as well.

[Proposal/Recommendation]

- 09 Although the expected roles of boards differ by country, it is important for a company to clarify the mission of the board within its policies and mid/long-term plan.
- 10 The board should strengthen its abilities by securing well-balanced skills and experiences, as well as diversity of values with respect to both its internal and external

³³ ACGA [2013] "The Roles and Functions of Kansayaku Boards Compared to Audit Committees"

directors. It should be noted that there is expectation that external directors make contribution from the perspective of the common interests of shareholders, fiduciary duties, and strategies beyond the bounds of industry.

- 11 Both the company and the independent directors themselves must strive to enhance the effectiveness of independent officers within a company. Specifically, within the board meetings and management meetings, independent directors should leverage their experience and knowledge to provide opinions and advice as well as point out critical issues. In order to facilitate this process, the company should provide independent directors with adequate explanations ahead of time, access to company information, adequate support from staff, regular meetings with executives, and opportunities to share opinions with other independent officers. These efforts will help to improve the quality of management while maintaining the independence of these officers.
- 12 With respect to the roles of non-executive officers and associated support structures, each company should create a framework that suits their specific needs. To this end, companies can refer to “Interim Report on the Roles of and Support System for Non-Executives including Outside Directors and Kansayaku”,
- 13 It is necessary to consider what kind of measures are needed in Japan in order to further strengthen functions of the board, by learning from other countries such as the UK, with regard to their board reviews and training and utilization of potential directors.

4.2 [Discussion Point]

What roles are expected of management in the context of sustainable growth of corporate value? Are management incentives (both financial and non-financial) aligned with such expectations?

[Discussion and Evidence]

Roles Expected of Senior Management

- 01 In order to execute measures towards the sustainable growth of corporate value and to drive reform, management leadership and abilities are critical. Attitudes of the senior management and abilities to execute plans are also essential factors for investors to assess a company’s sustainability of growth.
- 02 In particular senior management is expected not only to behave as a business operator but to also be equipped with abilities to make judgments on the overall business portfolio of the company.
- 03 In order for a CEO to fully execute on his/her management duties, it is critical that the CFO serves as counsel with respect to capital discipline. It has been noted that Japan may still lack truly competent CFOs.

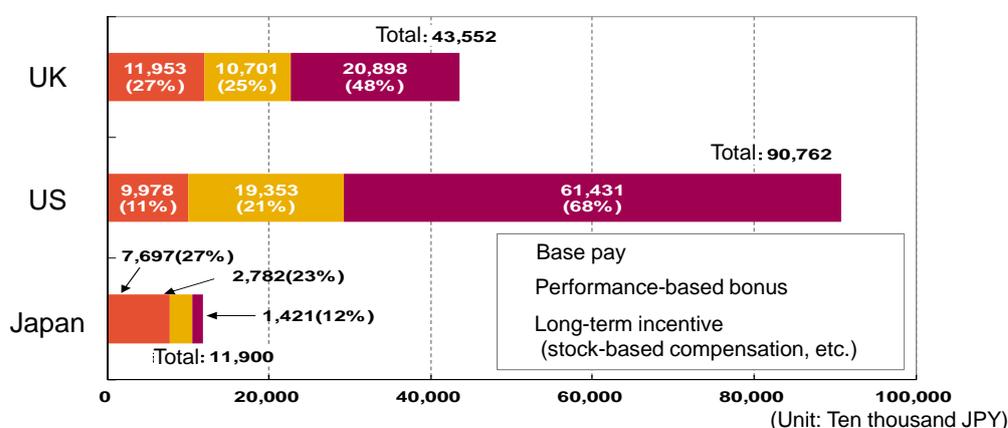
The Level of CEO Compensation

04 Regarding management's financial incentives, it has been cited that Japanese companies' management and officers' compensation is 1) relatively low and 2) has a smaller performance-based component compared to counterparts in Europe and the US.

05 The level of officers' compensation is statistically lower when compared to other countries. For example, there are not many senior managers in Japan who receive total compensation in excess of JPY 100 million.

<Chart 87: Cross-country Comparison of CEO Compensation>

[Comparison of CEO Compensation between Japan, the US and Europe (2012)]



Notes)

US: The median value of 180 companies with sales revenue of 1 trillion JPY or more among Fortune 500. Data Source: 2012 Proxy

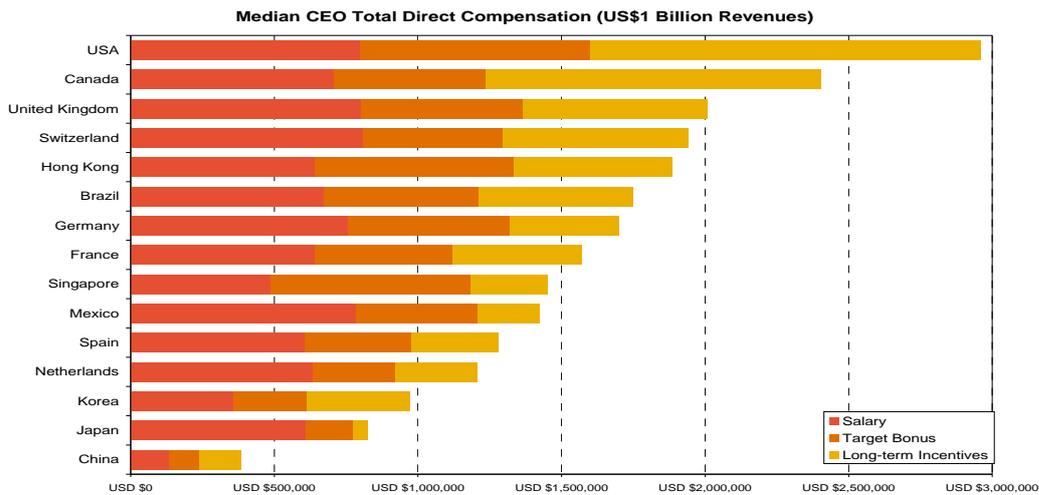
UK: The median value of 43 companies with sales revenue of 1 trillion JPY or more among FT UK 500 (excluding financial companies). Data Source: The most recent annual reports

Japan: The total amount is the median value of consolidated compensation of 77 companies with sales revenue of 1 trillion JPY or more among the top 100 market capitalization companies. The breakdown was calculated using the average value of 45 companies which disclose consolidated compensation (excluding outliers). Long-term incentives include single-year retirement benefits. Data source: securities reports

*The exchange rate used 2012 average TTM (1 USD= 79.82 JPY, 1 GBP= 126.49 JPY)

(Source) Towers Watson

[Comparison of Cross-country CEO Compensation (Companies with sales revenue of 1 billion USD (approx. 100 billion JPY))]



(Source) Towers Watson

- 06 In Europe and the US, disclosure of management compensation is required in order to confirm if it accurately reflects achievements and to assess whether compensation is unreasonably high. Some overseas investors appreciate the modest levels of compensation of Japanese management.
- 07 On the other hand, there is debate as to whether the low levels of compensation in Japan lead to inadequate management. One view would be that Japanese management is not compensated enough to take big risks. If compensation levels do not support management in driving innovation and boldly pursuing new business models, this is problematic as well.

Should Performance-Based Compensation be Increased?

- 08 As shown in previous charts, the portion of performance-based compensation at Japanese companies is smaller compared to companies in other countries. In Japan, 70~80% of listed companies have introduced performance-based compensation, but its proportion among the total compensation of senior management and directors is 10~30%³⁴. Furthermore, compensation is often not tied into specific performance metrics such as share price when compared to US companies³⁵.
- 09 In general, investors prefer a higher proportion of performance-based pay in order to align with shareholder interests. Overseas investors debate the introduction of Western-style performance-based pay and stock option plans in Japanese companies.

³⁴ Deloitte, “Executive Compensation 2013”[in Japanese] In this report, compensation of Chairperson, CEO, Directors, Senior executives and audit & supervisory board members. According to the survey, median of compensation for audit & supervisory board members ranges between 5-20%, while others ranges between 20-30%.

³⁵ Katsuyuki Kubo [2012] “Presidents’ Compensation in Japan”. If a Japanese company shifts from top 50% group to top 30% group in total return on its shares, its president’s pay will increase by JPY 20 million. For a US company, the increase is JPY 400 million.

Most argue that executive pay should be more aligned with shareholders and the capital markets.

Disclosure of Executive Pay

- 10 Compared to domestic investors, overseas investors are more accustomed to detailed disclosure of executive pay. They therefore expect higher standards of Japanese companies with regard to disclosures on this matter.
- 11 In response to such demands, some Japanese companies disclose their compensation scheme in detail including individual executive pay. For example, one company discloses the calculation criteria and weighting for fixed compensation, as well as short / mid / long-term incentive-based compensation for each officer-rank.

Non-Financial Incentives

- 12 Several non-financial incentives that motivate management have been cited. Some positively value these incentives, whereas others argue that these serve as impediment for management to conduct reforms.
- 13 For example, important incentives include a sense of mission and responsibility and the notion of social trust. It was noted that companies may emphasize solidarity with employees thus resulting in lower levels of executive pay. Other non-financial management incentives would include authority over personnel decisions, rules that exempt them from retirement age, possibilities to sit in honorary posts such as advisors after retirement as a director, or executive pension plans.

Problems with Managements' Terms of Office?

- 14 At many Japanese listed companies, management's term of office is often relatively short and fixed (e.g. 4~6 years) irrespective of their performance. This can prevent management's incentive to make mid/long-term decisions or to make efforts to increase profitability by taking risks. There is data showing that companies where management stay in their office for relatively long-terms (8~12 years) have a higher ROA, which suggests the CEO's long-term commitment towards the business and share price performances³⁶.
- 15 It was also noted that there is an established equilibrium between management's short and fixed term of office and relatively weak governance. This view suggests that if a company extends management's term of office (in order to increase corporate value), it

³⁶ Among 3,143 CEOs who served for 2,000 global companies from 1997 to 2010, the average term of office of CEOs of top 100 companies for stock price performance was 10.3 years (including incumbents).

Calculated by Mikiharu Noma, Associate Professor of Hitotsubashi University using the following source: Hansen, M. T., H. Ibarra and U. Peyer, "The Best-Performing CEO in the World", Harvard Business Review, January 2013.

must also strengthen its corporate governance.

[Proposal/Recommendation]

- 16 Management competency is critical in evaluating corporate value. Senior management must have a broad view based on a long-term perspective extending beyond specific industries, and should have a view on how their company contributes to society.
- 17 A precondition for bold decision making by the CEO is the presence of a talented CFO. CFOs play an important role in balancing capital efficiency and risks. Yet, Japan does not have an abundant talent pool for CFOs. It is necessary to foster CFOs who can play such an important role by expressing their opinions when there is a need to stop projects. Measures can include investors and external directors training CFOs and sourcing professional CFOs from the external labor market.
- 18 The term of office and compensation levels and structures are important factors of management incentives. Yet, what is also crucial is the way responsibilities are fulfilled. One should examine if a company does not impose responsibility on its CEO as part of his/her commitment. It is necessary to reconsider the breakdown of compensation and increase financial incentives so that management will drive innovation and boldly pursue new business model creation.
- 19 One of the biggest motivation and incentive for Japanese management is the sense of mission and appraisal by society. For this reason, the driver for Japanese management to promote corporate value creation can be the presence of society and the nation. One must note the fact that improvement of shareholder value of companies will contribute to improved Japanese pension assets, which in turn leads to the enhancement of the wealth for citizens and society at large. It is often quoted that US companies are nurtured by shareholders whereas Japanese companies are nurtured by consumers and customers. There is also a notion of asymmetry between Japanese individuals' strong sense as a consumer versus their weak sense as an investor/ shareholder. It is important for citizens to observe each company from the perspective of managing their future wealth, which should influence companies' attitudes. This will help to promote a sense of mission that will lead management towards building corporate and shareholder value.

5 Promotion of Mid/Long-Term Investments

5.1 [Discussion Point]

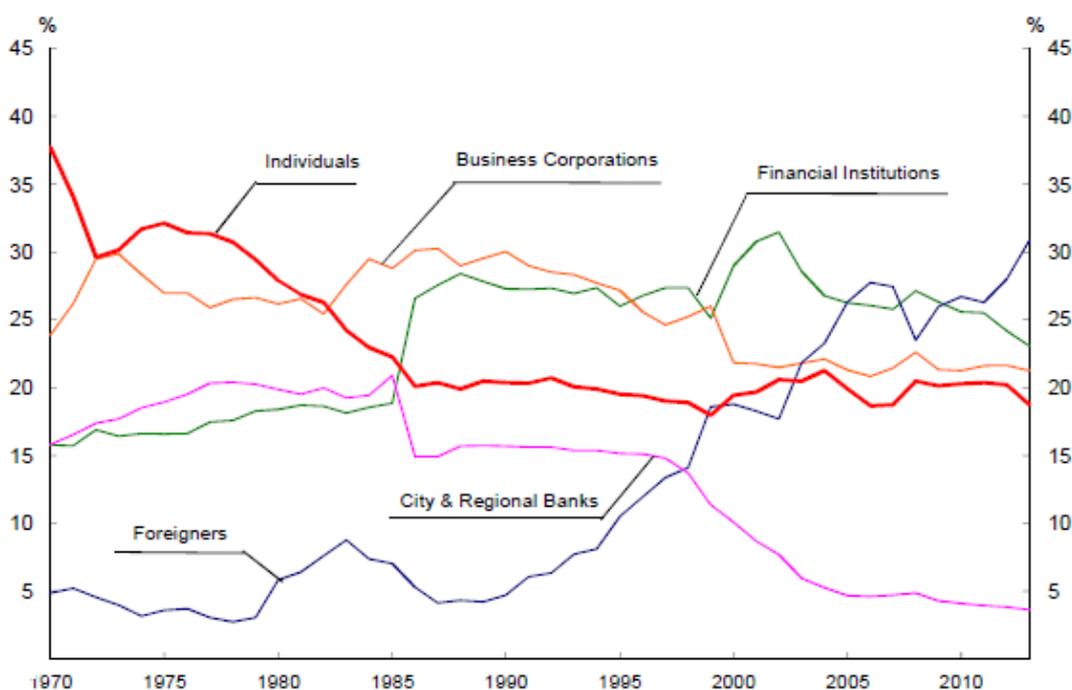
What is the situation of Japanese companies' finance structure and financial assets? Does the Japanese capital market fail to support mid/long-term corporate value creation and contribute to the development of long-term financial assets?

[Discussion and Evidence]

Change in Shareholdings of Japanese Companies

01 The percentage of Japanese companies owned by foreign investors has risen to around 30%, whereas the percentage of shares owned by domestic banks has rapidly decreased to below 5%. Domestic institutional investors claim 25%, exerting a stronger presence. The percentage of shares owned by industrial companies and individuals is around 20%.

<Chart 9: Japanese Equities - Trend of Shareholdings by Shareholder Type>



(Notes) 1. Survey has been conducted on a "Unit-of-Share" basis since 1985 Survey.
2. The market value of Financial Institutions excludes that of City & Regional Banks.

(Source) Tokyo Stock Exchange et al. "Results of FY 2013 Survey on the Distribution of Shareholdings"

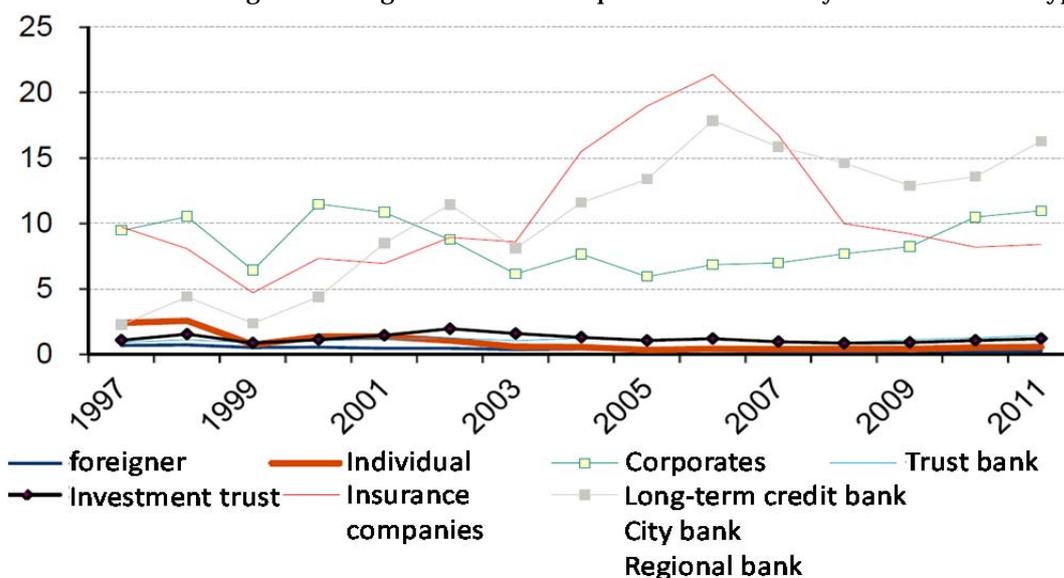
[URL: <http://www.tse.or.jp/listing/yakuin/>]

- 02 Due to the decrease of domestic buyers of Japanese equities, transactions by overseas investors have been increasing their influence on share prices.
- 03 The percentage of cross-shareholding has continued to decrease. In FY2012, the percentage owned by “listed companies” and “listed companies (excluding insurance companies)” was 16.8% and 10.8%, respectively, which are at the lowest level since 1990. The percentage of shareholding by listed banks or life insurance companies has greatly decreased due to Basel III and solvency margin regulations. The percentage of shareholdings by industrial companies has seen a small decrease³⁷.

Holding Period of Japanese Shares

- 04 Looking at the average holding period in the Japanese stock market, domestic banks, insurance companies, and industrial companies tend to hold shares for a long period. The average holding period for institutional investors is less than one year, and it is even shorter for individual investors.

<Chart 10: Average Holding Period of Japanese Shares by Shareholder Type ³⁸ >



(Source) Nikkei Astra, Tokyo Stock Exchange, and BofA Merrill Lynch Global Research

- 05 There are various views as to how we should view the relationship between the holding period and mid/long-term investments. Investors and market players have expressed their views that long-term investments mean investments based on evaluation of

³⁷ Since the end of 2000 to the end of 2012, the percentages of shareholdings by listed banks, life insurance companies, and listed industrial companies have each decreased from 11.5% to 4.4%, 8.6% to 4.3%, and 7.0% to 6.2%, respectively. Kengo Nishiyama [2013] “Japanese Companies’ Cross-Shareholdings” (in Japanese)

³⁸ Naoki Kamiyama [2013] “Japan’s Return Revolution (4): Proposal for Strategies to Revive Japan” (in Japanese)

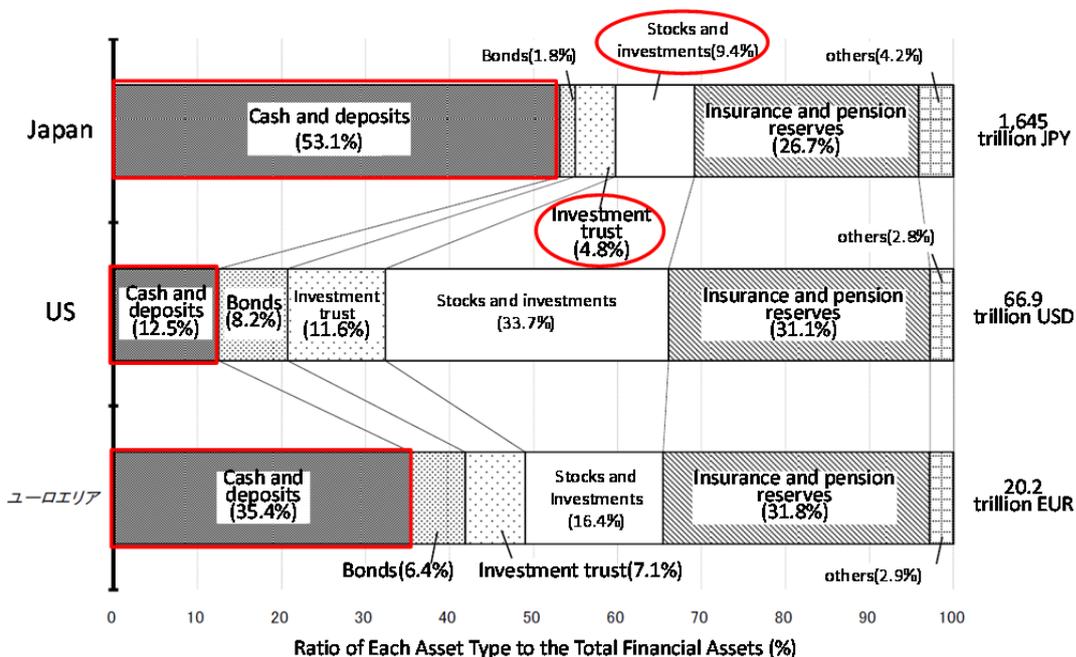
corporate value from a long-term perspective and that a short holding period does not necessarily mean short-termism.

06 In addition to the holding period, it has been noted that many (70~80%) institutional investors holding Japanese shares (e.g. pension funds) mainly depend on passive investment styles. Excessive passive (index-linked) investment would imply that companies trying to change themselves may go unnoticed, and a large number of institutional investors would target investment at market average performance in order to avoid risk. Relative to trading volume, it appears that the number of investors making long-term investment decisions account for only a small portion of the Japanese market.

Breakdown of Japanese Financial Assets

07 Compared to Europe and the US, the breakdown of Japanese household financial assets shows a very high proportion of cash and deposits. This proportion has been static for a long period (unchanged for 20~30 years). The proportions for shares and investment trusts are low. It can be said that Japanese household financial portfolios are not well-balanced from the perspective of mid/long-term asset building.

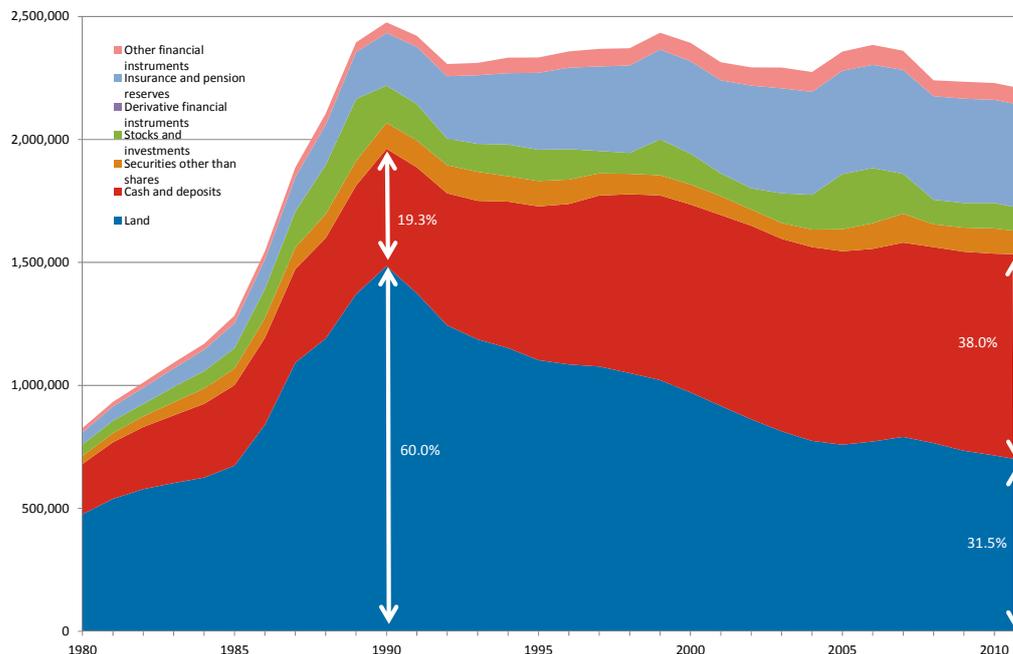
<Chart 11: Comparison of the Composition of Household Financial Assets in Japan, the US and Europe>



(Note) “Others” refer to the remaining balance of financial assets after deducting “cash and deposits”, “bonds”, “investment trusts”, “shares and contributions”, and “insurance and pension reserves.”

(Source) Statistics Office of the Bank of Japan, “Statistics on Fund Flows as Compared between Japan, US, and Europe” (March 2014)

[Transition of individual (household) assets]



(Source) Prepared by FIL Investments (Japan) Limited based on “Annual Report on National Accounts” by the Cabinet Office”

(Note) As for the period up to 1993, the data is based on FY2003 estimates using FY 1995 as the benchmark year. As for the period from 1994, FY 2005 is used as the benchmark year.

08 There is a notable example of Germany introducing policy change in the 1970s in order to improve the livelihood of citizens. Specifically, the German government replaced the promotion of house ownership, which was a major policy after WWII, with asset formation through share investments, and they stipulated several preferential tax measures. As a result, in the 1980s the portion of investment trusts had risen to the 10% range from almost 0%. Germany continued to promote individual investments, leading to big changes of the breakdown of German household financial assets, which, just like Japan, used to have a high proportion of cash and deposits until 1990s. In particular, in the face of the reunification of East and West Germany and the EU integration, ROE of German companies and disclosures have improved, precipitated by revolutions of capital market institutions in 1990s recognizing the need to deal with global competition and to finance from abroad and by tax exemption on capital gains from the unwinding of cross-shareholdings. As a result, the proportion of cash and deposits decreased, whereas the proportion of shares and investment trusts has risen.

[Proposal/Recommendation]

09 Currently the main customers of financial institutions are in their 60’s or 70’s. Those in their 30’s and 40’s, who will be the main customers after several decades, do not have

sufficient income necessary to accumulate financial assets for the future. A decrease in accumulated assets due to over-emphasis on savings and deposits or fees incurred by excessive transactions of financial products should be avoided. Through effective long-term asset management, financial assets as an important foundation for future growth and prosperity should be accumulated.

- 10 In order to make investments in sustainable growth companies so that household assets are enhanced over the long-term, it is important to create an environment that promotes an understanding of investments through direct holding of shares, investment trusts, and pensions.
- 11 As players of the capital market that support Japanese companies, incentive structures for institutional investors (e.g. pensions, insurances, investment trusts) and for individual investors should be analyzed so that measures for long-term investments can be considered.

5.2 [Discussion Point]

Are individual investors becoming short-termists? Can individual investors become long-term investors supporting the long-term growth of companies?

[Discussion and Evidence]

The Perspectives and Needs of Individual Investors

- 01 There appears to be increasing needs of individuals to shift from savings and deposits into investments. A representative from a direct selling investment trust has noted that the majority of their customers open accounts upon researching the nature of their products, and that there is a growing number of investors who have strong preferences for making investment decisions on their own.
- 02 Dividend yield is an important criterion for an individual investor investing in equities. When individuals invest in a company on a long-term basis, they focus on understanding the direction of the company, its business model, and future plans. Individual investors focus more on the impressions they have on these matters rather than detailed numbers and the current state.
- 03 Due to the evolution of the Internet, individual investors can now easily collect information on companies. Yet, rather than making investment decisions based on analysis of information, they often make decisions based on hunch or perception, leading to a stronger tendency of short-term transactions. This is exacerbated by the ease of trading through the Internet and low transaction fees.

Roles of Investment Trusts

- 04 The proportion of investment trusts per GDP in Japan is relatively low on an

international basis³⁹. The proportion of investment trusts to total Japanese household financial assets is also low⁴⁰. As investment trusts would enable individual investors to diversify their investments even with small funds, they can play a certain role as the first step for investments by individual investors.

- 05 The proportion of investment trust assets invested in Japanese companies is roughly 17%⁴¹. It was noted that some investment trusts recommend customers to switch to new funds in order to gain commissions. It was also noted that promotion of investment trusts does not necessarily lead to the promotion of mid/long-term investments based on company fundamentals since incentive for asset managers are not necessarily linked to performance.

[Proposal/Recommendation]

- 06 In order to promote long-term investments in the stock market, it is important to nurture and promote individual investors with a long-term view. Especially critical are those individuals who have been accumulating their financial assets solely in the form of savings and deposits. As explained, equities, bonds, and investment trusts account for 8~16% of individuals' financial assets. Savings and deposits continuously account for 50~54% of total household financial assets and amount to more than JPY 800 trillion, suggesting that Japan has a bigger pool of potential investors than other country.
- 07 If these individuals, for whom savings and deposits have been the only way to accumulate wealth, can learn the advantages and benefits of full-fledged long-term investments with a fresh mind, a totally new pool of individual investors will be created. In other words, it is necessary to foster individual shareholders who support companies over the long term. To do so, it is necessary to foster individual investors who are highly motivated to "make a better society by long-term investments" through equity investments including investment trusts. Individual investors are a key factor in thinking about the future of Japan. Given the enormous amount of funds now dormant as savings and deposits, there is room for vitalizing the Japanese economy by full-fledged long-term investments.
- 08 It is necessary to educate individual investors, who tend to make short-term investments based on hunch and experience, and convert them into long-term investors who make investment decisions based on corporate value. What is needed for

³⁹ The outstanding balance of investment trusts per GDP is 12%, 108%, and 83% for Japan, Australia, and the US, respectively. The Investment Trusts Association, Japan, & IMF.

⁴⁰ The investment trusts account for 4% of the Japanese household financial assets, which is lower than the US (12%), Germany (8%), and France (7%). Source: the Financial Service Agency's Financial research Center, the 1st meeting of the Study Group on Financial Education (November 8th, 2012) Document No.2 "International Comparison of Household Financial Assets" (both in Japanese)

⁴¹ Japan-US Comparison of asset breakdown of investment trusts. The Bank of Japan,

companies is to reconsider the way they approach their individual shareholders, trying to enhance dialogue and building constructive relationships with shareholders. Financial institutions such as securities firms also have a role to promote “correct investment education” as a corporate social responsibility.

- 09 In order to increase long-term individual investors, financial intermediaries are asked to structure investment trusts that aspire to gain long-term stable returns, which are appropriate for long-term investments by individuals. Companies are asked to make efforts to foster their supporters who hold their shares for a long period through emphasizing dialogue with individual investors and offering explanations on their management policies in a manner that is easy to understand.
- 10 It is expected that the Nippon Individual Savings Account (NISA)⁴², a scheme that offers tax exemptions for small investments starting in January 2014, will lead to the promotion of long-term investments. Some suggest further improvement of this scheme, such as extending the tax exemption period or raising the monetary limit. It was also noted that dollar-cost averaging, in which investors invest a fixed amount of money for financial products every month, may be an effective investment strategy to promote relatively long-term investing.

5.3 [Discussion Point]

Is the pension system – which serves a critical role in the accumulation of household financial assets – functioning as a source of mid/long-term capital for companies? Are there any problems with the system?

[Discussion and Evidence]

- 01 Investment in equities (i.e. Japanese companies) accounts for 11.9% of pension assets. The figure is 5~14% for public pensions and 15.8% for corporate pensions. The latter ratio is on a declining trend.

⁴² The scheme exempts dividend income and transfer income gained from new investments in listed stocks or publicly-offered investment trusts. 5 million JPY is the maximum limit for tax exemption (1 million annually JPY). The investment period is 10 years from 2014 to 2023, and the tax exemption period is max 5 years after the year of investment.

<Chart 12: Asset Management by Public and Corporate Pensions>

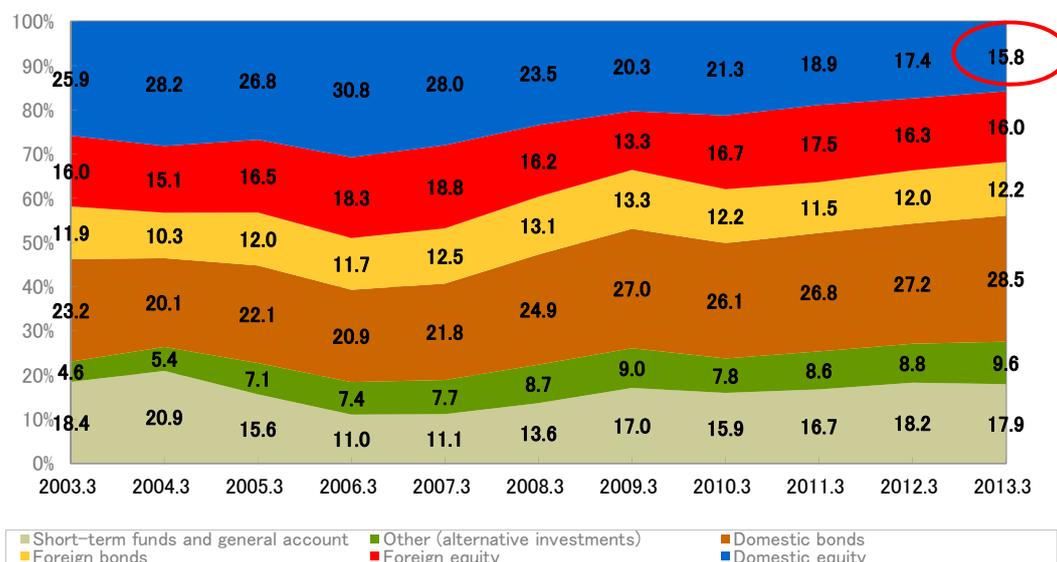
[Asset Management by Public Pensions]

	Government Pension Investment Fund (GPIF)	Federation of National Public Service Personnel Mutual Aid Associations (KKR)	Pension Fund Association for Local Government Officials	The Promotion and Mutual Aid Corporation for Private Schools of Japan	
Total assets <small>(As of the End of March 2013)</small>	120.5 trillion JPY	7.8 trillion JPY	17.5 trillion JPY	3.6 trillion JPY	
Basic Portfolio	Domestic bonds	60% (± 8%)	80% (± 12%)	64% (± 5%)	65% (± 9%)
	Domestic Equity	12% (± 6%)	5% (± 3%)	14% (± 5%)	10% (± 3%)
	Foreign bonds	11% (± 5%)	0% (+1.5%)	10% (± 5%)	10% (± 3%)
	Foreign equity	12% (± 5%)	5% (± 3%)	11% (± 5%)	10% (± 3%)
	Other	short-term assets: 5%	short-term assets: 4% (± 4%) Real Estate: 2% (± 2%) loans: 4% (± 4%)	short-term assets: 1% (+3%, -1%)	short-term assets: 5%

Prior to the change of the GPIF's basic portfolio on June 7, 2013, the breakdown of their previous portfolio was as follows: domestic bonds (67%), domestic stocks (11%), foreign bonds (8%), foreign stocks (9%), and short-term assets (5%).

(Source) Cabinet Secretariat, "Final Report of the Panel for Sophisticating the Management of Public/quasi-public Funds" (published on November 20th, 2013)

[Changes in the Asset Breakdown of Company Pensions (excluding defined contribution benefits)]



(Source) Prepared by FIL Investments (Japan) Limited based on "Results and Discussion of the Survey on Asset Management (FY2012)" by Pension Fund Association

02 It was noted that equity investments by pension funds have been declining in-line with the general trend of "de-risking (Departing from Risk)" after the Lehman financial crisis. It was also noted that companies tend to manage their pensions conservatively

in order to respond to the concerns of management given that insufficient reserves could adversely affect their profit and loss statement.

- 03 As for the US, the UK and Australia, where the defined contribution annuity plans have superseded defined benefit plans, investment trusts have become rapidly widespread among citizens and the individuals' mindset towards investment has changed as evidenced by large changes in household asset allocations⁴³.
- 04 In Japan, there is a growing shift from defined benefit plans to defined contribution plans, partly influenced by disclosure requirements for defined benefit pensions whose reserves are currently insufficient.
- 05 The US, the UK and Australia are implementing policies to promote greater financial literacy as defined contribution plans increase in number. For example, Australia has established the National Financial Literacy Strategy in 2011.

[Proposal/Recommendation]

- 06 Pension schemes, especially defined contribution plans, play important roles as sources of significant long-term capital for sustainable growth of companies, and towards fostering individual consciousness and understanding of investments. All of this would promote a more robust capital market.
- 07 Pension funds, as “institutional investors that are asset owners”, should be appropriately managed and incentive structures of asset managers commissioned by these asset owners should pursue the interests of beneficiaries. The establishment of “Principles for Responsible Institutional Investors (Japan’s Stewardship Code)⁴⁴” is expected to promote greater accountability and related disclosures for institutional investors.
- 08 Given that Japan is witnessing an increase of defined contribution plans similar to other countries, it is important to improve the usefulness of such plans. The limit for tax-exempt contribution, eligibilities for enrolment, and selections of various default investment products are some areas that have been cited for improvement. It is necessary to consider improvements to make the current scheme more user-friendly

⁴³ In the US, investment trusts were the driving force for the shift from savings to investment. In particular, IRA and 401(K) were institutional factors to promote investment trusts among ordinary citizens.

In the UK, a new Act has introduced enrolment for every employee into approved employee pension plans. There is a clear trend of shifting from defined benefit to defined contribution. NEST is provided as a governmental plan for every employer, and 250 thousand people are currently enrolled.

In Australia, mandatory enrolment in Superannuation, in which contribution is defined and employer contributes a fixed portion, the scale and proportion of investment trusts have rapidly increased. On the other hand, more than 40% of assets are invested in default products. This suggests that in Australia, a country where investments are advanced, investments in financial products (investment trusts) designed by professional fund managers.

⁴⁴ Japan’s Stewardship Code <http://www.fsa.go.jp/en/news/pub.html>

and to enhance financial literacy.

6 Incentive Structures of Asset Managers

6.1 [Discussion Point]

Are compensation schemes for asset managers (institutional investors as asset managers) linked to long-term perspectives or their performance? In Japan, is the incentive structure distorted due to the fee structure set by asset owners and how they evaluate their asset managers?

[Discussion and Evidence]

Evaluation and Compensation Schemes Within Asset Management Organizations

- 01 Most domestic asset management companies are affiliated with financial conglomerates, rendering it difficult for them to make long-term management commitments as asset management firms due to job rotations. It is noted that those in management functions often come from planning or sales departments. On the other hand, in Europe and the US, those engaged with asset management, such as CIOs, are often involved in company management. There is evidence that they also allocate personnel more flexibly⁴⁵.
- 02 With respect to compensation of asset managers, it was noted that an important challenge is to align the purpose of the company with the interests of the asset managers within the compensation structure and to decide compensation policies based on long-term performance, and to require disclosure of such compensation.
- 03 There are cases where compensation for asset managers, including buy-side analysts, is based on mid/long-term perspectives both domestically and abroad. There are examples in which buy-side analysts are evaluated not only on the performance of the current year but also on accumulated performance for two or three years, based on the so-called “1-2-3 formula”. However, weighting differs from company to company.
- 04 Compared to foreign-owned counterparts, domestic asset management firms tend to have less emphasis on paying-for-performance. Although they may differentiate annual salaries and bonus based on performance to some extent, the gap is much smaller than at foreign firms. There is a view expressed that this may have a commonality with executive compensation in Japan.

⁴⁵ For example, in foreign-owned asset management firms in Japan, the distinction between line managers and specialists tend to be based on their occupations. Managing directors (MDs) are regarded as one of senior executives, but there are cases where an MD is an experienced analyst of a specific sector. Also, in some cases a research director in 30s can be someone skilled at administration.

Evaluation by Asset Owners (Asset Managers' Perspective)

- 05 The question whether the compensation system for asset managers is distorted due to asset owners' stance is related to the issue of short-termism. It is noted that there are detrimental effects when asset owners evaluate asset managers (including buy-side analysts) based on a single year's or quarterly investment performance, sometimes even shorter. Even if this tendency doesn't result in the asset owner replacing an asset manager, management of asset management firms may adjust their internal evaluations and decisions to be more short-termed.
- 06 Asset owners also emphasize relative performance against a benchmark (index), therefore creating incentives to hug benchmarks as opposed to making optimal share selections.

[Further Considerations]

- 07 The gap of compensation levels between domestic and foreign asset managers used to be explained by differences in job security. It is necessary to verify if this reasoning is indeed valid. For instance, if the de facto parent company belongs to a different industry (e.g. banks, securities or insurances), is the compensation system of this parent company being imposed on the asset management company.

7 Challenges of Asset Owners

7.1 [Discussion Point]

Does the selection of asset managers by asset owners (especially pension funds) help eliminate investor short-termism and promote long-term investments and active engagement with portfolio companies?

[Discussion and Evidence]

Pension Funds as Asset Owners

- 01 In general, the personnel structure of pension funds is proportionate to their size. It has been noted that Japanese corporate pension funds are generally under-staffed.
- 02 Globally, pension asset managers are required to be specialists. In Japan, on the other hand, officers and fund managers of pension funds are often subject to job rotations, including non-investment functions such as human resources, labor affairs, and accounting and finance.
- 03 While pension fund managers around the globe typically receive high compensations after undergoing a rigorous evaluation process, in Japan compensation does not differ much from other staff, and very few pension funds treat their fund managers as specialists.

The Reality of Pension Fund Operations

- 04 Generally, consultants are involved when pension funds select asset managers. Therefore, evaluation criteria used to assess asset managers are usually standardized.
- 05 In Japan, corporate pension funds are often regarded as a “cost center” rather than a source to help accumulate employee assets. A company acquired by an overseas company cited that they actually set a threshold rate (based on cost of capital) for any potential investment, including pension assets.
- 06 Some pension funds, which by nature should look at the long-term profitability of investments, have fallen into short-termism. For example, some pension funds make evaluations based on short-term performance (e.g. quarterly) using monthly performance as benchmark. It was noted that relationships with the sponsoring company or accounting needs are factors contributing to this.

Evaluation of Asset Managers by Pension Funds (Asset Owners’ perspective)

- 07 It was noted that, in the context of evaluations of portfolio companies and asset management firms by corporate pension funds, while priority is placed on investment performances they also look at investment philosophies and ideas, risk management systems, asset management processes and structures.
- 08 The Pension Fund Association (PFA), a major Japanese pension fund, classifies actively-managed domestic equities into “Value”, “Core” and “Gross”. The PFA strives

to maximize returns from each asset class under the premise that the market is unpredictable. Asset managers are evaluated by their performance in each respective asset class, both qualitatively and quantitatively. From a qualitative perspective, they check for any discrepancies from agreed investment mandates and also ensure that there is a sound corporate structure. From a quantitative perspective, the PFA evaluates performances for 1, 3, and 5 year periods, although they do not terminate contracts solely due to a single bad performance.

- 09 In the past there have been many cases where pension funds ask for asset management firms to report their performance quarterly. Yet, it was noted that in recent years there have been a growing number of cases where certain influential pension funds only ask for semi-annual or annual reporting. In this sense, there is a view that there is decreasing pressure from asset owners contributing to short-termism at asset management firms.

[Proposal/Recommendation]

- 10 When asset owners select asset managers, they should not focus solely on short-term performance. Rather, they should make comprehensive assessments of performance including both qualitative and mid/long-term aspects. However, it should be noted that mid/long-term performance is a buildup of daily performance.
- 11 The main role of Japanese asset owners is to find capable asset management firms. In this sense, they are not committed to detailed research of individual portfolio companies. Therefore, in the process of engagement with companies, asset management firms are ones that play a direct and leading role.
- 12 In order to improve returns of the Japanese equity market as a whole, large asset owners, such as public pensions, should require asset managers to have policies on promoting engagement with portfolio companies, long-term oriented investments, and specifically avoid short-termism. In this regard, Japan's Stewardship Code is expected to function as a catalyst towards this. It is also important to consider the cost-effectiveness of this approach. In November 2013, "The Panel for Enhancing the Management of Public/Quasi-Public Funds" has published their proposals towards this end.
- 13 In some European countries, public pensions require a certain consideration on ESG issues in making investment decisions. The need and possibility of introducing such a requirement in Japan is worth discussion.
- 14 It is important for Japanese corporate management and related parties to reconsider the role and functions of pension management. Corporate pensions should not solely be regarded as cost centers. It is necessary to consider their roles given that their performance is reflected to the pension cost and the balance sheet.

8 The Role and Incentive Structure of Sell-side Analysts

8.1 [Discussion Point]

In response to a change in the needs of institutional investors, are sell-side analysts becoming more short-term and less focused on investment evaluation? Analysts may lack awareness of their social mission and may face deteriorating capabilities in critical questioning and analytical work. Are analysts being appropriately trained and developed?

[Discussion and Evidence]

Expected Role of Sell-Side Analysts

- 01 Investors expect sell-side analysts to provide meaningful and diverse information, thereby promoting market efficiency. The primary role of sell-side analysts, which is also beneficial to the public, is to perform a value discovery function within the capital markets by analyzing the fundamentals of companies and assessing corporate value. Analysts' secondary role is to analyze and predict the market price of publicly traded companies. While this is almost synonymous with the primary role in the case of long-term investment, short-term investment may require different skills and information.
- 02 Companies expect sell-side analysts to perform objective mid/long-term analysis of companies and assess their business strategies; provide strategic advice; and to encourage dialogue between companies and investors from a mid/long-term viewpoint.
- 03 It was noted that sell-side analysts also indirectly influence corporate governance. In particular, compared with institutional investors who can influence corporate governance by means of exercising voting rights and selling shares of portfolio companies, sell-side analysts have wide-ranging influence on corporate governance by publicizing their assessments of corporate value.

General Problems with Regard to Sell-Side Analysts

- 04 While there are various types of sell-side analysts, it was recognized that there are highly-valued analysts who conduct research to assess corporate value over a mid/long-term period, and who have detailed knowledge of specific industrial sectors.
- 05 On the other hand, as general problems with regard to sell-side analysts, the following were noted: 1) prevalent short-termism, 2) insufficient mid/long-term fundamental analysis, and 3) insufficient essential dialogue with companies.

Short-Termism of Sell-Side Analysts

- 06 Both companies and investors noted that the analysis performed by sell-side analysts has excessively inclined towards quarterly earnings and earnings forecasts, and that

event-driven reporting has increased.

- 07 Although sell-side analysts generally recognize problems associated with quarterly earnings, young analysts have no experience of the era before mandatory quarterly disclosures were introduced, and therefore they consider managing their work in short-term cycles to be their main duty. This is reflected by the fact that there are numerous short-sighted questions raised in IR meetings by these analysts.
- 08 Although quarterly reporting can be used to understand corporate performance over the immediate period, it is of concern that the function of long-term corporate valuation seems to have been neglected because sell-side analysts are too busy with short-term and event-driven tasks.
- 09 A unique trend in Japan, neither seen in Europe nor the US, is an increasing burden of tasks unrelated to corporate value creation, such as the need to conduct quarterly preview meetings.

Insufficient Fundamental Analysis

- 10 As a criticism against sell-side analysts, it was noted that long-term fundamental analysis has not sufficiently been performed because sell-side analysts have prioritized daily communication with asset management firms.
- 11 Companies also noted that the analysis done by sell-side analysts and their questions are limited to short-sighted matters and that their overall analytical capabilities seem to be on a decline.
- 12 For global institutional investors, who are clients of sell-side analysts, ESG (environmental, social and governance) has also become one of the research items in addition to conventional analysis. While numerous overseas independent research firms are conducting ESG evaluations, there is little independent research done in Japan on this front. Coupled with the insufficiency of ESG information provided by Japanese companies, this has led to the low coverage of Japanese companies.

Insufficient Essential Dialogue with Companies

- 13 Investment companies indicated that they expect sell-side analysts to provide corporate access rather than research work.
- 14 The amount of intense dialogue between sell-side analysts and management is decreasing. This is due to a falling relevance of information provided by sell-side analysts given the enhancement in company IR activities and the use of Internet as a medium for information distribution.

Hypotheses on the Causes of this Problem

- 15 The main cause of these problems are: 1) the fact that services are offered in response to demands of institutional investors and the structure of compensation and incentives; 2) the quarterly earnings disclosure system; and 3) the reduction of staff. In

addition, the influence of a downsizing in investment banking business was pointed out.

Incentive Structure Resulting from Client Needs

- 16 It was noted that the incentive structure for sell-side analysts reflects the fact that securities firms are tending towards short-termism as they have no choice but to cater services towards short-term investors which offer them higher turnover and thus commission income compared to long-term investors. The liberalization of commissions was raised as a cause for this trend. There is a view that the growing uncertainty of commission income as well as the trend of commission compression has encouraged the view within securities firms that analysts who do not generate revenues are not necessary. As a result, it was noted that securities firms perceive analysts over the short-term as a cost center, and hence the framework for supporting analyst education is weakening.
- 17 Although details differ from one securities firm to another, compensation of analysts is mainly based on 1) the evaluation of the brokerage firms by clients and 2) in-house quantitative and qualitative evaluation of each analyst. This may lead to a tendency to prioritize services (e.g. short-term information, corporate access) for higher-paying clients.
- 18 Some securities firms are increasingly paid by investment institutions such as hedge funds, which may have small assets under management but large transaction volume and pay a high commission rates (40~50% of all research commission according to the interviewed companies), and this has served to exacerbate this tendency. Hedge fund rankings of analysts are also published by a leading US analyst evaluation institution, which may have also promoted short-termism.
- 19 It was noted that since commissions have become a main source of income, there is more incentive to increase transaction volumes. Furthermore, some listed companies reject and/or exhibit distrust towards analysts that place a “sell” rating on them. These two factors appear to have resulted in analysts making more transaction-oriented (i.e. “buy” or “sell”) recommendations as opposed to “hold” recommendations.

Adverse Effects of Quarterly Disclosure and Earnings Forecasts

- 20 As mentioned previously, sufficient time has not been allotted for communication between analysts and management and for proper assessment of mid/long-term corporate value, mainly because analysts have become too busy with following quarterly earnings after mandatory quarterly earnings disclosure was introduced.
- 21 In addition, newspapers may publish earnings forecasts prior to the release by companies. Newspapers include expected achievement ratio of forecasted earnings, which matches with the data officially published by companies. Therefore, sell-side analysts are under pressure not to be slow at gathering information, and pay careful

attention to the fluctuations in company performance.

- 22 It was also noted that communications between sell-side analysts and companies have decreased because the length of the quiet period has doubled as a result of quarterly disclosure requirements.⁴⁶

Decline in Analyst Quality Resulting from Fewer Analysts

- 23 One cause behind the analyst problem is that the number of analysts is insufficient in Japan compared to other countries. Because of reductions in the number of analysts, the number of listed companies covered by analysts has decreased while the number of companies that each analyst must cover has increased. There was also an indication that an increase in working hours has led to a fall in the creativity and the quality of research.

<Chart 13: Coverage by Domestic Sell-side Analysts⁴⁷>

Number of analysts	Number of companies		Total number of analysts		Market capitalization (1 billion JPY)		
	Number	%	Number	%	Average	Total	%
0	512	30.8	0	0.0	11.0	5,630	2.1
1 - 3	554	33.3	918	12.5	46.1	25,516	9.7
4 - 6	180	10.8	871	11.9	88.7	15,970	6.0
7 - 10	160	9.6	1,318	18.0	153.9	24,616	9.3
11 - 15	107	6.4	1,360	18.5	335.7	35,919	13.6
15 - 27	151	9.1	2,875	39.2	1,036.6	156,521	59.2
Total	1,664	100.0	7,342	100.0	-	264,173	100.0

(Note) Using “TOT ANR REC” function of Bloomberg, the number of analysts covering each company listed in TSE 1st section was calculated.

(Source) Prepared by Strategic Research Department of Mizuho Securities Co., Ltd. based on Bloomberg data.

Downsizing of Investment Banking Support Functions of Sell-side Analysts

- 24 Another cause behind the fall in research quality is the downsizing of support functions within investment banks. In the US, segregation of sell-side analysts and investing banking departments has become mandatory after the Enron scandal. In Japan,

⁴⁶ Companies often limit their contact with investors during the period between the quarterly account day and disclosure, in order to prevent the risk of leaking undisclosed information.

⁴⁷ Goro Kumagai [2012] “Reconsideration of Practical Aspects of Disclosure of Earning Forecasts on the Tokyo Stock Exchange” Capital Market Research Vol.22 (in Japanese)

amendments of Code of Ethics by the Japan Securities Dealers Association in June 2004 prohibited analysts from being involved in investing banking matters. There is a view that these have contributed to a decrease in dialogue between analysts and management regarding management strategies.

[Proposal/Recommendation]

- 25 In consideration of improving evaluation of sell-side analysts and short-termism, it is worth examining the commission sharing arrangement (CSA), which has become prevalent in Europe and the US. Historically, institutional investors paid for research through trading commissions. However, for the purpose of increased transparency of the cost of pension funds, the increasing adoption of CSAs is resulting in the unbundling of research commissions from trading commissions so that research fees are paid separately from other fees. If research fees are measured in a more detailed way, improvements in the quantity and quality of research can be expected and it may promote the development of independent analyst firms.
- 26 In addition, it was also recognized that quarterly earnings disclosure and earnings forecasts have an effect on the activities of sell-side analysts and it is therefore important to examine a desirable disclosure system and how to best respond to the information disclosed.
- 27 It is important that sell-side analysts provide in-depth reports through sufficient dialogue with companies after carefully analyzing the fundamentals of companies in a detailed way and assessing corporate value and creating a long-term earnings forecast. Through dialogue about mid/long-term investment ideas between sell-side analysts and institutional investors, based on “in-depth reports”, the role of the analyst can be questioned and discussed. Through these “in-depth reports,” it will be necessary to develop a business model across the industry for promoting incentives for sell-side analysts to conduct corporate value assessments on a long-term basis. It should be reconfirmed that first-rate analysts can be nurtured in such an environment.
- 28 As often seen in fundamental research conducted in the US, it is important that an analyst report is sensitive to the particular analyst’s distribution of ratings across the coverage universe (to ensure no bias), contains detailed earnings forecasts, and provides solid rationale to support the investment rating. This approach contributes to evaluating a company from a long-term perspective and also helps to deepen constructive dialogue with companies.

9 Short-Termism of Investors

9.1 [Discussion Point]

The stock market has witnessed the phenomenon of short-termism in recent years. In Europe and the US, there have been arguments that short-termism in investment communities has negative effects, such as leading to short-termism in decision making of companies and their investment activities (e.g. UK “Kay Review”).

The same phenomenon seems to be happening in Japan. The capital market by nature requires diversity brought by investors with different time horizons, but there might be incentives to place a disproportionate emphasis on short-termism, including investors who should be long-term oriented.

[Discussion and Evidence]

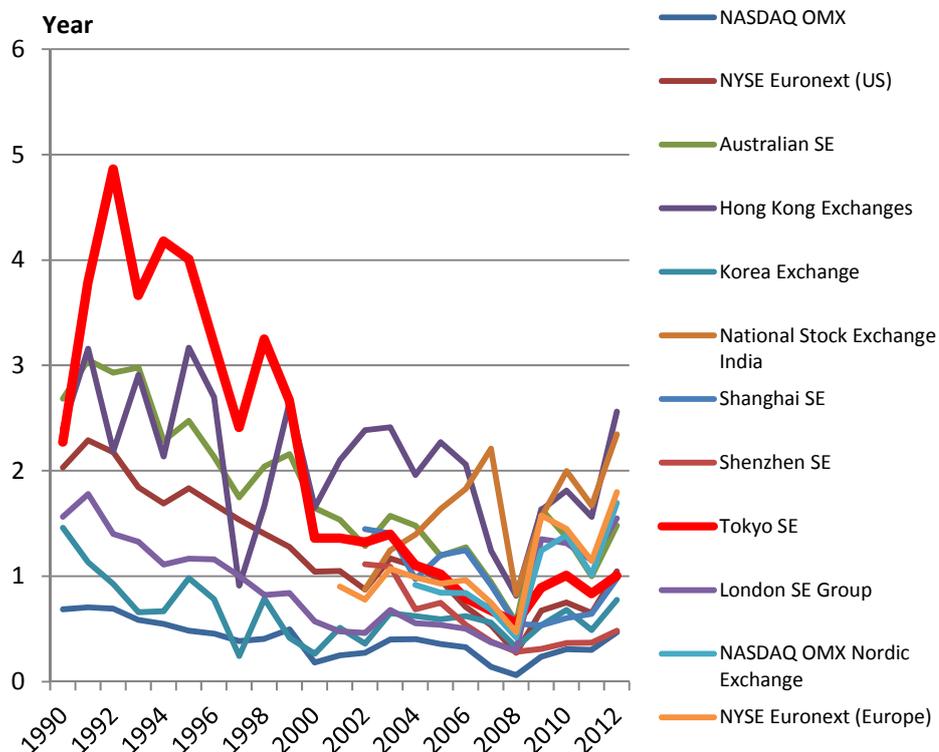
Indications of Changes in the Stock Market

- 01 As an indication of the change occurring in the stock market, holding periods of equities has become increasingly shorter while transaction volume has been greatly increasing. This indicates a shift in the capital markets from being a source of capital to a source of short-term trading opportunities.
- 02 The average shareholding period has become shorter (in other words, trade turnover ratio has been on the rise) across the world’s major stock markets [See below]. In particular, the average shareholding period for Japan, the US, and the UK has become amazingly short over the last several decades^{48 49}.

⁴⁸ The average stock holding period for three countries has changed as follows: 14 years (in 1940s) to 1 year (in 2000s) in the US; 8 years (in 1960s) to less than 1 year (in 2000s) in the UK, and 4 years (in mid-1990s) to less than 1 year (in 2000s) in Japan. Haldane, A.G, “Patience and Finance,” Oxford China Business Forum, Oct,2010

⁴⁹ Mid-1990s in Japan is a period where transactions, IPOs and rights offering were restrained given the fallen stock prices after the bubble burst. There is a view that using the trade turnout ratio in this period as the basis is not necessarily appropriate.

<Chart 14: Average Shareholding Term (in Years) of Major Equity Markets>



(Note) Approximate value calculated by dividing the aggregated end-of-year market capitalization by the annual trading volume.

(Source) Prepared by Shoichi Tsumuraya, Associate Professor at Hitotsubashi University using World Federation of Exchanges data

Issues Surrounding Short-Termism

- 03 Short-termism does not necessarily refer to the short shareholding period. In particular, when we look at the market's turnover ratio, this includes transactions both by mid/long-term oriented investors as well as traders who supply liquidity to the market through short-term arbitrage. Therefore this ratio would not necessarily serve as a benchmark to judge whether investors have become more short-term.
- 04 Therefore, in addition to shareholding periods one must assess the decision making criteria of each investor.
- 05 For instance, when short-term investors trade, they typically look at very short-term performance data, and the movements and directions of share prices (irrespective of corporate value creation). A typical investment technique is computer-based short-term transactions based on the analysis of vast amounts of data.
- 06 Investors (including buy-side analysts) with short-term approaches look at 1) earnings forecasts of sell-side analysts; 2) news flow such as introduction of new products; 3) rumors in the market; and 4) movement of sell-side ratings. Short-termism refers to

speculative behavior without detailed analysis of a company's fundamentals.

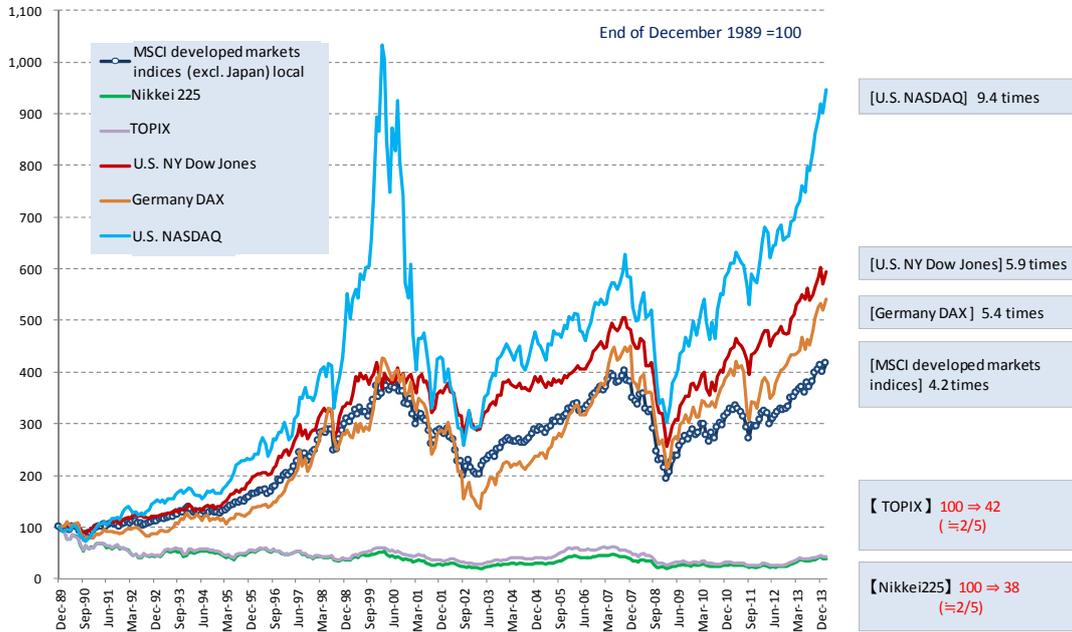
- 07 Another important perspective in considering short-termism is the need to distinguish between "Investors" (that aim to make investments in businesses) and "Traders" (that aim only to make transactions or speculations). Traders are by nature short-term; whereas the investors' perspective varies according to their respective investment horizons.
- 08 Short-termism and liquidity are not directly linked to each other. Liquidity is produced where there is diversity, which includes not only diversity of timelines but also diverse viewpoints for companies. With regard to liquidity and stability, attempting to reflect every piece of new information into investment decisions can be taken to be short-termism.

Reasons for Short-Termism in Investment Communities

- 09 In comparison to other countries, there appears to be economic rationality behind the prevalence of short-termism in Japan. For a long period, there has been little expectation of share price appreciation, therefore making short-term transactions a reasonable means of trying to maximize returns in such a market. As the chart below shows, if we take a look at the accumulated returns of major indices in the past 25 years, Japan is at a low level. As for the accumulated returns since the Lehman financial crisis (since September 2008), Japan has experienced a relatively slow recovery in its share prices compared to other countries.

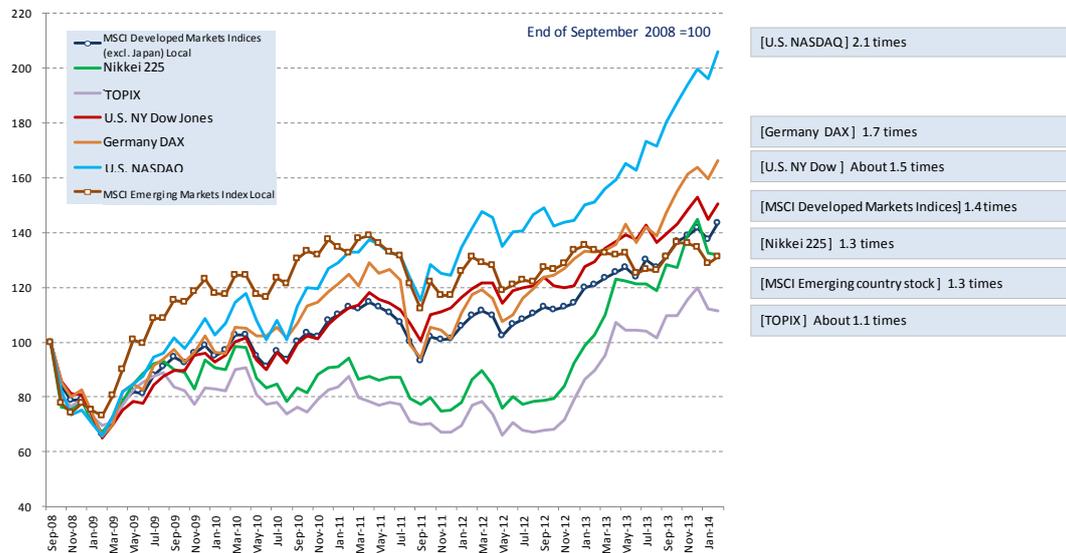
<Chart 15: Accumulated Returns of Major Equity Indices>

[Past 25 years (The end of 1989 to the end of February 2014)]



(Source) Prepared by Tokio Marine Asset Management Co., Ltd. based on Bloomberg data

[Post-Lehman financial crisis (The end of September 2008 to the end of February 2014)]



(Source) Prepared by Tokio Marine Asset Management Co., Ltd. based on Bloomberg data

- 10 Secondly, there is a strong incentive within investment communities to promote short-termism among asset managers, asset owners, and sell-side analysts.
- 11 Thirdly, companies may fail to effectively provide information necessary for investors to make long-term investment decisions. Institutional investors will have a long-term perspective for companies that clearly explain how they achieve corporate value growth over the long-term. On the other hand, investors have no choice but to pursue short-term profitability for those companies that do not offer such explanations. Given that there are always short-term fluctuations in share prices and little understanding of long-term growth, institutional investors have no choice other than leaning towards short-termism.
- 12 Fourthly, there are some regulatory frameworks that promote short-termism. For example, given the emergence of market infrastructure enabling rapid transactions at relatively cheap commissions, securities firms have been led to pursue higher transaction volume in order to make profits. In addition, quarterly disclosure requirements, which originally were intended to provide transparency of short-term earnings progress, have served to fuel short-term behavior of sell-side analysts and investment communities.

[Proposal/Recommendation]

- 13 In order to promote long-term investments, it is necessary to provide investors with expectations for a long-term rise in share prices. Short-term transactions are partly due to the lack of such rises in share prices. It would be meaningless to blindly promote long-term investments without making improvement in this situation. If there are a number of potential investment opportunities with soaring share prices, it is possible to lead investments towards these.
- 14 It is also 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 – that support Japanese companies – must be converted to drive mid/long-term investments. Towards this end, with the incentive structures and associated issues – for both institutional investors (pension funds, insurers, investment trusts, etc.) and individual investors – identified in this project as a base, the various discussions and proposals of this project should be holistically captured through the optimization of the investment chain⁵⁰. 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 lead toward excessive short-termism, and creating and implementing measures to promote greater breadth of players that will make long-term investments based on corporate value are

⁵⁰ The “investment chain” describes the various paths and processes of capital flowing from its providers down to where companies deploy it towards business activities.

important.

- 15 For each Japanese company, it is important to attract long-term oriented investors who understand the company well and support it. If management communicates the future vision of the company in their own words, while taking into account the perspective of investors, and execute on their strategies and policies steadily, this will lead to attracting long-term oriented shareholders. It is therefore essential for companies that management communicates with investors on their story for sustainable growth rather than spending too much efforts for short-term and boiler-plate disclosures. Integrated reporting can be one effective means towards this purpose.
- 16 It is important for the capital market that there are diverse investors, including not only long-term but also mid-term and short-term investors. It is important for capital markets to have not only long-term investors, but also a diverse range of medium- and short-term investors as well. Investors with different investment time horizons participate based on their respective share price valuation, and the resulting supply and demand drives share price formation. From the mid/long-term perspective, the suppliers of long-term capital (such as pension funds) promote the overall enhancement of management capability and corporate value creation by ensuring that funds are selectively invested in those companies that have strong business portfolios, strong competitive differentiation, and strong management capability that will help to drive their sustained growth. Taking the diversity of investors as a given, it is important to create alignment between the long-term viewpoint of investors and that of management, as well as maintain consistency between the long-term viewpoint of investors and that of management.

10 Short-Termism of Management

10.1 [Discussion Point]

As investment communities, both inside and outside Japan, are becoming increasingly short-term, is company management also becoming short-term oriented? Does short-termism of investors serve as a hindrance for companies to formulate and execute mid/long-term strategies?

[Discussion and Evidence]

Evidence for Short-Termism of Management in Japan and Overseas

- 01 In Europe and the US, there are arguments which suggest that investors' short-termism leads towards short-termism of company management. For instance, it was noted that disclosure of quarterly earnings compels asset managers to focus on short-term performance, which in turn contributes to the short-termism of management. Many authorities⁵¹ in business studies propose various ways to avoid such short-termism.

Recognition of Limited Short-Termism in Company Management

- 02 There are many opinions suggesting that investors' short-termism has little or no impact on Japanese companies' short-termism.
- 03 Looking at investment cash flow of Japanese companies, there appears to be no tendency of decreased spending relative to other countries. Japanese companies appear to make a certain level of investments, including R&D, and the data does not confirm the influence of capital market short-termism on company management.
- 04 Company representatives were of the view that short-termism does not present a barrier to sustainable growth of companies. Companies are of the view that there is no need run about in confusion unless their management has indeed fallen into short-termism.

Investors' Influence on Company Management and Differences in Time Horizons

- 05 It was noted that Japanese companies' management is not influenced by investor short-termism partly due to the relatively smaller influence of shareholders on management compared to in other countries such as the US. In general Japanese management regards their customers as the most influential constituency, and is relatively less influenced by investors.
- 06 There is a view that this tendency is caused by a perception gap between company

⁵¹ For instance, Hayes and Abernathy [1980], Porter [1992], Drucker [1993], Albert, Zaheer, and Zaheer [2000], and Rappaport [2011].

management and investors with respect to time horizons⁵². There are two aspects to this view.

- 07 Firstly, the time horizon of investors and that of companies are essentially different. The capital market portfolios can be shuffled in a short period, but business portfolios that aim towards sustainable growth are based on continuous value propositions to customers. Thus changing them by acquisition, sales, or withdrawal takes years to achieve. The equity market exists partly due to such differences in timelines.
- 08 Secondly, there are gaps in understanding and recognition due to insufficient dialogue between companies and investors. Such gaps could result in, for instance, the following situations: a company demands investors to hold its shares for the period it takes to recover capital investment. Alternatively, in order to gain short-term profits, an investor demands that a company takes short-sighted actions.

The Influence of Market Short-Termism on Company Management

- 09 There are phenomena which suggest that Japanese companies are potentially influenced by investor short-termism. For example, the following examples have been cited: Large investments such as R&D are postponed in order to adjust short-term profits. Investments are carried over in order to secure profits and to avoid risking investor concern towards share prices being affected by decreased profits or dividends. There is empirical research showing that companies whose shares are in large part owned by banks or have expensive debts from banks tend to decrease R&D investments when their performance is poor⁵³.
- 10 Quarterly earnings disclosures and booking of impairment losses are mentioned as factors with possible influence of the short-termism of Japanese companies coupled with short-termism of investment communities.
- 11 Regarding quarterly earnings disclosures, it was noted that it is useful in making short-term in-house checks in order to understand the progress of long-term directions of the company.
- 12 The influence of quarterly disclosures on sell-side analysts has already been explained. It was noted that even though both the company and their mid/long-term investors share a recognition that a stand-alone quarterly earnings disclosure in and of itself has little significance towards mid/long-term strategies, there is still an effect because management feels an accountability towards the disclosed information.
- 13 Regarding earnings forecasts, although short-term earnings (e.g. quarterly) only has a small impact on corporate value (e.g. future cash flows), there is a tremendous cost and

⁵² Corporate Reporting Lab, Ministry of Trade, Industry and Economy [2013] “Survey on Actual Practices of IR/Communication for Sustainable Creation of Corporate Values ” (in Japanese)

⁵³ Mikiharu Noma [2009] “R&D Investments and Analyst Coverage – Are Short-Sighted Activities Taking Place in Order to Achieve Benchmarks?” *Accounting & Audit Journal*, No. 643, FEB. 2009 (in Japanese)

influence associated with dealing with reported forecast figures and making necessary corrections. For instance, there are a growing number of cases where the impairment of goodwill and held assets grabs the spotlight. In such situations, companies put more weight on discussions with their independent auditors regarding their future estimates based on the purpose of timely and adequate disclosure. Analysts and investors must beware lest companies have lost a long-term perspective due to being too cautious about impairment risks.

Is Japanese Management Long-Term Oriented?

- 14 There is a view that Japanese companies have not fallen into short-termism influenced by the short-termism of capital markets. Even if they have, its influence is limited. However it is not necessarily understood that Japanese companies are managed from a long-term viewpoint. Although there is practice to disclose mid-term management plans, the actual level of achievement is very low. At the same time company management are overly concerned that they will be evaluated based on the progress of this plan, therefore making it harder for management to focus beyond the term of the plan. There is also a possibility that replacement of management occurring every few years is regarded as evidence for hesitation towards long-term investments greater than 10 years.

11 Corporate Disclosure towards Sustainable Growth

11.1 [Discussion Point]

High-quality disclosure is known to earn high appraisal from the capital markets, therefore resulting in a lower cost of capital. Does the current disclosure system of Japan encourage dialogue between companies and investors? Is it influencing short-termism of investors and/or companies?

[Discussion and Evidence]

Investors' Overall Impression on Japanese Companies' Disclosures

- 01 Investors note that Japanese companies have by and large improved and enhanced their disclosure levels, but still feel that it would be better for them to include more information on the mid/long-term management strategies and business models. They also noted that overseas companies offer their explanation based on KPIs they find important, but that it is difficult to tell how Japanese companies would like to be viewed.
- 02 It was also noted that global long-term investors seek to know “Why” (do companies think so) and “How” (companies will achieve so), but Japanese companies tend to emphasize “What” (companies intend to do) in their explanations.
- 03 With respect to the current disclosure framework, redundancies in content and timing between different disclosure policies were identified, and the view was expressed that this needs to be corrected across all such policies.

Discussions Surrounding Quarterly Earnings Disclosures

- 04 As one of the biggest issues of the current disclosure system, there was debate with respect to the state of the quarterly earnings disclosure system (unless otherwise stated this refers to both the disclosure of quarterly reports based on the Financial Instruments and Exchange Law and the quarterly earnings briefings based on the listing regulations).
- 05 Firstly, the degree of importance of quarterly earnings differs from industry to industry. For instance, in industries with big seasonal fluctuations, quarterly earnings are not that significant. The rhythm of a company (i.e. the speed of development, product life cycles) differs from company to company, and it was noted that a uniform requirement for quarterly disclosure is not adequate. On the other hand, there were views both from companies and investors that understanding the company performance quarterly has a meaning in order to check progress towards the long-term direction, and that companies can link financial accounting and management accounting.
- 06 Secondly, there is a view that quarterly earnings disclosures are too burdensome. In particular, quarterly reports and quarterly earnings briefings are mandatory

documents despite them not being useful either for investors or companies.

- 07 Thirdly, it was noted that disclosure of quarterly results takes time in Japan, prolonging the period in which dialogue between investors and companies cannot take place. The Financial Instruments and Exchange Law requires submission of quarterly reports within 45 days of accounting period-end. Whereas the quarterly earnings briefings do not have explicit deadlines, in practice they are submitted roughly one month after accounting period-end. In the US, on the other hand, there are examples where quarterly earnings are disclosed within 2 weeks after accounting period-end.
- 08 Fourthly, one cannot deny that the quarterly disclosure system makes discussions between investors and companies short-term in nature. That is to say, given that there are more and more short-term oriented investors, if companies hold quarterly dialogue with such investors they can be influenced by investors' short-termism. In such instances, there may be an "unintended consequence" whereby quarterly disclosures trigger short-termism.
- 09 Fifthly, there is an opinion that the market players' behavior has changed as a result of the introduction of the quarterly earnings disclosure system. Preview coverage, earning announcement and review coverage are repeated every three months and discussions tend to center around short-term figures and information. Although sell-side analysts cover companies after quarterly earnings, they are often accompanied by institutional investors as a way of service. There is concern that this contributes to a decrease of close-knit discussions between analysts and companies from a broader perspective. 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.
- 10 Looking at other countries, the EU currently mandates submission of an "interim management statement" under the Transparency Directive, which is different from the quarterly reports used in Japan and the US⁵⁴. The UK Kay Review (July 2012) proposed the abolishment of mandatory interim management statements. Also in the EU, the Transparency Directive was revised in November 2013, leading to the abolishment of interim management statements from November 2015 because 1) they are very burdensome to many small-mid companies; 2) they do not serve the purpose of investor protection; and 3) they promote short-termism and hinder long-term investment. The new Directive states that each Member State should not establish

⁵⁴ The current Directive requires issuers in markets regulated by the EU to disclose, in "interim management statements", important events and transactions that took place in the first and second semesters and their impacts, the financial status, and overall performances during period (more than 10 weeks after the beginning of the period and more than 6 weeks before the end of the period) in addition to annual and bi-annual financial statements (i.e. they are not required to submit interim financial statements). Also, the interim management statements are not required for companies that disclose quarterly financial reports in accordance with their own country's regulations or listing rules, or voluntarily.

topping up regulations to require companies to publish information more frequently than annually or semi-annually.

Earnings Forecast System and Reporting Corrections

- 11 Japan has a unique earnings forecast system. The Tokyo Stock Exchange's "Guide to Prepare Annual and Quarterly Earnings Briefings" (in Japanese) requires positive disclosures of future forecasts. Many Japanese companies disclose their forecasted "sales revenue", "operating profit", "pretax profit" and "current net income"⁵⁵. In the US and Europe, there are many examples which disclose future forecast information. However, the reporting items vary as they tend to choose among "sales revenue", "EPS", "EBITDA", "Free cash flow", and "Capital Expenditure". It was noted that US companies tend to disclose a range of forecasts rather than the specific figures.
- 12 Companies are also required to report corrections if there are discrepancies between forecasts and actual figures. Disclosure of annual forecasts is not mandatory, but if disclosure is made and there are discrepancies from previously reported figures, then timely disclosure is required. In practice, therefore, it is difficult for companies to not disclose annual forecasts.
- 13 Any future forecast has a common feature that it is intended to fill an information gap between companies and investors. Looking at the situation in Japan, where companies are often covered by a small number of analysts, the consensus formed tends to be influenced by the forecasted figures of companies. Also in the last several years, there is an increasing tendency to pay attention to forecasts of quarterly results. Listed companies only offer very limited forecasts of quarterly results as forward-looking information. The majority of forecast is created by sell-side analysts. Every time quarterly results are announced, discussions tend to center around the gap between the results and the consensus formed based on this forecast and the achievement ratio, as opposed to the full year outlook itself. One cannot deny that such a focus in discussions prevents dialogue between companies and investors with mid/long-term perspectives.

[Proposal/Recommendation]

- 14 Corporate disclosures should be reformed to provide investors with information that is useful in making appropriate assessments of mid/long-term corporate value creation. Integrated reporting is necessary to avoid an over-emphasis of short-term performance and to allow for assessment of corporate processes aimed at future value creation, including non-financial information.
- 15 As a first step towards this end, practical solutions and other measures that lead to beneficial, holistic, and comprehensive disclosures for investors – in the context of the

⁵⁵ The earning forecast system was amended based on the proposals made by the "Study group on the earnings forecast system for listed companies (July 2011)" and the "Expert meeting for listing system."

Financial Instruments and Exchange Law, the Company Law, and the regulations of the Exchange – should be considered.

- 16 There are controversies over the quarterly disclosure and the earnings forecast systems, and they should be discussed fairly and objectively from every perspective. However, it is noted that, as a result of these systems, discussions between companies and investors have become short-term oriented, especially due to the quarterly disclosure system. There are cases where some investors over-emphasize quarterly information and over-react to the achievement ratio of quarterly results against full business period plans. Such a situation should be rectified.
- 17 For example, with respect to the earnings preview problem described above, one possible measure that takes a fair disclosure approach would be for companies to disclose (using the exchange's timely disclosure system) the earnings figures they provide to institutional investors through IR materials used in investor meetings and overseas IR roadshows. An example was noted of a company that makes exchange disclosures of materials prior to conducting R&D explanation meetings. These are "unintended consequences" of the disclosure system, and it would not be wise to make changes to the system in haste based solely on such phenomenon. It is necessary to consider the most adequate systems earnestly from several perspectives, such as cost-effectiveness for companies and investors, promotion of dialogue between companies and investors towards sustainable growth, and effects on market player activities, while also referring to movements abroad on this topic.
- 18 In addition, in order to avoid falling into short-termism, it is necessary to restrain investors and analysts from overreacting to and placing too much emphasis on Q&A regarding quarterly results. They should have discussions and dialogues with companies from a mid/long-term perspective. In this sense, companies should be creative in their IR activities and strongly conscious of the linkage between IR and their stories for corporate value creation through, for example, integrated reporting.

11.2 [Discussion Point]

What are the disclosures necessary in order to promote mid/long-term dialogue between companies and investors?

[Discussion and Evidence]

Disclosure of Financial Management KPIs

- 01 Investors would like to see financial management KPIs (e.g. ROE, ROI, rate of return on invested capital) expressed in dialogue with companies, and would be interested to understand how they are used to discipline activity and contribute towards mid/long-term corporate value creation.
- 02 Investors put particular emphasis on the promotion of dialogue in which companies disclose their policies on cost of capital and investors offer their understanding on such

policies.

- 03 One company includes a target ROIC in their mid-term management plan and explains how it is translated into operational-level management metrics, using a logic tree. Another company tries to have dialogue with investors by showing increases in operating cash flow and free cash flows in order to explain achievements of growth investments using accumulated cash flow in addition to dividends.

Corporate Strategy Disclosure

- 04 Investors place importance on the performance of a company's mid/long-term strategy and business model, as well as its corporate value growth story. Companies, on the other hand, are concerned about losing their competitive advantage due to early disclosure of their strategies given that information on strategies useful for investors and shareholders can also be useful for competitors. In particular, such information disclosure in the manufacturing industries could lead to competitors catching up in just one year.
- 05 There is a contrasting view that losing competitive advantage due to disclosures is more about tactics. What is important is whether business models are translated into stories shown by companies. Investors have no disagreements over companies' reluctance towards disclosing certain items in order to avoid competitive disadvantages. If necessary, as pointed out by investors, they can conduct their own research.

Risk Disclosures

- 06 Risk disclosures are useful information for investors. If companies explain how they deal with risks, this would trigger dialogue about the foundations and mid/long-term plans of the company. Descriptions of risks in annual securities reports tend to follow the crowd, but investors expect companies to offer descriptions in their own ways.
- 07 On this point, one company prepares integrated reports as a means of offering multi-faceted information during ordinary times. They assume that disclosing risk information at ordinary times would lead to a quicker recovery of their share price in case something (e.g. scandals or big earthquakes) happens.
- 08 On the other hand, with respect to risk disclosure in annual financial statements, it was noted that there is an incentive to offer generic descriptions instead of narrowing down to specific issues, in order to avoid potential litigations. When disclosing company-specific issues it's possible to describe and disclose them in the context of ESG communication rather than risk information, which can also promote dialogue.

Disclosure of Governance and Other ESG Information

- 09 ESG disclosures by Japanese companies are recognized as being at a relatively high level internationally, and are regarded as best practices from several perspectives, such as CSR and governance. On the other hand, it was noted that explanation is needed as

to how they link with the long-term performance. Many ESG information currently disclosed are about efforts on the environment and society, and there is demand for enhancement of disclosures on governance issues.

- 10 International organizations of global investors (ACGA) suggests that areas for improvement in governance disclosures are background information of candidates for directors and audit & supervisory board members, the reasons for their nomination, expected contributions, and director trainings.

Mid-Term Management Plan

- 11 Many Japanese companies publish mid-term management plans. There are investors, including overseas investors, who regard Japanese companies' efforts to prepare and disclose mid-term management plans as providing a useful basis for dialogue with a long-term perspective.
- 12 On the other hand, there were also comments that mid-term management plans should include the future vision of the company from a finance perspective and also include forecasts. ROE, dividend ratio, and total shareholder return ratios are KPIs which investors expect companies to disclose in mid-term management plans but are often undisclosed in practice. Also, it was cited that these plans are not so useful for buy-side analysts when discussing with management about the 3 – 5 year outlook of the company, because they often simply show plans for constant growth.

<Chart 16: Desirable KPIs for Mid-term Management Plans >

	Requested by investors		Published by companies
ROE	90.8	>	35.8
Dividend payout ratio	52.9	>	21.8
Profit and Growth of Profit	37.9	<	62.7
Total return ratio	37.9	>	3.2
Profit margin on sales	27.6	<	48.0
FCF	27.6	>	7.1
ROA	23.0	>	17.9
ROIC	23.0	>	2.7
Sales and their growth rate	21.8	<	60.0
Capital cost (e.g. WACC etc)	20.7	>	0.2

Top 10 answers in the descending order of the number of responses by investors. (%)

Multiple answers were allowed.

(Note) Questionnaire survey targeted at 1,129 listed companies (respondents: 575 companies) and 158 institutional investors (respondents: 87 companies)

(Source) FY2013 Survey on Practices for Improvement of Share Values by the Life Insurance Association of Japan

- 13 There is a survey⁵⁶ showing that the achievement level of goals proposed in mid-term management plans is low, and it is noted that companies' abilities to execute plans are not entirely trusted.

[Proposal /Recommendation]

- 14 In order for companies and investors to have deeper dialogue from a mid/long-term perspective about improving corporate value, it is necessary to disclose mid/long-term information including non-financial information. In this regard, it is important to communicate corporate strategies, risk information, and ESG information by linking them with financial management KPIs such as cost of capital or investment returns.
- 15 It would be useful to disclose materials for discussion on mid/long-term strategies with investors and analysts by way of integrated reports. Some companies use integrated reports to explain items which investors are not usually conscious of (e.g. philosophy behind employee education and training) or to explain "invisible assets" such as human capital, brand value, and or technology.
- 16 There are several issues to be considered for integrated reporting. Firstly, unless reports are structured bearing in mind intense dialogue with investors, they can be rendered to integrated PR documents. Assuring the credibility of items disclosed in integrated reports should be an important issue. Another issue is that disclosure of non-financial information can be regarded as making public pledges. It may well be necessary to clarify the degree of liability companies will bear especially when companies disclose uncertain forward-looking information. In any case, it should be noted that integrated reports alone do not enable mid/long-term dialogue although integrated reporting may promote them. While integrated reporting may promote mid/long-term dialogue, companies should not stop at just producing materials (such as the integrated report itself) and should also strive to employ a variety of other measures to promote mid/long-term dialogue with investors.
- 17 Regarding mid-term management plans, investors, including overseas investors, value them as materials for mid/long-term dialogues. Yet, at the same time, the achievement levels of goals set in these plans and the relationship with capital efficiency are being questioned. For instance, ROE is pointed out as a KPI which many investors would like to see in mid-term management plans but is not frequently

⁵⁶ According to the survey conducted by Professor Yusuke Nakajo at Yokohama City University (answers obtained from 375 TSE listed companies. The survey was conducted in March 2011), the average levels of mid-term management plan goals attained were 8% for the sales revenue, 11% for operating profit, and 14% for the net income for the year.

included in practice⁵⁷. It is important to use ROE as a practical KPI taking into account the perspectives mentioned above.

- 18 In considering the concept that “Shareholders nurture companies”, it is necessary for companies to bear in mind that mid/long-term investors benefit from the increase of future free cash flow of portfolio companies. By bearing this in mind, companies can better understand the mindset of mid/long-term investors to nurture companies, which will contribute to enhanced dialogues with them.

⁵⁷ According to the aforementioned “FY2013 Survey by the Life Insurance Association of Japan”, 90.8% of investors who responded listed “ROE” as a KPI they wish companies to publish in their mid-term management plans.

12 Dialogue and Engagement

12.1 [Discussion Point]

Why is engagement necessary? Given that many Japanese listed companies now conduct IR activities, how does engagement differ from traditional IR? What are the components of engagement and how are they different from those of traditional IR? Considering “engagement” as a “purposeful dialogue,” what kind of dialogue contributes to the creation of corporate value?

[Discussion and Evidence]

Engagement: A “Purposeful Dialogue”

01 Although there are various definitions of “engagement”, Japan’s Stewardship Code defines “purposeful dialogue (engagement)” as “dialogue intended to enhance a company’s mid/long-term value and capital efficiency and promote sustainable growth.” Engagement can be perceived as companies and investors achieving a mutual understanding through two-way communication, and more importantly as mutually identifying issues (i.e., engagement agendas) to overcome and then carefully discussing solutions within the context of enhancing corporate value. The following section 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.

Purpose of Dialogue and Engagement

- 02 There are various interpretations as to what “corporate value” is. There are also perception gaps between companies, investors and analysts. By fulfilling these gaps, it becomes possible to have mutually effective dialogues. Therefore, one of the important purposes of dialogue/engagement is to fill these gaps through dialogue.
- 03 One of the purposes of dialogue/engagement is for company management and investors to understand what the other party perceives as valuable.
- 04 With a mutual understanding between companies and investors as a base and from the perspective of engagement being a problem solving process, the purpose thus becomes the clear identification of issues (engagement agendas) and the discussion of their resolution (i.e. suggestions of business restructuring and M&A strategy and presentation of capital policies), and through these actions the enhancement of corporate value.
- 05 The purpose of dialogue/engagement for an investor (i.e. asset manager) should be to maximize client (i.e. asset owner) returns through contributing to the enhancement of corporate value and sustained growth of portfolio companies, and to gather information useful in making investment decisions and exercising voting rights. It was raised that the purpose of engagement should be to determine whether a company is

befitting of long-term concentrated investment, confirm the company's strategy to enhance corporate value and make effective suggestions towards this, prevent any value destruction at the company, and assess directors and managements' ability to operate businesses.

- 06 On the other hand, companies perceive the purpose of engagement to be the securing of trust and support of investors with respect to management philosophy and strategy through promotion of mutual understanding. It was also noted that engagement appears sometimes to be aimed at obtaining shareholder views prior to shareholders' exercise of voting rights.
- 07 Discussions in the UK clearly note that improvement of investment return through engagement is one purpose for investors to engage.

Content and Agenda for Dialogue and Engagement

- 08 Institutional investors have a responsibility to understand and evaluate the management KPIs companies use and the measures employed to deliver on strategies.
- 09 Dialogue between companies that welcome dialogue and long-term investors tends to center on corporate philosophy, vision, specific strategies, and business models as a way to create corporate value. With respect to governance, there is a view suggesting that dialogue should put emphasis on the board structure, its independence and training of directors, its oversight for executive officers and strategies, and capital efficiency. Although it is important to disclose specific figures such as ROI or ROE, investors prioritize explanations by companies on how they use such KPIs to effect management discipline.
- 10 In such instances, investors do not require detailed insider information or information that companies prefer not to disclose for the benefit of competitiveness. Investors think basic discussions would suffice.
- 11 There are many types of investors and therefore topics of dialogue range from management to operations. However, from a company's perspective, operational topics proposed by investors tend to be superficial. They believe management-related topics often lead to deeper discussions.
- 12 When proceeding with engagement, the fact that many institutional investors rely on indices in managing their assets is problematic. Such investors have little interest in specific company fundamentals, and therefore are unlikely to be motivated to achieve long-term return goals through dialogue and engagement with companies.
- 13 Companies emphasizing dialogue with investors are involved in communicating non-financial information in order to gain long-term trust from investors so that they hold their shares. Regarding ESG (environment, society and governance), one company tries to ascertain relevant management topics and information needs through feedback from investors. As a way of promoting such dialogue, they also publish their efforts on ESG matters (i.e. matters that investors find important for their sustainable

growth) in integrated reports.

Methods and Styles of Engagement

- 14 There are various ways to carry out dialogue/engagement. There are investors who employ a hard-core approach (often avoided by companies) and those who employ a constructive approach in trying to have persuasive dialogue with companies.
- 15 Some overseas investors shared their opinion on the importance of opportunities for direct and bidirectional dialogue between investors and management or outside directors⁵⁸. It was also cited that disclosure of non-financial information in English and a common understanding of basic terms are important in order to enhance engagement⁵⁹.
- 16 As an example for engagement, one overseas investor selects potential investees based on analysis including ESG matters, and conducts dialogue/engagement for 6 to 18 months. Their aim is to have long-term and periodic dialogue/engagement with the company based on factual evidence, and for this to enhance corporate value through improvements in disclosures as well as internal policies and practices.
- 17 When its investee tried to issue a moving strike convertible bond (MSCB), one institutional investor expressed their view that they think financing with a MSCB is questionable and would be disrespectful to shareholders who have supported the company for a long period. Management reconsidered in a comprehensive manner and concluded that cancelling the MSCB issuance would be the best choice for maintenance and improvement of corporate value. The company announced the cancellation through the timely disclosure mechanism. The institutional investor voted affirmatively at the general shareholders' meeting.
- 18 The importance of promoting an active annual general shareholders' meeting (AGM) as a venue for dialogue between investors (shareholders) and companies was noted. At the AGM of many countries shareholders who directly hold shares and de facto shareholders – such as institutional shareholders who hold shares via trust banks, etc. – are treated equally. In Japan, on the other hand, while de facto shareholders can exercise voting rights via proxies, they are not afforded the same rights such as the ability to attend AGMs or the ability to propose an agenda item. Other impediments to an active AGM include concentration of AGM meetings of many companies within a specific period, the short interval between earnings announcement and the AGM, and the content and timing of disclosures (i.e. the relationship between the Company Act, the Financial Instruments and Exchange Act and the Listing Regulations) to

⁵⁸ On this point, there was a positive comment on the relative ease of access to board chairpersons, CEOs, and CFOs at Japanese companies compared to other Asian markets. (ACGA [2013])

⁵⁹ There was a comment emphasizing the importance of common understanding regarding the gaps in terminology such as “audit”, “auditor” or “supervision” for dialogues. (ACGA [2013])

shareholders. There are more and more companies which hold meetings with de facto shareholders and proxy advisory firms to explain proposals for the AGM before the actual event. Although these meetings are useful dialogue/engagements on corporate governance, they often take place shortly before the AGM.

- 19 Discussions on effective ways to conduct dialogue and engagement are taking place in many countries, involving international organizations and institutional investors. The UK, the Netherlands, and the United Nations are preparing best practices, frameworks, and networks among investors⁶⁰.
- 20 It was noted that in affecting the type of engagement as defined in the UK Stewardship Code, it is important that companies adhere to guidelines on engagement as defined in the accompanying Corporate Governance Code.

[Proposal/Recommendation]

Cooperation and Tension in Dialogue

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

Tension: Management must communicate with investors their visions and strategies for corporate value creation and gain their support and understanding. However, such dialogue may be used for evaluations and screenings by investors, which may in turn lead to termination of capital necessary for growth. This is a moment of “tension”.

Cooperation: Investors expect companies to accumulate “net income attributable to shareholders” as retained earnings and use it as drivers of sustainable growth. In other words, sustainable growth is a result of a common creation (cooperation). Promoting mutual understanding through quality dialogue and engagement and achieving the common goal of sustainable growth and long-term corporate value creation would result in mutually profitable outcomes.

Clarifying Purposes and Sharing Recognition

- 22 Companies should recognize that the quality of dialogue/engagement with investors affects the cost of capital. Not only business competitiveness but also management’s attitude and commitment to value creation, their ability to deal with changes in business environments, and their ability to solve problems affect any future uncertainties that investors are concerned about, and thus get reflected into cost of capital. Therefore, cost of capital can be lowered by management’s effort to gain the

⁶⁰ Proposals by the Investor Stewardship Working Party to deal with the UK Stewardship Code, tools by the National Association of Pension Funds, guidance by the UK Institute of Chartered Secretaries and Administrators (ICSA), movements of Eumedion (a Dutch investors’ network), and Clearinghouse of UN Principles for Responsible Investment.

understanding of investors through dialogue.

- 23 From the perspective of a company, the purpose of dialogue/engagement is to gain understanding and support by investors and thus to secure resources for long-term and sustainable growth and to reduce the cost of capital. To fulfill responsibility as a listed company is to aim for sustainable value creation through effective dialogue with shareholders/investors. If management and investors are collaborative creators of “sustainable growth”, they must together understand and share scenarios for attaining this goal. To this end, fundamental and mutual dialogue/engagement is necessary.
- 24 From the perspective of investors and maximizing their client’s returns, they must contribute towards corporate value enhancement and sustained growth of portfolio companies, and seek to gather information that aids them in investment decisions and exercising voting rights. Furthermore, the purpose of dialogue/engagement includes discussion aimed at problem resolution.
- 25 Given the main purpose of dialogue between companies and investors is to attain sustainable growth, the key to dialogue is not to seek undisclosed information but to understand and share in management’s thoughts behind strategy formulation and how they intend to achieve their management goals.

Agenda Items for Dialogue and Engagement

26. Dialogue/engagement is desirable as long as it promotes a company’s mid/long-term value creation and sustainable growth. Therefore, institutional investors should make adequate preparation to gain a deep understanding of portfolio companies and their business environment lest they fall into discussions on details of short-term earnings forecasts. Also, investors should approach dialogue with the aim of offering constructive discussions without interfering into the details of management and operation. This includes issues such as governance, company strategies, earnings performance, capital policy (structure, allocation, discipline), risk management measures (including those related to societal and environmental issues), and opportunities
27. Governance should not focus on superficial aspects, and rather should focus discussion on why a company employs a particular structure and/or framework. From the perspective of assessing how management discipline is ensured, issues such as the structure of the board, the role of external directors, management terms and succession policies, and compensation policies should be the focal points of discussion⁶¹.
- 28 When conducting dialogue, investors should make sure to have discussions from a

⁶¹ With respect to this, the questions and responses from the CEO/CFO interviews in the Corporate Reporting Lab Report “Corporate Governance Issues that Long-Term Investors Wish to Ask Company Management About” should serve as a reference in companies and investors having dialogue/engagement on governance issues.

[【http://www.meti.go.jp/press/2013/08/20130823001/20130823001-5.pdf】](http://www.meti.go.jp/press/2013/08/20130823001/20130823001-5.pdf)

long-term viewpoint covering not only the company's profit and loss statement but also its balance sheet, cash flows, and the relationships between these items. From this viewpoint, talking on management issues related to capital efficiency (adequacy of capital allocation) would be important. It is especially important to convey the company's ideas on cost of capital and how they use it in management decisions. Of particular interest to investors is how retained earnings are re-invested to drive growth, and therefore it is important for dialogue/engagement to include discussion about the use of retained earnings⁶². The specific focal points with respect to the agenda of optimal capital efficiency will differ between companies and their respective circumstances, and thus consideration of this matter must be done appropriately with flexibility.

- 29 Such dialogue is important for investors to convey their expectations and desires to portfolio companies. However, if the act of dialogue in and of itself becomes the purpose or if investors are not capable of having dialogue that contributes to a portfolio company's sustainable growth, then institutional investors should bear in mind that such engagement may impede enhancement of corporate value and sustainable growth by wasting precious time of management.
- 30 Furthermore, it is important to gain a mutual understanding regarding non-financial information including ESG. If mutual communication is strengthened based on such information, perception gaps on ideas of corporate value between companies and investors will be considerably smaller. Yet, in order to confirm the efficiency of such actions, it is necessary to promote further empirical research on how the evaluation of a company's ESG or CSR activities impacts its performance or cost of capital.

Attitude and Methods for Dialogue and Engagement

- 31 Dialogue and engagement should prioritize quality rather than quantity such as the number of meetings with companies. Also, dialogue that does not contribute to sustainable growth, such as short-term oriented quarterly earnings preview meetings, should be distinguished from engagement. It is important to deepen dialogue between companies and investors who aim for long-term total returns.
- 32 More so than traditional IR meetings, purposeful dialogue/engagement should emphasize being "bidirectional dialogues". Through IR activities, companies disclose information they would like investors to understand. It is desirable that investors not only communicate (and request) the type of information they need for their investment decisions, but also share their investment policies and time horizons with companies. Dialogue/engagement should not end with investors unilaterally asking questions, but should also involve investors listening to the questions from companies with respect to

⁶² On this point, considering the difficulty of debating the level of cost of capital, there is a recognition that it may be more practical for discussion to focus on the use of retained earnings.

investors and the capital markets, and provide their views with respect to assessment of corporate strategy and any associated suggestions for improvement. In order to do so, it is important for investors to recognize their responsibility to represent the voice of the capital markets and the common interests of shareholders..

- 33 In order to achieve problem resolution through engagement, investors must have a proper understanding of a company and the company must understand an investor's investment policies. The potential for engagement arises when companies select investors that align with their management policies just as investors select companies that align with their investment policies.
- 34 It does not need to be said that disclosure of information is an important foundation for dialogue/engagement, and thus there should be discussion pertaining to the methods and means of disclosures. In addition to the content of disclosure, the timing and medium for disclosures (e.g. IR events such as analyst earnings and management plan meetings, small/one-on-one meetings with company management, one-on-one meetings with IR representatives, non-statutory disclosures, and non-financial disclosures such as ESG and risk matters) should also be an important point of discussion.
- 35 With respect to this, it is important that the content of disclosures (qualitative and quantitative) is aligned with what investors seek in order to make their investment decisions, and that such disclosures also reflect the reality of company management. For example, if a company calculates and discloses a target ROE only because an investor requests it and does not actually use it as a KPI in managing its business, then it becomes pointless. On the other hand, given that ROE is a common language used in dialogue with investors, if company's present KPIs other than ROE they should be prepared to explain why they use such metrics and how it relates to ROE.

Desirable Attitudes and Capabilities of Institutional Investors

- 36 Japan's Stewardship Code asks that institutional investors (1) possess a deep understanding of portfolio companies and their respective business environments, (2) assess corporate value and (3) invest capital in companies where sustained growth can be expected, and (4) attempt to secure long-term returns for their customers/beneficiaries (including the end beneficiaries). Furthermore, in the process of executing and delivering on these items, it is expected that institutional investors will (5) engage in purposeful dialogue with companies.
- 37 In order for institutional investors to attain a deep understanding of portfolio companies, it is insufficient for a portfolio manager to simply have general knowledge, and rather requires the support of a capable buy-side analyst team. Alternatively, an exceptional portfolio manager – capable of also executing on the role of a buy-side analyst – would be required.
- 38 In order to determine the (4) long-term return it is necessary to employ an investment

valuation method that can assess the (2) corporate value of a company. In general, either the DDM (dividend discount model) or the DCF (discounted cash flow) methods – or a variation thereof – would be used. When using such valuation methods, analysts need to forecast earnings for mid/long-term earnings. Without this corporate value cannot be assessed, and an appropriate share price (fair value) cannot be calculated. Dialogue cannot be had if an institutional investor, describing itself as investing for the long-term, effectively resorts to short-term investment by only forecasting earnings out for two periods and overly focusing on achievement of quarterly earnings.

- 39 Japan's Stewardship Code states that "To contribute positively to the sustainable growth of portfolio companies, institutional investors should have in-depth knowledge of the portfolio companies and their business environment and skills and resources needed to appropriately engage with the companies and make proper judgments in fulfilling their stewardship activities." In order to ask meaningful questions when having dialogue with company management, investors must have an infrastructure that allows for the assessment of long-term corporate value. Therefore, institutional investors partaking in dialogue/engagement must clearly disclose their investment valuation methods to both companies and asset owners. There would be situations where companies refuse dialogue with investors that do not have such infrastructure. However, even where such infrastructure is absent but there appears to be room for education, there would be cases in which companies partake in dialogue/engagement with investors from the perspective of helping to educate them.
- 40 Incentives for institutional investors to conduct dialogue/engagement will be strengthened by concentrated investments in a small number of companies, rather than portfolio investments in a large number of companies. Promotion of corporate value and sustainable growth by institutional investors through adequate dialogue/engagement should be given due credit as new value added. As proposed in the "UK Kay Review," it is important that asset owners provide asset managers with adequate incentives for engagement through increased fees or positive appraisals.
- 41 Engagement by institutional investors should aim to enhance long-term returns for individuals as the final beneficiaries making investments through institutional investors. It is important for individuals to develop an increased interest towards institutional investors given that it directly ties to their own portfolio outcomes.
- 42 A change in the mindset of asset owners is needed in order for dialogue and engagement to take root. They need to take a patient stance to entrust long-term asset management without reacting nervously to quarterly performance. In order to confront companies seriously, it would require an investment horizon of at least 3 to 5 years.
- 43 Furthermore, as seen in other countries, in order to enhance their capability for having dialogue with companies, it is important for a platform to be established in which institutional investors can share knowledge and experience, and have frank discussions

on this matter⁶³. In such a case, focus should not be on the establishment of the platform in and of itself, but rather on a practical and continued assessment of what it takes in order to have meaningful dialogue and engagement with companies. It is expected that this platform will help to provide a shared intellectual basis for dialogue and engagement, including issues such as the depth, appropriate counterparty at the company, and focus of dialogue.

The Perspectives that Companies Should Have

- 44 From the perspective of the company, they should not only care about votes at AGM, but discuss reasons for these votes with investors worldwide. It is important for senior management to share the knowledge and information gained from dialogue with investors and use it in future management to the extent they agree with the opinions of investors.
- 45 Companies are also expected to actively deal with dialogue/engagement requests from institutional investors as a way of improving corporate value, without being afraid of such requests. As a basis for dialogue, it would be useful to disclose and explain business models appealing to long-term investors in the words of management through, for instance, integrated reports.
- 46 Companies should recognize that the quality of dialogue with investors affects the cost of capital. Not only business competitiveness but also management's attitude and commitment to value creation, their ability to deal with changes in business environments, and their ability to solve problems affect any future uncertainties that investors are concerned about, and thus get reflected into cost of capital. Therefore, cost of capital can be lowered by management's effort to gain the understanding of investors through dialogue.
- 47 In order to ensure that dialogue and engagement are mutually meaningful, not just investors, but also companies (IR team, etc.) must also train personnel to have a deep understanding of dialogue/engagement, shareholder value, and governance and accountability.
- 48 In deepening dialogue/engagement with institutional investors, it will be important to pay attention to information disclosure and IR activities towards other shareholders (e.g. individuals). In addition to considerations towards ensuring fair disclosures, it is important for companies to recognize the importance of increasing the number of individual shareholders that support long-term sustainable growth, and

⁶³ As a project under the Corporate Reporting Lab (Secretariat: METI/Business Policy Forum), a Working Group on Investors Forum was established and there have been discussions on methods of engagement from investors' perspectives in order to provide an intellectual basis for institutional investors. Issues discussed include depth of dialogue, counterparts, and viewpoints in conducting effective dialogue.

must strengthen a foundation for long-term management by promoting understanding and trust amongst individual shareholders.

“who” you are engaging with is just as important

- 49 In conducting dialogue and engagement between companies and investors, being conscious of “who” you are engaging with is just as important as the content itself. For instance, dialogue and engagement on company strategies and governance issues are useful to have with senior management, directors or the CEO. One may separately engage the IR department to solicit further numerical facts to support such dialogue. In practice, given the time constraint of CEOs, it is possible to use earnings briefings as the venue for dialogue with investors.
- 50 From the perspective that external directors are representatives of shareholders, it is important for such external directors to engage in dialogue with shareholders by participating in IR events, partaking in investor dialogue, and stating opinions in annual reports.

Reviewing annual shareholder meetings as an opportunity for dialogue

- 51 Leveraging the annual shareholder meeting as an opportunity for dialogue with shareholders and fulfilling explanatory obligations is an important issue. In particular, items that investors emphasize – such as the date of annual shareholder meetings and the length of the notice period to ensure adequate time for evaluation – should be assessed within an international context. In addition to rationalizing the disclosure framework towards shareholders, companies should also evaluate effective means of having dialogue/engagement with shareholders prior to annual shareholder meetings.

12.2 [Discussion Point]

How should exercise of voting rights be understood from the perspective of dialogue and engagement between companies and investors? In exercising their voting rights, how should institutional investors interact with proxy advisory organizations?

[Discussion and Evidence]

- 52 The proportion of votes exercised in Japan is higher than other countries, covering 75.7% of the 225 constituent companies of the Nikkei Index in 2013. The proportion of votes exercised by foreigner shareholders has been on the rise every year. Some factors underlying this trend include: 1) a heightened consciousness towards corporate governance; 2) concentration of funds from Europe and US institutional investors; and 3) early dispatch of proxy statements and their digital disclosure. There have been arguments that, given the high proportion of votes exercised, reactions by Japanese

companies to negative votes are not as keen as their counterparts in Europe and the US.

- 53 With respect to voting agenda items, institutional investors place greatest focus on the election of executive officers and the board of directors. Other proposals, such as anti-takeover measures and compensation are decisions made within the company, and therefore shareholders believe the most essential matter is who you entrust with these decisions.
- 54 With regard to voting, proposals that get the highest “against” votes on average are the following three items: proposals to introduce anti-takeover measures, proposals to provide retirement benefits; and proposals to elect external audit & supervisory board members. Given that voting rights are exercised as a result of dialogue between companies and institutional investors, there is a close relationship between such dialogue and engagement and the results of votes.
- 55 On the other hand, there are opinions suggesting that even if companies have a stance to promote disclosure and strengthen dialogue with investors, reality is that investment decision-making portfolio managers typically are not involved in exercising voting rights, which are instead dealt by other departments. Some companies suggest that those responsible for investment decisions should be involved in the exercise of voting rights for the sake of engagement.
- 56 Given the reality that companies have difficulty knowing who their real shareholders are, some companies ask for the results of votes and the reasons behind against votes.

Issues of Proposals to Elect Directors

- 57 With regard to proposals to elect directors, it was noted that it is difficult to make assessments of internal executive officers given that relevant information is not made available outside the company. This is different from the US in which specialized professional management often become (external) directors.
- 58 ISS (a proxy advisory organization) is currently considering adding ROE to their preferred selection criteria for internal directors. It was noted that this may influence the decisions by foreign institutional investors who have not used a company’s performance as criteria for voting.
- 59 It was noted that despite investors having trust for company management, they had no choice but to vote against the selection of management due to the absence of external directors. As such, it was raised that there should be a framework where investors can formally explain to company management their reasons for voting against them.

Issue of Independence

- 60 Election of external audit & supervisory board members is one type of proposal that attracts a large number of “against” votes. The main reason is the lack of independence. Investors do not have uniform criteria for independence. Therefore, even if candidates

meet the criteria for independent officers set by the Tokyo Stock Exchange, institutional investors may still regard them as lacking independence. As explained above, striking the right balance between independence and effectiveness is an important issue.

Anti-Takeover Measures

- 61 Anti-takeover measures are another type of proposal that attract a large number of “against” votes. In particular, the ratio of against votes is almost 100% among foreign institutional investors. Domestic institutional investors are also likely to vote against such proposals made by companies without external directors and by companies that have 2-year terms for their directors.
- 62 Some institutional investors noted that a blanket opposition to anti-takeover measures would result in losing opportunities for negotiations with companies. They also noted that they can vote in support of such proposals as long as companies offer reasonable explanations as to the purpose and situations underlying their decisions.

Executive Pay

- 63 While the issue of executive pay attracts huge interest in other countries, in Japan the proposal on executive pay only covers the revision of compensation and stock option payout as compensation, and usually does not necessarily stand out.
- 64 It was noted that institutional investors are interested not only in revisions of compensation and stock option payouts, but more so in the introduction of performance-based pay as an incentive to align interests with shareholders from a mid/long-term perspective and to enhance shareholder value.

Roles of Proxy Advisory Organizations

- 65 It was noted that while institutional investors find proxy advisory organizations useful for having their opinions checked, Japanese asset management companies seem to use them only as a reference and therefore the degree of influence they have over Japanese investors may differ from that of global investors. It was also noted, however, that the voting policies pertaining to passive investment strategies of Japanese asset managers may be drafted based on reference to proxy advisory organizations.
- 66 Japan’s Stewardship Code states that “when institutional investors use the service of proxy advisors, they should not mechanically depend on the advisors’ recommendations but should exercise their voting rights under their own responsibility and judgment and based on the results of monitoring the portfolio companies and having dialogue with them,” and also requires investors to disclose how they use proxy advisory organizations if they use them at all.
- 67 In the UK, proxy advisory organizations themselves participate in the UK Stewardship

Code and are beginning to disclose their policies.

[Proposal/Recommendation]

- 68 In particular, one purpose of dialogue/engagement is to solicit the opinions of shareholders prior to their exercise of voting rights. There is demand, both from companies and investors, to have an opportunity to confirm the reasoning behind votes, and therefore to include the exercise of voting rights as an agenda for continued dialogue/engagement.
- 69 With respect to the exercise of voting rights, it is important that institutional investors strengthen the coordination between portfolio managers/analysts and personnel responsible for execution of voting rights (or the corporate governance officer).
- 70 In order to conduct quality dialogue/engagement, institutional investors are asked to understand portfolio companies well, clarify their policy on voting and their purpose for engagement, and explain these to companies in an easily understandable manner. Close attention should be paid to the measures and disclosures that institutional investors take with respect to Japan's Stewardship Code.

12.3[Discussion Point]

Who should bear the cost of dialogue/engagement?

[Discussion and Evidence]

- 71 Japan's Stewardship Code states that stewardship activities, including dialogue/engagement, ultimately aim at the enhancement of the mid/long-term investment returns for clients and beneficiaries, and that institutional investors and their clients and beneficiaries should both recognize that costs associated with stewardship activities are an indispensable element of asset management.
- 72 Especially in relation to costs associated with dialogue/engagement, there is an issue of free-riding between investors who actually conduct dialogue/engagement and other shareholders who benefit from enhancement of corporate value through such engagement. As a related effort, the International Corporate Governance Network (ICGN) has been conducting discussions on engagement concerning ESG. This has been recently included in the ICGN Model Contract Terms Between Asset Owners and Their Managers.

[Proposal/Recommendation]

- 73 In relation to costs associated with engagement, some argue that they should be paid out of the usual commission fees, while others argue there should be other alternatives for cases where asset managers made special efforts or where it is clear that the result of their efforts has led to the benefit of asset owners. For example, it was suggested that asset owners can consider introducing performance-related pay if

dialogue/engagement and performance improvements have surely contributed to the benefits of asset owners and if they can deal with performance pay.

- 74 For institutional investors, dialogue/engagement with companies and asset management styles are inseparable. Aside from passive management, active management naturally requires dialogue/engagement with portfolio companies. According to some investors, they felt at odds with the idea of separating dialogue/engagement and asset management. There is a view that, as dialogue/engagement is by nature conducted by investors who employ active management styles in order to improve their performance, it would be odd to ask others to pay for the cost.

12.4 [Discussion Point]

Are there any current regulations that impede the deepening of dialogue/engagement? Are there any potential regulations that need to be stipulated in order to promote dialogue between investors and companies?

[Discussion and Evidence]

Insider Information and Related Regulations

- 75 Engagement at times results in obtaining insider information, and the manner in which investors deal with the issue varies. For example, one investor sends a letter to companies stating that they understand no material non-public information is included in information they have been supplied and request companies to make a formal disclosure if such a fact is accidentally disclosed. One UK asset management firm adds companies to an in-house list when they receive material non-public information and prohibit transactions in these company's shares. Receiving insider information would result in restriction on transactions until such information is disclosed. Therefore this creates an unfavorable situation for investors as well. Active investors in the US may in some case be appointed as directors. In such cases, they are regarded as insiders and cannot conduct transactions until they leave the office as directors.
- 76 Long-term investors do not care about short-term fluctuations as long as directions are set. They do not require short-term information and rather have discussions about a company's way of thinking and future directions. Therefore, they are unlikely to touch upon matters that can be regarded as insider information. For instance, if a company has diversification as one of their growth strategies, long-term investors discuss directions of the company, such as how the company's strengths will be leveraged.
- 77 According to Japan's Stewardship Code, institutional investors, in general, can conduct constructive and "purposeful dialogue" with portfolio companies based on publicized information without receiving material non-public information. It also states that careful consideration is necessary before receiving material non-public information in dialogue. In cases where they do receive such facts, it also recommends institutional

shareholders to attend dialogue having taken measures to prevent violations of regulations on insider transactions, such as halting transactions of the company's shares.

- 78 From the viewpoint of companies, there are certain concerns that they may violate insider regulations if they communicate material non-public information to institutional investors, therefore preventing them from having deep dialogue with investors. On this point, according to the Q&A published by the Financial Services Agency, deep dialogue between companies and institutional investors does not violate the rule of "helping others (institutional shareholders) make profits by inducing transactions before the publication of material facts" and therefore would not be a violation of regulations. In addition, it was noted that it may be beneficial for broader shareholder groups (including individual shareholders) if companies share the results of their dialogue with institutional investors through their website, explanatory meetings, and/or at annual shareholder meetings.

Relationship to the Large Shareholding Report Rules

- 79 In Japan, many institutional shareholders use the special provisions of the large shareholding report rules. This does not apply to those who conduct "act of making important suggestions, etc", which contain various activities. It is therefore noted that this exclusion potentially serves as a deterrent for engagement. In the US, many asset management firms use a simplified reporting system granted to passive investors stipulated under the large shareholding report rules. There was a view expressed that investors are not active in engagement because they are afraid of being exempted from passive investors if they conduct engagement.
- 80 The Financial Services Agency provides the following interpretations with respect to the terms "act of making important suggestions, etc" and "joint holdings". In order to be classified as "act of making important suggestions, etc", an act must meet all three criteria which are: 1) its objective contents of proposals falls under the listed items under regulations⁶⁴; 2) it has a purpose of making major changes to operational activities of the issuer or making serious influences; and 3) it is regarded as a proposal. Therefore, acts such as "offering shareholders' opinions in response to the issuer's request" or "offering opinions in dialogue (e.g. earnings meetings, IR meetings including small sessions) which the issuer has actively set up" do not fall under act of making important suggestions, etc.
- 81 With regard to joint holding, there is an interpretation that mere discussions of exercise of voting rights do not fall under this category, but that they do if "it is clear

⁶⁴ The Cabinet Order lists 13 items, including dispositions or transfer of major assets, high debt, election or removal of representative directors, major changes to the composition of officers.

that there is an agreement to exercise shareholder rights such as voting in concert”. In addition, an “agreement to exercise shareholder rights such as voting in concert” refers to an agreement regarding exercise of “legal rights as shareholders”, and an “agreement regarding general actions as shareholders except for exercise of legal rights” does not fall under this category.

- 82 The Financial Services Agency has published a “Summary of Legal Issues Relating to Japan’s Stewardship Code”, in order to facilitate dialogues between institutional investors and companies with respect to legal issues pertaining to the large shareholding report rules and the tender offer disclosure rules.

[Proposal/Recommendation]

- 83 Regarding the legal framework with respect to engagement, there has been clarification made on the interpretations of relevant laws and regulations. Institutional investors are requested to understand such clarifications and have constructive and “purposeful dialogue” with Japan’s Stewardship Code in mind. Within the context of practicing dialogue, it is important to consider measures to solve any impediments in the legal system.
- 84 Engagement is a collaborative activity between companies and institutional investors. Companies must sincerely respond to institutional shareholders who provide constructive “purposeful dialogue” based on a deep understanding of portfolio companies and their operating environments. While Japan’s Stewardship Code can be an opportunity to enhance the awareness of institutional shareholders, this might cause disruptions with companies. At this point, therefore, it is important to consider and share between companies and investors an ideal way of conducting fruitful dialogue and engagement.
- 85 In order to build desirable relationships between companies and investors, it would be useful to consider what can be learned from the corporate governance codes of other countries including the goals, content, drafting procedures, implementation, and role of such codes.
- 86 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 levels of disclosure 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. With respect to information required for dialogue, some items remain unchanged over time whereas other items change along with circumstances, and therefore continued and open consideration taking into account this potential for

change is important.

- 87 It would be appreciated if the content of this report would not only be discussed within the aforementioned forum, but also serve as the foundation for constructive discussions to be had by company management, investors, market participants, the government, and other related parties both domestically and internationally.

Reference Material

1. Dates and Topics of Meetings

1st Meeting July 16, 2013

General discussion spanning all themes of the project.

- The profitability and continuous value creation of Japanese companies.
- The capital markets and investors supporting the above.
- Establishment of a good relationship between companies and investors.

2nd Meeting August 20, 2013

General discussion spanning all themes of the project.

3rd Meeting September 9, 2013

General discussion spanning all themes of the project.

4th Meeting September 20, 2013

Summary of main issues

October 16, 2013

Release of the “Summary of Main Issues” and a request for information and evidence relating to this (submission deadline: December 10, 2013).

5th Meeting October 29, 2013

Guest speakers

- “Engagement with Shareholders”, Mr. Yosuke Mitsusada, Founding Partner of Asuka Corporate Advisory Chief Fund Manager Asuka Asset Management Ltd.
- “How to improve the accountability of corporate Japan: Benchmarking to corporate America”, Mr. Go Sato

6th Meeting November 19, 2013

General discussion spanning all themes of the project.

- About the new JPX Nikkei 400 Index
- Updates from each of the subcommittees
- General discussions with respect to main issues

7th Meeting December 18, 2013

- Exchange of opinions with respect to issues raised from each of the subcommittees (summary, main points, findings, and issues for further discussion)
- About the information and evidence collected
- With respect to the interim report

8th Meeting January 14, 2014

Guest speaker

- “Innovation and Execution”, and Dialogue with Capital Markets”,
Mr. Shuzo Sumi, Chairman of the Board of Directors, Tokio Marine Holdings, Inc.
- Discussions towards the interim report

9th Meeting January 28, 2014

Guest speaker

- “Trends of Japanese Hedge Funds and the Capital Markets”, Mr. Masahiro Koshiba CEO, United Managers Japan Inc.
- Discussions towards the interim report

10th Meeting March 12, 2014

- Discussions towards the interim report

11th Meeting April 3, 2014

Guest speaker

- “Long-term Equity Investment Contributing to Sustainable Growth of Companies – The Roles of Long-Term Investors”, Mr. Tadao Minaguchi, Chief Portfolio Manager, Japanese Equity Advantage Investment, Investment Division, Invesco Asset Management (Japan) Limited

12th Meeting April 22, 2014

- Towards finalizing the interim report.
- About the process going forward

April 25, 2014

Release of the “Interim Report” and a request for information and evidence relating to this (submission deadline: May 20, 2014).

13th Meeting June 6, 2014

- Discussions about submitted information and opinions with respect to the interim report.
- Towards finalizing the final report.

14th Meeting July 1, 2014

Guest speaker

- “My management principle” Mr. Kawamura, Chairman Emeritus Hitachi, Ltd.
- With respect to the final report.

15th Meeting July 10, 2014

Towards finalizing the final report.

16th Meeting July 25, 2014

Finalizing the draft version of the final report.

*** In addition to the general meetings held above, the three subcommittees (Corporate Value Creation, Investment Chain, Short-Termism and Disclosure) held various meeting between October 10, 2013 and January 23, 2014.**

2. Providers of Evidence, Information, and/or Opinions

- PricewaterhouseCoopers Aarata
- Ichigo Asset Management, Ltd
- Integratto Inc.
- Investment Bridge Co., Ltd
- NIPPONKOA Insurance Company, Limited
- Governance for Owners Japan KK
- Society of Industrial Valuation
- Sawakami Asset Management Inc
- J-Eurus IR Co.,Ltd.
- Shiseido Company, Limited
- Citigroup Global Markets Japan Inc.
- Sony Corporation
- DAIICHI SANKYO COMPANY, LIMITED
- Tokio Marine Asset Management Co., Ltd.
- Deloitte Touche Tohmatsu LLC
- Nissay Asset Management Corporation
- The Japanese Institute of Certified Public Accountants.
- Japan Corporate Governance Network
- The Japan Research Institute, Limited
- Japan Investor Relations and Investor Support, Inc.
- Nomura Institute of Capital Markets Research
- Nomura Securities Co.,Ltd.
- Value Create Inc.
- FIL Investments (Japan) Limited
- Mitsubishi Corporation
- Merrill Lynch Japan Securities Co.,Ltd.
- Lawson, Inc.
- Faculty of Commerce, Waseda University (Professor Kubo)
- Asian Corporate Governance Association
- Baillie Gifford & Co
- California Public Employees' Retirement System (CalPERS)
- Eikoh Research Investment Management
- Fidelity Worldwide Investment
- Fourth Swedish National Pension Fund
- GAM International Management Limited
- International Corporate Governance Network
- International Integrated Reporting Council
- J O Hambro Capital Management Limited

- Legal & General
- Network for Sustainable Financial Markets
- PGGM Investments
- RPMI Railpen Investments
- RWC Focus Asset Management Ltd
- Sloane Robinson LLP
- SNS Asset Management
- Standard Life Investments
- USS Investment Management

Companies and other parties, other than those listed above, also submitted evidence, information, and/or opinions.