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Japan's Coming Wave of Reform

Issues of corporate governance, capital management and sustainability have been on the radar in Japan for the past decade, but soon the pace of change could accelerate. The difference is a revised Corporate Governance Code and the upcoming overhaul of the Tokyo Stock Exchange, which aim to reinforce the role of sound governance and capital efficiency in enhancing shareholder value and are expanding their scope to issues such as diversity and climate change. In this white paper, we assess the potential implications, and explain why companies' ability to adapt to the new Code could be crucial to their success moving forward.

Introduction

Over the next 12 to 24 months, Japanese companies will embark on a historic overhaul of the ways they address corporate governance, capital management and financially material environmental and social risks to seek long-term sustainable growth opportunities. These issues have been on the radar since the early 2010s, when former Prime Minister Shinzo Abe placed corporate governance reforms at the heart of the nation's growth strategies, known as "Abenomics." What is different this time around, however, is the Japan Corporate Governance Code, which was revised in June 2021 to place greater emphasis on the role that corporate boards and their committees should play in enhancing shareholder value. The scope of the Code was also expanded to include sustainability issues such as gender diversity and climate change. Further, the Code now includes an enforcement element that targets nearly 60% of the country's 3,800 listed companies, which will have to adhere to the Code on a "comply or explain" basis to become members of the Tokyo Stock Exchange's (TSE) coveted Prime section, which is expected to go online in April 2022. Concurrently, the government is reportedly considering an overhaul of existing greenhouse gas (GHG) emissions and climate change risk-related disclosure rules for companies.

We believe Japan is on the cusp of a new wave of deeper and more comprehensive reforms than those of "Abenomics." The breadth of change may also be more pronounced among the small to midsize companies that previously were left behind in governance reforms. In our view, there will be winners and losers from these changes, while a bottom-up and active long-term approach to investing has the potential to help identify companies able to undergo fundamental reforms that could facilitate sustainable growth opportunities.

Time Is Running Out for Japan

We believe it is critical for Japanese companies to address deeply rooted capital management, governance and sustainability issues, and that now may be an opportune time. The numbers speak for themselves. Since the bursting of the economic bubble in the early 1990s, the total return of Japan's benchmark Topix Index has been a mere 79%. That compares to the EURO STOXX 600 Index's 830% and the S&P 500 Index's 2,025% during the same period.[1] Valuations tell a similar story, with the Topix price-to-book ratio (PBR) at 1.4 compared to the EURO STOXX 600 Index's 2.1 and S&P 500 Index's 4.7,[2] while other metrics like EV/EBITDA also support this view (see Figure 1).

We believe this disparity in valuation between Japan and other developed markets is due to a combination of the government's slow progress in revitalizing the economy from the so-called "lost decades," companies' inability to address fundamental inefficiencies in their businesses, and the public's struggle to wean itself from a deflationary mindset.

Today, with the COVID-19 pandemic, the accelerated pace of global digitalization appears to be widening the valuation gap further. In August 2021, the combined market capitalization of Google, Apple, Facebook and Amazon was some US$7.5 trillion, overtaking the US$6.8 trillion market value of all listed Japanese companies combined.[3] Further, the global shift in capital flows to sustainable investing, led by EU and U.S. investors, has also raised alarm as to whether ESG issues could lead to further underperformance. Japan is a net importer of energy, and its reliance on fossil fuels has increased sharply due to the government's revised energy policy since the 2011 Fukushima nuclear disasters. We believe the economy also remains skewed toward asset-heavy, carbon-intensive manufacturing, which makes up 21% of GDP versus Europe's 14% and the U.S.'s 11%,[4] raising investor concern that Japan could be put at a disadvantage in a global sustainability framework based on the European taxonomy system.

[1] Bloomberg. September 13, 1991 – September 13, 2021.

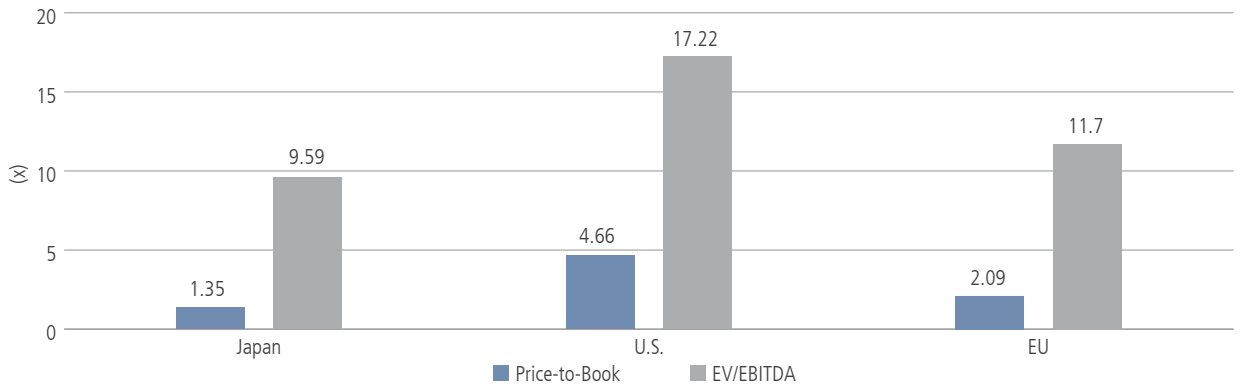
[2] Bloomberg, as of September 28, 2021.

[3] *Nihon Keizai Shimbun*, "GAFA overtakes Japanese companies on market valuations as stable earnings invite inflows," August 27, 2021.

[4] *The World Bank World Development Indicators*, as of September 13, 2021.

FIGURE 1: VALUATIONS OF JAPAN, U.S., EU COMPANIES

Lack of progress in the transformation of Japanese businesses has depressed valuations versus other developed markets



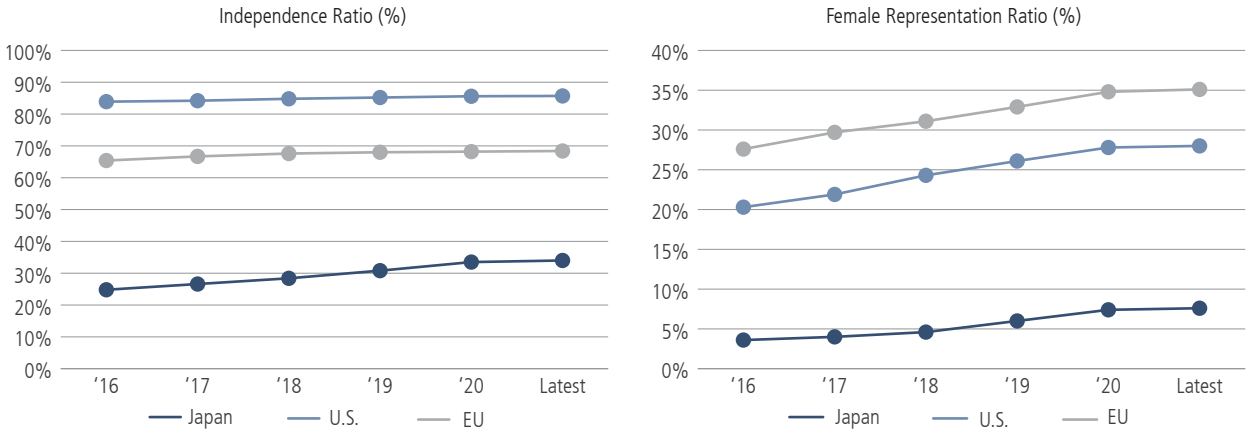
Source: Bloomberg, as of September 28, 2021. Japan: Topix, U.S.: S&P 500, E.U.: EURO STOXX 600. For illustrative purposes only. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed or any historical results. Investing entails risks, including possible loss of principal.

Japan's Smaller Companies Left Behind in Governance Reforms, Sustainability Transformation

Faced with a sense of crisis, then-Prime Minister Abe launched Abenomics and its "three arrows" in the 2010s, targeting monetary easing, fiscal stimulus and structural reforms. The third arrow included measures to strengthen corporate governance among Japanese companies in order to address inefficiencies, including the double codes of Stewardship (2014) and Corporate Governance (2015). While the impact of the first two arrows has yet to be determined, we believe the third arrow has not completely missed its mark. Since 2016, the average board independence ratio of companies listed in the Topix Index has increased nine percentage points to 34.0% while the average female representation on boards has gained four percentage points to 7.6% (see Figure 2).[5] Although these ratios still lag those of equivalent indices in the U.S. and EU, we consider this to be notable progress for a market where many companies have historically been run by majority-internal and male-dominated boards. We believe this gradual shift to improve board independence and diversity, along with increased pressure from institutional investors, has contributed to corporate management's early steps to address capital efficiency issues such as reducing surplus capital through higher shareholder returns, business restructurings targeting non-core assets, and the unwinding of cross-shareholdings (see Figure 3).

FIGURE 2: BOARD INDEPENDENCE AND GENDER DIVERSITY OF JAPAN, U.S., EU COMPANIES

Japanese companies have made some progress in reforming its majority internal and male-dominated boardrooms

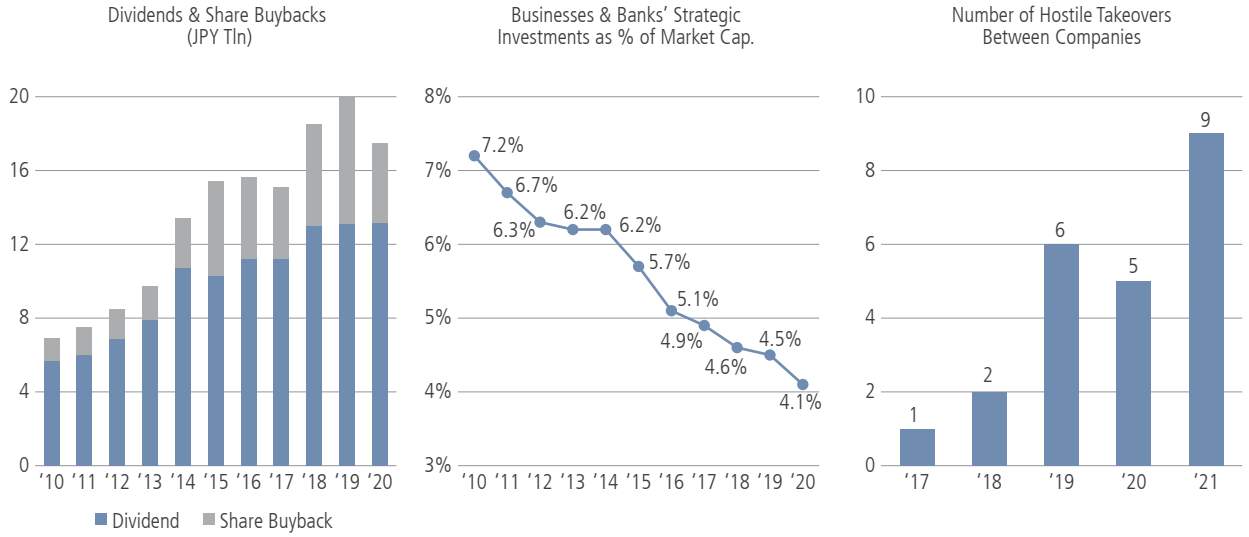


Source: Bloomberg, as of September 28, 2021. Japan: Topix, U.S.: S&P 500, EU: EURO STOXX 600. For illustrative purposes only.

[5] Bloomberg. Fiscal year 2016 – September 13, 2021.

FIGURE 3: SHAREHOLDER RETURNS, STRATEGIC INVESTMENTS, HOSTILE TAKEOVERS OF JAPANESE COMPANIES

Capital management reforms are taking shape among Japanese companies



Source: (LHS) JPMorgan, as of December 31, 2020; (middle) SMBC Nikko, as of August 31, 2021; (RHS) IR Japan, as of October 31, 2021. For illustrative purposes only. Indices are unmanaged and not available for direct investment. Investing entails risks, including possible loss of principal. **Past performance is not indicative of future results.**

We believe the previous administration's efforts have helped to raise awareness among Japanese companies of the importance of corporate governance and the role it can play to address capital management and sustainability issues. However, in our view, the awareness has not resulted in a fundamental shift in management decision-making on these topics. We see this in capital efficiency ratios like return on equity (ROE) and net profit margins, where Japan continues to lag developed market peers (see Figure 4)[6]—something we attribute to, in certain cases, overdiversified businesses resulting in a lack of focus, misallocation of resources, continuing uncompetitive products and bloated cost structures.

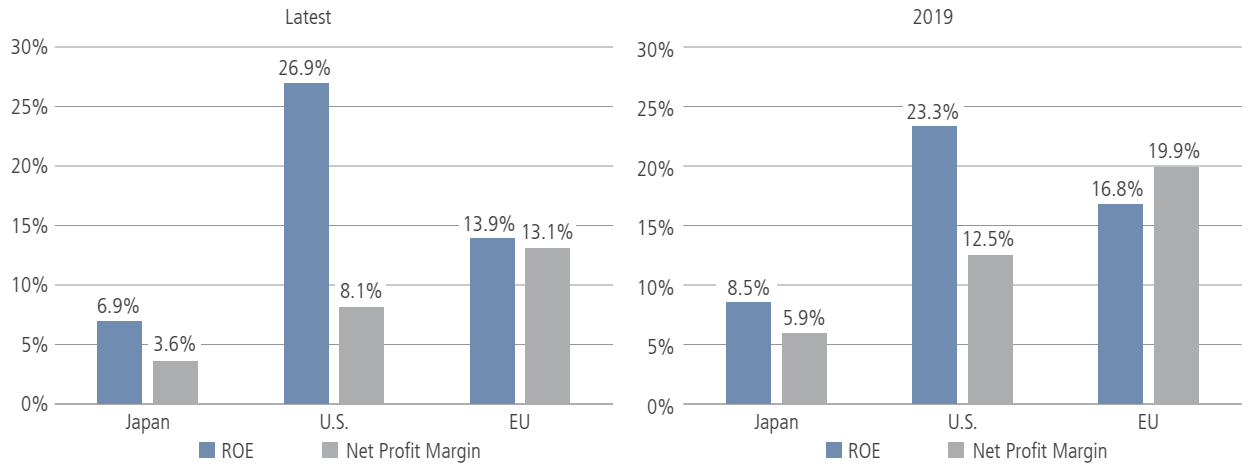
Further, many Japanese small to midsize businesses under one trillion yen in market cap have yet to implement corporate governance reforms or address financially material issues to their businesses. Since 2016, we have witnessed a small group of progressive companies in this cohort taking proactive measures to improve board independence and diversity, but the majority continue to lag bigger companies (see Figure 5).[7] Based on our conversations with corporate managements at small to midsize firms, a key reason is a perceived lack of qualified candidates for independent director and auditor roles, while the same rationale is cited for low gender representation in boardrooms. While many small to midsize companies do face challenges in accessing external talent, we believe some company managers have not embraced the importance of corporate governance and the role that it can play in fostering dynamic discussions within the boardroom to promote fundamental change.

[6] Bloomberg. Return on equity, net profit margin of Topix, S&P 500, EURO STOXX 600, as of September 28, 2021.

[7] Bloomberg, as of September 28, 2021. Percentage of independent directors and female directors on the boards of Topix constituents.

FIGURE 4: ROE AND NET PROFIT MARGINS OF JAPAN, U.S. AND EU COMPANIES

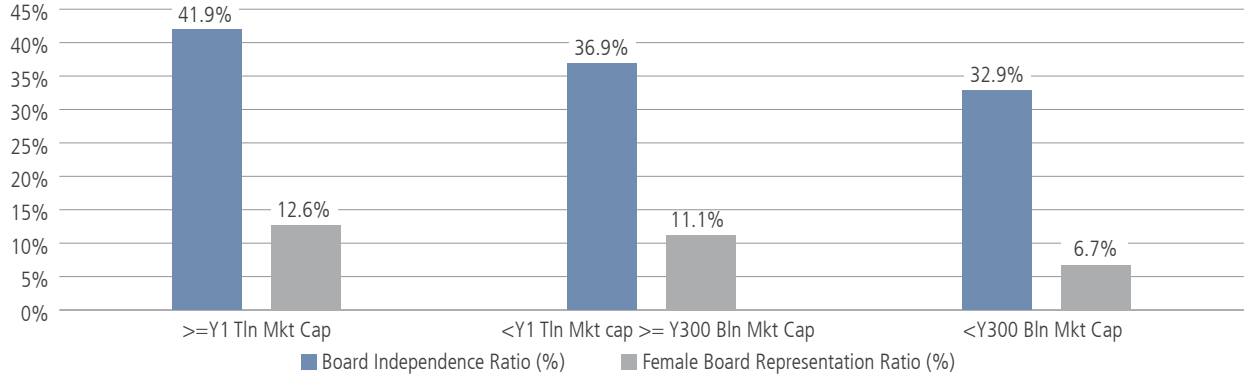
Japanese companies' capital efficiency have been depressed by slow progress in improving profitability



Source: Bloomberg, as of September 28, 2021. Japan: Topix, U.S.: S&P 500, E.U.: EURO STOXX 600. For illustrative purposes only. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed or any historical results. Investing entails risks, including possible loss of principal.

FIGURE 5: JAPANESE BOARD INDEPENDENCE, FEMALE REPRESENTATION RATIOS BY MARKET CAPITALIZATION

Smaller Japanese companies have seen slower progress in improving board independence and gender diversity



Source: Bloomberg, as of September 28, 2021. Japan Topix. For illustrative purposes only.

We have seen Japanese companies take a more proactive stance in recent years to mitigate sustainability issues related to environment and social responsibility and improving related disclosures. According to the Government Pension Investment Fund's (GPIF) annual survey of listed companies, the proportion of respondent firms that have voluntarily disclosed non-financial information including ESG topics rose nearly four percentage points to 78.5% from 2019 to 2020.[8]

[8] Government Pension Investment Fund, *Report of the 6th Survey of Listed Companies Regarding Institutional Investors' Stewardship Activities*, 2021, p. 16.

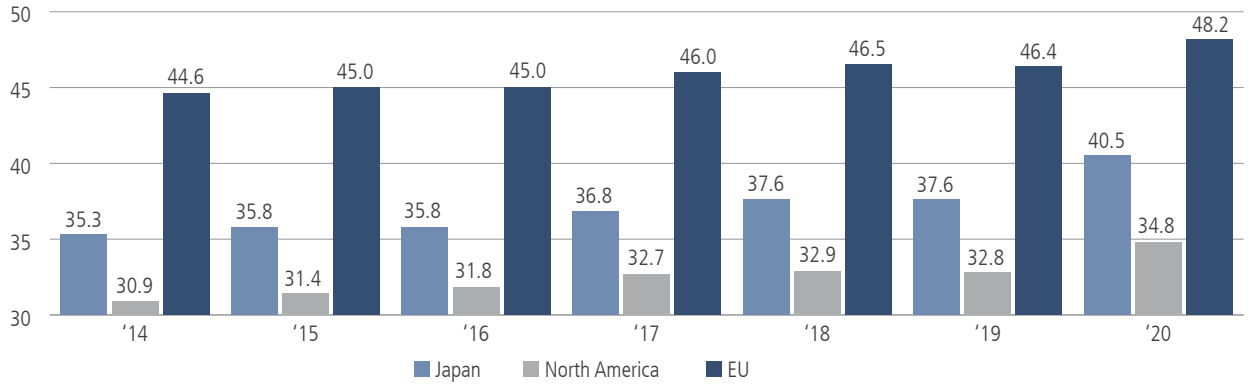
This improved disclosure may be one of the factors that contributed to the increase in some Japanese companies' ESG scores in the last several years (see Figure 6).[9] However, based on our discussions with Japanese firms, we believe that many are still at the early stages of embracing the concept of sustainability at the management level and as part of a long-term growth strategy. A case in point is the relatively low uptake of key sustainability disclosure standards like the Sustainability Accounting Standards Board (SASB) and its framework of materiality, which we view as a critical tool to address ESG risks for long-term value creation. However, the number of Japanese companies that have adopted and reported based on SASB standards remains at 31 companies or 2.4% of all SASB reporters, compared to 49% and 12% for the U.S. and EU, respectively (see Figure 7).[10] For reference, the 31 Japanese firms represent 13% of the country's listed companies by market value.[11]

Meanwhile, climate change has become a topic of growing interest among companies, especially after the 2020 announcement by the Japanese government of its intention to reduce GHG emissions to zero by 2050 to achieve "carbon neutrality."[12] This has been a key driver of the expanding support for climate change disclosure related to the Taskforce on Climate-Change Related Financial Disclosure (TCFD) framework, with Japan seeing the highest number of TCFD supporters in the world at 475 institutions.[13]

However, according to the GPIF, supporting public companies are generally larger, with less uptake in the small to mid-cap category (see Figure 8). In our meetings with such companies, often-cited hurdles to addressing climate change risks have included a lack of reliable data on emissions and the human and financial resources needed to undertake disclosure, especially in 2-degree scenario analyses.[14]

FIGURE 6: AVERAGE ESG SCORES BY COUNTRY AND REGION

Japanese companies' ESG scores have continued to increase on the back of improved disclosure



Source: FactSet, compiled by SMBC Nikko. Japan: MSCI Japan, North America: MSCI North America, EU: MSCI Europe. For illustrative purposes only. Nothing herein constitutes a prediction or projection of future events or future market behavior. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed or any historical results. **Past performance is no guarantee of future results.**

[9] FactSet, SMBC Nikko Securities, as of August 2021. Historical Japan ESG ratings of MSCI Japan constituents.

[10] Value Reporting Foundation, *SASB Standards Reporters,* August 2021.

[11] Tokyo Stock Exchange, as of September 20, 2021. Japanese SASB Reporters excludes NTT Docomo, which was consolidated by parent company NTT.

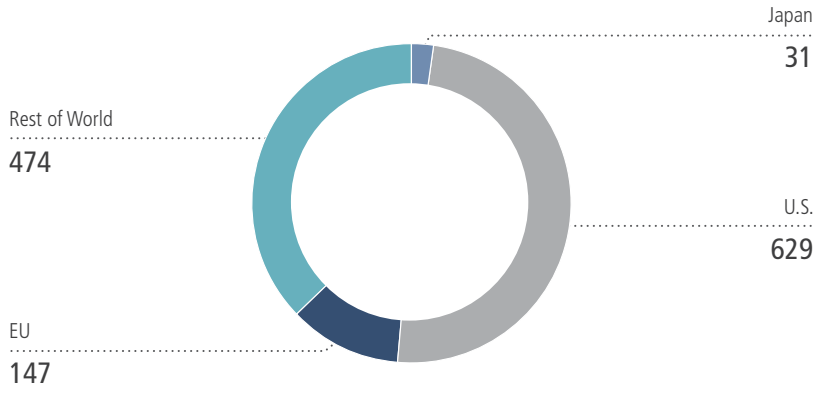
[12] Japan Ministry of Economy, Trade and Industry, *Japan's Roadmap to "Beyond-Zero" Carbon" Report,* November 11, 2020.

[13] *Nihon Keizai Shimbun*, "Pros and cons of strengthening disclosure within the context of climate change and finance," September 16, 2021.

[14] Government Pension Investment Fund, *ESG Report 2020*, p. 40.

FIGURE 7: SASB REPORTERS BY COUNTRY AND REGION

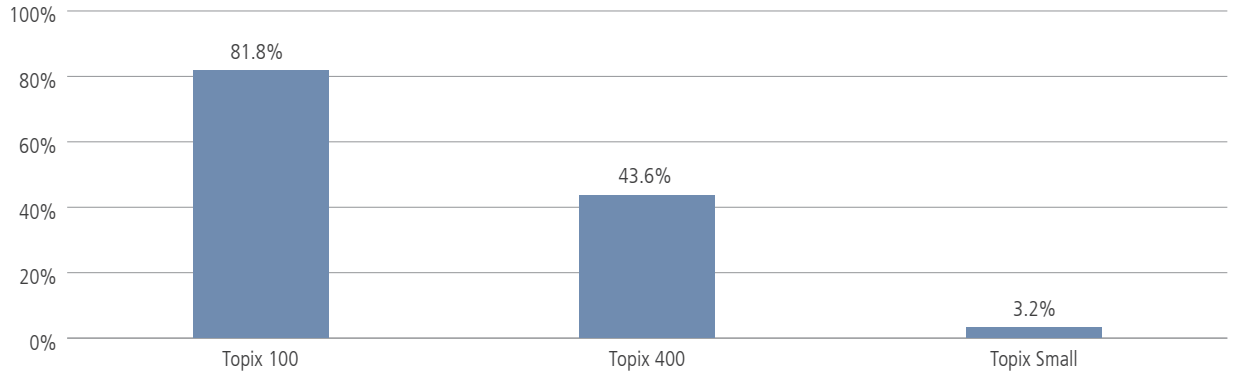
Uptake of ESG reporting based on SASB standards remains low in Japan versus other developed markets



Source: Sustainability Accounting Standards Board, as of August 31, 2021.

FIGURE 8: RATIO OF TCFD SUPPORTERS AMONG JAPANESE COMPANIES BY MARKET CAPITALIZATION

TCFD reporting on climate change has yet to be adopted by the majority of smaller Japanese companies



Source: Taskforce on Climate-Change Related Financial Disclosure, data compiled by Government Pension Investment Fund, as of June 30, 2021.

The Changes to Come in Japan

Japanese corporate governance has made progress over the last several years, but we believe one of the reasons this has not resulted in a rerating of the Japan equity market is that the changes have not addressed the fundamental issues of businesses. Based on our conversations with management, many companies still do not view enhancing board independence or diversity, improving shareholder returns or mitigating sustainability issues as requisites in seeking potential long-term sustainable growth. Instead, they see such changes as necessary to appease increasingly vocal stakeholders, raise ESG ratings and/or as an extension of their activities in corporate social responsibility. We believe this is partly because government-led reforms have lacked enforcement and incentives to instigate a fundamental shift in management mindset. Hence, we view Japan's recent revision of its Corporate Governance Code as a potential gamechanger. The revised Code gives more clarity to the role boards should play in protecting minority shareholder rights and raising company value.

FIGURE 9: JAPAN'S CORPORATE GOVERNANCE CODE

2021 revisions places stronger emphasis on the role of the board and mitigation of sustainability issues

General Principle 1	Securing the Rights and Equal Treatment of Shareholders
General Principle 2	Appropriate Cooperation with Stakeholders Other Than Shareholders
General Principle 3	Ensuring Appropriate Information Disclosure and Transparency
General Principle 4	Responsibilities of the Board
General Principle 5	Dialogue With Shareholders

Source: Japan Exchange Group.

With the Code becoming a criterion (on a comply-or-explain basis) for companies to be included in the new TSE Prime market starting in April 2022, we believe corporate management will have an incentive to comply. Further, we believe companies will need to consider more carefully the impact of their reforms within the context of corporate value creation, as they will need to maintain a market value above certain thresholds to remain constituents of the Topix Index, which is slated to undergo a phased overhaul starting in 2022. Below, we highlight some of the key upcoming changes that investors should consider.

In our view, many investors outside of Japan do not yet fully appreciate the magnitude of the impending changes to the TSE market in 2022. This is undoubtedly the biggest shake-up of the Tokyo bourse since its establishment in 1847. Starting next April, the current sections of TSE First, TSE Second, Mothers and JASDAQ will be consolidated into Prime, Standard and Growth categories. The most coveted market segment will be Prime, which is equivalent to today's TSE First; many companies see membership in this segment as a status symbol that helps to recruit top talent and maintain business relationships with clients and financial institutions. The more than 2,000 companies (roughly 60% of all listed companies in Japan) that make up today's TSE First section will have to meet various criteria to be considered a member of the new segment.[15] There are two requirements for Prime market listing, related to stock liquidity and corporate governance, that we see as particularly noteworthy: a minimum ratio of tradable shares and adherence to the revised Code on a comply-or-explain basis.[16]

With regard to stock liquidity, companies seeking listing in the Prime section will need to maintain a ratio of tradable shares at or above 35% of the outstanding amount (25% each for the Standard and Growth sections). In addition, the TSE has redefined "tradable shares" to exclude stakes held by domestic banks, insurance companies and/or business entities. In other words, the uniquely Japanese practice of making strategic investments via cross-shareholdings—often representing a large portion of equity—will no longer be counted as "tradable shares" (see Figure 10). We believe these new requirements will encourage Japanese companies to rethink their capital alliances with clients, business partners and group companies that have often been criticized as leading to inefficient allocation of capital and resulted in coordinated proxy voting. Should this happen, we anticipate that corporate governance could be strengthened as management accountability increases and capital efficiency improves, given capital redeployment that is more focused on growth investments and/or higher total shareholder return.

[15] Tokyo Stock Exchange, *Development of Listing Rules for Cash Equity Market Restructuring (second set of revisions)*, December 25, 2020), p. 8 – 12.

[16] Tokyo Stock Exchange, *Japan's Corporate Governance Code: Seeking Sustainable Corporate Growth and Increased Corporate Value over the Mid- to Long-Term*, June 11, 2020.

FIGURE 10: TOKYO STOCK EXCHANGE NEW MARKET STRUCTURES' INITIAL LISTING REQUIREMENTS
The coveted Prime Section includes new criteria regarding stock liquidity, company's adherence to CG Code

	No. of Shareholders	No. of Tradable Shares	Tradable Share Market Cap	Trading Value	Tradable Share Ratio	Business Performance	Financial Status
Prime	At least 800 shareholders	At least 20,000 units	At least Y10 bln	At least Y25 bln mkt cap	At least 35%	• Total profit for recent 2 yrs., at least Y2.5 bln • Sales at least Y10 bln • Market cap at least Y100 bln	At least Y5 bln
Standard	At least 400 shareholders	At least 2,000 units	At least Y1 bln	N/A	At least 25%	Profit at least Y0.1 bln in the most recent yr.	Positive
Growth	At least 150 shareholders	At least 1,000 units	At least Y0.5 bln	N/A	At least 25%	N/A	N/A

Source: Tokyo Stock Exchange.

With regard to the revised Corporate Governance Code, we believe that three key amendments could play a crucial role in promoting fundamental change in the way Japanese companies embrace corporate governance. First, the revised Code sets quantitative guidelines for all Prime-listed companies to have at least one-third board independence and for listed subsidiaries with controlling owners to have a majority independent board and/or a special independent committee to oversee potential conflict of interest issues like takeover proposals (see Principle 4.8: Effective Use of Independent Directors in Figure 11). In addition, compensation and nomination committees are recommended to be majority-independent (see Supplementary Principle of Principle 4.10: Use of Optional Approach, also in Figure 11).

We believe having a clearer definition of independence is vital to fostering dynamic and objective boardroom discussions on management issues that concern the protection of minority shareholder rights and corporate value. We believe this will be particularly important in the coming years as corporate mergers and acquisitions (M&A) and takeover activities are expected to pick up as companies review capital alliances as part of financial management reforms.

FIGURE 11: JAPAN CORPORATE GOVERNANCE CODE ON BOARD INDEPENDENCE, ROLE OF COMMITTEES
2021 revisions elevate criteria for board independence and establishment of committees at Prime-listed companies

Principle 4.8: Effective Use of Independent Directors

Independent directors should fulfill their roles and responsibilities with the aim of contributing to sustainable growth of companies and increasing corporate value over the mid- to long-term. ***Companies listed on the Prime Market should therefore appoint at least one-third of their directors as independent directors (two directors if listed on other markets) that sufficiently have such qualities.***

Irrespective of the above, if a company listed on the Prime Market believes it needs to appoint the majority of directors (at least one-third of directors if listed on other markets) as independent directors based on a broad consideration of factors such as the industry, company size, business characteristics, organizational structure and circumstances surrounding the company, it should appoint a sufficient number of independent directors.

Principle 4.10: Use of Optional Approach

Supplementary Principle: 4.10.1 […] ***In particular, companies listed on the Prime Market should basically have the majority of the members of each committee be independent directors****, and should disclose the mandates and roles of the committees, as well as the policy regarding the independence of the composition.*

Source: Japan Exchange Group.

Second, to help reduce the risk of companies taking a box-ticking approach to meeting independence requirements by appointing affiliated external members to the boards with misaligned skills, the revised Code also recommends that the board identify what it sees as necessary skills and experience to effectively monitor management and to present the analysis in the form of a "skills matrix" (see Supplementary Principle of Principle 4.11: Preconditions for Board and *Kansayaku* Board Effectiveness in Figure 12).

We view the skills matrix as a key piece of disclosure that could provide valuable hints as to the strengths and weaknesses of the board and where certain expertise may be over- or underrepresented. Historically, Japanese boardrooms have typically been composed of salarymen turned executives, who have spent their entire careers at a company and therefore offer operational skill and know-how, but lack in hard management experience in key areas such as corporate finance, M&A, human capital management and, more recently, on issues such as sustainability and digital transformation. From that perspective, a skills matrix could be instrumental to encourage and direct the company to appoint experienced male and female executives in fields where the board lacks expertise.

Third, the revised Code places a stronger emphasis on the importance of integrating material environment and social responsibility issues into management decision-making. Previous editions of the Code also emphasized the importance of addressing sustainability issues, but in our view their wording lacked specificity and the enforcement element. In this revision, the Code includes detailed language that all companies should consider establishing a basic policy on mitigating sustainability issues and that Prime companies should address specific topics like climate change risks, based on the TCFD framework or an equivalent internationally recognized standard (see Supplementary Principle of Principle 3.1: Full Disclosure in Figure 12).

FIGURE 12: JAPAN CORPORATE GOVERNANCE CODE ON BOARD EFFECTIVENESS, SUSTAINABILITY

2021 revisions point to diverse skillsets to improve board effectiveness and importance of addressing sustainability issues

Principle 4.11: Preconditions for Board and Kansayaku Board Effectiveness

Supplementary Principle 4.11.1: The board should identify the skills, etc., that it should have in light of its managing strategies, and have a view on the appropriate balance between knowledge, experience and skills of the board as a whole, and also on diversity and appropriate board size. ***Consistent with its view, the board should establish policies and procedures for nominating directors and disclose them along with the combination of skills, etc. that each director possesses in an appropriate form according to the business environment and business characteristics, etc., such as what is known as a "skills matrix."*** *When doing so, independent director(s) with management experience in other companies should be included.*

Principle 3.1 Full Disclosure

Supplementary Principle 3.1.3: […] In particular, ***companies listed on the Prime Market should collect and analyze the necessary data on the impact of climate change-related risks and earning opportunities on their business activities and profits, and enhance the quality and quantity of disclosure based on the TCFD recommendations,*** *which are an internationally well-established disclosure framework, or an equivalent framework.*

Source: Japan Exchange Group.

It's also worth highlighting that the government is considering amending existing public disclosure rules to include climate change risks, as part of the mandatory disclosure requirements in annual securities filings starting in 2023.[17] Should this materialize, it would apply to not just Prime section companies, but all publicly listed firms in Japan. A preliminary survey of companies during the public consultation period for the new Code found that small to midsize companies saw climate change risk mitigation and TCFD disclosure as top issues to address in the Code, which suggests to us that their mindset on this topic may be gradually changing.[18]

Disclosure reform may also take place on the operational level with the Ministries of Trade and Environment reported to be preparing revisions to companies' GHG emissions disclosure rules, also starting in 2023.[19] It's relatively unknown outside of Japan that the

[17] Nihon Keizai Shimbun, "FSA debates climate change disclosure requirements on US and EU moves," September 2, 2021.

[18] Nishiyama, Kengo, "Preview of the 2021 June AGM season and overview of the revised Japan Corporate Governance Code," Nomura Securities investor presentation, May 19, 2021.

[19] *Nihon Keizai Shimbun*, "Companies' emissions disclosure period to be shortened to a year, to include supply chain and operating companies," September 13, 2021.

country was one of the earlier adopters of mandated company disclosure on emissions, as part of the Act on Promotion of Global Warming Countermeasures, which was born out of the Kyoto Protocol. The Act covers key topics such as carbon dioxide, methane, hydrofluorocarbons (HFC) and sulfur hexafluorides (SF6).[20]

However, the Act was implemented in the mid-2000s and, over the years, its disclosure format has become out of sync with global ESG standards, for example, requiring just biannual reporting and parent company emissions sourcing. The Ministries are reported to be considering a change to disclosure on an annual basis, and including emissions by subsidiary and group companies. This could remove one of the key hurdles to obtaining reliable data, and facilitate the mitigation of climate change risks at the subsidiary level. It could also pave the way for more Japanese companies to pursue TCFD reporting, which could help long-term investors to assess company sustainability.

A Golden Opportunity

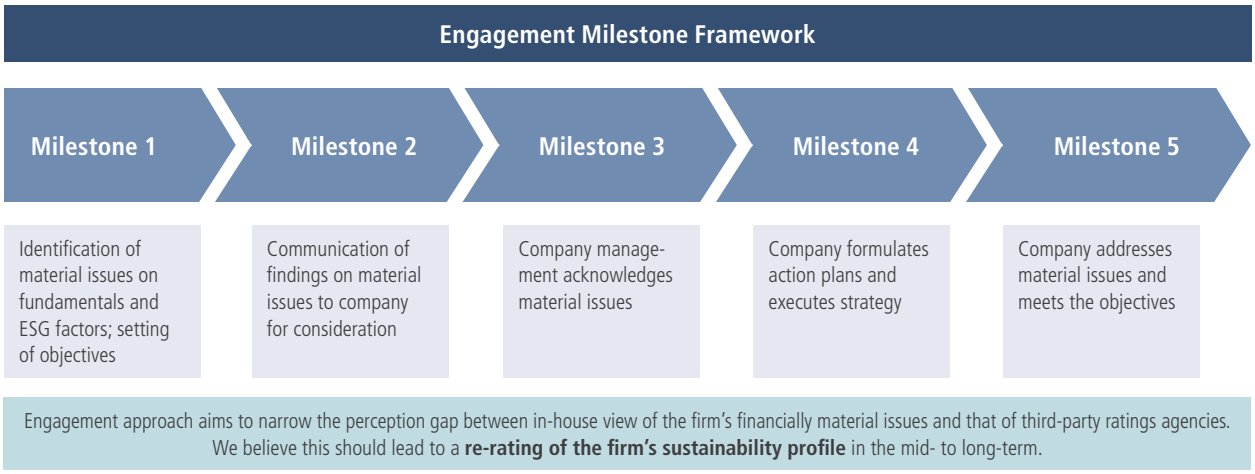
We believe the noted potential changes could help to push companies to embrace good corporate governance as part of a long-term strategy to raise corporate value. Naturally, we believe there will be winners and losers that emerge from such a transformation, as some managements will proactively pursue measures to seek sustainable growth potential while others will fail to keep up. As long-term active investors in Japan, we see the next 12 to 24 months as a golden opportunity to identify such differentiation.

We are also cognizant that many attractive firms, especially small- to midsize companies, may want to reform, but lack the know-how and resources to do so. Hence, we are taking a proactive approach to engaging corporate management and providing detailed overviews of what issues we believe are most pertinent to their business fundamentals. We are also suggesting practical ideas on how companies with limited human and financial resources can seek to mitigate these issues to access long-term growth opportunities. The engagements take place over the duration of our investment timeframe and are managed based on our "Milestone Framework," which includes an objective and a set of key performance indicators (KPIs) to consider in the interim (see Figure 13).

Through these discussions, we ask that companies integrate both capital management and sustainability issues as part of a long-term management strategy to seek sustainable growth potential. In doing so, we encourage them to set medium- to long-term plans along with realistic KPIs and to disclose their efforts on an annual basis based on internationally recognized disclosure frameworks. We highlight several examples from our engagement in the next section.

FIGURE 13: SAMPLE APPROACH TO ENGAGEMENT PRINCIPLES

Engage management on financially material issues for long-term sustainable growth potential



For illustrative and discussion purposes only.

[20] Japan Ministry of Environment, *Japan's Domestic Efforts to Follow up on the Kyoto Conference*, April 28, 1998).

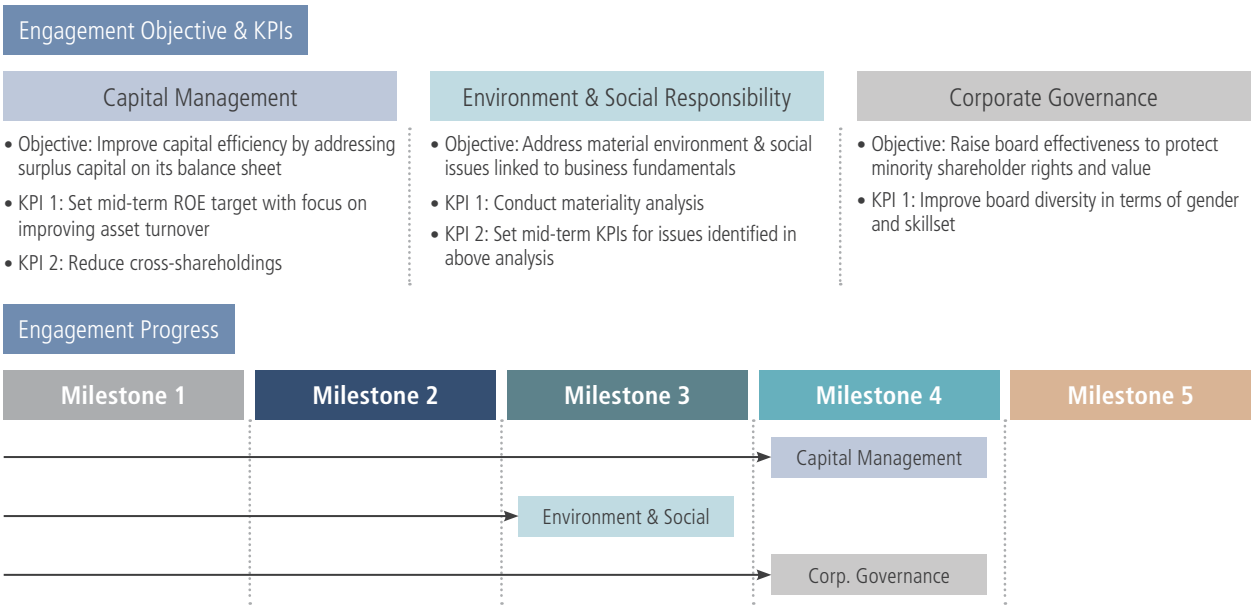
Engagement Case Study: Company A

Over the last several years, we have actively engaged with a road and highway maintenance services provider, Company A, and its senior executives on capital management, integration of financially material environment and social responsibility issues and corporate governance. We believe Company A's strengths lie in its unique business model, which focuses almost entirely on repairing and reinforcing Japan's aging highways, leveraging its technological know-how backed by skilled engineers. These strengths give Company A pricing power and the ability to choose profitable projects, unlike many Japanese general contractors that have to pursue lower-margin or sometimes unprofitable projects due to stiff competition in the tender process. On capital efficiency, we believe the company is a victim of its own success, as its profitable and asset-light business has generated strong free cash flow. This has resulted in a build-up of surplus capital that has weighed on return on equity over the years. Hence, in our engagement, we advised management to consider improving disclosure of its medium-term capital management strategy on the use of cash, as well as addressing its strategic investments like cross-shareholdings. We provided best-practice disclosure examples from other investment holdings, and pointed out the details that were particularly relevant to investors' long-term decision-making.

On material environment and social responsibility issues, we commended the company for undertaking materiality analysis, taking into consideration frameworks like that of the Sustainability Accounting Standards Board. However, we suggested that the company should prioritize among the more than 20 material issues, to determine which were most pertinent to its business fundamentals, and to address those issues first. On corporate governance, the company was ahead of peers in switching to a one-committee board structure (*Kansato-Iinkai*) in 2015, and has since continued to improve its board independence and even appointed its first external female director in 2017. However, the company's limited corporate governance disclosure gave little insight as to how the independent and diversified board was involved in monitoring management and participating in active debates on the company's efforts to mitigate material issues linked to its strategy. Hence, we sought clarity from the senior managing director (an internal board member) to provide clarity on the external executives' roles on the board.

FIGURE 14: SAMPLE ENGAGEMENT WITH COMPANY A

Constructive discussions on capital management, implementation of materiality framework and board effectiveness



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Since our engagement, the company announced a comprehensive medium-term plan that integrated both capital management and materiality strategies. The former addressed many of the issues we had raised, including the introduction of a multiyear share repurchase program and a plan to reduce its cross-shareholdings, which we took as positive steps toward improving capital efficiency. In the most recent meeting with us, the senior managing director indicated that the new three-year plan was part of the company's medium- to long-term strategy to improve potential ROE in a sustainable manner, and indicated that management had considered the decision based on our engagement. Although the company's strategic investments remain above our firm's Japan proxy voting guideline's threshold of 5% of total assets, we took into consideration the company's announced commitment to reduce such stakes over the next three years, and, after deliberating with our Proxy Voting Committee, decided to override the guideline and vote in support of top management at the September shareholder meeting.

With regard to material environment and social responsibility issues, the senior managing director explained that the company's efforts to integrate these issues into management strategy was still a work in progress. However, we were reassured by the company's plan to consolidate its material environment and social responsibility issues into four groups and its commitment to announce a set of KPIs during this fiscal year. In response, we provided best-practice examples from a French construction company and explained how its materiality framework and matrix helped investors to better understand how it was addressing medium- to long-term environment and social responsibility risks. The senior managing director expressed his appreciation for our suggestion and indicated that the company's Sustainability Committee would take it into consideration for its future disclosure.

Finally, we came away with a positive impression that the company's independent and diversified board was helping to support management in addressing fundamental issues to the business. The senior managing director shared an insightful episode regarding an industry-wide labor shortage of skilled engineers. In a recent board meeting, the management team had reported to the board on how they planned to strengthen its new graduate recruitment program given the many competing firms that were trying to woo the same talent. Company A's female external director, a leading academic in the field of civil engineering, weighed into the discussion, suggesting that the company consider focusing its efforts on recruiting female civil engineer and architect students instead of competing for the same male students as other firms. The senior managing director explained that such ideas would likely not have emerged on an all-male board. The company is now looking to set a quota for female new graduate hires with a focus on recruiting talented students in these niche fields. We have been impressed with the company's steps to address its financially material issues, and we believe the key driver of these positive changes is top management's buy-in on the importance of addressing these topics in seeking sustainable growth. Our next step would be to help the company disclose many of the above initiatives, and management has asked us to support the publication of its first-ever integrated report in 2022.

Engagement Case Study: Company B

For several years, we have engaged an office automation and equipment maker, Company B, and its investor relations and sustainability teams, as well as senior management, on capital management, corporate governance and financially material environment and social responsibility issues. Company B has a strong global brand and is currently reinventing its business to become a comprehensive provider of office IT services and solutions, riding the wave of office digitalization. Throughout this process, we identified several fundamental issues in the company's capital management and sustainability strategies that we believe needed to evolve with its turnaround plans.

On the former, we felt the company was not addressing its asset-heavy businesses that would no longer be central to its new business model focused on IT services and solutions. Our concern was that such non-core assets were locking up capital that could otherwise be used to fund potential growth investments and/or improve shareholder returns to raise the firm's capital efficiency. The latter was regarding financially material environmental and social responsibility issues specifically in supply chain management, employee engagement and workforce diversity.

In our view, the company has had a strong track record of addressing its environmental footprint. However, we believed the business transformation could also require a "rethink" of the company's materiality assessment to encompass social issues that would have a more significant impact on the company's fundamentals and growth outlook as it transformed from a hardware to a software-based

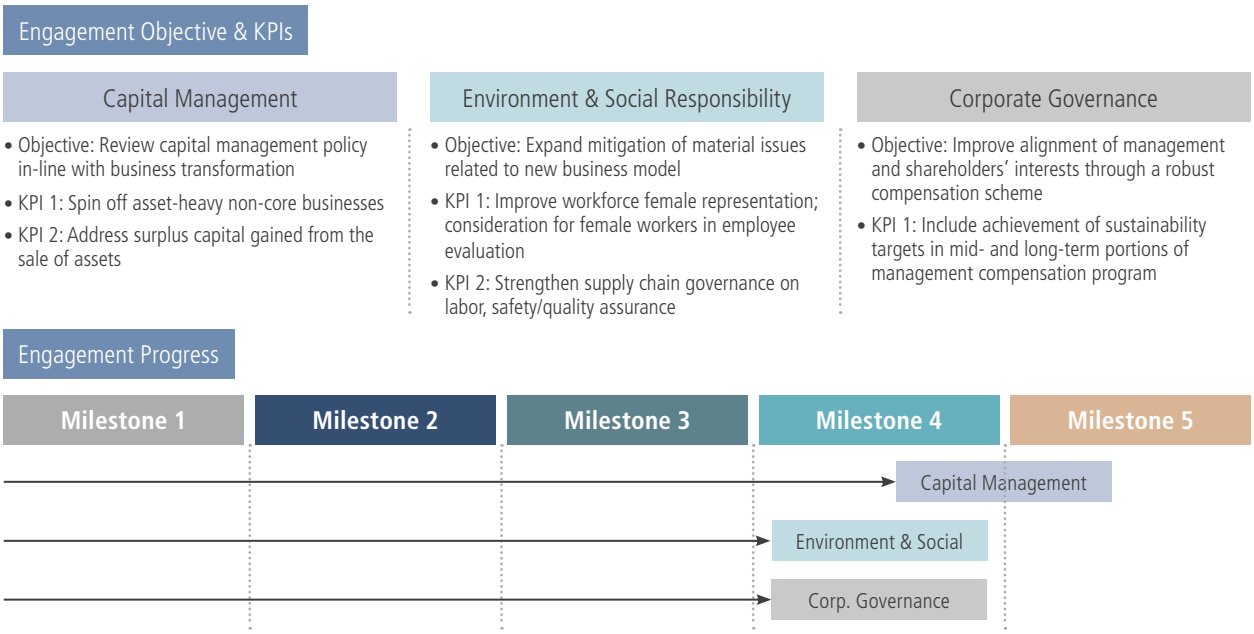
business. Finally, we noted that, although management was undertaking a dramatic transformation of the business and pursuing forward-looking sustainability initiatives, its achievements were not factored into compensation, which we viewed as misaligned with the long-term interests of shareholders.

Following our engagement, the company announced a series of notable changes to its financial and materiality strategies that we believed would significantly improve its long-term growth prospects. First, the company decided to spin off its asset-heavy leasing business, as well as utilize excess capital gained from the sale to invest in growth segments, while returning the surplus to shareholders in the form of sizable share buybacks and higher dividends. The company followed up with the announcement of a medium-term business plan to raise corporate value that included a detailed set of financial targets and a roadmap to help achieve those KPIs by raising profitability, while optimizing its capital structure and expanding cash-flow generation to potentially increase capital efficiency sustainably over the plan period.

Second, this new strategy integrated a comprehensive plan to address many of the environmental and social responsibility topics on which we had engaged the firm. On supply chain management, the company put forth a new plan to have all key suppliers sign its supply chain code of conduct, in line with internationally recognized best practices. It's worth noting that this framework played an instrumental role in its climate risk mitigation efforts as it sought the support of its suppliers to achieve its 2030 Science Based Target (SBT) approved goal of reducing Scope 1 and 2 emissions by 63% relative to 2015 levels.[21] On gender diversity, the company announced that it would expand its diversity and inclusion programs, including training and career development and more support for working mothers. We were also impressed by the firm's decision to integrate sustainability objectives into management and executive officers' long-term compensation. In light of the positive reforms that we witnessed to address its financial and materiality issues, we decided, with our Proxy Voting Committee, to publicly voice Neuberger Berman's support of the CEO's reappointment leading up to the 2021 annual shareholder's meeting as part of our "NB Votes" initiative. Going forward, we plan to continue engaging the company on its capital allocation as well as supporting its efforts to improve disclosure regarding its sustainability initiatives.

FIGURE 15: SAMPLE ENGAGEMENT WITH COMPANY B

Constructive discussions on capital management, mitigation of material issues and management compensation



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[21] Company B, *TCFD Report 2021*, September 2021, p.31.

Conclusion

We believe Japanese companies are at an inflection point. Companies that were once hesitant about fundamental reforms are facing mounting pressure from various stakeholders, including shareholders, lenders, the government, NGOs and, in some cases, even employees and suppliers, to take appropriate action on addressing capital management and sustainability issues. Failure to act now may result in a repeat of the so-called "lost decades." We are also cognizant that not every company will be able to keep up with the fast-changing environment. We will likely continue to witness corporate governance failures, accounting scandals and perhaps more cases than ever of companies trying to "greenwash" their failing businesses with false claims of sustainability initiatives. However, such companies will likely face increasing difficulty in operating as part of a "natural selection" process by investors and stakeholders in the new market environment. In turn, we believe this will help to focus investor attention on the companies that are likely to embrace fundamental reforms for sustainable growth, potentially leading to a rerating of valuations around estimated long-term performance outlooks. At Neuberger Berman, we will continue to actively seek investment opportunities in such promising companies and support their sustainability transformation through constructive engagement.

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Topix: The TOPIX, also known as the Tokyo Stock Price Index, is a capitalization-weighted index of all companies listed on the First Section of the Tokyo Stock Exchange. The index is supplemented by the subindices of the 33 industry sectors. The index calculation excludes temporary issues and preferred stocks, and has a base value of 100 as of January 4, 1968.

Topix 100: The TOPIX 100 Index is a capitalization-weighted index designed to measure the performance of the 100 most liquid stocks with the largest market capitalization that are members of the TOPIX Index. The index was developed with a base value of 1000 as of April 1, 1998.

Topix 400: The TOPIX Mid 400 Index is a capitalization-weighted index designed to measure the performance of the next 400 most liquid and highly capitalized shares, after the 100 most liquid stocks in the TOPIX 100 Index, that are members of the TOPIX Index. The index was developed with a base value of 1000 as of April 1, 1998.

Topix Small: The TOPIX Small Index is a capitalization-weighted index designed to measure the performance of the stocks listed on the First Section of the Tokyo Stock Exchange, excluding the TOPIX 500 stocks and non-eligible stocks. The index was developed with a base index value of 1000 as of April 1, 1998.

MSCI Japan: The MSCI Japan Index is a free-float weighted equity JPY index. It was developed with a base value of 100 as of December 31 1969.

MSCI North America: The MSCI North America Index is a free-float weighted equity index. It was developed with a base value of 100 as of December 31 1969.

MSCI Europe: The MSCI Europe Index in EUR is a free-float weighted equity index measuring the performance of Europe Developed Markets. It was developed with a base value of 100 as of December 31, 1998.

Euro Stoxx 600: The STOXX Europe 600 Index is derived from the STOXX Europe Total Market Index (TMI) and is a subset of the STOXX Global 1800 Index. With a fixed number of 600 components, the STOXX Europe 600 Index represents large, mid and small capitalization companies across 17 countries of the European region.

S&P 500: The S&P 500® is widely regarded as the best single gauge of large-cap U.S. equities and serves as the foundation for a wide range of investment products. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

Investing entails risks, including possible loss of principal. Investments in hedge funds and private equity are speculative and involve a higher degree of risk than more traditional investments. Investments in hedge funds and private equity are intended for sophisticated investors only. Indexes are unmanaged and are not available for direct investment. **Past performance is no guarantee of future results.**

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