

Material 2

Provisional
Translation

Capital efficiency/Allocation of management resources, etc.

January 26, 2021

Japan Financial Services Agency

1. General remarks

(1) Summary of previous code revisions regarding capital efficiency

- In the 2018 revision of the Corporate Governance Code, Principle 5-2 was revised to refer to **accurately identifying the company's cost of capital** and the allocation of management resources, such as **reviewing the business portfolio and investing in fixed assets, R&D, and human resources**.

Japan's Corporate Governance Code (Excerpt)

*The parts in blue were added in the last revision in 2018.

【Principle 5.2 Establishing and Disclosing Business Strategies and Business Plans】

When establishing and disclosing business strategies and business plans, companies should articulate their earnings plans and capital policies, and present targets for profitability and capital efficiency **after accurately identifying the company's cost of capital**. Also, companies should provide explanations that are clear and logical to shareholders with respect to the allocation of management resources, **such as reviewing their business portfolio and investments in fixed assets, R&D, and human resources**, and specific measures that will be taken in order to achieve their plans and targets.

(1) Opinions about management strategy, etc. in the post-COVID economy and society

- ❑ In the post-COVID economy and society, there are many opinions from both investors and companies about **the need to review business models, including business portfolio strategies**.
- ❑ In particular, there was a great deal of awareness of issues related to investment in DX and the review of face-to-face business models.
- ❑ There were also several comments from investors that **the board should be committed to making decisions on strategies and other matters related to these business**.



Investors

- **Business models will need to be revised.**
- **As management strategies need to be revised (including DX strategies), the skill set of the board, which plays a monitoring role, will also change.**
- **In order for the board to exercise oversight over business strategies and mid-term management plans, it will be necessary to have directors with skills related to execution.** In the future, it will be desirable to discuss how the board should commit itself to making major decisions.
- DX is important. (Personal connectivity, digital literacy needs to be improved [especially at the executive level], and **the perspective of changing business processes based on the possibilities of DX is required**, not just introducing digital technology into existing business processes.)

Source: Prepared by JFSA from interviews with companies, investors, and experts conducted by the JFSA since March 2020.



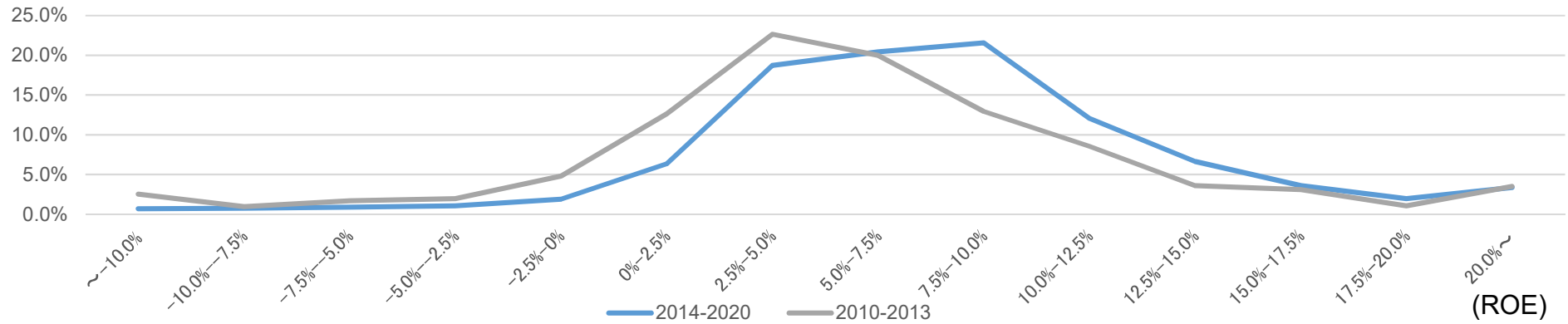
Companies

- Taking into account the changes in the demand structure post-COVID, we are **making selections and concentrating on core businesses** where demand is expected to continue, and on providing services in regions and locations where demand is expected to recover quickly.
- In the world of the new normal, the business models of the past will not work, so we have considered **changing our business portfolio**.
- Our company's strength was in **face-to-face** consulting that provided plans tailored to each individual, but in light of the impact of COVID-19, **we have to reconsider what the future should be**.
- This is not to say that we should review our business portfolio just because of the COVID-19 crisis, but **our basic stance should be to make management decisions in a timely manner** in the first place.
- We were required to **establish a new business model** (by further promoting digitalization, which we had been promoting before COVID-19).
- The importance of remote communication is increasing, and we are planning **to strengthen our online business**.
- In light of the growing e-commerce ratio in China, **it is necessary to increase investment in digitalization**. For services that used to be mainly face-to-face sales, the company will explore the possibility of considering e-commerce in addition to face-to-face sales.
- After the COVID-19 crisis, **non-contact services will be in greater demand** from customers, so we are accelerating investment in this area.

(1) ROE level

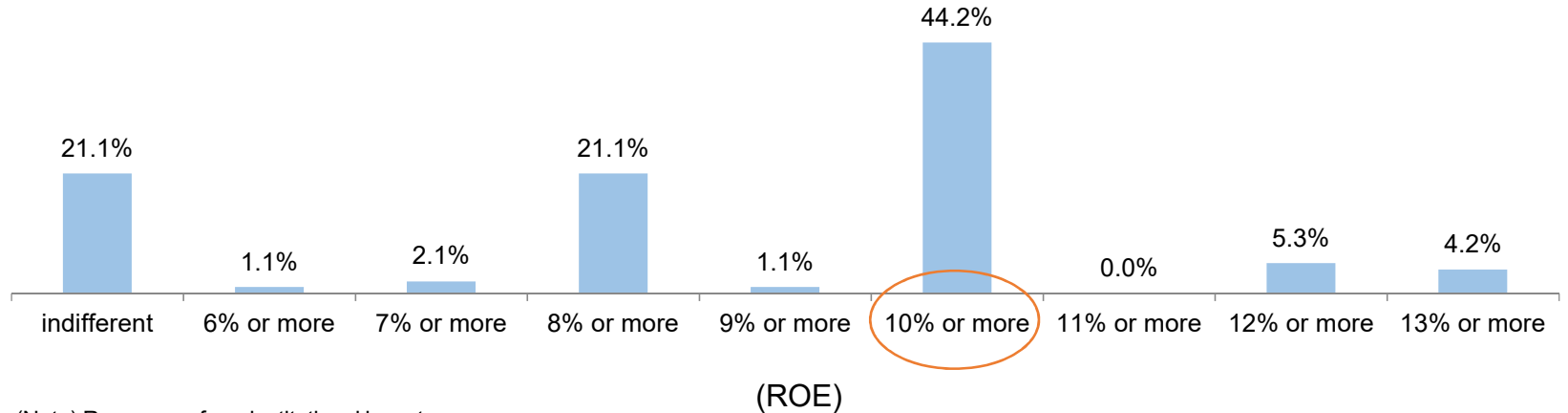
- ❑ The distribution of ROE is moving (**up**) to the right as a whole.
- ❑ On the other hand, about **44% of investors** consider "**10% or more**" to be a **desirable ROE level over the mid- to long term**.

The distribution of ROE



(Note) Comparison of companies listed on the First Section of the Tokyo Stock Exchange for the periods 2010-2013 and 2014-2020.
Source: Prepared by JFSA from Bloomberg

A desirable ROE level over the mid- to long term (Investors)



(Note) Responses from institutional investors
Source: Prepared by JFSA from the Life Insurance Association of Japan "Questionnaire on initiatives to enhance corporate value (FY2019 ver.)"

(1) Cost of capital as a key management consideration

- Compared to the U.S. and Europe, Japan shows a difference in ROE levels, especially in **net profit margins**.

<Comparison of Japan, US and Europe>

	Net profit margin (Net Income/Sales = ①)	Total asset turnover (Sales/Total assets = ②)	Leverage (Total Assets/ Shareholders' Equity = ③)	ROE (①* ②* ③)
Japan	8.5%	80.3%	3.9	10.1%
US	15.4%	66.0%	4.4	30.8%
Europe	19.1%	57.9%	6.0	17.5%

(Note 1) Based on calendar year actual financial results.

(Note 2) Data taken from TOPIX 500, S & P 500 and Bloomberg European 500 Index companies at year-end for which required data was available. Excludes companies recording a net loss or negative shareholders' equity.

<Japanese time series comparison>

	Net profit margin (Net Income/Sales = ①)	Total asset turnover (Sales/Total assets = ②)	Leverage (Total Assets/ Shareholders' Equity = ③)	ROE (①* ②* ③)
2019	8.5%	80.3%	3.9	10.1%
2018	8.8%	79.1%	4.0	10.5%
2017	8.6%	78.4%	4.0	10.1%
2016	8.2%	80.4%	4.2	9.5%
2015	8.0%	78.8%	4.1	9.0%
2014	7.4%	81.7%	4.2	9.0%

(Note 1) Based on calendar year actual financial results.

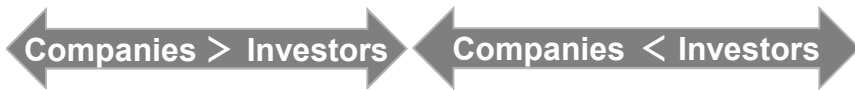
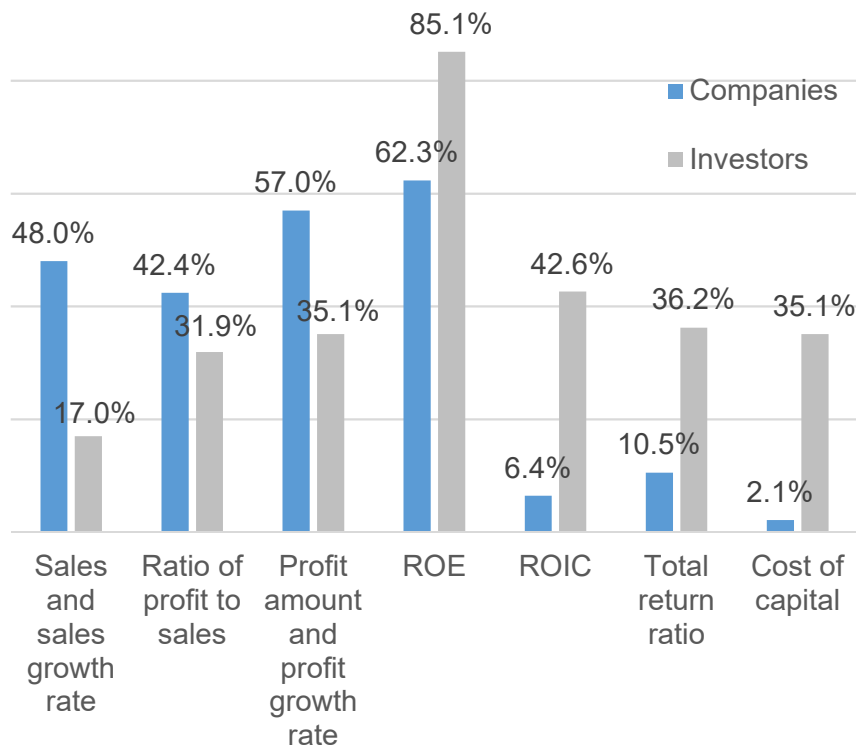
(Note 2) Data taken from TOPIX 500 Index companies at year-end for which required data was available. Excludes companies recording a net loss or negative shareholders' equity.

Source: Prepared by JFSA data from Bloomberg

(1) Management with an awareness of the cost of capital (i)

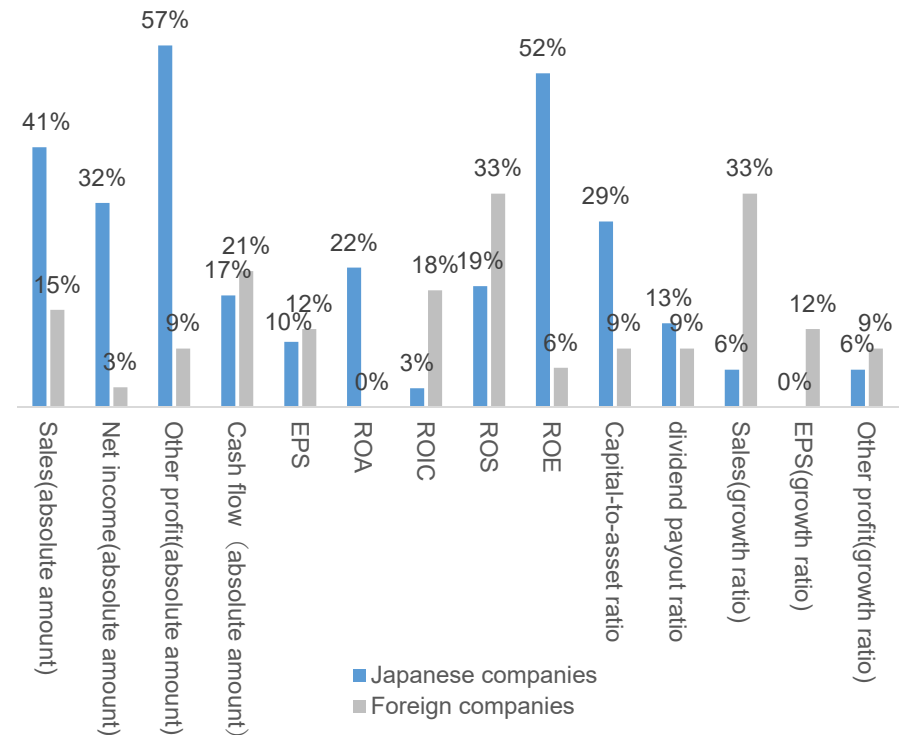
- In terms of indicators to be emphasized in management, **companies focus on indicators such as profit amount, sales, and profit to sales**, while **investors focus on indicators such as ROE, ROIC, total return ratio, and cost of capital**.

Indicators that should be emphasized as management indicators



Source: Prepared by JFSA from the Life Insurance Association of Japan "Questionnaire on initiatives to enhance corporate value (FY2019 ver.)"

Management indicators set forth in the medium-term management plans



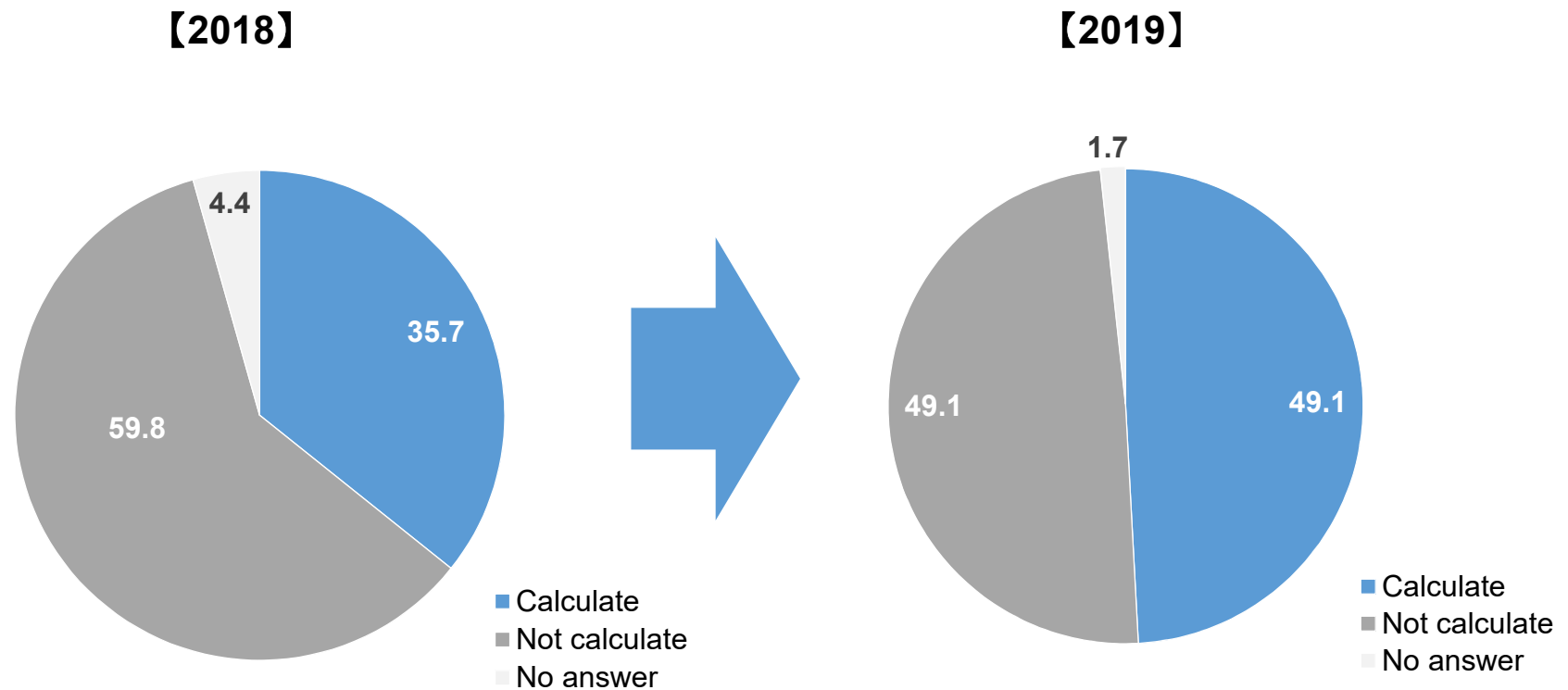
(Note) In the U.S., there are only a few companies that report ROE. There is a theory that investors are obsessed with ROE for Japanese companies because they have been forced to focus on ROE as they have been managing their businesses without considering capital efficiency.

Source: Prepared by JFSA from Assistant Prof. TSUMURAYA Shoichi, Hitotsubashi University, "Corporate Governance, is it true?"

(1) Management with an awareness of the cost of capital (ii)

- The ratio of companies that calculate their own cost of capital has increased by about 15% from 2018 to 2019. About half of the companies calculate their own cost of capital.

Calculation of cost of capital (Companies)



Source: Prepared by JFSA from Board Advisors Japan, Inc. "Survey on Corporate Governance"

2. Securing management resources

(2) Opinions about financial strategy in the post-COVID economy and society

- ❑ Companies are saying that they **are increasing their cash reserves in response to the COVID-19 crisis**, and that **it is important to maintain a balance with investments**.
- ❑ Investors are saying that **companies need to develop the ability to generate cash rather than simply relying on cash holdings**, given their business models in the post-COVID era.



Companies

- We recognized **the significance of holding cash** in an emergency situation such as the COVID-19 crisis.
- Due to the worsening of cash flow and the impact of the COVID-19 crisis, we have **increased our cash reserves**.
- During the COVID-19 crisis, we also expanded our bank credit line to avoid concerns about a shortage of cash.
- As for our approach to the cost of capital after COVID, I think that for the time being we will shift to **a trend of emphasizing safety**. Before COVID, when we sold a business, investors always asked us how we were going to use the funds, but recently we have received positive feedback because we have been taking safety into consideration. Nevertheless, **ROIC management with an awareness of the cost of capital is a major pillar of our business** and we will continue such management.
- We had set a standard for cash reserves based on the assumption of a Lehman shock-level situation, but this time we have exceeded that level and need more cash reserves. However, **we believe that increasing cash reserves blindly should be avoided, and we recognize the importance of maintaining a balance with investments**. For this reason, we are discussing what level is appropriate.
- We established our policy based on the idea **that cost reduction is partly a policy to stop the bleeding, but it is also an aspect to use as a source of investment so as not to lose the seeds of growth**.
- It does not mean that we should refrain from investment because of the COVID-19 crisis, but **we should invest in growth investment opportunities in a timely manner so as not to miss them**.
- **In order to reduce assets to improve cash flow, we are mainly working on the sale of cross-shareholding and idle assets**.



Investors, etc.

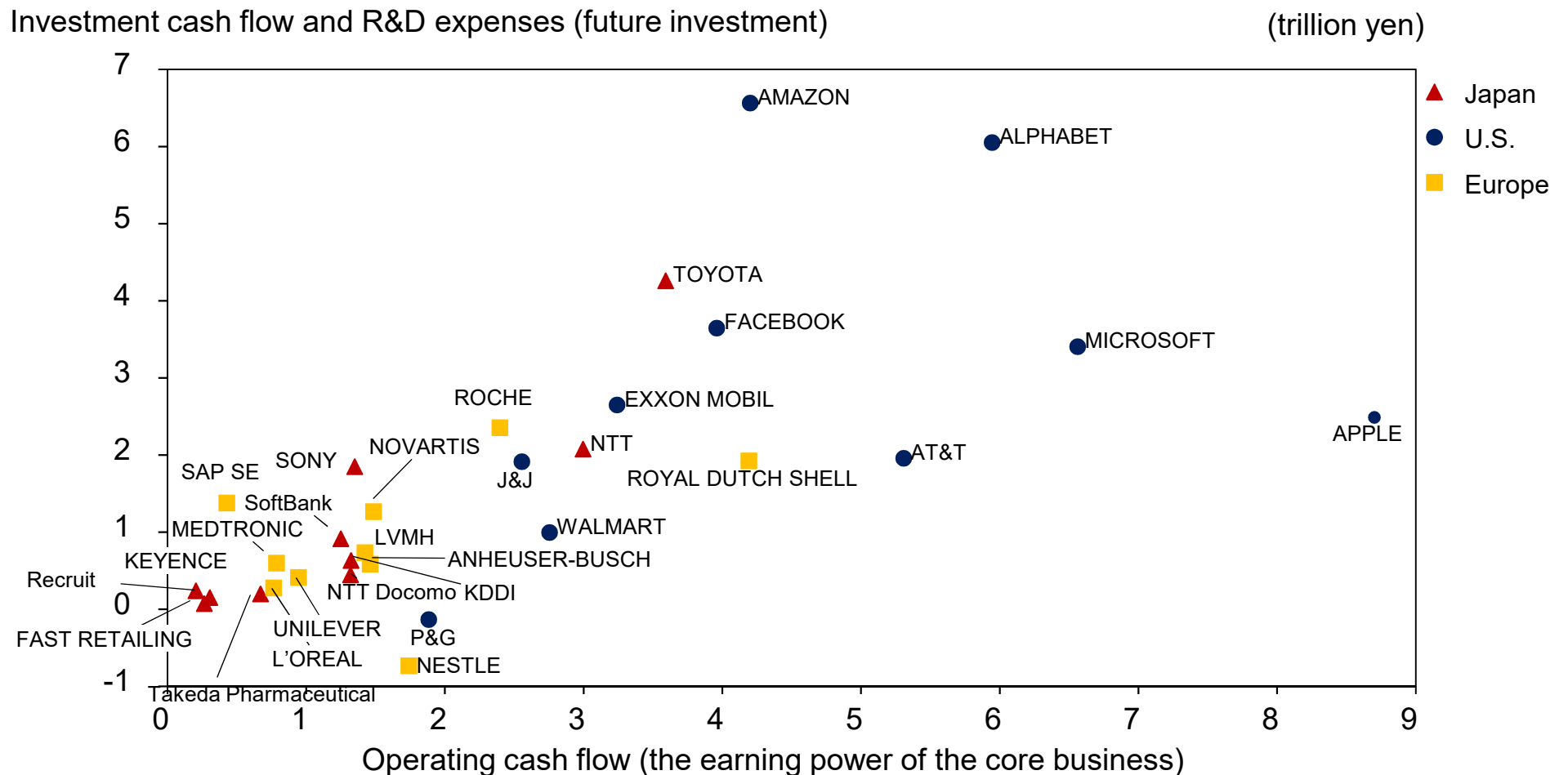
- From the perspective of demonstrating the competitiveness of Japanese companies, **it is problematic to simply sort out the COVID-19 crisis by saying that holding on to cash was a success**. Otherwise, **the ability to generate cash** in the future will be diminished. It is important to take action from a medium- to long-term perspective.
- From the perspective of improving capital efficiency, **it is important to scrutinize the options of how to raise funds** and prepare for a crisis.
- **Japanese companies should boost their earning power, especially the level of operating cash flow (≒EBITDA)**, which is the most fundamental earning power and real earning power. As for the issue of internal reserves not being used effectively, I think the real reason is that people are too afraid to withdraw their savings for emergencies, which they have been struggling to accumulate with their small income. The world's top class companies generate huge operating cash flow in the trillions of yen from their core business, which allows them to invest in risky R&D, M&A and long term ESG/SDG areas in the future.

Source: Prepared by JFSA from interviews with companies, investors, and experts conducted by JFSA since March 2020.

(2) Relationship between operating cash flow and investment cash flow, etc.

- Some data shows that **the higher the operating cash flow, the higher the investment cash flow and R&D expenses**, and it functions as a source of investment.

In the era of disruptive innovation, where the sustainability of high-risk, large-scale innovation investments will be questioned, the earning power of the core business will define future investment power and SDG/ESG investment power.



Source: Prepared by TOYAMA Kazuhiko from Bloomberg

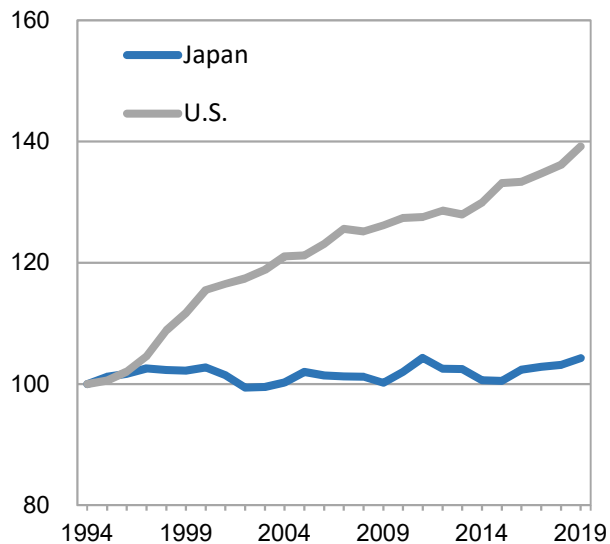
3. Investing for the future (Capital investment, R&D investment, human resource investment, etc.)

(3) Allocation of management resources (human resources, capital investment, and R&D)

□ The growth in **wages**, **capital investment**, and **R&D investment** by Japanese and U.S. companies is shown below.

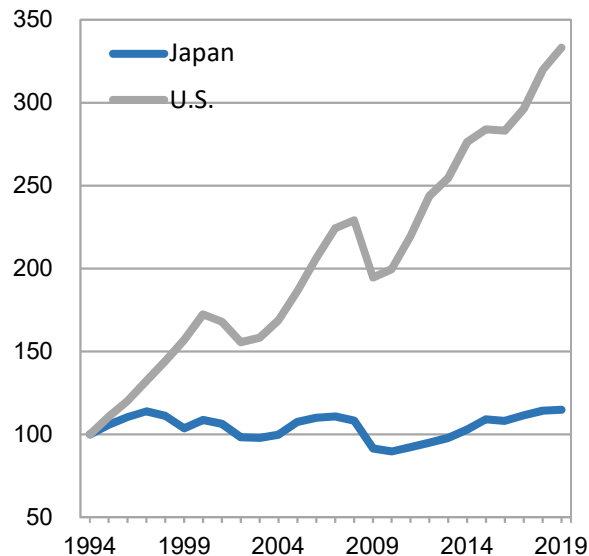
- Real wages (1994 = 100) Japan: 104 U.S.: 139 (Both 2019)
- Capital investment (1994 = 100) Japan: 115 U.S.: 333 (Both 2019)
- R&D (1994 = 100) Japan: 163 U.S.: 219 (Both 2018)

Trends in real wages



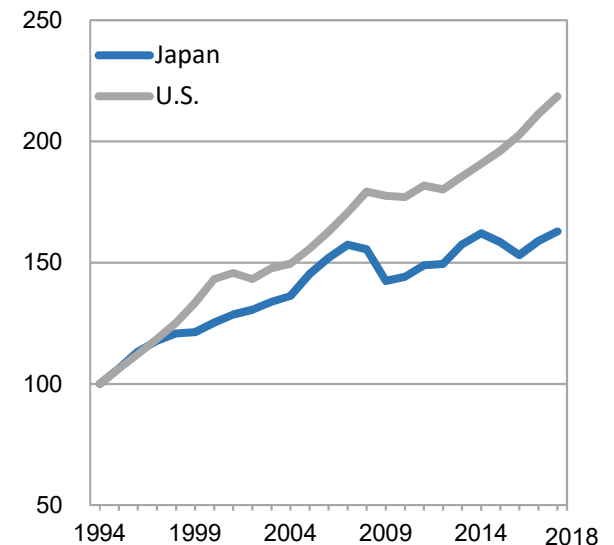
(Note) Average annual salary
Source: Prepared by JFSA from OECD Statistics

Trends in Capital investment



Source: Prepared by JFSA from Cabinet Office and Bureau of Economic Analysis

Trends in R&D

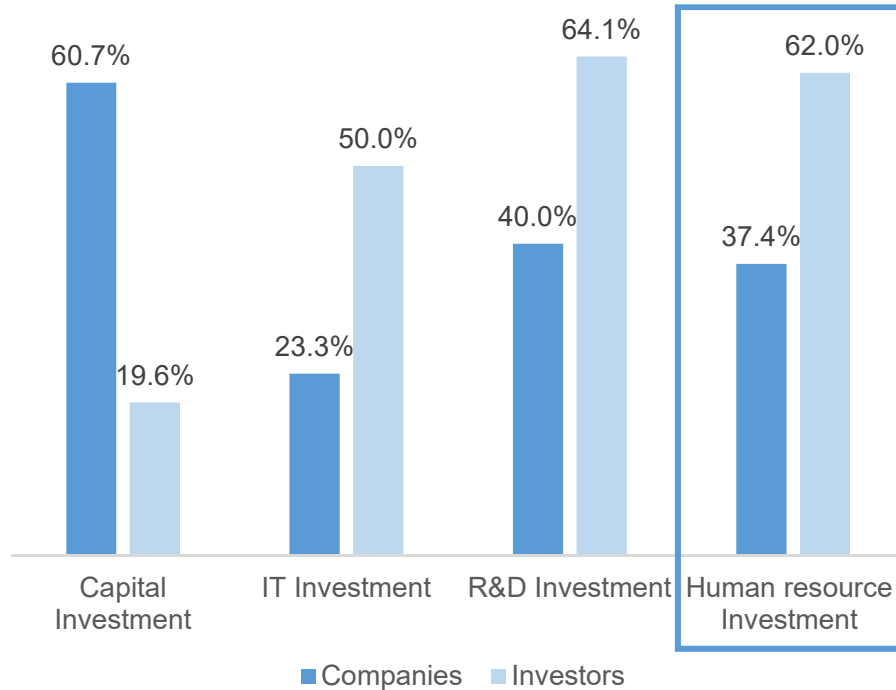


Source: Prepared by JFSA from OECD Statistics

(3) Human resource investment

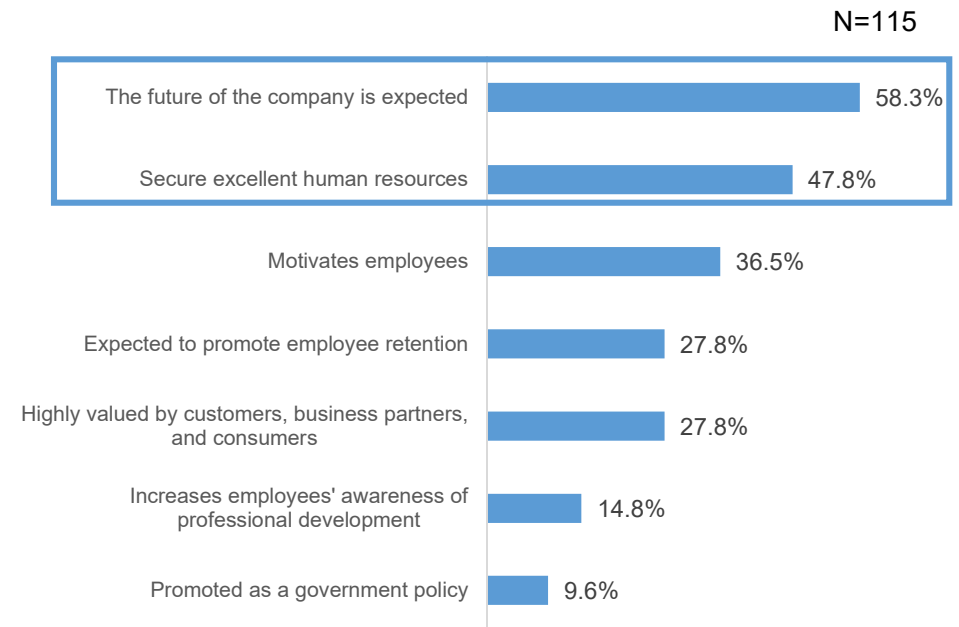
- Among the important items for mid- to long-term investment and financial strategies, **62% of investors place importance on human resource investment**, while **37% of companies** do.
- As for the reasons why institutional investors focus on information related to human resources, about half of them cited **expectations for the future potential of the company** and **the securing of excellent human resources**.

Important items in medium-to long-term investment and financial strategies



(Note) The number of responses from companies is 527, and the number of responses from investors is 92. Up to three items can be selected.
 Source: Prepared by JFSA from the Life Insurance Association of Japan "Questionnaire on initiatives to enhance corporate value (FY2019 ver.)"

The reason that institutional investors focus on human resources-related information



(Note) Multiple answers possible
 Source: Prepared by JFSA from The Japan Institute for Labor Policy and Training "A Study on the 'Visualization' of Corporate Human Asset Information" (Released December 7, 2018)

(3) Opinions about investment in human resources

- ❑ There have been opinions that investment in human resources should be viewed as an investment rather than a cost, but after the COVID-19 crisis, there is a growing awareness of **the importance of investment in human resources**.

Discussion before COVID

- **The fundamental element that generates innovation is human capital**. Therefore, it is important to ensure that the acquisition, development, and utilization of human capital is successful.
- In terms of **whether the human resource strategy matches the management strategy**, the common theme was the importance of consistency and alignment. As an investor, I find myself more and more interested in human resources as a part of business strategy, especially in situations where human resources are the key to a company's competitive advantage. **Companies that are engaged in businesses where the quality of human resources and the productivity of output are directly linked to the company's competitive advantage** should be closely monitored through dialogue.
- If there is a widespread **movement among companies to show the effect of investment in human resources rather than the cost**, this will not only result in an increase in the corporate value of individual companies but will also lead to an increase in the value of Japan and the value of Japanese companies as a whole, and there will be room for foreign investors to become more interested in the Japanese brand.
- **In Japan, investment in intangible assets related to human resources and organizational reform is low**, and the ratio of innovative assets such as R&D is relatively high. However, there is a sense that Japan is also investing in human resources, including on-the-job training, to a certain extent, and that **the effects of investment may not be well visualized or effectively communicated**.

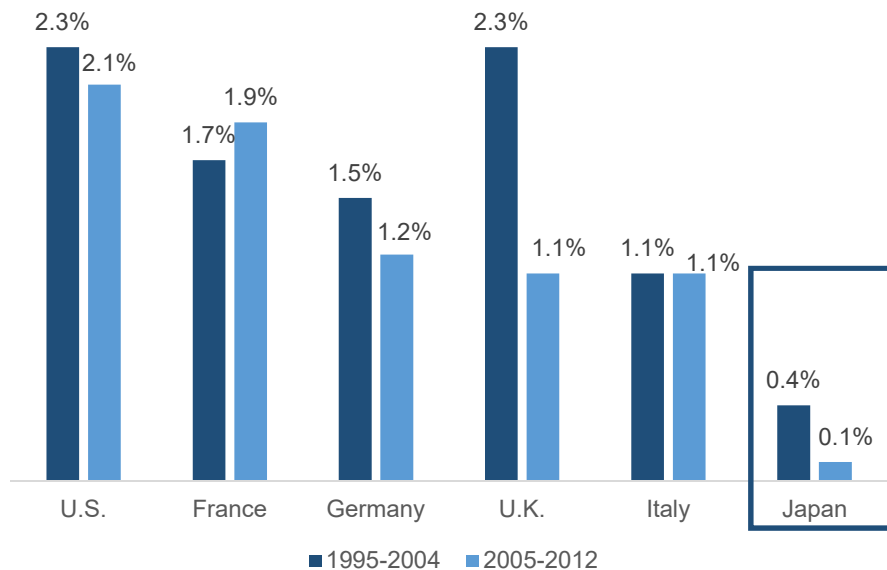
Opinion after COVID

- Post-COVID, **the role of individual employees will become more important**.
- Under the rapid changes after COVID, it will be **important for management and the board to understand the status of employees**.
- **Investment in human capital** (changes targeting **motivation, idea development, and productivity improvement**, rather than work style reforms focusing on shorter hours) is necessary.
- Diversity & Inclusion (**Diverse backgrounds** including non-Japanese as well as female employees [diverse backgrounds, including not only female employees but also foreigners, and an openness that prevents Japanese companies from suffering from the Galapagos syndrome or the "chicken and egg" problem of D&I, where one cannot understand the breadth of diversity unless one is exposed to it].)

(3) Human resource investment

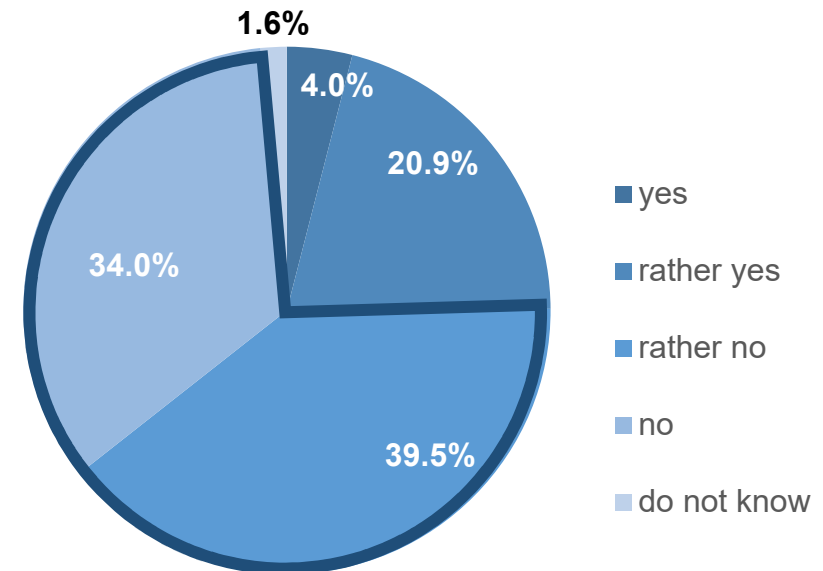
- ❑ Companies' investment in human resources (other than OJT) is lower than other countries.
- ❑ About three quarters of companies answer that they are unable or somewhat unable to recruit, deploy, and train the human resources necessary to realize their business strategies.

International comparison of human resource investment (other than OJT) (% of GDP)



Source: Prepared by JFSA from MIYAGAWA Tsutomu (2018) "What is Productivity?"

Status of recruitment, deployment, and development of human resources necessary to realize business strategies



(Note) Internet survey of members of "Japan's Human Resources Department (Nihon no Jinjibu)" from March to April 2020.
Source: Prepared by JFSA from Nihon no Jinjibu "Human Resources White Paper 2020"

(3) Labor productivity and wages

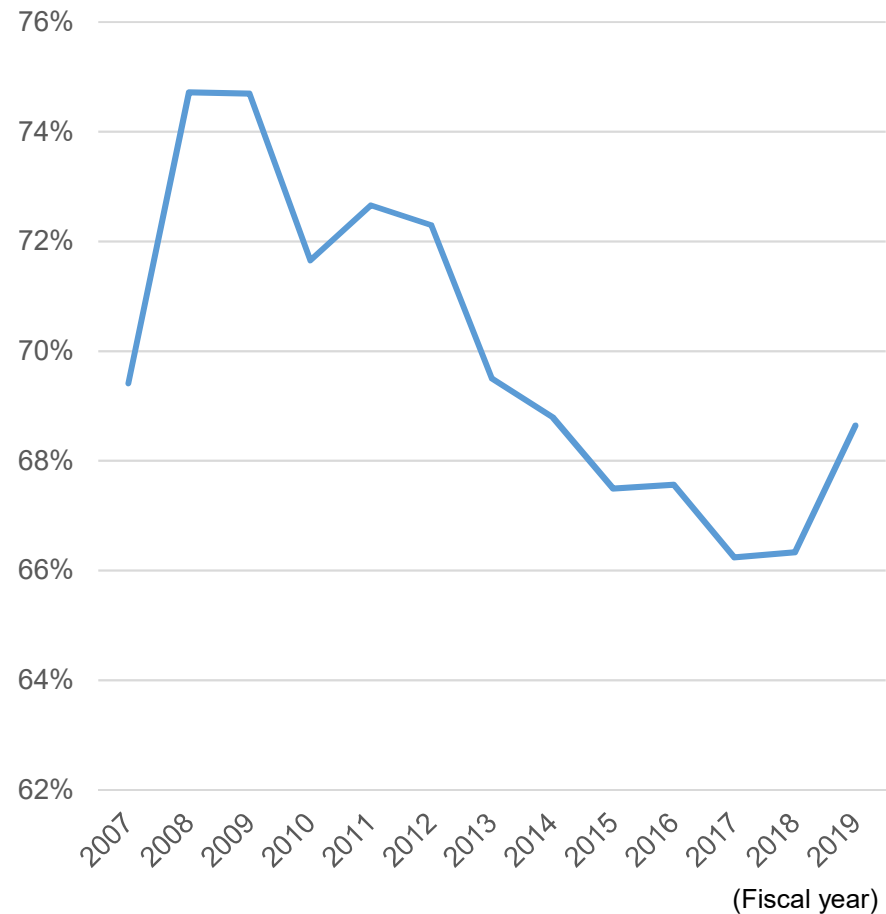
- ❑ In some periods, labor productivity growth has not been consistent with trends in employee wages.
- ❑ In the 2010s, the labor's share has declined.

Labor productivity and employee wages



(Note) Labor productivity and wages in 2010 are indexed as 100. Labor productivity = value added / number of employees; employee wages = (employee salary + employee bonus) / number of employees. Value added = labor cost + interest expense, etc. + rent on movable and immovable property + taxes and dues + net operating income
Source: Prepared by JFSA from Ministry of Finance, "Survey of Corporations"

labor's share

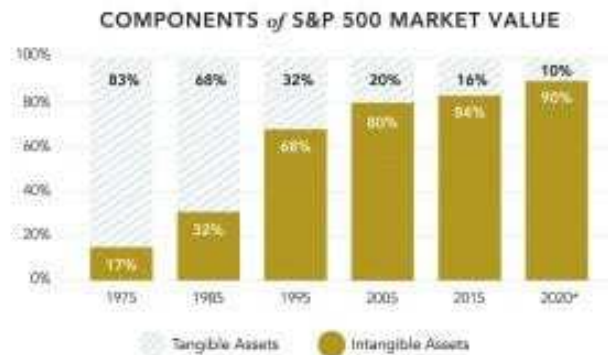


(Note) Labor's share = labor cost/value added
Source: Prepared by JFSA from Ministry of Finance, "Survey of Corporations"

(3) Intellectual property and other intangible assets

- ❑ In the U.S., the share of intangible assets in market value has been increasing.
- ❑ In ESG investment, the role of IP and IP information in particular is becoming more important, and there are estimates that this will have an impact on stock prices.

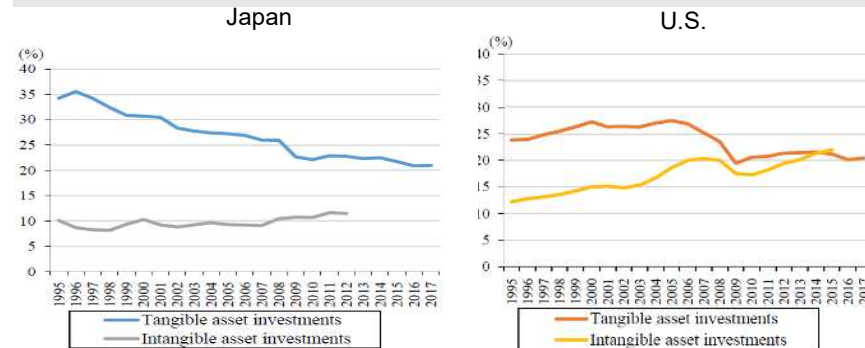
The share of intangible assets in market value (U.S., S&P 500)



Source: OCEAN TOMO, LLC INTANGIBLE ASSET MARKET VALUE STUDY, 2020
INTERIM STUDY UPDATE AS OF 7/1/2020

Investment in tangible and intangible assets in Japan and the United States (% of GDP)

Investment in tangible assets remains highly weighted in Japan

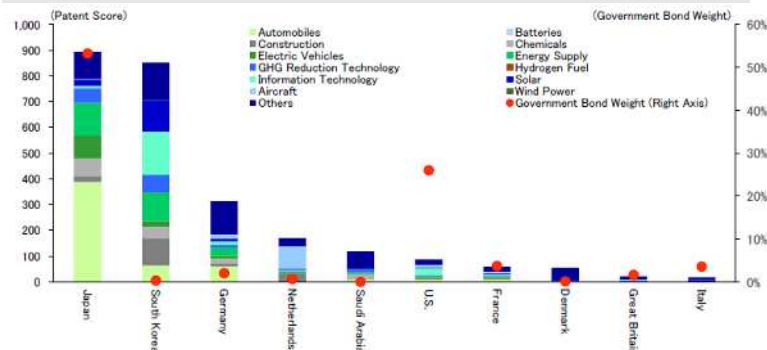


Source: "White Paper on International Economy and Trade 2020"

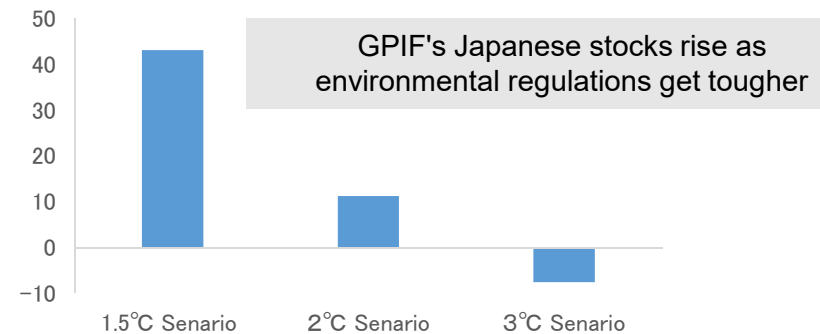
Environment-related patents and stock prices

- The GPIF has released an estimate, based on patent data, that Japanese stocks will rise if environmental regulations are tightened to combat global warming.

Japan's "low-carbon" related patent score is the highest among major countries.



Note: The patent scores of the companies used to calculate the technological machinery are aggregated by country.
Source: "Analysis of Climate Change-Related Risks and Opportunities in the GPIF Portfolio"

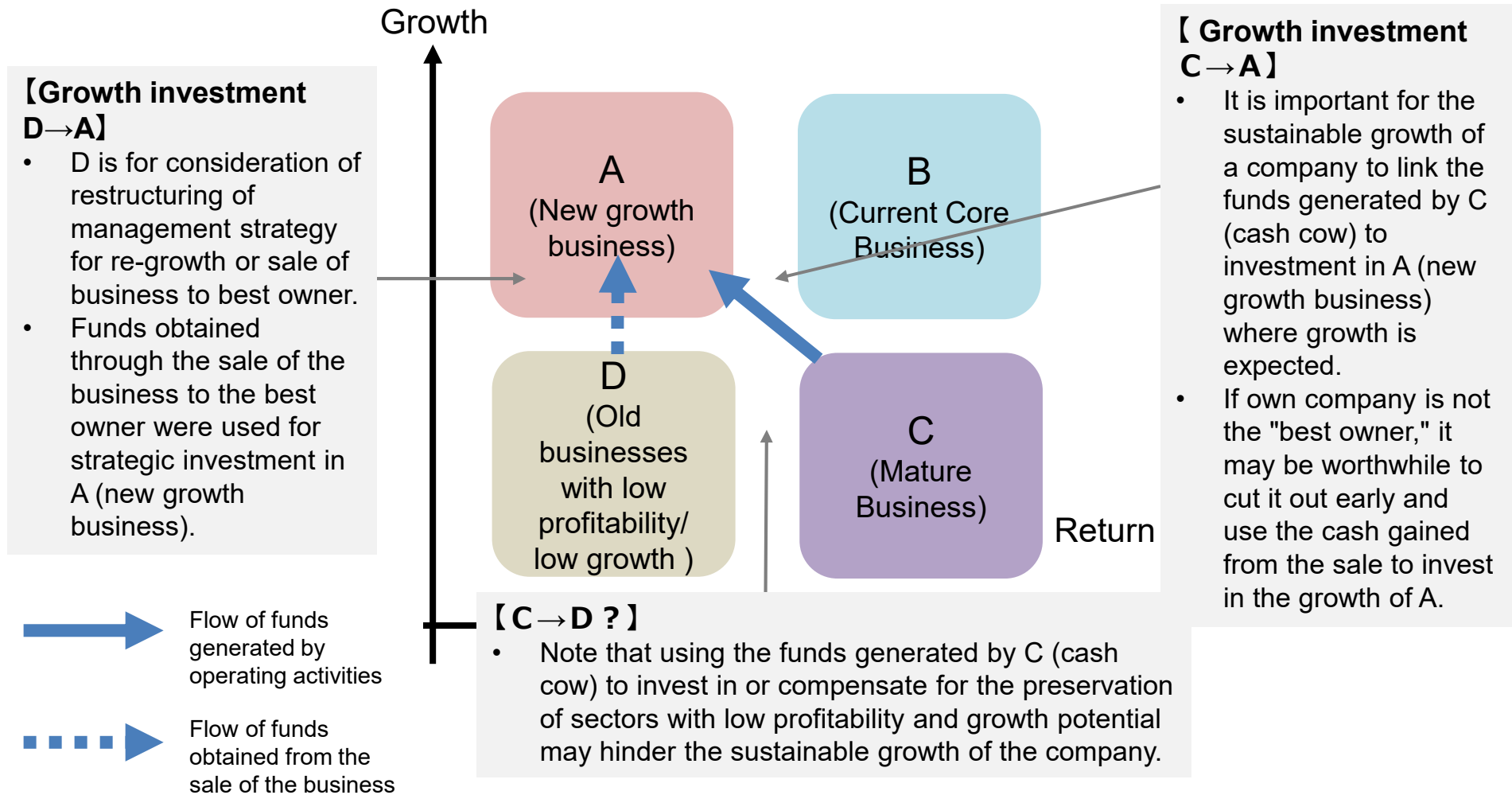


Note: The CVaR of the domestic stock portfolio held by the GPIF is calculated when the temperature rise scenario is changed to 1.5°C, 2°C and 3°C. CVaR is an analysis method developed by MSCI.
Source: Prepared by JFSA from "Analysis of Climate Change-Related Risks and Opportunities in the GPIF Portfolio"

4. Business portfolio strategy

(4) Securing and allocating strategic funding sources in diversified companies

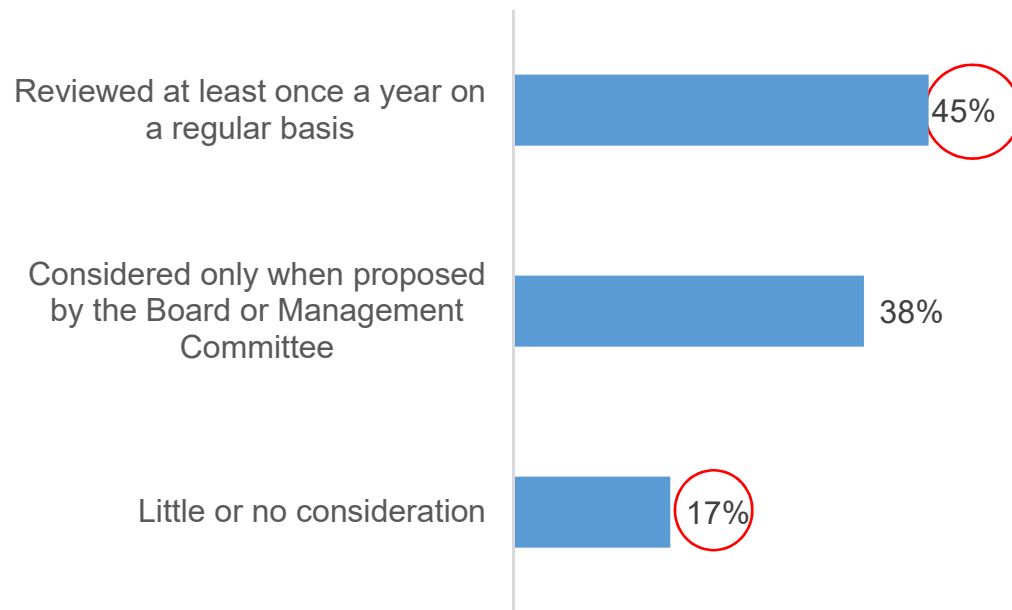
- It has been pointed out that, to achieve sustainable growth, it is important to **strategically allocate funds based on the life cycle of the business**, for example, (1) **use funds generated by mature businesses to invest in high-risk growth businesses**, and (2) **use businesses under consideration for liquidation or revitalization as a source of funds for investment in growth businesses by selling them**.
- In **diversified companies**, some investors place emphasis on the efficiency of internal capital markets.



(4) Disclosure of business portfolio strategies and policies (company surveys): Examination of business portfolio strategy and its disclosure

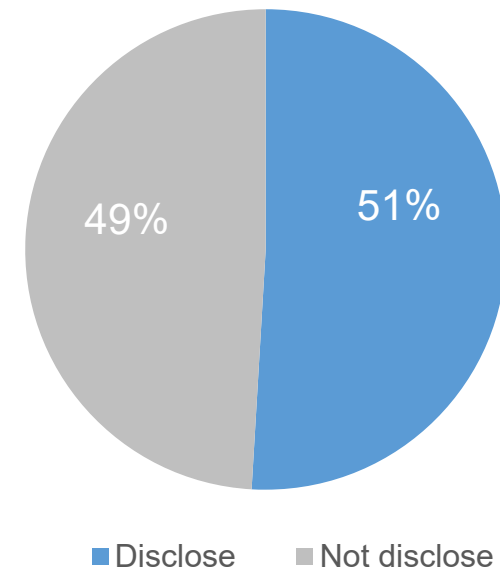
- ❑ 45% of companies "regularly review the business portfolio at least once a year," while 17% "rarely review the business portfolio".
- ❑ About half of the companies disclose their business portfolio strategies and policies.

Status of business portfolio review



(Note) Number of valid responses: 766 companies

Disclosure of business portfolio strategies and policies

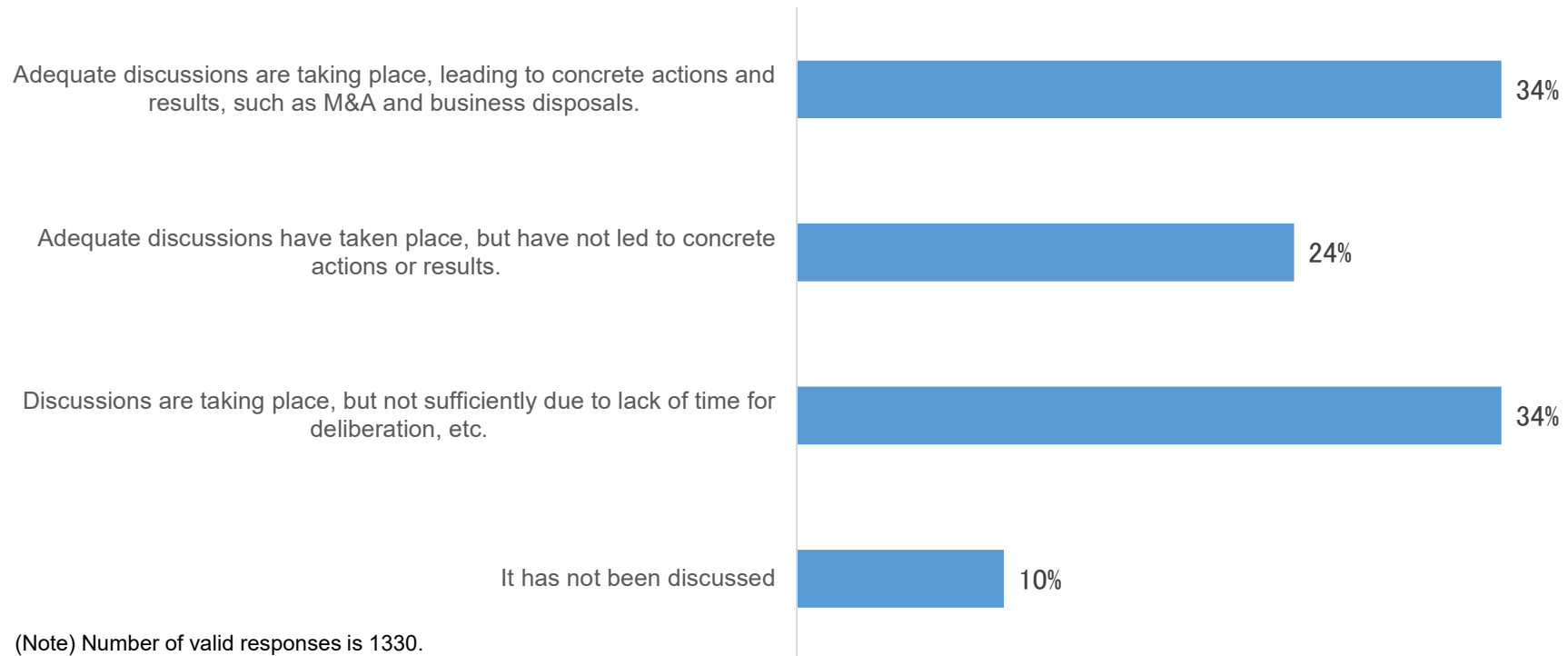


(Note) Number of valid responses: 771 companies

(4) Disclosure of business portfolio strategies and policies (company surveys): Discussions at the Board

- About two-thirds of independent directors are aware of some problems with the discussion of the business portfolio at the board, such as "it has not led to specific initiatives or results" (24%), "it has not been sufficiently discussed" (34%), and "it has not been discussed" (11%).

(For independent directors) Q. Does the board of your company fully discuss the current situation and review the business portfolio based on the relationship with management philosophy, business strategy, cost of capital, etc.? Please indicate your perception. (Multiple choices possible)



Source: Prepared by JFSA from the Ministry of Economy, Trade and Industry "Practical Guidelines for Business Transformations - Toward Changes to Business Portfolios and Organizations -" (July 2020)

Subjects to be discussed at the 23rd Council

- The importance of accurately assessing the cost of capital has been pointed in the past, and it has been pointed out that, during the COVID-19 crisis, this issue should be examined from the following perspectives.
 - Awareness of the need to hold cash in times of emergency, such as the COVID-19 crisis, and consideration of methods for securing and managing management resources (such as strengthening cash-generating capacity and business restructuring) that would allow investment for the future.
 - Investment in the future based on the role of human resources (employees) and the growing importance of intellectual property.
 - Building a business portfolio that recognizes and anticipates changes in economic and social structures.

- Based on the above perspectives, what do you think about the following issues related to capital efficiency?
 - Promotion of management that is aware of the cost of capital
 - Securing of management resources (improvement of operating cash flow, policy of holding cash and deposits, etc.)
 - Appropriate allocation of management resources (investment in human resources, intellectual property, R&D, etc.)
 - Promotion of review of business portfolio strategy