reference translation

Minutes of the Third Council of Experts Concerning the Follow-Up of Market Restructuring

Date: Wednesday, October 5, 2022 14:00 – 15:40
Place: Tokyo Stock Exchange 15F Special Conference Room
Attendees: See member list

[Kikuchi, Director, Listing Department, TSE]
The time has now come to begin the third Council of Experts Concerning the Follow-Up of Market Restructuring. Thank you for joining us today.

I would like to begin proceedings straight away. First we will explain today' s agenda.

[Ikeda, Manager, Listing Department, TSE]
Today, Mr. Ando will first give a presentation on the Essence of Sustainability Management, based on Document 2. Next, Mr. Koike, Director of the Global Investment Banking Division at Mizuho Securities, who has joined us as a guest, will give a presentation on Findings on Market Segmentation from an Issuer's Perspective based on Document 3. After each presentation, there will be time for questions and comments. After that, we would like to exchange opinions based on Document 4, bearing in mind the contents of today's presentations.

That is the end of my explanation of today's agenda.

[Kikuchi, Director, Listing Department, TSE]
Let's get started straight away with Mr. Ando's presentation. Please go ahead.

[Ando, member]
I am Ando. I would like to explain my thoughts on the essence of sustainability management.

As indicated in my biography on page 1, I am only one of OMRON's directors. At OMRON I served as an Audit & Statutory Board Member, and then as Managing Executive Officer in charge of IR and Corporate Communications, before being appointed as a director. During that time, I closely watched the progress of the reforms to the investment chain brought about by Abenomics. I would like to explain the various sustainability factors that have been incorporated into OMRON's management based on this experience.

Page 2 is a table of contents. My presentation today will be in two parts. The first half of this presentation will provide a conceptual explanation of the frequently used term "sustainability management" from three perspectives. Specifically, (1) understanding the essence of sustainability management, (2) the paradigm shift required to improve management capabilities, and (3) the significance and effectiveness of management information disclosure. In the second half of the presentation, I will introduce OMRON's initiatives in order to give you an idea of the specifics.

Moving onto page 4. As you all are aware, ROE, a typical financial indicator, can be factored into the following equation: net profit margin x asset turnover x financial leverage. Such factorization clarifies what needs to be done to increase ROE. Even if the ROE increases, we can also check whether it has contributed to the intrinsic value of the company. With this as a reference, I tried to factorize the concept of sustainability management in my own way in order to understand its essence. I concluded that the essences is "purpose management x cost of capital management x ESG management". If we replace the naming with the signature measures at OMRON, we get "practice of corporate principles x ROIC management x ESG integration". The meaning of these three measures, as described at the bottom of the slide, is simply to practice our corporate principles through our business, to continue to demonstrate sustainable earning power with an awareness of the cost of capital, and at the same time, to strengthen ESG factors in an autonomous and integrated manner.

Moving onto page 5. Next, I will talk about the paradigm shift needed to improve management capabilities. Traditional management reforms have focused on forecasting and at times have often tended to fall into short-termism. A little more than seven years have passed since the Corporate Governance Code was introduced, and companies are being forced to redesign the way they manage themselves. Compared to in the past, this redesigning is backcasting and requires long-termism. This means, in short, a shift away from PL management and a move toward BS management and cash flow management, in other words, a paradigm shift in management itself. Therefore, this paradigm shift cannot be realized without appropriate changes to the corporate culture and corporate climate, which is a mixture of strengths and challenges, with an emphasis on corporate principles and management philosophy.

Moving onto page 6. When I share my opinions with other corporate managers, I sometimes feel that they do not recognize the significance and effectiveness of management information disclosure. On those occasions, I list and explain five of the significances and effects.

(1) Reduce the cost of capital
(2) Reduce stock price volatility
(3) Expect early stock price returns in the event of negative events
(4) Deter insider trading
(5) Gain insights in order to upgrade management capabilities

Therefore, it is important to recognize the disclosure of management information not as a cost but as an investment, and to work on it voluntarily and seriously. The disclosure of management information is a top priority and a necessary condition for a company to fulfill its corporate governance responsibilities. On top of which, the conditions are only sufficient if the company can further increase its corporate value through dialogue and engagement with investors.

Moving onto page 7. I recognize the need for information disclosure in English, which has been pointed out at this meeting. However, it is also true that companies produce a variety of statutory and voluntary disclosure materials, each of which currently varies to such an extent that it is hard to believe that they are produced by the same company. This is because different departments prepare different disclosure materials. It is essential for corporate managers to take the time to check whether all disclosure materials are communicating an integrated message.

Moving onto page 8. What I became in charge of disclosing management information, what I did first was to recognize OMRON’s management characteristics. I looked at it from three layers, specifically, (1) what is the basic management stance, (2) what is the foundation that supports intrinsic corporate value, and then as written on page 9, (3) what are the drivers for long-term corporate value creation. This process enables one to extract the characteristics and strengths of your company while also exposing the challenges it faces. I will skip over the explanation of individual items, but in particular, I am aware that the concept of “autonomy as the primary principle and the perfect balance between autonomy and heteronomy”, mentioned in item 2) under (2) is the most important factor in strengthening corporate governance.

I will now explain some of the initiatives at OMRON outlined on page 10 and thereafter, which is the theme of the latter half of my presentation.

Page 11 shows our corporate principles. At the General Meeting of Shareholders in June 2022, we added the ‘practice of corporate principles’ to our Articles of Incorporation.

Our ‘management philosophy’ is shown on Page 12. This philosophy was newly formulated when we revised our corporate principles in 2015. To sum it up, it is a clear statement of our long-term vision and its relevance to our day-to-day operations, in order to put our corporate principles into practice. And I recognize that it states the very responsibility of corporate governance that a company must fulfill.

Page 13 shows our ‘practice of corporate principles’ framework. [Note: ‘practice of corporate principles’ in this presentation refers to management that puts corporate principles into practice.] OMRON’s practice of corporate principles is not simply management that values the corporate principles. In other words, we declared our management philosophy based on our corporate principles, stated our long-term vision, and operate in accordance with the OMRON Group management policy. And this is what we mean by the practice of corporate principles.

I have included a summary of our current long-term vision and medium-term management plan in the appendix. Please refer to it when you have a moment.

Please turn to page 14. The greatest feature of OMRON’s practice of corporate principles is the creation of corporate value from a global employee perspective, born from the fusion of top-down and bottom-up approaches. As you can see from the slide, we are engaged in many initiatives at various levels.

Moving onto page 15. One of the most distinctive initiatives of these is the OMRON Global Awards, commonly known as TOGA. Putting together a team of employees to solve social issues, and sharing and resonating their activities globally, proved to have been extremely effective in establishing our practice of corporate principles.

Page 16 shows the annual activities behind the process of choosing TOGA awards. This process shows that initiatives are being devised and implemented in each global area, and the winning team from each area participates in the global competition held in Kyoto, where they present their achievements.

Moving onto page 17. I will now briefly explain ROIC management.

As shown in the conceptual diagram on page 18, ROIC management is more than just using ROIC as a KPI to evaluate business value. That alone will never ever lead to an increase in corporate value. As explained at the beginning of my presentation, if we do not move away from PL management and switch our mindset to BS and cash flow management, we will simply be washing. After all, as with the practice of corporate principles, the various elements shown on the slide are necessary conditions.

Moving onto page 19. OMRON’s ROIC management is characterized by the ROIC reverse tree, which spreads throughout the global workforce, and management engages in sincere business portfolio management.

Page 20 shows the reverse tree. This tool is used to analyze ROIC and break it down into KPIs that are easy for employees to understand. By doing this, the tool can be used to manage the performance goals of individual employees, and links to increasing the corporate value of the entire Group. When first introduced, experts in finance and accounting at the head office, known as ROIC ambassadors, visited the business sites and conducted educational activities, while at the same time taking in good practices from the business sites and deploying them across the company. I am aware that ROIC management has now become widespread among our employees through these activities. Incidentally, we also publish the cost of capital, which is currently set at 5.5%.

Page 21 shows a conceptual diagram of management's approach to business portfolio management. Such frameworks identify products and services with returns below the cost of capital, and also take market value assessments into account to determine either profitability improvement or withdrawal. Incidentally, the number of products and services, which was 90-plus at the time in 2017, has been narrowed down to 60-plus, and the Group as a whole has an extremely muscular business and product portfolio.

Please turn to page 22. I will now touch on the evolution of ROIC management. When it was first introduced in 2013, the main objective was to track ROIC figures, but since 2015, under the name ROIC Management 2.0, management has evolved into something more conscious of the quality behind the figures. What it means is that, in terms of the numerator, we simply need to increase value provided to customers and stakeholders. At the same time, in terms of the denominator, we strive to increase investment in necessary management resources and drastically reduce stagnant management resources. And now we plan to evolve the ROIC reverse tree into a corporate value reverse tree, clearly stating the concept of 'high cycle management' as the source of our growth potential, and adding sustainability as a foundation. We are currently working hard on this and we expect to be able to disclose details soon, probably in November.

Moving onto page 23. This page shows you exactly how we have consequently restructured our businesses since 2011. On the left is a list of acquisitions and new investments, and on the right is a list of transfers and withdrawals. This is how much of our business we have restructured under our current CEO. Included among these is the transfer of shares in our automotive component business to Nidec Corporation in 2019 for 100 billion yen, although the business had sales of 130 billion yen, which exceeded its cost of capital. Meanwhile, this year we entered into a capital and business alliance with JMDC, a health tech company. JMDC is a publicly listed company and we invested 118 billion yen. These have been epoch-making events, among others, in the past 10 years of OMRON's history.

Page 24 shows how ROIC has changed over time. Some may believe that the goal is to continue to increase ROIC. But ROIC is merely an indicator that measures capital productivity and capital efficiency, and at OMRON we judge the range of 10% to 12% to be an appropriate level based on our current business portfolio, and we are managing our business in response to changes in the business environment.

Please turn to page 25. Meanwhile, our gross profit margin, an important component of ROIC, has been rising steadily. As you know, gross profit margins are the vertical profit margin of a product or service. As a result of steady efforts, our gross profit margin increased significantly from 36.8% in FY 2011 to 45.5% in FY 2021.

I will now explain the final part that relates to OMRON's initiatives, namely ESG integration.

Moving onto page 26. Here, I have purposely not used the term "ESG initiatives" because we call it "integration", in the sense of strengthening each of the E, S, and G factors in relation to our operations.

Page 27 indicates our ESG integration positioning. In other words, we revised our corporate principles and formulated our sustainability policy concurrently, and strengthened the link with our medium-term management plan and implemented initiatives from FY2017.

Moving onto page 28. In order to promote ESG integration, the Board of Directors resolved in 2017 that not only the CEO and other business execution departments but also management, in other words the Board of Directors, are ultimately responsible for ESG integration. At that time, we also adopted key sustainability items and materiality as KPIs for medium- to long-term performance-linked share-based compensation.

Page 29 shows our ESG integration framework. As with the 'practice of corporate principles' and 'ROIC management', this is also promoted through this kind of integrated thinking. In other words, we have been actively disclosing information on the three pillars, specifically, considering social issues to be solved through our business as part of our long-term management vision and considering issues that stakeholders expect us to address, and we have been engaging in dialogue and engagement with our stakeholders.

Please refer to page 30 for a brief summary of the features of OMRON's ESG integration, which I have explained in detail.

Page 31 lists the major measures we have taken over the past few years with respect to Governance, Environment, and Society. With regard to Governance, we added the practice of corporate principles to our Articles of Incorporation and introduced medium- to long-term performance-linked share-based compensation for the management team. With regard to the Environment, we have endorsed the TCFD recommendations and have set OMRON Carbon Zero. At the same time, we also disclosed our target for [emission reduction in] Scope 1 and 2 as well as Scope 3 Category 11. And with regard to Society, we revised our corporate principles and consolidated our retirement and pension reforms into a defined contribution pension plan for the working generation. We have also introduced performance-linked share-based compensation for our global management team, and uniformly distributing company stock to our employees in Japan. In terms of our systems, we have an application system and we have lifted the ban on second jobs and also take on workers who work for us as their second job. Several of the non-financial targets in our medium-term management plan were determined by global employees.

Page 32 shows how corporate governance at OMRON has evolved over time. Since 1987, we have been voluntarily implementing various reforms. The management team is constantly aware of this timeline and thinks about what we need to do next and what is expected of us by our stakeholders and by the investment chain, hoping to stay ahead of the curve.

Page 33, shows an overview of our compensation plan for the management team. While I will not explain it in detail now, if you look at the contents of 4) medium- to long-term performance-linked compensation, you can see that we have set weights and evaluation indicators for financial target evaluations, corporate value evaluations, and sustainability evaluations. For sustainability evaluations in particular, we have set a matrix of three items: internal targets to reduce greenhouse gas emissions, internal targets for scores in engagement surveys, and third-party evaluation of the Dow Jones Sustainability Index. The design enables objective evaluations and leaves no room for arbitrariness.

Page 34 is a list of our non-financial targets in our first medium-term management plan, called the 1st Stage of the long-term vision for FY2022 to FY2024, which I touched on earlier. Of these, (8), (9), and (10) were chosen by a vote by global employees.

Pages 35 through 37 summarize external evaluations of OMRON’s management.

I have rushed through somewhat, but that completes my explanation. Thank you for your attention.

[Kikuchi, Director, Listing Department, TSE]
Thank you. Does anyone have any questions or comments on the presentation we have just heard?

[Kumagai, member]
I have three questions.

The first one is that, OMRON’s initiatives have been very successful, and warm praise for them is spreading, but I would like to know the fundamental reason why you were able to get so much done in the first place. There is a concept known as the Toyota Way, which is used to identify the fundamental cause (or root causes) by digging five times to find out why, and I would like to know, for example, the top three reasons, if you know them. At the same time, I would also appreciate it if you could tell us what the triggers and breakthroughs were and what processes you went through.

My second question concerns whether the initiatives are reproducible. You mentioned the fine balance between autonomy and heteronomy, and I think there must be some degree of heteronomy for companies that are not performing well. If you have any ideas for measures to realize the initiatives you have described today at such companies, please let us know.

My third question, is that I would like to know what, if any, challenges, problems, or areas for improvement OMRON is facing in terms of sustainability management. For example, I would like to know what improvements you plan to make in the future based on past failures and current struggles.

[Ando, member]

Regarding your first question, the first reason is that, although OMRON's employees had been committed to placing importance on its corporate principles since its founding, even in 2011, employees did not question the fact that it did not necessarily lead to returns. In other words, the point is that we have changed the wrong assumption that if we operate our business by placing importance on our corporate principles, we will naturally be highly evaluated by our shareholders and other stakeholders.

The second reason is the division of roles among the management team. Until March 2013, there were no C-suite executives other than the CEO, and the CEO had full authority to execute operations. Subsequently, we created CFO and CTO positions, and we now have a system in which the CEO, CTO, and CFO divide their roles and operate the business as a trinity, supported by two non-executive inside directors. In this way, the inside directors are disciplining themselves while receiving suggestions from outside directors and Audit & Supervisory Board Members from a variety of perspectives and we are evolving our management.

The third reason is that OMRON has voluntarily disclosed management information. I served as the director in charge of investor relations and disclosure for six years from 2011 to 2017, and while I thoroughly disclosed information relating to our medium- to long-term corporate value creation, I stopped disclosing short-term information, such as monthly sales figures or order status, because it was meaningless to us and noise to investors. In other words, it was the thoroughness of such an approach that led OMRON's management to switch to long-termism.

I believe these three factors are what contributed to our success.

Regarding your second question, I believe our approach is reproducible, as it is no exaggeration to say that governance reforms have been made to maintain reproducibility. However, it might be dangerous if only the management team shared this common understanding. Since global employee-driven value creation is becoming more prevalent and taking root in corporate culture, I feel that reproducibility can be maintained by continuing to reform the management system without losing interest.

Regarding your third question about future management issues, I am aware of two issues, specifically accelerating innovation and promoting diversity. Currently, the CEO, CTO, and CFO are dividing their roles, while agilely changing the organization and culture under the CTO and advancing technological development at high speed. So I expect that we will be able to generate sufficient innovation by 2030. On the other hand, steady efforts to promote diversity will remain necessary in the future. The diversity I mentioned means creating a culture that tolerates different ways of thinking, not just such physical differences as gender and nationality. Until around 2010, OMRON was pure-blooded in terms its human resources, but now we are actively recruiting a sizeable number of mid-career employees, and we are also accelerating initiatives such as an application system that allows employees to declare the work they want to do and to challenge themselves, as well as permitting side jobs. I am confident that initiatives such as these will lead to enhanced diversity. The importance of human capital management is being emphasized at the moment, and I fear that diversity will not be possible without a fundamental change to personnel systems based on lifetime employment, which Japanese companies continue to practice. In this sense, I rate the consolidation of the working-age population into a lump-sum retirement benefit and a defined contribution pension plan, from FY2019 as a great success.

[Kumagai, member]

Regarding your second point, I believe that there are some companies in Japan where the management team’s skills and employees’ awareness are low and they do not even feel the need for reform. How can we encourage such companies to implement forward-thinking initiatives in the same way as OMRON? I believe that the cohesive power of the Tateishi family, OMRON's founding family, was a major factor in OMRON's success with such initiatives. I assume that the process was such that a bright executive would issue top-down instructions and employees working in the field would work out the details. I believe that if many other companies implement such forward-thinking initiatives like the ones at OMRON, this will be a major cornerstone in the revitalization of the Japanese economy. Do you have any suggestions as to how to make this possible?

[Ando, member]

To put it bluntly, the founding family has virtually no influence now. That said, the founding philosophy lives on, so when we evolved our management system, we were always able to explain it in relation to our corporate principles, which was in fact also very easy to do. In other words, the founding family had a strong belief in using the corporate principles as a centripetal force and at the same time, as a driving force for global growth, and OMRON's employees fully understand this belief.

[Okina, member]

Were the CEO, CFO, and CTO the driving forces behind the promotion of ROIC management? And, what roles did outside directors play with respect to portfolio management?

When you say 'heteronomy', what do you have in mind as heteronomous entity, while there are various possible entities such as shareholders, outside directors, or stakeholders?

How do you reconcile the continuous review of your business portfolio with employee engagement?

[Ando, member]

Regarding your first question, although the management took the initiative in introducing ROIC management, if employees do not understand it, it will just be pie in the sky, so I think that the ROIC reverse tree diagram played a massive contribution. Put another way, while ROIC is an important indicator for the management, it is quite a remote concept for employees, so we developed this method to encourage them to take ownership of it. Management's one-sided messages about the importance of ROIC is not enough to get employees to take action. We, therefore, established ROIC ambassadors, who visit the work sites and seek employees' understanding. Following a series of such opportunities, we got where we are now.

Regarding your second question, outside directors and outside Audit & Supervisory Board Members have made significant contributions to the advancement of our overall management, not just to our business portfolio management. That said, I understand that heteronomy is not just about outside directors, but rather all stakeholders. In addition to the traditional active dialogue and engagement with investors, we have been thorough in our disclosure of management information, in terms of how we make ESG rating agencies understand the characteristics and strengths of our management, as the passive shareholder ratio has been increasing in recent years. This is because, with a few exceptions, ESG rating agencies regard and evaluate that what is not disclosed as not having being done, and so we constantly have to listen out for what all stakeholders expect from OMRON, otherwise we will fall into a self-centered management style.

Regarding your third question, while traditionally, Japanese companies' handling of employees, especially those in Japan, focused on protecting employment, OMRON's priority is to have employees work with a high level of motivation. This is because employees working on low return projects are inevitably less motivated. While in the past we recognized that losses are bad, continuing to operate a business that returns less than its cost of capital, even if it is profitable, and having employees work in that business, is a sin of omission by the management. I used the expression "paradigm shift" in my opening explanation. OMRON's approach used to be one of protecting employment because we value our corporate principles, but this is no longer the case now that we are aiming to create corporate value from a global employee perspective.

[Okina, member]
So I take it that your employees understand this.

[Ando, member]

Whether its ROIC management, or practice of corporate principles and ESG integration, management is not possible unless these efforts are positively evaluated by global employees. I mentioned that one of the key concepts is the fusion of top-down and bottom-up approaches. Even if all important measures are communicated from the top down, whether it is designed to encourage employees to take specific action or whether employees understand and recognize its importance is an important factor in determining its success or failure.

[Sampei, member]
You mentioned earlier that employees originally valued the corporate principles and thought that if they operated their business with such principles in mind, they would be positively evaluated by stakeholders, including shareholders, and I think that there are many companies in Japan that still think like this. You said that situations change when a company realizes that the capital market will not positively evaluate it unless it leads to returns. I suspect that very few listed companies are aware of the five points you list of page 6 pertaining to the significance and effectiveness of information disclosure. Do you have any suggestions as to how to improve the understanding of many companies?

[Ando, member]
It is essential that text be concise, as it is on page 6. For example, if you factorize the concept of sustainability management, you will realize that this is what is meant. If you always show this kind of summary in internal meetings, understanding will quickly deepen. In other words, sustainability management has not been well-explained. Once the concept becomes clear and understood, situations will change. Soon after I was appointed director in charge of IR in 2011, I had the opportunity to speak with a young employee who asked me straight out, “Since OMRON values its corporate principles, it doesn’t have to make a profit, does it?” At that time, in response I explained that, “valuing our corporate principles means that we must send good products and services out into the world. We will need funds as we must engage in product development or capital investment to produce goods. Funds are also needed to reward hard-working employees with salaries and bonuses. Funds are also needed to provide shareholder returns, such as increased dividends, to shareholders who

support the management of listed companies. In other words, in order to manage the company based on our corporate principles, it is absolutely essential that we have money upfront and to earn money sustainably.” The young employee who heard this responded by saying, “I understand exactly what you are saying.” Consequently, and from 2015 in particular, after OMRON’s corporate principles was revised, I have advised the management team to refer to it as management that practices corporate principles instead of management based on our corporate principles, as we had been referring to it in the past. And we finally added the practice of corporate principles to the Articles of Incorporation in June 2022. I believe that once employees begin to understand this properly, we must create a virtuous cycle in which the concept is widely understood by stakeholders outside the company, and further motivates employees through feedback from outside the company.

[Sampei, member]

The example of the question from an employee and your answer was very easy to understand. However, even if employees understand deficits and surpluses, the hurdle is immediately raised when it comes to the cost of capital, and I think this is the reason why understanding does not spread.

[Ando, member]

So because of this, we have added the proviso “≈investor’s minimum expected rate of return” in parentheses after “cost of capital” to (1) on page 6. In other words, we have made the decision that the employee layer does not have to think any harder than necessary. Of course, finance and accounting experts must understand this, but it makes no sense to demand that all our global employees understand it, and so it is sufficient to explain that as long as we are a publicly listed company, “earning more than the rate of return expected by our shareholders” is necessary for capital conscious business operations.

[Koike, member]

I sensed a high level of awareness among the management with regard to thoroughly promoting a system that infiltrates through employees, as represented by the term ROIC ambassadors. I keenly felt the need to remind the management of listed companies that, as long as they are listed companies, even if they cannot raise it to OMRON’s level, they have a responsibility to improve their capital market literacy. In this sense, I feel it is important to provide opportunities to share best practices, such as OMRON's, to provide such opportunities for less conscious managers.

On the other hand, you mentioned engagement with investors, and based on my own reflections, I feel that we need to improve the engagement skills of institutional investors in order to achieve higher corporate value. We thought we had been working hard on this, but I felt that there is a need to find out what we, as investors, can do for improving corporate value, not for meeting formalistic standards. Your presentation made me aware that our approach to increasing the quality of engagement as an institutional investor is also an important factor in encouraging listed companies to increase their corporate value.

[Ando, member]

Japan's Corporate Governance Code was developed in 2015 and I feel that the literacy of management teams has improved considerably since then. However, awareness of the importance of dialogue with stakeholders, including investors, for gaining insights to improve one's own management capabilities, may still be low. Although it is said that dialogue and engagement with investors is effective, in reality, unless the management has the literacy to accurately understand points raised by investors and is clearly aware of its own issues, meetings with investors, if held, can end up as mere question and answer sessions, and this cannot be considered to be dialogue or engagement.

I distinguish between the concepts of dialogue and engagement. The dialogue phase is when the management, who understands its own strengths and challenges, explains those strengths and challenges to investors and receives comments from investors. After which there is engagement with commitment. If this process goes well, such as making efforts to implement the investor's suggestions into the management system, the investor will hold on to the stock in the long term.

[Koike, member]

We feel that it is important for us to have a deep understanding of the company, and to have a disciplined process through mutual engagement.

[Kikuchi, Director, Listing Department, TSE]

Thank you.

We will continue with presentations from our guest speaker. As I referred to earlier, Mr. Keigo Koike, Director, Global Investment Banking Division, Mizuho Securities, will now give his presentation. Many companies consult Mr. Koike on the subject of the market restructuring, so we have asked him to give a presentation today.

Mr. Koike, please go ahead.

[Koike, Director, Global Investment Banking Division, Mizuho Securities]
Thank you. I am Koike. I will use the summary in Document 3 for my explanation.

By way of introduction, my current title is Director of the Global Investment Banking Division. I have worked in capital market-related positions for around 25 years, and for nearly 20 years I have been involved with issuing companies in the equity capital markets. I have a wide range of experience, starting from a relationship manager to various management positions. Since last April I have taken a step back from the frontline of capital markets and have followed market and institutional trends from a broader perspective. Most recently, I have been involved in discussions with the Japan Securities Dealers Association on issues such as enhancing the unlisted stock trading system, SPACs (special purpose acquisition companies) and IPO pricing, all of which topics that are being reviewed by the government.

I have been asked to talk to you about approaches to market segmentation, focusing on the perspective of the issuing companies. Thank you for giving me this opportunity to speak to you. Allow me to comment that I have followed the discussions on market segmentation since the start, and I feel that, up till now, these discussions have not given sufficient consideration to the perspective of the issuing companies. In addition, in terms of maintaining and improving the competitiveness of the Japanese stock exchange market on a global level, there have been frequent discussions about what sort of companies should be listed on the Prime Market. I feel a little uneasy about whether the approaches covered in these discussions can realistically be applied to listed companies in general.

The most recent market restructuring on April 4 focused on how the "transition" of companies listed on the existing market to the new segments would work. I also think it is important to discuss the "entry points" for new listings in order to follow up on the approach to market segmentation and to encourage discussion about achieving the desired outcomes. I think it is important for companies seeking to go public to have a clear understanding of their motivation for going public. They should be firmly focused on what needs to be done after going public in order to continue as a listed company, since a market listing is not the end of the process. With this concern in mind, I would like to make my presentation today.

Please see the summary attached.

First, here are three examples of discussions I have had with companies regarding the listing classifications.

The first is an example of a question that frequently comes up when I speak to start-up companies about choosing which market to list on. I am often asked which market is best for a quick listing that allows companies a bit of time to establish themselves, if they need upfront investment in order to grow, and even if they are not generating a profit to start with because of marketing and promotion costs. In many cases, selection of the market to list on also depends on which market, including overseas markets, such companies are most highly valued, and that is why companies have chosen the erstwhile Mothers market or the Growth Market. There was an article in today's Nikkei Shimbun about the IPO market in the first half of FY2022. Of the 37 companies listed in the first half of the year, 30 were on the Growth Market. I think this proves the point that companies opt for the Growth Market because it is in fact the easiest market to list on.

The second example is in some ways a contrast with the first. It concerns companies that are already well-known who look to utilize a public listing for the purpose of, so to speak, reinventing or relaunching themselves. This means that there are cases when companies go public when they are mature, rather than when they are in a period of strong growth.

The third example relates not to new listings, but to the transfer of listed companies to another market. I remember that around a year ago, on the “eve of the transition,” many companies that were on the borderline between the Prime and Standard Markets expressed some concern. Specifically, they were concerned about the penalties they might face if they failed to comply with the listing criteria [of the Prime Market], and whether, if they failed to remedy this, they could voluntarily move to the Standard Market, and whether in that case they would have to go through the whole listing review process from scratch. They were worried about possible negative repercussions.

I have read the minutes of the first and second follow-up councils, and I appreciate that the approaches for companies that have submitted a plan for conforming with the listing criteria and selected a market to list on will remain a matter for discussion. Since the issuing companies have raised this as a practical concern, I would appreciate it if you could give this some consideration.

In my summary, I have again stated what the significance of a public listing is, albeit in textbook fashion. On the financial side, there are advantages such as diversification of sources of funding and strengthening of the financial structure. On the non-financial side, a listing helps to raise a company’s profile and reputation of creditworthiness, or to improve its internal management system through the TSE listing examination process. As Mr. Ando mentioned, another important aspect of listing on the stock exchange is to improve employee motivation and to attract good quality talent.

In addition, I separated the significance of the IPO from the significance of the listing itself. While points (1) to (5) relate to the significance of a listing and remain applicable even after the initial listing, point (6), which relates to the significance of an IPO, applies only at the time of the initial listing, in terms of crystallizing the founder’s profit and providing an exit opportunity for shareholders. In supporting companies with their IPOs, I have often seen situations where a company is keen to go public even though objectively it may be too early to do so. This tends to be because of the previously mentioned reasons.

I have referred to three examples of conversations I have had with companies. The significance of listing for these companies is as I described in my summary, and to this extent I believe that the non-financial aspects are also very important. Even if a company does not particularly need new financing, it may go public in order to increase, so to speak, its prestige. Conversely, in terms of why listed companies had a somewhat negative impression of the market restructuring, it can be assumed that they were concerned about the impact on their sales and recruitment.

At the time of the transition, there was inevitably a discussion about what transitional measures should be taken to mitigate the impact of drastic changes. In future, it is important to consider how to reach the optimal outcome. In this sense, I think it is very important to define the concept of the three market segments, and I hope you will allow me to express my personal view on this.

There have been many discussions on the Prime Market over the years, including the discussion earlier today, so I will not go into detail. Through stock exchange rule-making, the Prime Market should aim to be a more attractive market that is convenient and useful for investors and is comparable with similar markets on a global basis.

On the other hand, I feel that there is a need to discuss the Growth Market and the Standard Market in more detail.

First, regarding the Growth Market, I personally believe that it should be characterized as an “entry market” which gives companies an opportunity to go public, rather than prioritizing growth potential as the key criterion for listing. If this is the case, I believe that there needs to be more discussion about the listing requirement for the Growth Market that companies have “a business plan to realize high growth potential.” Regarding the market capitalization requirements, the new standard states that a company should have a market capitalization of at least 4 billion yen once it has been listed for 10 years. However, I think it is difficult for a management to commit to such a target 10 years into the future at a point when the company is just in the “entry stage” of seeking a listing. In addition, the current standard requires that the lead managing underwriter (securities company) should assess whether the company’s business plan is reasonable. However, it is quite difficult for a securities company to make a judgment on whether or not a company’s business plan is reasonable. So I am concerned that the parties concerned end up walking a thin line where they cannot be certain whether or not the company meets the listing criteria at the entry phase. As I suggested before, I think the standards should be revised in line with the circumstances. Also, there is an article in today’s Nikkei Shimbun suggesting that delisting requirements for the Growth Market should be stricter. Thus there are various opinions about how the Growth Market should be organized.

Next, for the Standard Market, instead of defining a specific market concept, we could regard the market as, to be extreme, a group of “ordinary listed companies” that do not quite fit the concepts of either the Prime or the Growth Market, or so to speak, as a “complement”. Nevertheless, we would want these companies to be generally recognized as being of an appropriate quality to have a listing on the stock exchange. If the Prime Market is like MLB (Major League Baseball), then we can think of the Standard Market as NPB (Nippon Professional Baseball). But if no disadvantage accrues from being in the Standard Market from a corporate management perspective, then the incentive for a company to stretch itself to retain its Prime Market status may diminish. Also, in terms of not making excessive demands on company management, with regard to the Standard Market, we may need to reconsider the pros and cons of setting criteria that are influenced by external factors, such as stock prices and trading volumes, over which the companies have little control themselves. To take this to the extreme, it may be possible to think in terms of a formal listing, whereby an indicative price is given even if trading volume is virtually non-existent.

Regarding transitional measures, as was pointed out at the past two Council meetings, I agree that it is important to consider how we deal with companies that are in breach of the listing criteria in such a way that we do not just give up on them simply because they have underperformed. In this sense, we believe it is essential to increase the relative attractiveness of the Standard Market as a berth for companies that transfer from the Prime Market. We believe that it is important for companies to fully appreciate the significance of a listing on this market, and that it is not something to be ashamed of. We should consider what needs to be done to achieve this. In addition to the three TSE market segments, we also believe it is important to have links with local exchanges and professional markets in order to cater for the listing requirements of companies of different sizes in different business categories at different stages of growth and so on.

Last but not least, I feel that in reality, many companies aiming for an IPO end up going public just for the sake of it, with the stock market listing as their end objective. To ensure that companies continue to strive to enhance corporate value after listing with the same level of enthusiasm that they had in their preparations for listing, they need to appreciate the positive effects of a stock market listing. In this respect, it seems that the key is motivation and compliance of their own accord, rather than this being forced upon them. In that sense, it would effective to highlight the attractions and benefits of making the step up from one market to another. The select status or “aspirational” quality of the Prime Market is important from this perspective.

I mentioned “escort runners” in my summary. Up to the point when a company goes public it is subject to review process by TSE, so there are people, such as the public underwriting departments of securities companies, whose role is to objectively evaluate companies from the outside and make recommendations based on this. However, it seems to be the case that once a company is listed, securities companies become more distant from them and are not able to give them support in the continuous improvement of corporate value post-listing. While it is naturally important for the company itself to take the initiative in enhancing its corporate value after going public, I think that it is also vital to have a “escort runner” who provides support from outside the company. As before, I suppose that financial institutions such as banks and securities firms are the protagonists here, but participation from other industries may also be effective for further development of the market.

Agenda setting is important because of the broad range of topics we cover in these meetings and the diverse situations of the stakeholders involved. I understand that it is quite difficult to summarize the discussion, but I hope that what we have talked about will contribute to further development of the market in future, and I will continue to follow this discussion with interest.

This concludes my presentation. Thank you for your attention.

[Kikuchi, Director, Listing Department, TSE]

Thank you. Does anyone have any questions or comments on the presentation we have just heard?

[Kumagai, member]

I have two questions. The first point is that there seems to be a split of opinion about the deadline for the transitional measures with some people saying it should be 2025, three years after the transition to the new market segmentation, and others saying that the deadline should be 2027, five years after the transition. In addition, various ideas have been presented, such as a “Two-step approach” with an intermediate target in 2025. Mr. Koike, do you have any suggestions for the implementation of the transitional measures? I would also like to ask how you think your proposal will be received by the market participants themselves.

My second point may be somewhat specific, but based on what I have heard, if, once the transitional measures expire, companies, one after another, switch their listing from the Prime Market to the Standard Market, it is uncertain whether the securities companies will have sufficient capacity to handle the screening and review process. Can you give us your sense of whether your company will have sufficient capacity in this respect?

[Koike, Director, Global Investment Banking Division, Mizuho Securities]

Regarding the first point, it is important to clarify a deadline for the transitional measures as soon as possible, whatever year it ends up being, and to set out a clear policy. However, as mentioned earlier, whenever the deadline is, this is closely dependent on how a berth will be prepared. Unfortunately, at this point, I suspect there is a view that the Standard Market represents a “step down” from the Prime Market, with companies in the Prime Market reluctant to accept the expiry of the transitional measures.

The second point is that the departments in charge of listing reviews at securities companies oversee both new listings and “step-up” transfers (including moves from the Second Section to the First Section under the old classification). However, until now, almost all of their resources have been devoted to new listings. In this sense, for example, if the annual number of new listings continues to be around 120, as was the case last year, we may find ourselves so preoccupied with new listings that we do not have the resources to consider transfers to other markets. However, if the actual number of new listings remains at a modest level, there is no reason why we cannot devote some resources to dealing with different types of listing reviews, such as transfers from the Prime Market to the Standard Market.

[Kikuchi, Director, Listing Department, TSE]
Thank you. This concludes today’s member and guest presentations.

Now, I would like to use the time we have remaining for exchanging opinions on the issues under discussion today, based on Document 4.

In his presentation today, Mr. Ando talked about the importance of factoring the concept of sustainability management and presenting it to employees in an easy-to-understand manner, as well as the importance of information disclosure upon similar factorization. Furthermore, Mr. Koike of Mizuho Securities has given us an indication of listed companies’ concerns from their own perspective, a view from front line. He has also mentioned the importance of being self-motivated in increasing corporate value.

Based on this, as shown in Document 4, I would like to have a discussion about specific approaches to encourage listed companies to improve their corporate value over the medium to long term. In particular, we would like to discuss how we can encourage companies in this other than those that are specifically engaged in complying with the criteria for maintaining their listing. In addition, the opinions received so far are shown from the middle section of the document onwards for your reference, so please refer to these.

Now, I would appreciate any comments from anyone who wishes to speak.

[Kumagai, member]
I may be retracing arguments from previous meetings, but I would like to

briefly highlight what I think are the key issues.

First, since the main objective is to improve corporate value through the market restructuring, it is necessary to set appropriate numerical targets and KPIs, and to measure and monitor the effects both quantitatively and qualitatively on a regular basis.

Second, the key principle here is so-called “market’s metabolism” that promotes entry and exit of companies. I think we need to be stricter in terms of criteria for the delisting of, for want of a better expression, so-called “zombie companies.” I also think we need to consider simplifying the procedure for switching markets from the Prime Market to the Standard Market. On the other hand, we need to stay consistent with the original concept that each market is a stand-alone market in its own right. This needs to be fully backed in terms of theory, but I do believe we need to simplify the procedures for changing from the Prime Market to the Standard Market.

The third point, which has been raised before, is to enhance the attractions of the index for investors. For example, in principle, we could consider excluding any company with a P/B ratio below 1x. Also, I think it would be very difficult to narrow down the number of component companies. For example, 100 companies is somewhat small, but we could focus on 200 high quality companies as one approach.

The fourth point is corporate governance. Prime Minister Kishida also mentioned the importance of “corporate governance reform” in his recent speech at the New York Stock Exchange. Of course, this is not something that can be done by the exchange alone. Up till now, the overall discussion on a national level has tended to favor a very formalized approach. From now on, verification based on facts is essential, and there needs to be a meaningful reform of corporate governance.

The fifth point concerns disclosure. It is extremely important to improve English-language disclosure for foreigners. In addition, there is no uniformity within a company concerning the content, method, and location of such disclosures, for example in integrated reports or medium-term management plans. For example, it is essential to make the content of disclosures easily comparable with other companies as in the annual securities report, or, as Mr. Ando mentioned, to provide a standardized message as a whole company, rather than to have a silo approach from each department.

My sixth point is about other initiatives that exchanges can undertake. For example, TSE could be more engaged and proactive in creating opportunities for dialogue between the management, including outside directors, and investors and underlying asset owners, or it could help with educating those companies that might be lagging in this, for instance, by highlighting examples of best practice, such as Omron.

The seventh point is on the approach to transitional measures. The discussions among the members have not been finalized, and there are differences of opinion. I think we need to reach some form of agreement on the deadline as soon as possible. Some say the sooner the better, others say about five years. Personally, I would take a “moderate” approach rather than setting a deadline in 2027, which is five years from now. Rather, for example, we could make it so that companies to whom transitional measures currently apply would not be able to renew these measures after 2025, or else would be prevented from updating their plans in this respect. This could be described as a sort of “Two-step roadmap.” In any case, I think the members should reach agreement as soon as possible on what transitional measures need to be implemented, and these measures should be firmly established.

[Matsumoto, member]
While it is important to improve corporate value over the medium to long term, I have serious doubts about the ability of the stock exchange to do this. I believe that we should discuss and decide on a specific agenda for what the exchange itself can do.

Listed companies are a kind of standardized product. There are plenty of companies in the world, and there are many excellent companies that do not need to go public. However, listed companies choose to go public because they want to be listed and to comply with a standard format that facilitates investment from ordinary shareholders. As an exchange, TSE is working to present this standard format as an attractive option for investors, so it is vital to have extremely clear standards. Therefore, this is not so much about how to improve corporate value, but only about objectively clarifying the standards required for listed companies, and what criteria must be fulfilled in order to become and continue to be a listed company. TSE doesn't have authority to do anything other than this and enforcement would be difficult to implement. On that basis, the shorter the transitional measures, the better. TSE should clarify when the transitional measures will end as soon as possible, whatever the time period.

Also, I do not think that Japanese companies as a whole will improve just because of the labeling of the market segments. In the previous discussion of the TSE index and Fidelity Investments, stock replacement was the most significant factor, and it seems that the presence or absence of a replacement process is the most significant difference between the S&P500 and TOPIX. The performances of TOPIX and JPX Nikkei 400 do not fluctuate much, so there needs to be continuous replacement of index constituents. I think we should go ahead with this.

The market has evolved to what is now because we respond flexibly to issuers' needs, and I think we need to establish firmer rules. For improving corporate value, we can think of this in terms of a school. It is easy to see how students with low grades can be made to step up: threaten them with expulsion if they get low grades, and that will give them a kick up the backside to improve their performance. On the other hand, if students do not get asked to leave if their grades are poor, or if they just stick around in the same class for a while without changing, the results will not get any better however much discussion there is about how to improve their performance. Therefore, I strongly believe that clarifying rules for the replacement of index components on an objective basis will yield benefits.

[Sampei, member]

The market restructuring is a kind of reform. If we only listen to vested interests when discussing reform, we cannot carry out reform. Some might say "abandoning the weak" by rephrasing "removing vested interests", but I think that would be a mistake. For example, take the general public. It is important to support the unemployed by setting up a safety net. However, it is wrong to say that listed companies are weak just because they are underperforming, when responsibilities come along with raising funds from many different people. You have listed many reasons for going public, but this is just from the point of view of the listing as a transaction, as opposed to the responsibilities associated with actually being a listed company. Therefore, I think it would be better for the exchange to clarify the actual responsibilities of being a listed company.

In the explanation given earlier by Mr. Ando, he mentioned that awareness can be raised by putting things in writing and expressing them properly. This is what we need to do. We need to clarify what the responsibilities of being listed entail and to lay out the reasons and responsibilities involved with continuing to have a listing, rather than the generic and intuitive reasons for going public.

It is also said that listed companies no longer need to raise financing these days, but that is terribly mistaken. There is profit attributable to shareholders, some of which is distributed as dividends, but a significant proportion is retained and remains unutilized. When they retain earnings attributable to shareholders, companies are raising funds. Since it is not right to raise funds (in terms of retaining earnings) if they are not needed, Japanese companies are being told to buy back more and more of their own shares, but companies are not really aware of this. Thus, they are not aware that they are raising funds [simply by retaining earnings]. Unless we clarify the underlying situation and the results of certain behaviors to ensure that listed companies fully appreciate the implications and that they are educated on these topics, lack of understanding will just continue to be misconstrued as a difference of opinion. This needs to be understood before we can move forward.

[Kanda, member]

It is hard to say whether market segmentation will lead to a medium- to long-term improvement in corporate value, but I would like to share my impressions on this. For example, if there are two preparatory schools for university, one where students are split into three classes, either A, B, or C, and one where there are no separate classes, in the school with separate classes, there will inevitably be some movement of students between classes. *Shogi* (Japanese chess) players have rankings, similar to the classifications of A, B and C. If these kinds of classifications are in place, this means that every year there will be some movement from A to B and so on. The same principle applies with soccer. If there is no promotion or relegation, there is no competition.

It is difficult to ask all listed companies to increase their corporate value, and that is not what the exchange should be doing, but it is preferable to have a range of different types of company listed on the exchange. Some companies may be able to increase their corporate value, while others may not. However, if market segments have been classified, there must be opportunities for replacement within these segments. Our focus is on an exchange that offers market segmentation, and this is the issue that we need to address. However, I don’t know the answer to these questions, whether market classification leads to better company performance, or if this is not the case, whether performance improves if companies stay fixed in one market. But when TSE decided to go for market classification, companies should be able to transfer between market segments, and I hope TSE can get this right. It would be good to discuss some specific measures at this meeting.

[Koike, member]

In the discussion of IPOs earlier, there was a comment that the end goal is simply to go public, which gives the impression that there is limited discipline imposed by market standards. As Mr. Kanda and Mr. Matsumoto suggested, we should create a mechanism that promotes a continuous cycle of entry and exit of companies. There are several approaches, but based on what Mr. Ando mentioned earlier, we can consider initiatives to help companies improve their capital market literacy through the Corporate Governance Code.

On the other hand, shareholders must also improve the quality of their engagement. Investment banks that act as lead managers on listings should also provide guidance to companies on how they can improve corporate value. It is not just listed companies that should have responsibilities to fulfill. This should also apply to the stakeholders of the listed companies and to the staff of the financial institutions, and we need to acknowledge this. I know the stock exchange is limited in what it can do, but since the stock exchange is a platform for trading, I feel that it should be proactive in providing programs, for example, to improve capital markets literacy or share examples of best practice.

[Nagami, member]

I have two points. The first point, which chimes with what has been said previously and with your comments on this topic, is an analogy with the tale, "The North Wind and the Sun," in terms of long-term enhancement of corporate value. While numerical indicators and governance are obviously important themes here, I believe the Sun's approach would be to create an environment in which management sees the improvement of corporate value as matter for the individuals concerned. For example, Western companies are very different to Japanese companies in terms of the scale of stock compensation that they offer. Management in those companies is focused on increasing corporate value as an individual objective. I am not sure if this is the best format for encouraging management to improve corporate value, but I think it is important to show that equity compensation should naturally be included in this discussion. As mentioned in Mr. Ando's slides, it is also important to clearly disclose the purpose and specific details of any stock compensation plan and to engage with investors. For example, in large Japanese companies, some might point out that it is not appropriate for future generations of management to have such system just because previous generations did not have any system like this. However, I believe that we need to firmly establish stock-based compensation as a "sunny" tool for resolving these issues and aligning management with shareholders over the medium to long term.

Secondly, since it is sometimes difficult to make progress by sounding out everyone on a topic (including the issuing company), the most important thing is for TSE to demonstrate leadership. Therefore, I hope it can find a definitive solution in a timely manner. To reiterate what I said earlier, I believe that our guiding principle should be continuous reform of the exchange to further revitalize the Japanese financial markets, resulting in a process of continuous renewal and innovation in Japanese industry and society. As a starting point, I believe it is necessary for the exchange to show leadership and take timely and definitive action.

[Kuronuma, member]

First of all, I agree with your point that since TSE has established market segments, TSE needs to have a process for replacing the companies in these markets, and that the first priority should be to clarify the listing criteria.

Also, I think it is important to clarify companies' responsibilities when they are listed, but this has already been covered to some extent in the Code of Corporate Conduct and the Corporate Governance Code. Therefore, I think the question is whether we need to do something in addition to this.

Another potential way of improving corporate value through the replacement process would be to gradually toughen up the delisting criteria, but I think this may be difficult to achieve in reality. As Mr. Kumagai suggested, if we set numerical targets and monitor them, in other words, if there is no transfer between market segments but companies' performance is disclosed publicly, we can encourage improvement of corporate value through publishing results based on indicators such as P/B ratio and ROE while maintaining the listing standards. In the future, I would be happy to discuss how effective this would be or whether we should do this.

[Okina, member]

Based on the criteria set, I think the main principle is that replacement is carried out according to the rules. Therefore I think it is important that the policy is clearly outlined.

Also, as Mr. Ando mentioned, I believe that autonomy and other disciplines are important. Once they have chosen a market segment, management has a responsibility for this, and it is up to them to fulfill their responsibilities. Although there is a discussion about how far the exchange should go, I think there are things that can be done in terms of changing the mindset of management and encouraging autonomy through sharing best practice examples and publishing a list of P/B ratios. Also, with regard to other disciplines, I think asset owners need to engage more.

[Ando, member]

I would like to confirm one thing. The word "replacement" is used a lot. Does this refer to replacement of companies for the three current market segments? Also, I understand that the index is not the subject of discussion here, but I think we need to clarify whether this is an issue related to the index before moving on with the discussion.

[Matsumoto, member]

I believe that the whole point of this is that companies can be replaced and this includes delisting.

[Kikuchi, Director, Listing Department, TSE]
Thank you.

Our time is up so we will conclude today's meeting here.

Finally, I will update you on the requests for stakeholder opinions and explain the schedule for next time.

[Ikeda, Manager, Listing Department, TSE]
Thank you very much for the lively discussion today.

First of all, I would like to inform you that we started accepting opinions on the TSE website on September 30. The period for submitting opinions will last for approximately one month until the end of October.

At the next meeting, we will continue with our exchange of thoughts and opinions. I would like to focus on the discussion concerning the transitional measures and go into more detail. We will also report back to you on the results of the request for your opinions. We will be in touch with more information shortly.

Thank you for listening.

[Kikuchi, Director, Listing Department, TSE]
With that, I hereby declare today's meeting adjourned.
Thank you very much for your participation today. We look forward to talking to you all again at the next meeting.

End