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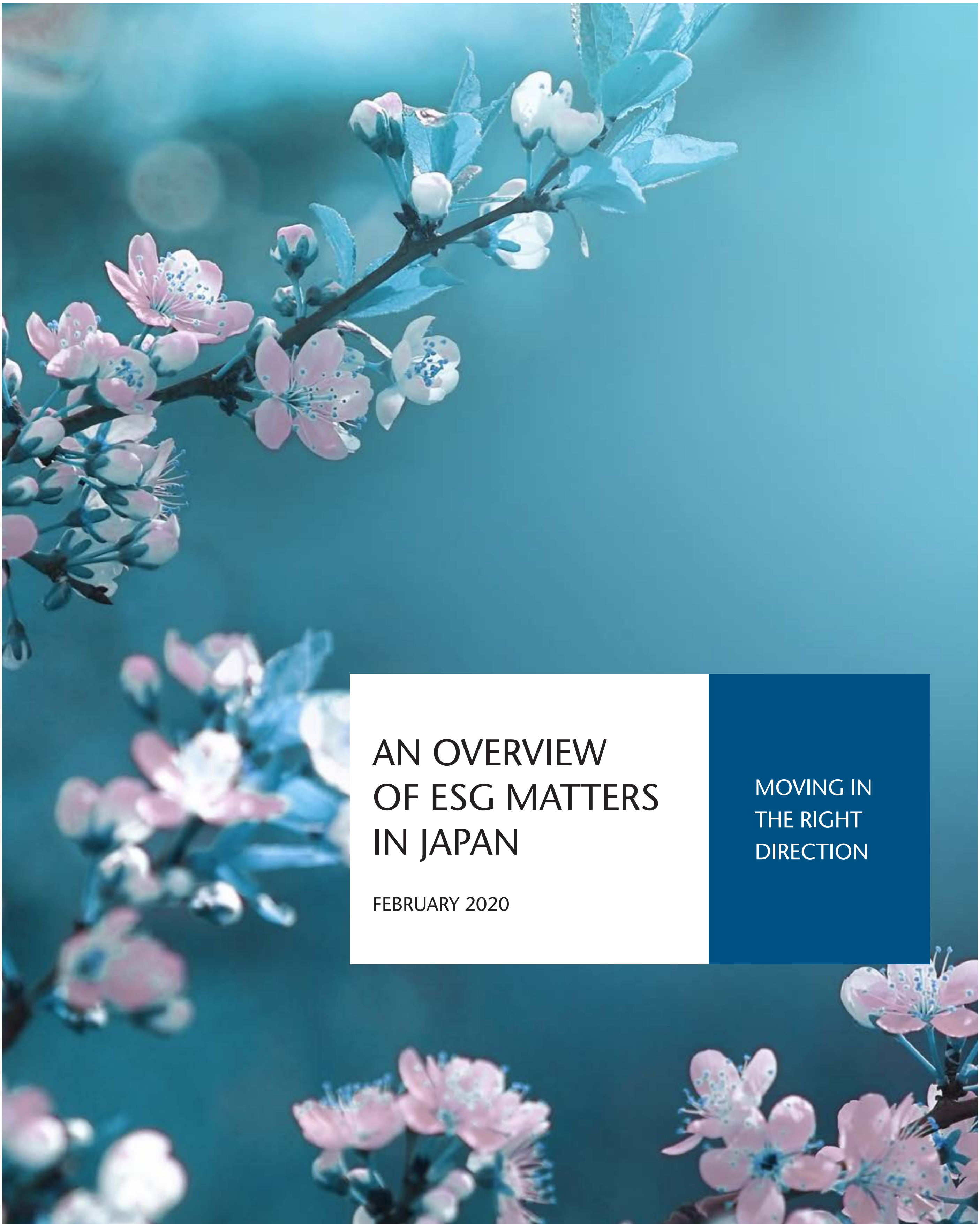

AN OVERVIEW OF ESG MATTERS IN JAPAN

FEBRUARY 2020

MOVING IN THE RIGHT DIRECTION

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AN OVERVIEW OF ESG MATTERS IN JAPAN

JAPAN OFTEN CONSIDERED A LAGGARD

Japan is often said to be lagging the rest of the developed world in terms of its companies' environmental, social and governance (ESG) practices. If we were just to compare the ESG ratings of its companies with those from elsewhere, we might conclude that this is indeed the case. However, a more in-depth analysis shows that this is not the whole story.

Of the world's major equity markets, Europe performs considerably better than the others when it comes to ESG ratings, with the highest proportion of best-in-class companies and a significantly lower proportion of poorly rated firms. The positive skew in the distribution of European companies' ESG ratings can be explained by their longstanding commitment to ESG matters. By contrast, there is a marked dearth of top-rated companies in Japan, although its overall distribution of ratings is not materially different from the US.

Breaking down ESG into its three individual constituents gives us more insight into the differences between the regions. We can see in the graphic below, for example, that Japanese companies perform similarly to those from Europe in terms of their social and environmental practices, but significantly lag European and American firms in governance. Japan's poor governance score is rooted in its firms' historically different practices from elsewhere in the world.

FIGURE 1:
ESG RATING DISTRIBUTION

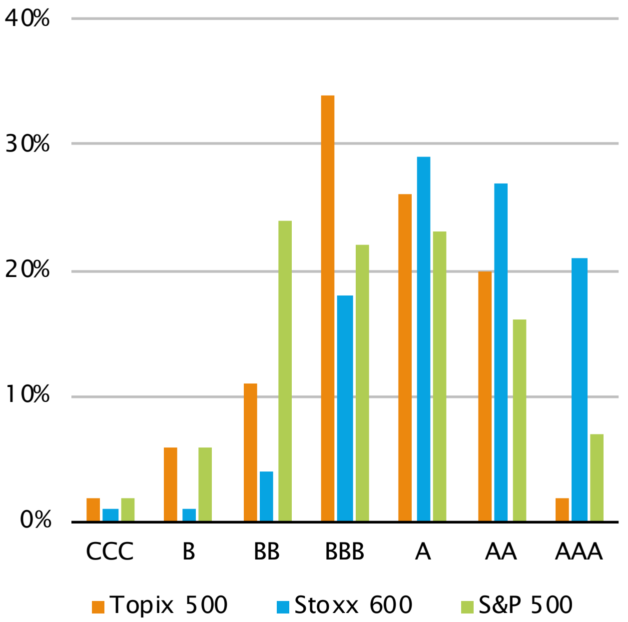

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FIGURE 2:
ESG RATING & SCORING FOR INDICES

		ENVIRONMENT	SOCIAL	GOVERNANCE
Topix 500	BBB	5,7	5,2	4,2
Stoxx 600	AA	5,9	5,1	6,0
S&P 500	BBB	5,5	4,5	5,4

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CONSIDERABLE CHANGES IN CORPORATE GOVERNANCE

BACKGROUND

As we have seen above, Japan's corporate governance practices are very different to those in Europe and the US. Post-war Japanese corporate governance has been characterised as stakeholder-oriented, in contrast to the shareholder-oriented model elsewhere in the developed world. In the stakeholder-oriented model the control of shareholders is limited and the interests of employees and business partners are emphasized.

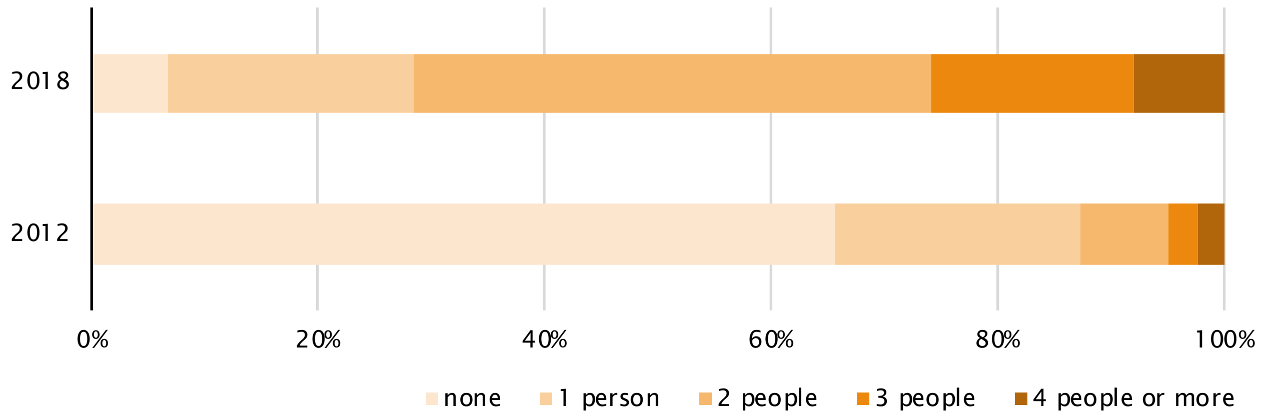
This focus on key stakeholders has historical origins. Firstly, during the Japanese economy's period of rapid growth from the 1960s until the 1980s, corporate financing was, due to Japanese regulations, dominated by bank lending rather than raising money by issuing shares. What's more, private shareholding was not incentivised: the equity market had not yet been opened up to foreigners, and stock ownership was dominated by inter-company networks of cross-shareholding. This meant that a majority of shares was held by business partners. As, starting in the 1990s, private shareholding grew and cross-holding declined the issue of underrepresented shareholder interests gained saliency. Another pillar of this model, also introduced in the 1960s, is the employment system. It is characterised by lifetime employment with seniority-linked wage- and promotion system. In fact, the board of directors was often treated as an extension of this promotion system and became dominated by insiders as a result. This leads to an overemphasis of employee interests.

Overall, the Japanese model of corporate governance has historically featured strong industrial and employee relations, dominance of insiders and a lack of independent oversight, to the detriment of shareholder interests. However, since the end of the bubble economy in the 1990s, these characteristics have weakened considerably due to pressure from foreign investors and, later on, pension funds for a shift to more shareholder-friendly models.

THE BOARD OF DIRECTORS

A typical Japanese board has nine directors with an average age of 64. Two of them are likely to be external, and one of the two maybe female. Internal female directors are rare. External directors are as likely to have an academic, bureaucratic or financial background as they are to have managerial experience. In contrast, typical boards from elsewhere in the developed world are mostly made up of independent directors, up to five years younger depending on the region they come from, and include a considerably higher proportion of women. The dominance of insiders and the advanced age of Japanese boards are consequences of the above mentioned promotion system.

FIGURE 3:
NUMBER OF INDEPENDENT DIRECTORS IN ALL TSE LISTED COMPANIES



SOURCE: TOKYO STOCK EXCHANGE, DATA AS AT 31.10.2019

CONSIDERABLE CHANGES IN CORPORATE GOVERNANCE

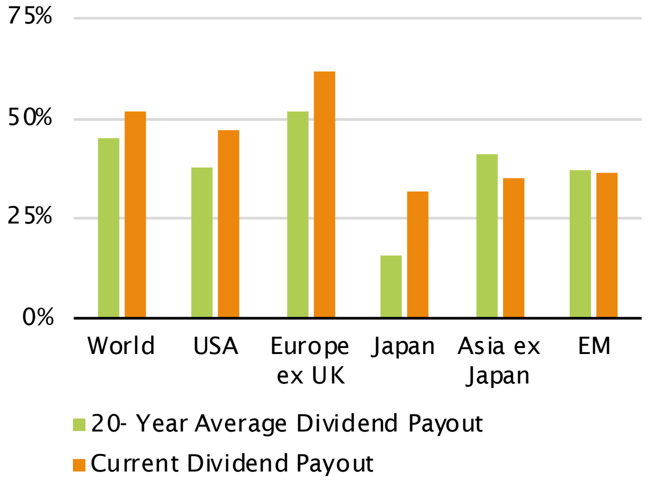
However, there have been improvements. The Japanese stewardship code of 2014 and the corporate governance code of 2015 have resulted in considerable changes: in 2012 most companies did not have any independent directors, but six years on over 70% had two or more independents. That said, many companies seem reluctant to further increase the proportion of independent directors, and a compromise seems to have been reached at a third of board members being independent, a goal specified in many institutional investors' voting guidelines. While most companies seem to be willing to meet this threshold, it will be a long time before the majority of Japanese board members are independent, as is the case elsewhere in the developed world.

WHY DOES BOARD INDEPENDENCE MATTER?
A board's role is to supervise management and represent the interests of shareholders and other stakeholders in the company. When the board is dominated by insiders, the company's management effectively supervises itself. This can lead to conflict of interests, with shareholders' interests underrepresented.

A tool that is often used to help align the interests of a company's management and its shareholders is stock options; however, they are rare in Japan. This lack of stock options and shareholding by management means there is a insufficient of alignment of interests with shareholders. This misalignment can be seen in the shareholder returns. Japanese firms are notorious for hoarding cash instead of rewarding their investors, such that returns to shareholders have long been far lower than the global average. However, the 2015 governance reform and pressure from institutional shareholders have borne fruit as shareholder returns have almost doubled in recent years. While dividend payments are expected to stagnate, total shareholder returns including buy-backs are trending upwards. This is because Japanese companies generally prefer to pay a stable dividend, so to avoid inflating the dividend during good year, they often generate additional returns to shareholders through buybacks. And while earnings have fallen in 2019, pay-out ratios are expected to increase further. Thus, the increase in independent directors seems to have shown some results and a realignment with shareholder interests is in progress.

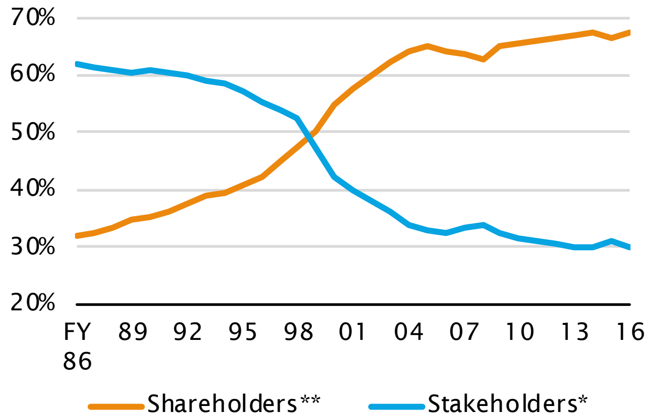
CROSS-HOLDINGS AND LISTED SUBSIDIARIES
Another distinguishing feature of the Japanese market is its high rate of cross-shareholdings and parent-child-listings. The former, also referred to as strategic-, stable-, or stakeholder-shareholding, describes arrangements were business partners such as suppliers, customers or lenders hold shares in each other's companies. The purpose of these arrangements is to ensure a stable continuation

FIGURE 4:
DIVIDEND PAYOUT RATIOS HAVE INCREASED MARKEDLY AND ARE NOW FAR MORE IN LINE WITH GLOBAL PEERS



SOURCE: MORNINGSTAR INVESTMENT MANAGEMENT CALCULATION.
DATA AS AT 31 AUGUST 2017

FIGURE 5:
MORE ROOM FOR CUTS IN CROSS SHAREHOLDINGS
(EQUITIES HELD BY SHAREHOLDERS, STAKEHOLDERS IN PERCENT)



* CITY BANKS, INSURANCE COMPANIES, CORPORATES
** TRUST BANKS, MUTUAL FUNDS, RETAIL INVESTORS, FOREIGN INVESTORS

SOURCE: TOKYO STOCK EXCHANGE.
DATA AS AT MARCH 2016

CONSIDERABLE CHANGES IN CORPORATE GOVERNANCE

of the business relationships, potentially conflicting with minority shareholder interests. Furthermore, analyses of the voting behaviour of cross-shareholders have shown that the managers of the involved companies use their vote to mutually shield each other from outside influences, making replacing directors or pushing through a shareholder resolution difficult. Nevertheless, the overall level of cross-shareholding has halved over the years to around 30% of the stock market. However, depending on how involved in these practices a company is it can constitute a serious risk factor to investors.

At the more extreme end of the cross-holding spectrum are parent-child-listings. Japan is home to over 300 listed companies that have a controlling shareholder that is also listed, a phenomenon rarely found elsewhere in the developed world. In such companies the potential for conflicts of interest between minority shareholders and the controlling shareholder is amplified because the parent has the ability to singlehandedly make decisions that might not be in the interest of minority shareholders.

THE OUTLOOK FOR CORPORATE GOVERNANCE IN JAPAN

Japanese corporate governance is moving in the right direction, with increasing board independence, cross-shareholdings on a 30-year downwards trend and shareholder returns increasing. But despite these improvements, there is still a lot of catching up to do. What's more, despite – or perhaps because of – the strides made over the past years, the momentum of improvements seems to be slowing. The proportion of independent board members seems to be levelling off at a third, and after a long period of significant unwinding, cross-shareholding has been falling at a somewhat slower pace over the past few years.

JAPAN'S ENVIRONMENTAL EFFORTS IN LINE WITH INTERNATIONAL COMPETITION

The E of ESG looks at the financial and reputational risks linked to companies' impact on the environment. With awareness of climate change and other environmental issues growing, consumer behaviour is shifting and environmental legislation has been increasing in Japan and elsewhere, as we can see in the chart below.

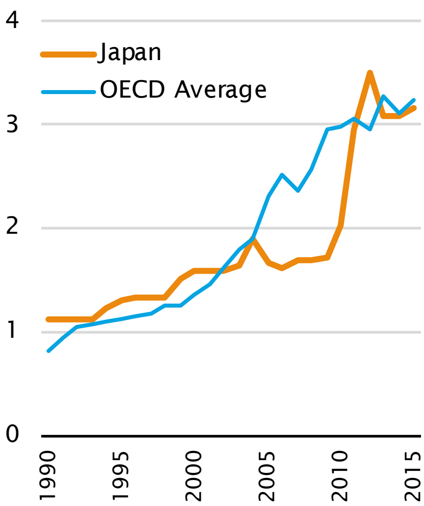
This trend of increasing regulation means that polluting is becoming more expensive. As more and stricter regulation is being created, the financial burden of a company's environmental impact will shift from the public to the firm.

On environmental issues companies tend to do a little worse than their European competitors but better than American companies. Their emission of regulated substances (e.g. NOx, SOx, VOC) tend to be low in international comparisons and they produce comparatively little waste going to landfills. However, the latter is due to a high degree of thermal recycling (i.e. burning vs. storing), both having different environmental issues. In regards to natural capital management Japanese and US companies considerably lag European ones. They use less sustainably produces raw materials (e.g. palm oil, wood, etc.), have less transparent supply chains, and face higher of water scarcity related risks.

On climate change the Japanese company's efforts seem to be comparable to their international competition. However, unlike the EU, Japan does not yet have a comprehensive carbon pricing scheme. As the country is projected to miss the targets necessary for the maximum 2°C temperature rise set by the Paris Agreement, Japan's environmental ministry is deliberating carbon pricing. It now seems to be more a question not of if, but when, such a scheme is implemented, and how comprehensive it is. The academic consensus for the necessary worldwide price of carbon to reach the goals of the Paris Agreement is USD 40–80 / tCO2 by 2020 and USD 50–100 / tCO2 by 2030. For some companies such prices would ruin their business model, making them unsustainable investments.

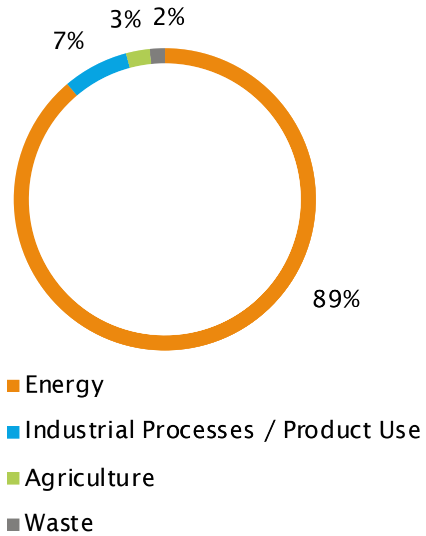
Industries with high carbon emissions and low mobility (in the sense that they have little chance of transferring their operations out of the regulatory jurisdiction) are at the greatest risk of being subjected to carbon pricing rules. Some examples for this are the utility, energy and materials sector. Almost 90% of Japan's greenhouse gas emissions stem from energy-related activity, among the highest levels of industrial nations. A major source of emissions is electricity generation because Japan relies heavily on fossil fuels, particularly since nuclear

FIGURE 6:
ENVIRONMENTAL POLICY STRINGENCY



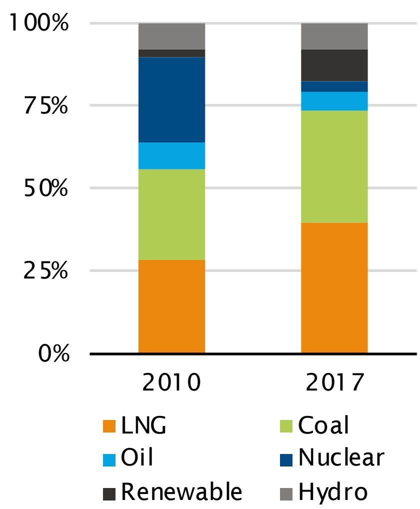
SOURCE: ENVIRONMENTAL POLICY STRINGENCY INDEX, OECD, 2015

FIGURE 7:
GHG EMISSIONS BY SECTOR



SOURCE: UN CLIMATE CHANGE SECRETARIAT, 2015

FIGURE 8:
ELECTRICITY PRODUCTION BY SOURCE
(IN TWH)



SOURCE: BP STATISTICAL REVIEW OF WORLD ENERGY 2018

JAPAN'S ENVIRONMENTAL EFFORTS IN LINE WITH INTERNATIONAL COMPETITION

power plants were shut down after the Fukushima disaster in 2011. Currently, around a third of Japan's electricity is produced by burning coal, which is highly greenhouse-gas-intensive. Coal is in fact the second biggest source of electricity, only exceeded by liquefied natural gas, which emits about 40% less greenhouse gas but is more expensive than coal.

Coal's relative cheapness is the reason it remains a major source of energy in Japan. Without carbon pricing, pricing pressure and capital expenditure requirements are preventing a shift to environmentally friendlier energy sources. And this has been apparent in our discussions with electricity utilities: many say they would like to become more environmentally friendly soon, but the economic reality makes this difficult. In capital- and energy-intensive industries like electricity utilities, significant environmental improvement is dependent on the implementation of policy that shapes market conditions to encourage change.

There is currently a somewhat confusing situation in Japan in that on one hand the environmental ministry says it is working on a carbon pricing scheme, while on the other the ministry of economy has identified thermal coal as a key industry for promotion and is factoring it into its long-term plans. Accordingly, utilities are trying to transition slowly to liquefied natural gas due to the risk of carbon pricing hitting their coal plants, but the contradictory messaging from government has slowed this process.

This dilemma is shared by companies across industries. For example, they may replace a few old boilers with more efficient ones one year, and work on saving energy another. The philosophy is one of slow but steady improvement (kaizen). Sweeping, disruptive change is not seen as feasible because it would destroy a company's profitability, increase its cost of capital and eventually result in bankruptcy. That said, this approach is insufficient to achieve the goals of the Paris Agreement and a policy intervention will become necessary. From an investor's standpoint, awareness of policy trends and assessing the risks they involve is vital to weather the carbon transition.

SOCIAL ASPECTS IN JAPANESE CORPORATE CULTURE

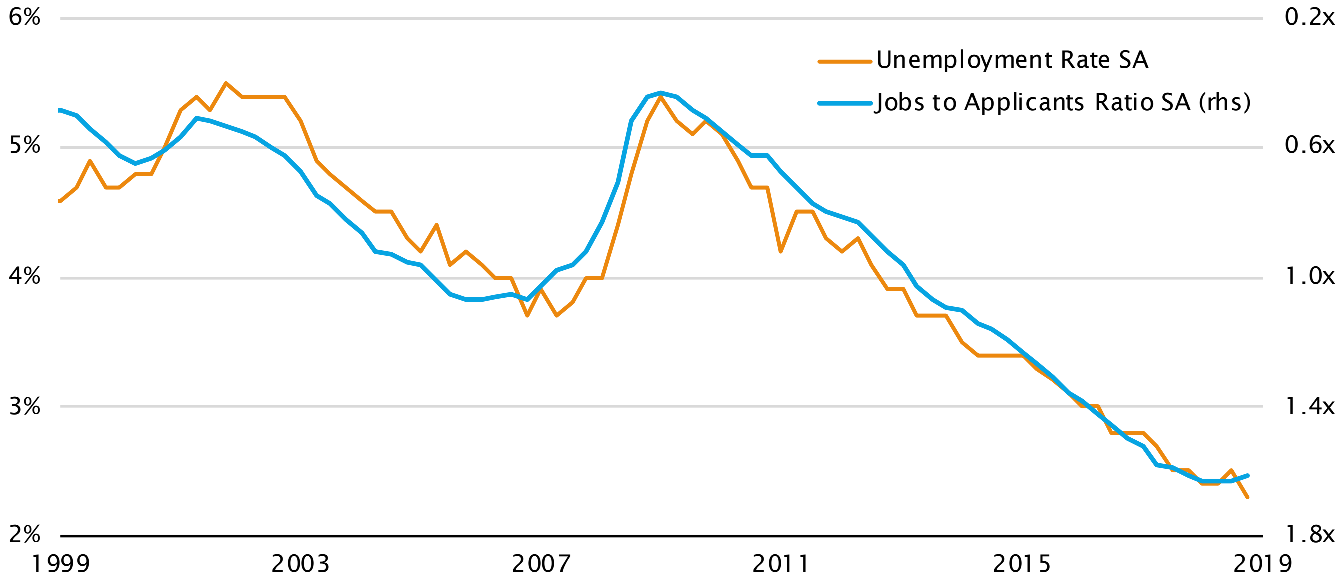
The social aspect of ESG looks at how a company treats its employees and other stakeholders as well as its effect on wider society. This covers a broad range of topics, but possibly the most relevant to Japan at present is how companies treat their employees.

A focus on employees is an important part of Japanese corporate culture. This has resulted in benefits for both sides, such as lifetime employment and a marked lack of labour unrest and strikes since the 1970s. Japan has long identified itself as a predominantly middle-class society, and this perception has been supported by the social contract based on shared economic growth, which has been passed on to the people. However, as economic growth has slowed, the perception that Japanese society is unequal has been growing. In particular, there have been two criticisms of the Japanese model: the binary labour market and a poor work-life balance.

The binary labour market describes the division between regular employees with permanent contracts and social benefits, who make up around 60% of the workforce, and irregular employees who have substantially lower wages, limited job security and do not receive many social benefits. The proportion of irregular workers has been increasing steadily over the years, driven by more women entering the labour market. However, with the labour market tightening, exacerbated by a looming fall in the population, the current situation is considered increasingly unsustainable. An unemployment rate of around 2.4% and a jobs-to-applicant ratio of over 1.5 shows that there are significantly more open positions than there are people to fill them.

As a result, some industries are facing serious labour shortages and competition for workers has become fiercer, putting pressure on salaries and work reforms to improve the work-life balance – a factor that many young workers are paying increasing attention to. Existing working and recruitment structures are crumbling as companies cast a wider recruitment net and employees change jobs more frequently. In fact, the state has identified work-life balance and the financial insecurity of irregular employees as causes of Japan's low birth rate. This has led to an increase in regulations covering matters such as the minimum wage, working hours and benefits. Monitoring a company's ability to attract and retain talent is therefore becoming increasingly important for investors. The two main quantifiable factors in work-life balance are overtime and paid time off. As working conditions start playing a bigger role in how young-

FIGURE 9:
UNEMPLOYMENT RATE & JOBS TO APPLICANT RATIO



SOURCES: MINISTRY OF INTERNAL AFFAIRES AND COMMUNICATIONS AND MINISTRY OF HEALTH, LABOUR AND WELFARE

SOCIAL ASPECTS IN JAPANESE CORPORATE CULTURE

er people choose a job, these figures serve as indicators of a company's competitiveness in the labour market. On average, Japanese employees have 18 days of paid time off available to them every year (not including public holidays, of which there are over 15). However, only half of these days are actually taken, with the result that Japan has the lowest rate of usage of time off in the world. The reasons for this low usage rate are both cultural and structural. On the one hand, employees are used to not taking their holidays and on the other, some companies make it difficult for employees to take time off, by not approving them or reprimanding employees.

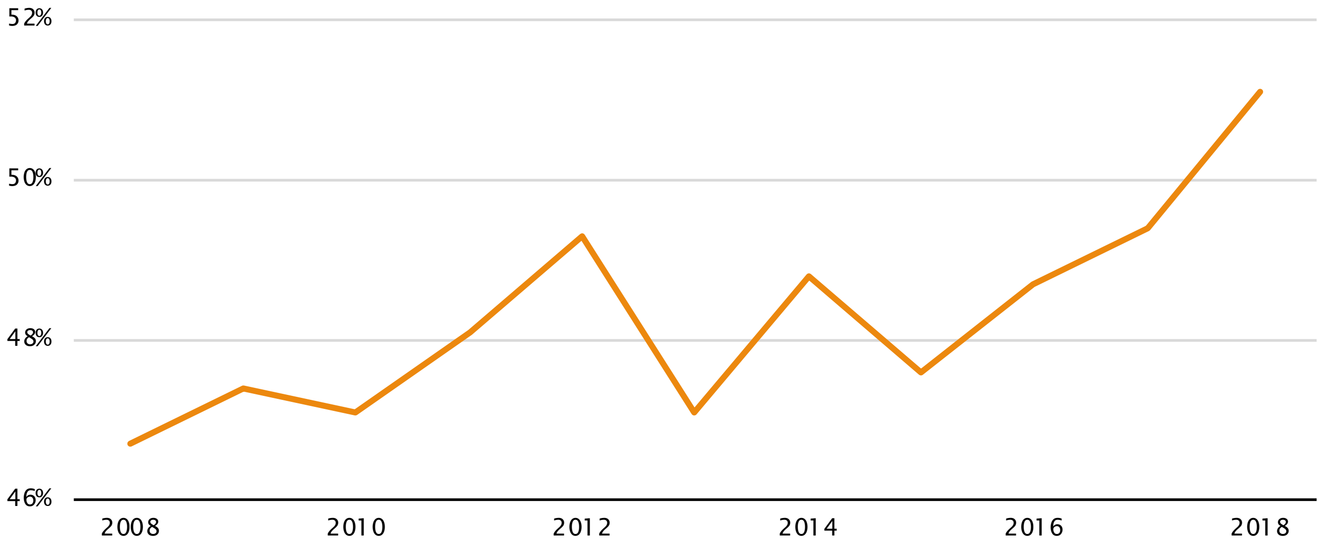
On top of this, Japanese working culture is famous for its overtime. Death by overworking (karoshi) is an officially recognised cause of death, and there are several hundred cases every year. Every such death exposes the company involved to the risk of a lawsuit, and there is a high chance that it will have to pay damages. Companies whose employees have a notoriously bad work-life balance are called "black companies" and are having increasing difficulty filling vacancies.

The good news is that overtime has been falling in recent years and the usage of paid time off going up. This is due to a competitive labour market, public pressure and encouragement from the government. This trend is expected to continue, and companies not taking part are likely to have increasing difficulty with recruitment.

Another indicator of a firm's ability to attract talent is the ratios of females in its overall workforce and its management. Historically, the participation of women in the workforce – especially in regular employment – has been low. However, due to the projected fall in Japan's population, both companies and the government have been trying to entice more women into work. Despite these efforts, there is still a marked lack of women hired as career-track employees (career trajectory is often decided in the hiring stage, and management is promoted from the ranks of career-track employees). This means that there is considerable gender disparity in the hiring and promotion process.

While female participation in the labour market has increased, only around 15% of company management are female, so the power to make decisions still lies in the hands of men and, on average, women earn about a quarter less than their male counterparts. So, even though they are becoming an increasingly vital part of the workforce, women's working conditions are inferior to men's. As a result, women have been shown to gravitate towards urban centres to

FIGURE 10:
PAID TIME OFF USAGE RATE (%)



SOURCE: RITSUMEI UNIVERSITY, BASED ON DATA FROM THE MINISTRY OF LABOUR, HEALTH & WELFARE

SOCIAL ASPECTS IN JAPANESE CORPORATE CULTURE

work in multinationals and other firms where opportunities are more equal. This shows that working conditions have an influence on job selection and companies with poor practices will find themselves increasingly side lined in the fight for talent.

Thus Japan is lagging Europe in work-life balance, and both Europe and the USA in workplace gender equality. The tight labour market means that these shortcomings have been emphasized. However, despite these shortcomings they tend to deal with social issues better than their international competitors. Domestic operations are at little risk of disruption due to labour disputes, even if labour management at overseas facilities is comparable to its European counterparts. American companies seem to have weaker labour management practices and, thus, a higher risk of walk-outs, strikes, and work stoppages.

In product liability, quality, and safety issues Japanese companies have been shown to do considerably better than its American counterparts and slightly better than European companies, with fewer recalls and fines, and industry leading quality assurance practices. However, these practices vary greatly from company to company and while on average quality control seems to be better in Japan, the country does also have a significant amount of black sheep.

MOVING IN THE RIGHT DIRECTION

The stakeholder-oriented approach to corporate governance in Japan has caused it to score poorly on shareholder-oriented matrices that look at board composition and supervision, shareholder returns, and ownership and control. Furthermore, despite the reforms having been effective, practices still lag those in other industrialized countries. For investors governance data can help gage quality of management and management supervision. Good supervision can help reduce risk and an alignment of shareholder and management interests can improve returns.

In terms of environmental issues the most material matter is climate change and the impending introduction of carbon pricing, which will have a significant financial impact on some companies. It is thus important to facture such issues into the analysis and adjust valuations accordingly. This prevents being wrong footed by regulations and reduces risk.

In the social sphere, apart from the universal social issues of human rights, supply chain management and local impacts, Japan's labour shortages, which are driven by demographic change, represent a significant challenge to businesses. In a highly competitive labour market, bargaining power shifts to the workers, so improvements in working conditions have become essential in the fight for talent.

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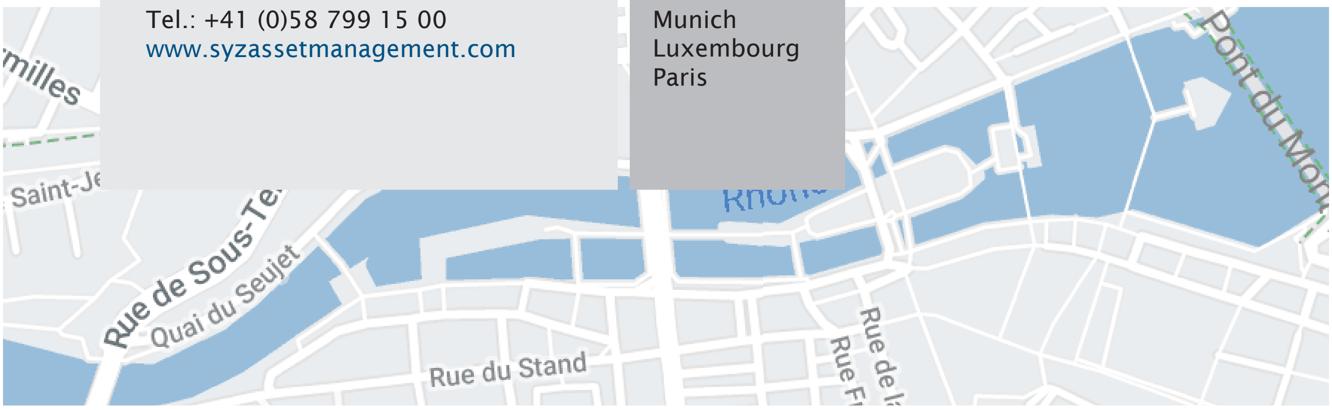

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