

January 15, 2018

Letter on Materiality Identification and Disclosure (*abridged translation*)

IICEF and the five participants of its collective engagement program (Pension Fund Association, Sumitomo Mitsui Asset Management, Sumitomo Mitsui Trust Bank, Mitsubishi UFJ Trust Bank, and Resona Bank) jointly have sent letters to multiple listed companies in Japan, asking the management teams to identify and disclose their materiality issues (important matters for their business model sustainability) more effectively and to provide collective engagement meeting opportunities.

1. Target companies

Out of Japan's leading companies that are actively engaged in CSR- and ESG-related activities and are proactive in integrated reporting of non-financial information especially on ESG matters, we picked up several companies. We believe that long-term investors can be even more confident of these companies' sustainable growth potential, when more effective disclosure of their materiality issue information would be available. This time, our focus is on large-cap names. At this point, no disclosure of specific target company name is planned, from our side.

2. Key messages

The participating institutional investors have spent time to discuss the materiality agenda, to come up with the following common views to be addressed in the letters.

(1) Investors' perspective on environmental and social issues

Environmental and social issues are attracting greater attention globally. Today responding to such issues is a very important management task from the viewpoint of business model sustainability, not just of nature conservation and contribution to society.

Also, ESG information is very important for investors. In particular, long-term investors find information on important issues for business model sustainability (materiality issues) critically important, as they would like to better understand how ESG matters are positioned in value creation, and how they affect robustness of business models and effectiveness of corporate strategies.

Typically, investors try to evaluate a company's growth potential as opportunity and incorporate it into their future cashflow estimates. At the same time, they also incorporate evaluated risk at a company in their discount rate and/or cost of capital estimates. If the management appropriately recognizes the risks assumed by investors as risks and takes sufficient measures, investors can evaluate corporate value highly, with lower cost of capital estimates. The management should not only explain to investors about their growth strategies but also their approach to risk, to gain more confidence from investors, of the company's value creation.

Given all the argument above, we would like to conduct collective engagement with each of the target companies, on identification of materiality issues and effective disclosure.

(2) Suggestion for specification and disclosure of materiality issues

To secure and strengthen intangible assets such as human capital, technology and know-how, intellectual property, etc., is getting more and more important these days. Environmental and social matters can be threats to companies' intangible assets, and they may bring higher risk for the companies' long-term value creation and business model sustainability. For example, procurement problems caused by depletion of fishery and agricultural resources, talented personnel outflow and manpower shortage due to poor working environment, damage to brand brought about by NGOs and consumers distrust, etc., could all be regarded as material risks with serious impact on value creation and competitiveness. We believe that it is essential for the management to identify specific environmental and social issues in business activities of the company, set them as important issues (materiality issues), share them within the company and consider appropriate measures to control such risks.

Meanwhile, responding to global environmental and social issues, utilizing value creation strength and competitive advantage, can be a new growth opportunity. Sustainable Development Goals (SDGs) will likely provide worldwide business opportunities. The management should not only discuss social significance of the company's business activities in each of SDGs domains, but recognize SDGs domains as new business development opportunities and make growth investment there. If possible, we would like the management to explain how much investment will be made and how much return is expected, if one of the company's businesses can contribute to certain domains of SDGs.

We would like the management to explain both of the two aspects of materiality issues recognized within the company – risks and opportunities – in an appropriate manner. With the effective disclosure of materiality issues, investors can better appreciate the management recognition and action plans, and become more confident about the company's sustainable growth potential.

(3) Clarification of business model and sources of value creation and competitive advantage

In order to make our engagement dialogues effective and constructive, we also would like the management to clarify the company's business model, the source of its value creation, and the source of its competitive advantage. After evolution of business activities for many years, the business model may have become complicated, and the source of value creation may have changed significantly. We believe that it is always fruitful to discuss the most updated management recognition of the company's business model and the sources of value creation and competitive edge.

(4) Remarks on terminology: “materiality”

Regarding the disclosure of materiality issues, still quite a few companies merely refer to their CSR activities, or their environmental and social contributions. They do not necessarily clarify the two aspects of materiality issues, opportunities and risks concerning their business model sustainability.

In our view, this is because there are various guidelines using the term “materiality.” It appears that many companies discuss the “material aspects” used in GRI’s “G4 Sustainability Reporting Standard” which is a disclosure guideline on CSR. This kind of CSR disclosure is informative for investors, but it is not always useful enough in their evaluation of opportunities and risks regarding the business model sustainability.

In the “International Integrated Reporting Framework” that assumes investors as the primary users, a matter is regarded “material” if it could substantively affect the organization’s ability to create value in the short, medium and long term. Also, the “Guidance for Integrated Corporate Disclosure and Company-Investor Dialogues for Collaborative Value Creation (Guidance for Collaborative Value Creation)” released in 2017 by Japan’s Ministry of Economy, Trade and Industry says “for investors, it is important to understand how companies understand the materiality of ESG factors to the sustainability of their business models and the ESG factors’ linkage with the growth of corporate value over the long-term, rather than looking at ESG in isolation.”

Please note that we do not suggest the management to stick to the term “materiality,” in the disclosures for investors. For example, some companies may want to discuss “important issues related to business model sustainability” or “factors with significant impact on the sources of value creation and competitive advantage” in their annual reports, integrated reports, IR materials, etc., while keeping the GRI-complied descriptions in the existing CSR reports separately.

We have initiated collective engagement dialogues with multiple companies, with the above-mentioned contents. Suggestions, opinions and inquiries are welcome, from investors who have other engagement agenda ideas, as well as from listed companies’ management teams.

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