NAOYOSHI KASUGA (Left)

Director and Group CFO

MAKOTO NAKANO (Right)

Director (Audit Committee Member)
(Outside, Independent Director)

DIALOG

To Link the Awareness of Each Group Employee to Corporate Value

In November 2022, Group CFO Kasuga and Director Nakano, an expert in business administration and corporate finance, exchanged views on the Value Tree, a mechanism for improving the corporate value of the Group.

See the next page for a diagram of the value tree.

Value Tree: TSR and Cost of Equity

Kasuga While the Group has formulated its strategic materiality of becoming a software company that enhances corporate value, we have also decided to create a Value Tree to clarify the mechanism by which corporate value is maximized. As the Group CFO, after repeated discussions with the CFOs of each operating company at weekly meetings, I named the spread between Total Shareholder Return (TSR) and the cost of equity Net Shareholder Return (NSR) and selected it as the final indicator for measuring the Company's ability to create corporate value.

Although we are aware that methods such as DCF are used to calculate corporate value, I believe there are several other indicators of corporate value that shareholders and investors attach importance to. Among them, TSR is also used in determining the remuneration of executive directors, Group CEO Morikawa and I, and this convergence of our goals and interests is why I chose it.

In addition, the Company has long considered reflecting TSR in the renumeration structures for non-Directors, and if this is realized, officers and employees can pursue the enhancement of corporate value from the same viewpoint as shareholders and investors. On the other hand, the Company believes that it is appropriate to calculate TSR over a five year period in line with the period of the Group's medium-term management plan because there is a possibility of temporarily increasing TSR in a very short period of time.

As I mentioned earlier, we initially regarded TSR as the only important management indicator. However, because TSR is a ratio, it is difficult to determine whether value is created. Therefore, we ultimately chose the spread between TSR and the cost of equity as the indicator. Another reason for this is to raise awareness of the cost of equity throughout the Group. The concept of subtracting the cost of equity from TSR is based on the Wealth Added Index (WAI™)*.

Nakano Indeed, it's a very easy to understand tree. The breakdown of TSR into capital gains and income gains, were easy to understand, as is the breakdown of capital gains into EBITDA growth and EBITDA multiple. If you increase EBITDA or the multiple, the share price rises. And EBITDA will increase as EBITDA margin or revenue grows. It's clear.

Kasuga Following the example of SaaS companies in the United States, the Group has emphasized Growth and Profit Point (GPP), which is the sum of sales growth rate and operating profit margin. Therefore, we thought that sales growth and EBITDA margin would be more familiar to operating companies than net income. With the intention of linking them with indicators actually used in the field, we intentionally broke down into EBITDA and linked it with stock prices. In the future, we will consider how to improve sales growth and EBITDA margin for each operating company, and expand it to divisions, units, and ultimately individuals. In addition to the cost of shareholders' equity I mentioned earlier, I believe that it is important to spread awareness among employees on the ground.

* WAI™ and Wealth Added Index are registered trademarks of Stern Stewart & Co., a consulting firm.

Value Tree with NSR as Top KPI

NSR (Net Shareholder Return) = TSR (Total Shareholder Return) – Cost of Equity

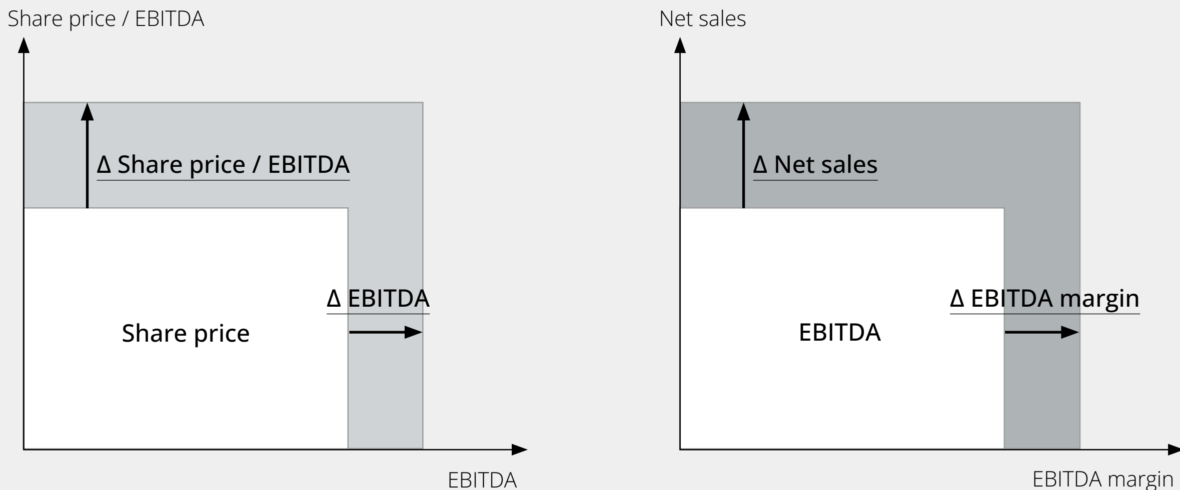
Maximize

- TSR
  - Capital Gain
    - EBITDA Growth → Business Strategy
      - Sales Growth
      - EBITDA Margin
      - Business Model Changes
    - EBITDA Multiple → IR Strategy
      - Brand
      - ESG
      - Information Disclosure
  - Income Gain
    - Dividend

Minimize

- Cost of Equity
  - B/S Management
    - Capital Structure (Funding) → Financial Strategy
      - Share Repurchase
      - Corporate Bonds and Borrowings
    - Investment (Management) → Investment Strategy
      - M&A
      - New Business
      - R&D
      - Business Divestment

Breaking Down Capital Gains



Nakano The Avant Group has almost no interest-bearing debt, so we can say that corporate value equals shareholder value and WACC equals cost of equity. At the end of the fiscal period ending June 30, 2022, assuming a market capitalization of ¥50.5 billion and a CAPM cost of equity of approximately 8%, this is a weighted average including ¥9.4 billion in cash and deposits. Assuming a 1% yield on cash, the cost of capital for business assets corresponding to the remaining ¥41.2 billion at market value, in other words, the expected return from the market, is approximately 9.6%. It can be said that WACC has been kept at about 8% due to the risk reduction effect of holding cash and deposits.

Kasuga The market's expected return of 9.6% is an indication that the current corporate value will be damaged unless the investment can increase the return more than that. Although some shareholders may wish we return surplus funds to them, the Company will continue to invest in business growth and increase corporate value by achieving business returns that exceed market expectations.

Nakano 9.6% is high enough compared to mature companies, so I think the market expects our growth to that extent. In addition, dividends and share buybacks essentially reduce the value of the company itself because they transfer value to shareholders. Dividends are returns to all shareholders, but share buybacks are limited to certain shareholders.

Kasuga At Board of Directors, the opinion has been expressed that as we have a large amount of cash and deposits, if we leave it as it is, we may be targeted by activists. Although I don't think it would be that easy given our shareholder structure, and I don't know what measures they would take, for example buying a large amount of our stock in the market.

Nakano If your price book-value ratio (PBR) is low and you have a large amount of cash and deposits, you are more easily targeted, but I don't think this is our case because our PBR is about 5 times. However, when a company has cash and can create value through its business, if it is small in scale, it may be targeted. In that sense, to maintain our current structure it would be reassuring if we could further increase our market capitalization. Or maybe you don't need to worry about it if you have the kind of high-quality management that makes activists think they can't improve their management any more even if they join.

EBITDA Growth and Multiples Are Key to Enhancing Corporate Value

Kasuga I recognize that within the Value Tree, my role as CFO will be centered on IR strategy, financial strategy, and investment strategy. Although IR activities alone may not be able to raise the EBITDA multiple, I think it is possible for IR activities to have an impact. In terms of financial strategy, now I don't feel it is so important. Although we have established commitment lines for emergencies, we have sufficient internal reserves, and if we do not make large-scale investments, including M&A, as things stand, we will not need to raise funds, including borrowing. I am aware of the technique of raising ROE by increasing borrowing and the leverage ratio, but I don't think it is the essence of financial strategy. As for our investment strategy, I am aware that I will play a role as a gatekeeper in implementing it.

Nakano What I felt when I looked at the decomposition chart of capital gains mentioned earlier was that the P/L (Consolidated Profit and Loss Statement) and stock prices were the main factors, so I wondered if the B/S (Consolidated Balance Sheet) could be factored in. The idea of using assets to increase sales, or investing, could be added to this diagram.

Kasuga As you say, business tie-ups by acquiring companies or businesses, or investing capital can be effective measures. However, rather than being driven by the Group holding company, the needs of the operating companies are the starting point for such investment.

There are various indicators to look at, but I feel that the one that ultimately has the greatest impact on corporate value is business strategy, especially the absolute growth of EBITDA. In fact, a sensitivity analysis of various companies shows that EBITDA growth as the driver of capital gains is overwhelmingly large.

I understand that the influence of growth is big.

Nakano To achieve EBITDA growth, simultaneously increasing both sales and margins may not be easy, but Group CEO Morikawa, is thinking that we must further enhance our growth potential. I think the best way to achieve this is to invest more in high margin businesses. What do you think?

Kasuga I think so. At the same time, currently there are no notably high margin businesses within the Group. Prior to the reorganization in October 2022, in the fiscal year ended June 2022 the Group Governance Business, with an operating income margin of 22.0% was not only the most profitable but also the largest profit contributor. On the other hand, many software companies have achieved operating margins of 30% or more. A business that develops and sells software packages should be highly profitable, but because many of our customers are large companies, the associated SI (System Integration) services are expanding, and profitability is sluggish. On the other hand, the Outsourcing and Digital Transformation businesses, which are generally regarded as labor-intensive and low margin, have achieved sufficiently high operating profit margins (21.7% and 17.7%, respectively) relative to the industry through the development of unique business models and a review of the business mix. Through sales growth, these businesses have achieved substantial profit growth. We would like to raise the profit margin of the Group as a whole by raising the profit margin of Diva which is the core company of the Group Governance business. As a result, following the reorganization Diva is moving further toward becoming a product-oriented SaaS company.

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Nakano As mentioned in the Cost of Capital section, I understand that the reason why the Company's PBR is approximately five times is that the market's return expectations are high, because the Company has created barriers to entry in its business and continues to earn excess profits. That's why it is troubling if you enter a new business in a field where there are already competitors, your overall profitability will decrease, and you will be unable to maintain a high valuation. But if the business model changes in the way you just mentioned and EBITDA growth continues to rise, I think EBITDA multiples should also benefit.

Kasuga I agree. It is like preaching to the converted, but in theory, the relationship of PER = 1 / (cost of equity – growth rate of net income) is established. For example, from the current PER and estimated cost of equity, the market's expectation for sustainable growth rate of net income is approximately 2%. In other words, I cannot help but say that there is little expectation of future profit growth at present. One way to increase the multiple is to raise market expectations for the Group's sustainable growth. To achieve this, I think the most important thing is to transform the business model to one that supports growth.

Nakano The growth of EBITDA itself is important, but the multiple that reflects the medium- to long-term growth based on the business model is also important.

Difficulty in Spreading Awareness of KPIs and Capital Costs on the Ground

Nakano Do you recognize any other issues as Group CFO?

Kasuga Although there are several issues, how to establish KPI awareness on the ground, including the Value Tree, has been a particularly big issue for some time. Since

I joined the Group in 2010, I have explained at several meetings of the Group Management Meeting and the Board of Directors that investments such as product development and M&A are a kind of cost, and that without a return exceeding that, no value is created. I have created a framework to evaluate such proposals, but I am acutely aware that in reality it is difficult to use, and proposals don't tend to pass. At present, I am beginning to think that a simpler indicator, such as EBITDA margin, or even gross profit, which is more widely understood and used by those on the ground and could be more effective than creating something elaborate and complicated.

Nakano Around 2000, when the Balanced Scorecard became popular, I provided consulting services to improve factory productivity. I told workers on the site that they would be able to do two types of work in half a year, instead of doing one type of work now. I think it is easier to convey a KPI if it is easy to understand.

Kasuga Similarly, I am aware of the problem that the operating companies only focus on the concept of P/L.

Nakano Yes, they tend to lack B/S awareness.

Kasuga Yes. To be honest, I feel that it is difficult for the operating companies to have B/S awareness, partly because until now, the holding company used to absorb all the profits of operating companies as dividends, leaving the operating companies poorly capitalized. For this reason, we introduced the concept of risk capital two years ago, which

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measures the risk level of each company's assets and allocates and accumulates capital using internal reserves. Until then, there had been no concept of "invested capital" as the denominator, so the concept of ROIC is still in its infancy.

I think value-based management frameworks such as Value Trees and ROIC trees have existed for about 40 years, but why haven't they really been put into practice in Japanese companies?

Nakano Especially in the case of Japan, the influence of the finance education may be big. It was about 15 years ago that I started teaching university courses about how to think about corporate value. The students at that time will only be about 35 years old now, and I doubt they have reached that far up corporate management structures yet. On the other hand, I also have the opportunity to explain matters like this to managements in executive training, so I think understanding is now gradually spreading from both the top and the bottom. I think it will change as the number of people at the management who understand it gradually increases.

Kasuga It seems that it will take some time for this trend to spread. The Group has developed a Value Tree for each operating company, and the Group Management Committee and the Board of Directors of each operating company discuss specific measures for sales growth and improvement of profitability. Together with Group CEO Morikawa, representatives of each operating company Group COOs Okabe and Nagata, and directors of each operating company, we will take a closer look at how we will develop and implement the plan. Although the Value Tree at the Group level was first developed by the holding company from above, I believe that the ultimate goal of the Value Tree at the Group level is to link it to the KPIs of individual Group employees.