

DIALOG 03

Outside Directors × Overseas Institutional Investor



MAKOTO NAKANO

SASHA THOMPSON

Investment Analyst
Highclere International Investors



CHIE GOTO

Corporate Governance of the Avant Group to Support the Realization of a “100-Year Company”

The Avant Group has worked to enhance its corporate value through creative dialogue with investors. In this integrated report, two outside directors held a dialogue with an overseas institutional investor, who is a long-term shareholder of the Group.



Sasha Thompson

Highclere International Investors is a London-based, long-only global (ex-US) small and mid cap specialist asset management company.

Q. Thompson

What do you consider to be the most important aspect of corporate governance?

Goto ■ As a company with an Audit Committee, we believe it is important for the Board of Directors, based on its fiduciary responsibility and accountability to shareholders, to formulate management policies and develop internal controls, and for the Audit Committee to fulfill its responsibilities of effective supervision of execution.

Nakano ■ In other words, it is to fulfill a monitoring function. We must monitor and, if necessary, apply the brakes to prevent the management from going off course or worse irregularities occurring at the company.

That said, it is also important for us to view the company from an investor's perspective and encourage it to increase corporate value over the long term, which is the role of a gas pedal for the company.

Q.

What is unique to the Avant Group in its corporate governance practices?

Goto ■ The first point concerns the number of outside directors. Taking into

consideration the requirements of the Corporate Governance Code regarding the number of outside directors, we voluntarily appoint four outside directors, the majority of the seven members of the Board of Directors, although this is not a requirement for a company with an Audit Committee. We believe that this provides a sufficient structure to reflect the knowledge and perspectives of outside directors in the formulation of management policies, and that the Board of Directors has effectively reserved the right to dismiss the Group CEO.

The second is the DX of the Board of Directors using TRINITY BOARD that we have developed. TRINITY BOARD is a tool that provides a mechanism for directors to access various documents at any time, contributing to the efficient operation of the Board of Directors and other important meetings. It is also useful for group governance, such as improving the Board of Directors through assessing its effectiveness and managing the boards of subsidiaries.

Third, outside directors provide training for directors, executive officers, and executive candidates, drawing on their areas of expertise. By deepening management's knowledge through training, outside directors contribute to the advancement of corporate governance.

Q.

You mentioned that four of the seven directors of the Avant Group are outside directors. How do you think the importance of these outside directors?

Nakano ■ We believe it is important that we serve as a bridge for communication with investors. Even ideas that are taken for granted internally are often difficult to understand from an external perspective, such as that of an investor. We believe it is an important role for outside directors to encourage internal management to communicate in a way that outside investors can understand. For example, in formulating the current medium-term management plan, we repeatedly pointed out the need to revise the wording so that it would be understood by investors.

Outside directors are also important from the standpoint of board independence. Because of our position as independent outside directors, we are able to ask frank questions of the group's CEO, CFO, and other senior management, without being disciplined, and we can sometimes express opposing views.

Corporate Governance of the Avant Group to Support the Realization of a “100-Year Company”



Q. What experience from your past has been most useful to you as an Audit Committee member?

Goto ■ I am a practicing attorney and CPA. As a lawyer, I am able to use my legal knowledge to supervise whether directors are managing the company in accordance with their duty of care, etc., and as a certified public accountant, I am able to look at the company from a numerical perspective, including its finances.

Nakano ■ In my case, my university experience in accounting research has been helpful. When significant changes are observed in financial statements, such as balance sheets and income statements, I am able to infer the factors behind these changes based on my experience in accounting research. This allows me to ask a variety of questions when checking financial statements at board meetings and other meetings.

Also, I have been a faculty member at an MBA school for 25 years and have been training executives of leading Japanese companies for about 20 years. In this context, I have a great deal of opportunity to see the management of Japan's leading companies, and

through this experience, I can envision the path to improving corporate value. I believe that such experience can contribute to enhancing the corporate value of our group.

Q. What are your personal responsibilities in serving as an outside director?

Nakano ■ It is to provide advice from a finance perspective. In order to increase corporate value, it is important to focus on and expand high-margin businesses, rather than just increasing sales. I believe it is my responsibility to constantly check whether such operations are being carried out.

In addition, it is my responsibility to ensure that the medium-term management plan, strategies, KPIs, and corporate value enhancement are coherent and feasible, and to give advice so that investors can understand and accept the plan.

Goto ■ As an outside director and a member of the Audit Committee, I am responsible for supervising and auditing the directors' execution of their duties. In addition, I chair the Remuneration Advisory Committee, which is involved in designing the compensation system and determining individual compensation for Group CEO Morikawa and other senior executives, as well as the compensation system for employees.

I also believe that my role is to appropriately reflect the opinions of minority shareholders and other stakeholders in the Board of Directors, and to utilize my knowledge as a lawyer to identify risks in M&A projects and other transactions from a legal perspective and provide my opinions.

Q. What opportunities and risks do you see in effective corporate governance in a situation

where the Group CEO Morikawa is both the founder and a major shareholder? What are your plans for dealing with them and how are they being addressed?

Goto ■ Group CEO Morikawa has grasped all of the Avant Group's businesses since the company's inception and has been able to make quick top-down decisions based on medium- to long-term management thinking, which he believes has enabled the company to quickly adapt to the rapidly changing external environment while enhancing corporate value over the medium- to long-term.

On the other hand, there can also be the risk of runaway and corruption due to absolute power, such as when top management disregards social common sense and ethics and violates laws and regulations, when they arbitrarily go ahead with high-risk projects, or when they misappropriate company assets and otherwise mix up company and private affairs. To prevent such a situation, the Board of Directors must establish an internal control system that is effective in supervising the execution of duties. The outside directors will seek explanations from the Group CEO regarding management until they are satisfied, examine whether there is anything that cannot be endorsed from the standpoint of shareholders, express their opinions frankly, discuss them at board meetings, evaluate management, and ultimately decide whether the management can be entrusted to the Group CEO.

In addition, if top management has personnel authority, it is difficult for other executives to express their opinions, and the whistle-blowing system may become dysfunctional. The Group plans to improve the system to avoid concentration of management personnel authority in the hands of the Group CEO, by changing the Remuneration Advisory Committee into a Nomination and Remuneration Committee.

Nakano ■ In many listed companies, various problems arise due to the separation of ownership and management. For example, it has been noted that the pursuit of self-interest and sabotage of daily operations can damage shareholder value. In this regard, since the Group CEO Morikawa is also a major shareholder, these so-called agency problems are unlikely to arise.

On the other hand, as Mr. Goto mentioned, there is a danger of falling into dictatorial management. However, I have the impression that the Group values transparency and fairness, and as an outside director I assess that such risks are low.

Q. How important is dialogue with external parties in the development of the Avant Group's corporate governance principles?

Goto ■ As stated in the Group's "Basic Corporate Governance Policy," dialogue with external parties is extremely important for improving corporate value over the medium to long term. The Group regards the



company as a public institution of society and seeks to develop in order to contribute to customers around the world. We express this activity in our corporate philosophy, "Creation of a 100-year company," which has been our management vision since our founding.

The Group aims to be an organization that provides value to society without being biased toward any particular stakeholder and that develops sustainably based on the growth of its employees, and corporate governance is the mechanism for achieving this. We believe that dialogue with various stakeholders, including shareholders, employees, and customers, and improvement of corporate governance as necessary, is important for continuous improvement of corporate value and is necessary to realize a 100-year company. In particular, we believe that dialogue with our shareholders will provide us with an opportunity to grow our Group from an objective and bird's-eye viewpoint.

Q. What is also the most challenging aspect of communicating management's thoughts to investors?

Nakano ■ We are sometimes told that our explanations to investors tend to be inadequate. Management is constantly thinking about the group's operations and tends to lack sufficient explanation of the assumptions behind our actions. Investors do not understand everything about our group, so careful explanations are required so that they can grasp the full picture.

There is also a tendency to undervalue and under communicate one's own company. Although our group's business model is highly profitable and our ROE is solid, we tend to take this state of affairs for granted internally, and we believe it would be a shame if this leads to an overly low reputation being communicated externally.

Finally, getting investors to understand the thinking of the Group CEO Morikawa is another area of difficulty. Group CEO Morikawa is an excellent practitioner as well as an abstract thinker. However, due to its very high level of abstraction, we believe that it is not easy for investors to understand his thought patterns and what he is thinking, and we need to take care to make it easy to communicate.

Q. Are there any areas for continuous improvement in your corporate governance practices?

Goto ■ First, there is insufficient diversity in the appointment of executives and core personnel. Diversity is an important issue for our group, but at present we have not yet set a numerical target for the ratio of women and foreign nationals in our workforce. Although greater diversity on the board of directors is expected to stimulate discussion and better decision-making, not enough is being done to address this issue.

Second, we have not been able to formulate a concrete plan for the selection of a successor to the Group CEO Morikawa. The Board of Directors began discussing this issue in the fiscal year ending June 30, 2018, but has yet to develop a plan, including the selection of specific candidates. We are currently in the process of developing an environment for succession planning, while working to separate the role of the founder from that of the group CEO. I mentioned earlier that we plan to reorganize the Remuneration Advisory Committee into a Nomination and Remuneration Committee, and after the reorganization, we plan to develop a succession plan for the management level, including the CEO. Since it takes time to materialize, we recognize that this is an issue that should be addressed for continuous improvement in our governance practices.