ESG INTEGRATION
INSIGHTS

INVESTORS IN THEIR OWN WORDS

Neuberger Berman

Integrating SASB Standards into Japanese small to mid-cap public equity strategies

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Foreword

Investing in Japan is often associated with the "lost decades"—a term coined after years of deflation and stagnant growth since the bursting of the economic bubble. But what many Japan critics often overlook is that amid the rubble of the old economy are shoots of small to mid-size businesses with solid fundamentals and great growth potential trading at attractive valuations. These companies have historically tended to be market leaders in niche industries protected by disruptive technologies and battle-hardened balance sheets after surviving the lost decades. We call these companies "hidden gems," and they make up our Japan Equity Engagement Investment Strategy. In our view, these gems have exceptional growth potential, but the key to unlocking and sustaining that growth would be for the company to undergo a sustainability transformation. This means recognizing, addressing, and disclosing financially material environmental, social, and governance (ESG) issues. In this case study, our aim is to demonstrate how we go about encouraging that transformation and how the Sustainability Accounting Standards Board's (SASB) Standards and concept of financial materiality plays an integral part in that process.

ESG in Japan

Contrary to critics, we believe Japan's last decade was hardly "lost," especially for ESG investing. The previous government's introduction of the double codes of Stewardship (2013)[1] and Corporate Governance (2015)[2] acted as a catalyst to push both companies and investors for governance reform. Moreover, the Government Pension Investment Fund's (GPIF) decision to sign the UN Principles of Responsible Investment (PRI) in 2015 marked a wake-up call for investors in Japan to focus on not just corporate governance (G) but also environmental (E) and social responsibility (S) issues. Since then, other Japanese institutions have followed suit to participate in the UN-led initiative. Today, Japan is home to the biggest signatories (in terms of assets under management) in the world[3] and more than half of all Japanese assets under management are now considered to include a sustainability component to their strategies.[4] (See Chart 1.) These private-sector efforts along with support from the government could help Japan

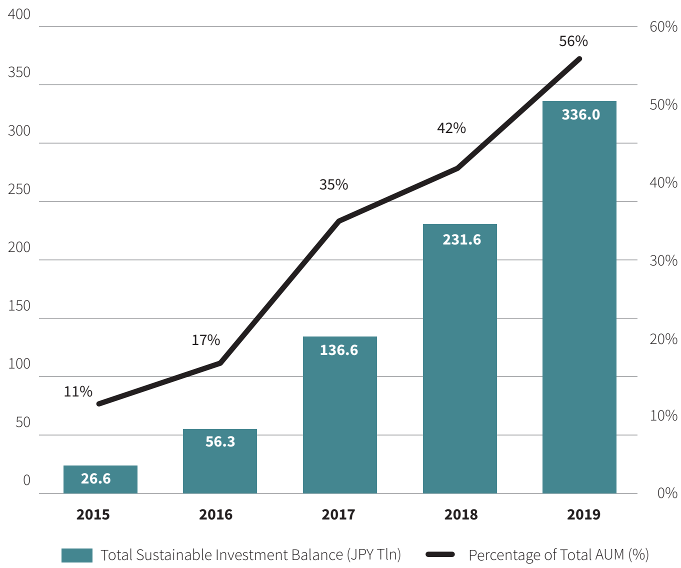
1 The Council of Experts on the Stewardship Code, "Principles for Responsible Institutional Investors <<Japan's Stewardship Code>>—To promote sustainable growth of companies through investment and dialogue—" (Revised March 24, 2020)

2 Tokyo Stock Exchange, Inc., "Japan's Corporate Governance Code, Seeking Sustainable Corporate Growth and Increased Corporate Value over the Mid- to Long-Term" (Revised June 1, 2018)

3 UN Principles for Responsible Investing, "UN PRI Signatory Directory" (October 30, 2020)

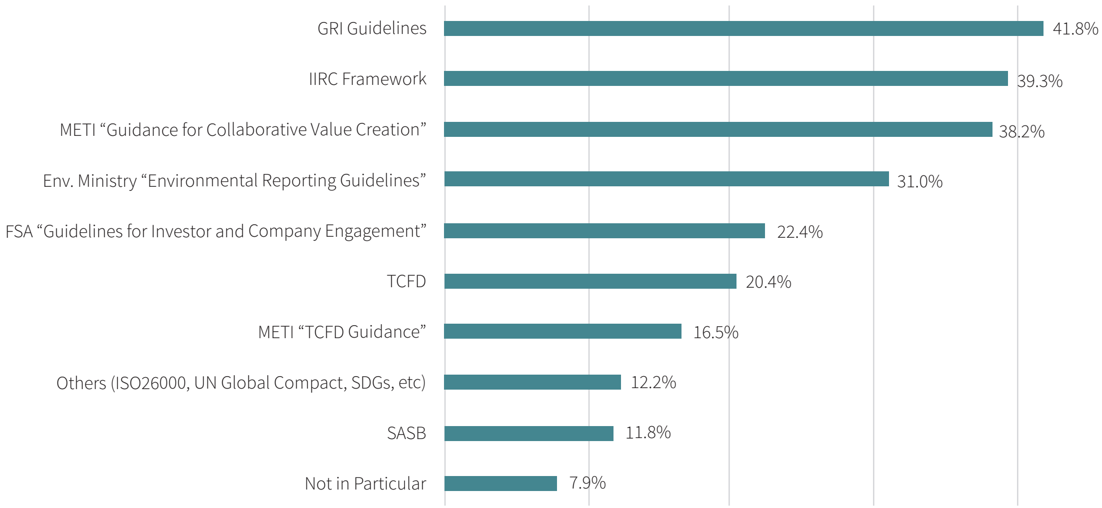
4 Japan Sustainable Investment Forum, "Sustainable Investment Survey 2019" (May 30,2020).

Chart 1: Japan Total Sustainable Investments



Source: "Sustainable Investment Survey 2019," Japan Sustainable Investment Forum, May 30, 2020

Chart 2: Japanese Companies' Frequently Referred Guidelines for ESG Reporting



Source: GPIF "Summary Report of the 5th Survey of Listed Companies Regarding Institutional Investors' Stewardship Activities" (English only available in 4th edition), Government Pension Investment Fund, May 2020 (multiple responses allowed for this question)

transform itself into a more sustainable economy beginning with the target to achieve carbon neutrality by 2050.[5]

These are welcome signs, but data suggests the ESG transition appears to be coming from selected parts of the Japanese economy. Studies have shown that larger-cap companies tend to receive higher ESG scores as opposed to small or mid-cap companies that are given lower or no scores due to lack of disclosure.[6] Based on previous engagements with Japanese companies, we believe there are several contributing factors to this trend. First is the lack of internal resources. Larger, and often blue-chip, companies tend to have teams of dedicated staff to address ESG issues and bigger budgets to outsource time consuming work related to reporting, including publishing reports in English. The second factor is differences in the shareholder base, as larger companies tend to have a higher ratio of foreign shareholders that engage the company and thus help raise awareness on such issues. The third factor is a lack of clarity around ESG reporting solutions. According to GPIF's survey of listed companies (See Chart 2), the most adopted ESG disclosure standard was Global Reporting Initiative (41.8 percent), followed by the Integrated <IR> Reporting Framework (39.3 percent) and the Ministry of Economy and Trade's "Guidance for Collaborative Value Creation" (38.2 percent), with SASB Standards (11.8 percent) further down the list.[7] The fragmented nature of Japanese ESG reporting has created an obstacle for small and mid-cap companies that are eager to improve their sustainability profiles but are often left with little to no guidance on how they should go about addressing and disclosing material ESG issues.

Introduction of the Strategy

The objective of the Japan Equity Engagement Investment Strategy is to seek long-term outperformance versus the benchmark by investing in "hidden gem" companies and to encourage their sustainability transformation through engagement. To realize this goal, ESG considerations are integrated throughout the investment process: starting with universe-level screening, followed by company-level due diligence, and finally the scoring system that ultimately helps determine the company's weighting in the portfolio. Once initiated, the team will continue to maintain close monitoring of the business fundamentals, valuations and the sustainability profile of the company. These factors are inextricably linked and for this reason the responsibility of the strategy's ESG analysis and engagement, including proxy voting, rests on the investment team and not on a separate entity such as a stewardship or responsible investing team. This ensures that our engagement on material ESG issues are linked to factors that move the needle specifically for the business and ultimately performance of the portfolio.

ESG Integration: Analysis and Scoring

We take a two-pillar approach to integrating ESG into our investment process. The first pillar focuses on financially material E and S issues and the second is dedicated to G. The reason we separate these two

5 Policy Speech by the Prime Minister to the 203rd Session of the Diet (Japanese), Prime Minister of Japan and His Cabinet (October 26, 2020).

6 Tomonori Yuyama, *Status and Issues Surrounding ESG Investing and Performance* (English Title), University of Tokyo Graduate School of Public Policy Working Paper Series (February 2019).

7 Government Pension Investment Fund, "Summary Report of the 4th (and 5th) Survey of Listed Companies Regarding Institutional Investors' Stewardship Activities" (English only available until 4th edition), May 2019, May 2020 (respondents allowed multiple responses)

is because our methods of analyzing and evaluating these issues are fundamentally different. (For the sake of this case study, we will focus only on E and S issues.) SASB's materiality framework plays a key role in helping us identify the sustainability factors that we believe could positively or negatively affect our investment thesis of the company during our long-term investment horizon. Hence, in our first step to analyze E and S, we reference SASB's Materiality Map® to identify the key issues within the industry or sector. In the second step, the lead portfolio manager (PM) or analyst will scrutinize these issues with respect to the business model, value chain, growth phase of the company, and competitive position to highlight high-priority issues that need to be addressed immediately. This is done through on-the-ground research combing through years of publicly available company disclosure (often only in Japanese) and through meetings with the company, competitors, suppliers, clients, and external research providers if available. During this process, we leverage Neuberger Berman's ESG team and our proprietary Materiality Matrix as a sounding board to ensure consistency across our assessment. The third step is team evaluation and scoring. Our focus is on how far the company is in mitigating the financially material issues it faces. These scores are then incorporated into the E, S, and G components of our scoring model, which ultimately helps determine the weight of the portfolio holding. The higher the score, the bigger the portfolio weight and vice versa.

ESG Integration: Engagement Process

Once the company has been initiated in our portfolio, we will set an engagement objective and a customized strategy to address the financially material ESG issues we have identified. Our experience engaging companies has shown that smaller companies require more time and resources to address these issues (average 2-3 years for E and S issues). Hence, given the relatively lengthy process, we have adopted a milestone system to ensure our engagement remains on track to achieve the objective. The system has five stages, beginning with our assessment of the material ESG issues to the company fully integrating all the issues addressed. (See Chart 3.)

Based on past engagements, companies have historically tended to face the biggest hurdles overcoming Milestones 3 (acknowledgement and commitment) and 4 (implementation of an action plan). Key reasons include internal opposition over resource allocation and concerns over public image if the firm is unable to achieve its key performance indicators. In our view, many of these concerns are based on outmoded perceptions of corporate social responsibility (CSR) activities (i.e., the perception that ESG activities are unrelated to the business) and short-termism on the part of middle-management. Therefore, our team places great emphasis on Milestone 2 (presentation of our "case" to the company). In this crucial step, we aim to clear away some of these misconceptions and draw a roadmap on how we believe addressing these material issues can ultimately contribute to the long-term sustainability of the business and consequently our portfolio's performance. In this process, we make it a point to meet with senior executives who are the decision-makers within the firm. Based on our previous engagements, the most successful mitigation of ESG issues has come from companies with leadership that is committed to addressing these issues. In the presentation deck used at this phase of engagement, we make a clear distinction between ESG and CSR by referencing the SASB materiality framework and our own proprietary research that links specific material issues with the fundamentals of the business. This part of the deck includes several slides covering how SASB Standards were developed and their relevance from an investors' standpoint.[8] We also present the importance of a materiality analysis to create a list of priority issues to tackle first to maximize the limited resources at their disposal[9]. Finally, we also describe in detail how these factors are woven into our scoring model and investment decision-making process as a message to the company that our long-term interests are closely aligned with management and the successful integration of sustainability into their business model. This is usually the "a-ha" moment of the meeting.

8 Sustainability Accounting Standards Board, "Connecting businesses and investors on the financial impacts of sustainability" (October 13, 2020).

9 Japan Exchange Group and Tokyo Stock Exchange, "Practical Handbook for ESG Disclosure" (March 2020) (Japanese version).

Chart 3: Engagement Milestone System

For illustrative and discussion purposes only. Portfolio managers' views may differ from those of other portfolio managers as well as the views of Neuberger Berman. See Additional Disclosures at the end of this piece, which are an important part of this presentation.

Case Study: Company A (IT Services)

Company A provides sales promotion services to e-commerce sites and in recent years has enjoyed robust growth as a result of the explosive growth of online gross merchandising volume (especially during the COVID-19 pandemic). Japan's e-commerce industry is still at a relatively nascent stage versus markets like the U.S. and China, and this suggests there's still good potential for growth for the company in the long-term. On the other hand, while the business continued to grow at an accelerated pace, we felt that the company's sustainability profile had not evolved in accordance with that speed. Leveraging the SASB materiality framework and our own proprietary materiality matrix, the lead PM analyzed the range of material issues affecting the company based on fundamental bottom-up research and interviews with the company as well as cross-checks with competitors. Based on this analysis, the key issues we identified were: 1) resilience of the IT systems platform (part of the "Data Security" disclosure topic in SASB's Software & IT Services industry standard and 2) employee- and management-level gender diversity (see the "Employee Engagement, Diversity & Inclusion" disclosure topic in the aforementioned Standard). One of the challenges within this firm was getting senior members to understand and embrace the concept of sustainability and how it pertains to the business' long-term sustainable growth. Hence, for this meeting, we invited not just the Director and CFO but also the executive officers in charge of corporate planning who would ultimately be responsible for addressing these issues to speak with us.

The meeting initially focused on data security and associated accounting metrics. The company provides sales promotion services to e-commerce sites and therefore is exposed to operational risks from potential data and systems breaches. Hence, in our review of the materiality of this issue for their business, we raised the fact that the company lacked disclosure on how these risks were being mitigated and highlighted the importance of appointing a management-level executive to oversee firm-wide cybersecurity initiatives. To illustrate this point, we provided examples of other portfolio companies within the sector that make best-in-class disclosures, including how the companies managed past breaches as well as internal stress testing and audits of software vendors. We then explained in detail how this information helped us as investors to better understand the way these risks were being managed and consequently resulted in improved E and S scores and ultimately a higher model weight within our portfolio.

On gender diversity, we commended the company's decision to appoint a female executive officer as a key step to creating female role models within the firm. As a next step, we suggested that the company consider formulating a basic policy on gender diversity that focuses on providing a working environment that supports female employees as well as setting up an evaluation system to promote more female managers to management-level positions. We also suggested that the company consider undertaking a comprehensive assessment of its board members' skillsets and appoint internal or external female executives in areas currently not covered by existing directors. We explained that a diversified boardroom would represent the interests of all stakeholders of the business and would help to foster more dynamic discussions about the company's long-term vision and strategy, which is core to managing a successful and sustainable business in the long-run. After the presentation, the senior managers who attended the meeting said they now had much better insight on why these issues were pertinent to long-term investors and the sustainability of the business. We will continue to closely monitor the progress of the company to determine the next steps of our engagement on these issues.

Challenges

Over the last several years, we have witnessed a substantial increase in Japanese companies' interest in ESG and sustainability topics. In addition to Japan being home to the largest number of UN PRI signatories by AUM, the country also has the highest number of supporters of the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD), at more than 300 institutions.[10] Integrated reporting has also taken off in Japan, with 536 organizations publishing reports based on the <IR> framework in 2019.[11] On the other hand, despite companies making the effort to expand disclosure, Japan's ESG disclosure scores and ratings have not improved at the same pace and continue to lag, especially on E and S, against international peers such as those in EU nations.[12] In other words, despite higher levels of disclosure, the information itself is not helping to improve the market's perception of the companies' sustainability profiles. Based on past engagements, we've noted several recurring themes to Japanese companies' approaches to ESG disclosure. First is the disconnect between the business fundamentals and the ESG issues. This is due mainly to not undertaking a materiality analysis and companies not being able to differentiate between CSR and ESG. Second is the lack of a functioning governance framework to oversee the ESG integration process and therefore running the risk of so-called "greenwashing." Third is the reporting of ESG activities, progress, and KPIs is not aligned with internationally recognized standards. On this last issue, some companies have suggested that the accounting metrics used by international standards are not consistent with industry norms in Japan. Hence, recent steps from organizations like SASB to incorporate more globally applicable accounting standards on financially material issues is a welcome step.[13]

10 "About TCFD Consortium," TCFD Consortium Home Page (September 28, 2020).

11 Disclosure & IR Research Institute, "Final Report on the Status of Integrated Reporting" (February 26, 2020).

12 Kyushu University, "Research on ESG Factors and Corporate Value" (English Title) (March 2018)

13 Sustainability Accounting Standards Board, "Promoting Clarity and Compatibility in the Sustainability Reporting Landscape," (July 12, 2020)

Conclusion

At the end of our engagement meetings, we often spend a couple of minutes asking management for feedback and whether other shareholders have approached them in the same manner. In almost every case, the company responds that while they have received questions on corporate governance, this meeting was the first on financially material E and S issues, and their first time hearing about SASB. We conclude that one reason why there appears to be a sustainability divide between large-cap blue-chips and small land mid-caps is because investors in Japan have not engaged small and mid-cap companies enough on these issues to help raise more awareness among small and mid-caps. In the 2020 GPIF survey of listed companies, 43 percent of respondents said they have been approached by an engagement or activist fund, of which 85 percent said they had agreed to meet the investors.[14] However, the majority of these meetings were focused solely on business fundamentals, strategy, and capital management, while only 10 percent covered topics related to ESG and sustainability pertinent to the business. A purely ESG meeting was a mere 2.2 percent.[15] Hence, it is our view that investors, especially those with a long-term view, may have a bigger role to play by integrating material ESG issues into their investment strategies, helping enhance the sustainability of portfolio companies and ultimately generating alpha over the long-term.

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14 Government Pension Investment Fund, "Summary Report of the 5th Survey of Listed Companies Regarding Institutional Investors' Stewardship Activities" (English only available until 4th edition), May 2020 (respondents allowed multiple responses)

15 Ibid

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