

Independent Director Dialogue

“History” and “Future” of the Evolution of Governance



Outside Director
Chair of the Compensation Committee
Member of the Audit Committee
Sayoko Izumoto



Outside Director
Chair of the Board of Directors
Chair of the Nominating Committee
Mitsudo Urano

Amid drastic change in society and economy, the HTS Group focuses on value creation through “LOGISTEED,” “collaborative innovation,” “expansion of ecosystem,” and “Gemba” Power. How has the underlying corporate governance changed so far and how will it evolve in the future to support sustainable increase of corporate value? Two independent outside directors held a dialogue.

Mr. Urano and Ms. Izumoto have served as the Company’s independent outside directors for six years and three years, respectively. What do you think of the characteristics of the Company’s current governance?

Urano: I think it’s easier to understand the characteristics of the Company’s current governance if we learn its history. The Company was established as a logistics subsidiary of Hitachi, Ltd., which still owned more than 50% of sharers when I became outside director in 2014. At that time, it had been over ten years since the Company transitioned to a Company with Committees in pace with Hitachi, Ltd., but the system was not fully functioning. However, as a result of our efforts to drastically change that for the past six years, I believe it is now effectively functioning. For example, based on various opinions from our stakeholders, the Compensation Committee successfully aligned the compensation plan for officers with the level required by the Corporate Governance Code in FY2020. The Nominating Committee also organized the

“Vision” of the Company’s board directors and executive officers and operates a system to objectively evaluate CEO. The Audit Committee inherited the excellent system of the Hitachi Group, which is functioning well.

Izumoto: As I concurrently hold a position of outside audit and supervisory board member in other company with an audit and supervisory board, I get the impression that in the Company, being a Company with a Nominating Committee, etc., each of the three Committees is clearly functioning. Resolutions at these Committees would never be altered by the Board of Directors, and each Committee is functioning quite well, ensuring the effectiveness.

Urano: On the premise that the three Committees are functioning well, I believe the core of governance lies with the Board of Directors. I’ve been saying at the Board of Directors meetings that “the Company’s growth strategy should aim to satisfy all stakeholders including the capital market.” If we can achieve this, I think we can say, “our governance is effective.” Because the Company was a

consolidated subsidiary of Hitachi, Ltd. in the past, there was plenty of room for improvement in terms of the consideration for the capital market. However, after Hitachi, Ltd.'s ownership ratio declined to 30% in 2016, the Company significantly changed its direction to push forward its growth strategy under its own governance. The Board of Directors feels proud that it has successfully strengthened the Company's initiatives to appeal its growth strategy to the capital market under its supervision.

I think that our growth strategy has three aspects of "M&As," "development of new products and services," and "productivity improvement." And what we should focus on should be discussed at the Board of Directors meetings based on the stage the Company is in at that time. The Company is currently in the middle of the growth stage and has achieved the growth strategy by "M&As" in the past ten years with revenues increasing more than twofold. We also made solid progress in the "development of new products and services" based on 3PL with our new business concept of LOGISTEED starting to be developed. As for "productivity," the Company is enhancing its initiative for "VC21 activities." I believe our growth strategy with "M&As," "development of new products and services," and "productivity improvement" has been making excellent progress so far.

Under such circumstance, if we are going to talk about some issues to be resolved as we continue to improve effectiveness of governance, the first one is that there is room for improvement in capital efficiency. The second one is that while most of M&As were successful, there is some room for improvement in group governance. The third one is that our IT infrastructure needs to catch up with the level of digital transformation (DX) in society. The Board of Directors will address these issues and share the growth strategy with each stakeholder. In specific, we will place emphasis on changing the portfolio and continue to focus on "M&As" and "development of new products and services."

Could you give us some examples of discussions toward the resolution of those issues at the Board of Directors meetings?

Urano: At the Board of Directors meetings, opinions offered and questions raised by directors from their professional viewpoints will always become useful in decision-making at some point in the future. As the Company adopted a Company with a Nominating Committee, etc. System, whereby the authority is substantially delegated to executive officers and day-to-day decisions are made by the Executive Committee while the Board of Directors concentrates on discussions on the underlying basis for such decisions. For example, before developing the Mid-term Management Plan with strong emphasis on capital

efficiency or introducing the concept of Total Shareholder Return (TSR), the Board of Directors first discussed the underlying basis for the decision-making.

How were you involved in making the sites aware of capital efficiency?

Izumoto: While the Board of Directors discusses the "underlying basis" for the enhancement of awareness of capital efficiency, the Audit Committee ensured to give instructions to incorporate performance indicators such as ROIC and total asset turnover ratio in their target whenever it visited the sites for audit. As a result, employees on sites are starting to become aware of not only profit and loss items such as revenues and gross profit but also balance sheet items such as capital efficiency and asset turnover ratio. I believe we have produced remarkable results in this regard.

Urano: While I value the fact that the Company has changed so much in four years, I also think we need to work on further enhancement. For example, the Company's asset balance increased significantly due to the adoption of IFRS 16 Leases in FY2019. When I discussed what we should do with the sites, I got an impression that they only cared about profit and loss items such as operating margin. If they truly understand ROIC, they can easily understand that the most important thing for the Company right now is to "improve turnover ratio." Furthermore, I believe we should expand collaborative innovation with SG Holdings Group, 24-hour operation of logistics centers, and collaborative logistics with multiple cargo owners under such BS-based thinking. It is true that ROIC management and BS-based thinking are starting to spread into the sites through the initiatives implemented so far, so I hope to see further evolution through activities such as VC21.

Please tell us about the benefit of a very high ratio of outside directors*.

Izumoto: As the Board of Directors comprises outside directors having a wide variety of expertise, it is expected to produce synergy effects, and also the atmosphere that allows directors to give their candid opinions to CEO and other directors and stimulates active discussions has been created. Prior explanation and sufficient information are provided to outside directors. I always felt that we could have more effective discussions if we add more outside directors with management experience, and we recently welcomed a new outside director, so I'm looking forward to the future Board of Directors meetings.

Urano: I think it is good to have more outside directors than

* Of nine directors, seven are outside directors including six independent outside directors (as of June 23, 2020).

inside directors. But having many outside directors will not lead to effective discussions if they don't say anything or they mainly ask questions. However, because the Company ensures to provide prior explanation to outside directors before the Board of Directors meetings, very few simple questions are asked now. So, I think it is important for outside directors to think regularly about "the fields in the Company they can contribute to" using their expertise and to express their opinions. As for me, since I became outside director, I've made use of my insights acquired over the years to call the Board's attention to the two points of "how to cope with the capital market" and "capital efficiency" in every discussion. I think each outside director express their opinion in consideration of "how and where I can contribute" based on the stage the Company is currently in. I agree with Ms. Izumoto about the attribute of outside directors. Considering the current stage of the Company, it is preferable if the majority of the outside directors have management experiences, and I recognize that as one of the issues that needs to be addressed in the future.

In association with the attribute of outside directors, what are your opinions on diversity of the Board of Directors?

Izumoto: We should discuss diversity in a broader context including background, skills, and insights as well as gender. About female directors, I haven't really thought about being one of them myself when I'm working. In terms of skill-mix, I think having more directors with management experiences or IT expertise will further stimulate discussions on DX. Considering that the COVID-19 pandemic is accelerating DX in society, I think this is an urgent issue.

Urano: As for diversity, I think the world has started to see its true nature. Until the 20th century, the strength of Japanese companies was that groups of the same nature were working hard, and that was one of the key growth drivers. All this has completely changed, and it is an era where companies made up only of people of the same nature are at risk of being endangered. Thus, I recognize the true nature of diversity is how people of different nature can pursue growth by interacting with one another. Of course, it includes women and also diversity of nationalities, and in a wider sense, I think human resources with different "cultural background" and "body of knowledge" should take advantage of diversity. In that sense, the Company, under the policy of President Nakatani, has proactively recruited outside talents mainly as executive officers and general managers in the past five to six years. For example, in the finance division, insights of the talent with finance experience in other company are quite valuable to the Company whose entire finance operations used to be handled within the Hitachi Group for a considerable period

of time. Also in the sales division, having the talent with experience in logistics sales in a trading company should bring a whole new perspective. If we are to try such various combinations, I think the quickest way would be to recruit human resources with experiences.

In FY2019, the Company engaged a third-party assessor for evaluation of the effectiveness of the Board of Directors for the first time in addition to the conventional self-assessment. Please tell us about the issues pointed out at the evaluation.

Urano: Various issues were pointed out, but the one pointed out in both the third-party assessment and the self-assessment was "whether the discussions by the Board of Directors really consider all stakeholders." With the expanding movement toward "stakeholder capitalism" in mind, we will deepen discussions to enhance dialogue with stakeholders by taking advantage of each director's characteristics such that some directors will take care of the capital market and some directors will take care of employees.

Izumoto: There was a recommendation to the Board of Directors to further deepen its discussions. It's true that because of the large number of agendas and the timing of receiving materials, we sometimes need to ask questions, but I hope to secure as many hours as possible for discussions. Moreover, we always need to understand the current situation and "atmosphere" of the sites to deepen our discussions, but information gap tends to occur between directors who are members of the Audit Committee who frequently visit sites and those who are not, which is also an issue. As this was also pointed out as an issue in the self-assessment, the Company created more opportunities for directors who are not members of the Audit Committee to visit the sites. I believe we can further enhance the effectiveness by continuing to increase such opportunities and deepening discussions closely linked to the "atmosphere" of the sites.



Please tell us about major improvements or changes in or themes that you think should be improved about the Company's governance in recent years other than the effectiveness of the Board of Directors.

Urano: Although we have resolved most of the issues that need to be improved one by one in the past six years, one thing that still remains as unsolved issue is a schedule of the Executive Committee meetings and the Board of Directors meetings. The Board of Directors meetings are often held on the following day of the Executive Committee meetings, but discussions at the Board of Directors meetings could turn out to be useless if directors don't understand the process leading up to decision-making at the Executive Committee meetings. There have been cases where I thought we could have had more constructive discussions if we had had the knowledge in advance. In companies where the executive committee and the board of directors are functioning well, they usually hold their meetings with an interval of approximately two weeks. I think it is possible in the Company as well if each executive officer moves up their process to obtain the president's approval. As we have already created the atmosphere where we can have a lively, open, and frank exchange of views, we should be able to further evolve the Company's governance if outside directors can know in advance what has been discussed by the Executive Committee.

Izumoto: I think we should proactively streamline wherever possible in order to secure time to discuss key themes as much as possible. For example, we receive reports from executive officers on the status of the execution of their duties at the Board of Directors meetings, but I feel the amount of information is too much. I think the objectives of the initiatives they worked on and a summary of the results and explanations on future issues and key points of priority measures should suffice for reports to the Board of Directors.

How do you recognize the effectiveness of the Board of Director's supervisory function over management?

Urano: As I mentioned earlier, I think the fact that we have changed the Company's "common sense" until six years ago from various aspects is a kind of proof that our supervisory function has been fulfilled. For example, under the recently introduced performance-linked stock compensation plan for executive officers, because of the new system aimed at the alignment of executive officers' interest with those of the shareholders, there may be a case where individual compensation will decrease depending on the business performance and fluctuations of stock value. Moreover, it was unthinkable in the Company's previous culture that the Nominating Committee evaluates CEO's performance based on concrete figures. In addition to these reforms, I think there are three essential points to the supervisory function of the Board of Directors: "is it consistent with the growth strategy?" "is the Company willing to take necessary risks?" and "is the succession plan of CEO fully operational?" With these in mind, each outside director should make recommendations by taking advantage of their expertise as I believe it will lead to further enhancement of the Board of Directors' supervisory function.

Izumoto: Our activity as members of the Audit Committee is based on a cycle in which we point out various matters, submit an audit report, receive reports on the progress of improvement measures regularly and point out again the matters that still need improvement. So, it is easy to feel that the Audit Committee is functioning well. On the other hand, what I said at a Board of Directors meeting is not necessarily reflected in the discussion in the next Board of Directors meeting, so it's hard to feel how much contribution I have made as supervisory function. However, we can clearly see how much things have changed over the long term if we look back. I think that's how we can feel for the first time that the supervisory function has been fulfilled.

Urano: In a Company with a Nominating Committee, etc. like the Company, I think there is a very sensitive issue as to how to use two words of "supervisory" and "audit" differently. In my personal opinion, "audit" refers to checking and instructing so that matters and budgets that a company has already determined are carried out as planned. On the other hand, "supervisory" covers a wider area and refers to recommending matters including those that a company has not determined or prepared yet. For example, recommendations from perspectives of "how will the Company's growth contribute to stakeholders?" "when the Company's core business becomes no longer the growth area, which area should we expand instead?" or

"assuming no growth, how should we share values with stakeholders?" The Audit Committee of the Company, however, is different from other companies' audit committees, and not only checks the status of budget attainment but also makes recommendations by looking slightly further into the future. I think this is excellent.

Please tell us how you are using your skills, achievements, and experience in the management of the Company.

Urano: For the persons with management experiences like myself, the key is how they can use whatever they have put all their energy into in their past careers. I've served as outside director in various companies, and I always asked first what they expected of me as outsider director. Sometimes I declined the offer because the answer was not clear. In the case of the Company, at the interview with Mr. Suzuki, then Chair of the Board, we both agreed that "HTS needs to give consideration to the capital market in order to function as an independent company," which was the deciding factor because what I put all my energy into in my former job was the improvement of capital efficiency. If each outside director clearly recognizes their respective role, it may lead to the most important diversity of "diverse capabilities."

Izumoto: As I'm a certified public accountant whose expertise is quite clear, I think I was expected to serve as a member of the Audit Committee from the beginning.

In association with the previous question, please tell us about the policy of the Nominating Committee for the selection of candidates for outside directors?

Urano: What kind of human resources a company needs differs depending on the stage that company is in. As I mentioned earlier, the Company is currently in the growth stage, and I believe it is preferable if the majority of the members of the Board of Directors have management experiences. Also, the succession plan clearly specifies profiles and job descriptions for the selection of the management members from within the Company, and we have been advancing relevant discussions. In particular, the succession of CEO is recognized as an urgent issue.

For the Company's future growth, what kind of management issues do you recognize?

Urano: Considering the industry HTS is currently in or HTS's position, I'm certain we have enough potential for growth. Based on such premise, I think there are mainly three management issues. The first one is the acceleration of DX. The Board of Directors also recognizes its importance, and we have to strengthen DX speedily, while bringing in outside talent, to the level that all business departments

can build their own IT governance. The second one is the change of the business portfolio. In order to present a convincing revenue growth scenario to the capital market, it is desirable to change the business portfolio including M&As during the period covered by the current Mid-term Management Plan. The third one is the enhancement of group governance. While the Audit Committee is functioning quite effectively, I recognize there still remains some issues if we include internal control and compliance. I think we should enhance the group governance with an aim to formulate an integrated group governance under the leadership of the Audit Committee.

Izumoto: I also recognize that the Company's issue is the enhancement of the group governance, especially the governance of the overseas group companies consolidated through M&As. Previously, there were some aspects resulting in insufficient group governance such that managers of the accounting division concurrently served as part-time audit and supervisory board members of several group companies. But the situation was considerably improved after the Group introduced a dedicated corporate auditor system about two years ago whereby a person serves as a dedicated corporate auditor of several group companies. As there are some group companies that haven't introduced this system yet, we will continue our efforts to spread the system. In addition, vigorous efforts have been made to hold the Group Corporate Auditor meetings for corporate auditors only to exchange opinions and various other briefing sessions, and I think the Group is headed in the right direction.

Finally, please give us a word of advice for further growth of HTS and sustainable increase of corporate value in the future.

Urano: I think it all comes down to the aim of "increasing capital turnover ratio to improve capital efficiency." I don't think the current HTS can improve capital efficiency without increasing turnover ratio. Even with the impact of IFRS 16 Leases, the Company has to improve total asset turnover ratio to 1 or higher by turning over capital as quick as possible. Keeping this in mind, I will continue to make recommendations on various matters.

Izumoto: As I mentioned earlier, the Company needs to enhance group governance, but we should not impose excessive burden on the sites by making too detailed and strict demands. As long as we stay on the objective and remember "what we are doing it for," I think it is possible to enhance governance effectively while reducing the burden on the sites. I will continue to make recommendations from such viewpoint.

