METRICAL INC.
corporate governance, investment research & solutions

8th April 2017

Corporate Governance Research: Canon (7751)

Summary:

Canon is a kind of a model of Japan's corporation in corporate governance. Japan's CG for many companies with poor performance (lower profitability) are attempting to "look good" in front of investors by adopting practices deemed to be preferable. These companies employing multiple outside directors is quite new and appointing 2 independent directors. Canon newly set up committees of nomination and compensation. But Mr. Mitarai is the chair of the both committees. In case of including CEO in the member, the nomination procedure might hardly conduct in objective. For compensation, the proportion of compensation between fixed salary and variable bonus should be revised by raising variable much higher. Lastly, the company does not seem to have used optimal capital allocation. For achieving growth of company or shareholders value, Canon should explain much clearer growth strategy by including optimal capital policy and business strategy.

CG Rating

B+

75.3

Shareholders:

1) Japan Master Trust trust a/c (5.00%), 2) Japan Trustee trust a/c (3.80%), 3) Daiichi Life Insurance (2.81%), 4) Barclays Securities (1.95%), 5) Mizuho Bank (1.69%), 6) Moxley & Co (1.51%), 7) State Street Bank Trust Client treaty 505234 (1.32%), 8) Sompo Japan Nippon Koa Insurance (1.31%), 9) Obayashi Corporation (1.24%), 10) Japan Trustee trust a/c 7 (1.13%)

Organizational Structure:

Company with corporate auditors

Board of Directors:

Term of office: 1 year
Chair of board: chairman
Number of directors: 7 *(increased from 6 of the previous year)*
Outside directors: 2 (Independent directors: 2)
Kunitaro Saida- lawyer, being in charge of 2 other outside directors and 1 outside auditor
Haruhiko Kato – ex-Ministry of Finance, being in charge of 1 other outside director
Nomination committee: 4 (Outside directors: 2) *Newly set up committee in September 2016*
Compensation committee: 4 (Outside directors: 2) *Newly set up committee in September 2016*
Corporate Auditors: 5
Outside auditors: 3 (Independent auditors: 3)
Tadashi Oe - lawyer, being in charge of 1 other outside auditor
Osami Yoshida – chartered accountant
Kuniyoshi Kitamura – ex-Daiichi Life Insurance, being in charge of 1 other outside auditor
Total independent directors + auditors: 5
The number of Board of Directors was added to 7 from 6, maintaining the number of independent directors of 2 which is at least requirement of Corporate Governance Code. May be an independent director is likely to be add, if the rule of JPX400 Index composite will revised to 3 independent directors in the coming year from 2. The big change of the board practice was newly set up committees of nomination and compensation. For both committees, they include 2 independent directors of total membership of 4, but the chair of the committees would be Mr. Mitarai as chairs are internal director and CEO is the member of the committees. The committees would not effectively function if all members are sit by independent directors in particularly nomination.

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Nomination of Director:

"In September 2016, the Company established the "Nomination and Remuneration Advisory Committee," a non-statutory committee, which consists of the CEO, two Independent Outside Directors and one Independent Outside Audit & Supervisory Board Member. In the future, at the time Director and Audit & Supervisory Board Member candidates are nominated and Executive Officers are selected (includes the selection of the successor of chief executive officer), the CEO recommends candidates thereof from among individuals that have been recognized as having met the prescribed requirements, and the Committee checks the fairness and validity of such recommendation prior to submission to and deliberation by the Board of Directors."

According to its CG guideline, the nomination policy is fair and transparent as stated above. However, the committee is consisted of CEO and 2 independent directors and an outside corporate auditor. This would hardly secure objectivity and transparency. Mr. Mitarai has been ruling the company almost 2 decades and maintains strong power in the company. How was Maeda decided as the new president? It is not certain if Mr. Maeda is a real successor after Mr. Mitarai. For long-term view, the nomination of directors and succession plan is one of the most important matter. Nomination committee should exclude the CEO from the committee first. Canon has also vague nomination policy. Candidates of director should have appropriate knowledge, skill and experience that should match with needs as well as mid-to-long term strategy of the company. Candidate searching should use outside source such as executive search and etc. Preferably, reasons of nomination should be disclosed on the above needs based matching. Making clear guideline is required.

Compensation Policy:

"The Company established the "Nomination and Remuneration Advisory Committee," a non-statutory committee, which consists of the CEO, two Independent Outside Directors, and one Independent Outside Audit & Supervisory Board Member. The Committee examined the rationale of the remuneration system, including calculation standards of the basic remuneration and the bonus, and reported to the Board of Directors that they considered the current remuneration system reasonable, at the meeting of the Board of Directors held in September 2016.
The basic remuneration and bonus amount for each Director and Executive Officer is determined by the Board of Directors in accordance with calculation standards examined by the "Nomination and Remuneration Advisory Committee." The total amount of "basic remuneration" for Directors is within the limit of the remuneration amount that is resolved by the general meeting of shareholders. As for the "bonus" for Directors, the payment is fixed provided that the proposal about such payment submitted at the ordinary general meeting of shareholders is approved."

As the company states above policy, Canon has still unclear compensation policy. Generally, compensation policy should reflect company's mid-to-long-term strategy and uses to motivate directors to perform well, considering compensation level of industry and its employees. Also, it shows how much the remuneration allocates to variable and fixed and more detail about design of incentive plan.

Compensation of Disclosure:

Disclosure of remuneration of each director: Partially disclosed
Guideline of remuneration: Yes

Due to transparency, ultimately full disclosure of compensation is recommended in each director level in future.

Incentive Plan:

"Incentive plan of Compensation: performance based remuneration + SO
Person to be entitled stock option: Executive Directors, Executive Officers and others
"As for the bonus, based on standards set by the Company, the total amount tied to

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performance in a given year is calculated and placed on the agenda of the Company's Ordinary General Meeting of Shareholders for approval." "Individual disclosure information for those whose total remuneration is 100 million yen or above is contained in the Company's annual securities report (as shown below)."
Fujio Mitarai JPY273 million (Fixed Salary), JPY24 million (Bonus), Total JPY297 million
Masaya Maeda JPY117 million (Fixed Salary), JPY14 million (Bonus), Total JPY131 million
Toshizo Tanaka JPY125 million (Fixed Salary), JPY14 million (Bonus), Total JPY139 million
"From 2008 to 2011, once a year, after being approved at the ordinary general meeting of shareholders, share options were granted as stock options with the aim of raising the motivation and morale of directors and executive employees, the target group, from a mid-to-long-term perspective. No new share options have been granted since the grant in 2011."
Preferably, incentive remuneration should incorporate long-term vision and short-term performance. As shown above, fixed salary is too high or variable remuneration (bonus) of total compensation is too low although earnings did not perform well. In this incentive or compensation structure, managers do not take risk for growing company.

Evaluation on Board of Directors:

"Once a year, the Board of Directors conducts analysis and evaluation based on equate for each Director and each Audit & Supervisory Board Member about the effectiveness of the Company's Board of Directors. For FY2016, the board holds the meeting in February 2017 and concluded the board is effectively functioning. The Board of Directors, based on such results, strives to improve the function of the Board of Directors when necessary in operation of the meeting (timing of material distribution, frequency of meeting and discussion time), function of decision-making and supervising (guideline and items of agenda and reporting) and role of outside directors and corporate auditors."
More importantly, action for enhancement should be explored. Unfortunately, current theme and future solution are not seen. Explicitly weakness should be listed and discussed more than once for improvement.

Training Policy of Directors:

"For Directors and Audit & Supervisory Board Members, when assuming their positions, training is carried out with the aim of thoroughly understanding their roles and responsibilities and securing necessary or useful knowledge for them to properly fulfill their duties. Also, incumbent Directors and Audit & Supervisory Board Members can, at the Company's expense, attend training courses held inside and outside the Company. Furthermore, Outside Directors and Outside Audit & Supervisory Board Members, to familiarize them with the Company's business, are given opportunities, including attending important meetings such as meetings of the Corporate Strategy Committee, holding meetings with the person in charge of business divisions, and visiting operation sites as necessary."
Periodical training and seminar are useful. All directors must maintain keeping up with knowledge level in all matter of management. The company should explicitly state fee of outside seminars is paid by company in the policy. A newly elected director should take training prior to AGM.

Shareholders Meeting:

Notice of Convocation: sent 24 days prior to the date held AGM
Date of AGM: held on March 30th 2016
Electronic Voting: Yes
Disclosure of AGM information on company web site: Yes
Notice of Convocation in English: Yes

Investors Relation:

IR meetings for analysts: semiannually (explanation by representative director: Yes)
IR meetings for overseas investors: Yes (explanation by representative director: Yes)

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Disclosure of IR information on company web site: Yes CG Report translated in English: Yes IR department: Yes

Takeover Defense:

Takeover defense Plan: No

Cross Holding Shares:

"For the mid- to long-term growth of the Company, ceaseless improvement of respective systems like development, production, and sales, is essential. It is, however, difficult to achieve all of this solely through the management resources of the Canon Group. The Company decides in some cases to hold shares of companies outside the Canon Group as part of cooperation with such companies, when it determines that such shareholding would be beneficial to strengthening of those systems." "Among the strategic shareholdings described above, for major ones, the Company examines the rationale of such share holdings by yearly and periodic evaluation of the significance of the holdings, the performance of the invested companies, and other aspects, and making reports to the Board of Directors." *Dollar value of holding shares other than investment purpose increased from JPY35,030 million (03/2016) to JPY35,978 million (03/2017). Holdings remain relatively small compared with company business. Holding shares/total sale is approximately 1% such as 1.06% (03/2017) from 0.92% (03/2016). 1 name was removed from its holdings for FY12/2016.*

Mid-Term Growth Target

Quantitative Target by company	Sales JPY5,000 billion, OPM15%, NPM10%, equity/Total Assets70% (12/2020)
ROE	5.2% (03/2016) actual
ROE or a concept such as Cost of Capital is preferably included if MTP is seriously projected on concerning about maximizing shareholders value. ROE is likely to improve for this FY hitting the bottom in the previous FY but ROA remains still lower at 2-3% level. However, both goals of achieving OPM=15% and equity/TA=70% seems to be difficult at the same time. Reasonable goal or explanation of the target should be explained.	

Shareholder Return

Dividend per Share	JPY150 (12/2016) actual, N/A (12/2017) company guidance
Dividend Payout	108% (12/2016) actual, N/A (12/2017) company guidance
Share Buyback	No (12/2016) actual
Operating CF=JPY500 billion (Net Profit=JPY150 billion, Depreciation= JPY250 billion), Capex=JPY206 billion + Acquisition=JPY650 billion, Dividend Paid=JPY163 billion (03/2016) actual	
FCF was negative of (-) JPY356 billion. In addition to stable increase in dividend, acceleration in business growth should be expected to investors more clearly after acquisition of Toshiba Medical.	

Capital Policy

Equity Issuance	No (12/2016) actual
Share Cancelation	No (12/2016) actual
No risk of dilution by equity issuance and no share cancelation for the previous year.	

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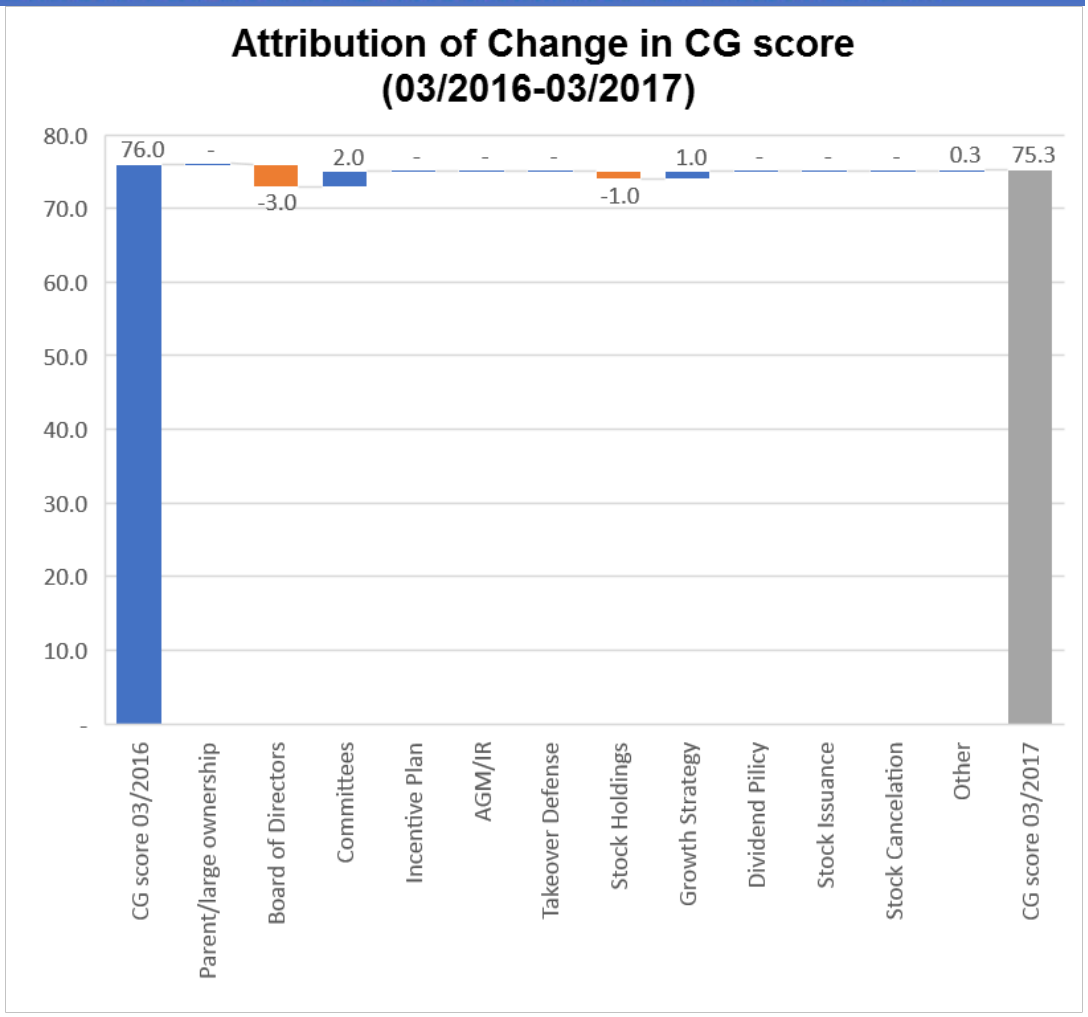

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The author of this report is not in relation of serious conflict of interest with the reported company.

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