13th August 2020

# Corporate Governance Research: Disco (6146)

**Summary:**
Disco's corporate governance was slightly higher than the average* and the financial performance such as ROE is above average, too. Capital policy is clearly stated including the shareholders return policy. Together with the superior performance, the shareholders would be happy to hold the shares. However, the corporate governance research helps to prevent from risks that would occur sometime in future. In this viewpoint, there are a number of issues on the corporate governance practices of the company.
In the board practices, the company should improve to diversity in the board of directors in gender and country, and preferably the majority of the board should be comprised of the outside directors. The board directors should be re-elected every year and the outside board directors are preferred to the business background rather than academic background. Nomination & Compensation Committee should run in transparency and objectivity. In fact, the chair of the committee is the president and the former chairman (ex-CEO advisor, at present) of the company is a member of the committee.
As for the compensation incentives, the allocation between fixed salary and the performance-linked remuneration of the board directors is half and half in the base case of achieving the recurring profit margin more than 10%. The scheme or the formula is designed to pay a stable salary first. Even in the incentive, the stock option has several issues in the asymmetric profit/loss profile that is different from the common shares and the granting the directors at JPY1 that offers the profit between the market price and the cost of JPY1 a share.
On the other hand, there are appropriate conduct in no takeover defense provision, little policy stock holding and clear capital policy. However, historically the president was from the founder's family, but the family's ownership seems to be about 20%. The 20% ownership would be comfortable % between the family and other shareholders. The president and family are aligning to the shareholders in securing the sustainability and maximizing the long-term interest. However, how long the relationship continue is unknown, as many Japan's family companies gave up the seat. As far as the company has no takeover defense provision although it would be set up in emergency, the share price to remain higher. In this sense, the company should try to enhance the corporate governance practice further, removing future risk and keeping good relationship with the shareholders.

*METRICAL CG Score of Disco was 64.34 (average of 1,748 companies as of July 2020 was 54.99). The score of the company was above average in the universe.

**1. Shareholders Structure**
The shareholder structure has been diversified for years but the president was served by the founder's family historically. The founder's family seems to maintain the ownership around 20% at present, including the several holding companies such as Daiichi Holdings, Daiichi Kogyo, Orange Coral Inc. and Blue Ocean Inc. The shareholder structure on the % of the family's ownership will not change much as the company hasn't raised equity capital since December 1999. 20% of family ownership would be a sort of comfortable balance for the family and the shareholders on the performance. Family ally to the shareholders in raising the shareholders return as one of the largest shareholders, while the family maintains controlling the company. Of course, the company must conduct the management in transparency.



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[Top10 Shareholders as of June 29, 2020]
1. Japan Trustee Services Bank (trust a/c) (8.18%)
2. The Master Trust Bank of Japan (trust a/c) (7.51%)
3. Daiichi Holdings Inc. (5.55%)
4. Daiichi Kigyo Inc. (5.15%)
5. OctagonLab Inc. (5.13%)
6. Japan Trustee Services Bank (trust a/c No. 9) (2.74%)
7. Japan Trustee Services Bank (trust a/c No. 4) (2.55%)
8. Kazuma Sekiya (1.94%)
9. Orange Coral Inc. (1.68%)
10. Blue Ocean Inc. (1.64%)

**2. Board Structure**
[Organizational Structure as of June 29, 2020]
Disco maintained its board structure of 'Company with corporate auditors.'

[Board of Directors: as of June 29, 2020]
An increasing number of companies has changed the term of office of the board directors from 2 years to 1 year. The company hold the term of office at 2 year. Reelection every year offers the shareholders an opportunity of reviewing the board directors by voting. The company should change it to 1 year soon. On the other hand, the good things of the board structure is the compact board. The board of directors is comprised of 6 board directors. Such a small number of Board of Directors (BoD) would lead to the quick decision-making. Ideally, the independent outside directors should become the majority of the BoD. As for the member of the BoD, 2 are from the founder's family, while the 2 outside directors are from academia but executive manager of a company. In the discussion in the BoD, business management experience is plus. If the company values the technology perspectives, professors can be hired as a technical advisor. As pointed out in the CG report, the diversity is a big issue of including a woman director. As the more than 80% sale is from outside Japan, the board members should be considered diversity in country. Another good thing is that few outside director holds outside director at not more than 2 companies. Inasaki serves an outside director at only 1 company other than Disco.

Term of office: 2 year
Chair of board: President
Number of directors: 6
All board directors are male (no female board directors)

Outside directors: 2 (Independent directors: 2)
1. Mr. Ichiro Inasaki – Professor emeritus at Keio University and Outside director at Sodick (6143, JP)
2. Mr. Shinichi Tamura – Professor emeritus at Osaka University

[Ownership of shares by directors: as of March 2019]
All the inside directors own the shares. This would secure the commitment of managing companies as well as the alignment of the goal of management and shareholders. On the other hand, outside directors aren't the shareholders. Even the outside director can hold the shares for further commitment of the management.

1. Kazuma Sekiya, President: 700,000 shares & (43 SO*)
2. Noboru Yoshinagai, Senior Managing Director, Sales: 5,000 shares & (10 SO*)



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3. Hideyuki Sekiya, Managing Director: 294,000 shares & (16 SO*)
4. Takao Tamura, Managing Director: 2,000 shares & (16 SO*)
5. Ichiro Inasaki, Outside Director: 0 shares
6. Shinichi Tamura, Outside Director: 0 shares

(Note) *Stock option is described as SO.

**3. Committees**

The company has Nomination and Compensation Committee, but the committee isn't statutory but advisory committee. The 2 outside directors isn't the majority of the committee of total 5 members. The 1 inside director is the president and he serves the chair of the committee. Furthermore, the 2 other members than board directors are from a statutory auditor and an ex-chairman (advisor, at present). The committee is fully controlled by the inside directors or the founder's family.
The compensation committee considers the remuneration level in the industry advised by the consulting firm. This would help the proposal of the compensation to secure objectivity. On the other hand, the company implement the evaluation of the CEO in the CEO evaluation committee that is comprised of 4 statutory auditors + 2 outside board directors and the result is consulted to the BoD and the nomination committee as well as published in the company website. However, I am doubtful whether it functions well due to the committee structure as mentioned above.

[Nomination Committee (Optional) as of June 29, 2020]
Number of Members: 5
Number of Inside Directors: 1 (President)
Number of Outside Directors: 2
Others: 2 (1 Statutory auditor + 1 ex-Chairman)
Chair of Committee: Inside Director (President)

[Compensation Committee (Optional) as of June 29, 2020]
Number of Members: 5
Number of Inside Directors: 1 (President)
Number of Outside Directors: 2
Others: 2 (1 Statutory auditor + 1 ex-Chairman)
Chair of Committee: Inside Director (President)

**4. Statutory Auditors**

[Board of Directors: as of June 29, 2020]
Many companies set the term of office of the statutory auditors at 2 years. The term of office at 4 year is too long. Reelection every 2 year offers the shareholders an opportunity of reviewing the statutory auditors by voting. Also, 4 statutory auditor seem to be too many, compared to the 4 board directors. If there is little problems in auditing process, the number of the statutory auditors can decrease. A good thing is that few outside director holds outside director/statutory auditor at not more than 2 companies. Yamaguchi serves an outside director at only 1 company other than Disco.

Term of office: 4 year
Number of corporate auditors: 4
Outside corporate auditors: 4 (Independent outside corporate auditors: 4)
All board directors are male (no female board directors)

1. Mr. Chikara Mimata – ex-Hitachi (6501, JP)
2. Mr. Tadao Takayanagi – ex-Sanwa Bank (Mitsubishi UFJ Bank, at present)



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3. Mr. Yusei Yamaguchi – ex-Sanwa Bank (Mitsubishi UFJ Bank, at present) & Outside director at Shinnihon (1879, JP)
4. Mr. Kazuyoshi Tokimaru – ex-Sumitomo Trust Bank (Sumitomo Mitsui Trust Bank, at present)

[Ownership of shares by corporate auditors: as of March 2020]
No statutory auditors are the shareholder. The statutory auditor doesn't necessarily own the shares as he/she isn't a board director.

1. Chikara Mimata, Corporate auditors: 0 shares
2. Tadao Takayanagi, Corporate auditors: 0 shares
3. Yusei Yamaguchi, Corporate auditors: 0 shares
4. Kazuyoshi Tokimaru, Corporate auditors: 0 shares

**5. Compensation Incentives**
The company offers stock options. This would align with the shareholders, as stock options has asymmetric profit/loss profile than common shares. The company grants 2 type of stock options such as ordinary-type stock option and stock compensation type stock option. The ordinary-type stock option has the argument on the asymmetric profit/loss profile. Therefore, we stand on the position that the common shares are more preferable in the viewpoint of the other shareholders. The stock compensation type of stock option is granted to the inside directors and executive officers etc. for JPY1 a share. The difference between the market price and the granted price is profit when the stock option is granted. This is another issue in addition to the asymmetric profit/loss profile.
Generally, the 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. In this sense, the company uses the recurring profit margin for 4 cumulative years as well as a single year, and outside information of the industry salary from a consulting firm. On the other hand, the company the remuneration is biased to the fixed salary. The balance between the fixed salary and the performance-based remuneration is designed to pay a stable salary. In case that the recurring profit margin for a single year is 10%, the balance would become half and half. The recurring profit margin for a single year was 31.4% for FY3/2018, 26.4% for FY3/2019 and 27.1% forFY3/2020. Although the performance-linked remuneration is based on the formula using the recurring profit margin for both 4 cumulative years and a single year for the both mid-term and short-term incentives, the allocation between the fixed salary and the variable remuneration should change to more variable remuneration in the base case.

[Disclosure of Compensation of Directors]
1. Total 5 Directors (ex. Outside directors):
Total Compensation: JPY 612 million=(JPY181 million, Fixed) + (JPY103 million, Stock option (of which JPY42 million is stock compensation-type stock option)) + [(JPY326 million, Bonus), Performance-linked]
2. Total 2 Outside directors:
Total Compensation: JPY24 million=(JPY24 million, Fixed only)
3. Total 5 Corporate auditors:
Total Compensation: JPY56 million=(JPY56 million, Fixed only)

[Disclosure of Remuneration of Directors who receive more than JPY100 million]
1. Kazuma Sekiya, Director:



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Total Compensation: JPY267 million=(JPY72 million, Fixed) + (JPY43 million, Stock option (of which JPY17 million is stock compensation-type stock option)) + [(JPY152 million, Bonus), Performance-linked]
2. Noboru Yoshinaga, Director:
Total Compensation: JPY114 million=(JPY6 million, Fixed) + (JPY76 million, Stock option (of which JPY3 million is stock compensation-type stock option)) + [(JPY152 million, Bonus), Performance-linked]

[Formula of Performance-linked Remuneration]
The compensation of the board directors is comprised of fixed salary and performance-linked remuneration. The ratio is almost the half and half, as the ratio between fixed salary and performance-linked remuneration is 1.0 : 0.9 or 1.0 (of performance-linked remuneration is divided into 0.4 for bonus and 0.5 or 0.6 for stock option) if the base goal (the recurring profit margin achieves more than 10% for a single year) is completed.
The performance-linked remuneration is comprised of bonus, ordinary-type stock option and stock compensation-type stock option. The bonus is considered as a short-term incentive and has been introduced since FY3/2018. The performance-linked bonus is paid based on the standard bonus amount adding the additional amount on the position, considering the performance-linked coefficients of recurring profit margin (<30% or >=30% for a single year, and <20% or >=20% for cumulative 4 years) and the evaluation of individual director. In case of achieving the base goal of recurring profit margin at 10% for a single year as well as the evaluation of individual director, the ratio between the performance-linked bonus and the evaluation of individual director is 4 : 1. The ordinary-type stock option is available to exercise for 6 years 2 years after granted. The stock compensation-type stock option has been replaced by the retirement allowance for directors is available to exercise for 20 years after the retirement.

[Compensation Incentive as of June 29, 2020]
Incentive Plan to Board Directors: Performance linked incentive and Stock option
Stock Option: Yes
Disclosure of Compensation: Partially disclosed (only a person who received more than JPY100 million)
Compensation Policy and Formula: Yes

**5. Ex-CEO Advisors**
Yes

Hitoshi Mizoroki, Advisor (ex-Chairman stepped down on June 27, 2017)
Mizoroki is in charge of a chair of the Nomination and Compensation Committee and responsible of DISCO VALUES. He works full-time and receive the remuneration. His term of office will renew every year.

MIzoroki still play a key role in the company as a member of Nomination & Compensation Committee after he stepped down the chairman. There would be a room that an ex-CEO advisor cut in on the decision-making on the business matter outside BoD.

**6. Takeover Defense**
According to the CG report, the company has no takeover defense provision unconditionally right now.

[Takeover Protection Clause]


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No

**7. Evaluation on Board of Directors**

Although does the self-assessment, surveying the board directors once a year, most of the questionnaire published on the website sounds like a surface of the evaluation. The question should focus on more detail and concrete issue. For instance, the company recognizes the issue on the diversity of the BoD and ask such a question in the survey. The website publishes only the result of the survey. We need not only the surface result but the result of the discussion on the self-assessment what issues the board directors share and how they solve it after the discussion on May 29, 2020.

[Method of Board Evaluation]

The company does the evaluation of the board of directors and statutory auditors by self-assessment once a year. The result of the self-assessment is published in the company's website.

**8. Training Policy of Directors**

The compact board is comprised of selective board directors of the company. Therefore, the training policy focus more on the outside director when he/she is elected, but also should enrich the training for the inside directors. For inside board directors in Japan, many of them are nominated from the senior employees within a company. Many directors lack knowledge about finance and accounting that require important decision making and of strategy and business. Training including finance and accounting is positive. Using training course by external provider would be plus, too.

[Method of Board Training]

When a new director and a statutory auditor is elected, he/she will be provided the opportunity to have better understanding of the company's business and philosophy. Also the company will provide training or seminar to him/her if necessary for pursuing the duty.

**9. Stock Holding**

Basically, the company doesn't hold the policy stocks as well as the trading-purpose stocks. The policy stocks that the company holds is small amount and they are all private stocks. Therefore, they would be owned for the purpose of some business relation.

[Stock Holding Policy]

The company doesn't hold the policy stocks in the policy basically. Therefore, the company has no proxy voting policy. If the need of holding the policy stocks occurs going forward, the company will publish it on the website, after carefully examination and discussion on the reasonable grounds.

[Stock Holding]

The policy stocks are small amount of totally 6 private companies and the holding was unchanged from the previous year.

1. Policy holding shares as of June 26, 2020: 6 names of private companies, JPY29 million
2. Policy holding shares as of June 25, 2019: 6 names of private companies, JPY29 million

**10. Growth Policy**

The company doesn't publish the mid-term management plan (MTP), but the quantitative target has been set by using a KPI, the recurring profit margin and RORA. The company's ROE and ROA are higher than the average of Japan's companies. In this sense, the company has performed pretty well.



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However, the recurring profit margin or RORA doesn't include the concept of the cost of capital. We recommend the KPI including the cost of capital and cash flows in using ROIC, EVA and etc.

[Mid-Term Management Plan]
Disclosed

[Quantitative Target]
Disclosed

[KPIs]
Disclosed on the company's web site
The company has set the following KPIs.
1. Recurring profit margin at more than 20% for the cumulative 4 years
2. Return on risk assets (RORA) at more than 20% for the cumulative 4 years

RORA=Recurring Profit / {(Inventory)+(Fixed Assets-Marketable Investment Securities-Differed Tax Assets)+Lease Balance}

[Recurring profit margin]
1. 27.4% for cumulative 4 years
2. 27.1% for FY3/2020

Other performance measures for reference:
[ROE]
1. 18.4% (act) for past 3 years
2. 15.1% (Toyokeizai E) FY3/2021 E

[ROA]
1. 15.3% (act) for past 3 years
2. 12.4% (Toyokeizai E) FY3/2021 E

**11. Capital Allocation Policy**
The company discloses the clear capital allocation policy when raised the dividend payout ratio from 20% to 25% in 2012 in the dividend policy. The capital allocation policy isn't based on the cash flows but the balance sheet. The excess cash on hand after the required capital such as working capital, R&D and etc. as well as CapEx, will be returned to the shareholders. Of the shareholders return, dividends will be secured a stable dividends in the 25% payout ratio and additional cash will be returned in dividends or share-buyback if the rest of cash exists. The company is less likely to repurchase shares but return through increasing the dividends. The dividend payout moved higher to 56.9% for FY3/2020, as the ratio increased gradually from 25.3% for FY3/2013 to 40.1% for FY3/2019.

[Cash Holding]
1. Cash Equivalent as of March 31st, 2020: JPY79,782 million
2. Cash Equivalent as of March 31st, 2019: JPY85,351 million
The average of cash equivalent / sales X12 =6.8 months as of March 31st, 2020

[Dividend Policy]
Dividend payout (net profit) ratio at 25% is set as the dividend policy.
1. Dividend (act) FY3/2020: JPY438 a share, Dividend Payout=56.9%



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2. Dividend (CE) FY3/2021: Disco unveiled JPY104 a share of the interim dividend in September 2020 Even the interim dividend will achieve the 25% payout on the projected EPS of JPY413.82 for FY3/2021.

[Share Repurchase and Retirement]
No
[Equity Issuance]
No

[Capital Expenditure]
1. CapEx FY3/2020: JPY24,962 million
2. CapEx FY3/2019: JPY14,515 million

[Free Cash Flow]
1. Free Cash Flow FY3/2020: JPY6,337 million
2. Free Cash Flow FY3/2019: JPY12,796 million

**12. Agenda of AGM**

The agenda of the AGM held on June 26, 2020 was only 1 proposal of Appropriation of Retained Earnings. The term of office of the board directors is 2 year and that of statutory auditors is 4 years, Therefore, the agenda was only the approval of the distribution of surplus for FY3/2020. The company's proposal of the distribution was paying JPY347 a share at the end of the fiscal year. The total dividends for the fiscal year was JPY438 a share (=JPY91+JPY347). The payout ratio on the net profit was 56.9% that was higher than the company's dividend policy of 25% payout.

[Proposal No. 1: Distribution of Surplus]
Approved: 98.3%

Aki Matsumoto, CFA





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fluctuate. Past performance is not a guide to future performance, future returns are not guaranteed, and a loss of original capital may occur.
The author of this report is not in relation of serious conflict of interest with the reported company.



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