16th April 2019

Corporate Governance Research: Nintendo (7974)

Summary:
Nintendo's corporate governance was lower than the average, although the business is doing better than the average in profitability such as ROE and ROA. The company has many issues in CG in Board Practice such as board of directors, committees, compensation incentives, ex-CEO advisors, board evaluation and training policy of directors. Conversely, Actions includes relatively fewer issues in dividend policy and capital allocation policy, while cross-holding shares should decrease much more rapidly and quantitative target and KPIs would show the mid-term growth more clearly. The balance in inferior board structure and relatively higher profitability and higher shareholder return looks different aspect from many companies in Japan that have diversified shareholders. This would be because the game business focusing strategy would lead to higher profitability and better capital policy and shareholder return. Meantime, the board practice has suspended improving and seemed to be lagging the other companies many of which wanted to look good due to soggy profitability improved mainly the Board Structure rather than Actions. Nintendo should move forward the CG practice, as the banks sold off the holdings in March 2019. CG practices is likely to improve a little faster going forward. Decreasing cross holding shares of banks and establishing nomination and compensation committees (optional) are most likely if the company gets to work on.

*METRICAL CG Score of Nintendo 42.9 (average of 1,770 companies as of March 2019 was 49.95)

1. Shareholders Structure

The shareholder structure has diversified after Yamauchi, the past president of founder's family passed away in 2001. The bank shareholders have supported the management in the AGMs as the 3 all agenda were approved more than 92% in pass rates at AGM on June 28, 2018. The share offering in March 2019 pulled the ownership of bank shareholders down but the bank shareholders maintain certain ownership. However, 45.4% ownership of foreign shareholders as of June 30, 2018 is likely to rise going forward. The management should hear the voices of other shareholders than banks.

[Top10 Shareholders as of June 30, 2018]
1. JP Morgan Chase 380055 (11.22%)
2. Bank of Kyoto (4.90%)
3. Japan Trustee Services Bank (trust a/c) (4.71%)
4. The Master Trust Bank of Japan (trust a/c) (4.52%)
5. The Nomura Trust and Banking (retirement benefit trust Mitsubishi UFJ Trust Bank a/c) (3.97%)
6. SSTC CLIENT OMNIBUS ACCOUNT (2.78%)
7. Japan Trustee Services Bank (trust a/c 5) (2.40%)
8. State Street Bank & Trust 505223 (1.66%)
9. State Street Bank & Trust 505234 (1.47%)
10. DeNA Co., Ltd. (1.46%)

*[Share offering in March 2019]
On February 22, 2019, Nintendo posted share offering from large shareholders below.
Bank of Kyoto: 1,000,000 shares
The Nomura Trust and Banking (retirement benefit trust MB UFJ Trust Bank a/c): 553,830 shares
Mitsubishi UFJ Bank: 446,200 shares
Resona Bank: 225,000 shares
Bank of Shiga: 203,700 shares

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2. Board Structure

[Organizational Structure as of December 3, 2018]

Nintendo moved to Company with corporate audit committee after the AGM on June 29, 2016. The company posted the benefit of the organization structure moving to Company with corporate audit committee from Company with corporate auditors on April 27, 2019. However, METRICAL believes that the organization structure would jeopardize the corporate governance of the company (Please refer http://www.metrical.co.jp/mwbhpwp/wp-content/uploads/Audit-Committee20160505.pdf).

[Board of Directors: as of December 3, 2018]

The directors of the board are elected every year and the size of the board is not so large (not compact yet) as the total number of directors is 9. The independent outside directors are none of the customer or supplier of the company and receiving fees from the company in the business. Of the 3, only Katsuhiro Umeyama holds an outside director of Kuraudia Holdings (3607) concurrently. The number of independent outside directors is 3. Independent outside directors account for 33% of the board. Ideally, the independent outside directors should be comprised of the majority of the board. However, the board is chaired by the president and the independent director positions as a minor. Moreover, the 3 independent outside directors lack involvement in the management in the business decisions, as all the 3 directors would focus on audit matters as the member of the audit committee.

Term of office: 1 year
Chair of board: President
Number of directors: 9
Outside directors: 3 (Independent directors: 3)

1. Naoki Mizutani - Lawyer
2. Katsuhiro Umeyama - Accountant
3. Masao Yamazaki – Tax Accountant

[Ownership of shares by directors: as of March 2018]

Out of 8 directors, 5 directors (all inside directors) own only each 100 shares. Satoru Shibata holds no shares in the inside directors, while 3 outside directors don't own shares. METRICAL believe that all board directors should own shares. Holding shares of a company align with the interest of shareholders. In this sense, the current board members are weak in alignment with shareholders.

1. Shigeru Miyamoto, Chief Representative Fellow: 100 shares
2. Shinya Takahashi, Senior Managing Executive Officer: 100 shares
3. Syuntaro Furukawa President: 100 shares
4. Kou Shiota, Senior Executive Officer: 100 shares
5. Satoru Shibata, Executive Officer: 0 shares
6. Naoki Noguchi, Director, member of audit committee (inside director): 100 shares
7. Naoki Mizutani, Independent Outside Director, member of audit committee: 0 shares
8. Katsuki Umeyama, Independent Outside Director, member of audit committee: 0 shares
9. Masao Yamazaki, Independent Outside Director, member of audit committee: 0 shares

3. Committees

The company has neither of Nomination Committee nor Compensation Committee. Nintendo posted the change of the president on April 26, 2018, but the decision-making process is unclear and doesn't secure transparency and objectivity. Nomination and compensation process/rules should be secured more objectivity, setting up even optional committees. As for the audit committee, the company has the committee, but it is questionable whether it functions effectively. Even though the committee

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consist of the majority of independent directors of the total 4 members, the chair is the inside director. Audit committee has no empowerment of investigation, whereas corporate auditor of company with corporate auditor does. If the internal control department does little help the audit committee hindered by the inside director, auditing would not function well.

[Nomination Committee as of December 3, 2018]
No
[Compensation Committee as of December 3, 2018]
No
[Audit Committee as of December 3, 2018]
Number of Members: 4
Number of Inside Directors: 1 (Naoki Noguchi)
Number of Outside Directors: 3 (Naoki Mizutani, Katsuki Umeyama and Masao Yamazaki)
Chair of Committee: Inside Director (Naoki Noguchi)

4. Compensation Incentives
The company does not offer stock options. This would align with the shareholders, as stock options has asymmetric profit/loss profile than common shares. Offering restricted common shares would be recommended. None of corporations in Japan does full disclosure of compensation in each board director. Only the following 2 directors (Tatsumi kimijima and Shigeru Miyamoto) who received more than JPY100 million a year report the remuneration. Also, the directors in charge of audit committee isn't entitled to receive performance-linked remuneration. For the % of compensation for the directors excluding the member of audit committee between fixed salary and performance-linked was 38% and 62% for 6 directors. This looks reasonable in a sense but looking at the higher position of former president Kimijima and fellow Miyamoto, the % of compensation was approximately 50% and 50% in Fixed and performance-linked. The performance-linked compensation should be paid much higher % than fixed salary.

[Disclosure of Compensation of Directors]
1. Total 6 Directors (ex. Audit Committee members and Outside directors):
Total Compensation: JPY504 million (JPY193 million, Fixed)+(JPY310 million, Performance-linked)
2. 1 Director of Audit Committee members (ex. Outside directors):
Total Compensation: JPY504 million (JPY32 million, Fixed only)
3. Total 3 Outside Directors:
Total Compensation: JPY28 million (JPY28 million, Fixed only)

[Disclosure of Remuneration of Directors who receive more than JPY100 million]
1. Tatsumi Kimijima: JPY205 million (JPY98 mil, Fixed)+(JPY106, Performance-linked)
2. Shigeru Miyamoto: JPY141 million (JPY70 mil, Fixed)+(JPY71, Performance-linked)

[Formula of Performance-linked Remuneration]
The performance-linked remuneration is calculated on the following formula.
Variable (performance-linked) remuneration=(consolidated OP x 0.2% x point of each director) / Total points of all director
*each point of directors
1. President (1 person): 6 points
2. Chief representative fellow (1 person): 4 points
3. Senior Managing Executive Officer (1 person): 4 points
4. Managing Executive Officer (0 person): 0 points
5. Senior Executive Officer (2 person): 3 points

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Total Points: 17 points

[Compensation Incentive as of December 3, 2018]
Incentive Plan to Board Directors: Performance linked incentive
Stock Option: No
Disclosure of Compensation: Partially disclosed
Compensation Policy and Formula: Yes

5. Ex-CEO Advisors

Tatsumi Kimijima stepped down at the AGM on June 28, 2018, but remain seat as an ex-CEO advisor, so-called “Sodanyaku.” He receives compensation as an advisor for 1 year and advise the management in cases. I don’t think there are other advisors who resigned a board director other than CEO, as many companies hold such ex-director advisors. However, such a person like Kimijima should remain in the company and says something about the management, as he is no longer a board director and has no responsibility to the shareholders.

[Ex-CEO advisors]
Name: Tatsumi Kimijima
Title: Advisor “Sodanyaku”
Job description: Advice on Management and etc.
Working type: Part-time, Paid
Term of advisor: 1 year

6. Takeover Defense

The company has no takeover defense provision. Of course, the company’s management sounds aggressive about anti-takeover, but METRICAL doesn’t believe that employing such provision is so easy for the company. Out of 1,770 companies of METRICAL core research universe, 84.5% has no takeover defense provision and some of them removed such unfavorable provision for many shareholders. The trend of removing anti-takeover will not change in legal and regulatory opinions. 45.4% of the shareholders are overseas, while the board directors own limited number of share right now. They should align with the shareholders for the sustainable growth of shareholders’ value.

[Takeover Protection Clause]
No
The shareholders’ meeting hasn’t approved the takeover protection provision. However, the company has studied to adopt such protection and still continues to study employing the anti-takeover provision, considering laws and opinions of regulators about takeover defense.

7. Evaluation on Board of Directors

The company’s CG report issued on December 3, 2018 says no concern about the board of directors in operation as well as structure after the once a year evaluation. To begin with, a board should discuss on the evaluation or how the board do much better multiple times a year. The content or method of the survey must do several attempt, improving better than the previous year. METRICAL pointed a number of issues above on 2. board structure, 3. Committee, 4. Compensation Incentive, 5. Ex-CEO Advisor. The company has never done board evaluation seriously.

[Method of Board Evaluation]
The company does evaluation of the board of directors one a year from March end to May. The evaluation is provided survey to each director and reported the result at the board meeting. According to the result for the previous year, there were no issue on the operation and the structure

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of the board meetings and providing information to outside directors in all items. As a result, the board of directors effectively functions well.

8. Training Policy of 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 should include not only compliance but also other area particularly finance and accounting.

[Method of Board Training]
The company tries to offer outside directors sufficient explanation time to time about the business and important information about the management. For inside directors, the company offers compliance trainings on roles and responsibilities for board directors and continue offering such a compliance training to them by using internal and external resources when needed.

9. Stock Holding
The policy below is the same sentence that we look at the CG report in other companies. Therefore, the policy doesn't make reasonably understood well investors/shareholders. For the past 1 year, 2 names of stock holdings were removed. In March 2019, Bank of Kyoto, Mitsubishi UFJ sold its stake of Nintendo, so the company should sell the bank shares off this year. Also, Nintendo and DeNA hold the shares each other. The both companies should realize alignment in business more clearly. The holding of JPY54,355 million is 6.11% of the value (Total Assets – Cash)or 5.15 of the annual sales of the company. This is not a small amount.

[Stock Holding Policy]
The company holds strategic holding shares other than investment purpose holding shares for the purpose of helping the company's corporate value raise in the mid-to-long term. These shares are reviewed by the board meeting how the holding would be appropriate to continue holding them.

[Stock Holding]
2 names were removed and the value of holding shares decreased for 1 year.
1. Strategic holding shares as of June 30, 2017: 36 names, JPY57,445 million
2. Strategic holding shares as of June 30, 2018: 34 names, JPY54,355 million

[Large Holding as of June 30, 2018]
1. DeNA: 15,081,000 shares, JPY34,067 million
2. Bandai Namco: 3,45,700 shares, JPY12,806 million
3. Bank of Kyoto: 4,542,297 shares, JPY3,683 million
4. Mitsubishi UFJ FG: 2,455,870 shares, JPY1,718 million

10. Growth Policy
The company doesn't disclose MTN plan, quantitative target and KPI. However, ROE and ROA are higher than average of Japan's companies.

[Mid-Term Management Plan]
Not disclosed

[Quantitative Target]
Not disclosed

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[KPIs]
Not disclosed

[ROE]
1. 10.9% (act) FY3/2018
2. 14.1% (Toyokeizai E) FY3/2019E

[ROA]
1. 8.5% (act) FY3/2018
2. 11.0% (Toyokeizai E) FY3/2019E

11. Capital Allocation Policy
Nintendo distributes about 50% of cash dividend out of the net profit. The game business doesn't have to spend large capital expenditure. Cash holding wasn't too high compared to the sales that jumped for the previous year. In March 2019, the company repurchased and retired 1,000,000 shares. But it is unclear the share buyback and cancellation continue in the following years.

[Cash Holding]
1. Cash Equivalent as of March 31st 2018: JPY484,480, Sales
2. Cash Equivalent as of March 31st 2017: JPY330,974

The average of cash equivalent / sales X12 =4.6 months

[Dividend Policy]
Target dividend payout is not disclosed.
The dividend is determined whichever 33% of consolidated operating profit divided by the total number of outstanding shares, excluding treasury shares, or 50% of dividend payout ratio that is rounded up to the 10 yen is higher.
1. Dividend (act) FY3/2018: JPY590 a share, Dividend Payout=50.8%
2. Dividend (CE) FY3/2029: JPY690 a share, Dividend Payout=51.6%

[Share Repurchase and Retirement]
1. 1,000,000 shares repurchased and retired in March 2019

[Equity Issuance]
No

[Capital Expenditure]
1. CapEx FY3/2019: JPY9,609 million
2. CapEx FY3/2018: JPY10,458 million

[Free Cash Flow]
1. Free Cash Flow FY3/2019: JPY142,599 million
2. Free Cash Flow FY3/2019: JPY8,643 million

12. Agenda of AGM
The agenda are not special for the year. As for #1, Dividend of JPY490 per share for the 2nd half 6-month period was approved. As for #2 and #3 in election of directors, only Masao Yamazaki was a newly elected director. Naoki Noguchi (inside director, chair of audit committee) was approved at the lowest pass rate of 92.51%.

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[Proposal No. 1: Distribution of Surplus]
Approved: 98.0%

[Proposal No. 2: Election of 5 Directors (ex. Directors who are Audit and Supervisory Committee Members)]
1. Shigeru Miyamoto, Chief Representative Fellow: 97.37% approved
2. Shinya Takahashi, Senior Managing Executive Officer: 97.28% approved
3. Syuntaro Furukawa President: 96.51% approve
4. Kou Shiota, Senior Executive Officer: 97.28% approve
5. Satoru Shibata, Executive Officer: 97.28% approve

[Proposal No. 3: Election of 4 Directors who are Audit and Supervisory Committee Members]
1. Naoki Noguchi, Director, member of audit committee (inside director): 92.51% approve
2. Naoki Mizutani, Independent Outside Director, member of audit committee: 95.74% approve
3. Katsuki Umeyama, Independent Outside Director, member of audit committee: 97.57% approve
4. Masao Yamazaki, Independent Outside Director, member of audit committee: 97.78% approve

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