Outside Officers' Views on Nikko's Governance and Future Prospects

In pursuit of its 2030 Vision and 2025-2027 Medium-Term Management Plan, the Nikko Group is taking an integrated approach to implementing its business strategies and sustainability initiatives. The supervision and guidance provided by its outside officers are at the core of these efforts. For this special feature, three Outside Directors and one Outside Audit & Supervisory Board member gathered to engage in candid discussions on a range of topics, including the improvement of capital efficiency, the operation of the Nomination and Remuneration Committee, the promotion of sustainability, the governance of the Nikko Group, and the achievement of an appropriate balance between the execution and supervision of duties.

Participants

Shigeru Sadakari	Outside Director (Nomination and Remuneration Committee member)
Rika Saeki	Outside Director (Nomination and Remuneration Committee member)
Masafumi Ishii	Outside Director
Naoki Ota	Outside Audit & Supervisory Board member

Q Following the Tokyo Stock Exchange's request for "management that is conscious of cost of capital and stock price," how have board meeting discussions evolved in terms of the return on and cost of capital evolved?

Ishii: Under the current Medium-Term Management Plan, we have set a target ROE of 8% by fiscal year 2027. Through discussions at board meetings, the entire management team has become increasingly aware of the importance of securing profitability that exceeds the cost of capital while maintaining financial stability and achieving a stock price that reflects a P/B ratio of ≥1.

Ota: The Board devotes considerable time to discussions on capital management and efficiency, including the reduction of strategically held shares. I understand that the executive team has demonstrated a strong commitment to achieving the targets it has set for itself. As an auditor of the Company, I make it a point to ensure that the management does not focus too narrowly on short-term goals while recognizing that the Company must naturally respond to the expectations of the capital market. To continuously enhance corporate value, making strategic preparations for sustained, long-term growth is essential.

Sadakari: Management that is conscious of capital cost and stock price will undoubtedly gain further momentum. We have set a target market capitalization in the Medium-Term Management Plan, making it clear that we aim to raise ROE in stages, from 5.9% at the end of the previous fiscal year to 8%. Achieving the target requires higher income levels. Making the Thai business profitable and improving the profitability of the service division in Japan will be the key. Furthermore, because the P/B ratio is a product of ROE and PER, we believe that it is important for us to foster market expectations for growth by proactively communicating our nonfinancial value, such as progress toward carbon neutrality, in addition to enhancing financial indicators.

Saeki: When reducing strategically held shares, we must carefully assess their cost-effectiveness. It is also crucial to ensure efficient use of the capital gained from their disposal. We must clarify the uses of that capital, such as growth investments and shareholder returns, and discuss the influence of uses like these on our PBR and PER, taking into account the capital market's perspective.

Q What are your views on the Nomination and Remuneration Committee's achievements so far and current challenges? How does the Audit & Supervisory Board evaluate and audit the appropriateness and transparency of the Committee's operations?

Sadakari: In the last fiscal year, the Nomination and Remuneration Committee met five times and held intensive discussions on the selection of a new president. We decided to nominate Mr. Nakayama because, as General Manager of the Business Division, he addressed some of Nikko's key challenges head-on until immediately before his nomination. These challenges included the low profitability of the asphalt plant business, labor management in the service divisions, and initiatives toward carbon neutrality. All of these are critical issues for sustaining future growth, and his deep understanding of their underlying nature led us to conclude that he was the most qualified candidate for the position.

Saeki: I have served as a member of the Committee over the past year. In the past, executive appointments tended to simply endorse recommendations from the executive team. However, the recommendation process has evolved with the introduction of an external evaluation system two years ago. Committee members now conduct individual interviews with candidates before recommending them for executive officer positions. I believe that as a result, the effectiveness of the Committee has been steadily improving.

Sadakari: The remuneration system requires further review. Under the current system, the performance-linked compensation threshold is set at a consolidated operating income of 2.5 billion yen. However, the target set in the current Medium-Term Management Plan is 5.2 billion yen, indicating a clear gap between the two figures. This system should be revised by raising the threshold to a more challenging level so that a higher level of remuneration can be granted once the target is achieved. At present, the fixed portion based on the job title carries weight. I believe that the system should be redesigned to align remuneration more closely with the achievements of targets and contributions to business performance.

Saeki: I agree. Financial targets defined in the current Medium-Term Management Plan, including operating margin, ROE, and market capitalization, should be reflected in performance-linked remuneration. Furthermore, by increasing the proportion of stock compensation, we can expect the management to share risks on an equal footing with shareholders and strengthen their focus on the sustainable enhancement of corporate value.

Ota: From the perspective of an Audit & Supervisory Board member, I think that the Full-time Audit & Supervisory Board member can ensure the appropriateness of the Committee meetings by attending them as an observer. However, because details of Committee discussions are not fully shared with Outside Audit & Supervisory Board members, we intend to include the Committee's activities within the scope of the Audit & Supervisory Board's audits and to consider how outside members should be more actively involved.

Sadakari: Previously, the Committee was chaired by the former President, who made a conscious effort to solicit input from outside directors, including myself, by refraining from expressing his own views and instead providing objective explanations. We understand that investors generally favor having an outside director chair the Committee; however, I believe it is more important to prioritize the substance of discussions over formal structure at this stage.

Q How do you monitor initiatives aimed at integrating the sustainability strategy with the management strategy? Which KPIs do you believe should be assessed in relation to future cash flow generation?

Ota: Nikko's sustainability strategy is crystal clear—its ultimate goal is to generate future cash flows through the achievement of carbon neutrality. A distinctive feature of this strategy is that it establishes targets for CO_2 emitted during the on-site use of our products and equipment by customers in addition to setting reduction targets for its own CO_2 emissions. Few companies have gone this far. The Audit & Supervisory Board audits the entire sustainability promotion process, monitoring the progress of KPIs, key goal indicators, and key success factors.

Ishii: Initiatives toward carbon neutrality also capture my attention. Nikko's strength lies in its proprietary technologies—for example, the development of burners that use alternative fuels and technologies that allow concrete sludge, an industrial waste, to absorb CO_2 and be recycled into construction materials. The commercial application of these technologies is already within sight, and a considerable market is expected to emerge depending on how the regulatory environment evolves. I intend to further strengthen partnerships with road builders—our key customer group—to explore together untapped markets. I think that it is safe to say that sustainability and growth strategies are two sides of the same coin.

Saeki: Another key pillar is the remote and automated plant operation. Our AI-enabled burner operation support system has already undergone demonstration testing at a customer's plant, where it has achieved operational performance comparable with that of skilled operators. This initiative directly addresses labor shortages and improves operational efficiency, potentially transforming Nikko's business model. I believe that the key step ahead is how quickly these technologies can be translated into profits.

Sadakari: The spread of carbon-neutral products is not without challenges. If a product is technologically superior but is too costly, customers may hesitate to adopt it. Ultimately, the decisive factor will be whether these products can be delivered to the market at an affordable price. Accordingly, alongside ongoing technological development, the management must seriously confront the task of promoting wider use while controlling costs.

Q How do you evaluate the overall effectiveness of corporate governance within the Nikko Group?

Ota: The Audit & Supervisory Board puts efforts into developing internal controls and improving financial reporting accuracy for subsidiaries that have recently joined the Nikko Group through M&As. In close cooperation with the internal audit division and the Accounting Auditor, we perform risk scoring across the Group. When a vulnerability is identified during the scoring, three types of audits are conducted to improve the score to an acceptable level.

This process is defined as a priority audit item. Through these initiatives, we are steadily enhancing the effectiveness of the Group's governance.

Ishii: Regarding M&A decision-making, we believe that decisions are made promptly and decisively in line with the business portfolio strategy we aim to pursue. We can also confidently expect to achieve synergies in the post-merger integration process, as members of Nikko's management team are dispatched to the boards of subsidiaries to lead the process. Simultaneously, because there are overlaps in certain business domains, a key challenge will be how to streamline operations and improve capital efficiency.

Saeki: Each company that has joined us through M&As has its own corporate culture. Therefore, we need to ensure that the Nikko Corporate Identity and Our Vision are fully shared across the Group to foster a sense of unity. We also need to optimize the overall business portfolio by carefully assessing each business field's growth potential and profitability. Furthermore, the selection of subsidiary executives must be transparent. Thus, the Nomination and Remuneration Committee should take a proactive role in this process and monitor it along with the appropriateness of remuneration.

Q To build an appropriate balance between the execution and supervision of duties, as expected by shareholders and investors, what do you see as the current challenges facing the Board of Directors? What should be addressed by Outside Directors and Audit & Supervisory Board members to further enhance the effectiveness of the balancing process?

Sadakari: For outside officers to fully fulfill their roles, they must maintain a certain distance from the executive team while building a trusting relationship. Sharing information forms the foundation of that relationship. In addition to board meetings, we organize sessions between outside and executive officers to exchange views on each business division's challenges. We also hold regular meetings between Outside Directors and Outside Audit & Supervisory Board members to minimize information asymmetry.

Saeki: As you rightly mentioned, sharing information is fundamental to building trust. Beyond reports from executive officers, gaining a deep understanding of on-the-ground realities is equally important. Field operators often perceive issues differently from the management team. By incorporating the different perceptions into board discussions, our supervisory function can be made even more effective.

Ishii: I also believe that maintaining direct contact with employees on the frontlines is important. For example, we gained valuable insights into creating a more employee-friendly work environment when we held informal meetings between Outside Directors and female employees. Reporting these findings to the executive team led to quicker action and resolution in some cases. It is also effective for Outside Directors to proactively request on-site visits, which I believe further enhances the supervisory function of the Board.

Ota: I think it is essential to foster an environment in which the executive team feels encouraged to take appropriate risks in pursuit of growth. Taking risks may lead to success, but what matters is ensuring that we can verify, after taking risks, whether the discussion process was sufficiently thorough and whether the decisions made were rational. As an Audit & Supervisory Board member, I think we can create an environment where employees can take bold but thoughtful actions without fear of failure by carefully auditing the appropriateness of the decision-making process.