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Charting a path from the *shuchu kiyaku* to ESG for Japanese companies

Long steeped in a sense of purpose, Japanese companies should naturally embrace ESG. But our analysis suggests they could be doing much more.

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Four hundred years before the acronym ESG was coined in 2004 to frame expectations around a company's environmental, social, and corporate governance impact, a Japanese document from the Tokugawa period encouraged corporations to think beyond profits. Commercial activity, the *shuchu kiyaku* (code of ethics) states, should not only be carried out for the sole benefit of a business but also for the benefit of society.[1]

It's an ethos that has endured in Japan's corporate culture, which has been underpinned by a robust network of multistakeholder relationships for centuries. Today, many Japanese companies make commitments to their surrounding communities and wider society, promising "lifelong employment, environmentally conscious production processes, customer-oriented products and services, and product safety."[2] Such purpose-driven traditions have yielded many benefits, including business longevity. According to the Research Institute of Centennial Management in Tokyo, Japan accounts for more than 40 percent of the world's companies that are over a hundred years old.

This rich history *should* make embedding ESG principles in the strategic and operational decisions of Japanese companies a natural process. Yet our research reveals that while Japanese companies are taking steps in the right direction, there is also significant potential to do more. ESG is not only a source of long-term corporate value: businesses that fall short of meeting ESG expectations disqualify themselves from myriad opportunities in the global economy. Investors from Europe, North America, and, increasingly, Japan, apply an ESG lens to investment decisions and will not make exceptions.

How can business leaders in Japan draw from the *shuchu kiyaku* to establish a competitive edge in ESG? It starts by knowing where Japan is on its ESG journey in a world where sustainability is rapidly becoming an integral part of doing business in many regions. This article presents an overview of the nation's ESG performance, identifying environmental, social, and corporate governance opportunities that leaders can capitalize on to generate value for their organizations.

Japan's ESG scorecard

Some actors in Japan are raising the bar on ESG and shifting norms around how business is done. For example, in 2020, Government Pension Investment Fund (GPIF)—Japan's largest pension fund—published a report in collaboration with Keidanren (the Japan Business Federation) and the University of Tokyo expressing the intention to accelerate investments in problem-solving innovation in order to realize the government's Society 5.0 initiative (an effort to create a "supersmart" society that emphasizes human-centric solutions) and the achievement of the UN Sustainable Development Goals (SDGs).[3] Another example is the Social Impact Measurement Initiative (SIMI), a group of nonprofit organizations, businesses, investors, government agencies, and researchers established in 2016 to promote social-impact management in Japan.[4] Meanwhile, the Financial Services Agency amended the Stewardship Code in 2019 to factor in ESG implications on risk mitigation and growth opportunities, explicitly instructing institutional investors to consider sustainability in their investment strategies.[5]

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1 Calvin M. Boardman and Hideaki Kiyoshi Kato, "The Confucian roots of business *kyosei*," *Journal of Business Ethics*, December 2003, Volume 48, Number 4, pp. 317–33, link.springer.com.

2 Kenji Suzuki and Kanji Tanimoto, *Corporate social responsibility in Japan: Analyzing the participating companies in global reporting initiative*, Stockholm School of Economics working paper, EIJS Series, number 208, March 2005, hhs.se.

3 *The evolution of ESG investment, realization of Society 5.0, and achievement of SDGs*, a joint research report by Government Pension Investment Fund, Keidanren (Japan Business Federation), and University of Tokyo, 2020, keidanren.or.jp.

4 *Social Impact Measurement Initiative road map ver. 1.0 2017–2020*, SIMI, 2020, simi.or.jp.

5 The Council of Experts on the Stewardship Code, "Revision of the Stewardship Code," Financial Services Agency, December 20, 2019, fsa.go.jp.

Alongside the growing number of actors who recognize the importance of ESG, sustainable assets under management in Japan quadrupled from 2016 to 2018 to total $2.2 trillion, the third highest globally. That said, although ESG investment is on the rise in Japan, a more complex picture emerges upon deeper analysis (exhibit). We assessed the ESG performance of 621 companies in Europe, Japan, and North America from 2019 to 2020, dividing the companies into large players (annual revenues of more than $10 billion) and smaller players. We used scores published by MSCI Bloomberg, RobecoSAM, and Sustainalytics, which are based on 120 ESG indicators from carbon emissions to community relations to shareholders' rights.

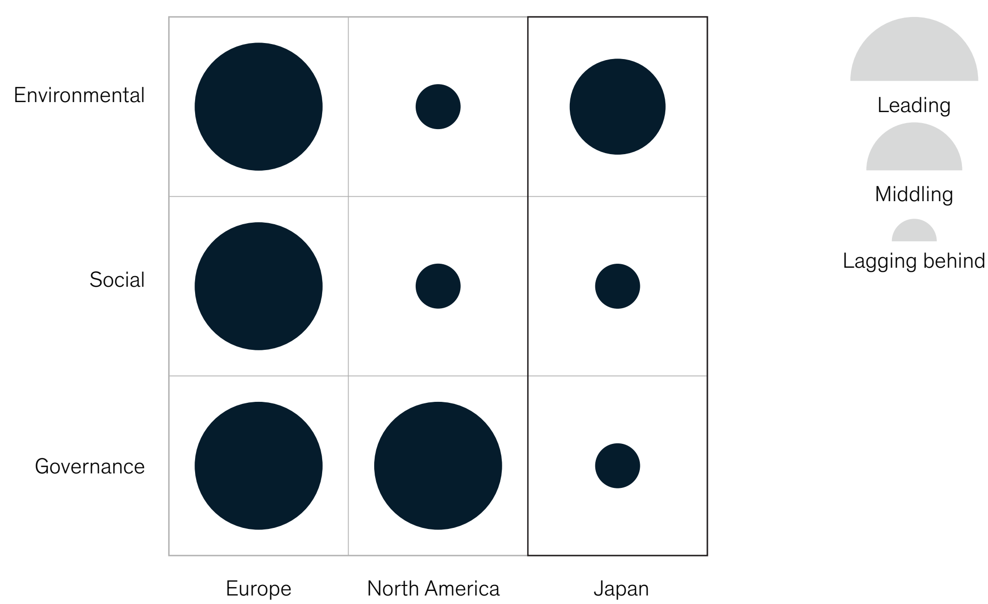
On our ESG scorecard, Japanese companies' overall performance lags behind that of companies in North America and Europe. Large players outperform smaller players, which trail in all three aspects of ESG. One reason is that large players generally have greater global exposure, making them naturally more attuned to changes in international norms and more inclined to adapt their brand messaging and business activities accordingly. From a sectoral perspective, consumer-goods companies in Japan tend to do better than companies in the extractive industries, manufacturing, or technology. As customers globally increasingly expect large corporations to help solve collective problems like climate change and inequality, businesses that do not make ESG a priority can find themselves tackling disruptive consumer responses such as boycotts.

Our analysis lays bare the work cut out for companies. All sectors—consumer-facing and otherwise—and small and medium-size companies can step up and double down on their ESG initiatives. Large companies, too, can build on the momentum and

Exhibit

Japan has the opportunity to unlock greater value across all aspects of environmental, social, and governance performance.

Environmental, social, and governance (ESG) performance (large and smaller companies combined)



Source: McKinsey analysis

stay on course. Across industries, we're seeing growing investor pressure for companies to consider their ESG performance. As the following sections explain, expressing a credible value position on a company's ESG impact can become a must-win for Japanese companies.

The environment: Capitalize on Japan's tech advantage

The "E" of ESG takes into account the environmental impact of a company's carbon emissions and waste discharge, including toxic and hazardous materials. Climate change—along with air, water, and soil pollution—falls into this category. In Japan, large companies perform relatively well on this front, broadly ahead of companies in North America and at a similar level to Europe.

Japan is also well on the road toward decarbonization. Efficiency gains of up to 50 percent in the electricity, steel, and chemical sectors were a major reason for a 40 percent reduction in energy intensity of GDP from the 1970s to the 2010s.[6] Last October, Japan joined Europe in pledging to reach net-zero carbon emissions by 2050. Before the announcement, the country was already planning to reduce its greenhouse-gas emissions by 80 percent by 2050—an objective we estimated needed an additional annual $19 billion to $24 billion in decarbonization-technology investment. The more ambitious target would require investments to be revved up, but the payoff could be significant. The government expects its green strategy to yield returns to the tune of $1.8 trillion by 2050.

However, reaping that benefit requires action from private corporations to make their business models and operations more eco-friendly. Some companies have managed to unlock value by investing in tech innovation. More than a decade ago, a Japanese automaker was among the first to roll out electric cars, opening up new revenue streams for the business. Other companies can explore ways of leveraging technology to fundamentally transform business and operational models, which would, in turn, stimulate the economy.

All companies can look at their energy consumption for opportunities to create value. Power and industry[7] are Japan's biggest sources of carbon emissions, respectively making up 38 percent (496 metric tons of CO_2 equivalent) and 32 percent (413 metric tons of CO_2 equivalent) of total emissions in 2019. What's more, lowering the energy demand with capacity retirement and shifting to electrification—powered by onshore wind, utility-scale solar photovoltaic (PV) technology, and nuclear—can reduce operating costs for companies, as well as their carbon footprint, over the long term. Europe is amid a "green steel" wave, and many steel producers are exploring technology changes. If Japanese carbon-steel producers were to consider this same blueprint and replace basic-oxygen-furnace technology (which uses a blast furnace) with electric-arc-furnace technology, they could halve their carbon emissions, even assuming the current electricity-production mix. And while the switch is a lengthy process requiring substantial investment, cost savings would accrue over the new facilities' life spans. When investing in long-lived assets, such as office buildings or production plants, employing the best-available technology helps to lock in energy efficiency for at least a few decades.

Transport is another major contributor of carbon emissions, accounting for 16 percent of Japan's total. Companies might want to take advantage of the declining costs in decarbonization technologies and consider replacing some gasoline and diesel vehicles, such as delivery trucks, with battery electric vehicles. In addition, advances in data analytics could also help companies optimize delivery routes. Last year, Coca-Cola Bottlers Japan started employing advanced data analytics to improve the distribution efficiency of canned beverages across its vast network of vending machines. Within four months, the company managed to reduce its routes by 20 percent, enjoying significant cost savings in the process.

[6] Lorenzo Moavero Milanesi, Eveline Speelman, Yoshitaka Uriuda, and Yuito Yamada, *Meeting Japan's Paris Agreement targets—more opportunity than cost*, March 2020, McKinsey.com.
[7] Industry refers primarily to iron and steel production, cement production, refining, and pulp and paper, along with many other small sectors.

While Japanese companies score high on employee health and safety, business leaders can focus more on well-being, talent acquisition and retention, and performance management.

The social factor: Put people first

For Japanese observers, the social dimension—which addresses the relationships a company has and the reputation it fosters with people and institutions in the communities where it conducts business—provides the greatest opportunity for improvement.

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A more humane management approach can have a discernable positive impact on a company's performance, and evidence suggests employee satisfaction is positively correlated with shareholder returns.[8] From 2003 to 2017, the top 100 companies on Nikkei's "great place to work" rankings generated 2 percent higher stock returns based on sector and market-cap benchmarks. Recognizing the necessity to improve the status quo, the Japan Business Federation substantially amended the Charter of Corporate Behavior in 2017 to include explicit references to human rights.[9] At the same time, the Cabinet Office launched a set of work-style reforms that aimed to address long working hours and introduce flexible working styles.

Gender diversity is one potential driver of business value in Japan. Our research shows that firms with more than 30 percent women executives tend to outperform companies with fewer women executives. We also found that companies in the top quartile for gender diversity on executive teams were 25 percent more likely to have above-average profitability than companies in the bottom quartile. Yet in 2019, women accounted for only 5.2 percent of board directors at listed companies in Japan, which comes in 121st out of 153 countries in the World Economic Forum's gender-gap rankings. Companies that improve their female representation in senior leadership can significantly increase their odds of fostering a more empathetic and diverse corporate culture that, in turn, translates to better performance.

Opportunities lie beyond the company's walls, too, and the Japan Business Federation has also urged companies to think through their societal impact proactively. The Japanese electronics company OMRON provides a good example. It instituted the "TOGA" award system among employees, which rewards solutions that solve social issues. One of these solutions was a 2-D code applied on bottles that tracks what happens at each stage of the manufacturing process. This not only helped embed

[8] Alex Edmans, "Does the stock market fully value intangibles? Employee satisfaction and equity prices," *Journal of Financial Economics*, September 2011, Volume 101, Number 3, pp. 621–40, sciencedirect.com.
[9] "Revision of the Charter of Corporate Behavior," Keidanren (Japan Business Federation), November 8, 2017, keidanren.or.jp.

more accountability and transparency across every step of the production chain but also opened up a new business opportunity for the company.

Corporate governance: Embrace transparency and accountability

In our analysis, Japanese companies trail businesses in Europe and North America on key metrics around corporate governance—the internal system of practices, controls, and procedures a company adopts to govern itself, make effective decisions, comply with the law, and meet the needs of external stakeholders.

Business leaders in Japan would be wise to preempt investor and government expectations on corporate governance. Investors require an increasing amount of transparency, disclosure, and accountability across a range of issues, including diversity, board composition, and board governance. According to the data company Activist Insight, the number of governance-related demands made by activist investors surged from 27 to 1,400 between 2009 and 2019. Articulating a credible ESG value position has become an imperative for Japanese companies that routinely undervalue their ESG propositions.

The authorities are paying closer attention to corporate governance, too. Former prime minister Shinzo Abe's Corporate Governance Code requires listed firms to have at least two independent, external board directors and encourages the disclosure of information regarding risk management and governance. As a result, the percentage of companies with two or more independent board directors in Japan has increased from 17 percent in 2012 to 93 percent in 2019.[10]

Companies in Japan must proactively reassess their corporate governance to embed more accountability, inclusion, and transparency into their organizational structures and decision making. For example, in 1983, OMRON leader Yoshio Tateishi kickstarted a series of management reforms; company targets and the principles behind the changes were clearly communicated to all stakeholders. Authority was delegated to division leaders across the organization, and each division was empowered to come up with its own business plan. Information about board members, including the rationale for their selection and their responsibilities, is now readily available online. In another example, cross-shareholdings, where banks own stakes in their corporate clients, have come under scrutiny in Japan. In response, the financial-services company Mitsubishi UFJ Financial Group was the first to publicly disclose its total cross-shareholding, pledging to cut ¥800 billion of such stocks by March 2021.[11]

Besides acting as a safeguard against regulatory penalties, increased transparency and accountability help companies identify and react to areas of strengths and weaknesses more swiftly. As a leader, there are some actions you can take to bolster your company's corporate governance. To start, reassess your board's composition, considering ways to make it more inclusive and professional while keeping an eye out for potential conflicts of interest. Ensure that relevant and critical skills are well represented and consider if term lengths are appropriate. Be open about remuneration policies for senior leadership, aligning pay with performance based on clear metrics. Keep shareholders and stakeholders up to date, maintaining transparency and consistency, especially during major events, be they transactions, audits, or the implementation of new business strategies. Of course, anchor everything in the company's purpose and mission statement.

[10] "Abenomics: For future growth, for future generations, and for a future Japan," The Government of Japan, June 2020, japan.go.jp.
[11] "Examples of good practice in corporate government," Tokyo Stock Exchange, December 2, 2019, jpx.co.jp.

Turning virtue into value: What does it take?

Our colleagues unpacked how ESG can generate value for companies. In most Japanese companies, ESG conversations are usually led by investor-relations teams rather than by the CEO and board.[12] But to reap the full value of ESG, commitment must come from the top. These three qualities can help leaders rally an organization around ESG priorities. First, be clear and concise. Successful leaders articulate no more than five specific priorities so that everyone in the organization understands what is expected. Second, be practical. Employ quantifiable metrics to measure progress and the value generated from ESG initiatives. Finally, be realistic about the risks of ignoring ESG. As a number of companies in recent years have learned the hard way, sudden negative public attention on ESG-violating business processes can lead to double-digit declines in market capitalization in a matter of days or weeks.

The good news is that the relationship between ESG and value is a positive one. In our experience, ESG can create value for companies in these five areas: new opportunities for topline growth, lower operating costs, reduced risk of governmental interventions, increased employee satisfaction and productivity, and asset optimization as companies realign their portfolio toward long-term sustainability.

Far from being a drag on performance, ESG can be an engine of value for Japanese companies. Business leaders must factor in their organizations' unique circumstances and purpose to determine which specific initiatives they should pursue, bearing in mind the downsides of doing nothing. Just as the *shuchu kiyaku* and a sense of mission have helped many of Japan's companies thrive through centuries' worth of change, staking out a credible ESG position is crucial for the country's businesses to continue to be a positive and resonant force on the global stage.

[12] Interview with experts on ESG investment in Japan, including experts at ORIX bank and a former VP at RobecoSAM.

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