

The Post-Digital World

Our New Reality

We use computers, smartphones, and a wide range of other electronic devices on a daily basis. The world of today is such that all objects, experiences, and actions are linked via digital technologies, connecting us to the entire world no matter where we are. This post-digital world, our new reality, is a world in which digital connections surround us like air, enveloping the physical world. The digital native generation born into a world permeated by digital terminals enjoys the post-digital world through social media and other venues as natural as they breathe the air around them. To companies, this world represents an increased range of touchpoints with users, making it possible to develop a deeper understanding of our customers and to communicate more closely with them. These changes in the times are pressing us to update how we think, reevaluating our lifestyles, business practices, and how we interface with others.



Online Merges with Offline—Survive in times without offline (Japanese only) by Yasufumi Fujii and Kazuhiro Obara
www.0101maruigroup.co.jp/en/ir/lib/book/002.html

Visiting Yurakucho Marui in June 2019, this young woman was clearly enjoying her day off, proclaiming happily that she was going to the gym next. With smartphone in hand, an emblem of the digital native generation, her steps were cheerful as she left the store.



An Inclusive World

Desire for Individuality and Connections

The post-digital world provides easy access to a vast library of information from anywhere in the world via the Internet. This access reveals an extensive range of options for any choice, whether fashion, anime, music, food, or something else. From among these options, we are free to choose the one that suits us best. More than just that, this access removes barriers of time and distance to allow us to connect instantly with people who share our interests and values that we would have never encountered in the physical world, further empowering us to shape our individual lifestyles. In an inclusive society, people of all genders, ages, nationalities, and physical and mental characteristics will be able to exercise their own individuality without reservation, and the concept of a minority will cease to exist as a result. We currently live in a world in which people seek options to live their own individual happiness while also forming connections and having exchanges with people who understand them.

The photograph to the right shows the famous Shibuya pedestrian scramble taken from Shibuya Modi. The people crossing are of various genders, ages, and nationalities. Their walks of life are varied, from students on their way home from school and fast-paced office workers to tourists lugging suitcases. One cannot help but wonder what each of them is thinking as they walk.



Our Planet

Crossroad for Humanity

Since the industrial revolution, humanity has continued to drive economic growth with energy generated by burning the fossil fuel accumulated within the earth. As we have burned this fuel, greenhouse gases have continued to accumulate in the atmosphere. These gases have increased the average global temperature, triggering droughts and forest fires through record-breaking heat along with widespread damage from concentrated rains, typhoons, and other extreme weather events. If action is not taken, the earth's average temperature is projected to rise to 4°C above pre-industrial levels by the end of the 21st century, which would have catastrophic impacts on the survival of the human race. We are currently placed at a crossroad. The current generation must choose whether to continue to deplete the rich resources and bountiful environment of our beautiful planet for their own benefit or to take immediate action to preserve these benefits for future generations. Once humanity has chosen its path, there will be no turning back.



Operating Manual for Spaceship Earth by Richard Buckminster Fuller
www.0101maruigroup.co.jp/en/ir/lib/book/001.html

The four-year-old son of a MARUI GROUP employee lifts a globe-styled ball above his head with both hands. He represents the future generations that MARUI GROUP has newly included among its focus groups of stakeholders. As the current generation, we are obligated to ensure a happy future for these generations.





Let's Join Hands

Co-Creation of a Platform for Happiness

MARUI GROUP's mission is to help build a flourishing and inclusive society that offers happiness to all. To guide us in accomplishing this mission, in February 2019 we released our long-term vision (MARUI GROUP's 2050 Vision)—“Harnessing the power of business to build a world that transcends dichotomies.” However, we realize that this mission cannot be accomplished alone: it will require that we co-create a platform for happiness together with future generations and all other stakeholders. Through this platform, we will then need to pool our strengths to generate synergies toward the resolution of social issues. This report's message of “Let's Join Hands” is an invitation for anyone who shares our ideals to join us in the co-creation of this platform for happiness.

“Let's Join Hands” is an invitation to take part in a shared activity. In Japan, this invitation is issued by extending one's finger. Whose finger is at the center of this picture? Turn to page 148 for the answer.



I invite everyone to join hands with us in co-creating value for the future.

Hiroshi Aoi

President and Representative Director
Representative Executive Officer, CEO

Co-Creation Management Report 2019 is our fifth co-creation management report. In this report, we will once again provide a look at MARUI GROUP's path to improved corporate value through financial and pre-financial information. At the same time, I would like to issue an invitation to anyone interested in co-creating this corporate value together with us.

Just like children invite their friends to join hands for playground games, we invite any of our diverse stakeholders who are interested in joining hands with us in co-creating value for the future. This invitation is issued to the customers who help us create better stores and services, the employees who work together with us, those who will join MARUI GROUP in the future, companies with which we engage in open innovation, long-term shareholders and investors, and every other stakeholder of the Company. This invitation inspired the photograph on the cover of this report. We hope that as many interested individuals as possible will join us in the serious but also fun game of co-creating value.

New EPS Record for the First Time in 28 Years

I would like to begin by looking back at the fiscal year ended March 31, 2019. We passed many milestones in this year. One of these milestones was the completion of the transition to shopping centers and fixed-term rental contracts that we started in the fiscal year ended March 31, 2015. Taking five years, the transition from department stores to shopping centers was a massive endeavor that transformed our prior business into something completely new. We were able to complete this undertaking thanks to the passion and dedication of our employees.

Meanwhile, EPOS card transactions exceeded ¥2 trillion for the first time, a notable milestone in the FinTech segment. After the launch of EPOS cards in March 2006, it took nine years before transactions through these cards climbed above ¥1 trillion in the fiscal year ended March 31, 2015; these transactions grew beyond ¥2 trillion a mere four years later. This success was a product of the accelerated growth we achieved through the nationwide deployment of EPOS card application centers and the promotion of Gold card issuance.

In terms of performance, these accomplishments led us to achieve operating income growth for the 10th consecutive year in the fiscal year ended March 31, 2019, and also to post a new record for earnings per share (EPS) for the first time in 28 years. As we grew our business and improved our earnings, we also worked toward

our targeted balance sheet. These efforts helped us achieve return on equity (ROE) of more than 9%, which exceeded cost of equity, resulting in a positive equity spread and enabling us to finally generate corporate value that surpassed the expectations of our shareholders.

With a five-year average annual growth rate of 15.6% for EPS and a policy of targeting ongoing increases in the consolidated payout ratio, we have realized seven consecutive years of higher dividend payments combined with three consecutive years of new records for cash dividends per share. As a result, the Company's total shareholder return has grown by 2.7 times over the past five years, well above the Tokyo Stock Price Index average growth of 1.5 times over this period. Moreover, the average annual growth rate for total shareholder return was 22.0%, 14 percentage points higher than the Tokyo Stock Price Index average rate of 8.0%. Only two years remain in our current five-year medium-term management plan, which is slated to conclude with the fiscal year ending March 31, 2021. We are currently on course with regard to this plan, and we feel that the plan's targets are entirely within our grasp. As seen in these accomplishments, the fiscal year ended March 31, 2019, was a year during which much fruit was borne of our initiatives thus far.



A selection of books, ranging from management guides to comics, recommended by President Aoi, an avid reader, can be found in the tamaru WORK LOUNGE established in MARUI GROUP's head office to help heighten the creativity of employees.

Accelerated Growth in Lifetime Value Stemming from Changes in the Nature of Sales

Next, I would like to review the status of MARUI GROUP's business model, which furnished the foundations on which we achieved this success. In last year's *Co-Creation Management Report 2018*, we described the business model we target as being characterized by transitions from a flow-type business to a stock-type business and from a business emphasizing on-balance sheet assets to one built on off-balance sheet assets (see Figure 1). These transitions are indicated by the two axes in Figure 1. Today, I would like to discuss the transition from a flow-type business to a stock-type business, the horizontal axis of this figure and an area in which we have seen great change over the past five years.

When we say a "flow-type business," we are referring to a business in which the earnings structure is oriented around profits generated within a given fiscal year. In contrast, a "stock-type business" features an earnings structure centered on recurring revenue. Profits generated within a given fiscal year are those profits that are not guaranteed to recur in the following fiscal year. For example, when we operated department stores in the past, we had our regular customers along with a large number of other customers. Just because a customer made one purchase at our store, there was no guarantee that they would make subsequent purchases, meaning that we had to value each individual transaction. Moreover, the earnings of department stores were influenced by external factors, such as weather, trends,

inbound demand, and consumption tax hikes, adding to the inconsistency of this business.

Our decision to transition to shopping centers and fixed-term rental contracts was predicated on our desire to move away from this inconsistent, year-by-year business to build a more consistent business structure. Changing the source of our earnings from sales revenues to rent revenues based on fixed-term rental contracts created a situation in which we can look forward to consistent rent revenues over a period of three to five years that is not influenced by external factors.

In the FinTech segment, meanwhile, the rapid growth in transaction volumes drove increases in consistent recurring revenues. The FinTech segment has always been in a position enabling it to achieve profits that continue beyond single fiscal years, through finance charges on revolving and installment payments. However, we have gone a step further by working to transform the nature of the transactions for which EPOS cards are used. We have thus sought to encourage customers to use their cards to make payments for communication fees, utilities, rent, and other ongoing payments in addition to one-time transactions at affiliates.

These efforts have caused the ratio of recurring revenue to total revenue to rise from around 26% in the fiscal year ended March 31, 2014, to approximately 54% in the fiscal year ended March 31, 2019. Revenue itself has increased for two straight years, but the growth in

overall revenue has been outpaced by the growth in recurring revenue. This change is even more pronounced in regard to gross profit. Recurring gross profit accounted for 34% of total gross profit in the fiscal year ended March 31, 2014, and 63% in the fiscal year ended March 31, 2019. Over the past five years, overall gross profit has grown by 22% while recurring gross profit has risen by 230% (see pages 34–35 for more information on recurring revenue).

In this manner, MARUI GROUP's earnings structure has undergone drastic change over the past five years, manifesting not only in stable growth in top-line revenue but also in the nature of sales. Rapid growth in recurring revenue is contributing to accelerated growth in lifetime value, the total of the present value of future profits (cash flows). As growth in lifetime value is directly linked to higher corporate value, one could thus say the MARUI GROUP's corporate value has improved greatly over the past five years.

MARUI GROUP's SaaS-Resembling Business Model

MARUI GROUP's business model is evolving beyond the prior model of combining, or perhaps synergizing, retailing and finance operations to become something resembling a software as a service (SaaS) model.* Comparing us to a SaaS company may seem like a little bit of a stretch. However, the business model of such companies is actually similar to a model we have been using for quite some time. Let me elaborate. It was apparently common for MARUI GROUP's founder to tell the former president that he should treasure the monthly installment payment business, as it was a lucrative business.

The reason monthly installment payments were lucrative was that they entail ongoing monthly payments after purchases, allowing for longer-term relationships to be forged with customers than would be possible under conventional retailing models in which relations end with single transactions. Also, under the monthly installment payment model, it is common for customers to make subsequent purchases after their payments have been finished. In this manner, MARUI GROUP's business was never a "one-and-done" retailing business, but rather was always a business of building long-term relationships off of single transactions.

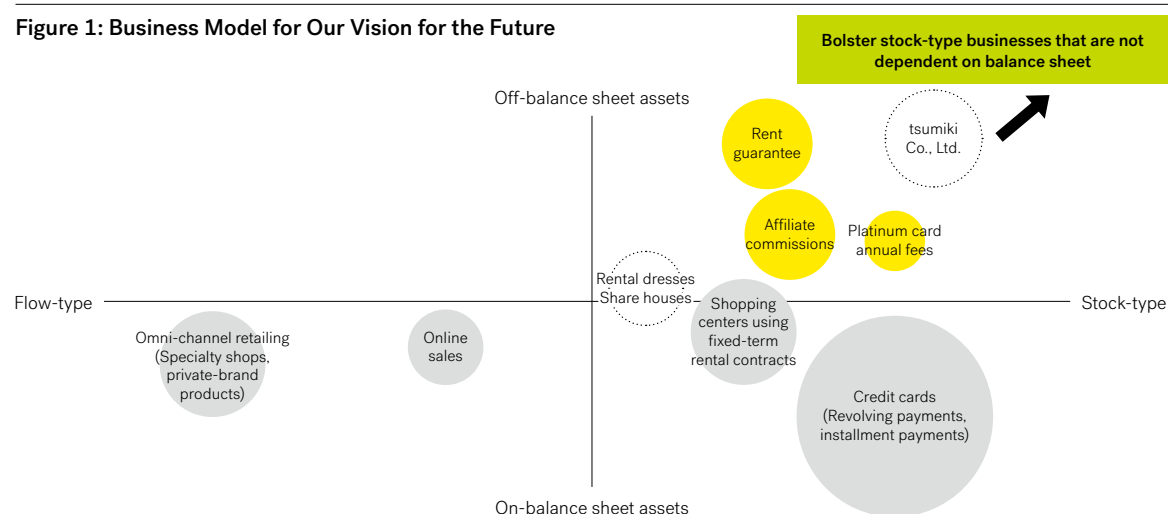
I would like to share a recent episode in this regard. We recently asked the president of a certain start-up company to give a lecture. This president was born in Osaka. He called his mother the day before the lecture to tell her about it. At this point, his mother informed him that, when his father worked in Tokyo, he bought his first suit on installment payments from Marui. The president of this company was around 50, meaning that his father most likely bought that suit more than 50 years ago. I was moved to hear that our customers still remembered such interactions with us. The truth, however, is that

there are many customers that have such memories. When I was a kid, I often heard adults speak of how they "had dealings with Marui." I had always wondered why so many people remembered their experiences shopping at Marui and expressed their experiences with the words "had dealings with." I found the answer when MARUI GROUP was grappling with a management crisis. The reason why these experiences remained with people for so long was because of the experience provided by monthly installment payments. Through this payment scheme, the co-creation of creditability with customers—our core value—had enabled us to forge strong, lasting relationships with our customers.

To use today's lexicon, this practice could be said to have been a form of "customer engagement." Such long-term relationships and strong engagement with customers are both characteristics of SaaS businesses.

MARUI GROUP's business takes place in an industry that is completely different from standard SaaS companies. However, the process of trial and error driven by our desire to translate the DNA we have held since our founding into a contemporary business has coincidentally led to a business model that resembles that of SaaS companies. Today, MARUI GROUP is enjoying consistent top-line growth while evolving to employ a new business model that boasts rapid growth in corporate value on par with new companies. At the same time, we recognize that this new business model requires a new method of evaluating corporate value. For this reason, we will look to engage in dialogue with our shareholders and other investors in a manner that goes beyond the conventional industry categories of retailing and finance to co-create corporate value together.

Figure 1: Business Model for Our Vision for the Future



* SaaS business models entail providing software and services through the Internet via cloud servers. Rather than purchasing packaged software, these models allow customers to choose their desired functions and use them on a subscription basis, thereby growing lifetime value through ongoing transactions with customers.

Concept of Stores of the Future—Stores That Do Not Sell

Now, I would like to talk about our vision for the future. I will be explaining this vision from the perspectives of stores, FinTech, and co-creation sustainability management. Beginning with stores, having completed the transition to shopping centers and fixed-term rental contracts, we are now poised to undertake the full-fledged development of the stores of the future. MARUI GROUP's business has evolved, taking us from running department stores to operating shopping centers. In the future, we will look to evolve beyond the boundaries of shopping centers to develop a completely new type of store—stores that do not sell. Delving into our concept of the stores of the future that do not sell reveals various new possibilities.

I will be explaining these possibilities in accordance with the eight operating environment changes described in *Co-Creation Management Report 2017*. The long-term trends pertaining to stores are primarily contained within changes (1)–(5). The concept of stores that do not sell has the potential to transform virtually all the threats associated with these changes into opportunities.

| | | | |
|--|---|--|---|
| (1) Transition to e-commerce | (2) Shift from goods to experiences | (3) Emergence of a sharing economy | (4) Declining birthrate and aging population |
| (5) Increase in demand from inbound travelers | (6) Rise of cashless payment methods | (7) Change of focus from saving to investment | (8) End of era of low interest rates |

The long-term trend represented by operating environment change (2), the shift from goods to experiences, for example, would have presented a significant threat to MARUI GROUP if we had failed to move beyond department stores. This is because the business model of procuring and selling products utilized by department stores, while excelling at selling goods, is not suited to the provision of food and services. Shopping centers, however, employ a real estate rental model that is ideal for the supply of food, services, and other experiences. Still, both department stores and shopping centers share the same Achilles' heel: they are both focused on sales.

To move past this limitation, we chose to think about our future course while placing selling, previously assumed to be the fundamental role of stores, on the

backburner. This opened the door for the provision of value in the form of experiences and communities. This is incredibly important because, as many have noticed, contemporary consumers desire the value offered by experiences and communities above that provided by goods and services.

This shift in contemporary tastes is even more apparent when it comes to operating environment change (5), the increase in demand from inbound travelers. It was only a few years ago when non-Japanese visitors to Japan would often plan their trips around shopping, purchasing electronics and luxury brand items in mass quantities. Today, such mass purchases are almost non-existent, and we have seen a rapid shift toward the consumption of experiences, with visitors looking instead to enjoy Japanese cuisine, traditional culture, and anime or the natural splendor throughout the country. This shift mirrors the shift that the Japanese population underwent over the course of decades, only condensed into a few years. This different speed of these trends is itself a highly interesting subject. Back on topic, we cannot deny that Japanese people as well are trending toward the consumption of experiences. This trend can be seen in how the vast majority of photographs posted on Instagram are representative of the consumption of experiences. In response to this trend, we aim to evolve beyond shopping centers to create stores that provide not just goods but also experiences and communities.

If we decide that our stores do not necessarily need to sell, the potential influences of changes (1), the transition to e-commerce and (3), the emergence of a sharing economy will become quite different. Looking first at sharing economies, these economies are the antithesis of consumption and thus represent a threat to stores focused on selling, whether they are selling products or services. Conversely, stores that are not preoccupied with sales are able to synergize with these economies. We are therefore working to recruit partners that develop their businesses around sharing economies, which we expect will experience growth over the long term. In addition to collaborating with these partners in our stores, we will also coordinate to introduce EPOS cardholders to these partners, provide convenient payment methods, and offer other value. This approach has been adopted because we recognize that such sharing facilitation constitutes the type of sustainable businesses we hope to advance going forward.

The same can be said of e-commerce. Stores preoccupied with selling goods will be forced to compete with e-commerce, and brick-and-mortar stores will be placed in a disadvantaged position, as seen in the "Amazon effect" that has transformed the market in the United States. The shift from physical stores to e-commerce is a long-term trend that Japan will not be able to avoid going forward. In other words, the trend toward e-commerce is, quite possibly, the greatest threat to traditional stores.

However, this threat too can be transformed into a massive opportunity by putting sales on the backburner. The new e-commerce trend toward direct-to-consumer (D2C) businesses is emblematic of this opportunity. D2C businesses were conceived when the Internet enabled manufacturers to connect directly to consumers without having to go through the middleman of a wholesale or retail venue. Amazon and other e-commerce sites of the same vein are counted as "retail venues" in this case. D2C businesses may only offer a limited scope of specific products, but their offerings are unique and thus stand unrivaled. They are also able to win exceptional levels of consumer support by offering products not found anywhere else.

What is perhaps most interesting about this trend is how it is common for D2C businesses, a type of

"second-wave" e-commerce business, to set up physical stores shortly after launch. One reason behind this drive to open physical stores is the fact that the fierce competition among e-commerce vendors is driving sharp increases in new customer acquisition costs. More important, however, is the fact that the increased engagement made possible through direct interactions with customers via physical stores contributes to ongoing use by customers and subsequently higher lifetime value. In other words, D2C businesses see physical stores as venues for increasing engagement and promoting high levels of communication with customers. This business approach targeting strong engagement and long-term relationships with customers matches that of MARUI GROUP.

However, there is one obstacle to this approach. Department stores and shopping centers, which are exceptional at drawing customers, are focused on generating sales within stores. These stores are therefore not welcoming of D2C businesses. MARUI GROUP has thus stepped up to remove this obstacle. We hope to work together with a diverse range of D2C businesses that help enrich customer lifestyles. I therefore issue an invitation to such D2C businesses to join hands with us in creating value.

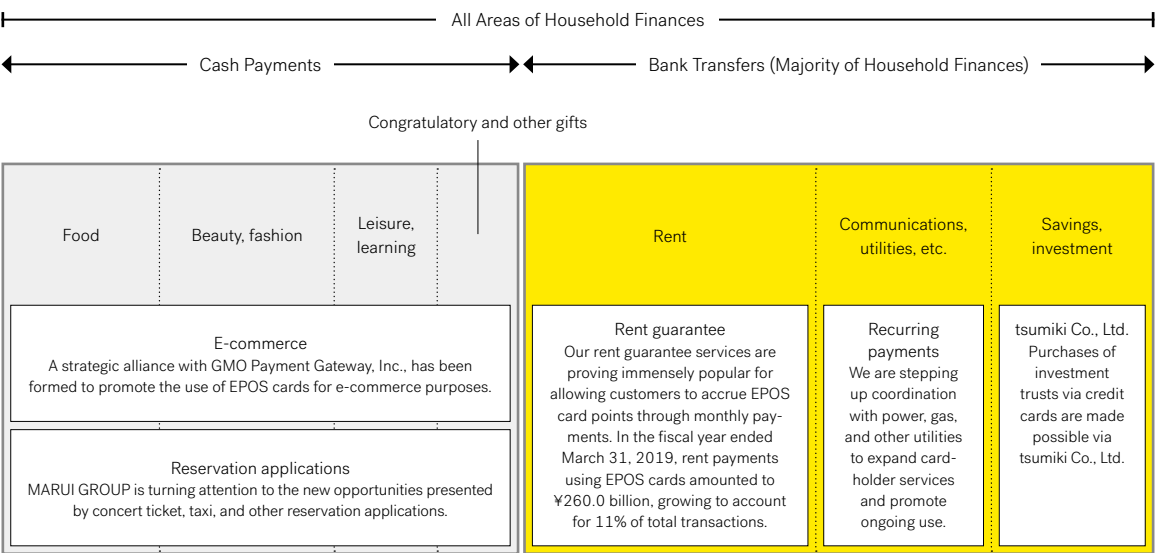
Distinctive Strategy of Maximizing Share of Household Finances

Moving on, we will now look at our future vision from the perspective of FinTech. I would like to take this opportunity to offer an update about our assessment regarding the opportunities and threats associated with operating environment change (6), the rise of cashless payment methods. In 2018, much attention was directed toward the advent of various payment services, which heralded a full-fledged transition to cashless payments. The advent of such services prompted many questions for a wide spectrum of stakeholders asking about the strategies MARUI GROUP would employ to combat new rivals such as IT companies pushing smartphone payment services. The common thread between these questions was the concern for the possibility of MARUI GROUP and its legacy credit card businesses being replaced by the innovative smartphone payment services of IT companies. We engaged in an active dialogue with shareholders, other investors, and employees for the purpose of responding to these questions and to this concern.

Through this process, we were able to clarify the direction needing to be taken in the FinTech's strategies going forward, thereby deciding the core thrust of these strategies.

This thrust is the maximization of our share of household finances. Specifically, we aim to maximize the share of EPOS card payments in household finances by offering assistance in the various areas that customers use money (see Figure 2). As shown in Figure 2, the household finances of customers can largely be divided into two categories: cash payments and bank transfers. Companies promoting smartphone payments are primarily focused on the cash payments category represented by the left side of this figure. MARUI GROUP, meanwhile, is turning its attention largely toward the bank transfers category on the right side of the figure. This is because the right side primarily represents regular, ongoing payments that can help us generate the recurring revenue we target.

Figure 2: Approach Targeting All Areas of Household Finances



The most representative example of such ongoing payments is communications and utilities payments. We have long been encouraging EPOS cardholders to use their card to make these payments. In this area, we are looking to step up initiatives for promoting the use of credit cards to pay rent, generally the largest outflow as part of household finances. It is normally impossible to make rent payments with credit cards. However, we offer rent guarantee services that allow for credit cards to be used for such payments. These services have proved immensely popular as they offer customers the benefit of accruing EPOS card points each month as they pay their rent.

Furthermore, we advanced into the areas of savings and investment in 2018. Savings and investments are not technically outflows, and credit card payments have therefore not been applicable in these areas in the past. Our initiatives in this field will be advanced by tsumiki

Co., Ltd., going forward (for more information on initiatives related to areas on the right side of Figure 2, please refer to "Progress and Future Strategies in the FinTech Segment," beginning on page 94).

Also beginning in 2018, we have been implementing initiatives for using EPOS Family Gold cards to convert all members of families into cardholders. Gold cards have substantially higher rates of ongoing use when compared to standard cards and also make large contributions to lifetime value. Given this fact, increases in the number of Gold cardholders will have an effect similar to growth in recurring revenue. As I have explained, our distinctive strategy is completely different from that of companies promoting smartphone payments. By advancing this strategy, we will turn the threats presented by the trend toward cashless payments into opportunities in order to improve corporate value by growing recurring revenue and evolving into a lifetime value-oriented business.

Ethical Responsibility of Securing a Number of Forward Days for Future Generations

Lastly, I would like to talk about the subject of co-creation sustainability management. MARUI GROUP was implementing environmental, social, and governance (ESG) initiatives previously. Seeking to evolve these initiatives to practice co-creation sustainability management, we devoted the year of 2018 to formulating a long-term vision and targets through discussion between employee volunteers and management.

These were compiled into our *VISION BOOK 2050*. This report describes MARUI GROUP's 2050 Vision: "Harnessing the power of business to build a world that transcends dichotomies." *VISION BOOK 2050* also provides information on our three businesses founded on co-creation—inter-generational businesses, co-creative businesses, and financial inclusion—through which we will seek to increase the happiness of all people. Concrete initiative plans will be drafted over the period of 2019, through a process focused on employee volunteers similar to the one for formulating a vision and targets in 2018. In drafting these plans, we will use a backcasting approach.

There are two principles that I feel are important in these initiatives. The first is to practice co-creation with a new group of stakeholders: future generations. Previously, we have focused our activities on the five stakeholder groups of customers, investors, communities and society, business partners, and employees. However, discussions about a long-term vision and targets made me realize that there was one more stakeholder group we needed to consider in order to co-create value for the future.

This stakeholder group was future generations. I became aware of this group when examining environmental issues. One may wonder who are the stakeholders that benefit from environmental preservation. People often talk of "being kind to the earth" or "protecting the environment." However, it seems odd to think of the earth or the environment as stakeholders in the same manner as customers or investors. When pondering this quandary, the idea of future generations popped into my head. From a different standpoint, addressing environmental issues can be seen as preserving a rich and beautiful environment for the sake of children and younger generations. Rather than squandering this bounty, depleting and destroying the natural environment and resources in the process, it is an ethical responsibility to preserve this bounty for future generations.

Richard Buckminster Fuller defined wealth as the number of forward days we are physically prepared to sustain for future generations. Replacing this definition of wealth with corporate value is the core of MARUI GROUP's co-creation sustainability management. To practice this type of management, we will promote the contributions of younger employees and engage in open innovation with entrepreneurs. We also hope to take part in co-creation with junior high and high school students. I would thus like to invite junior high and high school students to join us in thinking about the type of businesses that will create value for the future.

The second important principle is how we will shape our business going forward. In *Co-Creation Management Report 2018*, we declared the goal of MARUI GROUP's new businesses as being to commercialize initiatives for addressing social issues. We have made true on this declaration as all of the new businesses we are currently advancing or developing are oriented toward the resolution of social issues.

Following the example of these new businesses, in the future, I hope to re-orient our existing businesses toward the resolution of social issues as well. One goal of our co-creation sustainability management is to have all of our businesses addressing social issues. Accomplishing this goal will align the meaning of our work with the meaning of our lives, thereby transcending the dichotomy between work and life. The structure of capitalism, which has maintained its hegemony since the industrial revolution, is reaching its limit. As the world is pressed to evolve toward a sustainable society, MARUI GROUP will strive to create value for the future as a frontrunner in co-creation sustainability management.

I look forward to your ongoing support and understanding and to engaging in co-creation with you.

August 2019

Hiroshi Aoi

President and Representative Director
Representative Executive Officer, CEO

DIALOGUE 01

Approach to Transcending Dichotomy between ROE and ESG by Harnessing the Power of Business

The following is a discussion between Professor Kunio Ito, who advocates ROESG, a new integrated indicator for achieving high levels of ROE and ESG in the pursuit of sustainable improvements in corporate value, and MARUI GROUP President Aoi on the topic of co-creation sustainability management for transcending dichotomies.

Kunio Ito

Specially Appointed Professor
Graduate School of Business Administration,
Hitotsubashi University

Hiroshi Aoi

President and Representative Director
Representative Executive Officer, CEO
MARUI GROUP CO., LTD.

Poison Contained in ROE and ESG

Aoi: MARUI GROUP's 2050 Vision is "Harnessing the power of business to build a world that transcends dichotomies." Professor Ito, today, I would like to ask you about how we can transcend the dichotomy between ROE and ESG.

Ito: That is a task that must be addressed through a practical approach at the management level. In 2014, I published the *Ito Report*, which cast light on the low emphasis placed on capital productivity by Japanese companies and encouraged companies to target ROE of at least 8%. Today, the average ROE of all companies listed on the First Section of the Tokyo Stock Exchange is on the cusp of reaching this level. However, the focus on ROE can poison other areas. There are those managers who truly understand the essence of ROE and practice management accordingly. However, this emphasis on ROE threatens to give rise to those managers who focus only on short-term numbers and sometimes look to inappropriately adjust profits based on this limited perspective. An emphasis on ESG also carries such poison in its potential to become an excuse for low capital productivity. I think it is best to harmonize ROE and ESG through a company's core business activities. Dialogue is a powerful tool for overcoming this dichotomy. President Aoi, I understand that you are advocating the power of dialogue to drive

co-creation. Dialogue presumes differences of value, seeking to bridge the gap caused by these differences through extensive and ongoing communication aimed at determining from where these differences arise. With this belief, I find that various parts of the management stance of MARUI GROUP and of you yourself resonate with me.

Dichotomies Arising from Differences in Timeframes

Aoi: MARUI GROUP is generally evaluated by investors from the perspective of the traditional retail sector, resulting in many questioning our actual industry and how we should be evaluated. However, there are in fact many other companies for which the industry is unclear.

Ito: It is currently impossible to box companies into a single industry or sector. Given this reality, companies should stress in dialogue the fact that they have a large staff of talented individuals capable of creating new businesses and business models that do not conform to conventional industry boundaries. Effective dialogue is thus about how best to communicate that, fundamentally, employees are acting as the value creators in their companies.

Aoi: It is common practice for personnel expenses and human resource investments to be recorded as costs instead of as assets for accounting purposes. I think that this practice represents another textbook example



Kunio Ito

Graduating from Hitotsubashi University in 1975, Kunio Ito later became a specially appointed professor at this university. Professor Ito has been chairman of the Ministry of Economy, Trade and Industry's "Competitiveness and Incentives for Sustainable Growth: Building Favorable Relationships between Companies and Investors" project. In addition, the *Ito Report* integrated report published in 2014 garnered a great amount of attention, even overseas, elevating Professor Ito to the position of a leading figure in corporate governance reforms in Japan. He has written various works on topics including management for overcoming crises, new corporate value evaluation methods, and accounting of intangible assets.

Ito Report 2.0 (Japanese only)

www.meti.go.jp/press/2017/10/20171026001/20171026001-1.pdf





It is important to recognize that transcending dichotomies is not the same as compromising. Rather, transcending the dichotomy between Vector A and Vector B requires the establishment of a third Vector C.

Kunio Ito

of a dichotomy. The more investments a company makes, the more it seems that their profits decline. At the same time, the more a company invests, the more it will be able to generate value over the long term.

Ito: Baruch Lev, one of the writers of *The End of Accounting and the Path Forward for Investors and Managers*, criticizes our current accounting practices for how they record R&D expenditures and other investments in intangible assets as expenses, inviting bearish economies by encouraging managers to limit such investments. I believe that differences in timeframes, between short-term and medium-to-long-term perspectives in this case, are a source of dichotomies. There is no clear answer on how to transcend this dichotomy, but I think that a good start lies in being able to effectively explain how one's company is prefacing management on a medium-to-long-term perspective while doing their utmost to achieve success in the short term.

Selection of Managers as First Step in Effective Corporate Governance

Ito: If a manager who will only hold their position for four years attempts to postulate on their company's medium-to-long-term outlook, investors will perceive it merely as idealism or as an official stance. This is why the first step to effective governance lies in the selection of a company's manager.

Aoi: I think it is crucial for Japan to develop corporate governance frameworks based on timeframes that

enable managers to commit to fulfilling their duties over the long term.

Ito: You are exactly right. To add to this point, managers need to have experienced setbacks in the past if they are to hold their positions over the long term. A person that has never experienced setbacks will crack under pressure should a crisis occur. Of course, governance systems will also need built-in frameworks for dismissing managers that do not exhibit satisfactory performance. What is perhaps most important of all is the degree to which a manager is self-driven. In other words, governance should involve others monitoring the extent to which a manager can exercise a self-driven approach.

Aoi: I am the eldest son of the eldest son of our founder. When I took up the mantle of president, I thus assumed that I would be in this position for around 20 years. This assumed tenure has greatly influenced my actions as president. Faced with a management crisis that had lasted seven years, a commitment to moving forward welled up inside me when I realized that I still had more than a decade to go. Whenever I would visit the founder's grave during this period of adversity, I could not help but think that, if I were to bring about the end of the Company, my ancestors would haunt me. The pressure was enormous.

Ito: When a manager inherits a business from a family member, it is common for them to be able to effectively micromanage, being aware of the subtle inner workings of the company, while also acting based on exceptionally long timeframes. In this manner, these managers are often able to singlehandedly overcome

dichotomies. My research organization is currently performing pilot tests on ROA and ROIC. On average, these metrics peak when managers have a term of 10 to 11 years. If a manager recognizes that they will not be around to reap the benefits of structural reforms, they will simply refrain from those reforms.

Aoi: This is why it is important for presidents to be appointed when they are relatively young. A president appointed in their 30s or 40s will have time to fail when they are still new and to learn from and overcome this failure to succeed.

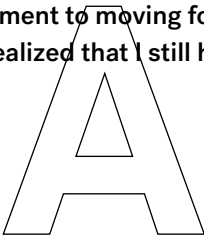
Ito: A president appointed while younger will have time to build a track record of success that they can take with them to other companies. This will also create an ecosystem in which such individuals are able to become investors that nurture the growth of start-up companies. Conversely, presidents that assumed their positions when older will have limited options for after they leave that position, which may lead them to become complacent. In this manner, age is important. However, this also presents another dichotomy, making it difficult to determine the appropriate weight to place on age in the selection criteria for managers.

ROESG Indicator Integrating ROE and ESG

Aoi: You yourself lauded 2019 as the first year of initiatives based on the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD).

This assumed tenure has greatly influenced my actions as president. Faced with a management crisis that had lasted seven years, a commitment to moving forward welled up inside me when I realized that I still had more than a decade to go.

Hiroshi Aoi



Hoping to adopt these recommendations, we decided to conduct a scenario analysis based on the TCFD recommendations. Do you think that the TCFD will serve as a catalyst for the integration of financial and non-financial information?

Ito: Scenario analyses based on the TCFD recommendations include both quantitative and qualitative perspectives. As the qualitative perspective pertains to non-financial information, these analyses will naturally lead to information disclosure that incorporates both financial and non-financial information. I am currently researching management based on ROESG, an indicator that integrates ROE and ESG. However, even if we understand this concept, it will be a difficult and unprecedented undertaking to actually incorporate this concept into management. It is important to recognize that transcending dichotomies is not the same as compromising. Rather, transcending the dichotomy between Vector A and Vector B requires the establishment of a third Vector C.

Aoi: That is why sustainability is a field that allows us to exercise the greatest creativity and is therefore among the most motivating and interesting fields.

Ito: The underlying principle of sustainability is a desire to evolve, whereas being a going concern only means continuing to exist. These two concepts are therefore completely different. Japan places too much importance on the simple continuation of companies. Sustainability, meanwhile, entails continuing to existing while evolving, and it is corporate governance that underpins this pursuit.

