

Six questions on Japan's ESG progress



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Japan's sustainable investment assets have grown by 16.4% CAGR¹ over the last five years. The strong commitment from both government and corporates to transition to a low-carbon economy by 2050 will create more opportunities going forward.

1. IS JAPAN NARROWING THE GAP WITH ITS PEERS ON THE ESG FRONT?

Japan has long been viewed as an ESG laggard within the OECD, weighed by the "E" and "G" factors. For sure, the country's climate track record is still far from ideal with its heavy reliance on fossil fuels (mainly coal and natural gas). But change is afoot. A new Green Transformation policy was approved in February 2023 to help Japan meet its net-zero goal by 2050. The policy outlines a 10-year roadmap to transition to clean energy via the usage of nuclear power, renewables, and carbon-pricing mechanisms.

While the medium-term transition targets may not achieve a complete break from the reliance on fossil fuels, renewable energy is expected to become the largest power supply source, comprising 37% of the power mix by 2030, thereby contributing to cutting greenhouse emissions by 46% from 2013 levels. See Fig. 1. Furthermore, if we add the expected comeback of nuclear energy, more than half of

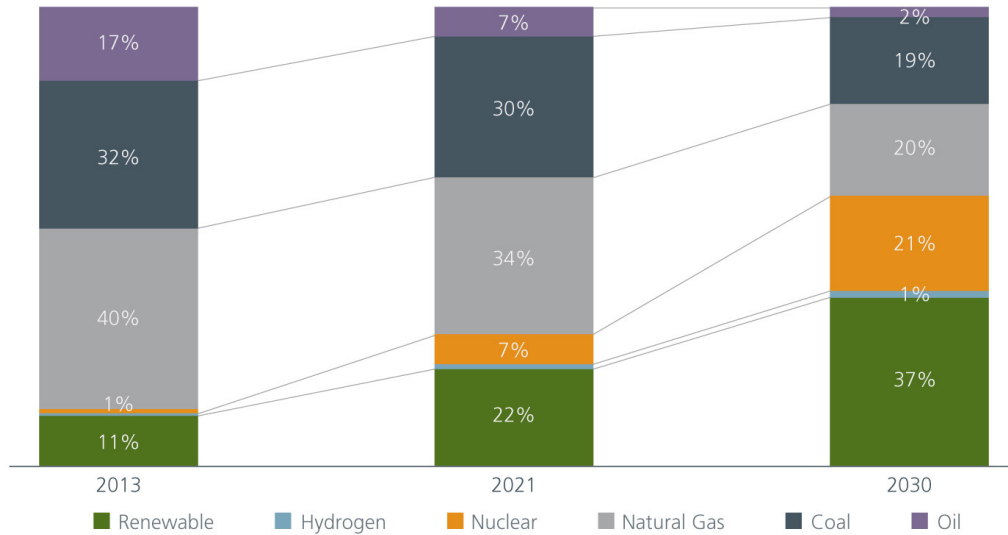
the power supply would be low carbon at competitive costs. We believe this will become a game changer for corporates and consumers, particularly if the "reshoring manufacturing" trend drives both domestic and global companies to expand and rebuild manufacturing bases in Japan.

The report card on "G" is better with ongoing corporate reforms bearing fruit. The behaviour of Japanese companies has changed significantly. The adoption of best practices, the unravelling of the cross-shareholdings and divestments of non-core businesses have resulted in improved returns on equity. More companies now have independent outside directors and there has been a steady improvement in reducing the number of boards without female representation.

According to the Gender Equality Council under the Cabinet Office, the percentage of the companies with all-male Board of Directors in the Prime segment of Tokyo Stock Exchange was only 18.7% in 2022, a significant decline from 84% in 2013. The government is stepping in to further improve the gender diversity by setting mandatory targets for companies listed in the Prime market; by 2025 all must have a minimum of one female Board member and by 2030 it has to hit 30%.

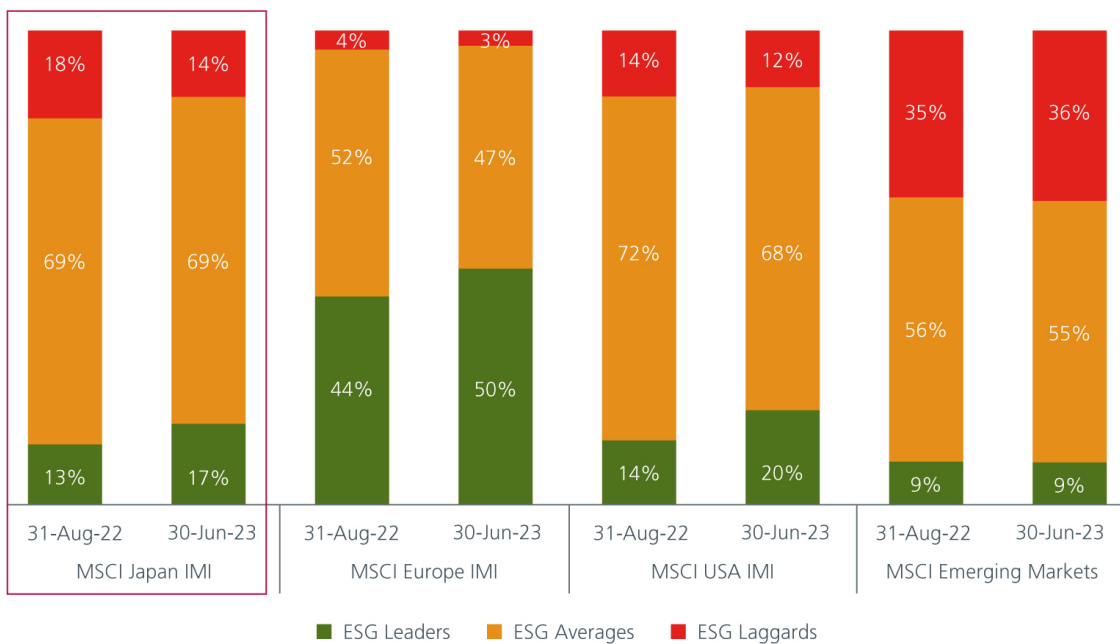
Source: ¹Compounded average growth rate from 2018 to 2022 based on data from Japan Sustainable Forum (JSIF) April 2023.

Fig 1: Japan's power generation capacity mix



Source: International Energy Agency, Ministry of Economy, Trade and Industry, Japan, 2022.

Fig 2: MSCI company ESG rating concentration across regions



Source: MSCI ESG Research. MSCI IMI are MSCI Investable Market Indexes cover all investable large-, mid- and small-cap securities across markets, targeting approximately 99% of each market's free-float adjusted market capitalization. MSCI ESG Ratings measure a company's management of financially relevant ESG risks and opportunities. The ESG Ratings range from Leaders (AAA, AA), Averages (A, BBB, BB) to Laggards (B, CCC).

On the “S” pillar, Japanese companies have always done better, having stuck to the unique practice of prioritising the interests of other stakeholders; a centuries old code of ethics (shuchu kiyaku) guides that trade should be mutually beneficial. Japanese companies also have a long tradition of taking care of employees and communities as per the “spirit of the corporation”.

Japan is also the first country to issue a new principles-based code of conduct for ESG ratings and data providers which has been adopted by several major ESG data providers such as FTSE Russell, Moody’s, S&P, Refinitiv and Sustainalytics. This should improve the transparency and quality of ESG ratings and data going forward. See Fig. 2.

2. ARE MORE JAPANESE CORPORATES EMBEDDING ESG PRINCIPLES?

Japan’s Government Pension Investment Fund (GPIF), the world’s largest pension fund, triggered a chain reaction from 2017 when it began allocating funds to ESG investments. Japanese corporates followed suit by embracing ESG so that their ESG ratings would appeal to GPIF and other investors. More recently, growing investor interest in Japan’s stock market is pressuring listed companies to improve their ESG standards.

We see a lot more companies now disclosing and mapping ESG strategies to the Sustainable Development Goals

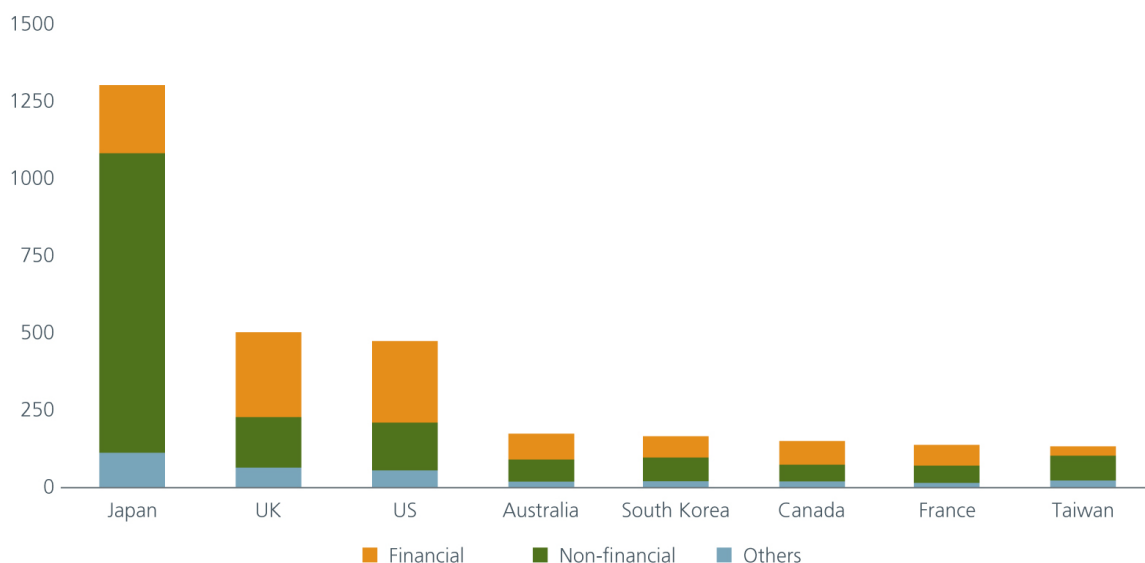
compared to five years ago. It is worth highlighting that more financial institutions and corporates in Japan support the Task Force on Climate-related Financial Disclosures (TCFD) than peers. See Fig. 3. From September 2023, all listed companies will also have to adhere to mandatory disclosure requirements on their sustainability and corporate governance strategies.

3. WHAT STRENGTHS CAN JAPAN LEVERAGE ON TO BECOME CARBON NEUTRAL?

Japan is well known for cutting edge technology. It is thus no surprise that they have a leading inventory of low-carbon technology patents. See Fig. 4. Japanese companies have a long history of reducing energy consumption and maximising energy efficiency given the scarcity of resources; they have accumulated the largest inventory of battery technologies in the world including lithium-ion batteries (with much higher capacity and durability) and all other solid-state batteries. The challenge is to quickly commercialise these technologies to capture growth opportunities both overseas and locally as Korean and Chinese peers are accelerating their pace of innovation.

The government is also pushing for technological development to take place within a cross-industry framework. By investing in tech innovation, companies can transform their business models and in turn derive business revenues from sustainable solutions.

Fig 3: Number of institutions supporting the task force on climate-related financial disclosures



Source: TCFD consortium data as of 24 April 2023.

The other aspect is the drive to become a circular economy. There are strict laws to control waste. Japan’s waste recycling is the highest in the world; plastic recycling for example amounted to 87% in 2021 from 80% in 2012².

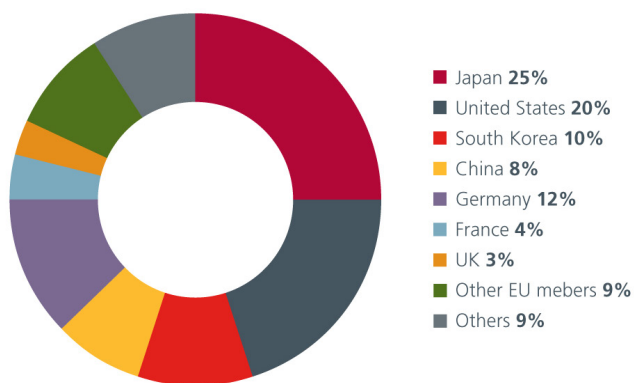
4. HOW CAN ASSET MANAGERS HELP ACCELERATE JAPAN’S PATH TO DECARBONISATION?

Asset managers should continue to encourage companies in their portfolios to address ESG in their business operations. At Eastspring we do this via active engagement and proxy voting, both of which are central to our investment process

and stewardship commitment. See Fig. 5. We will also engage in direct dialogue with the investee company’s management to influence policies on sustainability as well as address and/or rectify the issues as soon as practically possible.

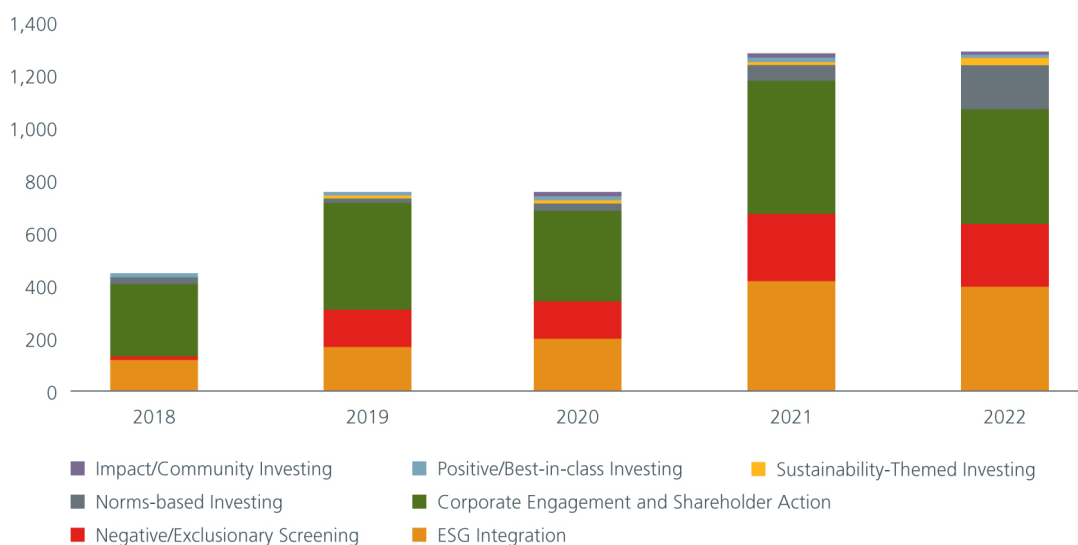
In addition, investee companies are monitored closely if they are on the Watch List for possible violations of Global Norms or assessed as having “Severe and Most Severe Controversies” by third-party research providers. Regular dialogue with senior management and the Board is conducted by our investment team to ensure awareness and willingness to address the issues in a timely manner.

Fig 4: Top low-carbon technology patent holders by countries



Source: European Patent Office, International Agency, “patents and the energy transition”, April 2023. Data is cumulative (2010-2019)

Fig 5: Engagement and shareholder action is Japan’s favoured strategy



Source: Japan Sustainable Investment Forum (JSIF), April 2023

Source: ²Statista, 2022.

5. WHICH SECTORS OFFER THE MOST ESG OPPORTUNITIES?

Japan’s green investment opportunities are underappreciated. The sustainable investment universe of listed equities is expanding. Within this space, we observe a diverse range of green business opportunities, from activities under research and development such as carbon capture and storage, hydrogen, fuel cells, etc. to activities that are already generating revenue and profit such as electric vehicles, renewable power generation, energy efficiency, pollution prevention, waste treatment and management, water treatment and infrastructure, etc.

Our investment team also considers the EU taxonomy guidelines to identify potential sustainable investment opportunities. This framework helps investors identify and measure business activities that are environmentally sustainable. An analysis of companies with over 5% revenues that are eligible and aligned with the EU Taxonomy in addressing two of the six environmental objectives i.e., climate change mitigation and climate change adaptation, reveal that European and Japanese companies have the highest exposure to sustainable business activities. See Fig. 6.

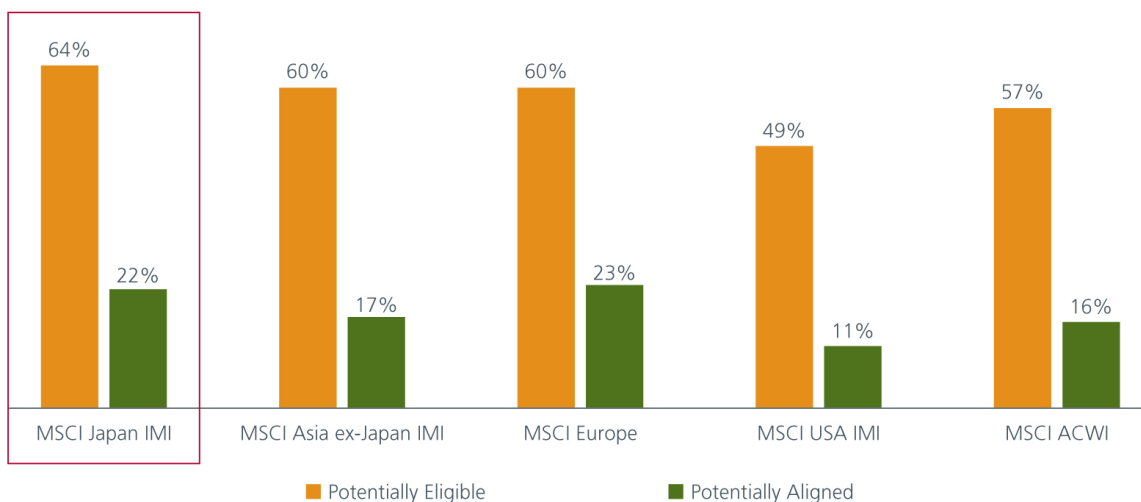
6. WHAT ARE SOME OF THE BIGGEST CHALLENGES FOR JAPAN?

On the “E” front, nuclear energy is the way forward, but public sentiment is against it. However geopolitical risks such as the Russia-Ukraine war, Sino-US tension, Middle East uncertainties, etc. may influence Japan’s domestic opinion to favour restarts of idle nuclear power plants. Still significant hurdles remain that prevent the reactivation of these plants.

Japan’s mountainous terrain running through all the four main islands limits the country’s ability to increase its renewable energy sources. According to International Energy Agency, to reach its carbon neutral goal by 2050, Japan would thus need to invest significantly to commercialise low carbon technologies such as hydrogen, fuel cell, carbon capture and storage, etc. alongside existing ones, and infrastructure such as electric vehicles, smart grids, energy storages, robotics, etc.

On corporate governance, remarkable improvement has been achieved in recent years thanks to the efforts of the government, the Financial Services Agency, the Tokyo Stock Exchange, and institutional investors. Despite this, Japan’s current governance practices are still not at par with their US and European peers, especially the Board structures (tenure, diversity, age, quality of directors, etc.).

Fig 6: Percentage of companies potentially eligible and/or aligned to the EU taxonomy by regions



Source: MSCI ESG Research, Eastspring Investments as of 31 March 2023 using 5% revenues as cut off point. MSCI IMI are MSCI Investible Market Indices that cover all investable large-, mid- and small-cap securities across markets, targeting approx. 99% of each market’s free-float adjusted market capitalisation. MSCI ACWI has over 8,000 investable securities.

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