Kempen

12 January 2022
Fujitec Co., Ltd.
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To: Board of Directors, Fujitec Co., Ltd
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Kempen Capital Management expresses concerns over disappointing mid-term plan and inadequate corporate governance at Fujitec

This letter is written by Kempen Capital Management N.V. ("Kempen", "we") as the manager of funds that are minority shareholders of Fujitec Co., Ltd. (6406 JP) ("Fujitec" or the "Company"). Funds managed and accounts advised by us currently own approximately 3.5% of the outstanding shares of the Company.

When investing, we always aim to be long-term shareholders, with an average investment horizon that extends beyond 5 years. We started investing in Fujitec in August 2014 and ever since have been in frequent contact with the Company.

Kempen takes its role and responsibility as long-term engaged shareholder very seriously. We consider it our fiduciary duty to share and discuss key observations and make suggestions to drive long-term sustainable value. Specifically at Fujitec, the underperformance versus peers and the structural undervaluation of the Company's stock led us to provide numerous suggestions to improve shareholder communications, capital efficiency, corporate governance and the geographical footprint.

While steps have been taken to address some of the issues that we raised, most notably with respect to improved shareholder communications, the mid-term plan released on 22 December 2021 ("Vision 24", the "Plan") nevertheless failed to adequately address our main concerns. This raises questions regarding Fujitec's leadership and governance, and whether the right structure is in place to address the persistent undervaluation and underperformance versus peers. Consequently, we are taking the – for us highly unusual – step of publicly voicing our concerns, and call on the Board of Directors to take action.

An inherently attractive business, but Fujitec is lagging peers on all relevant performance metrics

Fujitec is one of the largest elevator and escalator manufacturers in the world. With a history dating back to 1948, Fujitec is well regarded for its high-quality manufacturing, delivering safe and reliable elevators and escalators. It has strong market positions in the greater Asian region, benefitting from scale and high brand awareness.

The large installed base is one of the key attributes of Fujitec's business model. The maintenance and repair of installed units drive an attractive service model, resulting in a high level of recurring cash flows with low CAPEX requirements.

Despite the attractive business fundamentals, Fujitec's operating performance is severely falling short of its potential and significantly lagging international competitors, as shown in Table 1. We believe that a combination of inefficient capital allocation, operational inefficiencies, opaque disclosure and inadequate corporate governance are root causes of Fujitec's valuation discount versus peers.

More specifically, our main outstanding concerns are:

- Non-core exposure to North American and European geographies, where Fujitec lacks proper scale, thereby diluting operating margins.
- An inefficient balance sheet, with excess cash and a significant portfolio of investment securities depressing the Return on Equity (ROE).
- A combined Chairman and President/CEO role undermining the purpose of independent oversight.
- A traditional audit & supervisory board structure leading to inefficient decision making.

Table 1	Fujitec	Schindler	Otis	Kone
EV/EBITDA	6.8x	14.1x	16.7x	19.2x
Adj. Operating Margin	7.6%	11.4%	15.3%	12.4% - 12.8%
Return on Equity	7.6%	19.3%	n.m.	35.1%
Net cash as % of market cap.	41%	14%	-11%	7%

All data as of January 10, 2022 – based on last reported balance sheets and current full fiscal year's guidance. EV/EBITDA adjusted for treasury stock. Net cash includes investment securities. Otis metric ROE represented as "not meaningful, n.m." given the negative book value of equity. Schindler operating margin based on 9 months 2021 as no guidance on this financial metric is given. Kone net income based on Factset consensus forecasts as no guidance is given.

Our concerns related to the "Vision 24" plan

The Vision 24 plan lacks details and a commitment to address our concerns on capital efficiency, underperformance versus peers and corporate governance. We question the thoroughness and process by which the management team prepared the Plan. Furthermore, we have doubts on the level of scrutiny and challenge by the Board of Directions on the underlying assumptions and financial implications of the Plan. The low level of detail provided to the public gives us little confidence that adequate due diligence by the Board of Directors could have taken place.

Our main observations and concerns are the following:

- *Organic growth plans are difficult to understand*: Fujitec seems confident about organic growth opportunities and its ability to outgrow the market. The Plan outlines an ambitious growth target of +8.5% organic sales CAGR over the next three years. We are, of course, supportive of strong growth, but it is unclear how Fujitec plans to achieve this. While the regional breakdown is helpful, the Plan lacks numerical rationale. Terms such as "expand new installations in growth markets by active investment", "develop and expand sales of modernization products" and "strengthen cost competitiveness", sound appealing but there is no detail on how this would translate into actual topline growth. Short straplines do not make for a convincing strategy and without explaining how Fujitec plans to achieve the goals, we cannot be convinced of the achievability of these targets.
- *Unambitious operating margin improvement:* Fujitec targets a FY 2024 operating profit margin of 9.4%, which highlights an expectation for continued underperformance versus global peers. The operating profit margin target is also a step back from the "10% or higher" target outlined in the 2020 Future Strategic Direction presentation. Taking into account operating leverage from a planned +28% sales growth through FY 2024, the unambitious margin target represents a lack of commitment to addressing Fujitec's low profitability.

- *Substantial investments planned, but details and a capital allocation framework are lacking*: As part of the Plan, Fujitec intends to make substantial investments, grossly exceeding operating cash flows. The Plan lacks details on the investment parameters, where the capital will be deployed and at what conditions and expected returns. The fact that just two pages of the Plan were dedicated to the capital allocation policy showcases a serious lack of analysis and consideration. A vague JPY 68bn proposed investment budget exposes shareholders to an unacceptable amount of unknown risk.
    - CAPEX: Fujitec plans for JPY 33bn in CAPEX over the next three years. This level is more than three times Depreciation & Amortization and exceeds Fujitec's entire CAPEX over the past 11 years. There are no details on where or how Fujitec plans to invest this massive budget. Besides the magnitude of the proposed CAPEX budget, we question the investment rationale and economics. Such an allocation is counter to the capital-light outsourced strategy of more successful global peers and faster-growing after-market focused competitors.
    - M&A: Equally striking and alarming is the JPY 35bn budget for potential M&A. Unlike global peers, Fujitec has no credible track record of pursuing acquisitions. No parameters or guidelines around the M&A plan were given, and shareholders are left in the dark about where ~30% of shareholder's equity might be invested. Such an opaque acquisition strategy, even with a credible track record, is highly risky and something that we cannot support.
- *No step-up in shareholder returns, despite an inefficient balance sheet depressing ROE*: Fujitec outlined no plans to raise the dividend payout ratio nor commit to share repurchases, despite an inefficient balance sheet depressing ROE and Fujitec's shares trading well below peer group multiples. Considering Fujitec's valuation and attractive positioning in growth markets, we do not understand why investing in Fujitec's own shares has not been included as part of a capital allocation plan.
- *The 10.7% ROE target implies no improvement in capital efficiency:* The FY 2024 ROE target of 10.7% implies no improvement to Fujitec's overcapitalized and inefficient balance sheet. The Plan ignores Fujitec's excess cash and strategic investment securities, only perpetuating Fujitec's underperformance. We are disappointed at the lack of commitment to improving Fujitec's ROE by addressing the hugely important equity component of the equation.
- *Treasury shares act as an overhang:* Fujitec aims to "maintain treasury stock at an appropriate level." The treasury shares (4.8%) act as an unnecessary overhang. Fujitec has not issued treasury shares for corporate purposes before. Furthermore, Fujitec's shares are undervalued. It is a basic principle of corporate finance that investments should be funded with the cheapest source of capital.
- *Fujitec aims to further strengthen corporate governance, but details and commitments are lacking*: As part of the Plan, Fujitec aims to "strengthen corporate governance further". It is unclear what improvements will be imposed as the Plan lacks details and commitment.
    - Fujitec does not sufficiently address the topic of Board independence. Fujitec targets to "increase diversity of outside directors", but fails to address that the Chairman and CEO role is occupied by the same insider. METI's Practical Guidelines for Corporate Governance Systems encourage companies to examine whether the powers and title of Chairman and CEO should be separated.
    - Fujitec has a traditional audit & supervisory board structure in place and seems willing to continue with this structure. This prevents decisions from being delegated to management, thereby leading to inefficient decision making.
    - The topic of strategic (cross) shareholdings is not being addressed as part of the Plan, despite it explicitly being a topic of special attention within the Japanese Corporate Governance Code.

Our recommendations

We believe that the lack of details and commitment in the Plan can be a symptom of a deeper underlying issue, which is related to the quality, adequacy and the independence of decision making by the leadership team and Board of Directors at Fujitec. This raises questions whether the right structure is in place to address the persistence in undervaluation and underperformance versus peers.

We call on the Board of Directors to address our concerns, and undertake – or commit to – the following actions before Fujitec's 2022 AGM:

- *Sales growth and operating profit margin targets*:
  - Outline a clear explanation on how to outgrow competition and achieve the revenue targets.
  - Disclose a margin bridge to show how the 9.4% operating margin target is being achieved.
  - Assess opportunities to enhance profitability towards peer group averages, which would include addressing the margin-diluting activities in North America and Europe.
- *CAPEX budget*: Detail what JPY 33bn of CAPEX will be spent on, the impact on profits and the expected returns on investment.
- *M&A strategy and guidelines*:
  - Provide the investor base with a clear set of strategic and financial requirements against which M&A opportunities are evaluated. These should at a minimum include strategic fit, leverage on the existing asset base, minimum margin and ROIC hurdles. Explain how Fujitec takes into account its ability to execute (post) acquisitions.
  - We look for a strategy that is focused on smaller bolt-on acquisitions in Asia and aftermarket businesses, with a return on investment hurdle well above the cost of equity and higher than the EPS (earnings per share) accretion from buying back Fujitec's undervalued shares.
  - For acquisitions larger than JPY 10bn seek shareholder approval and – over the period of the mid-term plan – allocate unused M&A budget to share buybacks.
- *ROE target*: Revise the ROE target to 15%, which would be achieved by allocating the M&A budget to share buybacks.
- *Board independence and decision making*: Separate the Chairman and CEO role, appointing an independent Chairman. Furthermore, change the board structure to one with three committees.
- *Strategic (cross) shareholdings:* Commit to divesting all strategic (cross) shareholdings, over the period of the mid-term plan, and use the proceeds for share buybacks.
- *Treasury shares:* Cancel all remaining treasury shares.

Closing remarks

We are saddened that we have to take this drastic – and for us unusual – measure to publicly voice our concerns. We continue to believe that Fujitec is an intrinsically good business with an even greater potential, if its leadership team would embrace the opportunities to enhance operational efficiency, capital efficiency and corporate governance. Unfortunately our engagement behind closed doors has proven insufficiently effective and our concerns have remained largely ignored. Fujitec's persistent underperformance versus peers has also not gone unnoticed by other shareholders, as witnessed by earlier public campaigns by other shareholders. Simply ignoring Fujitec's problems is not a solution, nor do we expect this will lead to an abatement of shareholders' demands.

We hope that the Board of Directors will take adequate actions to address our concerns. As always, we remain open to continue our dialog with the Company.

Kind regards,

Chris Kaashoek

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About Kempen Capital Management

Kempen Capital Management is a specialist asset manager with a focused approach and a clear investment philosophy. We believe in long-term stewardship for our clients and other stakeholders. Kempen provides sustainable returns, fiduciary management services, manager selection, portfolio construction and monitoring, alongside a number of actively-managed investment strategies. As of 30 June 2021, Kempen Capital Management had a total of €88.3 billion in client assets under management.

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