

**PAINTING A BETTER SK KAKEN**  
May 2022

# Summary

Asset Value Investors (“AVI”)(“we”) would like to thank SK Kaken employees for their stewardship of the Company during the difficult past few years and for the hard work and commitment that they have shown. SK Kaken is a wonderful company, with a rich history and well-renowned product offering.

Unfortunately, despite SK Kaken’s high-quality business we believe it is being mismanaged by top management and the concentration of power with the 89-year-old founder is stifling SK Kaken’s potential. There seems to be a culture of intransigence and traditionalism, with voices promoting progress ignored.

We have tried to conduct our dialogue privately, but the founding Family has refused to listen to our suggestions and have repeatedly rejected our meeting offers. AVI is reluctantly submitting shareholder proposals to the June 2022 AGM. Although more actions are needed, we have identified six easily addressable issues aimed at sustainably enhancing SK Kaken’s corporate value and retaining SK Kaken’s TSE listing.





# OUTLINE OF SK KAKEN'S ISSUES

# Painting a Better SK Kaken

- SK Kaken is failing its responsibilities as a listed company with a falling share price, a woefully low valuation and barely meeting the listing requirements of the Tokyo Stock Exchange (“TSE”).
- SK Kaken’s issues reflect a lack of urgency and weak management discipline, a symptom of a company with a controlling shareholder. Approximately 40% of SK Kaken’s shares are owned by, and key senior executive positions are held by, members of the founding family. The average tenure of the SK Kaken board is 21 years and decision making is concentrated with the 89-year-old Founder, leading to a culture of intransigence and traditionalism, starving the Company of progress including on environmental concerns impacting wider stakeholders.
- AVI submitted shareholder proposals last year, seeking a 10-for-1 stock split and to cancel 90% of the outstanding treasury shares. Although general shareholders strongly endorsed both proposals (55% and 57% respectively), it has fallen on deaf ears.
- AVI asks its fellow general shareholders to continue to express their disapproval of management policies under the influence of a controlling shareholder who has neglected the interests of minority shareholders for too long.

**Encouraging SK Kaken to adapt and progress for the benefit all of stakeholders**

# Share Price Underperformance

- Over 5 years SK Kaken’s share price has underperformed all of its peers, both global and domestic.
- SK Kaken’s share price performance has significantly underperformed the wider TOPIX index.
- Shareholders are suffering and top management should be held accountable for the long-term share price decline.

**-30%**

SK Kaken's 5 Year Share Price

vs.

**+2%**

Domestic peers

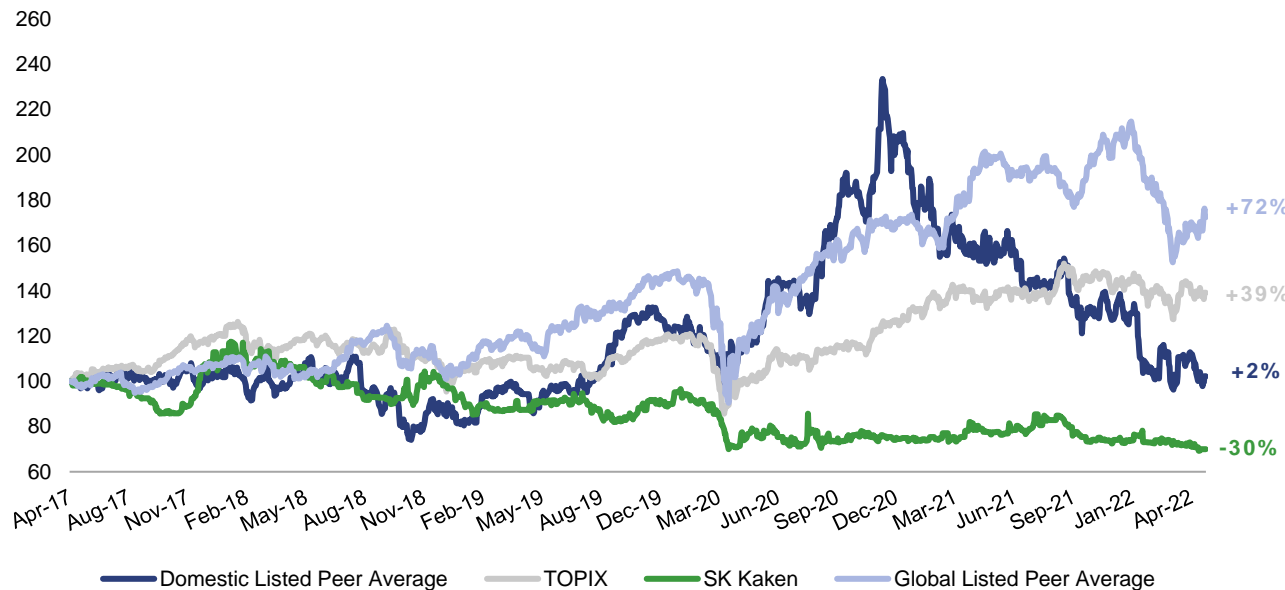
**+72%**

Global peers

**+39%**

TOPIX

## SK Kaken Share Price Underperformance



**Source:** AVI, Capital IQ (as at 30/04/2022). **Note:** Share prices are on a total return basis, including dividends and in each Company's local currency. SK Kaken, Nippon Paint and Kansai Paint JPY, The Sherwin-Williams Company, PPG Industries and RPM International USD, Akzo Nobel EUR. Simple average.

Global peers = The Sherwin-Williams Company, PPG Industries, Akzo Nobel and RPM International

Domestic peers = Nippon Paint and Kansai Paint

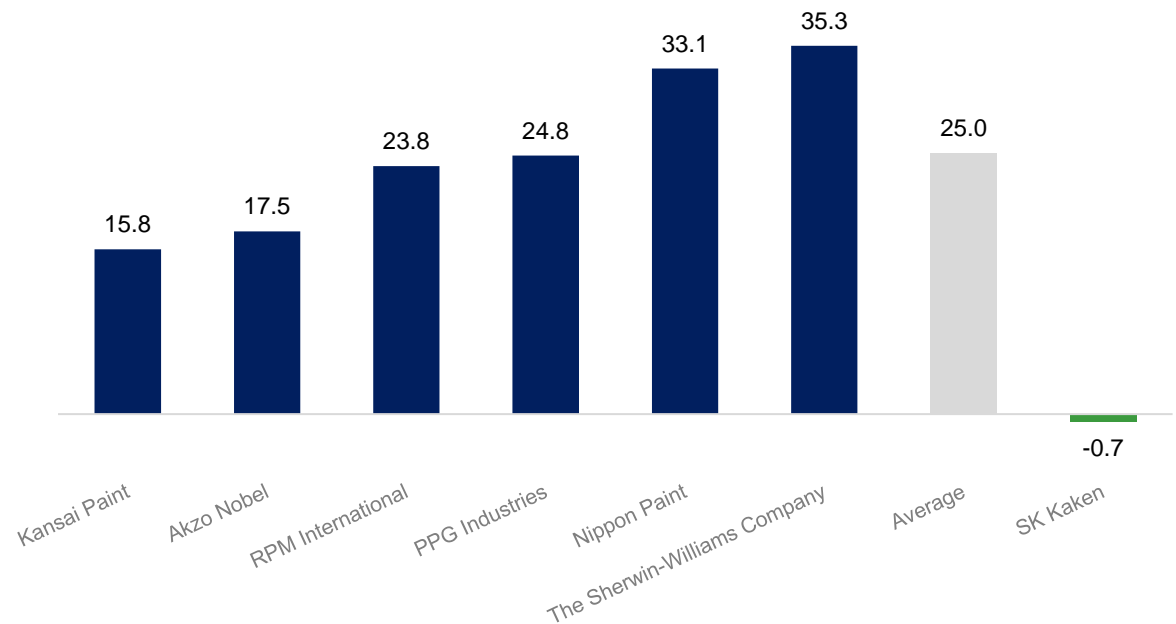
# Relative Undervaluation

- SK Kaken trades at a significant discount to its peer group
- We do not attribute the extreme undervaluation to an inferior business model. While SK Kaken has higher exposure to the domestic market, current management policies are to blame
- The low valuation should be an embarrassment to SK Kaken management, highlighting deep pessimism from investors and a low opinion of SK Kaken's current management

103%

SK Kaken's net cash as % of market cap

## Peer Group EV/EBIT Multiple



Source: AVI, Capital IQ (as at 30/04/2022). Note: Enterprise Value (EV) = Market Cap - Net Cash - Investment Securities. EBIT is based on trailing twelve month

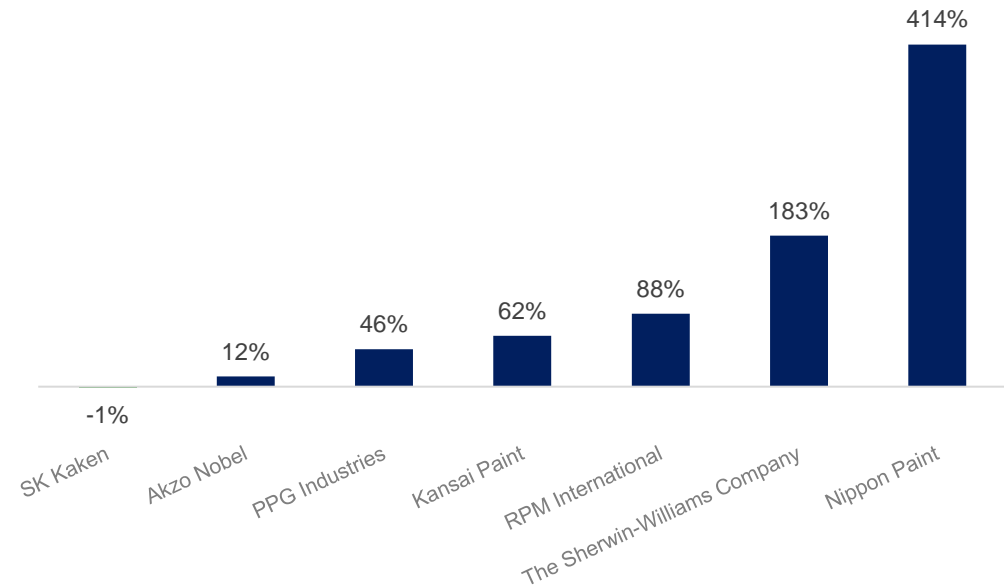
# Declining Profit

- Over 10 years SK Kaken's profits have fallen by -1%
- SK Kaken has generated the lowest profit growth of all its domestic and international peers
- We attribute the poor performance to a lack of investment, failing to successfully expand overseas and a culture of traditionalism stemming from the concentration in decision making with the 89-year old founder

-1%

SK Kaken's 10  
year profit growth

SK Kaken 10 Year Profit Growth vs Peers  
(local currency)



**Source:** AVI, Capital IQ, Company disclosure **Note:** Profits are in each Company's local currency. SK Kaken, Nippon Paint and Kansai Paint JPY, The Sherwin-Williams Company, PPG Industries and RPM International USD, Akzo Nobel EUR. 10 years ending at latest fiscal year. Year end 31<sup>st</sup> March 2022 for SK Kaken and Kansai Paint, 31<sup>st</sup> December 2021 for all other.

# Employee Dissatisfaction

- SK Kaken's governance and mismanagement seem not to just affect shareholders but also SK Kaken's employees
- The employees of SK Kaken are the pillar of its success
- Several posts made online by employees and ex-employees highlight frustration with the company culture and leadership
- Low overall review scores vs peers highlights employee dissatisfaction

**-3.1%**

Change in SK Kaken average employee salary over 10 years to Mar-2021<sup>2</sup>

## Voices of current and former employees<sup>1</sup>



“I question the fact that they did not try to change the old structure and were conservative.” *March 2018*

20s; male

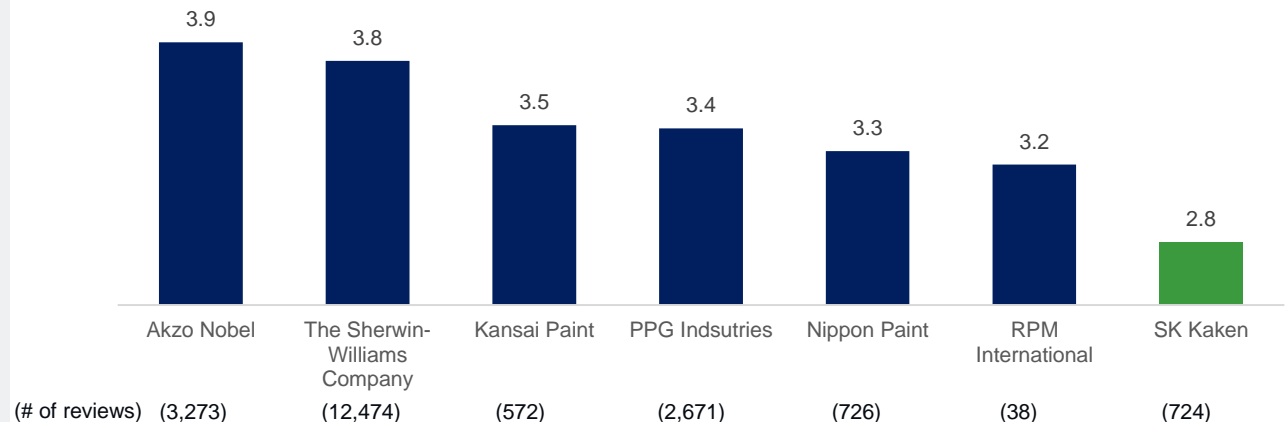
“The president's one-man management and organisational corruption, especially within the company. There was a lot of dissatisfaction among younger employees...” *April 2017*

20s; male

“They call it meritocracy, but in reality is more like a seniority system” *June 2020*

20s; female

## Weighted average employee review score on public job sites (/5)



**Source:** AVI, Capital IQ, Company disclosure (as at 30/04/2022).en Lighthouse, openwork, Tenshoku-Kaigi, Glassdoor, Indeed **Note:** <sup>1</sup>The comments were posted anonymously on Internet bulletin boards. As such, in conducting the investigation, AVI has not verified whether the persons posting these posts are in fact employees or former employees of SK Kaken, nor has it verified the credibility or accuracy, etc. of the content of the posts. Therefore, AVI hereby notes that AVI does not necessarily acknowledge nor makes any guarantee that the results of the investigation are true or accurate. <sup>2</sup>Average salary taken from SK Kaken's annual reports.



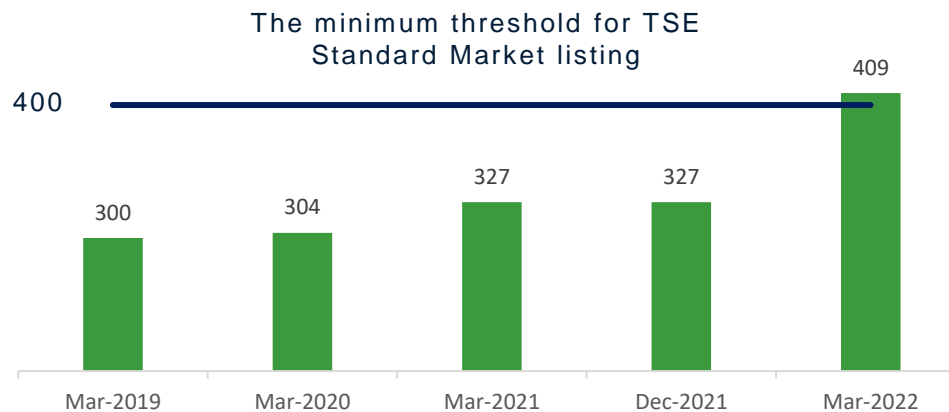
# Potential Delisting from TSE

- Despite being a well established large company, SK Kaken barely meets the TSE Standard market listing requirements
- SK Kaken has 409 shareholders vs. the minimum threshold of 400
- Furthermore, the average company in the Standard market of the TSE has a market cap of ¥14bn and sales of ¥27bn. SK Kaken has a market of ¥96bn and sales of ¥89bn
- SK Kaken should be on the Prime market, not struggling to qualify for the less prestigious Standard market

409

Number of shareholders  
as of 31<sup>st</sup> Mar 2022

## Number of SK Kaken Shareholders<sup>1</sup>



	Market Cap (¥bn)	Revenue (¥bn)
<b>SK Kaken</b>	93	89
<b>Standard Listing<sup>2</sup></b>	14	27
<b>Prime Listing<sup>2</sup></b>	357	425



# AVI'S RECOMMENDATIONS AND SHAREHOLDER PROPOSALS

# Overview of Shareholder Proposals

- We are putting forward a non-exhaustive set of easily implementable actions to address SK Kaken’s underperformance and attract more shareholders to continue to meet the requirements for listing on the TSE Standard Market

Issue	Suggested solution
Low trading liquidity	(1) A 10-for-1 stock split to reduce the prohibitively high minimum trading lot from ¥3,550,000 (the seventh-highest trading value among TSE-listed companies) to ¥355,000.
Treasury share overhang	(2) Cancel 90% of the 438,400 shares held in treasury. SK Kaken currently holds 14% of outstanding shares in treasury and has not put forward any plans to use the shares such as M&A or executive compensation.
Inefficient balance sheet	(3) Increase the dividend from Y400 per share to Y800, for a 30% payout ratio. SK Kaken has hoarded earnings on its balance sheet, with cash and cash equivalents accounting for almost 70% of balance sheet assets.
Poor Corporate Governance	(4) Shorten the Board of Directors’ term to one year. Against a background of increased awareness of the need to strengthen corporate governance, there has been a general trend of companies in Japan of reducing director terms from two to one year.  (5) Appoint a minimum of two independent directors. SK Kaken’s board of directors is currently only composed of one outside director, despite the Corporate Governance Code stipulating that for a company with a controlling shareholder, in SK Kaken’s case the Family, at least one-third of directors should be independent.
Lack of environmental policy	(6) Disclose Scope 1 and Scope 2 greenhouse gas (GHG) emissions. SK Kaken has not formulated even the most basic sustainability policy. The Corporate Governance Code stipulates that companies should promote positive and proactive responses to sustainability issues.

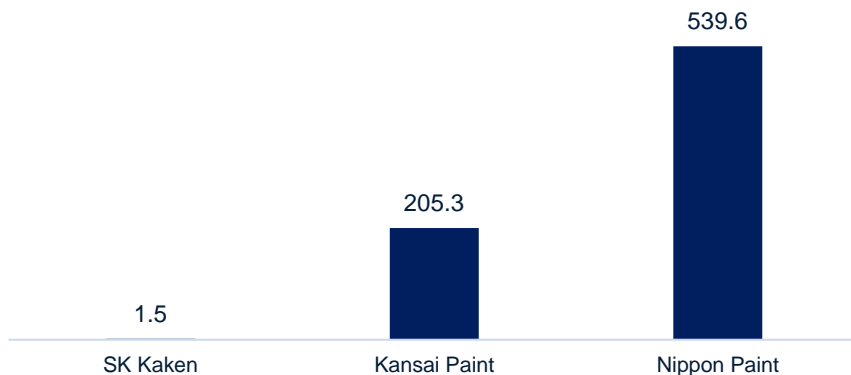


# Low Trading Liquidity

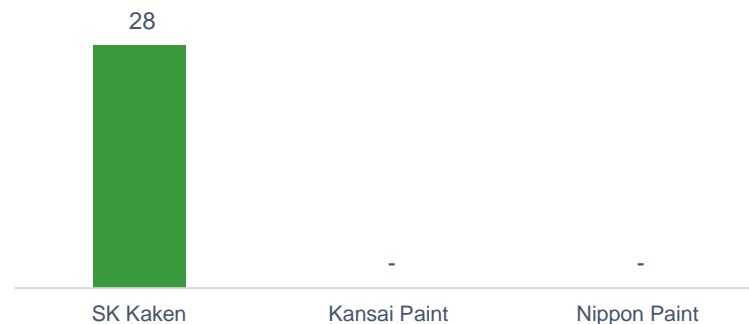
- Over the past six months only Y1.5bn worth of SK Kaken shares have traded and on 28 trading days (out of total 121 days) no shares traded, making it hard for potential new shareholders to invest
- In 2018, as part of the TSE’s efforts to standardise trading units, SK Kaken’s trading unit was reduced from 1,000 to 100, but at the same time SK Kaken decided to conduct a reverse stock split. The net effect was to only reduce the minimum trading size by 50%. It is unexplainable why management chose to undertake a reverse stock split

	Before	Oct-2018
Trading unit	1,000	100
Shares outstanding	15,673,885	3,134,777

Value Traded (Six months, Ybn)



Number of days where shares did not trade (last six months)



# Prohibitively High Minimum Investment Value

- We partially attribute SK Kaken's low liquidity to a prohibitively high minimum investment value of Y3,550,000, compared to the TSE's recommended value of between Y50,000 and Y500,000
- To attract new shareholders and improve trading liquidity we believe SK Kaken should undertake a 10-for-1 stock split

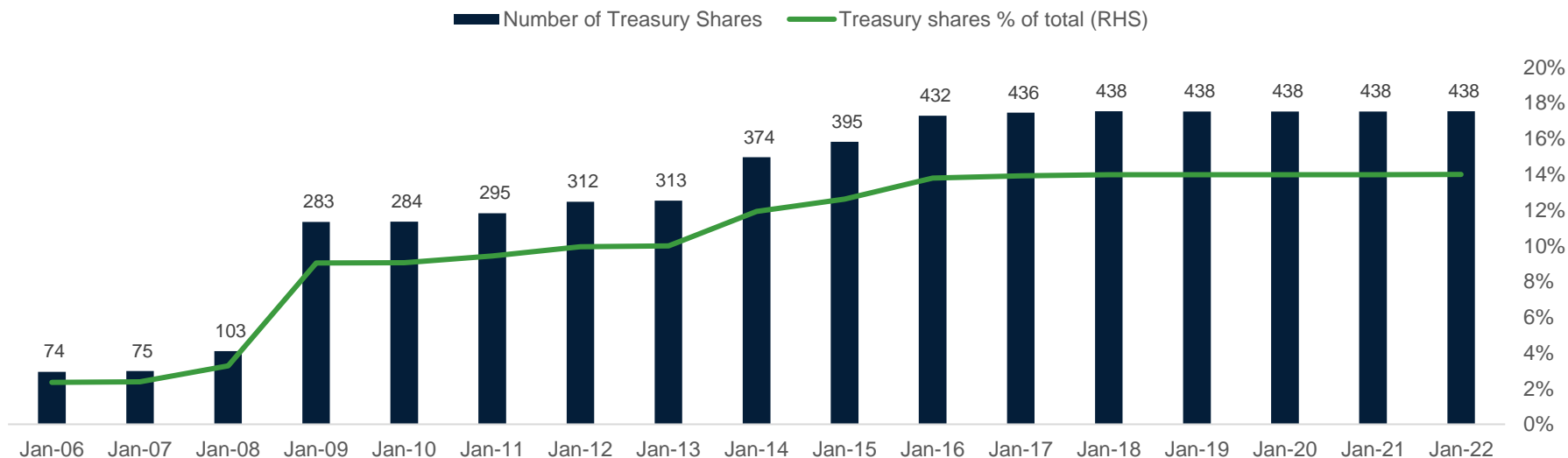
Minimum trading amount ranked by size  
(all TSE listed companies)



(1) Conduct a 10-for-1 stock split to reduce the prohibitively high minimum trading value.

# Treasury Share Overhang

- 14% of SK Kaken’s shares are held in treasury. SK Kaken has put forward no plans to use its treasury shares, and despite committing to “examine cancelling treasury shares as well as other flexible capital policies” in its response to our shareholder proposal last year, no improvements have been made
- Although the financial benefit from repurchased shares is the same whether they are cancelled or not, it is bad practice to hold a large portion of treasury shares and raises the possibility that they will be reissued, diluting existing shareholders.

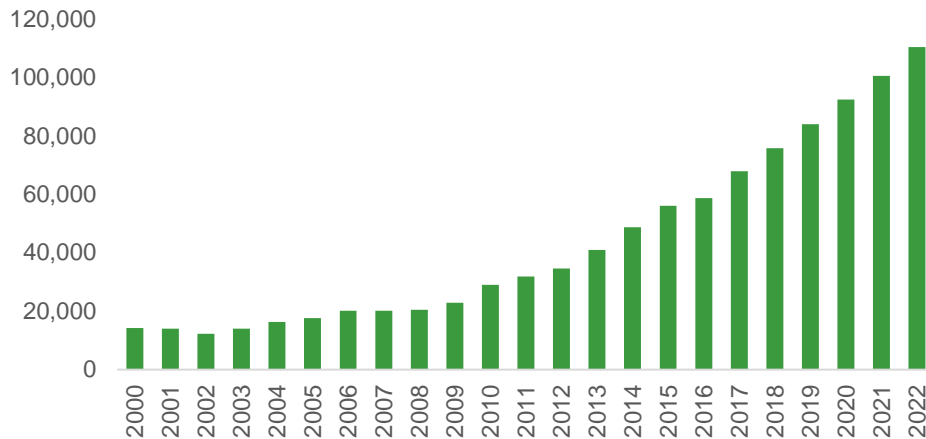


(2) Cancel 90% of the 438,400 shares held in treasury.

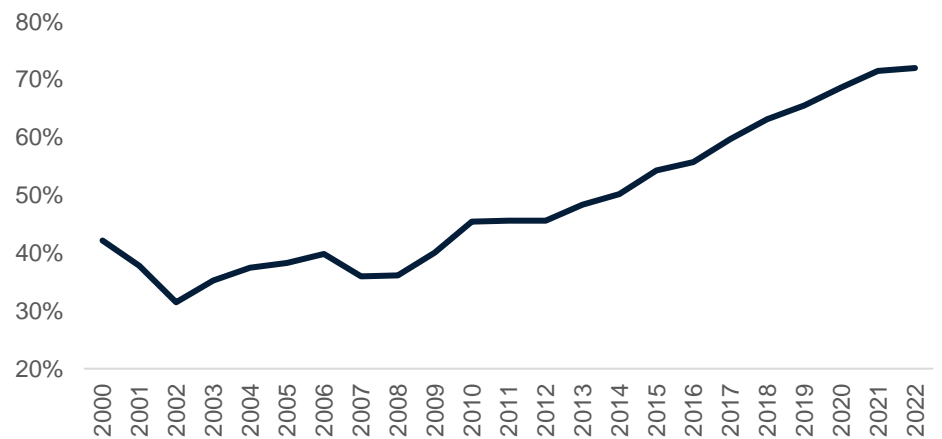
# Accumulation of Cash

- SK Kaken has allowed cash to accumulate on the balance sheet beyond reason
- Cash, cash equivalents and investment securities account for 72% of balance sheet assets compared to 42% in 2000 and 63% five years ago
- Cash less debt (net cash) has increased by 860% since 2000 and by 58% over the past five years

SK Kaken Cash, Cash Equivalents & Investment Securities (Ym)



Net Cash and Investment securities as % of Balance Sheet Assets

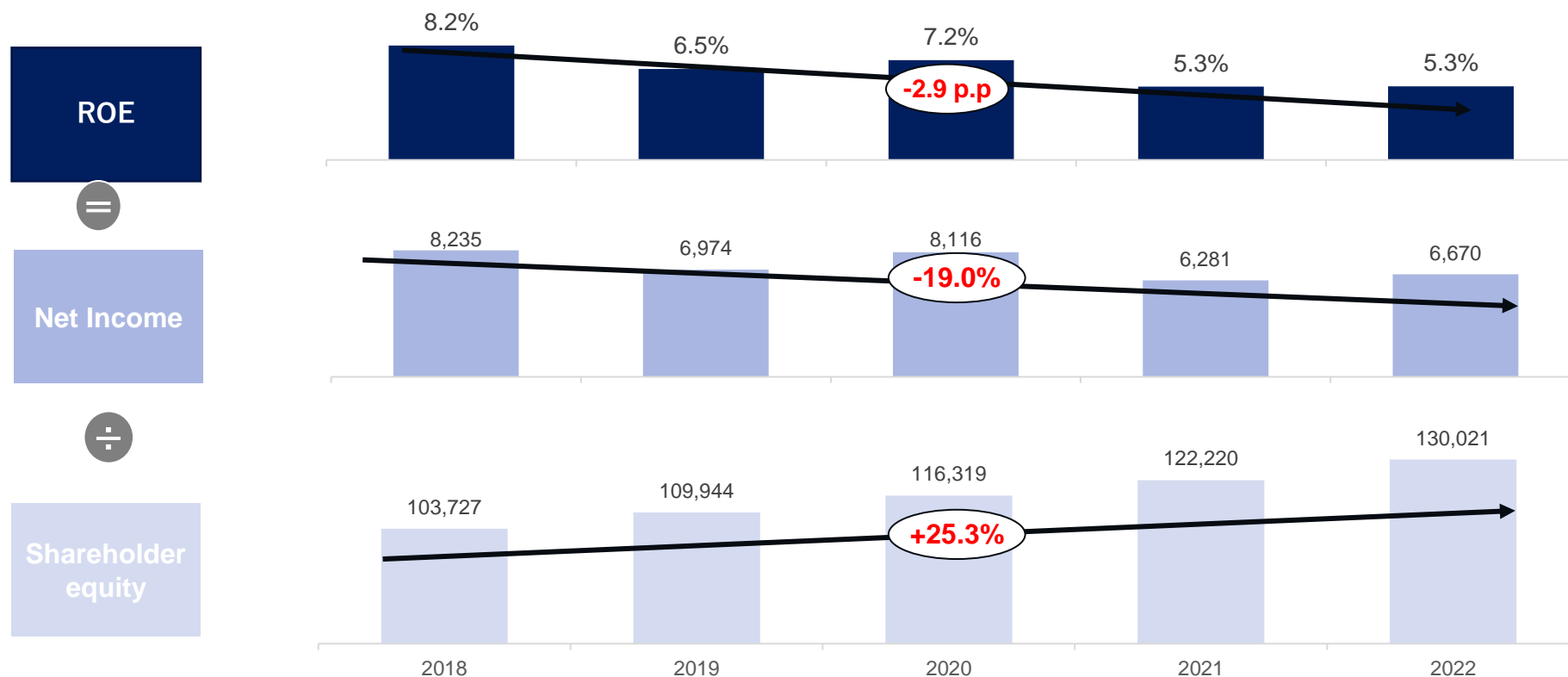


Source: AVI, Capital IQ, for financial year ending 31<sup>st</sup> March **Note:** Including investment securities for year ending March 2022 which totalled Y3,017m vs Y12m for the year ending March 2021



# Falling ROE

- Despite what should be a high return on capital business, SK Kaken’s ROE has been falling, suffering from both a declining net income and ballooning shareholder equity
- SK Kaken’s ROE is now at risk of falling below the 5% threshold required for voting support from ISS and far below the 8% recommended in the Ito review





# Lack of Investment Stifling Growth

- SK Kaken’s hoarding of cash has come at the expense of investment in CAPEX and M&A. Only 12% of cash flows generated over the past 10 years has been either returned to shareholders or invested
- SK Kaken has not undertaken any M&A, has not invested in upgrading aging facilities nor has it invested capital for overseas growth

## 5 Year Allocation of Cash

Company	10 Year Cashflow from Operating Activities (¥bn)	Shareholder Returns (o/w buybacks)	M&A	CAPEX	Working Capital	Cash Deployed as % Cash from Ops
SK Kaken	42	9% (0%)	0%	3%	-7%	12%
Kansai Paint	163	23% (0%)	9%	45%	14%	91%
Nippon Paint	448	19% (0%)	45%	27%	13%	104%
RPM International	343	52% (18%)	29%	26%	10%	116%
Akzo Nobel	557	205% (156%)	15%	44%	18%	283%
PPG Industries	1,101	65% (37%)	54%	21%	-4%	140%
The Sherwin-Williams Company	1,522	74% (56%)	78%	11%	-1%	172%
Peer Average		76%	42%	28%	8%	130%

# Low R&D Expenditure, Despite Cash Reserves

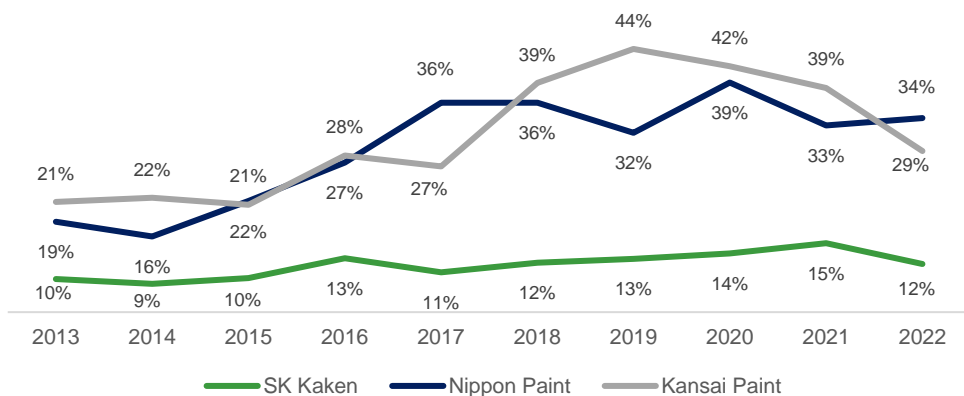
- SK Kaken has allocated only 0.9% of sales to R&D over the past five years
- With such a high amount of accumulated cash, SK Kaken can afford to be more aggressive in its R&D spending especially given how much smaller its R&D budget is compared to both domestic and international peers

<u>Company</u>	<u>5 Year Total R&amp;D Expenditure (¥bn)</u>	<u>5 Year Average R&amp;D Expenditure As % of Sales</u>
The Sherwin Williams Company	47	0.5%
SK Kaken	4	0.9%
RPM International	40	1.3%
Kansai Paint	31	1.6%
Nippon Paint	92	2.5%
Akzo Nobel	164	2.7%
PPG Industries	250	3.0%
Peer Average		1.9%

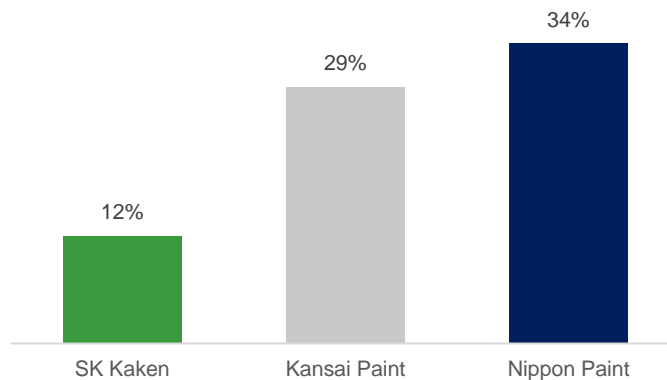
# SK Kaken Shareholder Returns

- SK Kaken’s peers have consistently paid out a higher portion of profits to shareholders while also allocating more aggressively to growing the business through CAPEX and acquisitions
- SK Kaken’s statement in their response to our shareholder proposals that “returning profits to shareholders is one of management’s top priorities” is hard to believe

10 year dividend payout ratio



Last fiscal year dividend payout ratio



(3) Increase the dividend from Y400 per share to Y800, for a 30% payout ratio.

# Poor Corporate Governance

- SK Kaken's homogenous board lacks diversity, with only one outside director and all inside directors having similar backgrounds
- All directors are male and Japanese, with an average age of 67 years and average board tenure of 21 years

## SK Kaken Board of Directors

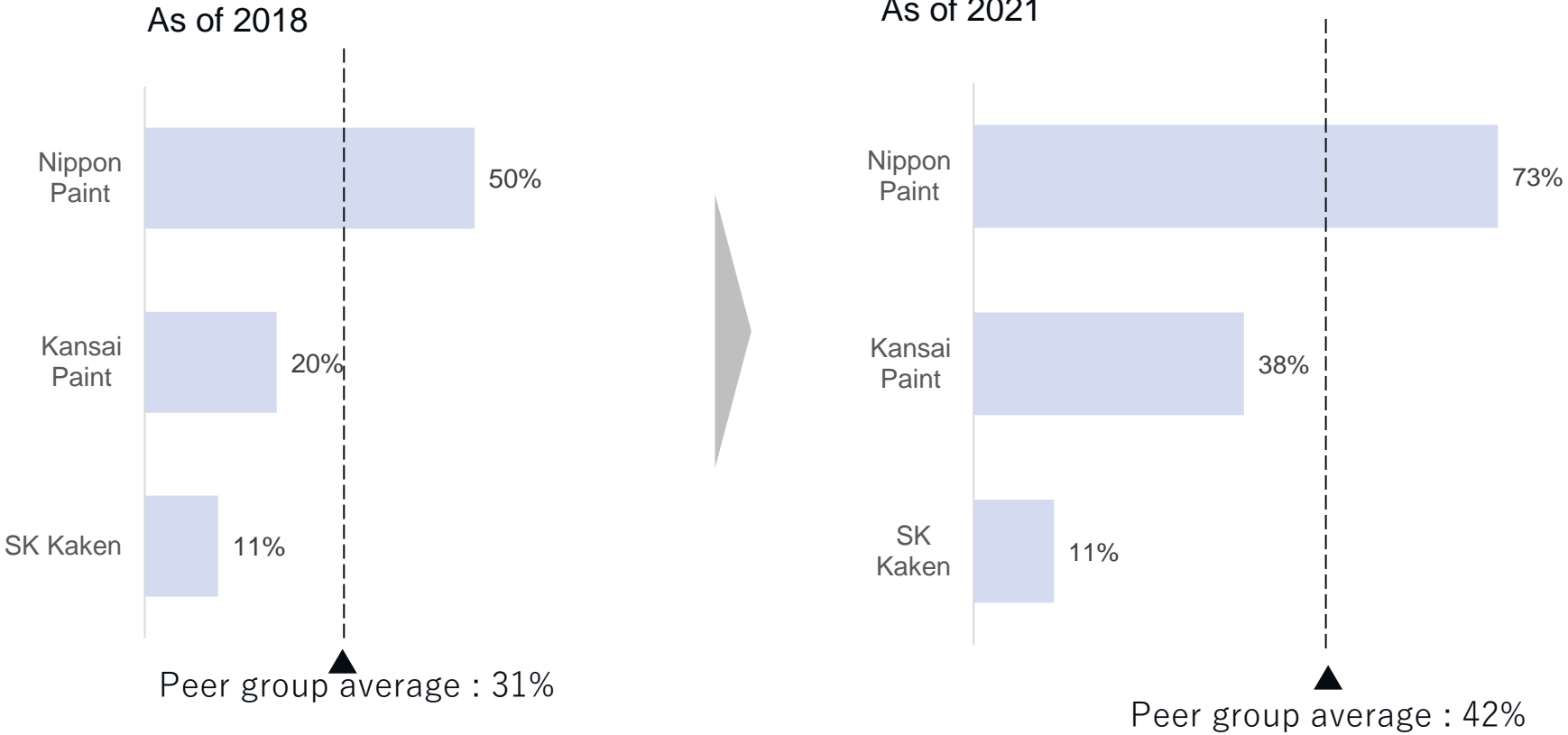
 Outside

	Gender	Nationality	Age	Tenure	Career
Mr Fujii Minoru	Male	Japanese	89	64	SK Kaken
Mr Fujii Mitsuhiro	Male	Japanese	56	22	SK Kaken
Mr Masahide Sakamoto	Male	Japanese	70	31	SK Kaken
Mr Fujii Kunihiro	Male	Japanese	53	18	SK Kaken
Mr Fukuoka Toru	Male	Japanese	63	17	SK Kaken
Mr Ito Yoshiyuki	Male	Japanese	68	16	SK Kaken
Mr Takeuchi Masahiro	Male	Japanese	65	4	SK Kaken
Mr Kataoka Hideto	Male	Japanese	67	3	SK Kaken
Mr Nagasawa Keizo	Male	Japanese	75	13	City Planning

# Ratio of Independent Directors to Peers

- Not only does SK Kaken have fewer independent board members it has made no efforts to improve independence over the past three years, unlike peers

## Percentage of independent directors



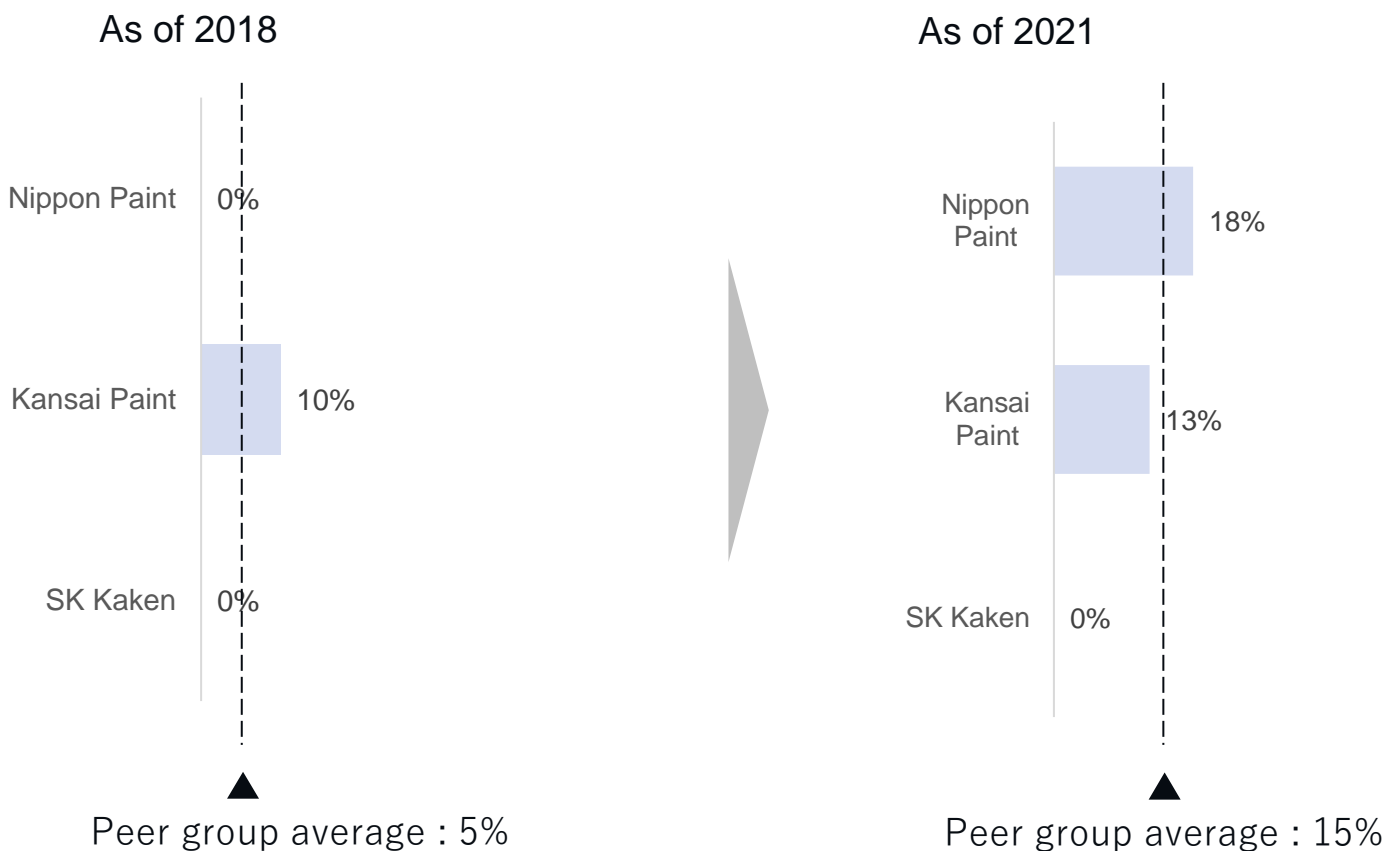
Source: AVI, Company disclosure (as of 30/04/2022) Note: As of June for SK Kaken and Kansai Paint, as of March for Nippon Paint



# Ratio of Female Directors to Peers

- SK Kaken has no female representation and has made no efforts to improve diversity over the past three years, unlike peers

## Percentage of female directors



Source: AVI, Company disclosure (as of 30/04/2022) Note: As of June for SK Kaken and Kansai Paint, as of March for Nippon Paint

# Corporate Governance Code

- Strengthening board diversity is called for in the Corporate Governance Code

## Corporate Governance Code

### Principle 4.11 Preconditions for Board and Kansayaku Board Effectiveness

The board should be well balanced in knowledge, experience and skills in order to fulfill its roles and responsibilities, and it should be constituted in a manner **to achieve both diversity, including gender, international experience, work experience and age, and appropriate size.** In addition, persons with appropriate experience and skills as well as necessary knowledge on finance, accounting, and the law should be appointed as kansayaku. (omitted)

- For company's with a controlling shareholder, in SK Kaken's case the founding family, the Corporate Governance calls for over 1/3 of directors to be independent

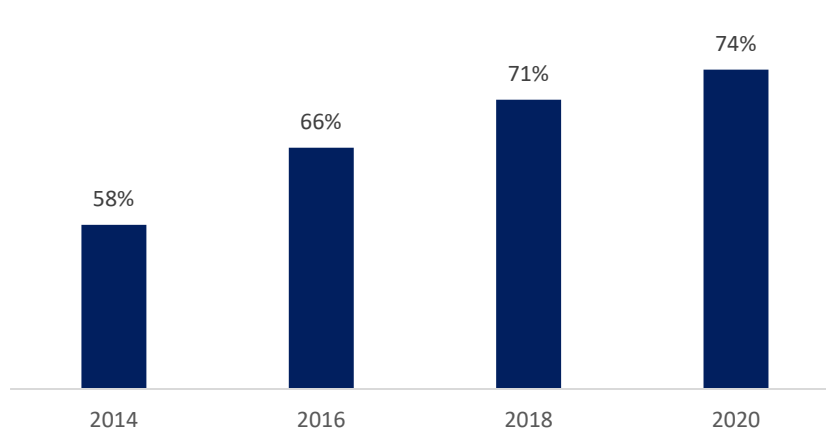
### Principle 4.8.3

Companies that have a controlling shareholder should either appoint at **least one third of their directors (the majority of directors if listed on the Prime Market) as independent directors who are independent of the controlling shareholder** or establish a special committee composed of independent persons including independent director(s) to deliberate and review material transactions or actions that conflict with the interests of the controlling shareholder and minority shareholders.

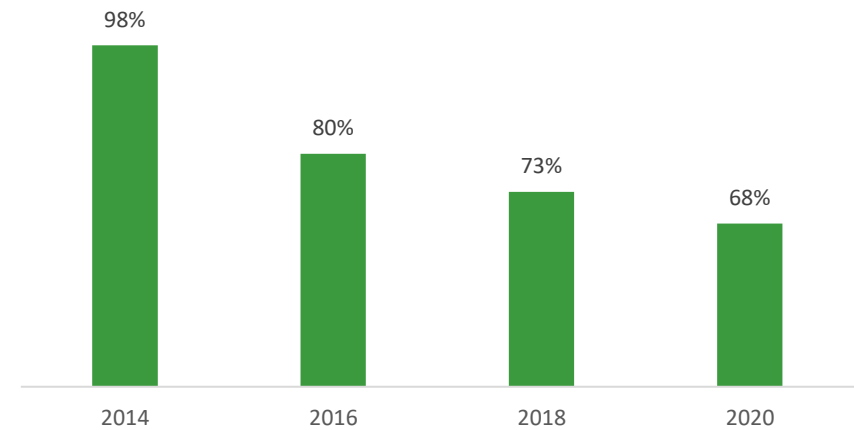
# Director Terms

- SK Kaken's Kansayaku board structure adopts two year terms for its directors preventing shareholders from expressing their views annually
- Companies listed on the TSE have been increasingly adopting one year director terms in light of improving corporate governance, and moving away from the antiquated Kansayaku board structure
- 74% of all listed companies on the TSE in 2020 had one year director terms

% of TSE companies with one year director terms



% of TSE companies with Kansayaku board structures



Source: Tokyo Stock Exchange "TSE Lighted Companies White Paper on Corporate Governance" 2021, 2019 and 2017. Note: Calculated from TSE disclosure of one year director terms for companies with Kansayaku board and estimated for all TSE companies based on % of companies adopting a Kansayaku Board structure





# Improving Corporate Governance

- Given the founding family's control over the Company it is vital that SK Kaken adopts the highest quality of corporate governance to protect minority shareholders
- SK Kaken's current corporate governance is lacking the basic requirements expected from a listed company and, we believe, is the ultimate root cause for many of SK Kaken's issues
- While SK Kaken should go further by shifting its board structure to one with an audit and supervisory committee, introducing an independent nomination & compensation committee and appointing over 1/3 of independent directors, shortening the director term to one year and appointing two independent directors is a start

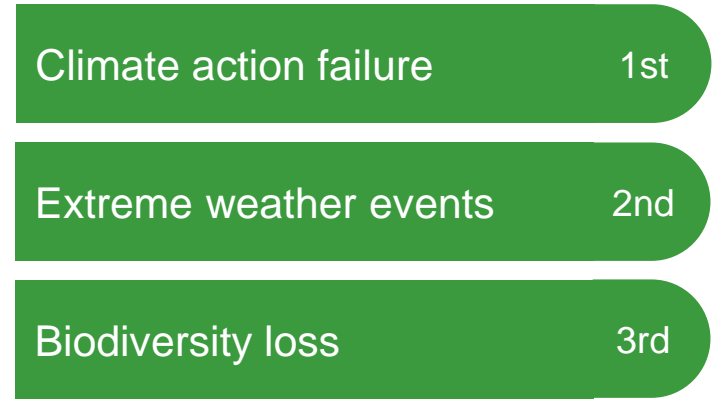
(4) Shorten the Board of Directors' term to one year

(5) Appoint a minimum of two independent directors

# Responsibility to Proactively Address Environmental Impact

- Climate change is perhaps the biggest global challenge we face, failure to act will have devastating consequences
- The chemical sector is the largest industrial consumer of both oil and gas and the largest industrial energy consumer overall, creating significant Scope 1 & Scope 2 emissions
- Japan’s industrial sector accounts for 37% of national energy-related emissions. Within this sector, the chemical industry is the second largest emitter, responsible for 15% of emissions
- SK Kaken, as the largest construction paints manufacturer in Japan should recognise its responsibility to proactively contribute to the development of a sustainable society and improve stakeholder trust by promoting transparency and accountability

## Top Global Risks by Severity Over the next 10 years



## GERMANWATCH Climate Risk Index 2020

Country	Rank	CRI Score
Japan	1st	5.5
Philippines	2nd	11.17
Germany	3rd	13.83

Japan ranked 1<sup>st</sup> in Climate Risk Index 2020 as the country most affected by extreme weather

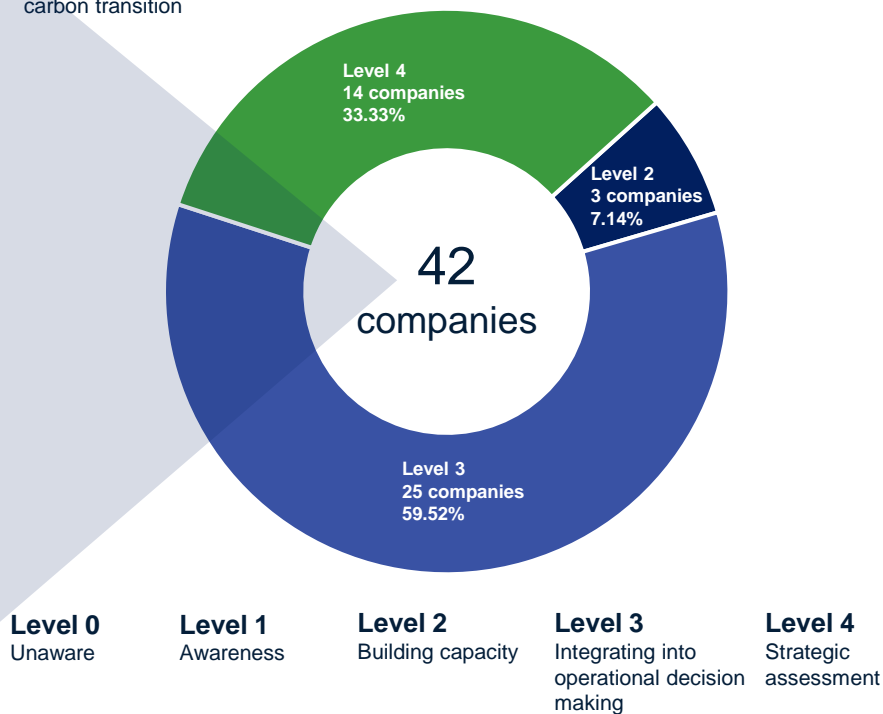


# Significantly Lagging Peers and Industry Standards

- All of the 42 companies in the chemical sector assessed by the Transition Pathway Initiative (TPI) receive a score of **Level 2 – Level 4**. SK Kaken would receive **Level 0 - Unaware**
- In May 2021, Japan Chemical Industry Association formulated a decarbonisation pathway stating “the Japanese chemical industry’s effort to realize carbon neutrality is very important for the preservation of the industry’s competitiveness”

Peer Analysis	Nippon Paint	Kansai Paint	SK Kaken	Global Chemical Sector Sample <sup>1</sup>
Member of JCIA	YES	YES	NO	–
Acknowledge climate change as a significant issue for the business	YES	YES	NO	100%
Measure and disclose Scope 1 & Scope 2 GHG emissions	YES	YES	NO	100%
Have a policy (or equivalent) commitment to action on climate change	YES	YES	NO	100%
Have set quantitative targets to reduce emissions	YES	YES	NO	93%

Transition Pathway Initiative’s assessment of global **Chemicals** sector according to the management of their GHG emissions and risks and opportunities related to the low carbon transition

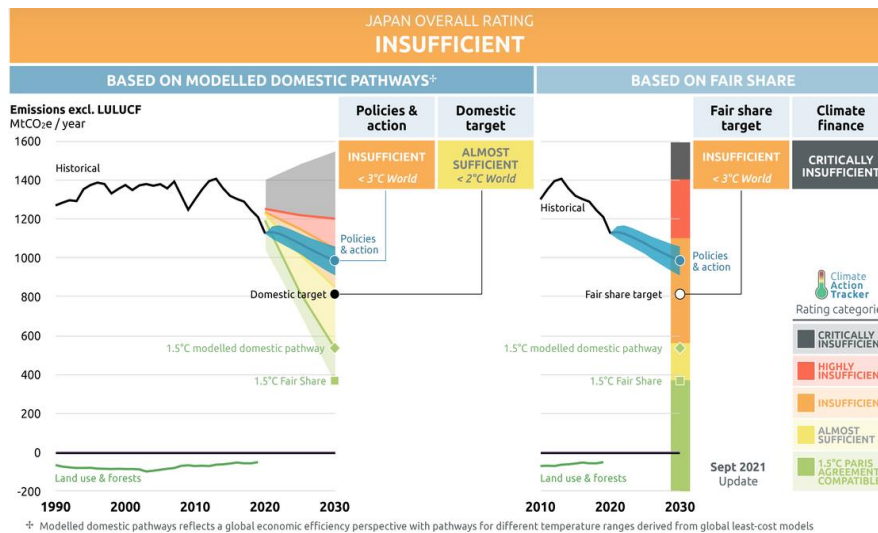


Note: <sup>1</sup>Global Chemical Sector Sample includes 42 small, medium and large companies in global chemical sector assessed by the Transition Pathway Initiative (TPI)



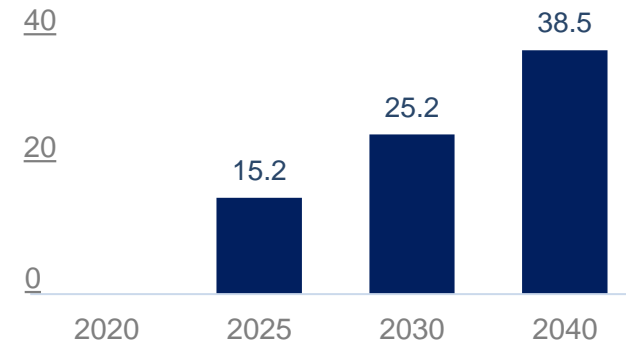
# Exposure to an Evolving Regulatory Environment

- In October 2020, Japan pledged to reach net-zero emissions by 2050, (46% reduction by 2030).
- Climate Action Tracker assesses that Japan’s current policies will only lead to a reduction in emissions of 25-35% below 2013 levels by 2030
- SK Kaken has been slow to address it’s environmental emissions, a symptom of intransigence. As a first step SK Kaken should disclose its Scope 1 & 2 Greenhouse Gas emissions



## Nippon Paint’s assessment of potential impact of carbon taxes

(100 million yen)



\* The survey coverage: Japan, NIPSEA, Dunn-Edwards, Dulux Group

(6) Disclose Scope 1 & 2 emissions as a first step in transparently evaluating and managing environmental impact.



# CONCLUSION

# Painting a Better SK Kaken

- We ask general shareholders to support six modest and easily implementable improvements to address SK Kaken's underperformance and failings
- While the six measures will only go so far in improving the situation, it would mark an excellent step in the right direction and strong support from general shareholders will send a powerful message to the Founding family that choosing to list SK Kaken on the public markets comes with a responsibility to enhance corporate value for all shareholders

(1) Conduct a 10-for-1 stock split to reduce the prohibitively high minimum trading value.

(2) Cancel 90% of the 438,400 shares held in treasury.

(3) Increase the dividend from Y400 per share to Y800, for a 30% payout ratio.

(4) Shorten the Board of Directors' term to one year

(5) Appoint a minimum of two independent directors

(6) Disclose Scope 1 & 2 emissions as a first step in transparently evaluating and managing environmental impact.

# Disclaimer

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