



**13 February 2024**

GMO USONIAN JAPAN EQUITY TEAM

Letter to Clients regarding Toyota Industries Corporation

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In recent days we have been discussing with clients concerns about the latest in a series of false certifications of safety and emissions test data by Toyota Group member companies, in the context of our 13+ year investment in Toyota Industries Corporation (TIC) (TSE 6201).

As an investment, TIC has been a paradox. We invested in TIC because of its extraordinarily compelling valuation, combined with its global leading businesses. TIC's market cap has been less than the value of its financial assets. In effect, investors have received "for free" the stub value of TIC's growing, world-class operating businesses, which is an anomaly in global capital markets, especially considering TIC's strengths. Globally, TIC ranks as the number one manufacturer of forklifts and automobile air conditioner compressors and the number three provider of logistics solutions. The paradox is that TIC's stock returns have been strong despite the company's poor corporate governance, which has been like a lead weight holding back this star athlete. Implications of governance shortcomings at TIC and the broader Toyota Group have been highly visible recently.

At the end of January, TIC released an investigation report, by the special investigating committee composed of outside experts, which documented that TIC personnel repeatedly altered and manipulated data to certify that TIC-manufactured engines met emissions standards. This followed earlier reports of the same kind of misconduct by Toyota Group members Hino Motors and Daihatsu.

As we see it, fraudulent certifications are just one symptom of a larger problem of broken corporate governance and culture at TIC and Toyota Group as a whole. In this letter, we share our thoughts on the nature of the underlying problems and concrete steps we believe TIC should urgently take.

The day after the TIC report, Akio Toyoda, Chairman of Toyota Motor Corporation (TMC), set out the Toyota Group's corporate governance challenges with admirable honesty. He candidly described the Toyota Group as a "weird hierarchy" of companies without clear direction, vision, or lines of authority.

Between TMC and TIC, the "weird hierarchy" takes the form of cross shareholdings in which TIC owns 7.31% of TMC, and TMC and other Toyota Group member companies own over 45% of TIC. The same cross-shareholding pattern appears across the eleven publicly listed member companies comprising the Toyota Group.

A closer look at TIC's portfolio reveals a web of allegiant shareholdings that is even more expansive than shares directly cross-held within the Toyota Group. Logistics companies, financial service firms, and other transaction counterparties shield TIC management from general shareholders utilizing a network of allegiant holdings. The shield's effectiveness was evident at TIC's most recent annual meeting, where a majority of general shareholders (i.e., those who were neither

Toyota family members nor allegiant transaction counterparties) voted against TIC top management. Nonetheless, TIC's allegiant shareholders quashed the will of general holders and protected TIC management to preserve allegiant shareholders' conflicted commercial interests.<sup>1</sup>

The full version of the investigation report exposes how this "weird hierarchy" was a root cause of the false certifications by TIC. The report documents how TIC was contracted by TMC, the leader of the Toyota Group, to develop engines. The hierarchical structure led to a "consignment mentality" and a passive disposition that precluded subservient group companies from discovering problems and developing solutions. The report also makes clear that TIC's consignment mentality resulted in a separate forklift certification fraud that was intentional, systematic, and repeated over years. Afraid to push back against unrealistic demands, TIC personnel up and down the organization falsified data to secure required certifications in time to meet deadlines. TMC Chairman Akio Toyoda apologized at a recent press conference for failing to recognize the Group's wrongdoings. We think, despite being a publicly traded company, Toyota Group's protective web of cross shareholdings has resulted in a submissive culture that is unable to oppose demands by the Toyota Group leader, TMC.

As a listed Toyota affiliate, TIC's management lacked the independence and courage to push back against TMC. Chairman Toyoda acknowledged as much: "TMC is usually the party placing the order, so I think it is often hard for other Toyota Group companies to say anything back." TIC's investigation report describes in detail a corporate culture that avoids confrontation and puts allegiant shareholders in front of the law.

To their credit, the Ministry of Economy, Trade, and Industry (METI), the Financial Services Agency (FSA), and the Tokyo Stock Exchange (TSE) have identified listed subsidiaries and corporate cross shareholdings as a source of conflicts of interest and misgovernance at odds with the interests of general shareholders. The sprawling corporate relationships also facilitate evasions of accountability; the blame can always be placed somewhere else. METI, FSA, and TSE have all issued guidelines recommending that listed subsidiaries and cross shareholdings be unwound.

Many of Japan's leading companies, notably Hitachi, Mitsubishi Electric, and NEC, have taken action in response to these guidelines. Conspicuously, the Toyota Group has shown little inclination to follow the consensus on corporate governance with respect to listed subsidiaries and cross shareholdings, independent directors, or capital policy. TMC's late-breaking decision to divest shares in family companies Denso and Aisin is welcome, but it is too little, too late, in our opinion.

<sup>1</sup> The below shows the non-supporting ratio for TIC's Chairman and President in the most recent AGM. "Against" votes exceeded "For" in both cases, excluding large allegiant shareholders mentioned in TIC's annual "yuhō" filing. Note: our calculation of large allegiant shareholders underestimates the true magnitude of actual allegiant holdings, as smaller allegiant holders are too small to detect in regulatory filings.

#### **AGM (6/2023)**

	Supporting Ratio	For (excluding allegiant shareholders)	Against
Tetsuro Toyoda, Chairman	74.9%	23.0%	25.1%
Akira Onishi, President	74.2%	22.3%	25.8%
Allegiant Shareholders**	51.9%		
Non Allegiant Shareholders	48.1%		

\*\* Toyota group + policy holding stocks

Over the years of our investment in TIC, we have regularly engaged with management on various governance topics. On behalf of our clients, we will continue to do so, with a particular focus on progressing our recommendations on the following topics.

- TIC must unwind its tangled cross shareholdings with the Toyota Group. Swapping TIC shares held by TMC and TMC shares held by TIC is an obvious first step.
- TIC must urgently establish an independent, experienced, vigorous, and diverse leadership team and board of directors, aggressively recruited from within and without. Mitsubishi Electric's aggressive and successful overhaul of its leadership following a similar scandal last year shows that it can be done.
- TIC must redefine its identity and rebuild its culture, in a way that is consistent with the corporate governance code.
- TIC must honestly account for and address past failures. TIC's summary of the investigation report avoids honest accounting by diffusely assigning blame to multiple parties and causes. The full report makes clear that the fraud was intentional, systematic, and long-standing and was undertaken to serve TMC's interests.

TIC has long been an extreme example of cross shareholdings and substandard corporate governance to the detriment of minority shareholder interests. Now, it is also a case study of the corrosive nature of those cross shareholdings on weak governance and decision-making, which harmed everything from proper compliance with environmental regulations to employee pride in their company to the proper functioning of capital markets. We will continue to represent the interests of our clients and all TIC shareholders. We believe this scandal puts not only TIC's management and board, but also TMC's management and board, on notice that Toyota Group is no longer exempt from following guidelines designed to make Japan's corporate governance work to the benefit of all stakeholders.

Sincerely,



Drew Edwards  
*Head of GMO Usonian Japan Equity Team*

***Disclaimer***

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