



Advanced Compensation Governance for Improving Corporate Value

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Characteristics of OMRON's Management

— Mr. Kamigama, you were appointed as an Outside Director of OMRON in 2017. Could you tell us about the characteristics of OMRON's management?

I can say that the strength of OMRON's management is, in a nutshell, the balance of capital efficiency-oriented ability to constantly earn profits, as represented by ROIC management, and faithful management focusing on the OMRON Principles.

Firstly, OMRON's earning capacity is characterized by its business operations emphasizing gross profit margin. OMRON's gross profit margin rose from 36.8% in fiscal 2011 to 45.5% in fiscal 2020. It is noteworthy that all departments, including the ones of development, purchasing, production, logistics, and sales, have been working together as a company to improve gross profit margin, an indicator showing the essence

of corporate earning capacity. In order to continuously increase the gross profit margin, which usually reaches a limit at a certain level, companies must carefully control their selling prices and costs, and improve their product portfolios. I believe that OMRON will be able to further enhance its profitability by focusing on service-based or recurring businesses rather than goods-based ones to shift its business model to one capable of adapting to ever-changing social needs.

Secondly, to survive this rapidly-changing and complicated era, we need principles or a compass as support for management decisions. My position as an Outside Director of OMRON reminds me of the importance of such principles. In particular, I've been giving my attention to the structure for implementing the OMRON Principles, and the ability to disseminate its messages both inside and outside OMRON. Every year, OMRON holds TOGA to share stories of employees practicing the OMRON Principles in daily operations. TOGA encourages employees from all over the world to team up, set their own

goals, and share their thoughts, activities, and results throughout the entire Group, which results in expanding the circle of empathy and resonance. Since assuming office as an Outside Director, I have attended TOGA events in Japan and overseas to witness new social issue-based services and businesses. I am impressed that TOGA, the source of OMRON's ability to create new businesses and of employees' high motivation in their work, is a best practice for sustainable management that is required in the SDGs era. In addition, OMRON formulates its 10-year vision to solve social issues based on the SINIC Theory, a managerial compass, with the aim of contributing to a better society. OMRON enhances its value by reviewing results and issues to formulate a new 3- or 4-year medium term management plan that is released three times during a 10-year long-term vision period. This is indeed a great initiative to autonomously implement management and business operations required by Japan's Corporate Governance Code, including ESG management, in order to meet the expectations of all stakeholders.

— Could you tell us about OMRON's compensation governance?

OMRON emphasizes compensation governance for two reasons. The first reason is to motivate directors to achieve the 10-year long-term vision targets in order to realize the sustainable enhancement of corporate value. Specifically, the results of the short- and medium-term management plans formulated based on the long-term vision are linked to compensation for directors, which leads to further sustainable improvement of corporate value. The second reason is to not only to ensure the transparency and objectivity of the compensation structure for directors through disclosure of the structure but also to promote better understanding of OMRON's management among stakeholders. In this sense, we consider the disclosure in this Integrated Report as part of our compensation governance.

Overview of Compensation Structure for Directors

— Please tell us an overview of the compensation structure for directors.

The current structure was established in fiscal 2017. This structure aims to reflect the perspectives of all

stakeholders, including shareholders, in OMRON's management. By clarifying a linkage between the directors' remuneration and improved corporate values (business value, shareholder value, and social value), we motivate directors to achieve the targets of the medium-term management plan. We also maximize their motivation to contribute to the sustainable improvement of corporate value by encouraging them to hold the company's stock. Specifically, compensation for directors consists of a base salary, or fixed compensation; short-term performance-linked compensation (bonuses) that varies depending on the company's performance; and medium-to-long-term, performance-linked compensation (stock compensation). When determining base salaries, to ensure objectivity, we refer to those of over 100 major Japanese companies that have been surveyed by an outside organization. We also determine the ratio of performance-linked compensation to base salary according to each director's position and role. For example, the ratio for President and CEO is 1 : 1 : 1.5 (base salary : bonuses : stock compensation). We adopted this relatively high composition ratio of performance-linked compensation after referring to the levels in Europe and the U.S.

In fiscal 2021, we revised the evaluation items and criteria for medium-to-long-term, performance-linked compensation (stock compensation) that is linked to the degree of achievement of performance targets in the medium-term management plan. Stock compensation comprises performance-linked component (60%), linked to the degree of achievement of the medium-term management plan, and the nonperformance-linked component (40%), which aims for director retention and motivation to improve share prices over the medium-to-long-term, and is paid under the condition of a certain term of service.

Objectives and Key Points of Revision of Compensation Structure for Directors

— What are the aim and approach for revising the compensation structure for directors?

The aim is to further motivate directors to achieve the targets of the next long-term vision and medium-term management plan. In addition, we need to improve the compensation structure whenever the management policy is required to be revised in accordance with changes in the business environment and stakeholder expectations. I feel

proud that the former structure, revised in fiscal 2017, was also an advanced one for its initiatives such as the introduction of sustainability evaluation. Our 4-year experience after the previous revision helped us to further improve the structure.

— **What are the key points of the revised compensation structure?**

This time, we revised mainly medium-to-long-term, performance-linked compensation (stock compensation). It will now be evaluated using three items, which are financial targets evaluation, corporate value evaluation, and sustainability evaluation. We calculate the amount of stock compensation by using these items that have their own set evaluation weights. Firstly, we set the highest evaluation weight of 60% for financial targets evaluation. Secondly, we newly adopted corporate value evaluation with its weight of 20%, for the purpose of maximizing our corporate value in the next long-term vision. Thirdly, we allocated 20% to the weight of sustainability evaluation, with the aim of not only promoting the implementation of the OMRON Principles, our most important values, but also further reflecting the expectations for the SDGs and the importance of sustainability. The weight of sustainability evaluation is relatively high compared to other companies, making it one of OMRON's features.

— **Could you give us more details of those three evaluation items? Firstly, please tell us about the financial targets evaluation.**

We removed net sales from the KPIs of the financial targets evaluation, which until now had been net sales, EPS, and ROE. Before reaching this decision, we had many heated discussions in the Compensation Advisory Committee. While some members pointed out that net sales are important for the manufacturing industry and that removing net sales could reduce employee awareness of business growth, there were various other views such as the need to focus on profits rather than net sales, and the inappropriateness of pursuing continuous sales growth in a rapidly changing business environment. In the process of discussions, we invited the President and CEO to the Committee meetings and asked him to explain the policy of the executives that aim to transform our business model from a product-based one by increasing the ratio of service and recurring businesses in the next long-term vision. Unlike the previous long-term vision and the VG2.0

medium-term management plan that were sales growth-oriented, the next long-term vision will give priority to maximizing corporate value as our management target. For this reason, the Committee members finally reached a unanimous decision to remove net sales from the KPIs.

— **Next, please tell us about corporate value evaluation.**

Medium-to-long-term, performance-linked compensation (stock compensation) aims to heighten director motivation to contribute to the sustained improvement in corporate value from the same perspective as stakeholders, including shareholders. Actually, OMRON's stock price rose from 4,885 yen (closing price on March 31, 2017) to 8,640 yen (closing price on March 31, 2021) during the 4-year period of the previous VG2.0 plan. This increase of 77% was far above the 29% rise in the Tokyo Stock Price Index, well known as TOPIX, during the same period. On the other hand, we didn't have any KPIs to evaluate the improvement of corporate value. For this reason, we introduced a new KPI named relative TSR, an indicator that compares OMRON's total shareholder return (TSR) in the covered period to the percentage change of the TOPIX Total Return Index. The use of relative TSR, which can evaluate increases or decreases in TSR by using the TOPIX Total Return Index as a benchmark, allows us to appropriately reflect the improvement of corporate value in compensation.

— **What about sustainability evaluation?**

OMRON's management is based on practicing the OMRON Principles that aim to create a better society by solving social issues through our business. For this reason, we adopted sustainability evaluation when introducing medium-to-long-term, performance-linked compensation in fiscal 2017. At that time, as there were only a few companies using sustainability evaluation for director compensation, we adopted only a third-party evaluation to ensure objectivity in our first attempt. On the other hand, for this revision, we introduced the new KPIs of "reduction of greenhouse gas emissions" and "score of Sustainable Engagement Index (SEI)^{*1} in engagement survey^{*2}," as our internal targets, in addition to the existing third-party evaluation. In ESG management, Environment and Social particularly contribute to OMRON's growth as well as attract the greatest interest from our stakeholders. That's why we adopted E- and S-related indicators. In addition, the revision of

sustainability evaluation is based on insights obtained through dialogues and engagement with institutional investors. We will strive to enhance the effectiveness of our compensation structure for directors through dialogues and engagement with our stakeholders.

*1 Survey measuring employees' voluntary motivation to contribute to targets of the organization
 *2 Indicator that measures the presence of a high level of motivation to contribute to the achievement of targets, maintained through good mental and physical health, or a strong sense of belonging to the organization, or a productive work environment

— Please tell us about the Compensation Advisory Committee that discussed and deliberated the revision of the compensation structure for directors.

The Committee is made up of three Outside Directors, including myself as the Chairman, and two Internal Directors, all of whom have diverse business experience and conduct discussions from various perspectives. For example, the Committee had held a meeting to discuss and deliberate the revision every month since October 2020 until we completed its design in

February 2021. In each of these five meetings, we took about an hour to deliberate it thoroughly.

— Lastly, could you tell us about your thoughts for the future?

I believe that the revised compensation structure covers all themes stakeholders currently expect of corporate management. In particular, I'm convinced that medium-to-long-term, performance-linked compensation (stock compensation) will be highly regarded as a good practice. On the other hand, I think OMRON has other management issues to address, such as how to accelerate innovation to design the next growth engine, and how to promote diversity by increasing the ratio of female executives and managers in Japan as well as of non-Japanese managers overseas. As an Outside Director, I will strive to actively contribute to sustainably increasing OMRON's value through monitoring and supervising in the Board of Directors in addition to activities in the Compensation Advisory and other committees.

■ Medium-to-long-term, performance-linked compensation (stock compensation) after revision

$$\text{Performance-linked portion} = \text{Base amount for each position} \times \left(\text{Financial targets evaluation 60\%} + \text{Corporate value evaluation 20\%} + \text{Sustainability evaluation 20\%} \right)$$

	Evaluation weight	Indicators
Financial targets evaluation	60%	• EPS • ROE
Corporate value evaluation	20%	• Relative TSR*1
Sustainability evaluation	20%	• Reduction of greenhouse gas emissions (internal target) • Score of Sustainable Engagement Index (SEI)*3 in engagement survey*2 (internal target) • Dow Jones Sustainability Indices (third-party evaluation)

*1 Indicator that compares total shareholder return (TSR) of OMRON in the covered period to the percentage change of TOPIX Total Return Index (Relative TSR = TSR - Percentage change of TOPIX Total Return Index)
 *2 Survey measuring employees' voluntary motivation to contribute to targets of the organization
 *3 Indicator that measures the presence of a high level of motivation to contribute to the achievement of targets, maintained through good mental and physical health, or a strong sense of belonging to the organization, or a productive work environment

■ Medium-to-long-term, performance-linked compensation (stock compensation) before revision

$$\text{Performance-linked portion} = \text{Base amount for each position} \times \text{Performance score (Net sales 30\%, EPS 70\%)} \times \text{ROE score} \times \text{Sustainability evaluation}$$