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Unearthing companies with hidden potential

- Interview with Yasunori Nakagami by Sadayuki Horie -

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Executive Summary

Japanese companies are plagued by low ROEs from a global perspective. Japan's Stewardship Code, unveiled last year, is predicated on the idea that investors share responsibility for boosting companies' value through engagement. Can investors really transform Japanese companies? What kind of skill set do they need in order to do so? Sadayuki Horie spoke about such topics with Yasunori Nakagami, CEO of Misaki Capital, an asset management company dedicated to shareholder constructivism.

Yasunori Nakagami

CEO, Misaki Capital

Joined Andersen Consulting (now Accenture) in 1986. Worked as a management consultant in a broad range of industries until 2005 where he was a partner at Corporate Directions. Founded an investment advisory firm in 2005. Served as the firm's president where he managed an engagement fund for over eight years. Founded Misaki Capital in October 2013 and began managing the Misaki Engagement Fund.

Sadayuki Horie

Senior Researcher

Financial Technology and Market Research Department

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Joined Nomura Research Institute in 1981. Seconded to Nomura Asset Management from 1996 to 2001. Currently a visiting professor at Osaka University of Economics' Graduate School of Business Information Systems. Member of FSA's Council of Experts Concerning the Japanese Version of the Stewardship Code since August 2013. Vice Chairman of Government Pension Investment Fund's Investment Committee since April 2014. Member of FSA's Council of Experts Concerning the Corporate Governance Code since August 2014.

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From management consultant to investor

Sadayuki Horie: Misaki Capital is a very unique asset management company that aims to be a "constructive shareholder." Could you explain the concept behind Misaki Capital, including your background?

Yasunori Nakagami: I started working as a management consultant straight out of college. I was a consultant for nearly 20 years, helping companies improve their management. When consultants and management successfully work together, companies change dramatically. When companies change, they increase in value and that increase is reflected in their share prices. I personally witnessed this numerous times during my consulting career.

After two decades as a consultant, I decided it would better to align our interests and become an investor who helps companies improve with the aim of generating investment returns from this improvement. This is our constructive shareholder concept.

Horie: How does being an investor differ from being a consultant in terms of expertise and your relationship with companies' management?

Nakagami: Management consultants are "hired guns." They don't get involved with a company unless the company has a problem it cannot resolve internally or wants a third party's perspective on some issue.

An investor, by contrast, identifies shortcomings and proactively recommends ways in which investee companies may be able to improve.

The basic skill set, however, is the same. For example, both consultants and investors must have the ability to logically persuade management to follow their recommendations.

Horie: Unlike consultants, who are hired to solve problems that the client company is already aware of, investors offer companies unsolicited advice. How do companies respond when you approach them as an investor?

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Nakagami: Some management teams reject our advice but many heartily welcome our input, given that management and shareholders' interests are aligned from the standpoint of outcome accountability.

Horie: Have you noticed any differences between industries in terms of companies' receptiveness to your recommendations?

Nakagami: I think differences in receptiveness are largely a function of management mindset, not industry or company size. We have coined the acronym HOP to sum up the qualities we look for in management teams. "H" stands for hungry, meaning management is committed to reforming and growing the company. "O" stands for open-minded, a willingness to listen to outsiders' opinions in pursuit of improvement and growth. "P" stands for publicly accountable, which means that management has a public-company mindset. Most corporate executives with such a mindset are highly receptive to input from shareholders.

Investee companies' management must be HOP

Horie: How does Misaki Capital differ from traditional asset managers in terms of the investment decision-making processes and subsequent engagements with investee companies?

Nakagami: Companies have an intrinsic value and a market price. We have no exceptional insight with respect to market prices, at least from a short-term perspective. But we believe we can ascertain companies' intrinsic value fairly accurately. Value stems from the free cash flows' robustness. We believe we can get a good handle of how robust a company's cash flows are by assessing the company's competitiveness through thorough research and analysis of the business and its industry.

Horie: Is that how you select the companies you invest in?

Nakagami: In addition to competitiveness and cash flows, we also evaluate whether management is HOP. We never invest in a company without first meeting with its management. This preliminary research phase takes a month or two to complete.

Once we decide to invest in a company, we invest in two stages. First, we accumulate an initial position to get our foot in the door. While doing so, we conduct additional

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research for 6-10 months. During this process, we repeatedly keep a continuous dialogue with management.

While establishing our “door-open” position, we look closely at the company's competitiveness and management and gauge how we can help with the management of their business. Once we are sufficiently confident with respect to these three points, we transition to the core investment stage, during which we invest with a long-term horizon while deepening our engagement with the company that will ultimately lead to direct value enhancement.

Horie: Many long-term buy-and-hold investors identify companies with strong long-term cash-flow generating capacity and hold concentrated portfolios of such companies without engaging with them.

Nakagami: Yes, that's the [Warren] Buffet approach: investing in businesses that can create value regardless of who manages them.

Horie: By engaging with management, can you better ascertain companies' true potential to expand their cash-flow generation capacity?

Nakagami: I firmly believe so based on my long experience as a management consultant.

Horie: I imagine that companies tend to be unreceptive to your management recommendations unless you are a fairly big shareholder.

Nakagami: I don't think that size of our equity stake is overly relevant. We found that there are three keys to building a good relationship with management and enhancing value together.

The first is selecting the right companies to invest in based on how HOP their management is. This point is absolutely crucial. If management is not HOP, we would never be able to work together to create value and transform the company.

The second and third keys pertain exclusively to the investor. The second is that the investor must be capable of making high-quality recommendations for dealing with the company's high-priority management challenges. Management often receives unsolicited advice from numerous sources. You will not be able to capture

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management's interest unless you have ideas worth listening to.

The third key is that the investor must "sell" his ideas to management. In other words, the investor must possess the know-how or skill set to persuade management to implement the recommendations.

Horie: How receptive are Japanese management teams to input from investors?

At one time, the media often reported on overseas activist investors' efforts to unlock value in Japanese companies. Personally, I found some of the activists' recommendations to be quite reasonable, but the companies rejected them. What did the activists do wrong?

Nakagami: First, I think they targeted the wrong companies. Engagement is futile if management is not HOP. Second, their recommendations were not compelling enough. For example, if an activist investor's pitch to a company is limited solely to capital policy, management might dismiss it as a relatively low priority or a generic investor complaint.

Getting back to the third key I mentioned a moment ago, did these activist investors place themselves in management's shoes, thoroughly conduct fact-finding research and cogently explain the rationale behind their recommendations? In order to persuade, you have to argue from their perspective, not yours. I believe that previous activist investors failed because they targeted the wrong companies and their process of persuasion was mistaken.

Horie: Personal relationships are crucial.

Nakagami: Yes, personal values have a big effect on how a company is managed. Companies change to an astonishing degree depending on who is managing them. A company's management team is a key factor in our investment decisions and we highly value our relationships with company management.

Horie: Are there many companies with the potential to increase the value of their businesses if they have a HOP management team and are persuasively presented

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with high-quality recommendations by an investor?

Nakagami: Absolutely.

Japanese companies' low margins

Horie: Japanese companies, from the standpoint of the right side of their balance sheets, appear to lack sophistication in many respects, including financial strategy, and have a lot of room for improvement. Also, I think the right side of their balance sheets offers more opportunities in terms of reforms that pay off within a short timeframe.

However, you said that you aim to improve how investee companies' businesses are structured on the left side of their balance sheets, although you of course work on the right side also.

The consensus among overseas investors is that, in comparison to US and European companies, Japanese companies' balance sheets are quite solid with little room for improvement on the left side but they have many shortcomings on the right side, including financial strategy. Many overseas investors therefore take the view that restructuring the right side of Japanese companies' balance sheets would be more effective time-wise.

Nakagami: I often hear the same thing, but I question whether that's really true. For example, when we conducted a DuPont analysis of capital productivity, we found that financial leverage and asset turnover ratios are similar between Japan and Western countries. Where Japanese companies fall far short to their Western counterparts

Exhibit. Factor decomposition of Japanese, US and European capital productivity

		ROE	Profit margin	Asset turnover	Leverage
Japan Topix 500	Manufacturers	6.8%	3.5%	0.92	1.91
	Non-manufacturers	6.7%	3.2%	0.86	2.28
	Overall average	6.8%	3.3%	0.91	2.02
US S&P 500	Manufacturers	18.1%	8.4%	0.87	2.24
	Non-manufacturers	14.5%	8.0%	0.61	2.33
	Overall average	16.0%	8.3%	0.77	2.29
Europe STOXX Europe 600	Manufacturers	15.3%	6.8%	0.86	2.44
	Non-manufacturers	15.6%	7.8%	0.66	2.74
	Overall average	15.4%	7.2%	0.79	2.58

Note : Based on trimmed data for calendar 2004-13. Financials excluded.
Source: Misaki Capital analysis of Bloomberg data

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is their low profit margins. Accordingly, if you want to be truly productive in your engagement with companies, you should definitely focus on profit margins.

Closing the gap between value and market price by focusing solely on capital policy or the right side of the balance sheet is a quick fix that will certainly pay off to some extent, but its payoff in terms of share price appreciation often has been 20-30%. Moreover, this would be a one-off, temporary impact. To give you an example of one of our successful investments, Pigeon substantially increased its value through overseas growth where our engagement activities were focused and directly led to margin expansion. Its market capitalization increased by a factor of seven or eight, a vastly bigger payoff than potential share price gains from improvement in capital policy alone.

Horie: So you're saying that Japanese companies' problem is low margins and they cannot increase their value much without improving their margins.

Nakagami: You can live off of low hanging fruit for a while but you'll soon end up starving unless you grow the tree into a big tree. I believe the same principle applies to investing.

Horie: Why are Japanese companies' margins so low?

Nakagami: There are various explanations but I attribute low margins to four factors.

The first is Japan-specific accounting practices and tax laws, such as goodwill amortization and high corporate income tax rates. Second, certain industries are overcrowded. Margins in such industries have been driven down by hyper-competition. While these two factors definitely contribute to low margins, they are not the crux of the problem.

The fundamental problem is corporate management. Specifically, I see two separate problems. The first is lax controls on business and product portfolios. This problem exists on a company-wide level.

Horie: In other words, companies fail to weed out low-margin products and businesses.

Nakagami: Exactly. This issue ties into the distinction between Q (quality) companies

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and O (opportunity) companies in the words of [Hitotsubashi University] professor Ken Kusunoki, who's on our Management Advisory Committee. Quality companies maintain high margins by focusing intensively on a single business, developing strong products, exhaustively refining them and prevailing over global competition. In contrast, opportunity companies broadly pursue market opportunities, even limited ones, in whatever markets such opportunities arise. They consequently over-diversify their operations with a large number of products and services.

Even Japanese automakers, for example, have too many models in the domestic market and frequently update them. Such diversity is not confined to the auto industry. It can be observed in many other industries, including food and beverages, mobile phones and consumer electronics.

Horie: Many Japanese companies do indeed try to capture all opportunities, even small ones.

Nakagami: But what happens when you do so? As products or businesses increase in number, management resources are spread thin. Operating efficiency is diluted across many individual products. R&D expenses are incurred to develop new products. Depreciation also increases when new production lines are installed. Budget constraints limit advertising of individual products. Meanwhile, manufacturing costs are high because individual products' production runs are too small to benefit from economies of scale.

Companies like Coca-Cola, Kellogg and Apple do not impetuously pursue marginal demand. Instead, they identify a small number of product markets in which they aim to be very successful. They focus exclusively on a limited number of products and businesses in which they can capitalize on their strengths. And they budget ample funds for advertising and operating expenses. If their products prove popular, they benefit from economies of scale that drive down manufacturing costs, enabling them to earn hefty profits. Their fundamental management philosophy differs from that of opportunity companies.

The second problem with corporate management is an inadequate recognition that

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CEOs are essentially investors. Of course, CEOs run their companies operationally and organizationally, but ultimately they are investors. High-level management decisions boil down to determining how to obtain the cheapest funding and deciding what to invest it in, a capital allocation decision. This is essentially no different from an investor’s decision-making process. Companies may invest in plant and equipment, M&A, or share buybacks. With little obvious growth prospects available, I feel that CEOs' investor mentality is weak. Japanese CEOs are generally not in the habit of thinking about how to allocate capital.

Companies face various investment issues. For example, should you really release a new product now? To do so, should you build a new plant and incur increased depreciation? If your stock is undervalued, perhaps a share buyback would give you a better return on investment.

Why are profit margins so low in Japan despite the high quality of Japanese goods and services? The reason is subpar management. I believe that better management would substantially increase profit margins. As former consultants, we see tremendous scope for enhancing companies' value by delving deeply into their businesses and recommending improvements.

Gauging corporate governance from companies' securities filings

Horie: I'm on the committee working to draft the Corporate Governance Code. Personally, I don't think that superficial governance standards have an effect on companies' value, but I do believe that there should be certain minimum standards. The code is intended to set such minimum standards.

Are your investee companies already at or above that minimum level in terms of governance? Does governance factor much into your engagement activities?

Nakagami: I think that companies are better off improving their governance than not, but I don't consider improving governance to be of primary importance in terms of enhancing a company's value. For us, good governance is not a prerequisite for investing in a company. Conversely, poor governance would not necessarily deter us from investing in a company.

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That said, we do in fact look closely at companies' governance. What we look for is diligent management. In other words, we look for evidence of how conscientiously prospective investee companies are managed. For Japanese management, governance and shareholder returns are often issues that are dealt with perfunctorily. If management has given serious thought to such issues and candidly answers questions about them, that's a very good sign.

Horie: Without revealing any trade secrets, could you be a bit more specific about how you evaluate a company's governance?

Nakagami: It's no secret at all. Management's attitude toward governance is obvious from reading a company's securities filings or annual reports.

Horie: Just reading securities filings is enough?

Nakagami: If you were to read an asset management company's press release announcing that it has adopted the Japan Stewardship Code, could you tell from the press release whether the asset manager had given serious thought to the stewardship code?

Horie: Yes, of course.

Nakagami: It's the same for us with governance. We look at whether management has thought deeply about governance and articulated their governance model in their own words. That's an extraordinarily good sign for investors like us who invest in management quality.

Horie: So whether a company has set up board committees or appointed corporate auditors makes absolutely no difference to you?

Nakagami: That's correct.

Horie: Is it fair to say that your message to companies is that they should write about governance in their own words without paying much heed to superficial standards?

Nakagami: Yes. The key point, in my opinion, is that the biggest pitfall for management is intellectual laziness. Management should be inquisitive. "Why does that company has such a high ROE?" "Why is governance such a big issue now?"

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"Why do foreign competitors employ so much financial leverage? Is it really smart to do so?" Such questions provide tremendous opportunities to learn. Management should open-mindedly learn from other companies and other countries instead of assuming that their current approach is best. And management teams should develop a management style that fits them and their companies. I believe those are the most important points for management. Conformism and perfunctory perpetuation of past practices are huge pitfalls.

Horie: What kind of messages should companies' management convey to investors? I personally often study shareholder letters of CEOs such as Berkshire Hathaway's Warren Buffett and JPMorgan Chase's Jamie Dimon.

Nakagami: I see no reason for management to limit themselves to communicating in writing only. Some people don't express themselves well in writing. I think management should communicate in whatever way they are most comfortable, without getting caught up in outward appearances. I think that speaking at shareholder general meetings, for example, is fine. So is giving interviews to media.

Horie: Many people in Japan get hung up on form. For example, many companies issue CSR reports, corporate governance reports, or integrated reports.

Nakagami: I think they do that for the convenience of the reports' recipients. Investors also fall prey to intellectual laziness. You should not count on companies to tell you everything you need to know in one convenient report. If you want to make truly good investments, I believe you must thoroughly research companies by your own methods.

Horie: I still have many questions for you but we're out of time. Thank you for the valuable insights you shared today.

Nakagami: My pleasure. Thank you.

As investors, we hope to contribute to the evolution of corporate management by providing HOP management teams with a fresh, third-party perspective.

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