Misaki Newsletter

Quest for “Excellence in Management”

Foreword for releasing the sixth edition of *Quest for "Excellence in Management"*

Our focus on identifying companies that are meant for true long-term investment is all about their "passion" in managing their business.

We believe such characteristic is implicitly expressed in the words which management carefully chooses to convey their message.

To that extent, we have found extraordinary meticulousness in "choice of words" by Mr. Sekiya, President of DISCO Corporation, and our interviewee of this edition. This is especially evident when dissecting through their Annual Reports, which is something that we believe is an ingrained habit of long-term investors.

We were excited to do this interview as we knew it would be very stimulating and full of inspirations. Indeed, the content was far more than we had anticipated.

"Economics-based governance" and "Opinion-based governance"…. We came across plenty of uncommon words in his remarks, but to understand later that these "words" represent the backbone of his management.

He is a man of abstract thinking who makes a sharp distinction between "science" and "engineering," and yet tries to make their interaction a driving force toward achieving an ideal management. At the same time, he concurrently holds a position as General Manager of Engineering R&D Division—a position that requires him to relentlessly embody these ideas.

What impressed me the most was his view toward organization and human behavior that lies behind such words and actions.

Running a business and truly understanding the basic human tendencies of what motivates and drives people is so very different from those just playing with numbers or settling for being average with a herd mentality.

I really look forward to seeing how Mr. Sekiya, still relatively young as an executive of a Japanese listed company, will continue to expand the horizon of corporate management.

Yasunori Nakagami, CEO

Misaki Capital Inc.

Yasunori Nakagami, CEO of Misaki Capital Inc., with Kazuma Sekiya, President of DISCO Corporation

* This interview was held in June 2016.

The Concept of "Four Styles of Governance"

Nakagami: DISCO boasts a dominant global share and outstanding profitability in the market for the later stage in the semiconductor fabrication process. It is also a well-established company that was founded in the city of Kure, Hiroshima Prefecture, as a manufacturer of grinding wheels and will mark its 80th anniversary next year.

What I would like to highlight in this newsletter is "the quality of DISCO's management," let alone the competitiveness in its business. From my experience of looking into the management of many companies, I can say that DISCO is running its business perhaps in the most unique fashion in Japan.

My view above is supported by various management tools of this company, such as "DISCO Values," which identify "the ideal" of the company by defining it from as many as 280 perspectives, and "Will Accounting for Individuals," which is a management accounting system that enables performance management at the level of individual employees. However, the most unique concept of all is your distinct approach to corporate governance, which I should say is a backbone of DISCO management. So could you start with elaborating this approach?

Sekiya: To put it in a simple way, “governance” to me means a system “to lead people to act in a highly desirable direction.” Or let me put it this way: As it is important for me “to design an environment under which employees can act freely on their own will and still at the same time can spontaneously take actions desirable to the company,” I am always thinking about the style of “governance” that can help build such an environment.

Corporate managers typically seek for a “law-based corporate governance,” or an “order-based governance.” But we don’t. Instead, we seek for a “principle-based governance,” under which we expect all the employees to share the company’s principles and take necessary actions on their own.

On top of this “principle-based governance,” we have three other styles of governance, namely “trust-based governance,” “economics-based governance” and “opinion-based governance.”

Nakagami: Well, things are getting pretty complicated from the very start (laughter). So, could we say that DISCO’s management tools, such as “Will Accounting” and “DISCO Values,” have stemmed from those four styles of governance?

Sekiya: Not exactly because we didn’t aim for these goals from the beginning. Each management tool was initially introduced to address certain issues. However, through such experiences, we have come to the conclusion and conviction that employees need more freedom to make the company stronger in the long run.

The concept of DISCO Values represents the “principle-based governance.” We formulated it for the first time in 1995 and have maintained it for more than 20 years. At the time when the concept was first formulated, our company carried more than 600 employees, which was more susceptive to a centrifugal force rather than a centripetal force that smaller-size companies inherently have. At that time there was a sense of crisis that made us feel that we could not possibly pass our business onto the next generation without a core philosophy. The concept of the “principle-based governance” has now become prevalent in our organization and works as a behavioral guideline for individual employees.

The “trust-based governance” is the concept that we have pursued for the last seven to eight years. When Chairman Hitoshi Mizorogi assumed the role of President in 2001, he coined a somewhat figurative and abstract slogan: “Let’s get along with each other.” This slogan stemmed from the belief based on his 30 years of business experience that good performance results cannot be achieved without good teamwork. However, it turned out that such a masculine-sounded message was quite not appealing to those with science or engineering background, accounting for about 70 percent of our employees.

Seven years later, one of our employees brought in an interesting model called "Core Theory of Success Model," advocated by Professor Daniel Kim of MIT. The theory is based on the premise that an organization can create a virtuous cycle consisting of "quality of relationship → quality of collective thinking → quality of actions → quality of results." We found this theory convincing to those with science or engineering background simply because it was invented by the MIT Professor (laughter). Since then, we have encouraged our employees to establish the "quality of relationship" based on trust in order to obtain the "quality of results." As a result, such a way of thinking has ended up in the governance style represented by the "trust-based governance."

Sekiya: The "economics-based governance" is the style of governance that was initially introduced as part of the process to implement "Amoeba Management[1]". However, as Amoeba Management only incorporates the income statement aspect of management and does not focus on effects on the balance sheet, which is sometimes inconvenient for a company like DISCO with a long production lead time, we evolved this tool in 2003 by incorporating the balance sheet aspect and named it "Will Accounting."

Back then, Will Accounting was merely an accounting system for each department. Although employees were aware of ordinary income of the entire company as a basis for their bonus payment, they were not aware of the financials by each individual department, and as such, were still less motivated to improve profitability.

As I considered it necessary to break down the financials and have each individual become more strongly conscious of profitability, I persuaded the head of management accounting to develop "Will Accounting for Individuals." Now that Will Accounting is fine-tuned for individual employees, each employee is strongly motivated to think about the individual performance (say, "I was in red for this month." "I spent too many man-hours on that deal."), which would have never happened under the old departmental accounting system. Looking back, we can say that Will Accounting for Individuals originally came from a simple question by our management: "How can we make our employees become more profit-conscious?"

---

[1] Amoeba Management is a management approach created by Kyocera founder (currently Chairman Emeritus) Kazuo Inamori to realize the goals of his management philosophy in company management. For more details, visit the official website of Kazuo Inamori. (http://global.kyocera.com/inamori/management/amoeba/)

The concept of the "opinion-based governance" was developed when we had a feeling that we needed something more to fill the gap between the principle-based governance, trust-based governance and economics-based governance. In an ordinary company, if a manager proposes a project that is not supported by his/her team staff, the manager simply applies an order-based governance model to make them work for him/her. In contrast, under the opinion-based governance model, it is the manager's responsibility to communicate a compelling and convincing plan to the team to make them motivated and willing to work for him/her. In this sense, we can say that the opinion-based governance requires leadership with a power of persuasion.

Management has evolved under the unrelenting semiconductor cycle

Nakagami: It sounds to me that the "four styles of governance" are a set of tools that helps the company and its organization run effectively rather than a set of new concepts of corporate governance.

Sekiya: You may be right if you define governance in a narrow sense. However, like I said before, if governance is defined as "a system to lead people to act in a desirable direction," the four styles of governance could have more positive implications.

Let me explain it from a national level. When the World War II ended, the economic environment in Western countries and Eastern countries were about the same, but now the West have gained the overwhelming lead over the East not only in the field of economy but also in science and technology. I believe this is the result of Western countries applying these four styles of governance.

Look at the United States, for example, where the excessively individualistic market economy is prevailing. We also know that the President took initiative in policy making based on the "opinion" as symbolized by the Apollo program. Given that, I am very curious why corporate management is not interested in taking the same approach, already proven to be effective at a national level.

Nakagami: I understand that your discussion is along the line with your former remark: "A company is an ultimate form of socialism."

Let's now talk about the efforts you have made to put these governance styles in place. While you assert that such governance styles are already proven to be effective at a national level, it is not easy for companies, even for a company like DISCO, to put them in practice. Take DISCO Values for example. You spent four years to formulate the concept, and another five years to introduce and ingrain it in the organization. Since then, you have reviewed it every year and the concept is now twenty years old. You also spent a considerable amount of time and cost for developing the Will Accounting system.

Management always needs to improve and evolve, but at the same time, it appears that the reforms are often too costly from a short-term perspective. Even if you made them, you might not be able to get a significant outcome. This is an inherent nature of management reform, which can be a big challenge for corporate managers. Having said that, my question is "Why can DISCO undertake such a reform on an ongoing basis?"

Sekiya: We call the whole system as "Will Management," which we might not have accomplished if we had made it a 20-year plan to build the whole system. In fact, each measure being taken under Will Management is nothing but a solution or response to impending day-to-day issues.

Fortunately, however, as we happened to position ourselves as a high-value-added supplier in the semiconductor industry, we could afford to invest a certain amount of energy in the development of management system for the last 20 years. I suppose such continuous investments helped us become consistent in a way.

Nakagami: I don't think that's quite true considering the cyclical and volatile nature of the semiconductor industry, which often makes it difficult for industry players to make money on a consistent manner. Furthermore, the cycle is so short that comes and goes like waves. Generally speaking, I assume it is not easy to take on a management reform in your industry, right?

Sekiya: Well, you are right. But thanks to such a tough environment, we were forced to think real hard because we had to survive. It is just like the civilization was evolved in cold climates. Although the semiconductor industry in the winter is so harsh, spring and summer will be sure to come. We know that things will be sure to get better. Thus, we can continue to get ourselves involved into forward-looking activities during the bad times.

Nakagami: So you are saying more companies can stay away from loose management under severe business environment. I agree, in general, that companies operating in a long-term stable business environment may have little incentive to implement a strict management control.

A management engineer and scientist

Nakagami: I have recently published a book written in Japanese with a title that should be translated into English as "Business management that is invested vs. business management that is traded"

A company suited for a long-term investment, in short, is a company that aspires to hone its management system or that pursues perfection in management. While you cannot avoid financial performance from fluctuating, you can nevertheless make cash generation less volatile with a mind to hone your management system. Furthermore, you can bring sustainable value into the organization even when you cannot make profits for a certain period of time.

It is sometimes difficult to recognize management passion from the outside, but I believe that such passion is implicitly expressed in the words management carefully chooses to convey their message. For example, I see extraordinary meticulousness in choosing words and expressions in DISCO's Securities Report, including the phrase "realization of optimal exchange of value with our stakeholders." This should be the result of the management's effort to practice abstract thinking.

On the other hand, you need to have the flexibility to switch between abstract thinking and concrete actions in order to achieve excellence in management. Mr. Sekiya, you serve as President and concurrently hold a position as General Manager of Engineering R&D Division. I am wondering how you find time to focus on management of the company.

Sekiya: I am quite focused during my leisure time, like when I am playing tennis or skiing on the weekends, rather than when I am sitting at my desk in the office. Once I start thinking over an idea at some odd moments, I never stop thinking until I reach some conclusions.

Nakagami: So you are thinking all the time, aren't you? When you became President , you said that you wanted to introduce a "scientific" approach to every piece of management.

Science is the work of pursuing truth. "Engineering" sounds similar to science but it takes an approach of finding a realistic solution by practicing the PDCA (Plan, Do, Check, Action) cycle. I think management is more like engineering than science. What do you think?

Sekiya: It is my understanding that an engineer invents something that works, while a scientist finds a reason why it works. As an engineer, I feel quite uncomfortable to be involved in the area of management without taking a scientific approach. I am a type of person who wants to act logically with the logic fully understood.

In my view, the human kind has been playing a cat-and-mouse game between engineering and science in each and every field. Take the phenomenon of "burning," for example. It has been revealed at a later stage that fire is the rapid oxidization of a material. However, humans have been using fire for a long time without knowing its mechanism. Thanks to craftsmen who had been using fire and thereby ensuring the reproducibility of the phenomena, scientists were able to reveal the theory behind.

On the other hand, craftsmen alone could have never imagined that things could burn in the water. Whereas scientists, knowing that burning is essentially a process of oxidization, assumed that burning could also be reproduced in the water. This is how an underwater fire burner was invented to make possible the underwater welding. This is a breakthrough that craftsman alone could have never possibly achieved.

I apply the same logic to manage the organization of DISCO. When measures to address a certain issue are found effective, I try to figure out a logic to explain why they have worked out. Once I come up with a good enough explanation, I try to apply the same measures to other issues. Given that there are engineers out there in our organization who make efforts to solve their own business issues, my mission is to figure out the logic as "a management scientist" and at the same time to steer the organization as "a management pilot."

You cannot lead people without understanding the human nature

Nakagami: I find that you are always trying to see things in a big picture by saying, for example, “Human kinds are … ” or “Company workers are ….” I should say that you have some kind of insight into fundamental human nature.

Sekiya: As a company is, after all, made up of a group of people, managers cannot lead them without knowing every aspect of human nature and the way they are motivated.

Unlike natural science, it is not easy to understand human behavior in a group because there are exceptions. However, you cannot be a good manager if you say you’re not interested in human nature because of such exceptions. Even with exceptions, you should be able to find a universal law in a big movement.

Nakagami: That’s the most important thing. You cannot manage a company based purely on science due to diverse nature of a human being.

It seems you’re trying to introduce a trading essence in your organization to create a market economy. Is it part of your strategy to develop a system that leads people to perform better?

Sekiya: I am not sure if the word “create a market economy” gives you the right impression. That’s why we call this system the “economics-based governance.”

Let me explain the concept by taking water supply for example. If bureaucrats dominate the water supply administration, they will assign the maximum monthly usage of water per capita and monitor it for the purpose of protecting limited water resources. Now, let’s say there is a sick child who is advised by a doctor to take shower three times a day. His/her parents then go to the government agency to apply for an exceptional treatment because it is the only way to have their child use plenty of water. However, once such exceptions are approved, people then start to look around for doctors who are their relatives, or whoever, for a prescription so they also can apply for using more water. As a result, the government gets overwhelmed and yet people have to wait for three months until the application is processed. Consequently, the sick child in dire need of water also needs to wait for three months. Nevertheless, they say that the socialism is wonderful because water is provided for free of charge.

Then what happens if water supply is administered in the free economy? The answer is simple: "Charge them." That's it. People won't use too much water if they are charged. If water resources are scarce, all you should do is to raise the price. Then see what happens in the business world. Companies see this situation as a business opportunity and start competing in developing water-saving shower heads.

The same thing may also happen in socialist nations where smart government officials order state-run enterprises to develop shower heads. In such case, they will probably pick one enterprise that appears to be competent enough to develop a good product, but no one is sure about it. When the product fails, the enterprise may have no other choice but to provide false data or bribery to government officials. At the end of the day, consumers will have to use shower heads with little water-saving function!

The free economy allows redundant inputs of resources because it is proven to be efficient in the end. You do not need instructions from the government. Just raise the price and companies will do the right job. That's the "merit of the economics-based governance."

As Will Accounting for Individuals gave us so many unexpected positive surprises, I tried to explain them from a scientific point of view. Water supply is one good example of how I deeply understood economics. This is the basis of the economics-based governance. Our economics-based governance is deeply rooted in the nature of human behavior, which is on a totally different dimension from that of the price competition.

Sekiya: There is another good thing about the economics-based governance. As you know, human beings always make mistakes. Embedded in the economics-based governance is a function to stop such mistakes.

Under the bureaucracy-based governance, once the budget is approved, it will be hard to revise even if you know that related policies are actually meaningless and therefore the budget is just a waste of money. Things get worse when those policies are initiated by the current Vice-Minister when he was Director General, and as such, cannot say no until he retires from office. Even worse, when he goes into politics after his retirement and it is likely that he will be promoted to Minister, it is almost impossible to deny the budget forever. However, this will never happen in private companies because they will be forced out of the business if they take measures based on a wrong policy. In this sense, you can say that private companies are equipped with a “built-in autostop function.” Actually, employees in the working field are asking more to management to make right decisions even faster. That’s the reason why we need the economics-based governance.

We have a system called Investment Box (IB). This is a system to encourage our employees to make an investment proposal. For example, an employee can initiate a one million dollar project any time as long as he/she is successful in raising funds internally under Will. He/she can solicit the funds from those working for other operating units or even from company cafeteria workers by showing them investment plans and dividend payment plans as well. The project ends once the one million dollar is used up unless the employee can raise additional funds internally. That is how a built-in autostop function works in our company.

I want investors look to the inside of DISCO for us to thrive as an excellent company

Nakagami: President Sekiya, you still belong to a relatively younger generation as a corporate executive, but it seems that you have already established such a unique management system based on the unique perspective on human nature and organization. Could you tell me how you want DISCO to evolve going forward?

Sekiya: I want DISCO to be “the strongest company.” I use the word “the strongest” instead of “the biggest” because it is quality, not quantity, that matters to me. I am not quite interested in increasing sales but I am definitely concerned about profit margin.

I am not saying that I don’t like the protective attitude of bureaucrats and company workers. It’s just that I want DISCO to thrive as an excellent company forever. No matter how brilliant a company is, it is usually the case that the organization becomes more bureaucratic with less flexibility over its long history. We definitely want to curtail the power of bureaucracy from our management system..

Nakagami: In fact, we investors live in the market whose cycle is as fast as or even faster than that of the semiconductor industry. If so, it seems logical that we should ideally follow the philosophical and theoretical approach that DISCO takes. However, in reality, majority of fund managers don't seem to care about such approach and are not learning from the past history of market bubbles and crash. As a last remark, could you give us your comment on the activities of Misaki Capital?

Sekiya: It is grateful that DISCO has attracted an investor like Misaki Capital, who makes every effort to understand not just superficial financials but also the inside of the company. I always tell our IR people to attract as many as possible high quality investors like Misaki Capital. I understand that it is not easy for investors to evaluate the qualitative aspect of a company. But it is my wish to establish a long-lasting relationship with investors who have expertise in evaluating qualitative values or at least are trying their best to do so.

Nakagami: I really appreciate your comment. As I write in my book, I believe that the very qualitative analysis is a test for investors on how perceptive they are. Thank you so much today to share with us your very insightful view.

Editor’s Note

The previous (fifth) edition covered Professor Kusunoki’s thoughts on the definition of a “good company.” According to him, while a company is evaluated by three markets in which it operates, namely, the labor market, competitive market and capital market, a good company is the one which exists where these three markets converge and maximizes its “long-term profit.”

This edition introduces DISCO Corporation as an example of “management that is invested (not traded)” from the capital market’s viewpoint. However, it is also worth mentioning that DISCO has been ranked in the “Great Place to Work” listing for eight consecutive years and also gains overwhelming customer acceptance in the competitive market. In other words, in the context of Professor Kusunoki’s “good company” theory, DISCO will serve as a good example of three rings coming to a complete overlap.

It is Mr. Sekiya’s “hone-to-perfection-styled management” that brilliantly sublates the trilemma of these markets as it is often difficult to satisfy all three.

DISCO Corporation, originally founded as a manufacturer of grinding wheels about 80 years ago, must still have a considerable number of craftsmen who have been literally honing their products. However, corporate values cannot be enhanced only with workforce/workplace empowerment. What makes them shine further is the abstraction of workplace wisdom combined with logical scientific management skillsets which in turn amplifies the value of the business.

Moreover, such “hone-to-perfection-styled management” is a result of maneuvering though the unrelenting semiconductor cycle. Difficult business environment keeps DISCO on its feet. Perhaps we, in the financial community should be learning from their discipline, and not just sit to expect more monetary easing to help us.

We, at Misaki Capital also pursue three rings. A trinity of values, which is to fulfill our responsibilities to create value for companies, for investors and for society. I believe that a keyword that sublates this trilemma is also “management.” We are investors, but at the same time we are a managing body of Misaki Capital Inc., an independent asset management company. While we have learned from our current experiences, we feel we need to refine our management in order to balance the centripetal force and centrifugal force of the organization as more professionals will be joining to match the steady growth of our fund. In fact we are following DISCO’s footsteps to formulate our “MISAKI VALUES”.

We are committed to aspiring towards more sophisticated management. It should not be a coincidence that a change in just one alphabet will transform “Misaki” to “Migaki” (which means “honing” in Japanese).

Nao Makino

Research Officer

Published by Misaki Capital Inc.

Sakurai Bldg. 3F, 5-11-1 Minami Aoyama
Minato-ku, Tokyo 107-0062 Japan
TEL +813-6427-7431
E-mail info@misaki-capital.com
Web http://www.misaki-capital.com/en