



Quest for “Excellence in Management”

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A Dialogue on “Where Does Ingenuity In Management Come From?”

Tetsuya Nakayama (President, TRUSCO NAKAYAMA Corporation) × Yasunori Nakagami (CEO, Misaki Capital Inc.)



Foreword for releasing the 11th issue of Quest for “Excellence in Management”

An investment business is a low value-added activity in accordance with the “inherent” meaning of the term. This is especially so in the case of investing in listed companies—an activity that Misaki engages in. All you can do is buy or sell listed stocks in the market just like everyone else. In such a world, you hardly have any room to add value.

Therefore, in order to produce sustainable returns in this vulnerable business, you have to develop “a discerning eye for management.” This is of course not easy, but when I visit companies, I sometimes feel a sense of *déjà vu*—a sense that I have seen such a company “crafted so meticulously like wooden mosaic parquetry” before. TRUSCO NAKAYAMA Corporation was just that.

TRUSCO NAKAYAMA is a latter entrant in the old-fashioned tool wholesale industry. Nevertheless, the company has rapidly expanded its sales and market share through their innovative strategies. On the opposite end of what seems to be an insane level of inventory and massive investments into their distribution channel comes an impressive level of high profit margin.

In the face of somewhat antiquated industry practices, where customers’ unreasonable demands are accepted based on long term relationships, TRUSCO has discontinued issuing notes to settle trade accounts payable, and has completely abolished the channel stuffing which had been carried out in the name of “sales growth.”

Turning our eyes to their organization management, we have found that the company has introduced innovative systems such as the 360 degrees evaluation system allowing all employees to cast a vote, and management meetings in which any employee can participate and no prior consensus-building processes are allowed. A company, once called not just an exploitative enterprise but a “deeply-exploitative” enterprise, now boasts the highest wage increase rate in Japan.

In this issue of Misaki Newsletter, we have focused on what derives such uniqueness of management. The proposition that came up through the course of this interview was a commonality between corporate managers and artists.

Whether an artwork is good or bad does not depend on its size nor style. Likewise, whether a company is well managed or not does not depend on its size of sales or profits, nor based on the history of the industry in which it operates in.

TRUSCO NAKAYAMA may not be well known yet. Their market cap is on the smaller end although operating in a mature industry. But still (or that is why) I feel that President Nakayama's "artisanship" is first-class.

Within the limited pages of this newsletter, I hope to be able to share the essence of TRUSCO Nakayama's quest for excellence in management.

Yasunori Nakagami, CEO
Misaki Capital Inc.



“Where Does Ingenuity In Management Come From?”

Tetsuya Nakayama (President, TRUSCO NAKAYAMA Corporation) × **Yasunori Nakagami** (CEO, Misaki Capital Inc.)

※This dialogue was held in December 2017.

| Success cannot be found by following the same path as others

Nakagami: Although TRUSCO NAKAYAMA is a latter entrant into the tool wholesale industry, it has been one of the best performers in the industry. The 10-year average sales growth rate is 5% as compared with the industry average of 2.5%, and the operating margin is 8% as compared with the industry average of 3%.

In our business, we have looked at a variety of companies and not only does TRUSCO NAKAYAMA have good earnings, but it supercedes in terms of uniqueness in the way it is managed.

So, in this issue, I am going to dig into the thought process of the management led by President Nakayama, and focus closely on what the ingenuity in management is and where it comes from.

First of all, the uniqueness of your business is well reflected in the mantra: Inventory is a strong magnet. However, generally speaking, lighter inventory is considered better, isn't it?

Nakayama: Common sense and standard practice are convincing in their own way. If everybody says that less inventory is better, it sounds true. However, if we had reduced inventory, we would have not existed in the way we are today.

In the manufacturing tool wholesale business, inventory is a means of providing value to customers. If we keep inventory level lower, we can surely make performance indicators look better, but at the same time we have to give up providing values such as broad product lines and same-day delivery to our customers. This is why we need

more inventory.

One example is our business with online sellers, which is expanding rapidly these days. We were able to capture this business opportunity because they have recognized the value of our ample stock of different product lines and delivery system.

Interestingly, sales to our peer wholesalers are also increasing. This is because they can procure goods quicker and at a lower cost through us than directly from manufacturers when in need of a small-lot order.

There are many things that you can realize only through challenging common sense. For example, it may sound surprising if I say increasing inventory reduces overtime work. But it's true because having a lot of inventory makes time-consuming ordering process dramatically easier. I wonder whether consultants advocating the importance of inventory reduction are aware of the power of inventory.

It may actually be true that our strategy is unconventional in the industry. We have, in fact, invested in inventory and distribution system to the extent that other companies may think that we are insane.

In this sense, the way we manage our company looks far from financially sound, but the results show that we have performed better than those companies that pursue financially sound management.

Nakagami: You do things differently from your competitors and produce results. This is precisely what you mean by “ingenious management.”

Nakayama: I don't know why, but Japanese business community is prone to appreciate financially sound management. However, I dare to say that financially sound management is just another term to describe “timid management.” I rarely find companies that were adamant about being financially sound and still achieved growth.

I don't think companies can grow just by repeating the same thing as in the past and doing the same thing as other companies do. Success cannot be found by following others' footsteps.

| “Return to the origin of your business, and you can find seeds of ingenuity”

Nakagami: That being said, challenging a common theory will never be easy. From the standpoint of a former management consultant, I should say that what you have been challenging is a big shift in a core strategy that may generally be referred to as “transformation of dispersed businesses into a scale business.” In fact, you have so far deployed 22 distribution facilities throughout the country, each of which costed as much as 3 to 5 billion yen. The magnitude of the capital expenditures is simply “flabbergasting” when compared with industry standard.

The industry has a long history and you are one of the last players who entered it. Now, my question is: What made you decide to develop such a unique business model?

Nakayama: To tell the truth, when a decision was made that I would become president, I was too worried about how I could run this company, let alone think about strategy. However, I decided to accept my fate, returned to basics, and asked myself a question: How should we define ourselves in the first place? Then I saw the path open up in front of me.

Since we are a manufacturing tool wholesaler, we sell manufacturing tools to retailers. However, it is the actual manufacturers who uses them. So, I thought that our mission should be to contribute to the Japanese manufacturing industry itself. Our slogan: “Gambare!! Japanese Monodzukuri” was born in this context. (Translator's note: Gambare means hang in there and don't give up. Monodzukuri literally means making things, but it actually represents the spirit to build excellent products and continually improve them)

Obviously, just putting up a slogan makes no difference. What should we accomplish to contribute to Japanese

Monodzukuri? Our answer to this question has led us to come up with an idea of implementing a quick delivery system that covers the entire country.

To realize the idea, it was imperative to deploy large distribution centers at key locations across the country, maintain large inventory at each center, and establish our own delivery system.

That was the prototype of our current business model, which requires big investments in inventory and logistics function.

Nakagami: By simply probing for the answers to the questions: “What is the essence of this business?” and “How can we provide value to customers and society?” you were able to justify seemingly insane investment in inventory and logistics function.



Nakayama: Of course, we cannot make a detailed strategy by forecasting everything precisely from the beginning. However, once the prototype is established, detailed designing naturally evolve. For example, we came up with an idea like: “This branch can share the warehouse with that sales office.”

In addition, triggered by a study tour to the United States that we took in the mid-1990s, we accelerated developing large-scale logistics facilities, and centralized inventory and purchase control.

Although the internet was yet to be fully in place at that time, the largest US tool

wholesaler used satellite communication to centralize the operations of order placement and inventory control at the head office so that branch managers could concentrate fully on sales and personnel development.

On the other hand, our branch managers had too many things to manage—spread too thin between employees, suppliers, inventory, and customer relations, none of them were satisfactory.

When I reconsidered how the branch operation should be, the obvious answer was: “It should focus on sales.” So, I thought we should make a large logistics center to centralize the supplier and inventory management there.

We also stopped getting involved in channel stuffing—a prevailing industry practice that we had engaged in under the name of “sales expansion effort.” We promoted products we wanted to sell, without knowing the actual needs of customers. On that note, because we sold products that customers did not really want, the return rate was high. I began to question what this “sales expansion effort” was all about.

We also introduced an automatic return system. Players in this industry tend to be reluctant in accepting returns, but since we always keep inventory of all of our products, all we have to do is to simply return them into the warehouse. So it doesn’t make sense to me not to accept returns.

Now we accept returns through the system and collect the returned goods at the time of next delivery. This is a great service you rarely see in the industry.

Nakagami: Revisiting the company’s raison d’etre will inspire you with a strategy prototype. Based on that, you will sophisticate your strategy with more inspiration and awareness.

I understand that, through the course of accumulating thoughts over many years, you have created a strategy that is very different from others.

Nakayama: The way our sales function operates is also quite different from other companies. In the tool wholesale industry, normal practice of maintaining customer relationships are basically through making the rounds to customers to accommodate customers' demand irrespective of how unreasonable it may be. However, we don't value this practice in our business.

Customers sometimes request us to do something unreasonable, or even wrong. If we say "yes" to all of their requests, we cannot sustain our business. And more than anything else, employees cannot work with pride.

When customers says something wrong, we should say it's wrong. As long as we remain to be a business partner that they cannot do without, it doesn't matter if they don't like us.

I might be choosing the wrong words in saying this, but our ultimate goal is to become a company that makes customers say: "Honestly, I don't want to buy from you, but I have no choice. (Laughter)"

Nakagami: That represents your slogan: "Mastering the wholesale business" Becoming a necessity to your customers is the ultimate relationship building.

Such a unique thinking comes up because you keep asking yourself: "What value are we providing and what value have we yet to provide to our customers?"

| Think things straight, and the path will lead its way

Nakagami: Next, I'd like to shed light on your organization management and personnel management system. First, what makes your company distinctive is the transparency and openness of your performance evaluation system, which is called Open Judge System (OJS). OJS is designed to incorporate opinions from not only their supervisors but also their subordinates and colleagues. That's what is generally referred as 360-degree evaluation, but your version is more thorough.

Nakayama: The idea behind OJS was to get rid of "feelings of discontentment" from the workplace. If you step into a pub around Shinbashi area after work, you will see scores of Japanese office workers complaining over drinks after a long day, saying something like: "My boss doesn't understand me," or "They don't appreciate how hard I'm working."

No company can be successful while employees have complaints, dissatisfaction or feelings of discontentment. We used to have an ordinary performance evaluation system, which resulted in directors and officers having a bigger voice promoting their subordinates. So it turned out to be a hotbed of complaints and dissatisfaction.

That's why in 2001 we decided to adopt a voting system participated by all employees as part of our performance evaluation to decide who should be promoted and demoted. Every one of our employees has a right to vote for or against promotion of any other employee—even ones in different areas or divisions—as long as they have related to each other through work.

Nakagami: All of your employees? There are many companies using 360-degree evaluation, but I've never heard of a company that allows all employees to participate in the feedback.

Nakayama: All of them, for sure, because you can find out who evaluated you if feedback is limited to people within your department. Instead, to prevent irresponsible votes, they are required to make sufficient comments when voting. Each employee is evaluated by the rest of the employees, so there's no complaining about their

supervisors or the company.

And this voting system involving all employees allows us to multi-dimensionally understand what kind of person the employee is. It reveals, for example, one who is always kissing up to the boss, or one who is underrated by the boss but highly trusted by their co-workers.

Nakagami: That reminds me of McKinsey & Company's evaluation system because it seems to me that your system is comparable to theirs. In McKinsey, Partners who are respected by peers are appointed as evaluation committee members, and they spend nearly two months a year evaluating the performance of offices that they have no affiliation with. It is natural that the firm should be tempted to have Partners spend their time bringing in more business rather than spending that amount of time on evaluations, but in order to accurately evaluate real human beings, they are more than happy to utilize the resources that way.

Many Japanese companies say that they value people, but I have rarely come across companies that offer fair evaluation, feedback, and growth opportunities to employees.

As OJS gives all the employees an opportunity to write lots of comments, you end up devoting a lot of time and resources just to read through them. However, I believe that without such cost, you cannot make fair assessments and evaluation of people and cannot eliminate dissatisfaction, either.

Your management meetings are also completely different from those held at other companies. Each meeting is participated by non officers as observers, and the minutes of the meeting is made available companywide within a week. I hear that even people from outside the company sometimes attend your meetings. Is that so?

Nakayama: Oh yes, because we have nothing to hide. By making meetings open to public, it can be a place for attendants to ensure a fair discussion, and for supervisors to get motivated because they are watched by their subordinates.

Most meetings start at around 10 in the morning and end late in the afternoon. Discussions takes quite a long time because we do not allow attendants to give any preliminary explanation or negotiation before a meeting.

But all in all, this saves a lot of time compared to proponents going around to detail their proposals to each participant who will be in the meeting beforehand.

Nakagami: When you say so, it sounds nothing special, but I've never seen any other company that has management meetings as open as yours.

Nakayama: It's not that I intend to manage our company differently or make our company unique (Laughter).

Nakagami: Another distinction is found in the remuneration program and employee benefits.

Last year, your pay raise rate was 6.4%, the highest in the country. A once-exploitative company is now one of the "good standing 500" companies. Your employee benefit system has repeatedly been covered by newspapers.

Nakayama: We worked on pay raises over the course of three years up to fiscal year 2017. I am very glad that our efforts paid off. Amid the recent hike in hiring demands within the job market, yet we have seen a 50% increase in the number of applicants this year. Also, we don't have turnover issue.

We have also established unique employee benefits. For example, we have a system called "transfer for couples." If an employee's spouse is transferred outside the region, the employee can choose to be transferred to our nearby office there. That makes the employee happier, encouraging them to continue working with us.

Many companies pay for the employee's annual medical checkups, but in our case, our employees' spouses are entitled for the same checkup using company cost. If a company wants employees to work hard, the company should also care about their family's health.

Recently, an increasing number of companies have been introducing similar systems in response to labor shortages and hiring difficulties, but our system has been in place for 15 years.

Nakagami: I think your company is different in terms of “the purity of motive” from others who rush to develop a system for recruiting purposes.

President Nakayama, I’m convinced that by thinking about what’s best for your employees has led to the firm’s unique measures.



| Ingenuity will never arise without accumulation of thoughts

Nakagami: Having heard your story, I’m very much amazed how detailed and analytical your thoughts are, and how thoroughly you think through each topic.

Do you allocate substantial time to think through every single issue?

Nakayama: Well, no. I can’t commit much time to every single thing. Rather, a good idea occurs to me when I’m pressed for time.

In fact, we used to be not just an exploitative enterprise. We used to be more like a “deeply exploitative” enterprise (Laughter). I don’t mean to praise being exploitative, but it is true that our ingenuity was fostered while we were racking our brains to find the way out of the deep exploitativeness.

The saving grace is that if you think 10 times harder than others do, I bet you can come up with some decent ideas. I always encourage our employees to do the same, saying: “Think 10 times more than others” and “Don’t consult. Use your own head.”

Nakagami: You cannot develop ingenuity without thinking that much, right?

President Nakayama, you may only have a short time to think about each issue, but you are thinking about something all the time, and it is really conveyed to me that you are thinking very hard.

Naturally, an accumulation of thoughts will eventually lead to ingenuity.

| What prominent managers and artists share in common

Nakagami: You regard every component of the company as objectives of management. I see that through the Annual Report full of your passionate words and expressions such as “Those who control logistics control the commercial distribution.” and “Top-level Parties Conference”; your Convocation Notice of Annual Shareholders’ Meeting is one of the most informative materials amongst all the listed companies; and the employee directory is rich in employees’ information.

In fact, you have incorporated to the headquarter building earthquake resistant seismic isolation structure and emergency power generators, but there are many more particularities, right?

Nakayama: Yes. We carefully thought about even the number of power outlets and where to place them. It actually costs more if you add after the construction is completed, but much less if they are designed at the beginning of the construction.

The same applies to plumbing. As it’s especially difficult to add draining functions after the construction is completed, it’s important to plan plumbing from the beginning with a clear image of how to use the space of the entire building.

Space for washing machines is spared purposely on each floor of the building. The architects of the building looked at us questioningly when we were discussing about the plan, but even at the workplace there is actually more laundry than people think. Also handicapped accessible restrooms are installed on each floor so that we can lease the building by floor should we need to downsize.

Currently five new distribution centers are being constructed nationwide. So I am busy attending every construction meeting.

Nakagami: You attend every meeting? That's surprising.

Your employee directory, which I heard is one of your favorite books, is amazingly rich in content.

Nakayama: Every year we use pictures of newly opened buildings and facilities for the front cover of the employee directory. The directory contains a lot of data, such as date of joining, department they belong to, home address, cellphone number, hobby, and blood type, let alone their name and photo.

Recently in order to enhance its function as a communication tool a new column was added to the directory: "When do you think that a person is amazing?" I expect employees to be inspired by unexpected answers which may lead to doing new challenging things. It sounds exciting, doesn't it?

For the team pictures, I also tell the employees to post unique and funny group photos of each department. If they fail to do so, I berate them. (Laughter)

Keeping an employee directory seems so old, but I think if I try to spur the employees to work harder without even knowing their names, they wouldn't listen to me. It's as if I'm talking to a wall. That's why I always have it with me. It's also a useful communication tool for the employees. When you contact a person for the first time, it's smoother if you already know something about them.

Nakagami: I can see that you really think about the company in detail. Could you tell me where your passion comes from?

Nakayama: I just like to improve each and every element of the company and its management. I believe that management is an act of enhancing functions of a company. Nothing more, nothing less.

Of course expanding network and strengthening relationships with people outside the company are important for managers. However, their communication should not be just for fun. They should always keep their eyes and ears open to catch unconventional ideas through these conversations to make their companies better.

Nakagami: I've often felt it firsthand when a manager is thoroughly thinking about managing the business. It appears that prominent managers share a common idea.

They focus on just one thing: "enhancing functions of a company." As they always look at the surrounding environment from that point of view, they can conceive new ideas and run their business very well.

Nakayama: What is important in managing a company is honing all elements surrounding it, not just the few in sight.

It's like building a big house by hand with wood or Lego blocks. In the past, I've had to tear down what I had built and do it all over again from scratch. I never want to go back to that. (Laughter)

Nakagami: The venerable Mr. Konosuke Matsushita said: "Business management is a live composite art." TRUSCO NAKAYAMA Corporation is precisely a kind of an art work that President Nakayama continues to refine.

The theme of this newsletter is "ingenuity in management." Come to think of it, art is a discipline that requires ingenuity more than anything else. In this context prominent managers may be like artists. In order to deliver their work to the world, they must always be on alert for new ideas, and be mindful about the origin of their business and missions for their customers. As the answers do not spring up immediately, they must continue making efforts

tenaciously and learning through trial and error. They are surprisingly obsessive in details because the output is their own work of art.

I suspect that there may be no room for investors like Misaki Capital to help improve the process of a manager putting their heart into making their work of art.

However, it's true that brilliant artists have understanding patrons, isn't it?

After this interview it has re-iterated to me that Misaki Capital would like to stay beside strong willed managers and support them.

Thank you very much for sharing your thought-provoking story today.

December 2017
At Toranomom

* No part of the reference to the company featured in this newsletter is intended to suggest our past investment performance or current investment policy.

Interviewee Profile



President,
TRUSCO NAKAYAMA Corporation
Tetsuya Nakayama

1958 Born in Osaka in 1958 as the second son of Mr. Chuji Nakayama, the founder of Nakayama Kiko Shokai (currently, TRUSCO NAKAYAMA Corporation). Joined the company after graduating from university
1984 Director
1994 Representative Director and President (current position)

Misaki's Voice



Investment Associate
Yuki Takenaka

As part of the Investment Office, I am responsible for researching companies and the peers within its industry. As a long-term researcher, I spend my time looking at companies' business history and thinking about the intrinsic value of the companies and their businesses.

Editor's Note

The theme of this issue is “ingenuity,” which at a glance seems quite removed from the world of investing. It was especially hard to grasp for someone like me who has spent most of my career in the financial industry.

To put it bluntly, participants within the financial world are expected to come up with a “correct answer” through processing information available to them using “common sense” within the industry. They do so because they would not be able to take responsibility for possible loss that their clients could suffer as a result of their decision made against common sense. The asset management community in which Misaki Capital is part of, is structured the same. As an investment manager entrusted with our investors’ capital, lack of common sense is not accepted.

However, when investing in listed companies where all investors have access to the same information, it would be difficult to provide value add if we only follow our “common sense” therefore consequently reaching the same conclusion as others.

In a world where common sense is expected, how do you challenge that in order to produce returns? I believe this is a question that every corporate manager faces each day. If they increase inventory, they may be criticized by their shareholders who believe that increasing inventory is against “common sense”. However if they decrease inventory, they cannot grow their business to be more profitable. I believe President Nakayama who has pursued “ingenuity in management” has been confronting this dilemma between common sense and ingenuity in management for a long time.

For corporate managers to continue challenging what is considered common sense in defiance of external pressure they must have strong confidence in their decision making. I believe President Nakayama continues to be ingenious because his decision is made after he “thought 10 times more intensively than others.”

What it takes for investment managers like us to keep generating returns is also nothing but this “confidence.” The stock market is a reflection of participants’ common sense. It has dawned on me that in order to be confident about being a contrarian means that I need to think and research 10 times more intensively than others. From that point of view, the theme of “ingenuity” is not completely unrelated to investing as I had originally thought. As always, investors can learn a lot from prominent corporate managers.

It is a great pleasure for Misaki Capital to meet excellent companies and their prominent managers, and to have an opportunity to invest with them. But at the same time, it’s a big challenge for us. How can we contribute as a “constructive shareholder” to a company that has refined themselves through in-depth thinking for many years to be recognized like an artwork? The amount of thinking that we’d require would be far more than 10 times. It is not an easy path, and there will to be a lot of work ahead, but for that very reason we believe that there is a room for us to add value. To this end, we will continue to align our interest with companies and their management.



Yasunori Katsuno
Investment Officer



* Cover photo: Cape Chinen

Located in the southern part of the main island of Okinawa, the cape commands a distant view of a remote island Kudaka Jima, also known as the “Island of God.”

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