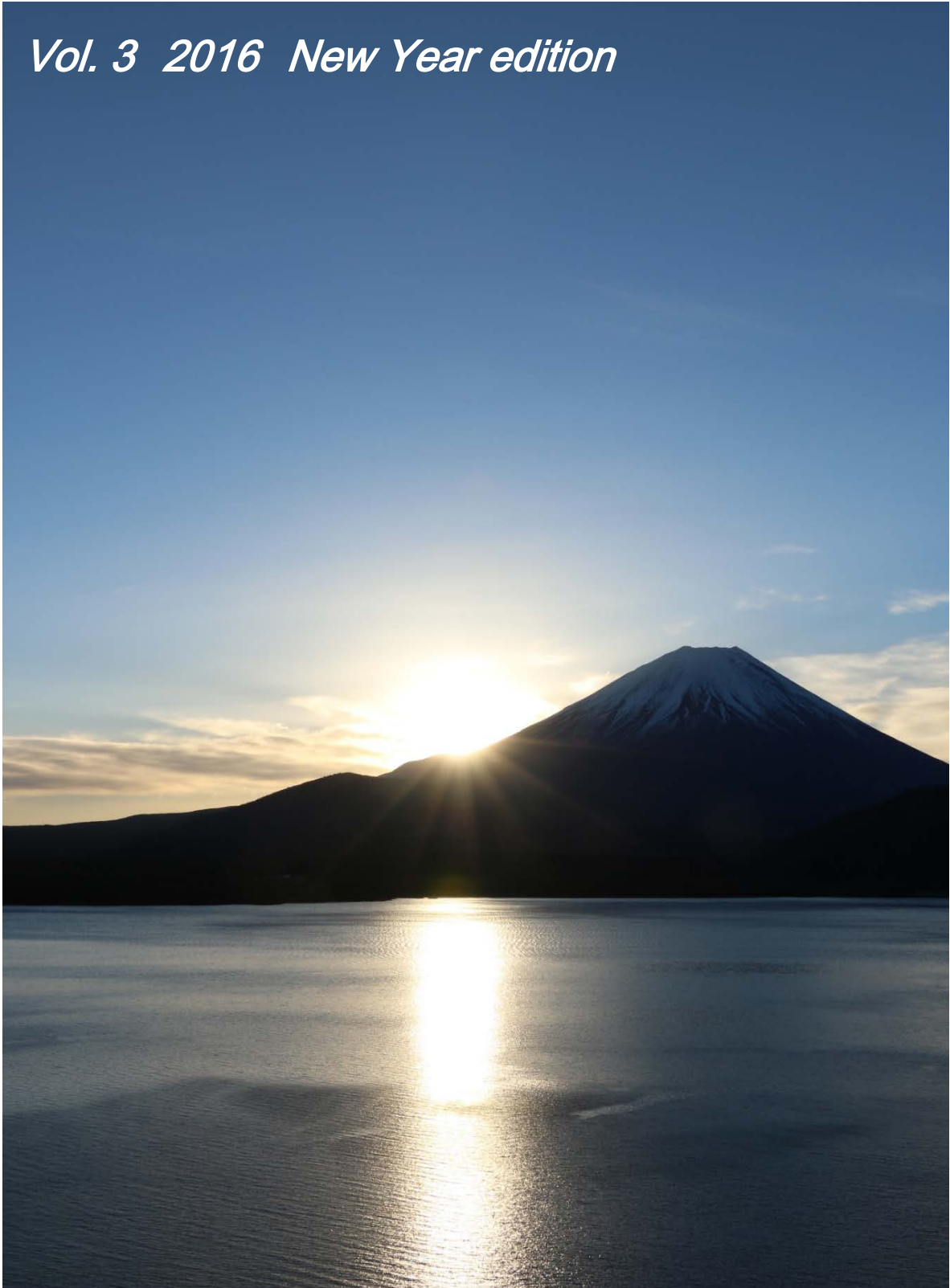


Misaki Newsletter

Quest for “Excellence in Management”

Vol. 3 2016 New Year edition



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Foreword for releasing the third edition of Quest for *“Excellence in Management”*

I have great pleasure in offering you my best wishes for the New Year.

The year 2015 saw a great start in the field of corporate governance, including the introduction of a range of new policies and reports.

To be quite honest, I was not a big supporter of companies just focusing on appointing multiple independent directors or introducing the nomination committee system, which seemed to me like a token gesture of applying governance “hardware” within companies.

In other words, I was not quite sure how the implementation of governance “hardware” could contribute to the “sustainable growth of corporate value,” which represents a crucial concept for making long-term investments.

However, such skepticism was drastically changed after interviewing Mr. Masatoshi Matsuzaki, Chairman of the Board of Konica Minolta, Inc., one of the leading public companies actively promoting corporate governance.

Mr. Matsuzaki is also the author of the best-selling book, *“Boryu Kakumei—The Revolution Begins at the Border,”* published (in Japanese) last year. In his book, he shares his story of going through difficult times in making management decisions that resulted in withdrawing from its founding business, streamlining the business portfolio, and introducing a voluntary retirement program.

The very question I had to ask Mr. Matsuzaki at the interview was the following: “How could Konica Minolta make all these tough decisions, those that a lot of management could possibly want to avoid, without postponing them?”

The interview provided me with an insight into the importance of governance “software,” meaning that good governance requires good process design and operational ingenuity. This is something that many Japanese companies have to keep in mind to avoid the pitfalls when making decisions.

There is a popular joke saying: “A computer without software is just a box.” Likewise for corporate governance, recent corporate scandals around the world indicate that preparing a fancy hardware is not enough for achieving sustainable growth of corporate value.

I hope that this interview will help to raise awareness of the importance of governance software and provide practical insights for executives who are at the forefront of corporate management.

Yasunori Nakagami, CEO
Misaki Capital Inc.



Masatoshi Matsuzaki, Chairman of the Board of Konica Minolta, Inc., with Yasunori Nakagami, CEO of Misaki Capital Inc.

*This interview was held in December 2015

Governance system that does not allow for procrastination on issues

Nakagami: In the past, Konica Minolta has made some bold management decisions such as withdrawing from the founding businesses of cameras and photographic films, or soliciting voluntary early retirement during the very year in which it reported a year-on-year increase in profit. Many managers are usually hesitant to take the plunge to go through painful reforms, I wonder what makes it possible for Konica Minolta to make such tough decisions all the time.

Matsuzaki: I think it lies in the design of our governance system, which is structured in a way that leads the management into making such decisions.

One of the features that we have incorporated into the system is that it is operated by those who devote themselves to the function of “supervision.” Another feature is that it is monitored by outside directors.

Where the Board of directors is effectively controlled by the executive team, it tends to focus on “results” and “accomplishments.” However, our Board focuses on “issues” because it is controlled by those who take on the supervisory functions.

Each time the executive team report on their business at the Board meeting, they are subject to strict scrutiny on their assessment of current situations or their plan to turn around the business if it is performing poorly. Our system works so that you can't procrastinate on any problems.

When I was serving as the President of the company, the HDD glass substrate and healthcare businesses were not performing as well as we had projected. Because outside directors repeatedly questioned us, saying: "How are you going to turn them around?" The executive team was forced to think for themselves to find solutions.

As a result, we withdrew from the HDD glass substrate business as we concluded that the market will shrink for a structural reason.

Nakagami: There is an English idiom referred to as the Elephant in the Room. This is a metaphor used to express a situation where an obvious problem is being deliberately ignored by all parties. There is a big elephant in the meeting room, but everyone pretends not to see it. It's an attitude that is far from "intellectual" honesty. So I understand that you have a governance system that does not allow this very "Elephant in the Room."

But then again, there are many other companies that separate supervision from execution, but not all these companies are successful in effectively confronting issues. What makes Konica Minolta different from these companies in making the governance system function organically? Do you have any tricks that you use to select the right people for the Board or operate effectively?

Matsuzaki: Well, the first point is making a rule that a person who is determined to dedicate him or herself to the supervisory function shall be the one who will establish and operate the system. At Konica Minolta, the Chairman of the Board is committed solely to the supervision and is not involved in any executive capacity.

Currently, a former President happens to serve as the Chairman, but we have no problem at all even if someone from outside assumed the position instead. The Chairman will select an agenda with a focus on management issues, urge others to ask questions, and encourage those who may have harsh opinions to speak up. That's what those who are committed to supervising should do.

The second point is selecting the right people. When you are reported of a certain situation of the business, as a director, you have to be able to make judgements on whether you leave it as is, try to find solutions, or take measures against it. It's necessary for directors to have this competency, and the best candidates are those with experiences as CEO.

At the Board meeting of our company, the members ask questions relevant to the issues and make suggestions based on sufficient level of understanding of the industry in which

we operate. For example, they may say: “Why don’t we explore the possibility of selling this business?” thinking that “Now could be the right time to find a buyer.”

Operational ingenuity to make the governance work

Matsuzaki: It is also important that we have our own corporate governance constitution, called “Corporate Organization Basic Regulations.” It was created by Tomiji Uematsu, who became the first Chairman of the Board after the management integration of Konica and Minolta. Upon taking the office, he made a firm commitment to dedicate himself to a supervisory function and created the said regulations. It defines what we must at least observe, for years to come, generations after generations.

In a company, most of the decisions made by the President will be finalized without any debate. It’s nice on the President’s part, but it’s very dangerous for the company. Mr. Uematsu probably realized that it was imperative for the company to establish a system overseen by a third party instead of relying 100% on management’s capability.

Nakagami: People tend to pay more attention to the form of the governance system, such as the number of outside directors. However, what matters is the spirit of the governance system, as indicated in the Stewardship Code and the Corporate Governance Code of Japan. I understand that the “Corporate Organization Basic Regulations” indeed represents the spirit of how to manage Konica Minolta, and this itself is the “Code.”

Matsuzaki: The Regulations prescribe essential matters on what needs to be done for the governance to properly work and for the third party to effectively monitor it.

For example, the Regulations do prescribe the total number of directors and their roles, but does not refer to the composition of directors. I believe that we should from time to time discuss matters such as how many outside directors we should appoint, or whether we need inside non-executive directors or executive directors.

However, with an aim to preclude any risk of a former President being involved in execution to exert influence, the Regulations explicitly prescribe essential matters such as a rule that the Chairman of the Board shall be selected from non-executive directors, and a rule that the Chief Executive Officer shall not be the Chairman of the Board, but be the President.

Nakagami: As for outside directors, I believe selecting the right person is of utmost importance. I often hear people say: “We can’t find appropriate candidates for outside directors.” Could you tell us the methods and procedures for selecting outside directors at Konica Minolta?

Matsuzaki: We have a list of people with experience as top management at a Japanese company. Our secretariat has compiled a list including information such as their field of expertise and industries, so we use this as a reference. Members of the Nominating Committee also makes the nomination either from the list or elsewhere, and will debate on who is most suitable in strengthening our governance function.

New members of the Nominating Committee are appointed annually after the general shareholders' meeting held in June. Although I am a non-executive Chairman of the Board, I also have a position as a member, not the Chairman, of the Nominating Committee only.

We start our discussion on the kind of person to look for from July, by narrowing down the specific skills that we would require. For example, if we were considering a cross-border M&A, we would narrow down to someone conversant with it; or if we were considering strengthening IT-related business, then someone with the experience of managing an IT firm. We come up with a prime candidate by October, and the Chairman of the Nominating Committee and the Chairman of the Board will together request and sound out interest of the candidate in joining the Committee.



Nakagami: So you have no time to relax even after the shareholders' meeting. Listening to your nomination process, I can see that it is very tailored to focusing on the requirement at hand, which then naturally translate into identifying the best fit candidate.

Matsuzaki: In the case of many companies, those who are being overseen choose the outside directors. Naturally, they will tend to avoid anyone with a stern character. Who would want someone that may likely grill the President?

But at Konica Minolta, those that supervise choose the outside directors. Because the required skillsets are already identified based on the focus at hand, there was actually a case where we had indeed appointed a very stern person to serve the role. The President can also nominate candidates, but the selection process is entirely left to the discretion of the Nominating Committee.

In fact, I nominated candidates every year during the five years of my tenure as the President, only to see one candidate actually get selected (with a bitter laugh).

Nakagami: Considering that the selection of outside directors requires such a rigorous process, presumably deciding the next President must have an even more stringent process.

Matsuzaki: When the TSE released the Corporate Governance Code consisting of 73 agendas, we found that we already met 90 percent of them as we had implemented the system in the way I have already explained.

What we needed to work on, however, was a succession plan. We recognized its importance, but it was not effectively implemented yet. Our previous succession process was for the preceding President to make the proposal to the Nominating Committee of the prospective candidate whom he wanted to appoint as the next President, and the Nominating Committee will proceed with the process based on that premise.

However, to enhance the succession plan, we now have a process that requires the President to report to the Nominating Committee important skillsets for his successor, names of the possible candidates as well as the process for narrowing down the list. The actual process itself is put under the supervision of the Nominating Committee.

This process was added on to the Corporate Organization Basic Regulations because we wanted this to be the standard for many generations to come.

Konica Minolta as a group of people who relentlessly pursue functionality

Nakagami: You were once the President, a top executive, and now you are the Chairman, a supervisor.

As we all know, Japanese tend to be attentive to their seniors, and seniors often show their seniority to junior fellows. I wonder if it's difficult for the Board members to have a tough argument if the Chairman was a former President.

Matsuzaki: That's why we have four outside directors. If the Board was comprised of inside directors only, it would be natural that they may align their interest with the former President. But in the case of our company, this will not happen because outside directors may voice opinions which could differ from that of the former President.

In addition, the Board itself is subject to an annual self-assessment check. They freely speak out their opinions on matters such as whether the Chairman is effectively managing the Board, or whether the agendas are selected and the meetings are ran appropriately. We think self-assessment is sufficient at this stage, but we may introduce

a third-party assessment system in the future.

Nakagami: So the Chairman does his job as a chairman, the President does his job as a president, and the outside directors do their job as an outside director, all aware of their part and are evaluated for their respective roles.

Konica Minolta seems to be a group that relentlessly pursue functionality. I think I'm beginning to see the essence underlying the management reform discussed in your book.

Matsuzaki: What underlies the management reform is our governance system. Because we never make any decisions behind closed doors, we never come to a decision that we can't explain to a third party. We disclose everything and are assessed on everything we do.

Nakagami: So is that what you mean by "managing the company from the viewpoint of shareholders," as you wrote in your book?

Matsuzaki: I do care about being conscious of shareholders' viewpoint indeed, and managing the company in a way that will be acceptable.

However, the relationship between shareholders and the company is nothing special. Being a public company, it is quite natural that we be assessed on how we manage the company.

Customers, suppliers and other business partners choose us by evaluating our behavior and our products. So do shareholders by judging our management capabilities.

My aim is for Konica Minolta to become a company that will be evaluated and chosen by investors who will listen to our story and the plan that we have laid out for sustainable growth of our company, and who will give us their opinions and advices that will help us achieve our goal.

Nakagami: So the point is that corporate managers do not have to manage the company being overly conscious about shareholders but rather run the company in a proper way because they are eventually evaluated by investors by virtue of being public.

As Konica Minolta is a group that pursues functionality, issues will be dealt by assigning tasks and evaluated accordingly. I fully appreciate that you put this in practice both internally, and externally as well.

The dialogue on “m” in management

Nakagami: At Misaki Capital, we take into heart about “investing in people”. We place special emphasis on whether the manager has what we call a HOP (meaning Hungry, Open, and Public) mindset. We would not risk putting assets that have been entrusted with us to a company whose manager doesn’t have a HOP characteristic. In this sense, I feel that a HOP culture has effectively been ingrained within Konica Minolta over time.

As for “sustainable growth of corporate value,” we have our own investment principle called “Misaki Principle®.”

Under the Misaki Principle, corporate value can be represented by an equation $V = (b \times p)^m$. This equation is formed upon perception that Business (b) and People (p) are the source of corporate value, and Management (m) applied thereto will result in an increase in Value (V) exponentially.

Among the elements of “b”, “p” and “m,” “b” and “p” are considered highly specific to each company. Each company or organization will have their own, unique “b” and “p.”

However, “m” represents all kinds of management capabilities, methods and skills, including and related to sophisticated marketing methodologies, business portfolio management, balance sheet or ccc (cash conversion cycle) management, and establishing good governance system, all of which are examples of management skillsets universally applicable to any industry or country.

As investors, we analyze and research various industries and companies, so we should be in a position to have insight into “m” which can be implemented cross-border or cross-segment.

You have mentioned that Konica Minolta is looking for investors who will give you their opinion for achieving sustainable growth of the company. Though investors may not be as familiar with the individual businesses as those working in the company, you may still be able to have a good dialogue with them about effectively applying the “m”. What do you think about this?



Matsuzaki: As I recall, when I meet with investors, I discuss topics about “m” more often with senior investment professionals. More so with a fund manager compared with an analyst, and with the CIO compared with a fund manager.

Nakagami: That’s interesting. Even at fund management companies, people of senior rank are more interested in learning about “m” more deeply because as managers, they are fully aware of the importance of “m”.

Unfortunately, quite a few corporate managers say that meeting with Japanese investors is not particularly interesting because they only talk about numbers. On the other hand, when they go abroad, they find many investors who are willing to discuss topics about “m,” which is quite enlightening and beneficial for them. As a person in the Japanese fund management industry, I must say that such situation is quite disappointing.

There are many companies in Japan that have both outstanding “b” and “p.” For manufacturers, “b” will represent the high qualities of products that are accepted in any part of the world, and for service providers, it will represent the high quality “*omotenashi*” (or hospitality in English). As for “p,” Japanese people are very diligent and unlike in other parts of the western world, we seldom find corporate managers who receive several hundred-folds in compensation compared to that of their employees.

Equipped with such outstanding “b” and “p,” combining an excellent “m” should significantly increase the value of the company.

This is my true impression after listening to your story about Konica Minolta, which has built the governance system to create sustainable value in an exponential fashion.

Matsuzaki: Our basic philosophy lies in the belief that “the company must grow sustainably”. I took the post as the President in 2009 which was the year right after the financial crisis, and therefore the economy was extremely sluggish.

If I hadn’t experienced that, I might have pushed for “expansion of scale” similarly to that of my predecessors and tried to create a new record for the firm.

However, the economic situation was far from that. So I decided to set the goal to build a robust foundation that would enable the company to grow in the long term.

The base of all reforms is “to grow sustainably.” This includes reorganization of the Group’s management system from a holding company system to a group of operating companies, withdrawal from underperforming businesses, and solicitation of voluntary retirement. Human resources development is of course crucial. We put our efforts into continually cultivating the next generation of employees and managers because that is essential to achieving a sustainable growth.

Engaged investments to improve lives of the people

Nakagami: Before we conclude, I would appreciate your comment if there are anything you expect from Misaki Capital.

Matsuzaki: I relate with what Misaki Capital is trying to pursue. For a company to achieve sustainable growth, investors' alignment of interest means a lot.

An increase in corporate value will enhance the fund performance for pensions, which will ultimately improve lives of the people. I feel that Misaki Capital is a cornerstone in creating that eco-system.

You analyze the current status of a company with a long-term view and always share your opinion candidly by saying: "We believe such and such." I think companies and investors can both benefit from continuing these type of discussions.

I hope that we will have more investors like you in Japan. I would like Misaki Capital to be the vanguard of such movement, and look forward to the continued dialogue.

Nakagami: Thank you very much for such a generous comment. "Misaki" is an old Japanese word, and when it is written in *kanji* characters it expresses the meaning of "a guide for a noble person."

We will do our best to become a guide for the new era. I also look forward to our continued dialogue.

Editor's Note

The Volume 2 covered a story from Mr. Yamashita, the President and COO of Pigeon Corporation, on how he had applied theories of cost of capital and capital productivity to manage his company: a story primarily from the perspective of "finance." This volume introduces a story from the Chairman of the Board, Mr. Matsuzaki, focusing mainly on the "governance" aspect of management. From the viewpoint of the two functions: execution and supervision, he has shared with us how he made tough decisions at times in order to achieve sustainable growth of the company.

Konica Minolta is also well known for its support for the marathon. The firm's culture which values discipline (both in good times as well as bad times) and also spirit (reflected in "Corporate Organization Basic Regulations") reminds me of a true marathon runner. At Konica Minolta, they have a corporate word, "business athlete management." This expresses the company's management style of having the best of both disciplines: intelligence from a businessperson and tenacity from an athlete.

Mr. Matsuzaki and our CEO, Yasunori Nakagami, first got acquainted at a Corporate Governance study group. During the interview, it was pointed out that investors should have vast knowledge about and insight into 'm' in different fields. Mr. Matsuzaki on the other hand has vast experience of dealing with challenging issues at the forefront of managing a company. I was made to realize once again that it is through dialogues with people like Mr. Matsuzaki that we, as investors, can gain more insights into "m."

Furthermore, we believe that it is our duty and responsibility as an investor to share through our engagement efforts on what we have learned about "Excellence in Management." Publishing this newsletter is part of this endeavor.

In order to become a "Misaki," a guide for a group of companies who need to endure the spirit of marathon runners, we must also strengthen our body and soul even further. In 2016, we will do workouts to become a "running shareholder" in addition to our original concept of a "constructive shareholder."

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