KEYNOTE INTERVIEW

Driving ESG from the top

ESG has come a long way over the past five years and now it's starting to show through in financial performance, say NSSK's CEO Jun Tsusaka, chief administrative officer Shohei Akiyama and ESG leader Kiyomi Matsuda

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Q How does your firm view ESG?

Jun Tsusaka: If you go back five to six years, there was increasing dialogue around the Principles for Responsible Investing and brainstorming on how to incorporate non-financial outcomes to investment strategies. When we established NSSK, we put ESG front and centre of what we were doing. We were able to bring something unique to the Japanese market: infusing global best investment and operating practice to the middle market while integrating our mission to promote responsible investing.

We worked to define and identify how we could generate meaningful social returns through investment while also delivering strong financial returns. And, given that we needed to work within private equity timeframes, that naturally narrowed our focus to specific areas. One of these is diversity and inclusion and we've carved this out as an area for specific attention.

Q How has an ESG focus translated into how the firm is run and how investments are managed?

JT: ESG initiatives have to start at the top – that's why, as CEO, I am also chairman of our ESG committee. We have a control buyout strategy and so we are positioned to influence portfolio companies' direction around ESG and sustainability – if they aren't doing well on these measures, then it is on us. ESG had to be built into our modus operandi. Not only have we established separate "impact funds" from a fund formation perspective, we have identified and incorporated 66 ESG objectives for all of our portfolio companies, across all of our funds, and report outcomes on a quarterly basis.

We have created the position of chief philosophy officer – that's pretty unique – whose job it is to integrate ESG values, help portfolio companies implement ESG objectives and business practices into their daily activities. We have also moved one of our top operational people to the position of ESG audit officer – he is responsible for auditing our activities and publishing our ESG annual review. Last, but not least, our investment committee discussions around ESG and diversity and inclusion also drive portfolio construction. It is not a coincidence that many of our investments are in businesses where gender equality and inclusion can drive better outcomes.

Shohei Akiyama: Organisational behaviour is really important. We see this as a combination of three factors – structure, conduct and performance. So our structure, which is reflected in our organisation, includes the chief philosophy officer, whose role is to set business principles and promote ESG. We conduct training and coaching led by our chief philosophy officer. Conduct is driven by our structure that includes compensation programmes and resources that reinforce our objectives.

The ESG audit officer role helps enforce our objectives through monitoring and measuring our performance. Our teams compensation programmes include performance against ESG objectives as well. In this way, we can ensure that we are actually doing what we say we are doing. We report quarterly on our ESG objectives and outcomes to our LPs. We also have weekly firm-wide meetings in which ESG is top of the agenda. These two factors – structure and conduct – then feed into performance and outcomes.

Q What results have you had so far on performance?

SA: It's really interesting because these are just early results, but they really seem to reinforce our thesis that ESG can drive returns. Our current fund, which is a control buyout fund with ¥60 billion of commitments, has so far generated over 30 percent gross IRRs and over 90 percent DPIs. This puts us in line with top quartile managers in the US, Europe and Asia-Pacific.

We think this is indicative of a dynamic correlation between fund performance and diversity and inclusion at the portfolio company level. In this fund, we have increased the number of jobs by 12 percent, 40 percent of our CEOs or COOs are women or minorities, 78 percent of the total employee base is female and 49 percent of managerial positions are held by women. These women are driving superior outcomes for our investors.

Q So how do you address the gender gap in portfolio companies?

JT: It starts with deal sourcing. Gender diversity, or the potential thereof, is one of the key criteria for selecting the companies we back. But we also have to make change happen – even in companies with predominantly female employees, such as the elderly care business, the management team is usually dominated by men. It's our job to push for greater gender parity in senior roles and to make empowerment happen. That is why having a control position is important.

KM: Management control enables us to create human resource processes and career path programmes for employees looking to build long-term careers and seek senior management positions as well as more flexible work rule-based positions to accommodate personal situations and life styles. We can help our companies be more merit based and improve transparency, where there is a clear career path for all staff – and this increases retention rates, which has a direct impact on the financial performance of a business.

Q Why did you decide to focus on diversity and inclusion, particularly in a country where gender equality has been culturally difficult to address?

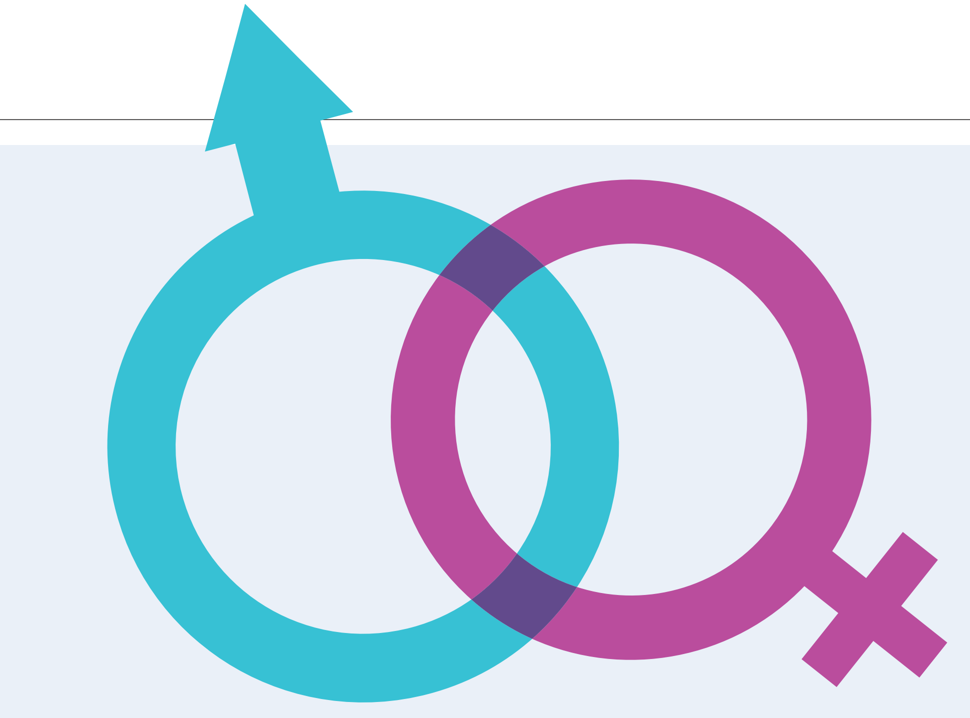
JT: As Shohei has indicated, we believe that strong investment returns are correlated with strong gender diversity and empowerment. Also, Japan does not fare well in gender gap surveys. It ranks at 121st of 153 countries in the World Economic Forum 2020 index of economic, education, health and political disparities between the sexes – and that's down 11 places since 2018. Only 15 percent of leadership positions are held by women and their incomes are around half those of men.

Kiyomi Matsuda: Yet there is growing research suggesting that there is significant potential in Japan for companies that bring women into a more active role in the economy – there is a strong financial argument for doing so and it is the right thing to do. We can also look to other markets where women have far higher economic participation rates and the success that has been achieved there. That's why we're making a bold attempt to address the gender gap in Japan while also showing that it can lead to good financial and business outcomes. As our early results suggest, our systematic and strategic approach to this is working and the returns are starting to come through.

Q Can you give an example?

JT: Vati, a nursing home business, is a great example of how we have addressed the gender gap and generated strong returns. If you're looking to grow a care home business, you can do so by increasing the number of facilities and/or by increasing the capacity utilisation at your facilities. In either case, you require motivated employees and need to be able to recruit and retain staff. When we invested in 2016, annual staff turnover was 29 percent. That's pretty high, although lower than the industry average of 33 percent.

If you think about why people leave, it's usually because they are unhappy about one thing or another. So at Vati, we worked on ensuring that its mostly female employees felt it was a good place to work from the perspective of



compensation, career development, work life balance and safety. Roll forward to today, Vati's annual staff turnover has dropped to 17 percent, one of the lowest turnover levels among the top 10 industry players. Not to mention the fact that over 60 percent of managerial positions are held by women. In addition, we were able to achieve 3x multiples and over 40 percent IRRs in the process.

Q You also manage regional impact funds. Can you tell us more about these?

JT: When we established NSSK, launching a fund dedicated to responsible investing was a top priority. With the strong support from REVIC, a government entity focused on the vitalisation of Japan's regional economy, as an anchor investor, we were able to form a fund that would focus on driving positive environmental, social and governance outcomes while generating solid financial returns. Even though Japan is geographically small, it has a massive economy – the size of India and Brazil combined. As such, we decided to focus our first impact fund on the central region of Japan, representing eight prefectures and about 14 percent of Japan's GDP.

We raised about ¥6 billion for the Chubu-Hokuriku Vitalization Fund - with 20 percent of the capital coming from government and the remainder from local financial institutions, including regional banks. The impact fund's mission is to create social impact in central Japan by increasing employment, gender diversity and local community commitment in addition to pursuing our 66 ESG objectives.

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>
> **JUN TSUSAKA**

SA: This first fund has become the basis for further expansion of our regional impact funds as stakeholders in other regions asked us to establish similar vehicles. We have now launched another four funds – even in the middle of the pandemic – so we cover the entire nation. We offer an attractive solution for local businesses looking to thrive in local markets at a time of uncertainty, increasing global competition and the rise of disruptive technologies. Many of these businesses do not have the resources to keep up with these changes, attract the right human capital or incorporate new technologies into their business processes – private equity can change the equation further in favour of these businesses and NSSK operates in these local markets to this end.

Q What's next for ESG in Japan?

JT: We are only at the beginning and this isn't just in Japan. I think we will see more focus on developing better processes and refinement of integrating ESG into the daily business activities of organisations. We firmly believe that good things come when there is a big common goal.

There also needs to be a recognition that not all ESG objectives are created equal. Different objectives have different costs and timeframes. If we take carbon emissions, which is clearly an environmental priority, we need to set aggressive, but realistic goals around the speed and level of investment we make to get to carbon neutral.

Return on investment and impact on jobs, among other things need to be taken into consideration. As a result, there continues to be a debate around how returns are correlated with ESG. But there should be no question that from an absolute return perspective, we will all be better off by investing in programmes, processes and technologies that enable us to achieve our ESG goals. And finally, I think there is a lot that can be achieved collectively. The PRI signatories, for example, now represent a significant amount of capital and there is much that could be done if we all work together to share best practices as well as data and outcomes. Exciting times ahead. ■