“Choose and Focus”: The Transformation of Japanese Business Strategies

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Five Surprising Facts

- In April 2008, Japan marked 73 months of economic growth.
- In March 2008, Japan’s current account balance surplus increased for the 6th straight year. It reached its highest level since 1985 (¥24.6 trillion).
- For FY 2007, Japanese listed firms posted record combined pretax profits for the 6th year in a row.
- Between January 2003 and 2007, the Nikkei 225 stock market index increased by 100%.
- Leaders behind this growth include companies such as JSR, Nitto Denko, Teijin, Softbank, Astellas.
GDP Growth, 1998-2007

How is this possible?

Real GDP y-o-y in %; Source: Cabinet Office

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Who Makes Screens for LCD-TVs?

Samsung, LG/Philips, Sharp, AUO, CPT, CMO

The new growth is driven by the materials and electronic component industries.

Source: Nitto Denko Annual Report 2006
1998-2006: Strategic Inflection Point

A point in time when industry dynamics are altered so profoundly that there is a fundamental change in what it takes to win (Burgelman/Grove)

- Banking crisis
- Globalization ("hollowing out"; imports reach Japanese markets)
- Political entrepreneurship ("Leave it to the Market")
- Social distress (crime, suicides, homelessness)

In 1998, Japan reached a tipping point.

- Irreversible change in laws, processes of regulation, and markets 1998-2006
- New strategic context for Japanese firms
- New industrial architecture
1998–2006 Strategic Inflection

- 1998 Banking Crisis
  - Switch to direct disposals of bad loans (sell off assets).
  - Banks develop risk management capabilities.
  - Disintermediation in finance: away from banks; consolidation.
- “Sunshine” rules
  - New accounting rules (esp. consolidated balance sheets)
  - New disclosure requirements (e.g., quarterly earnings reports)
- New laws on bankruptcies, corporate reorganization, stocks, mergers, takeovers, etc. (2000–2006)
  - Internal oversight committees: directors are liable
- Stricter prosecution of corporate wrongdoings
- Undoing of cross-shareholdings, influx of foreign investors
1998-2006 Legal Reforms

- Financial Reforms: Disclosure and Transparency
  - “Big Bang”, 1998
  - Consolidated, mark-to-market accounting, 2000
- Bankruptcy Legislation
  - “Chapter 11” reorganization and liquidation
- Commercial Code (annual revisions, 1997-2005)
  - Different types of stock (e.g., Treasury Stock)
  - Transfer of Ownership (M&A)
- Corporation Law, May 2006
  - Reorganization and restructuring
  - Corporate Governance: Shareholder rights increased
  - Management accountability and liability
- FIEL (Financial Instrument and Exchange Law), 2007
  - J-Sox: internal control system
  - Financial regulation by product, not by company
New Demand for Law

- From “ex ante regulation” (Civil Law-based) …
  - Judges only “interpret” the law.
  - Markets don’t have access to lawmaking (to introduce a new process, lawmakers must write the law first).
  - People have limited access to courts, which are slow; i.e. very little precedent, no developed legal doctrine.

- …to “postremedy regulation” (Common Law-based)
  - Everything that is not prohibited is o.k.; problems legislated in the courts.
  - Courts make law, in reaction to market initiative.
  - Access to courts is assured through lower fees, more attorneys, better court processes, more judges.

⇒ Greater managerial flexibility, but also legal liability (e.g., derivative shareholder suits)
⇒ Supervisory agencies and courts instead of informal regulation

- A Market for Rules
What We “Know” about Postwar Japanese Business Organization

- Business groups (*keiretsu*)
  - Horizontal (inter-market); vertical (subcontractors)
- Main bank system
  - Regulated interest rates; loans cheaper
  - Informal bailouts, few bankruptcies
- Internal processes of corporate governance
- Lifetime employment
  - Seniority wages and promotion
- Industrial Policy
  - Administrative guidance/extensive intervention
- Difficult entry for (foreign) competitors

*The strategic logic underlying these has changed.*
Strategic Drivers in the Postwar Period of Rapid Growth

- Bank strategies
  - regulated interest rates $\rightarrow$ **volume**
  - risk exposure $\rightarrow$ diversification

- Companies
  - Large firms’ DER: over 600 $\rightarrow$ **stability**
    - business groups
    - steady sales revenues to pay interest

- Lifetime employment
  - Diversification easy, but trimming down difficult
  - Promotion of special talent under seniority pay
High Leverage, High Risk

- Buy insurance through stable owners ("cross-shareholdings")
- Buy insurance through preferential trades ("inter-market groups")
- Buy insurance (loan access, rescue) through a main bank
- Diversify into many markets

⇒ Steady process of conglomeration
40 Years of Diversification

- **Companies: Market share in many product markets**
  - Banks wanted to see sales revenues.
  - Industry rankings based on sales:
    - Access to talent in hiring.
    - Access to favorable industrial policies (quotas).
    - Access to bank loans.

- **Shareholders: stability is critical**
  - Any sale is a good sale.
  - Any investment (growth) is a good investment.

- **Stock prices reflected expectation of market share.**
  - Lenient accounting and disclosure rules.
Diversification vs. Unbundling

- **1970s view on diversification**
  - Reduces risk of corporate failure
  - Increases profits if “related”
  - Decreases profits if “unrelated”

- Optimal point differs by company.

- Coupled with sales priority

  ⇒ decline in performance over time

- Bubble period excesses

  (exuberant diversification)
Studies on Diversification

At a minimum: diminishing returns

More likely: costs greatly exceed benefits

Performance

Diversification

Single Related Unrelated
Refocusing: From unwieldy goliaths to nimble competitors

- “Choose and Focus” (選択と集中)
  - Exit: spin-offs, M&As, MBOs (focus on core business)
  - Reorganization: “company system”, holding company structure (implement new goals through incentives, promotions, accountability)
  - Consolidation: purchase competitors (choose core businesses and dominate in those)

- From sales focus to profitability focus
  - From “stability” to “winning”
Japan’s Restructuring Wave: “Choose and Focus” of Nikkei 500 Firms, ‘00-’06

Criteria:
1) Exit: sale/liquidation of a business unit
2) Reorganization: holding company, with SBUs spun off into independent entities
3) Consolidation: acquisition of a company in the same industry

Findings:
1) 75% of Japan’s largest firms have undergone reorganization.
2) 41% (194 firms) have restructured in more than one way.
3) 25% (177 firms) have done nothing.

* Without financial institutions, n=472
Is that a lot or a little?

- **U.S. refocusing of the 1980s:**
  - At least 20%, but more likely about 50% of U.S. *Fortune 500* firms restructured in the 1980s (Markides 1995)

- **Compare to Japan:**
  - 36% of firms have divested, 75% have restructured

- **A truly remarkable episode in global business history.**
Implications for Corporate Strategy

- Reduced role of banks
  - Less focus on pleasing main bank (sales, cash flow)
  - Change in corporate governance
    - Less loyalty, more voice and exit
    - Threat of hostile takeover with poor performance

- Need to attract outside investors
  - Profitability is key!
    - Determines price of financing
    - Determines quality of investors
  - Need to disclose ROE, ROA etc.
    - Shed unprofitable business units, holdings (real estate, stock)
    - Reduce costs (production, purchasing)

- Compete through “Choose and Focus”
  - Identify core business areas
  - Reduce diversification → Reorganization
New Japan Corporate Incentives: Efficiency and Profitability

- Shareholders demand profits:
  - Attract outside financing (stocks, bonds).
  - Make institutional investors happy.
  - No more cross-subsidization across business units:
    - Cost-sensitivity, accountability
    - Every project must yield positive income streams.

- Nimble, lean and mean:
  - Compete through better ROE, ROA, ….
  - Compete through better products (no more “also-rans”)

- Implementation: new HR policies
  - Performance pay, meritocracy promotion

- Market hierarchies changing
  - Profitability beats size
  - Hostile takeovers
What we “Knew” about Postwar Japan is no longer true

- Business groups (keiretsu): Repositioning or Dissolving
  - Horizontal (inter-market); vertical (subcontractors)
- Main bank system: Gone (for large firms)
  - Deregulation; loans no longer cheaper
  - Bankruptcy rules vs. informal bailouts
- Internal processes of corporate governance
  - Externalized through M&As, hostile takeovers
- Lifetime employment:
  - Towards performance pay, wage by job category, individual career paths
  - Externalization of labor: 35% non-regular work force
- Industrial Policy
  - Government reorganization and laws: “Leave it to the Market”
- Difficult entry for (foreign) competitors
  - Market opening through price competition!
Stable Shareholdings

% of Firms that Engage in Cross-Shareholdings (LHS)

- Stable Shareholdings (RHS)

Reciprocal Shareholdings

- % of Firms that Engage in Cross-Shareholdings (LHS)
Reasons for Unwinding

- Banks
  - Ownership Limit Law (shareholdings limited by Tier 1 capital)
    - irreversible change
- Corporations
  - Profitability
  - Merit?
    - *No longer effective as defense against hostile takeovers*
Who bought these shares?

- Banks: “overflow repository” institutions
  - Bank of Japan
  - Banks’ Shareholdings Purchase Corporation
- Corporate share buybacks
- Japanese institutional investors
- Foreign investors
  - Funds managed by Wall Street and London firms
  - Japanese funds registered abroad
TSE Shareholder Structure

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<th>Year</th>
<th>Large Banks</th>
<th>Trust Banks</th>
<th>Insurance &amp; Inv. Banks</th>
<th>Corporations</th>
<th>Foreigners</th>
<th>Individuals</th>
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<td>7.3%</td>
<td>19.3%</td>
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<td>6.2%</td>
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<td>1989</td>
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<td>9.8%</td>
<td>18.7%</td>
<td>29.0%</td>
<td>4.3%</td>
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<td>1991</td>
<td>15.7%</td>
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<td>30.1%</td>
<td>4.7%</td>
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<td>1993</td>
<td>15.6%</td>
<td>9.9%</td>
<td>17.4%</td>
<td>28.5%</td>
<td>6.3%</td>
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<td>1995</td>
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<td>15.6%</td>
<td>25.6%</td>
<td>11.9%</td>
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<td>1999</td>
<td>13.7%</td>
<td>13.5%</td>
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<td>25.2%</td>
<td>14.1%</td>
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<td>17.4%</td>
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<td>10.0%</td>
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<td>18.3%</td>
<td>8.6%</td>
<td>21.9%</td>
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<td>2007</td>
<td>4.6%</td>
<td>17.9%</td>
<td>8.6%</td>
<td>20.7%</td>
<td>28.0%</td>
<td>18.1%</td>
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Source: TSE, 平成19年度株式分布状況調査の調査結果について
Japanese Institutional Investors

- **Trust Banks**
  - Investment trusts (= mutual funds)
    - 5% of total shareholdings
  - Trusts of trusts (= corporate investments)
    - Japan Trustee Services Bank
      - Sumitomo-Mitsui, Resona
    - Nippon Master Trust
      - Mitsubishi UFJ, Nippon Life, Meiji Yasuda Life, Nochu

- **Investment Funds**
  - Private buyout funds (turnaround investments)
Foreign Investors

- Institutional Investors
  - CalPers, etc.

- “Street Names” (investment trusts)
  - State Street, Chase Manhattan, …

- Private Equity Funds
  - Hedge funds, buyout funds, activist funds, corporate reorganization funds, real estate funds
  - Ripplewood, Cerebus, Lone Star, Goldman Sachs, Merrill Lynch, Bain, KKR …
  - Note: not all of their funds are raised abroad

- Small Japanese funds registered in the Caymans, trading out of Singapore, and located in Kayabacho
Why are these suddenly in Japan?

- **1998 Foreign Exchange Law**
- **Strategic Inflection Point: Legal change**
  - Transparency, disclosure, access
- **Exchange rate, growth prospects, comparative pricing**
- **1998 Banking Crisis**
  - Banks’ switch from informal workouts to direct loan disposals
  - Increased activity with bankruptcy laws 2000
- **Opportunity**
  - Shift to “choose and focus”: lots of good stuff to buy
M&A (number of deals)

2006: Total of 2775 M&As (of which 416 in-out, 194 out-in)
Domestic M&A (by scheme)

- Capital Participation (Minority Control)
- Acquisition of Assets
- Takeover (Majority Control)
- Mergers

Yearly breakdown:

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Domestic M&A (by objective)

- Enter into New Business
- "Choose and Focus"
- Raise Equity Stake in Affiliates
- Intra-Group Restructuring

Yearly Breakdown:
- '93: 486
- '94: 703
- '95: 703
- '96: 703
- '97: 703
- '98: 703
- '99: 703
- '00: 703
- '01: 703
- '02: 1993
- '03: 1993
- '04: 1993
- '05: 1874

Total: 1874
Successful Hostile Takeovers

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Source: Recof data, quoted by ESRI
Hostile Bids

- Horie and Livedoor (2005)
- August 2006: first intra-industry bids
  - Oji vs Hokuetsu, Aoki vs Futata
    - First use of TOB for industry reorganization
    - change in industry leaders, market shares, competitive jockeying
- 2007 Bull-Dog Sauce
- 2008 J Power; Aderans
- Trendline will slope more steeply
  - Corporate restructuring
  - Increasing performance
  - Industry realignment
2007: Bull-Dog Sauce

- U.S. Steel Partners
  - 30+ investments, mostly mid-sized firms
  - High equity ratio, low ROE
- Bull-Dog Sauce
  - 28% market share after acquisition of competitor
  - Mid-sized firm with family ownership
  - Unwilling to cooperate with Steel Partners
- The Battle
  - Steel Partner owned 10.52%, launched takeover bid
  - Bull-Dog asked shareholders to launch poison pill (warrants to dilute Steel Partners’ share to 2%)
  - Request for injunction denied; shareholders approve poison pill
  - Lawsuit on the grounds of discrimination
    - Steel Partners lost because “by nature” different type of investor
- The Result: Losses Only
  - Except: fast-growing market for legal advice
Can this be good?

- Goal behind a takeover is to improve the target’s operations to make it work at full potential.
- Best defense against hostile takeovers is to operate at full potential.
- Bull-Dog case caused losses in one company, but also a quiet turnaround in a million other mid-sized firms.
- For Japan’s economy overall, this is important weeding-out, social costs notwithstanding.
Summary (1)

- Old Japan’s political economy set strong incentives for CEOs to pursue market share, and therefore stability and security (安全第一).
- Since 1998, Japan’s business organization has moved towards the market.
  - 1998-2006 strategic inflection point
  - CEO incentives: risk and return
- New Japan competitive repositioning:
  - From sales (at any cost) to profitability
  - From diversification to focus
(2): What does this mean for Japan?

- Leading firms are adjusting
- Laggards may try to “muddle through” for a while, but their influence is waning
- Overlooked transformation: no longer end products, but components and materials
- New firms, new competition, new profitability.
- Newly empowered actors:
  - Consumers
  - Entrepreneurs
  - Employees (professionals, women)
(3): What does this mean for Global Competition?

- Japan’s leading firms are re-entering world markets as lean, focused, driven competitors.
- New competitive dynamics within Asia
  - Asia is more than mass-production, and more than China.
  - Samsung: “China is catching up, while Japan continues to lead. We are sandwiched between them.”
- Relying on what we used to “know” about Japan is a recipe for failure.
Your Comments, Questions, Feedback?

Choose and Focus

Ulrike Schaede

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