“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.
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 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
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
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)
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”

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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 SBU's 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
Stable Shareholdings

<table>
<thead>
<tr>
<th>% of Firms that Engage in Cross-Shareholdings (LHS)</th>
<th>Stable Shareholdings (RHS)</th>
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<tbody>
<tr>
<td>75.0</td>
<td>80.0</td>
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<tr>
<td>24.3%</td>
<td>44.9%</td>
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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*
TSE Shareholder Structure

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)
M&A (number of deals)

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

Successful Hostile Takeovers

Source: Recof data, quoted by ESRI
Summary (1)

- Old Japan’s political economy set strong incentives for CEOs to pursue market share, and therefore stability and security.
- 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.