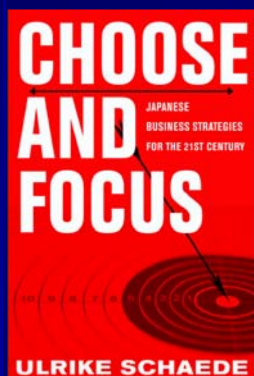
"Choose and Focus": The Transformation of Japanese Business Strategies



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June 5, 2008

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 → **volume**
  - risk exposure → diversification
- Companies
  - Large firms' DER: over 600 → **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

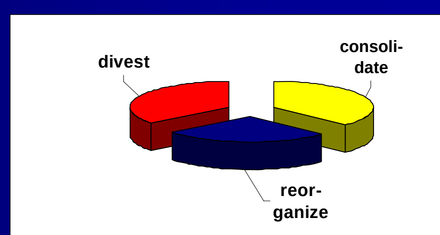
- 1970s view on diversification
  - Reduces risk of corporate failure
  - Increases profits if “related”
  - Decreases profits if “unrelated”
- Optimal point differs by company.
- Coupled with sales priority
  ⇒ decline in performance over time
- Bubble period excesses
  (exuberant diversification)

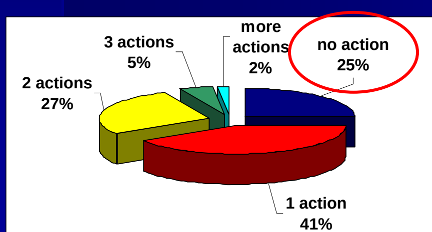
Refocusing: From unwieldy goliaths to nimble competitors

- "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"

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

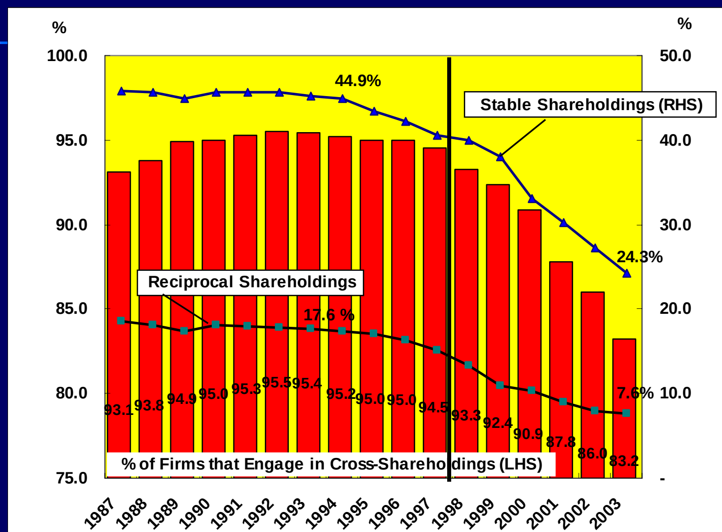
Is that a lot or a little?

- 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

Stable Shareholdings



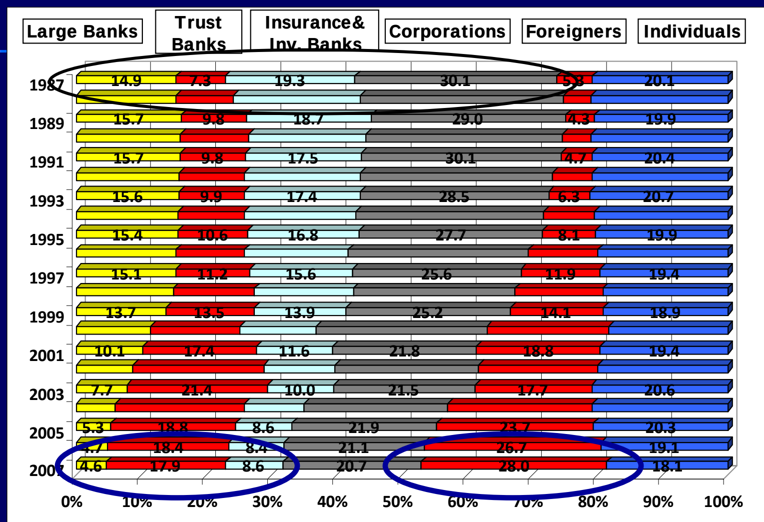
 13

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*

 14

TSE Shareholder Structure

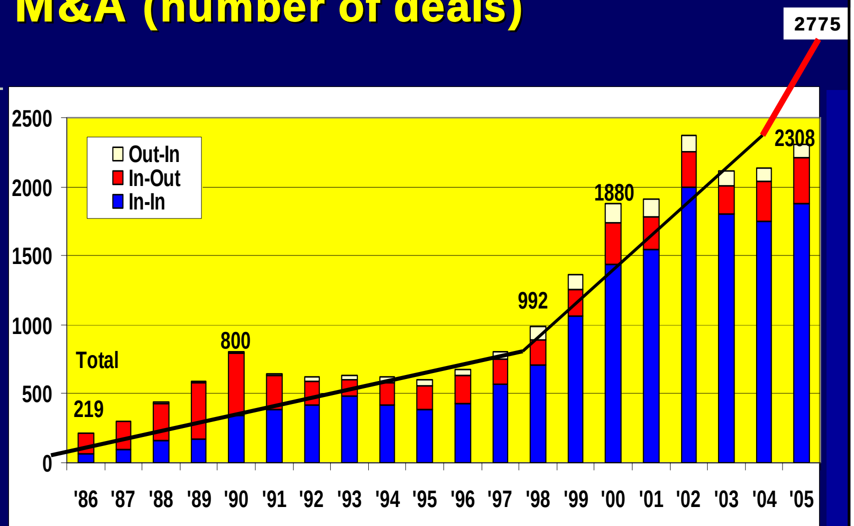


Source: TSE, 平成19年度株式分布状況調査の調査結果について

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)

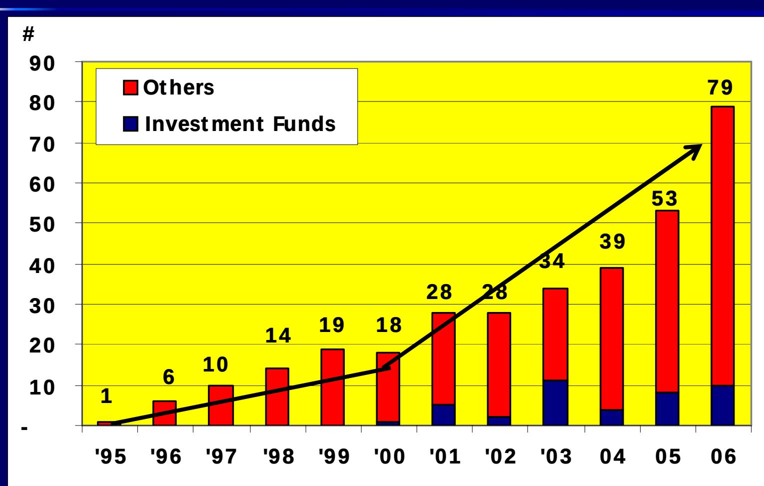
M&A (number of deals)



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

 17

Successful Hostile Takeovers



Source: Recof data, quoted by ESRI 18

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.