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Whither corporate reform? Mixed Messages

Mixed messages about the economy's short-term prospects have emerged from indicators issued over the past few weeks, leading to a consensus view that GDP will probably show 2.6% annualized growth for January-March, but slower growth during the rest of this year (see pg. 10).

More important to us, however, are the mixed messages Japan is giving out on the pace of corporate reform. For it is the latter that will determine the living standard of the Japanese people, as well as Japan's standing in the world, over the next couple decades.

Between 2005 and 2025, Japan's working age population will shrink by 13 million people, or 16%. Hence, the only source of GDP growth will be increased output per worker. Meanwhile, the total population will shrink "only" 7%, i.e., 9% less. Each worker has to produce 9% more output just to prevent a fall in GDP per person. For per capita GDP to grow more than trivially, each worker must produce, say, 20-30% more GDP in 20 years.

To make matters even more difficult, during the same period, the number of aged will increase by 10.5 million, or 41%. Since older people cost more to maintain—due to health care costs, assisted living, and so forth—even if per capita GDP remains the same, real living standards will fall.

The missing ingredient

What, then, are the odds of Japan enjoying a productivity revolution? Perhaps the best way to begin is to look at some of the key elements contributing to America's post-1995 revival.

One ingredient in the US was low interest rates. Japan certainly has that. In the US, those low interest rates made it possible for firms to afford a lot of new investment. Japan certainly has a lot of investment. In the US, much of that investment served as the conveyor belt for the introduction of Information Technology (IT) and other innovations. Japan has certainly invested a lot in IT.

Despite all this, Japan has not gotten the same bang for the buck for its efforts. Aside from a statistical uptick common to cyclical recoveries, trend productivity growth in the last couple years is no better than during the "lost decade," about 1.5% per worker-hour.

So, what was present in the US that is still missing in Japan? At least one key missing ingredient is "corporate reengineering," a big shakeup in the corporate world. Corporations learned, not only to do things more cheaply, but to do different things in different ways. One of the hallmarks was that big diversified conglomerates like General Electric undertook a surge of divestment, focusing only on those few activities that they did well. Meanwhile, in a host of sectors, new

firms with new ideas replaced older, more ossified companies.

Consequently, the majority of America's great leap forward came, not from the misnomered "new economy" sectors, but from traditional sectors like banking, retail and rust-belt manufacturing that, under the pressure of stiff competition, adopted new technologies, new ways of operating, and experienced the entrance of new players.

How about Japan?

So, if institutional revolution is the herald of productivity revolution, can the herald's trumpet be heard in Japan? Yes and no.

Much of what has been called "corporate restructuring" over the past several years is not so much restructuring as cost-cutting and balance sheet restoring. Firms have cut "the three excesses" of excess debt, excess capacity and excess labor. Their balance sheets are healthier and profits are up. They have

learned to do things more cheaply, but not necessarily differently. Nor is it much easier for new firms to enter an industry and challenge longstanding leaders.

Undeniably, there are tons of changes in corporate Japan. There are events taking place everyday today that were very rare five years ago and virtually inconceivable ten years ago. But what they add up to is less clear. The action is rapid compared to the past, but is it rapid and big enough to meet the need created by the demographic crunch? The critical question is the pace and magnitude of these myriad changes. That is harder to assess.

Fewer is better

One of corporate Japan's biggest problems has been mindless diversification. Firms often produced scores, hundreds, or even thousands of products without really knowing which ones made money and which did not. And, until recently, not necessarily caring.

Sometimes the products were in barely related sectors, e.g. everything from toasters to transistors to turbines. Sometimes, the various divisions had no connection whatsoever. One electrical machinery firm that made blood pressure monitors and automotive testing equipment also ran a catering service and an insurance subsidiary. On the other side of the pole is Canon, a very profitable firm that focuses on having superb technical prowess in just a few products based on optical technology: cameras, photocopiers, and printers.

Firms are said to be shedding non-core operations. And, in some cases, this is true. The firm cited above has shed its catering service as well as various segments of electrical machinery that don't meet



certain criteria. The firm—which asked not to be named—has dictated that each of its business divisions meet a Return-on-Equity (ROE) hurdle rate of at least 6.5%. Units that fail to meet this hurdle and cannot improve will be sold. In the last few years, the firm has sold off product lines and divisions that employed a combined 15% of its entire work force. Some of the excess workers were given incentive packages to retire early. Others were transferred to another division.

For example, the firm spun off a money-losing division to a joint venture it formed with another industry leader. The JV now has a 50% market share and good profits. Great for the JV, but is it good for Japan? Or, is it simply an oligopolistic firm with pricing power making money at the expense of its suppliers, customers and workers?

In another instance, this firm allowed the managers of a lackluster division to do a management buy-out (MBO). The managers, happy to be running their own show their own way, are now making money in a case that seems to represent genuine efficiency improvements.

This case also represents an important lesson. All over Japan, there are good businesses trapped in the wrong companies. If only the business were owned by a different firm and managed differently, it could do quite well. A semiconductor division that was losing money when owned by Nippon Steel did quite well after being bought out by a Taiwanese semiconductor firm.

What is driving this firm to strip down? The executive in charge of corporate planning told us that the driving force was globalization. 40% of the firm's shares are owned by foreigners and only 25% by stable shareholders. In the future, the firm could be vulnerable to a takeover. Beyond that, due to aging, domestic sales growth will not be as robust as in the past. A decade ago, the firm sold only a third of its products overseas. Now, the overseas ratio is above 40% and will top 50% within a few years.

We're convinced that, in the case of this firm, the changes are real (*honno*) and not just Public Relations (*tatema*). But we asked the planning chief about other big firms. He said: "It's probably 2/3 *tatema* and only 1/3 *honno*." He suspected that the firms "walking the walk" are mostly those exposed to international competition or with a lot of foreign shareholders or with younger managers.

We met with an even bigger firm that produces thousands of products. They, too, told us about shedding divisions that can't meet an ROE hurdle (about 8.5%). They, too, said the executive, have reduced the number of business divisions and product lines. But when we asked how many products they made five years ago and today, they said they didn't have the data at hand. Maybe this firm, too, is moving in the right direction. But we wonder about the pace and magnitude.

In both cases, firms spoke of the need to meet an ROE hurdle rather than, say, a hurdle involving Return-on-Assets (ROA) or Return-on-Invested Capital (ROIC). While shareholders are powerfully focused on the former, the latter figures are probably more important to the economy's long-term growth. Note that these ROE hurdle rates are

far below the average ROE of 16% in Europe and 20% in the US.

Prosecuting corporate fraud

Another "driver" for change is reforms in accounting rules and the enforcement of those rules. As long as firms can hide money-losing operations in far-flung subsidiaries, they can cover up their losses. The onset of consolidated accounting, and the recent more rigorous enforcement of those rules, has made it harder for firms to hide their dirty laundry.

But as we discussed last issue (April *TOE*, pg. 9), there is a serious question whether Japan has applied enough resources to really concentrate minds in corporate boardrooms.

Buyout funds

It was a spectacular deal that made the front pages. All Nippon Airways (ANA) decided that, although both airlines and hotels serve travelers, an airline company was not necessarily the best manager of a hotel chain. So, ANA sold its 13 hotels to Morgan Stanley for the unexpectedly huge sum of ¥280 billion (\$2.35 billion). One losing bidder said it believed Morgan Stanley overpaid. Reportedly, ANA itself had placed the value of the properties at only ¥100 billion, about a third of what it reaped.

Whether or not this proves to be lucrative for Morgan Stanley, it certainly seems like a good deal for ANA. Although ANA is profitable, unlike its floundering rival Japan Airlines (JAL), it still felt it could do better by shedding the hotels. In the fiscal year ending in March, the ANA group made ¥32.6 billion (\$274 million) in net profits. However,

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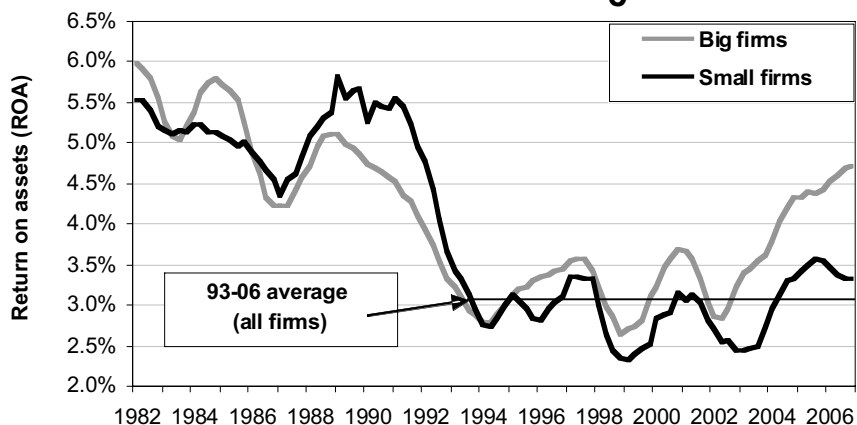
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ROA rebound limited to big firms



Source: MOF

Note: Big firms are 5,700 firms that all together employ only 10% of the workforce

the hotel division suffered an operating loss in fiscal 2005, profits of ¥4.6 billion (\$38 million) in fiscal 2005, and somewhat better profits in the first half of fiscal 2006.

So, while the hotel chain was not hemorrhaging cash, it seemed a fetter on ANA's struggle to overtake JAL, and to take advantage of new opportunities now that Haneda will become an international airport in 2009 and a new international airport will open in Chiba prefecture the same year.

In sum, this was not a fire sale by a company in distress. It was a strategic chess move by a healthy company sacrificing an important piece in order to focus its resources. That's exactly what Japan needs. Five years ago, the deal would have been nearly inconceivable. Today, such deals are flourishing.

An increasingly popular type of deal is the management buyout (MBO), a phenomenon that barely existed just a couple years ago. There were 80 such deals in 2006 with a value totaling ¥687 billion (\$5.7 billion). This year, a subsidiary of Nomura Securities is leading an MBO involving Tsubaki Nakashima, a leading producer of ball bearings. Its value of ¥106 billion equals almost one-seventh of all 80 deals put together in 2006.

In 2007, according to a *Nikkei* survey, buyout funds and other investors are raising about ¥4 trillion (\$34 billion) in capital to buy Japanese firms or their divisions. That's up 240% from 2005. If, as often happens, the buyout funds borrow an amount equal to 3-5 times their capital, they'd have a kitty of perhaps as much as ¥20 trillion (\$168 billion). That's a third more than the ¥15 trillion in Merger and Acquisition (M&A) deals carried out by Japanese firms in 2006.

Funds are driven by different motives than companies who take over a rival or a firm in a related industry. The fund wants a high return on its investment.

In some cases, this leads to true efficiency improvements. Take the case of a foreign real estate fund that took over a set of office buildings. Because the owner was an over-diversified firm whose primary business was not real estate, the offices were run down with a high vacancy rate. With some additional money and new management, the vacancy rate dropped, rents increased, the fund reaped huge profits and Japan's economy gained a bit of improvement in its inefficient capital stock.

But there are a couple flies in the ointment. While some deals produce genuine improvements, others make money mostly

via financial machinations. Studies of the leveraged buyout (LBO) surge in the US in the 1980s showed that the initial wave of LBOs really improved operations. However, many subsequent deals using junk bonds were done just for the sake of the deal itself. Investment bankers reaped rewards; firms were left with unsupportable debt loads.

There is a second concern: is this yet another case of too much money chasing too few deals? How many companies are like ANA and willing to sell non-core operating divisions? That remains to be seen.

"I don't care about my share price"

Another new kid on the block is the activist fund. While the regular buyout funds cooperate with incumbent management, the activist funds seek to take over the firm, and/or replace management, or else pressure incumbent managers to operate in the interests of shareholders by generating better profits.

But the activist funds, who tend to be seen as "vultures," often meet the kind of resistance that typifies Japan's maladies. One

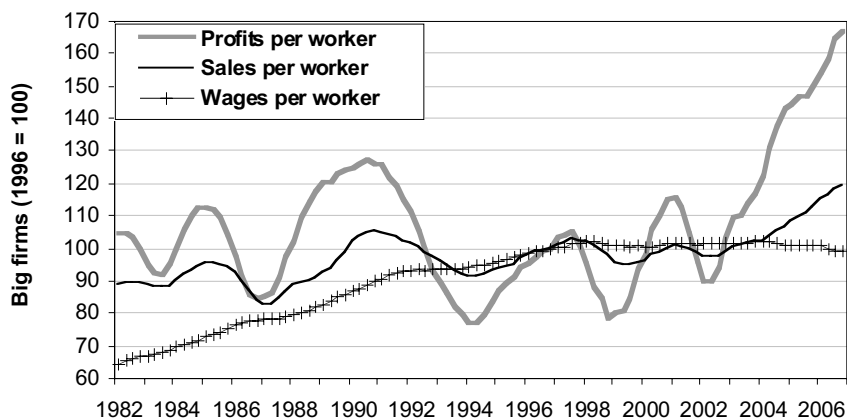
fund manager told us of an attempt to buy into one of the smaller of the 1,600 top companies listed on the First Section of the Tokyo Stock Exchange (TSE). This firm had a low stock price and had hordes of cash salted away "for a rainy day." The fund told the CEO that such a horde of excess cash meant money lying fallow. If the firm returned the cash to shareholders via dividends and stock buybacks, and if it improved its operations, the fund manager predicted that the firm's stock price would likely double.

"Why do I care if my stock price doubles?" retorted the CEO. The firm is not planning on issuing any stock. It does not need to borrow more money any time soon. And, if it gets into trouble in the future, the cash will enable to keep its workers and keep the banks at bay. Despite mantras about shareholder value and corporate attention to ROE, this story is all too typical.

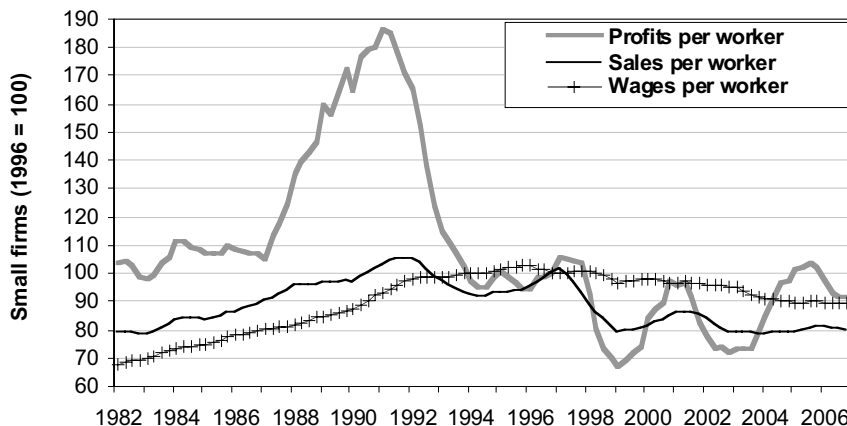
Torpedoing "triangular mergers" for FDI

In virtually every country enjoying successful reform, increased trade and/or foreign

Sales per worker up at big firms . . .



. . . But not at small



Source: MOF

direct investment (FDI) was part of the recipe. The Chinese miracle has been built on FDI. It contributed mightily to Korea's recovery for the Asian crisis of the late 1990s.

In Japan, FDI still lags. The total value of all existing FDI hit 2.4% in 2005. That's double the level of 2000, but far below the 13% level in the US or Germany's 25%. Prime Minister Shinzo Abe says he wants to double or triple the 2.4% ratio in another five years. Not only would that pace still leave Japan far behind comparable countries, but his administration has already put the fetters on one measure that would help boost FDI: cross-border stock for stock swaps for M&A.

In most rich countries, FDI does not consist of building new "greenfield" facilities, like the Japanese auto transplants in the US. Rather, it entails acquisition like Renault's takeover of Nissan. In fact, in 2006, 95% of all FDI into Japan involved acquisition.

Across the developed world, one of the most popular means of acquisition is stock-for-stock swaps. Instead of paying cash, the acquiring firm pays with its own stock.

Until now, Japan has penalized cross-border stock for stock swaps by imposing a capital gains tax at the moment of acquisition rather than when the shareholder eventually sells his shares. A revision of the corporate law proposed to end this tax penalty but only if firms used a very cumbersome procedure called "triangular mergers." In the latter process, the foreign firm sets up a Japanese subsidiary and it is the latter that merges with the Japanese firm.

Unfortunately, the powerful Keidanren business federation strongly opposed stock for stock swaps, ostensibly on the grounds that they would open the door for a plethora of hostile foreign takeovers. In fact, the rules require a friendly takeover in that both the target's board of directors and two-thirds of the shareholders (by value of shares) must approve the deal.

In its efforts to stymie the deal, Keidanren proposed a number of tacks in the road. Instead of approval by investors owning two-thirds of the shares, Keidanren proposed approval by two-thirds of the individual shareholders. So, if 100 shareholders owned 70% of the shares and 24,000 others owned 1 share each, Keidanren's proposal would require getting more than 16,000 shareholders to approve the deal.

In addition, to gain tax deferral, the for-

eign buyer would have to show a true business synergy, not between itself and the Japanese target, but between its Japanese subsidiary and the Japanese firm. In most cases, it is the global synergies that make the deal worthwhile.

Not all business leaders agreed with Keidanren. In 2005, Keizai Doyukai, a group of progressive-minded CEOs, proposed a long-term goal of raising FDI to 10% of GDP and argued, via a vis triangular mergers, "We call for extreme caution with regard to any measures tightening the taxation of capital gains by overseas investors." But Keidanren spoke for most business leaders on this issue.

Abe's chief of staff Yasuhisa Shiozaki struggled mightily against Keidanren's lobbying, as did a number of internationalists within the Ministry of Economy, Trade and Industry (METI). But at the end of the day, the "domestics" within METI and the Finance Ministry (MOF) sided with Keidanren. While the MOF voided Keidanren's version of the two-thirds rule, it did validate the tax rule requiring synergy between the Japanese target and the foreign firm's Japanese subsidiary.

The end result, say foreign firms already operating in Japan, is that few stock-for-stock swap deals will be concluded in the coming years. FDI will continue to grow, but only in an incremental fashion.

Who do you anti-trust?

There is no competitiveness without competition. Unfortunately, on this front, Japan is, in the politically correct word for retreat, "advancing to the rear."

Up until now, Japan's Fair Trade Commission (JFTC) would approve mergers virtually automatically as long as the combined firm's market share did not exceed 35%. METI recently succeeded in getting the adoption of new rules that, in effect, mean mergers will be almost automatically approved even if the new firm has a market share as high as 50%.

METI claims that Japan's firms need economies of scale to compete in a global market. The JFTC, it contends, should consider not a firm's share of the Japanese market, but its share of the global market. The argument is false. Japan's strongest exporting industries are not those with highest market shares by the leaders, but those with fierce competition within Japan. Equally important, how many sectors are really part of the glob-

al market? Few sectors import a high share of their consumption, making the global market irrelevant to judging the threat of monopolistic power.

Hostile takeovers

Hostile takeovers in the US are legal, rare and safe. They should be so in Japan as well. It doesn't take many of them to give night sweats to CEOs who run their companies into the ground.

Hostile takeovers are legal in Japan. Yet, not a single one has yet succeeded, mainly because stable shareholders refuse to sell at almost any price. Most efforts have been launched either by foreigners, like Steel Partners, or by Japanese outsiders, like the Murakami Fund.

Eventually, however, a hostile takeover will succeed and then the dam could burst. Opinions began to change last year when establishment firm Oji Paper tried to take over a competitor. Even though Oji failed, it created a sense of legitimacy. This year, people are watching very closely the efforts of Hoya, an internationally renowned maker of optical glass, to take over floundering camera-maker Pentax. This episode began as a friendly effort until Pentax' directors ousted their CEO to stop the merger. Now, Pentax' biggest shareholder, a Japanese investment fund called Sparx, says that, at the June shareholders meeting, it will call on directors who oppose the merger to resign.

Another closely watched case is the effort of TPG, American buyout fund, to buy JVC from Matsushita. Originally, Matsushita intended for the JVC managers to buy the unit in an MBO. Then, TPG came up with a higher bid. If TPG succeeds, it will be the first time an outsider bested incumbent managers in a buyout. In fact, previously, management almost never faced any contest in MBO efforts.

Even if TPG does not win, shareholders will certainly benefit just from the contest since managers have typically offered very low prices in MBOs.

Pace and magnitude

There are changes galore in Japan. Some good; some are not so good. As for the good changes, the real issue is whether the pace and magnitude is sufficient to launch the productivity revolution that Japan so desperately needs. One day, this will be the case. As for whether that day is already here, or even near, the jury is still out. (RK)