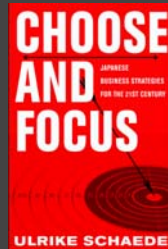


CHOOSE AND FOCUS: The Transformation of Japanese Business Strategies

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Excerpts from Japan's Recent Shopping List

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- Nihon Seishi bought Australian Paper (\$360 million)
- Asahi Beer bought Schweppes Australia and 20% of Tsingtao
- Kirin bought stakes in San Miguel and Lion Nathan, and is pursuing Dairy Farmers (Australia) (\$960 million)
- Mitsubishi Rayon to acquire Lucite International (U.K.) for \$1.6 billion
- Fujifilm Corp acquired North-Carolina-based Empiric Systems LLC (radiology)
- Daiichi-Sankyo bought 52% of Ranbaxy (\$4.6 billion)
- Takeda acquired Millenium (\$8.8 billion)
- Eisai bought MGI Pharma
- Nissin Foods ("Cup Noodle") to invest \$250 million in Russia
- Tokio Marine bought Kiln (U.K.) (\$881 million)

⇒ **Not trophies, but strategic investments**

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Japan's Outlook

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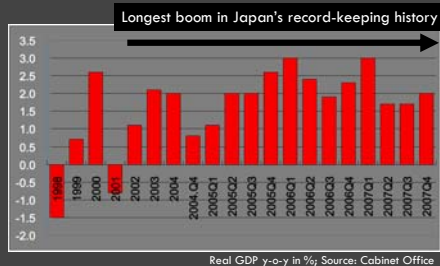
- FY2009 GDP forecast: -2.6%; FY 2010: +2.1%
- Outlook poor, but not nearly as bad as in the U.S. and Europe
- Re-emergence of competition from Japan
 - Global crisis hit large firms in position of strength
 - Crisis as opportunity: innovative, driven, nimble, focused
 - Leading in industries that will be critical in the future (chemicals, components, green technologies)

⇒ **What happened in Japan?**

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GDP Growth, 1998-2007

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In FY 2007, Japanese listed firms posted record combined pretax profits for the 6th year in a row.

Leaders behind this growth include companies such as JSR, Nitto Denko, Ibiden, Teijin, Softbank, and Astellas.

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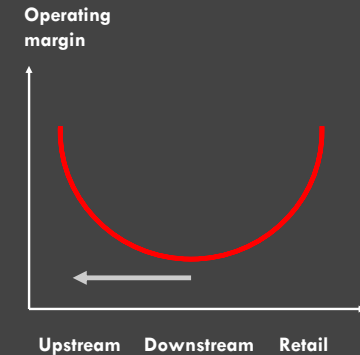
Strategic repositioning towards upstream products

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The "Smiley Curve" of Profits

Japanese companies cannot and should not compete in downstream products.

"Choose and Focus" strategies have accelerated this transition.



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New Leadership: Green Technologies

- Industrial machinery
 - Boilers, steam turbines, control rooms
 - Hardware of the smart grid
- Alternative energy solutions
 - Solar power storage
 - Batteries
- Chemicals
 - Membranes, filters, plastics
- Automobiles
- New combinations

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The Challenge is ...

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- We have not looked at Japan since the late 1980s/early 1990s.
- Business interest has shifted to China.
- The new Japanese strength is in intermediate products and components, not in end products.
- There is limited awareness of the New Japan and its strategic repositioning.

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What We “Know” about Japanese Business

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- **Business groups (*keiretsu*)**
 - Horizontal (inter-market); vertical (subcontractors)
- **Main bank system**
 - Preferred loans; informal bailouts, few bankruptcies
- **Internal processes of corporate governance**
 - Cross-shareholdings
- **Subcontracting hierarchies (*shitauke*)**
- **Lifetime employment**
 - Seniority wages and promotion
- **Restricted distribution system**
- **Industrial policy**
 - Administrative guidance/extensive intervention
- **Difficult entry for (foreign) competitors**

The strategic logic underlying these has changed.

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The Argument in Brief: 1998-2006 = Strategic Inflection Point

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- Banking crisis; recession of the 1990s
 - 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

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Strategic Inflection Point

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- “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)
- An irreversible change in the competitive environment so that the balance of forces shifts away from previous ways of doing business to new ones.
- Examples in business history: the arrival of telephony, mechanical refrigeration (shipping), the semiconductor, the internet,
- In Japan, the entire political economy shifted, thereby completely changing incentives and constraints for corporate managers.

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Japan’s Strategic Inflection Point 1998-2006

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- **Banking crisis**
 - New ways to write off bad loans
 - New business model for banks
- **Recession: Need to restructure and reorganize**
 - New laws on bankruptcies, corporate reorganization, stocks, mergers, acquisitions, hostile takeovers, etc.
 - New labor rules to increase flexibility
 - New shareholder rights
- **New rules on corporate governance**
 - Internal oversight committees: directors are liable
 - Stricter prosecution of corporate wrongdoings
- **Undoing of cross-shareholdings, influx of foreign investors**
- **Shift to formal regulation**

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1998-2006 Legal Reforms

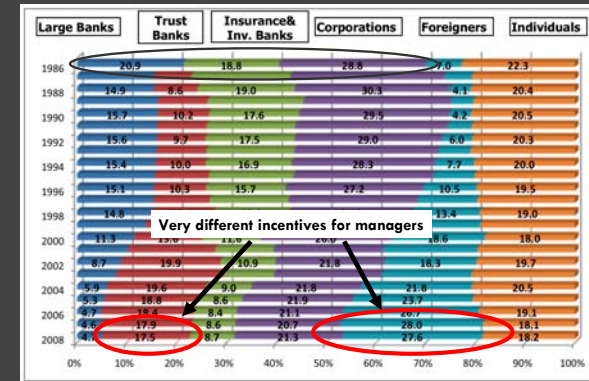
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- **Financial Reforms: Disclosure and Transparency**
 - “Big Bang”, 1998
 - Consolidated, mark-to-market accounting, 2000
 - New disclosure requirements (e.g., quarterly earnings reports)
- **Bankruptcy Legislation: Entry and Exit**
 - “Chapter 11” reorganization and liquidation
- **Commercial Code (annual revisions): Restructuring**
 - Different types of stock (e.g., Treasury Stock); transfer of ownership
- **Corporation Law, May 2006**
 - Clear rights for managers and shareholders
 - New possibilities for corporate strategies
- **Financial Instrument and Exchange Law, October 2007**
 - J-Sox: internal control system
 - Financial regulation by product, not by company
- **New Labor Laws: Dismissals, Temp Workers, Labor Contracts**

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TSE Shareholder Structure

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Source: TSE, 平成19年度株式会社分布状況調査の調査結果について

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How to Increase ROI? - Refocusing: From unwieldy goliaths to nimble competitors

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- **“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”**

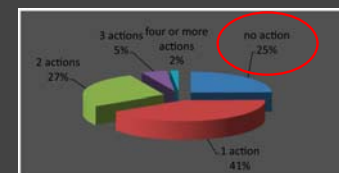
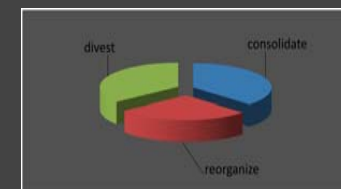
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Japan's Restructuring Wave: “Choose and Focus” by Nikkei 500 Firms, '00-'06

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Criteria:

- 1) **Exit:** sale/closure of business unit
- 2) **Reorganization:** company system, holding company
- 3) **Consolidation:** acquisition of a competitor



Findings:

- 1) 75% of Japan's largest firms have reorganized.
- 2) 41% have restructured in more than one way.
- 3) 25% have done nothing.

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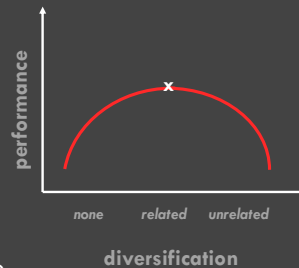
* Without financial institutions, n=472

Diversification vs. Unbundling

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- Old Japan: Size and market share
- 1980s Strategy Advice: Diversification
 - Reduces risk of failure
 - Increases profits if “related”
 - Decreases profits if “unrelated”
- Optimal point differs by company.
- 40 years of conglomeration
- ⇒ Decline in performance over time

- Bubble period excesses (exuberant diversification)
- 1990s recession: need to restructure
 - Laws that facilitate spinoffs, etc.



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Is that a lot or a little?

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- U.S. wave of refocusing 1980
 - Conglomeration in the 1960s (mostly unrelated)
 - Refocusing in the 1980s
 - Reagan Administration: change in antitrust enforcement
 - New insights into finance
 - Companies should be specialized and comparable
 - Investors should engage in their own portfolio diversification
 - Emergence of buyout funds
- At least 20%, but as many as 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.

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Strategic Inflection: Implications for Corporate Strategy

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- **Need to attract outside investors**
 - Profitability is key: price of financing
 - Need to disclose
 - Shed unprofitable business units, holdings (real estate, stock)
 - Reduce costs (production, purchasing)
- **Change in corporate governance**
 - Less loyalty, more voice and exit
 - Threat of hostile takeover if suboptimal performance
- **Compete through “Choose and Focus”**
 - Identify core business areas → Reorganization
- **New System of Innovation**
 - From in-house to the market

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What does this mean for Japan?

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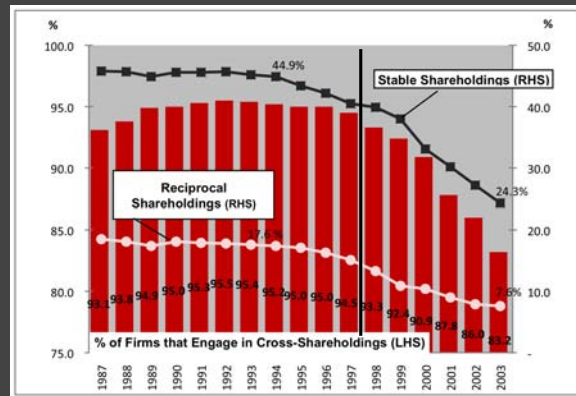
Change is underway toward ...

- **New technological leadership**
 - No longer end products, but components and materials
 - Laggards' influence is waning
- **New firms**
 - Mergers between spun-off SBUs: unencumbered by business groups; focused, driven
 - New entries
- **Newly empowered actors**
 - Consumers
 - Employees (professionals, women)
 - Entrepreneurs
- **New markets**
 - Focus ⇒ outsourcing ⇒ startups, new (foreign) entry

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The Decline in Stable Shareholdings

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Source: Nihon Life Institute

Who bought these shares?

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- 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

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Why all these *gaijin*?

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- **Access**
 - 1998 Foreign Exchange Law
- **Information**
 - legal change with strategic inflection point: transparency, disclosure, access
- **Comparative pricing in the 1990s**
 - exchange rate, growth prospects
- **Opportunity**
 - banking crisis
 - switch from informal workouts to direct loan disposals
 - increased activity with bankruptcy laws 2000
 - shift to “choose and focus”: lots of good stuff to buy

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Strategic Drivers in the New Japan

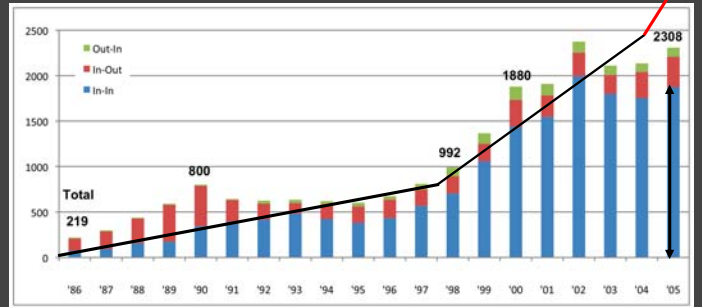
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- **Compete for investors through higher ROI**
 - credit ratings, ROE
 - threat of hostile takeovers
- **Compete through high margins**
 - no longer an advantage in mass production of standard goods
 - no longer “also-runs” in many industries
- **Compete through technological leadership**
 - focused R&D on clearly defined areas of excellence
- **Compete through efficiency and “getting things done”**
 - new work content, performance pay, a market for talent
- **Compete through lower costs**
 - global sourcing / weeding out Old Japan suppliers
 - no longer insurance through relational pricing

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A Market for Assets: M&A (number of deals)

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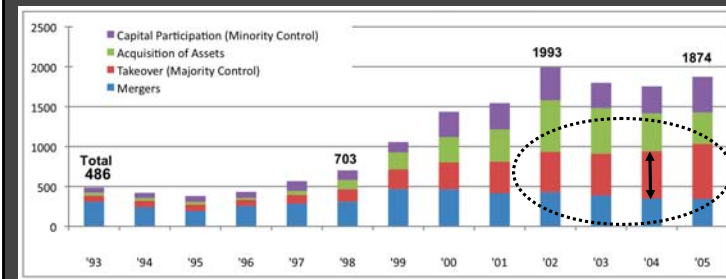


2006: Total of 2775 M&As (of which 416 in-out, 194 out-in)

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Domestic M&A (by scheme)

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3 Types of Mergers

- Among equals
 - JFE Holdings (NKK, Kawasaki Steel), Daiichi Sankyo, Astellas (2005), Dainippon Sumitomo (2006), Mitsubishi Tanabe (2007), Isetan Mitsukoshi (2008), Kirin and Suntory (proposed)
- Among not quite “equals”
 - Panasonic – Sanyo (2009)
 - Hoya – Pentax (2008)
- Partial Mergers (“baby mergers”)
 - Elpida Memory = Hitachi + NEC (now public)
 - Renesas Technology = Hitachi + Mitsubishi Electric
 - SUMCO = Mitsubishi Materials + Sumitomo Materials
 - IPS Alpha Technology = Hitachi + Toshiba + Panasonic
 - Almost all companies in the PVC industry

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Partial Mergers, 1994-2004

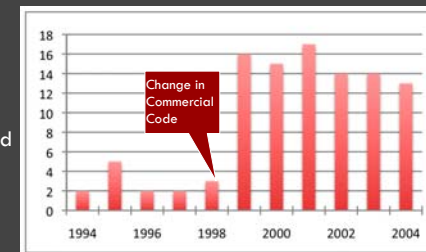
Mother companies:

- more focused due to spin-out

New companies:

- by definition highly focused
- not bound by *keiretsu* constraints

Great change in industry hierarchies



Source: Ushijima (2008), based on search in 4 Nikkei newspapers

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Summary (1)

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- Old Japan's political economy set strong incentives for CEOs to pursue market share, and therefore stability \Rightarrow 40 years of diversification
 - Since 1998, Japan's business organization has moved towards the market \Rightarrow Refocusing
 - 1998-2006 strategic inflection point
 - New competitive repositioning: profits through focus
 - New technological leadership: materials and components
- \Rightarrow This has positioned Japan's leading firms well to use the 2009 crisis as an opportunity.

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Recent Industrial Data and Surveys

Confidence Survey



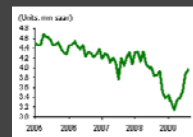
Exports



Industrial Output



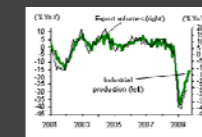
Japan car sales in the U.S.



Labor demand



Exports and Industrial Production



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Source: Macquarie Securities

Summary (2)

What does this Mean for Global Competition?

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- Japan's new, leading firms are re-entering world markets as lean, focused, driven competitors
 - Not your old household names
 - New leadership is in materials and components
- New competitive dynamics within Asia
 - Asia is more than mass-production
 - Asia is more than China
 - Samsung: "China is catching up, while Japan continues to lead. We are sandwiched between them."
 - Japan's new technological drive is pulling and pushing Asia to new levels (e.g., LCDs in Taiwan).
- Relying on what we used to "know" about Japan is a recipe for failure.

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