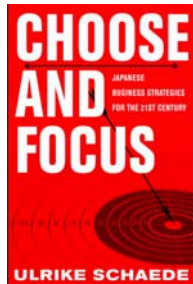


## “Choose and Focus” 選択と集中: The Transformation of Japan’s Industrial Architecture



Ulrike Schaede  
Graduate School of International Relations  
and Pacific Studies  
University of California, San Diego

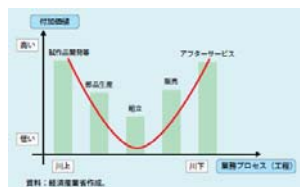
RIETI, Tokyo  
August 5, 2008

## 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 6<sup>th</sup> 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 6<sup>th</sup> 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.

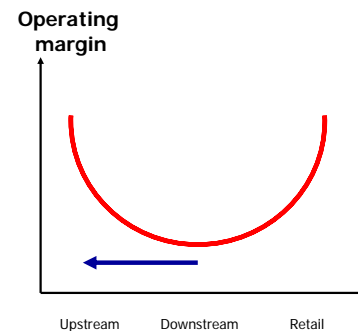
© Ulrike Schaede, *Choose and Focus*, Cornell University Press 2008

## The “Smiley” Curve



Japanese companies cannot and should not compete in downstream products.

Choose and Focus strategies have propelled this transition.



© Ulrike Schaede, *Choose and Focus*, Cornell University Press 2008

## Strategic Inflection Point 戦略的な変曲点

- “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, ....

© Ulrike Schaede, *Choose and Focus*, Cornell University Press 2008

## 1998-2006: Japan's Strategic Inflection Point

- 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

© Ulrike Schaede, *Choose and Focus*, Cornell University Press 2008

## Strategic Inflection Point 1998-2006

- Banking Crisis
  - “Big Bang” reforms of 1998; new business model for banks.
  - Switch to direct disposals of bad loans (sell off assets).
- “Sunshine” rules, 2000
  - New accounting rules (consolidated balance sheets)
  - New disclosure requirements (e.g., quarterly earnings reports)
- New laws on bankruptcies, corporate reorganization, stocks, mergers, acquisitions, hostile takeovers, etc.
  - Annual revisions of 商法
  - 会社法 2006
- New rules on corporate governance: FIEL and J-SOX (2007)
  - Internal oversight committees: directors are liable
  - Financial regulation by product, not by actor
- Stricter prosecution of corporate wrongdoings
- Undoing of cross-shareholdings, influx of foreign investors

© Ulrike Schaede, *Choose and Focus*, Cornell University Press 2008

## New Demand for Law

- From “ex ante regulation” (Civil Law-type) ...
    - 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-type)
    - 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  
 ⇒ Supervisory agencies instead of informal regulation

*A market for rules and regulations.*

© Ulrike Schaede, *Choose and Focus*, Cornell University Press 2008

## What Foreigners “Know” about Postwar Japanese Business

- Business groups
- Main bank system
- Internal processes of corporate governance
- Subcontracting hierarchies
- Lifetime employment
- Restricted distribution system and relational pricing Industrial polic
- Difficult entry for (foreign) competitors

*The strategic logic underlying these has changed.*

© Ulrike Schaede, *Choose and Focus*, Cornell University Press 2008

## The Challenge is ...

- People in the U.S. have not looked at Japan since the late 1980s/early 1990s.
- Business interest has shifted to China.
- If you ask: "What do you know about Japan?", they repeat "wisdom" of the 20<sup>th</sup> century.
- Limited awareness of the New Japan.

© Ulrike Schaede, *Choose and Focus*, Cornell University Press 2008

## Strategic Drivers in the Postwar Period (1950s-1980s)

- 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
  - Exit difficult → **diversification**
  - Promotion of special talent under seniority pay

© Ulrike Schaede, *Choose and Focus*, Cornell University Press 2008

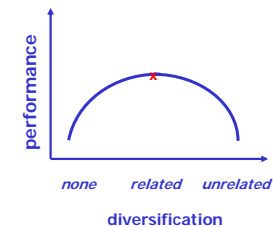
## High Leverage, High Risk

- Buy insurance through stable owners
    - cross-shareholdings
  - Buy insurance through preferential trades
    - intermarket groups
  - Buy insurance through a main bank
    - access to credit, rescue
  - Diversify into many markets
- ⇒ Steady process of conglomeration

© Ulrike Schaede, *Choose and Focus*, Cornell University Press 2008

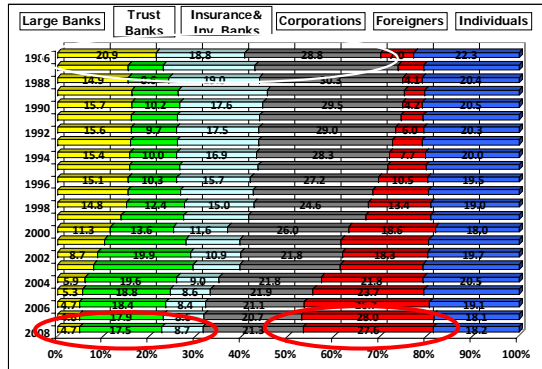
## Diversification vs. Unbundling

- Diversification
  - Reduces risk of corporate failure
  - Increases profits if "related"
  - Decreases profits if "unrelated"
- Optimal point differs by company.
- In Japan, coupled with sales priority.  
⇒ decline in performance over time
- Bubble period excesses (exuberant diversification)



© Ulrike Schaede, *Choose and Focus*, Cornell University Press 2008

## TSE Shareholder Structure



Source: TSE, 平成19年度株式会社分布状況調査の結果について

© Ulrike Schaefer, *Choose and Focus*, Cornell University Press 2008

## Strategic Drivers in the New Japan

- Compete for investors through higher ROI
  - cost of financing determined by credit rating, 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
  - new system of innovation
- Compete through efficiency and "getting things done"
  - new work content, performance pay, a market for talent
- Compete through lower costs
  - global sourcing
  - 空洞化 and weeding out Old Japan suppliers
  - no longer insurance through relational pricing

© Ulrike Schaefer, *Choose and Focus*, Cornell University Press 2008

## Refocusing: From unwieldy goliaths to nimble competitors

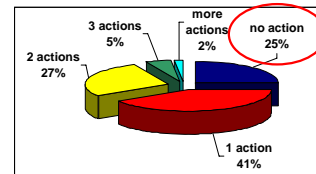
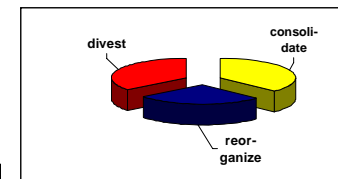
- "Choose and Focus" (選択と集中)
  - Exit: spin-offs, M&As, MBOs (focus on core business)
  - Reorganization: "company system", holding company structure (implement new goals through incentives, promotions, accountability)
  - Consolidation: purchase competitors (choose core businesses and dominate in those)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

© Ulrike Schaefer, *Choose and Focus*, Cornell University Press 2008

## Japan's Restructuring Wave: "Choose and Focus" of Nikkei 500 Firms, '00-'06

### Criteria:

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

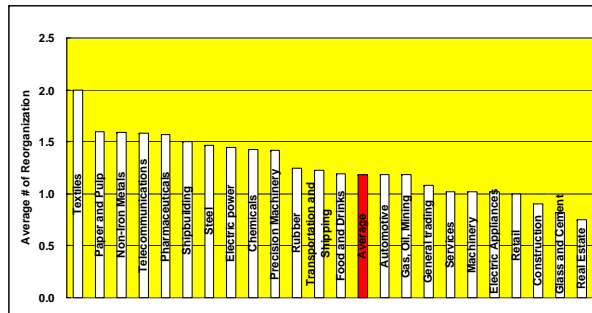


- ### Findings:
- 75% of Japan's largest firms have undergone reorganization.
  - 41% (194 firms) have restructured in more than one way.
  - 25% (177 firms) have done nothing.

© Ulrike Schaefer, *Choose and Focus*, Cornell University Press 2008

\* Without financial institutions, n=472

## Was this a sectoral phenomenon?



© Ulrike Schaefer, *Choose and Focus*, Cornell University Press 2008

## Is this 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.

© Ulrike Schaefer, *Choose and Focus*, Cornell University Press 2008

## Japan's Changing Industrial Architecture

- 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, new laws
- Lifetime employment:
  - Towards performance pay, wage by job category, individual career paths, labor mobility
  - 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.

© Ulrike Schaefer, *Choose and Focus*, Cornell University Press 2008

## Implications for Japan

1. New Market Dynamics
  - New industrial architecture
  - New business organization
2. New Human Resource Practices
  - Labor shortage
  - New complexity in HR management
3. New Leadership Style

© Ulrike Schaefer, *Choose and Focus*, Cornell University Press 2008