The Evolving Japanese Corporation: Transforming Manufacturing Companies into Financial Enterprises

Where Should the Japanese Manufacturing Industry Go from Here?

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The Japanese Manufacturing Industry: Forced to Reassess its Strategy

Japan is experiencing a rapidly declining birthrate and aging population. Social security expenditures are expanding at a rate of more than one trillion yen per year while the public debt, now surging to nearly 200% of GDP, has increased Japan's risk of financial collapse. The development of the global economy and the rise of China and India have made it an uphill battle for Japanese corporations. Notably, Korean corporations have recently risen to prominence in such Japanese fields of expertise as electronics and automobiles. With growth rates slowing, Japan is permeated by a sense of stagnation.

Under such conditions there are only two strategies that Japan should pursue today. One is fundamental reform of public finance and social security. The other is growth. The government is currently pouring its energies into addressing the former, including integrated reform of the tax and social security systems. The latter – a strategy for growth – is also critical. The role that government can play is to prepare an environment that promotes growth; needless to say, the success or failure of a growth strategy ultimately depends on corporations' own efforts and reforms.

Meanwhile, the iPhone and iPad from Apple, products to which the company's founder Steve Jobs devoted himself until he passed away last year, have been sweeping the world. The tides of the times turn quickly, however, and Android smartphones from Google have also been spreading rapidly.

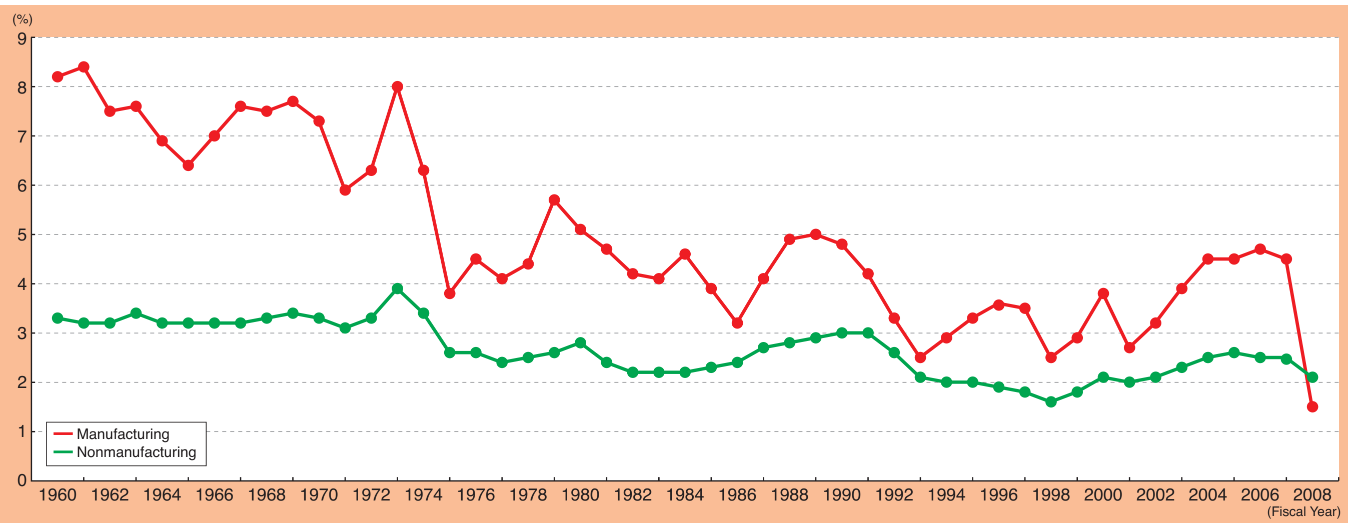
The spread of iPhones and other handheld devices has led to the assimilation into the Apple business model of products such as the Sony Walkman and CD players that were Japanese manufacturing industry strengths. Games and apps for devices like the iPhone are growing rapidly and may even come to compete with devices like the Nintendo DS and the Sony Playstation. Even digital cameras, the iTunes music marketplace, and digital books are being drawn in. Over the medium to long term, televisions and HDD recorders also seem likely to be incorporated into this business model, leading to the gradual disappearance from homes of many of the products that Japanese corporations have produced.

Manufacturing industry operating margins are on the decline *(Chart)* and it is clear that Japanese corporations, particularly in the manufacturing industry, must reassess their strategy. In other words, Japan today is at a crossroads where it must think seriously about how the companies that have supported manufacturing to date are going to generate profits going forward.

Meanwhile, a media firestorm ensued last year when it was revealed that Olympus had been covering up massive losses. This episode of "window-dressing" has been disastrous for the Japanese stock market but, seen in a different light, may contain hints for how the Japanese corporations that shoulder the burden of manufacturing can survive in the global economy.

CHART

Decline in Manufacturing Operating Margins



Source: Business and Investment Survey of Incorporated Enterprises

Seek to Strengthen Three Functional Capabilities

In this column I would like to discuss briefly the lessons that the Olympus incident offers for Japan's manufacturing industry in thinking about where to go from here.

The three key factors are 1) strengthening financial capabilities, 2) strengthening consulting capabilities, and 3) strengthening overseas marketing capabilities.

Let me begin with a summary of the Olympus incident. According to some reports, Olympus suffered massive losses due to money management (securities investment) failures in the early 1990s, which it then concealed from the public. By the time that current-value accounting was adopted in 2001 these losses had swelled to more than 100 billion yen, which the company window-dressed using overseas M&A activity as cover.

This sort of window-dressing is a betrayal of stockholder and investor trust, raises doubts overseas about the transparency of the Japanese market, and is unforgivable behavior for a publicly held corporation.

There is no doubt that the money management efforts that started the window-dressing were part of a context in which Japanese corporations sought to make productive use of the extra money they were accumulating during the economic bubble. Surely the greatest failure lies in the way such money was used during the bubble period – that it was directed to real estate and securities investments unrelated to increasing enterprise value.

Indeed, with emerging nations such as China and India rapidly catching up with the Japanese economy today, that time would have offered an excellent opportunity for the Japanese manufacturing industry to have strategically shifted away from its traditional manufacturing-centered business model and leap to a new, higher-level stage.

The important key in this regard is strengthening financial capabilities, in other words, to enhance the ability of the Japanese manufacturing industry to use Japan's enormous financial resources to invest in, or purchase through M&A, overseas corporations in the fields and domains that make up their core businesses. The idea is to turn the manufacturing industry companies themselves into something akin to private equity funds for manufacturing.

In doing so, the ability to increase the value of the overseas company that is the target of the acquisition or investment derives from the experience and expertise cultivated to date by the Japanese manufacturing industry. Many people say that the strength of Japanese manufacturing in a fiercely competitive global economy is its precision fitting and craftsmanship in areas such as process control and design and development, and these strengths are recognized overseas. Utilizing some of these comparative advantages to strengthen their consulting capabilities, therefore, is one way Japanese manufacturers could increase the value of the overseas companies that they acquire or invest in. (If necessary, the acquired companies could be sold at a high price.) To give a concrete example, a Japanese corporation could increase its enterprise value by consulting (e.g., dispatch of executives, plant managers, and foremen for manufacturing and production or selection of partner companies or raw materials suppliers) for a same-industry company that it has invested in from an emerging nation, one that lacks specialized knowledge and experience but has low labor and other costs.

Increase Enterprise Value by Promoting M&A Activity in Asian Markets

The most important thing in determining which overseas companies to acquire or invest in with the above funds is actually strengthening overseas marketing capability.

According to the Peter Drucker definition, "Marketing is not only much broader than selling, it is not a specialized activity at all. It encompasses the entire business. It is the whole business seen from the point of view of the final result, that is, from the customer's point of view. Concern and responsibility for marketing must therefore permeate all areas of the enterprise." Also, "Because the purpose of business is to create a customer, the business enterprise has two – and only two – basic functions: marketing and innovation. Marketing and innovation produce results; all the rest are costs. Marketing is the distinguishing, unique function of the business."

It is, therefore, critical in terms of marketing to understand the needs of the customers of the overseas companies being invested in. If this marketing effort is off the mark, there is no way to determine which overseas companies to acquire or invest in, or how Japanese manufacturing strengths might be appropriately applied through consulting.

In this sense, the Olympus window-dressing incident is extremely disappointing. Had the company engaged in overseas M&A for the reasons above, it could have increased its enterprise value.

In terms of Drucker-style innovation, the use of finance to create value should be appealing because Japan, which has already caught up with the United States, needs to plan its strategy recognizing that manufacturing is now a high-risk, high-return game. Adopting the form of a "fund" is a preferable way to create the next product like Apple's iPhone.

Investing in a company that is a good match and improving its management division's quality management capability establishes a position in a growing market with the possibility of increased market share and profitability. Finding and negotiating with such companies, however, is difficult for financial managers at manufacturing companies who have previously dealt primarily with banks regarding cash flow management or to procure funds for capital investment. Initially, there may be room to rely on general trading companies or US investment banks that have local offices and staff around the world as well as expertise in cross-border mergers and acquisitions.

But China, India and other emerging nations in Asia surely offer many opportunities for rapid growth in manufacturing. It goes without saying that Olympus needs to strengthen its corporate governance before it can embark on strengthening its functional capabilities as described above. Still, one hopes that the recent incident offers an opportunity for the Japanese manufacturing industry to move ahead to the next stage (for example, private equity funds for manufacturing). The Japanese government will be called upon to create an environment that facilitates the manufacturing industry's progress to this next stage. Now, when the Japanese economy is permeated by a sense of stagnation, is the time for government and the private sector to come together in an effort to stimulate the evolution of the Japanese corporation. JS

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