The Direction of Japanese Corporate Governance

The Key to Enhancing Corporate Value

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Economic Growth Requires Continuous Creation of Corporate Value

The ultimate objective of economic policy is to enhance the overall standard of living in Japan by raising the economic growth rate. Changes in capital and labor aside, it is improving productivity that drives economic growth. The productivity of a national economy is called total factor productivity (TFP) in macroeconomics.

The long-term stagnation of Japan's TFP is obvious. According to the JIP Database maintained by RIETI and others, Japan's TFP grew at an average annual rate of approximately 2% in the 1970s and 1980s, but it has remained around zero since the 1990s. The consensus among economists is that an annual TFP growth rate of 2% is achievable for developed economies with the right economic environment, given that the average annual rate for the United States and Europe has been around 2% *(Table 1)*.

Capital productivity expressed as return on equity (ROE) serves as a proxy variable for measuring TFP at the corporate level. It is often noted that the ROE of Japanese companies is low. As the international comparison of the average annual ROE over the past 10 years shows in *Chart 1*, Japan's ROE averaged slightly under 7%, below many other economies. Japan is particularly low compared to other developed countries such as the US (S&P 500) at approximately 15%, Canada and Switzerland each at 12%, France at just over 10% and Germany at just over 9%.

Moreover, the distribution of Japanese companies by ROE level (most recent 10-year average) shows that the number peaks around 4%, and approximately 71% of public listed companies have ROEs below 7%. If we assume that the cost of shareholders' equity as demanded by shareholders is 7%, this means that seven-tenths of publicly listed companies in Japan are unable to earn enough to cover the cost of shareholders' equity *(Chart 2)*.

It is clear that Japanese ROE has stagnated for a long time. However, there is not necessarily a general consensus that ROE and productivity are interchangeable. There is a persistent view that the low ROE is the outcome of the difference in the corporate cultures of Japan on the one hand and the US and Europe on the other. ROE is defined as the product of the "return-on-sales ratio (net current profit ÷ sales; also called profit margin ratio)", "total asset turnover (sales ÷ total assets)" and "financial leverage (total assets ÷ shareholders' equity)". This view is that Japanese companies have developed a strong aversion to borrowing since the financial crisis near the end of the 1990s, and that this has made ROE lower than it is in the US and Europe. In other words, Japanese companies do not have lower productivity than their US and European counterparts, and it is their financial strategy which avoids borrowing that is the cause of the low ROE. However, this is wrong. The low ROE of Japanese companies is a reflection of their low profitability, as we

TABLE 1

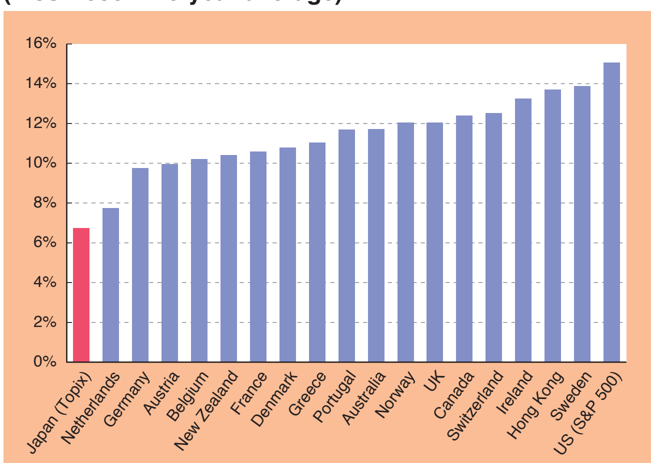
Japan's economic growth rate & productivity

	70-80	80-90	90-2000	00-11	05-10	10-11
GDP growth rate	4.6%	4.9%	0.7%	0.4%	-0.7%	0.1%
Contribution from labor input increase	1.1%	1.0%	-0.3%	-0.4%	-0.4%	-0.4%
Man-hours increase	0.2%	0.4%	-0.8%	-0.9%	-0.8%	-0.7%
Improvement of labor quality	1.0%	0.7%	0.5%	0.5%	0.4%	0.3%
Contribution from capital input increase	1.4%	1.9%	1.0%	0.3%	0.2%	-0.1%
Increase in capital volume	1.6%	1.5%	0.9%	0.1%	0.0%	-0.2%
Improvement of labor quality	-0.2%	0.4%	0.1%	0.2%	0.1%	0.1%
Contribution from TFP	**2.0%**	**2.0%**	**0.0%**	**0.5%**	**-0.5%**	**0.6%**

Source: JIP Database 2014, Research Institute of Economy, Trade and Industry

CHART 1

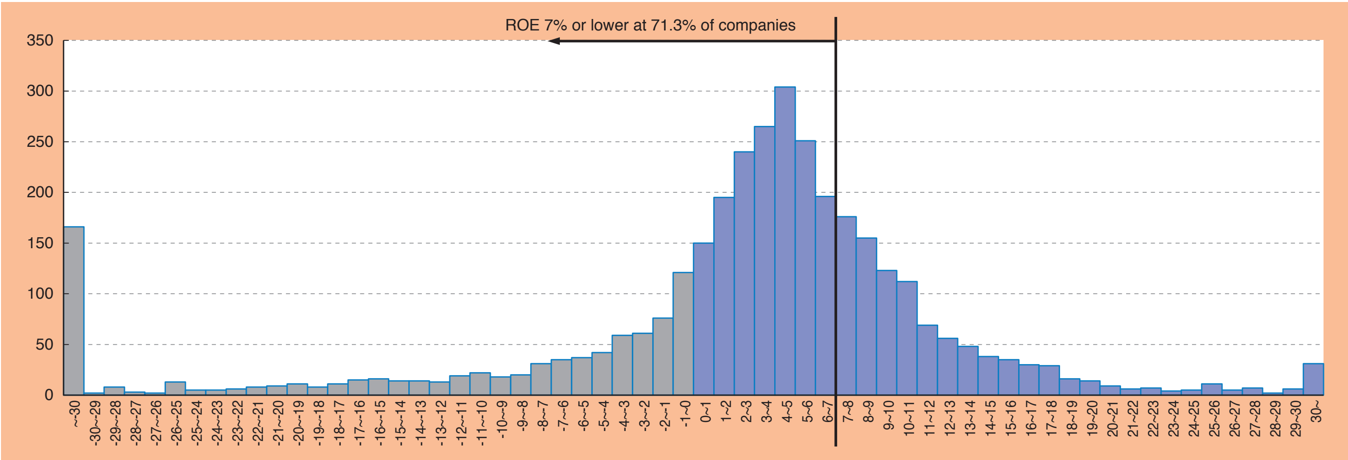
International comparison of ROE
(most recent 10-year average)



Source: Created from Bloomberg, etc. by Misaki Capital Inc.

CHART 2

Distribution of ROE in Japan



Source: Created from Bloomberg, etc. by Misaki Capital Inc.

TABLE 2

Breakdown of capital productivity of Japan, US & Europe into factors

		ROE	Margin	Turnover	Leverage
Japan	Manufacturing	6.8%	3.5%	0.91	1.91
	Non-manufacturing	6.7%	3.2%	0.86	2.28
	Total	6.8%	3.3%	0.92	2.02
US	Manufacturing	18.1%	8.4%	0.77	2.24
	Non-manufacturing	14.5%	8.0%	0.61	2.33
	Total	16.0%	8.3%	0.87	2.29
Europe	Manufacturing	15.3%	6.8%	0.79	2.44
	Non-manufacturing	15.6%	7.8%	0.66	2.74
	Total	15.4%	7.2%	0.86	2.58

Notes: 1) 2004-2013 calendar years. Finance and outliers excluded.
2) TOPIX 500 (Japan), S&P 500 (US), and STOXX Europe 600 (Europe)
Source: Created from Bloomberg, etc. by Misaki Capital Inc.

will see. *Table 2* gives a breakdown of ROE into its various factors in Japan, the US, and Europe.

The table shows that the main reason for the low ROE of Japanese companies lies in their "earning power (return on sales ratio)". Specifically, asset turnover ratio and leverage do not differ that much between Japan, the US, and Europe, while the Japanese return-on-sales ratio (profit margin) is slightly below half of the figures for the US and Europe. It is the extremely low return-on-sales ratio that is keeping ROE dramatically lower in Japan than it is in the US or Europe.

Enhancing capital productivity over the long term will be a critical challenge for the economic development strategy going forward. And enhancing capital productivity depends on "continuous value creation" at the individual corporate level.

The Japanese Stewardship Code, the Ito Report, the Corporate Governance Code, the revision of the Companies Act and the like that have been developed and made public over the last couple of years are all elements of a consolidated policy package aimed at this "continuous value creation".

The Key to Continuous Creation of Value

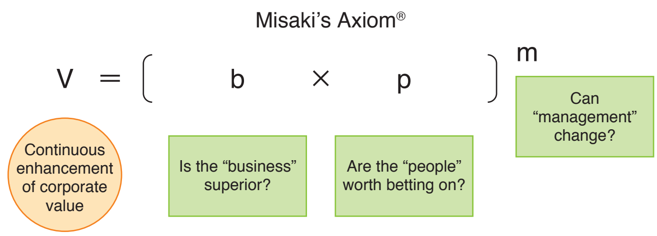
As we have seen so far, there is a strong concern in Japan about "continuous value creation" which is to be welcomed. I share this concern. There has been too little discussion in Japan till now about what "corporate value" actually means, what factors determine "corporate value" and which factors pose the greatest challenges to Japanese companies. My long years in management consulting and on the frontlines of corporate investment have led me to believe that "corporate value" is determined in the following manner *(Chart 3)*.

The importance of the strength of "b (business)" as a determinant of corporate value goes without saying. If "b" is not sufficiently competitive, it will be difficult to continuously enhance corporate value in the face of bruising intercorporate competition. At Misaki Capital, the investment management company that I manage, we set a higher bar for the strength of "b" using the concept "barrier against competition". Only an outstanding company that poses a "barrier" to all competition is qualified to take on the daunting challenge of continuously enhancing corporate value.

No matter how high the barrier is with "b", though, note that it will not be sufficient on its own to continuously enhance corporate value.

CHART 3

How continuous value creation is determined



The level of value created will differ greatly with the quality and corporate strategy of the top management. Our experience on the frontlines of consulting and investment also has driven home the lesson that the management depth supporting top management is crucial to the degree to which the corporate strategy is actualized. The corporate culture of the organization as a whole also has great bearing on value creation over the long term. The Japanese adage "A firm begins and ends with the people in the firm" is true; "p" is an important factor in the continuous enhancement of corporate value.

Unfortunately, having a high "b" and "p" does not mean that corporate value will rise continuously. In the real world, the "b" of a company has a life span, and superiority will not necessarily last forever, given such factors as the lifecycle of the business, technological progress, and changes in customer behavior. As for "p", management depth and corporate culture do not change overnight. The rate of change for "p" is usually particularly slow in Japan, where human resources for management are illiquid.

This means that two out of three factors, "b" and "p", are actually more or less constants, which would make "V" a constant as well. This will not allow corporate value to rise "continuously". This means that the continuous value enhancement required in a mature society needs some other factor.

This is where "m", the last variable, comes in. The "m" stands for "management". Many management skills are involved in "m" that transcend individual companies and industries. Business strategies to enhance long-term profitability; business portfolio management for business line turnover and the requisite business investment and pullout standard; management of the cash conversion cycle by controlling accounts receivable, accounts payable, and inventories; and designing the governance architecture to ensure the legitimacy of management decisions are just a few examples.

The wide breadth of "m" that is required to properly manage the increasingly complex companies of today and successfully compete is obvious just from those examples. These management skills have been studied and systematized over the last 50 years, particularly in American businesses and business schools, fed back to actual business management, and continue to evolve day by day. Intercorporate competition is no longer limited to "b" and "p" — it is also the competition in "m", where the necessary management skills including the latest academic findings are deployed in the actual management of companies.

There are companies that are aware of the importance of "m" and utilize it. Some of these companies show dramatic, not to mention continuous, improvement in their corporate value. Here are some examples of successful companies that I have been involved with in their reform or otherwise know close at hand.

Dramatic Gains in Corporate Value Through "m" Reform

1. Using the Operation Research Method

The first example is the AIN Pharmaciez Group, the largest dispensary pharmacy group in Japan. Under the government policy of separating prescription from dispensing, all a dispensary pharmacy had to do to be profitable was to open for business in front of a major hospital. This meant that there was little need or incentive to adopt sophisticated "m" other than some store-opening strategy. Attention given to reducing waiting time, a must for any business line that requires servicing customers, was spotty at best, and it was not unusual for customers to have to wait for an hour or longer at peak time. Although the AIN Group was an exception among dispensaries in that it was working to reduce waiting time, it was not making much headway. I believed that good results could be achieved by transferring productivity enhancement knowhow from manufacturing, and introduced a highly experienced consultant acquaintance to the company.

The regulated dispensary pharmacy business turned out to be an "orchard full of low-hanging fruit" in the eyes of this consultant, who had spent long years on making improvements on the factory floor, while the "scales fell from the eyes" of the pharmacists dispensing the drugs, revealing enormous opportunities for improvement. The efforts are still ongoing, but the measures have produced dramatic results at the stores where they have been implemented, reducing peak waiting time to a matter of minutes, slashing store inventory from two weeks to three days, and increasing the average number of prescriptions filled by a pharmacist by 15%. There are cases of patients switching from other pharmacies as the reduction in waiting time has become known. The pharmacists, who had previously been working strictly according to the book, were now doing their own "thinking". It is interesting that this improved motivation dramatically, reducing turnover and lowering hiring costs for pharmacists.

Undertaking the "reduction of client waiting time", a classical "m" subject in operations research, is beginning to produce major results in many areas of corporate management such as the enhancement of customer satisfaction, generation of cash flow by speeding up inventory turnover, enhancement of pharmacist motivation and general motivation, and reducing hiring costs.

2. Organizational, Operational & IT Reform Drawing on Ideas from Other Industries

The second example is Otsuka Corporation, which sells and provides support services for copiers, personal computers, servers and other information technology devices. Otsuka is now firmly established on the First Section of the Tokyo Stock Exchange with a market capital of just under 600 billion yen and over 600 billion yen in sales, but in the 1990s it had been groaning under the weight of excessive inventory and debt. Current president Yuji Otsuka assumed that role in 2001 and immediately embarked on an organizational and operational reform process entitled "Grand Strategy Project" — an ambitious undertaking of business process reengineering (BPR) that concentrated the operational functions and authority for inventory, distribution, invoice, collection, and other functions that had been scattered among the branches at the headquarters, making it the true center of operations, and dedicated the branches to sales and marketing. It also provided cross-training for sales and marketing and support staff to develop multiple skills and introduced information systems to enhance operational efficiency.

As a result, productivity and profitability has improved dramatically since 2000, when the reform was launched. Sales and operating profits per employee have increased dramatically to 1.7 and 1.5 times their respective levels at the beginning of the process.

It should be noted that the average wage of the employees has risen by a half against the background of this improvement.

This BPR process was started by President Otsuka, who saw that the centralized management system of banks could be applied to Otsuka Corporation, a prototypically decentralized organization. The dramatic enhancement of its corporate value is the result of making excellent use of "m" in the form of "utilizing BPR and IT".

3. Mature Business Resuming Growth Through an Overseas Growth Strategy

The final example is Pigeon Corporation, a manufacturer of nursery items. Pigeon was already a company with an overwhelming share of the Japanese nursery item market, but was marked in the stock market as a company with little growth potential due to the declining number of childbirths in Japan. However, I had been surprised to see the overwhelming popularity of Pigeon products overseas when conducting field surveys in China and Southeast Asia, and became convinced of the high growth potential of the company. I conducted monthly discussions with Pigeon management over the following 10 months or so, provided the market size and growth potential of overseas markets, analysis of the international competition, and other materials, and worked with them to put together the specific overseas strategy, financing strategy and other details that the company should pursue.

The outcome was announced in 2008 as the Third Mid-term Plan. The company has since moved forcefully into the overseas market and built factories there, with the result that the overseas market now accounts for more than 50% of its sales. The operating profits ratio has jumped from 6% to 15%, and ROE has more than doubled. Pigeon has established a reputation as a top-flight global company among mid-sized companies, with a market capital currently over 300 billion yen — a more than tenfold increase in 10 years.

Baby bottles may be a niche product, but Pigeon has moved forcefully into the global market with its technological edge, a success case making the utmost use of "m" in the form of an assault on the overseas market as a market segment with a potential for high returns. In addition, a member of an investment company that I manage is currently on the Pigeon board as an outside director, and is engaged in further improving "m" there.

Significance of "Dialogue" with Investors

These are examples where long-term corporate value has been enhanced dramatically by pursuing "m". You must have noticed that these examples of corporate reform are cases where cross-sectoral, universal management skills were applied to the management of individual companies. I have nothing against the inductive management style based on an on-the-spot knowledge and actual experience of the individual firm. But business management today is becoming increasingly complicated and sophisticated. The management skills required of corporate leaders are, as Professor Kazuhiro Mishina at Kobe University points out, less like the driving skills necessary to acquire a run-of-the-mill driver's license for driving on ordinary roads and more like the skills demanded of the pilot of a jet fighter that must maneuver in three-dimensional space against enemy aircraft.

Japan is effectively devoid of business schools that teach basic management skills systematically, providing few opportunities to secure training and acquire theory. This means that top management consists of members who have achieved results in specific business operations such as sales and marketing and manufacturing and are required to make management decisions without systematic training. One management academic told me that "If you brought together 1,000 division heads from publicly listed companies in Japan and asked those who could read balance sheets to raise their hands, probably only one-tenth would do so." He could well be right. Moreover, the practice of lifetime employment means that well-experienced managerial talent is highly illiquid, so there is a tendency for the management of individual companies to rely on inductive methods based on the limited experience of the individuals within a single company.

In other words, there is a potential in a Japanese company to enhance the overall corporate value exponentially by thoroughly studying sophisticated universal management skills and deploying them deductively in actual management. This is why "Misaki's Axiom®" defines the factor "m" as an exponent, not an addend or subtrahend.

This is why it is important for investors in the stock market to engage in dialogue with the companies. The significance of Japan's top management, which is managing on the basis of limited experience within their companies, and institutional investors, who are able to think universally based on their observation of a large number of businesses and management methods, engaging in "constructive dialogue" lies in achieving the evolution of the corporate "m" through the dialogue.

Conclusion

Since the inauguration of the administration of Prime Minister Shinzo Abe, we have seen significant progress in "institutionalizing" corporate governance, such as the adoption of the Japanese versions of a stewardship code and corporate governance code and the revision of the Companies Act. The next step in this Japanese undertaking is not to merely keep loudly proclaiming the "continuous enhancement of corporate value" but to have a profound understanding of how corporate value is determined based on the realities of corporate management, identify the specific drivers of continuous value enhancement in the Japanese management culture, and have management and investors begin engaging in their improvement. Nothing would please me more than to see "Misaki's Axiom®", which emphasizes "m" based on a focus on the management structure and characteristics of Japanese companies, provide insights for this process.

JEF translated the original Japanese text into English. JS

Yasunori Nakagami is CEO of Misaki Capital Inc. He worked as a management consultant for almost 20 years on a wide range of industries at Andersen Consulting (now Accenture) and Corporate Directions, Inc., where he became a partner. He established an investment advisory company in 2005 to begin highly selective investment activities in publicly listed companies. He is coauthor of ROE Saihinkoku Nihon wo Kaeru *(Changing Japan, One of the Worst ROE Countries in the World), recently published by Nikkei Publishing Inc.*