Japanese Sogo-Shosha & Their New Frontiers

By Shunichi Enomoto

The Revival of Sogo-shosha in the 2000s

What is a Sogo-shosha? What is its business model? This topic was the subject of intense debate in the early 2010s. Now a decade has passed since then.

In the wake of the bursting of the so-called bubble economy in the early 1990s, Sogo-shosha had been on the verge of bankruptcy due to massive interest-bearing debts and experienced a "winter period" between 1995 and 2005. They finally succeeded in emerging from their hard time and went on the offensive. Soaring commodity prices due to China's rapid growth in the 2000s continued to improve their business performance. The "Big Five" Sogo-shosha – Mitsubishi Corp., Mitsui & Co., Itochu Corp., Sumitomo Corp. and Marubeni – set the highest records of their consolidated net profits until the early 2010s.

In the early 2010s various business models of Sogo-shosha were proposed to help especially foreign investors understand the Sogo-shosha business. Traditionally Sogo-shosha were recognized as distributors intermediating between producers and consumers, whereas the Big Five redefined themselves as supply chain management companies. They committed to multiple processes of the supply chain through trading and business investments, etc. to foster the growth and development of the supply chain.

Supply Chain Management of Sogo-shosha

Sogo-shosha implement two types of supply chain management. One is known as "Value Chain Design" where they engage in the entire supply chain as its organizer. Mitsubishi Corp. deploys "Value Chain Design" in resource businesses such as LNG and food. The other is deployed in non-resource sectors. Sogo-shosha focus their engagement on key segments of the supply chain, where they generate revenue and extend their engagement in its upstream/downstream processes or adjacent supply chains to create synergy and enhance collective revenues.

Value Chain Design

An LNG project needs a 20-30 year operational period and huge investment of 2 to 6 trillion yen and stands on the long-term solid business partnership of upstream producers (state-owned resource companies in the Middle East, etc.) and downstream users (Japanese power and gas companies). Their difference in nationalities/regions, businesses, cultures and customs, however, are too huge to form and maintain partnerships and collaboration spontaneously. For that reason, Sogo-shosha step in, and arrange and develop their partnerships and collaboration to form LNG projects. In addition, they secure LNG liquefaction companies and shipping companies to complete the whole supply chain.

A multitude of actors are involved in the LNG supply chain, which makes it difficult not only to form but also to revise or develop LNG projects. Expanding LNG production simultaneously requires the resource company's commitment to produce more gas upstream and the power and gas companies' consent to consume more gas downstream. The additional production and consummation of LNG further needs the concurrent expansion of liquefaction and transportation capacity midstream.

This necessitates an organizer who oversees the entire supply chain, coordinates the activities of all the players in the supply chain, and facilitates collaboration among them. In the LNG project, Sogo-shosha act as its organizer not as mere intermediaries for commodity transactions, and ensure the whole supply chain functions smoothly and efficiently through multi-stage trading, business investments, and other activities. Sogo-shosha generate revenue from their trading and business investments, and their revenue increases with the growth and development of the supply chain. This serves as an incentive for Sogo-shosha to grow and develop the supply chain as its organizer *(Chart 1)*.

Key Segment-focused Approach to the Supply Chain

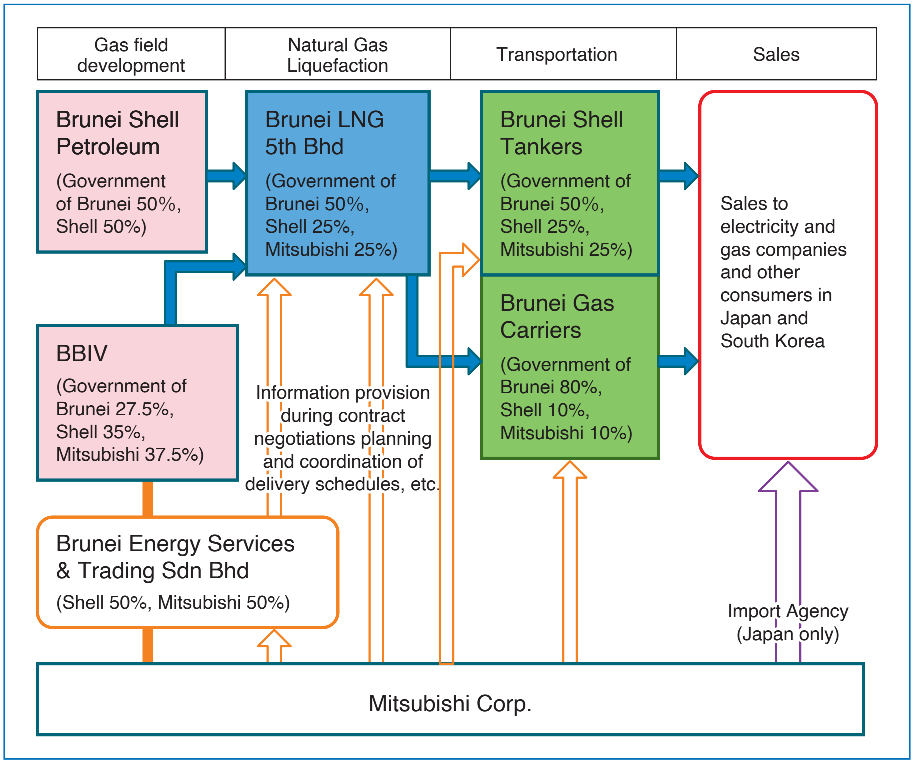
"Value Chain Design" is quite an attractive business idea. However, even the Big Five can realize it on only quite a limited number of supply chains. One reason is that "Value Chain Design" is feasible only when upstream and downstream actors are market-wise or transaction-wise fragmented. Imagine both producers and end users coexist in the same country. They can make direct contact with each other and build their own partnership in the LNG project without any help of Sogo-shosha.

Another reason is that "Value Chain Design" requires an investment of significant human resources and capital for multi-stage engagement in the supply chain and Sogo-shosha need commensurate return to cover the costs of their supply chain management. Resource transactions is the optimal business for "Value Chain Design", where Sogo-shosha can gain profits through repeated high-volume trading and sales, even at low profit margins.

Due to these difficulties, "Value Chain Design" does not necessarily match the business conditions in many cases. Sogo-shosha rather focus their engagement on only a key segment of each supply chain, where they generate revenue and then extend their

CHART 1

Mitsubishi Corp.'s Brunei LNG project



Source: Compiled by the author based on Mitsubishi Corp. documents

engagement to its upstream/downstream processes or adjacent supply chains to create synergy and enhance the collective revenues across the entire supply chain or the adjacent supply chains. In contrast to their engagement with the whole supply chain in "Value Chain Design", Sogo-shosha first select and establish a core profit segment in the supply chain; they then expand to another segment upstream/downstream on the same supply chain or adjacent supply chains, and launch new ventures leveraging the know-how and capabilities cultivated in their core profit segment. Through this process, they create synergy between the core profit segment and subsequently developed segments and enhance the collective revenues.

Business Portfolio Management Based on Quantitative Risk Management

Proclaiming itself as the "Top Sogo-shosha in Non-Resource Business", Itochu Corp. takes a key segment-focused approach to supply chains and has developed 250 business operations. While Mitsubishi Corp. generates over 200 billion yen in consolidated net profit from its LNG business, Itochu generates hundreds of millions to billions of yen from each business operation. Nevertheless, Itochu has frequently succeeded in surpassing Mitsubishi Corp. and others in total consolidated net profit, accumulating these hundreds of millions to billions of yen from 250 business operations.

To generate consistent and high returns from a group of numerous, low-margin divisions, one must manage business risks and returns rigorously, and simultaneously restructure one's business portfolio to be more profitable. Sogo-shosha regard their rigorous business portfolio management as an essential business foundation supporting corporate growth. Their emphasis on portfolio management is ascribed to reflection on their reckless investments during the bubble economy of the late 1980s. Sogo-shosha have developed and implemented their business portfolio management based on quantitative risk management since the late 1990s.

Based on their business portfolio management, Sogo-shosha allocate their finite funds for each business unit and supervise their operations. If some business unit fails to realize its annual and medium-to-long-term plan for consecutive years, the headquarters assess the plan's feasibility and reallocate theirs fund to high-profit and/or high-growth areas *(Chart 2)*.

Resilient Growth Since 2010s

The business model of Sogo-shosha has demonstrated great resilience through repeated trials in the 2010s and the early 2020s.

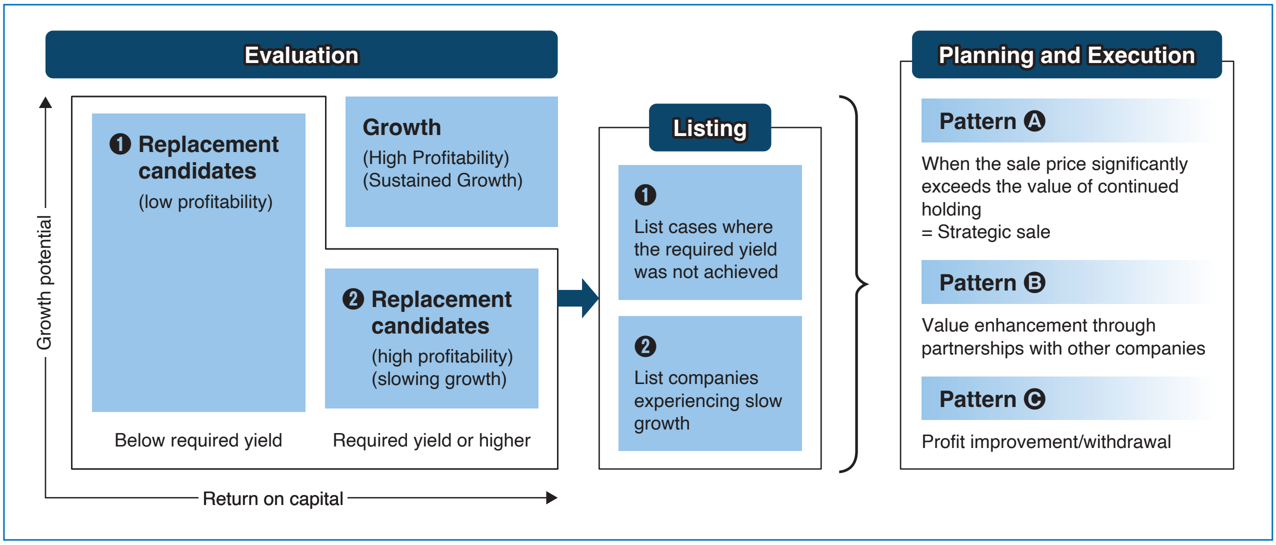
Burst of the "Resource Bubble"

The slowdown in China's economy in the 2010s had a significant impact on the global economy. Resource prices had been believed to be ever rising in the 2000s. Once the so-called "Resource Bubble" burst in 2012, resource prices continued to fall unstoppably and caused a deterioration in the performances of Sogo-shosha. In fiscal year 2015, Mitsubishi Corp. and Mitsui Corp. recorded their first-ever consolidated net losses in their history.

Never having settled in slumps, however, Sogo-shosha showed a V-shaped recovery in performance in the fiscal year 2016, and four of the Big Five achieved record profits in fiscal 2017. While one cannot deny their V-shaped recovery was largely attributed to the price rebound of resources such as coal, iron ore, copper, one must admit their rigorous portfolio management helped their resilience and high profitability. Even their resource business portfolios were so resilient that profits could rapidly recover once prices bounced back above a certain level again *(Chart 3)*.

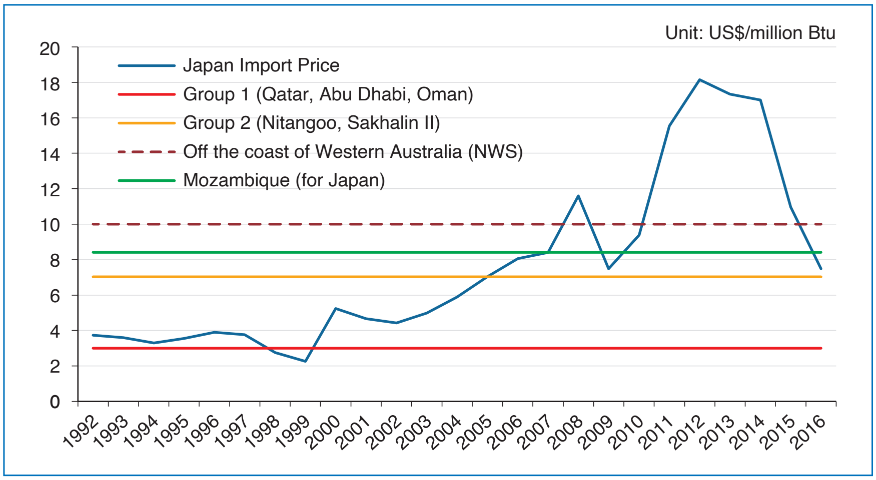
After the "Resource Bubble" burst, Sogo-shosha began to restructure their business bases dependent on resource sectors. It is particularly noteworthy that Mitsubishi Corp. declared it would break away from its dependence upon resource businesses and strengthen its non-resource businesses. Itochu Corp., which had maintained a balanced revenue structure across resource and non-resource businesses, further strengthened its non-resource sectors. Its business reform led Itochu to rise into the top three of the Big Five.

CHART 2
Mitsubishi Corp.'s business portfolio management



Source: Nihon Keizai Shimbun (Nikkei), Dec. 25, 2024 article: Mitsubishi Corp. Aims for Stable ¥1 Trillion Net Profit, Refining "Asset Recycling"

CHART 3
Profitability of Mitsui & Co.'s LNG project



Note: The break-even point for each project assumes an LNG price at the start of operations. Please note the difference from the import price.
Source: Shunichi Enomoto (2017), "Japanese Sogo-shosha's Future toward the 2020s"

Global Economic Downturn Caused by Covid-19

Rapidly spreading worldwide in 2019, the Covid-19 pandemic hampered global trade and plunged the world economy into recession. Sogo-shosha could not escape its impact and the fall in resource prices such as oil and iron ore hit Mitsubishi Corp., Mitsui & Co. and Sumitomo Corp. hard as they were highly dependent on resource business. In contrast, Itochu Corp. and Marubeni maintained relatively stable performances due to their competitive non-resource sectors. Notably Itochu surpassed Mitsubishi in consolidated net profit in fiscal 2020 to become top of the Big Five.

However, Sogo-shosha showed their resilience again. As the pandemic subsided and the global economy rebounded sharply in 2021, resource prices started to surge again and greatly contributed to a rapid recovery in the performance of Sogo-shosha. In addition, non-resource sectors, which Sogo-shosha had been developing as a second pillar of revenue, helped them achieve new consolidated net profits records ranging from 400 billion to over 1 trillion yen. Especially, Itochu has exceeded 800 billion yen in consolidated net profit since fiscal 2021.

But will current high profit and high growth be guaranteed for Sogo-shosha in the future?

New Frontiers

In Sogo-shosha, the current generation of employees owe their success to their predecessors who pioneered new frontiers a decade or even a few decades ago. The LNG business is currently a cash cow for Mitsubishi and Mitsui & Co. but their LNG business units operated at a loss and had no guarantee of future success when the LNG projects started in the 1970s. But they tackled a new frontier, formed alliances with overseas resource companies and domestic users one by one, and forged LNG supply chains. The predecessors' relentless efforts led to the current generation's success. To continue growing their business without resting on past successes or legacies, Sogo-shosha must never cease to pioneer new frontiers. So what is a new frontier for them?

Globalization of Supply Chains

Sogo-shosha, relying on transactions with domestic customers, cannot escape the challenges Japan faces. As the Japanese government failed to break away from zero growth through quantitative easing in the 2010s, they cannot rely on domestic growth for their future and need to find an alternative driver of growth. Now that the center of global economic growth has shifted to China and India, Sogo-shosha must shift their business bases from the stagnant domestic market to leverage global growth opportunities. (Interestingly, Itochu currently intends to expand its domestic business in its aim to be the "Domestic Business No. 1 Sogo-shosha".)

From a supply chain management perspective, this means that Sogo-shosha must shift their business gravity from domestic-oriented supply chains to global supply chains. A domestic-oriented supply chain connects overseas producers upstream and domestic consumers downstream to obtain overseas resources for domestic consumers, while a global supply chain connects directly overseas producers and overseas consumers to obtain resources for the latter. The shift to global supply chains entails a shift from domestic customers to overseas customers.

While Sogo-shosha traditionally have adopted domestic-centered corporate organization aiming to serve their domestic customers, now they face an unprecedented challenge to restructure their organizations to serve overseas customers. Some people mistake Sogo-shosha for transnational or international firms when seeing that they operate globally and their employees are proficient in working in a global environment. The reality is that they are typical of traditional Japanese companies with domestic-centered decision-making and human resource systems, which makes it difficult for them to shift from domestic to global supply chains.

Global Supply Chain Transformation in a Trial-and-Error Process

The shift to global supply chains is still in a trial-and-error phase. A frontrunner in globalizing supply chains, Mitsui & Co. acquired a Brazilian soybean trading company, Multigrain AG in 2011. Multigrain AG conducted the collection, processing and sale of soybeans and corn in Brazil and Mitsui & Co. aimed to create a global supply chain in the soybean trade. However, a Chinese company's unexpected market entry so intensified the competition that Mitsui & Co. accumulated deficits, halted all operations and liquidated the company by the end of 2018.

However, Mitsui & Co. never abandoned globalizing its supply chains. From the Multigrain case, it learned the importance of securing reliable partners with deep local knowledge, and building agile, flexible business models. Mitsui & Co. invested in a UAE company handling African agricultural products and built grain supply chains straddling the African Continent.

In 2007 Mitsui & Co. invested in the Mozambique LNG Project, considered as having one of the largest reserves in the world. The final decision of full-scale involvement was made in 2019 and the company plans to supply natural gas to customers in India, Southeast Asia, and Europe. This is expected to be a turning point for Mitsui & Co. to shift from domestic-oriented oil & gas business to one globalizing its supply chains.

Globalization of Mitsubishi's Steel Supply Chain

The steel business is a classic example of a domestic demand-oriented industry. See, for example, the supply chain from upstream to downstream. First, iron ore and coal are imported from overseas production sites. Next, blast furnace steelmakers (Nippon Steel etc.) manufacture steel plates and other steel materials. Then, three-tier value-added logistics providers distribute and process steel materials and finally supply steel products to domestic end users. The steel supply chain relies on domestic demand, and the profits of Sogo-shosha steel business swing up and down with fluctuating domestic demand.

Since the bubble economy burst in the early 1990s, steel domestic demand had continued to shrink and crude steel output fell short of 100 million tons in 1998, due to Japan's prolonged economic stagnation and the relocation of manufacturing sites overseas. Recognizing there was no room for the growth of its domestic steel business, Mitsubishi Corp. relocated its headquarters for steel raw material trading to Singapore in 2013, aiming to transform its domestic steel business into an Asia-wide one.

The company planned to supply iron ore and coal, secured through interests in Australia, to blast furnace steelmakers in South Asia and other regions and then to have steel materials distributed and processed by local value-added logistics providers, and finally to supply steel products to local end users. At present, there are no reports of steel raw material supply contracts with any overseas blast furnace steelmaker, and the globalization of the steel supply chain appears to be still in a trial-and-error phase. Nevertheless, this initiative should be highly commended and publicized as a brave attempt *(Chart 4)*.

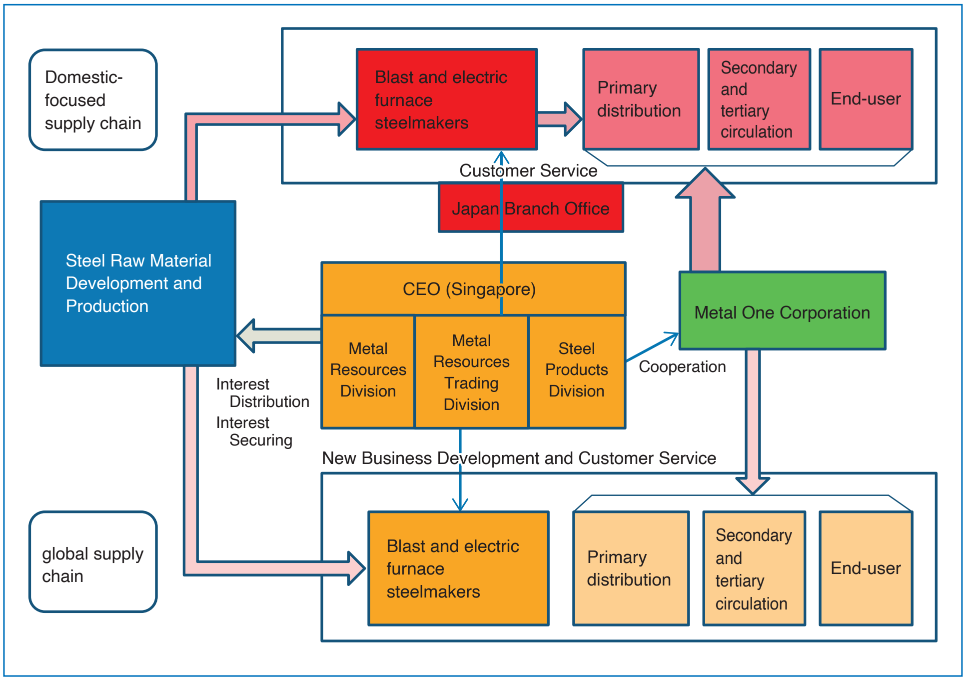
Creeping Crisis of Sogo-Shosha

At first glance, Sogo-shosha have been currently enjoying a boom-driven resource prices rebound and global economic recovery following the pandemic. But at the same time, they are facing a crisis: no new frontiers are in their sight.

To establish global supply chains, Sogo-shosha must prevail against local companies especially in overseas upstream (production and securing of resources) and downstream (sale to end-users) processes. This is not an easy task. For example, Sogo-shosha failed to compete with state-owned resource companies in ore and coal trading with local blast furnace steelmakers in China, because they could not demonstrate a competitive advantage against local state-owned resource companies. China's state-owned resource companies can not only offer more business to Australian ore and coal producers in China than Sogo-shosha but can also be better business partners for local blast furnace steelmakers because they share Chinese business culture and practices. Nobody can say the same thing never happens in India and other growing areas again.

Furthermore, it is true the business portfolios of Sogo-shosha show high profitability, but their domains are centered on 20th-century industrial sectors such as manufacturing and social infrastructure and lie outside the growth area of the 21st-century global economy. Will these domains continue to guarantee high profitability in the future? Recognizing their weakness in 21st-century industrial sectors, Sogo-shosha established representative offices in Silicon Valley to gather information on

CHART 4
Global headquarters functions relocation & supply chain management for the entire metal group



Source: Compiled by the author

innovation trends, and build networks with entrepreneurs and investors. They have started to invest in tech start-ups and entered IoT solution businesses such as smart factory and supply-demand forecasting AI.

First, regarding tech start-ups investment, the problem is that Sogo-shosha lack expertise in venture capital investment. Choosing investment opportunities based on marketability and stage of innovation, venture capitals build high-profit potential and high-growth potential portfolios. They can simultaneously make massive investments and diversify risk with their expertise. Lacking expertise in venture capital investment, Sogo-shosha can neither do the same thing nor create high-return opportunities like unicorn investments. In the first place, Sogo-shosha have a cap on investments and can commit only a small portion of their annual investments totaling 300-500 billion yen. Their profit goals and time-framework also make it difficult for them to create high-return but high-risk opportunities.

Second, regarding the IoT solution business, the problem is that Sogo-shosha are not originally IT solution providers and lack a competitive advantage against specialized companies. Considering that many IT solution providers operate with low operating profit margins, it is also questionable if Sogo-shosha can really achieve minimum profit goals and proceed with full-scale commercialization in the IoT solution business. Mitsubishi Corp. announced that it would provide a demand forecasting and logistics coordination system, leveraging its multi-stage involvement within the food supply chain. However, numerous competitors have already developed and supplied excellent systems both domestically and internationally, and it is questionable if there is an opportunity to enter the market.

Exceptionally, Itochu may be able to succeed in the IoT solution business. It has originally possessed an IT solutions provider subsidiary and newly established an in-house company to fully launch its IoT solutions business, focused on the domestic market. Domestic companies generally lag behind Europe, the US, and China in adoption and implementation of IoT technologies. This means not only that Itochu can expect future business opportunities in the domestic market, but also that no solution provider still holds a dominant position there, even in the smart factory solution area, where commercialization is said to have progressed earlier. Therefore, Itochu's full-scale entry into the domestic IoT solution market is expected to yield results.

Facing an uncertain future, Mitsubishi Corp. declared its new "Business Management Model" and expressed strong determination to leverage all its capabilities to create new businesses. It envisioned transforming itself into a "venture group" where all employees become entrepreneurs, launching new businesses and nurturing them as business operators. This is not a business model but rather a management philosophy aiming not for the status quo but for pioneering new frontiers.

I admire this philosophy as a symbol of Sogo-shosha's firm determination to confront the unknown future, but at the same time I cannot neglect the fact that it gives no answer to what the frontiers for Sogo-shosha are. The "Business Management Model" only emphasizes the importance of developing new business frontiers and calls for its employees to create new businesses through entrepreneurship. It is easy to praise Sogo-shosha for their current performance, but we should be mindful enough to sense a crisis waiting them in the future.

This article was drafted by the author based on translation of the original Japanese by Naoyuki Haraoka, editor-in-chief of *Japan SPOTLIGHT* & executive managing director of the Japan Economic Foundation (JEF). JS

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