Salomon Brothers: Long-Term View of Tokyo Market

By Nagami Kishi

The Japanese financial market, which has grown to be one of the largest in the world, has attracted the world's major securities companies to Tokyo—there are now 46 of them in the Japanese capital. Only a few of them managed to keep their accounts in the black during fiscal 1988, however. Some companies even went into the red to the extent of more than ¥1 billion (about $7 million). Salomon Brothers Asia Ltd., the market leader, alone earns two-thirds of the aggregate profit made by all foreign companies operating in the black. The company's structure and business strategy are among the major reasons for its outstanding performance.

Salomon Brothers Inc. established Salomon Brothers Asia Ltd. in Hong Kong in 1977. The company had planned to open a branch office in Tokyo and had even started negotiations with the Ministry of Finance (MOF). These negotiations and various other procedures, however, took longer than it had expected, because the MOF in those days was much less willing to allow foreign securities companies into the Japanese market.

The company therefore decided to establish a subsidiary in Hong Kong to take advantage of the delay; three years later it opened an office in Tokyo for a resident Japanese representative. In May 1982, two years after the Tokyo office opened, the MOF finally granted Salomon authorization to establish its Tokyo branch, and the branch started operations in September.

Salomon started recruiting prospective new university graduates during 1984, rather early for a foreign securities company without a long history or recognition in Japan. Though such recruiting was very difficult during the early stages, it became progressively easier as the company grew; now, graduates from leading universities such as the University of Tokyo are eager to enter the company. Salomon lays great emphasis on the development of its new employees, offering training in New York or London as well as other educational opportunities before settling people into their first posts.


Deryck C. Maughan, chairman of Salomon Brothers Asia Ltd.

Dealings with ministry

Despite being one of the largest U.S. securities companies, Salomon was a latecomer to the Japanese market. There were already six or seven other foreign securities firms established in Japan before Salomon.

In those days, the MOF was obviously determined to treat foreign securities companies more strictly than domestic companies. Most importantly, the laws were different: those for authorizing the operation of foreign securities companies were separate from the Securities and Exchange Law. While the latter, which had been in effect for more than 20 years, gave complete details regarding securities and other related business, the special law for foreign companies was inadequate and ambiguous. Salomon made great efforts to urge the MOF to improve its provisions, concerning both clarity and coverage.

Salomon Brothers is the world's largest investment bank, operating as a consultant for corporate activities, investments and banking operations. Therefore, unlike Japanese securities companies, it specializes in bond dealing. Securities, as defined by Japan's Securities and Exchange Law, is based on the brokerage business in which companies trade products on behalf of their customers without having inventories. Therefore, purchasing products for business just as Salomon did at home resulted in greatly restricted business activities under the regulations limiting the aggregate value of holdings/debts and other activities.

The Japanese government established the Japanese Securities and Exchange Law on the basis of the brokerage business and regulated dealing to an extent which seemed excessively strict in view of the controlling speculative activities in the industry. This made the law serve as a safety measure to avert securities crises and other undesirable situations. In those days, the MOF had no idea that Tokyo was or would soon become an international money market.

Salomon Brothers chose to be a bond house when entering the Japanese market and this was one of the major reasons for its success.

With a history of almost 100 years, the Japanese securities market was burdened with many rules and established practices, and institutional investors traded according to a predetermined number of shares for each securities company. There seemed to be very little room for foreign companies. On the other hand, since the bond market was rather new, the rules and practices were not inhibitingly excessive. Moreover, Japan had been adapting new concepts, such as futures trading and options, from the United States. These generated great opportunities in the Japanese market for U.S. companies strong in the bond business.

An upturn in Salomon Brothers' business started when Deryck C. Maughan, the present chairman of the company, arrived in Tokyo as branch manager in August 1986. He immediately got down to modernizing the business practices in Tokyo, giving a clear picture of the strategies to be carried out, such as the delegation of authority and business objectives.

"A company has to be valuable to the market in which it operates," Maughan says. "Especially in Tokyo, which is undergoing such drastic changes in the market, governmental regulations and useful techniques, the company has to be flexible enough to cope with these changes. The MOF imposes on us various regulations; every country, more or less, has its own regulations. If one wants to do business somewhere, it is necessary to conform to the regulations enforced in that country," he adds.

While asserting that the Japanese government bond market was too large to exclude foreign securities companies, Maughan won the confidence of MOF officials by offering the MOF wide-ranging information and advice based on his extensive experience in the U.S. bond business, including how loan markets for bonds were being created in the U.S. and the concept of "when issued" trade.

To qualify for bidding opportunities for government bonds, Salomon raised its capital fund for the Tokyo branch 10-fold, to ¥51.4 billion, and thus became the fifth-largest securities company, following Japan's big four.

Two weeks after the increase, on Feb. 3, 1987, Salomon tendered for medium-term government bonds due in two years, and made a successful bid for bonds worth ¥45 billion, 40% of the total value. Salomon won the largest share, far exceeding Nomura, which ended up with only ¥30 billion worth.

Based on such achievements, Salomon Brothers became the first foreign company to be appointed a permanent manager of the underwriting syndicate. Salomon now accounts for an 8% share of the underwriting market.

Improved image

Around the time of the capital increase, Henry Kaufman, then Salomon Brothers' chief economist, visited Japan to give a series of lectures. Adherents of his theories believed that Kaufman's forecasts could change stock prices, and he attracted a lot of attention, especially from people who were engaged in the securities and banking businesses. Very few Japanese, however, had previously associated Kaufman with Salomon. Salomon Brothers effectively used the Kaufman-Salomon impact in an extensive public relations strategy to improve its corporate image.

Emphasizing Salomon's research strength, Jeffrey Hanna, the managing director in charge of research activities, says, "Concerning information related to Japan, obviously we cannot match Nomura and other Japanese companies. We are stronger, however, in offering both global information as well as reliable world and U.S. economic perspectives."

"During the first four or five years after opening the Tokyo branch, we focused on solidifying our base here, by both recruitment and working hard on management and bonds. From 1986, efforts have centered on stocks, research and other businesses, while we have also promoted aggressive marketing strategies. From now on, we will stress the field of investment banking, which we believe has great future potential," says Maughan.

Maughan mentions M&A (mergers and acquisitions) as one of the most promising sectors of the investment banking business. The acquisition of Rechhold Chemical in the U.S. by Dainippon Ink & Chemicals, which attracted a lot of attention because it was an unusual case of an American firm being purchased by a Japanese company, was arranged by Salomon Brothers. It was the first sign of an M&A boom in Japan. The company, recognizing increased momentum in the M&A business from this success, posted John Schlesinger, the chief executive of the M&A Division in the Asian area, to Tokyo in October 1988.

Schlesinger, now managing director, was bracing himself for the coming challenges. "Japanese companies will need business bases both in the U.S. and in some European countries. Besides, the recent higher yen makes it much easier to buy foreign firms," he says.

In pointing out why Salomon Brothers has been so successful in Japan, one financial journalist said, "Salomon Broth-

Table 1 Japanese Operations of Major U.S. Securities Firms

Revenue ($ million)

	1986	1987	1988	1989
Salomon Bros.	100.9	167.9	157.3	158.0
Morgan Stanley	54.3	99.5	125.6	93.1
Merrill Lynch	76.9	98.8	92.4	54.3
Goldman Sachs	36.0	67.0	84.7	67.8
First Boston	20.5	39.5	55.7	48.7

Pretax earnings ($ million)

	1986	1987	1988	1989
Salomon Bros.	34.8	47.5	31.3	53.6
Morgan Stanley	8.6	10.8	0.4	5.8
Merrill Lynch	11.8	25.5	8.0	1.0
Goldman Sachs	1.1	9.3	3.7	12.8
First Boston	5.2	4.7	5.6	7.3

Notes: 1. Fiscal years ended Sept. 30, except 1989 figures, which are for six months to March 31.
2. Converted from yen at mid-1989 rates.
Source: *Nihon Keizai Shimbun*

Table 2 Ranking of Participation in 10-year Japanese Government Bond Auction in 1989

	Amount (¥ billion)	Share (%)
1. Salomon Brothers Asia Ltd.	527.3	18.6
2. Nomura Securities	454.8	16.0
3. Daiwa Securities	249.3	8.8
4. Yamaichi Securities	154.3	5.4
5. Nikko Securities	121.9	4.3
6. Sumitomo Trust & Banking	96.7	3.4
7. Industrial Bank of Japan	70.9	2.5
8. Mitsubishi Trust & Banking	63.0	2.2
9. New Japan Securities	53.3	1.8
10. Kokusai Securities	53.1	1.8

Source: *Nikkei Financial Daily*, March 2, 1990

ers only works with companies, not with individual investors, which is quite different from the approach taken by Merrill Lynch & Co., Inc., for example. While Merrill Lynch, in spite of 20 years in Tokyo, is still suffering deficits, Salomon Brothers has achieved considerable success in Japan in just seven and a half years. As Japanese companies have become more and more globalized, they have been seeking increasing amounts of world information. Thus, a company like Salomon Brothers with its worldwide network can increase its role in the Japanese business world."

Dwight L. Barker, Salomon's managing director, commenting on how Salomon started its business on the Tokyo Stock Exchange (TSE) in May 1988, says, "We had virtually no market share initially; by the end of 1989, our share was in excess of 1%. We hope we will reach 2%, though we'd like to see our share increase even further to about the same value as we have in the U.S., which is about 5%. We are neither Nomura nor Merrill Lynch, and are not looking for a 25% market share."

In March 1990, the TSE suffered a drop in stock prices, an event usually referred to as a "slump." Some analysts say this phenomenon is due to excessively high stock prices; others say that uncertainty concerning the future of the Japanese economy caused the fall.

"The fall in stocks on the TSE is nothing like a panic; it is quite normal in this business. If there are ups, there must also be downs on the market, and people are now seeing the downside. We are not in a recession in the States, nor in Japan," says Barker.

Influence on market

There are many people in the Japanese securities industry who believe that the sale of large amounts of stocks by Salomon Brothers was a major cause of the March fall. Whether this is correct or not, the fact that such an opinion was voiced in Japanese business circles is a clear indication of Salomon's influence.

In any case, Barker counters by saying, "Though Salomon is blamed for the 'trigger effect' that caused the market fall, there is no evidence to support that argument, since we have only a 1% market share. Our business can stimulate as well as depress the market. We are not a piper calling the tune, and feel that this allegation is a witch-hunt."

"The U.S. market went up while the Japanese market went sharply down; this has happened before, when the markets crashed in 1987. While the U.S. market didn't recover in the wake of the crash, the Japanese market did. Now the Japanese market is going down as the U.S. market is going up, because we have separate and distinct economies. However, people tend to invest in their local markets," Barker said.

The policy of Salomon Brothers during this time of falling prices is to help investors cope with the situation by providing them with a better strategy. "Falling prices are offering opportunities for our company in a sense," adds Barker, "and if we can sell our service to institutional investors, our business will grow accordingly because of their growing assets."

Barker further claims that though Salomon would like to see a growing market, it is possible to make money even in a down market like the present one. "They are not comfortable with the down market," explains Barker. He adds, "We're not stupid. We are not uncomfortable making investments, having a strategy and hedging to protect our position. We are not speculators; we are as conservative as anyone balancing their checkbooks. If people see our position in 10 years, they will find that it is pretty much balanced and hedged."

People no longer speculate on the interest rate and make lots of money. "In the '70s and '80s in the U.S., we had a fairly hedged bank. Since 1974, individual investors have been buying fewer and fewer individual shares. Instead, they buy mutual funds now," said Barker.

"We are a young, growing company and we are optimistic about the future of the Tokyo market and believe that the market will become the most exciting international money market. We don't take a quarter-to-quarter view. We have a long-term view of the market," he said.

Nagami Kishi is a free-lance writer specializing in foreign businesses in Japan.