

Rebirth of Japanese Companies Through Governance Reforms

Takashi NARUSAWA, Masafumi EMORI and Satoshi OHMORI

Nomura Research Institute

Rebirth of Japanese Companies Through Governance Reforms

Takashi NARUSAWA, Masafumi EMORI and Satoshi OHMORI

- I Urgent Need for Structural Reforms in Japanese Firms
 - 1 Corporate Earnings Began to Recover
 - 2 Inadequate Recovery in Earnings
 - 3 Delayed Structural Reforms in Japan
 - 4 Signs of Progress in Structural Reforms in Japan
- II Business Environments Requiring Adaptability to Changes
 - 1 Far-Reaching Changes in Business Environments
 - 2 Need to Quickly Respond to Changes
- III Major Traditional Firms Require Revolutionary Reforms
 - 1 US Firms Suffer Setback After the Booms of the 1960s
 - 2 Successful Examples of Management Reforms in the United States
 - 3 Increasing Influence of Institutional Investors
- IV Governance Promotes Responses to Changes
 - 1 Changing Governance Structure in Japanese Companies
 - 2 Reinforced Supervision Over Companies
 - 3 Boardroom Reforms on the Starting Line
 - 4 Towards the Creation of a New Administrative System

Since the collapse of the so-called bubble economy, Japanese companies have been working to overcome their sluggish performance by means of reforms in business management strategies. While corporate earnings have begun to recover to some extent, returns on assets and other indicators of profitability are still hovering at very low levels, suggesting that structural reforms in business management are far from satisfactory. Recent slumps in the stock markets also suggest that investors are still disappointed over the delays in corporate structural reforms. The discussions on the need for such reforms have been fully exhausted, and the time has come to actually start carrying them out.

It is difficult for companies to put reforms into practice by themselves, however, as they invariably involve internal pain. In many cases in Europe and the United States, for example, such reforms were achieved under outside pressure, especially shareholder governance. In Japan as well, recent trends towards selling off cross-held shares by banks and affiliates, the increase in overseas shareholders, and the introduction of the current value accounting system are expected to reinforce the power of shareholder governance. And as shareholders demand improved investment returns, directors are being forced to concentrate on their fundamental functions such as strategic planning and operational supervision as the representatives of the shareholders, accelerating the momentum for structural reform. In short, the rebirth of the Japanese economy is conditioned on the recovery of Japanese companies, which in turn fully depends on the firm establishment of corporate governance.

I Urgent Need for Structural Reforms in Japanese Firms

1 Corporate Earnings Began to Recover

It is commonly held that effective business management requires a quick response to changes. During the high growth period from the 1960s through the 1980s, Japanese firms were able to enjoy prosperity thanks to the clear objectives of achieving stable and continuing economic growth and catching up with and surpassing their counterparts in other advanced nations—without worrying too much about how to respond to changes.

With the bursting of the economic bubble in the 1990s and the start of a period of sustained sluggishness, however, companies suddenly found themselves facing the need to quickly and properly respond to environmental changes. During the last 10 years, Japanese firms have been working desperately to improve corporate earnings. In the first half of the 1990s, the major target was to improve operating efficiency, including reforms in sales activities and slimming down the administrative functions of headquarters departments. Following some successes in these areas, the second half of the 1990s saw firms concentrating their efforts on reviewing and reforming company systems and organizations by introducing a performance-based personnel evaluation policy, reducing the number of directors and introducing a corporate officer system, and reviewing strategies for industrial groups as a whole.

After achieving partial success in these efforts and some improvement in earnings, many firms have finally started a reexamination of their fundamental strategies. For example, they have begun to withdraw from unprofitable lines, to implement revolutionary measures aimed at reorganization and to create new businesses. As a result of these responses, companies in general appear to have made a start towards getting out of the earnings doldrums. A number of securities firms expect that the level of current profits for fiscal 2000 may return close to the peak recorded before the collapse of the bubble economy.

2 Inadequate Recovery in Earnings

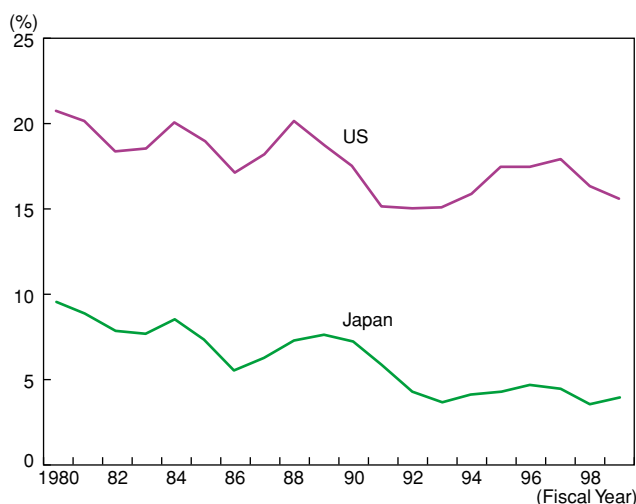
In contrast to a superficial recovery in earnings, however, we believe that the structural reforms needed to set a new stage for development in Japanese industries are still insufficient. This inadequacy seems clearly evidenced by the fact that no real turnarounds have yet emerged in the prolonged decline in the return on assets (ROA), a major indicator that monitors business profitability. According to the NRI 400 averages compiled by Nomura Research Institute, the ROA for Japanese companies (excluding financial, utility, transportation and trade sectors) stands at 5 percent, or roughly one-third of the 15 percent reported by the S&P 500 averages for US compa-

nies (excluding financial, utility, and transportation sectors). (See Figure 1.) Even measured on a time-series basis, there have been no signs of a changing direction in these long-term ROA declines since the 1970s.

The ROA data can be divided into the rate of turnover on total assets and operating returns on total sales. Comparing these indicators between Japan and the United States indicates that a large part of the differing ROAs between the two countries comes from a significant gap in the latter—suggesting that Japanese companies are still hamstrung by basic structural deficiencies, including excessive competition and high costs.

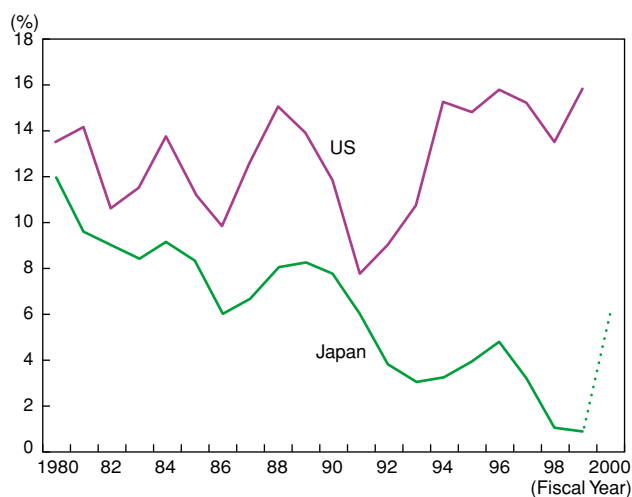
At the same time, US industries enjoy a high level of returns on equity (ROE) at about 15 percent, or roughly three times the 6 percent (fiscal 2000 estimate) for Japanese industries as shown in Figure 2. In addition to the

Figure 1. Changes in the Return on Assets of US and Japanese Companies



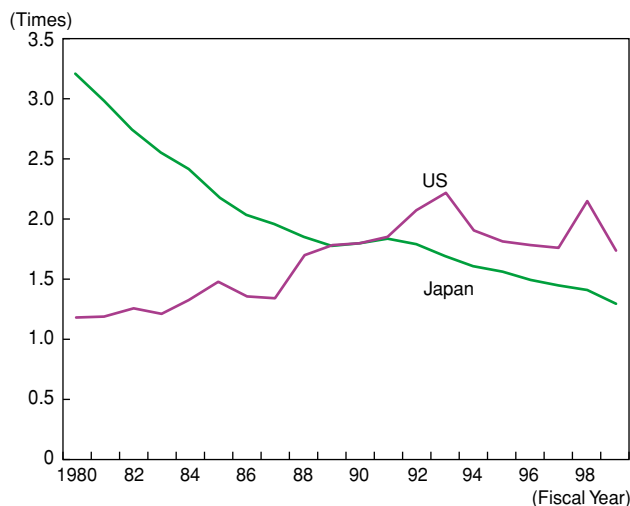
Notes: (1) Figures for Japan are based on the NRI 400 averages compiled by Nomura Research Institute (excluding financial, utility, transportation and trade sectors); those for the US are based on the S&P 500 averages (excluding financial, utility and transportation sectors); (2) Return on assets: (Operational profits + interest received) / total assets (average during the fiscal term).

Figure 2. Changes in the Return on Equity of US and Japanese Companies



Notes: (1) Average values of NRI 400 for Japan and S&P 500 for the US (2) Return on equity: net profits for current term / equity capital (average during the fiscal term)

Figure 3. Changes in the Financial Leverage of US and Japanese Companies



Note: Average values of NRI 400 for Japan and S&P 500 for the US.

large differences in ROA data, this weakness can be attributed to the low use of debt in financial leveraging (i.e., the high equity capital ratios for Japanese companies). (See Figure 3.)

Japanese companies endeavored to enhance their equity capital ratio even before the age of high economic growth, and continued to pay back debts to improve their equity capital ratios in the 1990s even when their earnings were deteriorating. As a result, their ROE performance has been further lowered. On the other hand, US companies have tried to maintain a proper equity capital ratio by means of buying back their own shares even when the value of their equity capital increased due to improved operating performance. This has enabled them to improve their ROE results.

The fact that there is a three-fold difference in ROEs between US and Japanese industries means that recovering investments requires three times longer in Japan than in the United States. This difference in risk exposure cannot be neglected in the current age of rapid changes.

3 Delayed Structural Reforms in Japan

The primary cause for the prolonged slump in the profitability of Japanese companies in comparison to major companies in the United States and Europe comes from inadequate structural reforms in the business management of the former, especially in terms of the four points that follow.

The first is the tendency towards an increasing labor share, as shown in Table 1. While corporate profits have declined since the beginning of the 1990s, the levels of employment and wages have remained mostly unchanged, resulting in a rising labor share. On the contrary, US companies have continued to maintain a tight control on employment and wage levels despite extremely high earnings and have actually succeeded in lowering the labor share. In Germany as well, companies have been

successful in reducing labor shares in the 1990s, while maintaining their commitment to stable employment.

The second important factor has been the delays in corporate reorganization. This is clearly shown by the fact that the turnover ratios for tangible fixed assets have been deteriorating since 1990, as indicated by the figures of 4.4 times in fiscal 1990 and 3.2 times in fiscal 1999.

Many companies have been working hard to carry out operational reforms and organizational and personnel policy reviews throughout the 1990s. But only a few of such firms have started to proceed with the fundamental restructuring of their business domains. In particular, it has been difficult for matured industries to reduce the size of unprofitable business sectors or withdraw from such businesses because of strong internal resistance. Although there is a consensus among major industries that there are simply far too many companies for the size of the current markets, industrial reorganization has not been progressing well. Despite the fact that the overall situation in Japanese industries is seeing some changes, structural reforms are further required at an accelerated pace as some 10 years have elapsed since the collapse of bubble economy.

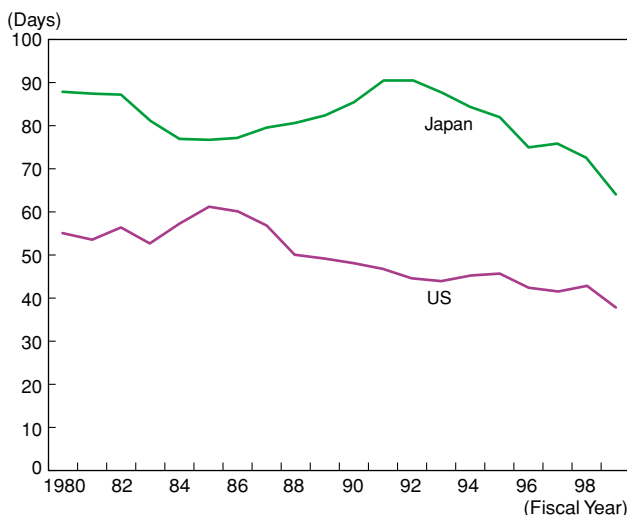
The third factor involves the efficiency of business models. As indicated in Figure 4, for example, large gaps exist in the inventory turnover periods between Japan and the United States. While US companies have succeeded in reducing inventory turnover periods since the second half of the 1980s, Japanese companies have seen increased inventories even at the beginning of the 1990s. Conse-

Table 1. International Comparison of Labor Shares

	1990	1995	1998
Japan	67.9	73.1	74.3
US	72.2	71.5	71.0
Germany	70.6	73.1	71.4

Source: *International Statistics Comparison*, Bank of Japan.

Figure 4. Changes in Inventory Turnover Rates of US and Japanese Companies



Note: Average values of NRI 400 for Japan and S&P 500 for the US.

Table 2. Earnings Comparison Between US and Japanese High-Tech Companies

(%)

	ROA	Operational Profits Rate	Total Assets Turnover Rate	Sales Growth
Cisco Systems	41.1	33.0	1.32	57.8
Intel	35.2	35.0	0.93	20.6
Dell Computer	30.7	9.6	3.05	48.7
Solectron	15.0	5.9	2.36	41.9
IBM	12.5	11.9	1.00	6.4
Motorola	6.5	6.8	1.14	6.8
Sony	6.3	5.6	1.05	10.9
Matsushita Electric	3.6	3.6	0.91	1.0
Fujitsu	3.6	3.6	1.00	10.0
NEC	2.1	3.1	1.01	5.8
Hitachi	1.9	2.4	0.84	1.1

Note: Figures are averaged values over the past five years (1995–1999).

quently, even though efforts to reduce inventories in Japanese companies have achieved some results, there still are significant gaps between the US and Japan.

As a background to these inventory gaps, we can point to the fact that US companies have successfully used IT technologies to advance business management reforms, including supply chain management. SCM has enabled companies to quickly respond to changes in demand, and has proved extremely helpful in minimizing opportunity and inventory losses, and in maximizing profits.

At the same time, structural reforms are advancing in US companies through the reconstruction of value chains in some sectors. High-tech firms such as Dell Computers and Cisco Systems have been concentrating corporate resources on product development and sales by outsourcing production processes. This has recently enabled Solectron and other EMS (electronics manufacturing services) contractors to enjoy rapid growth by shouldering the production processes of other manufacturers. These high-tech and EMS firms are now concentrating management resources in their strongest fields and responding to environmental changes with highly flexible tactics, and achieving high growth, high earnings and high efficiency in the process. (See Table 2.) While their operational efficiency was once a powerful weapon in which Japanese firms took a great deal of pride, they are now falling behind their US counterparts in the use of IT strategies.

The fourth important factor is that new growth industries, including new venture businesses, have been facing difficulties in developing a critical mass in Japan. As is widely known in the case of the US, venture capital firms have played a major role in creating the new technologies and new businesses that have been instrumental in activating the industrial structure as a whole. Because such ventures can be highly profitable and capable of greater growth than traditional firms, they have stimulated business activities on an overall basis.

4 Signs of Progress in Structural Reforms in Japan

A steady flow of structural reforms has recently been seen in Japan, mainly centered on the electronics indus-

try. In particular, the moves of Matsushita Electric have been attracting attention, although the company still lags far behind Sony in the pace of developing structural reforms.

The leader of the reforms at Matsushita is President Kunio Nakamura, who took the helm of the company in June of 2000. Nakamura's strong commitment to reforms grew out of his experience in witnessing the dramatic recovery of Western industries between 1987 and 1997, when he was working in the United States and Europe. As the factors contributing to successful revitalization, Nakamura cites the efforts of Western firms to streamline operations and improve efficiency by thoroughly utilizing IT, reconstructing value chains, developing flat organizations to better reflect customer perspectives, and effectively utilizing outsourcing tactics.

Nakamura's "Value Creation 21" plan—which is built around the catchphrase "Deconstruction and Creation"—actually includes the dissolution of the system of operating divisions established by the company's founder Konosuke Matsushita. Accordingly, the plan means that the company is embarking on a series of reforms that includes no sanctuaries. The current structural reforms are heading in the following major directions: "manufacturing reforms" that separate manufacturing functions from the traditional divisional system controlling development, manufacturing and sales activities; "domestic consumer sales system reforms" that create two new, brand-based corporate marketing divisions via self-completion marketing strategies; and "business reorganization" to review businesses not capable of creating added values.

As announced on January 10, 2001, the business administration policy for fiscal 2001 revealed such drastic measures as headquarters reforms to realign units into the two major functions of corporate strategy and professional services, substantial reductions in employment, allowing production plants to adopt self-supporting accounting systems, and reassigning 13,000 employees to high-growth sections.

From the viewpoint of asset efficiency, measures to improve competitiveness in production sectors are especially worthy of note. Major plants will be reorganized

to factory centers with self-supporting accounting systems that may accept orders from outside customers. In addition, 30 unprofitable plants will be consolidated with others or liquidated over the next three years.

As these drastic reforms would be difficult to achieve if business divisions were allowed to protect their own interests, Matsushita is trying to bring the entire company aboard the reform bandwagon by announcing a revolutionary grand design for the firm. Nevertheless, the reforms will pose difficult challenges for the company, as they can be achieved only if steady efforts are continued to realize their effects.

II Business Environments Requiring Adaptability to Changes

1 Far-Reaching Changes in Business Environments

All observers expect that the environments surrounding business management will become even keener in the future. The first challenge facing executives will likely come from the severe cost competition that is emerging on the global stage. The end of the cold war and the rapid economic development now gaining speed in Southeast Asia has helped China and other developing nations enter the global market economy. As a result, extremely low-cost labor (barely one-tenth or less of Japan's labor costs) is now appearing in the world market. As this low-cost workforce is estimated to include some one billion workers in the long term, this trend will inevitably reduce the cost competitiveness of Japanese industry.

This erosion of Japan's cost competitiveness is expected to accelerate in the future, as more and more developing nations join the market economy and semi-advanced nations experience further industrialization. In those sectors capable of transferring production overseas, firms will naturally choose to move their factories to low-cost areas, including Asia. And in industries such as steel where the shift of production facilities is difficult, major reductions in the domestic labor force will be inevitable. From 1994 to the present, for example, Nippon Steel Corporation has cut the number of employees by 50 percent. In any case, Japanese firms are facing the need to shift to more evolutionary businesses with high added values.

The second problem confronting Japanese companies is the decline in Japan's population figures. The productive segment reached a peak in 1997 and has started to decrease, and the total population is also expected to peak out in several years and start shrinking. While declines in population statistics do not directly lead to economic stagnation, the trends will exert significant effects on the environments important for business management, includ-

ing changes in consumption patterns and behavior, changes in employee mind-sets, and an increase in the number of non-Japanese workers.

The third factor relates to continuing progress in deregulation and globalization. The deregulatory trends that started in sectors such as information, telecommunications, finance and distribution are expected to see further advances. While Japan's major industries have traditionally embraced a large number of firms thanks to the government protection (i.e., the "armed convoy policy"), industrial reorganization is becoming inevitable as more and more overseas firms enter Japanese markets due to deregulation measures. In the automobile industry, for example, only two purely domestic capital automakers still remain, and other industries as well—including shipbuilding, textiles and construction—have started to adapt to environmental changes. Management is under strong pressure to develop proper strategies through rapid changes in corporate structures.

The fourth point lies in the fast development of information technologies. In the age of ubiquitous networks in which everybody can access networks from anywhere, factors that are important for business administration, including customers, products, and employees, are highly likely to undergo significant changes.

2 Need to Quickly Respond to Changes

Under these structural changes in the industrial and social environments, business management must develop new strategies in response. First, in line with the changing business environment, business strategies and asset structures must be reviewed more frequently than in the past. The peculiarities of what is often called Japanese-style management, exemplified by stable and fixed business models such as lifetime employment, must be completely reexamined, and developing long-term insight and quick decision-making will become one of the most important assets for top management. At the same time, corporate organizations and systems as well as corporate culture cannot be held exempt from the required reforms.

Second, the recovery period for investments will be shortened. This means that high profitability is a must for a company. In traditional Japanese-style management, models usually assume that even if profitability is low, investment can be recovered through long-lasting operations. Such models will be discarded in the future. Neither can high profitability be achieved if a company indulges in excessive competition with other firms by offering products similar to those of its competitors and fighting price wars. Business models are needed that can open the path to high profits by offering differentiated products and winning the game in a short period of time. Accordingly, structural reforms will become indispensable for corporate strategies.

Although a few advanced firms have achieved some results with structural reforms, most Japanese companies

have not enjoyed much success over the past ten years as noted above. In a large number of these cases, managers have tended to avoid short-term, drastic reforms in favor of slow but steady modifications over the long term.

III Major Traditional Firms Require Revolutionary Reforms

1 US Firms Suffer Setback After the Booms of the 1960s

It is often difficult for a company to undertake structural reforms by itself. However, US firms have been notably successful in implementing structural reforms in the face of severe environments during the past 20 years by weathering some major turbulence and surmounting serious tribulations. Analyzing cases of successful structural reform in the US can offer some useful suggestions for future advances.

The United States has achieved a high level of growth and earnings through the 1990s as the world leader and has become a model in business administration on a global scale. The progress of this success, however, was not an easy one.

The US enjoyed a period of high economic growth known as the “Golden Sixties” until the first half of the 1960s. From the end of the 1960s through the 1970s, however, US firms tried to free themselves from management models formed under the premise of high economic growth through a process of repeated trials and errors in formulating new management models that could be adapted to low-growth, unstable economic conditions.

At the time, the large majority of US firms were generally reluctant to withdraw from existing business sectors even when they were not profitable. Rather, they opted to proceed with business diversification as an easy way to continued high growth. However, most of these attempts to diversify into new fields in which they lacked experience were unsuccessful. Efforts to introduce other measures such as business divisional systems, SBU (strategic business unit) systems, or internationalization, also failed to achieve favorable results, and a large number of companies suffered from setbacks in their business performance.

Stock markets were so dismayed by the downturns that *Business Week* magazine published a special edition entitled the “The Death of Equities” in 1979. Indeed, it took 17 years until 1983 for the Dow-Jones Industrial Average to recover the high it had recorded in 1966.

During the 1970s, large traditional companies maintained bureaucratic internal organizations and continued to advocate long-term employment. Hostile buyouts were taboo and virtually no cases were actually seen. It need hardly be added that the term shareholder value was a totally foreign concept among most corporate executives.

If we can compare the US situation in 1980 to the current situation in Japan, the process of recovery in the United States from that point to the prosperity of the 1990s offers a good reference for Japan. Several good examples of successful companies can be cited.

2 Successful Examples of Management Reforms in the United States

(1) GE firmly implements business reorganization

It was General Electric, a leader among US industries, which pioneered the road to recovery for the entire American business world. When Jack Welch became GE’s chairman and CEO in 1981, the company was a highly reputed blue-chip corporation with a triple-A bond rating and a 20-percent ROE. Welch’s predecessor, Reginald H. Jones, had retired as a highly respected executive.

However, Jones and other GE executives had been keenly aware of the need to reform the GE management strategies that they themselves had established, as they foresaw a number of tasks the company would have to tackle—including improving productivity, the shift towards high-tech fields and responding to international competition. It was because Welch shared an awareness of the risks and was strongly committed to structural reforms as a promoter of evolution that he was selected as CEO from among 12 candidates.

Although GE was not a high-growth company, it was not under any immediate pressure to start corporate restructuring when Welch took over. The most important issue he had to cope with was the company’s low share prices, as markets were less than enthusiastic about the firm’s conglomerate management strategies of producing a wide variety of products from light bulbs to jet engines. Accordingly, GE’s stock prices were not ranked among the high-growth issues.

Welch’s responses to the market evaluation took the shape of what became known as the “No. 1 and No. 2 strategies” and “Concentration on high-tech, core and service businesses”—new strategies that required structural reforms within the company. The approach also reflected the severe competition with Japanese companies, which was intensifying at that moment. As the first step, each business section was evaluated objectively on whether it would be able to win the race, and the consumer electronics and semiconductor businesses were sold off in accord with the fundamental policy of “not fighting wars we cannot win.”

In line with the business reorganization, Welch concentrated on improving the profitability of the surviving business sectors. In particular, he emphasized the following two dimensions: for business departments, delegating authority and responsibility for achieving the expected results; and for headquarters, breaking up staff sections and reassigning their roles. These two dimensions essentially represented different sides of the same coin. As the first step, the headquarters’ planning department was dis-

solved and its functions were transferred to other business departments.

Instead of being given increased authority, business departments were placed under tight supervision to achieve operational results, with unsuccessful departments facing the possibility of a sell-off or reorganization. The headquarters' role was shifted to an educational one, in which it focused on the development of new business administration tactics, including "Work-Out" (expanding evolutionary movements to the entire company), "Best Practices" (adopting excellent business methods of other firms) and "Six Sigma" (quality improvement activities), and disseminating these new precepts to all departments.

As a result of these reforms, GE's 1999 net profits rose some seven times above the figure for 1980, with its capitalization growing more than 40 fold during the same period. These achievements can be attributed to the fundamental policies Welch started implementing from the day he took over; namely, making stockholder value the first priority. He made it a point to explain his business administration policies and strategies to the capital markets in an understandable manner, and steadily set about to implement these promises.

(2) Outside pressures lead to GM's management reforms

Following its quick recovery from the depressed automotive market at the end of the 1970s, General Motors invested more than \$10 billion in business diversification, plant automation and new product development. Without exception, however, all of these new businesses proved to be unsuccessful, and the company's market share declined by more than 10 points from the second half of the 1980s to the beginning of the 1990s. Moreover, Jack Smith, the company's CEO throughout the 1980s, had ignored the repeated requests of Ross Perot (then a member of GM's executive board) to make business administration reforms and took almost no effective measures of a fundamental nature. As a result, GM recorded a loss in 1990 and the accumulated deficits had expanded to \$4.9 billion in 1991.

Under these critical circumstances, Robert Stempel, who succeeded Roger Smith as CEO in 1990, announced restructuring plans that centered on closing 21 plants and laying off 150,000 employees. Unfortunately, however, these plans were not fully carried out. Faced with the sharp decline in the company's stock price and a lowered rating by S&P, outside directors started to move. At the beginning of 1992, John Smale, former Proctor & Gamble CEO, and other outside directors embarked on a series of in-company examinations that queried senior corporate officers on the company's future prospects and the feasibility of the restructuring plans. These hearings led the outside directors to conclude that the company's current CEO had to be replaced and that business reforms had to be started immediately. The board moved Stempel

to the chairmanship with no actual power, and appointed Jack Smith—who had demonstrated excellent earnings improvements in European operations—as the new CEO.

As his first move, Smith embarked on a variety of operating reforms such as streamlining the corporate headquarters organizations and enhancing productivity. At the same time, he launched on a number of reorganization measures, including selling the Electronic Data Systems (EDS) subsidiary, spinning off the parts unit (Dephi Automotive Systems), and expanding Internet business operations. Global strategies were also promoted as evidenced by increased stakes in two Japanese manufacturers (Suzuki and Isuzu). Coupled with the revitalization of its North American markets, GM's recovery plans were eminently successful, and profits rose to \$6.9 billion in 1995.

As indicated by this example of the world-famous automotive giant GM, the success of outside pressures in pushing for structural reforms offers Japanese companies a valuable lesson in terms of discipline in corporate governance.

(3) IBM's 180-degree turnaround in renewing corporate culture

Under the leadership of John Akers, who had assumed the CEO position in 1985, IBM lagged far behind in the trend towards downsizing and continued to report disappointing corporate performance. As an IBM native who had grown up under the restraints of the company's successful experience in mainframes, inflexible policies (including the commitment to lifetime employment established in the high growth period), and a huge bureaucratic organization, Akers was simply unable to rush into fundamental reforms. IBM recorded unprecedented losses in the 1991 term and accumulated deficits expanded to \$6.8 billion in 1992, forcing the company to announce plans to reduce personnel by some 25,000 and embark on other restructuring plans.

While Akers faced a barrage of severe criticism from a number of groups during this period, it was the USA (Union of Shareholders Associations) that issued the final ultimatum to IBM through widely publicized media reports that it would call for Akers' dismissal at the next general shareholders' meeting and the appointment of a new CEO from the outside. When the California Public Employees' Retirement System (CalPERS) and other major institutional investors also joined in the demand for his head, Akers finally surrendered to the pressure from shareholders and announced his retirement in January 1993.

Following the announcement of Akers' imminent departure, a nomination and remuneration committee headed by James Bark (former CEO of Johnson and Johnson) carried out extensive efforts over a period of three months to recruit a new CEO. Fully aware that a complete reform of the corporate structure was necessary, the committee agreed on finding a candidate out-

side the company and finally nominated Louis Gerstner, then the CEO of RJR Nabisco, to head IBM.

Gerstner's first move as CEO was to completely re-vamp IBM's fundamental policy and to turn the firm into "a service company providing customers with total solutions." The efforts quickly started to pay off and the company recorded a profit of \$3 billion in 1994, which marked a dramatic turnaround from past deficits. Since then, the level of profits has improved year by year to reach a record \$7.7 billion in 1999.

Such phenomenal successes in business administration strategies can be attributed to the intense pressures for reforms exerted by shareholders as well as such drastic moves as bringing in professional executives from the outside. The selection of Carlos Ghosn as Nissan Motor's new president also demonstrates another example of business administration reforms in Japan.

3 Increasing Influence of Institutional Investors

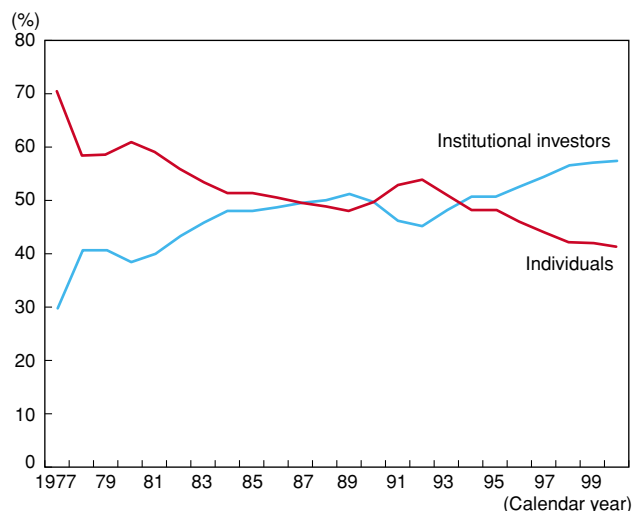
A number of factors can be singled out as contributing to the remarkable success of American companies during the period from the middle of the 1980s through the 1990s in climbing out of the prolonged downturn. These include: (1) US industries were acutely aware of the crisis resulting from the long slump and the rise of new economic powers, including Japan; (2) the IT revolution was achieved under US leadership; and (3) a large cadre of management professionals had been developed. Apart from a comprehensive analysis of business administration reforms that would require a separate report, we will focus on the role of shareholder governance in this article.

Since the beginning of the 1980s, a significant change has taken place in the shareholder composition of major US firms. The most prominent has been the rapid increase in shareholding ratios by institutional investors, including pension funds. As shown in Figure 5, the shareholding ratio of pension funds has grown sharply, from 9 percent in 1970, to 17 percent in 1980 and to 27 percent in 1989.

In his famous 1976 book *The Unseen Revolution*, Peter Drucker predicted that pension funds would come to dominate two-thirds of the shares issued by major US firms by the 21st century, and suggested that if socialism were defined as "the ownership of the means of production by laborers," the United States would become the first truly socialist country in the world. Drucker's predictions started assuming elements of reality at the beginning of the 1980s, and now appear to have reached full fruition as far as major corporations are concerned as we stand at the gateway of the 21st century.

Institutional investors are professional asset managers whose responsibility is to pursue investment returns as the representatives of the original investors. They are usually capable of providing professional supervision of the business administration and long-term operational

Figure 5. Changes in Stock Ownership Ratios by Owner in the US



Notes: (1) Institutional investors: pension funds + investment trusts + banks + insurance companies + foreign investors; (2) Values for 2000 are as of the end of the second quarter; others are as of yearend.

Source: Prepared from *Flow of Funds*, US Federal Reserve Board.

performance of target firms. This shift from stock markets centered on silent individual investors to those dominated by institutional investors has decisively changed conditions for US equity markets, and signals a shift of major proportions in terms of four factors.

(1) Outspokenness of institutional investors

The first factor is that institutional investors are fully willing to aggressively voice their demands for management reforms. In particular, major pension funds such as CalPERS as mentioned above, and the New York State Employees' Retirement System (NYSERS), or the previously cited USA, which was established by the well-known and powerful private investor T. Boone Pickens (and involves some 65,000 individual investors) have been exerting a considerable influence on major firms.

As pension funds are managed with a major focus on index operations, they face some limitations on disposing of specific stocks in principle. Accordingly, they prefer to demand that low-performing firms implement reforms in their business administration, which may lead to improved operational results.

CalPERS has been especially assertive in its demands by publishing the results of Governance Ranking List calculations and negotiating individually with some 10 to 20 problematic firms selected each summer. In cases where negotiations are unsuccessful or refused, or agreements cannot be reached, CalPERS has shown itself willing to exercise its rights on some occasions by submitting proposals, at which time the name of the relevant company is disclosed and cooperation is requested from other institutional and/or individual investors.

In addition, it is important to note that legal reforms have made it significantly easier for dissident shareholders to speak out. In the Trust Union case in 1985, for example, the rights of management to exercise its own

judgment in an issue relating to the merger of a rolling-stock leasing company became the subject of a successful class-action suit by shareholders. And in 1992, the Securities and Exchange Commission relaxed the rules on exchanging views among major shareholders before shareholders' meetings.

Under these circumstances, the "age of executive managers," in which authority was concentrated among top management, has given way to a new age that fully considers the interests of a broad range of stakeholders—including shareholders.

(2) Increasing influence of investment trusts

Investment trusts have seen their share in stockholder compositions expand rapidly during the 1990s, from 7 percent in 1990 to 18 percent in 2000. As the returns from investment trusts are subject to close and constant customer scrutiny, their operations often involve short-term transactions and turnover rates are generally very high compared to those of pension funds. As a result, investment trusts exert a strong influence over stock markets by their willingness to quickly unload a position and drive stock prices down whenever poor performance comes to light.

Many may recall the several recent cases involving CEOs who have fallen victim to plummeting stock prices as a result of short-term trading. These include the dismissal of Procter & Gamble CEO Durk Jager due to large declines in stock prices caused by the acquisition of pharmaceuticals giant Warner Lambert and continuing downward revisions in earnings estimates.

(3) Increasing M&A and LBO cases

Direct attacks against companies that have delayed needed administration reforms include mergers and acquisitions (M&As) and leveraged buyouts (LBOs; an acquisition tactic in which money is borrowed against the target's own assets to finance the buyout). Specifically, the number of hostile M&A and LBO initiatives increased significantly in the United States from the 1980s to the 1990s in response to the sluggish stock markets.

In addition to such direct effects, structural reforms predicated on the logic of capital markets have increased the pressure on corporate executives by letting them know that they may be fired if such reforms are unsuccessful. As a result, both M&As and LBOs have played important roles in the US economic recovery since the 1980s.

(4) Strengthened supervisory functions by the board of directors

Since the 1980s, we have seen a marked increase in the number of outside directors sitting on the boards of major firms. Indeed, there are not a few companies in which the only insider on the board is the CEO, as seen in companies like IBM and Coca-Cola. Although people from different walks of life such as prominent members of the clergy were frequently nominated to outside directorships

in the past, executives with long and extensive experience in other companies have most often been selected in recent years. A number of overseas executives have also been invited to serve.

These moves are intended to strengthen the supervisory functions of the board of directors and encourage its functional separation from corporate officers. Specifically, a board of directors should be able to control the behavior and decisions of the CEO and COO (chief operations officer), who represent the internal corporate officers, by their professional management capabilities in terms of comparable or superior administrative judgment.

This being the case, what can we make of the way in which these outside officers have been exercising their increased power on the board? Our analysis of several examples would indicate the following. First, as they are directly exposed to shareholder views, outside directors have played an active role in demanding that corporate officers implement needed reforms. In many cases, outside directors have tended to gather around a key person and have acted as a body in making their wishes known. In the most drastic cases, the CEO and other existing corporate officers have been dismissed and replaced by outside professionals.

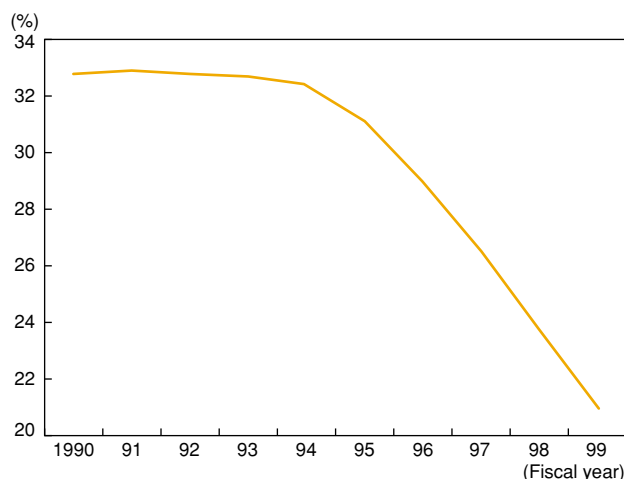
IV Governance Promotes Responses to Changes

1 Changing Governance Structure in Japanese Companies

The shareholder composition of Japanese companies has been rapidly changing over the past few years. One important factor accelerating this trend has been the rush by banks and related companies to shed cross-held shares and back away from the practice entirely. As indicated in Figure 6, Japanese companies have been trying to dissolve such relationships since 1995 and the ratio of cross-held shares among total holdings has declined to 21 percent.

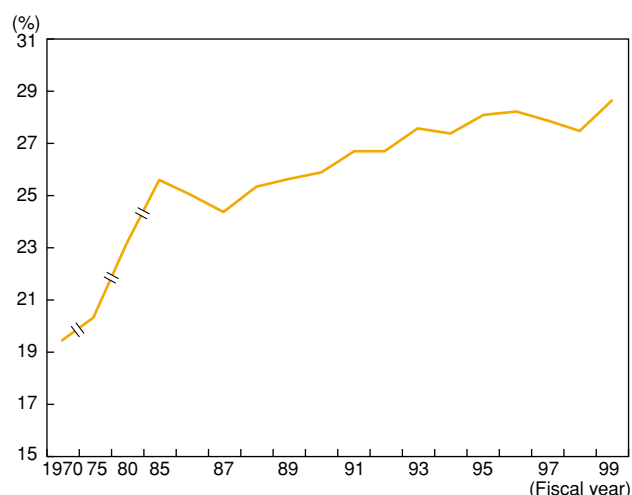
There are several reasons that this long-observed practice has now fallen into disfavor. In the first place, the introduction of the current value accounting system is forcing companies to evaluate their portfolios under current values, resulting in increased stockholding risks. In addition, as financial institutions are being pressed to improve asset profitability, they simply no longer have the marginal capacity to hold the stocks of transactional partners. For companies with limited need for bank financing, moreover, holding bank stocks just means an ineffective use of their cash reserves. Another factor has been the weakening of the affiliation relationship among companies in recent years. As a result of all of these factors, companies are expected to sell off more than ¥8 trillion in cross-held shares during fiscal 2000.

Figure 6. Changes in the Cross-Holding Ratio Among Japanese Companies



Note: The cross-holding ratio is defined here as the ratio of listed shares (current value basis) owned by the total of listed companies. The number of listed shares of all listed companies is included.
Source: Financial Research Center, Nomura Securities.

Figure 7. Changes in the Ratios of Shares Owned by Institutional Investors



Note: Institutional investors: pension funds + investment trusts + banks + insurance companies + foreign investors
Source: Prepared from *Stock Distributions Surveys*, National Exchange Association.

On the other hand, institutional investors have substantially increased the ratio of equity issues in their portfolios. As seen in Figure 7, the ratio of corporate stocks held by pension funds, life and casualty insurance companies, investment trusts and non-Japanese investors will reach 30 percent of total assets by the end of fiscal 2000. This means that the same phenomenon that occurred in the United States in the 1980s is now taking place in Japan. And as more money continues to pour into pension funds and investment trusts, the role of institutional investors as shareholders is expected to grow even larger.

2 Reinforced Supervision Over Companies

This elimination of cross-held shares and the increasing power of institutional investors as shareholders are expected to have a significant impact on companies and corporate management. In the first place, such investors will

demand major improvements in the generally low profitability of Japanese companies, thereby intensifying the interrelationship between profitability and corporate values. In the age when the practice of cross-holding shares dominated all industries, companies holding the stocks of other firms had ways of earning investment returns rather than through rising stock prices and dividends.

For example, shareholder banks could acquire higher returns as a whole if the companies in which they held shares maintained large credit lines at high interest rates. And automobile manufacturers that held the stocks of affiliated companies benefited from the cooperation of these parts makers in developing high-quality cars. In short, shareholders faithful to the cross-holding practice remained satisfied as long as a cooperative relationship could be maintained with the companies in which they held a stake. And as both companies submitted blank proxies to the general shareholders' meetings of the other, the owners of cross-held shares had absolutely no impact in terms of scrutinizing the performance or practices of the target firms.

On the contrary, institutional investors own stocks purely for the purpose of earning a high return from price increases and dividends. Because of this, they are constantly supervising the targets of their investments with respect to implementing adequate measures to secure long-term growth and proceeding with necessary structural reforms in response to market changes. The net result is that corporate governance by shareholders in the true sense of the term is now starting to appear in Japanese markets.

3 Boardroom Reforms on the Starting Line

It was Sony that heralded governance reforms in Japan as a result of its American-style shareholder composition—domestic institutional investors and non-Japanese investors own two-thirds of the issued shares. The company has developed a top management structure that enables quick strategic decision-making under an environment specific to Japan.

Sony had already embarked on a series of structural reforms in 1994, including the introduction of an in-house company system and the reinforcement of headquarters functions. In addition, the company reorganized its board of directors and corporate officer system. The number of directors was reduced from 38 to ten, including two outside directors, and the board's responsibilities were redefined to cover only decision-making concerning management policies for the entire Sony group and acting as the representatives of the shareholders in supervising the operational functions of corporate officers. As the officials responsible for the operation and the management of individual businesses, corporate officers were entrusted with the authority relating to actual business administration. They were also assigned the responsibility to realize the expected earnings for the businesses under their control.

“Different personal traits are needed for a director who develops long-term strategies and a corporate officer who supervises business site activities,” said Chairman Nobuyuki Idei. “Just one year after the start of the new system, the board of directors has finally grown up to freely discuss strategies.” As Idei’s comments indicate, essentially different roles, authority, and personal qualifications are required for a director and a corporate officer. And one issue that Sony’s board of directors discussed at length throughout the second half of 2000—and which required the longest deliberations of any item ever to reach the board’s agenda—was essentially this: “What should we do now as we enter the 21st century?” (Nikkei Business, January 1, 2001).

Encouraged by the reforms of Sony’s board, similar moves have been rapidly gaining ground among Japanese companies in the past few years, including the introduction of corporate officer systems, seating outside directors on the board, and establishing advisory boards.

The concept of an in-house company system is further augmented by a pure holding company. As an organization that is the true representative of the shareholders, a holding company is responsible for planning long-term strategies and the supervision and inspection of subsidiaries under its role as the major shareholder. In particular, the holding company system is expected to realize significant effects in promoting autonomous and decentralized administrative measures for large companies. As consolidated settlements are not yet allowed for this system, a number of companies are passing up opportunities that could be valuable. But once consolidated settlements are allowed after 2002, cases in which this system is introduced are expected to increase.

4 Towards the Creation of a New Administrative System

The rebirth of the Japanese economy depends on whether Japanese companies can recover from the current slump and achieve high growth and profitability. In examining the possibility of such a recovery, we have to start by looking at the following three fundamental conditions.

The first condition is that the environments surrounding Japanese companies will change further while they try to improve their management positions, and they will be exposed to severe global competition in the domestic and international arenas.

The second is the fact that Japanese companies have failed to implement structural reforms and have opted instead for some minor modifications in the existing systems during the past ten years following the collapse of the bubble economy—as did the Japanese government. As a result, their profitability remains at a low level.

And the third is that the influence of institutional investors who focus on investment returns has been strengthened in line with the dissolution of the practice of cross-holding shares.

As these factors continue to unfold, corporate governance by shareholders will inevitably become stronger. In short, structural reforms will be encouraged as we move towards a new age.

This also means that the improvement of corporate profitability will become more important than ever. As gradual reforms will no longer be adequate to meet the pressing demands of shareholders, an increasing number of companies are expected to start restructuring through undertaking major reforms. This means that flexible enterprise models with the capability of quickly responding to changes will gain the upper hand among industries, and the type of high-growth stable models from the past will gradually disappear.

The greatest challenge facing companies will be the problem of employment. Of course, it is obvious that emphasizing the importance of employees is the key to business administrative success in the East as well as the West. In a period of structural reforms, the reeducation of employees and the enhancement of employment flexibility become urgent tasks for management, and the government needs to take prompt action to construct effective employment safety nets. Now that the entire work force is being reduced, mismatches in the labor force are expanding, creating a pressing need for improving and reforming the labor distribution markets.

Takashi NARUSAWA is a managing director of NRI, and the head of the Research/Consulting Division. His specialty includes business administration and financial strategies.

Masafumi EMORI is a consultant in the International Consulting Department. His specialty includes international business administration.

Satoshi OHMORI is a consultant in the Industrial Consulting Department. His specialty includes business strategies and the electronics industry.

As a leading think-tank and system integrator in Japan, Nomura Research Institute is opening new perspectives for the social paradigm by creating intellectual property for the benefit of all industries. NRI's services cover both public and private sectors around the world through knowledge creation and integration in the three creative spheres; "Research and Consulting," "Knowledge Solutions" and "Systems Solutions."

The world economy is facing thorough structural changes led by the dramatic growth of IT industries and the rapid expansion of worldwide Internet usage—the challenges of which require new concepts and improvement of current systems. NRI devotes all the efforts to equipping the clients with business strategies for success by providing the best in knowledge resources and solutions.

NRI Papers present selected works of NRI's 3,000 professionals through its worldwide research network. The mission of *NRI Papers* is to contribute new ideas and insights into business management and future policy planning that are indispensable for overcoming the obstacles to the structural changes in our society.

All copyrights to *NRI Papers* are reserved by NRI. No part of this publication may be reproduced in any form without the prior written consent of NRI.

Inquiries to: Editorial Section I
Corporate Communications Department
Nomura Research Institute, Ltd.
E-mail: nri-papers@nri.co.jp
FAX: +81-3-5255-9373