

Options Available for Japanese Companies in a Globalized Market Environment

Yujiro TAKI, Jun NISHINO, Yasushi KONUMA

Nomura Research Institute

Options Available for Japanese Companies in a Globalized Market Environment

Yujiro TAKI, Jun NISHINO, Yasushi KONUMA

- I Changing Corporate Governance Environment and Widening Gaps between Companies
- II Active Shareholders Having Major Impact on Corporate Governance
- III Factors behind the Increase of Companies Pursuing Conservative Growth and Their Conduct
- IV Behavioral Principles of Companies Pursuing Aggressive Growth Strategies
- V Companies Opted to Leave the Market in Pursuit of Growth
- VI Future Direction of Corporate Behavior

In recent years, Japanese companies have been facing growing changes in their business environments. In their efforts to meet these changes, Japanese companies can broadly be divided into two groups. One group of companies aims to achieve greater corporate value through firmly establishing and augmenting their core businesses; the other group does not. Among companies striving to raise their corporate value, many are making full use of not only their internal management resources but also outside resources.

While the Japanese institutional environment is also undergoing major changes, an increasing number of shareholders started to intervene in business management with their deep understanding of “corporate value” and “shareholder value.” To successfully deal with such an environment, Japanese companies must show strategies to the market that set forth measures to maximize corporate value in a rapid manner and that can convince the market, and must actually implement such strategies.

Delays in enhancing corporate value as seen in some companies are attributable to the poor recognition of their management executives regarding corporate value, which widens gaps between these companies and the capital market. These companies tend to adopt measures to attract stable shareholders and to prevent hostile takeovers. Because the market does not endorse such measures, their corporate value is lowered even further, falling into a vicious circle.

At the same time, some companies are skillfully utilizing outside management resources and M&A (merger and acquisition) schemes to further augment their corporate value. Nevertheless, there is a growing difference in market capitalization between even such companies and the world’s top-ranked companies.

There are also companies that consider it difficult to achieve growth from mid- and long-term perspectives while keeping their shares listed on the stock exchange. After reconsidering the importance of listing, these companies have decided to delist their shares and have been pursuing the enhancement of their corporate value outside the market.

Becoming a winner in the global market is predicated on how quickly corporate value can be enhanced. If a company finds it difficult to pursue the improvement of corporate value while continuing to list their shares, one realistic option is to build corporate value outside the market.

Recently, Japan's capital market has been undergoing major changes through such occurrences as the globalization of management, financial liberalization and the elimination of cross-shareholdings. Spurred on by these changes, shareholders have been increasingly engaging in governance activities, leading to changes in corporate behavior.

This paper suggests the direction that Japanese companies should proceed in response to vitalized governance activities by shareholders.

I Changing Corporate Governance Environment and Widening Gaps between Companies

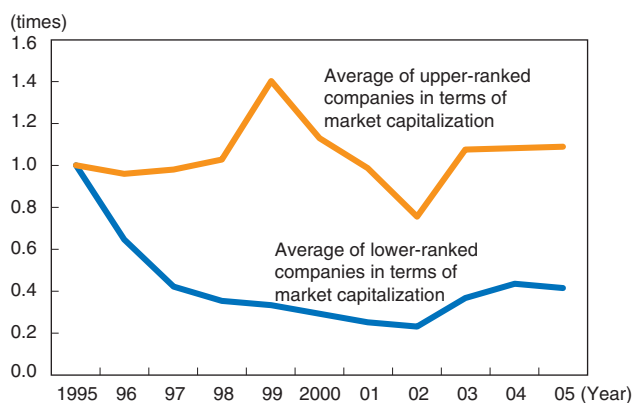
1 Japanese Companies Separating into Two Groups

In recent years, along with the globalization of management, progress has also been made in the globalization of the capital market. Through such progress, European and Japanese capital markets are becoming increasingly influenced by the US capital market. For example, hostile takeovers, which once took place only in the US, have begun to occur in continental Europe and Japan in the past several years. Furthermore, the behaviors of active shareholders have become increasingly prominent not only in the US but also in Europe and Japan.

As if keeping pace with such changes in the capital market, gaps in market capitalization between companies are widening in Japan.

In Figure 1, companies with high market capitalization and those with low market capitalization as of July

Figure 1. Changes in Market Capitalization of Upper- and Lower-Ranked Companies



Notes: (1) The top 10 percent of companies in the ranking of market capitalization in 2005 among companies listed on the First Section of the Tokyo Stock Exchange are grouped as upper-ranked companies; the bottom 10 percent of such companies are grouped as lower-ranked companies. The average of the market capitalization for each year is calculated respectively. (2) By regarding the average of the market capitalization of each group in 1995 as 1, the value at the end of March of each year is calculated. (3) Companies that have continued to be listed since 1995 were subjects of this survey.

2005 are grouped, and changes in value during the past decade are shown. Although some fluctuations occur from time to time due to economic conditions, the upper group increased its market capitalization as compared to that of ten years ago. However, the lower group substantially decreased its market capitalization during the same decade, widening the gap between the two groups.

As background factors, such a phenomenon is attributable to the development of the competitive environment through various deregulation measures and structural reforms as well as an increase in the number of shareholders who actively demand improvements in corporate value.

Incidentally, this paper treats market capitalization as a synonym for corporate value. This is because if shareholder value (market capitalization) increases from the financial perspective, corporate value (sum of market capitalization and interest-bearing liabilities) also increases.

2 Corporate Activities Aiming to Strengthen/Establish a Core Business

Since the 1990s, as represented by the core competence management theory, the concept that "allocating management resources to a core business on a focused basis will contribute to the maximization of corporate value" has penetrated into most European, US and Japanese companies.

The core business that fully utilizes a company's strengths constantly varies according to the market environment such as technical innovations and changes in customer demands. Because of this, a company must continually be aware of what its core management resources are, including technology that serves as a seed of future growth, human resources, customers and management expertise. Achieving sustainable growth requires the perspective of "how to establish a new core business" in addition to that of "how to strengthen an existing core business."

Actually, companies that announce their growth strategies that take these perspectives into account to the capital market in an easy-to-understand manner and that implement such strategies are properly evaluated by the capital market and are increasingly improving their corporate value. Such companies give high priority to the enhancement of corporate value and have a strong tendency to focus their investments on their core business by taking risks to divest themselves of non-core businesses.

For example, Konika Minolta Holdings withdrew from the photo film and camera business. Such a withdrawal indicates that the company's core business had shifted from photo imaging to business technologies such as multifunctional copy machines and optics such as LCD materials.

Besides these moves, in addition to their own management resources, companies are also actively utilizing

outside management resources by establishing strategic alliances and/or implementing M&As (mergers and acquisitions) in order to strengthen and/or establish a core business. For example, Sony and Nippon Sheet Glass implemented M&As to reinforce their existing core businesses. Sony purchased the digital single-lens reflex camera business from Konika Minolta Holdings to augment its digital camera business. Nippon Sheet Glass acquired Pilkington plc in the UK with the aim of further strengthening its sheet glass business.

SoftBank and Toshiba implemented M&As with the objective of establishing a new core business. SoftBank purchased Vodafone Japan to enable participation in the mobile phone market. Toshiba acquired Westinghouse in the US to enhance its nuclear energy business.

In contrast, some companies are unable to strengthen their core business and some are unable to establish a new core business. In many cases, these companies generally have a low recognition of corporate value and a tendency to pursue conservative growth strategies without taking risks. Because their evaluation in the capital market is low, it is highly likely that their stock prices may be undervalued. Actually, the price book-value ratio (PBR) of about 25 percent of companies listed on the First Section of the Tokyo Stock Exchange is less than 1, indicating that their stock prices are undervalued. In addition, there are many companies that follow conservative growth strategies and are not making any progress in strengthening and/or establishing a core business, even if their PBR is above 1.

The next chapter discusses changes in the capital market environment that form background factors behind the widening of disparities between companies.

II Active Shareholders Having Major Impact on Corporate Governance

1 Institutional Reforms Stimulate Competitive Environment

In May 2006, the Corporate Law came into force. The effect of this law can be viewed as incorporating all measures for deregulation as represented by the Big Bang in the financial sector in 1996 and all measures for applying international standards to structural environments.

The Corporate Law has enabled a more flexible institutional design (design of company organs such as a general shareholders' meeting and a board of directors) than before at a company's own discretion, and increased the extent of management autonomy. At the same time, the law has required companies to exercise greater accountability to their shareholders, thereby strengthening the functions of management supervision by shareholders. In addition, the introduction of new accounting systems,

such as accounting for the impairment of assets and accounting for business combinations, will increase the transparency of corporate management.

Through progress in international standardization of various systems, a competitive environment is being established that requires each company to maximize its corporate value. Such an environment will enable companies that have strengthened and/or established a core business and are expanding their corporate value to evolve strategies that are more active.

2 Increasing Number of Shareholders Actively Intervening in Corporate Management

Figure 2 shows changes in the equity ownership ratio (on a monetary basis) by investor. According to this graph, during the past 15 years, the equity ownership ratio of operating companies and that of financial institutions, under a cross-shareholding scheme, decreased, and those of foreign and individual investors increased.

Table 1 divides shareholders by two attributes: "long-term vs. short-term ownership" and "active vs. passive shareholders."

Governance activities by shareholders include the following four patterns.

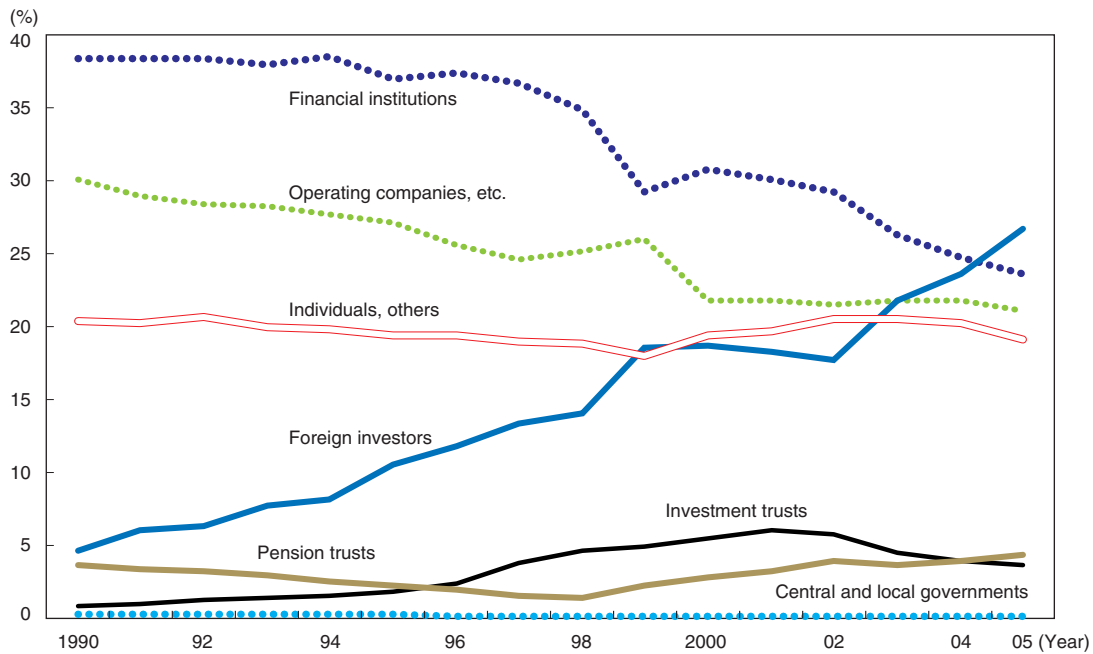
- (1) When an investor is dissatisfied with the management of an invested company, the investor conveys such dissatisfaction to the management by selling its shares (the so-called Wall Street Rule).
- (2) An investor exercises a shareholder's right by nominating a director or making a management proposal to an invested company.
- (3) An investor expresses its opinion by voting in favor of or against an agenda item at a shareholders' meeting (exercising voting rights).
- (4) An investor puts pressure on management executives of a target company to improve corporate value by initiating an acquisition action (a hostile takeover).

All four of these patterns are applicable to the behaviors of active shareholders, and Item (1) is applicable to passive shareholders, which usually form the majority in Japan.

According to Figure 2, in recent years, the number of shareholders falling under Category III in Table 1 has been decreasing and the number of shareholders falling under Categories I, II and IV in the same table has increased.

(1) Active shareholders holding shares for a long time
Shareholders falling under Category I in Table 1 are active shareholders who usually hold shares for a long time. Specifically, these shareholders include investment funds and institutional investors that actively exercise

Figure 2. Changes in Equity Ownership Ratios by Investor (on Monetary Basis)



Note: Investment trusts and pension trusts are not included in the figures for financial institutions.
 Source: "Stock distribution survey for fiscal 2005 (summary version)," Tokyo Stock Exchange, etc., June 2006.

Table 1. Attributes of Shareholders

	Active shareholders	Passive shareholders
Long-term ownership	I <ul style="list-style-type: none"> • Investment funds • Active institutional investors 	III <ul style="list-style-type: none"> • Shareholders through cross-holdings • Japan's financial institutions
Short-term ownership	II <ul style="list-style-type: none"> • Greenmailers • Activists 	IV <ul style="list-style-type: none"> • Hedge funds • Day traders

their voting rights. Because these shareholders require a majority of voting rights to enable them to have their opinions acted upon, they are usually major shareholders.

Especially in recent years, the number of cases in which investment funds intervene in management has been increasing under a worldwide trend towards excess liquidity. In the past, investment funds tended to buy and sell shares in a short term after demanding a substantially increased dividend. Recently, however, these funds have been investing from the viewpoint of whether it is possible to raise corporate value from the mid- and long-term perspectives, without necessarily aiming to earn profits through short-term holdings.

In the future, major overseas investment funds that have successfully improved the value of many companies in the European, US and other markets are expected to actively practice their investment activities in the Japanese market.

At the same time, institutional investors, primarily overseas institutional investors, have started to aggressively exercise their voting rights based on their independent standards. For example, CalPERS (the California Public Employees' Retirement System), which is

America's largest pension fund, analyzes a company's added value, its investment performance and its corporate governance. Based on the findings of such analyses, CalPERS directly gives its opinions and makes proposals to the management of a company not showing satisfactory performance.

In Japan, in February 2003, the Pension Fund Association announced its standards for exercising voting rights. There are also moves among some institutional investors such as defined-benefit pension funds to select companies for investment by considering a company's posture to values of other stakeholders in addition to shareholder value. Funds making socially responsible investments (SRIs) examine whether a company is fulfilling its social responsibilities from ethical, social and environmental aspects.

This means that these investors are aware that management must consider other stakeholders in addition to shareholders in order for a company to enhance corporate value from the mid- and long-term perspectives.

Shareholders falling under Category I in Table 1 usually have highly professional understanding about the improvement of corporate value, and actively offer their

comments and/or make proposals to management executives. Because these investors are becoming involved from the mid- and long-term perspectives, their concerned involvement may function as a positive factor to improve corporate value in some respects if management executives can skillfully work with them.

(2) Active shareholders aiming to earn capital gains by selling shares through short-term ownership

Among active shareholders, those who intend to hold shares for only a short time fall under Category II in Table 1. Specifically, these shareholders include activists who buy shares on the assumption of short-term ownership as represented by the Murakami Fund, and greenmailers.

Shareholders in this category attempt to coerce companies that have surplus and/or idle assets to distribute profits to their shareholders by selling or effectively utilizing such assets, and/or increasing dividends. Shareholders who sell their shares when the stock price goes up because of the measures taken by the targeted company to meet their demands are called activists. Shareholders who purchase enough shares to threaten a takeover and force the target company to buy back such shares at higher prices are called greenmailers (a play on the words “greenbacks” for US dollars and “blackmail”).

Because the goal of activists is the improvement of corporate value by actively making proposals to management and then selling shares when corporate value is increased, it can be argued that the other shareholders also benefit. In contrast, greenmailers impair corporate value because only the acquirers obtain profits. However, there is no clear borderline between activists and greenmailers.

In many cases, the shareholders falling under Category II in Table 1 cause headaches for management executives because they become involved in management on the assumption of short-term ownership. With the strengthening of the monitoring functions by shareholders through the enforcement of the Corporate Law, companies with poorly developed governance systems and whose shares are undervalued are highly likely to become targets of these shareholders.

In other words, companies that are unable to strengthen or establish their core businesses and, because of this, whose corporate values remain low are prone to become targets of activists and/or greenmailers.

(3) Passive shareholders holding shares for a long time

Conventional financial institutions and shareholders owning shares under a cross-holding scheme fall under Category III in Table 1.

Generally, a cross-shareholding scheme that has little strategic meaning is exposed to the criticism of stakeholders including shareholders. For this reason, with pressure from shareholders getting stronger in the future, the number of companies adopting this scheme is expected to decrease.

On the other hand, moves have also been seen in some companies recently to resume cross-shareholdings to deal with the increased risks of hostile takeover bids. These moves are described in detail in Chapter III.

(4) Passive shareholders aiming to earn capital gains by selling shares through short-term ownership

Shareholders falling under Category IV in Table 1 simply pursue returns on investment. Specific examples include hedge funds aiming at arbitrage (this is the practice of taking advantage of inefficient market price formation in which profit is gained with no risk by purchasing undervalued assets and selling overvalued assets) and day traders who hold shares only for a short time.

In order for companies to secure liquidity, a certain number of such shareholders is necessary. Yet, more than a few companies are plagued with intense fluctuations in their share prices due to increases in the ratio of these shareholders.

As such, the objectives for holding shares and the sense of value that shareholders have are becoming more diverse, which naturally leads to the diversification of shareholder behaviors. Accordingly, companies are required to address such diversification in shareholder needs and sense of value.

In the future, in particular, active shareholders coming under Categories I and II who have a high-level understanding of “corporate value” and “shareholder value” and who actively exercise their rights as owners are expected to have greater influence on corporate management. This situation requires companies to establish strategies for improving corporate value that can quickly meet the expectations of the capital market and that are compatible with investors’ sense of value. Companies that are successful in establishing such strategies will be able to build the trust of the capital market. However, companies that can only present conservative growth strategies that lack rapid response and the ability to convince the capital market will not be able to gain the confidence of the capital market.

III Factors behind the Increase of Companies Pursuing Conservative Growth and Their Conduct

1 Japanese Management Model Giving Rise to Conservative Growth Strategies

One of the primary reasons behind the existence of a great number of companies pursuing conservative growth strategies is the Japanese management model

that was in favor before the collapse of the bubble economy. The features of such a model can be summarized as follows:

- From the perspective of fund procurement, funds are chiefly provided by a main bank at low cost and in a stable manner. Upon entering the 1980s, however, among listed companies, direct fund raising from the capital market by means of equity finance and debt finance increased.
- From the perspective of personnel management, stable employment relations are maintained based on lifetime employment and seniority systems.
- From the perspective of shareholder relations, stable relationships are established by means of cross-shareholding schemes.

Prior to the collapse of the bubble economy, Japanese companies had made efforts to develop stable shareholders and had established a system in which shares were mutually held by related companies. Institutional investors such as investment trusts, non-life insurance companies and life insurance companies as well as individual investors accepted their position as passive shareholders. Under this stockholding structure, there were almost no cases of hostile takeover bids and almost all agenda items proposed by a company's management were approved at the shareholders' meeting.

In other words, until the collapse of the bubble economy, nobody other than management executives supervised the management of a Japanese company. Authority was concentrated in the management executives and not much attention was paid to their accountability.

Management executives who were comfortable under such an environment unconsciously tended to maintain peaceful relationships with passive shareholders, and such intentions were reflected in their management stance. Actually, these behavioral principles of management executives could be seen in the actions taken by Japanese companies in the past and in recent cases in which gaps in recognition between a company's management and its shareholders were exposed.

For example, since the latter half of the 1990s, in response to demands by overseas institutional investors for the enhancement of corporate value, programs embracing corporate value have been introduced by many Japanese companies. These programs were chiefly for the sake of formality, such as stock options (rights to purchase shares at a predetermined price) and economic profit, which is well known as EVA or economic value added, a registered trademark of Stern Stewart & Co. However, only a limited number of companies could actually build a management system that is consistent up to a level at which corporate value can actually be improved.

Upon entering the 2000s, with the emergence of active shareholders, companies have faced increased pressure for

effective utilization of surplus assets. While many companies have been implementing measures to return profits to their shareholders through means such as dividend increases and liquidation of a company's own shares, only a small number of companies have concurrently defined mid- and long-term growth strategies. Actually, measures to return profits to shareholders should be determined along with strategies to improve corporate value from the mid- and long-term perspectives.

In many cases, rather than implementing bold strategies at the risk of failure to improve corporate value, companies opt for conservative decision making that entails no risks. For example, European and US companies substantially and autonomously change their business domains and business portfolios. In Japan, however, there have been no such cases of drastic group-level reorganization.

Instead, companies tend to focus on "how to avoid interference in management by shareholders who actively present their own views about management" or "how to prevent a hostile takeover by a third party."

Companies pursuing conservative growth strategies still give priority to periodic income indexes based on profit and loss statements such as sales and profits, and have an inadequate understanding of corporate value indexes such as the cost of capital and economic value added (EVA). In addition, because the common meaning of the term "corporate value" in the capital market is lost on these companies, gaps in understanding between these companies and their shareholders with respect to corporate value have been widening.

2 Behavioral Principles of Companies Pursuing Conservative Growth Strategies

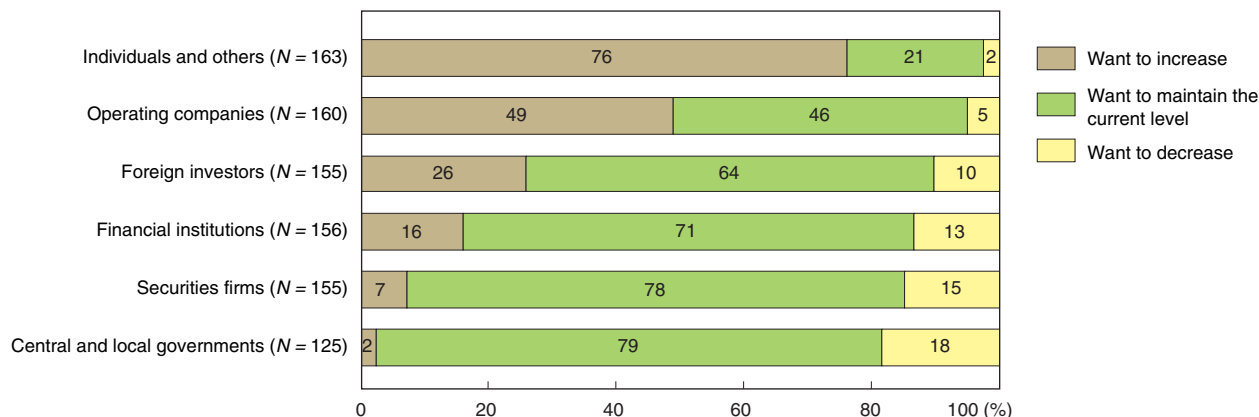
When companies pursuing conservative growth strategies have decided to adopt a cross-shareholding scheme and/or introduce measures to defend against a hostile takeover, an increasing number of institutional investors have been putting up opposition. The reasons for such opposition can be boiled down to the fact that no consideration is given to the enhancement of corporate value and/or securing shareholder interests.

After the collapse of the bubble economy, Japanese companies moved to unwind cross-shareholdings. Because the companies faced the need for business restructuring and improving financial standing, shares mutually held by the companies were sold in the form of "selling by the piece" as part of the process of disposing of assets held.

However, in recent years, shareholders have become increasingly involved in management and the risks of hostile takeovers have been increasing. Such a situation has been encouraging companies to move to resume cross-shareholdings.

Figure 3 shows the results of a questionnaire survey conducted by Nomura Research Institute in May 2006 of the presidents of companies listed on the First Section of

Figure 3. Desired Shareholder Composition in the Next Ten Years from the Perspectives of the Presidents of Japanese Companies



Source: Compiled based on a questionnaire survey conducted by Nomura Research Institute in May 2006 of the presidents of companies listed on the First Section of the Tokyo Stock Exchange.

the Tokyo Stock Exchange. In this survey, about half of the respondents selected “operating companies” as the type of shareholders that they want to increase in the future.

Generally, business partnerships are the primary reason for an operating company to hold shares. However, it is highly likely that a certain ratio of such holdings constitutes cross-shareholdings that do not affect corporate value.

Actually, Nippon Steel, Sumitomo Metal Industries and Kobe Steel moved to strengthen capital ties in the face of a threat of a hostile takeover by foreign companies. Another example is the start of cross-shareholdings between FamilyMart and Ryohin Keikaku.

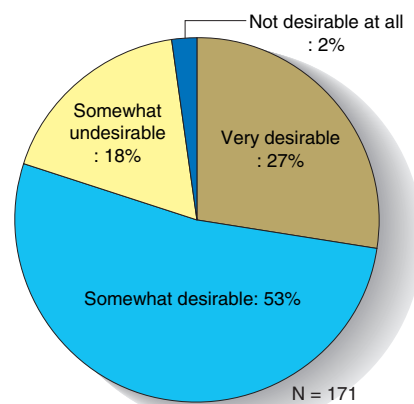
In view of these moves, investors, in particular overseas institutional investors, have voiced their objections on the grounds that such moves are out of synchronization with the times.

At the same time, since 2005, an increasing number of companies have been adopting measures to defend against hostile takeovers. According to a survey conducted by Nomura Securities, 170 listed companies had announced such measures as of July 2006.

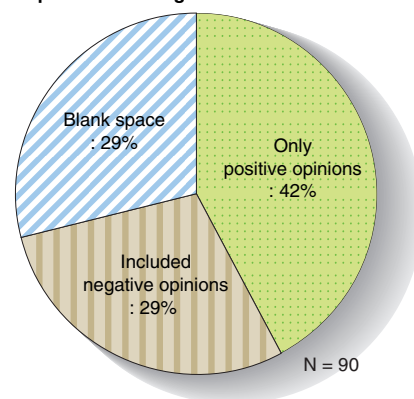
However, the market shows stern response to most companies introducing such measures. In many cases, the stock prices of companies that announced such measures have hovered at a low level. In the case of Nippon Steel, mentioned above as well, its stock price has remained weak for some time after the company’s announcement of defensive measures. Because numerous factors can be assumed for such a weak response, it would not be correct to unconditionally attribute declines in stock prices to defensive measures. Nevertheless, the market gave a relatively negative reaction to such decisions, which was contrary to the intentions of companies endeavoring to preserve appropriate corporate value through the adoption of such measures.

If shareholders consider such defensive measures as having a strong tinge of protecting the interests of man-

Figure 4. Views of Presidents regarding Moves towards Shortening the Account Settlement Cycle and Stricter Accounting Rules



Open-ended Answers by Companies Selecting “Somewhat Desirable”



Source: Compiled based on a questionnaire survey conducted by Nomura Research Institute in May 2006 of the presidents of companies listed on the First Section of the Tokyo Stock Exchange.

agement executives and thus having a high possibility of impairing the improvement of corporate value, such decisions may likely result in not only opposition raised by many institutional investors but also in a decline of stock prices.

Management executives who attempted to seek stable management status through the adoption of defensive measures ended up revealing their poor understanding of increasing corporate value.

While the market also seeks to shorten the account settlement cycle (for example, from quarterly to monthly) and the adoption of stricter accounting rules, management executives also show their concerns over these issues. According to Figure 4, which shows the results of the questionnaire survey, many responses selected “desirable,” reflecting their official posture. However, about 30 percent of the open-ended answers of the respondents that selected “somewhat desirable” noted concerns over costs as well as concerns over corporate management leaning towards pursuing short-term achievement.

As these findings suggest, while many management executives are aware that they should deal directly with shareholders, they are reluctant to accept intervention in management by concerned shareholders. This tendency appears to be stronger in companies pursuing conservative growth strategies that have a poor understanding of corporate value.

IV Behavioral Principles of Companies Pursuing Aggressive Growth Strategies

1 Wholeheartedly Devoted to Enhancing Corporate Value

While many Japanese companies are following conservative growth strategies, some companies are raising their

corporate value by taking risks in implementing aggressive growth strategies. The features of these companies can be found in their strategies that are conducted with agility and are fully convincing to the capital market, and in the implementation of such strategies to establish and augment core business. One of the means for this purpose is the utilization of outside management resources through M&A, etc.

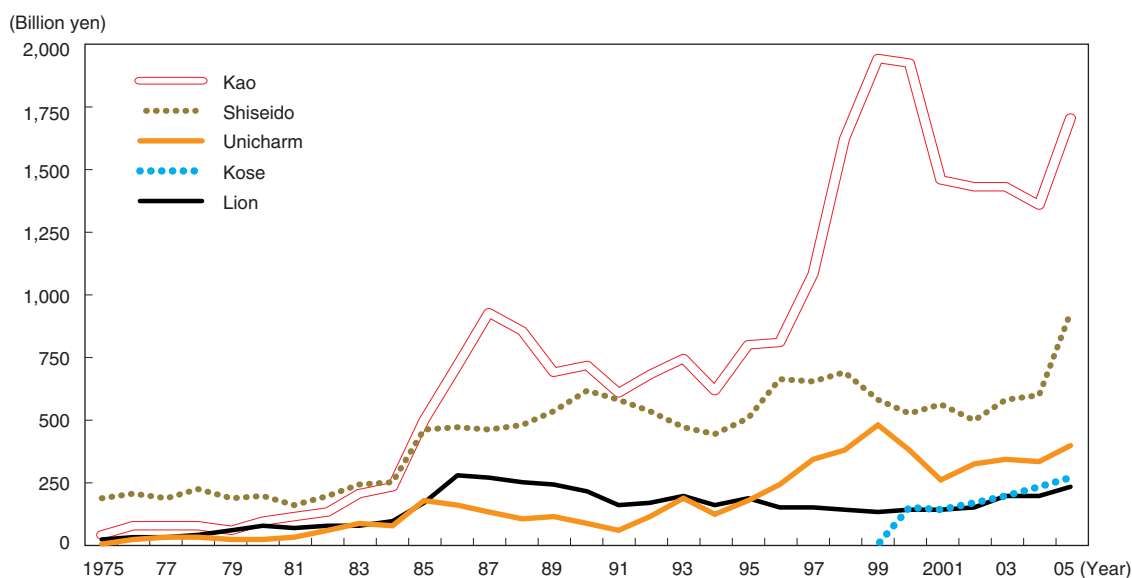
As a typical example of cases that employ these techniques, the following section discusses cases in the toiletries and cosmetics industries in Japan and the United States. As is clear in Figure 5, which indicates changes in the market capitalization of the top 5 companies in the Japanese toiletries and cosmetics industry, market capitalization of Kao has sharply increased since 1985 as compared to other companies.

Table 2 also indicates a greater number of M&A transactions conducted by Kao than by other companies. These data suggest that Kao increased its market capitalization by making full use of outside management resources through repeated M&As in addition to its efforts to augment its growth by using internal management resources. However, there are large gaps in corporate value between top-ranked global companies and even Kao, which is considered one of leaders in the Japanese market.

Figure 6 compares the market capitalization of Kao and P&G (Procter & Gamble) over the past 20 years. While their business domains are not exactly aligned, these companies are used as target companies for comparison because the toiletries and cosmetics sector is a core business for both of these companies.

What is notable about this figure is that as we entered the 1990s, the difference in market capitalization between Kao and P&G has substantially expanded. In the same way as with many American companies, Kao

Figure 5. Changes in Market Capitalization of Top 5 Toiletries and Cosmetics Companies



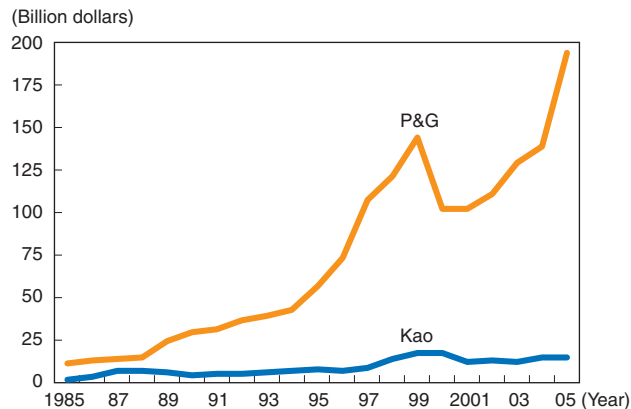
Note: Market capitalization as of March 31 each year.

Table 2. Comparison of Number and Value of M&A Transactions in the Japanese Toiletries and Cosmetics Industry

(Unit: Million dollars)

	1985 – 1994		1995 – 2005		Total	
	Number of transactions	Value	Number of transactions	Value	Number of transactions	Value
Kao	12	449	15	4,907	27	5,355
Shiseido	5	343	11	43	16	385
Unicharm	0	0	2	0	2	0

Note: Only transaction values announced publicly were totaled.
Source: Compiled based on Thomson Financial's "Thomson ONE Banker."

Figure 6. Changes in Market Capitalization of Kao and P&G

Notes: (1) Market capitalization as of December 31 each year. (2) P&G = Procter & Gamble.
Source: Compiled based on Thomson Financial's "Thomson ONE Banker."

is also operating with a focus placed on strengthening its core business by aiming to maximize its corporate value. However, the primary reason for such an extremely large difference in market capitalization is considered attributable to the discrepancy in the target level set by P&G to become a top-ranked global company.

Background factors behind P&G's significant increase in its market capitalization include that P&G utilized large-scale M&A transactions to a greater extent than did Kao in addition to P&G's efforts to improve the efficiency of its administrative departments and to develop new products by employing technology from outside the company. As shown in Table 3, large differences can be seen between Kao and P&G in the number and value of M&A transactions in the past 20 years.

In 2001, P&G purchased Clairol, a personal care products division of Bristol-Myers Squibb in the United States for about 580 billion yen. In 2003, the company also acquired Wella in Germany for about 930 billion yen. In 2005, P&G purchased the American company Gillette for about 6,600 billion yen. In this way, P&G engaged in large-scale M&A transactions one after another to strengthen its core business.

At the same time, P&G took an active approach to improving the efficiency of its administrative operations such as the management and operation of information systems, personnel affairs management and facilities

management through outsourcing such operations. These efforts enabled P&G to reduce its indirect costs by some 58 billion yen during the period from 1999 to 2002.

As is clear from these achievements, it is the company's single-minded devotion to selection and concentration in pursuit of enhancing its corporate value that led P&G into a positive spiral. In other words, P&G concentrated its management resources on its core business and skillfully utilized the management resources of other companies.

Figure 7 compares the market capitalization of top-ranked Japanese and US companies in the same industries. With the only exception being the automotive industry, the market capitalization of Japanese companies is substantially lower than that of US companies in other industries. These differences appear to come from whether a company established and strengthened its core business in a short time and was able to improve its corporate value by making the best use of outside management resources while highly evaluated by the capital market.

2 Incorrect Perception of Top-Ranked American Companies

The differences in market capitalization between Japanese and US companies do not necessarily come from the differences in the concepts regarding stakeholders to which companies give priority. In other words, US companies that are firmly committed to raising corporate value do not necessarily give the highest priority to only shareholders.

Rather, many US companies listed in Figure 7 maintain mid- and long-term perspectives and are striving to provide value to other stakeholders as well as shareholders. A trade-off is not necessarily involved between securing profits from the short-term perspective and growth from the mid- and long-term perspectives. The cases of many American companies suggest that it is possible to pursue both these goals simultaneously.

For example, in addition to its shareholders, P&G treats its employees as important stakeholders. At P&G, newly recruited employees must undergo a complete series of training programs. Employees who are appointed to important posts are principally selected from among career employees. Ahead of other US companies, P&G

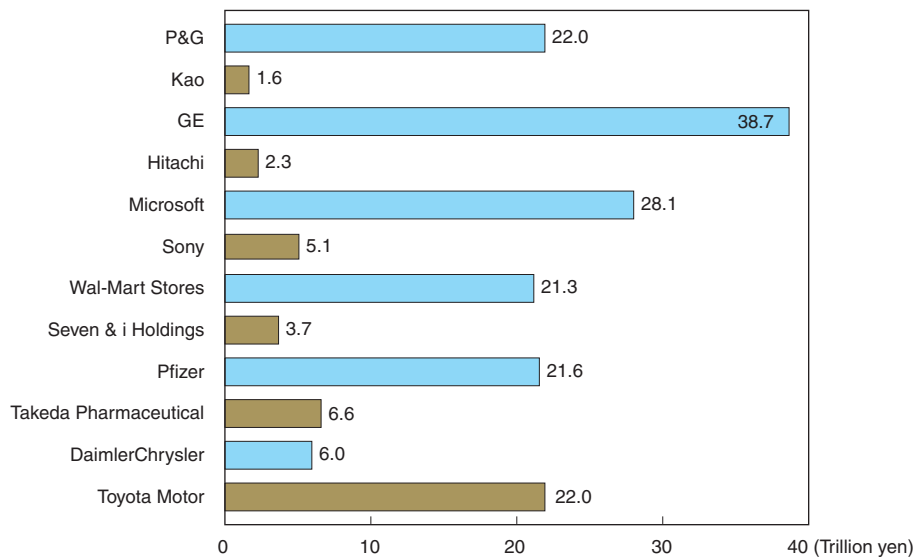
Table 3. Comparison of Number and Value of M&A Transactions by P&G and Kao

(Unit: Million dollars)

	1985 – 1994		1995 – 2005		Total	
	Number of transactions	Value	Number of transactions	Value	Number of transactions	Value
P&G	35	6,652	40	75,840	75	82,492
Kao	12	449	15	4,907	27	5,355

Note: Only transaction values announced publicly were totaled.
 Source: Compiled based on Thomson Financial's "Thomson ONE Banker."

Figure 7. Comparison of Market Capitalization between Top-Ranked Japanese and US Companies (As of August 6, 2006)



Notes: (1) 1 dollar = 115 yen. (2) GE: General Electric

adopted programs to increase employee loyalty, such as profit sharing, an employee stock ownership plan (ESOP) and an employee health insurance program. These efforts are obvious indicators that P&G is fully aware that its employees are vital in the effort to improve corporate value from the mid- and long-term perspectives.

In J&J (Johnson & Johnson), a multinational manufacturer of healthcare products that is based in the US, we can also see aspects similar to those seen in P&G. Specifically, J&J is neither pursuing profits only from the short-term perspective nor is it giving the highest priority to only shareholders. The market capitalization of J&J is some 21 trillion yen, which indicates about the same corporate size as that of P&G. When we look at the number of M&A transactions conducted by J&J during the period from 1985 to 2005, we find that there were 82, and the value of such transactions (only those announced publicly) exceeded 3,680 billion yen. These moves suggest that, similar to the top-ranked global companies indicated in Figure 7, J&J is also one of the "companies pursuing aggressive growth strategies" that has been improving its corporate value by making the best use of outside management resources.

The corporate philosophy of J&J puts customers first and stockholders last. In its credo, while the company

defines its responsibilities to all stakeholders, the priority of company responsibility is placed in the following order: customers first, followed by suppliers and distributors, employees, communities and, finally, stockholders.

This credo guides all employees to act in conformity with the philosophy it embraces. Specific responsibilities stated in the credo include: (1) to customers, the responsibility to produce high-quality products and services in meeting their needs; (2) to employees, the responsibility to give them a sense of security in their jobs and to provide fair and adequate compensation and clean, orderly and safe working conditions; and (3) to stockholders, the responsibility to realize a fair return.

The most evident incident in which the philosophy embodied in the credo inspired the company's managers and employees was the TYLENOL crisis, which occurred in 1982. This acetaminophen pharmaceutical product targeted for the mass consumer market was adulterated with cyanide. With its reputation at stake, J&J immediately withdrew the product from throughout the nation at a huge cost of about 7.5 billion yen. While J&J incurred a great amount of loss by this crisis from a short-term perspective, the company's reputation was preserved and even increased relative to subsequent corporate activities.

P&G and J&J are listed on the New York Stock Exchange, and the performance of their management is constantly and carefully monitored by their shareholders. Under these circumstances, these companies are providing value to all stakeholders including shareholders based on their positions of pursuing profits from the mid- and long-term perspectives and, at the same time, securing profits from the short-term perspective.

In sum, both P&G and J&J are striving to convince shareholders and investors that pursuing mid- and long-term growth is a key factor for success in securing profits from the short-term perspective, and are gaining their trust and confidence. As a consequence, these companies are successful in establishing a stable relationship with shareholders, and in improving their corporate value.

V Companies Opted to Leave the Market in Pursuit of Growth

Recently, in addition to efforts to improve the value of companies while remaining listed, moves have also emerged among a limited number of companies to enhance such value by leaving the market.

To begin with, companies list their shares on the stock exchange for purposes such as expanding the means of raising funds, increasing their reputation and brand image and strengthening their governance system. In particular, listing a company's shares on the stock exchange brings significant advantages in expanding the means to obtain funds. For example, a company can raise a large amount of funds by leveraging a high stock price. When a company wants to acquire or sell a business, its shares can function as the currency for such a transaction. Therefore, keeping a company's shares listed will essentially bring greater advantages in any efforts to enhance corporate value.

However, in many cases of companies that choose to leave the market and pursue growth, their stock prices remain low because their growth strategies do not necessarily meet the expectations of the market in terms of pace of growth and strategic scenario. Accordingly, such companies are unable to make good use of the advantages available in the capital market. Instead, keeping their shares listed on the stock exchange sometimes works as a disadvantage. In a company whose stock price is undervalued, the risk of being the target of a hostile takeover increases.

As such, by delisting their stocks, companies opting to leave the market in pursuit of growth intend to implement their growth strategies with a limited number of shareholders who endorse their strategies.

Specific examples include WORLD, POKKA and SKYLARK that delisted their stocks through management buyouts (MBOs).

One of the factors common among these companies is that the market gives them a poor rating. For such reasons, these companies decided to delist their stocks from the stock exchange by MBOs in an attempt to implement drastic reforms in an environment where they will not be subject to the influence of shareholders with varying needs and expectations.

It appears that an MBO is a welcome means for management because it frees a company from shareholder pressure. When its performance improves, the company's stock can again be listed. However, after a stock delisting, a company's growth strategies and progress in business restructuring will be rigorously monitored by financial institutions such as investment funds that might provide funds to the company. As such, after an MBO, a company is required to ensure the improvement of corporate value under the strict supervision of specific active shareholders exercising their rights as owners.

VI Future Direction of Corporate Behavior

All management executives must be promoting their companies' growth to a greater or lesser degree. However, based on the differences in perception regarding corporate value between management and shareholders, we can divide currently listed companies into the following three types (Table 4).

Type 1 companies are pursuing aggressive growth strategies, Type 2 companies are pursuing conservative growth strategies and Type 3 companies are opting to leave the market in pursuit of growth. The following section discusses the future direction of companies falling under each of these respective types, and options available for Japanese companies.

1 Companies Pursuing Aggressive Growth Strategies

Companies in this category are firmly committed to enhancing corporate value. To establish and strengthen core business in their quest of further improving corporate value, they make full use of strategic alliances and M&As to incorporate outside management resources in addition to their efforts to attain organic growth using internal management resources. This means that these companies adopt strategies to increase corporate value as quickly as possible in an easy-to-understand manner for the market, and actually implement such strategies.

In addition to their focused efforts to conduct investments such as for M&As to improve corporate value, they concurrently introduce a governance system and internal control system, and adopt defensive measures against shareholder actions that may impair corporate value. These features ensure that aggressive and defensive

Table 4. Corporate Characteristics by Type

	Type 1 Companies pursuing aggressive growth strategies	Type 2 Companies pursuing conservative growth strategies	Type 3 Companies opting to leave the market in pursuit of growth
Priority management indexes	<ul style="list-style-type: none"> • Cost of capital and EVA (economic value added) with the aim of improving corporate value from mid- and long-term viewpoints 	<ul style="list-style-type: none"> • Periodic income indexes based on income (P/L) statements 	<ul style="list-style-type: none"> • Cost of capital and EVA on the assumption of exit (selling shares to new shareholders) by fund providers from the mid-term viewpoint after delisting
Market evaluation (for Type 3, investor evaluation and/or action)	<ul style="list-style-type: none"> • The market expects high return from these companies in the future because they adopt aggressive and thorough growth strategies in which growth potential from the mid- and long-term perspectives is evident. • Because of this, stock prices of many of these companies remain high. 	<ul style="list-style-type: none"> • The market does not expect a high return from these companies in the future because they adopt status quo growth strategies in which growth potential from the mid- and long-term perspectives is unclear. • Because of this, stock prices of many of these companies are undervalued. 	<ul style="list-style-type: none"> • Financial institutions that are investors after delisting and leaving the market carefully examine return on investment. • If actual performance falls short of planned performance, investors may intervene in management.
Characteristics of corporate behavior	<ul style="list-style-type: none"> • These companies aim to maximize corporate value by making substantial amounts of investments to establish and strengthen core business. • To expand their core business, they adopt growth strategies to incorporate outside management resources through strategic alliances and/or M&As, in addition to efforts to grow by using internal management resources. 	<ul style="list-style-type: none"> • Distinction between core and non-core business is not clear. These companies operate business by maintaining the status quo and using internal management resources alone without taking risks. • They are unwilling to allow intervention by active shareholders and tend to give higher priority to cross-shareholdings and measures to defend against hostile takeovers than to the establishment of mid- and long-term growth strategies 	<ul style="list-style-type: none"> • These companies aim to improve corporate value through the implementation of thorough management reforms under support of specific shareholders (financial institutions, directors, employees, etc.) who endorse their strategies.

approaches are taken in a well-balanced manner from the perspective of their ultimate goal of enhancing corporate value.

In recent years, the number of companies strengthening their efforts to enhance the value of a company through large-scale M&As involving domestic and foreign companies has also been increasing in Japan. As briefly mentioned in Chapter I, such companies include Sony, SoftBank, Toshiba, Nippon Sheet Glass and Oji Paper.

Large-scale M&As by Japanese companies also occurred frequently during the period of the bubble economy in the latter half of the 1980s. However, at that time, companies embarked on M&As in many cases for purposes such as strengthening non-core businesses to promote horizontal diversification and endeavoring to expand their business scale without any specific principles.

In the past few years, Japanese companies have been undertaking large-scale M&As as a means of strengthening their core business after they engaged in the “selection and concentration” process during the period of economic downturn following the collapse of the bubble economy. In particular, the goal of many M&A cases is to secure a competitive edge in the global market rather than in the domestic market, reflecting the economic trend towards borderless business operations.

For example, in February 2006, Toshiba acquired Westinghouse, a major nuclear power generation facility

manufacturer, from its parent company, British Nuclear Fuels (BNFL) for 621 billion yen. In order to enhance the existing nuclear power generation business, the company purchased Westinghouse in expectation of the growth of the nuclear power generation market up until 2050. Accordingly, this acquisition can be viewed as an attempt to firmly establish a new core business from the long-term perspective.

Nippon Sheet Glass purchased Pilkington for 616 billion yen. Through this acquisition, the company increased its world share of the sheet glass market to 14 percent, thereby approaching Asahi Glass, which is ranked top in this business field.

Both Toshiba and Nippon Sheet Glass undertook such large-scale M&As to secure a competitive edge in the global market and to substantially improve their corporate value. In fact, Nippon Sheet Glass acquired a company greater than itself in terms of business scale.

In the future, in Japan, an increased variety of M&A techniques will become available, such as greater flexibility in the form of merger compensation (other than equities in the surviving company) and triangular mergers (equities of the parent company are given as compensation for a merger when its subsidiary becomes the surviving company). Such diversification in M&A schemes will naturally increase the necessity to choose M&A to win positions in global competition. The number of M&As in which a Japanese company acquires another Japanese company (in-in M&As) or those in

which a foreign corporation purchases a Japanese company (out-in M&As) is expected to increase.

In addition, “hostile” M&As are also projected to increase. In continental Europe, where conservative management style as represented by cross-shareholdings and lifetime employment has long been dominant in the same way as in Japan, attempts to make hostile takeover bids have started to occur frequently, and the number of such attempts resulting in success is increasing.

Specific examples include the case of Sanofi-Synthelabo vs. Aventis Pharma (both companies are based in France) in the pharmaceuticals field, and the case of Mittal Steel (the Netherlands) vs. Arcelor (Luxembourg) in the steel industry. Because competition is evolving on a global basis, it is quite natural that similar moves occur in Japan as well.

Under the circumstances where the impact that foreign companies have on the Japanese market poses a threat, we find it difficult for Japanese companies to survive in the domestic market, not to mention the global market, unless they intend to become one of the Type 1 companies.

Accordingly, to secure a competitive edge in the global market in the future, Japanese companies must make use of large-scale M&As as part of their growth strategies, and to accumulate experience in M&As and build their level of expertise in attaining success.

2 Companies Pursuing Conservative Growth Strategies

Type 2 companies tend to give more importance to conservative growth strategies based on their internal management resources than to the utilization of outside management resources, as well as placing greater emphasis on securing profits every year than on the long-term improvement of corporate value. Because they are unwilling to accept intervention in management from the outside and their stock prices are often undervalued, they give priority to strengthening their defenses against interference by shareholders through means of cross-shareholdings and measures to avert hostile takeovers.

While they are not at all pleased to be in this category, many listed companies end up falling under Type 2. Because of their poor understanding of corporate value, gaps in recognition have become apparent between these companies and active shareholders who get involved in management in quest of increased corporate value.

To bridge such gaps in recognition, Type 2 companies must build a management system that shares a common standard of “corporate value” with the capital market.

In recent years, funds have been flowing globally as seen in moves by investment funds holding an enormous amount of funds for participation in the Japanese market. These trends increase the risks of Type 2 companies

to become the target of M&As by investment funds and/or competitors.

Even mature industries such as the food and pharmaceutical sectors with their focus on domestic markets are increasingly faced with moves of foreign companies to enter the Japanese markets, reflecting the accelerated globalization of the competitive environment.

In addition, through institutional amendments such as lifting the ban on triangular mergers, companies in any industry will inevitably face global competition transcending national borders.

Under such an environment, Type 2 companies are likely to fall into a situation where equilibrium is maintained by reducing supplies in the face of reduced demand, and may be subject to a weeding-out process.

3 Companies Opting to Leave the Market in Pursuit of Growth

Type 3 companies are those selecting a way of delisting to avoid the costs and risks incurred by listing their shares on the stock exchange. These companies intend to return to growth by rebuilding their business models and implementing growth strategies from the mid- and long-term perspectives.

One of the realistic options for some of the Type 2 conservative companies is to delist their shares from the market by means of MBO, etc. and seek to improve corporate value from the mid- and long-term viewpoints. However, even if companies opt for delisting through MBO, they will be unable to escape from and will still be subject to interference by shareholders exercising their rights as owners to improve corporate value. Rather, they must face the situation of strengthened relationships with active shareholders who have owned their shares for long time.

4 Options Available for Japanese Companies in the Future

Essentially, listed companies should aim to become Type 1 companies that pursue aggressive growth strategies. Now, even companies considered successful in the Japanese market have sharp differences from top-ranked global corporations. In domestic demand-driven industries as well that are considered to have nothing to do with global competition, more than a few companies are planning to enter overseas markets because they cannot expect further growth if they confine themselves to the maturing Japanese markets. Unsurprisingly, many foreign companies are establishing their firm positions in the Japanese markets by making good use of their abundant funds.

As such, many Japanese companies, whether they like it or not, have already become involved in a swirl of global competition. For Japanese companies to survive such global competition, they must make the utmost use

of outside management resources and must establish and implement strategies that can convince the capital market to create and enhance corporate value on a timely basis. In implementing these strategies, companies should make the most of the advantages of support provided by the capital market.

Management executives of each Japanese company should objectively evaluate their company's current behavioral stance based on relationships with the capital market and should implement strategies from the standpoint of raising their corporate value.

Yujiro TAKI is a consultant of NRI's Management System Consulting Department. His specialties include support for listing companies on the stock market and support for the implementation of business strategies.

Jun NISHINO is a consultant of NRI's Management System Consulting Department. His specialties include support for corporate rehabilitation, business evaluation and financial strategies.

Yasushi KONUMA is a senior consultant of NRI's Management System Consulting Department. His specialties include corporate reorganization strategies, M&A strategies and group-level management strategies.

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 its efforts to equipping its 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, which are indispensable for overcoming 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: Corporate Communications Department
Nomura Research Institute, Ltd.
E-mail: nri-papers@nri.co.jp
FAX: +81-3-5533-3230