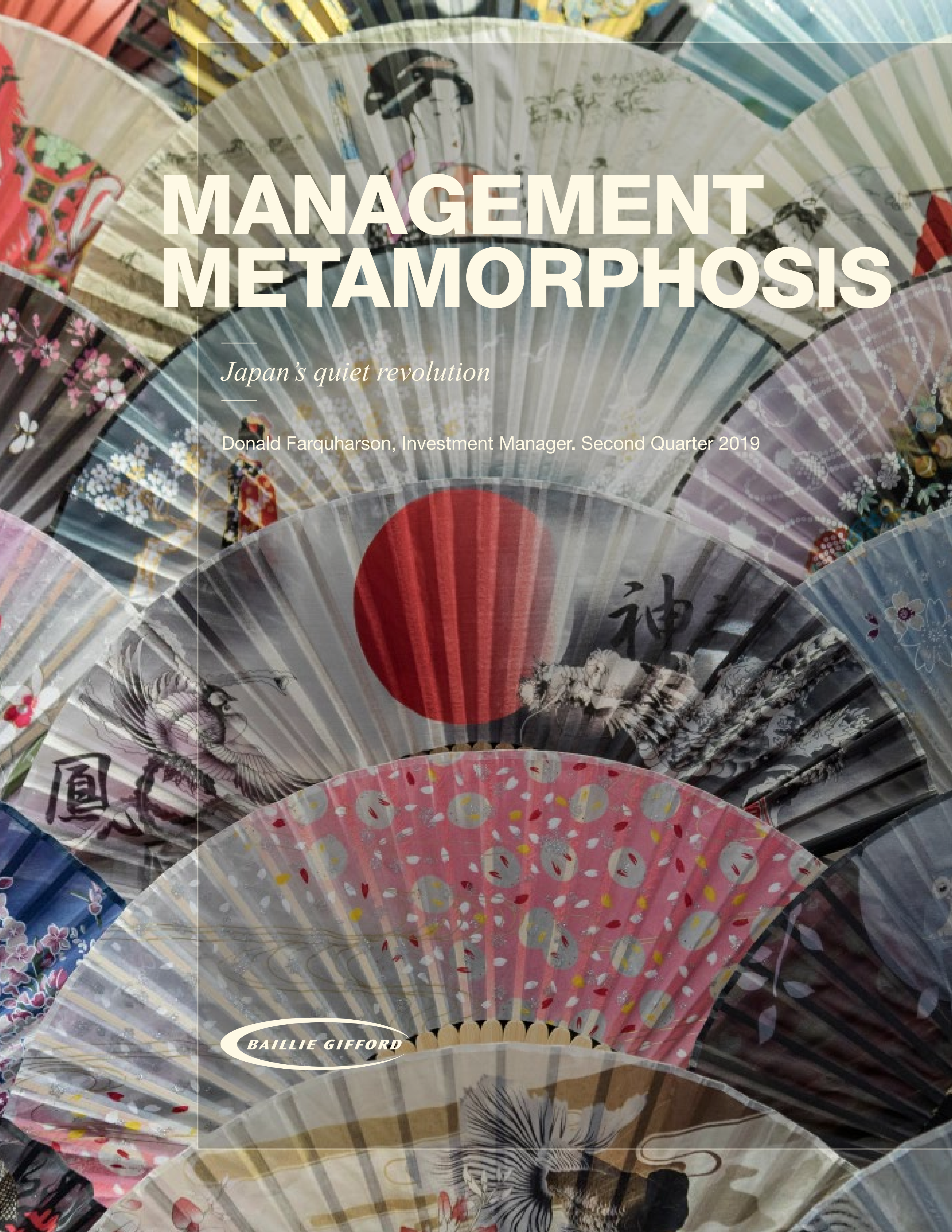
MANAGEMENT METAMORPHOSIS

Japan's quiet revolution

Donald Farquharson, Investment Manager. Second Quarter 2019



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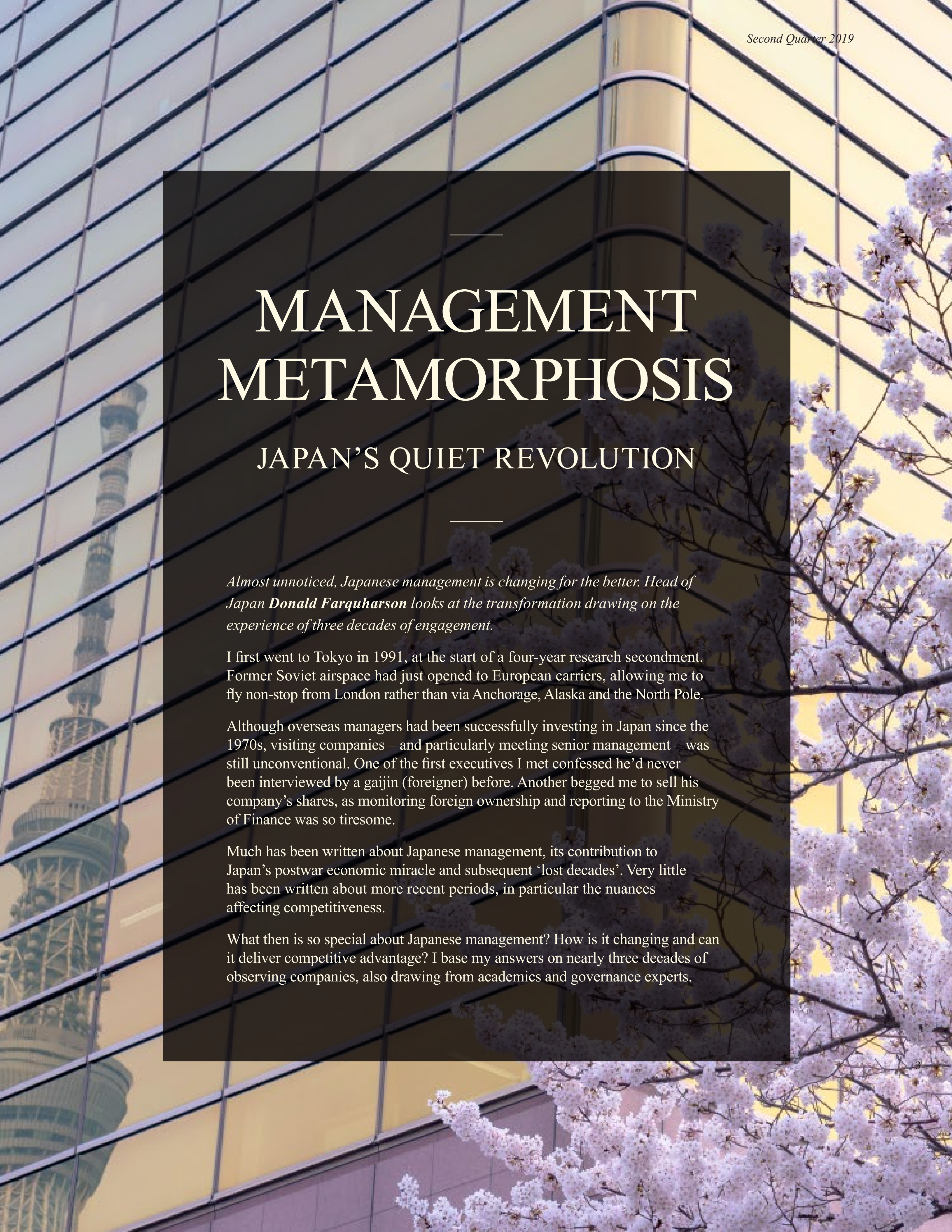


MANAGEMENT METAMORPHOSIS

JAPAN'S QUIET REVOLUTION

Almost unnoticed, Japanese management is changing for the better. Head of Japan ***Donald Farquharson*** *looks at the transformation drawing on the experience of three decades of engagement.*

I first went to Tokyo in 1991, at the start of a four-year research secondment. Former Soviet airspace had just opened to European carriers, allowing me to fly non-stop from London rather than via Anchorage, Alaska and the North Pole.

Although overseas managers had been successfully investing in Japan since the 1970s, visiting companies – and particularly meeting senior management – was still unconventional. One of the first executives I met confessed he'd never been interviewed by a gaijin (foreigner) before. Another begged me to sell his company's shares, as monitoring foreign ownership and reporting to the Ministry of Finance was so tiresome.

Much has been written about Japanese management, its contribution to Japan's postwar economic miracle and subsequent 'lost decades'. Very little has been written about more recent periods, in particular the nuances affecting competitiveness.

What then is so special about Japanese management? How is it changing and can it deliver competitive advantage? I base my answers on nearly three decades of observing companies, also drawing from academics and governance experts.

THE END OF GROUPTHINK

It is too easy to slip into cultural stereotyping and overgeneralisation about the pace and nature of change in Japan. But companies across many industries do face similar challenges: an ageing population, stagnant domestic markets, commoditisation of products and the threat from nimbler Asian competitors or multinational giants.

Many companies appear to be addressing these challenges in similar, predictable ways – with off-the-peg mid-term plans, or formulaic mergers and acquisitions in emerging markets, which will only incrementally bolster the top line. Sales are still regarded as an important measure of scale and total assets as a measure of power.

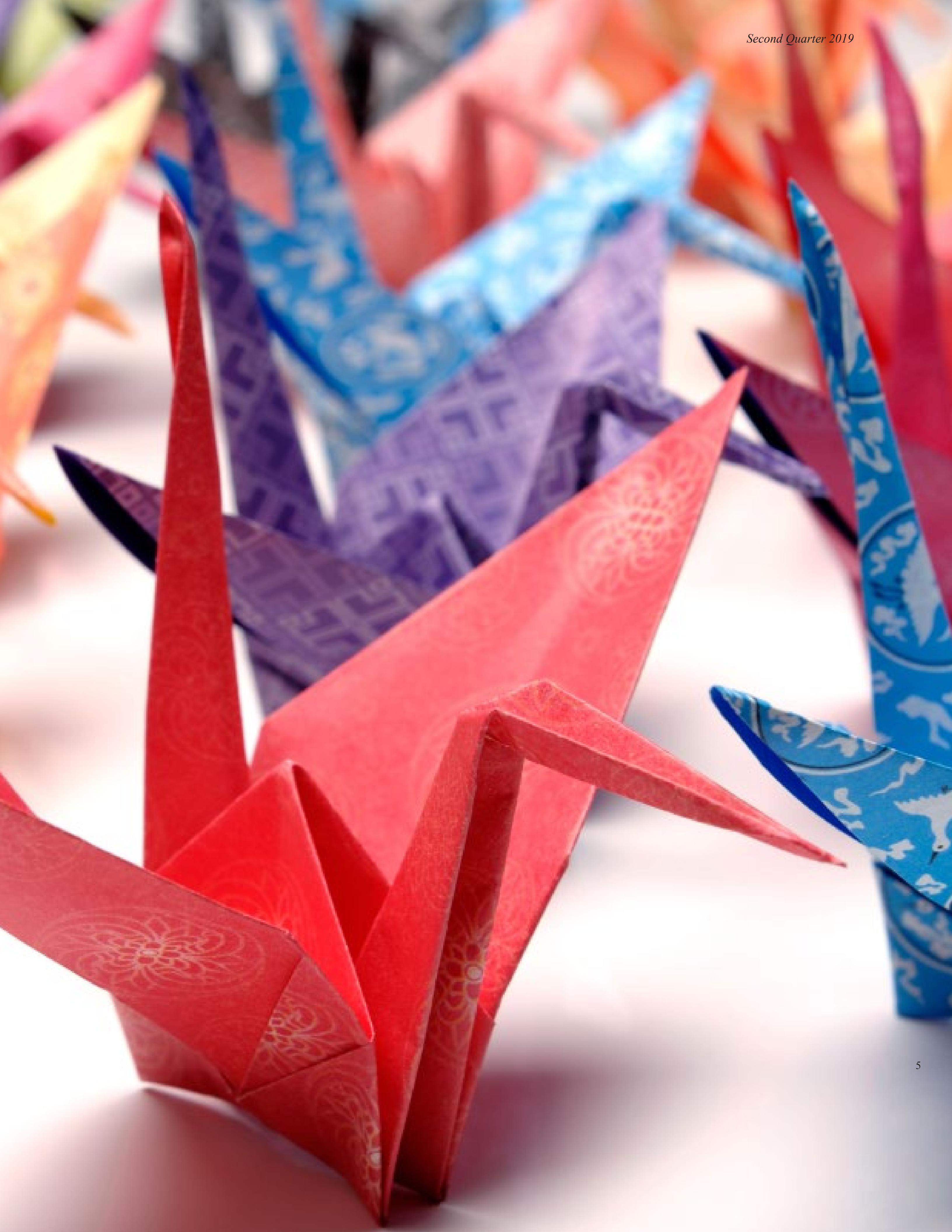
Japanese business continues to value group consciousness, despite knowing that herd instinct can be self-defeating. As the US business strategist Michael Porter observed almost 20 years ago, Japanese competitiveness tends to involve head-to-head competition in the same product category rather than genuine innovation, an example being the me-too offerings of its beer industry.

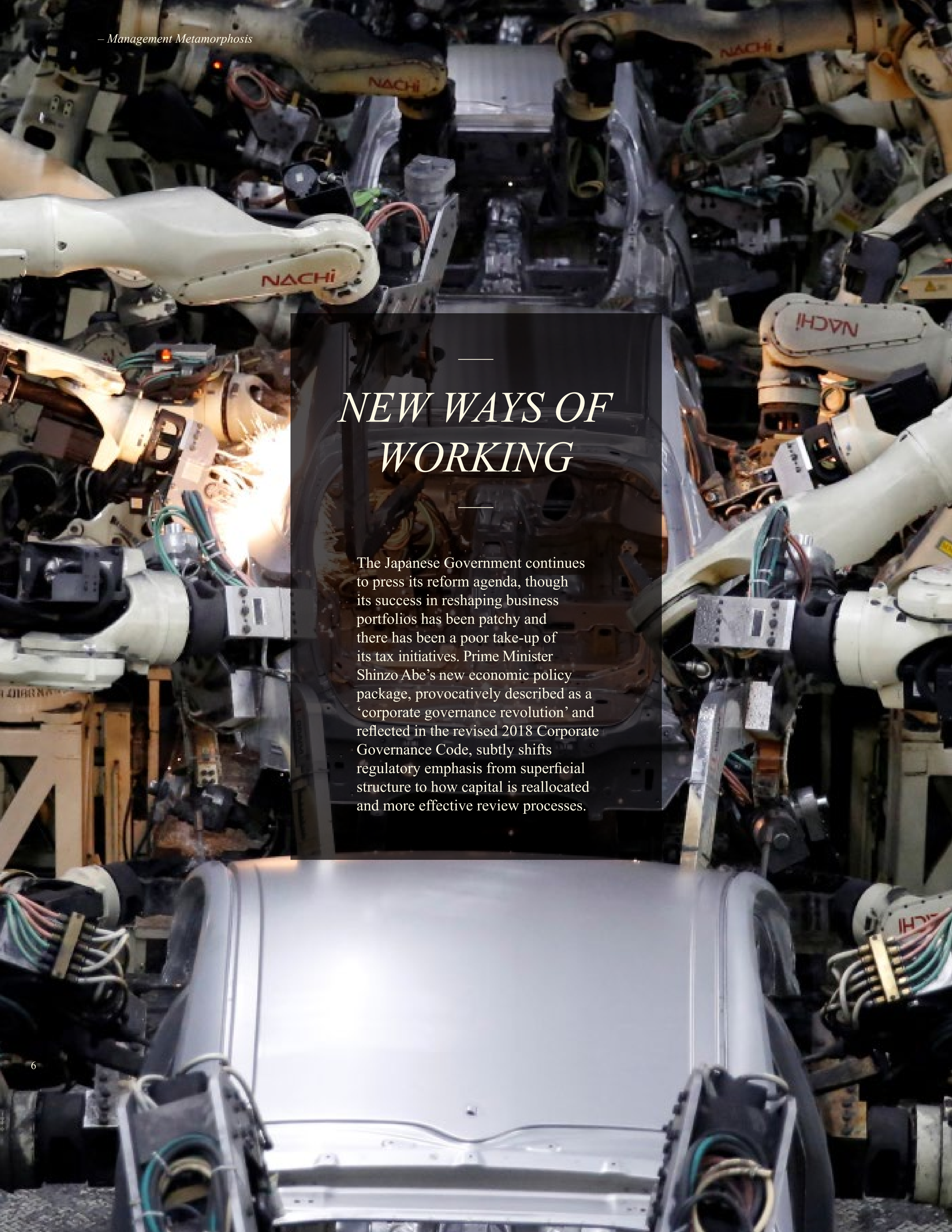
This practice is changing at a pace that should make investors sit up. The catalysts are partly demographics and partly evolving attitudes. The foundations of traditional Japanese HR – lifetime employment, seniority-based pay and single-company trade unions – have been crumbling since the 1990's breakdown of the 'convoy' system, where government, regulators, banks and firms travelled together towards an agreed common goal.

The tight labour market is encouraging the restructuring of underperforming segments. I often see companies closing failing divisions to move personnel to faster-growth areas. Sony, for example, has all but stopped making consumer electronics. Lifetime employment has survived, but only for a lucky few. The five-year job retention rate has slumped, especially among young workers.

According to recruitment specialists Hays, Japanese companies now fill half their vacancies with mid-career job-changers; a third of them motivated by career ambition and another third by salary ambitions. This would have been unheard of just 20 years ago.

Demography is realigning the corporate pecking order. All employees under the age of 50 are part of a post-Bubble generation that does not presume that Japanese practices are best. The layout in newer office developments is subtly less hierarchical, implying a more open mindset among middle management, often seen as the bottleneck of new ideas. A more ambitious and less uniform management culture appears to be emerging.





NEW WAYS OF WORKING

The Japanese Government continues to press its reform agenda, though its success in reshaping business portfolios has been patchy and there has been a poor take-up of its tax initiatives. Prime Minister Shinzo Abe's new economic policy package, provocatively described as a 'corporate governance revolution' and reflected in the revised 2018 Corporate Governance Code, subtly shifts regulatory emphasis from superficial structure to how capital is reallocated and more effective review processes.

When I lived in Japan back in the early 1990s there was little criticism of a system which favoured discipline, uniformity and group consciousness. Japan's stubborn belief that firms exist not just for profit but also for social good now looks quite prescient. Consideration of wider stakeholders is more marked in Japan and studies suggest shareholders are much less driven by profit maximisation and short-term motives than elsewhere. Provided all stakeholders are treated equally, investors will benefit more than from short-term fixes, such as share buybacks.

Kodawari (uncompromising attention to detail) is highly respected in Japan yet, because it is expected, it is often unrewarded. Many companies complain to us about the low-margins available in Japan. Yet this creates opportunities for innovation around service and product delivery, where new skills can boost expansion elsewhere, especially where a high degree of consultancy is required. The success of Japanese engineering companies like SMC or Keyence shows this.

The revered Japanese concept of *monozukuri* (literally: 'making of things') takes for granted that excellence demands interdisciplinary coordination. Likewise *kaizen* (continuous improvement) rests on the belief that management processes can be perfected, and that the quest for perfection should be internalised by every worker. The *kaizen* concept demands consistent, small changes based on constant inter-communication. Semi-formalised 'quality circles' support employees in contributing ideas, encouraging patience and openness to trial and error.

Management in Japan is a bottom-up process. Top-down is antithetical to the practice of *kaizen* within *monozukuri*. Indeed, management strives to prevent work from becoming dehumanising, by involving everyone in a shared endgame. The automotive crisis of the late 1980s and 90s, when Ford and Renault took controlling stakes in Mazda and Nissan, and Chrysler bought into Mitsubishi Motors, helped spur the industry into improving internal capability and learning from others.

Today, Japanese makers outperform US and European counterparts in competitiveness and profitability. A third of the world's top component suppliers have a Japanese domicile. Much of this is due to a culture of sharing ideas, even between competitors, wherever mutually beneficial. Observe, for example, Toyota's collaborations in hybrid and electric vehicle technologies with other Japanese – and even Chinese – carmakers.

Firms' ability to build, integrate and share knowledge also extends to creative industries. Japan's gaming sector, for example, builds on dense informal networks around Tokyo to exchange knowledge and develop ideas. The fashion industry is clustered in the downtown Tokyo hotspots of Harajuku, Shibuya and Akihabara, where competiveness-hampering structures and standards hold less sway.

The electronics and car industries are contrasting examples of Japan's adaptiveness. In the analogue age *suriawase* (repeated adjustment and optimisation) afforded electronics' makers advantages in design and integration of key components. The digital age, with its more modular architecture, is widely seen as having ushered in the decline of Japanese electronics.

By contrast, the car is still a highly integrated product, meaning that all components deliver all of the functions and can be optimised to improve quality. This is a better fit with the organisational capabilities of Japanese manufacturers.

It has not escaped the industry's notice that today's cars increasingly resemble the personal computer. How it deals with this will ultimately determine its survival.

A third of the world's top [automotive] components suppliers have a Japanese domicile.

Robots weld car bodyshells at Toyota's Tsutsumi plant.

© REUTERS/Toru Hanai.

CULTURAL CHANGE

More generally, Japanese management still seems to me to suffer from several structural weaknesses. These are: poor strategic decision-making; lack of specialisation and poor incentivisation; absence of shareholder orientation; poor financial literacy; and lack of diversity. The remarkably frank independent report on the demise of Toshiba in 2015 cited virtually all of these, in a company that had the same auditor for nearly 47 years.

That report called for "reform of the corporate culture", blaming lack of accounting awareness, poor governance, opaque evaluation, a presumption against disclosure and unaccountable advisors.

Whilst few are likely to be as extreme as Toshiba, such practices occur in other companies. We challenge them whenever we spot them. In many companies, there is still little or no reward for success. Not being seen to have fallen below a low bar is regarded as a good result. When failures happen, they must be concealed until the situation has been redressed. Most Japanese corporate scandals are less about substandard performance than efforts to cover it up.

Japanese organisation places strong emphasis on middle management and comparatively little on top executives.

This can make company meetings with senior management frustrating and evaluating their quality and alignment challenging, to say the least. Everyday operational decisions are taken by middle managers, whereas major decisions need to be sent up the chain. Yet *honne* (what one genuinely feels) and *tatemae* (what one says to promote harmony) can impede objectivity.

This tends to lead to a lack of strategic prioritisation and timely decisions. The need for *hanko* (personal seal) rubber-stamping slows decision-making, encourages imitation and leads to fast-followers rather than risk-takers. This is an obvious weakness in the online age.

Many large firms still prefer generalists to specialists. Job rotation is seen as creating strong identification with the firm as a whole, rather than just a single department. Seniority still plays a major part in how businesses are organised and pay-for-performance remains relatively rare.

However, the old order is fraying. A recent Hays survey shows that almost two-thirds of Japanese are dissatisfied with their salaries while the low pay of senior executives fails to attract top international talent, especially in the technology and internet sectors.

There has been a long-held association of Japan with indifference to shareholder interests. As Akira Matsumoto, one of Japan's most respected executives, said recently: "It's shareholders last. That's actually the best thing for them." To be fair he was alluding to shareholder short-termism and his view is echoed by a growing number of corporate leaders.

Nevertheless, a tendency to seek stability, for example through cross-holdings, still prevails. As much as 22 per cent of listed shares by value is held by supportive corporations, a proportion unchanged from 15 years ago, according to US investment bank Jefferies, though banks and other financial investors have reduced their holdings.

Since Japan's Corporate Governance Code was introduced in 2015, companies have been required to account for their cross-holdings to the Tokyo Stock Exchange. Only 10 per cent of companies phrased their reports in 2017 on the assumption that cross-holdings would not be held in future, and only 17 per cent included wording which even considered the possibility of disposals. Firms with large cross-holding shareholders have been shown to be less likely to undertake restructuring. Poor return on equity (ROE) is a function of both poor capital allocation and an associated management mindset which resists setting minimum thresholds.

Along with this goes poor financial literacy. Strikingly, almost half of Japanese corporates surveyed in 2017 believed that their ROE exceeded the firm's cost of equity, whereas only four per cent of investors agreed. Cash balances are still growing 20 per cent faster than turnover according to CCGJ, a governance research firm. They calculate that, if 2012 cash levels to sales were appropriate, at least ¥25 trillion ($228 billion) in excess cash has built up since. The problem is all too common and is associated with risk aversion, management continuity and the weak authority of the central financial department. Identifying these factors helps us to understand the sort of company we are dealing with.

Another weakness is lack of diversity among Japan's senior executives and board members. This is at odds with the large number of companies that want to expand abroad. Non-routine succession, often associated with strategic change, remains extremely rare. At 27 per cent, the gender pay gap is wider in Japan than elsewhere in the OECD and female board representation is negligible.

BETTER GOVERNANCE

But change is coming, for several reasons. First, a closer alignment of management reward with company performance; secondly the increased emphasis on governance; and thirdly, the changing nature of Japan's corporate landscape. Whether or not external factors change behaviour, they seem to have been more effective in Japan than elsewhere.

We have long argued for a stronger link between pay and performance in Japanese management and at last this is starting to happen. Over two-thirds of Topix 500 companies now have share-based incentive plans. The difficulty is in distinguishing structure from actual behaviour.

The Tokyo Stock Exchange has clamped down on companies' retaining retired executives as 'senior advisors'. As well as improving transparency and accountability, perhaps retired executives will stop expecting paid consultancy and look for better long-term compensation and equity ownership when in post.

Another improvement has been the empowerment of the chief financial officer (CFO). As the person meeting investors, the CFO fulfils a vital role: aligning management with performance goals, improving financial literacy and providing challenge in the boardroom.

Though many believe the behavioural impact of the Corporate Governance Code to be modest, viewed over a 30-year time frame it looks substantial. For years, Japan relied on bank-led governance to reduce the risk of corporate conflicts of interest. Management claimed to have its own code of governance before it was formalised and believed that its sense of broader social responsibilities anticipated today's environmental, social and governance priorities.

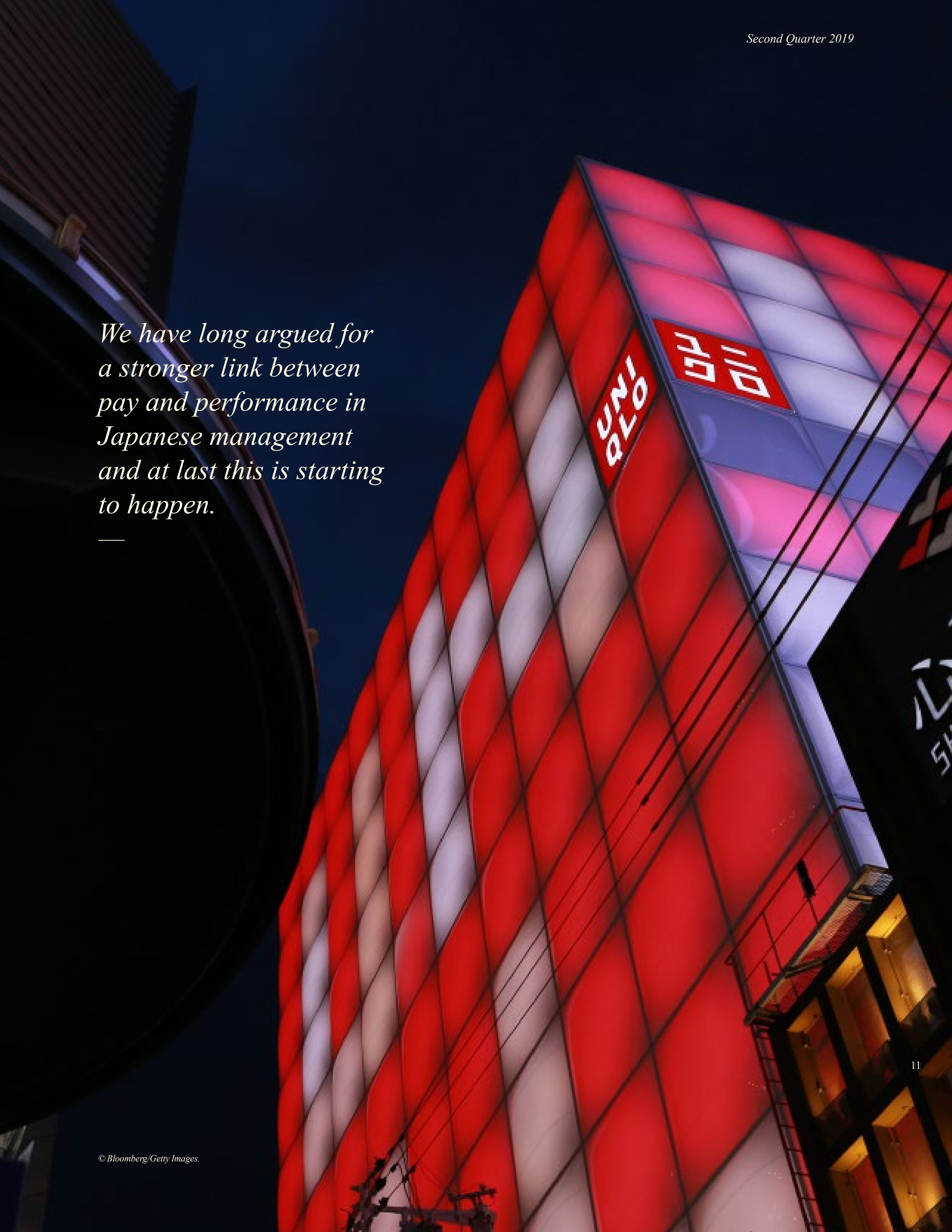
But the new code has undoubtedly made a difference. It gives powerful tools to activist investors and has transformed board dynamics by increasing the number of independent directors. There are obvious weaknesses, certainly: most 'independent' directors are hand-picked by the CEO; they often have limited external experience; and most prioritise defensive roles, such as risk management, general monitoring or compliance. They rarely challenge strategic objectives. Few firms have a formal system of identifying, developing and evaluating executive talent.

There is improvement nonetheless. The revised code is much more prescriptive: 'comply and explain' rather than 'comply or explain'. The focus has moved to the exercise of board powers; it clarifies the need for diversity (gender and international experience) and relevant skills of auditor directors; it presses all companies to have nomination and compensation committees, regardless of the formal governance architecture; it places greater emphasis on designing remuneration systems to provide healthy, long-term succession planning, appointing and dismissing the CEO; and it cites a need to identify accurately a firm's cost of capital and provide a rationale for holding relationship equity.

Trailblazers such as Fast Retailing, the Uniqlo fashion retailer, have shown that it is no longer acceptable to coalesce around the median. Tadashi Yanai, founder and owner of over a quarter of the company, believes that successful firms should be fast-morphing organisms responsive to market nuances. He discourages standardised operating manuals and gives full autonomy to store managers – something he says prevents employee apathy and "mummification". The extraordinary success of his business has set a new benchmark for Japanese managers and is widely followed.

Meanwhile, market forces are making themselves felt. Private equity and venture capital are having an impact. Hostile takeovers remain difficult as boards tend to be dominated by insiders and government often intervenes in failing companies, muscling aside private equity.

But Japanese companies are no longer forever. They are becoming more like their western counterparts, to be merged, bought, sold, split up or shut down as economic necessity demands. From the early 2010s, Japan's IT start-up ecosystem has benefited from an effective pipeline of entrepreneurs, venture capitalists and angel financiers, promoting action throughout the ecosystem.



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OWNERSHIP AND MANAGEMENT

It is a paradox of Japanese management that it thinks long term, yet has a low regard for shareholders. According to research commissioned by the Bank of Korea, 56 per cent of all global companies over 200 years old are Japanese and, until recently, Japan was home to the oldest known family enterprise in the world. Family culture has its roots in Japanese feudalism and Confucianism, seniority and social relations, mutual rights and obligations and belief in trust over achievement. Diligence, frugality, obedience to government and defence of reputation have a significant influence on codes of behaviour.

Japanese long-termism succeeds thanks to the harmonious relationships it helps create. It is generally supportive of research and development (at 3.3 per cent of GDP, Japan spends proportionately more than any country other than South Korea) even where the objective is not immediately apparent. Toyota, for example, is the world's largest investor in artificial intelligence for autonomous driving, while accepting the redundancy of much of its research.

The relative success of founder – or family – run businesses is not particular to Japan, but it highlights a source of competitive edge. Founder-run businesses show better long-term thinking and a more strategic approach to risk taking. This contrasts to the survival mentality that goes with traditional 'salaryman' culture. Decision-making is usually faster in owner-run businesses, as the concentration of ownership and control speeds up decision and action.

Owner-run businesses also tend to greater entrepreneurialism, risk-taking and optimism than large, salaryman-staffed businesses. By investing in them, we stand to gain from better decision-making, strategic vision and alignment.

In Japan more than elsewhere, the question of management quality and alignment is more nebulous. Equity ownership tends to be low in companies listed pre-1989, before the end of the Bubble, and alignment comes through institutional kaizen.

Many of the newer companies more closely resemble western counterparts in areas such as profitability, returns to shareholders and even issues such as board structure, performance-related pay and personnel promotions and so can be more easily compared. Asking questions about decision-forming and internal promotions won't always produce satisfactory answers, but it may help you understand the organisation.

Much remains to be learnt, but the relationship between ownership and management structure with competitive edge is especially intriguing in Japan. With clearer reporting and alignment among many newer companies, it is easy to assume an edge, but there are obviously dangers of conflicts of interest between dominant and minority owners, and interference from non-commercial factors stemming from self-interested shareholders. Nevertheless, new external and internal influences are transforming opportunities and making this a particularly exciting time to be investing in Japan.

Founder-run businesses show better long-term thinking and a more strategic approach to risk taking.

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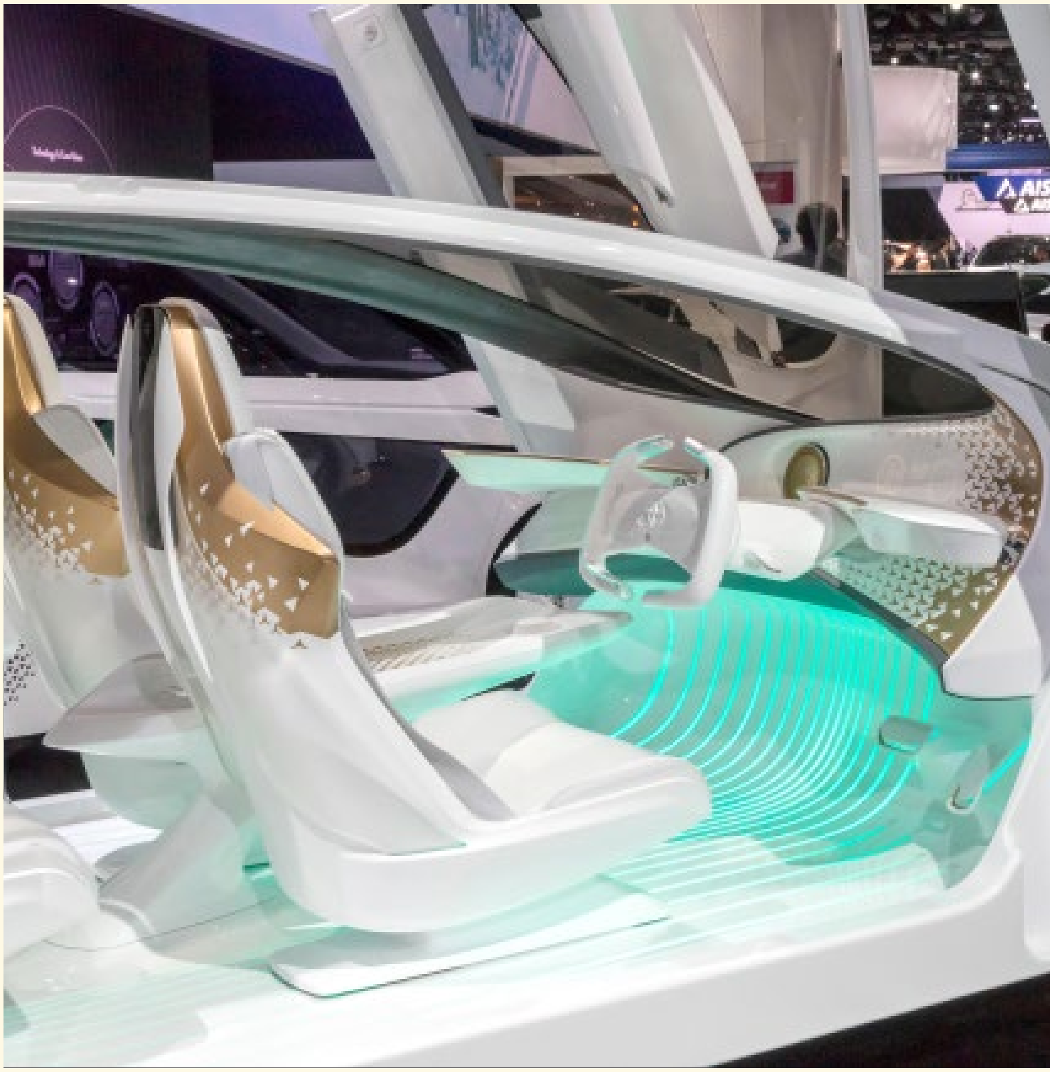

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