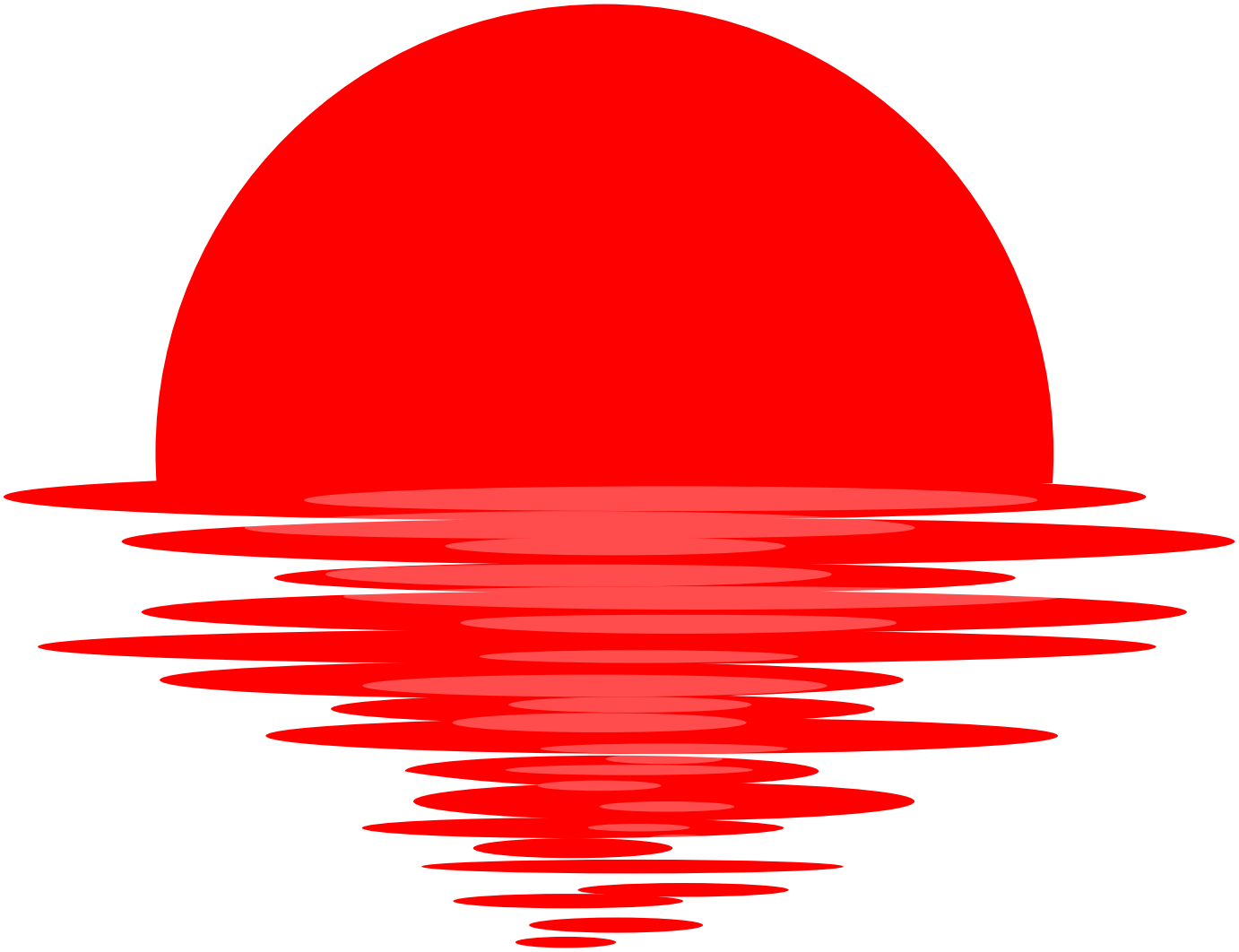
M&A

By Richard Katz

JAPAN AS 196TH

THE TRUE NATURE OF INWARD FDI AND HOW TO IMPROVE IT



One hundred ninety-sixth out of 196 countries. Just behind North Korea. That's how Japan ranked in 2019 when the United Nations Conference on Trade and Development (UNCTAD) measured the cumulative stock of inward foreign direct investment (FDI) as a share of gross domestic product (GDP).[1] FDI ranges from foreign companies setting up new facilities to them buying domestic companies. What a shocking result considering the 20 years Tokyo has spent trying to increase its cumulative stock of FDI.

Unless policymakers understand why past efforts have failed, Tokyo is unlikely to realize the new goal it announced in June: to hike inward FDI to 12 percent of GDP by 2030. That would triple today's ratio. The main hurdle is Japan's impediments to carrying out the primary form of FDI, namely, foreign companies buying healthy ones to gain a built-in labor force, customer base, brand name, suppliers, and so forth. Typically, in a rich country, 80 percent of inward FDI takes the form of mergers and acquisitions (M&As). In Japan, it's only 14 percent.

(ACCJ) governor. Many ACCJ leaders believe that, as listed corporations face increased pressure to focus on profitability rather than just sales, they will increasingly focus on core competencies. Consequently, they will hive off lackluster divisions as well as hosts of affiliates that some other company could operate more productively. If so, this will not only boost Japan's growth rate, but also greatly increase the number of companies available for foreign purchase.

To assess these potential drivers, let's examine the lay of the land.

Sine Qua Non of Successful Reform

Increasing FDI was incorporated into Japan's growth strategy by Junichiro Koizumi during his time as prime minister (2001–06). That was a welcome reversal of attitude. Hardly any country has succeeded in economic reform without embracing inward FDI. Success stories range from the developing countries of Asia to the Eastern European transition states to mature economies. A study of 19 rich countries—

TYPICALLY, IN A RICH COUNTRY, 80 PERCENT OF INWARD FDI TAKES THE FORM OF MERGERS AND ACQUISITIONS (M&As). IN JAPAN, IT'S ONLY 14 PERCENT.

While the government has yet to see the light, two new conditions may drive substantial change anyway.

One of these is a succession crisis at small and medium-sized enterprises (SMEs). Over the coming years, according to the Ministry of Economy, Trade and Industry (METI), 600,000 profitable SMEs may have to close because their owners are over age 70 and have no successor. Up to six million jobs are at risk.

To prevent this, a 2020 interim report of the cabinet-level FDI Promotion Council advocates helping these SMEs find suitable foreign partners by "facilitat[ing] business transfers between third parties,"; in other words, M&As. Unfortunately, the final report, published in June, has purged all talk of inward M&A. Clearly, some powerful forces feared foreign purchases more than the closure of hundreds of thousands of healthy companies. Still, the fact that the proposal even made it to the interim report is an encouraging sign.

A second potential driver is the push for corporate reform, as exemplified by the 2014 Stewardship Code and the 2015 Corporate Governance Code. The latter was proposed to the government by Nicholas Benes, a former American Chamber of Commerce in Japan

where cumulative FDI had risen from six percent of GDP in 1980 to 44 percent by 2019—shows that inward FDI mainly lifted growth by improving output per worker.

It is not the higher efficiency of foreign-owned enterprises that provides the main fillip to the host country. Rather, it's the spillover effects as their new ideas boost the performance of local suppliers, business customers and, sometimes, even competitors. For example, when Japanese automakers took "transplant" factories to North America, Detroit learned that it cost less to prevent defects in the first place than to fix them afterwards. Japanese economists, such as Yasuyuki Todo, Toshihiro Okubo, and Kyoji Fukao, have found that foreign firms bring similar spillover benefits to Japan.

When Koizumi came to power in 2001, the stock of inward FDI was a minuscule 1.2 percent of GDP. In 2003, Koizumi vowed to double FDI. In 2006, he set a goal of five percent of GDP by 2011. At first, there was marked progress; by 2008, FDI had risen to four percent.

Then momentum stalled. Despite Prime Minister Shinzo Abe's 2013 pledge to double FDI, as of 2019

Richard Katz
New York City correspondent for *Toyo Keizai*

1. UNCTAD Foreign Direct Investment: Inward and Outward Flows and Stock, Annual https://unctadstat.unctad.org/wds/TableViewer/tableView.aspx?ReportId=96740

HOW MANY 70-YEAR-OLD OWNERS OF SMEs WOULD REFUSE TO SELL TO A FOREIGNER ... IF THE GOVERNMENT OR A BIG TRADING COMPANY MADE THE INTRODUCTION AND VOUCHED FOR THE BUYER'S INTENTION TO HELP THEM GROW RATHER THAN ENGAGE IN MASS LAYOFFS?

the ratio had barely risen to 4.4 percent. That figure is dwarfed by the 44 percent median ratio in other rich countries.

To make matters worse, the government glosses over how badly it has failed. The Ministry of Finance (MOF) reported that inward FDI climbed to ¥40 trillion in 2020, thereby ostensibly achieving Abe's goal. In reality, however, the 2020 figure was just ¥24 trillion, according to the International Monetary Fund (IMF), the Organisation for Economic Co-operation and Development (OECD), and UNCTAD.

How is such a huge discrepancy possible? Two sets of numbers are approved by the IMF, but only one—called the directional principle—is authorized for looking at a country's FDI over time or for comparing countries. MOF, by contrast, highlights the other set, called the asset/liability principle. The latter has its uses, but it also includes items having nothing to do with real FDI (e.g., loans from overseas affiliates back to their parents in Japan). A spokesperson for MOF confirmed that such loans accounted for most of the discrepancy. Asked about MOF's choice of numbers, an OECD official replied: "The directional principle is better suited to analyze the economic impact of FDI. It is the recommended presentation for FDI statistics by country and industry." If solving a problem requires recognizing that you have one—in this case low levels of inward FDI—then Tokyo is in trouble.

Why Did Japan Come in Last?

FDI has soared in other countries that switched from resisting FDI to welcoming it. In South Korea, inward FDI has leaped from two percent of GDP before reformer Prime Minister Kim Dae-Jung came to power in 1998 to 14 percent today. In India, the share has jumped from 0.5 percent in 1990 to 14 percent now. In post-Communist Eastern Europe, the ratio has mushroomed from seven to 55 percent. Why, then, have Japan's efforts failed?

In its June policy statement, the FDI Promotion Council wrote as if Japan didn't appeal to foreign companies. Hence, most of its focus was on creating an "attractive business environment." But the premise is inaccurate.

MOST ATTRACTIVE SME TARGETS ARE OUT OF REACH BECAUSE THEY BELONG TO CORPORATE GROUPS—THE VERTICAL *KEIRETSU* (COMPANY NETWORKS).

In survey after survey, multinational companies list Japan as a top target due to its large, affluent market, well-educated workforce and customer base, high technological levels, and so forth. In fact, Japan came in fourth out of 27 rich countries in the 2020 *Kearney Foreign Direct Investment Confidence Index*, an annual, global survey of senior executives conducted by the US-based global consultancy Kearney. Scholars Takeo Hoshi and Kozo Kiyota calculated that, if Japan performed like other countries with similar characteristics, the ratio of inward FDI to GDP would have already reached a very impactful 35 percent by 2015. In the 2021 survey, Japan slipped to fifth overall, but topped the

list for economic outlook in net terms. Business leaders were most optimistic about Japan, Germany, Canada, and Switzerland, with the United Arab Emirates and Australia tied for fifth.

The real problem is that Japan's most attractive companies are largely off limits to foreign purchasers. The press covers the spectacular exceptions where foreign enterprises rescue failing giants such as Nissan Motor Corporation, Sharp Corporation, and Toshiba Corporation. But the data shows that most foreign investors seek good companies that can not only help their sales in Japan, but offer resources that enhance the parent's global expansion. By contrast, most domestic purchases are largely rescue operations. The foreign firms are not pursuing companies that need downsizing. In fact, the usual Japanese target for foreign acquisition has higher profits, better technical capacity, and a greater willingness to adopt new practices than the typical organization in its industry.

Foreign companies also select fairly sizeable targets. From 1996 to 2020, non-Japanese paid $112 million for nongroup companies on the stock market and $60 million for unlisted ones. Domestic buyers bought much smaller companies: group members worth just $11 million and nongroup companies worth $30 million.

Unfortunately, the most attractive SME targets are out of reach because they belong to corporate groups—the vertical *keiretsu* (company networks). Japan's 26,000 parents and their 56,000 affiliate companies employ 18 million people, a third of Japan's employees.

This does not count other attractive companies among unaffiliated subcontractors and closely allied suppliers where the parent holds no company stock. The Toyota Group, for example, has 1,000 affiliates plus 40,000 suppliers, of which the majority are subcontractors. From 1996 to 2000, non-Japanese were only able to buy a trifling 57 member companies of corporate groups, whereas they bought about 3,000 unaffiliated companies.

This obstacle is a legacy of the early postwar era, when Tokyo restricted FDI out of fear of foreign domination. In the 1960s, when Japan had to liberalize to join the OECD, the government devised what it called liberalization countermeasures to create structural impediments. These ranged from reviving cross-shareholding among corporate giants and their financiers, to shoring up the horizontal and vertical *keiretsu*.

Under Koizumi, with input from ACCJ leaders such as Benes and despite the resistance of the Keidanren (the Japanese Business Federation), Tokyo reformed the company law in 2007 to make inward M&A easier. For the first time, foreign companies were allowed to use cash in so-called triangular mergers to buy 100 percent of a Japanese company's stock and, for the first time, they could use their own stock to pay for a company using a triangular merger. In both cases, they could squeeze out small holders of stock.

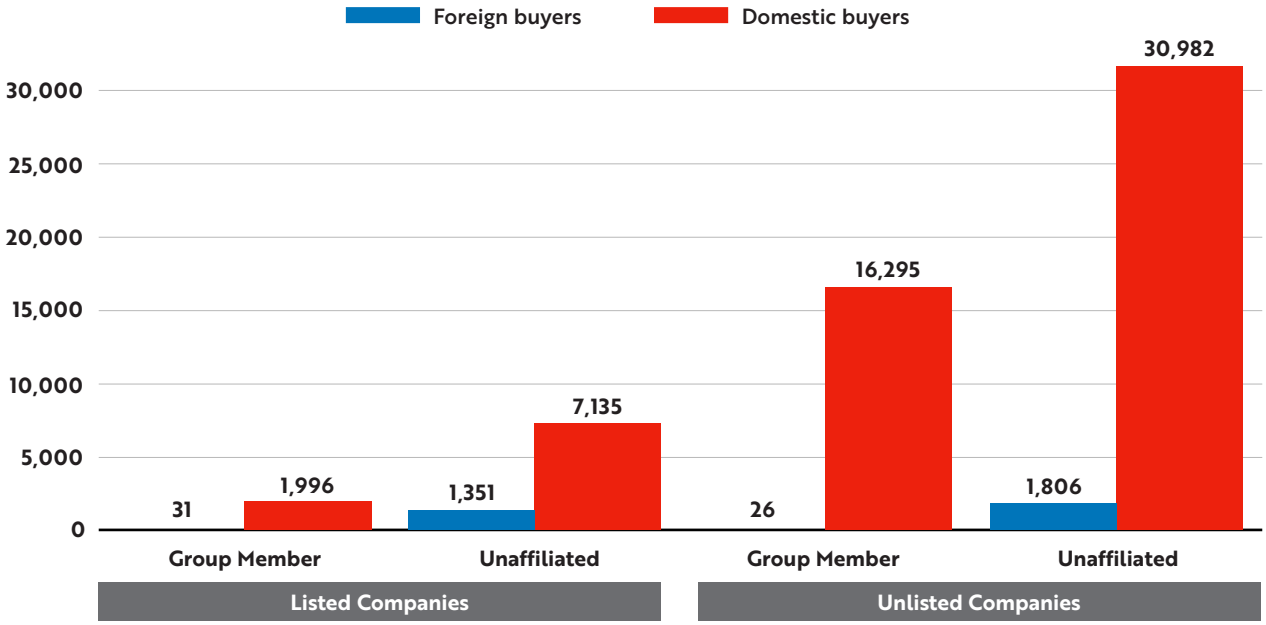
In a triangular merger, the foreign buyer sets up a Japanese subsidiary as a vehicle for the purchase, and that subsidiary must meet certain conditions. Would-be buyers still face some unwieldy rules and unfavorable tax treatment, including the way capital gains are counted and taxed in stock swaps.

The good news is that, over time, many of these formal hurdles in the M&A rules have been ameliorated, or companies have found a way to outflank them, according to Benes, ACCJ FDI and Global Economic Cooperation Committee Chair Kenneth Lebrun, and former committee co-chair Bryan Norton.

Both Lebrun and Benes have, in their professional careers, represented companies involved in inward M&A. The reported intention of Western Digital Corporation to use a stock swap to pay about $20 billion for Kioxia Corporation (the chip company spun off from Toshiba), will be a test case for the ease and cost of using an option that is more common and less tax-burdensome in other countries.

Total Number of M&A Cases

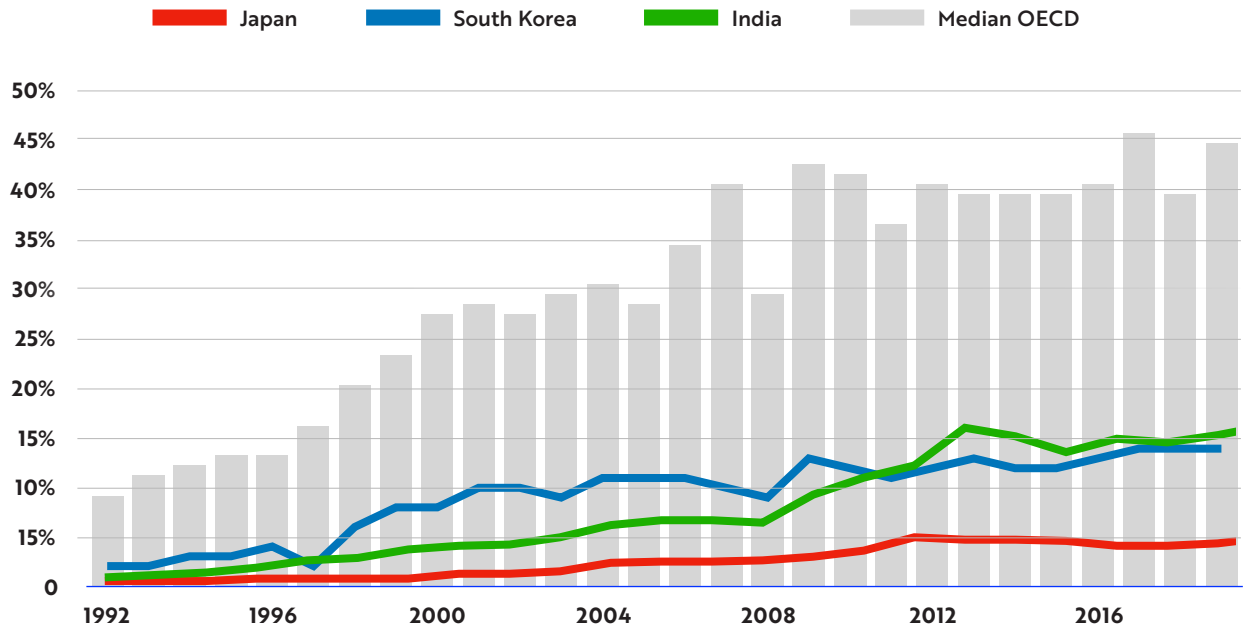
1996–2020



Source: RECOF M&A database: https://madb.recofdata.co.jp

Inward FDI: Japan vs. Others

Stock of inward FDI percent of GDP (1992–2019)



Source: UNCTAD Foreign Direct Investment: Inward and Outward Flows and Stock, Annual

Despite the remaining legal and regulatory hurdles in rules, the biggest impediment these days, said Benes, is the reluctance of companies to sell off divisions or affiliates to foreign strategic buyers. Yet he added that, largely due to governance reforms, even here the ice is beginning to crack.

"The difference now compared with 2005 is like night and day. Domestic M&A is common and, in some cases, shareholders have forced management's takeover defenses to be dismantled. This new atmosphere may be the biggest reason to expect more FDI via M&As in the future. Still, the floodgates will open more slowly than is optimal for Japan."

Despite this progress, many legacies of the past—from the vertical *keiretsu* to obsolete attitudes among some policymakers—still curb inbound M&As. One prominent US business executive noted how Toshiba's management and METI used the pretext of "national security concerns" in a failed attempt to block a shareholder vote against management. He feared that the same thing might occur in other cases.

Officials sometimes claim they are simply acquiescing to the public's fear of foreign takeovers. The reality is that the government lags a big change in the public mood. As early as the mid-2000s, 47 percent of respondents in surveys said the impact of foreign companies on the Japanese economy was positive, whereas only eight percent thought it was negative. Just four percent held the once-common view that foreign companies and financiers were "vultures" who wanted to buy Japanese companies on the cheap and then sell them to make a quick buck. Twenty percent of respondents said that they wanted to work for a foreign business while another 20 percent said that they did not want to. The rest offered no opinion.

Business leaders are divided. While the Keidanren has often been obstructionist, the more progressive Keizai Doyukai, the Japan Association of Corporate Executives, has welcomed FDI. In 2005, during the debate over Koizumi's Commercial Code reforms, it called for increasing inward FDI to 10 percent of GDP, twice Koizumi's goal. It advocated revising the tax code to allow deferment of capital gains taxes on M&As financed via stock swaps while warning against proposals that would impose a more difficult capital gains tax environment. In a 2015 document, it once again advocated better tax treatment of inbound M&As.

Keidanren, by contrast, recalled Benes, successfully lobbied METI to make the tax treatment for cross-border stock swaps as "burdensome and difficult as possible." At the very last minute, a senior METI official reversed the agreement that its own team in charge had already agreed on with MOF for convenient tax treatment. Unfortunately, the Keidanren continues to have much more sway with the government on these matters than does the Keizai Doyukai.

Three Drivers

Could inward FDI take a leap forward despite the government's resistance to inward FDI? Yes, it's possible because of three drivers.

First, as detailed above, is the sea change in attitudes among the general public as well as parts of the business community and some officials.

Second is the succession crisis at SMEs, also noted above. If necessity truly does give birth to invention, this could be the entrance ramp to making inward M&A a standard tool. How many 70-year-old owners of SMEs would refuse to sell to a foreigner, let their business die, and leave the employees jobless if the government or a big trading company made the introduction and vouched for the buyer's intention to help them grow rather than engage in mass layoffs?

Japan already has a number of companies, such as Nihon M&A Center Inc., which arrange domestic M&As for healthy SMEs with no successor. That has made M&As more acceptable.

So far, however, almost none of these cases have involved foreign buyers. There is also Japan Invest, a program of the Japan External Trade Organization (JETRO), which actively courts foreign companies to set up greenfield operations in Japan; but it makes no effort to recruit foreign companies to buy Japanese ones. Inbound M&A should be added to JETRO's mandate. Japan's giant *sogo shosha* (general trading companies) and megabanks, with their skill sets and extensive networks inside Japan and overseas, are very well suited to act as matchmakers for inbound M&As for these SMEs. It could be a very lucrative business for them.

Studies show that SMEs are more likely to sell to a foreign company if they see that other SMEs have done so successfully. Hence, as foreigners buy and improve SMEs, the process is likely to snowball.

Will better corporate governance become a driver? Many US executives expect that it will. Speaking of return on equity (ROE), one noted: "Ten years ago, when I used the term ROE, many Japanese executives asked me what I was talking about. Not these days." Some analysts point to companies such as Hitachi, Ltd. and Shiseido Japan, Co., Ltd. that sold healthy divisions to foreign private equity (PE) firms to focus on their most lucrative activities. Lebrun noted that, "the stock market has certainly rewarded companies that are taking these steps."

This logic may eventually bear fruit, but it will take years to see how much impact these reforms will have. Hitachi and Shiseido are the kind of globally active corporations that are most likely to improve efficiency for their own strategic reasons, not because of new governance rules. In fact, Hitachi began divesting before the change in the two codes. While "select and focus" has been a big buzz phrase in boardrooms during the past decade, it's hard to find data measuring how much the typical corporate giant has really implemented it, either by narrowing the range of products or shedding affiliates. In any case, the total number of subsidiaries and affiliates in 2017 was more or less the same as in 2007.

In anticipation of a boom in carve-outs, KKR, Bain Capital, LP, CVC Capital Partners, and about 80 other domestic and foreign PE firms are building up their war chests. So far, however, the anticipated upsurge has yet to emerge. Since 2004, there have only been 10–20 domestic divestitures above ¥10 billion ($100 million) to PE firms per year, a figure that has not increased over time.

The typical sale has been priced at about ¥50 billion ($500 million), with the notable exception of 2017, when a group led by Bain Capital paid $18 million for 40 percent of Toshiba's memory unit. There has so far been no trend increase in the total value of deals. The delay, commented consultancy Bain & Company, Inc. in a 2018 report, is due to the fact that there is still "insufficient pressure on corporates to sell quality assets" and that

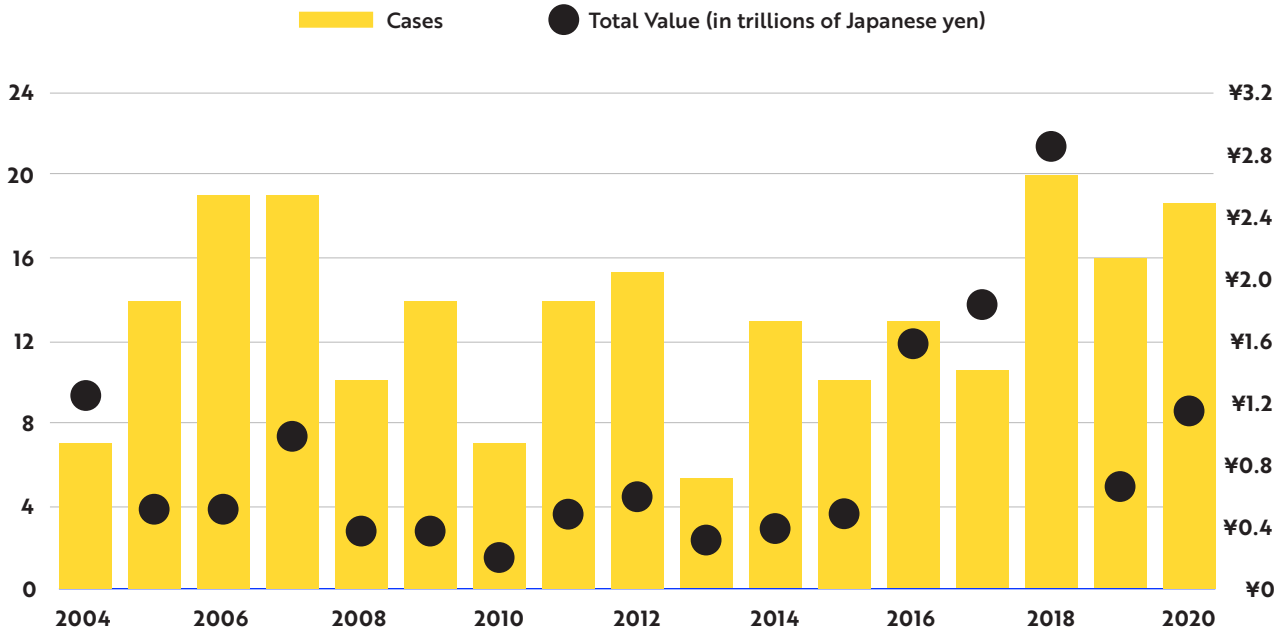
FDI Confidence Rankings

	2021		2020
United States	1	—	1
Canada	2	—	2
Germany	3	—	3
United Kingdom	4	▲	6
Japan	5	▼	4
France	6	▼	5
Australia	7	—	7
Italy	8	▲	9
Spain	9	▲	11
Switzerland	10	—	10
The Netherlands	11	▲	14
China	12	▼	8
New Zealand	13	—	13
Sweden	14	▲	15
United Arab Emirates	15	▲	19

Source: *2021 Kearney FDI Confidence Index®*

Corporate Divestitures via Sales to Private Equity Firms

Cases and total value (2004–20)



Source: Bain & Company analysis using AVCJ data. 2019–20 author's rough estimate.

"boards and shareholders do not yet push for strategic divestitures," i.e., selling profitable but lackluster units that don't enhance core competencies. Instead, Bain & Company added, corporations are taking easier routes to show better ROE numbers, such as stock buybacks and selling low-quality assets, namely, those that are unprofitable or suffer declining sales and a worsening competitive position.

Regardless of any rules on paper, shareholders' power over management is limited by a simple financial fact: Japan's 5,000 biggest corporations have little need to raise money on the equity markets to fund new investments, since their internally generated cash flow regularly surpasses their investments in new plant and equipment. The overall decline in stable shareholders (i.e., cross-shareholders plus other management allies) should be a force for improving shareholder power. However, as Benes points out, the Financial Services Agency (FSA) has issued rules that make it hard for minority shareholders to act collectively to make suggestions to management, as they can in the United States and the UK.

Beyond that, companies can make financial measures look better without any improvement in real efficiency. For example, if companies use current profits to measure ROE or return on assets (ROA), then the Bank of Japan's continual lowering of interest rates will make the measures look better. However, when ROA is measured in terms of operating profits—profits before interest—it's hard to find much improvement so far.

At the 5,000 biggest corporations during 1996–2012, ROA averaged just 3.5 percent. It rose only a smidgeon to 3.8 percent from 2013 to 2019. Worse yet, these companies increased their profits primarily by cutting wages rather than improving efficiency. In 2019, operating profit per worker was 70 percent higher than in 1996, even though sales per worker were only three percent higher.

How did companies pull that off? By cutting wages three percent per staffer and thereby shifting a big chunk of value-added from wages to profits. However, for an economy to be healthy, it is necessary for productivity, profits, and wages to grow in tandem. Unless shareholders care how better profit numbers are achieved, it's not clear how increased shareholder power would lead to more productive corporate strategies.

AS EARLY AS THE MID-2000s, 47 PERCENT OF RESPONDENTS IN SURVEYS SAID THE IMPACT OF FOREIGN COMPANIES ON THE JAPANESE ECONOMY WAS POSITIVE, WHEREAS ONLY EIGHT PERCENT THOUGHT IT WAS NEGATIVE.

Perhaps changes in corporate governance rules, the succession crisis, and other drivers will eventually add up to a force powerful enough to alter deep-seated mindsets regarding product diversification, vertical keiretsu, and sales to foreign strategic investors. Still, the likelihood is that the magnitude of change required in inward FDI will require a concerted policy effort by the government and business leaders. Otherwise, when 2030 arrives, Japan might still be little better than in 196th place. ■

This article was adapted from Katz's forthcoming book on reviving entrepreneurship in Japan.