Thematic Insight

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The Likelihood of Business Restructuring and Improvement in the Earnings of Japanese Companies

- **In Japan, companies with diversified businesses have relatively low profit margins. While diversification is an important option for companies whose core business are mature, a diversification strategy that does not incorporate exiting low-margin businesses is problematic.**
- **However, the factors that have hindered companies from divesting or selling businesses are receding. As corporate governance has improved, managers have become more focused on the cost of capital and capital efficiency, while securing labor has become an issue for companies given Japan's chronic labor shortage and increased labor market mobility. We expect an increasing number of companies to move forward with restructuring their business portfolios.**
- **Japan is often portrayed as slow to implement industrial restructuring, but the number of companies that have closed or been dissolved has risen sharply since the mid-2010s. Some listed companies, such as Hitachi, have improved earnings through restructured operations.**

Reasons for weak earnings at Japanese companies: Diversified firms have low margins

Japanese companies have achieved significant earnings growth over the past 20 years, but their margins are still lower than their US and European peers. Japanese companies' EPS increased by nearly 3.8x between 2000 and 2023, in line with US companies' EPS, but ROE in Japan was only 8.9% (FactSet; Exhibit 1), compared with 18.7% in the US and 14.8% in Europe (Exhibit 1). While a diversification strategy that lacks a divestiture and sale component is one reason for low margins, in this report we consider how the factors that have impeded divestitures are fading.

One reason why Japanese companies have suffered from low profitability is diversification. If we define "diversification ratio" as the share of a company's sales accounted for by non-core businesses (those other than its largest sales), we can divide companies in the MSCI Japan Index into four groups based on diversification ratios. In FY22, the group with a diversification ratio of less than 10% (specialized companies) had a net profit (NP) margin of 8.5%, while the group with a diversification ratio of over 50% (diversified companies) had the lowest NP margin (6.1%) (Exhibit 2). Net profit margins have been relatively low for diversified companies since FY18.

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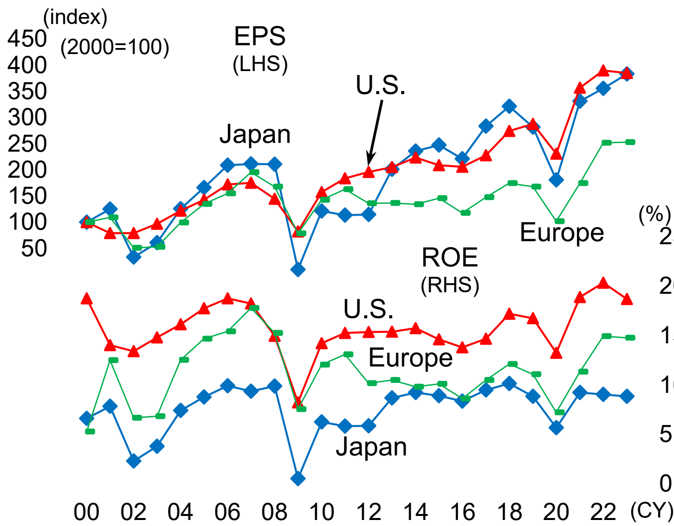
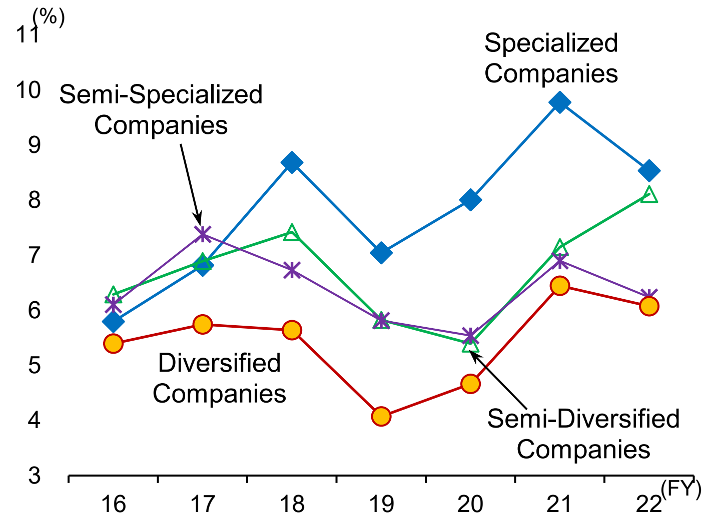
Exhibit 1: ROE of Japanese Companies Remains Low



Note: Universes are TOPIX500 for Japan, S&P500 for the U.S. and STOXX600 for Europe; data as of 2023.
Source: FactSet, MUFG: Trust Bank

Exhibit 2: Diversified Companies Have Low Profit Margin

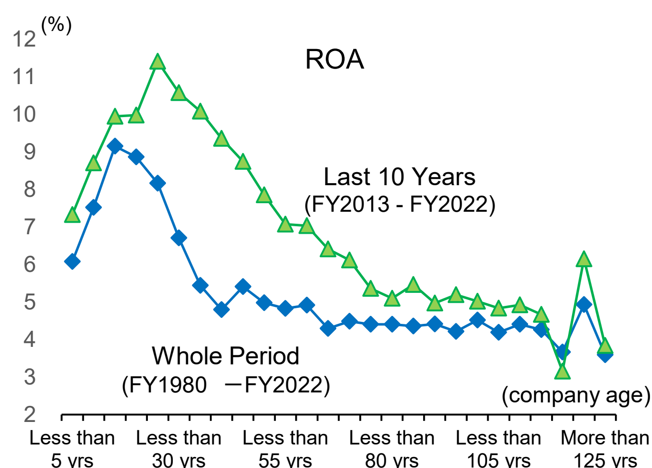


Note: Universe is MSCI Japan Index (excluding financials and REITs); the degree of diversification is the ratio of businesses other than the business with the largest sales to total sales, with less than 10% being specialized companies, 10% to 30% being semi-specialized companies, 30% to 50% being semi-diversified companies, and 50% or more being diversified companies.
Source: FactSet, MUFG: Trust Bank

A diversification strategy is not inherently bad. One recognized benefit of a diversified company is the diversification and reduction of risks. Companies that operate only a single core business tend to experience significant swings in earnings depending on demand trends, changes in consumer needs, and industry competition. It is not easy to sustain high profit margins over the long term when operating in only one business. Looking at the relationship between the company's years in business and its profitability (ROA), over the past 10 years, we see that ROA has tended to peak in 20 to 30 years after the company was established, and then decline thereafter. This is mainly due to pre-tax profit margins (Exhibits 3 and 4). We attribute this to a maturing market in a company's core business, and slower demand, as its products and services become more widespread. On the other hand, as the market for a company's mainstay products grows, new market participants increase, and new technologies emerge, competition will presumably intensify.

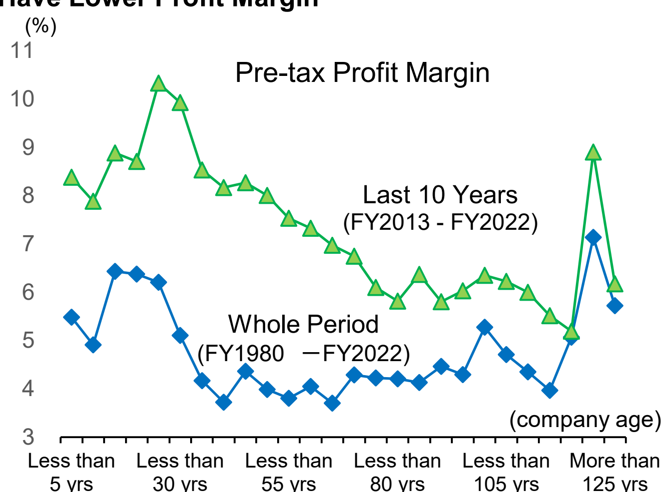
If the core business declines, moving into new businesses is extremely important. For example, as the market for silver halide film contracted along with the growth of digital cameras, Kodak was forced into bankruptcy due to its reluctance to invest in new technologies and new businesses whose future earnings potential was uncertain. For Fujifilm, by contrast, although its film business accounted for two-thirds of earnings at one point, as the company made progress in digital cameras, sales grew in areas such as medical systems, bio CDMO, semiconductors and LCD/OLED materials, and other products. Entering new business areas is a useful option for companies to achieve growth.

Exhibit 3: Companies with a Long History Tend to Have Lower ROA



Note: Universe is companies listed Prime Market and the First Section of TSE (excluding financials and REITs); company age is the years since establishment.
Source: Quick Workstation, MUFG: Trust Bank

Exhibit 4: Companies With a Long History Also Tend to Have Lower Profit Margin



Note: Universe is companies listed Prime Market and the First Section of TSE (excluding financials and REITs); company age is the years since establishment.
Source: Quick Workstation, MUFG: Trust Bank

However, when businesses diversify, there is a risk that management resources can be spread too thin and lead to a decline in management efficiency. In the 1990s, when Japan's economic growth slowed, diversified electronics companies, diversified chemicals companies, and general contractors saw their earnings slump. Some companies posted huge extraordinary losses for multiple years in a row. Directors at large companies represented their business divisions, making it difficult for directors in other divisions to demand aggressive strategic changes even if earnings had slumped for a prolonged period. In the case of the integrated electronics companies, it was allegedly impractical to operate, within a single company, both the semiconductor business, where management decisions are required on a monthly basis, and the nuclear power business, which involves executing business strategies on a ten-year scale, given the differences in organizational culture and management perspectives.

At the same time, when many companies operate in the same line of business, sales volumes are lower, and companies cannot benefit from economies of scale. In the chemical industry, there are seven Japanese companies in the global top 50 in terms of sales (as of 2022; Exhibit 5). While this is less than the US, with 10 companies, it is more than China (5), Germany (4), and the UK, France, and South Korea (2 each). The Japanese chemical companies have sales in the range of USD10-30bn, less than half the level of the top US and European companies. Scale is not necessarily important in the field of specialty chemicals, but it is a key determinant of competitiveness in commodity petrochemical products. If international competitiveness is not high, companies end up competing for limited domestic market share, raising the odds of excessive competition.

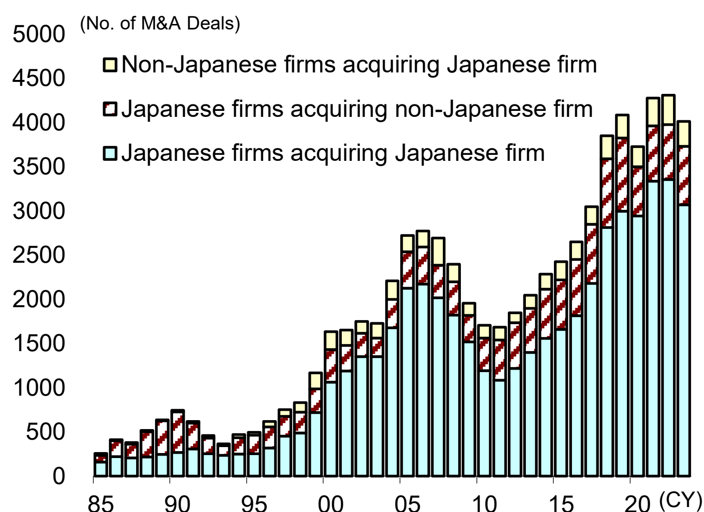
The lack of withdrawals or divestitures is the main problem. Although Japanese companies also use M&A as a business strategy option, they tend to focus on acquisitions (of business lines or whole companies), while the sale of a business unit remains rare. The number of M&A deals involving Japanese companies has risen sharply over the past 30 years and has hovered around 4,000 per year since 2018. However, based on Recof data, the number of M&A transactions where an overseas company acquired a Japanese company (283 deals in 2023) was approximately half of the number of deals where a Japanese company acquired a foreign company (661 deals in 2023) (Exhibit 6). According to the Ministry of Economy, Trade and Industry (METI), the number of business sales (e.g., sales of subsidiaries or business units, spin-offs, etc.) per listed Japanese listed company is around one-third that of the US (2018).

Exhibit 5: Global Top Chemical Producers

Rank	Company	Headquarters	Sales ($ bln.)
1	BASF	Germany	92.0
2	Sinopec	China	66.9
3	Dow	US	56.9
4	Sabic	Saudi Arabia	48.8
5	ExxonMobil	US	47.5
6	Ineos	England	41.2
7	Formosa Plastics	Taiwan	40.2
8	LG Chemical	South Korea	40.2
9	Lyondell Basell Industries	US	39.5
10	Petro China	China	38.3
14	Mitsubishi Chemical Group	Japan	29.4
20	Shin-Etsu Cemical	Japan	21.4
30	Sumitomo Chemical	Japan	16.9
31	Toray Industries	Japan	16.7
33	Mitsui Chemical	Japan	14.3
42	Resonac Holdings	Japan	10.6
45	Asahi Kasei	Japan	10.0

Note: Data as of 2022.
Source: Chemical & Engineering News, MUFG: Trust Bank

Exhibit 6: M&A Deals Involving Japanese Companies Have Increased, but …



Note: Data as of 2023.
Source: RECOF, MUFG: Trust Bank

With the aim of facilitating business restructuring, the spin-off tax system was revised in FY17 to allow existing shareholders to defer taxes on gains/losses on transfers and dividends when companies spin off specific businesses and divisions independently. However, use of the spin-off tax system is low, and among listed companies, Koshidaka was the only example in 2019.

The Trade White Paper (2015) shows that the efficiency of R&D investment is declining at Japanese companies with diversified businesses. It notes that, compared to leading companies in the US and Europe, management resources at diversified Japanese companies are spread widely, making it difficult to invest sufficiently to transition toward high growth and high profits. It also points out that growth and profitability could be low because rapid adjustments to a company's business portfolio, with a focus on its own competitive advantage, are not being carried out.

According to a paper by Waseda University Professor Hiroshi Shimizu et al. ("Staying Young at Heart or Wisdom of Age: Longitudinal Analysis of Age and Performance in US and Japanese Firms" 2018), even American companies that have been in business for a long time have not seen their profitability (operating profit margin) decline as significantly as Japanese companies. The paper attributes this to the tendency for Japanese companies to continue operating existing businesses and not change the allocation of management resources. We believe the reason for low profitability is because companies lack clear business strategies and fail to keep management resources focused on core businesses. Diversification that never involves exiting from a business is an issue for low margin Japanese companies.

Improved corporate governance and greater awareness of the cost of capital

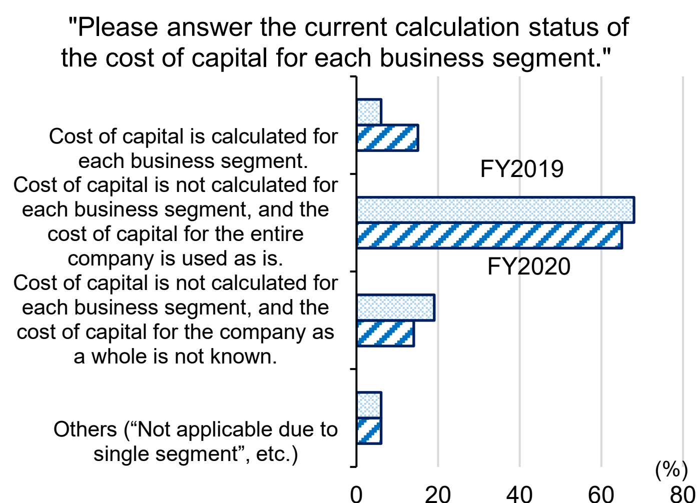
However, the factors that have hindered companies from divesting or selling businesses are receding. The first is a growing awareness of the cost of capital.

In the past, Japanese companies have focused on income statement items such as sales and profits, without taking their balance sheets or capital efficiency sufficiently into account. Companies that at least calculated the cost of capital for each line business were in the minority. According to a 2020 survey of listed companies, although the number of companies that calculated the cost of capital for each business segment increased from the previous year, these represented only 15% of the total. Meanwhile, companies that did not calculate the cost of capital by business segment and used the cost of capital for the entire company stood at 65% (Exhibit 7). In terms of problems related to exiting or selling businesses, the most common response was "unclear criteria" (39%), followed by “internal deliberation process lacks clarity” (25%). Against this backdrop, companies made little progress in withdrawing from or selling off businesses.

However, an increasing number of companies are taking note of the cost of capital and capital efficiency. According to the Life Insurance Association of Japan, the percentage of companies disclosing ROIC (return on invested capital) in their medium-term plans rose from 3.8% in FY17 to 17.6% in FY22 (Exhibit 8). While they are not as commonly used as metrics such as ROE or profit growth rates, companies are now keeping an eye on capital efficiency when making decisions on capex and M&A. The percentage of companies disclosing their cost of capital (e.g., WACC) has risen from 0.5% to 3.0%.

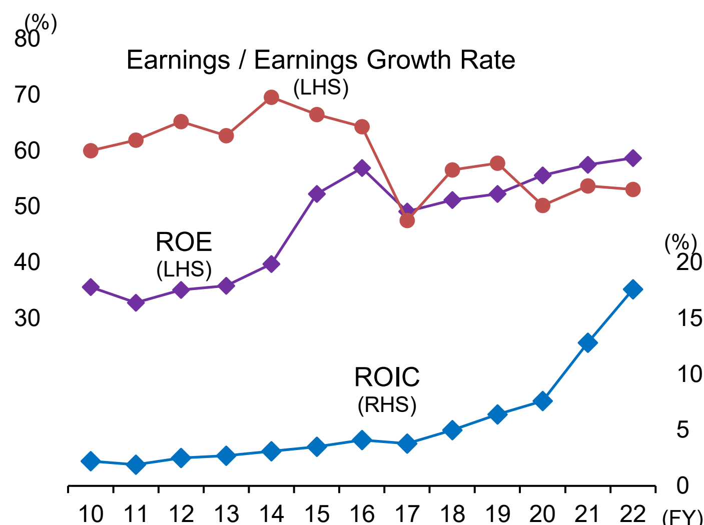
The cost of capital has been widely discussed in the media and is gradually becoming more widely recognized by society. An increasing number of companies grasp the concept of a "Best Owner" as a management team capable of maximizing the long-term value of a business.

Exhibit 7: Many Companies did not Calculate the Cost of Capital for Each Business Segment



Note: Universe is companies listed the First and Second Section of TSE; the number of valid responses in 2020 was 946 companies.
Source: METI, MUFG: Trust Bank

Exhibit 8: More Companies Emphasizing ROIC as a KPI in Their Mid-term Business Plans Recently



Note: Universe is 1,200 listed companies with largest market caps; other options include “sales/sales growth rate,” “profit margin on sales,' “dividend payout ratio," etc.; data as of 2022.
Source: Life Insurance Association, MUFG: Trust Bank

Despite some lingering issues, we attribute this to the stock market’s impact on improving corporate governance. After World War II, corporate governance in Japan was centered on indirect financing, which was known as the main bank system. From a creditor’s perspective, expanding sales and diversifying risks through business diversification is a desirable strategy to ensure the certainty of interest and debt service payments. Main banks and other creditors were also major shareholders of listed companies through cross shareholdings. In FY92, banks (city and regional banks) and life insurers held, respectively, 15.6% and 12.4% of the shares of listed

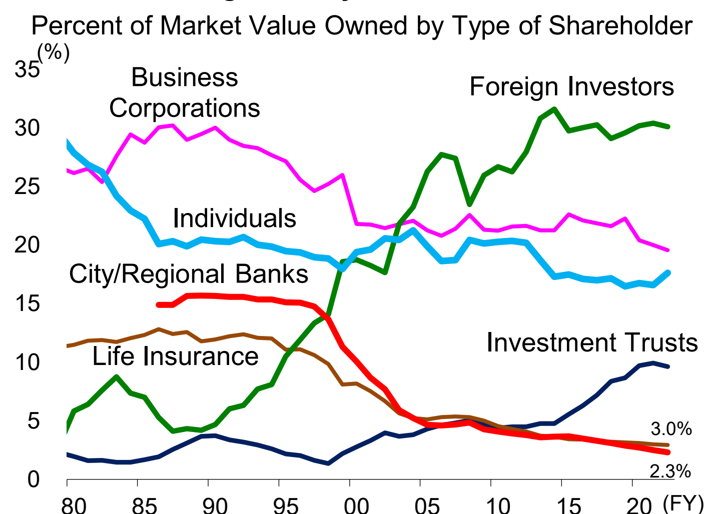
companies (Exhibit 9). From a certain angle, Japanese companies had diversified their businesses in the interests of their creditors, who were major shareholders, and thus failed to stress the importance of capital efficiency.

However, listed companies improved their financial position, making it easier for them to raise funds through capital markets. As a result, the main bank system morphed into a mere shell in the 1980s. Since the latter half of the 1990s, banks and life insurers have been forced to unwind cross-shareholdings in order to dispose of non-performing loans, and their equity stakes have fallen to 2.3% and 3.0%, respectively (FY22).

On the other hand, pure investor shareholders such as foreign investors, Japanese pension funds, and investment trusts, have increased their presence. The Stewardship Code (2014) and the Corporate Governance Code (2015) have led companies to recognize the interests of minority shareholders, including the cost of capital, through dialogue with shareholders and investors. For example, the proportion of companies with one-third or more outside directors on the board rose from 6.4% in 2014 to 95.0% in 2023. Total dividends paid by Prime Market companies (TSE1-listed firms) increased from JPY3.0trn in FY00 to JPY17.3trn in FY22.

Market pressure has mounted on companies that remain wed to inefficient management. Activist shareholder proposals are no longer unusual occurrences for companies with problems such as excessive levels of cash or securities holdings (Exhibit 10). Unfriendly M&A deals are on the rise, such as Nidek's launch of a tender offer for machine tool maker TAKISAWA in 2023, without the consent of TAKISAWA's management. TAKISAWA initially rejected the takeover bid but has now expressed its support. Likewise, after M3 made a tender offer for Benefit One, Dai-ichi Life Holdings launched a competing takeover bid.

Exhibit 9: Ownership of Stocks by Banks and Life Insurance has Significantly Decreased



Note: Shaded area indicates period of recession; data as of FY 2022.
Source: TSE, MUFG: Trust Bank

Exhibit 10: Number of Shareholder Proposals From Activists is Increasing

Note: Data as of September 2023.
Source: IR Japan HD, MUFG: Trust Bank

Against this backdrop, METI released its Action Guidelines for M&A in August 2023. Given the importance of optimizing resource distribution through M&A and industry reorganization as well as reshuffling the structure of the company through sound capital market function, this policy established a code of conduct for corporate directors and the board when corporate acquisitions take place. In addition, it revised previously used expressions such as "hostile takeover" and "takeover defense measures" to "takeover without consent" and "takeover response guidelines and countermeasures."

It asserts that acquisitions that secure or improve corporate value and shareholder profits are desirable and displays the principle that the right to control management should derive from the rational will of shareholders. It urges corporate boards not to misinterpret sincere acquisition proposals and to be cautious about not casually rejecting bids that could boost corporate value. Companies that are unable to build an appropriate business portfolio and have low capital efficiency will find it difficult to fend off M&A without board consent.

Increased labor market mobility

At the same time, the chronic labor shortages and increased labor market mobility are also points of interest.

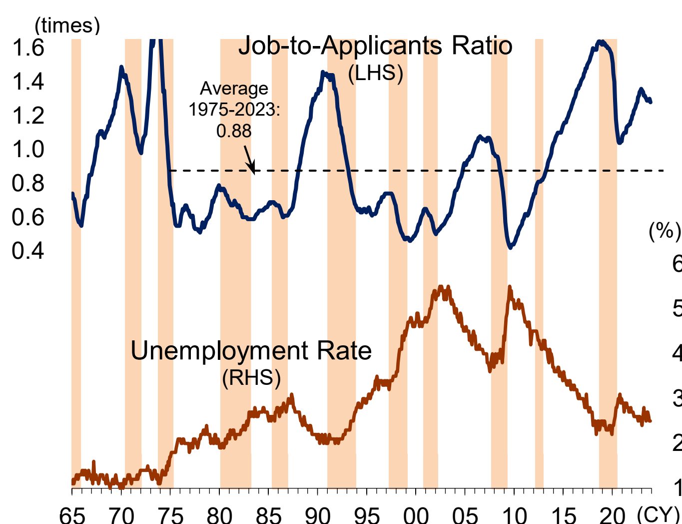
In the past, Japanese companies have, to some extent, pursued business diversification to provide a safety net for employees. The Japanese employment system, premised on lifetime employment and seniority-based pay, has made it difficult for companies to reduce headcount, and companies have presumably been unable to sell low-margin businesses. While dismissal of an employee without cause is not technically prohibited by law, companies have, given historical precedents, typically built business strategies on the assumption that workers will not be fired. Pioneer faced harsh criticism from the media in January 1993 when, in the face of worsening earnings due to Japan's asset bubble collapse and ongoing yen appreciation, it issued nomination retirement recommendations (effectively dismissals) to 35 managerial staff aged 50 and above.

However, the labor market has clearly changed. The number of workers has increased over the past 30 years, despite a decline in the working-age population, driven higher by women and the elderly. The labor force participation rate for women aged 15-64 reached 74.3% (OECD data, 2022), well above the US and France and on par with Germany and the UK. The job openings-to-applicants ratio has consistently exceeded 1x since 2014 (Exhibit 11), a situation that has not held since the early 1970s. The BoJ's Tankan survey shows that "insufficient employment" has consistently exceeded "excessive employment" since 2013. Japan is facing chronic labor shortages, and the challenge for companies has shifted from reducing headcount to securing human resources.

At the same time, there has been a change in attitudes toward work and companies, particularly among younger people, with individuals increasingly changing jobs in order to achieve self-fulfillment. In recent years, there has been a noticeable increase in job changes from regular employees to regular employees. The number of job seekers remained in the 8 million range until 2020, but then increased to 10.35 million (September 2023,Exhibit 12). Since around 2015, the majority of job changers aged 45 or younger have seen higher incomes as a result of changing jobs, reducing the likelihood of job-switching hesitation due to fears that pay will go down. The average length of service for people aged 45-50 fell from 19.4 years in 2001 to 16.4 years in 2022.

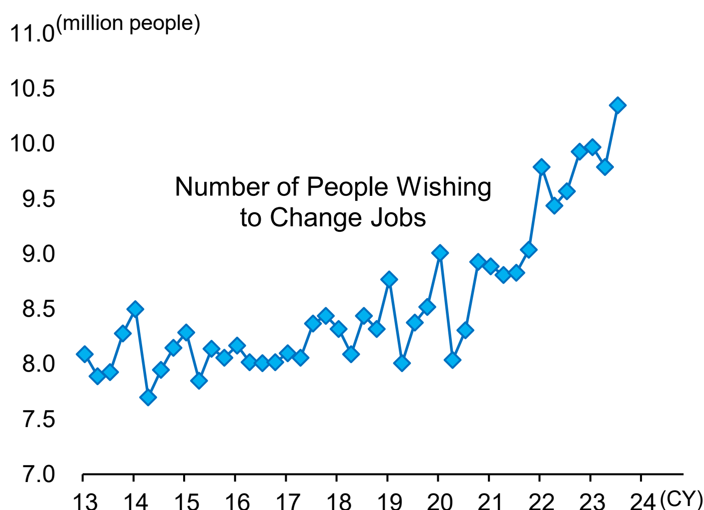
We believe companies are unable to secure sufficient human resources unless they provide compensation and work that employees find acceptable. It will be difficult even for large companies paying fairly high wages to hold on to talented personnel in businesses that are treated as burdens within the company. The notion of not withdrawing from low-profit businesses as a safety net to hold on to employees is a relic of the past. As labor market mobility increases, we expect an increasing number of companies to withdraw from or sell low-margin businesses.

Exhibit 11: Labor Market Continues to be Tight



Note: Shaded area indicates recession; data as of November 2023.
Source: MHLW, MIC, MUFG: Trust Bank

Exhibit 12: More People Wish to Change Jobs



Note: Quarterly data; data as of September 2023.
Source: MHLW, MUFG: Trust Bank

Business reorganization leading to earnings improvement

In Japan, some companies are improving their earnings through business restructuring.

Hitachi is a prime example. After overcoming substantial recurring losses stemming from the global financial crisis (FY08) through significant cuts in fixed and material costs as well as by raising capital, Hitachi openly pledged to restructure its business in its 2015 mid-term management plan ("Building a Foundation for Growth and Replacing Businesses"), unveiling a business strategy geared towards growth. The company conducted a thorough review of its sprawling business structure. Actions were implemented in areas deemed to be non-core, such as discontinuing in-house production of flat-panel TVs, selling the Hard Disk Drive (HDD) business, and establishing a joint venture for the thermal power business. The company reduced the number of listed subsidiaries from over 20 to zero, including the sale of Hitachi Metals and Hitachi Chemical, which were part of its so-called "Big Three," and the partial sale of shares in Hitachi Construction Machinery. Meanwhile, the company concentrated its managerial resources on the "Social Innovation Business," turning its listed subsidiaries in core businesses into wholly owned subsidiaries. Additionally, the company acquired ABB's power grid business and GlobalLogic.

Hitachi adopted ROIC (return on invested capital) as a performance metric in 2019 in order to focus on capital efficiency and discloses ROIC by segment (Exhibit 13). The 2024 medium-term plan calls for a shift from business portfolio reforms to organic growth, with adjusted EBITA as a key metric for each segment. During this period, NP grew from JPY175.3bn in FY12 to JPY649.1bn in FY22. Over the past five years, TSR (total shareholder returns) have grown at an annualized rate of 15.2% (vs. 5.7% for TOPIX; March 2023).

Hitachi's business reorganization was triggered by the booking of massive recurring losses in FY08, when the company was shaken to its foundations. However, we believe that governance reform under the leadership of Takashi Kawamura and Hiroaki Nakanishi, who had experience in managing overseas companies, played a major role in its transformation. There is substantial room for corporate governance reform at Japanese companies to lead to earnings improvement through business restructuring and other changes in business strategies.

Exhibit 13: Performance Targets by Sector in Hitachi Integrated Report FY2018

Sector	Item	FY2018 results	FY2019 forecast	FY2021 targets
IT	Revenues	¥2,121.6 billion	¥2,060.0 billion	**¥2,600.0 billion**
	Adjusted operating income (Adjusted operating income ratio)	¥230.1billion (10.8%)	¥220.0billion (10.7%)	**¥338.0billion (13.0%)**
	ROIC	19.6%	15.9%	**15.0%**
Energy ※1※3	Revenues	¥456.6 billion	¥384.9 billion	**More than ¥1,700.0 billion**
	Adjusted operating income (Adjusted operating income ratio)	¥35.9billion (7.9%)	¥24.9billion (6.5%)	**More than ¥170.0 billion (More than 10%)**
	ROIC	5.8%	6.0%	**7.5%**
Industry ※1※3	Revenues	¥843.6 billion	¥839.6 billion	**¥1,000.0 billion**
	Adjusted operating income (Adjusted operating income ratio)	¥58.2billion (6.9%)	¥58.4billion (7.0%)	**¥91.0billion (9.1%)**
	ROIC	9.0%	10.1%	**10.8%**
Mobility ※1	Revenues	¥1,238.1 billion	¥1,155.0 billion	**¥1,270.0 billion**
	Adjusted operating income (Adjusted operating income ratio)	¥100.2billion (8.1%)	¥96.2billion (8.3%)	**¥124.8billion (9.8%)**
	ROIC	13.6%	11.6%	**13.1%**
Smart-life ※2	Revenues	¥1,816 billion	¥1,723.2 billion	**More than ¥2,100.0 billion**
	Adjusted operating income (Adjusted operating income ratio)	¥93.4billion (5%)	¥119.0billion (7%)	**More than ¥210.0 billion (More than 10%)**
	ROIC	10.0%	10.0%	**More than 15%**

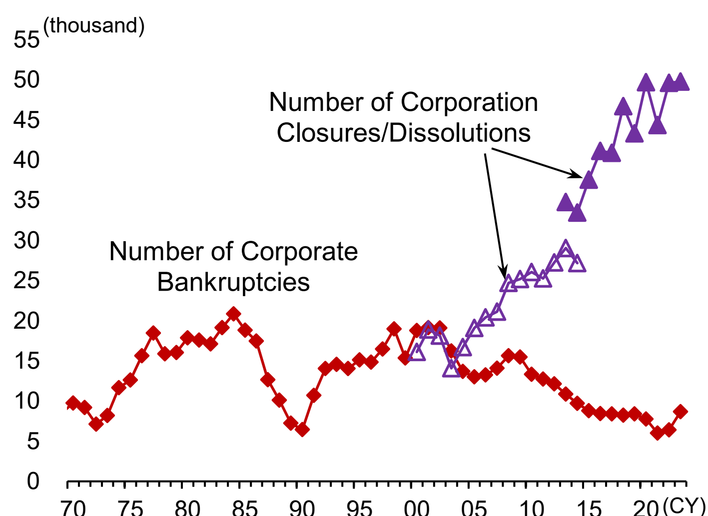
※1 It includes the control system business reported on IT sector. ※2 It includes the healthcare business of Hitachi High Technologies. ※3 Figures for FY2018 except one-time expenses.

Source: Hitachi Integrated Report

If many companies revamp their business strategies, including withdrawing from or selling off businesses, we would expect industry realignment to make headway. It is often said that corporate rejuvenation and industry restructuring are not making much progress in Japan, but the number of business closures, suspensions, and dissolutions has increased significantly since the mid-2010s. Compared with 8,690 bankruptcies in 2023, 49,788 companies were shut down or dissolved (Tokyo Shoko Research, Exhibit 14). An increasing number of unlisted SMEs are closing due to the aging of managers and difficulties in securing employees. Moreover, if interest rates normalize, shareholders and creditors will no longer sanction the maintenance of low-margin businesses. In addition to business closures and dissolutions, corporate bankruptcies may also increase.

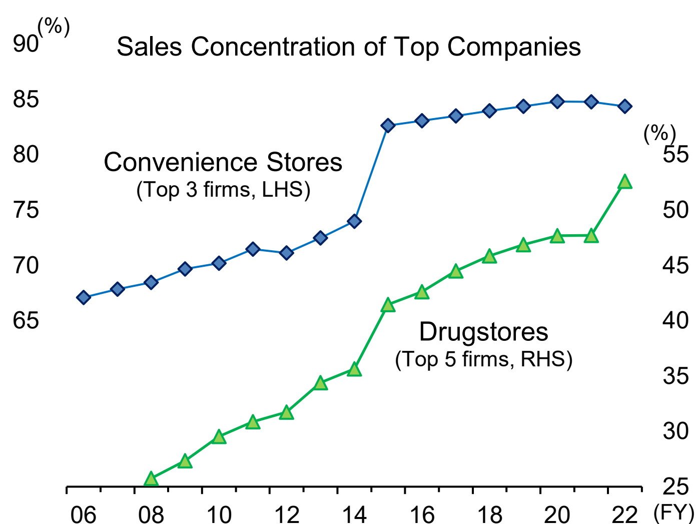
Listed companies are also undergoing industry realignment and consolidation. In the convenience store industry, the share of industry sales accounted for by the top three companies rose from 67.1% in 2006 to 83.1% in 2015, while the share of the top five drugstores rose from 25.8% in 2008 to 52.6% in 2022 (Exhibit 15). Over the long term, if industry consolidation progresses, the winners will be able to grow sales by increasing their market share, while also securing appropriate margins by easing excessive competition, which should lead to substantial profit growth.

Exhibit 14: Number of Corporate Closures and Dissolutions is Increasing



Note: Number of corporate suspensions/dissolutions is counted differently up to 2012; data as of 2023.
Source: Tokyo Shoko Research, MUFG: Trust Bank

Exhibit 15: Top Companies Enjoy Higher Market Share in Convenience Stores and Drugstores



Note: The top five drugstore operators differ by fiscal year; data as of 2022.
Source: METI, Home Center Institute, company data, MUFG: Trust Bank

Diversification is not always a mistaken strategy. For companies facing a contraction in their core business, entering new business areas is one option. However, it is unwise to stick with a business that is unlikely to grow or improve margins. To date, many Japanese companies have stuck with low-margin businesses based on corporate governance structures focused on creditors. However, companies now stress the cost of capital and capital efficiency and face a chronic labor shortage. A growing number of companies are likely to restructure, including withdrawing from or selling off businesses.

The focus by management on capital costs, and the resulting dividends and share buybacks, has been highly rated by the stock market, which has taken it as a sign of revamped capital strategy. We think Japanese equity valuations will rise in the future as this revamp of corporate strategy, including divestments and withdrawals, makes progress and leads to further improvement in corporate earnings. In terms of individual companies, we believe this will create disparities in long-term profit growth and stock returns. For value investors, it will be extremely important to assess not only the value of assets but also the business strategies and management leadership qualities.

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