

Fukao Report

Executive Summary

Chapter 1: Introduction

Unlike portfolio investment, direct investment brings lasting benefits: new management resources, know-how, technology, methods and products. Although the Japanese government has declared its intention to double foreign direct investment (FDI) in five years and urged the people of Japan to welcome foreign investment, a surprising lack of empirical analysis of FDI hampers achieving that objective—especially on mergers and acquisitions (M&A) which constitutes the bulk of FDI among developed countries, including Japan. Consequently, numerous misunderstandings and an aversion to FDI remain widespread in Japan.

This study presents an in-depth analysis of FDI in Japan based on empirical evidence. It seeks to answer such questions as how much FDI actually exists, where is it concentrated; whether FDI only seeks short-term profits and technology, or grows companies over time; whether greenfield investment and M&A differ in terms of their impact and benefits; why FDI in Japan has increased recently (albeit from a low base); what policies will be needed in order for the government to realistically hope to meet its goal of doubling FDI in five years; and why FDI is important to revitalizing the Japanese economy.

Chapter 2: FDI In Japan

FDI flowing into Japan is extremely low compared to other industrialized countries, where it makes important contributions to employment and capital investment. As a percentage of GDP, Japan's cumulative "stock" of FDI is one-eleventh that of the U.S., one twenty-second that of Germany, and far less than China or South Korea. Only 1.36% of workers in Japan are employed by foreign-affiliated firms, while 11% are in the U.S. These low levels result from policies dating back to the Meiji period that have included outright prohibition, restrictive licensing, currency controls, liberalization only as Japanese companies become competitive, cross-shareholdings, other barriers to M&A, and import restrictions. This historically restrictive policy stance has contributed to the misunderstandings and negative feelings towards foreign investment among the Japanese people.

At the same time, the rapid and massive outflow of direct investment from Japan is "hollowing out" Japan's manufacturing sector. As these outflows are five to ten times as large as the inward FDI flows, the effect of this huge and persistent "disinvestment" on the economy is not being offset. As in other developed countries, M&A is the main driver of inward FDI, but since Japan's M&A market (even now) is narrow and undeveloped, total FDI inflows remains relatively small.

Japan can no longer simply rely on its high savings rate and its own R&D and management resources in order to compete in global markets and generate sufficient domestic investment to support growth of the economy and employment. In order to do this, it will need to attract investment that has higher productivity—and is therefore more sustainable—from any source it can.

FDI in Japan is concentrated in a limited number of industries. One reason for this is that some industries are “sanctuaries” that are not open to entry by *any* new investors, whether foreign or domestic. Examples include transportation, employment services, agriculture services, health care, education, electric power, and electric power. Another reason is that trade tends to *precede* investment, and therefore import barriers have dampened inward investment that might have come later had trade flows been larger. Today, most impediments relate more to entry restrictions that equally affect *all* new investors, than to trade barriers. Although FDI has grown nearly 50% in the past four years, in the services area it is still only one-fifth, and in manufacturing sector only one-eighth, of the U.S. level.

Contrary to popular belief, FDI in Japan has benefited regional Japanese economies. While 87% of foreign affiliated firms are headquartered in Tokyo, Kanagawa and Osaka, 54% of their facilities and more than half of the jobs are located elsewhere. This is despite the fact that local governments have had very limited resources and authority to attract foreign investors.

A so-called FDI “boom” during the last half of the 1990s was spurred by deregulation (largely in non-manufacturing), declining stock and land prices, and the global boom in M&A. But in relative terms, Japan is still losing out in the international competition to attract investment from global companies—including Japanese companies—that would support the jobs and wealth of the Japanese people.

Chapter 3: Why Inward Direct Investment Is Important to Japan

Japan’s “lost decade”—triggered by overly restrictive monetary and financial policies leading to deflation, a liquidity trap, and deteriorating balance sheets—can be traced back to the 1970s when growth of the working population slowed, thus increasing costs and lowering productivity and returns on capital investment. Private savings remained high as domestic investment fell, resulting in excess savings, slow economic growth, and falling corporate earnings. Low profits led to shrinking capital investment and—most critically— a further slowdown in total factor productivity (TFP).

Channeling excess savings into inefficient public works projects, and relying on exports—mainly to the U.S.—did not solve the structural problems of excess savings, falling manufacturing productivity and weak private sector demand. Non-performing loans (NPLs) mounted and the current account surplus provoked protectionism in the U.S.

The key to restoring economic growth is to raise productivity. In the 1990s TFP in the manufacturing sector rose only in electronics and chemicals. However, it improved in the service sector in response to the greater competition brought about by deregulation in industries such as finance, wholesale/retail sales, broadcasting and communications. Still, TFP improvement and productivity in the services sector lagged other developed nations. In manufacturing, moreover, the “metabolic rate” turned negative, as high productivity companies left the market entirely (or went overseas) but the low productivity companies that remained were kept alive. The inefficient banking and finance system was one of the major causes for this low “metabolic rate”.

Chapter 4: Do Foreign Firms in Fact Bring Higher Productivity (TFP)?

Empirical analysis shows that relative to Japanese companies, foreign firms in Japan have about 10% higher TFP and profitability; employ a higher rate of capital investment per employee; spend more on R&D per worker; grow their tangible assets 4% faster; pay wages that are 1.21 million yen higher per employee; and enjoy 2.3% higher sales margins, and higher per-worker operating margins. Moreover, during 1994-98, they did not appear to reduce employment more than Japanese firms. Accurately analyzed, FDI enhances private investment, boosts productivity, spurs demand and raises TFP for the economy as a whole.

Investee companies in inbound M&A transactions (more than 33.4% equity) also demonstrated higher TFP gains, return on capital, and labor efficiency than firms acquired in domestic M&A transactions. (Actually, on average, M&A between domestic firms lowered TFP.) Employment by inbound M&A target firms does usually fall in the short term, since without restructuring many of these firms almost certainly would have failed. Although so far data is limited, it can be assumed that inbound M&A investees will reach the levels attained by other foreign affiliated firms for profitability, capital investment, wage rates, and R&D expenditures, thereby raising stimulating the economy as a whole and creating new and better jobs.

Chapter 5: Background on the Increase in Inbound M&A

M&A is the principal driver of FDI in all developed countries, including Japan. Most of the recent increases in Japan’s FDI has come through new inbound M&A transactions or follow-on investments to grow acquired firms not through “greenfield” investment.

However, Japan’s M&A market is not large by international standards. Within this small market, Japanese domestic firms (not foreign firms) carried out by far the largest number of M&A transactions during the 1990s. The inbound portion of all M&A peaked at around 11% in 1999 and fell to 7.5% in 2002. Furthermore, of the M&A flows involving foreign-affiliated firms listed on the Tokyo stock exchange, 63.9% were already affiliated with foreign capital. If these cases and those involving inward investment to make up for capital deficiencies due to the recession

are excluded, inbound M&A only accounted for 5% of total M&A on a value basis. Thus there is much room for expansion.

Private equity funds serve many purposes, including investing in new ventures and spin-offs from existing firms, and rehabilitating distressed firms so they can be sold at a profit. Reforms to the Corporate Rehabilitation Law and various government laws/policies have led to a proliferation of private equity (PE) funds in recent years, including by government-owned financial institutions such as the Industrial Revitalization Corporation, mainly in order to deal with excessive NPLs and revive distressed companies. It is estimated that today 30% of PE investment relates to distressed loan assets in some way or another.

At the beginning of 2002, the growing number of M&As by PE funds comprised almost 20% of total announced M&A volume in Japan. Despite media comments that sometimes suggest otherwise, in point of fact, investments by *foreign* PE funds account for only about 5% of total inbound M&A by foreign firms.

As is the case with out-in M&A, inbound PE M&As tend to be large deals. Additionally, their objective is often to revive the acquired company quickly and then sell it, which is why some people call them “vulture” funds. However, this short-term technique for reviving companies could well become more widespread.

In terms of type of M&A transaction, in 2002 only 4.9% of transactions were mergers; acquisitions comprised 34%; business transfers totaled 24.7%; capital participation deals made up 31.7%; and capital increases comprised 4.8%. Further, more than 77% of all deals were between domestic Japanese companies. Out-in transactions constituted only 7.9% of all M&A in 2002. Most M&A takes the form of acquisition or capital participation because foreign investors cannot use parent company stock for stock-swap or merger transactions, and because foreign acquirers usually seek management control in order to speed up decision making and revive the company quickly.

In Japan, M&A of any type has long been inhibited by corporate governance practices such as internally promoted board directors or blood relatives in the case of family businesses and the restrictive or defensive influence of main banks and cross shareholdings. Other inhibiting factors include a high level of retained earnings (“internal financing”), and in some cases the inability to rationalize operations through labor force adjustments.

Most of the recent regulatory reforms have focused on facilitating reorganization by domestic companies or among companies belonging to the same business group, rather than facilitating M&A with unrelated “third parties”, including foreign companies. “Noncash” structural methods such cross-border stock exchanges on a deferred tax basis, or so-called “triangular” mergers, are not available to foreign acquirers. (In contrast, seventy percent of domestic (in-in) M&A in 2002 consisted of transactions including such “noncash” components.) Additionally, low

corporate earnings, severe domestic competition, lack of labor mobility and employment rules, and *keiretsu* relations have contributed to making Japan's M&A market the least active and smallest among OECD countries.

The "FDI boom" in Japan during the last half of the 1990s was led by M&A, and was caused by deregulation in non-manufacturing sectors, rising corporate failures and falling asset values, reduced cross shareholdings, and a global boom in M&A. Another large factor was corporate governance reforms— including greater access to information, use of outside directors and changes in accounting rules. Also attracting the attention of foreign acquirers were factors such as: greater emphasis on profitability and added value, increased labor market liquidity, somewhat improved human infrastructure (such as investment bankers, accountants, and lawyers), and simplified procedures.

Chapter 6: Post-Deal Performance of Japanese Firms Acquired in Inbound M&A Transactions

Successfully restructuring a target company has four essential elements: changing the business portfolio (or lines of business), obtaining economies of scale through integration and rationalization, adopting the right financial structure, and/or reorganizing top management.

Usually a firm pursues an M&A strategy in order to obtain new know-how or management methods, product lines or productivity-enhancing technology, a sales network, a better financial structure, operational integration and greater efficiency, and a management team that has the new ideas and skills to improve productivity. Mergers in Japan between companies in different industries have generally resulted in higher profitability, whereas mergers in the same industry experience declining profits on a cash flow basis, because many mergers are agreed principally in order to save a seriously ailing company from failing rather than for more rational strategic goals. This helps explain why stock valuations for individual companies have tended to track closely the movement of the market as a whole, rather than displaying more variance.

M&A has been effective in bringing increased cash flow and higher returns on stock prices, especially for transactions done on a cash basis, and even more so when the two companies are from different industries. In industries where deregulation has occurred, M&A has spurred industrial revitalization, strengthened competitiveness, spawned new markets, and improved productivity.

Comparison of the actual performances of domestic M&A and inbound M&A target firms reveals that: 1) domestic M&A target companies improve sales, profitability and stability, while sustaining employment levels; 2) inbound M&A target companies (which may have been more distressed to begin with) perform relatively less well at first due to previous mismanagement that causes headquarters to impose strict financial controls and reduce employment to restore the company to health quickly. However, later on there is substantial improvement and recovery of sales, profitability and stability; and 3) at first, both domestic

and foreign-acquired companies perform more poorly than capital participation investees, and require an infusion of new management resources. However, subsequently performance improves significantly for both acquisitions and capital participation targets. .

Chapter 7: Doubling Japan's Inward FDI – Policy Recommendations

Between 1997 and 2002, Japan's stock of inward FDI rose 2.7 times to 9.4 trillion yen on a net foreign assets basis. From this perspective, reaching the government's goal of doubling the stock of FDI in five years might seem easy. However, the first round of deregulation is over; and it is unlikely that significant new investment expansion will occur under present conditions. FDI into Japan has fallen 42% from the most recent six-month period. Extrapolating from recent trends, inward FDI would rise 4.5 trillion yen – a far cry from the 9.4 trillion yen needed to double the FDI stock. Further large-scale deregulation will be necessary to attract more FDI, especially additional M&A which has the greatest potential to contribute to growth of FDI flows and stock. However, such a policy thrust does not appear to be underway today.

Still, Japan has vast potential to increase inward FDI. It has the world's second largest domestic market and is located in East Asia, the home of the world's most dynamic developing economies. . If Japan were to raise its stock of inward FDI from 1.1% of GDP to the U.S. level of 12.4%, capital investment by foreign-affiliated firms would lead to a 1.5% increase in capital stock (a 18.8 trillion yen impact), and the GDP would expand by 1.5% or 7.5 trillion yen. Moreover, if foreign-affiliated firms raised their share of total employment from the current 1.3% to the U.S. level of 8.6%, they would support some 4,600,000 jobs as compared to the current 700,000.

Because M&A is such a large part of FDI in any developed economy, facilitating M&A transactions is an exceedingly important part of the necessary policy mix. Whereas most recent Commercial Code reforms related to M&A have addressed the needs of domestic companies, foreign companies are not free to engage in cross-border stock swaps or triangular mergers. This should be remedied. It is all the more important because the steam has gone out of the global M&A boom, and hence in Japan as well. During the first half of 2003 inbound FDI flows to Japan dropped to a level 42% below the prior year.

Since most remaining restrictions on FDI (including M&A) in Japan generally affect market entry or actions by both foreign and domestic Japanese companies, the other major key to raising the level of FDI in Japan is to deregulate further and remove the restraints on market entry for all newcomers. The other important area for reform is the privatization of public services such as education, healthcare, posts, social insurance, and social welfare. It has been estimated that if public corporations were reduced by one-third, employment by non-manufacturing foreign firms would rise 43% compared to 1996 levels.

Between 1996 and 2001, foreign-affiliated employment rose by 209,000 jobs and inward FDI increased by 3.2 trillion yen. If employment and FDI move in simple proportion to each other, raising FDI by 9.4 trillion yen from its 2002 level would result in an increase of 614,000 jobs. Based on this simple analysis, even deregulating to a US level and privatizing 30% of public corporations would only achieve less than one-half of the government's goal of doubling FDI, if there are no other policy changes made. Clearly, it will not be easy to achieve the government's FDI goals.

So far, the government has worked to promote FDI through halfway measures such as disseminating information internally and externally, setting up a "one-stop" investment center, and establishing special reform zones. Such makeshift steps to increase FDI will not achieve the government's laudable objectives. Major reforms are necessary— not policies based on weak analysis and optimistic forecasts that use up valuable resources and do not hold anyone accountable for failure. Since this study shows that expanding FDI to the level of other developed countries could be a key to lifting the Japanese economy out of stagnation, the Japanese people have a huge interest in the success or failure of policies in this area.