HORIZON KINETICS

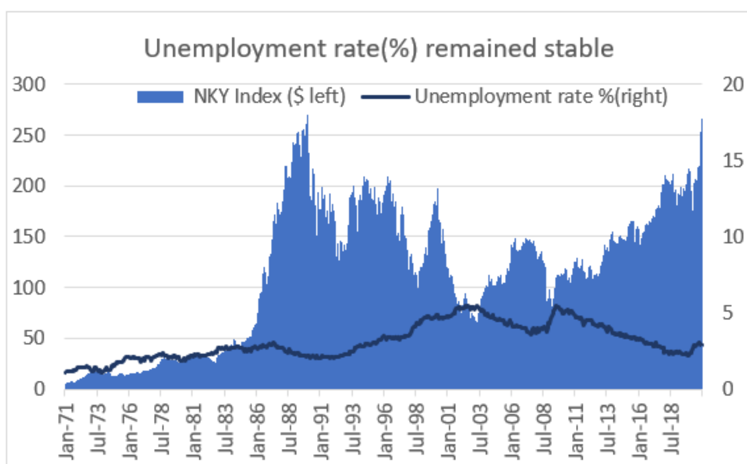
JAPAN SPECIAL
OPPORTUNITY STRATEGY

Part 2: How the System Was Built, then Failed, and the Slow Beginnings of Its Rehabilitation

How the System Was Built

Despite the presence of index-centric mega-cap companies like Toyota, Japanese corporations and the Japanese capital markets have been structurally decoupled from western developed markets for decades. That phenomenon has its roots in the unique social and economic system Japan built in the aftermath of World War II. To rebuild a stable society and economy, the government adopted a lifetime employment system, in which employees committed to work for one company for life. In return, the corporation guaranteed a unique salary, promotion, and benefits-by-seniority system. Upon being hired after school graduation, employees already knew what their title, salary and benefits would be at various ages, when they would retire, and how much they would be earning at that time.

During the nation's high economic growth phase from the 1950s onward, this stable workforce and controlled wage scheme supported Japanese corporations in investing in and expanding their businesses both domestically and globally. It did indeed provide social stability; even when the Japan credit bubble burst in December 1989, the unemployment rate remained as low as 2.1%.



Source: Ministry of Internal Affairs and Communications, Bloomberg

The successful history and the crisis-proven resilience of this system had a follow-on consequence. An outgrowth of this success was that maintaining the lifetime employment social contract and delivering the promise of promotion by seniority became the primary perceived responsibilities for corporations. This imperative became more strongly institutionalized over time. The managements, who are typically selected from among the most senior employees, are incentivized to pass on this system to the next generation.

However, it also created certain structural inefficiencies and even dysfunction. The system of labor market rigidity that worked in the four-plus decades of economic reconstruction and expansion following WW II was not structurally suited to a slower-growth environment.

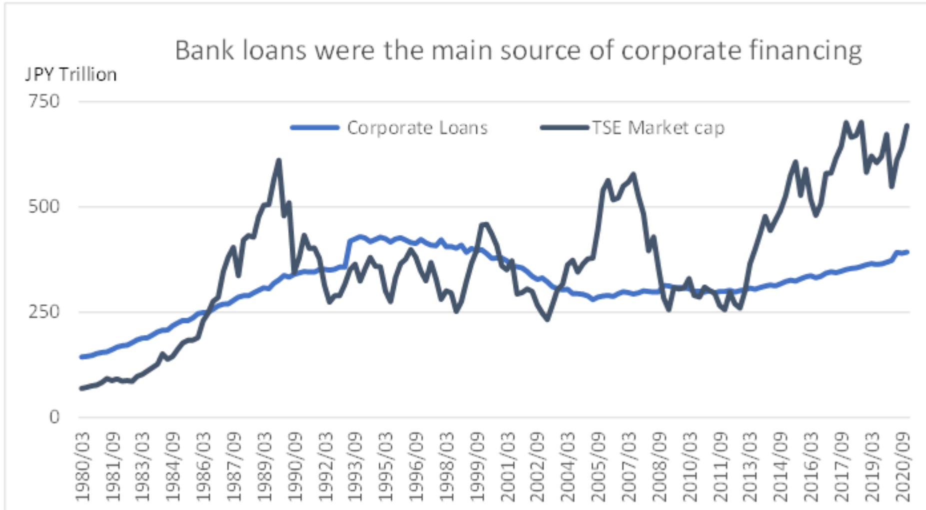
Beginning in 1992, real GDP growth slowed from a roughly 4.5% steady-state rate toward 1.0%. However, there was no employment market fluidity. Older workers could not be displaced by younger workers, because employees were not dismissed. There was not even a mechanism, even in principle – for no one would have considered it – for a mid-career employee to seek, much less obtain, employment elsewhere. Moreover, a more talented entry-level employee could not be promoted above an earlier hire, because the system was based upon seniority, not merit.

Without an external solution, companies resorted to internal solutions. In response to overstaffing, they would create business divisions and subsidiaries for the express purpose of making new senior positions available for employees whose tenure had earned them this level of reward, while, thereby, making room for less-senior workers. The executives would bring with them the full complement of supporting personnel. A few aspects of this must be understood. First, the subsidiary created likely did not have a legitimate business purpose; it was often simply an existing department or function that was now given a separate corporate structure. Secondly, the executive chosen to head this new subsidiary was not necessarily qualified or best-qualified to do so, but was simply being accorded a degree of respect in accordance with his seniority. These subsidiaries were either wholly owned or, if eventually brought public, were captive to their majority-controlled parent company.

Drastically changing the business structure or cutting personnel costs to seek a higher financial return was simply considered neither necessary nor desirable, as long as the business remained profitable. However, when the economy slowed, the lifetime employment arrangement became increasingly difficult because it did not allow for layoffs. It made it impossible to swiftly restructure or eliminate a shrinking line of business in order to shift resources to new endeavors. Those drastic changes were allowed only when the business began to operate at a loss – in other words, when it was already too late to adjust and recover without significant resources and capital.

Another reason these inefficient corporate behaviors were allowed and accepted in Japan is because the country historically practiced a form of indirect finance, the so called “main bank system”, where banks played a major role in corporate finance. Banks’ aggregate outstanding corporate loan balances trended at about the same level as the Tokyo stock market capitalization until 2012 (that is, on a 1:1 basis).

Conversely, the U.S has a robust direct finance system, with the capital markets facilitating the majority of corporate financing. The U.S. securities exchanges aggregate market capitalization is about $45 trillion, which is about 4.3x the amount of bank loans outstanding [1]. Unlike the U.S, where corporations face positive incentives, as from equity and debt capital providers, to increase the transparency of their businesses and to grow the enterprise value and shareholder returns, Japanese corporations are incentivized to cultivate their relationships with their "main banks". A typical Japanese company will deposit and transact the majority of its cash management at its main bank and, in return, the bank provides loans and necessary financing. When the corporation might face financial difficulty, those "main banks" were expected to provide the necessary support.



Source: BOJ, Bloomberg
Note: corporate loans before 1993 were calculated as total loans-individual loans

Often the "main bank" employees were seconded to client corporations to monitor and intervene in their businesses. Banks were also protected by the government. The Ministry of Finance used the so called "Convoy System" for regulating the banking industries by setting interest rates, transaction fees and even service hours to eliminate competition, and did not allow a single banking bankruptcy. The relationship between a company and its bank was cemented by each owning some of the other's equity. At one point, banks owned almost 21% of the Tokyo stock market.

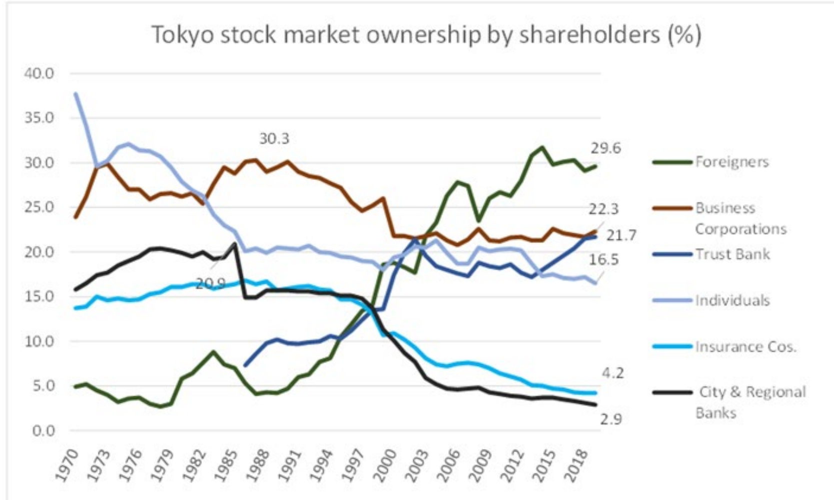
This cross-shareholding mechanism was also extensively practiced among Japanese corporations, separate from their banking relationships, especially within keiretsu groups of businesses that shared interlocking business relationships. These often derived from the vertically integrated Zaibatsu groups that operated through the end of World War II, created and controlled by dominant founding families, and their supply chain companies.

These business corporation cross-ownerships of the Tokyo stock market reached 30.3% by the late 1980s. This was a way to sustain long term business relationships and prevent disturbance from outsiders, namely, unknown shareholders. It also created an information asymmetry in the capital markets that supported the insular corporate culture. As a result, Japanese managements could dismiss "investors" who had no business relationship with the company, yet demanded higher shareholder returns, as "greedy" short-term traders. Japanese media supported this view. Consistent with this, the

[1] *The U.S commercial banks total loans and lease is Y10.4 trillion as of January 2020. Federal Reserve Bank of St. Louis, Bloomberg*

notion of a hostile take-over was long culturally taboo and criticized as a manifestation of greedy, uncivilized egos.

Moreover, Japanese management rarely owned shares of their own company. Rather, they were paid in salary, according to their positions and seniority instead of in relation to their skills or capabilities and achievements. Therefore, share price became irrelevant for them.



Source: Japan Exchange Group

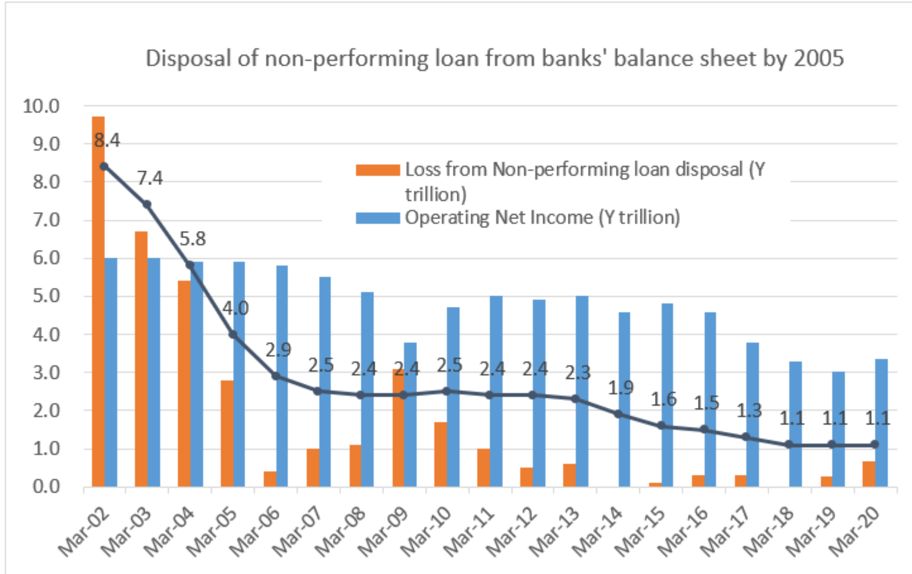
The lifetime employment, dominance of indirect financing, and extensively practiced cross-shareholding among Japanese corporations all contributed to the creation and longevity of the insular systems in Japan. Those 'insiders' worked closely for their own mutual benefit, and dismissed 'outsiders', those who were not part of the system. The system lacked any self-correction mechanism; all were in the same ship, yet no one on the ship was incentivized to act against the consensus, a certainly painful path even if that was the right path. As a result, the system became inefficient and even dysfunctional when the Japan credit bubble collapsed in 1989. It took the country over 15 years to clean it up.

How the System Failed, and the Slow Beginnings of Its Rehabilitation

This system all worked well while the economy was expanding. Japan generated remarkable real GDP growth, at about 10% annually, during the high growth period from the mid-1950s to the early 1970s. The growth rate remained around 4.5% during the 1980s. The growth period came to an end after the Japanese credit bubble burst in 1989. This was a classic asset bubble created by loose monetary policy. The BOJ cut interest rates from 5% to 2.5% during the last four years of the bubble period, in an effort to combat the negative economic impact caused by the sharp appreciation of the JPY against the USD, which resulted from the Plaza Accord in September 1985. The bubble collapse significantly impaired the balance sheets of banks and corporations, which had expanded their investments in land and stocks, including cross-shareholdings. Economic growth thereafter declined to the 1% level in the early 1990s. However, this closed, stringent system lacked the flexibility to cope with that change.

It was after the first post-war bankruptcy of an insurance company and a securities firm in 1997, followed by the bankruptcies of large banks such as The Long-Term Credit Bank of Japan (now Shinsei Bank) and The Nippon Credit Bank (now Aozora Bank) in 1998, that the Japanese government finally recognized that the non-performing loans left from the 1980s credit bubble would not disappear without intervention and were causing serious social and economic damage. The government injected about Y7.5 trillion ($63.6 billion) of public funds into 15 large banks in 1999.

Yet, even this was insufficient. Banks, afraid of being blamed for the mismanagement and of the possibility of government control, continued to avoid disclosing the actual level of non-performing loans. This, though, became increasingly difficult to hide, and in 1997, consolidated accounting reporting effectively became mandated, and Japanese corporations were forced to disclose their subsidiaries' assets and liabilities.



Source: FSA

In 1998, the Ministry of Finance, which had long protected the banks from failure, spun off its monitoring division, which in 2000 was established as an independent financial regulatory agency, the Financial Service Agency (FSA), analogous to the U.S. SEC. In 2001, mark-to-market valuation accounting was mandated for the investments held on corporate balance sheets, and in 2002, this was also applied to cross-shareholding securities that were not categorized as subsidiaries or equity-method affiliates.

These changes obliged corporations and banks to disclose to the public the true value of their business investments and balance sheets, which had long been hidden among insiders, including their main banks. These regulatory and accounting changes set the stage for Prime Minister Koizumi's "Financial Revitalization Program." Launched in 2002, this was aimed to clean up banks' non-performing loans, for the Japanese financial system to regain the trust of their investors. It targeted a lower non-performing loan ratio, to below 4%, prepared the public fund financing scheme[2], and ensured support from the Bank of Japan to avoid systemic risk. During this period, dozens of large banks merged for survival, ultimately consolidating into today's three mega banks, Mitsubishi UFJ Financial Group, Mitsui Sumitomo Financial Group, and Mizuho Financial Group[3]. In 2003, the largest regional bank, Resona Bank, accepted public funds and was practically nationalized[4].

[2] Under the "Financial Revitalization Program", the government set up guidelines to utilize The Resolution and Collection Corporation and set up The Industrial Revitalization Corporation of Japan to inject necessary liquidity to support corporates and absorb NPLs from banks' balance sheet. The Industrial Revitalization Corporation was dissolved in 2007 after completing its mission.

[3] Dai-ichi Kangyo Bank, Fuji Bank, and Industrial Bank of Japan merged to form Mizuho Financial Group, Sakura Bank and Sumitomo Bank merged to form Mitsui Sumitomo Financial Group, and Sanwa Bank, Tokai Bank and Toyo Trust Bank merged to form UFJ Holdings, which was subsequently merged with Mitsubishi Tokyo Financial Group that was formed from a merger of Tokyo Mitsubishi Bank, Mitsubishi Trust Bank and Nippon Trust Bank, to establish Mitsubishi UFJ Financial Group.

[4] Resona Bank accepted about Y2 trillion (USD 18.7 billion) from Deposit Insurance Corporation of Japan in exchange with preferred stock and common stock.

This was the turning point for Japan. This structural reform was painful yet necessary. Corporations, including financial institutions, were facing a significant economic downturn in the aftermath of the September 11 terror attacks and collapse of the dot.com bubble in the U.S. Japan's export-oriented economy was highly correlated to global economic growth and liquidity. The deterioration in corporate earnings placed further pressure on Banks's balance sheets, which were in the process of eliminating decades of old non-performing loans (NPLs). For the fiscal year ending March 2002, the Tokyo exchange-listed companies, in aggregate, posted a net earnings loss. In 2002 and 2003, the unemployment rate reached 5.5%, almost doubling the normal post-war level. Japan finally cleaned up most of the NPLs and zombie companies that had been hidden in banks' balance sheets, and resumed the economic recovery with a renewed system that had better transparency and sound relationships between banks and corporations.

As seen in an earlier chart of the market ownership structure of Tokyo Stock Exchange listed companies, banks' holdings of publicly traded stocks came down from around 15% of the market's share base to just 5% in 2005, and was further reduced to 2.9% as of 2019. At the same time, the ownership of Tokyo Stock Exchange companies by foreign investors had doubled from 13% to 26%, to surpass the domestic corporate cross-shareholding and group ownership level of 21%. Consequently, the Japanese equity market was finally beginning to open up, and the number of hostile take-over cases began ticking up in 2006 and 2007.

However, many of these take-over bids failed, because shareholders rarely voted for the bidder. After all, Japanese corporations owned more than half of the market in 2007: Japanese financial institutions, including banks, Trust banks and insurance companies, owned about 30% of the market, and non-financial Japanese corporates owned over 21%. Moreover, companies hastily adopted takeover defense measures to protect themselves. The number of companies that adopted takeover defense measures surged from about 100 as of June 2005 to 567 by 2008, reaching about 24% of listed companies[5].

[5] *Daiwa Institute of Research Holding Ltd, MARR Online (RECOF Corp)*

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