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Institutional Investors, Investment Funds,
and Hostile Takeovers in Japan**

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Abstract

The recession and banking crisis of the 1990s have triggered a complete reorientation in corporate strategy by large Japanese firms, away from the previous goal of diversification financed by bank loans, and towards market-financed concentration on select core businesses. The transition has necessitated corporate reorganization by almost all large firms, causing a wave of spin-off, mergers, and acquisitions. Extensive legal reforms have enabled this reorganization and introduced more stringent rules on accounting and disclosure. The confluence of these two events – access and transparency – has paved the way for a market for corporate control, fueled by institutional investors and investment funds, including foreigners, as major players. While the M&A boom of the early 21st century may partially be attributable to a window of economic opportunity, the systemic changes in Japan’s financial markets are irreversible and therefore constitute a strategic inflection point. Contested corporate control has become an indelible part of Japanese finance and corporate governance.

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1. Introduction

Livedoor's spectacular bid for a broadcasting station, possible jail time for Mr. Murakami for insider trading, Oji Paper's failed hostile attack on its second largest competitor – even the most fleeting observer of Japanese business will have noticed a fresh type of news from Japan, revolving around activities by large investment funds, the emergence of activist investors, the increase in mergers and acquisitions, and hostile takeover battles, sometimes reminiscent of a good *kabuki* play. Seasoned analysts, too, are wondering what to make of these news: are they a harbinger of a rapidly developing market for corporate control in Japan, or just a short-term blip caused by the temporary confluence in the early 2000s of corporate restructuring that made underpriced objects available, and super-low interest rates that made them cheap? In other words, is the recent upswing in the market for corporate control just an entertaining but short-term spectacle, or does it constitute a true reorganization in Japanese finance and business processes?

One group of protagonists in this new play is investment funds. These pursue a variety of specializations, such as generic financial investing (hedge funds), buying up underperforming corporations (private equity funds), launching turnarounds for companies or spin-offs (buyout funds), staging shareholder initiatives and takeovers (activist funds), or buying the collateral underlying non-performing loans such as real estate (corporate reorganization funds). Because disclosure rules are limited, their assets under management, returns on investment, or even the total number of investment funds are difficult to gauge. Regardless of their success rate, however, in the early 2000s these funds brought a flurry of novel activity to Japan's financial markets, changing the processes and competitive forces for corporate control. As main banks had declined in

relevance, and cross-shareholdings had been dissolved throughout the 1990s, Japanese companies had become more dependent on the financial markets for financing. This made more shares available for trade, and it also introduced new pressures to disclose reliable financial information in order to attract outside investors. The arrival of foreigners, institutional investors and investment funds has launched a virtuous cycle: attracted by the higher liquidity in Japanese financial markets they have invested more and demanded more disclosure of profitability measures, and the more these were provided, the more investors were attracted to Japan.

And yet, as of 2006 uncertainty remained whether this was merely a temporary shift. The doubtful predicted cross-shareholdings to reconfigure, restrictive anti-takeover defenses to reemerge, and old processes of keeping shareholders quiet to reappear with economic recovery. Investment funds would retreat once underpriced targets were no longer available and interest rates had been raised (e.g., Ekonomisuto 2006). Companies would return to postwar period management processes with an emphasis on long-term, repeated interactions with trading partners, and a very limited role for shareholders.

In contrast to this view, this paper shows that the transformation of Japan's financial markets and business organization that began in the late 1990s is irreversible, and therefore constitute a strategic inflection point for Japanese business organization. So fundamental are the changes in laws, oversight, and corporate governance that a return to previous practices of informal, relation-based financial schemes is inconceivable. Society, too, has come to expect financial transactions to be governed by accountability and due process, as regulators are prosecuting violations much more rigorously than before. Japan's financial system has graduated from postwar bureaucratic guidance and taken a

irrevocable turn towards market-based processes.

The emergence of institutional investors and investment funds in Japan is a prime indicator of how these changes are manifesting themselves, and why they are permanent. The paper begins in Section 2 with an expose of the main argument, describing the strategic inflection point of the turn of the century, which divides the “postwar period” up until the 1990s from “21st century” Japan. This strategic inflection has necessitated a reorientation of Japanese corporate strategy, away from the previous emphasis of pleasing banks as the largest lenders through aggressive diversification, towards a concern about anonymous institutional and foreign investors strictly interested in profitability. Section 3 shows the growth and institutionalization of Japan’s markets for mergers and acquisitions, including hostile takeovers. Section 4 analyses how the resulting corporate reorganization has attracted these new institutional investors and their meteoric rise to the largest group of shareholders in Japan. Section 5 concludes on the implications for Japanese corporate management.

2. Strategic Inflection: From Diversification to “Choose and Focus”

The severe recession of the 1990s culminated in a fundamental reorientation of Japan’s legal framework for business and finance, and with it the processes of regulation and oversight. This shift marked a strategic inflection point in Japanese business organization, in that the previous ways and processes of doing things were no longer a means to success; to compete, companies and banks had to completely reorient their business strategies (Burgelman/Grove 1996).

During the postwar period (1950s-1990s), Japanese corporate strategies were geared towards growth through long-term relations. These were established through business groups (*keiretsu*), main banks and a dominance of bank loans in corporate finance, as well as long-term supplier and labor relations. Bank loans dominated corporate finance because interest rates were regulated at a low level, while restrictions on the bond and stock markets made bank loans cheaper and easier to attain. The high dependence on bank loans resulted in a very high debt-equity ratio, which reached an average of 600 for all large firms (with capital exceeding ¥1 billion) in the 1970s (see Figure 1). A company so highly dependent on outside funding will concentrate its corporate strategy on pleasing the main lenders, which were represented by the company's main bank in a system of delegated monitoring (the main bank would take the lead in arranging not only loans, but monitoring the borrower and, if need be, step in to structure a solution to financial problems; Aoki et al. 1994; Hoshi/Kashyap 2001).

The banks' dominant strategy was to furnish ever more loans, for under regulated interest rates (i.e., fixed margins) volume was the way to increase profits. Their main concern was corporate failure; profitability was of secondary interest. To be able to pay interest on the extensive and growing loans outstanding, companies needed to ensure growing revenues. This resulted in two dominant corporate strategies: (1) a focus on increasing sales, and (2) constant growth through diversification into new business segments. The first was ensured through membership in horizontal business groups with stable trade relations and cross-shareholdings. Companies also expended great effort to structure vertical distribution line-ups, to stake out a certain market share and tying

consumers into their product lineup.¹

Under fast economic growth competitors were constantly investing at a rapid rate, forcing each company to invest aggressively to maintain its established market share (Abegglen 1985). This necessitated new bank loans and increased the pressure to maintain sales revenues. Where existing businesses were not enough, companies pursued growth by entering new business areas. As a result of this diversification strategy, so-called “general companies” emerged in most industries. For example, the ten largest electronics firms were all such “*sōgō denki*” companies, producing white and brown goods (household appliances and audio/TV) as well as parts (batteries, cords, light bulbs, LCDs, or semiconductors), while running their own distribution chains. The banks were supportive of this aggressive diversification, as it increased interest income and provided insurance against bankruptcy: should a company see one of its businesses suffer from a cyclical or structural slump, it would still survive by virtue of being represented in other business segments.²

The bubble economy (1987-1991) added to this strategic diversification (which was also actively pursued in other countries at the time) a wave of exuberant diversification, such as through investments in hotel chains, baseball teams, or real estate not required for production purposes. When the bubble burst, the losses from this exuberant diversification grew enormously, while the stagnation of the 1990s undermined sales such that many companies were suddenly unable to pay interest on their mushrooming debt. This led to a corporate crisis that eventually triggered a banking crisis.

¹ See Gerlach (1992) and Lincoln/Gerlach (2004) on business groups. In many products, the system was fortified through price agreements among competitors; see Schaeede (2000). This interpretation of postwar corporate strategy is developed in detail in Schaeede (forthcoming), Chapter 2.

² Lifetime employment increased the tendency towards aggressive diversification, because it was difficult to close down a business unit but easy to create new ones.

In the postwar period, banks addressed nonperforming loans by structuring informal turnarounds which left the loans on the banks' books, covered annually by loss reserves taken from bank profits. The idea was to save the company by structuring a turnaround and recouping the debt in the long run. In the 1990s, informal debt refinancing put such tremendous stress on banks' profits that it caused a banking crisis in 1998 in which Japan came perilously close to a financial meltdown.³ This necessitated a switch to direct bad-loan disposal methods, in which the bank suffers a one-time "extraordinary" loss by writing off the loan, and initiates bankruptcy procedures and "restructuring" (closing down or selling off the least profitable business units). One way for the banks to hold on to at least something of value in these write-offs was to structure debt-forgiveness in which bad loans were swapped into equity shares which might gain value with a successful turnaround. These shares were sold off, typically at only a few cents for each dollar of bad debt, to outside investors – in the late 1990s, mostly to U.S. investment funds.

The new strategy that emerged in the early 21st century for corporate reorganization was labeled "choose and focus" (*sentaku to shūchū*). Referring to corporate unbundling, this was a call for companies to identify their core businesses and concentrate all their resources (human, capital and managerial) on winning in these core

³ The bankruptcies of a city bank and a leading investment bank in November 1997 revealed that most large banks were unable to reach the capital adequacy ratio of 8% required for banks operating internationally. Any large bank dropping below this ratio would most likely have triggered a bank run. The government injected a total of ¥9.3 trillion (roughly \$90 billion) into the countries' leading banks. Fierce political debate translated into stringent rules for the recipient banks on how to improve their business, including an aggressive cleanup of bad loans. A 1998 legal revision allowed holding companies and enabled the 13 leading banks to merge into four large financial groups (Mizuho, MUFG, Sumitomo-Mitsui, and Resona). Two long-term credit banks under government receivership were revived by two U.S. investment funds into Shinsei and Aozora. Smaller banks were in a similarly perilous situation, and their restructuring triggered the "credit crunch" of the period 1998-2003, during which many small firms lost access to funding. All this exacerbated an already ongoing recession, increasing pressure on the government to execute legal reforms. Amyx (2004) analysis the political background to this crisis.

businesses. This strategy involved shedding all non-core business units and downsizing through outsourcing processes and functions not directly contributive to core profits.⁴

Banks and corporations were suddenly in the business of active reorganization, pursuing direct loan disposal methods and a reorientation of corporate strategy. Both required a rewriting of Japanese rules and regulations pertaining to corporate reorganization and spin-offs, mergers and acquisitions, and bankruptcies. Understanding that the existing system stymied restructuring, the government had begun successive revisions of the Commercial Code in 1998. Changes were accelerated in 2002, which entered the books as the year of “*saisei*” (revitalization), a government moniker for an aggressive reform program including new rules of financial regulation and oversight, new transparency through stricter accounting and disclosure requirements, and new options for corporate reorganization.⁵

All this culminated in a new “Corporation Law”, effective May 2006, which replaced the Commercial Code as the main set of rules on corporate behavior. This law was based on nothing less than a complete reversal in regulatory philosophy, by shifting from the previous logic of “ex ante regulation” (i.e., everything that is not explicitly allowed is therefore prohibited) towards “post-remedy” rules (everything that is not specifically prohibited is therefore allowed, with courts ruling on problematic issues as they occur).⁶ Whereas in the postwar period, corporate management had limited flexibility

⁴ Until a 2002 Commercial Code revision, labor could veto transfer to a spun-off business, to maintain employment at a large firm with higher wages. On the implications of “choose and focus” on employment, see Schaede (forthcoming).

⁵ Shifts in politics were critically important. See Pempel (1998) for a prescient analysis of the precursors to this “regime shift”, and Vogel (2006) for the interplay of government and business in this reform process.

⁶ Fujita (2006) describes the shift as one from “preemptive rules, with informal bureaucratic discretion in ambiguous areas” to “freedom in principle, with ongoing formal oversight”. This shift had formed the basis of Commercial Code revisions since 2000; see Ministry of Justice, “Japanese Corporate Law: Drastic Changes in 2000-2001 and the Future”, www.moj.go.jp/ENGLISH/information/jcld-01.html.

but could not easily be held responsible as long as it operated within the law, in the 21st century, management is free to shed old businesses, purchase new businesses, and manage the company as it sees fit, but the law has greatly empowered the rights of shareholders, the need for disclosure, and the accountability of management for its actions. The 2006 Corporation Law is the clearest sign of the strategic inflection in Japanese business organization.⁷

Legal Reforms

Table 1 provides a timeline of the legal reforms between 1997 and 2006, which can be categorized into four groups. The first set of changes concerned regulation, transparency and oversight, which began with the “Big Bang” financial reforms of 1998. The Big Bang, importantly, also included the 1998 revision of the Foreign Exchange Law, which removed last vestiges of cross-border financial controls, thus greatly facilitating financial operations by foreigners in Japan. In terms of domestic markets, Big Bang reforms (and their subsequent continuations) covered almost all financial areas, and had in common a big push towards stricter disclosure, in particular, a shift to accounting at current market values as opposed to historical book values, as well as consolidated balance sheets. New transparency was paired with reforms in financial regulation, as the previous reliance on informal process regulation through administrative guidance and behind-closed-doors workouts was replaced with by-the-book inspections and meaningful sanctions of violators. In particular, with the establishment of the Financial Services

⁷ Liability by management has been limited, comparable to other countries. Some have interpreted the new limited liability as a sign of continuing old practices. However, it seems not feasible to introduce market-based processes of corporate governance without clear liability delineations. Thus, the new limitations do not contradict but rather prove the shift towards greater shareholder rights.

Agency in 1998, and the fast rise to true authority by that agency, even laggard banks had to face the reality of their non-performing loan quandary. Beginning with the first quarter of fiscal year 2003, the Tokyo Stock Exchange introduced a requirement of quarterly earning statements for all listed companies.⁸

A second change came with new bankruptcy legislation. In the postwar period, failing firms had little choice but to follow an informal workout led by the main banks, because existing laws were too cumbersome for “Chapter 11” type reorganizations. The 2000 “Civil Rehabilitation Law” facilitated such reorganization (including for individuals), and together with the 2003 revision of the “Corporate Reorganization Law” introduced new processes for efficiently structured turnarounds. The courts of Tokyo and Osaka established special divisions to handle such procedures efficiently. A further reform in this area was a 2001 guideline for “out-of-court workouts” that clarified the structure of bank-led turnarounds. Finally, the 2004 revision of the Liquidation Law established clear-cut rules for a shutdown of debtors and a fair distribution of assets. All this triggered a wave of shutdowns and reorganizations, and helped greatly in cleaning up non-performing loans.

The third area of reform pertained to corporate restructuring and reorganization. At the end of this process, Japanese companies now have a variety of options for reorganization through mergers and acquisitions and spin-offs. Stock market rules were reconfigured to allow for the exchange of ownership stakes, friendly or hostile; for example, in 1998 stock buybacks were allowed to enable companies to repurchase the equity overhang created during the bubble years. It became possible to swap stocks to

⁸ The Osaka Stock Exchange followed suit the next year. For the more recently established exchanges for startup companies, such as MOTHERS and Hercules, quarterly earnings reports were already required.

accomplish a merger, and by allowing a variety of different types of stock, companies could give different rights to different types of owners (e.g., for a takeover defense). Labor laws were also revised, in particular with the 2003 revision of the Labor Standards Law, to clarify the conditions under which dismissals are justified, thus affording companies more freedom in reorganization.⁹

A final set of revisions concerned corporate governance. For corporate strategy, the shift towards ex-post dispute settlement means greatly increased managerial flexibility. The 2006 Corporation Law is explicit about this increased flexibility, but also introduces new means of oversight, by granting shareholders significant monitoring powers. Japanese annual shareholders' meetings in the past were known for record-breaking brevity (lest any trouble occur). This has been replaced newly defined and much increased shareholder rights that facilitate, and structure the processes of, challenging management decisions (Schaede 2006).

Market Change: The Unwinding of Cross-Shareholdings

These systemic changes occurred before the backdrop of a larger, underlying shift in corporate finance and corporate governance (Hoshi/Kashyap 2001). Beginning in the mid-1980s, financial deregulation allowed large firms to diversify their sources of funding, and many began to issue bonds and stocks more aggressively. By 2005, this had lowered the debt-equity ratio by more than half for all large firms, and even more dramatically in certain industries (cf. Figure 1). Figure 2 shows sources of financing outstanding for Japan's largest firms for the period 1960-2005, both in terms of annual

⁹ The new labor law ended as a compromise between the political parties, employers and unions and still leaves ample ground for court interpretations in dismissal cases. However, in 2000 the courts had begun to water down the prohibitively stringent requirements for lawful dismissals, thus changing the legal interpretation to be more open towards corporate reorganization. See Schaede (forthcoming), Chapter 8.

flow (Figure 2a) as well as in stock of outstanding sources of finance (Figure 2b). Over time, bond and equity issues have risen such that, in 1998, for the first time since WWII Japanese large firms relied on more external financing in the form of stocks and bonds, than on bank loans. The banks' role has further declined since, whereas market financing (through stock and bond issues) continues to rise.

Related to the decline in the role of the main bank was the loosening of business group (*keiretsu*) ties. Especially the horizontal groups have greatly reduced their cohesion, including in terms of preferential trade.¹⁰ One means of cohesion – both between banks and their clients, and among *keiretsu* members – had long been mutual shareholdings based on a tacit agreement that these would not be traded, in particular in times of crisis. These stable shareholdings had limited the number of shares actually traded, making the Japanese stock market very thin (i.e., illiquid). Thin markets constitute a problem for investors because positions cannot easily be altered in reaction to new information. Many Japanese stocks were easily subjected to price manipulations because so few shares could be bought or sold, leading to an amplified effect of any shifts in supply and demand.

This, too, began to change when cross-shareholdings unraveled throughout the 1990s. Detailed data for the years 1987 through 2003 are available through two annual surveys that reveal a marked decline in cross-shareholdings, especially after 1998, from 45% of all shares outstanding in the 1980s, to 38% in 1999 and 24% in 2003 (NLI 2004, DRI 2005). Moreover, a subgroup of stable shareholding, the strictly reciprocal “mutual shareholdings” (*mochiai*) have also greatly declined, from 17% of all shares outstanding, to 7% in 2003. The phenomenon had become so small that in April 2005 NLI announced

¹⁰ The Mitsubishi Group is a possible exception. See Schaede (2006) and Schaede (forthcoming, Chapter 4) for a detailed analysis of business groups.

the termination this portion of its survey (NLI web site, April 7, 2005; Suzuki 2005).

Companies were eager to reduce their stable shareholdings, because these had caused great losses in the 1990s, just when profitability was becoming a critical measure. The new accounting rules, effective 2001, of mark-to-market of cross-held shares added pressure to dissolve holdings that deteriorated performance data. The weakening of intra-group trade relations made “friendship shares” strategically less relevant. Adding to this were the bank mergers: companies that held stable shares in several banks to assure continued borrowing from these banks, could now reduce their holdings to just one (Kuroki 2003, Schaede 2006).

Yet, the largest contributors to the unraveling of cross-shareholdings were the large banks (city and long-term credit banks). Whereas in 1991, these 16 top banks held about 11% of total stock market capitalization, their holdings reduced to a mere 3.6% in 2003 (DRI 2004: 6). If we include in the group of “large banks” the 47 regional banks, as of 2005 these banks owned a mere 4.5% of total shares at the Tokyo Stock Exchange (cf. Figure 3). The sell-off began with the bankruptcies of a few large and many smaller banks in the mid-1990s. An important trigger of the mass sell-off after 2001 was the new Law Limiting the Bank’s Stock Ownership (*Ginkō-tō no kabushiki-tō no hoyū no seigen-tō ni kan suru hōritsu*; hereafter “Ownership Limit Law”). Designed to limit the banks’ exposure to risky assets and thus improve the stability of the banking system, this law limits the total amount of corporate equity that one bank can own to its equity capital, narrowly defined as “Tier 1 capital”.¹¹ In Fiscal Year 2001, the largest four banks alone

¹¹ The Basel (or: BIS) Accord established two types (tiers) of capital, of which Tier 1 refers to the bank’s paid-in capital, shareholder’s equity, and retained earnings not yet appropriated at the end of the fiscal year. Tier 2 capital, in contrast, consists of the bank’s stock portfolio, plus loan loss reserves and subordinated debt issued by the bank.

were estimated to face a “shareholding overhang” of about ¥7 trillion, but remarkably, the banks did even more than was required. Between March 2001 and March 2003, commercial banks (excluding trust banks) reduced their shareholdings from ¥35.7 trillion to ¥18.2 trillion. The stock market moved sideways in this two-year period, so that banks halved their shareholdings, not due to stock price levels but to sell-offs (TSE 2004: 66, 79).¹²

The unraveling of cross-shareholdings introduced new liquidity into the market which made stock prices meaningful. In addition, Japan’s sudden attractiveness for foreign investors in the early 2000s was a confluence of several economic conditions that created investment opportunities. The write-off of non-performing loans and the aggressive “choose and focus” strategies made assets (firms, real estate, shares) available for purchase. The government’s zero-interest rate policy meant that financing these purchases was cheap. Moreover, in comparison to the US, Japanese assets were inexpensive (Diamond Weekly 2005, Ekonomisuto 2006). With legal processes clarified and the market offering a tremendous business opportunity, institutional investors and investment funds arrived in Japan.

The Rise of New Shareholders: Institutional Investors

The changes in corporate finance and stable cross-shareholdings resulted in a

¹² Reducing banks’ shareholdings lasted through April 2006. To facilitate this self-off, two “overflow repository” (“*ukezara*”) mechanisms were put into place. The first was the “Banks’ Shareholdings Purchase Corporation”, founded in 2002 by its member banks with a limited lifespan of 10 years. Equipped with funds of ¥2 trillion, the corporation was tasked with buying shares from its members and selling these back to the market as appropriate. Between November 2002 and September 2004 the Bank of Japan absorbed another ¥1.7 trillion worth of banks’ shares (Nikkei May 11, 2006; Kuroki 2003: 6). By May 2006, it was estimated that the “overflow repositories” had earned combined paper gains exceeding ¥2.8 trillion on their holdings (Nikkei May 22, 2006). Note that the purchases by the Bank of Japan and the Banks’ Shareholding Purchase Corporation both count as “corporate ownership” in Figure 3 below, so that the share of corporate holdings would be even smaller without those “repository” holdings.

dramatic shift in Japan's shareholder structure. At the height of the postwar system in the mid-1980s, corporations and banks together owned more than 70% of shares, while foreigners held less than 5%. The unraveling of cross-shareholdings has given rise, in their stead, to two new groups of owners: institutional investors and foreigners. Figure 3 illustrates this shift: as of March 2006, foreigners represented the largest groups of investors at the TSE with 26.7% (in comparison, the share of foreign investors at the New York Stock Exchange was roughly 7% at the time). Industries in which foreign investors held more than 30% in 2005 included pharmaceuticals (37%), insurance (35%), precision machinery (34%), electronics (33%), non-bank financial services (32.5%), and automobiles and real estate (both at 31%) (TSE 2006: 8). Eleven of the largest listed companies had foreign ownership exceeding 50%, including Orix, Yamada Denki, Hoya, Rohm, Fuji Photo Film, Canon and Sony (Nikkei June 19, 2006).

It is important to note that not all "foreign" investment necessarily rooted in foreign money, as there was reason to believe that some foreign trust and hedge funds had attracted large amounts of Japanese money. Japanese banks in particular might have been interested in such indirect investment, because they were cash-rich during a period of zero interest loans in which they had curbed their lending due to capital adequacy constraints and the nonperforming loan crisis (Diamond Weekly 2005). Regardless of who was behind the money, however, foreign investors had arrived. In contrast to the previous "stable" shareholders, these aim to maximize return on investment and are unlikely to suffer quietly through long episodes of poor management. They have begun to challenge the processes of corporate governance and corporate control.

A second factor contributing to changes in corporate governance is the

emergence of Japanese institutional investors in the form of trust banks. As we can see from Figure 3, all financial institutions (large commercial banks, trust banks, insurance companies, and others) reduced their holdings from a total 41.5% in 1986, to 31.5% in 2005. Within that group, the shrinkage in bank and insurance company holdings was counterbalanced by a substantial increase in the role of trust banks, from less than 10% in the 1980s, to 18.4% in 2005. Detailed data breaking on the trust category reveal that mutual funds (*tōshi shintaku*) account for 4.4% of total shareholdings, whereas pension funds make up 3.6% (TSE 2006). The remaining 10% of total shareholdings are so-called “investment trusts”, i.e. pooled investments by corporations, banks, and others that are administered by trust banks.

Trust banks have long enjoyed special status within Japan’s banking system, as they are commercial banks (collecting deposits) allowed to offer securities investments through funds. There were seven such banks in the postwar period, all of which suffered badly during the bubble period. Still, the trust bank as a category survived, and eventually these banks, through mergers into the newly established financial holdings, assumed increasing importance when fund investing became more popular in the 21st century.

Trust banks, therefore, are custodians for pooled investments. To streamline this administration, in the early 2000s the major bank groups consolidated securities processing by establishing three mega-trust banks. In 2000, the Japan Trustee Services Bank, Ltd. (*Nihon turasuto saabisu shintaku ginkō*) was founded by Sumitomo Trust & Banking, Resona Bank, and Mitsui Trust Holding. Referred to in Japanese as “trusts of trusts” (*sai-shintaku*), this bank specializes in securities processing and administering the trust businesses of two of the four main banking groups, as well as managing its own fund,

the “Japan Master Trust”. In 2006, 75% of revenues were fee income. Assets under management stood at ¥75 trillion in 2002, but doubled to ¥144 trillion (roughly \$1.3 trillion) as of March 2006.¹³ This tremendous growth makes Japan Trustee Services appear as a major shareholder for many major listed firms, often replacing the previous main banks as major shareholder.

Similarly, the Master Trust Bank of Japan (*Nihon masutaa turasuto shintaku ginkō*) was founded in 2002 as the specialized trust investor of the Mitsubishi UFJ group. In addition to Mitsubishi UFJ Trust&Banking, Nippon Life Insurance, and Meiji Yasuda Life Insurance, this bank also counted Nōchū Trust, the trust arm of the umbrella bank for all agricultural cooperatives, as a shareholder. With ¥106 trillion (almost \$1 trillion) to invest, this bank became the second seemingly ubiquitous shareholder in the early 2000s, and 84% of revenues in 2006 were fee income.¹⁴ The Japanese trusts were joined by foreign trust administrators in the form of “street names”, which are investment vehicles for foreigners (these are included in the “foreigners” share in Figure 4.1). The two most prominent were State Street Bank & Trust Co. and Chase Manhattan Bank, London. These were mainly custodian holders for global institutional investors, and their rise is another contributing factor to the dominant role of foreign investors.

While these trusts are, at one level, simply custodians, they have begun to affect corporate management and the workings of the stock market. To be sure, custodians vote on proxy, i.e., as determined by the retail institution that offers the fund to investors, such

¹³ See the trust’s website, www.japantrustee.co.jp.

¹⁴ Moreover, in January 2001 the Mizuho Financial Group established Trust&Custody Services Bank, Ltd. (*Shisan kanri saabisu shintaku ginkō*). Owned by Mizuho (54%) and four life insurance companies that became part of that financial group after the merger of the three original banks (Dai-Ichi, Asahi, Meiji Yasuda, and Fukuoka Mutual Life), as of 2006 this company was investing assets of ¥94 trillion (roughly \$900 billion). See www.mastertrust.co.jp, and www.tcsb.co.jp.

as an investment bank or a trust bank. Yet, it is usually not the original investors but the retail institutions that determine how to vote at the shareholders' meeting (activist shareholders tend to invest on their own accounts rather than through trusts). Fund managers are competing against each other for returns on their various funds, and therefore value returns on equity higher than long-term stability. The difference to Japan's previous main banks and business group members as major shareholders could not be more pronounced, because institutional investors have the opposite interest in corporate performance. Recall that banks pushed their clients towards diversification to increase loan volume while reducing risk as companies were hedged against failure through their diversified business portfolio. Trusts, in contrast, diversify their portfolio through their own investments. They demand transparency and simplicity: ideally, they want a company to be in only one business, easily comparable to its competitors. Trusts pick the most profitable firms, and invest across a large number of industries. This shift in interest of dominant providers of finance has further reinforced the strategic shift away from high diversification to "choose and focus" strategies.

3. Mergers and Acquisitions: The Buyout Wave

These developments have invited unprecedented activity in the market for mergers and acquisitions. Figures 4 through 7 highlight the recent quantitative explosion and qualitative change of M&A in Japan. Figure 4 shows the steep increase in the overall number of deals, in particular after 1998 (the onset of strategic reversal). The chart displays three types of deals, "out-in" (foreign money purchasing Japanese assets),

“out-out” (foreign money purchasing foreign assets in Japan), and “in-in” (domestic deals). Although we see an expansion of “out-in” M&A beginning in 2000, the main reason for the increase in activity is clearly the upsurge in domestic deals from a level of roughly 600 per year in the mid-1990s, to 1,800 in 2005. In terms of value of these transactions, data are available only for public deals, which amount to 20-40% of total transactions. These data exhibit a similarly dramatic rise: the annual value of domestic M&A rose from less than ¥2 trillion in 1997 to over ¥10 trillion level in 1999, and ¥15 trillion (roughly \$13 billion) in 2005 (Nomura 2006). The upward trend continued in the first half of 2006, when both the number of deals (1,409 in six months) and their value (¥7.3 trillion) hit record highs (Nikkei, July 1, 2006).

Figures 5 and 6 speak to the type of M&A as well as the objective underlying these acquisitions. The lowest bar in Figure 5 shows that mergers (a marriage between equals) account for only a small portion of all deals and have not increased over time. The growth in activity is attributable to takeovers (checkered bar), the purchase of assets from another company, and the purchase of minority stakes in other companies. Figure 6 identifies the reasons why companies would make these purchases: almost two thirds of deals in the early 21st century were made with an eye towards “choose and focus” (the striped bar), that is, to strengthen existing businesses by purchasing either assets or entire organizations of competitors in order to assume a more dominant market position. “Intra-group restructuring” refers to the reorganization of business units, including spin-offs or mergers among subsidiaries; these increased in the “*saisei*” (revitalization) years of 2002 and 2003, but have petered out, perhaps because this type of reorganization has been accomplished in many companies. In other words, Figure 6 tells a story of

increased M&A activity, initially to reorganize existing business, then to acquire competitors in the same business. In contrast, entering a new business, which accounted for a quarter of all domestic deals as recently as the early 1990s, has become negligible.

Critics submit that recent growth notwithstanding, the Japanese market for M&A remains deplorably small. In 2004, total global mergers topped \$2 trillion, but Japan accounted for only 4.3% of that total. And even though overseas buyers have spent plenty on Japanese companies, that investment is tiny compared to the \$1.2 trillion of U.S. buyouts between 1999 and 2004 (Dhaliwall 2005, Rowley 2005). A 2004 government report identified five main infrastructure problems obstructing an even faster growth of M&A in Japan (ESRI 2004): (1) human capital (building of expertise in analysis and information brokerage); (2) knowledge of M&A strategies (to alleviate “vulture” fears and allow firms to adopt appropriate defensive measures against hostile takeover bids); (3) infrastructure that supports new business creation (ranging from ease of starting a new firm to societal judgment against failure); (4) legal infrastructure; and (5) related services (including law firms specializing in M&A). It is important to note, however, that since 2004 great strides have been made in all of these areas. Therefore, even though Japan’s M&A market may still be comparatively small, it is growing rapidly, and the infrastructure – supporting industries such as litigation and financial lawyers, securities analysts, and the legal environment – is likewise growing towards accommodating a more active market.

Hostile Takeovers

Figure 4 revealed that one third of all M&A (or 690 deals) in 2005 were

takeovers. These come in two flavors: friendly and hostile. In a friendly majority acquisition, the target agrees with the deal, a fair price is established, and executive management of the target may remain involved in running the business. In contrast, hostile takeovers often involve fierce battles which typically end in shareholder discontent, price run-ups, and even lawsuits. Traditionally, Japan has recorded very few hostile takeovers. One reason may be an element of “saving face”, by no means singular to Japan but possibly more pronounced there, which entices parties to label an acquisition “friendly” even when it is not. More importantly, the extensive amount of cross-shareholdings in Japan until the 1990s thwarted the purchase of a company against its wishes. Adding to this, until 1999 Japan did not have a rule of compulsory acquisition of minor stakes once a raider had managed to buy up the majority of shares, which made it difficult to acquire 100% of stock. And finally, capital gain taxes applied to the sale of shares even in a hostile takeover bid, making many minority owners even less willing to surrender their shares to a hostile raider (Higashino 2004).¹⁵

Takeover data show that the 1999 revision of these bottlenecks have opened the door for hostile takeovers in Japan. The increase in highly touted successful and failed bids suggests that “saving face” is no longer as important as corporate reorganization. Figure 7 shows the increase in uninvited yet successful takeover bids. While the absolute number is still small, the steep slope of the trend line is surprising, and by 2005, there was on average one successful bid per week. The majority of these hostile takeovers is not

¹⁵ Antitrust rules on mergers are also being revised. The traditional rule-of-thumb had been to permit mergers that resulted in a market share of the new entity of no more than 35%. In the early 2000s, to support the government program of “reorganization” Japan’s Fair Trade Commission had allowed mergers even where they resulted in market share exceeding 50%. In 2006, the JFTC suggested to replace the maximum market share rule with a case-by-case evaluation, similar to that in the U.S. and Europe, based on more sophisticated market share calculation and the particular situation of the industry concerned. See Nikkei Weekly June 16, 2006, Nikkei June 16, 2006, Nikkei January 10, 2006.

launched by funds, but rather due to corporations acquiring other corporations. This trend continued into 2006, which recorded the first intra-industry hostile takeovers. The August 2006 bid by Oji Paper to acquire Hokuetsu Paper for its advanced production facility was Japan's first true "choose and focus" bid, in that Oji attempted to acquire a direct competitor to establish dominance of the domestic paper market. In the same month, menswear retailer Aoki launched a hostile bid for Futata, a competitor with a presence in Kyushu that Aoki lacked. Both battles occupied headlines for a while, though neither bid was eventually successful. However, both resulted in a reshuffling of their industries, as the targets then tied up with another competitor to strengthen their market positions. The high profile of the two concurrent intra-industry battles caught the public's attention. The fact that both battles plaid out in mature industries, with very traditional companies involved, characterized that hostile takeovers had reached "old" Japan, and that slimming margins and a fierce fight for competitive positioning were likely to trigger a bigger hostile takeover wave yet to come (Sankei Shinbun, August 9, 2006).

In light of the rapid increase in takeovers in the early 2000s, the Ministries of Justice and that of Economy, Trade and Industry in 2004 convened a study group to prepare the release of a new Takeover Guideline. The study group was tasked with addressing the political reality of fast-spreading fear of aggressive foreign investment and the economic necessity of companies to develop legal and market strategies for corporate renewal. The resulting 2005 Takeover Guideline was based on four principal objectives: to ensure the increase in corporate value, to adopt global standards in Japan, to ensure equal treatment of all bidders (domestic or foreign), and to expand the choice for managers in defending hostile bids. From these principles, it was only a brief jump to

allow “reasonable defense measures”, and the Guideline effectively validated a “poison pill” (a mechanism that makes a hostile bid prohibitively expensive) in the form of new warrant issues that dilute the raider’s stake.¹⁶

The 2006 Corporation Law made the 2005 Takeover Guideline binding and clarified the role of shareholders in the structuring of defense mechanisms against takeover attempts, by giving shareholders a choice to issue a *carte blanche* for such mechanisms, or to insist on ratification each time new defense schemes are introduced. However, based on the opinion that Japan remained comparatively weak in takeover defense (in particular in comparison with U.S. mechanisms such as poison pills and golden parachutes or golden shares as known in Europe), the Corporation Law’s final market-opening clause was delayed until May 2007, until when foreigners could acquire Japanese firms only with cash but not through stock swaps. This one-year delay looked more like a political compromise within Japan than a market-closing measure, because share-for-share deals are hardly ever hostile, so that the delay obstructed friendly acquisitions while leaving the door wide open for hostile bids by foreign entities. Moreover, all hostile takeovers in 2005 were domestic. In any event, many expected a further increase in hostile takeovers for 2007.

Some observers predicted Japanese firms to use the new Takeover Guideline to introduce a plethora of defense mechanisms. However, according to a poll of June 2006, only 27% of listed Japanese companies were considering the introduction of such measures (Nikkei June 19, 2006). Nishiyama (2006) found that between May 2005 and

¹⁶ Milhaupt (2005) offers a detailed analysis how the Guideline represents an adaptation of Delaware takeover rules to the Japanese setting. See METI/MOJ (2005) for the “Guidelines for Corporate Value Protection” (Takeover Guidelines), and CVSG (Corporate Value Study Group, 2006) for the 2006 report on takeover activities and policies.

May 2006, only 91 very large Japanese companies (all with below average return-on-equity and capital market evaluation) had introduced defense mechanisms. Similar to the recent experience in Europe, the main concern expressed by shareholders on these various tools to thwart attempted takeovers was a lack of transparency and a potential override of shareholders' rights and interests by self-serving incumbent management. While, as of October 2006, it was too early to discuss the actual processes and defense mechanisms Japan will establish, it was noteworthy that these mechanisms were discussed within Japan with uncommon and unprecedented interest by shareholders themselves. The fact that shareholders now vote on takeover defenses means that Japanese companies will differ over time in the extent to which shareholders can affect takeover battle (Miyazaki 2006, Nikkei June 27, 2006).

Also as of 2006, critics complained that the Takeover Guidelines and the delay of share-for-share deals by foreigners were all signs of "old Japan's" restrictive practices prevailing. However, it should be noted that the United States, with the most active market for hostile takeovers, takes credit for inventing some of the most powerful defense mechanisms, so that the argument that Japanese companies ought to be allowed to structure their own defenses in an effort to create a level global playing field is not unreasonable. But perhaps more importantly, the objective with a hostile takeover is typically to purchase an underperforming company, replace its management and business model, and improve performance of the company. The best defense against such a takeover is for management to undertake these reforms by itself, to ensure that its stock price is not underperforming. Therefore, whether or not a hostile bid is launched or eventually successful is not as relevant as the potential threat of a hostile takeover in

introducing managerial discipline. The one-year delay in allowing all types of foreign purchases of Japanese companies does not negate this positive overall effect on corporate governance and economic performance.¹⁷

4. Investment Funds

As institutional investors began to affect the dominant mode of stock investments in Japan, the market became ever more attractive to one type of institutional investor, the investment funds. Perhaps the first contemporary buyout fund that attracted general interest to this industry in the United States was Kohlberg Kravis Roberts & Co. with its takeover of RJR Nabisco in the 1980s (KKR contributed to the image of “vultures” for realizing that RJR Nabisco’s parts were temporarily worth more than the total and breaking the company into pieces for immediate financial gain rather than longer-term value creation). The late 1990s saw the resurgence of private funds that pool investments by a large number of investors (e.g., wealthy individuals, pension funds, and corporations) into targeted, aggressive investments. Their area of specialization differs, as some invest generically in underpriced assets and arbitrage opportunities, while others focus on a particular type of investment, such as real estate. The most dominant type in Japan in the early 2000s were private equity funds that identified underperforming corporations and brought in their own management team for a turnaround. Ripplewood’s 1999 purchase of the Long-Term Credit Bank and transformation into and partial sale of the highly

¹⁷ The threat of a potential takeover is fundamentally different in terms of corporate governance from the previous system of bank monitoring. See Schaefer (2006) and Schaefer (forthcoming) for the differences between the banks’ “contingent monitoring” (activated only when a company fell into negative net worth, but not when it was underperforming for years on end) and “continuous” governance by institutional investors and others constantly monitoring management performance.

successful Shinsei Bank in 2004 is a prime example for this type of activity. In April 2006, KKR launched a new fund of an estimated \$12 billion, and in June 2006 Bain Capital, one of the world's largest buyout funds, also opened offices in Tokyo (Nikkei, May 16 and June 30, 2006).

Figure 8 sheds light on acquisitions by investment funds in Japan between 1998 and 2005. Whereas in 1998, investment funds accounted for only 2% of all M&A in Japan, by 2005 their share had increased to over 13%. Initially foreign investors (striped bars) were prominent, but in the early 2000s, the domestic investment funds joined the fray and overtook deals by foreign funds in 2005.

Foreign Funds

The first foreign investors with a keen interest in Japan's 1990s recession were financial firms (such as GE Capital), insurance companies (after deregulation of that industry in 1995) and investment banks. Realizing that Japanese assets were offered in fire-sales, often as low as for 10 cents to the dollar, the early investors made bets on long-term recovery. Ripplewood's takeover of Long-Term Credit Bank, Lone Star's acquisition of Tokyo Sowa Bank, and Cerberus purchase (from Softbank) of Aozora Bank are all examples of their activities around the turn of the century. A bit more quietly, Goldman Sachs began to purchase hotel resorts and golf courses. When the real estate market began to thin out at around 2000, the foreign investment funds started "turnaround" (or "distressed") funds aiming at companies hit by the extended recession, which earned them the nickname "vulture funds". According to one estimate, between 1997 and 2002, the "vultures" bought more than ¥30 trillion (\$300 billion) of distressed

assets (Kawakami 2002).

The foreign interest in Japan was sustained in the early 2000s when U.S. assets (in particular real estate) began to look overvalued compared to Japan. Positive economic forecasts for Japan promised quick returns on investment. But perhaps most importantly, it was easy to launch new funds in Japan, as Japanese institutional investors such as pension funds, life insurance companies, and banks were flush with money but badly lacking investment opportunities. Japanese banks, in particular, were often interested in quietly investing in foreign buyout funds, to avoid to appear unpatriotic “vultures” when buying up assets underlying their own, or their competitors’, bad loans. According to one estimate, foreigners provided hardly more than 10% of total buyout fund capitalization in Japan in 2004 (Diamond Weekly 2005).

Japanese Funds

The success of U.S.-managed funds in Japan naturally also attracted Japanese players. The first independent Japanese buyout fund was Advantage Partners in 1997, which continues to be one of the industry leaders (CJEB 2005). At the turn of the century, it was joined by some of Japan’s more aggressive and established venture capital funds, who with the burst of the IT bubble identified better opportunities in management buyouts. Led by JAFCO and Tokio Marine Capital (TMC), many Japanese VC began to launch new MBO funds, beginning in 2002, to shift business away from the sluggish domestic startup market and into the hot “reorganization and revitalization” segment of the economy.¹⁸

¹⁸ Interview, Tokio Marine Capital, January 2005, Tokyo. See Schaede (2005) on Japanese venture capital firms, and their activities in management buyouts in the early 2000s.

Figure 9 highlights the development of the Japanese investment fund industry. From the humble beginnings of Advantage Partners in 1997, the total number of funds had risen to 108 in 2005, with a total of ¥1.8 trillion (roughly \$ 15 billion) in assets raised during this period. Many of these funds are subsidiaries of banks, insurance companies, and corporations, such as Aozora Investment Co., Millennia Venture Partners, Nikko Antfactory, ORIX Capital, or Mitsui Ventures. While they attract a variety of investors, such as pension funds or other companies, their objectives may be guided by the parent's interest. Beginning in the late 1990s independent investment funds also became prominent, such as MKS Partners and Unison Capital. The introduction of the limited liability partnership as a legal organization in 2006 allowed these funds to reward partners according to their own track record, which has attracted new funds as well as new talent to work at these funds.

The industry received a further push by the government, when in 2001 the Development Bank of Japan (DBJ) received a special budget of \$900 million to invest in “corporate revival funds”, which were buyout funds geared toward supporting corporate reorganization of smaller firms in rural Japan. This triggered the formation, in 2002, of Phoenix Capital, a joint venture between Tokyo Mitsubishi Bank and DBJ. Other banks soon followed suit, leading to large banks establishing buyout funds to accelerate reorganization of their business groups (Kawakami 2003). In other words, banks began to buy out the assets underlying their own non-performing loan portfolios, to create an upside potential for the restructuring of these companies through debt-equity swaps (MRI/Chikusei 2004).

The combination of the active launching of private equity funds and bank-led

funds to purchase assets in corporate reorganization schemes have contributed greatly to the restructuring of Japanese industry. One industry where “choose and focus” is particularly visible is electronics, where the ten “general electronics firms” have all spun off large chunks of peripheral business to zoom in on core businesses in which to compete more powerfully. In some cases, the spun-off entities remain exclusive suppliers; in others, they are shaped by their new owners into independent companies that supply multiple buyers in an increasingly global marketplace. These developments have begun to affect industrial organization in Japan, as market shares have become much less stable and industry leaders are more frequently replaced by newly strengthened old competitors or new entries to the industry.

5. Conclusions: The New Competition for Investors

The composition of shareholders in Japan has greatly changed over the last decade. For companies, this shift has enormous implications for business strategies and corporate management. During the postwar period, management of large firms aimed to increase sales, almost at any cost, to please the main lenders as well as, to a lesser degree, other members of their business groups and stable shareholders. The typical process for rectifying mismanagement was for the business group to consult quietly, but only when the company faced bankruptcy did the main bank step in to replace management with bankers who organized an informal debt restructuring. The main banks had a stronghold over corporate information, and details of the restructuring were rarely made public. In this setting, the president of a large firm was mostly interested in stability and certainty: if

there were no large swings in corporate performance, there would be no outside interference. Risk-taking was rarely rewarded. Shareholders other than banks and corporations were typically too small or too diversified to intervene. Shareholder rights were limited, and shareholder meetings were typically short and provided limited opportunity for activists to speak out.

All of this has become a thing of the past. Companies are now concerned with the cost of financing: unlike the postwar period, when interest rates on bank loans were regulated at a low level and were the same for companies of similar size, capital market financing is based on the price mechanism. The better the corporate performance, the cheaper it is to raise money from the markets. The new dominant shareholders, institutional investors, are driven by a profitability goal in competition with each other for investors. Low performing companies will either face intervention (voice) or be dumped from the portfolio (exit). Loyalty, as exhibited by the previous stable cross-shareholders, cannot be expected from these investors. Therefore, underperforming companies will see a drop in stock price, which in turn might invite hostile takeover bids. The new owners have also reinforced pressure on Japanese firms to reorient their corporate strategies, as their interests – transparent business models with clear-cut performance data, ideally in a limited set of businesses so as to allow direct comparison with competitors – differ fundamentally from those of Japanese banks in the postwar period.

Where institutional investors fail to monitor, two new potential threats to management have appeared: buyout funds and hostile bidders. Considered by some for their potential negative effects as either “vulture funds” or “corporate raiders”, these nonetheless work to keep management on its toes. Because this is a recent development,

data are still too limited to analyze whether mergers and acquisitions in Japan have served to increase performance of the buyout targets. However, the effect for the overall economy is to increase large firms' sensitivity to profit measures, efficiency, and competitiveness.

The legal reforms between 1997 and 2006 enabled the M&A market in Japan, and they also reflect a shift in corporate strategic thinking, as many firms were highly supportive of these reforms. Japanese firms now pay close attention to measures such as return on equity, return on investment, and profit margins. Revisions of accounting rules towards consolidated statements and mark-to-market of assets make it impossible to hide loss-leaders in subsidiaries. Increased disclosure requirements give all investors easy access to the same information. The introduction of quarterly earnings reports for listed companies has further increased the timeliness of this information. Overall, Japanese management practices have been oriented towards the market.

This change towards the markets is anchored in a large number of separate laws, supported by complementary legal revisions in employment, and the rapid emergence of supporting industries, such as financial lawyers, litigation lawyers, securities analysts and other information providers, and the courts. Underperforming management now can, and is, being sued by shareholders. Violations of rules are prosecuted strictly, as the Livedoor accounting scandal and the Murakami insider trading violation have made clear. Gone are the days when corporate executives caught at wrongdoing were simply promoted to chairman; in the 21st century, they might be serving a prison term. While recent accounting and other scandals suggest that there is still room for regulatory improvement, the direction of change is clearly towards the market. It is inconceivable that all of these

reforms can be unraveled; the new market orientation of Japanese firms as they compete for investors is here to stay.

From a normative perspective, it is difficult to say whether the shift towards “choose and focus”, the increased attention to institutional investors and investment funds, and the emergence of hostile takeovers are necessary all positive. Research for the United States has provided mixed evaluations of the benefits of mergers and acquisitions. As we learned from the memorable Gordon Gekko in the 1987 Hollywood movie “Wall Street”, buyout funds are not primarily interested in economic value creation. Moreover, after a decade of aggressive unbundling in the 1990s, US firms are moving back towards strategic diversification around well-defined core businesses. It is clear, however, that the “choose and focus”-type reorganization of Japan in the early 21st century has greatly contributed to cleaning up the aftermath of exuberant diversification of the bubble period years. Moreover, for better or for worse, after a decade-long hiatus Japanese companies are now reentering global markets in full competitive strengths with corporate profiles closer to global standards and more attractive for global investors to pursue.

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Figure 1: The Debt-Equity Ratio of Japanese Firms, 1960-2004

Source: Calculated from *Hōjin kigyō tōkei*; “large companies” refer to firms with capital of more than ¥1 billion.

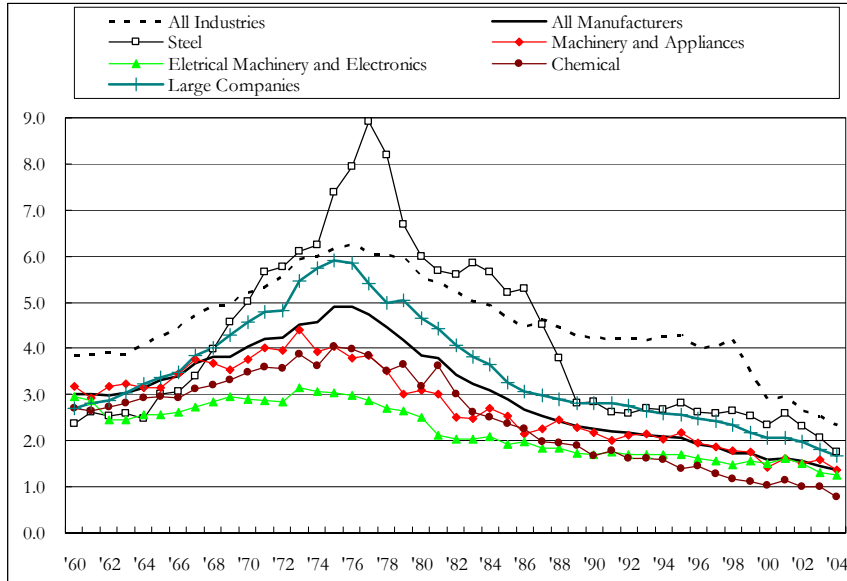


Figure 2a: Flow Data for Corporate Financing, 1960-2004: Retained Earnings, Bank Loans and External Financing

Source: calculated from *Hōjin kigyō tōkei*; for all “large firms” with capital exceeding ¥1 billion, all industries (n=5,275); in million Yen.

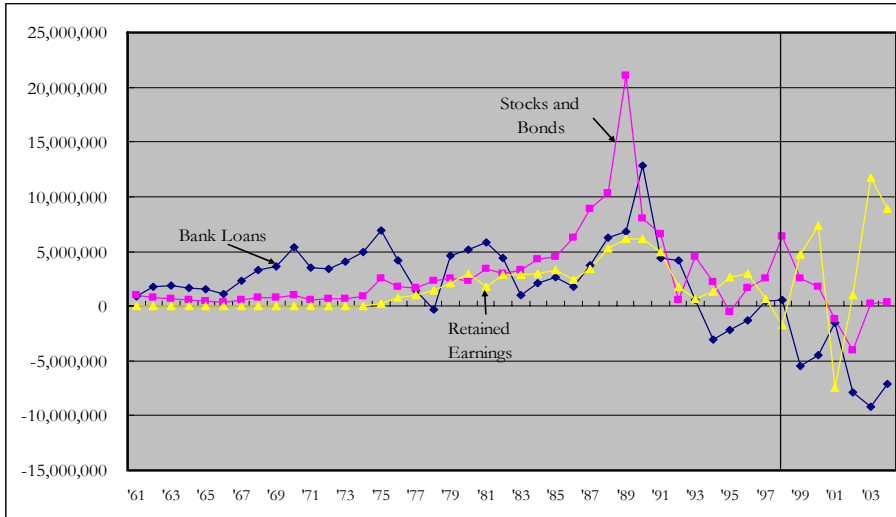


Figure 2b: Stock Data for Corporate Financing, 1960-2004: Retained Earnings, Bank Loans and External Financing

Source: same as 2a

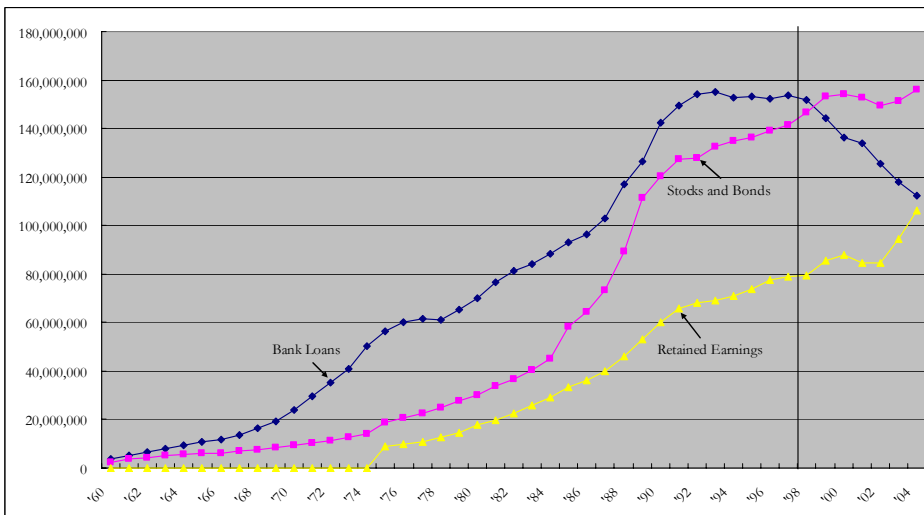


Figure 3: Ownership Percentages, by Type of Investor

Source: TSE (2006), in % of total market capitalization, as of March of each year.

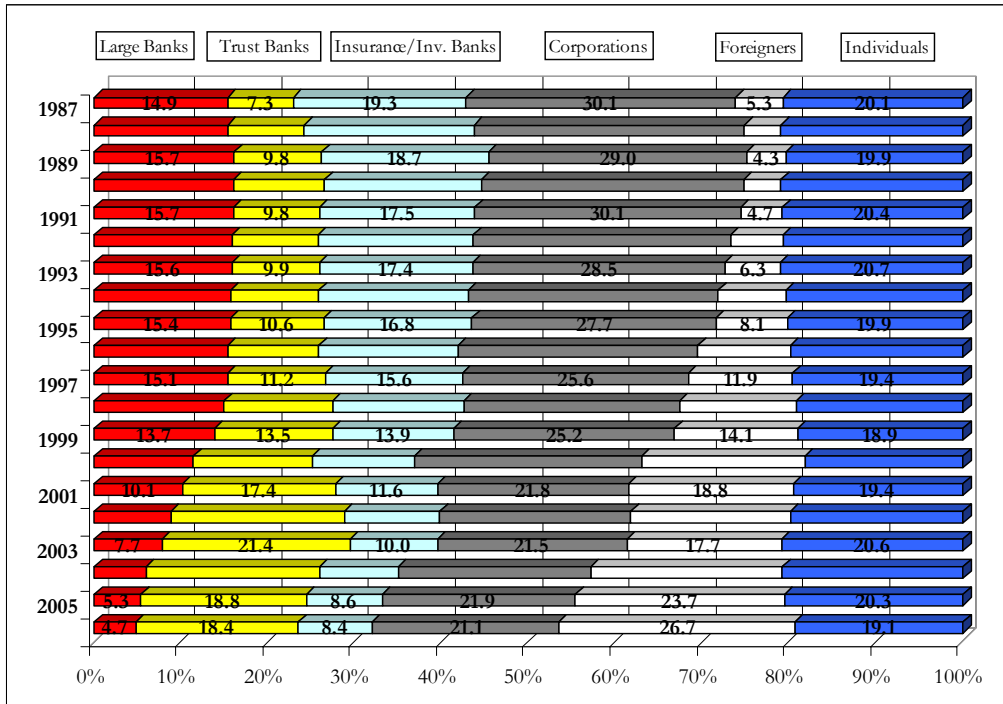


Figure 4: Mergers and Acquisitions, by Number of Deals, 1986-2005
 Source: Nomura (2005, 2006)

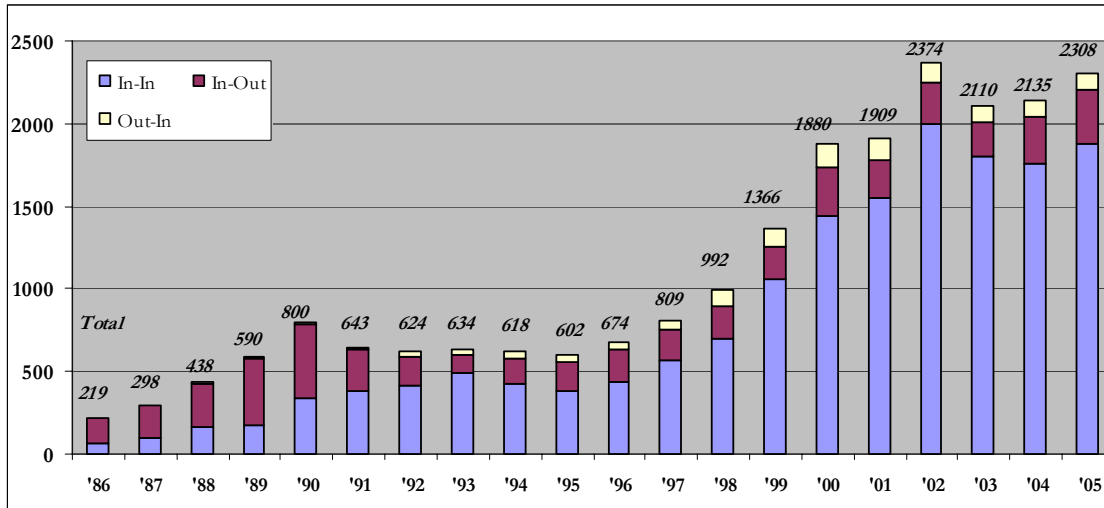


Figure 5: Domestic M&A Deals, in Number, by Deal Scheme
 Source: Nomura (2005, 2006)

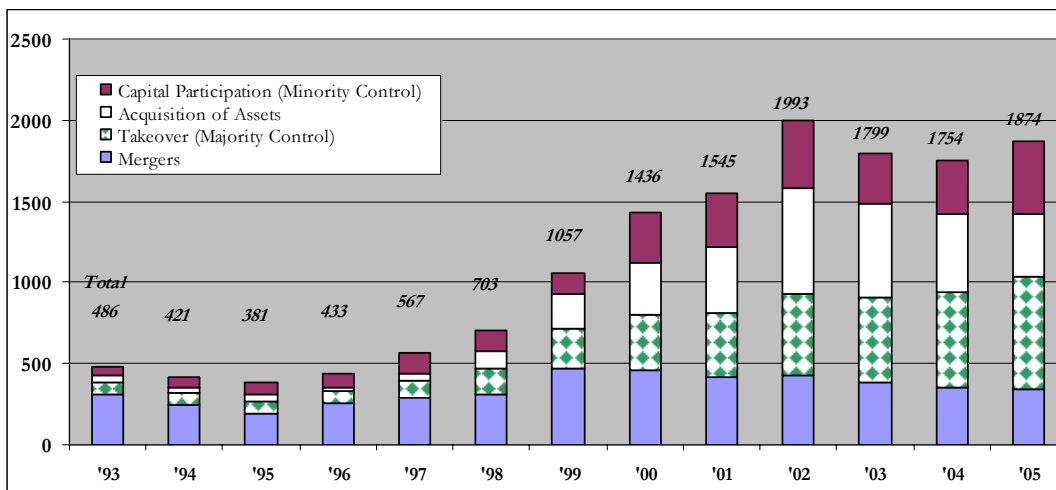


Figure 6: Domestic M&A Deals, in Number, by Objective
 Source: Nomura (2005, 2006)

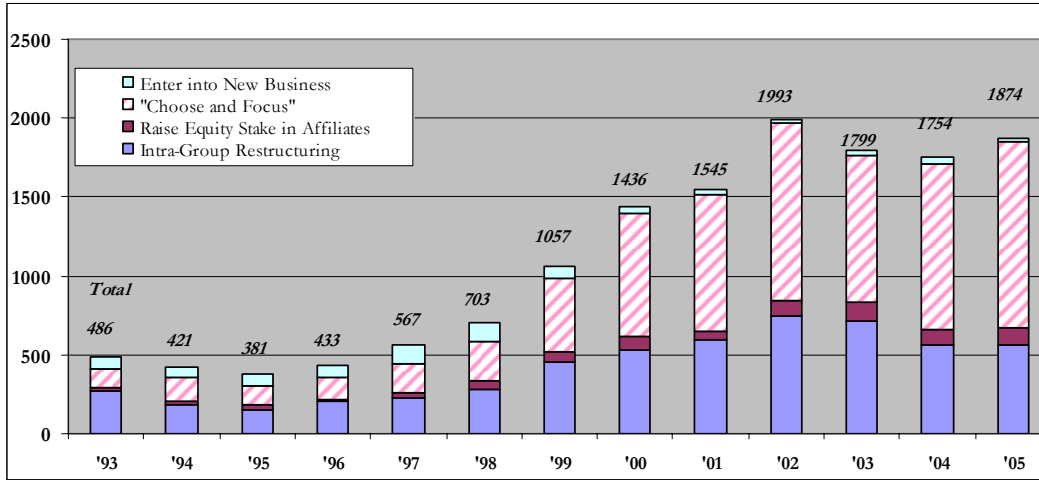


Figure 7: Hostile Takeover Bids, in Number of Successful Deals, 1995-2005
 Source: Fujioka (2006), based on Recof data

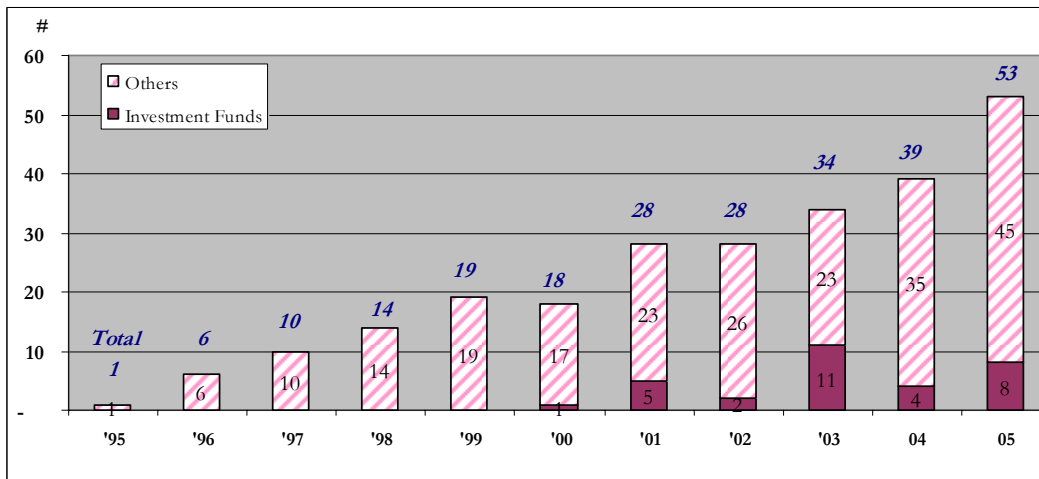


Figure 8: Acquisitions by Investment Funds, 1998-2005
 Source: Fujioka 2006, using Recof data

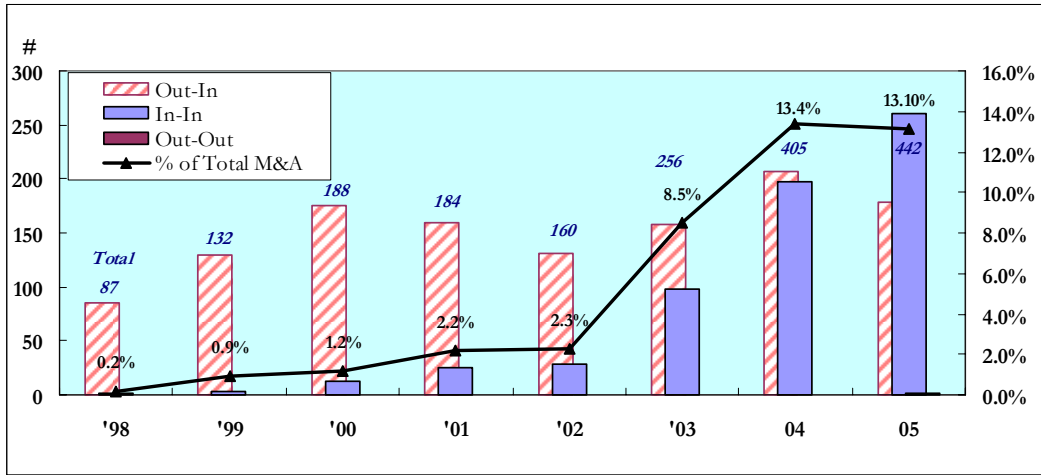


Figure 9: Japanese Investment Funds: New Fund Creations and Assets under Management
 Source: *Ekonomisuto* June 13, 2006, p.10

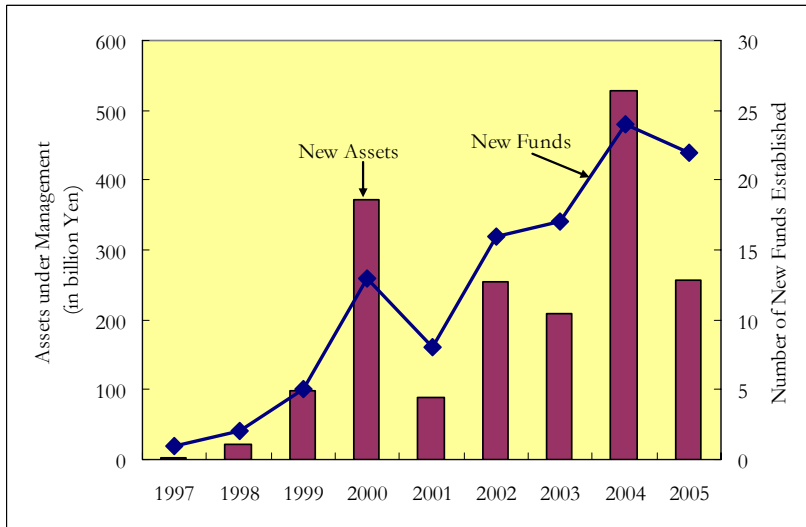


Table 1: The Most Important Legal Changes of the early 21st Century

(Note: Unless otherwise noted, the date refer to the time that the revision passed the Diet; implementation usually occurs the following year)

Source: Schaede (forthcoming), Chapter 1

Year	Commercial Law	Other Laws	Accounting/Tax	Labor
1997	Simplification of merger processes	Lifting ban on holding companies (AML revision)		
1998	Stock repurchases allowed	Foreign Exchange Law; Financial System Reform Law (“Big Bang”); Two laws to rescue/revitalize financial institutions (enforced immediately)		
1999	Equity-swap system; Equity transfer system	Special Measures Law on Industrial Revitalization	Adoption of tax effect accounting; Introduction of cash flow statements	Equal Opportunity Law revised
2000	New spin-off (divestiture) system; Simplification of transfer of business, M&As	Civil Revitalization Law, to streamline bankruptcy procedures	Full-scale shift to consolidated accounting; Mark-to-market valuation of financial assets (except cross-shareholdings)	Employees stripped of veto right in business spin-offs
2001	Abolition of par value stock system (stock splits facilitated); Treasury stocks; New legal reserves system	Emergency Economic Measures; “Guideline for Multi-Party Workouts” for bankruptcy cases; Law Limiting Banks’ Shareholdings	Accounting for employee retirement benefits; Mark-to-market for cross-shareholdings; Statutory auditor system expanded; Corporate reorganization tax rules	Law for Facilitating the Resolution of Individual Labor Disputes
2002	Various types of stocks allowed; New stock option system; New corporate governance rules	Program for Financial Revival; Banks’ Shareholdings Purchase Corp. begins holdings of corporate equity	Consolidated tax return system	
2003	Treasury stock purchase system (for use in M&A)	Revision of Corporate Reorganization Law and Liquidation Law; Revision of Industrial Revitalization Law; New Business Development Promotion Law (¥1 firms)	New standards for accounting of impaired assets; Listed companies must file quarterly earnings reports (TSE rule)	Labor Standards Law revised (clear rules on dismissals); Working Dispatching Law revised (2004)
2005		Takeover Guideline		
2006	Corporation Law enacted: abolition of YK; introduction of LLC; M&A rules streamlined; variety of stock types that limit certain privileges allowed; officer/auditor rules reduced for closed-held KK; managerial flexibility and liabilities increased for large KK (shareholder litigation; derivative suits; internal controls)		Minimum capital requirement for incorporation abolished; Impairment accounting to be fully applied for fixed assets; LLP Law (with tax pass-through)	Law Concerning the Stabilization of Employment of Older Persons revised (retirement age raised to 65)