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Why Do Foreign Firms Leave Japan?

– A Survey of Investment Experiences and Exit Considerations –

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Summary

To identify some of the most important market obstacles, this research focuses on a survey of foreign companies in Japan that found it necessary to significantly change their business strategy in Japan, or even decided to leave the market entirely. Surprisingly, most companies were rather positive in their valuation of Japan's market environment. Instead of fully retreating from the market, they had divested from (one of) their affiliates, remained in a smaller market niche, or focused on importing and selling their overseas products.

Their main complaint is about the costs and time requirements to enter the market, the difficulties to restructure a business, and low prospects for growth. Basically, foreign companies are facing the problems as competitive domestic companies as well. Their policy recommendations are therefore not different from their Japanese peers: improve conditions for domestic growth through deregulation and fostering competition. FDI promotion on the other hand, might be helpful to improve the internationalization of the Japanese business environment in general. The promotion of a more positive image of foreign companies, for example, might help to reduce "attitudes" towards foreign investors and would help to reduce many implicit market barriers.

Contents

1. Evaluation of the General Market Environment

Foreign Direct Investment (FDI) in Japan has increased significantly over the last few years, but the overall level remains low compared to other countries. It is therefore highly likely that Japan's investment environment still harbors major obstacles for foreign companies. To identify some of the most important market obstacles,[1] this research focuses on a survey[2] of foreign companies in Japan that found it necessary to significantly change their business strategy in Japan, or even decided to leave the market entirely.

Most companies consider Japan as a challenging investment environment. The most often quoted obstacles are, however, of basically cultural nature and cannot easily be solved: language and historically grown business structures and practices top the list. Certainly, however, the relatively low level of FDI in Japan is not only a result of Japan's "uniqueness", it also a major cause of the lack of internationalization of the domestic economy.

Almost no company recommended incentives-based investment promotion programs for foreign companies to improve the market environment. Rather, they recommended promoting a competitive market environment for all companies. An important part of such an effort would be to put an end to regulations that are intended to discriminate against foreign companies. Few companies complained about protectionism (with the exception of public procurement, which can have an important signaling function), and

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[1] Most existing obstacles and problems of Japan's market environment are already well documented by eminent business organizations in Japan like the American Chamber of Commerce (ACCJ) and the European Business Council (EBC). The EBC's "Report on the Japanese Business Environment" and the ACCJ's "Viewpoint" series are sources to these research efforts. Furthermore, for more than ten years now, under the auspices of Japan's prime minister, the Expert Committee of the Japan Investment Council (JIC) has been actively collecting information about market obstacles from foreign firms and promoting necessary changes in the market environment. A series of research reports (in Japanese) has been published on the JIC's homepage.
In contrast to existing studies, however, our research targets were live interviews with executives of foreign companies with significant operations in Japan that decided to change their business strategies. We are very grateful to the EBC, the ACCJ, and many other foreign business associations, chambers of commerce, and consulting companies in Japan for opening doors to many interview partners in restructuring corporations or with eminent experts.

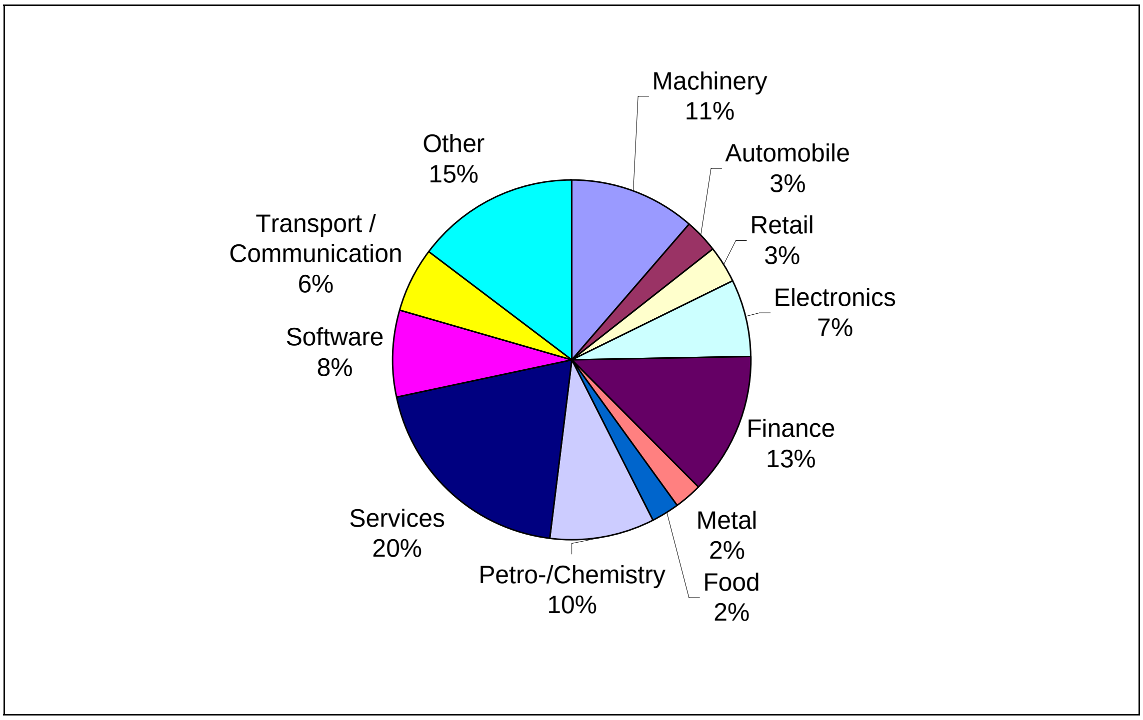
[2] Overall, we conducted 21 interviews with 12 companies and 9 experts. Most of the experts provided information about several corporate exit and restructuring cases. We are therefore able to cover a considerably greater number of cases than would have been possible without the experts' support. The survey covers the following sectors:
Consulting/Business Services, M&A Consulting, Tax Accounting, Legal Services, Human Resource Management, Marketing, Retail, Wholesale, Logistics, Transport, Utilities, ICT, Machinery, Chemicals, Pharmaceuticals.
An unfortunate limitation of this direct, interview-based survey method is, however, that almost all interviews required non-disclosure agreements for the interviewees' names and their companies.

most companies thought that remaining issues can be dealt with by the investing companies if their market segments show potential.

When comparing market exits by sector, Figure 1 reveals little surprises. The shares of disinvestments are roughly in line with the overall shares of the sectors among foreign affiliates. Although finance and IT services saw comparatively high rates of market exits, this comes hardly as a surprise because the IT bubble of 2001 is included in our sample.

In contrast, clear outliners are the companies that are engaged in wholesale in each sector. Throughout all sectors, 36% of Foreign Affiliates are active in wholesales, but only 26% of wholesalers in our sample exited the market. The foreign wholesalers demonstrated an astonishing persistence, which might be explained by the fact that sales are the last resort of market presence for most foreign firms in Japan. But since so many firms seem to prefer to keep their sales in their own hands, the fact might also be an indicator for continued inefficiencies at Japanese wholesalers and possible hopes for future potential in this highly regulated and unproductive sector.

Figure 1 Foreign Company Exits by Sector: (Percent of Total in 1999-2005)

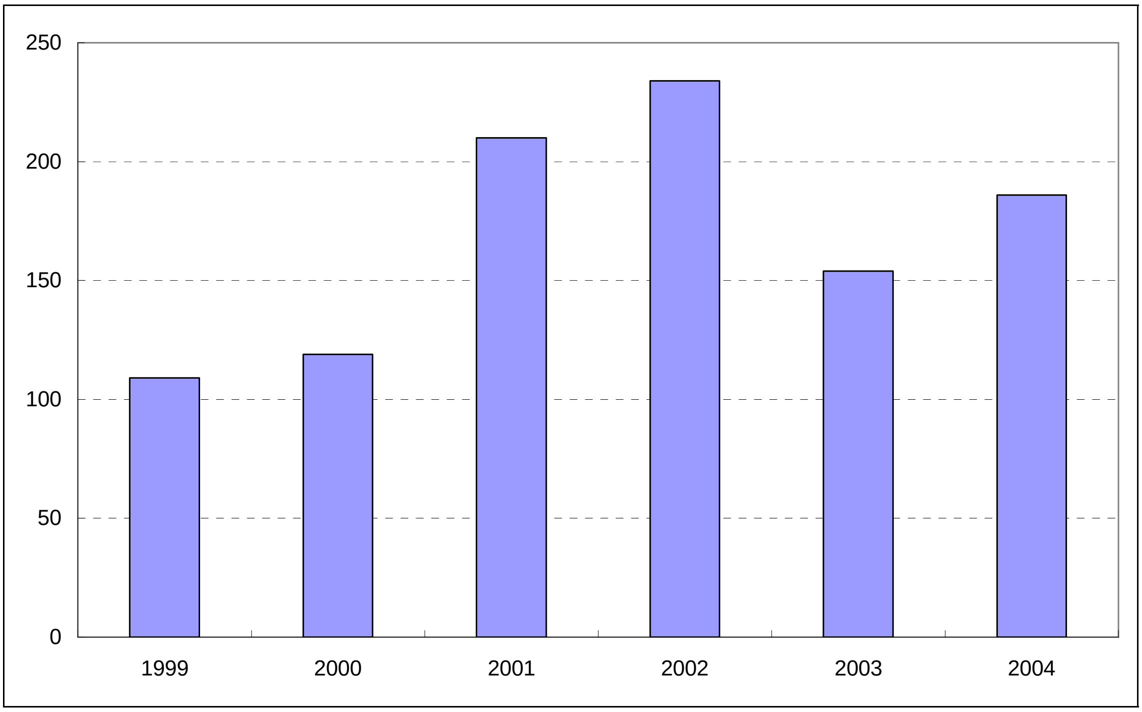


Source: © FRI 2006. Data from Toyo Keizai (1999-2005).

Note: Percent of Exits between 2000-2005 per Sector. Active Company Sector Shares on Basis of 2002 Data.

But there are also worrying trends in the foreign companies' exit data. After a peak of exit cases during the bursting of the IT bubble in 2001-2002 the numbers of disinvestments have not yet returned to earlier levels. On the contrary, Figure 2 shows a trend of exits, which is surprising as Japan's economy has clearly been recovering since 2002. If this trend continues into the future, Japan would certainly need to increase the number of incoming corporations by far more than is yet apparent in FDI data.

Figure 2 Foreign Exits by Year: (Cases 1999-2004)

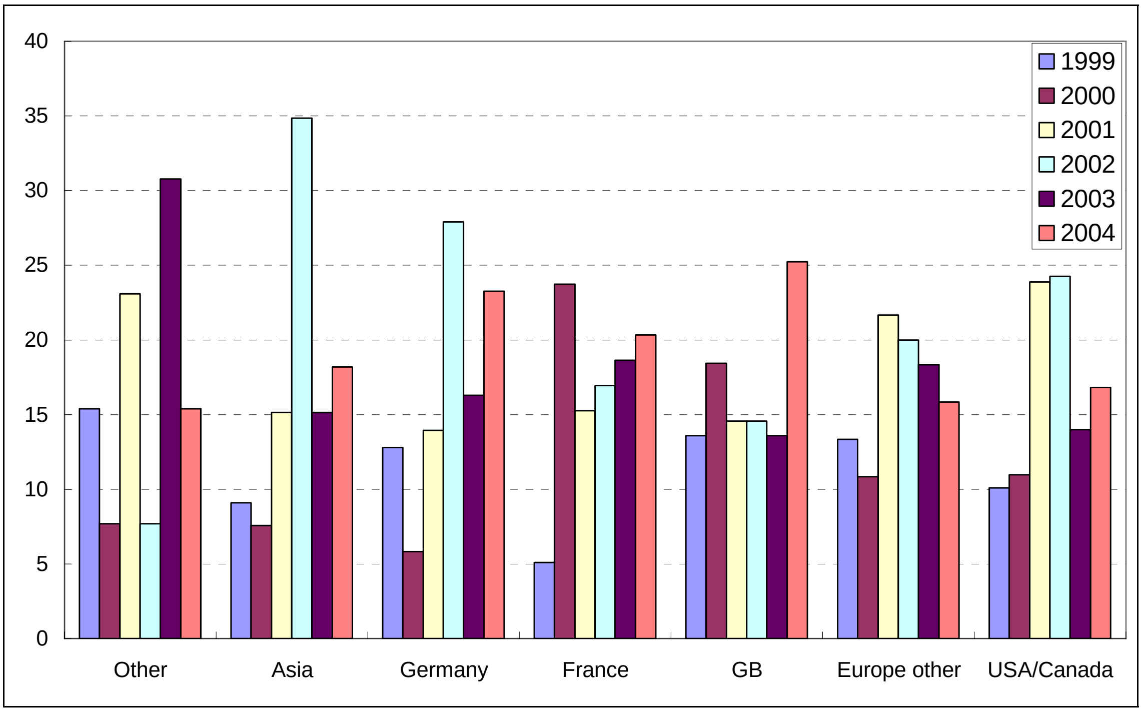


Source: © FRI 2006. Data from Toyo Keizai (1999-2005).

Note: Data for exit cases by calendar year.

An important question in this respect is if there is a difference in perception of the Japanese investment environment among foreign companies from different regions. Figure 3 shows IT-bubble peaks for exits from all investor regions – with the exception of France and the U.K. At least for the U.K., this is surprising because the U.K. has considerable investments in IT and finance in Japan.

Figure 3 Foreign Exits by Region and Year: (Percent of Total in 1999-2004)



Source: © FRI 2006. Data from Toyo Keizai (1999-2005).

Note: Data for percent of total exit cases by country.

The U.K. and the rest of Europe (other than Germany and France) are also exceptions in terms of general disinvestment trends: they do not show a trend towards increasing disinvestments, as is the case in the U.S., Germany, France and Asia.

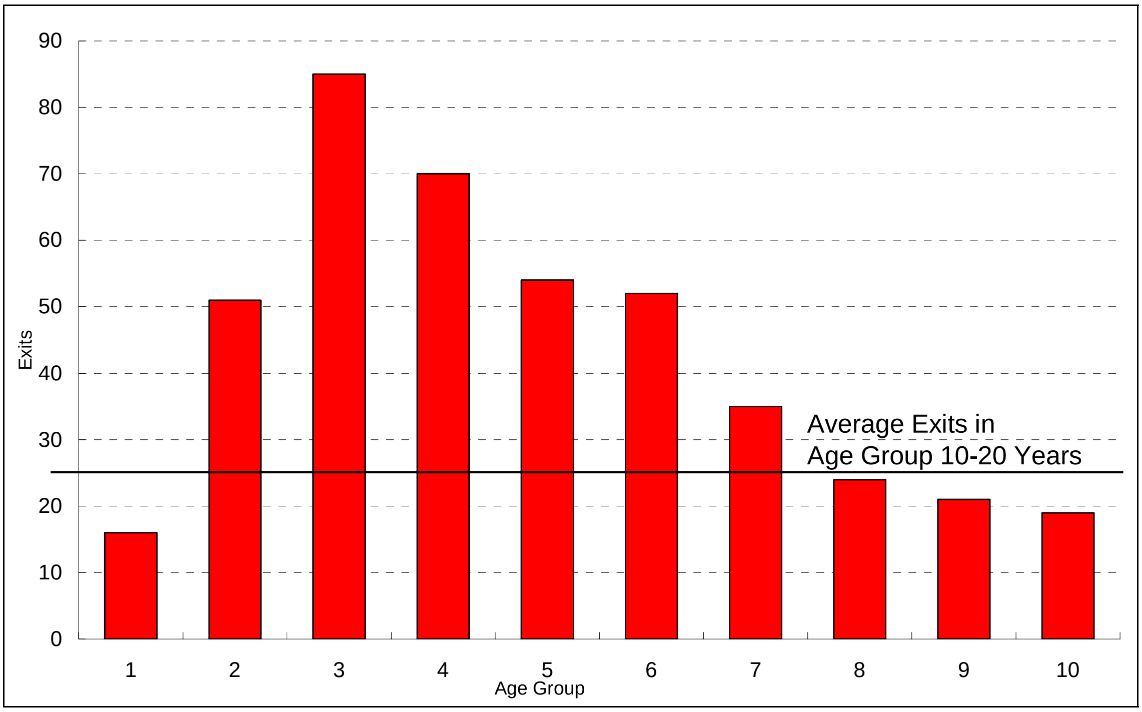
1.1. Market Entry Time Requirements

Most companies caution that an initial investment in Japan might require a time-horizon of 3-5 years to break even. This is a considerably longer period than in most other markets and therefore often a source of frustration in the foreign headquarters or a source of uneasiness with the original business strategy.

Indeed, in our sample, a high number of corporations (24% of all exit cases) had already disinvested before the recommended five-year probation period was over.[3]

[3] Disinvestment notification before and including the fifth year of investment. In the overall sample of the Toyo Keizai Database, this number is even slightly higher (27%). Probably because the database includes more smaller companies and has a higher share of IT and finance companies.

Figure 4 Foreign Exits by Age Group (Exit Cases 1999-2005)



Source: © FRI 2006. Data from Toyo Keizai (1999-2005).

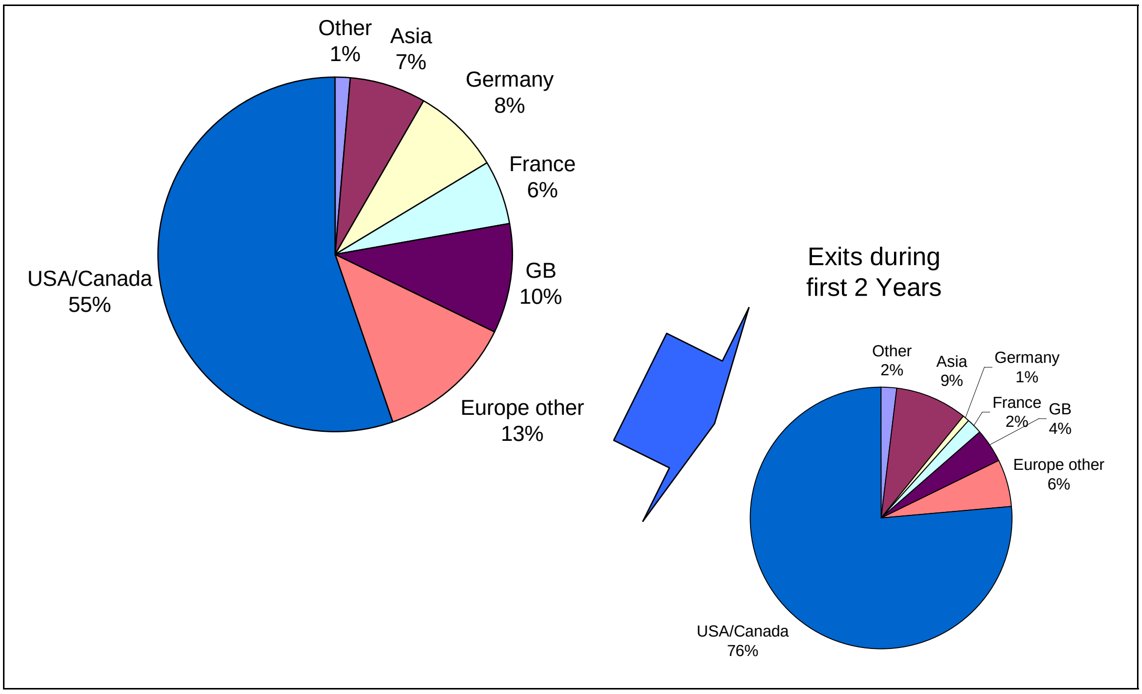
Note: We assume that the companies in the Toyo Keizai Database own the Japanese Affiliates from the year of establishment.

Figure 4 shows a clear peak in disinvestment notifications in year 3 of the foreign investment in a Japanese affiliate. After five years, in year six of their investment in Japan, the final group of investors seems to have decided about the fate of their initial investment in Japan. After year 6, the number of exits is already very close to the long-term average of yearly 26 exits per age group (based exit cases of companies between their 10^{th} to 20^{th} years of operation under foreign control).

As in Figure 3 before, it seems to be interesting to see if there are regional differences in the timing of exit decisions among foreign investor groups. Between 1999-2005, a higher number of U.S. corporations left the Japanese market than would have been expected (Figure 5). The share of withdrawal cases from the U.S. and Canada was 55% of the total, while their overall number of affiliates in Japan was only 39% (METI 2005). At the same time, about as many European corporations left as their overall share in Japan had been (37% exits vs. 42% of the foreign affiliates). Asian companies were even more persistent: their exits accounted only for 7% of the total, while their overall share was 15%.

In terms of timing of the exit decision, U.S. corporations also seem to be more impatient than their European peers: among the disinvestment notifications during the first two years were 76% U.S. or Canadian companies.

Figure 5 Foreign Exits by Region: Total and during First Two Years (1999-2005)

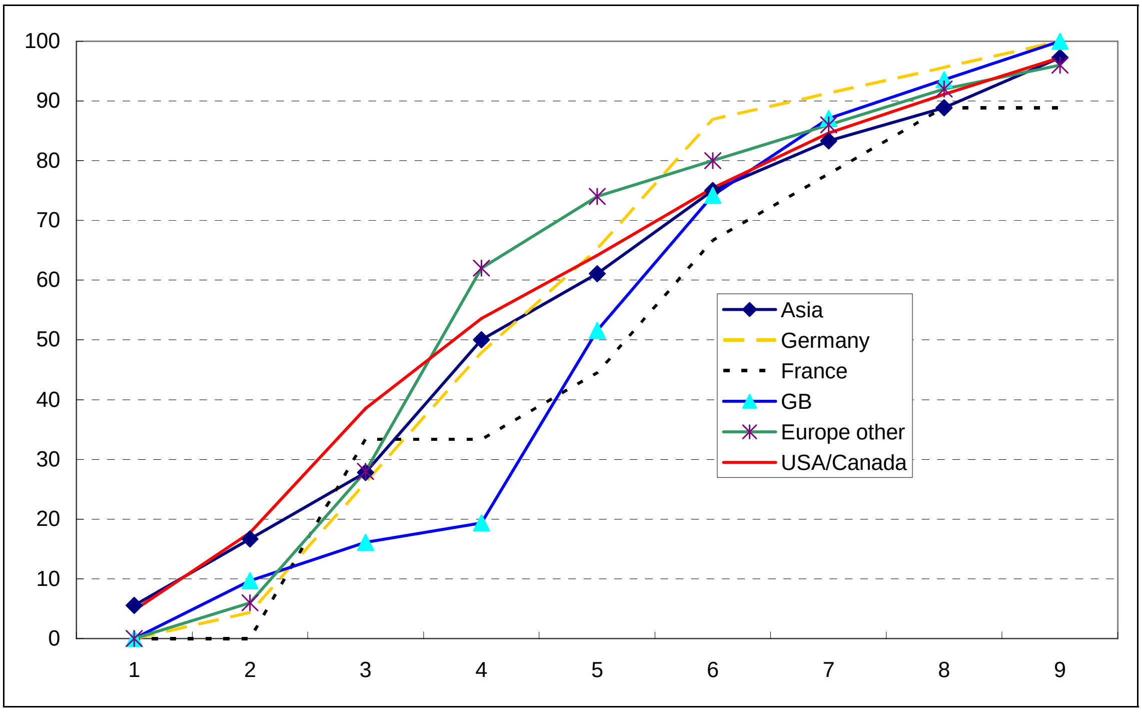


Source: © FRI 2006. Data from Toyo Keizai (1999-2005).

Note: We assume that the companies in the Toyo Keizai Database own the Japanese Affiliates from the year of establishment.

The U.K. seems to be the country with the most patient investors during the first four years, as Figure 6 shows. France is close, but many corporations seem to review their investments during the third year. The U.S. is the most impatient investor during the first three years, while "other Europe" cuts most strings during the fourth and fifth years, and Germans cut the most ties in their sixth year.

Figure 6 Foreign Exits by Region and Age: Exits during the First Ten Years (Cumulative Percentages per Region 1999-2005)



Source: © FRI 2006. Data from Toyo Keizai (1999-2005).

Note: Data for Cumulative Percentages of Exit Cases by year per Region 1999-2005. We assume that the companies in the Toyo Keizai Database own the Japanese Affiliates from the year of establishment.

1.2. Market Entry Expectations

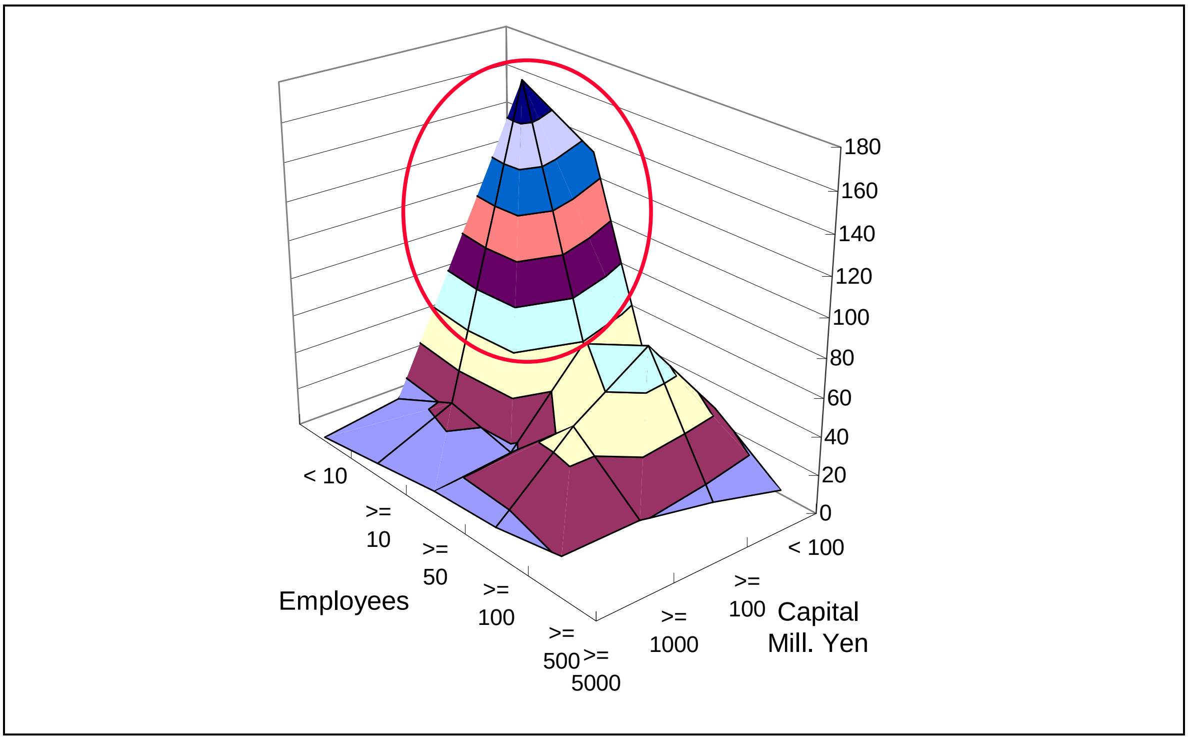
Companies that changed their business strategy over the last years realistically did not expect significant market growth, and rather targeted substantial sales growth by increasing their market share. Over the last years, however, even such gains in market share were hard to achieve.

Many companies blamed Japan's low interest rate environment and public policy. On top of "artificially" low interest rates, additional subsidized credits are available for ailing domestic companies through public programs. So too many competitors could subsist on negligible profits and focus on intense price competition (see "Living on the Edge: Business in a Japanese Market Niche" below). In the foreign press, Japanese "living dead" or "zombie" companies, which haunt otherwise healthy companies, have even become a buzzword in the meantime.

For many foreign companies, this might be one important reason why market growth remained below expectations over the last few years. But the issue is a much more longstanding one. Companies that come to Japan are usually smaller companies that are looking for a market niche for their specialty products or services, or bigger companies that do not expect to achieve much more against their Japanese competitors. Of the 127 newly established or funded foreign affiliates in 2003, almost 67% were companies with capital of 50 million yen or less (METI 2005).

According to the Toyo Keizai Database, the exiting companies are somewhat bigger, which is certainly not good for Japan's investment environment. But most investing companies are small in size as well. Almost 67% of the companies had capital of less than one billion yen to disinvest. More significantly, almost 59% of all companies had less than 50 employees (Figure 7).

Figure 7 Foreign Exits by Company Size (Employees/Capital)



Source: © FRI 2006. Data from Toyo Keizai (2005).

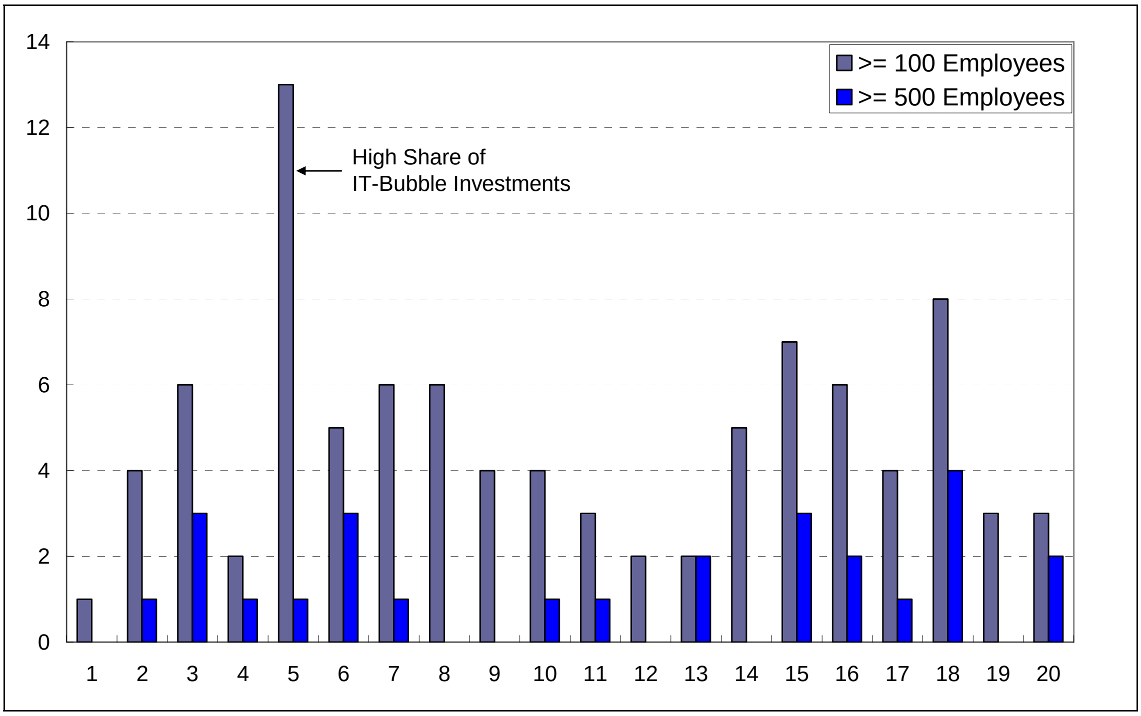
Note: Data for Cases between 1999-2005

Clearly, Japan is not a country for major market expectations when investing. At the time of disinvestment, it is also not a country where major operations of foreign investors are failing. Foreign companies are entering small and carefully. They test the waters, pull out after two years if not successful, or, depending where they come from, give it a try for 3-4 years. But most companies do not expand much during this time.

According to our interviews, this pattern might change for a company that decides to stay after an initial investment period of five years. After deciding to stay in the long-term in Japan, many companies think about how to firmly increase their market share and improve their operations beyond initial levels. For many companies this means to open more direct sales channels and to drain more value from Japan's multilayered distribution system (see 2.1 Sales and Distribution).

Unfortunately, we do not have appropriate data for this important phase of the lifecycle of a company after market entry. But when analyzing the data for market exits of larger companies with more than 100 employees, we find comparatively many exits after the initial phase of investments of five years. In many of these cases, the corporations might have concentrated on establishing larger operations or to restructure a major Japanese affiliate, before finally deciding to retreat. A second wave of exits can be found in older corporations of the age groups beyond 13 years after establishment, however. For many of these corporations, the disinvestment decision is not linked to the initial investment decision any more. These companies have been running major operations in Japan, but finally decided to that their efforts are not paying off.

Figure 8 Foreign Exits of Companies with more than 100 Employees by Age-Group



Note: Data for Exit Cases by exit year 1999-2005. We assume that the companies in the Toyo Keizai Database own the Japanese Affiliates from the year of establishment.

Source: © FRI 2006. Data from Toyo Keizai (2005).

1.3. Market Entry and the Market for M&As?

When coming to Japan, companies realize that market entry costs in Japan are considerably higher than in other major markets. For most companies, an important component of these costs is their investment in deep pre-investment market knowledge before market entry.

These costs are hard to quantify for the corporations, but consulting fees for M&A advisory work and the time required for a typical deal can be used as rough estimates. According to M&A consultancies in Tokyo, a typical M&A transaction takes about 2-3 times longer than in other major markets (between a few months and more than a year). A typical M&A fee for small transactions (below 5 billion yen) at Japanese M&A boutiques is between 2-3% of the transaction value,[4] which is at least twice as much as

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[4] In a stock acquisition, this is the sum of equity and debt outstanding.

a comparable fee in the U.S.[5]

Due to the peculiarities of the Japanese market environment, the choice of an excellent Japanese partner and the transfer of considerable decision powers to the partner seems to be one of the most important factors for a successful market entry. This choice of an appropriate business partner is still much harder than in most other markets, however. Selling to a foreign investor still seems to be fraught with stigma, so the market for foreign M&As remains biased towards the weakest companies. Companies therefore often end up with the wrong business partners, and/or do not trust their partners in important decisions. This further increases the risk of restructuring necessities in the partnerships and adds to the costs of doing business in Japan.

Quite a few companies, especially capital goods producers and retailers who sell imported products, therefore, decide to "go it alone" as early as possible and with as much control over the distribution channel as possible. This approach is, of course, only an option for a major company, and it is fraught with considerable risk. Especially when the support of Japanese suppliers is important for the success of the foreign company, the company needs a strong domestic partner. Retailers, for example, usually need not only an effective distribution channel. They also need to source many of their products close to consumers, as in the case of fresh food. The company therefore faces Japan's entire distribution network, from production to delivery, and will hardly be able find its way on its own or grow fast enough to become (completely) independent. The retail case studies below give an impression of these issues and the potential pitfalls of the various possible strategies (see 5　Cracking the Distribution System:).

For many companies, a flexible market of M&As is therefore an important issue and they support the initiatives of the ACCJ, EBC and the Japan Investment Council to improve cross-border M&A deals between Japan and the rest of the world by providing more flexible alternatives to structure transactions (see ACCJ FDI Task Force (2004) and EBC (2005)).

But the companies also mention that their problems when acquiring a Japanese company are at least as much a matter of "attitudes" towards foreign investors than of regulation. To improve the situation, Japan needs to adopt proactive policies to facilitate cross-border M&As, as has been recommended in the resolution of the Japan Investment Council (JIC) of March 27, 2003.

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5 According to Thomson Financial, typical M&A fees in the U.S. have come down to below 1%. In Japan, even the public Japan Development Bank (JDB) would charge 1.6% for a 5 Bill. yen transaction.

1.4. Market Exit Mode

Most of our interviews were related to significant business restructuring, not full retreats from the Japanese market. Basically all corporations seem to keep some kind of business representation in the world's second biggest market, even after selling an affiliate. This result is empirically supported by David (2006).[6] Only 10% of the companies in his sample completely retreated from the Japanese market. The remaining 90% are still present in Japan with another affiliate (40%), a reduced ownership stake and/or through import of their products to Japan. Almost 10% of the companies have reestablished an affiliate after divesting their earlier venture.

This pattern of market exit reinforces the many comments we got on the difficulties with Japanese partner companies. Often, disagreements about the right strategies for market share development were at the heart of the foreign companies' divestment. David (2006) shows that affiliate-specific factors appear to be most dominant in the decision to retreat: first, and most importantly, the parent company was not satisfied with the overall financial performance of its affiliate. This becomes especially apparent when looking at the relative performance of the Japanese affiliate in comparison to affiliates world-wide: more than half of respondents in his survey think that the Japanese affiliate performed worse than most other affiliates of the parent company. But it was not simply the missing of performance targets that lead to the divestment. More importantly, it seems that there was quite some tension between the headquarters and the affiliate leading up to the market exit: on the one hand, disputes between headquarters and local management about the strategic direction of the Japanese affiliate were quite frequent. On the other hand, in the headquarters' perception local management lacked some of the capabilities necessary to run the business in Japan.

This impression is further supported by the result that only 16% of the withdrawing companies had a minority stake in their Japanese affiliate. In most cases companies were withdrawing from a 50/50 joint venture (JV) or majority stake by selling it (to the Japanese partners), reducing their ownership to a non-strategic level below 20%, or

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[6] Steffen David of the University of Duisburg (David 2006) conducted a major empirical survey of exit cases of foreign affiliate companies. From the Toyo Keizai Gaishikei Kigyo database of 1,075 cases of foreign affiliate market exit in Japan between 1999 and early 2005 he identified 420 cases in production industry sectors (his target group). He recovered the contact details of the (former) headquarters, and contacted them. Until February 2006, he received 48 valid responses to his anonymous questionnaire. The final results of his survey have not yet been published (forthcoming in David 2006a), but Mr. David was so kind to provide us with some preliminary information on the results of his research.

merging it with another affiliate (12%). In our interviews, the main reason for such a change in strategy was that the foreign partner wanted to develop its market share by focusing on its specific segment or products, while the Japanese partner wanted to keep a broader market segment or product lineup. If such disputes could not be solved for good, the foreign partner was often retreating because it saw only limited chances to restructure the affiliate or taking full control by dismissing the (Japanese) management (see 3. A Stylized Case: Market Entry and Exit Considerations).

2. Obstacles for Foreign Investment

2.1. Sales and Distribution

Due to Japan's sophisticated and costly market, most companies come to Japan to sell (and not to produce) their products and services. About 80% of the foreign affiliates that disinvested in Japan were active in distribution (David 2006). Furthermore, due to high domestic competition in almost all sectors, most companies come with comparatively small operations to test the waters at first (see "1.2. Market Entry Expectations").

For most companies, the Japanese distribution system is therefore a decisive factor in their business strategies. Companies in almost all sectors recognized the distribution system as multi-layered and strongly driven by informal relationships, traditions and the selective intervention of government. Rough estimates by some companies produced figures of almost 20% reductions in the profit margin compared to markets where direct sales are possible. The companies think that distribution has significant potential for rationalization and cost reductions, but do not think that Japanese companies or the government has a strong interest in changing the system fast because it would require a rather large number of domestic company failures.

Supplier relations play an important role in the retail sector, and foreign corporations warn that suppliers have strong market power in relatively closed sectors like fresh food (with dominant first tier wholesalers) and specialty products (manufacturers of cosmetics, for example). Often, supplier-distributor relations reach well beyond sales agreements because the supplier often controls the point-of-sales real estate as well. This makes it considerably difficult to break the barriers of Japan's distribution network for foreign corporations. The fall of land prices and the necessity of cost cutting and restructuring on the supplier's side (especially in manufacturing) now increase the hopes of foreign corporations that the closely knit relations will open up from the supply side. Unfortunately, however, the existing – and in the future possibly tightened – Large Store Law works in the opposite direction and negatively preserves retailer dependencies and high cost structures in Japan's distribution network.

2.2. Quality Controls

For the foreign companies, Japan's famously finicky consumers are the ultimate quality controller. High importance is given to secondary product features such as packaging quality, "look & feel" even for non-consumer goods. Even for non-consumer goods, customers in Japan tend to take purchase decisions based on non-rational elements, such as preference for individual suppliers or sales representative preference, traditions (loyalty) or desire to achieve "harmony" by purchasing from all vendors.

Companies therefore see the need to adapt to market demands by adding additional quality controls for the Japanese market or even by upgrading their products. This increases the prices of their products over the price levels of other markets. For most foreign companies, such additional quality controls are a higher burden than for Japanese companies because only about 50% of the subsidiaries that have withdrawn had production facilities in Japan (David 2006).

Adding additional quality controls for their overseas products for only one market is certainly a burden for the companies, but all foreign corporations accepted Japan-specific upgrades as long as the changes are adding value. Some executives even recognize that selling their products on the Japanese market improves their image in other Asian markets, or gives them a quality-based edge when upgrading their products to new quality levels in general.

Often, however, quality and safety demands in Japan seem to be rather due to regulatory peculiarities than to consumer attitudes. The long-standing complaints about additional testing and licensing, especially in pharmaceutical and food industries, are examples of cases where Japan-specific standards do not add value but rather hurt the Japanese market in general.

The companies complain that many administrative procedures are still based on unnecessary and scientifically unjustified requirements in cases where applications for pharmaceutical and health, and food products are required. The creation of the Food Safety Commission seems to have increased the costs for the corporations and extended application process times. Foreign corporations see this development in the Japanese market as running against international trends towards the streamlining of approval processes and self-regulation to ensure product conformance. Clinical trials should not be required where well-documented international trials are available. Manufacturing and import licenses should be based on internationally accepted Good Manufacturing Practice (GMP). Decisions should be based on documentations that have been approved by an official body, such as the U.S. Food & Drug Administration (FDA) or the EU Agency for the Evaluation of Medical Products (EMEA), and not only on Japan-specific application data requirements.

The companies in general accept Japan's tight quality and safety standards, but want to see a clear trend towards mutual recognition agreements and approval of internationally accepted positive lists of additives. They also need more regulatory transparency where controls are involved, and hope for more cooperation from (local) authorities with foreign corporations. For example, food products with lower levels of accepted and harmless preservation additives than is standard in Japan should be accepted. Similarly, in cases where harmless additives that are in common use internationally but not (yet) accepted by Japan are detected, the situation should be discussed with the foreign manufacturer or importer at first. The current system, where the retailer is notified directly and required to dispose the product immediately, often including all affiliated products, rather produces an unnecessarily negative image of many international food products among wholesalers and retailers.

The companies stress that it is not in their interest to lower Japan's quality standards, but that they hope to see a wider range of international products with a positive image available in Japan. A more transparent and flexible policy of licensing and control would be an important step in this direction.

2.3. Human Resources

Skilled personnel: Sufficient skilled personnel is on the market, but companies still face difficulties to attract good staff as the reputation of foreign-affiliated companies is generally lower than first-tier domestic companies.

Foreign companies also have the impression that Japanese university education is too general, and graduates lack specialty degrees. Training employees in the company, on the other hand, seems to be more difficult for the foreign companies than for their Japanese peers. Because of the small size of many foreign corporations, they often do not have the resources for sufficient training of specialty skills. Furthermore, because Japan still has a rather limited number of foreign companies, job hopping is significant. Many employees see their employment at a foreign company as stepping stone for an international career, and not as a chance to develop necessary specialty skills (in pharmaceuticals, for example).

Beyond the internationalization of education in Japan, a relaxation of work visa applications for foreign experts would also help. Accepting foreign certifications and licenses below university degree levels or ten years working experience would be an important step in this direction.

2.4. Management Styles

Domestic middle and upper level management often lacks detailed product and market data knowledge, and instead focuses on relationship management and representation. Japanese managers that are successful with traditional domestic relationship management, in contrast, typically struggle to fit in their multinational peer groups.

Especially if restructuring in joint ventures (JV) with foreign companies is necessary, the existing human resource officer is often seen as an obstacle to restructuring or changing governance styles in the middle management, for example. "Westernized" domestic managers, on the other hand, often have low acceptance among domestic staff and industry peers. Finding good domestic management that can play "both games" is a key success factor, but very difficult to achieve.

Communications between the HQ and Japanese Affiliate is traditionally a difficult area due to (1) a lack of sensitivity and market know-how in the HQ, and (2) low expectations by domestic management for potential added value from HQ decisions. This area highly depends on having the right management personnel on board on both sides. Although the companies do not think that there is an out-of-the-box solution for this problem, some managers recommended exchange programs for graduates and young professionals to increase the Japan-market knowledge of foreign executives and professionals. They also think that extended Japan-promotion initiatives (like "Invest Japan") in overseas markets can improve Japan's image as an investment location in general, and at their HQ specifically.

2.5. Labor Market Regulations

More transparent labor market regulations, especially for the dismissal of managers and during the restructuring of a company, remain a key issue for foreign companies. The new Labor Standards Law does not provide enough guidelines for the foreign companies to positively structure restructuring efforts in their affiliates. They also do not see generally accepted rules for severance payment that would protect them from unreasonably high demands. The companies have the impression that Japanese labor market regulations continue to produce an atmosphere of legal uncertainty that makes it difficult for the foreign firms to reorganize their affiliates when necessary. As mentioned above, many firms therefore rather prefer to divest and reinvest with another affiliate, which produces higher costs and a loss of working relationships.

2.6. R&D and Technology Spill-Over

Of the exiting companies, almost 50% performed R&D in Japan – but only 10% had basic R&D activities, i.e., were developing new products, services or technologies in Japan David (2006).

In our interviews, the companies were impressed by Japan's R&D environment. They see good interaction between national, prefecture and private research institutes. They also commented on instances of favoritism of public research institutions for domestic companies, however. And pharmaceutical and health related firms see cases where (academic) members of licensing committees seem to exploit the (commercial) product testing process for their individual research interests.

Most companies are surprised by the high level of innovation despite the comparatively fragmented industries (many medium-sized players) and generally poor profitability of local companies. Some companies claim that Japan's strong technology environment is one of the reasons to remain in Japan even at low levels of overall profitability and limited growth chances. R&D and access to sophisticated technology is also one of the major reasons for many foreign companies to stick with joint ventures and partnerships although business plans and management styles might differ on other issues. The companies are happy, of course, to share and develop new products and technologies in Japan because they can apply their innovations in their internationally distributed products while the Japanese partners or competitors remain limited to the Japanese market.

Some of the companies see risks for the Japanese innovation environment, however. They know that their own R&D and innovation process is costly and only pays because the related products are marketed on a global basis. But most of their Japanese partners or competitors remain focused on the Japanese market, and will be less and less likely to recover their costs. So some companies are concerned because they fear the loss of Japanese innovation potential in the long run and fear that Japan might close the market even more when more SMEs are getting into trouble because of their international competition. Basically, the companies hope that the opposite will happen and that a process of consolidation and internationalization continues with the cooperation of foreign partners. To achieve this, Japan would need much more liquid, willing and flexible markets for M&As, however.

2.7. Intellectual Property Rights

Companies see IPR protection as one of the strongest factors for market attractiveness because it is directly related to the price level of their products and profitability. A licensing company mentioned, however, that Japan is still lax on grey imports of products that are licensed for another market and sold in Japan.

But beyond the benefits of strong IPR protection, many companies commented that an overly strong focus on IPR protection in Japanese companies can rather lead to a "castle mentality" that might negatively affect future innovation capabilities in international production and innovation networks. Keeping core technologies and innovation at home, while only transferring lower level production, technology, and R&D abroad does not seem to be a good strategy to many foreign corporations in Asia. In contrast, they recommend developing Japan's positive image as an innovation and technology center in Asia by getting involved in Asia-wide research projects and opening more research centers in neighboring countries.

2.8. Non-Tariff Barriers

Companies see non-tariff barriers rapidly decreasing on an organizational level in general. Exceptions are unnecessary and unscientific quality controls and licensing processes (see 2.2 Quality Controls), and public procurement, which so far has not really opened to foreign corporations. Given the high prices of many public goods and utilities in Japan, this is seen as a major market obstacle and disadvantage for the entire economy. It is also a bad advertisement for foreign corporations because it might reinforce the impression of the Japanese public that foreign investment should not be trusted in sensitive areas.

Many companies also see remaining barriers on an individual company level. Many Japanese companies, especially prefecture-owned companies or coop-owned companies continue to prefer domestic business partners even if this might not be economically justifiable. Opening up public procurement for foreign companies and promoting foreign investment in Japan from the government side might go a long way to reduce reservations against foreign companies.

2.9. Regulatory Transparency

Most companies have complaints about a lack of regulatory consistency (transparency), and claim that they often face difficulties to receive definite and binding replies from ministries in due time. Their major complaint is about the comparatively wide leverage of discretionary decisions by the ministries. Though a limited base of legislative jurisdiction might help to keep the economy flexible, the setup tends to work against foreign companies. Since foreign companies are less skilled with the internal "rules of the game", they prefer clear cut regulations and decisions.

A "formal rulings process" with written, binding clarification regarding a planned business transaction or a particular regulatory situation ("no action letter") would be highly appreciated by the companies. The companies also want this process to be handled in a direct reply procedure, with an anonymous body of precedents published in order to help companies navigate the regulatory process. So far, however, the companies are very aware of the risk of getting negative publicity (especially when dealing with the Tax Agency) when they inquire about regulatory issues during restructuring because the agency might publish their cases in an identifiable way. If, on the other hand, the corporations wait for ex-post auditing in cases of doubt, they also run the risk that information from the tax agency is leaked to the press when major back tax payments are necessary.

The companies recognize the availability of excellent statistics (market segments, distributor sales, technical information) in Japan, however. They also think that the government's translation project of 200 key laws, such as the Commercial Code, the Penal Code and laws protecting intellectual property rights, into English is a laudable attempt to increase a reliable information basis for foreign investors.[7]

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[7] With the translation project, the government reacts to complaints about the lack of reliable unified translations of laws. So far, government ministries and agencies, as well as business corporations, have used their own translations.

3. A Stylized Case: Market Entry and Exit Considerations

Due to non-disclosure agreements with our interview partners, we cannot provide detailed case studies in this report. Instead, the following stylized case study is based on the experiences of most companies and experts we have interviewed for this study. It should provide a good insight in the companies' deliberations during market entry and the initial phase of investment when the companies are still vulnerable to Japan-specific obstacles in the market environment.

A typical case of market entry would be a company that comes to Japan with its internationally successful product and signs a contract with a Japanese distributor or business partner to promote and sell the product. For the Japanese partner (distributor; wholesaler) in Japan's multi-layered wholesale system, the foreign product is usually only an additional (foreign) product among its lineup of competing domestic products, so the product is not exclusively promoted. Growth rates therefore often remain below expectations.

If the foreign company remains interested in the Japanese market and convinced in the potential of its product, it needs to deepen its involvement, usually through a joint venture with a Japanese partner. The company weighs up this step carefully because the costs of setting up a JV in Japan are about 2-3 times as high (and time consuming) as in other countries. Such partnerships also remain subject to Japan's multi-layered distribution system, and therefore need to perform in two directions successfully: deep knowledge and commitment to the foreign product, and excellent relations with Japanese distributors are required. The JV needs excellent personnel and management to live up to this task.

Underperformance leads to the need of restructuring the JV. This often proves to be difficult, however, because of the reluctance of the Japanese partners to agree with foreign performance targets or product strategies, and because of the difficulty to dismiss personnel in Japan's tightly controlled labor market. The restructuring therefore often requires the divestment from the original partnership and a fresh start by reestablishment or merging affiliates. As a result, the already significant costs of restructuring often lead to a decision to either sell the operation (to the former partner) or to "go it alone" and to leapfrog various layers of the distribution network.

Such a stylized business entry with several investment steps requires a very strong market commitment and deep pockets. Most companies therefore either retreat during the phase of joint venture restructuring and return to (comparatively) low-margin distribution agreements, or settle in a market niche with acceptable profitability.

4. The Common Case: Business in a Japanese Market Niche

The following case study is a stylized case, based on the experiences of most companies and experts we have interviewed for this study. Due to non-disclosure agreements with our interview partners, we cannot provide detailed case studies in this report. This case should provide a good insight in the experience of especially smaller companies – the "typical" company – that entered Japan and stayed without gaining a major market share.

Among the companies that remained in their market niche, most companies agreed that the considerable efforts they invested to build their market position were well-spent. The market is stable, safe, and the companies enjoy, after an initial phase of challenges, the same protection from their foreign competitors (who were not willing to cover the necessary entrance costs or gave up early) as Japanese corporations.

The companies face, however, cut-throat competition from their Japanese competitors. The reach of most Japanese SMEs is still limited to the Japanese market. So they are unwilling to give up market share, even at the price of insufficient profitability. Furthermore, since these companies are under intense competition – and often poorly capitalized – they tend to compete heavily on price, personal relationships and after-service. Foreign corporations, on the other hand, have an advantage from their global know-how and product development. But this only gives them an edge if their products are presented and promoted properly.

Most companies are therefore carefully screening the gradual improvements in the structure of the distribution system. Fortunately, their Japanese competitors are now under high pressure to reduce their costs by establishing more direct sales channels. This trend towards "cutting out the middlemen" seems to work to the advantage of the foreign companies because their internationally proven products tend to look more competitive without the filter of Japan's domestic-product oriented wholesale and distribution system.

Furthermore, the increasing internationalization of Japan's production networks is increasingly working in favor of foreign producers and international services. Since most of the foreign companies are offering their products in all major markets, they become very attractive suppliers for Japanese companies that are expanding overseas. In the future, Japanese suppliers need to adjust to this trend by further consolidation at home to get ready for overseas expansion. Alternatively, they might choose to venture into new partnerships with foreign corporations. Especially when restructuring is necessary for the Japanese partner, a foreign partnership has a potential advantage:

foreign companies can use management and supervisory boards more effectively as a restructuring tool than Japanese companies, where boards rarely have many outsiders or significant strategy powers. Foreign companies are also able to bring in executives temporarily, for example in human resources, to push restructuring efforts that might otherwise stall because of internal resistance.

But with higher growth in other markets, especially in Asia, the foreign companies see the risk that consolidation and internationalization in Japan is not progressing fast enough. Ironically, the companies are quite concerned about the continued underperformance of their Japanese competitors because a loss of innovation potentials in Japan and an increasing "castle mentality" would hurt the entire market in the long run.

5. Cracking the Distribution System: Four Attempts, Limited Results

This case study is based on publicly available material. It focuses on strategies in Japan's distribution network by covering the cases of Wal-Mart, Carrefour, METRO and IKEA.

Wal-Mart's usually superior retail technologies and highly cost-effective supplies from its bases in China have not yielded the expected positive results in Japan so far. One of the key issues is that the company could not find an appropriate partner when entering the market. Usually, the company focuses on finding an appropriate business partner that would be majority owned and would immediately adopt the Wal-Mart business model to open large-scale markets. In Japan, however, the company had to focus on restructuring one of Japan's weakest supermarket chains because this was the only major retailer willing to sell to a foreign partner. So Wal-Mart ventured into the Japanese market with a business model that is largely alien to its usual strategy.

In 2002, the takeover transaction of Seiyu Inc., a rather outdated major supermarket group, started with only a 6.1% share. At the end of the same year, additional warrants were sold by Seiyu to increase Wal-Mart's stake to 33.4 percent, and to 50 percent by the end of 2005. Finally, the staged takeover should be completed when Wal-Mart holds 66.7 percent of Seiyu by the end of 2007. As part of a five-year plan to overhaul the company, Wal-Mart is trying to make the revamped stores resemble its own model in terms of floor layout, displays and pricing. So far, however, the staged strategy has shown only limited results: most Seiyu stores still resemble Seiyu stores much more than Wal-Mart stores.

This case is also technically significant, because it is the first high-profile use of stock option provisions, which have been introduced by Commercial Code amendments only in 2002.[8] Before, such an arrangement was not available as a tool of investment or acquisition, and the Seiyu deal (with Sumitomo Corp.) might not have materialized at all.

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[8] "The WalMart-Seiyu transaction is probably the first use of the newly introduced stock options as an acquisition tool. WalMart and the Japanese retailer Seiyu agreed to enter into a comprehensive business relationship. In May 2002, Seiyu decided to issue new shares and to grant several series of stock options to WalMart. WalMart only purchased roughly 6% of Seiyu shares at the end of May 2002, but WalMart received stock options allowing it to increase its share ownership up to 66.7%, enabling WalMart by itself to approve any agenda item requiring a special resolution of the shareholders' meeting (including an amendment to the articles of incorporation and dissolution of the company). Reportedly, Seiyu issued three different types of options: those exercisable until December 2002, until December 2005, and until December 2007. Depending on Seiyu's business performance, WalMart retains the ability to decide at future stages whether to further invest in Seiyu" (Anderson Mori 2005).

The bottom line is that new regulations for M&A transactions are increasing business opportunities in Japan, but that the market for M&As and restructuring has not yet evolved enough to produce significant opportunities for foreign companies.

Carrefour, the world's second largest retail company, therefore decided after a careful market analysis to "go it alone" and to try to circumvent as much of Japan's multi-layered distribution network as possible. In this case as well, the strategy was rather alien for the company. Carrefour usually starts to enter a market by opening small pilot stores that can be later expanded. Renting versus buying store space and forming strategic partnerships are risk reducing strategies. In Japan, however, without a partner, the company needed to enter big and to build everything from scratch. Size was required from the start because otherwise negotiations with Japanese suppliers would have been virtually impossible. It was not enough to crack the market, however. The approach proved to be wrong for a retailer that depends on (domestic) fresh products. The investment failed before a necessary change in strategy was implemented by teaming up with Aeon, one of Japan's biggest large-store retailers, which later took over the remains of Carrefour.[9]

The METRO group, a major German wholesaler/retailer, chose another option: it entered as a wholesaler and competes with a rather limited segment of small delivery wholesalers. Its concept is to replace this segment of Japan's wholesale network with well-located wholesale markets that can easily be approached by restaurants and stores directly. In this case as well, the strategy is alien to the major European wholesale group that usually goes for large scale wholesale stores in the vicinity of cities. By pacing its approach small and carefully, the group seems to be able to build its necessary supplier relations and to gradually get prices down. The prospect in terms size and sales volumes – its usual targets - remain limited, however.

Finally, IKEA is another retailer that has entered Japan's market on a large scale by "going it alone." The major furniture maker and retailer already had a negative investment experience with a Japanese business partner in the 1980s. It had therefore decided to reenter the market without a business partner. IKEA will not only run its own stores, it is also organizing its own Japan-wide logistics network from port entry to distribution centers for its stores.

The prospects seem to be much better than for Carrefour because the retailer does not

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9 Carrefour sold its Japan operations to Aeon, which now distributes its Carrefour's brand products and runs its hypermarkets.

need to rely on many locally sourced products. Many products will come from its Chinese manufacturers and its Asian distribution center in Shanghai. By cutting out most middle men in Japan's distribution and supply chain, the company should be able to add significant value in Japan's high cost market.

IKEA is the only case among the major retailer that sticks to its "native" strategy in Japan. But it also only does so for the second try, and only after having become a really huge operation in Asia already. It is hard to think of other international retailers that could run such a large-scale strategy to finally successfully land in Japan.

6. Foreign Investment in East Asia – Japan compared to Other Markets

All foreign corporations are looking towards China, of course. It is already obvious that Japan is losing (or has already lost) its role as a doorstep towards the Chinese market. Asian HQs, which so far could be attracted by Japan's secure investment environment, are now much more likely to be established in Hong Kong, Singapore or Shanghai. All these locations now have excellent infrastructure, highly skilled personnel, and strong government support for attracting foreign companies. Especially Singapore is also highly active in investment promotion measures and incentives. In combination with very liberal investment regulations, it has become attractive especially for service companies that are looking for an Asian service and off-shoring hub. Singapore, as well as Hong Kong, has no major home market on a par with Japan or (potentially) China, however. The companies therefore rather think of Hong Kong and Singapore as regional business centers for logistics and many services in (South-) East Asia.

During our interviews, many foreign executives even had the impression that their affiliates in Japan are already losing out to China. But this might rather be an impression that is determined by the strong attention China is currently getting in their HQs. After doing comparative interviews in China, it seems to be unlikely to us that the markets and affiliates are competing for investment funds from the HQs. China rather seems to be a special market for the foreign companies – a singular investment chance that needs to be addressed now. Furthermore, China does not seem to be part of an "Asia" strategy. Though this might change in the future, especially if Shanghai is able to establish itself as a major business hub, the current investment picture of Asia looks more like patchwork than like an aquarelle with China as a whirl in its middle.

So Japan remains to be a major market that still offers growth opportunities due to an under-proportional market share of many foreign companies. FDI chances in Japan therefore depend on Japan's domestic market development, and not so much on its relative competitiveness in comparison with East Asia or Western markets. Certainly, however, Japan needs to develop a more positive image as a foreign investment location. This is important abroad, but especially important inside Japan's domestic market where many potential partners are still reluctant to do business with foreign companies.

7. Conclusion

In contrast to our earlier expectations, the main complaints of foreign corporations after divesting in Japan are less about specific issues, such as non-tariff barriers, excessive quality controls for foreign products, or high costs of Japan's multilayered distribution system. All these issues certainly exist and are rightly criticized by foreign business associations, like the ACCJ and the EBC. But the main complaints of exiting or restructuring foreign companies are about the high costs of doing business in Japan that challenge their Japanese peers in the same way.

When coming to Japan, companies realize that market entry costs in Japan are considerably higher than in other major markets. A typical M&A transaction takes about 2-3 times longer than in other major markets, and consultancy fees might be more than twice as high as the companies expect. To some extent, the peculiarities of Japan's market, like language or opaque regulations, or "attitudes" towards foreign investors (because of the still low levels of internationalization) play a role here. But more important is that Japan's markets for M&As are still too inflexible and underdeveloped. Not only market entry, but also restructuring or expanding a business in Japan is therefore loaded with unnecessary risks - which negatively affect Japanese companies in the same way and often drive them abroad as well.

Foreign companies recommend improving the cost structure of the Japanese economy in general. Deregulation and fostering competition would be important measures to do so. Furthermore, many companies think Japan's public policy of "artificially" low interest rates and additionally subsidized credits for ailing domestic ("zombie") companies rather hamper the investment environment in the long run. Too many otherwise defunct competitors can subsist on negligible profits and focus on intense price competition, which haunts otherwise healthy (foreign) companies. Most likely, this contorted market structure is an important driver behind many disagreements between the foreign companies and their Japanese affiliates, which have been reported in most of our interviews, as well. When coming to Japan, foreign companies usually try to implement straightforward market strategies to break even within three years, or, this being Japan, in at least five years. The Japanese management, on the other hand, often sees better prospects in focusing more on long-term relationship management strategies and playing existing market structures, which might not necessarily satisfy the foreign HQs' profitability and growth expectations.

As a result, the affiliates that have been established in Japan are usually smaller companies (even if the foreign mother is a major company), which test the waters for their products and services and pull out if expectations are not matched during a period that might be too short for a proper entry to Japan. Many companies that stay, on the other hand, remain in an (usually quite profitable) market niche and do not try to expand their businesses aggressively. This situation does not seem to have changed for the better over the last few years. For these companies, Japan clearly needs to improve its domestic business and growth environment to convince them to stay and to invest.

Finally, some foreign companies see increasing risks for the Japanese innovation environment. Most companies are surprised by the high level of innovation despite the comparatively fragmented industries (many medium-sized players) and generally poor profitability of local companies. Some companies even claim that Japan's strong technology environment is one of the reasons to remain in Japan even at low levels of overall profitability and limited growth chances. But the foreign companies warn that their Japanese partners or competitors will be less and less likely to recover their costs in the future if they do not internationalize faster. Eventually, Japan might lose its innovation potential in the long run, and fall victim to a "castle mentality" when trying to keep core technologies and innovation at home, while only cooperating with foreign partners (or at foreign countries) on lower level production, technology, and R&D. In contrast, they recommend developing Japan's positive image as an innovation and technology center in Asia by getting involved in Asia-wide research projects and opening more research centers in neighboring countries.

In terms of policy recommendations, the companies think that a positive mind-set in Japanese ministries towards foreign investors would help to improve the entire investment environment. Positive publicity, as recommended and actively promoted by the Japan Investment Council, would be an important tool to achieve this. Such positive publicity would be especially important within the Japanese market because many potential business partners still have reservations about foreign companies. Additionally, positive publicity about the Japanese market abroad might help the foreign affiliates in Japan indirectly, because positive headlines about improvements in the investment environment might contribute to a long-term commitment to Japan in their home-country headquarters.

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