Successful Japanese organisations will need to embrace change and begin their transformational journey

Japan Rebooted
A time to embrace change

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At a glance

$1.56bn

Amount invested (¥160bn) by Japanese venture capital funds in 2013, falling way short of the more than $25bn a year invested by US venture capital funds.

1/3

Foreign investors now own almost one third of the stock of major Japanese corporations.

92%

Percentage of Japanese companies yet to put in place plans to promote returning expatriates to executive levels.

20%

Percentage of the world's patents that are filed by Japan, just behind the 25 per cent filed by the US.

⇩50%

The number of Japanese students in American universities has fallen by half in the decade to 2012.

1%

Women accounted for just above 1 per cent of executives at major Japanese companies in January 2013.

$140bn

The amount of R&D investment by Japan Inc. over the past decade.

All monetary amounts shown in this report are denominated in US dollars (unless otherwise stated).

Embracing change

Hiroyuki Suzuki

Jason Hayes

Corporate Japan is undergoing tremendous change against a backdrop of new government policies designed to stimulate growth in the economy, which as we know has remained stagnant for a considerable period of time.

With change comes many challenges. Japan continues to play an important role in helping shape the global economy with its current financial wealth, leading-edge technologies, workforce dedication and standards for quality. These continue to allow Japan to maintain a position that many countries envy. But to sustain our position, the actions of companies and business leaders will be critical to ensure our country can adapt to the increasingly complex and volatile business landscape.

The heart of the matter is embracing change. Japanese business leaders need to address strategic and operational challenges by embracing new attitudes towards governance, innovation, talent management and diversity. This transformational journey is imperative to future-proof corporate Japan, and will help us all achieve renewed growth and prosperity for our great nation.

Each of us knows that the world needs a healthy and resilient Japan.

Hiroyuki Suzuki
Territory Senior Partner
PwC Japan

Jason Hayes
Partner – Japan Practice Leader
PwC Australia

"The most important area for Japanese companies to modernise is their management. Modernising can mean having the latest technology and up-to-date information.

What I mean by modernising is improving the receptiveness and responsiveness of Japanese management to what is going on in the world right now."

Yasuchika Hasegawa, President and Chief Executive Officer, Takeda Pharmaceutical

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Introduction

Amid the promise of Abenomics – and the return of stable government and renewed prospects for reform in Japan – it is easy to lose sight of one major development: that Japan's major corporations have effectively been thrown into a blast furnace of change and will emerge in a substantially different form to what they look like today. That is, if they hope to prosper in a radically different world.

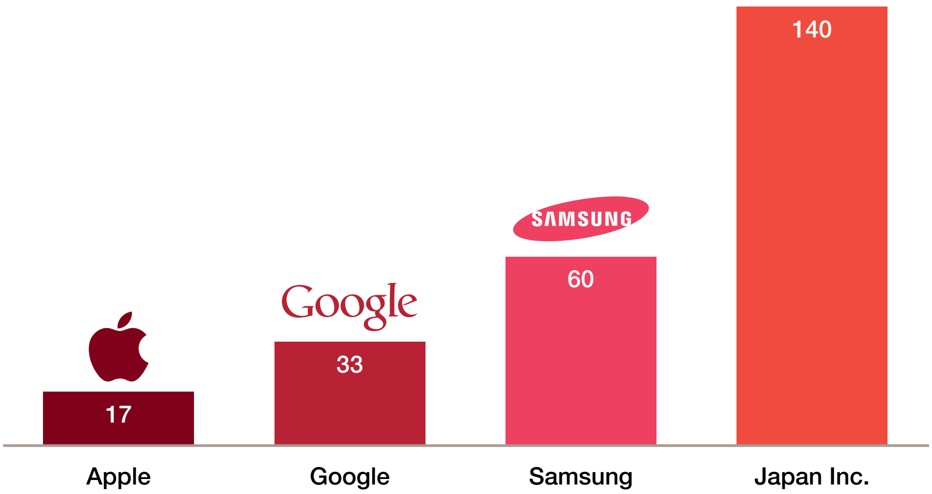
It's not just the changed domestic environment (which we covered in the first Japan Rebooted publication) that is fuelling these fires of change: there is the driving need to internationalise, to harness synergies, and to deal with demographic change and increasing competition from Korea, China and other industrialised nations.

At its core, the challenge for Japan's corporations in coping with these external factors is to rediscover their "innovation mojo", and establish more effective and internationally deployable management and governance models.

In the era of big data, connectivity and open-source collaborative solutions, many of the products that Japan excels at producing – LCDs, silicon chips and other electronic equipment – have almost become commodities. The true innovation race is in how to build business models and distribution systems around the advantages that these technologies - and the reach of the internet - provide. And then to use this as a path to sustainable profits.

Now that the torch of technological supremacy has passed from Sharp and Panasonic to Apple, Google, Samsung and a range of other non-Japanese firms, the need for improvement is clear.

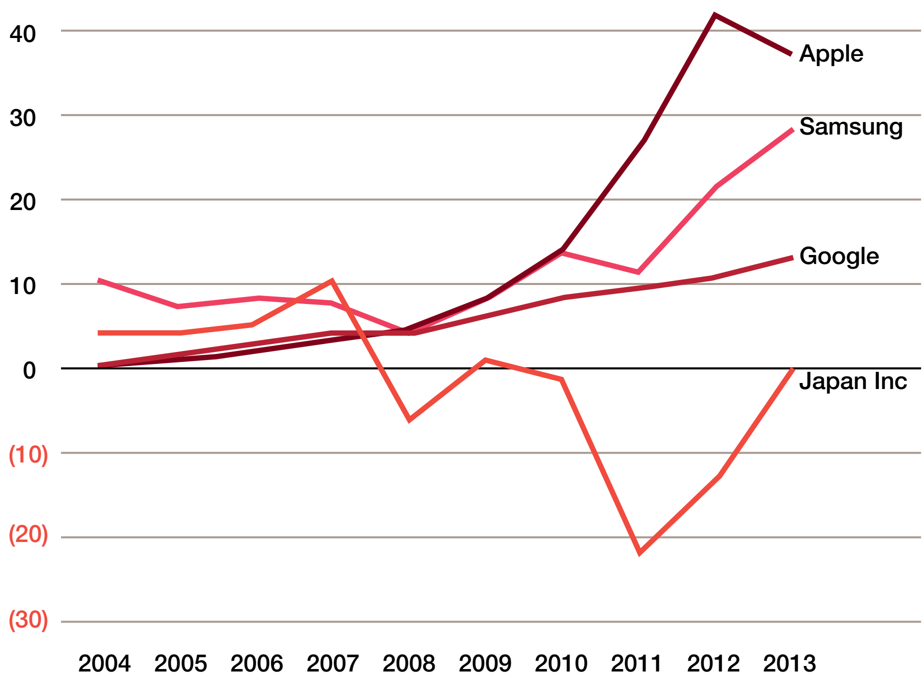
Figure 1: Total R&D expenditure. Past 10 FYs, $bn



Japan Inc – Panasonic, Sharp, Sony, NEC, Nintendo

Source: Thomson Reuters

Figure 2: Net profit 2004-2013 $bn



In the rapidly growing online gaming and publishing space, GREE, Line and other new-wave Japanese companies are performing strongly, while the giants – Sony, Canon and others – remain under intense pressure.

"Japan's consumer electronics makers are in total breakdown. They need to compete with ideas not technology," is how hedge fund executive Masamitsu Ohki puts it.

Nevertheless, Japan remains an innovative country. It files 20 per cent of the world's patents (just behind the 25 per cent filed by the US with its much larger population). And when it comes to patents granted it has a significant edge, securing 55 per cent more than the US.

But on the global innovation index – published by the World Intellectual Property Organisation – Japan sits 21st out of the 142 countries, coming in behind both Australia and New Zealand, and just above Spain and Estonia.

That may be something of an anomaly, but Japan is finding that in the information age, the edge is in data, usability and in collaborative systems as much as it is in skilfully engineered hardware.

Firms, too, must work to implement far more accountable and effective governance models. The Japanese government and the more proactive companies realise that drawing board members solely from executive ranks and operating without external directors hurts accountability as well as corporate performance and value.

And as Japanese companies embark on the looming wave of M&A (which we covered in the second publication of our Japan Rebooted series) it will become ever more important for Japanese companies to control newly acquired foreign subsidiaries and integrate them into their operations, maximising their potential rather than simply living off the rents they provide.

So far, Japanese companies have not had a good track record in this area. To improve, Japanese companies will have to drastically lift the capacity of their management and staff to better understand foreign cultures, management styles and decision making processes, and develop a greater appetite for risk. Or, in lieu of that, coming up with a model that allows the parent company to remotely monitor and influence the full range of their subsidiaries' activities from balance sheets and expenditure, to recruitment, information technology and customer service.

In this third publication in our Japan Rebooted series, we look at how Japanese companies are tackling these imperatives and what more needs to be done to boost Japan's global competitiveness and ability to operate in today's global corporate landscape.

This issue of the series will focus on the battle to recapture innovation, update management styles and philosophies, and improve governance structures among Japanese firms.

Interview with *Yasuchika Hasegawa of Takeda Pharmaceuticals*

Yasuchika Hasegawa

President and Chief Executive Officer, Takeda Pharmaceutical

As part of this publication in the Japan Rebooted series, PwC asked leading businessman Yasuchika Hasegawa to share his thoughts on the environment facing Japanese companies today and what changes need to occur.

Takeda, with a market capitalisation of about $US35bn, is one of the world's top pharmaceutical companies and Asia's largest drug maker. The company is also at the forefront of the trends among fast-moving Japanese corporations in embracing English in the workplace, drawing in talent from abroad (chief operating officer Christophe Weber is French, as is the company's CFO) and acquiring a string of offshore subsidiaries to boost growth.

Mr Hasegawa, along with steering Takeda through this transition towards becoming a truly global company, is also the head of the Keizai Doyukai, or Japan Association of Corporate Executives, and has been a vocal commentator on trade liberalisation, innovation and the future of Japan.

He continues to enhance his reputation as a fearless and accurate observer and participant in Japan's revival through his comments for this issue of the Japan Rebooted series.

PwC: How globally competitive are large Japanese companies today?

Hasegawa: *You can see by their results. Uncompetitive companies do not remain large for long. Canon, Honda, Toyota, and Komatsu are large, globally competitive Japanese companies that you will probably have heard of. There are a quite a few other examples that you will probably not have heard of such as Murata, TDK, and Rohm, because they sell components. Then there are large companies like Shiseido and Nintendo that show Japan can compete in areas such as beauty and entertainment. About three quarters of Japanese people work for small and midsize companies. So it's important for Japan that small and midsize Japanese companies are globally competitive as well.*

PwC: In what areas is it most important for Japanese companies to modernise?

Hasegawa: *The most important area for Japanese companies to modernise is their management. Modernising can mean having the latest technology and up-to-date information. What I mean by modernising is improving the receptiveness and responsiveness of Japanese management to what is going on in the world right now. Once they realise the balance of power has shifted from the seller to the buyer, I think the old attitudes of industrial capitalism will fade away. I also foresee a more modern role for women and for non-Japanese people in Japanese companies.*

PwC: How has Takeda moved to integrate foreign subsidiaries and staff and create a more global corporation?

Hasegawa: *We made decisions on how our foreign subsidiaries could best contribute to Takeda's overall business. As a result we integrated some; others we left more or less autonomous. With acquisition of foreign subsidiaries came the need for global leadership and governance from Tokyo. For this we brought in non-Japanese executives because they have experience in emerging markets and in other areas that we lacked. Binding all together is a corporate philosophy called "Takeda-ism" that has guided the company for 232 years. Based on integrity, it is as relevant in today's global pharmaceutical market as it was in old Japan.*

PwC: Can Japan recapture its innovative spirit, and if so, how?

Hasegawa: *Japan should not try to recapture anything it might have had before. Too much has changed. Technology, capital and talent are now available everywhere in the world. That was not the case in the 1970s and 1980s. In general Japan must be prepared to accept the risk and failures that go right along with innovating. And it needs to provide the things that bring about innovation: immigrants, risk money, a tax system with the right incentives, and so on. The Abe government has set up special economic zones for this purpose. Japan can be as innovative as it wants to be. We haven't even scratched the surface of our potential.*

PwC: What changes are necessary or important in Japan towards ensuring there will be innovative, well managed and powerful Japanese companies in the future?

Hasegawa: *After years of deflation we need business confidence to rise and investment to go up. So in addition to the points I made above, lowering corporate taxes, freeing up trade, and making employment laws more flexible. I am pleased that we have a government willing to make such changes. We need to free up resources held by vested interests – they are playing a losing game. We also need a workforce with better English skills. The problems are well known. How soon we solve them and ensure a prosperous future for Japanese companies is up to us.*

Competitive collaboration
Striving to be the best

Silicon Valley has the rare distinction of being a place that has actually become a byword for a whole industry, and a very profitable and powerful one at that.

Thirty years after the term was coined, this part of the San Francisco Bay Area has become internationally renowned as the epicentre of global technological innovation.

It's home to thousands of startups as well as technological giants that, while they may have begun in a garage, now dominate the corporate landscape in the US and throughout the world.

In some instances, the "disruptive" innovations emerging from this crucible of innovation have changed the face of whole industries, such as publishing, gaming and retailing.

So it's little wonder that it is to Silicon Valley that Japanese companies are heading en masse to try to rediscover the energy and innovation of the 70s and 80s when they swept all before them amid heady predictions Japan's economy would overshadow that of the US.

This flood of Japanese firms wanting to place themselves alongside the fount of technological progress is a measure of how much the innovation pendulum in the technology sector has swung back towards the US.

Rakuten, long seen as one of Japan's most creative and vibrant companies of the modern era, was quick to set up a development centre in San Francisco to identify new technologies and acquisition targets.

New-wave Japanese companies Gree and DeNA have both made acquisitions in Silicon Valley giving them a presence there, while Softbank – arguably one of the most aggressive Japanese major firms – has plans for a new Silicon Valley office to house Japanese engineers on secondment, as well as key staff from its $21bn US acquisition, Sprint.

Car makers Nissan, Honda and Toyota, while they are traditional industrial companies (albeit with a strong technological edge) have R&D centres in Silicon Valley focused on improving in-vehicle infotainment options, as well as, in Nissan's case, autonomous vehicle technology.

Medical device maker Terumo, advertising giant Dentsu and old-school electronics giant Panasonic are among the other Japanese firms establishing a presence in Silicon Valley.

At a basic level the idea seems to be about exposure to new ideas and personnel through simple proximity to the modern world's epicentre of innovation.

The companies hope that this spawns ideas and inventions – and executives – that will come to lead the world.

"That's where the talent is – that ecosystem produces some amazing talent and business models – and they want to tap into that," Wei Ku, a US-based PwC partner who is on secondment in Japan, says.

PwC recently studied the success or otherwise of investments in Silicon Valley by Chinese, Japanese, Korean and Israeli firms.

It's not just the more avant-garde Japanese companies turning to Silicon Valley

Even NTT, a former public utility and one of the world's largest telecommunications companies, has established an institute in Silicon Valley, complete with a suitably trendy name.

NTT I^3 is a wholly owned subsidiary of NTT Group and will focus on information security, cloud computing, and the commercialisation of advanced technologies.

NTT believes the talent pool in northern California will drive leading edge research and innovation. The telecom giant plans to send young Japanese researchers on overseas assignment to Silicon Valley, starting in 2014.

This past summer, NTT announced a new CEO for I^3 – Srini Koushik – former CEO of Right Brain Systems, and previously chief development officer for HP's Enterprise Services unit.

Only the Israelis, Ku says, succeeded. "They spoke the language and they stuck around and treated the startups as business partners," he says.

"Their cultural upbringing allows them to embrace change and embrace failure. In Japan, if you fail, you are miserable – therefore risk taking is shunned."

The other crucial element in innovation success is risk tolerance. The premium placed in most Japanese firms of avoiding failure at all costs may be hurting their ability to innovate.

Some argue that Japanese firms need to embrace the concept of intrapreneurship – creating a culture or environment within a firm that rewards and encourages risk taking and innovation.

At the moment, the freewheeling, fast-talking world of start-ups and their upstart leaders is a world away from the heavily ritualised and formal business world of Japan.

It's completely different to the hierarchical, risk-averse management structure of corporate Japan. A seniority-based promotion system, for example, would be mocked as absurd in Silicon Valley.

Even the major league technological players in California – such as Google and Facebook – operate under a management philosophy that grants staff much more freedom and responsibility to innovate and develop their ideas.

The Silicon Valley move may finally create some pressure for culture to change among Japanese business and it may come from the ground up – those employees that pass through the Bay Area divisions of the leading Japanese firms.

Ku says the current round of Japanese investment in Silicon Valley differs from previous ones in that this time firms are sending their key staff to the Bay area as well as their cash.

"You are seeing a lot more key personnel and technical specialists being situated in Silicon Valley," Ku says.

The rising interest level from Japan in Silicon Valley is clear. The Abe government's information technology minister, Ichita Yamamoto, recently led a large delegation of business leaders to the Bay Area where they toured the headquarters of Twitter and a range of successful start-ups, influential venture capital firms and other main stream players in the Silicon Valley ecosystem, including Mayor Edwin Lee of San Francisco.

But Japanese firms that set up in Silicon Valley will have to do more than simply show up with cash. In the frenetic and fast-paced world of technology investing in the US, companies that continue to live by the mantra of *ishibashi o tataite wataru* – tapping each stone in the bridge as you cross – may find they miss the best opportunities.

And they will have to convince potential partners that they are prepared to embrace risk, and its occasional consequence – failure.

"There's lots of money in Silicon Valley," Ku says. "They (start-ups) aren't looking for money – they are looking for good business partners. Japan has to compete by being the partner of choice.

"That means embracing startups as partners and equals and sharing what you can bring to the table – distribution channels, key technology and whatever else you can contribute.

"Once you find the right partner it's about setting up the right guidelines and metrics as opposed to pouring money in and saying 'Report back to me when you are done'."

PwC's Global Lead for Innovation Strategy, Rob Shelton agrees.

"The winners will be those that can collaborate effectively and become proficient in the way the game is played in the Valley – fast moving, high value initiatives to be in the front of the pack," he says.

"To be credible in the Valley, companies need fast, reasoned decision making, solid, high clock-speed implementation, and a clear value proposition. Said differently, the best players – venture capitalists, start-ups, big established companies, universities – have a clear brand positioning and a reputation for delivering value. If you have those you get invited to the party. If not, you get to watch."

Venturing abroad

The other upshot of this trend among Japanese firms to look to Silicon Valley may be to breathe new life into the venture capital industry in Japan, which has a proud history but remains a comparatively minor source of funds.

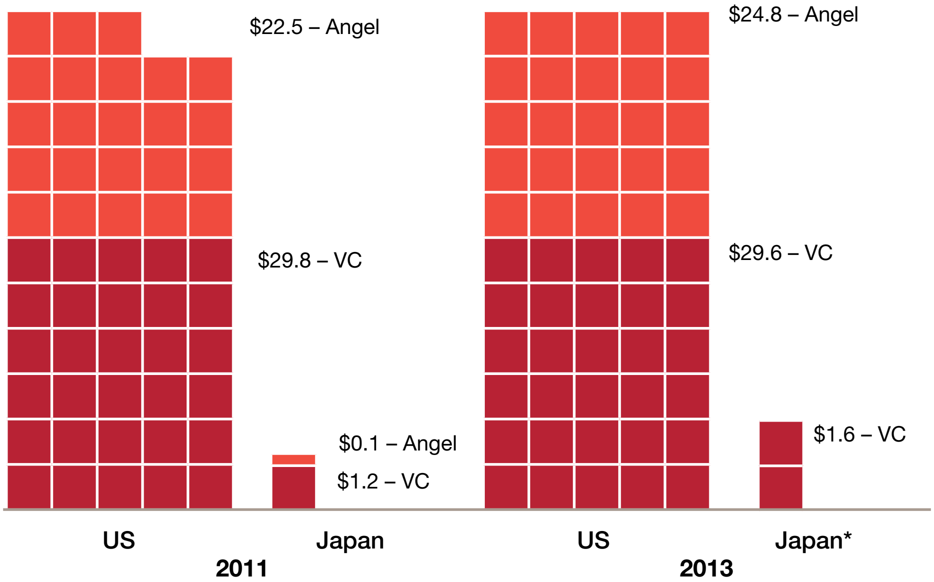
In the US, by contrast, venture capital – along with funds from angel investors – is a mainstream source of capital for companies and products that have innovation at their core.

Data released at a recent Japanese venture capital symposium found Japanese venture capital funds invested 160bn yen ($1.56bn) in 2013. That falls way short of the more than $25bn a year invested by US venture capital funds, which is matched in size by the so-called angel investing sector.

However, the venture capital sector in Japan is at least growing and the Abe Government has pledged to amend laws to boost tax incentives for venture capital investments.

It is hoped that the changes cause Japan's cash-rich corporations to allocate more of their vast piles of capital towards creating tomorrow's innovative technology and to recognise that not all innovation can be done in-house. The Abe government is also introducing changes to make crowd funding – a growing source of capital for both philanthropic and niche entrepreneurial projects – legal in Japan.

Figure 3: Venture capital and angel investing $bn



*Japan numbers are for FY so 2013 is April 2013 to March 2014. Data not available for Japanese angel investing.
Source: PwC/National Venture Capital Association Moneytree™ Report, Thomson Reuters, Center for Venture Research, Venture Enterprise Center

Management matters
Ensuring Japan's future leaders can survive in a global economy

Japan Inc's acquisitions or investments in Silicon Valley – and elsewhere for that matter – may also be about buying talent or more specifically, about getting access to the kind of employees who can work effectively in the acquired business, or in other subsidiaries around the world.

It could be argued that Japanese management ranks are looking increasingly threadbare and non-competitive, on the global scale at least. It's a view backed by Rakuten chief Hiroshi Mikitani, who set up his own Japan Association of New Economy after defecting from the tradition-steeped Keidanren, for years Japan's premier business lobby group.

He believes Japan's decades of stagnation are more to do with the lack of quality management personnel than any shortage of ideas and innovation.

On one hand you have the swashbuckling, baby-boomer generation of Japanese managers who may have been confident and capable enough to work abroad, but whose skills are losing relevance in the information age and are culturally ill-equipped to run a modern globalised workplace.

Then there is the younger generation of Japanese, who are more attuned to the modern world, but paralysed by doubt in an era of economic uncertainty and reluctant to embrace responsibility. They are especially reluctant to travel or work overseas.

Figures on younger Japanese working abroad are difficult to obtain, but statistics on those studying abroad show a sharp fall in the number of Japanese enrolled in foreign schools or universities.

Global language educator Education First has found that the number of Japanese students in American universities has fallen by half in the decade to 2012, and that drop is mirrored elsewhere in the world.

These statistics can arguably serve as a rough proxy for the number of Japanese working abroad or seeking to do so.

A recent Mizuho/Nikkei survey of 100 major Japanese companies highlights the fact that in many Japanese companies, there is little incentive for staff to work abroad because their expatriate experience is not valued when they return.

The survey found 92 per cent of companies were yet to put in place plans to promote returning expatriates to executive levels.

In light of the limited number of globally capable Japanese employees, companies such as those heading to Silicon Valley are often looking abroad for employees capable of running subsidiaries, as well as a means to absorb foreign technology or management practices.

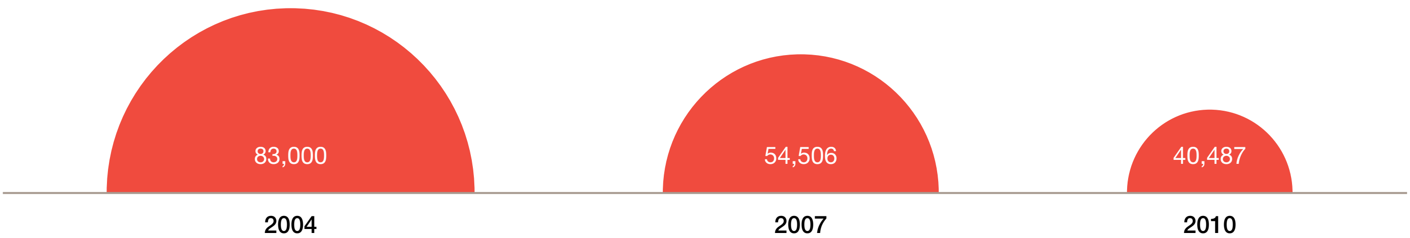
Suntory's recent $16bn acquisition of Beam, the US distiller of the famous Jim Beam range of bourbon whiskies, is cited as an example of this development.

As well as creating scale (Suntory has become the third-largest global spirits producer under the deal), the move was about talent recruitment and retention.

CEO Nobutada Saji, the grandson of the founder Shinjiro Torii, has steered the company through an ambitious program of offshore acquisitions, including the $4 billion takeover of the French Orangina Schweppes group, the Beam acquisition and the UK-based Lucozade and Ribena brands.

Suntory has placed its faith in a few key foreign executives to handle the integration of some of these subsidiaries. Former Danone executive Stanislas de Gramont was appointed to run the European operations (Suntory Beverage and Food Europe), while the CEO and president of Beam, Matthew Shattock, was left in place to run Beam Suntory, which the company expects to be pivotal to higher global revenues and profits.

Figure 4: Number of Japanese students abroad



Source: Institute of International Education

Parts of the puzzle

Suntory is already taking the first steps down the track of grappling with how to meld these culturally and linguistically different parts into one properly functioning whole that responds and reports to the parent. Or, alternatively put, how to integrate the distinctive business cultures of Paris, London and the United States, and then incorporate the most desirable elements of them into the global organisation.

Ryosuke Sasaki, a specialist in talent retention and director of People and Change for PwC Japan, said this was a process Japanese companies had struggled with in the past, perhaps because the changes needed often had uncomfortable ramifications for the organisation, such as lay-offs, a transfer of power from head office, or policies to force the headquarters to become more international.

Sasaki believes that almost all Japanese companies now believe in the need to become more internationalised, but less than 10 per cent are moving purposely towards a solution.

While the 'job for life' compact has disappeared, Japanese human resources practices remain unique, and firms continue to be reluctant to reduce headcount in the Japanese operations even when they know it's needed to remain competitive, he says.

They are also finding, according to Sasaki, that the old ways of governing subsidiaries – relying on personal relationships between managers as the key linkage – was not working and new guidelines and systems had to be put in place.

The current situation "creates a cultural issue where others don't understand why a person is promoted when it is linked to seniority", he says.

"The same thing happens with expatriates, whether they are Australian or another nationality, it is not clear to them why they aren't promoted faster. So many non-Japanese managers become demotivated and leave the company.

"That's why Japanese companies are trying to set clear standards and make their operations at head office more internationalised. Otherwise they can't accept talent from outside Japan."

Sasaki says some firms are trying to devise their own globally compatible standards and procedures from out of head office, while others were prepared to take the existing standards and procedures from their subsidiaries and implement them across the company.

"These flexible companies think there is no need to reinvent the wheel. To me, this approach seems reasonable but there are some issues around corporate values," he says.

"When they accept the international standard they are worried about Japanese corporate values being diluted. The presence of headquarters is being minimised. Some mid-sized companies have shifted the global headquarters to Singapore or the Netherlands. This is a big issue in terms of identity for the company."

Rakuten, Fast Retailing and Softbank are among those Japanese firms that are leading the internationalisation race, according to Sasaki, and have created workplaces that largely march to the beat of the global drum with merit-based promotion, no job for life, higher staff turnover and Western language and management practices.

"Those are really obvious ones that have started internationalising and a younger generation are working at headquarters. They have a very different culture," he says.

They are the minority though. Others appear to see empowerment of regional headquarters as their preferred route to becoming more international. Companies are recognising that it might take significant time to make the environment in the Tokyo headquarters fully internationalised, but it is a lot easier in Singapore or the US or Europe, Sasaki says.

Once that is achieved, then the regional headquarters becomes the take up point to draw in talent from outside Japan.

English matters

Paramount to the ability of Japanese firms to integrate foreign subsidiaries will be the English proficiency of their management.

Like it or not – and in Japan it's fair to say that's a not – English is increasing its grip as the global language of business, while Japan's grasp of it is getting worse.

Research from Education First says Japanese adults have failed to boost their English ability in the past six years. Instead, their skills have declined as China, Indonesia, Vietnam and other Asian countries have logged significant increases in proficiency.

"Despite being a far wealthier and more developed country, Japan is struggling to teach its students English for use in a competitive global economy," Education First noted in the latest edition of its English Proficiency Index.

The report of the index – which is based on hundreds of thousands of test results from students across the world – makes grim reading when it comes to Japan.

It criticises Japanese schools and teachers for failing to properly instruct pupils in spoken English while obsessing with grammar, and it attacks corporations for discriminating against expatriate staff returning home.

"The most common English exam in Japan is the Eiken, taken by 2.3 million people in 2011. Although it includes a speaking section, only more advanced students take it, and they must first pass a grammar test in order to be tested on spoken English. In all cases, the majority of a candidate's score is determined by grammar, vocabulary, and translation questions," the 2013 EPI notes.

For companies, the situation is a paradox, according to the EPI 2013. While they recognise they need to boost the English levels of their staff, some remain wary of hiring returning expatriates or graduates who have studied abroad for cultural reasons.

"Instead of seeing the economic value of ambitious, bilingual graduates, some Japanese companies hesitate to hire culturally diverse junior staff who may not be inclined to adopt traditional corporate roles," the report says.

"A survey of 1,000 Japanese companies in 2011 found that less than a quarter planned to hire any Japanese applicants who had studied abroad.

"We're cautious because we emphasise continuity and long-term commitment to the company," Keiichi Hotta, a recruiter for the giant Japanese financial bank Tokyo-Mitsubishi, told The New York Times in 2012.

This prejudice, in turn, reduces the incentive for young Japanese to study abroad, even if they have the desire.

Ryosuke Sasaki, PwC Japan's People and Change director, says the more conservative Japanese companies preferred to try to make their existing staff more international through English training and other measures, rather than hire graduates who have studied abroad.

But Sasaki says new-breed companies, such as online auction giant Rakuten, the rapidly growing Fast Retailing (the parent company of Uniqlo) and Softbank, are completely different, preferring to hire globally savvy graduates even if means their staff turnover is higher.

These companies are often also the ones that have made more radical steps towards embracing English in the workplace.

Rakuten and Fast Retailing are the most prominent of this small group, but Nissan, Bridgestone, Sharp, Takeda Pharmaceutical and a few other major Japanese companies have followed suit in embracing English in the workplace.

These companies are reaping the benefits of attracting and retaining a globally savvy workforce while their rivals persist with the slower and less successful route of trying to make their existing employees more internationally capable.

"When I announced my plan to make English the official language of my Tokyo-based company, a lot of people said I was crazy. At least one fellow Japanese businessman said I was stupid. But three years later, it's clear to me that 'Englishnisation' works."
Hiroshi Mikitani, CEO, Rakuten

The Abe government – as part of its growth strategy – has pledged to try to double the number of Japanese students studying abroad from 60,000 to 120,000 by 2020 as well as improving the standard of English education in schools.

It has mooted the idea of "global" high schools to cater for outward-looking students and pledged to review the underperforming system of English education in schools. The government also wants to introduce an English-language entrance exam for the public service next year and wants universities to take similar steps.

Governing principles
Establishing more diverse and accountable corporations

For Japanese companies, the pressure to become global is not just occurring at the managerial level, but also when it comes to how the board is configured.

The Olympus issue thrust the shortcomings of Japanese corporate governance into the global spotlight, highlighting the prevalence of companies run by veteran insiders with close personal links to each other and no independent directors on their boards.

With non-executive directors scarce in Japan (only 1.1 per cent of TOPIX members have a majority of independent directors versus 65 per cent for MSCI developed world shares based on Bloomberg data), boards struggle to fulfil the function of watching over management and contributing fresh ideas. Independent directors made up just 8.8 per cent of board members of Topix companies according to Bloomberg, compared with 84 per cent for the S&P 500 and 42 per cent for Hong Kong's Hang Seng.

Paul DeNicola, director at the Centre for Board Governance at PwC in the US, says governance is critical because good governance structures can help attract investors if the firm is moving towards an IPO and provide improved performance and protected shareholder value for those already listed.

He says family firms, or private firms that retained influence from their founding family members, (an example analogous to many Japanese public companies) are those that often need a closer look at their governance, yet are the most resistant to change.

"The perception is that they are giving up control in bringing in external directors," he says. "I think, for the most part, one of the most important things to look at is how the board can add value to the company."

"With some insider boards you don't necessarily have directors who have had the experience of sitting on other boards-directors who have served across different industries and in companies of different sizes."

As a complement to recruiting the right skills to a company's board, he says the benefits of gender diversity and ethnic diversity in board composition have been proven.

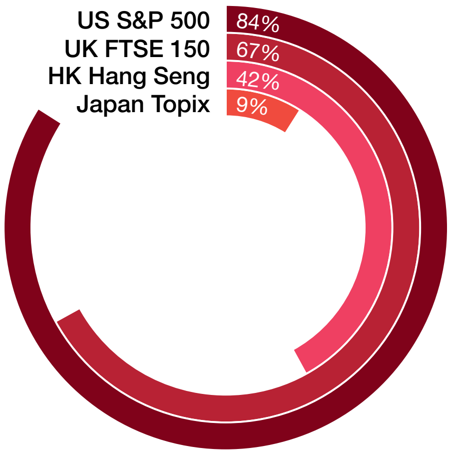
"There have been a number of studies in the US that show that with the presence of three or more women on corporate boards there is a relationship with better performance." he says.

"Studies also show something similar for boards when it comes to ethnic diversity.

"People have begun to realise that diversity of perspective can help protect stakeholders and ultimately results in greater shareholder value."

DeNicola says he recognises that firms in Asia have been slower to change corporate governance practices, but the advisory board model that some firms had adopted could be used as an arena to trial board candidates from more diverse backgrounds and particular skills, with a view to them eventually joining the main board.

Figure 5: Independent directors as a percentage of Board of Directors



Source: Bloomberg

"The advisory board concept is a clever, yet highly effective, interim solution for Japanese companies to implement following the acquisition of foreign businesses as it helps to form a bridge between head office and subsidiary management teams, particularly given the disparate business cultures that exist in such situations," he says.

The benefits of more robust and diverse boards have also been borne out in studies of Japanese companies.

Japan passed laws in 2003 allowing firms to institute a Western-style model of board governance and by 2009 more than 100 listed firms, including Sony, Nomura and Hitachi, had taken this opportunity.

The two-track governance approach that emerged has given researchers an opportunity to study the performance of the two groups.

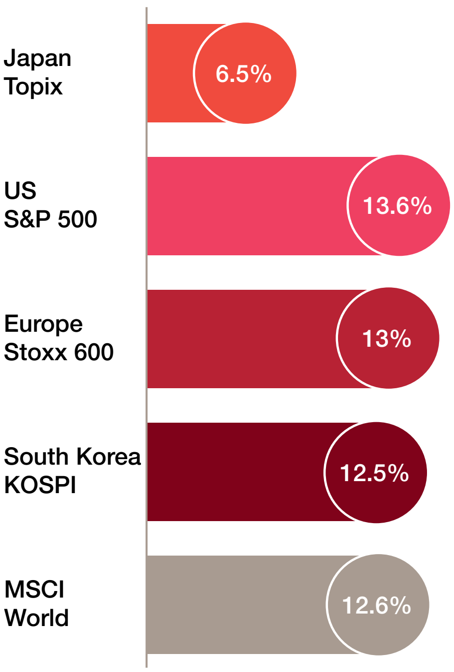
Stanford academic Robert Eberhart found in a January 2011 paper that Japanese firms that adopted the Western-style model of outside directors (known as the *iinkai* system in Japanese) were actually valued more highly than those sticking with the system of directors sourced from within the company and the accounts approved by a statutory auditor (the *kansayaku* system).

"We find that the *iinkai* corporate governance system produces higher corporate value than the traditional *kansayaku* governance," the paper finds.

"These results provide empirical evidence of the economic efficiency, in terms of investor value, of the *iinkai* system with implications for the corporate governance convergence debate."

This perhaps explains why the Japanese stock market has historically traded at a discount to asset value. Prior to Abenomics and the related bounce in the Nikkei, some 70 per cent of firms traded at a discount to book value. That's an indictment on the management and boards of these companies – they are essentially a drag on the ticket.

Figure 6: Average return on equity 2003–2013



Source: Bloomberg, FT

One Mizuho Corporate governance in Japan's financial sector

With the exception of Nomura, Japan's financial sector has largely failed to embrace Western-style governance practices.

But that is beginning to change with Mizuho, reeling from a scandal in which a consumer loans subsidiary was found to have lent money to *yakuza* (mafia) criminals, unveiling a board with an independent chair and five external directors, as well as a committee structure to complement it. In April this year, Mizuho named Hiroko Ota, a female academic and former politician, as the new chair of the board of directors and as an external director (subject to shareholder approval).

President and CEO Nobuhide Hayashi made no bones about linking the changes to the scandal in recent comments.

"We are prioritising opinions from third parties," he said. "From now on our decision-making process has to be transparent and reasonable, and also has to bear in mind the response from the public. Our brand image was damaged and must be restored."

The move comes under the umbrella of the firm's One Mizuho policy aimed at establishing common policies and practices across its group operations.

Keisuke Yorihiro, the leader of PwC Japan's financial services regulatory practice, says since the Olympus scandal, governance has been a big issue in Japan, but Mizuho was the first major firm to make significant changes.

"As far as the financial sector is concerned, Mizuho's model is quite advanced. Maybe not by Western standards, but certainly by Japanese standards," he says.

Mr Yorihiro says "Some firms are still coming to terms with establishing robust internal audit teams and Japanese companies are a long way from setting up the kind of global compliance structures that existed in J.P. Morgan, HSBC Citigroup and others."

The recent lift in the Nikkei has eroded this deficit and Japan's TOPIX index now trades just above book value, but returns on equity remain poor: 6.5 per cent versus Korea's 12.5 per cent over the past decade, according to figures published in the *Financial Times*. That return was second worst in the world beating only the returns in debt-hobbled Greece.

The recent rally in Japanese stocks has been driven strongly by foreign investors, who now own almost one third of the stock of major Japanese corporations. They will be expecting changes to the management and governance practices of the firms in which they invest.

As the government progresses its changes, the Tokyo stock exchange is promoting a new JPX-Nikkei index of 400 companies, chosen for their higher returns on equity and relatively strong governance.

A number of established Japanese companies have bowed to the pressure for more modern governance models with Canon, Toyota and Nippon Steel now appointing some outside directors to their boards.

The Abe government has also moved to tackle this issue with lawmakers beginning in April this year a process to push for more outside directors and the introduction of audit committees more typical of Western companies via proposed changes to the Companies Act. The ruling Liberal Democratic Party will soon present a plan to improve governance and appears serious about driving change as part of its structural reform agenda.

"Corporate governance (change) has to work. Otherwise companies won't boost competitiveness," Yasuhisa Shiozaki, the LDP's deputy policy chief said in a recent interview.

A key aspect to the changes is a proposed stewardship code governing institutional investors and prodding them into closer engagement with, and oversight of, the companies in which they invest their clients' money.

The changes to the Companies Act are likely to go further than that. Draft legislation published on the Ministry of Justice website suggests firms will be directed to either appoint at least one independent director or be forced to explain why they didn't.

And under a proposed code on company behaviour, companies will be encouraged to have a separate chair and CEO, and firms that are large or medium-sized should have a majority of independent directors. The move would bring Japan into line with most of the developed world where such guidelines are in force.

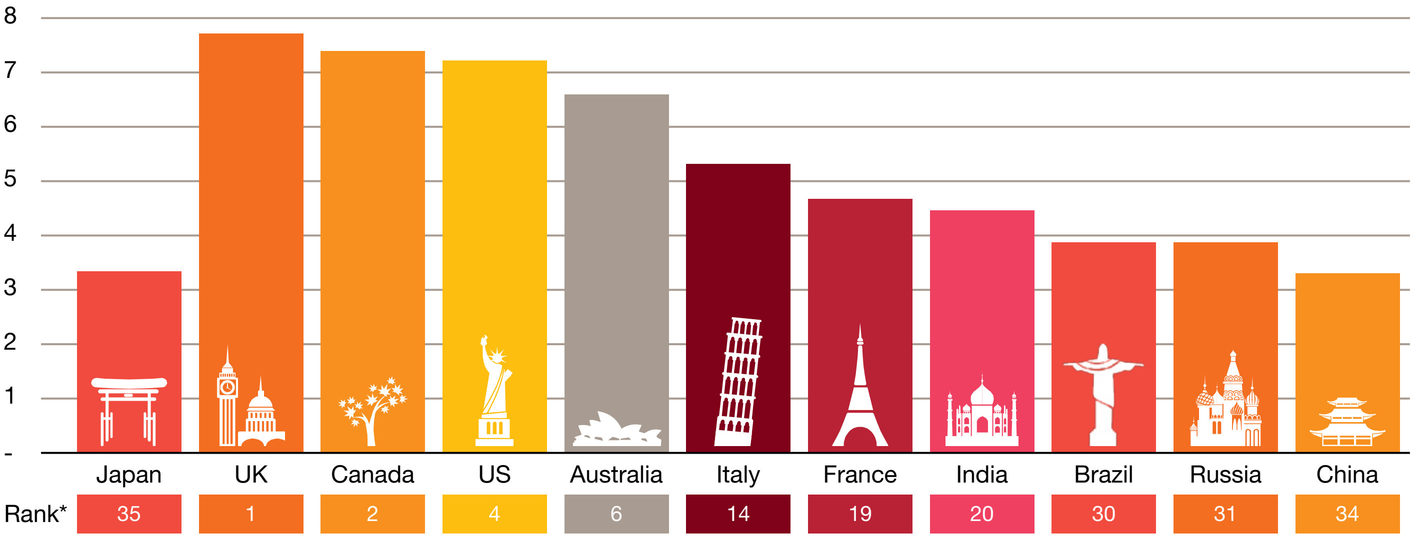
Both the New York Stock Exchange and the NASDAQ require that a majority of directors on the board be independent and it is common for the CEO to be among only one or two non-independent directors.

A 2012 report from the National Association of Corporate directors in the US shows that 73 per cent of US companies have at least one woman on the board, and 48 per cent have at least one minority director. The percentages are even higher for companies with the highest market capitalisation (more than $10bn), according to the same report.

According to the latest Governance Metrics International rankings for corporate governance, Japan trails countries such as the UK, Canada and the US by an embarrassing margin, rating just 3.3 out of 10 compared to the league leader UK on 7.6 out of 10. Japan ranked 35th of the 38 countries included, sandwiched between China and Indonesia.

Compliance with codes is one thing, but the follow-up challenge for firms prepared to modernise is finding the right talent to fill these vacancies. It won't necessarily be easy, initially at least, to look beyond the management's immediate circle of contacts and find talented, ethical and ambitious people to fill these slots adequately. Yet it must be done.

Figure 7: Governance Rating 2010



*Out of 38 markets

Source: GMI Ratings

Womenomics at work

The other area in which Japanese companies, like society as a whole, will have to change is in female participation in the executive ranks, as well as in the makeup of the general workforce.

According to research company GMI Ratings, women accounted for just above 1 per cent of executives at major Japanese companies in January 2013, a ratio dwarfed by the figures from almost all other industrialised countries. More than 15 per cent of executives in the US are female. In Sweden, that figure is more than 25 per cent, and in Norway, 35 per cent.

The Abe government has called on all listed companies to appoint at least one female director, and signs from the financial sector – where a flurry of recent female executive hirings have been announced – suggest the call is being heeded.

But Japan also lags the world on female workforce participation with a 20 per cent participation gap between men and women, according to OECD figures.

Not surprisingly, the country fares poorly in PwC's Women in Work Index, which ranks countries in the OECD according to labour market data including the share of women in full-time employment, pay gaps between men and women and the female workforce participation rate. The latest version of the index ranks Japan 24th out of 27, beating only Italy, Greece and Korea.

Scoring just over 40 in the index, Japan's tally is about half of Norway's and two-thirds of the United States' score.

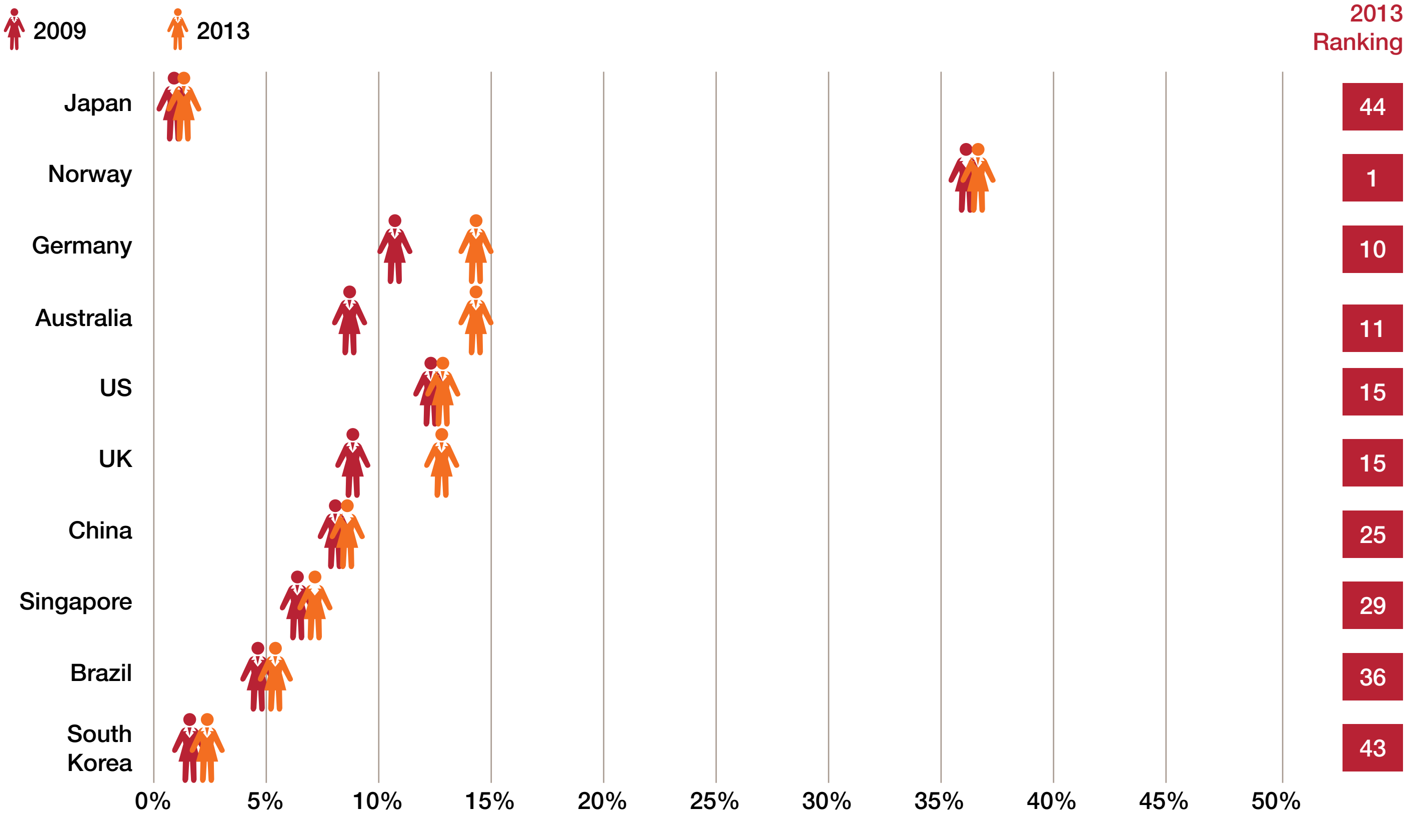
Clearly the country has a long way to go in reaching Prime Minister Abe's goal of having women filling 30 per cent of all senior positions in Japanese society by 2030.

But 16 years may not be long enough to break down the many cultural and structural factors that prevent women in Japan from continuing their careers after they have children.

Goldman Sachs' Chief Japan equity strategist Kathy Matsui is one of a handful of senior women in her sector and is the author of several reports on addressing gender equity in Japan under the banner of Womenomics.

She was cited directly by Mr Abe in one of his early speeches as Prime Minister about boosting female participation in the workforce and recently published a new report titled *Womenomics 4.0: Time to Walk the Talk, on how to break down the barriers*.

Figure 8: Percentage of women in the boardroom



*Out of 45 countries, US ranking based on 2012 number.

Source: GMI Rating

Matsui calls for the deregulation of both the daycare and the nursing care industries, dramatic reforms to immigration laws and changes to make both the tax and social security regulations gender neutral, as well as a campaign to promote gender equality in Japanese households.

She calls on the private sector to press for more flexible and diverse work environments, establish gender-neutral employee evaluation schemes and consider diversity targets.

Vanessa Wallace, a specialist in workplace diversity and chair of PwC's newly acquired Strategy& (formerly Booz & Company) in Tokyo, says Japan has entered a new era of opportunity, and addressing organisational and workplace rigidities must be one of the top priorities for successful management teams.

"Leaders must proactively address the formal and informal work practices that stifle the potential of the current workforce, restrict innovation and inhibit change from happening," she says.

"Diversity and workplace flexibility is just good business. Companies that act now could fuel their prosperity for decades; those that don't may stall."

The proverb "Japan is a land where dawn doesn't break without a woman" has been around for centuries, but it is not until now that the first genuine signs have emerged that this might one day be true.

The last word from Hiroyuki Suzuki

As we have highlighted throughout the Japan Rebooted series, and particularly in this third publication, Japan has many challenges to overcome; they are linked to its demography, its geography, and its history and culture.

In today's world, there is so much interconnectivity and competition that it seems right in this issue of the Japan Rebooted series that we have held Japan up against international best practice, even if some of these comparisons have proved unflattering.

This report was prepared with input from both Japanese partners and foreign partners so PwC could present an "inside-out" view and an "outside-in" view of corporate Japan. Why? Because we wanted to bring the debate out into the open, and start a conversation in Japan and beyond about the transformational journey to restore the country's position as a global powerhouse.

By grasping the nettle of change and reform, Japan can capitalize on the green shoots of recovery that Abenomics and its fiscal and monetary stimulus have generated. If companies and the government are prepared to embrace change, the rewards may be amplified as the recovery in US and Europe takes hold and supplements the growth being achieved in emerging markets.

PwC recognises that the path ahead is difficult, and that any reform process naturally involves winners and losers. To sustain Japan's position, the actions of companies and business leaders will be critical to ensure our country can adapt to the increasingly complex and volatile business landscape.

The solution for individual companies will vary, and will require careful consideration and external input, but in general, the way forward for many firms requires risk-taking, flexibility and adaptability, embedding change into strategies, and creating a new set of behaviours in the workforce.

The heart of the matter is embracing change. Japanese business leaders need to adopt new attitudes towards governance, innovation, talent management and diversity. They need to be prepared to explore, challenge, innovate and listen. And they must then drive changes in attitude throughout their organisations.

This journey is imperative to future-proof corporate Japan, and helps us all achieve renewed growth and prosperity for our great nation.

As much as Japanese companies need a more modern, globalised and innovative structure to go forward, the world needs a Japan that fits those characteristics too.

A rejuvenated Japan that not just matches world's best practice, but exceeds it in key areas will again provide a path for others to follow.

Hiroyuki Suzuki

Where to now?

We recognise there is no one-size-fits-all solution for many of these current day challenges as each organisation is different and the issues faced are complex. We help clients respond to the strategic and operational challenges including:

Innovation

Generating top-line and bottom-line growth lies at the heart of any organisation's ability to deliver shareholder value. Leading companies today recognise that innovation is critical to delivering consistent business results in all economic conditions. The speed of change in the new economy has reinforced the value of innovation. We can help our clients:

- Define paths to more profitable growth, from core product development to radical business innovation.
- Establish the resources, organisation, processes, metrics and other elements to create incremental and breakthrough innovations.
- Define winning innovation and product strategies, optimise portfolios and balance roadmaps.
- Increase new product profit growth by increasing development productivity, managing complexity and reducing time to market.
- Optimise innovation and R&D footprint for access to markets, ideas, talent, and for cost and tax efficiency.
- Select and implement optimal product lifecycle management systems and realise rapid ROI.

People & Change

Getting the best from people at every level when there is constant change is the key to sustainable competitive advantage. Solid strategies, processes and technology alone do not deliver results. It takes people to accept, adopt, drive, and sustain the change to realise tangible impact. Success in business hinges on strategic agility and the ability to execute. We can help you:

- Structure your organisation with the right capabilities and leadership to execute the business strategy.
- Develop effective strategies for people development and growth.
- Support change by involving the people impacted and enabling them to drive and sustain the business change.
- Position the organisation's culture to be a competitive advantage.
- Design and support training programmes covering a wide variety of topics.
- Benchmark the efficiency and effectiveness of HR.
- Establish the control and coordination required to manage projects and programs successfully, achieving the right business results.
- Optimise the engagement and motivation of a diverse workforce to focus on the right things and strive for excellence.
- Support the alignment of risk, strategy, performance management and reward, and ultimately, provide a greater likelihood of strategy being executed.

Governance

Any organisation that wants to survive, let alone succeed, will have to manage new risks, embrace new regulations and technologies, and prepare for the future with robust succession planning. That means many private companies and public institutions will need new governance models. We can help our clients:

- Design and implement a best practice, strategic corporate governance framework that integrates advanced risk management techniques and controls with your mission, vision and stakeholder expectations, using flexible, scalable solutions to address your unique needs.
- Design and implement governance and compliance programmes to ensure that the company continues to operate within the boundaries of relevant legislation and regulations.
- Engage in a dialogue with your stakeholders and give them a clearer understanding of your business, whether that's through traditional reporting or more forward-thinking ways of communicating.
- Protect and strengthen every aspect of your business, from people to performance, systems to strategy, business plans to business resilience, and help you to build confidence in transformation.

*For more information on today's issues, log onto **www.pwc.com/gx/en/issues***

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