

Corporate leaders need to champion organisational transformation to succeed in today's complex international environment.

Revitalising corporate Japan

A prescription for growth



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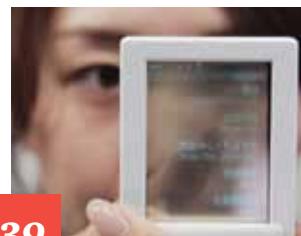
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A message from our chairman

Japan was the trailblazer for today's emerging economies, as the first non-Western nation to become a modern economic power. Its meteoric rise from postwar poverty and landmark achievement in establishing "Made in Japan" as the global catchphrase for quality set the benchmark in economic development.

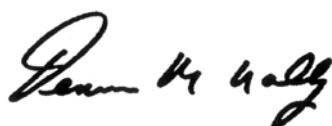
Today, Japan is also the pacesetter for the advanced economies, the first to face challenges looming in everyone's future: the ageing of society and the imperative to transform mature economies to meet the demands of an increasingly complex global business environment.

How Japan fares will hold lessons for us all — which is why PwC believes the world needs a deeper understanding of Japan's current situation.

We saw an opportunity to focus the unparalleled expertise of the PwC global network on the issues facing Japan and Japanese corporations. A PwC team sat down with 60 senior business and political leaders, academics and specialists for extensive discussions, and to learn what changes they're making in their own organisations in response to current challenges.

I would like to thank each of them for taking time from their busy schedules to meet with us. We greatly appreciate their candid participation; they have added invaluable context to our research.

We hope our analysis will contribute to today's debate on the future course of Japan and its leading firms. Our aim — pursued with great respect and affection — is to enrich the dialogue between Japan's business leaders and their stakeholders.



Dennis Nally
Chairman
PricewaterhouseCoopers
International Limited



Transformation towards tomorrow

This is an exciting chapter in Japan's history. It's a time of change and transformation. A time that presents opportunities for leaders to take bold steps that will redefine how their organisations continue to be economic trailblazers. A time for decisions that will leverage existing strengths and substantial advantages to improve competitiveness and optimise globalisation.

As advisors to the world's largest companies, we know that change can be difficult. It presents a measure of uncertainty that requires strong leadership. While there is a measure of risk in pursuing new approaches and ideas, the risks of doing nothing are far greater.

After speaking with Japanese CEOs over the past year, we believe that many business leaders are already aware of the degree of change required. Our hope is that this report will help many Japanese corporations start the process of strategic and operational transformation they seek.

But we're not just offering a report. PwC has been doing business in Japan for over 80 years. Our people work very closely together to support the growth of Japan's great companies — its global champions — providing services here in Japan and around the world. We remain committed to helping Japanese businesses take the necessary steps to pivot, adapt and grow in an extraordinarily complex and fast-paced international environment.



Juan Pujadas
Vice Chairman
Global Advisory Services
PricewaterhouseCoopers
International Limited



Hiroyuki Suzuki
Territory Senior Partner
PwC Japan



Executive summary



Japan is an inspiration to the world. Its people live longer and are healthier than in any other nation. Japanese society benefits from an extraordinary degree of social cohesion and trust that allows it to accomplish remarkable things.

Japan's corporate community has long held the world's respect. For decades, corporate Japan has been counted among the short list of global leaders for its advanced technology, standards for quality, dedicated workforce and internationally competitive private sector.

The world needs a strong, confident and vibrant corporate Japan.



Executive summary

And the need today is greater than ever. The extraordinary postwar era of peace, prosperity and dominance for businesses in the world's mature industrial economies appears on the surface to be coming to an end. Issues around globalisation and newly emerging competitive nations and companies, resource pressure, environmental degradation and climate change have destabilised the traditional economic structures.

The countries and sectors that formerly dominated international commerce are giving way to emerging markets with growing middle classes and increasing exports. While these new competitors on the global stage present real challenges for the economies and businesses that have traditionally dominated world markets, they also offer an opportunity for growth, improvement and greater competitiveness. Indeed, competition breeds success, and Japan is in an excellent position to capitalise on this critical moment in history.

And yet, despite Japan's capability to be the trailblazer, those both inside and outside Japan feel its extraordinary vitality ebbing.

The country's longevity sits at the top of Organisation for Economic Co-operation and Development (OECD) rankings, while fertility rests at the bottom, leaving the country with a shrinking workforce and rising elderly population. Demographics combined with very high public debt levels and operating costs much higher than emerging competitors' imply that without a revitalisation of its economic performance, Japan's society is going to suffer a decline in living standard.

But PwC strongly believes this vitality can — and must — be restored. While there are many dimensions to this nexus, in this report we focus on what Japanese corporations can do. We chose this focus because while public policy initiatives are essential, the needed reforms will not be effective unless Japanese corporations also play their part.

In many ways, Japan is the world's first advanced economy to face challenges like an ageing society and how to transform a mature economy so it can thrive in an increasingly complex global business environment. How it tackles these challenges will serve as models for the world.

That is not to say the answers to the new global questions will come easily. All nations must weigh their current advantages and circumstances in the face of new global "Realities," which include:

1) The arrival of Asia Asia, the engine of the world's economic growth, is producing fierce, new competitors. However, a new middle class of Asian consumers gives Japan an opportunity to secure its niche market advantages.

2) Increasing business complexity Growing connectedness between economies and more complex trade and financial relationships necessitates updated management approaches.

3) New models of innovation Encouraging entrepreneurship and innovation within companies can boost competitiveness and help capitalise on diverse ideas and efforts to support new and better product development and manufacturing.

4) Ageing economic metabolism Restructuring domestically focused businesses as well as addressing Japan's ageing workforce and need for skilled human capital are important for greater national prosperity.

Revitalising corporate Japan

A prescription for growth

Corporations need to embrace rapid transformational change with attitudes of boldness, risk-taking, velocity, flexibility and adaptability.

1

The arrival of Asia

Globalisation is a business imperative and Asia is a focal point. New, aggressive competitors are emerging from Asia.

- How can you compete with your “fiercest competitor” from the new Asian economic powers?
- What is the right approach to deal-making and alliances in the region?

2

New models of innovation

Entrepreneurship and co-creation re-energise the innovation processes as corporations pursue open models.

- How well is your organisation adapted to working with outsiders and new partners?
- How are you encouraging collaboration among your employees and partners in innovation?

2

Increasing business complexity

New strategies are required to deal with the growing interconnectedness in trade and financial relationships.

- How integrated are your foreign operations within your business?
- Do your board and executive team have a diverse view of the world?



4

Ageing economic metabolism

Japan is the first advanced economy to face challenges like an ageing society and transforming the organisation to thrive.

- Is your organisation using capital efficiently?
- How will you compete in the global war for talent?

Strategic priorities

Transform the organisation

Leaders need to champion major organisational changes to achieve success in the twenty-first century. Embrace diversity top to bottom to have the talent, fresh perspectives and vitality you need in today's world.

Adapt innovation

Put yourself in the place of an outsider — perhaps an entrepreneur with a good idea or technology that will advance your business: How easy is it for these potential partners to work with your organisation and find the right people?

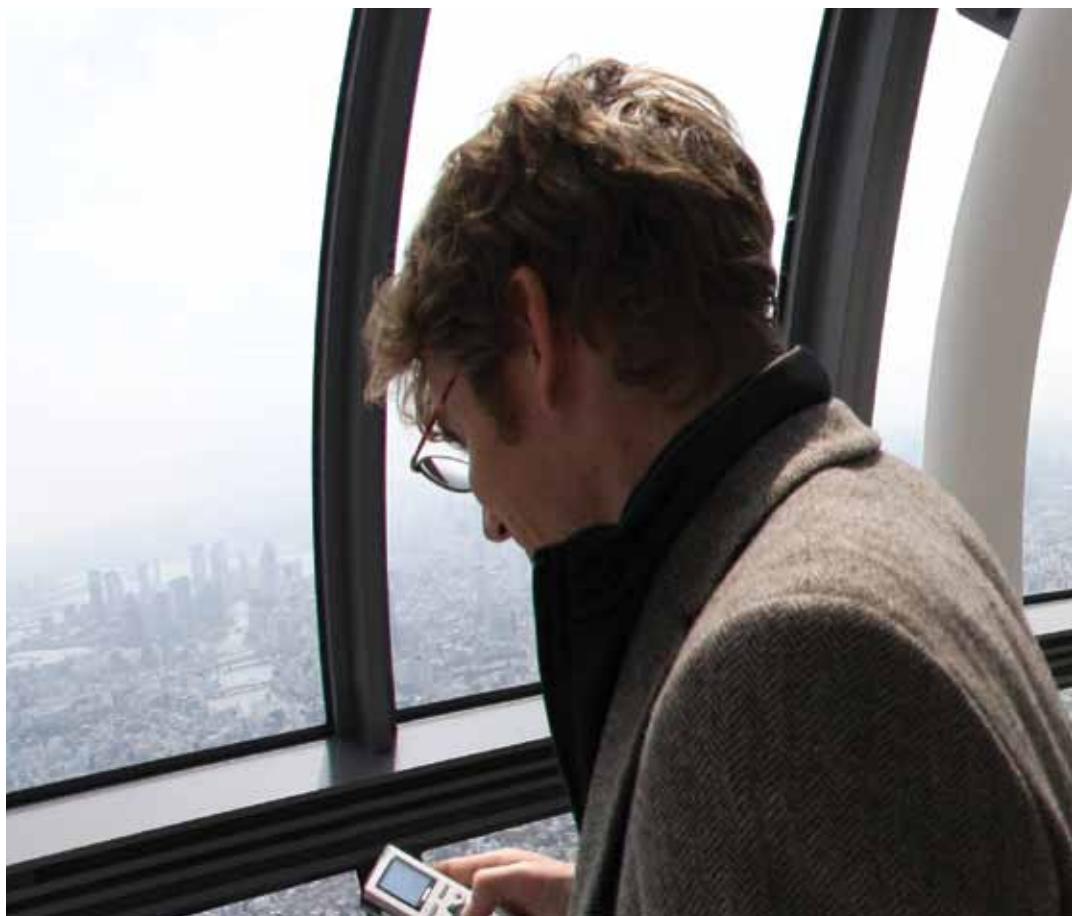
Grow your leadership pipeline

Corporations need to understand the full range of capabilities required to successfully lead in today's world and makes changes to promotions, training, rotation and compensation that will produce more global leaders.

Focus your growth strategy

Consider aggressive growth strategies such as M&A activity, direct investment and partnerships. The objective is to focus more effort on opportunities that will deliver the type of value-added activities Japan needs in markets that are growing.

Executive summary



Each of these Realities has enormous consequences for corporations aiming to survive and prosper.

To be sure, Japan, the US, European countries and other nations face similar challenges. The need for human capital, entrepreneurship and innovation, and a pro-business atmosphere — these and other issues will require solutions unique to each country's traditions, social makeup, business strengths and history of success.

Japan holds attributes no other country can match. To maintain these advantages, it is important for Japanese business leaders to closely consider the many aspects of the dynamic international business landscape. With external changes comes an inevitable need to adjust and improve to access emerging opportunities and leverage existing national strengths.

For Japan, there are specific areas where focused effort can produce real and lasting competitive business advantages. On the whole, Japanese corporations must do more to adapt. To be sure, many Japanese corporations are doing lots of the right things, and some are doing many of the right things — but given the enormous size of the Japanese economy, not enough companies are adapting fast enough to transform and thrive in the future.

This type of rapid transformation requires new attitudes that will embrace boldness, risk-taking, velocity, flexibility and adaptability.

Armed with these attitudes, Japanese companies should pursue a combination of four themes of major actions to help navigate today's complex international environment:

- **Transform the organisation** – Leaders need to champion major organisational change to enable their companies to succeed in today's world. The talents and fresh perspectives of a wider group of people, throughout the organisation and in the governance structures, are needed. Japanese women, foreigners, midcareer hires and the young generation are all groups that bring a huge amount of energy and multitude of ideas. Japanese corporations that embrace these groups will find they are better able to win against both domestic and foreign competitors.

- **Adapt innovation** – Open up the organisation to accelerate innovation. Put yourself in the place of an outsider — perhaps an entrepreneur, small business owner or foreign multinational corporation — with a good idea, technology or even a network



that will advance the aims of your business: How easy is it for these potential partners to work with your organisation and find the right people? For most Japanese corporations, the answer is, not easy at all. Japanese corporations are going to have to use new approaches like intrapreneurship and co-creation with outside organisations to re-energise the innovation processes required to be global leaders.

- **Grow your leadership pipeline –** *Understand the full range of capabilities required to successfully lead in today's world.* Corporations must make changes to promotions, training, rotation and compensation that will produce more leaders who are able to navigate the challenges of today and tomorrow. Companies should open themselves up to more merit-based promotion and external senior-level recruitment in order to foster leaders who are

not risk averse and have the skills to confidently guide their organisations in new directions.

- **Focus your growth strategy –** *Many Japanese corporations can become more aggressive,* with options including mergers and acquisitions (M&A) activity, direct investment and partnerships. As of yet, domestic markets have not rationalised, conglomerates continue to be in too many businesses and corporations' use of capital is inefficient. Understand the unique opportunities that a high yen provides. The objective is to focus more effort on opportunities that will deliver the type of value-added activities Japan needs in markets that are growing.

Of course, different corporations are at different starting points, and in different industries, so the exact required mix of action will vary. Companies will have to make

progress simultaneously on a variety of issues, including globalisation, governance, innovation, strategic thinking, capital planning, M&A, pay and performance management.

Japan is at the forefront of change. Its longstanding global leadership gives the country an opportunity to act and adapt before many of its competitors. The challenges addressed today will be those that the rest of the world attempts to overcome tomorrow. In this sense, quick action is important. Some Japanese corporations have already begun taking important steps to address the issues detailed in this report. With a more robust and complete corporate effort, there is no question that Japan will continue to lead the world in many respects. Action, attentiveness to innovation and detail, and courage to overcome any challenge are the qualities that will win the day, all of which are attributes Japan has enjoyed for centuries.





Introduction

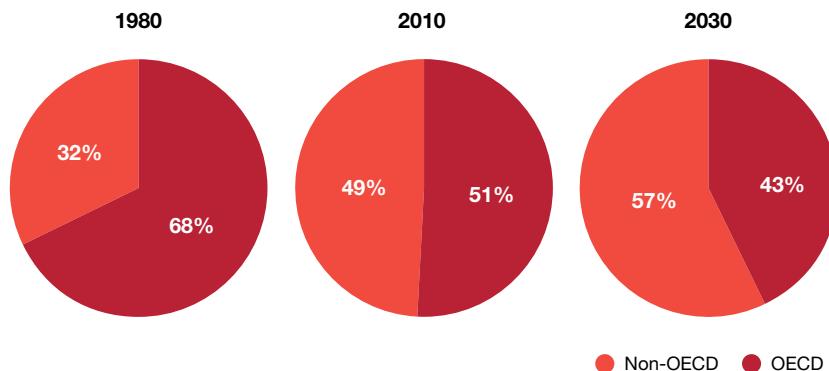
Corporate Japan's rise to the centre of the global economic system throughout the second half of the twentieth century represents an economic achievement without parallel or precedent. During the postwar period, Japan laid the foundation for economic strength, becoming the world's second-largest economy in 1968 and experiencing explosive growth in the subsequent two decades. The reconstruction was backed by an almost unmatched mastery of the manufacturing process; "Made in Japan" was firmly established as the global benchmark for product quality. Japan's global reputation for quality stands as the collective achievement of hundreds of enterprises and millions of people. The strength of Japan Inc is a testament to the exceptional characteristics of the Japanese people: personal diligence, respect for education, teamwork, loyalty, craftsmanship and a tireless work ethic.

Introduction

Exhibit 1: GDP growth for developed vs emerging economies

Gross domestic product (GDP) at purchasing power parity (PPP).

In current international dollars



Source: The World Bank: World Development Indicators; World Bank, International Comparison Program Database; and Organisation for Economic Co-operation and Development (OECD): Perspectives on Global Development 2010: Shifting Wealth.

Japan's extraordinary dedication to quality and engineering in every aspect of life means not only its companies offer extraordinary products, but over the past 50 years, it has led a restructuring of global manufacturing, pressuring every company and country to up its game and deliver much improved quality at every price point in every corner of the globe. This dedication continues to manifest itself in new fields such as nanotechnology, robotics and material science, areas that need to progress to improve our quality of life.

But the global economy is changing. Emerging markets are challenging developed economies, shifting away from low-tech assembly towards research and development (R&D)-driven innovation. To meet these new competitors on the global stage, the nations and businesses that have traditionally led world markets must pivot, adapt and grow. (See Exhibit 1.)

When Japan began its export drive after 1945, most market opportunities were found in North America and Europe. Today, the hotbed of global growth is in Japan's backyard. With a capacity for R&D that rivals the United States', as well as the capital resources needed to invest in new ventures across the globe, Japan is in a prime position to develop and provide innovative solutions to emerging market aspirations.

Yet, despite Japan's capability to be the trailblazer, those both inside and outside Japan feel its extraordinary vitality ebbing. The phenomenal achievements of postwar Japan are in danger of being eclipsed by 20 years of "flat" growth at a time when other countries like South Korea and China took flight and are catching up to Japan. The erosion of historic competitive advantage is coupled

with fundamental changes to the domestic economy: the decline in working-age population is accelerating, public debt levels are rising and domestic consumption is declining.

To capture today's opportunities, Japan's business leaders at home and abroad must move quickly and decisively.

Businesses cannot wait for government policies that, for example, seek to soften the impact of a stronger yen rather than focusing on strategic planning and global diversification strategies. An important impetus for change must arise from the nation's business leaders. Some Japanese businesses are already taking steps to adapt to today's economic realities, and even more robust private sector efforts will support a competitive and growing Japan.



To identify the current challenges and opportunities for Japan's corporations, PwC spoke with over 60 business and political leaders, academics and other specialists and combined this with extensive research and analysis. We began with two fundamental questions:

- **How has the world changed?**
Shifts in the global economy can be summarised as four Realities: the arrival of Asia as an economic powerhouse; an increasingly complex international business landscape; the emergence of new models of innovation; and an ageing economic metabolism.

- **What do companies need to do to address these Realities?**
To effectively address the four Realities, companies must face and overcome central challenges common to many established markets. For Japanese companies, these include accepting a measure of risk with their business strategies; embracing diversity throughout the corporation, including in the boardroom; encouraging entrepreneurship; and fostering a more diverse workforce, including expanding leadership opportunities for women and foreign workers. This will require bold leadership. Indeed, Japan will be hard-pressed to navigate the four Realities without addressing these challenges.

Now is the time when everyone in Japan needs to share a sense of crisis and act quickly so that the entire power of the nation can be applied to the issues at hand. However, I feel a sense of crisis because that is not happening.

Eizo Kobayashi
Itochu Corporation

Introduction

The challenges identified here will only increase. Nevertheless, Japan has substantial advantages and strengths, which, leveraged correctly, can support a renaissance in Japanese competitiveness.

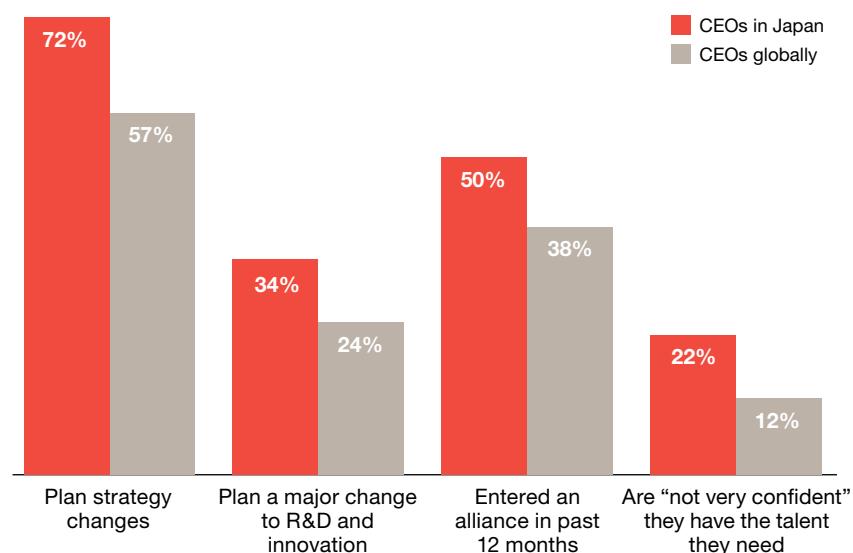
Overall, while many Japanese corporations are adapting and pursuing solutions (and we feature many of these in the report in special call-out boxes), more need to do so in order to revitalise their prospects for economic success.

Our interviewees highlighted the issues. We were struck by the consistent and considered messages we were given, whether the interviewee was from industry, the government or academia. This consistency from such a broad group of distinguished Japanese and friends of Japan gives us a great deal of confidence in putting forward this report's ideas in a bold and direct way.

Of course, diagnosing the challenges is just a first step. In each of the sections, we start to describe the type of business implications that Japanese corporations will need to address to adapt and thrive.

Change can be difficult, in part because it presents a measure of uncertainty. There is risk in pursuing new approaches and ideas, but as this report shows, the risks of doing nothing are far greater. The business implications are presented as a series of provocative questions that Japanese corporations should be asking themselves. The purpose is to help Japanese companies to begin the process of transformation that they require. We believe many business leaders are already aware of the degree of change required, as evidenced by the responses of Japanese CEOs to PwC's annual CEO survey. (See Exhibit 2.) Japanese CEOs see a greater need for change in some key areas than their counterparts elsewhere.

Exhibit 2: Business leaders in Japan recognise the need for change



Source: PwC, *Delivering Results — Growth and Value in a Volatile World: 15th Annual Global CEO Survey*, 2012, Japan base: 169 CEOs of which 45% are from companies with at least US\$ 1 billion in revenue in the last fiscal year and 73% are from organisations in business for over 40 years.

Japanese corporations, like their competitors, need talent models that fully mobilise and engage the best and brightest from Japan and around the globe. This need must be addressed and embraced throughout the organisation. How companies manage, incentivise, collaborate and communicate with their employees and partners can set them apart in a world where highly skilled people are an increasingly scarce and valuable resource.

To best identify the steps Japanese corporations — and in particular, their leaders — can take to improve national competitiveness and growth, it is important to understand the ways in which the world has changed and what that means for the realities of today's global business community.

Changing the way we work

Some leading companies in Japan are already taking important measures to adapt how they work. More of Japan's corporate community should address contemporary challenges and quickly, as global competition is accelerating. Among many important actions, companies should consider making critical changes to allow them to:

- **Harness the energy of entrepreneurs and employees alike** – Large companies can make changes big and small to support their innovative employees and Japan's community of entrepreneurs. There are ways to empower employees (both young and old) and outside partners to share their ideas and bring new approaches into their companies, even when this may involve tough choices and challenging more traditional business practices and approaches. Discontinuous innovation often means breaking with the location and culture of the mother company. In Japan, the concepts of "incubation from within" and "intrapreneurship" are critical to fostering the risk-taking that Japan so sorely needs.
- **Cultivate leadership from new sources** – Reversing today's low retention rates of career-oriented women and opening companies up to talent from around the world can bring in new perspectives to top-level management and provide a competitive advantage in a complex marketplace.
- **Seek greater diversity in the boardroom** – Diverse perspectives and experiences are an important asset for corporations, all the more so in times of change. The accelerating pace of change today — whether in technology, regulations or the global economy — means diverse perspectives and experiences at the board level can be a real asset to the corporation.
- **Refine the decision-making process** – Enhancing and refining chains of authority helps ensure companies fairly consider important new strategies or innovations that might disrupt existing business units.
- **Strengthen corporate governance** – With global investors placing an increased emphasis on corporate governance, corporations should evaluate whether their governance structures meet evolving international standards.

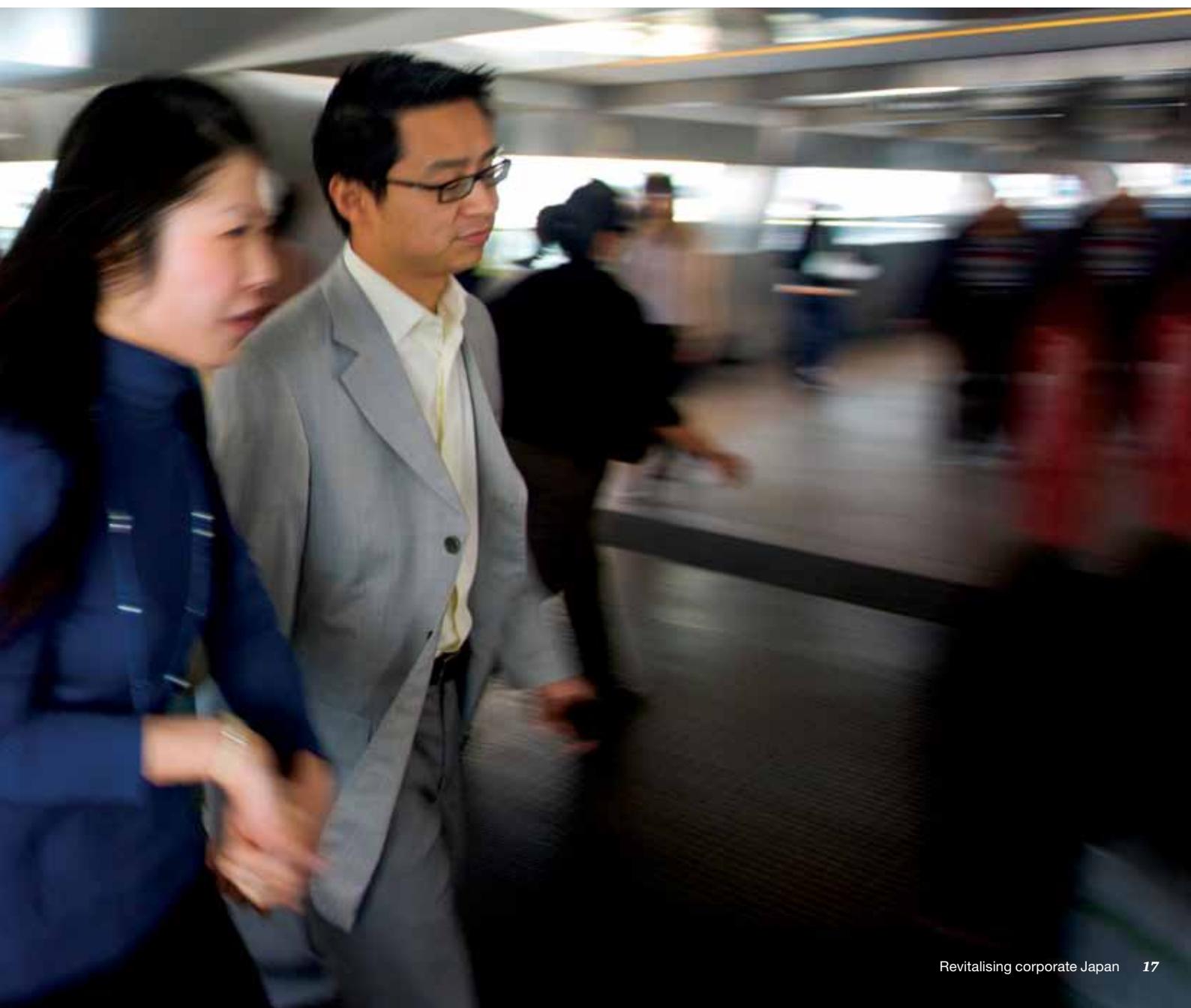
Reality 1

The arrival of Asia

Opportunities on Japan's doorstep



- *Asia is now the world's engine of economic growth.*
- *Asia's emergence is producing not only new consumer markets, but also world-class competitors.*
- *Japan appears to be lagging some other economies in integrating with the overall Asian economy.*
- *Competitiveness in the region can't be achieved by simply trying to "catch up." Japan Inc is too far behind already, so a different — and much more aggressive — approach is needed to fully participate in Asian growth.*



Reality 1

We are moving to another stage. Now we are expanding exports of final goods to China, and those final goods that are produced in China are being consumed by the Chinese rather than by Americans. So in this real sense our economy is becoming more dependent on China.

Takahide Kiuchi
Nomura Securities

Over the past 40 years, the world economy has expanded by a steady average of more than 3% per year, notwithstanding the decline of 2009. Masked beneath this stable path, however, has been a dramatic change in the engine of global growth: The world's economic centre of gravity has shifted demonstrably towards

Asia. In 1970, only three countries in Asia had a GDP in excess of US\$ 100 billion (in 2005 constant prices), led by Japan's growing economic might. By 2010, 16 countries in Asia were members of the US\$ 100 billion club, boosting billions of new consumers into the Asian middle class. (See Exhibit 3.)

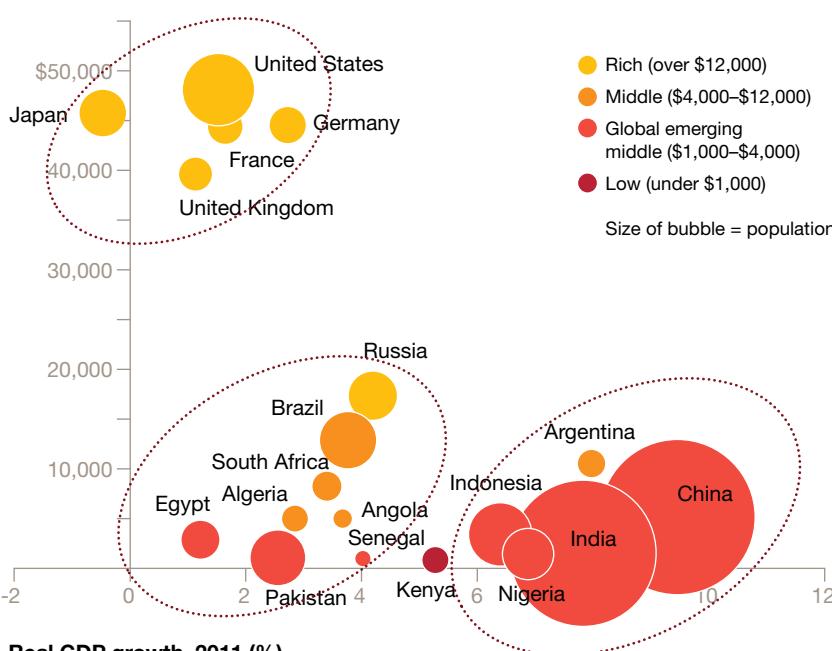
The rising attractiveness of nearby markets has not escaped the attention of Japanese companies. Outward foreign direct investment (FDI) headed to Asia averaged 31% of total FDI in the 2005–2011 period, a trend that needs to accelerate. For example, Kunio Yoda, CEO of Morito Company, Limited, a components supplier for automobile, train and apparel makers with global operations in China and the U.S. and, later in 2012, Vietnam and Myanmar, explains his company's changing approach: "We are shifting control of the network to Hong Kong. It is a global market, and so the president of the Hong Kong office is the top leader for our overseas subsidiaries. He is not an executive but an operating officer, and all of the overseas offices have been placed under him. He reports everything to Japan but it is all under him. We are moving management operations to the Hong Kong headquarters little by little."

And the pace of economic integration is accelerating. Aided by a strong yen and aware of constraints on domestic growth, Japanese companies have recently ramped up their acquisitions across Asia. In 2011, the number of Japanese deals in the region rose 42%, compared to a 26% rise in deals in Europe (which includes high-value deals such as Takeda's purchase of Nycomed) and a decline in North America. (See Exhibit 4.)

Exhibit 3: World GDP per capita, growth and population distribution

Customers from different markets are at different stages of development, each with vastly different needs and price points. Japan's corporations accustomed to serving customers in the top left quadrant of this chart need to change their approach, product mix and strategy to successfully go where the new growth markets are.

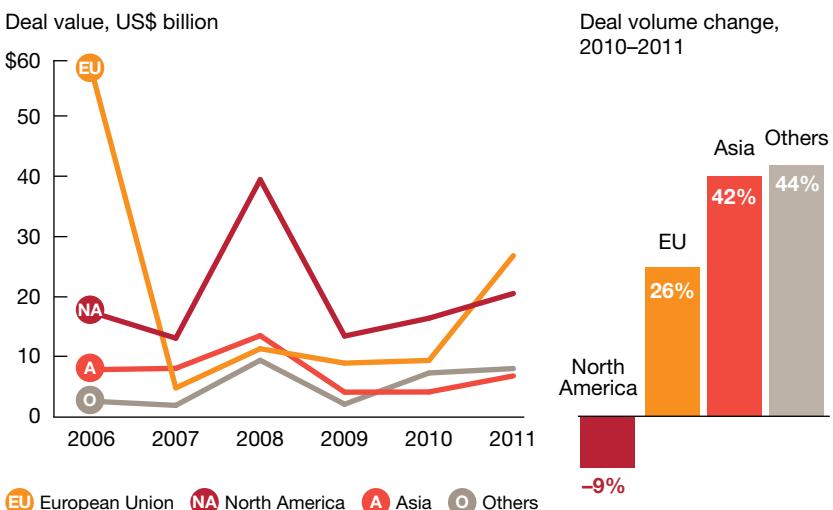
Annual per capita income, US\$



Source: IMF and World Bank

Exhibit 4: Change in Japan's outbound M&A, by destination

Outbound M&A has grown accompanied by an increasing focus on smaller acquisitions in the last year; however, investment in Asia and other emerging regions still lags investment in more mature markets.



Source: RECOF Corp.

Small and medium-sized Japanese companies are participating in the deal flow. According to Robert Eberhart, research leader of the Stanford Project on Japanese Entrepreneurship, Japanese start-ups in software and the high-tech materials and machinery that support new factories across Asia are seeing “explosive” growth. M&A in the region is a core strategy for these medium-sized firms. “Their innovations are directed towards

the factories and heavy industry as that’s where the opportunity is,” he told PwC. “They are right in the middle of the global supply chain and, in my view, they’re driving it.”

For many large corporations with existing operations in Asia’s largest economies, expansion across Asia is the next growth strategy. According to Yukio Toyoshima, General Manager, International Strategy Division of Hitachi, Limited, finding

the right talent within these markets, and leveraging their expertise to expand into other markets, is the key. When the company entered the Thai market, for example, they sent a Japanese manager with technical knowledge and manufacturing experience. Yet as the Thai economy grew, he said, “we came to need a general manager who could manage all of the business processes, including sales, procurement, etc., to explore another emerging market

Maintaining leadership in high-value niche markets

Tochigi-based Mani, a producer of precision surgical and dental equipment, generates two-thirds of sales today in Japan, the US and Europe, where its “tier one” customers reside. Offerings for “tier two” and “tier three” customers in developing economies largely follow from the products sold to tier-one markets.

Toshihide Takai, Senior Executive Vice President and CFO, believes that developing Asian economies will eventually represent a majority of sales — that markets currently categorised as “tier two” will become much more important to Mani’s business. To protect its advantage in a space that a low-cost, mass-producer will find difficult to take over

— among other products, the firm makes 100 million disposable needles a year and each needle is inspected by a person — Mani plans to continue to focus on equipment that surgeons and dentists need to use by hand, including needles and root canal instruments. In addition, R&D will remain in Japan, staying close to what Mani believes are that market’s standard-setting demands. Yet as production shifts to locations outside of Japan, Mani is more deeply integrating management from across its operations, rotating foreign employees into Japan, for example. Indeed, Takai believes that within two years it is likely that either one or two senior company officials in its Vietnam production centre will become a board director for the company.

Reality 1

in order to build a new plant for the business in Thailand.” The company decided that the head of a new manufacturing plant outside of Thailand “should be a local Thai resource who knows our Thai business operations very well. Such a cycle will be repeated when we grow our business in emerging markets.”

Implied within this conversation is the need for a new breed of leadership — one which can operate effectively both in Japan and globally.

But are corporations moving fast enough? As Asia’s most advanced economy, Japan should be thriving; its corporations are ideally placed both geographically and strategically because of previous investments and existing economic relationships in the region. Yet even as exports to the region have increased, Japan’s share has not.

Japan’s export mix tells the story. As Asian economies develop, Japan’s prosperity depends on maintaining or

increasing its share of high-tech and services exports, and deemphasising lower-value-added exports, where lower-wage Asian countries have already eroded competitive advantages. Yet, Japanese high-tech exports have actually decreased as a percentage of total exports to China over the past decade. High-tech exports to India also showed a slight decline in the same period. This is not just an issue for Japan, but for all high-wage economies. (See Exhibit 5.)

To date, Japan’s superb reputation for quality, innovation and advanced technology hasn’t led enough Japanese corporations to find and fill the high-value niches where they are uniquely qualified. In fact, Japan has seen an alarming decline in its export-pricing power. (See Exhibit 6.) That is, in a number of industries, Japan is maintaining a position in products where the value is declining precisely at the time maintaining and enhancing living standards in Japan requires increasingly focusing on higher-value products.

Germany, which started with a similar high-value, manufacturing export-led economy as Japan in the 1980s, has maintained its terms of trade, while Japan has seen an alarming decline — particularly over the last five to seven years.

What this shows is that Japanese companies are often not moving fast enough and are retaining lower-valued activities even as they are increasingly attacked by lower-wage countries such as China.

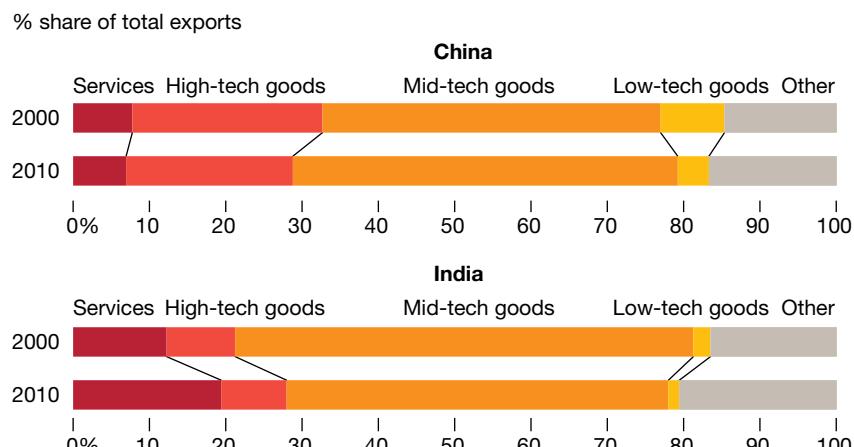
Asia’s increasing importance is not just producing new consumer markets; it is also creating new competitors. Korea’s emergence has led to new global champions in, for example, electronics (Samsung and LG Electronics) and automobiles (Kia and Hyundai), two sectors where Japanese companies have had great success historically. Many other companies emerging from China, India, Malaysia, Indonesia, Singapore and other growth economies are battling Japanese

Our generation has a chance because markets are growing in India, China and elsewhere in Asia, and we need to get to those markets.

Gen Miyazawa
Yahoo! Japan

Exhibit 5: Japan’s export structure to China and India

Japan is experiencing a declining share of high-tech and services exports to China relative to its total exports. The export structure to India shows better performance, albeit from a smaller base.



High-tech, mid-tech and low-tech are terms classified by the OECD. High-tech includes the majority of ICT products and also refers to electronic engineering, computers and office equipment, precision and optical equipment, aerospace and pharmaceuticals. More information is available at: <http://www.oecd-ilibrary.org/docserver/download/fulltext/5lgsjhvj7nkj.pdf?Expires=1343065200&id=id&accname=guest&checksum=7CB5ECDD0D19E00A01F24393FA89C8287>

Source: Oxford Economics/OECD

corporations in their own home markets, across Asia and the world.

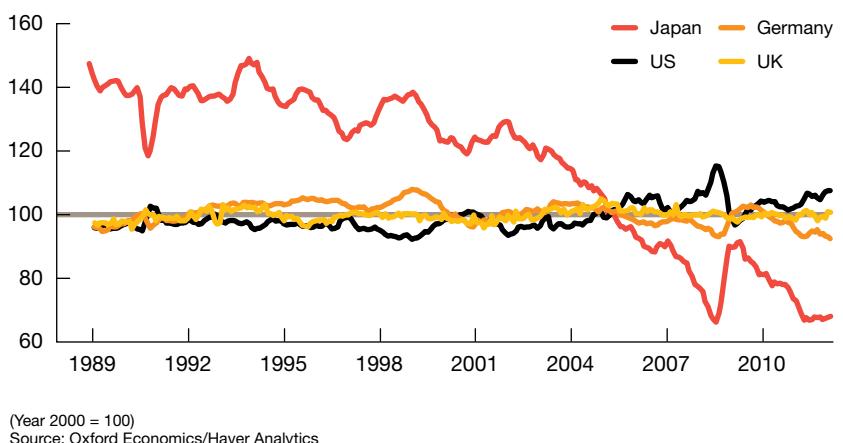
Services are playing an important role in Asian growth. Indeed, growth in services industries will outpace GDP growth in most Asian economies for the foreseeable future.

Aside from demands from growing middle-class markets for services, increasing intra-Asian business penetration will create new services opportunities as modes of communications, capital markets and regulatory policies across those markets adapt. And, of course, services exports tend to be high value-added. No doubt, there has been some progress. Retailers — notably online, in domestic convenience stores and in global chains such as Fast Retailing Company's Uniqlo brand — are making significant headway.¹ But Japanese companies overall are just catching up — and need to quicken the pace.

¹ "Japanese Banks in Asia: Lending a Hand," *The Economist*, May 19, 2012.

Exhibit 6: Decline in ratio of export prices to import prices

The terms of trade — the ratio of import prices to export prices and an important indicator of the competitiveness of a nation's exports — are declining for Japan while holding steady for the United Kingdom, Germany and United States. The decline shows that in a number of industries, Japan is getting less for its products.



(Year 2000 = 100)
Source: Oxford Economics/Haver Analytics

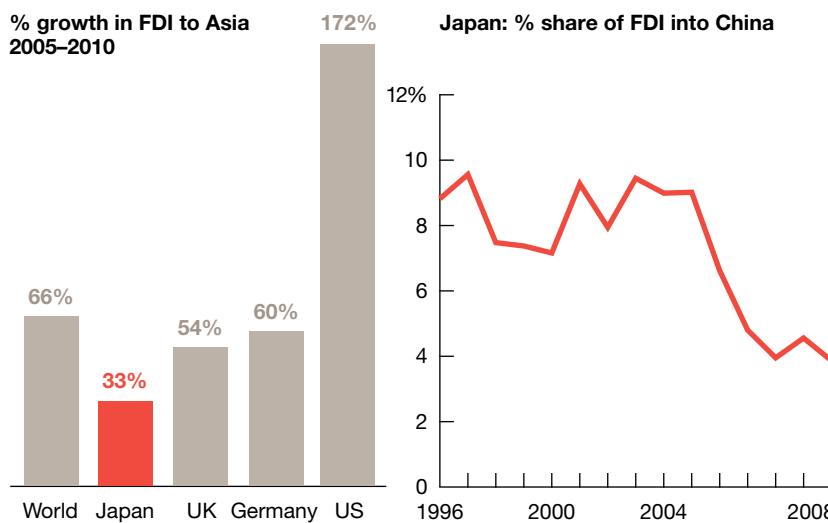


While the world is evolving to system thinking, unfortunately Japan is becoming a parts supplier. The margins are getting thinner and thinner, and [companies] still justify their existence because of this, yet it is very dangerous because you are on the lower end of the cost-profit side.

William H. Saito
Intecur, KK

Exhibit 7: FDI growth to Asia

A relatively lower rate of FDI growth means that Japan's share of investment into important Asian markets, particularly China, is declining rapidly.



Source: Oxford Economics/Haver Analytics

Companies can do their part; policy changes are also important. Takeshi Niinami, President and CEO of Lawson, one of Japan's leading convenience store operators, told PwC, "Bold reforms and revisions of regulation must be undertaken decisively in order to root out vested interests and create jobs. This will give hope to the younger generation and activate the nation."

Japanese investment in Asia has room to grow. Japanese companies have long experience working in Asia as they've shuffled production over the past few decades. That experience needs to shift from the arm's-length supply relationships to complex market-facing collaborations, as we cover in Reality 2 and Reality 3.

Japanese foreign direct investment is not keeping pace with other major investors. (See Exhibit 7.) The absolute level of FDI is not the most important factor to consider; after all, it can be wasted. Yet given the overall weight of the Asian economy and Japan's own economic structure, Japan should play a significant and meaningful role investing in Asia.

Similarly, Japanese M&A remains below that of Europe and the US, relative to the sizes of their economies, notwithstanding a record year in 2011. Japanese corporations continue to sit on a large stockpile of cash despite ideal conditions for acquisitions, including a soaring yen and a need to enter growth markets.

"Global competition is getting harder and harder for Japanese companies. They have to change, probably by restructuring by themselves, domestically and also globally," said

Myanmar

Myanmar offers an example of the significant opportunities that exist in frontier markets as well as the large role South-South trade can and does play. For example, Myanmar's GDP is forecast to expand by 4.8% annually in 2012 and 2013, driven by large investment projects funded by investors from China, South Korea and Thailand in natural gas and infrastructure. Growth is projected to accelerate to an average of 6.5% a year in 2014–2016 due to anticipated increases in foreign investment following the expected lifting of sanctions in 2013 as the local government progresses on human rights issues. As Northern firms begin to gain access to this market, the risks and opportunities presented by existing South-South trade and investment will come to fruition.

Many of my customers are moving to Vietnam, Indonesia and now Myanmar. A ton of companies are in Myanmar right now. We are going to open [a sales] office [in Myanmar too].

Kunio Yoda
Morito Company Limited

Tamotsu Adachi, Managing Director and Co-Representative in Japan for The Carlyle Group, “They need to expand their global businesses by acquiring global companies and foreign companies; also, within Japan, consolidation is probably critical for a lot of industries.”

While there are examples of Japanese corporations that have done an excellent job adapting to the rise of Asia, these seem to be exceptions. Many mid-sized Japanese companies still view their main competition as domestic rather than global.

“Globalisation is obviously important but what is needed to achieve globalisation is more than simply going abroad. It is also extremely important that globalisation is in-bound too, that foreigners come to Japan,” said Eizo Kobayashi, Chairman of Itochu Corporation. “We must deeply understand the ways of thinking, laws, regulations, commercial ethics, business practices, religions, history, cultures and other characteristics of the people of each country in order to promote globalisation.”

We cannot do everything in Japan. We have R&D centres in Europe and the United States but we are shifting to more emerging markets; for example, to India and China.

Toshiyuki Shiga
Nissan Motor Company, Limited

The rise of collaboration in Asia

The infrastructure sector illustrates how multinationals use new strategies involving complex alliances. Infrastructure projects, such as new power generation plants, are complex and have components that extend for years. Services, maintenance programs, skills training and project financing are no longer sideline programs for infrastructure companies in Asia; they are an integral part of a product offering. It often takes several partners to bring these offerings to market.

On top of these structuring complexities, heightened competition from low-cost rivals based in Asia and changing environmental standards are influencing market dynamics.

Given these realities, Electric Power Development Co., Ltd (J-Power), is pursuing what Yoshihiko Nakagaki, a Senior Board Advisor and former President, calls integrated infrastructure systems and project-based solutions to expand in Asian markets. The clean-coal technology company’s Build-Own-Operate-Transfer (BOOT) investment in a coal-fired power generation plant in Indonesia in 2011 is a case in point.

Working together with Japanese trading group Itochu Corporation and Indonesian coal company PT Adaro Energy, the deal involves the construction and operation of a new plant in central Java. J-Power’s ultra-supercritical (USC) technology for higher energy efficiency and lower carbon emissions is an important component of the joint offering. “As we face vehement competition in this export business, our quality in technology determines whether or not we can win a deal. This is going to be the next challenge we will face,” Nakagaki told PwC. “What enabled us to win the deal was our technology development results.”

Engagements for J-Power in developing Asia won’t end with construction. The company expects to continue with skills training and technology development in the countries where it operates. This too, Nakagaki believes, is part of the attraction of its offering for Asian customers.

Business implications

Where is your company focused in Asia?



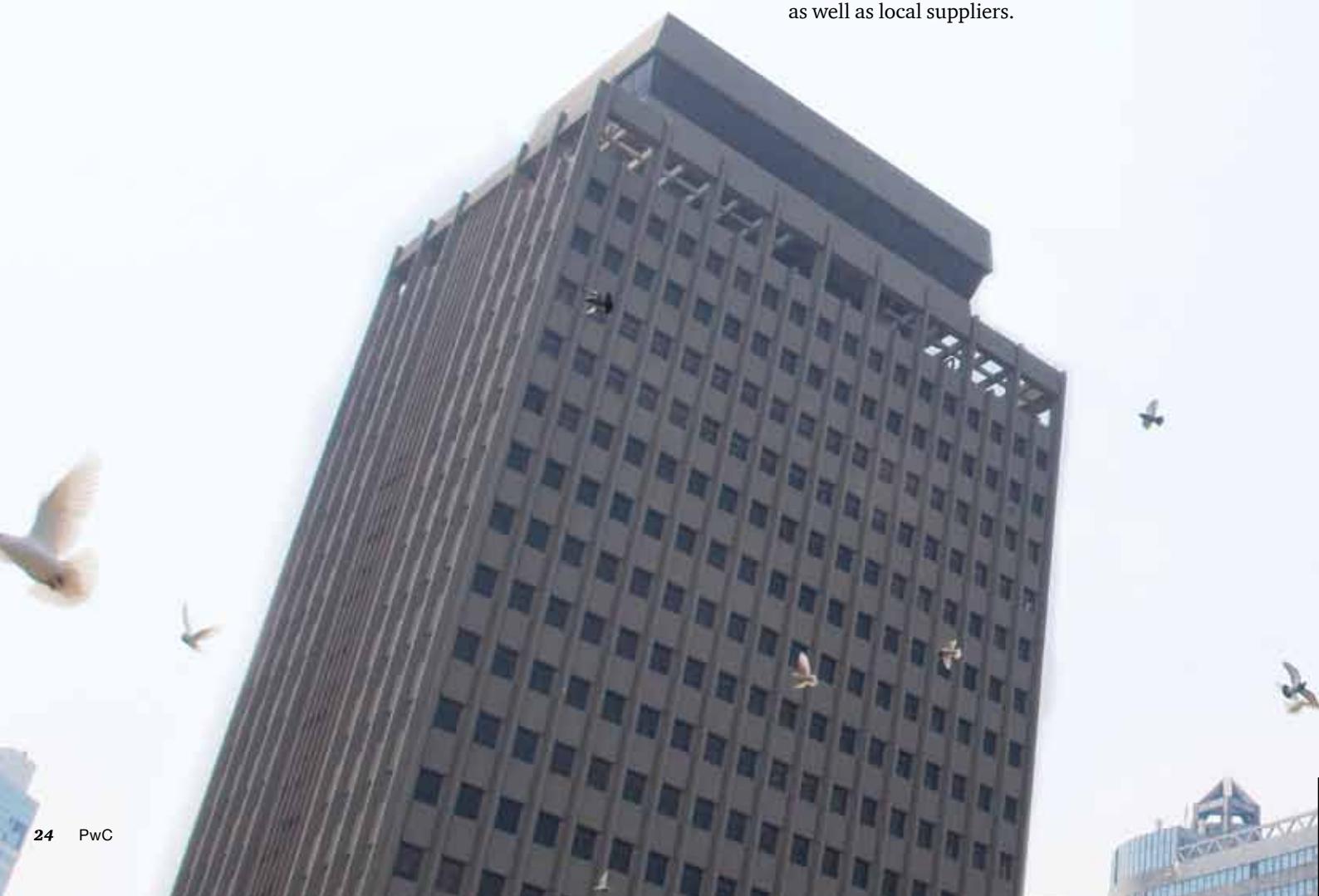
Fast-growing Asian economies are evolving quickly. The spread of low-cost assembly and production, an array of trade pacts and infrastructure build-outs are pushing the boundaries of business-to-business opportunity in high-value niches for those domestic markets. Understanding where to best locate manufacturing or development assets

within the region is as important as deciding in which countries to market your products. These decisions involve a host of considerations such as intellectual property (IP) strategy, tax credits, local market requirements and access to talent. A successful growth strategy will, in part, be driven by a thorough assessment of these and many more factors.

Given the diversity in markets — and in standards — how will your company achieve scale in your priority Asian markets?

The processes that make operations efficient in developed markets don't always work in regions where suppliers are undercapitalised and infrastructure insufficient. This is particularly true as different competitive models such as state-owned enterprises thrive in this region.

On top of locally driven adaptations, companies are optimising global capabilities where they can to achieve cost, talent and market access goals. This is evident in that almost every major company is establishing R&D centres around the globe and they are sourcing from an ever-wider base of global as well as local suppliers.





What is the right approach to deal-making and alliances in the region?

Any strategy for Asia needs to have M&A as a key tool. And yet, the traditional Japanese approach to acquisitions will not work in these rapidly evolving markets. A hands-off strategy — where few operations are integrated and local management runs largely independent of headquarters after an acquisition — faces diminishing returns in a region that is rapidly changing. A cohesive, company-wide integration strategy can better balance global and local capabilities, achieve synergies and, in turn, establish the flexibility required to respond more quickly to opportunities, as they are more likely to spread from investments in these markets than from headquarters. Whichever the approach, however,

management needs to “think locally” to take advantage of any newly acquired assets.

There are a variety of partnership structures — from joint marketing or development agreements to joint ventures and acquisitions — that can be used in the pursuit of growth and establishing a presence in these economies. As a result of the speed with which these alliance models are changing, companies need to actively manage their various relationships. The rewards of effective management will be high (in the form of profitable growth) — and the costs of not doing so high as well (in the form of lost IP or competitiveness).

How is your company planning to address the changing needs of emerging middle classes in Asia?

Needs differ greatly from country to country, and even city to city. As the (updated) saying goes, “if you’ve seen one emerging market, you’ve seen one emerging market” — in other words, don’t assume that what worked in one place will work

in another. Product and services offerings need to be tailored — or built from scratch — for the particular needs and tastes of emerging middle-class segments. Brands often need to be rebuilt too.

How can you compete with your “fiercest competitor” from the new Asian economic powers?

Within Asia, new competitors are growing rapidly. From giants like Samsung to government-sponsored entities in China, understanding the competition is a critical first step. From there, it is imperative to consider novel approaches to these markets in response. One way to do this is to have management, including local representatives in new markets, imagine that they have been given access to capital and local talent to compete against their own company. Most executives know their company’s major market weaknesses — the soft underbelly, if you will — and where the opportunities lie in a market for a firm that can move with a new model. This exercise helps senior executives find new ways to compete.





Reality 2

Increasing business complexity

Companies are managing a greater number — and a wider range — of stakeholders

- *Interconnectedness among economies is vastly increasing the number and diversity of meaningful economic relationships.*
- *Complexity manifests not only in trade and financial relationships, but also in stakeholder relations.*
- *This environment requires organisational principles that are different from those that have succeeded in the past.*

Reality 2

It comes as little surprise that 59% of CEOs around the world believe emerging markets are more important to their future growth than developed markets.² Yet, when thinking of emerging markets, some analysts focus attention on a select few economies with size and influence — think of acronyms like BRICS (Brazil, Russia, India, China and South Africa) or N11 (the “Next 11”).

Those groupings alone don't fully capture how broad and diverse the global economy has become. If South America, developing Asia, Africa and the Middle East were combined into a single market, it would represent 85% of the world's population, half of the world's GDP and an aggregate growth rate much higher than that of developed economies.³

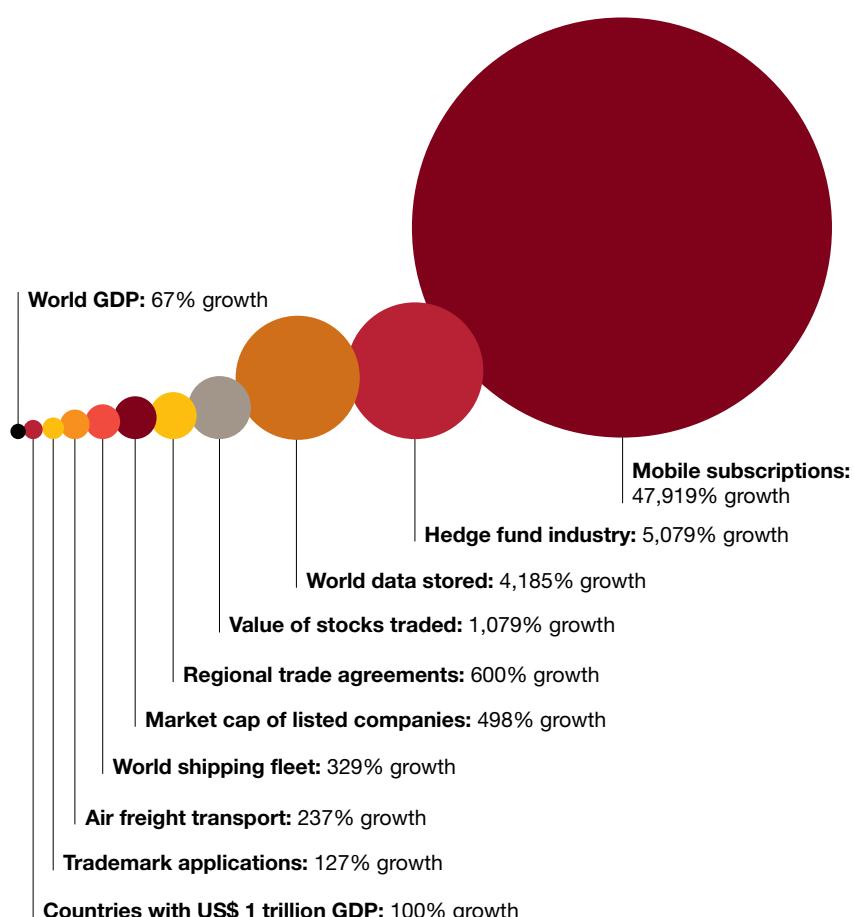
That's an enormous opportunity — but one fraught with complexity. The growing interconnectedness among fast-growing regions and countries has vastly increased the number of economic relationships — in trade and investment, culture and people — that an organisation must keep up with. (See Exhibit 8.)

2 PwC, *Delivering Results — Growth and Value in a Volatile World: 15th Annual Global CEO Survey, 2012*. Available at: <http://www.pwc.com/gx/en/ceo-survey/download.jhtml>.

3 PwC uses the term SAAAME to describe this grouping of South America, emerging Asia, Africa and the Middle East. See PwC, *Project Blue: Capitalising on the Rise and Interconnectivity of the Emerging Markets*. Available at: <http://www.pwc.com/gx/en/financial-services/projectblue/rise-of-the-emerging-markets-saaame/rise-of-the-emerging-markets-saaame.jhtml>.

Exhibit 8: Two decades of increasing complexity

Despite remarkable global economic growth of 67% over the last 20 years, many factors related to the global economy are growing even faster. The result is a world with deepening complexity.



Source: PwC analysis based on data from various sources, including UN, World Bank, World Shipping Association and government databases

Why can't we run the decision process differently to support [local staff] so that they can innovate themselves, decide on the business, the speed, how to communicate? You can't succeed in the US or Europe in the Japanese way. You need people to do it on their own. My responsibility was really to style that kind of management organisation.

Ray Hatoyama
Sanrio Company, Limited



Operating in a G-Zero world

“It’s not enough to invest in partnerships. These companies must invest in a culture of adaptability.”
Ian Bremmer, President, Eurasia Group

G-ZERO - - \JEE-ZEER-oh\ - - n
A world order in which no single country or durable alliance of countries can meet the challenges of global leadership. What happens when the G7 is history and the G20 doesn’t work.

In his new book, *Every Nation for Itself — Winners and Losers in a G-Zero World*, geopolitical strategist Ian Bremmer argues that a new political reality is taking shape, defined by the lack of a single power or alliance capable of providing global leadership. The resulting leadership vacuum and diverse political and economic values have produced global gridlock when coordinated action is required on many issues, from the stability of the global economy and climate change to cyberattacks, terrorism, and the security of food and water.

Who wins and who loses in this exceptionally fluid international environment? The key is to be a “pivot state,” a country able to build profitable relationships with multiple other countries without becoming overly reliant on any one of

them. The ability to pivot is a critical advantage. Bremmer provides examples of some “pivot” countries, like Brazil, Indonesia, Turkey, Vietnam and Singapore. Africa, the world’s most under-rated growth story, has become a pivot continent. And not all pivot countries are in Asia or emerging markets: on the back of recent energy deals, Canada has successfully pivoted from an exclusive US sphere to one that includes China.

What are the lessons for business leaders? Multinational companies will have to move past traditional models of cross-border collaboration and integration. The successful companies will be adapters — those that understand the changing competitive landscape and are agile to exploit the advantages it provides. Perhaps that means investing in markets with different tax or regulatory landscapes. Or it can mean transforming a state-backed rival into a commercial partner by offering something that a government-controlled enterprise can’t get anywhere else, like unique expertise or specific technology. Adaptability, however, is not one-size-fits-all. Successful companies in the G-Zero world will be the ones who can “pivot” easily and quickly to respond to fast-evolving markets, cultures, economies and governments.

Reality 2

Established patterns of doing business are changing. Traditional centres of commerce are being bypassed. Sovereign wealth funds in the Middle East, for example, no longer need to flow capital through banking centres in London, Tokyo and New York. They can invest directly in Latin America, developing Asia and Africa. And consider how Africa, with its fast population growth and huge resources, certainly adds to the complexity of the world economic system.

One consequence of this is that economies have become more specialised over time. According to

an OECD analysis, over the past 30 years, G7 economies have become more concentrated, with the top four sectors representing 55% on average of total value added as of 2007.⁴

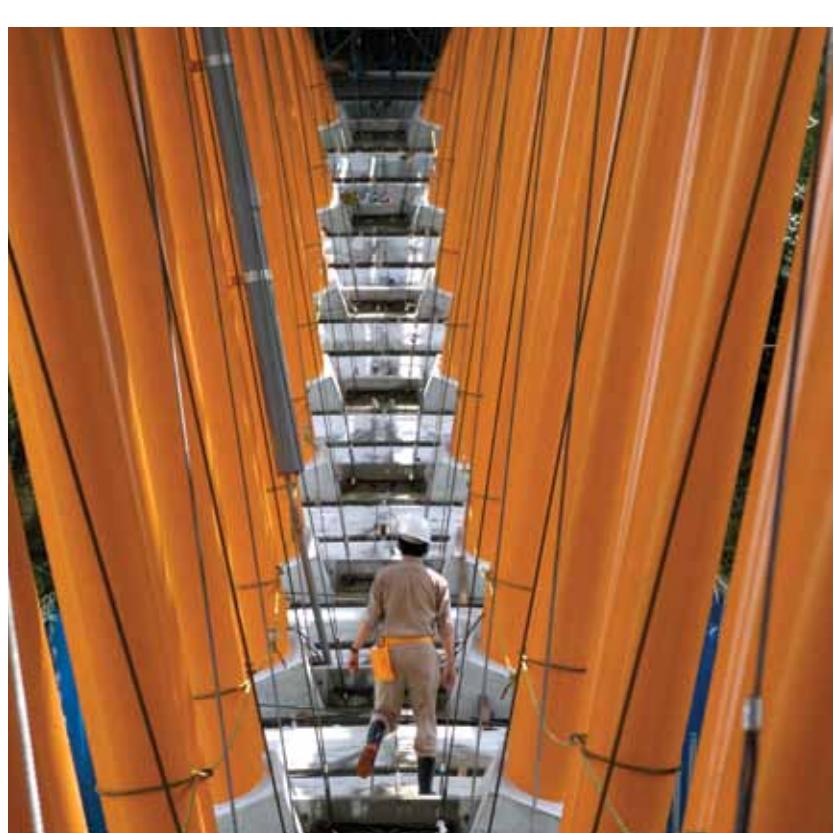
Complexity creates tremendous new management challenges.

As Yoshihide Fujii, CEO of Toshiba America Incorporated, explains, business leaders face a much wider range of strategic choices. “Where do you allocate R&D? Where do you do designs, manufacture, procure the parts and components, and where do you sell? The logistics are very complex.”

As are the risks. The profound effects of deeper economic integration started to become more appreciated after the Great East Japan Earthquake in 2011. The tragedy devastated the entire country of Japan, not just the Northeast area. But businesses around the world in sectors such as automotive and electronics also realised that their supply chains were much more exposed to the region’s tragedy than they first thought. As leaders understood how quickly the effects of distant events could spread, cascading both financial risks and inventory supply chain risks, they began to reposition inventories to erect firewalls across their supply chains and to seek greater transparency — especially into the strength and resiliency of their business partners — from their networks to assure robustness. And business continuity planning was reinforced as a critical exercise.

In one survey during the fall of 2011, a quarter of CEOs across Asia Pacific planned to build *more* redundancy — not less — into their supply chains.⁵ Just 10 years ago, those moves would have been inefficiencies targeted for elimination under “lean manufacturing disciplines.” Now they are important risk management responses to an integrated environment.

Complexity is not limited to the supply chain. Today’s complexity is giving rise to demands for greater transparency as diverse pressures of governance and accountability in different locales rise, argues David Kennedy, Director of Harvard Law School’s Institute for Global Law and Policy. The more businesses rely on collaboration between diverse



⁴ OECD Directorate for Science, Technology and Industry, “Competing in the Global Economy: Sectoral specialisation.” In *OECD Science, Technology and Industry Scoreboard 2011*. Available at: http://www.oecd-ilibrary.org/science-and-technology/oecd-science-technology-and-industry-scoreboard-2011_sti_scoreboard-2011-en.

⁵ PwC, *The Future Redefined: Asia Pacific at an Inflection Point*, 2011. Available at: <http://www.pwc.com/us/en/apec-ceo-summit-2011/index.html>.

Complexity's new demands: Q&A with Harvard Law School's David Kennedy

David Kennedy is Manley O. Hudson Professor of Law and Director of the Institute for Global Law and Policy at Harvard Law School, a member of the Council on Foreign Relations, and past Chair of the World Economic Forum's Global Advisory Council on Global Governance. Here, he speaks with PwC on the implications of rising business complexity for executives and corporate directors.

PwC: What is behind the drive for more corporate transparency?

David Kennedy: First and foremost it is coming from business partners who need to understand who they are dealing with. If they cannot see your exposures across geographies, then there is a risk, which will change their assessment of investing with you. It may not be decisive, but it will be a factor.

Second, it is coming from an investment community. They want to understand the management structure and corporate governance patterns in the same way they understand accounting practices.

Third, it's coming from a diverse regulatory environment. We continue to live in a world in which the economy is becoming increasingly integrated but the political and regulatory environment for that remains fragmented.

If you put the pressure from business partners and investors together, plus the internal pressure to be able to make your business model and regulatory practices visible and compliant with diverse regulatory demands, then you have a recipe for a reexamination of governance structure. And that requires a kind of management innovation that will be difficult and is difficult for everyone.

PwC: What are some of the ways corporations are becoming more visible?

DK: The ISO14000 standards in environmental management are an example. They provide a vocabulary of transparency across businesses. Japan was very quick to become a leader in compliance because they could see

the significance of industry-set and industry-monitored manufacturing standards for disciplining their own supply chains. That exact analogous process is now happening across a wide range of other elements of the business process.

PwC: How is management changing as a result?

DK: The challenge is to develop and sustain a culture of leadership that is responsive to this newly integrated and diverse global environment. Management teams that are multinational, that involve people who have had a lot of global experience, who are familiar with dealing in diverse business and regulatory environments at the same time are going to be more easily able to assess those risks in a satisfactory way. Building the judgements and insights of diverse components into the central leadership structure is a challenge to every industry that has long depended upon leadership candidates who have come up through the lines.

PwC: Is there a particular challenge for Japan with global business complexity?

DK: Japan has supported their national champions at home, supported their penetration of foreign markets, but they have not seen their role as participating in a global strategic discussion about the regulatory playing field for transnational business. Supporting Japanese companies in an increasingly divergent globalised economy will mean partnering with business in quite different ways from those characteristic of the export-led period of expansion.

Leading Japanese industry has benefited from governments that understood very precisely how to move the levers of their national regulatory and financial systems to support national leaders as they penetrated the global market. The game has changed. They must now figure out how they can change the environment for their companies abroad rather than change the structure of incentives for them within Japan, as businesses insert themselves into a more dispersed global economy.



The electronics industry, including semiconductors, is one of the cores of monozukuri. Japan has lost out miserably and why? In my mind, it is because of the marketing.

Shoichi Oka
Japan Industrial Solutions (JIS)

groups of people, the more they need to open up on procedures and processes and thus accelerate the shift from disclosure to dialogue.

Corporate governance “is probably the weakest area that Japanese companies have,” said Carlyle’s Tamotsu Adachi. Weak financial disclosure among a minority of companies “is definitely hurting the image of Japanese companies and the Japanese business community.”

Different governments have different expectations for private-sector actors. Other stakeholders have become more demanding and new stakeholders, such as corporate social responsibility (CSR)-driven groups, have arisen, increasing the dimensions of demands. And, of course, technology makes this all happen in a compressed time frame. Product cycles in consumer electronics, for example, have accelerated to 18 months or less with software upgrades in between.

The auto industry, for instance, depends on good collaboration with the community where production sites are located. As Carlos Ghosn, Chairman and CEO of the

Renault-Nissan Alliance, told the French Chamber of Commerce and Industry in Japan in March: “Corporate social responsibility is not a fad. It is the building of relationships between companies and communities. Ethically and morally, it’s the right thing to do—and it’s also the smart business choice because corporate social responsibility ensures competitiveness and allows us to understand current and future customers on a truly personal level.”

Japan’s corporations — like corporations everywhere — need to deal with complexities such as increased economic integration. When the world was simpler, executives could control production conditions in a few key locations and understand customer dynamics in relatively similar core markets from headquarters.

Today, there is a greater need to ensure a central strategy is adapted to fit operations in different markets. That usually means devolving greater authority to increase the corporation’s ability to respond to local conditions. Thus, decisions can be taken under greater uncertainty, with greater speed.

We need drastic change in order to respond to global competition. Maybe it's not just a leadership problem, but (one that is) an overall aspect of the company.

Takahide Kiuchi
Nomura Securities

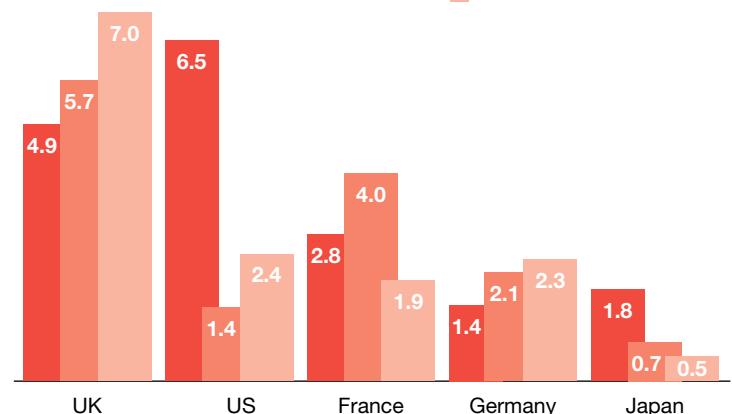
On balance, Japanese corporations have been slower to adapt to today's complexities. They have traditionally been more deliberate when considering major strategic decisions. A conservative approach to investing risk capital has served Japanese companies well in the past. Yet being deliberative can actually put more capital at risk and it is now exposing them to fast-moving competitors — both from outside Japan and from Japanese upstarts — that are more ready and willing to take big bets quickly (See Exhibit 9.)

Ray Hatoyama, Director and General Manager of Sanrio Company, Limited, the company behind the Hello Kitty brand, believes more responsibilities should be held within operations in priority markets to speed up decision-making and address innovation needs. "You can't succeed in the US and in Europe with the Japanese way," he said. "You need people in local areas to do it on their own. My responsibility was really to implement that kind of management organisation style."

Exhibit 9: Japan deal activity lags mature economy peers

Average of M&A from 2005–2010 as a % of GDP

Domestic M&A as a % of GDP
Outbound M&A/GDP
Inbound M&A/GDP



Source: Thomson Reuters, with PwC analysis

If the yen stays high, and Japanese companies are smart, they will buy more and more assets overseas, and try to integrate them. That is where their lack of ability to interface becomes a real problem.

Kenneth Grossberg
Waseda Marketing Forum

Acquisitions in an era of complexity

Japanese corporations are in the midst of a wave of M&A activity; the surge in deals in 2010–2011 — and extending into 2012 — is bigger than previous booms in the late 1980s and early 2000s. Now, as then, a strong yen and high corporate cash holdings support the acquisitions drive.

But much has changed. A recent Economist Intelligence Unit (EIU) analysis says this time, targets have been strategic rather than the sort of “trophy” deals seen in previous M&A bursts. Acquisitions today tend to be smaller and targets tend to be closer to core competencies. Growth in deal numbers is strongest in Asia, where companies are seeking to extend their market reach. The EIU further concluded that Japanese buyers are also more likely today to seek full control over their acquisitions, suggesting a move away from the minority-stake investments that restricted buyers’ influence to a limited sphere of operations such as sales.⁶

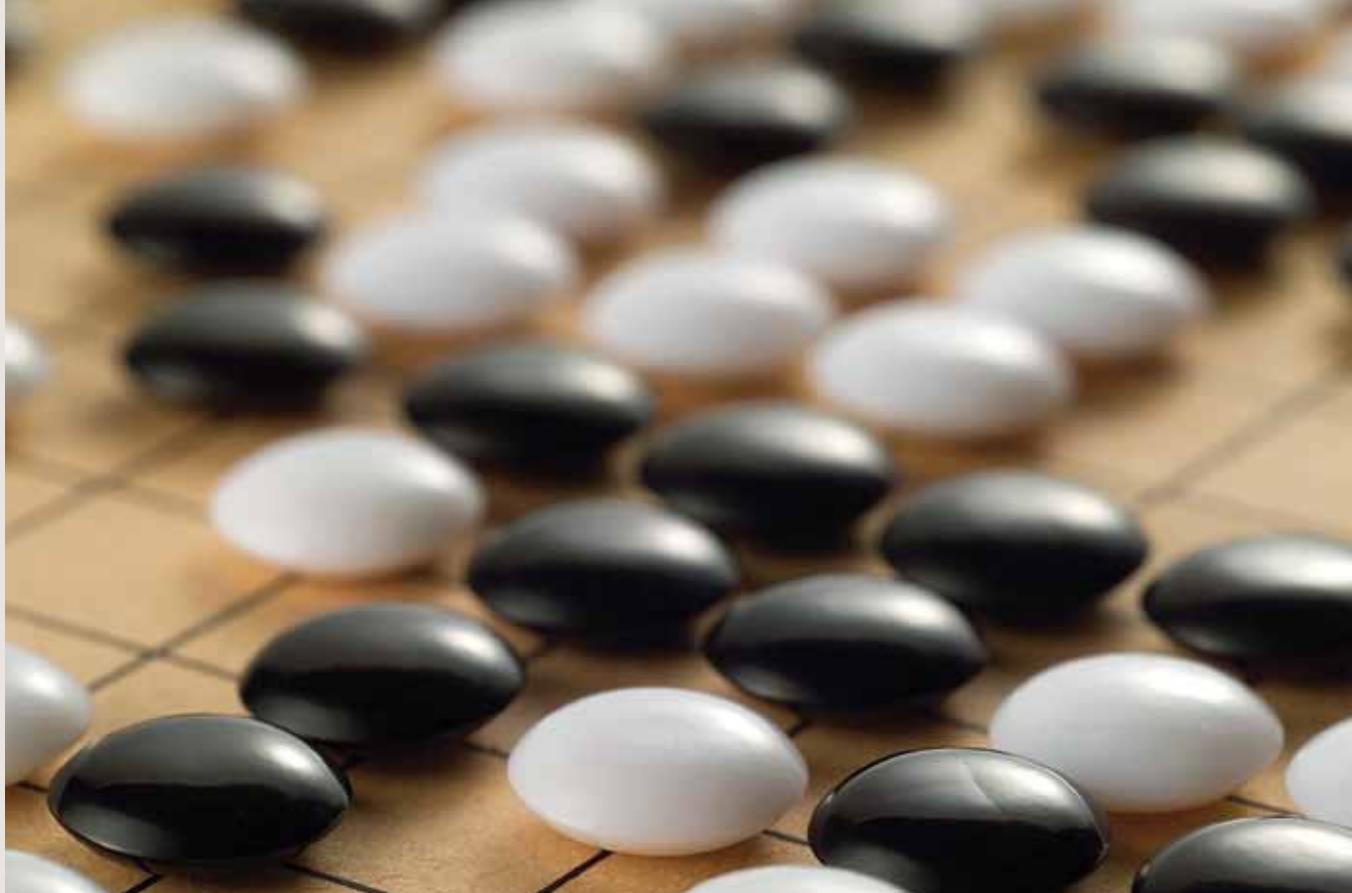
As recent deals at an active acquirer such as the Japan telecom conglomerate NTT Group show, growth strategies can be achieved by acquiring access to markets outside of Japan. NTT Communications Corporation, a long-distance and international communication and information and communications technology (ICT) solutions provider within the Group, is taking a controlling stake in data centre operator Netmagic Solutions to

accelerate the expansion of its infrastructure and cloud services in the Indian market. “Speed is key,” said Akira Arima, President and CEO of NTT Communications Corporation. “Everybody is talking about cloud-based services. You need to enter the markets as soon as possible to obtain a leadership position.”

Sister company NTT Data Corporation, an IT service provider, has been focused on large IT markets, still mainly in the US and Europe, with the aim to become one of the five biggest IT vendors in the world. “When we think about our growth in terms of the next 10 or 20 years, it seems really obvious that there is no future for companies that rely on the domestic market,” said Takashi Enomoto, a corporate advisor and former Senior Executive Vice President and Executive Board Member. “The hurdles [for NTT Data’s acquisition targets] get higher and higher. The companies that we are approaching after having whittled down our long list are entirely different from the companies seven years ago and even three years ago.”

NTT Data has changed how it approaches acquisitions, incorporating lessons from previous experience in the early 1990s. “In hindsight, it is clear that in those early days we were somewhat naïve in our projections,” said Enomoto. “However, those early experiences now enable us to do what we are doing today.” Top

⁶ The Economist Intelligence Unit, *Buying Up the World: Japan’s Outbound M&A Spree and the Bid for Value*, March 2012.
Available at: <http://www.managementthinking.eiu.com/buying-world.html>.



management is involved in face-to-face meetings with the management team of target companies, often in English. “It is very important to understand not only the financial figures, but also who they are.”

Even with the most disciplined approaches to acquisitions, the risks of failure are high. As Kathy Matsui, Chief Japan Strategist for Goldman Sachs Japan Company, Limited, noted, “It is one thing just to acquire an asset, a company abroad, and say, ‘I’m 20% global now,’ but it is quite another thing to run the business... How are you integrating that business? How are you going to make that business $1 + 1 = 3$ as opposed to $1 + 1 = 2$? ”

Doubts remain whether Japanese acquirers, particularly large companies, in general are moving fast enough today to fully integrate target companies once an acquisition closes. The EIU report terms this the “one area in which Japanese companies seem to be still off-course.” The larger the acquirer is, the more difficult it can be to move quickly through the various stages of an acquisition, starting with the investment decision. Tamotsu Adachi, Managing Director and Co-Representative in Japan for The Carlyle Group, said the private equity investment group finds a lot of opportunities to work with midcap companies, but added that “as far as the large corporations are concerned, they are still very slow at making decisions.”

How quickly an acquisition is integrated, with a process that makes the strategy transparent to all stakeholders, is important. A PwC survey of deal-makers found a clear and direct link between the speed at which integration activities are pursued, the rate at which integration goals are achieved and deal success. In fact, those reporting higher levels of deal success — especially financial and operational success — also reported a tendency to align leadership styles and speak with one voice in three months or less.

Talent, in particular, must be addressed directly in postmerger integration. Buyers who are accustomed to keeping a foreign acquisition (and its managers) at arm’s length from headquarters — to allow the business to continue doing what it’s good at — are finding this approach will no longer suffice. Just as IT systems are now integrated quickly at the close of the deal — precisely because the advantages of a fully linked global network are so clear — so too must global management teams integrate. The strong rise in M&A activity in the past two years is a welcome sign, but these deals will need to follow through with strategies that tackle important integration hurdles and retain pivotal talent. As Carlyle’s Adachi noted, “In order for Japanese companies to really manage their acquired companies well, they really have to bring the global management team into the Japanese management team. That is the key.”

Business implications

Have you assessed and prepared for the impact of global risks?

Having a plan for different scenarios — from food shortages in Africa to a Euro-zone breakup to an outbreak of cyberwarfare — is essential. You can't prepare for every risk that's out there — try to do so, and the costs would be overwhelming. So you need to focus on the threats with the greatest potential impact, and forcing yourself to consider these risks invariably increases the leadership team's grasp of a very complex situation. As an example, considering supply chain risks today, some companies have identified alternate outsourcing providers if their primary provider's contingency planning is less mature. In the end, this kind of exercise should lead an organisation to be more flexible and adaptable.

How integrated are your foreign operations within your business?

Organisations that are able to speak with one voice globally and are more fully integrated, from IT systems to management, are better equipped to compete in a more complex global business environment. If all decision-making takes place at home, foreign operations will become slow and inflexible. They will be out-manoeuvred by smaller, more nimble, local competitors. At the same time, if far-flung operations are granted a large degree of autonomy, headquarters is missing out on understanding the market dynamics on the ground. Finding the right balance is a key challenge for today's top management.

Are members of your management team in agreement on the important stakeholders in your organisation?

Corporations operating globally are dealing with a much wider array of partners and stakeholders than in the past. Businesses need to understand who is shaping the agenda for their companies and industries — and how the globalisation of their business is transforming stakeholder maps. Management needs to constantly reassess who has the most at stake from their operations. Relatively small increases in the transparency of businesses — internally (on promotion practices, for example) and externally (in explaining corporate decisions to shareholders, for example) — can pay big dividends. This is especially true as Japanese corporations come into contact with new stakeholders from increasingly diverse perspectives and backgrounds than they did in the past. With recent scandals fresh in their minds, investors are calling for more disclosures or improvements to corporate governance.

A discussion about what governance is needs to take place; otherwise, it will be de-minimised to an internal control or compliance discussion, which is not really governance, it is only a part of governance.

Shoichi Oka
Japan Industrial Solutions (JIS)

As the size and complexity of your operations increase, how can you ensure that your board has the right information to effectively oversee the business and communicate effectively with investors?

Do your board and executive team have a diverse view of the world?

The more that dialogue and discussion at the highest levels of the organisation are infused with diverse global experiences and perspectives, the better the company can grasp how the world is changing. Diversity can help keep a board's collective skill sets sharp for overseeing and mentoring management and being connected.

Are you planning your post-acquisition strategy to meet tactical integration goals?

Integration of acquisitions must happen quickly and systematically to successfully capture anticipated value. This is true even in Japan where important measures must be taken to preserve the culture and value of acquired institutions. The period of time between deal announcement and deal close, and the first 100 days postclose, are absolutely critical to preparing the combined company to maximise value over the long term. Your approach to deal integration will vary with geography and transaction.

How are you modelling for future constraints on energy supply?

Restrictions on electricity supply — and rising costs — are deeply concerning to Japanese manufacturers, but the new realities of energy constraints will affect Japanese business more broadly. The summer of 2011 was challenging for all in Japan as building temperature control and electric usage — including in manufacturing facilities — were limited to make up for the decreased supply. Corporate management should consider drawing up mid- to long-term energy supply and usage plans, based on the national energy policy. Changing environmental standards regarding emissions, for example, are an important component of such plans.





Reality 3

New models of innovation

Are Japanese businesses adapting their approaches to innovation?

- *Japan ranks highly with patents in nanotech, biotech and energy alternatives, key technologies that will lead future growth.*
- *Global innovation today embraces open and collaborative approaches to attract more ideas and technology — and to lower the risk.*
- *Japan's innovation abilities are clear, but one of the issues is whether companies are exploring enough avenues with customers and other partners to expand their innovation capacity.*

Reality 3

Anyone can manufacture or design, but I still think we can find new spaces for us to survive or become more successful. I am very confident that technology will continue to progress.

Yoshihide Fujii
Toshiba America Incorporated

With advancing technologies driving whole new industries and shaking apart established modes of doing business, being innovative in part simply means being open enough to see what's coming. To do that, a company has to join the conversation — and that conversation has become increasingly global.

The amount of knowledge and experimentation in business is exploding, as are the number of countries, companies and people developing innovative products, ranging from mobile payment systems in Kenya to refrigeration in India to tablet computers in the

US. There are many components to success in innovation, and harnessing knowledge in new ways is one of them.

Breakthroughs will still come from R&D centres, but innovation now encompasses the continuous need to improve and reinvent products, processes and services and even brands. That task involves a lot more people — inside and outside the organisation. Thus businesses are working far more closely with suppliers, customers and a wide network of external partners to extend competencies. In short, they are innovating how they innovate.

The capacity for innovation in Japan is not in question. Japanese firms have surprised and delighted customers worldwide over decades with hit products developed by engineers in a process continually refined by diligent factory workers — the *genba*.

And Japan's technology achievements are highly regarded by researchers worldwide. When asked to rank 10 top nations' pole positions in 10 R&D-intensive areas, researchers scored Japan as first or second in 4 out of 10. Crucially, Japanese researchers received high marks in areas that are likely to drive significant future growth: nanotech, biotech and energy efficiencies. (See Exhibit 10.)

Exhibit 10: Global researcher views of leading countries in R&D by technology research area

Automotive & other motor vehicles	Composite, nanotech & other advanced materials	Environmental & sustainability	Healthcare, medical, life sciences & biotech	Information & communications technology (ICT)	Instruments & other non-ICT electronics
Japan #1	US	Germany	US	US	US
Germany	Japan #2	US	UK	Japan #2	Japan #2
US	Germany	Japan #3	Germany	China	Germany
China	China	UK	Japan #4	India	China
South Korea	UK	China	China	Germany	UK

Source: Battelle/R&D Magazine, 2012 Global R&D Funding Forecast, Dec. 2011

Japanese companies have to adapt to cope with changing circumstances but they also need to keep their corporate strategy or culture of fostering, or cultivating, people within the company.

Professor Atsushi Seike
Keio University

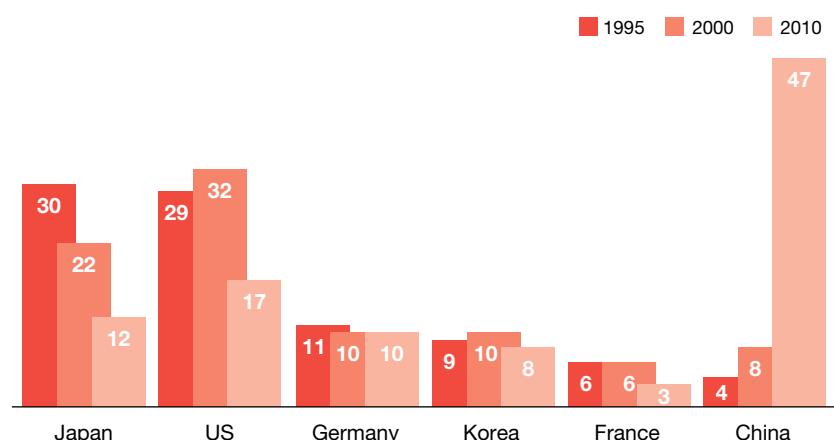
Yet bringing inventiveness to market is more challenging today for companies. Threats to Japan's comparative advantages in technology are most apparent in high-value ICT goods (this includes, for example, computers, communications equipment, consumer electronics and related components). By 2010, China had become the preeminent exporter in this segment, with the US second and Japan dropping to third. (See Exhibit 11.)

Japanese R&D spending is not being comparatively matched by market share in R&D-intensive exports. (See Exhibit 12.)

One possible explanation for this misalignment is offered by Michael Porter, who highlights that Japanese corporations tend to focus on product feature enhancement to the detriment of other types of deeper innovation — business system, place in the economic ecosystem, etc.⁷

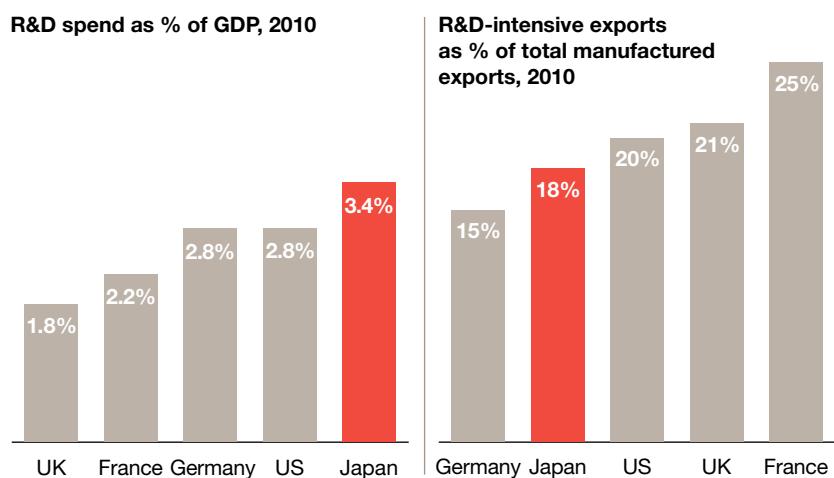
⁷ Michael E. Porter and Scott Stern, "National Innovative Capacity." In *The Global Competitiveness Report 2001–2002*, Oxford University Press, 2002.

Exhibit 11: Info-tech exports: % of share of ICT manufacturers' total exports



Source: Oxford Economics/Haver Analytics

Exhibit 12: R&D spending and export trends



Source: Oxford Economics/OECD/Battelle/World Bank

Reality 3

Many global competitors have learned to collaborate internationally on innovation and in R&D in more open ways.
A wave of initiatives in the form of R&D credits and other incentives underscores the importance of economic openness for policy-makers to secure business growth and foreign investments. Today more than 20 OECD countries, including Japan, offer incentives

for business R&D, up from 12 in 1995.⁸ Open and collaborative approaches are being adopted to attract more ideas and technology and to lower the risk, not merely for cost savings.⁹

Greater openness can take many dimensions. Some businesses are experimenting with partners on joint marketing and product development, with technology

start-ups as an alternative to traditional vendor relationships that are strictly under the company's control. This type of innovation is also occurring outside sectors traditionally considered R&D intensive. For example, the experiences of IHI are instructive. As we detail nearby, the industrial conglomerate discovered investing in new companies can also inject IHI's expertise into wholly new areas.

⁸ Andrea Beltramello et al., "Opening Japan: Comparisons with Other G20 Countries and Lessons Learned from International Experience." OECD Science, Technology and Industry Working Papers, 2011. Available at: <http://dx.doi.org/10.1787/5kg6nk6w3v7c-en>.

⁹ Indeed, an OECD analysis in 2010 found that firms that collaborate spend more on innovation than those that do not collaborate, suggesting costs are not the driving force for shared innovation endeavours.

The lack of innovation, and the aversion to risks, are the outcome of monoculture, an absence of diversity.

Toshiyuki Shiga
Nissan Motor Company, Limited



Inside high: Mazda's Seita Kanai on innovation and branding strategies

Getting closer to customers can also drive innovation. But it becomes difficult with more diverse end markets. "In the past, we may have been overly preoccupied with technologies from an engineering perspective, where we needed to consider what technologies were really good from the customers' perspectives," said Yukio Toyoshima, General Manager, International Strategy Division at Hitachi, Limited. "We need to focus more on our customers' perspectives, particularly in social innovation and social infrastructure."

How does a manufacturer with a smaller sales volume than its peers compete in the global innovation stakes? We asked Seita Kanai, Representative Director and Executive Vice President at Mazda Motor Corporation and a key figure in the automaker's *monozukuri* innovation strategies, to discuss balancing new technology development with cost considerations and changing customer demands.

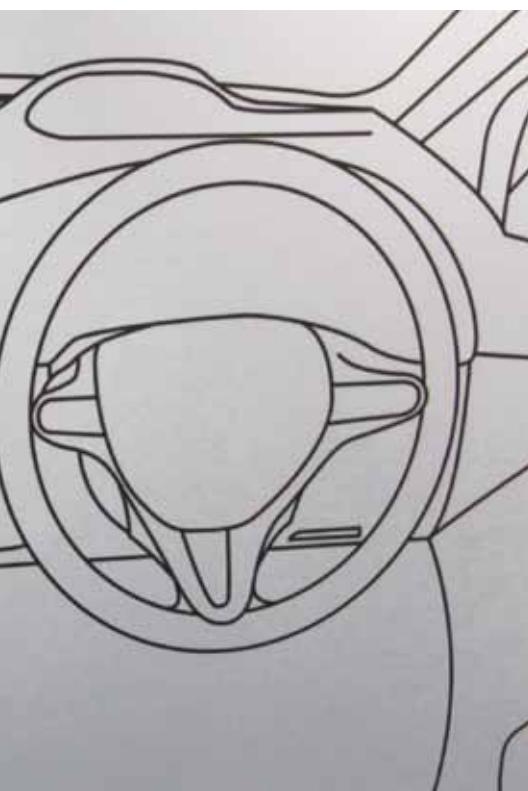
Perhaps surprisingly, staying competitive in a tough global market begins with a longer planning horizon than many business leaders would consider possible, given accelerated technology cycles. Most of the technology in new cars today, Kanai believes, can be overtaken in about three years.

"Even if we established a goal three years in advance, everyone would gather reasons as to why they would not be able to meet it, and declare their inability to carry it through. In actual fact, they would probably not be able to do it. However, if it were six years in advance, we would also attempt to undertake projects that we do not know we would succeed at until we try. In two and a half to three years, we can terminate the attempt if it appears to be failing." Kanai continued, "If it goes well, the start line would have shifted forward significantly at that point in time. After that, we would only need to succeed in mass production."

So given the challenge of fast-moving customer demands and a longer product cycle for new models, how does Mazda gear up to compete with larger rivals? Kanai, an avid baseball fan, describes a "strike zone" mind-set. Strong brands will attempt to capture the centre, but Mazda knows it must aim differently and has been successful doing so.

"The markets, segments and eras that we produce our products in are the elements that contribute to changes in the strike zone," Kanai said. "For instance, the strike zones for sports cars and the B-cars, and on top of that the so-called minivans, are different in Japan, the US and Europe. So too for emerging economies and developed countries. It is also different today compared with 10 years ago. It moves and evolves."

Kanai concluded that he is confident as he prepares to pitch his fastball. "Larger automakers can and do aim for the centre of the strike zone. Yet if we first took aim at the same course and threw, it would not enable the customer to find a reason to buy a Mazda. Too much competition. That is why Mazda does not aim for the centre, but shifts away from it. All Mazda cars must be distanced from this vector, rather than be in the centre of the market. Where do we target? Inside high."





Seeking solutions: Incubating new businesses in mature companies

“Corporate venturing” adopts the role typically played by venture capitalists to connect companies more closely to emerging technologies. The experiences of Yukiya Nakagawa, who ran the first such fund for IHI, a 150-year-old industrial conglomerate that produces ships, jets and turbine engines, show how this more open approach to innovation can evolve in Japan.

In 2002, IHI sent 11 young managers to work with a venture group in Boston to explore the potential of over one hundred start-ups based in the US, Canada and Europe. By 2006, they had cemented alliances with seven of these firms by creating comarketing or joint R&D projects.

The team was making the right connections for IHI’s core businesses, precisely what they were expected to do. Yet it was not enough. Nakagawa, an engineer by training, believed what IHI needed was investments that could seed new business opportunities.

Engaging with early stage start-ups to support existing businesses “could not be considered efficient,” Nakagawa told PwC. Division heads with deep experience in their markets and a short-term market view on product life-cycles had little appetite for innovative improvements.

Thus four years into project, Nakagawa’s team moved out of R&D and operations and into IHI’s Corporate Planning Group. “We concluded that if you are going to start new businesses in a mature company, you have to

do it as a headquarters function,” he said. Full support from top IHI executives released the venture team to go after various collaborative projects with start-ups on the sharp end of new, disruptive technologies, such as clean energy and desalination processes. They expanded their visits for research to 300 companies, some of which were focused on technologies well removed from IHI’s core competencies.

Among other investments, IHI would eventually make a US\$ 25 million equity investment in a US-based battery-maker. They also signed a licensing agreement in 2011 that helps IHI access customers in Japan with new products that include, for example, hybrid engines for tugboats. Tugboats require massive power over a short time; rechargeable batteries are effective for starting up an electric motor and help decrease emissions to meet environmental standards on diesel fuel. “Our company did not realise that this new technology could be applied to our products, and now we have found a commercial market for it,” he said.

Looking back, Nakagawa, now a senior advisor for IHI, believes that collaborating closely in marketing and product development with start-ups in targeted technologies is critical for innovation success. This creates a relationship that can be more productive for both parties than a classic vendor relationship. “It’s impossible to find the embryo of new businesses by reading the literature or sitting in conferences. You have to go to the labs and the factories,” he said.



Japanese companies are collaborating — but not enough by some measures. While Japan's researchers and institutions generate significant patents, innovative Japanese firms have been less likely to collaborate with international researchers. In 2010, just 3% of patent applications were filed listing a foreign co-inventor in Japan, as opposed to 9% of EU patents and 12% of US patents.¹⁰

In addition, while Japan invests substantially in R&D, Japanese companies aren't spending resources outside of Japan at the same rate as some peers are

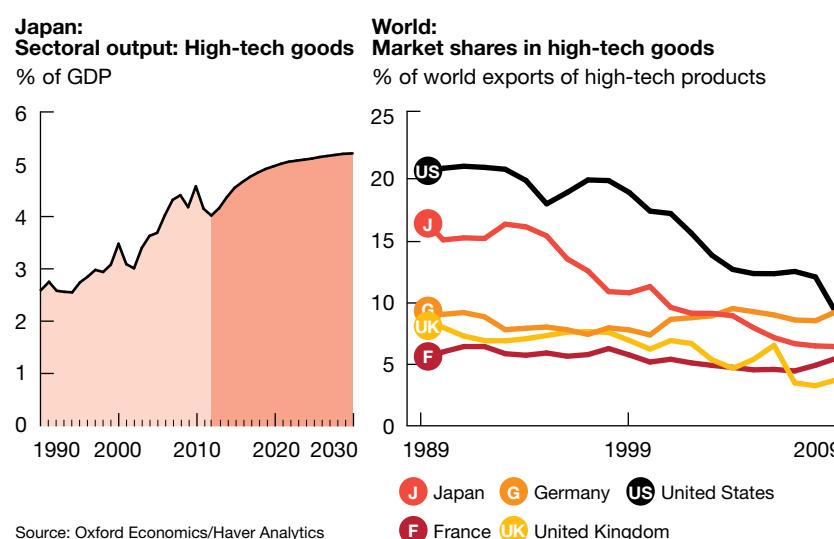
outside of their home markets. Japan trails only the US in absolute spending on R&D, and spent more as a percentage of GDP in 2011. Nonetheless, European majority-owned affiliates outspent their Japanese counterparts on R&D spent within the US in 2008.¹¹ Separately, a survey of US companies in 2011 found that only 6% plan to expand R&D operations in Japan, as opposed to 30% in China and 24% in India.¹²

To be sure, collaborative innovation isn't easy, particularly in large organisations. The inward focus of very large organisations creates a

natural barrier to outside ideas and creative thinking. As Akira Arima, NTT Communications Corporation President and CEO, noted, "The model whereby products researched in our research institute were developed and manufactured by Japanese manufacturers, then released in markets worldwide, has already collapsed." Instead, Arima recognises that a more open approach to innovation is taking hold. "In reality, our form of innovation would probably be in the sense of combining the latest technologies in the world."

With the commitments to innovation already in place, innovation models in Japan can adapt to work more effectively in today's global economy, generating results that more closely reflect the skills and investments being placed in R&D and innovation efforts. Collaborative innovation approaches are an important tool in this regard.¹³

Exhibit 13: The highly competitive world of high-tech goods



10 OECD, Directorate for Science, Technology and Industry, Economic Analysis & Statistics Division, "Patent Applications Filed under the PCT: Patents with Foreign Co-inventor(s)," *International Co-operation in Patents*, 2012. Available at: http://stats.oecd.org/Index.aspx?DatasetCode=PATS_COOP.

11 National Science Board, Table 4-12, "R&D Performed by Majority-Owned Affiliates of Foreign Companies in the United States, by Selected NAICS Industry of Affiliate and Country: 2008," *Science and Engineering Indicators 2012*. Available at: <http://www.nsf.gov/statistics/seind12/tables.htm#e4>.

12 Battelle/R&D Magazine, 2012 Global R&D Funding Forecast, Dec. 2011.

13 There is one model of innovation with proven power in the Japanese context: *kaizen*, the process of continuous improvement that engages research engineers and factory workers alike. Japan might do well to dispatch expert veterans of its auto assembly lines to fine-tune innovation processes in those same companies.

Reality 3

Ultimately, successful innovation requires courageous leadership.

Nissan Motor Company COO

Toshiyuki Shiga cites an example where leadership from the top was critical in Nissan's decision to take on innovative risk. In 2007, Nissan was tagged as an environmental laggard while archrival Toyota reaped rewards from its hybrid technology. CEO Carlos Ghosn decided to roll the dice on electric vehicles. But in taking this gamble, he had to overrule Nissan's "powertrain tribe," engineers strongly wedded to the internal combustion engine. "The powertrain is the heart of the car," Shiga said. "With a hybrid, you still have an internal combustion engine, so the engineers could accept that. But to eliminate the internal combustion engine was — wow — to completely go against all the expertise of the industry. In the end, I think innovation requires strong leadership and a diversified organisation."

Much of innovation today requires driving deeper changes. Bolder leadership is required to move away from sheltering innovation as a way to enhance existing products and services. The growing scale of innovative capacity around the world means that it is increasingly easy to be left behind by disruptive technological changes. Businesses that encourage innovation within the company — such as the intrapreneurship scheme employed by IHI — may well be better equipped to deal with the new reality.





Innovation in action: Q&A with Twitter Japan's James Kondo

PwC: Twitter opened its first office outside of the US in Japan in 2011. Why?

James Kondo: Japan is one of our top markets in terms of the number of Twitter users. Japanese users are also very active and tweet a lot. From a commercial perspective, Japan is one of the top online advertising markets in the world. Also, Japan leads the world in many mobile technologies — whether it be mobile gaming or electronic payments. By meeting the high standards of Japanese users and advertisers, and by collaborating with the most innovative mobile technology firms, Twitter would gain competitive advantage to scale those learnings across the region and the world. We had to be here.

PwC: Twitter played an important role in Japan in 3/11, acting as a lifeline at times when people couldn't use their mobiles. How has that changed things for Twitter?

JK: Because this is the first place where we encountered a huge disaster, in a hugely mobile, well-connected, high-tech country, we now know what we can be doing within seconds. We are definitely fleshing that out, and I think the more Japanese users are in on it, the better, but it has also become a source for innovation within Twitter to say, "Okay, let's build a framework."

We hadn't done it by design. It is interesting in hindsight. We knew that Twitter usage really picks up whenever there is a disaster because people want to get real-time information and they also want to find real-time solutions. For example, in Japan, people who were stranded would type *#stranded* in Japanese and the fire services could geolocate them and pick them up. There were a lot of hashtags created, like "pregnancy," which was developed by women who were about to give birth and were in places where the hospitals couldn't operate. Doctors could answer questions on that hashtag to help.

PwC: What are you seeing in general in how Japanese firms are approaching innovation?

JK: I do see a tremendous amount of innovation. When we go out and talk to engineers, there are huge, huge pockets of ideas that we run into. People who are truly smart, doing great things. One thing that Japan really needs to do as well as it used to do, and it is probably more important because the marketplace is just more competitive, is apply the intensity with which one scales globally. The skill set needed to do that is what I see as the missing link these days. Whenever I see great ideas, at least in my industry right now, those great ideas are also in Japan. People have tested them. They are in this marketplace.

Look at electronic payments in Japan. Nowhere else in the world will you see that many stores just using electronic payments on mobiles as you do see regularly in Japan. Yet this practice is not spreading because, for one, Japan may just be comfortably large enough for those companies to operate in and so they are not aggressively pushing it out, creating joint standards, getting it out there in the market and scaling drastically. But I know that in three years there are probably going to be five other places in the world that are going to have electronic payment formats.

I do think that companies need to be much more aggressive about doing something on a global scale much faster. That is primarily about top management decision-making.

Reality 3

Business implications

How is your organisation incubating innovative ideas?

One way of looking at this question is to put yourself in the place of an outsider — perhaps an entrepreneur, a small business or a large foreign company — with a novel idea, technology or even a network that will advance your business aims. How easy is it for these people to work with the right people in your organisation to move the idea forward to the testing stage and eventually to market? Potentially disruptive innovations often encounter significant

resistance from management focused on cost or the day-to-day activities of the business. In order for an organisation to support innovative thinking and help incubate an idea, it needs to be able to balance the “everyday” with the new. Good product development practices will allow this. But will the process allow truly innovative ideas to survive? In some cases, this may even mean establishing organisational separation for the new idea or model.

How well is your organisation adapted to working with outsiders and start-ups?

Steps businesses can take range from small considerations — for example, adapting to the cash management requirements of start-ups — to larger transformations that can involve ceding control by forming joint marketing or product development and licensing activities with smaller companies rather than large, established vendors. Working with smaller companies is much more about partnerships as each

side seeks to extend their reach to new customers. Being flexible on where incubation takes place is an important factor in the success of a partnership. Incremental enhancements are the norm in a well-funded and experienced R&D organisation, but market-changing innovations often emerge from the outside. The challenge is recognising good ideas, and taking the risk to support them.

Do you have broad perspectives from across your value chain represented in your development process?

Innovations must look beyond the product itself to the complete system of environment, products and services that ultimately delivers value to very particular customer segments. This often means

involving the customer earlier in the development cycle to ensure their needs are fully met. A new technique called co-creation can significantly support innovation success.



How are you encouraging collaboration among your employees and partners in innovation?

Being open means fostering an environment internally where employees from different functions and from different geographic operations are collaborating. Opening up the development process can counter a culture where R&D divisions in large organisations compete against one another for resources rather than against emerging competitors. Talented people, too, should be able to actively partake in the global information flow and be given a degree of autonomy to pursue their ideas. 3M and Google, for example, set aside blocks of time for some employees to do this.

Reality 4

Ageing economic metabolism

The longer Japanese corporations delay responding to demographic realities, the more painful the adjustment



- *With Japan's working-age population now in decline, business leaders should expect intensifying competition for talent.*
- *Higher capital costs are a distinct possibility as Japan seeks to attract foreign investors to service its debt.*
- *Domestic operations need to adapt to the reality of a slower growth environment. Tomorrow's competitors are not just in Japan; they come from around the world.*



Reality 4

Rising public debt and ageing populations are trends common to many mature economies. Japan is no different in this regard. But Japan is also in the vanguard. How Japan and its leading businesses manage these trends will be a lesson for other nations. (See Exhibit 14.)

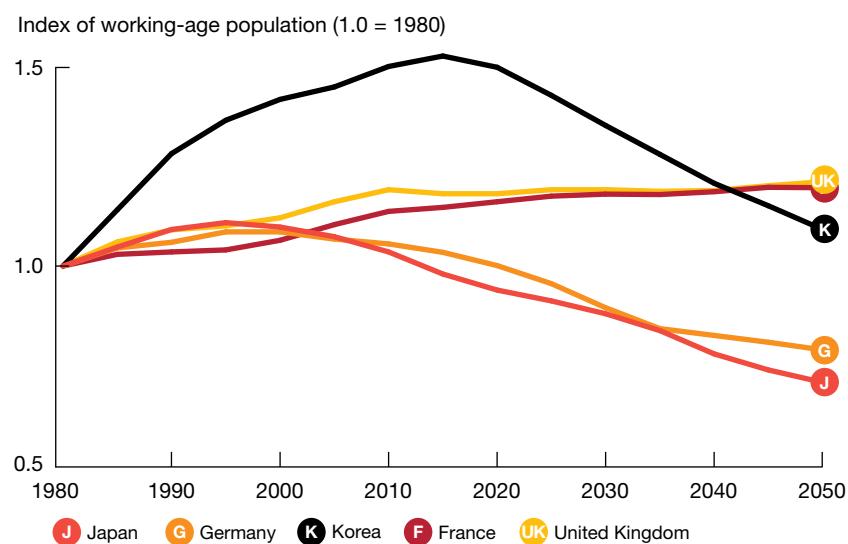
Japan's economic expansion in the period after the Second World War coincided with a growing population and a shrinking dependency ratio. During Japan's economic boom, these favourable demographics combined with an increase in worker productivity — fuelled by education and technological advancement — to create extraordinary prosperity.

That demographic dividend has now reversed. Japan's population hasn't grown since the 2005 census figure of 126 million. With no change in net immigrant or birth rates, there will be 2.2 working adults for every person at retirement age by 2025, according to current projections.¹⁴ Productivity gains have slowed just as Japan will face relentless upward pressure on its expenditures to support social programs including public healthcare and eldercare.

Graduates used to want to join large, famous companies and then work there for the rest of their life. The C Generation [Millennials] are interested in developing their skills — they want to do what they want to do as individuals.

Yoriko Kawaguchi
National Diet of Japan

Exhibit 14: Working-age population trend projections



14 United Nations, Department of Economic and Social Affairs, Population Division, *World Population Prospects, the 2010 Revision*, 2011. Available at: <http://www.un.org/esa/population/>.

Source: UN Population Division of the Department of Economic and Social Affairs



We have to increase the capital market here. And governance is essential to doing that. It is also essential that there be a more dynamic and efficient M&A market to reallocate assets to their best uses faster.

Nicholas Benes
The Board Director
Training Institute of Japan

These factors have led to a “decrease in economic metabolism” as characterised by Bank of Japan Governor Masaaki Shirakawa.¹⁵ The pace of change in Japanese business has equally slowed. According to Toshihiko Mukoyama at the University of Virginia, Japanese companies start up and close at a rate about 4% per year, significantly lower than the 10–12% rate in the US.¹⁶

What are some consequences of this slowing economic metabolism? Consider, for example:

- With limited opportunities to reinvest in Japan, there will be increasing pressure for firms to invest outside of Japan if they are to grow.
- Paradoxically, the need to attract foreign portfolio investors to buy Japanese shares and bonds will rise, as older Japanese spend their savings in retirement.
- A shrinking domestic workforce will intensify competition for skilled talent.
- Continued deflationary pressure will affect housing, office space, and industrial and commercial real estate markets.

These are not easy consequences to swallow. Yet there are a few ways by which companies could get ahead of these trends in domestic operations.

Face the realities of an ageing economic metabolism at home.

Growth abroad is an imperative. But the Japanese domestic market is too large to be easily ignored and will continue to be an important source of revenue. A fundamentally different strategy will be needed at home versus in the faster-growing markets abroad. Without the traditional secular growth drivers of population increases, household formation and a growing consumer class employed in the private sector, revenue growth will be difficult to achieve in the domestic market.

There are more than 900 corporations in the Hitachi Group. We are planning to create a database and install a common grading system for every position throughout the group.

Yukio Toyoshima
Hitachi, Limited

15 Jon Hilsenrath et al., “Transcript: Shirakawa on Japan’s Economy,” *Wall Street Journal*, March 1, 2011. Available at: <http://online.wsj.com/article/SB10001424052748704615504576172300556921580.html>.

16 Greg Ip, “From Zombie Banks to Zombie Mortgages? Japan misallocated capital during its lost decade. How the U.S. can avoid its mistakes,” *Wall Street Journal*, September 10, 2010. Available at: <http://online.wsj.com/article/SB10001424052748704358904575478072373684644.html>.



*You should promote people with potential.
You should let them know that they can climb up
in the company and align your interests together.*

Ray Hatoyama
Sanrio Company, Limited

Japanese firms will have to focus on cost control, exiting unprofitable business lines and consolidating market share to achieve greater pricing power and economies of scale on the one hand, and building new business lines that match demand from a changing demographic on the other. The firms that can accelerate their internal metabolism will be best positioned for this long-term change in the economy.

Given the economic outlook, Toshiba's Yoshihide Fujii expects more restructuring to take place as demands for higher return on sales force businesses to reconsider strategies in Japan. "There will be a few executives who can fully understand what is happening right now. There will be a few executives who will take proper action. On the other hand, there are many executives who will not do that. The winners will take over the losers."



If people can really have a work/life balance, that would be really good. I think that is something that can attract new graduates.

Kanai Doi
Human Rights Watch

Bridge persistent skills gaps.

As the working-age population in Japan declines — and graduating classes get smaller each year — changes to the way Japanese corporations manage workforces are inevitable. Managerial recruits that move in step with one another, through rotations designed to cultivate deep corporate knowledge, will give way to immediate needs to plug skills gaps at home and in operations outside of Japan.

The strains are already present: 80% of managers for Japanese companies reported difficulty hiring in 2011, the highest of any country in Manpower Group's global survey. Rapid growth in Asia and the degree of specialisation required to operate in many regions today virtually ensure that the difficulties in hiring will not abate any time soon.

Two common talent practices in particular are leaving many Japanese companies less competitive in the global market for skills: A rigid talent intake structure that relies on new graduates and a compensation/promotion system that is largely based on longevity. Combined, these features help sustain a general lack of diversity in the Japanese workforce, reinforcing traditional modes of work at a time when new approaches are needed to get the most out of the best.

Highly skilled and/or entrepreneurial people have many more choices. If they can't find what they need, they are likely to leave. This shift in favour of greater opportunities is happening now. Consider that

Tokyo University (Todai) may move the academic start to the fall. By aligning with international norms, the university hopes to attract more foreign students and to enable Japanese graduates to compete more readily for opportunities outside of Japan.

Without similarly bold reforms to open their own organisations to a larger pool of candidates, many Japanese companies may find themselves on the wrong side of the global talent equation. A call for radical policy reform from the *Keidanren*, the influential big-business club, in an April 2012 report that advocates sweeping changes to meet the looming demographic crisis underscores the urgency.



Lack of diversity is depriving companies of the perspective they need to navigate a big, complicated world. Women are Japan's neglected resource.

"I am living proof that business performance can be enhanced when a woman makes headway in a sector that has traditionally been dominated by men," said Fumiko Hayashi, Mayor of the City of Yokohama and formerly a top sales performer in the auto industry, who rose to the rank of president of both BMW Tokyo, Corporation, and Tokyo Nissan Auto Sales Company, Limited.

A strong voice for working women in Japan, Hayashi is pulling for more nursery spaces to ease the return to work following maternity leave as well as for assistance for women starting new businesses. "I believe that we must act proactively so that women can fully realise their potential and grow into professionals who can compete on the global stage," she told PwC.

Japan has the lowest female labour participation rate among the OECD nations, even though Japanese

women rank highly in global measures of educational attainment. This represents a failure to engage half of Japan's productive capacity. If Japanese female participation rates rose to levels of the US, this alone would add 2.6 million people to the workforce, raising the GDP growth rate from 1.2% to 1.5% over the next two decades, according to Goldman Sachs' Kathy Matsui.

The outsize economic impact of gender equity is strongly supported by analysis conducted by Keio University and the National Graduate Institute for Policy Studies.¹⁷ Japan's GDP is currently the third largest in the world, but by 2050 they estimate that real GDP could fall by more than \$USD 1.1 trillion, reducing Japan to the ninth largest. This decline can only be stemmed by improved gender equity in the workplace: an improved female participation rate. The economic simulation projects that, even with a participation rate as high

¹⁷ Kotaro Tsuru, Takeru Doi and Takashi Shiraishi, *Global Japan: 2050 Simulations and Strategies (summary)*, Keio University and National Graduate Institute for Policy Studies, April 2012. Available at: <http://www.21ppi.org/english/archive/global.html>.

It is obvious that Japanese society has to change drastically. Even compared to the other East Asian countries like South Korea or Taiwan, Japan is still behind in terms of the proportion of women in parliament, in CEO-class positions in the business sector, in mayoral or municipal board chief positions.

Professor Mariko Hasegawa
Sokendai, The Graduate University for Advanced Studies

as Sweden's, Japan will drop to the world's 4th largest economy (behind the U.S., China and India).

Akiko Domoto, the first female Governor of Chiba Prefecture (2001–2009), believes more women in the workplace is “absolutely critical” to Japan’s future. A tireless advocate of women’s rights, she founded the first women’s gender-specific health system that became a model for Japan and was recently honoured by Prime Minister Noda for her decades-long efforts and studies relating to gender issues in Japan.

Engaging female talent means much more than providing access to child care for those who are raising families. There are a range of issues to address, such as the underutilisation of women who do return to work and the unconscious bias of both men and women in the workforce. A recent study found more women (49%) leave the workforce because they feel stymied at work than leave for reasons related to child care (32%). (See Exhibit 15.) As Mariko Hasegawa, Dean of the School of

It was a little bit difficult to develop a career in a Japanese company after getting an MBA. There are not too many [women] like me who have two kids, quit their last company, and then went back to a Japanese company again.

Ikuko Tanaka
Benesse Holdings, Incorporated



Exhibit 15: Japanese women represent a ready source of highly skilled talent

Highly skilled women are underrepresented in the Japanese workforce...



...but it's not just because of child care issues



Source: Government survey, 2009; Catalyst; Sylvia Ann Hewlett et al., *Off-ramps and On-ramps Japan*, 2011

Note: Off-ramp is a leave from employment of six months or more

Reality 4

Japanese companies are looking at global resources. They want to hire them. The problem is that they are not set up in a way that is actually attracting the right people to them. They will tend to go for a male who has graduated from Waseda or Tokyo University.

David Swan
Robert Walters

Advanced Science at Sokendai, the Graduate University for Advanced Studies, noted: “The whole system is based on men working full-time, supported by women who cover the home. If you are a man and you become a father and you want to take parental leave, it is very difficult. Among civil servants, only 1.7% of fathers take that leave. In private companies, it is much less.”

Experienced (i.e., midcareer) hires are another underutilised resource. Where once thought to promote cohesion and loyalty, the remaining vestiges of lifetime employment may now be sapping the vitality of Japanese firms. The general lack of midcareer mobility opportunity leads unmotivated lifers to stay put; it presents a barrier to women

reentering the workforce after childbirth, and it shuts out global talent.

In a global business, this inability to admit new midcareer blood has obvious disadvantages. To grow in markets around the world, business needs to attract the best and brightest local talent with an unlimited career path. But for *gaijin* in Japan’s global companies, the ladder usually hits a ceiling. Those who are not Japanese, and don’t speak Japanese, have had limited long-term career potential in a Japanese firm. In a global war for talent, this handicaps Japanese companies against competitors able to take full advantage of a much larger English-speaking talent pool.

Immigrants represent less than 2% of Japan’s population. Easing access

for skilled foreigners is a policy issue for government, but businesses should recognise that if the heart and soul of its global corporations are to remain at home, global talent must come here. Otherwise, key business functions will inevitably migrate closer to rich talent pools and growing markets.

With its exceptional infrastructure, skilled and diligent workforce, clean and vibrant cities and democratic rule of law, Japan has every opportunity to selectively attract the world’s best and brightest. Given a talent-management system that encourages diversity and welcoming immigration and tax regimes, Japan’s leading cities could challenge Singapore and Hong Kong as Asian hubs for global business.



Even men who quit or jump around will have more challenges than people who have been with a company for a long time. The continuity part, regardless of children, is the key to how Japanese companies think.

Kahori Miyake
Claire's Nippon Company, Limited

Raise capital efficiency despite low costs of capital. To many people we've interviewed for this report, two decades of slow growth — and weak returns — have made it harder for Japanese corporations to take risks. Instead, among many of those reliant on business lines in Japan, there remains an intense price competition to capture more market share. “Japanese companies in many cases are getting very poor at taking risk, and therefore are building up a lot of cash, and not efficiently maximising the use of capital,” said Nicholas Benes, Representative Director of The Board Director Training Institute of Japan. A key contributor to the ageing economic metabolism is a persistently low interest rate. As with any resource — whether it is

oil, water, iron or capital — if access is cheap, corporations and societies tend not to use it efficiently. As a result, Japan uses natural resources very efficiently, but it is a spendthrift on capital.

Low capital costs reduce incentives to make portfolio-wide changes to generate more growth — or curb losses. To Goldman Sachs’ Kathy Matsui, this limits “the sense of urgency” in many companies in sectors that have yet to face tough competition and the reality of a shrinking population until recently. “If you have a cost of capital or hurdle which is zero, which it is, and which it has been for many years, if you are a manager, would you try very hard to aim for a high

return on capital when that cost of capital is free?”

Companies that think differently have opportunities at hand. As consumers age, the domestic economy will need to evolve to provide different services and even products. Think banking ... or retail ... or real estate. Companies in many sectors will need to change their product portfolios. Yet, by one measure, domestic M&A, not much change has already occurred — despite ready access to capital. Domestic M&A is lower than most peer countries, even as overseas acquisitions have picked up pace. Meanwhile, acquisitions by foreign investors in Japan — a second important source of consolidation as well as new ideas, managerial know-how and technologies — also remains low.

Japanese corporations need to inject an increased sense of urgency into their activities. They also need to drive productivity improvements and innovations in their domestic activities, particularly in sectors such as healthcare that will consume more of society’s resources. Most of all, Japan needs to move faster than ever so that productivity increases outweigh the demographic headwinds and living standards are maintained and improved.

Although gender is not widely recognised as a top priority issue, it is absolutely critical to Japan’s future. Without women’s full and equal participation in the workforce our economy will decline steeply from now. And unless women get the support they need to be both mothers and workers, our population will also decline steeply.

Akiko Domoto
Chiba Prefecture (2001–2009)

Reality 4

Business implications

Does your strategy recognise the changing domestic environment in Japan?

Your strategy and your product mix will need to match the realities of an ageing population and its dramatic effects on consumer needs and

capital markets. Think banking ... or retail ... or real estate. Companies in many sectors will need to change their product portfolios.

Are you taking enough risks in Japan?

Many companies accept a different rate of return on business lines in Japan than they do for international operations. There are many valid reasons why there may be a gap, yet it's clear that two decades of slow

growth — and weak returns — have made it harder for Japanese business managers in general to take the kind of risks that can raise returns. Instead, many are focused in an intense battle for market share.

Is your organisation using capital efficiently?

If, as we project, the cost of capital starts to rise as Japan competes for foreign investment to buy its debt, operating conditions could change markedly in Japan. Moreover, if the company's cost of capital reflected an emerging markets base, you might think differently. And emerging markets are increasingly where you'll be operating.



Are you creating an environment where high-value people will want to stay and contribute?

The opportunities for the best and the brightest to work where they want is growing, making competition for global talent fierce. Companies need to know what makes an employer attractive — be it compensation, risk-taking cultures

or flexibility — to key segments of the workforce. Diversity is an important component of a world-class talent base. Bringing together employees from different backgrounds helps promote creativity and risk awareness.

What policies are effective in keeping highly qualified women in your workforce?

Women represent a great under-utilised source of talent in Japan. But companies may need to change policies and cultures in order to hire, retain and motivate them. For example, greater flexibility in the workplace — ranging from hours worked to greater autonomy over tasks — are important to women, and increasingly, they are important to men too.

Do you have a clear view of pivotal roles within your business?

Understanding which roles that create (or destroy) disproportionate business value is a component of strategic workforce planning. Businesses can use engagement studies, for example, to identify barriers to high performance within specific groups of employees.

A final word

Japan's core challenge is to intelligently evolve how to work

Corporate Japan has reached a pivotal moment. Business opportunities in Asian markets are expanding, while growth is slowing in European and US markets. Challenges at home mount as the population ages and energy supply uncertainty grows. To survive in the fast-moving global currents, business leaders must be prepared to embrace change, as well as the risks that inevitably come with it.

We have described in this report four key Realities shaping the business environment and the set of responses corporations should consider. Yet, to successfully navigate these Realities, Japanese companies need to adjust accordingly. Some have already begun to take action, but a more robust private sector effort is needed.

This is not to suggest that Japan's public and private sectors become more like those of another country or that cherished values and traditions be forgotten. Rather, Japanese society, and indeed the world, is in a state of rapid flux and change. The efforts that win the day will address the challenges many countries face today, though in a uniquely Japanese way.

PwC believes companies are going to require new attitudes if they are going to successfully navigate these Realities. Success has bred caution. Corporations become more focused on defending what they have and forget the fundamental drivers of their original success.

As we discussed above, Japanese corporations are going to have to take stock of their own approaches to a changing world. In many cases, the new attitudes will need to embrace:

- **Boldness and risk-taking –** Japanese companies and executives can no longer assume they will be successful without risk. Companies need to take risks, and the individuals who take risks cannot have their career ended if an initiative ends in failure.
- **Velocity –** Many Japanese corporations have moved too slowly in reaction to a rapidly changing world. Domestic markets have not rationalised, conglomerates have continued to be in too many businesses and, at a cost of capital close to zero, Japanese corporations need to make a concerted effort to move more quickly.
- **Flexibility and adaptability –** Decision-making should be done with a view that direction is likely to change, and Japanese corporations need to do a much better job up front of building this flexibility into their strategies.

Of course, changes in attitude can only come from the top — one of the most urgent tasks for corporate leaders is to spearhead changes in attitude throughout the organisation.

As discussed above, each of the Realities gives rise to a series of business implications. How must Japanese corporations adapt to these business implications? Armed with a change in attitude, PwC believes there are four key themes for the decisive change Japanese corporations require:

- **Transform the organisation – Leaders need to champion major organisational change to enable their companies to succeed in today's world.** Japanese corporations need the talents and fresh perspectives of a wider group of people, throughout the organisation and in the governance structures are needed. Japanese women, foreigners, midcareer hires and the young generation

are all groups that bring a huge amount of energy and a multitude of ideas. Japanese corporations that embrace these groups will find they are better able to win against both domestic and foreign competitors.

- **Adapt innovation – Open up the organisation to accelerate innovation.** Put yourself in the place of an outsider — perhaps an entrepreneur, small business owner or foreign multinational corporation — with a good idea, technology or even a network that will advance the aims of your business: How easy is it for these potential partners to work with your organisation and find the right people? For most Japanese corporations, the answer is, not easy at all. Japanese corporations are going to have to use new approaches like intrapreneurship and co-creation with outside organisations to re-energise the innovation processes required to be global leaders.

- **Grow your leadership pipeline – Understand the full range of capabilities required to successfully lead in today's world.** Corporations need to make changes to promotions, training, rotation and compensation that will produce more leaders who are in tune with the four Realities. Companies should open themselves up to more merit-based promotion and external senior-level recruitment in order to foster the type of leaders who are not risk averse and have the skills to confidently guide their organisations in new directions.

- **Focus your growth strategy – Many Japanese corporations can become more aggressive,** with options including M&A activity, direct investment and partnerships. As of yet, domestic markets have not rationalised, conglomerates continue to be in too many businesses and corporations continue to be wasteful of capital. The objective is to focus more effort on opportunities that will deliver the type of value-added activities Japan needs in markets that are growing.

Exhibit 16: What young professionals think

Of Japanese under 30 years old...

14% **6%**

described their position
as a “dead-end job”

Global average: 3%

felt business leaders were looking
for “creativity and innovation”

from their new graduate recruits

Global average: 26%

Source: PwC, *Millennials at Work: Reshaping the Workplace*, 2011

Of course, different corporations are at different starting points and in different industries, so the exact required mix of action will vary. Companies will have to make progress simultaneously on a variety of issues, including globalisation, governance, innovation, strategic thinking, capital planning, M&A, pay and performance management.

And we do not underestimate the challenge of change. It is not easy at any level, be it in the workplace or the wider society. As Toshiba America CEO Yoshihide Fuji noted: “Japanese people have difficulty with moving and changing. It is not so easy for Japanese people [or Asian countries] to change dramatically, but in order for people to survive, they have to change.”

The heart of the matter is embracing change

Japan’s postwar economic miracle was a triumph of human energy, entrepreneurial initiative and — above all — public education. Within three decades, Japan educated tens of millions of diligent, highly skilled workers and harnessed them in a phenomenally successful system that delivered widespread prosperity and security.

Yet, there is now a widespread realisation that the tightly controlled system by which Japan cultivates and employs talent does not fit with the twenty-first century — and time alone will not fix it. Japan now needs new organisational approaches to unleash its citizens’ tremendous intellect and energy.

“You have to compete on intellect, on how you leverage and scale that in an efficient way,” said entrepreneur William H. Saito. “Japan is going to learn this first. I have faith in that. And I want to be there and learn that with them because many other countries, starting with South Korea, the United States, Europe, and China, will follow within 5 to 10 years. Japan is going to finally be first at something that every other country will start experiencing, and they will have a solution for this.”

Fostering opportunities drives innovation and ambition

Some have concluded that because Japanese citizens of all ages enjoy a satisfying lifestyle, ambition, particularly among younger populations, has been degraded. But we do not believe this.



In a PwC survey of young professionals from more than 25 countries, 14% of Japanese under 30 years old described their position as a “dead-end job.” Moreover, only 6% said they felt business leaders were looking for “creativity and innovation” from their new graduate recruits.¹⁸ (See Exhibit 16.)

As Gen Miyazawa, General Manager for Yahoo! Japan, noted the trouble for Japan is that many budding entrepreneurs can follow opportunities elsewhere. “When I started my own company in 2004, everyone I knew started their business in Japan,” said Miyazawa. “Now, my Japanese peers and younger people are starting their businesses in Singapore, or the United States or even Hong Kong.”

18 PwC, *Millennials at Work: Reshaping the Workplace*, 2011.

Innovative ideas are often the catalyst for new businesses and divisions, which themselves create jobs and opportunities and make the business environment more attractive to people at home and abroad. Countries throughout the world recognise this and are taking steps to foster entrepreneurship. Japan can be no different. Embracing new ideas and businesses will propel Japan ahead of the competition, in part because of the country’s long and rich history of turning good ideas into great products and services. Creating an attractive environment for entrepreneurs is in part dependent on government policy and approach to private sector needs, but Japan’s businesses can support this important entrepreneurial force by creating room for new ideas to grow and succeed.

Addressing the need for greater opportunities and innovation will not only help Japan’s younger generation but also reinvigorate the country’s growth, prosperity and competitiveness. Corporate leaders hold an important responsibility, impacting and guiding a nation’s human, physical and intellectual capital. The decisions they make, and the direction they set, matter. Implementing change in Japan’s corporations requires leadership and a readiness to have important (albeit sometimes difficult) conversations.

Japan faces steep challenges, but in every challenge lies opportunity. PwC, like others, believes the country’s horizon is bright, with the sun rising on a new era in global leadership. With a focused effort to put the country back on a prosperous path, corporate leaders are in an excellent position to transform Japan’s economy, its private sector, and indeed, its future.

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