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Making Money in Japan

A profitability survey among German affiliates in Japan

Introduction

Japan is regarded as a very challenging market. At the same time, the country has been experiencing an economic crisis for more than a decade. This has frightened many companies off from investing in Japan directly. The belief that “you can’t make money in Japan” is widely held.

But is this scepticism of Japan really justified, and if so, in what respect? This study was carried out primarily to provide substantive answers to these questions and in particular to establish the reality of the profit situation of German companies in Japan.

The study was jointly carried out in the first half of 2003 by the German Chamber of Commerce and Industry in Japan (DIHKJ) and Roland Berger Strategy Consultants of Tokyo. The 510 German companies known by the DIHKJ to be operating in Japan were sent a questionnaire. Ninety-seven measurable questionnaires were returned, giving a representative return rate of 19%.

Interviews were held with ten companies in order to discuss in more detail the qualitative responses on the reasons for their profitability. Because the analysis was largely based on confidential data, no information on the names of the participating companies can be given. Nor can any individual details from the interviews be specifically attributed to any company.

The study clearly establishes that the majority of German companies in Japan are profitable: 94% of the companies surveyed have a positive gross profit margin and 76% of the companies achieve a positive pre-tax profit. This study shows why, in their own view, German companies are profitable and analyses possible reservations which might currently be cited against a commitment to Japan. The result is encouraging: the Japanese market is very demanding, but for those who dare to meet the challenge a lucrative market awaits.

Chapter 1

The macroeconomic background

"Japan is on the way to becoming a major FDI recipient"

1.1. Foreign direct investment in Japan is increasing

Traditional reticence

For many years, foreign investment in Japan was regarded rather suspiciously, not only in conservative government circles but by the public as well. In the past, this unresponsive investment environment made market entry difficult for many companies.

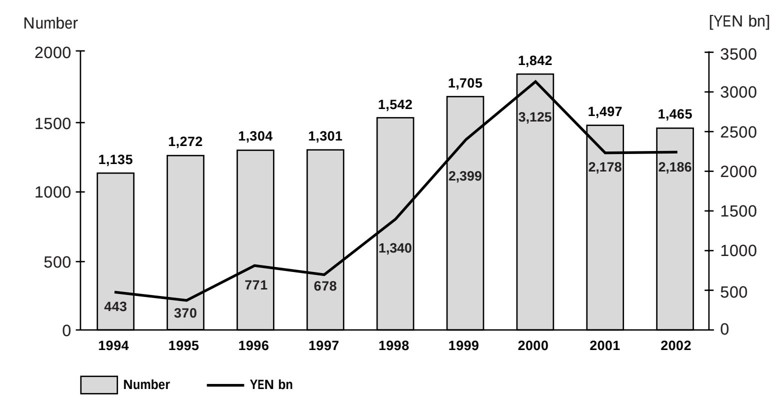
New awareness of the advantages of direct investment

This has changed in recent years. Now, the Japanese government has recognised that FDI (foreign direct investment) not only brings capital to Japan, but can also exert a positive influence in numerous areas. New dynamics are expected in technology, management methods and the labour market, and foreign direct investment is increasingly seen as a supporting factor in Japan's efforts to reform.

Sharp increase in Foreign Direct Investment since 1997

From 1997, foreign direct investment in Japan increased sharply (Figure 1), but has been decreasing since 2001. The recent decline is primarily attributable to the global economic downturn and to the decline of cross-border mergers and acquisitions, which have affected other countries as well.

Figure 1: Foreign direct investment in Japan

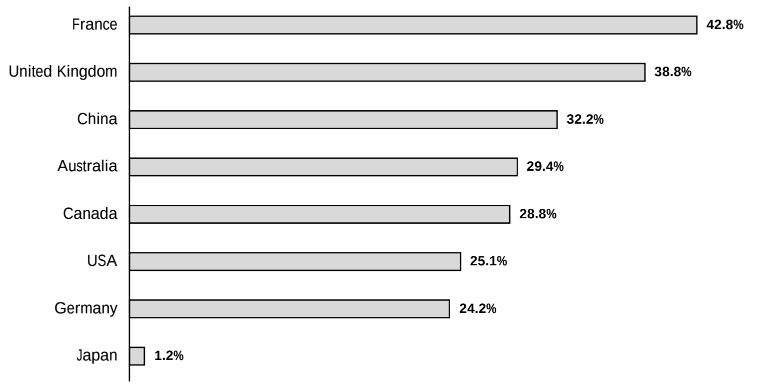


Source: Ministry of Finance Japan

Positive development, but from a low starting point

The significant increase did, however, take off from a low starting point: the value of foreign direct investment in Japan amounts to only about 1% of GDP. Japan therefore remains far behind other industrialised countries (Figure 2).

Figure 2: Direct investment in relation to GDP (%) 2001



Source: International Financial Statistics (IMF)

Little direct investment, but great potential

Despite the low investment volumes, Japan is an attractive country for direct investment. The UNCTAD *World Investment Report* compares 140 countries with regard to their foreign direct investment. The evaluation is measured according to two indices: the FDI *Performance Index* and the *FDI Potential Index*.

The FDI Performance Index places a country's share of international FDI inflows in relation to its share of world-wide GDP. The average index for industrialised countries is around 1.0. With an index of 0.1, Japan's position is 131st (out of 140).

The calculation of the *FDI Potential Index* is more complex and takes into account institutional, economic, political and social variables. It is an important indicator of the quality of the legal and economic framework, which determines investment success. With an index of 0.586, Japan is among the 20 countries with the highest potential for foreign investment. By comparison, China is in 84th position with an index of 0.251.

Increasing openness of the Japanese economy

Since the mid-1990s, the share of foreign economic activity (average of imports and exports) in GDP has increased — albeit slowly — from 6.5% (1993) to 8.5% (2000). This figure is more than 2% below that of the USA (10.2%).

Of particular interest for foreign corporations in Japan is the fact that imports to Japan have increased more sharply than exports from Japan in recent years. The share of national consumption accounted for by imports varies between sectors, but is increasing overall. In manufacturing industries, the share of Japanese consumption accounted for by imports rose by approximately one quarter in the 1990s.

1.2. Strengthened initiatives of the Japanese government

Japan Investment Council

With the establishment of the Japan Investment Council in the mid-1990s, the Japanese government sent a signal to business by beginning actively to seek foreign capital. Up to the present time, however, only some of the reforms which should improve the investment climate have actually been introduced. These efforts took on a new vigour when the government of Prime Minister Koizumi came to power in April 2001. Accordingly, in January 2002 Koizumi announced the ambitious target of doubling the volume of foreign investment within five years. Not all of the associated reforms have been introduced, but with Koizumi's confirmation as Prime Minister in September 2003 the increased initiatives in several areas are expected to continue further.

The *Japan Investment Council* was established to give foreign investors information in Japan as an investment location. At the same time it clarifies and explains the advantages of foreign direct investment for Japan, and strives to increase the acceptance of FDI in Japanese business and among the people.

Corporate governance

One focus of the government's work is on developing reforms in the field of corporate governance with the objective of bringing more effectiveness and efficiency into corporate management. For foreign companies this will be especially relevant in managing joint ventures. The Ministry of Justice (MOJ) is working on modernising the Corporate Law, which should make mergers and acquisitions easier. A draft is expected in fiscal 2004/2005.

Speeding up deregulation

The government is determined to heighten market transparency and drive forward deregulation. Extensive deregulation is planned in telecommunications, IT, energy, medical devices and pharmaceuticals, as well as financial services. In certain sectors however, reform will be slow to come.

Heightening transparency

Anyone who has had anything to do with Japanese bureaucracy will recognise the problem: for a long time it was difficult for foreign firms to obtain relevant information and to locate a competent contact person. The partially incomplete and unsystematic framework with its unofficial rules gave Japanese authorities wide room for interpretation up to now. Foreign companies were therefore obliged to react to decisions that frequently differed depending on who made them.

Invest Japan Business Support Center

This confusion was to be removed with the establishment of the Invest Japan Business Support Center in May 2003. This is a facility within the Japan External Trade Organisation (JETRO). The Support Center gathers all relevant information on the subject of investment and makes it accessible in English. Through this, foreign companies should shortly be able to obtain a much improved overview of the legal and economic framework.

Chapter 2

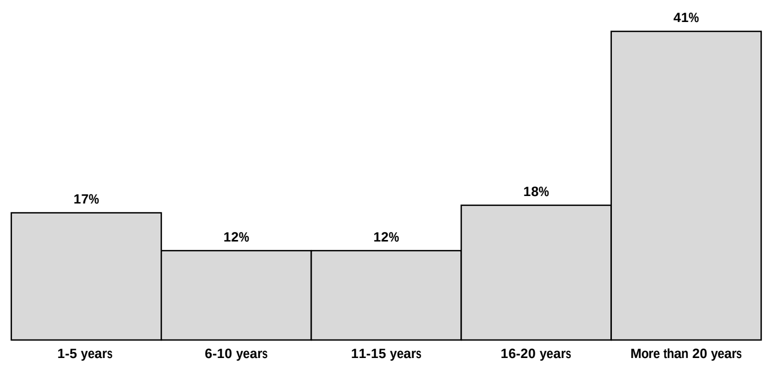
The earnings situation of German companies in Japan

2.1. Profile of the companies surveyed

Length of operations in Japan

Most of the ninety-seven companies who participated in the survey are small and medium-sized enterprises. 41% have been represented in Japan for more than 20 years through a subsidiary or a joint venture; 17% for five years or less (Figure 3). The survey is therefore representative of newcomers as well as those who have long been active in Japan.

Figure 3: Market presence of companies in Japan



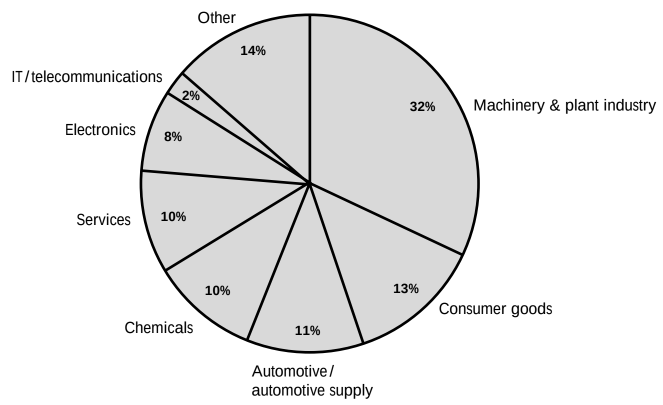
Basis: 97 questionnaires

The German parent companies of more than half of the businesses surveyed were founded 50 to 100 years before the start of their Japanese operation. Only 7% of the German parent companies decided as early as ten years after their establishment in Germany to set up operations in Japan.

Dominance of the machinery & plant industry

The machinery & plant industry industry, at 32%, is the sector with the strongest representation. Following this with shares of approximately 10% each are the consumer goods, automotive, chemicals, services and electronics sectors. IT and telecommunications were only weakly represented in the survey with 2%. The 'others' category groups together firms from various sectors (e.g. steel, optics, logistics and environment) (Figure 4).

Figure 4: Sectors in which the companies operate (%)



Basis: 97 questionnaires

Main activity: Sales

The companies were asked about the focus of their activity; and multiple responses were accepted.

At 87% sales was clearly seen as the focus of company activities, followed by provision of services (63%), production (23%) and research and development (17%).

Only a few companies, however, limited their activities to one field. Over 50% of the businesses are active in sales as well as service, whereas only approximately 25% of the firms concentrate their activities exclusively on sales.

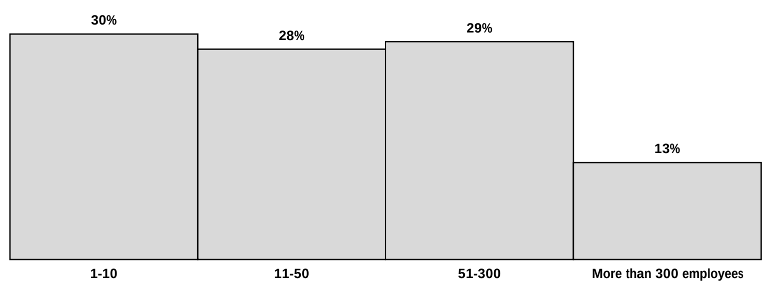
10% of the firms surveyed are pure service businesses.

Small number of employees

Around 60% of the German companies in Japan that were surveyed employ fewer than 50 people. This is rather low in comparison to the USA, where companies tend to employ more people. In Japan, only 13% of the firms surveyed have their own operations or are in a joint venture with more than 300 employees (Figure 5).

This finding is explained not only by the difference in the size of the countries, but also by the role of production in the USA, whereas in Japan, sales is seen as the main activity.

Figure 5: Company size by number of employees (%)



Basis: 87 questionnaires

2.2. The profitability of German companies in Japan

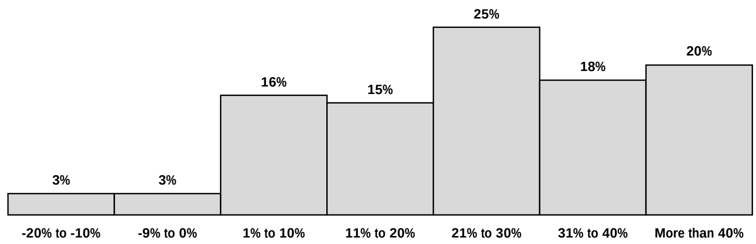
German business is profitable

The majority of German companies operating in Japan are profitable. The companies were asked about their average gross profit margin and their pre-tax profit in the years 2000, 2001 and 2002.

94% of companies have positive gross profit margin

94% of German companies surveyed have a positive gross profit margin. Almost one fifth of the companies surveyed achieved a gross profit margin of more than 40%; only 3% of the companies surveyed are operating with a serious deficit in the region of -20% to -10% (Figure 6).

Figure 6: Gross profit margin (% of companies surveyed)

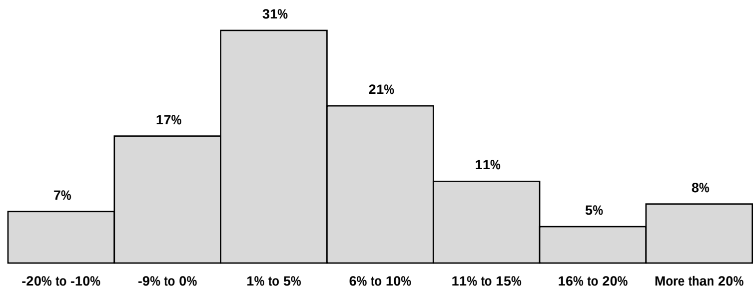


Basis: 79 questionnaires

Pre-tax profit

The pre-tax profit of the surveyed companies appears similarly positive, with 76% of respondents in positive territory (Figure 7).

Figure 7: Pre-tax profit (% of companies surveyed)

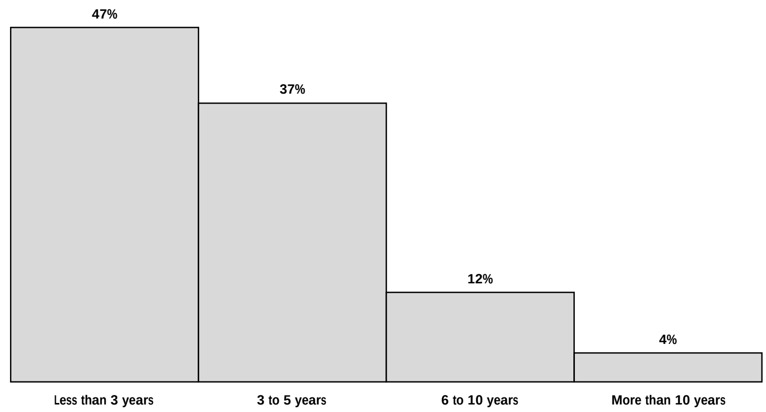


Basis: 75 questionnaires

Break-even within three years

It is generally asserted that an investment in Japan must plan for a long period before break-even is reached (the year in which revenues exceed expenses for the first time). Across all sectors, almost half of the companies surveyed took less than three years to reach break-even point. Only 4% of the companies took, or are expected to take, more than 10 years to reach this point (Figure 8).

Figure 8: Length of time to reach break-even — across all sectors (% of companies surveyed)



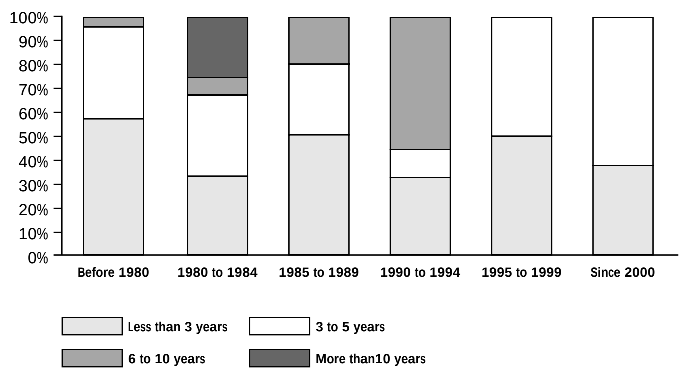
Basis: 76 questionnaires

This raises the question of whether, and to what extent, reaching break-even point is influenced by Japan's economic situation.

German firms that set up operations in Japan between 1990 and 1994, directly after the bursting of the bubble economy, tended to take longer to reach break-even. The proportion of companies that took more than six years to reach break-even grew from approximately 20% (1985 to 1989) to 56% (1990 to 1994) (Figure 9).

Companies that established their presence in the second half of the 1990s or later reached break-even sooner on average. In spite of the lingering crisis in Japan, they have succeeded (or expect to succeed) in reaching break-even within five years.

Figure 9: Time taken to reach break-even point depending on time of market entry (% of companies surveyed)



Basis: 79 questionnaires

Comparison with Japanese competition

The average gross profit margin achieved by Japanese firms across all sectors was 20% in 2001. That of the German companies surveyed was 24% on average.

In terms of pre-tax profits, Japanese firms even went into negative territory with an average of -0.1%.

This comparison should, however, be viewed in the light of the fact that the lower pre-tax profits of Japanese businesses can be explained by the fact that they are more strongly involved than German companies in production and research, rather than just sales, in their home market.

2.3. A comparison of profitability between the machinery and consumer goods sectors

Different gross margins

In terms of gross profit margin, at first glance the consumer goods sector seems more profitable. All of the companies surveyed in this sector reported positive gross profit margins. At more than 40% of the companies surveyed, the margin was more than 41%. In the plant & machinery industry, more than half of the respondents have a profit margin of between 20% and 40%, and 10% are operating on negative profit margins.

Few differences in pre-tax profit

In terms of pre-tax profits on the other hand, the two sectors have a similar pre-tax profile despite their differences in gross profit. In both sectors approximately 40% of the businesses achieve a pre-tax profit of 1-5%. In both cases 20% of the businesses are operating at a loss, and 20% are achieving a profit of over 11%.

The differences in gross profit margins and pre-tax profits between the two sectors are primarily a result of the higher sales costs in the consumer goods industry.

Chapter 3

Reasons why German companies are profitable in Japan

What the respondents said

In the survey and the interviews that form the basis of the study, the participants were asked which features of the Japanese market make their business involvement in Japan profitable. Besides some industry-specific reasons, the following factors were cited above all:

- German brands and products have a positive image in Japan
- Size of the Japanese market and high price levels
- Inclination of Japanese customers towards long-term business relations
- Low number of foreign competitors in Japan
- The greater freedoms enjoyed by foreign companies compared with their Japanese competitors
- Advantages brought by a higher degree of globalisation compared with their Japanese competitors
- Few risks

Four essential themes — the significance of the Japanese market, the advantages of foreign companies, the handicaps of Japanese companies and the risks — will be now explored in more detail. Essentially we were able to confirm the participants' comments.

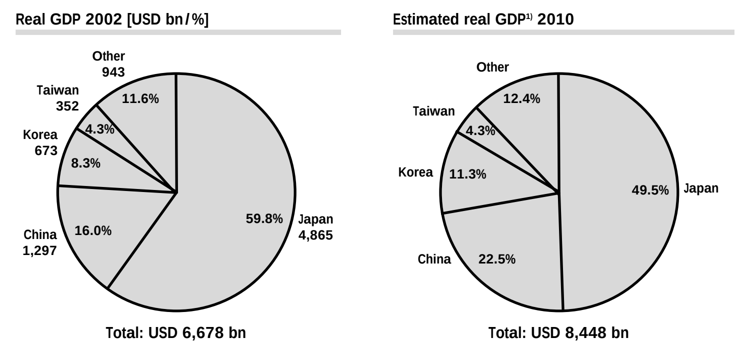
3.1. Japan is still East Asia's most important market

"Japan is the world's second-largest market!"

Japan is still the world's second-largest economy

Japan is still the second-largest economy in the world. Japan alone produces over 60% of East Asia's gross domestic product. Even if Japan's current low rates of growth and the high growth rates of other Asian countries continue, Japan's economic output in 2010 will still be more than double that of China.

Figure 10: Gross domestic product of East Asia in 2002 and forecast for 2010 (in USD billion)



1) Assumption: same average growth rate as 1999-2002

Source: EIU, 2003; Roland Berger analysis

High price levels

Due to the high purchasing power of private households in Japan, consumer goods manufacturers often achieve far higher prices than in Europe. So it was not without reason that the Japanese economics ministry issued a non-binding guideline in the 1980s, according to which the price a foreign consumer goods manufacturer can charge for its products should not exceed one and a half times the price in the country of production. Of course, these higher prices must be viewed in the context of the costs involved, which are also higher.

In the field of capital goods, the attainable premium is strongly dependent on the market concerned. In some cases, a premium of 10-15% is realistic. However, businesses engaged in strong international competition or in which the customer is engaged in strong international competition are experiencing difficulties in achieving any premium.

The deflation currently prevailing in Japan is noticeably reducing prices, which are certainly high when compared with other countries. In 2001, end-consumer price increases were -0.7% and in 2002 they were -0.9%.

Japan as the starting point for pan-Asian activities

In many respects, Japan sets the trends which are widely taken up by other countries in Asia. Japanese technology is ranked, now as before, in the ‘super league’ of numerous industries. Innovations appear first in Japan and only then find their way into China and other Asian countries. Japan is therefore very well placed as a starting point for a company that wishes to become active in Asia. Our interviewees confirmed that establishing a Japanese subsidiary inspires confidence among business partners throughout Asia and is advantageous in opening up business contacts.

3.2. Advantages of foreign companies in Japan — the ‘Gaijin bonus’

“Being different can be an advantage”

Being different is often seen as a disadvantage

Foreign businesses in Japan often have the initial impression that being different from their Japanese competitors is a disadvantage. In fact this was frequently the case in the past. Since then however, there are increasing indications that being different can be seen as an advantage.

But foreign businesses can react more flexibly in the Japanese market

Foreign companies often enjoy greater freedoms than their Japanese competitors because they are not necessarily expected to observe all of the unwritten rules. One area in which a deviation from the rules is possible and advantageous is payment terms. Foreign companies can often agree shorter payment terms with Japanese customers than their Japanese competitors can.

Such possibilities also exist in the field of corporate governance. It is customary in Japan for management boards and supervisory boards to be seen as a formality, but foreign companies can transform these bodies and their meetings into an effective guidance mechanism, for example in joint ventures.

Germany and German products have a positive image

German firms generally enjoy a good reputation in Japan. Germany is associated in the Japanese mind with attributes such as being 'industrious, precise and reliable'. Sectors in which Germany is ascribed a leading role are technology-driven such as the machinery industry, the automotive industry, medical devices, pharmaceutical products and environmental technology. This positive view is increasingly strengthened through the perceived closeness between Germany and Japan.

Of course the Japanese view of Germany has its reverse angle. Flexibility is not seen as an outstanding feature of the Germans. Similarly, in the Japanese perception, Germans are not 'fashionable' — an important criterion in the consumer sector. Here, Italy and France clearly lead the way.

Foreign employers are gaining popularity

Change is also occurring, albeit slowly, in the labour market. In a survey of foreign companies in Japan conducted by the *Foreign Chambers Information Group* (FCIG) in early 2003, two thirds of companies reported that it had become easier to recruit capable staff. The academic elite of Japan would not consider foreign companies as recently as five years ago when the country was already in the midst of crisis. However foreign employers are now becoming gradually more popular. Above all, students who want to assume responsibility and build their careers quickly are interested in foreign companies. Career-oriented women in particular appreciate the less strongly demarcated gender-specific career obstacles in foreign companies.

Admittedly this transformation is taking place slowly. Asked as part of a survey to rate employers in terms of popularity, students due to graduate in 2004 put Japanese companies in the top 23 places. Only ten foreign companies even managed to get placed in the top 100, mainly management consulting companies. The determining criteria for the selection of their future employers were visibility and size, which are associated with security. Thus, paradoxically, the beleaguered Japanese banks are still named among the most popular employers.

Use your advantages!

The 'Gaijin bonus' perceived by the surveyed companies does play an important role in certain sectors. Foreign companies should therefore make use of the specific advantages that arise from their being 'different', and should not abandon them prematurely to fit in with supposedly unchangeable Japanese customs.

3.3. Handicaps of Japanese competitors — the low level of globalisation

"Japanese competitors are not nearly so well-positioned internationally"

Globalisation as an advantage

Japanese companies differ considerably in terms of globalisation. For the most part, European companies in Japan appear to draw advantages from their global positioning. The companies surveyed stated that their Japanese competitors are less globally positioned, which is true to a large extent.

Japanese manufacturing is already strongly globalised

On the one hand, Japanese businesses have moved so much of their production capacity overseas that there is talk of '*kudouka*' — the hollowing out of the Japanese economy. By the year 2000, as much as 40% of all production capacity destined for export was already located overseas, and the trend towards investing in production capacity outside Japan continues unbroken. In terms of manufacturing, therefore, Japanese companies can be considered relatively globalised.

Establishment of a global supply base has just begun

On the other hand, Japanese enterprises still rely heavily on their long-standing relationships with Japanese suppliers, even 'taking them' with them when they set up new production plants overseas and encouraging them to establish local capacity. On the macro-economic level, imports account for a mere 8.5% of Japan's gross domestic product (2001), as opposed to 26.3% (2001) for Germany and 27.8% (2001) for the EU. However, global competition demands stronger globalisation of the supply base, and alliances with overseas enterprises are smoothing the way in the automotive industry.

International sales and service network as an advantage in third-country project management

It is in the field of capital goods that German companies, through their international sales and service network, derive advantages over their often medium-sized Japanese competitors. These come into effect particularly when a supplier's components are used in facilities and projects in third countries — for example in large industrial plants or power stations. In such cases, Japanese systems engineers who construct the plant overseas as the general contractors frequently prefer foreign suppliers who can supply the service in the third country, which Japanese firms, concentrating mostly on their home market, often cannot do.

Still little globalisation of human resources

In terms of human resources, the degree of globalisation in Japanese companies remains minimal. Both the absolute and the relative number of foreign employees in Japan are very low. In the last national census in 1999, foreign employees comprised only 0.2% of the total Japanese population. Although the share has subsequently increased, censuses taken recently at the prefecture level show a decline in 2002, probably because of the recession. Yet neither business nor the state will be able to do without the global labour market in the future. The rapid ageing of the Japanese population increasingly obliges Japan to bring in young labour from overseas. 'Value-for-money', well-educated specialists from China are already helping to ensure international competitiveness, for example in software engineering.

Some management pioneers

In management, too, foreigners are gaining visibility, albeit very slowly. At Nissan and Mitsubishi Motors, the new foreign partners have sent in entire management teams of expats. Admittedly, few companies will go as far as Asahi Glass. In 2002 the company divided its glass activities: Flat glass will be managed from its facility in Belgium and automotive glass from its headquarters in Japan. Both divisions are responsible for world-wide business in their respective sectors, and both are led by non-Japanese managers.

Prospects

With the increase in activity among foreign investors in Japan, the degree of globalisation in Japanese firms will inevitably increase. Laudable though this tendency is, the low starting point should not be forgotten. On an international level, foreign employees in Japan still play only a negligible role. For the foreseeable future, the language barrier will also greatly complicate the full-scale globalisation of human resources.

3.4. Relatively low risk factors in Japan

"Minor risks and few payment disputes"

In general, risks in Japan are few

Country-specific risks experienced by foreign companies in Japan can be divided into the following groups:

- Political risk — relatively low in Japan
- Risks of insufficient legal protection
- Non-payment risks (trade credit risks)
- Warranty and product liability risks

Other risks (defects, stock, etc.) are less country-specific and so were not considered.

"Out-of-court settlements are widely preferred"

The concept of asserting a legal position is not very common

The western concept of the individual who asserts his legal position over another with the help of the court was only transferred to Japan with the Meiji reforms at the end of the nineteenth century. Even now, the amicable out-of-court agreement of the parties is preferred by far. The notion of the contract as the basis of a business relationship, governing the rights and duties in various instances, is admittedly used in Japan, but in the event of a dispute it takes second place to the negotiation of an 'appropriate solution'. Contracts are therefore kept general in scope and are seen as 'temporary' solutions requiring common interpretation. Japanese companies therefore regard it as quite normal to adapt a contractual term later if the conditions have changed.

Japanese law is extensively modelled on German law

It is an advantage that Japanese law, and in particular civil and commercial law, is strongly influenced by German law. Consequently, agreeing that Japanese law should apply to a contract is not necessarily a disadvantage for the German side. Certain rules, such as the Securities Law are American-influenced and therefore differ from the prevailing rules in Germany. Certain differences in patent law grant Japanese companies greater protection in some areas than is the case in Europe.

High level of legal certainty

It is also an advantage that there is no jury in civil law; decisions are reached by professional judges. There is therefore a high degree of legal certainty, even though in a dispute it is the flexible, non-legal solution that is by far preferred.

"The payment behaviour is good — in four years we have not had a single missed payment"

Non-payment risks remain small, but are increasing

In the past there was scarcely any risk of non-payment for foreign investors or importers in Japan. In the recession, however, companies are increasingly paying late or not at all.

Insolvencies also increasing

The precarious financial condition of many companies is evident in the growing number of insolvencies. What is worthy of note here is not the absolute number of insolvencies, but the fact that even companies listed on the stock exchange are affected, and the associated defaulting credits are therefore clearly increasing. The total debts of Dai Nippon Construction for example, which became insolvent in 2002, amounted to more than 2 billion Euros. More than half of insolvent firms cite a decline in turnover as the reason for their insolvency. The government is now trying to prevent insolvencies by providing financial aid. Some initial successes can be perceived: the number of insolvencies declined slightly in the first half of 2003.

Major differences across sectors

The risk of non-payment differs considerably between sectors. German companies have relatively little contact with those sectors, such as the construction industry, that have been particularly shaken by the crisis. This may explain why none of those interviewed complained of any significant non-payments. So, although the payment risks have been rising in general, it would not appear to be of serious concern to German businesses.

"Despite changes in product liability laws, manufacturers in Japan are still in a better position than in Europe or the USA"

Performance risks are high due to high quality expectations

Japanese customers — be they customers of consumer goods or capital goods — are known to have high quality expectations. This leads to claims being made concerning capital goods with even minor cosmetic defects that do not compromise the functionality of the part or machine.

For this reason, German companies in Japan proceed differently than in other countries with goods from German production plants. Frequently an additional inspection is conducted by the sales force in Japan, and goods with even minimal defects are sent back. Customers also send goods back, with the result that the total cost of quality inspections and returns is higher than in other countries.

Product liability risks comparatively slight

A special legal framework for questions of product liability has existed in Japan since 1995 when the strongly EU-oriented 'Product Liability Law' came into effect. This law reversed the burden of proof, whereby the manufacturer must now prove his innocence. There is no upper limit of liability, but in contrast to the USA there are no 'punitive damages', and the Product Liability Law does not provide for compensation for suffering, which must be claimed separately on the basis of the Civil Code. The manufacturer can escape liability if he can show that the defect corresponded to the latest technical and scientific knowledge at the time of production. Claims are subject to a limitation of three years after the damage is incurred and the defendant's knowledge of the damage is established.

The number of official cases that come before the courts is relatively low. Only 27 cases were counted from 1995 to 2001. Furthermore, the value of damages dealt with in court cases is also relatively low. More than 70% of the cases involve amounts less than 360,000 Euros. There is however a large but unknown number of cases settled by out-of-court arbitration, which should be added to the number of official cases.

Chapter 4

Possible reservations about committing to Japan

Possible reservations about commiting to Japan

From the viewpoint of the companies surveyed, several factors speak against a commitment to Japan:

- Lingering economic crisis
- Continuing *Keiretsu* connections
- Complicated and expensive sales structure (large number of intermediaries)
- Strong competition from Japanese companies
- High labour and rent costs
- Tariff and non-tariff barriers to trade

The following section analyses how, and to what extent these arguments have had a negative influence on the business of German companies in Japan.

4.1. The lingering economic crisis — also an opportunity

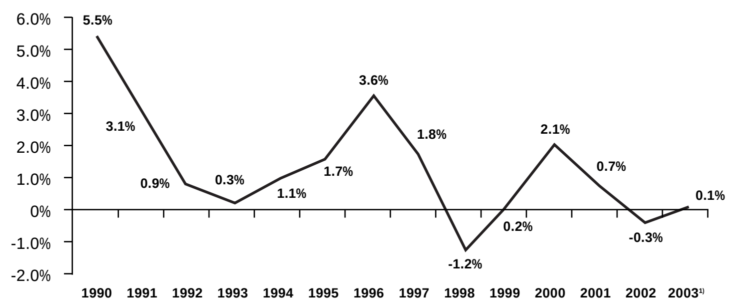
"The crisis works for us!"

Opportunity in economic adversity

Since the beginning of the 1990s, negative headlines have determined the picture of the Japanese economy: low economic growth, a fragile banking system, low productivity and minimal return on investment. In fact, the continuing recession since 1990 has frightened investors off from committing to Japan (Figure 11). It is a fact that the Japanese markets are no longer growing so strongly and that they have therefore lost some of their attractiveness.

Yet this recession is also breaking down rigid structures and opening new, promising investment opportunities for foreign businesses.

Figure 11: Development of real GDP in Japan (%)



1) Forecast

Source: EIU, 2003; Roland Berger analysis

4.2. The *Keiretsu* — declining significance

"The significance of the Keiretsu is exaggerated overseas"

In the past, *Keiretsu* were an important means of protection

Keiretsu (groups of companies) started to group together after the second world war, partly building on the family-led business groups of the pre-war years, the so-called Zaibatsu. The *Keiretsu* are mostly bound by cross-shareholdings. They grant each other preferential treatment in business transactions (exchange of products and services) and have a committee in which the presidents of the member companies exchange information and determine strategies. This resulted in a system that shared risks among the entire business group and offered protection against market forces and foreign competition. The most well-known are the 'big six' horizontal *Keiretsu* (including, among others, Mitsui, Sumitomo and Mitsubishi), each of which included a bank, an insurer, a general trading house and various companies from the manufacturing industry and the services sector.

Gradual opening

The system worked for as long as the Japanese economy was booming. Today it is more the handicaps that are felt — such as inflexibility in the choice of cost-effective business partners. This is leading the business groups to gradually open up.

Reduced shareholdings

The cross-shareholdings became increasingly unattractive as a result of falling share prices and the requirement (since April 2001) to value shares at market price, as well as the limitations on the share portfolios of banks (since January 2002) and finally the tendency of the large manufacturing businesses to concentrate on their core activities. The cross-shareholding ratio for listed companies in Japan, measured in share prices, halved from 18.4% (1987) to 8.9% (2001). For the six large business groups the value nevertheless stood at 14.1% in fiscal 2001, but even among these groups the value between 1990 and 2000 had declined by one third on average. Conversely, individual investors, pension funds and foreigners have since gained importance as investors.

***Keiretsu* — no barrier to foreign investors**

Despite this apparent dissolution, *Keiretsu* will continue to exist in the future. They will, however, be in less of a position to prevent foreign companies from gaining access to their members. The declining influence of these groups was also confirmed by the results of this study. Only 7% of the companies surveyed saw the *Keiretsu* connections as posing any problem for their activities in Japan.

4.3. The Japanese sales system — possible new sales channels

"The multi-level sales system poses no further barrier to trade in the real sense"

Multi-tiered sales system

The Japanese sales system was characterized over decades by multiple trading layers. Direct sales to retailers or end users was almost impossible, which, according to many of the companies surveyed, has reduced their profit margin by up to one fifth. Further problems arose in that the sales intermediaries (trading houses etc.) — in consumer goods as well as in complex technical products — did not have sufficient product expertise to present the technical advantages of the foreign product in a convincing way. Major competitive advantages were therefore given away.

Cutting out the middlemen

The increased financial pressure exerted on Japanese companies by the recession has, however, strengthened their efforts to reduce their costs through new purchasing and sales methods. Traditional business relationships are being increasingly given up in favour of more amenable suppliers, and direct delivery, cutting out the middleman, is increasingly accepted. The number of intermediaries has been sinking steadily since the beginning of the 1990s. This development is reflected in the number of wholesalers, which has fallen by 10.9%, from 426,000 (1999) to 380,000 (2002).

New generation of dealers

The new generation of dealers are increasingly customer-oriented: more dealers actively seek new and qualitatively high-value products in order to meet their customers' needs better. They are quite prepared to distance themselves from their traditional networks and to approach foreign manufacturers. But, as mentioned above, it must be acknowledged that in the field of capital goods Japanese dealers often lack the product expertise of the German specialists.

Multiple opportunities for foreign businesses

As the Japanese sales system changes, it opens up new opportunities for foreign businesses to establish themselves in the Japanese market and build their own sales and service network. In so doing they will find it somewhat easier than their Japanese competitors to break away from traditional sales patterns and to deliver directly to retailers (consumer goods) or to end users (capital goods).

There are of course numerous fields in which even German companies will continue to depend on intermediaries. However, almost all those surveyed emphasised that they have been able to increase their profit margins in recent years by reducing intermediary involvement.

4.4. Strong Japanese competition — winning through differentiation

"Excess competition does not have to be a barrier"

Numerous Japanese competitors

The general picture of the Japanese economy is determined by major corporate groups. In fact, however, 99.7% of firms are small and medium-sized companies.

Smaller competitors compete on price

Nearly all industries are dominated by three to five major companies, some of which have international activities. Next to them, however, exist numerous small and medium-sized enterprises, which compete mostly on a local level for a share in the remaining market. For the most part, these small competitors compete on price and personal networks. Our interviewees reported that the number of competitors in each sector in Japan is substantially higher than in the same sector in Germany. The considerable over-capacity associated with this has not been noticeably reduced despite the marked tendency towards consolidation.

Success through differentiation

Nevertheless, the numerous competitors and the price war do not necessarily represent a barrier to new entrants. The smaller Japanese companies who concentrate on their home market and have therefore been relatively protected from the global market rarely saw a need to increase their competitiveness by differentiating their product. Precisely the small suppliers whose products were fenced off from competition and who therefore missed the opportunity to adapt to international standards must therefore compete on price.

A foreign manufacturer with a global organisation can escape from this price competition if it emphasises differentiation, and can then turn the fragmentation of the market to his own advantage.

4.5. High labour and rent costs — with a downward trend

"Japan continues to be an expensive location — but there is a downward trend"

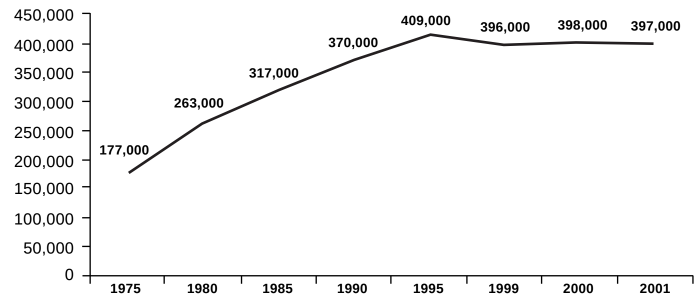
Declining operating costs through deflation

The high labour and rent costs in Japan deter many companies from investing. Japan is certainly an expensive location, but in this respect, too, the economic crisis has contributed to an improvement in the investment environment.

Stagnating labour costs

Data from the Japanese government office of statistics show that salaries have stagnated or even fallen since 1995.

Figure 12: Salary patterns in Japan (yen / month)



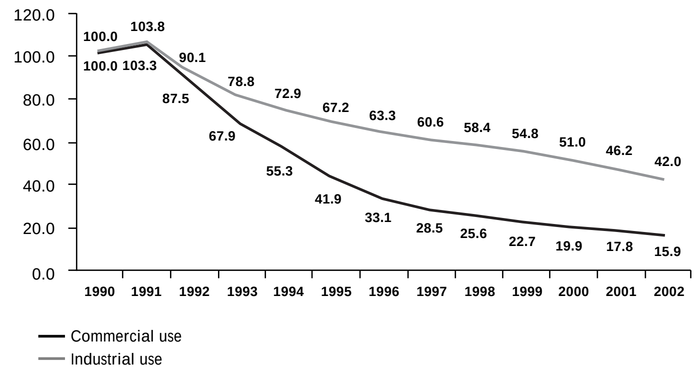
1) Companies with more than 30 full-time employees

Source: Ministry of Health, Labour and Welfare, 2003

Land and building prices sharply down

The price deflation in land and building is much more evident. The price index for the six cities with the strongest economies (Tokyo, Yokohama, Nagoya, Kyoto, Osaka and Kobe) shows the slump in prices since the beginning of the 1990s. The value of space for commercial use has now fallen to 16% of its value in 1990.

Figure 13: Land price development in Japan (Index 1990 = 100)



Source: The Japan Real Estate Institute, 2003

4.6. Tariff and non-tariff barriers — not insurmountable

"Barriers certainly exist, but for those who dare to tackle them, a lucrative market awaits"

Customs duties are relatively low

OECD statistics show that the average burden of import duties in Japan is lower than in comparable industrialised countries. In 2001 the applied rate of duty was on average 2.5% for all goods. Particularly high rates of duty of over 11% are applied to agricultural products. In the industrial sector, in contrast, average rates of around 1.5% apply. The companies surveyed did not see customs duties as a barrier to their activities in Japan.

Non-tariff trade barriers being slowly removed

Non-tariff trade barriers in the form of government regulations and standards could continue to present a problem. In March 1995, the Japanese government launched a programme to promote deregulation, which determines the focus of reforms every year; the following sectors, amongst others, are included: telecommunications, transport, energy, banking and insurance, as well as standards and certification.

There is considerable opposition, however, to deregulation measures. Above all the Ministry of Agriculture, Forestry and Fisheries of Japan (MAFF), the Ministry of Land, Infrastructure and Transport (MLIT) and the Ministry of Health, Labour and Welfare (MHLW) are implementing the deregulation measures very slowly. As a result, investing in the sectors under the control of these ministries still entails dealing with official barriers.

National standards conforming to international

Improvements can be recognized in the area of standards and approvals. The Japanese government has adapted 90% of national standards (JIS) to international standards, although they still represent a barrier to trade, albeit one of declining significance.

It is a problem specific to Japan that these standards, which are necessary for certain products (e.g. pressure tanks) to be certified for use, are an integral part of the law rather than — as in Germany — the law making reference to the corresponding standards. To adapt the standards to technical progress in such cases requires a time-consuming change in the law — outdated standards are the consequence.

Outdated standards do not just make it difficult to import foreign products; they also represent a trade barrier to Japanese businesses in that they have to develop and produce for export a variant which would not be permitted in the domestic market. For some Japanese companies this means a deterioration of their international competitiveness, and now more and more Japanese companies are demanding that standards be relaxed and modernised.

Foreign businesses use trade barriers as soon as they have overcome them

Trade barriers such as government regulations and standards certainly make initial market entry difficult and minimise the margins. And they have also contributed to weakening the international competitiveness of Japanese businesses. But for businesses that are established and have left the barriers behind them, the barriers themselves turn into an effective means of protection against new foreign competitors.

Summary

The profitability of German companies in Japan

This study establishes that the majority of German businesses in Japan are profitable. Of the companies surveyed, 94% have a positive gross profit margin and 76% have a positive pre-tax profit. On average, break-even point was reached in less than three years, even though companies that established themselves in Japan directly after the bursting of the economic bubble in the early 1990s tended to take longer.

Reasons for profitability

Leaving company-specific factors aside, the German companies surveyed believe that four particularities of the Japanese market contribute to the profitability of their operations:

Japan is still the world's second-largest political economy and the largest market in East Asia, and will not lose this position in the coming years.

Long perceived as a disadvantage, the skilful use of the differentiation of foreign business is turned into an advantage — the 'Gaijin bonus'. Foreign companies can react far more flexibly than Japanese companies; Japanese customers and employees are increasingly ready to accept foreign products and employers.

In their own evaluation, foreign companies in Japan derive particular advantages from their global orientation, because Japanese competitors are much less oriented to the international markets.

Finally, risk factors (non-payment, legal certainty, warranty and product liability) still play a relatively minor role, despite the increasing number of insolvencies and the customary practices of the Japanese legal system.

Possible objections to committing to Japan

The lingering economic crisis in Japan is often listed among the reservations. Yet the responses of the companies surveyed clearly show that the recession has also dissolved outdated structures, and has thereby opened up opportunities in the Japanese market for foreign businesses. As an example, the *Keiretsu* have gradually been opening up in the last few years. For the companies surveyed, the continuing *Keiretsu* connections scarcely pose any problem.

Even the multi-tiered Japanese sales system no longer represents a trade barrier in the real sense of the term. New sales channels such as direct sales have become possible and have increased the profit margins of the companies surveyed.

The sheer number of Japanese competitors does indeed intensify competition in Japan. Many of the competitors are, however, relatively small and are only active in the national market. The German companies see them as competing on their personal networks and on price. Foreign companies can escape from this price competition if they focus on differentiation in products and services.

Summary

The high price levels — an advantage in terms of attainable sales, can be a possible disadvantage when it comes to operating costs. However, labour and rent costs are stagnating or declining. Japan remains an expensive location, but the boom prices of the late 1980s are a thing of the past.

Although customs duties hardly play a role now, non-tariff barriers continue to pose a problem. The government's deregulation measures are slow to be introduced in some cases. Local standards are largely being made to confirm to international ones. The relaxation and modernisation of outdated regulatory structures is now being called for by Japanese businesses.

Conclusion

Japan continues to be a very demanding market, but foreign companies that are well-prepared to meet the challenges can take advantage and make a profitable business out of the size of the market and from the opportunities which it now offers to foreign businesses.

List of abbreviations

EIU	Economist Intelligence Unit
FCIG	Foreign Chambers Information Group
FDI	Foreign Direct Investment
JETRO	Japanese External Trade Organization
JIS	Japan Industrial Standards
MAFF	Ministry of Agriculture, Forestry and Fisheries of Japan
MHLW	Ministry of Health, Labour and Welfare
MLIT	Ministry of Land, Infrastructure and Transport
MOJ	Ministry of Justice
UNCTAD	United Nations Conference on Trade and Development

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The survey is also available for download in English and German
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