

Mitsubishi corporation analysis

[Business](#), [Company](#)



Capital structure in Japan has been noted to be more highly leveraged than comparative North American firms which brings to mind the question: how is it that Japanese firms have been able to take on such high levels of debt? The answer lies in the environment that Japanese firms have been operating in.

More specifically, the levels of debt are likely to have been induced by the lack of alternative sources of finance because of the effect of government regulations, and the different ownership structure in Japanese firms (with institutional lenders being major equity holders). So, the higher leverage has been a consequence of the conditions that Japanese business face - with a more pronounced effect (due to relationships) in companies which are in corporate groups known as keiretsu. These conditions were characteristic of the past.

As the benefits of debt are well known in finance theory (tax shields, signaling etc.), the lack of independence and efficiency in decision making borne by Japanese managers seem to be the costs. The result for some firms has been a reduction in debt levels to those more resembling U. S. companies. The questions now have become: What is the optimal debt level for a Japanese firm? Should firms still be taking advantage of the benefits of their keiretsu relationship that have allowed them to take on such levels of debt?

Our analysis focuses on Mitsubishi Corporation, a core conglomerate that is part of the larger Mitsubishi Group keiretsu having the capital structure characteristics mentioned above. The report will first explore the

circumstances that may have induced Mitsubishi to its present capital structure, then look at more recent events and trends that may affect future financing decisions, and conclude with the Mitsubishi capital structure/optimum debt level analysis.

Japanese corporations have outpaced rival firms in the US and Europe in terms of capital investment throughout the 1970" s and into the 1980" s. One of the main reasons behind the high level of investment is the better access to capital that Japanese firms have compared to their western counterparts-the result is that Japanese firms seem to have more debt than their U. S. counterparts. A common motive for taking on more debt is for the tax advantages, but there is little to suggest that there is much difference in the taxation systems between the two countries to support such a reason . The most likely factor for this trend in Japan has been the result of the close relationships that Japanese firms have with each other in a keiretsu.

In Japan the majority of companies are formed into enterprise groups called keiretsu (which translates as " series" or " group". The basic features of a keiretsu are as follows: cross-share holding agreements, interlocking directorates, intra-group financing, joint investing, and a consistent pattern of dealing among group members. The largest of the keiretsu are Mitsubishi, Mitsui, Sumitomo, Fuji, Daiichi Kangyo, and Sanwa (the latter three are centered around Japan" s largest commercial banks. Together, these six corporate groups account for a quarter of total Japanese business assets.

Prior to the Second World War, several large monopolistic companies dominated Japanese industry. They were known as zaibatsu - the dominant

four were Mitsubishi, Mitsui, Sumitomo and Yasuda. During the post-war Occupation the holding companies of the zaibatsu that controlled member firms were dissolved. Many firms subsequently regrouped to create the keiretsu we see today.

Types of keiretsu: Vertical and Horizontal

Vertical keiretsu are arranged hierarchically along production and distribution lines and organized under a principal manufacturer. The benefits of this network include increased efficiency and customer service, decreased distribution costs, simplified marketing channels, rationalized inventory controls and the facilitation of effective information sharing between members. Also, the principal manufacturers receive the benefit of being in a dominant position, which creates a high degree of bargaining power.

Horizontal keiretsu are large groups of Japanese companies in a wide range of industries, organized around a commercial bank. Direct competition is avoided between member firms by only having one company in any line of business. The success of this type of keiretsu is attributed to their cross-shareholding and the availability of bank loans to their members. This is supplemented with personnel exchanges and consensus decision making between member firms. Being in a horizontal keiretsu also means that a stable core of long-term shareholders is in place for a company. For our purposes we will be focusing on the capital structure and other features of firms in a horizontal keiretsu.

The economic environment that Japanese firms operated in favored highly leveraged capital structures. The following are some of the factors, besides belonging to a keiretsu, that have had an effect on a Japanese firm's capital structure.

The reluctance of Japanese managers to raise equity capital stems from the operations of the Japanese stock markets. Firstly, the Tokyo Stock Exchange is less stringent on disclosure requirements as compared to the NYSE, for example, which causes sharp asymmetric information differences between corporate insiders and the market. The result of this asymmetry is a severe underpricing of new share offerings and a reluctance to issue on management's part.

Firms, therefore, had a preference for bank debt which was less likely to suffer from such pricing effects. Secondly, equity has been an expensive form of finance in the past. The notion of issuing shares at market value is a recent phenomenon whereas traditionally firms issued equity at a historical par value of 50 yen with a fixed dividend. Investors typically demanded a 20 to 30 percent annual dividend on the par value (in essence the instrument was a preferred share), which were paid out of after-tax cash flows. Loans on the other hand were easily obtained through an affiliated bank at reasonable interest rates, and provided a tax shield through the deductible interest payments.

Government Regulations and the Bond Market

Table 1 shows how the domestic bond market in Japan began to open up during the 1980's. Until that time, strict bond issuing criteria that applied internationally kept most firms out of the domestic and foreign bond markets. Government regulations worked against issuing corporate bonds. The government saw corporate bonds as a competitive threat to its own bonds since interest rates would have to be raised in order for the government's bonds to compete with those of the top corporations. It wasn't until 1985 that unsecured straight-debt corporate bonds were even issued. These conditions meant that firms had a reliance on their bank for debt financing; and as a result of their close relationships to banks, had a lower cost of capital and the ability to invest more than those who did not.

Structure of Corporate Ownership in Japan

The structure of corporate ownership in Japan is quite different compared to their counterparts in the West, with ownership being highly concentrated in Japan. Japanese laws allow institutional investors to exert more control over firms and their management inducing them to seek higher levels of share ownership. Indeed, there is a striking difference between Japanese and US corporate ownership. Ownership by financial institutions (particularly commercial banks) is far greater in Japan than in the US.

Japanese commercial banks and insurance companies hold approximately two to three times the number of outstanding shares of public firms than their US counterparts do. On top of being a predominant shareholder, financial institutions play the simultaneous roles of also being the largest creditors of the firms as well being an important long-term commercial

business partner. For example, it has been shown that out of 344 manufacturing corporations, financial institutions own 34.48% of the common equity and individuals own 29.53%. Therefore, many Japanese firms have access to more debt since financial institutions have highly concentrated ownership in firms.

Ownership concentration does not differ significantly between keiretsu and independent Japanese firms. With high ownership concentration and cross-share holding by banks, suppliers and customers, keiretsu firms are better able to monitor decisions of firms within the group and direct management's actions to benefit the whole and to act as a collective rather than just being contractual business partners.

During the high growth era, the government of Japan's Ministry of Finance directed investment to high growth industries. To ensure that investment capital was available to firms in these industries, implicit guarantees on the liabilities of financial and non-financial corporations were given to lenders. The provision of a safety net for the loans made the banks eager to lend money to finance rapid expansion in these industries, and the corporations willing to borrow it.

Banks were also threatened by market bonds since they posed direct conflict to their business in two ways. First, there was a fear that interest rates on bank deposits would have to be raised from their artificially low rates to keep funds from migrating to other investment instruments. Second, banks did not want to lose their traditional customers for loans to the capital market.

Because of their presence in the management and the board of directors in

firms within the keiretsu structure, they were able to effectively keep these companies financing their operations with loans. This was relatively easy since most firms could not issue bonds anyhow until recently.

The keiretsu system helped to reduce many of the direct and indirect costs faced by Western firms, which may have allowed firms to raise their debt levels.

A major benefit arising from keiretsu affiliation is the reduction in costs of financial distress for member firms thus allowing them to take on a higher debt to equity ratio than otherwise possible. This is mainly attributed to keiretsu banking relationships and the consequent high levels of share ownership by financial institutions.

Since a Japanese keiretsu is primarily financed by its main bank, to which a firm has close ties to, the extent of financial distress is greatly reduced.

Hypothetically, when a firm within a keiretsu is entering financial distress, its main bank will coordinate rescue efforts by arranging loans from other banks as well as itself. In extreme cases, the bank will even find a company within the same keiretsu to merge with the distressed firm. In the event of a bankruptcy, the main bank will bail out the keiretsu firm by absorbing all losses by taking a subordinated position to other debt holders, eliminating the need for squabbling between the other claimants.

The other features of the keiretsu, namely cross-ownership of shares and intra-group financing, also decrease the cost of financial distress. Since all firms within a keiretsu have some sort of stake in the distressed firm, it is in

their best interest to try to keep that firm in operation . Aid from companies in the keiretsu can come in the form of stretched receivables, favorable transfer pricing and direct management incentives.

To decrease the probability of bankruptcy and to increase the likelihood of recovery by a financially distressed firm, it would be ideal to expand, invest, and allow their organizations to grow. This is consistent among keiretsu firms since in times of financial distress, they tend to invest 46 percent more compared to non-keiretsu firms .

Firms in financial distress generally have problems in raising capital, which may be in part due to a free rider problem. Firms with diffuse groups of creditors are faced with this problem because individual debt holders would not be willing to refinance the firm or renegotiate debt claims even though it would be in their collective best interests to do so. This problem is absent however, when a keiretsu firm is primarily financed with bank loans from a single creditor. Free rider problems are less severe or eliminated in keiretsu organizations.

In addition, keiretsu firms tend to stay out of Japanese bankruptcy courts. Since financially distressed keiretsu firms are bailed out internally, the direct costs of bankruptcy such as legal and advisory fees, are vastly reduced. American firms on the other hand see the majority of disputes, arising from financial distress, ending up in bankruptcy courts. This problem in the US corporate system can be partially attributed to the wide use of bond financing.

A multitude of bondholder claims are more difficult to restructure than a single bank loan and US bankruptcy legislation prevents companies from changing the principal, interest, and maturity without unanimous consent from bondholders. Therefore, keiretsu firms do not incur these large costs of financial distress, which can reach up to five percent of firm value, incurred by their US counterparts. In the end, the lower costs of financial distress is another reason why Japanese firms can take on more debt and thus lower their costs of capital even more with increased utilization of their tax shields.

A financial keiretsu, through its network of corporate cross-shareholdings and strong relationship with a main bank, serves as an effective system for monitoring the actions of a member firm. Member firms are in unique positions to serve as mutual monitors because the success of a single firm is in the best interests of the entire keiretsu. As keiretsu firms typically have seats on other member firm's board of directors, they can make sure that the actions of management are in accord with the interests of the entire group.

The main bank acts as the primary lender and as a major shareholder, also tends to have its own executives sit on the board. This dual role ensures that the banks will be looking out for the interests of both bond and equity holders of the firm. The costs of monitoring are not as high as they are in the US system for any one party since the ownership is not as diluted. Hence, each member has a significant interest in monitoring the firm's activities and the free rider problem is alleviated. This system of corporate governance effectively makes sure that management pursues long run value creation.

Agency costs are reduced in a keiretsu because of the unique relationships within the group. Shareholders cannot participate in moral hazard activities such as transferring risk to debt holders or transferring wealth from them by encouraging management to take on negative NPV projects. Both the higher level of debt and the structure of ownership, i. e. the bank being a creditor-owner and the high proportion of shares being cross-held within a keiretsu, serve the purpose of keeping managerial interests in accord with the group. The lower agency costs also results from the fact that most of the debt is short-term and secured.