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Follow the Customer, Follow the Car

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Global companies today can learn from the Japanese enterprises that thrived during the country's "lost decade."

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Some experts have observed that the current global financial crisis resembles the collapse of Japan's bubble economy in the early 1990s. Indeed, the U.S. and European governments have responded now much as Japan's did then (although at a faster pace). Authorities are reforming mortgage-related agencies, consolidating major financial-services companies, and injecting public capital into a few big banks. In Japan, these measures halted the collapse, but they did not lead to general economic recovery for a decade. What can today's policymakers and global companies learn from Japan's collapse?

At first glance, there might seem to be a fundamental difference between the world today and Japan in the early 1990s. During the Japanese bubble, commercial banks drove up stock and real estate prices with the capital from their deposits. In the U.S. and the European Union, the securitization market was the source of capital. But the underlying behavior was the same: Financial institutions, looking for fast returns, provided financing without enough restraint. This capital in turn fueled sectors of the real economy, such as durable consumer goods and housing, and caused them to overdevelop, as players in each industry competed for customers.

If the dynamics of the recent global bubble are the same, then the path to recovery may be clear. Before Japan could return to prosperity, its business community had to learn three critical lessons: the dangers of excess supply, the value of customers as scarce resources, and the need to embrace consolidation. Today's global business community, by heeding those lessons, may be able to recover more rapidly than Japan did.

The Dangers of Excess Supply

From the 1950s through the 1970s, the Japanese economy grew largely through exports. Japanese leaders took advantage of their country's low labor costs to develop the overseas market. They promoted exports because they understood that, with a population of 120 million and little growth, their own country's consumer base was limited.

The origins of Japan's bubble economy began after 1986, when there was a steep rise in the value of the yen. Japanese policymakers regarded this as a drag on Japan's export-driven economic growth. Thus, they increased deregulation and added more government supports to business, all aimed at stimulating domestic demand. The relaxation of some constraints on financial activity spurred investment; the manufacturing sectors interpreted this activity as real growth in consumer demand and accelerated investment in production capacity. The financial sector took this expansion

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as an opportunity to rush into real estate lending; they had too much deposit capacity relative to other lending opportunities. After a few years, as the bubble grew, the price of commercial real estate skyrocketed.

As long as real estate prices continued to rise, the Japanese banks did not have to worry about the risk of defaults, because the value of their collateral kept growing. Industrial companies, as well as real estate developers, expanded their businesses by relying on their increased ability to borrow. This business growth in turn drove up the Nikkei stock index. Along with rising stock prices, there was an extraordinary boom in convertible bond financing. Banks' corporate lending business needed to compete with market financing and went into stiff price competition in lending rates.

Only after the bubble collapsed in 1991 did the underlying problem with this growth strategy become evident: The consumer market in Japan was limited and the perception of high demand was fictitious. But many companies had invested in anticipation of future demand, and now the country had too much supply capacity and too much debt. The financial sector was criticized for over-banking, while nonfinancial sectors were criticized for over-borrowing. Many borrowers ended up with huge debts that exceeded the value of their collateral assets.

In our current economic crisis, the global financial community has fallen into the same set of traps; its members did not recognize the dangers of excess supply. A surplus of financing drove the excess supply in the industrial sector, which, in turn, drove fierce competition to fulfill future demands. That is why the damage caused by the collapse of the bubble was not limited to the financial sector.

Customers as Scarce Resources

After the collapse of the Japanese bubble, leading industrial companies had to rethink their assumptions about growth opportunities. Once they recognized that customers are scarce resources, they began to do more business with their existing customers, rather than churning their customer base.

Consider the Japanese automotive companies, for whom "follow the customer" has been a core strategy — especially valuable when demand for new cars is declining. Japanese auto companies in their home market emphasize revenues from the products that often accompany the purchase of a car, including insurance, loans, inspections, maintenance, parts, and accessories. Those revenues, stable even in recessionary times, are essential to keeping the dealer network alive.

"Follow the car" was the core of the strategy of the Japanese construction machinery manufacturing industry. (Construction vehicles are known as "cars" within their industry.) In addition to selling new construction vehicles, these manufacturers built an overseas business selling used equipment. Secondhand Japanese vehicles have good brand value and are sold at premium prices. The used machines exported to Asia engendered a good reputation for product durability, and they generated business opportunities as well: Manufacturers secured downstream revenues by selling parts and maintenance to those who might become customers for new machines in the future.

Today's global companies are not necessarily doing a good job of following the customer or following the "car." Throughout the early 2000s, they enjoyed revenues generated by a booming economy in the U.S., Europe, and the so-called BRIC countries (Brazil, Russia, India, and China). As Japanese companies had done 15 years earlier, they accelerated their investments in advance of real demand, pursuing the familiar business model of churning customers by focusing on new sales.

Now they must redefine their global business models, changing the focus from making and selling to making, selling, and servicing. The business opportunities in the near and mid-term will come from longer-term customer relationships, not just in existing markets but also in new markets. As established companies enter such countries as Vietnam, Turkey, South Africa, and Argentina, as well as "frontier markets" such as Mongolia, Uzbekistan, Iraq, and Libya — they need to understand that the customers in those countries are very price-conscious. Therefore, like Japan's construction vehicle makers, companies should consider competing on quality and customer relationship; for example, offering high-quality used products to compete with the inexpensive new machines being introduced by upstart Asian competitors. This strategy would not only be effective in attracting new customers, but would help maintain a durable brand image. By contrast, if a global company launched a new line of cheap, non-durable machines, it could jeopardize its established brand image.

Even with relatively inexpensive goods, the same lesson applies: a strategy based on retaining repeat consumers is possible and desirable. Printer toner cartridges, razor blades, and mop heads are all examples of complementary products that provide follow-on sales.

In short, global leaders will need to redefine their business models to pursue more revenue from the same customer base rather than chasing new — and uncertain — growth. Competition and oversupply have already eaten up demand for the near future. The number of customers will not increase. Making the most of an existing customer base is an effective strategy in a recession, and it will remain effective even in growing markets, especially for the long term.

Embracing Consolidation

In Japan, after the Asian financial crisis of 1997, 13 banks merged into four groups. Something similar will inevitably happen in the U.S. and Europe during the next year or two — not just in financial services, but in all sectors. Large companies will have to consider consolidating their excess capacity by acquiring (or allying with) overseas companies and their potential customer bases.

In Japan, this was a particularly important lesson for the financial and industrial sectors; they both had to solve excess capacity problems. But whereas the banking sector consolidated, Japanese industrial companies have been slow to follow suit. Instead, they have largely continued competing with one another. There are only a few models of constructive consolidation, such as the global alliance between the Renault Group and Nissan Motor Company. The two parties jointly pursued real synergies (for example, in reducing the costs of sourcing) rather than each seeking full control of the other party (as Daimler-Benz AG had sought with the Chrysler Corporation).

Some might argue that the Japanese consolidation was unique, because of the unusually close relationship between banks and borrowers. Japanese companies had depended on their banks for financing as well as overall corporate governance. After the bubble, industrial companies were forced to reduce their debt because banks had become too cautious about the soundness of borrowers' balance sheets. Japanese companies realized at that point that limited profitability (in terms of return on assets) was hurting their stock prices, and consolidation — in domestic retail industries, in particular — quickly followed. Only after the domestic industrial sector rid itself of its excess capacity did the Japanese economy became relatively stable.

But even though the context is different, multinational companies today face a similar challenge: excess supply, caused not only by financial leverage, but by excessive competition. Once again, consolidation is needed to provide stability. That consolidation will probably be driven by those with strong R&D leadership. Companies in the U.S., Europe, and Japan are rightfully spending a relatively high proportion of their research and development budgets outside of their home regions. Global access to R&D capabilities in, for example, energy or environmental innovation will drive demand in the future economy and position the companies that have it as industry leaders.

One exception to this trend is the global financial-services industry; it will also face consolidation in the future, but innovation will not shape the results. The overpopulation of this industry is a consequence of the global economy. In the past, banks did not compete across state lines (in the U.S.), across national borders (in the E.U.), or even across prefectures and provinces. But with the advancement of global economies, and the increasing cross-market competition among global players, banks no longer secure high enough profit margins in their home territories. Innovative financial products and services have limited power to solve excess competition in this sector, where they rapidly become commodities. Credit default swaps, high-risk solvency and leverage ratios, and other excesses were the products of a short-lived effort to compete through innovation, and they will all be regulated in the future. Banks and other financial-services firms will now have to refine their business models: Low cost structures, global economies of scale, internal risk management capability (as opposed to risk transfer technology), and a sufficient capital base will be hallmarks of this new, more mature business model.

During the 1990s, many Japanese business leaders waited years for recovery. After all, the fundamentals of the world economy were solid. They did not believe they had to do anything different. Productivity and quality were increasing, and global markets were expanding. Only a few companies took the measures that helped them rebuild: reducing supply, building a business based on repeat customers, and embracing consolidation. Many global companies, unwilling to forget the boom times, will make the mistake of waiting for recovery. Others may learn to be more proactive, in part from the Japanese example — and they will be the corporate leaders of the next decade. ✚

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