Companies Continue to Unwind Cross-Shareholdings — The Fiscal 1999 Cross-Shareholding Survey

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Introduction

Our survey found that companies are continuing to unwind their cross-shareholdings at a fast pace, and confirms that the scope of unwinding has spread beyond tenuous cross-shareholdings, the product of *zaitech* in the bubble period. However, no specific alternatives have emerged to replace cross-holdings as a management stabilizing mechanism. In any case, it appears that Japan's cross-ownership structure is being dismantled with the objectives of bringing Japan's corporate system into conformity with global standards, and reducing price risks of shareholdings. Meanwhile, the increase in shareholdings of foreign investors, institutional investors such as investment trusts and pension funds, and individual investors has raised concerns about the ability to secure a quorem at annual general meetings. To prevent confusion at the practical level, companies that are scrapping their cross-holdings now need to explore how to build new ways to achieve management stability.

1. The FY 99 Cross-Shareholding Survey

(1) Effect of Changes in Basic Data

The survey relies on the *Yuka Shoken Hokokusho* (Company Securities Reports) and *Major Shareholders Data* published by Toyo Keizai Shinposha. Since the *Yuka Shoken Hokokusho* reporting format was revised to a consolidated basis in March 2000, the basic data have been affected in two major ways.

First, with the shift to consolidated reporting, affiliated company data has been moved to the *Yuka Shoken Hokokusho*, while the portfolio data of affiliated companies has been removed from the attachments (Article 118 of the regulations concerning financial statements). As a result, data on shareholdings between affiliated companies not covered by the *Major Shareholders Data* has become unobtainable. In the fiscal 1999 survey, an estimated 856 companies of 2,472 companies covered have some sort of shareholdings in listed companies.

The second impact has to do with the revised standards for compiling the portfolio data. Under the new standards, any security valued on the balance sheet at 1% or less of capitalization can be omitted (form no. 8 of the regulations concerning financial statements). This represents a fivefold increase in the reporting minimum from 0.2% previously.

As a result, the number of confirmed cross-shareholdings plunged from 14,479 cases in fiscal 1998 to 10,742 in the latest survey. Thus to maintain consistency in the annual survey results, we recalculated the data for prior years by applying the new standards retroactively.

(2) Fiscal 1999 Survey Results

(All figures have been adjusted to the new standards.)

1. New low in cross-holding ratio: At the end of fiscal 1999, the cross-holding ratio stood at 10.53% in value (2.69% decline from the previous year), and 11.22% in share count (1.20% decline). These ratios mark new lows since the survey's inception, and indicate that cross-holdings continue to unwind at a rapid pace. Similarly, the long-term holding ratio — a broadly defined cross-holding ratio which includes not only the confirmed cross-holdings but one-sided shareholdings by financial institutions, and one-sided shareholdings of financial stocks by other companies — also reached new lows of 37.87% in value (2.03% decline) and 34.705 in share count (2.16% decline; Figure 1).

Figure 1 Cross-holding Ratio and Long-term Holding Ratio (Fiscal yearend, %)

FY	By value of holdings						By number of shares					
	Long-term holding ratio			Cross-holding ratio			Long-term holding ratio			Cross-holding ratio		
	Observed	Estimated	Change yoy	Observed	Estimated	Change yoy	Observed	Estimated	Change yoy	Observed	Estimated	Change yoy
1987	47.87	45.81	-0.87	21.47	18.33	-0.40	45.19	43.36	-0.59	18.11	14.75	0.18
1988	47.70	45.70	-0.11	21.00	17.90	-0.43	45.40	43.59	0.23	17.97	14.74	-0.01
1989	46.80	44.84	-0.86	20.30	16.88	-1.02	45.31	43.46	-0.13	17.79	14.48	-0.26
1990	47.58	45.58	0.74	21.42	17.97	1.09	45.78	43.90	0.44	18.62	15.19	0.71
1991	47.52	45.51	-0.07	21.32	17.76	-0.21	45.48	43.62	-0.28	18.60	15.09	-0.10
1992	47.63	45.69	0.18	21.21	17.73	-0.03	45.23	43.39	-0.23	18.39	14.96	-0.13
1993	47.04	45.20	-0.49	20.77	17.48	-0.25	44.23	42.48	-0.91	17.96	14.64	-0.32
1994	46.71	44.88	-0.32	20.70	17.35	-0.13	43.50	41.82	-0.66	17.67	14.37	-0.27
1995	45.16	43.36	-1.52	20.32	16.94	-0.41	41.79	40.16	-1.66	17.16	13.86	-0.51
1996	43.75	42.01	-1.35	19.52	16.20	-0.74	41.18	39.57	-0.59	17.10	13.87	0.01
1997	42.06	40.42	-1.59	18.19	15.03	-1.17	39.61	38.08	-1.49	16.41	13.21	-0.66
1998	41.27	39.90	-0.52	16.02	13.22	-1.81	38.23	36.86	-1.22	15.39	12.43	-0.78
1999	38.01	37.87	-2.03	10.87	10.53	-2.69	34.93	34.70	-2.16	11.70	11.22	-1.21

Notes: 1. Shows ratios to market valuations and share counts from the *Survey of Distribution of Shareholdings* (Securities and Exchange Council).
2. For estimated values, past data has been adjusted retroactively in accordance with the new disclosure standards of March 2000.

Source: Compiled by NLI Institute from *Yuka Shoken Hokokusho; Major Shareholders Data* (Toyo Keizai Shinposha); and *Survey of Distribution of Shareholdings* (SEC).

2. Both banks and business companies are unwinding: A breakdown of the decline in cross-holding ratio (value based) by shareholder shows that banks held 1.05% less of business company stocks, while business companies held 0.90% less of bank stocks, business companies held 0.32% less of stocks in other business companies, and other cross-holdings fell 0.42%. When cross-holdings began declining from fiscal 1996, business companies first began selling bank stocks, followed by banks selling business company stocks. But our results show that in fiscal 1999, both banks and business companies are actively unwinding cross-holdings in each other (Figure 2).

Figure 2 Cross-Holding Ratios by Shareholder (Value based, %)

(%)

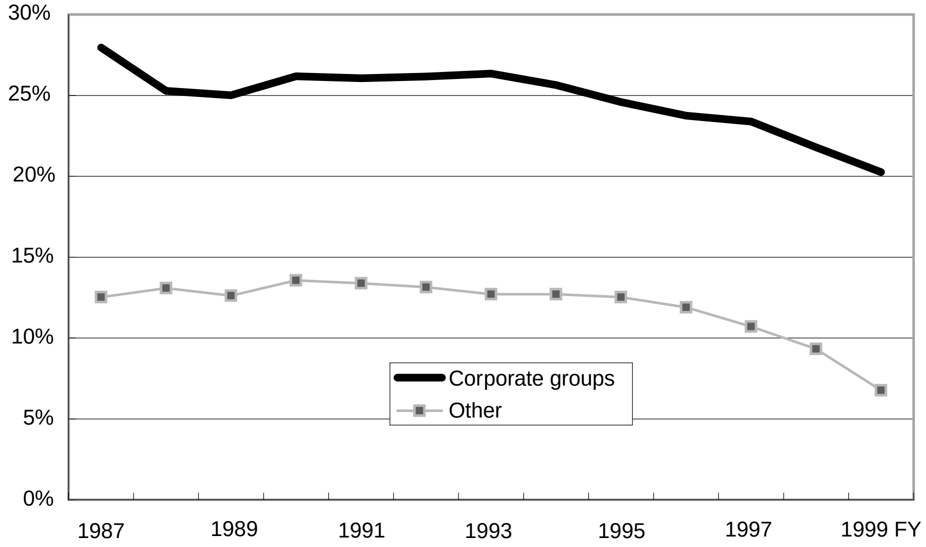
FY	Cross-holding ratio		Cross-holding by banks				Cross-holding by business companies				Other cross-holding	
	Observed	Estimated	Bank shares	Change yoy	Bus. co. shares	Change yoy	Bank shares	Change yoy	Bus. co. shares	Change yoy		Change yoy
1987	21.47	18.33	0.43		5.79		6.46		2.28		3.37	
1988	21.00	17.90	0.38	-0.05	6.27	0.48	5.81	-0.65	2.51	0.23	2.93	-0.44
1989	20.30	16.88	0.32	-0.06	6.37	0.10	5.34	-0.47	2.44	-0.07	2.41	-0.52
1990	21.42	17.97	0.38	0.06	6.77	0.40	5.74	0.40	2.54	0.10	2.54	0.13
1991	21.32	17.76	0.42	0.04	6.88	0.11	5.53	-0.21	2.50	-0.04	2.43	-0.11
1992	21.21	17.73	0.38	-0.04	6.75	-0.13	5.86	0.33	2.43	-0.07	2.31	-0.12
1993	20.77	17.48	0.36	-0.02	6.65	-0.10	5.71	-0.15	2.40	-0.03	2.36	0.05
1994	20.70	17.35	0.37	0.01	6.71	0.06	5.54	-0.17	2.45	0.05	2.28	-0.08
1995	20.32	16.94	0.33	-0.04	6.61	-0.10	5.23	-0.31	2.50	0.05	2.27	-0.01
1996	19.52	16.20	0.22	-0.11	7.33	0.72	4.09	-1.14	2.58	0.08	1.98	-0.29
1997	18.19	15.03	0.11	-0.11	7.14	-0.19	3.44	-0.65	2.44	-0.14	1.90	-0.08
1998	16.02	13.22	0.04	-0.07	6.18	-0.96	3.14	-0.30	2.30	-0.14	1.56	-0.34
1999	10.87	10.53	0.03	-0.01	5.13	-1.05	2.24	-0.90	1.98	-0.32	1.15	-0.41

Notes: 1. See Figure 1 notes for explanations of observed and estimated cross-holding ratios.
2. Other cross-holdings include those between banks and securities/insurance companies, business companies and securities/insurance companies, securities and insurance companies, etc.

Source: Compiled by NLI Research Institute.

3. Corporate group companies are slower to unwind cross-holdings: The cross-holding ratio of companies affiliated with corporate groups fell 1.54% to 20.25%, compared to a 2.56% decline among non-affiliated companies to 6.77%. This result indicates that depressed stock prices in the post-bubble period have triggered unwinding starting with tenuous cross-holdings, which grew in the bubble period for reasons other than the conventional objectives of stabilizing management and cementing business partnerships (Figure 3).

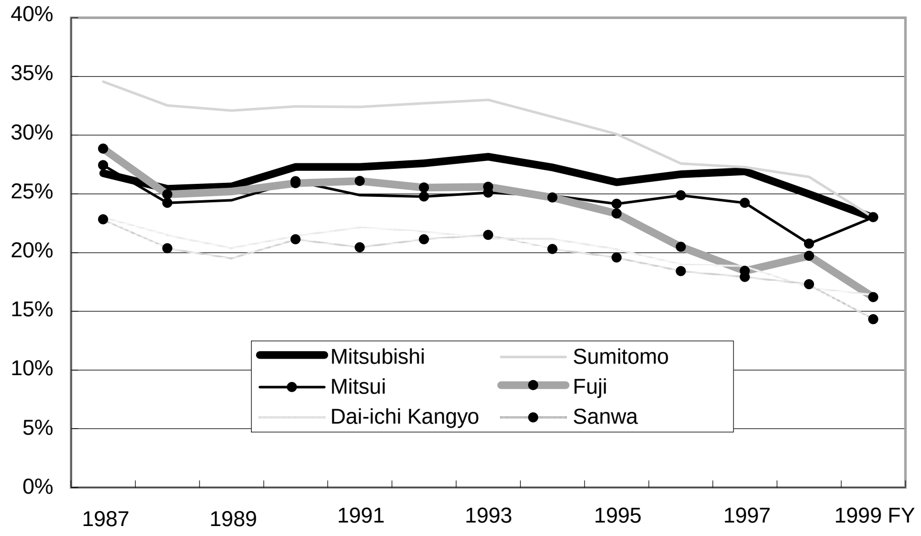
Figure 3 Cross-Holding Ratios of Corporate Group Companies and Unaffiliated Companies (Value based, recalculated)



Source: NLI Research Institute

4. Keiretsu cross-holdings decline significantly: Cross-holding ratios fell 2.01% to 22.96% for the Mitsubishi group, 3.45% to 23.00% for the Sumitomo group, 3.51% to 16.21% for the Fuji group, 0.68% to 16.38% for the Dai-Ichi Kangyo group, and 2.96% to 14.33% for the Sanwa group. The sole exception was the Mitsui group, whose ratio rose 2.26% to 23.01%. But even Mitsui's ratio would have declined if we were to exclude the extraordinary factor of change in major shareholders of group companies (Figure 4).

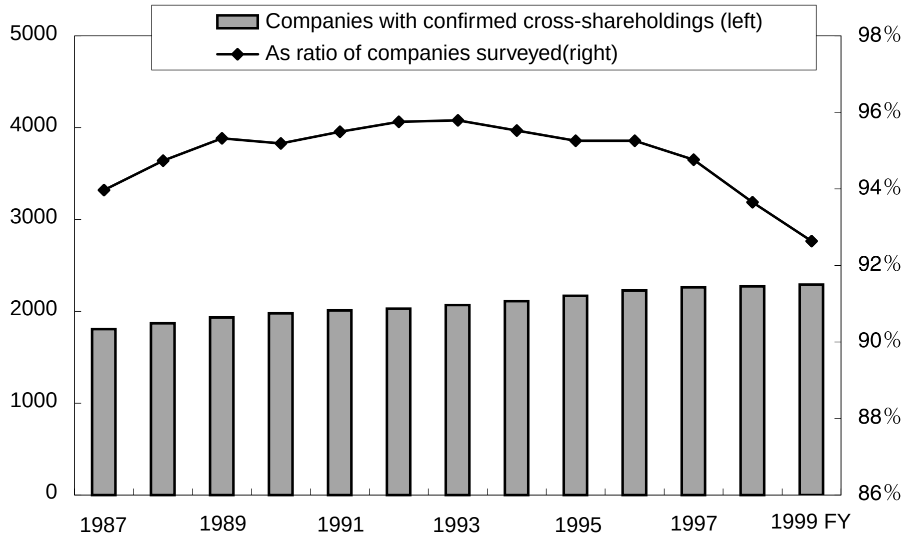
Figure 4 Cross-Holding Ratios of the Six Keiretsu (Value based, recalculated)



Source: NLI Research Institute

5. Decline in companies with confirmed cross-holdings: The number of companies with some form of confirmed cross-holdings continued to decline moderately to 2,290 companies under the new standards, or 92.6% of all surveyed companies (1.1% decline from previous year; Figure 5).

Figure 5 Number of Companies with Confirmed Cross-Holdings as Percentage of Survey Sample



Source: NLI Research Institute

2. Status of Reduction in Tenuous Cross-Holdings

Cross-shareholding grew from the 1950s to 1970s as companies sought to stabilize management and strengthen business ties with other companies. Then in the late 1980s, companies resorted to financial engineering to further expand their cross-holdings by buying each other's public stock offerings. These cross-holdings, which might be liquidated depending on share price trends, are referred to as tenuous cross-holdings (*moroi kabushiki mochiai*). From fiscal 1987 to 1989, companies issued ¥11.55 trillion in public offerings (670.5 billion shares).

Figure 6 Status of Tenuous Cross-holdings

(¥ billion)

	Total value of shares	Offering to Shareholders	Public offering	Private placement	Exercise of warrant
1985	803.1	187.9	439.0	27.2	149.0
1986	1,091.6	131.5	392.1	36.6	531.5
1987	3,296.9	469.1	1,528.0	112.5	1,187.4
1988	5,787.8	836.1	3,182.7	101.2	1,667.8
1989	9,834.8	835.8	6,839.8	264.3	1,894.9
1990	1,507.1	638.1	270.2	187.6	411.2

Source: *TSE Statistical Yearbook*

Public offerings in the bubble period (1987-89) amounted to ¥11.5505 trillion, as follows.

	(Public offerings in FY 87-89)			(Shares for which data is available)			
	Financing raised	Shares issued (millions)	(A) Shares in survey (millions)	(B) Bought by listed companies (millions)	(B/A)	(C) Shares sold in FY 96-98 (millions)	(C/A)
City & long-term trust banks	¥3,328.5 bil.	12.79	9.72	5.53	(56.9%)	5.05	(91.3%)
Regional banks	¥698.7 bil.	5.80	5.58	3.50	(62.7%)	1.36	(38.9%)
2nd tier regional banks	¥382.1 bil.	2.67	1.88	0.50	(26.2%)	0.23	(46.0%)
Trust banks (incl. Daiwa Bank)	¥723.1 bil.	3.22	2.97	3.12	(105.1%)	1.73	(55.4%)
Bank total	**¥5,132.5 bil.**	**24.48**	**20.15**	**12.66**	**(62.8%)**	**8.36**	**(66.0%)**
Securities	¥568.1 bil.	2.67	2.12	1.37	(64.6%)	2.74	(200.0%)
Insurance	¥264.6 bil.	1.93	1.93	0.61	(31.6%)	0.62	(101.6%)
Other financial	¥122.7 bil.	0.43	0.21	0.19	(90.5%)	0.04	(21.1%)
Business companies	¥5,462.8 bil.	37.54	33.64	16.46	(48.9%)	6.89	(41.9%)
Total financing	**¥11,550.5 bil.**	**67.05**	**58.05**	**31.30**	**(53.9%)**	**18.65**	**(59.6%)**

The size of fragile cross-holdings associated with the secondary offerings, and subsequent adjustments following the unwinding of cross-holdings from fiscal 1996 are shown in Figure 6. Due to constraints imposed by alterations in the basic data, our estimate covers the fiscal 1996-98 period and omits 1999. The estimate has a coverage of 87% (5,805 of 6,705 companies).

We found that approximately 54% of the shares offered in the bubble period (3.13 billion shares) were added to the tenuous cross-holdings of listed companies: 63% of the bank shares issued and 49% of business company shares. On the other hand, during fiscal 1996-98, listed companies shed 60% of these additional holdings (1.865 billion shares): 66% of the bank shares held, and 41% of business company shares. With the significant progress in unwinding of cross-holdings in fiscal 1999, the reduction of tenuous cross-holdings is thought to be almost complete. However, the progress is uneven between bank shareholdings (which business companies primarily increased) and business company shareholdings (which banks primarily increased). While business companies appear to be done adjusting their bank shareholdings, banks will continue selling business company shareholdings for the time being.

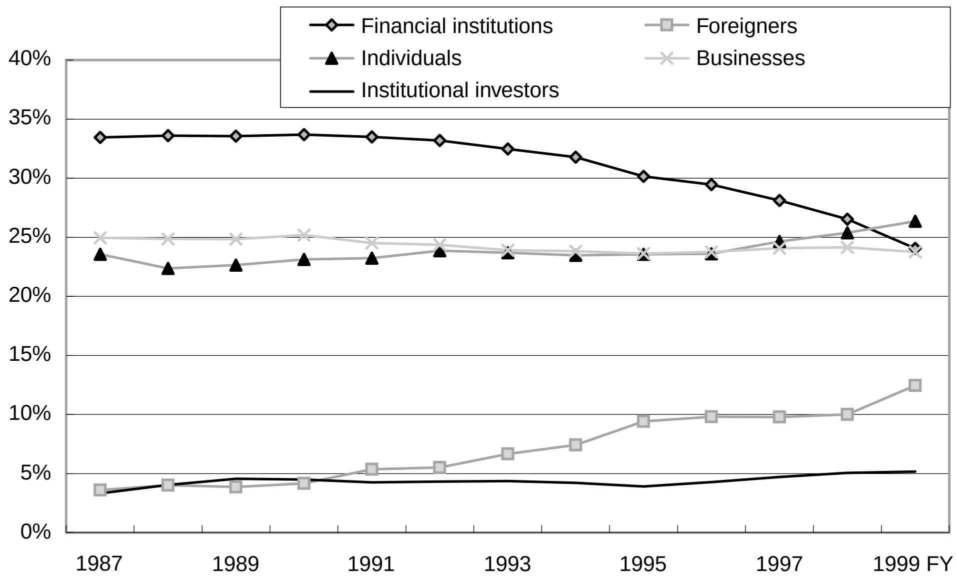
3. Pursuing Management Stability in the Absence of Cross-Holdings

With tenuous cross-holdings having been almost cleared away, any further unwinding is expected to impact the essential purpose behind cross-holding of stabilizing management. Below we make several observations in this regard.

(1) Change in Shareholding Structure

A shift has recently been occurring in the shareholding structure of Japan’s stock markets. The shareholdings of corporations (particularly financial institutions) have declined, while those of foreigners, institutional investors (investment trusts and pension funds), and individuals have increased (Figure 7). Compared to cross-holding structures in which corporate shareholders act as silent partners, the expected trend toward shareholder value focused on share prices and corporate management will heighten the importance of return on equity, disclosure practices, and investor relations activities by companies. However, while these issues are crucial for Japan’s corporate system to conform to global standards, their implementation will take much time. As a practical matter, concrete measures need to be considered to avoid any negative effects in the short term.

Figure 7 Shareholding Structure (No. of shares)



Notes: 1. Financial institutions include long-term credit banks, city banks, regional banks, and life and P&C insurance companies.
2. Institutional investors include investment trust funds and pension trust funds.

Source: Compiled from Securities and Exchange Council, *Survey of Distribution of Shareholdings*.

(2) Corporate Awareness

According to the EPA's fiscal 1998 *Survey of Corporate Activity* — taken when stock prices were declining and momentum for global standards for corporate systems was growing — companies see fewer positives and more negatives to cross-shareholding in the future. Nonetheless, two items in the survey defy this trend: the advantage of enhancing management stability by averting acquisitions, and the disadvantage of unrealized losses due to price declines in cross-held shares. These results can be interpreted as affirmations of the unwinding of tenuous cross-holdings and the management stabilizing role of cross-holding.

Figure 8 Company Survey: Advantages and Disadvantages of Cross-Holding

Advantages	Past	Future
Long holding period stabilizes share price	69.9%	55.2%
Facilitates long-term relationship with partner	52.3%	42.9%
Stabilizes management by preventing acquisitions, etc.	33.0%	36.8%
Partner contributes to capital increase	5.3%	3.8%
Unrealized profit from share price increase	4.8%	0.9%
Facilitates low-cost financing	1.6%	1.8%
No advantage	2.2%	9.3%
Other	0.5%	0.7%

Disadvantages	Past	Future
Unrealized loss from share price decline	58.6%	41.1%
Capital is fixed due to long-term holding period	37.8%	40.8%
Become desensitized to cost of capital	11.5%	19.4%
Unstable share price due to smaller float	10.5%	11.8%
Slows selection of other business partners	7.7%	12.0%
Reduces management disclipline	6.8%	6.9%
Management intervention by partner	5.4%	7.2%
No disadvantage	9.7%	10.1%
Other	0.2%	0.5%

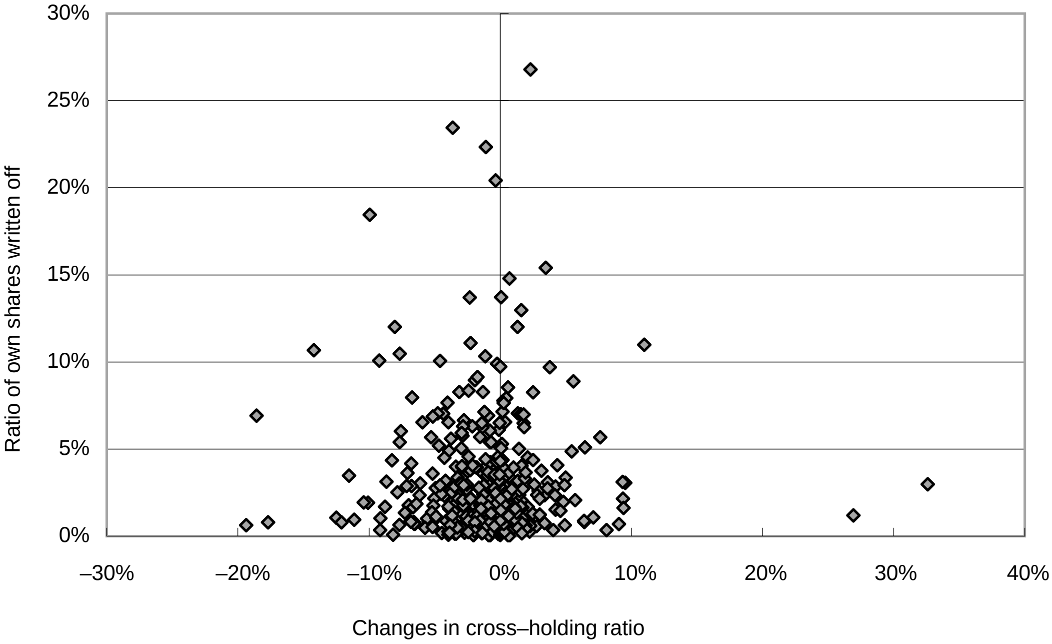
Source: EPA, Fiscal 1998 *Survey of Corporate Activity*.

(3) Absorption of Unwound Cross-Holdings

A major concern in unwinding cross-holdings is the potential negative effect on stock prices from releasing massive amounts of previously untraded shares. Thus partly from the viewpoint of stabilizing share prices, attention has focused on measures to absorb of these shares. There are two options — share repurchases and share contributions to pension funds.

1. Repurchase of shares — The fiscal 1994 revision of the Commercial Law allows share repurchases. This and the introduction of stock options are expected to alleviate supply and demand imbalances caused by unwinding. In fact, suspension of the tax on imputed dividends in fiscal 1995 made repurchases practicable for companies. Between fiscal 1996 and 1999, share repurchases of 439 companies totaling 2.34 trillion yen were reported in the *Nikkei Shimbun*. However, we found no correlation between changes in cross-holding ratios and share repurchases, and thus could not confirm that repurchases contributed to the unwinding of cross-shareholdings (Figure 9).

Figure 9 Share Repurchases and Change in Cross-Holding Ratio (FY 1996-99)

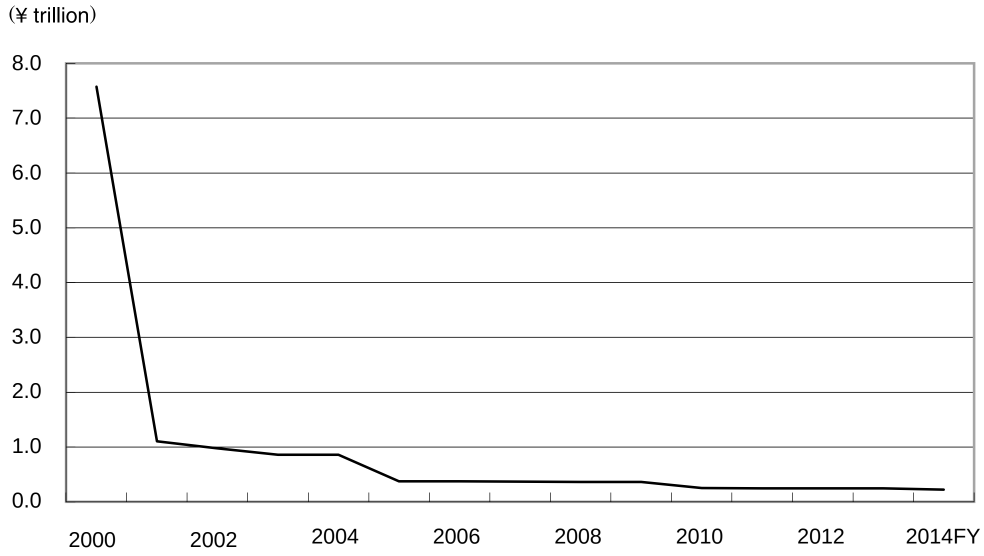


Notes: 1. Shows results of 439 listed companies reporting share repurchases from fiscal 1996 to 1999.
2. Horizontal axis measures change in cross-holding ratio from fiscal 1996 to 1999 (calculated using new standards).
3. Vertical axis shows ratio of shares repurchased during fiscal 1996-99 to shares issued as of the end of fiscal 1995.

Source: Compiled from *Nikkei Shimbun*.

2. Contribution to pension funds — When the accounting rules for retirement benefits are adopted in March 2001, companies will be required to record pension and retirement lump-sum reserve shortfalls as liabilities, and amortize them over a maximum of 15 years. Sony and other companies who have adopted SEC standards in their accounting rules have already been contributing cross-held shares to their underfunded pension funds. The development of trust products and establishment of accounting rules are expected to expand the use of this method significantly, thereby helping to alleviate unwinding to some extent. However, many companies are trying to reduce liabilities through early amortization. Based on data from the *Nikkei Kaisha Joho*, planned amortizations of liabilities are estimated to reach 7.57 trillion yen in the March 2001 term, but decline to approximately one trillion yen from the March 2002 term, and thus have only a transitory effect in unwinding cross-holdings (Figure 10).

Figure 10 Planned Amortization of Pension Liabilities



Note: Shows total for 1404 listed companies announcing amortization plans.
Source: Compiled from Nikkei Shimbun, *Nikkei Kaisha Joho*.

With efforts to unwind tenuous cross-holdings almost at an end, further progress in unwinding cross-holdings will require not only share repurchases and contributions to pension funds, but addressing issues for stabilizing management such as the scheduling of annual general meetings and exercise of voting rights. Unless these issues are specifically addressed, the unwinding of cross-holdings will only cause unnecessary confusion to corporate management. In addition to long-term reforms in the corporate system such as enhanced disclosure and IR activities, we need to address more immediate concerns such as share price volatility and management stability.