

DBA THESIS (2006)

**Development and Application
of Profitability Indices
(Executive Summary)**



M. Gary Okamoto

**DBA Program in International Business Strategy
Graduate School of International Corporate Strategy
Hitotsubashi University**

Executive Summary

While the topic of whether a company or industry is a good one may be forever arguable and ultimately subjective, the hope is that the development and application of objective and reliable profitability indices will offer insights into a company or an industry that would otherwise go unnoticed. To gauge how Japanese companies and industries fared against their global counterparts, this thesis compared Japanese industries against each other and to their competitors abroad. While looking at a closed region (e.g., Japan only, US only, etc.) provided reasonable results for some industries, it was quickly becoming inadequate for others. In a global economy, a cross-border analysis was needed to understand the relative positioning of a Japanese industry against its global peers. A new framework to measure performance is therefore being proposed.

To determine the profitability of an industry, traditional measures such as the return on sales (ROS), return on assets (ROA), return on equity (ROE), as well as the relatively new return on invested capital (ROIC) have been and should be used. This thesis chose to focus on the use of ROIC as a primary metric because ROIC attempted to isolate elements of a company and its operating environment that were specific to that region, making comparing companies in the same industry across country borders relevant. However one caveat is that ROIC was not deemed to be appropriate for financial institutions because of the different accounting principles used in these sectors and the way those principles affected the ROIC calculations.

This research thesis involved four key steps, first the presentation of the analyses framework, then the actual analyses, followed by the findings to validate the methodology, first at the industry level and then the company level. To select the Japanese industries for this study, a rigorous selection process was first undertaken to determine which Japanese industries were the most globally competitive. ROIC was measured across a total of 102 industries (manufacturing, service and financial industries), consisting of 1,922 Japanese companies, 10,034 foreign competitors and covering a consecutive five-year period. An industry-wide examination of this breadth and depth, comparing Japanese industries against other Japanese industries and against their overseas counterparts, is believed to be an unprecedented endeavor. The raw data presented in each page of the Appendix should be interesting in itself. Specific

findings for particular industries and companies should be of value to followers of those industries.

One general insight based on the data presented throughout the analyses that became vividly clear was that Japan lagged behind its international competitors in terms of profitability returns. While a few standout industries where Japan excelled were revealed from the analyses such as toys & games in manufacturing and Internet companies in service industries, some key industries considered once to be the pillars of Corporate Japan appeared lackluster. Results were simultaneously surprising and also discouraging.

For a Japanese industry demonstrating a consistent return in excess of the overseas return, it was labeled a “Diamond Industry”. In other words, those Japanese industries had proven that the collective profitability of companies in that industry excelled against its overseas benchmarks. The following industries were awarded Diamond Industry status based on this study.

Diamond Industries – Manufacturing & Service Industries (Exclude Financial Services)

Manufacturing or Service	Industry Description
Manufacturing	Toys, Games & Sporting Athletic Goods
Service	Internet Service Providers
Service	Transportation Services
Service	Business Services – Computer & Data Processing
Service	Retail – Food Stores
Service	Business Services – Buildings, including Security
Service	Television & Other Broadcasting
Service	Telecommunication Services

As further validation of the methodology, individual companies (with a market cap of greater than JPY50 billion) within those Diamond Industries were examined. Individual companies that continuously recorded higher profitability than their competitors in the same industry (in Japan and abroad) signified that they held a competitive advantage against their peers. This study found that these companies had effective corporate strategies and had successfully differentiated themselves against their competitors. These were referred to in this study as “Diamond Companies”.

Industries that stood out as a whole were built around a cluster of these Diamond Companies that drove the industry. It became evident from the research that as a whole however, Japanese companies were far behind their global competitors in profitability terms - with stress on "far behind".

Judging individual companies simply by their absolute returns, as trade publications tended to do, was limiting at best and misleading at worst. If a company operated in a booming industry, it would be difficult to discern fact from fiction to determine whether the company's own performance was genuinely a result of a unique and effective strategy. Conceivably the most effective way to evaluate a company like this was to benchmark it against the industry standard, which included all key domestic and overseas players. This is what this thesis attempted to do: to proffer a new metric to evaluate an industry of a particular country against other countries and in the process, also an individual company's performance against the worldwide industry standard.

This theory was put into practice during the selection process for candidates of the Porter Prize, which is referenced throughout this thesis. The Porter Prize was established to recognize strategy pioneers in Japan and through this process, to promote the importance of having a true, distinctive strategy, something astonishingly relatively rare among Japanese companies. In one of the final sections of this thesis, the industry-wide financial metrics were applied to demonstrate how certain companies were positioned relative to the industry benchmark. Porter Prize-winning companies (a total of 13 companies from 2001 to 2004), along with Diamond Companies discovered in this thesis, fared well, substantiating the importance of a clear, unique strategy and focus on profitability.

The world is quickly becoming a global marketplace. Changes in Japan have occurred primarily from the influence of foreign capital and ideas, but comparing the rapid pace that things have moved over the last decade around the world, Japan has not kept pace. This pace of change will only further intensify and Japanese companies, unless there is a fundamental change, will not be able to catch up. Japanese management needs to be more responsive to these changes and understand the strategic implications of decisions made. It is time for Japanese companies to prove they can be focused and show they can be different.

As with all benchmarking tools, the continuous and periodic application of these indices will be key to maintaining and improving its relevancy. If this thesis and methodology can act as a stimulus for companies to think about strategy and profitability and provide a mechanism to monitor their changes, the mission of this thesis has been accomplished.