
Osaka Renaissance News

No 15 April 2005

Welcome to “Osaka Renaissance News” - the email newsletter of Osaka City Government’s “Urban Revitalization Task Force”.

The Osaka Urban Revitalization Task Force

We are the first *City Task Force* established in Japan to address urban regeneration and revitalization at the same time. We are doing this in collaboration with the central government’s “Urban Renaissance Program”. The role of the task force is to coordinate and promote the set of initiatives that taken together form the Osaka Revitalization Plan.

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“Osaka Renaissance News” is distributed through multiple email channels to spread the word about important initiatives taking place in Osaka.

This Issue: Geographic Risk Diversification

In this concluding article in the series we argue that foreign companies in Tokyo face a serious risk of over-concentration in the event of a severe earthquake. A solution is to locate more assets outside Tokyo in Japan’s second largest market, and major transport hub.

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The Osaka City Blue Print for Urban Revitalization addresses:

- Urban Regeneration
 - Business stimulation (notably in knowledge-based industries)
 - Tourism and life-style
 - Education – especially professional and life-time learning
 - Foreign direct investment
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GEOGRAPHIC RISK DIVERSIFICATION

Contents

- (1) Kobe earthquake
- (2) Tokyo Risk Premium
- (3) Less at Risk Companies
- (4) Compliance Pressures
- (5) Commercial incentives
- (6) Distributed functions
- (7) Distribution infrastructure

AUTHOR'S INTRODUCTION

The likelihood of a major earthquake in Tokyo is far from remote, and yet without regulatory and compliance pressures, such as the financial services industry in New York faces, companies do not feel the incentive or requirement to prepare for a long-term (several months) disruption to normal operations. Here in Kansai, we have the experience of the Kobe earthquake, ten years ago, to remind us what a worst-case scenario may be like. Proctor and Gamble North East Asia, which has its headquarters in Kobe, could not return to its head office building for nearly half a year. How much worse it could be for companies in Tokyo.

The major risk facing foreign companies in Tokyo is that, unlike Proctor and Gamble, and similar foreign companies, which have their main base in the Kansai region, they have almost all of their operating assets concentrated in Tokyo. With so many major companies grouped in a small area there is unlikely to be enough extra office space, or other back up facilities, to maintain operations.

We believe that part of the solution lies in further expansion into Osaka. As this series of articles has shown, there are positive reasons to expand here. In particular, it is the gateway to the second largest metropolitan market in Japan. Its operating costs are significantly lower than in Tokyo. It is a major international hub. Companies in Tokyo could therefore increase their office capacity in Osaka to take advantage of extra sales and to lower back office costs. At the same time they can build into these new functions business continuity features, which will enhance the investment. The Osaka office could then maintain continuity in the event of a severe earthquake in Tokyo.

Companies have a requirement to their stakeholders to consider their risks. In doing so, they should also think more deeply about the opportunity of expanding regionally, from a business enhancement point of view. In short, they need to look at geographic risk diversification.

Alex Stewart

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The Osaka City Revitalization Task Force has commissioned Alex Stewart to author this series of newsletters. He is the president of Alexander Capital Access Co., Ltd., an investment catalyst and PR communications company based in Osaka. He is also an Executive Adviser to the Osaka City Revitalization Task Force. Questions about these articles can be directed to him at: alex@ac-access.com

GEOGRAPHIC RISK DIVERSIFICATION

In this issue we look at the risk foreign companies face in Tokyo and how they can mitigate some of that risk in Osaka.

Kobe Earthquake

The 10-year anniversary memorial services in February for those who died in the Kobe earthquake helped to concentrate the mind on the risks of doing business in Japan. The earthquake forced as many as 10% of the long-established Indian companies to leave Japan for good. Also, many smaller foreign companies and sole proprietors had to close down. In the case of one of the largest companies, P&G, it had to vacate its head office building for five months. The expat population also fell dramatically. The Foreign Buyer's Club, based in Kobe, described the lessons in the April 1995 issue of "Japan Computing" magazine. "What it comes down to is: businesses that were ready increased their chance of survival, and in a few cases came out ahead; many of those that were not have closed their doors forever. The first few days and hours after a disaster can determine a company's existence. It is only common sense that if you lose something, it is not always possible to get it back. It pays to take a few extra precautions."

Tokyo Risk Premium

The Tokyo risk premium was clearly spelled out in a report published by the reinsurance company, Munich Re, in December 2004, entitled "MegaCities-MegaRisks". The level of natural hazard risk, based on its measurement for the Tokyo-Yokohama area, was 710, compared with 167 for the next worst insurance risk, San Francisco. The corresponding level for Osaka was under 100. Despite this, a survey by KPMG Business Assurance, published this year, found that only 22% of major Japanese companies have contingency plans in place for a massive earthquake, although 77% recognised the need for them. Marsh Risk Consultants, another major risk consultancy, quotes research published in the Disaster Recovery Journal that, "93% of companies without a recovery plan go out of business five years after a major disaster".

Despite all of this, Tokyo has cast a spell over both foreign and domestic companies, which have been concentrating more rather than less of their assets, notably their strategic operational centres, in the Tokyo area. Foreign companies are most at risk

because they tend to have almost all of their assets in Tokyo. Japanese companies on the other hand are generally more regionally spread. In many cases, if the business was originally established outside Tokyo, say in Osaka, they maintain dual headquarters. Their ability to recover will therefore be better than their foreign counterparts and competitors.

The risk of a worst-case scenario is that foreign companies with all of their assets in Tokyo will not be able to function normally for several months. With nowhere to turn they will have to reduce their operations significantly. In some cases they may have to move their head office functions to an existing Asian centre, or back to their home office. The cost of this move in terms of lost business will be significant. Psychologically it will be difficult for many to return to Japan with the same commitment. They will have lost their footing in the market literally. To list some of the problems: They will be severely constrained in their ability to make promised deliveries to clients; they will suffer from loss of data, cancellation or postponement of orders, inability to replace stock, loss of trading income, operating losses, inappropriate insurance cover and insufficient cash flow.

Less at Risk companies

Long established foreign companies generally have at least a sales representation in regional centres, usually in Osaka, the second largest city. Even so, this often accounts for a small portion of their leased office space in Japan. On the other hand, there are a handful of major foreign companies, which have their head offices in Osaka. They include companies in the pharma sector, such as Astrazeneca, Abbott Laboratories,

and Bayer Pharmaceutical. They maintain large sales offices in Tokyo, which makes them more regionally balanced. They will therefore be better protected in the event of an earthquake in the Osaka area, and at a strong advantage relative to their peers in Tokyo in the event of a direct Tokyo earthquake.

What foreign companies in Tokyo need to consider as well, is a more regionally distributed strategy, more like Japanese companies operate. Some foreign companies in Tokyo already do, notably companies which have acquired through M&A, assets outside Tokyo. Examples of this include: Citigroup, Merrill Lynch, AIG and GE. For example, Merrill Lynch bought the branch network of Yamaichi Securities; AIG acquired a controlling interest in Osaka-based Fuji Fire and Marine; and GE Consumer Finance has bought several regional consumer finance companies. By broadening their regional bases, these companies have also put in place the capacity for a stronger, long-term business continuity strategy. By contrast, most foreign companies in Tokyo only have data back up and telecom support to protect essential existing business data, but not long term operational back up support.

Compliance pressures

To persuade them to do more, companies need either stronger commercial incentives, or regulatory compliance pressures. Currently the main compliance pressures are on the financial industry. They also have much more at risk from even short-term disruptions because they can lose literally millions of dollars if their computer systems fail and leave their own and clients' money at risk in the market. To avoid this, major foreign investment banks in Tokyo maintain

dedicated buildings, with rows of empty trading desks fully maintained, so that they can continue working without almost a day's loss of business in the event that their main operations have to shut down. The national government also uses Osaka as a back up, with the Bank of Japan maintaining a duplicate system in its Osaka branch office.

The regulatory pressure on the financial services industry increased after New York's 9-11. Of new measures, perhaps the most stringent is that companies regulated by the FSA are now required to maintain back up facilities further than 100 miles from their primary centres of operation. The New York Teachers Insurance and Annuity Association, for example, explains on its web site that: "critical business operations (are) conducted at multiple locations"; they "take into account the strength of vendor's continuity plans when determining whether to work with them;" and that their business continuity plans are designed to "recover critical business functions within one hour of a disruption, to recover important business functions within 24 to 48 hours, and all other business functions 48 hours to eight weeks afterwards". Two points stand out. First, that investment management companies have to comply with geographic risk requirements. Second, it recognises that non-critical operations could be down for 8 weeks.

Another pressure companies have to consider is public trust. The risk of a major catastrophe in Tokyo is too well documented to ignore. Therefore if companies are found not to have prepared sufficiently for it, management could be accused of negligence. Stakeholders will also attack the company if they are directly

affected by the fallout of a severe disruption. This would have a significant impact on the reputation of affected companies. Companies which have made a major investment in Japan will suffer most.

Commercial incentives

Meanwhile, the authorities in Tokyo are nowhere near as far forward as New York in stipulating measures companies must take to reduce the risks of a prolonged business disruption, even though the risks appear much higher. Without such pressures, the key to persuade companies to invest in additional office capacity outside Tokyo as a business continuity measure is going to be whether it can also contribute to the bottom line, either through increased sales, or/and reduced costs.

From a cost saving point of view, rental and land costs in Osaka are now on average some 30% lower than in Tokyo. Salaries and related overhead costs are between 10% to 20% lower than in Tokyo. It may be argued that there are cheaper regional centres than Osaka, the fact is, however, that their lower costs reflect the lower quality of their infrastructure and market opportunity. Osaka, on the other hand, is a genuine metropolitan city. Together with Kobe it forms a super-port and major distribution centre. The wider Osaka metropolitan area has a depth and flexibility of labour markets and distribution services to perform the functions of a major sales and distribution hub, in addition to a back up centre in the event of a major catastrophe.

Distributed functions

These arguments should appeal most to foreign companies that employ several hundred or more staff in service-type functions. They do this already in their

home markets where they operate from multiple bases. The reason is both to lower operating costs and to provide better sales and service support. Many larger foreign companies in Tokyo have also established second or third sales offices around Japan. Most of them however have yet to establish more back office facilities in their second or third sales office locations. Much less have they added more strategic functions, including management and accounting, to their regional functions. By comparison, large Japanese companies frequently divide Japan into two regional blocks, East and West. Operations are managed respectively from Tokyo and Osaka. The Osaka office is sometimes semi-autonomous. In the event of a serious earthquake this distributed layout will help them to resume normal operations more quickly than most of their foreign counterparts.

Foreign companies are not generally in a position to replicate Japanese systems. One reason is that there may be too much redundancy built into Japanese customer service models for foreign companies' liking. However, there remains a strong case for foreign companies to put more redundancy into their second and third offices outside Tokyo. This means that as they expand areas like sales, customer support, and especially back office, outside Tokyo, they also embed business continuity features, which will help to enhance as well as justify the additional investment.

Distribution infrastructure

As part of a robust business continuity plan, distribution infrastructure is critical. Business Continuity consultants talk of the need to have all of a company's "touchpoints" (downstream & upstream) ready against the event of business

disruptions. This means essentially all of the links in the supply chain, not only the company's internal links, but its service providers as well, such as transportation and warehousing. Osaka has an excellent infrastructure and the combination of the Osaka and Kobe ports can provide the capacity to absorb a large amount of additional trade. There is still capacity in the port area for building additional warehousing facilities. Several international logistics companies have been exploring the investment opportunity, including US-based ProLogis, which is building a second large container centre in the port. The second runway at Kansai International Airport, due for completion in 2007, will also add vital capacity in a worst-case scenario. All of this will help in ensuring that Osaka can serve as a genuine back up centre in the event of an earthquake in Tokyo which collapses the port and transport infrastructure

For logistics companies, which have most of their capacity in Tokyo, they will need to test whether they have the capacity to respond to a major disruption in Tokyo. It would be expensive and damaging to the long-term health of the Japanese economy if, because of a serious earthquake, trade shifted to other parts of Asia owing to insufficient capacity in Japan. There is at stake the impact on the national, as well as the broader Asian regional economies. The smoother the recovery of the Japanese economy after a serious quake the better for the world. Osaka has a role to play in this. Foreign companies have a duty to their shareholders to consider how they can best prepare for this. The dividend will depend on the foresight of companies and the preparations they take.

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