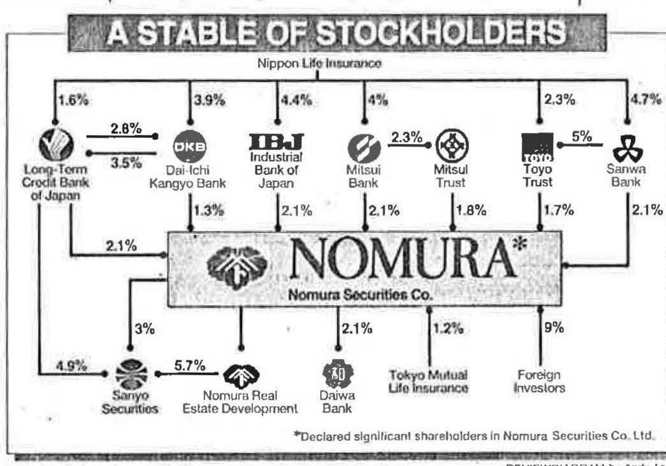
Japan's Nomura aims for the top slot

No more an outsider

By Robert Cottrell in Tokyo

Trendy bankers like to say that the world capital market is not so very different from the world car market. Once there was room for any number of small and medium-sized carmakers to operate profitably alongside one another: now there is room only for a handful of very big producers like General Motors or Toyota, and a handful of small but distinctive ones like Porsche or Rolls-Royce. Similarly, say the bankers, by the 1990s there will be room in the world for no more than a dozen giant international financial services groups, and a lower tier of much smaller "niche" specialists.



*Declared significant shareholders in Nomura Securities Co. Ltd.

REVIEWDIAGRAM by Andy Tang

There is no more powerful force shaping the structure of financial institutions today than the fear of being left out of that future first division. Every forward-looking banking or securities house now desperately wants to be seen to be active in every major market in every major financial centre in the world. Big capital is beautiful: and the world's richest securities house, Nomura Securities Co. of Japan, for years mocked as a country cousin of international finance, is fast finding itself treated by rivals with a gratifying mixture of deference, hostility and respect.

A few statistics about Nomura: it earns more profits than Barclays Bank and J. P. Morgan combined. It has a bigger capital base than Merrill Lynch, and underwrites more international bonds than Morgan Stanley. In the year to last September, it handled 15% of all share and 13% of all bond transactions in Japan. In the year to April 1986 it underwrote almost US$3.5 billion of Japanese Government bonds, while the country's biggest commercial banks took just US$1.4 billion apiece. It also underwrote 27% of all Japanese domestic equity issues, and 19% of all "shogun" and "samurai" bonds issued by foreign borrowers in Tokyo. (These figures come from a handy booklet published by Nomura itself. It is not, particularly by Japanese standards, a company unduly modest about its achievements.)

Nomura's leadership of the Japanese securities industry has never seriously been challenged since it emerged from a mid-1960s stockmarket shake-out as the strongest of the "big four" securities houses — the others being Daiwa, Yamaichi, and Nikko. But for as long as Japan's financial markets remained largely closed to foreigners, Nomura's strength was more or less irrelevant to competitors in Europe and the US: the foreigners could not do substantial business within Japan, and the Japanese firms lacked the internationalism needed to compete in foreign markets other than for the business of overseas Japanese clients.

In the past five years, all that has changed. Japan has progressively deregulated its financial system to the point at which — on paper at least — it is as open as that of Britain or the US. This process has brought Nomura into direct conflict with foreign rivals for market share in Tokyo, London and New York. Japanese houses, including Nomura, do lack skills in some key areas including fund management and merger-and-acquisition services, but they are catching up. Japan is beginning to export its financial services as aggressively as it has its industrial products. Cries of "dumping" are already being heard.

The question is not now whether Nomura and its compatriots can "cut it" in international terms, but how many other institutions, particularly outside the US, have the strength needed to put up an equal fight.

Competitors say that Nomura can afford to invest, to undercut, and to make mistakes in its expansion overseas because its domestic base is so strong. One of the pillars of that strength is Article 65 of Japan's Securities Act, which keeps banks out of the securities business and securities houses out of the banking business. (The US has a similar provision, the Glass-Steagall Act, though the greater fluidity of US capital-market structures and the high proportion of US funds raised offshore make Glass-Steagall less limiting in practice.)

An interviewer once asked Setsuya Tabuchi, then president and now chairman of Nomura Securities Co., what he thought about Article 65. "Ordinarily I am a liberal," replied Tabuchi, "but I don't believe everything has to be liberalised."

Small wonder that Tabuchi's liberalism met a natural limit. A repeal of Article 65 would bring the country's big banks tumbling in to snap up the securities houses' retail brokerage and corporate finance customers. Even the "big four" houses, with their 100-120 branches, would be overwhelmed at the retail level by the combined force of the 13 "city" banks with up to 300 branches each.

Share price doubles: **page 69**

Bonds boom: **page 70**

Tabuchi's thoughts

Yoshihisa Tabuchi, 53, took over the presidency of Nomura Securities Co. in December 1985. His predecessor, Setsuya Tabuchi (no relation) became chairman. Here is a selection of Yoshihisa Tabuchi's recent public comments:

"To work to your utmost, make money, win fame, beat the competition — I realised just how great those things are."

"We cannot and do not intend to get involved in commercial banking activities in Japan."

"Considered from the standpoint of the [Japanese] economy, the system of separating the securities and banking industries is working very well."

"I have always liked a saying by Sir Winston Churchill that goes something like 'people who dwell on past glories will lose the future'."

Although their ranks are gradually thinning, private investors are still big business in Japan: not for the absolute volume of shares which they hold — about 25% of market capitalisation — but for the volume of their turnover. This used to account for about 60% of market business in the 1970s. In 1984, it fell to 54%, and in 1985 probably dropped to marginally less than half, reflecting the growth of institutional assets such as corporate pension funds.

Another cartel privilege which helps keep Nomura's broking profits fat is Japan's system of fixed stock-exchange commissions. Institutional-sized share transactions are roughly twice as dear in Tokyo as in New York. After London's deregulatory "big bang" due in October this year, Tokyo will be the only major financial centre left with non-negotiable stockmarket commissions — though within the next year or two, fixed commissions may suffer some erosion if not abolition (*see box*).

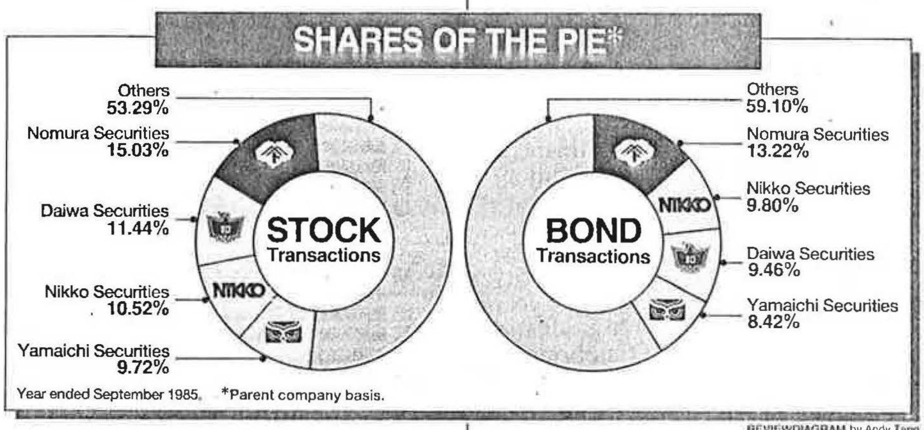
Article 65 looks a more durable entity, however frustrated Japan's commercial banks may be, and however hard innovators like Sumitomo Bank may lobby for the right to do more securities-related business. The banks' chafings reached a high point five years ago when the brokers, led by Nomura, began offering open-ended government bond funds which were in effect high-yield deposit accounts: a public squabble ensued. Last year, Tabuchi sought to restore the peace with his declaration of "an age of cooperation between securities companies and banks." Securities houses, he said, depended on banks to clear and settle their customers' accounts.

But banks might well ask whether "cooperation" also means co-prosperity. Nomura is making not just twice the profit, but also twice the return on equity, of Dai-Ichi Kangyo Bank, Japan's largest commercial bank. The banks are unlikely to close that sort of gap by turning themselves into glorified back offices for the brokers.

Nomura executives are fond of pointing out, whether in an attempt to placate their commercial banking rivals or to irritate them, that Nomura's own roots are in the banking sector. It was originally the bond department of the Osaka Nomura Bank (now Daiwa Bank) until it separated in 1925. After the 1941-45 Pacific War, Japan's bond market fell into long-term abeyance, and Nomura moved out of necessity into equities.

The Tokyo stockmarket is to this day a murkier and more manipulated place than London or New York: in the 1950s and 1960s it was far, far seedier. In the eyes of snootier Japanese businessmen and bankers, to be a stockbroker was akin to being at the rougher end of the used-car trade. Hideo Matsumura, an immensely elegant and courteous Nomura executive vice-president who has been with Nomura since its bond-house days, says perhaps only half-jokingly that he might not have joined the company if he had known it was about to plunge into share-dealing.

Yoshihisa Tabuchi.



In those early days, when Nomura was playing catch-up to the "big three," it decided to aim for volume growth among retail investors while its more powerful rivals were emphasising institutional business. "We imported democracy," says Matsumura. "Other securities companies laughed at us. They thought the cost of the back office would be too large."

In fact, Nomura was to ride a small-investor boom which brought economies of scale to its fast-growing operations. One way of keeping costs down was to consolidate small accounts into investment trusts: assets of such trusts rose 17-fold between 1955 and 1961, and at their peak in 1962 owned 10% of the Japanese stockmarket. Another was to automate the back-office work of documenting and processing trades, and it was here that Nomura

Of fixtures and favours

Japan's big securities houses say they would be happy to switch from a fixed to a negotiated system of stockbroking commissions, but that such a transition would cause too much instability among Japan's 230 smaller brokers. They also say that a move to negotiated commissions would drive up costs for the small investor — though in the US, which has lived with negotiated commissions for more than a decade, the advent of retail discount brokerages has in practice driven retail charges down, not up.

Japan's commission structure, while fixed, is not quite rigid. "Favours" can be and often are done for select clients. Some smaller, hungrier securities houses, for instance, "buy" commercially valueless corporate research from financial-sector clients to offset the client's commission cost; a friendly fund manager can be accidentally given a below-market price on a deal every once in a while; foreign firms can be dealt with on a discount basis offshore.

Loopholes like these help ease the pressure which might otherwise have built up against fixed commissions from institutional clients. Complaints from another lobby, foreign brokers, have become markedly more muted since six were admitted to membership of the Tokyo Stock Exchange last November: those firms are busy raking in the commissions to pay off the price of their seats, while others wait their turn.

The fixed commission system will receive a blow if the block trading favoured by big US brokers gains popularity in Japan: if a securities house quotes an all-in price to a client for a large block of shares sold out of inventory, who is to say what element of that price is commission and what element principal? — Robert Cottrell differentiated itself most successfully from its competitors.

Nomura was the first company in Japan to employ a large-frame computer, imported in 1955 from Remington Rand of the US. This valve-studded antique is now on display in a small museum at Nomura's newly built granite-and-steel computer centre outside Tokyo. It looks faintly comic amid its hi-tech surroundings but, as Matsumura says, "without computers there might have been no Nomura."

Computerisation helped keep back-office costs down and small accounts profitable. It also gave the company better-coordinated and updated information on its positions which proved crucial when, in 1963-64, a major crisis hit the over-heated stockmarket, and the public began liquidating investment trust holdings. The two worst-extended brokerage houses, Yamaichi and Oshi, survived only thanks to Bank of Japan (the central bank) lifeboat loans in the summer of 1965. Nomura, stronger and smarter, came out ahead of the game.

Matsumura would feel back on safe ground if he were to be joining Nomura today: a nationwide poll of final-year arts students recently ranked it the 14th-most desirable place to work of all companies in Japan. Deregulation and internationalisation of Japan's financial markets have left the banks, traditionally the financial sector's preferred employer, looking stuffy and unambitious. Nomura is attracting top-drawer new staff in Japan — 300 university graduates are being recruited this year — and also abroad: it hired 26 graduates last year from Oxford and Cambridge.

Nomura's 11,320-strong workforce is unusually productive, generating an average per-capita revenue of ¥45.6 million (US$276,364) last year, compared with ¥35 million for runner-up Daiwa. Within the limitations of Japan's consensus- and status-based business culture, Nomura is also trying to give brighter staff the freedom to manoeuvre: the "Heaven and Hell" foreign exchange–indexed 1985 bond issue for IBM Credit was devised by a young mathematician who had been with the securities company's new products development group for just six months. "Nomura is aggressive as well as big. They are entrepreneurial, they are making their own breaks," says Robert Burghart, a director in the Tokyo office of British stockbrokers W. I. Carr (Overseas).

Innovation is important because the Japanese securities markets have changed more in the past five years than they did in the previous 25.

Domestic investors are becoming more demanding, particularly big, mature Japanese companies doing more portfolio investment and less capital spending. Fund-management clients are starting to think about maximum performance rather than minimum risk. Most importantly for the rest of the world, Japanese investors have become heavy buyers of foreign securities. Foreign securities firms have multiplied in Tokyo, first opening branch offices and now gaining full membership of the Tokyo Stock Exchange (TSE). The newcomers are getting business: measured by operating profits, the 10th biggest securities house in Japan is now Salomon Brothers of the US.

The internationalisation of Japanese investment is related to the country's trade surplus which, at more than US$50 billion in 1985, exceeded that of any Opec nation at the height of the oil boom. Japanese investors spent US$53.5 billion on foreign securities last year, almost all on US bonds, but even that net figure understates gross trading volume. Japanese sales and purchases of US bonds totalled US$150 billion in January 1986 alone.

The recent strengthening of the yen will probably encourage Japanese manufacturing companies to channel some of their profits away from financial assets and into new direct investment in overseas production facilities: but Japan looks set to remain the world's leading capital exporter for many years to come, and its financial institutions among the largest purchasers of international securities.

For Japanese securities houses, internationalisation means a drive to dominate, not just transactions within Japan, but all transactions involving Japan — including sales of Japanese securities to foreign investors, purchases of foreign securities by Japanese investors, fund management for overseas institutions diversifying into Japan or Japanese institutions diversifying out, and the rapidly expanding offshore capital markets activities of Japanese companies.

Nomura says that, including sales of foreign securities to Japanese investors, it currently earns about 25% of its revenues from "international" transactions: president Yoshihisa Tabuchi says he wants that proportion raised to 50% within five years.

REVIEWDIAGRAMS by Ricky Ho

Building international market share means offering more, not just than the Japanese competition, but than the foreign competition too. In pursuit of this objective, Nomura's immediate strategy is the securing of whatever licence or status may be formally needed to originate a particular product or service on the finest possible terms. Thus it is now in what look like the final stages of applying for a primary dealership in US Government securities: it has been making daily position reports to the Federal Reserve Bank of New York since February.

As a primary dealer, Nomura will have close links with the Fed, a better feel for the market, better credit access for funding its inventory, the status to do business with central banks — and fractionally cheaper bonds. But where primary dealership may well count most to Nomura is in marketing terms. It will be able to tell its clients in Japan, busily buying and selling billions of dollars of bonds every week, that nobody — not even Salomon Brothers — has precedence in this market over Nomura. Deal with Nomura, and you deal with No. 1.

Similarly in London, Nomura this year bought a seat on the London Stock Exchange. Some people might question whether, as the structure of the City of London moves away from institutions and towards deregulated markets and independent market-makers, a seat on the stock exchange is particularly worth having. But it is the inner circle of the London equity market; its members have an accredited commitment to expertise in British shares. One of them is now Nomura, and there is nothing a British securities firm can offer Japanese clients in terms of London service which Nomura cannot in principle offer too.

More controversially, Nomura also wants to be a bank in Britain, an ambition which the Bank of England initially resisted because it was worried that Nomura was not subject to banking regulation in Japan. The argument became entwined with another reciprocity issue: Japanese reluctance to give securities branch status in Tokyo to British merchant banks. Now, following the admission last year of S.G. Warburg, a Bank of England favourite, to branch status and subsequent membership of the TSE, Nomura's banking licence is at short odds to materialise in the next few months.

But why? It is not as though Nomura needs a bank somewhere in the world as a place to book the odd transaction: it already has, a perfectly good bank in Amsterdam. And it is not that a banking subsidiary could raise noticeably cheaper funds than the parent itself. Masaaki Kurokawa, Nomura's managing director for international business, is tired of being asked: "Work it out for yourself," he barks.

The probable answer is that Nomura wants to create for itself the long-term freedom to become a major banking institution in one of the world's major international banking centres. It cannot do that in Tokyo, due to Article 65. It cannot do it in New York, due to Glass-Steagall. But it can do it in London, if it can persuade the Bank of England to give it the nod. The bank seems to have done so.

It is not that Nomura necessarily wants to leap straight into large-scale lending: it would probably be happy for quite a while doing foreign exchange, writing "swaps" to support its investment-banking activities and developing credit analysis. But when Nomura measures itself against the world, it does not see only its former model, Merrill Lynch (which also has a London banking licence). It sees Deutsche Bank, Citibank, Chemical Bank and NatWest Bank, all able to offer not just investment-banking services but also mainstream deposit-and-loan and money-centre services on an intercontinental scale. This is the league in which Nomura wants to play, and it wants to have at least the potential to offer an equal range of wholesale as well as investment-banking services.

In seeking its commercial banking licence, Nomura is covering itself against possible long-term trends. For the moment, commercial banks continue to struggle with the growth of securitisation of debt, which has seen many of their finest assets lured away to be repackaged into negotiable paper and sold by investment banks to the market-at-large. Demand for international syndicated loans, for instance, fell 60% between 1982 and 1985 — and most of what was left in 1985 was refinancings. The Bank for International Settlements estimated recently that securitised issues accounted for 80% of all capital-market borrowing in 1985, compared with 65% in 1984 and less than half in the early 1980s.

The world's biggest securities market is the US. It has also proved the most difficult for Nomura to penetrate. Despite its power to place almost any amount of US securities with Japanese investors, and despite having been represented in New York since the 1950s, Nomura has yet to be mandated by a single US corporation with lead management of a domestic public debt issue.

This may be tact on Nomura's part, a desire not to upset US banks by offering in their backyard the sort of terms which would be necessary to win a first piece of lead management. But even if Nomura proved itself as a paper-placer, it would still have other handicaps in US corporate finance. Friendly takeovers happen rarely in Japan, hostile ones never yet. Nomura has no corporate experience of fighting the sort of bid battles for which US corporations value most highly their investment banks, and in the service of which many debt issues are made.

Perhaps a little tired of banging its head against Wall Street, Nomura has in the past year been attacking with a vengeance the second-largest and much more accessible securities market, the offshore Euromarkets centred on London. The Euromarkets are an unregulated, over-banked, cut-throat battleground of ever bigger and ever more complex issues of long-term bonds and short-term notes. Most of the issues are in US dollars. But in 1984, Japan's Ministry of Finance decided to scrap most of the rules which had prevented companies borrowing offshore yen. Nomura made Euroyen issues a springboard from which to go vaulting up the league table of all Eurobond lead-managers.

In 1985, Euroyen instruments accounted for 5.1% of all Euromarket issues, triple the proportion in 1984. Virtually all the mandates to manage or co-manage Euroyen issues went to Japanese institutions, according to figures compiled by *Euromoney*: non-Japanese institutions won just 6.4% of the business. Nomura itself managed Euroyen issues worth US$2.6 billion, a 36.6% market share; runner-up Daiwa managed US$1.63 billion, or 23.2%.

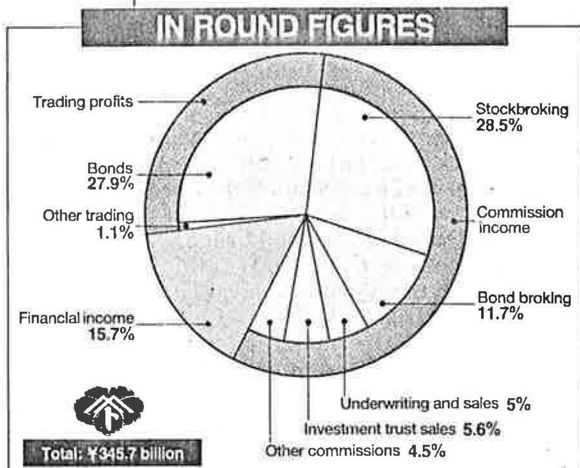
The Japanese houses managed an only slightly less comprehensive shut-out in all Japanese corporate issues in whatever Eurocurrency: the big four securities houses between them took 67% of the business, Nomura once more leading with a 19.7% market share, equivalent to management of issues worth US$1.3 billion. (An extension of Article 65 provides that Japanese commercial banks cannot lead-manage Japanese companies' Eurobond issues.)

The Euromarket is the place where cries of "dumping" are most frequently heard: in particular that Japanese houses "bought" the Euroyen market during 1985 by offering swap terms so cheap as to be sure loss-makers for the issue manager. It is also a place, however, where there seems to be considerable merit in the conventional Japanese long-term business strategy of striving first for market share, and worrying about profits later. A big corporate borrower does not shop round 30-40

Fair shares for brokers

Few stocks have done so well in the Japanese market this year as those of the securities companies themselves. Nomura Securities' shares, which were trading around ¥1,000 at the start of January, had more than doubled to over ¥2,200 in mid-June.

A major factor behind the price rise was analysts' perceptions of the benefits which Nomura would reap during its October-March first half from Japan's bond market rally. The eventual interim figures from the parent company more than repaid that optimism, with net profits of ¥58.7 billion, equivalent to a 40% gain over the previous year's first half. Han Ong, of the British brokers Rowak, expects Nomura to report net parent company profits of ¥108 billion for the full year to 30 September 1986, reflecting a slower second half and a 26.3% overall year-on-year gain.



Nomura Securities Co.: Sources of operating income in the six months to 31 March 1986.

REVIEWDIAGRAMS by Andy Tang

On a group basis, consolidating Nomura's share of its property, computer services, think-tank and other offshoots, net profits for the recent interim totalled ¥85.4 billion, or more than twice the ¥41.6 billion earned in the whole of the 1981-82 financial year. The current fiscal year looks certain to continue the four-year upward trend in group net profits, which rose to ¥69 billion in the year to 30 September 1983; ¥73 billion in 1984 and ¥111 billion in 1985.

Between 1982 and 1985, Nomura's gross revenues increased 2.2 times, while its expenses increased 1.8 times. The difference reflects Nomura's relatively high base of fixed costs: roughly 40% of its outgoings are staff costs, which are more or less invariable, while Ong estimates that another 45-50% of costs are "only weakly correlated to the volume of business." — Robert Cottrell

Euromarket banks for terms on a deal: it looks to five or six big players, and leaves these lead-managers to decide which smaller fry should be brought into the underwriting syndicate.

Nomura wants to be well up on that shortlist where treasurers take your calls — and sometimes call you. Since the mid-1970s, it has hovered on the edge. For 1985, it ranked No. 8 among all Eurobond underwriters, but said it wanted to be No. 5 or better. In the first four months of 1986 it was up at No. 3 behind only Credit Suisse First Boston and Deutsche Bank, and ahead of Salomon Brothers. It is a remarkable achievement, and more remarkable still if it can be sustained.

Nomura's strength in the Euromarket, as elsewhere, is based less on trading ability than on placing power. Its customer base in Japan backstops the sales effort for securities which it underwrites on behalf of issuers overseas. Whereas the comic-stereotype Eurobond investor is a Belgian dentist, about 40-50% of Japanese-managed Eurobonds are placed in Japan. Some so-called "sushi" issues are structured for 100% Japanese consumption.

This placing power can equally well be applied to equities: few things please Nomura more in its present cosmopolitan frame of mind than to be approached by foreign companies, such as British Telecom or Cable & Wireless, wanting to sell the odd hundred million dollars worth of new equity to Japanese investors. Nomura can do it, and wants to do more. It managed the introduction of five of the 10 foreign companies listed on the TSE during 1985, contributing to a total of US$1 billion net spent by Japanese investors on foreign equities during 1985.

Rival brokers say that Nomura can only place so assuredly because its customer base is so loyal and undemanding — that it can, in effect, load the terms of an issue against the investor and in favour of the issuer in order to win the business; or take a calculated underwriting loss abroad, as it has been doing in the Eurobond market, knowing that its profits from other business at home will be strong enough to absorb it.

This relationship is at least partially a function of the relatively early stage of Japan's financial internationalisation. Nomura is well established in foreign markets. Its clients by and large are not. They will be more inclined to accept Nomura's judgment until they are better placed to question it, and more inclined to trust Nomura as a long-established Japanese institution than to trust a rival British or US investment bank which may have been doing serious business in Japan for just two years or even two months.

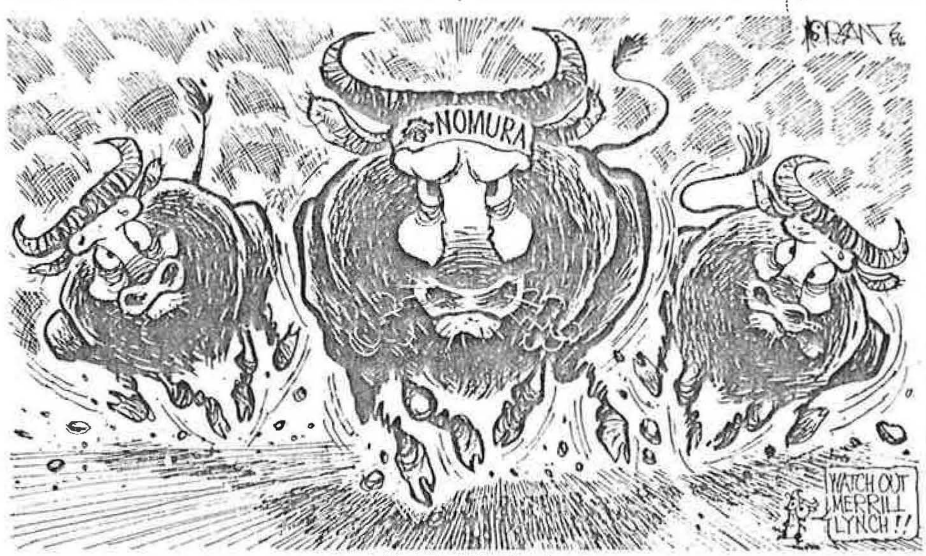
As Japan's international assets increase, so too will the international expertise and demands of its investors. They will be more aware of when products and services brought to them by Japanese securities houses might be bettered by foreign rivals. A Japanese securities house which then buys a foreign deal at a dumping price will have to cover the cost itself rather than pass it on to its investors.

If the emergence of a more discerning customer base in Japan meant simply the likelihood of intensified price competition between different securities houses offering similar products, the Japanese would be on familiar ground where they have fought and won enough past battles. But foreign houses also offer superior services in key areas where the Japanese houses must either smarten up or risk losing some business: research and fund management.

Japanese securities houses publish research in abundance. Foreign brokers say that Daiwa's is the best of the big four, Nomura's the second-best. General and sectoral reviews and economic overviews tend to be good; corporate research tends to be dull. Nobody in Japan writes "sell" recommendations, though the odd foreign house will chance its arm with a "fully valued." If a broker really does think you should buy or sell a stock, he will tell you over the telephone.

The Japanese stockmarket has traditionally been dominated by short-term speculators moving in and out on an hourly or daily basis following tips and trends; and stable stockholders who are in on a 100-year view. Neither group has much real use for orthodox company research. Neither, for that matter, has any particular expectation or desire that the stockmarket or individual stocks should move in a way susceptible to rational analysis.

The people who do want good research are fund managers trying to find stocks which will out-perform the market on a three-month to one-year view.



Ahead of The Herd

A profitable bond with the past

Nomura started life as a bond-trading house: its interim profit-and-loss account for the six months to 31 March 1986 suggests that it might be heading back that way. Bond profits — ¥40 billion from brokerage commissions and ¥96.4 billion from trading — outstripped stockbroking commissions for the first time since Nomura became a mainstream broker. Not that stockbroking did badly for Nomura: its ¥98.4 billion in commissions was 7% ahead year-on-year, while the other big four securities houses reported decreases. But helped by a steadily appreciating yen and a steadily declining discount rate, bond-trading profits tripled.

The Japanese bond market owes its strength to last autumn's G-5 meeting of international finance ministers, which precipitated a sharp decline of the US dollar and a corresponding appreciation of the yen. Successive Bank of Japan discount-rate cuts had by March brought the yield on long-term government bonds below 5% for the first time in 40 years. Investors piled into the market: Nomura reported its own trading volume of yen bonds was an annualised 42% up on the previous year.

Almost all new bonds in Japan are