The Sogo Shosha - An Insider's Perspective (Updated Version)

6/29/2017

Introduction

The sogo shosha are unique, diversified and complex organizations that are known to have played a significant role in Japan's modern economic rise. Following World War II, the sogo shosha, as super wholesalers/suppliers/distributors, optimized the supply chains of Japanese industry by providing for the raw material, energy and technological needs of upstream and mid-stream manufacturers in Japan, while also rationalizing distribution between the manufacturing sector and the downstream retail sector. At the same time, the sogo shosha marketed the products of Japanese companies overseas. This contributed greatly to Japan's ascent as an economic superpower. What is less known though is the significant role they have come to play on the world stage.

That said, outside of Japan there is little known about these organizations, and even those that do know of them, have a difficult time in explaining exactly what it is the sogo shosha do, at least in simple terms. The purpose of this paper is to help you better understand the sogo shosha, using Marubeni as the prime example, by explaining who they are, what they do, what makes them unique, how they developed and what their business model is, in a hopefully logical and easy to comprehend fashion.

This is not an academic paper, but rather an account of the sogo shosha from the perspective and experience of someone who has worked in one a sogo shosha for many years.

Some Recent Investments/Business Activities

To start, let's look at some of Marubeni's major investments and business activities over the last 4 years or so. Marubeni made around 70 investments and signed agreements for a number of major projects over that period with about 80% taking place overseas in approximately 30 different countries representing all regions of the world. The list includes everything from investments in copper and iron-ore mining projects to offshore oil field development and the purchase of a gas (utility) distribution company. From investment in an aircraft leasing and sales company and corrugated container manufacturing venture to participation in a feed and chicken processing project to the acquisition of a seafood distributor. From participation in electric power and rail projects to investment in off-shore wind farms, solar power plants and water treatment utilities. And, from ownership stakes in LNG vessels to large-scale multi-purpose real estate development to cloud computing services, electricity retailing and logistics operations.

Now, by multiplying these times the number of sogo shosha, 7, you can imagine not only their extensive diversity and broad global reach, but also the significant role they are playing in the world economy.

Some of Marubeni's Investment/Business Activities in Recent Years

Business	Details	Division
Deepwater FPSO chartering project for offshore oil fields in Ghana	Marubeni/MODEC/Mitsui/Mitsui O.S.K (Japan) will participate in a floating oil production, storage, offloading and chartering project in Ghana	Plant Division
Special economic zone (SEZ) development in Myanmar (port, industrial park)	Marubeni together with Mitsubishi and Sumitomo signed a JV agreement with Myanmar to develop the 2nd zone of the Thilawa SEZ	Plant Division
Investment in a leading distributor of replacement tires in Mexico	Marubeni aquired 49% of Radial Liantas, a Mexican replacement tire distributor with a large dealer network in Mexico	Lifestyle Division
Photovoltaic power plant in the UAE	BOT/PPA agreement for PV plant in UAE (Marubeni 20%) together with China's JinkoSolar (20%) and Abu Dhabi Water & Electricity Authority (60%)	Power Business Division
Gas -fired power plant IPP project in Indonesia	Marubeni and Sojitz will construct/own/operate a gas-fired power plant/floating storage and regasification unit in Indonesia	Power Business Division
Steel mill blast furnace revamping project in India	Marubeni together with Nippon Steel & Sumikin Engineering carried out blast furnace revampings for JSW Steel of India	Power Business Division
Join joint venture to produce corrugated containers in India	Marubeni has taken a 20% share in a corrugated container production venture in India with Oji Holdings of Japan and JK Paper of India.	Forest Products Division
Supply of renovated subway cars to Argentina	Marubeni received an order to supply 30 renovated metro coaches from a Nagoya subway to a subway line in Buenos Aires, Argintina	Plant Division
50% stake in U.S. aviation parts and services company	Bought 50% of Magellan, a U.S. after-market aviation parts and services company.	Aerospace & Ship Division
Acquire 100% of giant U.S. grain and fertilizer trading company	Marubeni acquired Gavilon Holdings of the U.S., one of the largest grain and fertilizer traders in the U.S. (it also is involved in energy commodities).	Grain Division
Take 50% stake in wind power project in the U.S.	Marubeni acquired a 50% interest in a wind power project in the U.S. with the French renewable energy company EDF (50%).	Energy Division/Power Business Division
Electricity retailing in Japan	Marubeni will provide electricity retailing services for low voltage users in Japan through its wholly-owned subsidiarty Marubeni Power Retail Corp.	Power Business Division
Investment in Malaysian thermal/carbonless paper converting printing firm	Marubeni/Oji Holdings have aquired (76%) the leading Malaysian thermal and carbonless paper converting and printing company TELE-PAPER	Forest Products Division
49% staker in construction machinery distributor Turkey	Marubeni acquired 49% of the the Turkish construction machinery distributor TIM, the sole Komatsu construction machinery distributor in Turkey	Construction & Industrial Machinery Division
Shipments of iron-ore from Australion iron-ore project begin	Shipments of iron-ore from the Australian Roy Hill mine project, which includes rail and port faicilites, has begun (Marubeni 12.5% participation)	Metals & Mineral Resources Division
Acquire 22% of Singapore-based reinsurance company	Marubeni took a 22% stake in ACR Holdings, a pan-Asian Singapore-based reinsurance company.	Insurance, Finance & Real Estate Business Division
Supply of coal-handling facility to Russia	Marubeni and Mitsui Miike Machinery concluded an agreement for the supply of coal handling facility to JSC Vostochny Port in Russia	Plant Division
Participation in a shale oil and gas project in the U.S.	Signed an agreement with Hunt Oil of the U.S. for a 35% share of a shale oil and gas project in the U.S.	Energy Division
Acquire seafood (salmon) cannery in U.S. Alaska	Marubeni's 100% owned subsidiary in Alaska, North Pacific Seafoods purchased the Red Salmon Cannery fron Yardarm Knot of the U.S.	Food Products Division
Copper minig development in Chile	Marubeni and Antofagasta of Chile have agreed to jointly develop a new copper deposit in Chile.	Metals & Mineral Resources Division
Pharmaceutical product distribution business between Japan and China	Marubeni/Shanghai Fosun Pharmaceutical Development to sell Japanese pharmaceutical products in China/export pharma raw materials to	Chemical Products Division
Acquire stake in Philippine thermal power station	Marubeni acqured a 20% equity stake in a thermal power station in the Philippines	Power Business Division
Manufacturing and repackaging of fertilizer in Myanmar	Marubeni will manufacture, repackage and sell fertilizer (in the Thilawa SEZ) in Mynamar with a local partner	Agri-Inputs Division
Large-scale real-estate development in China	Marubeni and Mitsubishi Jisho Residence to develop a large-scale multi-purpose real estate development with Jilin Weifeng Industry in China	Insurance, Finance & Real Estate Business Division
Feed and chicken broiler business in Myanmar	A Nippon Meat Packers Inc., Marubeni JV will construct/operate feed mills, broilers (chicken farms) amd chicken processing plants in Myanmar	Food Products Division
Aquire stake in offshore windfarm in the UK	Acquired a 49.9% ownership stake in an offshore wind power project by Dong Energy (Denmark) in the UK.	Power Business Division
Aquire stake in largest feed additive distributor in Europe	Marubeni acqires 60% stake in Dutch feed additive distributor Orffa International Holding, the largest feed additive distributor in Europe	Grain Division
Acquire Portugal, Brazil water utility business	Marubeni and INCJ of Japan (50%/50%) acquired one of the largest water service companies in Portugal that also has subsidiaries in Brazil	Plant Division
Solar power plant in Chile	Marubeni together with EDF Energies Nouvelles of France will construct and own a mega-solar PV power plant in Chile	Power Business Division
New grain silo construction in Brazil	Marubeni's 100% subsidiary, Terlogs Terminal Maritome of Brazil, will construct new grain silos at the Port of San Francisco do Sul in Brazil	Grain Division
Take ownership interest in 8 LNG vessels	Marubeni (48%), together with Teekay LNG Partners of Bermuda (52%), purchased 8 LNG vessels from APMM of Denmark.	Aerospace & Ship Division
Marubeni takes over ASICS' Japan logistics business, invest in ASICS Asia	ASICS (sporting goods) transferred their logistcs operations in Japan to Marubeni Logistics Corp. and Marubeni has invested in ASICs Asia	ICT, Logistics & Healthcare Division
To double ownership interest in aluminum smelter in Canada	Will double ownership interest to 13.33% in the Alouette aluminum smelter in Canada.	Metals & Mineral Resources Division
LNG purchase agreement with Russia's Rosneft	Marubeni has signed an agreement to purchase 1,25 million tons annually of LBG from Rosneft of Russia to be exported for sale	Energy Division
Exclusive off-take agreement for spherical natural graphite from Mozambique	Marubeni signed an off-take agreement with Australia's Syrah Resources Limited to export spherical graphite from Mozambique to Korea/Japan	Chemical Products Division
Participation in rail link project Australia	Marubeni will be the main operator in a fully-automated rapid transit railway project in Australia with companies from HK, Australia and Switzerland	Plant Division
Combined-cycle power plant project in Thailand	Marubeni together with Germany's Siemens awarded contract for a combined-cycle power plant in Thailand	Power Business Division
JV for the manufacture and sales of pasta and other food products in Turkey	Marubeni in a JV for the manufacture and sales of pasta and other food products in Turkey with Nisshin Seifun Group and Nuh'un Ankara (Turkey)	Food Products Division
To supply diesel locomotives to Bangladesh	Marubeni and Hyundai Rotem Company of Korea will supply 11 diesel locomotives to Bangladesh.	Plant Division
Long-term off-take agreement for polypropylene and sulfur in Vietnam	Marubeni will off-take polypropylene and sulfur from Nghi Son Refinery and Petrochemical of Vietnam for sales in Vietnam and overseas	Chemical Products Division
Participation in overseas vegetable factory business	Marubeni, Showa Denko, and Chiyoda Corporation ("Chiyoda") will jointly develop large-scale artificially-lit vegetable factories overseas	Plant Division
Provide cloud computing services in Japan	Marubeni in conjunction with Nifty Corporation will provide cloud computer services in Japan under the brand name Marubeni Cloud	ICT, Logistics & Healthcare Division

On the other hand, you may be wondering how could a company be so diverse and still be competitive as a business entity? Certainly, if a group of business professors were to look at this list they would likely conclude that this company was either a private investment fund or that it was a business likely in trouble, much too widely dispersed to survive. How can a single entity be involved in all of these different industries? What in the world is its core business competence?

This is what I aim to explain. What exactly is the sogo shosha's core competence that allows it to be so diversified? Before we go into that though, I think we should start by looking at the word sogo shosha in Japanese and see how it is translated.

Sogo Shosha/総合商社 - The Translation

The English translation for sogo shosha is often rendered as "(Japanese) general trading company, or firm, or house". In fact, this is a somewhat misleading translation. First of all, when a Japanese person, or even a Chinese person, looks at the kanji characters for sogo shosha they immediately have a strong image of what it means. Looking at the kanji for sogo shosha, one can conjure up a much more sophisticated, complex picture than general trading company. The first character "so 総" looks complicated because that is generally what it implies. It is often translated as general, but the nuance is more complex, as in comprehensive or all encompassing. It infers encompassing many different things. The second character "go 合" simply means to unify or combine. The third character "sho 商" means commerce or business, and the fourth, "sha 社", can be translated as organization, or in this case company. So, what sogo shosha actually means is to combine or unify a wide range of functions, goods and services into one commercial enterprise. A better translation for sogo shosh might be "diversified trading conglomerate".

The word sogo shosha itself, for all practical purposes, is a brand name in Japan. Japanese see it and might think; huge, diverse, sophisticated and international. In fact, the sogo shosha are quite renowned in Japanese society and operate at the top of Japan's business pyramid.

Size, Scope, Diversity Make Shosha Difficult to Imitate/Not Well-Known Outside Japan

The sogo shosa's organization and business model is unique to Japan. They are a reflection of Japan's own unique economic development, first during the Meiji Restoration's period of rapid industrialization and commercialization in the latter half of the 19th century and then in the rebuilding of Japan's infrastructure and industry following WWII. The sogo shosha have emerged as very large entities in both size and scope. They are extremely diversified, both in terms of products and services as well as geographically. Needless to say, they are extremely difficult to imitate. The closest thing the rest of the world has to a sogo shosha is the trading firms of such Korean chaebol as Samsung and Hyundai for example. However, they are much smaller and specialized in scope than the Japanese sogo shosha.

The sogo shosha are global Fortune 500 companies who in fact, in 1996, took 5 of the first 6 spots on the list. (Having shifted to international accounting standards from Japanese accounting standards in recent years sales volumes have been revised downward, therefore the sogo shosha rank lower but are still in the top 300 or so. If Japanese accounting standards were applied they would all be in the top 75 with two in the top 20.) However, if you were to ask a business executive from another country if they have ever heard of any of these sogo shosha, you might get an answer like, the steel maker Sumitomo Metal (now merged with Japan Steel) or the auto manufacturer Mitsubishi Motors (Mitsubishi Corporation has a less than 10% interest), neither of which are sogo shosha. The reason that most people have not heard of the sogo shosha is simple, the sogo shosha are not manufacturers. They do not have their names attached to consumer or other products. You do not see their name on any retail products, stores or outlets. This is because the sogo shosha are basically super suppliers, wholesalers and distributors that operate in the supply chain, upstream from natural resources, all the way downstream to the consumer and at intermediary points in between.

THE 1996 GLOBAL 500

rank	company	revenues
1	**Mitsubishi**	**184,365**
2	**Mitsui**	**181,518**
3	**Itochu**	**169,164**
4	GM	168,828
5	**Sumitomo**	**167,530**
6	**Marubeni**	**161,057**
7	Ford	137,137
8	Toyota	111,052
9	Exxon	110,009
10	Royal Dutch Shell	109,833
11	**Nisho Iwai**	**97,886**
12	Wal-Mart	93,627
13	Hitachi	84,167
14	Nippon Life Insurance	83,206
15	NTT	81,937
16	ATT	76,609
17	Daimler Benz	72,256
18	IBM	71,940
19	Matsushita	70,398
20	GE	70,028
21	**Tomen**	**67,555**
22	Mobil	66,724
23	Nissan	62,568
24	VW	61,489
25	Siemens	60,673

THE 2003 GLOBAL 500

rank	company	revenues
1	Wal-Mart	246,525
2	GM	186,723
3	Exxon Mobil	182,466
4	Royal Dutch/Shell	179,431
5	BP	178,721
6	Ford	163,871
7	DaimlerChrysler	141,421
8	Toyota	131,754
9	GE	131,698
10	**Mitsubishi**	**109,386**
11	**Mitsui**	**108,630**
12	Allianz	101,930
13	Citigroup	100,789
14	Total	96,944
15	ChevronTexaco	92,043
16	NTT	89,644
17	ING	88,102
18	**Itochu**	**85,856**
19	IBM	83,132
20	Volkswagen	82,203
21	Siemens	77,205
22	**Sumitomo**	**75,745**
23	**Marubeni**	**72,164**
24	Verizon	67,625
25	AIG	67,482

THE 2016 GLOBAL 500

rank	company	revenues
1	Wal-Mart	482,130
2	State Grid	329,601
3	China National Petroleum	299,271
4	Sinopec Group	294,344
5	Royal Dutch Shell	272,156
6	Exxon Mobil	246,294
7	Volkswagen	236,600
8	Toyota	236,592
9	Apple	233,715
10	BP	225,982
11	**Mitsubishi - 151 (57,689)**	***224,400**
12	Berkshire Hathaway	210,821
13	McKesson	192,487
14	Samsung Electronics	177,440
15	Glencore	170,497
16	Indust. & Comm.l Bank of China	167,227
17	Daimler	165,800
18	United Health Group	157,107
19	**Marubeni - 138 (60,810)**	***155,500**
20	CVS Health	153,290
21	Exor Group	152,591
30	**Itochu - 223 (42,345)**	***131,787**
66	**Mitsui - 245 (39,647)**	***95,200**
72	**Sumitomo - 308 (33,409)**	***89,500**

actual ranking/sales

*ranking/sales Japan standards were used

The Big Five and Others (Shakeout from 9 to 7)

So, who are the sogo shosha? Currently, there are 7 sogo shosha. The big 5, Marubeni, Mitsubishi, Mitsui, Itochu and Sumitomo, followed by Sojitz, a 2004 merger between Nisho Iwai and Nichimen, and Toyoda Tsusho, which was the trading arm of Toyota Motor Corporation handling mostly motor vehicle and motor vehicle parts but bought out the former sogo shosha Tomen, which was in financial trouble, in a bid to become a sogo shosha itself. Actually, Marubeni and Itochu were, for all practical purposes, the same company before WWII, but were separated by the Allied occupation following the war. From the latter half of the 1970s until the early 2000s there were 9 sogo shosha, however Japan's economic travails in the 1990s and into the 2000s took its toll on the likes of Kanematsu, which shed business divisions and became more of a specialized trader, Tomen, and Nisho Iwai and Nichimen, which as mentioned merged to form Sojitz.

To give you an idea of the size of a typical big 5 sogo shosha, the average sales volume of one of the big 5 sogo shosha is about $54 billion using international standards and about $133 billion using Japanese accounting standards. Net profit is nearly $3 billion and assets average roughly $100 billion per company. Moreover, a typical sogo shosha has on average over 500 subsidiary (+50% ownership) and affiliate companies (between 20% and 50% equity), with between 50,000 and 60,000 group employees. Obviously, the sogo shosha are very large organizations.

Operating Scale of the "Sogo Shosha"

As of April 2017 — As of June 2016

	Sales ($ million)		Net Profit ($ million)	Total Capital ($ million)	Total Assets ($ million)	*Number of Corporate Employees	*Number of Consolidated Companies	*Number of Group Companies	*Number of Group Employees
Marubeni Corporation	71,300	(151,900)	1,550	17,400	69,000	4,437	299	448	39,900
Mitsubishi Corporation	64,240	(208,100)	4,400	57,900	151,200	6,290	383	609	68,250
MITSUI & CO., LTD.	43,640	(87,300)	3,100	39,900	115,000	6,006	275	462	43,600
ITOCHU Corporation	48,390	(130,700)	3,500	26,600	81,200	4,279	212	326	105,800
Sumitomo Corporation	39,970	(89,100)	1,710	24,900	77,000	5,204	577	846	66,860
Big 5 -Average	**54,000**	**(133,400)**	**2,850**	**33,300**	**98,700**	**5,240**	**350**	**540**	**64,900**
sojitz { NISSHO IWAI CORPORATION / Nichimen Corporation	23,000	(37,460)	410	5,800	21,400	2,270	286	396	14,330
bought by Toyoda Tsusho — ~~TOMEN CORPORATION~~	34,800	(77,200)	1,030	11,500	41,000	2,829	741	991	58,000
~~KANEMATSU CORPORATION~~									

International Accounting Standards — Japan Accounting Standards, estimated based on previous years

However, the point that should be made here is that, while large organizations, they are also very similar in the lines of businesses they are involved in and in their organizational structures. The only real difference is in their areas of strengths. For example, Mitsubishi and Mitsui are known for their strength in energy and metals and mineral resources, while Marubeni is strong in such things as grain and electric power plants, Itochu in IT and textiles, especially downstream, and so on and so forth.

Importance to the Japanese Economy/Global Role

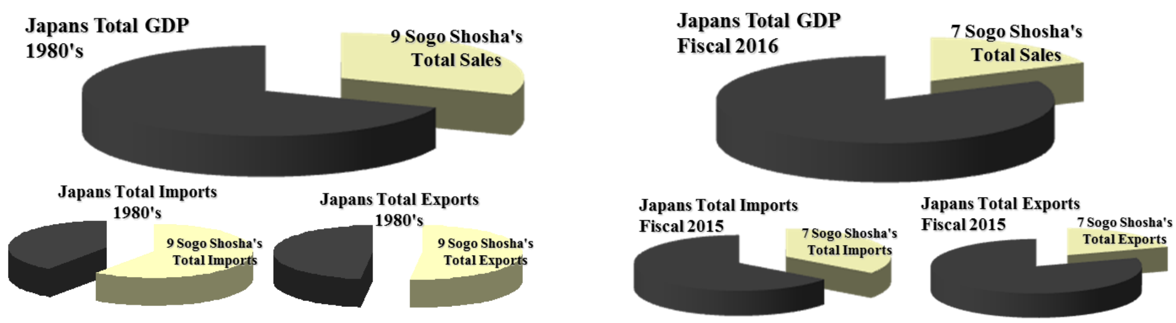
The sogo shosha are at the top of the Japanese business pyramid. They are also, in Japan, considered prestigious. One reason for this may be the important role they played in the economic development of Japan. Looking at the pie charts you can see that the total trade volume handled by the 9 sogo shosha during the 1980s was over 30% of Japan's total GDP, or economic size. Please note that Japan's economy in the 1980s was the world's second largest by far, nearly the size of the German, French and UK economies combined.

An even more impressive figure is total amount Japanese imports and exports they handled. During the 1980s, the 9 sogo shosha accounted for fully 65% of all Japan's imports and around 50% of its exports, importing mostly raw materials, commodities, and intermediate materials and goods and exporting manufactured products. It is hard to imagine just 9 companies having such a large share of one country's trade and gives you an idea of the important role the sogo shosha have played in Japan's economy.

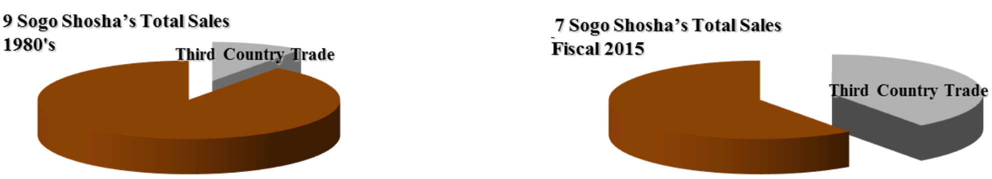
In fact, there were attempts by socialist governments (trade ministries) in some Eastern Europe countries and in China, as well as by private firms in the U.S. and a few other countries to create sogo shosha-type organizations in their own countries, mainly due to the important role the sogo shosha played in the success of the Japanese economy following WWII. However, as mentioned, the complex inner-workings of the sogo shosha, developed over decades, have proved too difficult to replicate.

Fiscal 2016 (end of March 2017) figures show that the current 7 sogo shosha's sales were about 15% of Japan's GDP, and in fiscal 2015 (end of March 2016) they accounted for around one-third of Japan's imports and about 18% of its exports, well off 1980s totals, but still large figures for just 7 companies. However, there is a structural reason for this. Around 85% of all Japan's foreign direct investment came after the mid-1980s. Starting with pressure by the U.S. government over trade, particularly related to automobiles, and combined with the depreciation of the yen from 1985, Japanese manufacturers began to move overseas. Prior to that, Japan was import-export concentrated.

- **Have played a major role in the Japanese economy**
  - Total sales volume of the **9 sogo shosha** averaged a little over 30% of Japan's total GDP, they handled about 65% of Japan's total imports and 50% of total exports in the 1980's, the current sales volume of the **7 sogo shosha** is about 15% of GDP and they handle around 33% of imports and nearly 20% (18%) of exports.



- **Increasing presence outside of Japan**
  - Off-shore or third country trade of the **sogo shosha** has shown a dramatic increase, from an 8%-9% portion of their total sales in the late1970's to 25% in the late1990s to around 40% today ($300 billion).



As such, the amount of 3rd country, or offshore trade, meaning trade handled by the sogo shosha that involves two countries other than Japan, for example trade between the U.S. and China, went from around 8% of their total sales volume in the 1980s to nearly 40% today, as they continued to supply Japanese manufacturers overseas with raw materials and intermediate goods. And, of course this naturally led to a reduction in imports to and exports from Japan handled by the sogo shosha as Japanese makers increased production in overseas markets.

This means that sogo shosha's presence, outside of Japan, in the global supply chain has been expanding significantly.

Business Model/Organization Unique to Japan

- **Business model unique to Japan, difficult to imitate**
  - The sogo shosha's size, scope, sophistication and diversity of business and functions not found in other organizations and make it virtually impossible to imitate by other enterprises

We have mentioned that the Japanese sogo shosha are unique business organizations not found outside Japan. So, what makes them unique, what are their distinguishing features?

Distinguishing Feature: ①Economies of Scope/Scale

- **Handle about 30,000 different items/products per shosha**
  - As a trader or middleman deal in a massive range of products - from raw materials/intermediates and commodities to consumer goods, high tech products and services
  - Diversity often expressed as: Everything from "noodles to satellites"
  - Traditionally handled these products in huge volumes

The first distinguishing feature is what I call economies of scope and scale. The sogo shosha are basically middlemen, brokers, intermediaries, suppliers, distributors or traders if you will, between buyers and sellers. All of these terms basically mean the same thing. This is their core competence. Following WWII, they imported the raw materials, intermediate goods, energy resources and industrial machinery and equipment needed for Japanese industry to rebuild. They also brought in foodstuff to help feed the Japanese populace. Eventually, as Japan's heavy industries rebuilt, the sogo shosha would begin to export whatever manufactures they could, for example steel, textiles, industrial machinery and ships.

Now, as the sogo shosha were basically just middlemen, with little or no ownership of resources or the means of production, there were only 2 ways they could really increase their earnings. One was to handle commodities and goods they traded in ever larger volumes, meaning scale; millions of tons of coal or grain or paper and pulp, or hundreds of thousands of computers. The other way to increase profits was to take their trading expertise and apply it to other items, including such higher value products as motor vehicles, aircraft, medical equipment, and so on. This is what is called scope, increasing the types of goods they trade. It is said that a single sogo shosha now handles around 30,000 different products on average, everything from “noodles to airplanes”, or from “chopsticks to satellites”.

The handling of such a wide variety of items in such huge volumes is a unique characteristic of the sogo shosha not readily found in other business organizations.

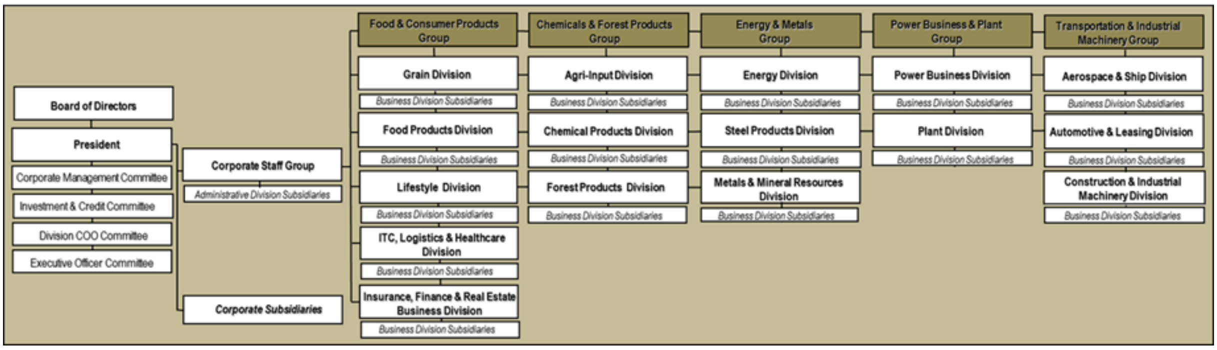
Distinguishing Feature: ② Center of a Conglomerate, Extensive Global Scope

- **A creator of companies, operates on a worldwide scale through an integrated global network**
  - About 110 -120 corporate offices in about 70 countries
  - Over 500 (540) group companies (about 60% or 300 would be overseas) = roughly 350 subsidiary companies over 50% owned (consolidated), a 20% to 49% interest in about 190 companies (affiliate) + a number of equity positions of less than 20% in other companies
  - More than 60,000 total group employees (about 5,000 corporate) with more than half overseas.
  - Amounts to about 400 organizational units in more than 80 countries worldwide

The second distinguishing feature of the sogo shosha is their industry diversity, the broad number of subsidiary companies they have and global scope. The sogo shosha operate in an array of industries as the center of a conglomerate through an extensive global network.

To simplify, the sogo shosha’s business is just basically divided by industry. Using Marubeni’s organizational chart, you can see that there are chemical, food, energy, metals and minerals, forest products, textiles (Lifestyle Division), plant and various machinery and other business divisions partitioned by industry. (While you may have noted that the divisions are clustered under a group, the group unit is basically for more efficient in-house management and decision-making purposes.) Now each of these divisions, 16 business divisions in the case of Marubeni, has responsibility for their own business strategies worldwide; upstream, midstream and downstream depending on the particular industry, acting almost like individual companies in their

Marubeni’s Business Structure



own right. As part of their business strategy each division may buy a company, make a joint venture or create a new company (or take an equity stake in company for strategic purposes). These are their business division subsidiaries and Marubeni has 448 of these business division subsidiary (+50% ownership) and affiliate companies (20% to 49%) worldwide including Japan, with the average sogo shosha having more than 500.

In addition to Marubeni Corporation Japan, which consists of these 16 business divisions (and 5 groups units), there are also corporate subsidiaries overseas (smaller versions of Marubeni Corporation Japan), for example, Marubeni America, Marubeni Europe, Marubeni China, Marubeni ASEAN, and so on, which have most of the same business divisions as Marubeni Corporation Japan, as well as their own corporate offices. Marubeni has 122 of these corporate offices, with about 110 being overseas. These 122 corporate offices combined with the 448 business division subsidiaries and affiliates form the Marubeni Group and employ about 40,000 employees with more than half being overseas. Now with roughly 60% of these subsidiary and affiliate companies also overseas, Marubeni has nearly 400 business units operating in 67 countries, whereas the average for the top 5 sogo shosha is close to 500 units located in over 70 countries.

The point here is that there are not many organizations involved in so many industries managing such a large number of companies on such a wide global basis.

Please note here that trading products in such huge volumes (scale) has allowed the sogo shosha to reduce costs and offer these goods at competitive prices. While at the same time, handling such a diverse array of products (product scope) in such a broad number of industries (industry scope) in so many different countries and regions (geographic scope) acts as a risk buffer, as usually not all industries and regions will experience economic difficulties at the same time.

Distinguishing Feature: ③ Economies of Functions

- **A number of functions integrated under one roof, rarely found in one organization**
  - In the course of executing the traditional core function of trader/broker/intermediary/wholesaler the shosha have developed other expertise and functions in the areas information, logistics, finance, risk management and coordination and organization of large-scale projects
  - The interaction and integration of these functions are key to the sogo shosha's business

The third distinguishing feature is what I call economies of functions. In the course of executing their traditional core business role of broker/intermediary/wholesaler/trader between sellers and buyers the sogo shosha developed other skills and expertise in the areas of information, logistics, finance, and risk management. These functions have become very important to their business. Moreover, by combining these functions they have also become organizers of large-scale projects.

The foundation of the sogo shosha's information function is their extensive global network. In Marubeni's case it is the 570 units (122 corporate offices and 448 group companies) in 67 countries, plus Japan, linked by digital hardware. The software of this system is the people they have in each of these units in each of these countries liaisoning with governments, businesses, partners, clients and customers allowing them to gather and analyze information first hand and create new business, supplement current trade and provide valuable information to their customers.

Another important function is logistics or the transport and distribution of goods and materials. As traders, this is a natural process for the sogo shosha. Through expertise in warehousing, customs clearance, various types of insurance, shipping arrangements and intelligent supply chain management systems they can efficiently and cost effectively move goods from the producer's door to the buyer's door.

Finance is also an essential function. In finance, they are involved in advancing credit (loaning money), debt guarantees, currency hedging and dealing, futures contracts, project finance and investment, among other things. Providing credit (loans) and debt guarantees to their customers, both buyers and sellers, to advance trade transactions is an important part of their business, as is project finance for large-scale projects and investment (ownership) in core businesses to protect themselves as intermediaries in the supply chain.

Another function is risk-management, including credit risk, investment risk and country risk. With long experience in carrying out business transactions between countries and in various industries and product areas they have been able to build sophisticated risk management systems to reinforce and complement their business.

Finally, by employing their global information network in combination with their trading, logistics, finance and risk management functions they can provide multiple services to their customers as a kind of one-stop shop super supplier, while at the same time enabling them to organize large scale (infrastructure, etc.) projects.

As a very simple example, by combining logistics with finance the sogo shosha can create a kind of one-stop-shop for its customers in their traditional role as supplier by handling the transport of the goods (economies of scope and scale allow for lower transport costs) reducing the risks to both seller and buyer, as well as providing finance in the form of loans (credit) to acquire the goods. At the same time, through their global networks (information) they may be able to find new markets (customers) for the seller.

In large-scale projects, they can use their global networks to find projects, coordinate with local governments and contractors, organize consortiums from client firms in Japan and/or overseas and source the necessary machinery, parts and materials for a large-scale project. At the same time, they will use their project finance skills to arrange for financing of the project (long experience with government and private financial institutions), which might or might not include their own investment. They can then use their logistics expertise to move the machinery, parts and materials and organize the construction of the project at the end-user destination.

(Please note these are very oversimplified examples.)

Undoubtedly, it is unusual to find such an array of functions integrated under one roof in one commercial enterprise.

The Sogo Shosha Mirrored the Development of Japan's Economy

To understand better the businesses the sogo shosha are involved in today, a look should be taken at how the sogo shosha developed over time. Although, I will concentrate on how the modern sogo shosha developed after WWII, a brief look at their origins might also be helpful.

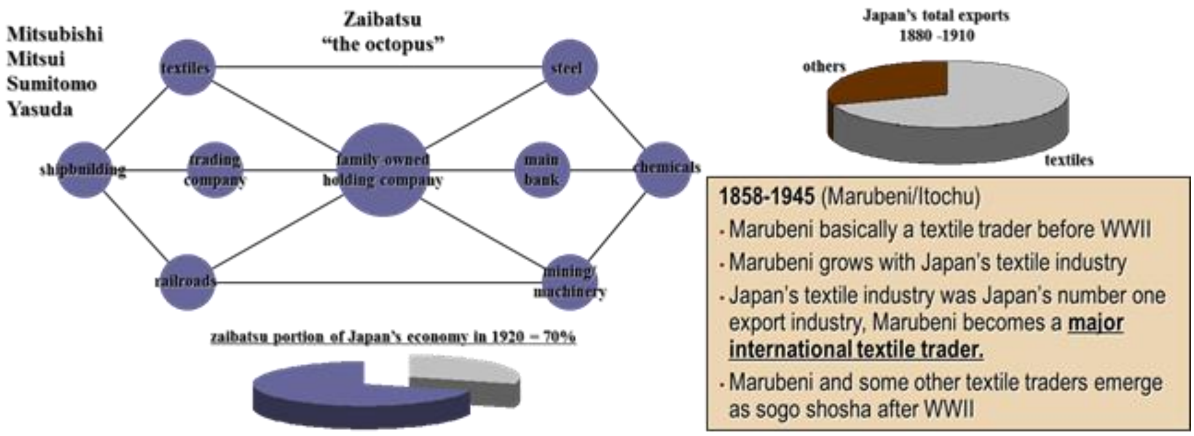
Pre-WWII

- **Meiji Restoration**
  - Rapid industrialization/commercialization to build a strong military, emergence of a bureaucratic oligopoly
- **Emergence of the Zaibatsu** (conglomerates)
  - Beginning of strong government (bureaucracy) - business cooperation
- **Emergence of the Traders within the Zaibatsu**
  - Unique role in the zaibatsu
  - A pooling of resources to gain economies of scale,

Actually, the emergence of the sogo shosha is quite easy to understand. In the late 1860s, Japan emerged, after 250 years of isolation from the rest of the world, from a civil war (semi) with a new samurai-controlled government under the auspices of the young Meiji emperor. Having been forced to open its doors to the West by superior military technology, the new government set on a course to build a strong military, especially to avoid what had happened in China, with the country being divided up by European powers (imperialism). To do this they set out on a course of rapid industrialization and commercialization. This became known as the Meiji Restoration.

To kick start this industrialization, the government took on the responsibility of developing various industries with the help of foreign experts. However, as the government began to run out of money they turned to private Japanese enterprises, selling off parts of various industries to them, many of whom had supported this government during the civil war, at extremely low prices. This was actually the beginning of close cooperation between business and government in Japan.

To speed up industrialization the government encouraged size, or economies of scale, within these enterprises. They came to be known as the zaibatsu, or family-owned conglomerates. By the 1900s, these conglomerates would come to dominate the Japanese economy, with the top 4 making up 60% of the shares of the Japan stock exchange. These conglomerates, for example Mitsui and Mitsubishi, became involved in a number of different industries. Typically, they would only have one main bank and one main trading company to handle the needs of the entire group, which created efficiencies through the pooling of resources and allowed each company to concentrate on their core business. To make a long story short, the trading firms for these organizations had to handle the supply and export needs for all the different companies in different industries in the group.



This was a very different experience than Western trading companies that developed over the long term during the industrial revolution specializing vertically in only a few products. While there were many Japanese trading companies before WWII, I would venture to say that Mitsui and Mitsubishi were in actuality the only true sogo shosha at that time, as most of the others were specialized traders, meaning involved in only one or two industries.

In terms of Marubeni, they were an international textile trader before WWII. During the Meiji period, the textile industry became Japan's largest and accounted for around 70% of Japan's exports by 1920. Marubeni became a large international textile trader (with some diversification into other industries in the 1930s, as the textile industry faltered) during this time, but didn't become a true sogo shosha until after WWII. (Note that Marubeni and Itochu were, for all practical purposes, the same company before WWII and were separated after the war.)

Post-WWII

1950s - early 1960s (1949-1964)

(Japan reindustrializes, high growth emerges)

The current formation of the sogo shosha began to appear in the years following WWII. This formation was determined by a number of important developments. One was the dissolution of the former zaibatsu and their companies following WWII. The other was the prevailing economic circumstances at the time and the government's industrial policy aimed at rebuilding Japan. And, the last was the re-emergence of many of the former zaibatsu companies from around the mid-1950s.

The U.S.-led occupation broke-up the zaibatsu and many of their companies in the wake of WWII as they were associated with the former military government (military-industrial complex). For example, the Mitsubishi zaibatsu's sogo shosha alone was divided into 138 companies. (Marubeni and Itochu were broken up as well.) This provided an opportunity for the large specialty traders like Marubeni, Itochu, Nichimen, Iwai and others to begin filling this void, gaining size and diversity in the process.

Also, as much of Japan's infrastructure was destroyed the Japanese government embarked on a policy of division of labor among Japanese industry. To simplify, the government basically ordered the large manufacturers to concentrate on manufacturing, the large banks to loan the major manufacturers whatever funds they had available and the trading companies to concentrate on import and export (the foreign exchange control law was used as a tool of control by the government). Given Japan's lack of raw materials, energy resources and foreign currency at the time, the sogo shosha's role in the rebuilding of Japan's economy would become significant.

Finally, with U.S. authorities turning their attention to the Korean War in the early 1950s, the former zaibatsu sogo shosha began to re-emerge. This forced many trading companies to merge or be bought-out by others in order to compete. The result was the emergence of 12 so-called sogo shosha, further reduced to 9 by the latter half of the 1970s through further reorganization (mergers, absorption).

As a result, during this period the sogo shosha essentially supplied the raw and intermediate materials, industrial machinery and equipment and technology Japanese industry needed to rebuild and reindustrialize. At the same time, they imported energy resources and foodstuff (living essentials) to support the Japanese economy. As Japan's heavy industry re-emerged the sogo shosha began to export heavy, intermediate and other goods, (industrial machinery, steel, ships, textiles, etc.) gaining needed foreign currency. Note that the sogo shosha didn't focus on any one industry, but provided supply and handled the goods for various different industries. With the economy beginning to boom in the late 1950s and early 1960s, the sogo shosha also began to supply small and medium size enterprises (SMEs) with goods, materials, export procedure assistance and especially financing (50% of Japan's exports during this time were carried out by firms with less than 300 employees). By the early 1960s the sogo shosha had emerged as linchpins of the Japanese economy.

The sogo shosha basically became super suppliers, particularly to upstream and mid-stream Japanese manufacturers in various industries during this time frame.

1960s - early 1970s (1964 - 1973)
(High growth continues, Japan becomes a consumer economy)

1960s
(1964-1973)

[High Growth, Consumer Economy] *(High growth continues, Japan becomes a consumer society)*

● **Shosha: Downstream Distribution, etc.**

- Export of higher value added manufactures/consumer products (electronic appliances/automobiles, etc.)
- Investment in natural/energy resource development, increased imports of raw/intermediate materials to fuel Japan's growth
- More integrated logistics/distribution networks (distribution processing centers), expanded overseas network
- Move into domestic real estate development, downstream distribution (food wholesaling, etc.)

The Tokyo Olympics marked the emergence of Japan as a consumer economy with the population growing, incomes rising and the economy expanding. In fact, the Japanese economy averaged over 10% annual growth between 1957 and 1972. Sales of TVs, refrigerators, automobiles, housing, etc., boomed. To fuel this growth Japan needed ever more raw materials. Given this situation and lacking natural and energy resources the government encouraged (and assisted) the sogo shosha to invest in natural resource development. As such, the sogo shosha increased their imports of raw and intermediate materials to support Japan's economic growth during this stage and handled the distribution of more sophisticated materials needed for consumer product manufacturing.

The sogo shosha also moved into domestic real estate development downstream. The sogo shosha were already supplying the construction industry with construction materials and equipment upstream, however, to handle the building boom construction companies needed the sogo shosha's financing, distribution and planning functions for this larger scale type of real estate development. The sogo shosha further entered food wholesaling and downstream food distribution during this period. As incomes rose, the Japanese diet shifted to more processed foods which required additional materials and more complex distribution. As many of the food processors were small they turned to the sogo shosha to handle this function for them.

As a result, the sogo shosha developed more integrated and expansive logistics/distribution networks (distribution processing centers, etc.) in the domestic market.

In addition to the domestic market, the sogo shosha began to export higher value-added manufactures (industrial machinery) and market such consumer products as automobiles and electronic appliances in overseas markets, considerably expanding their overseas networks in the process.

The most notable development during this consumer economy phase was that the sogo shosha began to move downstream and their integrated upstream-downstream supply chain business model began to emerge.

1970s - early 1980s (1973 - 1984)

(Japan becomes an advanced economy, service industry grows, resource vulnerability in wake off 1st oil shock)

1970s (1973-1984)

[Oil Shocks, Advancing Economy, Service Industry] *(Resource vulnerability after 1st oil crisis, becomes advanced economy, service industry grows)*

- **Shosha: Large Scale Project Organizer, *Trader's Dilemma***
  - Plant exports and infrastructure development (organize consortiums, Japanese ODA)
  - Increased investment in natural/energy resources (sometimes with the government)
  - *Winter of the sogo shosha: Large scale manufacturers begin to eliminate the shosha as middlemen*
  - *Begin to invest in supply sources (manufacturers, etc.) as a solution to trader's dilemma*

In the wake of the first oil shock in 1973, oil money began pouring into many oil producing countries, which wanted to invest in their own refineries, petrochemical plants and other types of infrastructure. The cause of the first oil shock was the outcome of the 1973 Arab-Israeli war in which Israel, supported by the U.S., emerged as victors. The oil-producing Arab countries and oil-producing allies soon embargoed oil to the U.S. and a few other countries, including in Europe, sending oil prices skyrocketing. Given the U.S. were now out of the infrastructure supply picture, and Japan having highly advanced engineering and technology capability, the sogo shosha, with a strong presence in oil and resource rich countries, were well-positioned to take advantage of the ensuing plant and infrastructure development boom. As a result, the shosha's large scale project business took off. (The shosha had been involved in some industrial machinery and plant export (and import from the 1950s) in the 1960s to a limited extent.).

With their network of partners in various industries (consortiums) and their trade (import-export procedures), logistics (transport of machinery, etc.), project finance and risk management expertise the shosha are ideally suited to the planning and organization of infrastructure, plant export and other large-scale projects. With Japan, up until recent years, becoming the largest contributor of official development assistance (ODA) to developing countries, this has become big business for the sogo shosha.

The sogo shosha also faced a crisis, or what I refer to as the trader's dilemma, in the late 1970s and early 1980s as large Japanese manufacturers questioned the need of the sogo shosha as middlemen and began to rely less and less on them. This was exacerbated by a worldwide recession brought on by the first and second oil crises and the period was dubbed the "winter of the sogo shosha".

Given that the sogo shosha's core business is trade and that the sogo shosha are essentially suppliers, without materials, intermediate goods or products to trade and supply their customers with the shosha would essentially be out of business.

The solution to this dilemma was to substantially increase their investment in manufacturers, or in manufacturing joint ventures, processors and distributors (all supply sources) in order to secure the goods and materials necessary to protect themselves in the supply chain. This marked a shift in the sogo shosha's role of being almost only an intermediate or middleman in the supply chain between buyer and seller to being an intermediate with increasing ownership of the sources of supply as well.

So, the sogo shosha's push into the large-scale project business as an organizer and new emphasis on investment upstream and downstream in the supply chain to protect their position as a trader and intermediary through ownership were the two most significant moves made during this period.

1980s - early 1990s (1984 - 1994)

(Bubble economy, high yen, deflation, manufacturers move overseas, bubble ends)

1980s (1984-1994)

[Bubble Economy and its End, FDI] *(Japan enters bubble economy era, yen rise, manufacturers move overseas, bubble ends)*

- **Shosha: Investment in Manufacturers, Service, Overseas JVs**
  - Continue to invest in supply sources as solution to trader's dilemmas/Increase overseas alliances
  - Increase trade/imports of higher value items (software/computers/medical equipment, etc.)
  - Enter service industry (fast food/health clubs/financial services, movie production, etc.)
  - JVs/logistic support for Japanese manufactures moving overseas

The sogo shosha continued to increase investment in supply sources and in joint ventures with manufacturers to secure goods and materials to trade during the latter half of the 1980s and into the 1990s. Reflecting the changing Japanese economy they also entered the service industry; fast food (KFC/Dairy Queen, etc.)/health clubs (leisure boom)/financial services (financial leasing of office equipment/automobiles/aircraft), among others, and began importing such higher value-added products as high-end medical equipment, personal computers/software, expanded their handling of aviation equipment, including aircraft and invested in the telecommunications field.

In addition, as Japanese manufacturers moved overseas in the 1980s and early 90s, spurred by U.S. and European pressure over imports as well as by the huge appreciation of the yen following the Plaza Accord in 1985 (most of Japan's accumulative foreign direct investment came after the mid-1980s), the sogo shosha provided logistics and distribution support, sometimes entering into JVs with manufacturers, expanding their third country trade in the process.

With the strong yen as backdrop, the sogo shosha also began to rapidly increase their own overseas investments and alliances with foreign companies (Marubeni had 97 overseas investments between 1987 and 1991). At the same time the Japanese bubble economy both came, temporarily providing business relief to the sogo shosha, although also leading to speculative investments in the domestic market, and went.

The sogo shosha continued to invest in supply sources upstream, while moving into some service businesses downstream during this time. They also increased their investment overseas, including an increased number of joint ventures, and began to handle even more sophisticated products.

1990s - mid-2000s (1994-2006)

(Post-bubble, low growth, mature economy, deflation, Asian crisis, deregulation, globalization)

1990s- (1994-2004)

[Japan's Lost Decade (Reform), IT, Globalization] *(Post-bubble, Japan economy matures, high yen, deflation, deregulation), Asian crisis)*

- **Shosha: Restructuring, IT/Medical-Health Care/Environmental Business**
  - Move into media contents
  - Restructuring (selection and concentration/expansion), more sophisticated management of investment
  - Average net profits 7 times higher than previous highs, D/E ration falls from 9:1 to 1.8:1 in 10 years
  - Move into IT, health care, environmental business
  - Expanded 3rd country trade, JVs with manufacturers continue

From the mid-1990s into the 2000s, the sogo shosha moved into a number of new fields. One that was rapidly entered into was the IT or information technology industry. The sogo shosha invested in a number of IT-related businesses after the internet took off from the mid-1990s; undersea optic fiber, broadband infrastructure, server storage, IT application software, internet service providers and media contents (cable TV, etc.) to name a few. During this period, they also began moving into the environmental field, for example reforestation projects, recycling and carbon emissions trading, and also into the medical-health care business which was being deregulated in Japan. They expanded their large-scale infrastructure project business as well as their handling of highly advanced materials. The sogo shosha also increased their investment in the retail sector.

Following the bursting of the economic bubble, the sogo shosha faced such domestic changes as a mature, low-growth economy (low birth rate/aging society), a financial crisis and credit crunch, deflationary pressures and deregulation in the economy. At the same time, they faced such global challenges as the IT revolution, the manufacturing rise of China and other newly emerging countries, the Asian crisis (heavily invested), and globalization, meaning mega-competition. This led to cash flow problems and financial losses at the sogo shosha.

<Domestic Changes>

- **A mature economy**
  - Low birth rate and an aging society (low growth)
- **Financial crisis after the burst of the "bubble"**
  - Balance sheet reforms (bad debt hangover); cash flow/profits
- **Economic reforms**
  - Deregulation: financial "big bang", large scale retail store law, nursing care, etc.
- **Deflationary Pressures**
  - Deflation leads to cost pressures, price destruction, distribution war (wholesalers)
  - Old relationships breaking down

<Global Changes>

- **Further globalization**
  - Mega-competition
  - Unified capital markets (electronic herd)
- **IT revolution**
  - Spread of internet/"speedy" management
- **Impact of China, other emerging economies**
- **Resource nationalism**
- **FTAs**

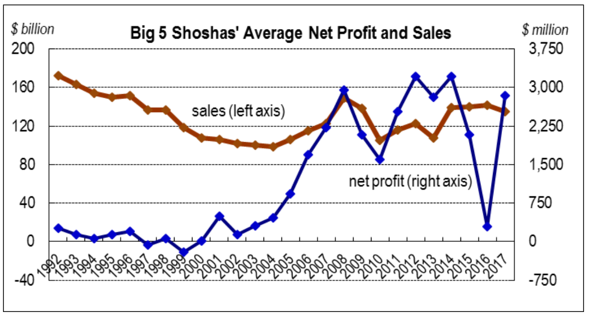
From the mid-1990s, it was clear that Japan's economy had matured and was facing lower potential growth. Furthermore, the financial problems following the burst of the economic bubble worsened. In particular, a credit crunch emerged as the bad debt portfolio of banks accumulated with more and more small and medium size businesses unable to pay back their loans. At the same time the government, worried about the continued hollowing out of Japanese industry due to the high cost of domestic industries, began to deregulate the economy. This led to a deflationary cycle and put a lot of cost pressure on companies.

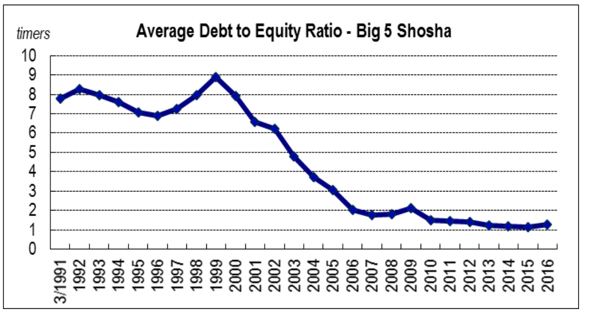
If that wasn’t enough the IT revolution, meaning internet access, globalization, including the emergence of China which has led to mega-competition, and the impact of the Asian, Russian and Brazilian currency crisis in the late 1990s and early 2000s, had a strong negative effect on the sogo shosha, which led to deterioration in their earnings and overall business.

The biggest impact for the sogo shosha was credit, which led first to financial balance sheet restructuring, a small shift in business strategy to selection and concentration, and to new ways of managing their risks, especially investment risk. I want to emphasize that the sogo shosha’s business model did not change, but the way they managed their businesses did.

As a result, from the late 1990s to the mid-2000s the sogo shosha were mostly focused on balance sheet restructuring and the revamping of their management systems, especially in how they managed their investments. Note though that their basic integrated upstream-downstream business model and core role as a trader/supplier/intermediary, as well as being an organizer of large-scale projects, remained unchanged.

After successfully emerging from restructuring, the sogo shosha have strengthened their business through aggressive investment both upstream in energy, metal and mineral resources and food commodities and downstream in wholesale and retail.





The sogo shosha emerged from this period of restructuring stronger and have reinforced their integrated upstream-downstream business model through aggressive investment.

Understanding How the Sogo Shosha Think - The Business Model

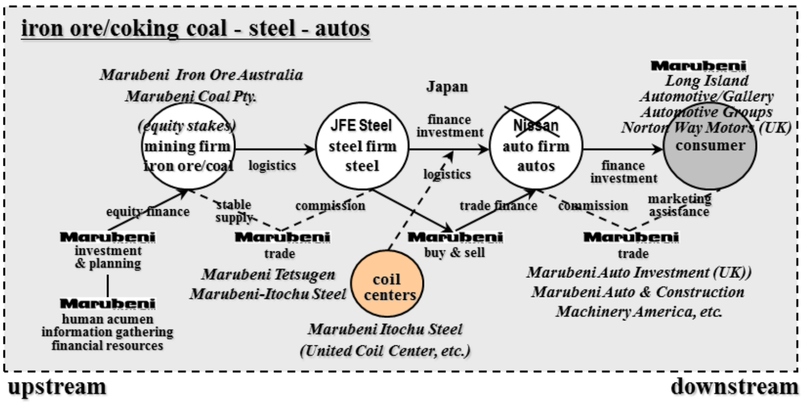
To understand the sogo shosha and their business model better one only has to think of the supply chain or value chain, or what some call the flow of trade. They all mean the same thing. Simply, every product has a supply chain, from the raw materials that are processed into intermediate materials and semi-finished goods upstream, which in turn are used to make a finished product midstream, to the wholesaler, then the retailer and finally the consumer in the downstream distribution process.

The sogo shosha's fundamental goal, or dream if you will, is to integrate the supply chain by being involved, if possible, at every stage of the chain, upstream, midstream and downstream. Of course, every finished product has its own supply chain, so there are literally thousands upon thousands of product supply chains. Certainly, the sogo shosha cannot be involved in every product supply chain at every stage, however, they have been able to integrate a number of different product supply chains to a considerable degree. By applying in particular their logistics and finance expertise, the sogo shosha have been able, in some cases, to partially integrate the supply chain from either upstream to midstream, or midstream to downstream, and in others fully integrate it upstream to downstream.

This is what forms the basis of the sogo shosha's thinking and their business model. To simplify this and make it more understandable, let's look at some examples using Marubeni cases:

Metals-Minerals/Motor Vehicle Supply Chain Example

iron-ore/coking coal - steel - autos (appliance makers, etc.)



This first example, iron ore and coking coal, steel and autos, would be a fairly traditional example of a sogo shosha supply chain (or value chain, or trade flow) and encompasses at least three different business divisions (Metals & Minerals, Steel Products and Automotive & Leasing).

Originally, as just a trader or intermediary between buyer and seller Marubeni would purchase iron-ore and coking coal directly from mining companies, arrange shipping to the buyers, which in this case would be steel manufacturers in Japan. They would then buy the finished steel product, or receive it on consignment, from the steel producer and arrange transport to the buyer, which in this case would be auto manufacturers (or appliance makers and other manufacturers in other industries). Following this they would arrange for export of the autos, let's say to the U.S., where they would market or wholesale them to dealers.

As just a middleman in this supply chain Marubeni would receive either the profit from buying and selling or a commission for handling the sale, and fees for arranging transportation, so the profit margins are relatively small. This is an example of the sogo shosha's traditional trading business.

Before going into the current business model keep in mind that in terms of natural resources sogo shosha like Marubeni are always searching for new supply sources. In the event new deposits of iron-ore or coal were discovered, let's say in an isolated location, such infrastructure as roads, water and electricity would be required. Theoretically, as organizers of infrastructure projects, Marubeni could arrange for the construction of the necessary infrastructure needed to extract the iron-ore and coal and receive a fee in return.

In the current model, Marubeni has taken equity stakes (investment) in mining companies, in this particular case in Australia, to secure a supply (ownership) of iron ore and coking coal to sell to steel companies in Japan. They would then arrange for shipping to Japan (logistics/distribution). Ownership allows Marubeni to receive the iron-ore and coal at cost thus increasing their profit margin, as well as giving them a secure source of supply.

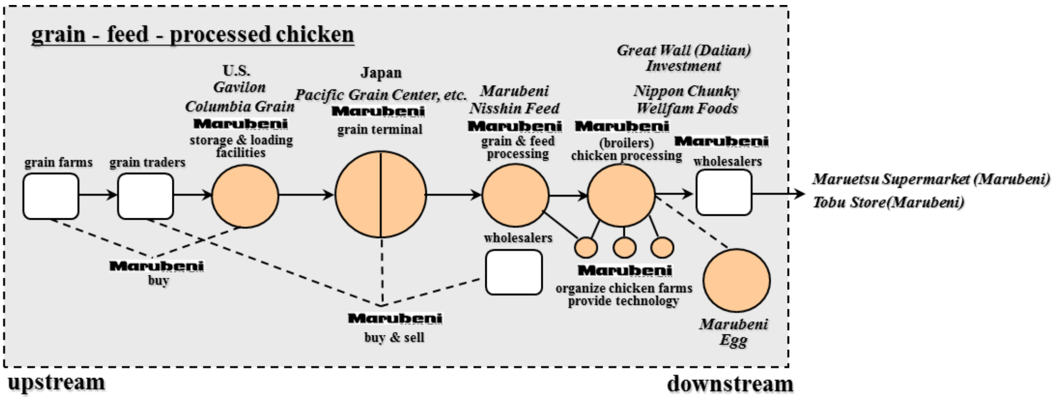
Note that the steel companies and the auto and home appliance makers could talk directly with each other and possibly eliminate Marubeni (sogo shosha), or drastically reduce their role in the supply chain. To partly counter this Marubeni has invested in coil centers through its subsidiary company Marubeni-Itochu Steel. As the specifications for steel used in the production of autos, appliances and other industries are different, these coil centers will cut the steel and/or produce steel products to meet the customers' (industry) standards and steel product needs. This is a type of outsourcing of part of the steel processing function to Marubeni, which allows them to protect their position as a supplier, while adding value (higher profit) over and above their traditional role as just buyer and seller or go-between (lower profit, commission).

Downstream, at one time, Marubeni was the wholesaler for a major Japanese motor vehicle manufacturer (Nissan) in the U.S., Europe and some other regions. However, over time many of the major automakers began to take on this marketing function themselves, especially after they began to directly invest in their own production overseas. In response, already knowing the retail auto business as a supplier/wholesaler, Marubeni began buying into auto dealerships themselves and providing auto financing at the consumer end (U.S., Europe, Australia, China, etc.).

In this way, through investment, by gaining ownership, they have been able to maintain their position as a supplier upstream, midstream and downstream in this particular supply chain.

Food Material/Food Product Supply Chain Example

grain - feed - chicken



The next example is that of grain, feed and chicken. This is a food supply chain and involves Marubeni's Grain and Food Product Divisions.

Traditionally, Marubeni bought grain from grain trading companies, imported it to Japan and sold it to feed (soybeans/corn) and flour (wheat) processors, beer producers, etc. They also handled distribution (logistics), in this case, of the feed to chicken farms and processors, and then the chicken product to the food retailer as a middleman and distributor. Again, the profit margins are small with earnings coming from the difference between the buying and selling prices and/or commissions and fees from handling distribution.

However, while Marubeni still buys some volume of grain from grain traders, they have increasingly integrated this supply chain and raised their value-added potential by investing in various stages upstream and downstream.

In this example, Marubeni created a subsidiary company (investment) in the Northwest U.S. which buys directly from farmers in the region and moves the grain to its own storage facilities (country elevators) and port operations. Marubeni also recently purchased one of the largest grain traders in the U.S. located in the Midwest U.S. as well. The grain is shipped (time charter) to Japan to Marubeni’s own grain (import, storage, mixing) terminals. It is next transported and sold to feed processors (corn, soybeans), one being their own majority-owned JV company with more than a 10% share of livestock feed market in Japan (they also have a majority-stake in a flour milling (wheat) company). The feed is then distributed, in this case, to chicken breeders/processors, and then wholesaled to food retailers. As can be seen in the diagram, Marubeni has wholly-owned companies handling the breeding, processing and wholesaling of chicken as a well as large ownership interests in supermarkets at the retail end.

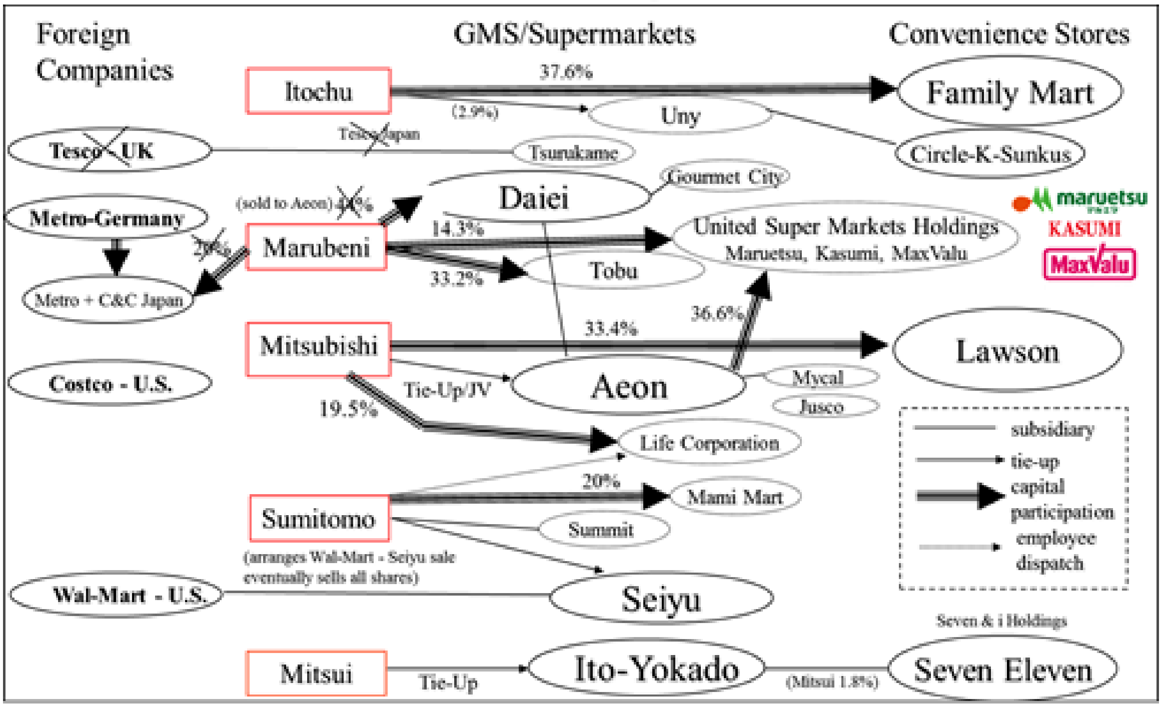
Thus, Marubeni has integrated this supply chain from the purchase of a raw commodity, grain, to feed processing and chicken production, to the sale of chicken as a retail food product by investing in and handling the logistics and distribution, and managing the process at each stage of the grain - feed - chicken value chain.

A similar integrated upstream-downstream model can be found in the beef, pork and seafood supply chains.

In this example, Marubeni maximizes their profit potential by securing grain at cost, adding value at the feed and chicken processing stages of the supply chain, and gaining full profit at the retail end. This increases the potential earnings of the companies they have invested in and thus the return (dividends, etc.) they receive from them. Furthermore, by dealing in such large volumes, especially in grain, Marubeni can lease entire vessels, lowering their transport costs in the process and making them even more competitive in this market.

While the sogo shosha have long been involved in the supply of food commodities and wholesaling of food products, it has been only in the last 10 or 15 years they have moved into the retail end of the food business, especially in the area of supermarkets and convenience stores.

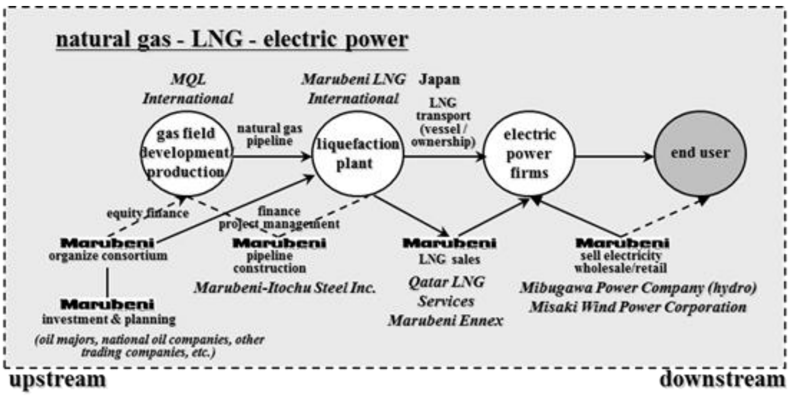
Food Distribution Alignment



One reason for this was deregulation in the retail market which led to a consumer-driven market increasing price competition and weakening the power of wholesalers in the distribution process. By having ownership at the retail end, the sogo shosha can rationalize the food distribution process, meaning make it more efficient (i.e., higher retail earnings), while protecting its position as a distributor in the process, not to mention that retail profit margins tend to be higher than those in wholesaling.

Energy Supply Chain Example - 1

natural gas - LNG - electric power



The next two examples are from the energy supply chain. This particular one entails natural gas, liquefied natural gas (LNG) and electric power companies and although mainly domain of the Energy Division it also includes the Steel Products and Plant Divisions.

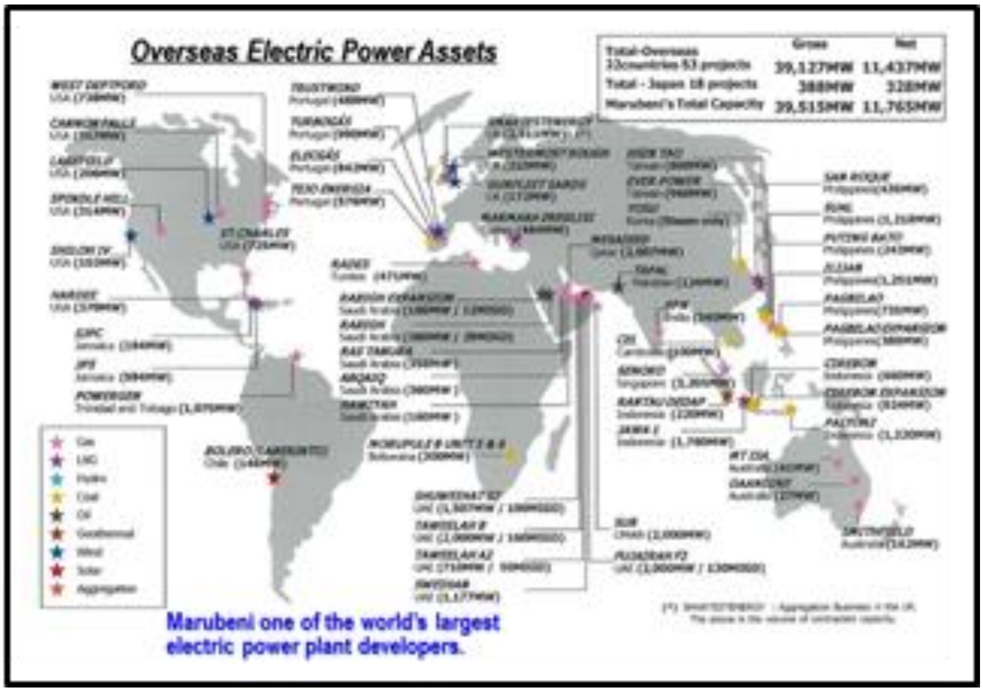
In this example, Marubeni took an equity stake in a gas field development in Qatar, as well as investing in a joint venture liquefied natural gas company. They then took part in arranging the supply (Marubeni-Itochu Steel) and installation of the pipeline needed to transport the gas to the plant (at a port) where this gas is liquefied. As a large-scale project organizer Marubeni also assisted in arranging the financing and the construction of the liquefaction plant (Plant Division) where the natural gas is liquefied to be shipped, in this case, to Japan.

Marubeni has also invested in LNG vessels and arranges for shipping of LNG from various overseas locations. In this example, Marubeni transports the LNG to the buyers, which are Japanese electric power utilities, on a long-term contract basis. (Energy Division)

Again, Marubeni has invested in each stage of the supply chain upstream from resource development to transport and delivery to the user.

Electric Power Business

Furthermore, over the years the sogo shosha supplied electric power companies, from its global network, with the fuels; coal, LNG, oil, uranium and the machinery and equipment (turbines, generators, boilers, etc.) needed to run their power plants. Through the knowledge of power plants gained through this and experience in

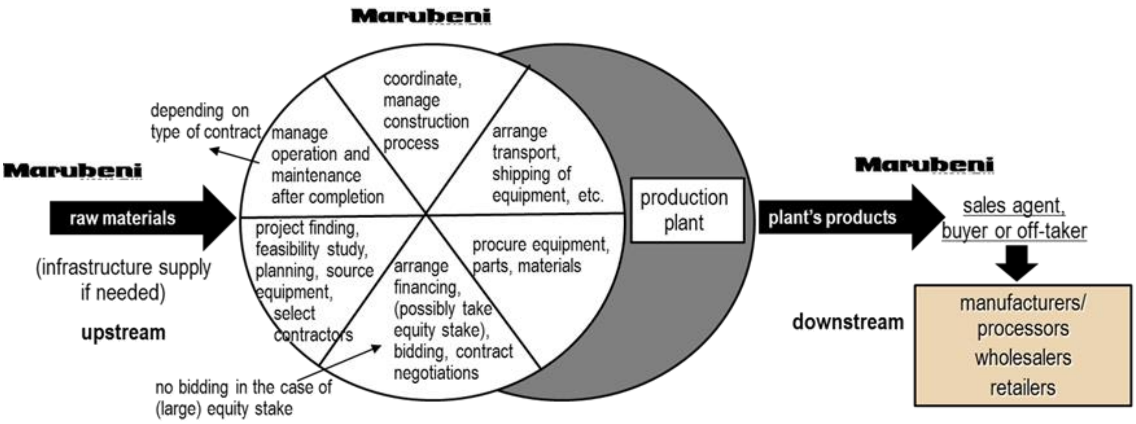


organizing large-scale consortiums Marubeni, through its Power Business Division, has become one of the largest electric power plant developers in the world and has significant electric power holdings overseas as an independent power producer (IPP). And, in Japan, Marubeni sells electricity to utilities and to retail users through its own hydro, wind, solar natural gas and coal-biomass power plants.

Large-Scale Project Development

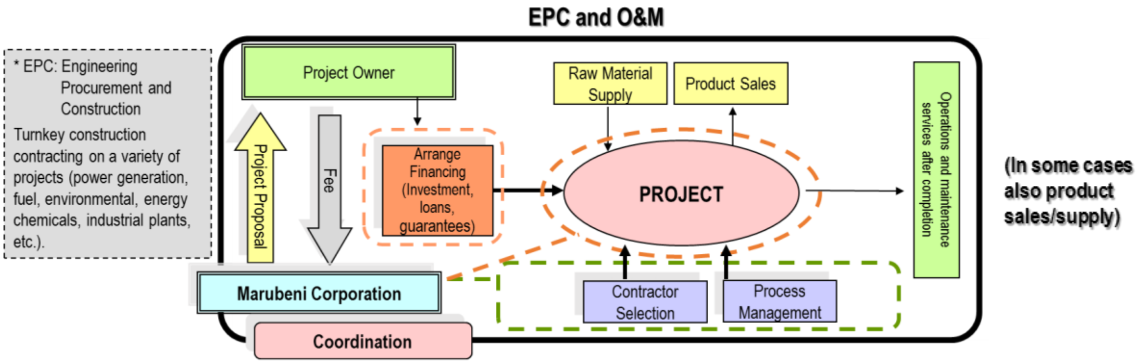
As mentioned, organizing large-scale projects has become one of the cores of the sogo shosha's business. The sogo shosha originally gained experience in this field when they supplied Japanese manufacturing with industrial machinery and equipment and construction materials following WWII. The sogo shosha are now involved in the development of various types of infrastructure projects including electric power plants, water treatment and sewage facilities, railways, airports, ports, industrial parks, telecommunication networks and smart cities among others, as well as in various types of industrial and production plants (petrochemical, refineries, chemical, industrial machinery, textile, etc.)

In general, the sogo shosha use their global information and business network to identify potential projects. Once identified, a feasibility study is carried out to see if the project is viable from various economic, technical, market, infrastructure, regulatory, environmental and other perspectives. Once the feasibility study is carried out the international sourcing and costing of all the machinery and equipment, parts and materials needed in the construction of the project takes place using their global information and business network to find the most suitable manufacturers/suppliers. At the same time contractors, both local and/or international, are selected for the construction work, costs assailed and construction arrangements agreed upon. The sogo shosha organizes all of this as part of the planning stage of the project.



Once the costs and other details of the project are finalized and planning finished, financing for the project must be arranged as in many cases the "owner" of the project is not able to fully finance it themselves. The sogo shosha use their wide experience in dealing with private banks and *government financial institutions and project finance expertise to organizing the financing, usually through a consortium of financial institutions, and providing credit (loans) to the purchaser of the project.*

Next is the tender negotiations and bidding stage of the project. If the bid is successful and the contract is signed the project execution stage begins. (Note: there are various types of contracts that I will not discuss here; EPC or engineering, procurement and construction, EPC and O&M or EPC and operation and maintenance, BOO or build, operate, own, BOT or build, operate, transfer, BOOT or build, operate, own, transfer, etc. EPC contracts have become the most favored in Marubeni's project business in recent years.)



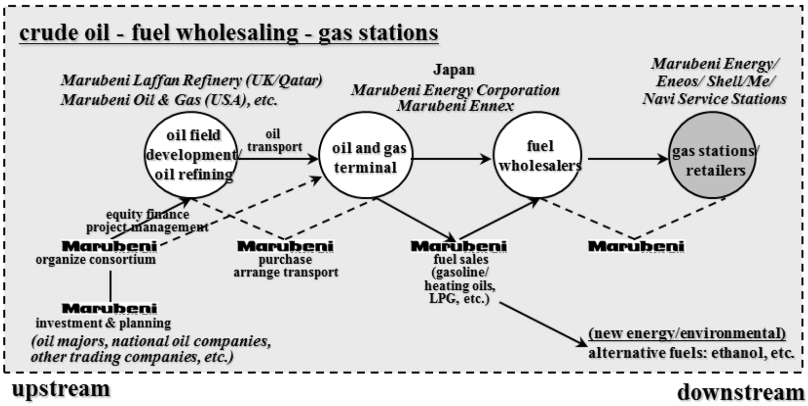
The sogo shosha, with their logistics expertise and knowledge of trade procedures, will arrange much of the transport and shipping of the machinery, equipment, intermediate goods and materials required in the construction of the project. Next the sogo shosha will coordinate the construction of the project and the consortium of contractors and handle any problems that may emerge.

Finally, in the case of a production plant the sogo shosha may also act as the upstream suppliers of raw materials for the plant and may become the sales agent, the buyer, or in the case the sogo shosha has an equity or ownership stake in the plant, the off-taker of the products to distribute and/or sell further downstream as wholesaler. In some cases, the sogo shosha may even receive the plant's products as part of the payment for the plant.

The diverse functions of the sogo shosha make them perfectly suited to carry out this kind of business activity. In fact, it can be considered a sophisticated form of trade and distribution in the supply chain; supply of raw materials, supply of the production plant, and the wholesale, or sometimes retail, distribution of the plant's products.

Energy Supply Chain Example - 2

crude oil - fuel wholesaling - service stations



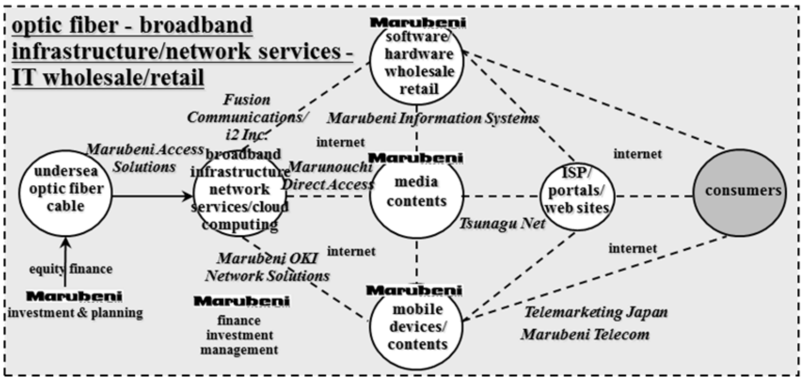
In the second energy supply chain example, crude oil, fuel wholesaling and service stations, Marubeni (Energy Division) might take either a major or minor stake in oil field (and gas) development projects and could assist in or lead the organization of a joint venture in the financing and development of the oil field (Plant Division). They could also just make an equity investment in existing oil production to gain ownership rights to the oil.

Marubeni has also invested in an oil refinery overseas from which they can import various fuels into Japan, as well as carry out traditional trading, or the buying and selling of crude oil and refined fuels. Marubeni will arrange for the fuels to be shipped to Japan to oil terminals from where the fuels are then distributed (sold) to end users and retail outlets throughout Japan through Marubeni’s own fuel wholesaling subsidiaries. Furthermore, Marubeni also owns a country-wide network of motor vehicle service stations (different brands of service stations) at the retail end in Japan.

Through Marubeni’s global information and business network, logistics, project finance and investment you can see how they have been able to integrate the energy supply chain upstream from energy resource development all the way to the end-user downstream.

These are just a few examples to help you better understand how the sogo shosha think and work. This integrated upstream - downstream supply chain business model can be applied to varying degrees to products in the chemicals, textiles (lifestyle), forest products, and even in the information and communication technology (ICT) fields.

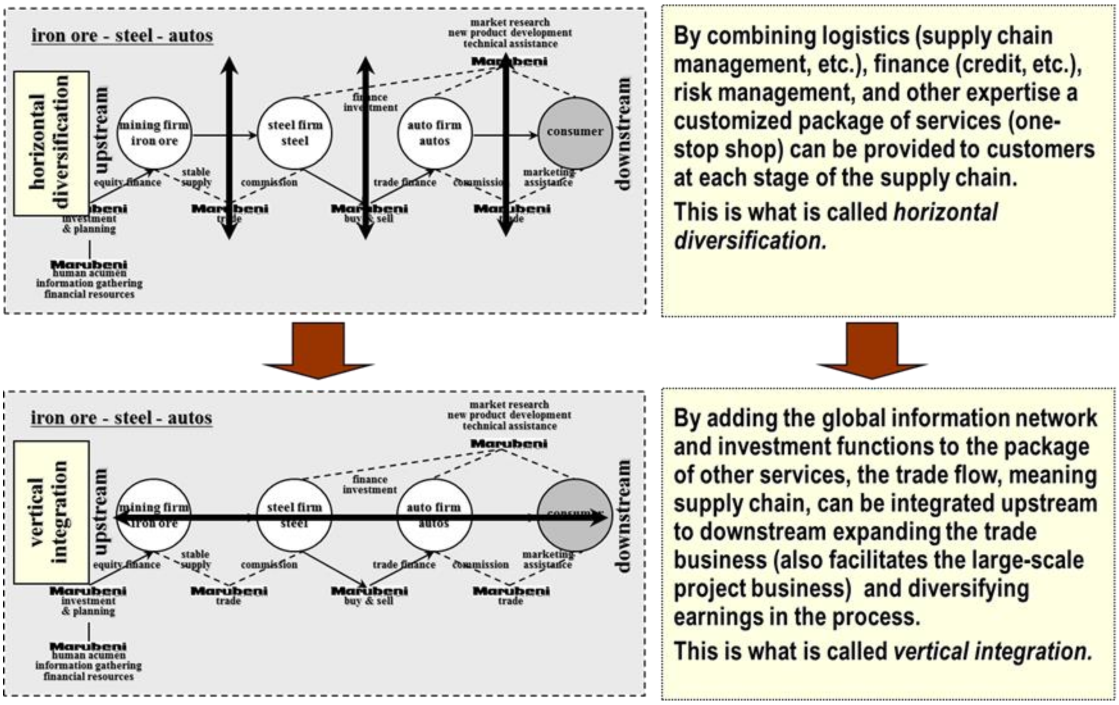
ICT Supply Chain Example (diagram only)



This integrated supply chain product trading and distribution in different industries and large-scale project development are basically what the sogo shosha do.

An Aside - Horizontal Diversification/Vertical Integration

There are some who have explained this upstream-downstream integration process by dividing it into two concepts, horizontal diversification and vertical integration. This is a little bit confusing, because the horizontal diversification and vertical integration are taking place at the same time. Simply, what is occurring is the business divisions are combining logistics (supply chain management, etc.), finance (credit, etc.), risk management and other expertise to provide a package of diverse services to fit each customer's needs at each stage of the supply chain. This is what is called horizontal diversification.



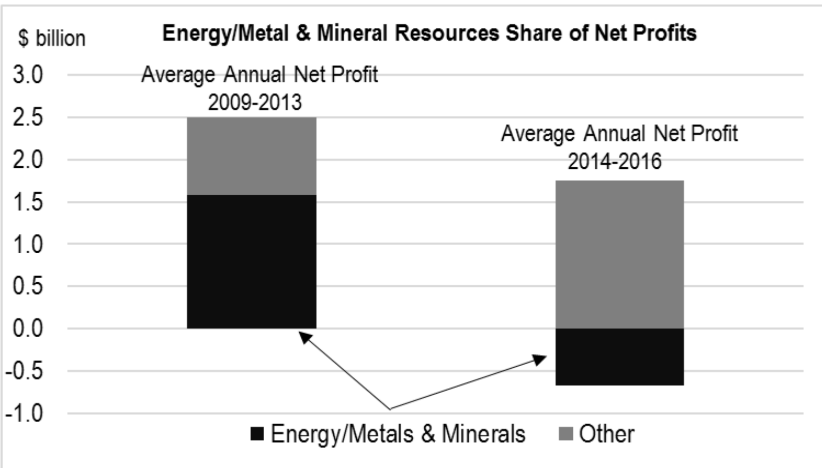
At the same time, each division is using the global network to coordinate and enhance their current business (confirming the needs of both the buyers and sellers), while searching for new business (new markets for existing customers and subsidiary companies), and making investments upstream and downstream in the value chain. The combination of these leads to what some refer to as vertical integration or the integrated upstream-downstream business model.

So, the business divisions, mostly through their business subsidiaries, are providing a package of services to existing customers, while at the same time using the global network to find new customers and markets, and make new investments to further secure their position in the value chain. This model is most applicable to the trading business, but also facilitates the large-scale project business as well.

Challenges

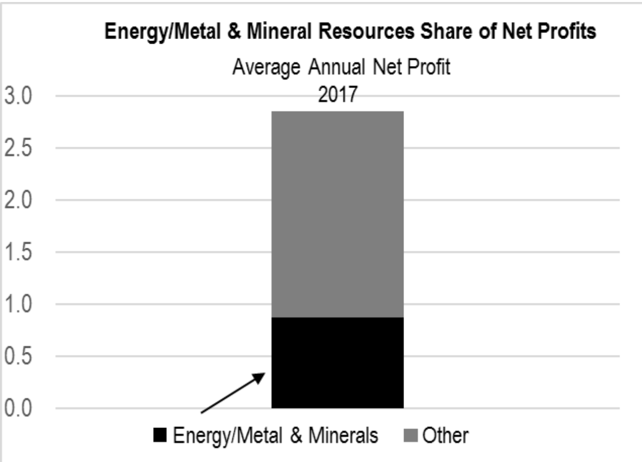
Dependence on Energy and Metal and Mineral Resources

One of the challenges the sogo shosha have been facing is that their net earnings have been highly dependent on metal, mineral and energy resource prices. In the 5 years from fiscal 2008 (end March 2009) to fiscal 2012 (end March 2013) roughly 63% of the net earnings of the top 5 sogo shosha, which averaged a robust $2.5 billion a year, came from energy and metal and mineral resources, a reflection of the high resource prices during that period. This was especially true of Mitsui and Mitsubishi whose dependence ratios approached 90% and 70% respectively. However, due to lower commodity prices, the average net profit of the top 5 sogo shosha fell to around $1.75 billion a year between fiscal 2013 (end March 2014) and fiscal 2015 (end March 2016), with the average being about $1.2 billion for 2015 and 2016 (the energy and metals and mineral resource businesses of the top 5 sogo shosha wrote off around $2 billion in the fiscal years ending in March of 2015 and 2016).   .



Given the deep drop in commodity prices in recent years things could have been much worse for the sogo shosha, however, they have been tackling this resource dependency issue for several years now. While the commodity markets will always be inherently volatile and subject to risk, the challenge for the sogo shosha is not to necessarily decrease their presence in the resource markets, given their broad experience and expertise in the field, but rather to strengthen and expand their other business segments and reduce the ratio of profits from metals, minerals and energy resources in the process. Certainly, they want to strategically protect and even expand their position in the natural and energy resource industry, but at the same time bring more balance to their profit structure through higher earnings from the other business divisions. This is exactly what they have been have been doing in recent years by bolstering their non-resource related business divisions.

In fiscal 2016 (end March 2017), there was a moderate recovery in commodity prices, but still below the peak levels seen between 2011 and 2014. Yet the average net profit of the top 5 sogo shosha at the end of fiscal 2016 was a strong $2.85 billion, with the non-resource related businesses making up nearly 70% if this (estimate based on the first 3 quarters of the year). So, the sogo shosha have been making strong progress in reducing their resource-related dependency, the challenge now being whether they can continue to maintain this momentum in their non-resource-related businesses.

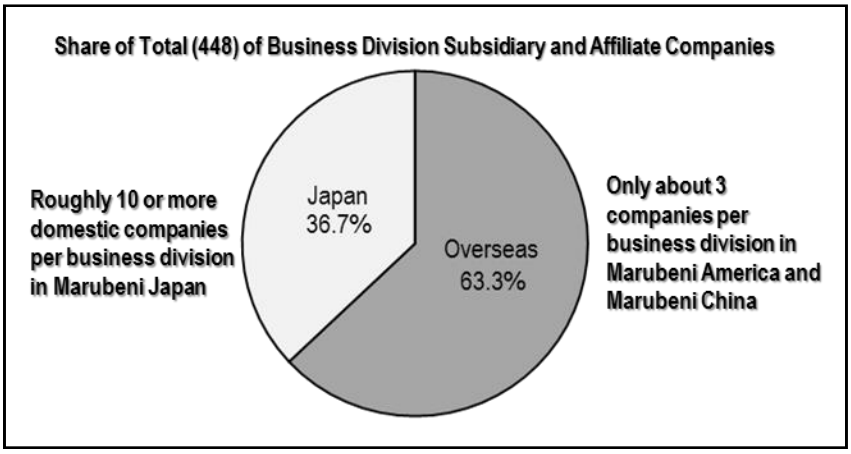


Capturing Growth in Overseas Markets

Another challenge facing the sogo shosha will be their ability to capture growth in overseas markets. Facing a mature Japanese domestic economy and a population already in decline, there are limitations to growth opportunities for the sogo shosha in the Japanese market. As such, the challenge is whether the sogo shosha can effectively adapt their integrated upstream-downstream supply chain business model in overseas domestic and/or regional markets.

Up until now, this integrated upstream-downstream business model is most prevalent domestically in Japan. To give you an example, Marubeni has about 448 business division subsidiary and affiliate companies operating upstream, midstream and downstream in the supply chain in various industries. These represent most of Marubeni's total investment. Approximately 64% of these companies are overseas, while about 36% are in Japan. While these overseas companies represent a strong global presence, they are dispersed in numerous countries around the world, while 36% of them are concentrated in Japan alone.

What this means is that, on average, each of the 16 business divisions in Marubeni Japan, representing different industries, have 10 or more domestic companies operating upstream and downstream in the supply chain in Japan, while in Marubeni America and Marubeni China, Marubeni's largest overseas corporate subsidiaries, each business division might have only about 3 companies in their respective domestic markets. Furthermore, many of these companies overseas are supplying Japan with goods or materials or representing a Japanese manufacturer in an overseas market or region. So, while this upstream-downstream business model is very strong in Japan or Japan-centric, it is still in the relatively early stages in overseas domestic and regional markets.



Therefore, the challenge for the sogo shosha will be to build some version of this integrated upstream-downstream supply chain business in overseas domestic and regional markets, not only so they can further expand their business and capture growth overseas, but to make this growth sustainable as well.

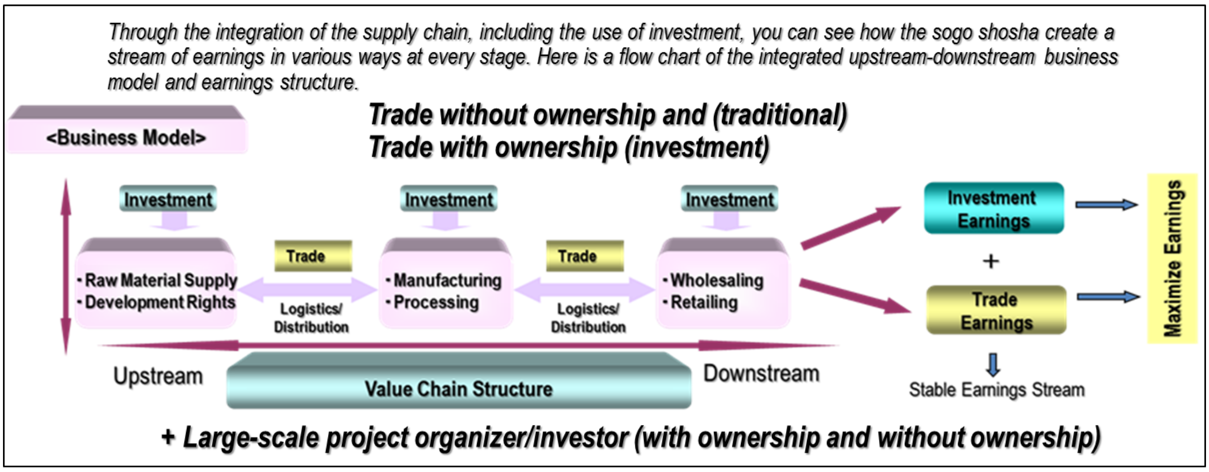
Developed versus Developing: There is a further challenge for the sogo shosha in terms of capturing future overseas growth; most growth, both population and economic-wise, will come from developing countries, both emerging economies and less developed nations. In the next 10 years, the population of developing countries is expected to rise by between 670 and 700 million people with an annual GDP growth rate between 4.8% and 5.0%, while the advanced countries will see population increase of between 20 and 40 million people with a GDP growth hovering around 1.8% a year. However, both population and economic growth in the advanced countries will be mostly bolstered by the U.S, which means minus the U.S. growth in the advanced countries will be stagnant (World Bank, United Nations, IMF and USDA data).

Therefore, it is obvious that the sogo shosha will have to more aggressively target emerging economies and less developed countries to capture future growth overseas. However, although the middle classes in developing countries are growing rapidly, the per capita income gap with the advanced countries is still extremely wide, which means the markets in advanced countries can't completely be ignored. Also, investing in developing countries is a much riskier proposition than investing in the developed countries. In fact, of Marubeni's current total investment, more than two-thirds is still in developed countries. So, the challenge will be to increase investment in the developing countries by finding ways to minimize the risks, while maintaining one's position or finding niche opportunities in the advanced countries.

Trader or Investor

Finally, there has been some confusion as to what path the sogo shosha have been taking in terms of their core function and role. There have been those in academia and even among the sogo shosha themselves who have been saying something along the lines that the sogo shosha have been reducing their traditional trading activities and taking on more of a role as an investor, or have been moving out of trading and into investment. The first statement is closer to the reality, but a little confusing, and the second is misleading to say the least.

The sogo shosha are not investment firms. The sogo shosha basically invest in the supply chain up, mid, and downstream to gain ownership and access to materials and goods at cost to protect themselves and increase their profits as traders and distributors in the supply chain. At the same time, many of these investments are value-added processes that provide extra earnings not found in the sogo shosha's traditional trading scheme as just an intermediary between buyer and seller. In other words, the sogo shosha are investing in their core competence, their core function of trading in pursuit of their quest to integrate the supply chain as traders. The sogo shosha will also sometimes invest in large-scale projects they are involved in, for example in power plants, often as an independent power producer and supplier of electricity.



So, the sogo shosha are not moving out of trading and into investment. Rather, the sogo shosha are reducing the amount of trade they handle traditionally as just a broker or go-between without ownership, and are increasing the amount of trade they handle that they have invested in and have ownership of.

Directions

The ability of the sogo shosha to survive up until this point, can to a certain extent, be attributed to their adeptness at being able to rapidly adapt to the changes that have taken place in the business and economic environment over the years. By moving quickly and being flexible the sogo shosha have been able to find new products, new customers and new markets to supply. Through it all though, their role as a trader, supplier and intermediary has remained the core of their business.

However, this does not mean their business model has not evolved. From simple middlemen collecting commissions the sogo shosha were able to develop other expertise in information (network), logistics, finance and risk management that allowed them to diversify their product base and extend their market reach. And, by combining these functions they were able to add large-scale project development to their business model. Furthermore, by injecting investment into the formula they have been able to integrate their supply chains much further, with value-added operations at certain junctures, and create a new earnings base in the process.

That said, over the last 50 years, the number sogo shosha has fallen from 12 to 7. Given Japan’s declining population and low growth prospects there is every possibility that this number could be reduced further. In the near-term, the key to the sogo shosha’s further evolution, even though they currently have a strong global presence, will be their ability to adapt their current integrated upstream-downstream supply chain business model, which is still somewhat Japan-centric, and their large-scale project development in growing overseas domestic markets in various forms. In the longer-term, the challenge will be to further combine, innovate (new expertise) and coordinate their logistics, finance and other non-trading functions to create seamless supply packages for their individual customers, while at the same time use investment and their global network to gradually integrate these domestic supply chains into regional and/or global upstream-downstream supply chains.

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